CATO HANDBOOK FOR CONGRESS

Policy Recommendations for the 108th Congress

CATO INSTITUTE
Washington, D.C.

65. U.S. Policy toward Latin America

Congress should

- unilaterally open the U.S. market to goods from Latin America,
- support a free-trade agreement with Chile,
- support the Free Trade Area of the Americas, and
- facilitate dollarization for any country that wishes to adopt the dollar as its national currency.

In limited but important ways, Washington can positively influence economic policy in Latin America. At a time when much of the region is experiencing economic and political instability, the rise of neopopulism, and a general backlash against free-market reforms that were partially implemented in the 1990s, the United States should exercise its influence by opening its market to the region's goods and by encouraging market reforms.

Since the passage of the North American Free Trade Agreement with Mexico and Canada in 1993, however, the United States has shown no such leadership. Instead, Washington promised to create a hemispheric free-trade zone, known as the Free Trade Area of the Americas, but made little effort to promote the idea.

The result was unfortunate and a window of opportunity was lost. Latin American countries that were eager to enter into an FTAA gradually became disillusioned with years of U.S. inaction, and many have now turned decidedly against the idea of free trade. Worse, as economist Sebastian Edwards points out, Washington's promise of promoting the FTAA had the perverse effect of actually halting unilateral trade barrier reductions in Latin America as those countries waited to negotiate reductions with the United States, an expectation that went unfulfilled. Moreover, since the Mexican peso crisis of 1994–95, Washington has supported massive International Monetary Fund bailouts that have encouraged irresponsible behavior by investors and policymakers and have surely increased the severity of economic crises in the region.

President Bush has recently emphasized the FTAA as a policy priority. But his administration's support for increased steel tariffs and farm subsidies has undermined Washington's credibility in a region already wary of U.S. intentions. The United States can take steps to regain the initiative. To do so, it must first understand where the region stands.

Latin America since the 1990s

The early 1990s saw the introduction of far-reaching market reforms in many, but not all, Latin American countries, especially in the areas of monetary policy, trade and investment liberalization, and privatization of state-owned enterprises. Countries in the region ended hyperinflation, reduced their tariffs unilaterally, and eventually sold more than $150 billion of state assets. The initial results were high growth and the widespread popularity of the reforms in the countries that did the most to reform. Mexican president Carlos Salinas was the most popular outgoing president in Mexican history in 1994, and Presidents Alberto Fujimori of Peru and Carlos Menem of Argentina were reelected by wide margins in the mid-1990s.

By the end of the decade and the beginning of the next one, however, a number of countries had experienced years of recession, political instability, and economic crises. Even countries that had introduced only timid reforms had that experience. The IMF bailed out Mexico, Argentina, Brazil, and Uruguay, some more than once. Most spectacular was the collapse of the Argentine economy in early 2002. That country's default and devaluation sent it into a deep depression, calling into question market reforms in the minds of many Argentineans. Latin America's disappointing per capita growth of 1.5 percent per year in the 1990s was still better than that of the ''lost decade'' of the 1980s (−0.68 percent), but it certainly did not live up to expectations and was too often accompanied by economic turmoil. It is within that context of disillusionment that politicians using populist or demagogic rhetoric have risen to power in Argentina, Brazil, Venezuela, Peru, and elsewhere, vilifying the free market as the source of their countries' troubles.

But to blame the market is hopelessly wrongheaded. It is important to remember that the regionwide shift to the market occurred because of the failure of past policies, not because governments were committed to free-market principles. For example, the left-leaning ruling party in Mexico, the Peronist party in Argentina, and Fujimori's upstart party, which campaigned against radical market reforms in Peru, introduced liberalization. By the mid-1990s, with the success of the early reforms, governments lost interest in liberalization. The unfinished reform agenda was extensive and brought diminishing returns in the form of slower growth and negative economic indicators. Argentina, for example, suffered from chronically high unemployment throughout the 1990s because it never reformed its rigid labor laws. Latin America had only begun to embrace economic freedom.

Indeed, a whole range of institutions and policies has been left untouched. The pervasiveness of a vast informal economy in most Latin American countries attests to that fact. The region's citizens have long responded to the high costs of the formal legal and regulatory system by simply operating outside it. They have found the formal system of rules to be prohibitively expensive. The private property rights of the poor in urban and rural areas, for example, are typically not recognized or protected by the state since property titling is complicated or impossible. Yet private property lies at the heart of a market system, and the absence of property titles severely restrains the creation of wealth. Bureaucratic red tape also pushes people into the informal sector. Opening a small business in Latin America legally can cost thousands of dollars in licensing fees and take months or years for approval—a procedure that costs less and takes days in rich countries. The rule of law, another institution essential to the functioning of a market economy, is severely defective or nonexistent in the region. Latin America has been given low scores on both the rule of law and business regulation in *Economic Freedom of the World*.

Other sectors, including health care, education, and public security, have seen virtually no reform although they have continued to deteriorate, often despite increases in spending. That situation has led Argentinean economist Ricardo López Murphy to complain that Argentineans pay Swedish-level tax rates for public services of African quality.

Thus, Latin America in the 1990s moved partially down the path of economic freedom, but it still has a long way to travel if it is to sustain growth and avoid financial turmoil. Indeed, the continued adherence to old policy practices in large part explains the region's economic crises of the past decade. The crash of the Mexican peso, for example, resulted from a government-managed exchange rate and expansionary monetary and fiscal policies during an election year, policies thoroughly inconsistent with market economics. Likewise, Argentina's default resulted from a 90 percent increase in both public spending and debt from 1991 to 2000, far outstripping the 50 percent growth in gross domestic product of that period.

Chile and Mexico Teach the Real Lessons from Latin America

Despite such disappointments, the most important lessons coming out of Latin America are encouraging. As Jackson Diehl of the *Washington Post* notes, ''The latest debt crisis is serving to underline not just the failures of those countries that embraced liberal economics in the 1990s but the breakthrough success of the two nations that did it right: Chile and Mexico.'' Those two countries, and some Central American nations including El Salvador and Costa Rica, are increasingly setting themselves apart from the rest of Latin America in terms of economic and political performance.

The sharpest contrast is provided by Chile, the country that has applied and maintained the most far-reaching and coherent set of market-liberal policies for the longest time. The resulting high growth has enabled the country to more than double its per capita income in the last 15 years and to achieve impressive advances in a range of human development indicators. According to the Santiago-based Institute for Liberty and Development, for example, Chilean growth of about 7 percent from 1987 to 1998 reduced the poverty rate from 45 to 22 percent during that period.

Mexico has likewise maintained economic stability and a growth rate notably higher than the regional average since the peso crisis of 1994–95. Like Chile, it has accomplished much within the context of democratic transfers of power. Mexican growth has raised per capita income above precrisis levels and has done so relatively rapidly. The key to Mexico's performance has been NAFTA. Free trade with the United States enabled Mexico to begin recovering from its crisis within a year. It took Mexico six years to recover from its economic crisis of 1982, at a time when its economy was fairly closed.

The divergence in performance between the free-trade countries of Chile and Mexico and the more protectionist countries in most of the rest of the region will become even clearer in coming years, especially if neopopulism holds sway in the latter countries. The United States can buttress that demonstration effect by signing on to a free-trade agreement with Chile, a treaty for which negotiations were completed at the end of 2002. A free-trade agreement with Chile would not only benefit the United States and Chile; it would also send a signal to the region that the United States is willing to reward countries that implement free-market policies.

Washington should follow suit with El Salvador and other Latin American countries that have liberalized their economies and are eager to sign a trade treaty with the United States. Indeed, Congress should also support efforts to promote a Free Trade Area of the Americas, although that initiative looks increasingly difficult to realize, given the region's political outlook.

Independent of free-trade negotiations, the United States should immediately reduce its barriers to Latin America's exports, especially textiles and agricultural products. At a time when U.S. credibility on trade is at a low point, such a move would restore some goodwill toward Washington and might help persuade reluctant countries to reduce some of their own trade barriers. At the very least, the United States could then not be blamed for hypocrisy, and the welfare of both the United States and Latin America would improve. Such a unilateral policy of reducing trade barriers, moreover, would not be in conflict with the goal of negotiating free-trade agreements. As Cato Institute scholar Brink Lindsey points out, the United States has successfully negotiated trade agreements affecting sectors in the U.S. economy that enjoy virtually no protectionism (e.g., telecommunications and financial services). For countries that are interested in free trade with the United States, such agreements offer the advantage of "locking in" free trade both at home and abroad. Indeed, the certainty provided by free-trade treaties is one of their greatest benefits and explains why they tend to result in increases of both trade and investment.

Dollarization

The United States should support another positive trend in the hemisphere: dollarization. In an effort to eliminate currency risk, including sudden and large devaluations and other manifestations of irresponsible monetary policy, Ecuador and El Salvador have joined Panama as countries that use the U.S. dollar as their national currency. Because most of the region's central banks have a poor record of maintaining the value of their currencies, Latin Americans already use the dollar widely, and it has become the currency of choice in many countries, including Cuba. Other countries, such as Argentina, may wish to replace their currencies with the dollar as well.

The United States should neither discourage nor encourage those moves but should facilitate official dollarization where it occurs. That may mean sharing the dollar's seigniorage—or the profit that derives from printing currency—with countries that decide to dollarize. In that way, the United

States would neither gain nor lose money as a result of another country's decision to dollarize, but the dollarizing country might more easily dollarize if it could still earn seigniorage from the currency it uses. Dollarization alone cannot solve a country's economic problems, but for countries with poor monetary policies, dollarization would end currency risk, reduce interest rates, and help stimulate investment and growth.

Time for a U.S. Policy toward Latin America

The United States can play a strategic role in promoting economic freedom, stability, and growth in Latin America—something it has not done for nearly a decade. That means reversing the current policy characterized by bailouts, protectionist measures, and mixed messages to the region. It also means that Washington must end its destructive war on drugs in the region, which works at cross-purposes with important U.S. policy priorities (see Chapter 56 on the international war on drugs). In drug-source countries such as Colombia, the drug war is fueling corruption and violence, financing terrorism, undermining the rule of law, and otherwise debilitating the institutions of civil society. The impact of the U.S.-led war on drugs south of the border has been imperceptible in the United States, but its consequences in Latin America are completely at odds with Washington's stated goal of encouraging free markets.

The rhetoric of free trade must be followed by policy actions consistent with such language. Congress should support a unilateral reduction of trade barriers to the region's goods and negotiate free-trade agreements with countries eager to do so, beginning with Chile. The United States would thus highlight the success of market reformers in the region by rewarding them without penalizing others. The diverging performances of the countries that embrace economic freedom and the rest can have a powerful effect on the policy direction that Latin American countries subsequently take.

Suggested Readings

Carpenter, Ted Galen. *Bad Neighbor Policy: Washington's Futile War on Drugs in Latin America.* New York: Palgrave, 2003.

Falcoff, Mark. ''Colombia: A Questionable Choice of Objectives.'' AEI Latin American Outlook, March 2002.

Haber, Stephen. *Crony Capitalism and Economic Growth in Latin America: Theory and Evidence.* Stanford, Calif.: Hoover Institution Press, 2002.

Mendoza, Plinio Apuleyo, Carlos Alberto Montaner, and Alvaro Vargas Llosa. *Guide to the Perfect Latin American Idiot.* New York: Madison Books, 2001.

Montaner, Carlos Alberto. *Las Raices Torcidas de América Latina.* Barcelona: Plaza & Janes, 2001.

Schuler, Kurt. ''Fixing Argentina.'' Cato Institute Policy Analysis no. 445, July 16, 2002.

Váliz, Claudio. *The New World of the Gothic Fox: Culture and Economy in English and Spanish America.* Berkeley: University of California Press, 1994.

Vargas Llosa, Mario. Foreword to *The Other Path,* by Hernando de Soto. New York: Harper and Row, 1989.

Vásquez, Ian. ''A Retrospective on the Mexican Bailout.'' *Cato Journal* 21, no. 3 (Winter 2002).

—Prepared by Ian Vásquez