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Demand for commodities ensured robust 2007 for Latin America

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Voracious global demand for commodities ensured another strong year for Latin America's economies in 2007.

Growth rates remained strong and governments continued to pile up foreign reserves thanks to exports of oil, iron ore, copper and soy, among other primary goods.

But the slowdown in the US economy and its possible knock-on effects has reinforced fears among analysts that the region's governments have done little during the boom to ensure long-term growth and remain overly dependent on the commodity cycle.

The prosperity in Latin America has coincided with the growing presence of China and India in the global economy which has boosted demand for goods creating what many are now calling a new commodity supercycle.

Latin American countries have been among the major beneficiaries and growth in the region has been revitalised during the past five years, averaging 4.4 per cent since 2003, compared to 2.6 per cent in the previous 10 years. This has coincided with the boom in commodity prices whose trend growth rate passed from 5 per cent year on year in 2002 to 10.2 per cent in 2006.

Where the region piled up debt in the 1990s now it piles up foreign currency reserves, and stronger currencies have allowed many governments to slay the old regional bogeyman, runaway inflation.

But fears exist that the boom has sapped the will of governments to tackle pressing structural reforms in areas such as labour legislation, taxation and energy reform that would allow the region boost its long-term growth rates which lag emerging economies in Asia.

"The good times have allowed governments to put problems in these areas aside," says Emy Shayo, a Latin America economist with Bear Stearns in São Paulo.

"For Latin countries to continue to grow and increase trend growth, they will need to do more in the area of structural reforms. As macro fundamentals stabilise, it is becoming more important to introduce important institutional changes in Latin America so that countries can grow beyond the commodity boom."

The World Bank rates the region poorly when it comes to ease of doing business. Many countries still have rigid labour laws that make hiring workers prohibitively expensive, pushing many into the informal economy.

Tax legislation is often convoluted and bureaucratic red tape eats into the region's competitive advantage. At every level the region's education systems lag far behind those of competitors in Asia.

The commodity-led boom has weakened the political will to tackle these issues. In Venezuela and Argentina cash from exports of oil and soy respectively, have funded new populist experiments.

In Venezuela this has been in the form of trying to create a state-run socialist economy. In Argentina the government has used taxes from agricultural exports to fund a protected domestic industrial sector. Both countries are now beginning to suffer from inflation and shortages of basic goods as a result.

In Brazil a fragmented political system that favours entrenched interests means that a popular president, whose allies control both houses in congress, has talked about undertaking structural reform since taking power five years ago.

However, he has found it impossible to make any progress on passing the necessary legislation.

But a slowdown in the US could push reform back up the agendas of the region's governments. In a recent research note Morgan Stanley warned: "The downturn should serve to remind the region that most of the improvement in growth in recent years has come from favourable external conditions [the hand the region has been dealt], while little has been done to insure long-term growth [the way the hand is played]."

The US slowdown in 2001 led to a dramatic reduction in Chinese demand for imports, a warning for Latin America given that China is the price-setter in commodities markets.

In a region notorious for booms and busts, defaults and hyperinflation, the concern now is not that it will suffer a new crash but rather fail to reach its potential because of the drag imposed by its weak institutions.

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