Latin America Initiative
at BROOKINGS

LATIN AMERICA ECONOMIC PERSPECTIVES

ALL TOGETHER NOW: THE CHALLENGE OF REGIONAL INTEGRATION

EDUARDO LEVY-YEYATI

WITH LUCIO CASTRO
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This report's data and other contents had no further changes as of March 10, 2012. Therefore, this report does not reflect any changes in economic conditions since that date. Guest contributors for this issue of the Brookings Latin American Economic Perspectives include Alejandro Grisanti, Esteban Jadresic, Mario Mesquita, Rafael Romeu, Roberto Steiner, and Alejandro Werner. The editors thank these contributors for their invaluable help with their respective country analyses. We would also like to thank Ignacio Caro Solís for his outstanding research assistance, Diana Caicedo for her logistical support and Sara Paoletti for her editorial design.

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INTRODUCTION: MISSING PARTS

It has been a good ride. After the dismal 1990s, which stigmatized Latin American and Caribbean economies as the paradigmatic emerging markets (a high-risk/high-return bet on inherently unstable countries doomed by the original sin of chronic mismanagement), the 2000s were something of a revelation. Dollarized external obligations shrank or were replaced by more manageable domestic debt issued in local currency, increasing tax revenues enhanced the fiscal capacity to reduce inequality and poverty, and policy continuity and consistency denied the stereotype of a region perennially oscillating between political extremes. Populism, all of a sudden, became smart pragmatism.

For many of the region's countries –particularly those in South America– this progress was to no small degree aided by an exceptional external context of low inflation, declining financing costs, stable global growth and supportive terms of trade. If anything, the region's governments took advantage of global tailwinds to reduce their long-dated financial vulnerabilities –an achievement that allowed them to implement, for the first time in decades, countercyclical policies that limited the depth and length of the contagion from the 2008– 9 global crisis, feeding the hope that the 2010s might be, for once, the Latin American decade.

Yet first impressions often overshoot reality. Much as the skeptical view prevalent at the start of the century may have exaggerated the irreversible nature of some of Latin America's earlier flaws, the goldilocks picture of the region's miracle overlooks a number of drawbacks that were temporarily dwarfed by the long bonanza. Now that the world has become less supportive, these drawbacks are returning to the foreground.

If anything, it appears that this decade, rather than marking the culmination of a virtuous process, poses a challenge. After working out the macrofinancial constraints that thwarted development policies in the past, can these countries address the pending tasks and issues that are critical to consolidate their gains and keep up the momentum?

We have tackled some of these tasks and issues in past editions of the *Brookings Latin American Economic Perspectives*. The region's gradual primarization of exports, its inadequate investment in physical infrastructure and modest productivity growth, and its deficits in social development and education, all cast doubt on its growth prospects looking forward.

In this edition, we concentrate on another economic dimension on which the region is falling behind: commercial integration. Our comparative analyses reveal that, in both the depth and quality of regional integration, the Latin American and Caribbean economies are lagging from their emerging peers in Asia. And this is happening at a time when the missing intraindustry trade could provide the economies of scale needed to increase productivity in nonprimary sectors, and when regional markets offer a welcome counterpoint to the growing Chinese influence and to a global context that, even as the worldwide financial crisis subsides, will not be as stable and supportive as in the 2000s. Chapter 3 highlights several reasons why the wave of free trade agreements in the 1990s fell short of achieving true commercial integration, and it argues that a more proactive political agenda is needed to counter short-term economic incentives to diversify away from the region.

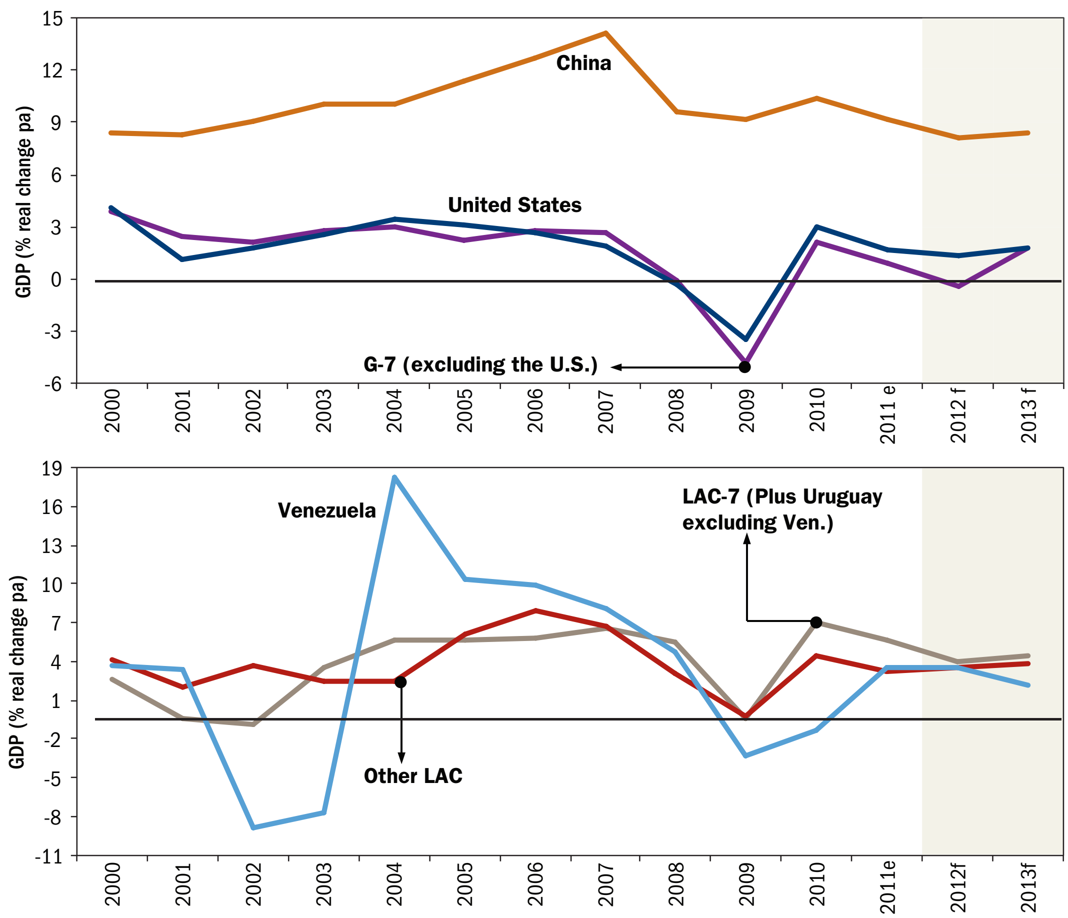
The chapter also tackles another topical aspect of regional integration: the pooling of financial resources to cope with the increasingly recurrent bouts of global financial distress. Now that the long debate about global financial safety nets –namely, multilateral liquidity facilities designed to mitigate the impact of financial contagion– seems to have reached its limit, can the discussion move forward at the regional level? It has been correctly pointed out that because the Latin American and Caribbean economies are all hit by global shocks in the same way, they cannot reduce the needed stock of aggregate liquidity by insuring each other. However, as we show in the pages that follow, regional cooperation in a reserve pool has additional advantages beyond the conventional diversification gains. Moreover, a regional pool is the natural vehicle for cooperatively mustering regional and multilateral resources, which is perhaps the missing link in the dysfunctional global safety net.

Trade and liquidity, external demand and financial stability—these are the two fronts on which the region can help itself in the next decade. Two varieties of integration important enough to be at the top of the regional agenda, and at the center of this report.

CHAPTER 1

LOOKING BACK: SIXTH MONTHS IN FIVE SNAPSHOTS

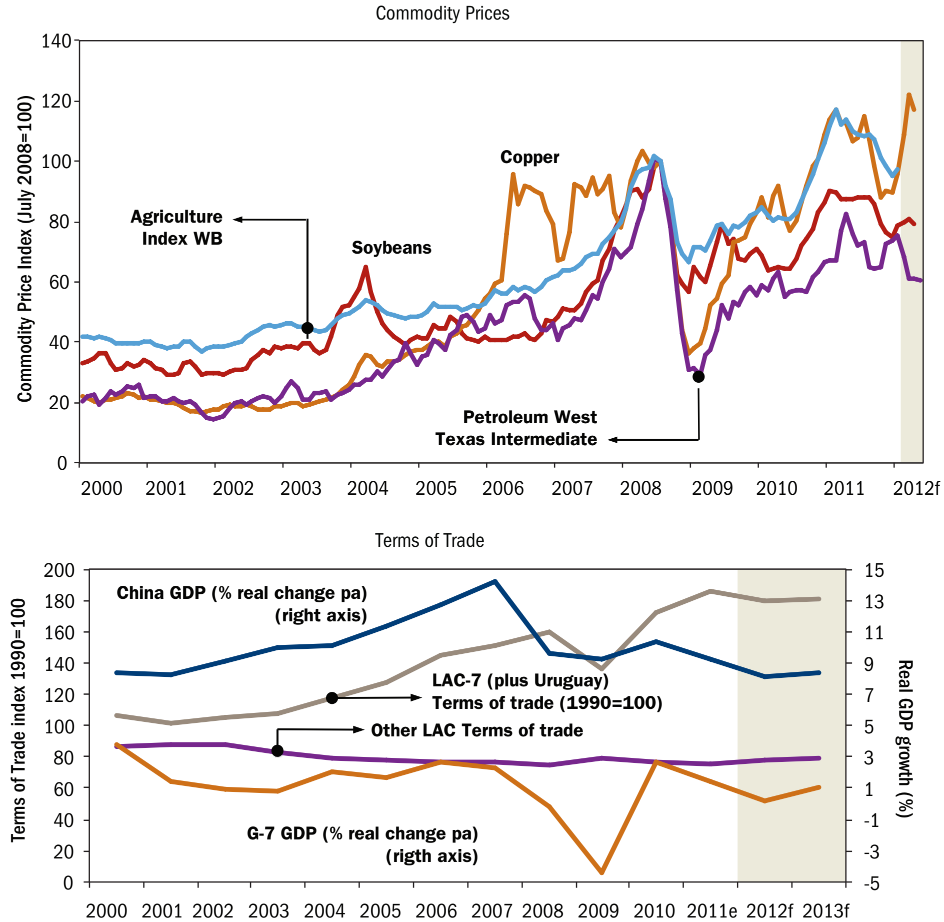
Figure 1.1. Growth and Growth Prospects: The Global Economy



Source: Author's compilations using data from the Economist Intelligence Unit.

The global outlook deteriorated in the second half of 2011 as financial stress took its toll on economic activity in the developed world, leading to a downward revision of growth prospects (compared with forecasts in the previous six months, growth expectations for 2012 were reduced from 0.9 to –0.4 percent in the non-US Group of Seven, or G-7, mainly reflecting persistent tail risks in peripheral Europe) (FIGURE 1.1). In China, monetary tightening brought growth down to about 9 percent, pointing at a soft landing that in 2012 is expected to put growth near 8 percent—the slowest rate in a decade and, quite possibly, an indication that two-digit rates are unlikely to be revisited in the future, given increasing capacity constraints and signals of an inward change in the Chinese model.

Figure 1.2. **Commodities and Terms of Trade** (2000–2010)

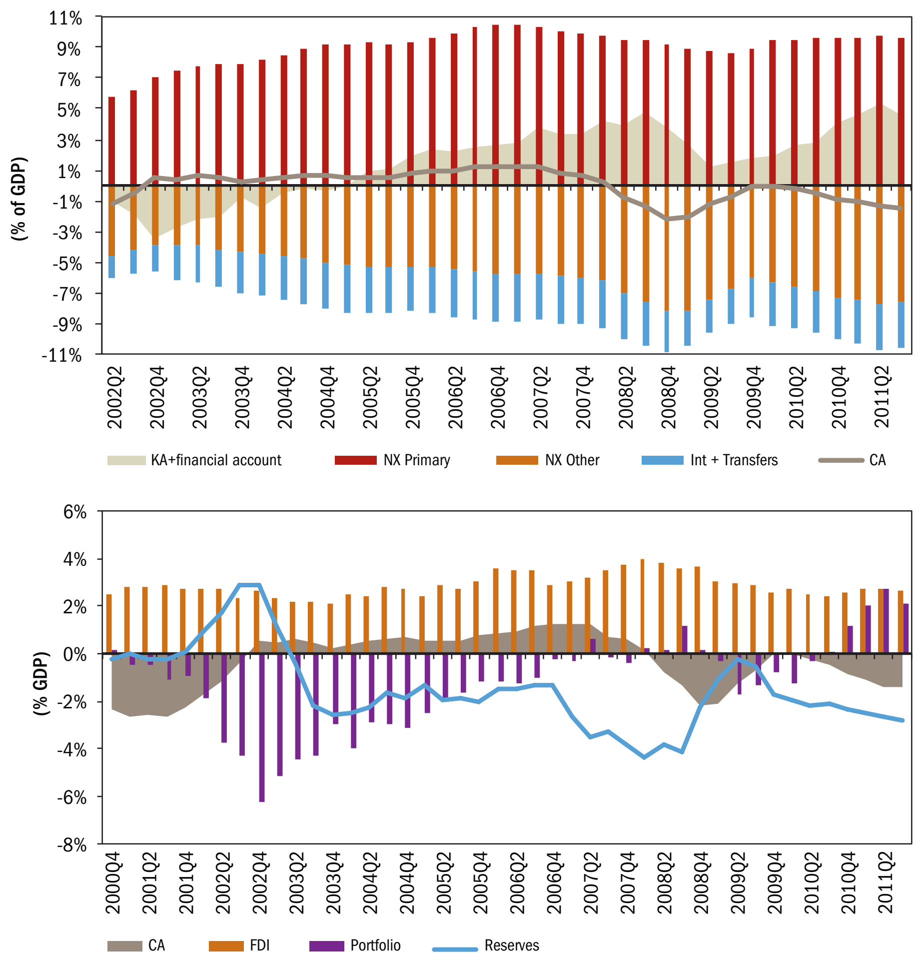


Source: Top panel, author's compilations using data from the World Bank.
Bottom panel, author's compilations using data from the Economist Intelligence Unit.

On the regional front, after the 2010 recovery, in 2011 Latin American and the Caribbean (LAC) felt the effects of financial stress and fading global demand. This should continue into 2012: LAC-7 economies—Argentina, Brazil, Colombia, Chile, Peru, Mexico and Uruguay—are expected to be more sensitive to global winds than the rest of LAC, with a deceleration that may be as strong as 1.6 percent (from 5.6 percent in 2011 to 4 percent in 2012) compared with a mild boost in Central America and the Caribbean (from 3.2 to 3.5 percent) .

Terms of trade and commodity prices reflected world financial and growth deterioration, experiencing a sharp drop in the second semester of 2011, wich partially reverted in a first-bimester rally (FIGURE 1.2). In LAC-7, terms of trade are still very supportive relative to historical levels; but in 2012, despite a good start, they are expected on average to remain below last year's, mostly reflecting the downturn in the second half of 2011. Specifically, as an input to economic activity in the region, they should be a neutral to mildly negative factor.

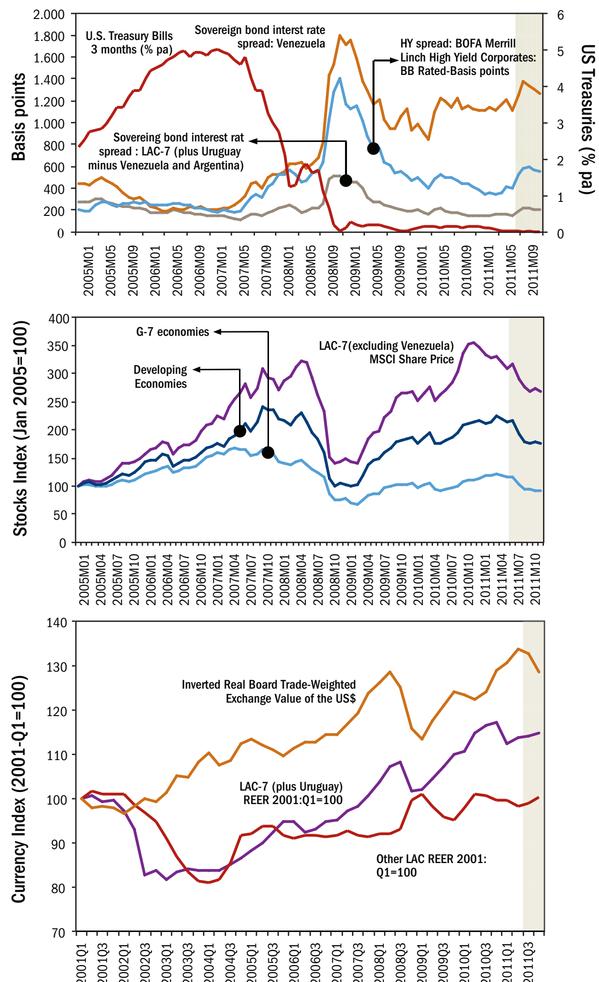
Figure 1.3. **Balance of Payments** (LAC-7, 2000–2010 and 2011–15 Forecasts)



Source: Author's compilations using data from the Economist Intelligence Unit, International Monetary Fund, and World Bank.

During 2011, LAC-7 has consolidated its role as an exporter of primary products, which, combined with solid foreign direct investment (FDI) and portfolio inflows, financed an increasing deficit in the nonprimary current account (FIGURE 1.3). In spite of these, the region managed to accumulate reserves, in the context of a "financialization" of capital flows (i.e., a rising ratio of portfolio over total inflows)—a trend that should have been more visible with the commodity slump in the last quarter of 2011 (excluded due to data availability).

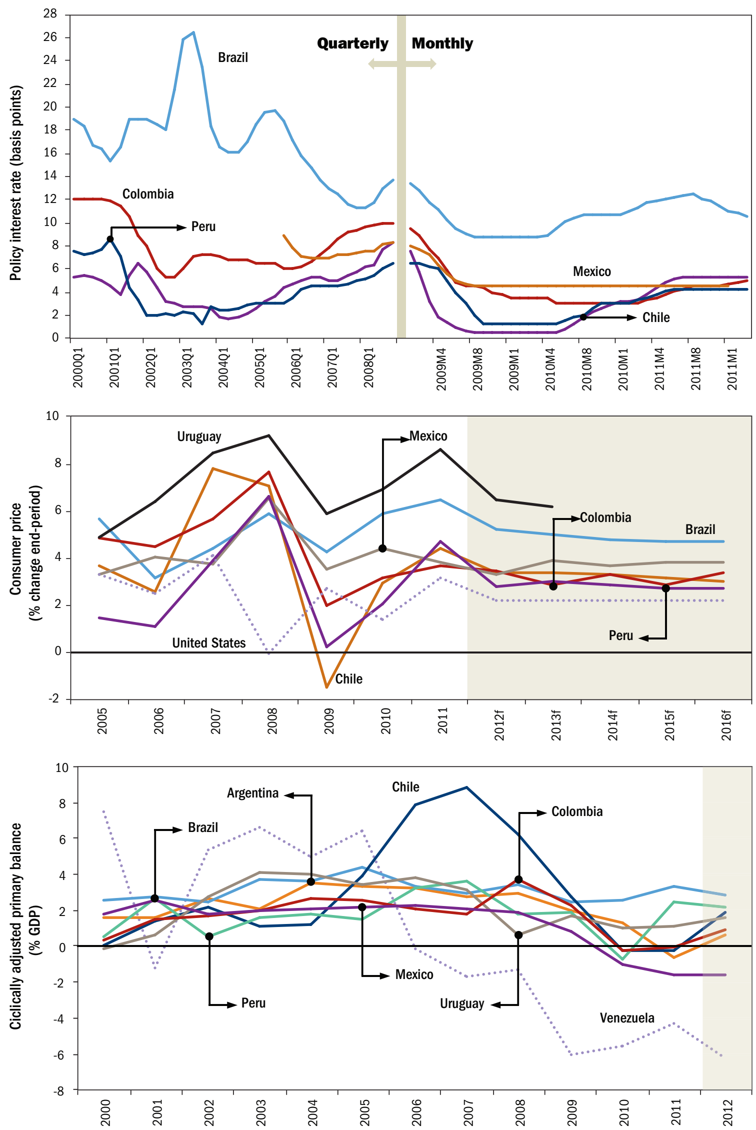
Figure 1.4. Financial Markets: Bonds, Equities and Currency



Sources: Top and bottom panels, author's compilations using data from the World Bank and the Federal Reserve Bank of Saint Louis. Middle panel, author's compilations using data from the World Bank.

Financial conditions worsened in the second half of 2011, after a smooth first (FIGURE 1.4). US Treasury rates that moved close to their technical floors due to flight to quality and explicitly accommodative monetary policy could not offset the increasing credit risk premiums and the euro zone's deepening crisis—a combination that hit LAC-7 financial markets. Breaking a pattern from the first half of 2011 that showed LAC-7 decoupling from financial distress in core economies, bond spreads jumped about 50 basis points from historically low levels, but remained contained. Similarly, after underperforming in the first semester, LAC-7 equity markets contracted 13 percent, well below the 22 percent seen in the G-7. Currencies also sold off but only briefly and moderately, rapidly coming back to a stable and firmer trend. Overall, market reaction confirmed the region's gradual decline in global risk sensitivity.

Figure 1.5. Interest Rate Targets, Inflation and Exchange Rates



Sources: Top panel, data from the central banks of Brazil, Chile, Colombia, Peru, the United States and Uruguay. Middle and bottom panels, author's compilations using data from the Economist Intelligence Unit.

The second half of 2011 saw the end of the tightening mood in most LAC-7 economies, as inflationary expectation seem to have been successfully contained, and the drop of commodity prices and the apparent signs of global deceleration tilted the balance of risks toward growth concerns (FIGURE 1.5). With the fiscal balance in a more delicate situation than in 2009, the countercyclical policy mix moved to a tight fiscal —loose monetary stance, with rates coming down particularly strong in Brazil, where the consolidation of lower real rates has become an explicit policy goal.

CHAPTER 2

IT'S A WILD WORLD: UPDATING THE BROOKINGS GLOBAL WIND INDEX

In the previous edition of *Brookings Latin American Economic Perspectives*, we introduced the Brookings Global Wind Index (BGWI) to measure how much of the local economic performance in Latin America could be explained by swinging global tailwinds and headwinds. There, we showed that on average 80 percent of common GDP growth of the Latin American and Caribbean seven (LAC-7[1]) since mid-2007 (the "crisis" period) could be explained by a simple index based on three global drivers: risk, commodities and global demand.[2]

How did the global wind evolve in the past semester? Predictably, global growth dynamics showed a clear geographical divergence. While the US and China kept most of their first-half momentum (with a mild deceleration; the average growth of industrial production slowed from 4.9 to 3.8 percent and from 14.2 to 13.3 percent, respectively), major European economies saw their average first-half growth of industrial production (5.5 percent on average) move to negative territory by the year's end, whereas Japan kept contracting, albeit at a slower pace. In turn, commodity prices largely mimicked global growth. After peaking in the second quarter, a downward trend returned prices to their levels in late 2010 and early 2011. This bearish trend showed signs of stabilization by the end of the year, leaving prices between 10 and 25 percent below than their peaks.[3]

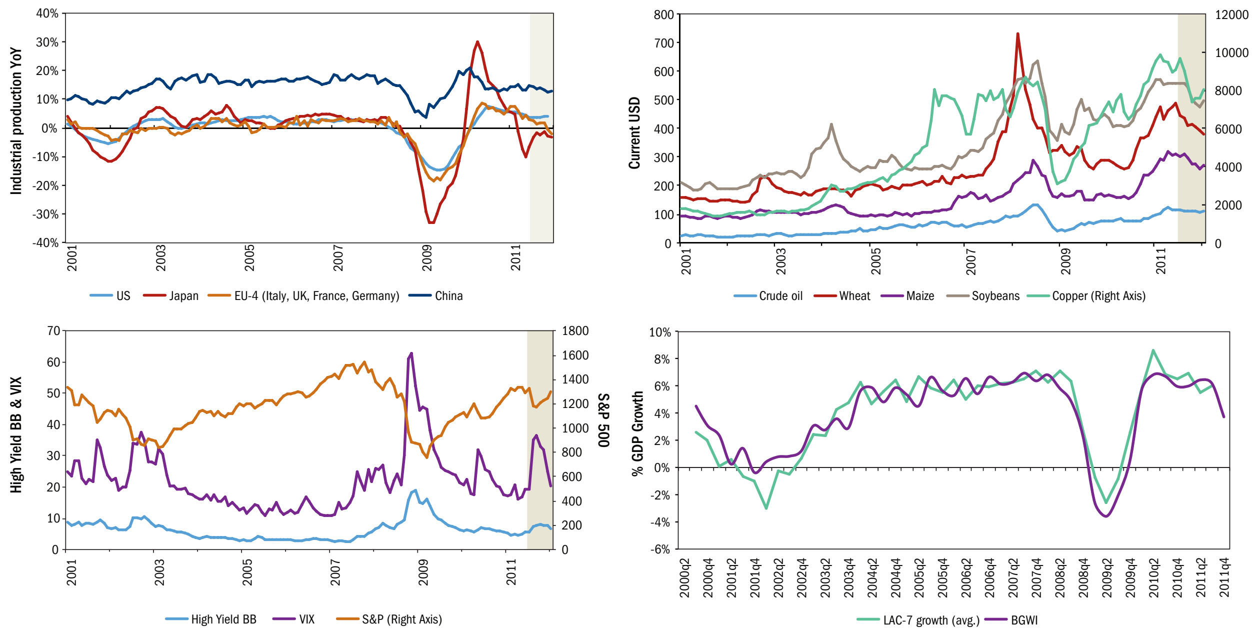
Finally, even though financial distress abated by the end of the period under analysis, conditions worsened in the second half of 2011 driven by the never-ending European crisis, which brought average credit spreads and market volatility for the period to levels that exceeded those prevalent during the sell-off in the second quarter of 2010.

All things considered, these developments led to a marked deceleration in the BGWI, to 3.7 percent in the fourth quarter of 2011, or 2.7 percent below the previous semester. As expected, this slowdown in the BGWI (which, in terms of average LAC-7 growth, would translate into a 0.7 percent decline compared with 2010) was mirrored by LAC-7's average growth rate, which decelerated from 7.0 percent in 2010 to 5.7 percent during 2011.

What does the BGWI promise for the near future? Growth in major economies appears to be following the trend of the past semester: The US is expected to accelerate slightly to 2 percent (vs. 1.7 percent in 2011), China's growth is experiencing a soft landing at 8.0 percent—the country's slowest growth in a decade—and Europe is entering a mild recession (see FIGURE 2.1, top panels). Based on this, our base case assumes 8.2 and 0.8 percent growth rates for China and G-7, respectively. Similarly, given that average commodity prices are forecast to remain below 2011 prices (mostly reflecting price action in the second half of 2011), our base case assumes prices stable at January levels (see FIGURE 2.1, bottom panels). Finally, in light of the balanced risks vis-à-vis the resolution of the European crisis and the ongoing consolidation of a modest trend growth in the US, we assume that global risk will remain at current levels, above 2011 averages. In sum, the combination of better financial conditions and worse growth and commodity outlooks gives a negative bias to the BGWI, which would in turn translate into a 2.7 percent fall in the average growth for LAC-7 in 2012 (which, compared against a 1.7 percent implicit in EIU estimates, suggests supportive local drivers).

1. LAC-7 in this chapter denotes Argentina, Brazil, Chile, Colombia, Mexico, Peru and Uruguay. Venezuela is excluded because of the nature of its economic cycle, which tends to be governed by idiosyncratic factors and is therefore less correlated with the global cycle or with the rest of the region
2. The explanatory power is measured as the average R2 of country-by-country regressions of realized growth on the BGWI.
3. Commodity prices recovered in January and February at the rhythm of the assets rally, but expectations maintained the bearish trend.

Figure 2.1. Global Drivers and the Brookings Global Wind Index



Alternatively, to allow for the possibility that the January–February rebound consolidates into a more supportive environment, we draw an alternative "good" scenario by setting drivers to 2010 "new normal" values, which brings the impact on average LAC-7 growth to a milder –1.4 percent deceleration (FIGURE 2.2).

Thus, even without receding into crisis mode, global winds are likely to remain a drag to economic activity for the most countries in the region, shifting the burden to sustain the economic recovery to domestic markets, internal demand and local policies..

Figure 2.2. Regional Impact of Global Conditions

CHAPTER 3

LOOKING FORWARD: THE CHALLENGE OF REGIONAL INTEGRATION

Unlike in past decades, macroeconomic risk for Latin America seems to be coming increasingly from abroad. This change in the balance of risks reignited two old but still critical strategic debates: the incidence of local and global drivers on the pace and stability of economic growth—which we have touched on past editions of *Brookings Latin American Economic Perspectives (BLEP)* and revisit briefly in chapter 2 above—and the benefits of real and financial integration in light of a less-than-stellar global outlook. Against the backdrop of globalization fears and more or less covert signs of protectionism, here we pose a simple question that points in a different, if not opposite, direction: If Latin America looks healthier and more resilient than most core economies, why not redirect integration precisely toward the region? Or, more generally, do persistent global concerns make a case for regional integration?

On the real front, there is empirical evidence indicating that, if external demand is a dominant driver of business cycles, output correlation is enhanced by trade integration—particularly intraindustry trade. Moreover, the data suggest that the composition of exports matters for development; concentration in low-value-added primary exports may inhibit capacity building and productivity, inducing a perilous dependence on cyclical and volatile international prices.[4] On the financial front, the global financial crisis showed that existing global financial safety nets (GFSNs; i.e., facilities of the International Monetary Fund and selective swap schemes from central banks such as the US Federal Reserve, the Bank of Japan and the Bank of China) worked as a safety belt that limited the damage but failed to avoid the crash, reviving the twin debates on capital flow management and GFSNs.[5] In turn, the scant progress within the Group of Twenty (G-20) working groups on the subject has gradually shifted the GFSN discussion from the multilateral to the regional level.[6]

In this context, many important questions arise. Why have Latin America's trade links remained so limited in the 2000s, and to what extent can commercial integration between growing Latin American economies help shield the impact of weak demand from the advanced world? Can regional integration mitigate the ongoing—and potentially risky—"primarization" of exports (i.e., the tendency of natural resource-intensive products to increase their share on the export basket)? Is it profitable for countries to mitigate excessive capital flow volatility through regional safety nets? Can Brazil be for Latin America what Japan and China are for Asia, or Germany is for Europe? And, ultimately, is it Latin America (as opposed to the individual sub-continents) the *region* that we should be talking about when we talk about integration?

Sail the Ship: Trade Integration and the Latin American Growth Model for the 2010s?

If trade links foster output co-movements, local economic conditions in integrated regions are likely to be more responsive to shocks within the region (more generally, other members´ output performance) than to

4. With intraindustry trade, specialization advances not across but within industries, thus leading to symmetric effects of industry-specific shocks; see Jeffrey A. Frankel and Andrew K. Rose, "The Endogeneity of the Optimum Currency Area Criteria," Economic Journal of the Royal Economic Society 108 (1998): 449. On the incidence of trade patterns in development paths, see Ricardo Hausman, Lant Pritchett and Dani Rodrik, "Growth Accelerations," *Journal of Economic Growth* 10 (2005): 303–29.

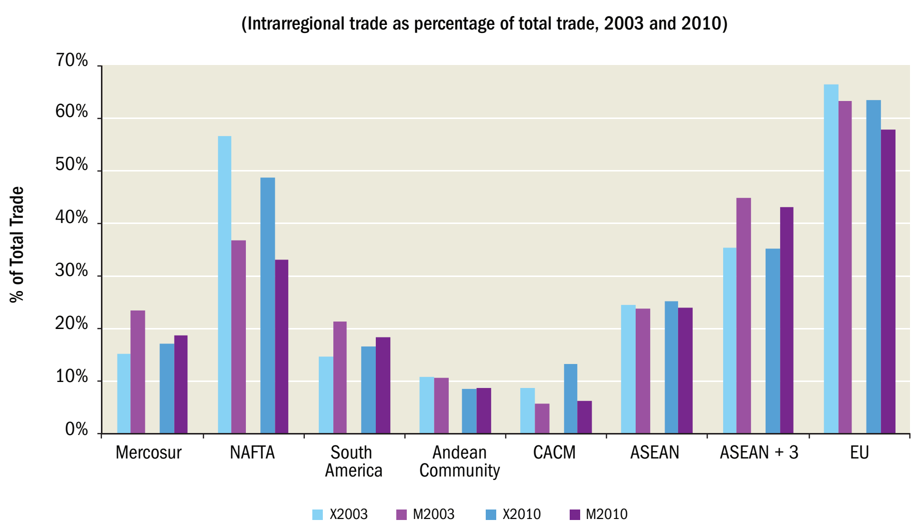
5. Eduardo Levy-Yeyati, "Fondo Latinoamericano de Reservas: Diagnóstico y Recomendaciones," unpublished paper, 2012.

6. The recent multilateralization of the Chiang Mai Initiative's or the potential development of the European Financial Stabilization Fund into an European version of the International Monetary Fund—both associated with the introduction of a regional evaluation office independent of the International Monetary Fund—are examples of this shift. The trend is also visible in South America with plans to redesign and expand the Latin American Reserve Fund (Fondo Latinoamericano de Reservas, FLAR). The launch of another regional development bank (the Banco del Sur) may be placed within the same group of initiatives.

output variations from outside the region (more generally, global growth). In addition, trade patterns may have a significant impact on development prospects; the production of internationally competitive elaborated goods and services has often been the basis for a sustained increase in wealth. Thus, one could argue a priori that the deepening of Latin American trade links could help isolate the region from a troubled international context (particular regarding the advanced world). Moreover, to the extent that regional trade exhibits a lower degree of primarization and higher value added, it can help foster a more sustainable growth path. In what follows, we show evidence along those lines, with the view to addressing two long-standing yet topical questions: *why did the regional process come to a stop, and how can it be reignited?*[7]

Where is Latin American regional trade—relative to other regions—a decade after the "new regionalism" of the 1990s that triggered a myriad of trade agreements? Apparently, pretty much where it started, and behind its peers. A first gauge of the relative intensity of trade links within Latin America is provided by the share of exports and imports traded within the region, where the latter is defined based on three regional arrangements—Mercosur, the Andean Community (AC), and the Central American Common Market (CACM)—and compare it with the North American Trade Agreement (NAFTA); the Association of Southeast Asian Nations, including China, South Korea and Japan (i.e., ASEAN + 3); and the European Union. Additionally, we include South America as a whole to see whether trade links in the subcontinent materialize beyond the presence of formal agreements (FIGURE 3.1).[8]

Figure 3.1 A First Pass at Trade Integration in LAC: Lagging Behind



Note: South America includes Argentina, Brazil, Chile, Colombia, Mexico, Paraguay and Uruguay.
Source: United Nations COMTRADE data, 2011.

7. Note that our analysis should not be taken as a call for a renewed old-style inward regionalism (including through tighten extraregional barriers) but rather as a case for heightened commercial links (and reduced barriers) within the region.
8. We concentrate on South America as opposed to Latin America, in line with the view that it is the former rather than the latter where a deeper integration would be most natural.

Two preliminary findings emerge from FIGURE 3.1. First, trade integration fares rather poorly in Latin American and the Caribbean (LAC): *in all three Latin American agreements, intraregional trade flows have been stable or declining*. By contrast, ASEAN + 3 and the EU exhibit significantly higher and increasing levels of intraregional trade. Similarly, NAFTA shows almost a sizable (albeit decreasing) share of exports directed to its region. Second, South America displays intraregional trade flows that are comparable with Mercosur (and larger that AC and CACM). Thus, *trade agreements in Latin America do not seem to make a significant difference in the direction of trade*.

FIGURE 3.1 also hints at a critical difference between trade in Latin America and elsewhere: *the marginal role of intraindustry trade*. Most of the ASEAN + 3 trade flows can be explained by intraindustry links to the large economies in the region: China and Japan in one case—indeed, ASEAN by itself looks only marginally more integrated than Mercosur. The same could be said for NAFTA and the EU.

A possible reason for this deficit may lie in intraregional similarities: Latin America is characterized by a relatively low difference in factor endowments.[9] Differences in standard proxies—such as income per capita, skilled labor and manufacturing hourly wages—are significantly lower in Mercosur, AC or LAC as a whole than in the EU, ASEAN + 3 or even NAFTA (TABLE 3.1). This low dispersion in factor endowments, together with the limited scope for economies of scale within the region, could be a factor behind the reduced number of multi-latinas (Latin American multinational corporations) and, more generally, regionally integrated companies, which are critical for integrating production networks across a region.[10]

Table 3.1 Low Dispersion in Factor Endowment

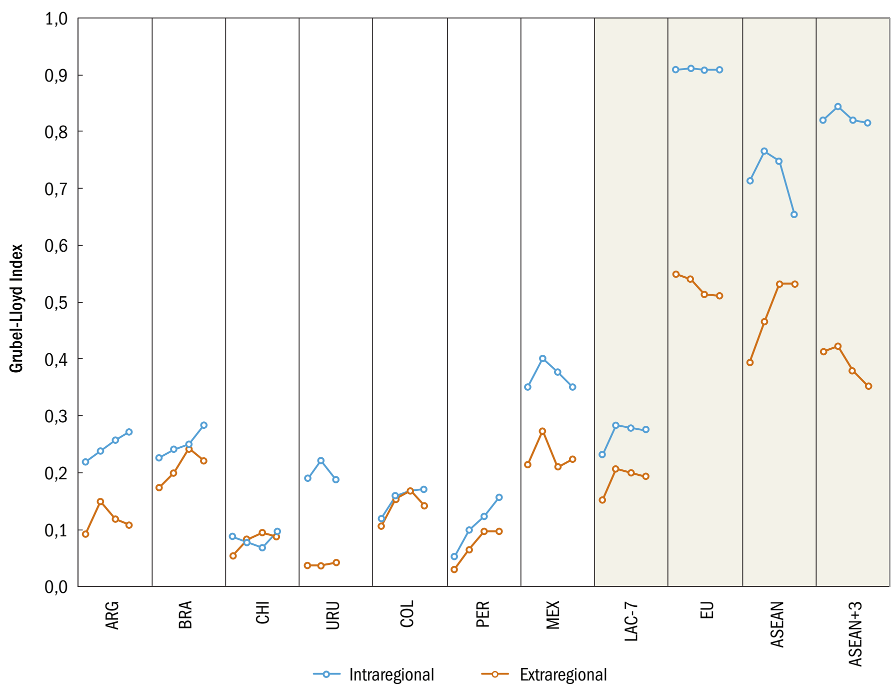
Measure	Parameter	LAC-7	Mercosur	AC	NAFTA	EU	ASEAN +3
GDP per capita[a]	SD	2.370	3.744	1.867	15.847	12.102	17.245
	CDV	0.22	0.36	0.27	0.52	0.43	1.16
	Distance	1.56	1.57	1.28	1.77	5.58	26.81
Skilled labor[b]	SD	9.17	8.47		22.27	8.13	12.10
	CDV	0.41	0.44		0.54	0.32	0.51
	Distance	2.28	2.17		1.92	3.24	2.37
Hourly Wages[c]	SD	0.99	1.89	2.59	15.11	15.81	10.98
	CDV	0.35	0.62	0.83	0.63	0.51	0.68
	Distance	1.46	1.89	3.82	1.68	5.48	2.27

Note: SD = standard deviation; CDV = coefficient of variation; "distance" = the ratio between the country with the highest indicator (e.g., GDP per capita) and the mean of the three countries with the lowest values.
[a]GDP per capita is expressed in constant 2005 dollars; source: World Bank, *World Development Indicators*.
[b]Workers with tertiary education as a share of the labor force; source: World Bank, *World Development Indicators*, 2007, the most recently available comparable data.
[c]Data are for 2012 and were taken from the Socio-Economic Database for Latin America and the Caribbean for LAC and the US Bureau of Labor Statistics for the rest of the countries.

9. Differences in factor endowments tend to foster vertical intraindustry links, as in the case of East Asia.
10. There, of course, other hypothesis behind this absence, including the high borrowing costs in a region plagued by financial crises until very recently, or the lower scale due to its relatively small economic size.

In turn, the diminished role of intraindustry links can be clearly seen in figure 3.2, which depicts—for the seven largest Latin American economies, LAC-7 as a whole, the EU, ASEAN and ASEAN + 3—the evolution of the Grubel-Lloyd Index of intraindustry trade with the region (intraregional) and with the rest of the world (extraregional).[11] *LAC-7 displays remarkably low intraindustry trade, both within and outside the region*. The cases of Argentina and Brazil stand out, mostly due to the special arrangement for compensated trade in the automobile industry. Mexico, in turn, reflects intraindustry links with the US.

Figure 3.2. Intraregional Intraindustry Trade
(Grubel-Lloyd Index, 1995, 2000, 2005, 2010)



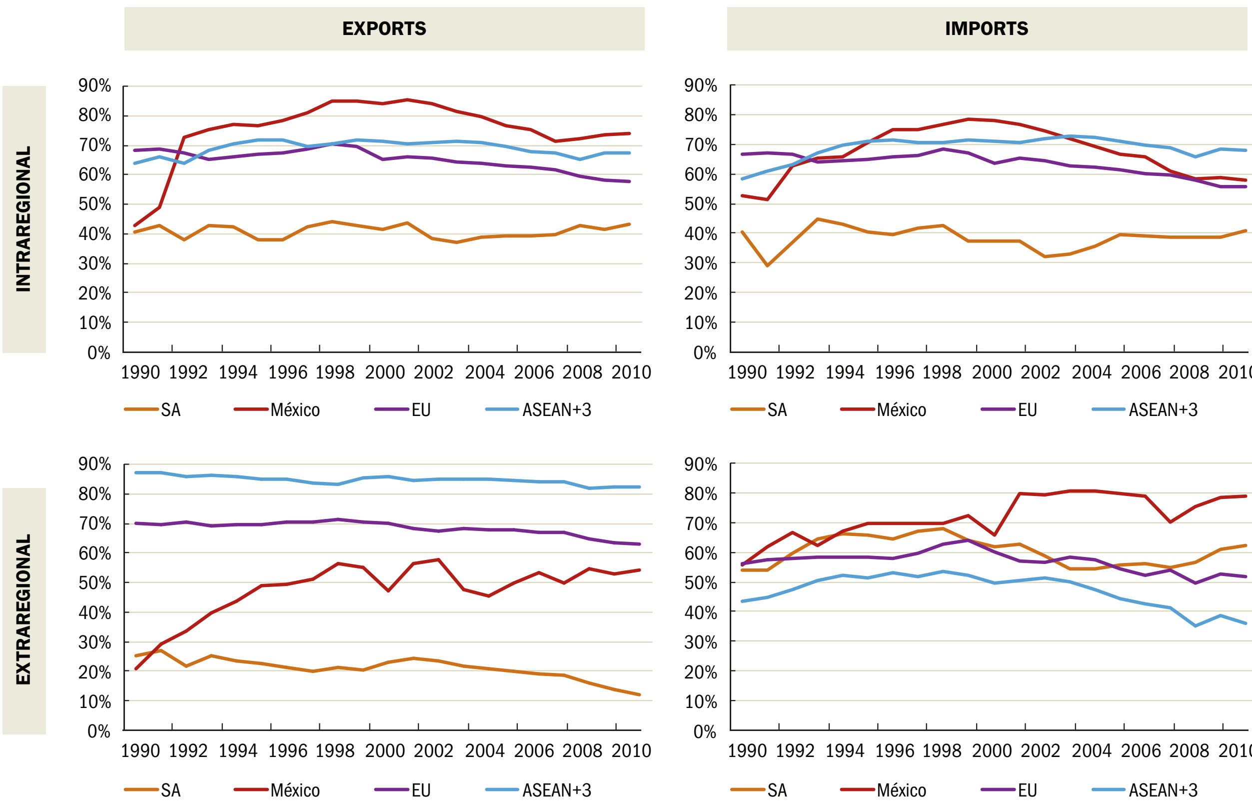
Note: This figure displays the normalized Grubel-Lloyd Index of intraindustry trade, calculated using disaggregated export and import data. LAC-7's index is the purchasing-power-parity–GDP-weighted average of the individual LAC countries' index.
Sources: Brooking calculations based on United Nations COMTRADE data for 2012 and World Bank, *World Development Indicators*, 2012.

Some observers have pointed out that the absence of intraindustry links in Latin America is in part the flipside of the growing "primarization" of the export basket, particularly to the rest of the world. A quick look at manufacturing exports within and outside the region (FIGURE 3.3) is at least consistent with this view. The figure highlights a few interesting stylized facts. First, the manufactures balance (the ratio of exports to imports) is balanced within the region, but it is imbalanced—and increasingly so—vis-à-vis the world—the expected result of the primarization of exports. Second, the manufacture share of exports within the region, at about 40 percent, is larger than with the rest of the world, albeit still significantly below that observed in other regions. Third, Mexico's exceptionality shows up once more with a much larger, albeit decreasing, manufacturing share.

11. The normalized Grubel-Lloyd Index (GL) is formally defined as $GL_i = 1 - [\,|X_i - M_i| / X_i + M_i]$, where Xi and Mi are exports and imports of product *i* at HS 6 digits.

In sum, Latin American regional trade flows appear to be stagnant, with very low intraindustry links and with a low manufacturing component that is nonetheless substantially higher than the one found in the increasingly primarized exports to the rest of the world. From a long-run development perspective, the diagnosis looks worrying at best.

Figure 3.3. Manufactures in Intraregional and Extraregional Trade
(as a percentage of the total)



Note: Manufactures defined as sections 6 (minus 68), 7 and 8 of SITC Rev. 3. SA = simple average of each South American country with its corresponding trade agreement (e.g., Mercosur or AC).
Source: Brookings calculations based on United Nations COMTRADE data for 2012.

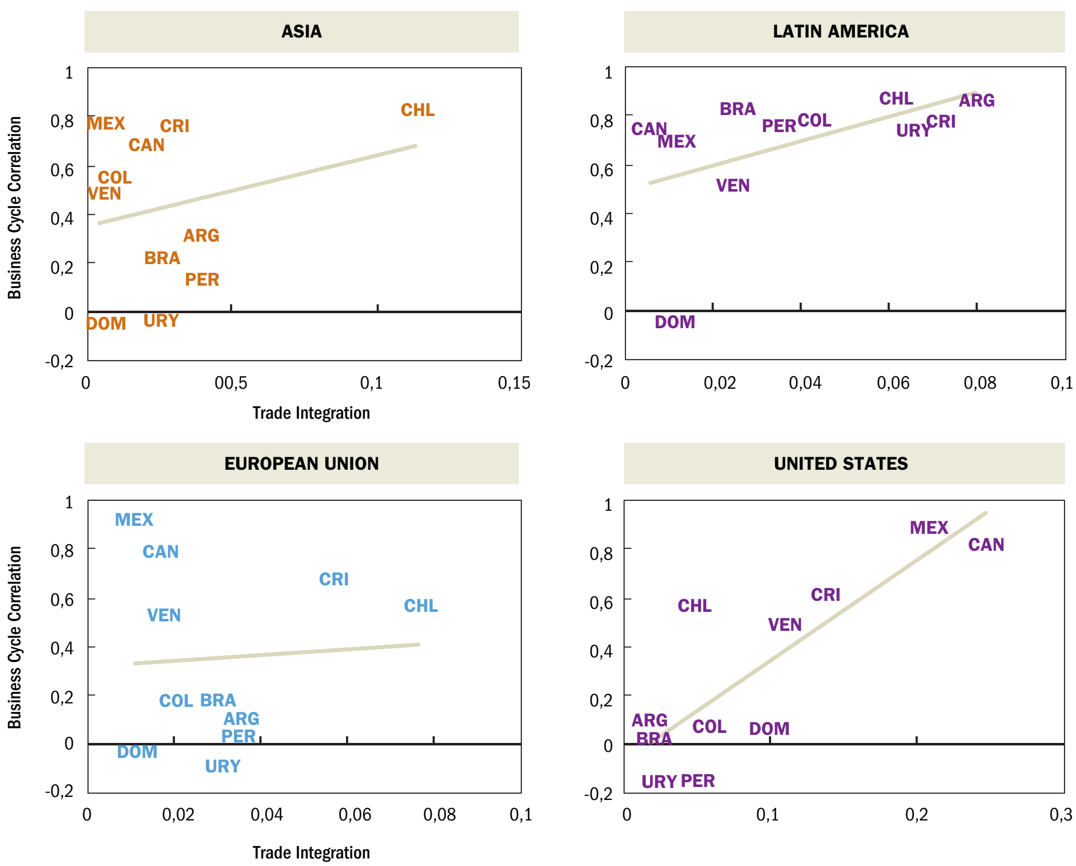
From Trade to Economic Activity

The optimal currency area literature has long maintained that integration is good for economies exposed to asymmetric idiosyncratic shocks. The current context, however, merits a revision to this conventional wisdom, as shocks become increasingly global (i.e., systemic rather than idiosyncratic): Integration as a way to synchronize output with growing countries in the region at the expense of lagging advanced economies. Naturally, excessive concentration in regional trade would raise the regional exposure and would be ultimately risky. But starting from a rather low level, the deepening of regional trade links could help cushion the influence of a global slowdown.

FIGURE 3.4 illustrates the connection between trade integration and output co-movement plotting, on the one hand, the correlation between the business cycle of selected Latin American countries and the business cycles of different regions (LAC, East Asia, the EU and the US) and, on the other, trade integration among with the same countries and regions. As FIGURE 3.4 shows, economies show a good correspondence among trade links and output co-movements, particular vis-à-vis its own region. In turn, if integration fosters correlation, one could argue that regional integration would tighten correlation with countries that have shown a solid growth record in the recent past.

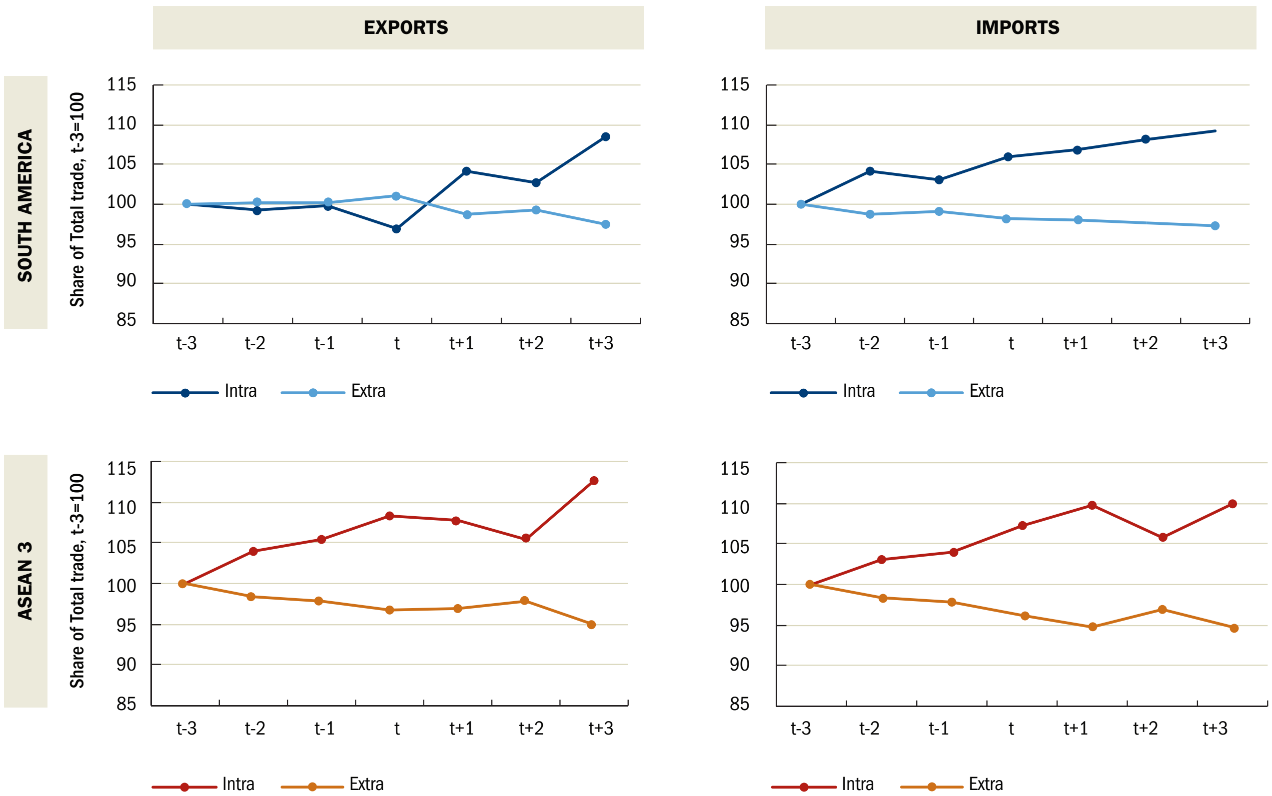
Another potential reason to engage in regional trade lies in the higher resilience of regional goods to generalized grade collapses. A good illustration is provided by the evolution of intraregional trade during recent global recessions. FIGURE 3.5 shows the median intraregional share in total exports and imports for South America and ASEAN + 3 during global GDP downturns since the 1980s. As can be seen, intraregional trade flows have shown a surprising resilience in South America during global downturns. Indeed, both in South America and East Asia regional flows tended to increase in the aftermath of the recession at the expense of trade with the rest of the world.

Figure 3.4. Latin America: Trade Integration and Output Correlation



Note: This figure displays, on the vertical axis, the correlation coefficient between the business cycles of each selected Latin American economy with the purchasing-power-parity–GDP weighted average of the HP cycle of Latin American countries—with the exception of that particular country—the US, the EU and East Asia, for the period 2000–10. On the horizontal axis, it shows the average ratio between exports to the "region" (e.g., Latin America, the United States, the EU and Asia) in the same period. Countries were selected based on data availability.
Sources: Author's calculations based on United Nations COMTRADE data and International Monetary Fund, *International Financial Statistics,* 2012.

Figure 3.5. **Global Growth Collapses and Intraregional Trade, 1980–2010**
(intraregional and extraregional exports and imports as a percentage of the total; medians; index = 100 in *t*-3)



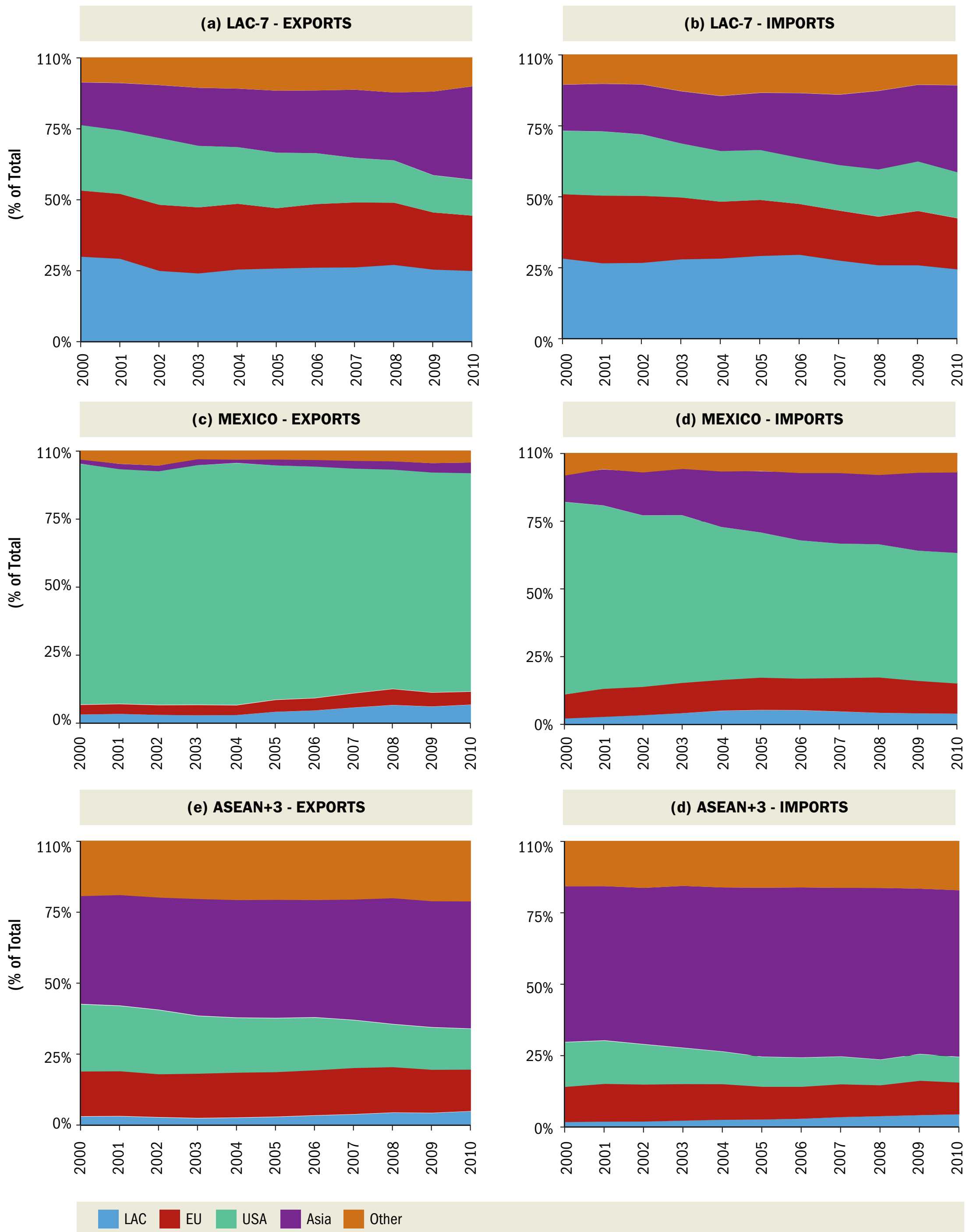
Note: This figure depicts the average share of intraregional trade in total during 4 episodes of collapse in global GDP growth: 1982, 1991, 2001 and 2009. Collapse episodes in year t are identified using the following criteria: (1) world real GDP growth below 2 percent; (2) a drop of more than 1.5 percentage points in world real GDP growth from previous five-year average to current rate; and (3) considering the previous two years and the following two years, growth is at a minimum. Intraregional and extraregional shares are normalized as an index number equal to 100 in *t*-3.
Source: Brookings calculations based on United Nations COMTRADE data for 2012 and World Bank, *World Development Indicators.*

Trade's Anatomy: Why Is Integration Lagging?

What is behind the peculiar pattern of Latin American regional commercial integration: low trade intensity, reduced the Grubel-Lloyd Index of intraindustry trade and manufacturing flows? Although a complete answer to this query clearly exceeds the limits of this report, the available evidence points at two possible factors. First, the sustained increase in commodity prices experienced by LAC in the last decade has provided incentives for *specialization in natural resource-intensive products and intensified trade links with Asia (particularly with China).* As a result, integration and intraindustry trade are likely to weaken as there are less economic incentives for further trade liberalization, and more generally, closer economic links within the region.

FIGURE 3.6 shows that, in fact, *LAC-7 exports to and imports from the region have been stable to weaker in the last decade*. In contrast, the relative importance of Asia in LAC's trade has visibly increased. Mexico, again, shows a distinctive pattern, with most of its exports directed to the United States. However, as in the rest of LAC's largest economies, Mexican imports are also increasingly sourced from Asia. In contrast, most of ASEAN + 3 trade flows remain within East Asia.

Figure 3.6. Stagnant Intraregional Flows and Rising Dependency from Asia in LAC's Trade



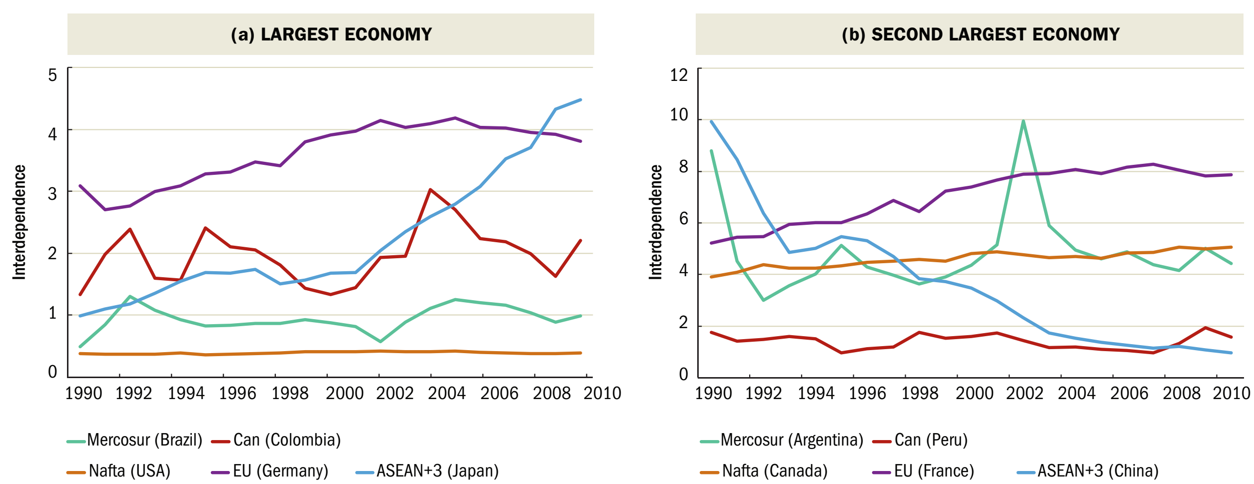
Source: Brookings calculations based on United Nations COMTRADE data for 2012.

A second factor behind the low levels of intraregional (and particularly, intraindustry) trade is the *limit on production fragmentation within the region*. It is well known that regional trade in ASEAN and the EU is largely driven by the commercial exchange of parts and components within regionally integrated production processes, in which regional and multinational companies play a crucial role. In turn, this process of productive fragmentation across national frontiers is largely driven by large differentials in factor endowments within the Asian and European regions, which, as noted above, is rather limited in Latin America.

A third reason in that the current *low trade interdependence within LAC regional agreements*, translates into a lower demand for integration (e.g., reduced trade and investment barriers) from the private sector, is a contrast with Asian and European cases. Moreover, the kind of asymmetric interdependence prevalent in LAC trade agreements also translates into a weak supply of regional public goods.

More specifically, in LAC agreements, the largest economies—measured by purchasing-power-parity–adjusted GDP—generally have less intense trade links wich the region than the rest of the (relatively smaller) trading partners. Thus, they have only weak incentives to internalize the costs—in terms of reduced economic policy autonomy—of supplying common regional norms and institutions (e.g., common external tariffs, harmonized nont-ariff barriers, monetary and financial policy coordination). In contrast to the EU and ASEAN + 3, within LAC trade agreements, this *problem of the "reluctant hegemon"* is not only acute for the largest economy (most notably, Brazil in Mercosur) but also for the second largest one (e.g., Argentina) **(FIGURE 3.7)**.

Figure 3.7. Interdependence and Regional Public Goods: Not Only a Problem with the "Número 1"



Note: The largest and second-largest economies are measured using the mean share of each country's GDP in regional GDP over 1990–2010. Interdependence is defined as $ID=(X_{jB}/\sum X_j)/ \sum X_{ij}/ \sum X_i)$, where X_{jB} are exports from the largest economy *j* in the trade agreement *B* to the rest of the trading partner members *i*; $\sum X_j$ *are total exports from the economy j*; X_{ij} *are exports from the rest of the partner countries i of agreement B to country j; and Xi are total exports from the rest of the partners i to the agreement B.*
Source: Author's calculations based on United Nations COMTRADE data and International Monetary Fund, *International Financial Statistics*, 2012.

What can we take away from this preliminary analysis? First, in a context in which the World Trade Organization faces non trivial constraint to promote further global economic integration, regional agreements are increasingly functioning as institutional devises to facilitate the provision of public goods among a limited number of countries. Predictably, collective action problems and preferences heterogeneity, which are likely to hinder the prospects of international policy coordination under the WTO, are generally less pervasive at the regional scale. Perhaps more importantly, the relative costs of providing regional public goods are lower than global policy coordination and harmonization.

Indeed, with the natural caveats of any generalization, one could argue that, at a time when the region is being lured by the sirens of protectionism (due to volatile capital flows, stagnant WTO negotiations and its own concerns about the natural resource-driven growth pattern), the enlarged regional markets gained in the 1990s should be preserved and enhanced as a means of fostering economies of scale and reaping the gains of specialization. And, in light of the recent ASEAN+3 experience, intra-industry trade should be promoted by fostering direct investment and regionally integrated production networks. The fact that intra-regional trade tends to display a more diversified and sophisticated pattern (relative to trade with the rest of world) should be seen as a window of opportunity to move up the development ladder through a freer movement of trade and investment flows from within.

Thus, integration agreements could be a powerful tool for Latin America to foster a more integrated regional economy in an increasingly adverse world, particularly in the case of South America. Leaving aside NAFTA (Mexico) and CAFTA, which are exceptional cases marked by their intense trade links with the U.S., it is South America that appears to have the largest potential for intensified regional economic links. The presence of a relatively large industrial economy (Brazil) coupled with a semi-industrialized medium-sized country (Argentina) provides an interesting backdrop to foster the kind of regionally integrated networks behind ASEAN+3´s rapid structural transformation. In turn, from a political economy point of view, a more integrated South America could provide the incentives for the local "Número 1" and "Número 2" to generate the regional public goods required to move forward existing regional integration agreements.

Chop the Tree: Financial Integration and Regional Safety Nets

It is well known that most LAC countries have gathered important stocks of international reserves during the past decade.[12] This accumulation, which has often been related to exchange rate–smoothing policies (as we discussed extensively in the April 2011 *BLEP*), reflects the need to self-protect against bouts of global financial stress and the resulting swings in capital flows and exchange rates.

However, is this enough? Can a regional, supranational entity report profits compared with "autarkic" self-insurance? What is the optimal safety net structure for the region? What learning can be extracted from comparable attempts in East Asia and the euro zone?

12. This sections borrows heavily from Eduardo Levy Yeyati, "Fondo Latinoamericano de Reservas: Diagnóstico y Recomendaciones," unpublished paper, 2012.

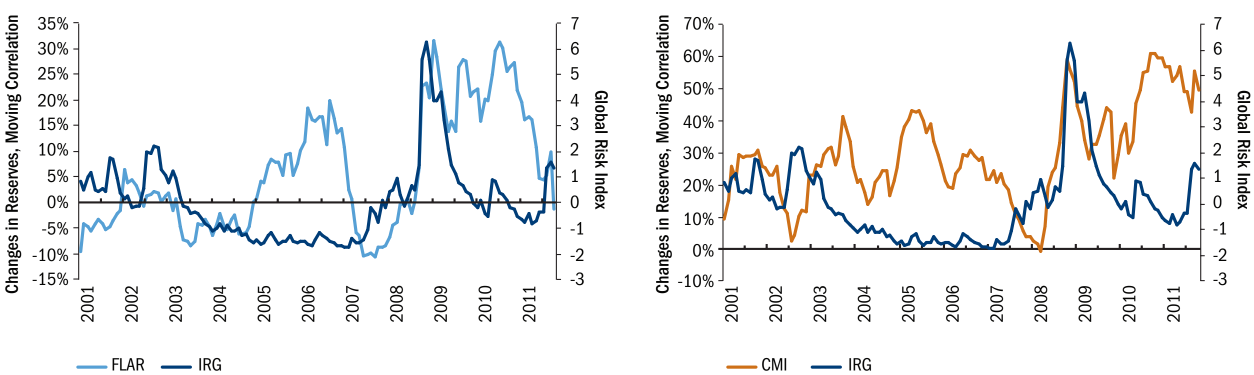
Advocates of reserve pools (or other forms of regional and multilateral GFSNs) usually emphasize the latter's capacity to reduce the minimum reserve stocks required to deal with external financial shocks.[13] Due to the *diversification benefits* of risk pooling, inasmuch as members do not use the common resources simultaneously, the same level of individual coverage could be achieved with a smaller stock. However, the very systemic nature of the crisis with which the reserve pool is intended to cope partially undermines the diversification argument. As the global crisis demonstrated, there is a risk that the diversification margin is substantially eroded when everything goes wrong at the same time—the so-called correlation risk.

The Bad: Correlation Risk and the Missing Issuer of Last Resort

The recent subprime debacle sheds some light on how these benefits may be overestimated in good times. One of the main lessons from the crisis is the notion that the correlation between individual risk events can increase rapidly under systemic stress. For example, mortgage-backed securities, engineered to profit from risk diversification in normal times, incorrectly assessed the probability that mortgage nonperformance rises *simultaneously* with a systemic decline in property prices.

Along the same lines, the correlation between liquidity needs usually tightens during episodes of global financial stress when GFSNs are expected to intervene, eroding the diversification margin. The synchronicity between reserve and exchange rate changes after the Lehman Brothers' collapse, as reflected in the rise in the average cross-country correlation, is a good example of this (FIGURE 3.8).[14]

Figure 3.8. Correlation Risk (quarterly changes in reserves)



Note: 12-month moving correlation (left scale) and Global Risk Index (IRG; right scale).
Source: Eduardo Levy Yeyati, "Fondo Latinoamericano de Reservas: Diagnóstico y Recomendaciones," mimeo, 2012.

13. Although empirical evidence is not conclusive, there would be a cost associated with self-insurance reserve holdings. A quick glimpse at what happened in the period 2005–10 illustrates the divergence between costs and benefits of intervention in emerging world; Eduardo Levy Yeyati, "What Drives Reserve Accumulation (and at What Cost)?" *VoxEu.org*, September 2010.

14. For simplicity "stress periods" are defined as the peaks in our Global Risk Index, the first principal component of the VIX and the corporate high yield bonds spread. See Eduardo Levy Yeyati and Luciano Cohan, *Latin America: Innocent Bystanders in a Brave New World* (Washington: Brookings Institution, 2011).

To understand the relevance of correlation risk on the viability of a regional safety net, it is useful to bear in mind that, during crisis episodes, reserve currencies (those that are effectively seen as store of value) are relatively few: the dollar, the yen and, although still not fully convertible, possibly the renminbi, due to China's trade surplus and massive stock of liquid foreign assets (which allowed the Asian giant to assist emerging economies during the 2009 crisis). Any safety net that fails to include one of the issuers of these reserve currencies ("issuers of last resort"), which posses the ability to collect and redistribute flight-to-quality liquidity, would need to hoard liquidity in good times. This would incur a cost of carry and thus only marginally improve on self-insurance by individual countries. In turn, the role of these issuers of last resort translates into an inevitable asymmetry between member countries, namely, the need to combine one or more large economies with access to liquidity that do not require external assistance with (typically smaller) countries that will become net borrowers during a crisis.

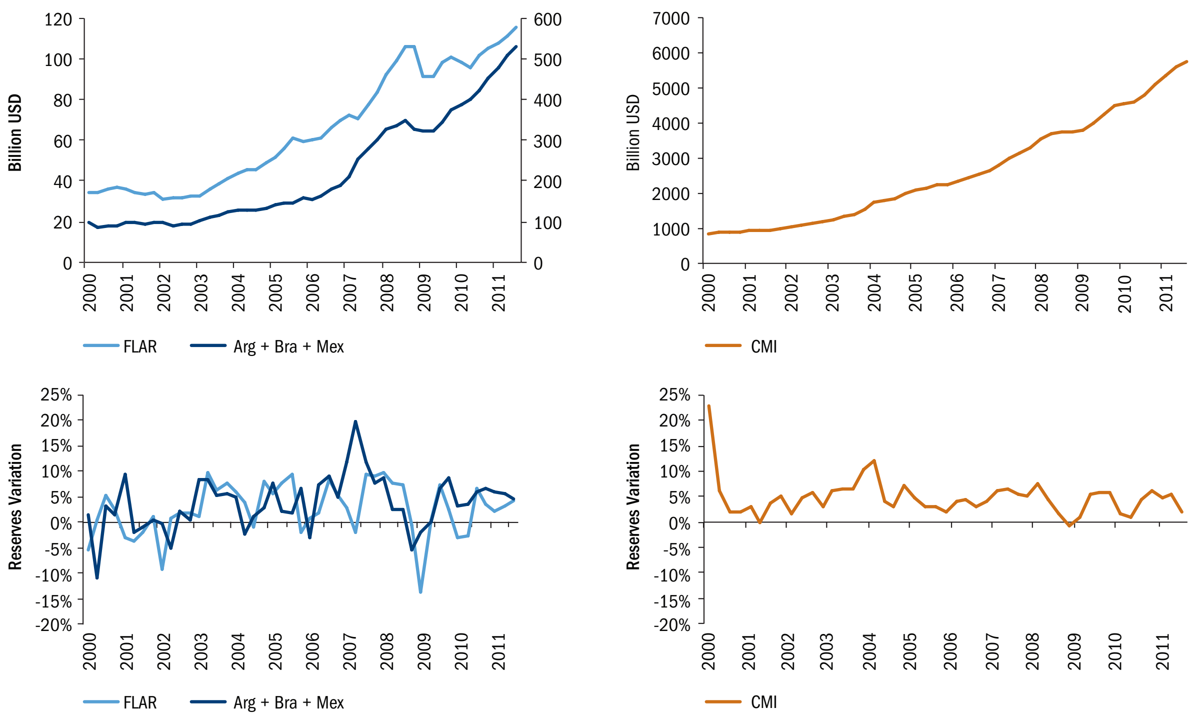
It is when the safety net's membership includes one of these issuers of last resort that regional diversification is maximized. In good times, capital would fly out from the issuers of last resort and into smaller countries, whereas the opposite would happen when risk aversion mounts. Thus, capital flows would cancel out within the arrangement, stabilizing aggregate liquidity. If there is no issuer of reserve currencies within the group, then the likelihood that the need for liquidity assistance arises simultaneously would be high, eroding diversification benefits and, ex ante, the reassuring effect that the safety net is intended to have vis-à-vis market investors.

Evidence of this can be seen by analyzing the evolution of the aggregate stock of reserves in the current and prospective members of the Fondo Latinoamericano de Reservas (FLAR; Latin American Reserve Fund) during the 2008–9 global financial crisis (FIGURE 3.9). As the figure shows, combined reserves declined by almost 20 percent for FLAR countries (and roughly the same for Brazil, Argentina and Mexico).[15] This performance contrast with the Changmai Initiative (CMI) group, where deep losses in reserves due to capital outflows in countries like South Korea where made up for by capital inflows into safe havens such as Japan or China.

FIGURES 3.8 and 3.9 together illustrate a difference between reserve pools in East Asia and Latin America. On the one hand, correlation risk does not appear to be less of a problem within most emerging Asian economies; it jumped significantly in both cases—and it has been generally higher in Asia. On the other hand, the fact that aggregate stock of reserves in CMI economies remained stable after the Lehman shock (whereas in FLAR economies it did not) shows the key role of the issuers of last resort, the recipients of the liquidity flowing out of the rest. Although the correlation between liquidity needs is not perfect and there may be a non-negligible diversification margin to be exploited in normal times, correlation risk begs the question about who would be the regional net lender within the FLAR family (or, under an extended FLAR, in the region) in a reenactment of the global crisis.

15. On a positive note, reserves in Brazil and Argentina showed a negative correlation with those in FLAR members in 2007, a reflection of the different exposure to the surge in commodity prices.

Figure 3.9. **International Reserves: FLAR versus CMI** (aggregate stocks in levels and changes)



Note: FLAR = Fondo Latinoamericano de Reservas (Latin American Reserve Fund); CMI= Changmai Initiative.
Source: Eduardo Levy Yeyati, “Fondo Latinoamericano de Reservas: Diagnóstico y Recomendaciones,” mimeo, 2012.

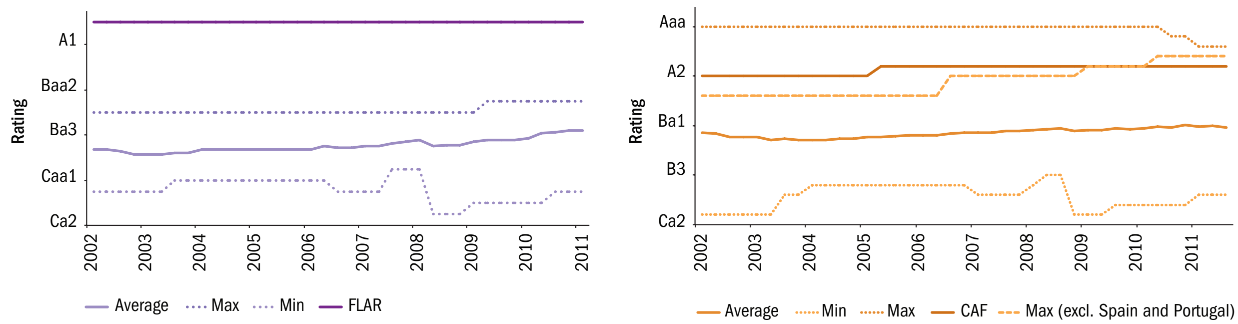
The Good: The Multilateral Effect

Despite this correlation risk and the associated limits to risk pooling, multilateral risk-sharing arrangements such as FLAR and CMI do seem to bring about a reduction in financial costs relative to individual members. *FLAR, for instance, has exhibited, since its inception, better credit ratings than any of its shareholders*, as well as a notable stability during crisis events, including those affecting the ratings of individual members (FIGURE 3.10), which translates into substantially lower credit spreads.

Why? Clearly, this could be related to low FLAR's leverage levels, which would cast doubts on the possibility to exploit these benefits on a greater scale. But this cannot be the sole reason, given that a similar pattern arises in the case of more leveraged multilateral financial institutions such as the Andean Financial Corporation (Corporación Andina de Fomento, CAF).[16] As noted, risk diversification may also play a role—a sovereign default requires that a country faces a severe foreign liquidity shortage; a default at FLAR would need several if not all participating countries to face a similar shortage at the same time. Here, however, we would like to highlight two aspects that have been far less studied and that, in our view, remain the main arguments for risk pooling at the regional level.

16. However, the pattern repeats in the case of the Andean Financial Corporation.

Figure 3.10. Can Multilateralization Rescue Borrowing Costs? FLAR versus CAF



Note: FLAR = Fondo Latinoamericano de Reservas (Latin American Reserve Fund); CAF = Corporación Andina de Fomento (Andean Development Bank).
Source: Eduardo Levy Yeyati, "Fondo Latinoamericano de Reservas: Diagnóstico y Recomendaciones," mimeo, 2012.

The first one is related to the fact that the joint management of reserves can reduce the credit risk associated to concerns about "willingness to pay," inasmuch as peer control *may contain idiosyncratic incentives to restructure debt unilaterally*, thereby reducing the overall likelihood of a default. For instance, if sovereign spreads reflect doubts about a country's willingness to pay, the country's contributions to FLAR would have a lower risk to the extent that the payment decision is now made jointly by all members with different propensities to pay, placing the probability of an opportunistic default at the level of the country with the highest propensity. Indeed, even if all of them share the same willingness to pay, peer control would reduce the incidence of individual motivations, canceling out default incentives.[17] This mechanism is associated to another one: because reserves contributed to FLAR are segregated from central bank reserves in each country, a sovereign default would not necessarily imply a decapitalization of the reserve pool.

There is also the related issue of the *implicit creditor status of the regional safety net*, similar to that enjoyed by multilaterals like the International Monetary Fund and the World Bank. Loans by the regional safety net to member countries are likely to be perceived as senior to—and, therefore, less risky than—private loans to the same country. This aspect brings up the question about the dilution effect of implicit seniority on the cost of borrowing from voluntary markets. However, if the potential credit event underlying the credit risk premium were associated, as it is often the case, with rollover and liquidity risks, the presence of a safety net that lends when nobody else does would never compete with private markets. Indeed, by ensuring that funds are available on demand and averting the risk of a liquidity crisis, its net effect on spreads should be positive.

FLAR: Prognosis and Proposals

In theory, GFSNs may be of two varieties: (1) an institution that centralizes funding and credit assessment activities, and mitigates country asymmetries related to the presence of net lenders by explicit (ex ante and ex post) eligibility criteria; and (2) customized bilateral arrangements (e.g., between members' central banks)

17. Even if in practice most defaults are rooted in capacity rather than willingness-to-pay problems, spreads often reflect market fears of an opportunistic debt restructuring.

where lender countries decide unilaterally when, whom and for how much to offer the credit facility, albeit at the expense of a usually weaker monitoring capacity.

Interestingly, the regional safety nets in Asia (the CMI) and Latin America (FLAR) fit neither of these categories. The CMI is a multilateral network of bilateral central bank swaps with no centralized credit assessment or risk sharing. FLAR, as noted above, is a reserve pool where countries can borrow with minimum requirements proportionally to their contribution to the pool. As shown by discussions at the International Monetary Fund and by the CMI's difficulty in breaking free from the IMF's interference, the process of moving from these limited arrangements to a fully functioning lender of last resort where lender countries are duly protected is far from trivial.

Who decides the conditions of access for a recipient country, and how restrictive should they be? The tension between the need for predictability (automaticity of access) and safety (conditionality to reduce credit risk) has brought back the debate on moral hazard and has determined, to a large extent, the scarce progress in the GFSNs' agenda. On the one hand, a case-by-case rule of access that is contingent on a complex (and often subjective) assessment of the repayment capacity of the applicant would be rather useless if the actors involved (the authorities and the investors) cannot know, ex ante, the size of the assistance to which the country has access in case of emergency. On the other hand, a more lenient approach may lead to a situation where political considerations override any ex ante conditionality, leading to the same moral hazard fears that inhibited similar initiatives in the past.

The CMI's case illustrates this dilemma. This Asian GFSN never actually reached the status of a reserve pool, merely structuring a network of bilateral arrangements between central banks where only 10 percent (20 percent since 2005) of total assistance could be disbursed without an ongoing stand-by negotiation with the International Monetary Fund.[18] However, the IMF's involvement proved to be self-defeating, in that the political stigma attached to the IMF in the region inhibited members from tapping the facility when the crisis exploded. This frustrating experience led to the rebirth of the plan to create an Asian Monetary Fund, a "regional IMF" thought of as a research bureau responsible for developing eligibility and monitoring criteria, among other more general duties.

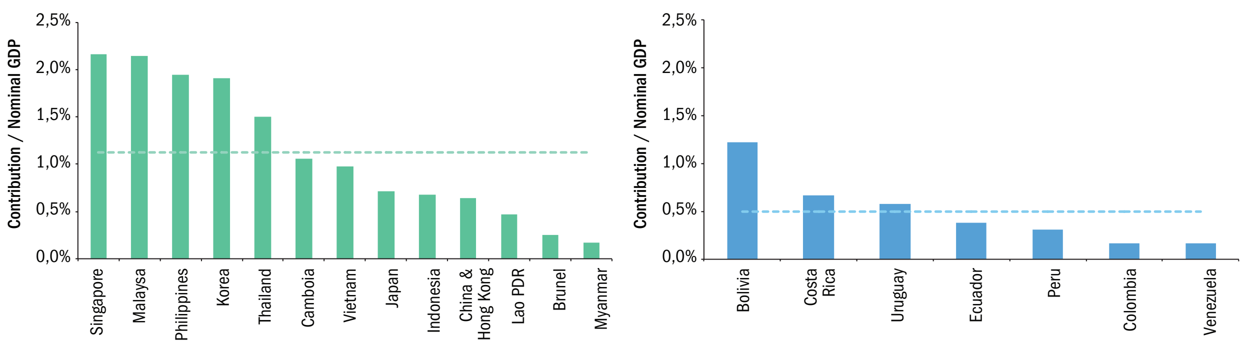
What hindered the original plan in the first place? The first factors were the difficulties in monitoring credit risk and reducing moral hazard incentives in an operational way. Defining conditionality and determining whether a crisis is exogenous or idiosyncratic—and denying access to neighboring countries in times of trouble on these bases—are difficult in a context where economic and political considerations may point in different directions, the more so in a region where deep trade links must battle a complicated historical situation that often placed neighbors against each other.[19] What criteria can China and Japan invoke to qualify financial assistance to Southeast Asia without triggering political friction?[20] Against this backdrop, in April

18. Although a proper program was not needed, the engagement of the IMF was intended to provide a certification for the recipient economy, in lieu of a regional evaluation of its intertemporal solvency and capacity to pay.
19. There are also idiosyncratic obstacles in the region. Indeed, it has been noted that the Asian project may be suffering from having not one but two issuers of last resort, Japan and China, with opposing views on sensitive economic issues (e.g., the discussion with the US on foreign exchange intervention), as well as from fears of the growing Chinese hegemony, which for some members may merit the presence of the IMF as a welcome counterweight.
20. Augmented by the presence of more delicate solvency problem, similar problems tend to limit the European Financial Stabilization Fund in the euro zone.

2011 the CMI launched the proposal for an Asian Macroeconomic Research Office (AMRO), based in Singapore and led by China and Japan, to monitor the region and develop early warning systems. This has been seen as the starting point for the design of eligibility criteria for the multilateral version of the CMI (CMIM). Unlike the originally planned Asian Monetary Fund, the AMRO aims to serve the CMIM by complementing rather than substituting the IMF in its standard monitoring functions.

By contrast, FLAR, even after taking into account the noted absence of an issuer of last resort, appears to operate in a more conducive political context without long-dated misgivings or the threat of an unwelcome hegemon. As such, FLAR is in a privileged position to become the vehicle to advance in the integration of liquidity resources as a complement to a GFSN—which, judging by the last chapters of the debate within the G-20, have reached the limit of what multilateral cooperation can offer in the medium term. How, then, can FLAR become a regional safety net? The previous discussion provides some preliminary suggestions:

Figure 3.11. Contributions to the Regional Safety Nets as share of GDP



Source: Eduardo Levy Yeyati, "Fondo Latinoamericano de Reservas: Diagnóstico y Recomendaciones," mimeo, 2012.

• ***Recapitalize:*** An apparent limitation of FLAR is its small size, related to the financial commitment of its members, its limited membership and its untested capacity to leverage in periods of distress. In comparison with its Asian peer, contributions are significantly lower in Latin America (FIGURE 3.11). For example, to achieve a GDP average contribution similar to the CMI's, the members of FLAR should triple theirs, a possible argument for FLAR recapitalization.

• ***Make FLAR truly Latin American:*** Including Brazil and Chile (countries with larges stocks of liquid foreign assets and a fluid access to markets) would be an important first step to scale up FLAR. For example, if these two countries were to join with the same percentage of their international reserves as the average current member, FLAR's capital would grow by 309 percent. If, additionally, Mexico and Argentina where added to the pool, the total increase would reached 475 percent. Conversely, with the contribution of countries with large reserves stock and better access to emergency liquidity, FLAR could deal with another obvious weakness: the fact that, unlike the CMI, the borrowing capacity of countries far exceeds fund's capital (TABLE 3.2). If, emulating the CMI, Brazil and Chile joined FLAR with a multiplier (the ratio of borrowing capacity to capital contribution) of 0.5, leaving the ratio at 2.5 for current members, the aggregate ratio of borrowing capacity to capital would fall significantly to close to one.

Table 3.2 Adding Up Resources: FLAR versus CMI

Country	Contribution	Multiplier	Borrowing Quota	GDP	Quota, % of GDP	IMF Delinked Quota	Quota, % of GDP
CMI							
Brunei	00.3	5	0.15	1.662	9.03%	0.03	1.81%
Cambodia	0.12	5	0.6	13.158	4.56%	0.12	0.91%
China-Mainland	34.20	0.5	17.1	6,988.47	0.24%	3.42	0.05%
China-Hong Kong	4.20	2.5	10.5	246.941	4.25%	2.1	0.85%
Indonesia	4.55	2.5	11.38	834.335	1.36%	2.276	0.27%
Japan	38.40	0.5	19.2	5,855.38	0.33%	3.84	0.07%
Korea	19.20	1	19.2	1,163.85	1.65%	3.84	0.33%
Lao PDR	0.03	5	0.15	7.891	1.90%	0.03	0.38%
Malaysia	4.55	2.5	11.38	247.565	4.60%	2.276	0.92%
Myanmar	0.06	5	0.3	50.201	0.60%	0.06	0.12%
Philippines	4.55	2.5	11.38	216.096	5.27%	2.276	1.05%
Singapore	4.55	2.5	11.38	266.498	4.27%	2.276	0.85%
Thailand	4.55	2.5	11.38	339.396	3.35%	2.276	0.67%
Vietnam	1.00	5	5	121.611	4.11%	1	0.82%
TOTAL CONTRIBUTIONS	120	Total Borrowing:	129.1	Average	3.25%	Average	0.65%
FLAR							
Bolivia	0.20	2.6	0.51	0.51	2.13%		
Colombia	0.39	2.5	0.98	0.98	0.30%		
Costa Rica	0.20	2.5	0.49	0.49	1.22%		
Ecuador	0.20	2.6	0.51	0.51	0.78%		
Peru	0.39	2.5	0.98	0.98	0.58%		
Uruguay	0.13	2.5	0.33	0.33	0.67%		
Venezuela	0.39	2.5	0.98	0.98	0.32%		
TOTAL CONTRIBUTIONS	1.89	Total Borrowing:	4.77	Average	0.86%		

Ratio of Borrowing of Contributions	
CMI	**1.08**
FLAR	**2.52**

Note: Contributions, quotas, and GDP figures are expressed in billions of dollars.
Source: Brookings Latin American Economic Perspectives, November 2011.

• ***Formalize the rules of engagement:*** The possible—and increasingly probable—expansion of FLAR to include new "lender" countries reintroduces the institutional debate about who decides the conditions of access. Again, the Asian and European experiences are illuminating. How prone is the region to self-evaluation? More important, is it conceivably a plan whereby the "lender" countries have the needed reassurance to become regional lenders without reproducing a situation similar to the International Monetary Fund (or, potentially, the CMIM-AMRO), which creates discomfort among "borrowing" members? Although this question involves complex political aspects, from an economic perspective it seems almost inevitable that an expanded, asymmetrical FLAR with lender countries would require the presence of an evaluation office that defines and monitors objective and verifiable conditions to size and activate the credit lines. Assuming, as in the Asian case, that this role cannot be delegated to the IMF, the question remains whether this evaluation should be taken over by FLAR (perhaps the most natural choice at the early stages) or by a new, independent unit.

• ***Make FLAR a vehicle to engage the international financial community:*** As noted, the multilateral debate on GFSNs seems to have come to a halt; even the most recent IMF proposal (a Global Stabilization Mechanism, still waiting for Board approval) vows to complement regional efforts as the next stage in the building up of financial safety nets. In this light, FLAR is the obvious vehicle to articulate the regional integration of financial liquidity with the international financial community. Indeed, its limited lending capacity could usefully be supplemented with lines of credit with international agencies such as the IMF, as well as with central banks like the US Federal Reserve—thus reducing the need for leveraged liquidity hoarding in normal times. Although this regional–multilateral collaboration would likely need to overcome the reluctant global counterparties to incur contingent liabilities with an institution funded by non–investment grade shareholders, it would not only be the ideal plan to further GFSNs but also an effective way for developed economies to help offset growing foreign exchange intervention in the developing world.

CHAPTER 4

COUNTRY ANALYSES

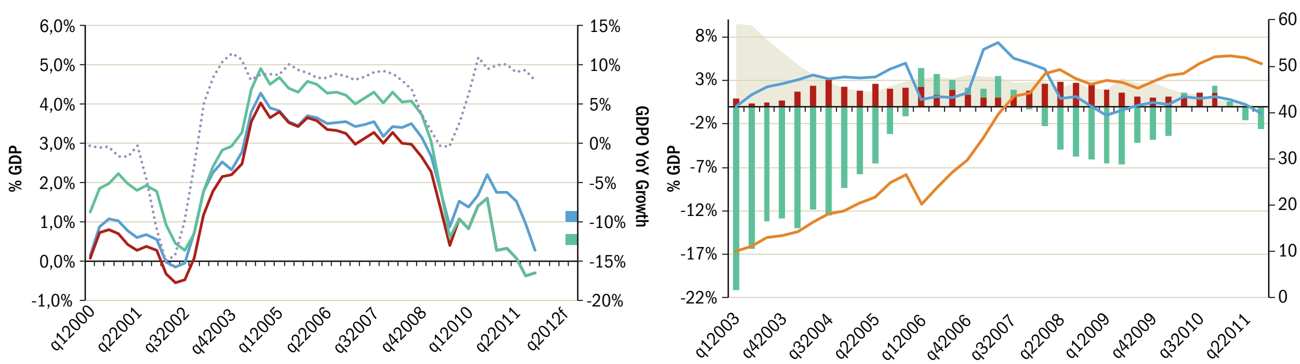
ARGENTINA 2012: THE SCARCITY TEST

Eduardo Levy-Yeyati, Brookings Institution

Abundance helps disguise policy mishaps. So far, the macroeconomic strategy of distributing inflationary growth into corporate profits, stable real wages and fiscal resources (to fund social protection and political transfers) has kept everybody happy—at the expense of narrowing the twin surpluses engineered in 2002 and cashing in on an inflation tax with diminishing marginal returns. Today, fiscal revenues (which were aided in the past by disguised pockets of public savings and, more recently, by the appropriation of pension fund assets) are running thin, and inflation is starting to take its toll on spending through ballooning energy and transportation subsidies—the flipside of artificially depressed tariffs and transportation tickets. In addition, export dollars are no longer enough: a shrinking current account surplus (from $3 billion in 2010 to an estimated $1 billion in 2011) and private foreign asset accumulation that neared $21 billion translated into a $6 billion decline in central bank reserves in 2011.

We need to keep in mind, however, that there is a difference between this comeback of the twin peso and dollar deficits and similar episodes in the past. The Argentine government (as well as the country as a whole) today enjoys a long dollar position in its near-term cash flow (a short dollar position was arguably the driver of most dollar liquidity crises in the 1990s); there is a depreciated exchange rate for which these two deficits are largely sorted out. Precisely because of this, the scarcity test introduces risks that are not as much economic, as they were in the past, as they are political. As a result, the implications discussed in this section differ from what conventional wisdom (and much of the tired media analysis) would suggest. In this light, the intertemporal trade-off is once again tilted to the present. Argentina will likely muddle through a complicated year without a significant revision of the "model"—albeit at a nontrivial cost in terms of stability and development: falling reserves, greater agro-dependence, declining investment, stagnant productivity and, ultimately, disappointing growth **(FIGURE 4.1)**.

Figure 4.1. Argentina's Adjusted Fiscal Deficit and Central Bank Reserves



Source: Elypsis, based on data from National Statistics and Census Institute, Ministry of Economy and Public Finance (Argentina).

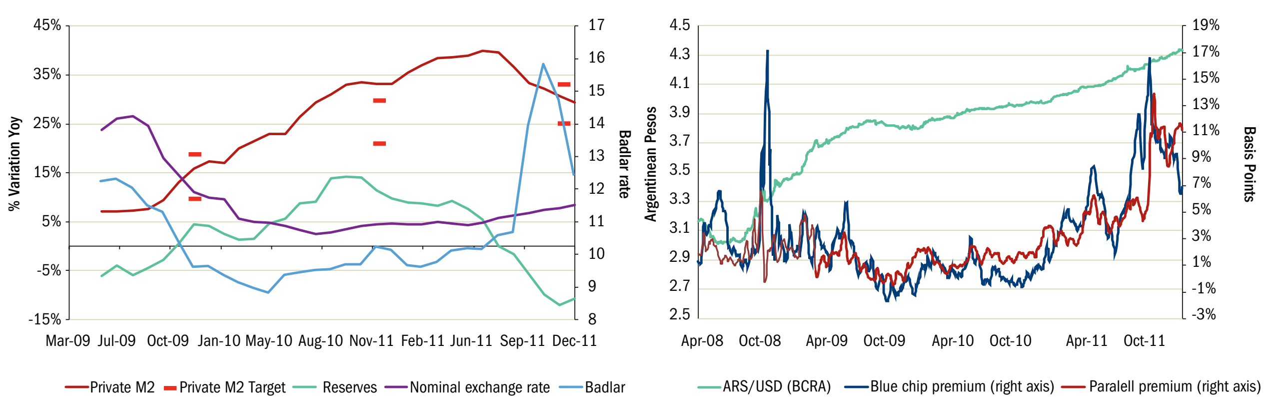
The Dollar Deficit: The Limits to the Exchange Rate Anchor

Central bank reserves declined in 2011 by close to $6 billion. While this loss (which would have been larger in the absence of controls on dollar purchases in the last quarter) speaks of a dollar shortage almost by definition, the underlying dynamics have less to do with an appreciating currency (the current account printed a very small surplus) than it does with two related Argentine standards: the lack of appealing financial instruments in pesos and, largely as a result of this, the propensity to keep a large portion of personal and corporate savings in assets denominated in foreign currency (which is usually referred to as "financial dollarization"). More specifically, *the dollar deficit was financial rather than real*—a reflection of private capital outflows that grew from a "typical" $1 billion to close to $3 billion per month in the third quarter of 2011, before the presidential election.

Many of the underlying reasons are not new and will not go away soon: negative real deposit rates (after peaking at 23 percent in September, deposit rates were brought down to 15 percent by the Central Bank), inflation underreporting that precludes CPI indexation, and a combination of two-digit inflation and one-digit depreciation rates that adds to the expectations of a discrete exchange rate correction. But the acceleration of capital flight (FIGURE 4.2) went beyond those structural factors and was closer to a speculative run; falling reserves creating the perception of an overvalued currency (or, at least, a dollar deficit) and triggering speculative dollar purchases that feed back into depreciation expectations.

Against this backdrop, the official response to intervene heavily and avoid a dollar correction even at the expense of reserve losses is moving closer to a *tablita*: a strong commitment toward a one-digit depreciation rate in a two-digit inflation context, reminiscent of an 1980s-style exchange rate anchor. The use of opaque criteria to directly limit foreign exchange purchases may have only validated the expectations that launched the run in the first place. As a result, *the parallel exchange rate "decoupled" from the blue chip dollar to trace the official dollar at roughly a 10 percent premium*.[21]

Figure 4.2. Argentina's Adjusted Fiscal Deficit and Central Bank Reserves



Note: Badlar is an average of interest rates on large deposits at private banks.
Source: Elypsis, based on data from the Central Bank of Argentina, MERVAL and Ministry of Economy and Public Finance (Argentina).

21. Often mistaken with each other, the blue chip (cross-market) premium reflects controls on capital outflows whereas the parallel (informal market) premium conflates both tax enforcement and administrative controls on dollar purchases.

Things will change in 2012. On the financial front, dollar repression should keep capital flight at "typical" levels ($12 billion per year or less), and the decline in the already low level of foreign direct investment (FDI cash inflows were just $6.1 billion in 2011) should be compensated for with limits on dividend transfer and forced profit reinvestment. On the trade front, the subsidy cut should contain the energy-related deficit, and slower demand and the strengthening of non-tariff barriers should keep a lid on imports, which we expect to increase modestly, well below the 31 percent in 2011. However, weaker and cheaper exports and a harvest handicapped by the drought should outweigh the decline in imports, leading to a drop in the goods trade balance, *and the first post-crisis current account deficit (about $6.5 billion, or 1.3 percent of GDP). Unlike in 2011, in 2012 the dollar deficit will be largely real* (TABLE 4.1).[22]

Table 4.1 Argentina's Balance of Payments: Alternate Takes

	2009 USD bn	2010 USD bn	2011e USD bn	2012f USD bn	% GDP
Current Account (A)	**11,0**	**2,9**	**1,7**	**-6,5**	**-1,3%**
Exports of Goods and Services	66,7	81,3	99,6	95,2	18,4%
Imports of Goods and Services	49,4	68,0	86,7	89,3	17,2%
Interest	-2,3	-2,7	-3,3	-3,3	-0,6%
Dividends	-6,6	-7,2	-7,3	-8,6	-1,6%
Capital and Financial Account	**-8,4**	**2,8**	**-9,8**	**1,0**	**0,2%**
By Type of Resident					
Non Financial Public Sector	-0,7	2,2	-0,5	0,9	0,2%
Private Sector(B)	-7,3	2,9	-9,2	0,0	0,0%
Financial	0,4	0,3	1,4	1,7	0,3%
Non Financial	-7,7	2,6	-10,6	-1,8	-0,3%
By Type of Asset					
FDI (Net)	3,3	6,1	5,6	7,2	1,4%
Portfolio + Finan. Derivatives	-4,4	5,1	0,9	0,9	0,2%
Other Investments	-7,4	-8,5	-16,3	-7,2	-1,4%
Errors And Ommisions	**-0,4**	**-1,1**	**-0,8**	**-0,8**	**-0,1%**
Reserves y/y	**1,3**	**4,2**	**-6,3**	**-5,8**	**-1,1%**
Reserves Stocks	**48,0**	**52,2**	**46,4**	**40,6**	**7,8%**
Memo: Reserves related Items	-0,9	-0,5	2,6	0,5	0,1%
Dollar Shortage (A + B)	3,8	5,8	-7,5	-6,5	-1,3%

Source: Elypsis, based on data from the Central Bank of Argentina, International Monetary Fund and National Statistics and Census Institute.

The Peso Deficit: Adjustment Semantics

In 2011, the primary fiscal balance reached negative territory for the first time since 2001 (–0.3 percent of GDP) and was offset by a 0.6 percent GDP quasi-fiscal surplus that mainly consisted of unrealized central bank profits. For 2012, a cyclical slowdown, coupled with tax procyclicality (including through lower compliance in bad years), points to tax revenues growing in line with nominal GDP. In addition, the combination of

22. Crucially, this scenario assumes a partial success of the blockade on imports and on dividend outflows (hence, the moderate increase in FDI).

slowing exports and stagnant imports should lead to a *fall in dollar proceeds from trade taxes* from $16.7 in 2011 to $15.8 in 2012 (a decline of 0.7 percent of GDP). The plan to carry on with the current exchange rate policy does not help on this front. Because the currency position of near-term public sector cash flows is long dollars, a slower depreciation should tighten the fiscal constraint.

Now that the post-crisis margins are all but gone, the government faces a trade-off between the political cost of adjustment and the economic (and ultimately political) cost of procrastination. Hence, the overdue subsidy cut and the proactive campaign to keep wage hikes below 20 percent were the two main fiscal responses on the table at the beginning of the year. However, the fate of these two measures was always uncertain, as efforts focused on reducing the political cost of the adjustment; moreover, a slowing down demand coupled with the political repercussions of the February 22 train wreck appear to have postponed the tariff adjustment almost indefnitely. Indeed, the soon-to-be-approved ammendment to the central bank charter seems to respond to this change of plans, as it releases constraints on reserves transfers and monetary financing of the deficit, hinting at a loose fiscal money policy mix. Against this moving backdrop, the base case scenario depicted in TABLE 4.2, which assumes $3.3 billion in subsidy cuts (out of roughly $20 billion spent in 2011) and a moderate increase (23 percent) in the pool of public sector salaries (with a resulting $3.5 billion primary surplus—$0.6 billion, if quasi-fiscal profits are excluded), most likely overstates the fiscal adjustment as it understates inflation.

In turn, net public sector borrowing requirements, assuming the rollover of debt with multilaterals and public sector agencies, would be roughly $10.5 billion—$6 billion of which will likely be met with the transfer of central bank reserves, placing them close to the $40 billion psychological level. With sovereign debt issuance out of the question, the remaining gap ($4.5 billion), though still "manageable," would likely feed into the political risk and fears of public intervention in private profit niches (as in the ongoing feud sorrounding the oil company YPF-Repsol) detracting from private investment.

Table 4.2 Argentina's Fiscal Outlook: Flows and Financing Gap

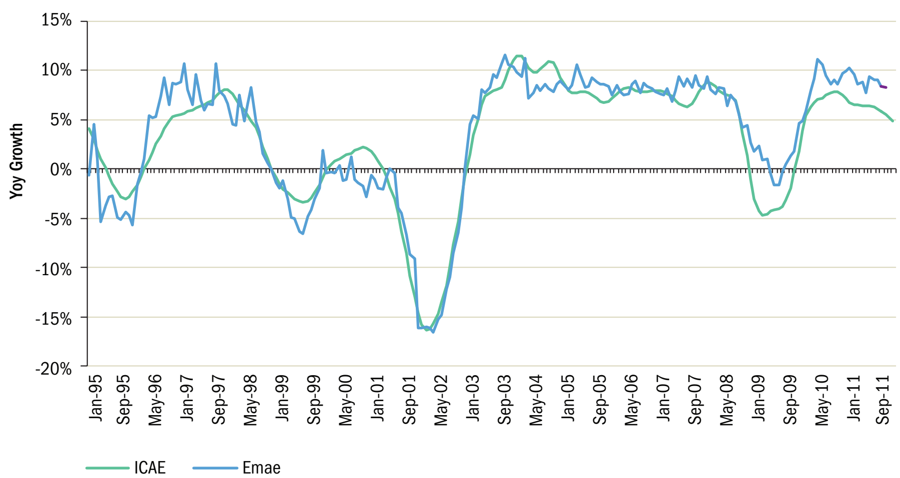
	Change (yoy)			% GDP			USD bn		
	2010	2011	2012f	2010	2011	2012f	2010	2011	2012f
Total Revenues	**35**	**24**	**24**	**24,3**	**23,6**	**24,2**	**90**	**105**	**119**
Tax Resources	37	28	22	14,3	14,3	14,4	53	64	71
Contributions	31	32	29	7,0	7,3	7,7	26	32	38
Property Income	104	-27	26	2,2	1,3	1,3	8	6	6
Others	-36	25	26	0,8	0,7	0,8	3	3	4
Total Expenditure	**30**	**37**	**22**	**20,9**	**22,3**	**22,5**	**77**	**100**	**111**
Remunerations	42	27	20	3,3	3,3	3,3	12	15	16
Goods and Services	34	34	25	1,1	1,1	1,2	4	5	6
Property Income	-10	61	26	1,5	1,9	2,0	6	9	10
Social Security	29	37	30	7,4	8,0	8,6	27	36	42
Transfers to private sector	45	36	1	5,3	5,6	4,7	19	25	23
Transfers to public sector	21	15	25	1,8	1,6	1,6	7	7	8
Capital expenditures	**27**	**17**	**25**	**3,2**	**2,9**	**3,0**	**12**	**13**	**15**
Primary net quasi-fiscal outcome				**0,3**	**-0,3**	**0,1**	**1,0**	**-1,3**	**0,6**

Source: Elypsis, based on data from the Ministry of Economy and Public Finance (Argentina).

Growth Prospects: A Shot in the Dark

GDP data have become increasingly suspect. Distorted since the beginning by the underreporting of the consumer price index used in the elaboration of the national accounts (most notably, private consumption), they are now widely perceived as deliberately exaggerated. As with the CPI, there is no simple way to make up for this statistical drawback. We constructed a Coincident Index of Economic Activity, an imperfect substitute, based on nine series that showed a tight contemporaneous correlation with the official monthly GDP proxy (Estimador Mensual de Actividad Económica, or EMAE), up until the intervention of the National Statistics and Census Institute (INDEC). *Our results indicate that (1) growth has been overstated since 2007, particularly during bad periods, accumulating a sizable 14 percent growth differential; and (2) economic activity slowed down considerably by the end of 2011 (with an average year-to-year change of 6 percent, compared with the official 9 percent we expect based on the evolution of the EMAE)* (FIGURE 4.3).

Figure 4.3. Argentina's Coincident Index of Economic Activity and Official Growth Figures



Source: Elypsis, based on data from the Ministry of Economy and Public Finance (Argentina).

It is hard to see where growth is going to come from in 2012. External demand appears softer than in 2011 (Brazil will likely have a modest boost, from 2.7 to 3.5 percent, and commodity prices are expected to remain stable). Local demand (particularly, durables) should suffer from the fiscal adjustment (subsidy cuts plus multiple tax hikes at the provincial level). And local supply should reflect a drought that is now expected to put the 2012 harvest a notch below 2011, and from restrictions on imports (most of which are capital and intermediate goods) that will eventually become a drag on output. All things considered, *we see a considerable downside risk to our 3.1 percent GDP growth forecast (a 1.6 percent carryover plus 1.5 percent underlying growth)—a number that is likely to be inflated by 2 to 3 percent in official statistics.*[23]

23. The Coincident Index of Economic Activity is built from the following nine variables selected according to their contemporaneous correlation with the EMAE for the period 1997-2006: Real values are computed using the official consumer price index until end-2006 and an estimated consumer price index based on information from provincial statistics bureaus thereafter. Year over year changes in the selected variables are weighted by the inverse of their standard deviation relative to the sum of the inverse of the standard deviation of all the series. The result is then rescaled to match EMAE's standard deviation and accumulated over time to obtain an index.

The Usual Disclaimers: It's Politics, Stupid!

What are the main risks of the outlook described above? On the upside, the government may find ways to fuel short-term demand with a view to next year's midterm elections (a small-probability event, now that the fiscal margin had run out). On the downside, the global environment can deteriorate, dragging down growth via slower external demand, lower commodity prices and more exchange rate pressure (which, under the tablita, has an amplifying effect on money and growth). And, with scarce fiscal space, the economy may prove to be less resilient than in the past.

That said, the main downside risks are, in our view, noneconomic: political misjudgment and policy mismanagement. The pseudo-currency run of the late 2011 is a good illustration. A moderate exchange rate correction in line with trading partners and a modest increase in the interest rate would have softened the speculative demand for dollars. Instead, the introduction of controls on dollar purchases and capital outflows only validated the transfer and convertibility risk fueling capital flight, and overshot the parallel exchange rate defeating the anchor benefits of the tablita. This notwithstanding, the government saw the controls as a victory against an "economic coup," and the current exchange rate policy will very likely prevail.

These "political" risks considerably widen the distribution of outcomes. Normal exchange rate pressure could translate into a full-blown currency run; manageable financing needs may trigger confiscation or nationalization fears; the easy rollover with multilaterals may be hampered by improvisation and ill-designed, underexecuted programs; the goal of preserving the trade surplus may lead to forceful trade barriers that choke an import-intensive industry; and the need to make up for dwindling credit to the private sector may expose the Central Bank to private credit risk that would compromise its balance sheet.

In the past, speculation that pragmatism would prevail in bad times proved to be wishful thinking. Similarly, today, as the government faces the scarcity test for the first time, it is showing little plasticity. Beyond a belated (and, possibly, failed) attempt at fiscal rationalization, symbols of politically motivated fiscal profligacy (e.g., Aerolíneas Argentinas, Fútbol para Todos), the complacent, conspiratorial rhetoric and a growth model driven by natural resources (now gearing toward controversial mining projects) remain intact. Moreover, most make-up resources (reserves, remaining pension fund savings) are one time only. Without a tactical change, the government is unlikely to pass the scarcity test.

BRAZIL: NEW POLICY APPROACH IN A VOLATILE GLOBAL ENVIRONMENT

Mario Mesquita, Brevan Howard Asset Management

The international environment, where emerging economies keep being hit by shocks emanating from advanced regions, and which has been characterized by ample liquidity provision by major central banks, at extraordinarily low interest rates, has tested the traditional policy framework in Brazil and the response, innovative.

In particular, Brazil in the second year of Dilma Rousseff's presidency is beginning to be marked by policy changes relative to the preceding Lula da Silva administration. Although there are differences in other areas such as trade and capital flows, nowhere has this been more apparent than in the government's approach to inflation control.

Essentially, the new approach seems to consist of a policy mix that relies more on fiscal and macroprudential policies to manage aggregate demand, and less on conventional monetary policy. The authorities have also been more patient with respect to deviations of inflation from its central 4.5 percent target, with more prolonged use of the tolerance band. This might be in order to, on the one hand, mitigate GDP volatility, and, on the other, moderate incentives to interest rate arbitrage that might contribute to additional strength of the Brazilian real. The new approach has stressed the Central Bank's role as the warden of financial as well as price stability—even though it has held prudential responsibilities since its inception in 1964.

Moreover, there is apparently more willingness to actively manage capital flows. On trade, there is clearly a more defensive attitude, especially regarding sectors that are deemed of strategic importance, like automobile manufacturing.

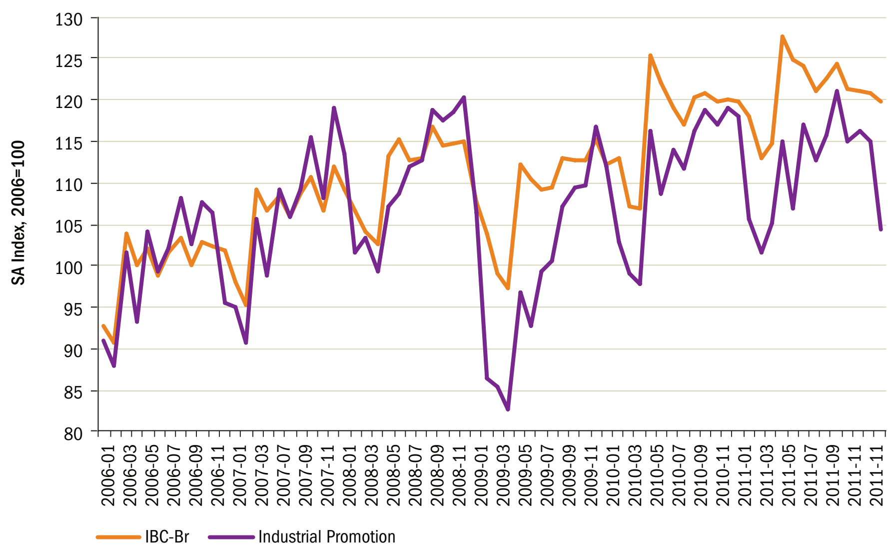
One area where we have, as yet, seen less substantial changes is fiscal policy. Although the government has resumed implementation of its reform agenda (which had been frozen for several years), most notably through the initiative to approve the creation of a defined-contribution pension fund for civil servants actual policy implementation has not changed much.

Specifically, while the primary surplus reached 3.1 percent of GDP in 2011, the first year of the new administration, compared with an average of 2.4 percent in the last couple of years under Lula, the average seen before the crisis (2003–8) was 3.5 percent of GDP. The same applies to primary federal expenditures—at 17.5 percent, the ratio to GDP is lower than in 2009–10, but higher than in 2008. With these figures, it may be premature to conclude that fiscal policy has been permanently strengthened.

The new policy framework became apparent during 2011, when the economy underwent a major deceleration engineered by the government to rein in inflation, which had ended 2010 at 5.9 percent. Implementation of the contractionary policies actually started in the final days of the previous administration, when a macroprudential package, including increase in reserve requirements and selective and targeted tightening of capital adequacy requirements, was introduced. This was followed by conventional tightening between January and July (175 basis points in total) and accompanied by the cited increase in the primary surplus of the consolidated public sector, from 2.7 to 3.1 percent of GDP.

As a result of this policy strategy and, to a lesser extent, the global slowdown seen in the second part of the year, activity weakened substantially during the first three quarters, as evidenced by the Central Bank's monthly GDP proxy (the IBC-Br). This series, adjusted for seasonal effects, peaked in March, and then trended lower to reach a minimum in October (FIGURE 4.4).

Figure 4.4. Brazil: Overall Activity vs. Industrial Production



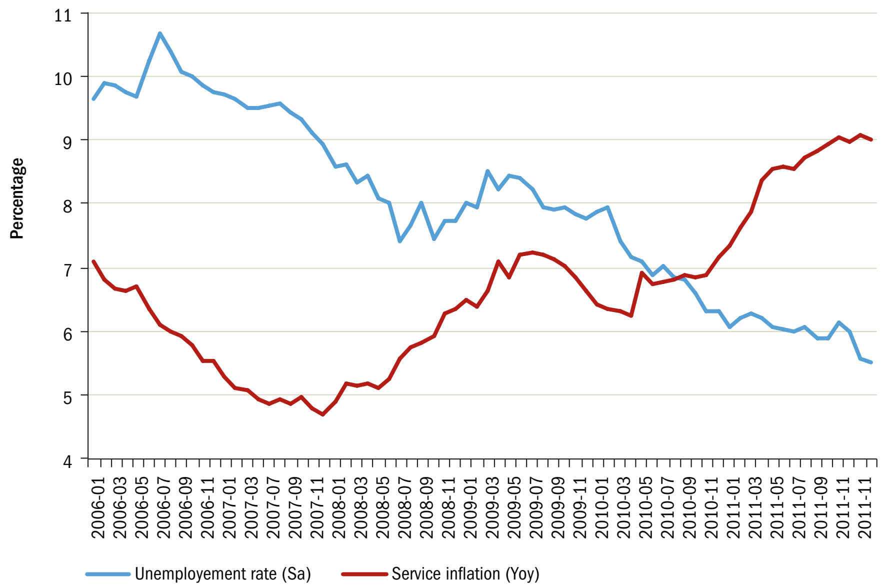
Note: IBC-Br - BCB's monthly activity indicator (proxy for monthly GDP)
Source: Banco Central do Brasil (BCB) and IBGE

The extent to which the slowdown may have widened the output gap is open to question, in particular as the labor market still seems rather tight. The unemployment rate, which is 5.6 percent in seasonally adjusted terms, is in fact below the bulk of estimates of the non-accelerating inflation rate of unemployment, and accounts for the high and persistent pressures on the price of services (FIGURE 4.5). Capacity utilization in manufacturing suggests more slack, as the last reading was 83.7 percent, compared with more than 86 percent in the maximum seen just before the 2008 crisis. But current levels are substantially higher than the minima seen at the worst moments after the crisis (77.9 percent in February–March 2009), and are in fact a bit higher than the series' long-term average.

Recently, there have been signs that activity may have rebounded ,albeit in a tentative way. The seasonally adjusted retail trade series rose by 3.2 percent in cumulative terms in November and December 2011, after having contracted by 1.5 percent between July and October. Industrial production, which had a dismal patch between April and October 2011, also revived in the last two months of the year, although it keeps lagging in demand-side indicators and was weaker again in January-February. The Central Bank's own seasonally adjusted monthly activity indicator posted a cumulative 1.9 percent increase in November and December, after contracting for three months in a row previously —it was marginally down in January.

Of course, a marginal improvement of the data is always subject to reversals, and the evidence still suggests that growth will be modest in 2012, starting weak but accelerating in the coming quarters—specifically, the current consensus estimate is that GDP that grew by 2.7 percent in 2011, will expand by 3.2 percent in 2012.

Figure 4.5. Brazil: Unemployment and Services Inflation



Note: Note: Unemployment based on own seasonal adjustment
Source: IBGE

Still, there are grounds to be confident that the recovery will take hold—assuming we have no additional deterioration in global financial and economic conditions. First, the Central Bank shifted toward easing in August 2011, and the bulk of the effects of its rate cuts on activity are still to play through.

In addition, the government decreed a 14 percent increase in the minimum wage, effective January 1, 2012, which will add about R$60 billion to household income this year (1.4 percent of GDP). Moreover, the tight labor market in itself should lead to sustained income growth, supporting the expansion of household spending.

The other main driver of consumption, credit, seems to be poised to be more supportive in 2012 than it was in 2011. Interest rate cuts will impact lending, and household indebtedness indicators seem to have stabilized—Brevan Howard proprietary debt and debt service to income indicators stabilized at 39 and 23 percent, respectively, in late 2011 (exhibiting similar behavior to those compiled by the Central Bank). High frequency delinquency indicators seem to have peaked in October 2011 and declined thereafter, which should also help support household credit, whose expansion slowed to 21 percent in 2011 from 29 percent in 2010. Recent initiatives to use public sector banks to foster credit growth may also provide additional support to activity.

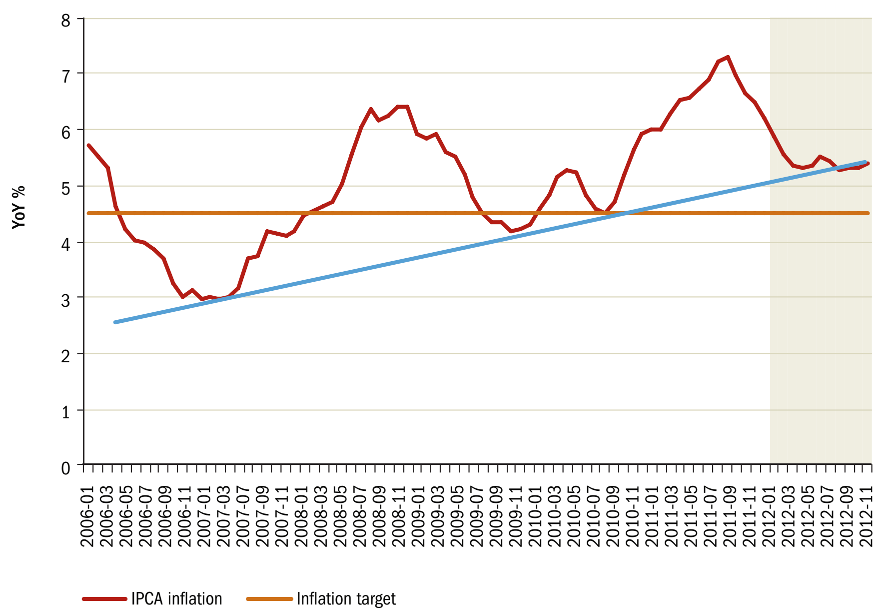
On investment, the approaching international events (the 2014 World Cup and Rio de Janeiro's 2016 Olympics) are leading to a much-needed, and long-delayed, effort to improve the country's infrastructure, especially in the key transportation sector—earlier this year the government auctioned concessions on three important airports, and more are likely to follow. Moreover, oil sector investment is likely to accelerate, as Petrobras gears up to explore sub-salt reserves. Investment in manufacturing in its turn is likely to be pulled by somewhat high rates of capacity utilization, the strong Brazilian real (hence higher affordability of capital goods) and favorable funding conditions—especially if there is a revival in risk appetite and more buoyant capital market activity.

The external sector, on one hand, should be a more intense drag on activity than in 2011, as domestic demand is likely to reaccelerate, and as the Brazilian real is likely to remain strong in inflation-adjusted terms. On the other hand, government consumption, especially in the first half of the year, before legal restrictions (linked with the October municipal elections) kick in, should be more supportive in 2012.

This moderately benign scenario faces risks, however. One is obviously the external scenario. Although Brazil is a closed economy (trade accounts for just 19 percent of GDP), financial linkages and the influence of the external environment on local monetary conditions, as well as on business and consumer confidence, are significant. Moreover, some key sectors of the economy, especially in manufacturing, are dominated by multinationals, several of which based in Europe, so a deep crisis in that region would inevitably spill over into Brazil.

Looking at the domestic economy, a risk stems from credit growth. It should be noted that whereas credit delinquency is lower than in 2008 and 2009, it has increased compared with 2010, and that has happened even though unemployment is historically at very low levels, and real interest rates are also below recent norms. Brazilian banks are operating with wide capital cushions, but years of rapid credit growth, and development of new product lines, such as housing (which saw 51 percent growth in 2010, followed by a 44.5 percent expansion in 2011), may have created vulnerabilities in the system.

Figure 4.6. Brazil: Inflation



Note: Shadow refers to forecasted values.
Source: IBGE, Brevan Howard.

Finally, a quintessentially Brazilian risk may be emerging: inflation. The fact is that since 2006 despite occasionall respites, Brazilian inflation has seemed to be trending up, with each successive trough higher than the preceding one (FIGURE 4.6). In an economy that still has a considerable memory of past inflationary excess—and with widespread, albeit informal, indexation (especially of wages and the prices of services)—this trend is worrying. Moreover, as the authorities themselves have been stressing, the global environment has been exerting a mostly disinflationary impact on Brazil. When the global economy recovers, with stronger external demand and faster increases in import prices, the domestic drivers of inflation will need to be reined in, and this may require a shift toward more contractionary policies 2013, which would probably take the same form as in 2011, a combination of macroprudential and conventional policy measures.

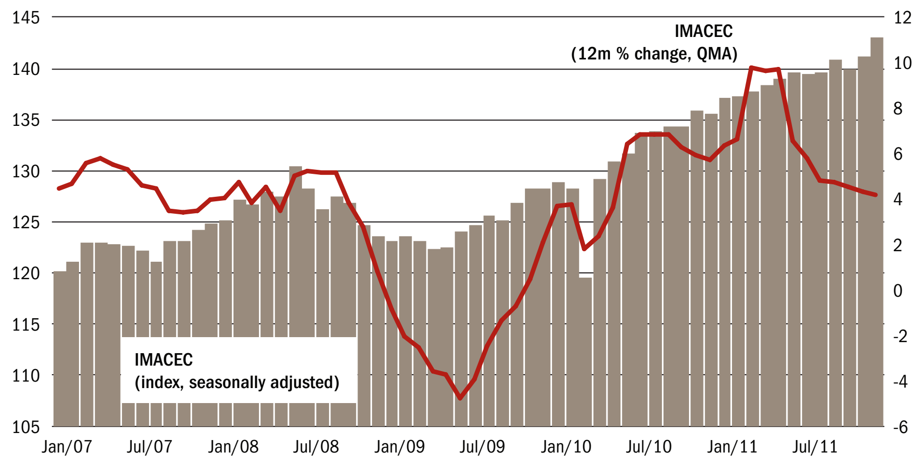
In the most likely, consensual scenario, Brazil will accelerate from a little less than 3 percent growth in 2011 to less than 3.5 percent in 2012, performance that would be decent but far from spectacular. In fact, if consensus expectations pan out, GDP growth in 2009–12 would average close to 3.5 percent, raising the issue of whether this might not be the post-crisis "new normal" for the Brazilian economy—which would still be better than the 3.1 percent long-term mean growth seen since the end of hyperinflation but would be definitely less exciting than the faster growth rates seen in the 2006–8 period.

CHILE: MODERATE GROWTH AMID RISING ECONOMIC AND SOCIAL CHALLENGES

Esteban Jadresic, Moneda Asset Management

The Chilean economy enjoyed rapid growth in 2011, estimated at 6.2 percent on a year-to-year basis. This growth was led by domestic demand, particularly investment in fixed capital and consumption, which grew at 16.9 and 8.1 percent, respectively. Although gross exports expanded by 7.4 percent, net exports were a drag on demand as gross imports increased 14.3 percent. These figures broadly represented a continuation of the economic dynamism seen since mid-2009, which was interrupted only briefly by the earthquake that hit the country in February 27, 2010. (FIGURE 4.7).

Figure 4.7. Chile's Monthly Economic Activity Index



Source: Central Bank of Chile.

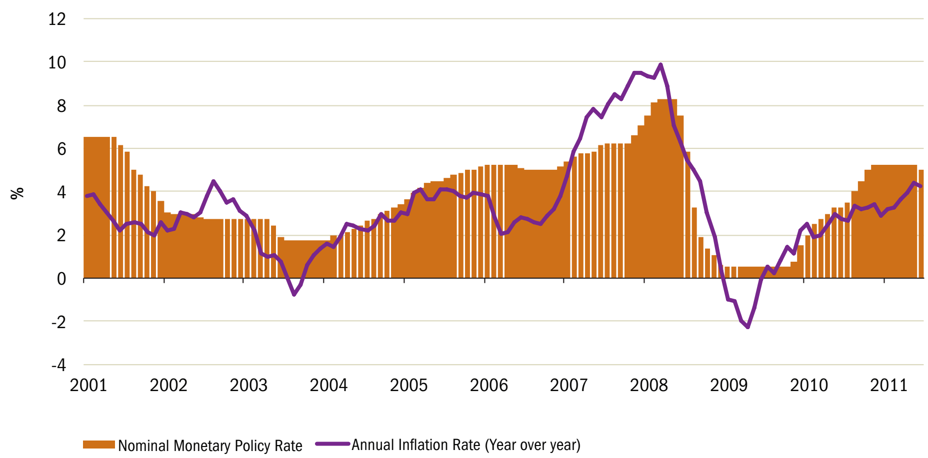
Output growth in 2012 is expected to moderate on a year-to-year basis, due both to the global slowdown and an internally induced decline of domestic demand. The latter is due to the wearing out of a cycle that brought up to date the purchases and investments that were postponed following the collapse of Lehman Brothers, as well as to a cycle of monetary policy tightening that the Central Bank implemented during the first half of 2011 (FIGURE 4.8). However, domestic demand, especially investment in construction, is likely to remain robust, providing support to growth above 4 percent for the current year, according to recent consensus forecasts. During 2013, and contingent on developments abroad, the economy could expand at close to its trend growth rate, which is currently estimated at 4.9 percent by the Ministry of Finance Committee of External Experts.

With output and employment estimated at close to their potential, the key short-term policy issue currently is how to best to fine-tune monetary and fiscal policies to deal with the downside risks coming from the global economy and the inflation risks due to tight labor and nontradable product markets.

During the second half of 2011 and until the start of 2012, both markets and policymakers focused on the potential need to apply countercyclical policies to compensate for the adverse effects of the financial crisis in

Europe and the slowdown of the global economy. In this context, the Central Bank first stopped its tightening agenda, then signaled the likelihood of interest rate cuts, and finally, in January 2012, reduced the monetary policy rate to 5.25 percent from 5 percent. Also, in December 2011 it took measures to provide extraordinary liquidity to the banking system. The Ministry of Finance, in turn, complemented its budget proposal for 2012 with the preparation of a contingency plan to support employment and investment in case the external scenario deteriorated significantly.

Figure 4.8. Chile's Monetary Policy Rate and Inflation



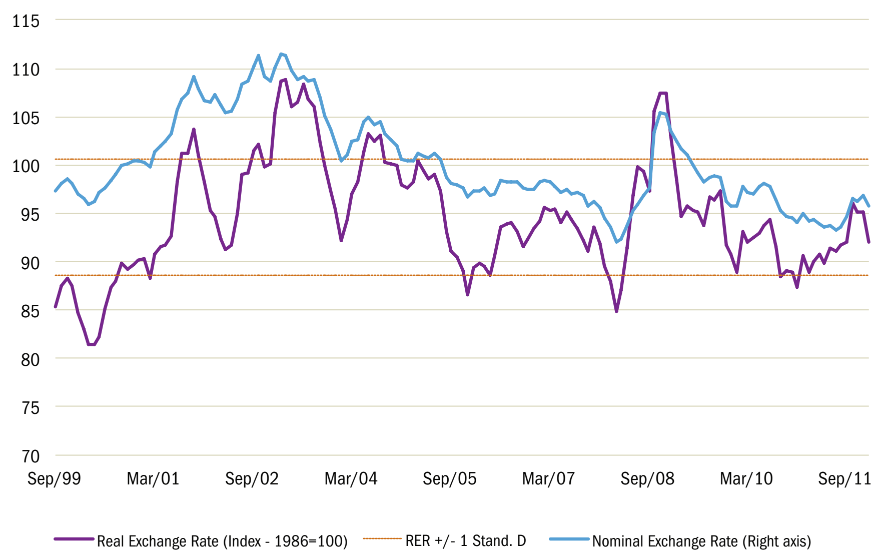
Source: Central Bank of Chile.

In early 2012, concerns about downside risks were tempered, in line with the improvements observed in the global economy and the publication of local data on inflation and output that surprised analysts by trending upward. Accordingly, in February the Central Bank did not cut the policy rate and refrained from providing a bias regarding its future movements, market expectations about rate cuts moderated, and most of the depreciation of the peso that occurred during the second half of 2011 reverted. (FIGURE 4.9). The government, in turn, seemed less likely to implement the above-mentioned contingency plan.

If the global scenario continues to improve, or perhaps even if it remains relatively unchanged, the recent appreciation of the peso may intensify and become an additional policy issue. While the external current account deficit remains relatively small (1.5 percent of GDP in 2011), policymakers are likely to worry about its long-term sustainability if terms of trade were to deteriorate in the future, and exporters have already started to more loudly voice their concerns regarding the value of the foreign exchange rate.

The perceived overvaluation of the peso has indeed been a relevant policy issue in the past, when its real value has moved beyond a band of normal deviations. In early 2011, in particular, it led the Central Bank to announce that it would buy $12 billion in foreign exchange during the calendar year. A new foreign exchange intervention program cannot be discarded, although the Central Bank is cognizant of the costs of increasing international reserves for its balance sheet and it thus seems unlikely to jump quickly into such a policy again.

Figure 4.9. Chile's Real Exchange Rate



Source: Central Bank of Chile.

All in all, what will happen in the aggregate indicators for the Chilean economy in 2012–13 is uncertain, but its macroeconomic policy institutions and policymakers should be able to manage the short-term scenarios reasonably well. Given its high degree of trade and financial openness, and the predictable framework offered by its mix of inflation targeting, a floating exchange rate, structurally focused fiscal policy, and tightly regulated banks, its outcomes are likely to depend mostly on external developments.

Beyond the short-term policy issues mentioned above, the key challenge that Chile needs to address is to simultaneously attend to growing social demands and attain faster growth. With a per capita income expected by the International Monetary Fund to reach almost $17,000 in 2012 (on a purchasing-power-parity basis), the ability to solve this challenge may determine the extent to which the country is able to escape the middle-income traps that have often prevented developing economies from reaching a developed economy status.

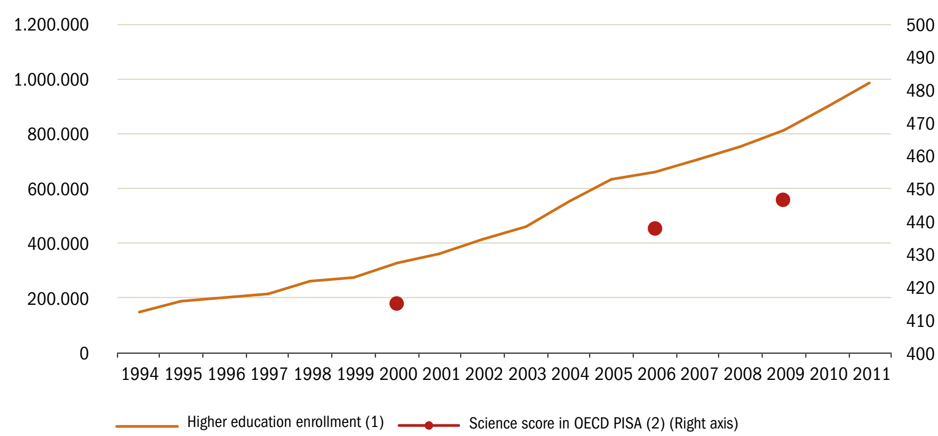
There is little question that Chile's government and Congress will need to deal with the growing social demands that have emerged in recent years. As was amply shown in the international media, during 2011 there were massive student-led protests across Chile, broadly demanding a larger role for the state in order to achieve cheaper, better and more egalitarian secondary and higher education. These claims have surfaced naturally as the number of students in higher education has multiplied fivefold in the last 20 years (FIGURE 4.10).

Other social demands have been increasing too. Since last year, there have been significant regional protests claiming for more resources from the national government, along with indigenous and environmental protests. Beyond these movements, the public has shown anger at state inefficiency and corporate foul play, and politicians at both ends of the spectrum have recognized that the country needs to do much more to fight inequality and abuse. Furthermore, there is growing agreement that to properly address and channel emerging social demands, both the tax and political systems need to be reformed.

The Chilean policy agenda has already incorporated some of these demands. For instance, the budget for 2012 includes a 10.1 percent real increase in spending on education, which in turn includes a 14 percent real increase in higher education, partly to improve students' access to subsidized government credit. Also, the government plans to enhance current transfer programs so that, through a variety of instruments, poor families will be able to earn a minimum "ethical family income," estimated at about 250,000 Chilean pesos a month (approximately $530) for a family of four members. Furthermore, starting with the parliamentary and municipal elections to be held in October, citizens will be able to vote without the need for previous registration, which will enlarge the electoral roll from approximately 8 million to 12.5 million people. Reluctantly, the government has also agreed to propose a tax reform soon, as well as further changes in the laws that regulate the political system.

Even so, the list of significant social demands and needs that have emerged is long. Further progress clearly will be required on education (at all levels), health provision, government decentralization, environment and consumer protection, crime prevention, and indigenous policies, among other issues and sectors. The government and Congress will surely be kept busy with these matters in 2012 and beyond.

Figure 4.10. **Chile's Higher Education Enrollment and Pisa Scores**

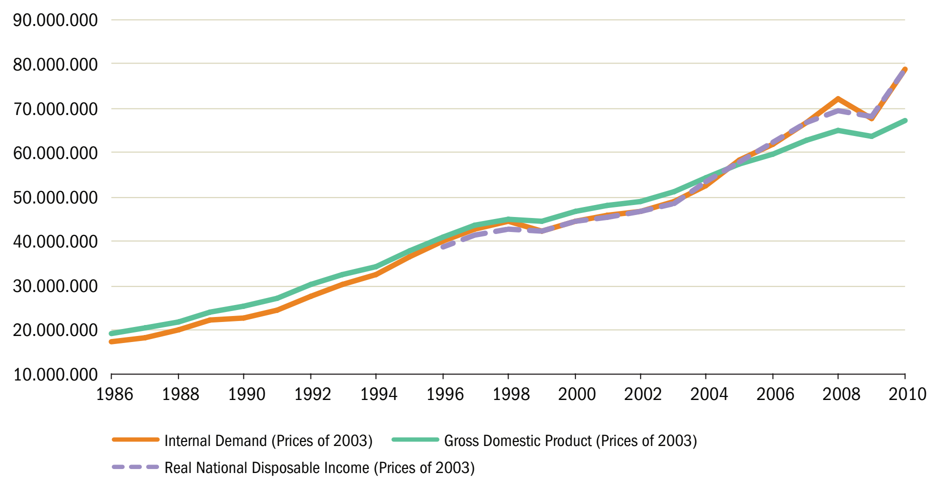


Note: Universities, Professional learning institutes and Technical training centers.
PISA: Programme for International Student Assessment.
Source: Consejo Nacional de Educación and OECD.

Chile's key economic and political challenge, however, will be to seek to meet the above-mentioned social demands at the same time that it returns to a faster growth rate. Indeed, whereas between 1986 and 1999 output grew at annualized rate of 6.7 percent, this figure for the period 1999–2011 fell to only 4 percent. Accelerating growth would allow the country not only to increase per capita income faster but also to better meet the rising social demands by providing the state with more resources for that purpose, and perhaps also by indirectly alleviating some of the pressures on public policy.

The importance of speeding up growth is stressed by the fact that between 2003 and 2010, real domestic spending grew on average 3 percentage points faster than annual real output—at 7 percent versus 4 percent, respectively (FIGURE 4.11). Because this was made possible by improved terms of trade, which boosted national income beyond output growth, the sustainability of Chile's external accounts has not emerged as a major cause of concern. It would be daring, however, to assume that national income will continue to persistently grow faster than output. Thus output growth acceleration appears to be the only sustainable means to maintain rapid growth in domestic spending, which in turn is key for achieving a satisfactory pace of improvement in living standards and in meeting social demands.

Figure 4.11. Chile - The Importance of Speeding Up Growth



Source: Central Bank of Chile.

The government's direct response to the growth challenge has been its "Competitive Stimulus" Working Agenda, announced in 2011, which is a package of 50 actions that aims to eliminate obstacles, speeding up procedures and improving the conditions to start businesses and innovate. In addition, burdens for start-ups have been reduced and new bankruptcy procedures will be proposed to Congress. There have been critiques, however, related to the slow implementation of the government's stimulus agenda, along with the lack of a broader agenda to foster innovation, promote regional development, ease employment protection for regular workers, strengthen competition law and support female labor participation.

Regarding growth prospects, an additional area of concern is energy. Increasing electricity generation costs due to rising oil prices and Argentina's decision to cut gas exports to Chile were a relevant drag on growth during the last decade. Although Chile's energy supply seems reasonably assured for the coming three years or so, prospects beyond that remain uncertain. Technical problems, legal requirements and environmental concerns have contributed to a slow approval of new projects. Recently, however, the government announced a new long-term energy plan that may contribute to the development of new projects.

To summarize, the Chilean economy is expected to grow in 2012 and 2013 at more moderate rates than in 2011, and this pace will depend mostly on developments in the global economy. Also, the growing social demands that have surfaced internally are unlikely to derail the country's sound macroeconomic management and institutions. However, the way in which they are addressed, and the development of a broader growth agenda, will determine the speed at which the country will continue to progress in attaining improved equality and standards of living.

COLOMBIA: ISSUES PERTAINING TO THE UPCOMING STRUCTURAL TAX REFORM

Roberto Steiner, Fedesarrollo

The 1991 Colombian Constitution states that the tax system should be built on three basic principles: efficiency, equality and progressiveness. Several studies have pointed out that the current tax code does not satisfactorily fulfill the first two criteria and does so only partially for the third criterion.[24] On account of this, the government has announced that it will soon submit to Congress a structural tax reform bill. While, from a technical point of view, the task at hand seems relatively clear—namely, to provide more efficiency, equality and progressiveness to the system—any discussion of tax policy implies facing important political and institutional constraints. In particular, any reform proposal must take into account two important elements: (1) the political commitment made by President Juan Manuel Santos during his election campaign not to increase tax rates and (2) the fact that the Constitutional Court opposes the universalization of the value-added tax (VAT).[25]

The political economy of taxation, which is merely a reflection of the attitudes of different interest groups toward equality and efficiency, is evidently quite complex. In all likelihood, "compensation schemes" will be needed in order to make the reform feasible. For example, if the VAT is simplified to make it more efficient, it is likely to become more regressive. This would suggest the need to (1) strive for greater progressiveness in the income tax, probably by shifting the tax burden from corporations to individuals; and (2) introducing well-targeted transfers to the poorest people.

The Tax Structure

Even though tax collections have increased substantially since 1990, this has proven to be insufficient to meet increased expenditures by the central government. The latter have largely been a consequence of the social spending commitments stemming from the 1991 Political Constitution, the costs associated with fiscal decentralization and the continuous increase in pensions, security and justice outlays. This process has led to what amounts to a structural primary deficit (FIGURE 4.12) and is evidence that the eight tax reforms undertaken during the past two decades have failed to balance the fiscal accounts.[26]

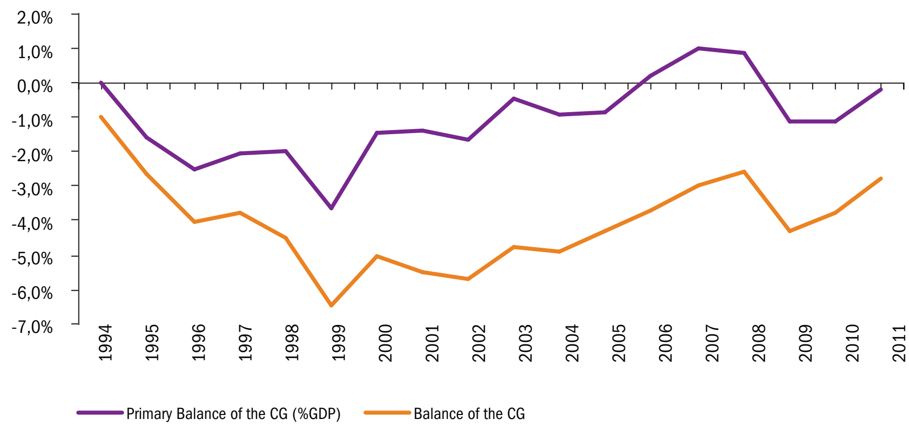
The Colombian tax structure includes taxes imposed by the central government and by departments and municipalities. Preliminary figures indicate that in 2011 about 80 percent of taxes (i.e., 11 percent of GDP) were collected by the central government, and the remaining 20 percent (or 2.8 percent of GDP) by subnational governments. The main national taxes are the income tax, the VAT, the financial transaction tax

24. See, e.g., S. Clavijo, "Tributación, equidad y eficiencia en Colombia: Guía para salir de un sistema tributario amalgamado," *Borrador de Economía* 325 (2006); and G. Perry, "Hacia una Reforma Tributaria," in *Propuestas de Politicia Pública 2010-2014*, edited by R. Steiner and L. Traverso (Bogotá: CAF Fedesarrollo, 2010)..

25. In 2002 (Article 116, Law 788) Congress and the government agreed to expand the VAT base in order to include (at a lower rate of 2 percent) all items previously excluded, such as basic foodstuffs. Arguing that this violated principles of fairness, progressiveness and minimum living standards, this Article was declared unconstitutional by the nation's highest court.

26. In 1990, 1992, 1995, 1998, 2000, 2003, 2006 and 2010.

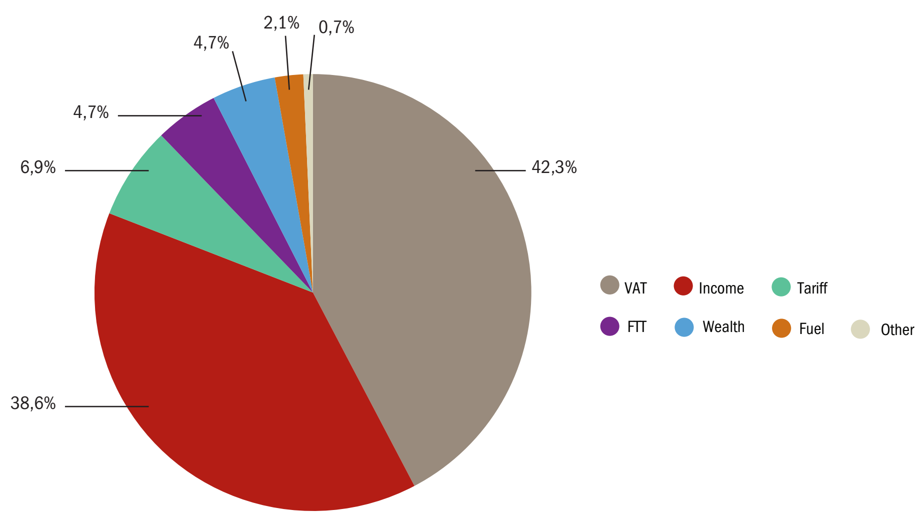
Figure 4.12. **Colombia's Central Government Primary Balance** (percentage of GDP)



Source: Ministerio de Hacienda y Crédito Público—CONFIS.

(FTT), wealth tax, tariffs on international trade and an excise fuel tax (FIGURE 4.13). At the territorial level, departments are responsible for taxes on alcohol and tobacco and for a share of a surcharge on gasoline. Municipalities, however, mainly collect property taxes and a turnover tax on businesses. In addition to these taxes, employers and employees pay a host of contributions or payroll taxes. Depending on the level of wages, payroll taxes represent between 50 and 60 percent of wages, by some accounts the highest percentage in the region. Although most of these payments are related to health and pension contributions that eventually benefit the employee and can therefore be considered as part of the compensation package, 13 percentage points actually represent a "pure tax" both for the employer and the employee.

Figure 4.13. **Colombia's Taxes Collected by the Central Government, 2010**



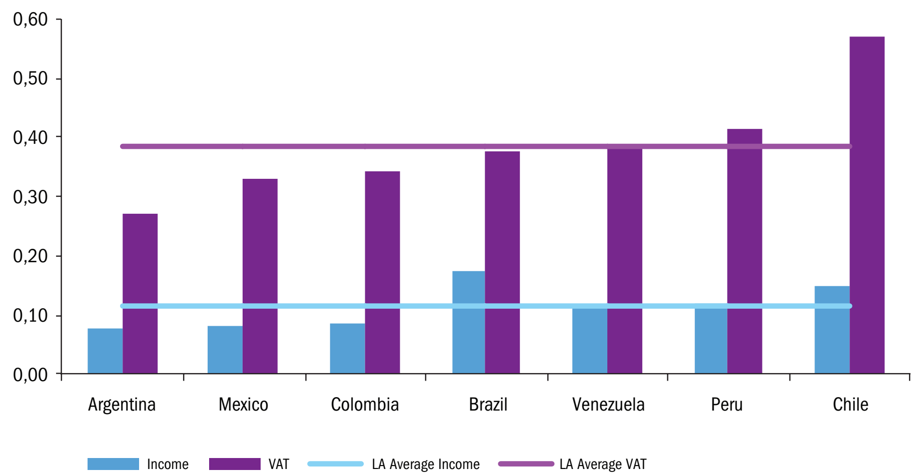
Source: Ministerio de Hacienda y Crédito Público—CONFIS.

Problems with the Current Tax Regime

Low Productivity and High Complexity

Although during the last two decades the productivity of both the income tax and the VAT has increased, it still remains low compared with the Latin American average (FIGURE 4.14).[27] Low productivity arises from the large number of exemptions and benefits, from the multiplicity of rates and from high avoidance and evasion. In the case of the VAT, there are nine different rates, which reduce the average effective rate and, in addition, make tax administration more complicated while also making it easier to avoid paying taxes. A similar situation occurs with the FTT, in which case increases in the rate have fostered financial transaction practices that have reduced the tax base.

Figure 4.14. Colombia's Productivity Income Tax and Value-Added Tax, 2007



Source: G. Perry, "Hacia una Reforma Tributaria," in *Propuestas de Politicia Pública 2010–2014*, edited by R. Steiner and L. Traverso (Bogotá: CAF Fedesarrollo, 2010).

The current tax code is made up of roughly 1,100 articles and 2,000 additional rules. This complexity hampers the payment of taxes, eases evasion and avoidance, and thus makes the monitoring role of the tax authority more difficult.

Unfair and Not Particularly Progressive

Maybe the most important problem inherent to Colombia's tax system is related to its extreme inequality, which in turn is the result of the many privileges and exemptions granted to certain groups and sectors of the economy. In what follows, I refer to the inequalities that characterize the main taxes.

27. The productivity of a tax is defined as the ratio between taxes collected (as a percentage of GDP) and the tax rate. Productivity increases with the tax base and declines with exemptions, evasion and elusion.

The income tax. The income tax is paid by both companies and individuals. With regard to companies, there are plenty of exemptions and differential rates. Companies pay an income tax of 33 percent, unless they operate within a free trade zone (FTZ), in which case they only pay 15 percent. This represents a clear example of horizontal inequality, a principle suggesting that two similar economic agents must face a similar tax rate. This is particularly inequitable because not all companies are allowed to operate within FTZs, which are only available to those that surpass a completely arbitrary threshold in assets. Conversely, individuals must pay a tax ranging from 0 to 33 percent of their taxable income. Individuals enjoy a host of privileges, which they can use to reduce their tax base—for example, discounting expenditures on education and health, among others—and the exemption level means that the income tax is paid by less than 2 percent of Colombians. The fiscal costs of income tax exemptions and tax deductions granted to individuals is around 1 percent of GDP.[28]

In Colombia, the income tax lacks the progressiveness called for in the Constitution, mainly because it is directed to companies, not to individuals. In 2010, 87 percent of income tax collections came from legal entities and only 13 percent from individuals. This, without doubt, has a negative effect on the economy's competitiveness, given that Colombian companies face a relatively higher tax rate in comparison with the one prevailing in most other countries. What is of even more concern is that the ability of firms to transfer the tax burden to domestic consumers implies that the tax burden is shifted to the latter, without regard to level of income. Both economic theory and empirical evidence suggest that for the country to maximize its tax system's potential progressiveness and thus achieve a better distribution of income, income taxes should mainly be collected from the wealthiest individuals, not corporations.

The wealth tax. This tax is charged directly to corporations and individuals for property or other rights that have a monetary value. As of today, only 51,000 individuals are subject to this tax, particularly due to the possibility of deducting from the tax base equity shares of Colombian companies as well as the first COP$319 million of the value of the individuals' primary housing. As a consequence, the wealth tax, like the income tax, has mainly been collected from companies.

Distortionary Taxes

Financial transaction tax. Financial depth in Colombia is low in comparison with its Latin American peers. According to the World Economic Forum 2011–2012, Colombia ranks 47th among 57 countries. This phenomenon of low access to the financial system mainly affects the poor. Although access to the financial system has several determinants—including the level of income and income distribution—it is clear that fees charged by financial intermediaries and the FTT exacerbate the problem. Due to the latter, in December 2011 the government announced that there would be limits on financial costs charged by banks. This measure should be complemented with the phasing-out of the FTT, something the government has announced should happen starting in 2014.

Payroll taxes. It comes as no surprise that the large tax burden on formal employment has led to high rates of unemployment and informality. In fact, during the last decade the average unemployment rate settled

28. Perry, "Hacia una Reforma Tributaria."

at 13 percent, without having any significant variation, even when the economy achieved real growth rates above 6 percent, thus highlighting the structural nature of the problem. Similarly, during the same period, informality remained at levels close to 55 percent, while self-employment continued to be the only source of employment that grew persistently since 1994.

Criteria for Tax Reform

A structural tax reform should remove (if not immediately, at least gradually) the more distortionary taxes, particularly payroll taxes, that constitute a heavy burden on formal employment, and the FTT. Naturally, it would be necessary to replace these with other taxes, in order to fund the activities that are financed today via the taxes to be suppressed. This necessarily requires an ambitious effort in order to increase income tax and VAT collections. This is by no means an easy task, on account of the political constraint on increasing the general VAT rate and economic considerations that warn against increasing the income tax rate applied to corporations.

Perhaps the most reasonable way to proceed and to deal with the enormous challenges in the design of a structural tax reform would be as follows. First, estimate how much would tax collection rise due to (1) a move as ambitious as possible to the general rate of 16 percent for all those goods currently paying lower VAT rates; (2) a unification of the rate of the corporate income tax at a lower level than the current general rate of 33 percent, but above the 15 percent rate applicable to companies located in FTZs; (3) elimination to the maximum possible extent of exemptions in order to increase the number of individuals paying income tax; and (4) elimination to the maximum possible extent those dubious tax-planning practices that allow companies and individuals, especially those with high incomes, to reduce their tax obligations.

A thorough simulation considering these alternatives would yield a proper estimate of the additional amount of resources that the government would have available to compensate for the phasing-out of the most distortionary taxes—that is, payroll taxes and the FTT. With respect to the wealth tax, although there is no fiscal space to remove it entirely, serious thought should be given to the idea of concentrating its collection on individuals rather than on corporations. This would make the tax less distortionary and much more progressive, a win–win situation of which the system should take advantage.

CUBA: REFORM CONTINUES

Rafael Romeu, International Monetary Fund [29]

In 2012, Cuba continues a reform effort that began in 2007 and is called an "updating" of its socialist economic system amid a sluggish economy, growing institutional uncertainty, and increasing expectations (TABLE 4.3). The central challenge facing Cuba is that its policy framework remains an impediment to productivity and growth. Pressure from both external vulnerabilities and increasingly, aging costs and emigration, are adding to this fundamental challenge. To their credit, since 2007 the Cuban authorities have publicly recognized that policies are at the heart of Cuba's economic difficulties rather than lay the blame externally. The reforms implemented to date, such as legalizing barbershops and home sales, have succeeded in raising expectations. The question now is whether they can meet their expectations with lasting economic improvements.

Table 4.3 Cuba: Selected Economic Indicators

	Selected Economic Indicators[1]				
	2008	2009	2010	2011	2012
(Annual percent change)					
GDP Growth	4.1	1.4	2.4	2.7	3.4
CPI Inflation[2]	-0.1	-0.1	1.6	2.2	0.6
Nominal GDP (in pesos)	60,806	62,079	64,328	67,534	70,236
M1 (change vs prior year)	16.9	1.7	1.7	...	...
M1 (in percent of GDP)	41.5	41.3	40.6	...	...
(Pesos, dollars per peso)					
Current account	-1,736	...	...	...	...
Goods	-10,570	-6,043	-6,049	...	...
Services	8,566	8,134	8,705	...	...
Of wich: Tourism	2,090	1,899	2,025	...	...
Income	-1,055	...	...	...	...
Transfers	482	...	...	...	...
Exchange Rate (official)	1.1	1.1	1.1	1.0	...
Exchange Rate (unofficial)	24.0	24.0	24.0	24.0	...
(Perecnt of peso GDP)					
Revenue[3]	71.2	70.7	66.4	66.0	65.9
Expenditure[3]	78.1	75.6	70.0	69.8	69.7
Balance	-6.9	-4.9	-3.6	-3.8	-3.8

1. Figures are official data in Cuban pesos unless o therwise indicated, missing means unreported data.
2. Budget growth forecast for 2012, GDP deflator based estimates for 2011-12, as official inflation not yet published.
3. 2011 expenditure estimated, 2011 bal. reported, 2012 balance, rev. and exp. from budget.
Source: ONE; Gaceta Oficial 048/2011; Triana, 2011; The Economist, Granma.

29. The views expressed in this section on Cuba are those of Rafael Romeu and should not be attributed to the International Monetary Fund, its Executive Board, or its management.

Cuba is about the size of Pennsylvania or Iceland and is located roughly 200 miles (320 kilometers) south of mainland Florida. Cuba's population of roughly 11 million possesses some favorable socioeconomic indicators, and income per capita ranges from $4,000 to $5,000 (similar to Peru or the Dominican Republic).[30] The changes that swept across Eastern Europe and the countries of the former Soviet Union in the 1990s did not reach Cuba. Instead, it embarked on a two-decade odyssey that included a crisis from the loss of Soviet subsidies, a limited opening to new activities (e.g., tourism, mining), and finally, a reorientation of economic activity toward Cuba's partnership with Venezuela. Hence, Cuba's economy is currently composed of remnants of the pre-1990 socialist system, new industries such as tourism and mining and the principal export of professional services.

The Growth Outlook

The baseline scenario for 2012 is a continued slow recovery from the onset of the recession in 2008–9, which resulted from the global financial crisis. The official projection of 3.4 percent growth is on the optimistic side, and could lead to a repeat of the December 2011 downward growth revision of 0.3 percent. Support from fiscal policy will be limited given the slow recovery in key trading partners and the need to control the monetization of deficits. Official inflation—an evolving concept, given the deliberate pace of price liberalization—increased to 2.2 percent in 2011 (according to estimates based on a GDP deflator). This is an elevated figure in the context of Cuba's largely fixed prices, and it could signal broader inflation risks and consequent increasing inequality. For example, food prices, as reflected in newly liberalized farmers' markets, reportedly increased by above 20 percent in 2011. In this context, the slowdown in inflation reflected in the authorities' figures for 2012 seems ambitious, in particular given more potential price and wage liberalizations and a closing output gap, which could require a reassessment of Cuba's procyclical fiscal stance (FIGURE 4.15).

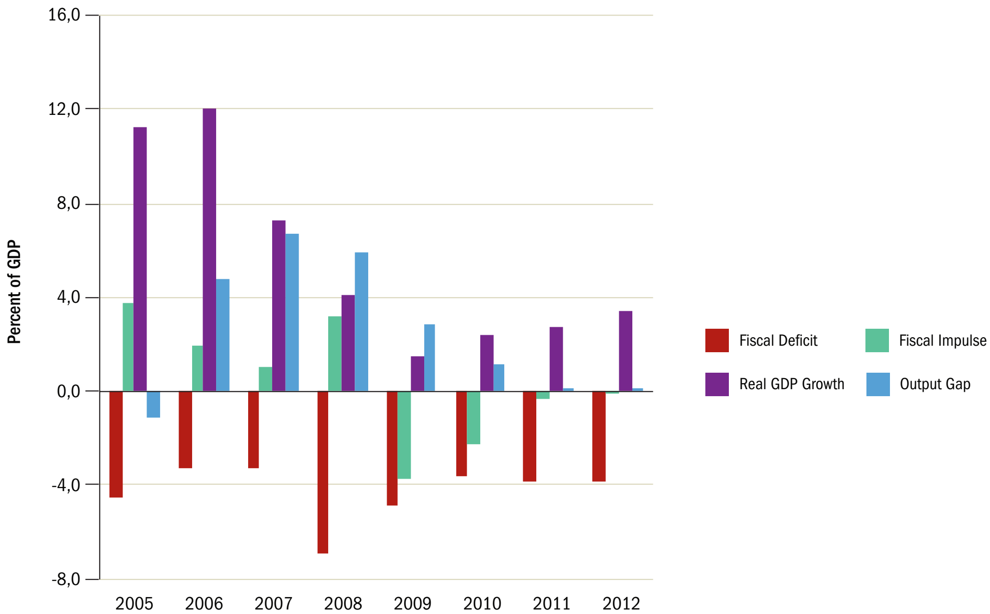
Despite a lack of conventional emerging financial market access, the global financial crisis reached Cuba through its external sector, net transfers, trade credits, tourism revenue, nickel exports, and remittances, and the like. As the global crisis continued, import credit lines collapsed and export cash flow declined. In November 2008, the authorities responded to the ensuing sudden stop by freezing bank accounts denominated in convertible pesos (called CUCs).[31] In addition, a second bureaucratic permission was introduced to convert CUCs into hard currency, essentially limiting the currency's convertibility. Estimates of the foreign currency assets frozen by the Cuban authorities range between $600 million and $1 billion during this period. By the spring of 2010, as the crisis passed, the authorities introduced a compensation mechanism for the frozen foreign assets, whereby claims would remain in the system but earn 2 percent interest for five years (with the proviso that payments can be missed if the money is not available). Though the plan is intended to buy time while the money is slowly released, no alternative or attempts to bargain with import suppliers were

30. Cuba's official statistics present a number of issues (e.g., there are two legal exchange rates 1/25 and 1/1 peso per dollar, but official statistics are only expressed in the latter; for details, see Gabriel Di Bella and Andy Wolfe, "A Primer on Currency Unification and Exchange Rate Policy in Cuba: Lessons from Exchange Rate Unification in Transition Economies," in *Cuba in Transition, Volume 18* (Washington: Association for the Study of the Cuban Economy, 2008). Hence, notwithstanding a litany of potential caveats, in this section every effort is made to reconcile figures according to the author's understanding of Cuba's official data, which are taken at face value.

31. See Pavel Vidal Alejandro, Cuban Monetary Policy: Response to the Global Crisis, Woodrow Wilson Center Update on the Americas (Washington: Woodrow Wilson International Center for Scholars, 2010), www.wilsoncenter.org/sites/default/files/LAP_Pavel_nl1.pdf.; and Luis R. Luis, "Crisis Management of Cuban International Liquidity," in Cuba in Transition, Volume 20 (Washington: Association for the Study of the Cuban Economy, 2010). The CUC is a convertible currency that maintains an official and legal parity with the dollar. One CUC costs about 25 nonconvertible pesos (called CUP), at the legal but unofficial exchange rate of 25. Cuba's official statistics are released in CUPs, not CUCs.

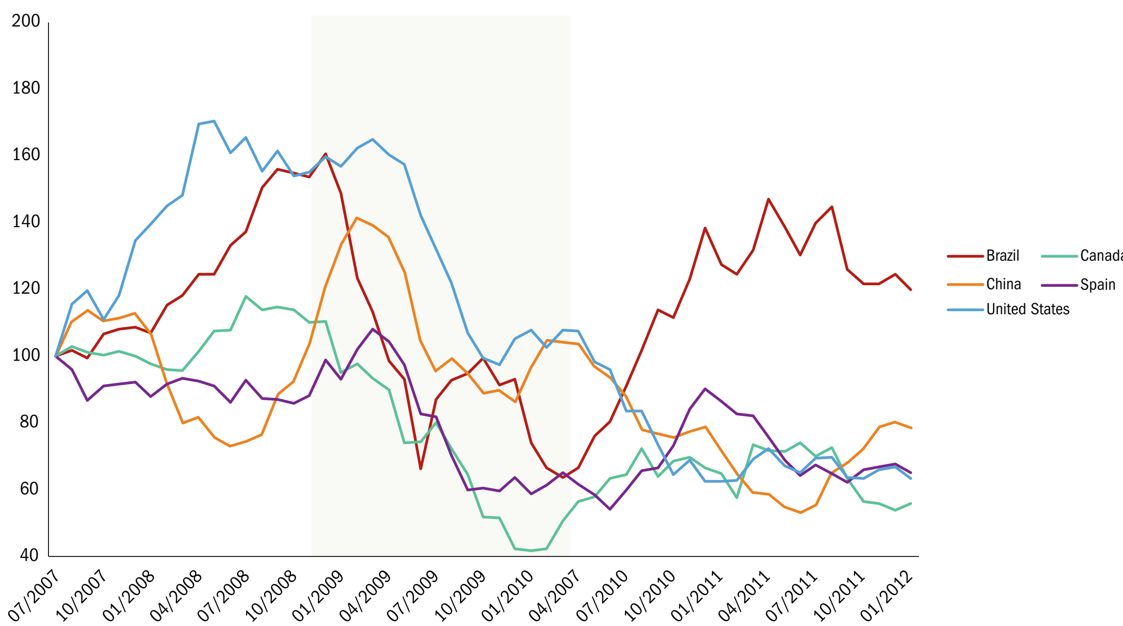
reportedly made. To some extent, this is consistent with prior difficulties with credit events, including breaking off talks with the Paris Club a decade ago, and suspending its Soviet-era ruble debt in the decade before that. An invitation to restart talks with Paris Club creditors was reportedly made to the Cuban authorities late last year, but no official response has been made public (FIGURE 4.16).

Figure 4.15. Cuba's Fiscal Policy, 2005–12 (percent)



Source: ONE, Author calculations.

Figure 4.16. Cuba's Imports during the Global Financial Crisis, 2007–12 (index)

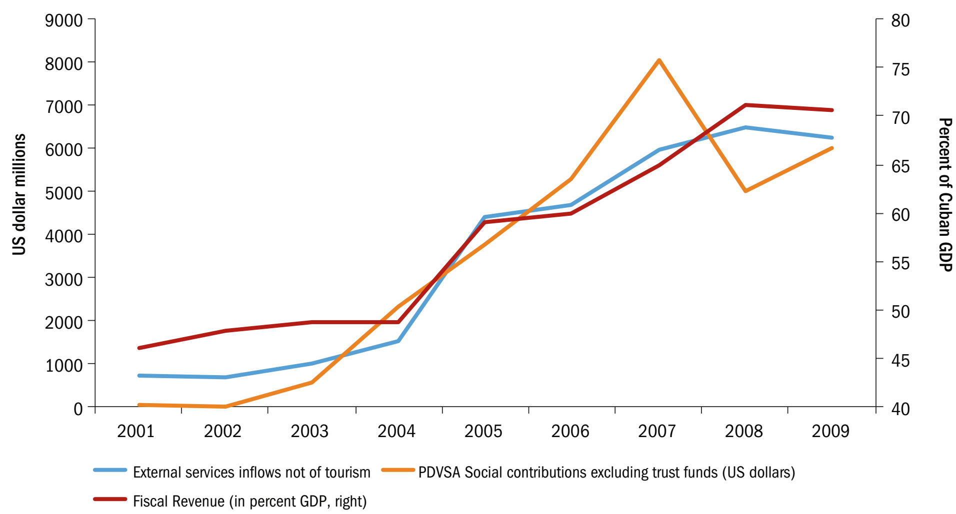


Source: Global Trade Atlas, Haver Analytics, Author's estimates.

The External Sector

Under various bilateral arrangements signed since 1999 (in the context of the ALBA Initiative), Venezuela has emerged as Cuba's most important strategic partner, providing oil at concessional terms, and engaging in various joint projects, such as infrastructure, refineries, and other investments. In addition, Venezuela pays the Cuban government for social development programs, where tens of thousands of Cuban professionals (doctors, teachers and others) deliver social services inside Venezuela. A possibly unintended consequence of this relationship is the increasing dependence of Cuba's fiscal policy on non-tourism services export revenues from Venezuela. FIGURE 4.17 shows the correlation of the financing of these social programs (misiones) by the Venezuelan state-owned oil company PDVSA, Cuba's non-tourism service exports and Cuba's fiscal revenue. Although exact figures have not been made public, alternative estimates suggest that at present, as much as 30 percent of total revenues could be attributed to non-tourism service exports to Venezuela.

Figure 4.17. Cuba's Fiscal Revenue, Service Exports and PDVSA, 2001–9

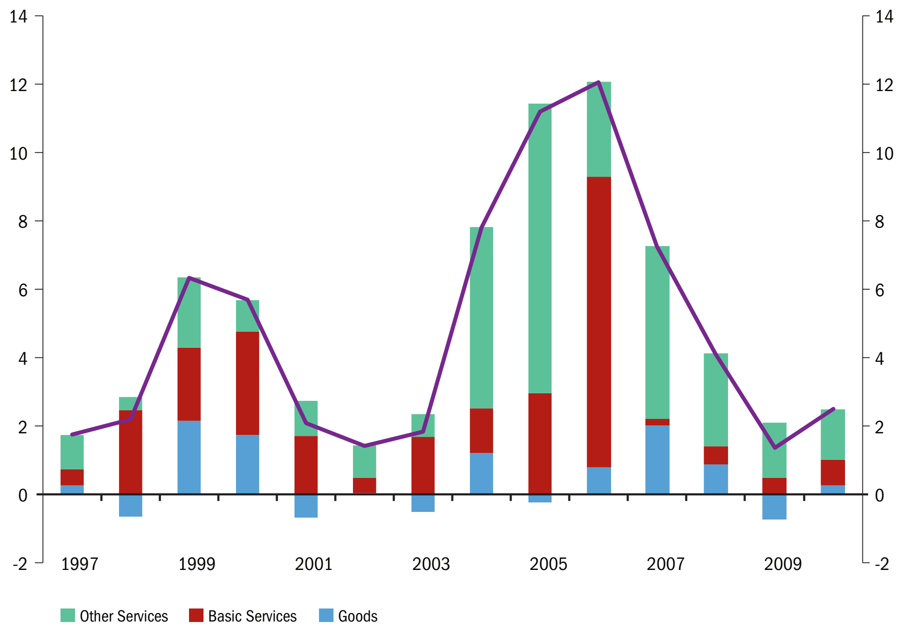


Source: One Cuba, PDVSA Annual reports.

As service exports to Venezuela have become the engine of growth for Cuba, they have created a complex vulnerability. FIGURE 4.18 partitions Cuba's GDP between goods production, traditional services (electricity, gas, water, construction, commerce, hotels and restaurants, transportation, storage, communication) and all other services (in particular, education, public health and social services, and sports and cultural services). The contribution to growth from services explains Cuba's double-digit real growth rates in the mid-2000s, and their decline after 2008 is one of the drivers of the present growth slowdown. A growth decomposition exercise reveals that net non-tourism service exports to Venezuela explain roughly 45 percent of total growth during the period 2004–8, and increased tenfold as compared with 1997–2003.[32] The potential for changes in Venezuelan willingness or ability to continue buying service exports or selling oil on concessional terms represent one of the most important vulnerabilities for Cuba in 2012 and onward.

32. Di Bella and Wolfe, (Association for the Study of the Cuban Economy, 2009, vol. 19), shows Cuba's growth accounting during this period. Romeu (Woodrow Wilson Center, 2011) shows the distortion present from Cuba's service sector in official growth statistics.

Figure 4.18. Cuba's GDP Growth by Sector, 1997–2009
(annual percentage change and contribution to growth)



Source: ONE Cuba, Author calculations.

In addition, the relationship between Cuba and Venezuela extends beyond the fiscal revenues, into GDP, employment growth and also trade in goods. With respect to trade in goods, Cuba's exports and imports can essentially be partitioned into trade with Venezuela and trade with the rest of the world (TABLE 4.4). On the import side, Venezuela is expected to continue its critical role in shielding Cuba from surging oil prices. In 2010, for example, imports from Venezuela (mainly oil, as well as some refinery-related imports) delivered 40 percent of Cuba's total imports on concessional terms. Although recent drilling off the north shore of Cuba by Repsol (a Spanish oil company) may prove fruitful, its potential benefits would only materialize in the long term, with limited short-term benefit in 2012. China, the next-largest trading partner, sold Cuba just 10 percent of its total imports in 2010 (mainly machinery and electronics), and Canada and Spain average 5 percent. In 2011, Brazil displaced the United States as Cuba's fifth-largest trading partner by import volume, focusing mainly on agricultural goods. Brazil also displaced Russia as Cuba's fifth-largest export market in 2011, purchasing mainly Cuban pharmaceuticals and minerals. The rest of Cuba's goods exports focused on nickel sales to China and Canada, and some sugar and tobacco exports. In addition to buying services and subsidized oil, in 2010 Venezuela purchased one-third of Cuba's goods exports.

Table 4.4 Cuba: Selected Economic Indicators

Cuba: Trade Structure

	2009	2010	2011					
			Imports (goods, US dollars, millions)					
Imports			Total	Machin.	Electric.	Cereal	Vehicle	Plastics
Sub Total (Cuba) 1/	5,726	5.769	...	...	...	...	...	
Sub Total (Partners) 1/	5,835	6.422	...	1.251	333	244	187	75
China	972	1,066	1.043	126	125	0	57	33
Canada	275	379	469	134	36	73	23	6
Spain	651	785	899	210	98	0	37	54
Brazil	277	415	550	46	11	67	5	7
USA	533	368	352	...	0	117	1	0
Venezuela	2.371	3.910	...					
Total	**8.096**	**9.679**						
Memorandum: Commodity prices (index, 2005=100)								
Nickel	99	148	155					
Sugar	180	207	260					

	2009	2010	2011					
			Exports (goods, US dollars, millions)					
Exports			Total	Nickel	Sugar	Tobac.	Bevs.	Pharma
Sub Total (Cuba) 1/	2.123	2.610	...	...	...	...	...	
Sub Total (Partners) 1/	2.113	2.464	...	1.251	333	244	187	75
China	575	765	904	556	302	1	0	0
Canada	444	633	713	695	0	4	4	0
Spain	165	171	238	...	0	49	60	0
Brazil	53	73	92	...	...	1	0	74
USA	66	54	50	...	34	6	5	1
Venezuela	480	1.570	...					
Total	**2.603**	**4.180**						

1/ Sub Total Cuba refers to the total excluding Venezuela for either imports or exports, as reported by the ONE in Cuba. Sub Total Partners refers to the same subtotal excluding Venezuela, as reported through the partners' exports/imports (i.e. the offsetting trade in the partner country).
Source: International Financial Statistics, Global Trade Atlas, Oficina Nacional de Estadísticas, Cuba; Haver Analytics, Author's estimates.

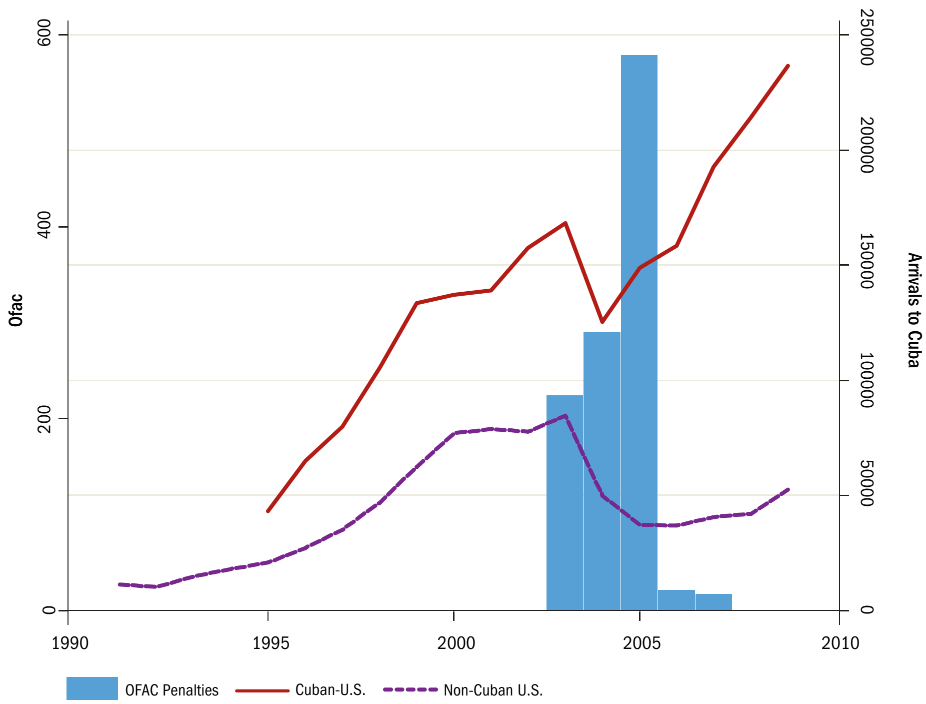
In the area of tourism, Cuba continues to excel; however, the impressive gains since opening the sectors to foreign investment in the 1990s have waned.[33] From virtually no commercial tourism in 1990, Cuba has grown to be the third-largest destination in the Caribbean (behind Cancún / Riviera Maya and the Dominican Republic) with 2.7 million visitors in 2011. Its main tourism clients are Canada (1 million visitors annually), followed by the United States (approximately 450,000 visitors). Despite much publicized bilateral

33. Romeu (IMF, 2008) and Romeu and Wolfe (IMF 2011) show that Cuba has become the third most important supplier of tourism in the Caribbean after Cancún and the Dominican Republic, and could surpass these in the absence of bilateral US Cuba travel restrictions.

trade and travel restrictions, in actuality the second most important source of tourists for Cuba is the United States. Every year, approximately 60,000 "non-Cuban" Americans visit Cuba, in addition to another roughly 400,000 visiting Cuban expatriates.

The renewed visits of Cuban Americans have come at a critical time for the Cuban economy, because these are not traditional tourists—they have strong linkages to the real economy. They are assumed to be financing an important part of the investment necessary to start Cuba's budding microenterprises through visits to Cuba and remittances. The latter are estimated to be at least $500 million, and perhaps exceed $1 billion annually. New travel restrictions and enforcement efforts in the 2004–9 period seemed to have had only a transitory negative effect, which has since been compensated for with the acceleration in arrivals (FIGURE 4.19). "Non-Cuban" Americans remain a potential source of future growth in this sector. Econometric estimates suggest that if restrictions on travel were removed, perhaps 3.5 million to 5 million US residents would visit Cuba annually. Substantial changes in the policy landscape are not expected in 2012, and hence tourism levels appear to have stabilized. As is the case for mining, growth prospects based on tourism appear limited. For example, these sectors drove approximately one-fifth of the 2.4 percent real GDP growth observed in 2010 (the latest available year).[34]

Figure 4.19. Arrivals from US and Close Relatives to Cuba, 1990–2009



Note: The graph superimposes the number of tourists arriving from the US to Cuba, both US citizens (blue, right scale) and Cubans residing abroad (persons under US jurisdiction with three degrees of family separation from Cuban citizens, red, right scale) on the estimated number of penalties imposed by the US Office of Foreign Assets Control for Cuba-related travel restriction violations.
Sources: US General Accounting Office; US Congressional Research Service; World Trade Organization.

34. Tourism proxied by Hotels and Restaurants, nickel by Mining. Cuba does not publish an estimate of the aggregate impact of tourism or mining. See Romeu and Wolfe (IMF 2011) on Cuba's tourism in the crisis.

Reforms

Starting in 2007, Cuba's president, Raúl Castro, unveiled an apparent relaxation of centralized economic control through a slow but steady progression of announcements and speeches. This policy effort is apparently aimed at improving productivity and efficiency within the existing broad institutional structure. It is referred to as an "updating" of the socialist model.

The reform process essentially began with the illness of the former president, Fidel Castro, in July 2006, after which the then–interim president, Raúl Castro, took a more visible role in shaping public discourse. In February 2008, Raúl Castro presented a critical public assessment of the Cuban economy and its inefficiencies. Notwithstanding what appeared to be a rebuke of the centralized economic system, the first substantive changes instituted were to legalize cellular telephones, computers and appliances in 2008, and to announce plans to tie wages to productivity. The process of allowing farmers to use fallow land was also initiated. Another round of reforms came in 2009, when employer-based lunches were substituted for stipends, and by the spring of 2010 barbershops were legalized. Nonetheless, during this period, two hurricanes and the global financial crisis drained international reserves, slowed growth, and led to a devaluation of the peso and the freezing of foreign suppliers' accounts in Cuban commercial banks.

In September 2010, the government announced the elimination of 500,000 public sector jobs by March of the following year. In addition, self-employment, farmers markets, and extended leases for tourism to 99 years were legalized. Later, the planned retrenchment of one-half million workers went unmet in the allotted time frame and was de facto abandoned. By 2011, state banks were allowed to begin giving microcredits for agriculture or home repairs (loan amounts capped at $125 to $200), and restrictions limiting the use of checking accounts, bank transfers and debit or credit cards by private sector individuals or for certain payments were lifted. Finally, an all-encompassing plan to guide the Sixth Communist Party Congress (called Líneaminetos) was approved in August 2011; and by the end of 2011, property sales (cars and houses) were legalized.[35]

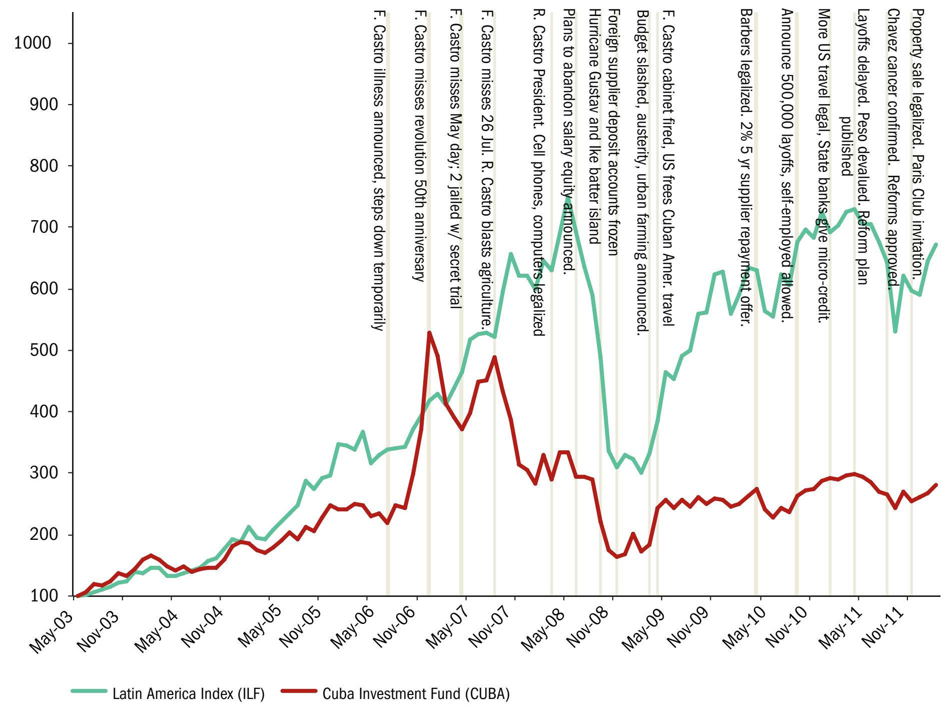
Although the official critiques of Cuba's economic inefficiency have been at times bold, subsequent policy seems to fall short of the rhetoric. The authorities face a trade-off where a modest pace of reform risks a final result that does not go far enough, but a rapid and deep reform risks losing control with unforeseeable social and political consequences. The downside of the former risk appears to be materializing. For example, though small businesses have been legalized, the regulation and taxation system appears onerous and clumsy. Among its elements are heavy and inefficiently designed tax codes (e.g., tax rates that increase with the number of employees) and seemingly extreme micromanagement (e.g., approximately 200 activities for legal self-employment specifically chosen, including jobs such as dressing up as a "dandy," no. 156).

Reforms such as currency unification, free access to information technology and free foreign travel in support of Cuba's knowledge economy, or a rationalization of the public sector, seem a long way off. An imperfect measure of the strength of reform in Cuba is shown in FIGURE 4.20, which captures one of the few investment funds aimed at profiting from Cuba's potential future growth (independent of any political outcomes).

35. See Vidal (2012) "Steps towards Access to Banking Services for Cuba's Non-Governmental Sector."

Although a very cautious interpretation of such a measure is warranted, clearly it captures financial market perceptions of major news events in Cuba (e.g., July 2006). None of the announcements in the four years leading to 2012 seem to have motivated major changes in the index.

Figure 4.20. Cuba's Reform Timeline, 2003–11



Sources: Bloomberg, Reuters, Yahoo!, Associated Press, CubaEncuentro, Author Calculations.

The recent reforms in Cuba have been characterized in some quarters as a fundamental change, perhaps because of their symbolism within the context of the country's 53-year socialist government. Although they have promising elements, so far the proposed reforms appear more to be a constrained policy response that is not at the level of Cuba's challenges. Notwithstanding that these policy changes go in the right direction, they appear to be limited in their ambition and effort. For example, legalizing cell phones and car sales seems to fall short of the mark in a country with Cuba's potential. Changes such as these would not stand the test of an objective comparison with international experiences. For example, China, which began a reform process in about 1978, had, within 5 years, legalized 15-year leases for small farmers and agricultural co-operatives (later extended to thirty years). Similarly, Vietnam began its reforms in 1986, and within 5 years it had passed a foreign direct investment law that was liberal by international standards, created a treasury and a two-tier banking system, eliminated its fiscal deficit and subsidies to banks and money printing, and largely liberalized control of output and prices (including a liberalized exchange rate). Exclusive land-user rights in agriculture were also fully instituted. From this perspective, it is difficult to see how these reforms can deliver the fundamental improvements that Cuba's authorities acknowledge the country needs.

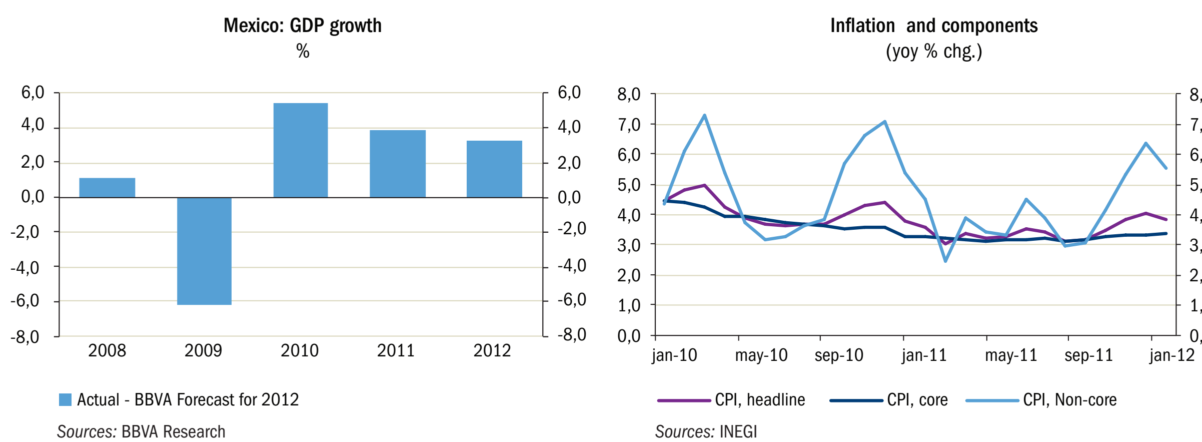
MEXICO: RECENT DEVELOPMENTS

Alejandro Werner, BBVA Bancomer

As the second half of 2011 progressed, the dark clouds that appeared in the US during the summer gave way to a better economic environment. GDP and industrial production grew at annualized rates of 2.4 percent and 5.1 percent, respectively, in the second half of the year, by 1.6 and 2.4 percentage points higher than in the first half of 2011. This provided a positive external backdrop for economic developments in Mexico, where activity was above expectations. For the year as a whole, GDP grew by 3.9 percent, with balanced contributions from consumption, exports and private investment. Inflation fell considerably, reaching 3.4 percent in 2011, 0.8 percentage points lower than in 2010. Finally, financial markets were driven mostly by external developments (FIGURE 4.21).

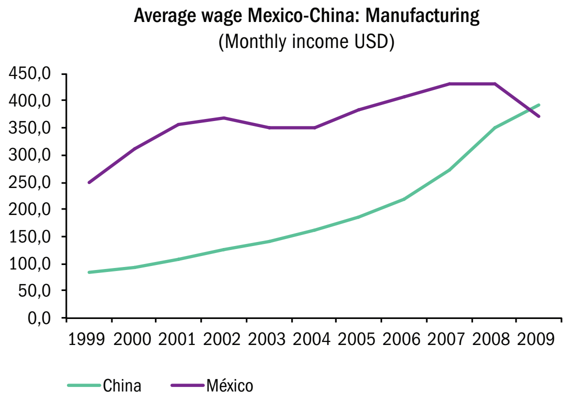
During the first few months of 2012, the economy continued to grow at an annual rate of 3.5 percent, with a reversal on the inflation front, as the annual rate increased from 3.4 percent in December 2011 to 4.0 percent in February 2012. This increase is mainly explained by the noncore components of inflation and therefore has not been a major concern for the Central Bank. For 2012, growth is expected to be about 3.5 percent and inflation to close the year below 4 percent Banxico's upper threshold. This equilibrium of mediocre growth, a stable financial situation and no external disequilibrium seems to be the most likely scenario for Mexico for the years to come. However, it is important to highlight some positive and negative elements that might have an impact on the country in the next several years.

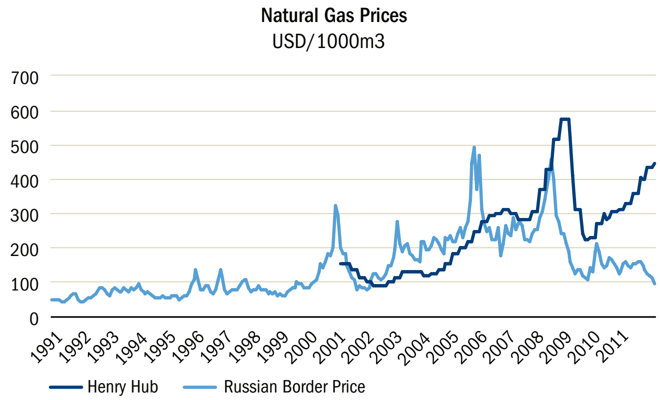
Figure 4.21. Mexico's GDP Growth and Inflation



On the positive side, several elements could accelerate growth. First, the relative advantage of Chinese unit labor cost has been significantly eroded in the last few years. Second, North America has become the region of the world with the lowest prices of natural gas in the world (FIGURE 4.22).

Figure 4.22. Mexico's and China's Manufacturing Wages Compared; North America's Natural Gas Prices





Sources: BBVA Research with data from OIT 2009 estimated

Third, transportation cost for Asian exports to North America have increased due to increases in the price of oil, making relevant the geographical advantage that Mexico has as an export base to the US (FIGURE 4.23).

And fourth, bank credit to the private sector and developments in capital markets continue to provide good support for the growth of internal demand.

On the negative side, Mexico confronts two important sources of risk. First, there has been a sharp deceleration in the US, leading to an important contraction of Mexican exports. And second, there has been an increase in violent activities in Mexico, which has significantly affected the economy. Public insecurity could have had an impact on economic growth in the last five years due to increased production costs and corruption, generating fewer incentives to invest in fixed assets. According to some estimates, the cost of the increase in violence is about 1 percent a year in GDP growth (FIGURE 4.24).

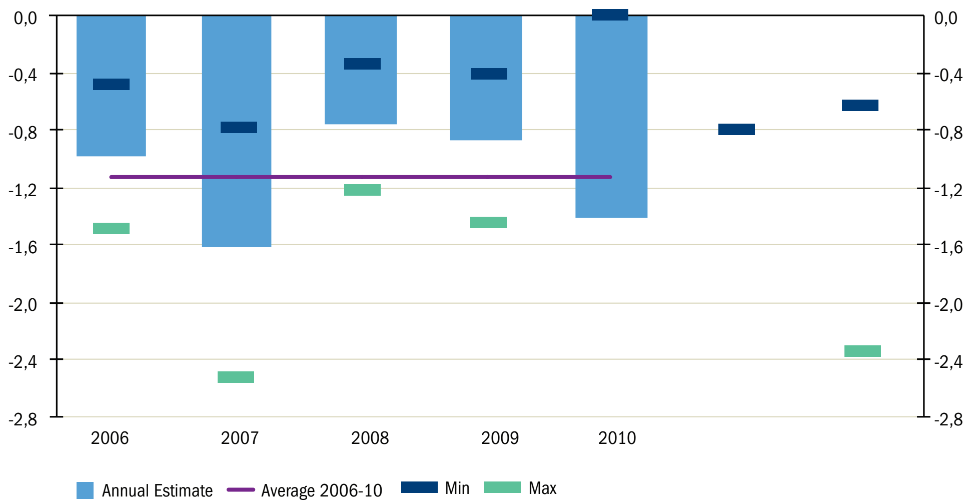
Figure 4.23. Transportation Costs for Asian Exports to North America

DISTANCE FROM MAIN CONSUMPTION CENTERS

	Mexico	China	India	Brazil	Korea	USA
USA (NY)	5.0	32.0	25.0	15.0	21.0	-
USA (LA)	4.0	18.0	310	23.0	17.0	-
Europe (Roterdam)	16.0	32.0	20.0	17.0	33.0	110
Japan (Yokohama)	19.0	4.0	17.0	35.0	3.0	15.0

Sources: BBVA Research

Figure 4.24. The Impact of Violence on Economic Growth in Mexico



Sources: BBVA Research

Some of these elements will be present in the discussions that will take place during the electoral campaigns that will start in April and finish with the national elections on July 1. On this day, the country will elect a new president, the two Chambers of Congress will be renewed, seven governors will be chosen and several other local elections will take place. An important element to highlight is that for the first time in many years, this process has not generated any uncertainty in financial markets and is expected to be a smooth transition. As it stands today, the front-runner in the polls is Enrique Peña Nieto, the PRI candidate, the runner-up is Josefina Vázquez Mota, the candidate from the PAN, and Andrés Manuel López Obrador from the PRD is in third position. Both front-runners represent a continuation of promarket economic policies. See TABLE 4.5 for a survey analysis on preferences.

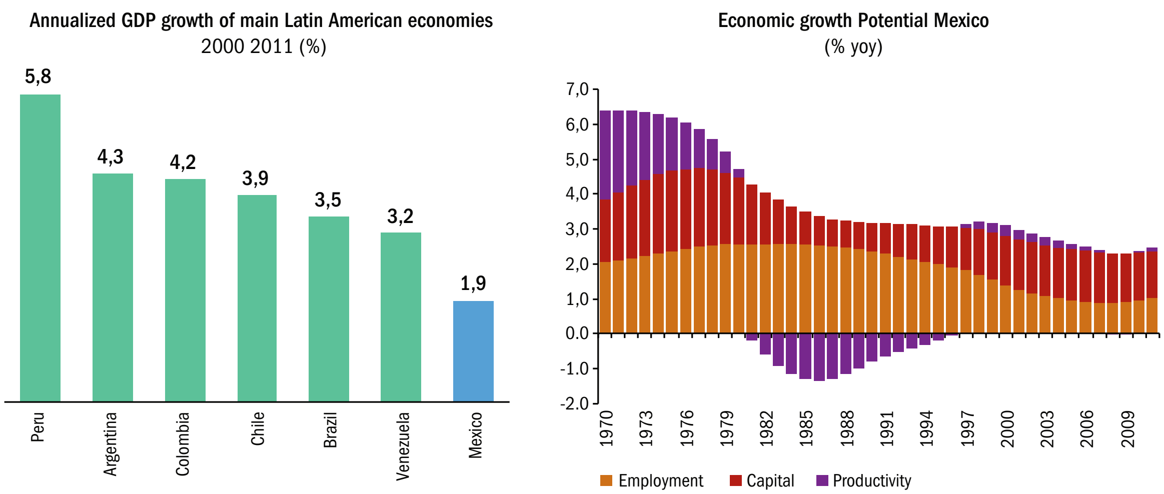
Table 4.4 Mexican Electoral Preferences, 2012: Survey of Surveys (percent)

Party	Date	Peña Nieto (PRI)	Vázquez Mota (PAN)	López Obrador (PRD)	Difference, 1° and 2°
Excelsior/BGC	March 5	47	29	23	18
Parametría	March 1	35	24	15	11
GEA-ISA	March 1	36	29	17	7
Mercaei	February 23	41	37	21	4
Mitofsky	February 23	40	25	17	15
Covarrubias	February 15	37	24	26	11
Buendía y Laredo	February 13	36	25	14	11
El Universal	February 10	48	32	20	16
Ipsos-Bimsa	February 9	36	24	16	12
Average		**39.6**	**27.7**	**18.5**	**11.9**

Source: Surveyors.

Independent of the election results, the new government will generate expectations regarding the acceleration of structural changes. The main task for the new government will be to accelerate economic growth in Mexico. The diagnosis that has been made during the last few years indicates that Mexico's lack of growth performance is driven by a very poor evolution of total factor productivity (FIGURE 4.25).

Figure 4.25. GDP Growth in Latin America and Mexico's Economic Growth Potential



To break this trend, the main areas where government changes could act as a catalyst are (1) energy reform, both oil and gas and electricity; (2) fiscal reform, where the low tax collection has been an important handicap for the country; (3) competition policies and the opening of key sectors to more players; and (4) reform of the educational system as one of the key elements that could provide the basis of a long-term sustainable growth process.

Every six years in Mexico, expectations that an aggressive reform agenda is going to take place increase only to give way to a deception phase sometime down the road. The weak external environment might provide the sense of urgency to prove that this time might be different.

VENEZUELA: THE BEGINNING OF THE END

Alejandro Grisanti, Barclays Capital

The impressive turnout in the Venezuelan primaries and recent announcements of the illness of President Hugo Chávez have considerably increased the probability that the opposition will win the election on October 7, 2012. To avoid this scenario, we expect an impressive fiscal and monetary expansion, with the fiscal deficit likely to reach 14.7 percent of GDP in 2012, mostly financed through monetization. But given the inefficiencies of an amorphous public sector, the political effectiveness of the expected fiscal expansion will be limited. In a debt-sustainability exercise, we find that high oil prices will bolster Venezuela's capacity to pay in the short to medium terms.

The Opposition Is Gathering Momentum

Henrique Capriles Radonski won the opposition primary with 64 percent of the valid votes (1.8 million), more than double the runner-up, Pablo Pérez. But perhaps the most important takeaway from the election was the participation level, with a total turnout of 3.1 million, well above the consensus expectation and international standards. Additionally, the fact that Capriles Radonski polled more than double the number of votes received by the runner-up, Pérez, gives him a stronger legitimacy as the principal leader of the opposition and should help to preserve the opposition's unity until the presidential election. It is also important to highlight the balanced and objective work of the army forces and the electoral authorities that supported the logistics of the election. We expect the results to mobilize the opposition and provide momentum to Capriles Radonski.

The primaries have revealed a mature and organized opposition with a disciplined strategy for the presidential election. The new generation of leaders averages 40 years old, providing a break from the past, and has high approval ratings among the population. Capriles Radonski's victory represents a win for what is known as the "renewers" over the "restorers." The renewers have been bold in consolidating their leadership of the opposition, distancing themselves from the abstentionist strategy adopted, which left it out of the National Assembly, and pursuing positions at the regional and local levels in 2008, as well as in the National Assembly in 2010. Capriles Radonski, who became governor of Miranda in 2008, led an administration that, even with its access to resources restricted by the central government, avoided the distraction of the polarized national politics and focused on social problems. He made education a key issue and undertook a massive program to build new public schools. In addition to having an image hard to associate with the political leadership that preceded Chávez, Capriles Radonski has benefited from a moderate approach, rarely even mentioning the president. This was risky ahead of the primary, when a strong, confrontational stance could have been attractive to core opposition voters, but it would have distanced him from the moderates and "light Chavistas." Now there is no need for an image makeover from Capriles Radonski's early candidacy to enable him to compete for the moderate voters necessary to defeat Chávez and/or the chavismo. Focusing on the economy and a better quality of life has so far proved more effective than polarization.

Capriles Radonski has endorsed the opposition platform, which proposes "straightening the institutional framework" of the country and a gradual economic adjustment, while offering job creation, a better quality of life, and an improvement of social programs and the supply of public goods. The opposition wants to remove most of the distortions in the economy, including exchange controls, price controls, gasoline subsidies and directed credit, but it advocates a gradual approach in order to minimize the social cost of the adjustments and guarantee the governability of the country.

Chávez's Deteriorating Health and the Possibility of a Democratic Transition

President Chávez's illness is a state secret. He and his followers have denied that the cancer has metastasized, but information published in the press points in the opposite direction, giving him a life expectancy of between two months and two years, depending on his willingness to receive proper treatment. His communication strategy was successful in passing the message that he was recovered, because 82 percent of the population considered him fully recovered or near to recovery from his illness and his vote intention increased by nearly 10 percentage points, to 47 percent, in December 2011. But the change in perception about his illness could significantly affect his reelection chances, creating doubts about the viability of a new term in office. In this context, we cannot discount the possibility of Chávez starting to make announcements regarding a possible transition sooner rather than later.

Our base case scenario continues to be that Chávez will try to be the candidate, if his health allows him to reach the presidential election, given that the whole system was built around this one person. In the event of a transition, it would be impossible to identify a "successor" because any of the top politicians in the Socialist Party (Jaua, Cabello, Maduro, Giordani, the president's brother Adan, et al.) has any opportunity to compete against Capriles Radonski, even in the not very probable case that they held together.

Even if the electoral calendar could be changed, the prospect of an attempt to derail the process cannot be totally discarded. However, we assign a low probability to such a scenario. In our view, with strong opposition and the division among the Chavistas, a non-democratic government could only be imposed by a massive use of force, which we do not believe the army will support. Despite signs of politicization, we believe that most of the army forces remain in an institutionalist position, and the proof of this was their participation in supporting logistics during the opposition primary. We believe that in any scenario, the election should be held before the end of the year because the Constitution says that "the elected candidate would be sworn in for the position of President of the Republic on January 10 of the constitutional period."

Chávez and the Chavismo Set to Use All Their Tools Ahead of Elections

In the middle of this political framework, the authorities have signaled their willingness to use all their ammunition to try to win the presidential election on October 7, 2012. With the Chavismo facing the biggest electoral challenge of his 13 years in power, the government has embarked on a huge fiscal expansion program. Indeed, the 2012 central government budget and the monetization of the deficit through PDVSA both point in this direction. Although, the national budget has lost relevance, given its usual underestimation of the oil price and the government's easy approval of uses of off-budget funds, a 46 percent increase in the 2012 budget against 2011 (17 percent in real terms) is a signal of an important fiscal expansion as the election approaches. Moreover, the first two months of the year saw a nominal increase of 62 percent (28 percent in real terms) in the central government's spending.

Meanwhile, PDVSA also looks likely to increase social spending before the presidential election, via monetization. The PDVSA account at the Central Bank (BCV) shows the oil company with a net debt to the monetary authority of VEB98.5 billion ($22.9 billion) as of February 17. Using PDVSA's account at the Central Bank as a credit line from which PDVSA can disburse the bolivars that it needs for its domestic obligations and social spending is a new practice. In our view, these transactions between PDVSA and the monetary authority reflect a mismanagement of public sector resources, in which BCV has become a direct creditor of PDVSA and, indirectly, of the Treasury, at the cost of higher inflation (TABLE 4.6).

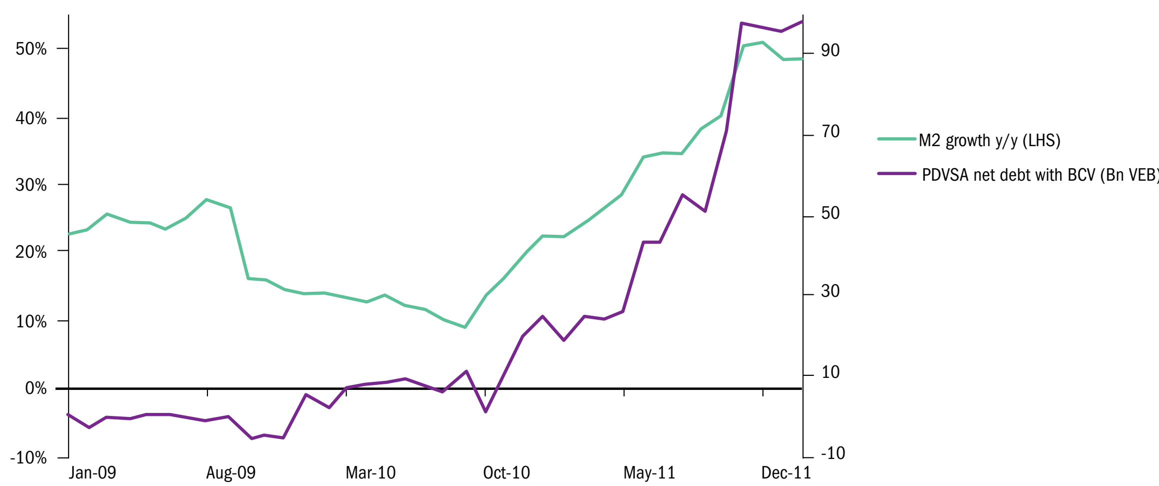
Table 4.6 **Deterioration of the Fiscal Balance in Venezuela** (percentage of GDP)

Non Financial Public sector	2008	2009	2010E	2011F	2012F	2013F
Income	**31,6**	**24,9**	**23,1**	**24,0**	**22,2**	**27,8**
PDVSA's Operational Surplus	13,9	4,4	8,7	9,1	7,1	14,8
Non Oil Income	17,8	20,4	14,4	14,9	15,2	13,1
Expenditures	**34,3**	**33,0**	**29,9**	**30,0**	**32,5**	**30,9**
Current Expenditures	22,9	21,9	18,3	18,4	20,8	21,1
Capital Expenditures	10,4	11,1	11,1	11,2	9,8	0,0
Balance (Surplus +, Deficit -)	**-2,7**	**-8,2**	**-6,9**	**-6,0**	**-10,3**	**-3,1**
Primary Balance (Surplus +, Deficit -)	-1,2	-6,7	-5,4	-3,6	-7,7	-0,5
Quasi -fiscal balance	**-2,4**	**-6,7**	**-1,8**	**-0,1**	**-4,4**	**-1,5**
Quasi Fiscal Revenues	4,9	1,1	7,3	12,2	9,3	1,9
Quasi Fiscal Expenditures	7,2	7,8	9,0	12,3	13,7	3,4
General Balance	**-5,0**	**-14,9**	**-8,7**	**-6,1**	**-14,7**	**-4,6**

Source: Ministry of Finance - Venezuela, BCV, PDVSA, Barclays Capital

The first signals of the monetization of the deficit are reflected in the monetary aggregates. As FIGURE 4.26 shows, in the 12 months to February 17, M2 has increased 52 percent in nominal terms, or 21 percent in real terms. As we said, given that we expect the opposition's standing in the polls to increase over time, the incentives for the government to increase this credit line are worrisome.

Figure 4.26. **Venezuela's Monetization Is Expanding M2**



Source: Ministry of Finance - Venezuela, BCV, PDVSA, and Barclays Capital.

On the fiscal balance side, we expect the previous fiscal expansion to lead to a public sector deficit of 5.9 percent of GDP in 2011 and 10.3 percent in 2012. However, including the off-budget funds, we estimate a deficit of 6.0 percent of GDP in 2011 and 14.7 percent in 2012. Part of this deficit will be financed by transfers from BCV (from international reserves deposited in Fonden and from PDVSA's overdraft at the Central Bank), but it also implies new indebtedness in the local and international markets and new loan disbursements from the Chinese government.

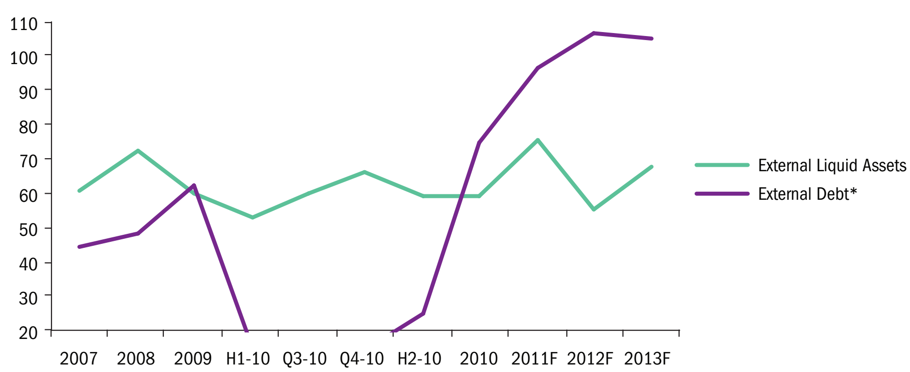
Fiscal Expansion Could Bring Few Political Benefits

Despite the great magnitude of the fiscal expansion, its effectiveness could be limited. On the one hand, it will be difficult to satisfy all the demands of the population via an amorphous public sector that now includes inefficient, nationalized public enterprises. On the other hand, as we have long maintained, for a domestic economy suffering from a lack of investment, it will be hard to respond rapidly to the fiscal stimulus, which will likely turn into higher imports and higher inflation. Therefore, we expect GDP growth of 4.9 percent next year, well below the average rate at which the economy grew (8.3 percent) in the period 2005–8. With regard to inflation, all these measures put pressure on prices, but at the same time, the authorities are tightening the use of price controls. For example, on February 27, Vice President Elias Jaua decreed a reduction in the nominal prices (of about 15 percent) of more than 600 items. In the end, inflation will depend on the efficiency of the government with regard to the price controls, closing at levels among 25 to 35 percent depending on it. In this environment, lower inflation will have the collateral cost of higher shortages.

Debt Dynamics Were on an Unsustainable Path, but Should Improve in 2013

The surge in external debt is the main factor behind investor perceptions of Venezuela as the country with the highest risk in emerging markets. As FIGURE 4.27 shows, total external debt has risen from $30.2 billion in 2006 to our projection of $106.2 billion in 2012. In terms of total debt, the figures more than triple, from $47.0 billion to $152.3 billion over the same period. We find it alarming that the amount of debt could rise to such an extent in just one presidential term and in the middle of a big positive shock in oil prices. In our view, whoever takes office in 2013 will need to change Venezuela's debt strategy.

Figure 4.27. **Venezuela's Increasing Debt Outstanding** (billions of dollars)

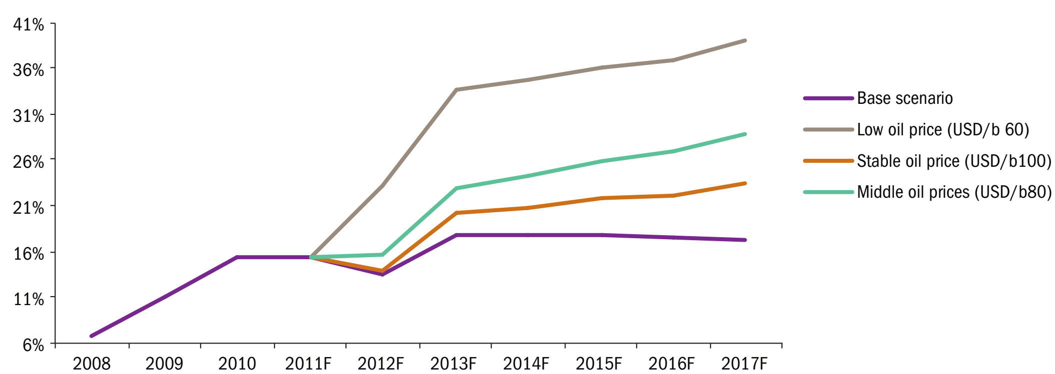


Source: Ministry of Finance - Venezuela, BCV, PDVSA, and Barclays Capital.

Even if the government has been rapidly increasing the debt, until last year it was doing so at a relatively low cost. The possibility of selling dollar-denominated debt in local currency allowed the government to play with the foreign exchange differential, issuing instruments with a lower yield than that demanded by the international market. However, since Jorge Giordani took charge of the Ministry of Finance, the government has maintained a strong overvaluation of the implicit exchange rate of debt issuances, leading to paying coupons as high as 12.75 percent. In consequence, even if new debt is being placed in the medium to long terms, interest payments are rapidly accelerating in the short term. We estimate that the external debt service will reach $12.5 billion in 2012, more than double the amount disbursed in 2008.

Despite the risks of a rapid increase in indebtedness, we maintain that the favorable oil market outlook bolsters the country's capacity to pay, even if the debt service is becoming heavier. Under our oil market base scenario (i.e., a linear increase in the oil price until it reaches $184 per barrel in 2020), even if Venezuela continues to issue $12 billion per year at a coupon of 12 percent, debt service would stabilize at about 18 percent of oil exports in 2017. Thus, Venezuela should not have problems paying its interest and debt amortizations for the next five years. FIGURE 4.28 sets out the external debt service under varying oil price scenarios.

Figure 4.28. **Venezuela's Debt Service Scenarios** (percentage of oil exports)



Source: Ministry of Finance - Venezuela, BCV, PDVSA, and Barclays Capital.

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Latin America Initiative
at BROOKINGS

1775 Massachusetts Avenue, NW
Washington, DC 20036
202-797-6000
www.brookings.edu/global