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Macroeconomic Outlook 2018-19 and main policy challenges in the CELAC area

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1. CELAC economies are in a cyclical recovery and short-term prospects looks better…

After six years of slowdown, including two of recession, and the lowest growth rates registered in the post-war period, all the forecasters are expecting Latin America and Caribbean region (CELAC) to recover in consequence of a better global outlook in the advanced economies (except in the UK) and in Asia. For the CELAC region this would mean nevertheless a rather moderate rate of growth around 2.5% for 2018 and 2019 (similar to the expected EU growth). The top performers would be Panama and the Dominican Republic (more than 5%) followed by Nicaragua and Costa Rica (+5%), Bolivia, Paraguay, Honduras (4%). Argentina, Chile, Colombia, Peru, Uruguay, would grow around 3%, Mexico 2.5%, Brazil 2%, the Caribbean and Equator 1.5%, and Venezuela would continue its frightening sharp fall that should cut its GDP per capita by more than 40% in only six years.

These expected growth rates for the CELAC region are highly dependent upon the global recovery and the recent optimistic outlook that has been developing since the end of 2017 and making most observers to consider this improvement as deeply rooted.

2. …however, there are three reasons for remaining very cautious for long-term growth

We consider however these consensual forecasts as much more fragile as usual for three reasons: first, this global outlook continues to be technically estimated from models of Dynamic Stochastic General Equilibrium (DSGE models) that don't take correctly on board the financial sector and especially the private indebtedness and are by construction unable to predict crisis. But our world is more exposed to high systemic risks for not having been resolved for ten years since the big global crisis; second, the CELAC region remains highly dependent upon two basic exogenous determinants: terms of trade development (closely linked to commodity prices) and inflows of capital; and third the weak endogenous growth of the region that is fundamentally hampered by the lack of regional integration, the failures of governance, and the lack of infrastructure and education. These three intertwined factors are responsible for the productivity stagnation in the region for two decades.

Let's examine these three negative factors for the CELAC growth in 2018 and 2019.

First, CELAC economies remain highly coupled with the global outlook, contrary to what was too quickly believed by some Latin American policy makers just after the big recession of 2008-09. The global outlook, in spite of the recent wave of rosy pictures, needs to be re-assessed shortly in its systemic risks which are underestimated by most forecasters.

As all international organizations and other official forecasters, the rosy global scenario relies upon the technical assumption of absence of any new global recession and the extrapolation of "business as usual" of orthodox economists. Although this working hypothesis is understandable, there exist serious growing risks that a systemic accident could occur in the considered period, not for cyclical reasons but for deeper systemic aspects linked to the global financial architecture. The major reason is the global over indebtedness which has not been resolved since the beginning of the big recession ten years ago, together with the lack of genuine reforms in the international financial architecture which remains amazingly without any rational management for not setting rules. Indeed, the International Monetary System is still a system based mainly upon the US dollar issuing massive spillovers upon global economy without neither effective adjustment mechanism to correct global imbalances nor rational means to moderate or accelerate the growth of global liquidity. Such a "non-system" using a national currency as main international reserve currency is incoherent as already formulated 60 years ago by the Belgian-American economist Robert Triffin (1911-1993) who developed in *tempore non-suspecto* the so-called "*Triffin dilemma*". This dilemma expresses merely that the inner logics of a currency being a debt-at-sight, condemns any system based mainly on the use of a national currency for supplying international reserve assets to the rest of the world to conflicting objectives leading inevitably to generate global macroeconomic instability. This creates a "*built-in destabilizer*" i.e. an endogenous generation of global monetary waves that constitute a systemic cause for recurrent global crisis inherent to the use of the US dollar as dominant reserve currency. This argument was again analyzed by the Robert Triffin International Association[1] (RTI-UCL, Belgium) as well as by others, as William White[2] at the Bank for International Settlements and the OECD: "[it*] is not really a system because it has no rules. It lacks an automatic international adjustment mechanism for current account imbalances. It allows massive spillovers, including gross capital flows, from larger countries (especially the United States) to smaller ones with potentially damaging implications. It is dangerously unanchored with respect to global credit and monetary expansion, and*

[1] *Using the Special Drawing Rights (SDR) as a lever to reform the International Monetary System*, by RTI working group on SDR, Robert Triffin International – RTI, ed. Versant-Sud, Louvain-la-Neuve, 2015

[2] White, W. "System Malfunction" in *Finance & Development*, IMF, March 2015, Vol. 52, No. 1

it lacks an international lender of last resort with adequate resources… There are no adequate sources of international liquidity should crises occur. The IMF's available resources to support countries with balance of payments difficulties would be totally inadequate if a number of small countries got into trouble simultaneously—or even just one big one. Without adequate public sector financing, a withdrawal of private sector financing would cause domestic demand to decline [excessively]…

In spite of these serious caveats, the status-quo remains very strong among officials and economists. The danger of complacency with the current system is explicit when one sees that 2018 Argentinean Presidency of the G20 considers that "*G20's programme of financial sector reforms has made the system resilient. Substantial progress has been made in making financial institutions more resilient*" at the very moment that the Trump administration is dismantling the few Obama's prudential measures and is taking cyclically inappropriate fiscal decisions which should exacerbate public debt accumulation when the US economy is close to full employment and the FED is obliged to reverse its historical huge quantitative monetary easing. On top of this threatening unbalanced policy-mix, the protectionist tone given by the US administration should add supply restrictions which should provoke additional risks of upward domestic price reactions generating impacts upon the financial sector. Therefore, it should be taken on board that systemic downward risks are much higher than the short-term, present optimistic consensus tends to project. IRELAC analyses consider that the kinds of international imbalances and financial mismatch which have been developing not only could not been solved with the present monetary system, but are the roots of an inevitable major systemic crisis which should appear in the period 2018-19 under review.

Second, the CELAC economies, with few exceptions, were not able neither to create or re-built sufficient rooms for manoeuver in their fiscal policies nor to resist to the "re-primarization" of their external trade i.e. the new increase in their dependency upon exporting raw-material at the expense of technologically-advanced exports. As a result of the booming commodity sectors, investments and exports increased strongly in traditional activities, and most of the external windfall profits generated by the Terms of Trade bonus obtained from the booming commodity markets from 2003 to 2012 were consumed and resulted in an unsustainable growth without sufficient improvements neither in lowering indebtedness nor in better governance and infrastructures or logistics. As explained by ECLAC[3], the Terms of Trade variations explain most of the growth in the region in the last 15 years, thus exposing this growth to unsustainability.

Third, going to the fundamentals and the endogenous growth determinants, the CELAC region is lagging behind the other emerging economies and even the advanced economies: the convergence, except very few small exceptions (Chile, Costa Rica and Dominican Republic, and very recently Peru and Colombia) is not only inexistent, but on the contrary the gap is strongly increasing, in spite of significant improvements in social conditions.

During the last favorable commodity episode (2003-20012), Latin American economies were able to increase both savings and investments and consequently opened the access to better technology. This allowed for a remarkable increase of potential output from 2.5% per year in the period 1994-2002 to 3.7% in the period 2003-20011. Unfortunately, in the same way that booms promote investment, crises destroy it, especially when myopic markets concentrate investment in commodity or non-traded

[3] *Preliminary Overview of the Economies of Latin America and the Caribbean*, ECLAC-CEPAL, Briefing paper, November 2017

sectors. Therefore, potential non-inflationary growth has again decreased towards 3% per year at the best, maybe to only 2.5%.

Indeed, the region is emerging from several years of economic stagnation with lower growth than the already very low rate in advanced economies from 2014 to 2018. This has halted social and infrastructure progresses while investment rates and ratios in GDP decreased to historically very low levels, hovering around 18% of GDP during the three last years (i.e. lower than in the EU which is close to a mediocre 20% for the same period). This low investment effort contrasts with the other emerging economies including the other commodity exporters. With respect to 2013, real investment levels in CELAC economies have decreased by 8% in 2017-2018 while other commodity exporters have increased by 5% and the rest of the world by 15% ! This lack of investment has a direct impact on potential output, fiscal sustainability and productivity performances through lower embodied technological progress, therefore on sustainable growth and social welfare. The long-term forecasting model of the IMF[4] (2017-2022) projects a growth rate for the income per capita in the region to remain around an average of 1.7% per year i.e. close to the same rate as during the period 1991-2016. To escape from this low growth path, require to escape from the present low investment ratio which cannot ensure a rate of growth higher than 2.5% (or maximum 3%) without being rapidly constrained again by external deficits, inflation and costly external indebtedness. This means that CELAC region has a very low capital productivity and needs to increase its investment ratio from 18% to at least 22 or 23% for reaching a sustainable growth path of 4% (or 3% per capita) i.e. an increase of investment of some 25%!

Taking into account the amazing stagnation of total factor productivity during the last twenty years – which is another manifestation of the structural inefficiencies of the CELAC economies – the outlook for this region remains very preoccupant.

Such too low growth rates of potential output are clearly insufficient for satisfying the social needs and the indispensable effort in infrastructure, education and R&D for managing a genuine catching-up and facing global competition. The region is trapped into a vicious circle of poor productivity growth making almost impossible to growth out of poverty and debts. The vicious circle is all the more visible that fiscal space is almost inexistent. With total external debts passing from US $ 823 billion in 2008 to US $ 1,812 in 2017, the external constraint is back again as is also the case for fiscal sustainability once already coming tensions on interest rates will become more effective along with capital outflows. Indeed, the debt ratio moved again above 50% for the CELAC as a whole, with interest charges on public debt already absorbing 2.3% of GDP in Latin America and 3.4% in the Caribbean. The prospect of a continuation of the increase in US dollar interest yields represents a worrying time-bomb. The structural fiscal balance (i.e. cyclically adjusted) for the region is extrapolated as a permanent deficit of about 6% during the period 2017-2022 according to IMF model while the current account deficits would increase from 2% to 3% during the same forecasting period.

Only monetary policies could spur this year the economic recovery (in absence of big crisis) but, although necessary for ensuring a transition from recovery to expansion, this instrument cannot be alone the needed new engine of growth for reducing poverty and boosting prosperity further.

[4] IMF Regional Economic Outlook, Western Hemisphere Department Regional Economic Update, Fall 2017, Washington DC

3. The key weakness of the CELAC region is its lack of regional integration which determines also its weaker insertion in global value chains

The CELAC region accounts for 8.2 % of global economic activity, but only about 5.1 % of global exports of goods and services. LAC's trade openness, the most widely used measure of trade integration, remains lower than in other regions of the world as well as intraregional trade and exchanges of intermediate goods, two complementary indicators. Weighted average tariff rates remain higher than those in other regions, and regional trade is the lowest compared to other regions with only about 15 % percent of total exports (as compared with 55 % in Asia and 23% in Africa!). This is the product of many barriers (not only custom tariffs but regulatory) but also weak connectivity among countries due to geographic factors, low investment in infrastructure and poor logistic efficiency. In intra-CELAC trade, the average tariff equivalent of all kinds of barriers amount to 28,2%. LAC is particularly weak in its customs efficiency compared to other regions with Venezuela, Argentina and Brazil having the lowest scores. The quality of port infrastructure is below the world average, although Chile, Ecuador and Uruguay score well in port efficiency.

The relative external closeness – except the Pacific Alliance members – plays a role in the poor productivity performance in the region, even in those economies which are already open, because the full potential of the region cannot be fully exploited. The most recent empirical researches[5] lead to conclude first, that trade openness and connectivity to the center of the trade network has substantial macroeconomic benefits, second, there is no statistically significant or economically sizable direct impact of trade on overall income inequality.

In spite of significant efforts for opening trade in the region and regional integration, levels of protection are particularly high on intermediate and capital goods, which could impact the ability of firms to participate in global value chains (GVCs). These GVCs create technological spillovers and allow for broadening the participation of smaller firms in trade. A successful opening requires to do it inside the region as well as outside: global competitiveness needs a broader regional basis in order to be able to incorporate global value chains and benefit from diversification and specialization; in a globalized world organized along very specialized output segments inside production chains, the free choice of industrial inputs, equipment and services are the key of export competitiveness. This implies to fulfill two basic conditions: (i) freeing much more imports of goods and services, foreign firm establishment and direct investment, (ii) boosting investment in logistics services and infrastructure which are very important obstacles for intra-regional trade and insertion into global value chains. Except for Chile, Panama and Peru, the average logistics costs are 3 to 4 times higher than OECD countries. Logistics costs in Latin America and the Caribbean range between 18% and 35% of the final value of goods, compared to 8% in OECD countries. For small and medium enterprises, this percentage may be over 40%. According to the IDB[6], If all countries in the region improved their infrastructure to the average level of other middle-income countries, the region's growth would increase, on average, 2% on a yearly basis. Merely some improvements in trade facilitation processes (such as National Single Window

[5] For example, Beaton, Kimberly, Aliona Cebotari, and Andras Komaromi, 2017, "Revisiting the Link between Trade, Growth and Inequality: Lessons for Latin America and the Caribbean," IMF Working Paper WP/17/46, March 2017.

[6] *Infrastructure, logistics and connectivity: Bringing the Americas Together*, IDB, Panama 2015

Systems, customs, and border crossings, amongst others) could increase exports in the region up to 38%, and GDP up to 8%.

Regional integration will lead to become more competitive at the global scale by increasing competition, productivity progress and the range of inputs necessary for diversifying exports. Furthermore, regional integration will be needed for facing new headwinds of rising protectionism in some important advanced economies. These Northern mistakes offer to the CELAC area an historical opportunity to re-orient the region's strategy toward enhancing regional integration. In addition, enhanced regional trade integration can yield growth dividends without adversely affecting elevated aggregate income inequality in the region, on the contrary, there exists consistent evidence (as shown by ECLAC analysis[7]) that regional trade tends to diversify export composition, to benefit more to SMEs and to generate more inclusive growth, bringing thus less inequality. Increasing intraregional trade is estimated to have important growth benefits: for every 10 % point increase in intraregional trade, per capita growth can increase by 32 basis points according to IMF empirical data[8]. Especially CELAC's openness and regional agreements remains very insufficient in financial services, which are in fact important for supporting regional integration by creating scope for financial institutions and private firms to operate regionally, increasing the availability of finance through the pooling of larger amounts of savings.

According to IDB[9], logistics costs in LAC range between 18% and 35% of the final value of goods, compared to 8% in OECD countries. For small and medium enterprises, this percentage may be over 40%. If all countries in the region improved their infrastructure to the average level of other middle-income countries, the region's growth would increase, on average, 2 percentage points on a yearly basis. Transportation costs between the region and its business partners are almost 9 times the tariff costs (in the United States, transportation costs are only twice as high as tariffs). Improvements in trade facilitation processes (such as National Single Window Systems, customs, and border crossings, amongst others) could increase exports in the region up to 38%, and GDP up to 8%.

Although the political will to integrate more in the CELAC region has been weakened by politic divergences, the new protectionist threat from the new US administration, the difficulties and weak performance of alternative schemes and the need to choose more freely adequate inputs for being competitive, and the possibilities provided by the EU partnerships, are powerful drives for realizing an effective convergence of the MERCOSUR with the Pacific Alliance scheme as well as with other sub regions. CELAC which was conceived for making possible a convergence across different political options, should recover its full role by overcoming some costly ideological divisions.

4. The road ahead: What to do?

Therefore, significant changes in economic policies and priorities are urgently required but remain politically difficult to implement, they are diplomatically named "structural reforms" and point to

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[7] *Globalización, integración y comercio inclusivo en América Latina*, Rosales, O. ECLAC-CEPAL, UN, Santiago, Chile, 2015

[8] "Trade Integration in Latin America and the Caribbean–Cluster Report." *IMF Country Report* 17/66, Washington, DC., 2017

[9] *Infrastructure, Logistic and Connectivity: Bringing the Americas Together*, IDB document for CEO Summit of Americas, Panama, 2015

ensure sustainable and inclusive growth by improving total factor productivity (efficiency of the economies) together with investment and social inclusion. Priorities include:

1. enhancing governance and curbing corruption
2. closing logistic and infrastructure gaps,
3. investing in human capital and encouraging female labor force participation,
4. reducing labor market informality,
5. furthering trade and financial integration both regionally and globally.

This kind of policies requires indeed first an improvement in governance in order to ensure the right priority decisions not just for increasing growth rates but for ensuring social equity. The concrete to-do list includes:

- To increase opening and fair access to domestic markets by cutting tariff and non-tariff barriers, implementing trade facilitating procedures (Customs) and spurring the free imports of necessary specialized inputs. In the near term, the region should focus on strengthening linkages between existing trading blocks, most importantly Mercosur and the Pacific Alliance, and on harmonizing the trade rules across the multitude of existing Free Trade Agreements in the region. It is alarming that LAC is now the region in which intra-regional trade is the lowest of the world! Inside LAC exchanges, the equivalent in tariff of all obstacles to trade amounts to 28,2% of which only 2.9% are custom tariffs (ECLAC[10])
- to address external and fiscal imbalances to build resilience to shocks –economic, natural, or social, including crime and violence – and encourage greater transparency and accountability. Shifting from a pro-cyclical to countercyclical policy framework is necessary to ensure sustainable and equitable long-term growth
- to reduce persistent inequality by investing in people, particularly the poor and the women, allowing for restoring productivity growth. CELAC region continues to underperform in education: around one out of every three youth doesn't finish high school. Investment in education quality will play an important role in allowing the poor to contribute to and benefit from future economic growth.

5. Conclusions

Despite a clearly ongoing cyclical recovery for 2018, prospects for sufficient long-term growth in Latin America and the Caribbean look dimmer now than they did 6 years ago for endogenous caveats. On top of these structural weaknesses, global systemic risks, both macro financial and commercial, are presently accumulating dangerously and could seriously complicate the task of the policy makers.

However, those responsible should find in these growing risks the arguments to organize a collegial change of direction by accelerating their regional integration with a view to increasing their productivity and upgrading their participation in global production chains. This is all the more feasible because the CELAC region enjoys two important and complementary advantages: (i) the fact that it is the only region of the world in which globalization has allowed a growth that is clearly favorable to the less affluent social classes, and (ii) the Summit diplomacy with the EU, which offers much more interesting strategic and economic Alliance modalities than with any other region for being collegially

[10] *Perspectivas del Comercio Internacional de América Latina y el Caribe*, ECLAC/CEPAL, 2017

decided across both regions. The commonly decided bi-regional Action Plan[11] 2015 identifies instruments and activities which - if properly re-organized for a coherent implementation - should resolve the main difficulties and give operational answers to the three axis of our "to-do-list" above.

Indeed, the Action Plan lists the crucial areas but looks more as a shopping list than an operational strategy. There is an urgent need for changing the way the EU Commission works with ALC through its agencies which lack synergy and strategic overview, there is in fact no connection between the related chapters; this requires a re-grouping of areas along 3 axes:

- Spurring Regional integration for growth and social inclusion with Chapter 3 "*Regional integration and interconnectivity to promote social inclusion and cohesion*" covers precisely the needs and means for spurring regional integration;
- Building conditions for resiliency and sustainability, with Chapter 2 "*Sustainable development*" together with Chapter 4 "*Migration*", Chapter 6 "*The world drug problem*", and Chapter 10 "*Citizen security*" deal with the need for building a framework with instruments for resilience;
- Stimulating innovation and productivity around Chapter 1 "*Science, research, innovation and technology*", Chapter 5 "*Education and employment to promote social inclusion and cohesio*n", Chapter 7 "*Gender*" and Chapter 9 "*Higher education*" should allow for finding solutions to the productivity stagnation and its social impacts.

It is important to draw the attention upon the kind of dynamics that a bi-regional cooperation could generate by incentivizing first regional cooperation on both sides, in order to make successful the bi-regional effort. Therefore, the bi-regional Strategic Alliance between the CELAC and the EU should be instrumental for making easier the implementation of the three axis of action listed above:

- An efficient trade and financial regulated opening should result from the partnerships with the EU thanks to the cooperation tools and resources combined with the joint-interests for private firms to improve their positions inside global value chains and by providing direct benefits to the CELAC for accessing to the UE markets while better inputs from CELAC region reinforce the joint-competitiveness along the output chains (GVCs).
- The EU experiences (bad and good) provide an effective way to emulate a collegial effort in the CELAC area for putting at work some macro-financial cooperation schemes with a view to monitor regional macroeconomic convergence giving access to a financial safety net; Concretely a bi-regional dialogue on macroeconomic policies would be beneficial on both side of the Atlantic and should be dealt with in the framework of the bi-regional cooperation and the policy dialogue. This approach could increase the weight of each region inside the IFIS (IMF, WB, UN etc…)
- The CELAC-EU Summit Action plan agreed upon in Brussels in 2015 points to create a common space for Higher Education, Sciences, technology and Innovation; this academic and technologic cooperation is geopolitically very crucial for organizing jointly a recovery in total factor productivity and for reducing social exclusion.

[11] VII EU-LAC Summit, EU-CELAC Action Plan https://www.consilium.europa.eu/media/.../eu-celac-action-plan.pdf

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