CHAPTER ONE

Macroeconomic overview

This chapter analyses the main macroeconomic trends in Latin America for the next few years. In the short term, Latin America will continue to witness moderate economic growth amid strong uncertainty worldwide. Countries in the region have some fiscal and monetary space they can use to deal with falls in aggregate demand. But current forecasts suggest that developed countries are on the verge of a long period of sluggish growth. In response, countries in the region would do well to make sure their policies to stabilise the economy are consistent with the actions they need to take to boost medium-term growth while transforming the production structure. Region-wide, greater trade integration could be an effective response to poor demand from developed countries and would at the same time allow non-traditional sectors and activities to boost their competitive advantages. Special attention should be paid to currency fluctuations, which in several countries could threaten the competitiveness of goods that are not linked to commodities. Identifying the causes of these fluctuations and using the appropriate instruments to mitigate them is one of the challenges faced by current macroeconomic policies.

Introduction

This chapter presents the macroeconomic outlook for Latin America, addressing the short-term future as well as more structural aspects. The chapter is composed of five sections. First, it briefly examines the impact that the prevailing situation of sluggish growth, high uncertainty and volatility in the global economy is having on Latin America and the Caribbean's economic growth, inflation, employment and wages. The next section analyses how prepared the region is to deal with trade shocks and financial shocks from other parts of the world in the short term. The third section looks at the space for fiscal and monetary policy in the region to act counter-cyclically and the specific tools countries can use. Next, the chapter considers the medium-term outlook in view of the forecasts of weak external demand and discusses its effects on the region. Finally, the chapter concludes with a brief recap before proposing the main challenge for Latin America and the Caribbean, which is how to sustain economic growth amid the poor, uncertain external outlook.

The economic situation in Latin America and the international environment

Moderate growth will continue in the region in 2012 amid high uncertainty and volatility, primarily from the external sector. According to the latest growth projections, the region's gross domestic product (GDP) will grow by around 3.2% in 2012 and 4.0% in 2013 (ECLAC, 2012a). These are good figures for the region compared to previous years and especially when compared to projections for more developed economies, where far more sluggish growth is expected. We must remember these figures are highly uncertain and subject to complex risks that make it hard to evaluate and quantify what impact they will have on the region's economies.

Latin America and the Caribbean will grow around 3.2% in 2012 and 4.0% in 2013.

Latin America and the Caribbean will record growth of 3.2% in 2012 and 4.0% in 2013.There are signs that growth and inflation are slowing in Latin America and the Caribbean, despite the job market remaining strong. In the first quarter of 2012, the slowdown in GDP was less severe than in previous quarters (Table 1.1), helped by domestic demand. Generally, private consumption continued to expand, and it accounts for most of the growth in the region's GDP in 2011. Private consumption was helped by improving job markets, with more and better-quality new jobs and higher wages, and by sustained credit growth to the private sector. In the early months of 2012 inflation fell in most countries, continuing the downward trend that began in the last quarter of 2011. In July 2012, average year-on-year inflation in Latin America and the Caribbean stood at 5.5%, down from 6.7% and 7.0% respectively in March and December 2011.

Falling international commodity prices caused a slowdown in the growth of exports in the first quarter of 2012, although this was offset somewhat by remittances and tourism. This slowdown began in the third quarter of 2011 in most countries. The year-on-year rate of change in exports for the region fell from 29.3% in the second quarter of 2011 to 10.4% in the first quarter of 2012. Exports to the European Union (EU) have fallen sharply since the start of 2011.

Table 1.1. **Indicators of economic activity in Latin America and the Caribbean[a], 2011-12**
(percentage changes compared to same quarter the previous year)

	2011				2012	
	I	II	III	IV	I	II
Argentina	9.9	9.1	9.3	7.3	5.2	0.0[b]
Bolivia (Plur. State of)	5.6	4.2	5.4	5.5	5.1	5.1[c]
Brazil[d]	4.2	3.3	2.1	1.4	0.8	0.5
Chile	9.9	6.3	3.7	4.5	5.3	5.5[b]
Colombia[d]	5.0	5.1	7.5	6.1	4.7	4.9
Costa Rica	1.9	3.6	4.6	5.4	7.9	5.7[b]
Dominican Republic[d]	4.3	3.6	4.6	5.1	3.8	3.8
Ecuador[d]	8.8	8.5	7.8	6.1	4.8	-
El Salvador	4.4	2.0	4.0	0.6	1.8	0.5[b]
Guatemala	4.8	4.1	3.3	4.6	3.3	3.6[b]
Honduras	5.8	5.1	4.8	6.7	5.3	5.0[b]
Mexico	4.4	3.1	4.3	3.9	4.5	4.1
Nicaragua	8.5	7.8	6.5	4.9	5.8	4.6[b]
Panama	5.9	8.5	7.0	9.8	9.4	9.6[b]
Paraguay	7.0	4.6	2.8	1.9	-2.6	-3.4[c]
Peru	8.6	6.9	6.6	5.6	6.1	6.1[b]
Uruguay[d]	6.7	5.1	7.7	3.5	4.2	3.8
Venezuela (Bol. Rep. of)[d]	4.8	2.6	4.4	4.9	5.8	5.4
Latin America[e]	5.7	4.3	4.3	3.6	3.6	2.4

Notes:
a) Percentage change in economic activity indices. Quarterly GDP is only used for countries without monthly activity indicators. For Mexico, although the country has an activity index, GDP was used.
b) April-June 2012 average compared to the same period in 2011.
c) April-May 2012 average compared to the same period in 2011.
d) Percentage change in GDP compared to same quarter the previous year.
e) Region-wide weighted average.
Source: ECLAC (2012a), *Economic Survey of Latin America and the Caribbean 2011-2012.*

The external outlook across the globe for 2012-13 will be marked by slow growth in the global economy, which is likely to continue until several developed countries end their high-debt and unemployment problems and until emerging countries can rebalance growth towards more consumption, thus raising global demand. External, real and financial volatility will drag on. Because of their low growth and ongoing fiscal constraints, some developed countries are expected to face more problems with the lack of confidence in the sustainability of their sovereign debt. Although this is likely to lead to financial, monetary and fiscal measures to resolve the liquidity and solvency problems, uncertainty will persist.

In 2012, the main assumptions of the most likely scenario are: *i)* the US economy will still see moderate, variable growth; *ii)* euro-area countries will continue seeing low GDP growth, or even negative growth in some countries, but the sovereign-debt problems will not spark a global financial crisis; *iii)* the Chinese and Indian economies will slow down, but mainly due cyclical reasons, with growth remaining higher than in Latin America and the Caribbean.

The impact of the global scenario for Latin America and the Caribbean will differ by country and depend largely on their export structures by markets and products.

As discussed below, the impact that the international economic situation will have on the region will vary from country to country, depending largely on their export structures by markets and products. While Mexico and some Central American and Caribbean countries will benefit from the moderate growth in the US economy, growth in countries that specialise in producing and exporting commodities will depend more on developments in the Asian economies, which are the main destinations for these kinds of exports.

In 2013, slow growth will translate into continued sluggishness in the global economy. Euro-area countries will remain affected by households reducing their debts, banks restricting their lending as they reorganise their portfolios and increase capital, sluggish growth in domestic demand resulting from unemployment and pessimistic expectations, and low or negative fiscal impulses. This weak growth is likely to continue for a few years, as the experience of other developed countries has shown that recovering from similar events takes at least three to four years. In the United States, the main risk for 2013 is likely to be a slowdown in growth, depending on how the country tackles the debt problem and the impending automatic spending cuts in late 2012. In China, the impact on overall demand will depend on how swiftly it changes its spending patterns from heavy investment to expansion of domestic consumption. Early estimates suggest that although consumers have seen their real income go up in recent years, the multiplier effect of growth in consumption is not yet enough to offset the projected drop in investment. This drop was caused by excess idle capacity following several years of very heavy investment (close to 50% of GDP). Several studies suggest that not only a reduction in Chinese economic growth but especially a change in its composition (*e.g.* reducing the rate of investment) would have a high spillover effect on demand for imports from the rest of the world and especially on international prices of certain metals. For instance, copper-producing countries are more exposed to lower investment in Chinese infrastructure than countries that export food and agricultural raw materials.[1] Consequently, risks to growth originating in China are also on the downside.

Short-term impacts

To assess how prepared Latin America is to face these risks one must separate the potential impact by country according to its level of exposure and its resilience or "defences" in terms of its economic structure and space for macroeconomic policy. Next, the region's exposure to trade and financial shocks and the effectiveness of macroeconomic resilience measures and the space available for counter-cyclical policy are considered.

Two useful indicators for a country's exposure to external risk are: the exports-to-GDP ratio and the contribution of exports to the growth of internal demand.

From a trade perspective, the level of exposure and the possible lines of defence vary from country to country in the region. The exports-to-GDP ratio and the contribution of exports to domestic income growth in current dollars are two indicators that can be used to analyse exposure to this risk. Remittances from Latin American migrants working in developing countries are another indicator of the transmission of growth from developed to developing countries. The differences in these indicators reflect different situations (Table 1.2). On the one hand, in some countries with large domestic markets, such as Brazil and to some extent Colombia, external demand is less important, with exports providing less than 20% of GDP in 2011 and less than 20% of domestic income growth for 2000-10. Remittances have no significant macroeconomic weight in these countries. Several countries are more exposed to risk due to the relative size of external demand (in smaller, more open economies) and/or remittances (especially in Central America and the Caribbean).

Table 1.2. **Latin America and the Caribbean: indicators of exposure and resilience to shocks to the current account**

Country	Exposure indicators			Indicators of export diversification	
	Exports (% GDP)	Contribution of exports to nominal GDP growth[a] (%)	Remittances (% GDP)	Product concentration index[b]	Market concentration index[b]
Argentina	21.7	49.0	0.2	0.0	0.1
Bolivia (Plur. State of))	41.2	56.2	5.5	0.2	0.2
Brazil	11.2	10.8	0.2	0.0	0.1
Chile	38.7	41.3	0.0	0.2	0.1
Colombia	15.7	15.6	1.4	0.2	0.2
Costa Rica	38.1	35.2	1.5	0.1	0.2
Dominican Republic	22.3	11.6	6.5	0.0	0.3
Ecuador	32.9	36.5	4.4	0.3	0.2
El Salvador	26.2	26.8	16.3	0.1	0.3
Guatemala	25.1	22.5	10.3	0.4	0.2
Honduras	43.9	36.6	17.2	0.1	0.3
Jamaica	25.6	70.8	14.1	0.2	0.3
Mexico	30.3	34.4	2.1	0.0	0.6
Nicaragua	41.3	72.7	12.6	0.1	0.1
Panama	65.2	59.3	0.9	0.1	0.1
Paraguay	57.1	69.2	3.7	0.2	0.1
Peru	25.1	30.1	1.6	0.1	0.1
Uruguay	26.9	38.5	0.7	0.1	0.1
Venezuela (Bol. Rep. of)	28.7	31.4	0.0	0.5	0.3
Average	**32.5**	**39.4**	**5.2**	**0.1**	**0.2**

Notes: The figures refer to 2011 data, or in some cases 2010 or 2009 for concentration indices.
a) This indicator is calculated as the percentage change in GDP in current dollars for the period 2000-10 versus the percentage change in exports in nominal dollars.
b) Both concentration indices are Herfindahl-Hirschman indices, which can range from 0 to 1. Indices close to 0 indicate greater diversification, while those close to 1 indicate greater concentration. The original data include re-exports and refer only to goods.

Source: Based on ECLAC's SIGCI databases and the World Bank's 2012 *World Development Indicators*.

Diversifying export products or destinations stands out among the economies' forms of structural resilience against shocks to external demand. The more diversified a country's exports are, the more flexibility it has to stand up to external shocks. But given the current plight, it could be easier to redirect exports of standardised goods, such as raw materials, than adapted or manufactured goods, depending on the traits of the target market. The impact of real external shocks on countries in the region depends more on how diversified each country's exports are than on its openness to trade. Analysis of a broader set of emerging and developing countries delivers similar results. When developing and emerging countries' economies were recovering from the 2008-09 global crisis, a high concentration of exports to high-income countries had a negative effect, while openness to trade positively impacted growth (Box 1.1). External vulnerability, therefore, is a multidimensional concept that must be analysed on a case-by-case basis. Developments in the level of exposure and resilience reflect the progress the vast majority of countries have made in recent decades and the still relatively concentrated structure of exports, which amplify external shocks (OECD, 2010).

Fluctuations in the prices of raw materials, meanwhile, affect external accounts; in the economies of countries that are more specialised in producing and exporting natural resources they also affect their fiscal accounts. In several countries in the region, this income makes up a notable percentage of total tax revenues, either as revenue from public enterprises that are included in the fiscal accounts or that transfer monies to the treasury (such as the Mexican state oil firm PEMEX or the Chilean state copper firm CODELCO), or through royalties and taxes on corporate profits in the sector (such as in the Peruvian mining industry).[2] A drop in the price of raw materials diminishes these countries' tax revenue, reducing their response capacity. Turning to external accounts, if the prices of raw materials fall and the terms of trade deteriorate, export income is hit, damaging the trade balance. In Central America, the reverse is usually true. Since the area is a net importer of food and fuel, a fall in world prices of these goods benefits the countries' terms of trade. However, since several Central American countries have schemes to subsidise power generation, a rise in world energy prices would negatively affect their fiscal balances. In the Caribbean, the effect is rather mixed, with some countries more specialised in producing and exporting natural resources while others are net importers.

The region's financial situation improved significantly during the first decade of this century, and it was not largely altered by the 2008/09 financial crisis.

A second important international transmission channel is the financial one. Looking at the region's finances, the overall situation in the region has improved substantially over the past decade, with the 2008-09 crisis doing little to abate this progress. In 2010, average external debt in the region fell to just 1.2 percentage points of GDP above the pre-2009 figure. Only in Jamaica and Nicaragua was external debt much higher than in 2008, and in several countries the 2010 figure was lower (Table 1.3). Private-sector debt showed similar trends. While the region has continued to integrate into global financial markets (assets and liabilities with the rest of the world), the private sector has brought down its net external debt (IDB, 2012). The region has maintained access to international financial markets while keeping country risk indicators relatively low. Looking at capital flows, current account balances have deteriorated slightly compared to the period 2003-08, falling by just under 2 percentage points of GDP in 2011. However, at present the balances of most countries in the region, especially those integrated into international

financial markets and therefore prone to changes in global risk appetite, do not seem to be too negative or especially vulnerable to a sudden stop in capital flows.

Several factors could lower the risk of disruptions in international capital markets causing a sudden stop and financing problems. This section emphasises aspects of the national balance sheet, such as the characteristics of the composition of external liabilities and the availability of liquid assets. International reserves remain high as a percentage of GDP and of short-term external debt. At the end of 2011, international reserves were one percentage point of GDP higher than at the end of 2008. Short-term debt represents only a small amount (about 15%) of total debt. Recent figures show that reserves exceed 100% of short-term debt in all countries. Though there are differences among countries, both indicators show that most countries should be able to cope with short-term external financing problems. In the international context, the expansion of contingent lines of credit and of currency swaps among central banks helps mitigate the associated risks.

Table 1.3. **Indicators of exposure and resilience to capital account shocks in Latin America and the Caribbean**

Country	External debt (% GNI)[a]			Current account balance (% GDP)			Reserves (% GDP)	Resistance indicators	
	2008	2010	Difference	2003-08	2011	Difference		Short-term external debt (% total debt)	Short-term debt (% reserves)
Argentina	37.2	36.1	-1.1	3.0	-0.5	-3.5	10.3	27.4	67.1
Bolivia (Plur. State of)	34.3	27.8	-6.4	7.3	2.2	-5.1	52.4	2.0	1.1
Brazil	16.2	16.9	0.7	0.6	-2.1	-2.7	14.2	18.9	22.7
Chile	41.5	45.9	4.4	1.4	-1.3	-2.7	16.9	30.0	93.0
Colombia	19.8	22.8	3.0	-1.8	-2.8	-1.1	10.2	13.0	29.2
Costa Rica	31.8	26.8	-5.0	-5.7	-5.2	0.5	11.9	27.5	52.5
Dominican Republic	23.2	26.2	3.0	-1.7	-7.9	-6.2	6.6	14.9	55.6
Ecuador	32.7	23.1	-9.7	1.4	-0.3	-1.7	4.6	2.5	14.1
El Salvador	49.1	53.2	4.0	-5.0	-5.9	-0.9	11.1	10.0	38.1
Guatemala	38.7	35.9	-2.8	-4.8	-2.8	1.9	13.4	11.1	26.8
Honduras	25.9	28.2	2.3	-7.6	-8.7	-1.1	16.7	9.6	14.7
Jamaica	76.2	104.2	28.0	-11.4	-9.9	1.5	13.4	8.5	47.2
Mexico	17.3	19.5	2.2	-0.9	-0.8	0.1	12.3	19.5	32.4
Nicaragua	68.8	76.9	8.1	-16.7	-17.9	-1.2	23.5	14.6	38.7
Panama	44.7	45.8	1.1	-6.5	-12.7	-6.3	7.4	0.0	0.0
Paraguay	25.0	25.3	0.4	0.9	-1.2	-2.1	20.8	23.2	27.5
Peru	28.8	24.6	-4.2	0.0	-1.3	-1.3	28.0	16.7	13.7
Uruguay	31.7	29.0	-2.7	-1.5	-2.2	-0.7	22.0	13.7	20.2
Venezuela (Bol. Rep. of)	16.9	14.3	-2.6	13.5	8.6	-4.9	12.3	27.8	52.0
Average	**34.7**	**35.9**	**1.2**	**-1.9**	**-3.8**	**-2.0**	**16.2**	**15.3**	**34.0**

Notes: Reserves are as of the end of 2011. All external debt indicators refer to 2010.
a) GNI refers to gross national income.
Source: Based on World Bank GDF, the IMF IFS, and IDB *Latin Macro Watch* data.

Box 1.1. **What explains the economic recovery in emerging and developing countries?**

Emerging and developing economies have been affected differently by the crisis. Several studies analyse how the initial conditions regarding structural characteristics and policies explain these differences. Berkmen *et al.* (2012) find that the trade channel (trade openness and manufactured exports) in 2009 had a negative impact on growth in developing countries. However, for a sub-sample of emerging economies the authors conclude that financial issues such as greater leverage of the financial system, credit growth and a higher proportion of short-term debt were more influential than the trade channel. They also find some evidence that the fiscal position and exchange-rate flexibility helped reduce the impact of the crisis, but the fiscal-soundness indicators are not significant enough to explain the different effects between one country and another. Similarly, Gallego *et al.* (2010) argue that differences in macroeconomic vulnerabilities explain the stronger recovery in Latin America compared to Eastern Europe. Cecchetti *et al.* (2011) argue that the strong domestic financial system, high levels of international reserves, current account surpluses and low levels of private debt explain why the region's economic growth is higher than the global average. Economies that are less open to trade and have fewer financial ties to the United States suffered least. Rose and Spiegel (2011) argue that few indicators were able to predict where and how severely the crisis would affect economic growth. They argue that current account surpluses are the only consistent indicator that an economy would be dealt less of a blow by the crisis.

As the crisis has not ended, the studies provide no conclusive answer as to which factors will determine how economies perform after the crisis. In a study related to this chapter, Avendaño and Daude (2012) show that more financially open economies (with openness measured as the total value of external assets and liabilities as a percentage of GDP) and economies with a greater presence of European banks (percentage of total external liabilities) have had a slower recovery. Openness to trade, meaning a high exports-to-GDP ratio, has a positive effect, although economies that export mainly to developed countries have been recovering more slowly. Finally, countries with financial systems where credit has grown quickly and has been more leveraged (domestic credit as a proportion of deposits) have also been hit harder by the crisis. There is some evidence that the crisis has been more costly to countries with a high debt-to-GDP ratio. For other factors, such as budget deficit and current account balance, there is no conclusive evidence of their effects. Some of these results are in line with the findings of other studies on the initial impact of the crisis (Berkmen *et al.*, 2012), but others differ, such as the finding by Avendaño and Daude (2012) that financial openness had a significant negative effect on the economic recovery.

Source: Avendaño and Daude (2012).

European banks entered the region mainly as subsidiary firms, that is, banks with their own capital, funded in the local market and subject to national regulation. This has mitigated much of the risk associated with Europe's financial woes. However, if the euro-area crisis were to get worse and the parent banks were to cut off lines of credit to their subsidiaries, credit in the local market could decline, with potential consequences on the region's real economy and financial stability. The figures show a decline in external banking finance to the region, but only slightly, especially in the light of exchange-rate variations. Most international banks in the region have equity and financing, including, for example, in Chile (Banco Central de Chile, 2012). However, some Caribbean countries might be more

exposed to lower international banking flows (IDB, 2012). In any case, central banks and the banking supervisory superintendents of Latin American and Caribbean countries should be ready for potential asset sales by European banks in the region.

Macroeconomic policy spaces

The region has some fiscal space available to address the problems resulting from sluggish growth in other parts of the world. In 2009, several Latin American countries with a relatively strong, solvent fiscal position used countercyclical fiscal policy to offset the recessionary effects of the global crisis (OECD and ECLAC, 2011). Public debt is at similar levels to 2008 in most countries of the region, with the simple average standing at around 39% of GDP. But this figure hides very different realities. Chile, Paraguay and Peru, for instance, have gross public debt levels below 20% of GDP, while other countries have much higher levels. Similar disparities exist in the budget balance figures. Bolivia, Chile, Paraguay and Peru have very sturdy figures, while other countries' figures are much weaker (Table 1.4). These differences in fiscal fundamentals are reflected in the financing conditions, which in turn feed back into fiscal sustainability. Country risk or sovereign spreads are at historically low levels, in part thanks to good macroeconomic fundamentals, but also thanks to general factors such as low interest rates and international liquidity.

Table 1.4. **Latin America and the Caribbean: fiscal indicators**

| Country	Gross government debt (% GDP)		Interest payments (% GDP)		Budget balance (% GDP)
	2008	2011	2008	2011	2011
Argentina	57.8	40.0	2.4	2.7	-2.3
Bolivia (Plur. State of)	43.1	41.4	1.0	1.4	1.0
Brazil	57.4	54.2	6.6	6.1	-2.6
Chile	11.4	16.5	0.9	0.8	0.9
Colombia	42.7	41.2	3.5	3.2	-1.8
Costa Rica	29.9	38.4	2.2	2.2	-3.6
Dominican Republic	24.4	30.3	1.6	2.1	-2.6
Ecuador	25.0	22.2	1.3	0.8	-1.0
El Salvador	36.9	44.3	2.4	2.2	-3.9
Guatemala	20.1	24.1	1.4	1.5	-2.8
Honduras	20.1	27.7	0.3	0.3	-4.6
Jamaica	126.1	139.0	12.5	9.4	-5.7
Mexico	26.9	35.5	1.6	1.8	-2.5
Nicaragua	76.6	42.7	1.2	1.4	0.5
Panama	45.4	41.2	3.2	2.4	-2.3
Paraguay	19.2	13.4	0.7	0.6	1.3
Peru	24.5	19.2	1.6	1.2	1.8
Uruguay	52.4	42.2	2.9	2.5	-0.4
Venezuela (Bol. Rep. of)	14.0	21.7	1.3	2.1	-3.4
Simple average	**39.7**	**38.7**	**2.6**	**2.4**	**-1.8**

Note: The figures are taken from the officially published public-sector data with the broadest institutional coverage. Data cover central government for Dominican Republic, Guatemala, Honduras, Jamaica and Venezuela (Bol. Rep. of); and general government for gross government debt for Brazil (Brazilian Central Bank). Interest payments for Paraguay are for 2010.

Source: Based on official figures.

Despite public debt reduction, several countries have a lower primary balance than in 2008. The fiscal balance is influenced by the economic cycle and in some countries by commodity prices (if some fiscal revenue is linked to these). But of the eight countries for which an estimated fiscal balance adjusted for the economic cycle and raw-material prices is available, only one has improved its balance (Figure 1.1). From a flow perspective, the region is therefore in a weaker position than during the critical event of 2008/09. However, three factors would help economies better overcome any future international capital-market volatilities like the one seen in September 2008 that followed the bankruptcy of the US investment bank Lehman Brothers: having savings available in sovereign wealth funds in some countries, having continued access to international markets, and drawing on the experience the region and the multilateral and regional financing organisations have acquired in dealing with severe shortages of international liquidity.

Chile, Paraguay and Perú have gross public debt levels below 20%
of GDP, while in other countries the figures are much higher.

Figure 1.1. **Primary balance adjusted for the cycle and raw material prices in 2008 and 2011 in selected countries Latin American countries**
(Percentage of GDP)
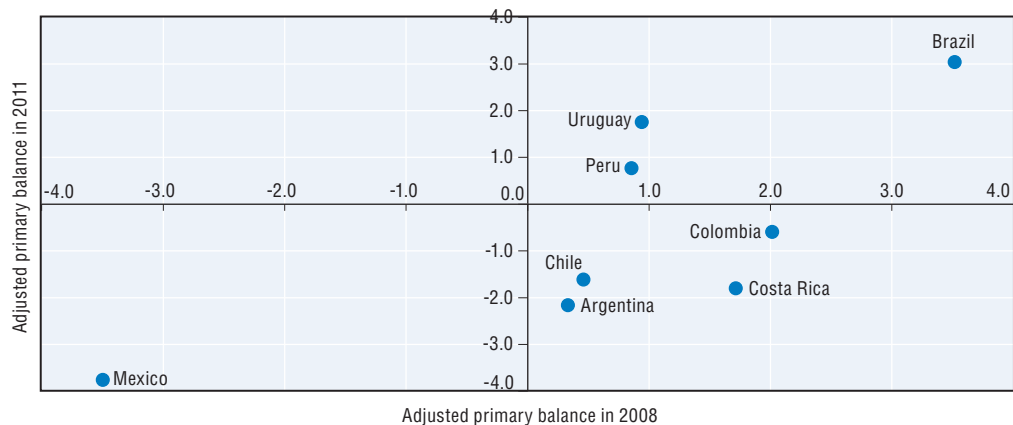
Note: For methodology details, see Daude *et al.* (2011).
Source: Based on information from national governments, the Chilean Copper Commission (Cochilco), Federal Reserve Economic Data (Federal Reserve Bank of St. Louis), Datastream and *World Economic Outlook* (IMF), April 2012.
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In addition, in the event of a short or moderate real-economy shock and/or financial shock, some countries in the region would have the necessary fiscal space to counter it, at least in part. But the current economic circumstances are highly complex due to both the magnitude and duration of external shocks. The situation that has gradually taken shape is one of sluggish growth in the region's external demand while the world's big economies (the euro area, the United States, China and India) are fighting against their own imbalances, which will likely lead to episodes of uncertainty.

A prudent fiscal strategy for the region should be built around tools that ensure stimulus measures are temporary and are withdrawn when the time is right and that they protect the sustainability of public finances at all times. Because expenditure-side automatic stabilisers are small and there are so few revenue-side stabilisers (compared to the fiscal revenue collected and its composition), an alternative solution for the region

could be to create social spending programmes that are activated and deactivated automatically (for instance, by unemployment levels), depending on each country's institutional capabilities. If the planning cycle contains infrastructure projects whose economic, social and environmental feasibility has been evaluated, investment plans could be brought forward or accelerated according to the economic cycle.

> *Various countries have the space and credibility to use countercyclical monetary policy, even if food and fuel prices once again push up price indexes in the region.*

Monetary policy is another tool available to most countries in the region when faced with a decline in aggregate demand. Inflationary forecasts are generally moderate and stable for the medium term, despite sporadic rises in food prices in the first six months of 2012. Central banks that follow inflation targeting regimes have generally managed to keep inflation within the boundaries they set or moved inflation towards those levels (Figure 1.2, left panel). Several central banks have used some of their policy room to tackle the signs of a slowdown in economic growth and lower inflationary pressures, while others have decided not to act unless they see clearer signals. Various countries therefore have the space and credibility to use countercyclical monetary policy, even if food and fuel prices once again push up price indexes in the region. The strong uncertainty surrounding global economic growth and the trend towards lower external inflationary pressures led most countries in the region to maintain their prudent monetary policies during the first quarter of 2012, with few changes occurring to existing rates. Countries that saw a rise in inflation (Colombia) or high, albeit falling, inflation (Honduras and Uruguay) raise their reference rate. Interest rates fell further where there was a much clearer economic slowdown, such as in Brazil and Paraguay. The second quarter of 2012 confirmed these trends, so more countries have begun to cut interest rates, including Colombia.

Figure 1.2. **Annual inflation rate forecasts for the next 12 months and evolution of monetary policy rates in Latin America**

(as percentages)
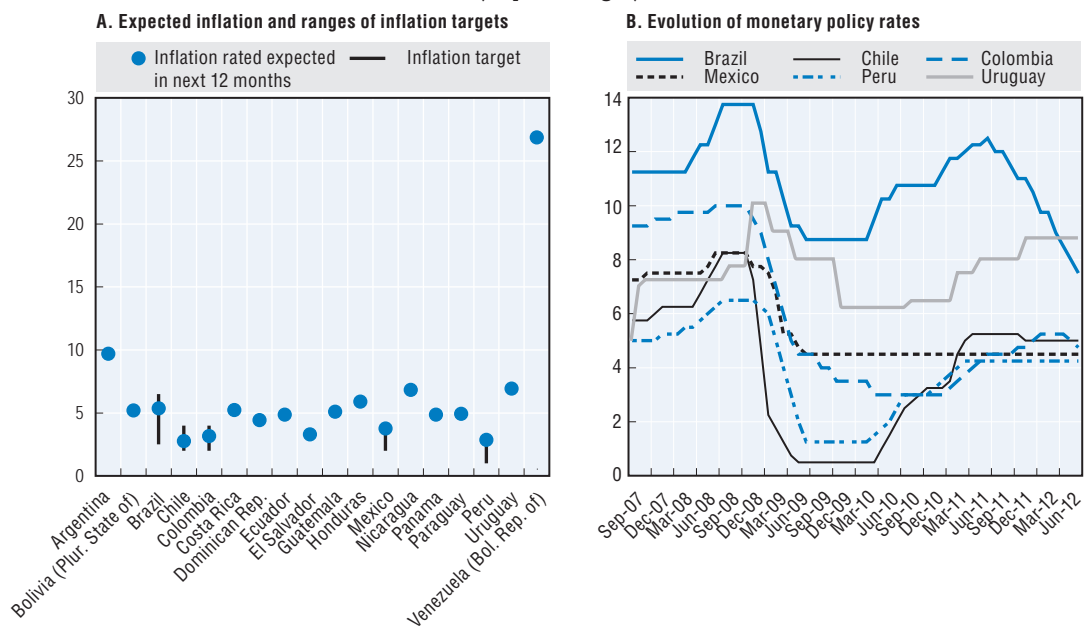
Source: Based on Latin American Consensus Forecasts, August 2012 and Datastream.

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The region's central banks still have space for expansionary monetary policy if necessary. Well-anchored inflation expectations – which most countries in the region have – are necessary for monetary policy to be effective in stabilising aggregate demand. Because nominal rates are well above the bottom limit of 0%, countries should have sufficient space to support aggregate demand. Estimates of monetary-policy reaction functions – called Taylor rules – show that at present countries with inflation targeting regimes have interest rates that reflect a neutral or slightly expansionary monetary policy (see Box 1.2 for the situation in Brazil).

A prudent fiscal strategy should be built around intervention tools that ensure stimulus measures are temporary and are withdrawn when the time is right and that public finances remain sustainable at all times.

Box 1.2. **Alternative estimates of monetary-policy rules in Brazil**

Taylor rules are a tool traditionally used to check whether monetary policy is expansionary or contractionary. They became popular following the study by Taylor (1993) on US monetary policy in which he argues that a relatively simple equation can be used to base the monetary-policy rate on the deviation of inflation from the target rate and difference between potential and actual output (the output gap). However, there is much criticism regarding which additional variables (such as performance of long-term bonds, real exchange rates and asset prices) should be included in the analysis and what precise methodology should be used to correctly estimate these relationships. In this respect, Brazil is an example of the potential complications.

For the period from January 2003 to August 2012, a series of alternative models were considered to assess Brazil's monetary policy to estimate the following equation:

$$i_t = \alpha + \beta \, (\pi_{t,t+12} - \pi^*) + \gamma \, (y_t - y^*) + \varepsilon_t,$$

where i is the Selic monetary-policy rate, $\pi_{t,t+12}$ is the expected rate of inflation for the next 12 months, π^* is the inflation target, $(y_t - y^\prime)$ is the output gap and ε_t is an error term. Normally, both coefficients (β y γ) should be positive. The coefficient β should be greater than 1, so the real interest rate increases with inflation expectations and thus raises the real interest rate and cools the economy. The opposite occurs if inflation is below the target rate. Meanwhile, if γ equals zero it means the government focuses purely on achieving the inflation target.

An alternative approach often used includes a lagged interest rate to reflect the central bank's aim of smoothing fluctuations in the interest rate and thus reducing financial markets' uncertainty and volatility. Often additional variables are included, either because they contain information regarding the prices or GDP or because they are part of the central bank's objectives. Here we will consider an open-economy version that includes the real exchange rate. Finally, the estimation of this single equation has potential problems because interest rates influence – although with some lag –inflation (and inflation expectations) and the output gap. The estimates could therefore be biased, especially if movements in the interest rate have a lot of inertia. A related problem in Brazil and other emerging economies is that the time series for interest rates and

inflation are not usually stationary, so the estimated relationships may be spurious. A multivariate cointegration analysis can be performed to counter these problems. The estimated coefficients are shown in the following table:

Alternative estimates of monetary-policy rules in Brazil

	(1) Closed economy	(2) Open economy	(3) Dynamic open economy	(4) Co-integration vector
Constant	12.83	-43.65	-1.02	38.13
	(0.33)	(4.56)	(1.28)	-
Inflation	2.21	1.29	0.07	3.56
	(0.21)	(0.15)	(0.04)	(0.99)
GDP gap	-0.27	-0.04	13.39	-0.33
	(0.18)	(0.12)	(2.41)	(0.64)
Real exchange rate	-	12.58	0.32	-11.84
		(1.01)	(0.33)	(4.37)
Lagged interest rate	-	-	0.96	-
			(0.020)	
R-squared	0.50	0.80	0.99	-
Durbin-Watson	0.04	0.11	0.43	-

Note: Standard error in parenthesis.
Source: Authors' estimates based on data from the Brazilian Central Bank.

The interest-rate projections based on these different econometric models show significant differences. For instance, the simplest model, shown in column (1), suggests the interest rate for August 2012 should be 14.5% instead of 7.5%. However, the Durbin-Watson statistic shows a very high autocorrelation, which means the model is clearly not well specified. When open-economy aspects are included (the real exchange rate), the projection falls to 12.3% for July 2012, while the average interest rate is 8.2%, but the high autocorrelation persists. If the lagged interest rate is included too, the estimated rate would be 9.3% at the same date. The interest rate currently observed would fall within the confidence interval. This means that although the point estimate indicates that monetary policy might be slightly more expansionary than what the estimated rule suggests, the difference is small. However, the high coefficient for the lagged interest rate suggests the interest rate is probably not stationary. The high R-squared value and low Durbin-Watson statistic also indicate problems with the model, which is perhaps spurious. Therefore, the estimate based on a cointegration analysis could give more reliable estimates. In view of this, the projections based on column (4) confirm the above result. Although this equation suggests the interest rate should be 1.3 percentage points higher than at present, this is not a statistically significant difference. In short, at present there do not seem to be indications that Brazilian monetary policy is too expansionary.

The medium-term international environment and its impact on the region

External demand from advanced countries will be fairly stagnant in the coming years. The crisis currently affecting several economies in the euro area will have medium- and long-term effects on many OECD countries. In particular, the significant increase in sovereign debt – coupled with spending pressures related to the ageing population – could stem growth for a long period due to the pressing need for fiscal consolidation.[3] For instance, to cut their gross debt to 50% of GDP by 2050, several countries, including the United States, the United Kingdom and Japan, would need to improve their cyclically adjusted fiscal balances by more than 8 percentage points of GDP (OECD, 2012). In this scenario, several advanced economies could be faced with growth problems similar to those faced by Latin American economies following the external debt crisis of the early 1980s. There are several ways this slower growth could come about. For instance, fiscal adjustments could significantly cut aggregate demand at a time when businesses' and households' balance sheets are still recovering. Since there is no clear roadmap for fiscal consolidation, high levels of debt could trigger expectations of a higher default risk. This would increase the risk premium, holding back private investment and therefore potential growth. Finally, the prolonged high unemployment could wind up raising structural unemployment, dealing a permanent blow to potential output in OECD economies (OECD, 2011).
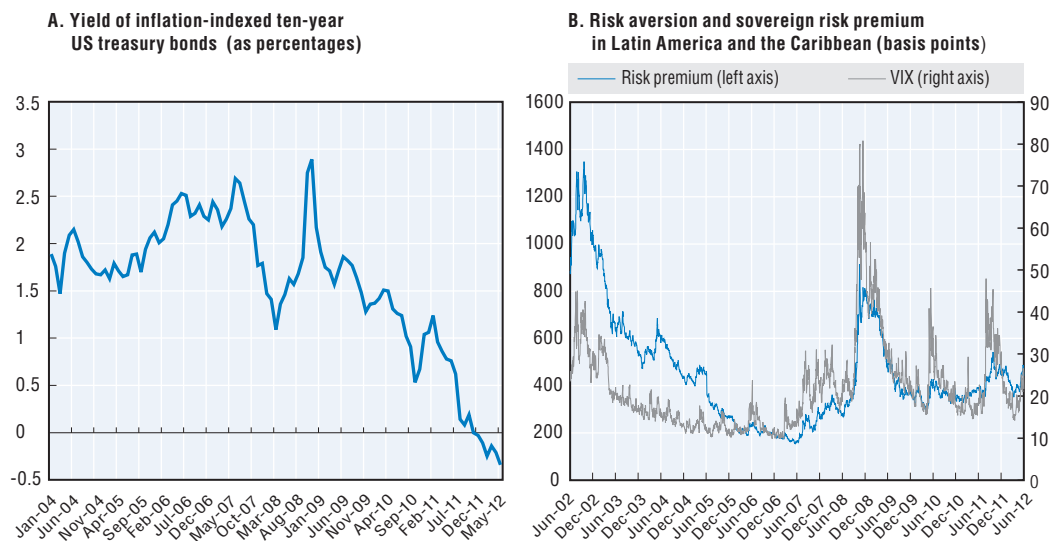
Because of weak cyclical economic conditions and structural problems in OECD economies, interest rates are likely to stay low for a long time.

Because of weak cyclical economic conditions and structural problems, interest rates are likely to stay low for a long time. With GDP growth below potential in many OECD economies and idle capacity high, the next few years will see low inflationary pressures (Figure 1.3, left panel). If so, central banks should not raise monetary-policy rates, and those with mandates not only to meet inflation targets but also to achieve full employment can return to using unconventional monetary-policy tools to reduce long-term interest rates. Several analysts believe governments in developed countries should allow higher inflation while introducing financial constraints to contain interest rates as a way of liquidating the high government debt and cutting debts with private debtors, thus facilitating the deleveraging of economies. This would result in a prolonged period of negative interest rates in real terms (Reinhart and Sbrancia, 2011).[4]

Even if no country abandons the euro zone, international capital markets will remain highly volatile, with capital flows switching from inflows to outflows in emerging markets' assets. Several of the current risks related to economic developments in the developed economies will not be resolved any time soon. Instead, given the significant institutional changes needed to solve the problems, there will be advances and relapses as reforms are implemented, for example in fiscal consolidation during an election cycle in the United States or changes to treaties in the European Union subject to ratification by referendum. Other uncertainties will only fade away gradually. For example, it will take today to assess what share of the slower growth in China that is due to cyclical reasons and what part is related to a reduction in potential output growth. Sporadic hikes in risk aversion in international capital markets are therefore to be expected. Global risk aversion has become one of the most important drivers of asset prices in emerging

markets. As these markets have become part of the international financial markets, some volatility is to be expected in the region over the coming years.(Figure 1.3, right panel).

Figure 1.3. **Risk-free asset rates, global risk aversion of investors and sovereign risk premium in Latin America**

A. Yield of inflation-indexed ten-year US treasury bonds (as percentages)

B. Risk aversion and sovereign risk premium in Latin America and the Caribbean (basis points)

Risk premium (left axis)   VIX (right axis)

Note: VIX refers to the Chicago Board Options Exchange Market Volatility Index.
Source: FRED (Federal Reserve Bank of St. Louis) database and Datastream.
StatLink http://dx.doi.org/10.1787/888932732500

> *Greater economic integration to remove trade, administrative and infrastructure barriers among countries in the region could provide a way forward in jointly dealing with the medium-term economic outlook.*

A regional response to sluggish growth in external demand is greater regional integration, which would allow the region's economies to develop competitive advantages in non-traditional sectors and activities. Despite weak external demand, several countries in the region have maintained good economic growth by expanding their local markets. However, many countries' domestic markets are small or can quickly face balance of payments problems due to the imports needed for this process. In this context, greater integration to remove trade, administrative and infrastructure barriers among countries in the region could provide a way forward in jointly dealing with the medium-term economic outlook. In addition to providing markets and scale, greater regional integration can also provide a platform for activities and sectors to learn and develop dynamic competitive advantages so they can export to the rest of the world. In many cases it can also improve macroeconomic resilience by diversifying the products exported and their destinations.

Although, comparatively speaking, Latin America is in a strong position with its low debt and external strength, this scenario means the region will probably be subject to large-scale capital inflows and outflows for a long time. Furthermore, these capital flows could cause major exchange-rate fluctuations. After dropping dramatically in 2009, capital inflows to the region have boomed to historically high levels in recent years (Figure 1.4, upper panel). Since capital inflows can trigger unsustainable price hikes for certain assets (such as real estate and capital stock) or can be channelled into the banking system and cause excessive credit growth, they could jeopardise the region's macroeconomic balance. This risk has recently given greater importance to macroprudential regulation measures and the openness of the capital account. The reasons why these are such important factors lie not only in their short-term macroeconomic effects, but also in the possible consequences of unsustainable real appreciations on the economic structure, since they could weaken the competitiveness of the tradeable-goods sectors and thus wear down future growth capacity (ECLAC, 2012b).

Macroprudential regulation and sterilised foreign-exchange intervention are the first line of defence against excessive fluctuations caused by short-term capital inflows.

The fluctuations in the real exchange rates in Latin American countries show that generally currencies have appreciated compared to their average value for 2003-08 – that is, before the economic crisis. Only the currencies of Ecuador, El Salvador, Mexico and Nicaragua have depreciated, albeit only slightly. But the currency appreciations since that period are greater than 20% in several countries in the region, especially in South America and among commodity producers. There are various reasons for these fluctuations in real exchange rates. Some are those related to the real economy, such as terms of trade, fiscal policy, trade openness and level of net investment. There are also changes in international financial markets, such as a greater appetite for emerging-market assets, and interest-rate differentials, which can trigger short-term capital inflows that could change direction once the external conditions change.

Despite the methodological difficulties, it is important to study and monitor the causes of fluctuations in the real exchange rate to determine the situations in which government intervention is needed and to use the most effective policy tools for each situation. For instance, if the fluctuations are caused by short-term capital inflows, then macroprudential regulation and sterilised foreign-exchange intervention are the first line of defence against these excessive fluctuations (Daude *et al.*, 2012). In other cases fluctuations may be due to short-term changes in the terms of trade. For instance, a drought somewhere else in the world can drive up the price of grain in a particular year. In such situations, foreign-exchange intervention can be effective, although countercyclical fiscal instruments such as stabilisation funds are usually more effective still. To avoid a temporary appreciation resulting from higher spending due to the quasi-rents created, tax schemes can be used that collect a relevant portion of the quasi-rents and invest these funds abroad. Finally, an appreciation could be caused by a permanent or long-term rise in raw-material prices. This is a classic case of "Dutch disease". When this occurs, foreign-exchange interventions are largely ineffective, but economic policy should still act to raise the competitiveness in the non-commodity sector. For instance, investing the additional tax revenue in the infrastructure, innovation and human capital needed by the tradeable-goods sector helps diversify production when the terms of trade do not generate the right market incentives.

Figure 1.4. Capital flows to Latin America and the Caribbean and real effective exchange rate

A. Capital flows (billions of 1990 USD)

B. Real exchange rate (May 2012 compared to the 2003-08 average)
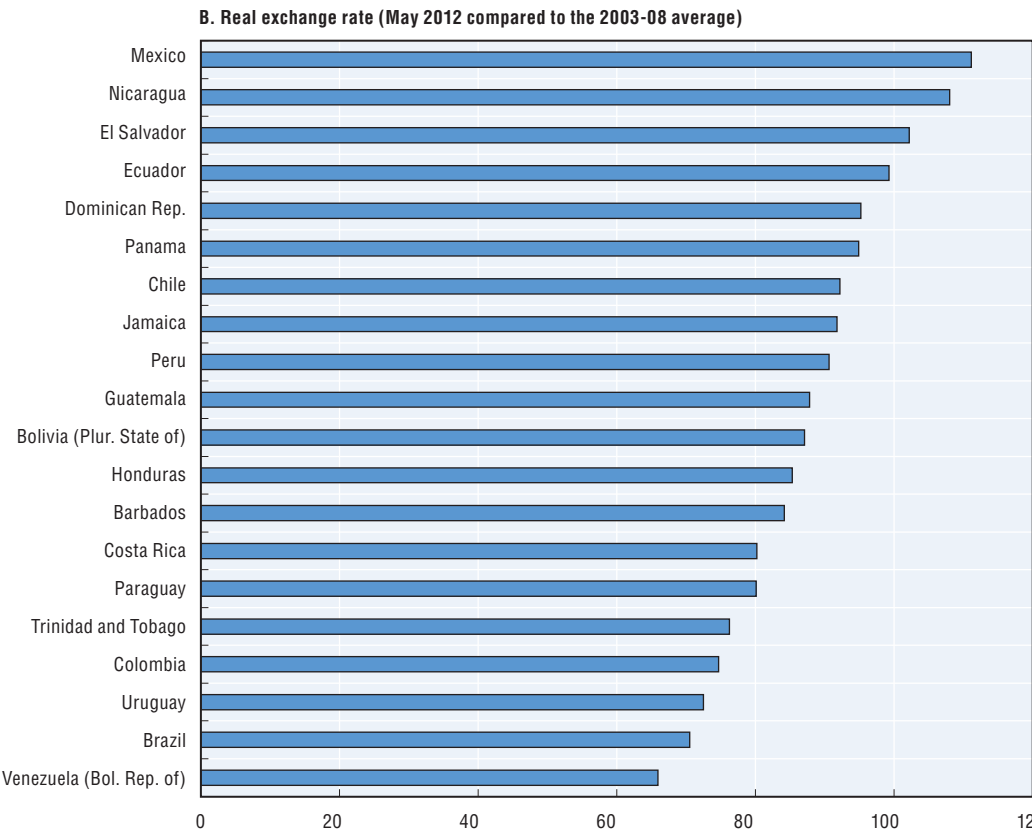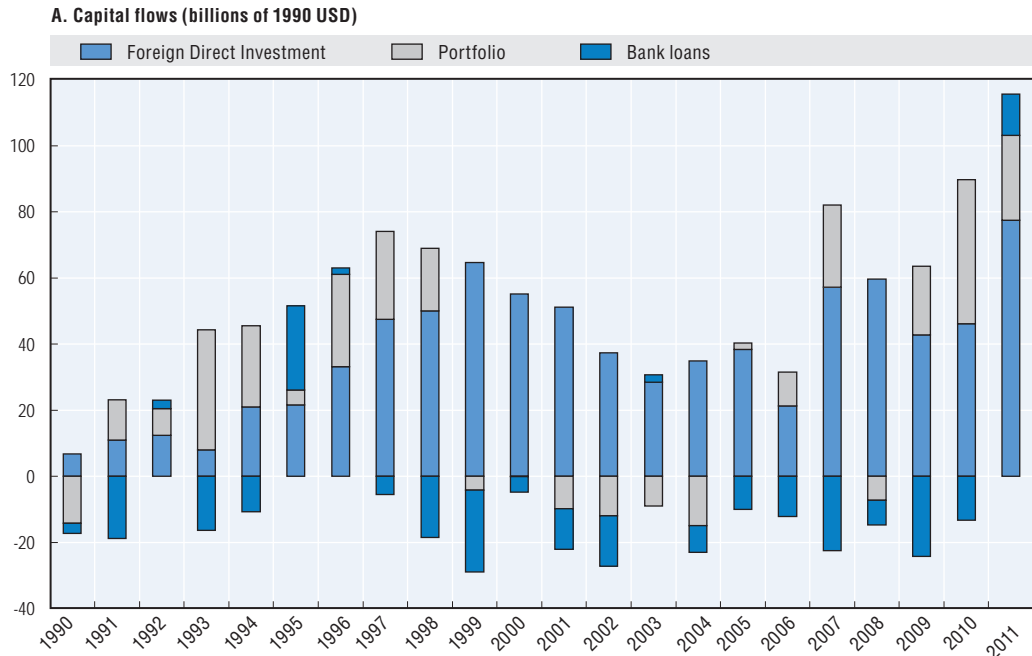
Note: a) In Figure B, which shows the real exchange rate, levels below 100 show appreciation, and levels above 100 show depreciation.

Source: Based on the IMF's IFS data and national sources, with data obtained in August 2012.

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It is important to track appreciations and their causes and potential effects on the economic structure, as well as better co-ordination of macroeconomic policy with production-development objectives. Although Dutch disease is not always easy to diagnose in an economy, potential competitiveness problems can be spotted through monitoring and a careful assessment of the economic situation. Medium-term competitiveness problems can be caused even by temporary fluctuations if they influence important decisions and investments. In several countries there is some implicit co-ordination among policies, but greater transparency can make these measures more effective.

Conclusions and recommendations

The economic context described in this chapter presents a mixed outlook for Latin American and Caribbean firms. The region is faced with uncertainty in the external environment, although some economies are more affected than others, especially those where the uncertainty is amplified by an appreciation in the real exchange rate of the national currency or exports that are increasingly concentrated in primary products. Because of these and other structural issues, Latin American firms, especially smaller firms, are immersed in an environment that poses major challenges to their development. Smaller firms play a vital role in economic growth, and how the fruits of economic growth are shared in the society. It is through these production units that the savings and investments of middle-income households are channelled, and those of poorer households too in the case of microenterprises, and they provide many jobs. If backed up by good policies, such firms can help expand production linkages and improve systemic competitiveness by driving up the productivity of the overall production system, making the most of the benefits of specialisation and the synergies and externalities generated by production clusters. Furthermore, SMEs are frequently a powerful vehicle for innovation and technological progress, which they then infuse into the production structure.

The challenge now is to balance short-term stabilisation measures by introducing monetary and fiscal policies that will prop up aggregate demand if low growth continues in developed countries and take structural measures to raise medium-term growth.

The biggest challenge for the region's macroeconomic policy in the current situation is to find the right balance for short-term stabilisation measures by introducing monetary and fiscal policies that will prop up aggregate demand if low growth continues in developed countries and take structural measures to raise medium-term growth. Governments in Latin America and the Caribbean need to find ways to combine demande policies and structural policies that help maintain macroeconomic stability and increase the region's productive capabilities. Given a less favourable international context, failure to do so would most likely steer the region towards the kind of growth levels and patterns it experienced in previous decades, with sluggish growth and a poor capacity to generate the necessary endogenous growth to transform the economic structure and foster a balanced distribution of income.

Notes

1. See IDB (2012) and IMF (2012).

2. For instance, Mexican oil revenue is worth close to 8% of GDP, the equivalent of almost 40% of total fiscal revenue.

3. Reinhart and Rogoff (2010); Kumar and Woo (2010).

4. Low yields could also be reflecting rising prices of risk-free assets, the supply of which has dropped significantly (primarily because AAA-rated assets, which are considered safe, such as secured mortgages in developed countries and the sovereign debts of several European countries, are no longer classified as risk-free).

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