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The Interactive Forum for the Region's Leaders

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Advisor ANALYSIS

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Abel Pacheco of Costa Rica's ruling center-right Social Christian Unity Party (PUSC) will face off against Rolando Araya of the National Liberation Party (PLN) in the second round of presidential elections on April 7. How do the two candidates differ on economic policy, i.e., development, privatization, and trade liberalization? Do foreign investors view one candidate as more business friendly than the other?

A

Guest Commentary: Cecilia Cortés: "One thing the Costa Rican electoral campaign has shown is that the principal contenders do not exhibit fundamental differences in their approaches on key issues such as development, privatization, trade liberalization, or economic policy. Although Rolando Araya manages the discourse on these issues better than Abel Pacheco, the differences are truly slight, or have to do with the means or the strategy for addressing them. For example, both agree on trade liberalization -- Araya with subsidies and tariffs, Pacheco without. The two candidates oppose privatization of state assets. In the case of investment, one also notes no differences, since it is clear that investment constitutes the engine of economic growth and employment. There would seem to be no reason why one candidate might be perceived as more friendly to foreign investors than the other. In addition, the belief in the country that the PLN and PUSC have electoral platforms that respond to the same interests and that their management of government tends toward convergence, due to the small room for maneuver allowed small economies in the international context, is becoming increasingly common."

“The quality of leadership, rather than the agenda ...”
will be the key to success.

-- Sylvia Saborio

Guest Commentary: Sylvia Saborio: "The Costa Rican electorate is in a funky mood: it feels bewildered and betrayed. The outcome of the first electoral round was a repudiation of the political class and a very low voter turnout is expected in the next round. The next President will thus face an unprecedented dual challenge: a weak mandate, coupled with a legislative assembly split four ways. The quality of leadership, rather than the agenda -- where differences among the major factions are in any case minimal -- will be the key to success, both in the election and in office. Indeed, a recent poll shows that while a majority of the electorate

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regards the PLN as the better party in terms of its demonstrated capacity to govern, it deems the PUSC candidate as the better one and is apparently willing to vote for him. The concern is not so much that the country be led astray, as that it not be led at all: the real risk is paralysis. In order to break the impasse, the new President will need to shift from a consensus-building mode to a coalition-building mode and be able to articulate a credible vision of the nation's future compelling enough to counteract a certain proclivity among Costa Ricans to seek refuge in their past. The question is, will he be up to the challenge?"

Guest Commentary: Manuel Orozco: "One major cause of voter abstention in the first round relates to the loss of confidence and support for the two major parties. This loss of support partly derives from citizens' perceptions that the two parties have come closer politically and it is difficult to distinguish them ideologically anymore. The likely winner of the second round will be Pacheco, and the main challenge for him is his lack of government experience and understanding of major issues, such as privatization, free trade, and social policy. These are issues of major concern to Costa Ricans. Privatization in particular plays a significant role in public opinion. Costa Ricans have a strong belief in social welfare policies and have supported state intervention in areas like oil refinery, mining, water and electricity, telecommunications, and transportation. Although Costa Ricans acknowledge that big government is no longer good for the welfare of their society, there is resistance to the privatization of some economic activities considered 'strategic,' such as water, electricity, and telecommunications. However, trade unions, political activists, and other leaders have agreed that some sectors within those industries could be privatized to improve efficiency. That has been the case in the privatization of the national airport and segments of health care, for example. There is a belief among the leadership in the PUSC, where Pacheco's team will be formed, that privatization is consistent with free trade and social welfare. Therefore, a new government will likely push forward the privatization agenda. The main issue will be to address privatization within a broader consensus. This is particularly more relevant given the new distribution of power within the legislative assembly that has limited the voting power of both the PUSC and PLN to less than 33 percent. Free trade will also be an issue of major discussion under the new government. The ratification of a free trade agreement with Canada will be one of the first issues to go for vote in the Assembly this year and there is concern it may not pass due to opposition from farmers. Again, consensus building will be key to the achievement of any agreement."

Cecilia Cortés is Executive Director of the Foundation of Foreign Service for Peace and Democracy in Costa Rica.

Sylvia Saborio is a Consultant to the Evaluation Office at the Inter-American Development Bank.

Manuel Orozco is Central America Director at the Inter-American Dialogue.

Economic News

Brazil Central Bank Raises 2002 Inflation Target to 4.4 Percent

Brazil's Central Bank on Wednesday announced a new inflation target of 4.4 percent this year due to higher-than-expected increases in cooking and gas prices. The original forecast for 2002 inflation was 3.7

percent. Consumer prices rose 7.67 percent in 2001. **Barclays Capital** Chief Economist John Welch told the *Advisor* that the main reason for the inflation revision is higher-than-expected administered prices for services such as electricity and phone. However, Welch noted that in contrast to 2001, this year the government can't use high oil prices, an energy crisis, a small agricultural harvest, or underused capacity

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at factories as an excuse. In other Brazil news, open unemployment rose to 7 percent in February, up from 6.8 percent in January and 5.7 percent in February 2000, the government's geography and statistics institute (IBGE) said Wednesday. The unemployment rate measures the number of people in Brazil's six main metropolitan areas who have unsuccessfully looked for jobs in the past 30 days.

Chilean Unemployment 8.3 Percent for December-February, INE Says

Unemployment in Chile reached 8.3 percent in the three months to February, up 0.3 percent from the November to January period, but down 0.1 percent from the same period last year, the government's national statistics institute (INE) said Wednesday. In the December-February period, employment grew most in the electricity, gas, and water sector (5.2 percent), followed by mining (2.6 percent), construction (1.2 percent), and the transport, food storage, and communications sector (0.1 percent), compared to the November-January period. However, employment fell in the financial services sector (2.2 percent); community, social and personal services (2.0 percent); agriculture, hunting, and fishing (1.3 percent); industrial manufacturing (0.9 percent); and business (0.5 percent). On April 1, the Chilean government will announce plans to stem growing joblessness and avoid the double digit unemployment rates of last year, Chilean daily *El Mercurio* reports. The new strategies look to the private sector to absorb unemployed workers.

Company News

Brazil's TCO Reports 61 Percent YoY Increase in 2001 Profits

Brazilian mobile operator **Tele Centro Oeste Celular Participações** (TCO) said Wednesday that consolidated profits rose 61 percent year-on-year to 208.1 million Reais (\$ US 89.5 million)



GUEST COLUMN

Argentina's Tango: *Deja Vu* Ecuador

By Enrique Mendoza

The urgent debate in Argentina is about designing a strategy to manage the transition out of Convertibility at the smallest economic cost. Regrettably, what has been implemented so far is not a strategy but a chaotic mixture of barriers and regulations that came to be in the panic-driven rush to contain bank runs and keep the devaluation from sky-rocketing into levels that would destroy the financial system and cripple the economy. They are clearly failing.

In evaluating alternatives, it is useful to recall two seemingly parallel recent experiences: Ecuador, 1998-1999 and Mexico, 1994-1995. As in Argentina, both countries suffered large devaluations in complex economic and political environments and with bankrupt financial systems. Ecuador ended up Dollarized and Mexico with a floating exchange rate. Both suffered severe recessions after they devalued but in a relatively short time returned to low inflation and improving levels of economic activity. In both cases there was also a secular contraction of bank credit, despite operations that cleaned up banks' balance sheets. Thus, at first sight it is not obvious that either country's approach differs much at the end.

Mexico begins to differ from Argentina when one notes that in Mexico the fraction of Dollar-denominated deposits was much smaller and the run that sank the Mexican Peso was a run on Dollar-denominated government bonds by foreign investors and Mexican banks and corporations. Mexico did not experience runs on bank deposits and the demand for money remained relatively stable despite the drain on international reserves. Mexico did not impose controls on bank withdrawals, forced extensions of time deposits, or forced re-denomination of Dollar contracts into Pesos (it tried this already in 1982). Mexico did face its most serious political crisis in over half a century, but even in this regard it did not reach the levels of instability observed in Argentina. Mexico gained access to official lending support in a couple of months and did not default on its entire stock of public debt. All these differences indicate that treating Argentina as a case in which switching to a floating exchange rate is the easy fix is a grave mistake, and this even before factoring in that the switch is being attempted through a series of ill-defined shortcuts: setting prices, interest rates, and maturities of financial assets, and imposing temporary, selective taxes and subsidies on foreign trade.

Mexico also differs in that it had NAFTA. Mexico's industry attained double-digit growth rates in the years after the devaluation not because of the devaluation's short-

“ Argentina seems headed
for a forced Dollarization ... ”

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in 2001. EBITDA (earnings before interest, taxes, depreciation, and amortization) came in at 460.3 million Reais last year, of which 89.8 million Reais was generated in the fourth quarter. Operating revenue increased 38.2 percent between 2000 and 2001, with consolidated average revenue per user (ARPU) of 43 Reais. TCO, which operates in 11 Brazilian states through seven subsidiaries, said it added 716,022 new customers last year, a 42 percent rise from 2000, and in the fourth quarter signed up 232,834 customers, of which 14 percent were post-paid.

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lived effect on external competitiveness but because of the ability to access the booming goods and financial markets of Canada and the United States. After 1995, Mexico's outward-oriented industry financed its fast growth with retained earnings, foreign direct investment, and commercial paper, while credit from banks in Mexico declined for six years in a row. In addition, Mexican government officials did not question the need for austere stabilization policy and the benefits of market-oriented reforms, as they have in Argentina. If this rhetoric translates into actions, it would be a disaster for an economy that badly needs fiscal reform and trade liberalization, but even the rhetoric itself is costly because it turns public expectations pessimistic, and in situations like this expectations alone can make all the difference.

Ecuador 1998-1999 looks more like Argentina precisely on the items that Argentina and Mexico differ. Ecuador floated the Sucre in February of 1999. In the four weeks that followed, the Sucre lost 30 percent of its value and inflation took off. In March, after a series of bank runs and with the threat of collapse of various banks, the government froze for a year the majority of bank deposits. This Ecuadoran "corralito" was complemented with restrictions on withdrawals for different bank accounts and a generous dose of forced "bank holidays." In August, Ecuador stopped paying its Brady bonds and its country risk rose to 40 percent. Thus, devaluation and a switch to a handicapped floating regime did not end the repudiation of the domestic currency reflected in the bank runs. To the contrary, they fueled the fire burning the financial system because of their negative effect on the public's expectations, which were also adversely affected by the restrictions on withdrawals, the fragility of the banks, the default on foreign debt, and the collapse of economic activity - Ecuador's GDP fell more than 7 percent in 1999. Add also Ecuador's political crisis, which looks like Argentina's even in the resignation of presidents.

By the end of 1999, a Dollar was worth three times more Sucres than in February and the government owned the non-performing half of bank assets it purchased through deposit insurance operations. Hence, some politicians and analysts may wish to see Dollarization in Ecuador as a decision of economic policy and engage in fruitless debate about its merits, but the truth is that Ecuadorans themselves ended the existence of the Sucre as a currency by refusing to hold it. Efforts by the government to keep the Sucre with the intent of retaining the privilege to exercise again in the future its confiscatory powers via monetary policy only worsened matters. The point was reached in which the choices were to give up to what was already a reality in Ecuadoran purses and wallets or to risk total collapse of the payments system and hence of the economy as a whole.

In light of these arguments, Argentina seems headed for a forced Dollarization of the economy driven by the acute economic survival instinct of its citizens, and very much independently of opinions in favor or against it coming from the country's political groups. The hope is that if this happens Argentina will do as well as Ecuador. After Dollarization, Ecuador gradually stabilized and began to grow. Domestic interest rates remain high, above 15 percent, reflecting the weakness of the banking system and the residual currency risk implied by the fact that Ecuador's Dollarization is not exactly as textbooks envisage: the total abandonment of the Sucre in favor of the Dollar with the Central Bank reduced to a bank-supervision agency. Even if it were a textbook Dollarization, Dollarization is not a panacea that can fix the fundamental economic and institutional problems plaguing countries like Argentina, Ecuador or Mexico. It is, however, unlike any other currency arrangement in that it ties as tightly as possible the government's hands, so as to prevent it from exercising its confiscatory powers, and in that simplifies greatly the task of assessing domestic financial policies, which is so critical for global capital inflows into emerging economies.

Enrique Mendoza is a Professor of Economics at Duke University. He would like to acknowledge the assistance of Duke University graduate student Cristina Arrelano with this article.

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