

Economic Watch

Cross-Country Emerging Markets Analysis

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Economic Analysis

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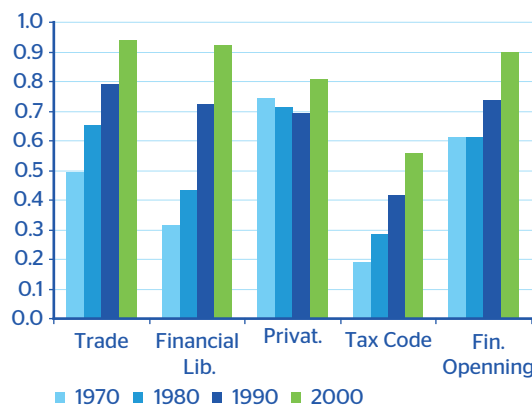
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Latin America breaking the middle income trap?: Lessons for China

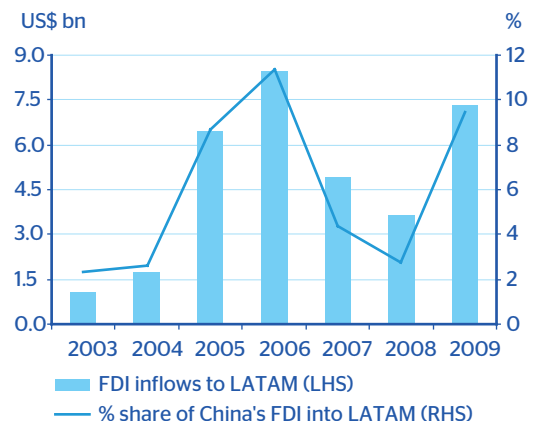
- **The world has changed, emerging economies are moving from the periphery to the core of the global economy.** Latin America is no longer a mere observer but is fully participating in this process.
- **The breakthrough with Latin America's past has occurred both in the political and economic spheres.** As for the economic reforms, they started with macroeconomic stabilization and then dug deeper in the roots of economic success (structural reforms).
- **Commodities are no longer a curse but a treasure.** Growing ties with China and improved terms of trade, which seem to be structural, explain the change in perception of being a commodity abundant region.
- **In any event, major challenges remain for the Latin American region.** Governments have to confront a demanding middle class, still underdeveloped education systems and ageing population.
- **Opening up the economy has helped LatAm to benefit from Asian markets.** It is important to note, specially when drawing lessons for China, that LatAm has benefitted not only from trade openness but also from financial openness in terms of the amount of capital it keeps on attracting, much of which is FDI. However, capital account liberalization was also behind several of the many increases experienced in LatAm during the last few decades.
- **Notwithstanding successful macroeconomic stabilization and the introduction of important structural reforms,** potential growth is still low. It needs to be increased through additional reforms specially on the side of investment in infrastructure and education.
- **China should become a natural partner for LatAm** given its experience in infrastructure development and its continuous search for natural resources.

Chart 1
LatAm: Economic reforms (index)



Source: BBVA Research based on IADB and ECLAC data

Chart 2
China FDI inflows to LatAm and Caribbean (USD bn)



Source: BBVA Research and CEIC

From the periphery to the core

Emerging markets are receiving more and more attention. Fast economic growth –coupled with much lower growth in the developed world - is behind emerging markets' growing contribution to global growth (about two thirds of total growth during the next ten years). This partially explains why investors feel so attracted by these markets. Beyond the BRIC economies, other large emerging economies have already started knocking to the group of respectable giants, many of which are Asian, followed by Latin American countries. Emerging Europe and Africa are far from contributing to global growth as much as Latin America.

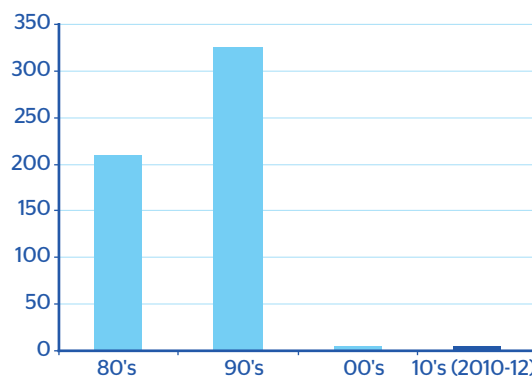
Latin America breaks with the past

After a few decades of disappointing performance, Latin American economies are finally back on the right track with very positive prospects for the coming years. The income gap with the Western World is being reduced. High inflation in 80s and 90s has been tamed and a significant progress has been made in order to bring the external and public accounts to a sustainable level. Along with macroeconomic stabilization, several structural and institutional reforms took place which have increased productivity and, thereby, potential growth. In the banking system, reforms have been even more evident resulting in growing bancarization, better asset quality and higher banking capital to provide a sufficient cushion against unexpected losses.

Tailwings from commodities

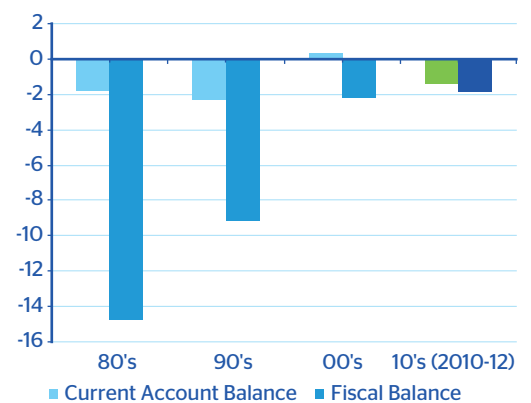
Benefiting from increasing trade integration with Asia, especially China, and rising commodities prices have helped Latin American economies to strongly rebound after the 2008 financial crisis. LatAm exports to Asia have been growing exponentially and this trend is expected to remain since Emerging Asia demands more and more commodity products in order to meet its domestic appetite and LatAm is commodity abundant. Higher commodity prices are expected to be driven by Asian industrialization. This is of course the case of China, which is half way in its urbanization and industrialization, but also India and Indonesia. Improving financial openness coupled with strong growth a relatively high return of investment and low sovereign risk will attract capital inflows to the region. China's FDI flows into LaTam (mainly oriented towards commodities) have gained attention in recent years since it already accounts for 10 per cent of the total inflow to the LatAm region and it is expected to grow even faster.

Chart 3
LatAm: Inflation (CPI, % yearly average)



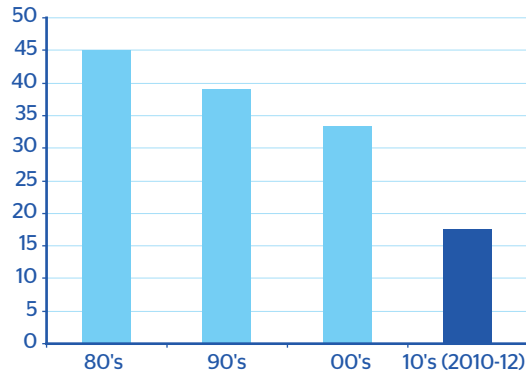
Source: BBVA Research

Chart 4
LatAm: External and Fiscal Balance (As % of the GDP)



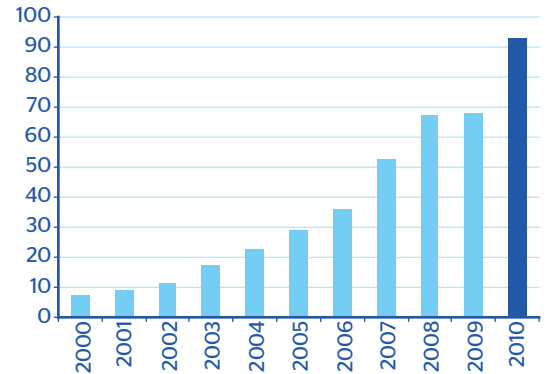
Source: BBVA Research

Chart 5
LatAm: External Debt (As % of the GDP)



Source: BBVA Research

Chart 6
LatAm Exports to Asia (US\$ Bn)



Note: Data up to November 2010
Source: IMF

Challenges remaining

Demographic transition in LatAm became a source of concern as ageing is likely to have a major impact in the labor market. Annual growth rates of working age population in the region are expected to decrease by almost a half during the 2000-2020 period. Ageing population among the LatAm countries will require implementation of prudent social protection for the elderly people. In order to avoid the possibility of a fiscal crisis, several countries have already started reforming their pension systems by switching from a model of defined benefits to that of defined contributions.

On the other hand, the importance of the labor market to the economic growth explains which additional reforms are required in LatAm to increase the flexibility of the labor market and labor productivity. The other challenge faced by the LATAM is the income inequality distribution problem, which results from the abundance of labor and natural resources and the lack of capital. Moreover, further work needs to be done in order to create a sound business climate that better supports business; as a precondition to expand investment efficiency gains and innovation.

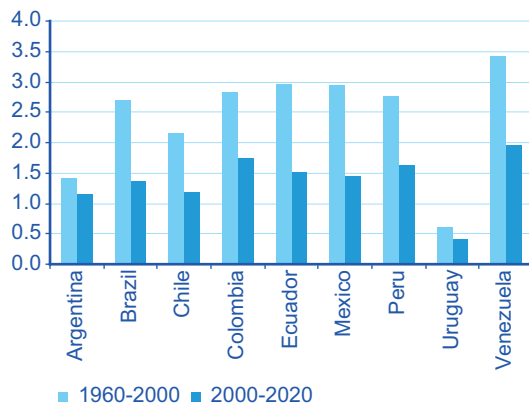
All in all, despite the sound macroeconomic conditions and political stability, other reforms are essential especially in the educational field, which is a major challenge for the LATAM countries. Notwithstanding, most of the countries reported notable improvements in education although there still a long way to go, particularly when compared with Asia.

Conclusions

LatAm's recent performance is filled with optimism thanks to its own efforts, but also to the very good evolution of commodities, its most important endowment. In fact, fast growing Asia - in particular China - is behind LatAm's success story but it is not only that.

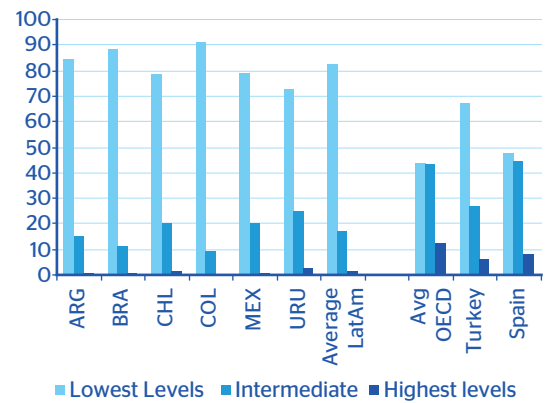
A good macroeconomic performance is essential to be successful as well as structural reforms particularly on the business environment and education. These two are key issues in which Asia is much more advanced than LatAm.

Chart 7
Annual growth rates of Working Age Population



Source: United Nations

Chart 8
PISA Test: Math



Source: OECD

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