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The Prospects for Latin America: Risks and Opportunities with a Historical Perspective

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Discussion Draft

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Looking back at Latin America in the last quarter century, it is possible to identify a number of troublesome features: low average and volatile economic growth; high inflation; significant terms-of-trade, capital flow volatility; fluctuating exchange rates; recurrent balance of payments, debt crises; high unemployment; and high levels of poverty and income inequality. However, conditions have changed more recently. Inflation in the region has been low; exchange rates in real terms have depreciated and have been managed more flexibly; indicators are much better with regard to the fiscal accounts and monetary policy; international trade has boomed; poverty has declined; and the external accounts are much stronger than in many years. This can be attributed to favorable world conditions, and much better policies. Not all countries have done equally well but the region has improved overall. However, the region today faces a major challenge. While conditions are better, they have given room for greater complacency, even as the relative role of Latin America in the world is shrinking. The rapid economic emergence of Developing Asia, and particularly India and China is changing the economic geography of the world, and may signal a further sharp loss in the weight of Latin America in the international arena, with adverse consequences for its economic and political well-being. This paper reviews recent economic performance, and provides a comparative study with regard to other regions, particularly Asia. It concludes that even with favorable developments, the region is far from resolving all the macroeconomic issues that are required for it to preserve its current favorable status

A. Recent performance

Latin America was characterized until very recently by **high volatility and about the lowest overall growth rate of any region**. Growth has picked up more recently, in line with the rest of the world, and prospects are favorable for the immediate future. The region experienced an average annual rate of growth of 2.8 percent since 1980, or 0.9 percent on a per-capita basis. Over the last 25 years, growth in the region has been below that of the world for 18 years (Figure 1). Only in the last five years has there been an acceleration of growth, helped by the favorable conditions prevailing in the world, and Latin America per capita GDP grew at about 2.9 percent a year. A related and dramatic picture emerges from the comparison of the cumulative per-capita income growth in Latin America and in other regions. Figure 2 presents the per-capita income for the region and others, with a common central point (1995=100). While excluding from the base the dismal period of the 1980s, the region still stayed behind, except for a short period in the 1990s.

Even under the described conditions, **the region remains ahead of most areas of the developing world**. The region has a comfortable third position both in terms of per capita income in terms of current US dollars, but more so in terms of purchasing power parity (PPP), i. e. in constant purchasing value terms. The comparison is even better when based on the human development index of UNDP, based on longevity, educational attainment and income per capita (Table 1). Furthermore general

indicators of longevity, education, and other measurements of well being place the region second or third in the world. LA has the lowest share of defense spending in the world as a proportion of GDP, and second highest spending in education and health.

Table 1

Key Indicators of Economic and Social Performance	Human Development Index (2004)	GDP per capita PPP terms (2005)(e)	Life Expectancy at Birth (2004)	Mobile Phone subscribers (per 1000 people)	Military Spending (%GDP, 2004)
High-income OECD	0.95	32003	79	770	2.5
Central and Eastern Europe and the CIS	0.80	11478	69	458	2.3
Latin America and the Caribbean	0.79	8620	72	318	1.3
East Asia and the Pacific	0.76	5900	70	243	1.8
Developing countries	0.68	5200	65	186	2.0
Key indicators of Economic and Social Performance	Adult Literacy Rate (2003)	Gross school enrollment ratio (primary-secondary) (2002/03)	Female to Male Attendance Ratio (2005)	Public Expenditure in Education (%GDP, 2002)	Expenditure in Health (%GDP, 2003)
High-income OECD	100	95		5.6	11.3
Central and Eastern Europe and the CIS	99	83	99	4.1	6.5
Latin America and the Caribbean	90	81	101	4.3	6.8
East Asia and the Pacific	90	69	99	3.2	5.0
Developing countries	77	63	91	4.1	17 5.8

Sources: World Bank, World Development Indicators, 2006, UNDP, Human Development Report, 2005; IMF, WEO, April 2006

Figure 1: Economic Growth in Latin America has been uneven, although it has recovered in recent years

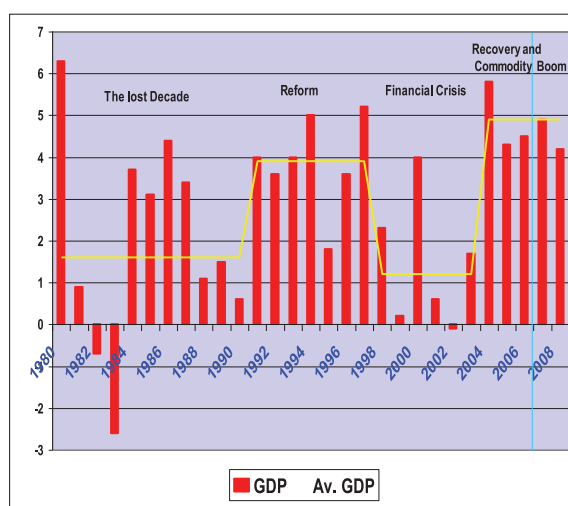


Figure 2: However, growth performance has lagged behind the World

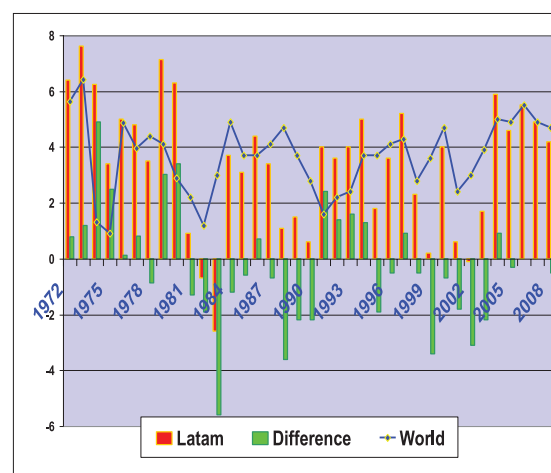
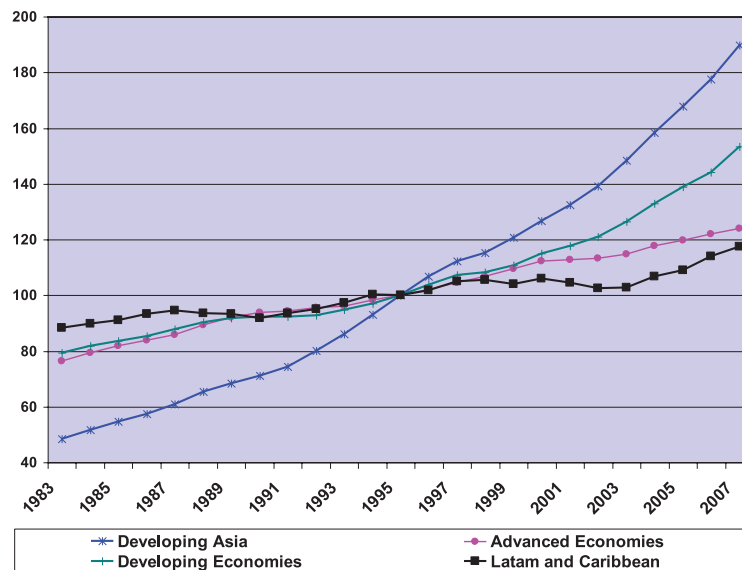


Figure 3: The region has lagged others in terms of GDP Per Capita (1995=100)



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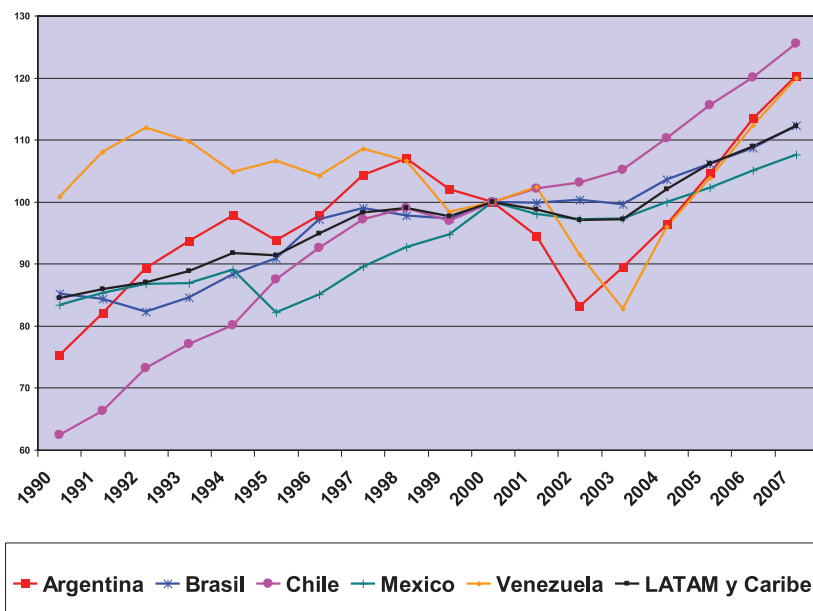
Table #2: Per Capita Income (Current US\$ and PPP-equivalent, and Human Development Index -2006)

Region	Per Capita Income Current US\$	Per capita Income PPP 1/	Human Development Index
Advanced Economies	35180	19920	0.95
Africa	1184	1668	0.5
Central and Eastern Europe	7244	7297	0.8
Developing Asia	1572	3150	0.68 2/
Middle East	4910	4209	0.68
Latin America and Caribbean	5396	5396	0.79
1/The estimate for purchasing power parity has been normalized on the basis of the per capita income of Latin America, for comparison purposes			
2/ Average of South Asia and east Asia-Pacific			
Source: IMF, World Economic Outlook, April 2007, IBRD, World Development Indicators, 2007; UNDP, Human development report, 2006; and own estimates			

The region cannot be seen as a single entity. **Performance among countries in the region has been divergent**, with some countries performing very well, while others did poorly, as shown on Figure 4 and Table 3. They provide information on the average economic growth rate for the group of the seven largest countries in Latin American terms of GDP in the region, ordered by descending order of their average growth rates for the period 1995-2006 and includes the values for the period 2003-2006. Surprisingly, while Chile is rightfully perceived to be the stellar performer of Latin America it only comes as the third fastest growing country in the group, after the Dominican Republic and Peru. Venezuela, Argentina and Uruguay perform worse than the region, as they experienced low growth in the second half of the 90s.

However, these three countries show a remarkable recovery in the last four years, and come at the top of the list, followed by Peru and the Dominican Republic, benefiting from favorable world conditions.

Figure 4: There is a healthy recovery in several countries, in addition to Chile



A key factor that explains the poor economic growth of the Latin American region in the last quarter century, and the more recent revival, is the **low growth in Labor Productivity (LP) and Total Factor Productivity (TFP)** in the region, particularly during the 1980s. Different estimates presented recently by CAF (Corporacion Andina de Fomento)¹ show that together with a very poor macroeconomic performance (see below), LP actually declined during the 1980s. To a large extent the phenomenon can be seen as part of the major crisis that the region confronted during the 1980s. Investment picked up in a more market friendly atmosphere in the early 90s during the process of reform, reflected in the renewed increase in LP during the past decade, which has continued even as capital flows declined. Within the totals, LP shows a significant dispersion among the larger countries. Somewhat surprisingly, LP in Argentina grew the fastest from 1990 to 2004 (6%). By comparison other countries recorded growth rates in LP as follows: Brazil: 3.5%; Chile: 3.9%; Colombia: 4.5%; Mexico: 2.9%; and Venezuela: 4.2% through 1997. During this period LP in the US grew by 4.6%.

¹ CAF,(2007) "Camino a la Transformación Productiva en America Latina"

Table 3: Average GDP growth rates- 1995-2007

GDP (percentage change)	1995-07	2003-2007
Dominican Rep.	5.9	5.7
Peru	4.3	6.0
Chile	3.9	5.1
Venezuela	3.3	7.5
Colombia	3.2	5.4
Mexico	3.0	3.3
Latin America	3.0	4.5
Ecuador	2.9	4.3
Brazil	2.8	3.3
Argentina	2.6	8.6
Uruguay	1.4	6.8

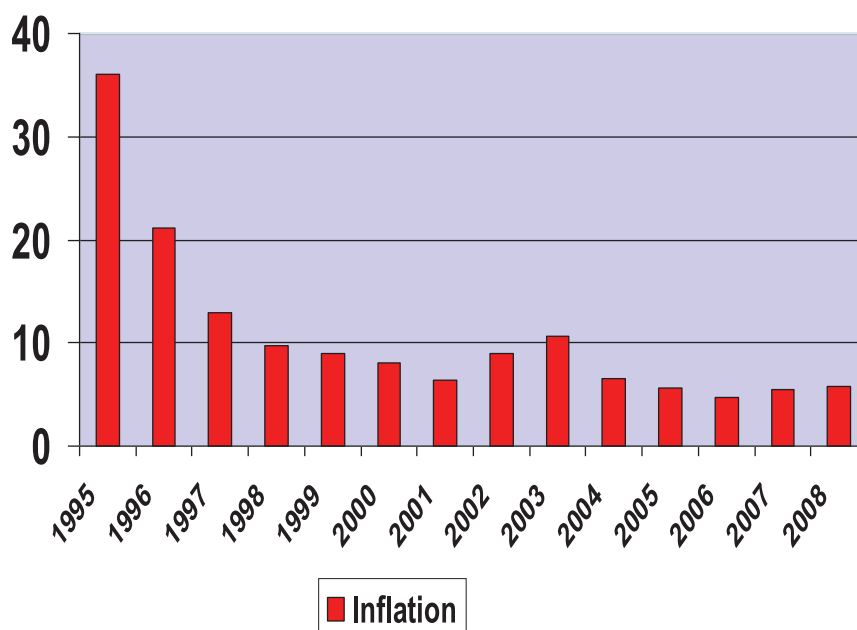
The growth in LA has helped reduce one of the main problems of the region, the **pervasive presence of poverty**. After increasing in the 1980s total poverty (in percent of population) has declined by one fifth (10 percentage points) in the last 16 years, and indigence or extreme poverty by one third. Even though some indicators have improved in recent years, significant portions of the population are excluded from education (about 10 percent of the population is illiterate); good health (10 percent of the population is undernourished, 11 percent have inadequate water supplies, and 25 percent have no sewage); and work opportunities (10 percent urban unemployment)².

Before the 1990s the **Latin American region had been for long the worst performer with regards to inflation**. Poor domestic policies, compounded by a high volatility of external conditions resulted in a high inflation, reaching almost 500 percent in 1990. The costs of inflation ended up being very significant. Inflation, recognized as the most regressive tax, contributed to the low growth track record of the region, until efforts started in earnest to reduce inflation. As a consequence, inflation converged quickly, although not fully, to existing rates of inflation in the rest of the world (Figure 4). The decline in inflation is possibly one of the main gains observed in the region in the last decade, together with the opening up to international trade. Only Venezuela and Argentina have experienced high rates of inflation notwithstanding price controls, tampering of statistics and jawboning.

The decline in inflation was the result of major efforts to control both monetary and fiscal policy. While many reforms are still pending, fiscal performance strengthened significantly, in terms of expenditure control, revenue enhancements, and reduced financing requirements by the government. Monetary policy has thus helped in reducing credit expansion, thus providing for adequate conditions for reduced inflation. Moreover, together with the more flexible management of exchange rates, there was a marked improvement in competitiveness and in the strength of the balance of payments, as discussed below.

² ECLAC, Social Panorama of Latin America, 2005

Figure 5 Inflation has come down on a sustained basis



In spite of major efforts aimed at import substitution and integration, **Latin America foreign trade has remained dependent on primary commodities, even as the productive base became more diversified.** Accordingly, the region has seen large fluctuations in terms of trade, while at the same time it has been affected by fluctuations in demand for its industrial products. The region has had the largest variability in exports of any large developing country region, and certainly much higher than that of industrial countries. This situation has generated a difficult environment for policy making in the region, resulting in stop-and-go cycles that have precluded stable conditions. LA's high proportion of commodity exports made the balance of payments and income highly dependent on developments in the "advanced" countries of the world. Accordingly, the region has benefited from the improvements in the world economy and the concurrent increase in commodity prices. However, it is susceptible to slowdowns in world activity. That is the case at present, when commodity prices are expected to decline in the near future (Figures 6 and 7 show the link between terms of trade, external performance and GDP).

In recent years the **importance of trade has increased significantly for the region.** The increase in trade has been associated with a sharp decline in the trade restrictiveness that characterized the region previously. The opening of trade in the region had a major impact in increasing the integration of Latin America to the world economy, and provided an effective increase in competitiveness. This has been helped by the rise of China as a main trading partner, although it constitutes only 5 % of total trade for the region, compared with over 40 % with the US, and more than 20% each within the region and with the European Union.

Figure 6: Terms of Trade and GDP

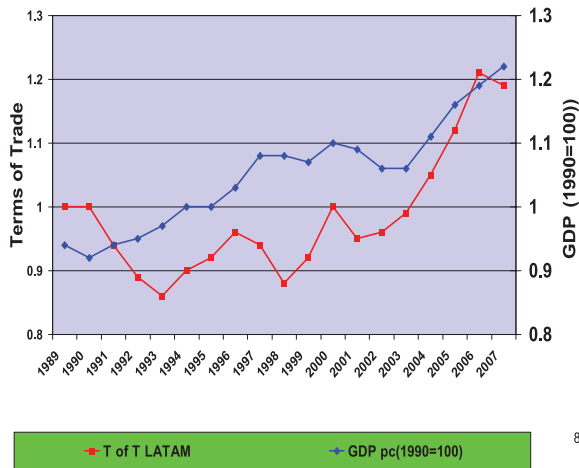
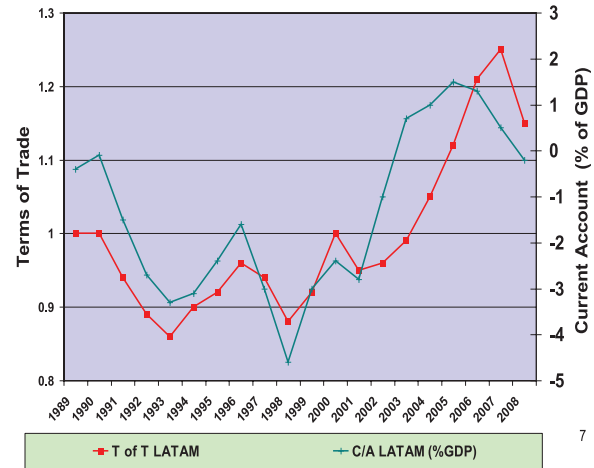


Figure 7: Terms of Trade and B of P

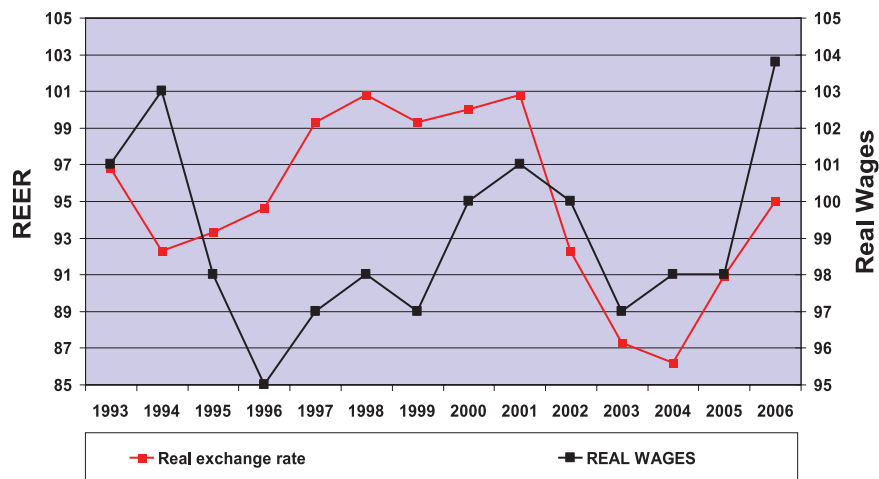


One of the most dramatic findings with regard to the behavior of the Latin American economy has been the **high dependence on private capital flows**, both in the form of foreign direct investment and portfolio flows. With limited reserves and only moderate access to official financing including from the IMF and the IFIs, the current account was dominated by these flows, and that economic policies had to adjust to this reality, in terms of adjustments in public and private expenditure. It is only in recent years that a different pattern has emerged. As countries were extremely affected by earlier crises, they started pursuing stronger macro-economic policies. The new stance, in addition to the increase in terms of trade of the recent past, allowed countries in the region to improve their external current account balance and accumulate reserves to record levels, some US\$350 billion as of mid-2007, while the debt burden has been drastically reduced. These trends have been strengthened further by the growing workers remittances for Central America, Mexico, the Caribbean, and parts of South America.

As a consequence of the previous high dependence on the terms of trade and private flows, countries in the region have been exposed to large swings in the balance of payments, and thus, by action or by default, witnessed significant changes in the real exchange rate and in the fiscal accounts. Favorable conditions resulted in an appreciation of the currency and fiscal expansion, and vice-versa. As expected, real wages have moved more or less in tandem, rather than increasing on a more sustained basis on account of increased productivity, as has been observed in other regions. This is illustrated in Figure 8 below.

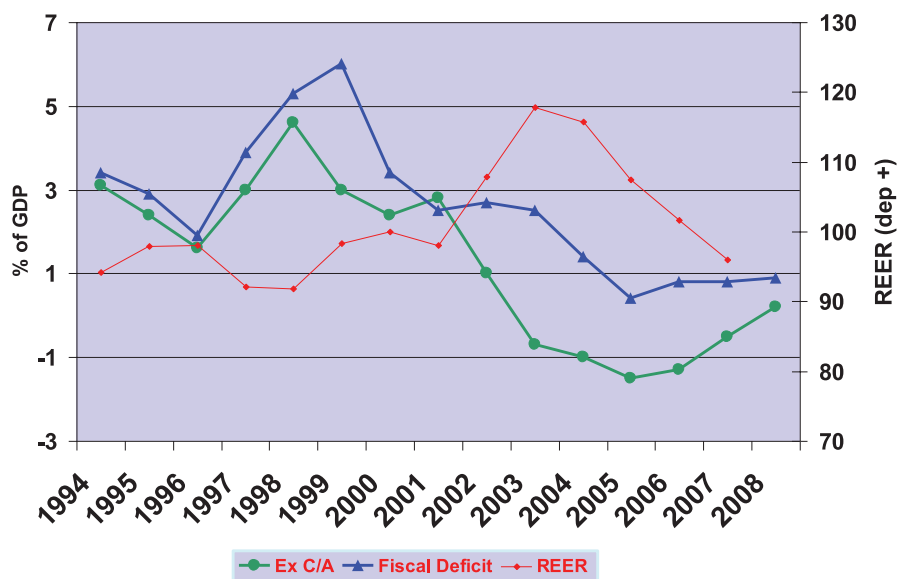
In the 1990s many **Latin American countries got engaged in market-friendly reforms**, including on taxation, public finances, financial sector reform, trade, privatization, and labor reform. The favorable impact of these policies on the region's performance was dramatic, even though certain countries went through major crises, as was the case of Argentina, Brazil, and Mexico. The decline in fiscal imbalances was particularly steep in recent years as the larger countries in Latin America, Argentina, Brazil, Chile, Colombia, Mexico and Peru adjusted their finances. As noted, a marked improvement in their fiscal primary balances had a direct effect on the fiscal balance and was the main contributor to the reduction in the vulnerability of the regional economies. Adjustments in the exchange rate also contributed to the outcome and helped in improving the external current account.

Figure 8 Real Wages and Exchange Rate



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Figure 9 External Accounts improved because of Domestic Policies...Namely Fiscal Policy and Exchange Rate Policy



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External public debt has declined markedly, from 32 percent of GDP in 2003, when it reached the highest point in recent years, to some 20 percent in 2007, as many countries, including Brazil, Chile and Mexico reduced their deficits. These efforts have been supplemented by an improvement in monetary policy, a generally more solid financial system, and a deepening of financial intermediation. The reduction in the levels of debt and a general decline in interest rates and spreads for the region helped improve the conditions for a more sustainable path for economic growth. At the same time, structural reforms helped in the revival.

As noted above, recently, the performance of the economy has been supported by a **sharp improvement in terms of trade**. At the same time there has been a **backlash in policies**, with greater government intervention, expropriations, and populist

policies. This has been accompanied by a rejection to IMF and World Bank policies and influence, as governments have become over-confident that the improvement in international conditions is permanent, and have been tempted to adjust policies accordingly.

B. Short Term Prospects for the Region

For the short and medium term the prospects for the region are positive, but with risks, which can be aggravated by the complacent policies being pursued in some of the countries. The world economic outlook issued by the IMF recently, and providing the most widely accepted projection of economic growth for the world, indicates a slowdown in economic activity for the world at large. As world-wide GDP growth rates are declining (figure 10) so are the prospects for growth in the LA region. Growth is projected to decline from a rate of 5.5 percent in 2006, to 4.8 percent in 2007, and 4.2 percent in 2008 (Figure 11). A slowdown in US economic activity, turbulence in financial markets, and possibly a deceleration in the rate of growth in China, will have a significant impact on Latin American exports. Again, on the basis of exercises carried out by the IMF (WEO, September 2007) the rate of growth of GDP could decline to as low as 3 percent within a margin of probability of 50 percent and less than 2% within a margin of 90 percent. This result has a low probability to occur but provides an indication of the possible problems faced by LA. Already, the turmoil in the markets on account of the “sub-prime mortgages” in the US has put considerable pressures on the system (See box below) even though the region has weathered the crisis rather well so far. Commodity prices declined, hitting the fiscal and balance of payments of many countries in Latin America but subsequently recovered. Risk premia increased as world markets became less liquid and reduced their “appetite” for risk including in emerging markets. The unwinding of derivatives and cross-currency transactions (for example, “carry trade”) also hit the markets in LA.

Figure 10: Prospects for World GDP Growth and Commodity Prices

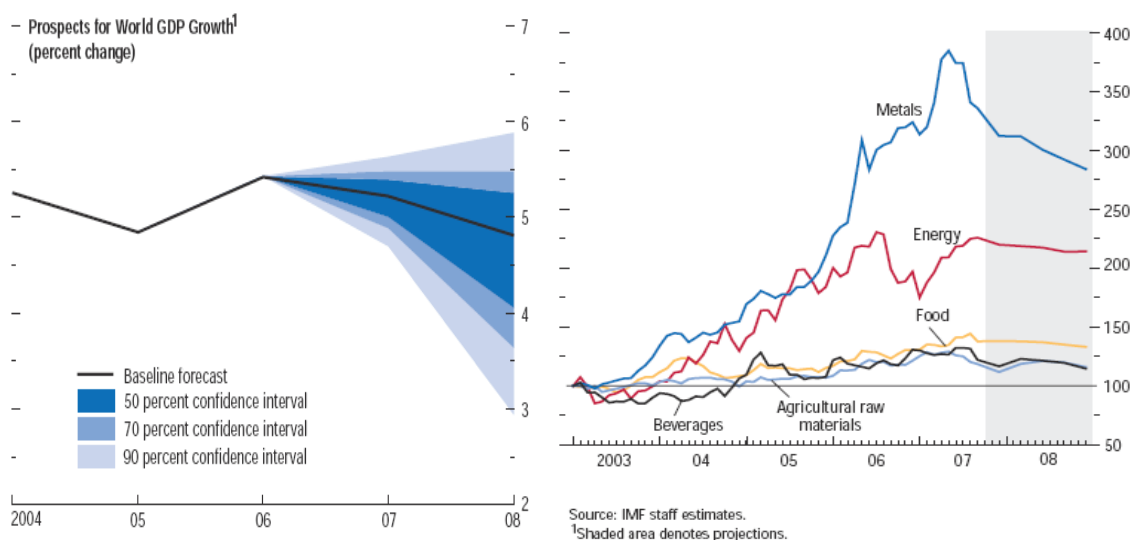
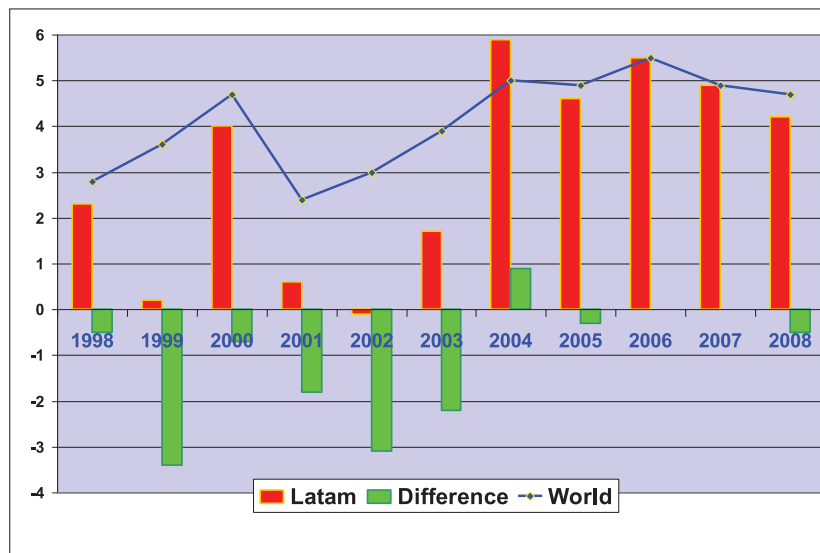


Figure 11: Economic growth in Latin America and the world



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The risks in the financial markets are somewhat mitigated by the fact that the market for domestic currency securities in the region has increased as well, particularly as currencies have tended to appreciate vis-à-vis the US dollar. Accordingly, risk premia have declined on domestic bonds. This has allowed countries in the region to borrow domestically, reducing the risks involved in changes in the exchange rates on foreign borrowing.

The vulnerability to external conditions has been aggravated by domestic circumstances. Several countries have veered toward populism (Venezuela, Ecuador, Bolivia, and to much lesser extent Argentina). Moreover, there is concern about more political contagion in the region, as populist candidates were close seconds in countries like Peru and Mexico. A further phenomenon that can increase the nervousness of domestic and foreign investors is a general rejection in LA of the IMF and the World Bank lending (even if not always their recommendations). The decline in lending by these institutions, as well as those of the IADB, has reduced the extent of external “checks and balances” which was available to investors in the past. While in many countries, it is clearly understood that self discipline will provide a strong positive signal and will shore up confidence; this is far from guaranteed in others helped in the short run by benign international conditions. Thus, foreign (and local) capital may become more prone to try to leave quickly some parts (or even all) of the region, weakening the ability of governments to react appropriately.

C. The Business Climate in Latin America

Domestic and foreign investors in Latin America confront serious problems when seeking to do business, and thus in engaging in new investments. The World Bank has very recently issued its 2007 edition of its Annual Publication *Doing Business* (available at www.doingbusiness.org). It reviews specific aspects of carrying out business in most of the countries around the world. The publication provides a comprehensive review of business practices around the world and covers 175 countries. This section provides a summary view of some key indicators covered in that publication.

Latin America and World Market Turmoil: Vulnerable Victim or Resilient Survivor?

The summer was extremely tough for financial markets around the world, in reaction to the “meltdown” in the sub-prime mortgage market in the US. As usual, attention also turned to the impact of the current volatility on emerging economies, and particularly those in Latin America.

Contrary to many financial crises in the past quarter century, Latin America was not at the center of storm. The debt crisis of the 1980s, the Mexican, Brazilian and Argentine shocks in the 1990s came about in or seriously affected the region because of institutional and policy weaknesses. In the recent episode certain countries, like Argentina, Ecuador, and Venezuela were hit hard with regard to interest premia, but in general the region has shown great resiliency so far. Interest rate spreads have increased but remain below the levels observed only 18 months ago. The stock market values declined (in dollar terms) but recovered and are more than 50 percent ahead of a year ago, in excess of performance in the US and Europe; and international reserves are at a record level of almost US\$400 billion, about US\$100 billion above end-2006.

There are two main explanations for this resiliency: international conditions provided a strong base for growth for most emerging economies; and Latin American countries have pursued generally better economic policies than in the past, with lower fiscal deficits or higher surpluses, low inflation, and flexible exchange rates. All these events strengthened the balance of payments, helping increase foreign reserves and reduce foreign borrowing. Moreover, the rising presence of China and India in international markets, and the economic recovery of Europe and Japan have helped diversify regional export markets, even as they have become strong competitors. In addition workers remittances at almost US\$70 billion a year, provide a very solid insurance against shocks among the (not so) poor in the region.

However, these favorable conditions have given a sense of security that is unwarranted, and in the end may have adverse consequences. Fiscal surpluses have been eroded by increasing government expenditures; currencies have strengthened, reducing competitiveness; and lower borrowing costs have been reflected in a rapid rise in consumer spending. These developments may have placed the region in an untenable path that requires further moderation.

While current events did not evolve into a major crisis, there are several other factors that will certainly jeopardize the observed rapid economic growth. The most important is the dependence in most countries on the performance of the external sector. To begin with, the limited financial contagion in Latin America reflected in part the effectiveness of the Federal Reserve and other Central Banks to stop the run on capital markets, which may be only a short term phenomenon. In addition, since 2003, the accumulation of reserves in Latin America has followed closely the increase in export prices. With world economic growth likely to slow down, the reversal in commodity prices can lead to a decline in reserves, or require an adjustment in policies. Interest costs will increase for most countries in the region as lenders become less inclined to take risks regarding emerging economies. Even though the public finances are strong, there is still a need for significant financing among a number of countries. Finally, with tougher conditions, investors will be less willing to engage in new projects, resulting in adverse consequences for economic growth.

None of these factors is catastrophic for the region. However, they will require considerable fine tuning by policy makers. Countries like Brazil, Chile, Colombia, Mexico, Peru, and possibly Uruguay, seem well prepared to confront unpleasant surprises in this regard. In contrast, countries where policies have been weak such as Argentina, Ecuador and Venezuela, have been hit by the financial market concerns, and need to act promptly to avoid serious damage from the current turmoil, as had been the case so often in the past.

Table 4: Doing Business in Latin America and Other Regions

	Ease of Doing Business	Starting a business	Obtain Licences	Employing Workers	Protect Investors	Export	Closing a Business
Country	RANK 2008 (Rank 2007)	Time (days)	Time (days)	Difficulty of Hiring Index (higher, more difficult)	Invest. Prot. Index (10=best; 0=wrst)	Cost to export (US\$ per container)	Recovery rate (cents per dollar)
<i>Singapore</i>	1(1)	5	102	0	9.3	416	91
<i>New Zealand</i>	2(2)	12	65	11	9.7	725	77
<i>United States</i>	3(3)	6	40	0	8.3	960	76
<i>Canada</i>	7(7)	3	75	11	8.3	1385	89
<i>Japan</i>	12(11)	23	177	28	7	989	93
<i>Chile</i>	33(28)	27	155	33	6	645	24
<i>Mexico</i>	44(43)	27	131	33	6	1302	64
<i>Peru</i>	58(56)	72	210	44	6.7	590	25
<i>Colombia</i>	66(79)	42	146	22	9	1440	58
<i>China</i>	83(92)	36	336	11	5	390	36
<i>Argentina</i>	109(101)	31	338	44	4.7	1325	34
<i>Brazil</i>	122(121)	152	411	78	5.3	1090	15
<i>India</i>	120(132)	33	224	0	6	864	12
<i>Venezuela</i>	172(164)	141	395	78	2.7	2400	7
Latin America (simple average for sample)	86	70	255	47	5.8	1256	24.4
Source: World Bank, Doing Business 2007- 2008, and own calculations. 175 countries							

Table 4 provides a few magnitudes for a number of representative countries in Latin America, and a comparison with the top world performers. The table also presents a simple average calculation for the rankings and other values for the advanced economies and for the countries in Latin America. It is clear that the ranking for the region is low. The average value of 86 is about in line with the world median ranking of 87, but compares poorly with the ranking of 23 for the advanced economies. Chile and Mexico are placed in the first quartile. Venezuela is placed within the last ten percent, with Bolivia and Ecuador (not shown in the tables) placed only somewhat better, in the company of India. Argentina falls well below the average for the region, in position 109, ahead of Brazil and Venezuela, but well below Chile, Mexico and Uruguay, the three countries at the top of the list. By comparison, China and India, the two giant performers among emerging economies, don't do particularly well either, but they tend to have lower costs and more flexible markets, and this helps them in being better placed in terms of competitiveness indices, with the possible exception of Chile.

There are a number of different indicators available world wide that reflect the noted risks, and place Latin America low and falling in the rankings, with only a few exceptions. Below (Table 5) are only a few of these indicator series, namely those on the global and business competitiveness index, prepared for the World Economic Forum, (2007);, the Globalization Index prepared by A.T. Kearney in Foreign Policy Magazine last year, the Economic and Investment Freedom Indices, produced by the Heritage Foundation

and Dow Jones this year (2007), as well the Corruption Perception Index produced by Transparency International in 2007. While not identified in the table, Latin American Countries are on average in the bottom half of the distribution. Chile is clearly at the top of the group, and among larger countries, Venezuela at the bottom within the region, closely followed by Argentina, and usually Brazil. Thus, the general indication of performance shows a mediocre outcome, that reflects the poor growth and stability performance of the various countries.

Table 5: Ranking of Latin America in Recent World Indices			
Competitiveness Index 2007 (World Economic Forum; 131 countries)		Globalization Index 2005 (A.T. Kearney, Foreign Policy; 62 countries)	
United States	1	Singapore	1
Switzerland	2	Ireland	2
Denmark	3	Switzerland	3
Chile	26	USA	4
China	34	Japan	28
India	48	Chile	34
Mexico	52	Mexico	42
Russia	58	Argentina	52
Colombia	69	Russia	57
Brazil	72	Brazil	
Uruguay	75		
Argentina	85		
Venezuela	98		
Index of Economic Freedom 2007 (Heritage Foundation and Dow Jones; 177 countries)		Corruption Perception, 2007 (Transparency International; 163 countries)	
Hong Kong	1	Finland, Iceland, N. Zealn.	1
Singapore	2	Singapore	5
USA	4	Canada	14
Chile	11	Japan	17
Japan	18	Chile, USA	20
El Salvador	29	Uruguay	26
Uruguay	33	Colombia	59
Mexico	49	Brazil, China, India,	70
Peru	63	México, Perú	
Brazil	70	Argentina	93
Colombia	73	Venezuela	128
Argentina	95		
India	104		
China	119		
Venezuela	144		

The infrastructure private investment attractiveness Index of the World Economic Forum (not included) reflects again a low standing, with Chile, ahead, followed closely by Brazil, Colombia, and Peru, a second group comprising Mexico, Uruguay, and El Salvador, with Argentina, Venezuela, Bolivia and the Dominican Republic, last. This ranking is somewhat different from the one presented in table 5, as infrastructure investment has been affected by difficulties of private investors in the area of utilities and energy in the latter countries.

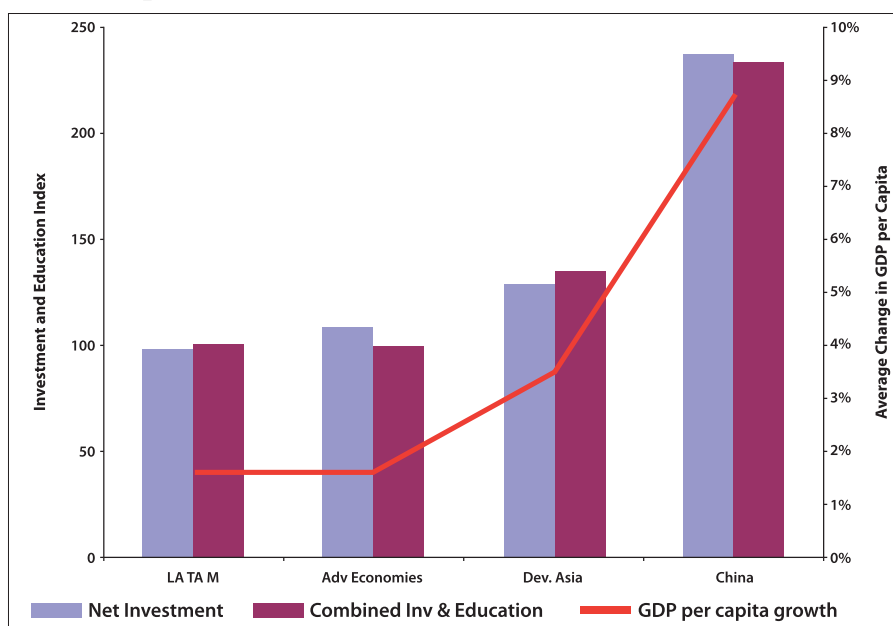
D. The Future of Latin America in the World

As discussed so far, Latin America has a reasonably high placement in the world, and has been doing well with respect to the past. It has also been suggested that many other areas of the world particularly in Developing Asia have been catching up at a feverish pace and even the Advanced Economies of the world have been growing at a faster rate. This section briefly reviews some aspects of this divergent behavior, as well as presents some projections for the next 25 years or so. While the projected results are not catastrophic they suggest a loss of relative position of the region that is certainly worrisome.

The most striking observation relates to levels of investment in the region compared to other areas of the world. Specifically, investment levels in Latin America have been significantly below those observed in Developing Asia in particular. Gross Domestic Investment for the period 2001-07, was the equivalent of 20 percent of GDP in Latin America, compared to 36 percent for developing Asia, and 21 ½ percent in the case of the Advanced Economies. Saving rates are equivalent with gross national savings being the equivalent of 18 ½ percent of GDP in Latin America over the same period, 36 percent in Asia and 21 percent in Advanced Economies, according to information included in the World Economic Outlook.

Figure 12 below provides an indication of investment, net of estimated depreciation for the period 1990-2005, and a combined index of improvements in education, measured by the increase in the years of education of the working-age population. While the numbers and the weights may be subject to further refinement, the results are striking. Latin America and the advanced countries of the world have broadly similar rates of investment and of the combined effects of education and investment. They also have very similar rates of growth of GDP per capita, however Developing Asia and China in particular, show much higher levels of investment, and of economic growth. While this chart provides no judgment of the quality of investment, and covers periods of crisis for all the regions (Asian crisis, tequila, Brazil and Argentine crises, as well as the dot.com bust) they clearly show the high correlation between the different variables and in large part the relative decline of Latin America in the world economy.

Figure 12: Comparative Performance of Investment, Education and Growth



Sources: PREAL, Inter-American Dialogue, IMF and World Bank.

Latin America's good position is eroding rapidly, reflecting the high levels of investment, productivity increase and the incorporation of labor into modern industries in countries like China and India. Surprisingly, while foreign direct investment is growing rapidly in those areas, it has represented about the same proportion of GDP as in Latin America during the current decade, and much lower than in Africa and Central and Eastern Europe. However, overall net private flows to Latin America are much lower as a percentage of GDP (and lower than direct investment), and reserve accumulation is smaller as well. This suggests relatively high private capital outflows (both investments and capital flight), at a time when the region is making net payments to official creditors. All these trends suggest a smaller retention of domestic savings than in other areas of the world (Table 6).

Table 6 Private Flows and Reserve Accumulation (2001-08, in percent of GDP)

	Emerging market and developing countries	Africa	Central and Eastern Europe	Developing Asia	Latin America and Caribbean
External Current Account	2.9	0.5	-5.4	4.2	0.2
Private capital flows, net	2.1	2.4	7.4	1.8	1.3
of which: Direct investment, net	2.2	2.9	3.8	2.1	2.2
Public Capital Flows	0.0	1.0	-0.2	1.7	-0.2
Change in reserves	-5.0	-3.9	-1.9	-7.7	-1.3

International Monetary Fund, World Economic Outlook Database, October 2007

In connection to these issues, Latin America remains considerably less developed in terms of financial depth, even though the quality of supervision and prudential regulations tends to be better than that of other regions. All financial indicators are well below the participation of the region in world GDP, with exceptionally low levels of participation in terms of Private Debt and Bank Assets, and about one half the levels observed in Developing Asia, with considerably lower per-capita incomes. While this reflects the degree of concentration of ownership and self-financing in the region, it may arguably also suggest fewer opportunities for newcomers and less innovation embodied in new enterprises (Table 7).

Table 7: Financial Market Indicators (2006)							
(US\$ billion)							
	Stock Market capitalization	Public Debt	Private Debt	Bank Deposits	Total Assets	% of GDP	GDP
World	50800	25600	43100	70860	190400	395	48200
EU	13070	7700	15500	36640	72900	534	13640
USA	19570	6230	20500	10200	56500	428	13200
Emerging Markets	11700	3880	2180	11270	29020	206	14080
Asia	6860	2020	1490	7490	17860	286	6250
Latin America	1450	1100	460	1430	4440	151	2940
Share of Latin America	2.8	4.4	1.1	2	2.3		6.1

Sources: IMF, Global Stability Report, September 2007 and own calculations

In addition to the projections on financial flows, the participation of Latin America in international trade remains much lower than it was half a century ago. In the mid-50s the participation of the region in total world trade was about 12 percent. In recent years it has hovered below 6 percent of the total, after having reached a low of 4 percent in the early 1990s. The recent recovery has reflected two factors: the opening of the region to international trade, particularly since the incorporation of Mexico to NAFTA; and the recent increase in commodity prices, which can be expected to be of a more cyclical

nature, and may well be partially reversed. During the same half century, participation of South East Asia and China in total trade has risen from some 3 percent to 17 percent, most of it in the last twenty years.

Even as the region's performance may be improving, it is very likely that Latin America growth will lag other regions in the future, in line with past performance. On the basis of a stylized exercise, the following figures and table show the path of Latin America's GDP in a world perspective. The data include projections through 2030, and assume that economic growth will be the equivalent to the average for the period 1999-2008, as projected in the September 2007 World Economic Outlook (WEO) exercise. Population growth is based on projections made by the UNDP. The exercise also includes two other projections: one based on the average rates of growth for the same period, reduced by one standard deviation from the mean, and one which includes specific numbers for Asian countries, as projected by the ADB for the period through 2020, and the standard average projections for the rest. The latter projections a more realistic projection for China and Asia, while still being much higher than the rates assumed for Latin America. There are caveats to this simplified approach, specifically the general equilibrium implications of changes in assumptions for a particular region to the outcome for other regions. However, the projections provide a good understanding of the implications to the Latin America of the rapid growth of Developing Asia, and particularly China.

From Table 8 and Figures 13-15 it is clear that under favorable assumptions with regard to relative economic growth, in per capita terms Latin America either falls behind China in fifteen years, or will be behind soon thereafter. Moreover, all of South Asia is catching up. Only under favorable worldwide assumptions in terms of economic growth would Latin America's share in world GDP increase at least initially. Latin America could confront a more favorable environment for its economy, based on its natural resources and greater and unexpected environmental and political pressures on countries like China and India. However, the progress of the region cannot be based on these imponderable factors. In fact the discussion above suggests that the region will need to define new policies, more conducive to increased investment in the region, in order to break this discouraging cycle. In their absence the region will see its already shrinking importance being reduced even further in world affairs.

Figure 13:

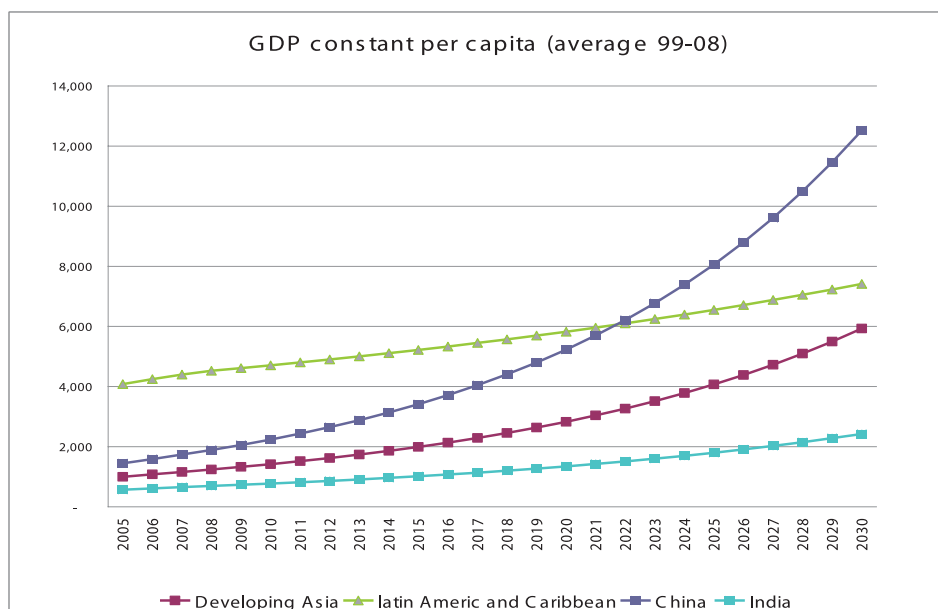


Figure 14:

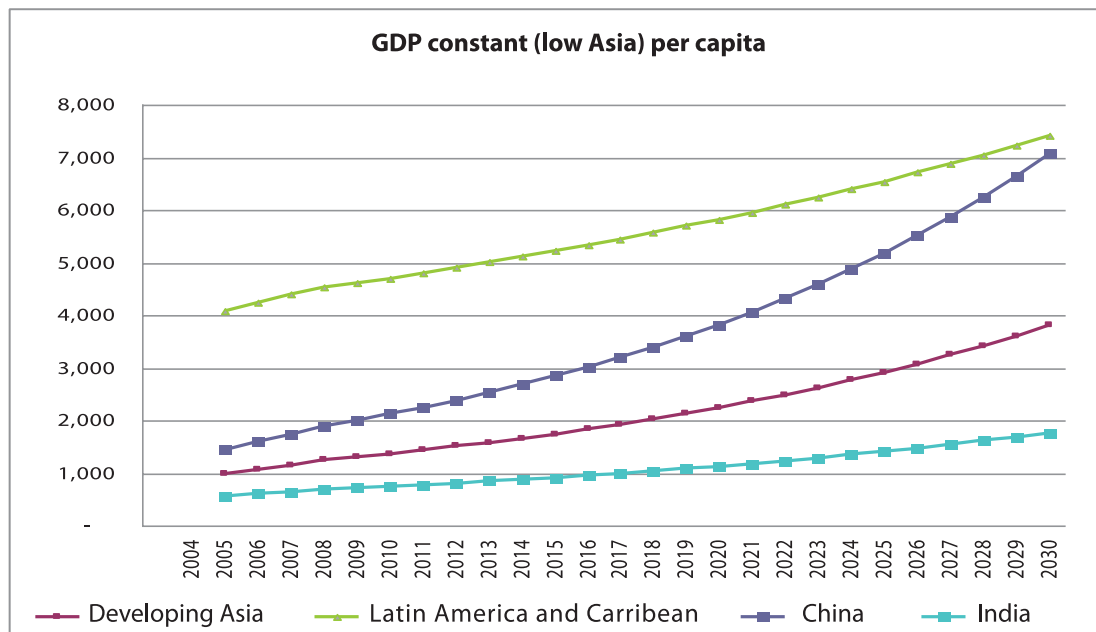


Figure 15:

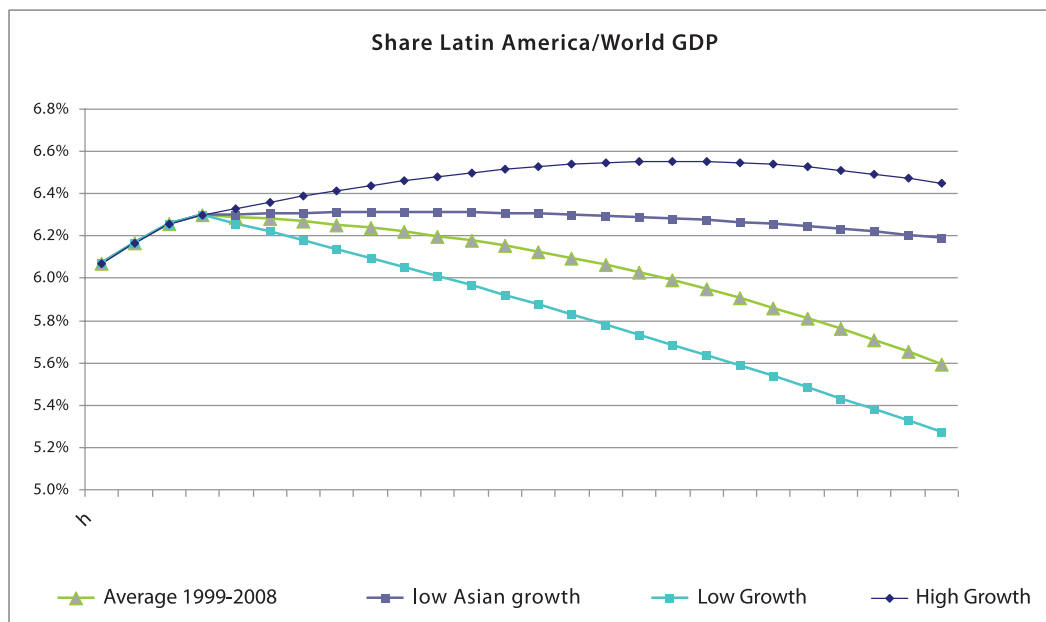


Table 9: GDP projections for Selected Regions - 2007-2030 (constant 2000US\$, unless specified)

	GDP growth rate 2009-30	2007	2010	2015	2020	2025	2030
GDP per capita-average(03-08)							
Advanced Economies	2.6	30304	32,260	35,941	40,204	45,130	50,826
Developing Asia	7.9	1,157	1,417	1,989	2,827	4,067	5,929
Latin America and Caribbean	3.3	4,397	4,705	5,215	5,823	6,547	7,411
China	9.4	1,736	2,236	3,412	5,226	8,055	12,519
India	7.0	652	771	1,014	1,343	1,796	2,423
GDP per capita-average with low growth for Asia							
Advanced Economies	2.6	30,304	32260	35941	40204	45130	50826
Developing Asia	6.3	1,157	1366	1746	2247	2913	3810
Latin America and Caribbean	3.3	4,397	4705	5215	5823	6547	7411
China	6.6	1,736	2123	2844	3825	5176	7063
India	5.5	652	750	918	1133	1410	1772
GDP per capita low growth							
Advanced Economies	2.1	30,304	31948	34741	37930	41558	45681
Developing Asia	7.5	1,157	1364	1737	2227	2880	3756
Latin America and Caribbean	2.0	4,397	4592	4788	5029	5319	5664
China	6.6	1,736	2123	2844	3825	5176	7063
India	5.5	652	750	918	1133	1410	1772
Share in World GDP average growth (03-08)							
Advanced Economies	2.6	75%	73%	70%	66%	62%	58%
Developing Asia	7.9	10%	12%	15%	18%	22%	27%
Latin America and Caribbean	3.3	6%	6%	6%	6%	6%	6%
China	9.4	6%	7%	9%	12%	16%	20%
India	7.0	2%	2%	3%	3%	3%	4%
Share in World GDP -low growth for Asia							
Advanced Economies	2.6	75%	73%	71%	69%	66%	64%
Developing Asia	6.3	10%	11%	13%	15%	17%	19%
Latin America and Caribbean	3.3	6%	6%	6%	6%	6%	6%
China	6.6	6%	7%	8%	9%	11%	12%
India	5.5	2%	2%	2%	3%	3%	3%
Share in World GDP- low growth							
Advanced Economies	2.1	75%	73%	71%	69%	67%	64%
Developing Asia	7.5	10%	11%	13%	16%	18%	21%
Latin America and Caribbean	2.0	6%	6%	6%	6%	6%	5%
China	6.6	6%	7%	8%	10%	12%	14%
India	5.5	2%	2%	2%	3%	3%	4%

Note: Average annual growth rate equivalent to average for 2003-07; low growth is average growth rate minus one standard deviation except for Asia; low growth rate for Asian countries data provided by Asian Development Bank for period 2006-20.

Sources: IMF; WEO; World Bank World Development Report; UNDP; and own estimates

Concluding Remarks

Notwithstanding many of the results and impressions noted, Latin America has gone a long way in the management of its macro economic policies. In the last fifteen years or so conditions improved, although not in all countries and not at all times. However, external conditions remain volatile. Perhaps the macroeconomic conditions for trade-related growth are more predictable and stable, but many reforms need to be pursued vigorously. Rankings of LA in the world are mediocre. It may well be that such rankings reflect past performance and underestimate prospects as investors magnify the risk perception. However, the recent deterioration observed in these rankings suggest otherwise.

In the end, Latin America cannot take its progress for granted. No matter what the reasons, it is mostly in the hands of LA to change this perception and firm up policies. The rich natural resource and human capital base for its historical growth will remain there, but it is only through increases in productive investment, including a large component regarding innovation and education, that the break with the past will be possible. The general improvements of macroeconomic performance and greater stability in its institutional framework have helped Latin America enhance its growth prospects. However, the next stage, more oriented toward productivity growth, is still incipient at best. It will require hard work and persistence on the part of policy makers and economic agents in more general terms, in order to regain the role that it played in the more distant past.

On this basis three general topics for discussion emerge with respect to the future performance of Latin America:

1. To what extent is the resurgence of the Latin American economy the result of favorable external conditions, as opposed to domestic policy improvement? If this is the case, what actions should the governments undertake to avoid falling into the stop-and-go cycle of the past?
2. Is there a need for further significant structural reforms to enhance investment prospects and productivity in the region, or should the policies be oriented towards further integration into the world economy, particularly with the emerging regions of the world (Asia and Eastern Europe)?
3. In light of the political trends observed in the region, and the growing needs for investment, what should be the appropriate approach to provide a productive association between the public and the private sectors, both in the area of project/enterprise management and financing?



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