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This *Regional Economic Outlook* was written by Benedict Clements, Roberto Benelli, Christopher Faircloth, Jorge Roldós, and Jeromin Zettelmeyer, under the direction of Caroline Atkinson and Anoop Singh, with contributions from Lisandro Abrego, Max Alier, Trevor Alleyne, Rodolphe Blavy, Marcello Estevão, Roberto García-Saltos, Alejandro López-Mejía, Evridiki Tsounta, and James Walsh, and support from economists in the IMF's Western Hemisphere, Monetary and Capital Markets, and Research Departments. Thomas Duffy, Angelo Alexander, Takahiro Atsuta, Priyadarshani Joshi, and Joy Villacorte provided research and production assistance.

Executive Summary

In the context of a still broadly favorable global environment, the economic outlook for the Western Hemisphere remains strong. Despite tighter monetary conditions, global growth is expected to be around 5 percent in 2006 and 2007, as a deceleration of growth in the United States to about 2½ percent in 2007 is offset by higher growth in the euro area and Japan, and continued high growth in emerging Asia. The Latin America and the Caribbean (LAC) region is expected to grow by 4¾ percent in 2006—making the ongoing expansion the most vigorous for some decades—and by about 4¼ percent in 2007. Domestic demand in the LAC region is buoyant, driven both by higher public spending, and private consumption and investment. Inflation has generally remained subdued and is expected to decline moderately further, to a regional average of about 5 percent in 2007.

However, there are clear downside risks to the outlook. They include: a possibly sharper slowdown in U.S. growth; unexpected tightening of global financial markets; commodity price volatility, particularly sharply lower nonoil commodity prices; and trade pressures following the erosion of preferential access in the Caribbean and lack of progress on agreements to liberalize trade further.

This expansion compares favorably to previous upswings in Latin America. External current accounts and primary fiscal balances are in surplus, exchange rates are more flexible, inflation is much lower, and the structure of public debt is safer, with lower shares of short-term and foreign currency debt in most large countries. However, some vulnerabilities remain. Public debt is still relatively high. Budgets are generally rigid in the sense that a large proportion of expenditures is mandatory and a large share of revenues is earmarked. Government spending has recently accelerated, even in countries in which surpluses are being driven by cyclical or temporary factors, and despite the vigorous momentum of aggregate demand. Public revenue remains low in some countries, particularly in light of social needs. And, while not yet a source of concern in most countries, high real credit growth requires close monitoring.

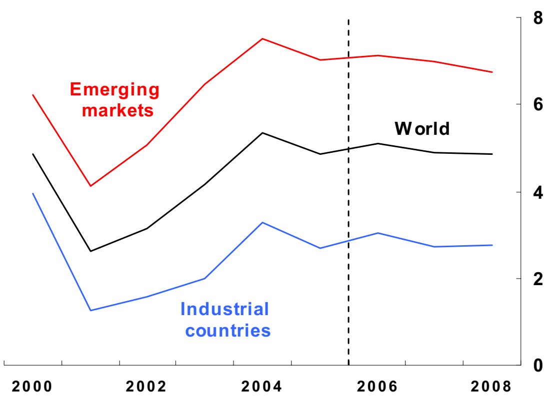
To entrench macroeconomic stability, raise growth, and help countries move toward investment grade ratings, country reform agendas will need to confront these vulnerabilities, and to address the longstanding causes of crises in the region, including high inequality. Both greater equity and stability will improve the prospects for sustaining the current expansion. Making societies more equitable is inherently a slow and difficult process. Nonetheless, policy levers exist that could be used more, including fiscal reforms encompassing both the tax system and public expenditures; labor market policies; and other reforms that extend public services and economic opportunity to disenfranchised groups. Matching such reforms with greater efforts to make Latin American economies more open and competitive, with stronger institutions, will lead to more vibrant and successful economies. Achieving lasting improvements in these areas will require building constituencies that support reform, raising the level of human capital in the region, and enhancing the quality of policymaking.

I. The Global Economy and Outlook for the United States and Canada

A. The Global Context

Global economic growth remains robust. First-quarter growth was especially strong in the United States, but has slowed since. The expansion has gathered momentum in the euro area, notwithstanding a slow start in Germany, and the Japanese economy continues to expand. China's growth remains rapid, with output expanding at an annual rate of more than 10 percent in the first half of 2006. Emerging Asia and Europe are also growing rapidly.

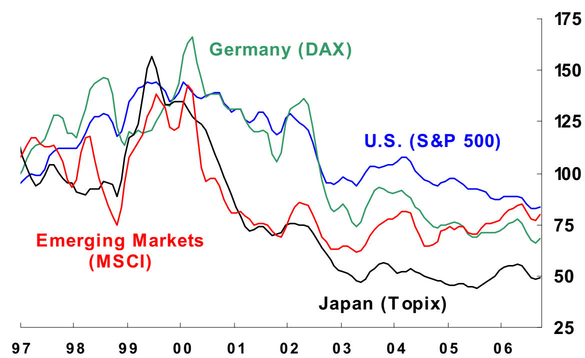
Global Outlook
(Real GDP; annual % change)



Source: WEO.

Although monetary conditions tightened in the first half of the year, conditions for growth mostly remain favorable, and the global economy is projected to expand by about 5 percent in 2006 and 2007. Robust growth in the first half of the year and higher commodity prices led key central banks to tighten monetary conditions, which has generally kept inflation subdued. Financial markets, however, have shown a heightened sensitivity to incipient global inflationary pressures, as evidenced by turbulence in both mature and emerging markets during May and June. In response to sell-offs in the United States and other mature markets, equity markets in Argentina, Brazil, Colombia, Hungary, Mexico, Russia, and Turkey experienced sharp declines. But these followed considerable increases, and markets have since regained strength. Moreover, sovereign spreads remain near historical lows, and the May-June turbulence did not appear to reflect a fundamental reassessment of prospects for emerging markets.

Global Equities: Price-to-Earnings Ratios
(3-month moving average) 1/



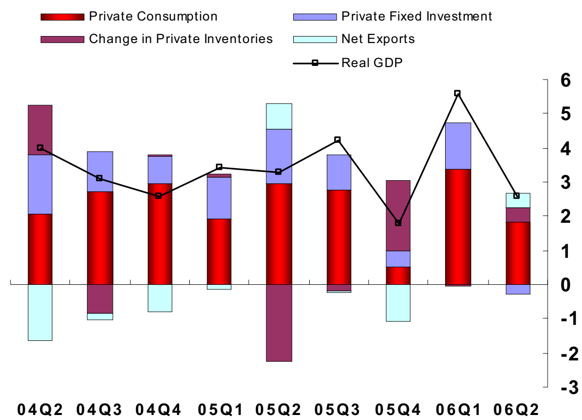
Sources: Thomson Financial I/B/E/S; and IMF staff estimates.
1/ 12-month forward earnings; period average (January 1990 - September 2006) = 100.

B. The Outlook for the United States and Canada

The United States remains a major engine of global growth, although growth is now expected to slow somewhat below potential. Following extremely strong growth of 5¼ percent in the first quarter (annualized, quarter on quarter), the pace of expansion in the United States fell back to 2½ percent in the second quarter. On an annual basis, growth is expected to decelerate from about 3½ percent in 2006 to around 2½ percent in 2007, as a cooling of the housing market slows residential investment and consumption spending. Business investment is likely to remain solid, especially in light of the recent decline in oil prices, strong profits, and low long-term interest rates. The risks to this forecast are mainly to the downside, particularly if there is a faster-than-expected weakening of housing activity in the next months. The external deficit is forecast to remain close to current levels, although weaker-than-expected activity could lower imports. Price pressures are expected to be contained, reflecting sustained productivity growth and some weakness in oil prices.

Performance on the fiscal front has been better than

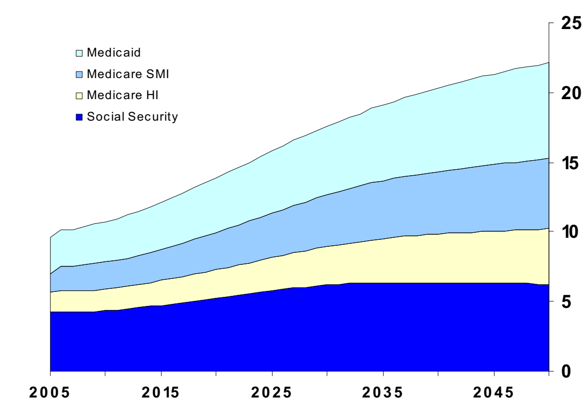
U.S. Real GDP Growth and Contributions
(Annualized quarterly contributions to growth; percent)



Source: Haver Analytics.

expected and the U.S. administration's goal of halving the deficit is ahead of schedule. Due to a surge in tax revenues and success in containing nondefense discretionary spending, the federal deficit fell to just under 2 percent of GDP in FY

Federal Government Expenditure
(% of GDP)

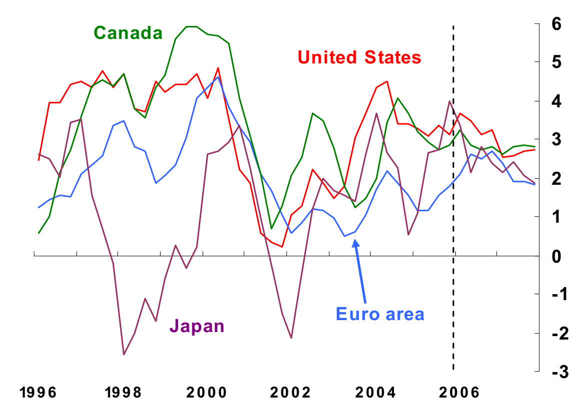


Source: IMF Country Report No. 06/279.

2005. However, longer-run sustainability remains a key challenge. Addressing it will require entitlement reform combined with medium-term deficit reduction to achieve broad federal budget balance (excluding the Social Security surplus). With greater exchange rate flexibility and supporting reforms in partner countries, such deficit reduction would also help reduce global imbalances and mitigate the risk of their disorderly resolution.

The Canadian economy continues to grow closely in line with capacity. The economy is projected to expand by about 3 percent in both 2006 and 2007—although outcomes will be closely linked with those in the United States. Economic growth has been boosted by high commodity prices, private consumption growth and, as in the United States, healthy corporate profits and business investment, which have offset the drag of a strong currency. Notwithstanding a relatively tight labor market, inflation is expected to remain well-anchored within the context of the inflation-targeting regime and fiscal surpluses, which have kept the debt/GDP ratio on a downward trajectory.

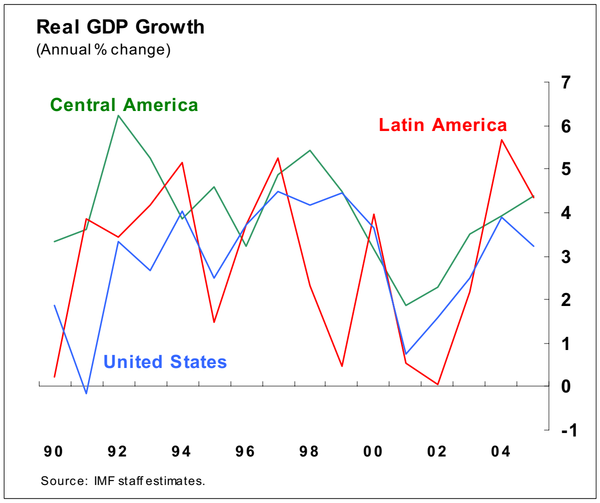
Industrial Countries
(Real GDP, % change from four quarters earlier)



Source: IMF staff estimates.

C. Global Challenges

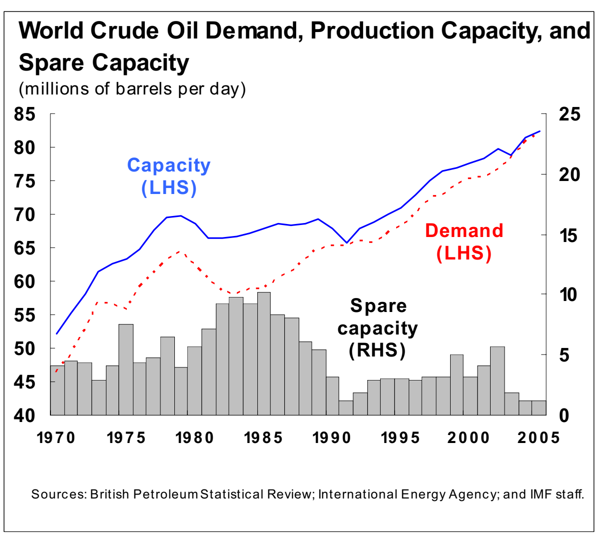
While the most likely near-term scenario for the global economy continues to be robust growth, the balance of risks is increasingly slanted to the downside. In addition to risks related to the cooling of the U.S. economy—which would especially affect Latin America—the global economy confronts a



Real GDP Growth
(Annual % change)
Source: IMF staff estimates.

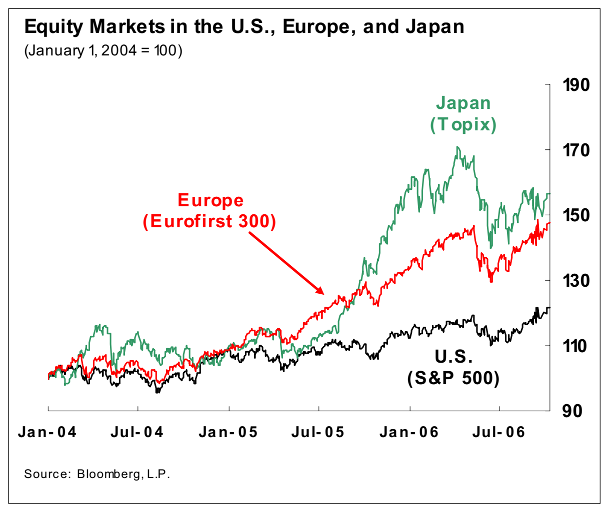
number of challenges over the near and medium term with implications for the outlook. These include (i) high and volatile energy prices; (ii) tighter global liquidity, in part in response to rising inflationary pressures; and (iii) the risks stemming from global imbalances.

Although they have declined following their August 2006 peak, high and volatile oil prices remain an ongoing challenge. In addition to buoyant global economic activity, spikes in oil prices earlier this year were driven by geopolitical events and supply concerns. Though these fears have recently receded, spare capacity is still at low levels, and the risk of supply-side shocks remains. A major disruption in one of the large producers could result in renewed price hikes, exacerbating inflationary pressures while also cooling demand. This underscores the need to achieve a sustainable medium-term supply/demand balance by eliminating obstacles to upstream and downstream investment to boost capacity, strengthening conservation efforts, and gradually reducing price subsidies that contribute to high demand over the medium term.



World Crude Oil Demand, Production Capacity, and Spare Capacity
(millions of barrels per day)
Sources: British Petroleum Statistical Review; International Energy Agency; and IMF staff.

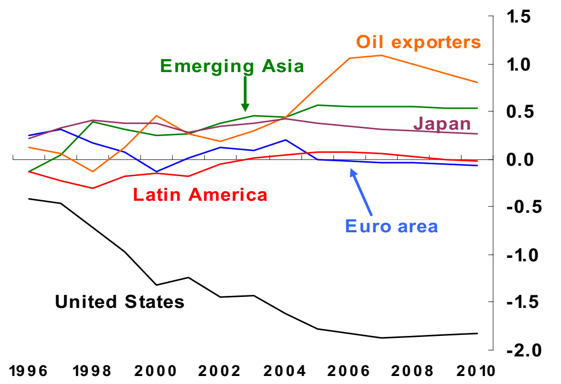
Financial market volatility earlier in the year highlighted the potential risks for emerging markets from an unexpected tightening in global liquidity conditions. So far, rising interest rates in the United States and elsewhere have not dampened growth in emerging markets, and further moderate hikes could be absorbed without much difficulty. Going forward, the challenge for major central banks will be to guard against inflationary pressures in a predictable manner that avoids excessive tightening.



Equity Markets in the U.S., Europe, and Japan
(January 1, 2004 = 100)
Source: Bloomberg, L.P.

Global imbalances remain a pressing policy challenge for the global economy. Over the past 10 years, the U.S. current account deficit has risen to unprecedented levels, matched by very large surpluses in Asia and—more recently—oil-producing countries. There is broad agreement that these imbalances are unsustainable over the medium term and that there is a risk that they could eventually lead to a disorderly adjustment, including a reduction in the demand for U.S. assets, abrupt movements in interest and exchange rates, rising protectionist sentiment, and a slowdown in global growth. The IMF is currently engaged in a multilateral consultation process, involving China, the euro area, Japan, Saudi Arabia, and the United States, to promote joint action toward reducing global imbalances while sustaining growth.

Current Account Balance
(In percent of World GDP)



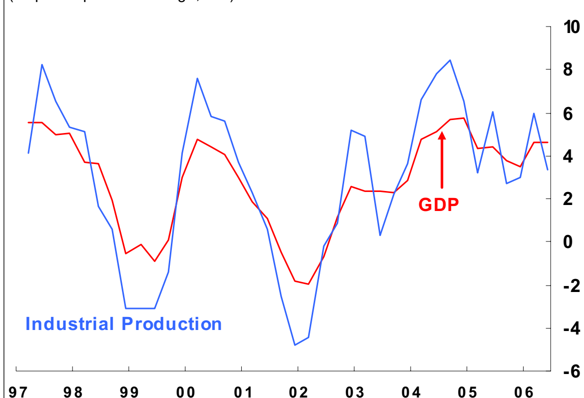
Source: WEO.

II. Latin America and the Caribbean (LAC)

A. Main Developments and Prospects

The Latin America and Caribbean region continues to grow robustly—and above its historical average—in the context of a strong global economy. In 2006, real growth should average around 4¾ percent, making the ongoing expansion the most vigorous three-year period since the 1970s. This forecast is about ½ percentage point higher than projected in the spring, reflecting upward revisions for several large countries. It is also about ½ percentage point higher than 2005, reflecting higher growth in Brazil, Mexico, and most Central American and Caribbean countries. On a cumulative basis, real output in 2006 will have risen by about 18 percent since 2002.

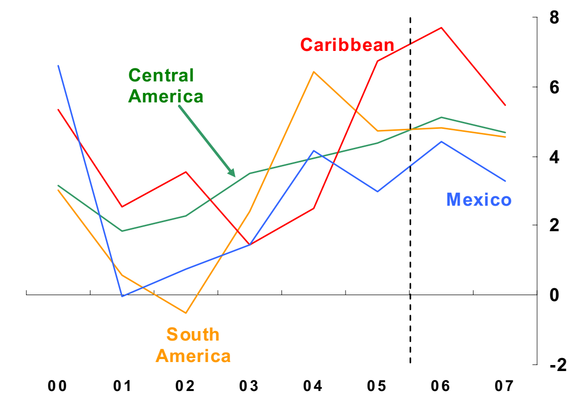
Latin America: Output Growth
(4-quarter percent change, s.a.)



Source: EMED; largest countries, excluding Venezuela.

Looking forward, LAC growth is projected to recede slightly to about 4¼ percent in 2007, in line with a more measured global expansion, the likely easing of commodity prices, and the maturing of recoveries within the region. Modestly lower growth is predicted for most countries in the region, and more significant slowdowns in the countries that grew at very

Real GDP Growth
(Annual % change)



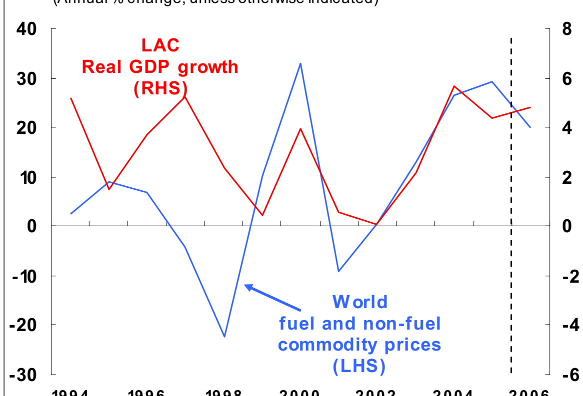
Source: IMF staff estimates.

high rates during 2004–06, as they converge toward their long term potential growth rates.

Demand Factors

Strong global demand for commodities has supported the regional expansion, with commodity prices tracking economic activity quite closely in recent years. Between end-2002 and the third quarter of 2006, primary fuel and nonfuel commodity prices rose by 150 and 80 percent, respectively. However, the impact of these increases has been uneven in the region. For example, while the terms of trade improved

Growth and Commodity Prices
(Annual % change, unless otherwise indicated)



Source: IMF staff estimates.

by 23 percent on average in South America and by about 9 percent in Mexico between 2002 and 2005, they deteriorated by 4 percent in Central America and 9 percent in the Caribbean. In 2007, high oil prices will continue to benefit especially Colombia, Ecuador, Mexico, Trinidad and Tobago, and Venezuela. In contrast, non-fuel commodity prices, which also surged in 2006—to the benefit of metal exporters such as Chile and Peru—are projected to decline moderately in 2007.

Domestic demand is forecast to remain the main driver of the expansion in the near term. Private consumption is expected to account for more than two-thirds of economic growth in 2006 and 2007, slightly below the three-fourths contribution registered in 2005 but still in line with historical averages. However, the contribution from investment over 2006–07 is expected to nearly double relative to the 2002–05 period, reflecting solid private investment growth in some countries, particularly Brazil and Mexico. Domestic demand has also been spurred by significant increases in primary government spending in several countries (see next section).

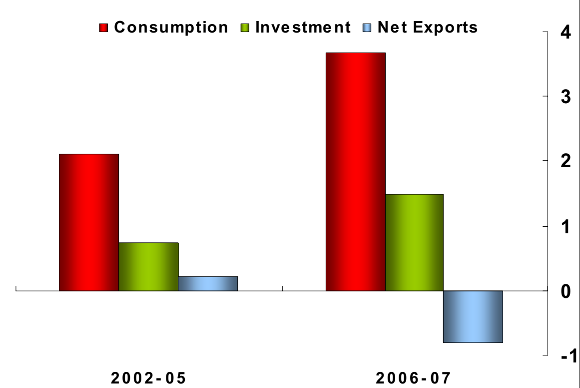
In the Caribbean, the pick-up in many countries has mainly reflected a sharp increase in construction activity, in part, ahead of the 2007 Cricket World Cup. The recovery in Jamaica also reflects rebounding tourist activity and a strengthening of activity in agriculture.

In Central America, buoyant remittances, which rose to 10–20 percent of GDP in 2005, will continue to support private consumption in the near to medium term. For the region as a whole, net exports are expected to exert a negative effect on demand over the projection period, reflecting rapid growth in imports. Further ahead, Central American growth could receive a boost over the medium term through the Panama Canal expansion project, which was approved in an October 22, 2006 referendum. The project will be implemented between 2007 and 2014 at an estimated cost of US$ 5.2 billion. In addition to exerting significant stimulus on Panama's economy, the project is expected to create demand for regional labor, goods, and services. Once the canal is in operation, it could have a catalytic effect on regional investment.

Inflation

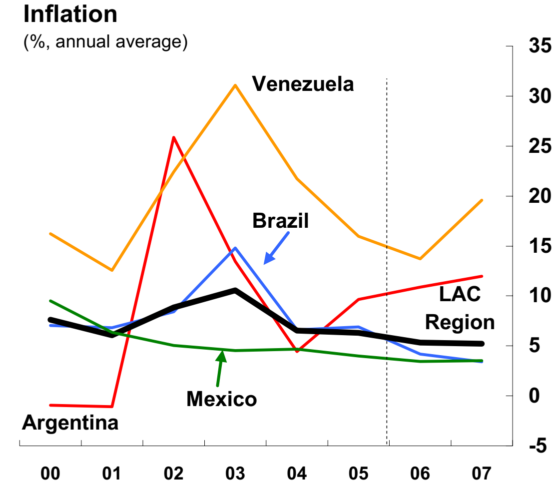
In spite of the sustained increases in commodity prices in recent years, inflation has generally remained subdued, and is projected to decline further. Annual average inflation in the LAC region is projected to be around 5¼ percent in 2006—about 1 percent lower than in 2004. This

Contributions to Growth
(%, per annum)



Source: IMF staff estimates.

Inflation
(%, annual average)



Source: IMF staff estimates.

is testimony to the credibility of monetary frameworks in most of the region, which have kept inflationary pressures and expectations in check. Inflation is projected to remain on a slowly declining path, falling close to 5 percent in 2007.

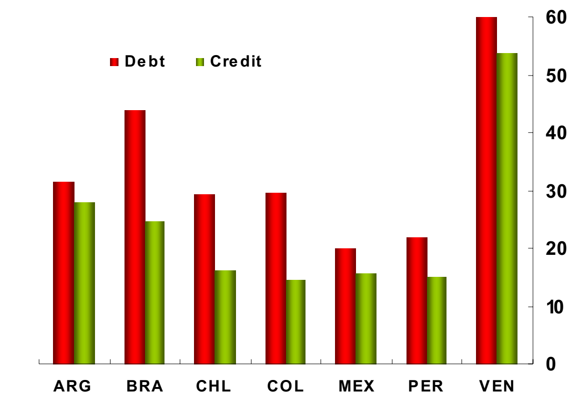
Nevertheless, there is some variation in inflationary pressures across the region, in part due to differences in cyclical positions. Argentina appears to be operating above capacity at this point, which yields inflationary impetus. Venezuela has been experiencing even higher, double-digit, inflation. In most other countries, inflation has been kept in check by the growing credibility of monetary policies focused on containing price pressures, upward flexibility in exchange rates, and remaining output gaps (see section II.B).

Financial Sector

In the past two years, domestic credit has picked up in several countries, driven mostly by lending to the household sector. Consumer and mortgage credit remain the main source of private sector credit growth in the largest countries in the region. Banks have focused on lending to the household sector that offers, in many cases, higher margins, better collateral, and lower credit risk than most corporates.[1] The latter have resorted to internal sources of funding and the capital markets to finance investment. Credit has also been growing at a rapid pace in some Central American and Caribbean countries.

Financial soundness indicators have, however, strengthened further during the current cyclical expansion. Improved asset quality has been reflected in a decline in nonperforming loans,

Household Debt and Credit Growth, 2005
(Annual % change)



Source: IMF staff calculations based on data from Central Banks.

while strong provisioning and a shift toward more lending has been associated with slightly lower capital adequacy ratios. Increased lending volumes and stable spreads have underpinned rising bank profitability in 2005–06.

Financial Soundness Indicators for Latin America
(In percent) 1/

	2002	2003	2004	2005	2006 2/
NPL ratio 3/	10.6	8.2	5.6	4.4	4.4
Provisioning of NPLs	91.7	98.3	112.8	121.0	119.2
Return on assets	-0.6	1.4	1.7	2.0	1.9
Return on equity	9.9	14.4	17.8	19.7	20.8
Capital adequacy ratio 4/	15.7	15.4	16.4	16.1	15.2

Source: IMF (2006b).
1/ Fixed sample of countries over time for each indicator. The number of countries varies by indicator.
2/ Latest data available.
3/ Non-performing loans (NPLs) as a share of total loans.
4/ Regulatory capital/risk weighted assets.

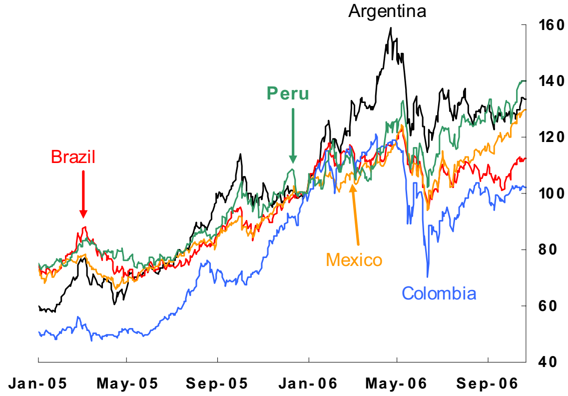
Sharp rises in asset prices in local financial markets were interrupted by a generalized sell-off during May–June. As in other markets worldwide, equity markets suffered the most, after a run-up in values that more than doubled the major indices between 2002 and the first quarter of 2006. Both the run-up in values and the sell-off were mostly driven by foreign investors. Countries that experienced the greatest equity price run-ups during 2005 and early 2006—such as Argentina and Colombia—experienced the largest subsequent declines.[2]

[1] For the seven largest countries in the region, credit to households rose to an average of about 9 percent of GDP in 2005 (an increase of 1½ percentage points of GDP relative to 2003). Credit to the corporate sector was approximately unchanged in relation to GDP (at 16 percent).

[2] Price-earnings ratios had increased to 19.5 in Argentina and 29.7 in Colombia by December 2005, compared with a historical average of around 13 for emerging markets.

Following the sell-off, equity prices remained above mid-2005 levels for most countries and, except in Argentina and Colombia, prices had fully recovered by the end of September.

Equity Market Developments
(December, 2005 = 100)



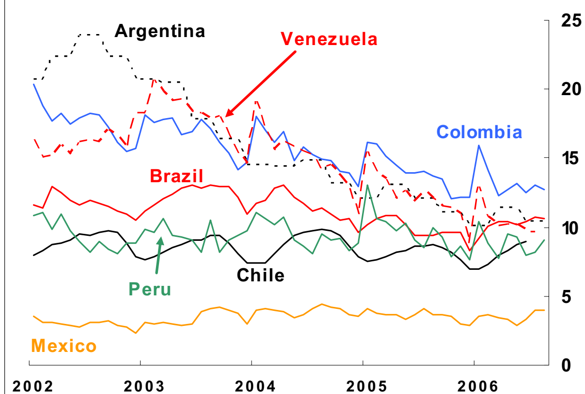
Sources: J.P. Morgan and Morgan-Stanley.

Foreign interest in local bond markets has increased, especially in Brazil, Colombia and Mexico, where domestic market developments provided new instruments for investors (see also section II.B). More generally, investment in local market instruments has been facilitated by improving fundamentals, as well as the inclusion of some local currency government bonds in global benchmark indices.

Employment and Social Developments

The region's recovery in recent years has helped increase employment and improve social indicators. In many countries—including Argentina, Brazil, Chile, Mexico, and Venezuela—employment growth accelerated in 2005 and in the first half of 2006, and formal unemployment has declined significantly toward 10 percent on average. In parallel, poverty has also been declining. According to preliminary estimates of the Economic Commission on Latin America (ECLAC), the share of the population in the region living in poverty—measured in terms of the capacity to purchase a basket of basic consumptions goods—fell from about 44 percent in 2003 to just over 40 percent in 2005. Over the same period, extreme poverty fell from 19 percent to 17 percent. Based on national definitions, poverty declined in Argentina from a peak of 54 percent in late 2002 to 31 percent in the first half of 2006. In Brazil, it fell from 28 percent in 2003 to 23 percent in 2005, with the income of the poorest 50 percent growing over twice as fast as that of the top 10 percent.[3] In Uruguay, poverty has come down from 32 percent in 2003 to 30 percent in 2005.

Unemployment
(In percent)



Source: EMED.

Countries have continued to improve and expand targeted social assistance programs. A number of countries now have programs that attempt to tackle the sources of poverty by making assistance conditional on the efforts of recipients to build human capital. In Brazil, the *Bolsa Familia* program is projected to reach 11.2 million families by end-2006, compared with 8.7 million families in 2005 and 6.7 million in 2004. In Mexico, total social assistance spending, including for the targeted and conditional *Oportunidades* program, has risen in recent years and is projected to remain roughly unchanged as a share of GDP in 2006. In Argentina, the *Jefes y Jefas de Hogar* program is being reoriented from an emergency income support program to a system that combines social assistance with opportunities for education and training. In Chile, social

[3] See Centro de Políticas Sociais (2006).

assistance spending—including for *Chile Solidario*, which ties family support to educational and job training goals—remains high by regional standards at 1½ percentage points of GDP; these outlays rose in real terms by 12 percent in 2005, and are projected to rise further as a share of GDP over the medium term. In Peru, the *Juntos* program, which was created in 2005, is projected to expand from the current coverage of about 70,500 households to 200,000 by end-2006. In Uruguay, a two-year social emergency program (SEP) was put in place in 2005 to mitigate the effects of the crisis, with a target group of over 80,000 families.

These and other social assistance programs show considerable promise as a tool for poverty reduction as they successfully target spending on the needy. Beyond conditional cash transfer programs, examples of social assistance include school lunch programs, training programs for youth, and financial assistance to the disabled. Evidence shows that a large share of the spending from these programs reaches the poor, although they account for a modest share of total public social spending. In Argentina, Brazil, Chile, Colombia, Mexico, and Peru, social assistance spending averages about one percentage point of GDP. This compares with total social spending—including pensions, health, and education, that may also benefit the better off—of 14 percent of GDP (Lindert, Skoufias, and Shapiro, 2006).

External Developments

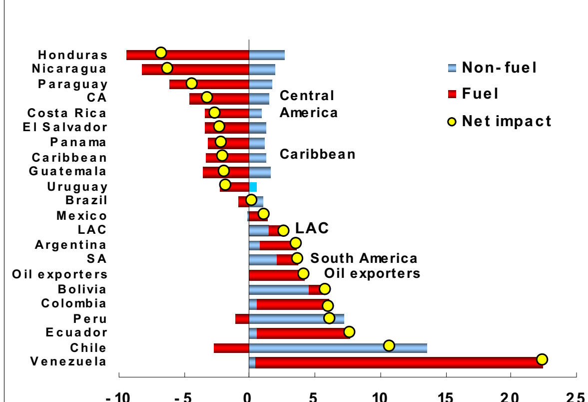
Although there are significant differences across countries, the region as a whole continues to exhibit large trade and current account surpluses. Sustained and strong growth of export receipts has led to trade and current account surpluses in every year since 2003. Much of this reflects improved terms of trade, which are estimated to have strengthened trade balances relative to 2002 by about 2¾ percentage points of 2006 GDP for the LAC region as a whole. This reflects a gain of about 3¾ percent of GDP in the trade balance for South American countries, which more than offset the terms of trade related deterioration of trade balances in Central America and the Caribbean, estimated at 3¼ and 2 percent of their GDPs, respectively. In 2005, the region's overall current account surplus rose to about 1½ percent of GDP. It is forecast to remain close to this level in 2006, before dropping to about ½ percent of GDP in 2007, as high import growth overtakes export growth.

External Balance of Payments Developments, 2002-06
(In % of GDP, unless otherwise indicated) 1/

	2002	2003	2004	2005	2006
Trade balance	0.4	1.7	2.1	2.6	2.6
Current account 2/	-0.8	0.4	1.0	1.5	1.3
Private capital inflows	0.2	1.0	0.1	0.6	0.5
o/w: FDI	2.7	2.1	2.3	2.0	1.7
portfolio	-0.7	-0.6	-0.7	1.0	0.1
Public inflows	1.0	0.3	-0.4	-1.2	-0.5
Reserves/ST-debt (%)	206	251	273	305	331
Reserves/monthly imports	6.8	8.3	7.5	7.3	7.0

Source: IMF staff estimates.
1/ Refers to LAC region as a whole.
2/ Includes grants.

Impact of Commodity Price Movements on Trade Balances
(In % of 2006 GDP) 1/

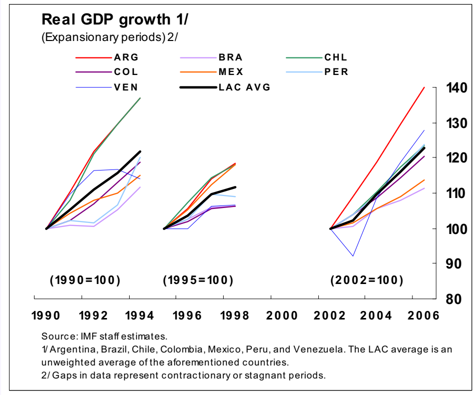


Source: IMF staff estimates.
1/ Impact of change in commodity price movement since 2002 on projected trade balances in 2006.

Despite historically low borrowing costs, net capital inflows have remained relatively subdued (Box 1). Private capital flows to the region picked up in 2005, as higher flows to Argentina, Brazil, Chile, Ecuador and Uruguay more than offset large net outflows from Venezuela. As a share of regional GDP, however, they remained modest, and are projected to remain flat through 2007. Unlike capital inflow episodes in

Box 1. Macroeconomic Policy During Expansions: Then and Now[1]

Latin America is undergoing a significant output recovery, with 2006 projected to be the third consecutive year with real growth in excess of 4 percent**.** In the past, similar upswings have often carried the seeds of their own destruction. Debt-financed growth in the 1970s led to the debt crisis and "lost decade" of the 1980s; the post-Brady plan recovery of the early 1990s ended in the Tequila crisis; and a subsequent recovery was cut short by the 1998 "sudden stop" in capital flows, for which many countries were not well prepared. More generally, growth spells in Latin America have tended to be short—shorter than in most other developing country regions (Berg, Ostry, and Zettelmeyer, 2006). Could the current recovery suffer the same fate? This box provides a partial answer, by comparing the macroeconomic management in the ongoing expansion to that in the previous two (1991–94 and 1996–98).

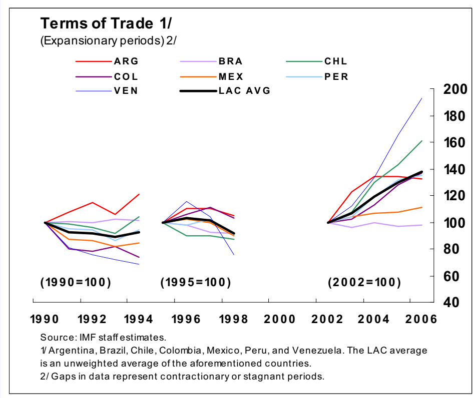


Real GDP growth 1/
(Expansionary periods) 2/

Source: IMF staff estimates.
1/ Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. The LAC average is an unweighted average of the aforementioned countries.
2/ Gaps in data represent contractionary or stagnant periods.

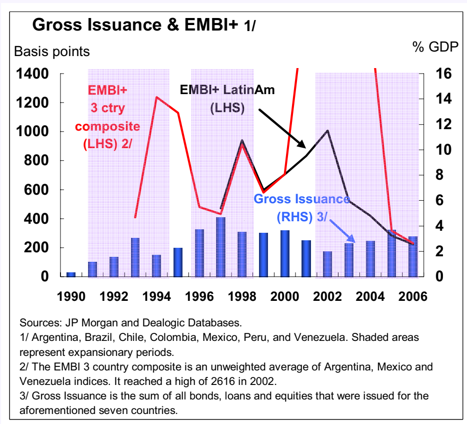
Favorable external environment

The external environment has been especially favorable during the most recent upswing. While financing conditions were favorable in all three episodes, low world interest rates contributed to historically low sovereign spreads in Latin America in the most recent upswing—about 200 basis points in October of 2006 compared with a lowest available observation of about 400 basis point during the 1996–98 expansion. Furthermore, terms of trade improved by 29 percent in 2003-06, compared with 8 percent declines in both previous cycles, and partner country growth was higher in the 2003-06 expansion than during either of the expansions in the 1990s. Against this background, the question is whether countries have used the opportunity afforded by the favorable economic environment to reduce vulnerabilities and put this expansion on a more solid footing than its predecessors. In general, the answer is "yes," although progress has not been uniform in all areas or countries, and there have been some recent signs of erosion.



Terms of Trade 1/
(Expansionary periods) 2/

Source: IMF staff estimates.
1/ Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. The LAC average is an unweighted average of the aforementioned countries.
2/ Gaps in data represent contractionary or stagnant periods.



Gross Issuance & EMBI+ 1/

Sources: JP Morgan and Dealogic Databases.
1/ Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. Shaded areas represent expansionary periods.
2/ The EMBI 3 country composite is an unweighted average of Argentina, Mexico and Venezuela indices. It reached a high of 2616 in 2002.
3/ Gross Issuance is the sum of all bonds, loans and equities that were issued for the aforementioned seven countries.

[1] Prepared by Rodolphe Blavy and Jeromin Zettelmeyer.

Box 1. Macroeconomic Policy During Expansions: Then and Now (continued)

Stronger fiscal positions

Fiscal positions have strengthened significantly in this expansion. ***Primary balances*** have so far been in surplus, the overall balance has been close to zero, and ***public debt-to-GDP ratios*** have declined. This contrasts with significant fiscal deficits during the two previous expansions. However, countries began this upswing with higher levels of debt than the previous two expansions, and the debt reduction during the expansion has so far been insufficient to reverse it to pre-crisis levels. The ***structure*** of public debt has improved, as most large countries have lowered their shares of foreign currency debt without resorting to more short-term debt. Countries are hence far less vulnerable to a sudden deterioration of the external environment than they were in the 1990s.

Latin America: Sovereign Debt Structures

	FX Debt Share 1/			ST Debt Share 2/		
	1996-98	2003-04	2005	1996-98	2003-04	2005
Argentina 3/	90.9	75.8	58.6	4.5	2.5	5.9
Brazil	n.a.	37.0	14.7	n.a.	30.8	35.9
Chile 4/	85.6	84.9	68.7	-	-	-
Colombia	61.0	50.6	40.9	1.5	0.6	1.7
Mexico	55.1	35.5	31.7	5.1	6.4	7.8
Peru	n.a.	84.7	78.4	n.a.	9.9	2.8
Venezuela	84.7	62.1	53.1	1.3	5.9	4.2

Source: IMF staff estimates.
1/ Foreign currency denominated debt or currency-linked debt in percent of general government debt.
2/ Short-term domestic debt in percent in percent of general government debt.
3/ ST debt data is on an original maturity basis, available from 1993.
4/ Debt data does not include central bank debt.

Lower inflation and more flexible exchange rates

Monetary and exchange rate management has also improved, supported by institutional reforms (notably, the adoption of inflation-targeting frameworks in a number of countries), and much greater public awareness of the risks of high inflation policies. Markedly low inflation rates—in the single digits in most of the large countries—are an impressive achievement of the current recovery, in stark contrast with the 1990s. Furthermore, exchange rates were generally more flexible in 2003–05 compared with 1996–98, suggesting that "fear of floating" has receded.[2]

Variance of Daily Exchange Rate Changes 1/

	1996-98		2003-06				
	1996-97	average	2003	2004	2005	2006	average
Latin American Countries							
Argentina	0.00	0.00	1.51	0.16	0.07	0.04	0.47
Brazil	0.01	0.01	0.91	0.55	0.83	0.87	0.79
Chile	0.06	0.12	0.30	0.43	0.33	0.29	0.34
Colombia	0.16	0.38	0.18	0.24	0.16	0.36	0.23
Mexico	0.17	0.42	0.38	0.20	0.17	0.29	0.26
Peru	0.05	0.05	0.01	0.04	0.04	0.11	0.05
Memorandum item:							
Canada	0.05	0.09	0.30	0.31	0.29	0.25	0.29

Source: IMF staff estimates.
1/ Estimated conditional volatilities, based on a first order autoregression of daily percentage changes in the bilateral exchange rate with respect to the U.S. dollar. Regression models include a GARCH(1,1) error term which allows the variance of exchange rate changes to vary over time. For each country, two regressions are run separately for the 1996-98 and 2003-06 period. These are used to generate fitted conditional variances at the daily frequency, which then are averaged over the periods shown above.

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[2] This can be shown either by extending Calvo and Reinhart's (2002) "fear of floating" measure to the present, or by examining simple measures of exchange variability, as shown in the table. In doing so, a complication arises from the fact that the 1996–98 period ended with a period of financial turbulence, owing to contagion from the Asian and Russian crises. If one excludes the turbulent period and compares 2003–05 to 1996–97 only, the table shows that out of the 6 major currencies shown, 5 now float more freely than they did in 1996–97. Two countries, Argentina and Brazil, went from pegs to floats or managed floats, and all countries except for Argentina moved to formal inflation targeting.

Box 1. Macroeconomic Policy During Expansions: Then and Now (concluded)

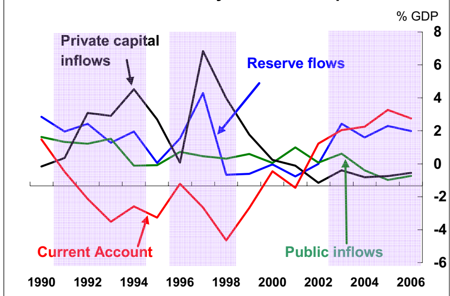
Increasing reserves, with current account surpluses

The external position also compares favorably so far to past expansions. By the end of 2006, the region will have built up reserves to almost US$300 billion, compared with about US$170 billion at end-1998 (as a percent of short term debt, 330 percent compared with about 140). Contrary to previous episodes, reserve accumulation has been driven primarily by current account surpluses, rather than capital inflows, reflecting favorable terms of trade (especially in Argentina, Bolivia, Chile, Colombia, Ecuador, Peru, and Venezuela; and to a lesser extent in Mexico), stronger fiscal positions, and relatively competitive real exchange rates (see section II.A). Strong export growth has also led to a more balanced growth pattern than in earlier expansions, with a greater contribution of net exports to growth. Furthermore, net capital inflows have been largely composed of direct investment rather than portfolio flows. In the four-year period from 1991 to 1994, Latin America received over 11 percent of GDP in net portfolio inflows, but only about 4 percent in net FDI. In contrast, between 2003 and 2006 net FDI amounted to about 8 percent of GDP, while aggregate net portfolio inflows were slightly negative.

Some emerging vulnerabilities

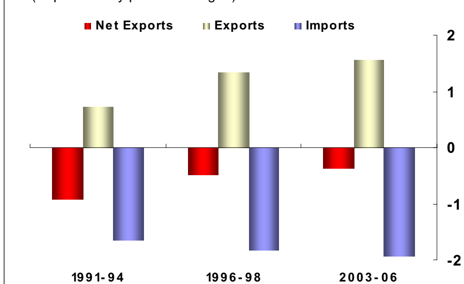
Recently, however, several of the characteristics that favorably set apart this expansion from its predecessors may have begun to erode. Import growth has been outpacing export growth since 2004 and, as in earlier episodes, the expansion is by now led by domestic demand. Though not yet a source of concern, real credit has been growing fairly rapidly, about in line with the two previous expansions (see Box 7). Finally, real public expenditure has recently been growing at a similarly fast pace as in previous cycles. Given that public debt remains high and the improvements in the fiscal position owe much to the favorable conjunctural and external environment, this is a significant source of concern, as explored in more detail in section II.D.

External Balance of Payments Developments 1/



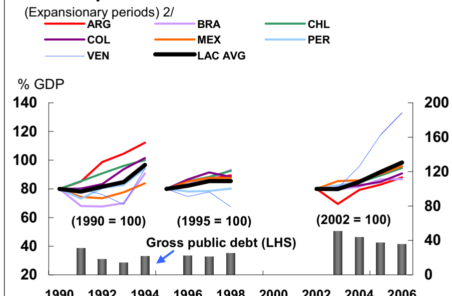
Source: IMF staff estimates.
1/ Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. The LAC average is an unweighted average of the aforementioned countries. Shaded areas represent expansionary periods.

Trade Contributions to GDP 1/
(Expansionary period averages)



Source: IMF staff estimates.
1/ Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. The LAC average is an unweighted average of the aforementioned countries.

Real Expenditure and Public Debt 1/
(Expansionary periods) 2/

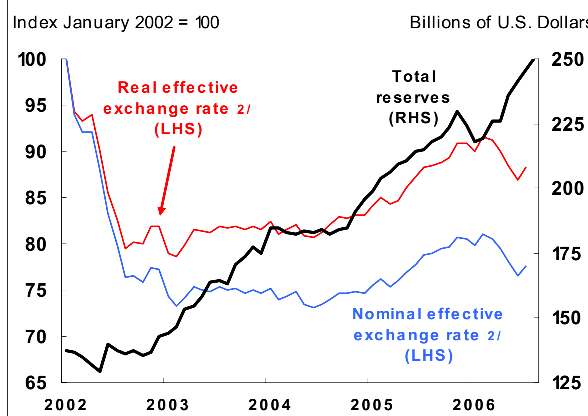


Source: IMF staff estimates.
1/ Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. The LAC average is an unweighted average of the aforementioned countries.
2/ Gaps in data represent contractionary or stagnant periods.

the 1980s and 1990s, private inflows have recently been dominated by FDI—though portfolio inflows picked up in 2005, driven particularly by flows into equity and local debt markets. Net official flows have been negative since 2004, reflecting large early repayments to the IMF by Brazil (December 2005), Argentina (January 2006), and Uruguay (March and August 2006), and net repayments to the World Bank.

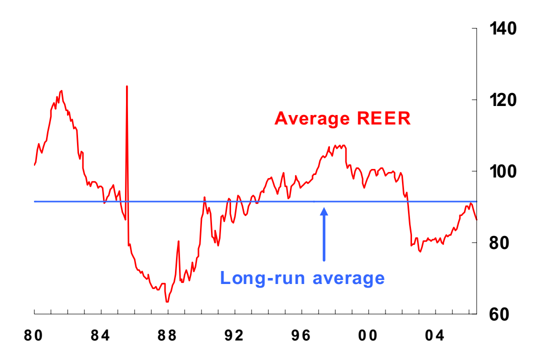
External surpluses have allowed countries to accumulate reserves and put upward pressure on exchange rates, but without significantly impairing competitiveness. Gross external reserves in the largest seven Latin American countries currently stand at an all-time high of over US$250 billion, as reserves in both Brazil and Argentina have recovered beyond their levels prior to the IMF repayments. In 2005, currencies appreciated in real effective terms by about 30 percent in Brazil, 15 percent in Chile, 11 percent in Colombia and 7 percent in Mexico. In most countries, currencies continued to appreciate in 2006, notwithstanding some declines in May–June. However, real effective exchange rates are generally close to their historical averages of the 1980–2005 period, suggesting that the currency appreciations from 2002 to 2005 have mostly been a correction of the sharp depreciations of 2001–02.[4] Moreover, export performance has generally been strong in the region and several countries—including Brazil, Chile, Peru and Uruguay—have gained global market share. Mexico's world market share did decline from 2002 to mid-2005—reflecting both relatively slow volume growth and less favorable changes in export prices (other than oil). But it has recovered somewhat since then.

Exchange Rates and Reserves 1/



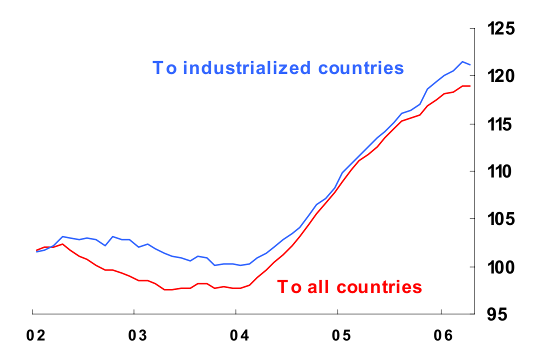
Sources: IMF, *International Financial Statistics;* and *Information Notice System.*
1/ Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
2/ Seven country monthly average. Increase indicates appreciation.

Real Effective Exchange Rate
(Index 2000=100) 1/



Source: IMF, *Information Notice System.*
1/ Unweighted average of Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

Average Export Share
(In percent of world imports, indexed 2001= 100) 1/



Source: IMF, *Direction of Trade Statistics.*
1/ Unweighted averages of Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

[4] Similarly, purchasing parity power (PPP) exchange rates—measured as the ratio of the domestic price level to international prices—are currently at or below what would be predicted by countries' relative incomes.

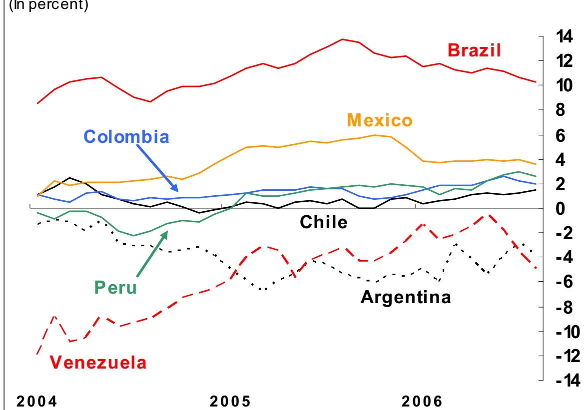
B. Macroeconomic Policy Stance

Monetary and Exchange Rate Policies

Central banks have followed a mix of inflation and exchange rate objectives. Most of the large Latin American countries—Brazil, Chile, Colombia, Mexico, and Peru—have successfully implemented formal inflation targeting regimes for several years now. In these countries, average inflation has declined steadily (to about 3½ percent in mid-2006), as has the gap between actual and targeted inflation (from an average of 2½ percentage points at end-2002 to ½ percentage point in mid-2006). These countries have generally allowed exchange rates to float, though some have intervened in the foreign exchange market to build reserves and, in some cases, to limit exchange rate volatility. In contrast, Argentina has geared its policies mainly to maintaining a competitive real exchange rate and accumulating reserves, while using sterilization and administrative price measures to limit the inflationary impact of reserve inflows. Among the smaller countries, Uruguay and Paraguay have recently shifted the emphasis of monetary policy toward inflation targets. Three countries in the region—Ecuador, El Salvador, and Panama—are officially dollarized, while several others, such as Honduras, Nicaragua, and the ECCU countries, maintain explicit exchange rate anchors. The remainder have managed floats or other intermediate regimes. Costa Rica has recently replaced its long-standing crawling peg with a crawling band. Initially set with a width of 3 percent, the band will widen over time, as its floor and ceiling will crawl at rates of 3 and 6½ percent per annum, hence allowing for progressively greater exchange rate flexibility.

The stance of monetary policy varies widely across countries. In countries that experienced large collapses in output during 2001–03, short-term real interest rates have been negative over extended periods. This, along with expansionary fiscal policies and delayed relative price adjustments, has contributed to a pick-up in inflation in Argentina, which the authorities are seeking to counter with a mix of administrative measures and gradual monetary tightening In Uruguay, where the rate of remonetization has been high and the output gap has closed more slowly, inflation remains more subdued, though it has increased relative to 2005. In Brazil, policy rates have been steadily eased since September 2005 as inflation has declined below official targets. Rates are now well below the levels prevailing prior to the 2002 crisis, though they remain high compared with other countries in the region. In most other countries, monetary policy is close to neutral, with real interest rates in the 1.5–4.0 percent range. The direction of recent policy changes has also varied in response to different inflation pressures; while policy interest rates have come down in Brazil and Mexico (until April 2006) and some of the smaller countries, they have been going up in Chile, Colombia, Paraguay, and Peru.

Short-Term Real Interest Rates
(In percent)



Source: IMF staff estimates.

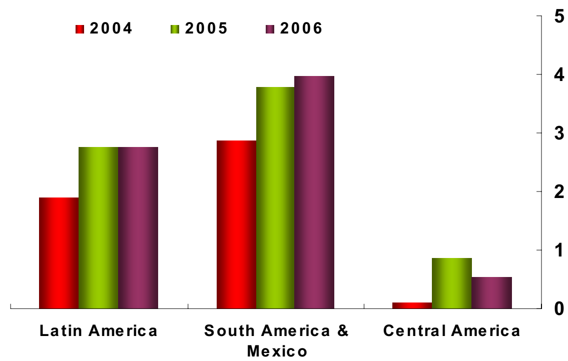
Fiscal Policy and Debt Management

Primary fiscal balances have been in surplus, and on average are expected to remain roughly unchanged as a percent of GDP in 2006.[5] In

[5] Fiscal figures refer to staff estimates and projections as of end-August.

Chile, the primary surplus is projected to climb further from already high levels, building on the country's exceptional performance in using the commodity boom to further reduce debt and increase fiscal savings (Box 2).

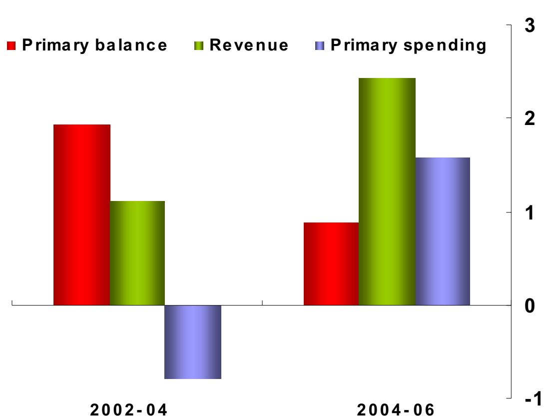
Primary Balance by Region
(% of GDP) 1/



Source: IMF staff estimates.
1/ Unweighted averages.

The rise in primary surpluses between 2004 and 2006 has been driven by revenues, particularly commodity-based revenues. In South America and Mexico, revenues rose by an average of 3 percentage points of GDP between 2004 and 2006, led especially by large increases in Bolivia, Chile, Ecuador, and Venezuela. Commodity revenues (from fuels and minerals) increased by about 2 percentage points of GDP, while other revenues (most notably in Bolivia, Brazil, and Uruguay) rose by about 1 percentage point of GDP during this period.

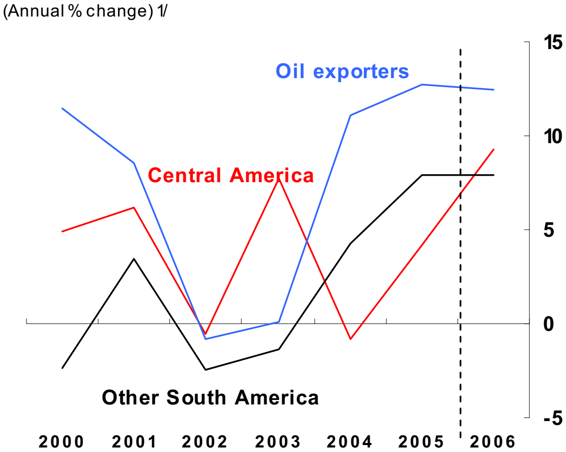
Fiscal Policy Stance, 2002-04, 2004-06
(Change in % of GDP between indicated years) 1/



Source: IMF staff estimates.
1/ Unweighted average for seventeen countries.

At the same time, government expenditures are now increasing at a brisk pace. Real primary spending growth reached 7½ percent in Latin America in 2005 (unweighted average) and is forecast to accelerate to 9 percent in 2006 (Box 3).[6] Spending increases have been widespread, with especially sharp rises in Argentina and some commodity exporters (notably Venezuela) experiencing rapid increases in revenues. Not all commodity exporters have seen a large surge in spending, as expenditure increases have been below the regional average in Chile, Colombia, and Mexico (Box 3). Although rapid economic growth has muted the effect of surging government outlays on primary spending-to-GDP ratios, these have nevertheless risen by about 1½ percentage points since 2004. This compares with the relatively modest expansion of government outlays during the earlier phase of the recovery in 2003–04, when spending-to-GDP ratios generally declined.

Real Primary Spending
(Annual % change) 1/



Source: IMF staff estimates.
1/ Unweighted averages.

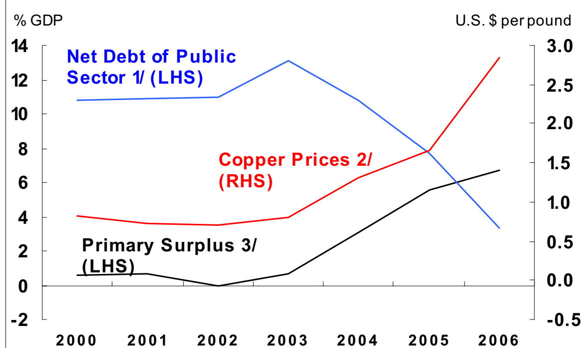
[6] Real spending increases are calculated on the basis of nominal spending increases, deflated by the GDP deflator. Deflating by the consumer price index (CPI) would provide higher estimates for countries experiencing improvements in the terms of trade and larger increases in the GDP deflator than the CPI.

Box 2. Managing Commodity Price Windfalls in Chile[1]

Since 2001, the structural surplus rule has constituted the main pillar of Chile's fiscal policy. The rule aims at annual surpluses equivalent to 1 percent of GDP in the accounts of the central government, after adjusting revenue for deviations from trend GDP and long-run copper prices. In recent years, the price of copper, Chile's main export commodity, rose sharply, from US$0.8 a pound on average in 2003 to US$1.7 a pound on average in 2005 and around US$3.5 a pound in early August 2006. Over the same period, the official panel of experts of the government estimated that the long-run copper price had only risen slightly, from close to US$0.9 a pound to around US$1.0 a pound. The fiscal rule, in effect, constrained expenditure growth to be consistent with these more modest increases in long-term copper prices and revenues. As a result, while revenues soared, expenditures were well contained and fell slightly as a share of GDP.

The fiscal rule has allowed Chile to achieve substantial primary surpluses. The primary surplus of the central government rose from ½ percent of GDP on average in 2002–03 to 4½ percent in 2005 (in 2006, the primary surplus is estimated to reach 6¾ percent of GDP). The surpluses of the government were used to prepay debt and accumulate financial assets, which amounted to US$6 billion (4 percent of GDP) in April 2006. The ratio of Chile's net public sector debt to GDP fell from 13½ percent of GDP at end-2003 to 7¾ percent at end-2005. Recently, the government introduced a draft law in congress specifying that the surpluses will be used to gradually recapitalize the central bank, save for future pension liabilities, and create a fund in which all remaining financial assets will be invested, including abroad.

Chile: Copper Prices, Net Public Sector Debt and Primary Surplus, 2000-06



Source: IMF staff estimates.
1/ Includes general government, central bank, and public enterprises.
2/ The price for 2006 is a January to July average.
3/ Central government.

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[1] Prepared by James Walsh.

Box 3. Trends in Real Primary Spending Across Countries, 2002–06[1]

Spending has risen sharply in the region over the past two years. After declining during the 2002 recession, real primary expenditure, on average, rose modestly in 2003–04 during the early phase of the economic expansion. Since then, there has been an acceleration in expenditure growth, with real average annual spending increases of five percent or more in 15 out of 17 countries in 2005–06.

Annual Growth of Real Primary Expenditures, 2002-06
(In percent) 1/

	2002	2003	2004	2005	2006
Latin America (unweighted average)	**-1.5**	**2.1**	**3.7**	**7.5**	**9.2**
Latin America (weighted average)	**0.1**	**2.1**	**4.6**	**7.4**	**7.3**
South America and Mexico 2/	**-2.0**	**-1.0**	**6.1**	**9.2**	**9.1**
Mexico	5.8	7.4	-1.7	3.9	7.2
Argentina	-20.3	11.1	14.1	14.4	8.4
Bolivia	7.2	-2.3	5.6	8.5	12.3
Brazil	2.4	-3.1	6.3	6.6	5.0
Chile	2.8	-1.2	0.4	5.9	2.6
Colombia	5.1	-0.7	1.5	5.6	8.3
Ecuador	8.5	-3.0	12.2	11.5	2.3
Paraguay	-0.2	-11.6	0.4	4.6	11.4
Peru	1.7	4.2	1.8	8.2	6.9
Uruguay	-18.4	-6.9	3.8	9.6	8.4
Venezuela	-16.6	-4.2	22.9	22.9	27.8
Central America 2/	**-0.5**	**7.7**	**-0.8**	**4.2**	**9.3**
Costa Rica	9.2	4.7	-0.2	2.2	9.8
El Salvador	1.7	1.5	-5.3	5.7	5.6
Guatemala	-5.5	13.3	-14.1	7.2	12.9
Honduras	-1.3	10.7	1.3	2.2	5.3
Nicaragua	-10.8	9.2	10.5	5.4	11.8
Panama	3.5	7.1	2.8	2.6	10.2
Oil exporters 2/ 3/	-0.8	0.1	11.1	12.8	12.4

Source: IMF staff estimates.
1/ Based on projections as of end-August.
2/ Unweighted averages.
3/ Ecuador, Mexico, and Venezuela.

There are considerable differences across countries. On average, spending increases have tended to be higher in oil exporters, reflecting high rates of expenditure growth in Venezuela, and until 2006, spending growth had lagged in Central America. In the majority of Latin American countries, current expenditure has accounted for most of the rise in primary spending over 2005–06, although public wage bills have generally been relatively constant or have declined in relation to GDP.

[1] Prepared by Benedict Clements.

Spending increases have been directed to both current and capital outlays. Primary current outlays rose by an annual average of about 7½ percent in 2005–06, with double-digit increases in Nicaragua and Venezuela, where spending rose by about 25 percent per annum. While current outlays rose by about 1 percentage point of GDP between 2004 and 2006, capital spending has risen by about ½ percentage point of GDP, largely reflecting increases in 2006.

In spite of strengthening primary balances, the underlying fiscal stance in most countries is turning expansionary at a time when rapid growth offers an opportunity to move more quickly to reduce vulnerabilities from high debt. The pro-cyclical impact of fiscal policy can be observed by assessing the estimated impulse imparted to aggregate demand over the past few years. The fiscal impulse measure used here captures the expansionary effect given by real expenditure growth that exceeds the historical rate of economic growth, adjusted for the dampening effects of revenue increases.[7] While the results should be interpreted with caution, they nonetheless suggest that the contractionary stance that prevailed in most countries in the early phases of the recovery is now being reversed, and not mainly on account of priority social or infrastructure spending. When an adjustment is made for the improvements in fiscal balances owing to higher commodity-based revenues—which in most cases are largely based on sales abroad and therefore do not reflect a withdrawal of domestic demand—the expansionary stance appears more pronounced. Changes in structurally adjusted budget balances also suggest that fiscal policy is becoming procyclical (see appendix).

Fiscal Impulses (FI), 2003-06
(In percent of GDP) 1/

	2003	2004	2005	2006
Argentina	-0.8	-0.4	2.2	1.1
Brazil	-1.1	0.7	-0.3	1.1
Chile	-1.3	-2.3	-2.6	-1.2
Colombia	-2.5	-0.9	-0.6	0.6
Mexico	-0.2	-0.7	-0.5	-0.1
Peru	-0.2	-0.1	0.0	0.5
Venezuela	-4.2	1.8	-3.5	4.9

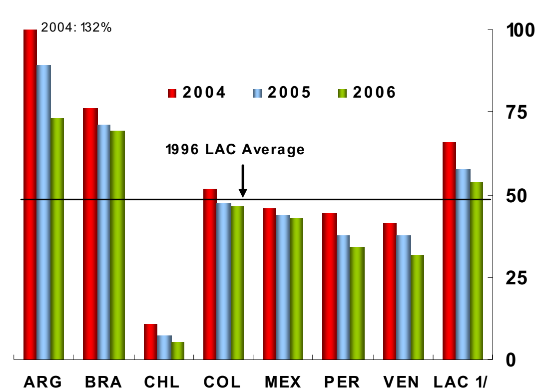
FI, Adjusting for Commodity-Revenue Effects

	2003	2004	2005	2006
Argentina	-0.8	-0.4	2.2	1.1
Brazil	-1.1	0.7	-0.3	1.1
Chile	-0.8	0.5	-1.3	-0.5
Colombia	-2.5	-0.9	-0.6	0.6
Mexico 2/	0.1	-0.5	-0.3	0.4
Peru	0.0	0.1	0.6	0.8
Venezuela	-1.3	3.8	2.6	7.3

Source: IMF staff estimates.
1/ Based on primary balances. See appendix for further details.
2/ Adjustment based on revenue from net hydrocarbon exports.

Primary surpluses and economic growth have nevertheless helped reduce debt burdens. Public debt is projected to fall to about 54 percent of GDP (weighted average basis) in 2006, a drop of 23 percentage points of GDP between 2002 and 2006. Stronger fiscal positions and economic growth have each contributed about one third to the decline, with most of the remainder accounted for by exchange rate appreciation, lower real interest rates, and debt

Total Public Debt
(% of GDP)



Source: IMF staff estimates.
1/ Weighted average.

[7] See the appendix for further discussion of the measure and an assessment of the robustness of the results using differing measures of the fiscal balance.

restructuring.[8] External public debt has declined more rapidly than domestically issued debt, and is expected to fall to less than a third of total debt by end 2006.

Looking ahead, budgets for 2007 are still under discussion in many countries, precluding a definitive assessment of fiscal policy for the coming year. IMF staff projections suggest that primary surpluses will remain high by historical standards, though they are expected to decline in most of the large economies as well as the commodity-exporting smaller countries. Combined with projected economic growth above 4 percent, primary surpluses are expected to reduce public debt ratios modestly further.

Vulnerabilities have been reduced not only by strengthened fiscal positions, but by continued efforts to improve debt management. Countries have taken a number of additional steps since early 2006 to lengthen maturities and reduce debt linked to exchange rates.[9] These include the tapping and issuance, respectively, of 30-year international bonds in Brazil (July), and Colombia (September), accompanied by the actual or planned buyback of existing debt with a shorter maturity. Several countries have also significantly extended their domestic currency yield curves. Mexico has just issued a 30-year peso-denominated bond for the first time in its history (October); Peru issued a 20-year domestic currency bond (May), while prepaying dollar debt; and Brazil issued a 16-year local currency global bond in September and announced that its external financing strategy for 2007–08 would rely predominantly on local currency instruments.

Policies oriented to the development of local capital markets have increased foreign participation in some local bond and equity markets. Improved debt management policies and local market infrastructure, together with strengthened fundamentals and macroeconomic policies, provided fertile ground for foreign investors in search of new instruments and higher yields. Although increased foreign participation helps develop local markets by providing liquidity and a more diverse investor base, it also increases countries' exposure to changes in global risk aversion. While foreign investors bear the foreign exchange risk, borrowers may face increased rollover risks if foreigners react more strongly to changes in external or domestic market conditions (especially if the substitution of local for foreign currency instruments is associated with a shift toward opportunistic—rather than dedicated—investors). As a result of the May–June sell-off, some countries suspended government bond auctions. However, the interruptions to debt programs aimed at improving the risk profile of government debt were minimal overall. Some countries (including Brazil and Colombia, in February and June 2006, respectively) have also removed remaining capital controls or taxes on foreign investment, whether to strengthen investor confidence, or to lower barriers to foreign participation in domestic financial markets.

[8] Argentina's 2005 debt restructuring helped reduce that country's debt ratio by 27 percentage points of GDP, and accounted for about 4 percentage points of the decline in Latin America's average debt ratio (Uruguay's 2003 debt restructuring focused on lengthening maturities that lowered the net present value of debt). These numbers are based on a decomposition of the change in Latin America's debt-to-GDP ratio between 2002–05, based on a sample of nine Latin American countries, which account for 90 percent of the region's GDP.

[9] For a description of developments through early 2006, see IMF (2006c), Box 1, "Recent Debt Management Operations in Latin America."

Box 4. Brazil: Recent Steps to Liberalize Foreign Exchange Market Regulations[1]

Recent steps to liberalize foreign exchange regulations have reduced transactions costs associated with Brazil's international trade and investment flows. The measures include the following:

- **Relaxation of export surrender requirements**. In July, the National Monetary Council (CMN) was authorized to reduce or waive foreign exchange surrender requirements to allow exporters to pay for imported inputs, settle financial obligations, or make investments abroad. Any reduction must be across the board and cannot be applied selectively to specific sectors. Export surrender requirements were lowered by 30 percent of export proceeds, at an estimated fiscal cost of 0.02 percent of GDP this year, as the foreign exchange kept abroad will be exempt from the bank debit tax (CPMF). This will reduce exporters' tax and other transactions costs by eliminating the two-way transactions required under existing regulations when export proceeds are used to pay for inputs and debt service abroad.
- **Unification of the settlement period for all financial transactions** (current and capital). In August, the repatriation period for the 70 percent of exports proceeds still subject to surrender requirements was increased from 7 to 12 months. The window to liquidate FX operations (financial transactions) was also extended from 2 to 12 months and the limit for the liquidation of Treasury dollar purchases from 6 to 12 months. With this change, the Treasury can purchase dollars in the market up to a year in advance of its external debt service commitments.
- **Allowing registration of foreign capital not previously eligible for registration**. The capital covered by these measures—so-called "contaminated capital"—was brought into Brazil legally (in some cases many years ago) but was not eligible for registration under previous central bank regulations. Regularizing the situation of this capital allows foreign companies to remit related profits and dividends abroad; previously, such remittances had to be made through indirect channels.

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[1] Prepared by Max Alier and Marcello Estevão.

C. Risks to the Outlook

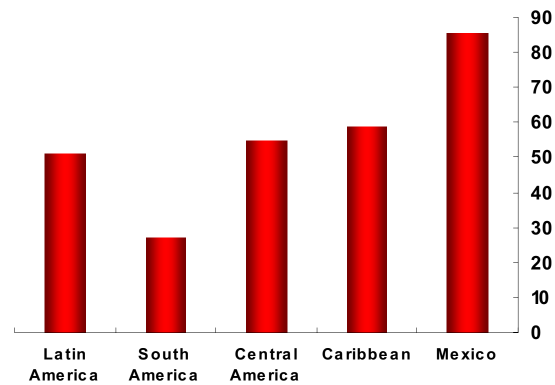
The region faces many of the same risks to the outlook as the global economy. As is the case for the world economy, these risks are slanted to the downside. They include:

- **An unexpectedly sharp reduction in U.S. demand**, as a result of a sharper-than-expected slowdown and/or a sudden adjustment of the U.S. current account, could have a large effect on the region, given its reliance on exports to the United States.

- **Tightening global financial market conditions:** The sharp compression of bond spreads in the region to historic lows in recent years was partly driven by liquidity in mature financial markets (IMF, 2006a, Box 1.5). A sharp tightening of global liquidity and/or abrupt shifts in risk aversion could lead to a much less favorable financing environment.[10] However, the region is less vulnerable to this risk than in years past, reflecting improved fiscal balances, current account surpluses in many countries, and safer debt structures (Box 1). Price movements during the May-June market sell-off were smaller than those in the 2004 downturn.

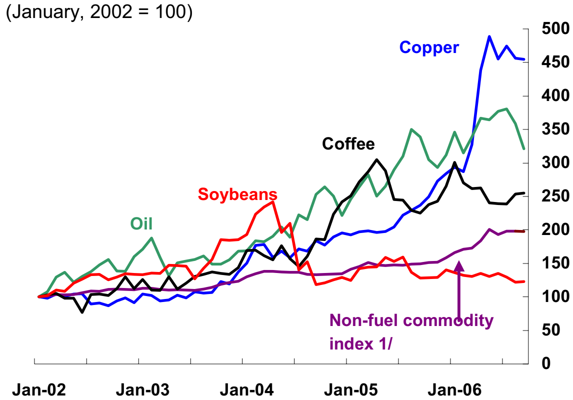
- **Volatile commodity prices**: While there are significant cross-country differences, the LAC region as a whole has so far benefited from high commodity prices. This reflects both higher energy prices (given the region's position as a net energy exporter) and high nonfuel commodity prices, which have helped to offset the negative impact of high oil prices in oil-importing countries. The projected gradual decline in nonfuel commodities prices beginning in 2007 could hence pose a challenge. Furthermore, the risks associated with possible new oil price hikes might outweigh their benefits for the region to the extent that they begin to weigh on global and partner country growth. Finally, developments in the regulatory frameworks for the energy sector in some countries could affect their long-term growth prospects (Box 5).

Latin America: Exports to the United States, 2005
(In % of total exports from the region or country to the world) 1/



Source: IMF, *Direction of Trade Statistics* .
1/ Total exports defined to include any intra-regional exports.

Commodity Price Developments
(January, 2002 = 100)



Sources: Datastream, WEO and IMF Research Commodities database.
1/ The non-fuel commodity index includes food and beverages, agricultural raw materials, and industrial metals.

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[10] Simulations reported in the September 2006 *World Economic Outlook*, for example, consider a scenario where U.S. inflation rises by ½ percentage point more than anticipated, prompting an increase in the federal funds rate by 75 basis points. Assuming that this coincides with reduced investor appetite for emerging market assets, interest rates in a representative Latin American country would need to rise by around 200 basis points to meet long-term inflation targets (IMF 2006d, Box 1.2).

Box 5. Changing Oil and Natural Gas Fiscal Regimes in Andean Countries[1]

High commodity prices have led to a trend among oil and gas exporters to secure a greater state share of the windfall profits made by foreign companies operating within their borders. The process has taken widely different forms, including increased state participation and higher export duties in Russia and Argentina, higher royalties in Kazakhstan, higher income taxes in the United Kingdom and Denmark, and lower cost recovery ceilings in Nigeria and Angola. Three countries in Latin America—Bolivia, Ecuador, and Venezuela—have made changes that fundamentally alter the fiscal regimes of the oil and gas sector.

Bolivia. A decree issued on May 1 mandated the nationalization of five hydrocarbons companies after a six-month negotiation period on compensation and operating arrangements with foreign parent companies. Full implementation of the decree would put the government in control of 81 percent of total natural gas production and 56 percent of gas reserves, and would put the state company YPFB in a dominant position both as a regulator and a monopolist controlling distribution and exports. During the negotiation period, the royalty rate on the two main natural gas fields, comprising 49 percent of total production, has been raised to 82 percent (after an industry-wide increase from 18 to 50 percent in May 2005). At current prices, the yield of these royalty and tax changes is estimated at 8 percent of GDP for 2006, although export prices are being revised through bilateral negotiations. Although an agreement on a 38 percent price increase has been reached with Argentina, negotiations with Brazil— the purchaser of 81 percent of gas exports—are still ongoing.

Ecuador. In May, a modification to the Hydrocarbons Law established a new tax equal to 50 percent of the additional gross revenue, resulting from oil prices in excess of those prevailing at the time the contract was signed (about US$20 per barrel). While firms have been paying the new tax, the required renegotiation of contracts is still ongoing. The full-year revenue yield from the change in the law is estimated at 2 percent of GDP.

Venezuela. In March, 32 oilfields under operating service contracts (accounting for about 20 percent of total production) were converted to PDVSA-majority joint ventures, consistent with the 1999 Constitution and 2001 Hydrocarbons Law. PDVSA has 60–80 percent equity in the new joint ventures, and full control over levels of production and budgets. Compensation for companies' past investments is being determined on a case-by-case basis, including in the form of equity in the new joint ventures, and bonds that can be used to finance future investment. The tax structure for these new companies includes a 30 percent royalty, 50 percent income tax, and a potential surcharge to ensure that total contributions equal at least 50 percent of gross income. Four existing joint ventures operating in the Orinoco Belt, accounting for another 20 percent of total production, have only minority PDVSA ownership, but this likely will change in the near future. As a first step, the tax structure of the existing joint ventures is being aligned with that of the new joint ventures (effective January 2007). This is estimated to yield revenues of 1.2 percent of GDP on an annual basis.

Impact

In the short run, these changes will substantially improve the public finances of each country. In addition, high oil prices, the desire to recoup sunk costs, and, in the case of natural gas, the difficulty in changing sources of supply, suggest that foreign investors will want to maintain a significant presence in these countries in the short run. However, over the medium term, the investment climate needs to be robust enough to also sustain new investments and raise production.

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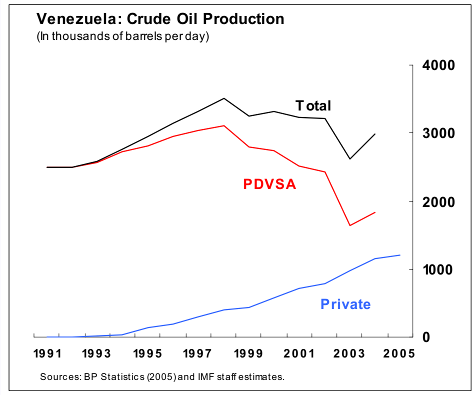
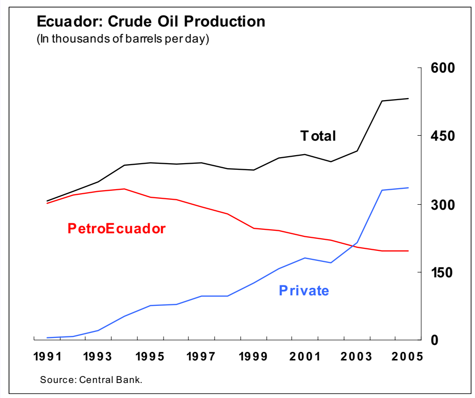
[1] Prepared by Trevor Alleyne.

Box 5. Changing Oil and Natural Gas Fiscal Regimes in Andean Countries (concluded)

Challenges





The key challenge is for the state oil and gas companies to increase their own investment and production, having assumed a larger direct responsibility for total production. Own production at both PDVSA and at PetroEcuador has been on a downward trend for some time, and overall crude oil production has so far been maintained or increased with the contribution of foreign companies. Achieving a turnaround in production will present important policy challenges:

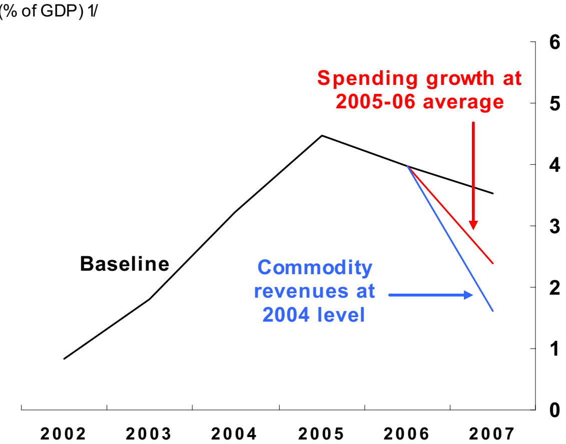
Redirecting resources to increase oil sector investment. Given the relatively strong outlook for oil prices, government oil revenues could play a key role in funding the increased investment requirements of the state oil companies as well as meeting social needs with well-targeted spending. In Venezuela, thus far, apart from continuing with fuel subsidies, PDVSA has been channeling substantial resources to directly finance social programs and new economic development funds (FONDESPA and FONDEN). In Ecuador, up until this year, the oil windfall was overwhelmingly used to fund increased current spending, while frozen domestic fuel prices since 2003—an implicit subsidy of 6½ percent of GDP in 2006—have caused cash flow problems for PetroEcuador. However, this year, the bulk of the oil windfall has been saved and a new law was passed that earmarks a part of the oil income specifically for energy-related infrastructure projects.

Improving governance to ensure that the state enterprises are competitive and run according to sound business practices. For example, in the case of PetroEcuador, a comprehensive reform to promote technically oriented decision making, transparency in procurement and financial practices, and overall efficiency has been on the agenda. In Bolivia, YPFB's new responsibilities will require strengthened technical and administrative capacity.

Another key challenge is to improve the climate for foreign investment. Notwithstanding Venezuela's and Bolivia's recent moves to reestablish majority state control in the energy sectors, both countries envisage foreign companies playing a significant role in the future development of the sector. In Ecuador, the government plans a new auction round for small oilfields before the end of the year and some private and foreign investors have announced plans to participate. Moving forward, it will be important to take steps to create an environment that offers a competitive return for investors and flexibility to accommodate government and investor interests under different international market conditions, stability of contracts, and well-designed dispute resolution processes.

- **Erosion of fiscal positions:** The combination of continued spending increases and lower commodity prices could quickly erode fiscal surpluses in the region, as commodity prices are projected to decline from generally high current levels. If commodity-based revenues in the seven largest countries in the region returned to the average level of 2004, this would worsen fiscal balances, holding other things constant, by about 2 percent of GDP. In addition, rapid spending hikes over 2005–06 may lead to pressures for continuing increases. If spending in the largest seven countries in the region, for example, were to continue to grow in 2007 at the same pace as in 2005–06, primary balances would worsen, on average, by about 1 percent of GDP relative to the baseline (1½ percent of GDP if Chile is excluded).[11]

Stress Tests of Fiscal Balances
(% of GDP) 1/



Source: IMF staff estimates.
1/ Averages of primary balances for seven largest countries.

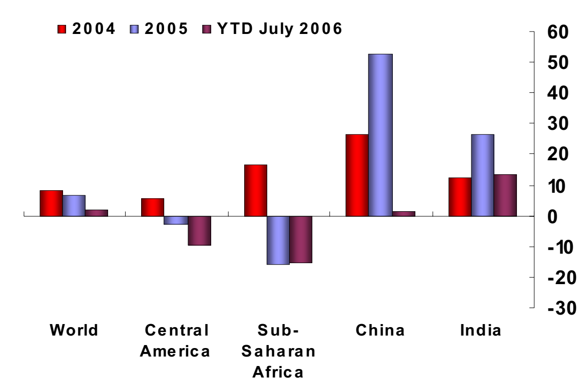
- **Trade pressures and protectionist sentiment in a number of countries:**

- The ***Caribbean*** will need to adjust to the erosion of preferential access for sugar and banana exports in EU markets. Early estimates show that the impact on exports could be several percentage points of GDP in some countries.

- In the ***Andean Region***, trade preferences under the Andean Trade Promotion and Drug Eradication Act (ATPDEA) are set to expire at the end of 2006, which would have a negative impact on countries in the near term. Assuming that recently negotiated free trade agreements (FTAs) with the United States are ratified, the impact of the loss in trade preferences is likely to be muted in Colombia and Peru. In Bolivia and Ecuador, however, the combined implications of trade preference expiration and increased competition from countries that have concluded FTAs could be more severe, including possible employment losses in exporting sectors and estimated one-off economic losses in the range of 0.2 and 0.4 percent of GDP. Slow progress on trade liberalization could also result in lower trade integration over the longer term, dampening the business climate and hurting the growth potential of these countries.

- ***Central America*** continues to be faced with competitive pressure in the textiles and clothing market from countries such as China in the wake of the elimination of the Multi-Fiber Agreement (MFA) quotas.

Textile and Clothing Product Exports to the US
(Year-on-year growth rate)



Sources: US, OTEXA; and IMF staff estimates.

[11] Based on preliminary fiscal projections for 2007.

Notwithstanding safeguard measures imposed by the United States on Chinese exports, textile exports from the region to the United States declined by 12 percent in the first half of 2006 compared with the first half of 2005, with all Central American countries except Nicaragua suffering declines. Given that the U.S. safeguards are set to expire in 2008, the near-term prospects for the textile and clothing market remain a concern.

- **Domestic policy context**: Macroeconomic volatility has been a recurrent risk in the region. However, recent electoral outcomes have not resulted in a weakening of macroeconomic policy frameworks. In part, this is a testimony to the increased social consensus for macroeconomic stability in the region in recent years (see Singh, 2006, and Box 3 in the 2006 Midyear Update of the *Regional Economic Outlook: Western Hemisphere*). In addition, with significant political shifts in some countries, there are high expectations that governments will make significant progress in addressing longstanding problems of poverty and income inequality, as further explored in section II.D.
- **Natural disasters**: In 2005 a number of severe hurricanes (Dennis, Emily, and Katrina) in the Gulf region and natural disasters had significant economic implications for affected countries. In Grenada, for example, the cost of hurricane Emily is estimated at 12 percent of GDP, while in Guyana, floods caused damage of 60 percent of GDP. The risk of natural disasters continues to be a concern for the Caribbean, especially those countries that were hard-hit in recent years and are still in the process of recovering.

D. Policy Challenges

The ongoing expansion presents a historic opportunity to entrench the recent reduction in the region's macroeconomic volatility and move forcefully forward with additional structural reforms. This will help lay the groundwork for sustainable economic growth and poverty reduction. It will also allow more countries in the region to move toward investment-grade ratings, further reducing financing costs and freeing fiscal resources for other uses.

Achieving this vision requires progress in three closely linked areas: first, macroeconomic policymaking, particularly in the area of fiscal policy; second, equity and social cohesion; and third, investment and entrepreneurship. Making Latin American societies fairer will remove an important source of volatility in a region in which economic inequality and social plight have often fed populist policies, which have in turn undermined stability. Higher trend growth is also important to lower the region's vulnerabilities in the medium term. But conversely, fewer macroeconomic crises, less policy volatility, and higher social cohesion would also raise investment and benefit growth, making it more sustained. And macroeconomic stability will particularly help the disadvantaged, who have often borne a disproportionate share of the costs of crises and high inflation.

Entrenching Macroeconomic Stability

Compared with previous cyclical recoveries, this expansion is generally on a solid footing (Box 1). In particular, primary fiscal balances and current accounts have consistently been in surplus in most countries; the recovery has relied far less on debt-creating inflows; exchange rates have been more flexible; and many Latin American countries have taken advantage of the favorable financing environment to prefinance their external financing needs, improve their debt structures, and accumulate reserves. In part, these improvements are the outcome of institutional reforms undertaken since the early 1990s, including greater central bank autonomy, and reforms of budgetary institutions, taxation, debt management, and intergovernmental relations.[12]

However, significant challenges remain to build resilience and reduce vulnerabilities further, particularly in the fiscal area:

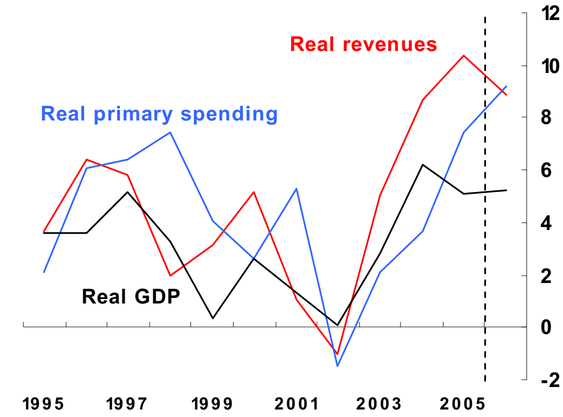
- **Primary (noninterest) spending** has recently accelerated;
- **the composition and quality of spending** needs to be improved;
- **budgets are rigid** in many countries;
- **public revenue to GDP is too low** in some countries; and
- **rising real credit growth** requires close monitoring.

Recent rapid spending growth risks repeating the procyclical pattern of previous expansions.[13] Strong economic growth has likely propelled output near or above capacity in several countries (see IMF, 2006c). A tighter fiscal policy stance—especially on the expenditure side—would help safeguard the region's hard-fought gains to achieve macroeconomic stability. It would also lighten the burden on monetary policy in keeping inflation low, while encouraging increases in private investment-to-GDP ratios, which remain below those prevailing in other developing regions. Additional fiscal consolidation would also dampen pressures for real appreciation, helping to maintain the region's recent healthy export growth.

Longer-term considerations also argue for more moderate growth in expenditures. In many countries, more durable growth could be achieved by using revenue windfalls to reduce

Real GDP, Revenues, and Primary Spending

(Annual % change) 1/



Source: IMF staff estimates.
1/ Unweighted averages for seventeen countries.

public debt ratios, which remain above 50 percent of GDP on average in the region. Lower debt levels would, in particular, reduce the vulnerability of the region to crises and eventually provide room for countercyclical fiscal policy. In countries where debt levels are low and revenue increases are expected to be permanent, the case is stronger for higher public spending on efficient, well-targeted social programs and public infrastructure. However, opportunities to reallocate spending from less productive programs should be fully exhausted, coupled with efforts to ensure that the quality of spending is maintained.

Rising current outlays also need to be contained to provide room for growth-enhancing public investment. While primary current spending has resumed its upward trend after a pause in 2003–04, capital spending has only recently started recovering. Capital outlays have declined from about 26 percent of government outlays in the late 1990s to 22 percent over 2005–06. Public investment remains low relative to that of other developing regions.[14] Addressing the region's

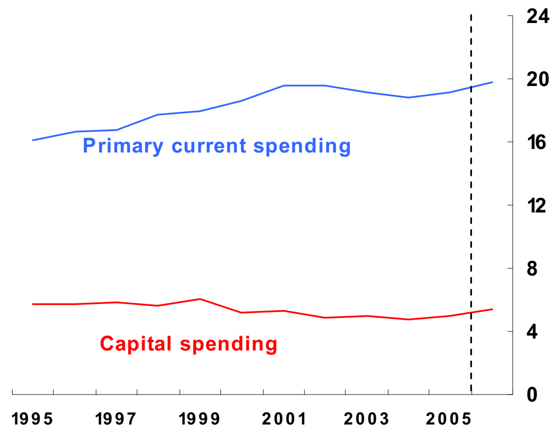
[12] See Carstens and Jácome (2005), Lora and Cárdenas (2006), Singh and others (2005), and Singh (2006).

[13] For recent empirical assessments of the cyclicality of government spending in Latin America, see Sahay and Goyal (2006) and Clements, Faircloth, and Verhoeven (2006).

[14] Over the 2003-06 period, public investment averaged 4½ percent of GDP in 16 Latin American countries, compared with 8½ percent of GDP in Asia and 8 percent of GDP in Africa.

significant deficiencies in infrastructure will, in many countries, require reforms to reverse the upward drift of current outlays. At the same time, weaknesses in the identification, evaluation, and implementation of investment projects also need to be addressed to bolster the productivity of capital outlays.

Primary Current & Capital Spending
(% of GDP) 1/



Source: IMF staff estimates.
1/ Unweighted average for seventeen countries.

Reducing budgetary rigidities will open additional fiscal space to improve the composition of spending and allow flexible reactions to economic shocks. In Latin America, revenue earmarking and mandatory expenditure requirements together affect a significant share of governments' budgets, ranging from two-thirds of primary revenue in Chile to over 80 percent in Brazil (Box 6). This creates significant obstacles for efficient fiscal adjustment. The earmarking of revenues for specific expenditures, for example, provides governments with limited scope to increase broad-based tax revenues for the purposes of fiscal adjustment. As such, fiscal consolidation must rely heavily on inefficient, narrowly based revenues, or cuts in discretionary spending that may be highly productive.

Some countries need to raise public revenue in order to entrench macroeconomic stability over the medium term. On average, revenue ratios in Latin America are broadly in line with other emerging markets. Based on data for the nonfinancial public sector (or the widest definition of government available), total revenue averages about 28 percent of GDP (figures refer to 2006 projections). On the basis of general government alone (which excludes public enterprises and the central bank), revenues average roughly 23 percent of GDP, compared with 26 percent in other emerging market countries.[15] [16]

However, there is considerable dispersion in public revenues: Bolivia, Brazil, and Venezuela generate more than 35 percent of GDP in public sector receipts; Argentina, Chile, Colombia, Costa Rica, Ecuador, Honduras, Mexico, Nicaragua, Panama, Paraguay, Uruguay, between 20 percent and 35 percent of GDP; and others less than 20 percent of GDP (El Salvador, Guatemala, and Peru). The collection of taxes on incomes and profits in the region is especially low relative to what would be predicted by countries at a similar level of development (de Ferranti and others, 2004; Perry and others, 2006). In some countries, the inability to raise sufficient tax revenue impedes the ability to use fiscal policy to address macroeconomic imbalances. It also constrains expenditures on public infrastructure and human capital development to levels that are insufficient for sustainable and equitable growth.

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[15] Some caution should be used in comparing the revenue effort across countries and regions, given the differing coverage of the public sector and the differing roles of public enterprises.

[16] The figure for other emerging market countries refers to an unweighted average of 16 countries (mostly from 2005) from the IMF Fiscal Affairs Department's Emerging Markets database. For some of these countries the data refer to central government. Commodity-based revenues comprise, on average, about 4 percent of GDP in Latin America, ranging from over 25 percent of GDP in Venezuela to zero in many countries. Based on a comparison of general government tax revenue alone, the ratios to GDP for Latin America and other emerging markets are 17½ percent and 20 percent, respectively.

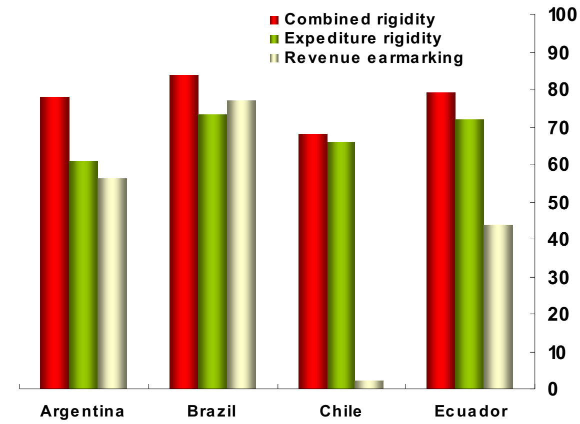
Box 6. Making Budgets More Flexible[1]

Widespread budget rigidities are an important constraint on fiscal management and fiscal space in Latin America. Budget rigidities stem from institutional arrangements that limit the budgetary authorities' ability to adjust the composition and size of the budget in the short run. A number of budget components like wages, pensions and debt service are naturally inflexible Other inflexibilities are rooted in the constitution, laws, or decrees that earmark revenues, set minimum spending requirements, or link spending to the evolution of certain macroeconomic variables, such as inflation and growth. Budget rigidities can be measured and compared across countries by adding expenditure and revenue rigidities, expressed in common units (e.g., as a share of revenue), after netting out the overlap that in some cases occur (e.g. when social security contributions are earmarked to make pension payments, which are mandatory and need to be honored regardless of whether enough contributions are collected).

In Latin America, revenue earmarking and mandatory expenditure requirements together affect a significant share of governments' budgets, ranging from two-thirds of revenue in Chile to over 80 percent in Brazil (estimates for all countries are based on 2003 data for primary revenues and expenditures). Not surprisingly, the lack of budget flexibility ranks high among the most pressing problems faced by budgetary authorities. Budget rigidities are also a source of frustration for country authorities who find little fiscal room for moving ahead with new priorities for government programs.

Budget Rigidity

(% of primary revenue)



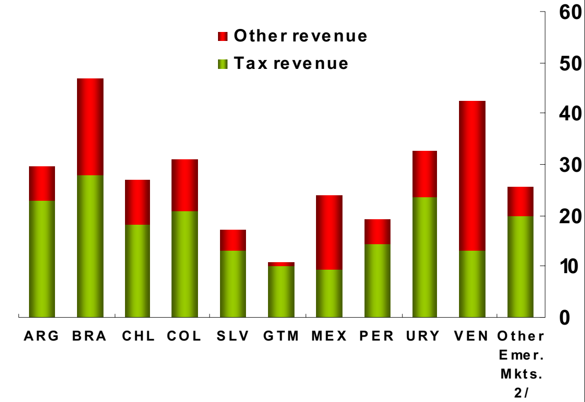
Source: Alier (2006).

Constraints to fiscal management introduced by budget rigidities also reduce economic efficiency and lead to suboptimal outcomes. The negative consequences of budget rigidities stem from limits to the extent that public spending can be reallocated in response to changing needs; a built-in bias toward higher spending and taxation; distortions introduced in tax policy choices; and weak incentives to improve the efficiency of public spending. Budget rigidities can also make fiscal adjustment more difficult, as increases in revenues may need to be allocated to preordained uses.

Budget management is particularly difficult when revenue and spending inflexibilities are incompatible with the government's overall resource constraint. When budgets are very rigid, governments face great difficulties in meeting all the obligations imposed by legislation. In practice, governments are often forced to resolve such conflicts by creating additional layers of legislation to bypass decrees and laws creating the rigidities, which reduces the transparency of the budget process and erodes the credibility of fiscal institutions. Moreover, the perception that certain legal mandates lose out relative to others may lead to a race to entrench the rigidities in "stronger" pieces of legislation (from decrees, to laws, to special majority laws, to constitutional amendments). This in turn compounds rigidities and sets up future potential conflicts between them.

[1] Prepared by Max Alier. For further discussion, including options for reducing budget rigidities, see Alier (2006).

Public Sector Revenues, 2006
(% of GDP) 1/



Source: IMF staff estimates.
1/ Nonfinancial public sector or total public sector. Chile: general government; Guatemala: central government. In Mexico, excludes local governments.
2/ Unweighted average for 16 countries for 2005 or latest data available.

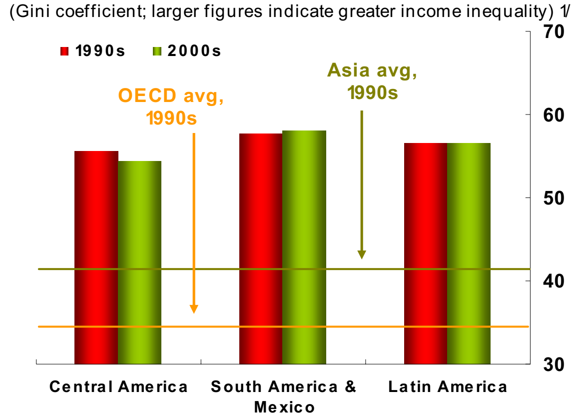
A broadening of tax bases and improved tax administration should be at the forefront of the revenue effort. The scope for raising revenues through higher tax rates is limited, except perhaps for consumption taxes. At the same time, given extensive exemptions and weaknesses in tax administration, there is ample scope to raise revenues without increasing tax rates. This avenue—rather than raising tax rates—should be the first priority. The productivity of the value added tax across the region, for example, varies considerably; based on data for 2002-03, the productivity of the VAT in Mexico was about half that of Chile, and in Argentina, Colombia, and Ecuador around two-thirds. There is also a wide dispersion in the efficiency of income taxation (Haindl Rondanelli, 2005).

While not yet a source of concern in most countries, high real credit growth—particularly to households—is an important development that should be watched carefully by financial sector supervisors (Box 7). The pick-up in credit growth follows a period of negative growth during the region's downturn in the late 1990s and early 2000s, and so far falls well short of a typical "lending boom"—a period when the ratio of credit to GDP deviates significantly from its historical trend. Moreover, past lending booms in Latin America were typically a result of financial liberalization and deregulation, while the current expansion comes after a period of regulatory reforms that have strengthened bank balance sheets and credit assessment capacities. This said, the fact that the current lending boom is in part centered on household credit (see section II.B) poses challenges, given the relative inexperience of banks with this type of credit and the short history of institutions such as credit bureaus in the region (IMF, 2006b).

Making Latin American Societies More Equitable

Persistent high inequality in Latin America has tended to erode social cohesion and diminish the impact of economic growth on poverty. Inequality reflects a number of factors, including the region's colonization and settlement history. Making societies more equitable without destroying prosperity is inherently a slow and difficult process: attempts in the region to redistribute quickly have led in the past to political crisis and economic collapse, and have often weakened institutions. Nonetheless, policy levers exist that could be used to make Latin American societies more equitable. These include fiscal reforms encompassing both the tax system and public expenditures; labor market reform; and reforms

Income Inequality
(Gini coefficient; larger figures indicate greater income inequality) 1/



Sources: ECLAC; and de Ferranti et al. (2004).
1/ For Latin American countries, 1990s = available observation closest to 1990; 2000s = most recent available observation.

that extend public services and economic opportunity to disenfranchised groups. Furthermore, macroeconomic crises and high inflation have tended to exacerbate inequities in the region. Entrenching macroeconomic stability would thus also benefit equity.

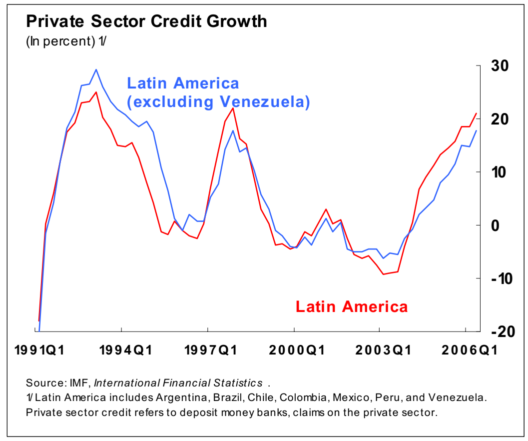
Reducing debt burdens will allow countries to allocate a larger share of spending to social sectors, as high levels of debt have squeezed out this spending in the past (Lora and Olivera, 2006). Beyond this, specific possible reforms of the tax system and of public expenditures include:

- **Base-broadening tax reform.** The scope for redistribution through the tax system is usually modest (Tanzi and Chu, 1998). Nevertheless, a reduction in tax exemptions and the broadening of the tax base can, in many cases, have a salutary effect on equity (Box 8). Higher tax revenues can also contribute to equity by providing resources for spending programs that benefit the poorest.
- **Increasing the share of pro-poor programs in government expenditures.** Allocating a greater share of spending to the provision of infrastructure, especially to poorer regions, could reduce inequalities (Calderón and Servén, 2004; Fay and Morrison, 2005). Within current spending, a reduction in nontargeted petroleum and electricity subsidies would also promote equity, as these benefits tend to be captured largely by middle- and upper-income groups (Gupta and others, 2000, 2003). In education, cost recovery could be increased at the tertiary level, as this spending largely benefits upper-income groups; this cost recovery could be used to strengthen the quality of secondary education, especially in rural areas (de Ferranti and others, 2003, 2004). Reforming public pension systems would also contribute to greater equality, as in most cases these pension benefits accrue to upper-income groups (de Ferranti and others, 2004). Finally, there is scope to further expand conditional cash transfer programs—such as *Oportunidades* in Mexico, *Bolsa Familia* in Brazil, and *Chile Solidario* in Chile—which in practice have been the most progressive form of government spending. The redistributive impact of these outlays has so far been limited by their modest size relative to other government outlays.
- **Reducing budgetary rigidities to make room for pro-poor spending.** Although budgetary rigidities sometimes have their origin in attempts to protect social spending—for example, when a particular level of spending on health, pensions, or education is mandated, or when revenues are earmarked for such purposes—in practice, spending within these broad categories is often not very progressive, benefiting the middle and upper-middle class more than the poor. While specifics vary from country to country, targeted programs—such as the conditional cash transfer programs mentioned above—tend to be financed from discretionary funds, which take the brunt of adjustment in a downturn. Hence, a sustainable expansion of targeted programs, or the reorientation of government spending to activities that are most productive in combating poverty, requires more flexible budgets.

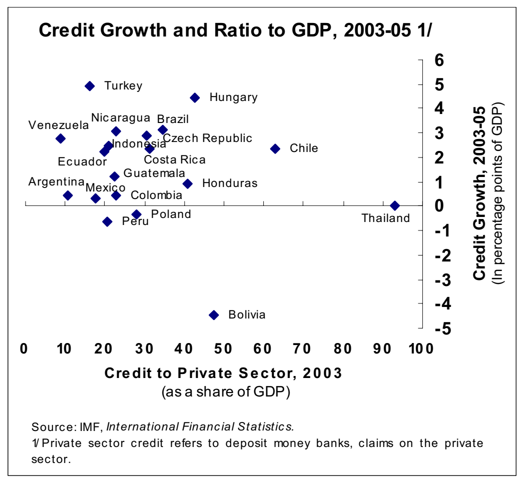
At a more fundamental level, greater equity requires better equality of opportunity, through reforms targeted at labor markets, government services, and credit markets. In Latin America, a large share of the labor force remains outside the formal sector, with consequently limited access to credit and financial services, and government services. This limits the extent to which members of these groups can accumulate human capital and financial wealth, and perpetuates inequality. Broader access to credit, financial services and educational opportunities are critical for reducing poverty and allowing upward mobility over the medium term (Perry

Box 7. Is Credit Growing Too Fast?[1]

Domestic credit has grown significantly over the past two years in several Latin American countries. In the first quarter of 2006, real credit grew at an average annualized rate of about 15 percent in the largest seven Latin American countries, excluding Venezuela, where the growth rate was 41 percent. The pick-up in credit growth follows a relatively long period of negative growth, a result of the region's downturn in the late 1990s and early 2000s, and is somewhat slower than in the previous expansions of 1991–94 and 1996–98.

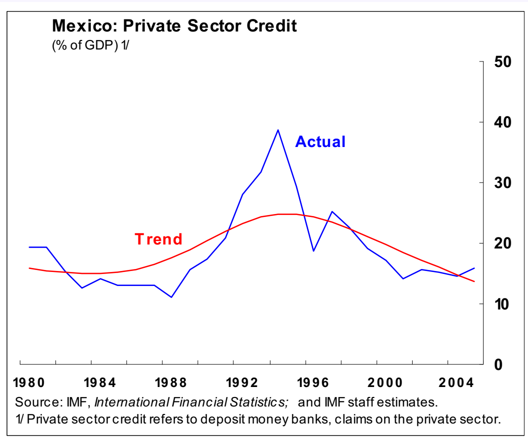


Is credit growth "too fast," in the sense that it may overstretch the capacity of Latin American economies to allocate it efficiently and foreshadow a new "bust"?



Credit growth, reforms, and the economic cycle

- In most countries, credit is growing from very low levels, following structural reforms in the financial system in the 1990s in many Latin American countries. Increases in credit-to-GDP ratios of around 2-3 percent per year are not unusual in countries that have restructured their banking systems and are experiencing a process of reintermediation and financial deepening. Credit growth has so far been below that benchmark figure.
- Credit growth rates are not unusually high for a cyclical recovery, especially one preceded by a relatively long period of negative credit growth.
- The current credit expansion does not so far rise to the level of a "lending boom" —a period when the ratio of credit to GDP deviates from its historical trend on a sustained basis, generally by more than 4-5 percentage points of GDP per year (Gourinchas, Valdes, and Landerretche, 2001; Borio and Lowe, 2002). Deviations from trend are rather small for the largest countries in 2005, as ratios of credit to GDP had been below trend in the early 2000s. In a typical lending boom experience, such as Mexico between 1988 and 1994, credit grew around 5 percentage points of GDP on an annual basis for six years in a row.



[1] Prepared by Jorge Roldós.

Box 7. Is Credit Growing Too Fast? (concluded)

- Although Latin America has a history of boom-bust cycles associated with lending booms, these were mostly associated with periods of financial liberalization and deregulation. The current expansion comes after a period of sustained bank and regulatory reforms that have strengthened banks' balance sheets and credit assessment skills, suggesting it is more likely to be a benign episode of improved access to credit and growth—especially in the large countries and with the possible exception of Venezuela.

Crowding in the private sector

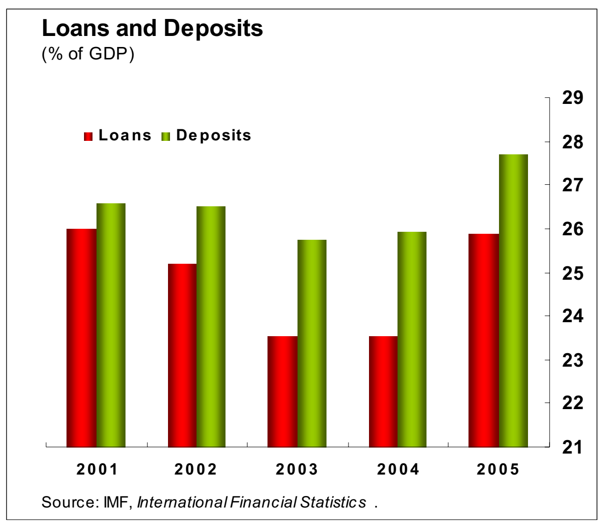
While credit growth has partly been financed by capital inflows, the foreign share of liabilities in the banking system has fallen. Furthermore, fiscal consolidation has resulted in more deposits being channeled to credit to the private sector, rather than government bonds. This healthy "crowding in" process can be inferred from the recovery in loan-to-deposit ratios.

Foreign Bank Financing of Domestic Banking Sector

	Cross-Border Claims of BIS Banks on Domestic Banking Sector (In billions of U.S. dollars)			Foreign Liabilities in Total Liabilities (In percent)		
	1997	2002	2005	1997	2002	2005
Latin America	**74.4**	**30.1**	**47.2**	**16.8**	**13.9**	**12.0**
Argentina	12.0	2.6	1.9	20.0	24.8	8.5
Brazil	26.9	9.9	18.1	15.0	17.0	8.2
Chile	3.6	3.1	6.0	5.0	12.9	13.6
Colombia	4.6	1.2	2.1	11.9	4.9	4.6
Ecuador	1.1	0.3	0.6	19.4	8.4	6.2
El Salvador	0.5	0.5	0.9	9.1	13.4	18.9
Mexico	13.5	5.5	10.4	23.7	25.2	37.0
Peru	3.3	2.0	1.7	15.3	4.3	4.6
Uruguay	1.6	0.4	0.4	35.3	31.5	16.5
Venezuela	1.3	0.7	0.6	1.2	1.5	0.2
Asia	**397.2**	**134.2**	**184.3**	**30.1**	**16.8**	**16.9**
Central Europe	**15.6**	**18.5**	**28.3**	**12.3**	**8.8**	**11.2**

Sources: BIS; and IMF, *International Financial Statistics*.

Supervisory challenges



Notwithstanding the largely benign nature of credit growth so far, financial sector supervisors will need to exercise careful surveillance, in particular with respect to lending to the household sector. As noted in section II.A., household credit has been growing rapidly in most of the large Latin American countries. Households are typically considered a lower-risk segment of the credit market than the corporate sector, owing to easier origination monitoring and collection of loans. However, the relative inexperience of banks and regulators with this type of credit raises potential concerns (see also IMF, 2006b). While the surge in lending activity owes in part to improved credit market infrastructure, including credit bureaus, revamped bankruptcy laws, and loan recovery frameworks, some of these institutions are relatively new and untested. Furthermore—and in contrast to the experience in mature economies— growth in household debt has been stronger in consumer lending rather than in mortgages, and in some countries has reportedly been associated with margin lending for the purchase of shares. Supervisors in the region should establish an active dialogue with banks to preempt potential overborrowing by individual debtors, and some have already done so. A tightening of prudential regulations might be warranted if household lending growth continues at this pace for much longer.

Box 8. Fiscal Reforms and Equity in Latin America and the Caribbean[1]

Fiscal reform can have a positive effect on equity. Fiscal reforms generally have redistributive implications. If well designed, these can benefit equity beyond the positive influence of sound fiscal policy on macroeconomic stability. Several recent or ongoing fiscal reforms in Latin America embody such redistributive elements, as follows:

Tax reform

- The introduction or expansion of progressive taxes, such as property taxes (Panama), the personal income tax (Antigua and Barbuda, Paraguay, and Uruguay), and taxes on financial income (Nicaragua, Uruguay);
- The reduction of exemptions for the income tax or VAT (Dominican Republic, El Salvador, Nicaragua, Panama, and Trinidad and Tobago). In the case of the VAT, the distributive effect of removing exemptions depends, inter alia, on which income groups most heavily consume the goods or services in question. In some Eastern Caribbean Currency Union (ECCU) countries, the introduction of the VAT is fostering equity by extending taxation to items more heavily consumed by higher-income groups that were previously untaxed;
- The generation of resources for spending programs that benefit the poor. Even in cases where the burden of higher taxes is proportionate or slightly regressive, the combined incidence of taxation and expenditures can be progressive.

Expenditure reform

- Reducing or better targeting subsidies for petroleum products and electricity, which tend to be captured by upper-income groups (ECCU countries, El Salvador, Paraguay, and Trinidad and Tobago).
- Reforming public pension systems. Beneficiaries of these systems tend to come from higher-income groups (Paes de Barros and Foguel, 2000) and contributions are often inadequate to cover benefits over the longer term. The track record in recent years has been mixed on this front, but progress has been made in Barbados, Panama, and Peru.
- Strengthening social safety net programs to protect the poor from the adverse effects of crises (Chile, Uruguay).
- Developing transfer programs that tie cash assistance to the poor to human capital development (Argentina, Brazil, Chile, Colombia, Honduras, Mexico, Nicaragua, Paraguay, and Peru).

Even bolder steps will be necessary to significantly reshape the region's legacy of inequality. While the sample of measures delineated above has moved policies in the right direction, in many countries the tax effort remains modest, and a large-scale effort to reallocate government spending programs to programs that most benefit the poor is yet to be undertaken. A key challenge for policymakers will be to generate the consensus needed to implement these reforms.

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[1] Prepared by Benedict Clements and Evridiki Tsounta.

and others, 2006). At the same time, improving governance could lead to sizable reductions in inequality (Gupta, Davoodi, and Alonso-Terme, 2002). Finally, labor market reform—which has made relatively little progress over the past decade (see Box 9) is critical to spur employment growth and facilitate the absorption of workers into the formal sector. This would allow the currently disenfranchised to benefit from government services that may be restricted to participants in the formal economy, including the pension system, and most of the social safety net.

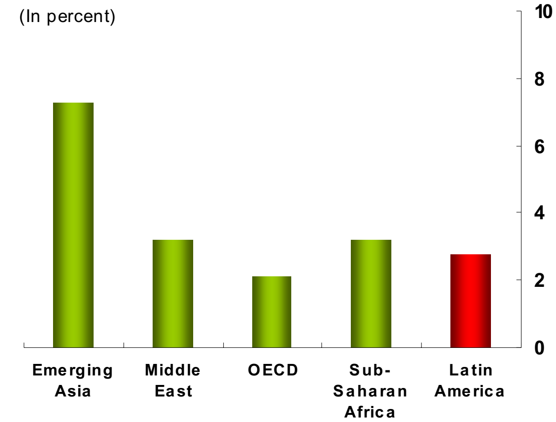
The adverse effects of inflation on inequality are well known (Guitián, 1998). In addition, economic crises tend to have deleterious effects on both poverty and income distribution, through several channels. Currency collapses tend to hurt the urban poor, whose incomes are tied to services, while a significant share of their consumption basket is in tradable items such as food (Fallon and Lucas, 2002; Agénor, 2004). Furthermore, crises produce sharp rises in unemployment, which usually hits unskilled labor the hardest. The concomitant reduction in labor earnings can also lead to higher inequality. Finally, even when inequality does not increase, crises have damaging long-term effects on the poor as government services are curtailed to respond to macroeconomic imbalances.

Reducing Barriers to Growth

Growth in Latin America and the Caribbean, although higher in recent years, continues to lag other emerging market and developing country regions. To achieve a rapid improvement in living standards and begin closing the gap with the advanced countries, growth will need to be raised in a way that is sustainable over the medium term.

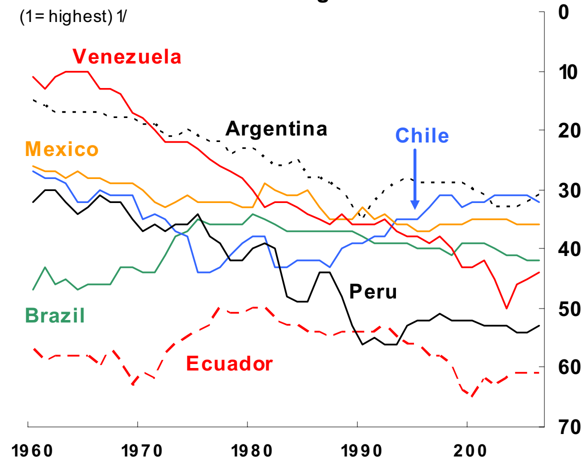
The recent policy debate has emphasized that the critical constraints to higher growth are not necessarily the same in all countries, and hence that growth policies need to be defined at the country level (see Hausmann and Velasco, 2005;

World Regions: Real GDP Per Capita Growth, 2003-06
(In percent)



Source: IMF staff estimates.

Latin America: GDP Rankings
(1= highest) 1/



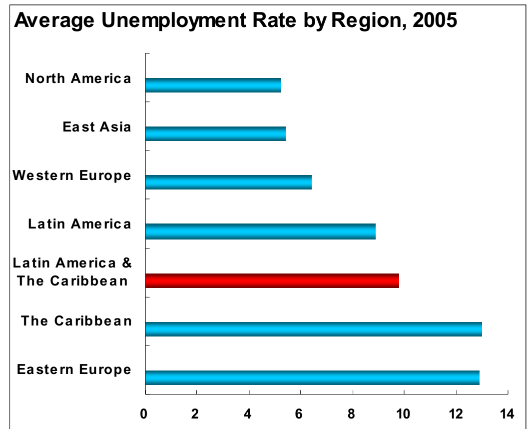
Sources: Penn World Tables Version 6.1; and IMF staff estimates.
1/Based on PPP-adjusted real per capita GDP in 108 countries.

and Zettelmeyer, 2006, for a survey). At the same time, it is clear that Latin American countries continue to suffer from a number of common problems that might be constraining growth. Among these are high macroeconomic volatility and highly unequal income distributions, which have recently been linked to the ability of countries to sustain growth spells (Berg, Ostry, and Zettelmeyer, 2006). Hence, progress on these fronts, as discussed in the last two sections, should improve growth performance in Latin America. Other problems include relatively low quality and coverage of education, institutional weaknesses, and lack of openness and competition.

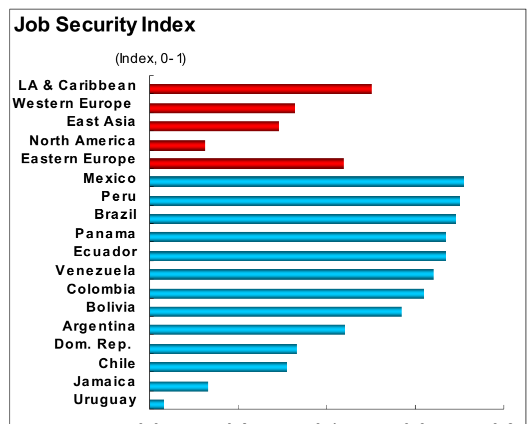
Box 9. Labor Market Regulations and Reform in Latin America and the Caribbean[1]

High unemployment

Labor market performance in Latin America and the Caribbean has been weak compared with other regions. Since 2003, unemployment rates have declined substantially in the largest countries in the region. Nonetheless, those rates are still above 9 percent (with the exception of Chile and Mexico), and higher than in most other parts of the world. Rates of unemployment are especially high for women and the young (IADB, 2004). Few workers (about 40 percent) are protected against the risk of income loss (Djankov and others, 2003).



Source: WEO.



Source: Djankov and others (2003).

Labor market regulations have had adverse effects on performance. These regulations create rigidities that allow vacancies and unemployment to coexist, contributing to high overall unemployment rates. Job security regulations (e.g., severance payments, job security rights enshrined in a country's constitution) are among the most restrictive in the world and indicators capturing key conditions of employment (e.g., hours of work, overtime work) also show that the level of protection in the region is very high—being surpassed only by Eastern Europe. Within the region, the countries with the highest job protection vary, depending on the indicator used. Indeed, while Heckman and Pagés (2004) find that workers in Colombia, Ecuador, and Venezuela, are the most protected, Djankov and others (2003) find that Brazil, Mexico, and Peru exhibit the highest job security.

Slow progress on labor reform

Few countries in the region have implemented significant labor reforms. In cases where reforms have been implemented, they were relatively narrow in scope (Saavedra, 2003). Some countries aimed at reducing firing costs, but with limited success, since the attempt to eliminate severance payments was not accompanied by alternative means of insurance. Many countries tried to avoid high dismissal costs by using temporary contracts (e.g. Brazil, Colombia, and Peru), but such contracts had negative effects on wages and increased workers' perception of job insecurity. Several reforms aimed at reducing the negative effect of high nonwage costs, but ended up increasing these costs. For example, health and pension contributions were increased in Colombia, and pension contributions were raised in Peru. Also, although the real minimum wage declined in many countries during the 1990s (e.g. Argentina, El Salvador, Mexico, Peru, and Venezuela), it remains binding in many countries, with a negative impact on labor market performance.

Agenda for reform

A comprehensive reform agenda needs to be implemented if labor market performance is to be enhanced. The implementation of such an agenda is key if the region is to benefit from the decline in the dependency

[1] Prepared by Alejandro López-Mejía.

Box 9. Labor Market Regulations and Reform in Latin America and the Caribbean (concluded)

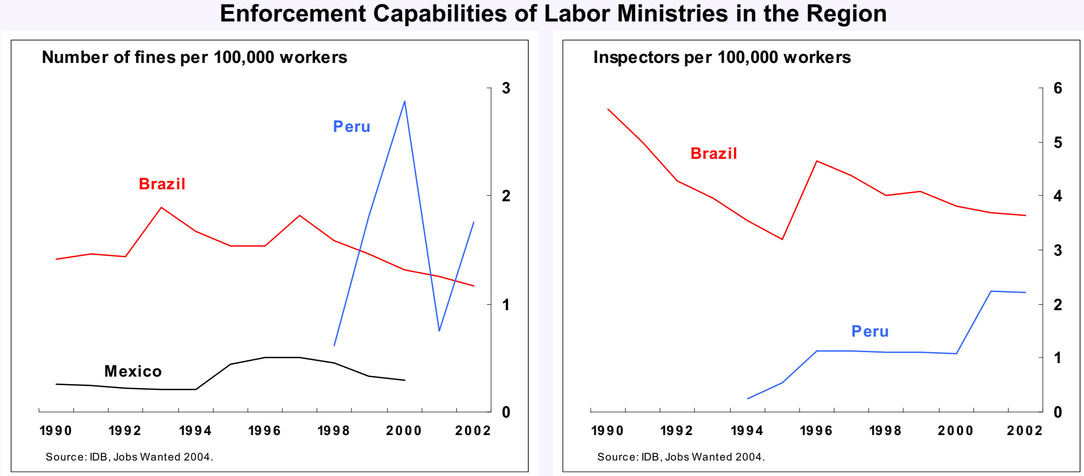
ratio, which represents a demographic opportunity to invest more per child and increase the average worker's savings for retirement.

- **Addressing existing rigidities in legal and regulatory frameworks**. These reforms could be designed, in particular, to benefit unemployed youth—and reduce the social tension associated with high youth unemployment—by relaxing existing barriers, regulations, and discriminatory practices that make it difficult for young workers to enter the labor market. Adequately sequencing product and labor market reforms will be helpful in making them politically more acceptable. Focusing first on deregulating product markets, in particular, would foster competition, increase real wages (through lower prices) and reduce unemployment. Active labor market policies can also play a role, but they have high budgetary costs (López-Mejia and Pazmiño, 2006). In the context of scarce public resources, there is a need for enhanced collaboration between the public and private sectors to improve the effectiveness of active labor policies. Such collaboration is taking place, for example, in Brazil, Chile, Costa Rica, and Mexico in the areas of training and labor intermediation services.

- **Protecting workers against the risks of severe income loss.** Workers in the region are protected by high severance payments, but these benefits cover few workers and have a negative impact on employment. Accordingly, efforts should focus on expanding public unemployment insurance—rather than severance payments—as a means to cover a larger share of the population against income losses. At the same time, unemployment contribution rates and benefits should be modest to avoid adverse labor market effects and benefits should be fully financed by contributions. To facilitate this expansion, many countries will first need to improve their enforcement and registration systems.

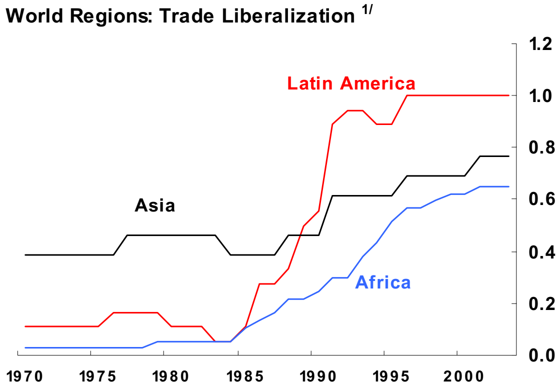
- **Developing strong labor market institutions**. Countries in the region have invested relatively few resources in the development of labor institutions. While regulations need to be modified, widespread noncompliance—including with rules for benefit payments and working conditions—must also be addressed. During the last decade, available data suggest that only Peru increased the number of inspectors needed to enforce regulations. It was also the only country in which enforcement results improved, with strong gains in 1999, 2000, and 2002. Such institutions are a key ingredient for effective labor policy and could help promote better relationships between workers, firms, and unions. Success in enhancing regulatory and enforcement capabilities will also require expanding public and private sector collaboration (IADB, 2004).

Enforcement Capabilities of Labor Ministries in the Region



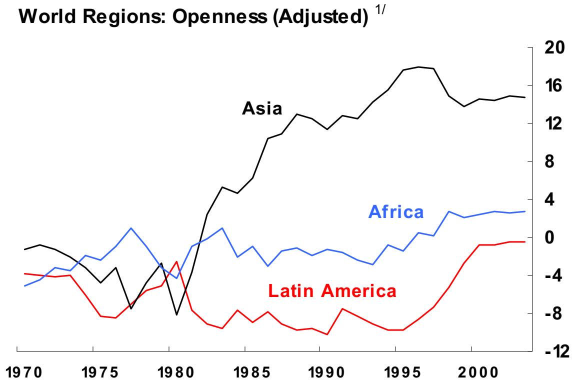
In spite of significant trade liberalization, Latin America remains comparatively less open to trade and competition. This is visible in both macroeconomic "openness" measures and survey-based estimates of entry costs (Djankov and others, 2002). This is one area whose importance for growth—both directly, and through institutional changes that come with greater openness—is broadly recognized. It is also one in which the region significantly trails

World Regions: Trade Liberalization 1/



Source: Wacziarg and Welch (2003).
1/ Latin America refers to an unweighted average of 18 Latin American countries, Asia to an unweighted average of 13 Asian countries, and Africa to an unweighted average of 37 African countries.

World Regions: Openness (Adjusted) 1/

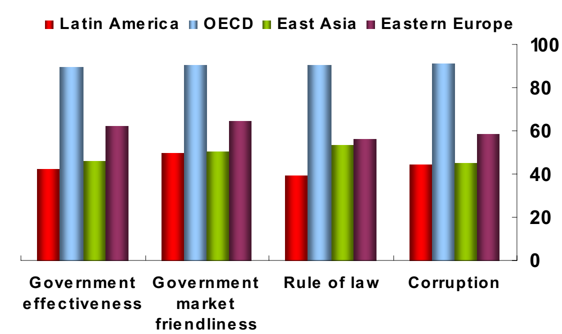


Sources: Zettelmeyer (2006); and IMF staff calculations.
1/ Latin America refers to an unweighted average of 18 Latin American countries, Asia to an unweighted average of 14 Asian countries, and Africa to an unweighted average of 41 African countries.

the growth leaders in Asia. Direct barriers to trade in goods—high tariffs and quotas—have been significantly reduced by now, but tariffs could be lowered further and made more uniform in structure. In addition, plenty of scope remains for reducing the costs of doing business, improving regulatory frameworks, and attracting foreign direct investment. Moreover, barriers to trade in services remain high, with adverse effects on the competitiveness of the region's manufacturing sector.

There is also scope for improving institutions, human capital, and administrative capacity in the region. In many countries in Latin America, growth has been constrained by a weak state: poor government services, a weak judiciary, high crime, corruption, tax evasion, and informality. Many of these weaknesses have shown themselves resistant to attempts to reform specific institutions (World Bank, 2005). Making institutional reform more successful and lasting will likely require efforts on several fronts, including: increasing the level of human capital in the region (both within the government, and in society at large); changing key rules and incentives in the political process that are likely to enhance the quality of policymaking; and building constituencies that support institutional reform. In this context, measures that lead to greater openness and competitiveness might be important not just in themselves but because they create a demand for better institutions and further reforms.[17]

World Regions: Quality of Governance Indicators, 2004
(In percent) 1/



Source: Kaufmann, Kraay, and Mastruzzi (2005).
1/ Percentile rank (percent of countries worldwide ranking below regional average). Sample includes China but excludes India.

[17] For recent contributions on these themes, see Glaeser, Ponzetto and Shleifer (2006); Johnson, Ostry, and Subramanian (2006); Inter-American Development Bank (2006); Rajan and Zingales (2006); and Tommasi (2006).

Box 10. The Evolving Role of the Fund in Latin America[1]

Favorable global conditions and economic performance have reduced the need for the Fund's direct financial support to the region. After the Fund-led support packages of 2002–03 that were assembled to address the crisis situations faced by many countries, the region quickly stabilized and returned to growth, with output in the most affected countries now well above pre-crisis levels. With improved domestic and external conditions, the Fund's financial assistance to the region has contracted sharply, with purchases falling from an average of over US$18 billion per year in 2002–03 to US$0.5 billion in the first seven months of 2006 and outstanding credit falling from US$48 billion at end-2003 to US$3.1 billion in July 2006. Improved conditions have also allowed Brazil (December 2005), Argentina (January 2006), and, recently, Uruguay (March and August 2006) to repay all (in the case of Argentina and Brazil) or a large fraction (in the case of Uruguay) of their outstanding Fund obligations ahead of schedule. Finally, Bolivia, Guyana, Honduras, and Nicaragua have been included in the Multilateral Debt Relief Initiative and have received debt relief from the Fund amounting to US$0.7 billion.

In these favorable conditions, the Fund is improving its collaboration with its members beyond crisis-driven lending. As the pressures of crises have subsided, Fund surveillance has sharpened—with greater emphasis on financial sector issues, debt sustainability and regional issues—both in the context of regular Article IV consultations and through ongoing contact with country authorities, parliamentarians, business persons, and members of civil society. This changed role for the Fund has enriched the policy dialogue with many countries. In this environment, the Financial Sector Assessment Program (undertaken in partnership with the World Bank) has continued to play an important role in Fund surveillance in Latin America, with 26 countries having participated so far in the program.

The Fund is currently reshaping its role in a way that could have important implications for the region. As a culmination of a two-year process, in April 2006 the IMF's Managing Director presented a set of specific proposals for the implementation of a medium-term strategy to deal with the challenges facing the Fund. These proposals have several goals, including:

- **Improved country surveillance**. Improved surveillance will entail more focused macroeconomic analysis with enhanced surveillance over financial and capital markets in emerging market countries. It will also involve more effective engagement in low-income countries, including by focusing on the macroeconomic implications of aid flows, and on ensuring that beneficiaries of debt relief do not again accumulate excessive debt.
- **Improved global surveillance through multilateral consultations**. The IMF is currently engaged in a multilateral consultation process, involving China, the euro area, Japan, Saudi Arabia, and the United States, to promote joint action toward reducing global imbalances while sustaining growth.
- **The proposed creation of a new lending instrument** to provide liquidity for emerging market countries that have strong fundamentals but remain vulnerable to shocks. The aim would be to provide assurances that substantial financing will be available in time of need, a framework for policy commitment and monitoring, and a signal to markets.
- **Improved governance**. On September 18, 2006, the Board of Governors of the IMF approved a resolution on quota and voice reform, which envisages (1) initial quota increases for the four most underrepresented members—including Mexico; (2) the elaboration of a new quota formula; (3) an amendment of the Articles of Agreement to increase (at least double) the number of "basic votes" of each member, so as to protect the voting power of low-income countries as a group, and to safeguard the proportion of basic votes in total voting power; and (4) a second round of quota increases following steps (2) and (3). The first step is to take place in late 2006, the remainder in 2007 and 2008.

[1] Prepared by Roberto Benelli.

Main Economic Indicators

	Output Growth (annual rate in percent)					Inflation (period average)					Ext. Current Account (in percent of GDP)				
	95-03 Avg.	2004	2005	2006 Proj.	2007 Proj.	95-03 Avg.	2004	2005	2006 Proj.	2007 Proj.	95-03 Avg.	2004	2005	2006 Proj.	2007 Proj.
North America 1/	**3.1**	**3.9**	**3.2**	**3.4**	**2.7**	**3.3**	**2.8**	**3.3**	**3.5**	**2.8**	**-2.8**	**-4.9**	**-5.4**	**-5.6**	**-5.8**
United States	3.1	3.9	3.2	3.4	2.6	2.4	2.7	3.4	3.6	2.9	-3.1	-5.7	-6.4	-6.6	-6.8
Canada	3.3	3.3	2.9	2.9	2.8	2.0	1.8	2.2	2.1	1.8	0.6	2.1	2.3	1.5	1.1
Mexico	2.6	4.2	3.0	4.4	3.3	16.4	4.7	4.0	3.5	3.5	-2.3	-1.0	-0.6	-0.3	-0.7
South America 1/	**1.9**	**6.5**	**4.7**	**4.8**	**4.5**	**12.7**	**6.3**	**6.9**	**5.7**	**5.7**	**-2.0**	**2.5**	**2.9**	**2.4**	**1.4**
Argentina	0.4	9.0	9.2	8.0	6.0	4.6	4.4	9.6	10.9	12.0	-0.8	2.3	2.1	1.5	1.0
Bolivia	3.2	3.9	4.1	4.1	3.9	5.3	4.4	5.4	4.1	4.0	-4.3	3.9	5.0	5.0	4.8
Brazil	2.1	4.9	2.3	3.2	4.0	14.9	6.6	6.9	4.2	3.4	-4.3	1.9	1.8	1.3	0.6
Chile	4.6	6.2	6.3	5.2	5.5	4.8	1.1	3.1	3.5	3.1	-2.2	1.7	0.6	2.1	0.9
Colombia	1.9	4.8	5.2	5.2	4.5	13.4	5.9	5.0	4.7	4.2	-2.5	-1.0	-1.6	-1.6	-2.0
Ecuador	2.2	7.9	4.7	4.4	3.2	35.6	2.7	2.1	3.3	3.0	-1.7	-0.9	-0.3	2.7	-0.3
Paraguay	1.2	4.1	2.9	3.5	4.0	9.9	4.3	6.8	8.6	5.2	-2.1	0.8	-2.7	-2.5	-2.0
Peru	3.4	5.2	6.4	6.5	5.5	5.6	3.7	1.6	2.1	1.9	-4.2	0.0	1.3	1.3	0.2
Uruguay	-0.3	11.8	6.6	6.5	4.2	16.6	9.2	4.7	6.3	5.3	-1.2	0.3	0.0	-3.1	-4.0
Venezuela	-0.6	17.9	9.3	7.5	3.7	39.1	21.7	15.9	13.7	19.6	5.6	12.6	19.1	15.0	12.1
Central America 1/	**3.7**	**3.9**	**4.4**	**5.1**	**4.7**	**8.2**	**7.4**	**8.4**	**7.4**	**6.4**	**-5.0**	**-5.5**	**-4.8**	**-4.8**	**-4.6**
Costa Rica	4.4	4.1	5.9	6.5	5.0	12.9	11.7	13.6	13.0	10.4	-3.8	-4.3	-4.7	-4.9	-4.8
El Salvador	3.0	1.5	2.8	3.5	3.5	4.1	4.5	3.7	4.1	3.5	-2.2	-4.0	-4.6	-4.5	-4.1
Guatemala	3.5	2.7	3.2	4.5	4.5	7.5	7.6	9.1	7.0	7.0	-4.7	-4.4	-4.4	-4.6	-4.6
Honduras	3.1	4.7	4.1	5.1	4.5	15.0	8.1	8.1	5.5	5.5	-3.7	-5.4	-0.4	-0.6	-0.9
Nicaragua	2.8	5.1	4.0	3.7	4.2	9.0	9.3	9.6	9.2	7.0	-21.5	-15.5	-15.9	-15.5	-15.1
Panama	4.1	7.5	6.9	7.2	6.7	1.0	0.5	2.9	2.6	1.9	-5.0	-7.5	-5.0	-4.0	-3.7
The Caribbean 1/	**4.2**	**2.4**	**6.7**	**7.7**	**5.5**	**9.5**	**26.5**	**6.7**	**8.3**	**6.9**	**-3.7**	**2.7**	**2.1**	**2.2**	**-1.2**
Barbados	2.1	4.8	3.9	4.2	4.9	2.1	1.4	6.0	6.3	4.9	-2.9	-11.9	-12.0	-11.9	-11.2
Dominican Republic	5.4	2.0	9.3	9.0	6.0	9.6	51.5	4.2	7.8	6.3	-1.7	6.1	-0.3	-2.0	-2.9
ECCU economies 1/	2.6	3.0	5.7	4.7	4.4	2.0	2.2	3.2	3.2	2.4	-16.4	-15.7	-20.3	-21.9	-19.7
Guyana	2.4	1.6	-3.0	3.5	4.1	6.1	4.7	6.9	7.5	4.4	-13.3	-4.6	-15.5	-22.0	-20.5
Haiti	2.4	-3.5	1.8	2.5	4.0	18.8	21.2	15.8	14.2	9.2	-7.9	-4.5	-6.3	-7.6	-9.6
Jamaica	0.5	0.9	1.4	2.8	3.0	11.5	13.4	15.3	9.6	9.0	-5.9	-5.8	-10.1	-10.5	-14.7
Trinidad & Tobago	6.2	9.1	7.9	12.5	6.9	4.3	3.7	6.9	7.7	9.0	0.0	13.3	24.5	25.7	15.4
Memorandum item:															
Latin America and the Caribbean 1/	**2.2**	**5.7**	**4.4**	**4.8**	**4.3**	**13.2**	**6.5**	**6.3**	**5.3**	**5.2**	**-2.4**	**1.0**	**1.5**	**1.3**	**0.5**

Source: IMF staff estimates, as of October 16, 2006.
1/ Weighted average. For output and inflation, weighted by ppp GDP; for external current account, dollar-weighted GDP.

Appendix

Methodology for Fiscal Impulse Calculations[1]

The fiscal impulse calculations presented in the text follow an approach similar to Chand (1993) and Heller, Haas, and Mansur (1986). The fiscal impulse is calculated as the change in the fiscal stance between two consecutive years, which in turn is calculated as the difference between the actual and a cyclically neutral fiscal balance.

The first step in the process is to estimate the fiscal stance:

$$FS = (T - G) - (T^* - G^*) \qquad (1)$$

where T and G refer to actual revenues and expenditures in the current year, and T^* and G^* to cyclically neutral revenues and expenditures (all as a share of GDP). T^* and G^* are from a base year when actual output was at its potential, with two additional assumptions: (i) T^* remains constant and (ii) G^* remains constant only as long as actual growth equals potential growth. In the case that actual growth is greater than (less than) potential growth, G^* falls (rises). For the present exercise, potential GDP growth was assumed to be the average annual growth rate over the past 20 years.

The fiscal impulse is the change in the fiscal stance in (1), multiplied by negative one (to indicate that a weakening of the fiscal stance imparts a positive fiscal impulse):

$$FI = (\Delta G - \Delta G^*) - (\Delta T - \Delta T^*) \qquad (2)$$

The first term in the fiscal impulse captures an increase in the spending to GDP ratio above what would occur if spending rose at the rate of potential output. The second term is equivalent to the change in the revenue to GDP ratio, since by assumption T^* is held constant. Thus, the fiscal impulse, on the revenue side, simply reflects changes in actual ratio of revenue to GDP.

Two sets of calculations were undertaken (these are reported in the main text). In the first, the fiscal impulse was estimated using equation (2). A second set of calculations adjusted equation (2) by adding an extra term related to changes in commodity-based revenue to GDP ratios. The rationale for this adjustment is that the vast majority of commodity revenues are derived from sales to nonresidents; thus, increases in revenues from this source do not withdraw purchasing power from the domestic economy and thus do not constitute a negative fiscal impulse.

Fiscal impulses were estimated for each of the seven largest Latin American countries. Average GDP growth rates over 1986-05 (the measure of potential growth) were estimated from the IMF's *World Economic Outlook* (WEO) database. Figures by country are as follows (in percent): Argentina, 2.7; Brazil, 2.4; Chile, 6.0; Colombia, 3.4; Mexico, 2.7; Peru, 2.6; and Venezuela, 2.5. The calculations for fiscal impulses were based on primary balances for the broadest definition of government available (either the public or nonfinancial public sector, except for Chile, where the estimates were based on general government data). Adjustments for commodity-based revenues were made only where their contribution to total government revenue was significant and not derived from new taxes (as in Argentina). The base year for estimating the cyclically neutral fiscal positions was based on IMF staff estimates of output gaps using WEO data over 1980–2005, and ranged from 1995 through 2006.[2]

To assess the robustness of the results, fiscal impulses were also estimated, and are reported in this appendix, on the basis of overall fiscal

[1] Prepared by Lisandro Abrego and Benedict Clements.

[2] In Argentina, 1995; Brazil, 2001; Chile, 2000; Colombia, 2006; Mexico, 1997; Peru, 2000; and Venezuela, 2000.

balances, rather than the primary balances reported in the text. In addition, fiscal impulses were estimated for general government only. Calculations based on overall balances show some important differences in certain years, owing to significant fluctuations in the interest bill. Looking at 2005–06 on average, however, the differences are small.

Fiscal Impulses, 2003-06
Consolidated Public Sector
(In percent of GDP) 1/

	2003	2004	2005	2006
Argentina	-10.0	0.3	0.6	1.2
Brazil	-0.4	-1.2	0.6	0.4
Chile	-1.3	-2.5	-2.7	-1.3
Colombia	-2.4	-0.8	-1.4	1.4
Mexico	-0.6	-0.8	-0.5	0.5
Peru	-0.2	-0.1	0.0	0.7
Venezuela	-4.5	1.1	-3.0	4.1

Source: IMF staff estimates.
1/ Based on overall balances.

There are arguments both for and against the use of overall balances or primary balances for the estimates. In cases where increases in government interest expenditure increase household incomes and purchasing power, an increase in the interest bill to GDP could potentially provide a positive fiscal impulse. However, if increases in interest expenditures are solely compensating households for higher inflation and erosion in the real value of government bonds, there may be no impact on aggregate demand (Chand, 1993). In addition, interest expenditure on foreign debt will have no impact on aggregate demand.

Fiscal Impulses, 2003-06
General Government
(In percent of GDP) 1/

	2003	2004	2005	2006
Argentina	-9.8	0.4	0.8	1.3
Brazil	0.5	-1.4	0.6	0.3
Chile	-1.3	-2.5	-2.7	-1.3
Colombia	-1.8	-0.8	-1.1	0.9
Mexico	-0.1	-0.8	-0.2	0.1
Peru	-0.2	0.0	0.1	0.7
Venezuela	-1.1	2.5	2.9	6.8

Source: IMF staff estimates.
1/ Based on overall balances.

The fiscal impulse estimates based on general government data largely provide similar results to those based on a broader definition of government. One exception is Venezuela, where the fiscal impulse is much stronger for the general government, reflecting the existence of very large oil revenues that accrue mainly to the state oil company.

As an additional robustness test, fiscal impulses were also calculated using IMF staff estimates of potential GDP growth, based on overall balances for the consolidated public sector. These estimates are typically higher than those based on average actual growth over 1986–2005.[3] The differences in the results vary by country but are generally small.

Fiscal Impulses, 2003-06
Using Staff Estimates of Potential Growth
Consolidated Public Sector
(In percent of GDP) 1/

	2003	2004	2005	2006
Argentina	-10.1	0.1	0.5	1.1
Brazil	-0.9	-1.7	0.0	-0.1
Chile	-1.1	-2.2	-2.4	-1.0
Colombia	-2.6	-1.0	-1.6	1.2
Mexico	-0.8	-1.0	-0.7	0.3
Peru	-0.6	-0.5	-0.4	0.4
Venezuela	-4.4	1.2	-2.9	4.2

Source: IMF staff estimates.
1/ Based on overall balances.

Finally, changes in the structural balances, as a point of comparison with our fiscal impulse figures, were computed. The elasticity of the revenue-to-GDP ratio to the output gap was assumed to be 1.0. The changes in the structural balances (times minus one) were nearly identical to the fiscal impulse estimates.

[3] IMF staff estimates are as follows (in percent): Argentina, 3.5; Brazil, 3.5; Chile, 5.0; Colombia, 4.0; Mexico, 3.5; Peru, 4.5; and Venezuela, 2.1.

Change in Overall Structural Balances
Consolidated Public Sector
(In percent of GDP)

	2003	2004	2005	2006
Argentina	10.4	-0.2	-0.6	-1.2
Brazil	0.3	1.3	-0.6	-0.3
Chile	1.3	2.5	2.8	1.3
Colombia	2.5	0.8	1.5	-1.4
Mexico	0.5	0.9	0.4	-0.4
Peru	0.2	0.2	0.0	-0.6
Venezuela	5.3	-1.2	3.0	-4.8

Source: IMF staff estimates.

The structural balance estimates used the same measure of potential output and the output gap as those in the fiscal impulse analysis. Under this methodology, potential output grows each year at a constant rate from the base year. If instead an HP filter is used to estimate the output gap (based on data from 1985–2010), the weakening of structural balances is smaller in five of the seven countries, but only by a slight amount.

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