Center for Global Development

CGD Note
DEC 2019

Latin America: A Sailboat in Stormy Waters

Latin American Committee on Macroeconomic and Financial Issues Statement N. 42

1. STRUCTURAL FRAGILITIES IN LATIN AMERICA

Latin America's economic growth has declined significantly in the last decade. Although a variety of causes can potentially explain this result, there are some structural weaknesses that distinguish Latin America from other regions in the developing world.

First, Latin America exhibits a low savings rate compared to other regions. The savings rate in Latin America is approximately 20 percent of GDP compared to, for example, levels above 30 percent of GDP in Asia. In the case of Argentina, the rate of savings has fallen to levels close to 14 percent, the lowest in the region.

Second, the low savings rate of Latin American economies implies a heavy dependence on external financing. The persistent excess of the investment rate over domestic savings leads to, also persistent, high current account deficits. In fact, the observed reduction in current account deficits in recent years respond to a lack of investment and growth, rather than to an improvement in savings.

Third, compared to other regions of the world, Latin America exhibits a high degree of openness to international capital markets (as measured by the generally low restrictions to the movement of capital flows). In contrast to its financial openness, most of Latin America remains relatively closed in terms of trade flows (measured by the ratio of exports plus imports to GDP). Moreover, the lack of export diversification in some of the economies in the region may contribute to increase their external vulnerability, especially to sudden changes in capital flows.

Fourth, the factors discussed above have led to high ratios of external indebtedness, Indeed, the region's financial vulnerability has increased recently because of a deterioration in fiscal positions and a significant increase in public and corporate debt. The sharp growth of indebtedness is already resulting in a decreased appetite for Latin American assets by international institutional investors in favor of a larger demand for high-performance corporate assets in the US.

These structural weaknesses are in turn coexisting with a greater international uncertainty derived from the large trade conflict between the US and China. In addition, the decline of the growth rate of the Chinese economy directly affects the markets for those commodities that are the main export products in the region.

Fifth, the low levels of productivity observed in Latin America has exacerbated the recent decline in regional economic growth. The low rate of economic growth also coexists with another worrisome feature: Latin America is one of the regions of the world with higher income inequality, at similar levels to those in Africa.

The combination of an anemic economic growth and high inequality is one of the factors that is driving a strong wave of social unrest in the region. The discontent has manifested itself visibly in various popular protests in Chile, Colombia, and Ecuador.

Moreover, with the rapid development and growth of social networks, social discontent has become much more visible and new technologies have fostered the interaction between protests. At the same time, there is a disconnection between the capacity of response of the traditional political sectors and the phenomenon of social protest. The political system has not been modernized in line with the technological development of social networks.

2. WHAT SHOULD BE THE ECONOMIC POLICY RESPONSE?

In order to address the dependence of the region on external financing, policymakers need to generate fiscal space to respond countercyclically to abrupt slowdowns of capital flows. To generate fiscal space, it is crucial to achieve ratios of public debt to GDP that are sustainable over time under different scenarios of macroeconomic stress.

Although there is not a consensus about the ratios of public debt that can meet intertemporal sustainability requirements, the Committee believes that the economies of Latin America should aim to significantly reduce their current ratios of public debt. Moreover, it is important to keep in mind that debt sustainability is defined not only by the volume of debt but also by some of the essential characteristics of such debt, such as its maturity structure and degree of dollarization.

Currently, countries such as Chile and Peru have healthy public debt ratios to GDP, but several countries such as Argentina, Brazil, Colombia, Mexico and Uruguay exhibit large public debt ratios to GDP. On average, the region has a ratio of public debt to GDP greater than 50 percent. In the opinion of the Committee, these levels exceed the amounts consistent with adequate fiscal space. Moreover, current risk ratings in the region reinforces the Committee's view since most countries are rated as high risk or, at best, in the low tranches of the investment grade category.

In some countries, despite efforts to develop domestic capital markets through the growth of institutional investors such as pension funds and insurance companies, there is still a significant degree of dollarization in the banking system and debt markets. Financial dollarization magnifies vulnerabilities and substantially complicates the management of monetary policy. Nevertheless, it is important to recognize that the process of reducing dollarization entails a short-term maturity bias in public and private debt markets.

In addition to fiscal deterioration, social unrest in Latin America also reflects a response to the inefficient use of public resources, either because these resources are not sufficiently allocated to investment relatively to current expenditure, or because the allocation of public funds in corruption cases has become more visible.

Fiscal consolidation requires facing difficult dilemmas in terms of the choice of instruments to use, particularly if public spending is reduced or the tax burden is increased. Recent empirical evidence suggests that fiscal austerity has very different effects on economic activity depending on whether fiscal consolidation is implemented through decreases in spending or increases in the tax burden. In particular, such evidence suggests that the recovery in economic growth is faster and stronger when fiscal austerity is based on decreases in spending rather than on tax increases[1].

Increasing fiscal space requires designing spending programs that clearly follow a countercyclical path. A credible transitory public spending program has a more expansionary impact on economic activity than a permanent increase in fiscal expenditures by reducing public expectations that higher permanent spending will weaken fiscal sustainability or lead to higher taxes in the future.

Monetary and exchange rate policies are also central when facing and reducing external vulnerabilities. The Committee recognizes that most countries in the region consider exchange rate flexibility as the best mechanism to cushion the effects of external shocks on the domestic economy. However, it also acknowledges the importance of accumulating international reserves above external financing needs and the convenience of intervening in the foreign exchange rate market to avoid rapid and sharp appreciations of the currency.

Faced with a low growth rate, governments may be tempted to boost economic activity by stimulating consumption, sometimes especially focused on lower-income sectors and beneficiaries of the social security system. The boost in demand is often seen as a valid mechanism to increase supply. Although in some cases this may be valid, three considerations are relevant. First, policies aimed at promoting consumption may be precisely against the objective of increasing the economy's savings rate, one of the weaknesses that increase the dependence on external financing.

Second, public spending policy to encourage consumption deteriorates the fiscal position and the sustainability of public debt. In this sense, a stimulus in demand makes sense in situations where the government has fiscal space and can respond with a countercyclical policy as in the case of Chile during the last global crisis. In these cases, it is important that the spending programs are transitory so as not to depress demand through the anticipation of a higher tax burden in the future.

Third, the stimulus in consumption does not automatically translate into more investment. Investment will respond positively if the conditions are favorable; that is, if investors expect stable tax, regulatory and financial conditions. The perception that the fiscal space is genuine and that the fiscal stimuli will not jeopardize fiscal sustainability is central to producing a virtuous cycle that results in an increase in investment.

The low economic growth of the region is consistent with a low productivity rate. Part of the causes of low productivity is, in some cases, the result of policies that try to favor small and medium-sized enterprises, as they are identified as vulnerable sectors, but also as important generators of employment. Mexico provides a good example of how this type of policies can be distortionary. Although Mexico has been successful in expanding and diversifying its tradable sector based on a solid manufacturing base, that growth has not spread to the rest of the economy. This problem is mainly attributed to the significant and growing microeconomic distortions that inhibit the efficient allocation of domestic resources and provide incentives for most businesses to remain small and mostly family owned. These incentives are based on tax systems and segmented regulations that place most of the levy on bigger and more efficient companies, while protecting the smaller companies from taxes and contributions to social security, although providing poor social security and health benefits.

1 Alesina, A., Favero, C. y F. Giavazzi, "Austerity: When it Works and when it Doesn't", Princeton University Press, 2019.

In other cases, the emphasis on favoring small economic units is counterproductive in terms of taking advantage of economies of scale and in terms of greater efficiency in general and it also contributes to greater labor and tax informality.

3. THE IMPORTANCE OF FINANCIAL SAFETY NETS

Domestic policies must be complemented by a financial safety net both at an international and at a regional level. The International Monetary Fund (IMF) constitutes the main global financial safety net for Latin America. During 2018 and 2019, the IMF played a very important role as a lender of last resort to countries that needed this financial support. The most significant case of financial support has been that of Argentina that has received a support of USD 44 billion to date under the IMF exceptional access modality, equivalent to approximately 6 percent of the IMF lending capacity, excluding the use of the General Agreement to Borrow (GAB). After a renegotiation in 2018, the program has been interrupted in the context of the change of government after the presidential elections in November 2019 and is currently awaiting a new renegotiation. Likewise, Ecuador has reached an Extended Facility Agreement with the IMF in 2018 that has just been renegotiated.

These experiences show that the IMF's ability to act as a lender of last resource in the region is certainly considerable at the level of individual countries. However, its lending capacity still seems somewhat limited in cases of sudden stops of capital flows at a systemic level. In addition, the Committee notes that the IMF financial support requires, in addition to meeting the criteria of conditionality established in the agreement, a favorable assessment about the probability of future debt repayment and the sustainability of public debt. These requirements generate the possibility that, in cases of a change in government, the IMF support can be interrupted, as has happened in Argentina.

The Committee believes that situations like the one described above are good examples of why it is important that the region continues to deepen the development of a regional safety net. The Latin American Reserve Fund (FLAR) is currently the organization that leads this task. Precisely, the FLAR has played a significant complementary role to that the one played by the IMF. Concretely, it has provided bridging financial support to countries that were in negotiations with the IMF, as in the case of Colombia.

The Committee believes that in order to strengthen and expand the lending capacity of FLAR and to provide better instruments to this regional financial security net, it is necessary that the main economies of the region become part of FLAR's membership, in particular, Argentina, Brazil, Chile and Mexico. The Committee believes that a strong regional financial safety net, in addition to the IMF, not only provides individual protection for its members, but also helps to reduce the likelihood of systemic financial crises in Latin America.

The Latin American Committee on Macroeconomic and Financial Issues (CLAAF) gratefully acknowledges financial support by the Center for Global Development, the Banco de la Ciudad de Buenos Aires, the Central Bank of Chile, and FLAR for funding its activities during 2019. The Committee is fully independent and autonomous in drafting its statements.

This statement was jointly produced by:

José De Gregorio, dean of the Department of Economics, University of Chile; former president of the Central Bank of Chile.

Guillermo Calvo, professor, Columbia University; former chief economist, Inter-American Development Bank.

Roque B. Fernández, professor of economics, CEMA University; former minister of economics, Argentina.

Pablo E. Guidotti, professor, Torcuato di Tella University; former vice-minister of finance, Argentina.

Paulo Leme, executive-in-residence, professor of finance, Miami Business School, Miami University.

Liliana Rojas-Suarez, president, CLAAF; director of the Latin America Initiative and senior fellow at the Center for Global Development; former chief economist for Latin America, Deutsche Bank.

Center for Global Development

Ideas to Action: Independent research for global prosperity

WWW.CGDEV.ORG

LILIANA ROJAS-SUAREZ is director of the Latin America Initiative and a senior fellow at the Center for Global Development.

Contact:
Diego Castrillon, research assistant,
dcastrillon@cgdev.org