

## Latin America.... is it another “Ugly Duckling” fairytale?

July 2008 - Author: Guido Giammattei, Fund Manager

**Having covered developed market equities for most of my professional life, when I joined Rexiter three years ago, I encountered a significant amount of scepticism among the ‘veterans’ (outside Rexiter’s team, of course) for my enthusiasm for Latin America’s attractive growth prospects. I rapidly grew accustomed to Brazil’s reputation as the ‘country of tomorrow’, as well as the notion that if there’s one constant in Latam, it would be that for every step forward a country makes – politically and economically – there will be, at some point, an equivalent step backward. How else could one otherwise explain the never ending roller coaster many Latin American countries have taken so far? Bursts of freedom, progress and energy followed by periods of inexplicable resentment and regression.**

In the last two decades, many countries in Latin America experienced moments of substantial economic growth. However, this growth was to an important extent artificial and overly dependent upon external financing and government spending, rather than on reforms and policies created to improve international competitiveness, private investments and entrepreneurialism. Hence, the region was too vulnerable to external shocks and liquidity.

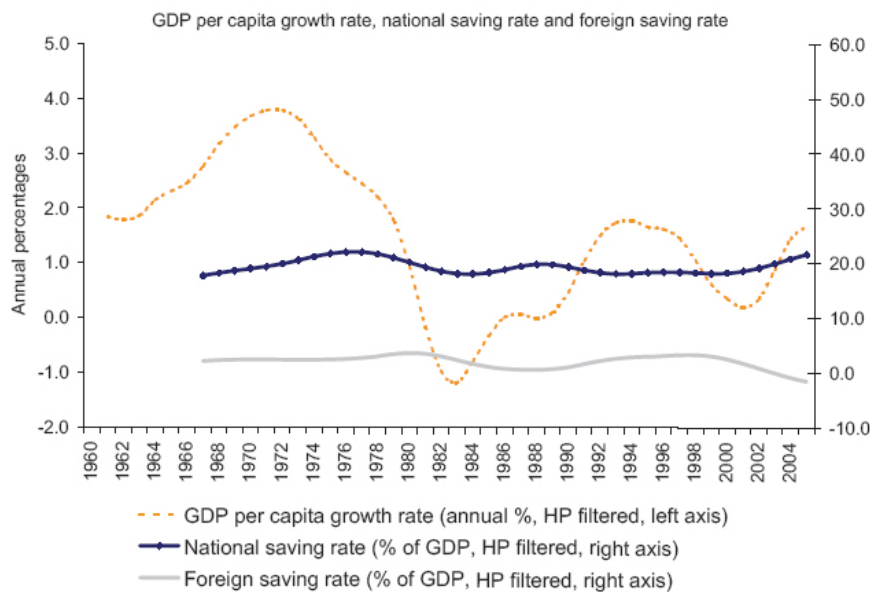
In most Latin American countries, the state had greatly expanded its size and scope of operations during the nineties and crowded out the private sector. Deficits in the public budget were increasingly financed through debt and inflationary means, with the yearly payments to service the debt consuming the greater part of export income generated during the favourable periods of high global liquidity and commodities prices. These loose monetary and fiscal policies, along with a lack of domestic private savings caused by income inequalities and a badly functioning too “fat” state apparatus, eventually derailed toward strong currency depreciations and hyperinflation. Capital flights in the difficult crisis periods made matters worse and resulted in a drop in investments, growth rates and often times in foreign debt defaults.

But over these last few years, Latin America has undergone quite an economic makeover and made considerable progress on a few of its long standing largest challenges (yes, I know, the ‘challenges’ list is extensive...):

- 1) A strong focus on inflation containment and legislation changes resulting in the successful development of independent monetary institutions, allowed the region to reach the nirvana of single digit inflation and price stability, resulting in a higher level of foreign confidence in the domestic currencies.
- 2) Unlike past decades, many countries in the region took advantage of the favourable global economic conditions from 2003 through most of 2007 to reduce their fiscal and external indebtedness. The primary surpluses generated by these last few years strong commodities export growth, robust capital inflows and higher tax receipts, have not led to uncontrolled and chaotic government expenditure. To the contrary, these funds have been used to significantly reduce national debts and deficits and accumulate unprecedented quantities of foreign exchange reserves and public savings. External debt, net of liquid assets, averaged 35% of current account receipts (CAR) in 2007 (and 26.4% as a percentage of GDP in 2007, down from more than 50% in 2002-2003), down from more than 100% in 2004 (*source: Standard & Poor’s Rating*). Most countries are now in a better condition than ever before and able to limit contagion from external stress and weather times of tighter global liquidity.

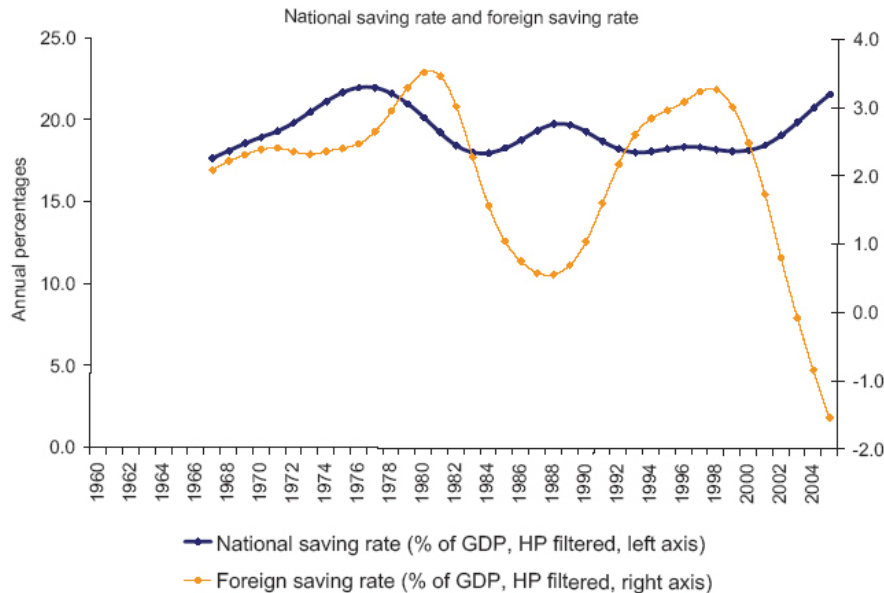
3) On average, the region has quite successfully overcome an authoritarian past by installing democratic institutions and procedures, along with more transparent regulatory processes, governing many segments of the economy such as in the Telecom, Electricity and Natural Resources sectors. This is a “conditio sine qua non” for the smooth functioning of the privatised economy and to continue to open its markets to foreign businesses and capitals, while improving productivity and international competitiveness.

4) Unlike in preceding years, factors encouraging economic development in the region have not only been export dynamics and rising commodities prices, but also the visible stimulation of domestic demand for investment and consumable goods, which was encouraged by price stability and the resulting reduction of interest rates. Latin America's income per capita has increased for the fifth year in a row by more than 5 percent. For the first time in many years, no country in the region has registered decreasing income per citizen. What's more, financial stability and faster growth are also starting to transform social conditions at an astonishing speed. The number of people living in poverty is falling, not only because of growth, but also thanks to the social policies of reforming democratic governments. The incomes of the poor are rising faster than those of the rich in Brazil (where income inequality is at its least extreme for a generation), Mexico, Colombia and Peru.



Source: Economic Commission for Latin America and the Caribbean (ECLAC)

5) Empirically, national savings and growth have been positively associated, especially in the case of developing countries. The trouble is that high savings seem to be both a cause and a consequence of high growth. When economies are growing fast, people get richer. They can afford to save more of their income without cutting current consumption. These higher savings in turn fuel more investment and higher growth: a virtuous circle. The difficulty is getting it to start. Since early 2000, savings rates have steadily grown across all the major countries in the region, from an average of 16% of GDP to over 21% of GDP (part explained by an increase in private savings following successful pension reforms as in Chile and Mexico, and part is simply a reflection of the general increase in public savings).



Source: Economic Commission for Latin America and the Caribbean (ECLAC)

## Meeting the challenges

The first precondition for this positive trend to continue is a change in the role of the public sector. Now that most countries (inevitably the speed of progress have been uneven, with Brazil playing the hare and Argentina the tortoise) have undertaken basic economic reforms and reduced the role of the state in economic affairs, they must create institutions that enable the state to be more efficient in areas that are most relevant to its domain such as tax collection, education, social security and healthcare. At the same time, we also need to see vital second generation reforms at the microeconomic level if these countries want to accelerate the sustainable long term rate of growth (ex commodities).

### Fiscal reforms

By improving the tax collection system, reforms at the fiscal level would bring quite a few clear benefits, such as reducing the costs of the state apparatus, widening the tax base by reducing the level of participation of the informal sector to the economy, improving the region's productivity levels and setting the foundation for and higher level of competitiveness and faster growth.

For example, one of the main causes of the region's sluggish economic growth (relative to Asia at least) has been its slow rate of productivity improvements. Among other things, this is the consequence of having a large informal sector and of having inefficient collecting entities unable to control tax evasion, despite the major reforms of the early 1990s. Without going into the specifics on how the law of diminishing returns assumes greater dimensions in the informal sector, we could just say for simplicity that most economists agree that a high level of informality discourages growth, limits investment in new technology, limits productivity improvements and, as you would expect, it also encourages corruption. This also limits the growth of the formal sector, as it puts all the burden of tax collection on its shoulders. In a region where the informal economy still represents approximately 50% of employment, this is a problem. From 1950 to 1980, total factor productivity increased at an annual rate of about 2%, but between 1991 and 2004, it rose by only 0.2% per year, after falling by 1.4% per year in the 1980s (source: ECLAC, 2004a).

It has now become imperative for the federal government and municipalities to tackle this issue. This means designing specific policies so that marginalised groups, mostly small and medium-sized enterprises, can secure access to credit, technology, markets and knowledge and can become increasingly integrated into the production structure.

Policies for implementing this strategy are broad, in terms of coverage, and include measures to reduce the cost of setting up a formal enterprise and to simplify the necessary formalities and procedures. In Latin America, the start-up costs for a formal enterprise (in terms of per capita GNI) are eight times more than in the high-income OECD countries, the number of formal procedures required is twice as high, and the process takes three times as many days. These difficulties go above and beyond the formal establishment of small businesses. Once they are set up, they will be required to pay a myriad of different types of taxes and social security contributions and will most probably be subjected to inspections to monitor their compliance with the particular regulations concerning their field of activity. On the other hand, legal incorporation will bring them few benefits in the short term. The policy in this area should therefore aim to reduce the tax burden on small enterprises, cut back on administrative requirements and offer visible short term benefits to compensate for the costs of formalisation (such as readier access to credit on advantageous terms and training programs). Moving forward, many countries also need some sort of fiscal reform whose aim should be at simplifying the tax system (i.e. in Brazil there are probably 20 different types of taxes!!) while widening the tax base, not so much in raising tax rates. Thus, improving the tax revenue structure involves, once again, making the tax collection system simpler, more effective and equitable to avoid exemptions and loopholes that make it easy for individuals to avoid paying taxes.

#### **Educational reform**

One of the basic pillars of successful development strategies is the accumulation of human capital, by improving the coverage and quality of education. As far as coverage, access to education varies greatly among different groups and regions in Latam. The one identifiable constant for every population group for which data is available is that educational coverage is far inferior to that in the East Asian "tigers". The second fundamental problem of Latin America's educational system has to do with quality. A recent World Bank study found that the quality of primary education in the region tends to be dismal. For example, in an international comparative study on the reading abilities of 9-year-old children from 27 countries, Venezuela's students scored the lowest, Mexican students did better, but still scored well below the average. Repetition rates in Latin America (except in the English-speaking Caribbean countries) are among the highest in the developing world. In Bolivia, for example, the repetition rate ranges from 16 percent in Beni to more than 35 percent in Chuquisaca. The estimated cost of repetition for the region as a whole in 1990 was more than \$4 billion. Although there are some first-rate private schools in the region, the disparity between public and private schools tends to perpetuate inequalities, undermining the basis of democracy. Improving the coverage and quality of education is an urgent task that requires strengthening management, reallocating educational resources, increasing funding and, most of all, making teachers accountable. Teachers should be trained using modern techniques and be required to refresh their skills periodically. Salaries could be based on some sort of performance metrics rather than on bureaucratic formulas. If countries in the region continue to neglect education, the likelihood of sustaining recent structural reforms over the long term will be greatly reduced.

#### **Labour reforms**

For many decades, countries in Latin America and the Caribbean have used labour legislation as a tool for achieving various social goals. A minimum wage, job protection and related measures were thought to be an efficient way of redistributing income and protecting the poor. However well intentioned these policies may have been, the result was overly rigid labour markets that were not responsive to changing conditions in the world economy. Unfortunately, recent market-oriented reforms have barely touched labour market legislation, and the situation has thus not improved. The region's distorted labour markets are in sharp contrast with East Asia's dynamic, modern labour markets. In general, East Asia's labour force is better educated and its labour markets are flexible, allowing companies to change their product mix in response to rapid shifts in competitive advantage.

### Will there be a happy ending?

These second wave of reforms or 'new challenges' seems to have a common denominator with the prior ones. Federal governments in Latin America need to widen the tax collection base by reducing the weight of the informal sector and by improving the efficiency of the state apparatus (i.e. just a simplification of the tax system in Brazil could significantly reduce the number of civil servants needed for tax compliance. It takes 2500 hours per year per person to 'enforce' tax compliance in Brazil, five times higher than in the US). Again, as in other cases in Latam, the problem is getting started. On the one hand, with a higher level of tax income and lower expenses to maintain/pay for an overweight state apparatus, they could invest more in the so called wealth fare system, which in turn would encourage a lower level of 'black' market activity and crimes. On the other hand, citizens will evade taxes if they do not believe they are getting quality government services for the taxes levied upon them, if they perceive the tax collection to be arbitrary and unfair. As three years ago, I still feel optimistic and believe in a happy ending.