Comité Latinoamericano de Asuntos Financieros
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Latin America´s Policy Options for Times of Protectionism

I. Latin America´s current external and domestic environment

As the Committee noted in its statement No.36, the external environment for Latin America has deteriorated markedly, reflecting worsening terms of trade, declining foreign direct investment flows, and stagnant or declining trade flows. The latter phenomenon has been consistent with global trends: after a recovery following a sharp contraction in 2009, global trade has displayed a marked lack of dynamism, especially so in the emerging market world. This contrasts sharply with the post-WWII trend, when global trade grew a sustained pace that exceeded the growth of world GDP.

The external scenario is being further affected by events that are shaping a new global political and economic context. The Brexit referendum, the views expressed by the new U.S. administration, and the rising importance of anti-globalization parties in Europe have increased global economic and political uncertainty. To be sure, the phenomenon of rising protectionism and anti- immigration attitudes in the advanced economies goes beyond the recent electoral developments in the U.S., as it reflects an underlying discontent of the middle classes in those countries. This contrasts sharply with the evidence in emerging market economies, where increased integration to international trade has resulted in higher living standards.

Rising protectionism in the U.S. is already affecting countries in the region in various ways. The U.S. has announced it will not join the Trans Pacific Partnership. According to Global Trade Alert, in the last 12 weeks ending in March 2017, the U.S. has adopted the largest number of protectionist measures in the world. The adoption of new trade restrictions (e.g., the closing of citric imports from Argentina), changes in immigration policy and higher uncertainty about the future of NAFTA have induced a significant volatility of the Mexican Peso.

A related issue that may affect U.S. relations with the rest of the world is the announcement by the U.S. administration that it will seek to implement a significant reduction in the corporate income tax, a decision that may generate incentives for companies to move away from the region, particularly Mexico. The pressure that the U.S. administration is increasingly exerting on U.S.-based companies with operations abroad (such as the well-known Carrier and Toyota cases) compounds this phenomenon.

The protectionist threat occurs at a time when the domestic macroeconomic outlook remains uncertain in a number of countries in the region. Growth performance has been lackluster in recently dynamic economies (e.g., Chile, Mexico, and Colombia), recovery from sharp recessions in Argentina (-2.6 percent in 2016) and Brazil (-3.2 percent in 2016) has been slow, recession continues in Ecuador, and Venezuela remains in a dramatic downward spiral. Moreover, the fiscal situation in several Latin American economies has deteriorated significantly, raising issues about future debt sustainability. For instance, Argentina, Brazil, and Ecuador exhibit nonfinancial public sector deficits above 8 percent of GDP. In Mexico, net public debt has increased from 30 percent to 48 percent of GDP between 2010 and 2016 with a budget deficit running at 3 percent of GDP. In Venezuela, the budget deficit reached 25.7 percent of GDP in the context of an output contraction of 10 percent.

In this scenario, increased external uncertainty may compound with already existing domestic weaknesses. Hence, the U.S. protectionist threat needs to be taken seriously. Though it is still uncertain how much of what has been announced will effectively materialize, Latin America cannot run the risk of being unprepared for the significant potential direct and indirect effects of such a menace to its exports, capital inflows, and growth.

THE PROTECTIONIST THREAT

The committee believes that the threat of U.S. adoption of protectionist policies has an important negative impact on the region's ongoing discussion on the benefits and desirability of international trade integration. The U.S. has traditionally played the role of promoter of free trade in the world economy and any backtracking paradigm could adversely influence policies in the region. Rising protectionism in the U.S. may fuel further protectionism in Latin America. This is especially dangerous as the political economy of anti-trade in the region usually reflects a capture of policy by domestic business leaders and special interest groups. Hence, rising U.S. protectionism may end up providing support to sectoral views that oppose the integration of Latin America into world markets, a process that has contributed to economic growth as well as to poverty and inequality reduction.

The potential adoption of protectionist policies by the U.S. administration may include: 1) adoption of a generalized border adjustment tax (BAT) and individualized trade restrictions (within or outside of WTO rules); 2) revision of existing trade agreements, in particular NAFTA;
3) official pressure applied to U.S.-based companies to redirect investments into the U.S. and away from other countries (particularly Mexico in the context of NAFTA); and 4) adoption of trade restrictions vis-á-vis China.

One of the most concrete announcements so far has been the creation of a commission that will soon propose the enactment of a BAT. Some have argued that imposing such measure—which may be viewed as a real devaluation—may be neutralized by an appreciation of the U.S. dollar. However, it may still be a way to meet two goals: honor protectionist promises and reduce the fiscal cost of adopting aggressive tax cuts for corporates (another campaign promise). However, this prediction of full neutrality lacks empirical support and reflects a narrow focus on the determinants of the exchange rate.

The committee believes that imposition of a BAT would not be neutral, not least because of doubts about its permanence, and would hurt Latin American exports to the U.S., whether protected or not by a free trade agreement. It could have additional serious effects on the region through its effects on growth, especially if it leads to defensive measures by countries in the region. The worst scenario, though improbable so far, would be that the application of trade restrictions leads to a generalized trade war. Such a development would, in the committee's view, increase the risk of a sharp reduction in capital flows that would compound the adverse effects of a reduction in trade flows.

The committee believes that implementation of a BAT may face significant opposition within the U.S. In particular, the modern structure of international trade, increasingly organized through global value chains, suggests the BAT's incidence may ultimately be uneven across firms and, hence, disruptive to U.S. international businesses (e.g., the Walmart case). In this context, the committee believes that the BAT is likely to have a bias in favor of incumbent global value chains. Hence, new entrants and countries that are less integrated to global value chains that do not include U.S. production may be more vulnerable to the enactment of a BAT. In that respect, Latin America is one of the world's regions that have integrated the least to global value chains (apart from more traditional value chains based on natural resources) and, where, the recent lack of dynamism in trade has been more apparent.

A reduction in trade with the advanced economies, and in particular with the U.S., may entail significant costs for Latin America. This reflects the fact that gains from trade, covering a wide array of factors, such as faster transfer of technology and improvements in input quality—in particular of capital goods—would be reduced or lost. Trade benefits domestic production processes, and provides incentives that attract foreign direct investment (FDI). FDI from advanced countries to emerging market economies related to global trade not only contributes directly to economic growth but also to institutional quality and corporate governance.

However, Latin America's history shows that not all FDI has the beneficial effects noted above. If governments attract FDI by means of excessive privileges, special tax treatments and protection of domestic markets, FDI may become as inefficient as the highly protected domestic sectors. In this case, FDI flows respond more to the recipient countries' lack of financing than to a desire to acquire technological progress and increase the economy's productivity.

The U.S. administration has already announced its intention to revise NAFTA. Such revision may be very complex in practice as the competitiveness of several U.S. industries (such as the automotive, medical equipment and computers industries) would be jeopardized.[1] Further, though the U.S. President possesses legal authority to take the U.S. out of NAFTA it is yet unclear whether any intended modifications require Mexican and Canadian acceptance and/or congressional approval in the U.S.

Still, the U.S. administration may be inclined to believe that protectionism may reinforce the current U.S. recovery, though this is not a foregone conclusion in a world where trade is dominated by global value chains. The stakes are very high for Mexico given its strong economic dependence on U.S. trade, investment, and financial flows: nearly 78 percent of Mexico's exports go to the U.S., and nearly 53 percent of Mexico's FDI comes from the U.S. ($101 billion in 2013).

Indirect effects to Latin America of eventual protectionist actions could be especially severe if the U.S. applies significant trade restrictions to China, as this may exacerbate current Chinese financial fragility and slowdown trends. Although the U.S. administration has already backed down on some of its initial positions (e.g., about strengthening links with Taiwan in defiance to China´s "one country" stance), it could happen that an eventual renminbi depreciation reflecting growing financial instability and capital outflows in China could be interpreted as "currency manipulation" and give rise to U.S. trade retaliations. A resulting worsening of the Chinese slowdown would hurt Latin American exports to China, leading to slower growth including via lower than otherwise commodity prices.

In addition, slower Chinese growth and lower commodity prices would also impact adversely Latin American capital inflows. The recent experience in 2013 and 2014 shows that the fall in commodity prices led to a sharp drop in FDI inflows in oil and mining exporting countries in South America. It also led, in some countries, to a (temporary) increase in sovereign risk and

[1] U.S. manufacturing industries, including automotive, electronics, appliances, and machinery, all rely on the assistance of Mexican manufacturers. One report estimates that 40 percent of the content of U.S. imports from Mexico and 25 percent of the content of U.S. imports from Canada are of U.S. origin. In comparison, U.S. imports from China have only 4 percent U.S. content. Taken together, goods from Mexico and Canada represent about 75 percent of all the U.S. domestic content that returns to the United States as imports. The North American Free Trade Agreement (NAFTA), U.S. Congressional Research Service, Villareal and Fergusson, 2015

fall of capital inflows due to reduced growth prospects, though this effect was partly counteracted by the continued world's ample liquidity. If, as expected, monetary conditions in the U.S. and Europe tighten, such compensatory factor may no longer be present in the future.

II. What are Latin America´s policy options to face the challenges and mitigate the risks?

As mentioned above, though it is still uncertain how much of the protectionist threat will become a reality, Latin America cannot run the risk of being unprepared for the significant potential direct and indirect effects on exports, capital inflows, and growth. Priority should be given to actions that would benefit Latin American economic growth in any event. On the one hand, the impact of rising protectionism can create social and political tensions that can widen the space for policy mistakes. On the other hand, it can create opportunities to broaden economic and financial integration outside the U.S. economy. The region's response must avoid self-defeating actions and seize opportunities proactively.

The committee recommends that policy implementation maintains a long-term perspective and resist alternatives that may seem reasonable from a short-term perspective, but can alter medium and long term sustainability, as has occurred in the past. In this sense, the committee considers that retaliation in the face of protectionism has always been and continues to be a very poor and very costly policy choice. However, the committee believes that the region should prepare itself to collectively counteract, jointly with countries in other regions, eventual U.S. protectionist measures within the WTO and other international organizations and fora.

Similarly, if regional economic growth indeed continues to underperform, policymakers may feel tempted to implement measures that presumably compensate domestic producers for the advantages granted to their foreign competitors by their governments. For instance, an important reduction in the corporate income tax rate abroad may elicit calls for an equivalent reduction in the domestic corporate tax rate or other fiscal stimuli, for instance through the financial sector. Regional policy makers must evaluate these proposals very carefully because fiscal sustainability might be compromised and, perhaps more importantly, because it may perpetuate inefficiencies and low productivity traps.

The committee believes that it is hard to envision strong growth without trade. However, Latin America displays a low level of trade openness and very low intra-regional trade. This is the case for South America, and in particular Mercosur countries, as Mexico, Central America, and the Caribbean are significantly more open. Central America and the Caribbean also display higher levels of intra-regional trade. Mexico, Central American, and Caribbean countries are those that would suffer the most from increased U.S. protectionism as the U.S. represents a higher share of their export markets.

Several studies suggest that a low level of trade openness is a serious impediment for higher productivity and economic growth, particularly when countries are not integrated to global value chains.[2] At the same time, it must be recognized that the process of international trade integration has significant adjustment and distributive costs that require compensating policies. To maximize its benefits, an opening process needs to be designed placing emphasis on factors that maximize acquisition of knowledge, transfer of technology, and contribution to value chains that incorporate domestic capital.

Strengthening Latin America's economic ties with Europe and Asia

Some countries in the region already have preferential trade agreements with the European Union, such as Chile, Mexico, Colombia, Peru, Ecuador, and the Central American Common Market countries. The Mercosur countries and the EU have been negotiating, intermittently, a free trade agreement for many years. However, these trade agreements have tended to be more restrictive than those signed with the U.S., reflecting the fact that the U.S. had a more open trade policy than the EU. If U.S. protectionism rises, it is likely that the EU will seek more aggressively to negotiate new trade agreements and be interested in deepening existing ones.

This is not surprising as for the EU deepening economic ties with Latin America and Asia now does not only represent a defensive move to partially compensate (though much less than for Latin America) the effects of eventual U.S. protectionist measures (such as the imposition of a BAT), but an opportunity to increase their exports, FDI, and geopolitical influence in these regions at the expense of eventually declining U.S. economic flows and influence.

The committee believes that Latin America should take advantage of this opportunity. Mexico and the EU are already negotiating the "modernization" and deepening of their free trade agreement, given that the stakes of the protectionist threat are higher for Mexico than for the rest of the region. The committee recommends that other countries in the region should follow this lead, making sure that the EU becomes more open to agricultural products from the region.

Similarly, several Latin American countries have also signed bilateral free trade agreements with Asian countries.3 The authorities of several Asian countries have also voiced their intention of deepening their economic relations with other regions as a response to U.S. protectionist threat.

The Chinese are seeing this as an opportunity to expand and strengthen their economic ties and geopolitical influence in other regions at the expense of the U.S. Prime Minister Xi has emerged

[2] Faundez, Sebastian; Mulder, Nanno and Carpentier, Nicole (2011). "Productivity growth in Latin American manufacturing: what role for international trade intensities?" ECLAC, November 2011. Pages, Carmen (2010). "La era de la productividad: cómo transformar las economías desde sus cimientos" Desarrollo de las Américas, BID.

[3] In particular, Chile has trade agreements with Japan, Korea, and China; Peru with Korea and China; México with Japan; and Costa Rica with China. Generally, these trade agreements have been more restrictive than those signed with the U.S. Chile, Peru and México are members of APEC and were partners to the TPP.

as the main advocate of globalization vis-á-vis the U.S. protectionist threat. The committee believes that this may open important opportunities for Latin America, provided China is more willing than in the past to open its domestic markets.

Strengthening regional economic integration through open regionalism

Another direction in which Latin America should move is in deepening intra-regional economic relations within the concept of open regionalism. That is, avoiding past mistakes when regional economic integration was seen as substitute for global integration.

Indeed, the orientation of some of the sub-regional integration schemes have been moving in the direction of open regionalism, e.g., CAFTA-DR agreements with the U.S. and the EU, in addition to some bilateral agreements. The Pacific Alliance (currently comprising Chile, Colombia, México, and Peru, but open to potential new members) was, since its inception, inserted in an open regionalism context, with a vision of "deep" integration that goes beyond trade liberalization, including convergence towards a common regulatory framework.

However, trade agreements in the region are incomplete. For instance, trade agreements between Mercosur and the Caribbean and Central America are almost non-existent. As are those between the Andean countries and the Caribbean and Central America. The committee believes that new trade agreements should be designed to increase coverage, uniting sub-regional groups that are not linked, and reducing gaps (missing links) within sub-regional groups.

Additionally, the current "spaghetti bowl" of trade agreements should be greatly simplified, particularly by harmonizing rules of origin and allowing their accumulation, as already done by CAFTA. In this respect, Mercosur rules of origin remain extremely complex and act as a deterrent to regional trade integration.

In connection to deeper economic integration, the committee recommends policymakers in the region to focus their efforts on coordinating regional logistics, and optimizing the infrastructure networks of ports, railroad, road, and energy. An important aspect of this process is the harmonization and coordination of customs requirements, particularly those related to transport logistics (e.g., establishing a single passport for trucking logistics). Integration and standardization should also extend to the regulatory environment to facilitate, for instance, the transfer of energy across countries in Latin America. All these initiatives have the objective of building important regional goods that have not been a sufficiently explored by policymakers in the region.

Further, President Bachelet's proposed Mercosur-Pacific Alliance convergence may for the first time have some real possibilities of success, given the recent changes in the orientation of trade and financial policies in Brazil and Argentina. This may be a long-shot objective given that Mercosur is significantly more closed to trade than the Pacific Alliance. However, the committee believes that the opportunity emerging from the new political landscape, and the incentives provided by both the region's current economic slowdown and the new protectionism threat, should not be wasted. Rather, it should jumpstart a pragmatic and expeditious process of conversations oriented towards a Mercosur-Pacific Alliance convergence within the concept of open regionalism.

There is already a significant process of regional financial integration going on through cross-investments in banking and insurance. This has been reinforced by the fact that some large international players have withdrawn from the region due to re-structuring efforts occurred after the global financial crisis of 2009, and the effects of Basle III agreements. This has prompted, in turn, some incipient efforts towards harmonization of regulations and cooperation in supervision, particularly between the CACM and Colombia. Such initiatives become crucial both to facilitate and make more efficient the current process of cross-border investments and provision of financial services, but also to make it safer by reducing opportunities of regulatory arbitrage and the possibilities of mutual financial contagion.

Although more difficult to achieve due to the lack of a common currency, there could be significant potential value in increasing further capital market integration, given the presence of economies of scale and the need of opportunities for risk diversification that characterize these markets. This is especially relevant if, as expected, international financial conditions tighten in the coming years making it more difficult for local firms to finance their investment projects and for some local investors to diversify and lower their portfolio risk.

Such initiatives may be especially important to increase long-term financing in areas such as infrastructure, where the region badly needs stepping up its efforts. And it could be especially important for the risk-diversification and growth of institutional investors, such as national pension funds and insurance companies, as well as for the development of regional mutual funds and higher investments of international portfolio investors in our region, as discussed in studies by the IMF (2017) and Wilson Center-IDB (2016).[4] [5] It seems to be the right moment to also pursue this Agenda.

Macro-prudential and monetary policy response

As it was discussed in the previous section, a rise in U.S. protectionism may generate retaliations from other countries, with the risk of generating a trade war. Such a scenario may imply conditions favorable to the emergence of an eventual reversal in capital flows to the region.

Given this contingency, and the current situation of ample international liquidity and low interest rates, the committee believes that policymakers should be especially vigilant about the presence of significant and transitory incentives for carry-trade and other short term inflows. In such context, the committee believes that macro-prudential policies, e.g., countercyclical reserve requirements, dynamic provisioning, taxes on short term foreign currency borrowing by banks, may be better than monetary policy to deal with this potential problem. This is, instead, a good moment to strengthen the external liquidity position and lengthen the maturity of public debt. Notwithstanding, the committee also believes that, in countries where central banks have space to lower interest rates without compromising their credibility, policy rates should be reduced to weaken the incentives to undertake carry trade.

[4] Perry and Auvert (2016).
[5] Eyraud, Singh and Sutton (2017).

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