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Competitive Challenge

The money that has been pouring into Latin America recently reflects the attractive returns that can be found in the region, not progress on reforms. By Jerry Haar*

Last year was a good one for both Latin America and the region’s financial markets, and 2006 could well see a continuation of these favorable trends. Currencies in Brazil, Chile and Mexico gained against the dollar on speculation that local yields will maintain their attractiveness in anticipation of the U.S. Federal Reserve’s halt in interest rate increases. Investors will be motivated to seek higher returns on riskier Latin American bonds and currencies.

A diversity of deals are continuing apace, from Colombia’s $1.13 billion buyback of dollar- and euro-denominated bonds, led by Goldman Sachs and Merrill Lynch, and Cerda’s $600 million perpetually global offering led by HSBC and Citigroup, to Mexican household goods manufacturer Controladora Mabe’s sale of $200 million in privately placed notes with a 10-year maturity. And while M&A activity in the region declined last year in dollar value, many acquisitions — such as the Brazil-based Synergy group’s purchase of Colombian airline Avianca or Argentine conglomerate Techint’s $2.25 billion purchase of Mexican steelmaker Hysames — were made by local Latin American companies. These astute buyers knew a value proposition when they saw one. Moreover, with four consecutive years of growth above 4%, Latin America’s outlook seems bright, correct?

Wrong. First, while the investment banking community may have enjoyed a stellar year, their accomplishments are products of the region’s financial performance, not its competitiveness. Unless Latin America gets its act together in this far more important arena, it will become increasingly irrelevant in the global economy. The region’s “remarkable” growth trajectory is unimpressive when one considers the awful decline at the beginning of the decade. And the drivers — US and Chinese demand, low world interest rates, and high commodity prices — are transitory.

Latin America’s global economic competitiveness ranks low and it’s clearly eroding according to the latest rankings of both the World Economic Yearbook and the World Economic Forum’s Global Competitiveness Report. The highest-ranking Latin American nation, Chile, comes in at 23rd in the latter report, with the next two places occupied by Mexico at 55th and Brazil at 65th. Asian countries claim six of the top 20 positions.

Regrettably, Latin America has not yet built a sustainable culture of competitiveness. The region’s historical development, the institutions it has created and the leaders it has produced, for the most part, have impeded the establishment of healthy, thriving societies where self-reliance, good governance, social justice, democratic capitalism, and effective and transparent institutions prevail. And institutions do matter greatly. Douglass C. North, the economics Nobel laureate, drives home this point in his compelling book Institutional Change and Economic Performance.

Recognizably, Latin America has made significant progress during the last two decades in a number of areas that relate to economic competitiveness. These areas include prudent fiscal and monetary policies, privatizations, economic liberalization and primary school enrollment. However, as Eduardo Fernández-Arias and Peter Montiel found in their study Reform and Growth in Latin America: All Pain, No Gain, there has been insufficient depth and breadth of macroeconomic reform and a lack of structural and institutional second generation reforms. Much remains to be done in the areas of tax reform, property rights and deregulation, as well as rural education, social safety nets, infrastructure and public services.

If Latin America is to develop and sustain a culture of competitiveness — a necessity not a choice — in today’s global economy, it needs to undertake a number of sweeping measures, foremost among them are:

Expedite and intensify economic liberalization. Ensure continued, deeper efforts to achieve macroeconomic reforms, including in areas where there has been slippage in recent years, such as public sector financial management and energy privatization. And instead of waiting for the creation of a Free Trade Area of the Americas or for the World Trade Organization Doha Round talks to conclude (sometime before the next appearance of Halley’s Comet), nations in the hemisphere should immediately implement the FTAA business facilitation measures that countries already agreed to in 1999 — customs-related reforms that companies insist are of greatest and most immediate benefit to them.

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Speedily adopt and implement “second generation reforms.” Prudent fiscal and monetary policies are necessary, but conditions are insufficient to achieve prosperity for all. Non-economic measures to improve education, health care, housing, social services and infrastructure are essential. Failure to do so will only hasten the election of more anti-market populist politicians.

Institute comprehensive microeconomic reforms. Microeconomic issues are the ones that are felt most directly by business, workers and consumers. Foremost among the microeconomic issues in dire need of reform are: regulations, taxation, administration of justice, labor, research and development and financial services. In the World Bank’s Doing Business in 2006 benchmark for business regulation in 145 countries, Latin America’s poor performance is nearly as miserable as that of Africa. In Brazil it takes 152 different steps and five months to start a business versus less than one month in Russia. Regulatory burdens are most harmful to small businesses and start-ups – the largest private employers in Latin America. Steep value-added taxes elevate retail costs and depress sales, harming both the poor and the productive sector. Argentina even taxes its own exports, further restraining domestic growth. Inadequate property rights keep poor citizens from titling real estate, denying them the right to sell it or use it as collateral for credit.

Most tax systems in the region are characterized by high rates and low collection. And corporate tax rates (averaging 35%) are higher than those in Asia. It is no wonder tax evasion and capital flight are rampant. And what do taxpayers get for their pesos? Ricardo López Murphy, the Argentine economist and former economy minister, summed it up when he complained that Argentines pay Swedish level taxes in exchange for public services of African quality.

With a backlog in cases, the best judges money can buy, incessant rule-bending and unreliable dispute settlement mechanisms, both local and foreign investors lack faith in the court system. In the area of public safety, criminal gang activity has been increasing in recent years. A recent UN study on urban violence reveals that multinational corporations plan to invest more in Poland and the Czech Republic over the next five years than in Mexico — the main reason being “lack of security” in Mexico.

Latin American labor rules raise costs, create barriers to entry and introduce rigidities in the employment structure. These include the exceedingly restrictive regulations on hiring and firing practices, as well as burdensome social insurance schemes. While salaries may be low by industrialized nation standards, non-salary costs such as benefits, labor production taxes and severance can actually double the cost of labor. Hiring a worker, like getting married, is relatively easy. Firing a worker, like getting a divorce, is very lengthy and extremely costly.

Research and development (R&D) infrastructure in Latin America is terrible. Without state-of-the-art technologies, innovation systems and products, the region will continue to lose attractiveness. Multinational R&D investments have doubled during the past decade, but most of it has gone to Asia and Central Europe. Asia claims 27% of new R&D investment but Latin America gets just 1%, and the vast majority of this is government-funded. Whereas South Korea spends 2.5% of GDP on R&D and turns out engineers and scientists, Latin America spends 0.5% and graduates lawyers and psychologists.

Despite some progress, Latin America’s banking industry is grossly inadequate, conservative, complicated and cumbersome. For the most part, bank activity is dominated by trading government paper. The financing that is provided is often in syndicate, for large preferred corporate borrowers. Were it not for the proliferation of credit cards and retailers providing credit to customers, such as Elektra’s Banco Azteca in Mexico, the working class would have even less access to consumer goods.

Latin America is becoming increasingly uncompetitive in an increasingly competitive world. In Cuentos Chinos, a new book by Miami Herald columnist Andrés Oppenheimer, Argentine education minister Daniel Filmus laments: “For the past 30 years, Argentina has not had a culture of excellence, nor a culture of effort, nor a culture of hard work. Our culture has rather been one of cutting corners and trying to pass the grade, rather than seeking excellence through effort, hard work and research.”

In historical context, the region’s descent is even more revealing. Between 1880 to 1930, Argentina was one of the world’s 10 wealthiest nations. In 1950, South Korea and Honduras had the same GDP. And before 1959, Cuba’s economic and social indicators ranked among the highest in the world. While the widespread adoption of neoliberal reforms begun in the 1980s has been laudable and highly significant, it has not been enough to create global competitiveness. Meanwhile, China, India, other Asian nations and Central European countries have extended, deepened and quickened their economic reforms during the past decade. Across a number of sectors, they are eating Latin America’s lunch and are poised to consume the region’s breakfast and dinner, too.

Culture is not destiny, however. If Latin American nations can act decisively and begin to institute reforms necessary to boost competitiveness, the region’s global fortunes could experience a turnaround. Finance is an important part of the region’s economic universe, and opportunities abound for individual and institutional investors, traders, brokers and dealmakers. There are vast sums to be made in debt and equity, private or sovereign. But none of this is relevant to the issue of competitiveness. The fortunes of individuals are distinct from those of nations. While the long term health of each is inextricably connected, the challenges are more urgent for countries than for those who work in the financial markets and who may find — and in fact, are finding — other regions of the world more enticing. LF

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