Latin American Economies Roundtable
Tuesday, October 1st 2013
5:00 – 7:00 pm
Inter-American Dialogue

-- *Summary Report* --

The nineteenth meeting of the Latin American Economics Roundtable dealt extensively with the government shutdown in the United States and the possibility of a breach of the debt ceiling. It also touched on the continued economic challenges facing Europe and the effects of post-financial crisis monetary policy in the US on Latin America. Notwithstanding the situation elsewhere in the world, Latin American governments will have to adapt to growing demands for more efficient and extensive services than before.

I. Shutdown and debt ceiling battles make US situation less certain

US economic expansion has been disappointingly slow, repeatedly failing to accelerate when it looked poised to move above the roughly 2% trend growth. The US economy in 2013 has seen improvements over recent years but will face challenges posed by the shutdown. If the shutdown lasts 1-2 weeks, its effect on GDP growth will not be dramatic and will be heavily concentrated in the fourth quarter of 2013. Speakers also discussed the debt ceiling mechanism and the possible outcomes of a breach.

Some participants addressed the sequestration cuts in the US, commenting that it may prove the only way to ever successfully cut the size of government. They argued that if the shutdown has a minimal impact, it could convince the public that much of what the government does is not as essential as some believed.

II. The worldwide situation is improving, but challenges persist in the Eurozone

While Chinese exports and industrial production have improved in recent months, the Chinese economy does seem to be shifting to a slower long-term growth path. So far, this looks to be less disruptive than originally feared. Incomes are rising rapidly easing the shift to a consumption-based, rather than export-based economy. However, if Chinese growth settles into 6-6.5% growth, the decline in commodity demand could prove very painful for Latin America.

In Europe, markets appear to be buying into the adjustment in the periphery. However, the process will be slow, and those economies will have low growth for years to come. Despite lingering challenges, it is increasingly unlikely than any country will leave the Euro. The results of the German election may reinforce the periphery’s commitment to reforms as the anti-Euro elements proved very weak.

The political situation in Italy was discussed. Participants suspected that Berlusconi would not precipitate a crisis but admitted it was a real possibility. Despite the potential turmoil, however, Italian bond yields remained very stable, indicating that there is less concern over the PIIGS economies than existed even a year ago.

Greece and Portugal will probably both need new restructuring packages in the coming years, which are likely to pass despite the strong political opposition such packages will face. Ireland appears to be moving in the right direction and slowly improving. Spain and Italy are lagging behind Ireland but are still making the desired reforms and their fiscal balance sheets. Structural changes are evidenced by declining real exchange rates and improved export growth. Labor reforms have been important, especially in Spain and Ireland. In Greece there has been a tremendous fall in wages. The fall in nominal wages has been a major distinguishing feature from IMF restructurings in developing countries, which typically included a devaluation to achieve the necessary decline in real wages. Multiple discussants mentioned this fact when addressing the slow recovery in the periphery countries from the crisis.

On the financial side, household debt has come down and, while government debt continues to accumulate, it does so at a much lower rate than before. European banks are still in worse shape than American banks, but their situation is improving, if gradually. They are rebuilding their balance sheets and have the ECB behind them providing liquidity. However, corporate debt in the periphery is high, growing and likely to become a major burden on banks in those countries.

III. Increasing uncertainty about Latin America's future

Little has changed for the region's macroeconomic outlook over the past few months. The US Supreme Court elected not to hear the Argentine case over its conflict with bondholders, but it could elect to later, leaving the conflict still unresolved. Quarterly GDP numbers were largely within expectations and positive, particularly for Colombia and Peru. Argentina has better growth than many expected, thanks to the agricultural sector, though the capital controls could have a negative effect in the coming months.

A. Brazil grows now but the outlook is uncertain

Brazil's second quarter economic performance was good, but the participants agreed that it is unlikely to maintain significant growth over the next few quarters. Although demand has remained strong, participants argued that Brazil's major challenge is loss of international competitiveness than domestic weakness as. Public sector bank loans have played a key role in maintaining private sector demand. However, the World Bank expects the credit growth to slow and for unemployment to begin ticking up in the next few years. Private credit is becoming increasingly important as BNDES draws down its loans.

Although there are some worries about Brazilian growth in the next few years, the speakers believe that it is in a stronger position than some other large developing economies like Turkey or South Africa. Its current account deficit is smaller and financed by FDI rather than "hot money" and the central bank maintains substantial international reserves.

B. Investors banking on reforms in Mexico

Mexico's disappointing growth has caused everyone to revise down their growth expectations for the rest of this year. Moreover, its fiscal reform has been disappointing, failing to address some of the structural tax issues and only projected to raise an additional 2% of GDP in revenues. The persistent, positive outlook appears to be largely based on optimism about its reform agenda overall and the perception that many of the headwinds that have slowed growth thus far this year—a large drop in government expenditures in the first half of the year, a slowdown in global demand—will abate beginning in the 4th quarter and permitting 3% growth next year.

C. What to make of QE3?

The drawdown of quantitative easing could restrict credit conditions in Latin America, but credit will still be very loose by historical standards. This is especially true because the liquidity generated by the Fed has not left the US to the degree many expected and therefore had less of an effect on Latin America. Some participants dissented and argued that the hedging done by central banks could backfire and quickly precipitate a situation similar to Mexico's in 1994.

Notwithstanding the risks, low interest rates in Latin America seem to have led to less investment than might otherwise have been expected. Uncertainty about the world economy during the initial period of low rates likely discouraged investors from making aggressive moves. However, during this period governments were more aggressive and dramatically improved their balance sheet positions by taking advantage of lower interest rates to refinance their debt. Corporations seem to have followed a similar refinancing strategy, though at a slower pace which, according to several participants should assuage concerns over their exposure to changes in US interest rates.

D. The growing middle class is challenging governments in new ways

A rising number of protests and plummeting presidential approval rates have been observed in some of the region's most successful countries, like Chile, Brazil, Peru and Colombia. The participants largely agreed that those protests were a result of an increasingly affluent population dissatisfied with the quality of government services. The crux of the problem is that these middle class people want higher quality services but are reluctant to pay the higher taxes necessary to fund them. The speakers also examined the degree to which information technology contributes to the discontent by making it easier to share experiences and compare them to better services provided elsewhere.

Despite the number of protests that have occurred, the movements have not always been able to gain traction. This led some participants to question the degree to which opposition will matter if they cannot become associated with organized groups. Others countered that the mere presence of these protests and those grievances is salient, arguing that governments respond to both protests and the potential for protests, affecting future policy decisions.