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### **Global Crisis' Impact on Potential Growth in Latin America**

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# Global Crisis' Impact on Potential Growth in Latin America

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## ABSTRACT

Latin America's capacity to grow increased in the last decade mainly as a result of the economy's openness and deregulation, which attracted more productive investments. The recent commodity boom allowed the region increase savings and consequently the accumulation of capital, one of the fundamental sources of permanent growth. However, the global crisis of 2008-2009 produced a massive destruction of capital around the world, which also affected the region and its production capacity. This explains the loss of one percentage point in the region's potential growth rate in the past few years. To reinforce its production capacity, Latin America necessarily requires deepening structural reforms.

## I. FUNDAMENTAL SOURCES OF GROWTH

Potential output is defined as the maximum production attained at the full employment of resources available. This implies that the steady state is reached at the point where the growth rate is constant and the economy performs free of imbalances<sup>1</sup>. Therefore, any deviation of growth from the steady state or potential is mainly caused by either domestic or external shocks. An increase in domestic demand that creates an excess puts the economy in a situation of overuse of resources, consequently leading to the development of major imbalances. Meanwhile, the sub-utilization of resources puts the economy below its potential performance. The difference in growth with respect to potential is called the output gap<sup>2</sup>.

JEL classification: E22, E23, F43, F44, F62, N16, O11, O47.

*Keywords:* Economic growth, potential growth, global crisis, capital stock, saving, investment, productivity, technological change, structural changes, Latin America.

<sup>1</sup> See Jones (1998).

<sup>2</sup> More details in Byrns and Stone (1995), and Dornbusch and Fisher (1990).

Broadly speaking the economy's capacity to grow is determined by the production infrastructure installed and the labor force available. In macroeconomic terms, production is determined by the availability of capital, labor and technology. In a reduced form, the potential capacity to grow depends on saving-investment, productivity and technological change<sup>3</sup>. Since growth above potential cannot be prolonged because it leads to imbalances, the only way to generate higher sustainable growth is by reinforcing the fundamental sources of growth, which increases production capacity. From here it is obvious that permanent growth cannot be generated by expansionary economic policies. In fact, policymakers generally use economic policy to reduce the volatility of growth around potential. In other words, expansionary policies should be used to compensate the economy when output is below potential and contractionary policies when output is above potential.

Since population does not change significantly over time and productivity highly depends on investment in technology and education, then the accumulation of capital turns to be the most important factor in determining the production capacity of an economy and consequently the potential output.<sup>4</sup> Thus, giving the labor force available, the acceleration of investment will allow not only increase infrastructure but also access to better technology and improve education, which at the end will expand the economy's potential. This clearly explains why countries with a high ratio of investment (China, India, and Chile) have been able to sustain high growth rates over time. To increase investment, a country needs to promote savings in both public and private sectors and also to attract inflows from abroad, which can be done by the combination of structural reforms and economic discipline.

## II. POTENTIAL CAPACITY IN THE REGION

Latin America's potential growth rate reached a maximum of 4.4% during the last decade, which coincided with its increasing economic openness and deregulation and also with the commodity boom<sup>5</sup>. In fact, during the last favorable commodity episode, Latin American governments were able to increase both savings and investments and consequently opened the access to better technology. Certainly, the commodity boom was a blessing for the region, with governments making extra efforts to keep fiscal discipline and saving for the future. This also explains why investment reached its peak during those years. Our estimates of the region's potential growth (using the Hodrick-Prescott filter)<sup>6</sup> indicate that Latin America gained significant production capacity in the past decade, reaching an average potential growth rate of 3.7% in the 2003-2011 period, compared with only 2.5% in 1994-2002. Thus, the commodity boom that started in 2003, and was interrupted in 2009, represented an important event in explaining the expansion of Latin America's potential capacity.

However, the same way that booms promote investment, crises destroy it. With the global recession of 2008-2009 and the crash in stock markets, savings were erased for firms and consumers and many companies disappeared. The crisis obviously generated not only a destruction of physical capital but also reduced the capacity for future investments<sup>7</sup>. Latin America did not escape this capital destruction, with investment losing a couple of percentage points of GDP in 2009. With the prolonged

<sup>3</sup> See Jones (1998), and Klein, Solís and Coutino (2000).

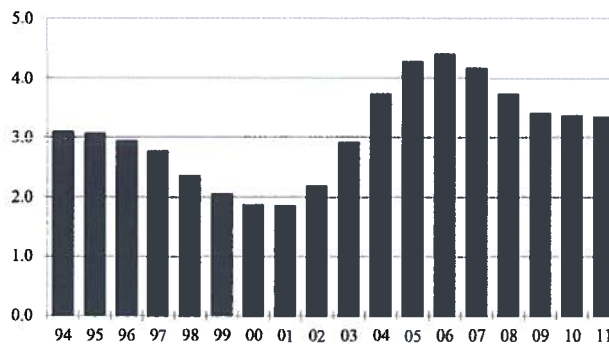
<sup>4</sup> See Romer (1996).

<sup>5</sup> See Coutino (2012).

<sup>6</sup> On the HP Filter see Hodrick and Prescott (1980).

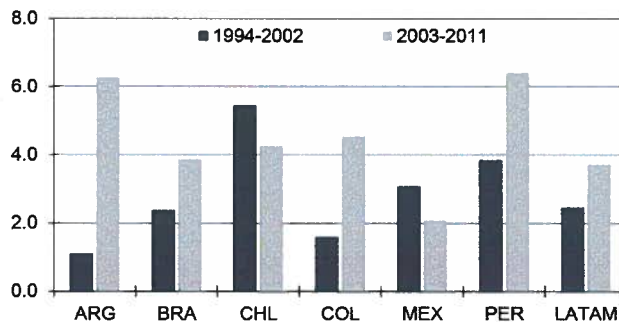
financial volatility in the past 3 years and the deterioration of external conditions, the possibilities for new investments remained limited. As a result, the region's potential growth declined from the peak of 4.4% in 2006 to 3.4% in 2009, and remained around that rate in 2010 and 2011.

**Chart 1: Latam Potential Growth Rate  
Potential GDP, annual % change**



Source: Author using the Hodrick-Prescott Filter.

**Chart 2: Average Potential Growth by Country  
Potential GDP, annual % change**



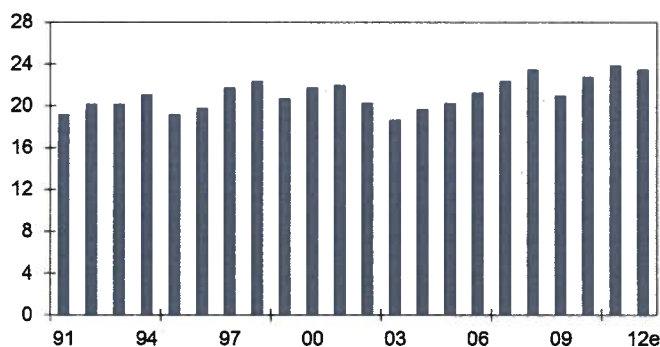
Source: Author using the Hodrick-Prescott Filter.

The potential output was reduced in all Latin American countries during the 2009 recession, precisely because of the financial losses that affected the accumulation of capital. However, during the commodity boom (2003-2008) most countries experienced an increase in their production capacity, with only two exceptions: Chile and Mexico. In the first case, Chile seemed to enjoy the commodity boom mainly through saving rather than investing, and maintained total investment at a constant ratio around 25% of GDP. This also explains why Chile was the country in Latin America with the biggest sovereign fund and with the highest countercyclical fiscal power. In the second case, Mexico lost potential capacity not only because of the absence of structural changes but also for its poor saving-investment efforts from oil exports, which limited the accumulation of capital and consequently restrained its production capacity<sup>8</sup>.

### III. RECOVERING THE CAPACITY

Fortunately, and after suffering some loss of production capacity as a result of the 2009 global recession, Latin America has recovered its pre-crisis potential to grow. The region lost investments totaling about 2.5 percentage points of GDP, with the investment-output ratio falling to 21% in 2009. Thanks to few reforms, discipline, and still-favorable commodity revenues, governments have been generating some countercyclical power through public savings and restoring the capacity lost during the recession. By 2011, the region had recovered the level of investment-output that existed in 2008. In 2012, the investment ratio remained around 23.5%, similar to the level before the 2009 contraction. Therefore, Latin America is back and in position to perform according to its potential capacity, assuming the global economy does not deteriorate further. South America has been the locomotive, followed by Mexico and Central America.

**Chart 3: Latam Investment-Output Ratio  
Gross Fixed Investment, percentage of GDP**



Source: Author using official statistics.

Even though fiscal policies adjusted in the recent years, government accounts still remain flexible thanks to still-favorable commodity revenues. Monetary policies remain expansionary in the whole region, though conditions moved closer to neutrality. As a result, some economies have been working around capacity, a few above potential, and only Brazil and Argentina below trend rates. The excess demand generated by flexible policies has been imposing pressures on imports and prices in economies running faster than potential. However, the healthy deceleration in 2012 reduced the risk of overheating and the development of imbalances. Domestic demand continued to be the main engine of growth, thus partly compensating for external weakness. However, the reduced fiscal space imposes limits to the use of countercyclical measures.

Indeed, the region has continued to save but has also used savings to support the domestic market. An adjustment in commodity prices will not prevent the region from using countercyclical policies in the event of another crisis, but it will be to a lesser degree given the smaller fiscal space. Since the global recovery is expected to be slow, Latin America should base its future performance less on the

external engine and more on domestic sources, through healthy and more balanced policies. However, the only way to strengthen its resilience to external shocks and to reinforce its permanent sources of growth is through deepening structural changes. By implementing reforms that increase investment, productivity and technological change, the region will be able to expand its production capacity and perform at higher, stable, and more sustained growth in the medium and long term.

#### IV. EFFORTS FOR THE FUTURE

In the last decade the region increased its production capacity thanks to efforts directed to increase savings and expand investments mainly as a result of its economic openness and favorable conditions in the commodity market. In the absence of permanently high commodity prices, the region will necessarily have to rely on structural changes to expand its potential output. The only way to put an economy on a sustainable growth path is through strengthening its permanent sources of growth. The region should have learned that the fundamental problem is not to grow more but to increase production capacity such that the economy can grow at higher rates with macroeconomic stability. To increase savings and investments, Latin American governments need to do two things. First, reinforce macroeconomic discipline to expand the policy's countercyclical power. Second, keep deepening structural changes to attract more investment, remove bottlenecks, and create an economy more resilient to external shocks. Therefore, Latin America's efforts for the future should be directed toward discipline and reforms.

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