

LATIN AMERICA:

GROWING IN DIFFERENT DIRECTIONS

As the world moves, slowly, past the global crisis, Latin American countries will be testing their economic strength after a decade of high growth. How successful they will be depends on where each is now.



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WITH ABUNDANT global liquidity and high demand for natural resources and agricultural commodities, the last decade was a period of growth and euphoria for Latin America. Peru, for example, despite its history of internal strife, recorded growth similar to those of Asian countries, Colombia's debt is now considered investment grade, and Brazil has attracted investor attention with a domestic market reinforced by its new middle class.

In the next decade, however, the external environment is likely to be more volatile and less favorable to growth. This issue looks into the policy challenges for Latin America that will be discussed on August 9–10 at a seminar organized by the Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation. We focus on six economies: Brazil, Argentina, Chile, Peru, Colombia, and Mexico.

In the short term, analysts do not see great turmoil in the region. "In the first

quarter of 2012 the region has already reduced the slowing of growth of the last quarter of 2011 and may grow 3.7% in 2012," says Juan Alberto Fuentes, director, Economic Development Division, UN Economic Commission for Latin America and the Caribbean (ECLAC). His bird's eye view of the region, however, conceals considerable variances. Mexico, which grew less in the last decade, has the best prospects now, thanks to the slow but real recovery of the U.S. economy, which accounts for 80% of its exports, and investments that stimulate the domestic market. Argentina's fate depends on whether it can correct its large fiscal deficit, which is independent of the environment. Brazil, Chile, and Peru are more vulnerable to the slowdown in China. "With its huge demand for natural resources, China . . . allowed Latin America to export enough to finance all its imports. Latin America has historically had short

cycles of growth that produced large external accounts deficits and exchange rate crises that stopped growth," says Armando Castelar, IBRE coordinator of applied economics.

To a greater or lesser extent, problems with infrastructure, training of qualified workers, and low savings are common to many countries in the region, and how they deal with them will make considerable difference to their competitiveness. "Today, Asian countries can grow at rates above 6% without problems, whereas in Latin America, growth above 4% means increasing inflation," says Tito Cordella, World Bank economist for Latin America and the Caribbean.

CHILE: A WORKING MODEL

With a domestic market of 18 million people and as the world's largest producer of copper, Chile has moved to open its economy and mitigate its vulnerability to external shocks. Today, the country monitors the international situation closely. "If some Spanish banks, such as Santander and BBVA, want to repatriate capital that could bring about a domestic liquidity problem, demanding government and central bank action," said Rodrigo Fuentes, associate professor, Institute of Economics, Catholic University of Chile. "[But] we have a solid financial system and a situation of almost full employment." Chile is expected to grow 4% to 5%, its central bank predicts; however, to do so, it will need much higher domestic demand to offset the decline of external demand.

Chile in the coming years will stick to its current model of monetary responsibility, control of inflation, fiscal discipline, and high international reserves (US\$40 billion). "In the long run countries do not grow because the government spends more, because that

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implies the need to increase tax revenues to cover these expenses. It's like mortgaging future growth," Fuentes says.

Chile's adoption of a structural public budget balance 10 years ago insulates the public budget from cyclical economic conditions. Revenue surpluses are saved to cushion the drop in tax revenues when copper exports fall. In addition, Fuentes explains, "When you have an open economy subject to external shocks, a flexible exchange rate helps to partially insulate the economy." Chile has also been negotiating trade agreements to diversify its markets.

However, Fuentes says, "Chile's economic expansion has not been sustained by productivity growth, but by investment growth." He thinks the productivity problems are rooted in the failure of the educational system. "Our biggest problem today is basic education," he says. "To [benefit from] new technology, it is necessary to have ... human capital capable of absorbing the technology."

Another risk factor is whether Chile can generate enough energy to sustain growth. The situation has worsened in the last decade with cuts in the supply of natural gas from Argentina, high oil prices (oil accounts for 43% of energy consumption), and public

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resistance to hydropower projects. “We need to define what our energy future will be,” says Fuentes. Historically, Chile’s electricity demand doubles every 10 years. “Oil-fired power plants have environmental impact, nuclear power is risky in a seismic country, and alternative sources may not be able to meet the demand.”

PERU: INCLUSIVE GROWTH

Although it represents less than 5% of Latin American GDP and lower growth is expected in 2012, Peru has taken advantage of the global expansionary cycle in the last decade to seek more inclusive growth, says Claudia Cooper Fort, an economist at the Research Center of the Universidad del Pacifico in Lima.

Moreover, according to the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), between 2002 and 2010, Peru reduced poverty by 23 percentage points, thanks mainly to the economic expansion. Fort points out a number of vital reforms: “New savings instruments have been set up that made it possible to reduce interest rates and finance investment on competitive terms,” she says, citing as an example the pension funds, and stricter banking supervision rules. And new laws now make Peru one of the most competitive countries in terms of securing property rights and allowing foreign investors total freedom to move their capital in and out of the country.

As a result, in 2011 Peru recorded a 5% increase in foreign investment flows, which reached US\$7.7 billion, well above the US\$ 3.6 billion average for 2000–10. However, despite the legal guarantees offered, Peru has not overcome domestic resistance to foreign investment in mining. “We have massive Chilean and Spanish investments in sectors such as retail, real estate, and finance, for instance. When it comes to projects related to natural resources, however, we are not able to channel the regions’ demands

Latin America's growth slows
(GDP growth, %)

	2008	2009	2010	2011	Projection 2012	
Argentina	6.8	0.9	9.2	8.9	3.5	
Brazil	5.2	-0.3	7.5	2.7	2.7	1.8*
Chile	3.7	-1.0	6.1	6.0	4.9	
Colombia	3.5	1.7	4.0	5.9	4.5	
Mexico	1.2	-6.3	5.6	3.9	4.0	
Peru	9.8	0.9	8.8	6.9	5.7	

Source: ECLAC. *IBRE latest projection.

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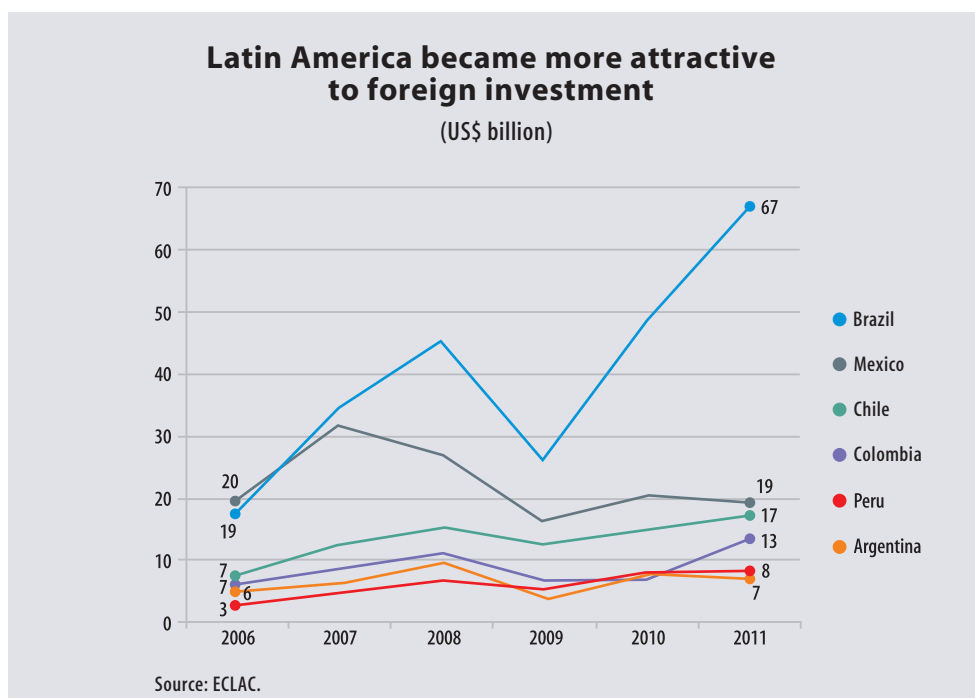
and resolve them in Congress,” says Fort. That is why a proposed US-Peruvian US\$4.8 billion investment in copper exploration in Cajamarca has been stalled since last November. Fort also points out that “We have resources in the public budget for infrastructure investment, but we cannot channel it cost-effectively because local governments lack capacity.”

Despite prudent economic management and high reserves, Fort warns that the Peruvian economy must prepare for the effects of a possible fall in copper prices,

such as a slowdown in new mining projects because of the perception of reduced external demand, and less tax revenue. “To mitigate the fall in tax collections, the first step is to encourage Peru’s underground productive sector to join the formal economy,” says Fort—informal activities represent 60% of Peruvian GDP. Reducing the informal sector would increase tax collections.

COLOMBIA: THE COMPETITIVE ISSUE

Reducing the informal sector is also important in Colombia. “While in Peru informality in the labor market is a historical feature, here it has surged over the past 20 years and now exceeds 60%,” says Roberto Steiner, research associate and former director, Foundation for Higher Education and Development. Also, rises in the minimum wage (now about US\$320/year) have not been followed by higher labor productivity. And Steiner adds that “As in Brazil, social security benefits are linked to the minimum wage, putting



pressure on the public budget.”

Steiner believes that the Colombian economy could become more dynamic if the tax structure were changed. In addition to reducing the social security tax on labor, the economist argues for changes in two main taxes, the VAT (value-added tax) and the income tax, to prevent tax evasion, ensure progressivity, and distribute taxation more equally between individuals and businesses. Moreover, he adds, “Inheritance is punished, pushing Colombians to accumulate assets abroad and discouraging companies to capitalize, which has a direct negative impact on growth.”

“Colombia has managed to mitigate the stigma of violence and drug trafficking with good public policies to attract investment,” Steiner says. Prudent and steady economic management and good regulation have shown results in the main exporting sectors, oil and coal. In the last decade, foreign direct investment accounted for 3.5% of GDP, against 2.7% in Brazil, for example. The valuation of commodities, as in other countries in the region, also made a big difference: while the volume of Colombian exports increased by 56% between 2000 and 2009, export receipts rose by 133%.

However, Colombia still has a high degree of protection compared to its neighbors. Average import tariffs exceeded 9% from 2000 through 2009. “Hence the importance of trade agreements,” says Steiner, highlighting the need for reducing protection, especially for agriculture. “In Colombia, over the last ten years while the economy grew on average 5% a year, agricultural GDP did not reach 2%,” he says. Beyond coffee, Steiner believes, “We can quadruple the acreage without touching the rainforest, and supply external demand for tropical fruits, vegetables, and

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other products, where we have comparative advantages.” With the reduction of violence in rural areas, investors, some of them Brazilian, have begun to buy large tracts of land there.

However, in addition to overcoming its infrastructure deficits, Colombia must also mitigate the effects of a paradoxical situation: although it has access to two oceans, 80% of its GDP is concentrated in three cities at 1,500 meters elevation, far away from the coast. “To take a container from Bogotá to Bonaventure port on the Pacific costs more than to get it from Bonaventure to China,” Steiner notes.

MEXICO: OUTLOOK SUNNY

Mexico was the Latin American country that profited least from the commodities boom and high growth. However, that lower exposure to commodities now means that the country is among those best positioned to grow in the next decade. Last year, Mexico’s growth surpassed Brazil and ECLAC’s Fuentes estimates that Mexico will grow 4% this year, from heightened domestic demand as well as exports.

After a painful transition to an open economy, which saw the entry of China into the WTO and the loss of Mexico’s share in the U.S. market, today the gradual recovery of the U.S. economy has increased demand for Mexican products while the restructuring of the Chinese economy makes Chinese

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exports less competitive in the United States. Although the U.S. economy will remain fragile for some time, Manuel Molano, deputy director general, Mexican Institute for Competitiveness (Imco), expects Mexico's external trade to improve. "The adoption of a free-floating exchange rate since 1994 has given us a completely different dynamic from the Chinese," he says, noting that the Chinese artificially devalued exchange rate is not sustainable.

Molano notes that, when it lost labor-intensive products to China, Mexico began to focus on products with higher added value, such as the automotive sector, which last year exported US\$2 billion. He points to the growth of an aerospace cluster in Querétaro, where Canada's Bombardier is already in operation and Brazil's Embraer is expected. A fall in the productivity of Pemex, the state oil company, has also helped change Mexico's export profile, Molano points out: "The composition of Mexican exports in 1980 was like Russia's today: oil accounted for 70% of total exports and non-oil exports were in general low value added. Today oil exports are 15% of the total, and non-oil exports are increasingly more value-added."

But José Gerardo Traslosheros, Mexican consul general in São Paulo city, sees some competitiveness problems: like Brazil, he says, "We need a more flexible labor market, upgraded infrastructure, and better training to increase the number of skilled workers." In this area Molano cited the lack of controls on spending by states and municipalities, where tax revenues are low, making them highly dependent on Pemex. Before the 1970s, Molano said, "Tax collection was very similar to Brazil, with taxes differentiated by region. Now the federal government collects most of the taxes and distributes them to the states ... The biggest problem is that state governors spend irresponsibly." Tax reform to mitigate the damage is unlikely: any change demands a majority in Congress or wisdom among legislators.

The biggest factor weighing on public finances is pension liabilities, which Molano believes already exceed 104% of GDP and are growing at an estimated 16% a year. This will create serious problems in the next 30 or 40 years. Also, he says, "We have high

Latin America's productivity has grown more slowly than Asia's

(Total factor productivity average growth, %)

	1981-90	1991-2000	2001-08
Argentina	-2.5	2.0	1.4
Brazil	-3.3	-1.7	0.5
Chile	-0.5	2.9	0.5
Colombia	-1.3	0	1.3
Mexico	-0.9	-1.6	0.3
Peru	-3.8	0.5	2.9
Venezuela	-1.6	-0.5	0.2
Korea	3.6	1.4	1.9
Singapore	1.7	2.9	2.6
China	1.6	3.4	6.2

Source: World Bank.

savings that exceed 20% of GDP, but we are investing in businesses with low yields. ... We should focus efforts on increasing productivity.”

ARGENTINA: WHAT NOT TO DO

While Chile, Peru, Colombia, and Mexico have based their growth on an open economy, Argentina has done the opposite. Enduring high inflation, large fiscal deficits, restrictions on external financing, and protectionist trade policy, the country has not taken advantage of favorable commodity prices to create a robust model of growth.

“The Argentine model is taking on water,” says Samuel Pessoa, consultant to the IBRE. Argentina’s growth has been intense and prolonged because of the reforms of President Carlos Menem (1989–99), the high price of soybeans, and fiscal discipline until the 2008 crisis. Menem had carried out a wave of privatizations and introduced profound reforms of the labor market, social security, and taxation, but at the time, Pessoa says, the reforms were not successful because the exchange rate was fixed. When in the 1990s Latin America was hit by unfavorable export and import prices, Argentina’s terms of trade fell by 28%, which was extremely difficult to accommodate with a fixed exchange rate. The Menem reforms only began to bear fruit during the Kirchner administration.

Daniel Artana, chief economist, Latin American Economic Research Foundation, says that after the 2008 crisis, the Argentine government abandoned fiscal prudence. Because of populist energy subsidies, he says, “the government has absolutely destroyed the [energy sector] fortress ... The result is an external trade deficit of US\$3 billion in the energy sector compared with a surplus of 2% of GDP for the previous decade.”

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Samuel Pessoa

Today, given fiscal deterioration and the subsidy policy, which was extended to other utilities to contain rising inflation, is unsustainable. “With the depreciated exchange rate, drought, and the economic downturn in Brazil,” Artana says, “a recession is very likely. With inflation above 20%, we are in a difficult situation.”

Latin American countries are among the least competitive.

(competitiveness ranging, best=1)

	2011	2012
Hong Kong	1	1
Singapore	3	4
Korea	22	22
Chile	25	28
Mexico	38	37
Peru	43	44
Brazil	44	46
Colombia	46	52
Argentina	54	55

Source: IMD World Competitiveness Yearbook 2012.

In the short term, the only option for the Kirchner administration would be a spending shock, cutting subsidies and improving the budget balance. With the president's popularity plummeting as the economy deteriorates, allegations of corruption, and measures to restrict the supply of dollars, drastic and unpopular measures are probably not on the agenda. "Argentina has no more room to offset one inconsistent policy by creating another. To some extent, Brazil's economy is moving toward this pattern of economic policy, though more gradually," Pessoa warns.

As for the medium term, Artana lists the need for Argentina to attract foreign investment, eliminating the negative

marks left by the nationalization of oil company YPF, and to increase productivity. "Currently, Argentina is carrying out the protectionist policies of the 1950s," he says, referring to trade barriers to imports to contain the trade deficit and the 5% tax levied on industrial exports since 2002. British consultancy Capital Economics reports that between 2009 and 2011, Argentina recorded 130 episodes of trade protectionism. This is one reason why analysts are forecasting lower growth for Argentina than for Peru and Colombia. And because "Argentina's economy is 20% of the size of Brazil's, we cannot achieve any scale [of production] from just the domestic market," Artana says. ■

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