A Clear Direction

Confidence in the economy's future is the key to Latin America's success

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ACADEMIC economists debate whether confidence is an independent force driving economic outcomes or it reflects fundamental information about the current and future state of the economy. But practitioners know that whatever its nature, confidence problems are real, and when times are hard, confidence in policies and policymakers is tested.

And hard times are here. After five years of declining growth, Latin America faces its slowest economic growth in a decade and a half. Business and consumer confidence is close to where it was in the aftermath of the U.S. investment firm Lehman Brothers bankruptcy as the prospect of protracted lower growth haunts many countries in the region. Indeed, confidence indices remain about 30 percent below their 2010 peaks.

There are a number of causes: lack of policy direction now that the commodity boom is over, uncertainty about potential new sources of growth, and political crises associated with unsustainable gains for a growing middle class, along with episodes of corruption. And recent presidential approval ratings mirror the decline in confidence.

A renewed push

To restore confidence, support sustainable long-term growth, and ensure shared prosperity, governments in the region must clarify the direction of their economic policies and deepen Latin America's democracies and market institutions. Stronger policy frameworks and structural reforms are necessary to support the recovery, but political leaders may have to take additional steps to strengthen governance, transparency, and the rule of law.

Trends in the global economy will continue to weigh heavily on growth and confidence in the region, despite an environment much improved over 2008–09. Most notably, the likely continued slowdown in China suggests that commodity prices will remain low for the next three to five years and that South American countries may need to find new sources of robust growth. In addition, the expected liftoff in the U.S. federal funds rate means a return to normal after a prolonged period of easy liquidity in global financial markets. While most observers expect a smooth process, financial markets could get turbulent. In some countries, the effects of these global conditions will be compounded by domestic worries, such as heightened concern about corruption or uncertainty generated by structural reforms that should ultimately boost growth but only after some initial disruption.

Restored confidence is essential to reversing declining growth. So it is imperative to maintain—and in some cases reestablish—fiscal and monetary anchors. On the fiscal front, countries may have to signal clearly that fiscal policy will get back on track following the countercyclical shift after the 2008 Lehman Brothers collapse.

Before 2008, high growth and rising commodity prices allowed governments to spend significantly more while reducing their debt-to-GDP ratios. In 2009, Latin American countries implemented bold fiscal responses to smooth the effects of the global financial crisis. Their countercyclical response successfully reduced the impact of the external shock, but IMF research shows that most of the fiscal expansion came through an increase in wages and expanded social programs, which will be hard to reverse. Moreover, the crisis also required some bending and relaxation of fiscal rules and increases in debt to GDP. The big challenge for the next couple of years will be to get debt-to-GDP ratios back on a downward path, adjust fiscal frameworks to guarantee reasonably quick reversal of countercyclical fiscal expansion, and significantly improve the efficiency of public spending.

On the monetary policy side, the main objective will be to stick as close as possible to what is warranted by the business cycle and inflation pressure, given differences in monetary policy normalization in the major advanced economies. A return to normal monetary conditions in the United States, the possibility of capital outflows, fluctuations in commodity prices, and the associated exchange rate changes—coupled with uncertainty about potential output and gaps—pose challenges for inflation targeting and monetary policy frameworks. In countries with solid inflation-targeting regimes, these challenges are manageable, and exchange rate movements will play a useful role in the adjustment. Countries in the region that lack access to international capital markets and/or have rigid exchange rate systems will face more difficult policy choices. And finally, some countries still have high inflation, which is likely to rise as a result of the external environment—perhaps triggering regime changes.

The reversal of previously benign external conditions warrants close monitoring of vulnerability in the private corporate sector to preserve financial stability. After a long period of high growth, low interest rates, lax financial conditions, strong terms of trade, and strong currencies, businesses in the region increased their leverage ratios. With the reversal of this unprecedented combination of positive conditions, some firms will find themselves with too much debt, which is likely to undermine their financial condition and cause potentially disruptive deleveraging.

Laying the groundwork

But the most important challenge facing the region is to lay the groundwork for the resumption of high and sustainable growth. During the boom years, attractive commodity prices and low interest rates allowed many of these countries to increase investment and maintain a healthy external balance. Now we are back to the historical trap of low saving, low investment, and low productivity growth that hurt the region for so long. To stimulate saving and investment and unleash productivity, structural reforms are critical. This is a continuous and decidedly country-specific process. Some countries may want to focus on reforms that reduce private sector investment bottlenecks, in particular by investing judiciously in infrastructure and facilitating the reallocation of labor and diversification of production. For countries in the region that have slipped in the World Economic Forum competitiveness rankings since 2012, strengthening institutions that foster competitiveness must also be a priority. Last but not least, enhancing labor force skills through education and training is critical to medium-term growth.

Such reforms usually take time to bear fruit, but one of the advantages of investment in infrastructure is the accompanying stimulation of short-term aggregate demand and output. As in other emerging markets, Latin America's widening infrastructure gap requires an estimated additional investment of 3 to 4 percent of GDP a year over the medium term. With few incentives for private sector investment in infrastructure projects, the public sector often has to step in, through public-private partnerships or undertaking investment on its own. Some of the largest countries in the region have already begun or announced important infrastructure programs to address these gaps. And the IMF is expanding its work in this area by helping policymakers evaluate the macroeconomic and financial implications of alternative approaches to infrastructure spending and assess and improve institutional capacity to manage public investment.

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But there's more to restoring confidence than strengthening policies and institutions. Political leaders must take charge, explaining priorities clearly and seeking support for hard choices through social dialogue. Studies of structural reforms show that design and social consensus are critical to the success and durability of reforms.

Consider Australia: after a period of subpar growth, it embarked on structural reforms beginning in the mid-1980s, which continued through several phases. In addition to restoring macroeconomic stability, the country undertook a series of fiscal, labor, and product market reforms that substantially improved macroeconomic performance. But a key ingredient of the success was the proactive building of political consensus across government and civil society. An environment that welcomed careful and open discussion of policy options—through think tanks, trade unions, universities, and other institutions—spawned a critical degree of support and social cohesion. Some countries in Latin America have begun to build such an environment, where expert commissions deliberate about the best reforms and propose and discuss them openly. This is an area of the policymaking process that needs and deserves more attention. Forcefully tackling corruption, as some countries in the region have started to do, can also do much to restore confidence and build the institutions needed for sustainable and inclusive growth.

Many countries in the region remain committed to their strong policy frameworks. But given the rapid change in economic performance and the surprising weakness in business and consumer confidence, it cannot hurt to reaffirm this commitment on an ongoing basis, especially with regard to macroeconomic policies. A clearly articulated agenda for structural reforms would also support confidence—in a climate of stronger governance and rule of law—while political leaders clarify policy priorities and foster support for hard choices through social dialogue. ■