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61. U.S. Policy toward Latin America

Policymakers should

- unilaterally open the U.S. market to goods from Latin America,
- support the Colombia and Panama Free Trade Agreements,
- end the hemispheric war on drugs, 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 some countries in the region have seen the rise of populist governments, political turmoil, 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.

During most of the time since the passage of the North American Free Trade Agreement with Mexico and Canada in 1993, however, the United States showed 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 a free trade agreement gradually became disillusioned with years of U.S. inaction, and some turned decidedly against the idea of free trade. Worse, as economist Sebastian Edwards points out, Washington's promise of promoting the Free Trade Area of the Americas had the perverse effect of actually halting unilateral trade barrier reductions in Latin America as those countries waited to negotiate reductions as a group with the United States, an expectation that went unfulfilled. Moreover, from the Mexican peso crisis of 1994–95 to the Brazilian currency crisis of 2002, Washington supported massive International Monetary Fund bailouts that encouraged irresponsible behavior by investors and policymakers and surely increased the severity of economic crises in the region.

President Bush emphasized free trade in general and bilateral trade agreements specifically as policy priorities. His administration's initial support for increased steel tariffs and farm subsidies damaged Washington's credibility in a region already wary of U.S. intentions. But the Bush administration quickly regained the initiative, having ushered free trade agreements with Chile, the Dominican Republic, and Peru and with Central America into law and having negotiated free trade agreements with Colombia and Panama. To understand the importance of free trade in Latin America, we must first understand where the region has been.

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, several countries had experienced years of recession, political instability, and economic crises. Even countries that had introduced only timid reforms had that experience. The International Monetary Fund bailed out Argentina, Brazil, Mexico, 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 Argentines. Latin America's disappointing average annual per capita growth of 1.2 percent in the 1990s was still better than that of the ''lost decade'' of the 1980s (−0.2 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, Bolivia, Ecuador, Nicaragua, Paraguay, and Venezuela, vilifying the free market as the source of their countries' troubles. Populist politics have influenced the leadership style of more responsible leftist governments, like that of Brazil, and still attract a following among large portions of the populations of countries, like Mexico or Peru, that have chosen not to go down that path. Latin America is thus a divided region between those who wish their countries to become modern democracies based on open markets and those who would opt for various forms of populism based on state-directed development.

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 received low scores on both the rule of law and its 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 Argentine economist Ricardo López Murphy to complain that Argentines 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 as a region, 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 problems since the era of market reforms. 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, Brazil has maintained more orthodox macroeconomic policies in recent years alongside some of the world's most burdensome regulations and most wealth inhibiting tax systems, according to the World Economic Forum. Those policies have contributed to an average annual growth rate (3.8 percent) far below that of developing countries as a whole (7.4 percent) during the global economic boom years of 2003–07.

Latin American Success Stories Teach the Real Lessons from the Region

The region's stark ideological divide is most visible along geographic lines. With a couple of exceptions, Latin American countries along the Pacific Rim have signed or are pursuing free trade agreements with the United States and have chosen market democracy as their model. Other countries, led by Venezuela, have chosen various degrees of greater state involvement in economic and social affairs. But not all leftist governments have accepted the populist agenda. Brazil and Uruguay, for example, have tried to maintain sensible macroeconomic policies with the latter country expressing interest in free trade with the United States. Chile, led by a Socialist government, has maintained its status as the freest economy in Latin America.

The most important lessons from the region come from success stories like Chile and from emerging successes that are increasingly setting themselves apart from the rest of Latin America. Chile stands out the most because it 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 since the late 1980s and to achieve impressive advances in a range of human development indicators. According to the Santiago-based Institute for Liberty and Development, for example, from 1987 to 2006 Chile reduced its poverty rate from 45 percent to 14 percent.

El Salvador has also seen impressive progress under democratic governance. Since the early 1990s, it has been a fast reformer, becoming one of the freest economies in Latin America. There too, growth has transformed the economy, cutting household poverty by about half and extreme poverty by about 60 percent. Peru is another example of a country that implemented and maintained market reforms, thus turning it in recent years into the highest-growth country in the region. Poverty rates have fallen notably, new industries have arisen, nontraditional exports have boomed, and the middle class has grown. Indeed, the growth of the middle class in much of the region is another positive outcome of a stable macroeconomic environment that many countries have achieved. Felipe Calderón's victory over the populist candidate in Mexico's 2006 presidential election was largely due to the middle-class vote. There, free trade played a key role by providing high-quality goods at lower prices to Mexican consumers and, just as important, by helping to spur growth in the Mexican economy. The North American Free Trade Agreement enabled Mexico to begin recovering from its 1994–95 crisis within a year. By contrast, it took Mexico six years to recover from its economic crisis of 1982, a time when its economy was fairly closed.

The policies of the successful countries contrast sharply with those of populist governments, namely, because the region's successes are producing growth based on wealth creation rather than growth based primarily on external factors, such as high world growth or high commodity prices, the earnings of which are then redistributed in the country. Although countries led by populist governments have also enjoyed high growth, their situation is more precarious, and social and economic problems are already emerging there. Uncontrolled spending, scarcity of certain goods, and rising inflation, for example, characterize the Argentine and Venezuelan economies. Populist policies, moreover, are not limited to economics. In Venezuela, President Hugo Chávez has violated the most fundamental principles of democracy, eliminating all checks and balances in government, curtailing freedom of speech and other civil and political liberties, and otherwise ignoring due legislative and legal processes. Because Venezuela is oil rich, the Chávez regime is not just a menace to Venezuelans but also to populations of other Latin American countries, where the regime is spending heavily to try to export its model. That model includes explicit rejections of free trade with the United States in favor of trade agreements between Venezuela and Latin American countries that would receive Venezuelan government subsidies purportedly to promote development.

The divergence in performance between the two models in the region will become even clearer in the coming years. The United States can continue to buttress that demonstration effect by ratifying the free trade agreements with Colombia and Panama. Those free trade agreements would benefit the United States and its trade treaty partners, and they would be yet another signal to the region that the United States is willing to reward countries that implement free-market policies. Nowhere is that more important than in the case of Colombia. That country is properly seen as the ideological opposite of Venezuela, successfully fighting the leftist FARC guerrillas on its own territory; aggressively pursuing free trade with the United States; and denouncing the kinds of populist policies and belligerent foreign policy of its neighbor, Venezuela. Were the United States to deny signing the free trade agreement with Colombia into law, it would not only be a blow to Colombia and Alvaro Uribe, who enjoys the highest popularity ratings of any president in Latin America, it would also be seen throughout the region as a blow to all those in Latin America who favor democratic capitalism.

Washington should likewise continue to pursue free trade with other Latin American countries that have liberalized their economies and are eager to sign a trade treaty with the United States. 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 is being questioned, 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 conflict with the goal of negotiating free trade agreements. As Cato Institute scholar Brink Lindsey points out, the United States has regularly signed trade agreements affecting sectors of the U.S. economy that enjoy virtually no protection. 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 development 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 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. Other countries 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—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.

A Constructive Policy toward Latin America

The United States can play a strategic role in promoting economic freedom, stability, and growth in Latin America. In addition to promoting trade, that 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 58, ''The International Drug War''). In drug-source and transit countries such as Colombia and Mexico, the drug war is fueling corruption and violence, financing terrorism, undermining the rule of law, and otherwise debilitating the institutions of civil society. In the first nine months of 2008 alone, drug violence killed almost 3,000 people in Mexico as a result of a more aggressive prosecution of the trade. The effect 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 and civil society.

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 continue to negotiate free trade agreements with countries eager to do so. 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

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