Executive Summary

Global economic activity is slowing amid increasing concerns about its prospects. Growth in advanced countries is stalling, owing not only to temporary shocks but also stronger-than-expected headwinds from sovereign and private balance-sheet strains. Fears of a renewed advanced-economy recession, along with concerns about negative feedback between sovereigns and financial institutions in Europe, and policy inaction in key advanced economies, have sparked risk aversion and market volatility. Meanwhile, emerging economies continue to rapidly expand, though domestic policy tightening—and more recently, global uncertainties are moderating growth.

The slowing recovery and sovereign strains in advanced economies are adversely affecting global financial markets and commodity prices. Stress in global financial conditions has recently spilled over to emerging markets as fears of a global slowdown have spread, triggering sharp sell-offs in currencies, commodities and equities. However, heightened risk aversion seems to have had a more limited impact on balance of payments and funding conditions so far.

Despite the recent deterioration in the global environment, our baseline entails only a modest worsening of the outlook for the region. Advanced economies are projected to grow at only 1½ percent in 2011 and just below 2 percent in 2012, constrained by continued balance-sheet headwinds. Growth in emerging and developing countries would register 6½ percent in 2011—led by emerging Asia, as softening exports would be offset by less policy tightening and stronger domestic demand. In this context, the tailwinds of easy external finance and still-high commodity prices (despite recent declines) would persist for much of Latin America, but would be far less brisk than expected in the spring.

But downside risks to the baseline are severe. The lack of a decisive solution to the intertwined sovereign and bank balance sheet stresses in Europe could worsen confidence and global credit market conditions, with spillovers to emerging markets. Also, a sharp slowdown in Asia—say, triggered by an advanced economy recession—could further hit commodity prices, with negative effects on Latin American commodity exporters. That said, upside possibilities also exist. Early resolution of uncertainties about global growth and European stresses could stabilize financial markets and reduce risk aversion. With global monetary policy likely to remain highly accommodative for a prolonged period, this could stoke stronger capital flows, exacerbating overheating and amplifying vulnerabilities in emerging markets.

In this environment, Latin America and the Caribbean should generally stay their present policy course and continue to rebuild buffers—but stand ready to shift tack if global winds change, starting with monetary policy.

- In South American economies where output hovers above potential and domestic demand is still strong, overheating dangers have lessened but not fully disappeared. Where inflation pressures have eased, inflation expectations are aligned with targets, and policy frameworks are credible, monetary tightening could halt until global uncertainty fades. In a downside scenario, monetary policy should be the first line of defense, including by providing liquidity support if funding conditions become stressed. Meanwhile, fiscal consolidation should continue, to avoid impairing fiscal credibility and create room for maneuver should downside risks materialize. In addition, macroprudential policies remain an important part of the toolkit.

- Countries with strong real linkages to the United States, like Mexico and much of Central America, face a somewhat weaker outlook. Still, because fiscal dynamics are more stretched, priorities should center on reducing public debt to pre-crisis levels, with monetary policy playing a more active role in managing the cycle in countries with credible inflation frameworks.

- While much of the Caribbean is finally recovering from a long and protracted recession, the outlook continues to be constrained by high debt levels and weak tourism flows in light of the subpar recovery in advanced economies. Greater resolve is required in bringing down high debt levels, as well as addressing financial sector vulnerabilities, without further compromising public finances.

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This edition of the Regional Economic Outlook: Western Hemisphere features an analysis of Latin America's vulnerability to a commodity price bust and the policies that could mitigate it. Latin America, on average, is as dependent on commodities today as it was forty years ago and commodity prices are quite sensitive to global output. Accordingly, faltering global demand could deliver a blow to the region's terms of trade. Analysis in Chapter 3 finds, however, that policies can play an important role in mitigating the economic impact of these shocks. Countries with strong policies—exchange rate flexibility along with sound external and fiscal positions—particularly during the boom phase of the commodity price cycles, fare better. This underscores the need to rebuild policy buffers, to better place the region to weather a commodity price rout.