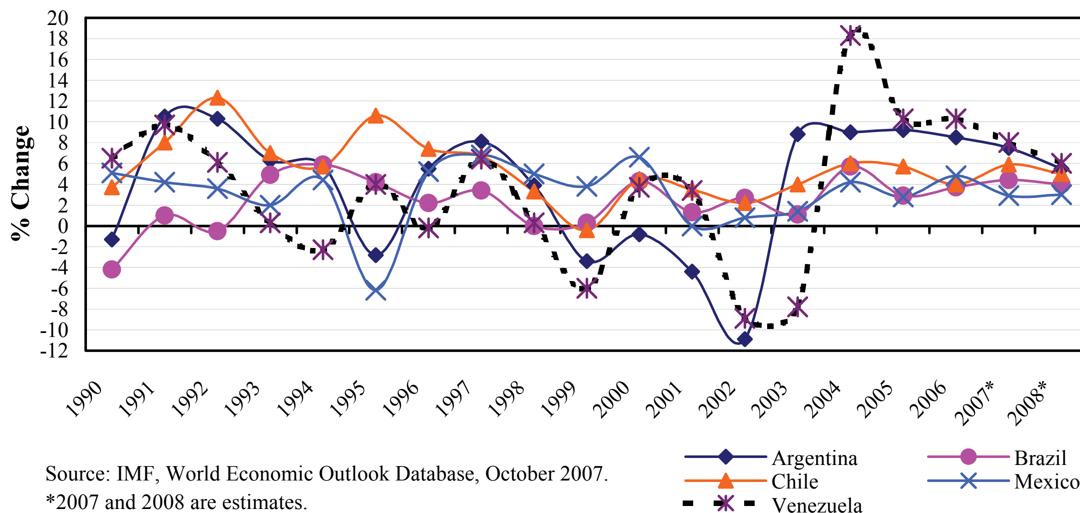
LATIN AMERICA IN TRANSITION
LESSON 3: Economics

(insert page 54 before "Regional Integration")

In 2008, Latin America is a place of bustling cities, vibrant universities, world-class industries, extensive agriculture, and vast natural resources. Brazil has the world's 9th largest economy, Mexico ranks 12th, Argentina 23rd, and Venezuela 30th.[1] The region has shown significant economic growth in recent years, averaging over 4.5 percent economic growth between 2003 and 2008 as most countries have stuck to an economic reform agenda.[2] Inflation is at historic lows. Finally, regional economic integration in the Americas, which gained steam in the 1990s, is ongoing, and Latin American countries have completed numerous trade agreements with states outside the hemisphere as well. Latin American total trade increased by 78 percent between 2000 and 2006.[3]

Still, 36.5 percent of Latin Americans, almost 200 million people, are poor, and 13.4 percent, over 70 million people, are extremely poor.[4] Latin America continues to be one of the most unequal regions in the world, with the top 10 percent of the population having over 45 percent of the wealth, and the bottom ten percent having less than 2 percent.[5] In recent years, major economic crises have buffeted each of the region's largest economies—Mexico in 1995, Brazil in 1998, Argentina in 2002, and Venezuela in 2003—and each of these crises had a spillover effect for the region as a whole (see Chart 1). Indeed, much of Latin America's recent growth has been fueled by a global economic expansion, not by significantly increased efficiency and productivity, and Latin American growth rates lag far behind those found in India, China, and elsewhere in the developing world. Despite a backlash against neoliberal reforms in several states, most of the region's countries face more painful reforms (such as revamping tax and pension systems, freeing labor markets, and strengthening governmental institutions), not less, if they are going to continue to make progress toward alleviating poverty and inequality.

Chart 1: Changes in GDP Growth for Select Countries



Source: IMF, World Economic Outlook Database, October 2007.
*2007 and 2008 are estimates.

Click here for larger version of chart.

This update addresses both the positive trends and the persistent challenges. First, we examine two important cases of economic transition from the Southern Cone: Brazil and Argentina. We then take a closer look at a key part of the reform agenda, regional economic integration.

Brazil

For most of the twentieth century, Brazil followed the corporatist, import-substitution model of development (see *Latin America in Transition*). The country significantly increased its industrialization, but it also went through long periods of dictatorship and repression. Even more, throughout the 1970s and early 1980s Brazil's military governments developed the world's highest foreign debt as they stuck with the import-substitution strategy.[6] By the late 1980s and early 1990s the country had taken steps to open its economy, but political turmoil and corruption in the transition to democracy undermined these steps and Brazil again faced economic crisis.

In 1993, Brazilian inflation was nearly 2,500 percent when President Itamar Franco appointed Fernando Henrique Cardoso, a prominent sociologist whose family had long been involved in Brazilian politics, as finance minister.[7] In 1994, Cardoso introduced yet another new economic plan, the *Plano Real*. Better conceived and implemented than earlier efforts, this plan included a massive privatization program, trade liberalization, spending reductions, and the encouragement of foreign direct investment. Economic growth in 1994 was 5.9 percent, the highest since 1986.[8] Inflation began to fall significantly. As a result, in October 1994, Cardoso was elected president, defeating labor leader Luis Inacio Lula da Silva (Lula).

The country's privatization program then picked up steam, attracting tens of billions of dollars in FDI. Still, Brazil continued to have a substantial debt and other unresolved problems. For example, an overvalued, government-controlled exchange rate for the Brazilian currency, the *real*, allowed Brazilians to buy more in imports than they were selling in exports, contributing to a growing trade deficit. Also, Brazil continued to have one of the widest gaps between the rich and the poor in the world, with many Brazilians living with intense social hardship. Because of such problems, and in light of severe economic crisis in East Asia (1997) and Russia (1998), international investors started to take their money out of Brazil. In late 1998, the International Monetary Fund (IMF) and the United States attempted to calm the situation by putting together a $41.5 billion loan package; however, international investors continued to take their money out of the country, and it fell into economic crisis. After the government took the controls off the *real* in 1999, the currency's value plummeted over 40 percent.[9]

There were significant consequences from such a sharp currency devaluation. Bankruptcies, unemployment, inequality, and poverty rose. The government was forced to cut spending, undermining an already weak social safety net. Brazil's trading partners also suffered, especially those in the Common Market of the South (MERCOSUR), a Southern Cone free trade area formed with Argentina, Uruguay, and Paraguay in 1991. Nevertheless, to the surprise of many, Brazil was able to quickly snap out of recession. Despite the unpopularity of the tough neoliberal steps taken by Cardoso, they reestablished the *real*'s competitiveness, curbed inflation, spurred exports and foreign investment, and kept the country within the spending targets imposed by the IMF. Cardoso stuck to the reform path until the end of his two terms in office in January 2003, with the country showing modest economic growth.

In anticipation of an electoral victory by leftist candidate Lula in 2002, international investors pulled significant sums of money out of the country. However, as soon as he was elected, Lula acted to reassure domestic and international investors that his administration would stick with economic liberalization and reform. In his first year in office, he cut back even further on spending and continued to pay international debts on time. Investors were pleased, but many in Lula's Workers' Party were not. They were upset because the working-class president's economic policies did not follow his campaign promises to expand social welfare programs. Lula argued that these policies were necessary and would spur the economic growth needed to fulfill his campaign promises. Indeed, the country has shown stronger economic growth since 2002, averaging 3.5 percent, and social programs and public works projects have been enacted to lessen poverty.[10] These economic changes helped Lula get reelected in 2006 despite corruption scandals surrounding high-level government officials.

Today, Brazil seems closer to fulfilling its promise of becoming a leading state on the world stage. It has the world's fourth most populous democracy, fair and competitive elections, a lively press, a growing middle class, and a working class president who has kept the country on a stable political and economic path. The country is among the world's top producers of numerous agricultural products, as well as a major industrial power. On the other hand, Brazil has hundreds of thousands of street children, massive urban slums, warlike violence between police and drug gangs, and corruption at the highest levels. The top ten percent of the population has roughly half the wealth, while almost a quarter lives on less than $2 a day.[11] People of African descent earn about 45 percent of the wages earned by their white counterparts.[12] The country remains a place of sharp contrasts.

Argentina

In 1983, Argentina returned to civilian rule with the election of Raúl Alfonsín, but the new president faced 350 percent annual inflation and imminent default on Argentina's huge foreign debt.[13] Alfonsín reached agreement on an austerity package with the IMF, but the economy continued to spin out of control. Inflation reached nearly 200 percent per month in 1989.[14] That year, Peronist Carlos Menen was elected president, inheriting a country exhausted by decades of political and economic crisis. To the surprise of many, Menem instituted a tough, Washington-backed, neoliberal reform program that finally brought economic stability.

Menem's economic reform program included fiscal austerity by the federal government, the widespread privatization of state-owned enterprises, deregulation, and trade liberalization. In 1991, the country became a founding member of MERCOSUR. Argentina also established a "convertibility law," which tied the value of the Argentine peso one-to-one to the U.S. dollar. These measures brought the country's runaway inflation down to single digits, and the economy showed its strongest period of economic growth in almost 50 years. Foreign capital poured in. However, privatization led to massive layoffs, with unemployment doubling and many in the middle class sinking into poverty.[15] The trade deficit soared because of an increasingly overvalued exchange rate, and balance of payments problems were partly covered by massive borrowing by the federal and provincial governments. Corruption remained a major problem.

Despite the economic stability and growth, by 1999, poverty, unemployment, and corruption undermined the Peronist party's popularity to the extent that Fernando de la Rua, the candidate

of the opposition alliance, was elected president. The overvalued, fixed exchange rate and growing debt unnerved foreign investors, who sensed a repeat of the 1990s economic crises seen in Mexico, East Asia, Russia, and Brazil. Indeed, the Brazilian crisis was particularly troublesome for Argentina, as almost 30 percent of Argentine exports went to its larger neighbor.[16] By the end of 2001, financial panic had forced de la Rua to resign and the country to default on most of its $141 billion debt, the largest government debt default in history. In January 2002, a new government ended the peso's peg to the U.S. dollar and the value of the Argentine peso began a plunge of almost 75 percent.[17] The country faced an economic collapse comparable to the Great Depression. Over 10 percent of GDP was lost during the year and the poverty rate rose to nearly 60 percent.[18]

In 2003, Peronist Nestor Kirchner won a presidential election and the country started the process of economic recovery. After a period of unsuccessful negotiations between Argentina and its creditors, including the IMF, new agreements were signed that significantly wrote down or restructured most of the country's debt. Government finances, at least initially, were kept under control. Economic growth averaged over 8 percent between 2003 and 2008, buoyed by high global prices for the country's agricultural and other exports, now much cheaper because of the currency devaluation. Unemployment fell from roughly 20 percent in 2002 to under 10 percent in 2007.[19] Still, key economic challenges include inflation brought on by rapid economic growth and government spending, energy shortages worsened by prices controls, and significant poverty and inequality. Roughly a fifth of the Argentine population remains poor.[20]

In October 2007, Kirchner's wife, Cristina Fernandez de Kirchner, was elected president. Both Kirchners are part of the trend to elect leftist presidents in the region. Indeed, both have had close relations to Venezuela's Hugo Chávez, who is seen as the leader of the Latin American left that leans toward the populist and nationalist policies of the past, such as price controls and heightened government spending. In contrast, leftist leaders in Chile, Brazil, and elsewhere have shied away from populism and economic nationalism, forging a path that tries to merge social welfare with neoliberal reform (see the update for Lesson 2, "Politics," for a discussion of Chile and Venezuela).

REGIONAL INTEGRATION

(insert page 57 before "Conclusion")

Efforts to establish free trade agreements (FTAs) have played an important role in Latin American attempts to develop economically. Free trade occurs when no tariffs or other restrictions are imposed on trade. The rationale behind free trade is that it increases the number of potential consumers for a country's goods. Companies will therefore be able to sell more, increase production, and reduce production costs. In theory, everyone wins as they stick to the economic activities they do best (click here for the Teacher Resource, "The Pros and Cons of Free Trade").

Acting on this belief, Latin American states have signed dozens of trade pacts since the 1950s. Key groupings inside the region include the Andean Community (CAN); the Caribbean Community and Common Market (CARICOM); the Central American Common Market (CACM); and MERCOSUR, whose original members were Argentina, Brazil, Uruguay, and Paraguay. Venezuela was accepted by the MERCOSUR governments as a full member in 2006;

however, its membership is still pending approval by the Brazilian and Paraguayan parliaments. Bolivia, Chile, Colombia, Ecuador, and Peru are associate members of MERCOSUR.

Latin Americans have also signed FTAs with the United States and/or Canada, as well as with countries outside the hemisphere. Indeed, since the signing of the North American Free Trade Agreement (NAFTA) in 1994, the U.S. has completed an FTA with Chile (2004); five Central American countries and the Dominican Republic (CAFTA-DR, 2005); and Peru (2007). Two additional FTAs with the region are before the U.S. Congress in 2008, one with Colombia and one with Panama. As discussed in *Latin America in Transition*, it is possible that all the agreements throughout the hemisphere could set the stage for a larger, region-wide agreement, as envisioned with the Free Trade Area of the Americas (FTAA). Here, we update both the FTAA and NAFTA.

Free Trade Area of the Americas (FTAA)

At the first Summit of the Americas in 1994, 34 governments throughout the Americas, including the United States, pledged to negotiate the elimination of all trade barriers between them by 2005 and create the Free Trade Area of the Americas (FTAA). However, a number of obstacles have prevented the 2005 deadline from being met, including long-standing Latin American apprehension about U.S. economic hegemony, a concern which is reinforced by the United States' reluctance to end agricultural subsidies and lower trade barriers in industrial areas of central importance to Latin countries, such as steel. Meanwhile, many Latin American states have been hesitant to grant free trade in such areas as services, and to guarantee intellectual property rights. Populist rhetoric, such as that of Venezuela's Chávez, also plays into the mix. At the 2005 Summit of the Americas, efforts to restart negotiations were blocked by Argentina, Brazil, Paraguay, Uruguay, and Venezuela (the five full MERCOSUR members). The FTAA would include 34 countries, almost 900 million consumers, and economies totaling $20 trillion, but this ambitious project remains on the backburner.[21]

NAFTA

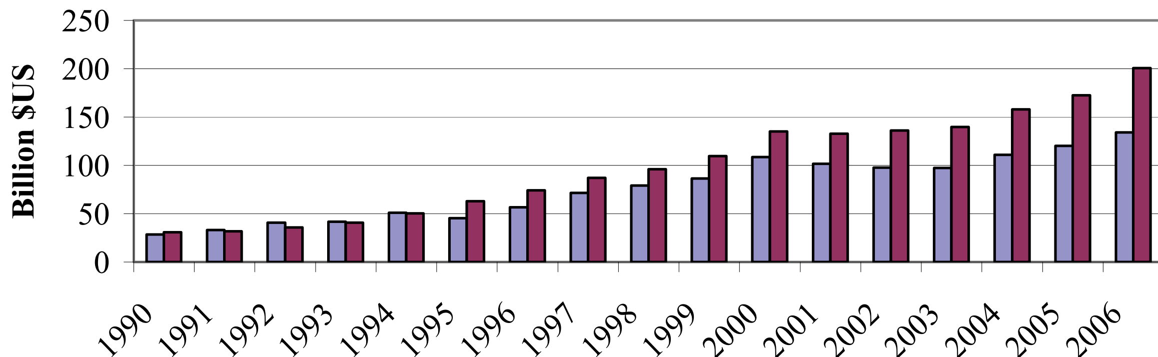
When it went into effect on January 1, 1994, NAFTA created the world's largest free trade area. Nonetheless, soon after the pact went into effect, Mexico went into economic crisis, as it continued its adjustment to more open trade and other economic reforms. Also, political instability came into play. During 1994, a top presidential candidate was assassinated and indigenous peoples revolted in the southern state of Chiapas. To help the Mexican government adjust during the crisis, the Clinton administration put together an assistance package that helped stabilize the Mexican economy. Between 1996 and 2000, Mexico averaged 5.5 percent economic growth; however, in the wake of the U.S. recession that began in 2001, Mexican growth slowed sharply. Like the United States, Mexico rebounded to modest growth, averaging 3.5 percent between 2004 and 2008. Indeed, since 1994, the fluctuations in the Mexican economy have become more closely linked with those in the United States.

The impact of NAFTA is ongoing, and the pact remains controversial. Between 1993 and 2006, trade between the three NAFTA countries more than tripled, with U.S.-Mexican trade quadrupling (see Chart 2). The United States now exports more to Mexico than to any other country except Canada.[22] Wal-Mart is now the biggest private employer in Mexico, and Home Depot became the largest home improvement chain in Mexico when it bought out its major

Mexican competitor in May 2004.[23] Still, while estimates vary widely, many agree that NAFTA has not led to a substantial overall gain in jobs for the United States. Some sectors, such as textiles and manufacturing, have seen painful job losses, but gains have been made across other sectors.

Chart 2

US-Mexico Bilaterial Trade



Source: IMF, Direction of Trade Statistics Yearbook, 1990-1996; Direction of Trade Statistics Yearbook, 2004; Direction of Trade Statistics Quarterly, December 2007.

US Exports to Mexico
US Imports from Mexico

Click here for larger version of chart.

As for Mexico, the country has seen a decade of economic stability since its 1994–95 economic crisis. Mexican exports to the United States have quadrupled since 1994, and the country has remained the largest exporter in Latin America.[24] Mexico has also seen a continued diversification in its exports, moving away from a reliance on oil and toward exports in manufactured goods. Non-oil exports have grown four-fold since the inception of NAFTA.[25] Foreign Direct Investment in Mexico has grown seven-fold.[26] Mexico has its own multinational corporations that are successfully expanding their operations, such as the telecommunications giant TELMEX and the cement giant CEMEX. More open competition has also led to a significant reduction in prices for Mexican consumers of many basic household goods.

Still, there continues to be criticism of NAFTA in Mexico. Mexico's modest, some would say disappointing, economic growth since 1994 (roughly 3 percent annually) means significant numbers remain in poverty (roughly one-third of the population, compared to 45 percent in 1994).[27] Increased competition has exposed Mexico's ongoing struggles with weak state institutions, poor educational systems, economic reform, corruption, and inequality. Rural subsistence farmers have been especially hard hit as they are forced to compete with giant, subsidized U.S. agricultural businesses. And continued poverty, inequality, and hardship in Mexico have led to a steady stream of Mexican immigrants, about 500,000 annually since the inception of NAFTA. This figure is a significant increase from the annual totals before NAFTA (less than 400,000), and not the hoped-for decrease.[28] Even more, despite NAFTA, Mexico faces serious competition from other developing countries. For example, China has significantly cheaper labor costs than Mexico, and can therefore produce products less expensively, even with free trade between the U.S. and Mexico. In 2003, China replaced Mexico as the second largest

exporter to the United States.[29] Because of its advantages in cheap labor, China also competes with Mexico for U.S. investment.

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[1] Central Intelligence Agency, *The World Factbook 2008*, https://www.cia.gov/library/publications/the-world-factbook/index.html (accessed January 31, 2008). Please note this ranking uses purchasing power parity (PPP) figures.

[2] International Monetary Fund (IMF), World Economic Outlook Database, http://www.imf.org/external/pubs/ft/weo/2007/02/weodata/index.aspx (gross domestic product; accessed January 18, 2008). Figures for 2008 are estimates.

[3] IMF, *Direction of Trade Statistics* (Washington DC: International Monetary Fund, 2007), Yearbook 2007, p.4.

[4] Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Version: Social Panorama of Latin America,* (New York: United Nations, 2007), p. 5, http://www.eclac.org/publicaciones/xml/9/30309/PSI2007_Sintesis_Lanzamiento.pdf (Accessed January 18, 2008). ECLAC defines extreme poverty, or indigence, as the percentage of the population with income amounting to less than the cost of a basic food basket. Poverty is defined as the percentage of the population with income amounting to less than twice the cost of a basic food basket, and includes the extremely poor population. Definitions appear in ECLAC, *Statistical Yearbook for Latin America and the Caribbean 2006,* Table 1.6.1 "Poor and Indigent Popualtion, Urban and Rural Areas," (New York: United Nations, 2006), http://www.eclac.org/publicaciones/xml/4/28074/LCG2332B_1.pdf (Accessed January 18, 2008).

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[8] World Economic Outlook Database, gross domestic product; op cit.

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[11] World Development Indicators Online Database, (Income share held by highest 10%; Poverty headcount ratio at $2 a day), op cit.

[12] World Bank Group, "Inequality in Latin America & the Caribbean: Breaking with History?," 2003, http://lnweb18.worldbank.org/LAC/LAC.nsf/ECADocByUnid/4112F1114F594B4B85256DB3005DB262?Opendocument (accessed October 4, 2007).

[13] Instituto Nacional de Estadística y Censos (INDEC), "Serie histórica del Indice de Precios al Consumidor (IPC) en el Gran Buenos Aires," http://www.indec.mecon.gov.ar/nuevaweb/cuadros/10/ipc-var-dde1943.xls (accessed February 29, 2008).

[14] Manuel Pastor, Jr. and Carol Wise, "Stabilization and its Discontents: Argentina's Economic Restructuring in the 1990s," *World Development* Vol 27.3: 1999, p. 478-479.

[15] World Bank, World Development Indicators Online Database, https://publications.worldbank.org/subscriptions/WDI/ (unemployment; accessed February 29, 2008).

[16] IMF, *Direction of Trade Statistics*, Yearbook 2003, p. 55, op cit.

[17] IMF, "Exchange Rate Archives by Month," http://www.imf.org/external/np/fin/rates/param_rms_mth.cfm (December 2001-August 2002; accessed February 6, 2008).

[18] IMF, World Economic Outlook Database, op cit; and World Bank, "Argentina- Crisis and Poverty 2003; A Poverty Assessment," http://go.worldbank.org/6I0HZ0DK50 (accessed February 8, 2008).

[19] ECLAC, CEPALSTAT database, http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp (urban unemployment rate; accessed February 25, 2008).

[20] ECLAC, *Preliminary Version: Social Panorama of Latin America*, p.11, op cit.

[21] Alca-ftaa.org, "Countries," Official Website of the Free Trade Area of the Americas (FTAA), http://www.ftaa-alca.org/busfac/clist_e.asp (accessed April 22, 2008); and IMF, World Economic Outlook Database, (population; gross domestic product, current prices), op cit.
[22] International Monetary Fund, *Direction of Trade Statistics* (Washington DC: International Monetary Fund, 2008), Quarterly, March 2008, 376-378.
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[24] International Monetary Fund, *Direction of Trade Statistics*, Yearbook 2007, op. cit.
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