Latin America's Hard-to-Escape Stagnation Trap

Liliana Rojas-Suarez

Recent forecasts for economic growth around the world place Latin America as the developing region with the lowest growth rate, a dubious distinction it has earned in six of the last ten years. For example, the IMF and the World Bank forecast a meager rate of growth for Latin America in 2023—1.8 and 1.3 percent, respectively—with little improvement for 2024. Discouragingly, these poor outcomes coincide with a period of high commodity prices, which in the past have enhanced growth in the region.

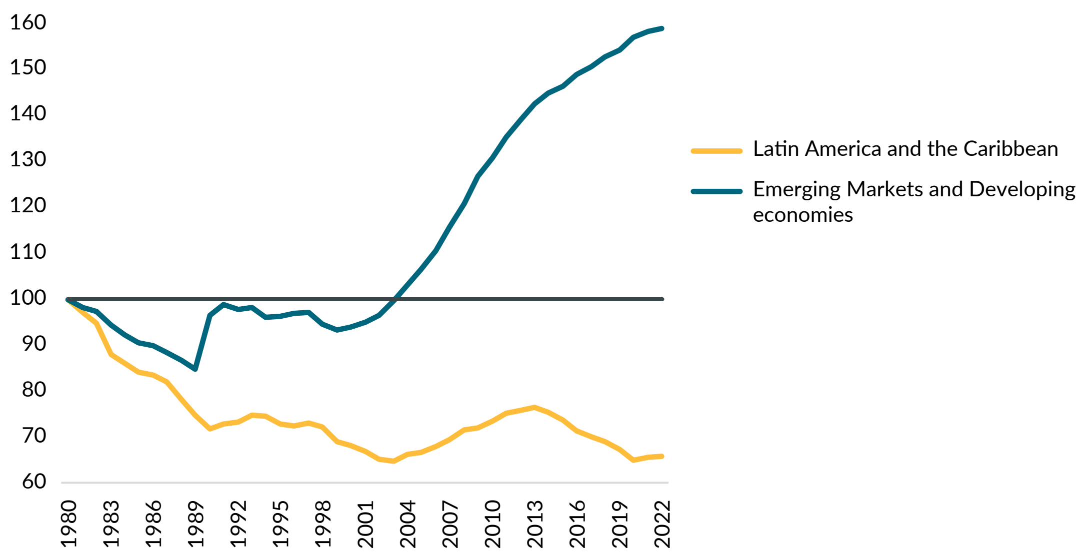
How concerned should we be by these numbers? Very, and not only because the latest figures are just one more data point in a persistent trend. The numbers are also worrisome because key fundamentals reveal that the region has fallen into a "stagnation trap," meaning there are no convincing reasons to believe that faster growth is in the cards in the foreseeable future.

Low growth rates and the reversal of convergence towards higher income levels

Over the last decade, the region grew at an annual average rate of 1.23 percent. Even excluding the 2020-21 pandemic period, the average growth rate remained extremely low at 1.6 percent. For comparison, during the so-called *lost decade* for Latin America, the region grew at an average rate of 2.2 percent.

These numbers suggest that Latin America not only stopped growing but also reversed its process of convergence to the per capita income levels of advanced economies. The recent evolution of income convergence can be approximated using IMF data on real GDP per capita adjusted for purchasing power parity. As shown in Figure 1, during the 2000s, Latin America started to converge to the per capita income of advanced economies. That process, however, did not last long and by 2012 it had started to reverse. By 2019, the year before the pandemic hit, Latin America's income gap compared to advanced economies was back to where it was two decades earlier! In contrast, the aggregate group of emerging and developing countries (which includes the poorest countries in the world) started the process of convergence in the early 1990s and continues to date. (A sound analysis of convergence for the group of emerging and developing countries can be found in Patel, Sandefur and Subramanian, 2021). In the 1980s, Latin America's income per capita was three times that of the entire group of emerging and developing countries; today, that difference has been reduced to less than 30 percent.

Figure 1. GDP per capita relative to advanced economies (adjusted for PPP) 1980 = 100



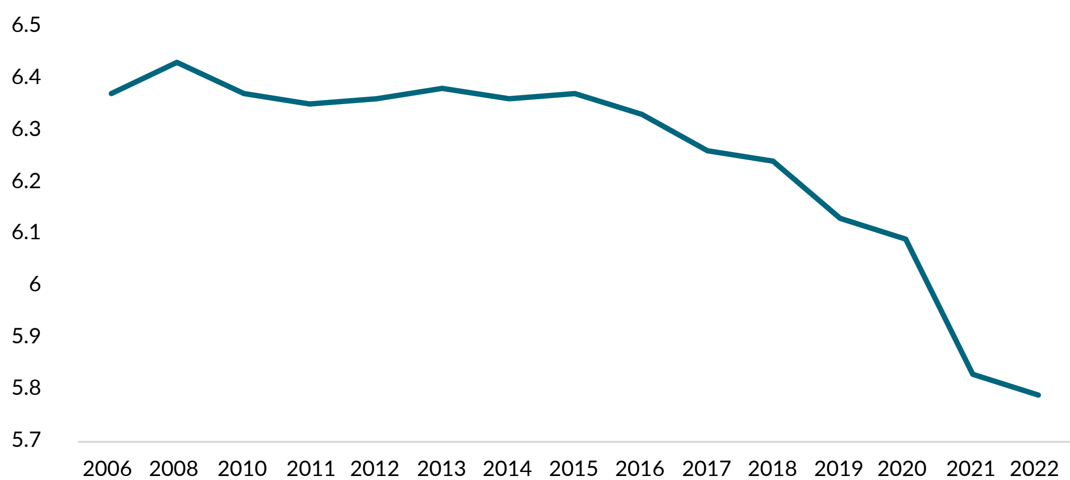
Source: Own calculations based on IMF data

Even more worrisome are the prospects that Latin America's stagnation problem will be resolved anytime soon. Leaving aside the highly uncertain international financial conditions, which are important determinants of short-term growth, the local motors of growth are quite dysfunctional, constraining long-term growth. Two interrelated factors that were present in the pre-COVID period but intensified during the pandemic stand out: the deteriorating quality of governance and democratic institutions, and the high and increasing degree of labor and firm informality.

Increasing deterioration of governance and institutions

The World Bank Governance Indicators shows that for a number of countries in the region, key indicators of institutional quality, such as adherence to the rule of law, control of corruption, and political stability, deteriorated in the last decade. This is consistent with the findings of *The Economist*'s 2022 Democracy Index, which scores countries in five categories: electoral process and pluralism; civil liberties; the functioning of government; political participation; and political culture. The 2022 index states that in terms of democratic quality, Latin America "continues its recent decline," with some countries like Mexico and El Salvador showing significant deterioration. (Figure 2)

Figure 2. Democracy Index in Latin America



Survey data from Latinobarometro offer further evidence of severe institutional weaknesses in the region:

- Trust in governments and their institutions is among the lowest in the world. For example:
  - only 13 percent of the Latin American population has some trust in political parties
  - only 36 percent of the population trust the police
- 70 percent of the population is not satisfied with the workings of democracy
- The systems of political parties are highly fragmented with some countries, including Brazil and Peru, having more than 20 political parties.

The number of government officials criminally charged in the region has skyrocketed in recent years, reflecting the deep institutional problems, including the prevalence of corruption. Perhaps the most alarming figure is that 20 presidents from 11 Latin American countries are either in jail or under judicial investigation.

The sustained weakening of democracies and their institutions does not bode well for investment and growth, as it conveys increasing uncertainty about the *rules of the game* under which local and foreign investors operate. Moreover, lack of trust in public institutions permeates into low trust between citizens, affecting their willingness to engage in private contracts necessary to conduct economic activities because of strong perceptions that enforcement of those contracts is not guaranteed.

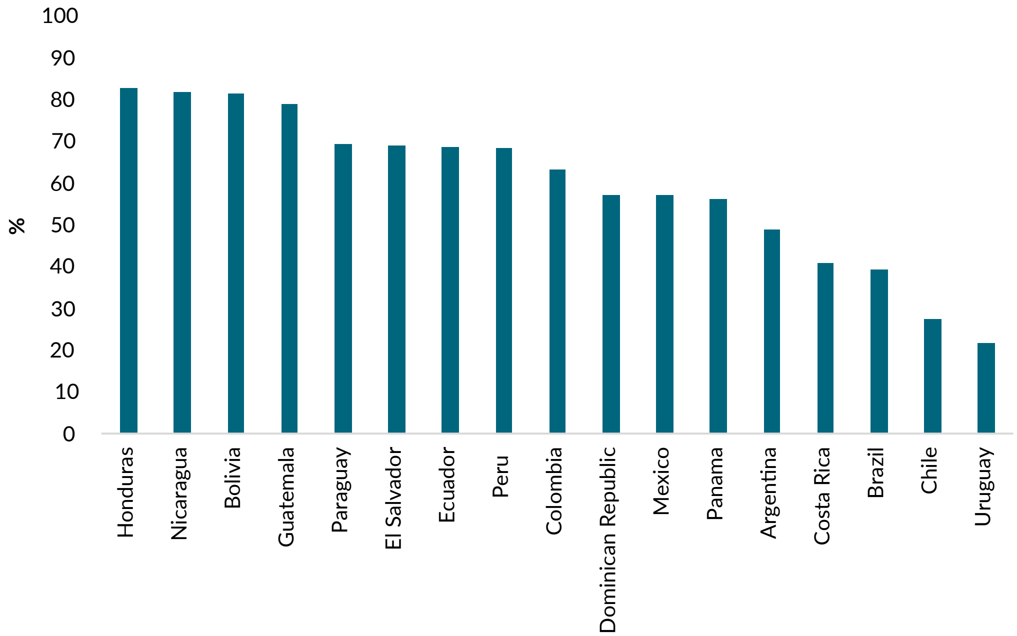
Productivity is weak and increased informality doesn't help

For several years now, low labor productivity has been a key obstacle to economic growth. As analyzed in Dieppe (2021), labor productivity in Latin America before the pandemic was below other emerging markets across different economic sectors. Contributing factors include high levels of informality, partly explained by distortionary policies, especially related to labor regulation, but also the weakening of institutions discussed above, including the low level of government effectiveness. Weak institutions constrain the provision of high-quality public goods and social insurance, and, therefore, reduce workers' incentives to participate in formal labor markets.

The impressive levels of high informality in the region are shown in Figure 3. Labor informality reaches over 70 percent of total workers in a number of countries, with the median for the region at 63 percent. Only in Chile and Uruguay is labor informality below 30 percent.

In a number of countries—Peru, most notably—the pandemic and accompanying lockdowns drove informality levels even higher. Moreover, given current uncertainties, the risks for increasing informality are rising in the region. Recent data from the International Labour Organization indicate that, among 11 countries with available data, by the end of 2021 one in every two new jobs created was informal. High levels of informality with risks tilted towards further deterioration are a severe constraint for improvements in productivity and, therefore, for getting out of the stagnation trap.

Figure 3. Labor informality in Latin America (workers in the informal sector as a proportion of total employment)



Source: ILOSTAT

Escaping the stagnation trap

Of course, a dark horizon on economic growth is not inevitable. The region has incredible potential. For example, it contains 60 percent of the world's lithium reserves (a mineral key to the global energy transformation) and there has been significant progress in digitalization. Most importantly, regardless of political orientation, most countries remain committed to maintaining macroeconomic stability, which is a key foundation for sustained and equitable economic growth. However, for the region to realize its potential, significant governance improvements are a must. These improvements require difficult reforms, such as those to legislative and judiciary systems as well as those to revamp state capacity. So far, such reforms have proven extremely hard to implement in most countries. The million dollars question is, can consensus on reforms be reached in Latin America's highly polarized economies? Unquestionably, this is the top challenge for the region.

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