



BROOKINGS LATIN AMERICA ECONOMIC PERSPECTIVES

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Brookings Latin America Economic Perspectives

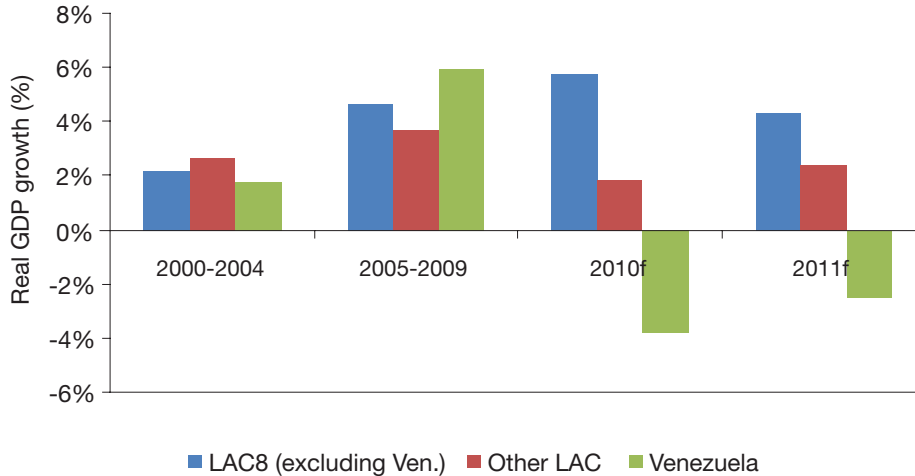
INTRODUCTION AND SUMMARY

There are two Latin Americas, and possibly three. The LAC-7 countries, plus Uruguay but except Venezuela, are growing robustly. This is the Latin America that is making headlines and that will continue to attract press attention and investors. However, there will be moderation, resulting from a less expansionist policy stance and less growth in the developed world. The second Latin America never managed to break free from macroeconomic constraints associated with high inflation and debt and will be more affected from low growth in the United States. Finally, there is Venezuela, where everything is out of the ordinary, including the political resilience of a government that has mismanaged the economy in ways that are becoming increasingly costly and evident.

As China continues to modernize, its demand for commodities will continue to increase. The marginal dollar of expenditures in China has a much greater impact on commodity demand than demand in the developed world, where services play a much greater role. This will continue to be a positive force for Latin America. But it is a mixed blessing. It will not last forever and Latin America in the meantime is experiencing a major transformation, with larger dependence on fiscal revenues that ultimately will need to accommodate once China reaches a level of income per capita where commodity demand stabilizes. Many analysts are arguing that this will occur in five years.

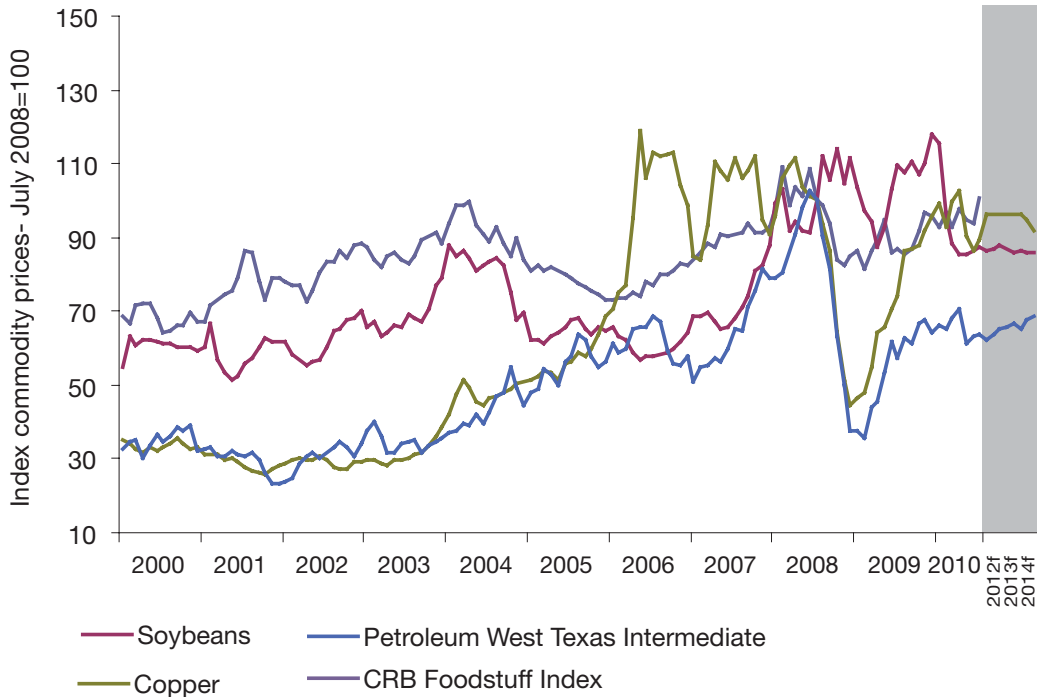
High commodity prices and, more recently, vigorous capital inflows translate into appreciated currencies, which are becoming a source of concern. Fortunately, this is unlikely to last long, although

FIGURE I.1 RECENT GROWTH (2000-2004, 2005-2009) AND GROWTH PROSPECTS (2010-2011, AVERAGE FROM IMF AND CONSENSUS FORECAST): LAC-8 (EXCEPT VENEZUELA), VENEZUELA, OTHER LAC COUNTRIES



Sources: Own construction based on the Economist Intelligence Unit; IMF's World Economic Outlook and Consensus Forecast.

FIGURE I.2 COMMODITY PRICES: THE EVERLASTING CHINA FACTOR



Commodity prices indexed to July, 2010=100, and deflated by the U.S. PPI; PPI assumed to maintain constant at July 2010 level for forecasts construction.

Source: Own construction based on World Bank's Global Economic Monitor; IMF's International Financial Statistics (IFS); Consensus Forecasts.

damage is already being felt. Central banks are responding by strengthening interventions in the foreign exchange market, which is the right thing to do given the alternatives. Appreciated currencies are not necessarily a sign of strength, but rather a sign of the exposure to global forces (China growth, financial flows), which cannot be taken for granted as the pillars of economic growth for the region in the decades to come.

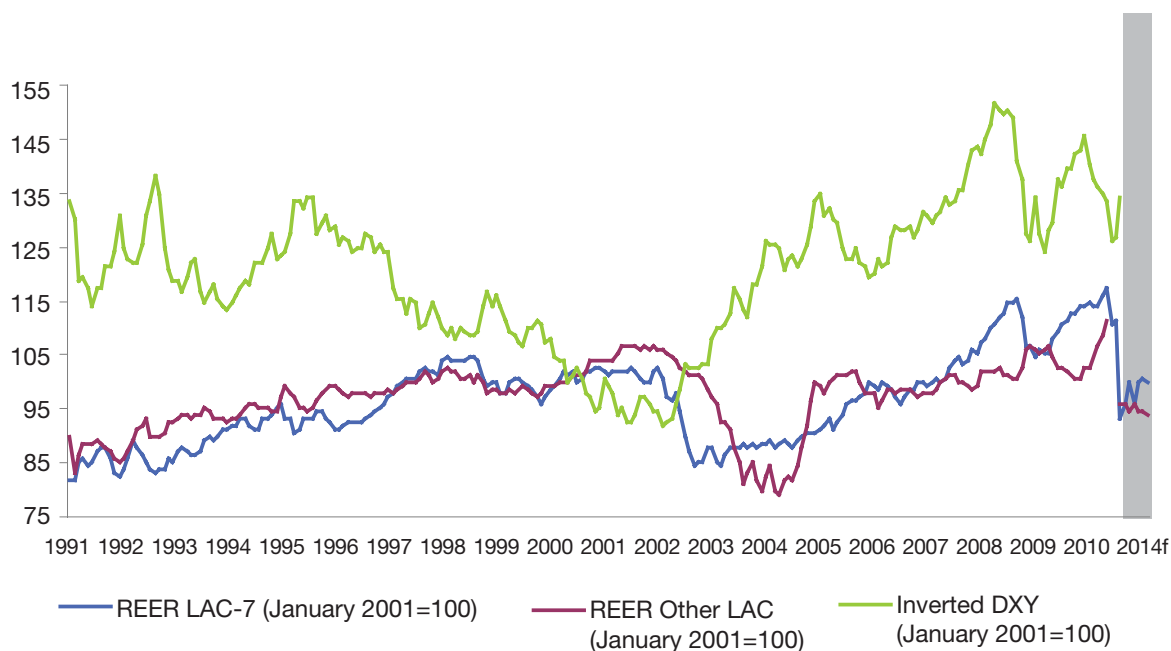
Surpluses are a thing of the past. The new reality is that even for the commodity-privileged LAC-8, the current account will be slightly negative in the future years. Once demand for commodities enters a plateau, while supply continues to expand,

export prices will decline bringing larger current account deficits. Latin America has to prepare for the mid-term scenario, strengthening competitiveness today.

For the remaining Latin American countries, current account deficits will narrow. This is the inevitable consequence of adjustment in the face of limited access to financing from abroad in a group of countries that remain poorly integrated with global capital markets.

But the general point is that in terms of global imbalances, Latin America as a whole will be invisible and will have little to add to the debate.

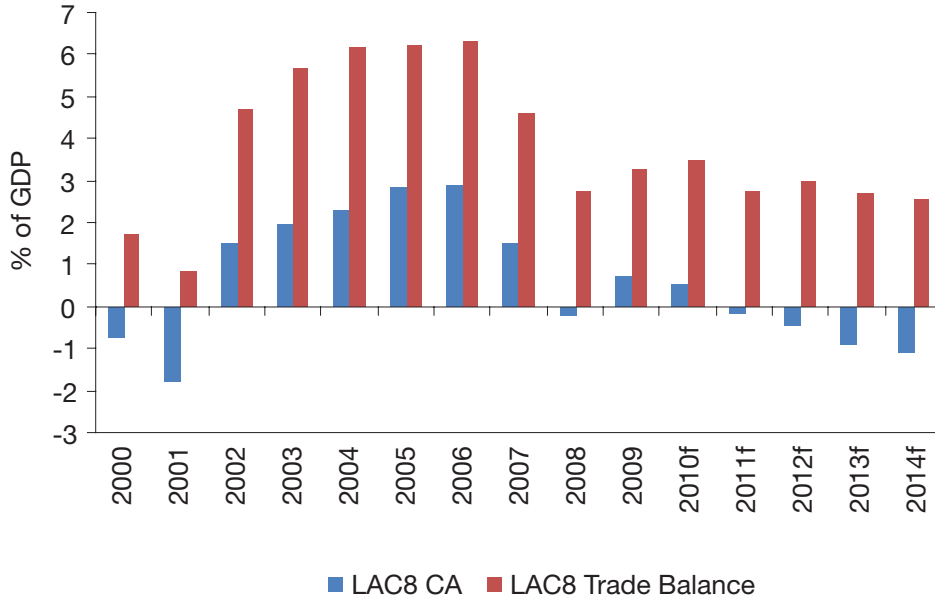
FIGURE I.3 REAL EXCHANGE RATES



Source: Own construction based on World Bank's Global Economic Monitor and Bloomberg.

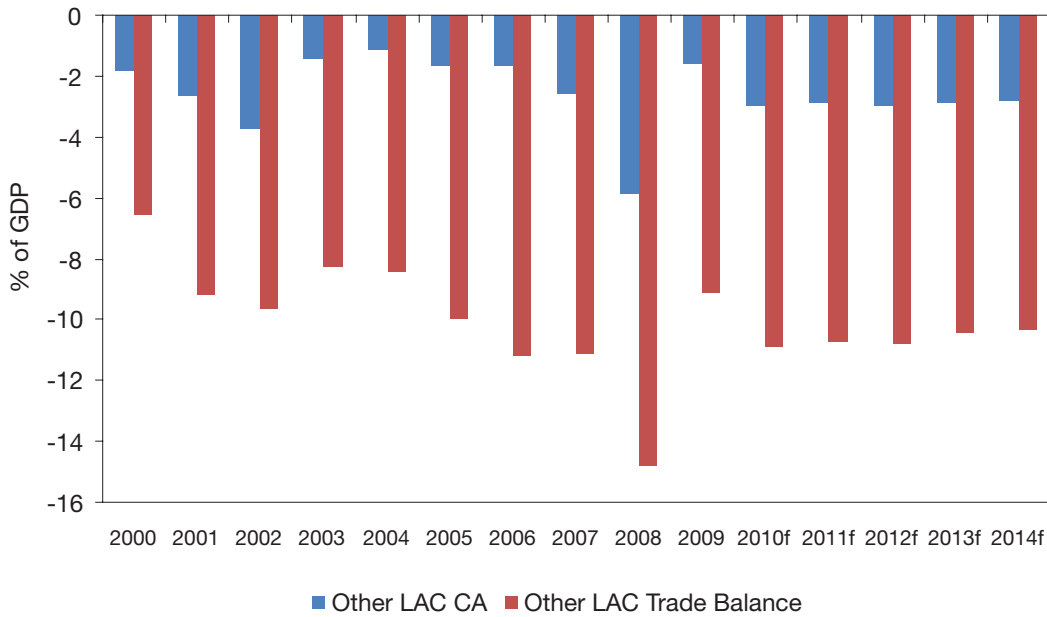
FIGURE I.4 CURRENT ACCOUNT BALANCE: LAC-7 AND OTHER LAC COUNTRIES (AS % GDP)

LAC-8 (LAC-7 PLUS URUGUAY)



Source: The Economist Intelligence Unit

OTHER LAC COUNTRIES

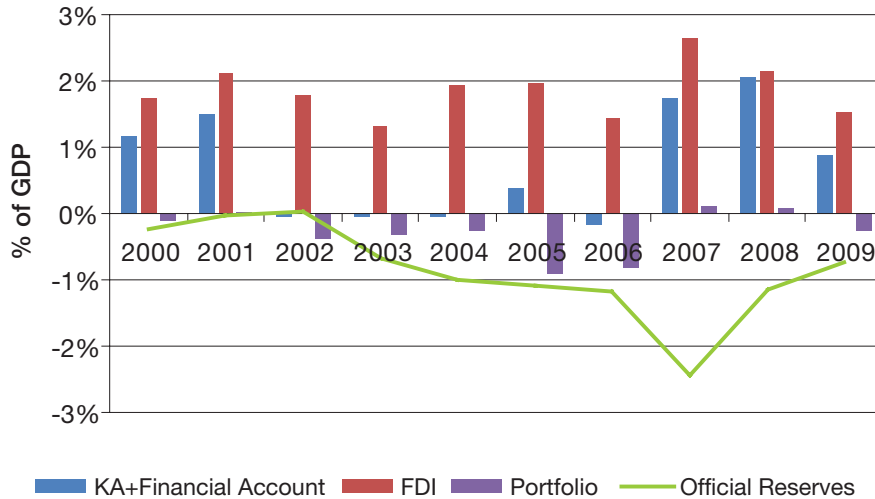


Other LAC countries: Costa Rica, Cuba, Dominican Republic, Ecuador and El Salvador.

Source: The Economist Intelligence Unit

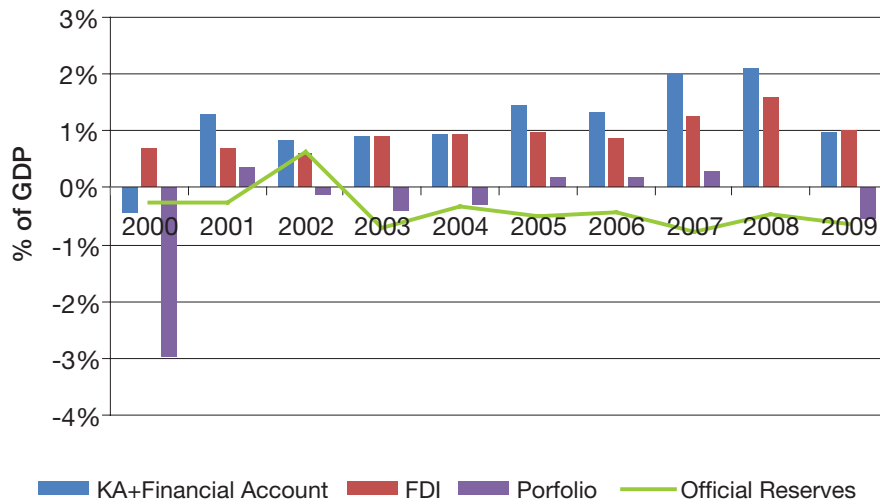
FIGURE I.5 CAPITAL ACCOUNT BALANCE: LAC-7 AND OTHER LAC COUNTRIES, 2000-2009 (AS % GDP)

LAC-7



Countries included: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela; Negative change in reserves implies accumulation of official reserves.
 Source: Own construction based on data from IMF’s International Financial Statistics.

OTHER LAC COUNTRIES



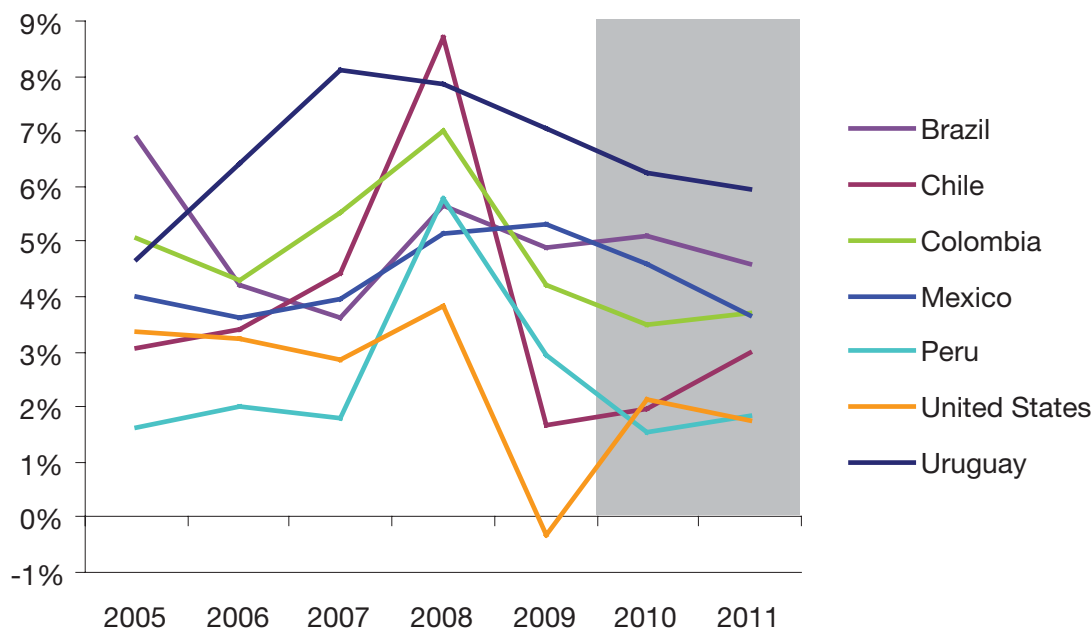
Other LAC countries: Costa Rica, Ecuador, Guatemala, Nicaragua, Panama, and Uruguay; Negative change in reserves implies accumulation of official reserves.
 Source: Own construction based on data from IMF’s International Financial Statistics.

Foreign Direct Investment (FDI) has been resilient, averaging one percent of GDP per year during the last decade. It is unlikely that this figure will change dramatically, and if anything it may begin to fall once commodity prices begin to stabilize and decline, as much of these investment flows are geared towards primary sectors. Portfolio flows are not a reliable source of financing. They come and go, depending on variables that are mostly outside the region's control. Precisely because of this, there is no need to change the macro policy framework to accommodate them. They are not applying for permanent residence, but rather for short term tourist visas.

MONETARY AND FISCAL POLICY

After the mid-2008 surge in commodity prices and the sharp 2009 correction inflicted by the global contraction, inflation is back on track. Interestingly, while some inflation pressures have caught the headlines, expectations already priced in the unwinding of monetary stimulus and a gradual and mild interest rate tightening should keep prints within target. The stability of inflation expectations in light of the recent rollercoaster, which reduces the needed amount of central bank response and the associated cost in terms of output volatility are perhaps the clearest proof of success of the inflation-targeting framework.

FIGURE I.6 THE MONETARY SIDE: INFLATION AND INFLATION EXPECTATIONS



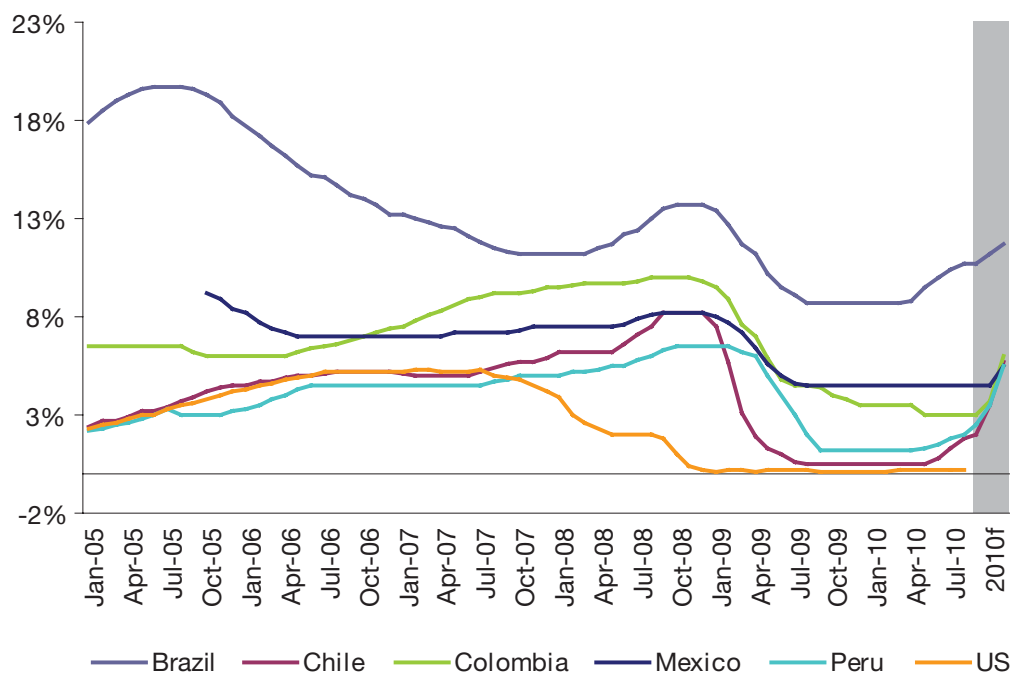
Source: International Monetary Fund, World Economic Outlook Database, April 2010

The unprecedented monetary decoupling between LAC countries with inflation-targeting and the U.S. in the first half of 2008 has been vastly commented as a key argument of the newly gained resilience in the region. The diverging growth pattern emerging in the aftermath of the global crisis—particularly the modest U.S. recovery contrasting with the swift and momentous rebound in LAC—is already leading to a second decoupling episode, where LAC central banks have already hiked policy rates or are in the process of doing so. But we do not expect rates to go back to pre-crisis levels. Central banks have one eye on inflation and another eye on feeble global demand. On top of that, real rates in the region

appear relatively high and should continue to decline, with the exception of Chile.

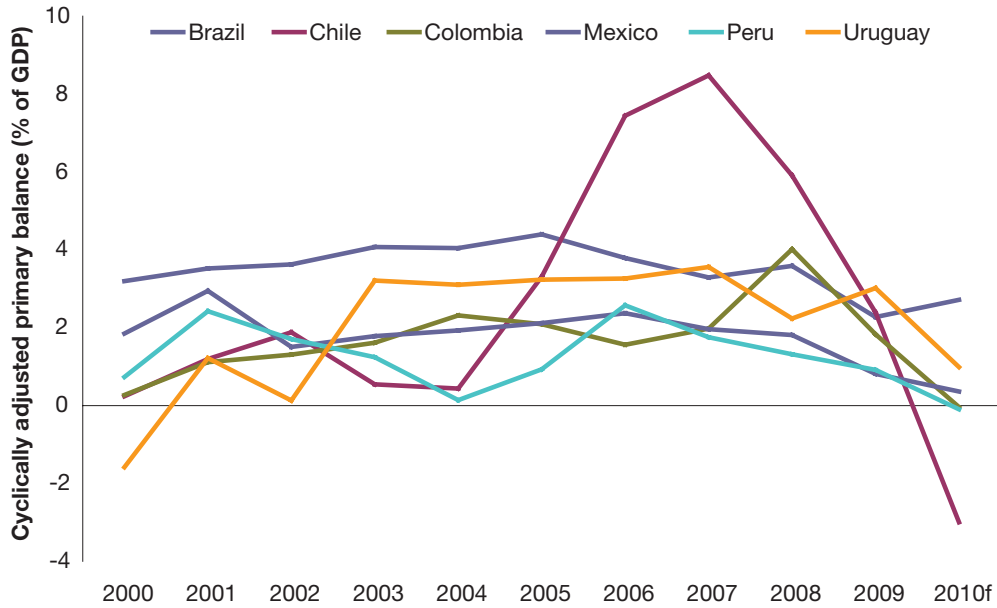
A story similar to the monetary decoupling and the space for monetary stimulus can be built on the fiscal front. For the first time in decades, LAC could profit from improved public accounts and balance sheets to reduce the primary surplus in a countercyclical way and cushion the impact of the global recession. As usual, it is easier to inject resources than to mop them up, particularly in an uncertain global context where advanced economies are debating the timing and pace of unwinding. So far, despite the rebound (see figure I.9), the fiscal stimulus is on.

FIGURE I.7 MONETARY POLICY RATES: A TEXTBOOK PATTERN



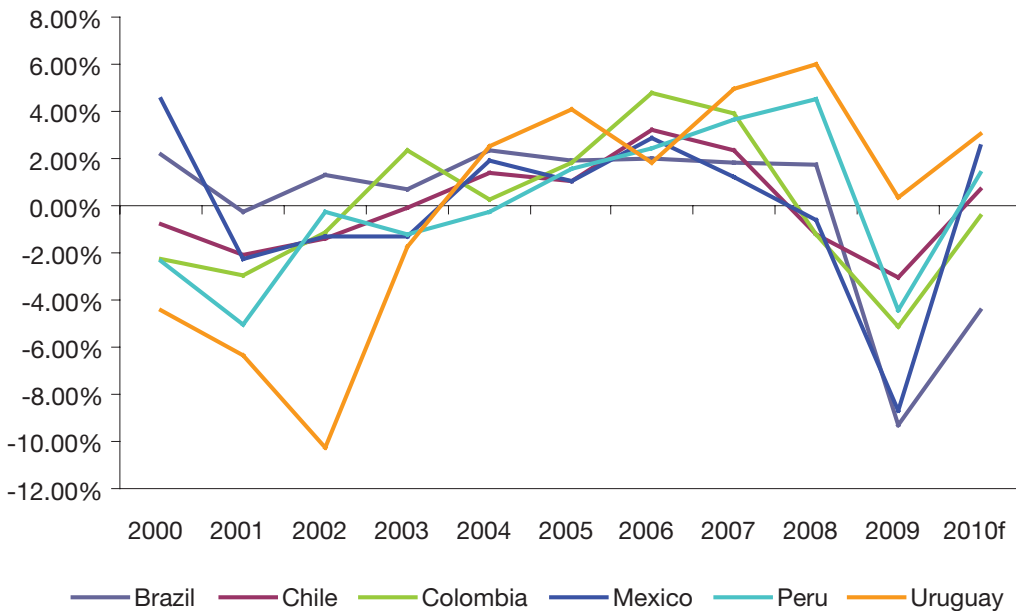
Source: Own construction based on Central Bank bulletins and the Economist Intelligence Unit.

FIGURE I.8 THE FISCAL SIDE: CYCLICALLY ADJUSTED PRIMARY SURPLUS (%GDP)



Note: Estimated as the intercept from a regression of the primary surplus on cyclical output, where the latter is obtained from the log-linear de-trending of real GDP.
 Source: Own construction based on The Economist Intelligence Unit.

FIGURE I.9 CYCLICAL OUTPUT GROWTH: HOW MUCH MORE IS NEEDED TO UNWIND?



Note: Cyclical output based on the log-linear de-trending.
 Source: Own construction based on Central Bank bulletins and the Economist Intelligence Unit.

The monetary and fiscal stimulus certainly played a role in ensuring a quick rebound of economic activity from its 2009 lows. While 2010 marked the year of the recovery, 2011 will shed some light on the longer term potential within LAC. We expect growth rates to slow down and diverge.

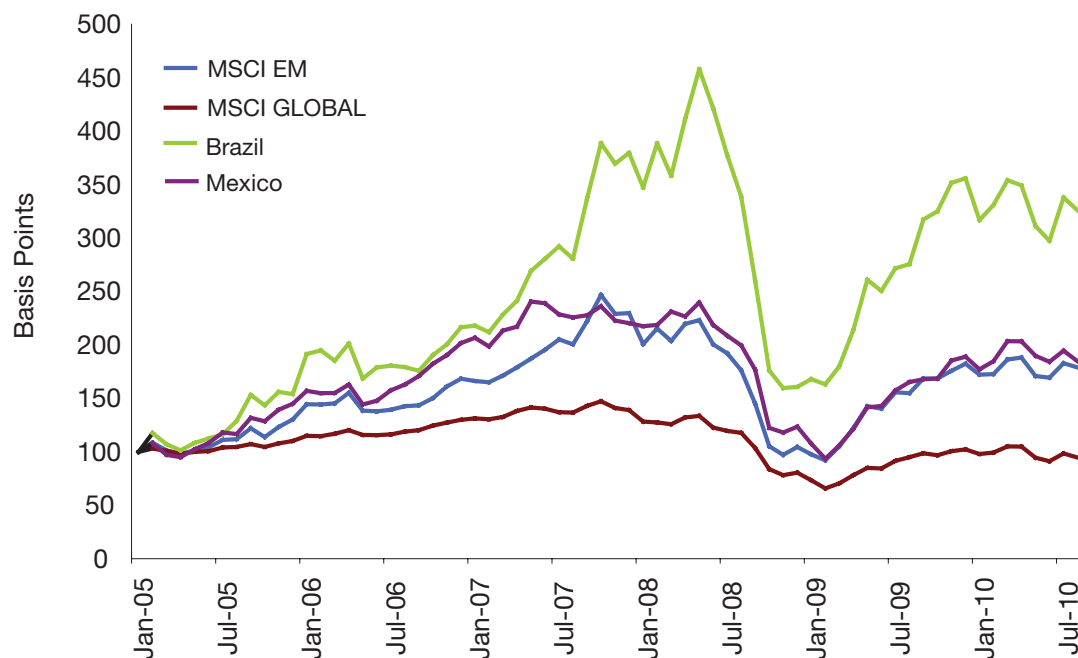
FINANCIAL MARKETS: A HIGH BETA-HIGH ALPHA PATTERN

For all the new macroeconomic resilience of LAC and the diversification of its trade links as well as its global influences toward emerging Asia, its main assets continue to exhibit a tight co-movement with advanced economies—even tighter in recent years than in the 1990s. But from a longer-

term perspective, the growth performance of the region and emerging markets as a whole do not go unnoticed. A high frequency correlation with core markets (in financial jargon, a high “beta” to the global portfolio) contrasts with a sizeable divergence in total returns over time (a high “alpha” that reflects a more fundamental economic outperformance). The equity markets provide the starkest illustration of this pattern.

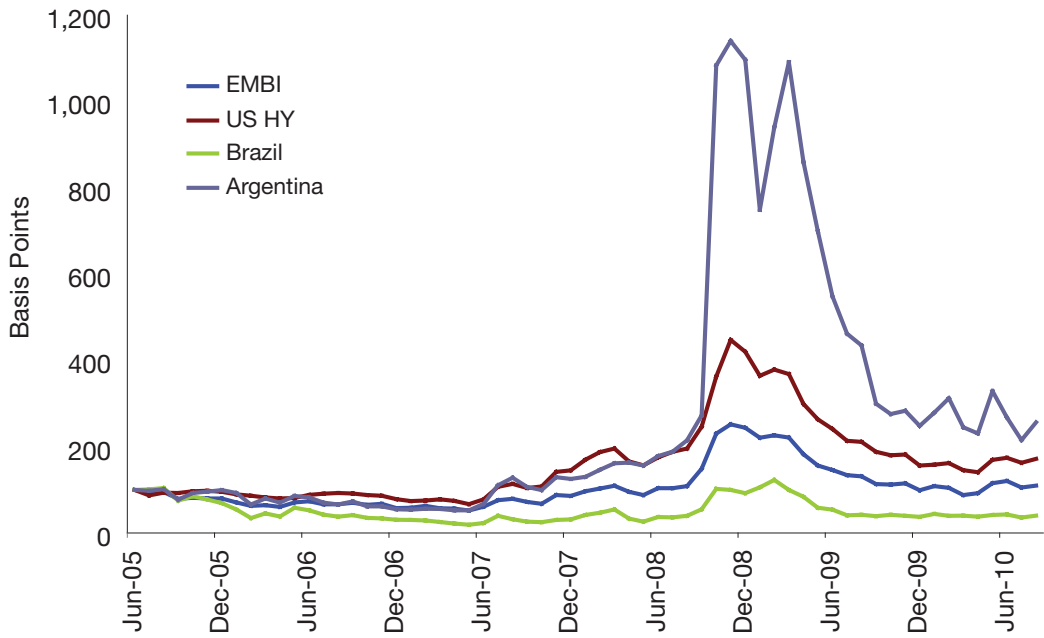
In the case of hard currency bonds, this high beta-high alpha pattern is compounded by the gradual recognition by the markets (and, belatedly, the credit agencies) of the dramatic improvement in

FIGURE I.10 EQUITIES



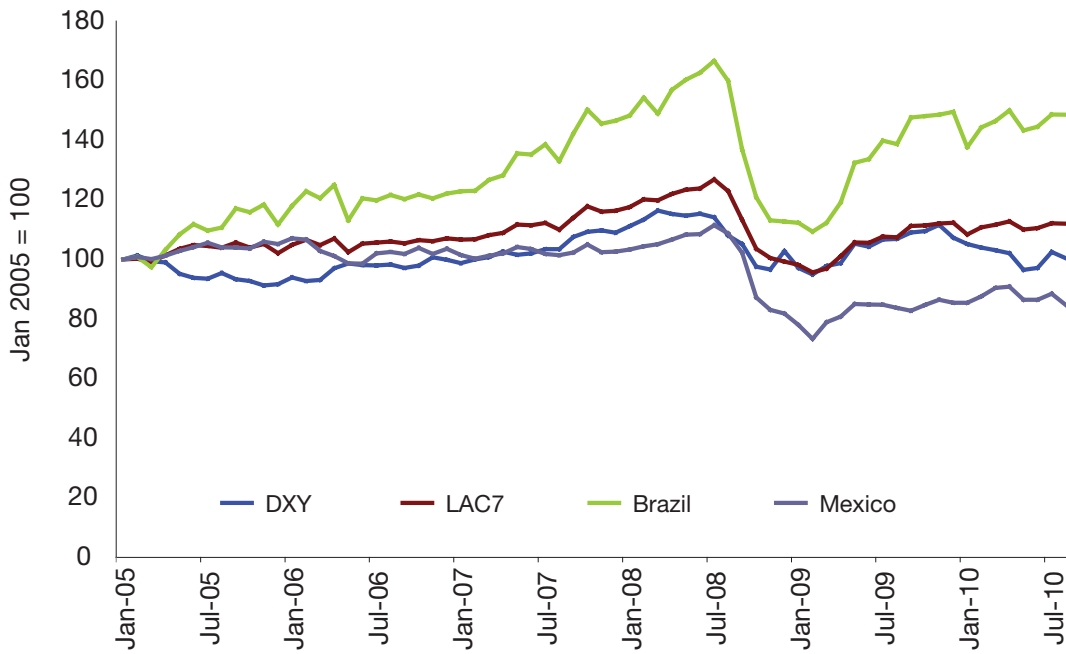
Source: Own construction based on Bloomberg.

FIGURE I.11 BONDS



Source: Own construction based on Bloomberg.

FIGURE I.12 EXCHANGE RATES (AND THE DXY DOLLAR INDEX)



Source: Own construction based on Bloomberg.

the LAC's public and private balance sheets. With a few exceptions, spreads have traded below U.S. non-investment grade corporates, and should continue to converge to those of investment-grade advanced economies.

Understanding the foreign exchange (FX) rate is typically elusive since it represents both a relative price (hence, the reflection of macroeconomic fundamentals) and an investment asset (hence, the reflection of technical and speculative dynamics). For all its complexity, and the ostensible co-move-

ment during the post-Lehman Brothers flight to-quality, FX has started to display some life of its own since late 2009. However, the sobering lessons from the crisis, and the fact that the appreciation phase was all but erased by a two-quarter sell off, validated ex post the fear of appreciation displayed to varying degree by LAC central banks. As a result, we expect FX intervention to continue at full speed, and LAC currencies to remain range bound and, with a few exceptions, well below their pre-crisis levels for the near future.

OVERVIEW: THE NEXT SIX MONTHS

At this stage, few would dispute that the global crisis provided a litmus test for the Latin America and Caribbean region (LAC). The region's performance during the crisis demonstrated that the substantive progress and benign market reassessment which characterized the early 21st century was the result of hard-won structural changes rather than a short-lived reflection of the commodity boom or the Great Moderation.

The ability of most LAC countries to cope surprisingly well with the most severe financial crisis in 50 years lies in two crucial and permanent developments. First, after the hard lessons of the financial crises of the 1990s, the drastic reduction of the dependence on external finance and the associated currency imbalances eliminated a key "structural amplifier" of external shocks. Unlike in the past, the proceeds of the commodity and growth bo-

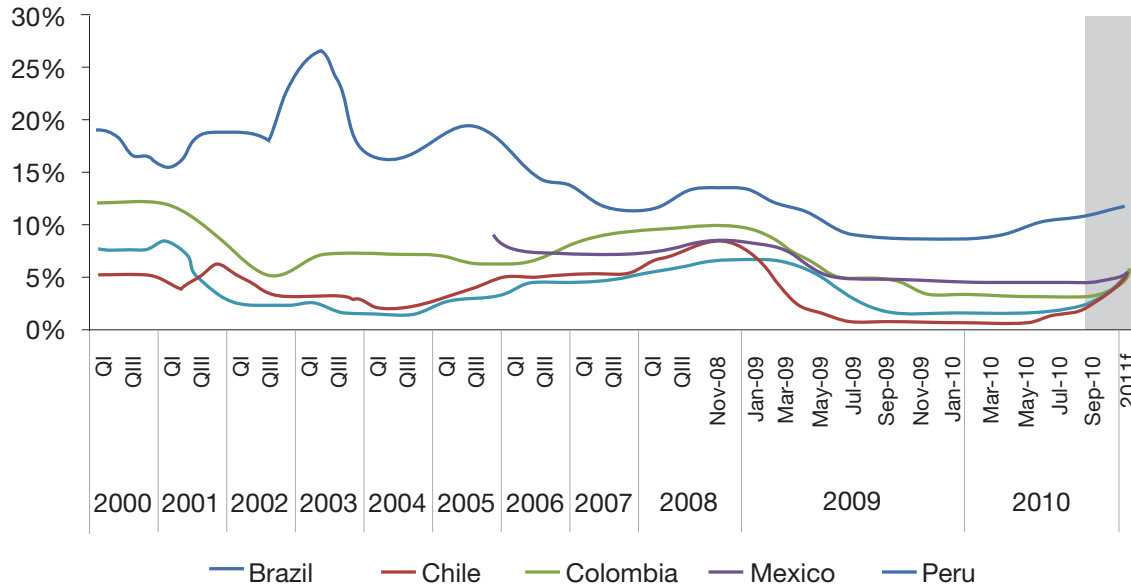
nanza were saved in the form of deleveraging and reserve accumulation, reducing financial dollarization and the net exposure to capital flow reversals.

Second, after the chronic inflation of the 1980s and the financial stress of the 1990s, macroeconomic stability—most notably through fiscal responsibility and independent central banks—gained much needed political support as a source of prosperity. Ultimately, it was these structural changes that gave the largest Latin American economies the ability to conduct proactive countercyclical policies (Figures 1.1 and 1.2), which is perhaps the most striking evidence of the divide between past and present-day Latin America.¹

PAST GROWTH NOT AN INDICATION OF FUTURE PERFORMANCE

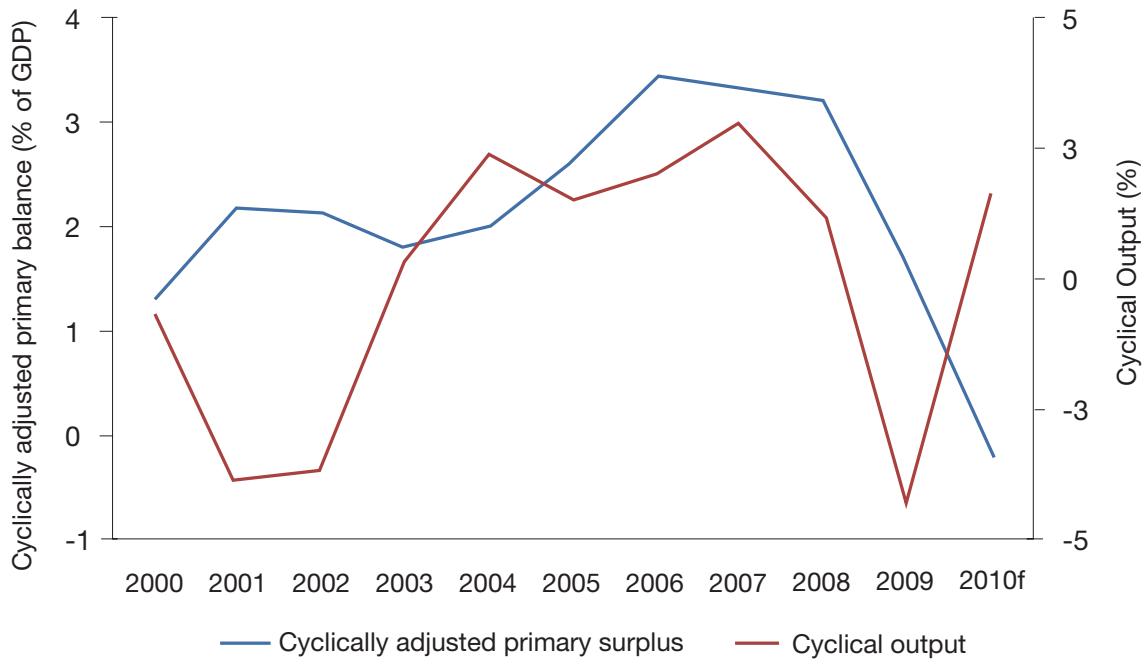
Despite all the progress, it would be naive to extrapolate Latin America and the Caribbean's recent performance into the near future.

FIGURE 1.1 MONETARY POLICY RATES



Note: Shaded region indicate forecasted values.
 Source: Central banks and Consensus Forecasts.

FIGURE 1.2 LAC CYCLICALLY-ADJUSTED FISCAL SURPLUS AND CYCLICAL OUTPUT



Note: Countries include Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
 Source: Own calculation based on data from the Economist Intelligence Unit.

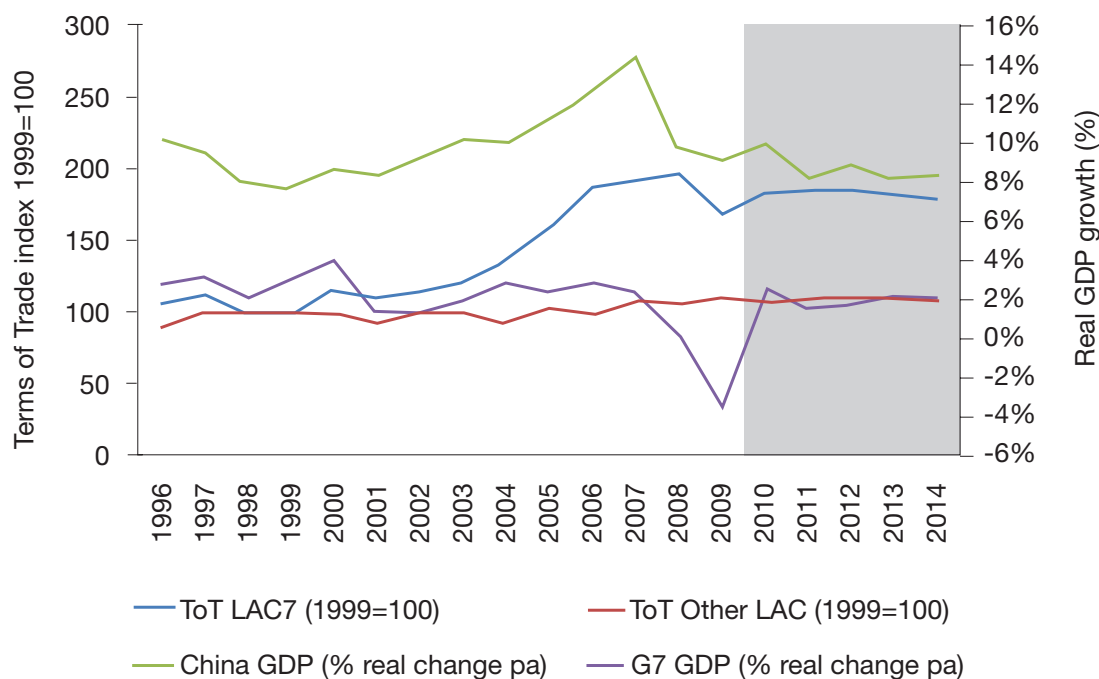
On the one hand, as the year so far has clearly illustrated, global tailwinds are not expected to continue to support the LAC region as they used to before the crisis and during the 2009 rally. If anything, we believe that the global outlook will be characterized by low and volatile growth, limiting global demand and further commodity upside (see Figure I.2).

Not everything is lost, though. China will almost certainly continue to offset the lack of dynamism of the G-7 countries and drive growth in commodity exporting economies (Figure 1.3). In addition, the gradual recognition of the LAC's re-

silience coupled with international interest rates at historical lows should contribute to fuel portfolio and FDI investment to the region. For the near term, we see neither tailwinds nor headwinds but something closer to a dead calm.

However, from a global perspective there are two Latin Americas. As Figure 1.3 clearly illustrates, the terms of trade boost that blessed LAC-7—Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela—external accounts and propped up their currencies were missing or, in some cases, even worked in the opposite direction for the other Latin American and Caribbean coun-

FIGURE 1.3 G-7 AND CHINESE GROWTH AND GROWTH FORECASTS (2010-2014) & LAC AVERAGE TERMS OF TRADE



Note: LAC-7: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. Other LAC: Costa Rica, Dominican Republic, Ecuador and El Salvador. Source: Own calculation based on data from the Economist Intelligence Unit.

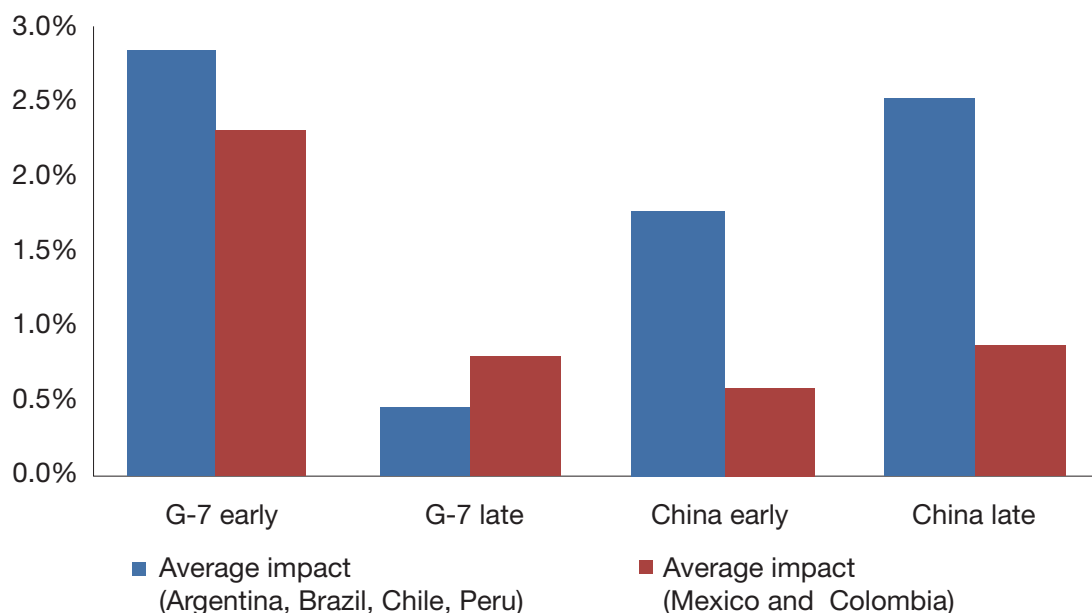
tries—Costa Rica, Dominican Republic, Ecuador and El Salvador. More generally, while there are in principle many different ways to cut the LAC economic space, the global growth map outlined above is a good place to start.

For all the debate about growth decoupling,² the changing nature of the output co-movement between emerging and advanced economies can be largely explained by a single factor, the emergence of China as a global growth driver. A simple comparison of the impact on growth of the Latin American region by the G-7 and Chinese growth before the 1990s and after the 2000s provides a straightforward illustration (Figure 1.4).³

The Chinese factor, which influences LAC both through external demand and through its effect on commodity prices and terms of trade, has very distinct implications for the region. It favors commodity producing South American countries with strong links to the East and punishes *maquila* exporting, commodity importing Central American and Caribbean countries with closer ties to U.S. economic activity. Countries such as Colombia stand somewhere in between.

In particular, the current divergent context, where China moves forward and the G-7 staggers, should bode well for most of the LAC-7 but drag down activity in the rest of LAC including Mexico and to a lesser extent Colombia.

FIGURE 1.4 IMPACT OF G-7 AND CHINA ON AVERAGE LAC GROWTH



Note: Estimates based on country-by-country growth regressions for the 1993:I-2009:IV period, interacting with period dummies to identify the late 2001-2009 period. Source: Own calculation based on IMF’s World Economic Outlook.

WHY LAC IS NOT ASIA: THE LIMITS TO NON-INFLATIONARY GROWTH

Prospects are also nuanced on the domestic front. Now that the boom-bust-boom rollercoaster has been left behind, the region still faces the same pending assignments that were dwarfed first by the global expansion and then by the crisis; in particular, the triad of inadequate investment, sub-par productivity gains and consequently modest non-inflationary growth. In other words, the LAC region is not the same as it was in the 1990s, but in terms of growth performance it is not an emerging Asia either, despite what the stellar record of the early 2000s may have led some observers to believe.

Although the region did perform relatively well in the context of the 2008-2009 crisis, the reality is that Latin America has a growth problem. As the region recovers from the crisis and GDP growth rates approach the 4-5 percent range, central banks are worrying about inflationary pressures and are beginning to discuss increases in interest rates to moderate aggregate demand. What this suggests is that potential GDP growth is too low for a region where poverty and unemployment still are a major problem.

The growth problem is not new. According to the historical databases constructed by Maddison,⁴ per-capita GDP growth in Latin America has been systematically below that of the U.S. at least since 1700; the only exception is the 1871-1929 period when growth rates were slightly higher in Latin

America. For example, between 1980 and 2000, average income per capita growth was only 0.4 percent in Latin America, in comparison to 2 percent in the U.S.

But the problem is not just in relation to the U.S. More worrisome is perhaps the evidence suggesting that the problem of economic divergence in Latin America relative to the rest of the world—with the sole exception of Africa—has worsened in recent decades.

In fact, per capita income in Latin America relative to the United States, the G-8 and East Asia is low, and has shown a declining trend. Differences in income per capita are essentially differences in output per worker. In 1980, output per worker in Latin America was roughly 35 percent of the U.S. level; it is now only 20 percent. In 1960, output per worker was more than 1 ½ times greater in Latin America than in East Asia; it is now 50 percent smaller. These facts clearly illustrate the region's growth issue.

To gain some understanding of the problem, economists usually apply a growth decomposition exercise that separates the contribution to growth of physical and human capital and a residual conveniently called total factor productivity. These decompositions systematically show that Latin America's low growth is essentially a total factor productivity (TFP) problem.

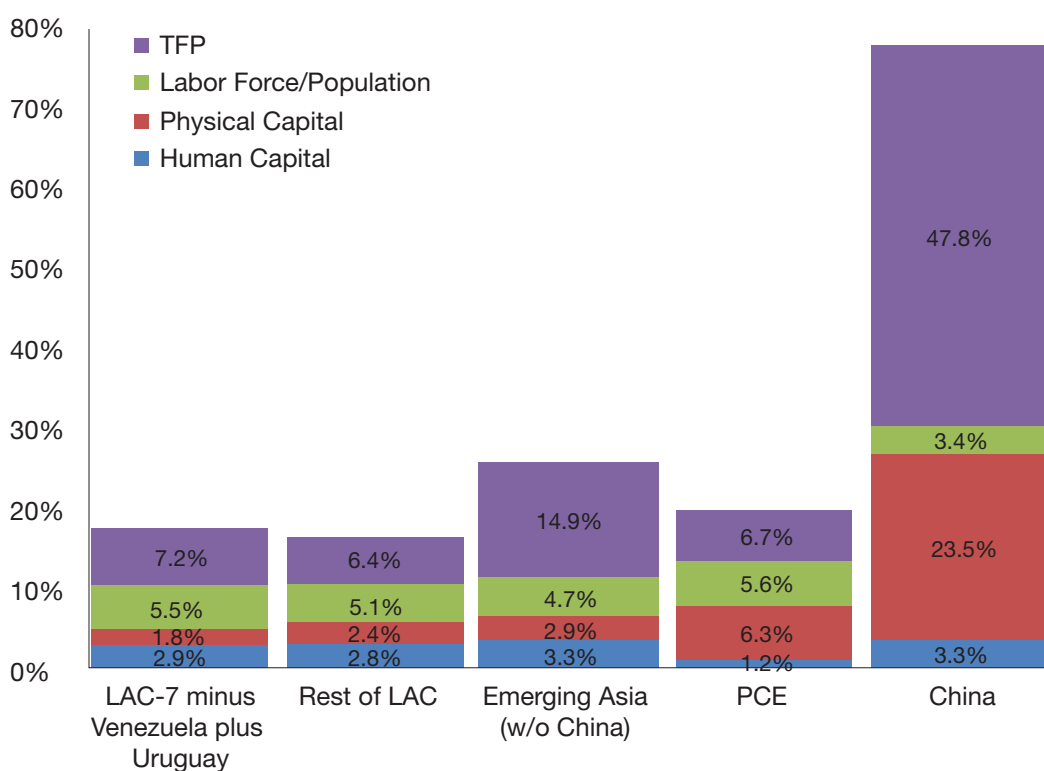
Using data from Blyde, Daude and Fernández-Arias,⁵ TFP in Latin America has been declining steadily since the 1960s, relative to other regions and particularly Asia. Indeed, while a simple growth accounting exercise for the booming 2000-2007 period shows the larger contribution of investment (capital formation) to growth in Asia, it highlights productivity gains as the single most important factor behind the LAC-Asia divide.

Low TFP is more a symptom than a syndrome, and there is no clear consensus as to what causes

it. One factor that has been singled out is the structure and composition of output in LAC, which continues to be very dependent on primary commodities. Only a few commodities, such as metals, resemble many characteristics of the highly differentiated manufactured goods. In most cases, commodities do not fit the theoretical “quality ladder growth models.”

But commodity dependence should not necessarily be regarded as a negative factor. Commodity production has the potential to give rise to product upgrading and quality-differentiation through

FIGURE 1.5 GROWTH ACCOUNTING BY REGION



Period: 2000-2007; PCE: Peripheral core economies (Australia, Canada, New Zealand, Norway, Sweden). Source: own calculations based on data from Blyde, Daude and Fernández-Arias (2009).

technological innovation. Countries have to move up in the ladder of product differentiation and value, but they should start with what they have now. Latin America needs to strengthen its productive structure by fostering policies that either upgrade the commodities or support other sectors with greater growth potential.

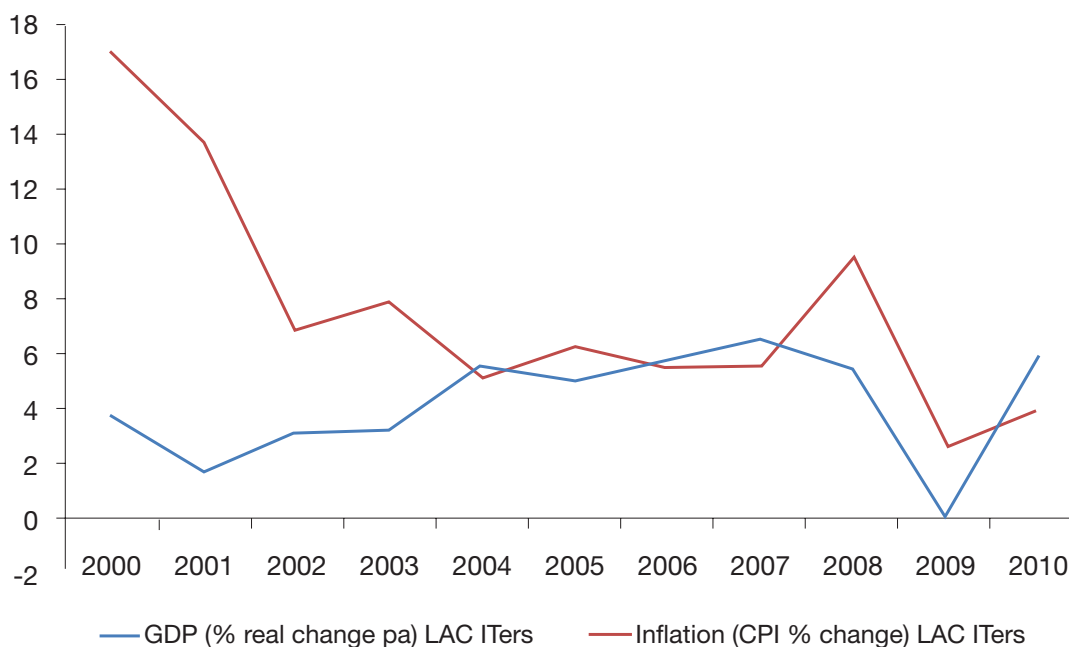
Latin America is in a unique position to begin a serious discussion about productive development policies. The fact that it was able to handle the crisis successfully has widened the policy space and has brought some sense of self-assuredness and confidence, which is a necessary ingredient for in-

novative thinking. Growth needs to be promoted by stimulating the development of new productive sectors and market niches, not too different from the ones existing today but with greater value added and growth potential.

Yet another illustration of the limits to non-inflationary growth comes directly from a quick look at inflation and growth performance in the 2000s, for the five inflation targeting countries in the LAC-7.

Now that the recovery from the crisis is nearly finished, the inflation-growth tradeoff is coming

FIGURE 1.6 INFLATION AND GROWTH IN LAC INFLATION-TARGETING COUNTRIES



LAC ITers: Five inflation-targeting Latin American countries (Brazil, Chile, Colombia, Peru and Mexico).
Source: Own construction based on the Economist Intelligence Unit.

back to the fast growing LAC economies; monetary tightening is already underway in Brazil, Chile and Peru, and expected in Colombia and Mexico. In other words, the recovery quickly brought about another round of the monetary decoupling between the LAC and the G-7 countries exhibited right before the crisis (see Figure I.6).

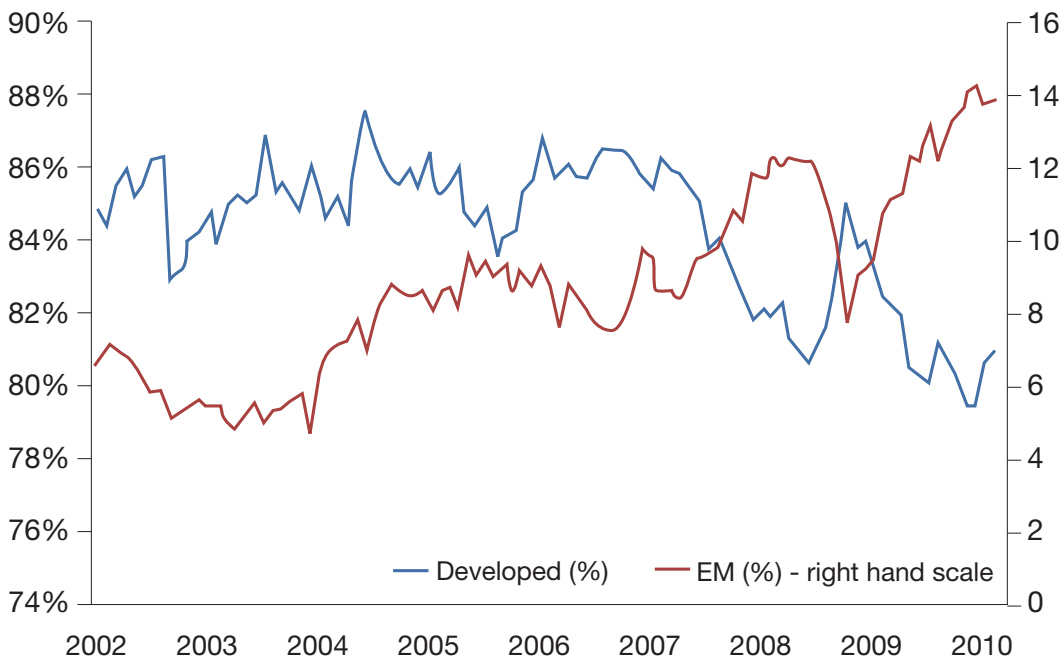
This tight monetary-loose fiscal pattern has many unexpected links. In particular, it can explain –together with an inflationary past and a propensity to adopt a tight monetary-loose fiscal policy mix– the high real interest rates that ultimately translate in attractive interest rate differentials with

U.S. or Japanese rates, fostering carry currency trades. Thus, the quest for growth in a context of a modest non-inflationary growth potential may be a contributing factor on the subject that is coming back to the foreground with the fading of the global crisis: exchange rate dynamics and the management of cyclical appreciation pressure.

THE PERILS OF OVERVALUATION

It is well known that the current global investor has been gradually relocating funds toward emerging markets, particularly to local currency instruments like equities, local bonds and exchange rate forwards in order to increase the portfolio share at the expense of core markets (Figure

FIGURE 1.7 EM EQUITIES IN THE GLOBAL PORTFOLIO: COMPOSITION OF EQUITY FUNDS



Source: own calculations based on EPFR.

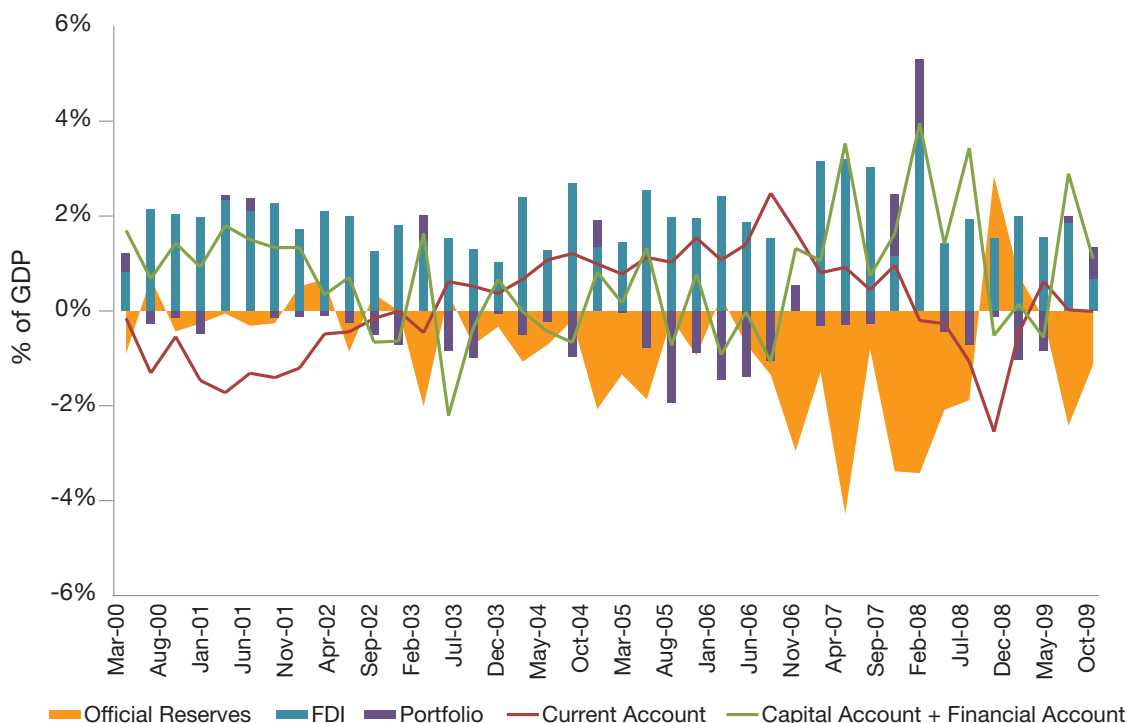
1.7)—a trend only temporarily interrupted by the post-Lehman Brothers sell off.

This steady portfolio flow contrasts with a stable to weaker supply of FDI funds in a context of re-valued emerging currencies and an overall feeble economic recovery. As a result, there seems to be a shift in the composition of capital flows toward typically pro-cyclical portfolio investment (Figure 1.8). This in turn calls for a more alert macro monitoring and ultimately more proactive policies to

curve inflows, such as capital controls or more frequently foreign exchange intervention.

In turn, the current account surplus of the pre-Global Recession years is a thing of the past. The new normal implies a lower trade surplus and a balanced current account for the region. However, a balanced current account combined with positive capital account is the source of pressures toward the appreciation of the currency.

FIGURE 1.8A THE CAPITAL ACCOUNT SIDE OF THE BALANCE OF PAYMENTS (LAC-7): PORTFOLIO VS. FDI



Notes: Negative change in reserves implies accumulation of official reserves.
 Source: Own construction based on the IMF's International Financial Statistics (IFS)
 LAC-7: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

That reserve accumulation is primarily driven by leaning-against-the-wind foreign exchange (FX) intervention and is at this stage difficult to question. Naturally, one could see fear of appreciation during expansions as the counter-cyclical prudential response to pro-cyclical capital flows. Avoiding current account deficits and over-appreciated currencies in good years is an effective way to prevent a dollar squeeze and a sharp depreciation when capital leave the country in the downturn.

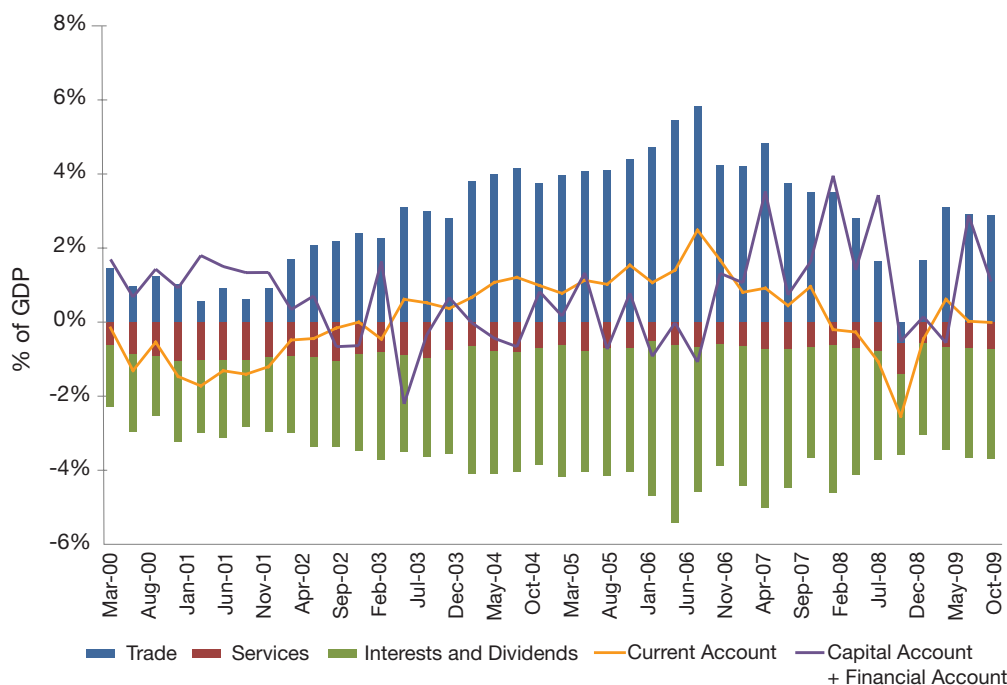
But intervention is also often geared toward preserving an undervalued currency as a develop-

ment tool to gain international competitiveness or reduce import competition.⁶

At any rate, while the relative importance of precautionary and mercantilist motives are hard to identify, the policy misgivings about a freely floating exchange rate are likely to be strengthened in the near future.

Is leaning-against-the-wind intervention the solution to this puzzle? How costly is FX intervention over time? The cost of reserves has been often estimated as the gap between the yield of hard-currency public debt and the return on reserves.

FIGURE 1.8B THE CURRENT ACCOUNT SIDE OF THE BALANCE OF PAYMENTS (LAC-7): SO LONG, TRADE SURPLUSES



Source: Own construction based on the IMF's International Financial Statistics (IFS)
LAC-7: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

Because reserves are held in short risk-free assets, this gap is in turn a function of the sovereign risk spread and the hard-currency interest rate premium.⁷

However, the cost of reserves tends to differ from this simple formula. First, to the extent that liquid reserves reduce credit risk and the interest rate paid on the total public and private debt stock, the marginal cost of carrying reserves for indebted economies may be significantly lower than the sovereign spread.⁸ Second, the fact that reserves are held in short-dated instruments is related less to liquidity than to central banks' reserve management practices, including possibly fear of mark-to-market losses; the term premium is in most cases an unnecessary cost.

Third and more importantly, reserves are typically purchased by central banks through interventions sterilized with the sale of local currency-denominated debt (see Levy Yeyati).⁹ This may result in central bank quasi fiscal losses associated to steep interest rate differentials. As a result, losses can also occur in the local-currency value of international reserves as the exchange rate moves toward its new, more appreciated equilibrium. But if appreciation pressures are due, for example, to cyclical inflows or short-lived terms of trade shocks, the reversion of the exchange rate to its earlier, more depreciated level would eliminate much of these valuation losses.

A quick look at the 2005-2010 period illustrates the profits and losses of intervention. Figure 1.9 shows back-of-the-envelope estimates of reserves purchases, and cumulative carry and valuation losses for three LAC economies, under the assumption that reserves are purchased through sterilized foreign exchange interventions.¹⁰ Monthly carrying costs are therefore computed as the cumulative purchases since the beginning of 2005 times the monthly equivalent of the difference between the yield of a representative local currency bond (proxied by the yield of JP Morgan's GBI-EM portfolio) and the representative reserve asset (proxied by the two-year U.S. Treasury yield). Valuation costs in turn are simply the difference between the cumulative investments in reserves (where a sale is recorded as a gain) minus the market value of the current stock of reserves.

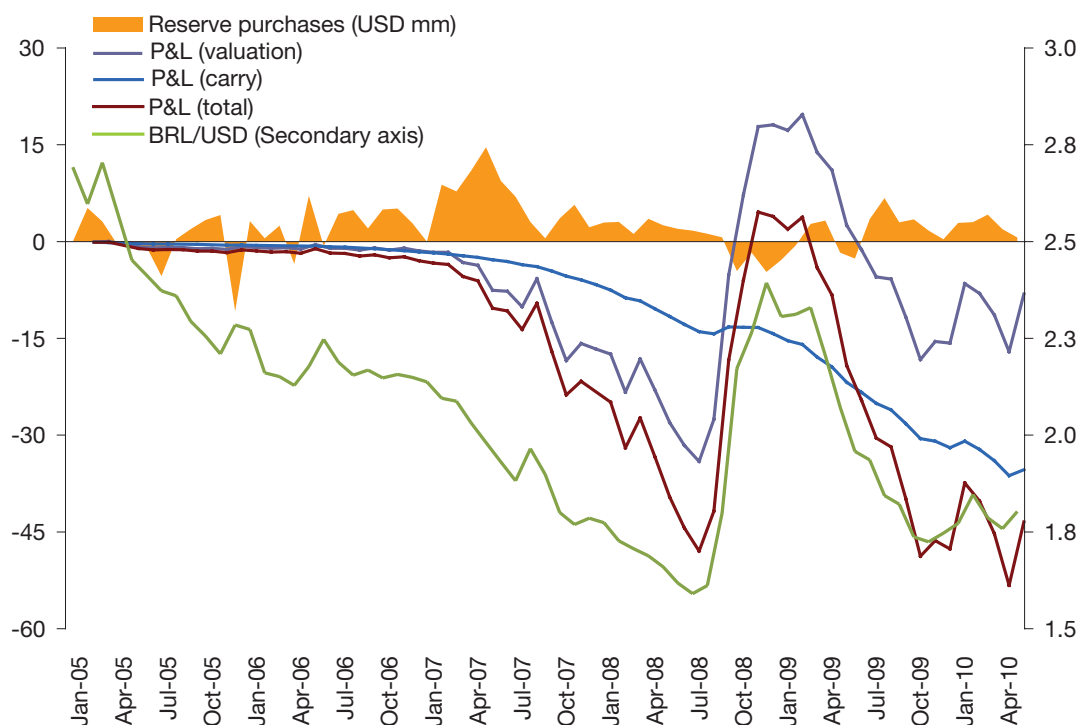
Predictably, valuation losses accumulate during the appreciation phase and decline during a sell-off, as the central bank sells expensive what it had bought cheap and as reserves stocks benefit from the revaluation of the dollar. Indeed, many heavy intervening central banks realized valuation profits during the period, as the early appreciation reverted and as reserves were sold at higher parities to contain the currency run.¹¹ On the other hand, carrying costs vary according to the local currency-dollar interest rate differential and tend to be substantial for the so-called "carry currencies" (a characteristic common to all three countries in the charts).

Thus, the bottom line cost of reserves differs. The intervention cost in Brazil, with a currency that appreciated moderately during the period and a sizeable carry, was considerable. The opposite is true for Argentina, where the currency actually depreciated and valuation gains more than compensated for carrying costs. Finally, intervention costs in Mexico, with a lighter and erratic intervention and a smaller carry, were close to zero.

In sum, the conventional view that intervention is too costly due to wide sovereign spreads or heavy quasi fiscal losses appears to be overstated—even abstracting from the benign effect of reserves on credit ratings and sovereign spreads.

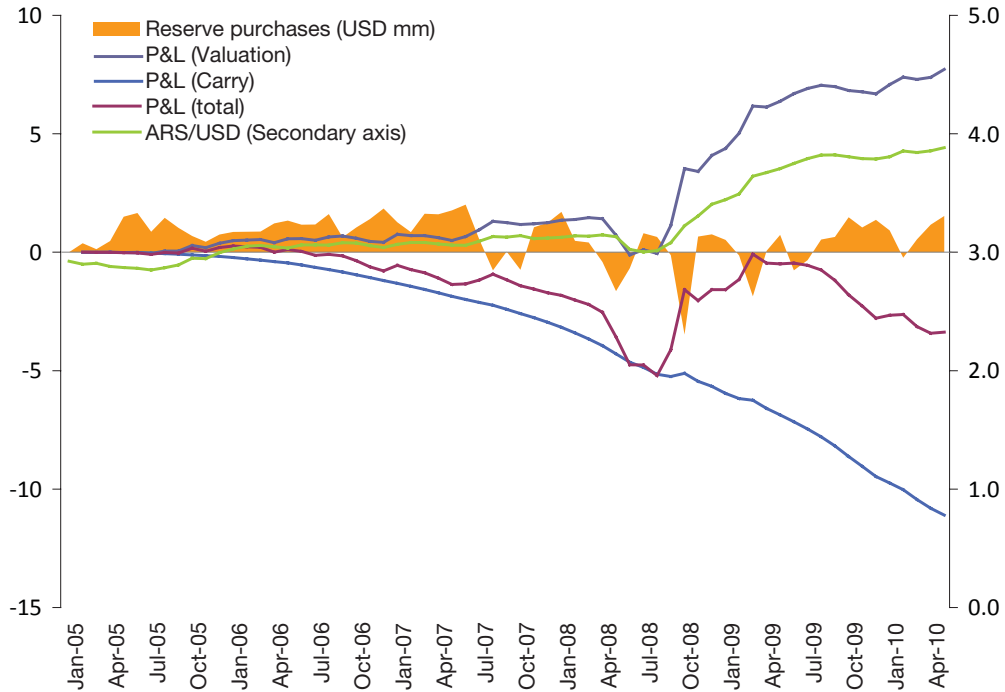
Moreover, exchange rate smoothing, whatever its motive, does not require reserves to be held in short, low-yielding liquid assets, as central banks do possibly for fear of booking mark-to-market losses. Even precautionary reserves can afford to be partially invested in higher yielding long-run saving instruments as in the case of sovereign wealth funds. Perhaps the realization of this inconsistency between goals and instruments by enhancing the return on reserves may help bring the cost of sterilized intervention very close to zero, making the intervention debate rather abstract. Be that as it may, both because of concerns about excessive speculative inflows or because of lack of concern about excessive costs, FX intervention will continue to be in the policy toolkit in the near future.

FIGURE 1.9A BRAZIL: PROFITS AND LOSSES FROM FX INTERVENTION (USD BILLIONS UNLESS OTHERWISE INDICATED)



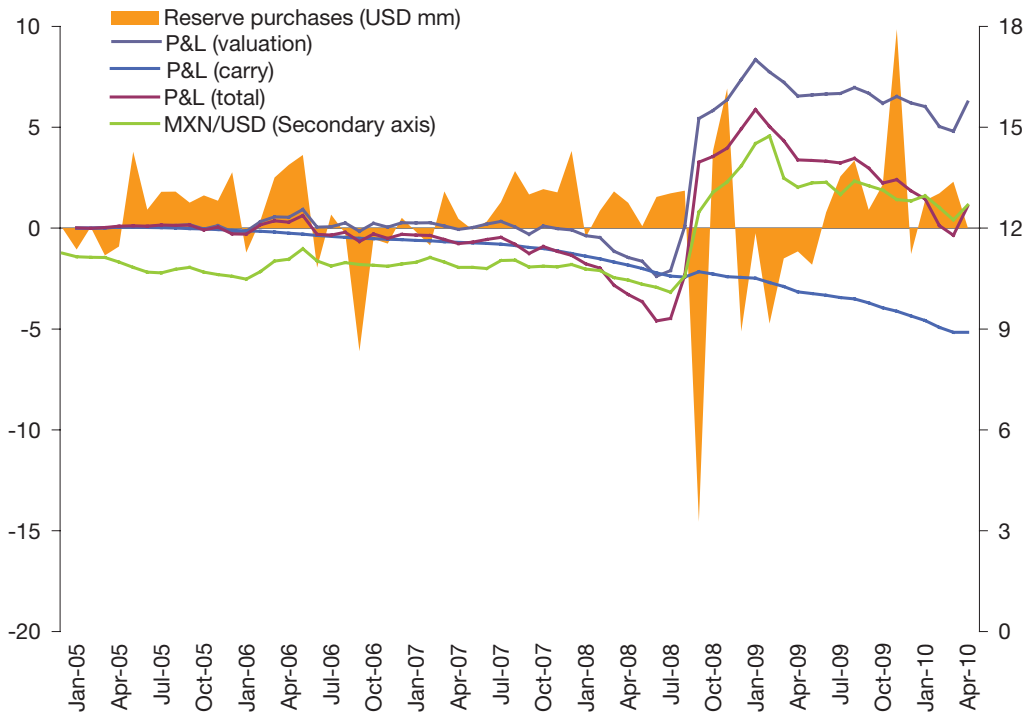
Source: Levy-Yeyati, E. (2008)

FIGURE 1.9B ARGENTINA: PROFITS AND LOSSES FROM FX INTERVENTION (USD BILLIONS UNLESS OTHERWISE INDICATED)



Source: Levy-Yeyati, E. (2008)

FIGURE 1.9C MEXICO: PROFITS AND LOSSES FROM FX INTERVENTION (USD BILLIONS UNLESS OTHERWISE INDICATED)



Source: Levy-Yeyati, E. (2008)

WHAT'S MISSING IN THE PATH TO GRADUATION?¹²

Resilience to the crisis, large stocks of liquid reserves and an improving debt profile, lower perceived risk, capital inflows and strengthened currencies, low inflation and countercyclical monetary and fiscal policies. Does all that mean that emerging LACs are finally on the verge of graduation to the developed world? Why then are credit ratings still far behind those for advanced economies apparently in no better shape?

To add a longer-term perspective to our near term outlook, we run a simple exercise to rank selected LAC countries relative to other emerging and developed peers according to variables that capture in a narrow way the critical aspects of the broader development concept.

What does graduation mean in this context? Needless to say, because there is no single definition economic development, there is no definition of graduation to the developed world. Moreover, graduation per se is hard to trace. While a few emerging economies (Singapore and Israel) have been placed by some analysts within the developed group and a few advanced economies (Greece) may be revised down to the emerging category, vertical mobility in the development casts is rather unusual. However, for simplicity, we could start by defining graduation as the achievement of solid, stable and sustainable economic growth.

How can graduation be defined in terms of economic outcomes? Again, there is no single set of variables that can encompass such a complex concept. But we could devise a parsimonious scorecard to shed some light on the relative standing of individual economies. For starters, since our goal is to identify countries that have left some of the traditional EM predicaments *permanently* behind, the scorecard should capture long-standing progress rather than yesterday's miracle. Because of that, the growth score complements simple historical averages with indicators of output vulnerability and resilience to extreme shocks.

In addition, to make up for the backward-looking nature of growth statistics, we look into three dimensions that are often perceived as characteristic EM handicaps: financial resilience (*FR*), policy track record (*PTR*), and broad development factors (*Dev*), each proxied by a small group of standard indicators.

Combining these three factors with the growth score, we compute our graduation score card as:

$$Score_j = \frac{(S_j^{Growth} + S_j^{FR} + S_j^{PTR} + S_j^{Dev})}{4}$$

Where $S_j(\cdot)$ is the average z-score for each of the four criteria, rescaled to the [0, 1] interval for comparability.

Financial resilience tries to capture debt sustainability, specifically, solvency (proxied by the

public external debt-to-GDP and the net external debt- to-GDP ratios) and liquidity (proxied alternatively by the net external financing needs over current account receipts, where the former is computed as short-term external debt plus currently maturing long-term external debt minus official foreign exchange reserves and by the country's borrowing cost proxied by the five year sovereign CDS spread).

Monetary and fiscal policy track record is proxied by risk-adjusted inflation (defined as the mean plus one standard deviation of the inflation rate); and by the average of the cyclically adjusted primary fiscal balance over 2005-2009, computed for simplicity as the intercept from the equation $primary\ surplus_t = a + b\ cycle_t + u_t$, where $cycle_t$ is obtained from the log-linear de-trending of the real GDP series.

Finally, development factors include income, human development and institutional indicators, proxied respectively by the Gini coefficient, the UN Human Development Index (which comprises life expectancy, education and living standards) and the World Governance Indicators.

We compute the scorecard for the LAC-7 plus Uruguay and Ecuador, and include for comparison selected countries from emerging Asia and five peripheral core economies (Australia, Canada, New Zealand, Norway and Sweden) that are often seen as the target toward which graduating emerging economies should gradually con-

verge. Table 1.1 at the end of this chapter reports the final ranking.

Predictably, Asian countries tend to rank on top of the EM group, benefitting from strong growth, stable policy frameworks and few if any financial vulnerabilities. Although, they tend to fare somewhat worse on the development front. Predictably also, Chile ranks first within the LAC-7, followed at a distance by Brazil.

Finally, the average scores for our sample of peripheral advanced countries (Australia, Canada, New Zealand, Norway and Sweden), to the extent that they represent developed economies for the average emerging economy to reasonably look up to as a model, shed some light on the distance to graduation. Here, the LAC region scores comparably in terms of risk-adjusted growth and, despite their higher sovereign spreads, close to developed countries on the financial front—a reflection of the already mentioned progress on the macro front in the 2000s. By contrast, they lag in policy track record, although the average fiscal surplus in our developed cohort is influenced by Norway's substantive oil revenues and more dramatically in development indicators.

This last point and the main policy take away from the exercise opens up a discussion about graduation—and, more generally, about economic development—that compounds the concerns about growth limits that we discussed above. After conquering macroeconomic stability,

policies are expected to focus on “micro” issues to address many of the economic shortcomings that appeared as we went over the LAC post-crisis landscape: health and education to support long-run productivity growth, social protection policies to enhance human capital and reduce the political dispersion, and institutional reform to stimulate local human spirits and foreign direct investment.

These are all strategic issues that require a solid and stable growth backdrop to avoid falling back in the shorttermism that characterized LAC policies in the past. In this sense, if human development and institutional strengthening appear to be the next frontier in the LAC’s graduation quest, near-term growth remains a necessary condition to avoid costly diversions in the path to graduation.

TABLE 1.1 GRADUATION SCORECARD

Country	Stable growth				Policy track record				Financial vulnerabilities				Development factors				Total Rankings								
	Risk Adj GDP	Stress test (2009)	Avg. Z-score (rescaled)	Avg. Z-score (rescaled)	Risk Adj CPI	Cyclically adj. fiscal balance (% GDP)	Avg. Z-score (rescaled)	Rank	Net Ext. Debt (% GDP)	Net Ext. Fin. Needs (% GDP)	Public Sector Debt (% GDP)	Spread Level	Z-score (rescaled)	Avg. Z-score (rescaled)	Rank	Gini index	Human Develop. index	WGI score	Avg. Index score	Avg. Index (rescaled)	Rank	Weighted score (rescaled)	Equally weighted score	Ranking (weighted score, rescaled)	
Turkey	0.6	2.4	0.5	20.0	50.0	1.7	0.4	29.0	0.3	114.6	0.1	236.1	0.3	24.0	0.4	0.8	-0.1	-0.2	0.1	0.5	16.0	-0.4	0.4	26.0	26.0
China	5.1	-0.1	1.0	1.0	1.0	3.9	0.7	18.0	-0.4	-139.1	0.0	67.6	0.9	3.0	0.4	0.8	-0.5	-0.7	0.0	0.4	24.0	0.7	0.7	3.0	3.0
Egypt	3.3	0.3	0.8	5.0	11.5	-1.5	0.6	24.0	0.0	-30.5	0.0	136.1	0.6	6.0	0.3	0.7	-0.5	-0.5	0.0	0.4	26.0	0.3	0.6	10.0	12.0
Taiwan	1.2	3.9	0.6	8.0	2.2	1.3	0.9	6.0	-0.7	-171.1	0.0	40.0	1.0	1.0	0.3	0.9	0.8	1.0	0.5	0.8	6.0	0.8	0.8	2.0	2.0
Russia	1.2	-0.7	0.4	22.0	42.5	3.7	0.6	23.0	0.0	79.2	0.0	224.3	0.5	17.0	0.4	0.8	-0.7	-0.5	-0.1	0.3	29.0	-0.1	0.5	24.0	25.0
Argentina	0.4	3.9	0.5	15.0	15.6	2.0	0.8	13.0	0.2	-74.7	0.2	740.1	0.2	27.0	0.5	0.9	-0.3	-0.3	0.0	0.4	20.0	0.0	0.5	21.0	22.0
Indonesia	3.1	1.2	0.8	3.0	14.4	-0.1	0.7	21.0	0.2	27.2	0.0	243.3	0.5	16.0	0.4	0.7	-0.5	-0.6	0.0	0.4	25.0	0.2	0.6	12.0	16.0
Mexico	0.6	2.6	0.5	19.0	10.0	1.5	0.8	11.0	0.1	8.2	0.0	193.0	0.5	14.0	0.5	0.9	-0.1	-0.4	0.1	0.5	18.0	0.1	0.6	16.0	17.0
Brazil	1.4	4.8	0.7	7.0	9.7	2.6	0.9	4.0	0.0	-12.7	0.0	210.5	0.6	11.0	0.6	0.8	0.0	-0.6	0.1	0.5	17.0	0.4	0.7	5.0	7.0
South Africa	1.7	-0.7	0.5	16.0	8.8	0.3	0.8	17.0	0.0	-6.7	0.0	180.7	0.6	10.0	0.4	0.7	-1.7	-1.6	-0.5	0.0	32.0	0.0	0.5	19.0	24.0
Hungary	0.8	-2.4	0.3	26.0	8.9	-0.3	0.7	19.0	0.8	76.6	0.2	246.7	0.1	30.0	0.3	0.9	0.8	1.0	0.5	0.8	5.0	-0.3	0.5	25.0	23.0
Colombia	1.0	1.5	0.5	18.0	8.7	1.9	0.9	8.0	0.1	1.9	0.1	208.7	0.5	18.0	0.6	0.8	-0.4	-1.0	-0.1	0.4	27.0	0.1	0.5	17.0	21.0
India	3.3	0.9	0.8	2.0	7.8	-3.3	0.5	28.0	0.0	-3.8	0.0	146.0	0.6	7.0	0.3	0.6	-0.2	-0.8	0.0	0.4	21.0	0.2	0.6	11.0	13.0
Philippines	2.4	1.7	0.7	6.0	7.5	1.2	0.8	10.0	0.1	17.8	0.2	230.5	0.3	22.0	0.4	0.8	-0.5	-0.7	-0.1	0.4	28.0	0.2	0.6	13.0	19.0
Poland	2.1	-1.0	0.6	12.0	6.7	0.9	0.8	12.0	0.4	51.7	0.1	160.0	0.3	23.0	0.3	0.9	0.6	0.7	0.4	0.7	10.0	0.1	0.6	15.0	9.0
Chile	1.4	1.5	0.6	13.0	5.5	3.1	1.0	1.0	0.3	10.6	0.0	130.5	0.5	13.0	0.5	0.9	1.2	0.3	0.5	0.8	4.0	0.5	0.7	4.0	4.0
Czech Republic	1.0	-2.3	0.4	25.0	4.4	-2.9	0.6	25.0	0.2	-16.2	0.1	90.0	0.5	12.0	0.3	0.9	0.9	1.2	0.5	0.8	3.0	0.0	0.6	22.0	15.0
Peru	1.4	2.0	0.6	11.0	4.2	1.7	0.9	3.0	0.0	5.7	0.1	182.4	0.5	15.0	0.5	0.8	-0.3	-0.6	0.0	0.4	22.0	0.3	0.6	8.0	11.0
Korea	1.8	1.5	0.6	10.0	3.9	-0.4	0.8	16.0	0.1	2.2	0.0	89.3	0.6	9.0	0.3	0.9	0.7	1.1	0.5	0.8	7.0	0.4	0.7	6.0	5.0
Thailand	1.6	0.0	0.5	14.0	4.2	-0.3	0.8	15.0	-0.3	-47.9	0.0	94.0	0.7	4.0	0.5	0.8	-0.3	-0.9	0.0	0.4	23.0	0.3	0.6	9.0	10.0
Malaysia	1.7	1.9	0.6	9.0	3.6	-3.5	0.5	26.0	-0.2	-31.9	0.0	147.1	0.7	5.0	0.4	0.8	0.3	0.2	0.2	0.6	14.0	0.2	0.6	14.0	8.0
Singapore	1.3	7.1	0.8	4.0	3.2	1.2	0.9	7.0	-0.9	-140.6	0.0	40.0	1.0	2.0	0.4	0.9	1.6	1.2	0.7	1.0	1.0	1.0	0.9	1.0	1.0
Uruguay	0.4	3.8	0.5	17.0	12.9	1.1	0.8	14.0	0.2	-46.7	0.3	238.4	0.2	28.0	0.5	0.9	0.7	0.2	0.4	0.7	12.0	0.0	0.6	20.0	20.0
Venezuela	0.3	-8.5	0.0	32.0	27.7	-3.9	0.2	31.0	0.1	-181.6	0.1	1030.0	0.4	20.0	0.4	0.8	-1.1	-0.6	-0.2	0.2	31.0	-0.9	0.2	32.0	32.0
Ecuador	0.9	-1.3	0.4	24.0	50.8	-3.3	0.0	32.0	0.2	22.8	0.0	869.5	0.3	26.0	0.5	0.8	-0.9	-1.0	-0.2	0.2	30.0	-0.9	0.2	31.0	31.0
Ukraine	0.6	-0.3	0.4	23.0	22.5	-0.6	0.5	27.0	0.6	19.1	0.1	640.2	0.2	29.0	0.3	0.8	-0.4	0.1	0.0	0.4	19.0	-0.4	0.4	27.0	28.0
Israel	1.2	-0.3	0.5	21.0	4.4	1.6	0.9	5.0	0.1	-62.1	0.0	123.0	0.6	8.0	0.3	0.9	0.6	1.0	0.4	0.7	8.0	0.3	0.7	7.0	6.0
Romania	0.9	-5.2	0.2	29.0	34.9	-1.9	0.3	30.0	0.5	46.8	0.0	285.0	0.4	21.0	0.3	0.8	0.2	0.4	0.2	0.6	15.0	-0.6	0.4	29.0	29.0
Bulgaria	1.3	-4.5	0.3	27.0	9.5	3.4	1.0	2.0	0.4	17.8	0.0	247.2	0.4	19.0	0.3	0.8	0.3	0.5	0.3	0.6	13.0	0.1	0.6	18.0	14.0
Latvia	0.5	-7.0	0.1	31.0	9.6	-1.2	0.6	22.0	1.3	94.9	0.0	627.0	0.0	32.0	0.4	0.9	0.7	0.6	0.4	0.7	11.0	-0.6	0.4	30.0	30.0
Estonia	0.6	-3.9	0.2	28.0	7.0	1.6	0.9	9.0	1.1	46.4	0.0	251.0	0.3	25.0	0.3	0.9	1.0	1.0	0.5	0.9	2.0	-0.1	0.6	23.0	18.0
Lithuania	0.6	-6.1	0.1	30.0	6.2	-0.8	0.7	20.0	0.7	47.5	0.2	386.0	0.1	31.0	0.4	0.9	0.7	0.6	0.4	0.7	9.0	-0.5	0.4	28.0	27.0
LAC (avg)	0.9	1.1	0.5	16.1	16.1	0.7	0.7	0.7	0.1	-29.6	0.1	422.5	0.4	0.4	0.5	0.8	-0.1	-0.5	0.1	0.5	0.0	0.0	0.5	0.5	0.5
Developed (avg)	1.6	0.0	0.5	3.2	3.2	4.2	1.1	1.1	0.3	128.0	0.0	41.0	0.4	0.4	0.3	1.0	1.7	1.7	0.8	1.1	0.0	0.5	0.8	0.8	0.8

ASSESSING THE RECOVERY IN LATIN AMERICA: SECTOR INDEX ANALYSIS

This section shows a composite index which combines real, financial and confidence variables for the seven largest economies in Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.¹³

The index is constructed using principal component analysis (PCA), which is a statistical methodology useful for identifying common patterns and trends present in a set of economic variables, all of which capture a different dimension. The components that emerge from the aggregation of the initial variables encompass a succinct economic overview. This section offers an outlook of the major Latin American and Caribbean economies and further discusses future economic trends and likely outcomes. Even if PCA is by no means a forecasting tool, it is extremely helpful in simpli-

fying common patterns and therefore in shading future trends.

This technique presupposes that the input variables are correlated and obtains uncorrelated indexes, which are linear combinations or components of the initial variables. Specifically, the index displays the common variance of the growth rate of a set of key economic variables and should be interpreted as an indicator that takes the pulse of their growth rates. It is important to interpret the indexes correctly. When for instance a particular index is at its highest point, it does not necessarily mean that the variables (in levels) are better off than at any previous point, but simply that the variable's compounded growth rate is the highest than in any other point in time.

For simplicity, the linear combination is scaled in a 0 to 100 range, corresponding to the historical minimum and maximum values. For each coun-

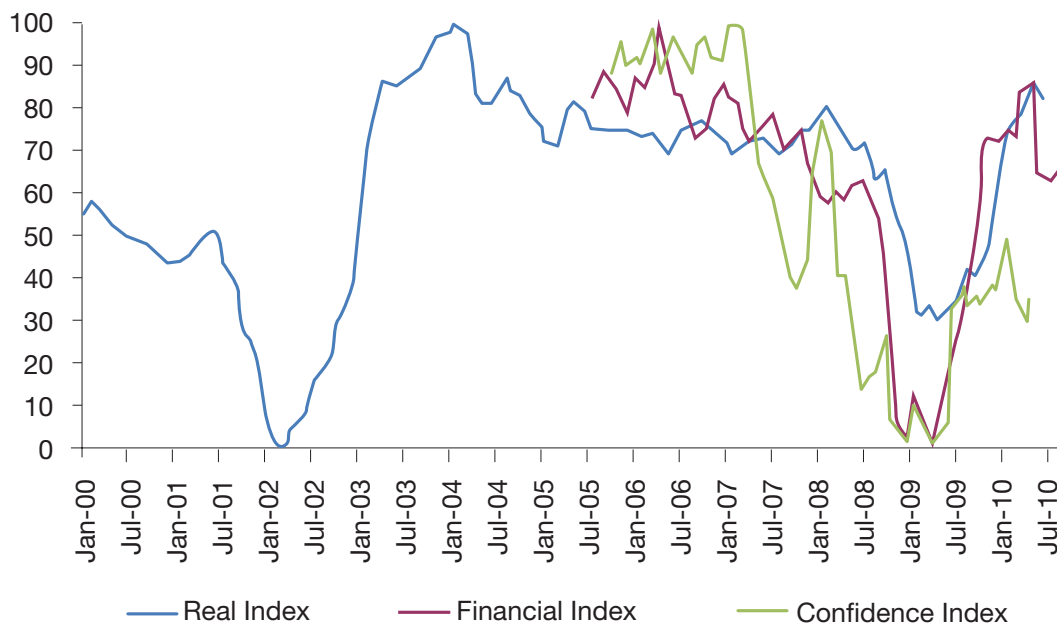
try we construct four indexes: one corresponding to each set of variables—real, financial and confidence—and a composite measure of these three indexes, the overall index.

The information on the real economy includes the following variables: employment level, import volume, industrial production volume and GDP. In all cases, we use the 12-month growth rate (GDP is the quarterly, year over year) of the seasonally adjusted data (not adjusted in the case of GDP). The financial sector variables include the 12-month growth rate in equity prices in domestic currency plus the emerging bond spread in basis points over U.S. Treasury. The confidence data includes results from business and consumer confidence surveys, except in Venezuela where the

data is not available. To capture long-run trends as well as short-term fluctuations, we use monthly data (except for GDP, which is quarterly).

After having experienced a modest economic recovery throughout 2009, **Argentina's** real GDP year over year growth rate for the second quarter of 2010 (11.8%) is evidence of a much more solid standing. In fact, in May of this year, the country's real index peaked. However, a misalignment between the real and the confidence and financial indexes is evident. Whereas the real index is considerably high, both the financial and confidence indexes are at lower levels. This imbalance provides us with evidence that suggests that Argentina's real index will converge toward the levels displayed by the financial and confidence

FIGURE 2.1 ARGENTINA'S CONFIDENCE MAY DRAG DOWN GROWTH MOMENTUM



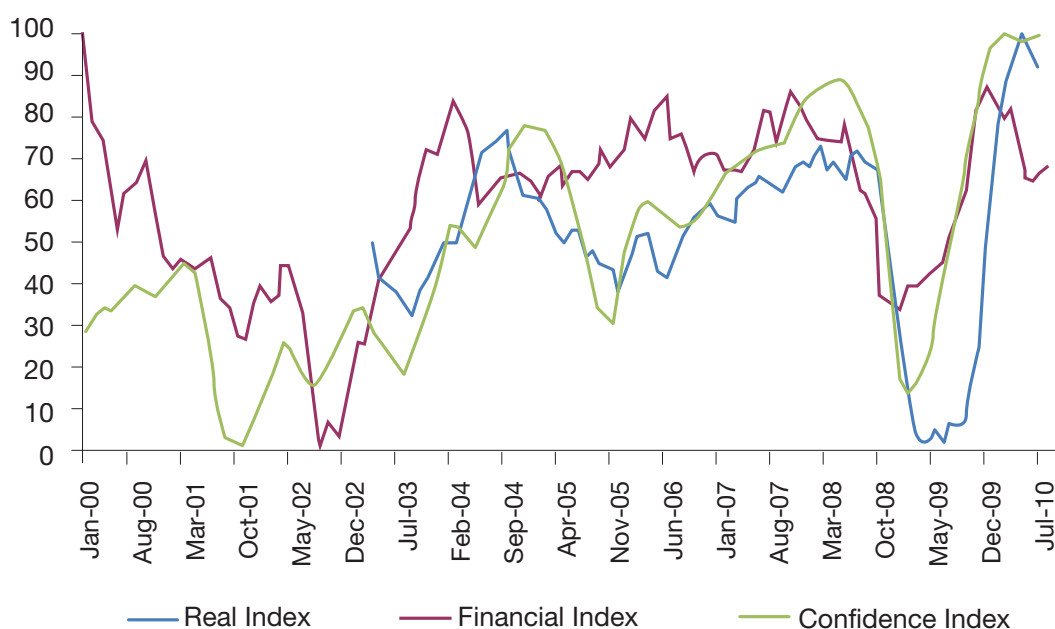
aggregates, which are on average 30 points lower. In fact, this downward convergence trend is already evident, at least in the financial index.

Brazil boasted the strongest recovery in the region. The real sector index reached its maximum historical value in April and it is still at historically high levels indicating that growth in the composite measure of real sector variables is in a stronger position relative to the last decade. In addition, Brazil's confidence index is displaying superstar behavior, as it has recently begun to exhibit yet another upward trend. The financial composite is displaying moderation, but it is still within the range of the pre-crisis financial levels. We expect a gradual convergence of the real index, which is already showing signs of deceleration, toward the

financial index mediated by the positive perception of business and consumers.

Mexico's confidence index is underperforming relative to the pre-crisis period partly because of its current domestic violence issues. This is especially true for consumer confidence, which is currently significantly lower relative to the previous decade. Business confidence, on the contrary, recovered after the financial plunge of mid-2008 and is now stable. In addition, the financial index is displaying a sharp decrease. The real sector compounded indicator is at its peak and presents signs of misalignment with the confidence and financial indexes. Inevitably, the real sector index will converge to the confidence and financial composite indexes, following a downward dynamic.

FIGURE 2.2 BRAZIL: CONFIDENCE OFFSETS FINANCIAL DOWNTURN



Peru exhibited a vigorous real and financial economic recovery. Nevertheless, the confidence index has not quite reached the levels it had attained before the crisis. However, given the strong fundamentals, it is feasible that the real and financial indexes continue at their high levels, pushing the confidence indicator to align upwards.

Chile's indexes show consistent economic behavior. Its real index is much more aligned with its confidence and financial indexes. However, if confidence and financial indexes can be interpreted as leading indicators, Chile's real index is expected to peak in the next quarter and to present a moderate converging slowdown.

In **Colombia** all three indexes are aligned. Confidence and real compounded indexes are highly synchronized and have not yet peaked. Financial variables have already peaked and are now in a decreasing phase. However, the three indexes stand in a closed range. Given the consistency between the three indicators, real sector growth in the next quarter can be expected to be more stable in Colombia in comparison to other Latin American countries. In other words, Colombia will be exempt from the boom-followed-by-moderation pattern so typical in Latin America these days.

Venezuela's real index is showing an uninterrupted economic decline since 2005. Real sector

FIGURE 2.3 MEXICO'S REAL SECTOR INDEX UNSUSTAINABLY HIGH

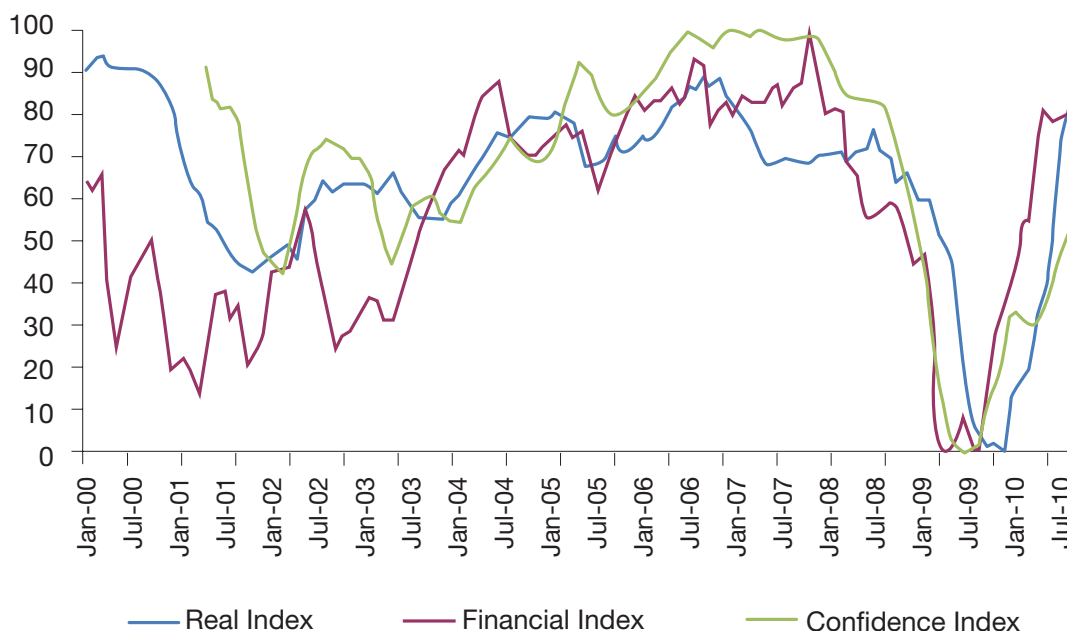


FIGURE 2.4 PERU: THE GOOD YEARS ARE BACK

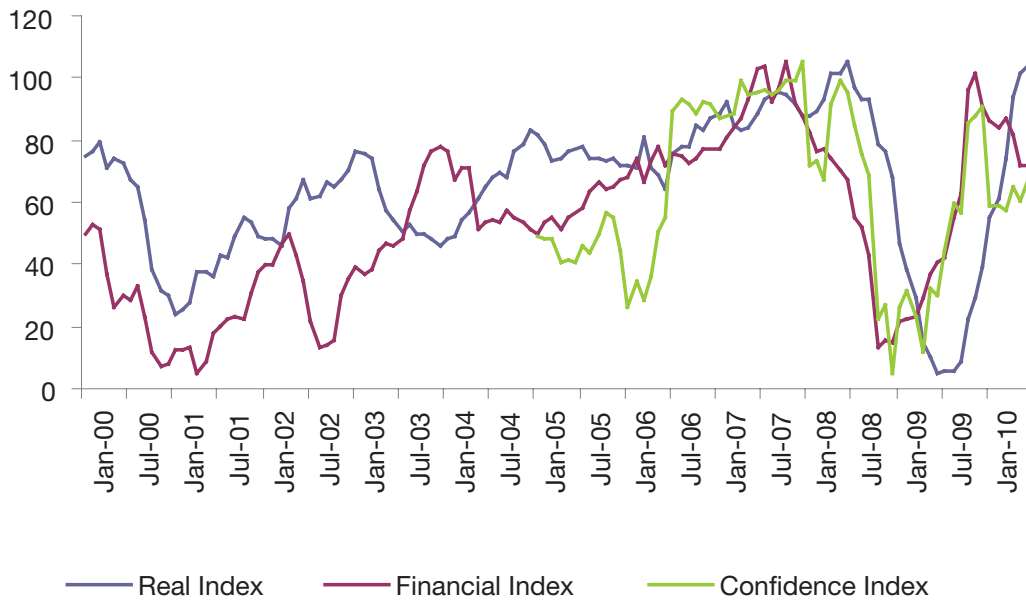


FIGURE 2.5 CHILE: REAL SECTOR STILL RECOVERING

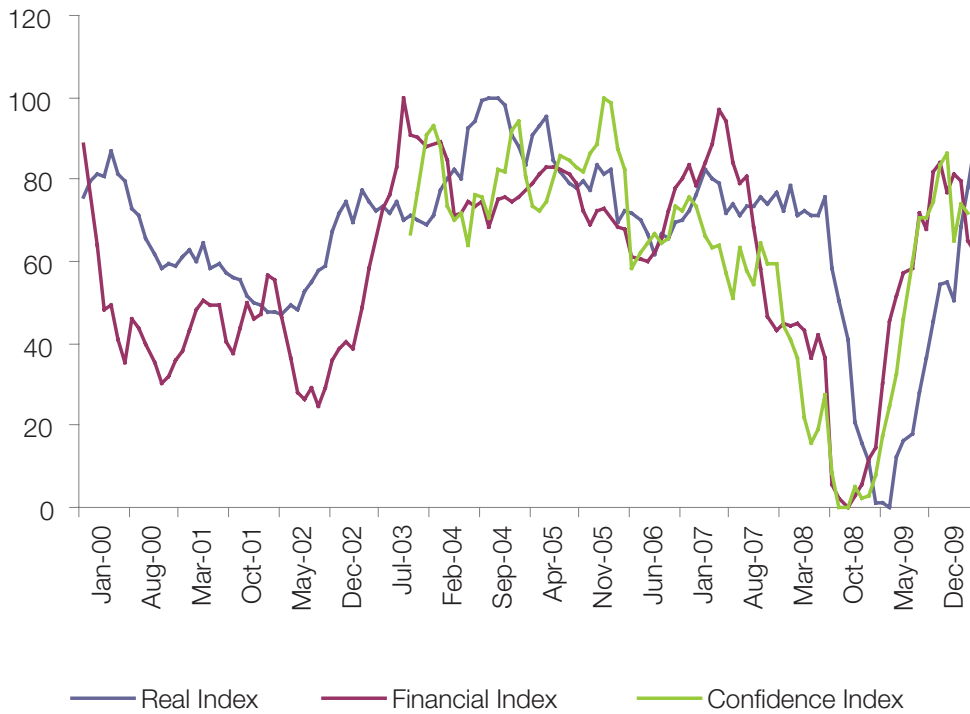


FIGURE 2.6 COLOMBIA: CONSISTENCY WITHOUT EXUBERANCE

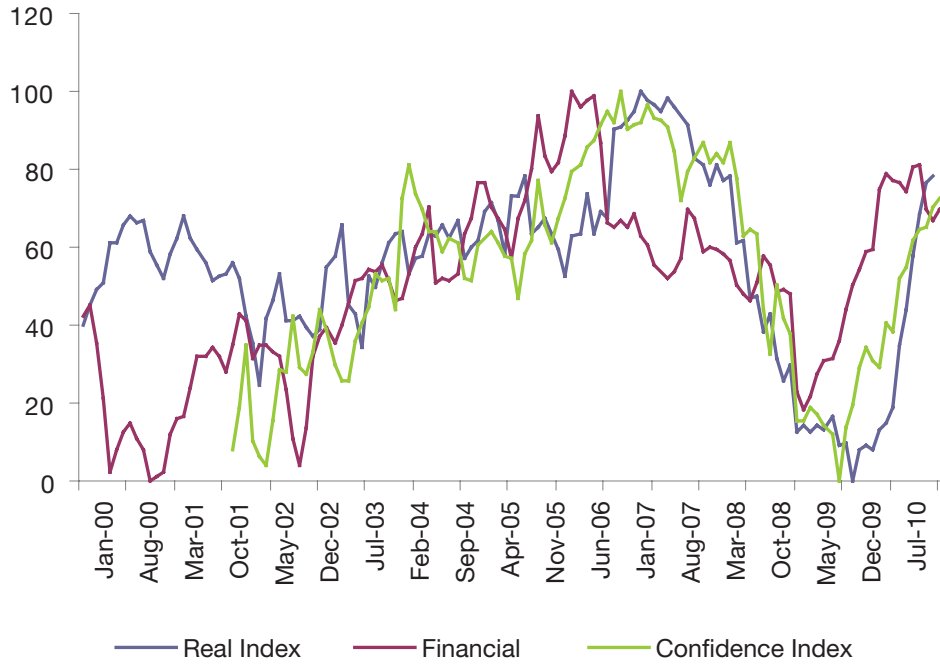
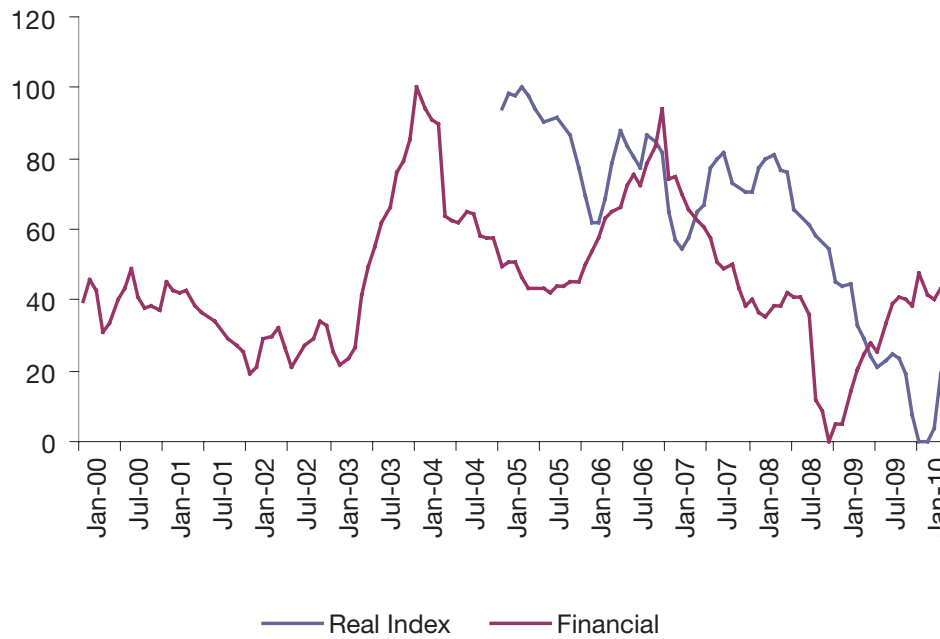


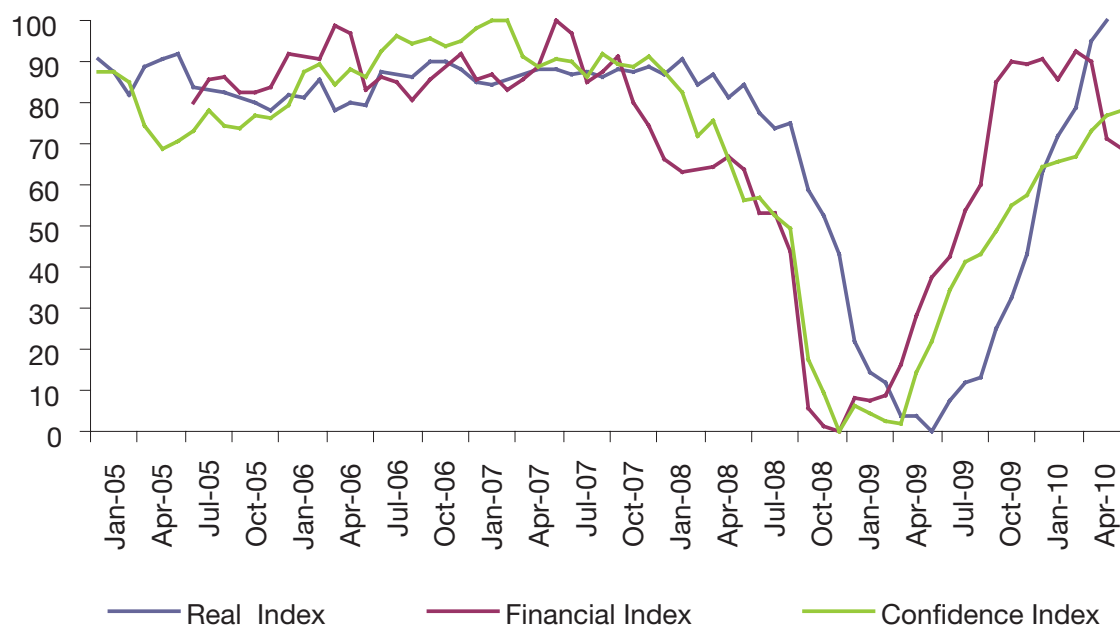
FIGURE 2.7 VENEZUELA'S NEW EQUILIBRIUM?



variables are at their lowest point in five years. The Global Recession accelerated the collapse but was not the cause of the decline. As is obvious from the figure, negative forces have build up throughout the years. Financial conditions have improved somewhat after reaching the lowest point in late 2008.

In general terms, the overall real index for the seven economies considered in this section is misaligned with respect to confidence and financial markets conditions. When one of the indexes is misaligned, it probably suggests future convergence. This is likely to occur with real activity, as it is unsustainably high relative to past performance and relative to the other two indexes.

FIGURE 2.8 ADDING UP: REAL CONVERGENCE EXPECTED



COUNTRY FOCUS

BRAZIL: CHALLENGING ACHIEVEMENTS

LULA'S LEGACY

Contrary to conventional wisdom, Brazil's present economic situation is probably brighter than its future. With an outstanding resilience to the global recession and an impressive economic recovery, Brazil is now one of the world's most dynamic markets. Millions of consumers are moving into the middle class, aided by cash transfers from the government and new access to credit. Despite this success, there are reasons for concern. Brazil's current economic strategy is too dependent on fast growth in China and the ability of the Brazilian state to redistribute resources to the poor. Public investment in key areas such as infrastructure is exceptionally low even for Latin American standards. Meanwhile, taxation is remarkably high at 34.4 percent of GDP in 2008, which is higher than in many developed coun-

tries such as Japan and the United States. This is causing competitiveness problems for many of Brazil's industries and sectors.

To sustain economic momentum, Brazil needs to close the gap in infrastructure, expand the already generous social policies and lower the tax burden. Achieving all this while at the same time preserving macroeconomic stability is not easy. Figuring out how to solve this puzzle will be the main challenge of Brazil's new administration.

Since the successful introduction of Plan Real in 1994, sound monetary and fiscal policies have been the policy imperative in Brazil. President Lula deserves credit for making the left part of this consensus by continuing the policies started by his predecessor, Fernando Henrique Cardoso. As a result, macroeconomic stability is the undisputed pillar of Brazil's development strategy.

However, Lula not only delivered declining public debt to GDP and a low inflation rate. He was also able to do this while adopting a second policy imperative: poverty alleviation. Providing economic opportunity to the poor with large-scale programs such as *bolsa familia*, noncontributory pensions and more access to credit became a pillar as important as macroeconomic stability. If it is true that Brazilian presidents have been electorally constrained by the “fiscal imperative” since 1994 with Plan Real, it is also true that from now on they will be constrained by the “social imperative.” This is no minor achievement in a society where macroeconomic mismanagement and inequality were for decades the most salient features. In the future, Brazilian presidents will be heavily scrutinized with the dual lens of poverty reduction and inflation control.

As Brazil approaches a presidential transition, many wonder about the ability of Lula’s successor to preserve the same type of economic policies seen during the last 16 years. A number of analysts anticipate mounting pressures for the new government to adopt a more populist stance, lower interest rates at the cost of higher inflation or a lower tax burden at the cost of a higher fiscal deficit. There have already been some puzzling setbacks in areas such as the government-owned banks, including BNDES and Banco do Brasil, where decisions are being made with some disregard for their future fiscal implications and questionable levels of transparency.

SOCIAL PROGRESS

Brazil’s economic strategy is paying a high dividend in social terms. Driven by the significant increase in the incomes of the poorest groups, income inequality has reached its lowest level in 30 years. In fact, between 2000 and 2007, the income of the poorest 10 percent of the population grew 7 percent a year, nearly three times the national average rate of 2.5 percent. As the poor in Brazil have enjoyed Chinese-style economic growth, extreme poverty was halved 10 years ahead of the 2015 Millennium Development Goals. Recent data show a sharp reduction in the Gini coefficient, which is remarkable not only because it had been so persistently high in the past, but also because it shows that much more can be done in the future with the adequate mix of social policies and market reforms.¹⁴

The Brazilian middle class, families earning between R1,100 and R4,800 per month, represented 42 percent of the population in 2003. Today that share is 52 percent and is expected to reach 55 percent in 2014. This means that nearly 2 million people enter the middle class each year, expanding not only the size of the domestic market but also the degree of political participation. However, a very important question is whether further progress in the reduction of poverty can be made or whether setbacks are likely to occur. Optimists argue that as the number of poor falls, the resources necessary to alleviate poverty also decline, making poverty alleviation and extreme poverty eradication a more viable goal. But it is

also possible to argue that to continue to reduce poverty beyond the current level the government will need to spend an even greater amount of resources in income transfers and other programs. If this is the case, additional social progress will impose increasing fiscal costs. The answer to these questions hinges on the ultimate causes of the recent reduction in inequality and poverty.

The decline in inequality and poverty in Brazil is the result of changes in labor and non-labor income, which respectively represent 75 and 25 percent of total household income. According to a recent paper by Ricardo Barros et al., half of the decline in inequality over the period of 2001-2007 is the result of changes in the distribution of non-labor income.¹⁵ Much of this income is of the result of transfers from the public sector, especially in the form of pensions, which explain 30 percent of the overall reduction in inequality. Other programs, such as *bolsa familia* and the *beneficio de pestacao continuada*, are much smaller in size. They only contribute 0.5 percent of the total household income but are equally important in their impact. The main reason is that they are better targeted when compared to other social interventions. They alone account for one-fifth of the reduction in the Gini coefficient, which is remarkable given their much smaller size relative to standard social security benefits.

However, not all the reduction in inequality is explained by public transfers. Changes in labor income have played an equally important role.

The inequality of the distribution of labor income per adult in Brazil has fallen considerably as a result of the accelerated expansion of access to education during the 1990s. There is a quantity effect, meaning for example more education means more income. And there is also a price effect, meaning for example more education compresses wage differentials between the highly educated and the poorly educated. In other words, lower inequality in education has led to lower inequality in labor income, while at the same time wage differentials have fallen as a result of higher educational attainment. Although both forces seem to be taking place, the latter is the dominant factor in explaining the reduction in labor income inequality in Brazil. This is quite significant as it shows that structural reforms in the education sector are finally paying off. The main message is that it is essential to keep momentum by increasing the quality of the educational system while at the same time reducing the gaps in enrollment between income quintiles, especially in secondary and tertiary education.

But the fact that half of the reduction in inequality comes from public transfers is a source of concern. This means that progress in this area will either slow down or will require additional fiscal resources, which are currently not available, to keep its recent pace. The government's strategy of increasing public transfers is based on the assumption that these interventions will pay back in form of faster economic growth and higher tax revenues. However, this is an expectation.

What is safe to assume is that Brazil's next administration will have a major challenge in order to show additional improvements in this area. The low hanging fruit of giving subsidies to very poor individuals, whether through conditional cash transfers or noncontributory pensions, has already been collected. Expansion in these programs will be more expensive and less effective in reducing poverty and inequality.

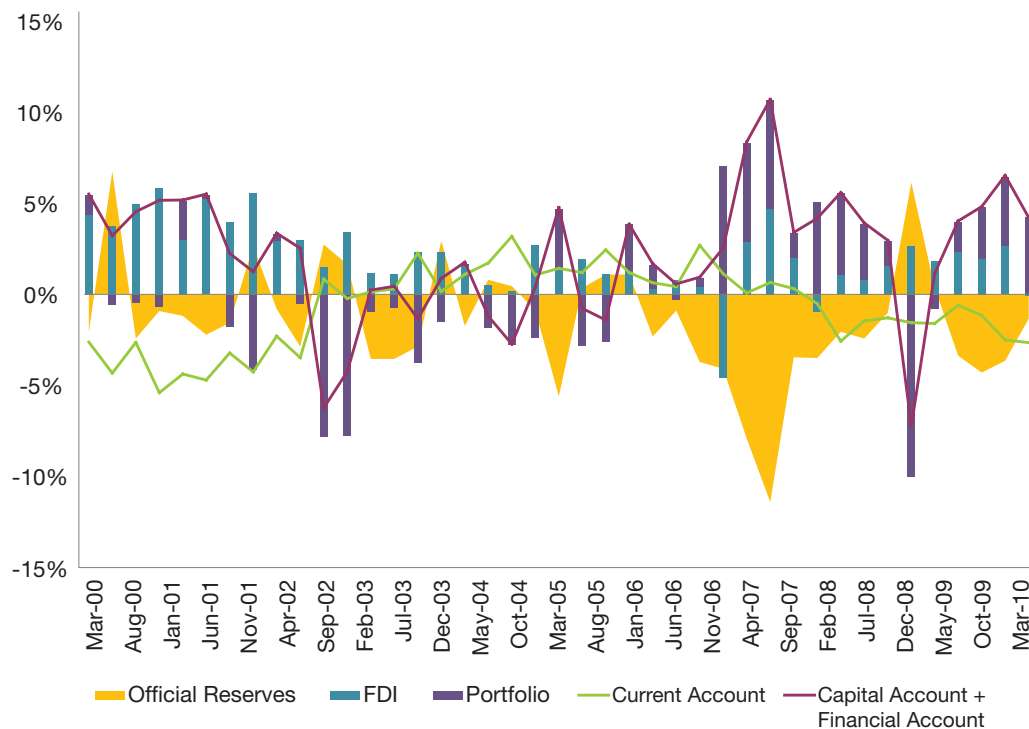
RISKS TO MACROECONOMIC STABILITY

During the year ending in July 2010, portfolio and foreign direct investment flows to Brazil reached \$100 billion—the highest level in the country's history and twice as large as Brazil's current account

deficit. Portfolio investments in equity alone were close to \$50 billion. The questions of the day are related to the way in which Brazil should handle this boom in order to prevent economic overheating and the risk of macroeconomic instability.

According to figure 3.1, the recent data shows that portfolio flows have become the dominant force in the capital account, while FDI has receded. The composition of capital flows can have major implications for policy. So far the central bank has responded by intervening heavily in the foreign exchange market. Foreign reserves rose to \$250 billion in July 2010 from \$200 billion the previous year. The sterilized interventions succeeded in

FIGURE 3.1 BRAZIL: CAPITAL ACCOUNT DECOMPOSITION (% GDP)



Notes: Negative change in reserves implies accumulation of official reserves.
 Source: Own construction based on the IMF's International Financial Statistics (IFS)

preventing a further appreciation of the currency, at least relative to the dollar. However, fiscal costs were particularly large given the negligible return on international reserves and the high interest rates paid on government bonds used for sterilization purposes. Given the recent increase in the intervention rate by the central bank, it is quite likely that short-term capital flows will continue to increase in the next quarters.

Looking ahead, the government may need to impose additional capital controls to discourage short term inflows. But this is unlikely to be enough. A reduction in the fiscal deficit may be necessary in order to lift some inflationary pressure. This would allow the central bank to reduce interest rates, or at least to prevent further money tightening. Additional increases in the policy rate will only result in greater inflows of fixed income portfolio investment and higher costs of sterilized interventions in the foreign exchange market.

Brazil is at a serious risk of overheating. Dilma Rouseff, frontrunner in the October presidential elections, has said that she will not undertake a fiscal adjustment if elected, mainly because Brazil does not need one. She believes that the Brazilian net public debt is on the right track after falling from 60 percent of GDP at the beginning of the Lula administration in 2002 to 41 percent in 2010. Her goal is to continue that trend, but mostly as a result of economic growth and a better tax administration. She has even hinted at the possibility of lowering certain taxes, which many consider to be too high in Brazil. This is not credible, even

if Rouseff prefers fiscal expansion and monetary tightening. The recent balance of payments data suggest that Brazil may need to change its policy of high interest rates in order to avoid large short-term capital inflows. This would only be possible if fiscal policy takes the front seat in curbing aggregate demand.

INFRASTRUCTURE AND PRODUCTIVITY

Brazil's problem is not just the size of the fiscal deficit or the level of public debt. A crucial issue is the composition of public expenditures, with a strong bias in favor of current outlays and very little emphasis on public investment. It is somewhat paradoxical that Brazil has the highest tax burden in Latin America but also one of the lowest public investment rates. Many now consider this as the major constraint on long-term growth and the source of inflationary pressures when aggregate demand grows above 5 percent. Poor infrastructure has been frequently mentioned as a factor that will limit the ability of Brazil to sustain Chinese-style economic growth in the immediate future.

Pereira has argued that the systematic lack of investment in infrastructure is part of Brazil's political equilibrium.¹⁶ Brazilian presidents, although constitutionally and politically very strong, have limited room to maneuver. A low fiscal deficit is a policy imperative to some extent imposed by the domestic political preferences and the international financial markets. But there are other factors as well. On the one hand, the executive has to comply with a myriad of constitutionally mandated expenditures. On the other, to assure

a working coalition in Congress, a share of the budget goes to projects promoted by legislators. This leaves the executive with only two instruments to achieve fiscal discipline, taxes and public investment. The strategy of raising taxes and compressing public investment has worked in the past, but it is not sustainable. The main challenge for Brazil's next president is how to deliver macroeconomic stability while at the same time rationalizing taxes and reducing the gap in infrastructure.

In order to achieve that goal Brazil's new administration has to reduce expenditures in other areas, such as social security and pensions. Practically one-third of the federal budget is devoted to these areas. Pensions in Brazil since the 1988 constitution have been notably generous, especially in the civil service. With about 11.7 percent of GDP, Brazil has one of the highest social security expenditures in the world, especially considering that the Brazilian population is much younger than that of most countries with similar levels of expenditure.

But there is no silver bullet to reduce expenditures to accommodate lower taxes and higher investment in infrastructure. Inevitably, the reduction in expenditures will imply tough choices. In the past few years, Brazil has opted for a strategy where social expenditures and the reduction of poverty have been the priority. This has brought an enormous political and economic dividend. On the political side, the wide support for Lula and Rousseff speaks for itself. On the economic front, the expansion of the middle class has meant

a larger domestic market with very profitable opportunities for the business community. But the strategy can lose steam if economic growth decelerates as a result of limited investments in complementary inputs, such as infrastructure.

Fortunately, Brazil has not reached a point where there is a clear tradeoff between investing in infrastructure or funding social programs to reduce poverty and inequality. First, there are a number of infrastructure projects which could have a large social dividend. Second and most importantly, there is room to reduce government programs that do not contribute to either goal. Cutting expenditures in this category would free resources to increase public investment without generating additional fiscal pressures.

THE ARGENTINE MIRACLE

Few countries have been written off more often than Argentina. A deeper examination of Argentina's recent economic history reveals an unusual share of unexpected swings and eclectic policies that may have induced a negative bias from baffled orthodox analysts.

The latest of these episodes has been a surprisingly long and resilient growth streak in the aftermath of its deep 2001-2002 financial crisis. From 2003-2010, Argentina's real GDP is expected to have grown on average 7.4 percent annually. As a commodity exporter, Argentina was certainly not immune to the 2008-2009 global meltdown, but it weathered the crisis relatively well with growth

rates dropping by around 5.9 percent in 2009 based on official numbers. This compares rather well with an average growth of 4.28 percent, and

a decline of 6.3 percent for the other LAC-7 countries (Figure 3.2a).

FIGURE 3.2A ARGENTINA AND LAC-7 NEIGHBORS: GDP GROWTH

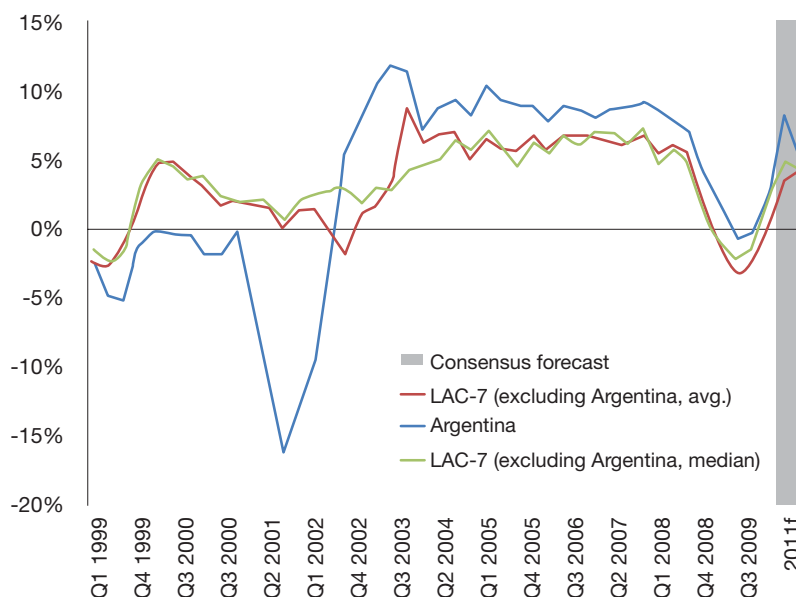
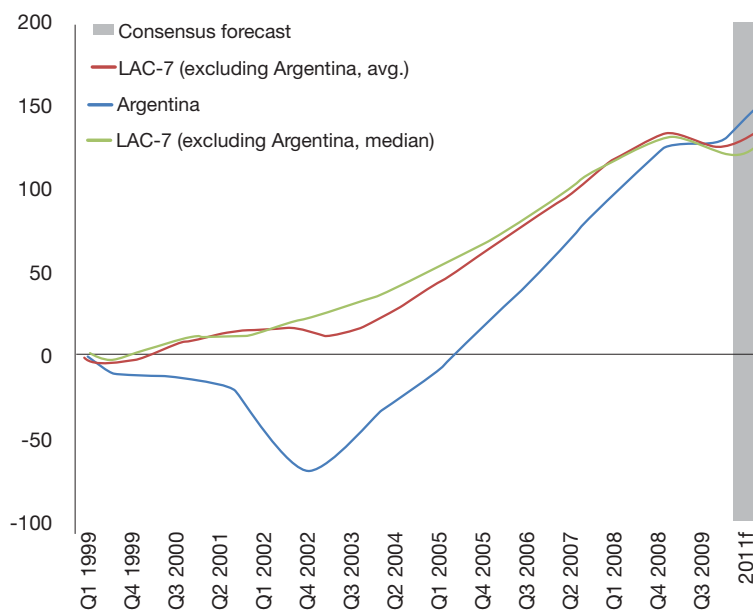


FIGURE 3.2B ARGENTINA AND LAC-7 NEIGHBORS: GDP PATH



Source (both figures): IMF's World Economic Outlook database April, 2010.

This performance may have been helped by underestimated official price levels and other manipulations that pumped up real figures. Private estimates place the cumulative GDP over-reporting since 2007—the beginning of the statistical manipulation—through 2010 at around 7 percent. But even correcting for that, the scenario contrasts with the predictions of a downturn that Argentine skeptics have been elaborating on since the beginning of the up-cycle. On the contrary, by end 2009, Argentina closed the considerable gap relative to its LAC-7 neighbors that opened during the 1999-2002 recession (Figure 3.2b).

Where is the catch? Can we speak of an Argentine miracle? Yes, if we define the miracle as the ability to systematically avoid foretold disaster. But as usual, the truth is more nuanced than what transpires in catchy slogans or concise editorials. To fully understand the Argentine saga, one needs to maintain an open mind and keep track not only of ongoing performance but also of the important one-off policy margins that were built up in the aftermath of the 2002 crisis and have been narrowing ever since.

GLOBAL TAILWINDS AND LIGHT CARGO: THE RECIPE FOR A SWIFT RECOVERY

We can identify two global tailwinds that supported Argentina's growth in the post-crisis years. First, there was strong global demand and particularly demand for commodities fueled by the Great Moderation and Chinese growth, which—together with solid and stable growth in Brazil—translated into continuous improvement in terms of trade and trade balances. Second, a

relative price effect as a result of the broad depreciation of the dollar, compounded by the appreciation of the emergent currencies vis-à-vis all reserve currencies, allowed Argentina to preserve an undervalued currency despite rising inflation.

But far more important and less visible in triggering the post-crisis reaction and compensating for inconsistent policies and political uncertainty are a few critical policy margins that were built as a result of the crisis, but allowed the country to grow above potential well after the output gap was closed without generating explosive dynamics.¹⁷

The first margin came from a classic change in relative prices. The 1999-2001 economic contraction, which had GDP declining by more than 20 percent in real terms before rebounding in the second quarter of 2002 together with 10 years of low inflation under a currency board, provided the perfect cushion for a devaluation that overshot to 300 percent by mid-2002 to stabilize at 200 percent in 2003. This limited the pass through to domestic prices and blessed the country with a heavily undervalued exchange rate. The implications of this margin were several: appreciation expectations that depressed local currency rates and deterred capital flight; an overflow of dollars used to cancel external debt and accumulate reserves; and a nominal anchor to an economy overheated by expansionary fiscal and monetary policies.

The second policy margin was engineered through debt restructuring by “pesification” of financial contracts under local law and default

on the non-pesifiable external ones under international law. Pesification and default on hard currency debt was the necessary condition for a successful devaluation without adverse balance sheet effects, which cleansed corporate and public balance sheets.

At the end of the day, this combination of currency undervaluation and low labor costs, along with sizeable commodity export taxes and debt restructuring, largely explains the generous twin fiscal and external surpluses and the record corporate profitability that financed the credit-less recovery behind the Argentine miracle. It also accounts for the pro-cyclical expansionary fiscal and monetary policy stance that fueled domestic demand and economic activity in recent years—at the cost of consuming the policy space gained in the hard days of the 2002 crisis.

PROGNOSIS: WHAT'S LEFT FROM THOSE GOOD OLD DAYS?

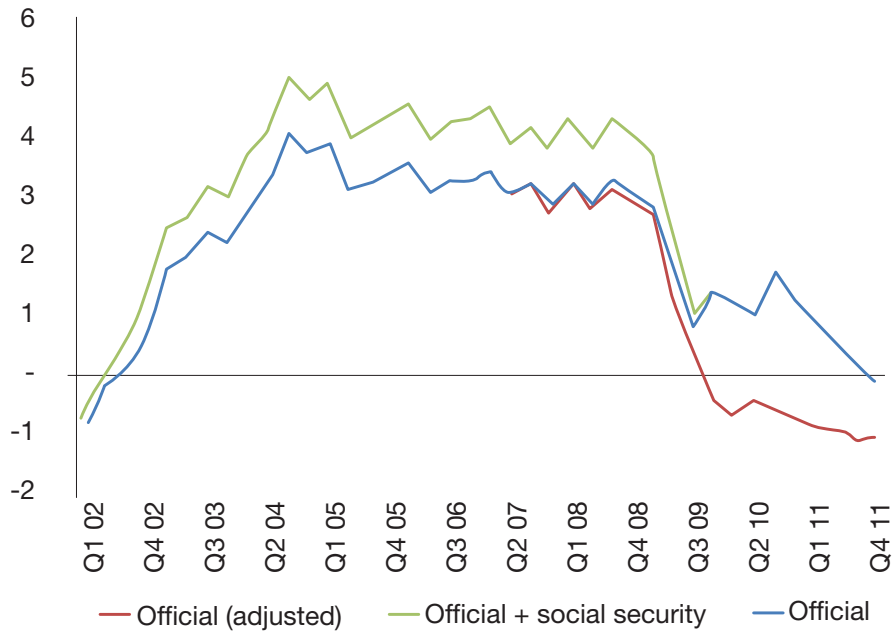
While we do not envisage important headwinds for commodity producing and fiscally solvent LAC economies, the tailwinds that propped their stellar performance in the 2000s have plateaued for the near future. In addition, emerging currencies, particularly those in Latin America, no longer appear undervalued so regional appreciation is unlikely to offset inflation differentials.

Moreover, most domestic amplifiers, particularly those critical one-off margins created through emergency measures in the rush of the currency collapse, have been largely used.

The fiscal surplus is already gone. Importantly, it is not its level that should set off the alarm. After all, even excluding the extraordinary quasi fiscal gains transferred this year and probably next year by the Central Bank, as well as other additions to fiscal revenues,¹⁸ the deficit is still within very manageable levels provided the country regains access to external finance. Also, while the nationalization of the pension system added to the income flow of social security contributions previously invested in private pension funds, this too is not unusual. Only a few developing countries moved all the way to a private system and, rightly or wrongly, the contingent liability of social security seldom enters the debt sustainability equation. However, the speed of the deterioration is a concern. Correcting for the new additions to the fiscal pockets—contributions, central bank transfers—to make the fiscal figures comparable over time, reveals a sobering picture. Argentina's primary surplus declined by about 5 percent of GDP in just three years (Figure 3.3).

The second twin did not fare better. With an income elasticity of imports exacerbated by political and exchange rate uncertainty that pushes producers to meet the demand peaks via imports and labor hours rather than investment and hiring, and despite the recovery of agricultural supply after a particularly damaging drought in 2009, analysts and the government anticipate a gradual narrowing of the trade surplus. Indeed should Argentina's economic overdrive continue, 2011 may witness its first current account deficit in 10 years (Figure 3.4).

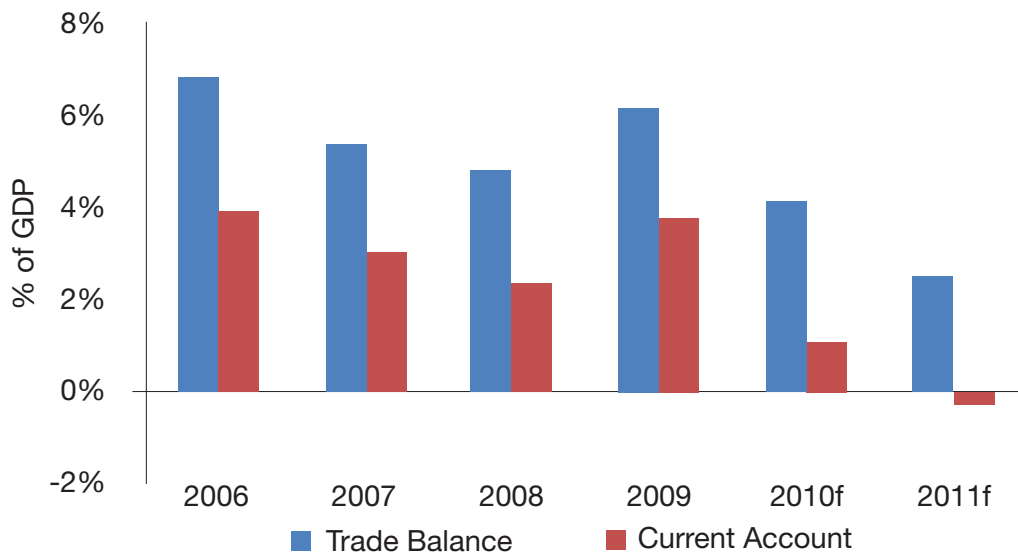
FIGURE 3.3 THE SWIFT FALL OF THE PRIMARY FISCAL SURPLUS (% GDP)



Note: Adjusted primary surplus excludes from the official figures the central bank’s quasi fiscal surplus, FGS profits and SDR issuance. Consolidated adds to the official figures the contributions to the social security system allocated to private pension funds prior to the 2008 renationalization.

Source: Ministry of Economics, Central Bank of Argentina and INDEC.

FIGURE 3.4 THE SLOW AGONY OF THE OTHER TWIN SURPLUS



Source: Own calculations based on Argentina’s Ministry of Economics.

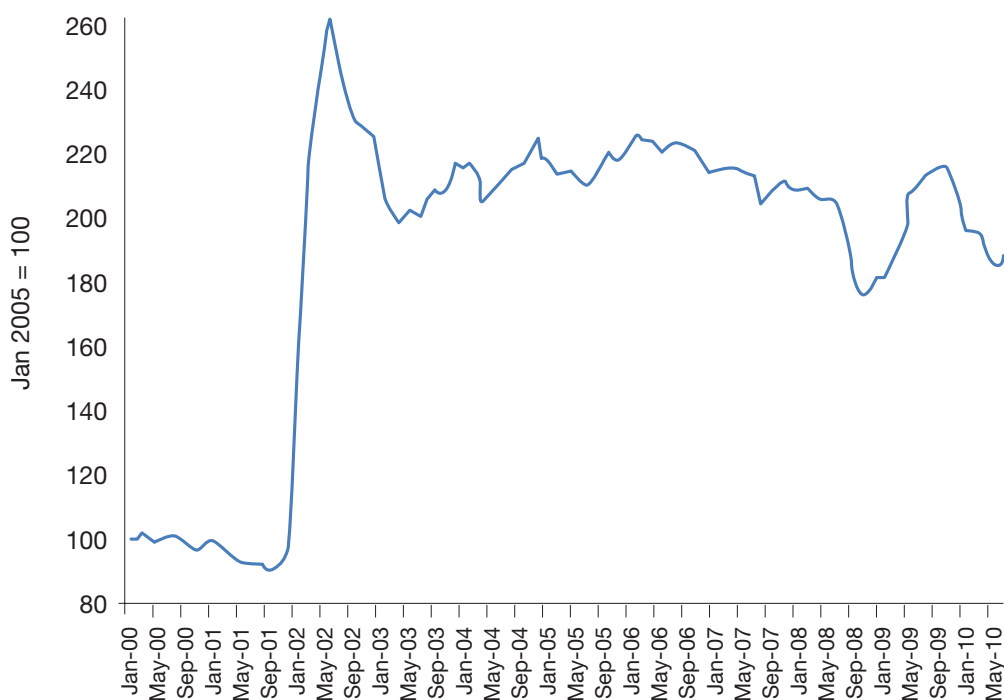
Excess demand and insufficient supply due to inadequate investment and productivity gains are not the only reasons behind the smaller current account surplus. The combination of rising inflation and a stable exchange rate seen by the government both as a competitiveness factor and as the remaining nominal anchor have accelerated multilateral real appreciation in recent months. Also, as noted, the global currency movements that in the past offset Argentina's bilateral real appreciation with the U.S. dollar due to a tightly managed exchange rate and a growing inflation are no longer there.

As with other issues like inflation and energy supply, Argentina is now ultimately facing the

short end of an inter-temporal tradeoff. Through reserve purchases, the Argentinean government was able to push back the real appreciation pressures that Brazil or Chile experienced through a nominally stronger currency, only to face them at a faster pace in 2007 at the hands of accelerating inflation fueled by the expansionary monetary policy associated with unsterilized foreign exchange intervention (Figure 3.5). The end of the emerging appreciation cycle due to the crisis only made this tradeoff more apparent.

This trend is here to stay. With expected inflation at around 25 percent for the 2010-2011 period, with a depreciation rate currently in the mid-single digits and without the cushion of appreciating

FIGURE 3.5 MULTILATERAL REAL EXCHANGE RATE: NO LONGER RANGE BOUND



Note: Trade-weighted multilateral exchange rate vis a vis the US dollar, yen, real, euro, and the Mexican and Chilean pesos. Source: CIPPEC, based on official sources.

trade partners, the real appreciation rate may exceed 15 percent per year. At any rate, by the time the next administration takes office in 2012, the scope to use an exchange rate anchor to fight inertial inflation will have been mostly consumed.

IS EVERYTHING LOST? BORROW MONEY TO BORROW TIME

How bad is a small twin deficit in the post-crisis landscape of fiscal stimuli and over-indebtedness? Now that Argentina's fiscal creativity seems exhausted, are we at the doors of a new downward cycle? The short answer is no. History does not repeat itself, and Argentina is not the same country as it was in the late 1990s. However, again the diagnosis has its nuances.

The first thing to note is that not all the policy margins are off. Deliberate or not, the balance sheet margin remains intact. Given that the country was largely excluded from international capital markets and an IMF program was political anathema, and helped by the rapid accumulation of reserves as a result of the government's leaning-against-the-wind exchange rate policy, Argentina has gone through a fast deleveraging and de-dollarization phase that outdid a similar trend common to emerging economies as a whole. The early fiscal surpluses were used to pre-pay the IMF and to cancel foreign currency debt as it matured.

In addition, manipulation of CPI data reduce the debt service on inflation linkers—in a move that creditors, but not rating agencies, have seen as an implicit default. Moreover, nominal debt have

benefitted both from inflation dilution, and from appreciation expectations that have depressed local currency rates. Last but not least, the nationalization of pension funds brought back to the Treasury a sizeable amount of long term debt previously placed with private funds—thereby undoing the debt inflation associated with the transition from a pay-as-you-go to a capitalization social security system.

Put all that together with a good spell of GDP growth and reflation, and the result is a remarkably low debt-to-GDP ratio that is close to 20 percent by end-2010 once cross-holding within the public sector are netted out.

In this context, even though fiscal adjustment cannot be done overnight, the twin deficits could easily be met by borrowing abroad and by FDI flows that have been exceptionally low compared to those of Argentina's neighbors. The to-do list to that effect is well known and was already proposed by the current economic team during its road show at the time of last year's IMF/World Bank Annual Meetings: (a) an IMF Article IV consultation mission, (b) restructuring of Paris Club arrears, (c) reform of the statistic bureau, and (d) debt exchange. Of these, only the latter was effectively done, which explains why the country still faces one of the largest borrowing costs in the region.

THE INFLATION-SPENDING RACE

The Kirchner's piecemeal approach to social spending and social protection has been as impor-

tant in building its popular support as its pro-cyclical, high inflation-fast growth strategy. Come the 2011 election, growth and income policies will likely play an increasingly dominating role.

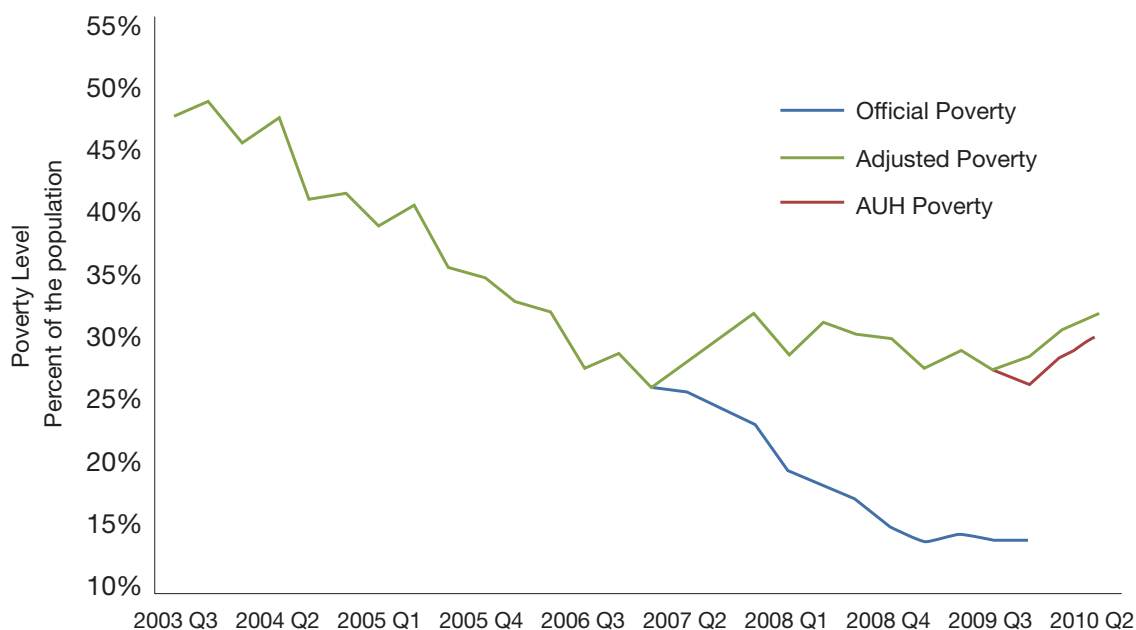
The benign effect from stable growth certainly helped. But whereas Lula had his *bolsa familia* and pension reform (see Brazil chapter) to address the long-standing distribution problem and defuse political resistance to more conventional macro policies, Kirchner had his own peculiar way.

During the first Kirchner administration, two ingredients combined to foster a significant improvement in social indicators. The first was the

low-wage, fast-growth model that reduced the unemployment rate from its crisis peak of 24 percent to high single digits and a successful policy to reduce labor informality. The second was discretionary increases in the minimum real wage and the minimum social security pensions.

This virtuous path faded by 2007 because the low-hanging fruit of post-crisis unemployment and low wages ran out and because of the acceleration of inflation; the same issues that triggered the intervention of the statistics bureau (INDEC). By using household surveys to simulate the inflation impact on the consumption basket used to compute the poverty line, it is easy to explain

FIGURE 3.6 THE REMEDY: SOCIAL SPENDING (AND INFLATION MAKE UP)



Source: Own construction based on INDEC

why poverty levels—estimated using a proxy for genuine CPI inflation based on manipulation-free reports by provincial offices of INDEC)¹⁹—started to falter in 2007 (Figure 3.6).

Enter the universal child allowance or AUH and a one-off pension moratorium, which allowed elderly citizens without a contribution record to receive the minimum pension at a small discount over the first few years, increasing the pension coverage levels to nearly 90 percent. Both policies were designed to offset the regressive impact of inflation.

Despite the parallels with Brazil, it is hard to analyze Argentina's social spending in isolation, as we did with Brazil. In Argentina, social transfers and the pension system are ultimately funded by the same inflation tax that they intend to make up for—especially now that the fiscal surplus is gone. In this sense, they could be seen as both consequence and cause of high inflation since inflation will likely trigger an adjustment in the AUH and pensions, which in turn through higher spending would require an additional inflation tax, thereby threatening to deepen the inertial causes of inflation. At any rate, rather than the means for long-standing improvement in income distribution, the inflation-social spending mix appears as a politically profitable patch.

ELECTION YEAR: A GARDEN OF DIFFERENT PATHS

What to expect from the election year? In principle, more of the same as the government

switches to full inflationary financing mode. The budget recently sent to Congress for discussion is compatible with double digit inflation and limited exchange rate correction. It already factors in an important transfer from the central bank's quasi fiscal results plus an additional \$7.5 billion transfer out of the reserve stock. Given that no increase in payrolls and the AUH bill is included, the spending projection is probably underestimated.

What to expect after the election? While it is still too early to judge the result, one thing that is becoming increasingly clear as we move on is the binomial nature of the post-election scenario.

A new government may borrow its way to fiscal and nominal stabilization. Consensus over the external and macro agenda and the need to control inflation is quite homogeneous within the strongest opposition candidates, although willingness to impose unpopular policies during the early honeymoon period after years of expansionism remains to be tested. Passing this non-trivial immediate test, the economic upside that the Kirchner administration failed to capture (for example, in the form of lower financing costs, and foreign and local investment) should add considerable support to the country's aim toward solid and equitable growth.

By contrast, we would expect a new Kirchner administration—a possibility that many analysts prematurely ruled out—to keep running in the

same direction, convinced of the infallibility of its no-holds-barred strategy. However, the administration will find out that the one-off margins which once allowed it to twist and shout with not-irreparable damage are all but exhausted. If the Kirchner administration remains reluctant to adapt to these new restrictions, the sequel may provide a smooth transition to a disappointing third period.

At any rate, even for a country used to athletic swings like Argentina, and despite one of the best economic streaks of its recent history, 2012 offers a remarkably disperse distribution of outcomes.

CHILE AND PERU: SIMILAR BUT NOT QUITE THE SAME

Section prepared by Luis Carranza

Chile and Peru are two examples of sound economic management, based on solid monetary and fiscal institutions. Good policies provided resilience during the crisis and a speedy recovery afterwards. However, these two countries are distinct in many ways, whether based on their past economic performances, economic specialization or initial conditions. While Peru's faster growth reflects lower initial per capita income and convergence, these two economies are exposed to similar shocks and handle them in ways that have become paradigmatic.

FUNDAMENTALS

Both economies have inflation targeting regimes. In Chile, the goal is to maintain annual inflation at

3 percent with a tolerance range of +/- 1 percent. After the hyperinflation during the 1980s, Peru adopted a money-based anchor regime which helped the economy achieve single digit inflation in 1997. In 2002, Peru's central bank transitioned to an inflation-targeting regime. The main difference is that Peru still is a financially dollarized economy, explaining why its inflation targeting is combined with a strong preference for exchange rate stability. Peru's target was set at 2.5 percent with a tolerance range of +/- 1 percent and since 2007 it was lowered to 2 percent (+/- 1 percent).

Peru and Chile are the two countries with the most robust fiscal results in the LAC region. Both countries ran surpluses during the years previous to the crisis (Figure 3.7). Low debt-to-GDP ratios allowed them to adopt large fiscal stimulus without raising sustainability concerns. However, Chile is in a better fiscal position; public debt fell from 13.4 percent in 2000 to 6.2 percent in 2009, while Peru's fell from 45.3 percent to 26.6 percent in the same period.

The solid fiscal position in Chile is a result of a political consensus still lacking in other countries in Latin America. In Peru, there is strong support for prudent fiscal management. However, in election years, it becomes clear that there are pressures for looser fiscal policies. Although fiscal rules and responsible frameworks are embodied in laws, they can change easily. There is no guarantee in the laws of either country. The guarantee resides in the political equilibrium that supports the law,

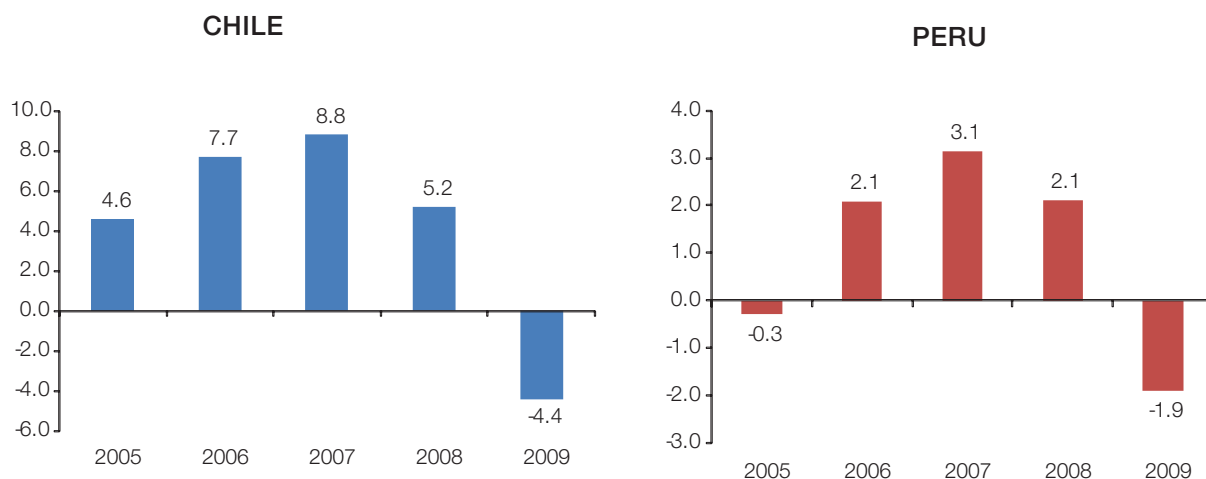
and in this regard Peru is more vulnerable than Chile.

In 2001, the Chilean budget law introduced a fiscal rule with the objective of maintaining a structural surplus of 1 percent of GDP, which was later reduced to 0.5 percent. In 2006, the fiscal responsibility law consolidated the fiscal rule and established how resources from the fiscal surplus should be allocated to the recapitalization of the Central Bank (0.5 percent of GDP). In addition, a minimum 0.2 percent of GDP and a maximum 0.5 percent of GDP should go to the Pension Reserve Fund, to complement financing of future contingencies in pensions. The rest of the fiscal surplus

goes to the Social and Economic Stabilization Fund to finance eventual fiscal deficits.

The Peruvian fiscal rule states that the nonfinancial public sector budget should be on balance in the medium term and there is an annual limit to the fiscal deficit of 1 percent of GDP. In addition, expenditures in salaries, goods and services, and pensions should not grow more than 4 percent in real terms per year, which is a rate below the potential GDP growth. Initially, the cap was on all types of expenditures, including public investment, which caused a bias against public investment favoring current expenditure.

FIGURE 3.7 FISCAL BALANCE (% GDP)



Note: Chile's fiscal balance is from the Central government and Peru's is from the nonfinancial public sector.
Source: Own construction based on Central Banks from Chile and Peru.

Fiscal rules are not written in stone. In Peru, during the last crisis, the ceilings were changed, allowing a 2 percent fiscal deficit and increasing the expenditure and debt limits for the 2009-2010 period for all levels of government. Peru's fiscal rule does not target a surplus as Chile's does. This explains why Chile's rule results in a faster reduction of public debt.

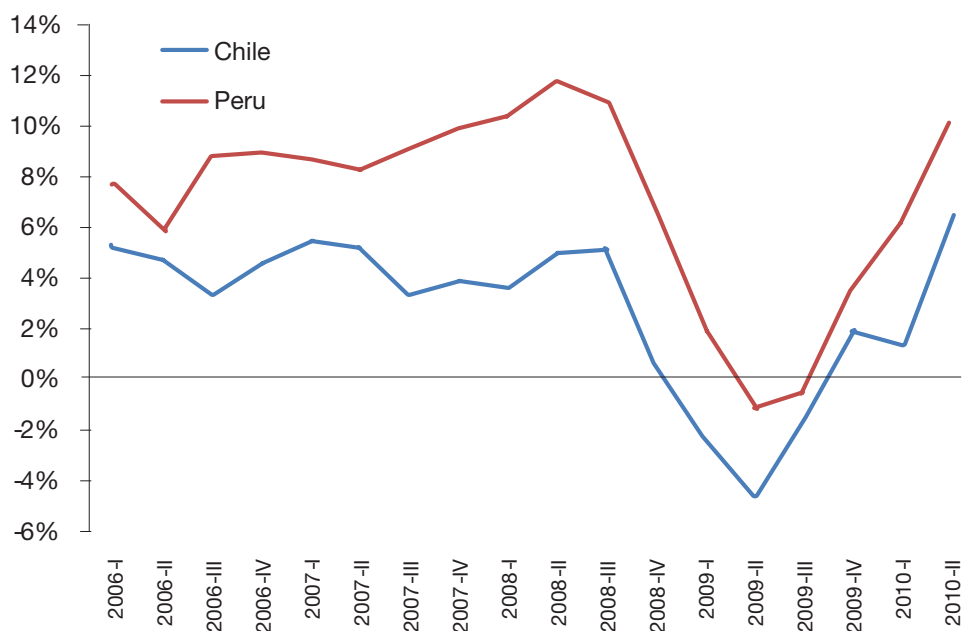
UNPRECEDENTED RESPONSES

In Chile, the first signs of crisis started to show during the fourth quarter of 2008 (Figure 3.8). Inventories fell dramatically that quarter and have continued to fall since then. Investment contracted significantly, falling from a 9.8 percent growth rate in the last quarter 2008 to 19.4%

decline in the second quarter of 2009. Meanwhile, private consumption has also slowed since the end of 2008 and even contracted during the first two quarters of 2009. In Peru, signs of the crisis appeared one quarter later than Chile. Private consumption began slowing down in the first quarter of 2009, but Peru did not experience negative growth rates. Investment began showing negative growth rates at the beginning of 2009, reaching its lowest point during the second quarter with a negative rate of 24.8 percent.

During the steep fall in economic activity, both countries increased public expenditure and lowered interest rates. On the monetary side, central banks from both countries used interest rates

FIGURE 3.8 GDP QUARTERLY (ANNUAL % GROWTH)



Source: Own construction based on Central Banks from Chile and Peru.

to stimulate the economy. Chile's central bank started lowering the monetary policy interest rate on January 2009. From 8.25 percent in December 2008, it reached 3.27 percent in March 2009 and went all the way down to 0.5 percent in August that same year. Peru's central bank started to gradually decrease its reference interest rate in February 2009. From 6.5 percent in January 2009, it reached 1.25 percent in August 2009.

Both countries announced their large fiscal stimulus plans in January 2009. Chile used a combination of investment in infrastructure, current expenditure and tax reduction, equivalent to 2.8 percent of GDP. Meanwhile, Peru concentrated its efforts in economic and social infrastructure, and some measures for social protection and private investment promotion, but no tax reduction was considered. The package's size was equivalent to 3.9 percent of GDP.

While investment in infrastructure represented less than 20 percent of the Chilean plan, Peru's share of investment in infrastructure was over 60 percent. In order to promote private investment in addition to a tax credit, Chile provided additional financing to small and medium enterprises (SMEs) since private banking credit was suffering a pro-cyclical fall. The Chilean plan also included the \$1 billion capitalization of Codelco to enhance its investment plan. Peru expanded its partial financial guarantee programs for SMEs, mainly for those which were export-oriented, while \$100 million was used

to capitalize COFIDE, a financial development corporation.

To support income and employment, the anticipated Chilean 2010 income tax returns resulted in the creation of a direct subsidy to employers per low-income worker between 18 and 24 years employed, as well as the adoption of direct transfers to families (\$62 per family). In Peru, more resources were injected into an already existing training and employment programs, irrigation maintenance, and education and health infrastructure, mostly in rural areas.

The countercyclical response was crucial for economic recovery. Signs of improvement started with private consumption accelerating its pace during the last quarter of 2009, followed by investment, which in 2010 presented positive growth rates during the first two quarters. As a result, the Chilean economy is expected to grow between 5 percent and 5.5 percent in 2010, and the Peruvian economy is expected to grow by 8 percent.

ROAD AHEAD

Chile's long-term GDP growth is 4 percent, which is not satisfactory. Consequently, fiscal policy is giving more weight to reducing technology, innovation and knowledge gaps by promoting and financing research and development activities. A number of government agencies are supporting projects carried out by universities, technological research centers, and private enterprises and oriented toward improving competitiveness.

CORFO, the public agency in charge of promoting entrepreneurship and innovation, administers several funds to finance R&D and technological innovation in enterprises and has several specific instruments to support firms during the different stages of the innovative process.

Peru has a long-term growth rate of 6-7 percent, but in the medium term faces bottlenecks, mainly from a significant infrastructure gap. As discussed, the fiscal rule was part of the problem. After the rule was changed, public investment rose from 2.8 percent of GDP in 2006 to 5.3 percent of GDP in 2009; it is estimated to reach 6.5 percent of GDP in 2010. There is more flexibility regarding the composition of expenditures in Peru than in Brazil and Colombia. This is a major advantage as the country has been able to steer resources into areas with a large growth dividend. This is one of the key aspects of the fiscal framework, which results from minimal constitutional interference in fiscal policies.

It is clear that fiscal policy in both countries is very pragmatic and has been modified according to their long-term strategies and needs. But markets understand that policies can change. The only lasting guarantee is a mature political system with strong political parties. On these fronts, Chile still fares better than Peru, where a weak political system leaves room for populism in every presidential election. The good news is that this is probably less true now than five years ago.

VENEZUELA: RECESSION OR IMPLOSION? *AN OUTLIER*

According to the International Energy Agency (IEA), Venezuela has the second largest oil reserves in the world. At the same time, sovereign debt spreads indicate that it has the world's highest default risk, at least in the group that issues bonds in international financial markets. Since 2008, inflation has been running at around 30 percent per year, while GDP has been contracting (see figures in Introduction and Summary). In fact, Venezuela is the only country in South America still in a recession despite this year's favorable oil market conditions.

Venezuela's economic woes are not simply the reflection of the global recession nor are they caused by other external forces. They are the consequence of years of macroeconomic mismanagement together with very weak rule of law. There is a serious risk of a protracted economic implosion if there is not a major policy reversal. But policy changes in Venezuela are usually maneuvers to buy time by taking shortcuts and rarely confront fundamental problems. As the precipice gets closer, the degrees of freedom are becoming narrower although the economy is not yet on the verge of a free fall, despite the fact that forecasts suggest that after a sharp contraction this year, the Venezuelan economy will continue to deteriorate in 2011. But robust growth will only occur in one of two scenarios: either the government reverses much of what it has done in the past to discourage

private investment and to stimulate capital flight, or luck brings good news in terms of oil production in the Orinoco basin. For different reasons, both are very unlikely to occur.

CHASING CAPITAL AND CAPITALISTS

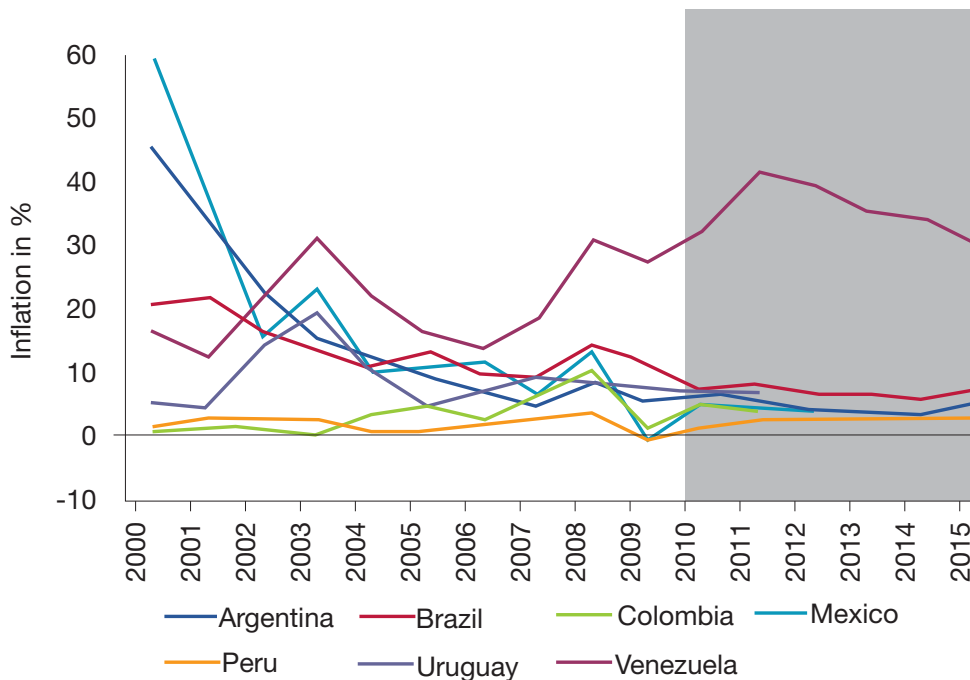
The fundamental cause of these maladies is weak governance. Crime rates have skyrocketed to a level that is clearly above the Latin American average. According to a recent report based on official data,²⁰ the homicide rate per 100,000 inhabitants rose to 49 in 2009 from 33 in 2001. Venezuela's homicide rate is now well above Colombia's (32 per 100,000 inhabitants) and only comparable to

those observed in the Central American countries, which have been struggling with organized crime in the past few years.

Other governance measures have also experienced a dramatic reversal relative to a decade ago and are lagging well behind Brazil, Colombia and the region's average. According to the World Bank's Governance Indicators, Venezuela has had major setbacks in all areas, but especially in regulatory quality and rule of law.

Not surprisingly, the private sector is responding by massively taking savings out of the country

FIGURE 3.9 INFLATION AND INFLATION EXPECTATIONS



Note: Inflation calculated as a percentage change of consumer prices, average; shaded region indicates forecast. Source: Own construction based on The Economist Intelligence Unit.

and putting extra pressure on the exchange rate. Without an anchor, inflation is out of control.

The economic model that has taken hold in Venezuela does not work. Without legal protection, there is no investment, and without investment, there is no growth. Just in the first quarter of 2010, investment fell 24 percent relative to 2009, which had already been lower than in 2008.

The most salient aspect of Venezuela's government is its heavy-handed intervention in the economy. An increasing number of private firms are being nationalized on the grounds of "strategic" interest. Others are taken over by the government when they do not comply with capricious regulations. Firms operate under the permanent threat of confiscation, especially in areas with price controls or legally contentious issues with the government. The state of despair and uncertainty is generalized. The most recent examples have to do with firms in the financial sector, where 43 brokerage companies were taken over by the government when the exchange rate system was reformed. Oil-services provider Helmerich and Payne, Inc. was also nationalized. Expropriations require an estimated compensation of \$14 billion, which the government is unable to pay under the current fiscal situation. Fedecamaras claims that the government has taken control of more than 200 businesses since 2005.

In addition, oil production is falling. According to the central bank, oil exports fell to 2.3 million bar-

rels per day (bpd) in July 2010 from nearly 2.6 million bpd at the beginning of the year. With lower export revenues, there is a shortage of foreign exchange. The government stepped up its exchange controls and is now criminalizing transactions in the black market. In the official market, there are three exchange rates: 2.60 for essential goods, 4.30 for preferred transactions, and a general-purpose rate that is practically fixed by the central bank at 5.30. Since the central bank is unable to satisfy demand, the black market rate has skyrocketed, putting pressure on most prices, which are essentially indexed to the dollar. With higher inflation, real incomes have been falling as well as private consumption, which just completed five straight quarters of negative growth. Everyone is seeking refuge in the dollar. Overvaluation in the official market, negative real interest rates and attacks on private enterprise all point in the same direction. Figure 3.10 illustrates this by showing the outflows of portfolio capital, which now exceed the current account surplus. With the current exchange rate, the country's economic situation is unsustainable, and soon the authorities will have to devalue the currency even further.

The multiple exchange rate system is the best example of the many distortions that are in place, generating a loss in efficiency. With the policy framework that the Venezuelan government has adopted, the market exchange rate is close to 8.5 bolivars per dollar, which prevails in the black market. Selling dollars at lower rates is akin to a subsidy assigned to sectors that are euphemis-

tically called “productive” or “strategic.” But everyone knows how this works. Government officials have ultimate discretion and use it effectively to generate support from individuals and firms that need hard currency.

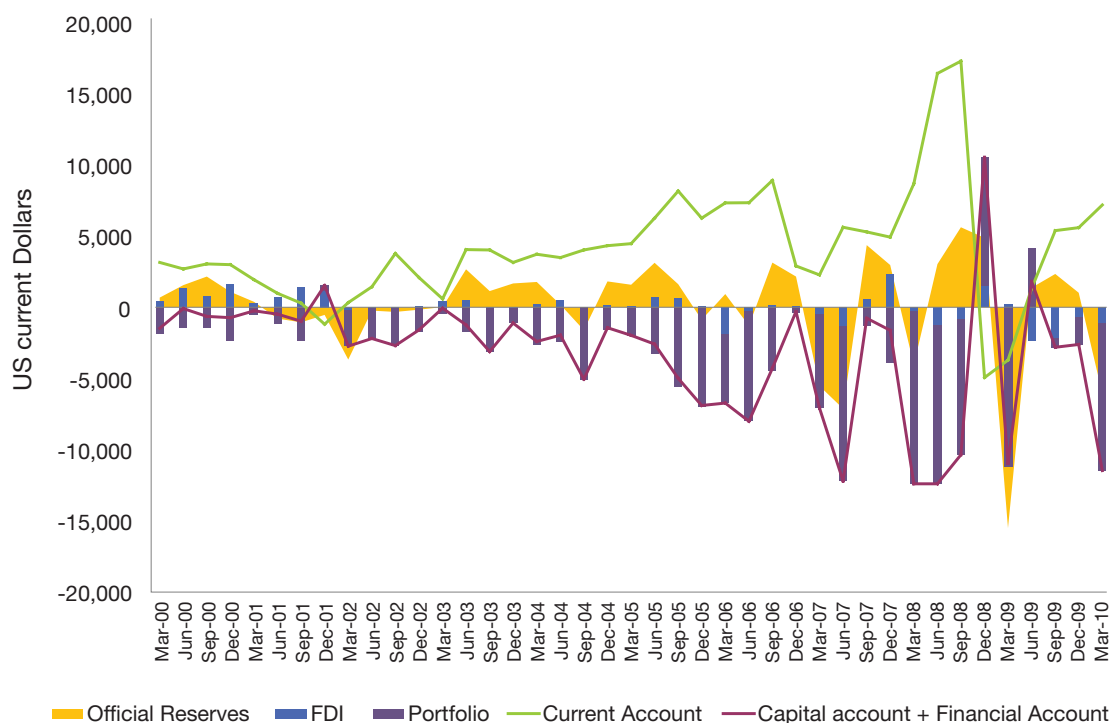
WHAT’S NEXT?

Despite this negative outlook, the Venezuelan government thinks otherwise. In official language, the major responsibility for the economy is in the hands of the Venezuelan Ministry of Energy and Petroleum, which is planning to reverse the negative trend in oil production. The

goal is to reach 3 million bpd toward the end of the year. The country’s economic fortune depends heavily on whether this goal is achieved or not. So far, however, it seems unlikely. Oil production and exports show a slow but steady decline and little indication that reaching this level of production is feasible. Investment in the sector is picking up, aided by contracts with a number of major players, and partly financed by China on the *Petróleos de Venezuela S.A. (PDVSA)* side.

The recovery of private investment seems even harder to achieve. Under permanent govern-

FIGURE 3.10 VENEZUELA: CAPITAL ACCOUNT DECOMPOSITION



Note: Positive change in reserves implies positive change in reserves.
Source: Own construction based on the IMF’s International Financial Statistics (IFS).

ment attacks and threats, and in an economy that is contracting, there are few reasons to invest in Venezuela. According to the latest survey by Conindustria, sales, output and employment expectations are at their lowest level since 2005.

A key factor for future economic performance is the ability of the government to stimulate the economy. There is no doubt that this is the only possible strategy for the government in the short run. But a large fiscal deficit and limited access

to international lending imposes constraints. The fiscal deficit is growing and is currently close to 8 percent of GDP. Despite higher oil prices than in 2009 and depreciation in the exchange rate applied by the central bank to PDVSA (4.30 from 2.15 bolivars per dollar), the government's ability to stimulate the economy is constrained. In the external front, Venezuela has been cut off from new lending. Domestically, monetary financing would only exacerbate inflationary pressures.

ENDNOTES

1. A third persistent (albeit probably not permanent) factor behind LAC's renewed resilience is China, whose economic size and rapid development had a substantive role in the improvement in LAC's terms of trade, which appears sustainable in the medium run.
2. See, among others, Rose, A. (2009), "Debunking 'decoupling'," VoxEU.org, 1 August. And Kose, A., Otrok, C. and Prasad, E. (2008), "Global business cycles: Convergence or decoupling?" NBER Working Paper 14292.
3. A simple regression of quarterly growth in emerging economies excluding China on G-7 growth shows a coefficient that is significantly larger for the 2000s. However, once Chinese growth is included as an additional regressor G-7 growth generally ceases to be a significant growth driver for the 2000s, as China increases its influence.
4. Maddison, A. (2003). Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD.
5. Blyde, S., Daude, C., and Fernández-Arias, E. (2009). "Output Collapse and Productivity destruction." Inter-American Development Bank Working No. C-666.
6. See, for example, Prasad, E., Rajan, R., and Subramanian, A. (2006) "Foreign Capital and Economic Growth," Research Department IMF, August 30; and Levy-Yeyati, E. and Sturzenegger, F. (2007), "Fear of Appreciation," Kennedy School of Government Working Paper 07-047, Harvard University. Aizenmann and Lee (2007) provide a useful discussion on alternative motives behind reserve accumulation (Aizenman, J. and Lee, J. (2007), "International Reserves: Precautionary Versus Mercantilist Views, Theory and Evidence," *Open Economies Review*, Vol. 18, issue 2).
7. See, among others, Jeanne, O., and Ranciere, R. (2006) "The Optimal Level of International Reserves for Emerging Market Countries: Formulas and Applications," IMF working paper 06/229.
8. More precisely, the marginal cost should net out the gains in rollover costs from the lower borrowing costs due to increasing the reserve stock (Levy-Yeyati, E. (2008), "The Cost of Reserves," *Economic Letters*, 2008, vol. 100 (1), pp. 39-42).
9. Levy-Yeyati, E. (2010), "Financial Safety Nets: Assembling the Parts," prepared for the Bruegel-ICRIER Conference on International Cooperation in Times of Global Crisis: Views from G20 Countries, New Delhi, September 2010.
10. Intervention is estimated as valuation-adjusted changes in reserve stocks. Cost of carry is computed as the local currency-U.S. dollar interest rate differential over the cumulative reserve purchases.

11. Note that valuation gains or losses need to be added to the carrying costs associated with the local currency-U.S. dollar interest rate differential, for the case of sterilized interventions.
12. This section borrows from, and updates the ranking reported in Levy-Yeyati, E., Ghezzi, P., Broda, C. and Christou, G. (2009), "Advanced emerging markets: The list," Barclays Capital Research.
13. For more details on the Index please refer to Cárdenas, M. and Henao, C. (2010). "Latin America and the Caribbean economic recovery." Retrieved from http://www.brookings.edu/~media/Files/rc/articles/2010/07_latin_america_economy_cardenas/07_latin_america_economy_cardenas.pdf The index follows Prasad, E., and Foda, K. (2010), "TIGER: Tracking Indexes for the Global Economic Recovery." Retrieved from http://www.brookings.edu/reports/2010/05_economic_recovery_prasad.aspx
14. According to Barros et al. (2010) the Gini coefficient fell from nearly 59 in 2000 to 54 in 2007. See Barros, R., de Carvalho, M., Franco, S., and Mendonça, R. (2010), "Markets, the State, and the Dynamics of Inequality in Brazil." In *Declining Inequality in Latin America: A Decade of Progress?*, eds. López-Calva, L. and Lustig, N. (Brookings Institution Press, Baltimore: 2010), 135.
15. Ibid, 134-174.
16. Pereira, C. (2010) "What is Limiting Brazil's Productivity-Enhancing Policies?" Retrieved from http://www.brookings.edu/opinions/2010/0901_brazil_economy_pereira.aspx
17. A third margin that predates the crisis is the technological advance in the agricultural sector, which increased productivity and extended the agricultural border, complementing the price boom with a substantial growth in agricultural output (particularly soybeans).
18. Since 2009, part of the peso profits of the social security fund, which barely make up for local inflation, has been transferred to the Treasury. In addition, the Treasury cashed the one-off SRD issuance by the IMF in 2009 for approximately \$2.5 billion.
19. Headline inflation in Argentina is measured based on the Great Buenos Aires area; hence, the official indifference about the publication of diverging provincial numbers.
20. "La Situación de Seguridad en Venezuela." Instituto de Investigaciones de Convivencia y Seguridad Ciudadana (INCOSEC). 2010 Q1.

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