

Armando Castelar talks about the outlook for the Brazilian economy, observed by Marcílio Marques Moreira and Carlos Fernandez Valdovinos.

Continent revisited

Latin American experts discuss what countries in the region must do to cope with a volatile global economy.

Solange Monteiro, Rio de Janeiro

AFTER A DECADE of healthy growth fueled by high commodities prices, capital inflows, and solid economic fundamentals—stronger currencies, robust financial systems, and sound fiscal policy—the larger Latin American countries are now moderating their optimism. Lower GDP growth projections in response to the protracted international crisis indicate that the continent is not as immune to what is happening in global markets as was thought. Analysts tend to concur that, to maintain growth, Latin America in general needs to advance reforms and increase productivity.

Strategies these economies could use were discussed at the seminar "Where Does the Economy of Latin America Go?" sponsored by the Brazilian Institute of Economics (IBRE) August 9–10 in Rio de Janeiro. Former Brazilian Finance Minister Pedro Malan stressed that the region must prepare to deal with a more volatile long-term external environment, warning that "The crisis will be with us for many years." For cyclical downturns, the textbook advice is still to exercise well-constructed fiscal, monetary, and credit policies. Andrew Powell, principal adviser in the Research Department, Inter-American Development Bank, said that though much has been done, Latin American countries must continue to upgrade their economic defenses. "Since

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the collapse of Lehman Brothers in 2008, the fiscal balance of these countries has deteriorated," Powell said. Malan responded by pointing out structural risks that must be mitigated if regional economies are to become more competitive, adding, "Countries in the region will inevitably have to face their problems."

EXCHANGE RATES AND CREDIT

The lowered expectations have been sobering. Even countries like Peru that still expect growth of above 5% this year know that behind the improved outlook hides a reality that is far from consistent with the initial euphoria. "In Brazil, we quintupled the size of our economy in less than a decade—but that speaks more to what happened with the exchange rate than the economy," said Armando Castelar, IBRE coordinator of applied economics.

Similarly, in Colombia, according to Roberto Steiner, former director, Fedesarrollo, the Colombian research center, "The increased share of the oil sector in the economy and the appreciation of the currency raise concerns because they compromise the productivity of other sectors. However, from the macro viewpoint, this free float is the most suitable for a small open economy like ours." José Guilherme Reis, International Department, World Bank, pointed out that Colombia has approved a fiscal rule, which will take effect in 2014, according to which part of the oil revenues will be saved just as Chile already does with copper revenues. "A significant part of the tax revenues comes from oil and mining, " he said, "and we do not know what the future holds for these products," he said, pointing to the need to save and plan public spending based on the possibility that oil prices will be lower.

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For Brazil, Castelar pointed out that more than the agricultural or mining sectors, what really boosted GDP were commerce, construction, and financial intermediation. "Brazil is becoming a service economy, with sectors that have grown much, and employ many," he said. Carlos Valdovinos, IMF Resident Representative in Brazil, underlined the importance of domestic demand for GDP growth. "Consumption as a percentage of GDP on average between 2004 and 2011 was much higher in Brazil than in other G-20 countries," he said, noting the imminent exhaustion of consumption-led growth. In addition to the pent-up consumer demand that was unleashed by rising incomes, Castelar pointed out that consumption-led growth was successful thanks to some slack—idle production capacity and appreciation of the exchange rate, which cheapened imports—that made it possible to accommodate increased demand without inflation as well as ample international liquidity, which allowed for expansion of domestic credit.



Luiz Guilherme Schymura



Pedro Malan

To maintain growth, Latin America in general needs to advance reforms and increase productivity

That was also true elsewhere in the region. "Latin America is where consumer credit grew fastest and became an important part of total loans," said Augusto de La Torre, World Bank chief economist for Latin America. In Peru, for example, growth of domestic credit between 2004 and 2011 averaged 21%, especially for mortgage and microfinance. "Will normalization of the situation in Europe and the United States move us backward?" Castelar asked, mentioning the impact of capital outflows on output and the reduction of interest rates in Brazil.

PRODUCTIVITY AND INVESTMENT

To keep GDP growing when the outlook is more uncertain, IBRE Director Luiz Guillherme Schymura emphasized that countries must focus on improving total factor productivity. He said, "Today, we often see the struggle of interest groups over public policies, and economic discussion is put aside. . . . We need to ensure that production inputs are efficiently allocated."

In Chile, where economic reforms came earlier, the fall in productivity is most obvious. "We look at the country as a star in South America, but in this first decade of the century growth was lower, which indicates the need for a new type of policy," Lia Valls, coordinator, IBRE Center for Foreign Trade Studies, said. Rodrigo Fuentes, associate professor, Catholic University of Chile, described what happened in Chile: from 1990 to 1998, the Chilean economy grew on average 7.2% a year, and productivity explained half of total growth, rising 3%. From 1999 to 2010, however, growth declined to an average of 3.7% a year and productivity to 0.9%. "If we are to achieve per capita income equivalent to 70% of the U.S. in 2030, we would have to grow 5.3%," he calculated. Fuentes recommended that Chile give priority to absorbing technology rather than investing in innovation: "The jump that we can give will depend on our ability to absorb technology, which in turn depends on eliminating institutional barriers and investing in research and development and the quality of human capital."

IBRE's Castelar pointed out the connection between investment and productivity, saying, "The issue is urgent because productivity has been stagnant or dropping; otherwise we will have to greatly increase the level of investment." Here, he thought, Brazil has not been very successful: "Brazil has serious problems with its investment climate, property rights protection, and high taxation. We have tried to solve this through loans by the National Bank for Economic and Social Development (BNDES), which increased from 1% of GDP in 1995 to 5% in 2010. This, however, has had little effect on investment. Our problem is not financing."

In Colombia, the situation has been changing. Steiner said, "We recorded an



Augusto de La Torre



Claudia Cooper Fort

investment-to-GDP ratio of 28%, with almost continuous growth over the past 12 years." In Chile, the investment-to-GDP ratio is about 23%, but Fuentes considers this less than ideal: "The ratio is lower than for other natural resource-rich countries when their per capita income was the same as ours today."

Claudia Cooper Fort, chief economist, Research Center, University of the Pacific, said that Peru has difficulties carrying out investment projects: "Today, we have a level of savings that may even be excessive. But we have problems, especially in regional governments, where leaders and officials are not properly prepared and are not willing to continue with projects when there is a change of government." Renato Fragelli, Graduate School of Economics, Getulio Vargas Foundation (FGV), pointed out, however, that "Peru has improved its regulatory framework and currently welcomes foreign companies in various sectors." Fort explained that the country guarantees equal treatment for domestic and foreign investment while offering complete freedom of capital flow. This has attracted foreign investments in the mining sector, although projects take longer to carry out due to conflicts with local communities. She added that "Currently, the concern is whether Peru will have the capacity to absorb all the projects that are in the portfolio and will have an adequate supply of engineers, construction companies, etc."

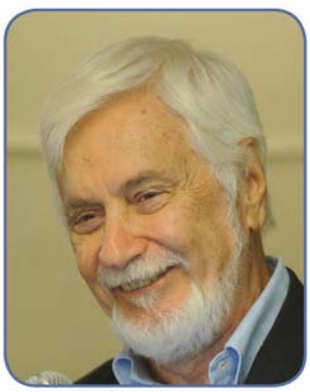
In Argentina, meanwhile, the interventionist bent of the Cristina Kirchner administration—such as the nationalization of the YPF oil company earlier this year—deters private investment. "Until 2010, our investment-to-GDP ratio was not bad, but there has since been a steep fall," Daniel Artana said, Foundation for Latin American Economic Research (Fiel). Artana estimates that Argentina's investment-to-GDP ratio, which reached 24% in 2010, will soon drop to Brazil's level.

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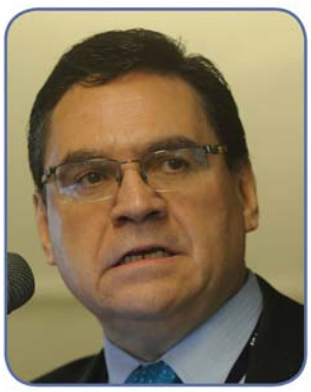
Luiz Guilherme Schymura

OPEN THE MARKETS

Although Brazil has low savings and investments, Edmar Bacha, director, Institute for Economic Policy Studies, argued these are not the factors most responsible for the growth decline. He said that investment costs have increased and capacity to produce declined, and the situation will only change with more openness to imports, stimulating competitiveness. "Despite all the opening of the economy in the last 15 years, Brazil still imports just 11% to 13% of GDP, while Chile imports 32%, China 22%, and Russia 22%. Unless there is a Brazilian miracle to open up the economy, we will continue to grow at 3.5%, "Bacha said.



Edmar Bacha



José Geraldo Traslosheros

"We need … a government model complementary [to the private sector] that does not resurrect the ghost of government interventionism of the type we can already see in Argentina, Bolivia, Ecuador, and Venezuela."

Augusto de la Torre

Here Brazil has a lesson to learn from Mexico. Although it did not have as economically positive a decade as Brazil, Peru, or Colombia, Mexico now is praised by international markets and has good growth prospects. "At first we feared that the trade agreement with the United States would bring about the de-industrialization of Mexico, but exposure to international competition strengthened us. Now we are competitive in industries such as aerospace, automotive, and electrical and electronics," said José Gerardo Traslosheros, Mexican consul in São Paulo city. In 2011, the country recorded exports of US$350 billion (80% manufacturing) and imports of US$351 billion. "We need to import intermediate goods and capital so we can expand exports," Traslosheros explained.



Regis Bonelli



Samuel Pessoa

While still concentrating its sales on the United States, Mexico has 12 free trade agreements with 44 countries—9 through the Latin American Integration Association and 28 for the Promotion and Reciprocal Protection of Investments. Mexico, Chile, Colombia, and Peru recently formed the Pacific Alliance. "We do not want a customs union like that sought by Mercosur, we want to integrate our production chains," Traslosheros noted.

"The challenge now is to start replacing some imports of capital goods in an open environment," Traslosheros went on. To ensure competitiveness, he said, it is necessary to fight monopolies in the energy, transport, and telecommunications sectors that raise production costs. "Currently, the struggle is to strengthen the regulatory agencies that have begun to address these powers," he said.

Mônica de Bolle, director, Institute for Economic Policy Studies, noted that despite differences in the degree of economic openness, Mexico still has challenges similar to Brazil's: "The perverse similarities are poor educational systems, a technological gap, high income inequality, and deficient infrastructure."

THE GOVERNMENT ROLE

Despite considerable gains in good times, especially macroeconomic reforms, countries have not addressed major traditional problems. "In sum, we can say that Latin America is doing well. This does not mean, however, that there are no problems; institutional weaknesses challenge our competitiveness," said IBRE researcher Regis Bonelli. Ambassador Luiz Augusto de Castro Neves, president of the Brazilian Center for International Relations, said that

in a world with very open and integrated markets there is no time to delay reforms: "If we want sustainable growth, it is absolutely essential that regional economies undertake structural reforms, such as tax reform."

The largest economies in the region must all deal in one way or another with the challenge of better collecting and distributing tax revenue. While Mexico needs to increase tax collection, Colombia needs to reform it. "A country that has an unemployment rate of 12% cannot focus the majority of taxes on formal work," said Steiner, who has led Fedesarrollo. Former Brazilian Finance Minister Marcílio Marques Moreira looked at the implications of high taxes and failure to modernize the business environment: "The World Bank Doing Business report indicates that Brazil's bureaucracy demands a huge investment of time, including time to pay taxes." Artana pointed out that in Argentina the tax burden has increased in recent years more than the average for the region, without sufficient consideration of public sector service quality. "With taxes like Sweden, we finance an African level of service," he said.

For Samuel Pessôa, consultant to IBRE, the combination of high taxes and a low-growth scenario throughout the region may become perennial, noting that "The political literature of the 1990s suggested that very unequal societies grow less because they favor higher taxes and income redistribution, which affects productivity and growth; this seems to be happening in the region now." Pessôa noted that from 1990 to 2009 there was a tendency to increase the tax burden throughout the region, not just in the countries with more populist governments, adding, "This could continue as the democratic process advances."

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The World Bank's de la Torre indicated that these choices are closely related to the government's role in the economy in each country and the promotion of social policies: "Today, there are two major groups of countries in terms of the relationship between the government and markets: those that are trying to prudently explore ways to expand the complementary role of the government to attract the private sector and not stifle markets, and those that are going the way of a more interventionist government, looking for quick results." Artana said Argentina has surpassed Brazil as the Latin American country where the government has the largest share in the economy. This year, he estimates, Argentina's public spending will reach 42% of GDP; he noted that "Since 2003, Argentina's government has increased its share in the economy by more than 13 points of GDP."

"In the 2000s, the region had improvements in social welfare and stronger social policies," de la Torre went on. "The downside risks of high dependence on commodities asked for government intervention, but we need a government model that is complementary [to the private sector] and does not resurrect the ghost of government interventionism of the type we can already see in Argentina, Bolivia, Ecuador, and Venezuela."