What's Next for Latin America After the Global Crisis?

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Time Magazine recently named Luiz Inácio Lula da Silva as one of the world's 100 most influential people for helping Brazil become the first Latin American power to matter in world affairs. The fact that Brazil will become the world's fourth largest economy in 2050, together with Lula's personal charm and self-confidence, has brought Brazil an unprecedented level of diplomatic influence. Other countries in the region have also gained status and credibility based on sound economic policies. But, whether this reflects a fundamental transformation for Latin America is still an open question. Can other Latin American leaders, including Brazil's presidential candidates, shape global policies while at the same time succeed in changing economic and social conditions?

Latin America has undergone radical political, economic and social changes during the last two decades. The region is no longer the stereotype of populism and economic mismanagement, to which Alan Greenspan devoted an entire chapter in his memoires. As the world's center of gravity moves east and south, and as emerging economies and their multinationals take the lead, global corporations cannot overlook Latin America. But it would also be a mistake to argue that the region has entered a smooth path toward development. Many problems remain, including social tensions, imperfect political systems and structural constrains on economic growth.

In addition, Latin America is perhaps the only region of the world where an ideological race is alive. Alternative development models are still competing in a way that is somewhat reminiscent of the Cold War, including its corollary of an arms race. While some countries are committed to market orthodoxy and responsible social policies, others proclaim a new form of socialism. In this latter group, anti-market policies and populism have become effective political strategies, especially when combined with swelling revenues from commodity exports.

But the region shares more than just a common culture. A combination of factors, of which culture is probably the least important, resulted in Latin America's "development problem", which is essentially the combination of low economic growth and high inequality.

Economic historians, including the late Angus Madisson, agree that around 1700 incomes were relatively similar in the U.S. and Latin America, but the 19^{th} century was disastrous for Latin America. During most of the 20^{th} century output per capita in Latin America remained at 30 percent of the U.S. level. But during the 1980s and 1990s the income gap widened, bringing relative incomes in Latin America to 20 percent of the U.S. level by the end of the century. The comparison with the Asian tigers is even more appalling. This group was well behind Latin America for most of the 20^{th} century, but a rapid expansion beginning in the 1960s led income per capita in Asia to exceed that of Latin America in the late 1970s. Today, the tigers' per capita income is more than twice the level for Latin America.

However, low growth is not the only problem. Of the 15 most unequal countries in the world, 10 belong to Latin America.[1] Compared to Latin America, the average income Gini is 8 points lower in Asia, 18 in Eastern Europe and Central Asia and 20 in the developed countries. More relevant, the level of inequality in Latin America is higher than predicted by its GDP per capita: the Gini coefficient is around 10 points higher in Latin America than in the rest of the world, after controlling for per capita GDP.

There is wide debate on when the region became so unequal. Some authors, such as Jeffrey Williamson of Harvard University, believe that inequality in Latin America was not higher than in other parts of the world from the post-conquest decades following 1492 to the mid-19th century. Here again the 19th century appears to be culprit, especially the first decades after independence. This fact is often ignored in the bicentennial celebrations currently taking place throughout the continent. Two centuries of entrenched inequality suggest that change will be slow and not necessarily easy.

Another feature that is particularly relevant and not independent from the previous discussion is Latin America's high dependence on commodities. As stated in a forthcoming World Bank publication, "the mural of the economic history of Latin America and the Caribbean has been painted in the colors of its commodities[2]." From the gold and silver that attracted the conquistadores, to the sugar and coffee plantations, copper and coal mines, to the "black gold," commodities have defined the fortunes of the region and will continue to do so in the foreseeable future. Whether this is part-effect, part-cause of the development problem continues to be debated, but the profession is gradually leaning towards the view that natural resources may indeed have a positive impact on growth, when properly managed. There is little doubt that commodities have been more a blessing than a curse in the last decade, which explains much of the favorable recent economic performance in the region.

The dependence on commodities explains why Latin America is highly influenced by events in China. In fact, the correlation between export prices in Latin America and industrial production in China is close to 60 percent. The greater dependence on China has some risks, not only because the Chinese economy can overheat, but also because Latin American governments are losing degrees of freedom in their interaction with China. Recent threats by China to end its imports of Argentinean soy oil in response to anti-dumping measures adopted by Buenos Aires give a sense of the problems that lie ahead. Also, Latin American governments are becoming increasingly aware that the appreciation of their domestic currencies vis-à-vis the U.S. dollar is a serious problem mainly because China's currency does not appreciate.

One final commonality impacting Latin America is the fact that the political systems have become more open and pluralistic. During the last two decades most countries reformed their

[1] According to the UNU/WIDER database.

[2] The share of commodities in total exports is between 50 and 60 percent in Argentina, Brazil, and Colombia. It is 77 percent in Chile, Ecuador and Peru, and 97 percent in Venezuela. The US is the main market for many countries. Exports to the US represent 80 percent of total exports in Mexico, 58 percent in Venezuela, 44 percent in Ecuador, and 35 percent in Colombia.

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constitutions to increase political participation and representation, including Chile and Brazil (1989); Colombia (1991); Paraguay (1992); Peru (1993); Argentina, Guatemala and Nicaragua (1994); Venezuela (1999); Ecuador (2008); and Bolivia (2009). Although the effects of these reforms on institutional performance have been varied, social policies and social expenditures have gained preponderance across the region. There have been successes, such as increased in enrollment rates in primary and secondary schools, but many problems remain such as low educational quality and low enrollment rates in pre-primary and tertiary education, especially for the poor. On the positive note, a large number of Latin American countries have implemented social interventions through programs based on conditional cash transfers (CCTs), which have become a model for the rest of the world. The existing evaluations suggest that these programs, however small, are effective ways of redistributing income to low-income households, while at the same time providing the incentives for investing in human capital.

But it is important to go beyond these commonalities, which do not provide much insight for a nuanced assessment of the region. As mentioned, the ideological divisions have resulted in differences in the way governments define their role both internally and externally. With some oversimplification, two camps can be distinguished:

1. Countries with market-driven economies, strong political and economic ties with the U.S., and where democratic governance prevails. This group has full access to international financial markets and includes, among others, Chile, Colombia, Mexico and Peru.

2. Countries with increased state presence and control over their economies, where the anti-American rhetoric resonates loud, and where tolerance to criticism from the media and civil society is increasingly low. The core members of this group are the ALBA countries (Venezuela, Bolivia, Ecuador, Nicaragua and Cuba), but with some qualifications the group can be extended to include Argentina and Paraguay. No leader in this group uses incendiary rhetoric and anti-imperialist demagoguery more effectively than Hugo Chavez, who has greater degrees of freedom than his followers.

Brazil is a separate category in itself. The Cardoso (1994-2002) and Lula (2003-2010) administrations have brought politics to a sensible center and have made Brazil more self-conscious of its status as a global power. Foreign policy is not fully aligned with the U.S., favoring alliances with other emerging powers. While Brazil shares the same approach on economic management as the first group, it often sides with the expanded ALBA countries on political matters. This has been exemplified in Brazil's approach to issues like the crisis in Honduras, the lack of political rights in Cuba, and the use of military bases in Colombia by the U.S. This serves Brazil well in its role as an independent global player, but generates some frictions regionally.

Inflation targeting has kept inflation rates low in Brazil, Chile, Colombia, Mexico and Peru, while exchange rate flexibility has been an absorber of external fluctuations. In contrast, the extended ALBA countries either experience high inflation or are highly dollarized. However, the real differentiation between these countries is their degree of integration with world financial markets. Given the long history with default and restructuring, countries like Argentina and Ecuador have been cut-off from international lending. As a result, they must tap into every domestic resource available in order to increase public expenditures, which occurred in Argentina with the privately held pension assets.

Industrial policies are another area of interesting differences. They range from the very timid in market-friendly economies fearful of past mistakes and excesses to outright nationalization of key sectors and industries in the extended ALBA countries. However, a new paradigm has emerged in Brazil, where industrial policies have been effective in promoting the development of new sectors and leveraging the global outreach of some key Brazilian corporations. The more interesting result is the emergence of the Brazilian multinational or *multilatina* that typically has more business abroad than in Brazil, such as Gerdau and JBS. The advent of these corporations explains why Brazil is now the world's fourth largest agricultural exporter, and the world's biggest exporter of several food commodities, including beef, chicken, orange juice, green coffee, sugar, ethanol, tobacco and soya complex. Brazilian *multilatinas* are not just in agriculture, but also in construction and manufacturing, as exemplified by Odebrecht and Embraer. Led by corporations such as Vale and Petrobrás, Brazil's outward FDI surpassed inward FDI in 2006, and the stock of FDI is fourth among emerging economies.

To a large extent, these multinationals are the creation of the Brazilian state. They not only have privileged access to long-term financing from the government-owned BNDES, but they also receive subsidies in various areas, including research and development. According to a recent study by IPEA, the BNDES has outstanding loans with all the top 30 Brazilian corporations and has equity positions in 17 of them, while the partly government-owned Petrobras has equity stakes in seven of them. What is unique about Brazil is the extraordinary capacity to combine social largesse with heavy handed support to private enterprise. As Lula himself says, "It's not about ideology anymore, it's about doing things right."

Brazil's strategy is paying off. The Brazilian middle class, families earning between R1,100 and R4,800 per month, represented 42 percent of the population in 2003. Today that share is 52 percent. In a country of 191 million inhabitants this means that nearly 20 million people entered the middle class in less than a decade. By 2014, the middle class will represent more than 55 percent of the population given current economic trends. Brazil's future, in addition to high commodity prices, will be shaped by the expansion of the domestic market. Growth will be constrained by public infrastructure, especially in transport, but nonetheless will range between 5-6 percent per year.

The trends observed in Brazil will not be easy to replicate elsewhere in the region partly because state capacity and domestic demand are instrumental in creating and expanding new industries. In smaller economies, growth will rely on the expansion of resource-based exports by attracting new FDI, as in Chile, Colombia and Peru. As incomes grow in these economies, the population will demand greater financial services and other non-tradable goods and services, which will continue to grow at a faster pace than the economy as a whole. Low financial intermediation is a constant throughout the region –even after controlling for income differences. This means that in the next two decades the catch-up effect in financial services will bring interesting opportunities to this industry, especially in the context of low inflation and macroeconomic stability. These economies will try to diversify their export base by engaging in as many free trade agreements as possible. Chile leads by example with nearly 33 bilateral free trade pacts.

Mexico is an interesting case because it has experienced subpar economic growth --even before 2008- 2009 global financial crisis—despite its pro-market economic strategy. Although a full discussion of this deserves more space, the conventional wisdom is that the state monopoly in the energy sector is turning out to be a very costly strategy. Mexico needs to increase its oil production and it is clear that PEMEX cannot do the job alone. In addition, many in Mexico complain about the lack of competition in key sectors, such as telecoms, public utilities and other services. The current and past administrations have tried to reform matters, but political gridlock has prevented significant progress. More worrisome is the lack of consensus on the political reform that will improve the workings of Mexico's nascent democracy. However, Mexico's adherence to sound macroeconomic policies will please international financial markets, which will continue to provide funds to the private and public sectors at relatively low rates.

At the other extreme is Venezuela, where a freefall of its economy has started. Despite high oil prices, ongoing forced nationalizations have stamped out private capital, which is now seeking refuge in assets abroad. With the government no longer able to meet the demand for dollars, a new law was enacted last week criminalizing foreign currency transactions in the parallel market. The exchange rate is now out of control and so is inflation. In this scenario, the economy is expected to contract once again this year. However, no one expects a smooth transition of power in Venezuela any time soon. Although Bolivia and Ecuador are experiencing somewhat better economic outlooks, their demise is only a matter of time. Low private investment is eroding productive capacity in these countries, where the rule of law and the protection of property rights is also receding according the World Bank's governance indicators.

In Argentina, in order for the government to sustain high public expenditures, it needs to reach an agreement with bondholders that did not participate in the 2005 restructuring and simultaneously come to terms with the IMF on the issue of Article IV consultations. This will not mean a Greek-type program, but will bring transparency to economic policies and data. However, a shift in policies –including the return to a more market-friendly development strategy—will have to wait until the change in government in 2011.

To conclude, Latin America is rapidly becoming an attractive investment destination. Households, firms and governments are not excessively leveraged, explaining the very limited contagion in the aftermath of the Lehman debacle. The same applies to recent events in Europe, which until now have not had a significant impact on spreads on Latin American sovereign and corporate bonds. This suggests that the region is now perceived as a better asset class than a decade ago. However, countries in the region will follow divergent economic growth paths in the next few years. Some countries will consolidate growth with equity while others are heading to economic disaster, repeating a cycle of short-lived economic expansions followed by protracted contractions that is well known to Latin America.