

Latin America At The End Of The Century:

More of the Same? *

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Latin America At The End Of The Century:**More of the Same?****By****Sebastian Edwards****University of California, Los Angeles****September 6, 1999****I. Introduction**

As the millenium comes to an end, the Latin American economies find themselves trying to recover from yet another crisis. This is a depressing, and yet familiar situation. And while some politicians argue that the first decade of the new century will “belong” to Latin America, most analysts are wondering how the region will manage to make it through the next four months. One of the most important issues is whether Latin America will, once again, be hit by another wave of speculation and capital withdrawal. This concern is so real that many policy makers are getting ready for the worse. Indeed, Chile’s recent decision to abandon the exchange rate bands, and all but float the peso, has been justified as a preemptive measure that would allow the country to face better possible region-wide upheaval.

During the next few months the international financial community will have its eyes on Latin America. Analysts and strategists will be closely watching developments in three fronts. First, they will follow closely Ecuador’s debt restructuring plan. Second, they will focus on whether Argentina will be able to resolve its exchange rate uncertainty. Third, they will assess carefully the evolution of Brazil’s recovery. Finally, and from a

longer run perspective, they will ask about growth prospects for the region. In particular, they will ask whether Latin America will be able to obtain the amount of foreign financing required to achieve its growth aspirations. In this paper I discuss some important aspects the Ecuadorean default, and of the Argentine exchange rate dilemma. I also discuss whether the region will be affected by a current account-constraint in the near future. In the final section I also make some brief comments on the Brazilian situation. My overall conclusion is that the region continues to face serious weaknesses and fragilities. Although a systemic crisis is unlikely, we cannot rule out localized crises. I believe that it is safe to say that it is highly likely that most – but not all -- of the region will continue to muddle through during the next year or so.

II. Ecuador's Debt Default: Whose Responsibility? Who will Benefit from It?

Ecuador's recent decision not to make an interest payment on part of its external debt – on the so-called *Brady bonds* – has rocked the international financial markets. What is surprising is not that a poor and over-indebted country defaults on its debt, but that it does it with the encouragement of the IMF and the U.S. Treasury. Because of its very small size, Ecuador was chosen as a trial-case for a new policy, allegedly the brain child of new Treasury Secretary Larry Summers, of forcing private investors to contribute to international rescue packages. This new approach, known as “bailing in,” was devised in the aftermath of the Mexican, Asian and Russian crises, as a way of deflecting the criticism that the IMF uses public monies to bail out wealthy international investors.

At over one hundred percent of its gross domestic product (GDP), Ecuador's public sector debt is unsustainable. Interest payments alone exceed one third of

government revenues, and have effectively crippled the functioning of the public sector. This situation clearly calls for some form of debt restructuring. The challenge, however, is to do this in an effective way, sparing the country from unnecessary pain, both now and in the future. Also, the restructuring should be done in a way that it does not generate systemic uncertainty, that could spill over to the rest of Latin America.

This requires three things: First, that during the restructuring process Ecuador maintains some minimum level of private international financing. Second, that the process is sufficiently market-friendly, so it does not choke future long term private financing in the form of new bond issues. And third, that Ecuador initiates a deep and serious effort aimed at reforming its economy, and achieving acceptable rates of growth. Unfortunately, it appears that none of these three goals will be accomplished.

By focusing on bonds issued by Ecuador's public sector, the IMF-supported restructuring program is missing the boat. According to data recently released in Geneva by the *Bank of International Settlements*, Ecuador's most pressing short-term financing needs come from over US\$ 2 billion in international bank loans, including trade credit, coming due during the next few months. Under normal circumstances these loans would be rolled over almost automatically. It is highly doubtful, however, that this will happen now. As recent history has shown -- Korea and Brazil, are two prominent cases --, at the first signs of default, international banks stampede out of the troubled country. Loans are not rolled over, and fresh financing all but disappears. Without vital trade credit Ecuador's chances for a speedy economic recovery are dismal. A possible way of dealing with this problem, is to (quickly) include bank loans to the private sector in the restructuring plan. This, however, would be messy and difficult to coordinate.

Moreover, with all likelihood, it would generate an avalanche of legal actions in international courts. This, in turn, would make what already looks like a legal nightmare – Brady bond holders have already announced that they would challenge the government’s decision – even more difficult.

Ecuador’s debt burden is so heavy, that reducing it to reasonable levels – say, to levels comparable to that of other Latin countries – would require major debt write-offs. The exact magnitude of the “required” debt reduction will depend on a number of factors, including:

- how large a primary deficit Ecuador can run;
- how fast the country will be able to grow;
- the public sector debt-to GDP ratio deemed acceptable;
- and who, exactly, is affected by the restructuring. If this is limited to a small group of creditors, the actual magnitude of the write-off would be very high.

Some Wall Street firms have calculated that if the restructuring is confined to Brady bond holders and the Paris Club, the write-offs would have to exceed 70% of the face value of the debt involved. This is hardly what one would call “market friendly,” and one should not be surprised if in the future Ecuador is largely cut-off from voluntary long-term international financial markets.

At the center of Ecuador’s problems is the country’s reluctance to join the rest of Latin America, in modernizing and reforming its economy. Government regulations continue to be rampant, inefficiency is legendary and corruption is pervasive. In spite of president Jamil Mahuad efforts, the opposition-controlled congress continues to reject

even a minimal modernization agenda. Without major reforms – including massive privatization of state-owned enterprises – Ecuador will not be able to achieve the growth rates that would put it back on its feet. The current U.S. Treasury and IMF–supported restructuring program does nothing to encourage Ecuadorean politicians to move forward in the reform arena. Quite on the contrary, there is evidence that the opposition, led by former president Leon Febres Cordero, has hardened its anti-reform stance.

But this is not all. This restructuring program is likely to have additional devastating effects Ecuador’s fragile economy. Many local banks have significant holdings of Brady bonds, and will suffer major losses as the restructuring plan goes ahead. This will further cripple the financial sector, and will end up burdening the public sector which, at the end, will have to bail out the banks. As recent figures coming from Mexico indicate, the cost of salvaging the banking sector can indeed be stratospheric, exceeding one fifth of gross domestic product.

Moreover, Ecuador-watchers have estimated that a number of local municipalities hold large amounts of the government’s domestic debt. If this becomes part of the restructuring effort, as many experts think it should, local finances would suffer a severe blow. Unfortunately, this blow would not be restricted to the economic sphere, and would also have major political ramifications.

Although Ecuador is a small country, it is naïve to think that its debt default will have no regional effects. First, it is almost certain that international investors will revise their funds allocation to Latin America. Second, history suggests that small countries tend to set important precedents that, some times play an important role in larger countries subsequent decisions. In that regard, it is possible to argue that Costa Rica’s

default in 1981 -- a barely noticed event at the time; Costa Rica, after all, is small --, was instrumental in Mexico's decision to default in 1982. And third, at this point the way in which President Chavez from Ecuador may react to all of this is a mystery. He may join forces, unleashing a domino effect.

III. Argentina and Dollarization: Lessons from Panama

From time to time people come up with what seem to be magic solutions for Latin America's traditional economic travails. One of the latest one is "dollarization," or the idea that the Latin American countries should give up their own currencies and adopt the United State dollar as legal tender. This idea was first proposed by President Carlos Menem last September, when he argued that, rather than devaluing its currency, Argentina was willing to give it up altogether, and adopt the dollar as legal tender.

The idea has since been promoted by a number of academics and experts, including Ricardo Hausmann the influential Chief Economist of the Inter American Development Bank. In Argentina and Mexico this proposal rapidly moved to the center of the political debate. While in both countries major presidential candidates have publicly rejected the idea, the debate continues at full speed in academic circles, think tanks and in the media. Many, indeed, believe that in both of these countries "dollarization" will become a reality sooner rather than later.

Proponents of dollarization have argued that if a country does not have a currency of its own, it cannot (by definition) face a currency crisis. In the absence of devaluation risk, the country will be face a lower cost of capital in international financial markets and will largely avoid the type of macroeconomics instability that has traditionally affected the majority of the Latin American nations. A country that gives up its currency, will

also have a low rate of inflation – in fact, as low as that of the United States--, and will have no alternative but to maintain a fiscal balance compatible with its monetary system. Indeed, according to this view, dollarization provides a perfect way for a country to convince the public that it will be fiscally prudent. In short, we are told, a “dollarized” country is bound to be an island of stability, growth and prosperity.

Supporters of dollarization, point out to Panama’s remarkably low inflation as living proof of the wonders of that system. What they don’t say, however, is that Panama’s monetary arrangement has survived largely thanks to IMF support. With the exception of a brief interregnum during the Noriega years, Panama has been almost permanently under the tutelage of the Fund. Since 1973 Panama has had 16 IMF Programs, the most recent of which was signed in late 1997, and is expected to run until late 2000. According to a new paper by IMF senior staff members Michael Mussa and Miguel Savastano, during the last quarter of a century Panama has been the most assiduous user of IMF resources in the Western Hemisphere; since 1973, only Pakistan has had a larger number of IMF programs.

The main factor behind this proliferation of IMF programs has been Panama’s inability, until very recently, to control its public finances. Between 1973 and 1998 the fiscal deficit averaged 4% of GDP, and during 1973-1987 – a period of continuous IMF programs – it exceeded a remarkable 7% of GDP. In fact, it has only been in the last few years that Panama has been able to put its fiscal accounts in order.

In 1904 Panama adopted the dollar as legal tender. Although there is a national currency – the Balboa --, its role is largely symbolic. There is no central bank and the authorities cannot issue Balboa-denominated notes. Since 1970 Panama has had no

controls on capital mobility, and has been financially integrated to the rest of the world. For decades it has been an important center for offshore banking, with a large number of international banks operating in the country. Panama's most remarkable achievement – and one that is heralded by dollarization enthusiasts – is its very low rate of inflation. Between 1955 and 1998, it averaged 2.4% per annum, and during the 1990s it barely exceeded 1 percent per year. In addition to low inflation, Panama has posted a healthy rate of growth during the last four decades. Between 1958 and 1998, Panama's real GDP expanded at 5.3 percent per year, and during the 1990s, growth has been a full percentage point higher than that of the Latin American countries as a group – 4.4 vs 3.4 percent per year.

Behind these achievements, however, hides Panama's serious historical addiction for IMF financing. In spite of not having a central bank, or a currency of its own, for years Panama failed to maintain fiscal discipline. Initially, these very large fiscal deficits were financed through borrowing from abroad. And when the foreign debt became too high, the IMF stepped in with fresh resources. And when this was not enough, Panama restructured its foreign debt.

Panama had its first IMF Stand-By program in 1965. A year later, adjustment was achieved, and the fiscal deficit was brought into check. In 1968, however, the fiscal accounts were again out of hand, and the IMF was called in once more. A remarkable nineteen-year period of uninterrupted IMF programs was thus initiated. Year after year, a new IMF program called for the strengthening of public finances. And, invariably, year after year, Panama failed to take serious action. After all, the authorities knew that the IMF was there, ready to bail them out, and allowing them to continue living in

“wonderland.” This vicious circle was only broken in 1987, when as a result of General Noriega’s confrontational policies and involvement in narcotics trafficking, Panama was subject to severe U.S.-led economic sanctions.

The IMF returned to Panama in September of 1990, with a monitored program. This was followed by lending programs in 1992 (22 months), 1995 (16 months), and 1997 (36 months). Significantly, in the last few years the authorities have finally acknowledged the need of maintaining a solid fiscal position. Between 1990 and 1996 the country posted public sector surpluses, and in the last three years it has run modest deficits. It is too early to know, however, whether the recently inaugurated administration of President Mireya Moscoso will continue to strive for fiscal solvency or whether it will return to the practices of the past.

In the last few years another advantage of the Panamanian system has become evident. Because of there is no devaluation risk, the country is not affected by the uncertainty and turmoil – both political and financial -- usually associated with major devaluations. This explains why, during the last few years, Panama has faced a relatively low cost of capital in international financial markets. In that regard, it is illustrative to compare the spreads over U.S. treasuries of Brady bonds issued by Panama and Argentina. Between January 1997 and December 1998 the average daily spread on Panamanian par bonds was 464 basis points, significantly lower than that of Argentine par Brady bonds, which averaged 710 basis points. The comparison between spreads over US 30 year Treasury Bonds, of Panamanian and Argentinian Brady par bonds is illustrated in figure 1.

Since the adoption of the Currency Convertibility Law, Argentina has been subject to recurrent devaluation rumors. These have increased significantly during the last few months. This has been the result of two factors. First, Argentina is battling a deep recession, and second, contrary to many analysts predictions Brazil appears to have successfully implemented a significant devaluation. But Argentina is not Brazil, and the existence of massive dollar debt, and high degree of corporate leverage suggest that a devaluation in Argentina would have devastating effects.

In fact, it is possible to argue that Argentina – with its commitment to a fixed exchange rate, a large stock of international reserves, a de facto quasi-dollarized economy, and a currency board --is indeed a premier candidate for dollartization. A move in this direction would remove any remaining uncertainty about the authorities intentions regarding exchange rate policy.

But before moving in that direction the authorities should carefully study Panama's monetary history. And what Panama's experience shows is that dollarization will not, on its own, assure fiscal solvency and prudence. And unless Argentina wants to be run by the IMF – a scary idea, if there is one--, it should build the institutions required to maintain fiscal policy under control. The recent approval by Congress of the *Fiscal Convertibility Law* – which requires fiscal balance by 2003, and calls for the creation of a fiscal stabilization fund --, is a step in the right direction. It is not enough, however. Legally, this law has limited teeth, and can be modified by the annual budget law. What Argentina needs is a truly credible fiscal commitment, through legislation that requires a super-majority to be amended. Moreover, some of the most obvious sources of potential fiscal imbalances should be eliminated swiftly. This means that remaining government-

owned banks – historically a source of fiscal largesse in most of Latin America --, and in particular giant *Banco Nacion*, should be privatized or closed in short order.

Additionally, government debt – which in the last few years has sky-rocketed to over 40% of GDP – should be retired gradually.

These fiscal measures should be complemented by the adoption of the much-discussed and perennially postponed labor market flexibilization. Although this is not a new idea – in fact, I have personally been writing about it, at least since the late 1980s --, its importance should not be underestimated. Only to the extent that the labor market can adapt quickly to changing international conditions, will Argentina fully reap the benefits of dollarization.

Interestingly enough, until recently, much of the discussion on dollarization in Argentina has ignored the fiscal dimension of the problem. As the discussion on Panama presented here suggests, this is a mistake. The Argentine debate has largely focused on the loss of seignorage that would result from unilateral dollarization. Supporters of the plan have argued that the way to deal with the seignorage issue, is to sign a monetary treatise with the United States, under which lost seignorage would be partially refunded to Argentina. This is not a new idea. In fact, it was proposed in 1972 by Chicago professor Harry Johnson within the context of the Panamanian experience. The problem, however, is that it is extremely difficult to believe that the US would politically accept such an arrangement. It stretches ones imagination to believe that Congress – an institution that has become increasingly parochial (a large number of members of the House don't even have a passport) – would go along with these payments.

Argentina's next president will have to squarely face the exchange rate issue during the first few months of his tenure. And he will have to decide whether he will pursue the plan in spite of the U.S. refusal to sign a monetary treatise. My personal view is that he should. Unilateral dollarization, although not the first best, is likely to have positive effects on the country. After adopting an institutional framework for credible fiscal responsibility, Argentina should move quickly – and unilaterally -- towards dollarization. This would consolidate the gains achieved since the pegging of the peso and the adoption of the Currency Board in 1991. With devaluation rumors out of the picture, Argentina will not only recover but is likely to become, once again, the dynamic country of a few years ago.

IV. Current Account Constraints for Future Growth?

An important question at the end of the century is what will be the sources of growth in Latin America. Existing historical evidence indicates that an increase in long-term sustained growth requires rapid TFP growth as well as a higher rate of capital accumulation (both physical and human). In most Latin American countries the potential for increasing investment, and thus the stock of fixed capital, has been historically limited by a low level of domestic savings. What makes this situation particularly difficult is that domestic savings change slowly through time. This means that, in many cases, development strategies aimed at accelerating growth tend to rely (at least during their early phases) on higher foreign savings. The extent of foreign savings, however, is limited by how large a current account deficit the country in question can run. The issue of a “sustainable capital account” has recently moved to the center of analyses of crisis prediction and prevention in emerging countries (Milesi-Ferretti and Razin, 1996). In

this section I develop a simple model of current account – and, thus, foreign savings -- sustainability. On the bases of the model I argue that Latin America’s growth in the next few years is likely to be “current account-constrained.”

During the last few decades there has been a considerable evolution in economists’ views regarding the current account. In an important article, titled “Does the Current Account Matter?”, Corden (1994) makes a distinction between the “old” and “new” views on the current account. According to the former, “a country can run a current account deficit for a limited period. But no positive deficit is sustainable indefinitely.” (Corden 1994, p. 88). The “new” view, on the other hand, makes a distinction between deficits that are the result of fiscal imbalances and those that respond to private sector decisions. According to Corden (1994) the extreme version of this new view states that “an increase in the current account deficit that results from a shift in private sector behavior – a rise in investment or a fall in savings – should not be a matter of concern at all (p. 92).”

In the aftermath of the Mexican crisis many analysts argued that the “new” view was seriously flawed. While some, such as Bruno (1995), argued that large deficits stemming from higher investment were not particularly dangerous, others maintained that any deficit in excess of a certain threshold – say, 4% of GDP – was a cause for concern. Partially motivated by this debate, Milesi-Ferreti and Razin (1996) developed a framework to analyze current account sustainability. Their main point is that the “sustainable” level of the current account is that level consistent with solvency. This, in

turn, means the level at which “the ratio of external debt to GDP is stabilized.” (Milesi-Ferreti and Razin 1998).

The basic idea behind this type of sustainability analyses is captured by the following analysis. Under standard portfolio theory, the net international demand for country j liabilities can be written as:

$$(1) \quad \delta_j = \alpha_j (W - W_j) - (1 - \alpha_{jj}) W_j;$$

where α_j is the percentage of world’s wealth (W) that international investors are willing to hold in the form of country j ’s assets; W_j is country j ’s wealth (broadly defined), and α_{jj} is country’s j asset allocation on its own assets. The asset allocation shares α_j and α_{jj} , depend, as in standard portfolio analyses, on expected returns and perceived risk.

Assuming that country’s j wealth is a multiple λ of its (potential or full employment) GDP, and that country’s j wealth is a fraction β_j of world’s wealth W , it is possible to write the (international) net demand for country’s j assets as:

$$(2) \quad \delta_j = \{ \alpha_j \theta_j - (1 - \alpha_{jj}) \} \lambda_{jj} Y_j;$$

where, Y_j is (potential) GDP, and $\theta_j = (1 - \beta_j) / \beta_j$.

Denoting, $[\{ \alpha_j \theta_j - (1 - \alpha_{jj}) \} \lambda_{jj}] = \gamma^*_{j}$, then,

$$(3) \quad \delta_j = \gamma^*_{j} Y_j.$$

Equation (3) simply states that, in long run equilibrium, the net international demand for country j assets, can be expressed as a proportion γ^*_{j} of the country’s (potential or sustainable) GDP. The determinants of the factor of proportionality are given by (3) and, as expressed, include relative returns and perceived risk of country j , and other countries.

In this framework, and under the simplifying assumption that international reserves don’t change, the “sustainable” current account – that is the current account

deficit consistent with a stable ratio of the country's (net) liabilities in hands of foreigners -- is given by.

$$(4) \quad (C/Y)_j = \{ g_j + \pi^*_j \} [\{ \alpha_j \theta_j - (1 - \alpha_{jj}) \} \lambda_{jj}],$$

where g_j is the country's sustainable rate of growth, and π^*_j is a valuation factor (approximately) equal to international inflation. Notice that if $\{ \alpha_j \theta_j - (1 - \alpha_{jj}) \} < 0$, domestic residents' demand for foreign liabilities exceed foreigners' demand for the country's liabilities. Under these circumstances the country will have to run a current account surplus in order to maintain a stable (net external) liabilities to GDP ratio. Notice that according to (4) there is no reason for the "sustainable" current account deficit to be the same across countries. In fact, that would only happen by sheer coincidence. The main message of (4) is that "sustainable" current account balances vary across countries and depend on whatever variables affect portfolio decisions, and economic growth. Portfolio decisions, in turn, depend on the perceived degree of country risk, and interest rate differentials, among other variables. These determinants of country risk tend to change through time and, in particular, as a result of changing political conditions, such as the end of a civil conflict.

Using a very similar framework to the one developed above, Goldman-Sachs has made a serious effort to actually estimate long run sustainable current account deficits for a number of countries. Using a 25-country data set G-S estimated the ratio of external liabilities foreigners are willing to hold -- γ^*_j in the model sketched above --, as well as each country's potential rate of growth. According to the Goldman-Sachs model the sustainable level of the current account deficit for the Latin American countries in their

sample is in the range of 1.3 percent of GDP (Ecuador) to 2.9 percent of GDP (Argentina, Chile and Peru).

These figures for long term current account deficit are significantly below the deficit levels posted by most Latin American countries during the last few years, and suggest (quite strongly) that the region will face a stiff current account constraint in the years to come.

The analysis presented above concentrates on the long run sustainable level of the current account. Equally (if not more) important, however, are transitional issues arising from changes in portfolio allocations. These, however, can have a fundamental effect on the way in which the economy adjusts to changes in the external environment. For example, the speed at which a country absorbs surges in foreigners' demand for its liabilities will have an effect on the sustainable path of the current account. The key point is that small changes in foreigners' net demand for the country's liabilities may generate complex equilibrium adjustment paths for the current account. These current account movements will be necessary for the new portfolio allocation to materialize, and will not generate a disequilibrium – or unsustainable – balance. However, when this equilibrium path of the current account is contrasted with threshold levels obtained from models such as the one sketched above, analysts could (incorrectly) conclude that the country is facing a serious disequilibrium.

Dynamic issues can be explicitly added to the analysis presented above. This would allow to move beyond the long run equilibrium level of the current account deficit, and compute its *sustainable path* through time. Equation (5) provides a plausible representation for the way in which the current account responds to change in portfolio

allocations. In this equation γ^*_t is the new desired level (relative to GDP) of foreigners' (net) desired holdings of the country's liabilities; γ^*_{t-1} , on the other hand, is the old desired level.

$$(5) \quad (C/Y)_t = (g + \pi^*) \gamma^*_t + \beta (\gamma^*_t - \gamma^*_{t-1}) - \eta ((C/Y)_{t-1} - (g + \pi^*) \gamma^*_t),$$

where, as before, $\gamma^* = [\{\alpha_j \theta_j - (1 - \alpha_{jj})\} \lambda_{jj}]$. According to this equation short term deviations of the current account from its long run level can result from two forces. The first is a traditional stock adjustment term $(\gamma^*_t - \gamma^*_{t-1})$, that captures deviations between the demanded and the actual stock of assets. If $(\gamma^*_t > \gamma^*_{t-1})$, then the current account deficit will exceed its long run value. β is the speed of adjustment, which will depend on a number of factors, including the degree of capital mobility in the country in question, and the maturity of foreign debt. The second force, which is captured by $-\eta ((C/Y)_{t-1} - (g + \pi^*) \gamma^*_t)$, in equation (5) is a self-correcting term. This term plays the role of making sure that in this economy there is, at least, some form of "consumption smoothing". The importance of this self correcting term will depend on the value of η . If $\eta = 0$, the self correcting term will play no role, and the dynamics of the current account will be given by a more traditional stock adjustment equation. In the more general case, however, when both β and η are different from zero, the dynamics of the current account will be richer, and discrepancies between γ^*_t and γ^*_{t-1} will be resolved gradually through time.

As may be seen from (5), in the long run steady state, when $(\gamma^*_t = \gamma^*_{t-1})$, and $(CY)_{t-1} = (C/Y)$, the current account will be at its sustainable level, $(g + \pi^*) [\{\alpha_j \theta_j -$

$(1 - \alpha_{jj}) \lambda_{jj}]$. The dynamic behavior for the net stock of the country's assets in hands of foreigners, as a percentage of GDP, will be given by equation (6).

$$(6) \quad \gamma_t = (\gamma_{t-1} + (C/Y)_t) / (1 + g + \pi^*)$$

Once these dynamic considerations are taken into account the short-run sustainable current account deficit is, in many countries, larger than the long run level computed by Goldman-Sachs. However, the short-run overshooting is neither very large, nor does it last for too long. This means, then, that even once these considerations are taken into consideration the room for substantial current account deficits – and thus foreign savings – is limited.

The discussion presented here, then, suggests that today as in the past, the challenge is to increase domestic savings to levels consistent with the region's growth aspirations. In that sense, things have not changed and we are seeing more of the same.

V. Concluding Remarks

Latin America's fate is greatly affected by what happens in Brazil. To the surprise of many, Brazil's devaluation has worked out relatively well. Inflation has been surprisingly low, the target on the public sector primary surplus has been achieved, and the magnitude of the recession has been relatively mild. The recent unveiling of the Federal Budget for Year 2000 was an important event. And after analyzing it carefully, I have come out on the optimistic side. The budget process has been highly transparent, most of the goals are realistic and achievable. On the negative side, the budget continues to rely on temporary measures, including a large number of tax surcharges, and no permanent policies aimed at tackling the gigantic social security deficit have been undertaken. What actually happens in Brazil will depend on how much progress the

country makes on those areas. There is a rather small window of opportunity, however, as political positioning for the next round of elections is likely to dominate public policy debate during the second half of 2000.

To summarize, Ecuador looks bad. The debt restructuring will be messy, and there is some probability (although a rather small one) that there will be contagion to the rest of the region. Argentina dollarization program is still very much alive. If it happens, however, it will have to be a unilateral move. In that case it is of essence to implement measures to protect the fiscal flank. Brazil continues to have a positive outlook, although political issues may cloud policy making in the second half of next year.

My overall conclusion is that the region continues to face serious weaknesses and fragilities. Although a systemic crisis is unlikely, we cannot rule out localized crises. I believe that it is safe to say that it is highly likely that most – but not all -- of the region will continue to muddle through during the next year or so.

FIGURE 1: Spreads on Argentine and Panamanian Brady Bonds Spreads

