LATIN AMERICA
NEW CHALLENGES TO GROWTH AND STABILITY
Editors
Dora Iakova, Luis M. Cubeddu, Gustavo Adler, and Sebastián Sosa
Note to Readers

This is an excerpt from Latin America: New Challenges to Growth and Stability.

Latin America’s economic performance during the period 2003–12 was remarkable. The region enjoyed strong growth, improved macroeconomic fundamentals, and declining inequality and poverty. However, more recently, the external tailwinds that propelled growth in the past decade have started to fade and the pace of economic activity has decelerated rapidly. This book addresses questions that are currently at the heart of the economic policy debate on Latin America. Can countries return to high rates of economic growth in the medium term? How vulnerable are the region’s commodity exporters to a sustained decline of commodity prices? Will there be significant spillovers from the normalization of U.S. monetary policy? Is the region well prepared to deal with new global financial shocks and increased capital flow volatility? The authors argue that Latin America can rise to the new challenges and return to robust growth, with reforms aimed at improving education outcomes, closing infrastructure gaps, and raising productivity growth.

The Table of Contents, Introduction, and Chapter 1 are included in this excerpt.

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Introduction

DORA IAKOVA

Latin America had a remarkable economic performance in the first decade of the 2000s. Real output grew at a rapid pace, inflation was low and relatively stable, public debt declined significantly, and international reserves increased. The economic prosperity was broadly shared: income inequality declined in many countries and there was a sharp reduction in poverty rates. Although prudent policies and skillful economic management contributed to these achievements, exceptionally favorable external conditions played a key role, acting as a catalyst for growth. Strong demand for the region’s commodity exports led to a wave of investment and an unprecedented income windfall, while easy global financial conditions pushed financing costs to record lows. The global recession of 2009 made only a temporary dent in the region’s growth ascent. In the two years following the crisis, many countries posted record-high growth rates.

More recently, however, Latin America has faced rising economic challenges. The external tailwinds that helped propel growth in the past are fading. Commodity prices have eased based on concerns about China’s ability to sustain high rates of investment-led growth. In the months following the May 2013 announcement by the Federal Reserve that monetary policy in the United States would gradually normalize, global financial conditions tightened and volatility in financial markets increased. At the same time, domestic bottlenecks have constrained the pace of growth in many Latin American countries. As a result, economic activity has decelerated across the region, and real output growth is expected to be only 1¼ percent in 2014, compared with 6 percent in 2010.

The chapters in this book address questions that are currently at the heart of the economic policy debate on Latin America. Can the region maintain high rates of economic growth in the medium term? How vulnerable is Latin America to a reversal of commodity prices? Have countries saved a sufficient share of the income windfall from the commodity price boom? Are fiscal fundamentals strong enough to withstand a deterioration of external conditions? Will there be significant spillovers from the normalization of U.S. monetary policy? Is the region well prepared to deal with new global financial shocks and increased capital flow volatility? The insights from these studies have provided the basis of an ongoing and forward-looking policy dialog with authorities across Latin America in the context of regional surveillance by the International Monetary Fund’s Western Hemisphere Department.

Part I of this volume analyzes Latin America’s medium-term growth prospects. The opening chapter by Dora Iakova, Sebastián Sosa, and Alejandro Werner provides an overview of the main economic challenges faced by the region and discusses policies to address them. The key recommendation is that in order to achieve sustainable growth, policymakers need to give priority to microeconomic
reforms to help improve educational outcomes, close infrastructure gaps, and increase productivity growth.

In Chapter 2, Marie Kim, Sebastián Sosa, and Evridiki Tsounta analyze the drivers of growth in Latin America during the period 1970–2012 from a supply-side perspective. The strong growth in the first decade of the 21st century was made possible by a significant increase in factor utilization, especially labor. However, in the coming years the pace of economic activity will depend increasingly on rising total factor productivity, as labor participation is already at relatively high levels and investment is likely to be affected by the expected tightening of financial conditions and the stabilization of commodity prices.

Turning to the effect of external conditions on growth, in Chapter 3 Bertrand Gruss presents an innovative empirical analysis of the effects of the end of the commodity price boom on Latin America’s economic prospects. His results suggest that medium-term growth for the region would be significantly lower than during the boom years, even if commodity prices were to remain flat at their current high levels.

Part II distills policy lessons from past episodes of terms-of-trade shocks and explores whether the region has built strong enough buffers during the boom years to guard against a deterioration in external conditions. In Chapter 4, Gustavo Adler and Sebastián Sosa assess the vulnerability of Latin America to a reversal in commodity prices. They document that the region remains heavily dependent on commodity exports, and find that a country’s vulnerability to swings in commodity prices is largely determined by the strength of its fundamentals and its macroeconomic policy framework. Limited exchange rate flexibility, large underlying current account deficits, and a weak fiscal position tend to amplify the effects of adverse terms-of-trade shocks on domestic output. Financial dollarization also appears to act as a shock amplifier. With improved fundamentals in many of these dimensions, the region today appears better placed to cope with commodity price volatility than it was in the past.

In Chapter 5, Gustavo Adler and Nicolas Magud present a new data set on terms-of-trade booms across the world over the last 40 years and develop a measure of the associated income windfall. They find that Latin America’s terms-of-trade shocks in the 2000s were of a similar magnitude to those observed during the 1970s. However, the associated income windfalls have been substantially larger in the 2000s because the region has become more open to trade. In some countries, such as Venezuela, Bolivia, and Chile, the additional income from the commodity price boom in the 2000s is estimated to have exceeded 150 percent of GDP. The chapter finds that aggregate savings during the recent boom in Latin America increased more than in past boom episodes, but that the share of the windfall saved (the marginal saving rate) was lower than in the past. The authors conclude that the marked improvement of economic fundamentals in the region largely reflects the sheer size of the positive income shock, rather than greater efforts to save that income.

Strong fiscal policy frameworks are critical for managing macroeconomic volatility triggered by external shocks. In Chapter 6, Gustavo Adler and Sebastián Sosa tackle the question of whether the region has built sufficient fiscal buffers to mitigate the effects of a less-favorable external environment in the coming years.
They examine empirically the link between global factors (such as commodity prices, world growth, and global financial market conditions) and key domestic variables (GDP growth, trade balance, real exchange rate, and sovereign spreads) that drive public and external debt dynamics. The results suggest that several countries in the region (such as Bolivia, Chile, Paraguay, Peru) have sufficiently strong fiscal and external positions to withstand moderate to severe external shocks, but many countries would benefit from building stronger buffers.

In Chapter 7, Alexander Klemm shows that fiscal policy procyclicality remains a issue in the region, though several countries have strengthened their policy frameworks and reduced policy procyclicality over the last decade.

Part III focuses on Latin America’s ability to cope with renewed capital flow volatility, and offers policy advice informed by the experiences of emerging market economies during historical episodes of financial turbulence. In Chapter 8, Gustavo Adler and Camilo Tovar study the role of financial integration and macroeconomic fundamentals in mitigating or amplifying the output effects of global financial shocks on Latin America and other emerging market economies. They establish that better fundamentals, such as exchange rate flexibility and a robust external position, strengthen an economy’s resilience to shocks. Moreover, greater financial integration amplifies global financial shocks in countries with fixed exchange rate regimes, but mitigates them in countries with flexible exchange regimes.

When nonresident investors withdrew capital from Latin America during the global financial crisis of 2009, in some cases residents played a stabilizing role by repatriating capital. It is an open question whether local investors will continue to play such a stabilizing role in future periods of capital flow volatility. In Chapter 9, Gustavo Adler, Marie L. Djigbenou, and Sebastián Sosa find that residents tend to repatriate capital to their home countries in the face of global uncertainty shocks (possibly reflecting asymmetric information or a home bias), but less so in response to increases in U.S. interest rates.

In Chapter 10, Alexander Klemm, Andre Meier, and Sebastián Sosa discuss potential spillovers to Latin America in the process of normalization of U.S. monetary policy. They conclude that the effects would likely be limited in a gradual normalization scenario, driven by improving growth prospects in the United States. Nonetheless, important risks remain. Renewed volatility in U.S. bond yields could trigger large moves in emerging market bond prices, especially if it were to coincide with other negative shocks to investor sentiment, such as adverse political or economic developments in emerging markets. Based on evidence from the mid-2013 taper tantrum, countries with domestic or external weaknesses would be especially vulnerable.

Housing market busts have been a trigger or a major channel of propagation of financial crises in the advanced economies. In the final chapter, Luis Cubeddu, Camilo Tovar, and Evridiki Tsounta explore whether the housing market is a potential source of vulnerability in Latin America. Their results indicate that housing prices do not appear to be significantly overvalued, though the rapid growth of mortgage credit in recent years (some of it extended by public banks) is a potential source of concern, as interest rates are set to increase, while growth is moderating.
PART I

Latin America’s Growth Prospects
CHAPTER 1

Latin America: Rising to New Challenges

DORA IAKOVA, SEBASTIÁN SOSA, AND ALEJANDRO WERNER

Over the past 15 years, the countries of Latin America have made tremendous progress in strengthening their economies and improving living standards. A growing and vibrant middle class has emerged. The weight of the region in global economic output increased from about 6 percent in the 1990s to 8 percent in 2012. The region has also achieved impressive gains in terms of macroeconomic and financial stability. Real output growth has been strong and steady, inflation has been low and well contained in most countries, and international reserves have increased significantly. Public debt has fallen, and most countries no longer suffer from “the original sin”—the inability to borrow abroad in their domestic currency—with government debt now issued mostly in local currency. The adoption of flexible exchange rate regimes has strengthened the resilience of countries to external shocks. Financial deepening has proceeded at a steady pace in the context of overall sound and resilient financial systems. These achievements helped the region weather the global financial crisis relatively unscathed. Although output fell temporarily, most countries staged a rapid recovery supported by countercyclical policy.

This success has owed much to good policies. The implementation of important structural reforms and the liberalization of trade in the 1990s, together with the establishment of stronger institutions and credible policy frameworks, provided the foundations for the economic resurgence. But good luck in the form of very favorable external conditions has also played a key role. Commodity prices rose sharply between 2003 and 2011, providing an unprecedented income windfall for Latin America’s commodity exporters. At the same time, global financial conditions eased progressively (apart from a temporary tightening during the 2009 global financial crisis), lowering the cost of debt for governments and corporations. These twin tailwinds helped propel economic growth and strengthen public finances.

More recently, however, Latin America has been facing rising challenges, both domestic and external. Externally, the favorable tailwinds that propelled growth in the recent past are turning into headwinds. Commodity prices have eased from their 2011 peaks and are expected to stay broadly flat or soften further in the medium term. Global financial conditions have started to tighten since mid-2013 when long-term interest rates in the United States increased from historically low levels.
Domestically, the pace of growth in Latin America has been increasingly constrained by supply-side bottlenecks, including low investment rates, inadequate infrastructure, slowing labor force growth, and skill mismatches. Several years of strong bank credit growth and bond issuance have resulted in some increase in private sector leverage, increasing vulnerability to a growth slowdown or tightening of financial conditions.

At the same time, with improved living standards and a growing middle class, demands for better public services are on the rise. Students are asking for better publicly funded education, firms expect infrastructure upgrades and a more business-friendly environment, and social pressures are mounting to alleviate poverty and provide greater opportunities for social mobility. Despite a marginal decline in income inequality in recent years, Latin American societies remain among the most unequal in the world.

Demographic developments will add another hurdle to economic prospects going forward. Latin America is currently reaping a demographic dividend, with very low dependency ratios and relatively low spending on pensions and health. However, this trend is projected to turn around by 2020, with dependency ratios rising quickly thereafter. This will constrain growth in living standards unless productivity increases substantially.

This chapter discusses how Latin America can build on its achievements to address these new challenges. With renewed commitment to growth-oriented reforms, the region can achieve lasting prosperity and stability.

EXCEPTIONAL GAINS

The period from 2003–12 was a time of exceptional gains in living standards for Latin America. Real GDP growth reached an annual average of 4.8 percent—close to two times higher than the growth rate in the 1980s and 1990s (Figure 1.1). The growth momentum was accompanied by an impressive strengthening of macroeconomic fundamentals and policy frameworks. Public sector balance sheets improved substantially, and external debt levels declined. Inflation remained low and relatively stable in most countries, in sharp contrast to the high inflation rates characteristic of the region in previous decades (Figure 1.2).

Most countries took advantage of the favorable economic conditions to improve their fiscal positions in the years prior to the global financial crisis. Chapter 6 in this volume documents that many countries ran substantial primary fiscal surpluses, leading to a marked reduction in public debt levels (amounting to 30 percentage points of GDP on average during 2003–08). At the same time, the currency composition and maturity structure of the debt improved significantly (Figure 1.3). The average share of foreign-currency debt in total public debt declined from 65 percent in the early 2000s to 45 percent in 2012. Moreover, average debt maturity increased, with the share of short-term debt in total public debt falling from over 10 percent of GDP in the early 2000s to about 6 percent by 2012.

External positions also strengthened across Latin America. In contrast with previous periods of rapid growth in the region, the high-growth episode prior to
**Figure 1.1** Latin America: Real GDP Growth\(^1\) (Percent)

Source: IMF, April 2014 *World Economic Outlook.*

\(^1\)Simple average of Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela.

**Figure 1.2** Latin America: Annual Inflation\(^1\) (Percent)

Source: IMF, April 2014 *World Economic Outlook.*

\(^1\)Simple average of Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela.
Latin America: Rising to New Challenges

The global financial crisis was accompanied by a significant improvement in current account balances. The more financially integrated countries in the region went from an average current account deficit of 2½ percent of GDP during 1997–2002 to a surplus of 1/2 percent of GDP in 2004–07 (Figure 1.4).\(^1\) Gross external debt levels declined by more than 30 percentage points of GDP on average during this period (though some of the decline was due to a trend apprecia-

\(^1\)As indicated in Figure 1.4, the more financially integrated Latin American countries are defined here as Brazil, Chile, Colombia, Mexico, Peru, and Uruguay.
tion of local currencies). In addition, the composition of capital inflows improved in the 2000s, with foreign direct investment accounting for a much larger share of inflows than in the previous decade. Countries also used a greater share of these inflows to build up international reserves and private sector foreign assets. Along with a much greater role for flexible exchange rates to act as a shock absorber, this buildup of external buffers led to a notable reduction in the region’s vulnerability to negative external shocks.

Bank soundness indicators also generally improved during the period, despite relatively strong credit growth over a number of years. After a history of repeated banking crises in past decades, banks in the region have behaved relatively conservatively in the 2000s, maintaining high deposit-to-loan ratios and strong capital and liquidity ratios. Improving supervision and regulation have also helped maintain the soundness of the financial system.

Gains in economic prosperity have been broadly shared. Employment rates for both males and females increased in most countries and there was a sharp reduction in poverty. Absolute poverty rates fell more than 10 percentage points between 2002 and 2010, lifting more than 55 million people out of poverty. 2 Contrary to the trends in other emerging and advanced economies, income distribution improved over the past decade. The region’s robust output and employment growth, and its success in bringing down inflation, played a decisive role in reducing poverty and inequality. Other contributing factors include increased government transfers to the poor (especially through targeted programs such as Brazil’s Bolsa Familia, Chile’s Ingreso Etico Familiar, and Mexico’s Oportunidades), and a narrowing wage gap between skilled and low-skilled workers (Lopez-Calva and Lustig, 2010; Tsounta and Osueke, 2014).

This extraordinary success has been underpinned by an increased social consensus on the importance of macroeconomic stability. Macroeconomic policies remained prudent in most of the region, despite successive transfers of power between elected governments of different political orientations. Many countries strengthened policy institutions and established credible monetary and fiscal policy frameworks. Some countries introduced formal fiscal rules and established stabilization funds, entrenching fiscal discipline in the law and reducing the tendency to run procyclical fiscal policy, which had been very common in the past (see Chapter 7). The adoption of credible inflation-targeting regimes, accompanied by greater exchange rate flexibility, played a key role in anchoring inflation expectations and reducing vulnerability to external shocks.

The significant improvement in policies and fundamentals was rewarded by the market, with credit ratings improving across all countries during the decade. In 2012, six of the eight largest Latin American countries had investment-grade ratings, compared with only two in 2003. Bond spreads declined sharply and market access improved across the board.

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Better macroeconomic management and stronger fundamentals also helped Latin America weather the global financial crisis of 2008–09 relatively unscathed. Improved government finances, reduced external debt, higher international reserves, more flexible exchange rates, and strengthened financial regulation and oversight all played a role in limiting the impact of the crisis on the region. In contrast to past crisis episodes (such as in 1982, 1998, and 2001), the region was well positioned to mitigate the external shock by implementing countercyclical stimulus. Practically for the first time in living memory, governments and central banks in many countries expanded public spending and reduced interest rates in the face of the global recession. Meanwhile, currency depreciations helped Latin American countries cope with the drop in external demand, without causing a spike in inflation or creating financial system turmoil.

While prudent policies explain part of Latin America’s success over the past decade, exceptionally favorable external conditions played an important role as well. Commodity prices almost tripled in U.S. dollar terms between 2003 and 2012, creating an unprecedented rise in the terms of trade for the region’s commodity exporters. As documented in Chapter 5, the income windfall associated with that commodity boom was much larger than in previous episodes. The average annual increase in income for the commodity exporters was 15 percent per year, with a cumulative average windfall over the episode of 100 percent of GDP. The largest gains accrued to Bolivia, Chile, and, especially Venezuela (for which the estimated cumulative income windfall was 300 percent of GDP). The terms-of-trade boom provided significant stimulus to domestic demand and output growth. Indeed, growth over the past decade was far stronger among South America’s net commodity exporters than it was in the rest of Latin America (Mexico and Central America) (Figure 1.5).

At the same time, the region enjoyed extremely favorable external financing conditions, with ample access to cheap credit, interrupted only temporarily by the 2008–09 crisis. Record low international interest rates, abundant liquidity in global financial markets, and strong risk appetite among global investors caused external spreads and interest rates to decline significantly across the region (Figure 1.6). This benefited not only sovereigns, but also private firms, which stepped up issuance of corporate bonds. Easier external financing conditions also spilled over into domestic-currency markets, fueling strong credit growth and providing further stimulus to economic activity. These two tailwinds helped propel growth and establish a virtuous cycle of strong growth, falling interest rates, and improving debt dynamics.

The countries were well-positioned to take advantage of these tailwinds given their cyclical position. In the early 2000s, most countries started from a position of substantial economic slack, with high unemployment rates and low labor participation rates. The favorable external environment stimulated growth without putting pressure on domestic resources.

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3See De Gregorio (2014) for a more detailed discussion.
Figure 1.5  Latin America: Commodity Exporters versus Noncommodity Exporters

Sources: IMF, April 2014 World Economic Outlook; and IMF staff calculations.

1 Simple average of annual data. Commodity exporters include Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela. Noncommodity exporters include Costa Rica, El Salvador, Honduras, Mexico, and Nicaragua.

Figure 1.6  Latin America Bond Yields and U.S. 10-Year Treasury Bond Yield (Percent)

Sources: Board of Governors of the Federal Reserve System; and Bloomberg, L.P.
Note: Latest observation is from August 30, 2014. EMBI = Emerging Market Bond Index.
DARKER CLOUDS ON THE HORIZON

All of these positive developments notwithstanding, a note of caution is in order when interpreting developments during Latin America’s “golden decade.” Much of the improvement in economic fundamentals took place during the period 2003–08. Since the global financial crisis, some of these favorable trends have been reversed, with current account and fiscal balances deteriorating in a number of countries. It appears that in the initial years of the commodity price boom, governments acted on the belief that the gains were likely to be temporary and saved part of the windfall. This prudent approach paid off during the sharp global downturn in 2009. However, as commodity prices recovered and kept rising after the crisis, governments increasingly perceived the positive commodity price shock as permanent and adjusted their spending behavior. The adoption of more accommodative policies resulted in overheating pressures and a widening of external imbalances in a number of countries during 2010–13, increasing vulnerabilities to external shocks.

More recently, the external environment has turned less favorable for Latin America’s commodity exporters. Commodity prices have softened since their peak in 2011, and are projected to moderate further in the medium term as demand from large emerging market economies (EMEs) is expected to decelerate (Figure 1.7) (IMF, 2014a). Even though prices remain high by historical standards, countries can no longer count on the tailwinds from steadily improving terms of trade. Chapter 3 finds that even if commodity prices simply stop growing and stabilize at their current levels, average output growth of Latin America’s commodity exporters would be about one percentage point lower than in 2010–12.

At the same time, the strong tailwind from ultra-low external financing costs is also coming to an end. Long-term U.S. interest rates have started to rise, with knock-on effects for EMEs’ financing costs. After May 2013, when the Federal Reserve first raised the possibility of tapering its bond purchases, bond yields in Latin America and other EMEs increased, equity prices fell sharply, and

![Figure 1.7 Commodity Prices (2005 = 100; index)](image)

Sources: Haver Analytics; and IMF, April 2014 World Economic Outlook.
Note: Shaded area refers to projections.
currencies weakened (Figure 1.8). There has been renewed appetite for emerging market assets since then, and financial conditions remained fairly benign as of mid-2014. However, volatility is likely to increase again when the Federal Reserve starts to raise interest rates.

Against this backdrop, economic activity across the region has been cooling off. Growth in Latin America declined from about 6 percent in 2010 to below 3 percent in 2013, and is projected to drop further to 1¼ percent in 2014, the lowest rate in 10 years (excluding 2009). However, it would be incorrect to attribute all of the recent slowdown to external conditions. Domestic supply

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4 As discussed in Chapter 10, a gradual increase in U.S. rates, driven by positive developments in the economy, should have a relatively moderate effect on Latin America, with some differences across countries. Close U.S. trading partners such as Mexico and Central America would benefit more from positive trade spillovers than would South America’s commodity exporters. Of greater concern is the risk of a pure U.S. interest rate shock, for example prompted by a rise in inflation in the United States, or a renewed bout of volatility affecting the prices of emerging market assets.
constraints are playing an important role in a number of countries. During the golden decade, employment growth was a major driver of economic growth, but unemployment rates already reached historical lows in many countries by 2012. There is also limited room to further increase labor force participation rates, which are already relatively high by international standards (though there is scope to raise female labor participation rates in some cases). Looking further ahead, demographic factors will become an increasing constraint on employment growth. The dependency ratio is expected to start to rise in a number of countries around 2020.

Compounding these challenges, the region suffers a serious and chronic shortage of human capital, with only a small share of the labor force occupied in high-skill professions. Poor schooling outcomes appear to be the main culprit. Indeed, the proficiency of the average Latin American student lags well behind that of peers in the rest of the world. Latin American countries have scored persistently among the weakest 20 percent in the rankings of the Program for International Student Assessment, despite levels of education spending that do not appear to be unusually low compared to other economies at similar income levels (Figure 1.9).

In addition, Latin America continues to have relatively low investment rates, especially compared to EMEs in Asia. As a result, many countries have inadequate physical infrastructure, including in transport, energy, and telecommunications. For example, physical infrastructure bottlenecks have been a significant constraint on activity in Brazil, while energy shortages have curbed production in Argentina and Venezuela.

These persistent challenges point to a broader gap in microeconomic reform efforts in the region. There is a clear need to improve educational outcomes, increase government efficiency, address perceptions of corruption, strengthen
security, and enhance the business environment. These deficiencies did not hold back growth during the commodity bonanza, but are clearly constraining it now. With output close to potential, maintaining growth requires greater investment and productivity gains, so emphasis on enabling reforms is critical.

Meanwhile, the macroeconomic fundamentals in much of the region have weakened somewhat compared to the period before the global financial crisis. First, current accounts have widened in many countries, increasing their vulnerability to a reversal of capital flows or to adverse terms-of-trade movements. Second, a prolonged period of high credit growth and strong external corporate bond issuance may have created pockets of financial vulnerability in the private sector. Third, the fiscal stimulus put in place during the crisis was not fully withdrawn in the following years. As a result, public debt stopped declining, and even increased in a few countries.

Looking at the fiscal accounts more closely, primary public expenditure has increased steadily as a share of GDP since 2009, while the growth in fiscal revenues has started to moderate. The slowdown of revenues is likely to persist in the medium term as a consequence of weaker commodity-related revenues and lower economic growth. At the same time, pressures to raise public spending remain high, reflecting increased demands for better public services and crucial infrastructure needs. The protests in Chile, Brazil, and elsewhere in recent years are a reflection of the increased social activism of the growing middle class. In the longer term, rising interest costs and aging-related spending would further add to spending pressures. Maintaining fiscal discipline will thus be a serious challenge, requiring difficult choices.

What Should Policymakers Do?

Addressing these challenges will require a clear focus on structural reforms to boost potential growth, while preserving the gains in macroeconomic stability. It will be important to preserve credible policy frameworks, carefully calibrate macroeconomic policies, and maintain strong external and fiscal buffers to cope with adverse shocks.

Calibrating macroeconomic policies appropriately to the new reality is a priority. Even though near-term growth is projected to remain below recent cyclical highs, output is generally close to potential. Still-tight labor markets, infrastructure bottlenecks, and sizable current account deficits all suggest limited spare capacity in most of the larger countries. The analysis in Chapter 2 suggests that potential growth in the medium term will also be significantly lower than growth during the boom years. In this context, countering the current slowdown with fiscal stimulus is not warranted. A neutral fiscal stance is appropriate in countries with strong public finances and low external current account deficits, while other countries should aim for gradual consolidation to put debt firmly on a downward path. Countercyclical fiscal stimulus would be recommended only in the event of a sharp slowdown in activity amid evidence of considerable economic slack, and only for countries with sufficient fiscal space.
Monetary policy and flexible exchange rates should provide the first line of defense to cope with external shocks and cyclical downturns. As demonstrated during the summer of 2013, countries with low inflation and well-anchored inflation expectations retain flexibility to ease monetary policy in response to a growth slowdown even in an environment of rising global interest rates. Large international reserve positions are an additional source of strength. All of the more financially integrated countries in Latin America have sufficient reserves to provide foreign exchange liquidity if faced with disorderly market conditions. Temporary interventions to smooth excessive exchange rate volatility could also be justified in some cases, although they should not be used to defend fundamentally misaligned exchange rates or as a substitute for macroeconomic policy adjustments. Indeed, exchange rate flexibility remains a critical instrument to facilitate the rebalancing of demand in response to shocks.

Similarly, strong and proactive financial sector regulation and supervision are crucial to safeguard financial stability in the region. Banks in the more financially integrated countries generally have sound capital and liquidity ratios, good asset quality, strict limits to open foreign exchange positions, and limited reliance on external financing. However, some of these buffers may be eroded in a scenario of weaker growth and tighter financial conditions. Targeted macroprudential measures could play a greater role in reducing financial vulnerabilities. Policymakers should strive to improve the quality of information and data collected to better understand changing patterns of interconnectedness among financial and nonfinancial institutions, and to identify potential risks early. The buildup of corporate debt in recent years bears close monitoring, especially where the debt is denominated in foreign currencies. More generally, maintaining credible policy frameworks, strong balance sheets, and adequate buffers are the best insurance against market pressures.

Early planning and prudent policies are critical to cope with long-term fiscal challenges. Countries would benefit from making long-term fiscal projections an integral part of the annual budget to help anchor medium-term fiscal goals (this is especially relevant for countries that rely heavily on fiscal revenues from exhaustible resources). Fiscal income windfalls from commodity booms should be used to increase public savings and for high-return investment projects. Many countries maintain highly inefficient and expensive energy subsidies, which should be eliminated and replaced with more targeted transfers to the most vulnerable (IMF, 2014b, Box 2.3).

The most critical task is to create conditions for sustainable and steady growth in the medium term. Continued convergence to a higher income level would not only increase living standards for the average person, but would also provide the foundation for further progress on the social agenda. Output growth in the past decade was driven mainly by factor accumulation, aided by favorable financing conditions and strong demographics. To sustain high growth rates in the medium term, policymakers need to boost productivity and competitiveness through structural reforms. Scarce budgetary resources should be focused on upgrading domestic infrastructure and enhancing the quality of education. Consideration
should be given to mobilizing resources where tax burdens are low. In much of the region, there is also a need to further improve the business climate and reduce barriers to entry, including reforming anti-trust frameworks. Increasing domestic savings, which are relatively low in Latin America by international standards, would also support investment and long-term growth.

**Specific Challenges Facing the Less-Financially Integrated Countries**

Some of the large countries in the region have resisted the general trend toward stability-oriented macroeconomic policies and are now facing increasingly urgent challenges. Argentina, and particularly Venezuela, have maintained highly expansionary fiscal and monetary policies for nearly a decade, helped by strong terms-of-trade windfalls. While these policies helped improve social indicators in the past, they have clearly become unsustainable, giving rise to significant fiscal and external imbalances.

These imbalances are especially acute in Venezuela, which suffered a sharp economic slowdown and a steep rise in inflation in 2013, together with widespread shortages of basic consumer goods as a result of price controls. Tight controls on trade and the foreign exchange market have failed to ease pressure on the external accounts, and reserves have declined to very low levels, prompting the authorities to introduce a third foreign exchange market segment (where the local currency is quoted well below the official parity, though still stronger than in the informal parallel market). In this environment, Venezuela is projected to suffer a recession in 2014, with significant risks of disorderly economic dynamics.

Argentina is also projected to see negative growth in 2014, as distortionary economic policies are taking a toll on activity. The authorities responded to growing economic imbalances by allowing a depreciation of the official exchange rate in early 2014, raising domestic interest rates, and reducing the level of certain utility subsidies. They have also made fresh efforts to normalize their relationship with international creditors, including the Paris Club, although the ongoing legal conflict with holdout bondholders remains a large source of uncertainty.

Overall, the recent policy measures in the two economies are steps in the right direction, but significant imbalances and distortions remain, as fiscal policy is not on a sustainable path, real interest rates are still negative, and a sizable gap persists between exchange rates in the official and the informal market. Thus, more fundamental policy adjustments are required to restore macroeconomic stability and lock in the social gains achieved over the past decade, especially in the context of less-favorable prospects for commodity prices. In particular, fiscal policy needs to be tightened on a sustained basis to address unfavorable public debt dynamics and reduce pressures on the current account. One important area for reform is energy subsidies, which are very high, especially in Venezuela. These fiscal efforts would need to be underpinned by sufficiently restrictive monetary policy to rein in inflationary pressures, regain central bank credibility, and allow a gradual move toward a market-determined foreign exchange regime. The phasing-out of distortionary
restrictions on trade, foreign exchange, and prices will have to be coordinated and managed carefully to avoid disorderly adjustment dynamics. Meanwhile, structural reforms are critically needed to raise potential growth, notably by improving the difficult business environment.

CONCLUSIONS

After a decade of impressive economic growth propelled by favorable external tailwinds, structural reforms, and good policies, Latin America is facing a more challenging period ahead. A continued rapid rise in living standards will be more difficult to achieve in an environment of flat or declining commodity prices and tighter financial conditions.

Even so, Latin America can rise to the challenge. The current environment provides an opportunity to reach consensus on targeted structural reforms that would help the region move to a new growth paradigm based on improved human capital, higher productivity growth, and more diversified and competitive economies. Policymakers in several countries are already implementing reforms in education, energy, and other sectors. More is needed, and more is possible, in Latin America’s quest to continue to improve living standards.

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