

# The Challenges to Achieving Sustainable Growth in Latin America

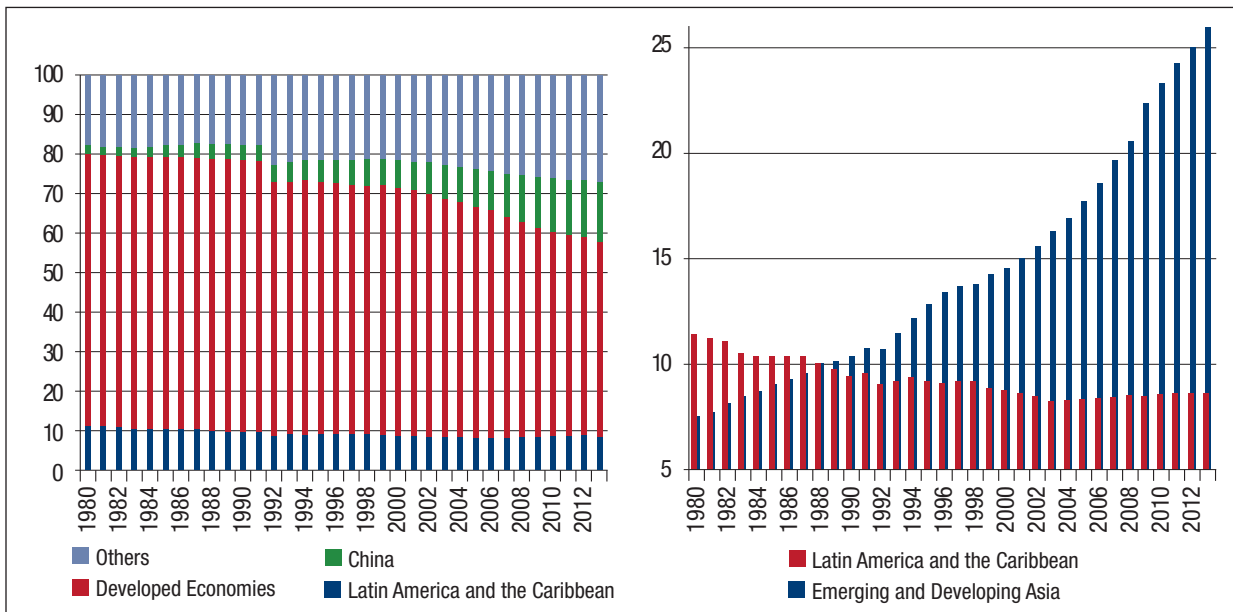
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## Introduction

The economic recovery after the Great Recession has been quite disappointing. Growth in advanced economies has been repeatedly revised downwards with respect to IMF projections. In this context, output in developed markets has underperformed measured against the IMF's original forecasts by 1.2 percent, on average, over the past five years.<sup>1</sup> In emerging markets, the initial phase of recovery was strong due to the use (for the first time in many cases) of countercyclical monetary and fiscal policies. However, the recent pace of growth has been disappointing in these economies as well. The slowdown is broad based particularly in emerging Asia and China, after the initial post-crisis surge,

in which growth has been significantly below the pace sustained during the decade before the crisis. Latin America is not an exception. After experiencing strong growth before the crisis, the situation has changed dramatically. The pace of growth has slowed, and some countries need to address inflationary pressures and certain imbalances in order to maintain their macro stability. In addition, the growth experienced for the region compared to other parts of the world has been disappointing. As Figure 1 shows, Latin America's current share of world GDP has dropped to 8.6 percent, down from 11.4 percent in the 1980s.<sup>2</sup> Therefore, it is fundamental for the region to undergo a supply-side structural reform agenda and achieve a sustainable path of higher growth rates, similar to those observed before the crisis.

FIGURE 1. SHARE OF WORLD GDP BASED ON PURCHASING PARITY TERMS (PPT) (PERCENT)



Source: IMF.

## Improvements in Latin America During the Last Decade

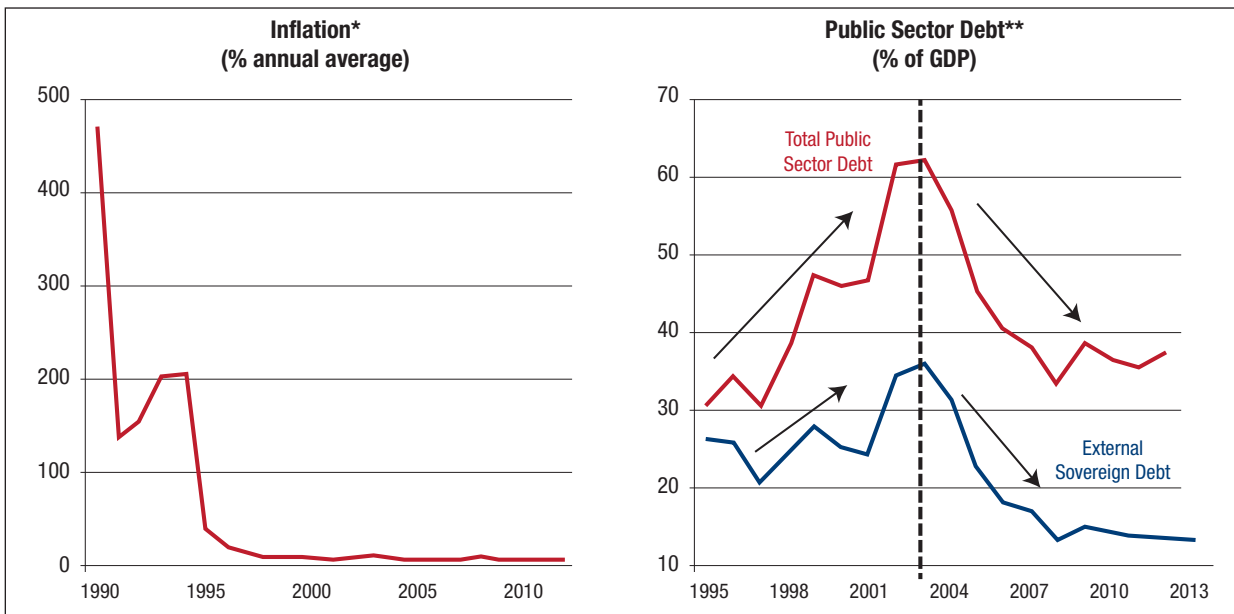
The improvements Latin America went through during the last decade are quite striking. From 1990 to 1995, the average annual inflation rate in Latin America was over 200 percent, while average inflation since 2010 has been about 6 percent.<sup>3</sup> The second outstanding shift in the Latin American picture is a substantial reduction in the traditional weaknesses of the region, particularly in terms of financial stability, the debt structure and the balance of payments. Total public sector debt, which peaked at slightly above 62 percent of GDP in 2003, declined sharply to around 37 percent by 2012.<sup>4</sup> The same goes for external sovereign debt (Figure 2).

In addition, reserve accumulation has increased significantly. On average, the nine largest economies of the region accumulated the equivalent of 16 percent of GDP in international reserves during 2003-2011.<sup>5</sup> This means that some of the traditional components that hurt Latin America in

the past, such as large current account deficits and huge exposure to sudden stops, have substantially improved over the past eight years. Correspondingly, the balance sheets of most Latin American countries are much stronger now compared to a decade ago. This is clearly reflected in the spreads of Latin American debt. For instance, during 1998-2003, the average spread of the Latin American EMBI+ (Emerging Markets Bond Index Plus) was more than 800 basis points (bps). In contrast, the average from 2003 to 2013 was less than half, at around 380 bps (Figure 3). This development allowed Latin America to weather the recent crisis. This represented a significant milestone for the region: For the first time in a very long time, Latin America was able to implement strong countercyclical monetary and fiscal policies in response to extreme external shocks of the nature seen during the Great Recession.

This is the result of a substantial improvement in the region's macro policy framework. Latin America had been building fiscal cushions in the decade prior to the Great Recession. The average primary surplus of Latin American countries was slightly

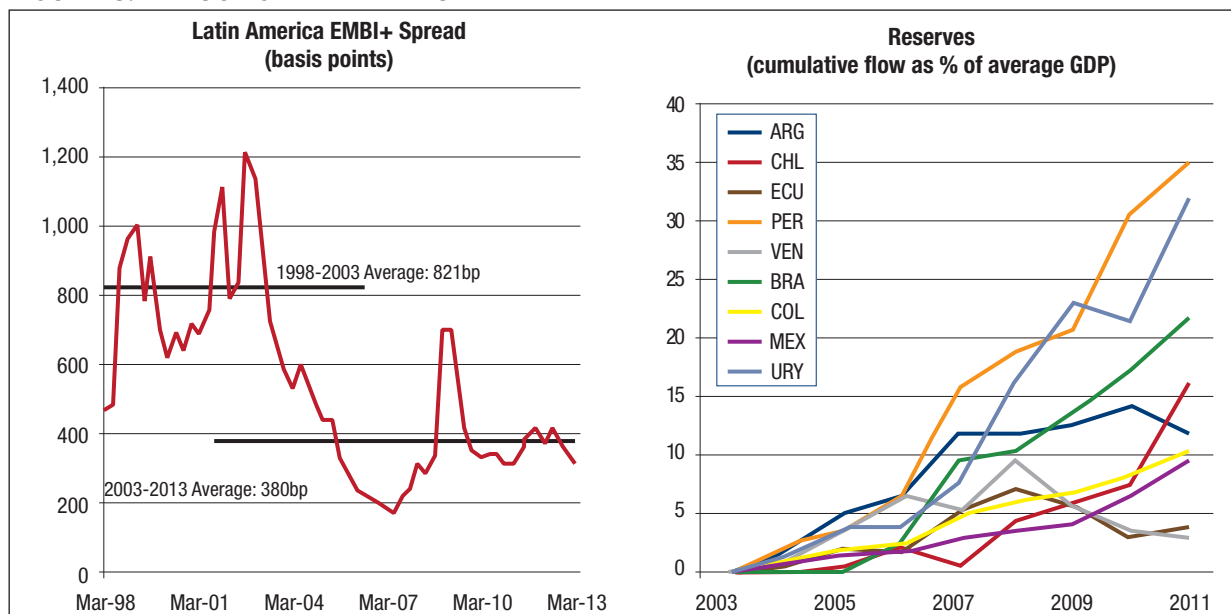
FIGURE 2. MACROECONOMIC IMPROVEMENTS



\*Average inflation of Latin America and the Caribbean  
Source: IMF.

\*\*Simple average of Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela  
Source: JP Morgan.

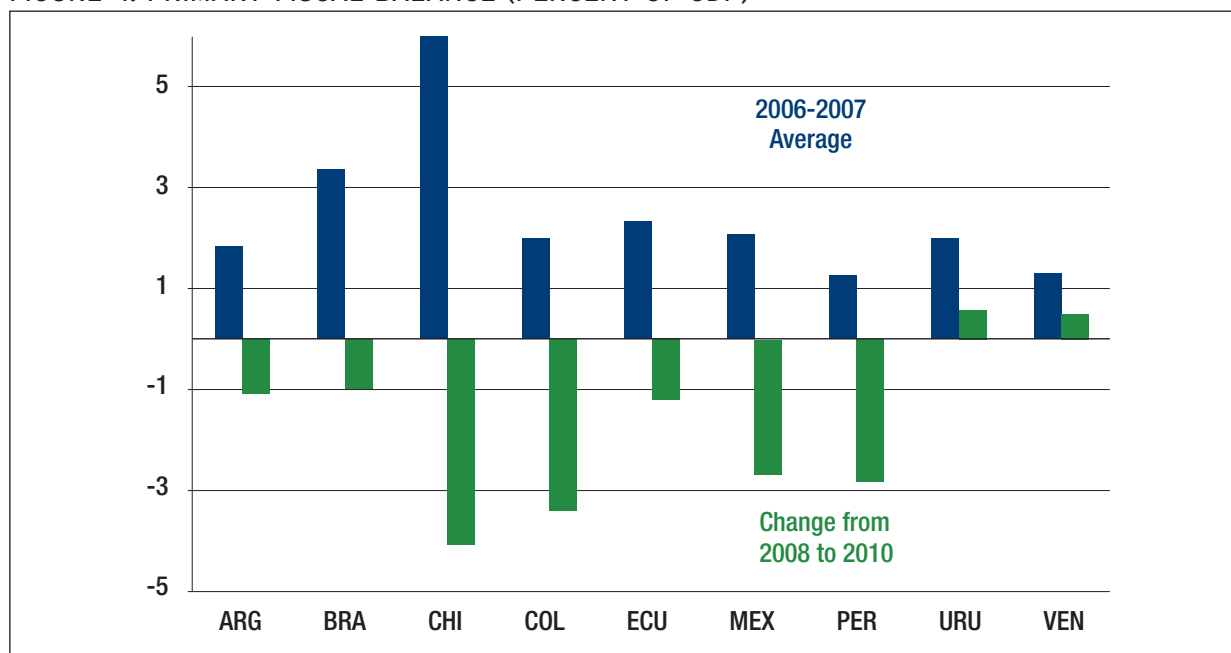
FIGURE 3. REDUCTION IN DEBT VULNERABILITY



Source: JP Morgan.

Source: World Bank.

FIGURE 4. PRIMARY FISCAL BALANCE (PERCENT OF GDP)



Source: JP Morgan.

above 2.5 percent of GDP before 2007. During the crisis, the reduction in primary balances was substantial, particularly from 2008 to 2010. In the case of Argentina, Chile and Colombia, the change was quite drastic, with an average reduction in the primary balance of these countries of nearly 3 percent of GDP. Moreover, several other countries

also implemented countercyclical fiscal policies in a very active way. Between 2008 and 2010, Mexico and Peru reduced their primary balances by 3 percent of GDP. Similarly, as Figure 4 shows, Brazil, Ecuador, and Venezuela averaged slightly below of 1 percent of GDP.<sup>6</sup>

The same is true for monetary policy. For example, from January 2009 to March 2010, Brazil lowered its policy interest rate by 500 bps, Chile lowered its rate by 775 bps, and Colombia followed suit with a 700 bps reduction from peak to trough. Noticeably, there was a strong policy response in the region. Governments used both monetary and fiscal policies to mitigate the impact of the 2007-2009 economic downturn, without suffering a greater economic dislocation as a result. This approach was largely unprecedented in Latin America, and in stark contrast to the region's experience during the 1990s, when high levels of indebtedness, currency mismatches, and poorly capitalized financial systems tended to amplify external shocks and limit countercyclical policy intervention. As a result, the growth performance of Latin America from 2003 to 2013 has been substantially better in most countries than in the previous decade. According to the IMF, Latin America experienced an average growth rate of 4 percent per year, almost twice the rate recorded in the 1980s and 1990s<sup>7</sup> (Table 1).

**TABLE 1. LATIN AMERICA'S GROWTH RATE COMPARISON**

	GDP Growth (%)	
	1990-2002 Average	2003-2013 Average
Argentina	2.1	6.9
Brazil	1.9	3.5
Chile	5.7	4.6
Colombia	2.8	4.7
Ecuador	2.7	4.6
Mexico	3.1	2.5
Peru	3.1	6.4
Uruguay	1.5	5.2
Venezuela	1.8	4.6
Latin America and the Caribbean	2.7	4.0

Source: IMF.

There is no doubt that the significant modifications to the macro framework, led by the important fiscal and monetary policy changes, were key for Latin America's higher growth in a more stable environ-

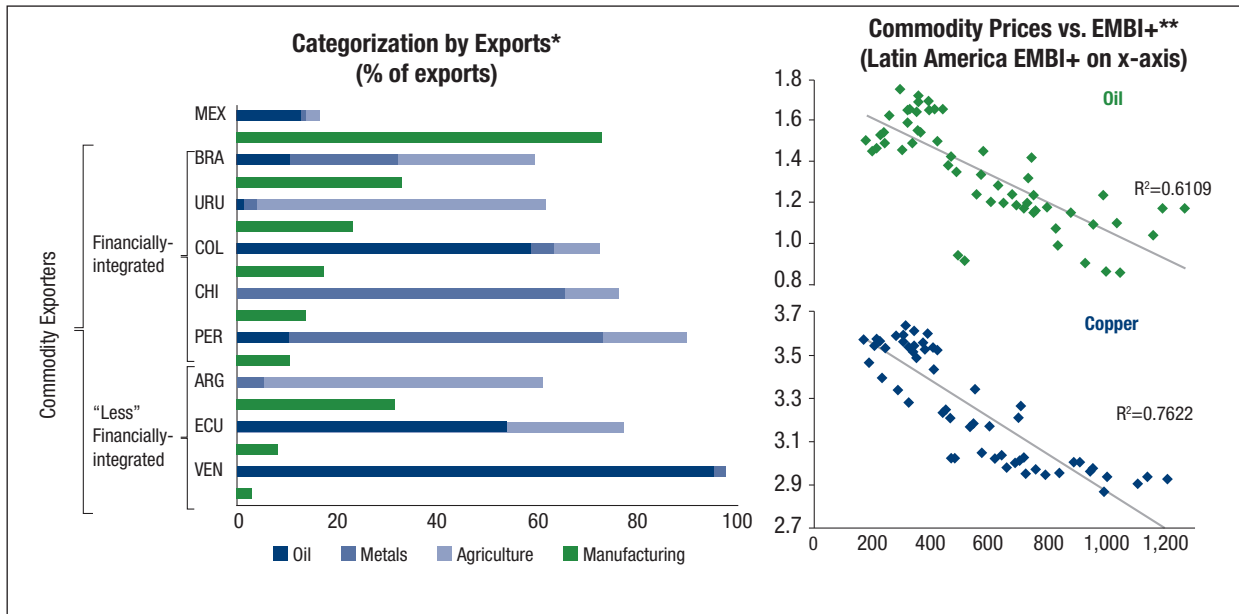
ment. But it is also worth noting that China's high growth rates since its accession to the World Trade Organization in 2001, as well as the commodity price boom, each contributed to higher growth rates in Latin America, particularly among commodity exporters and in those countries with a higher degree of financial integration (Figure 5).

## Heterogeneity and the Reasons Behind Latin America's Improvements

The major economies in Latin America—with the exception of Mexico—are commodity exporters (57 percent of total exports). For example, Brazil's commodity exports are around 59 percent in total. However, the concentration of commodities that are exported varies across countries. In the Brazilian case, agricultural products account for 27.5 percent and metal products account for 20.4 percent of total exports. Chile, on the other hand, is concentrated in metals (around 59 percent). Colombia mainly exports oil, which represent 58 percent of total exports, while Peru is concentrated in metals (about 65 percent).<sup>8</sup> These countries represent the financially integrated commodity exporters. Similarly, the less financially integrated exporters are also heavily weighted toward commodity exports. Commodities account for 76 percent of Argentina's exports, with a substantial concentration in agricultural products. Ecuador's exports are concentrated in oil (57 percent) and agricultural products (24 percent). Venezuela specializes almost entirely in oil, representing 98 percent of total exports. Given the country's greater specialization in manufacturing exports (72 percent of exports), and strong commercial links with the United States (79 percent of all exports), Mexico stands apart, with commodities representing just 16 percent of total exports.

The improvements Latin America experienced over the last decade were to a great extent due to very favorable external conditions. Increasing external demand—led by the advanced economies and China—created favorable terms-of-trade for most

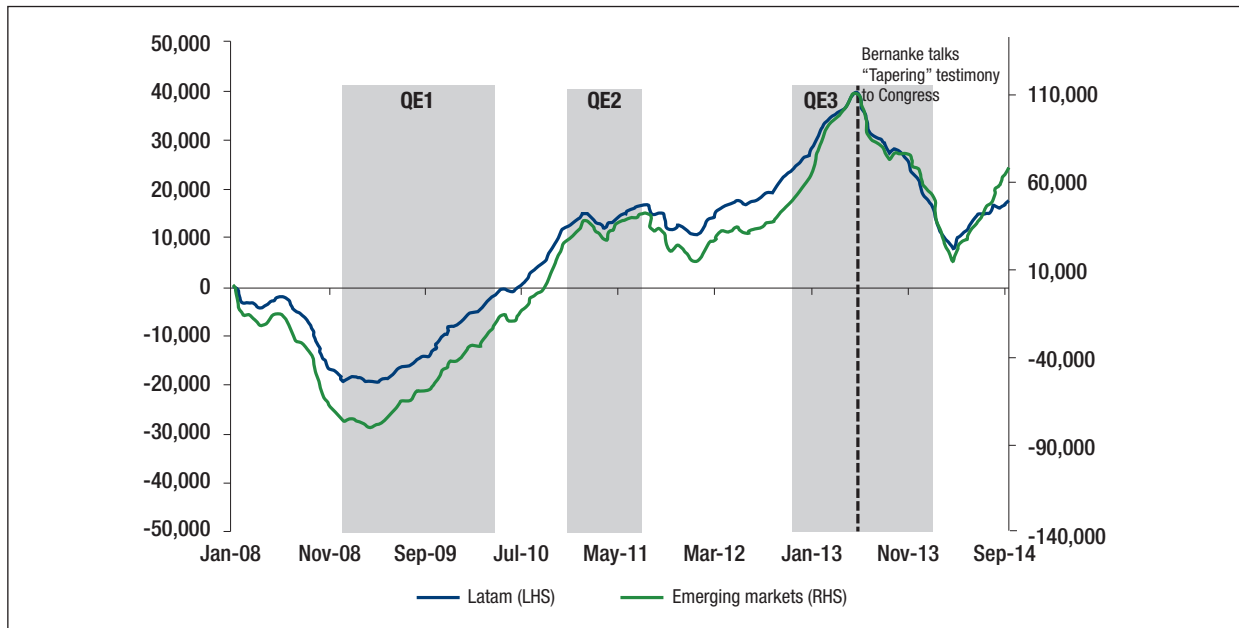
FIGURE 5. THE IMPORTANCE OF COMMODITIES IN LATIN AMERICA'S ECONOMIES



\*Categorization of commodity exporters due to IMF; see Regional Economic Outlook: Western Hemisphere (April 2012.) Source: JP Morgan and WTO.

\*\*Oil and copper are in logs of 1982 U.S. dollars: data from 1998 to 2013. Source: JP World Bank and Bloomberg.

FIGURE 6. FOREIGN INFLOWS INTO DEBT AND EQUITIES IN LATAM AND EMERGING MARKETS (CUMULATIVE SINCE JANUARY 2, 2008 USD MILLION)



Source: EPFR Global, Banorte-Ixe.

Latin American countries. Furthermore, the rise in commodity prices, driven mainly by increasing demand, helped to increase fiscal revenues for the commodity exporting countries. For example, one IMF study in 2010 estimated that the cumulative contribution to GDP growth from a one standard deviation shock to commodity prices in Argentina

between 1993 and 2008 was around 2.5 percent. The equivalent figures for other countries were 1.3 percent for Brazil, 1.1 percent for Chile, 2 percent for Colombia, around 1 percent for Ecuador and 0.6 percent for Mexico.<sup>9</sup> In addition, some countries, especially the financially integrated economies, benefited from favorable financial external

conditions. After advanced economies relaxed their monetary policy stance, these countries became very attractive for large capital inflows in search of higher yields (Figure 6).

Domestically, labor accumulation played an important role in output growth. Factor accumulation accounted for 3.75 percentage points of annual GDP growth in 2003-2012.<sup>10</sup> Low unemployment in many countries was the main reason behind this growth, but capital accumulation from global capital inflows into financially integrated commodity exporters also played a part. Today, however, external conditions are no longer as supportive as they used to be, and episodes of renewed volatility have exposed certain vulnerabilities in Latin America.

## The New World

In recent years, Latin America has experienced a rather complex cycle. Global economic conditions are not as favorable as they used to be, with global growth forecasts for 2014 having been adjusted to reflect a slower pace. The 2014 IMF World Economic Outlook indicates that the projected growth for this year is 3.3 percent, which is 0.4 percent lower than its initial projections. In this context, advanced economies are only expected to grow 1.8 percent. Meanwhile, the GDP growth rate in China has fallen to around 7.5 percent, down from 10 percent at its height. This has all contributed to a decline in commodity prices. According to an IMF report, commodity prices have already softened over the past 12 months and are projected to moderate further over the medium term, as supply is increasing<sup>11</sup> while demand growth from large emerging markets is expected to slow. On top of that, the reduction of monetary stimulus measures in some of the developed economies is reversing the flow of money Latin America attracted during the extended period of ultra-lax monetary policies. Therefore, the present global situation is likely to be characterized by slower external demand, abundant capital, and lower commodity prices.

In this context, Latin American economies are fac-

ing a cycle of lower growth and higher inflation, particularly those countries that have followed unorthodox policies and implemented no structural reforms. The projected growth for Latin America for 2014 is 1.3 percent, well below the 3 percent experienced in year 2012. In addition, inflation, which remains contained, is now starting to approach the “upper limits” in several countries. Relatively weak growth in financially integrated economies’ exports has decreased their revenues. The moderation of revenues is likely to persist over the period ahead, reflecting softer commodity prices, rising commodity extraction costs, and lower potential growth. In addition, primary public spending, as a share of GDP, has increased steadily since the financial crisis, even though revenue growth has started to slow. At the same time, pressures on expenditure are growing, including from higher interest bills, critical infrastructure needs, and demands for better public services. Aging-related spending is also expected to increase in the medium term.<sup>12</sup> More significantly, some supply constraints are starting to arise. Growth of physical capital is expected to moderate, as the low global interest rates that facilitated large capital flows to the region start to rise and commodity prices stabilize. In addition, the contribution of labor will likely be constrained due to an aging population and the unemployment rate likely to its natural levels.<sup>13</sup>

This new reality of lower growth and tighter financial conditions creates common challenges for Latin American countries. On one hand, Latin American countries need to preserve macroeconomic and financial stability to be more resilient to external shocks. On the other hand, the region needs to boost growth that is more reliant on domestic factors. In order to maintain stability, Latin America needs to keep strong balance sheets, credible policy frameworks, and a prudent macroeconomic stance. For this, the region needs to rebuild its policy buffers that were worn out by fighting the last recession, especially in commodity-exporting countries. In this context, it is important to create macroeconomic policies that address the vulnerabilities of the region. For instance, keep-



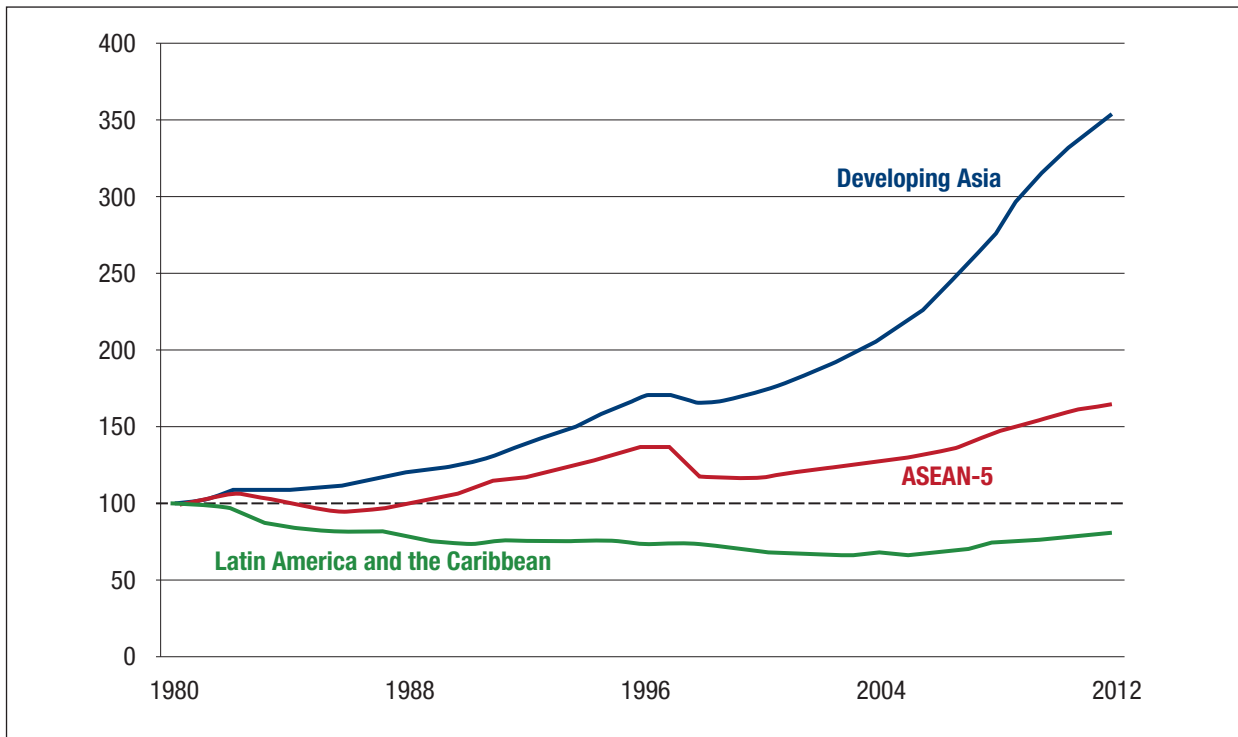
ing inflation low with well-anchored inflation expectations, together with a flexible exchange rate and a “high” level of foreign reserves, decreases the potential risks of volatility. Also, flexibility to ease monetary policy would allow the region to respond in case of a slowdown. It is fundamental for countries to adopt prudent fiscal policy and improve the efficiency of public spending, in order to apply countercyclical policies if needed. Over the longer term, boosting growth seems like a much greater challenge. This is especially stark when one looks at indicators of the relative performance of the region. Since 1980, Latin American income per capita, relative to the U.S., has decreased by around 20 percent. In contrast, developing Asia and the ASEAN-5 economies have increased their level of income per capita relative to the U.S. by 365 percent and 150 percent, respectively, in the same period.

A recent study by the Inter-American Development Bank (IDB) found that, by deconstructing

the trend using growth accounting techniques, total factor productivity (TFP) is by far the most important determinant of the income gap between these regions and the U.S. It is striking that TFP in Latin America declined by around 30 percent relative to the U.S. between 1980 and 2007, while in emerging Asia it increased about 20 percent. The simplest explanation for this divergence in TFP is a substantial misallocation of resources in Latin America. The IDB study attempted to measure the effect of improving resource allocation in the region and found that just a modest improvement would go a long way in elevating TFP.<sup>14</sup> A counterfactual exercise suggests that a gradual adjustment in the allocation of resources to that of the U.S. (in terms of efficiency) would have translated into a gain of 50-100 percent in TFP and an additional 1 percent of annual GDP growth on average, in the period of study.<sup>15</sup>

Latin America has to utilize those resources more efficiently. This is clear from the regional compar-

FIGURE 7. INCOME PER CAPITA RELATIVE TO USA\* (INDEX, 1980=100)



\*Income per capita is in purchasing parity terms.  
Source: IMF.

ison in the World Economic Forum's competitiveness index. In this dimension, Latin America scores lower than not just China and East Asian countries, but also Central and Eastern European countries. These rankings are based on the aggregate composite index but, on closer inspection, it is not difficult to see that Latin America falls behind these regions across the board. Only in "macro-economic environment and business sophistication" does Latin America score higher than Central and Eastern Europe. In terms of institutions, infrastructure, health and education, labor and goods markets, financial sector development, as well as in technological readiness and innovation, the region lags behind both regions.<sup>16</sup> To rectify this situation, Latin America needs to implement important structural reforms. This implies, first of all, strengthening the institutional framework to secure property rights and eliminate corruption. Also, reforms should be focused on developing infrastructure, which the IMF has recently endorsed as an effective way to strengthen growth financial pressures if invested "appropriately." In addition, promoting deeper and more efficient financial markets, increasing the quality of education, further developing the labor market, and investing more in innovation and technology will create the appropriate environment to boost productivity across the region. These reforms will allow Latin America to enjoy greater growth rates and be less vulnerable to external shocks. On top of that, if the region manages to successfully implement these reforms, it will be able to compete with economies with higher technological and skilled production. In this context, Latin America will possibly become a group of high-income countries, and leave behind the so-called middle-income trap.

## Moving From Stability to Reform

Latin America has improved from a macroeconomic perspective over the last decade. The region was able to weather the Great Recession without painful dislocations. Moreover, it was able to implement countercyclical policies to reduce the impact of the crisis. However, global conditions have

changed. The positive environment that allowed the region's development over the last few years is starting to vanish. China's growth deceleration, the decrease in commodity prices and the withdrawal of ultra-lax monetary policies from advanced economies are the main external causes of Latin America's recent performance. In addition, lower growth in major economies and tighter financial conditions bring new challenges to the region. Consequently, the next step is to maintain the macroeconomic and financial stability achieved over the decade and, at the same time, to press ahead on an important structural reform agenda. This will allow the region to finally escape from the "middle-income trap" and address its major development gaps.

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## Endnotes

1. The forecasts published in the World Economic Outlook of April 2014, covering the last 5 years.
2. IMF (2014)
3. IMF (2014), Latin America and Caribbean average.
4. JP Morgan (2014). Simple average of Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, Venezuela.
5. World Bank (2013), author's calculations.
6. JP Morgan (2014)
7. Average of the 9 largest economies: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela.
8. JP Morgan (2014)
9. Medina (2010)
10. Tsounta and Sosa (2013b)
11. IMF Regional Economic Outlook: Western Hemisphere (2014)
12. IMF Regional Economic Outlook: Western Hemisphere (2014)
13. Sosa and Tsounta (2013b)
14. IDB (2013)
15. The time period varies between countries depending on data availability, but is fixed at ten years in all cases.
16. WEF Report (2014), using the Region IMF division 2013