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"ADJUSTMENT AND GROWTH IN LATIN AMERICA"

Address

As Prepared for Delivery

by

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to the

Colegio de Mexico

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Thank you for inviting me to address this distinguished audience. And warm congratulations to the Colegio de Mexico on its fiftieth anniversary.

A decade of some of the most far-reaching economic and political changes has just ended. Here in Mexico, the decade of the Eighties began with a massive increase in the size of government, its ownership and interventions, and with an unmanageable debt. By the decade's end, Mexico had launched one of the most ambitious, courageous and determined programs of economic reform and institutional change recently undertaken in any country, developed or developing.

Your generation of Mexicans has had to contend both with the deferred cost of the economic policies in the previous decades and with changes in the international economic environment. While problems took decades to develop and accumulate, the adjustment had to be swift, because procrastination and muddling through would merely have aggravated the misery and many more years of development would have been lost.

I am painfully aware that for those whose incomes were eroded and for those who lost their jobs, these last seven years have been an eternity. But the Government of Mexico is keen to broaden human opportunity and create an efficient and mobile economic structure. And we are convinced that with the reduction of debt and debt service negotiated by your Government, and with the opening of the economy, increased efficiency, reduction of regulations and an emphasis on investments, the stage is set in Mexico for a resumption of growth and the resultant alleviation of hardship.

The Government is also aware that the benefits of this development should be distributed widely through emphasis on education and human services. We in the World Bank share these goals and expect to contribute to their achievement with analysis, advice, our own funds, and help in mobilizing other sources of finance.

The Three Decades that Ended in Crisis

The development record of the 1980s has been mixed. Some developing countries have made enormous strides in the past ten years. But we have also learned a bitter lesson: development can be reversible. More developing countries have suffered reverses in the past decade than have experienced success. But the crisis has been severest in Africa and Latin America.

During the previous three decades, the countries of Latin America experienced unprecedented growth, diversification of production and expansion of infrastructure and human services. For example, Mexico's per capita GNP increased 150% between 1950 and 1980, and Brazil's 330%. By 1980, they ranked as two of the largest and most highly industrialized countries in the developing world. There was expansion of employment and education, improvement of health, nutrition and longevity, and there were large investments in infrastructure.

In Brazil, Mexico and other countries of Latin America, the strategy of development had three fundamental elements. The first and foremost concerned the role of Government. Normal economic processes were accelerated by the Government's assuming a central role in stimulating and regulating economic activity, investing in economic and social infrastructure and often in direct production.

Second, to overcome the disadvantages of heavy reliance on the production and export of primary commodities, planned industrialization was undertaken, catering largely to the domestic markets and nurtured by heavy protection, subsidized credit and often the monopoly or quasi-monopoly of domestic markets.

The third element of the strategy was external borrowing. It was assumed by both lenders and borrowers that the productivity of new capital would be high and that it would be advantageous to borrow as much as possible. Added production would increase domestic consumption and also provide for debt service.

Each of these policy elements had some basis in logic. But carried to the extreme, each contributed to an unprecedented crisis of development and government in this hemisphere. The problem was compounded by the nature of the borrowing, particularly during the Seventies when most of the borrowing was done at short-term and at variable interest rates. Matters were made worse by the volatility of the international economic environment. By 1980, economic development was slowing down. Investments were yielding progressively lower returns. And world interest rate increases were reaching unprecedented levels. In countries such as Brazil, Argentina, Peru, Chile and Bolivia, there were periodic economic crises marked by inflation and difficulties in external trade and payments.

And then finally came the debt crisis. In a mere four years, between 1978 and 1982, Latin America's external debt doubled. Many countries were unable to maintain debt service. Creditors were beginning to withdraw, and new capital flows began to dry up. It was apparent that the process had reached its logical limits and if economic development were to be revitalized, there had to be fundamental changes in economic approaches and management, and international economic relations.

Let me take a moment now to review how the process evolved during the decades leading to the '80s so that we can see what guidance this provides for the future.

The Expanded Role of Government

In every country there was a substantial growth in the size of government in absolute terms and relative to the national economy. Governments expanded beyond their historical role of providing law and order, social services and infrastructure. They expanded into ownership and management of industries, such as steel, fertilizers, chemicals and petroleum. They provided industrial and agricultural finance, often at subsidized rates and regulated investments over a wide spectrum of economic activities. The trend towards the expansion

of governments accelerated in the '70s, fueled in the oil exporting countries by increased incomes and borrowings and in the oil importing countries by easy credit. Throughout Latin America, public expenditures as a percentage of GDP increased sharply between 1970 and 1982, and in a few countries it almost doubled.

The implications of this expansion for management, efficiency and finances of governments were serious. There was a proliferation of public enterprises, often running at a loss, and in a number of countries the state literally lost control of its various constituents and their finances. In Argentina, public employment by provincial and local governments doubled between 1970 and 1988, from half a million to one million; the losses of the railways amounted to 1% of GDP, while they carried a mere 6% of the freight; transfers to industrialists through various fiscal incentives amounted to more than 3% of GDP.

This expansion established large vested interests and rents. Attempts to reverse the process encountered the opposition of the many groups which benefited from it and change became politically hazardous. As the fiscal deficits of governments increased, so did inflation and domestic debt. In Brazil today more than 90% of public sector revenues are taken up by salaries and interest on domestic debt; there is little left over for investment or for essential materials and supplies to provide public services.

The Import Substitution Strategy

A word now about industrialization and import substitution. In the '50s and '60s there were certain deeply held convictions about primary production and industrialization. First, the real prices of primary product were destined to a secular decline and, therefore, the countries of Latin America could extricate themselves from a fundamentally inequitable international economic system only through industrialization. Second, the industrial countries had such an edge over them that industrialization could proceed only if the society subsidized the process by making foreign goods scarce and expensive and through subsidized investment funds and services. In theory, once a big push had been given, growth and development would be self-sustained.

But how has it turned out in practice?

There is no doubt that the industrial and technological base has expanded substantially in Latin America. But in many countries there are serious doubts about the sustainability of industrialization through subsidies and protection. The limits to the process have come from its social costs and from economic and technological stagnation. I have mentioned that in Argentina the cost of subsidies, through foregone taxes, is more than 3% of GDP and is a major cause of public sector deficits and inflation. In Brazil, the low interest credits from the National Development Bank provide the industrial sector with a subsidy equivalent to one percent of GDP. Some of these costs may be justified if the industries can, after a while, survive without the support. But in too many countries the protected industries have

become an organized force for the perpetuation of protection. Too often the very policy regimes that create these industries -- that is, subsidized credit, undervalued foreign exchange and monopoly or quasi-monopoly of the domestic market -- led to capital intensity and low employment generation.

So, perhaps the process of import substitution through protection has reached its logical limits and there is need now for a greater integration of the economies of the Latin American countries in the international system of trade -- trade with countries outside the Region and trade with each other. It is no accident that the best experience of growth and development is of Korea and Taiwan, and now Thailand and Chile which have taken advantage of the broader international markets and tilted the entire system of incentives in favor of exports and efficient import substitution. The issue for you is not just exports for foreign exchange; the issue is how efficiently the scarce resources of the Latin American countries will be used. Will the producers be exposed to competition and the short-term discomfort it brings, or will they continue to demand protection which will perpetuate stagnation?

Latin American Indebtedness

The third plank of Latin America's development has been external capital, overwhelmingly from commercial sources. At the peak in 1981, net external borrowings of Latin American countries were about $55 billion. During the '70s in oil importing and oil exporting countries there was a single-minded preoccupation with borrowing to the exclusion of consideration of costs, efficiency, indebtedness and risks. Oil exporting countries believed that the price of oil would continue to rise. Not only did they spend what they earned; they heavily mortgaged their future earnings. Large investments were undertaken, often uneconomic. In Venezuela, for example, during the oil boom years, heavy borrowings and investments did not lead to commensurate increases in domestic production. Most gains in living standards came from improvements in terms of trade. The oil importing countries, with encouragement from the international banking system, borrowed heavily to close the balance of payments gaps and to avoid painful domestic adjustment. In Brazil, for example, the state-run power companies were being forced by the Finance Ministry to buy equipment -- sometimes not needed -- on export credit from countries which also provided loans for local expenditure.

The cost to the Latin American countries of the easy credit and large borrowing of the '70s was extremely heavy. Governments lost control of individual borrowing operations. Some sense of priorities was lost. Costs and benefits of specific operations were seldom computed. Above all, lenders and borrowers did not pause to ask how the economies would bear the servicing burdens; and what the risks and uncertainties were. The burden that the debtor countries carried was not just debt. Free borrowing led to huge expansion of governments, public enterprise and subsidies. As the flow dried up, countries and governments were saddled with major structural problems, requiring years if not decades to resolve, with serious political and social consequences.

I have dwelt on the structures that the Latin American governments inherited in the early '80s simply to underline the challenge the governments and the peoples of the countries faced. Except possibly in Eastern Europe, no group of nations is facing such a daunting task of reform and reconstruction. So, let me devote the next part of my talk to the direction of changes in policies and institutions so that growth and development can be revived and human opportunity expanded.

The Need to Reform Governments

Central to change and revival has to be the reform of governments, their efficiency, their finances, regulations and the relationship between governments and non-governmental organizations and individuals. We have learned from the experience of developing countries and socialist countries of Eastern Europe that excessively centralized economic management leads to such inefficiencies that ultimately economic development comes to a halt.

The enlargement of governments, particularly the central government and central government enterprises, implies radical centralization, depriving private organizations and local governments of both responsibility and opportunity. Many decisions which should be taken on economic consideration become highly politicized. Governments' management capacity is overstretched; in many cases government finances are destroyed, and ultimately the financial and managerial resources devoted to social services, poverty alleviation, management of environment, and, in some cases, agricultural research prove hopelessly inadequate.

To address these problems, governments need to reduce their size. In many cases there is little social purpose served by direct management of industrial and financial institutions. Public enterprises which serve little social purpose should not be maintained. For those which are economically viable, divestment to private ownership and management, without substituting private monopoly for public monopoly, should improve the overall efficiency of the public sector. And where enterprises remain in the public sector, decentralized management, performance targets, and accountability should be introduced.

Most governments in the region have recognized the need to reconstruct their programs and finances. Their revenue base is narrow and inadequate, and often there is a heavy burden of untargetted subsidies, transfers and uneconomic programs on public expenditures. Too often tax systems provide large exemptions and subsidies for privileged groups such as industrialists or agriculturalists who pay little for infrastructure or services. For efficiency as well as resource mobilization such exemptions and subsidies need to be phased out.

A key issue that governments must tackle as they reconstruct their finances and reform their programs is the protection of the poorest and the most vulnerable. Subsidies on basic goods and

services should be targeted toward these groups. Experience has shown that it can be done effectively and at a moderate cost, increasing welfare while making savings in total expenditures.

In the Sixties and Seventies, economies of many developing countries became regulation-ridden. Governments acquired a predominant control of private economic activity, deciding who would produce and who would not; where it would be produced and at what cost; and who would benefit from the largesse that governments confer in terms of licenses, permits and protection. Each regulation, in isolation, may have served a perfectly plausible purpose. Regulations taken as a whole have become straitjackets around these economies. They hinder enterprise, efficiency of resources and their mobility, and prevent societies from realizing their full economic potential. Let me give examples from Mexico and Peru.

Until recently, the road transport industry in Mexico was highly regulated. Concessions were given for specific corridors and entry was closed; cargo was collected at freight centers and assigned to truckers without regard to the preferences of shippers; tariffs were set by the Government; and container movements could only be handled by a Government monopoly. Because of the cartel and monopoly position of existing truckers, there was little incentive to lower tariffs or provide a better level of service. Government estimates indicated that transport costs were 20-30% higher than in a deregulated system. In July 1989, the system was deregulated and entry into the road transport industry is now open. Lower freight tariffs can now be negotiated and other firms are now allowed to handle the movement of containers.

In Peru, bureaucratic obstacles and red tape have encouraged an informal sector amounting today to almost 40% of GDP. Establishing a small business in Peru requires 11 successive administrative steps, licenses and permits, whose total time of approval takes 289 days. The direct cost of these permits plus the time lost is equivalent to 32 times the minimum monthly wage.

It is clear that regulations which hinder efficiency and those that merely create monopolistic profits need to be removed. In some other areas such as control of monopoly, prudential legislation and environmental protection, regulations may need to be strengthened. The reduction of regulations has to be matched by increased dependence on the markets for the determination of key prices in the economy. And above all, in the long-term relations between governments and the public, there should be a lack of arbitrariness and stability of expectations.

The Need for Trade Reform

What about the integration of the Latin American economies in the international system of trade? I said earlier that import substitution through protection and heavy subsidization of industry has reached its limits and that the disadvantages of the process are now apparent. As your population and labor force expand, substantial new employment will have to be provided by the industrial sector, and

economic growth will have to come substantially from industrial growth. Yet the domestic markets are limited. Societies which need to invest heavily in infrastructure, social services and the rehabilitation of the environment cannot continue heavy subsidies for industries as well. Industries have to be given the incentive and the opportunity to cater to the international market, and they have to be exposed to pressure to use resources economically and efficiently. Protective structures should be drastically lowered; discrimination against exports should be eliminated. And broad-based domestic financial structures should be stimulated to mobilize savings and provide finance.

I know that many people are concerned about the disruption that exposure to external competition may cause, and about the irony of protectionism in industrial countries. Clearly, the opening up of economies has to be managed so as to minimize disruption. I deplore limitations that industrial countries place on the exports of developing countries. But it is also true that countries which have consistently maintained policy regimes which do not discourage and discriminate against exports have had a steady growth in exports and incomes.

We are aware of the experience of other developing countries, particularly in South-East Asia. But now here in Latin America, your own country has benefited immensely from a more open trade regime. Between 1982 and 1989, Mexico's non-oil exports more than tripled and now generate twice the amount earned from oil exports.

The Role of External Capital

As to external capital, the experience of Latin American countries -- and many other countries in the developing world -- has been sobering. External capital is a double-edged sword. Used judiciously, in an economic policy environment that stimulates efficiency and mobilization of domestic resources, it is an essential complement to domestic effort. However, it also adds to debt and mortgages the future. And this burden, as we all know too well, can be crushing if there is excessive borrowing, or if money is used injudiciously.

The debt burden of the Latin American countries is heavy. We in the World Bank support the reduction of debt where governments implement coherent policies to adjust domestic economies and improve their efficiency and self-reliance. But, as we know from the experience of a country like Peru which does not service its debt, unilateral debt and debt-service reductions do not by themselves solve economic problems. The fundamental thrust of adjustment has to address domestic policy. High debt is a symptom of economic structures and policies which should be reformed if the situation is not to be repeated.

The channels for the flow of commercial capital to developing countries have been damaged by the debt crisis. External capital will no longer flow in quantities and with the ease with which it was available in the '70s. And even if it did, developing countries

should not borrow as they did in the '70s. I am in no doubt that an essential aspect of the restructuring of economic policies and institutions in Latin American countries has to be reduced reliance on external borrowings. While saying this, I can assure you that the World Bank is ready and able to play a substantial and effective role in Latin America's development. Moreover, we hope that direct foreign private investment will, at least partially, replace public borrowings so that debt does not increase inordinately and capital is accompanied by technology and management.

The Recent Mexican Experience

As I was speaking about how the economies of the Latin American countries should be reformed, many of you may well have been thinking that I had in mind the program that Mexico has been implementing in the last few years. You were right. Your country has effected an impressive change. In a matter of six years the Government's non-interest expenditures have been reduced from 35% of GDP to 20%. More than 700 public corporations have been closed or privatized. Barriers to external trade have been removed. Exports have been stimulated. Now your Government is implementing a farsighted program to reduce and rationalize regulations to improve the mobility and efficiency of domestic resources. In the process, inflation has been controlled, non-oil exports have boomed, the growth of external debt has been moderated, and per capita growth has started again in Mexico in 1989.

The road has not been easy. Solutions had to be found for problems without precedent, programs had to be carefully formulated, coherent approaches and consensus had to be developed. There was a great demand on leadership at all levels.

But all the sacrifices and pain that the Mexican people have endured for the sake of reform and economic adjustment will have been in vain unless there is an improvement in the lives of the common people. There is every prospect of an acceleration of growth, and with the emphasis that your Government is placing on social programs, there should be a broad sharing of this growth.

I am also happy to see that your Government is beginning a determined effort to combat the scourge of environmental degradation. No one living in Mexico City can escape the intensity of that scourge. Trees, soil, clean air and water are a part of our economic capital. We waste this capital at our peril as environmental degradation proceeds, development becomes unsustainable and the quality of human life is seriously compromised.

Mexico's recent experience in economic reform can serve as an example for other Latin American countries. It shows that where there is leadership and consistent commitment to adjustment and economic growth, the public will accept the essential but temporary sacrifices.

The World Bank and Latin America

Before concluding, let me say a word on the World Bank's relationship with Latin America. The Bank has been a partner in the development of countries in this Region for forty years. We have financed a variety of projects and programs in infrastructure, rural development, industry and human services. In the last few years a substantial proportion of our loans has been in support of programs of economic and institutional reform. Today, nearly 400 projects with total investments of more than $90 billion and World Bank financing of $34 billion are being implemented in the Region.

Much of the emphasis of the World Bank's lending has been on specific projects and assistance. Yet, we have found that even the best of projects are a poor proposition if the overall environment of economic policy and institutions breeds inefficiency and misallocation of resources. Therefore, during the last five years 35% of our lending in Latin America has been for structural and sectoral adjustment, supporting changes in general economic and sectoral policies, so as to create an effective environment for investment and development. Here in Mexico, such loans have supported the key elements of the Government's program in the reform of public enterprise, financial reform, external trade, industrial deregulation and agriculture. And now that the 1989-92 financing and debt-reduction package is being concluded, the World Bank will provide $2 billion to support the reduction of Mexico's public debt with commercial banks.

Our affiliate working in the private sector, the International Finance Corporation, or IFC, has also helped the debt reduction process through recent IFC-led restructurings in that sector which have resulted in a more than $1.5 billion reduction in Mexico's private debt. IFC has now turned its attention to support for privatization and new investments in your private sector to strengthen its international competitiveness. In this way it can contribute to Mexico's overall economic well being and at the same time help companies to grow, generate employment, and increase profitability.

As to the future, I believe that development is a long haul, comprising as it does human development, development of institutions, maintenance of a liberal framework of policies and responding to changes in the international economic environment. In Latin America, we will work with governments to establish and sustain policies and institutions, and to implement investments which would broaden human opportunity and conserve natural resources. In countries which make determined efforts at reform we will come forward with economic analysis, advice and finance for adjustment.

We are also aware that along with reform, investments have to be revived. The Bank will focus increasingly on investments in human resources, environment, infrastructure and agriculture as improved economic structures take hold and as the rhythm of growth is resumed. And IFC will help the private sector assume the extra responsibilities it will carry with the shrinking role of the public sector in providing goods and services.

Conclusion

Mr. Chairman: We are keenly aware that the fundamental effort in development must come from the peoples and governments. The World Bank's role is to stimulate and suggest, and to respond to the policies and programs of those whom we seek to serve -- the peoples of the developing countries.

Thank you.