

LATIN AMERICA AND THE INTERNATIONAL CRISIS: SOME CONSIDERATIONS ON MACROECONOMIC POLICY*

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The onset of the recent international crisis marked the end of a period of six consecutive years of economic growth in Latin America, from 2003 to 2008. Due to its uniqueness, this growth period is unprecedented in the economic history of the region. Thus, this article aims to analyze the main characteristics of such expansion period in Latin America, and to study the main transmission channels of the international crisis to Latin American countries. Finally, it discusses some challenges of the macroeconomic policy in the region over the long term.

A AMÉRICA LATINA E A CRISE INTERNACIONAL: ALGUMAS CONSIDERAÇÕES SOBRE A POLÍTICA MACROECONÔMICA

O início da recente crise internacional marcou o fim de um período de seis anos consecutivos de crescimento econômico na América latina, que durou de 2003 até o final de 2008. Devido às suas singularidades, tal período de crescimento não encontra precedentes na história econômica da região. Assim, este artigo tem por objetivo a análise das principais características de tal período de expansão na América Latina, bem como o estudo dos principais canais de transmissão da crise internacional para os países latino-americanos. Por fim, serão discutidos alguns desafios para a política macroeconômica da região em longo prazo.

1 INTRODUCTION

Latin America went through six years of consecutive growth, since 2003 until late 2008. The intensity, duration and characteristics of this phenomenon were unprecedented in the economic history of the region. During this expansion period, which reached almost all of the region's economies, the regional product grew at an average annual rate of 4.8%, accumulating a per capita GDP of 22.1%, equivalent to 3.4% a year.

The recent international crisis marked the end of this period of growth and underscored the need to take stock of the recent growth cycle, whose characteristics make it truly unique, and to assess how the crisis was transmitted across the region's economies and why the impact is different from previous crises faced by the region. Finally, some challenges faced by the macroeconomic policy, beyond the crisis, must be tackled.

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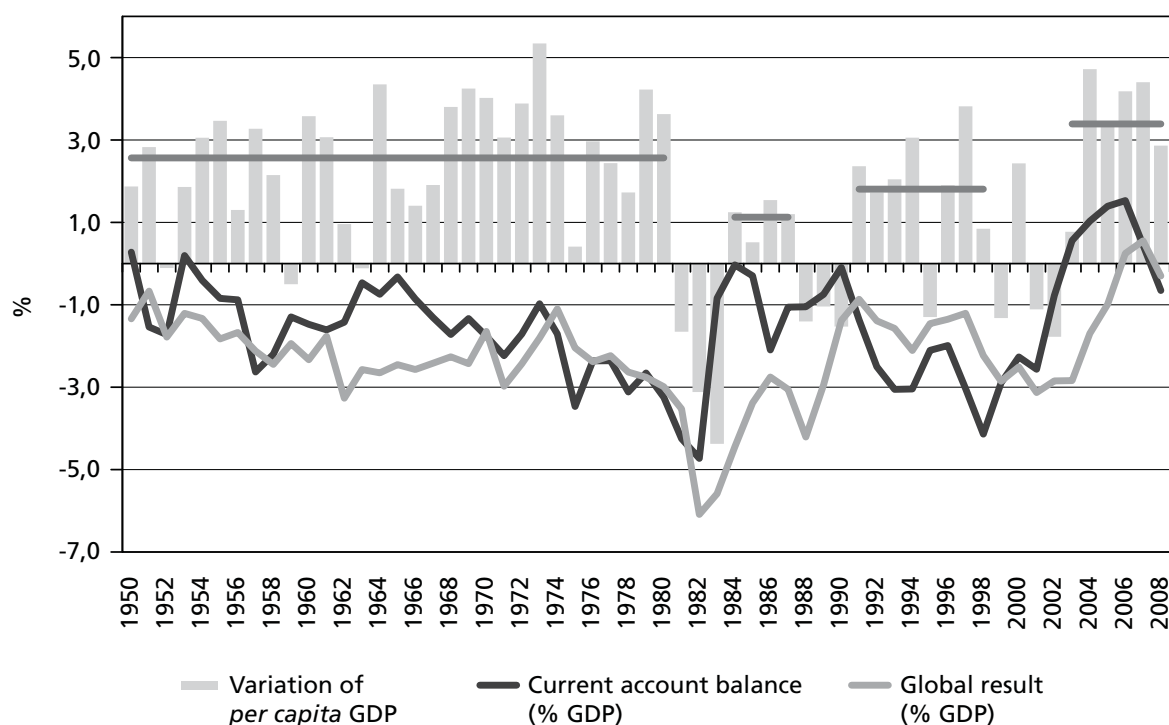
In order to address these issues, the article is structured as follows: Section II discusses the main features of the 2003-2008 growth period in Latin American countries, as well as the contribution of macroeconomic policy to reduce the region's vulnerability. Section III examines the main channels of transmission of the international crisis to Latin American economies, and finally, Section IV deals with some of the long-term challenges for macroeconomic policy.

2 LATIN AMERICAN ECONOMY BEFORE THE CRISIS: THE 2003-2008 GROWTH PHASE

As can be seen in Graph 1, in order to find a period when per capita GDP grew steadily over 3% a year, one would have to go back 40 years, when the region grew at comparable rates for 7 consecutive years, from the late sixties until the first oil price shock in the early seventies.

GRAPH 1

VARIATION OF PER CAPITA GROSS DOMESTIC PRODUCT, CURRENT ACCOUNT BALANCE AND GLOBAL RESULT



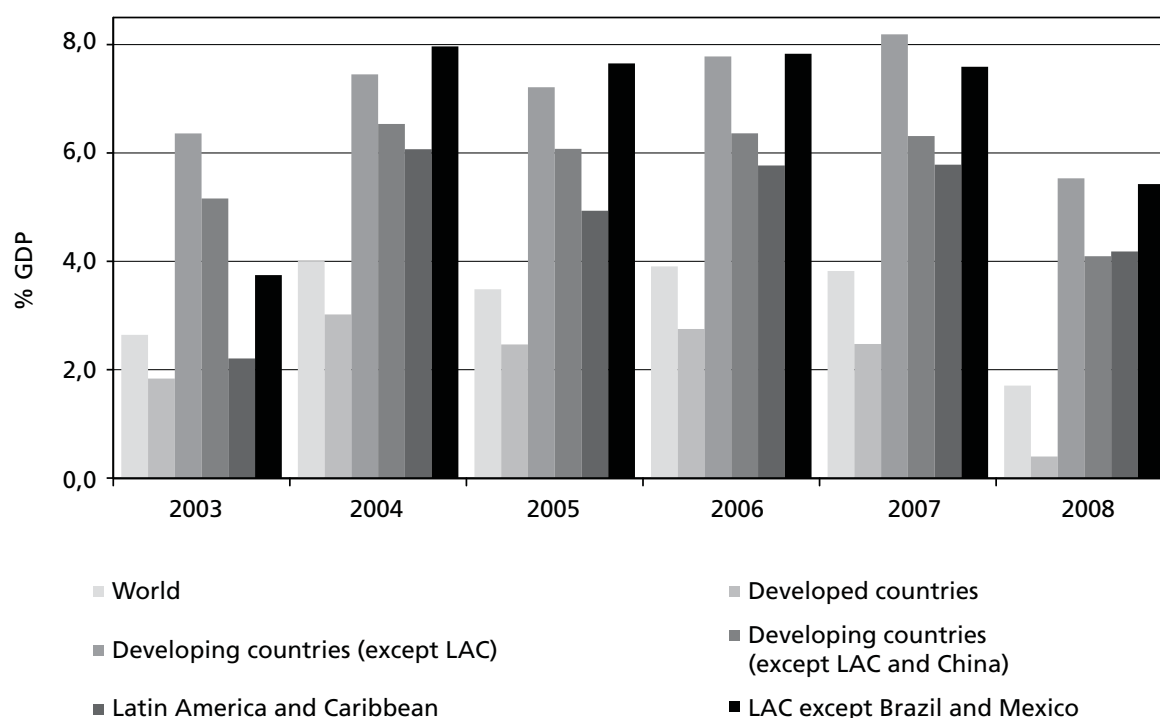
Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

However, as discussed in detail in this section, sustained growth was accompanied by a qualitative and quantitative improvement of key macroeconomic variables, which makes this period a phase of unprecedented expansion in the region's recent history. On the one hand, there was a surplus in the current account of the balance of payments, largely corresponding to the recovery of the terms of trade (especially in South America) and the growth

of remittances from migrant workers (in Mexico and especially in Central America). On the other hand, the evolution of public accounts during the expansion phase is characterized by an increase of the primary surplus, with near disappearance of the global deficit, which allowed a significant public debt reduction.

The good macroeconomic performance in Latin America during the 2003-2008 period took place in an international context characterized by growth in all regions of the world, and in particular by the good performance of emerging economies led by China and India. It should be noted that although growth rates in the region were high by historical standards, they were lower than those recorded on average in developing countries. However, it is evident that this comparison is influenced by the low growth observed in recent years in the two largest economies in the region, Brazil and Mexico, which together account for 60% of regional GDP. As shown in Graph 2, the performance of Latin American countries, without considering these two economies, is not very different from the performance of the developing world.

GRAPH 2
WORLD GROWTH BY REGIONS 2003-2008



Source: Prepared by the authors, based on United Nations and International Monetary Fund databases.

Overall, this period was characterized not only by current account improvements, but also by abundant liquidity in international capital markets and a decrease in country risk. In this context, international reserves increased and the net external debt dropped, led by the evolution of public accounts.

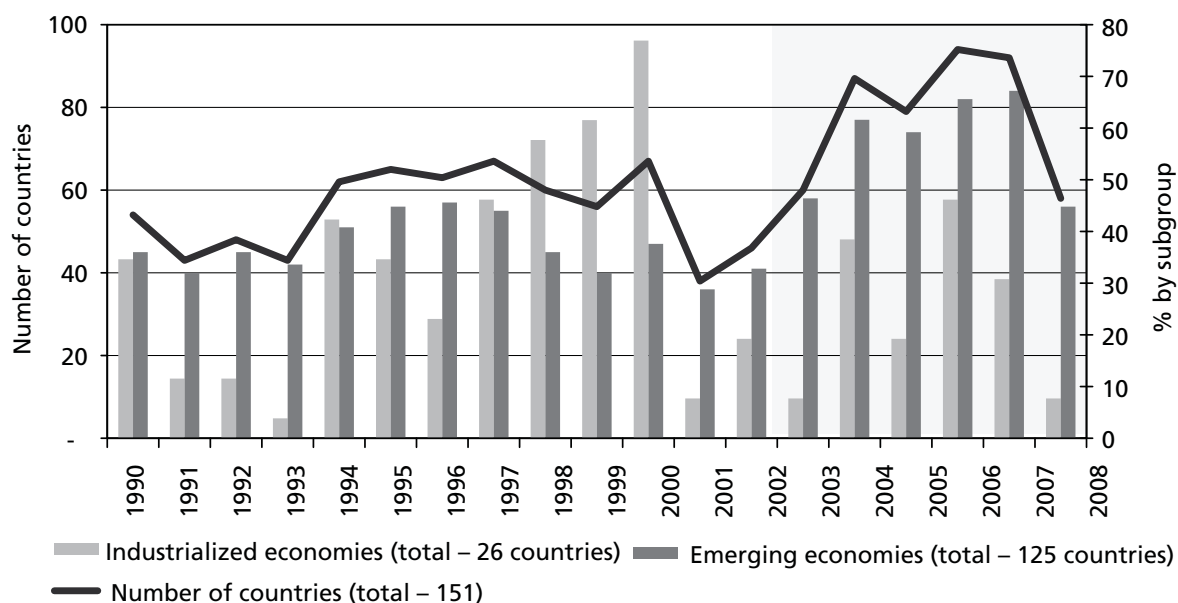
Moreover, better financial conditions allowed improvement of the debt profile, both in terms of deadlines and interest rates, as well as an increase of the share of debt denominated in local currency. As discussed in Section II.5, the expansion process resulted in improved labor market indicators, as demonstrated by the decline in unemployment rate at the regional level, which dropped from 11.0% in 2002 to 7.4% in 2008. Moreover, new and better quality jobs were created as a result of the growing share of formal paid jobs. The combination of economic growth, lower unemployment and better quality of jobs resulted in better social indicators.

2.1 The external context and the current account

As noted above, the good economic performance in Latin America in the 2003-2008 period occurred in a global context of rapid and widespread growth. Indeed, during the period there was an increase in the number of countries recording per capita GDP growth rates greater than 3% a year. This phenomenon is explained by the rapid growth in emerging economies, of which 57% had per capita GDP growth rates above 3% between 2003 and 2008, while only 25% of industrial economies grew at a comparable rate (see Graph 3). This pattern is remarkable when compared to the distribution of growth in the last decade, when on average only 38% of emerging economies and 33% of the industrial economies had a per capita growth above 3% a year, with marked acceleration of the pace of expansion in industrialized countries between 1998 and 2000.

GRAPH 3

NUMBER OF COUNTRIES WITH PER CAPITA GDP GROWTH HIGHER THAN 3%



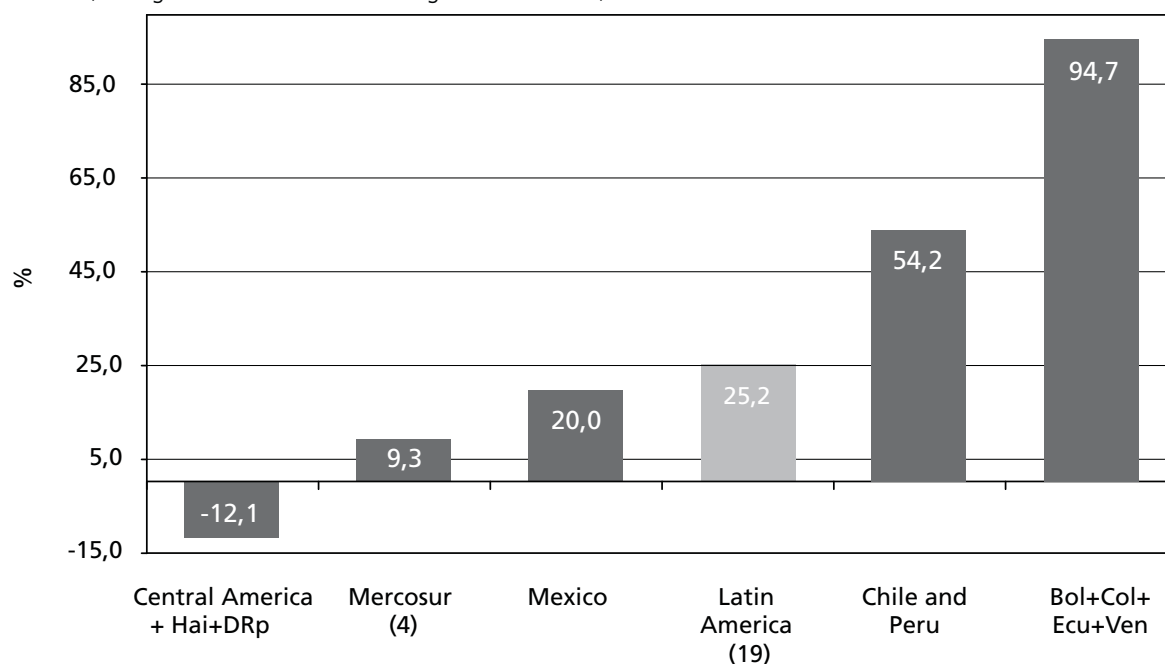
Source: Prepared by authors, based on United Nations and International Monetary Fund databases.

Other highlights in the context of the prolonged global economic expansion are the increasing participation of China and India in global demand and the ample liquidity that characterized international capital markets, at least until mid-2007. Favorable external conditions allowed growth to be accompanied by current account surplus, with the sole exception of 2008, in an unprecedented manner in the economic history of the region. Two main factors accounted for the evolution of the regional current account: terms of trade and remittances from migrant workers. However, both elements affected the region's countries differently. It is not surprising, therefore, that although on average the region achieved a surplus in current account during the 2003-2008 period, the surplus was concentrated in a minority of countries. Indeed, only 8 of the 19 Latin American countries had a surplus during the period of expansion, all of which are South American economies¹.

GRAPH 4

AVERAGE PERCENTAGE VARIATION OF TERMS OF TRADE 2003-2008

(Average 2003-2008 versus average in the nineties)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

Note: The numbers in parentheses refer to the number of countries.

Not incidentally, South American countries account for the aggregate external surplus, since the region benefited most from the increase in terms of trade when compared with the average level of the nineties (Graph 4). In fact, countries specializing in oil and oil products exports, as well as metals and minerals had the largest increase in terms of trade during the growth period. MERCOSUR

1. In fact, four countries (Argentina, Brazil, Chile and Venezuela) account for the current account surplus in the region.

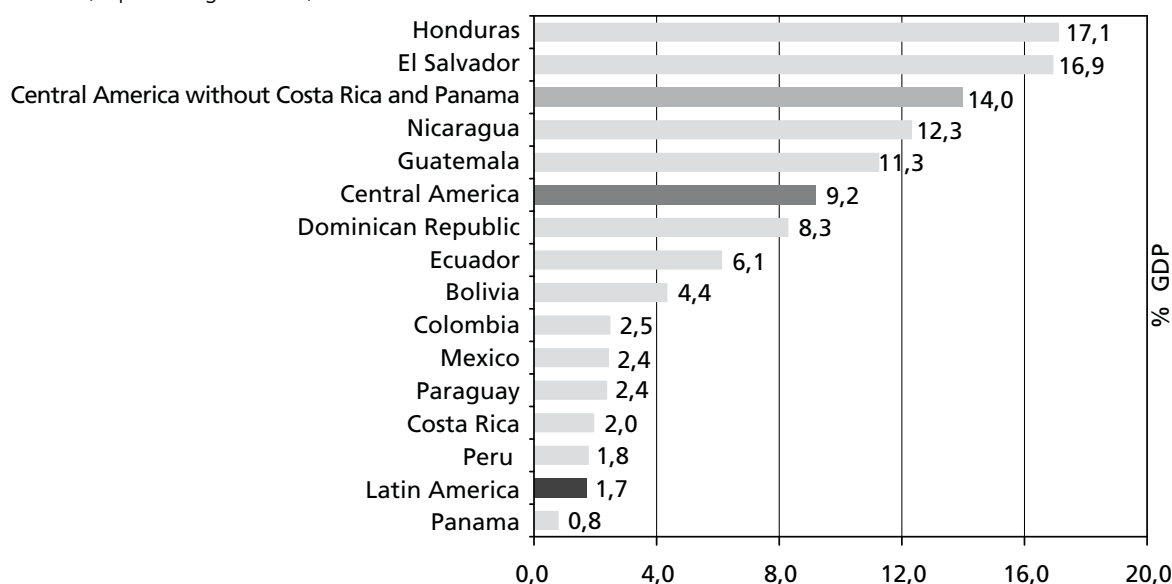
countries contributed through the increase in net export volumes, since the rise in relative prices of exports was modest (less than 10%). Mexico also experienced significant improvement in terms of trade, coupled with a rise in oil prices, although this was partially offset by the deterioration in net exportation of goods. As for Central American countries that are net oil importers and competitors of China in the U.S. market, the story is quite different. These countries not only suffered deterioration in their terms of trade during the period of regional growth, but also a reduction in foreign sales in real terms, both as compared to the average of the nineties.

On the other hand, Mexico and most Central American countries are recipients of significant resources in remittances from emigrant workers. The region as a whole received average remittances equivalent to 1.7% of GDP in the 2003-2008 period. However, Central America received the equivalent to 9.2% of GDP (although with the exclusion of Costa Rica and Panama, the average rises significantly, as seen in Graph 5), and Mexico received the equivalent to 2.4% of GDP, a figure comparable to what the country received in foreign direct investment in the period.

GRAPH 5

WORKERS' REMITTANCES, Average 2003-2008

(In percentage of GDP)



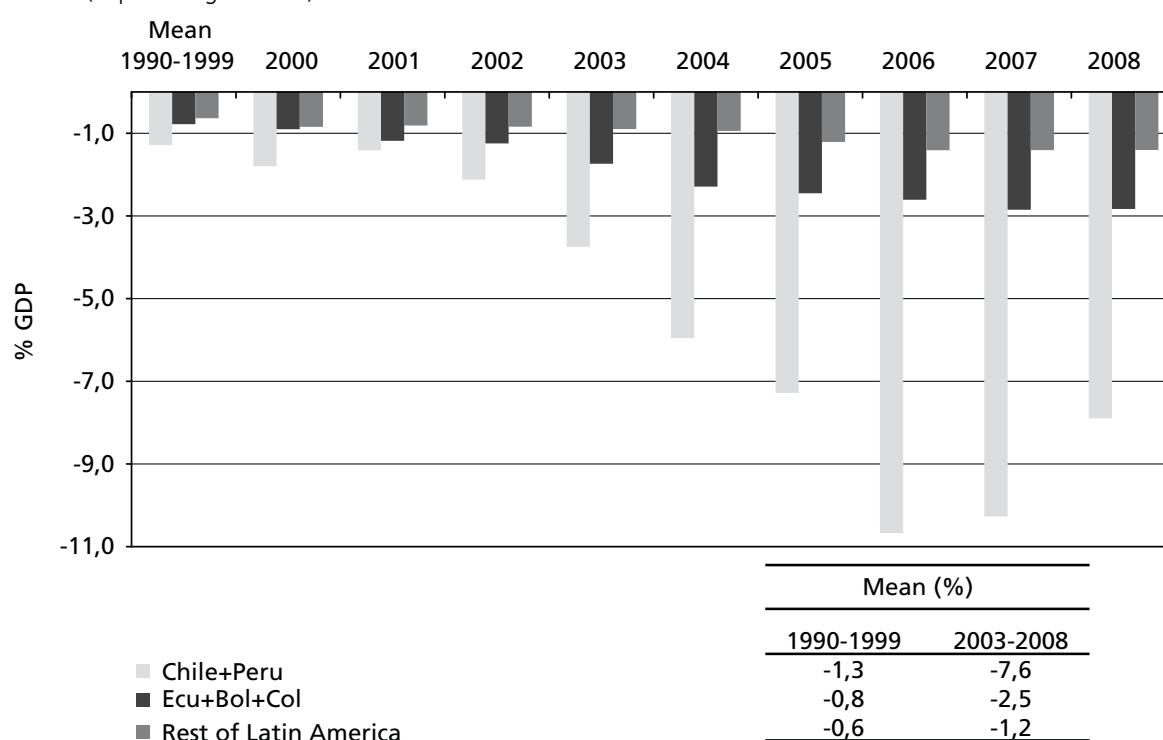
Source: Prepared by the authors, based on official figures.

Another feature of the evolution of current account in the balance of payments in the growth years was the significant increase in remittances of profits made by foreign companies to their parent companies. As can be seen in Graph 5, net profit flows in terms of GDP rose significantly in the economies linked to production and export of commodities in South America, mainly oil, metals and

minerals. This situation is in line with the improvement of international prices for these products and the fact that in many cases the exploitation of natural resources is in the hands of foreign companies. In this regard, it should be noted that Chile and Peru concentrated on average 33% of the net outflows of foreign exchange between 2003 and 2008, despite representing less than 8% of regional GDP measured in current dollars.

GRAPH 6
NET PROFIT REMITTANCES

(In percentage of GDP)



Source: Prepared by the authors, based on official figures.

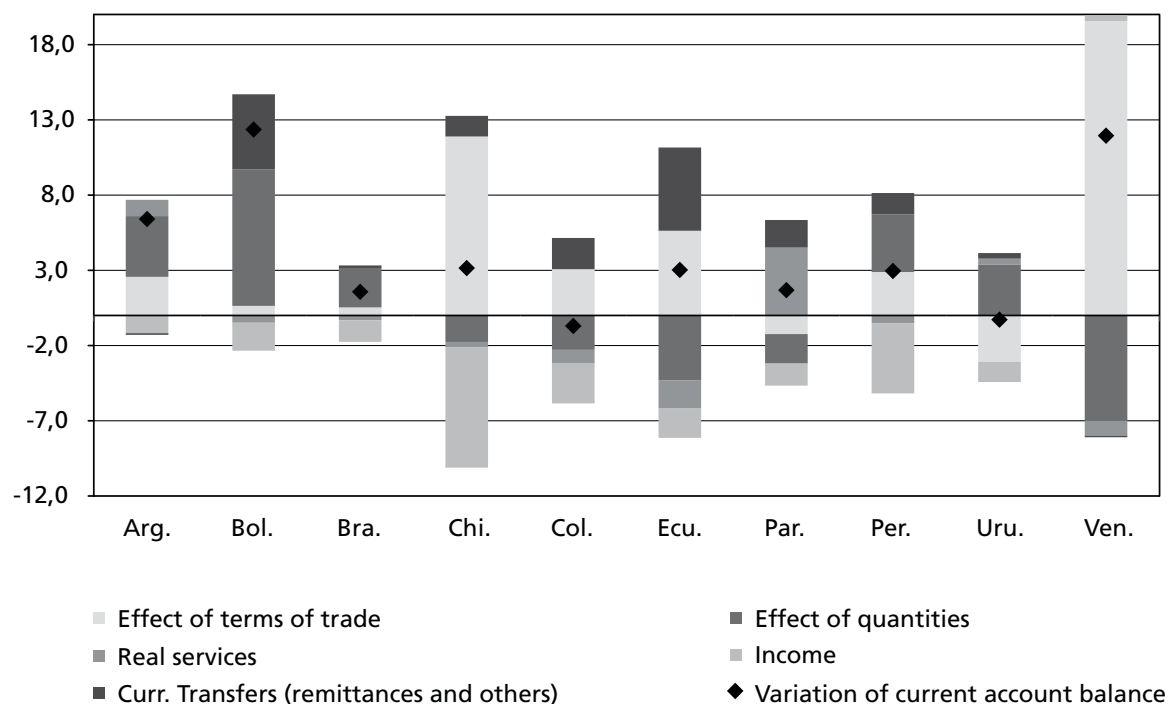
To illustrate the effects mentioned above and their impact on the current account balance, we will analyze the breakdown of average variations in current accounts by country during the expansion period (2003-2008), taking the nineties as benchmark. In South America, Graph 7(a), there was an improvement in the current account balance in most countries (with the exception of Colombia and Uruguay), mainly due to the effect of rising terms of trade, and in some countries, the improvement of the trade balance in real terms. The countries benefiting from improved terms of trade are Venezuela and Chile; in Peru and Chile this improvement was partially offset by the aforementioned remittance of profits abroad, mostly linked to mining. On the other hand, Argentina, Bolivia, Brazil, Peru and Uruguay recorded the largest increases in export volumes. It is interesting to note that in several South American countries (Bolivia, Colombia, Ecuador and Paraguay) remittances from emigrants began to rise, as compared with the average of the nineties.

GRAPH 7

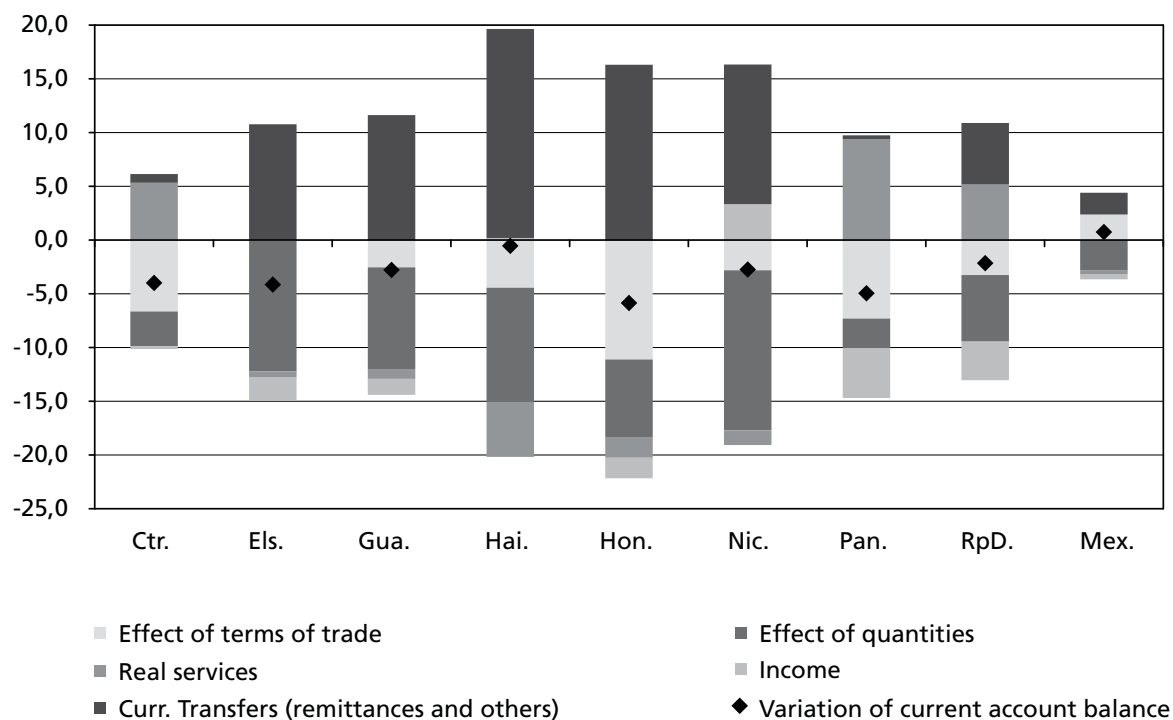
BREAKDOWN OF THE VARIATION OF CURRENT ACCOUNT BALANCE BETWEEN 2003-2008 AVERAGE AND 1990-1999 AVERAGE

(In percent of average 2003-2008 GDP)

(A) South America



(B) Central America, Haiti, Dominican Republic and Mexico



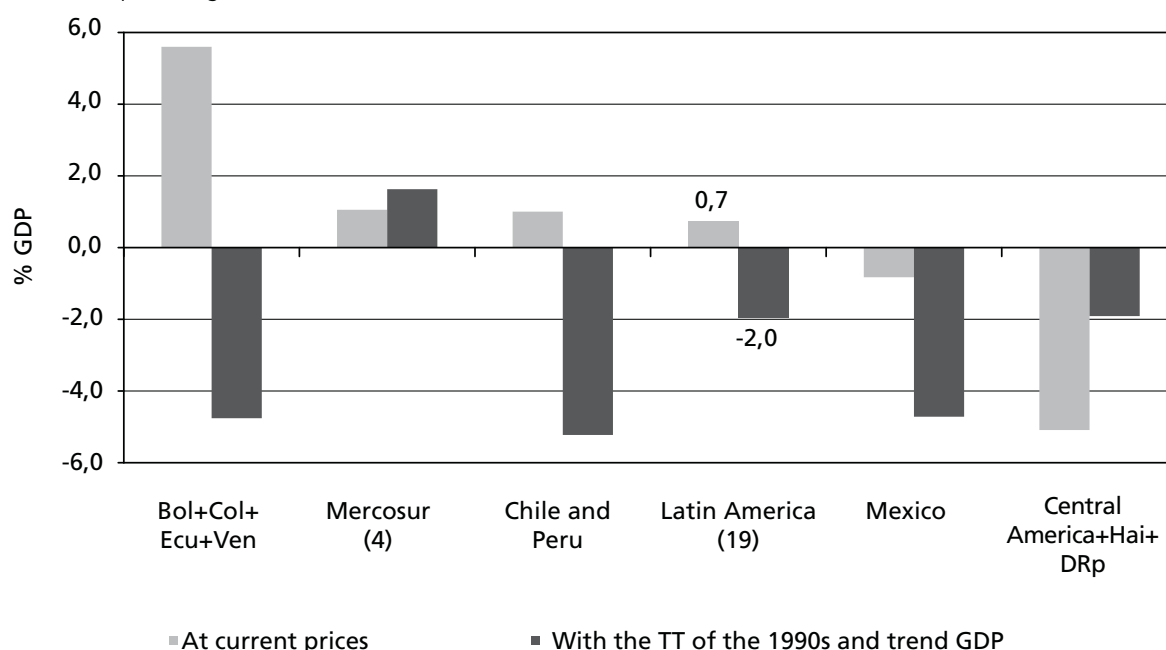
Source: Prepared by the authors, based on official figures.

Graph 7(b) shows the breakdown of current account variation for Mexico and Central America in the period analyzed. A common element in these countries is the deterioration of trade balance at constant prices and, with the exception of Mexico, the negative impact of changes in terms of trade. At the same time, there were significant foreign exchange earnings in remittances from migrant workers, with the exception of Costa Rica and Panama. These two countries, along with the Dominican Republic, experienced significant positive effects derived from the balance of services.

GRAPH 8

AVERAGE CURRENT ACCOUNT 2003-2008 AT CURRENT PRICES AND TERMS OF TRADE OF THE NINETIES

(In percentage of GDP)



Source: Prepared by the authors, based on official figures.

Note: The numbers in parentheses refer to the number of countries.

To assess the sensitivity of the external sector to the change in relative prices of foreign trade, we estimated what the current account balance would be if the terms of trade were equivalent to those of the nineties, also adjusting GDP growth, since it depends on the terms of trade (Graph 8)². At the aggregate level, the region went from a surplus of 0.7% of GDP at current prices to a deficit of 2%, considering the terms of trade of the nineties and the

² In order to arrive at the current account with the terms of trade of the nineties, real exports of goods and services were calculated with the price level of current imports, both of goods and services, adjusted by the average terms of trade of the nineties. The same procedure was used to calculate profit remittances sent abroad, since they are closely linked to changes in commodity prices. In turn, the growth of import volumes of goods and services each year was adjusted by the difference between actual GDP growth and the trend, the result of filtering the series with HP ($\lambda = 6.25$), and applying income elasticity of imports reported in Bello and Pineda (2007). In this exercise, the nominal GDP trend was also used for the calculation of the current account to GDP ratio.

rising trend over the 2003-2008 period. If the terms of trade were those of the nineties, the current account deficit in Mexico and Colombia would increase, while in Venezuela, Chile and Ecuador, the balance of current account deficit would drop, due to the decreased price of oil and metals in the nineties. In MERCOSUR countries, with the exception of Brazil, the current account surplus would increase, not as a result of changes in terms of trade, but because of lower demand for imports from less relative growth when considering the trend. On the other hand, the current account deficit in Central American countries would drop significantly, since the impact of their deteriorating terms of trade in the past six years would be eliminated.

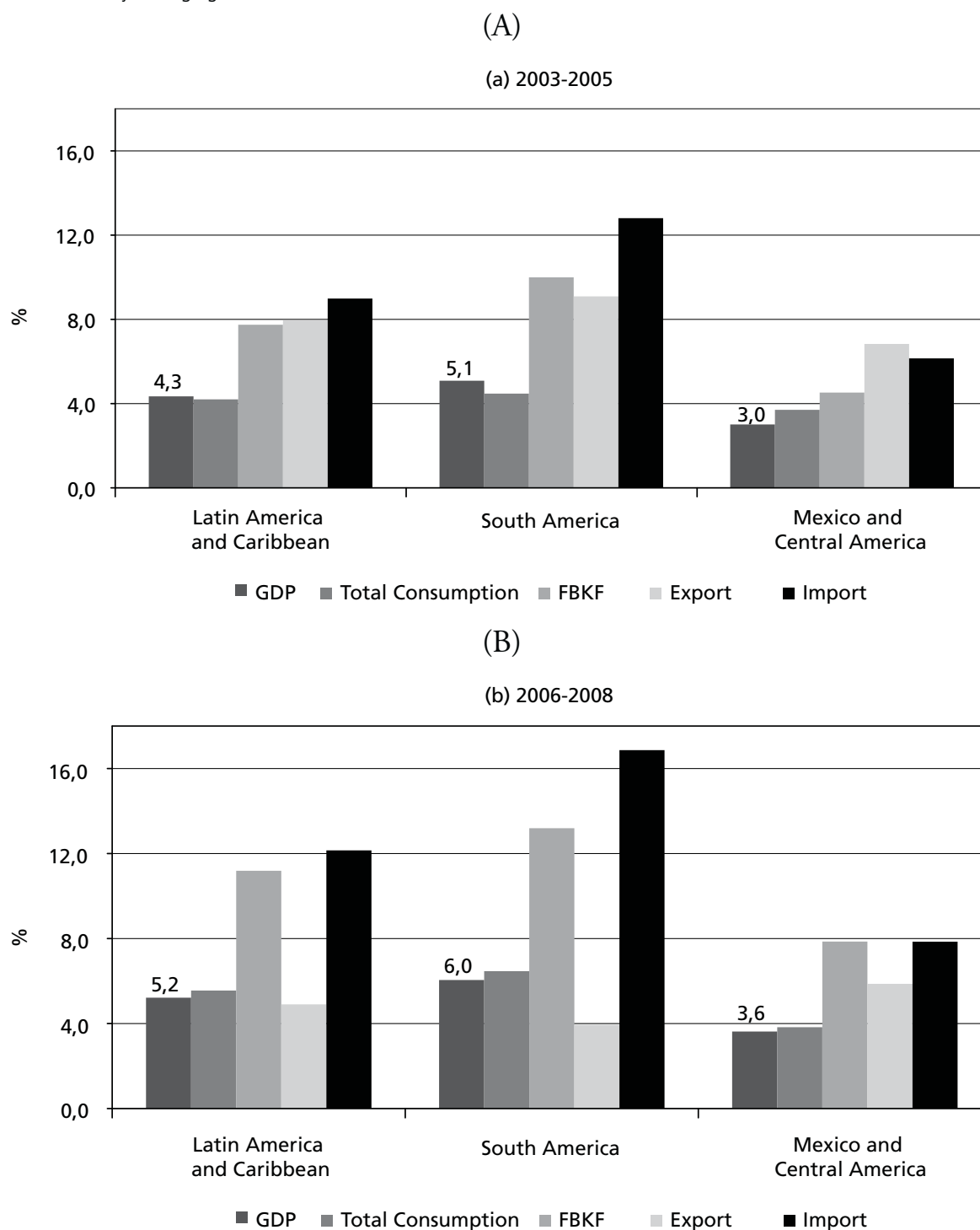
2.2 Product, income and demand components

In the 2003-2008 period, the available gross national income (GNI) of most countries in the region grew at a higher rate than GDP. While the region's GDP grew at an average yearly rate of 4.8%, the available GNI increased at an average rate of 5.7%. This phenomenon was stronger in metal, mineral and hydrocarbon exporting countries (Bolivia, Chile, Colombia, Ecuador, Peru and Venezuela) where there was a significant increase in available GNI in line with improved terms of trade, despite net payments of profits and dividends to the rest of the world (particularly in Chile and Peru, see Graph 5).³ In other South American countries, the available GNI also rose higher than the GDP, although more moderately. In Central America, despite a decline in the purchasing power of exports, increased remittances allowed available GNI to grow at a faster rate than GDP in some countries (Guatemala and Honduras). In Mexico, the expansion of national income may be attributed both to improved terms of trade and increase in net current transfers received.

Given the increase of available GNI in the region, and despite the significant rise in consumption, domestic savings increased substantially in most countries and, at current prices, represented on average 22% of GDP between 2003 and 2008, the highest since the nineties. Unlike the last decade, foreign savings became negative (-0.7% of GDP), implying that regional investment was entirely financed by domestic savings for most of the growth period, with the exception of 2008.

3. A detailed analysis of these aspects can be found in Kacef and Manuelito (2008).

GRAPH 9
GROWTH OF SUPPLY AND DEMAND COMPONENTS
 (Yearly average growth rates)



Source: Prepared by the authors, based on official figures.

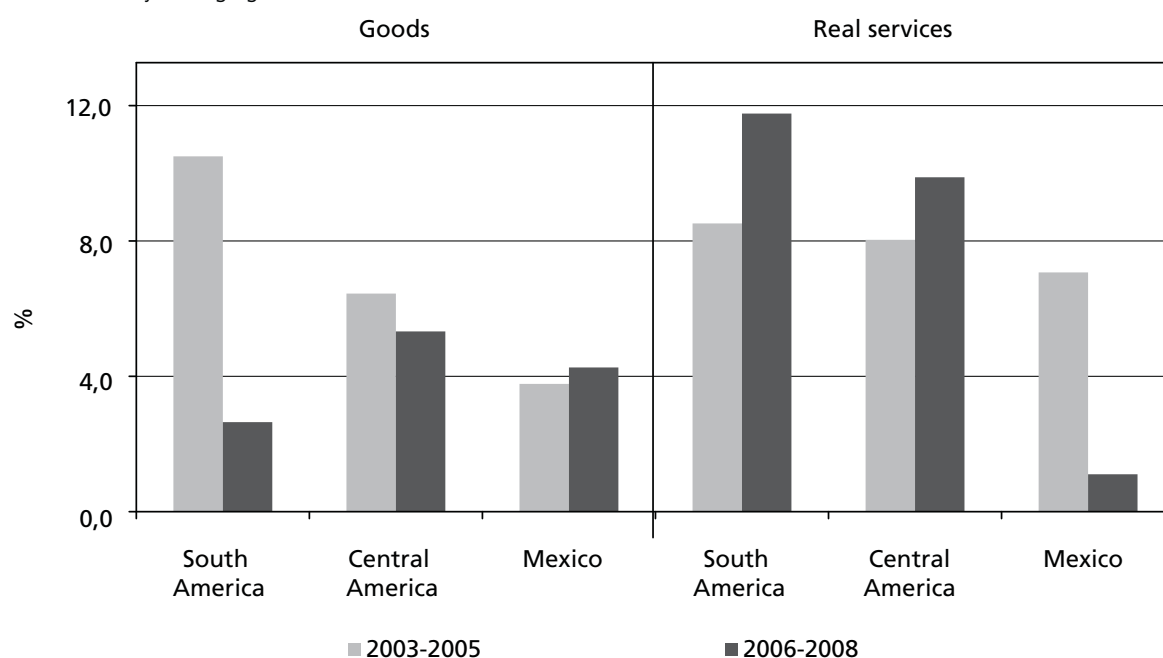
The growth period can be divided into two phases: 2003-2005 and 2006-2008. In the first phase, Graph 9 (a), the regional aggregate demand grew at an average rate of 5.0% a year, with gross formation of fixed capital and exports of goods and services being the most active, particularly in South American

countries. In the second phase, Graph 9 (b), the expansion of domestic demand across the region accelerated to 6.6% a year, coupled with an increase in average investment growth rates from 7.7% to 11.2% a year between the two three-year periods, and lesser increase in total consumption (from 4.2% to 5.6% a year), following the performance of South American countries. This increased internal absorption together with increasing currency appreciation pushed imports in real terms throughout the region and especially in South America, which grew at an average yearly rate close to 17% in the last three years. As found in several studies, a feature common to most Latin American countries is that long-term income elasticity of imports is substantially greater than one.⁴

GRAPH 10

GROWTH OF EXPORTED VOLUME OF GOODS AND SERVICES

(Yearly average growth rates)



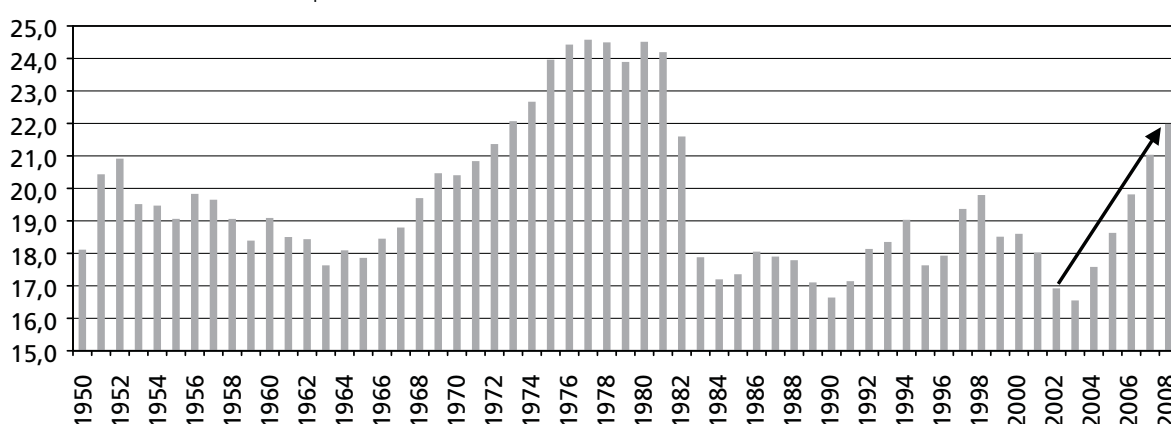
Source: Prepared by the authors, based on official figures.

At the same time, currency appreciation slowed the pace of growth in export volumes of goods and services throughout the region. However, this situation is mainly due to the sharp slowdown of real exports of goods in South America, which, after rising at 10.5% a year in the 2003-2005 period, grew at only 2.6% on average in the 2006-2008 period (Graph 10). By contrast, exports of real services in these countries maintained an upward trend, rising from an average

4. See, among others: Senhadji (1998) and Bello and Pineda (2007). In the latter work, using real GDP as income measure and prices as a measure of real exchange rate, income elasticity of imports ranges from 0.67 for Peru, to 2.54 for Uruguay, with a median of 2. When using the real GDP - exports as a measure of income, and again controlling for the real exchange rate, this elasticity ranges from 0.65 in Peru to 3.09 for Uruguay, with a median 1.4. In the first case, only one country reported an elasticity of less than one, while in the other case, two countries, Peru and Honduras, had an income elasticity of less than one.

yearly growth of 8.3% to 11.3% between both phases. Attention should be drawn to the significant growth recorded by real services in countries such as Argentina, Chile, Peru and Uruguay, with rates exceeding 10% a year. In Mexico and Central America, export performance took the opposite direction. While the volume of exports of goods slowed down in Central America in the last three years, its growth rate increased in Mexico. At the same time, real services exports slowed down sharply in Mexico (6 p.p.) while increasing in Central America, primarily in Costa Rica, Haiti and Panama.

GRAPH 11
GROSS FIXED CAPITAL FORMATION
(As% of GDP at 2000 prices)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

Gross fixed capital formation was the most dynamic component of demand throughout the 2003-2008 period of expansion, growing at an annual rate of 9.5%, and is obviously greater in countries in South America, favored by improved terms of trade. This growth reflects not only the drive in construction but, above all, of investment in machinery and equipment, whose contribution represented about two thirds of the average increase in gross capital formation in the past six years. As a percentage of GDP, gross fixed capital formation grew by over five percentage points during this period, rising from 16.9% in 2002 to 22.0% in 2008, its highest level in more than twenty five years (see Graph 11). Despite this sustained recovery, the investment rate in 2008 was still lower than the levels recorded in the late seventies and early eighties.

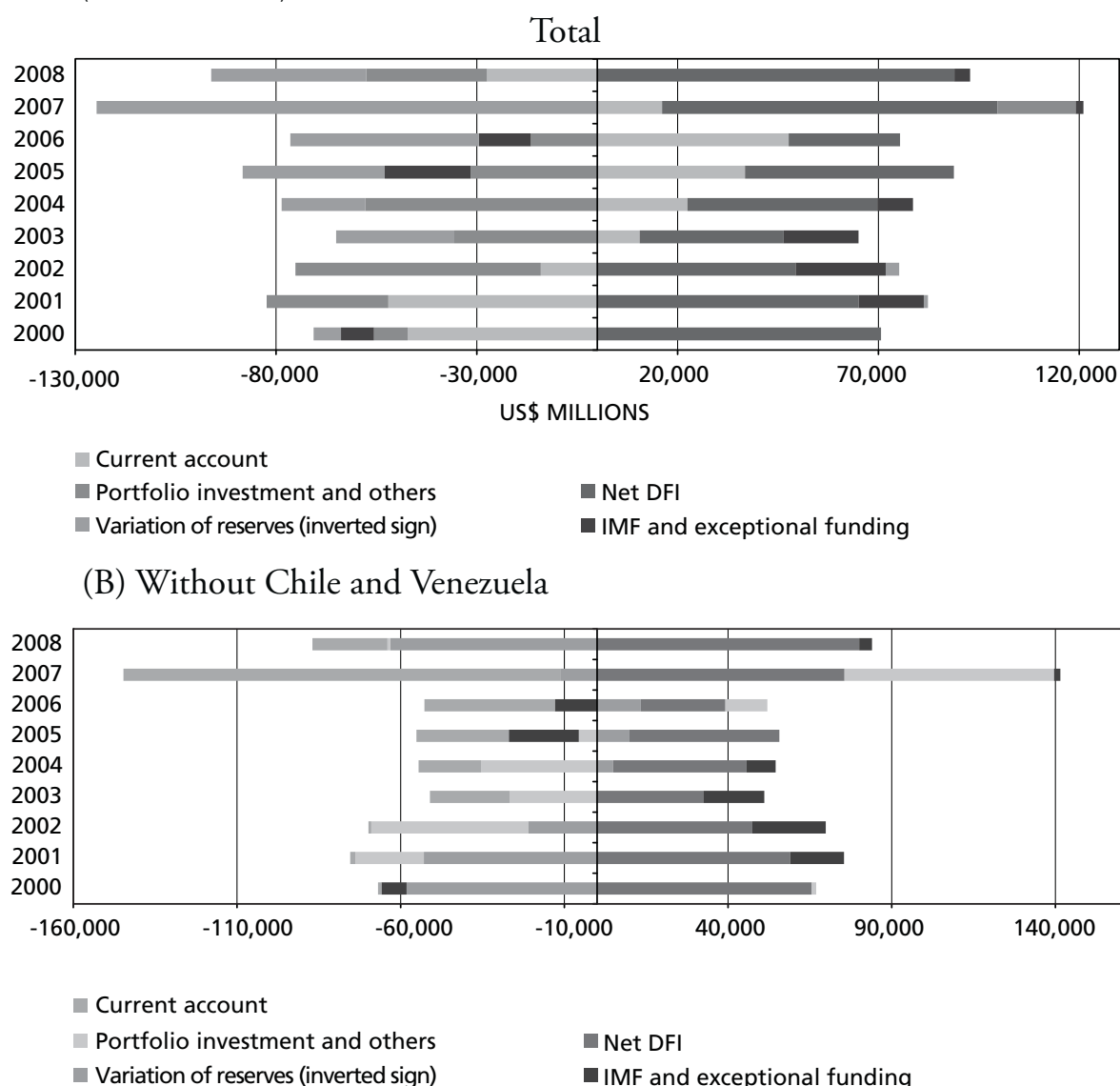
2.3 External vulnerability

Latin America recorded a surplus in its basic balance in the last six years, on average accounting for 2.7% of GDP, as a result of the positive balance on current account (0.7%) and the net inflow of foreign direct investment (FDI) (1.9%). As a result, many countries in the region strengthened their net external position, either by reducing foreign liabilities or through an increase in reserve assets.

GRAPH 12

SOURCES AND USES OF BALANCE OF PAYMENTS OF LATIN AMERICA

(in millions of dollars)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

The FDI inflows grew by a rate of 14.6% a year over the past six years, reaching a record high in 2008 (123,308 million dollars). However, as noted in Graph 12 (a), the region as a whole registered a net outflow of financial capital (portfolio and other investment) over recent years, with the exception of 2007, due to the solid inflow of financial capital in Brazil. This net outflow of capital decreased and even reversed in 2006, if not considering Venezuela and Chile in the regional aggregate (Graph 12 (b)). In the first case, there was a significant net outflow of capital, in both the private and public sectors, coupled with the surplus from oil exports. While in Chile, the net outflow of capital is explained by the creation by the government of a stabilization fund abroad associated with copper prices.

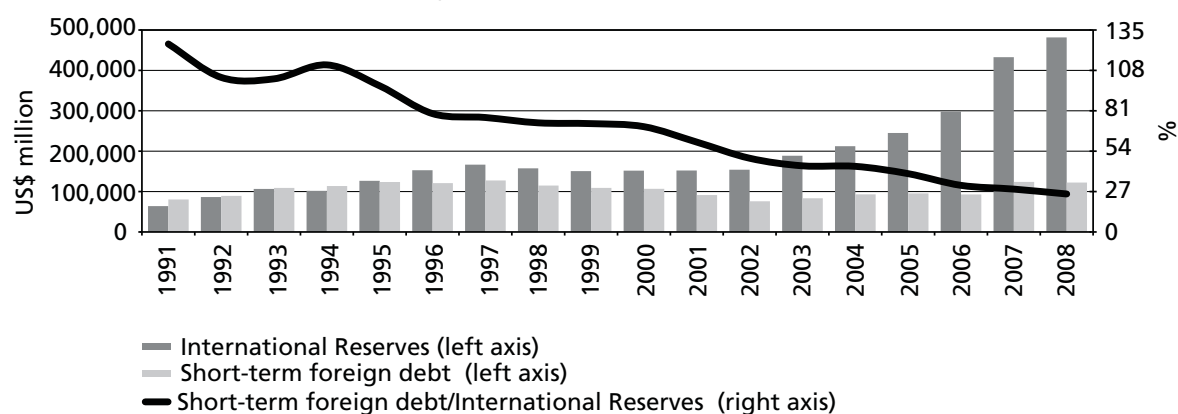
However, the total net outflow of capital in Latin America was much lower than the surplus recorded in the basic balance for the 2003-2008 period. This difference resulted in significant accumulation of international reserves, in a context where some central banks intervened in the currency exchange markets because of concerns regarding the level of real exchange rate. With the intervention in exchange markets, the stock of international reserves rose sharply in the last six years, serving as reinsurance against the subsequent international crisis (as discussed in Section. III)

The situation of external accounts in recent years favored a marked reduction in the external debt burden, both in relation to GDP and to exports.⁵ Although external debt remains high in some countries, the external debt to exports of goods and services ratio decreased to less than half the level recorded ten years ago when calculated on the basis of total debt, and to about one-third if calculated as net debt to international reserves. The increased liquidity and improved debt profile reduced vulnerability in the region, which is seen in the sharp decline in the ratio of short-term external debt to international reserves, from 49.3% in 2002 to less than 25.4% in 2008 (Graph 13). In addition to lower external debt ratios, vulnerability to external shocks has declined due to decreased dollarization in several economies in the region, especially South America (including Bolivia and Peru).

GRAPH 13

SHORT-TERM FOREIGN DEBT AND INTERNATIONAL RESERVES

(In millions of dollars and percentages)



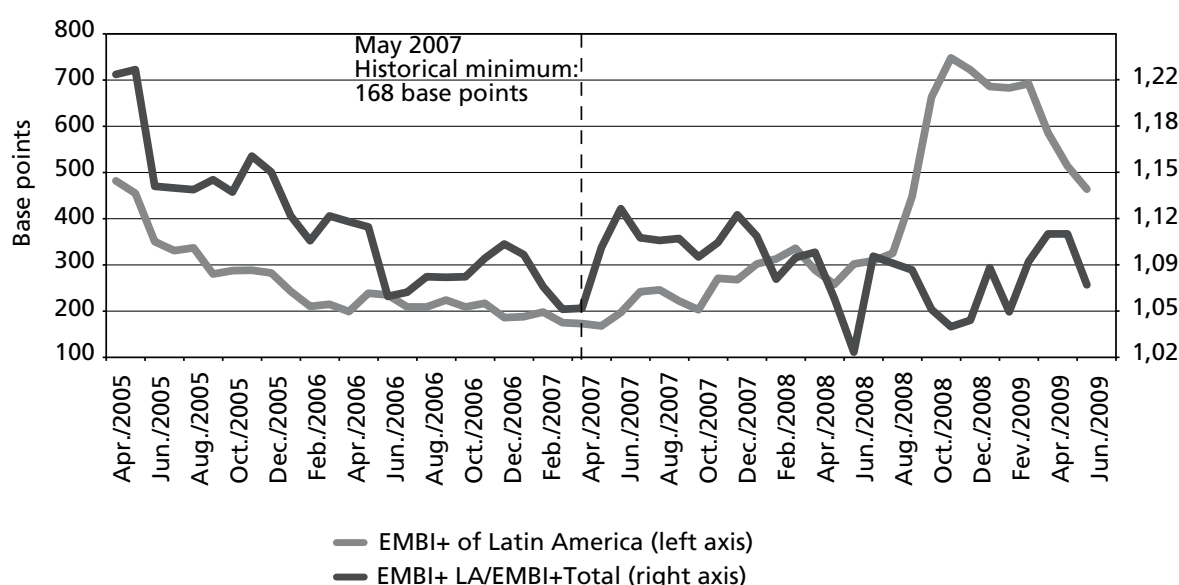
Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

The improved macroeconomic situation of Latin America during the 2003-2008 period reflected in the international financial markets, not only in the evolution of sovereign risk indicators but also in favorable debt ratings in several countries in the region. However, the international crisis that started in the U.S. mortgage market and quickly spread to all developed countries interrupted the

5. In both cases, attention should be drawn to the increase recorded in the variables of the denominator of these coefficients.

clear downward trend of sovereign risk in the region's countries. The increased volatility of international financial markets coincides with the deterioration of the subprime mortgage market in the United States in mid-2007. The EMBI+ of Latin America reached its historic low of 168 basis points at the end of May 2007 (only 17% of that recorded in late 2002), from which point it began to escalate. As shown in Graph 14, this rise increased Latin America's relative EMBI+ (as compared to emerging markets in general).⁶

GRAPH 14

EMBI+ OF LATIN AMERICA AND ITS RELATION TO TOTAL EMBI+

Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

2.4 The contribution of macroeconomic policy

2.4.1 Fiscal policy

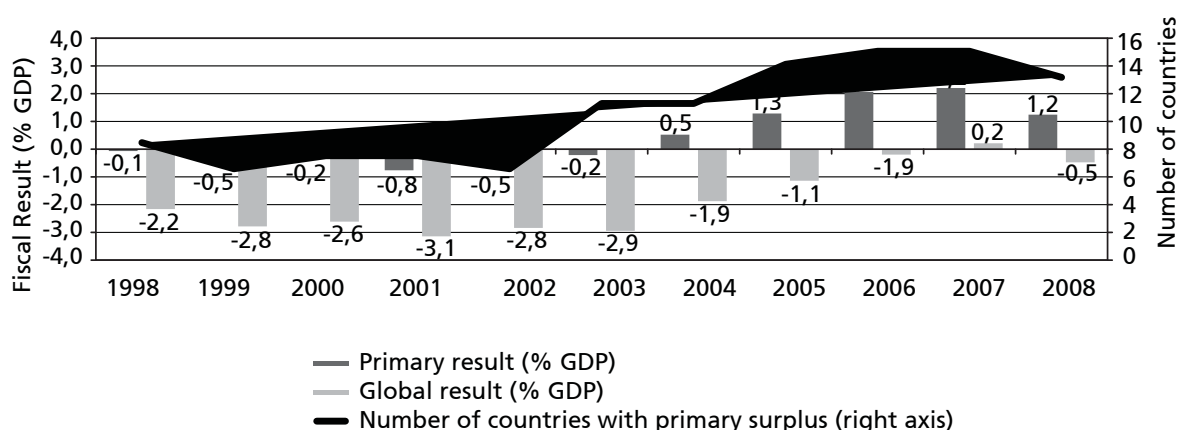
In recent years, central government fiscal accounts of Latin American countries showed a significant improvement both with regard to the overall deficit reduction and the primary surplus generated as of 2004, both calculated as a simple average (Graph 15). This average primary surplus reflects a general good performance of fiscal accounts of the countries in the region. Of the nineteen countries surveyed in 2008, 14 recorded a primary surplus (only Guatemala, Haiti and Honduras maintain a primary deficit), which contrasts significantly with 2002, when only seven countries had a surplus.

6. This increased relative risk of the region, however, is explained by the evolution in the price of bonds that took place in Argentina and Venezuela, even before the outbreak of the international crisis.

In turn, the positive evolution of fiscal accounts in a context of rapid economic growth allowed the reduction of public debt to GDP ratio, which at the regional level increased from an average of 58.4% in 2002 to 28% in 2008. In addition, countries in the region have taken advantage of macroeconomic conditions in recent years to implement active liability management policies that have helped reduce their financial vulnerability.

GRAPH 15

PRIMARY AND OVERALL RESULT OF CENTRAL GOVERNMENT AND NUMBER OF COUNTRIES WITH PRIMARY SURPLUS



Source: Prepared by authors, based on official figures.

The good performance of public accounts in the last six years differs from that occurred in other recent growth episodes, as shown in Graph 16 (a). During the 2002-2008 period, the primary surplus rose 1.8 points of GDP as a result of significant increase in total revenue equivalent to 3.4 percentage points of GDP, while spending increased 1.6 percentage points. On the other hand, in the two growth periods of the nineties (1991-94 and 1995-98), fiscal revenue did not grow as strongly and in both instances it was exceeded by the rise in primary spending in GDP terms, resulting in a worsening of the region's average primary surplus.

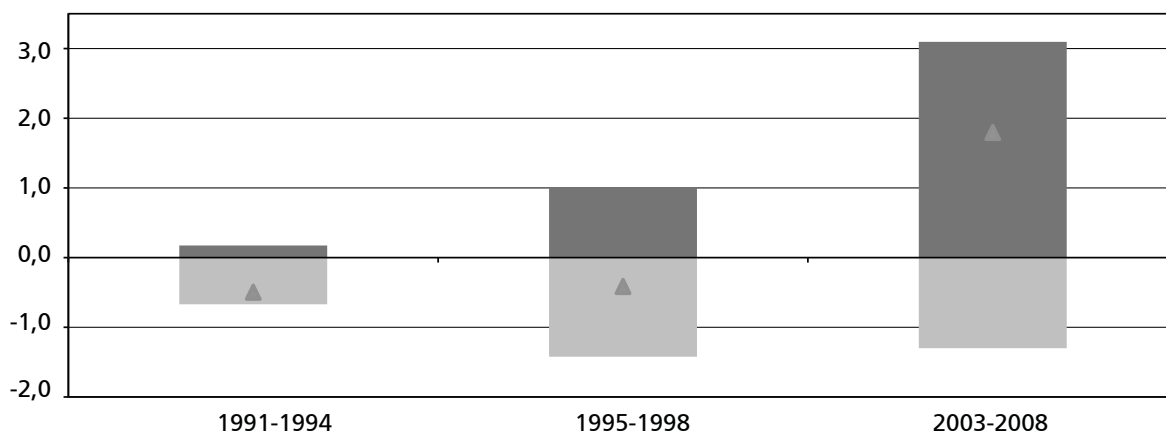
Attention should also be drawn to the evolution of the main fiscal indicators along the 2003-2008 expansion period. While the improved primary surplus in 2003 and 2004 corresponded to an increase in fiscal revenue, and at the same time expenses grew less than the region's product, in 2005 and 2006 the rise in the primary surplus corresponds to a significant increase in resources, which more than offset an increase in public spending in GDP terms (see Graph 16 (b)). Since 2007, primary spending has been accelerating while the rate of increase of total revenues in relation to the product has been dropping. This situation led to a deterioration of public accounts in 2007, which became worse in 2008.

GRAPH 16

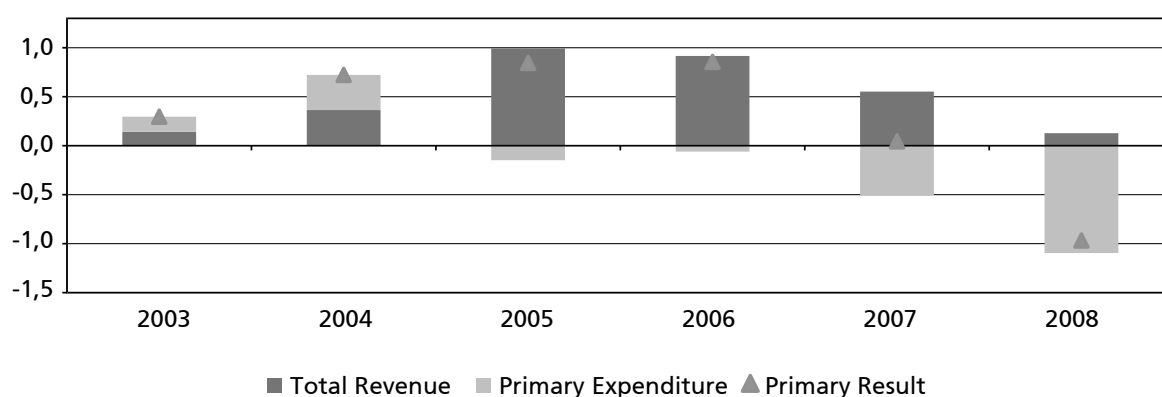
FISCAL INDICATORS: Evolution of primary result and contribution of income and spending

(Variations in GDP points)

(A) Comparison of periods: 1991-1994, 1995-1998 and 2003-2008



(B) 2003-2008

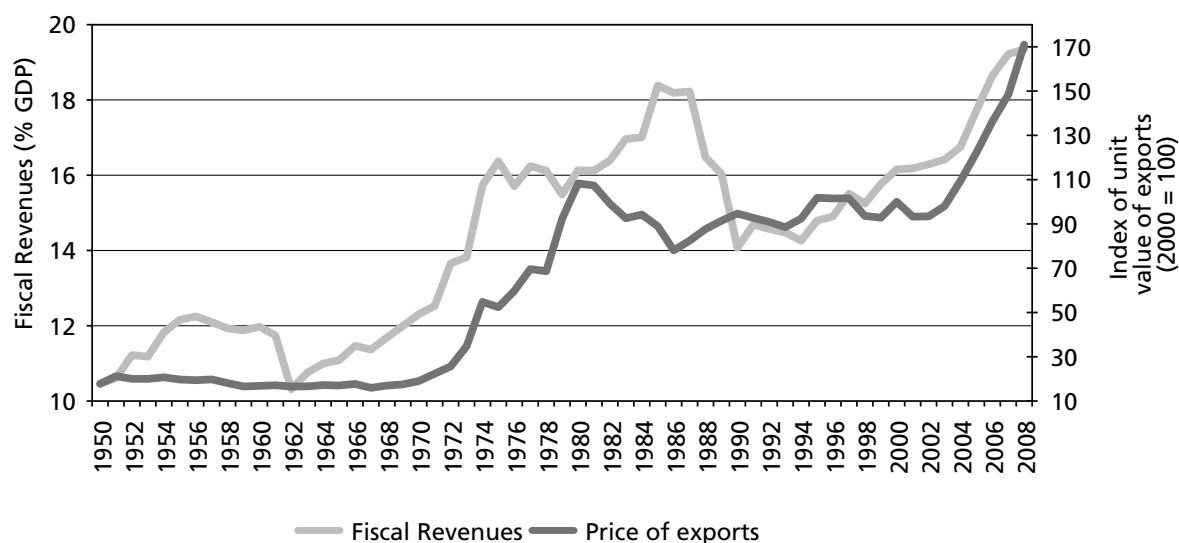


Source: Prepared by the authors, based on official figures.

As follows from the above analysis, the increasing fiscal revenue, coupled with a more controlled spending policy during the 2003-2006 period, accounts for much of the improvement in the primary surplus in GDP terms during the period of growth. The countries with more growth of fiscal revenues are those that recorded the highest increase in the prices of their export products. As shown in Graph 17, due to the region's high specialization and high proportion of commodity exports, fiscal revenues are very sensitive to changes in export prices⁷.

7. For an analysis of the impact of changes in export prices on tax revenues, see Jiménez and Tromben (2006).

GRAPH 17

LATIN AMERICA: FISCAL REVENUE AND PRICE OF EXPORTS

Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

Within fiscal revenues, tax revenues which, together with social security contributions, represent on average more than 80% of fiscal revenues (with differences between countries) grew steadily in terms of GDP until 2007, reaching the highest levels of the series. The item that increased most was general tax on goods and services, reflecting the fact that the tax structure has concentrated more on such taxes, emphasizing the regressive bias that characterizes the tax structure of Latin American countries.

The effects of the boom experienced by the region with regard to fiscal indicators depend on the origin of the extraordinary resources received by countries. In Central America, the national income increased primarily due to remittances from migrant workers received by the private sector. However, in almost all countries in South America and Mexico, most of the improvement is due to the effects of terms of trade, although Mexico is the largest recipient of remittances in absolute amounts. In countries where exports are carried out largely by state enterprises, a high proportion of the resources generated by improved terms of trade was received by the public sector. Generally, this is the case with oil exports and certain metals, including copper. When exports are carried out by public companies, resources are channeled to private companies and the state receives only a share of them through taxes.

Regarding the fiscal impact of rising remittances and export prices, it is possible to identify three situations with different impacts on public accounts. Remittances and better export prices when production is private have positive impacts on public accounts through increased tax revenues, directly in the case of higher prices of exports (by means taxes on benefits or exports) and indirectly

through the impact of increased remittances and rising export prices on domestic demand. An important difference is that remittances tend to increase consumption, while private companies can invest some of the benefits or increase profits sent abroad.

When it comes to state enterprises that produce and export, the impact on fiscal revenues is greater, while the impact on demand will depend on the public policy decisions to either save the surplus or increase spending. This choice confers to fiscal policy a greater stabilizing capacity and the ability to channel resources to higher investment spending, whether in infrastructure or human capital.

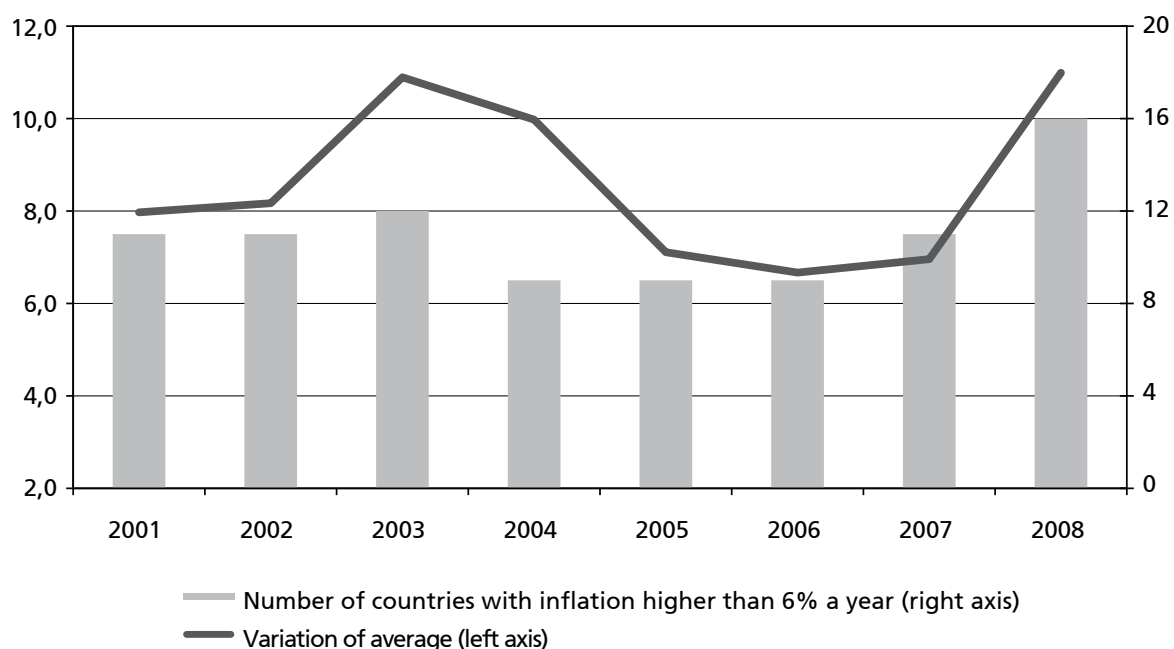
On the other hand, as mentioned earlier, the evolution of fiscal indicators in the past two years shows a marked acceleration of the primary spending to GDP ratio. While in 2007 capital expenditure accounted for a greater share in the increase in expenditures, in 2008 current primary expenditures grew more than capital spending. This increase in primary spending can be analyzed as the result of the considerable drop in public spending during the stabilization programs launched in the beginning of the decade, as well as increased social spending, following an upward trend that began in the early nineties⁸. From this perspective, the increase in social spending may be considered appropriate and even necessary, given the high levels of poverty and inequality. Moreover, unlike in the past, increased spending in recent years occurred in a context of fiscal consolidation that, with varying degrees according to the country, has been widespread in the region. This consolidation, as pointed out, is explained largely by the surge in fiscal revenues and is reflected in lower fiscal deficit and the generation of increasing primary surpluses, at least until 2007.

2.4.2 Monetary and exchange rate policy

In general, an element that characterized most of the period of growth in Latin America was the expectations of increase in inflation resulting from the sustained expansion of activity levels and the in commodity prices, particularly energy and some food products. After a slowdown of the region's average levels during the 2003-2006 period, inflation accelerated in 2007 until reaching double digits in 2008 (see Graph 18).

8. Social spending, following the sharp decline in the eighties, increased 40% in real terms between 1991-1992 and 2002-2003.

GRAPH 18

LATIN AMERICA AND THE CARIBBEAN: SIMPLE AVERAGE INFLATION AND NUMBER OF COUNTRIES WITH RATES HIGHER THAN 6% A YEAR

Source: Prepared by the authors, based on United Nations and International Monetary Fund databases.

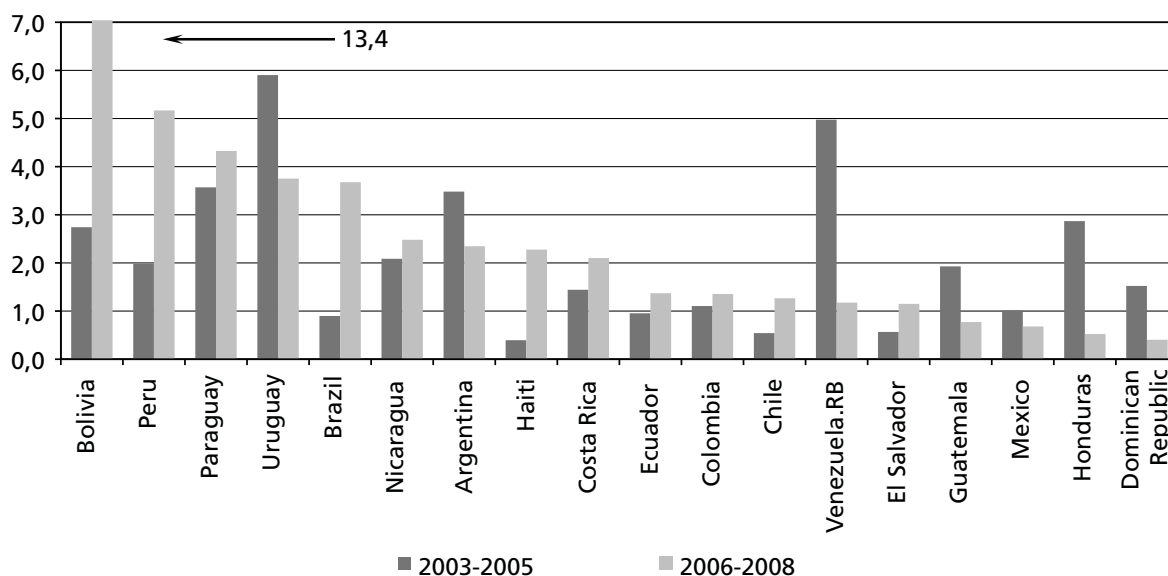
Between 2004 and 2006, nine countries out of nineteen had inflation rates above 6% a year, while in 2008 sixteen countries exceeded this benchmark. This rise in prices is not a phenomenon unique to Latin America; it took place in a context of increased global inflation fueled by the same causes as those found in the region: greater activity and commodity price increases.

In turn, after an initial period of sharp depreciation in the real exchange rate of the region's countries, in recent years there was an appreciation of the real exchange rate, particularly in South American countries. This situation prompted many central banks in the region to increase the level of intervention in currency markets, accumulating large amounts of international reserves (Graph 19).

GRAPH 19

VARIATION OF AVERAGE INTERNATIONAL RESERVES IN 2003-2005 AND 2006-2008.

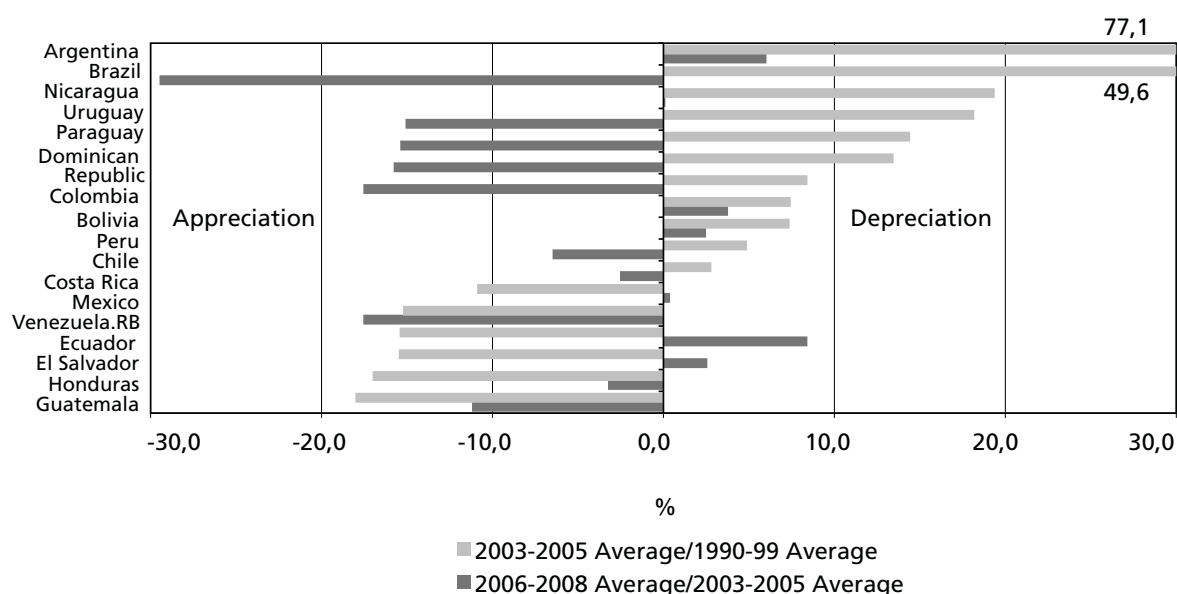
(In percentage of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

Alongside the pursuit of policies based on inflation targets in Brazil, Colombia and Peru, monetary authorities were concerned about the level of real exchange rate, which led them to intervene in currency markets. Also in Chile, the Central Bank decided to intervene in the market in April 2008 with the aim of strengthening the liquidity position of the Chilean economy against the expectation of a deteriorating external environment. This was seen as consistent with the assessment that the type of real exchange rate in Chile was below its long-term level. On the other hand, extensive interventions in currency markets were also observed in Argentina, Bolivia, Costa Rica and Paraguay. If the increase in reserves in recent years is added to the increase recorded during the initial 2003-2005 phase, the total accumulation of six years of reserve assets exceeded US\$327.5 billion in the region, equivalent to 11.3% of average GDP.

GRAPH 20
REAL EFFECTIVE EXCHANGE RATE



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

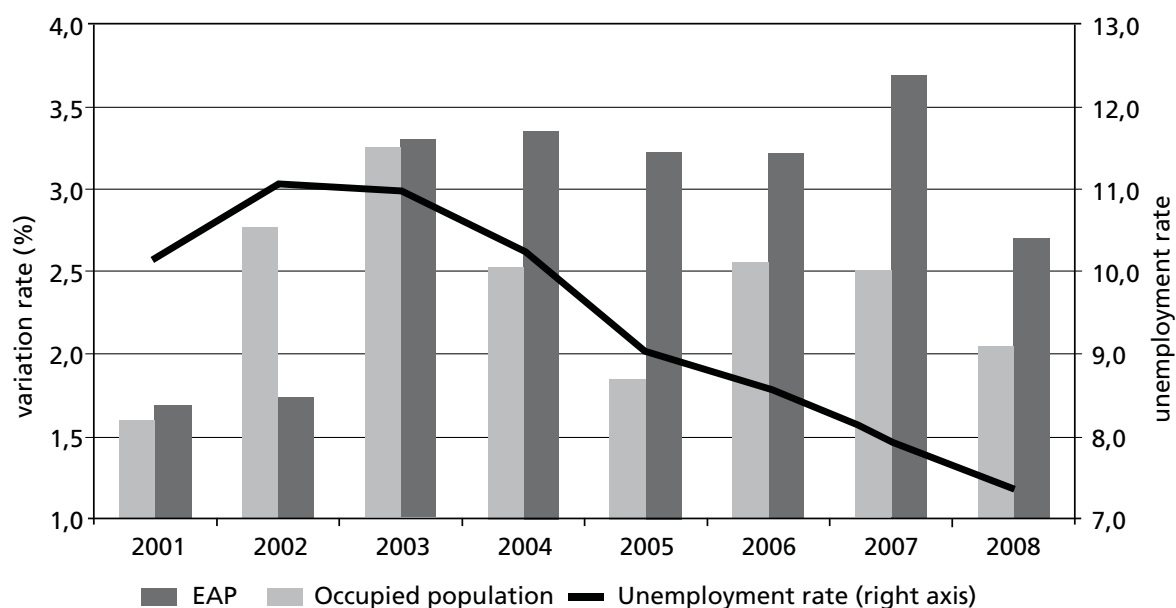
Despite the efforts by central banks, when the dollar was depreciating in relation to other currencies, there was an appreciation of the region's real effective exchange rate as compared to their 2003-2005 average in most countries of the region (see Graph 20). Improved terms of trade, increased demand for certain products exported by the region and increased resources from migrant workers' remittances constitute a set of factors behind this downward trend of real exchange rates. To a lesser extent, unlike in the nineties, the effect of increased external liquidity may be added. In short, excess supply in the foreign exchange market led to decreased exchange rates in the region in recent years, with varying intensity from one country to another, and regardless of the efforts of monetary authorities to intervene in currency markets to support parity.

The counterpart of the intervention in exchange markets has been a growing effort to sterilize monetary issuance in a context marked by increasing inflation expectations. The region's countries have been adopting absorption policies through open market operations, incurring costs of various types with different results. To mention just a few examples, Brazil's central bank intervened by purchasing foreign currency to maintain the exchange rate, paying a high cost in terms of interest rate of the absorption instruments, with a view to protecting its monetary program, but as we have seen, these efforts did not prevent the Real's appreciation. Something similar happened in Colombia. By contrast, Argentina's central bank has also bought foreign currency, with a better outcome in terms of exchange rate stability, but high cost in terms of capacity to manage the monetary policy. The common element in all three cases is that the costs associated with the strategy of intervention in the foreign exchange market (and the outcome thereof) were strongly influenced by the general economic policy, which included characteristics that contradicted the decision to maintain the real exchange rate.

2.5 Labor market and social indicators

Economic growth resulted in an increase in labor demand with significant generation of formal employment. Thus, after 2003 the employment rate began to recover, accumulating an increase of 3 percentage points until 2008, which corresponds to an increase in the number of employed workers of 3.3% a year on average for the 2003-2008 period, despite a sharp slowdown in the last year (see Graph 21). At the same time, the unemployment rate in the region as a whole declined from a peak of 11% in 2002 and 2003 to 7.4% in 2008. Thus, the unemployment rate returned to the levels of the early nineties, while real wages in the formal sector, because of the high levels of unemployment, showed moderate increases below the growth in labor productivity.

GRAPH 21

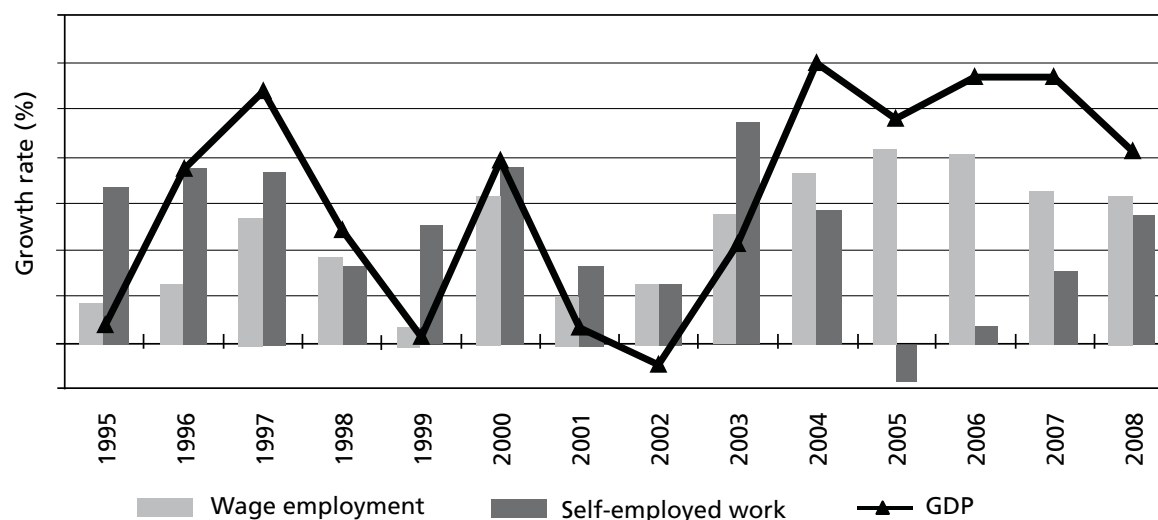
LATIN AMERICA AND THE CARIBBEAN: THE EVOLUTION OF THE ECONOMICALLY ACTIVE POPULATION, OCCUPATION AND UNEMPLOYMENT RATE

Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

Since the beginning of this decade, the urban economically active population has expanded at a pace of 2.4% a year. During the first years, the number of employed workers grew by less than 2%, resulting in a sharp increase in unemployment in 2002. However, economic growth led to accelerated growth of employment, causing a drop of the unemployment rate. The supply of labor has been growing in recent decades, due to the sharp increase in the participation of women, both in urban and rural areas where it was traditionally low⁹.

9. At the regional level, there has generally been a pro-cyclical behavior of the participation rate. By comparing the cyclical component of the participation rate and the product in different countries of the region, procyclical behavior of the participation rate was found in Argentina, Brazil and Uruguay, acyclic behavior was found in Chile, Costa Rica, Mexico and Peru, while in Colombia and Venezuela behavior was counter-cyclical. These results are obtained from regressions performed by the OLS method over the logarithms of the participation rate and GDP, both filtered by Hodrick-Prescott, to obtain the cyclical component of both series, in the period from 1985 to 2006 [Machinea and others (2008)]

GRAPH 22
ECONOMIC GROWTH AND EMPLOYMENT GENERATION, 1995-2008



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

As of 2003, employment generation accelerated alongside the growth of the economy and, in particular during the 2005-2007 period, the expansion of informal employment slowed down, in a context of rates of economic growth and generation of formal jobs unprecedented in the region as a whole, taking into account the past 25 years¹⁰. It should be noted that while there was an acceleration of informal employment in 2008, its growth rate was still lower than that of formal employment, a fact that characterized five of the six years of economic expansion.

Economic growth and improvement in labor indicators that accompanied the 2003-2008 expansion period had a positive impact in reducing poverty. In the beginning of this decade, 44% of the population of Latin America was considered poor, i.e., did not have the necessary income to meet their basic needs. Within this group, 19.4% of the population were extremely poor, i.e., could not even meet their need for food. With the sustained growth and improvement in the labor market of the last six years, poverty and extreme poverty rates of the beginning of the decade dropped 10.4 and 6.4 percentage points respectively (see Graph 23)¹¹. In 2006, for the first time, the levels of poverty and extreme poverty in relation to the population were lower than those recorded in the early eighties. However, in absolute terms, they were higher due to population growth.

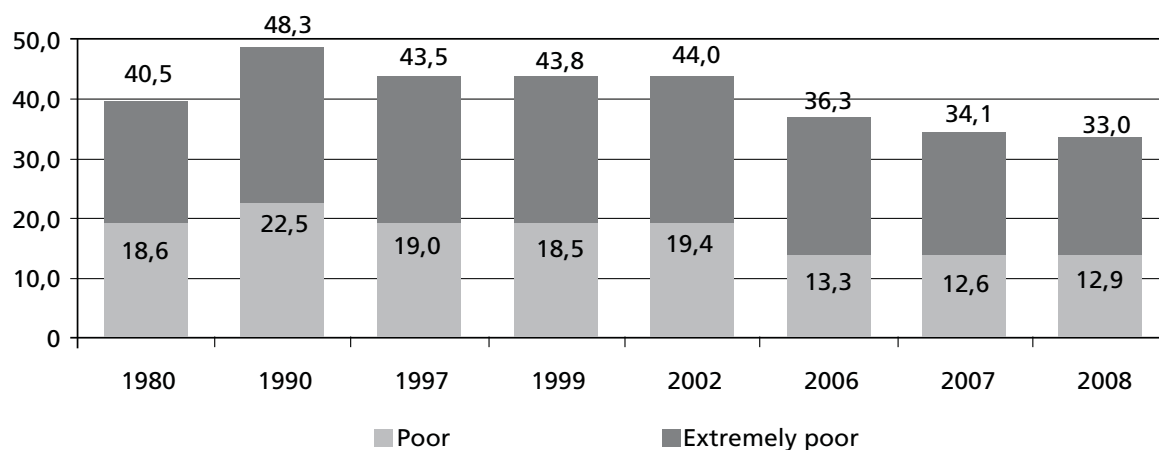
10. This shows that much of the increase in informality observed in the nineties is not due to a preference for this type of employment, but a forced option in face of the weak demand for labor of formal sector enterprises.

11. In 2008 there was a slight increase in poverty, although poverty continued to fall. This divergence is due to the significant increase in food prices recorded in the first half of 2008.

GRAPH 23

LATIN AMERICA: POVERTY AND EXTREME POVERTY

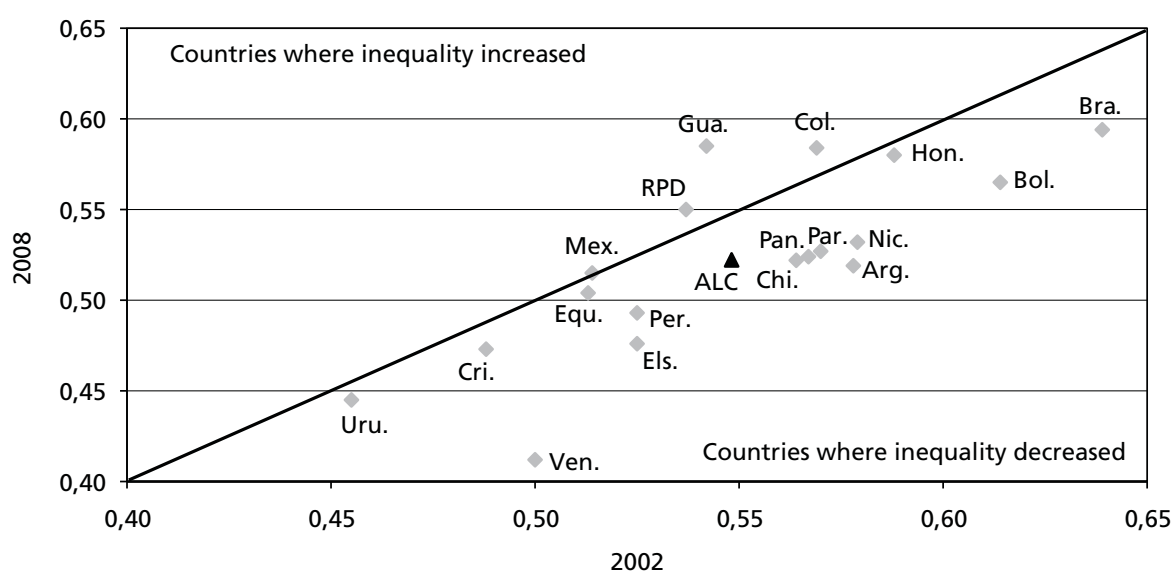
(Percentage of population)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

During the 2003-2008 growth period, not only did poverty and extreme poverty drop in Latin American countries, but there was also an improvement in income distribution in the region. As shown in Graph 24, inequality indicators for 2007, the lowest since the early nineties, revealed better income distribution in most of the countries of the region as compared to 2002.

GRAPH 24

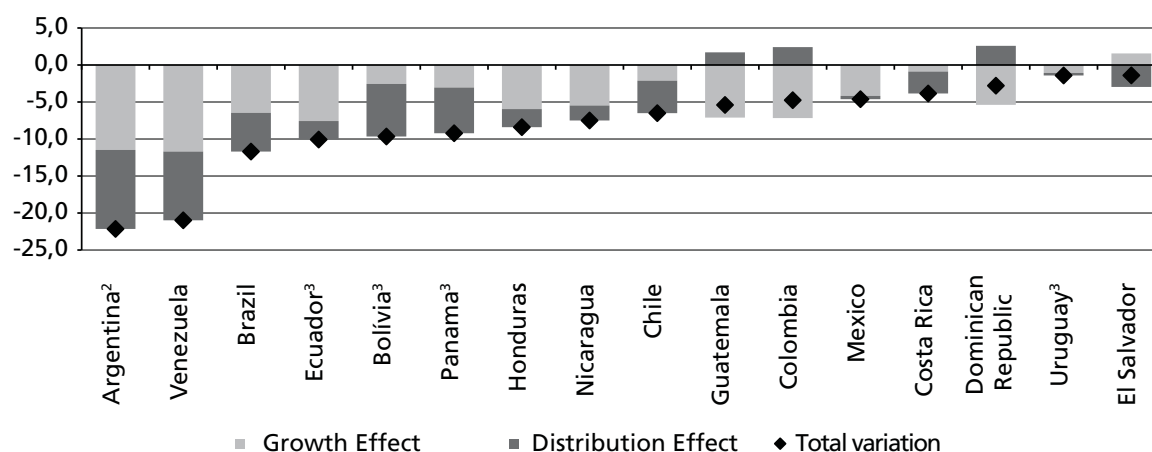
EVOLUTION OF INCOME DISTRIBUTION MEASURED BY THE GINI INDEX: 2007 vs. 2002

Source: Economic Commission for Latin America and the Caribbean (ECLAC).

The main cause behind the reduced rates of poverty and extreme poverty between 2002 and 2007 is the increase in average household income, although in almost all cases this effect was strengthened by improvements

in income distribution.^{12, 13} In turn, in the cases of Colombia, Guatemala and the Dominican Republic, the increase in inequality during the period tended to increase poverty, although this effect was more than offset by stronger growth in household income. On the other hand, in 9 countries of the region both effects simultaneously contributed to the decline in poverty, although with different intensity (see Graph 25). Interestingly, the increase in average income in lower income households can be explained largely by the improvement of their labor income when compared with other non-labor sources (public and private transfers, income from capital and other incomes). Of the seven countries where poverty dropped more sharply (Argentina, Brazil, Chile, Ecuador, Mexico, Panama and Venezuela) the increase of labor income on average accounts for 77% of the increase in total income of poor households and 69% of the income of extremely poor households. This phenomenon took place in the context of general quantitative and qualitative improvement in labor indicators in the region, analyzed previously.

GRAPH 25
"GROWTH" AND "DISTRIBUTION" EFFECTS OF CHANGES IN THE POVERTY RATE,
2002 - 2008¹



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of surveys of households in their respective countries

Notes: ¹ In some countries, it corresponds to the last available estimate.

² Metropolitan areas.

³ Urban areas

12. See ECLAC (2008).

13. This analysis is based on the Datt-Ravallion (1992) breakdown of variations in poverty and extreme poverty rates, averaging the effects calculated with different base years (as suggested by Kakwani (1997)) to prevent residue and dependence on a base year. For further details on the methodology, see ECLAC (2008, Box I.7)

3 THE IMPACT OF THE CRISIS ON LATIN AMERICAN MACROECONOMICS¹⁴

The global economic crisis marked the end of the longest and most intense phase of regional economic growth since the seventies. As mentioned in the previous section, this growth took place in the context of widespread international economic expansion, whose heyday spanned from 2003 to mid 2007, when the problems in the high risk mortgage segment of the United States began to spread. The impact reflected in the financial systems around the world and significantly affected the goods and labor markets, even more strongly since September 2008. Thus, an unusually severe global economic downturn gradually formed, which, given the similarities, has even been compared with the thirties Great Depression.

Indeed, there is more than one element in common: both started in the U.S. financial system and from there spread to other regions and sectors, and both were the result a bubble in asset prices leading to a problem of solvency in the financial system. This time, however, the size of the financial system and the international interconnections were much greater, and the degree of opacity of the financial system reached unprecedented levels.

On the other hand, this time the economic policy response was faster and more accurate. The thirties crisis left the lesson that it is necessary to limit the impact of the crisis as quickly as possible and implement expansionary fiscal and monetary policies to avoid the risk of an economic depression. That is what countries have generally been doing since 2008, despite huge differences determined by the different capacities and particularities of each case. Another major difference in relation to the thirties is that currently there are several instances of international coordination, both regionally and multilaterally, many of which were created after the Great Depression and World War II, while others were more recently established, such as the Group of Twenty (G20). Even with their limitations, these institutions have some capacity to support the policies that countries are implementing in isolation and to avoid, or at least limit, predatory practices - through trade policies or exchange rate policies - that can damage international trade, which has already been sufficiently hit by the crisis.

For the reasons stated in the previous paragraph, this episode was limited to a sharp and severe economic contraction, but for the global economy it did not reach the intensity of the Great Depression, in terms of levels of unemployment, contractual default, and underutilization of productive resources.

The financial crisis moved quickly to real variables and was internationalized mainly because of four factors¹⁵:

14. This section is based on Kacef (2009).

15. On the analysis of the international crisis from a Latin American perspective, see Machinea (2009) and Lopes (2008).

- The credit crunch resulting from the weakness of the financial system led banks to require greater liquidity, given the uncertainty regarding renewal of their liabilities and the need to rebuild their capital, on one hand, and doubts about the creditworthiness of potential borrowers, on the other.
- The destruction of both financial and non-financial wealth resulting from the depreciation of real estate, stocks, and other assets.
- The deterioration of expectations on the evolution of economic activity, which affected the decisions of household consumption and business investments.
- The decrease in world trade, which reached 21% in volume and 38% in value between July 2008 and January 2009, even though the decline began to reverse in the first half of 2009.

3.1 The crisis' transmission channels

One characteristic that distinguishes this crisis from previous ones relates to the transmission channels through which it affected the economies of Latin America. Unlike similar events, the strongest impacts have taken place through real channels. As further discussed below, export volumes and prices, remittances and other items directly linked to economic activity, together with the deterioration of consumer and producer expectations, were the factors that explain the sudden halt of growth observed in the fourth quarter of 2008.

Indeed, only three countries (Brazil, Chile and Peru) showed signs of a sudden stop in capital flows associated with the effects of the crisis.¹⁶ As shown in Graph 26, these are the three countries in the region whose financial systems remain at a net debtor position of greater relative scale.¹⁷ Meanwhile, in seven cases analyzed (Argentina, Brazil, Chile, Ecuador, Mexico, Peru and Venezuela), information suggests the existence of commercial turbulence due to reduction in exports considerably higher than would have been typical in a common cyclical movement. These disturbances, however, are largely related to the behavior of commodity prices, as they cannot be dissociated - in origin and effects - from a shock of a financial nature.

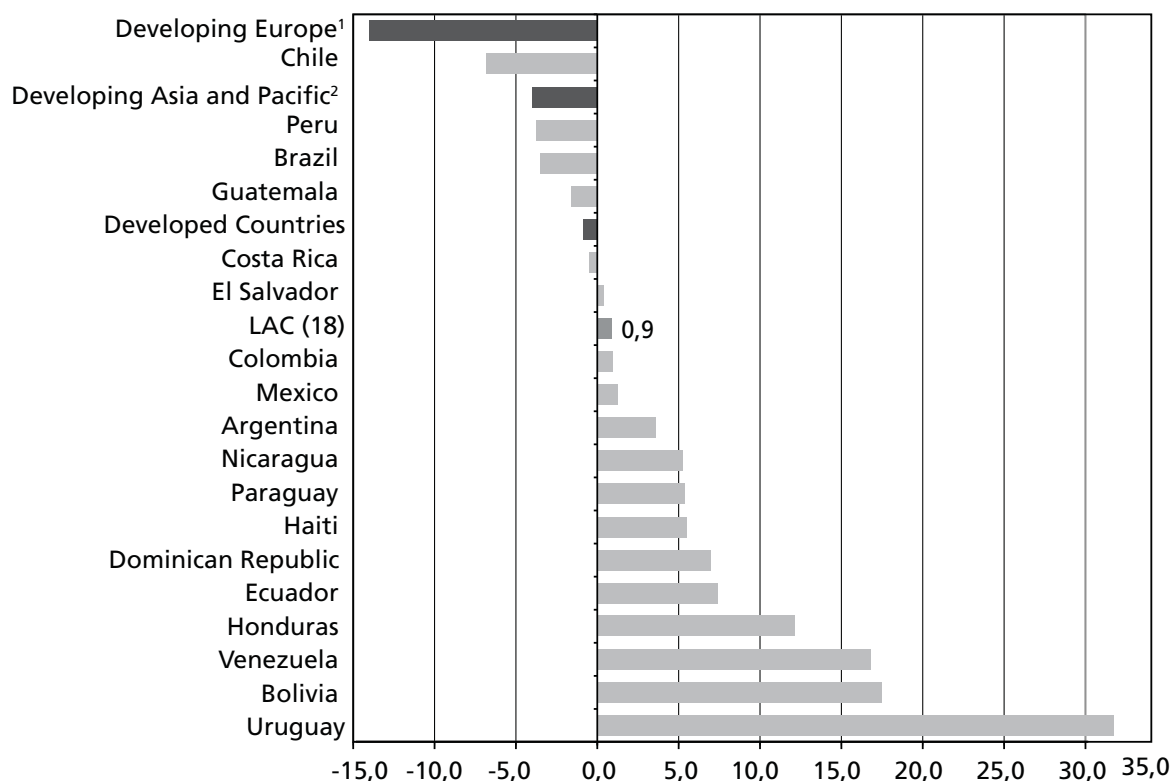
16. In order to estimate these effects, two different methodologies were used. The first focused on the reversal of Latin American countries' exports as a result of changes in global demand. This exercise used the deviation of the series of exports with seasonally adjusted long-term trend, calculated through the Hodrick-Prescott filter. Trade reversion was defined as any reduction of over one and a half standard deviation of exports. The second methodology was applied to episodes that markedly reduce capital flows. This series includes seasonally adjusted investment flows obtained from the difference between accumulation of reserves and basic balance. An episode of decline in capital flow is considered to occur when investment flows suffer a reversion of more than one and a half standard deviation as compared to the average for the whole period.

17. The fact that these countries maintain a net debtor position in foreign markets does not imply a negative assessment of their financial systems. On the contrary, this may be due to the fact that their markets are more developed and involve a larger scale of operations, which requires institutions to use international financial markets. In addition, it should be clarified that Chile shows a reversal of capital flows when the analysis discounts public sector flows. In the case of Venezuela, it is possible to identify a reversal of the capital account of balance of payments in the first quarter of 2009, but also during some moments in 2008, prior to the worsening of the crisis, so it cannot be associated to it.

GRAPH 26

NET EXTERNAL POSITION OF THE FINANCIAL SYSTEM, December 2008

(In % of GDP)



Source: Prepared by the authors, based on figures by BIS and ECLAC

3.1.1 The financial channel.

The fact that Latin American countries have reduced their debt levels and accumulated international reserves (see Section II.3) helps explain why, unlike other times, the region has not been hit by a financial crisis. Another important element in this regard is that the degree of external exposure of the region's financial systems is relatively low, so that the maintenance of domestic credit is not as sensitive to external conditions, especially when compared to other emerging economies.

Major difficulties in access to external credit were observed in the last quarter of 2008. In response, as discussed in the next section, central banks of several countries in the region took steps to ensure liquidity in domestic and foreign currencies to support their banks, and the United States' Federal Reserve established agreements with the central banks of Brazil and Mexico with the same purpose.¹⁸ Furthermore, the placements of corporate and sovereign bonds by countries in the region in world markets disappeared completely during the increase in risk premiums, as shown in Graph 27. These factors led to a reduction in international reserves in the region between late 2008 and early 2009. However, as of the second quarter, the reserves resumed growth until reaching a new historical high of over 530 billion dollars.

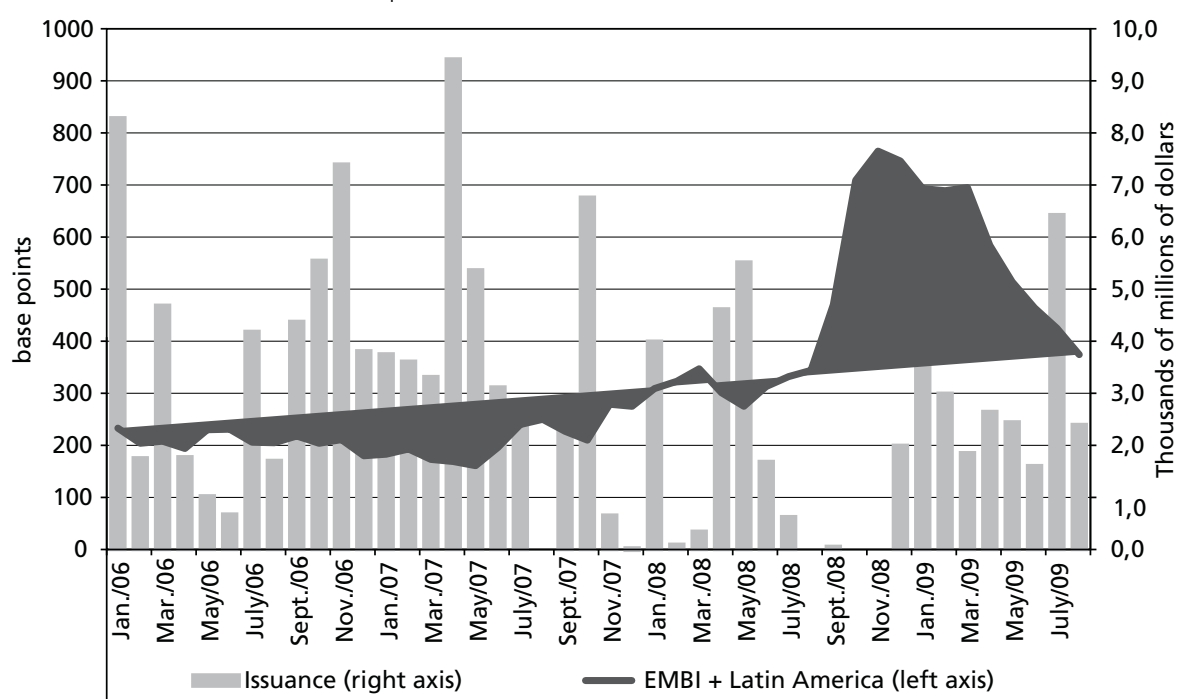
18. See ECLAC (2009b).

During the first months of 2009, the setting for the operation of financial markets began to change slowly. The programs implemented in the United States and, to a lesser extent, in Europe contributed to strengthen the expectation that, except for isolated cases, everything would be done to avoid bankruptcy of institutions with systemic reach. Similarly, the monetary policy in several developed countries aimed at restoring liquidity, reducing interest rates to near-zero levels, while seeking to restore the credit flow, with the offer of certain collaterals for interbank lending. This contributed for the perception of risk regarding emerging countries to begin to decline gradually, even though it remained at levels higher than during the three previous years and allowed countries in the region to re-access international capital markets, thus resuming the placement of sovereign and corporate bonds.¹⁹

GRAPH 27

LATIN AMERICA: PLACEMENT OF SOVEREIGN AND CORPORATE BONDS IN GLOBAL MARKETS

(In billions of dollars and base points)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures

3.1.2 The real channel

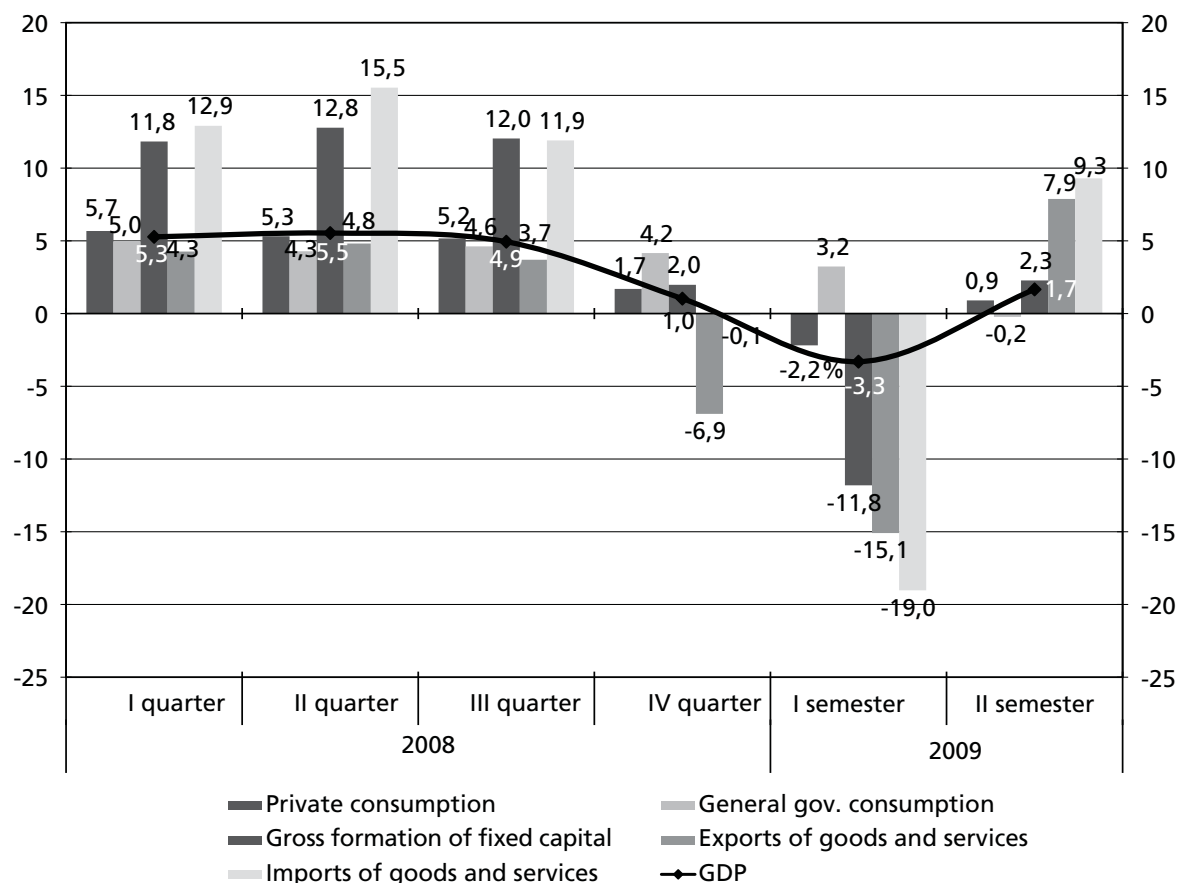
The impact was strongest in the trade transmission channel. On the one hand, there was a substantial reduction in export volumes of real goods and services, as shown in Graph 28, exceeding 15% in early 2009, although estimates show marked recovery in the second semester.

19. It should be noted that even at the peak of the crisis (September-October 2008), the increase in risk premiums implicit in sovereign debt yields was significantly lower than that found in other crises.

GRAPH 28

LATIN AMERICA: INTERANNUAL PERCENTAGE VARIATION IN AGGREGATE DEMAND, 2008-2009

(In constant 2000 U.S. dollars)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures

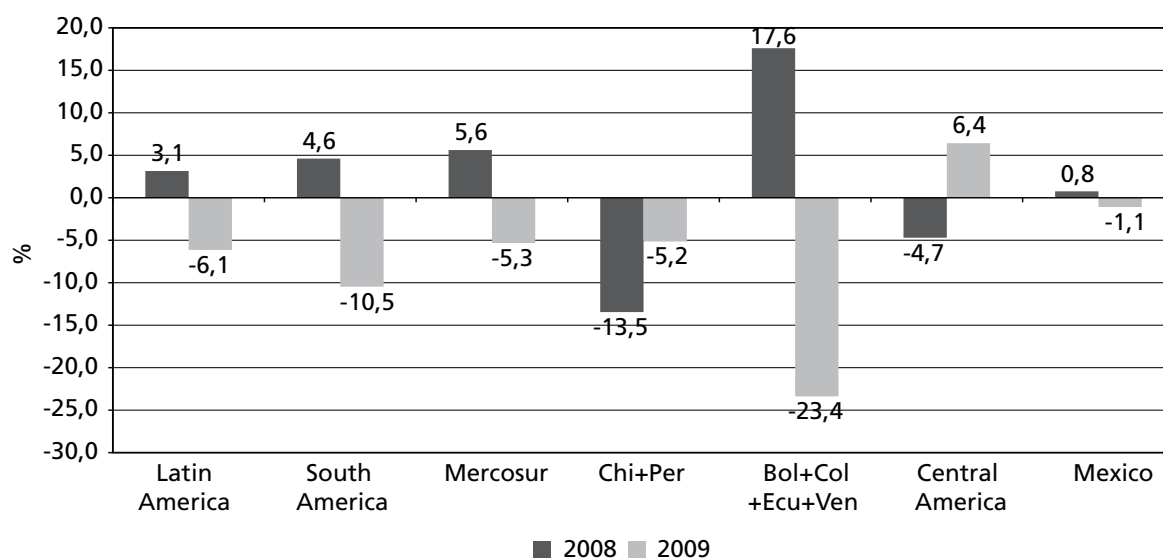
Moreover, the global recession and declining international trade adversely affected commodity prices, which decreased significantly from the high levels observed early 2008 impacting the evolution of regional terms of trade (Graph 29). Although this negative trend was partly reversed in the last months of the year, it is estimated that the drop in terms of trade for Latin America was of 6% in 2009, after rising 37% from the average in the nineties to 2008.

In addition to the international repercussions of the U.S. crisis throughout financial and foreign trade markets, there were other relevant factors, although more difficult to quantify, such as the destruction of wealth resulting from falling asset prices (financial and property) and the effects of deteriorating expectations of families and businesses in the demand for goods and services. These factors are especially important in countries with larger domestic markets that have greater weight in economic activity, and have led to reductions in investment and significant deceleration in private consumption. Conversely, as shown in Graph 28, public consumption shows greater growth, a fact that may be related to active fiscal policies which will be discussed further on.

GRAPH 29

ESTIMATED VARIATION OF TERMS OF TRADE, 2008-2009

(In %)

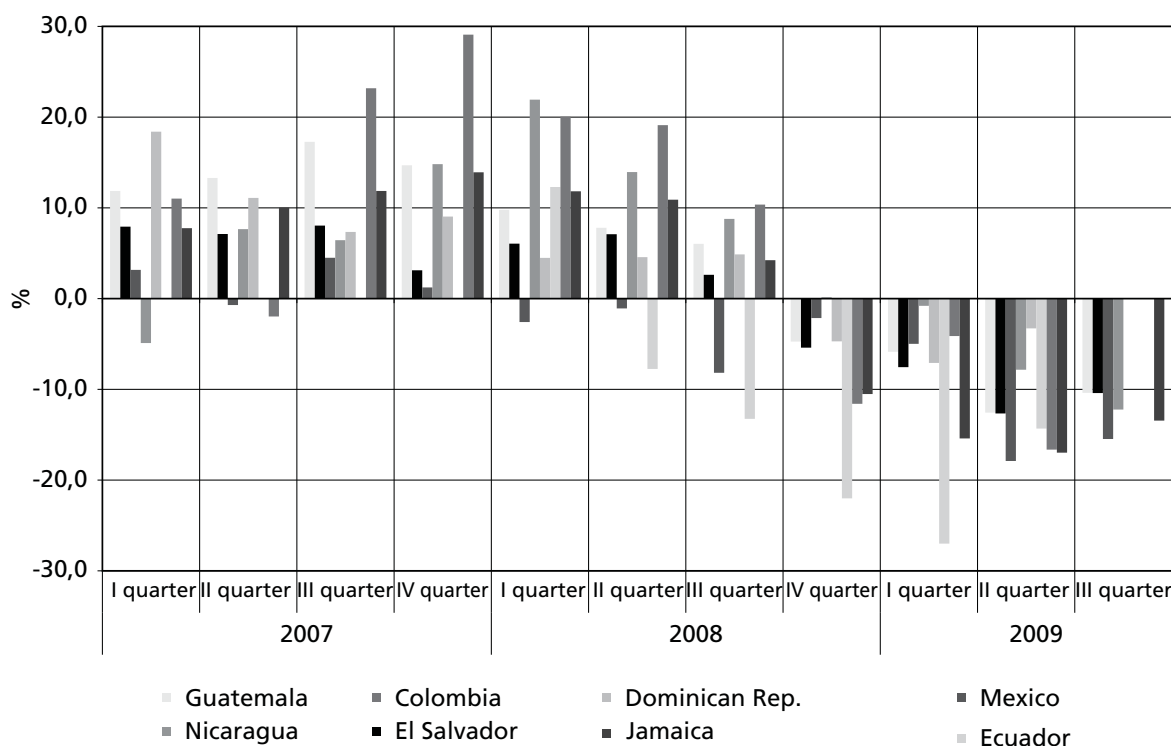


Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures

GRAPH 30

LATIN AMERICA (8 COUNTRIES): INTERANNUAL VARIATION OF REMITTANCES

(In millions of dollars and percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures

In some countries, the evolution of private consumption has also been affected by reduced remittances from migrants (Graph 30). Reductions started as of the third quarter of 2008, worsened in the first quarter of 2009, and tended to ease up towards the end of the year.

In turn, the reduction of foreign direct investment flows also reduced investment, which showed an estimated decline between 35% to 45% for 2009.²⁰ This had especially relevant effects in Central American countries, where these flows have a considerable weight in terms of GDP, even though they are not the main recipients.

3.2 The macroeconomic and political space to tackle the crisis

Although there are differences from one country to another, a change in macroeconomic behavior in the region has been observed in recent years, in contrast with previous episodes of boom, as discussed in detail in Section II. In the period before the crisis, increases in saving rates were promoted in the region, resulting in less reliance on external financial resources and, in many cases, reductions in external liabilities of governments, which fully compensated greater use of international credit by the private sector. This process was accompanied by the already mentioned significant accumulation of international reserves, in order to reduce dependence on external financing vis-à-vis potential liquidity problems.²¹ This self-insurance behavior reflected the decision to pay a price equivalent to the opportunity cost of accumulated external resources, as a result of the recognition of pro-cyclicality of the international credit supply and the desire to avoid financing-related conditionalities from multilateral sources.

This not only made a remarkable difference with respect to the financial difficulties usually faced by the countries of the region in similar episodes, but also enabled better implementation of public policies. However, recent developments marked by the impact of the crisis have narrowed the macroeconomic space available for implementation of policies aimed at increasing domestic demand, and have fueled competition for tools and resources available to governments.²²

Graph 31 shows the parallel development of two basic elements for the definition of space for economic policy, analyzed from the perspective of flows: current account balance and public accounts balance. As mentioned in the previous section, the boom period from 2003 until at least 2007 was accompanied by improvements in both balances, an unprecedented endeavor which allowed Latin America to record on average twin surpluses in 2006 and 2007.

However, most of the recent improvement in the fiscal situation followed the steady increase in commodity prices between 2002 and early 2008, and the deterioration observed as of mid-2008 imposed strict conditions to the fiscal space

20. See ECLAC (2009c).

21. The perception of the efforts of countries in the region would be even greater if the calculation of international reserves included what was saved by several countries in sovereign funds fed by fiscal surpluses. Of course, it was quite a costly effort in terms of opportunity cost of resources that the countries of the region and emerging economies in general had to incur to offset international financial market failures, against which they had been helpless in other crises.

22. See Fanelli and Jimenez (2009).

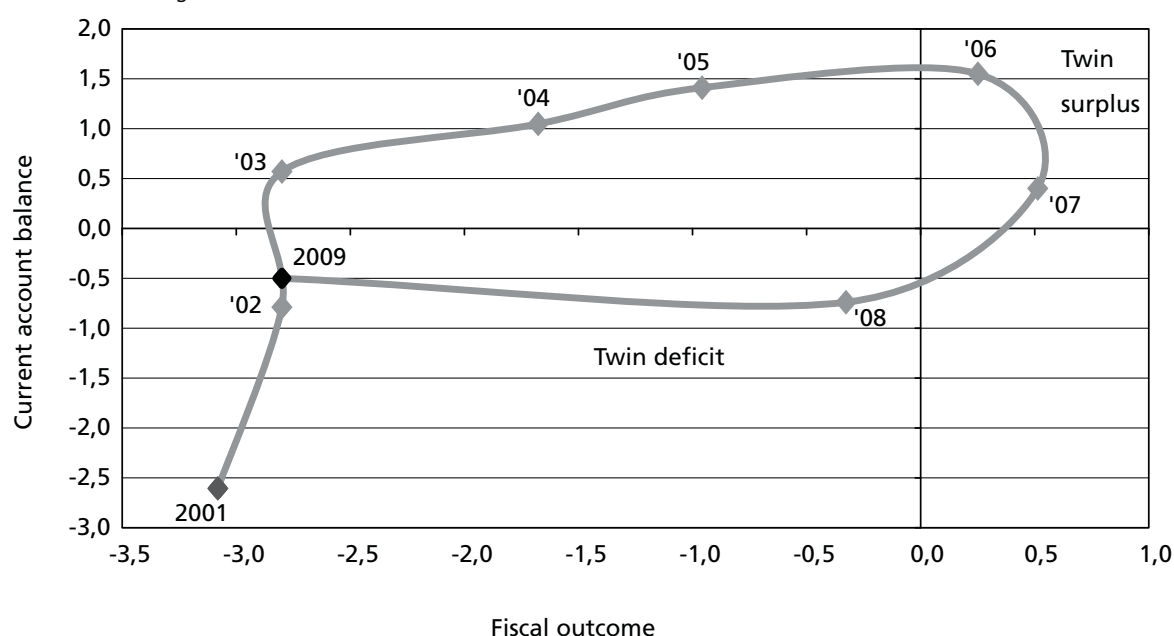
achieved. The decrease in tax revenues is estimated at around 1.4% of GDP (simple average), while the region's average overall deficit reached 2.8% of GDP in 2009.

The drop in internal demand, and in turn that of imports, offset the reductions in exports and remittances, generating a decrease in the deficit, which reached approximately 0.5%. Reduced consumption and investment generated a marked reduction in imports, almost 25% in current values, which offset the 23% drop in external sales in the region.

GRAPH 31

LATIN AMERICA: EVOLUTION OF THE CURRENT ACCOUNT AND FISCAL OUTCOME, 2001-2009

(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures

In addition to the limits imposed by the dynamics of public and external accounts on the resources available for counter-cyclical measures, some features of the region's economies raise additional issues that affect macroeconomic policy. In particular, apart from the importance of maintaining liquidity levels that allow smooth operation of financial systems, the effectiveness of monetary policies might be restricted in countries with low levels of monetization and financial soundness. Moreover, situations of high uncertainty may affect the transmission mechanisms between monetary policy expansionary measures and increases in credit supply, and between them and the effective use of available funding to raise the demand for goods.

In crisis situations, when credit markets tend to become segmented, fiscal policy could play a leading role in maintaining aggregate spending flows.²³ However,

23. On the effectiveness of fiscal policy against a financial crisis, see Baldacci, E, S. Gupta, and C. Mulas-Granados (2009).

the countries of the region sometimes face institutional constraints and restrictions concerning the public sector's implementation capacity, which set the limits for the flexible use of fiscal policy for the purposes of macroeconomic stabilization goals. In particular, while tax cuts are decisions whose implementation is relatively simple, the scale of their effect may be limited in countries where taxation levels are low and, in periods of uncertainty, where increases in income available are not necessarily translated into larger volumes of demand, particularly if the groups favored by tax cuts are in the higher strata of the distribution. In turn, increases in public spending bring about more institutional and administrative requirements. Increasing public investment takes time, especially since countries generally do not have projects evaluated and ready to implement. Similarly, the provision of targeted subsidies can be highly effective, but not all countries have developed mechanisms to identify and reach potential beneficiaries of social programs.

3.2.1 Monetary and Exchange Rate Policy

In face of the change in the international scenario late 2008, which brought about significant credit constraints in developed countries and less inflationary pressures than had characterized recent years (see Section. II.4.b), central banks of the region sought to ensure adequate liquidity levels in order to facilitate the functioning of domestic financial markets.²⁴ To this effect, the measures adopted included reduction in reserve requirements, cutting the maturity of liquidity operations, and the establishment or expansion of special lines for discount operations and reporting.

In the early months of 2009, central banks of most countries in the region lowered their policy rates to help economic recovery, in coordination with fiscal measures, although in some countries it could be expected that rates continued to fall, since they remained high in real terms. Reduced inflationary pressures and expectations of a fall in the pace of price increases led to this change in orientation of the monetary policy.²⁵

24. The acceleration of inflation observed in 2007 and early 2008 complicated the management of the monetary policy and imposed compliance with inflation targets set by central banks. In that period, inflation remained above the established target in Chile, Colombia, Mexico, Paraguay and Peru. Brazil was the only country where inflation remained within the target range, wider than in other countries, but the pace of price increases also accelerated and remained one step higher than the average level of the range. Although the observed acceleration of inflation was due largely to supply shocks associated with the prices of food and energy, most central banks increased their monetary policy rates, aiming to anchor inflation expectations. As inflationary pressures dropped in late 2008, in many cases very high real rates were observed by the end of the year.

25. Brazilian Central Bank reduced the benchmark interest rate of the Special System of Clearance and Custody (SELIC) on four occasions between December 2008 and April 2009, from 13.66% to 11.66%, and a similar trend was observed in the period in the central banks of Colombia, Guatemala, Mexico and Peru. Chile's central bank reduced interest rates drastically - 7 percentage points - going from 8.25% in December 2008 to 1.25% in May 2009. Considerable decline also occurred in central bank rates in Honduras, from 9% to 4.5% from November 2008 to March 2009. One exception was Argentina, where the evolution of the exchange market limited the ability of the monetary authority to lower interest rates.

However, the expansionary monetary policy could not prevent the slowdown of the credit market, especially after the aggravation of the international crisis. The slowdown in the growth rate of total credit in real terms continued in the first half of 2009 in Argentina, Brazil, Colombia, Mexico, Peru and Venezuela, although in several countries greater activity as observed on the part of public banks, which contributed at least to slow the fall in financing supply. This instrument was especially relevant in Brazil, where credit offered by public institutions represents around one third of the total credit to the private sector.

On the other hand, as of the worsening of the crisis towards the end of 2008, and despite the loss of reserves, the currencies of several countries in the region depreciated significantly, after considerable appreciation in the last three years (see Section II.4.b, Graph 18). Authorities intervened in different ways, including both cash market transactions and future markets. These movements partially reversed in early 2009 when, despite a general drop in interest rates by central banks in the region, currencies tended to appreciate in nominal terms, as a result of the improved environment in international financial markets. During this period, selling interventions in currency markets were progressively phased out.

3.2.2 Fiscal Policy

The challenge of a counter-cyclical fiscal policy takes place in a context of revenue reduction, at the same time protecting certain expenses - education, social protection and infrastructure - which are vital to prevent increasing poverty and lay the foundation for future growth. Although the governments in the region have some capacity to support the economy with fiscal measures, in practice, the room for maneuvering the fiscal sphere varies greatly from one country to another and depends on the availability of savings accumulated in times of boom, the degree of rigidity of expenditure, the duration of the crisis and the possibility to borrow safely.

The crisis placed public finances of Latin American economies in a complex situation. On the one hand, tax revenues showed a significant reduction, as a result of lower levels of activity and falling commodity prices. At the same time, countries adopted measures of fiscal stimulus and to offset the distributional costs of the crisis, which led to further deterioration of fiscal performance. Moreover, in many cases, this deterioration occurred as part of significant external financing contraction that limited the adoption of counter-cyclical fiscal policies.

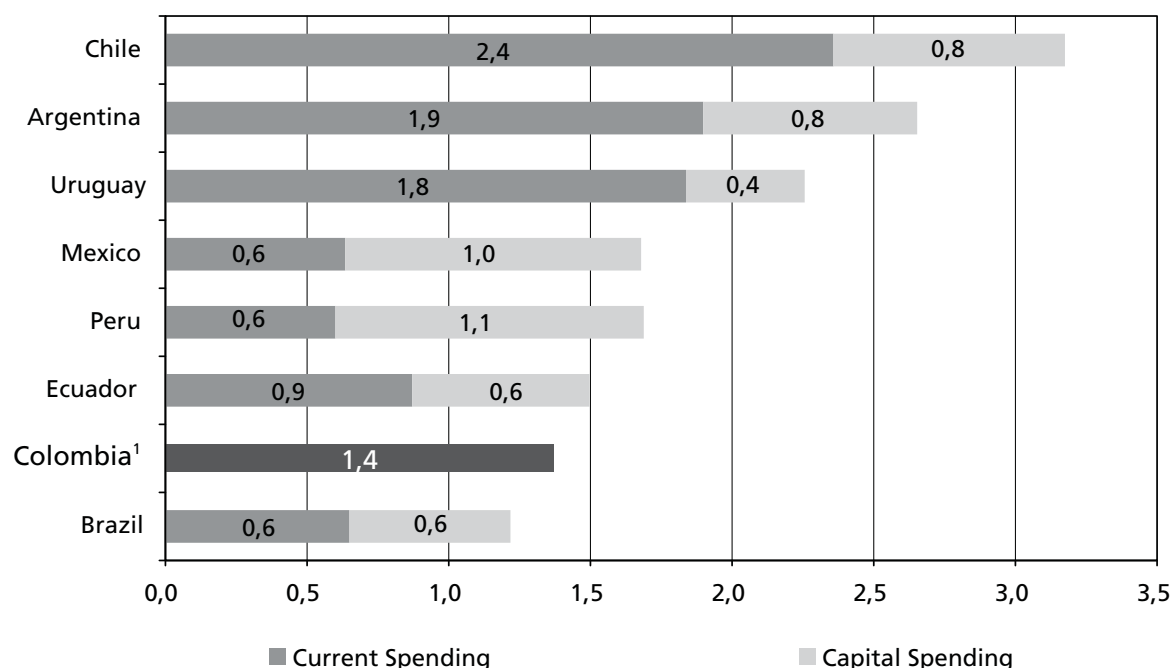
Also, the effects of international crises on tax revenues differ from one country to another depending on the tax structure, the level of collection and the sources of revenue-generating activities. In this sense, the degree of exposure to the crisis

was greater in countries with low tax burdens, or those with a high proportion of resources that are non-tax-related or derived from natural resources, and in those with a high level of trade liberalization, especially if they export mainly to developed countries. In contrast, it seems to have been lower in countries with high tax burdens and greater share of income tax and VAT productivity.

GRAPH 32

LATIN AMERICA (SELECTED COUNTRIES) PUBLIC SPENDING, NINE MONTHS IN 2008 – NINE MONTHS IN 2009

(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures

Increasing expenditure is explained by greater current spending and infrastructure investment costs, especially in housing construction. In the first nine months of 2009, there was a significant increase in current spending, and less capital spending, whose increase is usually slower (see Graph 32).

Even though the measures to increase spending prevailed over those related to tax reduction or increasing tax revenues, several countries in the region resorted to authoritative measures. Indeed, eleven countries implemented tax cuts on income tax for individuals, through changes in deduction regimes, reductions of rates, or greater exemptions - two of which are transitory. In addition, an equal number of countries announced changes in companies' income tax, through new exemptions, deductions and accelerated depreciation systems - four of which are transitory. It is worth mentioning the case of Brazil, where, although the increase in total spending was lower than in other countries, measures were adopted for reduction of tax rates over industrialized products

(temporarily on vehicles, appliances and building material), reduction of tax rates over financial transactions, and changes were made to the tax rates paid by low-income individuals.

The breakdown of social measures by sub-region reveals significant differences in the approaches to their composition. In South America and Mexico, three quarters of the measures announced are associated with support to poor families, while in Central America distribution is more balanced, and half of the measures announced are consumer subsidies, while the other half provide support to low-income families. As noted above, this shows a discrepancy in relation to institutional capacity to carry out these policies, since the measures in question, although more effective, require greater institutional efforts. Although consumer subsidies are relatively simple to implement, they reach a larger number of people, which can generate a regressive bias in favor of those who consume most.

Concerning the effect of the measures adopted, the difficulties involved in authoritative incentives and deductions in the region are well known - usually called "tax expenditures" - both in terms of quantification and measurement of their effects. On the other hand, it raises a question about the duration of the measures and the ability of some governments to sustain the level of spending entailed by these policies. It should also be noted that although measures were taken by central governments, many of them have required resources from subnational governments, which requires greater intergovernment coordination and adds an additional fiscal policy vulnerability vis-à-vis the crisis.

4 FINAL THOUGHTS: MACROECONOMIC POLICY BEYOND THE CRISIS

Although not as dramatically as in the past, the region was affected by the crisis, interrupting a process of six consecutive years of growth and improvement of social indicators. Regional GDP is expected to fall in 2009, mainly due to the sharp decline expected in the Mexican economy, with negative impacts on employment and poverty. As noted in the previous two sections, the growth of the 2003-2008 period was accompanied by increased employment and improvement in employment quality, factors that led to reduced poverty and inequality. In 2009, it was the opposite: low or even negative growth rates were accompanied by a rise in unemployment and informality, a weakening of employment with social protection and reduction of full-time employment.²⁶ The combination of these elements will result in increased poverty and inequality in a region with over 180 million poor and 70 million extremely poor people.

26. ECLAC / ILO Bulletin (2009).

It is hoped that the tentative recovery observed towards the end of 2009 will consolidate in 2010 and that Latin America will resume growth, although it is likely to do so at rates lower than those of the boom period cut short by the crisis. The expected growth may be insufficient in terms of employment demand, which may hinder rapid recovery of the amount and quality of jobs and, therefore, of social indicators.

On the other hand, reduced investment has an immediate negative impact not only on the demand for goods and the level of activity, but on the region's growth capacity in the long run. It is often argued that the region took 14 years to recover the per capita GDP in place before the eighties' debt crisis, and 25 years to recover the poverty rate observed before the crisis. As noted in Section II, the investment to GDP ratios observed in the region back in the seventies did not occur again. In recent years, Latin American countries were managing to increase their rates of investment, but this path was interrupted before they could recover the amount necessary to grow steadily at a rate higher.²⁷

On the other hand, it is highly likely that the crisis will bring about deep changes in the international arena that will generate an environment less conducive to growth than that experienced in the region between 2003 and 2008. First, it is likely that the post-crisis world will be characterized by lower global growth, due to less intense aggregate demand in developed countries, partially offset by increases in aggregate demand in developing countries.²⁸

As a result, it is expected that emerging economies will play a more prominent role in global growth, but in the context of a slowdown in trade flows. Reduced demand for imports in developed economies will narrow the space for emerging economies to introduce new products in these markets, boosting competition and encouraging the adoption of growth-oriented strategies directed to domestic markets, at least in the relatively larger economies.

On the other hand, the global financial crisis highlighted the need for deep reforms in the international financial architecture, especially in regulatory and supervisory systems, so as to ensure greater global financial stability. The crisis made it clear that institutional mechanisms for the control of systemic risks did not evolve hand in hand with the process of globalization and financial liberalization. Thus, it would be necessary to change the approach and scope of regulation and supervision of domestic financial systems, accompanied by a greater effort to coordinate global regulation. These changes will probably result in more comprehensive regulation and supervision over various financial instruments and market participants. The

27. It is estimated that in order to grow steadily at 6% a year, the average investment rate in the region should be between 24% and 27% of GDP. See ECLAC (2006)

28. See Rogoff (2009).

change in the banking model is expected to lead towards a more transparent banking system, with less incentive to risk-taking and lower levels of leverage, which will mean a reduction in international financial flows and, thus, a partial reversal in the process of financial integration observed until the onset of the crisis.

To recapitulate, Latin America faces the renewed challenge of increasing its growth rate in order to respond to the needs arising from a complex social situation that must be addressed urgently. But such growth requires more investment and, in our region, it implies an increased demand for currency to purchase capital goods which are mostly imported. One wonders then, how the region will fit into a world characterized, first, by lower growth in developed countries and greater participation of developing countries in global growth and, secondly, by financial systems subject to stricter regulation and supervision, with less buoyant credit markets and higher interest rates.

It is not our objective to provide an exhaustive answer to these questions, which ultimately entail the need for sustained economic growth supported by increased productivity and more equitable distribution. We simply intend to raise some contributions, which - based on the design of macroeconomic policy - can contribute to strengthening the link between growth and equity, which is quite weak in the Latin American experience.

Macroeconomic stability is a necessary condition for the region to grow more and to distribute better, but stabilization must be understood broadly, as an objective that goes beyond ensuring low and stable inflation. Undoubtedly, this is a central objective of macroeconomic policy, but the economic history of Latin America has given numerous examples of the major costs generated by real instability. This highlights the importance of sustainable macroeconomic management, defined in terms of expected trends of the main variables, to serve as a reference for decision-making that goes beyond the short term.

It is crucial for macroeconomic policy design to allow tackling the fluctuations associated with economic cycles, but this capability must be forged in times of economic boom to be used in times of recession, thus avoiding excessive fluctuations in public service provision and in real exchange and interest rates. This is an important lesson emerging from the crisis, as it highlighted the benefits originated from counter-cyclical policies implemented, in varying degrees, by different countries.

However, this was not always the case. On the contrary, a comparative view of the past thirty years shows that most Latin American countries' fiscal policy behaved pro-cyclically, in contrast to that observed in developed countries, where it has been counter-cyclical or at least acyclical.²⁹ Despite

29. See Lopez-Monti (2009b) for a comparative analysis of the cyclicity of fiscal policy in Latin America and developed countries.

recent improvement, Latin America still records very high levels of real volatility, which carry significant costs in terms of welfare.³⁰

Of course, the implementation of counter-cyclical policies is a task that is not free of tensions and conflicts, largely associated with the difficulty in identifying the long-term trend in many of our economies, but may also result from differences in preferences of different operators in specific situations. In this case it is highly probable that sectors with savings capacity or access to financing differ in their interests from those of the poorest strata, who face severe spending restrictions, since they lack savings capacity and have very limited access to financial markets.³¹ In this sense, counter-cyclical macroeconomic management is particularly relevant to lower income groups, and policy actions during booms to build capacity to cope with the downturn cycle are particularly important from the distribution perspective.

In general, macroeconomic policy affects growth and distribution through the way it combines the handling of variables that are, at least partly, under the control of economic authorities, such as the amount and type of tax collected, the level and composition of public spending, interest rates and the type of exchange rate. The way these instruments are used strongly affects decisions over production, accumulation, and income of different groups or sectors. The set of instruments available and the nature and intensity of their effects depend on the structure of the economy, their institutional framework (such as ownership of natural resources) and history (for example, experiences affecting the demand for domestic assets and the soundness of financial systems).

In Latin America, the tax burden of most countries is insufficient to guarantee the spending needs of States. But tax collection in the region is not only insufficient, but ineffective.³² In particular, the low participation of income tax and the fact that the tax structure is sustained mainly by indirect taxes of a regressive nature should be noted.³³ These tax systems are among the factors that contribute to the maintenance of an unequal income distribution framework and, therefore, to poverty and extreme poverty, given that the tax policy has relegated the goal of improving distribution in detriment of other purposes. The main challenge is not only to increase collection, but also improve its impact over income distribution, by increasing the burden of well-off sectors.

30. For an estimate of the cost, in terms of welfare, of the cycle fluctuations in Latin America based on different models, see Lopez-Monti (2009a)

31. See Krusell and Smith (2002)

32. See Cetrangolo and Gomez Sabaini (2007) on this subject.

33. This could also affect the effectiveness of automatic stabilizers. On this point, see Sescún (2007).

As regards spending, all areas of the public budget should be submitted to some kind of reformulation, in response to the dissatisfaction of society concerning the extent and form of government intervention.³⁴ In particular, with regard to social spending, reforms are expected to play a central role in building more cohesive societies, in allowing greater legitimacy of public policies and, therefore, the payment of taxes to finance them. However, the demands for increased public spending are not limited to the social area. They include, for example, public investment in infrastructure, which impacts activities of other sectors, plays a role in boosting the economy, has a significant impact on competitiveness, and on the definition of productive profiles³⁵.

In short, it is necessary to ensure sustainable financing of a number of services the States should provide to help achieve higher and more inclusive growth. Although this requirement directly involves different aspects of the fiscal policy, it far exceeds its scope, to become the basis for a new social pact, an issue that would require a whole new article to be addressed in detail.

Finally, the monetary policy should seek to achieve the lowest and most stable inflation rate possible. This consensus has been widely reached in a region that has gone through very difficult times associated with high inflation processes. However, it should not be forgotten that the choice of the monetary and exchange regimes determines a variable as important as the exchange model. The real volatility characteristic of Latin American economies is closely linked to the excessive fluctuation of real exchange rate, which has a negative impact on investment, especially in tradable goods. Therefore, macroeconomic policy should seek to avoid large and sudden real exchange rate fluctuations, regardless of whether nominal currency prices fluctuate according to market conditions or to what is set by economic authorities.³⁶

The difficulties associated with reducing the exchange volatility in a region exposed to strong external shocks are not minor, but it is clear that low prices of tradable goods resulting from excessive appreciation tend to induce a configuration of production and investments that hinders growth and diversification of exports.³⁷ Moreover, these relative prices lead to misperceptions of spending capacity (measured in foreign currency), which end up generating high external imbalances and unsustainable debt levels.

Therefore, the economic policy, and particularly central banks, should have the “second objective” of maintaining an exchange model that is real, stable and competitive. To that end the tools available range from direct interventions and

34. An assessment of the perception of social programs in Argentina can be seen in Cruces et al (2007). One interesting finding of this study is the need to include aspects of the flow of information relating to program content and evaluation as a way to improve their legitimacy.

35. See Lucioni (2009).

36. Bastourre and Carrera (2004) found a negative association between the degree of flexibility of exchange rate policy and real volatility.

37. Aghion et al (2006) show that exchange rate volatility adversely affects growth in economies, such as Latin-American, that have poorly developed financial systems.

actions of “deterrence”, to restrictions on short-term capital inflows, as relevant. Of course, a more active monetary policy to try to sustain a model of real exchange rate requires fiscal discipline as a counterpart. However, maintaining the real exchange rate at any cost may, in certain circumstances, lead to inflationary pressures, which goes against the main objective of the monetary policy.

The difficulties it may bring about should be addressed by strengthening coordination, so as to enable comprehensive and explicit evaluation of the costs of any relevant variable moving away from the target value in relation to the benefits of avoiding possible deviations of other variables which are also given weight in decisions. However, taking into account the importance of a real exchange rate model as a macroeconomic signal on decisions about production, investment, demand and financing, it seems inadvisable to treat it as a “residual” variable for the economic policy.³⁸

These paragraphs have attempted to identify some factors that should be taken into account in the design of macroeconomic policies aimed at mitigating volatility. The multiplicity of objectives involved calls for independent instruments. In turn, this requires acting over structural constraints that limit policy autonomy: institutions, the availability of tax resources and the quality of the state apparatus.

Economic development is a complex construction, which goes far beyond mere quantitative changes and leaps of scale, and should be seen as a process of continuous transformation of productive and social structures. The difficulty faced by Latin American economies in this regard is associated to the lack of some markets (such as long-term credit in local currency), imperfect competition of other markets, asymmetric distribution of information (e.g., credit markets or technology, and investment opportunities), and coordination failures. All this stresses the importance of the State’s presence, since the generation and expansion of public policy space, through the development of instruments and the strengthening of different spheres of coordination, are critical tasks to ensure growth and development.

The need to achieve sustained growth based on increased productivity and equity highlights the importance of reducing volatility to encourage growth, to generate more jobs, and to reduce the susceptibility of the most vulnerable segments of the population. Ultimately, as noted Prebisch 60 years ago: “If, for social purposes, one seeks to maximize real income, counter-cyclical considerations cannot be absent from the economic development program. The dissemination of cyclicity from the great centers to the Latin American periphery entails considerable losses of income. If these losses could be avoided, the problem of capital formation would be less difficult. There have been attempts of counter-cyclical policy, but we must recognize that the elucidation of this matter is still incipient.”³⁹

38. On the importance of the exchange rate instrument for emerging economies, see Eichengreen (2008), and Rodrik (2007), or, from a Latin American perspective, see Barbosa (2005) and Frenkel (2008).

39. Prebisch, Raúl (1949).

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