COMMENT & ANALYSIS: How Latin America can grow again

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Latin America and the US share history, a strong friendship and a commitment to democracy. We also share deep economic ties, particularly in trade and foreign investment. It is in our collective interest, and within our grasp, to share a stronger economic future.

Economic growth does not just happen by itself; good policies are needed. However, this essential focus on growth can be lost when the spotlight is focused on short-term stabilization, including decisions on which measures will lead to assistance from international financial institutions. This is unfortunate, because proper domestic policy choices are not only in the direct interest of individual countries, but are also essential for assistance from international financial institutions to be useful. What kinds of policies should be priorities?

First, the rule of law is an essential underpinning of growth. An essential component of the rule of law is that individuals must have confidence that their property rights will be respected. Without this confidence, economic activity is stifled, and assistance from the international community will be ineffective.

The current situation of the banking sector in Argentina provides a concrete example of what happens when there is a breakdown of this confidence. In contrast, Brazil has relied on market mechanisms in response to the challenges in servicing its debt, with the result that deposits have not been withdrawn from banks. In spite of its banking-sector difficulties, Uruguay has not interfered in lasting ways with foreign-owned banks, which have stood up well compared with domestic banks.

The second priority is a fiscal policy centered on limiting the size of government. While the state should provide essential public services and ensure a social safety net, it should not enter into areas more efficiently handled by the private sector. Too often, excessive state control limits the ability of the private sector to develop the financial capacity for growth, leading to excessive public sector spending and thus the need to raise corresponding revenues.

The problem is that most taxes distort economic activity and thus impinge on growth. The key is to finance government in the most efficient way. Faced with widespread tax evasion, governments might be tempted to turn to schemes that secure revenue despite their inefficiency and broad cost to the economy. One obvious example is increasing import and export tariffs. Another measure now in place in several countries in the region is the "financial transactions tax", in which a tax is levied on withdrawals and/or deposits from bank accounts, including clearance of cheques and payments of loans. Research suggests that in some countries in Latin America, the resulting distortions cost society nearly half as much as the revenue collected.

It is also vital that decisions made at different levels of government do not work at cross-purposes. Argentina and Brazil have highly decentralized political structures. In Brazil, the Fiscal Responsibility Law enacted in May 2000 has been seen as instrumental in imposing fiscal discipline across the levels of government. Among the provisions, the law creates checks on federal and state expenditures, and provides incentives for states to collect their revenues effectively or face loss of federal transfers.

In Argentina, provincial deficits have contributed to the inability to maintain an appropriate fiscal position. It has taken months of crisis for the federal and provincial governments to agree to rein in deficits.

The third policy priority for growth is effective monetary control. Individuals cannot form expectations for inflation without effective monetary policy - the resulting uncertainty depresses investment and growth. For monetary policy to be effective, it must be centralized - alternative quasi-monies issued outside the central bank are no more than inflationary financing of government spending.

Central bank independence is a useful feature, particularly if this helps the central bank to be seen as credible and free of political interference. But in the end, policy implementation is what matters. Bad fiscal-policy decisions - for example, steady increases in debt burdens during periods of growth - inevitably leads to economic difficulties.

Last, openness of markets is essential for economic growth. Integration with the global economy spurs competition and raises productivity. In addition to gains from openness to trade with the rest of the world, there are important gains to be had from increased openness to trade within the region. The US has an important role to play in this regard. As George W. Bush, the president, has stressed, trade liberalization is not just in the interest of the US, but is important for prosperity in the entire hemisphere. The recent passage of US Trade Promotion Authority provides a way forward.

Immediate benefits of the legislation will accrue to Bolivia, Colombia, Ecuador, and Peru, with important duty-free access to US markets in exports of apparel and tuna. Negotiating room under TPA permits conclusion of a free trade agreement with Chile that could increase Chilean gross domestic product by more than half a percentage point a year.

The recent enactment of TPA will also invigorate talks for the Free Trade Area of the Americas, which would be likely to increase Latin American exports of apparel, food, and manufactured goods into North American markets. Research has found that concluding FTAA would increase GDP in Latin American countries by more than 1 per cent each year - and this is for countries other than Chile and Mexico, which already have, or are now on track for, free trade status. TPA will also make a multilateral agreement on agricultural trade more likely, with potentially big benefits for Argentina, Brazil and Uruguay.

Our ties to Latin America give the US a strong interest in economic growth in the region. Pro-growth policies not only raise living standards in individual countries but also deepen ties with the rest of the world, and create conditions under which international assistance can be useful in times of need.

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