

CHAPTER ONE

Macroeconomic overview

Abstract

Latin American economies weathered the 2008-09 financial crisis better than those in other regions of the world—including in OECD outside Latin America—and their recovery has also been faster. The main challenge for the region is to manage this favourable environment with prudence in order to rebuild fiscal space to face potential risks, such as disruptions in capital markets due to problems in the euro zone.

Greater ties with China—which were important for the recovery—mean the region's economies are now more sensitive to a potential slowdown in Chinese growth, in particular because of its potential impact on the prices of raw materials and consequently, the fiscal accounts of many of the region's economies. The present chapter argues that it is essential to rebuild the defences of macroeconomic policy and increase predictability in public finances in order to implement policies that enable more and better growth.

1.1. Introduction

Latin American economies weathered the 2008-09 financial crisis well, and their recovery has been faster than in other regions of the world, including OECD economies. The region is growing rapidly, although there are significant differences among countries. This macroeconomic stability is the background for any discussion of the transformation of the state for development for three reasons: first, because stability provides a favourable context for designing and implementing reforms; and second, because there are factors in the macroeconomic panorama that threaten the current stability if governments do not take appropriate measures to avoid them. But the most important connection between the macroeconomic panorama and the transformation of the state is that the current favourable conditions are at least in part due to good practices in fiscal and monetary policies. In many cases, these good macroeconomic practices may be institutionalised, as was the case with the establishment of independent central banks or fiscal rules in various countries of the region.

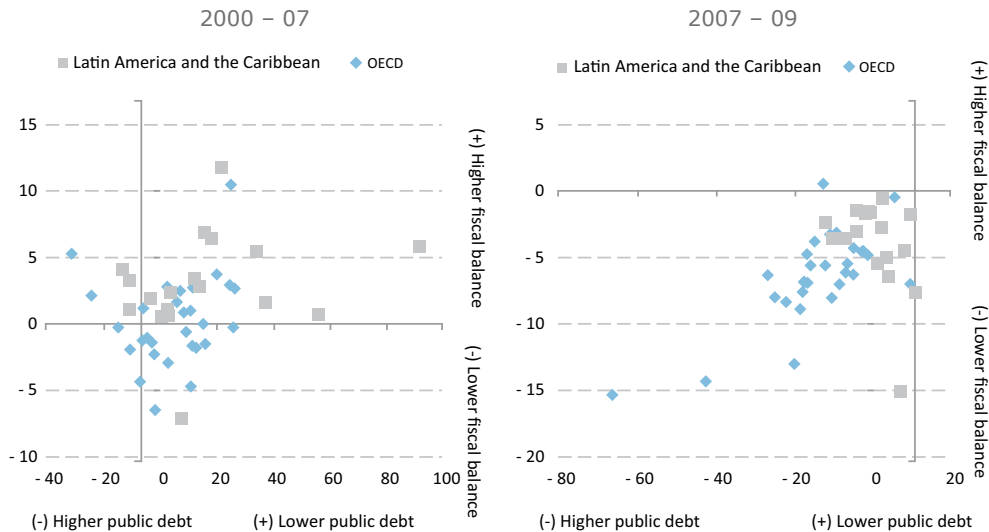
This chapter analyses recent macroeconomic performance. Latin America is expected to grow at 4.4% in 2011¹ thanks to strong domestic demand and the continuing robust demand in Asia for its exports (section 1.2). Nevertheless, this increase in demand puts pressure on the international prices for raw materials, which, among other factors, could lead to increased inflationary pressures. This scenario poses a challenge for the region's central banks, which have to contain rising inflation without accelerating capital inflows or sacrificing growth (section 1.3). In addition, increased capital inflows – in principle good news for the region's economies – also bring challenges in terms of exchange rate volatility, with consequences for countries' external competitiveness and the potential for unsustainable credit expansion (section 1.4).

Good macroeconomic policies during the period of strong growth from 2003 to 2008 led, in many cases, to the generation and expansion of policy space (Figure 1.1, left panel). In this way, monetary and especially fiscal policies were used in a counter-cyclical manner during the 2008-09 financial crisis, which help to avoid deep recessions and cushion the impact on society's most vulnerable sectors.

The main challenge for many economies in the region is to manage this favourable but volatile environment prudently in order to rebuild policy space and the ability for macroeconomic policy response. In addition, policies should aim to increase the stability and predictability of public finances so that gaps can be closed in infrastructure, education and innovation, which will permit more and better growth in the long term. This higher growth potential is necessary so that strong growth in domestic demand does not generate price instability. In the short term, the international economy continues to be the main source of potential shocks for Latin America. The current problems in the euro zone could cause serious problems in the international financial system, including emerging markets. Reversals of capital flows can lead to large fluctuations in exchange rates with disruptive effects on the real economy. The growing influence of China in Latin American trade relations was one of the factors that contributed to the rapid recovery of the region's economies. However, greater ties with China mean that the region's economies are now more sensitive to a potential slowdown in China's growth. A fall in demand for Latin American products and in the prices of raw materials would affect the fiscal accounts of many of the region's economies.

**Figure 1.1. Fiscal space before and after the crisis:
2000-07 and 2007-09**

(Variation in percentage points of GDP)



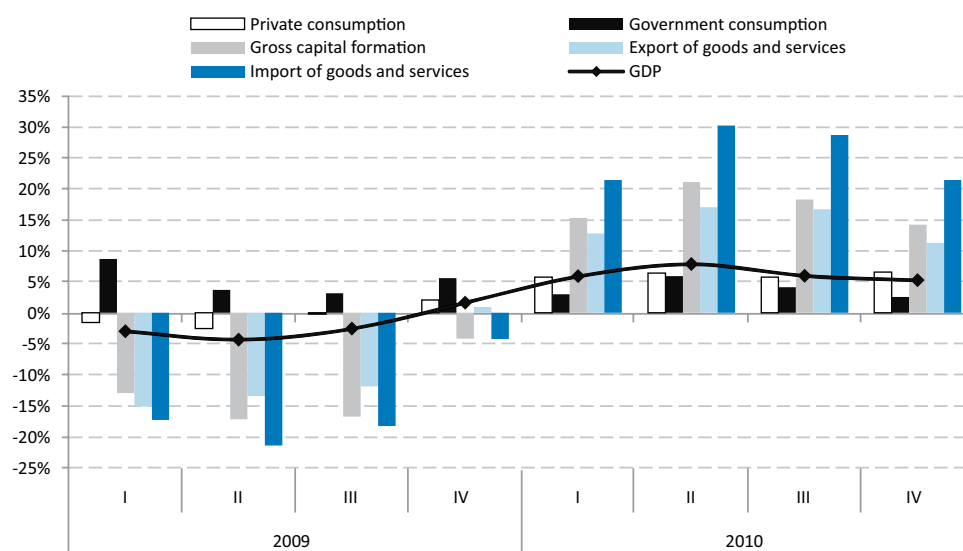
Note: each point represents one country. The panels include OECD countries and 19 countries from Latin America and the Caribbean.

Source: CEPALSTAT Statistics on public finances for Latin America and the Caribbean and OECD (2011) for the other countries.
<http://dx.doi.org/10.1787/888932522341>

1.2. From recovery to expansion

The recessionary effects of the international crisis on the region's economies in 2009 were only transitory. The economic growth seen in 2010 reflects the consolidation of the recovery that the majority of the region's economies began to experience in the second half of 2009. This recovery was accelerated by the impact of the counter-cyclical measures that many of the countries applied. The implementation of fiscal packages aimed at countering the effects of the international crisis was complemented by the rapid recovery of the international economy —led by the emerging economies— in the first half of 2010. As a consequence, levels of economic activity in general are now higher than before the crisis. During the first few months of 2011, economic activity for the majority of Latin American and Caribbean countries has remained buoyant, and ECLAC forecasts that growth in regional GDP in 2011 will approach 4.4%. South America will grow at a higher rate than Mexico and Central America, but the difference in performance between the two sub-regions is expected to decline in comparison with 2010.

Figure 1.2. Latin America (13 countries): variation rates of the components of expenditure in relation to the same figure in the trimester of the previous year, 2009-2010
(In percentages and USD at constant 2005 prices)



Note: The countries from Latin America covered are Argentina, Bolivia (Plur. State of), Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Paraguay, Peru, Dominican Republic, Uruguay, and Venezuela (Bol. Rep. of).

Source: Based on official figures.
<http://dx.doi.org/10.1787/888932522360>

The expansion of macroeconomic room for manoeuvre during 2003-08 in many countries of the region led to an unprecedented capacity for carrying out policies to combat the crisis. The strong macroeconomic showing of the majority of Latin American and Caribbean countries in the years leading up to the international crisis marked a significant difference from the usual financial difficulties faced by the region in difficult times. Between 2003 and 2008, these countries took advantage of the boom in the economy and in international finances, consolidating public accounts, increasing their international reserves and reducing and improving their debt profiles. The reduction observed in recent years of non-financial public-sector debt expressed as a percentage of GDP was the result of increased government revenue and economic growth, as well as changes in relative prices. In several countries, the composition of public debt changed significantly, with a higher prevalence of longer-term and fixed-interest debt and a larger share of debt held by residents and denominated in local currency.² All of this created more space for implementing counter-cyclical public policies, enabling unprecedented activism aimed at countering the negative effects of the deteriorating international scenario. It also made the initiation of the recovery in the second half of 2009 possible.³

A significant expansion of several components of GDP accounted for the high growth rate of the region in 2010 and enabled a balanced and strong recovery. The sustained dynamism of domestic demand, both from private consumption and from investment (Figure 1.2), was due to the relatively strong performance of labour markets, growth in real wages, the increase of credit to the private sector, as well as economic agents' improved expectations regarding the impact of the crisis. Low real interest rates also stimulated both consumption and investment. For countries with large volumes of remittances, their gradual recovery has also contributed to increasing levels of private consumption. Along with buoyant demand, rapid economic recovery was also facilitated by high levels of idle installed capacity, which made

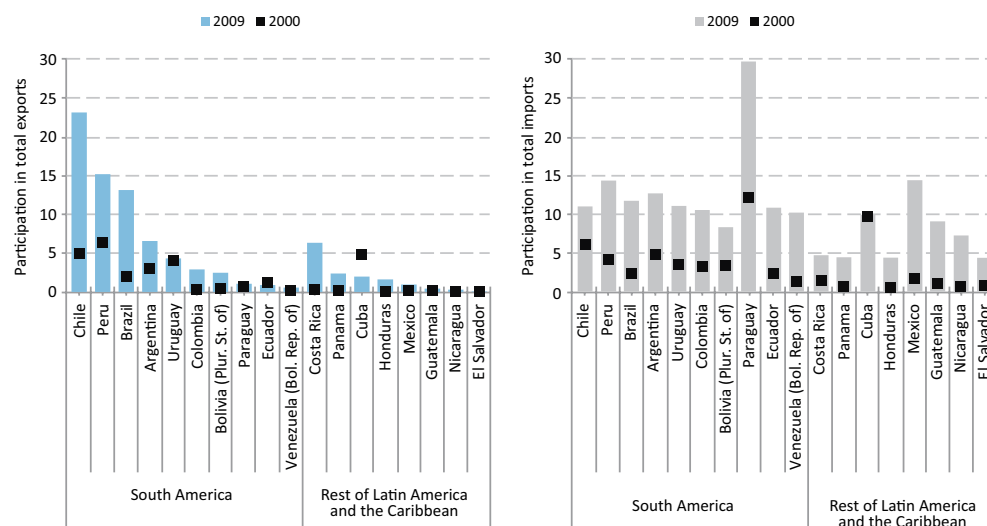
it possible to step up production levels quickly.⁴ Gross capital formation expanded to 12.9% in 2010 due to the increase in gross fixed capital investment (9.9%) and inventory restocking. The growth of fixed investment was primarily in machinery and equipment (mostly imported) and was driven by national currency appreciation, widely available credit and lower idle capacity amid burgeoning domestic demand.⁵ As a result, the rate of gross fixed investment, measured in constant dollars as a percentage of GDP, increased to 21.4%, above the 20.5% recorded in 2009 but below the 22.1% in 2008 and the maximum levels recorded in the 1970s.⁶

Strong domestic demand led to a significant upturn in the volume of imported goods and services (20.9%), in particular of consumer durables and capital goods. Given the behaviour of exports and imports of goods and services, the contribution of net exports to growth was negative in 2010. In fact, even though the value of exported goods is growing at high rates, in metal- and mineral-exporting countries (and in some hydrocarbon-exporting countries), this growth is mainly due to better export prices, rather than an increase in the volume of exports. For the region as a whole, the favourable external scenario led to an increase in the volume and prices of exports, although growth in imports was even greater, leading to a deterioration in the current account balance from -0.4% of GDP in 2009 to -1.2% in 2010.⁷

Increasing trade with China is another important factor to understand the recent dynamics of Latin American economies. The change in the world economy's centre of gravity towards the east and the south (above all China and India, but also other emerging economies) has led to a significant increase in trade with these countries.⁸ In the last decade, trade with China has increased substantially in South America. For example, its share in total exports increased in Brazil (from 2% to 13%), Chile (from 5% to 23%) and Peru (from 6% to 15%) during this period. However, China continues to represent a minor proportion of trade, accounting for less than 2% of total exports for most countries in Central America and Mexico, while it has become the leading market for exports from Brazil and Chile (up from 12th and 5th in 2000, respectively) and is now the second most important market for Argentina and Peru. At the same time, imports from China have increased considerably in all of the countries of the region (Figure 1.3). Various South American countries, such as the Plurinational State of Bolivia, Chile, Ecuador, Paraguay, Peru and the Bolivarian Republic of Venezuela, do not face much competition from China because of their high specialisation in raw materials. Brazil, Colombia, Argentina and Uruguay face more competition from China, but the economies most exposed are those of Central America and Mexico, as they have very similar export structures.⁹ The greater importance of emerging economies in trade relations—in particular China—is an important factor in explaining Latin American resilience during the crisis. It is also a factor in explaining differences within the region in regard to the pace of growth and policy space. This phenomenon, which has been developing since the end of the 1990s, manifests in a higher correlation between economic cycles in South America and China, while the correlation in cycles is lower for Central America and Mexico and has even been declining.¹⁰ Therefore, economies with greater commercial ties to China suffered less during the crisis and grew more.¹¹

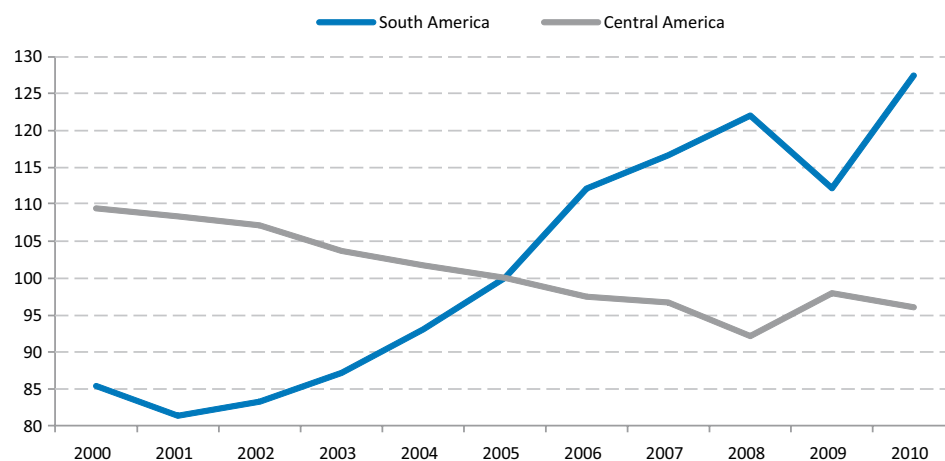
Trade relations with China also explain the differential evolution of the terms of trade in the region. The greater demand for primary goods tied to Chinese growth is reflected in an increase in the terms of trade in the majority of countries exporting these types of goods—mainly in South America. In the rest of the region, meanwhile, the terms of trade show a declining trend, given that these are oil-importing economies, and some countries, such as in Central America, do not produce commodities demanded by the emerging Asian economies (e.g. minerals and soybeans).¹² The terms of trade in South America have been on a growth path since the beginning of the past decade—interrupted only in 2009—and in 2010 reached 60% above the 2000 level, while for Central America we see the reverse trend (14% below the 2000 level) (Figure 1.4).

Figure 1.3. Latin America: China's shares of total exports and imports, by country 2000 and 2009
(In percentage of total exports and imports by country)



Source: Based on the United Nations Commodity Trade Statistics Database (COMTRADE). <http://dx.doi.org/10.1787/888932522379>

Figure 1.4. South America and Central America: terms of trade indices, 2000-2010
(Year 2005 = 100)



Note: The countries covered from South America and Central America are Argentina, Bolivia (Plur. State of), Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, Venezuela (Bol. Rep. of) and Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama, respectively.

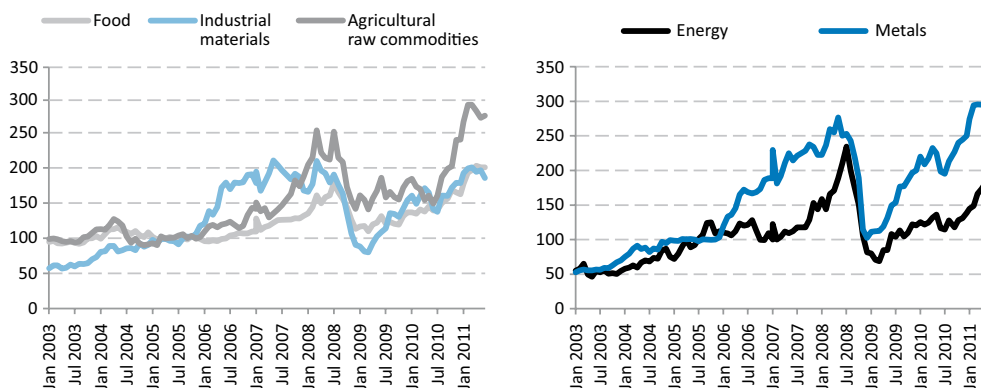
Source: Based on official figures. <http://dx.doi.org/10.1787/888932522398>

The new opportunities that open up with the trade dynamism of China and other emerging Asian economies also bring new challenges in terms of inflation and external vulnerability. Increases in food and fuel prices often affect the most vulnerable, particularly in urban areas of Central American and Caribbean countries that are not exporters of these goods. In addition, they create inflationary pressures and can have effects on general price levels if they translate into wage increases in a context of strong growth in domestic demand. Finally, economies that now trade more with China are more exposed to the cycles and shocks of its economy. Although it is expected that the Chinese economy will continue to be an important engine for world growth, a slowdown in Chinese growth could potentially have significant effects on the prices and volume of exports, as well as on public finances.

1.3. Inflationary pressures and price increases of primary products and fuels

Since the second half of 2010 and during the first two quarters of 2011, international prices for primary products have rebounded, while the inflation rate has begun to increase in most of the region's countries. The prices for various commodities have now gone beyond the levels reached during the 2008 crisis (Figure 1.5).¹³ One of the most important structural factors is the strong growth of China and India. The process of urbanisation and industrialisation in these countries has led to enormous demands for raw materials and fuel, as has the emergence of a middle class with considerable purchasing power and a shift towards a more Western diet.¹⁴ The increase in consumer prices went from an average 4.7% in 2009 to 6.5% in 2010, above all due to the increase in international prices for food and fuel. To this must be added the end of subsidies on certain food items and on fuel prices, particularly in Central America and Mexico. The rise in consumer price indices has been greater in Latin American countries with lower incomes, as the proportion of food in overall consumption is higher, even when the appreciation of national currencies observed in most countries in the region has mitigated the impact of the increase in prices of imported products on domestic prices.

Figure 1.5. Monthly evolution of primary international commodity prices, during the period January 2003-August 2011
(In current US dollars)



Note: Corresponds to the S&P aggregate GSCI index.

Source: Thomson Reuters Datastream.
<http://dx.doi.org/10.1787/888932522417>

In recent years, commodity price volatility has increased significantly. In fact, 2008 was the year with the greatest volatility since the first half of the 1970s. Volatility is affected by temporary factors impacting in the short term, such as supply shocks (for example, a poor harvest in an important producing country), variations in the effective exchange rates of the dollar and expectations in financial markets. Therefore, the forces that can lead to an increase in the volatility of agricultural markets are of at least two types: those factors that make supply and demand of these products less elastic, and those that increase the frequency and intensity of shocks. According to several studies, integration with other markets seems to be one of the main sources of increased volatility in the agricultural sector. These studies address not only integration in physical markets, such as the fuels market, or between different types of agricultural products, but above all, the closer links between commodities markets (among them, agricultural products) and financial markets.¹⁵

The impact of rises in food and energy prices is not the same in all countries. Apart from having a greater impact on lower income groups, these price increases create greater challenges for those countries with a high dependence on food imports. For example, in most Caribbean and Central American countries, food imports represent more than the equivalent of 5% of GDP, in comparison to an average of 4.3% for Latin America overall. Other Central American countries also have a relatively high dependence on food imports, with percentages varying between 2% and 5% of GDP. Mexico and South America have a lower dependence, which is the counterpart to the improvement in their terms of trade.¹⁶

Do these increases in consumer price indices warrant a response in monetary policy? The answer depends on whether inflationary pressures are more widespread than the increase of volatile components such as food and fuel. In this respect, there are differences across the region, even among countries that follow inflation-targeting policies. For example, core inflation —a measure that excludes the more volatile prices of food, drinks and transport (energy goods)— was negative in Chile and decreasing in Mexico during the first half of 2011. In Brazil, Colombia and Peru both the variation in price indices and core inflation show a rising trend. Therefore, there are indications in these economies that inflationary pressures are more intensive than the pressures generated by *commodity* prices. In these cases, especially when core inflation is near or above the upper limit of inflation targets, a more contractionary monetary policy can be effective, as in fact was observed during the second quarter of 2011.¹⁷

Beginning in the first quarter of 2010, as economic recovery was consolidating, some countries in the region began to implement a tighter monetary policy due to increased concern over inflation trends. Four of the countries with inflation targets —Brazil, Colombia, Chile and Peru— raised their monetary policy rates, a move that was joined by other countries such as the Dominican Republic and Uruguay, which also raised their reference rates. However, despite these increases, reference rates are still below 2008 levels, before the financial crisis spread to the region. Other countries in the region that have continued to focus on promoting economic growth have not increased their rates (such as Mexico) and have even tended towards a more expansionary monetary policy (Argentina and Costa Rica).

Actions taken by monetary policy makers seem designed to prevent increases in food and energy prices from producing changes in general price levels that could worsen inflationary expectations in the region. External pressures on the dynamics of inflation in the region, caused by rising food and energy prices, pose a new dilemma for policy makers. It is therefore necessary to balance the objectives of sustaining domestic economic recovery with avoiding monetary-financial conditions that might encourage a resurgence of inflationary expectations and the generation of bubbles in the price of domestic assets, particularly in a context of high international liquidity.

In this regard, the challenge for fiscal and monetary policy makers is three-fold: *i)* to determine to what extent external inflationary shock should be “accommodated”, while managing aggregate demand (and reducing economic momentum); *ii)* to

design fiscal and monetary policies that will minimise the economic cost of containing inflation and more importantly will not sharpen the risks associated with strong capital inflows and, consequently, associated with upward pressure on domestic currencies; and *iii*) adopt policies to reduce the social consequences from inflation as well as stabilisation policies.

1.4. Capital inflows: challenges to stability

Improved macroeconomic fundamentals in Latin America coupled with high liquidity and uncertainty in the capital markets of developed countries and historically low interest rates have led to large capital flows into several countries in the region. Although capital inflows, depending on their characteristics, may in principle represent greater opportunities for increasing investment rates and economic growth, the region's experience and emerging markets in general during the 1990s reveals that the volatility of these flows can generate severe macroeconomic problems and financial disruptions. Despite evidence that international investors today differentiate more among the countries of the region based on their fundamentals than they did in the past, the high synchronisation of flows towards emerging markets demonstrates the importance of global factors.¹⁸

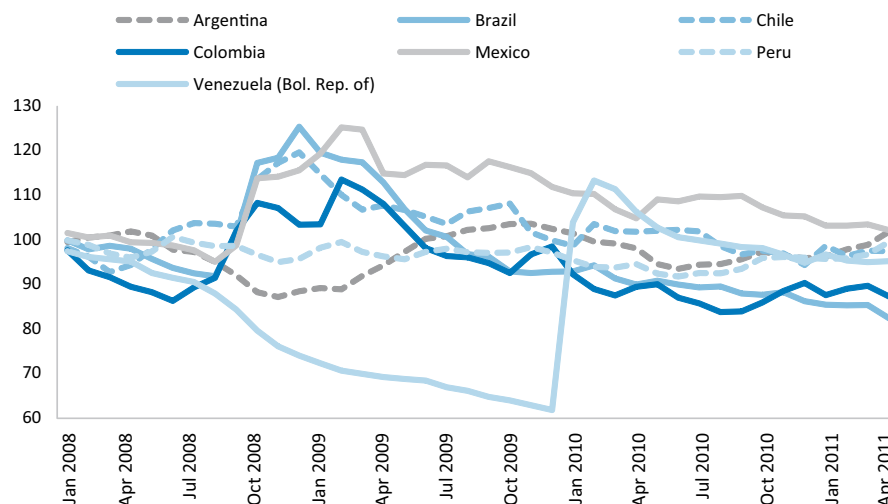
These capital inflows, as well as the increase in prices for basic products, contributed to the appreciation of nominal and real exchange rates in the region. This appreciation had a particularly marked impact on the currencies of countries with inflation-targeting schemes and flexible exchange rates. As a result, 11 countries recorded nominal currency appreciations during the first 10 months of 2010 in comparison with the same period in 2009, notably the Brazilian real (13.6%), the Colombian peso (13.2%), the Uruguayan peso (13.1%), the Chilean peso (9.4%) and the Costa Rican colón (8%). In contrast, only five countries recorded a nominal depreciation of their currencies, Argentina and the Bolivarian Republic of Venezuela standing out in this regard. In real terms the situations are diverse. On the one hand, the currencies of Brazil and Colombia have appreciated with respect to the average exchange rate for the 2000s (38% and 24% respectively), while the currencies of Chile and the Bolivarian Republic of Venezuela also seem to have appreciated slightly over the same period (around 10%).¹⁹ On the other hand, the currencies of Peru and Mexico seem to be near their historical average, while Argentina's has slightly depreciated (15% above the average for the 2000s) (Figure 1.6).²⁰

Volatility and excessive appreciations of real exchange rates —above that explained by changes in fundamentals— can reduce competitiveness in the tradable sector of the economy or in tradable activities that do not benefit from increases in export prices. Short-term fluctuations in real exchange rates can have permanent negative effects on economic growth, in particular when firms face credit constraints warranting policy intervention to curb their effects.²¹ Exchange rate appreciations can even nullify the effort in various countries to stimulate innovation, create new productive activities and diversify the economic structure.

Policy makers have adopted a series of measures to try to reduce the volatility of nominal exchange rates and reduce possible exposure to capital flow reversal. Among the measures to reduce capital-flow volatility and the consequent instability of nominal exchange rates are those that discourage short-term capital inflows as well as an increase in foreign exchange assets held by the public sector and certain private financial entities.

Measures to deal with capital inflows can be classified according to whether public authorities try to absorb additional flows or reduce their volume through capital controls.²² Several countries have accumulated significant quantities of international reserves by intervening in foreign exchange markets, including Argentina, Brazil, Colombia, Costa Rica, Guatemala, Mexico and Peru. In addition, countries such as

Figure 1.6. Indices of real effective exchange rates for 7 Latin American countries, January 2008-March 2011
(December 2007 = 100)



Source: Based on official figures.
<http://dx.doi.org/10.1787/888932522436>

the Plurinational State of Bolivia, Paraguay and Peru have high levels of reserves as a percentage of GDP (near or above 25%) in comparison to other countries in the region. Some countries have adopted a series of measures directly aimed at reducing capital inflows or increasing capital outflows. For example, Chile has gradually increased foreign investment caps for the country's pension funds, announcing in November 2010 that it would permit up to 80% of these funds to be invested abroad. Peru has adopted similar measures and in September 2010 it announced that it would allow the investment of up to 30% of the funds administered by pension fund managers to be invested abroad. For its part, Brazil increased its financial transactions tax on foreign investment in fixed-rate banking instruments, first to 4% and then, in October 2010, to 6%, while raising the tax on margin deposits in futures markets from 0.38% to 6% and leaving unchanged the 2% tax rate on equity investments. However, other administrative measures were introduced to increase the effectiveness of the tax in terms of curbing speculative capital inflows (see Box 1.1). Argentina, Colombia and Peru have maintained or introduced similar measures, while another instrument has been to increase unremunerated reserve requirements (Argentina, Brazil, Colombia and Peru).²³

The accumulation of international reserves strengthens the future capacity to cope with sharp drops in terms of trade or a "sudden stop" in capital flows and reduces exchange rate volatility. However, it also increases the challenges for monetary policy in the region. If the region's central banks intervene in the market without sterilising the injections of national currency, they increase the risk of affecting the inflationary expectations of the public. But if they intervene in the market sterilising these interventions (totally or partially), there is the resulting quasi-fiscal cost and risk of damage to their own balance sheet.

Box 1.1. Capital controls as part of the macroeconomic tool kit

“Not only are capital controls ineffective, but in addition they raise domestic interest rates.”

This type of internally inconsistent comments is not unusual when discussing capital controls—a subject marked with strong beliefs and weak data. To gain some perspective we must organise our analysis around two basic questions: *i)* Are they effective (i.e. do they affect the market in the desired direction)?, and if so, *ii)* are they efficient instruments (in other words, do the benefits outweigh the costs)? This box begins with the basics, analysing the first question in light of experience with controls on capital inflows through taxation.

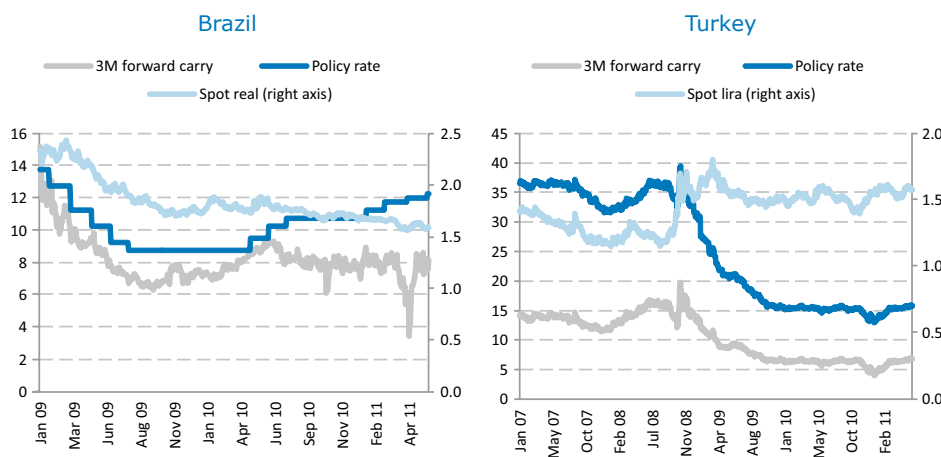
These controls, traditionally associated with unremunerated reserve requirements (URRs) on capital inflows imposed in Chile and Colombia during the 1990s, are basically a variation of the Tobin tax on international capital flows. In fact, Chilean authorities at the time offered the option of a tax equivalent to the URRs to those investors who preferred to pay upfront and maintain their liquidity.

The standard argument of the sceptics was that these controls failed to stop capital inflows and currency appreciation. However, this appreciation seems to be biased, since we do not know what the inflows and appreciation would have been if there were no controls. Yet, there are ways to quantify what capital controls aim to introduce in the first place.

The simplest and most natural way to measure the effect of capital controls is through deviations from covered interest parity, in other words, the differential between the difference in interest rates and the *forward* discount (or the “carry” in local currency that international investors receive).^a A study for the Chilean case shows that this difference oscillated between 2% and 3% during the period of controls, close to the value of the equivalent Tobin tax.^b A similar exercise for the most recent case of the Brazilian financial transactions tax (*Imposto sobre Operações Financeiras*, IOF) leads to the same conclusions: a 6% tax on capital inflows creates a 6% gap between the differential in interest rates (the difference between the Selic rate [the Brazilian reference rate] and the short-term rate on US *treasuries* that are near zero) and the *carry* of the Brazilian currency, the real (Figure 1.7, left panel). Similar behaviour is also found in the cases of the Turkish lira (Figure 1.7, right panel) and the Israeli shekel.

Figure 1.7. Effects of capital controls in Brazil and Turkey

(Interest rates in annual percentage and exchange rates in national currency per dollar)



Source: Prepared on the basis of data from Thomson Datastream.

<http://dx.doi.org/10.1787/888932522455>

Capital controls are also effective, as they impose a toll on traffic in and out of domestic markets. Their effectiveness depends on the cost of the toll (and the volume of traffic). For example, a 2% tax will not obtain much more than a 2% cut in the value of local assets (including the local currency); a 10% tax will obtain a proportionally (but probably not linearly) stronger effect; meanwhile, a 2% tax opened to future adjustments (as recently seen in Brazil) should have an effect somewhere in between, as it affects the expectations of short-term speculative investors.

Summing up, capital controls are not irrelevant, as their opponents argue, nor are they as influential as their defenders say. Rather, they are an additional element in the toolkit of macroeconomic counter-cyclical policies that should complement monetary, fiscal and exchange-rate policy and prudential regulation.

Source: Produced by Eduardo Levy Yeyati.

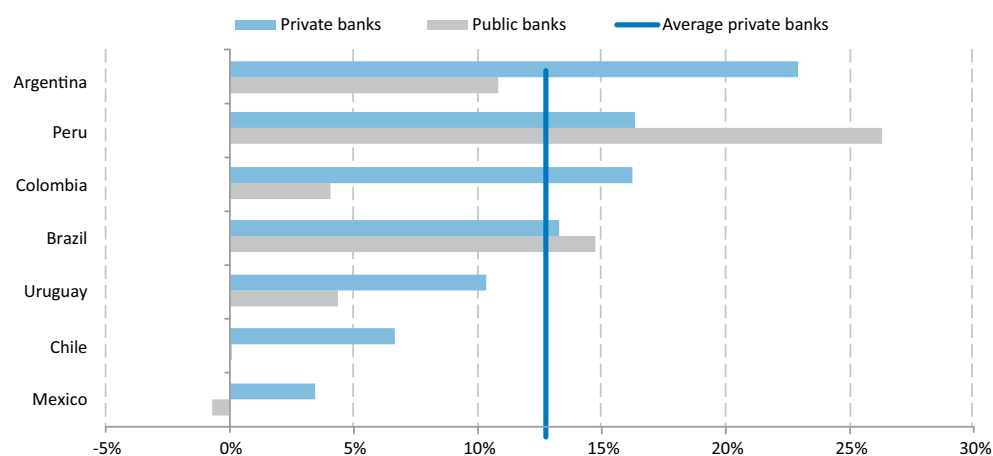
^a From a technical perspective, the covered parity implies that the *carry* for currencies (alternatively, the future discount) must be equal to the rate differential plus transaction costs, which include taxes on international capital flows.

^b De Gregorio *et al.* (2000).

For many countries in the region, a major challenge for current economic policy is to maintain financial stability if the increased availability of funds feeds a boom in bank lending or potential bubbles in certain asset markets. In this regard, stock prices in several local exchanges have shown a strong performance since early 2009.

Given the rapid expansion of credit, rising profits in the financial sector in some countries (such as Brazil), and the upward pressure on currencies in the region, it would be prudent for the authorities to adopt measures to slow credit growth (Figure 1.8). These measures could include, for instance, raising reserve requirements, bank capital requirements, or both, such as those implemented by Peru starting in June 2010. Peru raised the minimum legal reserve to 9%, increased the minimum demand-deposit requirements for banks, raised the marginal reserve requirement in soles and in foreign currency, and increased the reserve requirements for deposits of non-resident financial entities (up to 120%).

Figure 1.8. Real credit growth in seven Latin American countries, 2010
(Percentage rates)



Source: Based on official figures.
<http://dx.doi.org/10.1787/888932522474>

1.5. Challenges for macroeconomic policy

A greater effort to understand the structural situation, eliminating the transitory effects of the business cycle and other associated factors, can help guide policy decisions. Many indicators, such as fiscal balances, debt-to-GDP ratios and credit ratings, tend to be very pro-cyclical as they are influenced by economic growth, commodity prices and real exchange rates.²⁴ It is therefore important not to give excessive weight to the “success” of purely domestic factors and to maintain a prudent perspective on the duration of the favourable context, which allows rebuilding policy space.

In designing fiscal stabilisation policies in Latin America it is necessary to differentiate between normal shocks, which induce stationary fluctuations around a trend, and extraordinary shocks, which are long-lasting and may have irreversible effects. One obstacle to designing fiscal measures for exceptional events is that measures for dealing with non-stationary shocks, and due to the weakness of automatic stabilisers in the region, must have a significant degree of discretionality. In the case of a non-stationary event, it is impossible to know beforehand precisely how the trend will evolve —much less how the economic structure and its forms of governance may change as a result of the shock.²⁵ Thus, it is important to distinguish between strictly counter-cyclical policies and macroeconomic adjustment policies. The former aim to counter temporary shifts away from the current trend; the latter manage the consequences of permanent shocks through changes in rules. The objective may be to structurally reduce excessive volatility, or (in the case of multiple equilibriums) to co-ordinate decisions in order to put the economy in an equilibrium that is considered superior to another.²⁶ For commodity export economies, similar arguments also apply to the fluctuations in prices of international exports.

The recent international financial crisis has revealed the importance of fiscal policy as a tool for macroeconomic stabilisation. Most countries, including those that recorded positive rates of growth in 2009, have tried to combat the recession with larger fiscal deficits; this has in part been generated by automatic stabilisers, but primarily through the application of discretionary measures due to the weakness of the former in the region. This has allowed for a growing consensus on the legitimacy of applying transitory fiscal deficits as tools for macroeconomic stabilisation in periods of sharp decline in demand. Once the emergency is over, the strategies to exit the crisis must include goals for sustainable public debt that are consistent with the public investment and social policies required to accelerate progress towards sustainable development.²⁷

Clear counter-cyclical fiscal rules can help to reduce aggregate volatility and expand the tax base to increase spending and social investment needed to reduce inequality in the region. It is important not to reduce fiscal policy to mere quantitative control over public accounts (public debt, spending and deficit) so that the impact of public finances on crucial development objectives is not forgotten. The links between quantitative and qualitative aspects of fiscal policy must also be incorporated in the quality of public finances with the aim of ensuring the effective and efficient use of public resources.²⁸

The credibility of fiscal policy must be reaffirmed, given the region’s vulnerability of public finances to the economic and social situation and its institutional and political limitations. A tendency towards excessive discretionality must be avoided, and a limited and responsible discretionality encouraged. Nevertheless, recent experiences show that when rules are rigid and not adjusted to the economic cycle, they often end up being difficult to implement and therefore have little credibility. A recommended guiding principle on fiscal policy is the use of the structural balance indicator to complement effective balances. A temporary co-existence between fiscal deficits and macroeconomic stabilisation is part of a medium-term strategy that takes into account the performance of social indicators and productive development,

giving more weight to goals related to structural balance than to current effective balance. In addition, reality has shown that there are exceptional circumstances in which active discretionary policies are justified. The goal of any macro-fiscal rule must be to achieve structural balance (or balance in public debt) in the medium-term (sub-national governments included); it must also contain escape clauses and transition periods for significant macroeconomic fluctuations. Although fiscal rules do not assure per se fiscal credibility and solvency, if they have enough credibility and are part of a country's fiscal architecture, they can become powerful counter-cyclical tools. For this to happen, it is important to develop mechanisms that institutionalise counter-cyclical fiscal policies in the face of excessive fiscal discretion during periods of prosperity.²⁹

Funds aimed at stabilising tax revenues generated from the export of natural resources, whose prices are characterised by instability, are part of the fiscal stabilisation framework. When well-run, these funds can help stabilise recurrent expenditures, add financing in critical situations, and regulate the supply of foreign exchange. In turn, the smooth operation of stabilisation funds requires full co-ordination between fiscal and exchange-rate authorities. Its absence could be an obstacle to the match between the macroeconomic environment and achieving sustained development, causing imbalances between different objectives, such as inflation, employment, export quality and growth.

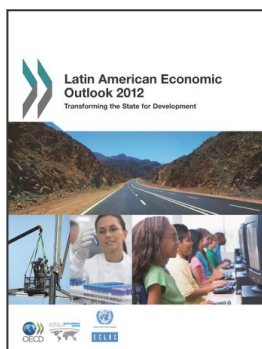
Despite its heterogeneous situation, this is a period of opportunity for more and better growth in Latin America and the Caribbean, but co-ordinated policies on various fronts are necessary in order to achieve this; among these, macroeconomic policy stands out. The history of Latin America shows that there has been a close relationship between the direction of macroeconomic policy and the region's volatile, poor development, its limited productive investment and low productivity growth. A macroeconomy at the service of development focuses on fiscal, monetary and exchange-rate policies and capital markets. There must be co-ordinated management of all these areas of economic policy if the macroeconomic environment is to stimulate capital formation, innovation and the creation of quality jobs.

Notes

1. ECLAC (2011).
2. Kacef (2009) and OECD (2008).
3. ECLAC, (2010a) and OECD (2009).
4. ECLAC (2010b).
5. With the exception of the Bolivarian Republic of Venezuela (where a fall was recorded), El Salvador and Colombia, the value of capital goods imports increased by two digits in the countries of the region, with the highest increases in Argentina, Chile, Ecuador, Guatemala, Honduras and Paraguay.
6. Regarding the composition by institutional sector, the evidence available for the countries that provide quarterly information (Mexico, Peru and Uruguay) indicates that during 2010, private investment was the component that exhibited the greatest expansion in comparison with 2009.
7. ECLAC (2011).
8. OECD (2010).
9. Blásquez *et al.* (2006).
10. Lederman, Olarreaga and Perry (2007).
11. The simple correlation coefficient between real GDP growth in 2007 and 2010 and China's contribution to the total trade of each country is 0.61,.
12. OECD (2010).
13. The ranges of price changes vary considerably depending on the type of product, but four situations can be identified: *i*) sustained increases in the case of tropical products (sugar, bananas and coffee) and non-food raw materials (cotton and rubber); *ii*) beginning in the second half of 2008, a stabilisation of prices in a range of 50%-100% above the average for 2000-05 for edible oils and soybean complex products; *iii*) an increase below 25% in the case of meat products; *iv*) wide variation for cereals and fertilisers (see ECLAC, FAO and IICA, 2010 and OECD 2011).
14. OECD (2010).
15. ECLAC, FAO and IICA (2010)
16. Jiménez, Jiménez and Kacef (2008).
17. However, uncertainty in the global economy and indications of a slowdown in domestic and external demand at the beginning of the second semester of 2011 has lead most central banks in the region to move towards a more neutral or easing stance.
18. OECD (2011).
19. Other countries in the region that find their currencies appreciated with respect to the average for the first decade of the 2000s are Costa Rica, Guatemala, Paraguay and Uruguay.
20. ECLAC (2011).
21. Caballero and Lorenzoni (2007).
22. Cárdenas and Levy Yeyati (2011).
23. Although instruments for capital controls exist in Chile, they are not currently being used.
24. Reisen and von Maltzen (1999).
25. Daude and Roitman (2011).
26. Fanelli and Jiménez (2009).
27. Carranza, Daude and Melguizo (2011).
28. ILPES (2011).
29. ECLAC (2010c).

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