BROOKINGS

LATIN AMERICA ECONOMIC PERSPECTIVES

Innocent Bystanders in a Brave New World

Eduardo Levy-Yeyati with Luciano Cohan

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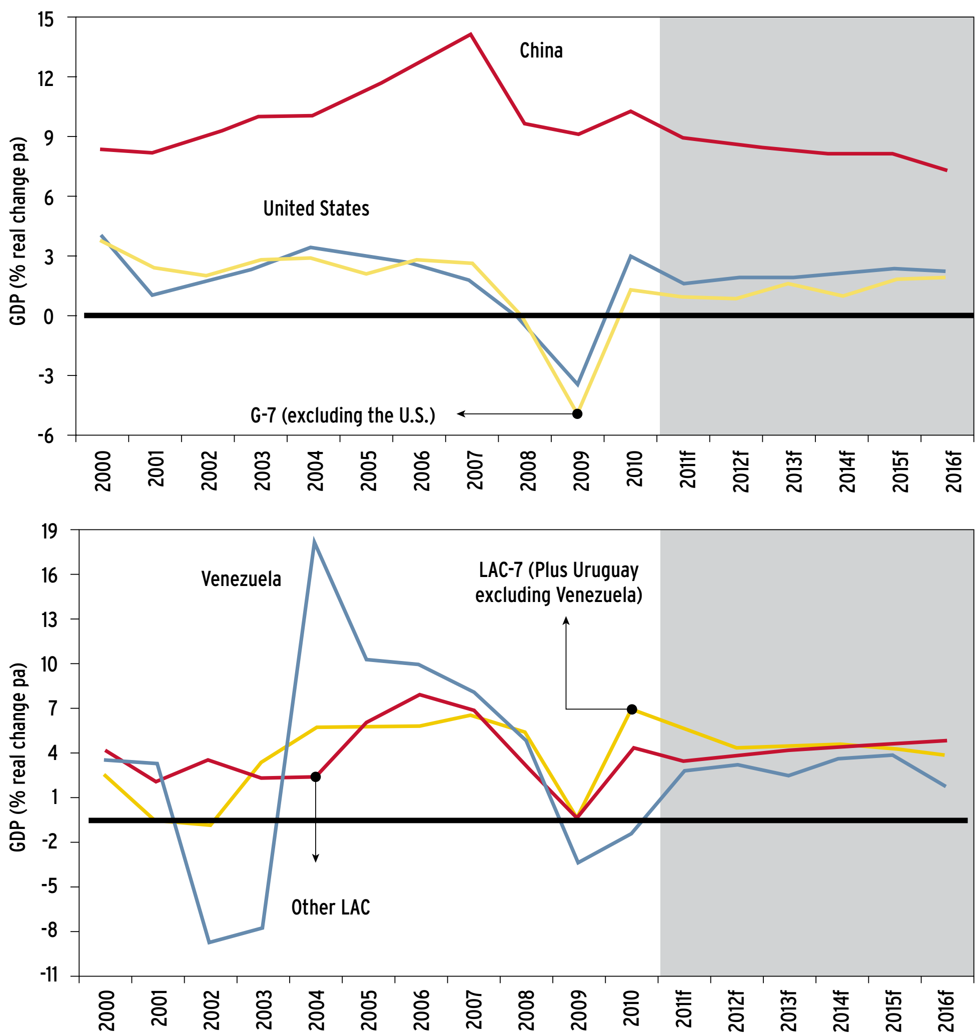
Looking Back: Six Months in Six Snapshots

The global outlook worsened in the second quarter of 2011 as stimulus programs failed to achieve self-sustained growth in the developed world, leading to a downward revision of past economic data and future growth prospects. Output gaps that may be larger than previously thought plus the eventual risk of a disorderly default in Europe kept risks tilted downward. In China, growth is still about 9 percent, but inflation is inducing a monetary tightening that may hinder growth.

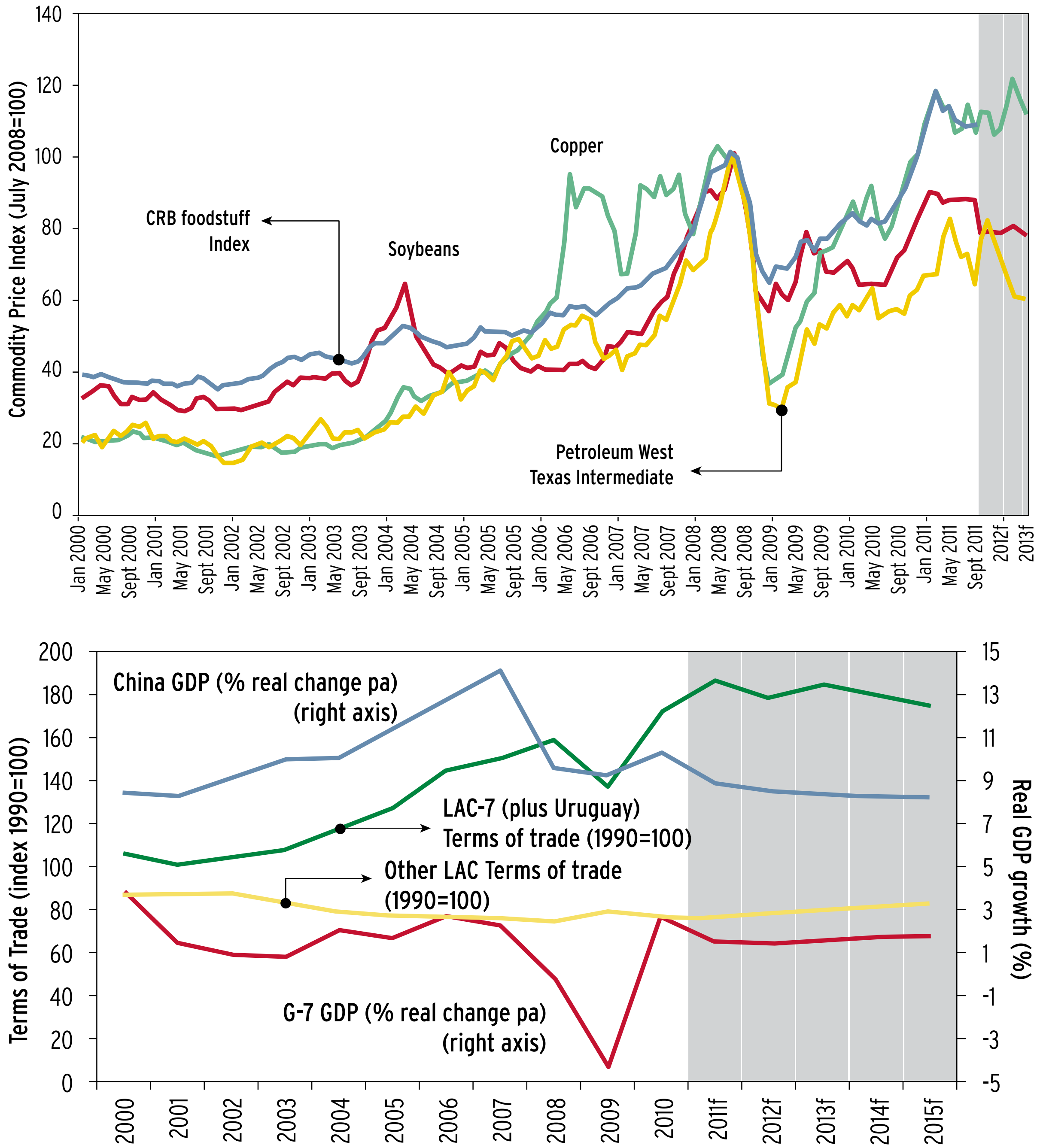
After a strong recovery, Latin America is starting to feel the combined effects of financial stress and dwindling global demand. The LAC-7 countries—Argentina, Brazil, Colombia, Chile, Peru, Mexico and Uruguay—are expected to outperform developed countries and other LAC countries, but the growth recoupling typical of systemic crisis periods indicates that the final score may be disappointing if the global outlook continues to deteriorate.

Figure 1.1. Growth and Growth Prospects, 2000–2016



Central America and the Caribbean countries: Costa Rica, Dominican Republic, El Salvador.
Note: Data for 2012–16 are projections.
Source: Authors compilations, data from the Economist Intelligence Unit

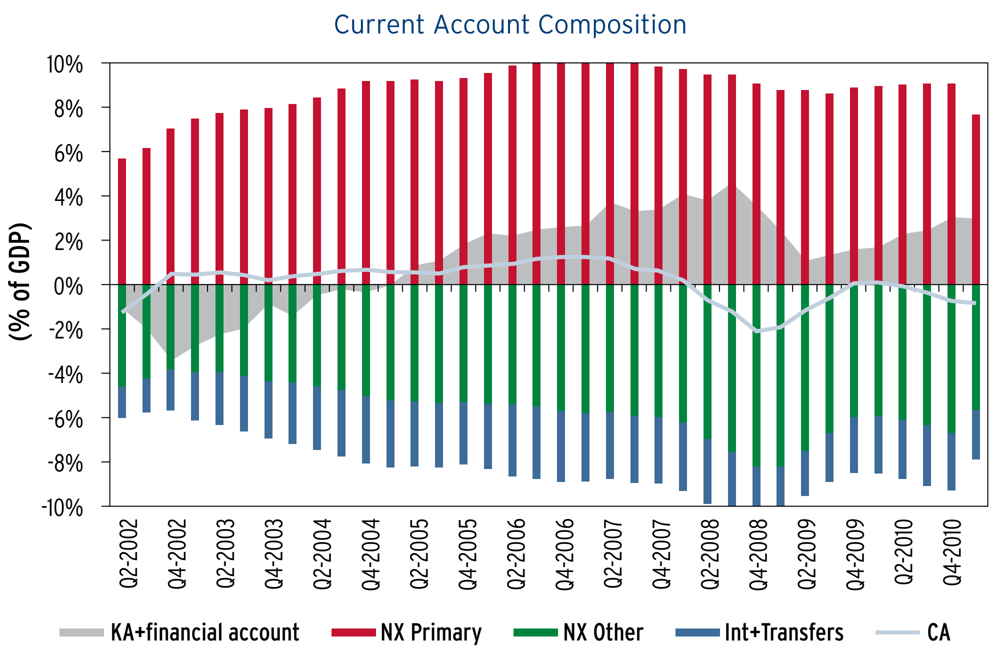
Figure 1.2. Commodities and Terms of Trade, 2000–2013

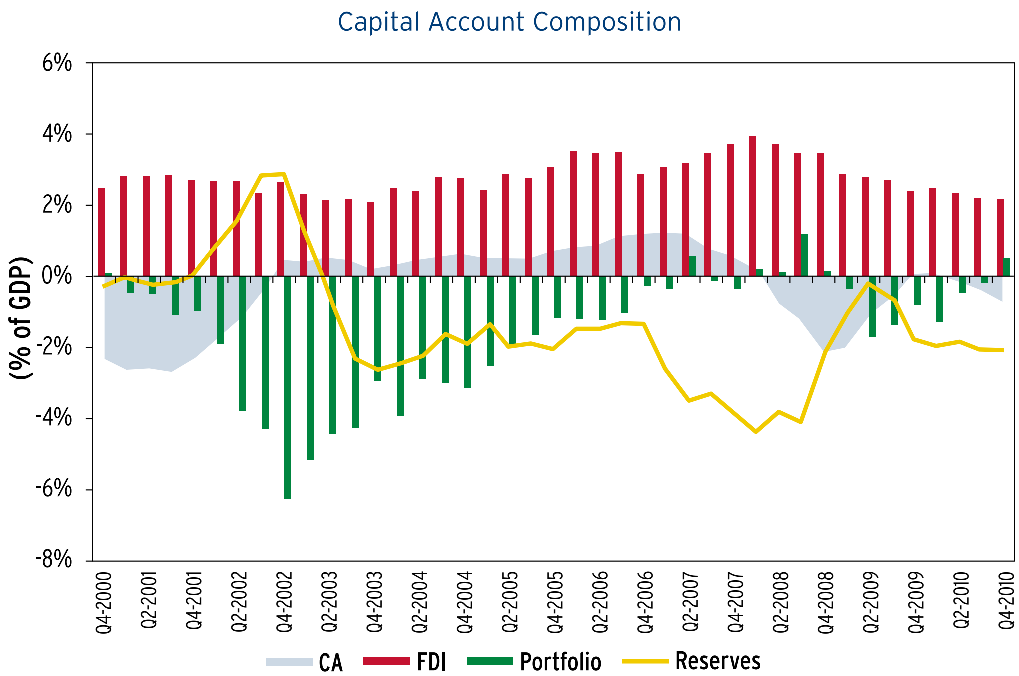


Source: Economist Intelligence Unit

Even though the region's terms of trade remain atypically high, the upward trend on commodity prices flattened at the beginning of the year, as growth previsions softened. In the LAC-7, levels of terms of trade are still supportive (although a slight reversion is expected for 2012), but, indeed, the headwinds from commodity price increases are largely gone.

FIGURE 1.3. BALANCE OF PAYMENTS, 2002–2010

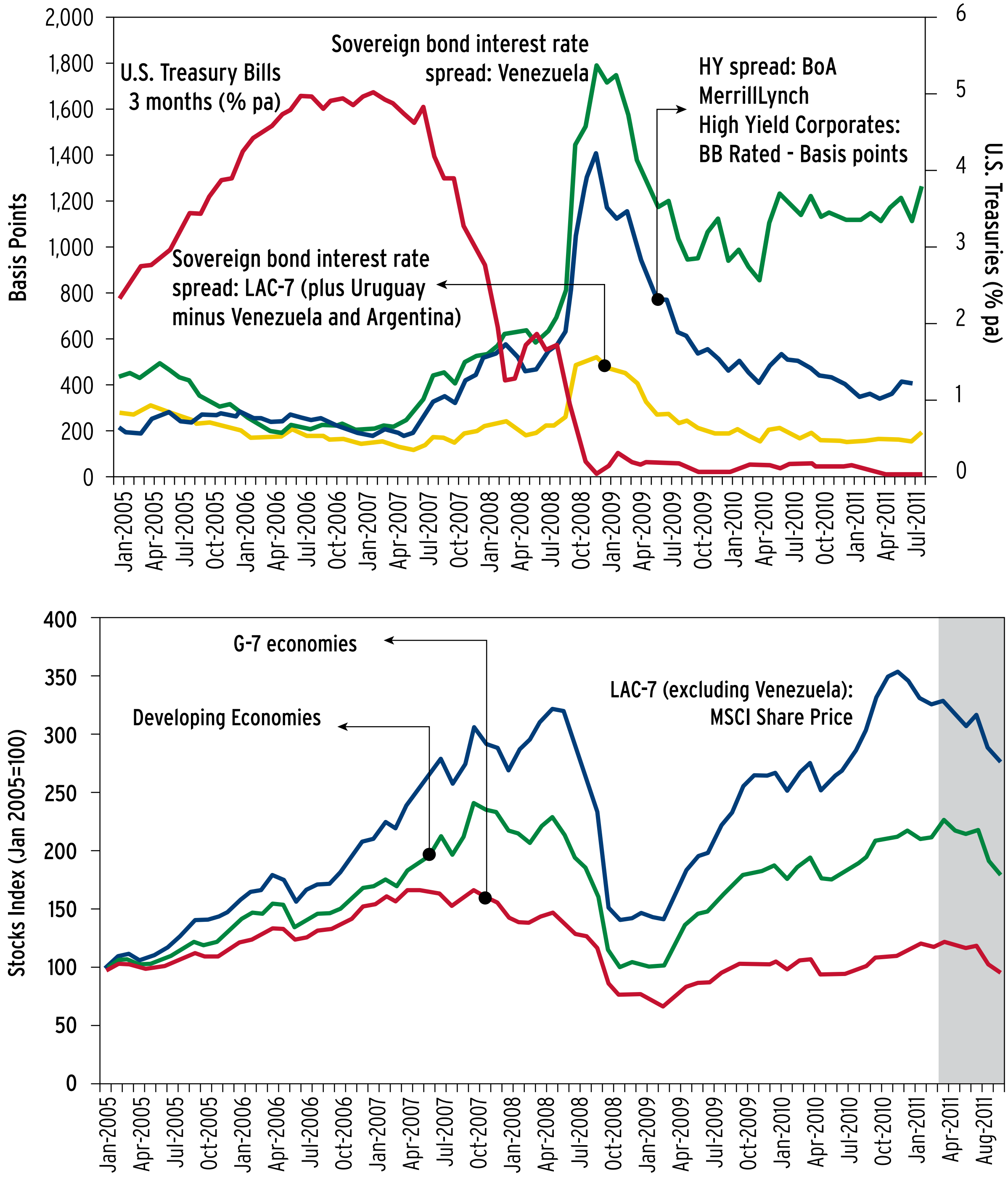




Source: IMF and The World Bank.

The current account balance is reverting as GDP and imports growth outpaces those in global trading partners, and terms of trade become less supportive: With the predictable exception of Chile, LAC-7 is once again moving into negative territory. Primary net exports and capital account flows (mainly foreign direct investment) remain the main sources of foreign exchange (10 percent and 2 percent of GDP, respectively), making up for a chronic deficit on non-primary trade, income and transfers (–2.6 percent and –6.6 percent of GDP, respectively). If the current risk-averse scenario continues, we expect slightly wider current account deficits, a smaller capital account surplus (i.e., flat portfolio flows) and a moderate decline in the stock of reserves.

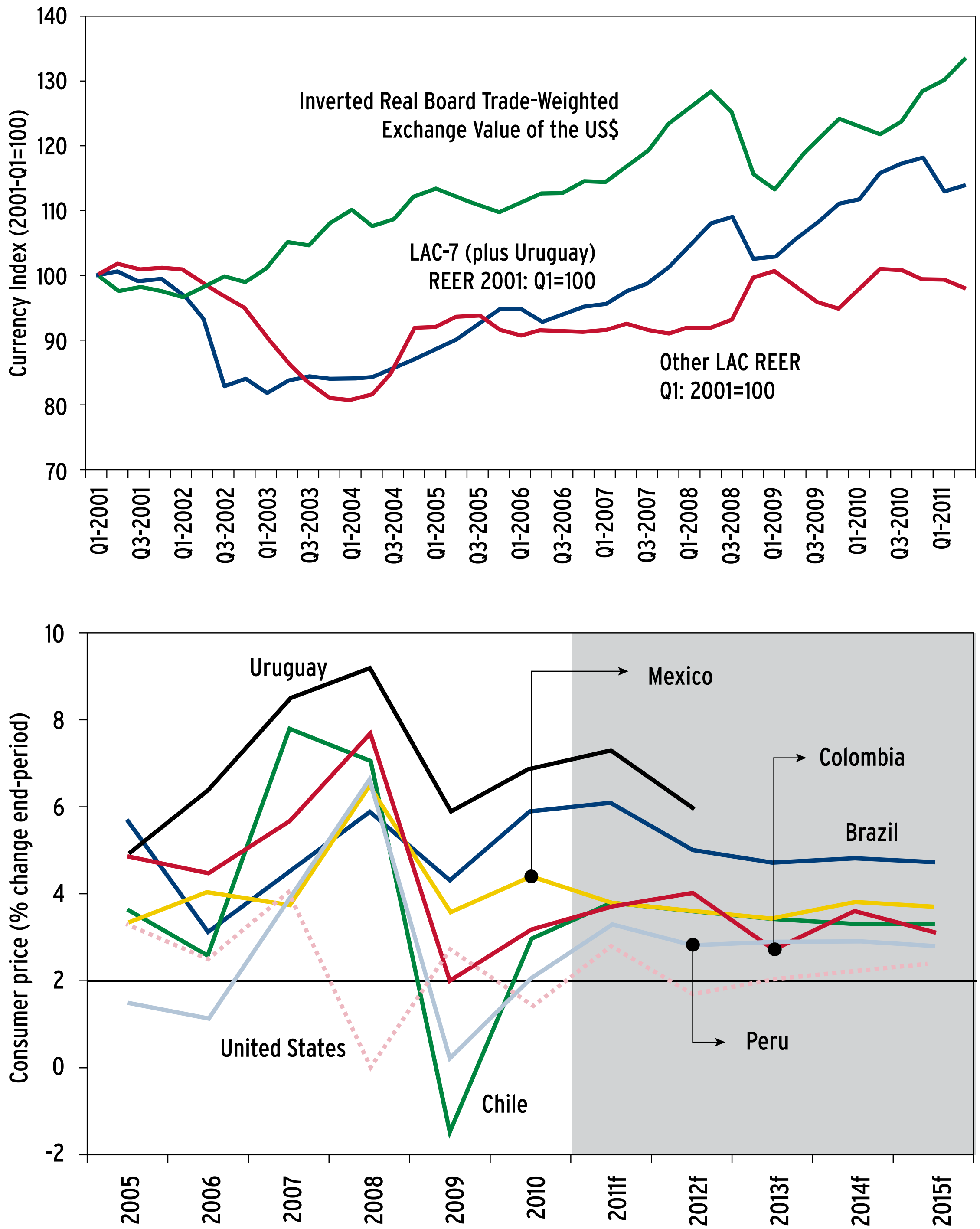
Figure 1.4. Financial Markets: Equities, Bonds and Currencies, 2005-2011



Source: MIDAS

As U.S. Treasury bill rates have moved close to their technical floors, corporate risk premiums have increased and several euro zone countries (some of which have recently been downgraded) have sold off. LAC-7 investors have finally capitulated, widening spreads and thus emulating—to a smaller degree—the financial recoupling due to the unwinding risk of late 2008. Conversely, equity markets have underperformed in LAC-7 throughout 2011.

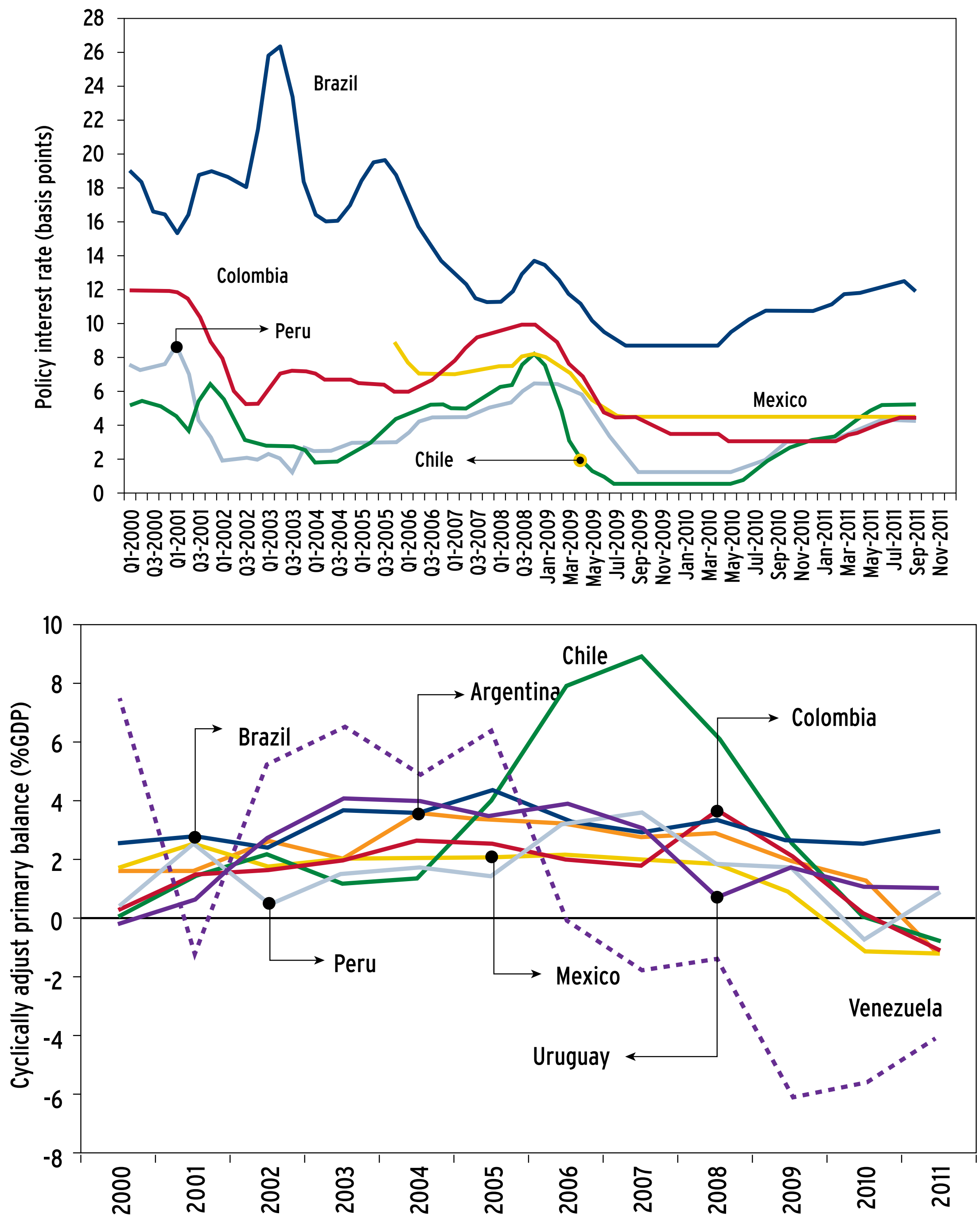
Figure 1.5. Inflation and Exchange Rates, 2001-2011



Source: Authors construction, data from Haver Analytics and World Bank's Global Economic Monitor.

Real exchange rates have pulled back in the third quarter after moderately appreciating in the first six months, to end close to the beginning-of-the-year levels. In turn, inflation peaked by midyear, partially contained by currency appreciation, the stabilization of commodity prices and, more recently, weaker domestic demand. Inflation expectations should be additionally tamed by the anticipated global slowdown.

Figure 1.6. Policy: Fiscal Balance and Central Bank Interest Rates, 2000-2011



Source: IMF International Financial Statistics and local sources

With inflation risk slightly tilted downward, central banks chose an early end to their tightening cycles and are now moving toward a data-dependent easing stance. Peru, Uruguay and Brazil have pushed their fiscal primary balances to a safer zone, in line with the tightening bias in monetary policy. By contrast, primary balances in Colombia and Chile have continued to weaken (in the latter, due to natural disasters). In fast-growing Argentina, the political cycle leading to the October 24 elections has dominated fiscal considerations, but a mild adjustment is expected for 2012.

CHAPTER 2

The Next Six Months: Back in Crisis Mode

Is It 2009 All Over Again?

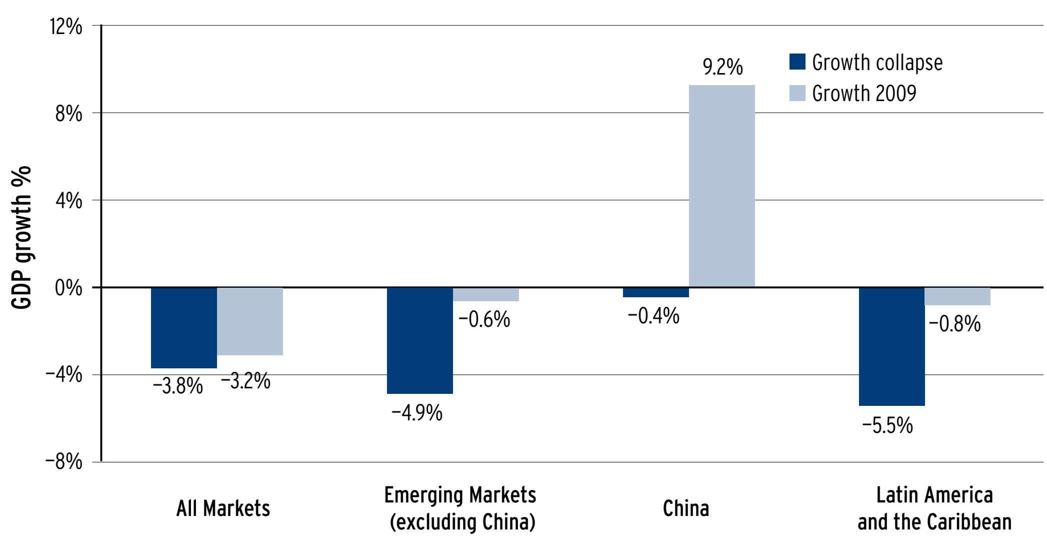
Despite its newly gained macro financial resilience, the Latin American region proved not to be immune to the contagion stemming from the 2008-9 global financial and economic crisis triggered by Lehman Brothers' default. Although the region continued to grow more quickly than developed countries, its growth collapse in 2009 was comparable to (if not larger than) that of the advanced world (figure 2.1), signaling that the real decoupling due to its increasing ties with the emerging Asian economies—most notably, China—which had characterized the precrisis period, was not sufficient to isolate it from a systemic economic slowdown.[1]

Now, after a swift recovery in 2010 that brought back expectations of a real decoupling of emerging economies, and the hope that the 2010s could become the Latin American decade (see, e.g., *The Economist*, September 9, 2010), the region is moving back into crisis mode and starting to feel the pain of the rapidly deteriorating global context.

Is it 2009 all over again? Probably not. For starters, there are important differences between the post-Lehman meltdown and the current episode of financial stress. Back then, the source of fragility was an over-indebted, opaque and highly interconnected financial sector that, after the Lehman debacle, fell prey to counterparty risk and close to total paralysis. At the time, after some predictable hesitation, the public sector came to the rescue, putting a floor to what was a dramatic but short-lived panic. As a result of bailouts, fiscal stimuli and poor growth, sovereign debt ratios started to creep up, leading to concerns about fiscal sustainability—or, alternatively, about the fiscal space needed to keep up the fiscal impulse at a time when growth continues to falter.

Now that the debt problem seems to lie within the sovereigns themselves, the base scenario is not panic-driven growth and trade collapse as in 2009, but rather a long period of subpar growth in the U.S. and Europe similar to that of Japan in the 1990s. Against this unsupportive backdrop, the downside risk of disorderly defaults in some

Figure 2.1. The Growth Collapse of 2009



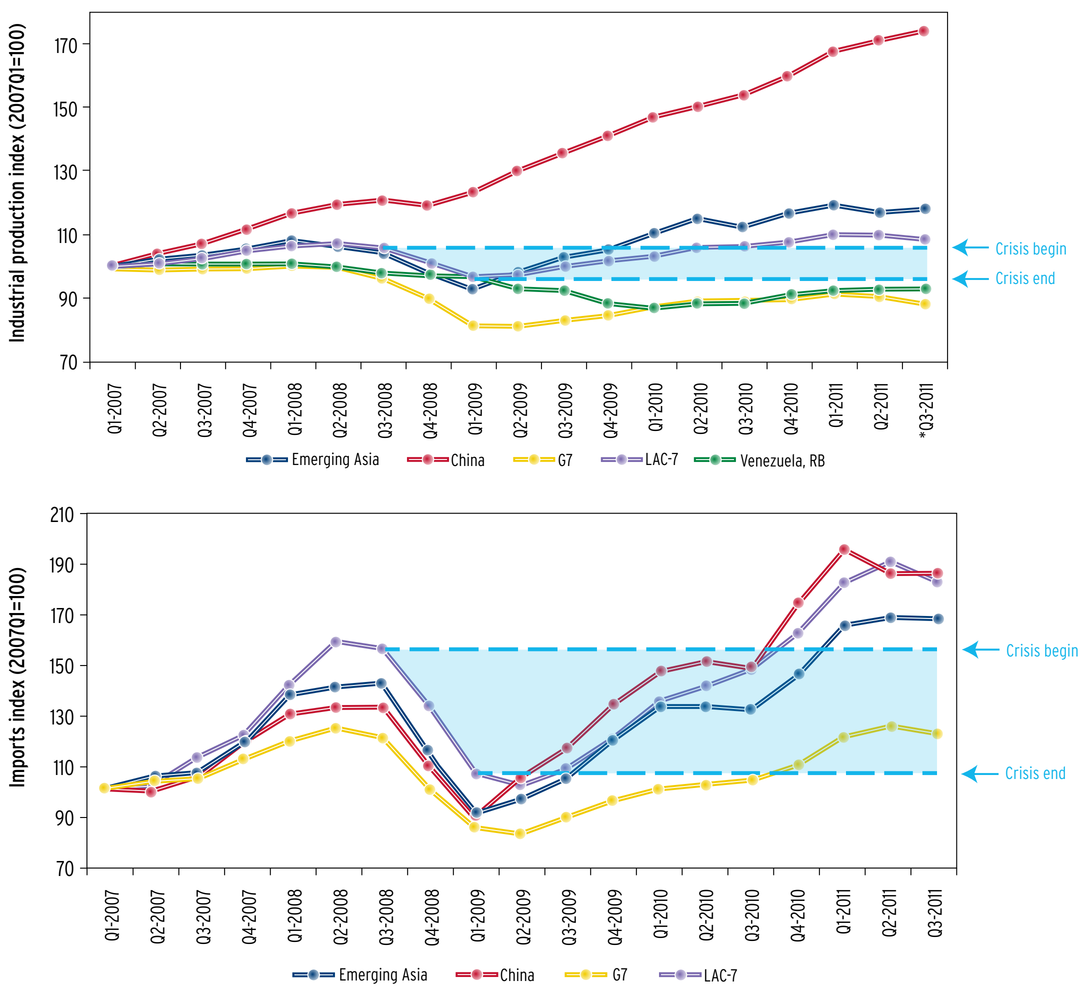
Sources: Brookings; World Bank.

[1] Eduardo Levy-Yeyati and Tomas Williams, *Financial Globalization in Emerging Economies: Much Ado about Nothing?* Policy Research Working Paper 5624 (Washington: World Bank, 2011).

European countries like Greece or an unexpected slowdown in China explains the risk-averse attitude of international investors and the volatility that has characterized emerging market currencies and commodity prices in the third quarter of 2011.

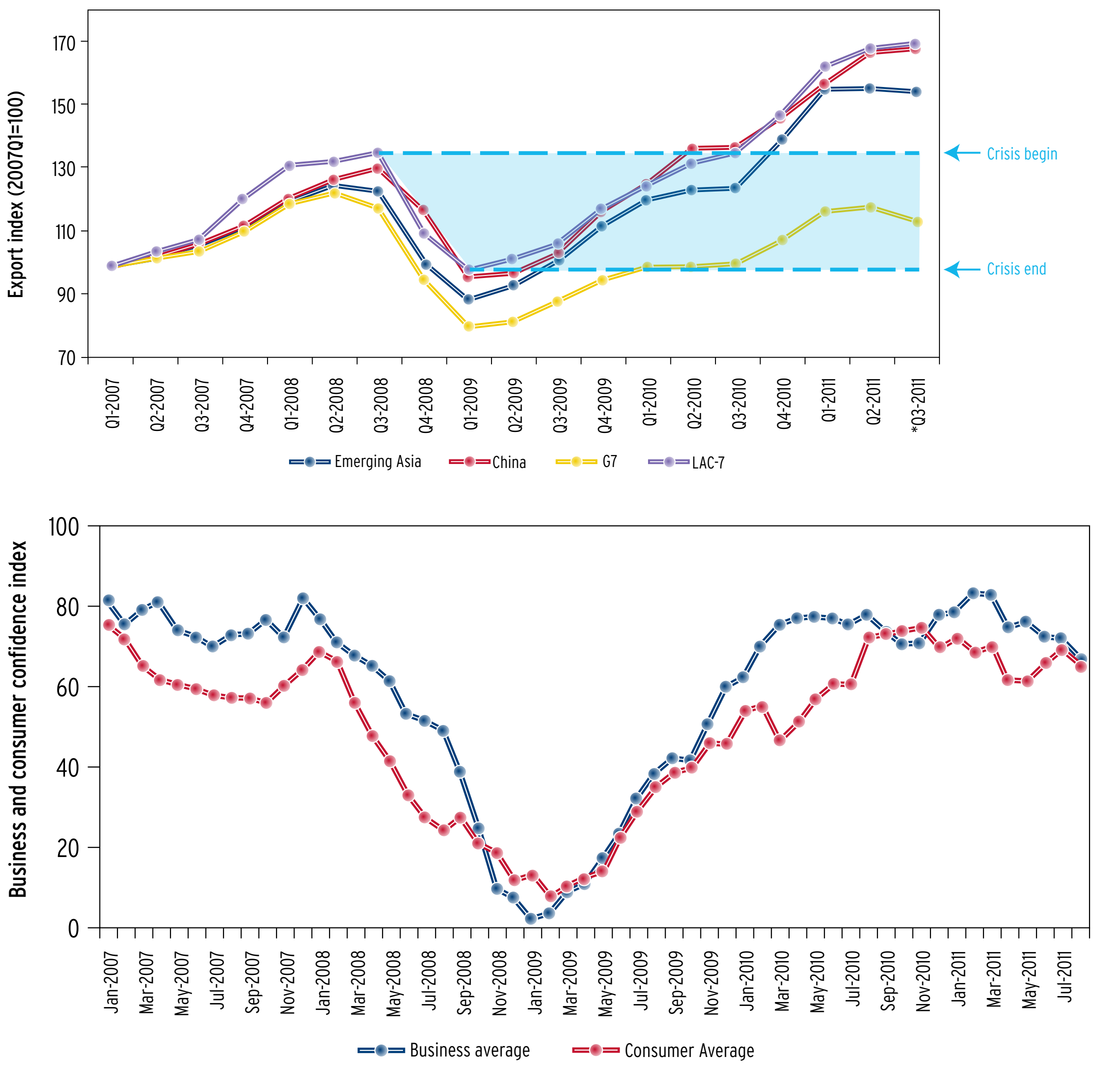
How is the situation in Latin America, relative to its emerging peers and to mid-2008 before the crisis blew up? Although there is no simple way to characterize the economic dynamics of a region as heterogeneous as Latin America, a few summary measures illuminate the big picture (figure 2.2). A quick glance at the evolution of exports and imports volume and industrial production reveals a few interesting stylized facts. First, unlike advanced G-7 countries, both Latin America and emerging Asia are above their pre-crisis peaks. However, after fully recovering the lost ground in 2010, both have started to emulate, with a lag, the ongoing decline in G-7 countries, slowing down slightly in the third quarter of 2011. The same can be said for business and consumer confidence, which reached pre-crisis levels and is now showing the signs of a gradual softening. Second, while the shape of the recovery looks comparable to that of emerging Asia, industrial production (and, to a lesser extent, growth) proved to be less sensitive in Latin America.[2]

Figure 2.2. Tracking the Crisis: Exports, Imports, Industrial Production, and Confidence



[2] This is possibly due to its larger dependence on commodities for which the adjustment to changes in demand is smoothed out by price flexibility—as opposed to manufactures that tend to react more dramatically through quantities.

Figure 2.2. Tracking the Crisis: Exports, Imports, Industrial Production, and Confidence (continued)

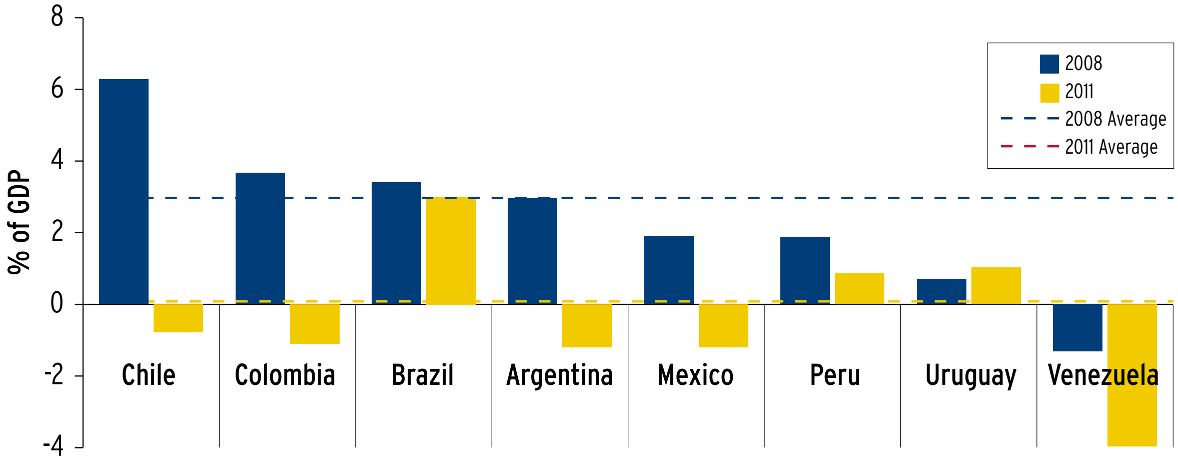


Note: * projected. The LAC-7 includes Argentina, Brazil, Chile, Colombia, Peru, Mexico and Uruguay.
Sources: World Bank, *Global Economic Monitor*; Indec; Universidad Torcuato di Tella; Icare; Organization for Economic Cooperation and Development; Adimark; Fedesarrollo.

Another important difference between now and then is the fiscal space with which Latin America enters this new phase of the crisis. After adopting a successful countercyclical fiscal stance in 2009 (see figure 1.6 above), many Latin American countries did not have the time to undo the fiscal impulse and are now facing the new challenge with more limited fiscal ammunition to sustain domestic demands (figure 2.3).

At any rate, inasmuch as the global context remains uncertain and volatile, discussing the region's prospects in the near future amounts to discussing the effect of alternative global scenarios on the individual economies. Specifically, at the current stage, the relevant question is not whether the global situation can derail Latin American growth—which it certainly can—but rather to what extent it can do so. How exposed is Latin America to a global recession? How can the region best prepare itself for such an unfavorable environment? These are the questions that are addressed in this chapter.

Figure 2.3. Cyclically Adjusted Primary Balances for the LAC-7



Sources: Brookings; Economist Intelligence Unit.

News of the World: The Global Risk Cycle

The previous Brookings Latin America Economic Perspectives (*BLEP*) report highlighted what we believe is the pattern that should guide any top-down analysis of the impact of the global events on the Latin American region: the combination of a synchronous global risk cycle and its strong incidence on portfolio flows and exchange rates. To phrase this differently, fundamentals do not seem to matter during the outbreak of a crisis; no matter how solid balance of payments and financial balance sheets look in individual countries, capital tends to pull out (and currencies to sell off) everywhere at the same time.

What do we talk about when we talk about risk cycles? A few graphs can help illustrate their workings. First, in figure 2.4, we estimate a risk index as the first principal component (PC) of two standard risk proxies in core financial markets: the VIX and the U.S. high-yield (HY) corporate credit spreads.[3] Thus, the risk index allows us to summarize the common movements of the two series and to assess how much of the individual movements are explained by a common driver.

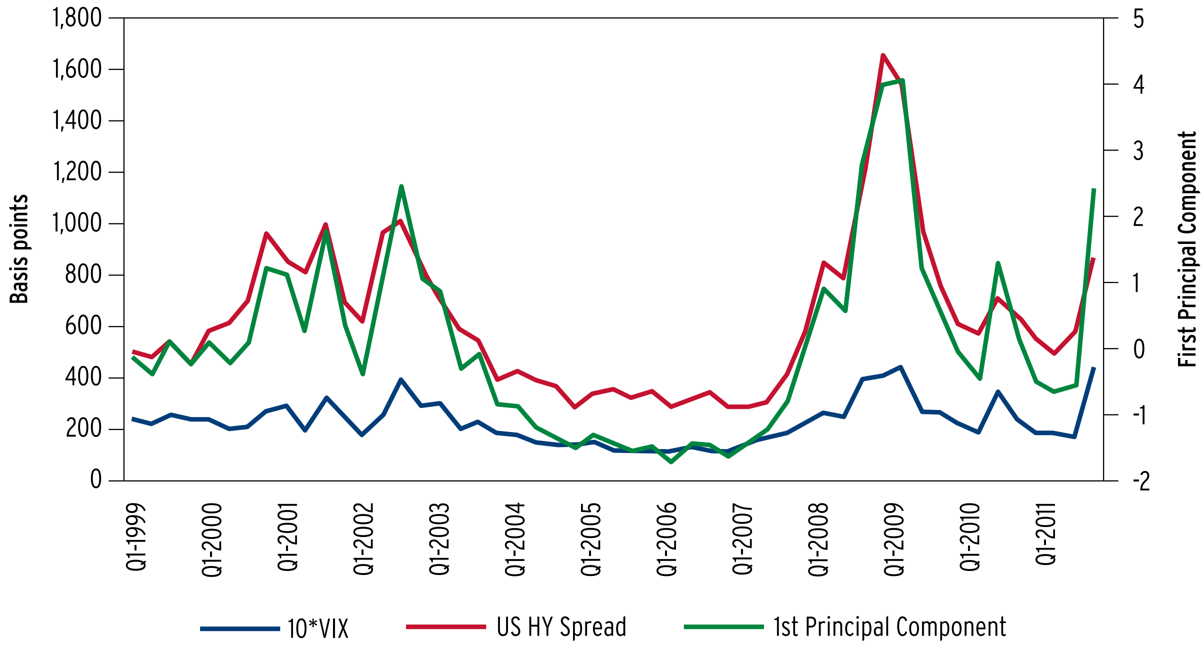
Second, we replicate the same exercise for what we believe are the two main financial vehicles for the risk cycle to affect individual emerging economies: capital flows; and, largely as a consequence of these flows, exchange rates. More precisely, we update the estimation of the first PC of portfolio liability flows and changes in the real effective exchange rate that we reported in the previous *BLEP* report, and plot them against the risk index to illustrate their tight correlation (figure 2.5).[4]

What this simple exercise tells us is that portfolio flows and exchange rates react almost in tandem across the emerging world in the event of a swing in global risk aversion as we saw in late 2008—or the one we are witnessing at the time of this writing. Why? One could point to a real financial contagion, namely, the fact that a global downturn should ultimately reduce growth prospects in emerging market economies as much as it does in advanced ones. After all, this was what happened

[3] The Chicago Board of Trade's Options Exchange Market´s Volatility Index (VIX) tracks the volatility implied in the pricing of options on the Standard & Poor's 500 equity index, and is often nicknamed the "fear factor" because it tends to rise not only with expected price volatility (as it should) but more generally with financial distress and bouts of risk aversion. The high-yield index computed the interest rate premium over comparable U.S. Treasury bills played by non–investment grade, high-yield corporates in the U.S. The first principal component provides the common series that best explains the joint dynamics of the two series, reducing in a simple way the dimensions of the risk space.

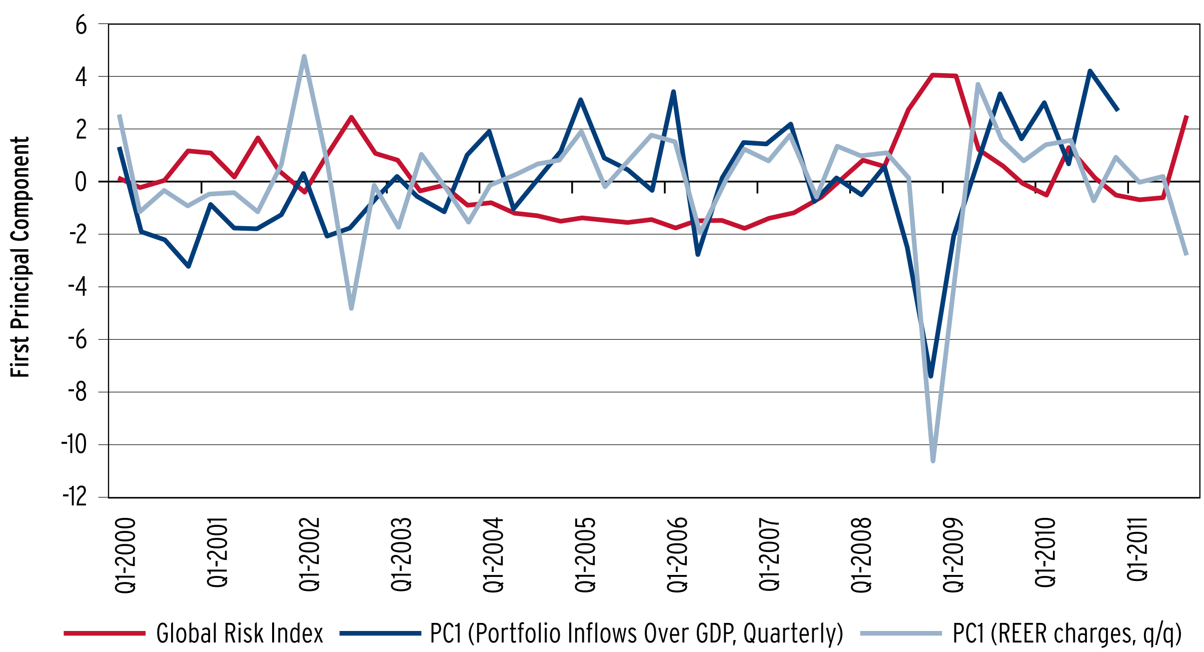
[4] The correlation with the risk index is even stronger when we look at nominal exchange rate changes. However, because we are more interested in the way in which the risk cycle affects the real economy in the region, we prefer to focus on the real effective exchange rate—in our view, a better gauge of international price competitiveness.

Figure 2.4. The Global Risk Cycle, 1999–2011



Sources: Brookings; Chicago Board of Trade Options Exchange; Merrill Lynch.

Figure 2.5. The Incidence of the Global Risk Cycle: Portfolio Flows and Real Exchange Rates, 2001–2011



Note: REER = real effective exchange rate.
Sources: Brookings; Chicago Board of Trade Options Exchange; Merrill Lynch; International Monetary Fund.

in 2009; why would that be the case again in 2012? According to this story, the correlation between risk in the U.S. and flows in emerging markets, as shown in figure 2.4, would simply reflect a missing common factor: bad economic news in the U.S., which may be driving up risk in American markets, leading to a downward revision of emerging markets' growth.

However, this argument does not address the particular channels at play. In particular, it does not explain why outflows in emerging economies do not discriminate between current account deficit and surplus countries. Moreover, it does not account for the fact that the risk cycle appears to precisely benefit those core economies like the U.S. and Japan that are at the center of the financial storm and thus closer to real stagnation.

Alternatively, one can point to financial contagion. For example, a recent paper shows that the growing presence of global funds (including the increasingly popular exchange traded funds—ETFs) in emerging markets may be behind the synchronicity displayed by flows and asset prices (which this paper labels "financial recoupling").[5] The intuition is straightforward: Fund managers tend to stay close to their benchmarks and to liquidate assets proportionally (i.e., assets are liquidated everywhere, at the same time) in the event of massive redemptions such as those experienced during risk cycles.

Another related source of financial contagion has been examined by Bloom: the effect of a financial scare on the propensity of private agents to consume and invest.[6] A "panic effect" (measured as the impact of a sudden drop in equity prices and volatility on the gross domestic product) may lead to a collapse of economic activity, as he shows for the U.S.

All this evidence suggests that the real contagion view may not be as clear-cut as typically posted. Is it the cooling of the center that causes slow growth on the periphery through the usual trade links? Or is it rather the incidence of the risk cycle through the financial account and the associated panic effect that is causing production in emerging market economies to tremble?

From a Latin American perspective, we believe that the key threat from a long spell of financial stress lies in the combination of financial recoupling and the panic effect, as a downward spiral of asset sell-offs, nominal instability and capital flight may freeze domestic demand, deepening the economic consequences of a global slowdown. Moreover, as witnessed in 2009, real exchange rate depreciation hardly helps in a context where the only country appreciating its currency (the U.S.) is cooling off its own domestic demand. An important implication of this view is that—the financial health of the Latin American economies notwithstanding—a risk cycle tends to significantly influence growth.

The Real Side of a Financial Crisis

Ultimately, we care about growth, which underpins both the strengths of the labor market and the fiscal balance to provide the safety net needed to cope with the social consequences of an economic slowdown. And though global growth prospects still look much better than at the end of 2008 (see figure 1.1 above), they may not be too bright, given recent developments. Consequently, Latin America needs to brace itself for the tail risk of a global recession.

Inverting the old Tolstoyan saying, countries are different in good times but tend to look alike in bad times. The reason is simple: Common factors that lie in the background when the world surfs

[5] Eduardo Levy-Yeyati and Tomás Williams, "Emerging economies in the 2000s:Real decoupling and financial recoupling," CIF Working Paper 6/11, UTDT.

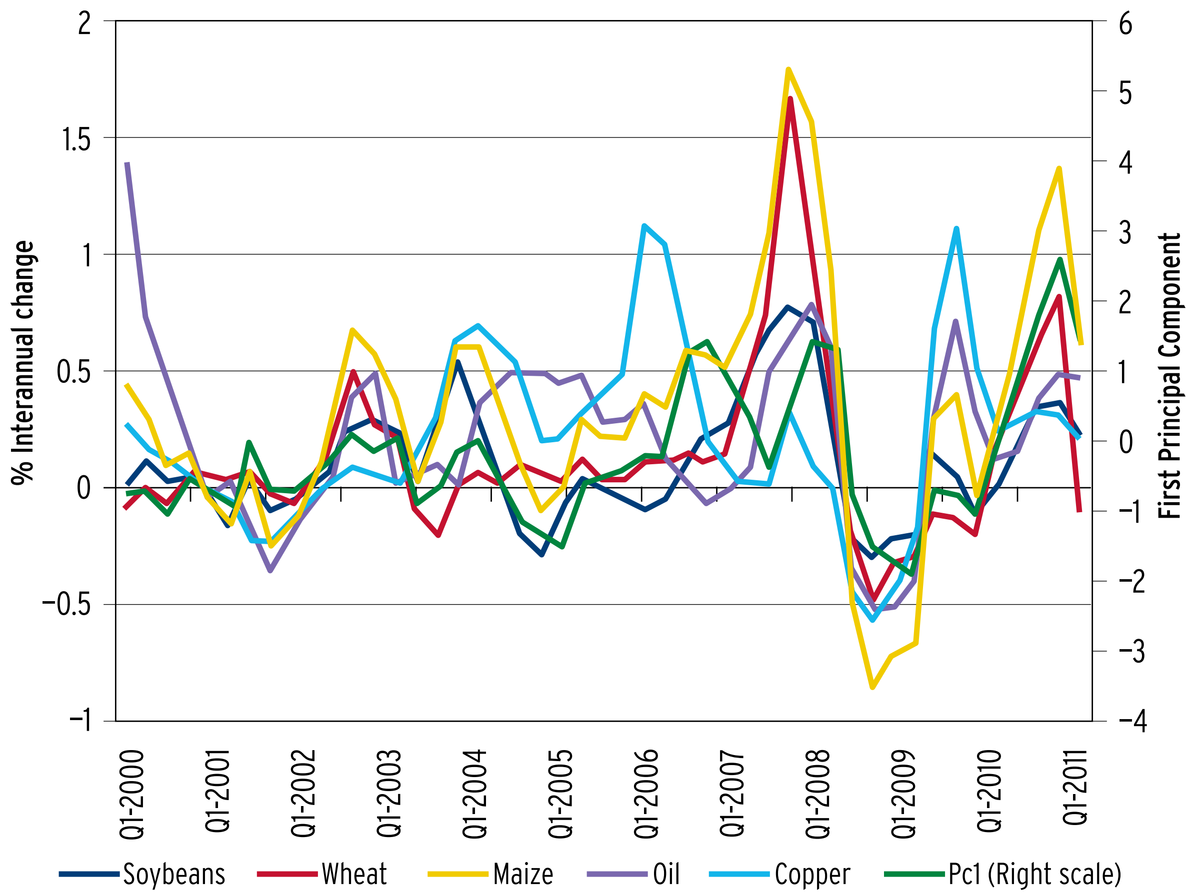
[6] Nicholas Bloom, "The Impact of Uncertainty Shocks," *Econometrica* 77, no. 3 (2009): 623–85.

the cycle become relatively more important when a crisis shakes countries off their smooth path. In this situation, small, open emerging market economies suffer the double whammy of skyrocketing risk and a fall in commodities and global demand.

Commodities provide a good example of how risk and the global business cycle are interrelated: They tend to move together, but it is at times of financial volatility that their correlation visibly rises (figure 2.6), both because of the speculative drivers of commodity prices (including the influence of global liquidity, as was shown in the previous *BLEP* report), and because of the downward revisions to global demand. The latter effect, however, draws a line within the emerging world. It is a growth revision in Asian countries with emerging markets (which are big consumers of base metals, energy and grains), typically leading to a repricing of commodities that ultimately affects Latin American commodity exporters.

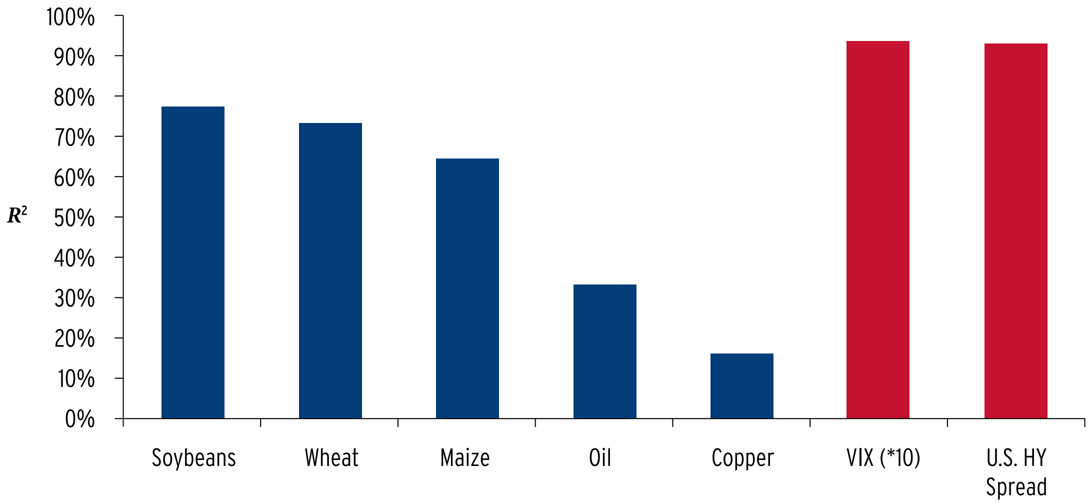
How much of the total volatility of these global variables can be explained by their common trails? Quite a lot according to figure 2.7, which shows the R^2 of regressions of individual series on their corresponding first PC. On the one hand, the first PC of commodities explains about 70 percent of the price changes in each of the three grains (although the explanatory power is ostensibly lower for oil and copper). On the other hand, the risk index explains more than 90 percent of total variability of the VIX and the HY spread.

Figure 2.6. Comovements in Commodities, 2000-2011



Sources: Brookings; World Bank.

Figure 2.7. How Much Do Common Factors Explain?



Source: Brookings.

To what extent do these global drivers affect emerging markets in general and Latin America in particular? Although causality is always a tricky question when it comes to growth (is there any variable that has not been proved to correlate with growth in the economic literature?), one can infer the presence of global factors by looking at the common (i.e., non-idiosyncratic) part of the region's growth rates (figure 2.7). Using the same approach as discussed above, we compute the first PC of growth for the LAC-7 countries, and estimate its explanatory power relative to individual growth rates—about 50 percent, on average.[7]

Although this provides prima facie evidence that exogenous systemic factors may shape economic performance in the region, assessing the incidence of global drivers on the region's growth requires a more rigorous test. To this we turn next.

The Brookings Global Wind Index

Much has been said about how the Latin American region, and in particular but not exclusively its commodity-exporting countries, has been swinging at the rhythm of the global tailwinds and headwinds associated with global liquidity, commodity prices and demand. But how much do these winds explain the economic performance of these countries? And how are these winds blowing right now?

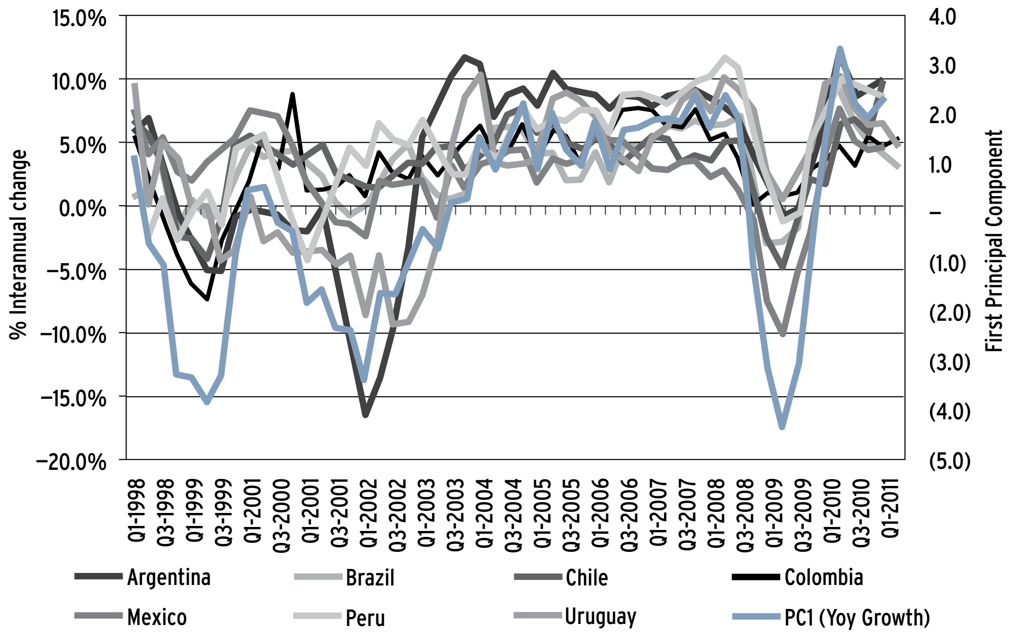
To shed some light on this hotly debated issue, we construct a simple index by regressing the LAC-7's common growth component shown in figure 2.8, on three global drivers: risk, commodities and global demand—which are proxied, in turn, by the risk index, the first PC of commodity price changes and G-7 and Chinese growth rates (table 2.1). We use the fit from this regression as a summary measure of global factors, which we call the Brookings Global Wind Index (BGWI).

Not surprisingly, the index fits the common growth pattern well: The strong comovements in LAC-7 growth appear to be largely explained by the three global factors included in the BGWI. But does it explain the performance of individual countries? And does its incidence rise, as expected, during periods of turmoil? Reassuringly, the answer to both questions is yes. The average R^2 of the BGWI goes from a considerable 46 percent up to 80 percent during the crisis period (figure 2.9).[8]

[7] As noted, 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.

[8] The crisis period, is defined for the purpose of this exercise as the period from the first quarter of 2007 to the second quarter of 2011.

Figure 2.8. The Common Growth Component, 1998–2011



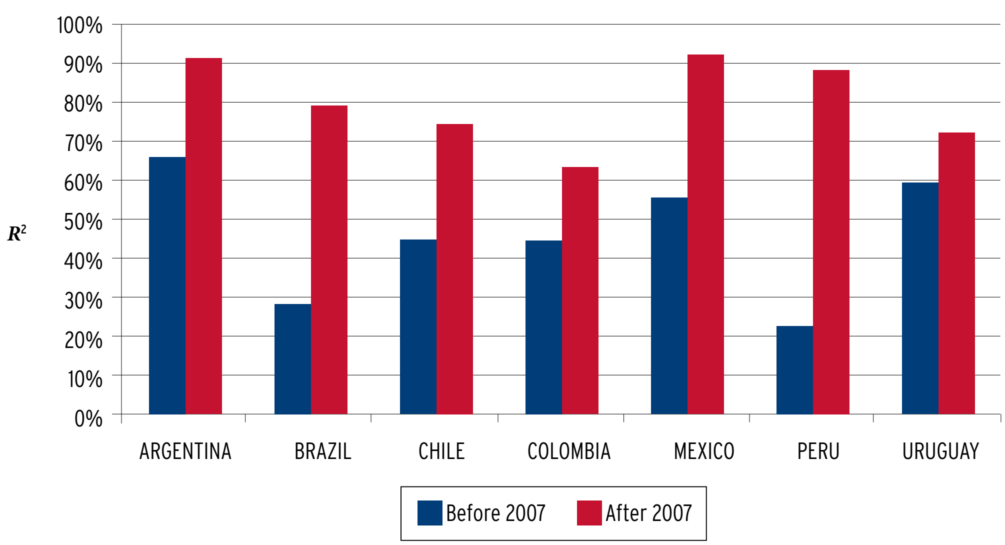
Sources: Brookings data; World Bank, *Global Economic Monitor*.

Table 2.1. Estimating the Brookings Global Wind Index

	Risk Index$_{-1}$	PC (Comm)$_{-1}$	G-7 Growth	China's Growth$_{-2}$	Constant
Beta	-0.320	0.225	28.475	34.034	-3.534
p-value	(0.046)	(0.046)	(0.058)	(0.007)	(0.006)

Note: Estimated using an AR(1) model. Dependent variable: first principal component of year-to-year real GDP growth for LAC-7 (Argentina, Brazil, Chile, Colombia, Peru, Mexico and Uruguay), for the period from the first quarter of 2000 to the second quarter of 2010 (43 observations). R^2: 89.6 percent.

Figure 2.9. The BGWI and Individual Growth Rates: Tranquil and Crisis Periods



Sources: Brookings; Economist Intelligence Unit; World Bank.

According to the BGWI, how is the wind blowing for Latin America? To answer this question, we project the BGWI for 2012 based on the current latest values of the global drivers, and then use this value of the index to project growth rates for each of the countries in the LAC-7 sample to obtain an average growth for the year of about 2.7 percent.[9] Why the decline? The benchmark assumes today's level of risk and commodity prices, and reduced G-7 growth—in other words, a lack of global tailwinds (with some headwinds coming from financial risk). This, in the absence of local growth drivers, would be enough to cause the LAC-7 to slow down considerably, to a pace that stays nonetheless well within positive territory.

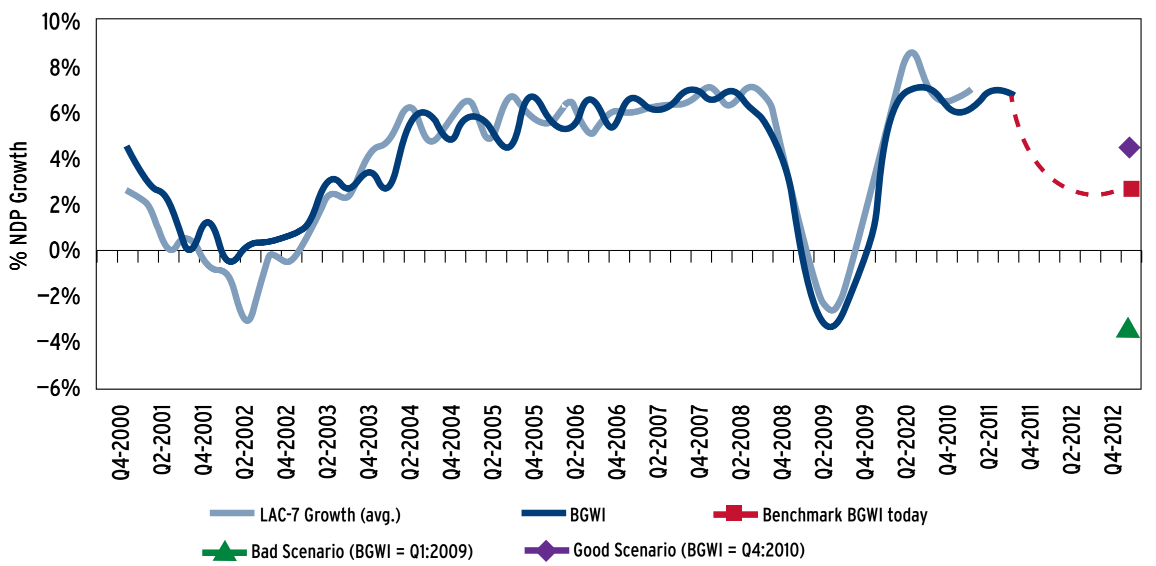
As was mentioned above, while the current scenario is not a bad indication of the expected global environment in 2012, there is always a minor probability of a "perfect storm"—a disorderly default coupled with a panic episode as in 2009. Alternatively, one could conceive another low-probability scenario in which the European crisis is resolved quickly and smoothly, the U.S. economy recovers some speed and the world goes back to the "new normal" as of the end of 2010. For the sake of perspective, figure 2.10 maps these two alternative scenarios, obtaining average LAC-7 growth rates of –3.4 and 4.5 percent for the perfect storm and quick resolution outcomes, respectively.

Is Latin America Ready to Act as a Region?

Naturally, the probabilities to be assigned to each of the three scenarios (or the characterizations of the scenarios themselves) are a question of debate, particularly in this moving global context. The objective of this simple exercise is not to produce a forecast but rather to illustrate the two main message of this chapter: the rather large incidence of global factors in the near-term outlook for the region; and, in particular, the consequences of the current reversal of global tailwinds.

As was already flagged in the October 2010 *BLEP* report, the low-hanging fruits of productivity catch-up gains and income redistribution in successful Latin American countries are mostly exhausted, and further improvement should be slower and based on finely tuned interventions. Against this uncertain backdrop, the fact that the world no longer blows in the region's favor represents an additional development hurdle.

Figure 2.10. Alternative Scenarios for the BGWI and Average LAC-7 Growth, 2000–2012



Source: Brookings data.

[9] To rescale back from principal component index scale to growth, the LAC-7 countries growth where regressed against the BGWI, fitted and then averaged to obtain a regional.

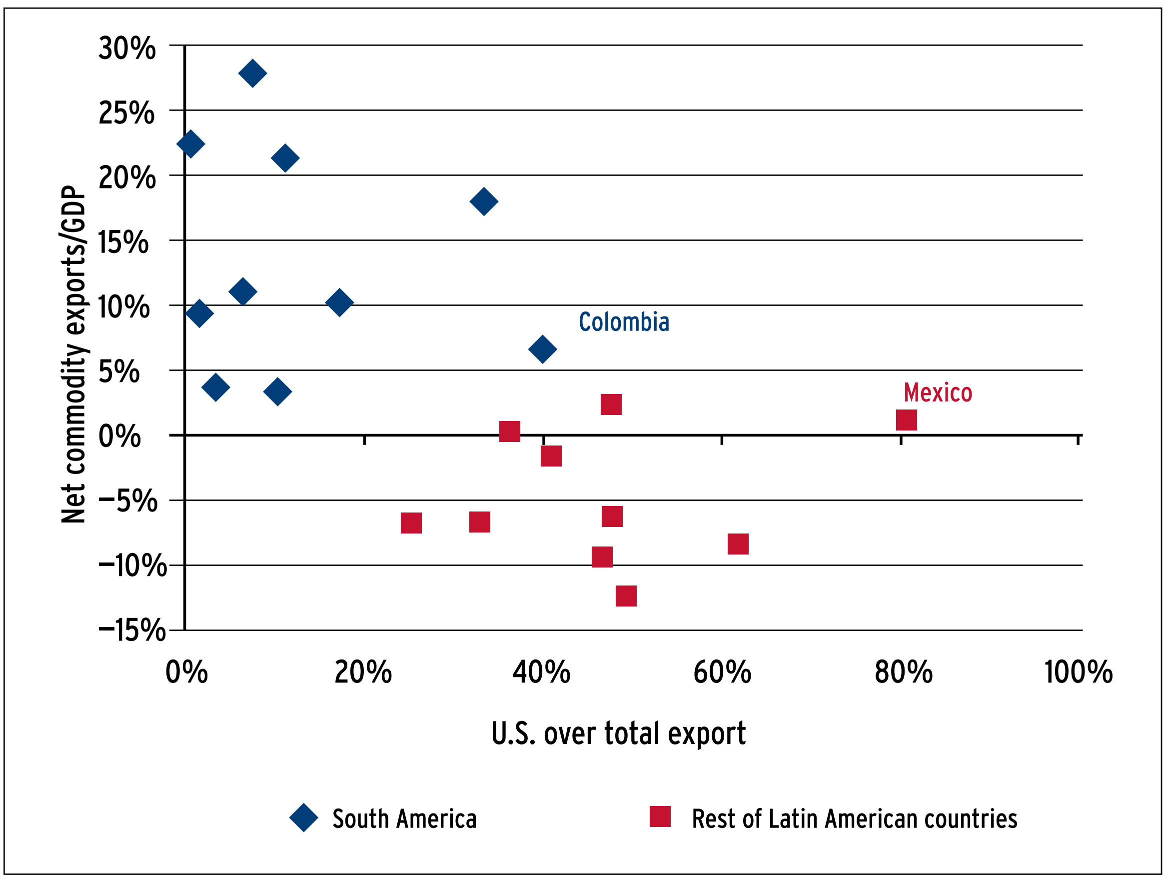
Policymakers are rapidly coming to terms with this new reality. And though the response to this challenge is bound to be specific to each country, there are at least two aspects in which the regional angle (and, more critically, regional cooperation) becomes relevant: trade integration and financial safety nets. To these we turn next.

Trade Integration: Is Latin America One Region or Two?

Where is the Latin America region's trade pattern heading, now that the commodity boom is over? In seeking to answer this question, it becomes apparent that the concept of Latin America as a region is somewhat odd. On the economic front, there are clear asymmetries between net commodity exporting, geographically diversified South American economies, and net commodity-importing, U.S. trade–dependent Central America and Mexico, for which the commodity boom of the 2000s was certainly not a blessing. This distinction, which is loosely captured in figure 2.11, explains in part the lack of a Latin American trade agenda: Whereas one subregion leans toward the big partner of the north, the other one looks to the south and, increasingly, to Asia—a pattern also to some degree responsible for the lack of a common political agenda.

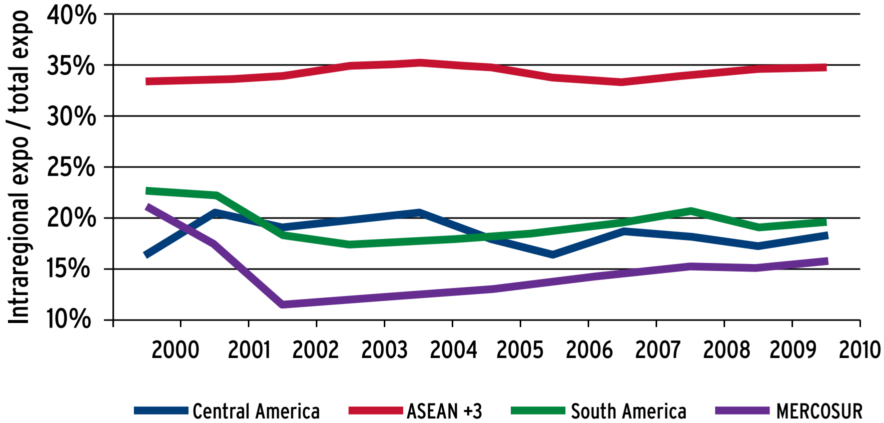
But even within South America, regional integration has been limited, at least judging from the evolution of trade links (figure 2.12). Whereas intraregional exports in Asia (represented here by the ASEAN, + 3) amount to 35 percent of total exports, reflecting to a large degree intra-industry trade, in South America they have remained below 20 percent, with limited cross-border vertical integration.

Figure 2.11. The Two Latin Americas: Commodities and U.S. Trade Links



Sources: Brookings data; World Trade Organization; UN Comtrade database.

Figure 2.12. Intraregional Trade (Exports to the Region / Total Exports), 2000-2010

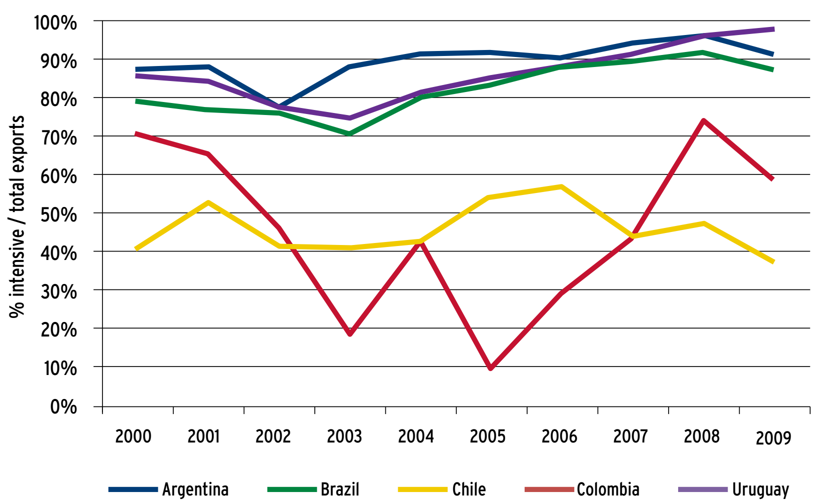


Sources: Brookings data; UN Comtrade database.

The gradual specialization in primary exports with little value added, particularly in the region's booming trade with China, probably plays a part in this outcome. Indeed, its trade links with China—reminiscent of those that many Latin American economies had with the British Empire at the beginning of the 20th century—could be seen as a centrifugal force. Primary products do not require economies of scale or industry integration, and the local demand for manufactured products can be easily met by cheap Chinese imports.

The primarization of the region's trade with China is apparent in figures 2.13 and 2.14. Both the natural resource-intensive share of total exports to China and its degree of homogeneity—associated with a lack of differentiation and smaller value added—have been rising in recent years.[10]

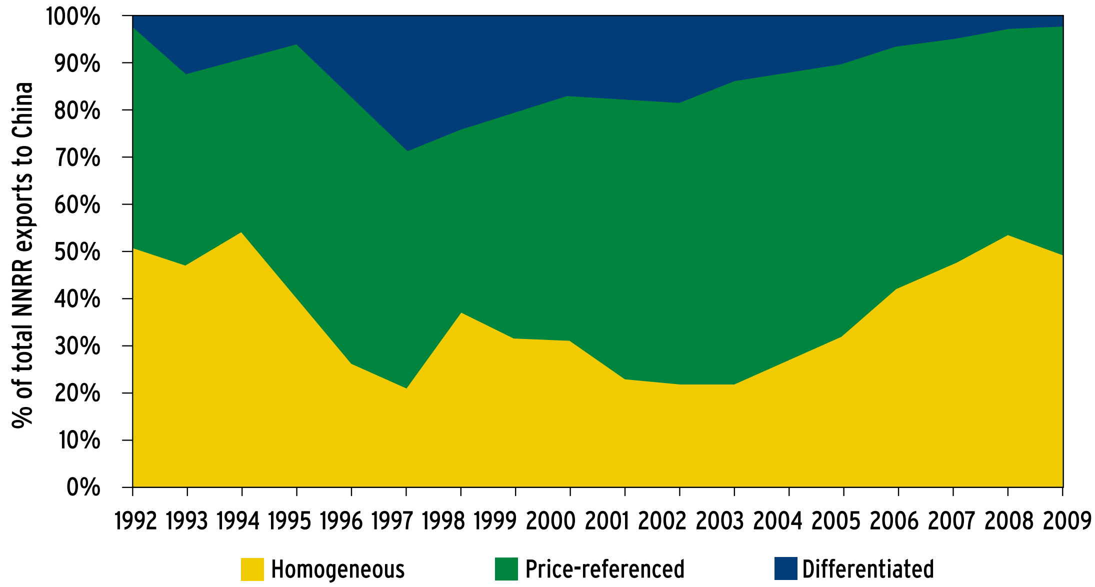
Figure 2.13. LAC's Natural Resource-Intensive Exports Relative to Its Total Exports to China, 2000-2011



Source: Lucio Castro, "Variedades de primarizacion: Recursos naturales y diferenciacion productiva—el desafio de America Latina con China," unpublished paper, CIEPLAN, Santiago, 2011.

[10] Homogeneity is measures using by Rauch's classification, which divides goods into three categories: differentiated, price-referenced and homogenous. The latter are goods traded competitively in organized exchanges (e.g., grains); price-referenced goods are trade in a similar fashion but their prices are note made publicly available; last, differentiated goods are "branded" with specific attributes that prevents an organized trade. See J. E. Rauch, "Networks versus Markets in International Trade," *Journal of International Economics* 48 (1999): 7–35; and Lucio Castro, "Variedades de primarizacion: Recursos naturales y diferenciacion productive—el desafio de America Latina con China," unpublished paper, CIEPLAN, Santiago, 2011.

Figure 2.14. The Composition of LAC's Natural Resource-Intensive Exports to China



Note: Average for Chile, Colombia, Peru, Uruguay and Venezuela.
Sources: Brookings; Lucio Castro, "Variedades de primarizacion: Recursos naturales y diferenciación productiva-el desafí de América Latina con China," unpublished paper, CIEPLAN, Santiago, 2011.

This primarization did not pose a problem during the commodity bonanza, which allowed South American governments to assign part of the rents to subsidize local industry. But now that the boom is over, it may limit future developments if it is not complemented with the specialization and sophistication that would allow for a more balanced trade composition (as seems to be the case, e.g., for China's Pacific and Asian trade partners).

Thus, trade is perhaps the main example of the scope for further regional integration and its benefits, in a world that is becoming less amenable to developing economies. It is also one among many other angles from which to approach a development model that needs to be rethought. As was argued in past *BLEP* reports, the development challenge—the conditions for this decade to genuinely be a Latin American one—lies precisely in this quest for sustainable, productivity-driven improvement in incomes.

There is, in addition, a macroeconomic rationale for integration. Now that the main source of macroeconomic risk is coming from outside, trade, by broadening the regional market, not only could complement investment in social and physical infrastructure to achieve the much-needed productivity gains but could also help stabilize demand and buffer the region from noisy external influences.

The Financial Side: The Quest for a Local Liquidity Safety Net

One of the consequences of the worsening of the global crisis and the sudden reversal of capital flows in 2011 was the revival of the debate on safety nets—this time, in light of the limited advance within the G-20, with a view to broadening it by adding Argentina and Brazil as full members; and by revamping the Latin American Reserve Fund (FLAR), a small reserve pool set up by the Andean countries. Initiatives that bring together the interests of the region in the face of a common challenge are always welcome. But just how much can we expect from this one?

In principle, due to diversification benefits, a regional pool should reduce the required size of the (arguably costly) stock of international reserves needed to deal with recurrent flights to the dollar.[11] This is trivially true in theory, but the diversification gains may be very limited in practice, in the event of a crisis of the type on which these funds are usually predicated. The reason is obvious: In a synchronized systemic crisis, all member countries are likely to draw liquidity from the fund at the same time.

Indeed, judging from the dynamics of currency demand—and the related currency swaps between participating central banks in both advanced and selected emerging market economies—the menu of reserve currencies (i.e., those that are in demand during a financial sell-off) appeared to be restricted to the dollar and the yen—and, to a lesser degree, given its lack of convertibility, the renminbi. Ultimately, in the event of a global liquidity crunch, only these "issuers of last resort" (ILR)—namely, the issuers of reserve assets in demand during the crisis—could bear the systemic risk in good times without the need to pay the cost of carrying reserves.[12] A reloaded FLAR without access to these sources of systemic liquidity could do little to improve on the current situation whereby countries hoard reserves individually.

The Asian Chiang Mai Initiative (CMI) offers a useful perspective. Born out of the disappointment with the International Monetary Fund's involvement during the 1997-98 financial crises, the CMI expanded a network of small swap facilities within the ASEAN group with bilateral currency swaps between its members and South Korea, China and Japan (where the latter two worked as the local ILR). The system is now being replaced by a $120 billion reserve pool system against which the "weaker" countries would be able to borrow up to a specific multiple of their contribution (Table 2.2).[13] Clearly, within this arrangement the ILR contribute the lion's share of the pool and share token borrowing rights (for only a fraction of their contribution).

The CMI cannot be replicated in Latin America because the region lacks its ILR.[14] Note also that, unlike the CMI, the FLAR is highly leveraged: Aggregate borrowing rights far exceed aggregate contributions to the pool, which implies that the FLAR borrowing rights shown in table 2.2 could not be fulfilled in a systemic crisis. In this light, there are two relevant questions at the core of the debate about a Latin American safety net. First, to what extent are ILR willing and able to provide liquidity to the Latin American countries (either directly through a swap arrangement, or indirectly through a multilateral agency such as the International Monetary Fund)? At the moment, there is no indication that the U.S. Federal Reserve or the Bank of Japan is planning to extend liquidity assistance to the region. And possibly for political reasons, the partial delegation of this task to the IMF has been, judging from the very low demand for the IMF's facilities, not very successful.

Consequently, if liquidity from the center is not forthcoming, to what extent can a regional agency reduce the cost of carrying reserves by enhancing market access? Anecdotal evidence suggests that FLAR (as well as the Corporación Andina de Fomento, a regional development bank) is able to obtain better credit ratings and borrowing costs than the best of its member sovereigns. Borrowing by FLAR has thus far been extremely limited, so one cannot rule out that this ratings divergence may fade once the institution reaches leverage ratios comparable to those of its member countries. That said, regional multilaterals may benefit from the same preferred creditor status as the IMF. And strong peer pressure, coupled with the fiduciary nature of a reserve pool (i.e., the possibility that

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[11] Note, however, that the cost of reserves may have been overstated in the current debate, as we argued in our September 2010 *BLEP* report.

[12] Eduardo Fernández-Arias and Eduardo Levy Yeyati, *Global Financial Safety Nets: Where Do We Go from Here?* IDB Working Paper 231 (Washington: Inter-American Development Bank, 2010). Note the similarity with the central bank that can assist commercial banks with liquidity simply by printing money on demand.

[13] Borrowing was subject to the IMF supervision of the borrowing country, the reason why the CMI was not activated in the recent crisis. As a result, the role of the IMF is in the process of being relaxed.

[14] The European region also has a strong anchor in Germany, which allows it to recreate a regional IMF if it so chooses.

Table 2.2. The Latin American Reserve Fund (FLAR) vs. the Chiang Mai Initiative (CMI)

Country	Contribution	Multiplier	Borrowing Quota	GDP	Quota, % of GDP	IMF Delinked Quota	Quota, % of GDP
CMI							
Brunei	0.03	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	11.28	834.335	1.36	2.276	0.27
Japan	38.40	0.5	19.2	5,855.38	0.33	3.84	0.07
South Korea	19.20	1	19.2	1,163.85	1.65	3.84	0.33
Laos	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	23.875	2.13		
Colombia	0.39	2.5	0.98	321.46	0.30		
Costa Rica	0.20	2.5	0.49	40.024	1.22		
Ecuador	0.20	2.6	0.51	65.308	0.78		
Peru	0.39	2.5	0.98	168.459	0.58		
Uruguay	0.13	2.5	0.33	49.423	0.67		
Venezuela	0.39	2.5	0.98	309.837	0.32		
Total Contributions:	1.89	Total Borrowing:	4.77	Average	0.86		

Ratio of Borrowing to Contributions	
CMI	1.08
FLAR	2.52

Note: Contributions, quotas, and GDP figures are expressed in billions of dollars.
Sources: C. Sussangkarn, *The Chiang Mai Initiative Multilateralization: Origin, Development and Outlook*, ADBI Working Paper 230 (Tokyo: Asian Development Bank Institute, 2010), www.adbi.org/working-paper/2010/07/13/3938.chiang.mai.initiative.multilateralisation/; International Monetary Fund, *International Financial Statistics*; Fondo Latinoamercano de Reservas and 13th ASEAN+3 Finance Ministers' Meeting.

reserves are actually integrated into a trust that is automatically separated from individual central banks), could explain the decoupling of ratings and the lower borrowing costs—albeit at the expense of that for individual countries.

Perhaps in the understanding and exploitation of this feature lies the best chance to build a liquidity network to buffer the region from the global risk cycle.

Country Analyses

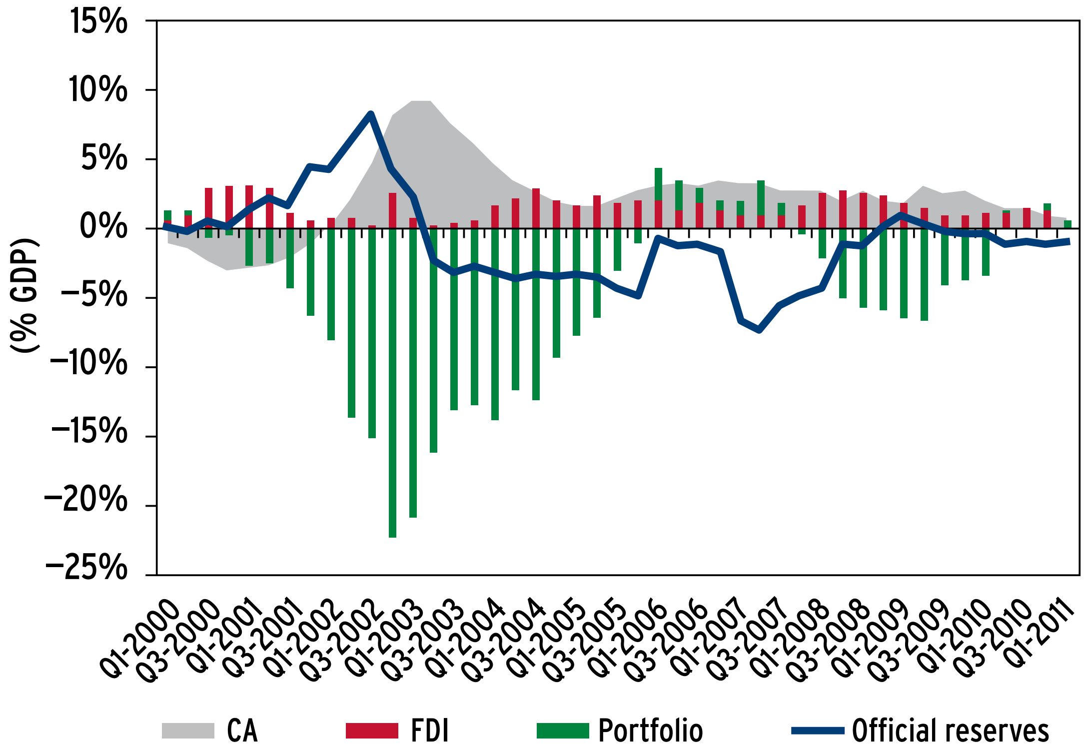
Argentina: The Exchange Rate Trap

In the first decade of the 2000s, Argentina followed an idiosyncratic balance of payments pattern: Dollars came from the current account (reflecting an early collapse of imports and, particularly, the boom in commodity exports) and left through the financial account (figure 3.1). Export dollars (which threatened to appreciate the peso beyond politically acceptable levels) went to build up international reserves. As a result, Argentina managed to keep a positive current account balance and an undervalued peso (at least relative to its neighbors).

Conversely, the indifference relative to the development of local markets—epitomized by the manipulation of the Consumer Price Index (CPI) to which most local bonds were linked at the time—along with the nationalization of private pension funds (which were the main holders of domestic assets) contributed to the historical Argentinean preference to save abroad. This in turn added to a well-rooted propensity to run for cover to the dollar at the slightest indication of uncertainty.

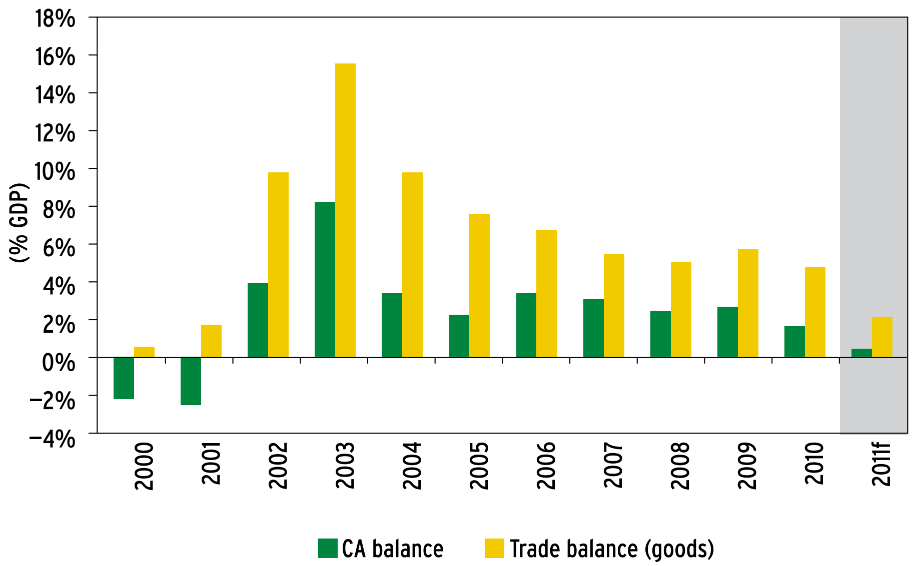
At a time when export dollars are starting to falter, due to growing imports fueled by excess demand and real appreciation (figure 3.2), savers have been turning to the dollar because they believe that, if the ongoing "neglect" of financial markets were to continue, current account dollars would no longer be sufficient to support real appreciation.

Figure 3.1. Argentina's Balance of Payments, 2000-2011



Note: CA = current account; FDI = foreign direct investment.
Source: Instituto Nacional de Estadística y Censos.

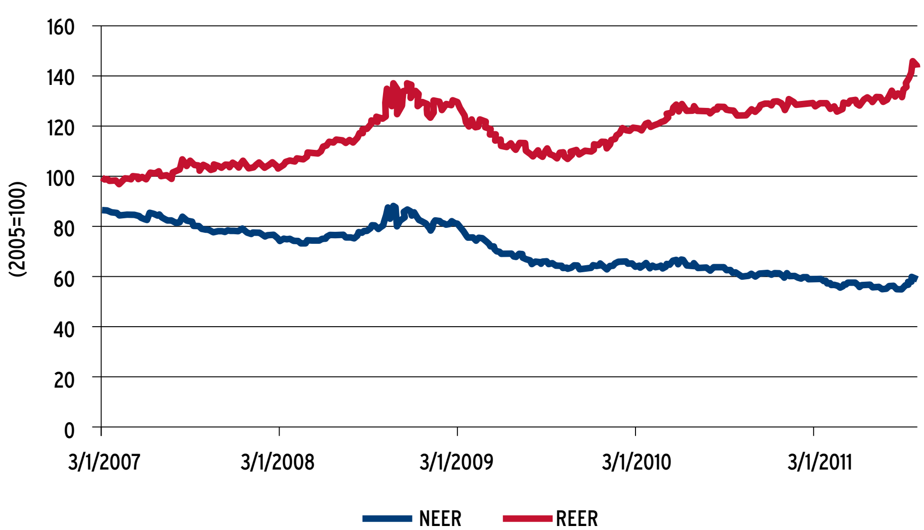
Figure 3.2. Argentina's Current Account and Trade Balances, 2000-2011



Note: CA = current account.
Source: Instituto Nacional de Estadística y Censos.

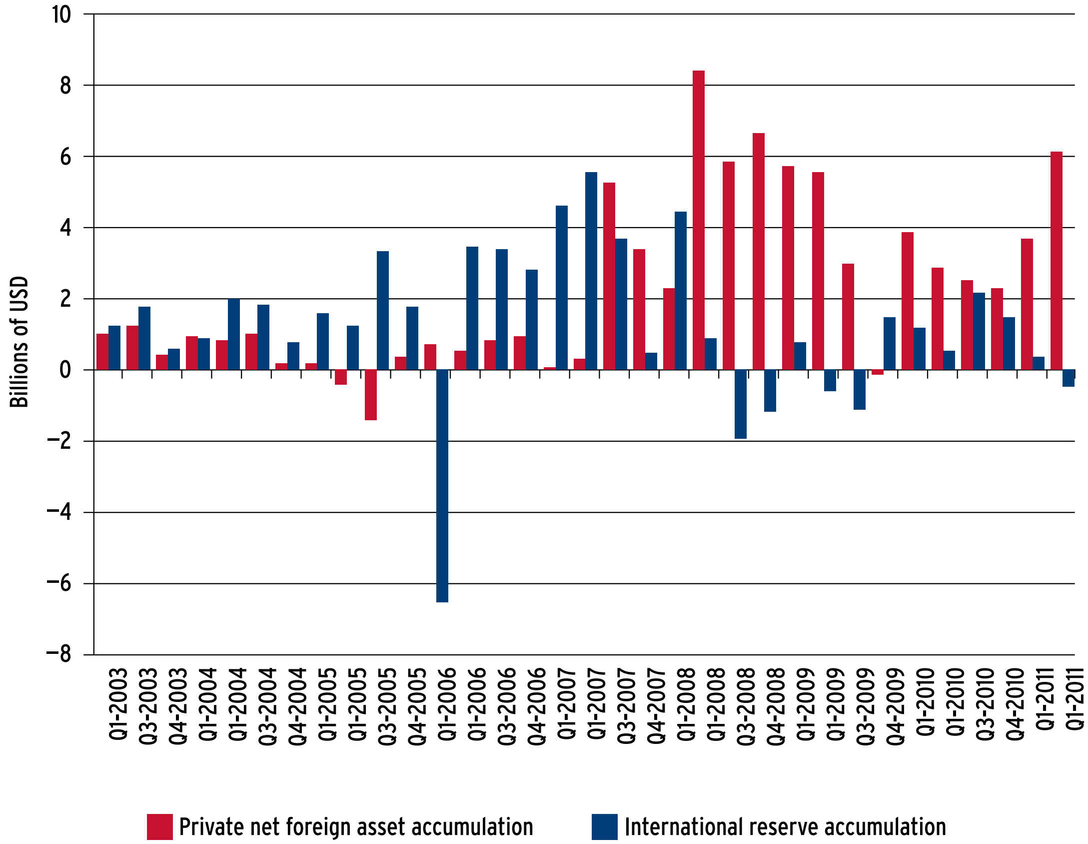
The recent relapses of the global turmoil and the associated dollar rebound certainly have not helped; on a multilateral basis, the peso has been appreciating *nominally* (figure 3.3). It was no surprise, then, that capital flight increased during the September jitters and that reserves declined accordingly (figure 3.4).

Figure 3.3. Argentina's Multilateral Effective Exchange Rates, 2007-2011



Note: NEER = nominal effective *exchange* rate; REER = real effective *exchange* rate.
Source: Brookings data. IMF. World Bank, *Global Economic Monitor*.

Figure 3.4. Argentina's Capital Flight and Central Bank Reserves, 2003-2011



Source: Central Bank, Argentina.

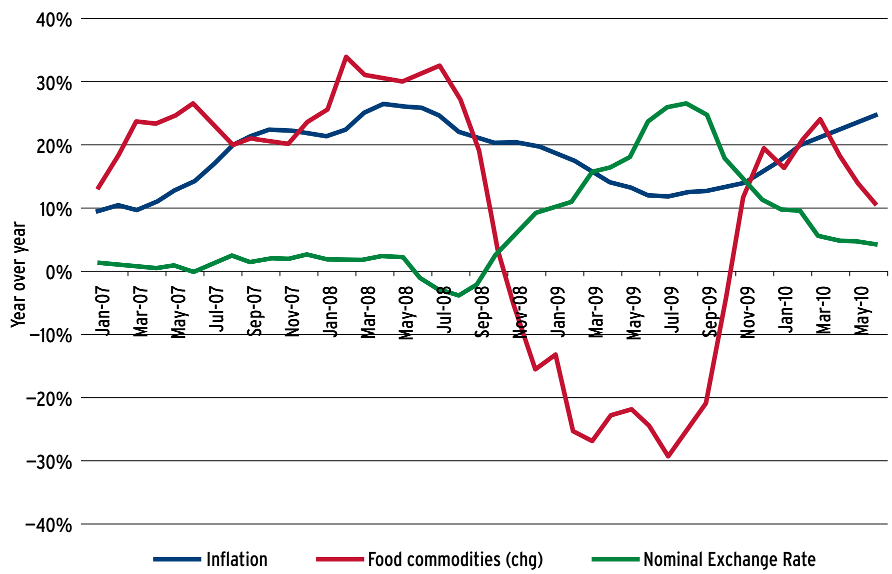
This illustrates a debatable but nonetheless relevant aspect of Argentina's exchange rate policy: The stronger the market pressure, the lower the flexibility allowed for the exchange rate. Thus, the countercyclical nature of a leaning-against-the-wind policy, (which reduces the currency's appreciation during the upturn to enable it to depreciate more comfortably in the downturn), is stretched to the point of becoming pro-cyclical: meaning that as a result of heavy intervention, the peso *appreciates* when economic activity weakens.

Fear of floating? Why?

What`s wrong with letting the exchange rate accommodate swings in the international value of the US dollar? For starters, given historical reasons, the peso value of the dollar is a politically charged issue. A rapid depreciation tends to signal (incorrectly, in my view) economic weakness and policy incompetence. Thus, whereas a 10 percent correction in a matter of days may be tolerable or even welcome in Brazil or Chile, in Argentina it may be construed as the preamble to the next currency crisis.

An additional reason is related to inflation, which in Argentina is rather high (in the mid 20s, according to non-doctored official numbers and most private estimates). With the economy at full employment in most quarters, some fear that the pass-through of a discrete depreciation may be much higher than in the first decade of the 2000s. This may have been so in previous years, but today—with the economy decelerating, commodities stabilizing, and the labor market looking increasingly soft—the reference point appears to be 2009, when the peso was allowed to adjust by as much as 27 percent and inflation actually declined (figure 3.5).

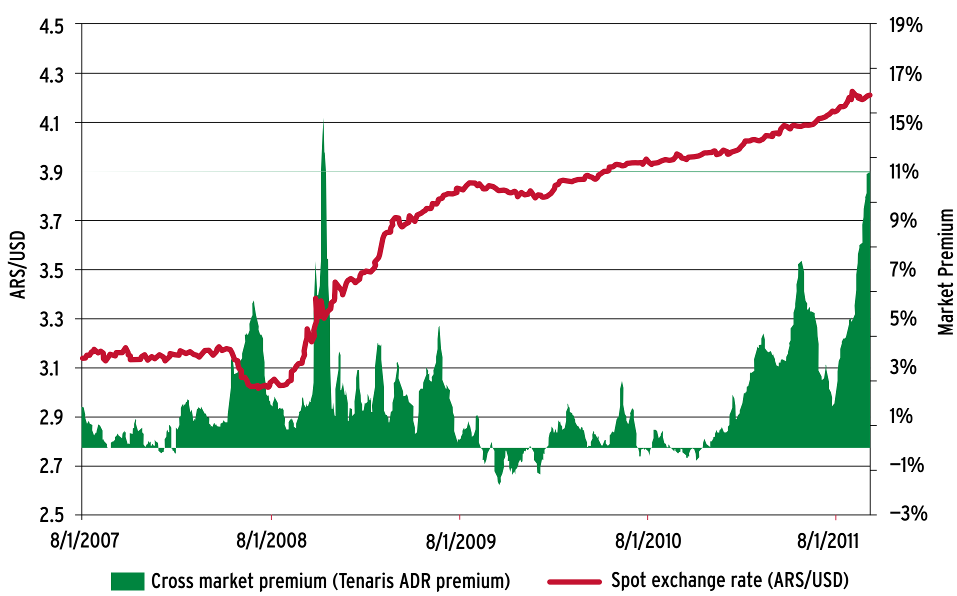
Figure 3.5. Argentina's 2009 Exchange Rate Correction: Commodities and Inflation



Sources: Instituto Nacional de Estadística y Censos and Economist Intelligence Unit.

Be it as it may, the response to exchange rate stress so far has been to tighten controls on imports through import surveillance measures (such as quid pro quo import licenses), as well as on dollar purchases and unreported outflows. At any rate, signs of market pressure have remained intense — even after Cristina Fernández de Kirchner`s landslide victory on October 23—keeping the cross-market premium and the parallel spread at record highs (figure 3.6).[15]

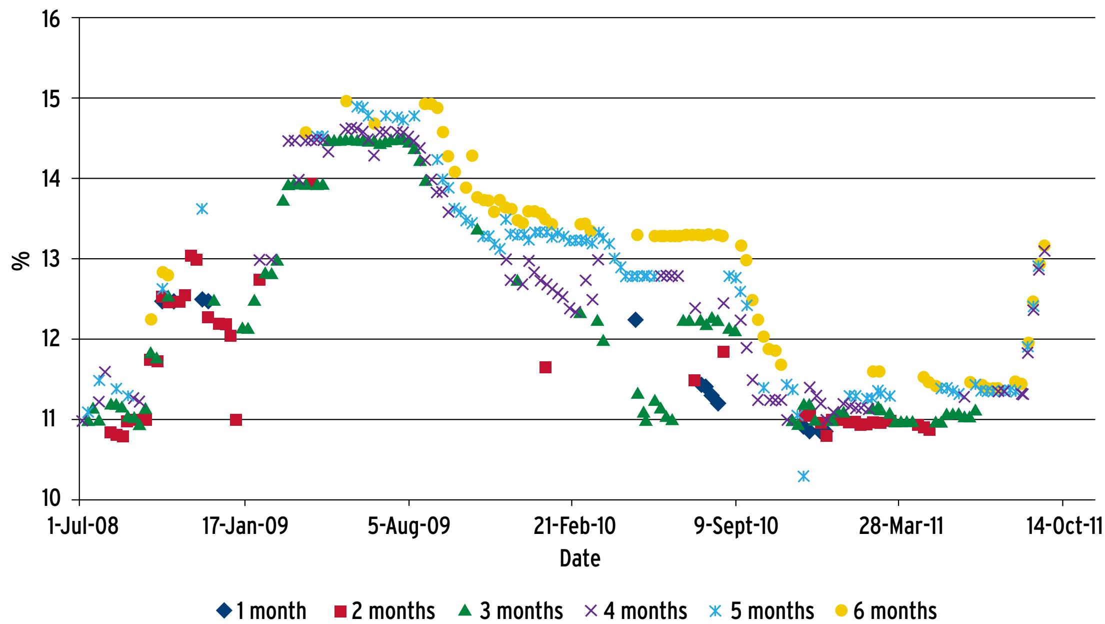
Figure 3.6. The Cross-Market Premium in Argentina, 2007–2011



Source: Central Bank of Argentina.

[15] The cross market premium is measured as the price difference between the same asset as traded in the domestic market and in a foreign market. While it is typically computed based on liquid stocks that trade both domestically and as American Depository Receipts in the NYSE, in the case of Argentina there are also several bonds (most notably, the USD Discount) that also trade in both markets and offer an alternative vehicle. See Eduardo Levy-Yeyati, "Do Capital Controls Work?" VoxEu.org, 2011, http://www.voxeu.org/index.php?q=node/6031.

Figure 3.7. Argentina's Central Bank Bills, Primary Auction Rates by Maturity, 2008-2011



Source: Central Bank of Argentina.

In addition, the dollar hoarding is starting to take its toll on the real economy through a decline in loanable funds that is already causing interest rates to rise (figure 3.7) and lending costs to increase, threatening to cool down a personal credit boom that has played a part in the strong performance of the durables sector—at a time when global headwinds (e.g., those captured by the Brookings Global Wind Index; see chapter 2) are starting to materialize.

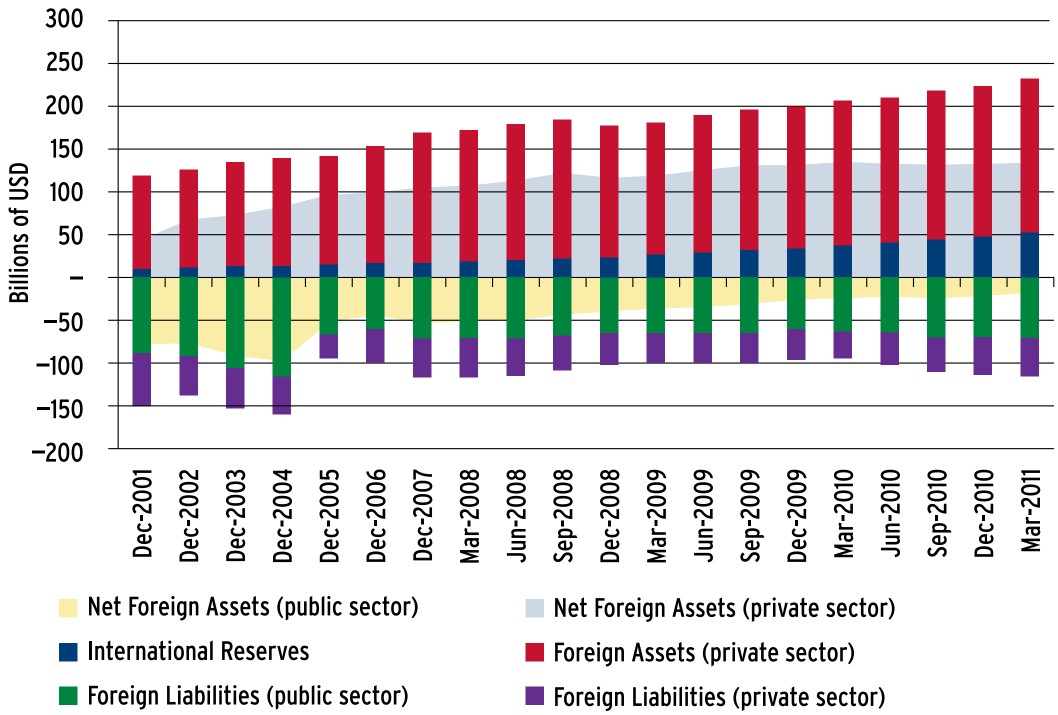
What to Expect? From Half Empty to Half Full

It is hard to forecast what the government's response will be because Argentina faces a critical crossroads. On the one hand, the government is close to its peak in terms of popular support and political capital. The election´s outcome was due in part to a macroeconomic strategy that fostered inflationary growth and distributed its dividends into corporate profits, strong employment and stable real wages, while enhancing fiscal resources to fund social protection and political transfers—keeping everybody happy.

Logically, this virtuous distributional arrangement becomes harder to sustain as the surpluses narrow. Fiscal resources (which were aided in the past by disguised pockets of fiscal savings and, more recently, by the appropriation of pension fund assets) are running thin. Additionally, private profitability is being put to the test by higher costs that cannot be passed through prices as before due to weaker demand. In addition, there is a correspondence between fiscal deterioration and inflation, because the item driving public spending above budget is precisely energy and transportation subsidies—the flipside of artificially depressed tariffs and transportation tickets.

Now that the export dollars are not enough, the debate within the government oscillates between a position that accepts and exploits the open nature of Argentina's economy, and another one that rejects it. The latter centers on the need to preserve a positive current account and to quell the flight to the dollar through the strengthening of current practices (e.g., extensive red tape barriers and financial sector audits). In that case, barring unpredicted improvements in the global context, one would expect the exchange rate pressure to continue to a point in which it may compromise economic activity, as savers postpone consumption to hoard dollars.

FIGURE 3.8. ARGENTINA'S NET FOREIGN ASSET POSITION, 2001–2011



Source: Instituto Nacional de Estadística y Censos.

However, the above-noted neglect of financial markets (reflected in very limited public debt rollover and financial inflows, coupled with a sustained private accumulation of assets abroad) not only reduced debt ratios dramatically but also increased the country's net foreign asset position (figure 3.8).[16] In other words, Argentineans own a considerable stock of foreign-denominated assets abroad, a large share of which is held in low-yielding high-grade paper. Indeed, according to official estimates of foreign asset and liability holdings, the country as a whole appears to have been a net international creditor since its 2005 debt exchange.[17]

Thus, unlike in emerging economies with a current account deficit like Brazil (or, more notably, Turkey), the exchange rate adjustment needed to stop Argentina's reserve hemorrhage may prove to be minor, provided a depreciated peso stops the speculative flight of capital and, ideally, lures offshore savings back home.

An attempt at price stabilization (through the undoing of the intervention of the Instituto Nacional de Estadística y Censos, the end of CPI manipulation and a proper monetary program) can help on that front as it slows down the real appreciation of the peso, softening depreciation expectations. Other elements of an often-discussed but never-implemented menu look less likely: A consultation under the International Monetary Fund's Article IV still would look like political anathema, and a

[16] The decline in Argentine debt ratios was additionally aided by the effect of the real appreciation on dollarized debt, and by the underreporting of inflation that diluted inflation-linked bonds.

[17] Two caveats are in order for this computation. First, the actual nationality of the ultimate bondholders is in most cases impossible to identify, although this drawback also applies to similar estimates by Philip R. Lane and Gian Maria Milesi-Ferretti, and the World Bank's Global Development Finance Database. The second caveat relates to Paris Club arrears and remaining defaulted bonds, but adding the former and pricing the latter at market value would still leave the country with the positive net foreign asset position in recent years. See Philip R. Lane and Gian Maria Milesi-Ferretti's "The External Wealth of Nations",; and World Bank, Global Development Finance Database, http://data.worldbank.org/data-catalog/global-development-finance.

restructuring of the Paris Club debt without the IMF's signature would entail front-loaded payments at odds with the current dollar shortage.

But the key to a smooth adjustment is ultimately simpler: the use of exchange rate flexibility. A faster depreciation that brings the multilateral exchange rate back to where it was at the beginning of the year should diffuse devaluation expectations and speculative demand for the dollar. In addition, it will protect more efficiently import-substituting labor–intensive sectors that appear more vulnerable to an economic downturn. Finally, the depreciation's positive wealth effect on dollar asset holders should buttress the real estate and durables sectors in surfing the downward cycle, just as it did, to a much larger degree, after the 2002 devaluation.[18]

For a number of reasons, then, financial integration and exchange rate flexibility in Argentina may give the government the policy space it needs to deal with growing domestic constraints, particularly in the event of a protracted global slowdown. More than any time in the past decade, the final outcome will depend on the right policy choices.

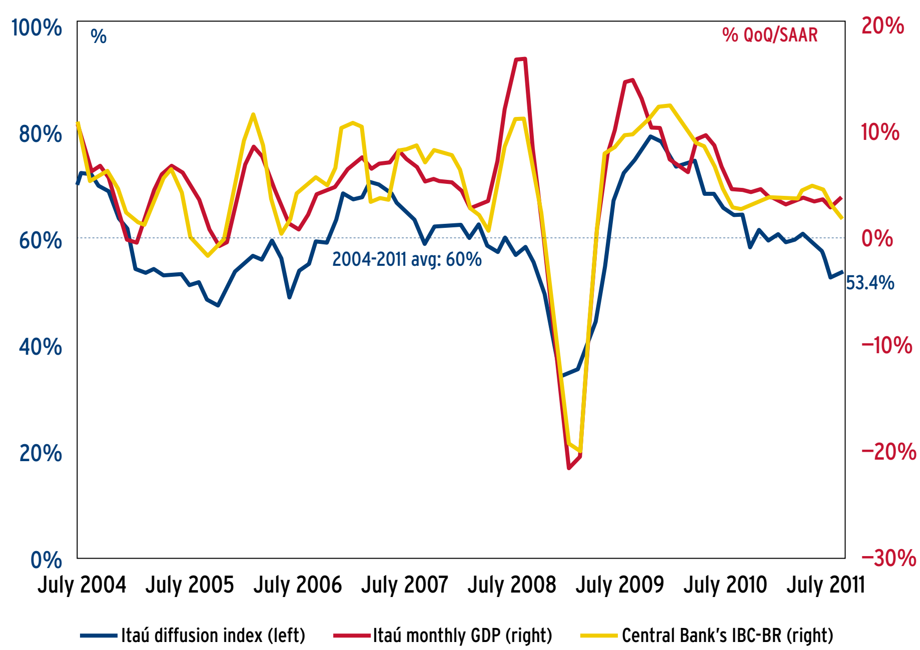
Brazil: Acting Before the Rain

The Economy Loses Steam, but Inflation Is Still an Issue

Even before the impact of worsening global conditions, the signs of softening in the Brazilian economy were already evident. After a strong rebound in 2010, the country's economy decelerated because of tighter monetary policy (through both interest rate hikes and macroprudential measures targeting consumer loans) and a more neutral fiscal policy (through slower growth in expenditures and a higher primary fiscal balance).

The loss of momentum in broad activity is reflected in high-frequency indicators, such as Banco Itaú's diffusion index—measuring the share of variables in a comprehensive activity data set pointing to expansion—and monthly GDP proxies , such as Itaú's monthly GDP index and the Central Bank's IBC-Br Index (figure 3.9).

Figure 3.9. Brazil's Diffusion Index and Monthly GDP Proxies Point to a Softening, 2004-2011



Sources: Brazilian Central Bank and Banco Itaú.

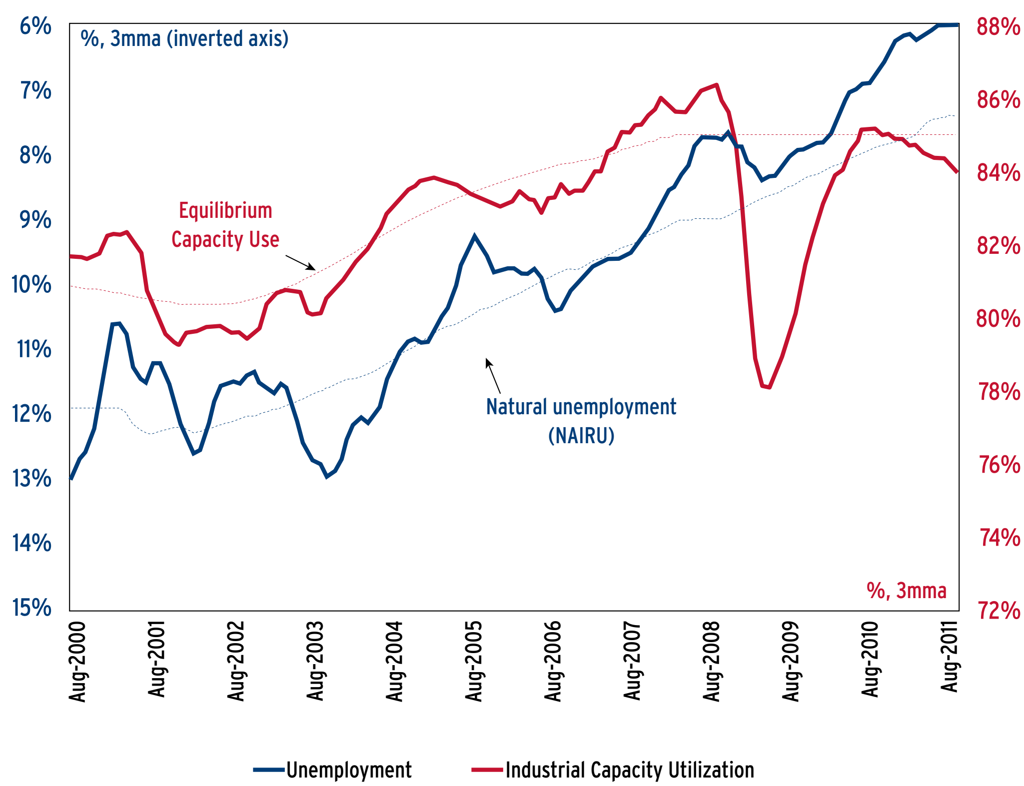
[18] Eduardo Levy-Yeyati, "How Argentina Left Its Eurozone," VoxEu.org, 2011, http://www.voxeu.org/index.php?q=node/7055.

The six-month average of the diffusion index, which correlates closely with GDP trends, slid to 53.4 percent in July, short of the 2004–10 mean (i.e., 60 percent) and last year's average (i.e., 66.0 percent). In the same period, Itaú's monthly GDP index eased to a quarterly annualized rate of 3.7 percent (from 6.0 percent during 2010), and the Central Bank's IBC-Br Index posted the lowest annualized growth in more than two years, 1.7 percent. Given the residual impact of the policy tightening, the deterioration in global financial conditions and the possible loss of consumer and business confidence, the economy looks poised to move no faster than the current annual speed of nearly 3.5 percent.

The moderate deceleration in Brazil's GDP growth hides important changes in its composition. Though local manufacturers face strong headwinds due to weak orders from abroad, stiffening import competition, a strong currency and tight local credit, the service and retail sectors are still expanding at a relatively robust pace, powered by a solid job market. Resource utilization reflects this dichotomy, with overheating in sectors that are more exposed to domestic spending and cooling in sectors that are more reliant on foreign demand. One can contrast the unemployment rate, a measure of labor market slackening, with capacity utilization, a measure of industrial slackening (figure 3.10).

The economic asymmetry is clear. Joblessness moved about 6.0 percent in July, short of our estimate for the non-accelerating inflation rate of unemployment (7.5 percent), while capacity utilization stood near 84 percent in August, below the level we calculate to be the long-term equilibrium rate (85 percent). Thus, the underlying activity data are consistent with the large, persistent inflation pressures seen in the non-tradable sectors. These pressures could intensify, or at least fail to dissipate, if job creation does not slow sufficiently to bring unemployment back to equilibrium.

Figure 3.10. Brazil's Output Gap Proxy: Overheating in a Two-Speed Economy, 2000–2011



Sources: IBGE, FGV, and Banco Itaú.

This could happen, for instance, if firms decide to hoard labor, bearing in mind the recent shortages of human capital.

The global downturn could further slow the local economy. Econometric models suggest that the activity weakness abroad (not yet factoring in further financial distress, which could be caused, for instance, by a disorderly debt restructuring in Europe) could drive Brazil's GDP growth down by nearly a percentage point, to just below 3 percent. Countercyclical monetary policy could prevent this from happening.

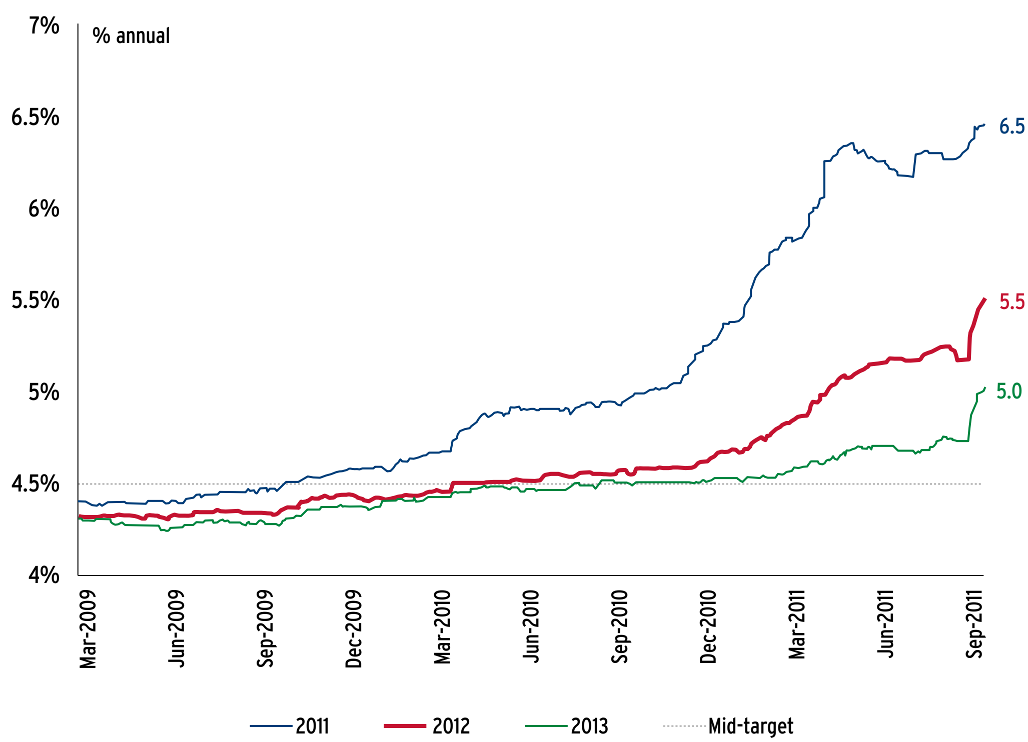
In the meantime, inflation is still an issue. A Central Bank survey points to another bout of upside revision in inflation forecasts, with inflation expectations exceeding the 4.5 percent center target. The rise is now spilling over into longer horizons. Early in September, the average of projections of the Índice Nacional de Preços ao Consumidor Amplo (National CPI) reached 5.5 percent for 2012. And despite the usual inertia in expectation surveys for longer time windows, mean forecasts stood at 5.0 percent for 2013 (figure 3.11).

This upward trend in inflation estimates could further worsen the trade-off for monetary policy (with any activity level now associated with higher inflation). In the best of situations, it leaves policymaking dependent on the actual realization of projected negative shocks that could potentially affect the economy and the other inflation drivers (e.g., raw material prices).

The outlook for commodity prices also contributes to a more challenging outlook for inflation. Even amid a global slowdown, binding supply constraints and persistently solid emerging market demand could keep commodity prices at historical highs.

A good deal of inertia (e.g., stemming from a slow-moving, overheated service sector) is still expected to weigh on 2012, limiting the downside risks for

Figure 3.11. Brazil's Inflation Expectations on the Rise, 2009-11



Sources: Brazilian Central Bank and Banco Itaú.

inflation. Barring a slump in commodity prices caused by a financial meltdown (just as in 2008), the outlook suggests that consumer inflation is doomed to stay in the upper range of the tolerance band for some time to come.

A New Policy Mix to Face the Crisis?

For quite a while, the Brazilian economy has lived with an asymmetric policy mix: on the fiscal side, fast (nearly double-digit) real government spending growth; and on the monetary side, a high real interest rate. This combination has kept inflation from rising and the economy growing at its potential rate. But high interest rates (and also appreciated currency levels) have generated all sorts of unwanted consequences (e.g., limited long-term market-driven financing), which require fixing.

Renewed intentions to change the policy mix are back. The recent decision by the Brazilian Central Bank (BCB) to reduce the Selic rate by 50 basis points (to 12.0 percent) reflects the government's strategy of taking advantage of a (potential) global slowdown to try to engineer a faster convergence in Brazilian interest rates to levels consistent with other emerging markets.

The BCB surprised the markets with its timing, which was earlier than expected. The rationale for the decision, which was explained in the BCB's minutes and communications, is supported by newly announced fiscal measures—intentions, more precisely—and worsening global activity. According to the BCB, a combination of these two effects would cause inflation to fall below the middle target.

By undertaking this early move, the BCB became a pioneer (in the emerging market world) in using rate cuts as a relevant response to a deteriorating global outlook. This contrasts with the strategy adopted in 2008, when the monetary authority waited for more concrete evidence of the crisis impact before acting (the BCB was raising interest rates before the Lehman collapse).

The BCB will likely continue to reduce interest rates (at a pace of 50 basis points per meeting), bringing the Selic rate to 10.0 percent. That would take the ex post real interest rate down to 4.3 percent. In fact, if the stage is adequately set (especially with an austere fiscal policy), Brazil could follow other emerging markets that took advantage of an adverse global cycle to normalize interest rates.

Naturally, there are risks associated with this objective (and strategy); inflation expectations could continue to rise, the global slowdown might be less destructive than foreseen, and political headwinds could make fiscal policy more expansionary than anticipated. In all these cases, the risk of an inflationary spike could well materialize. Only time will tell.

Fiscal policy will play a key role in determining if the lower Selic level tested by policymakers will be more transitory or permanent. If permanent, then more forceful actions need to be taken. In the meantime, the most tangible fiscal commitment was a decision to increase the 2011 primary fiscal balance target to 3.15 percent of GDP (from 2.90 percent). In practice, this increase implied a decision to save rather than spend the large flow of extraordinary revenues coming in this year.

So far, news about the 2012 budget does not quite ensure that the fiscal target will be achieved in full (3.10 percent of GDP), as assumed by the BCB. The first draft of the budget law, submitted to Congress by the executive branch, projects a primary fiscal balance of just 2.5 percent of GDP. The budget proposal implies a hefty pickup in inflation-adjusted spending (to 9.1 percent, up from the 3.5 percent expected for 2011), with government transfers poised to accelerate following a higher minimum wage readjustment (14 percent, in nominal terms). FDI is also likely to pick up, amid a need (and will) to improve infrastructure.

There are further chapters in the 2012 budget discussions. At the end of the day, last-minute adjustments could eventually be made when the executive branch announces the amount of budget outlays that will be frozen (via the so-called *contingenciamento* decree). Given that a tighter fiscal stance, understood by the authorities as hitting the primary surplus target in full for the coming years, is a key assumption behind the BCB's improving inflation outlook, then fiscal disappointment is a risk to bear in mind. This disappointment could also materialize if fiscal results improve more on the heels of extraordinary revenues than on slower spending growth.

In sum, Brazil has a welcome opportunity for a change in its economic policy mix. But at the same time, its challenging fiscal and inflation outlook could create implementation risks.

Colombia: Strong Macroeconomic Fundamentals Amid Structural Challenges

During the 2008–9 global financial crisis, the Colombian economy exhibited great resilience and a strong ability to withstand external shocks, a consequence of the sharp improvement in its macroeconomic fundamentals during the last decade. This process started in 2000 and has resulted in less public debt, which decreased from 48 percent of GDP in 2002 to 38 percent in 2010; reduced exposure to currency risk, with foreign public debt declining from 55 percent of total public debt in 2000 to 37 percent in 2010; a smaller financial burden for households, as reflected in the reduction of debt service as a proportion of wages from 28 percent in 1998 to 14.6 percent in 2010; and a profitable and well-capitalized banking sector, with a return on equity of 15.6 percent and a solvency margin of 15 percent in 2010. In addition, monetary policy has been credibly undertaken under an information technology framework with significant exchange rate flexibility; as a result, inflation and inflation expectations are quite stable and near the midpoint of the target range of 2–4 percent set by the Central Bank.

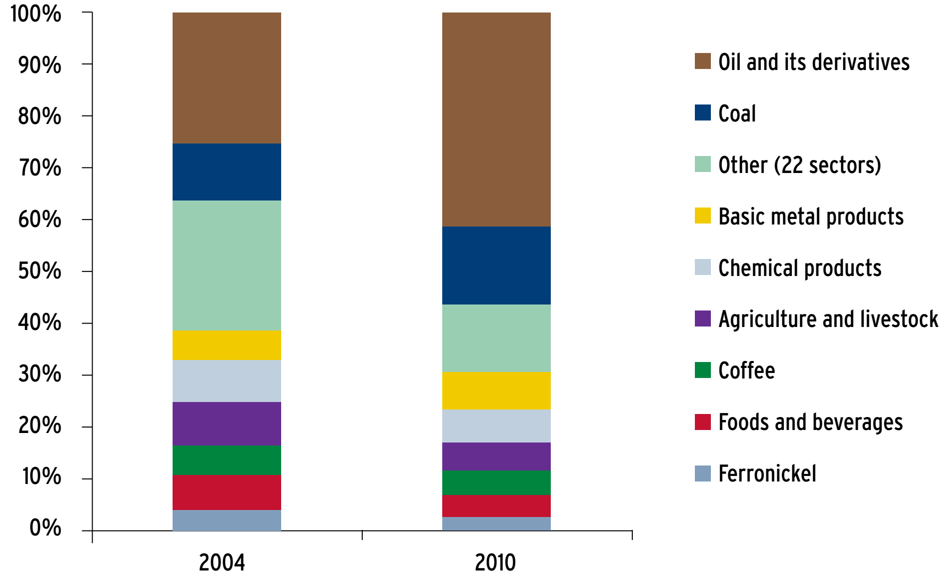
This notable resilience to financial turbulence allowed the economy to expand by 1.5 percent in 2009 and 4.3 percent in 2010, with FDI in 2010 reaching $9.13 billion (or 2.1 percent of GDP, an increase of 41 percent compared with 2007). Recognizing these strong fundamentals, all rating agencies have awarded Colombian bonds investment grade, starting with Standard & Poor's on March 16, 2011.

These impressive results at the macroeconomic level should not make us lose sight of several important weaknesses in Colombia's economy, which can be grouped into four categories: (1) the sectoral composition of its output; (2) the extremely weak prospects of its major trading partners; (3) its remarkably poor transportation infrastructure, which threatens its ability to compete in the global economy; and (4) its very expensive and rather ineffective social policy.

First, Colombia's sectoral composition of output, and particularly of exports, has changed quite significantly in the recent past. In 2004, exports of petroleum and its derivatives accounted for 25 percent of total exports; that proportion reached 41 percent in 2010. Something similar happens with coal, whose share of exports went from 11 percent in 2004 to 15 percent in 2010 (see figure 3.12). These developments and trends pose major macroeconomic and institutional challenges for the country in avoiding a "natural resource curse." To that effect, the government that was inaugurated in August 2010 was able to pass important legislation through Congress on the fiscal front, in particular the adoption of a fiscal rule with numerical targets and a comprehensive reform of the laws governing royalties.

Second, Colombia trades mainly with low-growth countries and very little with more dynamic ones. Its main trading partners are the United States and the European Union, to which it sent, respectively, 39 percent and 14 percent of its total exports between January and July 2011, while its exports to China accounted for less than 5 percent of total exports (figure 3.13). Although quite late in comparison with other countries in the region, Colombia is now eagerly looking forward to expanding its trade with Asia, and there are significant expectations with regards to a very advanced free trade

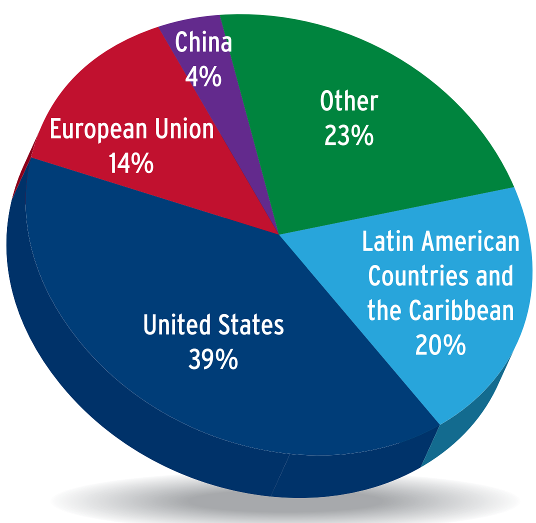
Figure 3.12. Colombia's Exports by Economic Sector, 2004 and 2010



Source: Departamento Administrativo Nacional de Estadística (DANE).

agreement with South Korea. In addition to these agreements, some tariffs have been unilaterally reduced, but at 8.2 percent the average tariff rate remains high, with particularly strong protection for agriculture. Colombia is maybe the only large country in the region that during the last decade has experienced a rate of growth of agriculture that is not even half that of the economy as a whole.

Figure 3.13. Colombia's Exports by Destination, January–July 2011

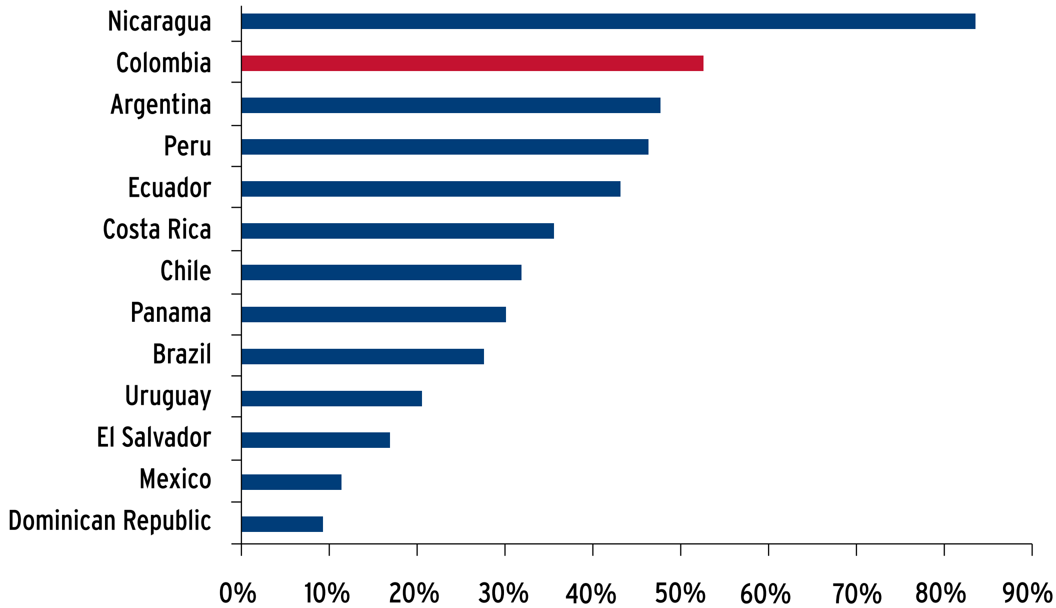


Source: DANE.

Third, even if Colombia manages to mitigate its "Dutch disease" problems and opts for a more open trade policy in general, and with Asia in particular, its poor transportation infrastructure will continue to act as a constraint on manufacturing and agricultural exports and as a natural protection to import-competing local production. According to the 2011–12 *Global Competitiveness Report*, Colombia was ranked 95 among 142 countries, with an overall rating of its transport infrastructure of 3.6 over 7. The quality of its roads gets a score of 2.9, port infrastructure 3.4 and railways 1.7, ranking 108th, 109th, and 99th, respectively. The challenges the country faces in this field are enormous, including a much-needed, but politically charged, reform of the laws governing the concessions mechanism in order to ensure that the private sector participates in the provision of infrastructure according to the best practices of efficiency, timeliness and transparency.

And fourth, Colombia exhibits the highest unemployment rate among major countries in the region and one of the highest rates of labor informality. These rates are partly the result of the fact that it has the second-highest minimum wage in

Figure 3.14. Colombia's Minimum Wage as a Percentage of GDP per Capita, 2010



Source: Santa Maria et al. (2010).

the region (as a percentage of per capita GDP; see figure 3.14) and very high payroll taxes (between 50 and 60 percent of wages) that fund various social security programs. High unemployment and informality, which are problems in and of themselves, also threaten the sustainability of the pension and health systems.

Regarding pensions, very few people above retirement age receive these, and less than half the economically active population regularly contributes to the system. To make matters worse, the public pay-as-you-go system costs the government's budget about 4 percent of GDP, with 97 percent of these resources benefiting people in the two highest quintiles of the income distribution. With regard to health, 97 percent of Colombians have health insurance; unfortunately, there are more people in the subsidized health care system (58 percent of the insured) than in the contributory system. This, coupled with several decisions of the Constitutional Court regarding benefit plans, determine major fiscal risks in the medium and long terms, and the government has not hinted at having a clear view as to how to deal with these issues.

Fedesarrollo's projections show a good growth prospect for 2011 and 2012. Notwithstanding financial turbulence in developed countries, the Colombian economy could expand 5 percent this year and 4.7 percent in 2012. However, unemployment will almost certainly remain high, at about 10.2 percent in 2012. Inflation is expected to hover at about 3 percent, with an external current account deficit of between 2 and 3 percent of GDP, which could be comfortably financed with strong FDI inflows.

Mexico's Early Slowdown

During the first half of 2011 the Mexican economy continued growing at a rate above the projected potential and was assisted by increased exports and an accelerating domestic demand. In this context employment grew and the unemployment rate remained relatively constant. This blissful scenario, however, came to a sudden stop when the outlook for the world economy during the summer of 2011 dramatically changed. As the world's developed economies faced fears of another recession due to unresolved fiscal and financial issues, significant concerns emerged regarding the sustainability of their fiscal habits and the vulnerability of their financial systems.

The change in the international environment significantly affected expected growth rates in Mexico for the rest of 2011 and 2012, and caused the Mexican economy to operate below its potential resulting in a maintained declining trend in inflation rates and financing conditions that were supportive of the growth process. Simultaneously, risk aversion in financial markets reached Mexico causing a depreciation of the currency and a drop in asset prices. Such unexpected slowdown came at a very unfortunate time as Mexico prepares for the 2012 general elections. The eventual change in government will generate a period which, aside from a short term pre-election aggregate demand impulse, a slowdown of the economy and political considerations cloud policy making.

The First Half of 2011: A Nice Ride

In the first two quarters of 2011 export-led growth continued boosting the Mexican economy as GDP grew by an average quarterly annualized rate of 3.5 percent, exports by 11.2 percent and industrial production by 4.1 percent (manufacturing by 6.2 percent). During this period, domestic demand accelerated, and private investment and consumption also continued healthy expansion. It is also important to highlight that during this period government demand, both in consumption and investment, had a negative effect on growth as well as in the primary sector. Therefore, it is fair to say that during the first half of 2011, underlying growth showed a very healthy behavior even with external scenarios that caused negative transitory factors including the Japanese tsunami and the increased price of oil. During the first six months of 2011, employment kept growing smoothly and the unemployment rate remained flat.

On the monetary side, both core and general inflation continued to decline due to a negative output gap and some help from the non-core components of inflation. General and core inflation fell from 4.40 and 3.58 percent y/y in December 2010, to 3.28 and 3.18 percent in June 2011, and to 3.14 and 3.12 percent on September 2011. It is important to emphasize that core inflationexcluding tortilla, corn and tobaccoreached an annual rate of 2.7 percent in June 2011, and the nonfood core inflation index reached almost 2 percent that same month. Financial markets reacted to international developments with relative stability in the FX market and external volatility being reflected on the yield curve, as the central bank continued building its international reserves war chest and kept its monetary policy stance constant. Throughout this period, financial analysts expected an eventual increase in interest rates by the end of the year or the beginning of 2012.

Table 3.1 Mexico's Aggregate Supply and Demand, 2008-2011
(% QoQ annualized; SA; GDP 2003=100)

	2008				2009				2010				2011	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP (MdP03=100)	3.1	-1.8	0.0	-5.8	-24.1	-0.6	11.7	8.2	1.7	7.6	3.0	4.7	2.4	4.5
Imports	1.4	9.1	6.9	39.9	-47.3	-17.1	49.9	31.5	33.3	20.3	10.5	5.5	6.6	5.3
Supply=Demand	**2.6**	**0.9**	**1.7**	**15.8**	**-30.2**	**-4.5**	**19.2**	**13.2**	**8.7**	**10.7**	**4.9**	**4.9**	**3.5**	**4.7**
Consumption	5.0	2.5	-4.9	-5.1	-19.7	-6.6	17.4	3.6	1.7	5.3	5.7	3.7	3.0	1.7
Private	6.9	2.2	-5.7	-6.7	-23.9	-6.5	19.3	4.0	1.4	4.6	7.5	4.5	3.3	3.0
Public	-6.4	5.0	0.6	5.7	11.8	-7.3	6.8	1.6	4.1	9.5	-4.5	-0.6	1.2	-6.5
Investment	2.8	6.6	1.8	-13.9	-22.9	-14.4	-2.3	-6.0	15.1	2.2	4.0	7.0	7.3	16.7
Private	-6.7	6.1	-9.1	-23.4	-26.8	-17.8	-5.8	-5.4	15.5	4.9	11.6	0.4	49.5	11.2
Public	50.9	8.5	51.8	23.8	-10.7	-4.2	7.7	-7.6	14.1	-4.7	-14.5	27.8	-62.7	39.4
Exports	-4.7	11.3	-2.2	-33.5	-39.3	-6.2	31.4	48.9	31.9	27.4	7.1	3.8	19.4	3.1

Source: INEGI

Table 3.2 Mexico's Price Indexes (% YoY), 2008-2011

	Dec-08	Dec-09	Dec-10	Q1-2011			Q2-2011			Q3-2011		
				Jan-11	Feb-11	Mar-11	Apr-11	May-11	Jun-11	Jul-11	Aug-11	Sep-11
CPI	6.53	3.57	4.4	3.78	3.57	3.04	3.36	3.25	3.28	3.55	3.42	3.14
Core	5.54	4.16	3.58	3.27	3.26	3.21	3.18	3.12	3.18	3.19	3.22	3.12
Merchandises	6.5	5.57	3.82	3.6	3.71	3.97	4.07	4.12	4.36	4.49	4.49	4.42
Services	4.72	2.94	3.36	3	2.89	2.57	2.44	2.3	2.19	2.1	2.1	2.03
Non-Core	9.8	1.72	7.09	5.39	4.53	2.46	3.9	3.45	3.34	4.51	4.51	2.98
Non Food Core	4.29	3.63	3.31	2.85	2.74	2.41	2.22	2.05	1.92	1.83	1.83	1.7
Corn & Tabacoo (C&T)	8.89	7.49	7.27	11.45	12.94	15.79	16.71	17.08	17.89	18.48	18.48	19.49
Trimmed CPI (exc. C&T)	6.48	3.49	4.34	3.6	3.35	2.75	3.05	2.92	2.93	3.2	3.2	2.76
Trimmed Core (exc. C&T)	5.44	4.06	3.47	3.03	2.97	2.83	2.76	2.69	2.73	2.73	2.74	2.62

Source: INEGI

In summary, the first half of 2011 was a continuation of the previous three quarters with GDP growth being supported by exports and by domestic demand, and a very favorable inflation and financial market environment. However, as the summer progressed, financial markets started to focus on the underlying vulnerabilities of the world economy: vulnerable public finances in most of the developed world, weak financial systems, rigid exchange rate regimes and a protracted deleveraging process that still had a long way to go.

Changing Winds: The Summer of 2011

Three important factors shaped the expected economic scenario for the second half of 2011.

- A negative forecast for the U.S. economy combined with the anticipated end of the fiscal stimulus package triggered a decreased expected GDP and industrial production growth rate in the United States.
- Intensified financial and fiscal problems in the eurozone caused by the financial community's realization of the lack of political will to resolve the sovereign debt crisis.
- The lack of consensus in the U.S. to address its long term fiscal situation.

When the expected growth rate in the U.S. for 2012 went from 3.1 to 2.1 percent, and the probability of a recession taking place in the next 12 months increased from 0.9 to 23.6 percent,[19] Mexico's expected GDP growth mimicked the U.S. growth projections and negative readings on the export and manufacturing front occurred. During the month of August in particular, exports and manufacturing production fell by (-)3.2 percent m/m (exports excluding oil fell by -5.1 percent m/m, SA) and (-)1.5 percent m/m. As growth projections for the world economy were revised and financial volatility around the world caused investors to flee to stable currencies, the Mexican peso depreciated and interest rates increased. Under this environment, the Central Bank quickly signaled its intention to indefinitely postpone its interest rate hike and introduced a downward bias in the policy rate. The exchange rate depreciation weakened the policy stance automatically, causing the central bank to face a dilemma as markets normalized and the exchange rate returned to less depreciated levels. These economic conditions will allow for a lower interest rate, however, such a move could affect

[19] Source: *Center for Research on Economic and Financial Cycles* for January 2011 and July 2011.

the expectation formation process and lose the opportunity to finally anchor inflation expectations around 3 percent, the government's elusive long term inflation target. Currently, the forecast for GDP growth in 2011 and 2012 stands at 3.9 percent and 3.3 percent, and expected inflation for the same years at 3.4 percent and 3.6 percent.[20]

The bad news is that this slowdown came much sooner than expected and at the beginning of election season. In this scenario it is almost impossible to expect significant structural changes that could accelerate productivity and investment. The paralysis that traditionally accompanies the change in government will extend the current slowdown for at least 24 months. During this period, Mexico will grow at a quarterly annualized rate between 2.4 and 3.2 percent, with a significant downward bias associated with a worse scenario looming over the U.S. economy. The good news is that the newly elected government will inherit a healthy economy with many margins that it can use to jump-start growth with a comprehensive reform package that opens key sectors and promotes a significant increase in investment, productivity and employment. More importantly, and as a positive outcome, it is likely that the slowdown might become the catalyst that is needed for the frequently discussed, but never implementedreform agenda to be adopted.

Peru: New President; Same Economic Strengths and Political Inconsistencies

After an unusual and highly competitive electoral process, Ollanta Humala, an extreme leftist candidate who moved toward the center, won the presidential elections and took office on July 28. Thus far, as president, he has ratified his centrist position and is trying to follow the Revised Government Plan Guidelines signed during the campaign. But his intentions of keeping everyone happy, from his leftist party members to the center-right people who supported him during the last stage of the campaign, have so far driven him to make decisions that are giving confusing signals to economic agents.

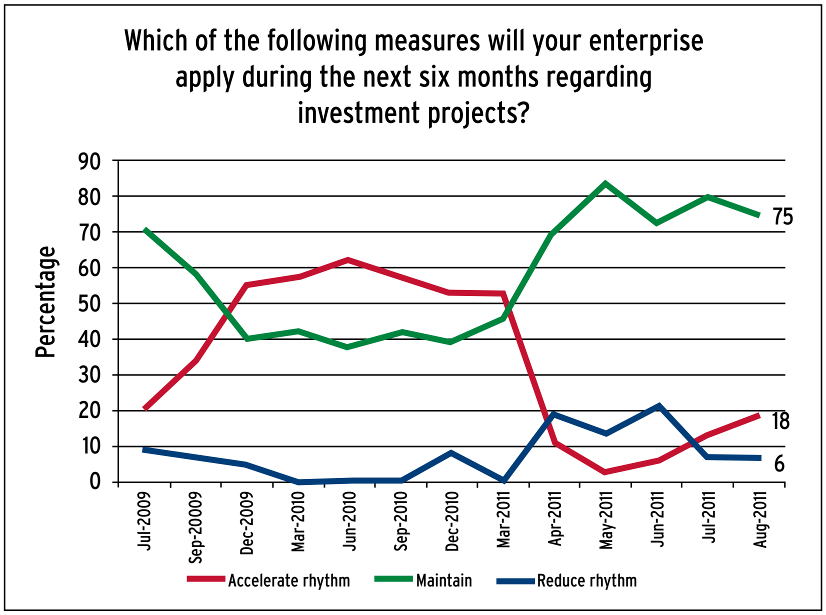
On one hand, President Humala announced that the president of the Central Bank, Julio Velarde, would be kept in office, and Humala named the former deputy minister of finance, Luis Miguel Castilla as minister of economy and finance. Both appointments were well received by the market as an interpretation that prudent fiscal and monetary policies—which have characterized the Peruvian economy during the last 20 years—would continue. This was reinforced by the country's risk rating upgrade from Standard & Poor's, giving Peru a BBB bond rating. However, economic agents' expectations remain depressed. Since June there has been a slow recovery, but expectations remain significantly low compared with March of this year or, at the worst, with June last year (figure 3.15).

The main reasons for this situation are that the new president's other appointments to the Cabinet or other key positions do not represent centrist tendencies but instead have extreme left-wing positions or are from groups that are against private investment, free markets and an open economy. In particular, the government's positions regarding sensitive issues—such as labor market legislation, public enterprises, pension system reforms and the state's role in the economy—are as yet unclear.

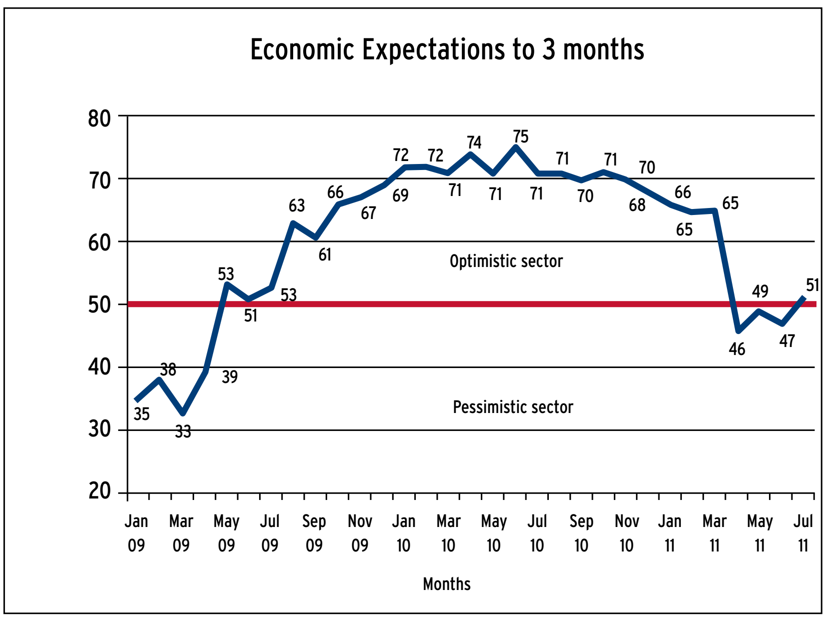
There is also uncertainty in key economic sectors. In the mining sector, for example, an extraordinary profit tax was an issue that worried mining companies during the campaign. To confront this, representatives of the mining sector sat down with government officials and negotiated an additional contribution of 3 billion soles ($1.1 billion). But uncomfortable situations for the mining sector do not end there; the Law of Community Consultation—which states that local and native communities should be asked for their opinion re-

[20] Source: LatinFocus Consensus Forecast, October 11, 2011.

Figure 3.15. Peru's Economic Expectations, 2011



Source: Apoyo Consultoría, monthly poll.

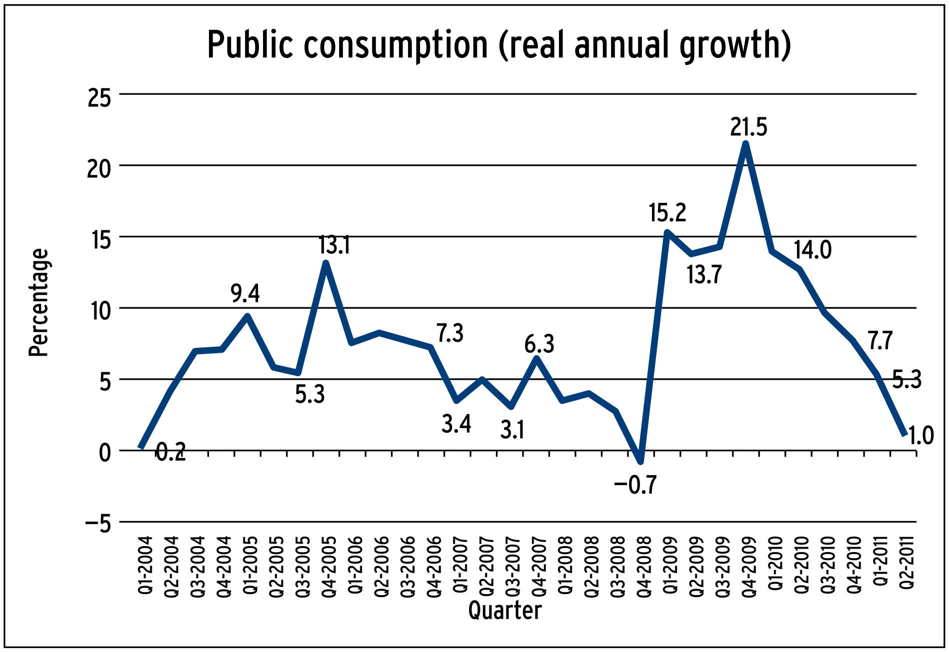


Source: Central Bank of Peru, Economic Expectations Poll.

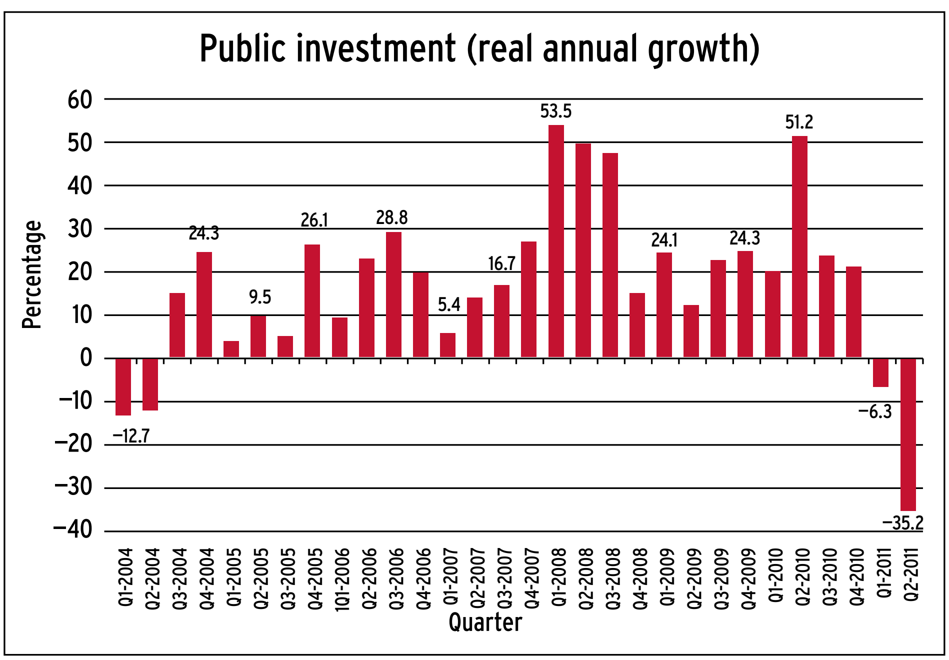
garding oncoming investment projects exploiting natural resources—may delay the execution of important mining projects. Regarding hydrocarbons, gas and oil, there is a lack of definition in the government's general policy for these sectors in terms of royalties and the participation of public enterprises. In transportation and communications, two of the three ports awarded concessions—Muelle Sur and Muelle Norte—would be held to political scrutiny, on the basis of the argument that the contracts for these ports' projects debilitate the National Port Enterprise (ENAPU) and diminish the government's capacity to guard national interests. In addition, the government also announced that telecommunication tariffs would be revised.

There are also some inconsistencies within the executive branch. Regarding taxing policy, for example, the minister of the economy and finance announced in Congress that the overall tax burden will reach 18 percent of GDP by 2016; however, he did not give details of how he planned to achieve this goal. According to the *Multiannual Macroeconomic Framework* (*MMM*, reviewed last August), 2010 closed with a tax burden of 15.3 percent of GDP, and the forecast for 2014 is 15.8

Figure 3.16. Peru's Public Consumption and Investment, 2004–2011



Source: Central Bank of Peru.



Source: Central Bank of Peru.

percent. The only new source of tax income that has been announced is the Extraordinary Mining Tax, which together with tighter control measures by the national tax authority, Superintendencia Nacional de Administración Tributaria, are not likely to fulfill the gap of 2.2 percentage points of GDP by which the tax burden is supposed to increase in less than two years.

There is a higher expenditure burden, especially in social sectors such as education and health. In fact, for 2012, the budget for education will increase by 19.5 percent, representing 0.2 percentage point of GDP (from 2.8 percent of GDP in 2011 to 3.0 percent of GDP in 2012), while the budget for health will be raised by 21.2 percent, representing 0.1 percentage point (from 1.6 percent of GDP in 2011 to 1.7 percent in 2012). To intensify this concern, during his message, the minister announced an increase in salaries for certain public servants[21]—mostly hired as independent professionals—and although such increases should be tied to a culture of good performance, the Urgency Decree approving this measure does not establish the criteria for evaluating "good performance" and instead leaves the justification to the ministries.

Conversely, the 2012 Public Budget does not contemplate increases in salaries for public servants. However, political pressures coming from the military forces and the Public Teachers´ Union are likely to appear.

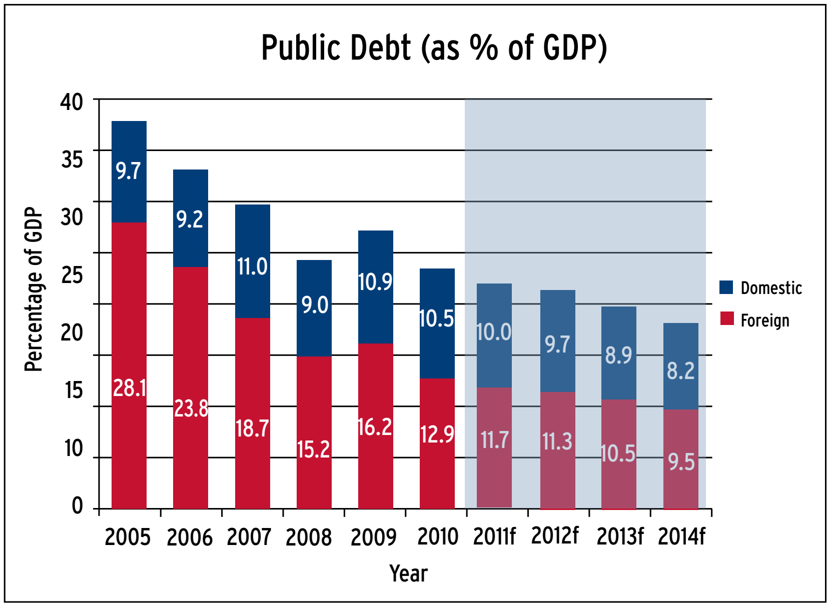
Moreover, public expenditures during the first six months of the year have shown a notably downward trend. Public investment contracted significantly, from 5.3 percent and 35.2 percent, during the first and second quarters, respectively; and public consumption suffered a severe fall in its growth rate during the whole of 2010 and first half of 2011, showing a meager 1 percent growth rate for the second quarter of 2011 (figure 3.16). With these numbers, it is likely that the positive fiscal balance of 0.8 percent forecasted in the MMM will not be reached and that the actual surplus will be higher than 1.5 percent of GDP; meanwhile, in 2012 the fiscal balance of 1.0 percent should be difficult to attain in the middle of the likely recurrence of the international financial crisis and internal political pressure.

Even in antidrug policy, the executive branch presents contradictory arguments. Though the chief of the Antidrug Agency (DEVIDA) claimed that coca leaf eradication would halt, the minister of the interior said that eradication would continue, and that the antidrug czar should align with the government's drug eradication and input control policies. Moreover, the antidrug czar has recently been linked to coca leaf producers, and a video has surfaced of now–president Humala during the campaign promising coca leaf producers to halt eradication. Although antidrug policy does not directly affect economic development, such ambiguity diminishes the government's credibility, and may even affect international relations, especially with the United States, one of Peru's main commercial partners.

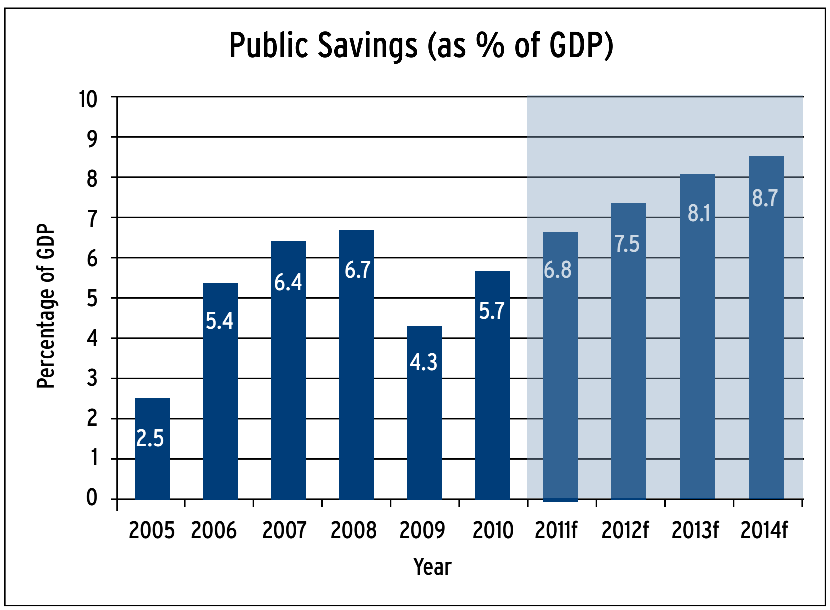
In the middle of this internal struggle, the continuing deterioration of the international environment exacerbates agents' weakened expectations through decreasing global growth forecasts and the probability of confronting a new financial crisis. Fortunately, the Peruvian economy's fundamentals remain strong. International reserves are near $49 billion ($48.9 billion as of September 9), which is equivalent to 1.3 times the stock of public debt for 2011. Public savings in 2010 represented 5.7 percent of GDP and, according to the *MMM*, will continue growing, closing 2011 at 6.8 percent of GDP and reaching 8.7 percent of GDP by 2014 (figure 3.17). The downward trend of the public debt will continue; after a slight increase in 2009, in 2010 it reached 23.4 percent of GDP, 2011 is expected to close at 21.8 percent and by 2014 it would be equivalent to 17.5 percent of GDP. However, despite the Peruvian economy's strengths, investment expectations will be negatively affected by the international situation.

[21] García set up a limit with the Austerity Law, which remains up to date.

Figure 3.17. Peru's Public Debt and Savings, 2005–14



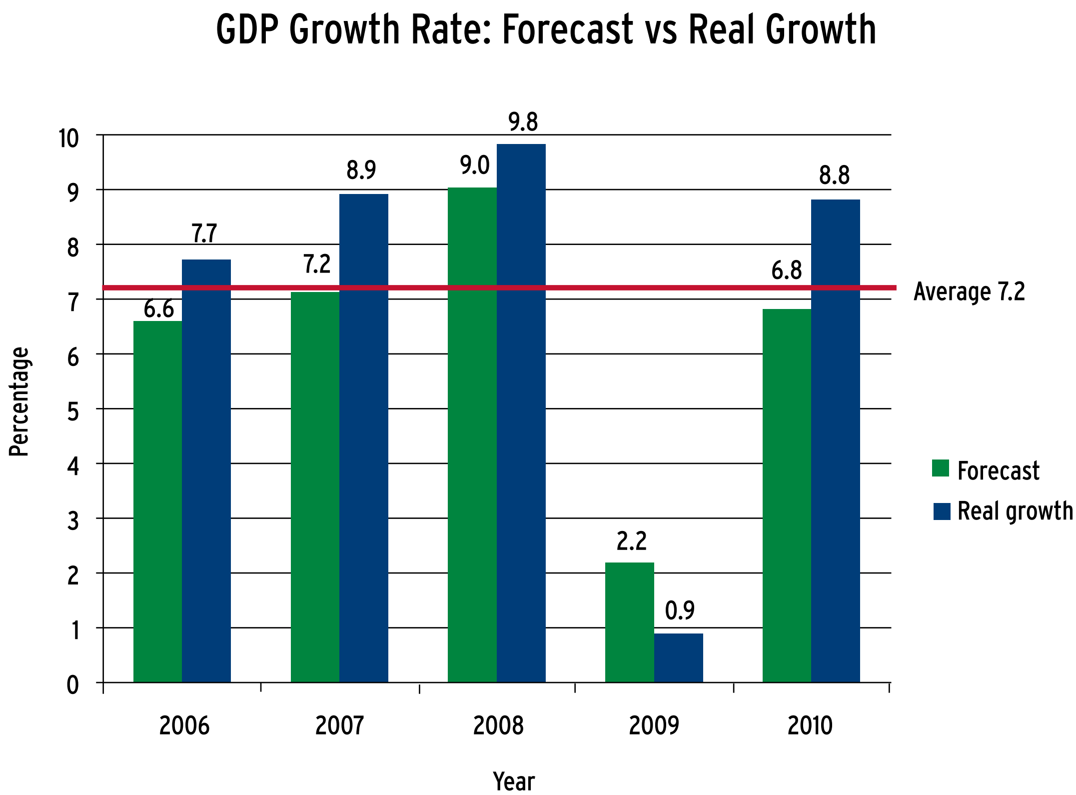
Source: Ministry of Economy and Finance, *MMM* 2012–14.



Source: Ministry of Economy and Finance, *MMM* 2012–14.

This year, the Peruvian economy is expected to grow by about 6 percent. During the year's first six months, GDP expanded 7.7 percent and domestic demand 9.5 percent, stimulated by consumption and private investment. During the second half of the year, GDP's growth rhythm will decrease due to the weakening of the world economy and a slower pace in the growth rate of private investment. In fact, during the last years, construction has been the economic sector leading GDP growth, but this year it is expected to increase only 4.8 percent—compared with 17.4 percent in 2010. For instance, total cement deliveries have fallen four of the first seven months of the year; and for local deliveries, June (–2.2 percent) and July (–4.0 percent) were negative months, anticipating a deceleration in the

Figure 3.18. Peru's GDP Growth, 2006–10



Source: Ministry of Economy and Finance, *MMM*, revised, 2007–9, 2008–10, 2009–11, 2010–12, 2011–13.

construction sector. For 2012, economic growth is estimated to be 4.5 to 5 percent. Despite a weaker and more uncertain world economy and domestic political inconsistencies, for the period 2012–14 Peru has the capacity to remain the region's fastest-growing economy (figure 3.18).

Venezuela: The Paradoxes of an Oil Economy

In the case of Venezuela, highly incoherent economic policies—characterized by a very inflexible foreign exchange policy that generated a strong appreciation of the exchange rate (creating an import boom and the destruction of the economy's tradable sector); a highly pro-cyclical fiscal policy; an environment of hyperregulation (with price, exchange rate and interest rate controls, among others); and systematic expropriations and nationalizations—caused a contraction in the productive system in 2009 and 2010.[22] Nevertheless, in 2011 an oil boom—with average prices of $99.50 per barrel for the first nine months of the year and a projected oil export income of more than $80 billion—combined with the fact that 2011 is a pre-electoral year, have contributed to a change in the direction of fiscal and monetary policy. These factors have generated an economic recovery this year, despite macroeconomic mismanagement and the existence of profound distortions in the economy.

Economic Recovery: Fiscal and Monetary Stimulus

In 2011, the Venezuelan economy received a strong fiscal and monetary stimulus, which translated into the recovery of growth and the persistence of

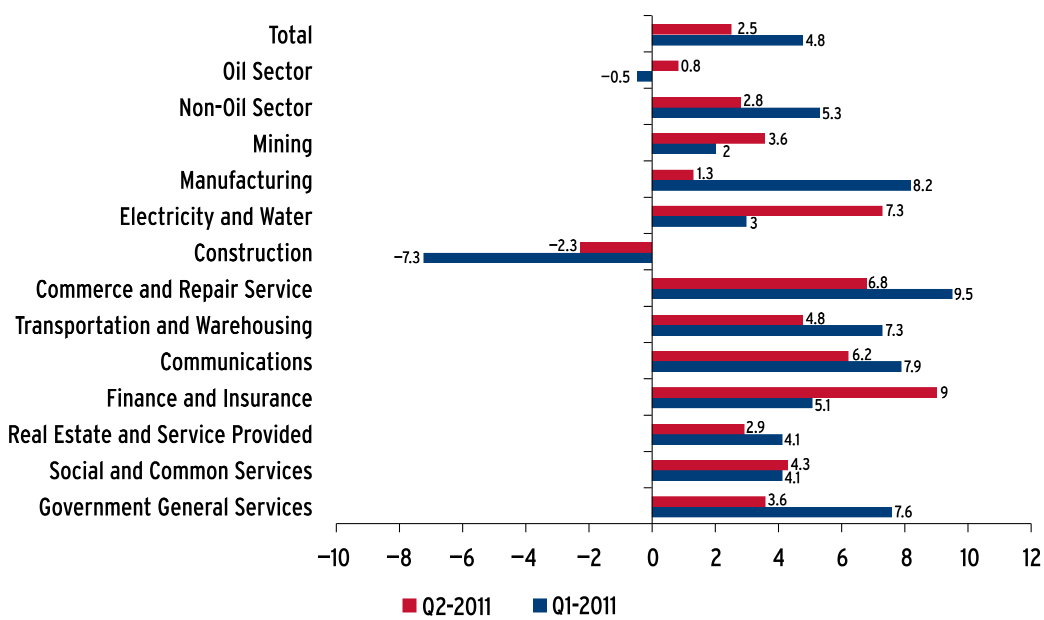
[22] S. Malone and J. Puente, "Boom and Disequilibrium in the 21st Century Venezuela: The Macroeconomic History of the Bolivarian Revolution," paper presented at Latin American Studies Association conference, Toronto, October 2010.

high inflation. The economy grew in the first and second quarters of 2011, after two years of deep recession. In the first quarter it grew by 4.5 percent and by 2.5 percent in the second. Moreover, the fiscal stimulus, along with an improvement in the release of dollars by the Comisión de Administración de Divisas (Commission for the Administration of Currency Exchange)—translating into the greater availability of imported goods—has helped private consumption to recover by 3.7 percent and 2.6 percent in the first and second quarters of this year, after two years of contraction.

In particular, the country's fiscal management during the first quarter of 2011 was marked by a significant increase in public expenditures, which were fundamentally due to the recovery of oil prices and the greater contribution of oil exports to fiscal income following the unification of official exchange rates. According to the Treasury, for the first seven months of the year, primary spending rose in nominal terms by 31.9 percent, which signifies an increase in primary spending in real terms.[23] This trend is in marked contrast to 2009 and 2010, when primary spending fell, highlighting the lack of a countercyclical fiscal policy (figure 3.19). Similarly, liquidity (i.e., M2 money) expanded by more than 14 percent during the first six months of this year in comparison with the same period in 2010. This represents growth in real terms It constitutes the highest growth rate since 2006, and it demonstrates the expansive direction of fiscal and monetary policy.

This money supply growth rate derives from stronger growth in the monetary base and in the multiplier, indicating stronger bank lending activity. This is undermining the credibility of the government's inflation target for 2011 (23–25 percent). Therefore, even in the presence of an overvalued exchange rate and price controls, inflation continues to accelerate. Core inflation grew to 16.9 percent in the first half of 2011 from 15.8 percent for the same period last year. Seven of the 13 CPI subindexes, accounting for 49 percent of the CPI basket, accelerated in the first half of 2011 with respect of the first 6 months, and in the last 12 months inflation reached 26.5 percent. Salary

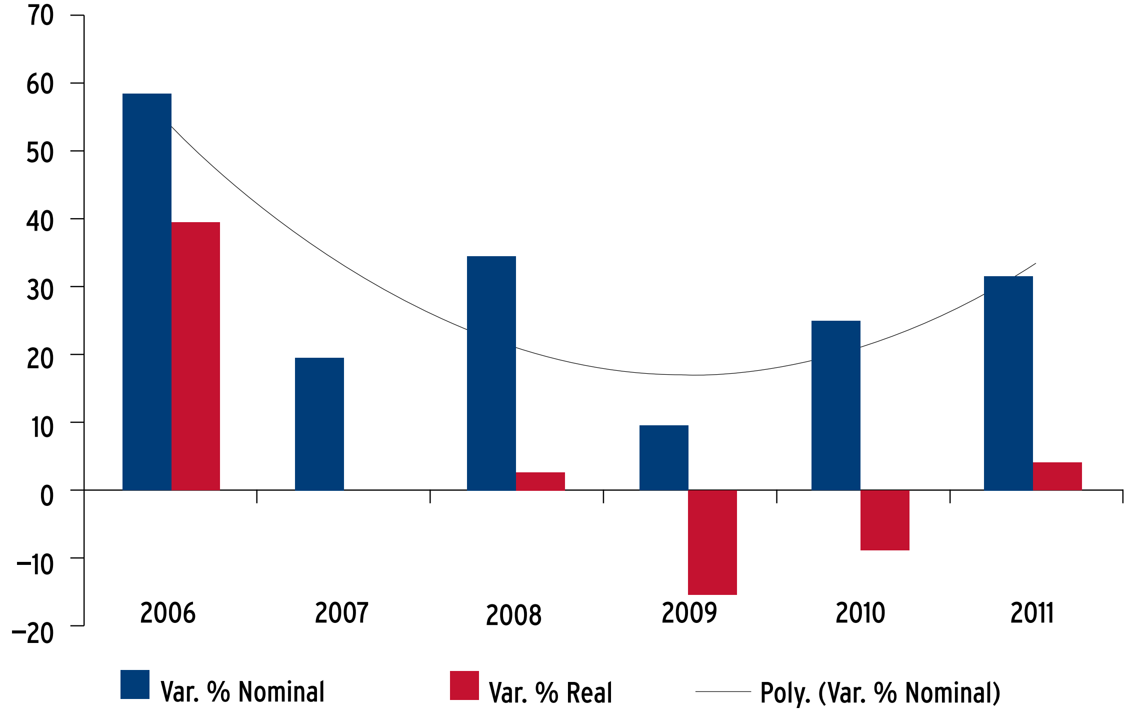
Figure 3.19. Venezuela's GDP by Economic Sector, 2011



Source: Venezuelan Central Bank.

[23] Banco Mercantil, *Monthly Economic Bulletin*, July 2011.

Figure 3.20. Venezuela's Primary Spending, 2006-2011



Sources: Ministry of Finance - Venezuela, Banco Mercantil and the author's calculations.

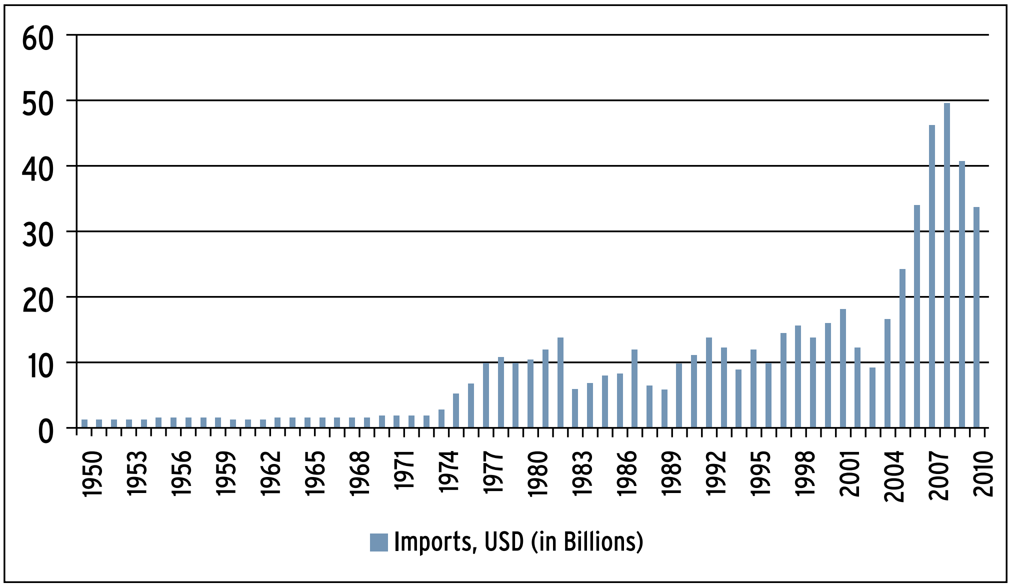
and wages indexes published by the Venezuelan Central Bank show a fall in real wages in the last 13 quarters (figure 3.20).

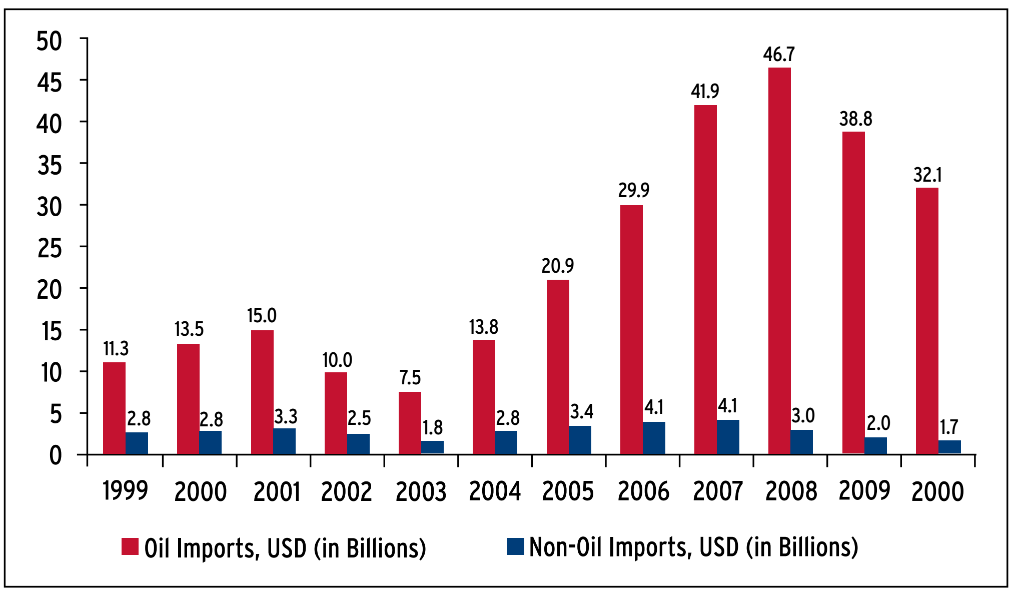
Great Reserves, Great Income, Great Paradoxes . . .

According to the annual report published by the Organization of Petroleum Exporting Countries for 2010, Venezuela's proven reserves of crude oil reach 296,500 million barrels, which means that Venezuela now officially occupies first place globally in certified oil reserves. In fact, in the last decade, and particularly since 2004, Venezuela has experienced one of the greatest external shocks of recent times. From 1999 until 2010, the country obtained $519 billion in income from oil exports, and in light of its oil income for the first six months of 2011 ($43.6 billion), the country could receive $80 billion this year. The price of oil jumped from an average of just $16 a barrel in 1999 to $99.58 in the first 9 months of 2011, making the average price of Venezuelan oil during the 12 years of President Hugo Chavez's government $48.05 a barrel. However, economic policy during these years has exacerbated the more profitable economic model implemented during the preceding decades. In particular, during this period, economic dependency on oil has increased, accompanied by a strong appreciation of the exchange rate ("Dutch Disease"), which has weakened the domestic productive system for tradable goods, particularly in the industrial and agricultural industrial sectors. The concomitant import boom has in turn sharpened the mono-export and rentier nature of the economy and increased the control and discretionary power of the state in the management of oil rents.

In particular, the strong appreciation of the exchange rate has created an import boom. Yet, at the same time, and as a consequence, it has contributed to a fall in non-oil exports. Thus, as figure 3.21 shows, at the end of 2010 non-oil exports were less than in 1999, and the last five years in particular have registered a sharp contraction in the non-oil export sector. Conversely, imports in 2010 reached

Figure 3.21. Venezuela's Imports, 1950–2010



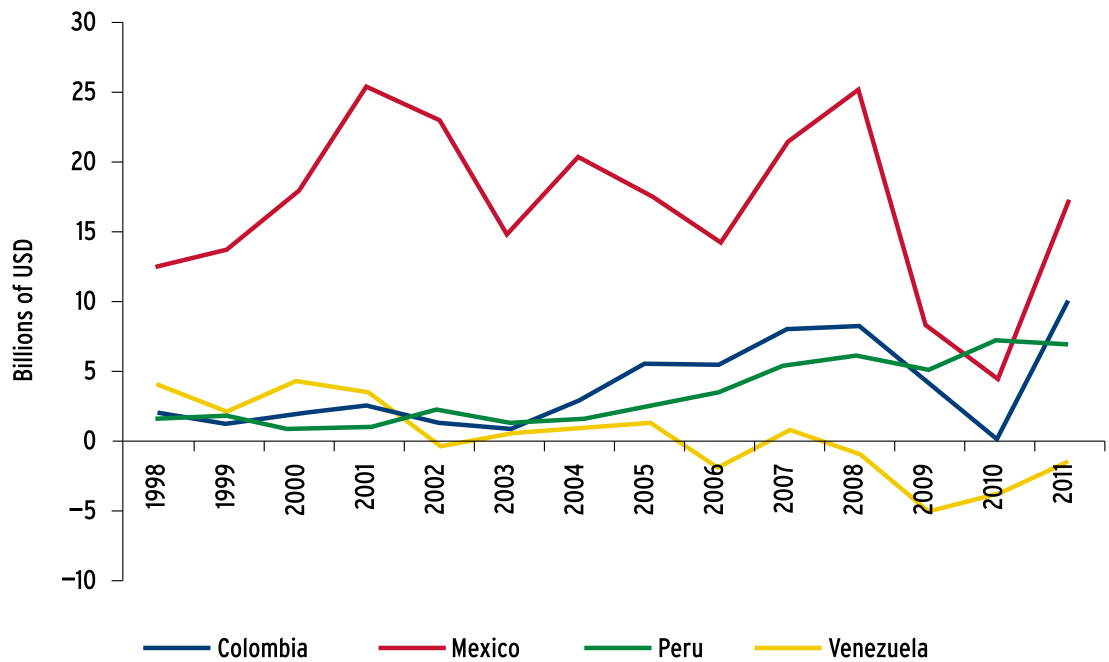


Source: Venezuelan Central Bank.

$38.6 billion and could be more than $44 billion in 2011, a level three times higher than the average for the last three decades (figure 3.21).

This appreciation of the exchange rate has been possible to maintain due to the high oil prices that the Venezuelan economy has enjoyed in recent years, which have sustained the external balance of payments despite persistent deficits in the capital account and a systematic reduction in oil production. Indeed, the oil sector has been experiencing a contraction in activity since 2001, which could indicate a sustained deterioration of operational capacity, management and a fall in investment in the state-owned oil company Petróleos de Venezuela. Estimates by the International Energy Agency for the first three months of 2011 place Venezuela's production levels at 2.5 million barrels per day, which represents a decrease of nearly 600,000 barrels from the level of production during the first

Figure 3.22. Venezuela's Net FDI Flows, 1998–2010



Source: UN Economic Commission for Latin America and the Caribbean.

quarter of 2001. This drop in the levels of oil production and the absolute concentration of exports in oil (i.e., 95 percent of exports in 2010) make the economy more vulnerable to fluctuations in oil prices.

Another fundamental factor explaining the boom in imports is the environment of hyper-regulation, along with systematic expropriations and nationalizations, which have hit domestic production hard. These factors have resulted in a fall in the country's structural productive capacity, which has forced an increase in imports to satisfy internal demand. This in turn has created serious dilemmas for the sustainability of the economy's external sector; for if oil production falls and imports increase exponentially, there is a danger that the balance of payments could become unsustainable.

Venezuela's low levels of FDI are a further expression of its incoherent macroeconomic management, the negative business environment resulting from its current model of development, and its economic dependence on oil rents. As figure 3.22 shows, in recent years Venezuela has ceased to be a net recipient of FDI, placing it among the lowest recipients of FDI in South America. In addition, the figures for private national investment (gross fixed capital formation) also indicate an important reduction. In general terms, the total private investment in the country decreased from 68.7 percent (of all investment) to 34.0 percent in 2009. This is a result of the adverse conditions that the development of the country's private sector. This once again sharpens the economy's dependence on investment flows generated by oil.[22]

Final Remarks

In the short and medium terms, there is a high probability that oil prices will remain high. Consequently, the performance of Venezuela's economy during the rest of 2011 and 2012 will continue to be linked to high oil rents and the electoral incentives associated with the presidential elections of 2012. It is likely that these factors will create the perfect conditions for continuing the country's policy of fiscal and monetary stimulus, which generates the recovery of growth, but with persistent inflation and an increase in macroeconomic unsustainability in the medium and long terms. Oil can create these economic paradoxes and even delay the timing of adjustments, but sooner or later Venezuela's economy will need to face the consequences of macroeconomic mismanagement and the mistaken model of economic development that has been implemented.

[24] J. Puente and H. Gutierrez, "La Economía Venezolana: ¿Y si el Milagro no Llega?" Debates IESA, Volume 15, No. 4 (October–December 2010): 69-72.

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1775 Massachusetts Ave., NW
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