General Discussion:
Public Sector Deficits and Macroeconomic Stability in Developing Economies

Chairman: Jacob Frenkel

Mr. Frenkel: Thank you very much for the paper and for the two discussants. Indeed, these final remarks about transition economies and the former Soviet Union have indicated how far we are from the old days when President Ronald Reagan said that the Soviet Union "will always have only a one-party nation, because even if opposition parties were permitted, everyone would join that party." And, indeed, we now have seen fundamental developments. Let me, with the limited time that we have, open the floor for discussion before we converge to the Overview session.

Mr. Bruno: This has been a discussion of hard landings. I think Sebastian Edwards' paper, with John Flemming's and Pablo Arellano's remarks, was very good. Very good discussion. I would just like to generalize one point that John Flemming made. Namely, if you define a "deep crisis" as a high-inflation crisis—as was done in the recent study at the World Bank, and if you include countries from Latin America, and some Asian countries, as well as those African countries that had deep crises in that sense, invariably they were caused by large fiscal deficits. Invariably, to get out of the crisis, you have a very large fiscal correction—on average, 5 percentage points and in some countries, of course, 10 or 15 percentage points. The only way to get out of this is when the politicians have their backs to the wall and no one is willing to bail them out. I can take my own country as an example, which went into a very deep crisis. Our deficits were cut by 10 percentage points. A second point is that growth dividends are enormous. You get a fiscal cut, and growth rates rise—very often to higher rates than during the crisis. One region has been left out of this discussion, and that is Africa. And, if we go back to yesterday's paper by Mussa and Masson, the highest deficits in 1993 are those of Africa. And, that was not due to low revenue, at least by those numbers, but to high expenditure. The share of expenditures there comes from state-owned enterprise. In Latin America a major element in the reform was the divestiture. These countries, of course, are in much worse shape as far as development is concerned. They have much tougher political and social problems. It is not high inflation which characterizes them. So that is a much tougher problem to solve, but the remaining one on the agenda. Thank you.

Mr. Frenkel: Thank you. I wonder about the distinction between a soft and hard landing, because your remark indicates that if you are really in deep trouble, there is only one form of landing—the hard one. It is like the guy who jumped from the Eiffel Tower and when he was asked, "How do you feel?" he said, "So far, so good." But when he arrived downstairs, he was asked then, "How do you feel?" He said, "I don't know, I just arrived." Morris Goldstein.

Mr. Goldstein: I have two brief questions for Sebastian Edwards. Sebastian referred to the large costs associated with the public bailout of failed financial institutions. First, I wanted to ask him, for Latin America as a whole, whether he sees evidence that the regulatory and supervisory framework has really been improved, so that we should expect to see over the next few years much less of these financial banking crises than we have in the past. Second, given that capital market liberalization and integration have increased and it is now so much easier for local depositors to alter the currency composition of their assets, should we expect to see a lot more cases of depositors running to Miami whenever there are adverse shocks to the financial sector?

Mr. Frenkel: Yes. Please, Sebastian.

Mr. Edwards: I think, Morris, that we are seeing an important improvement in the regulatory framework in most countries. This is, in part, a result of the hard lesson learned related to these banking crises. The World Bank, itself, with the IDB, is committed and is engaged in a number of projects in Argentina, Mexico, and other countries to greatly improve the regulatory framework—particularly the early warning system. Also, the New York Fed is working very closely with the Argentines to deal with this problem. The second problem that you raise is the issue of capital mobility and currency substitution. That has raised a problem throughout the region, and in other parts of the world, that I think we are only beginning to understand. We need to do significantly more work. That work has to do with who is the lender of last resort in financial systems that are extremely open and where a large proportion of the deposits are held in foreign currencies. That is the case in a number of Latin American countries—in Peru, in Uruguay, and in Argentina. The absence of a lender of last resort, of course, is something that should concern us and there are no easy solutions. Guillermo Calvo, I think, has suggested that the Latin American countries become members of the Federal Reserve System. I think theoretically this may be a good idea, but I don't see it happening anytime soon.

Mr. Frenkel: I don't know if you were talking about the supply side or the demand side. Yes, please.

Mr. Salinas: Moisés Naím recently has done some interesting work on what he calls the second wave of reform throughout Latin America. Concerning this concept of reform, which focuses more on microeconomic aspects—labor reform, law reform, social security reform—I would like to hear your comments on the three great problems that you outlined vis-à-vis the durability of sound fiscal policy and sound macroeconomic policy.

Mr. Edwards: Very briefly, I think it is absolutely fundamental for Latin America to move into the second wave of reform. I would point out three areas: First, the creation of institutions, including independent central banks. The Mexican crisis suggests that it is easier to legislate independent central banks than to obtain them. We have to look at this more carefully. Second, labor market reform is absolutely fundamental. The World Bank just finished a very important study, "The World Development Report of 1995," on labor markets; and it provides a number of very important suggestions in that regard. Third, education reform is absolutely key today within Latin America; the educational system is really of a very, very low quality, and that is related to the labor market reform, because teachers' unions are standing in the way—in most countries—of true reform. In a way, unless we solve the problem of labor markets, we are not going to get to the problem of education. I think those three issues are fundamental. We could name some others, but I don't have enough time.

Mr. Frenkel: Thank you. Last question or comment. John.

Mr. Lipsky: This is basically for Sebastian and perhaps José Pablo. Your presentations have offered as a benchmark of success in Latin reforms the achievement of accelerated growth in output per capita simultaneously with a decline in inflation. On the fiscal side, you've cited four elements of reform: budget discipline, tax reform, privatization, and social security reform. Do you consider all of these elements necessary conditions for the achievement of that benchmark of success? Are they equally important? Obviously, the model of successful reform is that of Chile. But at the end of the day, Chile is a relatively small country. Is the adequate implementation of these reforms dramatically complicated when you increase the size of the economy—in other words, is your model equally relevant for countries such as Mexico and Brazil? Thank you.

Mr. Edwards: I think that to one extent or another all four elements will have to be present in every country. Only in this case will they be able to grow at a sufficiently fast rate as to deal with the social problems in the region. However, I think the combination and the importance of those elements tend to be very different across countries. The question is particularly important because we have seen in a number of quarters a tendency toward oversimplifying the reforms and, in particular, toward trying to "impose" the Chilean model on everyone else. I think we have to be very careful when dealing with these issues. In particular, we have to consider, first of all, history, and second of all, the very different starting points. We cannot do the Chilean financial and pension reforms, for instance, in the very poor countries of Central America. In Honduras, in Guatemala, it would be extremely difficult to have that kind of reform. Chile is a unified republic. Argentina and Brazil are decentralized federal governments. All these issues have to be taken into account. And at the end of the road, unless we are respectful of cultural differences and history, we may run into problems. On the other hand, of course, there are elements like fiscal discipline, savings, and so on, that will have to be present to one extent or another in all the countries.

Mr. Frenkel: Thank you very much. Well, those are indeed the four key elements of reform that more and more countries are turning to to become believers. The danger of not becoming a believer is becoming more and more apparent. You know the story about Voltaire, the very famous unbeliever, who on his deathbed was exhorted to at least repudiate the devil. He said, “Is this the time to make new enemies?” Ladies and gentlemen, we are now converging to the final Overview session. I hope the panelists can bring us to a soft landing.