Economic prospects depend on reforms
THINK TANK

SUBJECT: Outlook for economic development in Latin America over the next five years.

SIGNIFICANCE: Latin America and the Caribbean currently are enjoying high rates of growth. The extent to which this positive performance will be sustainable in the medium term depends on a combination of internal and external factors, including the evolution of global imbalances.

ANALYSIS: After a five-year recession, Latin America and the Caribbean (LAC) has benefited from high rates of economic growth since 2004. In 2004 and 2005 regional GDP per capita grew by 4.3% and 2.8%, with Argentina and Venezuela performing particularly well. Latin America outperformed both developed countries and the world average, but experienced lower rates of growth than the rest of the developing world.

Latin America and the Caribbean (LAC) has benefited from high rates of economic growth since 2004. The sustainability of this new expansionary cycle will depend on a combination of domestic and external factors. Prudent macroeconomic management together with positive external conditions may help secure high economic growth.

Nevertheless, several factors may have a negative effect on some countries in the region. The evolution of the US and Chinese economies will have a significant influence on the fate of many Latin American countries. The response of new governments to mounting social discontent, evolution of the global imbalances and performance of the US economy will be particularly important.

Economic success may be more difficult for countries in Central America than in other sub-regions, as they face increasing Chinese competition and the need to adapt to the Central American Free Trade Agreement.

Growth of GDP per capita in constant dollars, 1999-2005, %

	1999- 2003*	2004	2005**
LAC	-0.4	4.3	2.8
Argentina	-3.3	8.0	7.6
Brazil	0.3	3.4	1.1
Chile	1.4	4.9	4.9
Mexico	1.0	2.8	1.6
Venezuela	-5.1	15.8	7.1

**average annual growth rate*
***preliminary figures*
Source: CEPAL

Exports were the main engine of economic growth:

Latin American exports (in current US dollars) increased by 23% in 2004 and 19% in 2005.

Export expansion was high in Bolivia, Brazil, Chile, Peru and Venezuela and much lower in Central America and the Dominican Republic, which faced increasing Chinese competition.

The expansion of exports together with an improvement in South American countries' terms of trade increased the amount of foreign exchange available for imports and debt repayments.

LAC is also benefiting from low interest rates as real interest rates in the United States have remained below 2% and country risk for emerging markets has decreased steadily since 2003. At the same time net foreign direct investment (FDI) recovered in 2004 and 2005, amounting to more than 47 billion dollars in 2005.

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External factors. Changes in the global economy and the outcome of international negotiations will determine the set of opportunities and constraints for Latin American countries. There are three important external factors for the near future:

Evolution of macroeconomic imbalances in the global economy. Since the mid-1990s the United States has been the engine of global economic growth

The United States accounts for over one-fifth of world's total output and its GDP has grown faster than that of other developed countries. For example, in 2004, real GDP grew at 4.2% in the United States and only 2.0% in the Euro-area and 2.7% in Japan.

Economic growth in the United States has resulted in a rapid expansion of its imports, which have been financed through raising capital inflows. Between 2003 and 2005, US merchandise imports increased by a total of 33.0%, while the current account deficit amounted to 6.5% of national income in 2005.

The expansion of imports and capital inflows in the United States has had a mirror effect in China and other East Asian countries:

China has become the world's manufacturing centre and has expanded exports significantly. For example, merchandise exports to the United States increased by 60% between 2003-05, going from 152 billion dollars to 243 billion dollars.

At the same time, the country has increased its reserves and become one of the main lenders to the US economy.

Latin America has benefited from this pattern of growth based on US-China interaction in two ways:

Latin American exports to the United States have expanded continuously from 78 billion dollars in 2003 to 123 billion dollars in 2005.

The growth of the Chinese economy has resulted in an expansion of global demand for the types of raw materials produced in Latin America. China has become a key trade partner of Peru (China is now its second importer), Chile (third), Argentina (fourth), Brazil (fourth) and Uruguay (fourth). In the case of Mercosur, exports to China have increased from less than 700 million dollars in 1990 to 8.2 billion dollars in 2004.

Therefore, Latin America has become dependent of the survival of the global model based on interactions between the United States and China.

Progress in the WTO Doha Round. The WTO Doha Round, which could reduce protection in the agricultural sector and make large developing countries more open, has suffered several setbacks:

The ministerial meeting in Hong Kong and subsequent gatherings have managed to keep negotiations alive, but real progress remains elusive .

The EU is unwilling to reduce agricultural protection as much as other countries have requested, and developing countries have demanded preferential treatment with little success.

Given the expiry of fast track trade promotion authority in the United States in mid-2007, the next few months will determine the fate of the Round. Its failure probably would lead to further proliferation of regional preferential trade agreements between the United States (and EU) and various Latin American countries.

New developments in the 'war on terror'. New terrorist attacks on US soil would have a negative effect on the global economy. They would particularly hurt sectors such as tourism, in which Latin America is building new comparative advantages.

Internal factors. Latin Americans are disappointed with the results of neoliberal reforms. Economic growth has been lower than expected and corruption, insecurity and inequality have triggered demands for change:

In a poll in November 2005, only 27% of the population was "very satisfied" or "somewhat satisfied" with the market economy.

In a number of countries, the electorate has voted for left-of-centre governments that face high expectations.

While governments face country-specific challenges, there are at least two common problems:

Economic and political inequality. In LAC, inequality in distribution of income and other resources, and inequality in political participation, are high and reinforce each other. Indigenous and black populations usually have less income and lower access to health and education than the white population. They also have fewer representatives in Congress. For example, in Ecuador, the indigenous population represents 34.0% of the total, but only 3.3% of legislators are indigenous. Political marginalisation and income inequality have been partly responsible for increasing social instability and have become a central medium-term challenge.

Lack of competitiveness and insufficient linkages. While exports have increased over the past few years, they have grown less than in East Asia and have remained concentrated in primary goods. Even in Mexico, Costa Rica and the Dominican Republic, which have built new comparative advantages in manufactures, few small and medium-sized domestic firms have become suppliers of new exports. As a result, export growth has had little impact on many other sectors of the economy.

Extreme scenarios. Most observers are fairly optimistic about the evolution of Latin America in the next few years. Prudent macroeconomic management together with positive external conditions may help secure high economic growth. Nevertheless, several factors may have a negative effect on some countries in the region and call into question the survival of the current expansionary period. 'Dream' and 'nightmare' scenarios can be elaborated to demarcate possible outcomes for the region.

Dream scenario. The 'dream' scenario would depend on several positive external conditions:

Global imbalances become sustainable or are corrected without major costs for the global economy. If net foreign inflows continue financing a growing current account deficit in the United States, global economic growth and demand for raw materials will remain high. High global economic growth also could be maintained if the US current account goes down thanks to an appreciation of the Chinese real exchange rate and expansion of US exports and Chinese domestic demand.

The Doha Round is completed successfully and results in a stronger global institutional setting with more understanding of developing countries' problems. Reduction in agricultural protection in the United States and EU would contribute to the growth of primary exports from Brazil, Argentina and other large Latin American agricultural producers. Advances in WTO negotiations may strengthen the influence of large developing countries like Brazil in the multilateral economic system, and further erode incentives for hemispheric integration in the Americas.

Stable political international conditions, the absence of major terrorist attacks and stable oil prices also would contribute to a positive global environment and high economic growth.

The extent to which positive external conditions result in long-term growth ultimately would depend on the performance of new governments. Prudent macroeconomic management needs to be combined with improvements in living standards for a majority of the population. In Central America and the Dominican Republic, the approval of the Central American Free Trade Agreement (DR-CAFTA) with the United States will make imperative economic reforms that improve efficiency and -- in particular -- compensate losers.

Successful domestic reforms may require some common measures across all countries:

Tax reforms that help expand revenues as a percentage of GDP. With the exception of Nicaragua, Uruguay and Brazil, all Latin American countries have low tax burdens relative to their level of economic development. In countries like Guatemala and Paraguay, tax receipts are below 11% of GDP. While tax reforms are difficult to implement, as recent experiences in Mexico and Costa Rica illustrate, they are extremely important if countries are to distribute the benefits of high growth and improve competitiveness. Increased and more effective social spending. In countries such as Bolivia, where popular expectations of the new government are extremely high, a rapid expansion of spending in some public services may be required if social stability is to be secured. Indeed, new reforms that improve the amount and quality of social services and extend them beyond the extreme poor should be slowly implemented in all countries. An expansion of public spending on secondary education may be particularly important to increase competitiveness and reduce income inequality: at present enrolment in secondary education is only 55% of the relevant population in Latin America, compared to 85% in Central and Eastern Europe and 65% in East Asia.

Further export expansion and strengthening of linkages. If high global economic growth were to carry on, the expansion of Latin American primary exports would continue. However, export expansion by itself may not be enough to sustain GDP growth and secure a more equitable distribution of resources because of its limited impact on the rest of the economy.

Economic development in the medium term in Latin America will require measures to expand the productivity of small and medium-sized firms (both in the formal and informal economy), create new comparative advantages in agro-businesses and other manufacturing sectors, and promote new linkages. Nightmare scenario. The 'nightmare' scenario would result from negative external shocks that effective domestic policies do not mitigate successfully. The continuous expansion of the US current account deficit may not be sustainable, as foreign investors are unlikely to continue accumulating limitless dollar-denominated foreign assets. Given the high level of indebtedness of US households (close to 130% of disposable income), and housing bubble, a rapid change in foreign investor behaviour could translate into a serious recession.

If global imbalances were to trigger a recession in the United States and thus a reduction in Chinese exports, the consequences for Latin America would be rather negative:

If the United States increased interest rates to reduce capital outflows and limit the inflationary effect of devaluation, Latin American debt would increase in the short run and domestic investment would deteriorate.
A global recession also would have a negative impact on demand for raw materials, thus resulting in a deterioration of the most Latin American countries' terms of trade.

In Mexico, Central America and the Dominican Republic, the US recession also would reduce manufacturing exports produced in free trade zones. Increasing global political instability and new terrorist attacks on US soil also could trigger a deterioration of external conditions for Latin America. The failure of the Doha Round, while less costly in the short run, would increase uncertainty in some sectors. Slowdown of multilateral trade arrangements also would make South American countries more dependent on bilateral negotiations with the United States and the EU.

While macroeconomic management has been relatively prudent in the last few years and debt levels have been reduced in LAC, negative external shocks could easily trigger a domestic vicious circle in many countries. An increase in interest rates together with a reduction of exports would make tax reforms and expansion in social services unlikely. New left-of-centre governments would be unable to meet the demands of key constituencies and lose popular support. Left-leaning governments in Bolivia, Argentina, Venezuela and even Brazil, would be forced to manage an increase in social instability, something for which they may be ill equipped.

CONCLUSION: The evolution of the US and Chinese economies will have a significant influence on the fate of many Latin American countries in the near future. Nevertheless, economic performance in each country ultimately will depend on the ability of governments to introduce reforms that reduce political and economic disparities and improve competitiveness. Economic success may be more difficult for countries in Central America than in other sub-regions, as they face increasing Chinese competition and the need to adapt to DR-CAFTA.