As seen in:
gtnews.com, 14 November 2011

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Latin America Economies: Heating Up, Cooling Down

Thirty years ago, what were described as 'emerging markets' accounted for one-third of global gross domestic profit (GDP). Now the number is over half and emerging markets accounted for more than 80% of growth in real GDP in the past five years. The Latin American economies are notable contributors to these increases and their rapid growth has recently raised concerns about overheating. This article will discuss the merits of these concerns and the state of the Latin American economies generally.

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In April 2011 the International Monetary Fund (IMF) issued a regional economic outlook on the western hemisphere entitled Watching Out for Overheating. The report predicted "continued recovery of the global economy, led by emerging markets, amid high commodity prices and easy global financing conditions. At the same time, economic slack and easy monetary policy in advanced economies will keep global financing sources cheap." About the Latin American and Caribbean region, the report said: "[Economic factors] remain especially stimulative for those that are commodity exporters and are well integrated with global financial markets, as they experience double tailwinds," but cited three factors that threaten economic stability within the region: inflation; account deficits, as imports begin to outstrip exports; and accelerating credit and asset prices, due in large part to increased external borrowing.[1]

Overheating: Where Are the Hotspots?

What is true on average, however, does not necessarily reflect the case of any one of its constituents. A recent study in The Economist[2], noting the undifferentiated manner in which the emerging economies are described as heating up, attempted to determine whether such forecasts are true generally and, if not, which economies are in fact worrisome. The study evaluated the economies of 27 nations according to six indicators: inflation, GDP growth rate, tight labour markets, excessive credit expansion, real rate of interest, and external balance and within Latin America (as elsewhere), found notable discrepancies, country to country.

Argentina and Brazil, the two largest Latin American economies, were ranked first and second, the 'hottest' of all the emerging economies, with Argentina the only nation that showed signs of overheating for each of the six indicators. Peru was 11th, Chile 13th, Colombia 15th, Venezuela 19th, and Mexico 23rd. However, while Brazil's rate of inflation, at 5.5%, is cause for some concern, Argentina's is near 20%; and Argentina's real rate of interest is negative and inflationary, while Brazil's real interest rate is close to 6%, among the highest in the world.

However, Argentina and Brazil, given their economies' sizes, cast long shadows over Latin America generally. GDP growth in both countries has exceeded long-term trends; both have very low jobless rates and increasing wages; and credit is running far ahead of GDP, all potentially worrisome signs.

One needs to note that overheating, while certainly problematic, is largely the result of stunning economic success, prosperity, and growth, problems that many developed nations would happily take on, in exchange for their own. Also, Latin America is, to a degree, insulated from the problems of the developed countries.[3]

Its growth has been driven in large part by China's demand for raw materials, something not likely to change any time soon and, as Latin America has grown wealthier, regional demand has also grown to absorb further increased production. Moreover, governments are taking steps to keep inflationary trends under control and, perhaps most notably, the need for improved infrastructure, if continued growth is to be sustained, has been recognised throughout Latin America. This, particularly, bodes well for the future and will be discussed below in some detail.

Industrial Policy

Both Argentina and Brazil have moved to address foreign exchange (FX) imbalances. In Argentina, manufacturing has been a fast-growing sector since 2001, due to a cheap peso. But inflation has shrunk Argentina's trade surplus and, in response, President Cristina Fernandez has imposed severe restrictions on foreign trade, in some cases, (e.g., RIM, maker of BlackBerry) encouraging foreign manufacturers to set up production in Argentina. In April, a bill was put forward (though it has not yet passed) intended to cap foreign real estate ownership at 20%. Membership in the Mercosur customs union keeps Argentina from raising tariffs on its own, but it has instead used a tool called non-automatic licensing that lets countries delay imports for 60 days. Since the beginning of this year, licensing restrictions have been placed on 600 products, up from 400.

In Brazil, in October 2011, President Dilma Rousseff eliminated a payroll tax for four labour-intensive industries such as clothing, footwear, furniture, and software to effect a decrease in prices for domestic goods and to help domestic producers cope with an increasingly strong real. In other market segments, e.g., electronics, tax breaks allow local producers to undersell importers. In addition, futures contracts that bet on the real's strengthening will be taxed, in an attempt to decrease speculation and weaken the real against the US dollar. Brazil has also placed restrictions on foreign oil concessions and, like Argentina, on real estate ownership.

It is difficult so far to measure the impact of these measures (imports have continued to grow faster than exports, although growth might have been even more rapid, absent controls), and they may drive inflation, even if they reduce trade imbalances. Also, some trading partners and foreign investors have found some of the measures heavy handed and have lodged complaints with the World Trade Organisation (WTO).

Investment in Infrastructure: Positive Signs

The importance of infrastructure investment is that it has a multiplying effect: it not only attracts investment and creates jobs, but helps foster future growth. In most of Latin America, there is considerable private, foreign investment in infrastructure, but the strong involvement of the individual governments should help control and steady interest rates. Some of the efforts either planned or underway in various countries are discussed below.

Brazil

In Brazil, investment in infrastructure is seen most dramatically in the northeast. Former President Lula da Silva's anti-poverty programme has moved an estimated million-plus citizens in the northeast out of poverty which, in turn, has attracted foreign investment. In response, the government is building highways and railways, increasing the capacity of the port city Suape, and creating programs for educating workers. This has attracted further investment from China, which is increasing the capacity of Ponta da Madeira, the private port of the mining firm Vale, from which China imports iron ore. The improved railway has had spillover effects, increasing agricultural trade as well.

Panama

Panama's economy expanded by 8% a year between 2005 and 2010, the most rapid growth in the western hemisphere and the IMF predicts a continued 6% per annum growth over the next five years. Much of the growth is driven by foreign investment, 9% of GDP, one of the highest in the Americas, and has been spent on infrastructure: a US$5.3bn expansion of the canal and a US$13.6bn investment in schools, hospitals, and transportation. Whether these numbers can be sustained will depend on improving notoriously poor schools, expanding a small pool of skilled workers, and getting past a lingering reputation for political corruption. But these are steps, certainly, in the right direction.

Colombia

Colombia has long faced internal security issues as a detriment to foreign investment. But its President, Juan Manuel Santos, when military commander under President Alvaro Uribe, reduced the number of FARC guerillas from an estimated 18,000 in 2002 to approximately 8,000 today. Santos has also created a national infrastructure agency with a ten-year, US$55bn investment plan aimed at improvements in rail, roads, airports, and shipping. Problems with FARC violence remain, but, despite that, Colombia is a different culture than it was ten years ago and foreign investment is readily available.[4]

Chile

Chile is rich in many assets, but poor in energy resources: 75% of its energy – oil, coal, and natural gas – is imported. Argentina has closed off its natural gas resources, and political differences rule out Peru and Bolivia as alternate sources, at least for the present. President Sebastian Pinera approved plans for hydroelectricity, in the form of dams, but he has been met with resistance from environmental groups; and nuclear energy is a frightening prospect in a country prone to earthquakes. Pinera wants to increase domestic energy production to 20% by 2020, up from 4% today. Such hopes may ride on solar energy, geothermal wells, and energy derived from oceanic tides, dubious prospects at best. In any event, Chile aims at economic increases of 6% per year, which will require doubling its energy usage in a decade.

2020 is also Chile's bicentenary and the Ministry of Public Works has major construction plans (called 'Chile 2020') to coincide. Projects planned are the enlargement of Santiago's airport, the creation of reservoirs and irrigation canals, shipping and coastal infrastructure, and a coastal road spanning two-thirds the country's length.

Mexico

In 2008 Mexico established the Fondo Nacional de Infraestructure (FONADIN), the government agency for infrastructure in the sectors of communications, transport, water, the environment and tourism. According to the 2007-2012 National Development Plan, the Mexican economy is expected to grow on average by approximately 3.5% per year, allowing for major investment in highways, roads and bridges; water, irrigation, drainage and sanitation; railways, ports, and airports; and environmental and biodiversity projects.

Peru

In October of 2010, Peru's Ministry of Economy and Finance (MEF) announced the launch of the US$460m Brookfield Peru Infrastructure Fund to promote development of infrastructure in Peru, which they said was an "essential requirement" to increase competitiveness. The ministry said that the fund will invest in the energy and gas sectors; in airports, seaports, highways and railways; and in water and sewage projects.

Problems, However, Remain in the Cities

Latin America has allowed the infrastructures of its cities to fall behind, according to a McKinsey report[5], even as it has witnessed a significant population shift toward urban living. Eighty percent of Latin Americans live in cities, half in the 10 largest. The result has been congestion, pollution and lack of housing, compounded by lack of urban planning. Said the report, "[Latin American cities are] congested, poorly planned and dangerous." Once growth drivers, cities now typically lag national growth statistics. Sao Paulo's and Rio de Janeiro's economic growth both lag the nation at large, Rio de Janeiro only slightly better than a third of the national number. Only three of Latin America's largest cities – Lima, Monterrey, and Mexico City – exceeded their nation's overall growth. The report found a lack of urban planning contributed to a housing shortage and lack of needed services that would require US$3 trillion by 2025 to address. Bogota would need to double its housing stock within the same period. Whether these issues are addressed will determine whether Latin American cities, with their great potential for economies of scale, will be economic drivers of – or anchors on – future prosperity.

Conclusion

It is one of the ironies of economics that there can indeed be too much of a good thing. Strong currencies, low jobless rates, and increased wealth and buying power can be harbingers not of continued prosperity but rather inflation, over-production, and trade and foreign exchange imbalances. A number of the Latin American economies are vulnerable to such inflationary set-backs and determined actions will be necessary to keep them under control. As mentioned, Latin America is to a degree insulated by robust trade with Asia from the on-going problems in Europe, but not invulnerable. Boosting interest rates can help slow growth, but can also spur speculative foreign investment.

To the extent possible, foreign speculation in Latin American currencies needs to be discouraged, public sector savings encouraged, and interventions in the foreign exchange market probably necessary. But, as seen, there is great reason for optimism in Latin America, very strong indicators in many areas and, it appears, the political will to take necessary steps. With careful attention to monetary policies and both macro and micro economic trends, Latin American economies should be able to control the present inflationary tendencies and, if they do, seem well positioned to maintain strong growth in the years ahead.

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Dino Sani has more than 28 years of global trade, international cash management and banking services experience. Most recently Sani was responsible for the development of a US-focused initiative for Banco do Brasil. He previously served as general manager of the New York branch of Banco Itau. While at Itau, he was responsible for the planning and implementation of a trade strategy for business development in Latin America. Sani received a bachelor's degree in economics from Pontificia Universidade Catolica of Sao Paulo and a master's degree from Stern School of Business at New York University.

[1] While the IMF recommended a tightening of macroeconomic policies, believing that inflation is a result of excess demand and higher commodity prices, at least one analyst questioned the value in this, finding the correlation between inflation and fiscal policy to be weak. He noted that, in the past, rising domestic prices correlated with an external fall in the value of domestic currency, whereas what is seen currently is a modest fall in the value of Latin American currencies domestically, but a rise in their value externally, insisting that this cannot be seen as overheating. Matias Vernengo, "Are the Latin American Economies Overheating?", Triple Crisis, 24 May 2011.

[2] The Economist, "Economic focus: Some like it hot," 02 July 2011.

[3] Although not entirely. In August, in response to worldwide unease, Bovespa's index lost 8.1% in a single day and the exchange rates of the real and Mexican peso dropped with it.

[4] In February 2011, President Santos claimed that Colombia and China were together planning to build what he called a "dry canal," a railway connecting Colombia's Caribbean and Pacific coasts that would compete with the Panama Canal. What is not clear is whether this is an actual project. Santos described the plan as "well advanced," but transport minister German Cardona described the plan as a "rough draft" floated by the Chinese. Another government official, speaking anonymously, described the canal as a "Chinese story," a Spanish idiom for "tall tale."

[5] All statistics: "Building globally competitive cities: The Key to Latin American Growth," McKinsey Global Institute, 2011.