A NORTH-SOUTH OF ELUSIVE BORDERS:
Challenges for Latin America

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From 2003 to 2013 the Latin American countries were doing much better than the United States or Europe. There was a lot of enthusiasm in the region, and many commentators within the region and outside were talking about “the Latin American decade”, as a decade of take-off. This was very different from the previous hundred years, in which although Latin America grew, it grew less than the more developed countries, meaning that we were getting behind and not converging towards the richer countries in the world. Unfortunately, after 2013 the story began to change again and the past few years we had been doing worse than the United States and presently than Europe.

All the emerging and developing regions began to slow down from 2013, but the sharpest deceleration was in Latin America, even more than in Africa. We had a couple of years of slightly negative growth, in 2015 and 2016. However, we must be careful about averages. If you take out the three countries that had some years of strongly negative growth – Venezuela (around minus 9% in those years), Brazil (minus 3.5% to 4%) and Argentina (at minus 2%), the rest has been growing at about 3% positive. It is not big news, but it is not as bad as the average data would suggest.

The slowdown affected mostly South American countries, and not so much Central America (which has continued to grow at very decent rates) or Mexico (that had a very difficult period during the 2009 crisis due to its close ties with the US and it’s beginning to catch up). The fact that the slowdown was a South American problem is related to the fall in commodity prices, because these countries are net exporters of commodities. This is not the case in Central America or the Caribbean, which are net importers, or Mexico that exports oil, but imports as much of many other commodities, and therefore it is only slightly affected by changes in overall prices of commodities.

For South America, 2003-2013 was a period of unusually high export prices, specially of metals and energy (oil, gas, coal), but also of other minerals and even agriculture products, such as soy and coffee, although much less than minerals and metals. After 2013/2014, when the prices began to go down, the collapse was very significant, initially for metals and other minerals since late 2012 and afterwards, in late 2014, for oil and coal.

What was behind the boom of commodity prices from 2003 to 2013 was mostly the very high grow rates of China, India and the rest of Asia, which are major importers of commodities.
Thirty years ago the United States and Europe responded for about 70% of imports of most commodities, so whenever the United States or Europe were growing well, commodity prices were high. That changed drastically, as, given its much higher growth rates since the 70’s, Asia has become responsible for the imports of around 67% to 70% of most of the commodities. Since around 2000, Asian demand for imports of commodities was growing so fast, that supply couldn’t catch up, especially in oil, minerals and metals that you should explore and develop, meaning that it takes 6 or 7 years to get production on stream. When demands grow so rapidly, you can’t keep the supply-demand balance and prices hike and remain very high, but once there is a slowdown in demand and supply is responding to the previous growth, then the drop in prices is very significant. In the case of oil, this was compounded by a technologic revolution, with non-conventional oil and gas adding a huge amount to production, so in oil and gas it was both a demand and a supply shock that explains a deeper fall than in mineral prices.

However, the story of commodities is only a partial explanation, because when we look at the differences in growth among South American countries, we should explain why there were some countries that got into very bad shape even before the fall in commodity prices. When we analyze how they individually benefited from the commodity boom, namely by the terms of trade gains during 2003-2013, we conclude that the big winner within the boom was Venezuela. Nobody would believe it now that you see how Venezuelans have to make huge lines to get basic food and there is basically no foreign exchange for essential imports. Other big winners were countries like Chile and Peru, who are major exporters of metals. Somewhat less Colombia, which is a modest exporter of oil, and even less Argentina and Brazil that are exporters of agricultural goods.

Let’s begin by the countries that did worst in later years. Since 2007/2008, even in the middle of the boom of oil, Venezuela began to lose reserves and built a huge fiscal deficit. Even when a huge amount of foreign exchange and fiscal resources was still coming into the country, Venezuela was managing to spend even more than that. Argentina accumulated reserves until 2009, and then also began to lose them well before the commodity price boom ended. All the other countries were accumulating international reserves during that period, while these two countries had to apply capital controls and reduce imports even before the commodity prices fell. Therefore, the story of bad performance was built from inside, due to very poor macro and micro policies that basically reduced private investment in a major way in both countries. Almost nobody wanted to invest in Venezuela and Argentina in those days: both countries were cut off from access to financial international markets, saw a major reduction in foreign investment and many wealthy Venezuelans and Argentineans were taking out their capital, despite the capital controls.

During the period of the boom, the cost of foreign indebtedness was very low for all countries until around 2007; the other side of this was that huge capital inflows were coming into all countries of Latin America. Basically, there was a lot of liquidity in the world, because the central banks of the United States, Europe and Japan were printing a lot of money. Growth was very anemic in the US, non-existing in Europe for some time, and very low in Japan as well, so money was looking for returns somewhere else, and it looked towards the countries that were growing. This meant that big flows of capital went to Asia, Africa and Latin America, because these countries were growing and interest rates were higher there, so part of the boom story was also these huge capital inflows.

But, at the beginning of the global crisis in 2007, investors began to get nervous with some countries. Venezuela, Argentina and Ecuador became unable to access foreign financing since 2008/2009 and were kept out of the international capital markets (the Argentine situation began to change with the new Government in 2016). The other major countries in the region –especially Mexico, Peru, Chile, and Colombia- continued with very low spreads, low cost of financing and getting large capital inflows.
Since 2013, however, Brazil also began to get into trouble. Brazil, at some moment, was seen as one of the countries that were doing very well, one of the BRICS stars.

Fernando Henrique Cardoso, former president of Brazil, has always said that he loves that idea that since the 1950’s Brazil was deemed to be the country of the future, but he is afraid that this will always continuing to be true.

Brazil has a different structural problem than the rest of Latin America: it let the size of the state to get totally out of control. The state in Brazil spends around 32-33% of GDP, so it needs to tax the private sector around these rates (this is about the higher tax rates in European countries), but the state doesn’t deliver the goods: infrastructure, education and health services are poor in coverage and quality, unlike what happens in the European states. Brazilians, especially the private sector, suffer a huge level of taxation, and they don’t get enough public goods. In addition, the state is not able to finance itself only with taxes, so it should borrow a lot, and this continuous pressure on the markets are reflected in the highest interest rates in the developing world. Due to this very high level of taxation and very high interest rates, private investment is very low in Brazil: it never gets above from 18-19% of GDP, while in the rest of Latin America about it went up to 25-26% of GDP. It is very difficult, in those conditions, to grow steadily by more than 3% or 4%.

Unless Brazil is able to get some way of controlling the growth of public expenditures, or improving the efficiency of the state, it is not going to become the country that we all want. And it weights enormously on Latin America. In addition, there is always the risk of a fiscal crisis. When the Dilma Government began to fail in complying with its own prudential fiscal goals since 2013 (which the Lula Governments had kept faithfully), Brazil lost its investment grade and capital inflows were drastically reduced. Then it came the political crisis that made impossible for Dilma to solve the fiscal problem. As a consequence we witnessed a very sharp recession.

Let me now talk a little bit about the countries that are growing at about 3% or 4%, while keeping Brazil in the picture. A very important issue for Latin America is the fact that, differently from the past, there is a large group of countries that have flexible exchange rates and central banks with autonomy and credibility in their monetary policies. In the past, Latin America always tried to keep fixed exchange rates, but whenever things went wrong (either because commodity prices went down or mistakes were done at home and the countries began to lose international reserves), central banks had to increase the interest rates, aggravating the slowdown produced by the adverse external or domestic shock. This usually went on until the country had lost most of its international reserves, had to make huge devaluations and then inflation would pick up enormously.
This story of “ups and downs” or ‘stop and go’ was very common to Latin America in the past, and it is unfortunately still the story for countries like Venezuela and Argentina (although Argentina appears to be now getting out of this problem).

Having flexible exchange rates have meant a lot for many Latin American countries, particularly as they have a large dependence on commodity prices, that go up and down very easily. Thus, in 2009, many central banks in Latin America could reduce interest rates at the moment of the global crisis, contributing to a very fast recovery. In fact, Latin America went almost unscathed during the 2009 global crisis, and this (the fact that monetary policy could be counter cyclical for the first time in decades) was one of the reasons.

However, because the swings in commodity prices are so high, you have to control a little bit the movements of the exchange rate, because otherwise you’ll get huge appreciations of the exchange rate in the good times (like Brazil or Colombia did). This was not the case of Peru and Chile, which despite having had even higher exceptional gains in foreign revenue, could avoid a huge appreciation of the currency.

Flexibility of the exchange rate is very important in the good times, to avoid excessive current account surpluses and over-heating of the economy, and in the bad times, to be able to close foreign exchange gaps without major recessions. But, because Chile and Peru could avoid big appreciations of their currency, their industrial and agricultural exports continued to grow during the boom, though they of course grew less than the export of minerals. Colombia and Brazil let the appreciation go too far and had industrial recessions. Therefore, the problem of early deindustrialization in Latin America, which was highly discussed in the region during those years, was mostly a problem of a couple of countries (particularly Brazil and Colombia, in addition to the long standing problem Venezuela) that let the appreciation of currency go too far.

When the tide goes in the other direction, the countries that let their currency to appreciate too much, find that they have now very fast depreciations of their currency. These countries, like Brazil and Colombia, had therefore inflationary pressures on top of the slowdown. This meant that the central banks of Brazil and Colombia had to increase interest rates to control inflation, when there was a slowdown and made the slowdown worst by such pro-cyclical monetary tightening. Chile and Peru, that had controlled the appreciation of their currencies during the boom, had more moderate depreciations during the bust, had very mild inflationary pressures and, hence, did not have to engage in pro-cyclical monetary policies.

The reasons why Peru and Chile had lower appreciations during the boom was because they accumulated larger holdings of international assets (as a % of GDP) and had fiscal surpluses, in contrast to Brazil and Colombia and most other countries in the region (except Bolivia). Hence, in addition, they do not have to engage now in pro-cyclical fiscal adjustments, like Brazil and Colombia (and Venezuela, Argentina and Mexico) have to.

In addition to these macro issues, let me look a little bit further to different problems. From the point of view of our region, we still feel that there are other risks in the global economy that can affect us in a negative way.

First, the US is beginning the normalization of its monetary policy, starting from 2013 when the FED announced that they were not going to continue to expand monetary policies as much as before. This announcement was made exactly at the moment in which people began to get nervous with the Brazilian situation. If the increase in US interest rates proceeds smoothly, without causing major perturbations in financial markets, it is not going to pose additional problems for Latin America, especially for the countries that have high reserves and keep a sound fiscal situation. But something can go wrong, because the way that monetary expansion was done this time in the US, Europe and Japan, was through very heterodox ways. Central banks know well how to do a traditional monetary contraction, but this will be the first time they undergo into a deleverage of a heterodox monetary expansion, so there may be some surprises and volatility along the way.

The second issue is the possibility that the present woes in China go worst. We cannot discard this possibility, because China is in the middle of a readjustment process. It grew very fast, basically led by exports for more than two decades (double digit export growth), until 2009, when the US and Europe got into a recession. Since then, there was no way to continue with such fast growing exports to these countries, so China had to shift into stimulating domestic demand. They tried to do it both with investment and consumption but they haven’t been able to get the Chinese to consume. So almost the whole change was on investment rates, which shot up from 38% to 50% of GDP. Nobody can invest 50% of GDP and still do profitable investments in the margin. In addition, this huge increase in investment was financed with what they called “shadow credit”, which unfortunately is not shadow-banking in the sense that it is not unconnected with their banks, posing serious threats to financial stability.

China is therefore in the middle of a very difficult financial problem and, furthermore, Chinese political authorities decided they wanted the Renminbi to be a hard currency, in the worst moment to do that.
This is creating several financial problems around the world. If the separation between the political leadership goals in China and what the economic technicians in the rest of the world think that China should be doing continues, we are all going to have a difficult time because of the transition in China.

Thirdly, we also feel that Europe is not fully outside of the woods, because we have the uncertainties related to the Brexit, and the lack of a stable solution in Greece.

While we are now in a difficult external environment with a lot of risk, the only way in which Latin American countries can grow is by their own efforts. Productivity is THE major issue in this regard. If we measure total factor productivity in major countries of Latin America compared to the US, we see that we’re not catching up. In contrast, Asian countries have been increasing total factor productivity more than the US, so catching up in productivity. Of course, there are significant variations in productivity between countries in Latin America, with Chile and Peru doing a little bit better than the others, but this—and reducing inequality—continue to be the major challenges for Latin America as a region.

Besides the macro financial challenges, the critical issue is the micro agenda.

First, increasing the quality of education. In the last 3 or 4 decades, Latin America has invested a lot in education, and the coverage of education has improved significantly: 95% of children are getting into schools, 70% are leaving high school, around 50% are going to tertiary, and the only number that looks bad in terms of coverage is early childhood interventions. But the big issue is the quality of education; for some reason our students are not making as well in the student tests as students from Asia or Central Europe or from the developed world. Around 2/3 of our students that go out from secondary school don’t have the necessary competencies to be highly productive in today’s world, with advanced technologies, and this is a critical issue.

Second, stimulating innovation by firms. This is linked to the previous point, because if firms don’t have high quality workers and engineers they cannot innovate fast enough; on the other hand if firms don’t innovate fast enough there is not enough demand for better education. These two elements are therefore essential for Latin American countries to escape the middle-income trap, or, as I prefer to call it, the problem of the knowledge trap.

There are a few other things that could help, like flexibilizing the labor markets, enhancing trade, overcoming transports infrastructure lags, or improving access to finance and reducing cost of doing business, particularly to small and medium enterprises.

To conclude on a more positive note about the region, I would like to mention the emergence of a large middle class and the reduction of poverty levels.
The World Bank definition for middle class is people that have a level of income that is stable enough to have a very low probability of falling back into poverty and being able to do investment for the future. In Latin America, despite the statement that we were the middle income countries in the world, the middle income classes were less than 30% of the population. They are now getting up to around 50% of the population, so this is not an insignificant issue. At the same time, poverty is coming down significantly.

This is a major issue, because this group is much more stable, has more skills and has more political voice. The political demonstrations in Latin America are for quality of services; people are not asking for quantity, but rather for quality of services and quality of government, against corruption. These people are not so afraid of their material well-being, so they are asking for other things, and I think this is a very powerful force going forward.

Another positive point is that we were able to go through these upheavals in the global economy and financial system with only a few countries being hurt. This is very different from the past, when Latin America was a region of financial crises. But in 2009, in the midst of the worst financial crisis, not a single Latin American bank had to be rescued by the government.

I think most Latin American countries were able to learn from the past mistakes to avoid the financial crisis, building stronger macro-financial frameworks than in the past, through: inflation targeting regimes by independent and credible central banks; flexible exchange rate systems; higher fiscal prudence (major advances in Chile and Peru); and stronger banks, well managed and better regulated/supervised than in the past. There is also a very interesting development now, with the so-called emergence of competitive “multilatinas”.

I would like to conclude with two points. Basel III (the international regulatory framework for banks) meant that many investors in Latin America in previous years - especially in the financial sector - have to get out, because they need their money to strengthen themselves. While they are selling, there are some very competitive Latin American companies buying from European or American firms. Some of these companies are even beginning to invest in some of the European countries, and this is a totally new phenomenon.

Finally, there are a couple of very healthy trade and cooperation agreements in the region. The Central America is really doing very well; it is a deep integration in which countries are working in tandem and in a very sensible way. The same is beginning to happen with the Pacific Alliance, which is not looking only to integrate itself but integrating with the Pacific South of Asia.

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