

## *Background*

# *Rise and decline in Latin America: the current state of the three largest economies*

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Latin America's GDP forecast has got worse as analysts cut it from 2.0% to 1.8% in June. If the 2014 results will underline this number, the country will face the slowest pace of growth since 2009. Apart from Colombia and Mexico, the GDP growth in the Latin American economies decelerated in the first quarter of the year. The region has relatively subservient global liquidity conditions, however, the United States' monetary policy still can cause harm to them. But now let us see what the Latin American countries have managed to achieve so far in 2014.

### **Mexico**

According to the OECD, 95.5% of the businesses in Mexico have only ten or fewer workers. Manuel Molano, a member of a think-tank called Mexican Competitiveness Institute, named this phenomenon "Peter Pan system". It means that the businesses prefer to stay small because of the taxes and regulation. However, there is a really interesting fact as for these small and informal businesses, since they contributed more to the growth of employment in the country between 1998 and 2008 than the legal firms – who are, by the way, more valuable for the economy. But the local firms are far less productive which means they produce only the one-fiftieth of the larger companies' productivity and it sets back the GDP growth. These little firms operate also like a social safety net by legally paying their employees in cash

without contributing to the official health-care and pension scheme. Only 8% of bank loans is lent to small and medium-sized enterprises (SMEs) and according to McKinsey the ratio of loans to GDP in Mexico matches with Ethiopia's. Maybe its most important cause is that they do not trust in the banks. However, it is really hard for a firm to grow without credit. The other problem with the Peter Pan syndrome is the lack of efficiency, innovation and technology, since they do not have the capacity or the necessary sources for that. But the government is about to help the SMEs by weakening the dominance of oligopolies with the constitutional reforms. President Enrique Peña Nieto's aim is to cut the prices of banking services, electricity, gas and the internet. According to a fiscal reform the SMEs would get a year tax holiday to have time and opportunity to enter the formal economy instead of the informal. And the state development banks provide them loan guarantees and allow them to obtain credit. The country is using e-invoicing to help these businesses find their way to the formal economy.

The most important reform which is being implemented is about the liberalisation of the energy sector. The state oil firm, Pemex brings the third of the revenues to the government but its production levels have been declining. The industrial electricity prices are much higher than in the United States – it means 80% – but the electricity industry will be liberalised as well. And in August, 2014 the Congress in Mexico decided to open the Mexican deepwater and shale fields to foreign investment.

In the first quarter of the year the public spending rose by 13.2% and so did the non-oil exports by 5.2% but the total sales fell for the first time in 30 years. So the president still has to take steps to revive the country's economy which is expected to grow by 2.4% this year. However, the costs of the reforms – such as higher taxes and denser accounting rules – have come faster than their benefits so far. The fastest way to get the economy out of the shadows would be spending money on the infrastructure; therefore the priorities include new natural-gas pipelines and a new airport in Mexico City. Independent regulators will be needed if the government wants to facilitate competition in the economy. And Mr. Peña has to implement the reforms to be beneficial not only for a privileged class but for everyone in the country.

## Brazil

Last year Brazil had an economy growth by 2.3% thanks to the public spending and investment. President Dilma Rousseff managed to raise the investment by 6.3% - it means \$65 billion foreign direct investment altogether – to convince the firms that the confidence is returning. The interest rates were increased by 10.75% by the Central Bank and it helped to make the inflation shrink to 5.6%. But Brazil somehow still has to overcome the relapse after the dependence on the Chinese market ceased in 2010. This year the economy is expected to grow by 1.8%.

A forecast report about boosting Brazil's economy by the FIFA World Cup 2014 said that thanks to the event the infrastructure would be improved, the new stadiums would revive urban economy and real estate development; increase tourism; and the feel-good factor would be also better. But the benefits will be seen only in the next few years, not immediately. The costs of organizing the event is estimated to be about \$15 billion and it should be paid back into the economy in time. However, the World Cup generates positive revenues, as well, by corporate promotion and merchandising. According to the minister for strategic affairs, Marcelo Neri, Brazil is starting to open towards foreigners – it has been indicated by easing the way for them to get a work permit in Brazil and inciting businesses to invest and participating in world economic forums already in the past two years.

Several causes contribute to the underperformance of Brazil. One of them is the tax structure, since it takes about 1,200 hours a year for a company to prepare the taxes. The other problem is related to the strict labour requirements as the employees have broad rights to strike and employers can easily find themselves in the legal system for dismissing one of their workers. The Brazilian bureaucracy is another barrier: it takes a lot of time to get the government's approval for a business transaction – for instance, it can take six month for the government to approve a new label on a product.

In July, 2014 the Central Bank released forecasts about the Brazilian economy and according to them the economy is weakening. The IBS-Br index – which is used by the Central Bank as a monthly economic indicator to forecast the GDP growth monthly and yearly – confirms this statement as it shrank by 0.18% monthly and 0.2% in the year. So the economy did not expand in the first half of this year but the chief of the Central Bank, Alexandre Tombini, says growth can be expected in the second six months.

## Argentina

In the beginning of the year the forecasts about the Argentine economy were positive saying the country will avoid recession, but will still struggle with financial volatility, unemployment and inflation. The United Nations Commission for Latin America also predicted a 3.2% GDP growth. But there are some more uncertain issues apart from unemployment and inflation, like the government budget balance and the limit of external credit. One of the most relevant problems that have contributed to the underperformance of the economy is the climate change, the draught to be precise. The currency dropped last year by 20% but this year it was supposed to be more stable. By April, 2014 the inflation hit 40%, according to unofficial estimates the inflation rate was above 25%.

The government could stop the further drop of the currency but the fiscal deficit and the government spending is still significant. The rising incomes, the inflation and therefore the growing consumer spending, along with the remarkable sales of soybean caused the reduction of the reserves below \$30 billion. As a consequence, the devaluation is accelerating. The inflation made the people spend more or move their money abroad – but this is beneficial for the automobile industry, since the sales of the machines hit the record last year.

According to an emerging markets economist, Michael Henderson, the cause of the inflation can date back to the government's decision in 1991 when it accepted a currency board which fixed the Argentine peso with the US dollar at 1:1 rate. By this move some economic problems could be stabilised but only a few options were left for the country to protect its economy against external shocks. Though, the devaluation of the currency has been managed at a certain level, as mentioned above, the consumer price inflation is still hitting about 14%.

The latest and most important problem for Argentina right now is the legal battle between the government and the US holdout bondholders over a \$1.3 billion debt as the Argentine law does not allow the country to pay more to the holdouts than the other holders. There have been months-long negotiations between the two sides but the Argentine delegation, led by Axel Kicillof, the Minister of the Economy, could not satisfy the demands of the hedge funds and in the end of July, without stay and payment, the country defaulted. But as a consequence of the default, the exchange bondholders – who took bonds in 2005 and 2010 in exchange for the bonds they held following the default in 2001 – are likely to sue for all their money at once which will cost much more for Argentina – about \$29 billion. The government is not willing to make any steps that can hurt the country's economy and still has a chance to reach a

settlement with the holdouts in order to access the international debt markets but it is uncertain how much time it will take to find a solution. Analysts say that an agreement can be made earliest by the first months of 2015.

In conclusion, as for the three largest economies in Latin America we can observe progress since there have been reforms launched in Mexico which seem to have more costs than benefits right now but will help the country to find the way to development. Brazil's economy is also expected to grow after the first six months. The biggest bunch of problems is ahead of Argentina and the government has to find the way out of darkness protecting its economy and citizens and without seeming weak.

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