

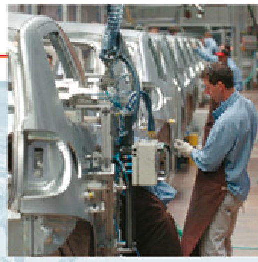

Dialogue on Globalization

BRIEFING PAPER
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Financing for Development and the Reform of the Financial Architecture: A View from Latin America

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1. Introduction

Latin America seemed to face a new world at the beginning of the 2000s: prices of the main commodities exported by the region rose enormously, providing extra sources of financing and easing old "bottlenecks" that affected their economies during the 1980s. The new growth limitations were associated with insufficient infrastructure and the need to channel resources in a way consistent with development goals. The favorable external environment provided the impulse to accumulate vast amounts of reserves and design new policies to sustain growth. However, by the middle of 2008, the scenario had changed drastically. The outburst of the financial crisis in the United States began to propagate around the world turning it into a "global crisis." As a consequence, Latin American countries are expected to face a less benign international context since commodity prices started to drop and global trade and growth decrease.

In the same vein, The Monterrey Consensus was revisited in 2008 in the middle of the turmoil and faced numerous challenges. Due to the current circumstances, the project of financing development is in jeopardy and governments in developing nations need to take hold of the situation immediately. Nevertheless, this is a good moment to reflect on the course of globalization and carry out a comprehensive debate on the reforms that the global financial architecture needs. Taking all of these issues into consideration, the objectives of this briefing are four-fold. First, it will revise alternative forms of financing that Latin American countries have developed throughout the years to attain certain levels of "independence" from traditional sources, such as the World Bank and the Inter-American Development Bank; second, the implications for domestic policies will be addressed with a special emphasis on the fiscal realm; third, the essay will reflect upon the prospects of the global financial architecture in light of recent developments; and finally, conclusions will be drawn.

2. Financing for Development

Domestic savings

In the 1990s, Latin America undertook an ambitious liberalization program that gave priority to the private sector in administering financial resources. This was carried out through the privatization of public banks, pension systems, and the opening of capital markets. Despite these efforts, national savings continued to be linked to fiscal surpluses and income from the pension system rather than to additional rises in interest rates that stemmed from the liberalization process. This low "sensibility" of domestic savings to interest rates have two important implications for economic policy: first, financial reforms that raise real interest rates will not automatically cause increases in private savings; and second, fiscal incentives aiming to augment private savings will be ineffective. In addition, improvements in national savings alone do not guarantee that those funds will be channeled to sustainable growth. This latter goal requires those funds to be directed to the most dynamic sectors of the economy.

Despite the fact that banks dominate the financial system in Latin America, the productive sector also has access to financing at the capital market. This market suffered important changes in most of the countries in Latin America during the 1990s: new laws were ratified and a set of new regulations and norms were launched to organize stock exchanges and bond markets. These reforms and better economic indicators during the 1990s accelerated the development of these sectors. On many occasions, however, transnational companies and governments participated more actively in international markets than in local markets reaping the benefits from internationalization. In this realm, the public sector took advantage of the new opportunities and issued in local and international markets to assure sources of funding. Nonetheless, capital markets showed low levels of capitalization and liquidity in terms of international standards. Issuing in foreign currency was common and the actors that actually profited from participating in these markets were mainly top companies. Therefore, capitalization levels were concentrated in few shares.

The experience of capital liberalization in Latin America showed that capital markets have not been fully connected to development requirements. Thus, alternative ways need to be explored to channel savings to productive sectors of the economy.

Foreign Direct Investment: Revisionist Attitude and New Actors

The search to reap the benefits from foreign direct investment (FDI) drove countries in Latin America to pursue a stark competition to attract investors. Many countries have set up public institutions with the goal of promoting FDI and design policies to seduce and provide incentives to foreign capital. Just to mention a few examples, in Argentina, an institution called ProsperAr was created to promote investments, and in Brazil, the Program to Accelerate Growth (PAC) was launched.

In Latin America, the liberalizing experience, together with the remission of restrictions to FDI, did not fully generate complementarities with local economies; on the contrary, transnational corporations were allowed to take full advantage of the local capabilities. In many cases, and contrary to neoclassical theory, crowding-out of investment was experienced. The relation between FDI and domestic investment is not always positive, initial conditions, local capabilities, and policy instruments are important inputs in explaining the possibility of creating technological spillovers. The presence of FDI alone does not assure technological spillovers; the experience during the 1990s in Latin America showed that the "quality" of FDI becomes more important than "quantity." In South America, most of the transnational corporations followed a source-seeking behavior looking for natural resources such as copper, gas, and oil. In these types of sectors, technological transfers to the domestic economy are smaller and they operate as "enclaves."

According to the Economic Commission for Latin America and the Caribbean, in 2007, the region showed the highest increase in the stock of FDI (46%) compared to other developing regions of the world, reaching USD 106,000 million. This sum was unevenly distributed; Brazil received USD 34,585 million while Mexico benefited from USD 23,230 million. In turn, Chile received USD 14,457 million, and Colombia USD 9,028 million. This performance is related to the boom in natural resources during that year. The rising demand of China and India propelled businesses around the production of basic commodities. Despite the fact that developing nations continue to grow in 2009 commodity prices are expected to decline.

In terms of countries of origin, the share of Spain and the United States as main investor countries decreased and that of the Netherlands increased timidly. This is due to advanced privatization processes where companies from Spain had a key role, while some US companies left the region. Nevertheless, a new dynamic added to this trend. This is the increasing participation of Latin American companies that lead intra-regional trade where Brazil, Chile and Mexico are leaders in the region. Labeled "translatins," these companies are expanding their transnationalization in sectors such as natural resources, manufactures, mining, cement, steel, and food. Petrobras (the Brazilian state oil company) always had an important role in the industrialization process of the country, especially through its policy of buying national products.

It is still premature to judge how this new configuration of investors will change the logic of transnational corporations in the region since "translatins" are also motivated by natural resources and access to the regional markets. However, the transnationalization of these companies in the region raises complex issues regarding energy security and basic services where there is potential conflict with governments.[1] The scenario is still not clear as to what extent "translatins" can mold the integration process in the region and whether they can play a better role than extra-regional FDI in bringing about developmental outcomes.

Development banks in Latin America: New Priorities and Challenges

The World Bank and the Inter-American Bank (IADB) had a key role in the region during the 1980s and 1990s. However, their presence has been challenged by local development banks and regional associations with the same aim: to provide funds for development projects in Latin America. In 2007, countries in South America supported the initiative to create the Bank of the South. With an initial capital of USD 7,000 million, the Bank seeks to fund infrastructure projects for the nations belonging to the South American Union of Nations.

In general terms, the debt issued by regional development banks shows a better credit rating in relation to issuances by national governments. Therefore, these banks allow government better access to international markets by providing funds at better conditions. This is especially crucial for smaller countries such as Bolivia and Paraguay. In addition, the management of these regional and development banks is in charge of the countries interested in those development projects, giving them greater independence from the IADB or even the World Bank, where industrialized countries control an important part of the governance mechanism.

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1 Roberto Bouzas, Pedro Da Motta and Sandra Rios, "Crisis y perspectivas de la integracion en America Latina del Sur", in Ricardo Lagos (comp.) *America Latina: integración o fragmentación*?, Edhasa, Buenos Aires, 2008.

In this vein, many Latin American countries together with private funds and bilateral loans were able to set up their own development banks with the aim of funding projects considered strategic for them. Among this proliferation, the National Bank of Economic and Social Development (BNDES) from Brazil stands out. Its loan portfolio is similar to the one administered by the IADB. In 2007, its loans totaled USD 33,962 million, representing a 43.8% annual increase.

Similarly, from 2000 on, the Corporacion Andina de Fomento (CAF) has become the main source of financing for Andean countries, exceeding the volume of loans issued by the IADB and the World Bank. The CAF is a multilateral financial institution that mobilizes resources from international markets to Latin America, in order to provide multiple banking services to both public and private clients of its shareholder countries. The main reasons Andean countries resort to it are: a) loans are approved within three to four months; b) there is no formal conditionality as the international financial institutions pose; and c) despite presenting the same cost as the IADB for instance, these loans represent an easier alternative for countries with poor credit ratings.

Additionally, regional banks assure countercyclical flows while private funds are normally very cyclical. Due to the current financial context, where developed nations are trying to solve their own financial problems, private flows to developing countries are expected to decrease. Therefore, regional banks represent a more stable source.

Finally, in recent years, regional banks also provide "regional public goods" by financing activities with positive externalities in the region. For instance, efforts to maintain tropical forests have been led by Costa Rica and Brazil with the support of governments, civil society and, academic institutions as well.

All in all, regional development banks help challenge the paradigm that Latin American countries should rely on the World Bank or other international financial institutions to carry out their development processes. In the current financial turmoil, these banks will play an even more active role in financing development in the region. Therefore, the region's governments should put further efforts in fostering their activities.

3. Domestic policies: What are the options?

Rising commodities prices throughout the 2000s allowed governments in Latin America to accumulate vast amounts of reserves and also improve their fiscal balances. Mexico, Chile, Bolivia, and Ecuador profited from higher prices for minerals. However, in Latin America, 35.1% of the population live below the poverty line. Close to 7% of Latin American children under five years old weighs less than normal, and three in a thousand births die before the age of five. This situation clearly calls for sound social policy and increased social spending. Social spending is an important factor to reduce poverty and to enhance development conditions.

Currently, tax regimes among Latin American countries vary substantially; nevertheless, they share a common feature: the tendency to propagate unequal distribution of income. Regional GDP reaches USD 2 trillions, but only a small share of the society can reap the benefits of that production. Looking at the Gini coefficient (which is a good indicator of income inequality), we see that the richest 10% of the population earns thirty times more than the poorest 20%. Fiscal policy could play a big role in easing inequality, but for many years, it has been focused on obtaining fast revenues by regressive tax instruments such as the VAT. In addition, many of the fiscal incentives to production have been channeled to big corporations instead of enhancing business opportunities for mid-sized companies that are the main source of job creation.

Since the financial markets of the region have a low degree of capitalization and depth, a package of fiscal measures is also needed to keep up lending. This is the policy that many countries are pursuing. However, the extent of these measures depends on fiscal capabilities and possibilities to access funds. At this stage, it is very important to highlight that the fiscal conditions in many countries are much better than in the past and although the region will not be immune to the financial crisis, quickly acting governments may ease the pain.

The current situation will impose new constraints and will affect Latin American economies differently, thus, governments need to outline measures to minimize the impacts of the global downturn. Let us now have a brief look at the fiscal policies introduced in some of the countries:

Argentina. The government introduced a controversial reform of the pension system that eliminated pensions linked to capitalization in private markets transferring those funds to the public sector. The government will administer all the funds and will be in charge of the pensions. In 2009 it will put in place an ambitious plan in infrastructure of around USD 17,100 million. It has also extended incentives to purchase capital goods that guaranteed a drop in tariffs and reimbursed 14% to local producers for one year. Finally, a reduction in export taxes was agreed to.

Bolivia. The government had to intervene to maintain the price of zinc through a special account that deals with these contingencies. Public investment will be 20.6% higher than 2008. It is also envisaged that the budget for housing, agricultural projects, the energetic sector, and especially mining will increase considerably in relation to the previous year.

Brazil. The government reduced its target of primary surplus from 4.3% to 3.8%. In order to assure the level of investments, the level of indebtedness of Petrobras will be authorized towards the BNDES in USD 5,300 million. The expenditures for the social program Bolsa Familia will also be extended. A sovereign wealth fund of 0.1% of GDP will be established to protect the economy from the oscillations of the cycle. Together with these measures, the government is trying to expand consumption and public investment to stimulate the economy.

Chile. The Fund for Social and Economic Stabilization will be used for the first time to provide fiscal stimulus to the economy. In addition, special economic support to investment and consumption, financing for enterprises and early reimbursement of income tax due to 2010 is expected. The country plans to apply countercyclical policies in 2009.

Colombia. A USD 500 million infrastructure fund will be created with the help of the CAF and the IADB. There will be higher investments in infrastructure and a tax cut in 2009 that has already been approved.

Ecuador. There will be a deferral in income tax for exporters who suffered a drop in their sales, and a reduction in taxes levied on exports. The tax on capital flight will be augmented from 0.5% to 1%. The government put in place a project to reform the tax system to provide better opportunities to the productive sector and improve the local financial system.

Mexico. A plan was approved to increase expenditures related to infrastructure and a program of national purchase from small- and medium-sized enterprises. The government assured coverage in USD 70 per oil barrel against price fluctuations. There will also be a freeze in the price of gasoline and a decrease in the price of electricity.

Venezuela. The government announced that it will maintain an active program of public infrastructure.

Despite all efforts, the reform of the tax system in many countries in Latin America is still a pending subject. Countries face the challenge of introducing changes that will benefit long-term sustainable growth while caring for the pressures of the short term.

4. Towards a more inclusive financial architecture

The policies and measures that Latin American countries are putting in place are no substitute for a real and inclusive debate over the future of the global financial architecture. The subprime crisis and the way it unfolded showed that industrialized countries gathered around the G8, the Financial Stability Forum, or any other ad-hoc groups, can no longer outline global policies without considering the global reconfiguration of power. The current crisis has its epicenter in the developed world, but the consequences will be global, therefore, real global action is needed.

Industrialized nations will not prioritize development in the current financial turmoil since they are still trying to put the pieces of the breakdown together and the crisis has still not fully unveiled. Thus, it is imperative for developing countries to take the bull by the horns and play a more active role in the new blueprint of the financial world. The crisis revealed that financial stability, which is a public good, it is not provided by financial markets so countries need to reflect seriously about the course of modern capitalism and its underlying assumptions.

What should countries consider for a more comprehensive and deeper reform?

- ***A more effective division of labor in development policy.*** Currently, there are many organizations and institutions within the UN, the World Bank, the IADB, and regional banks that deal with the same problems. The creation of the Bank of the South adds another element to this constellation of international organizations. To assure that funds are effectively channeled to attaining development goals, the debate over global reform should reflect upon what roles are desirable for each institution and effective coordination can be accomplished. It is important not to lose the vision of "system" within discussions over the reform of the financial architecture because finance for development lies at the intersection of two spheres: the international financial system and international development organizations. The vision of "system" does not imply that all institutions should be regarded as the same; it actually means taking into consideration its specificities and regional operations.

- ***Revisit the Monterrey Consensus.*** The Doha Financing for Development Review Conference, which took place in 2008 in the midst of the propagation of the crisis, has not addressed the urgency that the development challenges need. It does not provide a full rethinking of the way the global systemic forces unfold and how they should be tackled to meet development goals. The Consensus continues to promote Bretton Woods institutions as the core pillars of international governance, without acknowledging the obsolescence of some of their policies and the democratic deficits in their governing boards. Without tackling these thorny issues in a more realistic way, the global financial architecture reform will not materialize and if it does, it will not be sufficient for developing nations.
- ***Institutional configuration of institutions should be inclusive.*** Developing nations not only need their voices to be heard within international summits and international organizations, they should also be able to rewrite international norms according to their developmental goals and participate more actively in the reform process. So far, only the IMF has introduced some modifications but they have been very modest.
- ***A stronger multilateral regulatory framework.*** Basel II, with its emphasis on internal model of risk regulation, should be revisited and work towards a regulation of financial transactions involving derivatives, options and riskier instruments that are sometimes not traded within transparent markets. Regulatory loopholes should be closed to avoid the repetition of current crises.
- ***Form a consensus on macroeconomic policies.*** In Latin America, many countries have implemented expansionary fiscal policies, but these policies were not coordinated among countries; rather, they resulted from the current situation. It would be desirable for developed countries to agree on expansionary policies to mitigate the downturn. Many policies in this regard have been implemented in the United States and most of the EU countries, among others, but there is still no coordinated action. This could be important to counter fears of harmful and rising protectionism.

All in all, developed countries should exercise their leadership by putting forward the debate about the reform from a more responsible and inclusive standpoint. Development is a long-term process that requires financial stability – globally and internally – therefore, it should be addressed immediately. Developing countries in Latin America are in a better position than in the past and regional banks will have a key role in making the impacts of the crisis less severe. However, this is no substitute for global rethinking and reform.

5. Conclusions

Despite the fact that direct causality between the role of regional development banks and economic and social performance in Latin America is hard to establish, they did have an important role in determining public policies and providing funds in those activities where social earnings are higher than financial ones. Moreover, they have lately acquired a more prominent role in the provision of regional public goods. This is extremely important when we consider the reform of the global financial architecture because regional development banks can play a stabilizing role in the current financial turbulence. In addition, developing countries need to gain policy space to design their monetary, fiscal, and trade policies so that funds can be channeled to development. This autonomy in the mapping of public policies is relevant to palliate the adverse effects of the cycle.

In terms of global reform, developing countries should be effectively incorporated in the policy and decision making mechanism of the debate. It is not enough for their voices to "be heard." Instead their questions and needs should be internalized.

Finally, the crisis brings a good opportunity to reflect about globalization and the course of capitalism. This includes returning to the "political" within "economics." The separation of "states" and "markets" – which is the main triumph of neoclassical economics – has fallen short of solutions to social and economic problems (especially in the developing world). Therefore, we need a reconceptualization of the framework in which we design policies to achieve a fruitful reform of the international financial architecture.

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