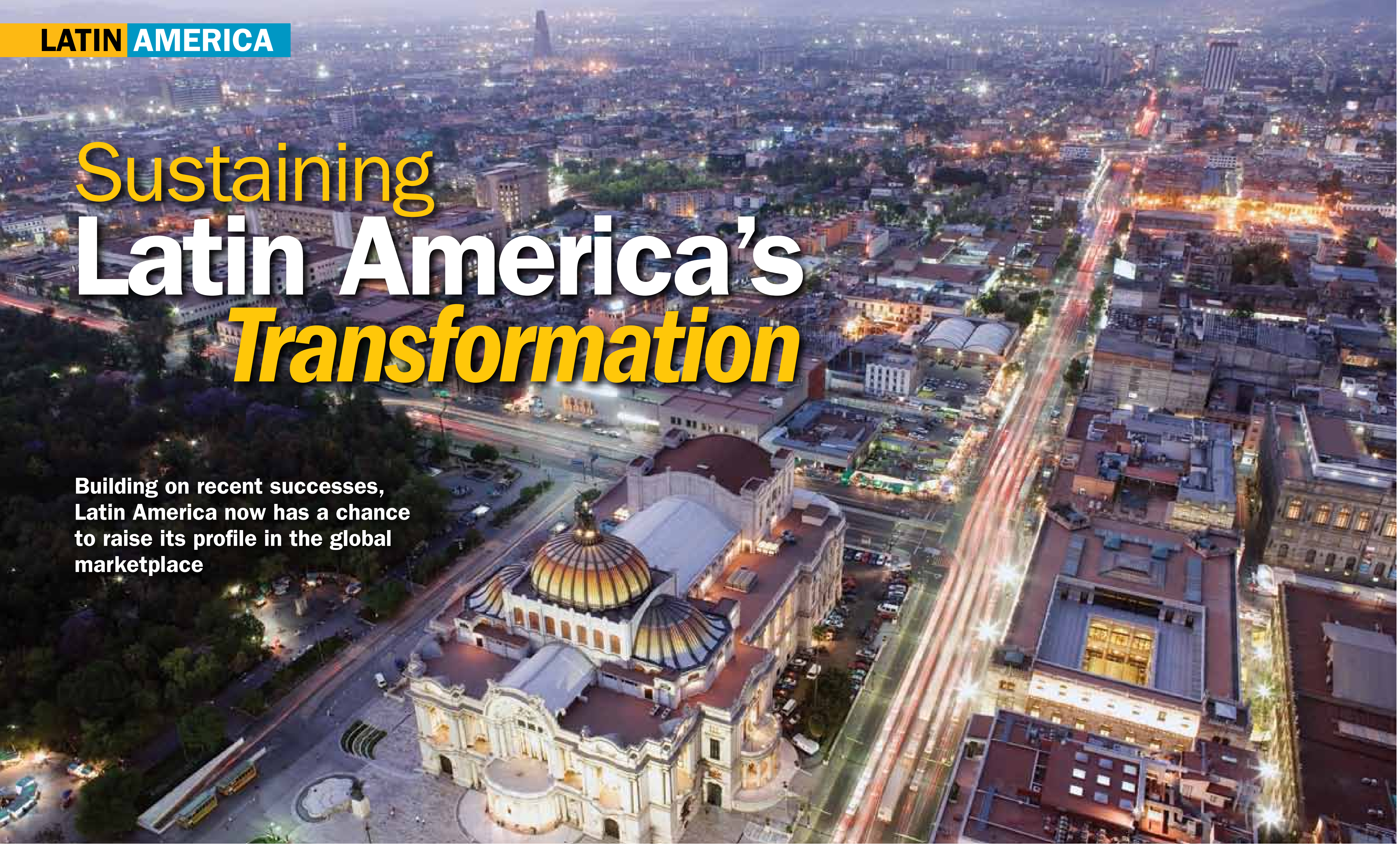
Sustaining Latin America's *Transformation*

Building on recent successes, Latin America now has a chance to raise its profile in the global marketplace



Federal district of Mexico City, Mexico.

Nicolás Eyzaguirre

"There is nothing so joyous as a Mexican fiesta, but there is also nothing so sorrowful," wrote Nobel-Prize-winning poet Octavio Paz, in The Labyrinth of Solitude. *"Our fiestas are explosions. Life and death, joy and sorrow, music and mere noise are united."*

Across Latin America, countries will soon join Mexico in celebrating their 200th anniversaries of independence. There are many reasons for Latin America to feel proud of how much it has achieved over the past two centuries, including in recent years. But despite its potential, the region is still underdeveloped and profoundly unequal, with about one-third of its people living in poverty.

Latin America has long been a region of paradox and contrasts: a land of prosperity and poverty, of independence and dependence, of stability and instability.

But things may be changing. Throwing off its reputation for boom and bust, over the past decade the Latin American region has prospered. Faster and sustained output growth during much of the 2000s was accompanied by big improvements in social conditions. In addition, the region strengthened its economic fundamentals and better prepared itself for economic shocks—so the impact of the recent global crisis was in most cases relatively mild and short lived when compared with the crushing economic problems during previous episodes of global turbulence.

With the global crisis behind it, the region—endowed with a wealth of commodities and now facing favorable external conditions—has great economic opportunities and the potential to become an increasingly important global player.

Three countries in the region—Argentina, Brazil, and Mexico—are members of the Group of Twenty, which is playing an increasingly prominent role in shaping the world economy. The region can advance even more by building on recent progress to lock in economic stability and with the determination to tackle long-standing problems of low productivity and high inequality.

Improved policies

Better policies played a critical role in the region's recent relative success, supported by much broader social consensus about the importance of macroeconomic stability. In fact, macroeconomic policies remain prudent in many countries, regardless of transfers of power between elected governments of different political orientation. At the same time, keeping fiscal deficits down became easier, thanks to the generally favorable external conditions prevailing during much of the past decade.

Strengthened macroeconomic policies brought new resilience. The region got through the global economic crisis of 2008–09 relatively unscathed. Output, after beginning a sharp contraction in late 2008, had rebounded in many countries by the middle of 2009 (see Chart 1). Improved government finances, reduced external debt and higher international reserves, more flexible exchange rates, and strengthened financial regulation and oversight in the years leading up to the global crisis played an important role in limiting the impact of the crisis on the region.

In part, that is because the region generally did not have to cope with homegrown problems as it did in the past. Unlike in past international shock episodes—in 1982, 1998, and 2001—the region was in a stronger position to take steps to counteract the effects of the global recession (see Chart 2). This time, many governments and central banks were able to fight the impact on output and employment by expanding public spending and reducing interest rates, allowing their currencies to depreciate along the way. And this time, currency depreciation helped Latin American economies cope with external shocks without triggering a severe jolt to inflation or widespread financial system distress.

Chart 1

Climbing a rollercoaster

Latin America's growth since 1980 has been erratic but on an upward trend, with a striking recovery from the crisis.

(real GDP growth, annual percent change)

Sources: IMF, World Economic Outlook database; and IMF staff estimates.
Note: Red line represents average growth for each decade; for 2000s, covers precrisis period 2000–08.

And now even more people are experiencing a higher standard of living, compared with previous periods of economic expansion. Poverty rates fell by more than 10 percentage points between 2002 and 2008, bringing over 40 million people out of poverty. Income distribution, a long-standing weakness in the region, also improved in 15 out of 18 countries in the region (see "Spreading the Wealth" in this issue of *F&D*). This stands in sharp contrast not only to the trends of the 1990s, but also to those observed in recent years in many other emerging economies and in advanced economies, where the distribution of incomes has become more unequal. Increased government transfers to the poor, as well as a narrowing of the wage gap between skilled and low-skilled workers, help explain these improvements (Lopez-Calva and Lustig, 2010). The region's success in bringing down inflation, which hurts poor people most, has also played a key role.

Differing performance

Not all countries have done equally well, however. In part this is because global developments affect countries in differing ways. Many of the commodity-exporting countries of Latin America are benefiting from high export prices and low global interest rates (see Chart 3). Yet some still have only limited access to external financing and some others—including the countries of Central America—are net importers of commodities. Countries with stronger ties to the dynamic emerging markets of Asia, especially China, have been more successful recently. Record-high commodity prices have also made these countries more attractive to foreign investors.

By contrast, countries with strong economic ties to advanced economies have recovered more slowly from the crisis—the result of weaker economic growth and employment conditions in the United States. Mexico and Central American countries faced a significant blow from the weak recovery in the United States, which is a major source of their income—from exports, tourism services, and remittances from their nationals working there.

Countries with weaker policies did less well than those with a record of more prudent fiscal and monetary policies. Not only were they unable to adopt countercyclical policies during the downturn, but they are benefiting much less from the current favorable external financing conditions. This has been particularly true for some of the oil-exporting countries, where, despite the rebound in oil prices, output has been lagging or even contracting. A combination of weakness on the supply side (the product of a business environment that hinders investment) and policies that support excessive demand has led to substantial inflation, particularly in Venezuela, which also saw output contract in 2010. In Argentina, where growth performance has been much better, demand is also putting upward pressure on inflation.

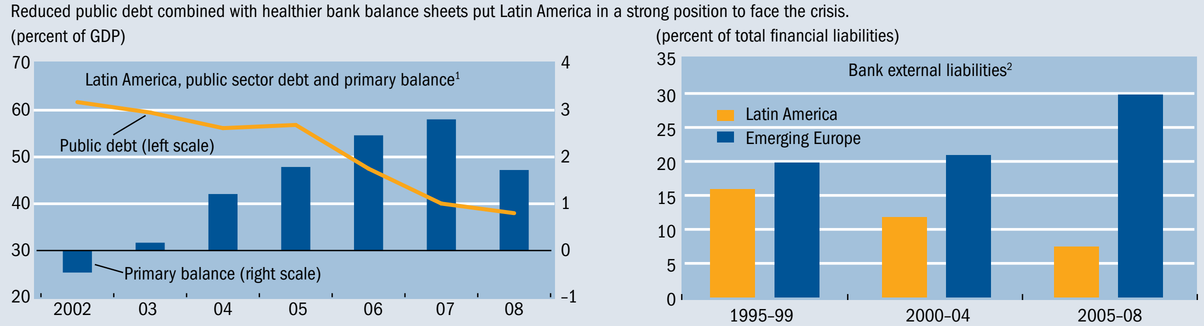
Strong potential

With the effects of the global crisis mostly past, the region has the potential to become more prominent on the global stage and raise its share of world output, which has been stable at about 8 to 9 percent in recent decades. The region's output grew by about 6 percent in 2010 (second only to emerging Asia) and is projected to settle at about 4 to 5 percent in the coming years, still well above its 30-year average of less than 3 percent.

Chart 2

Be prepared

Reduced public debt combined with healthier bank balance sheets put Latin America in a strong position to face the crisis.



Sources: IMF, *International Financial Statistics* and World Economic Outlook database; and IMF staff estimates.
[1]General government. Simple average for Latin America, excluding Argentina.
[2]Ratio of nonresident liabilities to total financial liabilities. Simple average for Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

Achieving—or even bettering—this outcome will require skillful macroeconomic management in the near term, as well as structural reforms to strengthen the region's resilience to shocks and boost growth. In light of the region's legacy of macroeconomic and financial instability—including a tendency to boom-bust cycles—it is important to take stock of efforts to enhance resilience and prepare for shocks to come.

Where are the remaining challenges to stability? The region has made important strides in terms of its macroeconomic policies and in building institutions, but progress should be extended in three key areas: ending procyclical patterns of government expenditure—boosting spending too quickly or cutting taxes when times are good, which forces sharp spending cuts or tax increases when times are bad; allowing greater exchange rate flexibility; and tightening financial sector regulation and supervision.

For fiscal policy, the challenges are to ensure sustainability, but also to avoid excessive procyclical swings in government spending. Many countries have brought public debt down to more moderate levels. Countries with safer debt levels face another problem: how to manage cyclical swings in government revenue. Policy targets that hold the fiscal balance steady mean that expenditures can rise whenever more revenue comes in, regardless of whether the increase is transitory or permanent. Some countries would benefit more from targeting cyclically adjusted balances (as Chile does), which keep spending steady in the face of temporary revenue fluctuations. This is particularly true for countries where revenue is linked to commodity exports and temporary price booms can mask a weakening of the underlying fiscal position.

Many countries have benefited from allowing greater exchange rate flexibility, as a way not only to deal with external shocks but also to increase the freedom and effectiveness of their monetary policy in ensuring low inflation and output stability. Those that have moved their monetary policy all the way to inflation targeting have seen good results (see "Ending Instability" in this issue of *F&D*). Countries that have more recently begun allowing limited currency flexibility will likely benefit from continuing in that direction, which will help reduce dollarization and improve monetary policy effectiveness. Those that have chosen fixed exchange rates will need to create alternative buffers against shocks, in particular on the fiscal policy side.

Despite the region's recent relative success in avoiding banking crises, it has to move further ahead on financial policies. The lessons of the recent failures of regulation and supervision in advanced economies are broadly applicable to Latin America as well. Financial regulation and supervision should now look beyond the stability and solvency of individual institutions and also take a macroprudential approach, addressing systemic risk interconnectedness and excessive procyclicality of credit (the tendency of credit to grow too quickly during good times, only to crash later). This is a fairly new area, which will require a high level of coordination at both the country and global levels.

Many of the commodity-exporting countries of Latin America are benefiting from high export prices and low global interest rates.

Beware today's blessings

In addition to these underlying issues, Latin America also needs to be careful about complacency when things are going well. Currently, global conditions have combined to create two very strong tailwinds that are helping Latin America—easy external financing and strong commodity prices that imply a bonanza for the region. These twin tailwinds are a blessing in many ways, but they will not last forever, and they could even end abruptly. In the meantime, they can create risks for the future.

With extremely low interest rates in the major reserve currency countries, and the return of global investors' risk appetite, foreign financing is now cheap and abundant for many of the region's economies. But over time, interest rates will naturally rise from these low levels, as monetary policy normalizes in advanced economies.

On the commodity front, prices of many of the region's key exports are now unusually high, thanks largely to strong growth of commodity demand, especially in emerging Asian economies. While some part of this windfall may be persistent or even permanent, the high markups on many commodities are expected to result in an expansion of their supply that will eventually take prices down.

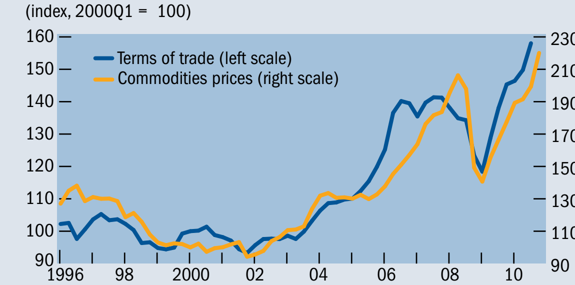
Experience shows that these favorable external conditions can lead to an accumulation of risks, by overstimulating both domestic demand and credit. The near-term challenge for much of the region, therefore, centers on avoiding a boom-bust cycle by managing the current abundance to avoid trouble down the road. So policymakers will need to be alert to financial excesses and vulnerabilities and watch

Chart 3

Looking up

Latin America is benefiting from favorable commodity prices.

(index, 2000Q1 = 100)



Sources: Haver Analytics; Commodities Research Bureau (CRB); IMF, World Economic Outlook database; and IMF staff estimates.
Note: Simple average of Brazil, Chile, Colombia, and Peru.

out for excessive consumption and/or investment spending growth.

Such unbridled growth in demand could, in turn, lead to large and risky external current account deficits and higher inflation. Increased demand sustained by foreign capital inflows almost inevitably brings with it a stronger real exchange rate—whether from appreciation of the nominal exchange rate or, if that is suppressed, from higher inflation.

Boosting productivity and competitiveness remains the key policy challenge over the medium and longer term.

To manage these risks, policymakers can act on a range of fronts. A first step, already under way in varying degrees, is to remove the macroeconomic policy stimulus adopted during the crisis. It is especially important now to reverse the earlier easing of fiscal policy, to avoid excessive reliance on monetary policy tightening. Exchange rate flexibility—in this setting, allowing the currency to appreciate—is also important. Appreciation causes foreign investors to think twice about future exchange rate risk and this can help slow capital inflows.

Careful regulation and supervision of domestic financial developments is essential not only for financial system stability but also to prevent credit from growing excessively during good times—often associated with boom-bust behavior in the private sector. Several countries are already developing and applying new macroprudential policy approaches, and further experimentation will likely be needed (IMF, 2010). Capital controls could also be considered in some cases, though these cannot substitute for adequate policies in the other areas.

Sustaining strong and more equitable growth

Boosting productivity and competitiveness remains the key policy challenge over the medium and longer term. It is well documented that the region's subpar growth performance over the past 30 years is largely attributable to low productivity growth. Although the reasons for low productivity are complex (see "Face-to-Face with Productivity" in this issue of *F&D*), there is a need for progress on several fronts.

- ***Public investment***, which is low relative to the more dynamic emerging economies, must be boosted from current levels to address the region's infrastructure gap. The development of human capital, through better schooling and training, is also essential.
- Improvements in the ***business climate and overall governance*** are also essential to harness private investment (including from Asia) and strengthen financial intermediation. This will likely require diverse efforts, ranging from trimming red tape to improving security and reducing crime to strengthening creditors' rights. Barriers to competition need to come down, and sectors that may be natural monopolies—in such areas as water, electricity, and telecommunications—should be better regulated to ensure the quality, efficiency, and affordability of services.
- The region still has considerable room to benefit from expanding ***external trade***. Trade with the faster-growing emerging economies can be deepened further, and exports can be diversified more generally to reduce over time the region's reliance on advanced economies and commodity exports. The region needs to harness the benefits of increased trade openness, such as from recent trade agreements. The development of better trade infrastructure, including through public investment, can help.

More progress is needed in ensuring that the benefits of growth are shared more broadly. Despite improvements over the past decade, poverty and inequality in the region remain high when compared with other regions and countries with similar living standards. Further efforts are needed to improve the targeting of government spending and effectiveness of social safety net programs. This is particularly critical in the current environment of rising food and energy prices: policies should aim to protect the poor, avoiding generalized subsidies that are costly and distort the allocation of resources (for example, by encouraging overconsumption of fuel). The region can learn from the success of conditional cash-transfer programs in Brazil (*Bolsa Família*) and Mexico (*Oportunidades*), which grant payments to families in need, on conditions such as keeping their children in school. Countries will also need to accommodate the demands of a growing middle class and increased global competition by upgrading the quality of services in the areas of education, health, and public security.

Although the region's population is still young, public pension and health systems will require strengthening to meet the demands of a growing elderly population. These challenges must be met without compromising the sustainability of government finances: this will require boosting government revenue in some cases and being more careful about spending priorities, including cutting subsidies that are not targeted to the poor.

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Despite its bumpy history, Latin America now has the potential to build on its new strength and resilience. Policymakers will need to carefully manage the generally stimulative global conditions to avoid a recurrence of the boom-bust cycles of the past, while making new efforts to cement conditions for stronger and more equitable growth.

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