

ECONOMICS: LATIN AMERICA PERSPECTIVES—JULY 9, 2010

Latin America Moves Toward Sustained Growth

■ **Lars Pedersen**

Senior Economist—Latin America Research, (212) 823 3420

Rising income and healthy growth cycles in countries such as Brazil and Mexico are supporting a new economic balance in which emerging-market demand supports the global recovery.

Sustained income growth has appeared in several Latin American countries as low-income workers have been pulled into the global economy, leading to higher and more stable pay. This higher income, when leveraged with borrowing, fuels demand for homes and cars, which in turn can trigger a domestic capital-spending cycle. As the process has played out, we've seen healthy economic growth developing in both Brazil and Mexico, although the two countries are at very different points: Brazil is early in the cycle and Mexico is late. Several smaller Latin American countries fall somewhere between the two.

As productivity improves in these countries through direct investment and trade, more individuals take the step up from marginal jobs to "formal" jobs, resulting in reliable paychecks, taxes and social charges contributed to the official economy, as well as the chance to leverage new income with credit to buy durable goods. In concert, these developments can spur a powerful consumer boom. In Brazil, for example, consumer spending was up 20% in March from a year earlier.

Major Job Gains for Brazil

Brazil's formal job gains hardly slowed during the recession, and they've surged since. In 2008, Brazil used many tools to protect itself from the global downturn: aggressive rate cuts, lower bank reserve requirements, provision of foreign exchange cover, aggressive public-sector lending at subsidized rates, and a measured increase in the public-sector deficit. With the recession over, formal job growth has surged—Brazil has created 2.1 million jobs year-to-date through May.

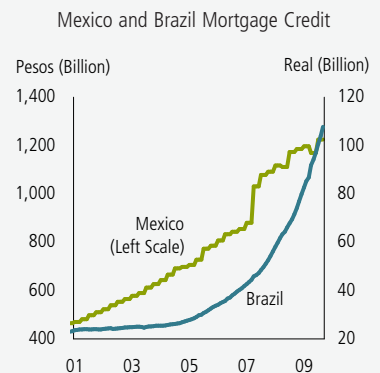
Mexico's experience has been more challenging, in part due to its close ties to the US economy through the auto sector and immigrant construction workers. A sudden shock to both of these areas in the US undermined formal jobs in Mexico and, to a lesser extent, remittances from immigrant workers. The recession also coincided with declining Mexican oil production in a weak oil market, prompting fiscal tightening that hardly softened the downturn. Formal jobs dipped sharply and are only now starting to come back, along with the restarting of the North American automobile industry (**Display 1**).

Display 1
Formal Jobs Mean Income...



Source: Banco Central do Brasil, Banco de México, Haver Analytics, Instituto Brasileiro de Geografia e Estatística and Secretaría del Trabajo y Previsión Social

Display 2
...That Can Be Leveraged



Source: Banco Central do Brasil, Banco de México, Haver Analytics, Instituto Brasileiro de Geografia e Estatística and Secretaría del Trabajo y Previsión Social

Expanding Credit Allows Leveraging of Income

As jobs have picked up, bank credit in Brazil has expanded sharply, leveraging income gains into greater consumption. Lending has been fueled by a variety of state-directed and mandated credit programs financed by public-employee pension funds and small-scale savings deposits. Mortgage lending has been expanding at an explosive pace, up 51% in 2010 through May, and it has room to grow, because total mortgage lending remains minimal, at less than 2% of GDP—a residual of Brazil's high-inflation history, which discouraged lending activity.

Mexico's efforts so far have been tame in comparison with Brazil's (**Display 2, previous page**). This is partly due to a more highly leveraged home mortgage market, which has been through an expansion cycle that ended in 2006—although overall lending remains low relative to GDP. The later start in mortgage lending might also be a result of caution among the Spanish bank subsidiaries prominent in this market.

Brazil's Strong Recovery Feeds Inflation

Driven by strong income gains leveraged by available credit, Brazil's economy has already staged an impressive recovery. Not even slower economic growth or a recent recovery by the real will prevent a gradual climb in inflation through 2011 (**Display 3**). Only a major development would alter this trend: a renewed world recession, a sharp cutback in subsidized credit or a sizable rate hike to slow growth. A reversal of recent food price increases has kept monthly inflation low, but that may not last.

Meanwhile, Mexico's growth is slower than Brazil's, creating less risk that inflation will exceed the upper range set by policymakers. There are several reasons for a more benign inflation picture. The extreme depth of the recession gave the subsequent recovery more room to run

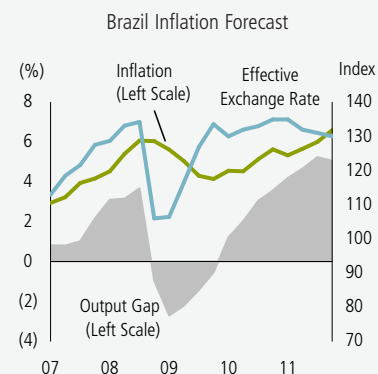
before it encounters potential capacity limits. And the peso had tumbled further than the real: the Mexican central bank had kept reserves low, forcing it to allow a deeper depreciation in 2008–2009. This created more upside for the peso, which can help reduce inflation pressures, than for the real.

Finally, the sales tax and price increases that Mexico imposed in early 2010 to help balance its budget caused a bulge in inflation early in the year compared to what it would have been without the measures, shown by the dotted line in **Display 4**. Even if underlying inflation gradually rises again after declining early next year, it would bring inflation up only slightly for 2011, resulting in lower headline inflation than in 2010.

Rising income and the use of credit against that income by a growing portion of the Latin American workforce can play a key role in sustaining demand in the region—a vital part of a new economic balance in which emerging-market demand supports the global recovery. In an increasingly integrated world, global firms seek out low-wage countries, bringing with them more efficient processes that boost productivity and the value of labor. This benefits workers through higher wages that can lift standards of living—often at a surprising pace. As long as formal wage gains are supported this way, they could continue for quite some time, fueling a sustained and healthy credit cycle.

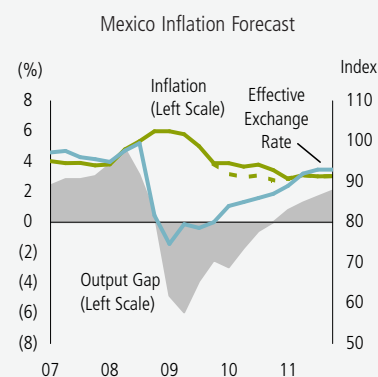
*Economic forecasts for Brazil and Mexico can be found in **Display 5**.* ■

Display 3
Stressing Capacity in Brazil



Source: Banco Central do Brasil, Bank for International Settlements, Haver Analytics and Instituto Brasileiro de Geografia e Estatística

Display 4
Much Less So in Mexico



Source: Banco de México, Bank for International Settlements, Haver Analytics and Secretaría del Trabajo y Previsión Social

Display 5
Forecasts (in %)

	2009	2010F	2011F
Brazil			
Real GDP	-0.2	8.0	5.0
Inflation (Avg.)	4.9	5.5	5.8
Policy Rate (End Period)	8.75	12.00	12.50
Mexico			
Real GDP	-6.5	4.3	3.0
Inflation (Avg.)	5.3	4.0	3.5
Policy Rate (End Period)	4.50	4.50	4.50

Source: AllianceBernstein

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