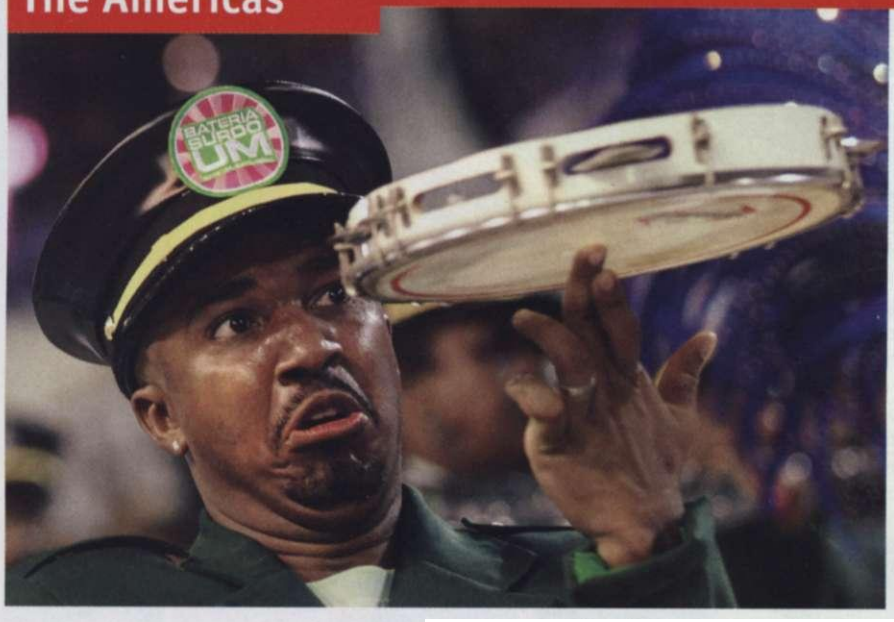

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Latin America's economies

The balancing act

The region faces slower growth, but not disaster. To up the pace, now is the time for reforms to boost productivity

FOR the past couple of years many Latin American political leaders have been able to contemplate the world with a certain smugness. While Europe and the United States have been mired in economic stagnation, Latin America has enjoyed a strong recovery, having for the most part sailed through the recession without lasting damage. Boosted by capital inflows, by record prices for commodity exports, by sound policies and by a heady expansion in domestic credit, the region saw economic growth of 6% last year and is on course to notch up close to 5% this year.

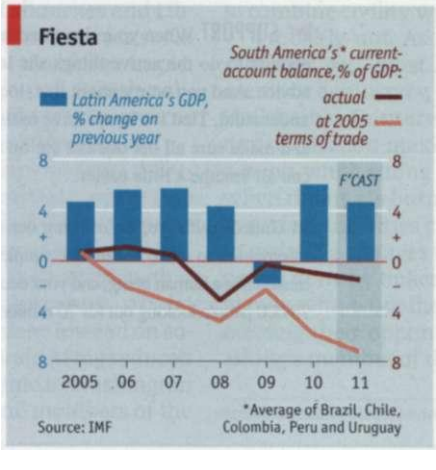
This week brought a jolt to such complacency. As fear stalked financial markets around the world, the region's stockmarkets and currencies tanked on August 8th. Brazil's Bovespa index plunged by 8.1%, the real fell to its weakest against the dollar in three months and the Mexican peso plunged to its lowest value in six months. The markets remained choppy thereafter.

So is Latin America's recovery threatened? "This is the second time crisis affects the world, and for the second time Brazil isn't trembling," declared Dilma Rousseff, its president. "We are in a much stronger position to confront this crisis than we were at the beginning of 2009 and the end of 2008."

In some ways that is true. The region's foreign-exchange reserves have increased substantially since October 2008 (in Brazil's case from $200 billion to almost $350 billion). Faced with overheating and currencies that have become uncomfortably strong, hurting manufacturers, policymakers in Brazil and some other South American countries would quietly welcome a modest fall in their exchange rates.

One worry is that inflation has edged up in South America (in Brazil it is 6.9%, above the Central Bank's target). But Augusto de la Torre, the World Bank's chief economist for the region, points out that devaluation has less impact on inflation expectations than it used to in the 1990s. That is tribute to the credibility accrued by the region's economic policymakers.

The better-run countries of Latin America also have more policy weapons available than most rich-world economies. Having spent the past nine months raising interest rates to cool demand, central banks could cut them again if needed (though inflation worries mean that they probably won't rush to do so). Fiscal deficits are relatively modest. So is the burden of public debt: excluding the heavily indebted Caribbean, this averaged only 32% in 2010, according to the UN Economic Commission for Latin America.



The main reason for Latin Americans to remain sanguine is that the threat from the outside world is different from the one in 2008. Back then the fall of Lehman Brothers prompted a sudden stop in capital flows to the region. Now, unless panic spreads about euro zone banks, the fear is of a long period of stagnation in the developed world. Two things offset this in Latin America. First, the main motor of growth for South America in particular has been China's demand for its minerals, foodstuffs and other raw materials. That looks set to continue. Second, the growth increasingly comes from consumption by Latin Americans themselves, as tens of millions edge out of poverty and benefit from newly available credit. Thus Mexico, which suffered more in 2009 and is vulnerable to slower growth in the United States, has more scope than others in the region to expand domestic credit.

But even before the latest market turmoil, economic growth in Latin America was expected to slow, to around 4% a year. The region "is hitting the speed limit after a very vigorous recovery," says Mr de la Torre. "Latin American economies don't have a BMW engine, they have a Lada engine, and they overheat very quickly."

That is because most countries neither save nor invest enough. And they do not use their resources efficiently. McKinsey, a management consultancy, reckons that between 1991 and 2009 labour productivity in Latin America grew at an annual rate of just 1.4%, compared with 3.9% in South Ko-

• rea and 84% in China. The reasons for this poor performance include a big informal economy and rigid labour laws, a lack of innovation by firms, and insufficient public investment in education and transport infrastructure (see next story).

Governments could do more to change all this. For a start, they have left too much of the task of preventing overheating to monetary policy, pushing up the cost of credit. John Welch of Macquarie Capital, part of an Australian investment bank, points out that Brazil still only invests 185% of GDP (the equivalent figure for China is 49%) because low savings, high interest rates and protective tariffs on inputs make investing unusually costly.

Given the strength of the recovery, governments could have tightened their fiscal policy more quickly. Chile has gone furthest. Thanks partly to tax rises, it will cut its fiscal deficit to 18% of GDP this year, despite extra spending after a big earthquake last year, says Felipe Larrafn, the finance minister. Brazil is curbing its deficit this year, but plans big pension and public-sector wage rises next year. Meanwhile, the public sector needs to invest more, especially to eliminate transport bottlenecks.

But there is a political obstacle. "To preach fiscal adjustment amid abundance is very difficult, because of the social demands" in Latin America, admits Nicolas Eyzaguirre, the IMF'S most senior official for the region, who has been trying to do so for the past couple of years.

The longer South American countries, in particular, postpone structural reforms, the more they leave themselves hostage to the outside world. Their current-account deficit is rising even though their terms of trade (the ratio of export prices to import prices) have jumped by 25% since 2005 (see chart on previous page). Many countries are spending their commodity windfall on imports and a consumer boom, rather than investing it, argues Neil Shearing of Capital Economics, a consultancy which forecasts Latin America's growth will fall to 35% next year and just 3% in 2013.

For all the region's new-found strengths, its growth has been powered by what the IMF calls the strong "tailwinds" of cheap money in the rich world and high commodity prices. The first may now continue for a while, but the second may not. If the market jitters inject a sense of urgency, it will not be in vain.

Foto

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