Latin American Economies Roundtable

Monday, May 23, 2011
5:00 – 7:30 pm
Inter-American Dialogue

—Summary Report—

The thirteenth Latin American Economies Roundtable ("LAER") began with a review of the most prominent "red flag" in the global economy: the debt crisis in the Eurozone. Participants discussed the troubled state of the U.S. economy and the debate surrounding the debt ceiling. The roundtable addressed China's minor economic slowdown and its potential ramifications on growth in Europe and Latin American. Participants looked closely at how politics are affecting economies and vice versa in Brazil, Peru, and Mexico.

I. Debt Crisis in the Eurozone

The debt crisis rumbles on in the Eurozone, with Greece as its most troublesome economy. Fitch recently downgraded Greece's debt rating to B+ from BB+ and put the rating on "rating watch negative." The rating reflects the challenges Greece faces in implementing radical fiscal and structural reform necessary to secure solvency of the state and the foundations for economic recovery. The market and lowered ratings continue to push the price of Greek bonds downward.

Portugal, Ireland, Italy, and Spain are also roiling with debt problems. Standard and Poor's put Italy on negative watch, and Ireland's economy is still plagued by debt despite its 2010 bailout. The Portuguese government is struggling to reach a consensus on austerity measures. Although some believe Spain is on a slow road to recovery, it will still struggle to meet its debt-reduction targets on time.

It is unknown how contagious these crises in the Eurozone periphery are. If they begin to move into Central Europe or the rest of the United Kingdom beyond Ireland, the ramifications could be catastrophic for Europe and the rest of the world. Participants speculated over the impact of the crisis on Latin American economies. As of now, the effects have been neutral, but some worried that "contagion" or "spillover" effects would negatively impact Latin American markets. Other participants suggested capital flight from Europe may actually benefit Latin American economies as international investors look outside Europe.

GREECE

Participants held different views on the cause of the crisis. One camp argued that the origin of the crisis was the fall of Greece's commodity prices, particularly of iron, aluminum and copper, after a long period of inflation. The other camp believed the origin could be traced to ratings agencies downgrading Greece, and the subsequent high interest rates. One participant contended with both camps, explaining that the causality debate was a roundabout, "the chicken or the egg" discussion. There is no one direct cause, the participant argued, only a series of negative occurrences that compounded into the current debt crisis. He applied this argument to all troubled, Eurozone periphery economies.

Participants presented several options on how to deal with the crisis. The European Central Bank (ECB) could give more funds to Greece to help it repay its debts. The ECB could extend the maturity of Greece's debts. Taking the previous option one step further, the ECB could embark on tougher restructuring, including rescheduling *and* reprofiling Greece's debt.

Regarding the ECB assuming the debt, some argued that Greece would never be able to repay its level of debt, so at some point it must be eliminated. Yet, participants deemed this option highly unlikely. Regarding extending timelines, maturities may have to be extended for decades in order for this option to be effective. The combination of restructuring and reprofiling Greece's debt could increase government spending and consumption without pressuring the Greek legislature to implement austerity measures. The ECB, as well as many European politicians, are very much opposed to restructuring and reprofiling. One participant emphasized patience, arguing that it is unwise to take any drastic measures now without a better idea of how the next few months will play out.

No matter what option the ECB chooses, Greece will not be able to reenter the markets in 2012, the original goal of the 2010 bailout. All participants agreed the economic situation in the Eurozone will be highly uncertain for at least the next four months and possibly into the next couple years.

II. The US Economy and the Debate Surrounding the Debt Ceiling

The US economy is showing troubling signs. Several factors, such as the falling Purchasing Managers Index (PMI), industrial production, U.S. stock prices, commodity prices, equity markets, consumption, and treasury bond yield, indicate that the rate of recovery from the financial crisis has slowed considerably. Gasoline prices are up and U.S. manufacturing was hit hard by Japan's earthquake, tsunami, and nuclear crisis. The housing sector is far from recovered. It is still too early to tell if this slowdown is just a "soft patch," common in the recovery process, or if the above factors indicate a more serious development.

The U.S. government implemented the financial stimulus approximately two years ago and participants questioned whether it has run out of steam. If so, few political and fiscal tools that have not already been utilized remain. However, there are some positives in the US economy. Job creation has been rising for three months in a row, and, as opposed to this time last year, no one is talking about a "double dip" recession.

On Monday May 16 the U.S. hit its debt ceiling. The U.S. Treasury is currently taking "extraordinary measures," such as tapping into the pension funds of federal employees, to continue to pay its debt. It will be able to do so until approximately August 2, 2011. Democrats and Republicans generally agree that the debt ceiling needs to be raised in order for the government to continue to function without defaulting on its debt, thereby triggering a financial crisis potentially larger than that of 2008. However, Republicans do not want to vote to raise the debt ceiling without major spending cuts and moves towards long term debt reduction. Democrats would like to portray Republicans as erratic for letting the government shut down, while Republicans would like to paint Democrats as irresponsible for not implementing stricter austerity measures. Both sides are exercising brinkmanship and waiting for the other to compromise.

Despite the prospect of a government shutdown, the market seems convinced that a compromise will emerge. Interest rates are still low, demand for U.S. debt remains high, the stock market is relatively stable, and banks are continuing to lend to companies and each other. Participants agreed that at this point the issue is largely a political battle. One participant commented that Congress is employing "good old fashion horse trading" to come to some sort of resolution.

III. China

In China prices have risen 5.5% since last year and inflation has soared to its highest point in the last three years. These figures are increasing the pressure on policymakers to raise interest rates for the third time in 2011 and continue to tighten lending. Participants agreed that China should tighten fiscal and monetary policy to keep interest rates and asset bubbles from spiraling out of control, while avoiding over-tightening and pulling itself into a recession. A slowdown in China could be a positive for the global economy and for China.

The rebalancing of global economic power that would occur if China's growth slowed could prevent the rest of the world from becoming too dependent on the Chinese economy. Germany's successful export performance, for example, is in large part due to trade with China. Much of Europe is dependent on Germany's powerhouse economy. Without redirecting Germany's export strategy away from unilateral dependence on China, an additional slowdown in China could severely damage Europe and have catastrophic effects on the U.S. Therefore, countries like Germany can take China's minor slowdown as an opportunity to become less dependent and turn to other markets.

A slowdown could also benefit China. Previously, China's economy has exhibited signs of overheating. A slowdown gives the Chinese economy the chance to avoid overheating and "cool down." The question is whether it can handle a slowdown now and still resume 7-9% growth later.

IV. Recent Developments in Latin American Economies

BRAZIL

The rise of commodity prices and capital inflows has caused inflation in Brazil, particularly in the service sector. According to one participant, the rise of commodity prices cannot go much higher than they were at the beginning of the year. Studies in Brazil show that capital inflows to the private sector do not curb the domestic credit growth nationally. Rather, they have substantially increased credit growth, because interest rates have been very responsive to capital inflows. Brazil faces increasing pressure from multinational Latin corporations ("multilatinas") who are lobbying hard to maintain easy credit via large campaign contributions to Brazilian Congress members.

One participant feared inappropriate levels of fiscal restriction or monetary tightening on behalf of the Brazilian government and central bank. There are limits on what can be done in the short term with fiscal restriction, partially because the fiscal stimulus put in place by former President Lula is not easily reversible. Reigning in fiscal policy is also made difficult because Brazil has the most expensive cost of nominal and real debt in the world. Many believe the $30 billion budget cut proposed by President Dilma Rouseff is not enough. However, most participants believed that Rouseff has a large enough base of support to catalyze a combination of fiscal and monetary tightening.

PERU

Peru's model for growth has been working well for the last ten years. In the presidential election, three candidates, Alejandro Toledo, Pedro Pablo Kuczynski, and Luis Casteñeda, fatally divided the majority of the population that preferred a continuation of that model. Thus, Keiko Fujimori on the right and Ollanta Humala on the far left emerged as candidates in a highly polarizing election. Fujimori and Humala both have questionable pasts and links to corruption. Many Peruvians voted as a rejection of a non-candidate, Alberto Fujimori in the case of Keiko Fujimori and Hugo Chávez in the case of Ollanta Humala.

Participants discussed the respective impacts on Peru's economy if either Keiko Fujimori or Ollanta Humala were to win the presidential election. One participant advocated for Fujimori, because although she many change the Peru's politics, the macroeconomic model would remain the same and she would be less disruptive to Peru's growth rate. Other participants argued that Humala will facilitate a more equal distribution of Peru's wealth as Peru's lower socio-economic sectors, including most of Peru's rural population, reap few of the benefits from Peru's growth.

MEXICO

Participants discussed the violence and drug trade consuming Mexico. Some said that it was extremely unlikely that Mexico would change course on counternarcotics strategy. One participant argued that the Mexican government was making slow but real progress. Others contested that while Mexico may see the volume of drugs traded fall, the volume of drugs traded overall is constant. Pushing the drug trade out of Mexico simply moves to Central America, as it moved from Colombia to Mexico. Participants agreed that no one has a full-proof strategy alternative to the current policy.

Despite the political and social upheaval caused by violence in Mexico, one participant explained that it has actually had very little impact on the economy. The economy is competitive and foreign investors have not fled, rather to the contrary.

This report was prepared by Cory Siskind.