BROOKINGS

LATIN AMERICA ECONOMIC PERSPECTIVES

SHIFTING GEARS IN AN AGE OF HEIGHTENED EXPECTATIONS

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CONTENTS

TABLES AND FIGURES

Tables

Figures

Introduction: Shifting Gears

The mirage of the Great Moderation is over and, after years of being on autopilot, Latin America's economic policymaking is slowly but steadily adjusting to the brave new world. On the fiscal front, the region's deservedly praised ability to conduct countercyclical policy during the crisis is now facing the well–known fact that tightening during an upturn is harder than loosening during a crisis.

The consensus appears to have moved toward fiscal activism and a larger role for the state, a pendulum swing from the minimalist view of the state somewhat discredited by the 2008-10 global financial and economic crisis. This bias, together with lingering economic fears–exacerbated by the Japanese earthquake catastrophe, Middle Eastern unrest, and the unresolved debt crisis in some European countries–is offering grounds for postponing fiscal adjustment, and will likely have a broader influence on policies in the next few quarters–and, possibly, the years ahead.

Governments are proceeding with hesitation on the fiscal front

This is a common thread that emerges time and again in the country analyses included in this report. For a variety of reasons, governments are proceeding with hesitation on the fiscal front, a strategy that can backfire in the form of greater inflationary pressures and stronger currencies, ultimately undermining the prospects for the so-called Latin American decade.

On the monetary side, one of the lessons from the Global Recession is that low inflation is a necessary condition for macroeconomic stability, but clearly not a sufficient one. Thus, the simplistic beauty of inflation targeting is being replaced by a combination of targets and ad hoc instruments. Financial stability, or bubble prevention, is the most recent addition to new set of targets (a still ambiguously defined "inflation targeting 2.0"). In terms of the toolkit, prudential macroeconomic rules have gained status as an instrument to deliver financial stability.

In all fairness, this is not news to Latin America, where distrust of markets' disciplining role is not a recent fad. Policymakers in the region have been aware of the devastating effects of financial crises, if only because some countries had only returned to normalcy a few years before the global crisis began in 2008. Indeed, as we note below, the "macropruden-

tial" approach was built precisely from the lessons of the emerging market crises on the late 1990s.

Macroprudential regulation is not new to Latin America

But even if macroprudential regulation has long been part of the Latin American toolkit, the global crisis highlighted the relatively overlooked angle of the prudential implications of standard macroeconomic policy (or, paraphrasing, the prudential macroeconomic view). It put the focus on the link between interest rates, both at home and abroad, and asset inflation, and between the latter and the real business cycle–and, ultimately, headline inflation. In this sense, it reaffirmed the view that monetary and prudential policies cannot be conducted in isolation.

Policymaking is made even more complex in the presence of a never-oblivious exchange rate-smoothing objective. While inflation targeters initially addressed the issue with their characteristic benign neglect–and some, like Mexico, have adamantly resisted it–sterilized interventions have gradually become the rule. The twin shocks to the terms of trade and capital inflows have produced an avalanche of foreign exchange, pushing domestic currencies up. Sterilized foreign exchange interventions have become a permanent guest of the macroeconomic policy framework, although never quite a full member. In addition, recent years have seen a comeback of reserve requirements, not only selectively as a tax on inflows but also uniformly as a monetary policy tool to raise lending interest rates without enhancing the appeal of carry trades.

In chapter 2 of this report, we discuss the empirical motivation and offer an economic taxonomy of exchange rate–smoothing policy and its links with the traditional central bank handbook. Our central message is that while intervention and controls have often been framed in a negative light, they are increasingly seen as a useful complement to countercyclical macroeconomic policy toolkit in a financially globalized environment. Practitioners are likely to succeed in adding these chapters to the standard macroeconomic policy textbook.

There is a greater risk of policy inconsistency today

Economic policies are at a crossroads in Latin America. The consistency of the policy package mix was not an issue when the output gap was large and there were no inflationary pressures. Lowering interest rates, stimulating the expansion of credit and accumulating foreign reserves were all desirable complementary objectives. But that is a thing of the past. Today, overheating and inflationary pressures are rising, and many financial regulators wonder whether domestic credit is already growing excessively. An area of special concern in countries such as Brazil is the role of large government-owned banks, in particular the unwinding of their earlier boost to credit. Interestingly, one of the main differences be-

tween developed and emerging economies is that in the latter, the credit channel never ceased to work–perhaps too well.

Macroeconomic stability cannot rely exclusively on monetary policy

These tensions cannot be resolved by monetary policy alone. Part of the overheating and the threats to financial stability is the result of excessive fiscal expansion. Bringing macroeconomic stability back by relying exclusively on monetary policy will be too costly. The necessary increase in interest rates will only create more upward pressures on exchange rates, fostering a never-ending destabilizing spiral. If only for this reason, fiscal unwinding is indispensable for economies to return to normalcy.

CHAPTER 1

Looking Back: Six Months in Five Snapshots

Growth in the U.S. loses 25 b.p. for each $10 increase in oil prices

The global outlook promises modest and volatile growth, with China decelerating below 9 percent, and a sustained but unimpressive recovery in advanced economies, threatened by recent hikes and uncertain prospects around oil prices. In the U.S. alone, it is estimated that the economy decelerates by 25 basis points for each $10 increase in oil prices. With current and projected increases, U.S. growth can be pushed back the 3 percent range in 2011. With the exception of a few oil exporters, higher oil prices should have a largely negative but, at this level, a limited impact on Latin America and the Caribbean (LAC); with global tailwinds or headwinds offsetting each other, near–term economic performance in the region will be determined by local factors, most notably, the monetary and exchange rate policy response to inflation and appreciation pressures.

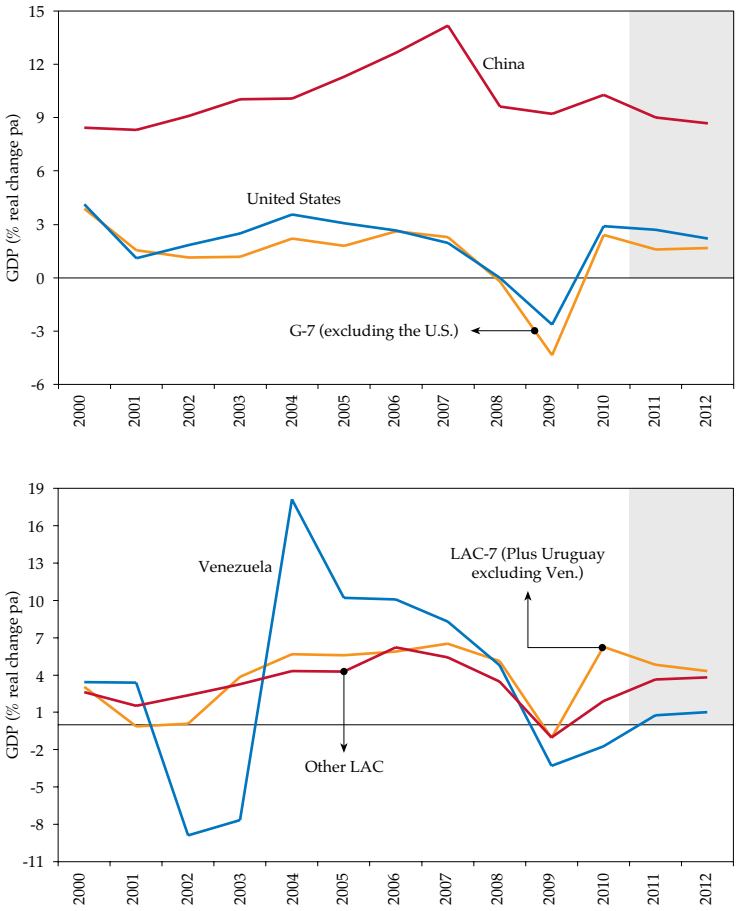
The Darien Gap is dividing the region as never before

The so–called Darien Gap continues to divide the region broadly into two sides. While our revised LAC-7 group (i.e., the conventional LAC-7–Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela–plus Uruguay and minus Venezuela) is forecast to grow at about 5 percent in real terms in 2011, average growth in other LAC countries (mainly in Central America and the Caribbean) is expected to be at below 2 percent, widening the intraregional growth differential (see figure 1.1). LAC-7 (plus Uruguay) countries' terms of trade look quite supportive in the near term, despite the fact of China's deceleration and relatively stable commodity prices (see figure 1.2).

The greatest difference between LAC-7 countries and other LAC countries is the balance of payments. For the past decade, LAC-7 had current–account surpluses. However, for 2011 and beyond, it is projected to shift to a small deficit. For 2011, the deficit is estimated to be 0.3 percent of GDP, but it will continue with an increasing trend and reach almost 2 percent of GDP by 2015. In contrast, the other LAC countries had large current account deficits throughout the last decade. This will continue to be the case for the foreseeable future, although they are likely to experience a slight reduction in their level after 2012. The greatest difference between the two groups is their trade balance, which has always been positive for the LAC-7 group but largely negative for other LAC countries (see figure 1.3).

On terms of capital accounts, strong foreign direct investment has been the most salient characteristic of LAC-7 since the early 2000s. The magnitude of these flows has resulted in large accumulations in international

Figure 1.1. Growth and Growth Prospects: The Global Economy and LAC, 2000-2012

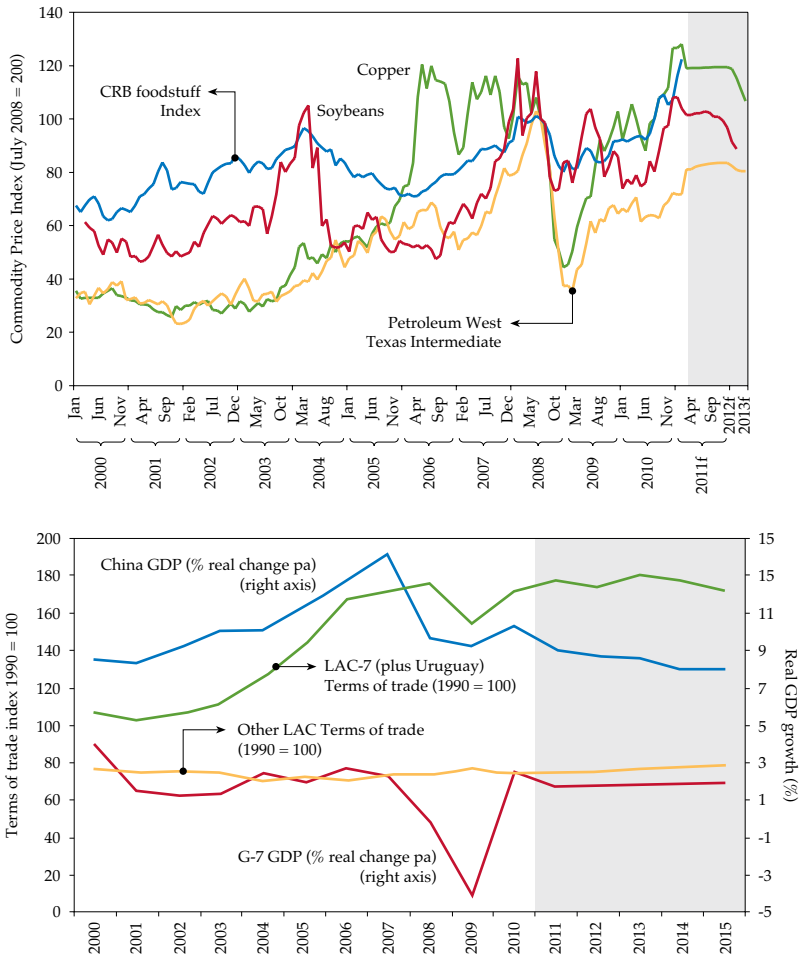


Note: Average forecast from the IMF and Consensus forecast (except for "other LAC," for which forecasts are from the IMF's *World Economic Outlook*); Other LAC countries: Antigua and Barbuda, Bolivia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Panama, Paraguay, St. Kitts & Nevis, St. Lucia, St. Vincent & Grenadines, Trinidad and Tobago.

reserves even during periods of negative portfolio flows. As portfolio flows return to the region, reserve accumulation is likely to increase even further.

Stock prices at the end of 2010 reflected a gradual rotation from emerging to core markets, on positive economic surprises from the developed world (most notably, the U.S. and Central Europe), and inflation and monetary tightening fears in the emerging world. The social upheaval in

Figure 1.2. Commodities' Prices and Terms of Trade, 2000-2010 and 2011-13 Forecasts



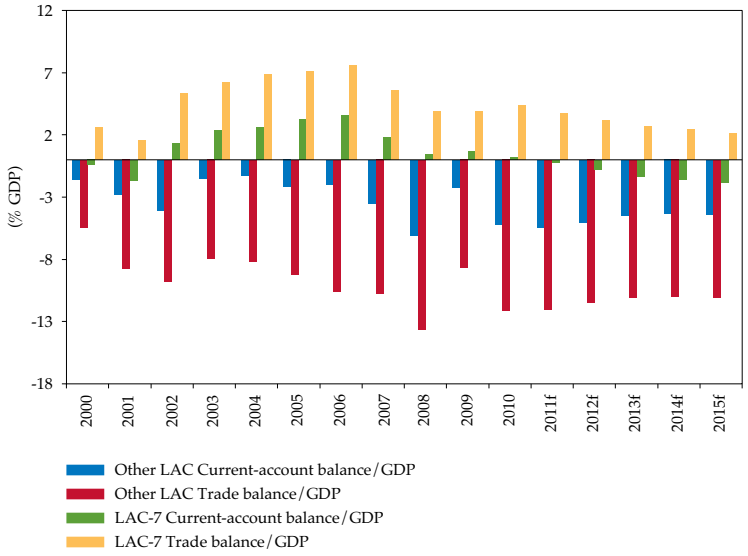
Note: Commodity prices indexed to July, 2008 = 100, and deflated by the U.S. PPI; PPI were assumed to maintain constant at January 2011 levels in forecast construction. Other LAC: Costa Rica, Dominican Republic, Ecuador and El Salvador.
Sources: Authors' calculations based on World Bank Global Economic Monitor; IMF International Financial Statistics, Bloomberg, and Economist Intelligence Unit.

the Middle East and a devastating earthquake in Japan have generated a broader risk, so flight to quality remains dominant at the time of this writing (see the top graph in figure 1.4).

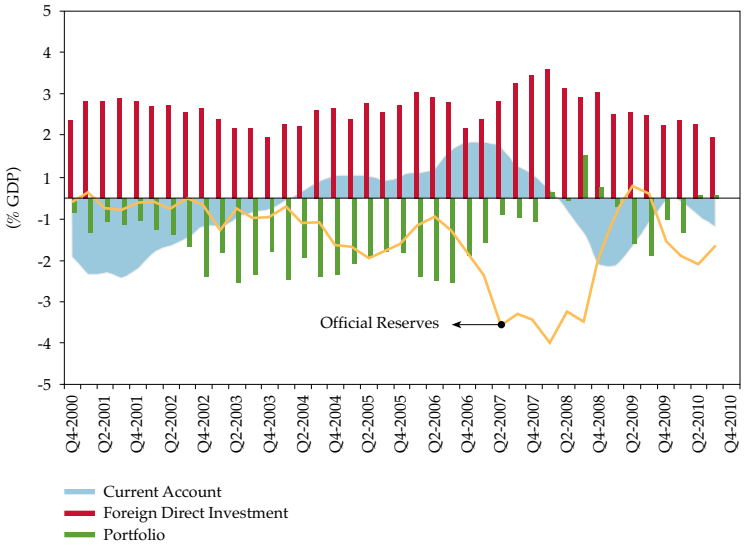
Sovereign bond spreads failed to emulate the compression in U.S. High Yield (and widened in Venezuela and Argentina), reflecting the perception that the 2010 rally was overstretched and the U.S. Treasury rates

Figure 1.3. Balance of Payments, LAC-7 and Other LAC, 2000-2010 and 2011-15 Forecasts

Current Account, 2000-10, and Forecast, 2011-15



Capital Account: LAC-7, Fourth Quarter of 2000 to Fourth Quarter of 2010



Note: Other LAC: Costa Rica, Dominican Republic, Ecuador and El Salvador.
Source: Authors' compilation using data from Economist Intelligence Unit, IMF's International Financial Statistics, and Haver Analytics.

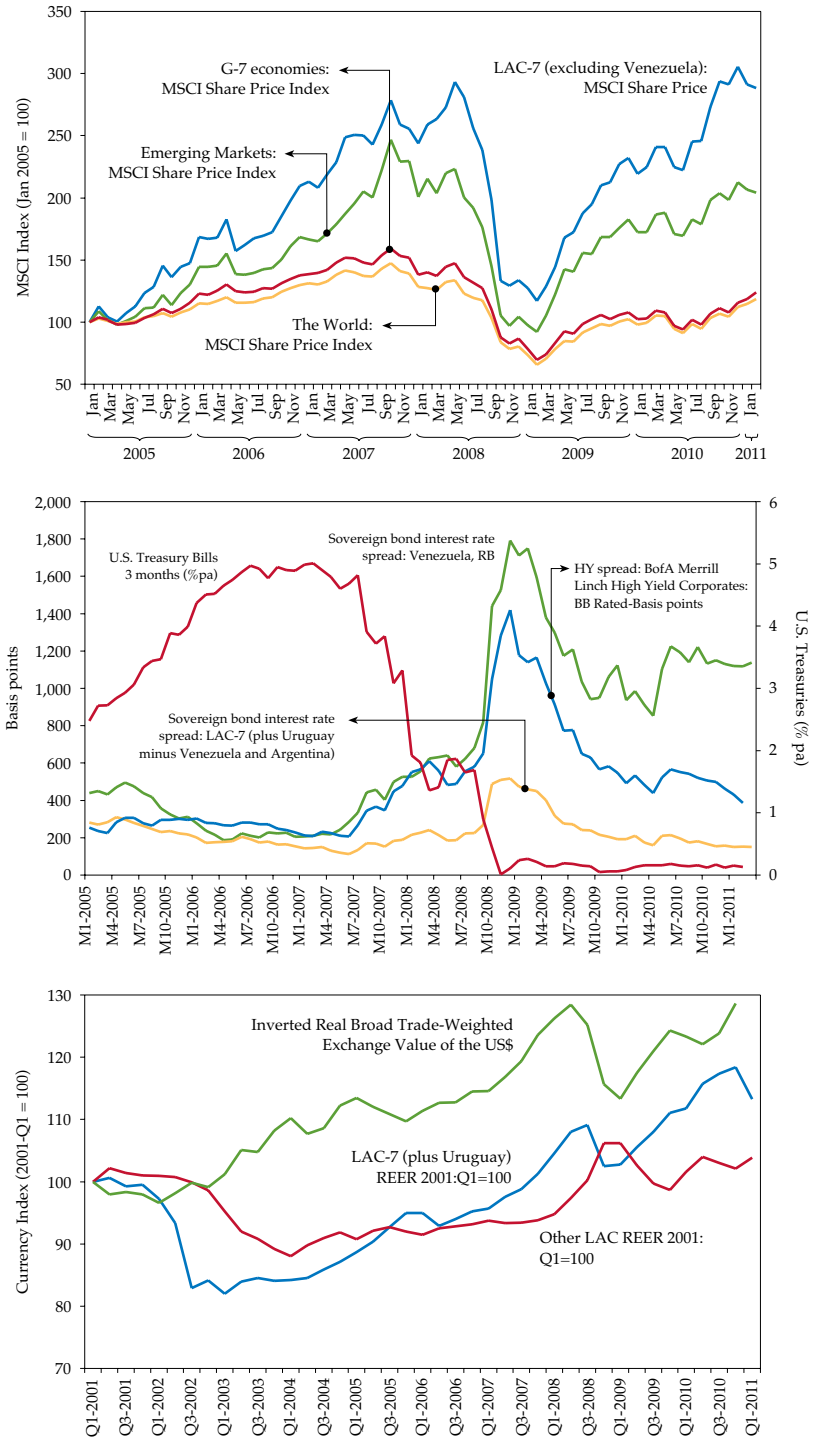
started to rise but, while under stress, they did not sell off with the recent peak in risk aversion (see the middle graph in figure 1.4).

LAC-7 currencies appreciated somewhat with the weakening of the U.S. dollar, but retrenched and are currently slightly higher than late 2010 levels on intervention, controls and the recent flight to reserve currencies (as was expected in the last Brookings Latin America Economic Report– September, 2010). Overall, we foresee side moves with no clear appreciation trend in the near term (see the bottom graph in figure 1.4).

Countries are slowly moving in the fiscal front

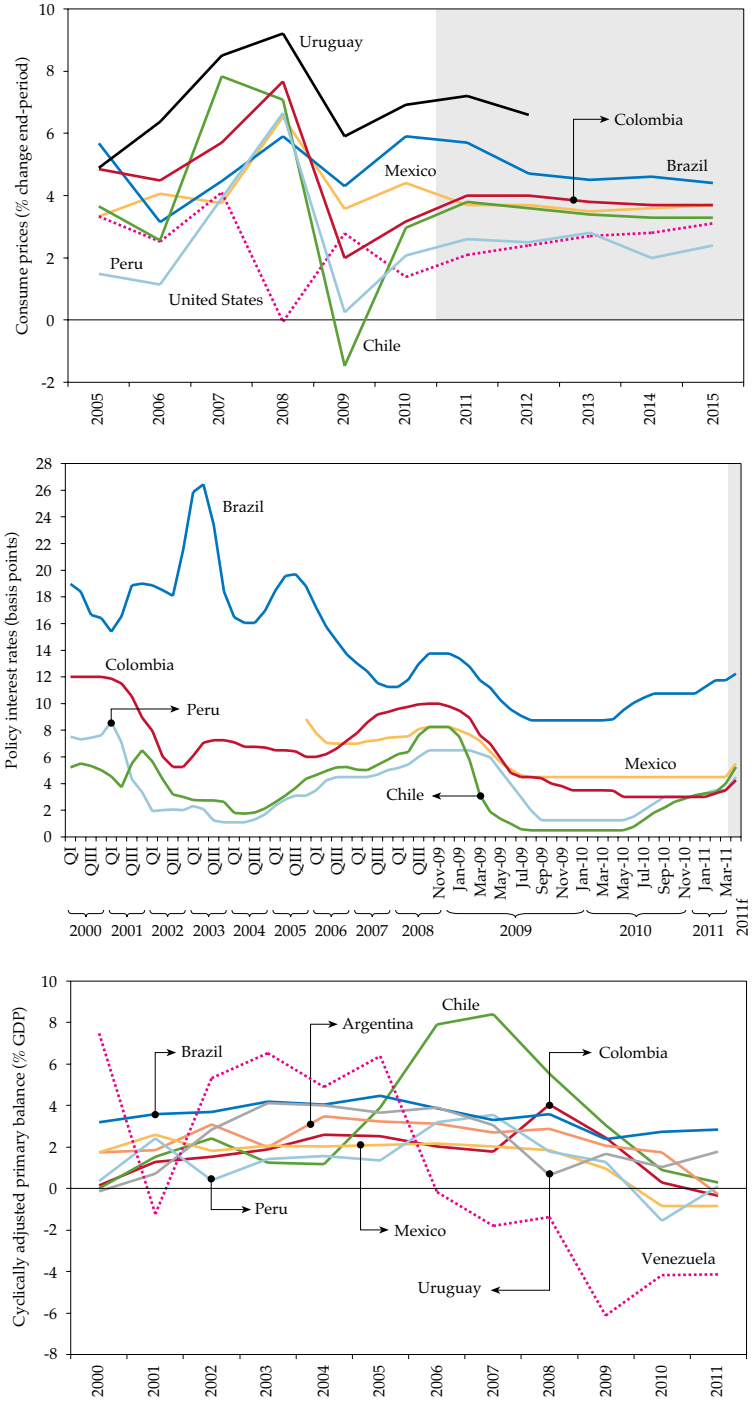
As shown in figure 1.5, inflation and inflation expectations are rising in the LAC region, on rapidly closing output gaps, and imported food inflation and, more recently, energy prices. Central banks have begun their tightening cycle and, with the exception of Mexico, average 2011 monetary policy rates in inflation targeting countries are expected to increase– although fears of the global impact of the oil plus Japanese crises may slow down the tightening cycle. Peru, Uruguay and Brazil have moved to tighten their fiscal stance, while primary balances in fast–growing Argentina, Colombia and Chile continue to weaken. Although, in Colombia and Chile, the fiscal stance is a response to recent natural disasters (an earthquake in Chile; heavy rains in Colombia), in Argentina the procyclical nature points to the political cycle (the upcoming presidential elections). Venezuela's cyclically adjusted deficits have shown a pattern that preceded the global financial and economic crisis and shows no signs of abating.

Figure 1.4. Financial Markets: Equities, Bonds and Currencies



Source: Authors' compilation based on Haver Analytics; World Bank's Global Economic Monitor.

Figure 1.5. Policy: Inflation, Interest Rates and Cyclical Fiscal Balance



Note: Estimated as the intercept from a regression of the primary surplus on log-linear de-trended real GDP growth.
Source: Authors' compilation based on data from Economist Intelligence Unit.

CHAPTER 2

Looking Forward: The Issues

Prudential Macro Policies: The Age of Experimentation

Macroprudential is the new buzzword...

As noted in a recent survey by the Bank for International Settlements, "'Macroprudential' has become a true buzzword in the wake of the recent financial crisis" (Clemens 2010). However, as often with topical buzzwords, the term has been given several and often unrelated meanings.

The term "macroprudential measures" was coined circa 1979 to refer to initiatives that were taken to deal with such issues as credit booms, mounting sovereign risk and sudden capital flow reversals that escaped the typical approach to bank regulation through individual banks' prudential indicators. At the time, these initiatives included restrictions on banks' foreign exchange positions, country exposures and maturity mismatches. The next big appearance of the term was also triggered by the Asian crises in the late 1990s, leading to the development of "macroprudential indicators." As defined at the time by Andrew Crocket (2000), "the macroprudential *objective* can be defined as limiting the likelihood of the failure... of significant portions of the financial system... limiting 'systemic risk,' as opposed to the traditional microprudential objective to limit the likelihood of failure of individual institutions, or 'idiosyncratic risk.'"[1]

... but it is also a big umbrella

Recently, however, the term has been used more broadly to denote policies designed to address macroeconomic sources of risks: procyclical capital flows, excessive currency volatility and asset inflation –as well as macroeconomic tools aimed at deterring those flows, such as exchange rate intervention and capital controls– are often bunched together under the macroprudential umbrella. The contents of this new compound are broad, varied and extremely topical. They go from the domestic effect of global business and interest rate cycles (e.g., the incidence of Chinese growth or the U.S. quantitative easing) to large swings in risk appetite (e.g., debt crises in Europe or political upheaval in North Africa). In between, they delve into exchange rate misalignments, asset and consumer price inflation, and the undesired macroeconomic consequences of credit booms.

[1] "To bring out the contrast, think of the financial system as a portfolio of securities, i.e., the individual institutions. The macroprudential perspective would focus on the *overall* performance of the portfolio; the microprudential vision would give equal and separate weight to the performance of *each* of its constituent securities" (Crocket 2000).

Thus, if anything, the broad macroprudential agenda revisits old debates from a "fresh-from-the global-crisis" perspective. Indeed, *prudential macroeconomic policies* (a more accurate but still imperfect label for monetary, exchange rate and fiscal policies aimed at mitigating the effects of temporary financial shocks) could be seen as a global component of the standard countercyclical macroeconomic toolkit.

Why Bother? Smoothing Out Imported Exchange Rate Volatility

Overvaluation is a shared concern in LAC-7

The overvaluation of exchange rates –for example, due to current account inflows from a boom in commodity prices, or capital inflows fueled by excessive global liquidity, as in the periods before and after the global crisis– has been for long one of the most immediate macroeconomic concerns of financially integrated developing economies. The perils of overvaluation can be argued in at least two alternative ways: (1) as increasing the risks of a sudden exchange rate correction, with the concomitant deleterious effect on inflation and financial stability; and (2) as taxing unnecessarily –and, to some extent, irreversibly– economic activity and employment in the tradable sector, due to the associated loss of competitiveness. In both cases, the underlying concern comes from the risk of a reversal of these inflows and a related exchange rate correction down the line. Thus, it is not a particular exchange rate level (as in the case of the mercantilist view), but rather the excess volatility due to these transient underlying factors that is at the aim of exchange rate-smoothing policies.[2]

Naturally, the final verdict cannot ignore a reference to an equilibrium real exchange rate (ERER). Has the currency exceeded the equilibrium level (or is it in the process of doing so)? A static approach to defining and measuring an ERER based on the country's fundamental variables is an exercise so elusive that it often favors an agnostic position: An equilibrium exchange rate is whatever the exchange rate is in the absence of intervention.[3]

More interesting, from a policy standpoint, is a dynamic approach that focuses on the probability of unexpected swings in the currency, regardless

[2] This crucial distinction separates the discussion below from the debate on exchange rate undervaluation as a development tool (see Levy-Yeyati and Sturzenegger 2007, and the references therein).

[3] Note that equally misleading would be the claim that any deviation from long-run averages constitutes a misalignment, because many changes in fundamental are highly persistent if not permanent. Perhaps the key challenge in exchange rate policy is telling structural from cyclical elements behind real exchange rate pressures.

of whether it is in equilibrium at current levels. For example, if the ERER is assumed to be partially determined by external factors such as global demand, terms of trade, or global liquidity and risk aversion governing capital flows, the concern may lie not in the probability that the ER be away from its equilibrium *today*, but rather that any of those drivers, most of them cyclical, move in a way that changes the ERER *tomorrow*, leaving the current exchange rate misaligned.

The ERER depends on external and volatile forces

An IMF survey on exchange rate modeling highlights six fundamentals as the key influences over the ERER: (1) productivity differentials (positive –more appreciated– effect, in line with the Balassa-Samuelson effect); (2) trade restrictions that may lead to higher domestic prices (positive); (3) price controls (negative, to the extent that they artificially depress nontradables such as services and transportation); (4) government consumption (positive, to the extent that it favors the demand for nontradables); (5) commodity terms of trade (positive); and (6) net foreign assets (NFA; positive).[4]

The first four factors are largely local and can be expected to remain stable or move slowly over time. By contrast, the last two are globally determined and highly volatile. They are also at the center of the prudential macroeconomic debate. How can we be sure that the current exchange rate reflects current and expected values of these fundamentals, when the NFA and commodities have displayed such an unpredictable behavior in the past? And just how unpredictable are these global influences after all?

The first thing to note in this regard is that capital flows in emerging economies move in sync across countries and, to the extent that they play a role in the determination of exchange rates, generate common exchange rate trends (figure 2.1).[5] In turn, these common trends can be related to a few well-known, globally determined speculative drivers such as risk appetite, or the value of U.S. dollar (figure 2.2).

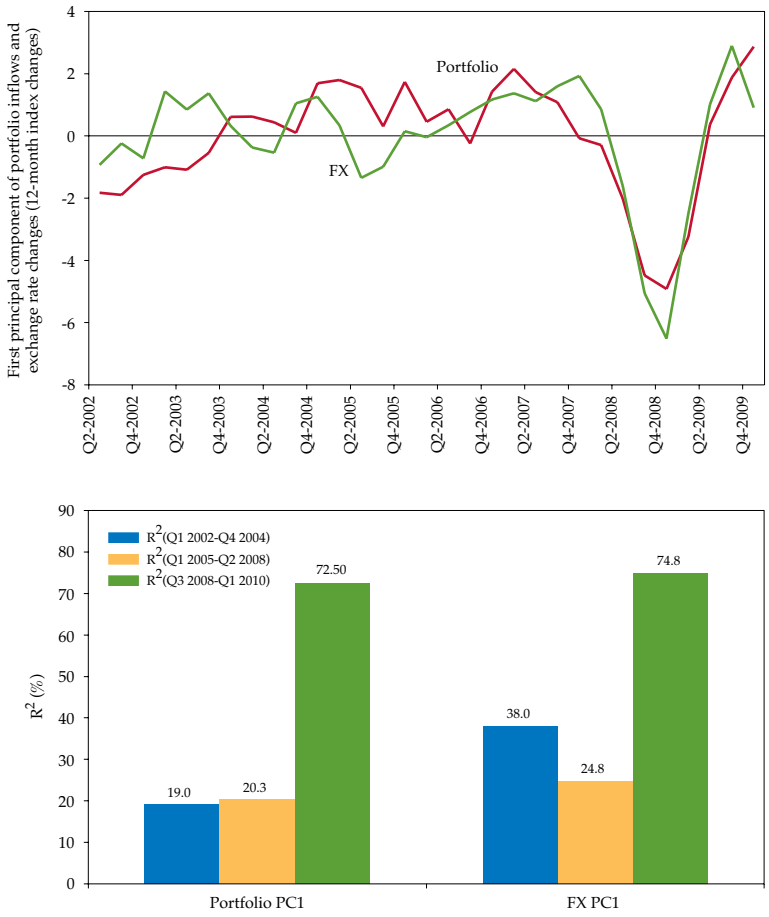
Moreover, in addition to these globally determined portfolio flows, the NFA position, typically defined as a ratio to GDP, may reflect valuation changes due to moves in relative prices that are, unsurprisingly, also influenced by the same global variables. For example, it is easy to show that big swings in risk appetite, to the extent that they result in asset market

[4] See IMF (2006). Note that the NFA is an appropriate measure of the "transfer problem" only to the extent that rates of return on external assets and liabilities are comparable (Lane and Milesi-Ferretti 2002).

[5] The sample of emerging economies is the one used in the Brookings Graduation Scorecard included in this report; see chapter 4.

rallies and selloff, can inflate the NFA positions of emerging economies (Levy-Yeyati and Williams 2011).[6]

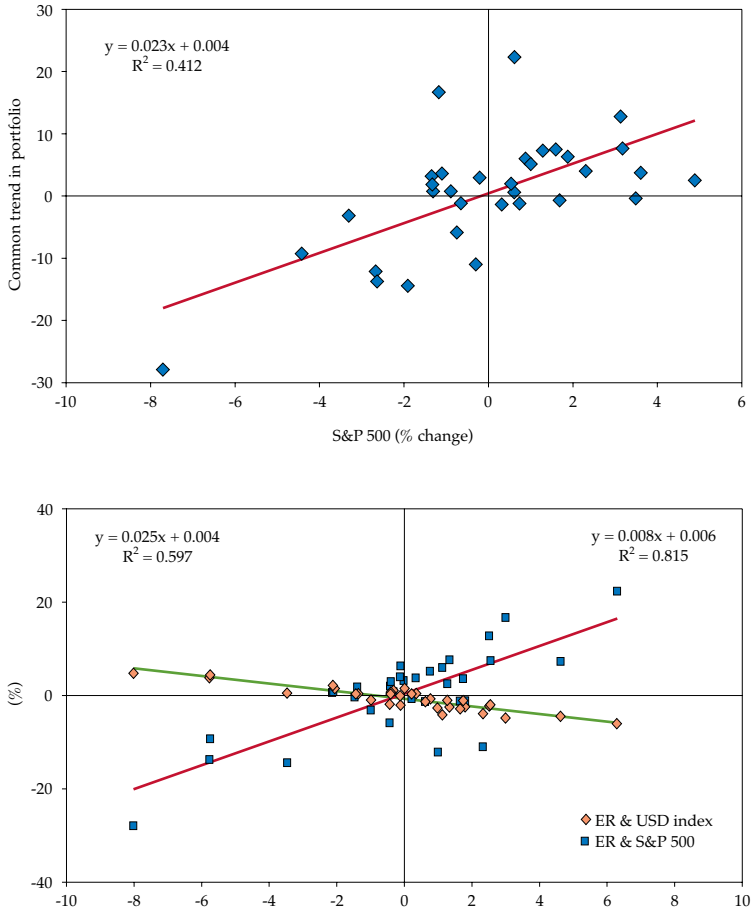
Figure 2.1. The Growing Synchronicity of Portfolio Inflows and Exchange Rates



Note: The top graph shows the first principal components (PC1) of quarterly portfolio inflows and exchange rate changes, over the emerging market sample. The bottom graph shows the period average R2 from country-by-country regressions of portfolio inflows (on the left) and foreign exchange rate changes (on the right) against the corresponding principal component (PC1).
Source: IMF data.

[6] Changes in NFA can be decomposed into net flows and capital gains, namely, the change in the value of net holdings due to valuation changes. In this context, for example, an equity rally that increases the value of both equity assets and liabilities relative to GDP, would inflate the absolute value of NFA, whatever its sign.

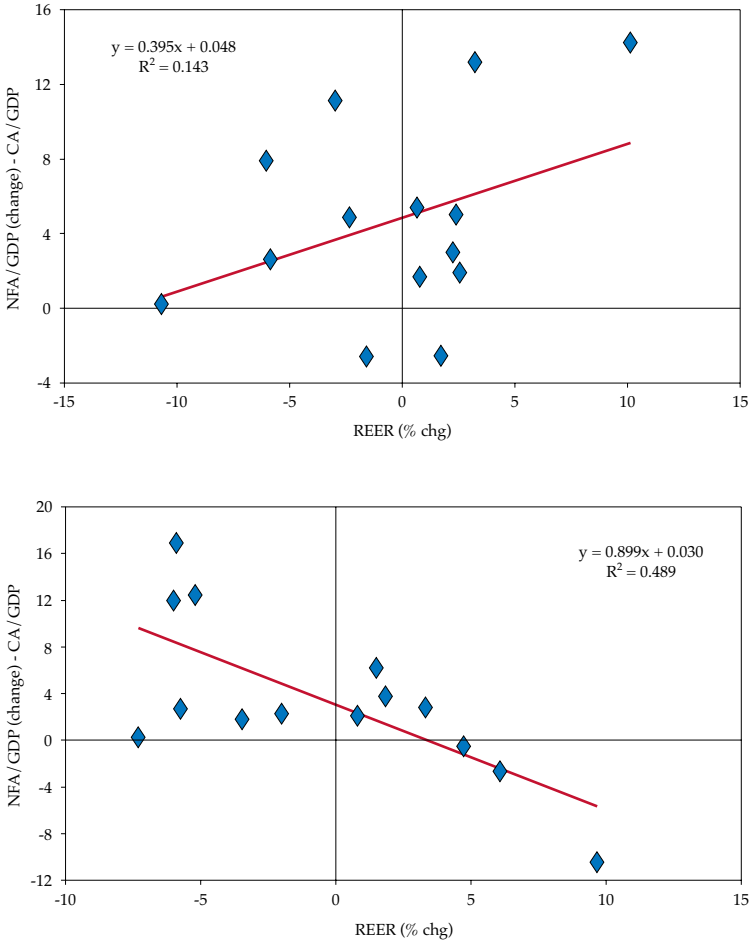
Figure 2.2. Global Drivers: Inflows to Emerging Markets Respond to Risk Appetite; Exchange Rates React to Risk and the U.S. Dollar



Note: The top graph shows the link between the first principal components (PC1) of quarterly portfolio inflows with S&P 500 returns. The bottom graph shows the link between the PC1 for exchange rates changes, on the one hand, and S&P 500 returns and the US broad dollar index, on the other.
Sources: U.S. Treasury, IMF, and World Bank data.

Indeed, precisely because of these valuation changes, the connection between real exchange rates and NFA changes can cut both ways (figure 2.3); thus, a net dollar debtor like Peru would benefit from an appreciating currency (as its debt-to-GDP ratio falls), whereas the opposite would be the case for a net dollar creditor like Chile (as the value of its dollarized sovereign assets declines in GDP terms). Interestingly, in the first case, the positive association between NFA and the real effective exchange rate (REER) would simply reflect the valuation effect of a stronger currency

Figure 2.3. Valuation Changes: Appreciation and Net Foreign Assets in Peru and Chile



Note: To isolate the valuation component of the NFA change, the latter is taken net of the current account (CA) balance. A positive change in REER denotes appreciation. NFA data are from Lane and Milesi-Ferretti (2007).

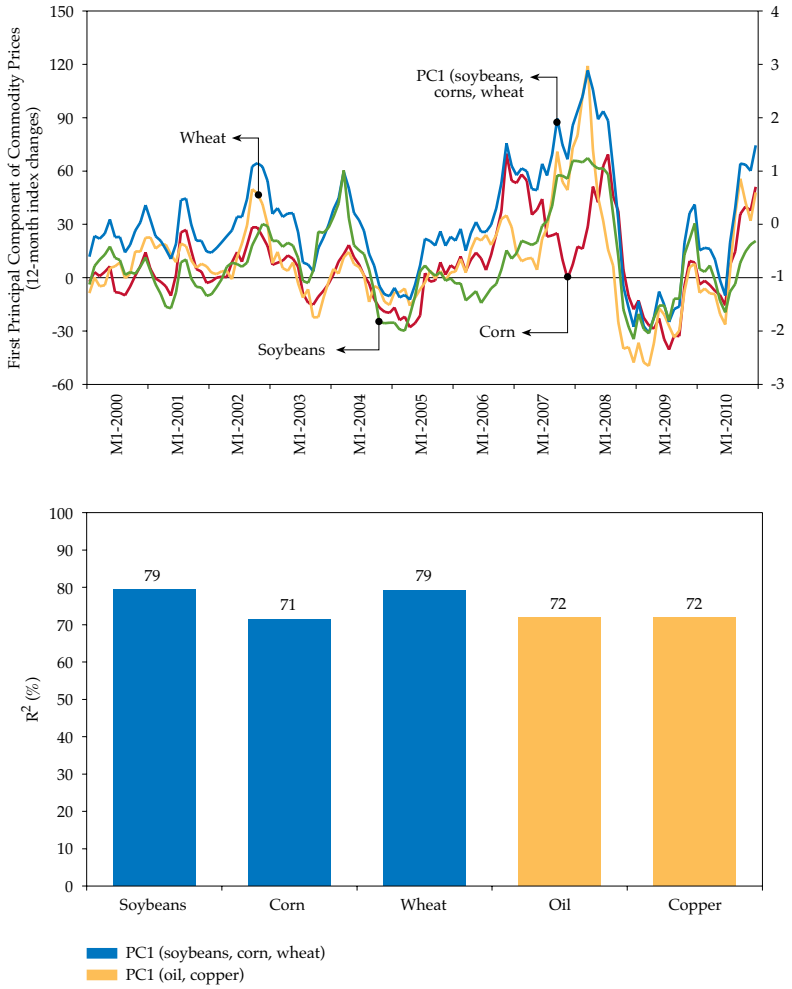
on dollarized debt liabilities. Inverting the causality to interpret this as evidence that better fundamentals are validating the stronger currency would be a circular (and misleading) argument for complacency.

The same short–run global influences can be identified in the behavior of the other global driver of ERER: commodity terms of trade. Once we take into account that commodities respond to global drivers differently –and therefore cannot be summarized by a broad commodity index– it is easy to illustrate the presence of common patterns in items relevant for the

region such as grains, copper and oil. Changes in the price of grains (e.g., soybeans, corn and wheat) tend to correlate very closely, and common factors can be identified even in less obviously related commodities such as oil and copper (figure 2.4).

In turn, as before, these common threads can be related to a few global drivers: liquidity and risk appetite (possibly a reflection of the growing role of speculative investors and positioning in commodities markets);

Figure 2.4. Commodities: Common Trends in Grains, as well as in Oil and Copper



Note: PC1 computed based on price index changes. The graph on the bottom shows the group average R^2 of a regression of each commodity against its group PC1.
Source: World Bank data.

the U.S. dollar (a numeraire effect due to the fact that commodity prices are quoted in dollars); and the world economic cycle (including a growing demand from emerging economies and, in the case of grains, from the biodiesel industry). Table 2.1 reports quantitative estimates of these influences during the 2000s.[7]

The ERER can change overnight

Naturally, this does not deny the validity of the traditional bottoms–up approach based on microeconomic data on supply and inventories, which in some cases remains essential (Frenkel and Rose 2010). But in times of global financial distress like the ones we have been living since 2008, microeconomic considerations are often dwarfed by the common impact of global shocks that can reverse trends –and render the current ERER obsolete– almost overnight.

Varieties of Dutch Disease

A key concern associated with a temporarily overvalued currency is the loss of international competitiveness. In particular, the commodity surge that benefited most emerging economies in the 2000s (and appears to continue, albeit at a slower pace, in the near future) have started to sound the alarm about the possibility of catching a mild case of Dutch Disease (DD).[8]

Table 2.1. Demand, Supply and Speculative Factors Behind the Common Commodity Trends, 2000-2010

1st Principal Component	IP EM (% change)	IP AM (% change)	U.S. Real Rate (change)	S&P 500 (% change)	U.S. Dollar index (% change)	ln(U.S. HY) (% change	Observations	R^2
Grains	11.82 *	8.916 ***	-0.811 ***	-2.406 **	-9.766 ***	-	129	0.5
Copper and oil	18.34 ***	-0.655	0.535 ***		-4.110 **	1.190 **	129	0.68

Note: Industrial production (IP) indexes are weighted by GDP. Robust standard errors in parentheses. EM = emerging market; AM = advanced markets; HY = BofAM Merrill Lynch High Yield Corporate Effective Yield. ***p < 0.01, **p <0.05, *p < 0.1.
Sources: IMF, World Bank and Haver Analytics data.

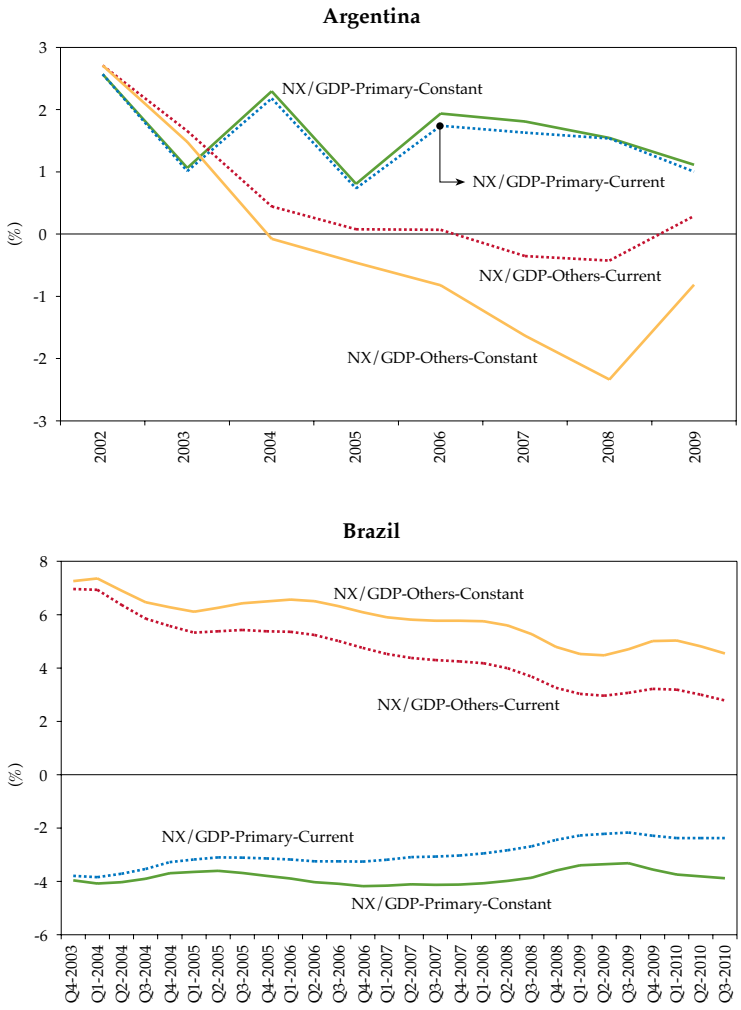
[7] Just to mention a few recent samples of a long and vast literature, let us note that commodities have been shown to be affected by lower U.S. real interest rates (Frenkel 2008), global demand both from advanced and, increasingly, the emerging world (Frenkel and Rose 2010); (Cevik and Sedik 2010), and global equity returns (Carrera et al. 2010). Specific results are far from systematic, as they vary with the commodity and the sample period of choice.

[8] With the exception of Mexico, where oil exports have steadily declined in importance, the other LAC-7 members are all important commodity producers. By contrast, Central America and the Caribbean, as net commodity importers, stand on the opposite side of the prudential macroeconomic dilemma. Needless to say, competitiveness is one angle of the overall concern with excessive appreciation. The other one is inflation, either of assets (with the risk of creating a credit boom or a real estate bubble) or, if the appreciation is resisted, of goods and services.

Traditional-cum-financial DD is affecting LAC-7

The term "Dutch Disease" (DD), originally coined by *The Economist* in 1973 to refer to the decline of the manufacturing sector in the Netherlands after the discovery of a large natural gas field in 1959, is used to denote the effects of large inflows of foreign currency on the international competitiveness of the manufacturing sector. The story is well known: An increase in revenues from the booming primary sector appreciates the currency, resulting in a loss of competitiveness (and, ultimately, a decline in production) in the lagging manufacturing sector. Although DD has also been used to refer to capital inflows such as foreign aid, foreign direct investment

Figure 2.5. Dutch Disease and the Gradual "Primarization" Process: Net Goods Exports in Commodity Exporters

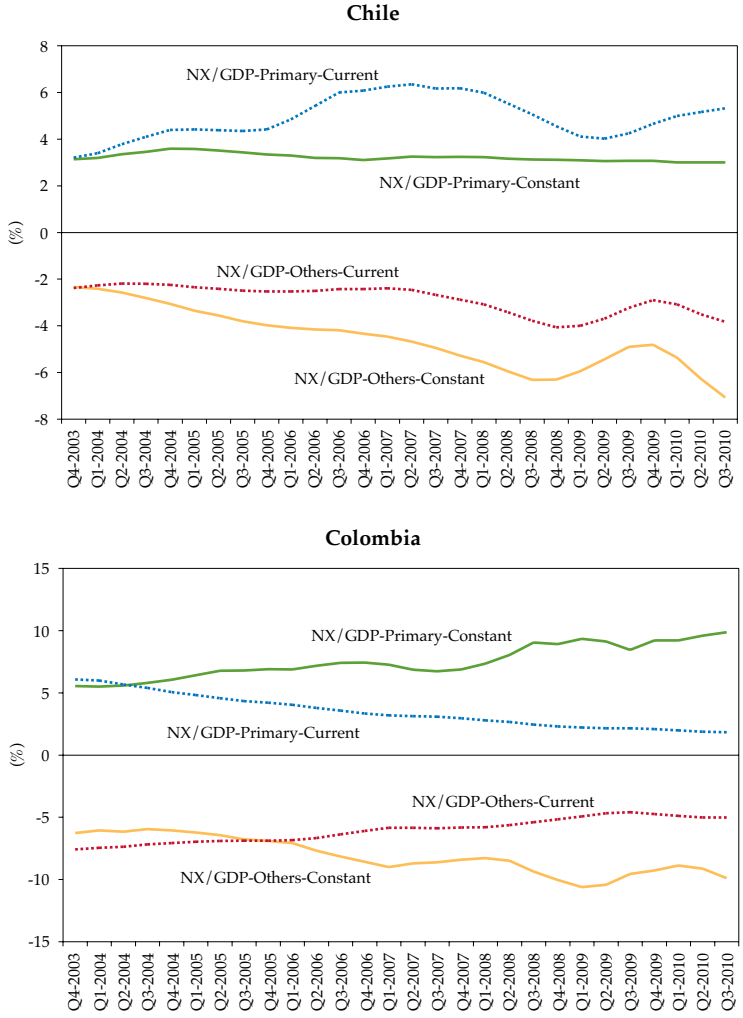


Note: Exports (imports) are deflated by export (import) price indices.
Sources: Official national data.

(FDI), and even portfolio flows, it is useful to distinguish between a "financial" DD driven by capital inflows (at the expense of a generalized loss of competitiveness and a current account deficit) from the traditional DD, in which a growing trade surplus in the primary sector offsets a growing trade deficit in the manufacturing sector, as the real exchange rate adjusts.

Although available labor market and manufacturing production data may not yet capture the DD symptoms, a casual look at net primary and manufacturing exports in four likely candidates –the commodity exporters Argen-

Figure 2.5. Dutch Disease and the Gradual "Primarization" Process: Net Goods Exports in Commodity Exporters



Note: Exports (imports) are deflated by export (import) price indices.
Sources: Official national data.

tina, Brazil, Chile and Colombia– offers some incipient reasons for concern. The fact that their total net exports to GDP have declined in constant terms may be attributed to the real appreciation, which in turn owes as much to improving terms of trade as it does to financial inflows. But whereas the volumes of net primary exports have remained stagnant (with the notable exception of Colombia, blessed by growing mining and oil export), the volumes of nonprimary net exports have been falling rapidly into deep negative territory (with a transitory pause during the 2009 GDP contraction).

Brazil is an example of financial DD

To be sure, this pattern is the result of both a dramatic improvement of commodity terms of trade and sustained inflows of capital, still dominated by FDI but increasingly biased toward portfolio investments. The former, according to the canonical model discussed above, would have strengthened the ERER, and accounts for the gradual real appreciation despite the official efforts to postpone it. The latter, closer to our "financial" variety of DD, explains the narrowing of the trade balance and, more recently, the incipient current account deficits.

Each type of DD requires different policy tools

Brazil deserves a special note in this regard. It has a diversified manufacturing export menu that makes up for its negative primary net exports, and accounts for the country trade surplus. Therefore, it is hard to argue that the country's competitiveness is at stake due to a traditional case of DD triggered by booming soybean prices. On the contrary, the country appears to epitomize financial DD, losing competitiveness through FDI and, more recently, portfolio flows.

The traditional recipes against DD (slowing the real appreciation rate and increasing the productivity of the manufacturing sector) can be evaluated in light of the previous distinction. For example, commodity booms call for sector–specific interventions, such as the Social and Economic Stabilization (Copper) Fund in Chile, or a mix of taxes and subsidies designed to mitigate its impact on the relative competitiveness of the industrial sector. By contrast, a case of financial DD that detracts from the competitiveness of the country as a whole requires a macroeconomic dam to keep away the dollar flood. Given that even in countries with strong commodity–intensive trade surpluses like Chile, there seems to be a financial component to dollar inflows, the debate has concentrated in the second groups of tools, namely, prudential macroeconomic responses, such as sterilized exchange rate intervention and capital controls.

A Taxonomy of Prudential Macro Policies

Ultimately, regardless of whether the exchange rate is thought to be misaligned vis-à-vis current fundamentals (e.g., due to the amplifying effects

of speculative capital flows) or aligned with volatile fundamentals that are likely to change in the near future, the key prudential macroeconomic question remains: *How can macroeconomic policy smooth out excessive exchange rate volatility?*

The past six months have witnessed a few experiments on this front. In Turkey, a cut in the policy interest rate that reduced the carry on the lira, was combined with successive hikes of reserve requirements that kept lending rates high, thereby neutralizing the monetary effect of the rate cut. In Israel, a policy rate hike was coupled with the imposition of a Tobin tax on forward positions, thus detracting from the appeal of the increase in the carry.

Policy menu: intervention and "sand in the wheels"

However, despite what seems to be a increasingly populated menu of alternative measures, for the purposes of the prudential macroeconomic debate, exchange rate-smoothing policies can be usefully grouped into two categories: *intervention* in the foreign exchange market ("buying inflows"), and *sand in the wheels* of portfolio inflows ("taxing inflows"). In the first case, the public sector (the Central Bank or the Treasury) takes the buy side of the dollar market to stabilize the clearing price. In the second one, it discourages the sell side, fending off inflows instead of absorbing them.

Intervention, in the hands of the Central Bank, can take the form of sterilized dollar purchases in the spot market, whereby the Central Bank "issues" peso paper in exchange for dollars, changing the supply and demand in the foreign exchange market (i.e., it meets the speculative demand for peso assets without altering the money supply),[9] and intervention in the forward market, which has no immediate monetary effect and therefore needs no sterilizing open market operations. But the Central Bank does not need to be alone in this effort, because a similar effect could be achieved through balance sheet operations by the Treasury, by issuing peso debt to cancel or buy back dollar debt, or by investing public external surpluses (as in the Chilean Copper Fund) or fiscal surpluses (as in sovereign wealth funds) in foreign assets.

On the other corner, sand-in-the-wheels measures include capital controls –the already- discussed Chilean-type Tobin tax or the equivalent unremunerated reserve requirements on selected foreign inflows,[10] as well as Asian

[9] In practice, the Central Bank seldom issues its own paper; rather, it mops up the pesos injected through dollar purchases by reducing its stock of Treasury securities.

[10] Naturally, this is a particular case of the differential reserve requirements widely used in LAC in the past to discourage dollar intermediation.

-type quantitative caps on cross-border flows and foreign ownership. In addition, within this category we can count microprudential measures, such as limits to banks´ foreign exchange positions and restrictions on dollar lending to non dollar earners, red tape options like reporting requirements of foreign exchange transactions, and the lifting of capital restrictions on outflows (as in the relaxation of foreign asset limits to local institutional investors).

Perhaps more controversially, we can also group under the "tax" umbrella the use of traditional reserve requirements to widen the wedge between the deposit interest rate that determines the currency carry, and the lending rate that governs the transmission of monetary policy, as recently in Turkey (or in Peru up until the September 2008 crisis). Though in principle, this combination of lower rates and higher reserve requirements could be seen as business-as-usual monetary policy, from the perspective of the foreign exchange market, the lower carry is the flipside of a tax, in this case on financial intermediaries (banks), that detracts from the speculative returns of the carry trade much in the same way as a Tobin tax.

Table 2.2 summarizes this taxonomy, the logistics and costs involved, and the recent policy track record in the emerging world.

The Effectiveness of Exchange Rate Interventions

A normative assessment of the optimal degree of intervention exceeds the scope of this report. But a positive question about its effectiveness is a good starting point: Can intervention artificially depress the value of the currency? There is surprisingly little consensus about the capacity of intervention to fend off appreciation pressures; policymakers seem to prefer intervention to benign neglect, despite the skepticism often voiced in academic and policy circles.

Quantifying this effect is not simple, because it entails not only a good account of other factors that may be pressing on both the exchange rate and the level of reserves but also accurate measures of intervention and currency strength. A "conservative" intervention measure that filters out changes in money demand, the annual change of the ratio of reserves to broad money *(M2)* can be defined, for country s and year *t*, as:[11]

[11] Though unlikely, an appreciation can cause reserves to grow if the latter are held for precautionary motives (Obstfeld, Shambaugh and Taylor, 2010), and a stronger currency "deteriorates" the reserve-to-money coverage ratio thanks to valuation changes, inducing dollar purchases. The measure used here controls for that potential bias.

Table 2.2. Policy Taxonomy

Taxonomy	What?	How?	How costly?	Who?
Direct intervention (buying inflows)	Unsterilized central bank purchases	Auction or discretionary purchases	Inflation	**LAC7**: None **Asia**: Infrequently **Elsewhere**: Turkey, Russia, Romania, Baltic pegs, Bulgaria´s currency board.
	Sterilized central bank purchases	Auction or discretionary purchases; sterilization through bill sales or repos; sale of peso paper settled in foreign exchange	Sterilization costs	**LAC7**: Brazil, Colombia, Argentina, Chile, Peru, Uruguay. **Asia**: Singapore, Korea, Taiwan, China, Philippines and Thailand **Elsewhere**: SA, Israel, Egypt, Poland, Hungary.
	Government purchases (stabilization and SW funds; debt de-dollarization and buy backs)	Through state or private sector banks	Fiscal costs (under market arbitrage, similar to sterilization costs)	**LAC**: Chile, Brazil. (Argentina and Peru in the recent past.) **Asia**: None. **Elsewhere**: Poland, Israel (matching dollar debt)
Sand in the wheel (taxing inflows)	Tobin tax on cross-border transactions; withholding tax on non-resident incomes or capital gains	Law or decree	Lower market liquidity	**LAC**: Brazil (6% IOF), Chile (4% withholding tax), Colombia (33% withholding tax), Peru (5% WHT on up to 60d NDFs) **Asia**: Philippines (20% withholding tax), Thailand (15% withholding tax), Korea (14% withholding tax), India (30% maximum withholding tax). **Elsewhere**: Egypt (20% withholding tax) **LAC**: Argentina (30% of foreign inflows, albeit with multiple exceptions), Brazil (60% RR on banks' short spot USD positions), Peru (60% RR on short-term bank borrowing).
	Unremunerated reserve requirements on foreign inflows	Law or decree	Wider interest rate margins	**Asia**: Indonesia (increase RR on IDR and FX deposits), China hiked RRR 6 times by 300bp since Dec 2009 **Elsewhere**: Israel (10% on local bank foreign exchange derivative transactions with non residents). **LAC**: Argentina, Colombia, Brazil, Peru.
	Quantitative restrictions on foreign access to local markets	Financial market regulation	Lower market liquidity	**Asia**: Taiwan (restricting FINI from buying bonds), India (outright FII level limits), Indonesia (SBI min holding period) and Sri Lanka (proportional limit for offshore holding) among others. Elsewhere: None. **LatAm**: Almost all
	Limits on residents´ foreign exchange exposure	Banking regulation on banks´ currency positions; restrictions on dollar lending to non dollar earners.	Higher ex ante borrowing costs	**Asia**: Korea (limits on FX forward exposures), Indonesia (limits on short term FX borrowing). **EMEA**: SA, Hungary, Poland **LatAm**: Peru.
	Reserve requirements as a substitute for interest rate hikes	Monetary policy decisions	Wider interest rate margins	**EM Asia**: Rarely. In many cases, rate gradualism reflects fear of appreciation. **EMEA**: Turkey.

$$Intervention_{s,t} = R2_{s,t} - R2_{s,t-1}$$

where

$$R2_j = \frac{Foregin\ Assest_j - Foreign\ Liabilities_j - Gov.Deposits_j}{M2_j}$$

As for currency strength, given that there seems to be no single measure that can at the same time summarize the competitiveness effect and the fact that in most cases the policy target is a bilateral nominal exchange rate rather than a real effective one, we prefer to use a number of alternative options.

Intervention does work, marginally

Does intervention lead to a weaker currency, relative to the non intervention case? Yes, it does–marginally. From the results reported in table 2.3, intervention in Peru in 2007 (9 percent, according to the measure defined above) had an estimated effect of 2.7 percent on the GDP-adjusted RER and 1.1 percent on the REER.

Table 2.3. Does Intervention Matter for Exchange Rates?

				3-Year Averages		
	Bilateral RER		REER	Bilateral RER		REER
	PPP	GDP	IMF	PPP	GDP	IMF
Intervention	0.122 ***	0.304 ***	-0.141 **	0.277 ***	0.504 *	-0.412 **
	(0.035)	(0.108)	(0.071)	(0.076)	(0.275)	(0.168)
Observations	2,271	2,039	1,155	791	746	428
R2	0.803	0.975	0.639	0.827	0.978	0.673

Note: Sample period: 1974–2007. PPP = purchasing power parity-adjusted RER are from the Penn Tables. GDP: RER adjusted by the GDP deflators. REER: real effective exchange rate from IMF. Panel regressions, including the following additional controls: terms of trade, trade-weighted GDP of trading partners, the financial account over GDP ratio, and year dummies. All variables in logs. Robust standard errors in parentheses. * significant at 10%; ** significant at 5%; *** significant at 1%.
Source: These regressions update work first reported by Levy-Yeyati and Sturzenegger (2007).

What about the cost? As we documented in our previous *Brookings Latin American Economic Perspectives (BLEP) Report*, the conventional view that intervention is too costly due to wide sovereign spreads or heavy quasi-fiscal losses appears to be overstated–even more so if one considers the benign effect of reserves on credit ratings and sovereign spreads. Moreover, the carrying cost can be further reduced by investing in higher-

yielding long-run saving instruments as in the case of sovereign wealth funds, because prudential macro policies do not require reserves to be held in short, low-yielding liquid assets. At any rate, as a careful analysis of the realized cost of intervention reveals, they appear to be quite smaller than originally thought.[12]

The Effectiveness of Tax-Based Capital Controls

Of all the sand-in-the-wheels options, the one that best fits the macroprudential mandate-and the only one endorsed by mainstream economists and the IMF –is the tax-based control on capital inflows of the type introduced in several Latin America countries in the mid- 1990s. This modality usually takes the form of an unremunerated reserves requirement (URR) on capital inflows, and is virtually identical to a Tobin tax– so much so that back in the 1990s, the Chilean and Colombian authorities offered the option of an upfront payment tax in lieu of the URR to those investors with a stronger preference for liquidity.

The Latin American experience with tax-based controls generated more than a few empirical attempts to quantify its effects.[13] Perhaps the simpler approach is the one proposed by De Gregorio, Edwards and Valdés (2000): the difference between the (90-day) UF-U.S. dollar forward discount and interest rate differential (i.e., the deviation from covered interest rate parity), which during the period of controls oscillated between 2 and 3 percent, in line with the value of the equivalent Tobin tax during the period, calculated by the authors in the paper (figure 2.6).[14] In other words, the rate differential widened proportionally to the strength of the URR, as intended.[15]

Another way to gauge the same effect is by comparing prices of identical assets trading domestically and abroad, for example, stocks and Ameri-

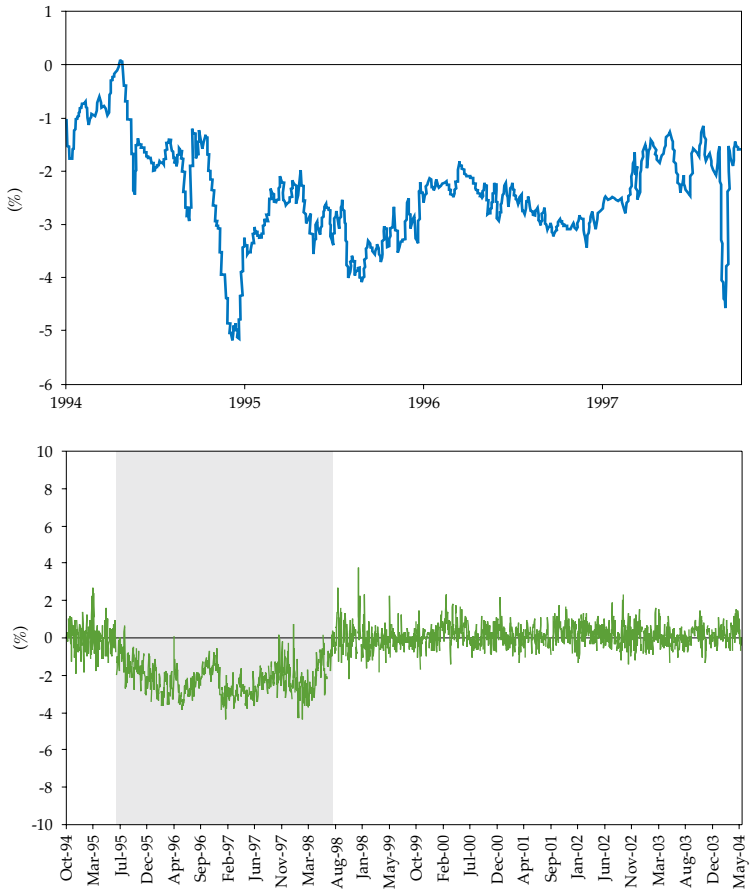
[12] See Cárdenas and Levy-Yeyati (2010) and references therein.

[13] See, among others, Cardenas and Barrera (1997), De Gregorio, Edwards and Valdes, (2000), Edwards (1999), and Gallego and Hernández (2003).

[14] The Unidad de Fomento (UF) is indexed to the Chilean CPI.

[15] Indeed, the higher domestic interest rates sometimes highlighted by control skeptics (Forbes 2003) could be seen as a prima facie proof of their effectiveness.

Figure 2.6. Chile: Forward Discount versus Interest Rate Differentials in Times of Controls



Note: The graph on the top shows the difference between the 90-day UF-U.S. dollar forward discount and the interest rate differential (De Gregorio, Edwards and Valdés 2000). The graph on the bottom shows the percentage difference of the price of the stock in the domestic market and the corresponding American Depository Receipts (ADR) on the New York Stock Exchange (Levy-Yeyati, Schmukler and Van Horen 2009).

can Depository Receipts (ADRs).[16] Assuming expected return arbitrage across markets, the percentage price discount between the (underlying) shares in Santiago and the corresponding ADR in New York (the *cross-*

[16] ADRs are shares of non-U.S. corporations traded in the U.S. (and denominated in dollars), while the underlying shares trade in the domestic market of the issuer. ADRs are issued by a so-called depositary bank in the U.S. and represent a specific number of underlying shares remaining on deposit in a custodian bank in the issuer's home market.

market premium), can be attributed to transaction costs including, most notably, the 3 percent Tobin tax, as the international investor demands a compensating 3 percent yield premium (a 3 percent price discount) from the stock in Santiago. This is precisely what is found in the data during the period of controls (the shaded area in the graph on the right in figure 2.6), where it can be seen how the ADR premium rises and declines reflecting the intensity of capital inflows.[17]

Capital controls are effective, again marginally

Are controls effective? Yes, because they impose a toll on traffic in and out of domestic markets. How effective are they? As with exchange rate intervention, the impact of controls will be small if they are administered in small doses. For example, a 2 percent tax will not obtain much more than a 3 percent cut in the value of local assets (including the local currency); a 10 percent tax will obtain a proportionally (but probably not linearly) stronger effect. A 2 percent tax opened to adjustments (as the IOU recently introduced in Brazil) should have an effect in between, as it affects the expectations and should keep the position of short-term speculative investors relatively light.[18]

What Is a Small Open Economy to Do?

From the discussion above, it follows that, from the perspective of an emerging economy, the question at the origin of countercyclical (prudential) macro policy is not so much whether the exchange rate is currently misaligned as whether it is likely to be misaligned in the future, and by how much. If ERERs change over time, in line with country fundamentals such as the NFA or terms of trade that reflect short-term influences that are both financial (risk appetite, the world interest rate cycle, the U.S. dollar), and real (the world business cycle, China), what is a small open economy to do to reduce the exposure to those factors?

In theory, one could address this question by decomposing fundamentals into a permanent and transitory component and use the permanent component to calculate the ERER and detect potential deviations. However, this is

[17] The same measure can be readily applied to assess the effect of quantitative limits on capital flows, like those that characterized emerging Asia in the 1990s, or, more recently, the ones imposed in the midst of the Argentine crisis in 2002 (Levy-Yeyati, Schmukler and Van Horen 2004).

[18] An additional finding of the empirical literature on tax-based controls points to their benign composition effect (the lengthening of cross-border transactions), which, to the extent that it lowers flow volatility, should have positive prudential implications.

easier said than done. While it is intuitive to see that the interest rate cycle in the U.S. or the euro zone is bound to come to an end in the near future, it is much harder to forecast a Chinese deceleration or the evolution of the demand from biodiesels, two critical inputs to time the end of the grains up cycle. Moreover, the ERER is a multilateral concept; by definition, any short-term deviation will depend on other countries' performance, including their own prudential macro response to exchange rate pressures –an aspect that insinuates the benefits of the always-elusive macroeconomic coordination. Perhaps for this reason, prudential macro policies have been–and will likely continue to be–an erratic and exploratory affair.

Ultimately, an unbiased look at the available evidence on exchange rate-smoothing policies appears to indicate that they are not as powerful as fervent proponents would argue, nor as damaging as opponents would claim. But are they efficient? They probably are, if the objective is to mitigate the impact of transient global factors on domestic cycles, and to prevent asset inflation and overvaluation that are costly to revert in the down cycle. Rather than as a temporary last-resort option, as they are often characterized by mainstream analysts (Ostry et al. 2010), we see these policies, together with microprudential and macroprudential regulation on financial intermediaries, as an essential part of the macroeconomic toolkit to ensure that globalized emerging economies are the beneficiaries of financial integration and not its victims.

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CHAPTER 3

Country Analyses

Argentina After Nestor Kirchner: The Export-Led Model In Reverse

Argentina still surprises on the upside...

In Latin America, Argentina's growth is somewhat of a puzzle for mainstream analysts, because it is a country that contradicts (at least rhetorically) most tenets of the macroeconomic toolkit and yet does not cease to surprise on the upside. These surprises are due in part to the very unorthodoxy of the country's decisions, which underlie the negative bias it is assigned by both markets and the media. Thus, whereas Brazil is the poster child of what *The Economist* has called–prematurely, in our view–the Latin American decade, Argentina (which did not make it to *The Economist*'s Latin American dream team) is depicted as little more than a basket case of misguided policies comparable to Venezuela and Ecuador.

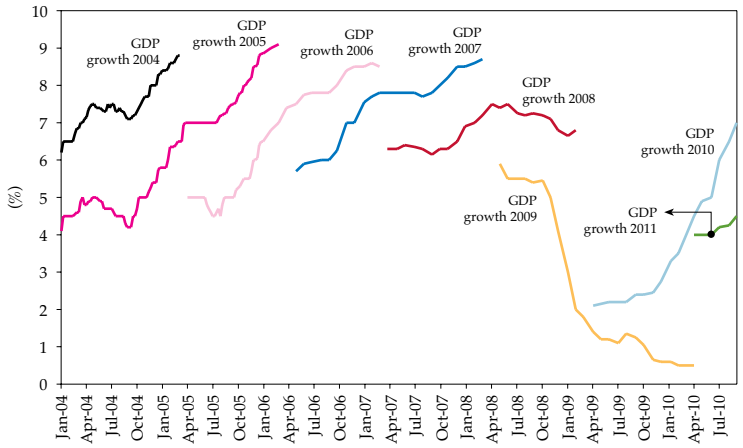
Figure 3.1 provides a simple numerical illustration of this bias, by tracking the market growth forecasts over time (as collected for the expectations survey of the Central Bank of Argentina).[1] With the predictable exception of 2009, when the country was hit by the global crisis, analysts have been revising up expectations as time goes by–pushing the "inevitable" but elusive growth deceleration further down the line.

...but current automatic pilot is not sustainable

Given this track record, any observer will be best advised to think twice before writing off Argentine growth. However, economic history seldom repeats itself; as we highlighted in our last *Brookings Latin America Economic Perspectives (BLEP)* report, the gradual erosion of the twin fiscal and external surpluses generated in the aftermath of the 2001 crisis, coupled with increasingly inertial inflation, makes the current automatic pilot nonviable for the medium term. And though nothing is likely to happen before October's presidential election, we believe that this time something will have to give on the macroeconomic front. In this section, we describe the key pressure points that the next administration will likely face, and discuss possible alternative paths.

[1] The figure shows, at each point in time (horizontal axis), the growth forecasts for the current and the following years included in the survey. Forecasters include both local analysts and top international investment banks.

Figure 3.1. Keeping Up with the Kirchners: Argentina's GDP Growth, 2004-9



Source: Author's calculations using Central Bank of Argentina data.

The Comeback of the External Front

When discussing Latin America in the 2000s, one needs to be aware of the many structural changes that have changed the regional landscape for good–among them, dramatic improvement in the countries´ financial balance sheets. In this, Argentina is no exception; by most accounts, once debt cross holdings within the public sector are netted out, sovereign debt-to-GDP ratio by the end of 2011 is in the range of 15 to 20 percent.

The current account has the leading role in Argentina...

But that does not mean that the external front should play no role for the upcoming administration. On the contrary, the current account has remained an important cushion for two reasons. First, it has provided a flow of foreign exchange that dispels expectations of a dollar run in times of financial distress (e.g., during the 2007 farmers' conflict, the 2008 nationalization of pension funds and the 2009 global recession). More recently, in 2010 and 2011, it contributed to the financing of the fiscal deficit by the Central Bank through the annual transfer of $7.5 billion in reserves.

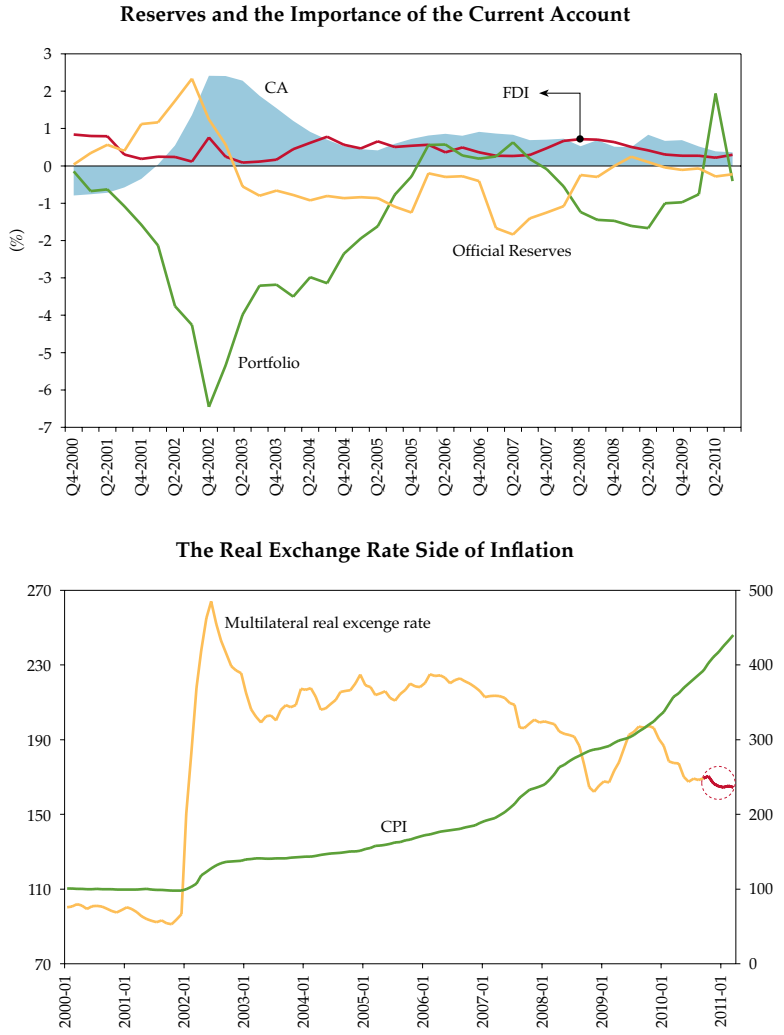
A key distinctive aspect of the Argentine model (in contrast to, say, that of Brazil) is that dollar inflows came from the current account, and not from a capital account that, due to a historical pro-dollar bias that fueled portfolio outflows and a less-than-friendly official rhetoric that fended off portfolio inflows, systematically printed deficits in the past decade (compare the top graph in figure 3.2 with figure 1.3). This is more than just accounting; if the current account ceased supplying the needed foreign exchange,

it is not obvious that the country could rely on foreign capital to balance the external sector without reserve losses or an exchange rate correction.

...but is losing strength due to real appreciation

What is driving the deterioration of the current account? On the one hand, the overheated economy is running at full capacity in many sectors, which results in an increase in imports that outweighs the growth in

Figure 3.2. The Comeback of the External Front in Argentina

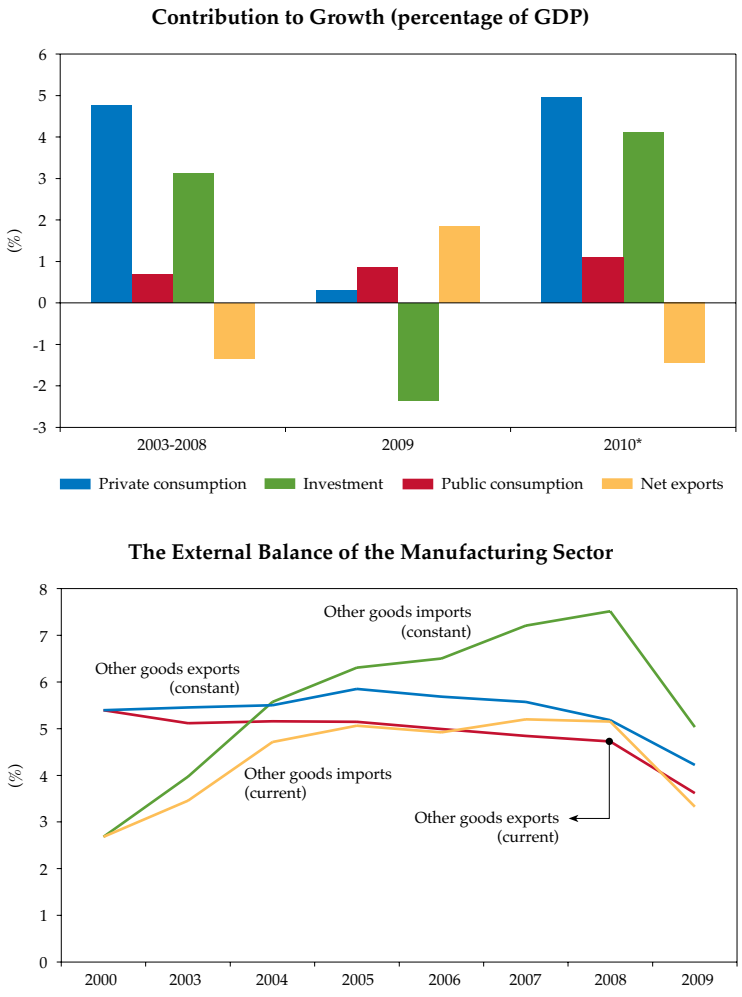


Note: Multilateral real exchange rate is trade weighted based on real bilateral exchange rates vis-à-vis Brazil, Chile, China, Mexico, the U.S. and the euro zone. Due to official misreporting, from January 2007 the consumer price index is estimated based on official figures from provincial INDEC branches Negative change in reserves implies accumulation of official reserves.
Sources: Author's calculations based on data from IMF's International Financial Statistics and Haver Analytics.

export receipts–despite improving commodity prices. On the other hand, the growing real exchange rate appreciation (see the bottom graph in figure 3.2) reflects not only demand factors (pressures associated with the overheating) and supply factors (the pass-through of international food and energy prices) but also, and perhaps more importantly, the surge in inertial, backward looking inflation that, in the absence of income policies, may add as much as 15 percent to the headline number.

Indeed, despite help from an undervalued currency, Argentina's growth has been driven by domestic consumption since the beginning of the postcrisis recovery (see the top graph in figure 3.3). The underlying dy-

Figure 3.3. The Export-Led Model in Reverse in Argentina



Source: Author's calculations based on INDEC data.
Source: Author's calculations using data from the Central Bank of Argentina.

namics are easy to understand: A considerable external surplus in the agricultural sector (captured by the government through export taxes) and a reasonably successful tax performance, redistributed through wage increases and social protection plans (e.g., the universal child allowance and increases in pensions and pension coverage) leading to a consumption boom that created new jobs, reinforcing the stimulus.

In this context, productivity gains in the primary sector coupled with a commodity boom were enough to fund growing import shares–albeit at the expense of growing external deficit in manufacturing (figure 3.3). Indeed, a closer look at the external balance for the manufacturing sector shows the upward trend of the import-to-GDP ratio–which temporarily abated due to the 2009 GDP contraction–coupled with a stagnant and ultimately declining export ratio (see the bottom graph in figure 3.3). In sum, one sees a pattern that looks like the negative of an export-led model: one in which positive terms-of-trade shocks compounded by an undervalued currency, rather than building up competitiveness elsewhere in the economy, subsidized domestic demand for noncompetitive sectors.

Inflation, Consumer Credit and the Demand for Durable Consumer Goods

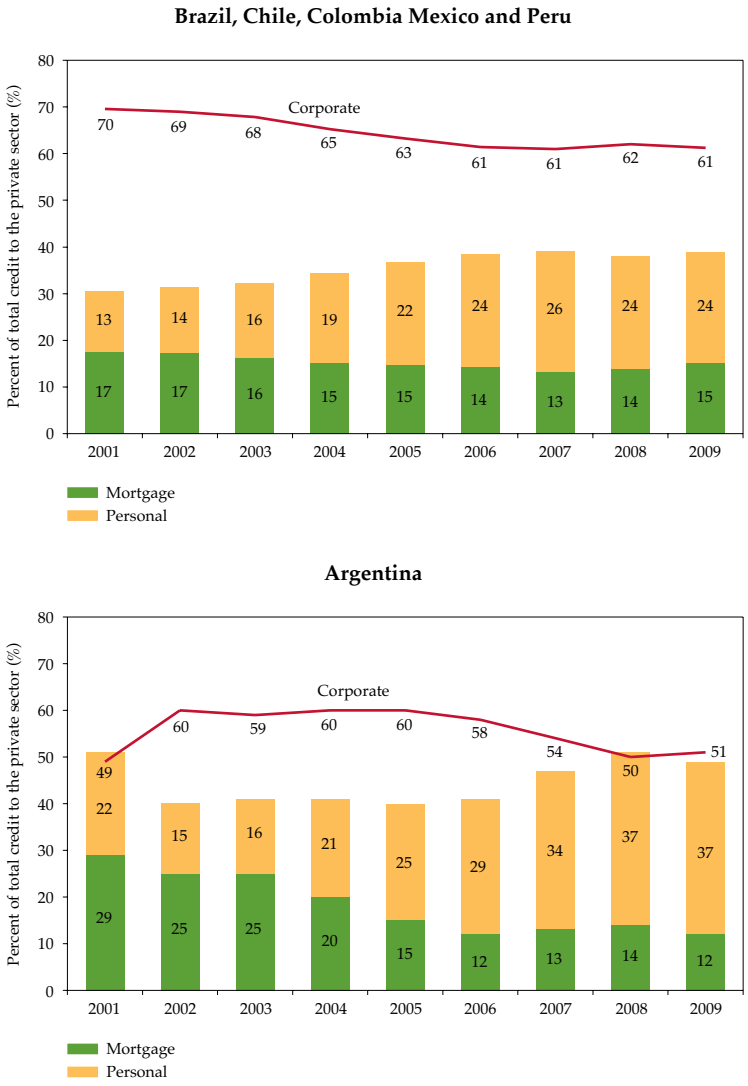
Consumer lending is prolonging the expansion

An often-downplayed aspect of the domestic market-driven model to which Argentina (and, to a lesser extent, the region) has been heading is the role of private credit–in particular, its growing bias toward personal loans for the purchases of durable consumer goods (such as cars and large domestic appliances) at the expense of corporate (commercial) and mortgage loans (figure 3.4).

The evolution away from financing supply (i.e., investment in productive capacity) into financing demand (i.e., intermediating households' deposits into short-term consumer and credit card lending to the same households) is a well-known pattern in commercial banking across the world (and, certainly, in the rest of the LAC-7).[2] However, though most developed and advanced emerging economies make up for this deficit

[2] Technological innovation facilitated the pooling of standard personal and mortgage loans through securitization (at the expense of customized corporate loans) and relaxed geographical barriers inducing banking competition and consolidation-an influence reinforced by an increasingly tight prudential regulation that was relatively more costly for smaller institutions. At any rate, these factors have led to a gradual shift from "relationship" to "arm's-length" banking based on credit records and scoring, and from the funding of supply (investment) to the funding of demand (consumer and credit card loans, and household mortgages).

Figure 3.4. Argentina's Bank Credit Compared with Selected Other Countries (percentage of total credit to the private sector)



Source: Author's calculations using data from national statistical bureaus and Central Banks of Argentina.

in investment finance with growing capital markets or, in many cases, development banks and agencies, in Argentina, by failure or design, none of these options is available.

Inflation has deepened this bias in two ways: (1) by inhibiting the recovery of the mortgage market, and (2) by inducing those consumers who

lack the saving capacity to invest in real estate to "save" in consumer durables as a very imperfect store-of-value substitute.[3]

As a result, sales of cars and other consumer durables have been booming, accounting for a big part of last year's (and possibly, this year's) growth. More generally, the financial sector has been instrumental in fueling consumption at a pace that exceeded GDP, narrowing the trade surplus despite the country's solid agricultural performance and the steady increase in commodity prices.

Where Will the Dollars Come From?

Presidential elections are momentous

At any rate, unless the country finally accesses international capital markets, it is difficult to see where the $7.5 billion in Central Bank reserves transfers will come from in the next few years. The scenarios will be starkly different, depending on the October elections results. If a new administration is elected, one would expect, in most cases, two main policy changes: an explicit inflation policy (a mix of inflation targeting "lite" and income policies to reduce backward indexation), and a more proactive engagement with international markets that, by funding the incipient current account deficit, would provide space for a moderate use of an exchange rate anchor.

The options appear less clear if the current government is reelected. Because of the apparent inconsistency between inflationary growth (more precisely, real appreciation) and the need for an undervalued currency (more precisely, the need for export dollars) in the absence of market access, many observers have started to speculate that there might be an exchange rate correction right after the elections. But the inflationary consequences of a depreciation (alternatively, the need to preserve the exchange rate anchor) are likely to limit any recourse to this option. Moreover, the premium on Argentine assets, demanded by the financial markets despite a solid and continuously improving financial balance, could only be attributed to concerns about the official rhetoric and style. To that extent, should the government try to access international capital early next year, it may find that markets are less willing to lend then than they were at the end of 2010, when the chances of a political renewal–either within the government or in the coming elections–fueled a brief rally.

Against this backdrop, the most likely scenario would be a moderate fiscal adjustment, in the form of government spending rising by less

[3] Due to inflation misreporting that rendered CPI indexation useless, and to a loose monetary policy that kept interest rates artificially depressed, there is an ostensible lack of savings instruments to protect against rising inflation.

than the current 40 percent, possibly aided by a tariff adjustment (and the concomitant reduction in utilities and transportation subsidies) and by partnering with the private sector to finance public investments that are now funded from current revenues. These marginal tweaks to the old model may help push backward the solution to fundamental issues such as inflation policy and government finance, shifting the pressure point to the midterm election year 2013. At any rate, it remains to be seen whether and to what extent the Argentine government has the ability to adapt to an increasingly tight macroeconomic context in a more permanent way.

Brazil: New Government, New Policies?

There is not much space for further monetary tightening

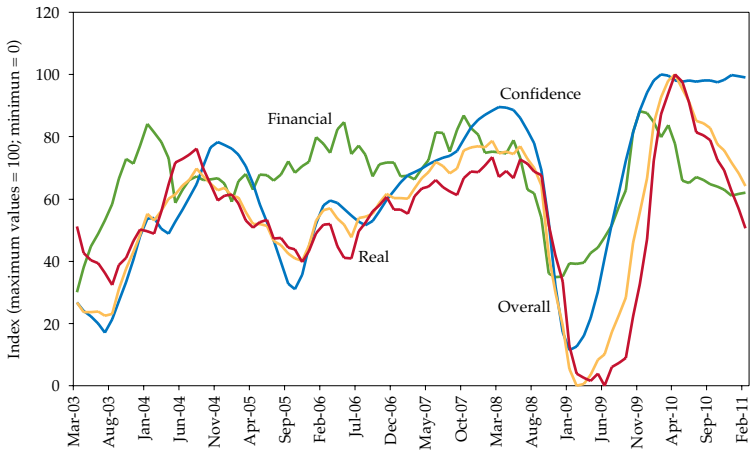
The largest economy in Latin America appears to be overheating. Record high food prices, loose fiscal policy and limited monetary policy space due to already-high interest rates have combined to create a situation where Brazil's inflation/growth trade-off –its modest noninflationary growth potential, which we flagged in our latest BLEP–is back on the front seat. The Dilma Rousseff government will be thoroughly tested in the coming year as the need for fiscal consolidation becomes apparent to policymakers, as noted by the government's announced R$50 billion cut in the 2011 budget. After an extended period of countercyclical fiscal policies that were initially designed and supported in response to the crisis, two years of high government spending and loose credit have been helping to push inflation and inflation expectations upward. Global food and commodity prices along with record low unemployment and wage pressures are also helping push up prices.

Tight monetary policy, as evidenced by already high interest rates and reserve requirements, leaves little room for rates to go much higher, especially when capital inflows and exchange rate pressures are already strong. In the need to control inflation, we see in Brazil that the combination of tight monetary policy and loose fiscal policy can no longer work, putting fiscal policy up to the challenge.

Losing Steam: Slower Growth

Given that much of the recent sources of growth, such as public spending and cheap credit, are not sustainable drivers over the long term, Brazil will likely experience a slowdown in growth this year as inflationary pressures pick up. In fact, our updated sector index analysis Index for Brazil shows that the slowdown is already under way (see figure 3.5).[4]

Figure 3.5. Sector Index Analysis for Brazil, 2000-2011 (Principal Component Analysis Index)



Sources: Author's calculations based on data from the World Bank, International Monetary Fund, International Labor Organization, Economist Intelligence Unit and Organization for Economic Cooperation and Development.

The sky is the limit for confidence in Brazil...

Although the principal component analysis for Brazil shows an overall economic slowdown, confidence however, appears to remain very strong. Of particular importance, though is the strength of Brazilian confidence (especially consumer more than business confidence), which has been at its highest levels during the past decade, is one of the country's main assets, it is also a key indication that policymakers need to tame inflated expectations.

...but not so for output and employment

By contrast, the Real Index has been slowing down with declining industrial production, imports and GDP growth during the most recent quarter. Although the unemployment rate has recently hit record lows, employment growth is tapering off. In the Financial Index, although the sovereign bond interest rate spreads are low, equity market indices are back to where they were a year ago, and much of the decline in recent months has been partly due to inflation concerns and, more recently, global risk aversion.

[4] The sector index analysis, as introduced in the September 2010 BLEP, looks at a set of economic indicators to help keep a pulse on the speed of an economy's real economic activity, its financial sector and overall confidence as measured by consumer and business confidence. The Real Index, measuring the speed of growth in the real economy, looks at annualized growth rates of trade, industrial production, employment, and GDP, and the Financial Index looks at growth in equity market indices and at sovereign bond interest rate spreads over U.S. treasuries.

Fiscal Consolidation and Monetary Policy

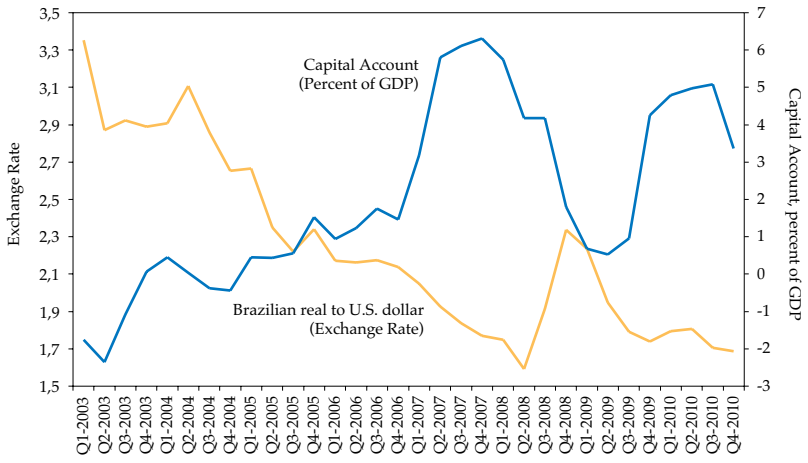
The need for fiscal consolidation stems primarily from rising pressure on inflation and the already-tight monetary policy's limited ability to tighten even further. As indicated by lower government bond spreads and historically low country risk, the calls for fiscal adjustment are not centered on the government's solvency but on the need for fiscal policy to support monetary policy in the battle against inflation. It is also important to recognize that cheap credit and public spending constitute an unsustainable source of growth in the long term.

The Central Bank needs a hand from the Treasury

As can be seen in figure 1.5, the benchmark SELIC policy interest rate, currently standing at 11.75 percent, is the highest among all inflation targeting regimes in Latin America. Reserve ratio requirements, which were last increased in December 2010 from 15 to 20 percent, are also already high by international standards. For the Central Bank of Brazil to take new action in an attempt to tackle inflation, it would need to raise rates even higher. And this, despite the 6 percent IOU tax on cross-border transactions, would likely promote more capital inflows and added pressure on a real that has remained stable of late but has appreciated relative to the dollar almost to precrisis highs, as shown in figure 3.6. The Central Bank's limited policy space is therefore clear, calling upon the fiscal side to step up and tighten its position in order to curb the looming threat of inflation.

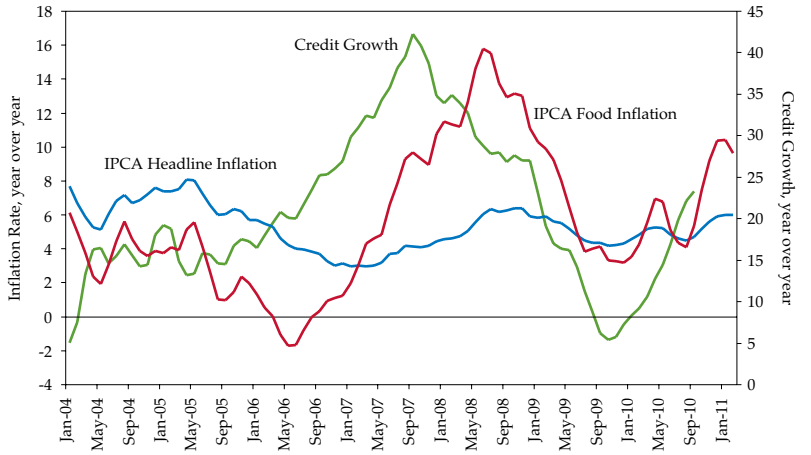
As figure 3.7 shows, there was a rapid buildup in credit before the crisis that is now continuing, and is surely a contributor to the rising pressure

Figure 3.6. Brazil's Exchange Rate and Capital Account, 2003-10



Sources: IMF, Balance of Payments Statistics; IMF, International Financial Statistics.

Figure 3.7. Inflation and Growth in Credit to Brazil's Private Sector, 2004-11



Note: Credit growth is based on three-month moving averages.
Sources: Brazilian Institute of Geography and Statistics; CEIC Data Company Ltd; IMF, International Financial Statistics.

on prices. The correlation with food price inflation is also interesting to note. Imported price shocks have not been accommodated with an appreciated exchange rate (as was the case in the years that led to the 2008 crisis) as this time around a more stable currency has been the result of more foreign exchange intervention and controls on capital inflows.

Although the government has declared the need for an adjustment in public spending, it has also declared that spending on social programs and investments in the Growth Acceleration Program would not be cut, and its ability to reduce wages, a major source of expenditures, is limited at best. To help deal with inflation expectations, which have been yet another source of price pressures, clear steps need to be taken to tighten fiscal policy (see figure 1.5).

As we pointed out in the September 2010 *BLEP*, one area outside Brazil's self–imposed restrictions on limiting expenditures involves its lending to and support for public development banks, most notably the Brazilian Development Bank (BNDES). Scaling back funding to the BNDES will, on the one hand, contribute to the government's goal of reigning in expenditures and, on the other hand, slow down the rapidly growing rate of cheap credit made available to the private sector. Moreover, a more limited participation of BNDES fixed-rate lending in credit markets would enhance the effectiveness of monetary policy-one of the key reasons why

Brazilian real interest rates have traditionally been among the highest in the emerging world.[5]

It is time for BNDES to unwind

As we emphasize throughout this *BLEP*, recoveries are the litmus test for countercyclical policymakers. BNDES credit and liquidity boomed countercyclically during the crisis to compensate for the retreat of private lenders. With the economy returning to normalcy and inflation concerns growing, it would be logical to expect the BNDES to unwind part of this extraordinary lending and let private banks step back in. An increase in the marginal cost of borrowing and a fall in the supply of credit should help fight inflationary pressures, strengthen the effectiveness of monetary policy and free up the fiscal resources that can lower the deficit.

In sum, in a context of incipient overheating, the relationship between tight monetary policy and loose fiscal policy is no longer working in Brazil, where food prices, credit growth and wage pressures are helping to drive up prices and inflation expectations. Fiscal consolidation–which includes a countercyclical BNDES retrenchment–appears to be the natural recipe for Brazil in 2011. Although this will help improve the effectiveness of the country's monetary policy without severely undermining its economic growth, the government will need to make a concerted communication effort after years of inflated expectations. If selling Brazil was one of Luiz Inácio Lula da Silva's main tasks as president, containing the country's sometimes unwarranted excitement has now become one of President Dilma Rousseff's assignments.

Chile: What Changed, And What Did Not?

Igal Magendzo and Alejandro Micco

Crisis and Recovery

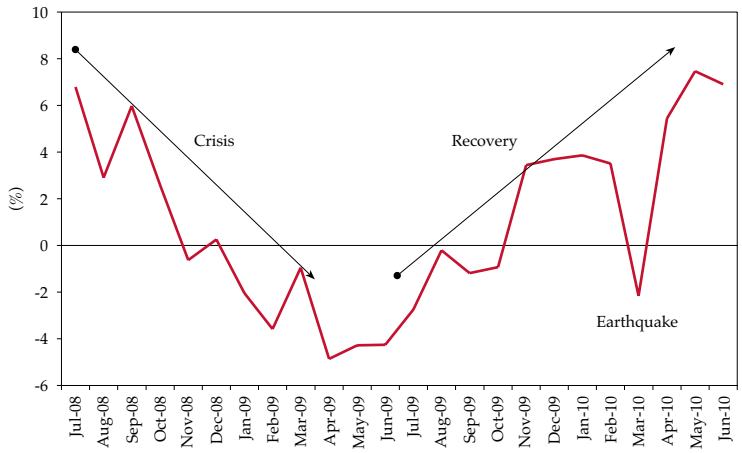
The global financial crisis had strong consequences for Chile's economy. Exports contracted by the equivalent of 14 percent of GDP in the last quarter of 2008 and the first quarter of 2009, while the cost of and access to external credit abruptly deteriorated. In the fourth quarter of 2008, the economy contracted by 2.3 percent compared with the previous quarter (corrected for seasonality and working days).

[5] As the BNDES supply is scaled back, private borrowers would need to resort to nonsubsidized credits, therefore raising both lending rates and their sensitivity to the SELIC policy rate.

Nevertheless, strong initial conditions made possible a rapid and strong policy response. In January 2009, Chile was one of the first countries to react to the global crisis by announcing an extraordinary fiscal expenditure plan of $4 billion (2.8 percent of GDP). The Central Bank aggressively reduced its monetary policy rate by 775 basis points over the course of 2009, bringing the Central Bank's interest rate to a historic low of 0.5 percent.

While the recovery was under way, one of the strongest earthquakes in recorded history hit Chile in February 2010. Nevertheless, the earthquake affected a region with a relatively low share of total capital stock and output. A month later, positive growth had resumed (see figure 3.8).

Figure 3.8. Chile's Monthly Economic Activity Index (year-on-year percent change)

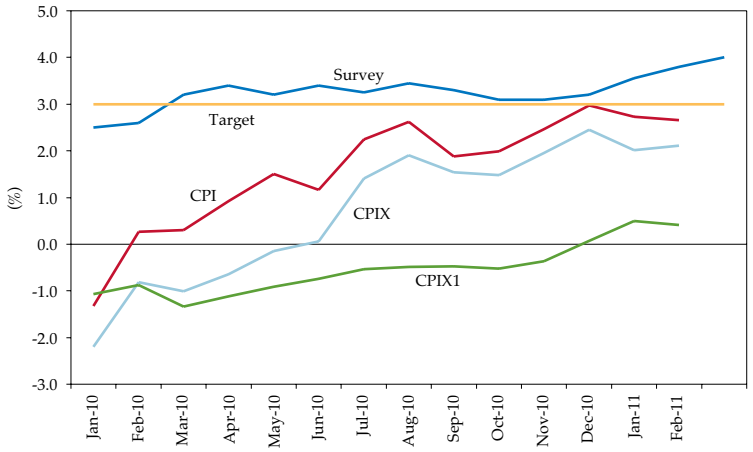


Source: Central Bank of Chile.

Where Does the Country Stand?

Between April 2010 and January 2011, Chile's economy expanded by an average of 6.4 percent, capacity gaps were closing and the unemployment rate fell from 11.6 percent in mid-2009 to almost 7 percent at the end of 2010. This expansion has been led by internal demand (17 percent), favored by strong terms of trade, low international interest rates and falling unemployment, as well as expansionary monetary and fiscal policies. The rapid expansion of internal demand and GDP, in conjunction with higher commodity prices (especially for food and oil) has led to mounting inflationary pressure (figure 3.9). CPI inflation has gone from negative during 2009 to close to 3 percent. Inflation expectations have been going up as well, especially for the short run.

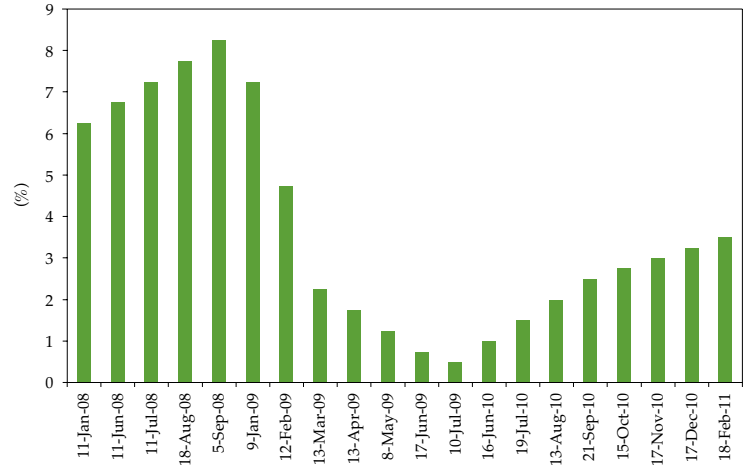
Figure 3.9. Inflation, Core Inflation and Expectations in Chile



Note: "Survey" refers to market analysts' expected inflation for one year ahead.
Source: Central Bank of Chile.

Notwithstanding this scenario of closing gaps and increased inflation, both monetary and fiscal policies continue to be expansionary. The Central Bank in mid-2010 started a gradual normalization of its monetary policy, reaching 3.5 percent in February 2011 (figure 3.10), still well below the neutral rate (estimated at about 6 percent). The Central Bank has announced that it will continue to reduce the monetary stimulus throughout 2011.

Figure 3.10. Chile's Monetary Policy Rate, 2008-11

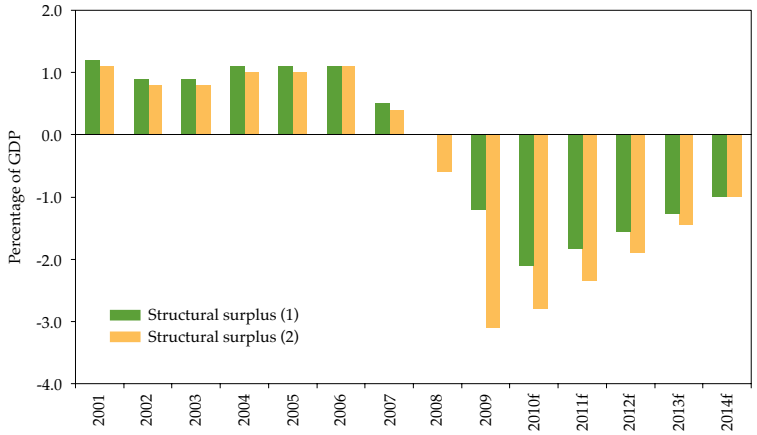


Source: Central Bank of Chile.

Chile has recently departed from its fiscal rule

Fiscal policy has continued to be strongly expansionary. In 2009, the structural fiscal rule–which had framed Chile's fiscal policy since 2001–was abandoned in order to inject a stronger fiscal stimulus during the global crisis. This departure from the rule was supposed to be temporary, but during 2010 government spending grew 7 percent in real terms and the structurally adjusted deficit reached 2.1 percent of GDP. For 2011, the government budget contemplates a real expansion of spending of 5.5 percent, consistent with a structural deficit of about 2 percent of GDP. The government has announced structural deficits to continue at least until 2014 (figure 3.11).

Figure 3.11. Chile's Structural Fiscal Deficit



Note: The blue bars show structural surplus (1), according to the 2009 methodology; the red bars show structural surplus (2), according to the Structural Balance Committee, 2010.
Source: Chilean Ministry of Finance.

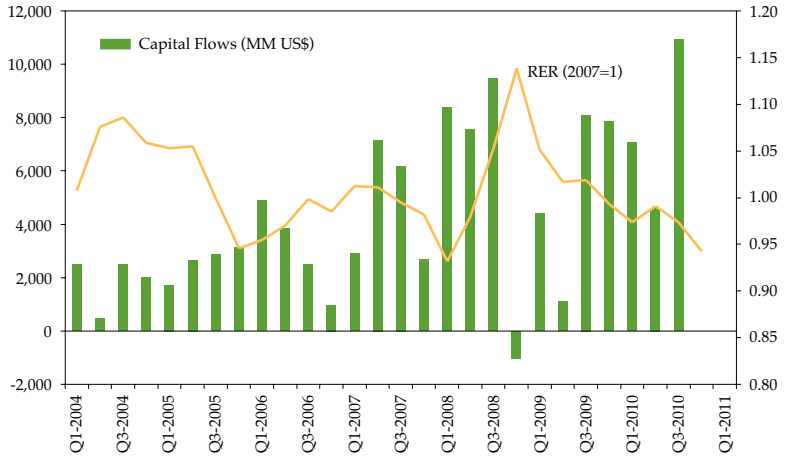
Policy Mix

As the Central Bank has increased its Monetary Policy Rate from 0.5 to 3.5 percent, there has been a rapid increase in capital flows to Chile (figure 3.12). At the same time, commodity prices have surged, reaching all-time highs for some metals, including copper, whose price went from just above $1.00 a pound at the beginning of 2009 to more than $4.10 a pound in February 2011. This has implied an important wealth effect for the economy, and an important increase in tax revenue for the central government (in 2010, Chile increased the mining tax from an average of 4.5 percent to almost 9 percent of profits).

By the end of 2010, the Central Bank viewed the real exchange rate as "fairly close to the minimum levels considered consistent with its long-

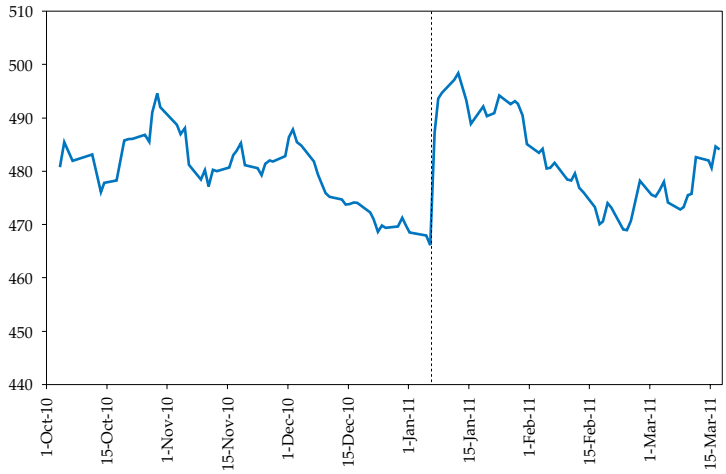
term fundamentals." Therefore, it decided to intervene, increasing its international reserves by $12 billion, reaching a level of reserves equivalent to 17 percent of GDP. This intervention is being carried out through daily auctions of $50 million. The nominal exchange rate depreciated about 7 percent immediately following this announcement (see figure 3.13). This, in turn, fed additional inflationary expectations.

Figure 3.12. Chile's Capital Flows and the Multilateral Real Exchange Rate (RER), 2004-11



Source: Central Bank of Chile.

Figure 3.13. Chile's Nominal Exchange Rate, 2010-11



Note: Line signs the intervention date. Bilateral nominal exchange rate with the U.S. dollar. The vertical dotted line mark the intervention announcement.
Source: Central Bank of Chile.

At the same time, as mentioned above, signs of a tight labor market and overheating economy are starting to emerge, pushing the Central Bank to consider tightening policy faster than previously expected. The resulting interest differentials may lead to additional capital inflows and will intensify current policy dilemmas, between inflation control and further upward pressure on the peso.

Chile should return to a structural fiscal surplus of 0.5% of GDP

In this scenario, fiscal policy has sent timid signal aiming to reduce expectations of continued appreciation resulting from the terms-of-trade gains, global liquidity and interest rate differentials. To contain a further appreciation of the Chilean peso, the fiscal policy should reach the precrisis annual structural surplus target of 0.5 percent GDP before 2014.[6]

Final Remarks

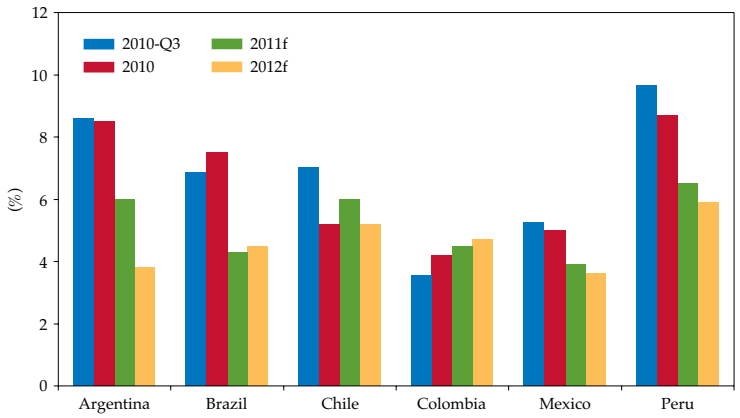
Before and during the global crisis Chile ran an aggressive countercyclical fiscal policy. This was reflected in enormous fiscal savings in the years of commodity price boom preceding the crisis and a strong increase of fiscal spending during the crisis. The Chilean case shows that unwinding expansionary fiscal policy is not an easy task. The newly elected government made campaign promises of achieving high growth and low unemployment relatively fast. Probably this, together with the February, 2010 earthquake and a falling popularity of President Piñera, has been behind the move toward a procyclical fiscal policy since 2010, putting extra pressure on the exchange rate toward appreciation and complicating the task of inflation control for the Central Bank.

Colombia: Gaining Momentum

When compared with its peer LAC-7 group (which, again, as revised includes Uruguay but subtracts Venezuela), Colombia's 4.2 percent GDP growth in 2010 was moderate (figure 3.14), despite high consumer and business confidence. In fact, Fedesarrollos's consumer confidence index as of February, 2011 is 6.7 percentage points above the index' average of

[6] The initial annual structural surplus target was 1 percent of GDP. This target was chosen for three reasons: first, the existence of contingent liabilities in the pension system; second, the structural operating deficit and negative net worth of the Central Bank of Chile, resulting from the debt crises and the exchange rate policy of the 1990s; and third, the currency mismatches. By 2008, currency mismatches and negative worth were less of an issue, and then the government reduced the structural surplus target to 0.5 percent of GDP.

Figure 3.14. Colombia Is Growing, but It Is No Superstar, 2010-12 (annual real GDP growth and growth forecasts)



Note: The figures for 2011 and 2012 are forecasts.
Source: Author's calculations based on data from the Economist Intelligence Unit.

the last 10 years, while consumer credit is vigorously growing (at about 14 percent year-on-year). An even better financial sector performance is expected following the March 2011 Standard & Poor's rating upgrade of Colombia's debt to investment grade (and expectations of further upgradings down the line), which should renew optimism about the country's economic outlook (figure 3.15).

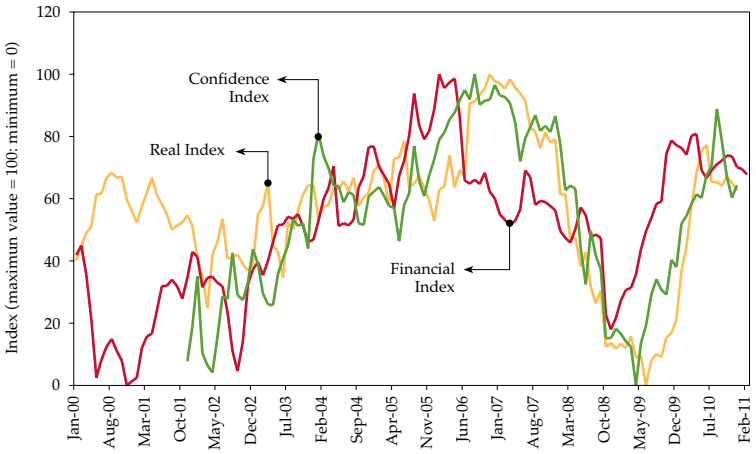
Colombia lies halfway between Brazil and Mexico, not just geographically

Why, then, is Colombia's growth so unimpressive? The underlying reason seems to be poor export dynamics, which resulted in a subpar growth relative to the solid performers elsewhere in the region (figure 3.16). In this regard, two main factors negatively affect Colombia's exports. First, they are much less diversified and are more dependent on the U.S. market relative to the other LAC-7 countries (figure 3.17). Whereas Argentina's, Peru's, Chile's and Brazil's export shares to the U.S. are well below 20 percent, Colombia's is about 40 percent, only surpassed by Mexico's 80 percent. In this regard, Colombia lies halfway between Mexico and Brazil, suggesting once again that geography plays an important role for trade.

The second factor behind the weak performance of Colombia's exports is the share that went to Venezuela, which in 2010 decreased by 11.4 percentage points relative to the 2007-9 average. As a result, noncommodity exports fell 2.9 percent in 2010, even though they grew 19.1 percent when Venezuela is excluded.

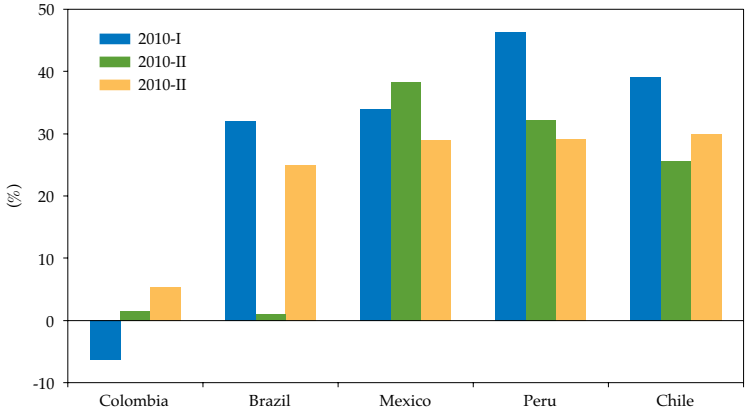
Colombia's high consumption growth has been supplied with imports (20 percent year-on-year growth in the third quarter of 2010) leading to a

Figure 3.15. Sector Index Analysis for Colombia, 2000-2011 (Principal Component Analysis Index)



Note: Real Index is the 12-month growth rate of seasonally adjusted employment, imports, industrial production and GDP; the Financial Index is the 12-month growth rate of equity prices and EMBI in levels; and the Consumer Confidence Index combines Fedesarrollo's Consumer Confidence Index and Industrial Confidence Index.
Sources: Author's calculations using data from the World Bank, Global Economic Monitor and Fedesarrollo.

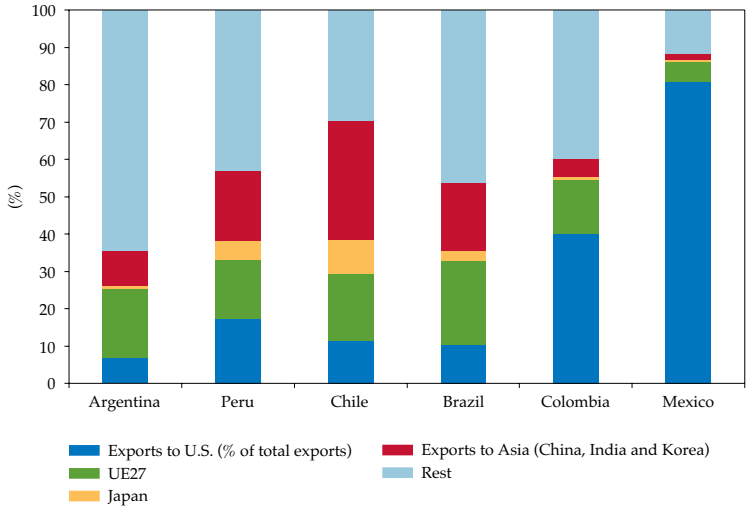
Figure 3.16. Annual Export Growth for Colombia and Selected Countries, 2010 (year-on-year percentage growth rate)



Source: Author's calculations using data from each country's statistical departments and central banks.

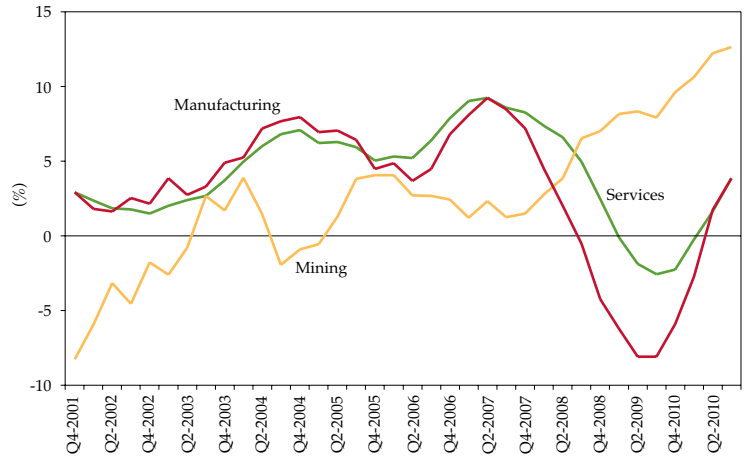
retail sector boom. Interestingly, the manufacturing sector has been faring very poorly (figure 3.18), with its share of GDP decreasing dramatically. Dualism is becoming a major policy concern in Colombia, mainly because

Figure 3.17. Market Share of Colombia's Exports, by Destination, 2009 (percentage of total exports)



Source: Author's calculations using data from Fedesarrollo and U.N. Comtrade.

Figure 3.18. Colombia's Annual Sector Growth, 2001-10 (annual growth of four-quarter moving averages, fourth quarter of 2001 to third quarter of 2010)



Source: Author's calculations using Haver Analytics.

higher-productivity industries are employing a smaller share of the economy's labor force, and thus contribute a smaller share of final output. In other words, Dutch Disease preoccupations have resurfaced in Colombia.

Rain on the Policy Front

Fiscal policy has been under pressure in Colombia due to the heavy rains and floods that occurred at the end of 2010. However, the government quickly responded by effectively raising additional fiscal revenues through a December 2010 tax reform that is expected to yield 0.3 percentage points of GDP in 2011, which will be used for relief and reconstruction. The overall effect on growth will crucially depend on the public sector's capacity to set in motion infrastructure and housing projects, about which there are still many concerns.

Fiscal expansion and monetary tightening, as elsewhere

The recent hikes in the policy rate (25 basis points on February 28, 2011, and another 25 basis points on March 18) are evidence that Colombia's monetary policy has begun its transition toward a less accommodative stance. At least three factors explain the timing of these hikes. First, there seems to be a general recognition that the starting policy rate (3 percent) was too low to achieve long-term price stability, and specially to achieve the 2 to 4 percent inflation target. Second, inflation and inflation expectations are on the upside, and global commodity prices (especially energy prices) are high. And third, the decision to decree a 4 percent increase in the minimum wage has put even more pressure on inflation and inflationary expectations.

As in other parts of the continent, the dilemmas faced by the authorities include the fear of raising the policy rate in an economy that has not fully recovered and the uncertainty regarding the long run potential growth. In addition, the Central Bank is aware that the policy rate hiking cycle which will most certainly affect the foreign exchange rate, presenting another quandary.

Labor Markets: Good News amid Persistent Problems

In 2010, labor markets performance was slightly better than in 2009, urban wage employment growth rate accelerated; urban formal employment grew at 5.5 percent year-on-year, while informal employment is shrinking at 2.4 percent year-on-year. However, many problems still persist. Rural wage employment has decreased by 33 percent in the last three years, reflecting the very weak performance of agriculture. Furthermore, the unemployment rate is highly persistent and has decreased marginally after the crisis (for the November 2010–January 2011 period, it is still 11.6 percent); the expansion of the formal urban employment is biased toward skilled workers (which has important implications in terms of redistribution). Dualism is also evident when examining employment growth; industrial employment fell 2.4 percent in 2010, while "other industry" employment (which includes mining) grew at 17.3 percent.[7]

Concluding Remarks

Diversification is the keyword for Colombia

For exports not to hinder Colombia's growth dynamics, the country needs to diversify its trading partners and to minimize its dependence on Venezuela and the U.S. Thus, it is in its best interest to seriously consider strategies to engage more decisively with Asia–especially China. Colombia's Central Bank is immersed in a policy rate hike, and we expect it to continue to raise the monetary policy rate on a monthly basis until inflation and inflationary expectations yield. While fiscal outcomes are expected to improve in the medium term, the key obstacles today remain in the labor market.

Mexico: Waking Up, Or Another False Start?

Alejandro Werner

During 2010, the economic recovery that started in the third quarter of 2009 gained strength in Mexico, as the manufacturing sector continued posting solid growth rates on the back of a U.S. consumer market that has been recovering faster than expected. As the year progressed, domestic demand picked up as an important source of growth. For the year as a whole, the country's economy grew by 5.5 percent, significantly above what was expected at the beginning of the year, and there was a significant generation of jobs. Although the unemployment rate remained stable, the underemployment rate declined as firms engaged workers for longer hours. Core inflation came down rapidly as the negative output gap narrowed, and the stable-to-appreciating exchange rate restrained both domestic and foreign inflationary pressures.

As the economic recovery was slower compared to other countries in Latin America and the real exchange rate continued to be more depreciated than its precrisis levels, the Central Bank had a less pressing job in handling capital inflows than its peers in the region. In 2011, growth in the U.S. will continue in the 3 percent range and the recovery of domestic demand will strengthen, delivering another year of solid growth for Mexico.

Further into the future, the growth process is surrounded by uncertainty as Mexico sits in the middle of the bipolar world growth process not feeling the full benefits of the commodity boom, but experiencing the upside of being a large emerging market with a solid macroeconomic and finan-

[7] DANE Household Survey, January 2010.

cial environment and a growing and young middle class that provides a solid foundation for the growth of domestic demand. As this recovery continues, the question will become if Mexico's growth potential has increased or if we are witnessing another false start associated with the large economic swings that have characterized the Mexican business cycle.

2010: The Economic Recovery Gains Strength

2010 was a year of better-than-expected results

Since the third quarter of 2009, Mexico has experienced an export-led recovery, and nowhere has this been more evident than in the automobile sector, where production has recovered from a drop of more than 40 percent during the global financial and economic crisis to an average quarterly growth of 11 percent, as measured from the second quarter of 2009 to the last quarter of 2010. These strong dynamics have been a constant throughout manufacturing, as production and exports in this sector have experienced average quarterly rates of growth of 2.5 and 6.5 percent, respectively, from the second quarter of 2009 to the last quarter of 2010. By the end of 2010, manufacturing production and exports already surpassed the precrisis levels and maintained their strength as both variables closed the fourth quarter, growing at rates of 4 and 12.4 percent, respectively. During this period, Mexican nonoil exports as a share of total nonoil imports in the U.S. showed an important increase. At the same time, Mexican nonoil exports going to the U.S as a share of total Mexican nonoil exports declined. These trends are a clear signs of the gains in competitiveness and diversification achieved by Mexican exports.

Domestic demand had a more muted recovery and was held down by several factors. These include a job market that was slow to respond and a consumption credit market that was going through an important redesign. Major losses were incurred by banks as their business models lead to increases in delinquencies, unrelated to the crisis, that were compounded by the increase in unemployment during 2009. Other factors that held down domestic demand include the still-prevailing uncertainty, the depressed levels of remittances and the low readings of consumer confidence. All these factors strengthened throughout 2010, and private consumption grew by an annualized rate of 8 percent in the second half of the year. As always after a severe downturn, spare capacity is holding down the recovery of private investment, which is still 20 percent below precrisis levels (see table 3.1).

As far as policy is concerned, 2010 was a comfortable year for the Mexican authorities as the stronger economic recovery, the high price of oil and the stabilization of oil production led to a level of public sector income higher than projected; therefore, the fiscal targets were met and the

Table 3.1. Mexico's Aggregate Supply and Demand, 2008-10 (quarterly percentage change, seasonally adjusted series)

	2008				2009				2010			
Variables	I	II	III	IV	I	II	III	IV	I	II	III	IV
Supply	1.3	0.1	0.4	-5.4	-7.8	-1.4	5.7	2.3	1.8	2.1	2.8	1.0
GDP	0.7	-0.3	0.1	-1.4	-7.0	0.1	2.8	2.1	-0.1	2.4	0.8	1.3
Imports of gods and services	5.5	0.8	-2.5	-15.2	-9.9	-3.0	8.6	4.3	9.6	6.6	0.2	0.1
Demand	1.3	0.1	0.4	-5.4	-7.8	-1.4	5.7	2.3	1.8	2.1	2.8	1.0
Consumption	1.4	0.3	-1.0	-1.3	-5.1	-2.3	4.5	1.0	0.5	1.2	1.6	1.8
Private	1.7	0.3	-1.3	-1.6	-6.4	-2.2	4.9	1.1	0.4	1.3	1.9	2.0
Government	-1.4	0.9	0.4	1.0	3.2	-2.5	2.1	0.0	1.6	1.6	-0.6	0.4
Gross fixed capital formation	1.4	2.6	0.5	-2.7	-9.1	-1.7	0.1	0.1	0.4	-0.2	3.3	-0.8
Private	-1.1	1.8	-2.3	-7.4	-6.3	-4.6	-1.8	-3.5	7.3	-2.5	0.6	-0.7
Government	11.5	0.4	11.0	7.3	-1.6	-2.1	2.5	0.5	-2.2	10.0	0.9	-0.9
Exports of gods and services	5.1	0.0	-3.0	-14.9	-5.8	-1.2	7.9	7.4	7.8	7.0	-4.1	4.2

Notes: The data for 2010 were estimated. Gross fixed capital formation excludes changes in inventories.
Source: Instituto Nacional de Estadística y Geografía.

debt-to-GDP ratio showed a marginal decline. If there was a black spot in public finance, it was the lost opportunity to start refilling the depleted oil stabilization funds. Regarding monetary policy, the year turned out much brighter than what the Central Bank had expected in its first Inflation Report of 2010, when its official inflation projection put year-end inflation at 5 percent, while year-end inflation turned out to be 4.40 percent and core inflation came in at 3.60 percent. The better-than-expected behavior of inflation, together with the stable-to-appreciating currency, led the markets to postpone the expected date of the start of the tightening cycle and therefore put in motion a positive cycle in money markets.

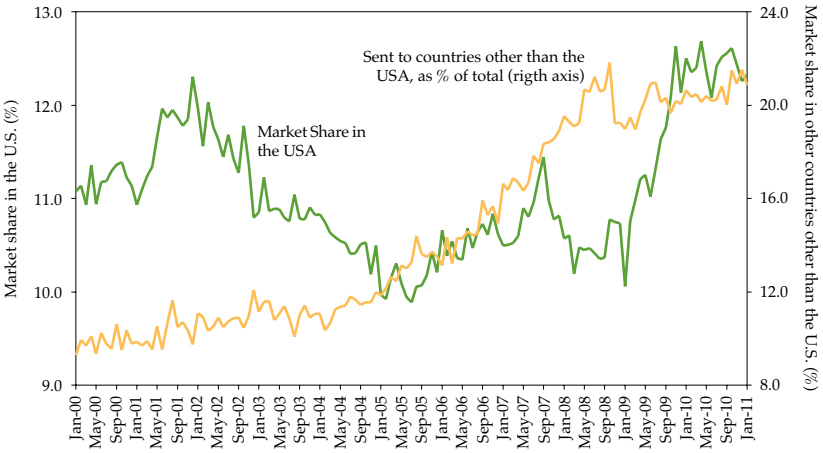
The Mexican authorities also took advantage of the opportunities in capital markets to strengthen their financial position in three main ways. The first was by accelerating the accumulation of international reserves by reintroducing the option program, whereby the Central Bank buys foreign currency. The second was by undertaking important debt operations to strengthen its liability position, including the placement of a 100-year dollar bond, and finally by increasing the size of the Flexible Credit Line with the IMF to more than $70 billion.

2011: Domestic Demand Recovery Gains Force

For 2011, expected GDP growth has been revised upward to more than 4 percent by the main analysts following the Mexican economy. Three fac-

tors are behind these recent revisions: (1) the implementation of the U.S. Federal Reserve's second wave of quantitative easing and of the second fiscal stimulus in the U.S., which has led to an improvement in economic perspectives in that country; (2) the competitiveness gains made by Mexican exports in 2010 as they increased their shares in key markets; and (3) the strengthening of domestic demand that is still taking place. These factors could be counteracted by external crosscurrents, driven mainly by the increases in oil prices associated with the turmoil in Northern Africa, the continued bouts of financial instability coming from Europe and the highly unlikely event of a fiscal scare in the U.S. Although it is highly likely that fiscal policy will still be going through a comfortable period, monetary policy challenges will heighten given that inflationary pressures are building through the increase in commodity prices, and capital inflow issues could resume in the near future. Therefore, the challenge of containing inflationary pressures without choking the recovery and/or significantly appreciating the currency will prevail in Mexico, as in the whole region. Inflation is expected to close 2011 at about 3.5 percent.

Figure 3.19. Mexico's Nonoil Exports, 2000-2011 (seasonally adjusted)



Source: Bando de Mexico and SHCP.

Solid performance is expected during the next 12 months

Together with the cyclical recovery, important structural changes during 2010 should affect potential GDP growth. First, the opening of the pension funds investment regime has led to a wave of initial public offerings and capital injections into private equity and infrastructure funds that will complement the capital base for Mexican firms and projects. Second, after four years of experiencing an important decline, oil production stabilized,

providing support for public finances and stopping its negative contribution to growth. Third, there has been a significant convergence process between wages in China and Mexico, and thus by 2009 Chinese wages had closed almost 90 percent of the gap they had vis-à-vis Mexican wages in 2002; this, together with current increases in transportation costs, will benefit Mexico's position in the North American market. Fourth, the real exchange rate in Mexico is still 9 percent weaker than its precrisis level. Fifth and finally, several of the structural changes made in the last few years (e.g., fiscal, pension and energy reforms as well as the deregulation of economic activities) have materialized into important improvements in Mexico's position in competitiveness indexes. For example, Mexico's ranking in the World Bank's Doing Business report moved up six positions, making it the best-ranked economy in the region. On the negative side, the increasing number of deaths associated with the war on drugs has led to concern about its possible impact on the economy.

No overheating in sight

Mexico's economic recovery will provide solid growth for the next 12 months. Further into the future, the extent of the cyclical recovery will be determined by three important factors: the developments in the U.S., the extent to which the output gap has already been closed, and the effects of recent middle-of-the-road structural reforms on potential GDP growth. Regarding the possible overheating of the economy, Mexico is in a comfortable short-term situation vis-à-vis its peers in Latin America, for it is not yet in that situation, given that it is more a manufacturing- than commodity-based economy. But the other side of the coin is that the medium-term challenges regarding growth, income distribution and social development are more daunting.

Turning the Cyclical Recovery into a Long-Run Growth Trend

But the pending agenda is sizable

During the past decade, Mexico's economic performance has been below that of the Latin American region as a whole, as a result of five main factors. First, starting in 2000, Chinese exports displayed a remarkable expansion. Given that Mexico's exports are concentrated in manufacturing products, this represented a significant negative shock. Second, the implementation of the Central American Free Trade Agreement in 2006 may have generated additional external competition for some productive sectors in Mexico, like the textile industry. Third, the two recessions of the U.S. economy during the decade led to a dismal performance of industrial production in that country. Due to the high correlation between production on both sides of the border, the effect on Mexico was important. Fourth, there was a decline in oil production of almost 25 percent between 2004 and mid-2009 due to the exhaustion of the Cantarell oil field. Fifth and finally, most countries in Latin America have benefited from the increase in the international price of

commodities during the decade as they have exported natural resources, in contrast to Mexico. Although it is unlikely that Mexico will face a series of negative shocks during the current decade of a similar magnitude that it suffered in the previous one, as has been argued in the paragraphs above, the external environment will not be totally favorable for Mexico. That is why it is of the utmost importance that the current recovery is taken as a platform to launch an aggressive progrowth agenda that will transform the current cyclical recovery into a self-sustaining growth process. This agenda should at least address five key issues.

The first issue is public finances. Tax revenues in Mexico are low, with a level of only 10.4 percent of GDP compared with, for example, 22 percent in Chile and 20 percent in Argentina. Higher tax revenues are essential to substitute for oil revenues and to potentially increase the resources devoted to infrastructure, security and/or social programs.

The second issue is the need to take advantage of the current level of oil prices to increase public sector savings. A substantial part of oil income in the following years should be saved in the oil stabilization funds or used to pay down debt.

The third issue is to transform the pricing structure of energy products to eliminate generalized subsidies and to provide incentives to renewable energy sources, public transportation and the implantation of energy saving measures.

The fourth issue is to improve the rule of law and establish a more equal playing field. A deficient and cumbersome legal system, excessive regulation and a lack of competition in some sectors increase the costs of economic activities across the board, but especially for startup and small and medium-sized firms as they increase the fixed costs of operation in the Mexican economy. In this respect, there is an important need to reform the judicial system, to undertake a full revision of the regulatory framework and to promote stronger competition in both input and final goods markets.

The fifth issue is that to increase growth in the short run, Mexico needs to remove barriers in the three strategic sectors where there can be an immediate effect on investment and growth. These sectors are also representative of the type of bottlenecks that lead to low growth rates in the Mexican economy.

The first strategic sector is the agriculture. Fragmented landholdings and low levels of capital and productivity have meant that Mexico has not taken advantage of the increase in the demand for commodities in Asian

countries and the increase in productivity in the sector that has been observed in other countries. Therefore, the agricultural sector in Mexico grew 1.6 percent on average during the 2000-2009 period, compared with 5.4 percent in Chile, 3.4 percent in Brazil and 3.1 percent in Australia. In all the Central American countries, the sector had growth rates between 3 and 5 percent. If the sector in Mexico had experienced a growth rate similar to that in Chile, the growth rate of total GDP would had been 0.2 percent higher each year.[8]

The second strategic sector is mining and energy (including metals, oil and electricity). Oil production has declined by close to 25 percent relative to the maximum levels in 2004. Even though the mining sector has benefited from higher commodities prices, a number of industrial conflicts have limited its growth potential. Overall, the mining and energy sectors registered average growth in 2000-2009 of only 1.2 percent. In comparison, growth in Saudi Arabia, Australia and Brazil was 23.4, 12.5 and 4.1 percent, respectively. Growth in this sector in Mexico comparable to that in Australia would have led to higher GDP growth by 0.8 percent.

The third strategic sector is telecommunications, where worldwide technological changes have led to rapid growth, high levels of investment and a significant decrease in costs. However, investment in this sector in Mexico is less than half that observed in Chile, India and Peru–0.3 versus 0.65 percent of GDP.

Among the factors that could derail Mexico's current recovery and its long-term prospects for a pickup in potential GDP growth, two in particular stand out. The first is the war on organized crime. Regardless of whether it has already affected the economy; and recognizing that it was a much-needed strategy to contain an important threat to the country's institutional stability, if current trends continue, sooner or later, investment, consumption, tourism and other important economic variables will be affected. The second factor is the sustainability of the U.S. economic recovery and the risks of a negative market reaction to the lack of capacity to handle the snowballing debt dynamics in that country. Therefore, for Mexico, the key to transforming these good years of high growth into a self-sustaining dynamic development process is the implementation of structural changes–and, as always, a little bit of luck.

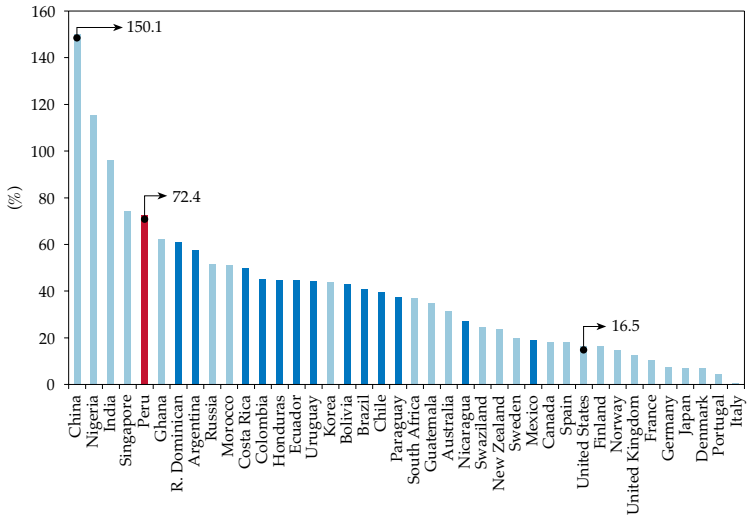
[8] Data for the agricultural, mining and energy sectors are from the CEPALSTAT database and statistical publications, CEPAL; and from the STAN database for structural analysis of the Organization for Economic Cooperation and Development.

Peru At A Crossroads

Luis Carranza

Peru will hold general elections on April 10, 2011. For the first time in many years, the electoral process coincides with strong economic growth and the improvement of social indicators. During the period 2002-10, cumulative economic growth reached 72 percent, and Peru was among the top 10 growing economies in the world (figure 3.20). The reasons for this first class performance rely on macroeconomic stability, with the lowest inflation rates and the most stable currency in the region, as well as important structural reforms including free trade agreements, public investment with emphasis on infrastructure and reforms on social programs.

Figure 3.20. Peru's GDP Cumulative Growth Rate, 2002–10



Source: IMF, World Economic Outlook Database, October 2010.

However, before the next president reaches the crossroads, the current government will need to cross a short-term "macroeconomic bridge." This administration needs to find the optimal combination of monetary and fiscal policies to sail in the choppy waters of inflationary pressure and exchange rate appreciation, a likely scenario for this year.

From a Strong Recovery to Overheating?

In 2010, economic growth reached 8.7 percent (preliminary), inflation rate was 2.1 percent, and prudent fiscal management led to a fiscal gap equiv-

alent to 0.6 percent (preliminary) of GDP, just as intended according to the fiscal stimulus plan and in fulfillment of macroeconomic fiscal rules. The Peruvian economy's strong resilience and the rapid recovery, even faster than expected and without permanent harmful consequences, were mainly for three reasons: (1) The crisis did not affect the financial system's health, so although credit did suffer a deceleration during the crisis, it actually never paralyzed and it was able to reactivate quite rapidly. (2) Enterprises were in good health, and exporting enterprises–where the main effects concentrated–had a flexible labor regime which did not generate permanent problems for nontraditional exports; also, supportive measures, such as facilitating access to credit and a temporary drawback increase, were quite effective. (3) There was a strong recovery of private investment, which began to register significant growth rates starting in the first quarter 2010 (after falling for three quarters) as previous formulated projects began to be executed, and economic agents' expectations have resurged quickly since mid-2009.

In 2011, the strength of domestic demand will prevail and, although the economic growth rate is expected to be about 7.5 percent, there is concern about inflation. The possibility of inflation overshooting might be due to supply shocks, which could be back fed by second round effects that operate through expectations.

In this context, the fiscal policy of the last several months, which implies contraction of fiscal income of about 1 percent of GDP for 2011, is hard to understand. The reduction of 1 percentage point of the value-added tax as well as the lowering of other minor taxes (summed to the shifting in the band for oil prices) will have permanent effects on fiscal accounts. These measures are inconsistent with the successful fiscal policy followed during the last decade and may reveal underlying political reasons, perhaps not for the elections this April–given that the party now in power is not running for the presidency and is not publicly supporting any of the candidates–but for 2016.

The Peruvian Central Bank is expected to raise the policy rate to 4.5%

Because the burden of stabilization is on the monetary policy, the Central Bank is very aggressively raising the monetary policy interest rate up to 3.75 percent, and it is expected to reach 4.50 percent by the end of 2011 (see table 3.2). It will be quite difficult to further increase the domestic interest rate if the spread relative to the U.S. interest rate widens, given that the resulting capital flows would mean pressure for a stronger currency. To deal with this dilemma, the Central Bank is using reserve requirement instruments to hold back credit growth. However, increases in reserve requirements have only temporary effects, as private banks find mechanisms to circumvent them.

Table 3.2. Economic Indicators for Peru, 2010, and Forecasts for 2011

	2007	2008	2009	2010*	2011**
GDP (annual % change)	8,9%	9,8%	0,9%	8,7%	7,5%
Inflation	3,9%	6,7%	0,2%	2,1%	3,2%
Exchange Rate S/. Per US$1	3,13	2,93	3,01	2,83	2,72
Fiscal Balance (as % GDP)	3,1%	2,1%	-1,9%	-0,6%	-0,3%
Domestic demand (annual % change)	11,8%	12,3%	-2,8%	10,9%	8,5%
Monetary policy interest rate	5,00%	6,50%	1,50%	3,00%	4,50%
Terms of Trade (annual % change)	3,4%	-14,4%	-2,9%	17,9%	-2,0%
Trade Balance (as % GDP)	7,9%	2,0%	4,7%	4,4%	2,5%

* Preliminary; ** Forecast.

This situation requires a combination of macroeconomic policy, whereby fiscal policy bears part of the weight of holding back domestic demand, because this would mean lower domestic interest rates and therefore less pressure toward exchange rate appreciation. So the main problem in the short term is an expansive fiscal policy combined with a contractive monetary that will most probably lead to domestic currency appreciation.

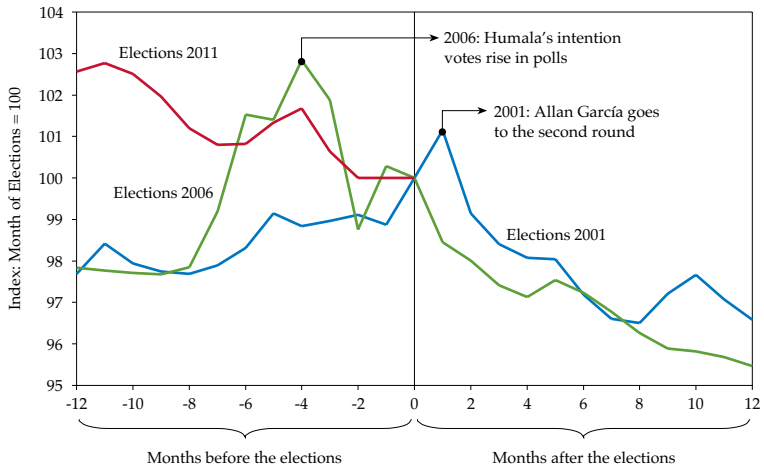
An Unusually Calm Election

One month before the presidential elections, Peruvians seem unusually calm. Unlike previous general elections, there is no financial turmoil and private expenditures continue strong. Credit available to the private sector has not lost its momentum from the recovery and continued to increase every month throughout 2010; and the exchange rate has not appreciated. Likewise, the general index from the Lima Stock Exchange reached the 2007 peak (figure 3.21).

There are three major forces behind the preelectoral calmness. First, the three favorite candidates are market friendly; second, all the candidates are committed to maintain macroeconomic stability; and third, free trade agreements signed with the United States, Canada, China, Japan, South Korea and Europe ratify basic guidelines of economic policy; rescinding them would have a very high cost.

Improvements in social indicators can also explain why the candidates from the political center have an overwhelming majority of support according to opinion polls, and hence why even extreme left parties from previous elections are moving toward the center and have a less radical speech. Poverty, inequality and malnutrition have decreased and middle class is growing. Recent polls place Alejandro Toledo as the favorite, with about 23 percent of likely votes, followed by Keiko Fujimori, about 4 per-

Figure 3.21. Peru's Exchange Rate Behavior during Presidential Elections



Source: Central Bank of Peru.

centage points behind, and Ollanta Humala–the "left" candidate, though now more moderate than in 2006–in third place with 2 percentage points less. The candidates who are more to the "right," Luis Castañeda Lossio and Pedro Pablo Kuczynski, tie for fourth place with 14 percent each.

In terms of issues, this has been a dull campaign

However, the voters' opinions keep changing every week. Toledo started with a clear lead, with just over 30 percent of likely votes, followed closely by Castañeda, and a few points behind Fujimori. However, the first two lost significant percentage points of intentional votes during recent weeks, while Humala has kept on growing slowly and Kuczynski has almost tripled his mere 5 percent of a month ago. A second round is certain, but what remains uncertain is which two candidates will run. If Toledo runs against Fujimori or Humala, rejection rates will play a key role against the two latter candidates; however, if Toledo runs against Kuczynski, the results will be much closer, and with Castañeda, perhaps there would be a technical tie. If Castañeda goes to the second round with any other candidate, he would win, but apparently he has lost his option of passing through the second round. These results are inconsistent seen from a logical point of view and reveal that tendencies will keep changing during the next three weeks, until the elections take place.

The candidates' positions stated in debates and government plans show that there are more similarities than differences among their proposals, but they try to differentiate themselves from each other by their key messages.

Thus, Toledo emphasizes education (e.g., 20 percent of public budget will go to education), employment and price stability; his promises are quite ambitious, and to finance them he proposes working hard on the taxing arena. Fujimori calls for more inclusive economic growth, and her public propaganda concentrates on working for poor people and abused women. Castañeda's message conveys two clear goals: create equal opportunities for everybody, and improve the nation's competitiveness. He also capitalizes on the infrastructure works done during his period as Lima's mayor. Humala's bastion is ending corruption, and he proposes to draft a new Constitution mandating a more decentralized and participative state; he also criticizes the neoliberal economic model and proposes a new development model based on a "national market economy open to the world."

The Crossroads: Complacency or Structural Reforms?

No clear sense of where the country is heading in terms of structural reform

During the last 60 years, Peru has been a poor or middle-income country. Currently, the tailwinds of high commodity prices may give the feeling of prosperity, while hiding the fact that the country is stuck in the middle-income trap. However, for it to escape from this trap, structural reforms will need to be implemented. And though every single candidate knows that these reforms are necessary for the country to sustain its high growth rates and attain prosperity, they are not mentioning the subject in the debates or including it on their agendas–perhaps as a campaign strategy.

If Peru does not escape from the middle-income trap, its growth rates will start declining, and the vicious circle of poverty will continue. The risk of continuing with lagged economic growth remains latent as long as structural reforms are not implemented. Will the next president be willing to take the path to prosperity?

In summary, Peru faces two challenges, one in the short term and one in the long term. In the short term, the government needs to find the optimal balance between monetary and fiscal policies to cope with a likely scenario of inflation and exchange rate appreciation. And in the long term, the future president will need to bear the political cost of implementing the necessary structural reforms to free the country from the middle-income trap.

Venezuela: A 21st-Century Natural Resource Curse

Alejandro Grisanti

During the past 12 years, President Hugo Chávez's policies (expropriation, price and exchange rate controls, etc.) have exacerbated Venezuela's "natural resource curse"–low growth, high volatility, Dutch Disease, fis-

cal voracity and weak institutions. A country such as Venezuela, with its abundant natural resources, should be seen as having high potential investment in various projects and abundant access to foreign exchange to purchase capital goods and raw materials. From 1999 to 2010, it received $529 billion in oil income, and we expect it to receive at least $155 billion in the period 2011-12. Additionally, it has increased its total debt from $31.3 billion in 1998 to an estimated $98.0 billion at the end of 2010 and a projected $133 billion in 2012. This very high amount of resources should give it the opportunity to grow, rebuild infrastructure, and finance health and education projects, and reduce poverty. However, the results have been, by a number of metrics, very poor.

Venezuela has 280 years of oil reserves

The relation of Venezuela with oil is very confusing, to say the least. According to official figures, its proven oil reserves are 296.5 billion barrels, which at current levels of oil production of 2.89 million barrels per day give a ratio of proven reserves to oil production of more than 280 years. Compare this with this ratio's 17 years for North America and Asia Pacific or its 20 years for Europe and Eurasia; it also is more that three times the Middle East's 82 years. As Sheikh Yamani, oil minister of Saudi Arabia, said, "The stone age did not end because we ran out of stones"; the oil era will end when the world finds an alternative form of energy. Questions about nuclear energy given the current situation in Japan support the vision of oil as the main source of energy in the long run. But with 280 years of reserves, it is not easy to understand why Venezuela's oil production is falling.

Natural resource curse is an understatement in Venezuela

Part of the explanation is the easy wealth derived from oil. Broadly, the adverse effect of a country rich in natural resources is, again, what is known in the economic literature as the "natural resource curse"–low growth, high volatility, underdevelopment of nonoil productive sectors, fiscal voracity and corruption and weak institutions. Chávez's economic policy over the past 12 years has amplified the natural resource curse to the extreme: expropriations and nationalizations that evaporated private investment, a capital control regime that has resulted in an overvalued and subsidized exchange rate that exacerbated deindustrialization, price controls and general subsidies (e.g., the one for the domestic price of the gasoline that represented 4.6 percent of the GDP in 2010[9]), and so on.

[9] The gasoline subsidy in 2010, compared with what is established in the 2011 National Budget Law, represents 2.9 times what the national budget has earmarked for health care, 70 percent more than what the country plans to spend on education, and almost four times what has been allocated for universities. Moreover, the subsidy is regressive, with the 25 percent of the population that is in the highest income bracket receiving almost nine times more resources than the 25 percent in the poorest.

Since 1998, despite the oil windfall, Venezuela has grown just 2.3 percent per year, in contrast to 3.4 percent for the six largest Latin American countries and 6.1 percent for the Organization of the Petroleum Exporting Countries (OPEC) (excluding Iraq). Venezuela has the second-lowest growth (after Mexico[10]) among the combined OPEC and Latin American countries. If it had grown at the average rate of the latter countries, today its GDP would have been 14.9 percent larger. Doing the same exercise with the average OPEC growth, Venezuela's GDP should be 55.3 percent larger.

In terms of volatility, within this period, Venezuela was simply on a roller coaster, with five years of negative growth with an average contraction of 5.6 percent and seven years of positive growth with an average expansion of 8.4 percent. No other country in our LAC sample exhibits this instability. Venezuela is by far the country with the largest growth volatility measured as the standard deviation over its mean (3.3). This means that from 1999 to 2010, it had shocks (positive or negative) equal to 3.3 times its average growth, representing 8.7 percentage points of GDP. It should be mentioned that during this short time, OPEC grew at a faster rate and with lower volatility than the Latin American countries. This is mainly explained by the fact that in this period there was a strong an unambiguous positive trend in oil prices. Over a longer period, OPEC shows lower growth and higher volatility.

Venezuela represents an extreme example of Dutch Disease (DD); in nominal terms, oil exports have grown 410 percent since 1998, while imports have grown 130 percent. This is basically the result of the effects of the jump in oil prices from $10.6 per barrel in 1998 to $72.7 per barrel in 2010. The DD problem has been exacerbated by Chávez's economic policy of capital controls to sustain a highly overvalued currency and a subsidized dollar. During this time, nonoil exports fell to $3.6 billion in 2010 from $5.2 billion in 1998. As a result, the ratio of oil exports to total exports rose to 95 percent in 2010 from 70 percent in 1998. In real terms, the figures are more dramatic, with a fall in real exports of 40 percent and an increase of real imports of 103 percent. With regard to industrial production, the manufacturing sector has contracted in real terms, from 16.9 percent of total GDP to 9.3 percent. There is no other country in the world not at war that has destroyed its capacity of production in so short a time.

[10] Mexico did not benefit from the commodity boon and, given its close relation with the U.S., has been affected by the two U.S. crises.

At the same time, Venezuela's institutional development lags well its Latin American and more impressive OPEC peers. Using the World Bank Governance Indicators for 2009, Venezuela does better than OPEC only in voice and accountability. In all the other institutional indicators (government effectiveness, political stability and absence of violence/terrorism, control of corruption, regulatory quality and the rule of law), it does much worse than its Latin American peers and OPEC partners. The worst case is the index of the rule of law, in which Venezuela got 2.8 percent, against 34.1 percent for OPEC and 45.1 percent for Latin America.

To measure the "Chávez effect" that has amplified the natural resource curse, the pre-Chávez period is compared with 2009 for an average of the six institutional indices. In 1998, just before Chávez took office, Venezuela had a slightly better index than the OPEC countries, but 15 percentage points below the other Latin American countries. In the 11 years of the Chávez administration, the institutional framework has deteriorated, and in 2009, Venezuela was 21 percentage points below the average institutional index of OPEC and 40 percentage points below its Latin America peers. The fact that Venezuela was always below its Latin America peers suggests that the abundance of natural resources has a negative effect over the institutions, but the trend in the last 12 years is a signal that the Chávez administration has caused a deterioration of the country's institutional framework, which partly explains the decline in investment from 28.6 percent of GDP in 1998 to 17.6 percent in 2010, limiting the economy's capacity to respond to the fiscal stimulus.

Fiscal Voracity

Oil production is falling...

The recovery in oil prices since 1998 and several devaluations of the currency (passing from 0.57 Venezuelan bolivars per dollar to three different bolivar/dollar exchange rates of 4.3, 5.3 and 9.0) were not sufficient to drive an improvement in the public sector accounts. In the case of the state-owned oil company, Petróleos de Venezuela, the government extracted most of the additional revenues and benefits from cost reductions, exacerbating the significant fiscal pressure on the company. This has limited the company's capacity to invest, causing a long-run production decline that, coupled with increased consumption in a highly subsidized domestic market, has reduced the volumes exported.

...and the fiscal deficit is rising

Despite the increase in the Venezuelan oil basket, from $10.6 per barrel in 1998 to $72.7 per barrel in 2010, the deficit of the nonfinancial public sector increased from -4.0 percent in 1998 to an estimated -6.9 percent in 2010 (-4.3 percent in the first three quarters of the year). Despite the impressive increase in oil prices, oil income increased by only 2 percentage

points of GDP, signaling a rising diversion of resources from the "formal" public sector to parallel agencies (mainly Fonden and the Chinese Fund), which are responsible for a large portion of public sector expenditures that are not incorporated in the official figures. These quasi-fiscal funds will remain the depositaries of the oil windfall, in order to finance off-budget expenditures ahead of the 2012 presidential elections and, at the same time, help the government avoid transfers to regional authorities. Therefore, we do not expect a significant improvement in official public sector statistics, which we feel are becoming less reflective of the real performance of the country's finances.

To summarize, for the period 1998-2010, Venezuela's consumption and investment have grown at a higher rate than GDP, with imports satisfying this overdemand. Conversely, exports were contracting by 3.9 percent a year. For the case of investment, I believe that it is important to divide the Chávez era in two periods–before and after the nationalization spree, which started in 2007. For the period 1998-2007, President Chávez received the benefit of the doubt by the private sector, with investment growing at 70.3 percent, or 6.1 percent a year. After all the announcements of nationalizations, expropriations and so on, investments has declined 5.3 percent a year. For president Chávez, it will be extremely difficult to regain the private sector and to create wealth with just the current oil boon.

No Cash Flow Issue–at Least until 2013

Given Chávez's main desire to remain in office, changes should not be expected in terms of any adjustment of the official exchange rate, the domestic price of gasoline, increases in taxes and/or a halt in expropriations. From the cash flow figures, the country has the capacity to pay its external obligations, with debt service representing just 12 percent of gross oil exports in the next two years. Political instability in the oil-producing countries and the questions about nuclear energy after the situation in Japan are extremely supportive of oil prices and Venezuela. With regard to oil exports, although Petróleos de Venezuela figures show a fall of nearly 700,000 barrels per day from 3.1 million barrels per day in 1998, despite the incorporation of approximately 500,000 barrels per day from the Orinoco belt projects, Venezuela is exporting 2.4 million barrels per day and effectively charging 1.9 million barrels per day.

However, the market's perceptions have been that there is little or no flexibility in Venezuela's fiscal expending, regardless of oil prices. The market gives little credit to Venezuela for making adjustments when oil revenues have decreased significantly. At any rate, fiscal policy has been, and will continue to be, procyclical–fluctuating at the rhythm of oil prices.

CHAPTER 4

A Graduation Scorecard

As the structural shift in the global economy triggered by the financial crisis continues, many emerging market economies are seeking to place themselves on a more confident and economically robust path toward *graduation*. In this section we use our Brookings Graduation Scorecard (BGS) to shed some light on the standing of individual economies in their road to economic development.[1]

Acronyms that capture yesterday's star performance do not say much

Clearly, there is no single definition of economic development, nor is there a solid definition of graduation to the developed world. To approach the analysis in a parsimonious yet comprehensive way, the BGS ranks emerging markets based on their scores in four core areas: growth, financial resilience , policy track record , and broad development factors –each proxied by a small group of standard indicators. The aim of the BGS is primarily to identify the standings of those emerging markets that have permanently left behind some of the traditional predicaments of these countries. We therefore complement present-day information with historical averages to observe risk-adjusted and cyclically adjusted indicators to ensure that the BGS captures long-standing progress rather than a present-day offshoot.

In this update to the BGS, we incorporate available data for 2010 to find that, as expected from a methodology aimed at long-run determinants, almost all Latin American countries (as well as fellow emerging markets) stayed within the same neighborhood of rankings, with Singapore, Taiwan and Chile at the top and Venezuela, Ecuador and Ukraine at the bottom.

In addition, this update focuses on cross-sectional differences in key economic development indicators within the emerging market group, and it argues that present-day acronyms that attempt to identify last year's star emerging market performers–from the seminal BRIC (Brazil, Russia, India, China) to the recent CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey, South Africa)–do not warrant much merit in identifying a larger, more structural economic phenomenon and are becoming, perhaps because of their excessive topicality, anachronistic snapshots of a slow-moving picture.

[1] The BGS, introduced in the September, 2010 BLEP, builds on and updates Levy-Yeyati et al. (2010).

Creating the Scorecard

A total of 11 variables are used to construct the scorecard

The BGS is created by aggregating data on key indicators based on four criteria: growth, financial resilience (*FR*), policy track record (*PTR*), and broad development factors (*Dev*). Each category, comprising different indicators, is aggregated by taking the z-score for each indicator and averaging them to get the country's z-score for the category. Next, we take the score for each of the four criteria and compute our graduation score card as:

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

where $S_j(.)$ is the average z-score for each of the four criteria, rescaled to the [0, 1] interval for comparability. Thus, we can rank countries by their overall score, as well as by their scores in each of the four criteria.

The growth criteria comprise two indicators: risk-adjusted GDP growth and a stress test. The risk-adjusted GDP growth is the average real GDP growth rate during the last ten years, divided by 1 standard deviation. The stress test is the difference between the growth in the crisis year of 2009 and the average growth rate for the precrisis decade, measuring a country's resiliency to extreme shocks.

Financial resilience tries to capture debt sustainability, specifically, solvency (proxied by the public external debt-to-GDP and the net external debt-to-GDP ratios) and liquidity (proxied alternatively by the net external financing needs over current account receipts, where the former is computed as short-term external debt plus currently maturing long-term external debt minus official foreign exchange reserves and by the country's borrowing cost proxied by the sovereign bond interest rate spread over U.S. Treasuries). These four indicators–public external debt-to-GDP, net external debt-to-GDP, net external financing needs over current account receipts, and the sovereign bond interest rate spread–comprise the *FR* score.

The monetary and fiscal policy track record is proxied by risk-adjusted inflation (defined as the mean plus 1 standard deviation of the inflation rate); and by the moving five-year average of the cyclically adjusted primary fiscal balance (which in this update covers the 2006-10 period), computed for simplicity as the intercept from the equation $primary\ surplus_t = a + b\ cycle_t + u_t$, where $cycle_t$ is obtained from the log-linear detrending of the real GDP series.

Finally, development factors include income, human development and institutional indicators, proxied respectively by the Gini coefficient, the

UN Human Development Index (which comprises life expectancy, education and living standards) and the World Governance Indicators.

LATIN AMERICA AND THE SCORECARD

There have been visible improvements in Uruguay

Like the larger set of emerging market economies included in the BGS, the set of represented Latin American countries have broadly kept their positions in the graduation rankings: Chile remains one of the overall leaders in the path to graduation, while Ecuador and Venezuela continue to struggle. The sole exception is the visible improvement in Uruguay, where modest gains distributed across each of the four areas helped give its overall standing a well-rounded push upward. An improved cyclically adjusted fiscal balance and slight improvements in the spread on its government bonds and in its governance ranking were among the underlying drivers.

Relative to the wider set of emerging markets in the BGS, Latin America is represented throughout the rankings, with Chile near the top, thanks to a strong policy track record and human development indicators (figure 4.1). Venezuela remains near the very bottom of the rankings, held down by high inflation, persistently large deficits during the past several years, unstable growth patterns, and low development factors.

Latin American countries have benefited most from improving policy track records-perhaps a lesson from the recurrent macroeconomic crises of the 1980s and 1990s. With the exception of idiosyncratic Venezuela and Ecuador, Latin America is ahead of most Asian emerging markets in that category, with Chile holding a convincing lead. Growth scores and financial resiliency, however, rank behind fast-growing emerging Asian countries with a history of fiscal stability and large and growing net creditor positions vis-à-vis the world (as reflected by the massive accumulation of international reserves, triggered in part by the financial crises of the late 1990s).

Where Latin America exhibits the largest cross-sectional variations is, not surprisingly, in development indicators. Chile, driven by strong governance, ranks among the highest across all emerging markets, while Ecuador and Venezuela are near the lowest. In relative terms, however, Latin America does not impress; besides Uruguay and Chile, the other Latin nations come below their Asian counterparts. As we emphasized in our latest BLEP, after gaining policy credibility and macroeconomic stability, classical development aspects such as education, health, income distribution and institutional building remain the top regional priorities to advance in the graduation path.

Figure 4.1. Scores in Graduation Criteria

Anachronistic Acronyms

Grouping emerging markets into catchy acronyms have become something of a sport in financial markets looking for headlines-as well as a good marketing excuse to create new structural products. From the popular BRICs to the zoological CIVETS, MAVINS and EAGLES, without forgetting the MITSK (a BRICs sequel), all of them have sought to singled out a narrow set of countries that presumably presents certain characteristics that makes them stand out from the rest.

Figure 4.1. Scores in Graduation Criteria

Trivially, BRICs are the larger emerging market economies. However, similarities stop there; whereas China is a class by itself, India is a fast-growing deficit country, Brazil shares Latin America's limits for non-inflationary growth, and Russia is mainly an oil-exporting country. Looking to the BGS, we can see that, while these economies are all well advanced in their pursuit of development beyond many other emerging markets, many emerging markets lie between the higher-ranked China and the lower-ranked India, with Russia predictably running well behind the rest.

The EAGLE club, launched by the economic research team at BBVA, added Egypt, Indonesia, Mexico, South Korea, Taiwan and Turkey to the BRICs, based on a simple criteria: What are the countries expected to contribute the most to global growth? The EAGLE's net captures large, fast-growing emerging market (based on BBVA's frequently revised own growth forecasts), regardless of any other development quality or real hard data. Predictably, Brazil and Mexico in Latin America make the team on size alone, while smaller economies like Chile fail to qualify despite its solid performance on all fronts.

The acronyms sound right, but often do not say much

The same inevitable arbitrariness applies to HSBC's CIVETS–Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa. The argument is that they all have large young populations, diversified economies, political stability (the recent events in Egypt simply reminding us that perhaps this aspect was overstated), deep financial markets, low inflation, solid trade balances and limited sovereign debt ratios. Judging by, say, Egypt's political risk, Turkey's currency imbalance and growing current account deficit, Vietnam's incipient financial markets and fat fiscal deficit–not to mention South Africa's commodity dependence or Colombia's modest growth performance–one wonders how these countries were indeed picked. Forming a memorable acronym can lead to wrong choices.

Looking at CIVETS more systematically in the BGS is revealing; only South Africa ranks close to the top 10, with Indonesia not far behind. Two CIVETS–Indonesia and Turkey–are also placed within another recent acronym, MITSK (Mexico, Indonesia, Turkey and South Korea), created as a supplement the BRIC elite.[2]

Unfortunately, an acronym that could successfully encompass all key emerging market performers would not only too long and cacophonous but also almost an economic oxymoron, given that development is, by definition, an evolutionary process. Moreover, while large countries are significantly different as they represent, for good or bad, systemic drivers of the world economy, there is a priori no reason why size should be correlated with development, growth or return potential. Finally, from an economic prospective, there is more to development that meets the media; last year's growth, or the latest terms-of-trade boost or credit rating

[2] In a similar vein, another group of countries–Business Insider's MAVINS (Mexico, Australia, Vietnam, Indonesia, Nigeria, South Africa)–picks a few CIVETS and a few MITSK and adds exotic Nigeria and even a developed economy, Australia. The criteria: Anybody's guess.

upgrade, are often lagging rather than leading performance indicators. It is with this in mind that the BGS, shown in table 4.1, tries to capture, imperfectly, the complexities and nuances of the graduation process.

Table 4.1. The Graduation Scorecard

	Stable Growth				Policy Track Record				Financial Vulnerabilities					
	Risk adj GDP	Stress test	Avg. Z-score (rescales)	Rank	Risk Adj CPI	Cyclically adj. fiscal	Avg. Z-score (rescaled)	Rank	Net Ext. Deb t (% GDP)	Net Ext. Fin. Needs/ CAR (%)	Public sector External Deb (% GDP)	Spread	Avg. Z-score (rescaled)	Rank
Singapore	1.3	-7.6	0.4	21	3.3	4.5	1.0	1	-89.7	-140.6	0.0	40	1.0	1
Taiwan	1.2	-6.5	0.4	20	2.2	-0.8	0.6	16	-69.1	-171.1	0.0	40	1.0	2
Chile	1.5	-5.3	0.5	15	5.3	4.5	1.0	2	30.6	10.6	1.6	129	0.5	13
Israel	1.3	-3.1	0.5	11	4.3	2.7	0.8	3	8.4	-62.1	5.3	123	0.6	8
China	5.4	-1.0	1.0	2	4.1	-0.9	0.5	19	-42.8	-139.1	0.1	77	0.89	3
Korea	1.9	-5.4	0.5	8	3.9	-0.9	0.5	18	8.3	2.2	0.7	89	0.6	9
Brazil	1.3	-3.8	0.5	13	9.5	3.1	0.8	4	1.7	-12.7	2.6	202	0.6	11
Uruguay	0.4	1.9	0.5	9	12.5	2.4	0.7	8	13.2	-46.7	22.2	216	0.3	24
Poland	2.2	-2.4	0.6	6	6.5	0.2	0.6	12	33.5	51.7	13.4	156	0.3	26
Czech Republic	1.1	-8.2	0.4	22	4.3	-1.5	0.5	20	22.0	-16.2	6.3	90	0.5	12
India	3.4	0.4	0.8	4	9.3	-0.8	0.5	21	-3.0	-3.8	0.0	146	0.6	6
South Africa	1.8	-5.8	0.5	12	8.6	0.5	0.6	13	0.7	-6.7	2.9	167	0.6	10
Bulgaria	1.2	-10.3	0.4	23	9.2	2.7	0.8	5	34.6	17.8	3.7	245	0.4	20
Malaysia	1.8	-7.4	0.5	16	3.5	-2.5	0.4	22	-19.1	-31.9	1.4	140	0.7	5
Indonesia	3.2	-0.1	0.8	5	14.0	1.1	0.6	17	9.3	27.2	2.5	218	0.5	16
Thailand	1.7	-7.3	0.5	18	4.2	-0.3	0.6	14	-28.3	-47.9	0.2	94	0.7	4
Peru	1.5	-3.8	0.5	10	4.1	1.2	0.7	6	-4.2	5.7	7.0	172	0.5	15
Vietnam	6.1	-2.0	1.0	1	12.9	-1.8	0.3	27	14.6	4.9	2.6	296	0.5	17
Egypt	3.5	0.0	0.8	3	11.9	-1.9	0.4	26	-2.3	-30.5	2.2	173	0.6	7
Colombia	1.1	-2.6	0.5	14	8.7	1.9	0.7	7	12.1	1.9	6.5	189	0.5	18
Philippines	2.4	-3.9	0.6	7	7.4	1.5	0.7	9	4.4	17.8	14.4	206	0.4	22
Mexico	0.7	-9.0	0.3	26	9.7	1.2	0.6	11	8.9	8.2	4.2	187	0.5	14
Estonia	0.6	-21.3	0.1	31	6.7	0.1	0.6	15	120.2	46.4	0.4	251	0.28	28
Argentina	0.5	-1.9	0.5	19	15.5	2.3	0.6	10	21.6	-74.7	13.5	690	0.3	27
Hungary	0.7	-10.4	0.3	27	8.7	-1.7	0.4	23	80.1	76.6	18.1	274	0.1	31
Turkey	0.7	-9.0	0.3	25	48.1	3.0	0.2	29	28.3	114.6	6.1	221	0.32	25
Russia	1.2	-14.9	0.3	29	40.7	3.1	0.4	25	-4.4	79.2	2.1	229	0.5	19
Romania	0.7	-12.0	0.3	28	33.5	-2.4	0.0	33	46.5	46.8	2.5	285	0.4	21
Lithuania	0.6	-21.3	0.1	30	6.0	-2.3	0.4	24	60.8	47.5	28.4	386	0.0	33
Latvia	0.5	-26.1	0.0	33	9.4	-2.5	0.3	28	135.4	94.9	4.7	627	0.0	32
Venezuela	0.3	-6.7	0.3	24	28.4	-1.6	0.1	30	14.6	-181.6	10.6	1082	0.3	23
Ecuador	0.9	-3.2	0.5	17	48.4	0.3	0.0	32	23.1	22.8	1.8	925	0.2	30
Ukraine	0.6	-21.7	0.1	32	21.8	-2.8	0.1	31	52.0	19.1	5.9	591	0.3	29
LAC (average)	0.9	-3.8	0.5		15.8	1.7	0.6		13.5	–29.6	7.8	421	0.4	
Developed (average)	1.7	-4.8	0.5		3.2	4.4	1.0		24.5	128.0	3.3	41	0.4	

Table 4.1. The Graduation Scorecard

	Development factors							Total Rankings	
	Gini	Human Development index	WGI	Avg. score	Avg Index	Avg. Index (rescaled)	Rank	Weigh ted scores (rescaled)	Ranking (weigh ted scores, rescaled)
Singapore	38.4	0.8	1.4	1.0	0.6	1.0	1	0.9	1
Taiwan	34.0	0.9	0.8	1.1	0.5	0.8	4	0.7	2
Chile	52.0	0.8	1.2	0.7	0.5	0.8	5	0.7	3
Israel	30.1	0.9	0.5	0.6	0.4	0.7	12	0.7	4
China	44.7	0.7	-0.5	-0.6	-0.1	0.2	29	0.7	5
Korea	29.0	0.9	0.7	0.8	0.4	0.8	7	0.6	6
Brazil	55.8	0.7	0.1	-0.1	0.1	0.4	17	0.6	7
Uruguay	47.1	0.8	0.8	0.4	0.4	0.7	9	0.6	8
Poland	34.5	0.8	0.8	0.5	0.4	0.8	8	0.6	9
Czech Republic	25.8	0.8	0.9	0.8	0.5	0.9	3	0.6	10
India	33.1	0.5	-0.2	-1.0	-0.0	0.3	20	0.6	11
South Africa	43.5	0.6	0.3	-0.4	0.1	0.5	16	0.5	12
Bulgaria	30.9	0.7	0.3	0.1	0.2	0.6	13	0.5	13
Malaysia	36.0	0.7	0.2	0.1	0.2	0.6	15	0.5	14
Indonesia	37.6	0.6	-0.4	-0.8	-0.1	0.3	26	0.5	15
Thailand	54.7	0.7	-0.2	-0.5	-0.0	0.3	24	0.5	16
Peru	50.5	0.7	-0.3	-0.3	-0.0	0.3	22	0.5	17
Vietnam	37.8	0.6	-0.5	-0.9	-0.1	0.2	30	0.5	18
Egypt	32.1	0.6	-0.4	-0.7	-0.0	0.3	25	0.5	19
Colombia	58.5	0.7	-0.4	-0.4	-0.1	0.2	27	0.5	20
Philippines	44.0	0.6	-0.5	-0.7	-0.1	0.2	28	0.5	21
Mexico	51.6	0.8	-0.1	-0.1	0.0	0.4	19	0.5	22
Estonia	31.0	0.8	1.1	0.7	0.5	0.9	2	0.5	23
Argentina	48.8	0.8	-0.4	-0.1	-0.0	0.3	21	0.4	24
Hungary	26.9	0.8	0.8	0.5	0.4	0.8	6	0.4	25
Turkey	41.2	0.7	0.0	-0.3	0.1	0.4	18	0.3	26
Russia	43.7	0.7	-0.7	-0.5	-0.1	0.2	31	0.3	27
Romania	32.1	0.8	0.2	0.1	0.2	0.6	14	0.3	28
Lithuania	36.0	0.8	0.7	0.4	0.4	0.7	10	0.3	29
Latvia	36.3	0.8	0.7	0.4	0.4	0.7	11	0.3	30
Venezuela	43.4	0.7	-1.3	-0.9	-0.3	0.0	33	0.2	31
Ecuador	54.4	0.7	-0.9	-0.7	-0.3	0.1	32	0.2	32
Ukraine	27.6	0.7	-0.5	-0.4	-0.0	0.3	23	0.2	33
LAC (average)	51.3	0.7	-0.1	-0.2	0.0	0.4		0.5	
Developed (average)	30.0	0.9	1.7	1.4	0.9	1.2		0.8	

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