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Between past and future of Latin America: Lessons from Brazil, Chile, Costa Rica and the Dominican Republic

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Working Paper No. 2010/95

Between Past and Future of Latin America

Lessons from Brazil, Chile, Costa Rica and
the Dominican Republic

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Abstract

This paper provides a synthesis of the four papers on the Latin American and Caribbean economies: Brazil, Chile, Costa Rica, and the Dominican Republic. It focuses on the following themes: macroeconomic stabilization and fiscal challenges, poverty and inequality, and the use of natural resources to create growth. The paper then draws lessons for development.

Keywords: macroeconomic growth, fiscal challenges, resource-rich countries, Latin America and the Caribbean

JEL classification: N86, O1, O38

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1 Introduction

Do Brazil, Chile, Costa Rica and the Dominican Republic serve as successful role models for other developing economies? Big differences in size and performance set apart the four countries under consideration (see Table 1). Brazil has a population that is more than tenfold Chile's population and more than forty times Costa Rica's population. Chile has the higher income per head: more than twofold the income per head of the Dominican Republic. Despite some recovery in Brazilian growth rates over the last four years, its growth remains well below that of the other countries in the region. Although all four countries have important lessons to offer, Chile is the only star performer growing with stability, not only in recent years, but also over the last 20 years.

Table 1: Population, real GDP, growth and inflation

Brazil, Chile, Costa Rica and Dominican Republic

(2007 and 2003–7) (millions of people, US\$ and percentages)

| | 2007 Population (millions) | 2007 Real GDP per head (US\$ billions at market exchanges rates) | 2003–7 Real GDP growth rate (% per year) | 2003–7 Inflation rate (% per year) |
|----------------|----------------------------------|---|---|--|
| Brazil | 189.3 | 6,900 | 3.6 | 4.2 |
| Chile | 16.6 | 9,900 | 5.0 | 2.9 |
| Costa Rica | 4.5 | 5,900 | 6.4 | 11.3 |
| Dominican Rep. | 9.3 | 4,700 | 6.0 | 18.1 |

Source: Economist Intelligence Unit.

Despite these differences, we can observe both common strategic orientations and shifts in policies in response to external shocks. Three important themes permeate the literature on economic development in Latin America: (1) macroeconomic stabilization after a long history of inflation, (2) income inequality and (3) the impact of exports of natural resources on development. This brief overview starts with a discussion of macro developments in each of the four countries under consideration, and then moves to the other two themes.

2 Macroeconomic stabilization and fiscal challenges

2.1 Brazil

The year 1985 saw the end of military rule in Brazil and by 1995 the government had put an end to hyperinflation. Despite reforms to liberalize the economy, economic growth remained low and public debt indicators deteriorated until the crash of the Real in early 1999, when the government introduced an inflation targeting regime with a floating exchange rate.

De Mello (2008) emphasizes that growth has been driven essentially by the accumulation of inputs, rather than gains in overall economic efficiency. But some resumption of total factor productivity growth since the mid-to late 1990s appears to be

closely associated with the implementation of pro-competition reform, including some liberalization of trade and the consolidation of macroeconomic adjustment.

Structural reform in the 1990s was marked by withdrawal of the public sector from manufacturing, especially in activities, such as telecommunications and the steel industry that had hitherto been dominated by state-owned enterprises. Liberalization of entry into those sectors that had until then been treated as state monopolies, including public utilities and network industries, followed divestiture, which accounted for over US\$100 billion in assets since 1992. These reforms have contributed to raising productivity by exposing producers to competition from abroad and from domestic peers. At the same time, the alleviation of trade protection seems to have been important in boosting labour productivity.

The main element of institutional reform towards fiscal sustainability was the enactment of the Fiscal Responsibility Law in May 2002. The law imposed hard budget constraints on all levels of government, tightened the requirements for the creation of new expenditure commitments and strengthened budget reporting standards, among other provisions. It built on and consolidated previous legislation introducing ceilings on government spending on personnel and debt service in relation to revenue. And yet, much remains to be done on the fiscal front in order to consolidate macroeconomic adjustment, boost human capital accumulation and improve the business environment, if growth is to be sustained over the longer term.

The current government, under the president, Luiz Inácio Lula da Silva, helped by a very favourable international context, has been successful in consolidating macroeconomic stability, while stepping up social spending. Strong external demand and high prices for commodities have contributed to booming export earnings since 2003, and have led to swelling trade surpluses that transformed the current account from a deficit of 4.6 per cent of GDP in 2001 to a surplus for several years. But stronger growth in import value than in export earnings caused this surplus to shrink and led to a deficit in 2008.

Fiscal problems persist and prevent a steeper decline in interest rates. Net public debt remains high and social security expenditure is on an unsustainable path. Brazil has a revenue system characterized by a heavy tax burden, a narrow base, complicated levies and tax evasion. Foreign and domestic companies devote sizeable resources to managing their tax affairs. The World Bank ranks 178 countries according to the impact of taxation on business. Brazil occupies the 137th place. The average Brazilian enterprise spends a record 2,600 hours per year to fulfil its tax obligations. Deeper reforms, needed to accelerate growth, include fiscal reform to streamline the complex tax system and tackle labour informality.

2.2 Chile

Chile's achievements include a sustained increase in GDP growth rates, while maintaining low inflation and bringing about a reduction of public debt from 39 per cent of GDP in 1990 to 4.9 per cent of GDP in 2007. A free market revolution in the mid-1970s broke with a historical pattern of fiscal imbalances and protectionism. Chile's general import tariff rate is 6 per cent, but its trade-weighted effective average tariff rate is below 2 per cent, owing to tariff preferences granted through trade agreements, most

importantly free trade agreements with the European Union, the United States, Canada, Mexico, South Korea and China. Chile is negotiating agreements with Japan and India.

Important institutional reforms were sustained through the 1990s until today. Free markets and a prominent role for the private sector occupied central roles in Chile's development strategy. Solimano (2008) compares the period of 1986–2007 to the period of 1940–85 and shows a shift from fiscal deficits to fiscal balance and surpluses; a sharp rise in the export share in GDP that almost doubled between the two periods; an increase of over 7 percentage points of GDP in investment; an increase of around 10 percentage points of GDP in national savings; an acceleration of total factor productivity growth and a steady decline in inflation.

Between 2003 and 2007, taking advantage of the rise in the price of copper, Chile increased its fiscal surplus, year on year. In 2007, this surplus reached 8 per cent of the GDP. The government has applied its savings in diversified financial assets with (risk adjusted) rates of returns higher than those of copper. When turbulence hits, it looks like Chile will be able to weather the storm.

2.3 Costa Rica

A short civil war in 1949 created the opportunity for institutional reforms that led to a long period of rapid economic growth and significant improvements in human development in the oldest democracy in the region. But since a debt crisis in the early 1980s, Costa Rica struggled in search for a new economic model. The country has attracted high-tech investment and export value growth increased quickly thanks to the dynamism of free trade zones and strong demand for microprocessors from China. Trejos (2008) describes fiscal progress in the following words:

Government deficits have been low since the adjustment measures were implemented in 1982, and indebtedness has plummeted. Costa Rica has kept a relatively good record since renegotiating its foreign debt in 1987, regaining access to national and international credit and maintaining acceptable credit ratings. To achieve this, Congress has frequently passed both permanent and transitory tax reforms. Budgetary priorities were clearly established, protecting expenditures on health, education and the environment, along with the network of safety-net institutions, while total outlays were kept under manageable limits, mostly by postponing investments in infrastructure.

Yet, social tension has grown and the economic reform agenda has suffered delays. A gradual move towards implementing inflation-targeting, which would require eventually freeing the exchange rate, will enhance monetary policy effectiveness. A partial recapitalization of the debts and related losses of the Central Bank is needed. The government is set to capitalize state banks with surplus fiscal funds. The Inter-American Development Bank is also prepared to provide capital.

Future funding of this recapitalization also depends on the approval of a fiscal reform. The overall level of taxation is relatively low. Tax evasion has been reduced since 2006, contributing to growth in tax collection, but remains high. A long delayed project for fiscal reform seeks to overhaul existing taxes and create new ones to broaden the taxpayer base, needed in order to further reduce the public debt burden, which makes

the economy vulnerable to shocks and constrains monetary policy. In the meantime, the burden of public debt will continue to limit public investment.

2.4 Dominican Republic

In the mid-1980s, the country opted for a more open development strategy centred on export-oriented free trade zones and tourism, as shown in Pozo, Sánchez-Fung and Santos-Paulino (2008). Notwithstanding periodic financial crises, the strategy has delivered economic growth. Nonetheless, social development has been disappointing and public spending on education and healthcare remains low.

In the early 1990s a new stabilization and structural adjustment reform package was successfully implemented. The programme included trade, taxation and financial reforms. Leonel Fernández, in his first presidential term from 1996–2000, ran the economy's miracle growth. But four years of profligacy under Hipólito Mejía (including a dubious bank bail-out) doubled the public debt and wrecked what was one of the Caribbean's success stories of the 1990s. The currency collapsed, inflation surged and capital fled.

Fernández's second presidential term since 2004 has restored stability and growth via fiscal adjustment, debt restructuring, tight monetary policies and strengthening of the financial system since 2004, supported by an IMF stand-by arrangement. But real export growth has been sluggish since 2006, despite the access to the US market provided under the Dominican Republic–Central American Free Trade Agreement. The free zones sector has lost competitiveness. Record levels of foreign investment in 2007 continue to reflect business confidence in the Dominican Republic and its government promises to address a lack of competitiveness. But, as GDP growth slows down, fiscal consolidation will become more difficult to achieve.

Taxation remains poor despite successive reforms that, since 2004, have expanded the base of the value added tax. Despite winning by a comfortable margin in May 2008 elections, Fernández is in a weaker position than during his previous term (2004–8), owing to lingering discontent over corruption and sharply deteriorating economic conditions. In 2009, the administration's ability to meet its macroeconomic and fiscal policy goals will be limited by the extent of the global economic downturn and the poor state of the government's accounts.

3 Poverty and inequality

Latin America is notorious for its extreme inequality. Recent developments have improved income distribution in Brazil, as argued by de Mello (2008). Chile and Costa Rica have managed to reduce poverty, but continue to share with other Latin American countries the failure to reduce chronic inequality of income and wealth, as discussed by Solimano (2008) and Trejos (2008).

In Brazil, a more stable economy is paying off in terms of poverty reduction and improvements in the distribution of income. The incidence of poverty fell in the second half of the 1990s. Income distribution has also improved in recent years, especially since the turn of the century, although it remains severely skewed. Increased emphasis since the late 1990s on income redistribution through targeted conditional transfer

programmes and improvements in the distribution of labour income on the back of rising human capital have played important roles.

In the last 20 years, Chilean development mixes success in the macro, growth and trade fronts on one hand and, on the other, failure to reduce chronic inequality of income and wealth. Governments have undertaken policies to reduce poverty and improve social protection, but social inequality and social stratification have not diminished. Inequality in Chile is mainly explained by the concentration at the top of the distribution of incomes. Poverty (measured as the per cent of population below a certain poverty line) declined from levels above 40 per cent in the late 1980s to around 14 per cent in 2006.

Costa Rica's income disparity, like in other Latin American nations, is high. Poverty reduction during the last 20 years has come from growth, not from a better income distribution as inequality has increased. While not as high as during the volatile 1970s and during the debt crisis of 1980–2, it increased between 1990 and today. The upward trend in the education premium has put pressure on income distribution.

4 Natural resources: a curse or a blessing?

Economic literature links resource intensity to slow economic growth as in Sachs and Warner (1995), Sala-i-Martin and Subramanian (2003) and Humphreys, Sachs and Stiglitz (2007). In principle, we should expect the abundance of natural resources to create growth and attract productive external investment. But, unearned riches are a curse because governments with treasure in their soil get fat on revenue from mineral sales and do not have to tackle the far more difficult task of creating a framework of laws and institutions that generate sustained growth and stable tax revenues.

In Latin America, the colonial legacy of the exploration of natural resources resulted in poorly diversified economies subject to instability and crises. The volatility of export revenues and growth affects the government's budget and, thus, has consequences on macroeconomic management. The Mexican historian Enrique Krauze once said about Mexico that, 'the weight of the past has sometimes been more present than the present itself', a situation that leads to the unending repetition of economic crises being played out in the evolution of Latin American countries through time.

At the beginning of the 20th century, Latin America was still a region centred on a strategy based on the export of raw materials. Today, the most important export of almost all Latin American countries is still a commodity. As the share of primary goods of total exports continues to be high, the result is that fluctuations in the price of commodities and the rate of growth of the countries in the region go hand in hand.

In Brazil, Chile and most countries in Latin America main exports are commodities. But both Costa Rica and the Dominican Republic have diversified exports and more than 70 per cent of them are manufactured in free trade zones. In the 1960s and 1970s, the economy of the Dominican Republic had been highly concentrated in the production and export of primary commodities. The overall export performance and export earnings have been susceptible to trends and fluctuations in world commodity prices. Growth peaked in 1975, when sugar prices peaked. By 1980, the mining industry became a major source of foreign exchange: exports of gold, silver, ferronickel, and bauxite contributed with 38 per cent of the country's total exports. Negative shocks to

the country's terms of trade in the late 1970s – following swings in sugar prices and high oil prices – caused the economic growth slowdown. Since then, as much as Costa Rica, the Dominican Republic has diversified its exports away from primary resources.

Although commodities and products based on commodities still account for more than 50 per cent of Brazilian exports, Brazil has also achieved some diversification of exports. Reason for concern is that Brazil was doing well until mid-2008 mainly because of high commodity prices. If it were not for this cyclical stimulus the country's performance would look less shiny. Yet, a recent claim has surfaced which argues that Brazil is the beneficiary of a structural change as a consequence of the rise from poverty in Asia. Besides, its newly discovered offshore fields of oil and natural gas and its comparative advantage in the production of biodiesel from sugar cane will make it a new super power.

Yet, high commodity prices are a reason for concern if they continue to weaken an already weak resolve to move ahead with a necessary fiscal reform. The oppressive tax system and the current labour code make firms wary of hiring and confines around 40 per cent of the workforce to the informal economy. Instead of spending on infrastructure, the current government has used record tax revenues to finance a bloating public payroll.

What is more important to break these deadly cycles? To introduce a counter-cyclical fiscal policy as Chile did? Or to diversify exports, as Costa Rica and the Dominican Republic have done?

In my judgment, just diversifying exports cannot rid Latin American countries from their fragilities. In contrast to Costa Rica and the Dominican Republic, which diversified their export away from primary exports, but did not solve their fiscal imbalances, Chile's economy still relies on agricultural products, copper and other metals for more than 80 per cent of its export revenues. Nonetheless, by conquering a counter-cyclical fiscal policy it turned itself into a clear economic success in contrast with other Latin American countries where uncertainty still prevails. Thanks to counter-cyclical fiscal policies, Chile appears to have attacked the underlying fragility of Latin American economies: the propensity to get into recurrent balance of payments crises, following reversals of terms of trade.

5 Concluding remarks

It is common to split Latin American countries according to whether their governments fall into one of two groups: the reformists or the populists. In truth, none of the leaders of the four countries under analysis exactly fit into either camp and the classification would stand in the way of a more complete understanding of possible economic policies.

Even those who cannot resist the colourful populist concept know it is either too generic when applied to any demagogue, or so narrow that only Perón – the anti-hero from a period of Argentina's history that has already been left behind – would fit.

Even harder is finding an out-and-out reformist. I turned on my spotlight and tried to find a politician to whom the term could be applied, but with no luck. More forgiving

with their definitions, some analysts call Brazilian President Lula a reformist. But the fact is that Brazil continues unreformed. Regulations and heavy taxes are detrimental to business. Labour laws hinder employment and watchdogs set up to oversee monopolies and promote competition lack independence and act sluggishly. If all that is not enough, the levels of urban crime and violence clearly show the need for reforms to the police, prisons and the judiciary systems.

But everything in life is relative and Brazil looks rosy when compared to Venezuela or Argentina. The Brazilian government no longer manipulates the rates of inflation, as the military used to and Argentinean President Kirchner still does. When the Argentine government announced that the rate of inflation for 2007 stayed at 8.5 per cent, independent calculations pointed to a rate that could be as high as 25 per cent. Manipulating the rates reduces the service of the public debt as it is partially indexed to inflation. But, the Argentine people have already started beating pans outside the Pink House in Buenos Aires.

If a comparison to Argentina or Venezuela makes Brazil look good, the same cannot be said when compared to Chile. It is certainly true that, over the past three years, the Brazilian government might have made better use of the favourable international conditions. Chile managed to maintain a fiscal surplus, unlike Brazil, which continued to produce fiscal deficits due to the dizzying increase in public spending and despite an ever more onerous tax burden. Such fiscal policy contributed to overvaluation of the currency, as the exaggerated growth of government expenditure heated the economy, leading to expectations of increases in the interest rate that in turn contributed to the appreciation of the currency.

This combination of policies was risky as the last quarter of 2008 has proved. The fall in the flux of capital to emerging countries and the effects of a reversal in the terms of trade has moved Brazil into recession in 2009. The issue now is what to do to preserve achievements in a harsher environment. The solution to the problem would be to adopt an anti-cyclical fiscal policy. But Chile is the only country in the entire region able to do so without compromising its fiscal balance.

At first glance, Chile appears extremely vulnerable to an inversion in the price of commodities. After all, they account for 70 per cent of the country's exports. Furthermore, the relationship between Chile's international reserves and GDP is one of the lowest in the region. The government, however, adopted a prudent policy. Chile's Structural Fiscal Rule is based on an annual structural surplus target and structural balance is defined as the difference between structural fiscal revenues and observed fiscal expenditures. By embracing a counter-cyclical fiscal policy it turned itself into a clear economic success in contrast with other South American countries where uncertainty still prevails.

In Brazil's case, large reserves and a flexible exchange rate has helped to guard against the external squeeze resulting from the inversion in the price of commodities and the international credit crunch. The drop in commodity prices and the global recession are driving its exports sharply lower. But this time, the reaction is different from what used to be the case in previous external shocks.

In the past, faced with the expectations of a devaluation of the currency, international reserves were insufficient to respond to a speculative attack and the Central Bank was

forced to raise interest rates because devaluations affected the expectations of inflation. This time, with foreign reserves at record highs, external debt at record lows, and the public sector as net external creditor, the Central Bank was able to avoid the need of increasing interest rates to respond to a sudden stop in capital flows. While currency depreciation may keep some components of the cost of living high, the pass-through is being overwhelmed by the drop in commodity prices. The Central Banks will be able to meet inflation targets in 2009 and has room to cut interest rates in response to the external shock.

Yet, financing and institutional constraints still remain an obstacle to counter-cyclical fiscal policies. The government debt is high and the government cannot use big fiscal stimuli to avoid a contraction of the economy without creating uncertainty and perception of risk of future insolvency. Brazil would be better prepared to respond to external turbulence if, in the period of plenty, it had used the increase in tax revenues to create fiscal surpluses and reduce the internal debt. This means Brazil must tackle fiscal weaknesses.

No doubt, the biggest challenge to Brazil, as well as to the rest of the region except for Chile, is what was left largely unreformed: the state. The region could follow Chile's example, because an unreformed state is particularly deadly in a region rich in natural resources. It can do so because after all, our lives are not ruled by fate, but by a sequence of events interlinked with our reactions. A necklace is formed not by its beads but by the thread that links them together. Similarly, it is not unforeseen events that define a country's wealth, but our actions that gather accidents and twist the strand that weaves the life of the country. This is a task that demands enormous amounts of patience and dedication. The good news is that public opinion and many politicians have started to realize that progress requires deeper reforms than those of the past.

There is little doubt that all the four countries present important lessons from Latin America. Openness to the world economy and the ability to diversify exports has served Costa Rica and the Dominican Republic well. And so have competitive economic reforms by Brazil. However, in my view, these reforms have not been sufficient to produce durable sustainable growth. Chile's much deeper reforms hold the key to longer term sustainability.

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