

JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
RICE UNIVERSITY

THE END OF THE LATIN AMERICAN BOOM

BY

JOSÉ ANTONIO OCAMPO
WILL CLAYTON FELLOW IN INTERNATIONAL ECONOMICS
JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
RICE UNIVERSITY

AND

PROFESSOR IN THE PROFESSIONAL PRACTICE OF INTERNATIONAL AND PUBLIC AFFAIRS
COLUMBIA UNIVERSITY

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Abstract

Latin America experienced rapid rates of economic growth from 2003 to 2007. The boom was based on the extraordinary coincidence of three favorable external shocks: high commodity prices, exceptional external financing and high levels of remittances. Since mid-2008, all of these factors have turned negative and deteriorated further with the deep world financial crisis that erupted in mid-September. As a result, the boom is now over, but compared to previous crises, countries now have more room to maneuver to manage adverse external conditions.

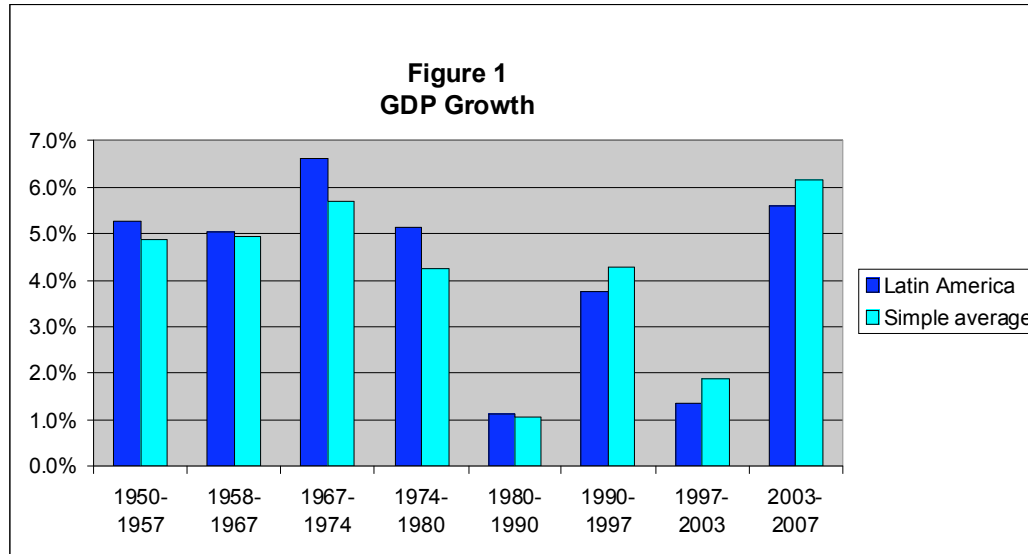
The recent boom

Although not necessarily spectacular by East Asian standards, Latin America experienced from 2003 to 2007 the most remarkable period of economic growth since the long post-war boom that culminated in 1970s. This took place after almost a quarter of a century of unsatisfactory performance, marked by the “lost decade” of the 1980s, the “lost half-decade” from 1998 to 2002, and a period of weak performance between the two.

As Figure 1 indicates, recent rates of growth were below the previous record set between 1967 and 1974 (5.6% vs. 6.6% per year). However, this is entirely explained by the relatively slow growth in recent years of the two largest Latin American economies, Brazil and Mexico. If we estimate simple averages, recent rates of growth are actually the highest of the post-war period (6.2% between 2003 and 2007 vs. 5.7% between 1967 and 1974). This is a reflection of the excellent performance of most of the small and medium-sized economies of the region.

The boom was based on the extraordinary combination of three factors: high commodity prices, exceptional financing conditions and high levels of remittances (Izquierdo et al., 2008; Ocampo, 2007). The economic history of Latin America shows that the combination of the first two factors invariably leads to rapid economic growth. The last time these two positive factors coincided was in the 1970s. All three factors have never been seen together before.

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Source: Author's estimates based on data from the United Nations Economic Commission for Latin America and the Caribbean.

Improvements in terms of trade, facilitated by the commodities boom, were uneven across the region. Minerals, including energy products, experienced a spectacular boom, more than doubling in price in real terms in relation to the 1970s. Agricultural prices also increased, but the gains largely represented a recovery from losses during the price collapse of the 1980s and 1990s. At their peak, in March 2008, agricultural prices merely hovered near real 1970s prices (indeed, they were still somewhat below those levels, particularly in the case of tropical agricultural products (Ocampo and Parra, 2008)). As a result, the countries that benefited most from the commodities boom were all mineral (including energy) exporters, essentially the Andean economies in a broad sense (from Venezuela to Chile—see Table 2 below).¹ Major agricultural exporters (Argentina and Brazil) experienced only moderate improvements in terms of trade. Energy importers, such as the Central American countries and Uruguay, had the strongest negative shocks, which were nonetheless moderated by the high prices of their commodity exports.

The boom of external financing had three notable features. First, the cost of financing was sharply reduced as a result of the fall in risk premia, which since mid-2004 were systematically below pre-Asian crisis levels. Second, the availability of financing increased and became a

¹ This may sound strange for Colombia, but two-fifths of its exports are also minerals (oil, coal, nickel and gold) and its manufacturing exports are largely destined for its two oil-producing neighbors.

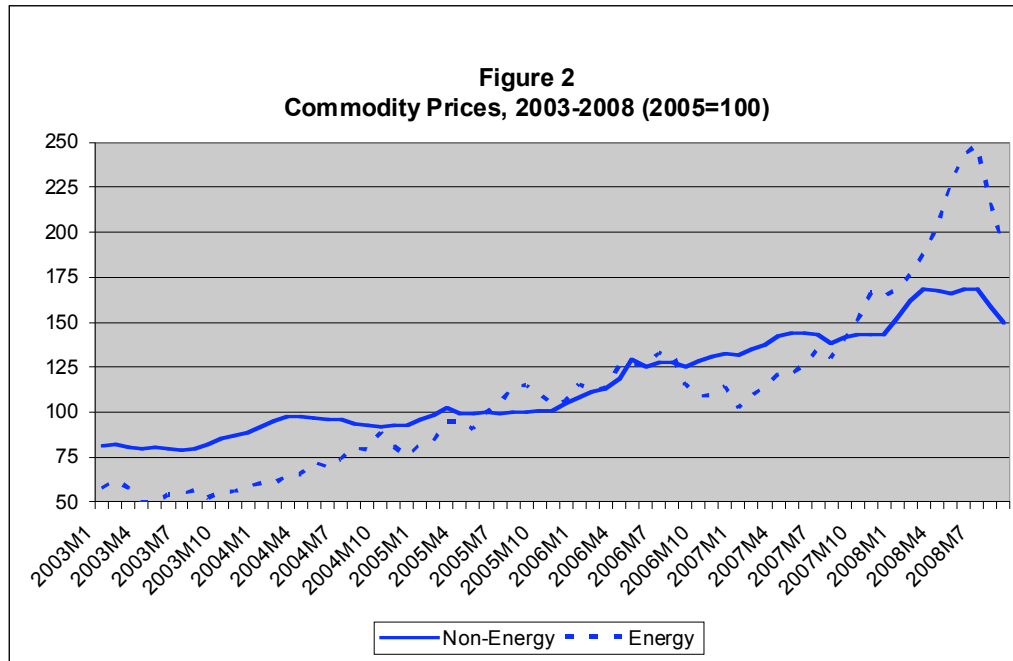
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veritable flood from mid-2006 to mid-2008, particularly to some countries (most importantly, Brazil), with a brief interruption during the first phase of the subprime crisis in the United States (July and August 2007). Third, governments were more circumspect in their use of external financing, and private funds came with a larger component of equity financing.

The third factor, remittances, had increased since the late 1990s, from less than 1% of Latin America's gross domestic product (GDP) to 2% in 2003 and 2004. Remittances played a crucial role in the economies that are closest geographically to the United States, and they comprised a much higher proportion of those countries' GDP. Interestingly, remittances were particularly important in most of the small economies of Central America that were experiencing an adverse terms of trade shock due to high oil prices.

All of these factors turned negative even before the dramatic financial events that started in mid-September 2008, but the rate of deterioration accelerated as a result of the ongoing financial crisis. The tendency of remittances was the first to change. Their growth was slow in 2007 and turned negative for many, if not all, countries during the current year. In Mexico, for example, they fell 4.2% between January and August 2008 compared to the same period in 2007. The basic explanations for this outcome are reduced employment for migrants in destination countries (the United and Spain, in particular) as well as increased enforcement against undocumented migration in the United States.

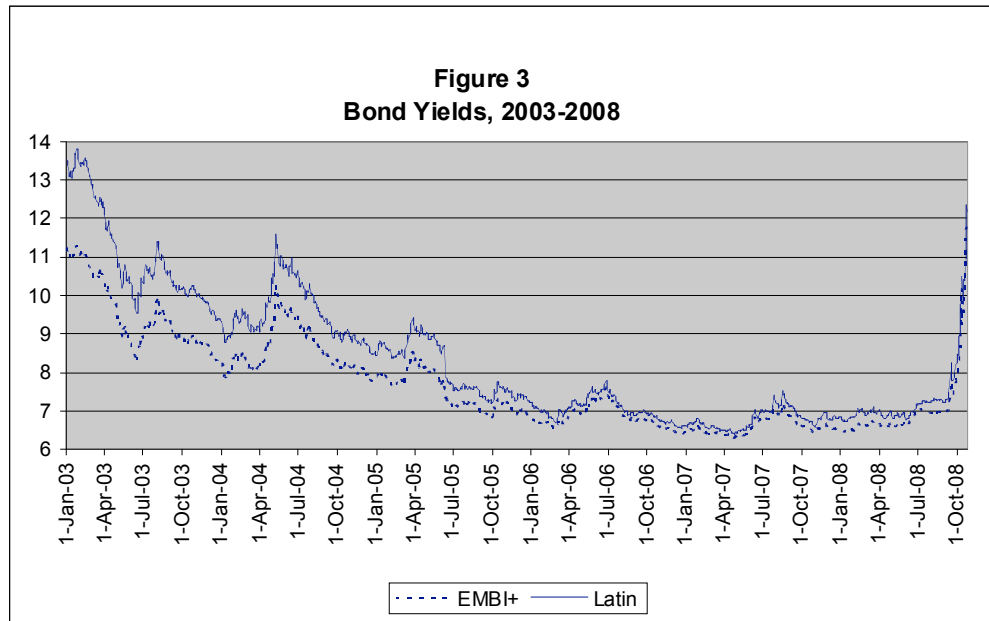
The tendency of commodity prices also turned negative before the current turmoil. If we follow the International Monetary Fund (IMF) commodity price indices (Figure 2), non-energy commodity prices peaked in March 2008 and started to fall rapidly in August 2008. Energy prices peaked later in the year, in July, but have also been falling at a very fast rate since August. They all plunged during the recent financial turmoil (close to 17% from mid-September to mid-October, according to *The Economist* commodity price index).



Source: International Monetary Fund

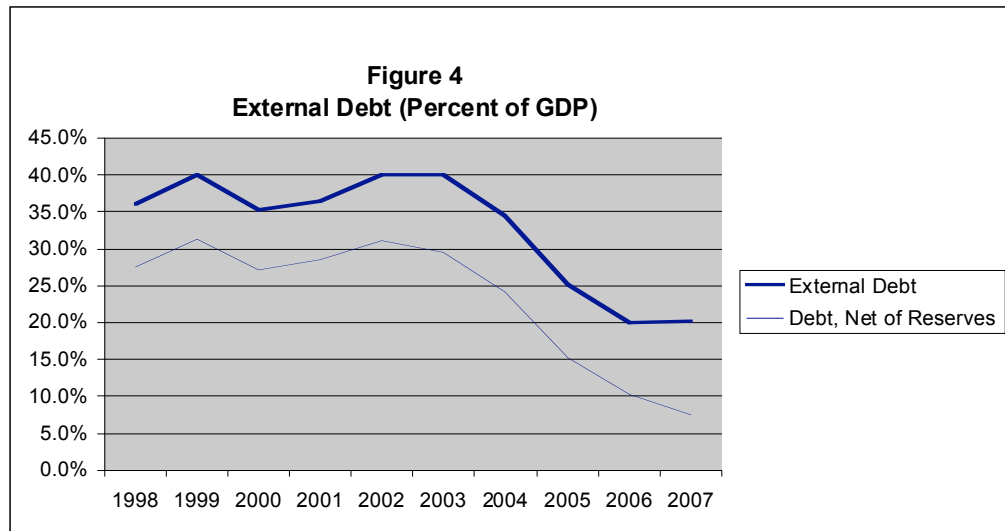
Latin American spreads bottomed out in June 2007, prior to the subprime crisis, and have essentially risen since then. Up to mid-2008, however, yields remained essentially trendless, thanks to the fall in the interest rates of U.S. Treasury bonds, which serve as a reference for pricing Latin American bonds. Since mid-2008, however, yields have been rising and in early October reached levels that had not been seen since 2003 (Figure 3). External capital flows fell in mid-2008 and, as a result, stock markets collapsed. Exchange rates have uniformly trended down (or up, if measured in domestic currency per dollar) and sharply so during the recent turmoil.

This process has accelerated since mid-September, reflecting several factors: cuts in commercial credit lines, which fell victim to the credit squeeze; liquidation of investments by international funds that must cover withdrawals in the United States, debt repayments and increased collaterals (margin calls); and the unwinding of the so-called “carry trade” in which investors borrowed at low interest rates in Japan to invest in more profitable markets. Losses in derivative markets also hit a few countries during the recent turmoil, most noticeably Brazil and Mexico. In any case, as pointed out, the recent shock was not the turning point: it accelerated negative trends that were evident since mid-2008 and, by some indicators, before.



Domestic authorities’ room to maneuver

In recent years, economies have been managed in ways that have produced both positive and negative effects. On the positive side, debt levels have been significantly cut and, contrary to recommendations to freely float the exchange rate, most countries have intervened heavily in foreign exchange markets in recent years, accumulating massive international reserves. The most notable exception is Mexico, which had the cleanest float in the region, although it still accumulated an important level of reserves. The magnitude of the improvement in debt ratios can be observed in Figure 4. The debt-to-GDP ratio fell by half, from 40% to 20%; net of international reserves fell from 30% to 7%, though it fluctuated widely within the region, from nearly zero to about 40% in a few countries (see Table 2 below).



Source: Author's estimates based on data from the United Nations Economic Commission for Latin America and the Caribbean.

This gives Latin American countries room to adopt expansionary monetary policies that they did not enjoy during past crises. Some have used them during the recent turmoil, providing additional domestic liquidity as well as dollar financing to exporters who may be unable to access external commercial credit lines. How extensive this policy space is remains to be seen. The central issue here is that expansionary monetary policies will tend to enhance the depreciation of exchange rates. Authorities may fear the inflationary effects of such depreciation, as well as the erosion of foreign exchange rates, due to the incentives for capital outflows that it generates. In light of these two factors, a country may not initially appear to have broad space for counter-cyclical monetary policies, and central banks may be somewhat reluctant to use them very extensively.

Also, and unlike previous adverse external shocks, domestic financial systems now look generally healthier. For this reason, central bank governors from major Latin American countries have correctly argued that there is no need to adopt rescue packages such as those that industrial countries have put in place in recent weeks, and that many Latin American countries have had to adopt during previous crises. Strong deleveraging (debt reduction) in industrial countries may lead, however, to a severe cut in external financing that could put some domestic financial institutions under stress.

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Fiscal balances are generally healthy, and certainly healthier than during previous crises. This situation does not reflect austere spending policies during the recent boom, but rather a rapid growth in tax revenues and, in countries that have a large component of financing from natural resources, booming government revenue from natural resources. The latter includes Argentina through its system of taxes (“retentions”) on commodity exports, as well as the Andean countries through the revenues from their oil, gas and copper state-owned enterprises. Chile is the only country where a truly counter-cyclical fiscal policy was put in place, leading to the accumulation of \$21.9 billion in its two stabilization funds (the Economic and Social Stabilization Fund and the Pension Reserve Fund), equivalent to over 13% of GDP.² Chile will therefore enjoy greater room to maneuver. Other countries will have more limited space for expansionary fiscal policies.

In any case, even the worst central government deficits (in the 2% to 3% range) are rather moderate by world standards and those of previous Latin American crises. Public sector debt ratios are also lower than prior to the Asian crisis in 11 out of the 18 countries reported in Table 1. In those countries that benefited from the two initiatives aimed at reducing the debt overhang of low-income countries (the Highly Indebted Poor Countries and the Multilateral Debt Relief Initiatives), debt ratios are substantially lower. This is the case of Bolivia, Honduras and Nicaragua. In five countries, however, central government debt ratios are substantially larger than in 1998 and cross a 30% of GDP threshold: Argentina and Uruguay, which accumulated a large amount of debt during the crisis of the late twentieth century, as well as Brazil, Colombia and El Salvador. So, the room for expansionary fiscal policies in the immediate future excludes several major countries in the region.

² ECLAC (2008b, chapter IV) also includes Brazil in the list, but this is more debatable.

Table 1 Central Government: Fiscal Balance and Debt Ratios (Percent of GDP)			
	Deficit 2007	Debt Ratio 2007	Change in Debt Ratio 1998-2007
Argentina	0.6	55.8	18.2
Bolivia	0.8	37.3	-17.8
Brazil	-2.0	32.2	8.6
Chile	8.8	4.1	-8.4
Colombia	-3.0	39.9	17.8
Costa Rica	0.6	32.6	-10.3
Dominican R	0.6	21.9	3.7
Ecuador	-0.1	30.5	-26.5
El Salvador	-0.2	37.6	10.4
Guatemala	-1.5	24.3	7.9
Honduras	-2.3	19.8	-46.5
Mexico	-2.0	22.9	-4.9
Nicaragua	0.6	47.9	-76.3
Panama	1.2	60.5	-1.5
Paraguay	1.0	19.9	-0.6
Peru	1.8	30.2	-12.8
Uruguay	-1.7	59.1	35.1
Venezuela	3.0	23.9	-5.5

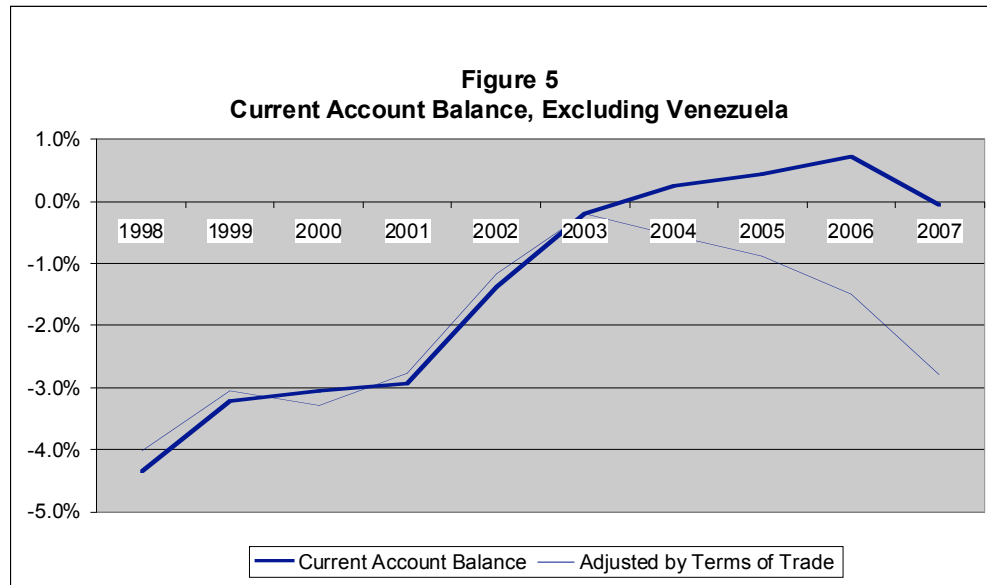
Source: Author's estimates based on data from the United Nations Economic Commission for Latin America and the Caribbean.

More generally, most countries managed the recent boom with a macroeconomic policy mix that was, on the whole, expansionary (IADB, 2008; Ocampo, 2007). This is reflected in high rates of inflation in Argentina and Venezuela. It is also reflected in high or rising current account deficits in Brazil and Colombia, where it was accompanied by an exchange rate overvaluation prior to the September turmoil. The smaller countries of Central America also accumulated relatively large current account deficits.

A simple measure of external vulnerability is the magnitude of the current account deficit adjusted for variations in the terms of trade.³ Figure 5 shows the evolution of the current account balance for Latin American countries, excluding Venezuela, as a proportion of GDP; it also shows an estimated balance, adjusted for variations in the terms of trade (with the year prior to

³ An early warning on the fallacy that the current account surplus reflected a strong balance of payments came from Calvo and Talvi (2007).

the boom, 2003, as a benchmark). As Figure 5 indicates, the adjusted current account experienced a strong deterioration throughout the boom, and sharply so in 2007. With the rate of deterioration experienced in that year, it is likely to reach in 2008 levels similar to those seen prior to the previous crisis.



Source: Author's estimates based on ECLAC data

In turn, Table 2 estimates the current account deficits of Latin American countries in 2007, both at current prices and adjusted for changes in terms of trade since 2003. As can be seen, once adjusted for terms of trade variations, most economies had a sizable current account deficit in 2007. This includes most mineral exporters, including well-performing Chile and Peru, which indeed had adjusted deficits that exceeded those of Venezuela and Colombia in that year. The only true exception among energy exporters was Bolivia. In several of these countries, we should make an additional adjustment for the heavy profit remittances by foreign investors active in the mining sector, which is likely to decrease as mineral prices fall, but would not change the basic conclusion: adjusted current account deficits were large. Countries with adjusted current account surpluses were exceptional: Argentina, Bolivia, Paraguay and Uruguay. Brazil and Mexico had moderate deficits, but in the case of the former, the current account was deteriorating very rapidly. The other interesting exception was Costa Rica, which was basically burdened by expensive oil; it is therefore the country most likely to benefit from the reversal of high energy

prices.

Table 2 Current account and External Debt Ratios (Percent of GDP)					
	Terms of trade 2003-07	Current Account	Adjusted Current Account	External Debt	Debt, Net of Reserves
Argentina	9.2%	2.8%	1.0%	47.0%	29.4%
Bolivia	41.9%	13.8%	3.7%	40.9%	0.3%
Brazil	10.0%	0.1%	-1.0%	15.2%	1.0%
Chile	85.5%	4.4%	-14.6%	33.0%	13.3%
Colombia	30.7%	-2.9%	-6.4%	22.1%	11.7%
Costa Rica	-11.1%	-5.7%	-1.3%	31.8%	16.1%
Dominican R	0.1%	-5.4%	-5.5%	18.4%	11.3%
Ecuador	25.8%	2.5%	-4.4%	40.5%	32.4%
El Salvador	-3.2%	-5.5%	-4.8%	44.5%	33.7%
Guatemala	-5.5%	-5.1%	-3.9%	12.6%	-0.3%
Honduras	-7.3%	-9.9%	-6.4%	24.6%	2.5%
Mexico	6.3%	-0.5%	-2.1%	12.2%	3.7%
Nicaragua	-6.5%	-19.2%	-16.4%	59.1%	39.9%
Panama	-7.4%	-8.0%	-4.2%	42.1%	32.3%
Paraguay	-1.3%	1.1%	1.6%	25.8%	5.2%
Peru	53.2%	1.4%	-7.7%	29.3%	3.4%
Uruguay	-12.7%	-0.8%	2.4%	52.9%	35.1%
Venezuela	104.8%	8.8%	-6.7%	23.2%	8.5%

Source: Author's estimates based on data from the United Nations Economic Commission for Latin America and the Caribbean. In the case of Chile, net debt excludes both international reserves and fiscal funds

Prospects

News on growth was unfavorable during the first semester for several countries (Colombia, Mexico and Venezuela) and others are on a downward trend now. Many countries, still absorbing the effects of contractionary policies adopted to face rising inflation, are now also dealing with the effects of the current global recession. The most optimistic recent projections for 2009 (e.g., those of the IMF, 2008a, Table 1.1) are now slightly over 3%, but it is most likely that Latin American growth rates for the second semester and next year will hover around 2%.⁴ This is not a very bad outcome, as it would still allow for a small but positive per capita GDP growth, in marked contrast to previous crises. Of course, the strength and duration of the

⁴ Indeed, the IMF downgraded its projection on November 6 to 2.5% (IMF, 2008b).

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downturn will depend on the global economy, which is still subject to significant uncertainties.

In the immediate future, the entire region, but particularly South America, is bound to experience strong economic pains from its heavy reliance on commodities. As pointed out, even the best policy performers among the larger economies, Chile and Peru, are highly vulnerable to the unwinding of the very favorable terms of trade shock they enjoyed in recent years. To the north, most of the smaller countries will benefit from lower energy prices, but they will be more directly hit by the fall of remittances and heavier dependence on tourism and exports to the United States. Due to the high concentration of exports to its northern neighbor, Mexico's economy is the most vulnerable to a U.S. recession.

Vulnerability to capital account shock is hard to predict. During the boom, Brazil and Colombia were the two countries where capital flows generated the strongest macroeconomic impact (Ocampo, 2007), and are thus likely to feel the strongest effects of their reversal.

Policy space is much larger now than during previous crises. If we are to gauge from the different indicators summarized in Tables 1 and 2 above, most countries have modest net external and government debt ratios. The least favorable mix of these two indicators can be found in Argentina, El Salvador, Nicaragua, Panama and Uruguay. Brazil and Colombia combine a relatively weaker fiscal strength with a possible vulnerability to a capital flow reversal, though their net external debt position is strong. Ecuador has the opposite mix: high net external debt ratios but stronger fiscal position.

In short, the outlook for the region is certainly better than it was during the two previous crises, but high vulnerability to external events continues to be the rule. Perhaps more fundamentally, current projections indicate the structural rate of growth of countries in the region will be slower than recent optimism might suggest. In this regard, the focus should certainly be on productive structures, where some of the fundamental problems of the region seem to lie (see, in this regard, ECLAC, 2008a).

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