A special report on Latin America

So near and yet so far

A richer, fairer Latin America is within reach, but a lot of things have to be put right first, says Michael Reid.

AT DAWN on September 16th 1810 Miguel Hidalgo, the parish priest of Dolores, a small town in central Mexico, rang the bells of his church to raise the cry of rebellion against the Spanish crown. Mexico, Spain’s richest American colony, thus joined a struggle for independence which had already seen the colonial authorities ousted and rebel juntas installed in Caracas, Buenos Aires and other South American cities. Two years earlier, following Napoleon Bonaparte’s invasion of the Iberian peninsula, King João VI of Portugal and his court had been installed in Rio de Janeiro by a British fleet. Brazil would never again be governed from Lisbon.

As Latin America marks the bicentenary of the start of its struggle for political independence, many of its constituent countries have more recent cause for celebration too. The five years to 2008 were Latin America’s best since the 1960s, with economic growth averaging 5.5% a year and inflation generally in single digits. Even more impressively, a region which had become a byword for financial instability mostly sailed through the recent recession. After a brief downturn in late 2008 and early 2009, a strong recovery is now under way, with most forecasts suggesting economic growth of over 5% this year for the region as a whole.

Along with growth came a better life. Between 2002 and 2008 some 40m Latin Americans, out of a total population of 580m, were lifted out of poverty, and income distribution became a bit less unequal almost everywhere. Poverty increased in 2009 because of the recession, but will start declining again this year. Average unemployment went up slightly to 8.2%, but should come down again this year to 7.8%, according to the United Nations Economic Commission for Latin America and the Caribbean (ECLAC).

Latin America weathered the recession partly thanks to good fortune but also to sound policies. After the cataclysmic debt crisis of 1982 the region’s policymakers abandoned the protectionism and fiscal profligacy that had brought hyperinflation and bankruptcy. In their place they adopted the market reforms of the Washington Consensus (opening up their economies to trade and foreign investment, privatisation and deregulation).

But they found the road to stability and faster growth a long and bumpy one. During a second bout of instability, from 1998 to 2002, the region introduced more pragmatic policies. The formula has generally included flexible exchange rates, inflation-targeting by more or less independent central banks, more responsible fiscal policies and tighter regulation of banks, as well as social policies aimed at the poor. The recession was an important test. Last year “may have been the final exam and the graduation party” after Latin America’s lengthy education in getting macroeconomic policy right, says Santiago Levy, the chief economist at the Inter-American Development Bank (IDB).

The region’s newfound economic stability and social progress also owes much to the fact that over the past 30 years democracy has become established almost everywhere. Nearly all elections are now free and fair. The big exception remains the gerontocratic dictatorship of the Castro brothers in Cuba. There are threats to democracy in some other places: last year a coup toppled an elected government in Honduras, and opponents of the governments in Venezuela and Nicaragua face growing harassment and intimidation. But broadly speaking Latin America today is more democratic than ever before.

Latin America's new resilience and faster growth is starting to attract increased interest from outsiders. That is especially true of Brazil, now often perceived to be in a league of its own. That is only partly because Jim O'Neill, an economist at Goldman Sachs, did it a huge favour when in 2001 he bracketed it together with Russia, India and China as one of the BRICs which would dominate world economic growth over the coming decades. Another reason is Brazil's sheer size: with a population of 191m it accounts for a third of Latin America's total and 40% of the region's GDP. Since 2007 Brazil has begun to grow faster than the regional average—although by common consent its red-hot pace of 11% in the year to March 2010 will subside to less than half that rate next year.

As multinationals face mounting difficulties in China, some bankers and businessmen are looking at Latin America—and not just Brazil—as an alternative. The region has 15% of the world's oil reserves, a large stock of its minerals, a quarter of its arable land (much of it unused) and 30% of its fresh water. Mexico, its other giant, with almost 25% of its GDP, suffered a deeper recession in 2009 and is struggling to deal with violent drug gangs, but it has maintained economic and political stability. Like the big two, Chile, Colombia, Panama and Peru have investment-grade credit ratings, and all four are growing fast. Governments, households and companies in all these countries are less indebted than those in many developed countries.

Already, Latin America takes a quarter of the total exports of the United States and around a fifth of its outward flow of portfolio investment. Total bank credit in the region will grow by about 12% a year over the next few years, faster than anywhere except China and India, reckons Manuel Medina Mora, who heads Citibank's Latin American operations and its global consumer-banking business. Its share of the market capitalisation of publicly quoted companies and assets under management is only 3-5% of the world total but growing at 25% a year, faster than anywhere else, according to Paulo Oliveira of Brain Brasil, a body set up to promote the country as a business hub.

Marketing people are beginning to talk about a "Latin American decade". If the region can keep up the growth of the past few years, it will double its income per person by 2025, to an average of $22,000 a year at purchasing-power parity. By then Brazil may be the world's fifth-biggest economy, behind only China, the United States, India and Japan. Half a dozen countries may have achieved developed-country status, with an income equivalent to Spain's today.

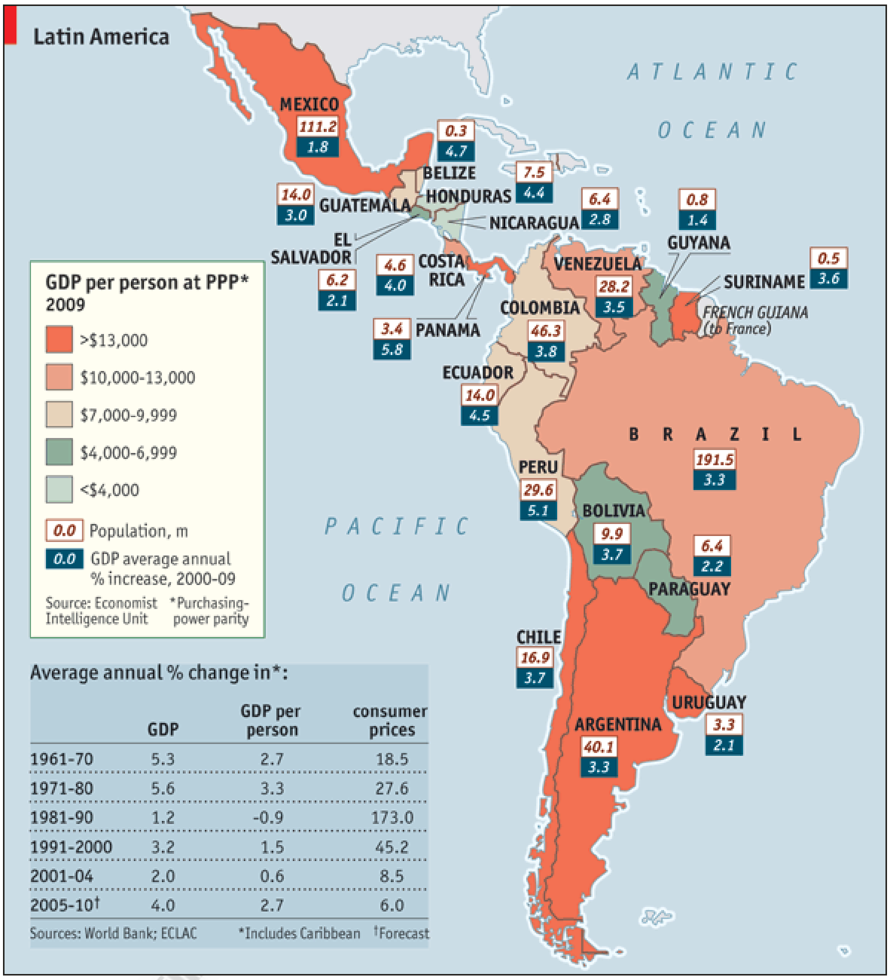
Causes for caution

Some Latin American countries may at last have found a path towards economic development. But getting there may be no quicker or easier than achieving independence. Latin America has often flattered to deceive (see article). Today there are at least three big worries. First, since 1960 it has seen the lowest growth in productivity of any region in the world, not least because around half of all economic activity takes place in the informal sector. Second, despite some recent improvement, its income distribution is still the most unequal anywhere. This has acted as a drag on growth and caused political conflict. Third, it suffers from widespread crime and violence, much of it perpetrated by organised drug gangs. The murder rate is hideously high in some countries.

A problem for any report such as this one is that Latin America is so diverse as to defy most generalisations. For some purposes it includes the small English-speaking island-states of the Caribbean. Haiti's problems were more akin to Africa's even before its devastating earthquake. On the other hand, some Brazilians argue that their country—differentiated by speaking

Portuguese and, until recently, geographically isolated from its neighbours—is not really part of Latin America.

Income per person also varies widely, from $15,300 in Panama to $2,900 in Nicaragua (see map). And there is an ideological divide too. Venezuela's Hugo Chávez and the Castro brothers in Cuba reject integration with the world economy in favour of state socialism and managed trade. Their economies have suffered for it: Venezuela's economy has become a lasting casualty of the recession, despite the swift recovery in the oil price.



Average annual % change in*:

	GDP	GDP per person	consumer prices
1961-70	5.3	2.7	18.5
1971-80	5.6	3.3	27.6
1981-90	1.2	-0.9	173.0
1991-2000	3.2	1.5	45.2
2001-04	2.0	0.6	8.5
2005-10†	4.0	2.7	6.0

Sources: World Bank; ECLAC *Includes Caribbean †Forecast

So there are differences. But there are clear trends, and an identifiable majority. Mr Chávez, for instance, has his allies but very few want to embrace fully his brand of economic mayhem. Rafael Correa in Ecuador is discreetly distancing himself. Evo Morales in Bolivia has pursued a prudent macroeconomic policy at the same time as launching a collectivist experiment under which people of indigenous descent are being granted special rights. Despite the efforts of its first family, the Kirchners, Argentina retains a vigorous private sector.

This report will concentrate mainly on the region's larger countries that have embraced globalisation: Brazil, Mexico, Chile, Colombia and Peru, which between them represent three-quarters of Latin America's GDP and more than 70% of its people. They have all recently enjoyed a huge bonus: the world commodity boom that began earlier this decade as China and India sucked up foodstuffs and raw materials.

Two centuries of hopes and fears

A history of disappointment

OVER the past two centuries Latin America has seen bursts of exaggerated optimism interspersed with long periods of disappointment. It was the original “emerging market” long before the term was invented. Indeed, at the time of its first centennial celebrations in 1910 parts of Latin America seemed to have emerged already. Argentina was one of the world’s ten richest countries; in Mexico guests from around the world took part in lavish banquets organised by Porfirio Díaz to celebrate more than a quarter of a century of stability under his constitutional dictatorship.

But only weeks later the Mexican revolution broke out and was to last a decade. Argentina, for its part, started a long decline from 1930 onwards. Brazilian leaders in the 1950s and then again in the 1970s claimed that their country had taken off, only to see it engulfed by economic turmoil both times.

All in all, the record of the past 200 years has been dispiriting. Income per person in Latin America around 1750 appears to have been broadly similar to that in the future United States, but then an enduring gap opened up. By 1820 the figure had slipped to only about half that in the United States, and by 2000 it had dropped to little more than a fifth, according to the late Angus Maddison, an expert on economic history. Even more galling, over the past four decades many Asian countries have begun to close their income gap with the United States.

What caused the gap with the United States to widen was a pair of disastrous periods for Latin America. The first was from 1810 to 1870. The independence struggle in Spanish America (though not Brazil) was far longer and bloodier than in the United States, and the new states took much longer to achieve political stability.

Between 1870 and 1930—the first great period of globalisation—Latin America did reasonably well, slightly narrowing the income gap with its northern neighbour. But it fell behind again from 1970, mainly because of bad policies, just when Asia began to forge ahead. Latin America took state-led industrialisation behind tariff barriers to extremes, financing it with debt when the oil-price rises of the 1970s slowed the world economy. After adopting liberal economic reforms, the region has begun to narrow the income gap with the United States once again, clearly so since 2003.

The causes of Latin America’s relative failure to develop are the subject of intense ideological debate there today. Popular explanations have included a difficult geography, the cultural legacy of Iberian Catholic corporatism and, as Venezuela’s Hugo Chávez argues, exploitation by outsiders and especially the United States. But many serious scholars now blame the region’s extreme and persistent inequalities, which went hand in hand with political instability, poor policy choices, weak institutions and the undermining of the rule of law.

It's only natural

Commodities alone are not enough to sustain flourishing economies.

IT MAY seem a safe bet that billions of Asians will continue to gobble up oil, iron ore, copper, soyabeans and meat as they get richer. But one day they may not; and one day, too, the world will surely come up with alternatives to fossil fuels that emit less carbon. Indeed Brazil already has, in the form of ethanol from sugar cane, and Colombia and Central America are following suit.

Latin America is uncomfortably dependent on commodities. In the past decade they accounted for 52% of the region’s exports, according to the World Bank. That is down from 86% in the 1970s, but over the same period the figure in East Asia and the Pacific fell from 94% to 30%. Chile, Peru and Venezuela still rely on raw materials for more than three-quarters of their total exports. In all, as the World Bank notes in a report published this month, more than 90% of Latin Americans live in countries that are net exporters of commodities, the exceptions being in Central America and the Caribbean. Governments have also become more reliant on raw materials for their tax revenues (see chart 1).

There is nothing wrong with producing raw materials. The rise in world prices for Latin America's commodities, and the related increase in their output, may have accounted for between one-third and half of the region's growth over the past decade. And thanks to Asia's economic vigour, commodity prices fell only briefly during the recession and remain at historically high levels. Over the past decade a region that has habitually suffered from balance-of-payments troubles has benefited from the foreign exchange that commodities bring in. This bonanza seems to refute the thesis put forward by Raúl Prebisch, the founding director of ECLAC, that the price of commodities is bound to decline in relation to the price of manufactured goods.

Even so, relying on raw materials carries a series of risks. One is volatility: their prices are more variable than those of manufactures. Second, many economists worry about "Dutch disease", a term coined by this newspaper in 1977 to describe the impact of a North Sea gas bonanza on the economy of the Netherlands. This malady involves commodity exports driving up the value of the currency, making other parts of the economy less competitive, leading to a current-account deficit and even greater dependence on commodities. This matters all the more because mining and hydrocarbons are capital-intensive businesses, generating relatively few jobs.

The commodity boom, together with capital inflows attracted by better economic prospects, has already pushed up the value of some of the region's currencies. For example, São Paulo seems extraordinarily expensive to any visitor. The strength of the Brazilian currency, the real, worries officials and industrialists.

A third concern is that many non-agricultural commodities are not renewable (although high prices encourage new discoveries), so governments should invest the tax revenues they generate in infrastructure and training to diversify the economy. Producing commodities may also involve local environmental damage. In parts of Latin America mines and oilfields are in areas inhabited by people of indigenous descent and have caused cultural clashes.

A fourth problem is the potentially corrosive effect of commodity production on political institutions. Many commodities incorporate rents (ie, excess profits derived from the fact that supply is usually limited in the short term). It is in the state’s interest to capture those rents, but corruption often follows when it does. Mines and oil- and gasfields often involve high sunk costs and low variable costs, making them a tempting target for expropriation. Venezuela provides the clearest evidence of these ills.

Given the risk of price volatility and depletion, it is sensible to save some of the bonanza from commodities for a rainy day. That is what Chile has done. The price of copper, its main export, has been high for the past few years, allowing the country to accumulate $20 billion, equal to about 12% of GDP, in a stabilisation fund by the end of 2008. It was able to draw on this fund to pay for a big fiscal stimulus, equal to about 3% of GDP, during the recession. On a smaller scale, Mexico, Peru and Bolivia too have saved part of their windfall gains from high commodity prices. Brazil’s Congress is considering a bill under which part of the revenues from big new deep-sea oilfields will be placed in a special social fund. But most of the money will be spent on education and anti-poverty programmes rather than saved.

Where innovation flourishes

Agriculture in Latin America shows clearly that commodities can be a blessing, not a curse. Much of the region enjoys fertile soils and sunshine, but it has also made the best of that natural bonus. Since 1990 productivity in farming in Latin America has risen faster than in East Asia or the United States, according to a study by the IDB. Colombia’s Federation of Coffee Producers has managed to extract a brand premium for its product through clever marketing, and has successfully diversified into retailing with its international chain of Juan Váldez coffee shops. Chile has created new export industries for fruit and vegetables. In Peru the spontaneous privatisation in the 1980s of state farms set up by a left-wing military government has spawned labour-intensive commercial farming on the fertile coastal strip. Argentina’s farmers, and its agricultural-research institute, are consistently innovative.

Brazil has the most impressive record of agricultural innovation. In 1973, when the country was still a net food importer, its military government set up Embrapa, an agricultural-research institute. Within six months it had sent 1,200 young Brazilian graduates abroad to obtain further qualifications. When they came back, they adapted plant and animal varieties so that they could thrive in the tropics and especially in the acid soil of the cerrado, the vast, largely flat savannah of the interior. This green revolution hugely increased productivity: over the past 30 years only 20% more land has come into agricultural use but production has risen by 150%, says Pedro Antonio Pereira, Embrapa’s director.

Brazil is now the world’s biggest exporter not only of coffee, sugar, orange juice and tobacco but also of ethanol, beef and chicken, and the second-biggest source of soya products. It is exporting fruit and wine from the São Francisco river region, close to the equator. Its goal, says Mr Pereira, is to become the world’s leading food exporter by 2025, displacing the United States, without inflicting damage on the environment. That means pushing up productivity further, and in particular putting some 70m hectares (173m acres) of degraded pasture to better use. Much of that pasture supports just one cow for every two hectares. With better breeding and improved techniques, each hectare could accommodate three cows as well as some grain and trees.

In São Carlos, in São Paulo state, Embrapa has the world's only laboratory deploying nanotechnology for agriculture, creating plant varieties that absorb fertiliser more efficiently. Embrapa has a research centre in Central America and is planning to open one in Peru.

Unfortunately there is little of this kind of innovation in other parts of Latin America's economies. Latin American firms invest only 0.5% of gross revenues in research and development, compared with the 2% spent by companies in the rich world. To help encourage innovation, there is now a revival of interest in industrial policy—partly because of worries about Dutch disease and commodity dependence.

The idea that governments should help particular companies or industries went out of fashion in the region a generation ago, mainly because it had been taken to extremes. In the 1960s and 1970s governments tried to foster industrialisation through tariff protection, state ownership and heavily subsidised credit. Brazil and Mexico did indeed industrialise. But across the region these policies also funded expensive white elephants and giveaways to favoured businessmen, all courtesy of the taxpayer. Mr Chávez in Venezuela is echoing some of these policies, as are the Kirchners in Argentina, albeit on a minor scale.

Elsewhere there is little appetite for a return to the past, but many agree that the state needs to do more to promote innovation and co-ordinate production chains and clusters to add value. In Mexico the government has encouraged the clustering of software and electronics firms in Guadalajara and an aerospace industry around Querétaro, including a factory in which Bombardier makes components for its aircraft. In Chile Fundación Chile, a public-private partnership, and Corfo, a state development agency, have promoted new industries. Chile's government persuaded GE to set up a software-development centre. In Colombia the public and the private sector have collaborated to develop a cluster of firms in Medellín supplying components for the electricity industry. A similar joint effort in Costa Rica secured an Intel chip plant and other foreign investments in high-tech projects.

Brazil never wholly abandoned industrial policy. Interest on loans made by its giant national development bank, the BNDES, is set at less than half market rates, involving a selective subsidy. Since Luiz Inácio Lula da Silva was elected president in 2003, industrial policy has become more pronounced and explicit. The BNDES supports innovation by providing seed money for ventures in biotechnology, pharmaceuticals and information technology. More controversially, it backs mergers and foreign takeovers by big Brazilian companies. These have included the creation of Brasil Foods, a big food company, and the merger of two big meat firms, JBS and Friboi. The petrochemical industry has consolidated in Braskem, a joint venture between Odebrecht, a construction giant, and Petrobras, the national oil company. The electricity industry is reorganising around Eletrobras, the former state monopoly.

Critics denounce all this as the creation of "national champions" that are beholden to the government, either directly or indirectly. Luciano Coutinho, the BNDES's president, retorts that Brazil's new multinationals are highly competitive Darwinian survivors of decades of economic volatility. "We have an open economy, it's different from the model of the 1960s and 1970s. The market is imperfect, but the state also makes mistakes," he concedes.

The guiding hand

Defenders of industrial policy—who include Dilma Rousseff, Lula's chosen candidate in next month's presidential election—as vindication point to the examples of the ethanol industry (which began with a 1970s government programme to reduce dependence on imported oil), Embrapa and Embraer, an aircraft-maker. Critics counter that Embraer started to thrive only after being privatised (see article), and that ethanol took off only after multinational car companies developed engines capable of running on either petrol or ethanol.

The Lula government's most ambitious attempt to go beyond commodities involves trying to use new oil discoveries to build an oil-services industry. The new fields, known as pré-sal because they lie beneath a volatile layer of salt 7km below the surface of the Atlantic, were discovered in 2007, with huge proven reserves. What led to the discovery was the previous government's oil-policy liberalisation, which meant ending Petrobras's monopoly, selling 60% of its shares on the stockmarket (though the government retains control of the company) and granting concessions for exploration rights in auctions that were open to foreign companies.

Lula has respected these contracts (in sharp contrast to Mr Chávez, Mr Morales and the Kirchners), but after the 2007 discoveries his government decided to draw up new rules for exploring the rest of the pré-sal (about 90% of the total area). These involve vesting the oil in a new state company, Petrosal, which will operate the new sovereign-wealth fund. Petrobras will be the monopoly operator of new fields, and both it and its partners will get a share of the output.

To finance its massive investment plan of $224 billion over the next five years, Petrobras is to get a capital injection. The government has paid its share in oil, and the company hopes to raise $25 billion in what will be the world's biggest ever public share offering. The government has required Petrobras to buy at least 65% of its inputs—from tankers to drilling rigs and platforms—in Brazil. It is applying similar rules to other oil companies.

Such national-content rules may make sense, but only if they are temporary, since they will drive up costs. And Petrobras itself is said to favour a lower requirement for national content. Officials point out that the new rules have revived Brazil's shipbuilding industry, which in the 1970s was bigger than South Korea's but then shrivelled. Norway adopted similar rules when it used its North Sea discoveries to establish a thriving oil-services industry.

The aim should be the development of local knowledge and skills, says Pedro Cordeiro of Bain, a management consultancy that produced a study on the subject for the BNDES. But he worries that having Petrobras as the sole operator may make it more difficult to create a competitive oil-services industry. "Monopsony is always bad for innovation," he says.

It may also foster corruption and cronyism. Norway, one of the world's richest countries, grants concessions to oil companies, which is more transparent. Brazil's new rules give Petrobras enormous power but also place it under huge strain, especially since the oil is at even greater depths than that in the Gulf of Mexico.

Brazil, the world's 16th-largest oil producer, is set to move up the scale. According to official forecasts, output is due to reach 5m barrels per day by 2020. Some of the government's critics worry that the country may go the way of Mexico and Venezuela, where state oil monopolies have been plagued by mismanagement and corruption. Colombia operates an alternative model, granting concessions to the highest bidder. Oil production there should reach 1.2m b/d by 2012, nearly double that in 2009.

Other critics are concerned that Brazil will lose its status as a clean-energy power. At present around 30% of its energy comes from hydro power and another 15% from biomass. The government expects both of these to keep growing. But the ethanol industry, which is made up of a large number of private companies, worries about the growing clout of Petrobras.

The ethanol industry has an impressive record of innovation, including electricity generation from cane residue and the development of bioplastics. To some, that suggests a different kind of industrial policy: providing more support for research and development, cutting Brazil's budget deficit (currently around 3% of GDP) and promoting saving. That would allow interest rates to fall and make companies less dependent on the BNDES.

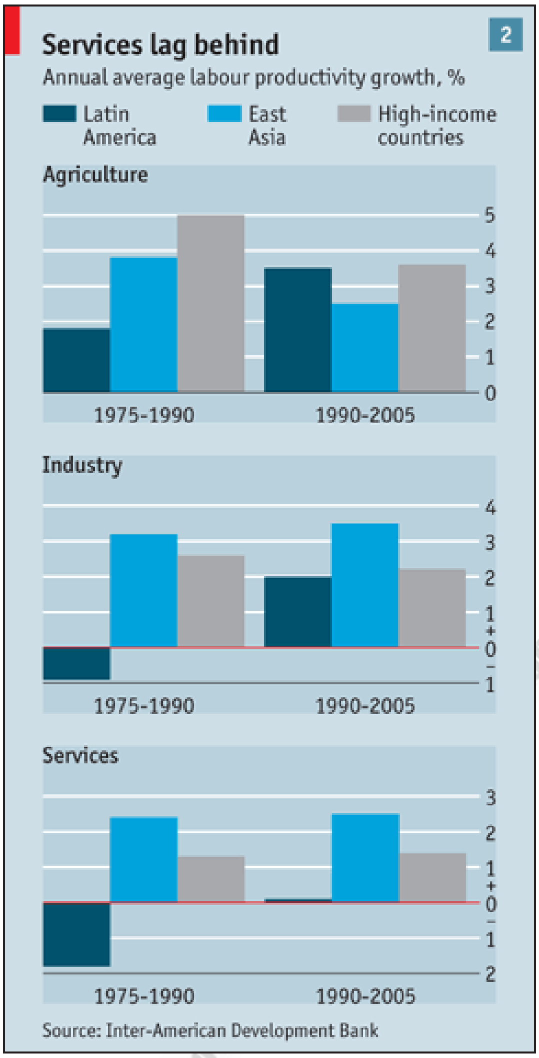
There is no evidence that Brazil is suffering from Dutch disease and deindustrialisation, according to a paper by Albert Fishlow of Columbia University and Edmar Bacha, an economist who advised Lula's predecessor, Fernando Henrique Cardoso. But the authors share the concern about the economic volatility that comes with commodity wealth. "The question is how to cope. That internal response determines whether natural resources translate into a virtue or a curse," the authors conclude.

Dutch disease or not, though, non-commodity industries find it harder to export than they used to, although they have plenty of room to expand in the domestic market. Much of their difficulty stems from lagging productivity.

Efficiency drive

Too many of Latin America's businesses are uncompetitive—or outside the formal economy.

IF PRODUCTIVITY growth in Latin America since 1960 had kept pace with the rest of the world, real incomes in the region would be 47% higher than they are, reckons the IDB. Part of the problem is that the region neither saves nor invests enough. According to ECLAC, in 2008 it saved 23% of GDP and invested around 22%, which is better than it used to be but not nearly as good as China's investment rate of close to 40% of GDP. But Latin America lags even further behind in total factor productivity, or the efficiency with which it combines capital, technology and labour. Between 1975 and 1990 both labour and total factor productivity actually fell in both industry and services (meaning that businesses became less, not more, efficient). Since 1990 productivity in industry has grown more slowly than in East Asia, and in services hardly at all (see chart 2).



Measuring productivity is not straightforward, and economists often disagree about it. Augusto de la Torre, the World Bank's chief economist for Latin America, reckons that since 2002 productivity has been growing in several countries in the region, including Brazil, Chile, Colombia, Costa Rica and Panama. Heinz-Peter Elstrodt, who heads the Latin American practice of McKinsey, a consultancy, says that privatisations in the 1990s spurred productivity growth but is not so sure that this has continued in recent years. Certainly, no one is claiming that, leaving farming to one side, Latin America is a world leader in productivity.

Some of the reasons why manufacturing and services in Latin America are relatively inefficient are structural: economic activity is dominated by a mass of small and inefficient service businesses, and perhaps as much as half the population works in the informal economy. The causes of this are deep-rooted, but they include poor infrastructure, badly designed taxes and regulations, a lack of competition, which means businesses have less need to innovate, and lack of credit.

Clogged ports and airports and poor road and railways connections meant that the region's opening to foreign trade in the 1980s and 1990s brought less benefit than it should have done. Astonishingly, freight costs for exports from Central America to the United States can be higher than from China, for example.

Counting both private and public sources, investment in infrastructure totals only around 2-3% of GDP, of which a third is in energy and much of the rest in transport, according to Jordan Schwartz of the World Bank. He thinks the region needs to invest twice as much if poor infrastructure is not to hold back growth. As well as money, better organisation and coordination is needed. Road and rail transport to ports can be as important as dockside facilities in moving cargo swiftly, for example.

The quality of infrastructure across the region varies widely. Only Chile has a modern transport network comparable to China's, and even there railways are neglected. But Chile has succeeded in attracting large-scale private investment in toll roads under a concession system. São Paulo's state government in Brazil has done something similar. The federal government, after much delay, has put road improvements out for private management, but its insistence on low tolls has deterred investors. At the same time private investment has helped Brazil's railway network to expand rapidly. The share of freight going by rail has risen from 16% in 1999 to 26% in 2008 and could reach 35% by 2020, according to a study by the Institute of Applied Economic Research (IPEA), a government-linked think-tank. Ports vary widely too: Montevideo in Uruguay, Panama and the main Colombian and Chilean ports are efficient, others much less so. Panama, which has embarked on a $5.25 billion scheme to expand its canal, has a chance of becoming a Singapore-style entrepot for Latin America.

Rules and regulations are often an even bigger brake on productivity. High payroll taxes in many Latin American countries penalise workers in the formal economy, and rigid and over-generous labour laws discourage the creation of formal jobs. New non-contributory pensions and social programmes, introduced with the best of intentions, have had the unintended consequence of dissuading workers from moving into the formal economy where they would have to join contributory schemes, as Mr Levy of the IDB points out.

If many Latin American companies are inefficient, it is partly because governments have allowed them to be so by not doing enough to stimulate competition. Private oligopolies and state energy monopolies still survive in Mexico, for example. It may not be coincidental that Chile is the one country in Latin America where since 1960 productivity has grown faster than in the United States: it opened up to international trade and reformed its economy earlier and more thoroughly than most other countries in the region.

Peru, though poorer, is going down the same path. In the 1970s its military government nationalised a big chunk of the economy and the private sector was further weakened by hyperinflation and terrorism. But since the early 1990s Peru's economy has been growing rapidly. The corrupt authoritarianism of Alberto Fujimori, its president from 1990 to 2000, undermined many of the country's institutions, but Mr Fujimori did create an effective competition authority. Possibly as a result, several new business groups have emerged—a rarity in a region where companies tend to be of long standing.

An example of the new breed is Grupo Interbank, based on a bank privatised in 1994. Its boss, Carlos Rodríguez Pastor, is the son of a former finance minister who grew up in the United States when his father was exiled by the military government. He recruited young Peruvian MBAs who were working abroad, promising them a meritocratic culture ("This group has no surname," he says). Under their stewardship Interbank has turned into a retail bank in which revenues have grown tenfold, to $1.5 billion last year, and which has launched an insurance business. The wider group is now Peru's second-biggest retailer and runs the country's largest chain of multiplex cinemas and a fast-growing hotel chain as well as some smaller businesses. "In Peru you can go from zero to relevance in five years," he says.

Keep it in the family

That lack of a surname makes Grupo Interbank an exception. In Latin America the family-owned conglomerate rules the business roost. A decade ago many management gurus regarded this breed as inferior to Anglo-Saxon equity capitalism. Yet many such firms have fared well and expanded abroad. According to McKinsey, publicly quoted family-controlled companies worldwide tend to perform better than average. In Latin America such firms cope well with volatility, says Mr Elstrodt. They can take decisions quickly but can also take a long view.

Many family firms now have stockmarket listings, which has imposed greater financial discipline, improved their corporate governance and made them more open. Such companies generally have professional managers, and the younger generation of family owners has become more forward-looking. In Peru, for example, some of the best companies are starting to appoint innovation managers, according to Felipe Ortiz de Zevallos, a consultant. “Family owners used to say, ‘let the gringos innovate, we live for the fiesta’. The younger generation is more Protestant in style,” he says.

Or take Grupo Bimbo, a Mexican firm that is the world’s second-biggest baker (after Kraft). It is publicly quoted but 70% of its shares belong to four founding families. Although Mexico still accounted for almost half its total sales of $8.6 billion last year, 43% came from the United States and 12% from the rest of Latin America. It also has a small operation in China. Entering the United States was a defensive move, in an industry that in North America is consolidating, but expansion in Latin America and China represents “10-15 year bets”, says Roberto Cejudo, Bimbo’s finance chief. In these countries “our objective is to develop the market for wrapped, sliced bread, and for that you need innovation, know-how and time.”

Giving and taking credit

Perhaps the biggest cause of Latin America’s low productivity is lack of credit that would allow businesses to expand and modernise. Total credit to the private sector in Latin America has averaged just 31% of GDP over the past four decades, less than half the figure in East Asia and in the rich world, according to the IDB. This constraint, at least, is starting to weaken. The conquest of inflation and achievement of macroeconomic stability, together with the improvement in sovereign-credit ratings, is allowing more borrowing to take place, though so far mainly in the form of consumer loans and mortgages.

But capital markets are developing too, thanks partly to pension reforms in the 1990s, creating privately managed pension funds which in many countries became the first institutional investors. Blue-chip companies in Mexico and Chile, especially if they are exporters, are no longer at much of a financial disadvantage compared with their rivals in rich countries. For example, Grupo Bimbo raised $2.5 billion last year to buy a business in the United States that belonged to Canada’s Weston Foods.

Medium-sized firms across the region have a tougher time. In Brazil businesses find it hard to get loans from private banks for longer than a year, and interest rates remain high. In real terms the Central Bank’s benchmark rate, the Selic, is now only around 6%, down from 11% in 2001. But market rates are higher because the banks are required to lodge up to 60% of their sight deposits with the Central Bank and because of taxes. Many firms finance expansion from retained profits or from state banks, especially the BNDES, which provides ten-year loans at around half the Selic rate.

During the recession state banks across Latin America played an important role in providing emergency financing when private credit temporarily dried up. The BNDES has almost doubled its annual lending (to 4.5% of GDP) since 2007, thanks to a large cash injection from the federal government to boost its capital base. Mr Coutinho, the BNDES’s president, hopes that in due course the private banks will start to provide long-term loans again. That will require savers to switch to longer-term instruments. “The last step [in Brazil’s economic stabilisation] is for the saver to trust in the future of the country,” he says.

That prospect remains distant in Argentina, where the banking system has yet to recover from the default and devaluation of 2001-02. Private credit amounts to only 13% of Argentina's GDP, and deposits are very short-term. Confidence has been further damaged by violations of property rights and by the opaque decision-making of the governments of Cristina Fernández and her husband and predecessor, Néstor Kirchner. Argentine companies have no choice but to try to survive, generate cash and get it out of the country, a management consultant says.

Elsewhere, as credit takes off some worries about home-blown bubbles are emerging. A study by Tendências, a consultancy, found that Brazilians are now devoting 26% of their incomes to repaying debt.

In Brazil the expansion of credit and capital markets has been linked to a decline in the informal economy. The construction industry, for example, used to be almost entirely outside the formal sector, but thanks to a booming property market housebuilding companies have listed on the stockmarket and their suppliers have entered the formal economy in turn. Between 2003 and May 2010 the number of formal jobs in construction alone increased from 1.5m to 2.5m. But in Mexico and Colombia the share of the informal economy may still be growing.

At the bottom of the pyramid, many Latin American countries are seeing a boom in microcredit. The best example is Peru. A recent study of the industry shows that over the past two decades microloans have expanded at an annual rate of 19%. In 2009 there were more than 220 lending institutions, 1.8m borrowers and total outstanding loans of $3.8 billion, accounting for 11.2% of financial-system credit to the private sector. But Richard Webb, one of the authors of the study and a former governor of Peru's central bank, cautions that there is no clear evidence that more microfinance means less poverty, or that it automatically brings borrowers into the formal economy. "The idea of separate formal and informal sectors is wrong," he says. Rather, "there are degrees of formality."

José Sevilla (not his real name) would go along with that. He lives in a large house in a dusty but aspiring suburb on Lima's southern edge and runs a business with one of his sons slaughtering and wholesaling chickens. After various ups and downs he formalised his wholesale business in the 1990s. He also has three chicken restaurants, set up with loans from a bank and Mibanco, a big microlender. In all, his turnover is about $1.8m and he employs 31 people, making his a medium-sized business. But few of his restaurant staff are legally registered.

The jet set

Embraer bucks the trend.

THEY may be the exception rather than the norm, but Latin America is clearly capable of producing world-class companies. Embraer, set up in 1969 as an aspiring national aircraft-maker by Brazil's military government and privatised in 1994, has since established itself as the world's third-largest producer of commercial jet aircraft and the market leader in jets with 50-120 seats.

To do so, it has had to be nimble. Its first commercial jet, the 50-seater ERJ-145, sold mainly to North American regional airlines keen to skirt union restrictions on the crewing of larger planes. With its bigger E-170-190 range (of 70-122 seats) the company broke out of that niche, finding customers among many of the world's main airlines. In 2002 it set up a joint venture in China to manufacture the ERJ-145. It is now building factories in Florida and Portugal.

The recession has hit the aircraft industry hard, and Embraer has not been spared. It has gone from assembling 14 E-jets a month to just eight, and has mothballed one of its three production lines. Revenues last year fell by 14%, to $5.5 billion, and more than a quarter of the company's workforce was laid off, bringing it down to 16,800. Embraer also faces growing competition. As well as Canada's Bombardier, a long-standing rival, this will soon include companies from Russia, China and Japan that are developing small commercial jets.

But Frederico Fleury, Embraer's chief executive, reckons his reliable commercial jets with their established brand will be hard to beat and can win new orders for routes currently being flown by bigger planes. Rather than develop larger aircraft of its own, which would pit it against Boeing and Airbus, the company is diversifying in other ways. The rise in the oil price has made the ERJ-145 uneconomic, and Embraer will shut its factory in China next year unless it secures an agreement to make the E-190 there. At its main factory at São José dos Campos it has reconfigured the ERJ-145 production line to make executive jets, and its defence business is expanding. Between them these two parts of the business are likely to grow to make up half the company's sales, up from 27% now, says Mr Fleury.

Embraer, he insists, has been strengthened by adversity. It has improved its productivity, partly through a host of small changes such as switching off lights during the lunch hour, and partly through more automation. It has continued to invest in research and development and will launch two new executive jets in the next three years. The company's competitive advantage is not cheap labour, says Mr Fleury, but its know-how (of composite materials, for example), its highly educated workforce (a third of them engineers) and its network of local suppliers. In other words, it is not very different from any other high-tech global company.

Democracy, Latino-style

Visible disorder, hidden progress.

EARLY in the morning on June 28th 2009 a group of soldiers barged into the official residence of Honduras's president and bundled its occupant, Manuel Zelaya, onto a plane out of the country. Mr Zelaya's opponents claimed he had violated the constitution, though their real fear was that he was plotting to hang on to power beyond his term with the help of his ally, Mr

Chávez. He was replaced by the head of Congress, who organised an election in November last year won by Porfirio Lobo, a traditional politician not unlike Mr Zelaya.

To many in Latin America Mr Zelaya's ousting recalled the nightmare of past military coups. The region's presidents, led by Brazil, took a stern line: Honduras was suspended from the Organisation of American States and the new president has still not been recognised by many governments. But what happened in Honduras was an isolated incident. Nearly all Latin American elections now are free and fair. After a period of instability during the economic slowdown of 1998-2003, governments generally run their full term.

That said, democracy in Latin America faces two significant threats. The first is autocracy, a danger which harks back to the caudillos (strongmen) who emerged from the independence wars. Elected but autocratic presidents have neutered judiciaries and other democratic institutions. Mr Chávez has turned Venezuela's courts into a tool of the executive and used them to jail, harass or disqualify a growing number of his opponents. Nicaragua's president, Daniel Ortega, has abused his power to rig both municipal elections and the supreme court. Less blatantly, Ecuador's Mr Correa has tried to muzzle the media, and the Kirchners in Argentina have used the presidency to bully opponents in business and the press. Yet the leaders of the region's main powers have stayed silent about these abuses.

The second danger to democracy is incompetence. Even in countries where the separation of powers is respected, the institutions often do a poor job of protecting the rule of law, providing effective government and advancing the rights and freedoms of citizens.

Take Peru, where the economy has grown at Asian rates for several years but politics are anarchic. Neither the current president, Mr García, nor his predecessor, Alejandro Toledo, has had a majority in Congress. Apart from Mr García's APRA, which is notoriously corrupt, the remaining political parties are personal vehicles with little organisation. For local elections in October, no fewer than 60,000 candidates have registered in 14,000 slates for just 2,000 municipalities. Most of the outgoing regional presidents are local figures without national allegiances. There is no civil service. Bright young people increasingly go into business rather than politics. There are constant demonstrations, some violent. In a recent poll 22% of respondents outside Lima approved of blocking roads as a form of protest. Although the economy has grown, Mr García is unpopular (as was Mr Toledo).

Stability is relative

Having listed these problems, Martín Tanaka, a political scientist in Lima, points out that "Peru is quite a stable country" where economic policy commands a broad consensus. But because so much depends on who is at the top, that continuity will be at risk in the presidential election next year. In 2006 Mr García won with a lead of only 5% over Ollanta Humala, a populist former army officer who was friendly with Mr Chávez and would have ruptured that economic consensus. Mr Humala will be a candidate next year, though his chance of winning this time is smaller.

Peru is at the extreme end of the spectrum, but to some degree the same flaws are in evidence in many other countries. In much of the region (though not in Chile and Uruguay) political parties are weaker than they used to be. Presidents struggle to get laws through a many-sided legislature. Mexico has moved from one-party rule by the PRI, which ended in 2000, to three-way gridlock. In Lula's first term in Brazil leaders of his Workers Party resorted to buying votes in Congress. The resulting scandal caused Lula to lose interest in difficult tax and labour-law reforms in his second term and to forge an alliance with the PMDB, an agglomeration of regional barons with a voracious appetite for patronage and pork.

Even so, over the past two decades Latin America's politics have become more inclusive. A wave of electoral victories by the left in the early 2000s brought to power leaders who had grown up poor, such as Lula and Bolivia's Mr Morales. And democratic politicians have achieved more than meets the eye. There are islands of excellence in the public service, especially the institutions that make economic policy, and there has been much innovation in social policy. Decentralisation has brought waste and corruption in some places, but in others it has produced better urban management. That is important: 15 big cities generate more than half of Latin America's GDP, says McKinsey's Mr Elstrodt.

Some of the change has been driven by public opinion. When governments fought inflation with free-market reforms they both forged and reflected a societal consensus in favour of economic stability. A similar consensus is beginning to emerge on education.

A second trend is competitive emulation. Like CCTs, fiscal-responsibility laws and stabilisation funds have ricocheted around the region. Colombia's new president, Juan Manuel Santos, is the latest to say he will implement them. The same process applies at local level. The Complexo de Alemão, a crime-ridden labyrinth of favelas in Rio de Janeiro, is now trying to replicate innovative urban management pioneered in Medellín in Colombia, with cable cars connecting hillside slums to the urban railway network and new libraries and community centres. Citizens' monitoring groups in a dozen Latin American cities have formed a regional network.

Lower middle classes to the fore

The big political question in Latin America is whether the swelling lower middle class will become a force favouring better governance, stronger democratic institutions and the rule of law. The evidence is mixed. "They are a group that demands more subsidies from the government than they contribute: representation without taxation, that's the middle class in Latin America," says Mauricio Cárdenas, a former Colombian minister who is now at the Brookings Institution in Washington, DC.

But Bolívar Lamounier, a political scientist in Brazil, says the lower middle class there is politically divided, and over time will tend to support market policies rather than statist and protectionist ones. This social cohort is clearly intolerant of crime and of inflation. In Mexico the lower middle class may have tipped the 2006 election narrowly in favour of Mr Calderón because they felt that his opponent, Andrés Manuel López Obrador, was jeopardising economic stability.

But public opinion can favour populist giveaways, too. And bad examples can be copied, as the Kirchners have done, in imitation of Mr Chávez, by grabbing foreign-exchange reserves from the central bank. Argentina and Venezuela provide cautionary tales: they were the richest countries in the region but fell back, unable to break the downward spiral of commodity dependence and populist politics.

A Latin American decade?

The reformers have won, but they have yet to consolidate their success.

SUMMIT meetings involving Latin America's presidents are so frequent these days (one is pictured above) that Mexico's Mr Calderón has likened diplomacy in the region to a mountain range. Yet for all the talk of regional integration, political Latin America looks more divided than ever. Mr Chávez likes to threaten war against Colombia, which in turn accuses him of harbouring its FARC guerrillas. Sub-regional trade groups such as Mercosur and the Andean Community, which made progress in the 1990s, have stagnated or fallen apart.

Yet while the politicians bicker, corporate Latin America is quietly moving closer together. A growing army of multilatinas have expanded abroad. Some, like Embraer or Bimbo, have become global multinationals. Many others, including Chilean retailers and Brazilian banks and construction firms, have expanded within Latin America. Some Mexican firms, led by América Móvil, a telecoms giant, are moving into Brazil. Until recently such firms tended to list their shares in New York, but now a Latin American capital market is poised to emerge. In three to five years there will be a seamless network of Latin American stock exchanges, including Mexico's, reckons Mr Oliveira of BRAIN Brasil.

The market-oriented reforms of the 1980s and 1990s, combined with a few years of commodity-driven prosperity, are transforming Latin American business. Together with more progressive social policies, these forces are starting to create more dynamic and less unequal societies too. Whether these trends can be sustained depends in part on what lessons the politicians draw from the region's relative buoyancy in the recession.

Thanks to the commodity boom and rising revenues, governments in many countries have had an easy time of it in the past few years. Presidents have generally been able to avoid difficult reforms. All this has generated a sense of complacency, even triumphalism in the region. After all, as Lula put it, it was "blond, blue-eyed bankers" elsewhere who screwed up world capitalism on a scale that not even Latin America managed in the past.

Perhaps the region first had to stabilise its economies and build its social safety net before embarking on microeconomic and institutional reform. But if it is to achieve the goal of development over the next decade, more reform will be needed. The list of pending tasks is long: set aside some of today's revenues for long-term infrastructure projects, for saving against a commodity bust in a stabilisation fund or for pensions for a population that will soon start ageing; get the rich and the tens of millions in the informal economy to pay more tax; take on the teachers' unions to improve schooling; reform labour laws, pensions and health care to create a fairer system of social protection; tackle the drug gangs and the vested interests in the judicial system.

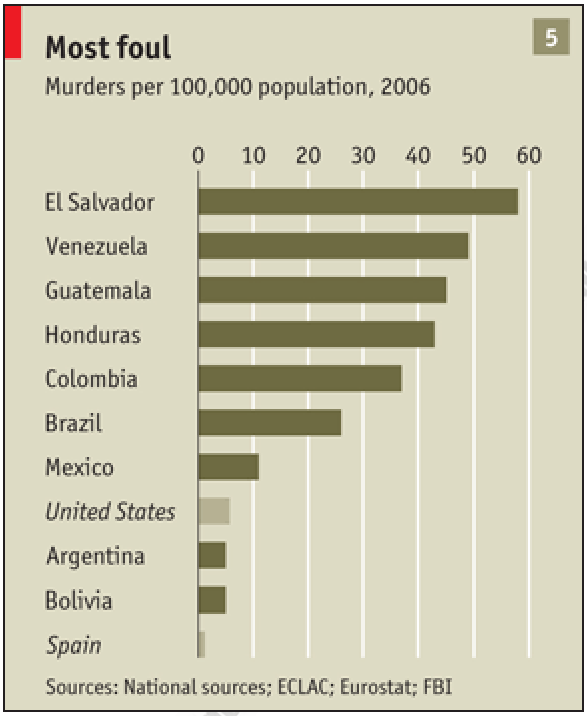
Though daunting, this should be less difficult to achieve than dismantling dictatorship and stabilising the economy proved to be. Latin America turned to the market and to democracy because in 1982 it was bankrupt. The new policies mostly worked eventually, once they were backed by a social safety-net. But some countries did not stay the course. For the past decade an ideological battle has raged between reformers—be they liberals or social democrats—and those, such as Mr Chávez, who would return to the authoritarian past. The reformers seem to have won the argument, though it may take a while longer for that to become clear. Now they must consolidate their victory by demolishing the remaining barriers to development.

The dark side

The drug business is a blight on societies

ASK community activists in Neza what their main problem is and the answer comes instantly: crime. This mostly involves "express kidnaps", in which the victim is required to hand over all his cash, or extortion from small businesses. The perpetrators often claim to be from La Familia or the Zetas, two drug gangs notorious for their violent methods. The other threat, says María Elisa Solís of Fundación Estrella, an NGO, is "the authorities themselves", who rarely investigate crimes but demand bribes.

Powerful mafias who derive massive profits from the rich world's demand for drugs, especially cocaine, have exploited the weakness of the rule of law in many parts of Latin America. This organised crime has brought increased violence (see chart 5), though not everywhere. In Mexico, for instance, the murder rate has probably doubled since 2006, when Felipe Calderón cracked down on the trafficking mobs, but officials stress that many parts of the country are peaceful.



The profits generated by cocaine exports to the United States and Europe have allowed drug gangs to turn themselves into illegal armies. In some places, such as Mexico and Central America, this has turned a problem of policing into one of national security that becomes a drag on development and deters investment.

The same used to apply to Colombia, where drug money allowed the communist FARC guerrillas to outlast the end of the cold war. But that country offers an example of how the threat can be tackled. Álvaro Uribe, the country's president until earlier this year, vastly increased spending on security. Thanks partly to foreign aid, prosecutors are backed by a fairly effective force of detectives and a witness-protection programme. Between 2002 and 2008 the murder rate halved and killings of human-rights activists and trade-union leaders abated. To match Colombia's relative success may take a decade or more in Mexico, which is a federal state and lacks Colombia's national police.

Controlling crime is even harder in weak Central American states such as Guatemala, Honduras and El Salvador. Although politicians point the finger at youth gangs (maras), it is the drug trade that is the main cause of the rising violence, according to the World Bank.

Brazil has come up with some answers. In the decade to 2008 the murder rate in São Paulo state fell by 70%. Economic growth helped, but so did better police management. The police gave priority to catching murderers, with the clear-up rate for killings rising from 20% in 2001 to 65% in 2005, according to Tulio Kahn, a criminologist who advises the government. Upgrading slums with things like better streetlighting and keeping young people at school or in job training also helps to cut crime. In Mexico City the local government offers scholarships to encourage youngsters to stay at school. Marcelo Ebrard, the mayor, says that in Mexico 7m young people neither study nor work: “They can organise an army.”

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