

## Introduction and Overview

Latin America is showing the world a face with attractive new features: more stability in its macroeconomic environments, and greater pragmatism in policy and institutional reform. Regional success, measured in terms of economic growth, foreign investment inflows or export dynamism, may not yet be as impressive as in parts of Asia, but many significant developments are quietly under way.

In this volume, the spotlight is directed at some of the most exciting experiences taking place in the region today: reinforcement of the link between democratic governance and public finance; the emergence of private pension funds and their positive impact on financial development; the impact of multinational corporate activity in the telecommunications sector; and trade complementarities and competition with China and India. What role does fiscal policy play in Latin American democracies today? Can private pension funds provide countries in the region with much-needed domestic savings? How can international investment in the telecommunications sector help improve conditions for Latin Americans to access communications services? Is the world's growing trade with Asian emerging economies having a positive effect on the integration of Latin America into the global economy?

Such are the questions addressed in this first edition of the *Latin American Economic Outlook*. Future editions will explore other issues, just as crucially important for policy makers and private decision makers, in an effort to indicate the best paths for development.

Chapter 1 of this volume looks at the coherence of policies for development, with a focus on the role that fiscal reform and greater fiscal legitimacy can play in fostering governance and democratic consolidation. Chapter 2 examines new areas of financing for development, and specifically the growth of funded pension systems. Chapter 3 considers how business and the private sector can help foster development, in particular how competition and foreign investment can spur access to telecommunications services and improve living conditions amongst the middle-income and poorer segments of the population. Chapter 4, which looks at issues of trade for development, refutes the frequent claims that growing world trade with China and India poses a threat to most Latin American countries. On the contrary, new global trade patterns and Latin America's own growing engagement with emerging Asian economies offer the region an opportunity and incentives to strengthen competitiveness by investing more in infrastructure and innovation.

### Policy Coherence for Development

#### *Fiscal policy and legitimacy in Latin America*

Democracy puts fiscal policy at the heart of the relationship between citizens and the state. Fiscal policy, one of the region's main challenges today, will continue to be a major development issue for Latin America, as it is in the OECD countries. Latin America has the

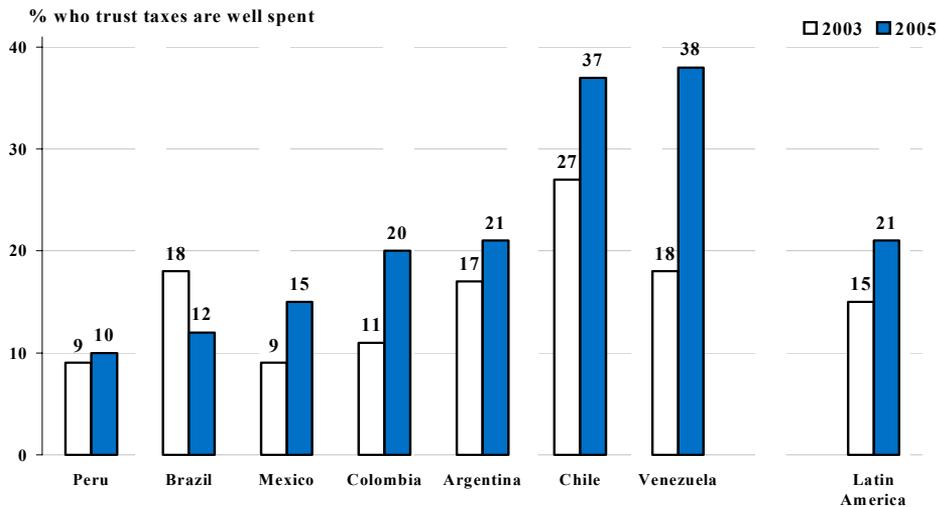
most inequality of any region in the world. Close to 40 per cent of the population, or more than 200 million people, live in poverty. Governments cannot ignore the challenges involved in fighting poverty and inequality while at the same time promoting stable and sustainable economic growth and development.

In many Latin American countries, fiscal performance and democratic governance suffer from low fiscal legitimacy. Good democratic governance paves the way to democratic legitimacy by building people’s faith in democracy over all other forms of government and ensuring their acceptance of the way democracy works in their country. Analogously, fiscal legitimacy is a reflection of the confidence people grant their government’s performance in collecting and spending its tax revenue.

Fiscal legitimacy is low in many Latin American countries. Less than 25 per cent of Latin Americans trust that their taxes are being well spent, according to Latinobarómetro surveys of local voters in the mid-2000s. Even allowing for some volatility or measurement error in those opinion surveys, there can be no doubt of the low orders of magnitude of fiscal legitimacy in most countries in the region, as those scores are corroborated by the views of local and multinational enterprises operating there. According to similar indicators and business-climate measures that allow for cross-regional comparisons, these companies consistently rate Latin American countries worse than those in other regions. An important explanation for this lack of trust in fiscal policy is that, in contrast to an important effect of fiscal systems in most OECD countries, taxes and transfers play little or no redistributive role in most Latin American states. When taxation fails to help bridge the gap between the rich and the poor, the credibility of the fiscal system suffers. Poor-quality fiscal policy hinders the generation of tax revenue, frustrates public expenditure, and undermines fiscal and democratic legitimacy.

Figure 1. **Percentage of Population Trusting That Taxes Are Well Spent**

Selected Latin American countries and average



Source: OECD Development Centre (2007); based on Latinobarómetro (2003, 2005) data.

StatLink <http://dx.doi.org/10.1787/120484410425>

Fiscal reform in the 1980s and 1990s has already made significant progress and produced positive results in Latin America, where many governments are now trying to do a better job in terms of improving fiscal efficiency and promoting socio-economic equity. Successful reforms to strengthen fiscal institutions include the introduction of new rules to control public deficits, new fiscal-responsibility laws, and measures to enhance transparency. In part as a result of these reforms, much of the region now offers the world a new face: stable and predictable macroeconomic environments thanks to lower inflation, sounder public finances, more reasonable debt management and lower risk premiums.

Yet much remains to be done. A comparison of Brazil and Mexico serves to illustrate the challenges the region faces today in trying to improve the quality of fiscal policy. Brazil collects and spends a lot: at about 35 per cent of GDP, its tax revenue is close to the average for OECD countries and far above the average of 17 per cent for Latin America as a whole. More is not better, however, as Brazil does not rank much better than most other Latin American countries — and does poorly by OECD standards — on numerous social indicators that reflect the quality or effectiveness of public spending. Mexico, whose tax revenue is below 15 per cent of GDP, stands at the opposite end of the spectrum in terms of the ratio of tax revenues to GDP, by regional as well as OECD standards. But less is also not better, as Mexico, like Brazil, scores poorly on numerous measures of the quality of public goods. At opposite ends of the regional spectrum in terms of their tax-revenues-to-GDP ratios, Brazil and Mexico, like many other countries in Latin America, need both better collection systems and better public spending.

## Looking ahead

Latin America's fiscal reforms can succeed by strengthening democratic governance. People will support fiscal reform, including tax reform, if they see results. First, public spending should be targeted better. The region needs better, fairer and more public spending, certainly on health and education, but also on infrastructure and innovation. In many countries, fiscal policy is regressive because wealthier households receive most of the benefits. Social-insurance programmes, in particular, are notably regressive throughout the region. Conditional cash-transfer programmes, such as *Bolsa familia* in Brazil or *Oportunidades* in Mexico, on the contrary, are very progressive but still relatively minor.

In terms of tax reform, a major pending challenge is to make collection systems fairer and more balanced through elimination of special exemptions from direct and indirect taxes. Such reforms will operate as a disincentive for tax evasion and increase revenue, and thus broaden the tax base. Revenues from indirect taxes, value-added taxes (VAT) in particular, play a large role in tax collection. Tax structures can only be balanced by increasing the share of revenue coming from direct taxation.

## Fiscal performance and democratic governance

Having experienced major fiscal reforms in the 1980s and 1990s, the region is now moving into a new set of reforms. An open debate on public policies will enhance not only the approval process of reforms and new tax mechanisms but also their implementation. Expectations are growing for measures that can help strengthen accountability mechanisms and bring official policies closer to the population and public scrutiny. Transparency should reinforce citizens' perceptions that they are getting value for their money and that taxes are being well spent.

Local think tanks can play a very important part here. Their independent monitoring of public spending and fiscal policy-making can strengthen a sense of public ownership over democratic processes. In many Latin American countries, think tanks already play an important role, but their ability to criticise is limited by scarce funding and limited human resources. The creation of larger endowments would be an important step in providing Latin American think tanks with greater and better resources they need to analyse and evaluate public policies. Financial means and stability are also important elements for securing their independence from public players, so allowing them to exert their watchdog functions and express dissenting views.

Decentralisation can also play an important role in strengthening accountability and democratic governance by reinforcing the capacity, authority and accountability of sub-national governments, especially through direct taxation. New ways of empowering local governments in taxation need to be explored, as these are not without challenges. In Brazil, for example, where states have been granted authority over VAT rates, there is evidence of harmful “tax wars” amongst different states

Governments can enhance fiscal legitimacy, in sum, by: i) involving independent third parties in the auditing and evaluation of public policies to strengthen transparency and accountability; ii) promoting better, fairer and more public spending; iii) broadening the tax base and making tax systems fairer and more balanced; and iv) reinforcing the capacity, authority and accountability of sub-national government bodies, especially with regard to direct taxation. Fiscal legitimacy is not only an issue of capacity, however, and strengthening administrative capabilities can only take tax administration part of the way. The case of Peru during the Fujimori administration shows that even the most capable administration can be manipulated and misused. While tax administration and tax policy may be one and the same thing, as some fiscal experts have asserted, tax administration is not the same as tax politics.

In their efforts to enhance fiscal legitimacy and reinforce democratic governance, Latin American countries need to bring politics back into tax and fiscal policy-making, explicitly and transparently. Fiscal reform should aim at broadening benefits and bringing people and the state closer. An open and informed political debate, which can only happen if there is more transparency in the system and more public access to information, is an excellent way of achieving this goal. Independent actors with the capacity and the financial independence to carry out a critical evaluation of policies and proposed reforms can powerfully enrich such a debate. In the process, fiscal policy will help strengthen democratic governance.

## Finance for Development

### *Pension reform, capital markets and corporate governance*

Latin America leads the developing world in pension reform. Chile launched the process in 1981 with its radical pension reform. Since the early 1990s, that reform has been a model for nine other countries in the region, as well as for a number of countries outside the region, including OECD countries. Amongst Latin America’s large countries, only Brazil has not undertaken a similar reform.

These pension reforms involve a transition from unfunded, publicly managed “pay-as-you-go” pension systems to privately managed, fully funded defined-contribution systems of individual accounts for beneficiaries. While some countries have replaced their previous system with the new one, others have introduced it on a voluntary basis.

The reforms pursue several objectives. The most important have been to provide a reliable source of retirement income for workers and to reduce the fiscal drain on governments caused by existing systems. Further objectives, to which this chapter gives particular attention, have been to boost local savings, provide a stable domestic source of development finance and promote the development of local capital markets. The importance of these objectives reflects the fact that many economies in Latin America have long suffered from low domestic savings and financial fragility. These have slowed growth and increased dependence in the region on volatile international capital flows.

The reforms have also sought to rely on competition amongst private interests — notably the pension and insurance companies, which are the institutional investors that manage retirement savings in the new pension systems — to enhance real economic efficiency by channelling savings into more productive uses. The subsequent accumulation of significant amounts of savings in pension funds has drawn attention to the considerable potential for pension funds to induce companies outside the pension sector, in whose equities they may invest, to make significant improvements in the quality of their corporate governance, which would be of major benefit to all stakeholders — including active and retired workers — and to long-term productivity growth in the economy as a whole.

### The impacts of pension reforms

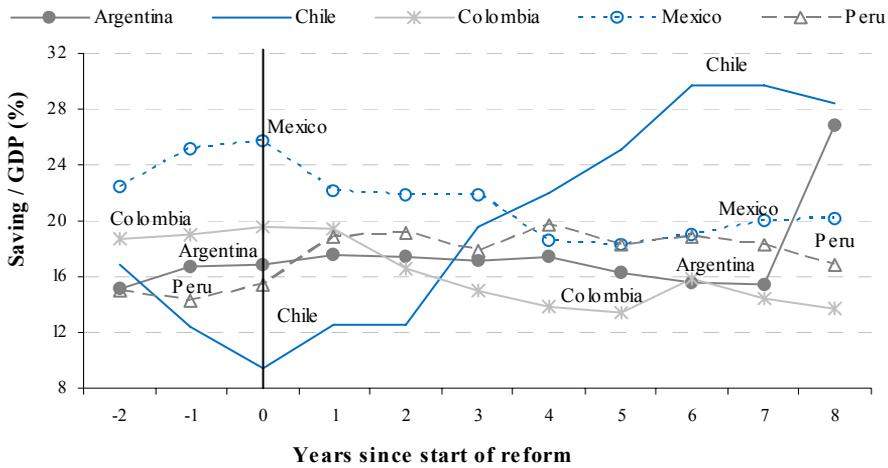
Results of the reforms vary amongst countries, in part because the reform was launched much more recently in some countries than in others. In Chile and more recently Peru, pension reform has been accompanied by fiscal consolidation and by increased national saving. In Chile, it has also contributed to financial development — notably by increasing both the role of the stock market and the size of the mortgage bond market — and, together with other reforms, has helped to improve local corporate governance.

In other countries, the picture is less encouraging. Argentina and Bolivia succumbed to fiscal pressures that weakened their pension-fund systems. In many countries, saving has failed to increase, or even fallen. The impact of pension reform on capital markets has also been constrained by regulations that limit pension funds' investment options and drive them to invest in government debt. As for the expected impact on corporate governance, in most countries, pension funds have yet to become the drivers of improved economy-wide corporate governance that some experts think they may still become.

Analysis of the impact of pension reform on national saving is made difficult in Latin America by the fact that the reform has coincided with other major policy changes that may have had a large impact on saving. In Chile, for example, saving has grown strongly since 1985, after the country recovered from its financial crisis of the first half of the 1980s, but this rise might not have materialised without the important reforms Chile implemented in other areas of the economy. Figure 2, which gives countries' saving rates during the ten-year period running from two years before to eight years after they launched their pension reform, shows that after the pension reform, besides Chile, only Peru has experienced an increase, albeit small, in national saving as a share of GDP. In Argentina, saving remained virtually unchanged, and in Colombia and Mexico it declined.

Pension reform in Latin America has had considerable impact, on the other hand, on local capital markets. The accumulation of large financial resources by the new pension funds has quickly allowed these funds to gain a dominant position in their domestic financial systems. By the end of 2006, pension-fund assets under management in the region amounted to \$390 billion.

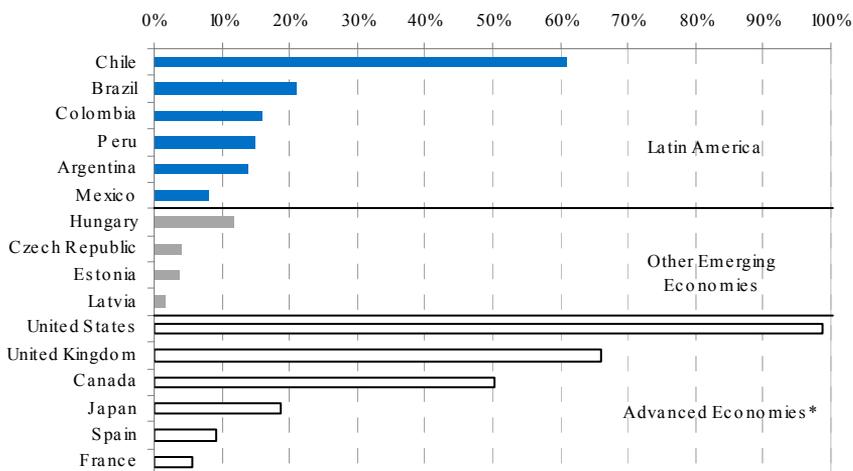
Figure 2. Trends in Gross Domestic Saving as Percentage of GDP



Source: OECD Development Centre (2007); based on World Bank, World Bank Development Indicators (2006) data.  
 StatLink <http://dx.doi.org/10.1787/120676251351>

Brazil — which has not followed Chile’s route to pension reform but did create voluntary pension funds in the 1970s, of which there are now more than 400 — and Chile have the largest pension-fund industries, accounting for approximately 65 per cent of all pension assets in the region. The early establishment, by regional standards, of pension funds in these two countries, plus the large size of Brazil’s economy, explains the large size of these countries’ pension industries. Chile has by far the largest pension industry in the region relative to the size of its economy, with assets as of December 2006 worth more than 60 per cent of GDP — a size comparable to those found in OECD countries with well-developed private-pension industries. Brazil’s private pension-fund assets, the second largest in the region and now worth about 20 per cent of GDP, have grown more slowly than Chile’s primarily because of the voluntary nature of contributions to those funds.

Figure 3. Pension Fund Assets as Percentage of GDP, 2006



Note: (\*) 2005  
 Source: OECD Development Centre (2007); based on OECD Global Pension Statistics database data.  
 StatLink <http://dx.doi.org/10.1787/120755578734>

## Looking ahead

Policy makers throughout the region have moved to ensure better regulation of their pension-fund industries, but significant room for improvement remains both in the regulation and in the governance of these industries. Clearly written mission statements, codes of conduct and mechanisms for enhancing the accountability of pension-fund administrators, for example, could help improve the alignment of incentives amongst members (that is, active and retired workers), sponsors (employers) and administrators (the private companies that manage pension funds), and provide better protection of members' interests.

As governments move to liberalise their restrictions on pension-fund administrators' investment options, the quality of administrators' self-regulation, together with effective governance of pension-fund administrators, will become even more important. This applies especially to the many countries where pension-fund administrators have become entrenched in dominant local-market positions as the largest institutional investors. Greater attention to their governance and self-regulation should also induce a healthy reorientation in their investment strategies towards seeking higher returns from less liquid but potentially profitable and socially necessary investments, for example in housing, infrastructure and innovative technologies.

The probably inevitable high degree of market concentration in strictly regulated, mandatory, funded pension systems further highlights the need for much greater attention to the quality of the governance of pension-fund administrators. Equally important is the potential those administrators have to induce widespread improvement in the quality of governance in the enterprises whose equities they acquire as assets.

Combined, the result of such enhanced governance — of both pension-fund administrators and the corporations in which they invest members' pension monies — should be a far more productive economy-wide use of real capital and human resources. Countries throughout the region would thus enhance national saving and reduce their financial fragility and dependence on volatile international capital markets.

## Policy recommendations

To achieve such results, policy makers in different countries would benefit through learning more actively from one another's experiences. Policy makers should exchange their experiences and lessons learned within the frameworks of the OECD Principles of Corporate Governance and the OECD Guidelines for Pension Fund Governance, with the active support of the OECD. Five policy areas deserve particular attention:

First, given that pension-fund assets are likely to continue to grow in Latin America, priority must be given to strengthening local financial-market infrastructure and financial regulatory frameworks.

Second, regulations that hamper a healthy diversification of pension assets should be re-examined with a view to facilitating asset diversification while maintaining high prudential standards. Increasing the share of equities and/or foreign assets allowed in the investment portfolios of pension funds, in countries where current limits on such assets are close to zero, would contribute not only to better pension-fund risk management through enhanced asset diversification but also to reducing the undesirable side-effects of current pension-fund investment patterns on domestic asset prices. And, regarding equities, for pension funds to become active shareholders capable of exercising effective voice in the quality of the governance of the companies in which they invest money, regulators in

countries that limit pension funds' equity investment to indexed funds should consider allowing pension funds to buy and sell the shares of individual companies. Any such relaxation of investment limits must be accompanied by effective incentives and tools for asset managers to diligently monitor and be held accountable for the investments of their funds.

Third, policy makers should consider the benefits of allowing pension-fund asset managers the possibility to offer members a diversity of funds in terms of risk-yield profile, which today only Chile, Mexico and Peru allow. In addition to giving individual members a broader range of investment options, such multiple funds enhance the incentive for members to seek information on performance differences amongst fund investments, which may in turn help improve resource allocation.

Fourth, governments must give attention to the high administrative fees and costs that pension funds charge members in some countries. The two principal policy options for addressing this problem are: i) to strengthen competitive pressures on funds by liberalising the market to allow banks, insurance companies and perhaps other financial organisations to compete directly with pension funds for members' contributions; and ii) to reduce administrative costs through economies of scale by centralising, for the country as a whole, the collection of members' contributions, record keeping and reporting to members, and reduce administrative fees by limiting incentives for members' costly and inefficient switching between administrators. While the former option relies more on the competitive market mechanism, it requires careful evaluation to avoid exposing workers' pension assets to the excessive risk-taking that may plague the investment and management behaviour of non-specialised financial organisations.

Fifth, the laws and regulations that govern private pension funds need to be revised to strengthen the role and responsibilities of institutional investors as fiduciaries of other people's retirement assets. Transparency and effective rules of communication between fund managers and members are required for the governing bodies of pension funds to act consistently in the best interest of their members. Improved governance of pension funds can in turn greatly enhance the positive impact and simultaneously lower the risk of investment by pension funds in the equity of enterprises active in all sectors of the local economy, as well as internationally. By serving as powerful agents for improved corporate governance throughout their economies, well-governed pension funds can thus also contribute forcefully to long-term real economy-wide productivity growth. Workers, active and retired, and employers alike should benefit significantly.

## Business for Development

### *Multinationals, telecommunications and development*

Foreign direct investment (FDI) flows have stepped up dramatically around the world since the mid-1980s. In Latin America, the 1990s were a period of accelerated FDI inflows, led by the entry of developed-country multinationals into newly privatised or liberalised sectors.

The real change, however, is not in the game but in the players. Of worldwide FDI stocks, the share emanating from developing countries has increased by half, growing from 8 per cent in 1990 to 12 per cent in 2005. Latin American enterprises now also play away from home. Since 2006, the value of annual outward FDI flows from the major countries in the region has flirted with the \$40 billion mark. This explosion of outward investment is

largely the result of the rapid internationalisation of a small number of large enterprises, mainly from Brazil and Mexico. Indeed, in 2006, Brazil was a net source of FDI, with outward flows amounting to \$26 billion, as compared to inflows of \$18 billion.

The largest Latin American multinationals are in primary commodities and related activities; Mexico's cement producer, CEMEX, and Brazil's Petrobras, in oil, and Companhia Vale do Rio Doce (CVRD), in mining, are important examples. Services and final goods have also become key areas of multinational activity by Latin American firms, first regionally, and now, for a small number of very successful enterprises, globally. While these firms' multinational growth reflects diverse corporate strategies, scopes and ambitions, it places Latin America firmly on the new global map of home countries for multinational corporate activity.

### The telecommunications contribution

The telecommunications sector is at the crossroads of these new trends in multinational investment. While several multinationals from Europe and North America entered the sector aggressively in Latin America during the region's privatisation and liberalisation period in the 1990s, consolidation and competition have given the upper hand amongst these firms to Spain's Telefónica. Since 2000, successful expansion within the region by Mexico's América Móvil and its sister company Telmex has in turn created a formidable new regional competitor for Telefónica. The role of these two multinationals from opposite sides of the Atlantic, who now dominate telecommunications in Latin America, sheds valuable light on the contribution of multinational enterprise to sector-specific and broader economic development in the region.

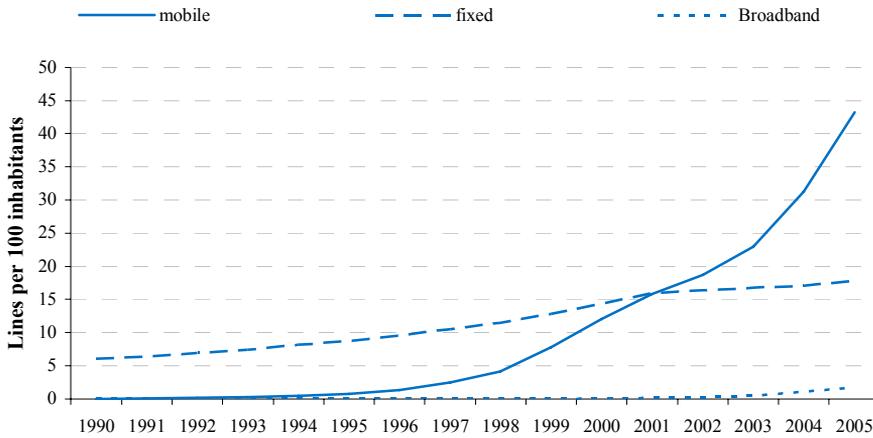
Telecommunications contribute to the economic performance of countries as a whole because of the importance of the services they provide. By increasing the availability and speed of information flows to a broad range of potential users, the sector can transform both economic and political life. For the sector to play this transformational role, however, much depends on the extent of its coverage of the population and the degree of access it provides to different segments of the population. It is precisely in its impact on coverage and access that FDI in telecommunications has played a transformational role in Latin America.

Since privatisation started in the region at the turn of the 1990s, cumulative FDI flows in the sector — including the entry of foreign enterprises through privatisations, capital expenditures and the establishment of new mobile operations — have exceeded \$110 billion. FDI in this sector has thus been a major source of Latin America's total FDI inflows. Equally important is the fact that in such non-tradable services as telecommunications, where responsiveness to local conditions is crucial for success, multinational investors have pursued strategies adapted to individual host countries ("multi-domestic strategies") that have in turn generated significant employment and fiscal revenues in host countries.

FDI in this sector has also helped bring about the rapid progress of connectivity in Latin America. Telephone density (lines per 100 inhabitants) has not only increased significantly: it has increased most where the sector has received the most FDI per capita. Figure 4 shows the impressive speed at which mobile telephony has spread in the region since the late 1990s. The growth in landline density is also significant, especially during the 1990s, although it has visibly slowed since then (and at 18 lines per 100 inhabitants, remains far below universal service). By 2005, the region thus attained a combined teledensity of 61, above the world average of 54, and well above South Asia's 12 for example (although still a long way from average levels in OECD countries of 130).

Figure 4. **Mobile, Landline and Broadband Penetration**

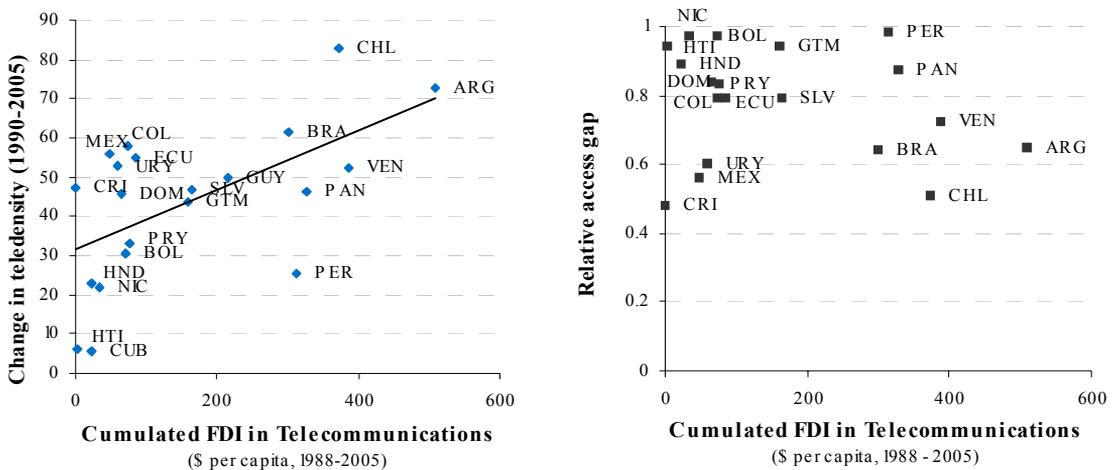
Latin America population weighted average



Source: OECD Development Centre (2007); based on ITU (2006) data.  
[StatLink !\[\]\(8b57f0e15e7dda24cf9977561475f640\_img.jpg\) http://dx.doi.org/10.1787/121327185628](http://dx.doi.org/10.1787/121327185628)

Privatisations, sizeable flows of market-seeking FDI and competition amongst investors in the sector have combined to play a key role in bringing about this growth in connectivity. Also important has been the rapid spread of mobile technology — sizeable investments have gone into telecommunications infrastructure, especially linked to the spread of mobile technologies — together with process innovation (e.g. pre-paid phones) and regulatory innovation (e.g. calling-party-pays charging). Figure 5 confirms that teledensity has increased the most in countries that have received the most FDI per capita in the sector.

Figure 5. **FDI Impact on Telecommunications Outcomes**



Source: OECD Development Centre (2007); based on ITU (2007), IADB (2007), SEDLAC (2007) and World Bank PPI Database (2007) data.

[StatLink !\[\]\(8a8ea273bba45b658cf4779d37ab61e8\_img.jpg\) http://dx.doi.org/10.1787/121701322488](http://dx.doi.org/10.1787/121701322488)

Figure 5 also shows, however, that this impressive growth in connectivity has not significantly lowered the access gap between the rich and the poor in most countries of the region. The increase in service initially benefited mostly the better-off, while the poor remained underserved. Inequality — as measured by the difference in the proportions of rich and poor people who have telephones at home — remains high. For the region as a whole, an individual in the highest income quintile is more than three times more likely to have a phone than one in the lowest income quintile.

### The importance of regulatory frameworks

In countries with a particularly dynamic telecommunications sector, such as Brazil or Chile, some reduction in inequality occurred more recently (e.g. a rich Brazilian was 10 times more likely to have a phone than a poor one in 1997, but only 2.5 times by 2004). Contributing to this reduction in inequality have been moves by government regulators in these countries to supplement market mechanisms in the telecommunications sector with universal-access obligations on incumbent suppliers, or to constitute funds for the promotion of universal access. Chile's innovative project-selection mechanisms are an important example.

The most successful regulatory models for telecommunications in Latin America, in terms of increasing coverage and simultaneously lowering inequality of access between rich and poor, have ensured competitive behaviour in the sector through careful but determined regulation. While the performance of public monopolies ranges from good to dismal in countries where those monopolies still exist, even the better performers are less responsive to the new opportunities offered by mobile technologies. The privatisation of those same monopolies or the granting of long exclusivity periods to incumbents, as in Mexico, Nicaragua and Peru, while attractive in terms of revenue generation, has created uncompetitive markets that are seriously underperforming for users, especially in landline coverage.

The gap in access to telephone services between rich and poor thus remains substantial in most countries in the region, and while the provision of voice service can go a long way towards strengthening social ties and increasing mobility, it is only the first step in bridging the communications and digital divide between rich and poor. Undeveloped telecommunications networks will also remain a bottleneck for broadband access, notwithstanding the value of communal approaches to providing internet access, which are helping internet services outpace landline expansion.

The bottom line is that the spectacular progress of mobile telephony constitutes an important opportunity to reach (including through mobile banking) major segments of Latin America's population hitherto largely excluded from productive integration into the modern economy. Only a regulatory framework that ensures contestable-market behaviour by the suppliers of telecommunications services can ensure the affordability of those services for large numbers of poor households and small enterprises. The combination of such a regulatory framework, technological innovation, and competition by multinational investors for local consumers holds a significant potential for enhancing the productivity and living standards of large numbers of people.

## Trade for Development

### China, India, and the challenge of specialisation

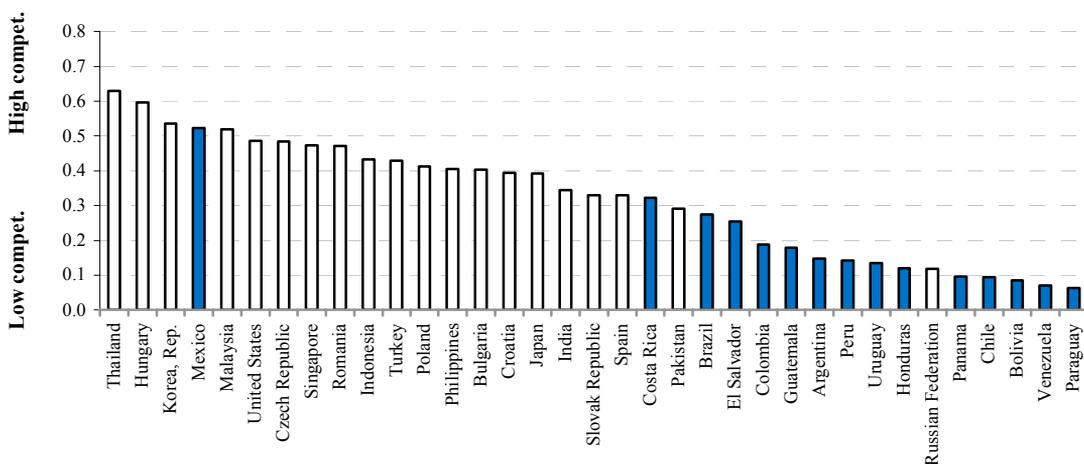
The rise of China and India in the global economy has had important effects on Latin America and been the subject of passionate public debate. Both these Asian giants have outperformed Latin America since the mid-1990s in terms of growth, exports, FDI attraction and innovation, giving rise to considerable apprehension in the region. While there are many examples of business co-operation between Latin America and the Asian giants, and trade agreements are being signed between their governments, public opinion has at times seen Asia’s increased presence as a threat to national industries. A closer look at the real impact in Latin America of the world’s rapidly growing trade with China and India nevertheless offers a much more encouraging assessment.

### Trade competition between Latin America and the Asian giants

The United States, the European Union and Japan are where most third-market competition takes place between Latin America and the Asian giants. That competition is fiercest in the United States, which alone received 57 per cent of Latin American exports in 2006. China and India have been increasing their market shares in the United States — and, in the case of China, have already overtaken Mexico’s share, for example.

Closer inspection shows, however, that only a few countries in Latin America face much trade competition with China and India, and that the latter do not constitute a significant threat to Latin America as a whole. Figures 6 and 7 provide indicators of export competition between China and India and selected countries. The competition is measured by comparing the trade structure of each country with that of China, in Figure 6, and with that of India, in Figure 7. A high score indicates similarity in export structures, which suggests more third-market competition.

Figure 6. **China’s Export Competition with Latin American and Other Selected Countries**

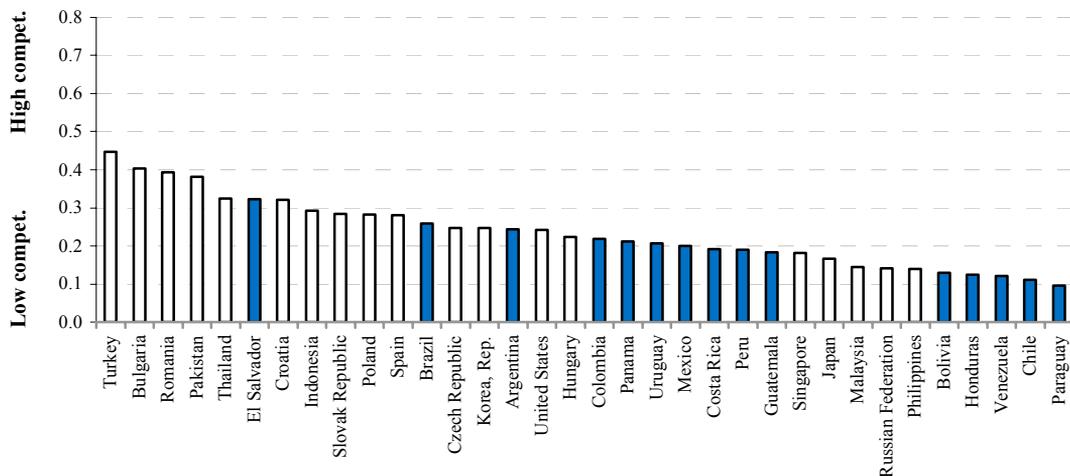


Note: Measured by Average Coefficients of Specialisation and Coefficients of Conformity.

Source: OECD Development Centre (2007); based on World Integrated Trade Solution (WITS) and Comtrade (2007) data.

StatLink <http://dx.doi.org/10.1787/121447200442>

Figure 7. India's Export Competition with Latin American and Other Selected Countries



## Notes:

Measured by Average Coefficients of Specialisation and Coefficients of Conformity.

For more details, see Statistical Annex table 4.A5a and 4.A5b.

Source: OECD Development Centre (2007); based on WITS and Comtrade (2007) data.

[StatLink !\[\]\(ef57557257cbb5c674d51a9e0a98bb4d\_img.jpg\) http://dx.doi.org/10.1787/121480464125](http://dx.doi.org/10.1787/121480464125)

The data show that the export structures of most Latin American countries are very different from Chinese and Indian export structures, implying that they have little to fear from China's and India's export dynamism. Other emerging economies such as Thailand, Hungary and Malaysia are facing substantially tougher competition from Chinese exports. Mexico and Central America are the exceptions to this general pattern in Latin America of non-competition with China. Latin America's competition with India is similarly low, with El Salvador, Brazil and Argentina apparently facing the most exposure to competition, and emerging economies in other regions — notably Pakistan, Romania, Turkey and Bulgaria — facing much tougher competition with India. Not surprisingly, Latin American countries that export mainly commodities face the least trade competition with China and India, as the latter are net importers of these products. Paraguay, Venezuela, Bolivia and Chile thus suffer the least from Chinese and Indian trade competition.

### Export bonanza in commodities

Equally significant is the fact that rapid growth in China and India is opening important export opportunities for Latin American countries. Thus, while Mexico's export structure suggests it is the most vulnerable amongst Latin America's large countries to Asian competition in third markets, especially in manufactures, Mexico is also one of the Latin American countries, together with Colombia and Venezuela, that stands to gain the most from increased commodities exports to China and India. Indeed, of the 19 biggest Latin American and Caribbean exporters, 11 are specialised in commodities, and both China and India are prime importers of these products. Their heightened demand for oil and minerals has already substantially increased Latin America's export earnings, which have benefited both directly, from the increased volume of the region's commodities exports to China and India, and indirectly, from the increase in world prices for the region's commodities exports to Asia and elsewhere induced by strong Asian demand. Few countries in Latin America, in contrast to Southeast Asian developing countries for example, appear likely to benefit from

potential intra-industry trade growth with China and India, however. Mexico and Brazil may be partial exceptions in this regard, as they may have some potential to benefit from intra-industry trade in manufactures with the Asian giants.

## Dutch disease, or the natural-resource curse

While China's and India's growth dynamism thus offers major benefits for Latin American exporters of primary goods, including oil, minerals and agricultural products, the principal risk is that as commodity exports become more valuable and commodity exporters see their incomes rise, they will rely on commodity exports to the detriment of other sectors. As is well-documented in the literature on the so-called Dutch disease, surges in commodity-export income, while increasing both growth and government revenues, can have substantial adverse effects if they are not managed responsibly. Surging commodity exports can easily drive up a country's exchange rate, which induces a long-term decline in non-commodity exports, notably manufactures, to the detriment of economic development.

Recent data on trade patterns in Latin America are partially consistent with the need for concern about Dutch disease in the region. The terms of trade have notably risen in Colombia, Chile and Uruguay, for example, indicating that the prices of their main exports are increasing faster than those of their imports. Specialisation has also increased, with most Latin American countries showing a higher degree of export concentration in commodities than at the beginning of this century. The trend towards greater specialisation in commodities is most marked in Venezuela, Ecuador, Bolivia and Chile; the exceptions are Costa Rica and Argentina.

More reassuring is the fact that real exchange rates have not appreciated as much as could be feared. Macroeconomic stability has also been maintained, with inflation contained. Fiscal reform is in part to be credited for these successes, especially recently established oil and stabilisation funds. New transparency rules, such as freedom-of-information laws, should further stimulate responsible and accountable policies.

## Enhancing competitiveness

The current commodities boom also intensifies the need for both governments and firms in Latin America to redirect windfall revenues towards strategic growth-enhancing activities in order to maintain growth beyond the natural-resource bonanza. These activities include building up capabilities in innovation, education and physical infrastructure. They are needed to strengthen the competitive position of the economy's non-commodity exporters, including those involved in intra-industry trade, and to offset the negative impact of any exchange-rate appreciation. Diversifying the economy and taking advantage of non-commodity export opportunities also require a sound business environment, and it is important that Latin American countries be attractive destinations for FDI and for co-operation on innovation. Yet spending on innovation remains insufficient, and what is spent goes largely to basic research with little private-sector participation. Education, too, remains a major challenge, even for the region's best performers.

Moreover, for those parts of Latin America's economy that do compete against Chinese and Indian exports, including much of Mexico's and Costa Rica's manufacturing export industries, as well as labour-intensive sectors in other parts of Latin America and the Caribbean, proximity to the United States offers a major potential competitive advantage in goods where fast delivery or short turn-around times are crucial. These goods include clothing whose fashions change frequently and rapidly, for example, and intermediate automotive and electronic products in lean production systems that rely on just-in-time delivery of

manufactured inputs. To take competitive advantage of proximity to the United States nevertheless requires well-performing infrastructure, in transportation as well as in telecommunications. Yet current infrastructure investment levels in Latin America remain substantially below those of Asian countries, and many countries need to rethink their infrastructure-investment strategies.

Infrastructure thus constitutes a potentially critical part of Latin America's response to increased competition from Asia. Mexico needs to exploit its geographical position fully by improving infrastructure, and Latin America as a whole needs to invest more and better in infrastructure. Such investment is also likely to help reduce inequality and poverty. It requires a well-organised public sector capable of managing infrastructure projects while maintaining fiscal discipline and engaging the private sector.

## Looking Forward

Latin America benefits today from stable macroeconomic environments and pragmatic policy making. Democracy is widespread, and is gaining strength from improving fiscal policies. Pension reform is promoting financial development, if not raising savings. Foreign direct investment is strong, and the region has become an important home, as well as host, to multinational corporations. Rapid development of telecommunications, to which foreign investors are major contributors, should help raise the productivity and living standards of many people. And trade with Asia, contrary to widespread fears, constitutes more of a bonanza than a competitive threat for the region as a whole. Indeed, the preservation of macroeconomic stability in the context of such a bonanza is itself an important achievement.

The challenges Latin America faces today are no less impressive. Continuing high levels of poverty and inequality top the list. Together with policies to sustain growth, they call for less regressive and more efficient social and public expenditures that help build fiscal and democratic legitimacy. They call for pension reforms that, in addition to deepening capital markets, provide reliable sources of retirement income for much broader segments of the population. They call for regulatory systems in key public services (including telecommunications) that are carefully designed to complement market incentives while effectively lowering inequality of access between the rich and the poor. They call for governments and firms to redirect more of their windfall commodity export earnings to strategic long-term growth-enhancing activities, including more and better spending on education, innovation capabilities and infrastructure. Above all, they require efficient and responsive public sectors that benefit from fiscal legitimacy and are capable of providing strategic vision while maintaining fiscal discipline and fully engaging the private sector.