

**LATIN AMERICA:  
IS IT MOVING FORWARD?**

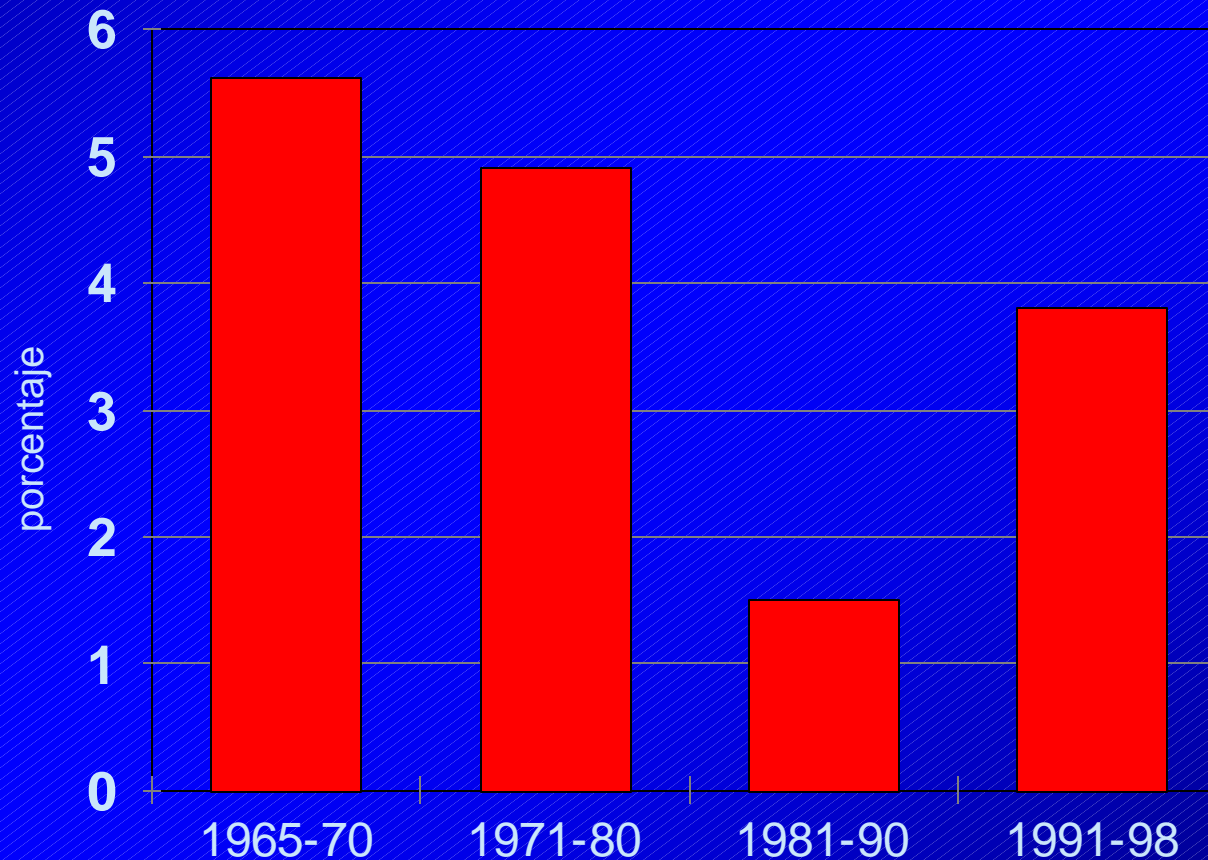
**Ricardo Hausmann  
Kennedy School of Government  
Harvard University**

# Outline

- Structural reform and growth
- Demographic window of opportunity
- Financial Turmoil and contagion
- ‘Original sin’: an interpretation of the problem
- The boom in FDI: what does it mean?
- The recovery in Latin America
- Prospects for long-run growth

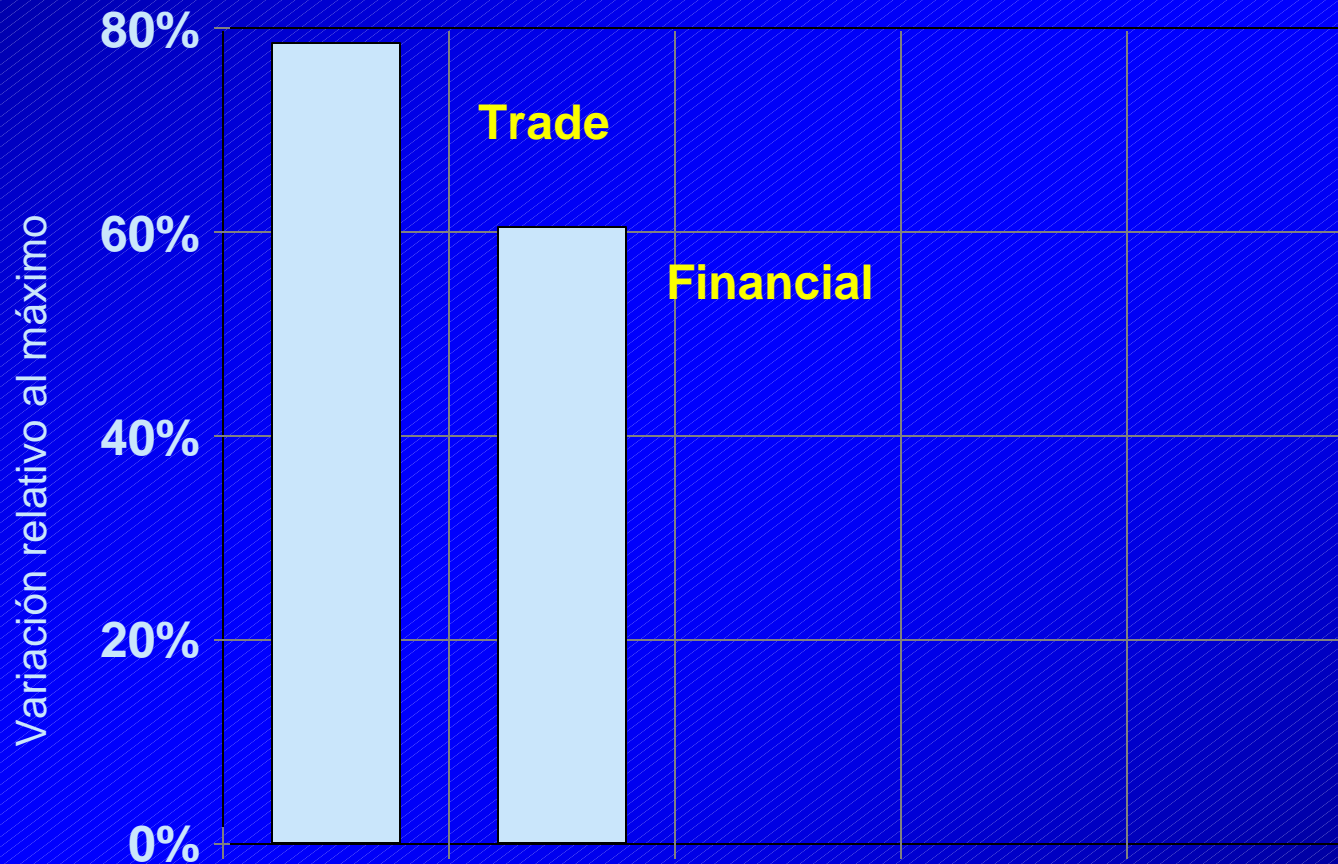
# Latin America recovered in the 1990s

## GDP Growth



# Based on significant structural reform

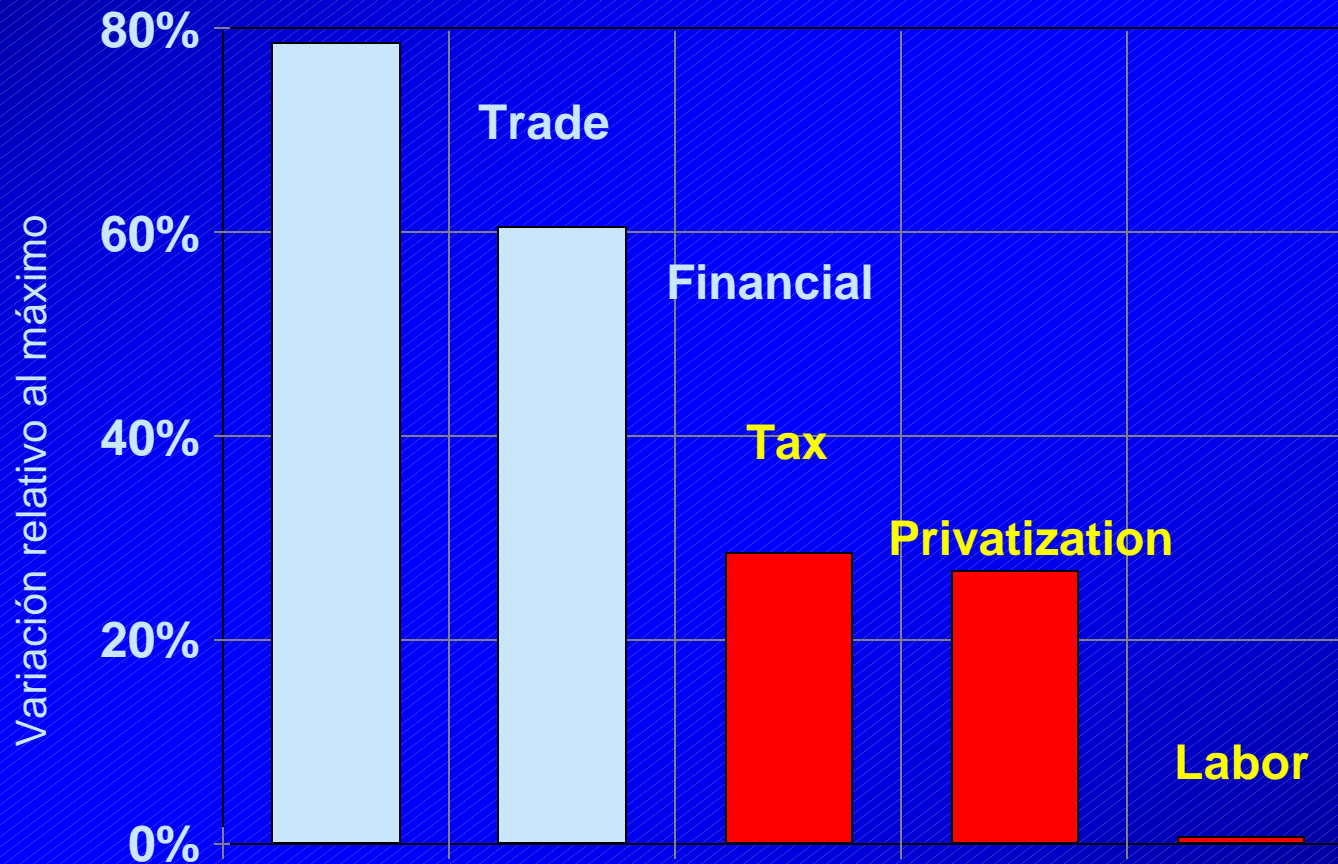
## Avance de las políticas estructurales



Fuente: Lora, 1997

# ...that is still incomplete by area

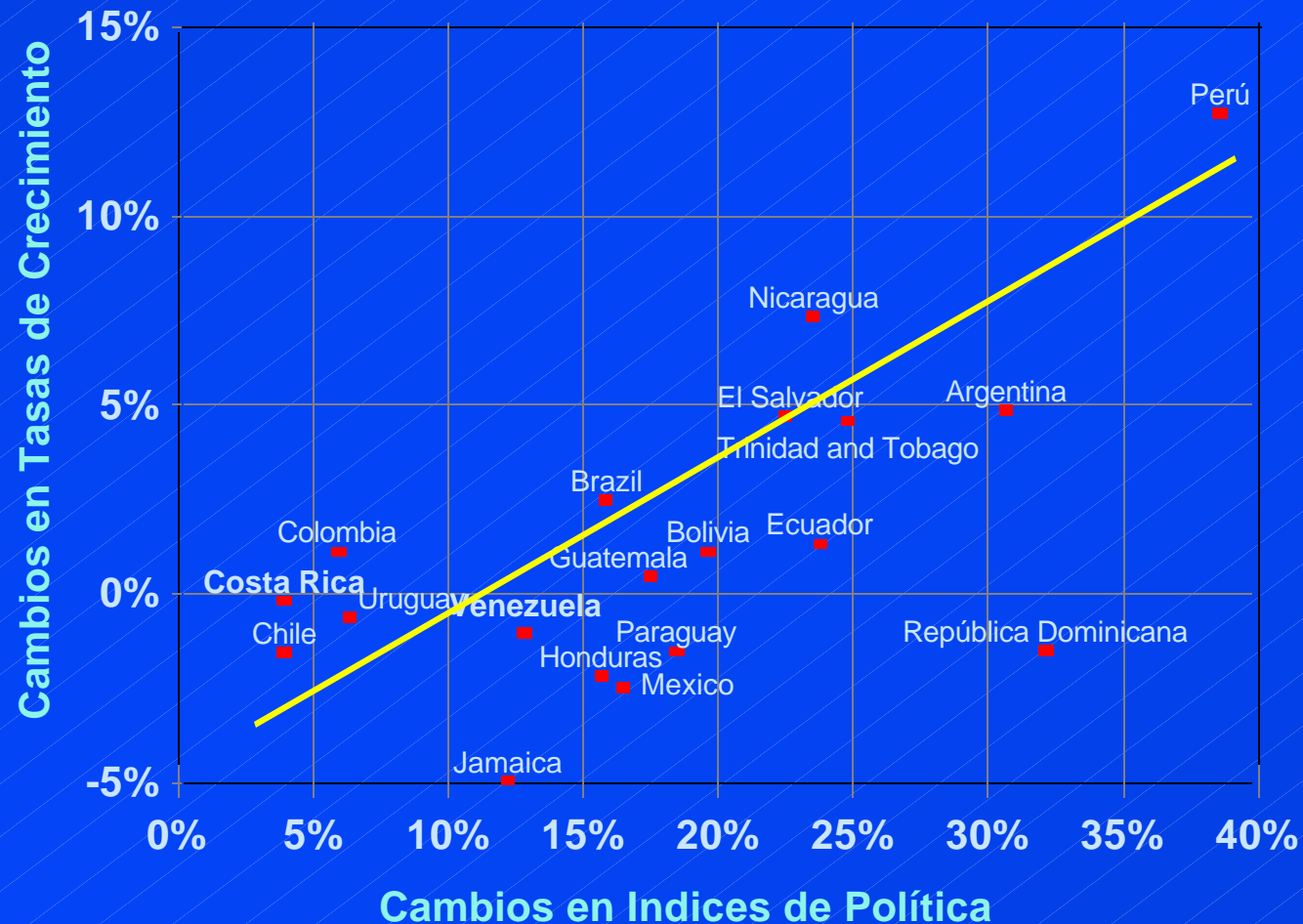
## Avance de las políticas estructurales



Fuente: Lora, 1997

# More reforms, more growth

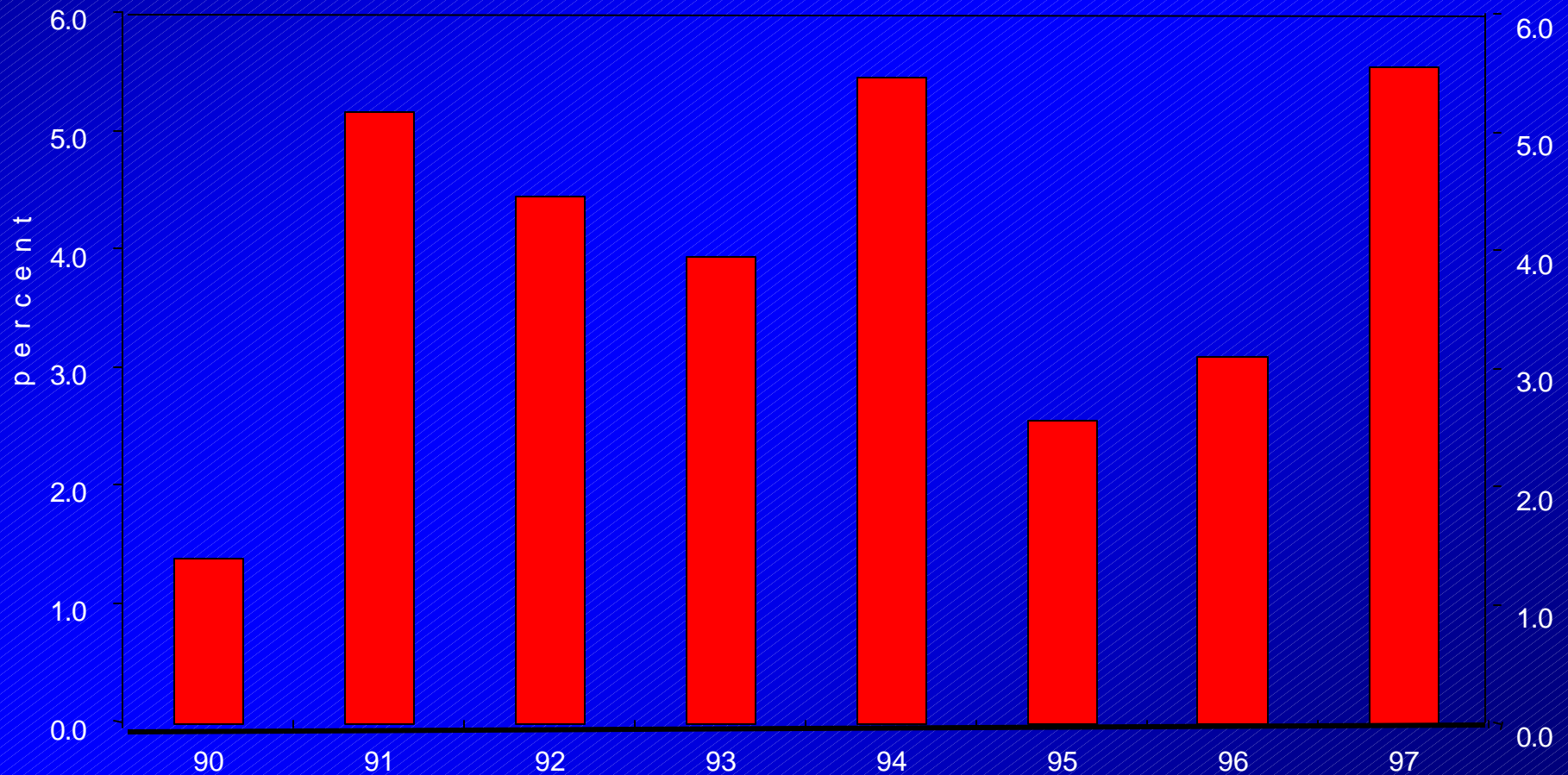
## Cambios en Crecimiento y en Políticas Estructurales (1993-95 vs. 1987-89)



Fuente: Lora y Barrera, 1997

# 1997 was a very good year

Real GDP Growth  
(Average 8 Largest Economies)



## ...but then came a bad streak

- Asian Financial crisis
- Collapse in the terms of trade
- El Niño
- Russian crisis and contagion
- Hurricanes Georges and Mitch
- Brazilian crisis



# The collapse in the terms of trade

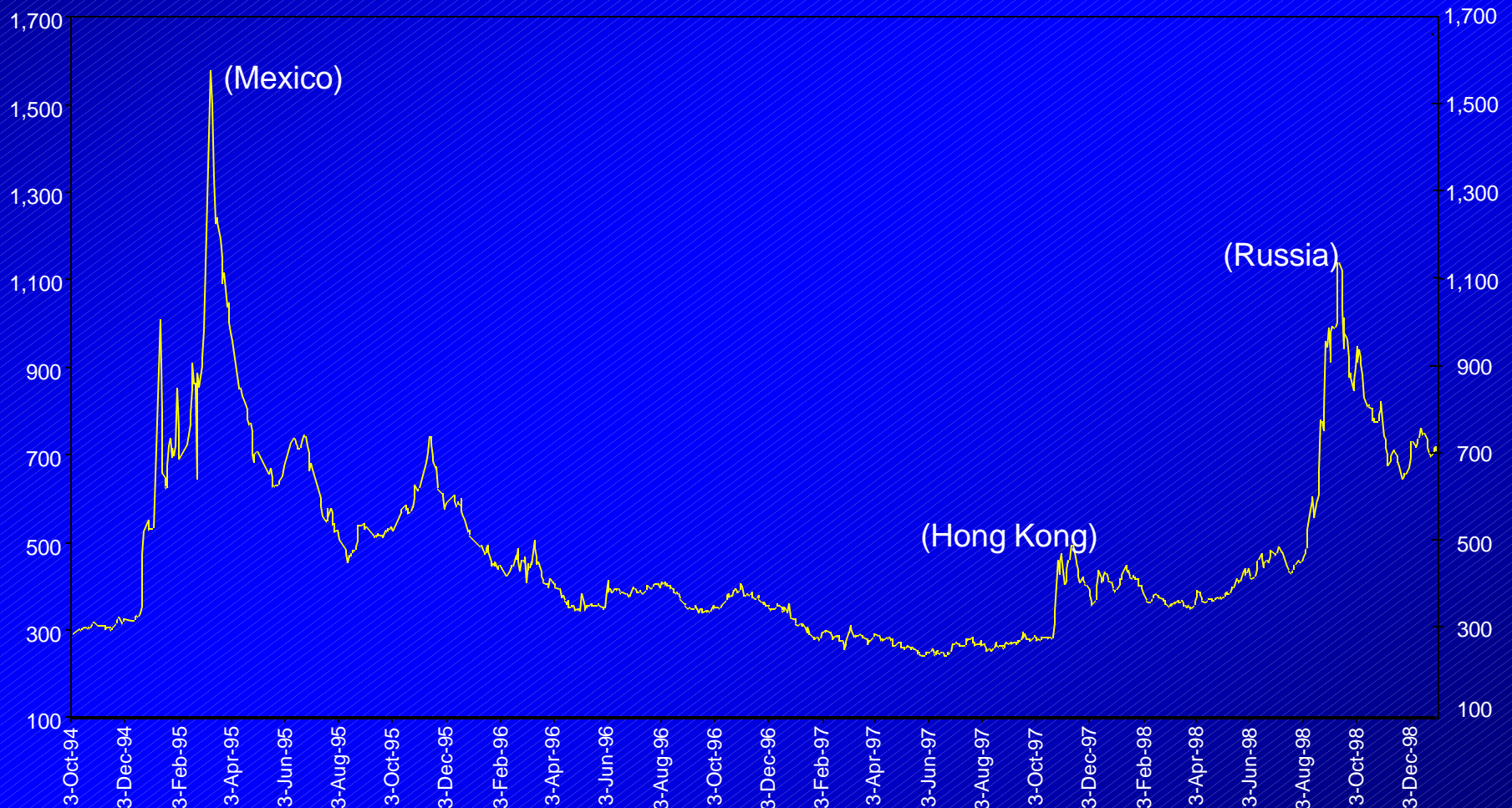
## Commodity Prices



Index 01/02/97 = 100

# Major financial shocks... and recovery

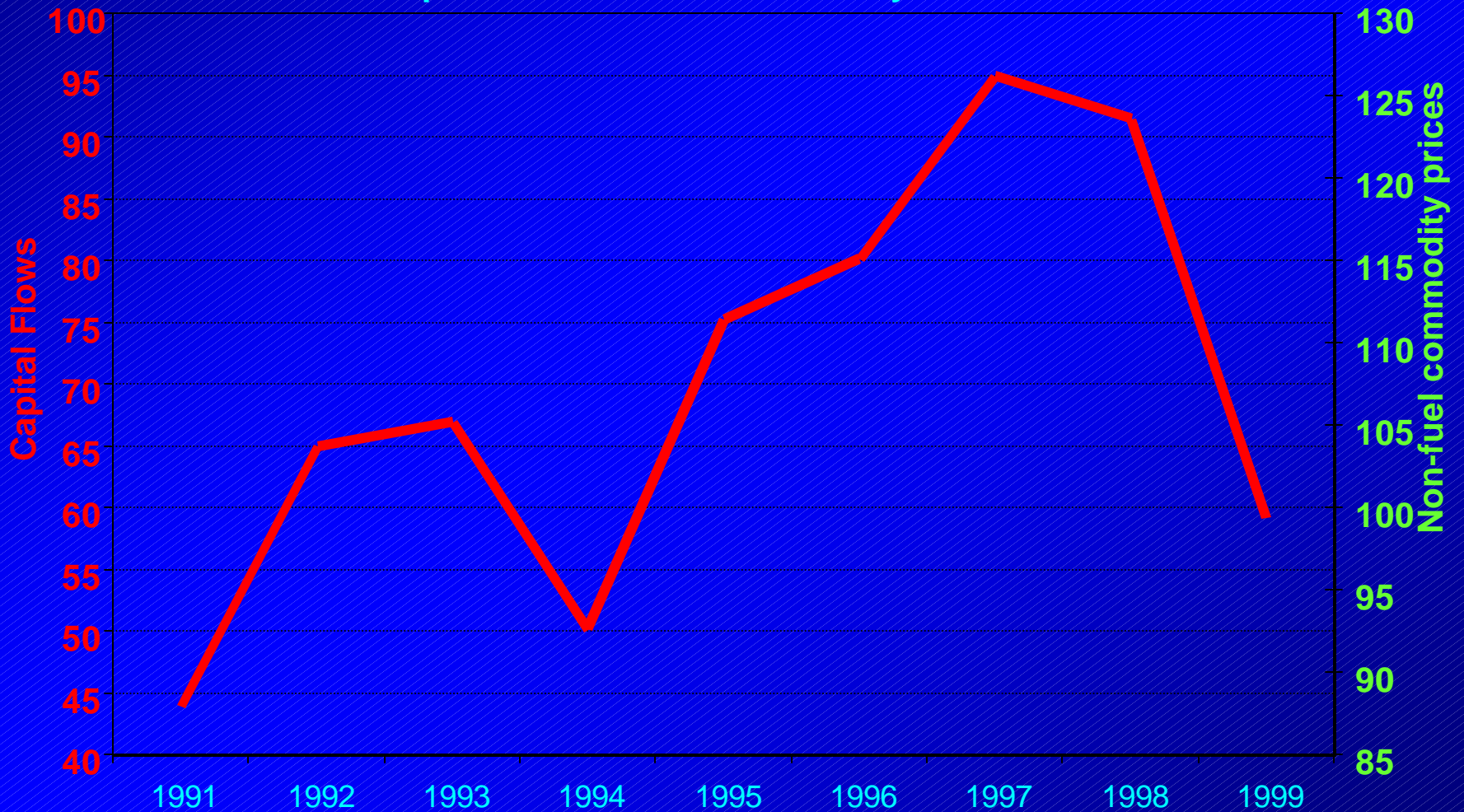
## Latin Eurobond Index Spread (1994-98)



Source: JP Morgan.

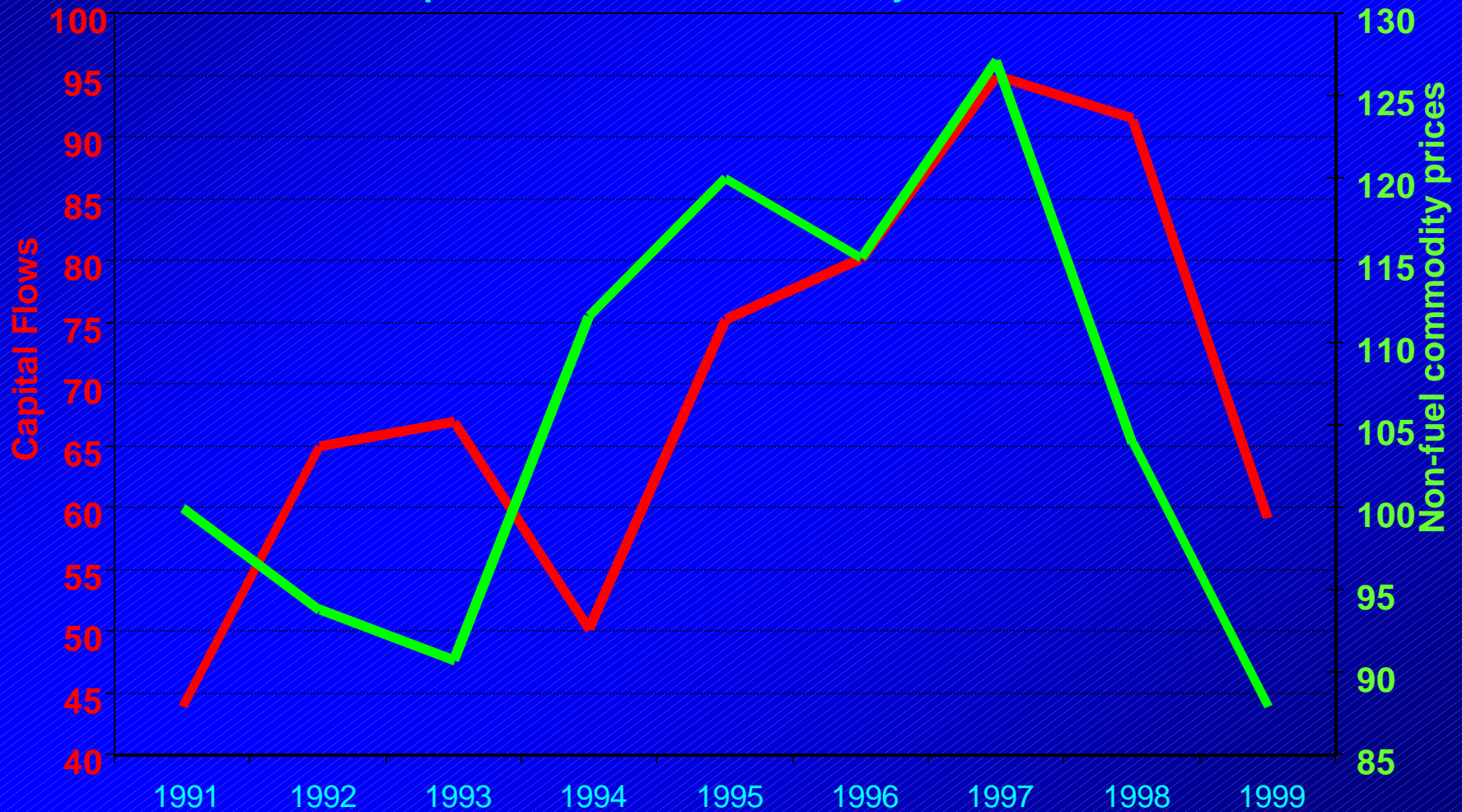
# Private capital inflows collapsed

Net Capital Inflows and Commodity Prices

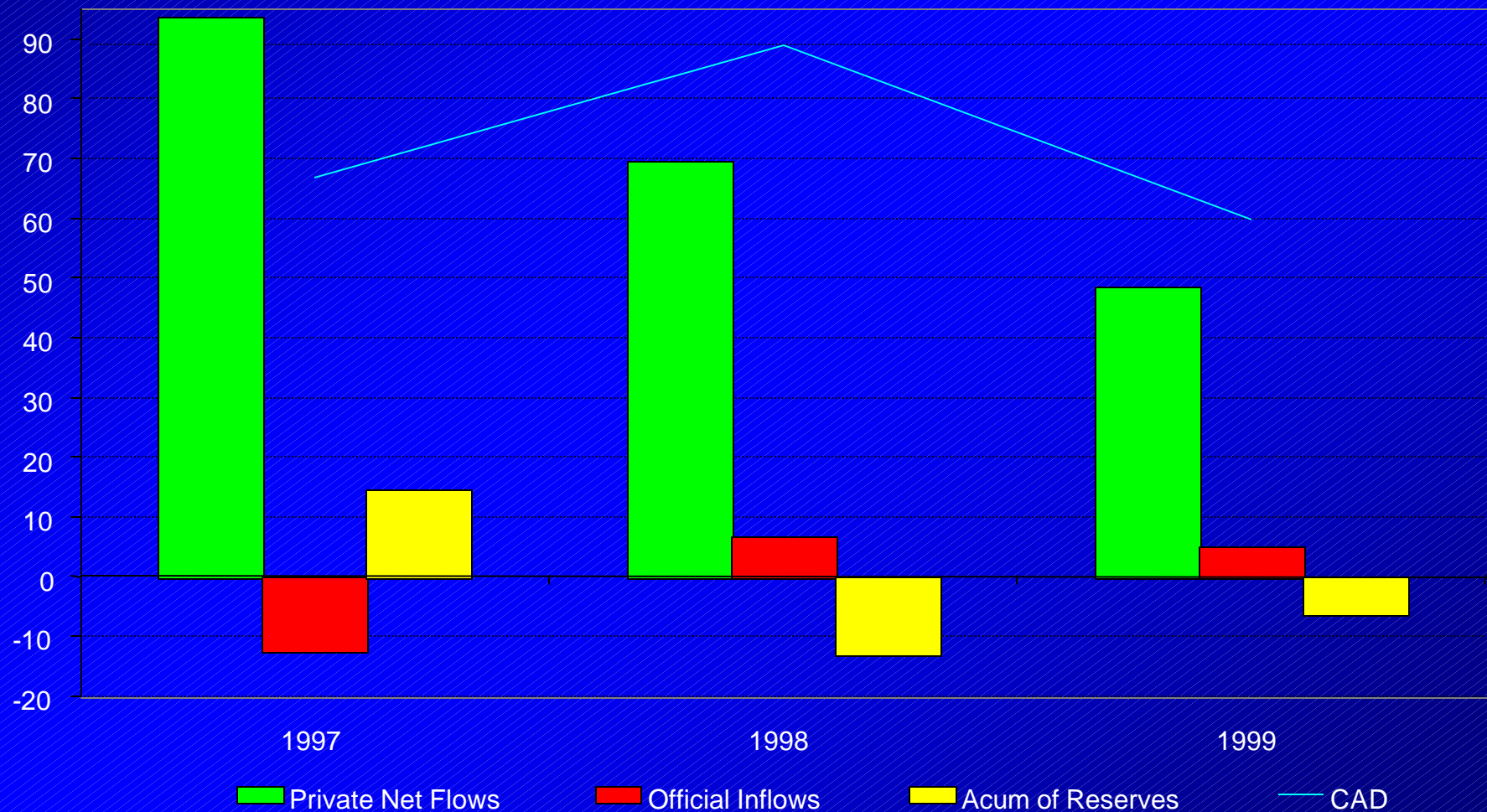


...when they were most needed

Net Capital Inflows and Commodity Prices

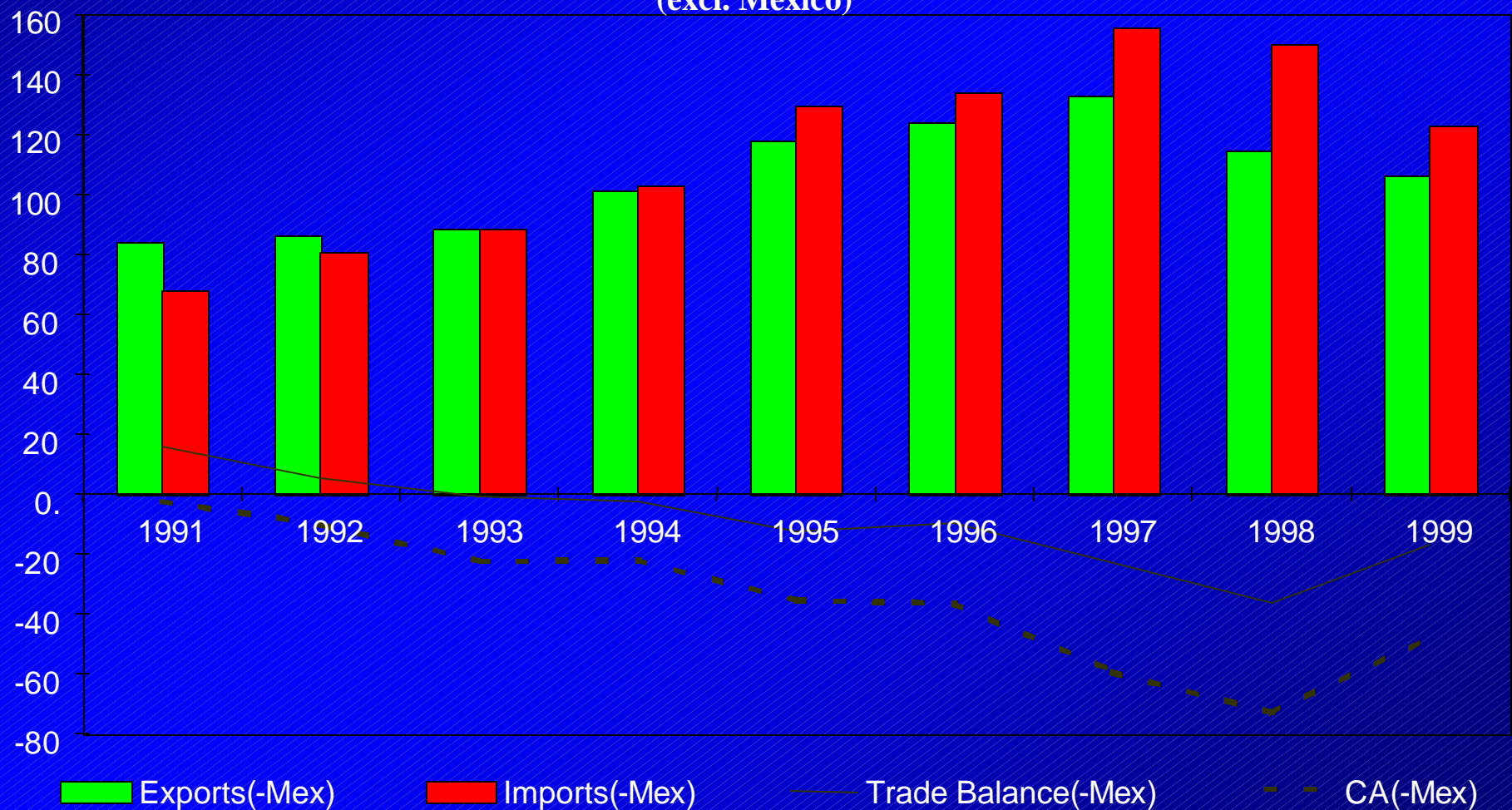


...only marginally offset by  
official financing ...



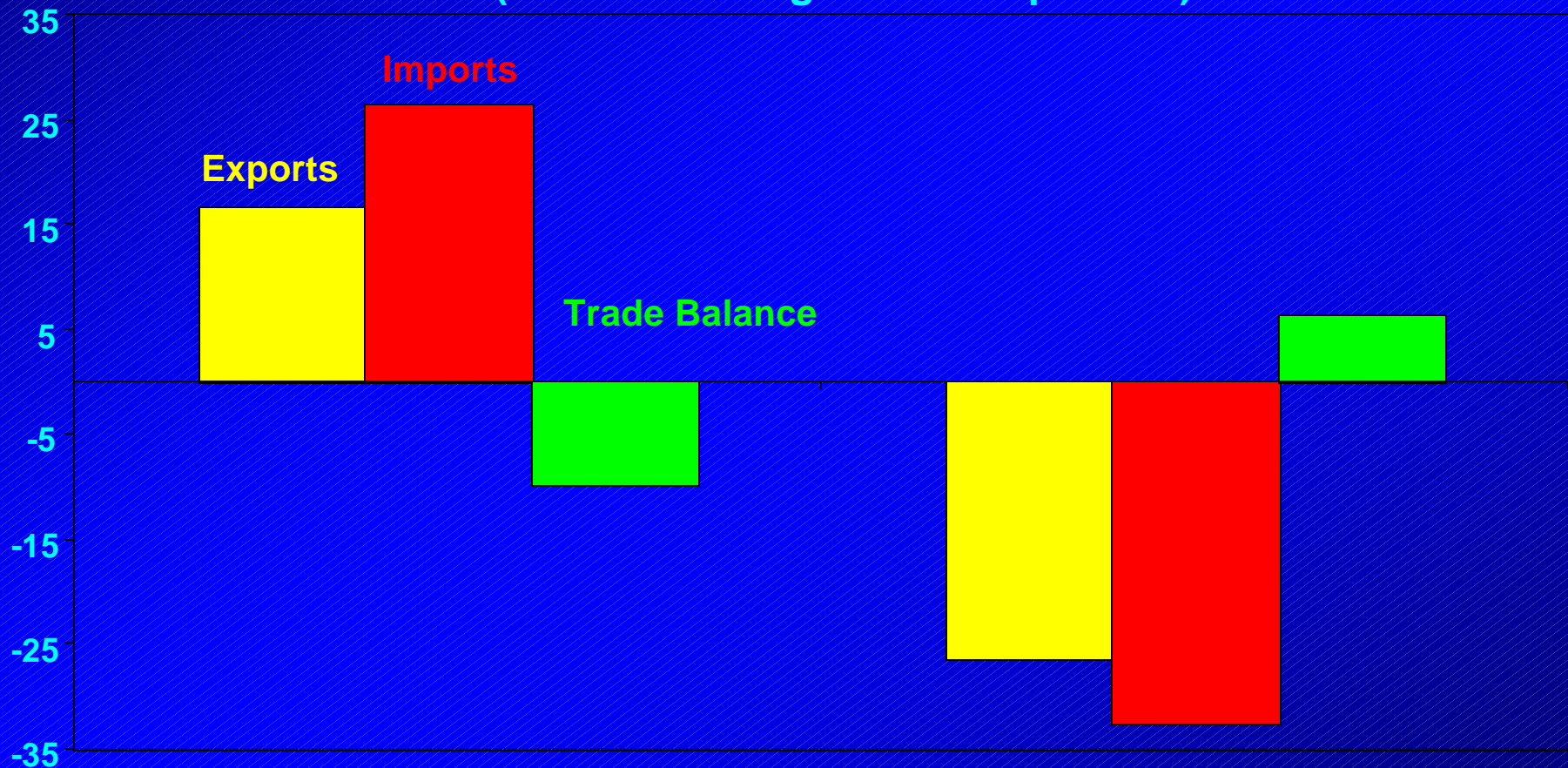
# ...causing a collapse in imports

Trade and Current Account  
(excl. Mexico)



...that exceeded the fall in exports

## Comparing Recessions (absolute change between periods)



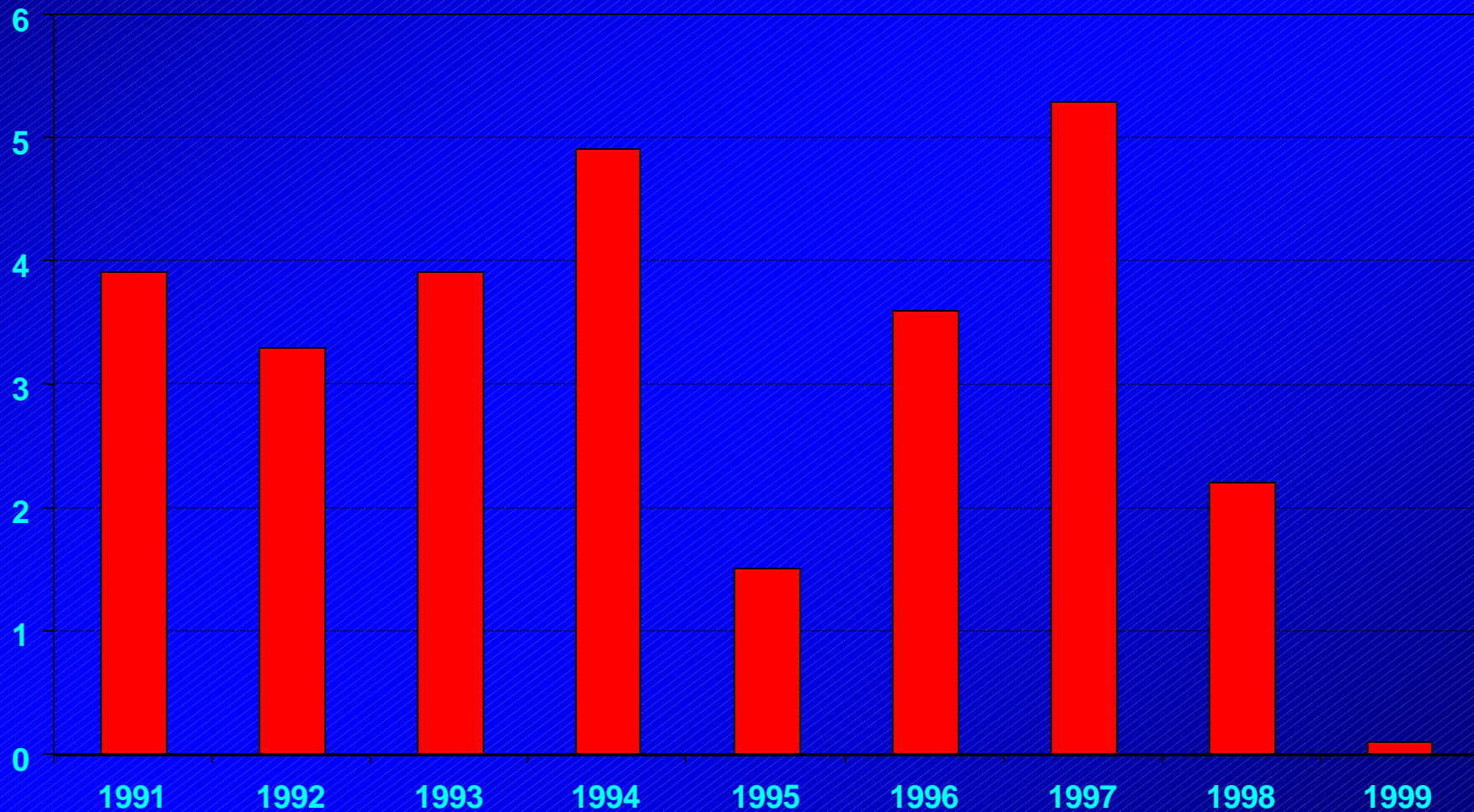
Source: WEO

1994-1995

1997-1999

...and caused a collapse in growth

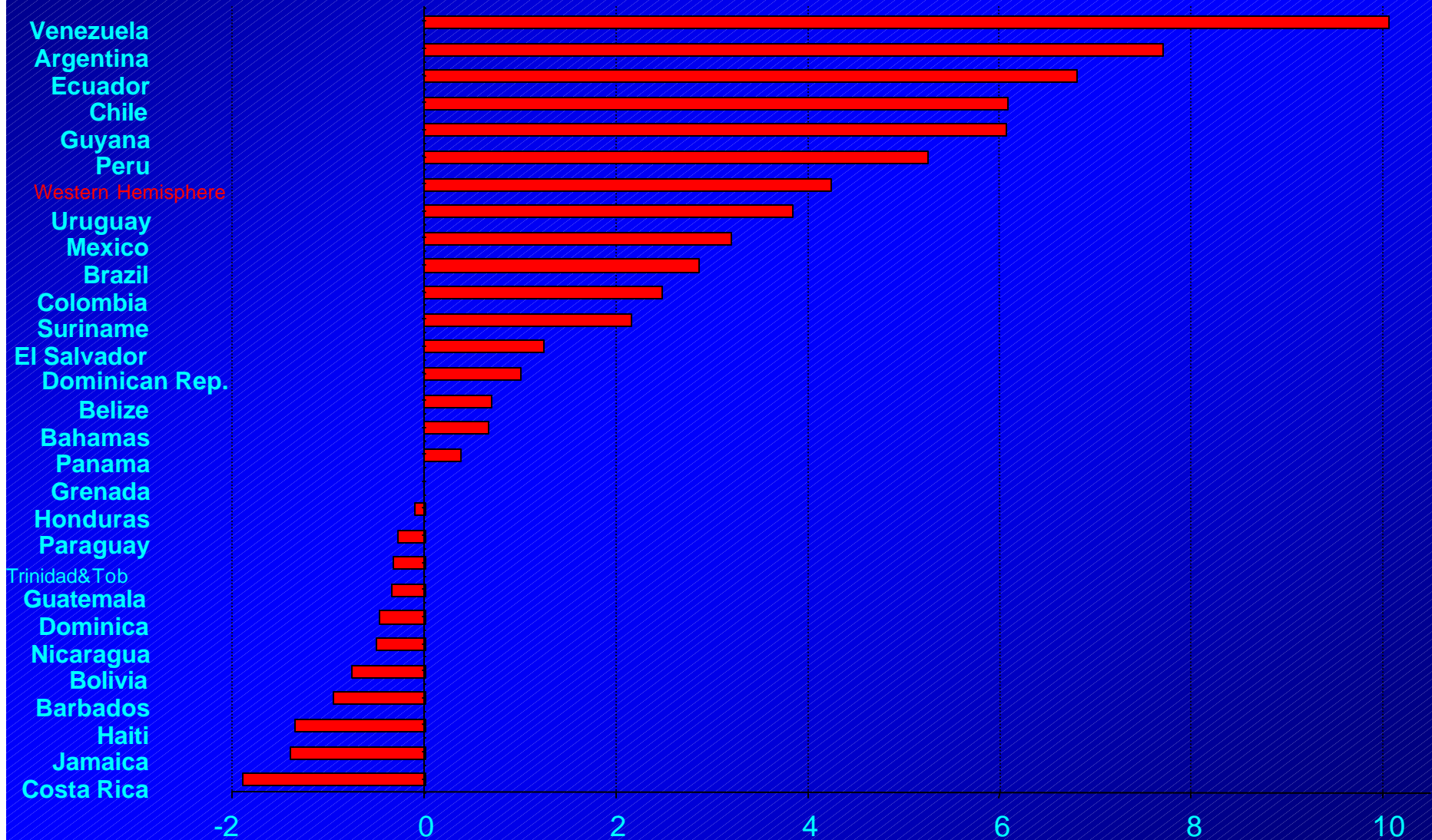
## Real Growth in Latin America





# ...that affected most countries

## Fall in Growth (Average 1999-98 vs 1997)



# Latin America: no Fireworks

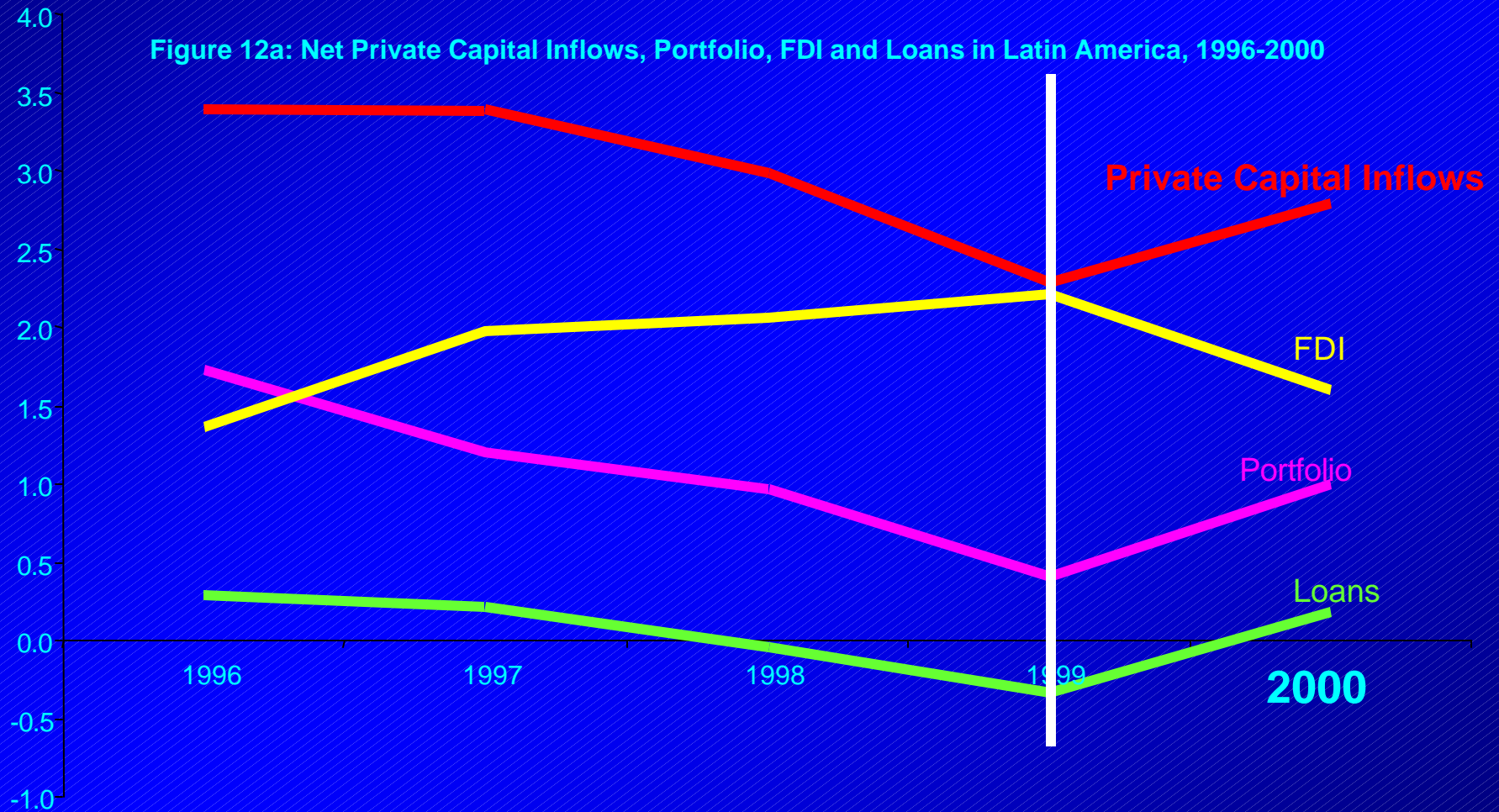
Since the East Asian crisis

- No systemic banking crises
- No widespread currency crises
- No inflationary crises
- No debt crisis
- No reversal of reforms

# Exceptions

- Ecuador is a real exception
- Brazil: not really an exception, just a currency realignment that has not generated any other symptom
- Colombia? Venezuela?

# Capital flows have been recovering

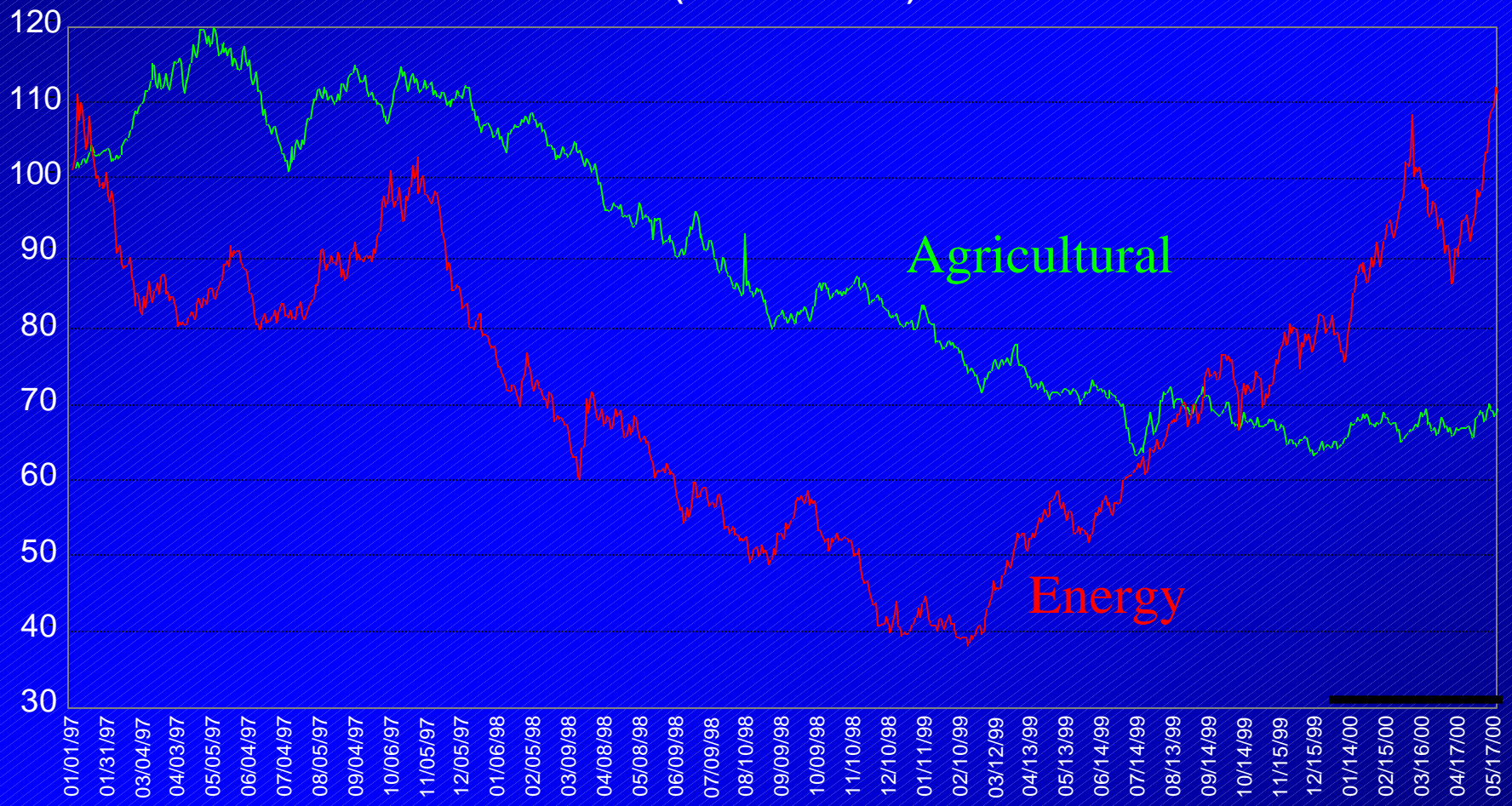


Note: As percentage of GDP.

Source: Balance of Payments, IMF.

# Commodity prices have stopped falling

Commodity Indexes  
(Index Jan 97=100)



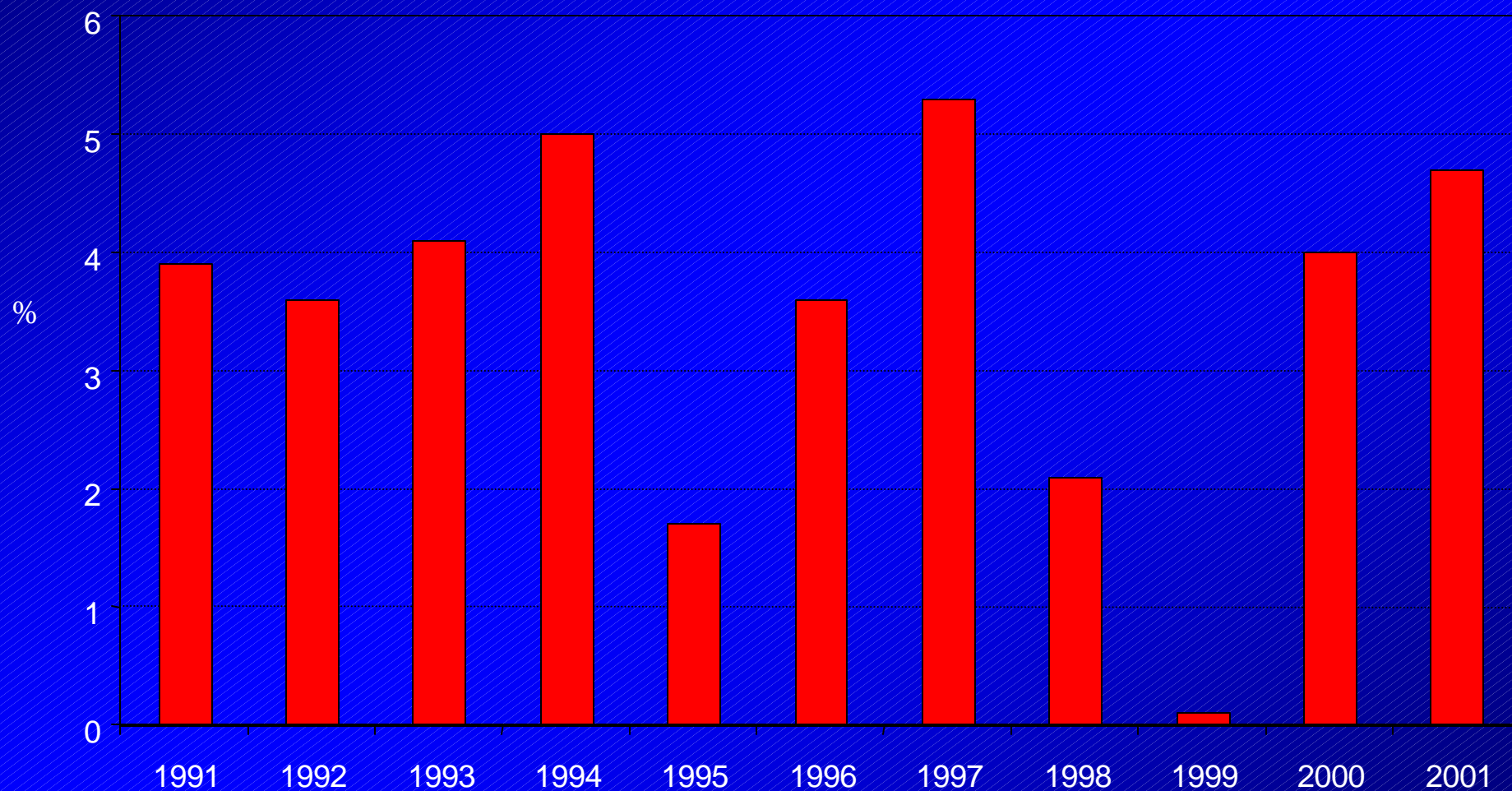
Source: Goldman Sachs Commodity Indexes

# World outlook looks good

- Continued recovery in Europe
- ...and in East Asia
- ...mild recovery in Japan
- ...and a roaring US economy

# ...and the region is expected to recover

Real Growth in Latin America  
Annual percent change



Source: WEO

# What will the future bring?

- Are we facing another boom?
- Will it be followed by another crisis?
- ...or will it be sustained?



# Four scenarios ahead

	Dangerous	Safe
Deep	Boom - Crisis	High, sustained flows
Shallow	Mild boom-crisis	No boom-no crisis

# The origin of crises: the mainstream approach

- Booms and crises were caused by moral hazard
- and an inadequate perception of risks

# Mainstream View #1

## Shallow and safe

- Large recent losses
- ...and changes to international financial architecture:
  - lower bail-outs, more bail-ins
  - more flexible exchange rates
- ...will reduce moral hazard, giving rise to a more moderate but sustainable scenario.

# Mainstream View # 2

## Deep and dangerous

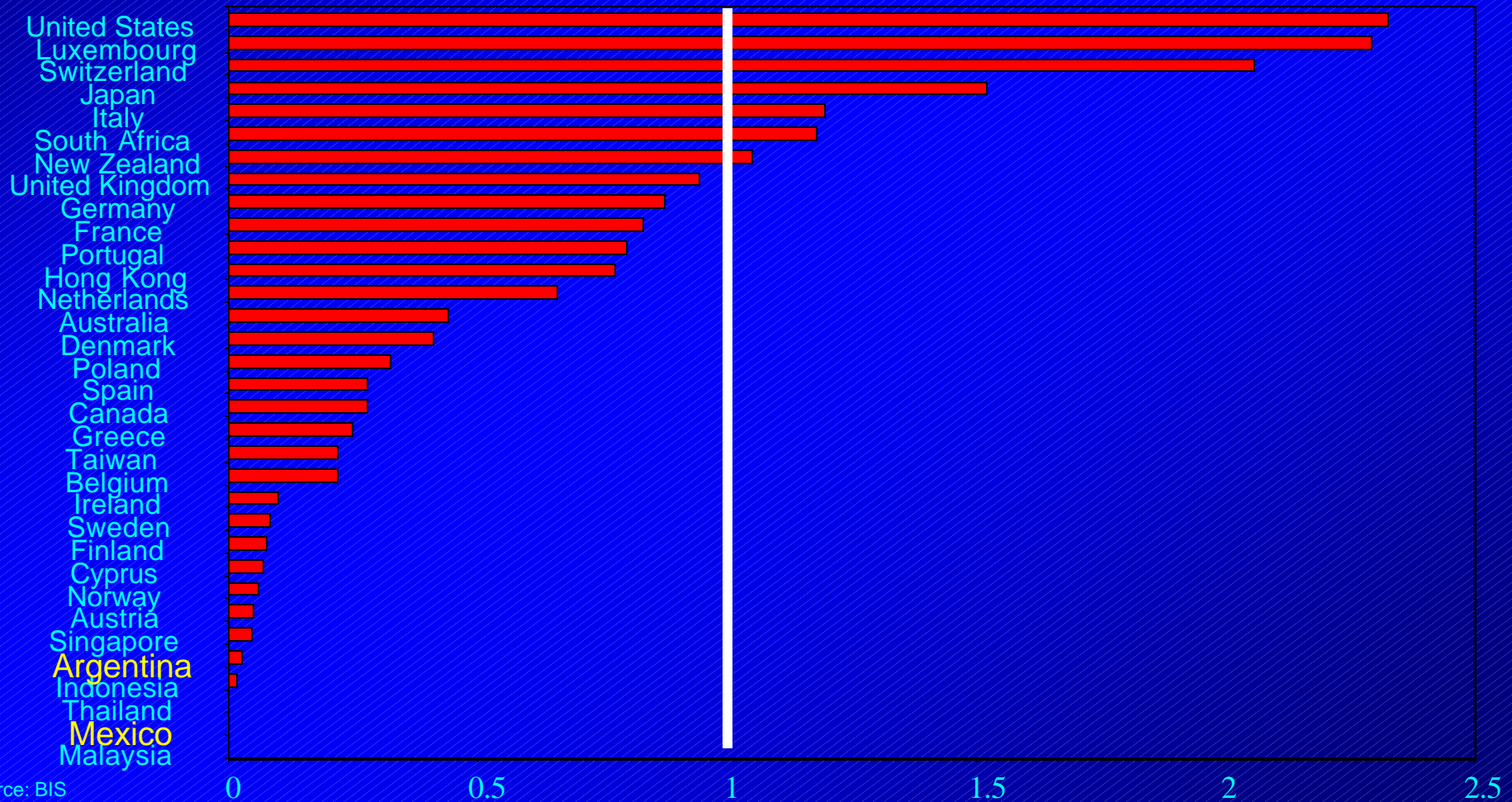
- Booms and crises are caused by moral hazard
- ...but nothing substantial has changed
- ...so we will get another boom, followed by another crisis

# The origin of crises: the mismatch approach

- Crises are not caused by moral hazard.
- They are caused by mismatches which leave countries vulnerable to self-fulfilling attacks.
  - ORIGINAL SIN: unable to borrow internationally in own currency
- Changes in architecture have made things worse
- The mismatches are in the stocks, not in the flows.

# Original sin: World Comparison

Debt in Currency X Over Debt in Country X, 1998  
(Money Market Instruments and Bonds)



# View # 3

## Shallow and dangerous

- Countries do not deal with the mismatches
- Risks are perceived as high,
- Flows will be low
- ...but still a crisis.
- Deep and dangerous also a possibility if the market focuses on the good equilibrium

# View #4

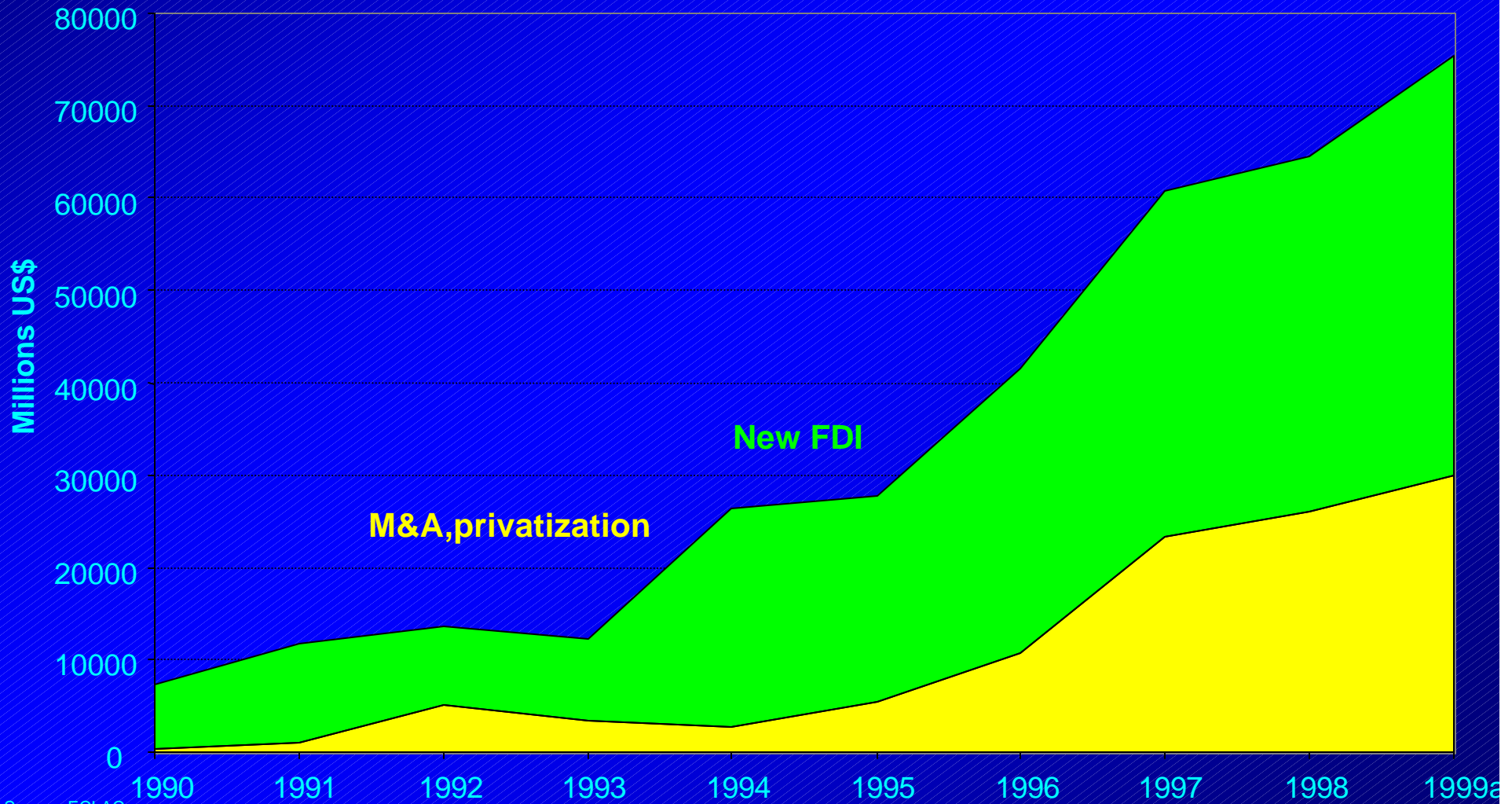
## Deep and Safe

- Countries deal with the mismatches:
  - developing the ability to borrow internationally in their own currency
  - adopting common currency that does not have original sin.
- The market can support large, sustainable flows



# FDI has been booming

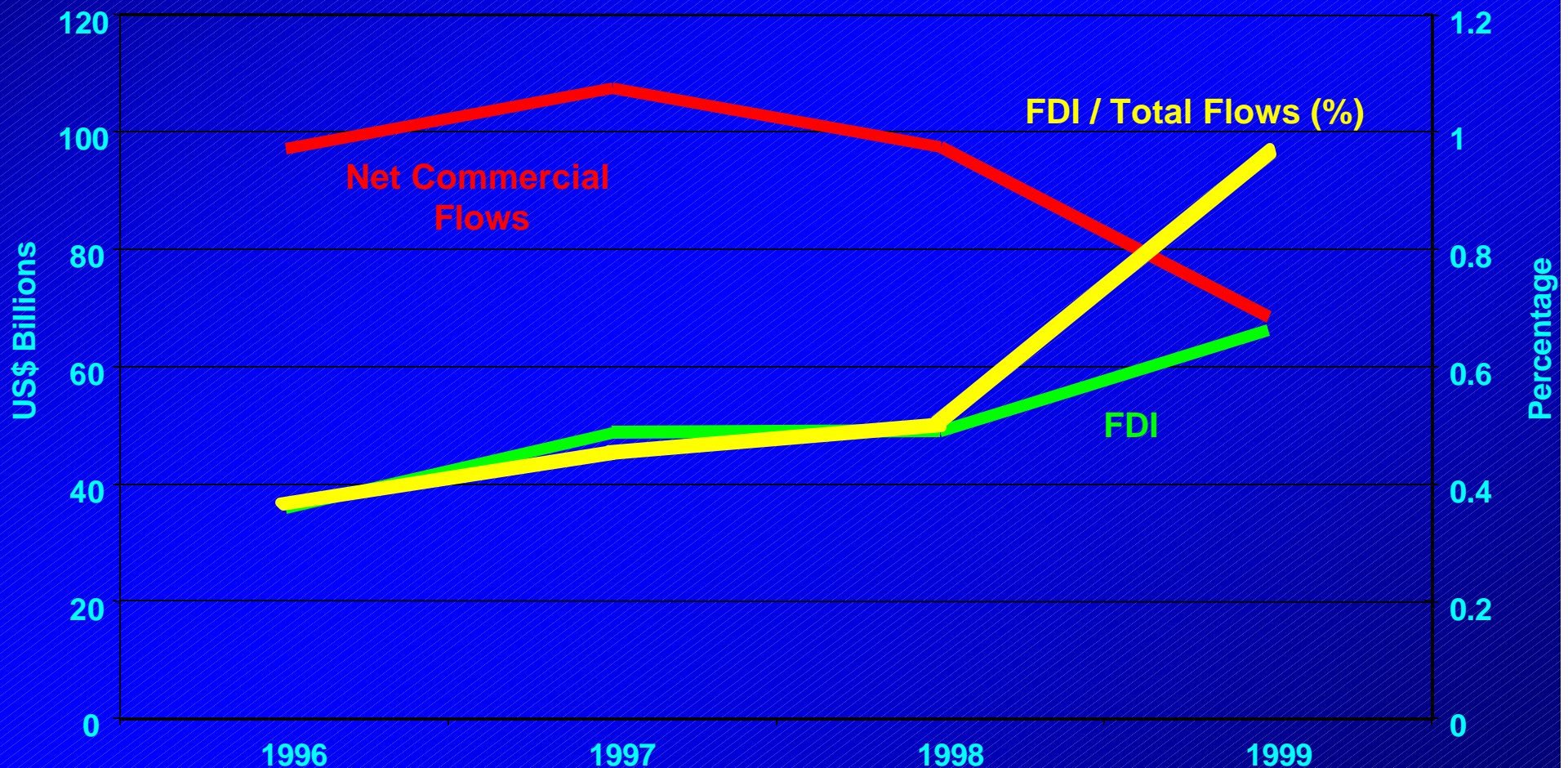
## FDI Flows 1990-1999



Source: ECLAC

...but in the context of declining  
total flows

### Net Commercial Capital Flows and Its Composition for Latin America



Source: IIF

Is FDI like good cholesterol?

# Conventional wisdom

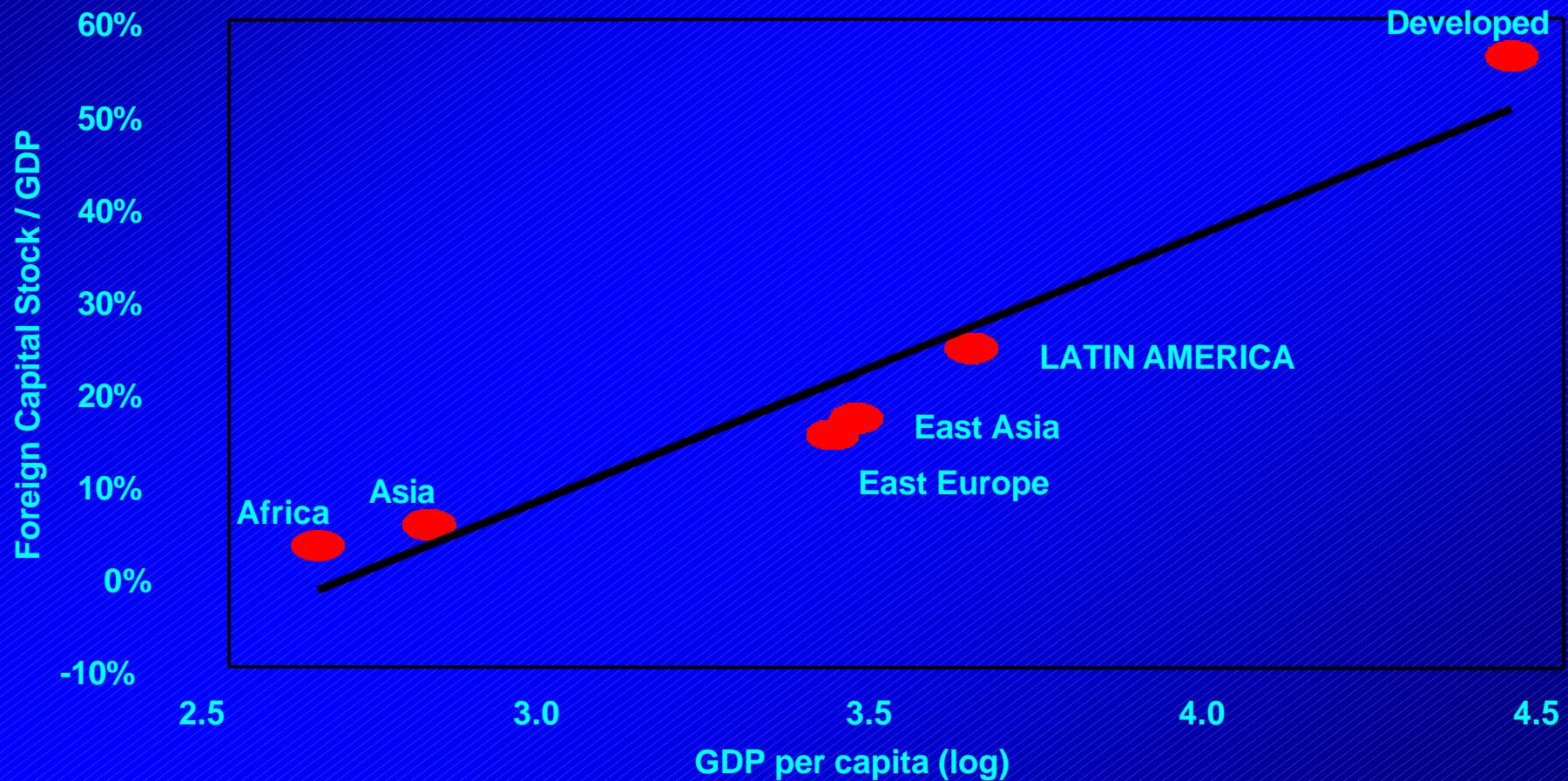
- Capital is like cholesterol
- Good cholesterol FDI
  - Brings technology, market access, managerial skills
  - It is “bolted down”
  - It is attracted by long-term prospects and good institutions

# Conventional wisdom

- Bad cholesterol “Hot” portfolio money
  - Driven by short-term speculative considerations
  - Affected by moral hazard
  - First to flee

# More development, more foreign capital

## Foreign Capital Stock and Income

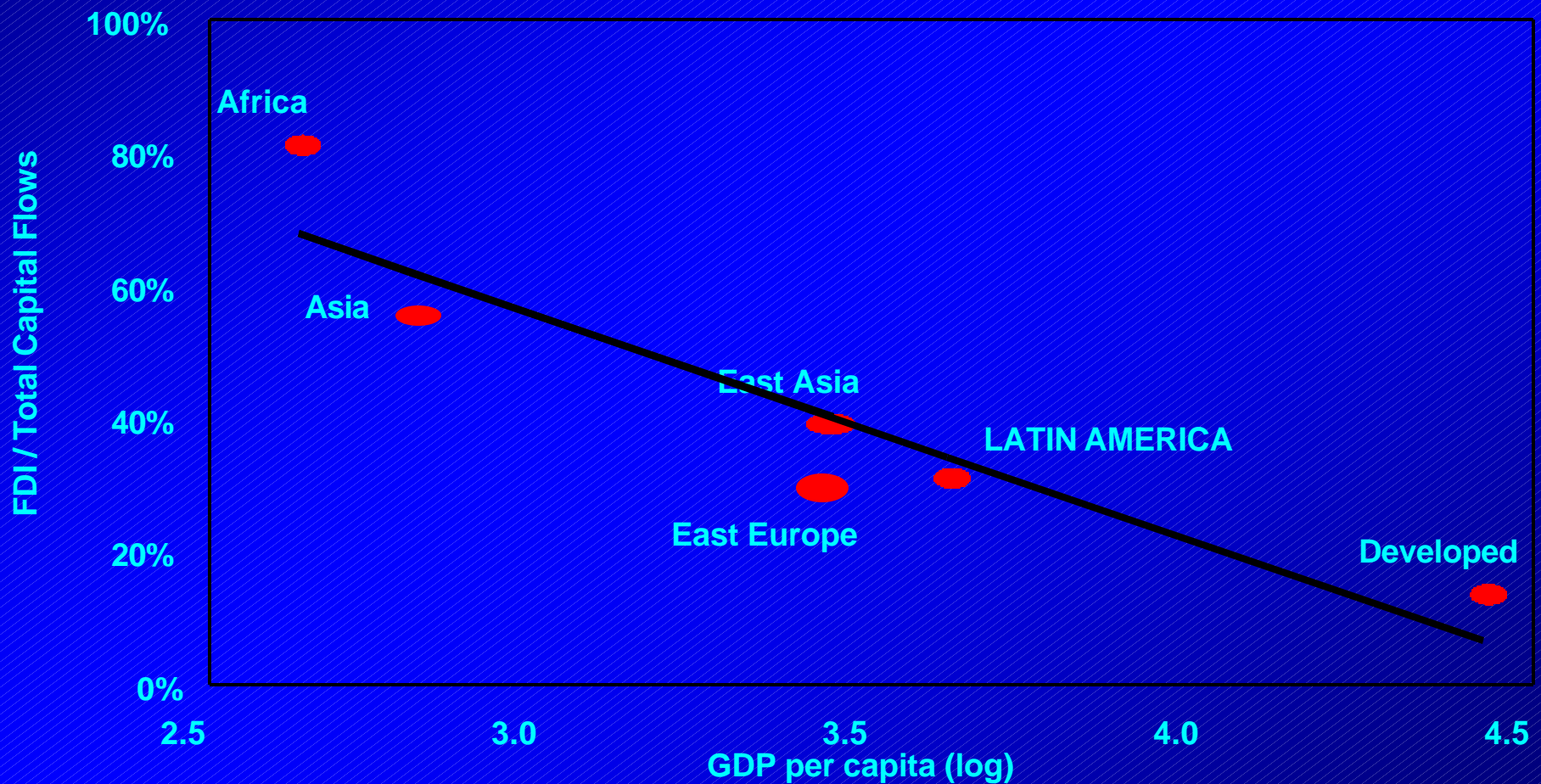


\*Data refers to stocks of 1997 in current dollars and GDP in PPP current dollars. The GDP per capita is a weighted average of countries for the same year.

Source: IFS, WB and RES-IDB.

...but a smaller FDI share

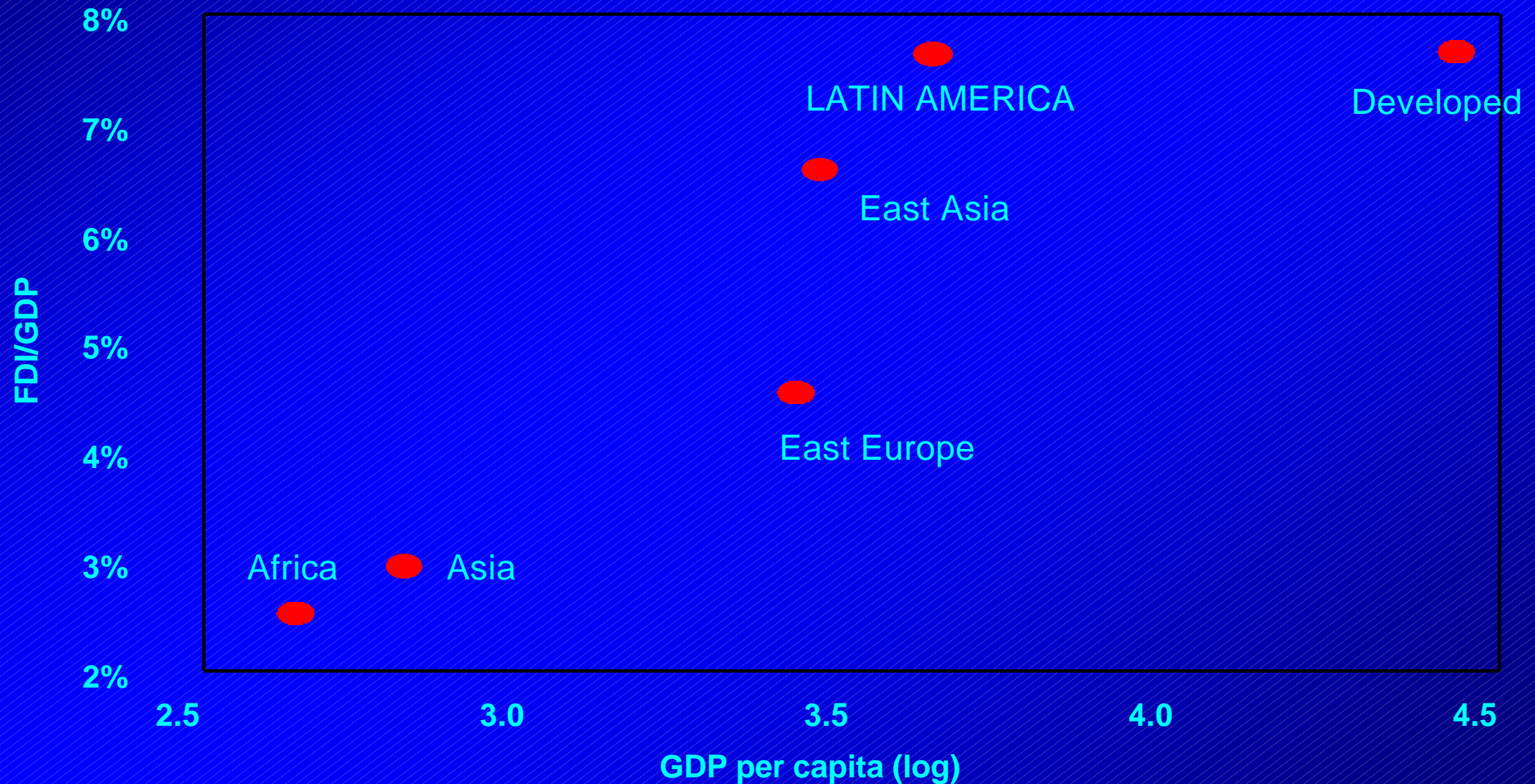
## Composition of Foreign Capital Stock and Income



\*Data refers to stocks of 1997 in current dollars and GDP in PPP current dollars. The GDP per capita is a weighted average of countries for the same year.  
Source: IFS, WB and RES-IDB.

# FDI/GDP: Outcome of opposite forces

## FDI Stock and Income

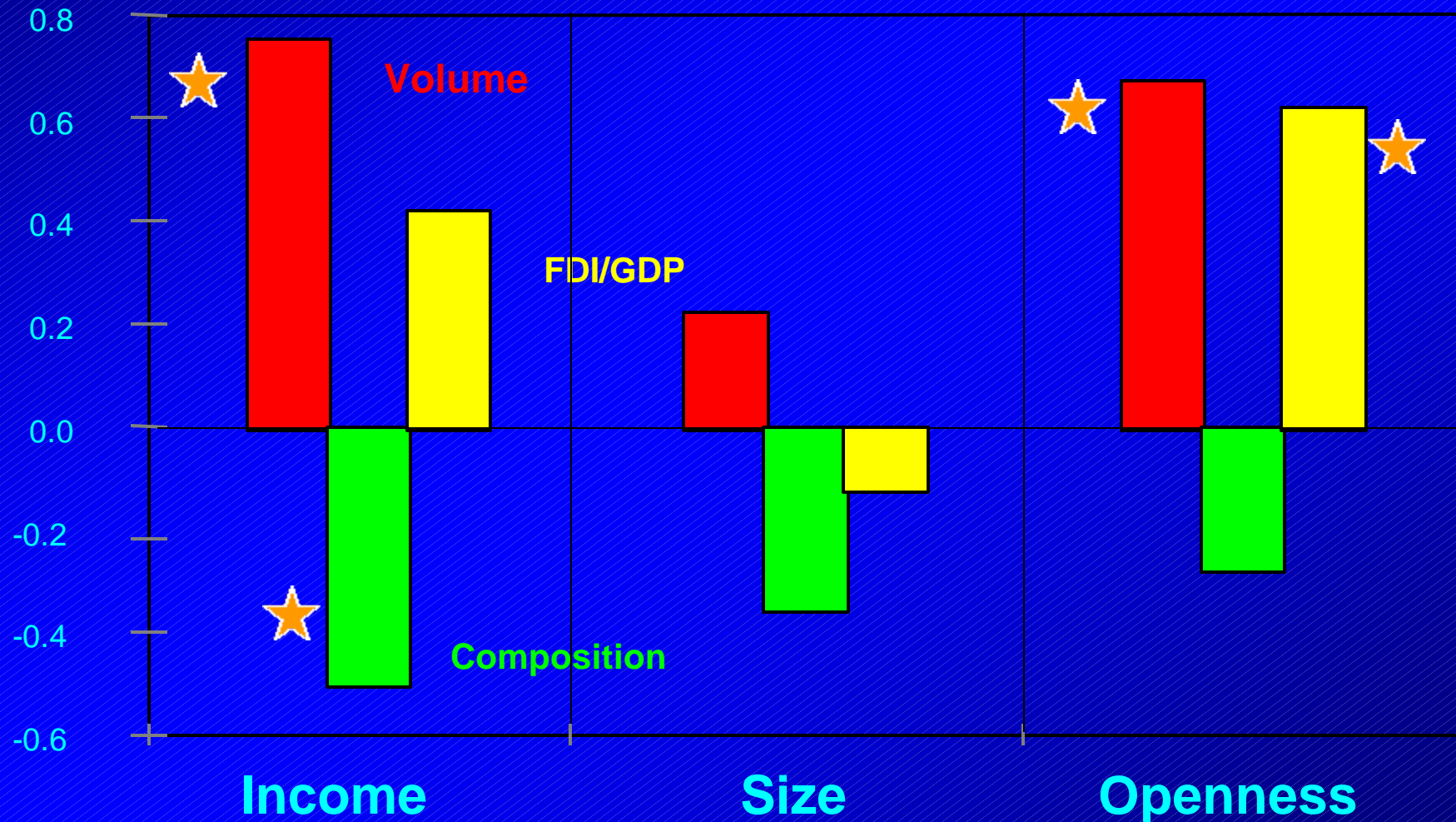


\*Data refers to stocks of 1997 in current dollars and GDP in PPP current dollars. The GDP per capita is a weighted average of countries for the same year.  
Source: IFS, WB and RES-IDB.



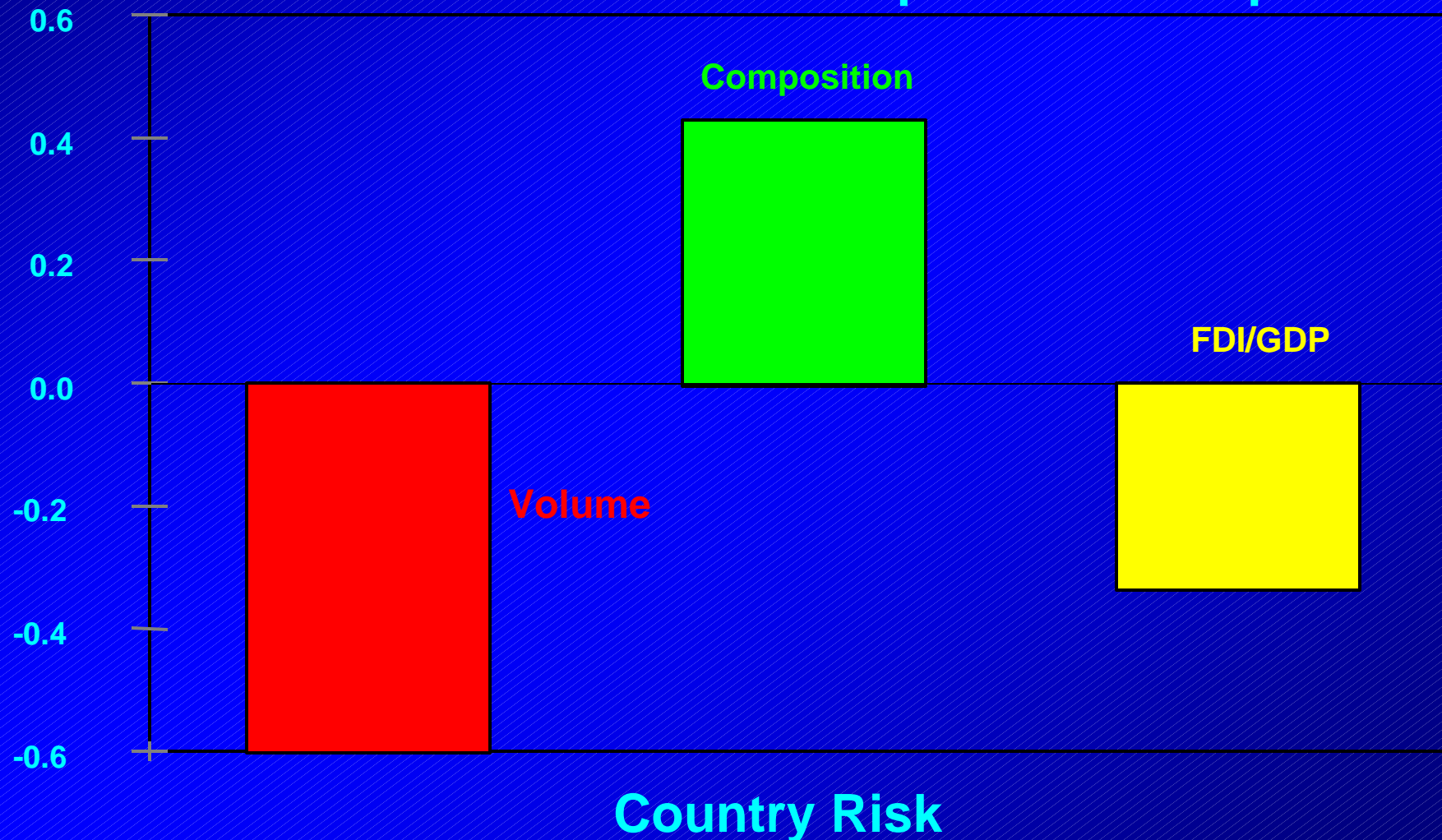
# Richer, larger, more open economies don't have higher FDI-shares

Correlations with Volume and Composition of Capital Flows



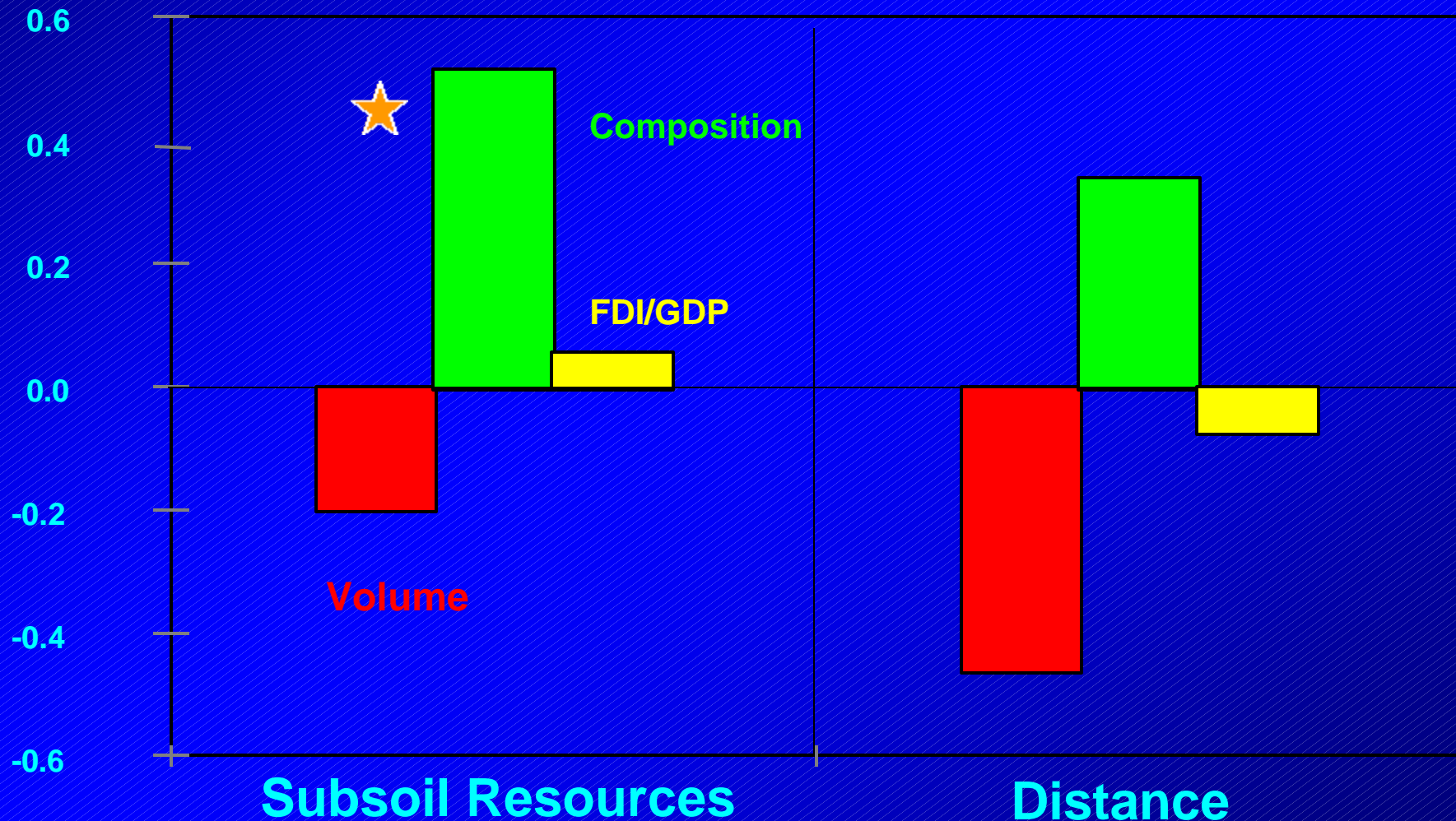
# Riskier countries get less capital, but a larger share of FDI

## Correlations with Volume and Composition of Capital Flows



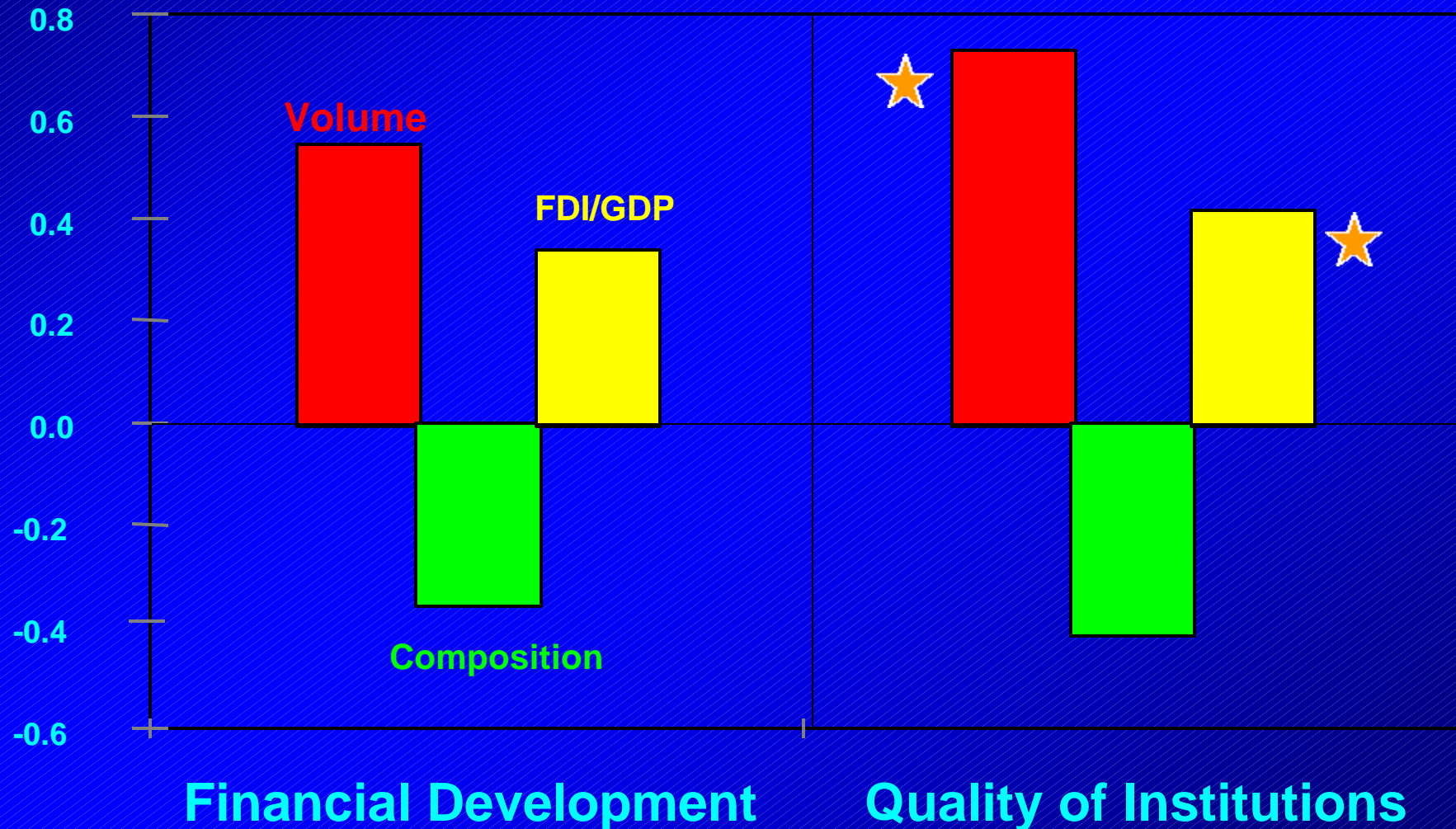
# Resource rich, distant countries don't get more capital, but higher FDI-share

## Correlations with Volume and Composition of Capital Flows



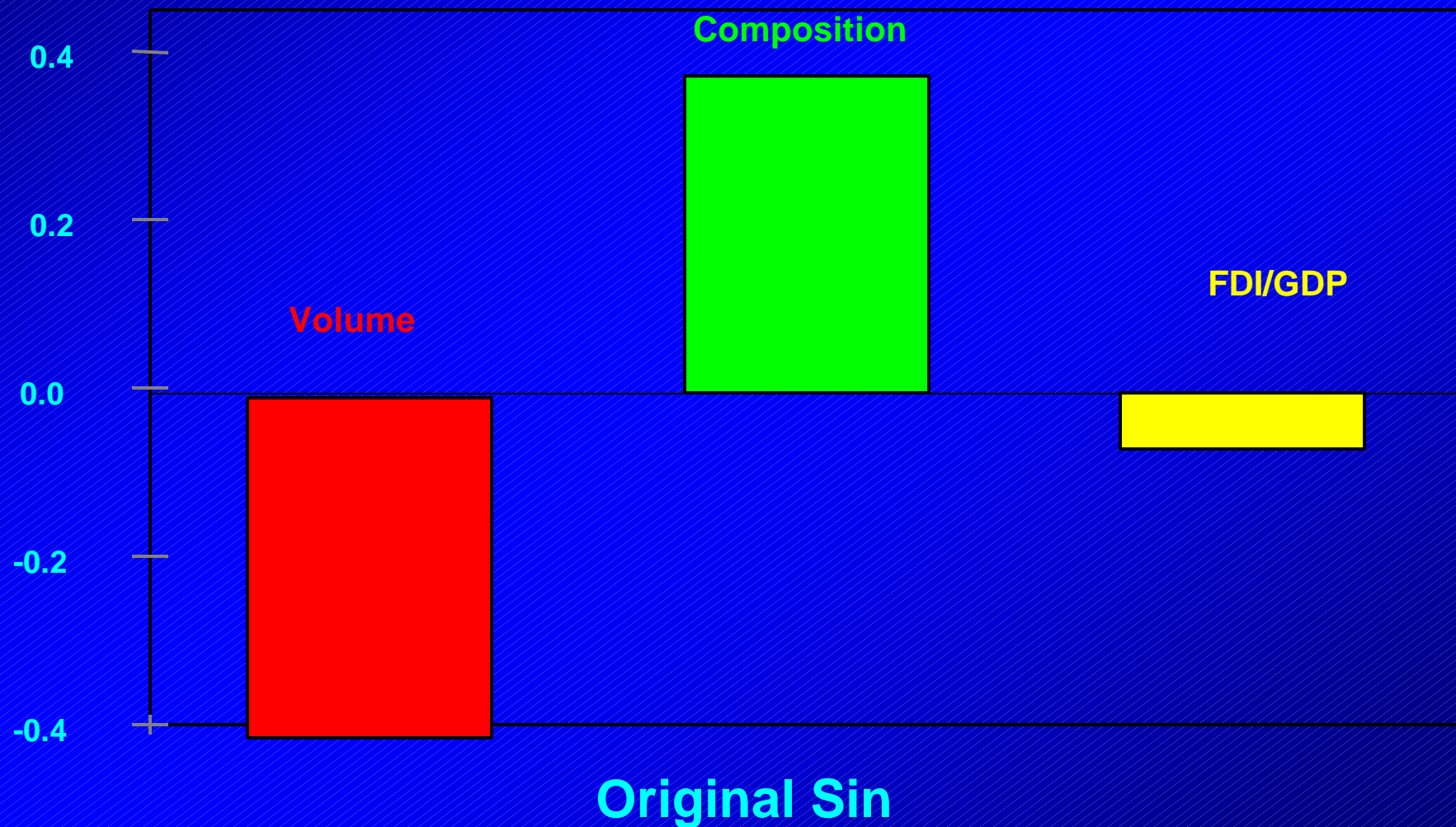
# Better finance, better institutions don't beget more FDI-share

Correlations with Volume and Composition of Capital Flows



# Original sin increases FDI-share

## Correlations with Volume and Composition of Capital Flows



“Good things” are associated  
with more foreign capital inflows  
but a lower share of FDI

Controlling for income, size and  
openness, lower risk and better  
institutions do not increase the share  
of FDI

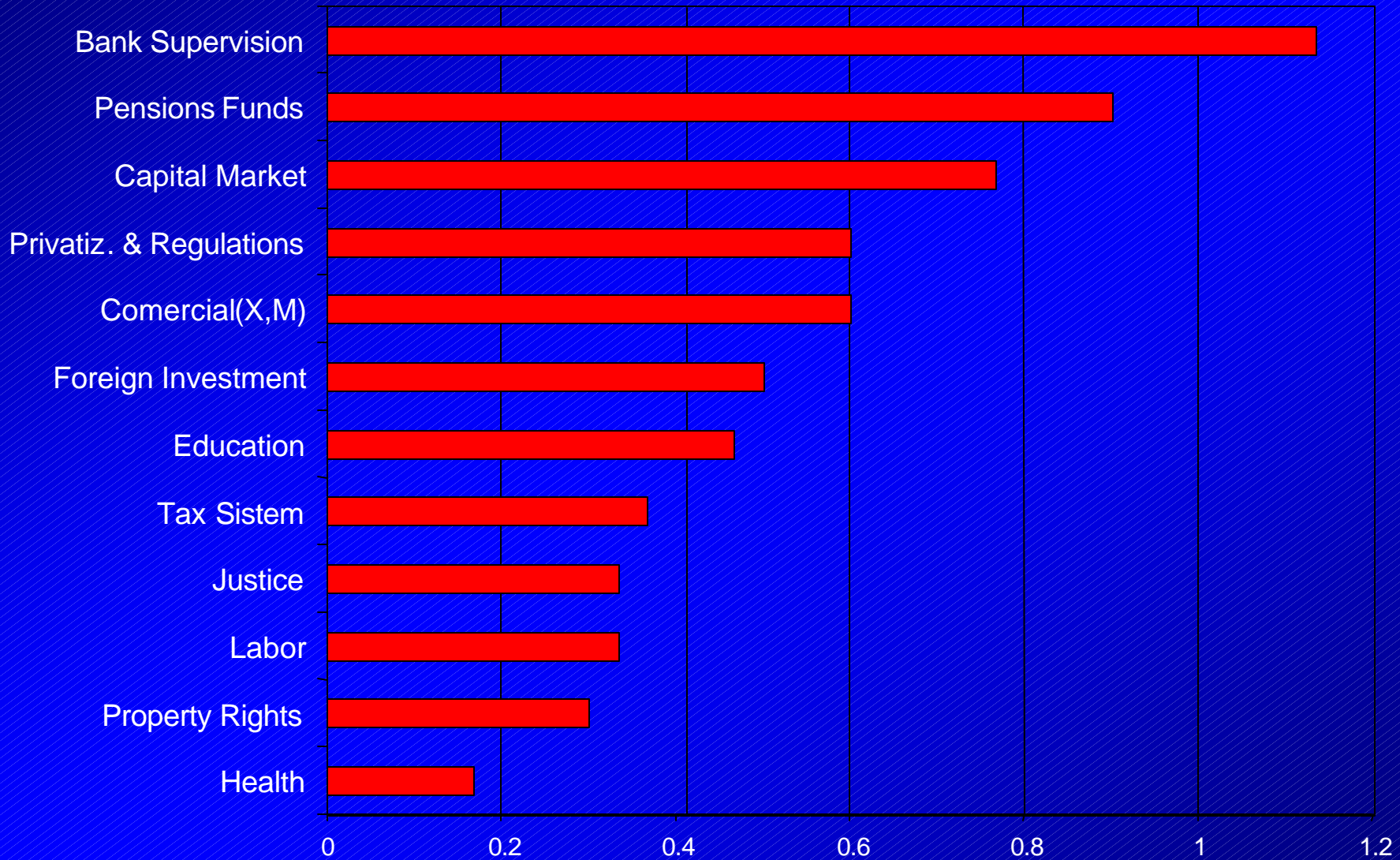
# Hypothesis

- FDI is booming because firms are redefining their shape so as to circumvent lousy debt markets
- FDI is a solution to the mismatch problem caused by original sin
  - Long term and no currency denomination
- FDI may also limit liquidity problems
- Implications for optimal financial structures
  - IPOs to domestic market or M&A to a strategic investor?

Looking into the more distant  
future



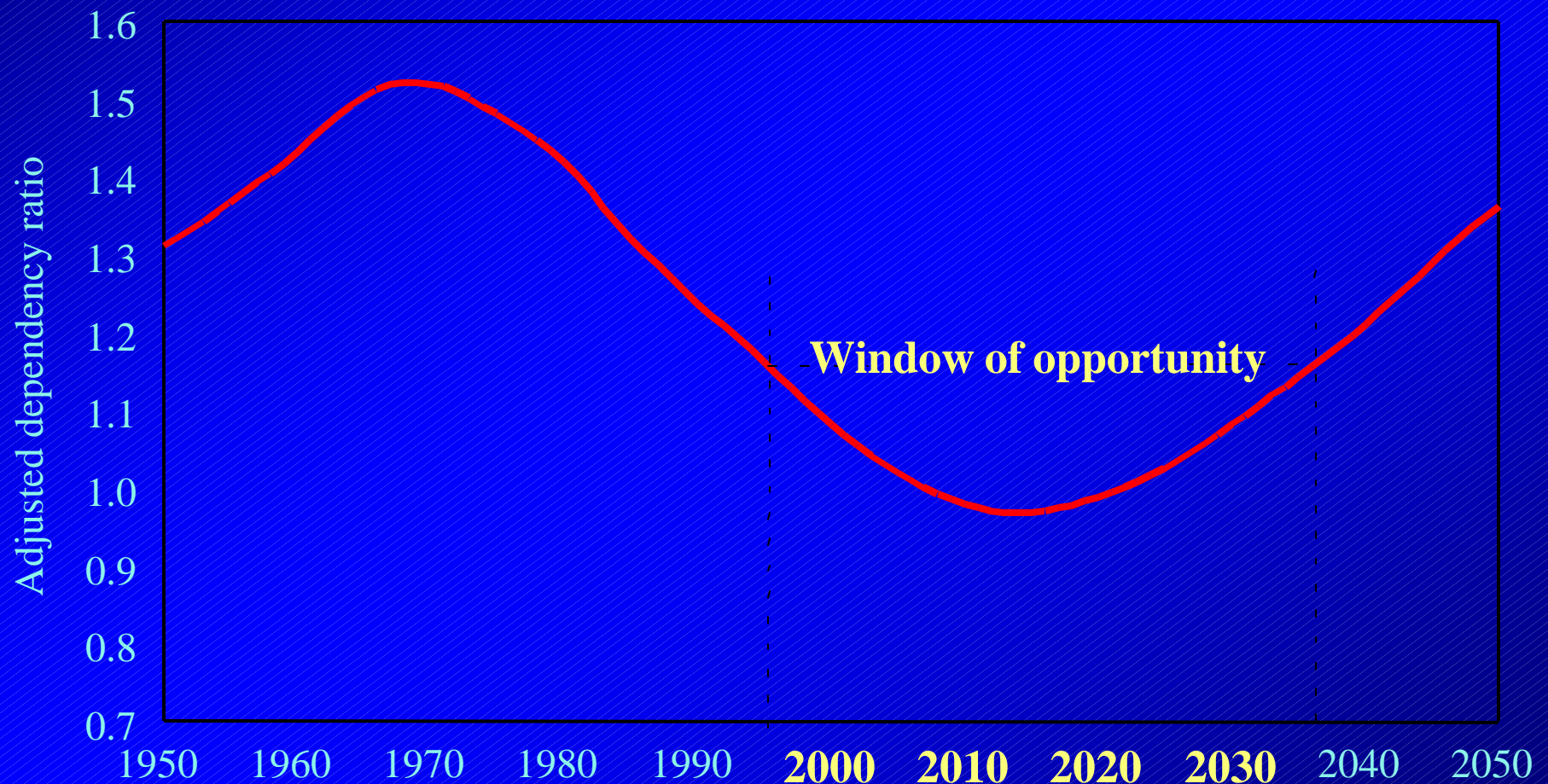
# Structural reforms are continuing



Source: Survey. Note: Difference with respect to 3 years ago (based on scale 0-5)

# Latin America has a Demographic Window of Opportunity

Adjusted dependency ratio



Source: Duryea and Székely (1998)

# ¿What does demographic opportunity imply?

- **More work**
- **More savings**
- **More education**

THE OPPORTUNITY TO BE THE FASTEST GROWING  
REGION IN THE WORLD