EmNet Meeting Policy Note: May 2014

Latin America: Facing a New Economic Cycle? Prospects for Policies and Business Strategies in an Evolving Global Context

The general outlook: the good news and the bad news for Latin America

Overall, **2014 brings good news to advanced economies**, underpinned by supportive financial conditions and reduced fiscal drag. This is especially the case for the United States and the United Kingdom where recovery is advancing; not so in Japan and the euro area[1]. Global GDP growth, should reach 2.8% in 2013 and 3.4% in 2014, according to OECD forecasts. **Risks have shifted to emerging economies**, in particular China where growth was below the emblematic 8% in 2012 and 2013. This triggered again the debate over a potential hard landing or on whether China would get stuck in the middle-income trap. The **Chinese slowdown**, which also reflects the government's priority to rebalance growth, has had an impact on commodities prices and led many experts to declare the **end of the commodities supercycle in 2013**[2].

The upcoming normalisation of monetary policy in the US has also sparked expectations of capital outflows from emerging markets as investors turn back to advanced economies[3]. This marks the end of "easy money" for many emerging countries. As pointed out in a previous EmNet meeting on Asia, capital outflows are expected to be larger in countries with deteriorating fundamentals and credibility concerns with regards to policies implemented in the past years. This leads to a **growing differentiation between emerging markets**, and this discriminative approach by investors is likely to affect Latin America as well[4]. As a result, **Latin America faces a series of risks that can impact the region's financial conditions, macroeconomic stability and public revenues**. Since May 2013, with the announcement of tapering, capital flows and exchange rates have experienced increased volatility.

Although Latin America has enjoyed solid growth over the past years – an average annual rate of 4.0% between 2003 and 2012[5] in spite of the contraction brought about by the financial crisis of 2008-2009 –, the **combination of increased financial volatility and declining commodities prices** (notably metals) linked to the slowdown in China have casted a shadow over the region's prospects. In 2013 GDP growth averaged around 2.6%[6], and 2.2% for 2014[7].

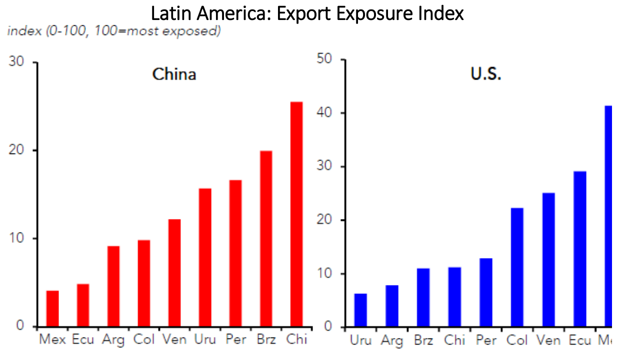
Latin America: Regional and Selected Countries Outlook

	2013	2014	2015
GDP growth (%)			
Brazil	2.5	2.2	2.5
Chile	4.2	4.5	4.9
Mexico	1.2	3.8	4.2
LAC	2.7	3.1	3.5
Consumer price inflation (%)			
Brazil	5.9	5.0	5.1
Chile	2.0	2.9	3.0
Mexico	3.8	3.0	3.1
LAC	6.7	6.5	6.0
Current account balance (% of GDP)			
Brazil	-3.6	-3.3	-3.2
Chile	-3.3	-3.8	-3.6
Mexico	-1.8	-1.1	-0.7
LAC	-2.4	-2.4	-2.5

Source: For Brazil, Chile and Mexico: *OECD Economic Outlook*, November 2013. For LAC: *IMF World Economic Outlook*, October 2013.

Source: Latin America's challenge, *OECD Observer*, Q4 2013

Latin America: Export Exposure Index



Source: IIF based on UN Comtrade, national sources.

Source: IIF, Latin America: We're Not in Kansas Anymore, March 2014

In particular, **countries structurally reliant on commodities (with the exception of oil and food) exports and with a strong trade exposure to China**, such as Chile, Brazil or Peru, are being **affected through the trade channel**. On the other hand, **countries more exposed to the US market** (which absorbs 35% of the region's exports) **should benefit from the recovery**, especially Mexico which directs 80% of its exports to the US, as well as oil exporters like Colombia, Ecuador and Venezuela[8].

Latin American policymakers will have to manage weaker fiscal and external positions, implement credible policies to maintain financial stability and avoid the worst scenario of a sudden stop in capital flows. Another challenge will be to **avoid an abrupt drying of credit after several years of strong credit expansion, which could lay the ground for banking and financial crises** as experienced in the 1990s, with dire consequences on the real economy.

In spite of the grimmer external context, Latin American economies can capitalize on **increasingly dynamic domestic markets thanks to the emergence of middle classes**. Indeed, the golden decade has allowed a substantial reduction in absolute poverty, from 33% in 2002 to 22% in 2010[9]. **The middle class, which represented 29% of the Latin American population in 2009, should reach 42% by 2030**[10]. Higher consumption levels boost domestic demand, which will keep bringing opportunities for local and foreign businesses if the right policies to shelter the middle classes and incentivise job creation are implemented.

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1 OECD Economic Outlook, May 2014
2 Synthesis of the EmNet Session on Global Trends in Energies and Metals: Fueling Growth?, October 2013
3 World Bank, Capital flows and risks in developing countries, *Global Economic Prospects*, January 2014
4 BBVA, Latam: increased differentiation, February 2014
5 OECD Development Centre, Latin American Economic Outlook 2014. Logistics for Competitiveness and Development, November 2013
6 Christian Daude, Latin America's challenge, *OECD Observer*, No 297, Q4 2013
7 Consensus Forecasts, Latin America Consensus Forecasts, April 2014
8 OECD Development Centre, Latin American Economic Outlook 2014. Logistics for Competitiveness and Development, November 2013
9 Christian Daude, Latin America's challenge, *OECD Observer*, No 297, Q4 2013
10 World Bank, Economic Mobility and the Rise of the Latin American Middle Class, 2012

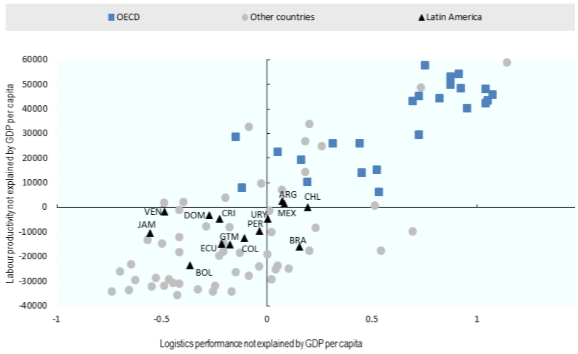
Working towards greater productivity and competitiveness

This less favourable economic environment is likely to **expose persistent structural weaknesses** in many Latin American countries, in particular **where the spillovers between the commodities sector and the rest of the economy are weak**. To foster inclusive growth, **countries need to move towards better diversified production structures** more reliant on technology, innovation and knowledge in order to bolster productivity. Indeed, low productivity is one of the main factors preventing the region from creating more value added and achieving sustained growth. **The productivity gap between most Latin American countries and the more developed countries is still increasing**, whilst Asia's productivity gap has closed. Latin America lags far behind in indicators related to the sophistication of its production, such as technological effort, knowledge intensity and the adaptability of its exports, which are fundamental for promoting structural change. A key component of the **structural change needed by Latin America involves transferring labour from low-productivity sectors** that tend to have high levels of informal employment **to higher-productivity businesses that can generate production linkages and knowledge spillovers**.

Against this backdrop, **policymakers in Latin America in general have shown a renewed interest in "industrial policies"**, following the successful experiences of Asian countries which were driven and steered by the public sector during most of their economic transformation. The return of industrial policy in the region must be backed by full legal support and complementarity of different policies in the areas of **infrastructure, innovation, education and skills, labour markets, investment and trade**.

The development of industrial policy and promotion of productivity require improvements to logistics, which encompass a range of key elements for production and trade, and is defined as all the services and processes needed to transport goods and services from the point of production to the end consumer. There is a significant association between improved logistics performance on the one hand, and productivity gains and greater sophistication of exports on the other and **improvements to logistics services could substantially boost labour productivity in the region**[11]. And there is an urgent need for progress: in Latin America, logistics costs are almost nine times larger than tariffs. Modifying rules and regulations to enable more effective use of current infrastructure is also needed. For example, single-window facilities for foreign trade can reduce time and logistics costs.

Logistics and economic performance: Partial correlations



Source: OECD Development Centre, Latin American Economic Outlook 2014. Logistics for Competitiveness and Development, November 2013

EmNet Meeting Highlights
The Reform Agenda in selected countries

- **Chile**'s per-capita GDP has more than doubled over the last 25 years, allowing a substantial reduction in poverty, from 38% in 1990 to 11% in 2011. However, the country still faces a massive social inequality challenge, with the highest Gini coefficient among OECD countries. The country is going through a period of adjustment due to declining commodities prices, in particular copper, potentially eroding its fiscal revenue. To face the fiscal and social challenges, two areas of reform were identified by the new government: **taxation and education**. The **tax reform** aims to collect 3% of GDP by 2018 to finance the education reform and to converge to a structural fiscal balance by 2018. The government will put in place mechanisms to reduce tax evasion. The reform is also aims at stimulating savings and investment. **The education reform** will focus on access and quality, starting from early education by allowing free access to nursery school to 60% of the poorest population. Free general and high education will be gradually implemented over the next six years and training of teachers will be strengthened. New universities will be open in regions that do not have, and technical institutions will be created in all regions.

- In **Colombia**, macroeconomic stability and recent structural reforms approved have boosted economic growth. However, challenges remain to **increase productivity and reduce inequalities**. Historical credibility of monetary and fiscal policies have allowed to the Colombian economy to reduce progressively the inflation rate and to guarantee fiscal solvency. In particular, today the inflation rate at below 3% is under control and inside the inflation target. The **use of a fiscal rule will avoid procyclicality**. Also, the new **royalties system** allows a better redistribution of natural resources across provinces. In addition, a **tax reform** has contributed to reduce Non-Wage Labour Costs (NWLC), favouring the future creation of formal jobs. However, the macroeconomic consolidation achieved by Colombia needs to improve further inclusive growth. The role of **infrastructure** in helping closing productivity and inequalities remains crucial and more investment is needed. Furthermore, improving the quality of **education** remains a challenge to match the skills needed in the labour market. The integration of Colombia in the **Pacific Alliance** is considered as a great opportunity to further plug the country in regional and global value chains.

- **Mexico** is implementing its ambitious **reform package** to improve productivity and competitiveness. The government has undertaken major steps, in particular in liberalising the **telecommunications and energy sectors**. The energy reform is expected to stimulate foreign investment (especially in petrochemicals) and should provide cheaper energy for the manufacturing sector, with a positive impact for job creation. Cheaper prices in the telecom sector will allow a wider access to technology for the population. The **judicial system** is also undergoing change, with new requirements of transparency and efficiency. The impact of the reforms on medium-term GDP growth is evaluated at 2 percentage points, allowing a future 5% growth instead of 3.5% if the reforms were not implemented.

EmNet Meeting Highlights
Key Messages from the Business Sector

- **The lack of infrastructure** ranks among the most important bottlenecks to improve productivity and competitiveness. It hinders private sector development and increases costs for small as well as big firms. To effectively address this challenge, Latin America should invest more in infrastructure, from 3% of the region's GDP to 5-7%, representing between 200 and 250 billion USD per year. To attract long-term private investment in infrastructure, sound regulatory frameworks are needed, as well as a clear definition of the extent of involvement of the public sector to reduce uncertainty.

- Latin American countries need to **unleash their human capital, through better education and training**. Demographics are not the problem, yet companies find it hard to hire the people they need because of a skills mismatch. For instance, according to Manpower Group's Talent Shortage survey, employers in the Americas are having more trouble filling jobs than the global average, with 37% of employers reporting difficulty filling positions due to lack of available talent. In Brazil this rises to nearly six in ten employers, while in Mexico 42% are having difficulty filling jobs. These figures show that Latin America needs to develop the talent and skills to create a globally competitive workforce. This entails strengthening the quality of education, and improving the coordination between governments, education institutions, businesses and families to design better education policies and training strategies.

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[11] OECD Development Centre, Latin American Economic Outlook 2014. Logistics for Competitiveness and Development, November 2013