

## KEYWORDS

Economic growth  
Economic conditions  
Economic policy  
Monetary policy  
Financial policy  
Economic crisis  
Macroeconomics  
Economic stabilization  
Latin America

# Latin America, from boom to crisis: macroeconomic policy challenges

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**T**his article analyses the most recent phase of growth in Latin America, lasting from 2003 to late 2008, and the way the different policies applied in this period lessened its countries' vulnerability and gave them greater macroeconomic policy space to confront the international crisis than in other negative shocks of the past. In addition, it briefly surveys the main countercyclical fiscal, monetary, financial and exchange-rate policy measures applied in the region's economies to mitigate and reverse the effects of the crisis. It concludes by discussing post-crisis macro policy challenges in the region.

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# I

## Introduction

Latin America experienced six consecutive years of growth from 2003 until late 2008, an expansion whose strength, duration and characteristics were unprecedented in the economic history of the region. It encompassed almost all the region's economies, and regional output growth averaged 4.8% a year over the period, with cumulative per capita gross domestic product (GDP) growth of 22.1%, equivalent to 3.4% a year.

The recent international crisis brought this period of growth to an end and showed the need to take stock of it, to analyse the channels through which the crisis was transmitted to the Latin American economies and its repercussions for a region that was better prepared than it had been for other crises

in the past, and to consider some of the post-crisis challenges for macroeconomic policy.

To address these issues, the present article is structured as follows. Section II analyses the main features of the growth period running from 2003 to 2008 in the countries of Latin America and the contribution of macroeconomic policy to reducing the region's vulnerability. Section III studies the main channels through which the international crisis was transmitted to Latin American economies, while section IV examines the macroeconomic scope for addressing the crisis and the fiscal, monetary, financial and exchange-rate measures taken. Lastly, and by way of conclusion, there is a discussion of some challenges for macroeconomic policy in the longer term.

# II

## The main characteristics of the growth phase, 2003-2008

The period we are concerned with was clearly unprecedented in the economic history of the region, not only because per capita GDP grew steadily at over 3% annually, which had not happened in the last 40 years, but because this growth was accompanied by a quantitative and qualitative improvement in fundamental macroeconomic variables. For one thing, the balance-of-payments current account went into surplus, largely because of a recovery in the terms of trade (especially for South America) and rising remittances from emigrant workers (in Mexico and, most particularly, Central America). The excess growth of national disposable income over consumption provided a basis for higher national saving and investment financing. External surpluses and policies to accumulate "reinsurance" and stabilize real

exchange rates allowed central banks to build up large quantities of external assets. Meanwhile, developments in the public accounts during the expansion phase included growing primary surpluses and the virtual disappearance of overall deficits, allowing public debt to be reduced substantially. Unemployment fell and the quality of new jobs improved during this period of growth, leading to a reduction in poverty and indigence and a small improvement in equity. Each of these stylized facts will now be analysed in greater detail.

### 1. The external context and the current account

The good economic performance of Latin America in the 2003-2008 period occurred in a general global context of rapid growth. The number of countries achieving per capita output growth rates of more than 3% a year increased over the period, and this was due essentially to rapid growth in emerging economies: per capita GDP growth rates exceeded 3%

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□ The authors are grateful for the comments and suggestions made by José María Fanelli, Daniel Heymann, André Hofman, José Luis Machinea, Miguel Torres and colleagues at the Economic Development Division of ECLAC on different versions or sections of this document.

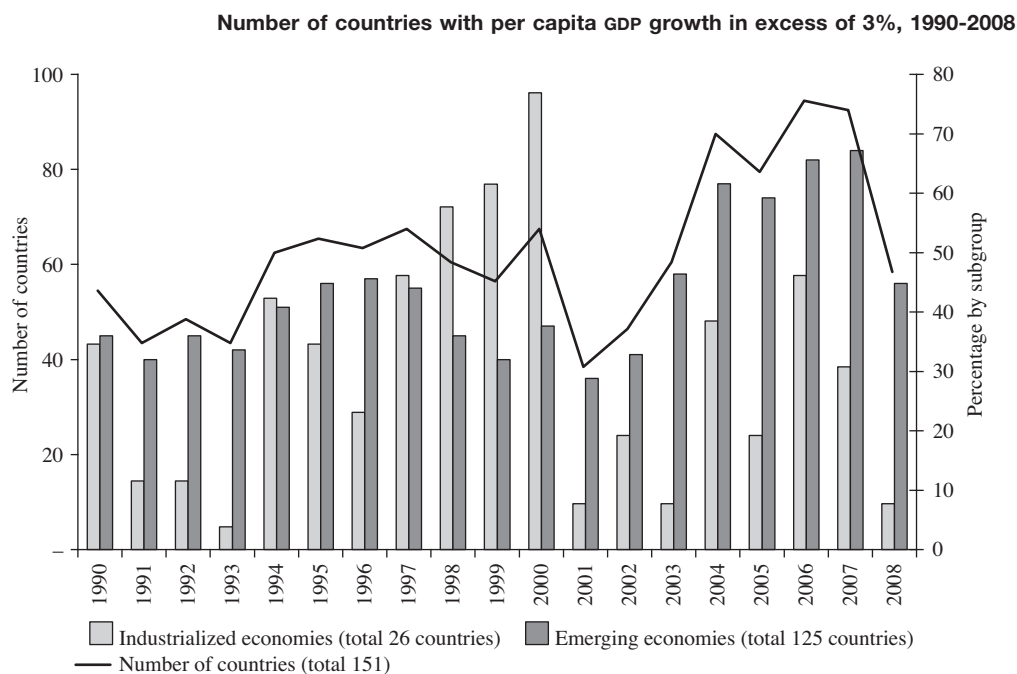
in 57% of these between 2003 and 2008, while only 25% of industrialized economies saw comparable growth (see figure 1). This pattern is remarkable when compared with the distribution of growth in the 1990s. Then, just 38% of emerging economies and 33% of industrialized ones averaged per capita output growth of more than 3% a year, with growth in the industrialized countries picking up strongly between 1998 and 2000.

Other major developments in the context of this prolonged expansion of the global economy were the growing share of global demand accounted for by China and India and the high level of liquidity in international markets until mid-2007. The favourable external conditions meant that growth in the region was accompanied, unprecedentedly in its economic history, by a current-account surplus every year except 2008. Two main factors account for the evolution of the regional current account: the terms of trade, and remittances from emigrant workers. These affected the region's countries differently, however, so that although the region as a whole averaged a current-account surplus between 2003 and 2007, just eight countries (all in South America) actually ran surpluses during the period of expansion, something that is largely explained by the behaviour of their terms of trade.

As figure 2 shows, countries specializing in exports of oil and oil derivatives and of metals and minerals experienced the greatest improvement in their terms of trade during the period of growth. In the case of the Southern Common Market (MERCOSUR) countries, higher net export volumes were mainly responsible, since the rise in relative export prices was not particularly large (less than 10%). Mexico is another country that saw a large improvement in its terms of trade, in this case thanks to higher oil prices, although these were partly offset by a decline in net goods exports by volume. The experience of the Central American countries was different. As net oil importers competing with China in the United States market, not only did they suffer from a deterioration in their terms of trade during the regional growth stage, but their external sales actually declined in real terms, in both cases relative to the average for the 1990s.

Mexico, the Dominican Republic and most of the Central American countries are large recipients of remittances from emigrant workers, as to a lesser degree are some countries in South America (Ecuador, the Plurinational State of Bolivia, Colombia and Paraguay). The region as a whole received remittances equivalent to an average of 1.7% of GDP in the 2003-

FIGURE 1



Source: prepared by the authors on the basis of data from the United Nations and the International Monetary Fund (IMF).

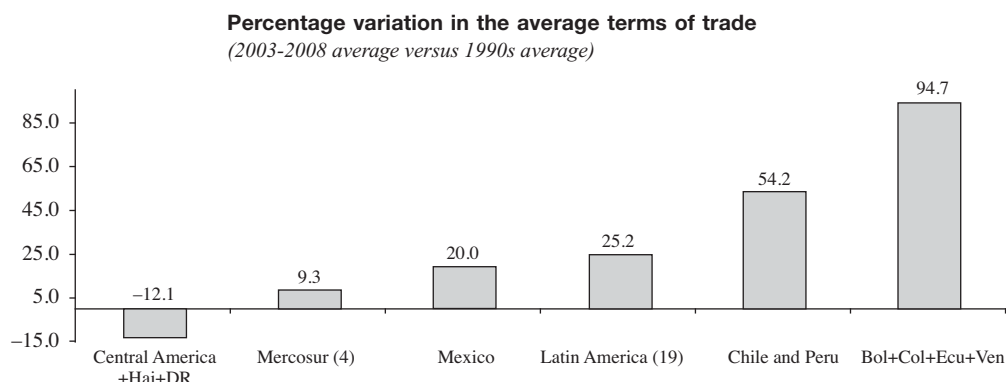
2008 period (see figure 3). However, Central America received the equivalent of 9.2% of GDP on average (rising to 14% when Costa Rica and Panama are excluded) and Mexico some 2.4%, a figure comparable to the country's inward foreign direct investment (FDI) over the period. Remittance inflows in South America were most substantial for Ecuador and the Plurinational State of Bolivia, followed by Colombia and Paraguay.

Another characteristic of the balance-of-payments current account in the growth years was the substantial rise in profit remittances by foreign firms to their parent companies. As figure 4 shows, net profit flows

as a share of GDP grew strongly in South American economies largely reliant on the production and export of commodities, chiefly oil, metals and minerals. This is consistent with the improvement in international prices for these products and the fact that, in many cases, natural resources are exploited by foreign firms. Chile and Peru accounted for an average of 33% of net currency outflows of this type between 2003 and 2008, even though they represent less than 8% of regional GDP as measured in current dollars.

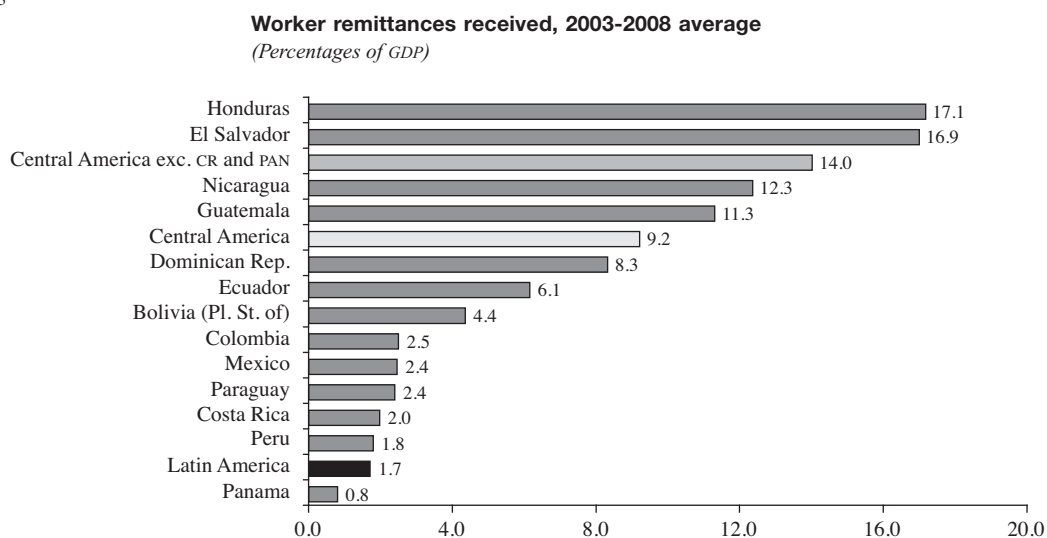
To illustrate the effects referred to above and their repercussions for the current-account balance, we shall now analyse disaggregated changes in current-

FIGURE 2



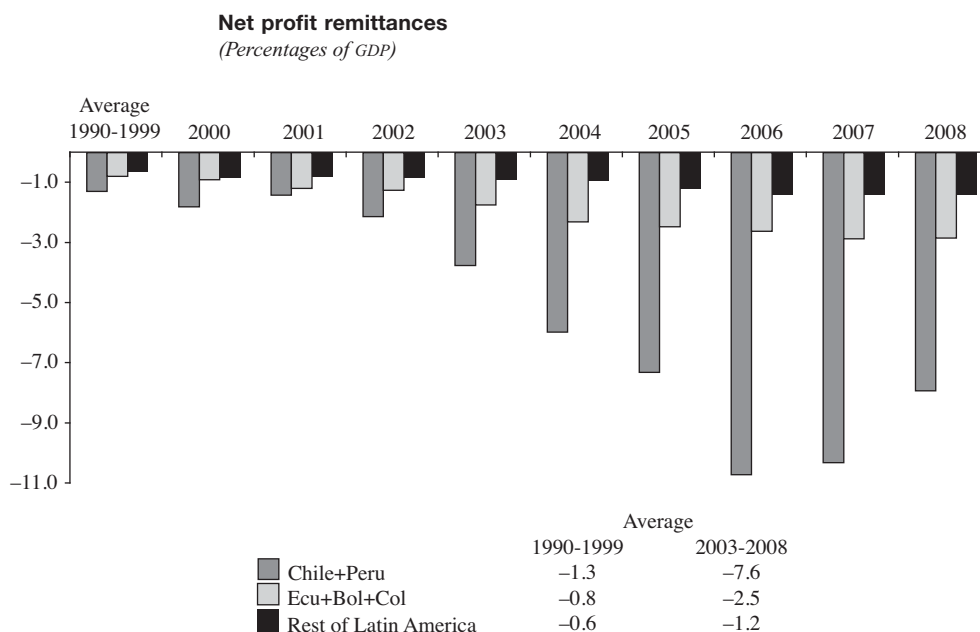
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

FIGURE 3



Source: prepared by the authors on the basis of official figures.  
Exc. CR and PAN.: Except Costa Rica and Panama.  
GDP: Gross domestic product.

FIGURE 4



Source: prepared by the authors on the basis of official figures. GDP: Gross domestic product.

account averages by country over the growth period (2003-2008), using the 1990s average as a yardstick of comparison. In South America (see figure 5a), current-account balances improved in most of the countries (the exceptions were Colombia and Uruguay), essentially because of better terms of trade and, in some countries, improved trade balances in real terms. The countries that benefited most from improving terms of trade were the Bolivarian Republic of Venezuela and Chile although, as already discussed, the improvement was partly offset in the latter and in Peru by the remittance of profits abroad, particularly in the mining industry. The economies of Argentina, the Plurinational State of Bolivia, Brazil, Peru and Uruguay recorded the largest rises in export volumes. It is interesting to note that emigrants' remittances began to play a prominent role in a number of South American countries (the Plurinational State of Bolivia, Colombia, Ecuador and Paraguay) when compared to the averages for the 1990s.

Figure 5b gives a breakdown of current-account developments in Mexico and Central America between the periods analysed. A common element in these countries is the deterioration of trade balances at constant prices and, other than in Mexico, the negative effect of terms-of-trade developments. At the

same time, currency inflows from emigrant workers' remittances were very significant everywhere except Costa Rica and Panama. In these two countries and the Dominican Republic, the services balance had a significant positive effect.

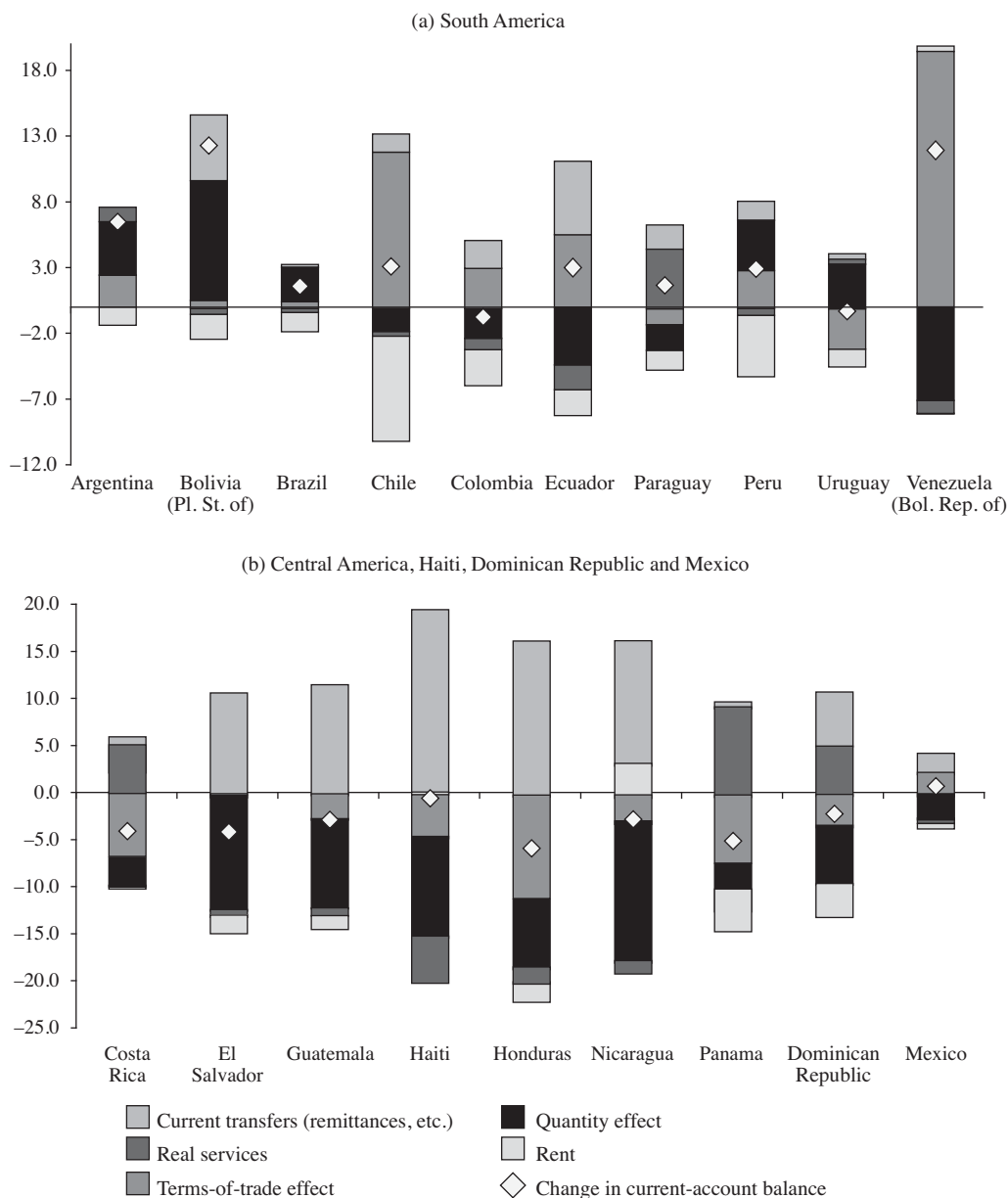
## 2. Saving and external vulnerability

One thing that characterized the 2003-2008 period of expansion was that gross national disposable income (GNDI) expanded more quickly than GDP in most of the region's countries. While regional GDP grew by an average of 4.8% annually, GNDI growth averaged 5.7%. This development was most pronounced in countries exporting metals, minerals and hydrocarbons (Plurinational State of Bolivia, Chile, Colombia, Ecuador, Peru and the Bolivarian Republic of Venezuela), which saw a substantial increase in GNDI consistent with terms-of-trade improvements, even though in some cases there was also a considerable rise in net payments of profits and dividends to the rest of the world.<sup>1</sup> GNDI growth also

<sup>1</sup> A detailed analysis of these issues can be found in Kacef and Manuelito (2008).

FIGURE 5

**Breakdown of changes in current-account balances between the 1990-1999 average and the 2003-2008 average**  
*(Percentages of average 2003-2008 GDP)*



Source: prepared by the authors on the basis of official figures.

outstripped GDP growth in the other countries of South America, albeit to a lesser degree. In Central America, notwithstanding the declining purchasing power of exports, rising emigrants' remittances allowed GNDI to grow more strongly than GDP in some countries (Guatemala and Honduras). In the case of Mexico,

the expansion of national income can be attributed both to the improved terms of trade and to the growth in net current transfers received.

Dynamic consumption notwithstanding, the rise in GNDI in the region meant that national saving rose strongly in most of the countries, averaging 22%

of GDP between 2003 and 2008 at current prices, the highest level since 1990. By contrast with the last decade, external saving turned negative (−0.7% of GDP), meaning that regional investment was wholly financed out of national saving for much of the period of expansion, the exception being 2008.

The situation of the external accounts led to a remarkable build-up of international reserves, with some central banks intervening in currency markets because of concerns about the level of the real exchange rate. The stock of international reserves has grown strongly over the past six years as a result of such intervention, and it provided “reinsurance” when the international crisis struck. At the same time, the external debt burden fell greatly as a share of both GDP and exports.<sup>2</sup> Although external debt remains high in some countries, the ratio between external debt and goods and services exports has dropped to less than half its level of 10 years ago when calculated on the basis of total debt, and to about a third when calculated as debt net of international reserves.

Increased liquidity and the improved debt profile reduced vulnerability in the region, something that was manifested in a large decline in the ratio between short-term external debt and international reserves from 49.3% in 2002 to less than 25.4% in 2008 (see figure 6). Besides the lower external borrowing ratios,

vulnerability to external shocks diminished thanks to a reduction in the degree of dollarization in a number of the region’s economies, especially in South America (including the Plurinational State of Bolivia and Peru). The improvement in the Latin American macroeconomic situation between 2003 and 2008 was clearly reflected in international financial markets, not only in the evolution of sovereign risk indicators but also in more favourable debt ratings for several of the region’s countries.

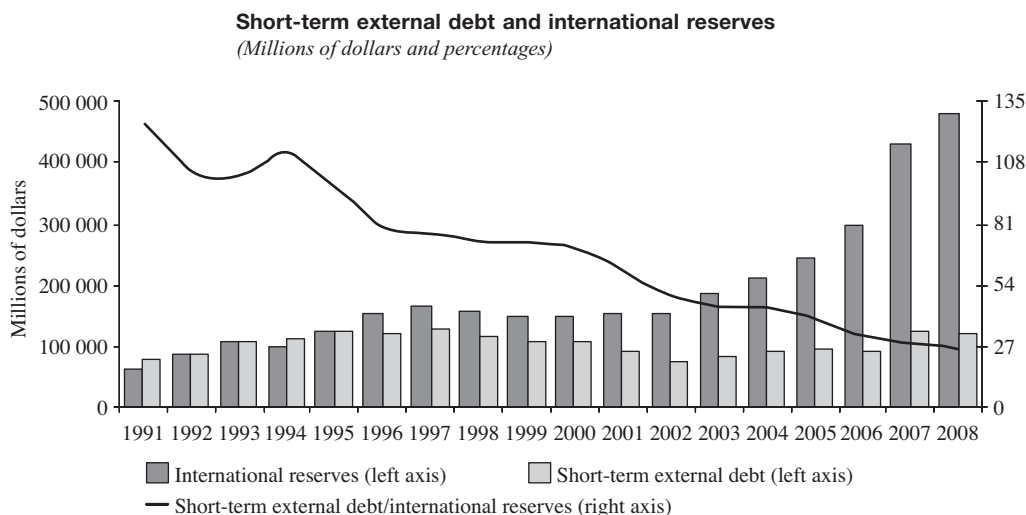
### 3. Social indicators and labour markets

Economic growth led to expanding demand for labour and thence to many new formal jobs. The employment rate began to recover in 2003 and was 3 percentage points higher by 2008, equating to annual average growth of 3.3% in the number of people in work over the 2003-2008 period, although there was a marked slowdown in the last of those years (see figure 7). At the same time, the unemployment rate in the region as a whole fell from a peak of 11% in 2002 and 2003 to 7.4% in 2008, bringing it back down to its early 1990s levels. Because unemployment was still high, however, real wages in the formal sector saw only moderate increases that did not keep pace with labour productivity growth.

The urban economically active population (EAP) has grown by 2.4% a year since the beginning of the current decade. Since the numbers in work grew by less than 2% in the early years, unemployment

<sup>2</sup> Mention should be made in both cases of the increase in the variables of the denominator of these ratios.

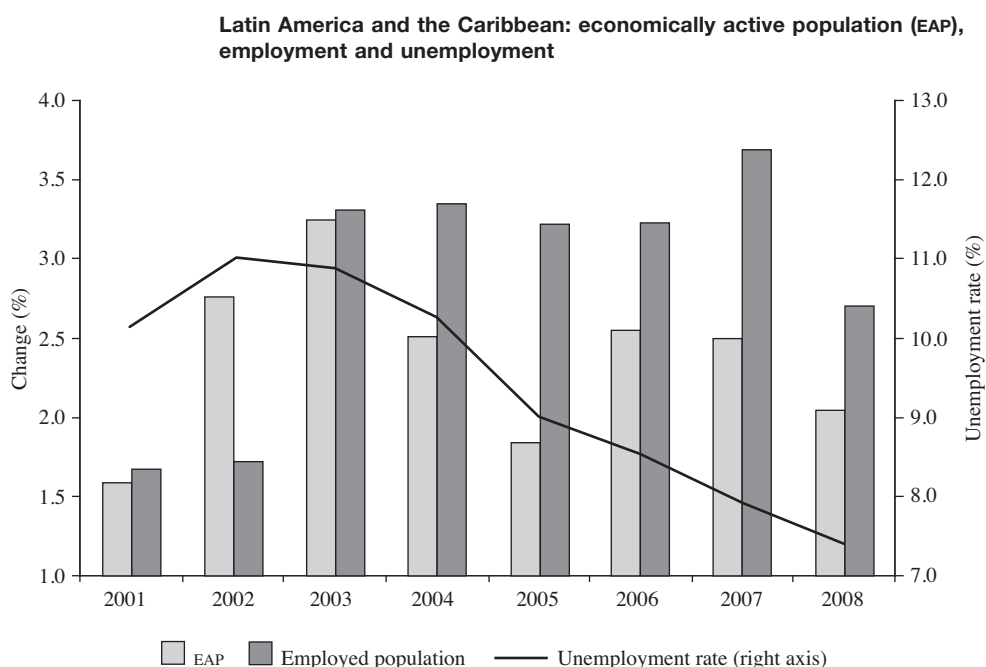
FIGURE 6



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



FIGURE 7



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

was sharply up by 2002. As noted above, however, employment picked up along with economic growth, causing the unemployment rate to fall. The labour supply has been rising in recent decades as a result of the sharp increase in the female participation rate, not only in urban areas but also in rural ones, where it has traditionally been low.<sup>3</sup>

Job creation began to accelerate in 2003, along with the economy; in the 2005-2007 period particularly, the expansion of own-account working stalled as a result of growth in the economy and in wage employment that was unprecedented for the region, at least by the standards of the past 25 years.<sup>4</sup> Although own-account employment growth accelerated in 2008, it was still outpaced by wage employment, and this was true of five of the six years of economic expansion (see figure 8).

Economic growth and improving labour market indicators in the 2003-2008 period of expansion had a positive effect in terms of poverty reduction and

also, although only incipiently, of income distribution. Poverty and indigence rates fell by 10.4 and 6.4 percentage points, respectively, from their levels of the beginning of the decade.<sup>5</sup>

A recent ECLAC study (ECLAC, 2008b) states that one of the main causes for the decline in poverty and indigence rates between 2002 and 2007 was the so-called “growth effect” or increase in mean household incomes. In a number of the region’s economies, however, improving income distribution, or the “distribution effect”, was the main factor in the reduction of poverty and indigence.<sup>6</sup> It is important to appreciate that both effects contributed simultaneously to the reduction of poverty in nine of the region’s countries, albeit to differing degrees (see figure 9). Interestingly, the rise in average incomes in the lowest-income households was mainly due to higher labour incomes, as opposed to non-work income sources (public and private

<sup>3</sup> At the regional level, the participation rate has generally behaved procyclically (Machinea, Kacef and Weller, 2008).

<sup>4</sup> This appears to indicate that the increase in informal working in the 1990s was not due to a preference for this type of employment; rather, workers had no choice given weak demand for labour in the formal sector.

<sup>5</sup> Indigence increased slightly in 2008, even though poverty continued to fall. This divergence was due to the large increase in food prices in the first half of 2008.

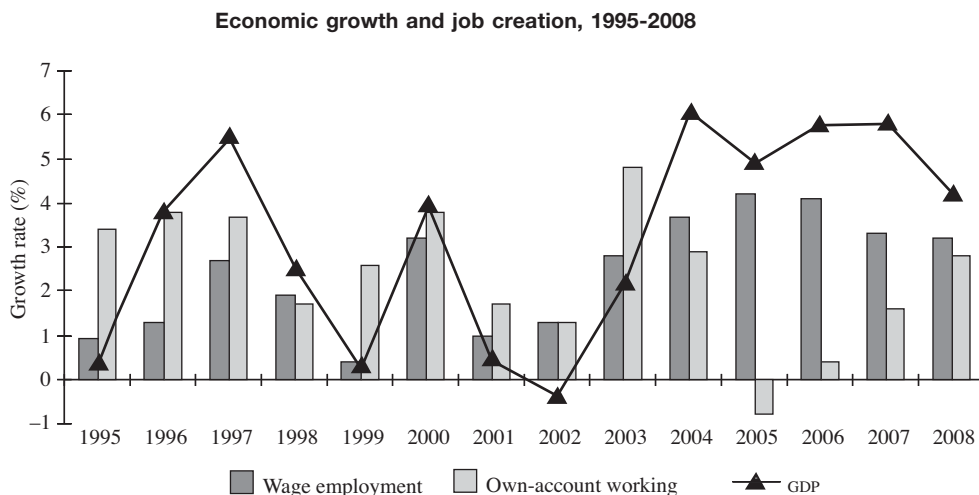
<sup>6</sup> This analysis is based on the decomposition of changes in poverty and indigence rates developed by Datt and Ravallion (1992), averaging out the effects calculated using the different base years (as suggested by Kakwani, 1997) to avoid the residual and not have to depend on a single base year. See ECLAC (2008b, box I.7) for a fuller description of the methodology.



transfers, capital income and other income). Of the seven countries where poverty declined most rapidly (Argentina, Brazil, Chile, Ecuador, Mexico, Panama and the Bolivarian Republic of Venezuela), higher labour incomes accounted for an average of 77%

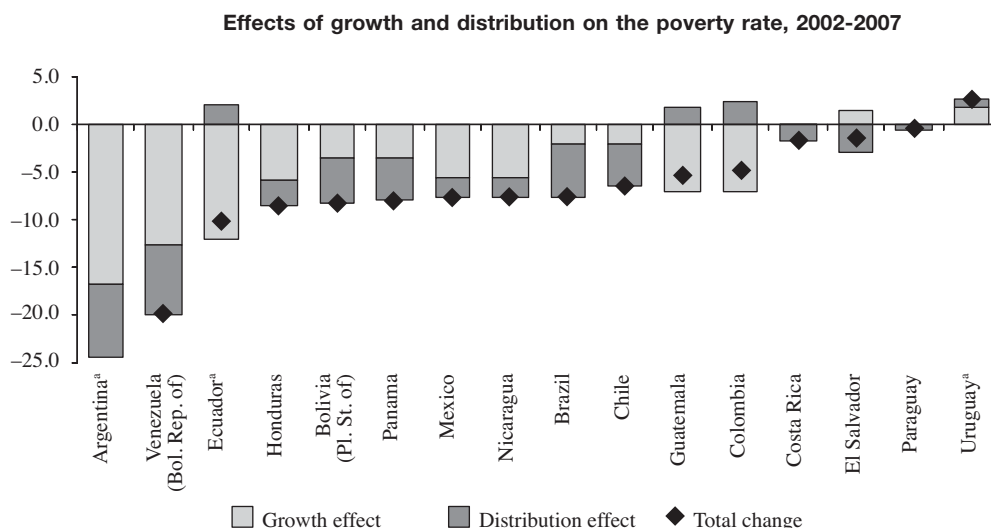
of the rise in total income in poor households and 69% of income in indigent households. As analysed earlier, this occurred against a background of both qualitative and quantitative improvements in the region's labour indicators overall.

FIGURE 8



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures. GDP: Gross domestic product.

FIGURE 9



Source: Economic Commission for Latin America and the Caribbean (ECLAC), Social Panorama of Latin America, United Nations publication, Chile, 2008.

<sup>a</sup> 2002-2006.

### III

## The contribution of macroeconomic policy during the boom

### 1. Fiscal policy

The central government fiscal accounts of the Latin American countries have improved greatly in recent years. Not only has the overall deficit been reduced, but since 2004 there has been a primary surplus, calculated in both cases as a simple average. This average primary surplus reflects a good fiscal performance throughout the region. Of the 19 countries analysed, 14 had a primary surplus in 2008 (only Guatemala, Haiti and Honduras still had a primary deficit). This is in great contrast to 2002, when only seven countries ran a surplus.

Meanwhile, the positive evolution of the fiscal accounts in a context of rapid economic growth made it possible to reduce the debt-to-GDP ratio, whose regional average fell from 58.4% in 2002 to 28% in 2008. The region's countries also took advantage of the favourable macroeconomic conditions in the period to apply active liability management policies, reducing their financial vulnerability.

The good performance of the public accounts over six years prior to the crisis contrasts with what has happened in other recent episodes of growth (see figure 10a). During the 2002-2008 period, the primary surplus grew by 1.8 points of GDP thanks to a large increase in total revenues equivalent to 3.4 points of national output, while spending increased by only 1.6 percentage points. In the two growth periods of the 1990s (1991-1994 and 1995-1998), by contrast, fiscal revenue growth was not so strong and in both cases failed to keep pace with primary spending growth as a share of GDP, as a result of which the region's average primary surplus decreased. It is nonetheless interesting to observe the evolution of the main fiscal indicators during the recent period of expansion. Whereas the improvement in the primary surplus between 2003 and 2004 was due to higher fiscal revenues and the fact that spending grew by less than output in the region, the rise in the primary surplus in 2005 and 2006 was due to a surge in revenues, easily outstripping the growth of public spending as a share of GDP (see figure 10b). From 2007 onward, primary spending accelerated while the rate of growth

in total revenues as a share of national output tailed off. This caused the public accounts to deteriorate in 2007 and again in 2008.

As the above analysis shows, continuing fiscal revenue growth and a more restrained spending policy during the 2003-2006 period accounted for much of the improvement in the primary surplus as a share of GDP during the period of expansion. The countries whose fiscal revenues grew most are those whose export product prices rose most strongly.

The effects of the fiscal boom in the region depended on the origin of the extraordinary resources received by the countries. In Central America, national income growth was mainly due to emigrant worker remittances received by the private sector. In almost all the South American countries and Mexico, on the other hand, most of the improvement was due to the terms-of-trade effect, even though Mexico is the largest recipient of remittances in absolute terms. In countries where exporting is largely carried out by State-owned enterprises, a large share of the resources generated by the terms-of-trade improvement went to the public sector.<sup>7</sup> This is generally the case with exports of oil and certain metals, including copper. Where exporters are not public-sector firms, the resources go to private-sector firms, and the State only receives a portion of them in the form of taxes.

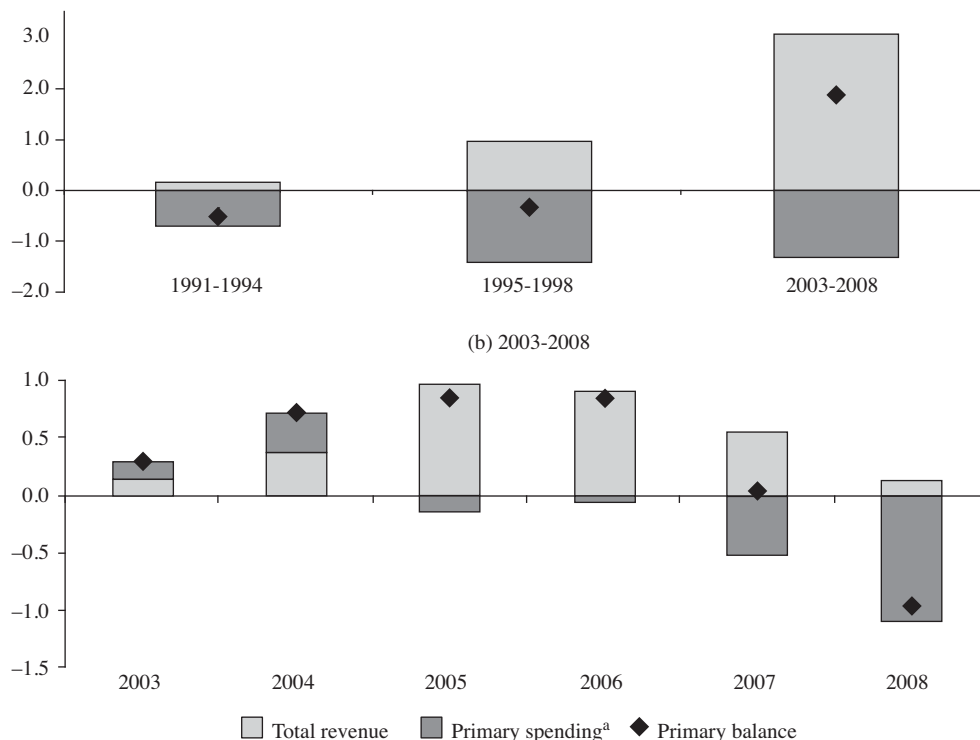
Where the fiscal repercussions of rising remittances and export prices are concerned, it is possible to distinguish between three stylized situations with differing effects on the public accounts. When production is carried out by the private sector, remittances and higher export prices have positive effects on the public accounts because tax revenues rise, directly in the case of higher export prices (via profit or export taxes) and indirectly through the effects of higher remittances and export prices on domestic demand. An important difference is that remittances tend to boost consumption, while private firms may invest some of their profits or increase

<sup>7</sup> See Jiménez and Tromben (2006) for an analysis of the effects of export price changes on tax revenue.

FIGURE 10

**Fiscal indicators: primary balance and contribution of revenue and spending**  
(Changes in points of GDP)

(a) Comparison between periods: 1991-1994, 1995-1998 and 2003-2008



Source: prepared by the authors on the basis of official figures.

<sup>a</sup> A negative contribution means a rise in primary spending.  
GDP: Gross domestic product.

the amounts they remit abroad, an effect that was analysed earlier. When the producing and exporting firms are State-owned, the effects on fiscal revenues are greater, while the consequences for demand will depend on public policy decisions as to whether to save the surplus or increase spending. This alternative gives fiscal policy a greater stabilization capacity and the option of channelling resources into higher investment spending, whether on infrastructure or on human capital.

As already mentioned, meanwhile, fiscal indicators showed a marked acceleration of primary spending as a share of GDP in the last two years of the growth period. Whereas capital spending accounted for a larger share of the increase in outgoings in 2007, in 2008 current primary spending grew more strongly than capital spending. This increase in primary spending can be interpreted as a consequence of the large fall in public spending during the stabilization

programmes of the early part of the decade, combined with the expansion of social spending, which followed the upward trend already in evidence for part of the 1990s.<sup>8</sup> From this perspective, the rise in social spending can be considered appropriate and indeed necessary, given the high levels of poverty and inequity in the region. By contrast with what used to happen, the rise in spending over recent years has taken place in a context of fiscal consolidation throughout the region, albeit with some differences between countries. As already discussed, this consolidation is largely explained by the strong increase in fiscal revenues and is reflected in the shrinking of the overall fiscal deficit and the generation of a growing primary surplus, at least up until 2007.

<sup>8</sup> After falling sharply in the 1980s, social spending increased by 40% in real terms between 1991-1992 and 2002-2003.

## 2. Monetary and exchange-rate policy

Broadly speaking, one thing that characterized most of the growth period in Latin America was an increase in inflationary expectations as a result of the steady expansion in activity and rising commodity prices, especially for energy and some foods. After a decline in the regional average during the 2003-2006 period, inflation worsened again in 2007 and reached double digits in 2008 (see figure 11).

From 2004 to 2006, nine countries out of a total of 19 had annual inflation rates in excess of 6%, whereas in 2008 this benchmark was exceeded by 16 countries. Rising prices were not an exclusively Latin American phenomenon but occurred in a context of higher inflation around the world, driven by the same causes as in the region: higher levels of activity and rising commodity prices. This is borne out by the fact that the number of emerging economies with inflation rates of more than 6% a year rose from an average of 42 countries in the 2004-2006 period to over 70 in 2008.

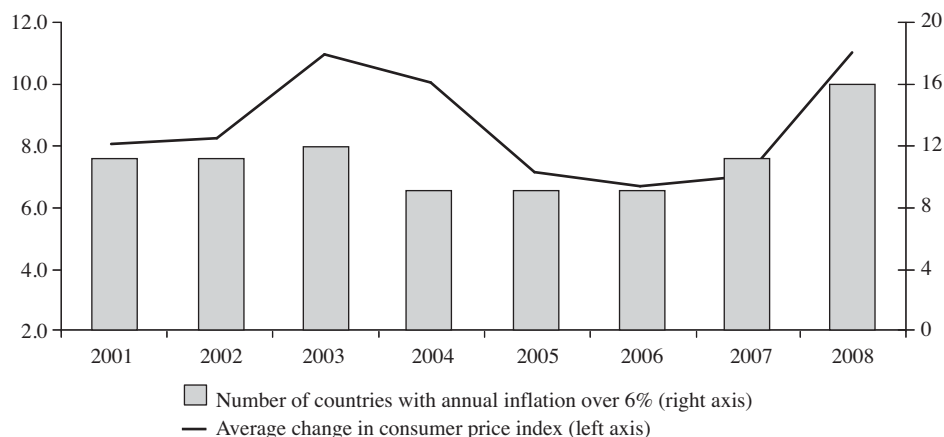
Meanwhile, an initial stage of sharp depreciation in the real effective exchange rates of the region's countries was followed in the latter years by a pattern of quickening real appreciation, particularly in the South American countries. This led many of the region's central banks to step up the pace of intervention in currency markets, building up large international reserves (see figure 12).

While policy continued to be based on inflation targeting, concerns about the real exchange rate led the monetary authorities of Brazil, Colombia and Peru to intervene in the currency markets. The same happened in Chile, with the Central Bank deciding to intervene in April 2008 with a view to strengthening the liquidity position of the Chilean economy in anticipation of a worsening external environment. This measure was considered to be consistent with the assessment that the long-term real exchange rate of the Chilean currency was stronger than its equilibrium level. There was also large-scale currency-market intervention in Argentina, the Plurinational State of Bolivia, Costa Rica and Paraguay. If the increase in reserves over recent years is added to that seen during the initial phase in 2003-2005, the total build-up of reserve assets in six years was in excess of US\$ 327.5 billion in the region as a whole, equivalent to 11.3% of average GDP.

For all the efforts made by central banks, this was a time when the dollar was depreciating against other currencies, and the real effective exchange rates of most of the region's countries appreciated relative to their average levels in the 2003-2005 period (see figure 13). Improving terms of trade, rising demand for some of the region's export products and growing inflows of emigrant workers' remittances were all factors in the appreciating tendency of the region's real exchange rates. Increased external liquidity was also a factor to a lesser degree, by contrast with the

FIGURE 11

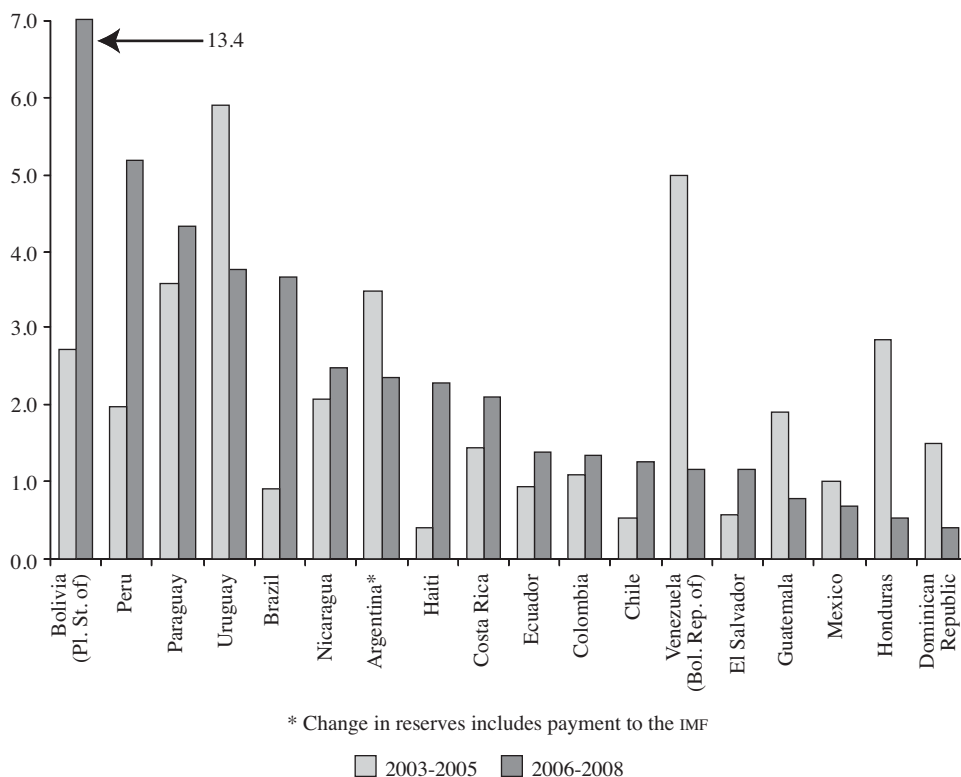
**Latin America and the Caribbean: simple average of inflation rates and number of countries with annual inflation over 6%**  
(Percentages)



Source: prepared by the authors on the basis of official figures.

FIGURE 12

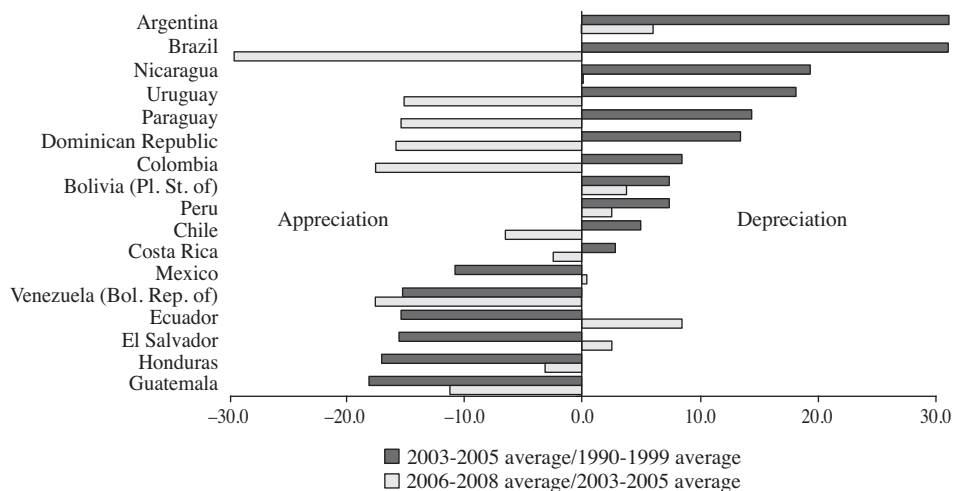
**Latin America and the Caribbean: average change in international reserves in the 2003-2005 and 2006-2008 periods**  
(Percentages of GDP)



Source: prepared by the authors on the basis of official figures.  
GDP: Gross domestic product.

FIGURE 13

**Latin America and the Caribbean: real effective exchange rate**



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

1990s. In summary, excess supply in the currency market created pressure for real exchange rates in the region to appreciate in the years leading up to the international crisis. The strength of this effect differed from one country to another, but did not depend on the scale of efforts made by monetary authorities to hold exchange rates steady by intervening in the currency markets.

Currency-market intervention was matched by an increasing effort to sterilize currency issuance, in a context of rising inflationary expectations. The region's countries applied absorption policies via open market operations, entailing costs of different kinds and leading to a variety of results. To cite just a few examples, the Central Bank of Brazil bought reserve currency to hold the exchange rate steady, paying a high price in terms of interest rates on the neutralization instruments to avoid jeopardizing the

monetary programme; as we have seen, though, these efforts did not prevent appreciation of the real. Much the same happened in Colombia. In Argentina, on the other hand, the Central Bank also purchased foreign currency and was more successful in stabilizing the exchange rate, but there was a high cost in terms of control over monetary policy.

The central banks of the two countries cited in the first instance also kept interest rates high, which encouraged capital inflows, whereas in Argentina domestic demand was increasing strongly, partly because of public spending growth. The element common to all three cases is that the costs associated with the currency market intervention strategy (and its outcome) were largely determined by a general economic policy context with characteristics that conflicted with the decision to stabilize the real exchange rate.

## IV

### The repercussions of the crisis for the Latin American macroeconomy<sup>9</sup>

The global economic crisis cut short the longest and most vigorous period of economic growth in the region since the 1970s. As mentioned in the previous section, this growth took place against the background of a worldwide economic expansion that was strongest from 2003 until mid-2007, when the problems originating in the United States subprime mortgage market gradually began to spread around the world. The impact was felt in financial systems worldwide and significantly affected goods and labour markets, particularly from September 2008 onward. This built up into a global economic shock of unusual severity, with similarities to the Great Depression of the 1930s that have elicited comparisons with that episode.<sup>10</sup>

The repercussions of the crisis for the economies of Latin America were manifested through the real sector, negatively affecting the performance of what

until recently had been the main engines of regional growth. Exports fell significantly in both volume and value from the second half of 2008, reflecting the fall-off in world trade (see figure 14). Where services are concerned, the contraction in tourism was particularly damaging, as this accounts for a large share of economic activity in Central America and the Caribbean.

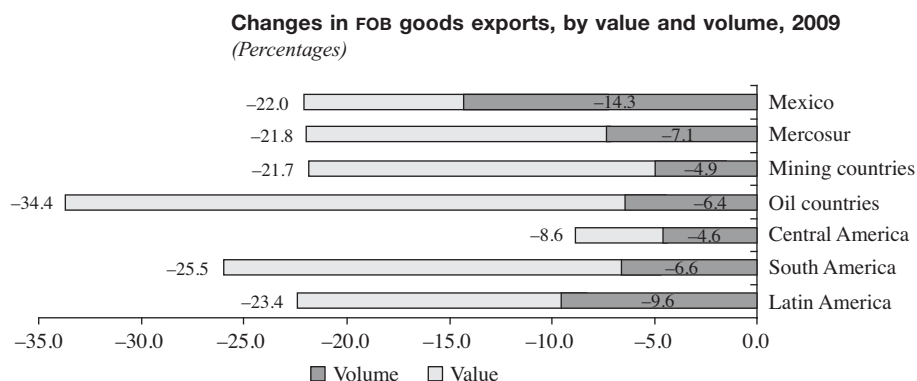
The sharp decline in global activity and the reduction in trade flows had a negative effect on commodity prices, and thus on the region's terms of trade. Following the rise in the first half of 2008, the crisis impacted international goods markets quite severely following the collapse of Lehman Brothers in September. While international commodity prices tended first to stabilize and then to recover from their sharp decline in the early part of 2009, the averages for the year were considerably down on 2008 levels, so that the terms of trade for the region as a whole deteriorated by about 4%. This primarily affected South America, most particularly countries producing oil and hydrocarbons and metals and, to a lesser extent, those specializing in food production. Conversely, the terms of trade for Central America are estimated to

<sup>9</sup> This section is based on Kacef (2009). See also Machinea (2009) and Lopes (2008) for an analysis of the international crisis from a Latin American perspective.

<sup>10</sup> See Eichengreen and O'Rourke (2009) and Krugman (2009) for a discussion of the similarities between the Great Depression and the recent crisis.



FIGURE 14



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

have improved, since it imports these types of goods, although without fully offsetting the deterioration of earlier years.

The fact that most Latin American emigrants work in the United States and Spain, two of the countries worst affected by the crisis, explains why remittances fell so sharply. The data available suggest annual declines of some 10% in certain Central American countries such as El Salvador and Guatemala, and even more in the cases of Colombia, Ecuador and Mexico.

While we have stated that, on the whole, the consequences of the international crisis were felt primarily through the real channel, in some cases there were impacts on financial systems that may have had substantial repercussions on activity levels. Thus, while trade shocks were a greater factor in the region than capital flow reversals, there were three important exceptions to this rule: Brazil, Chile and Peru, countries whose financial systems presented the greatest degree of external exposure relative to the rest of the region as of late 2008.<sup>11</sup>

As figure 15 shows, the situation was manifested in these countries' financial systems by way of a sharp real-term contraction in private-sector bank lending. As will be seen later on, the public banking system took on an active role in many countries as

part of the countercyclical strategies implemented. However, with the exception of Brazil, where the public banking system accounts for a large proportion of total lending, its ability to offset the reduction in lending by private-sector banks was relatively modest in the region.

In our judgement, this factor played a fundamental role in the relative weakness of the Chilean economy between late 2008 and the third quarter of 2009, despite the country's sound macroeconomic fundamentals and active State intervention through countercyclical policies. The evidence set out in figure 16 on the scale of lending as a proportion of GDP reveals the greater effect that the contraction in private-sector bank lending may have had on activity levels in the Chilean economy as compared to the Brazilian and Peruvian economies and those of the rest of the region in general.

Broadly speaking, and particularly in late 2008 and early 2009, there was a deterioration in consumer and business expectations that was reflected by a decline in both consumption and investment in the private sector. The latter was exacerbated by the drop in foreign direct investment, estimated by ECLAC at between 35% and 40% in 2009.<sup>12</sup> As figure 17 shows, only public-sector consumption recorded positive growth in the early part of the year, thanks to the leeway many of the region's countries had at the time to implement countercyclical policies that partially offset the negative evolution of the other components of domestic demand and accelerated the recovery process in the latter part of 2009, something that will be analysed further on.

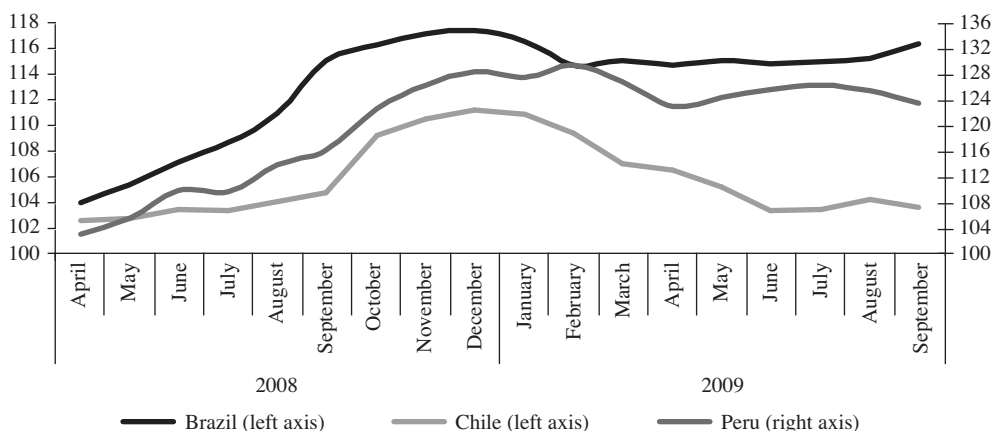
<sup>11</sup> According to ECLAC estimates (see ECLAC, 2008a), only these three countries showed signs of a sudden stop in capital flows associated with the effects of the crisis. In the region's other countries, the information analysed suggests a trade shock caused by an export decline that was considerably greater than would have been expected in a typical cyclical movement. These shocks, however, were strongly associated with the behaviour of commodity prices, which means that they cannot be dissociated, in either their origins or their effects, from a shock of a financial kind.

<sup>12</sup> See ECLAC (2009a).



FIGURE 15

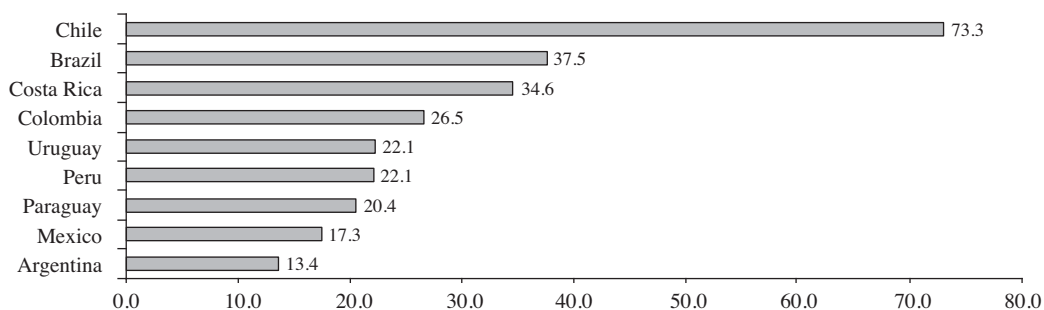
**Private-sector bank lending in Brazil, Chile and Peru**  
*(Index: first quarter of 2008=100)*



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

FIGURE 16

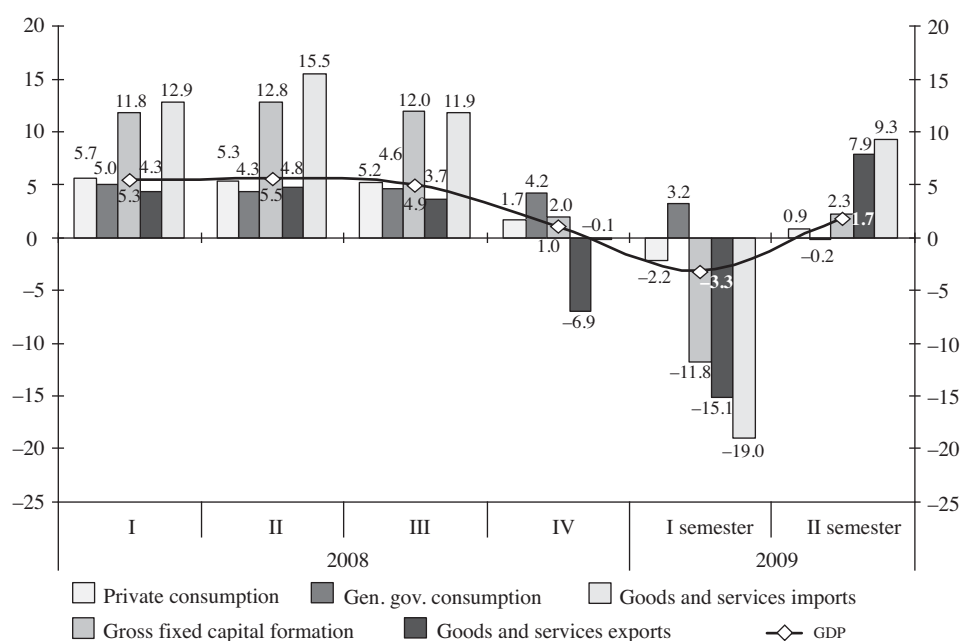
**Latin America (selected countries): financial system lending**  
*(Percentages of GDP)*



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.  
 GDP: Gross domestic product.

FIGURE 17

**Composition of total supply and demand**  
(Percentage change compared to same period the previous year)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures. GDP: Gross domestic product.

## V

### Macroeconomic policy space to deal with the crisis

While the situation differs from one country to another, in recent years there has been a change in macroeconomic behaviour in the region so that it contrasts with what was seen in earlier episodes of expansion, as discussed in section III. In the pre-crisis period, increased rates of saving in the region resulted in a lessened dependence on external financing and, in many cases, in a reduction of external liabilities in the public sector, easily offsetting the greater use of international credit by the private sector. This process was accompanied by the large build-up of international reserves referred to earlier, as a result of the decision to accumulate external assets in order to reduce dependence on international financing in the

event of any liquidity problems.<sup>13</sup> This self-insurance approach embodied a decision to pay a price equivalent to the opportunity cost of the external resources accumulated, owing to recognition of the procyclical character of the international credit supply and the desire to avoid conditionalities tied to financing from multilateral sources.

This not only represented a major change from the financial difficulties the region's countries were

<sup>13</sup> The efforts of the region's countries would look even more impressive if international reserves calculations included the savings built up by a number of them in sovereign wealth funds financed out of fiscal surpluses.

accustomed to facing in similar episodes, but created greater latitude for public policy implementation. Nonetheless, more recent developments, shaped by the repercussions of the crisis, have reduced the leeway for policies to increase domestic demand and have intensified conflicts between objectives that compete for the use of government instruments and resources.<sup>14</sup>

Figure 18 shows the parallel evolution of two factors that are crucial constraints on the scope for applying economic policy as analysed from a flow perspective: the balance of the current account and the balance of the public accounts. The boom period from 2003 to 2007 was accompanied by a parallel improvement in both balances that ultimately led to Latin America as a whole posting unprecedented twin surpluses in 2006 and 2007.

However, much of the improvement in the fiscal situation in recent years was due, as noted earlier, to rising commodity prices between 2002 and the first half of 2008, so that the decline since mid-2008, although it has recently eased, has reduced the countries' fiscal

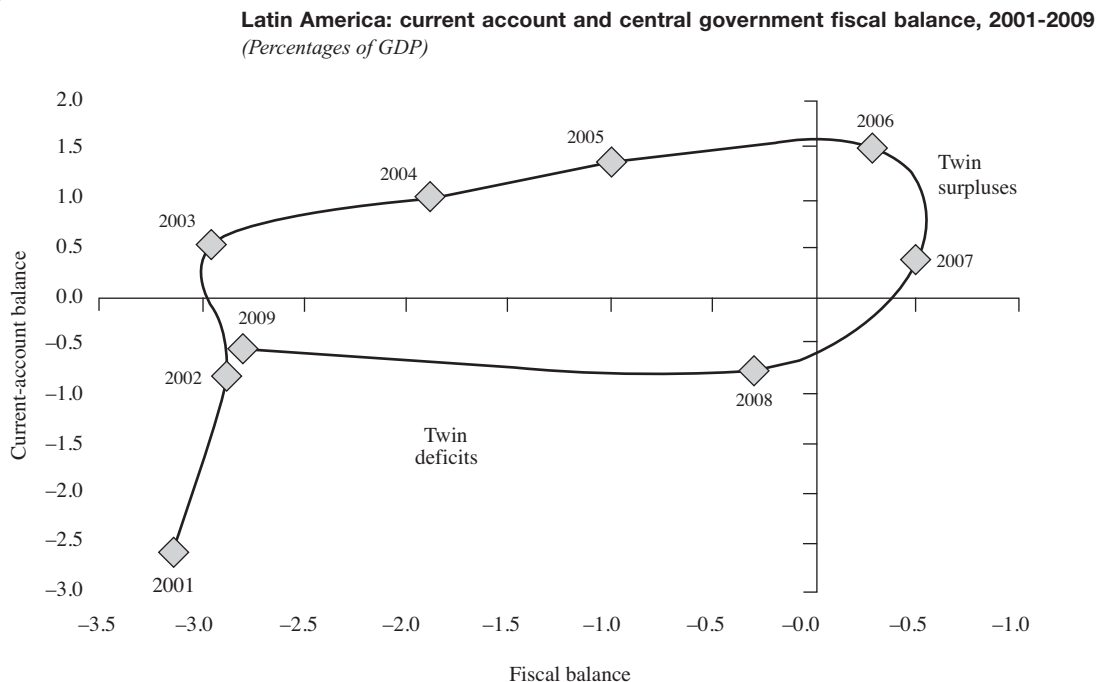
space once again. Thus, in 2009 the overall effect for Latin America was a loss of revenues estimated at 1.4% of GDP (simple average), leading to an average overall deficit of 2.8% of GDP for the region.

As regards the region's current-account deficit, this was 0.7% of GDP in 2008 and a further deterioration was expected, but falling domestic demand and thus imports more than offset the contraction in exports and remittances, with the result that the deficit actually narrowed to about 0.5% in 2009. Collapsing consumption and investment caused imports to plummet by almost 25% in current values, offsetting the drop of about 23% in the region's external sales.

Besides the constraints on the availability of resources for countercyclical intervention that may result from the dynamic of the public accounts and the external accounts, the characteristics of the region's economies mean that there are other factors which may influence the capacity of macroeconomic policy. In particular, over and above the importance of preserving sufficient liquidity to allow financial systems to operate smoothly, the effectiveness of monetary policy is constrained in countries that have limited monetization and financial depth. Moreover, situations of elevated uncertainty affect the mechanisms

<sup>14</sup> See Fanelli and Jiménez (2009).

FIGURE 18



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

of transmission between expansionary monetary policy measures and growth in the credit supply, and between these and the effective utilization of the available financing to increase demand for goods. In some cases, the existence of a public-sector banking system with a large share of domestic lending made it possible to stimulate and replenish lending at times when private-sector banks were cutting theirs because of the elevated uncertainty.

In crisis situations, when credit markets tend to segment, fiscal policy has a crucial role to play in maintaining aggregate spending flows.<sup>15</sup> The countries of the region are sometimes faced, however, with institutional constraints (and limited implementation capacity in the public sector) that reduce the scope for using fiscal policy flexibly for macroeconomic stabilization purposes. Although tax-cutting decisions can be implemented fairly simply, their effects may be limited in countries where taxation levels were low to begin with, and in conditions of uncertainty higher disposable income does not necessarily feed through into greater demand, particularly if the groups favoured by tax cuts belong to the upper strata of the distribution.

Increasing public spending poses greater institutional and administrative challenges. Expanding public investment takes time, particularly since the countries do not usually have enough projects that have been evaluated and are ready for implementation. Likewise, providing subsidies to the sectors in greatest need can be highly effective, but not all the countries have developed mechanisms for identifying and reaching potential beneficiaries of social programmes. Although more closely targeted policies are more efficient than universal measures, in many cases this option is limited by the lack of institutional development, making across-the-board subsidies the only option. In short, the availability of resources is not the only precondition for implementing countercyclical policies; the institutional framework also needs to provide access to a sufficient array of instruments for goals to be effectively achieved.

### 1. Monetary, financial and exchange-rate policy

Faced with the changing international situation in the last four months of 2008, which entailed major

credit constraints in the developed countries and an end to the inflationary pressures of recent years, monetary authorities in the region took steps to ensure adequate liquidity in order to facilitate the functioning of domestic financial markets.<sup>16</sup> The measures taken included cuts in reserve requirements, shortening of payment periods or the suspension of operations to reduce liquidity, and creation or expansion of special lines of credit for discount and repurchase operations. As figure 19 shows, most of the region's central banks cut their monetary policy rates several times during 2009 in response to the slowing of inflation that began in late 2008. As in the developed countries and China, lower interest rates provided greater liquidity to reactivate the economy in coordination with fiscal measures.

Even an expansionary monetary policy, however, could not prevent a loss of dynamism in the credit market. The lending slowdown in 2009 was mainly seen in the private-sector banking system, with some countries experiencing a contraction from 2008 levels (Chile, Colombia, Mexico and Uruguay). This loss of dynamism was due both to a lessening of the supply from private-sector banks and to lower demand, owing to the decline in activity and increased uncertainty. To counteract the lesser availability of credit from private-sector banks, however, public-sector banks in a number of the region's countries increased their lending as part of government-led countercyclical strategies (see figure 20). As already noted, the effectiveness of such strategies depended on the share of total financial system lending accounted for by public-sector banks, something that was very significant in the case of Brazil, where lending by public-sector banks accounts for about 35% of the total.

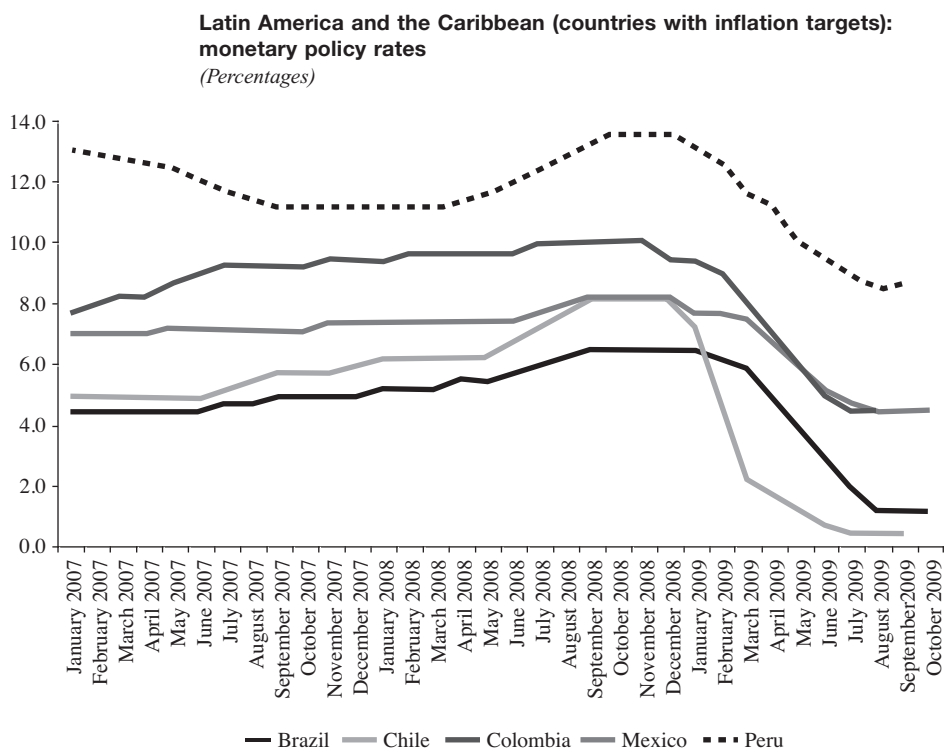
After the crisis worsened in late 2008, and despite the loss of reserves, the currencies of a number of the region's countries depreciated substantially following three years of appreciation. Intervention by the authorities took a range of forms, including operations in both the spot and forward markets.<sup>17</sup> These movements were partially reversed in the first half of 2009 when, despite a round of interest rate cuts by the region's central banks, currencies tended to appreciate in nominal terms, reflecting better conditions

<sup>15</sup> See Baldacci, Gupta and Mulas-Granados (2009) on the effectiveness of fiscal policy in a financial crisis.

<sup>16</sup> The pick-up in inflation in 2007 and the first half of 2008 complicated monetary policy management and posed a challenge for central banks seeking to meet inflation targets.

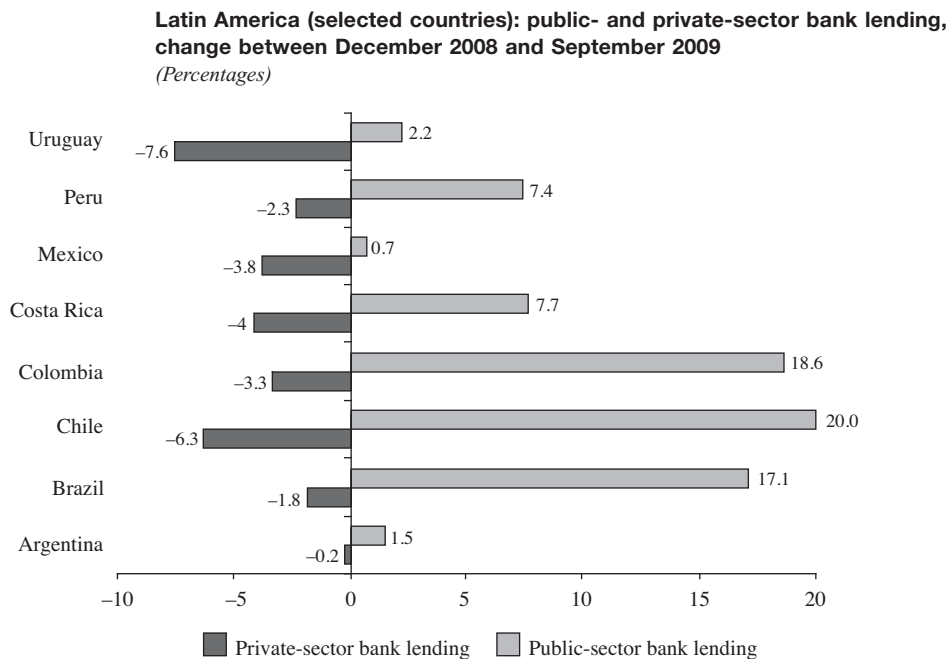
<sup>17</sup> See Jara, Moreno and Tovar (2009).

FIGURE 19



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

FIGURE 20



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

in international financial markets. Selling intervention in the currency markets progressively diminished over the period and eventually ceased.<sup>18</sup>

## 2. Fiscal policy

Faced with the crisis, the challenge for fiscal policy was to implement countercyclical measures in a context of declining revenues, whilst protecting certain types of expenditure (education, social protection and infrastructure) that were vital to prevent poverty from rising and to lay the groundwork for future growth. Although the region's governments have retained some capacity to buttress their economies with fiscal intervention, in practice the room for fiscal manoeuvre has differed greatly from one country to another, being dependent on the existence of savings built up in the good times, the degree of spending rigidity, the duration of the crisis and the scope for prudent borrowing.

The crisis placed the public finances of the Latin American economies in a complex situation. Fiscal revenues fell substantially as a result of lower activity levels and falling commodity prices. In addition, the countries undertook fiscal measures to stimulate their economies and offset the distributional costs of the crisis, which resulted in a further deterioration of their fiscal balances. In many cases, furthermore, this deterioration took place against the background of serious external financing constraints that affected the scope for applying countercyclical fiscal policies.

The effects of the international crisis on fiscal revenues differed from one country to another depending on their tax structures and revenue levels and the different current financing sources they used.<sup>19</sup> Thus, exposure to the crisis was greater in countries that had a low tax burden or relied heavily on funding from non-tax or natural resource revenues, and in those that were very open to trade, particularly if their exports went mainly to developed countries. Conversely, countries where the tax burden was large and where the share of income tax and the productivity of value added tax (VAT) were high seem to have been less exposed.

From the expenditure point of view, rising outlays are explained by growth in both current spending and infrastructure investment spending, especially on new housing. Current spending rose strongly in the first nine months of 2009 and so, to a lesser extent, did capital spending, implementation of which is generally slower (see figure 21). While extra spending measures predominated over measures to cut taxes or increase revenues, a number of the region's countries did apply taxation measures. In fact, 11 countries brought in personal income tax reductions (by changing the system of deductions, reducing rates or extending exemptions), two of them on a temporary basis, while the same number of countries announced changes in corporate income tax (new exemptions, deductions or accelerated depreciation systems), which were temporary in four cases. Brazil deserves a special mention: although total spending growth was less than in other countries, measures were taken to reduce tax rates for industrial products (temporarily for vehicles, household appliances and construction materials) and the financial operations tax; income tax rates for lower-income individuals were also changed.<sup>20</sup>

When social measures are broken down by subregion, their composition reveals a large difference of approach. In South America and Mexico, three quarters of the measures announced were designed to support poor families, whereas in Central America the distribution was more balanced, half of the measures announced being consumption subsidies while the other half consisted of support for lower-income families.<sup>21</sup> As noted earlier, this reveals a divergence in countries' institutional capacity to implement such policies, since targeted measures, while more effective, involve a greater institutional effort. While consumption subsidies are more straightforward to apply, they reach a larger number of people and can create a regressive bias in favour of those who consume most.

Where the effects of the measures are concerned, the difficulties of quantifying and measuring the impact of tax deductions and incentives (usually called "tax expenditure") in the region are well known.<sup>22</sup> There are also question marks over the duration of

<sup>18</sup> The exception was Argentina, where the peso gradually depreciated from mid-2008.

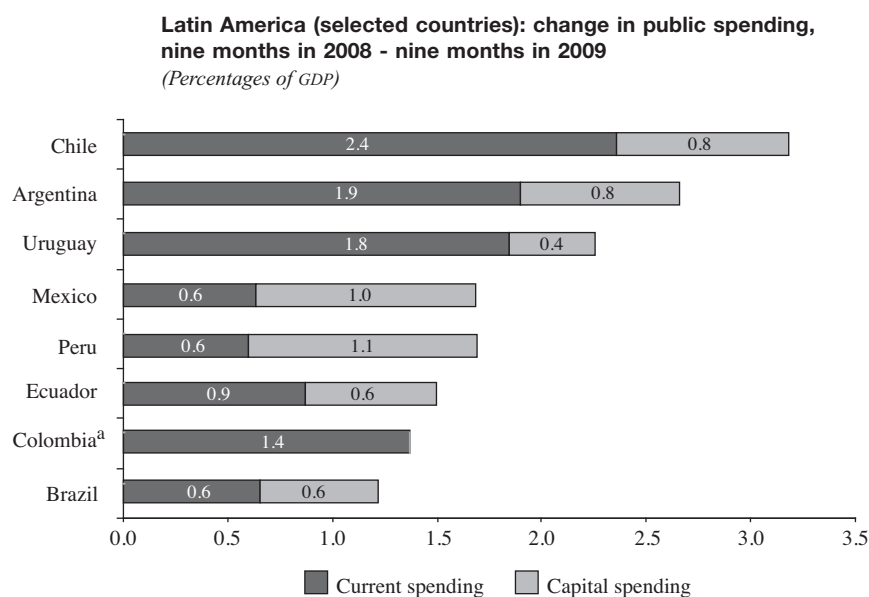
<sup>19</sup> Gómez Sabaini and Jiménez (2009) quantify the degree to which the various countries' fiscal revenues are exposed to different variables, dividing them into three groups by exposure level: high, medium and low.

<sup>20</sup> The effect of these tax measures is estimated at 0.8% of GDP.

<sup>21</sup> See ECLAC (2009b and 2009c) for further details of crisis measures applied in the region.

<sup>22</sup> See Jiménez and Podestá (2009) for further information on the use of tax expenditure in the region.

FIGURE 21



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

<sup>a</sup> Change in total spending.

measures and the ability of some governments to sustain the level of spending that these policies entail. Furthermore, while these measures were taken by central governments, many of them have required

resources from subnational governments, which introduces a need for greater intergovernmental coordination and a new source of vulnerability for fiscal policy in the crisis.<sup>23</sup>

## VI

### Some post-crisis macroeconomic policy considerations

Albeit to a lesser degree than on other occasions, the region was affected by the crisis, which cut short six consecutive years of growth and improving social indicators. Regional output fell in 2009, chiefly owing to the sharp recession in the Mexican economy, which has had negative repercussions on employment and poverty. As noted earlier, growth in the 2003-2008 period was accompanied by higher and better-quality employment, and poverty and inequality diminished as a result. The opposite happened in 2009: low or even negative growth was accompanied by rising unemployment and informal working, a decline in employment with social protection coverage and a contraction in full-time employment (ECLAC/ILO,

2009). This combination of factors drove poverty and indigence levels higher.

It is to be expected that the incipient recovery seen in late 2009 will consolidate in 2010 and that Latin America will start growing again, although probably at lower rates than in the period of strong

<sup>23</sup> Although subnational levels of government have improved their accounts in recent years, this improvement has largely been due to the increasing scale of transfers from national governments, which rose by two points of national output from 1997 to 2007. In some cases, meanwhile, the public debts of subnational governments are large and account for a significant proportion of total public debt.



growth cut short by the crisis. The expected growth could be inadequate in terms of demand for labour, which will impede any rapid recovery in the quantity and quality of jobs, and thus in social indicators.

Lower investment has not just had an immediate negative effect on demand for goods and activity levels, but has impaired the region's capacity for future growth. It is often argued that it took Latin America 14 years to return to the level of per capita GDP it had prior to the 1980s debt crisis and 25 years to bring the poverty rate back down to what it was before that crisis. As section II pointed out, the region has never recovered its investment rates of the 1970s, measured as a share of GDP. The Latin American countries have sought to increase investment rates in recent years, but this effort was cut short before the level needed to sustain a higher rate of growth could be achieved.<sup>24</sup>

The crisis is also highly likely to lead to profound changes in the international situation, resulting in an environment less favourable to growth than the one the region became used to between 2003 and 2008. In the first place, it is possible that the post-crisis world may be characterized by lower global growth owing to a decline in the dynamism of aggregate demand in the developed countries, partly offset by higher aggregate demand in developing countries.<sup>25</sup>

In consequence of this, the expectation must be that emerging economies will play more of a leading role in global growth, but against a background of slowing trade flows. Lower demand for imports in developed economies has been reducing the scope for emerging economies to sell their products into those markets, intensifying competition and at the same time providing incentives for growth strategies oriented mainly towards domestic markets, at least in larger economies.

At the same time, the global financial crisis has revealed the need for deep reforms in the international financial architecture, particularly regulation and oversight systems, to ensure greater global financial stability. The crisis exposed the fact that institutional mechanisms for controlling systemic risk had not kept pace with financial liberalization and globalization. There will therefore be a need for changes in the approach and reach of regulation and oversight in domestic financial systems, accompanied by a greater effort to coordinate regulation at the global level.

These changes will probably result in an expansion of the scope of regulation and oversight of the different financial instruments and different market participants. The expectation is that the banking model will shift towards one that is more transparent and has fewer incentives for risk-taking and lower levels of leverage, implying a reduction in international financial flows and thence a partial reversal of the financial integration that had been taking place until the crisis.

To recapitulate, Latin America is faced with the renewed challenge of raising its growth rate to be able to accommodate needs arising from a challenging social situation which it is increasingly urgent to resolve. Growing more means investing more, however, and what this implies in the region is higher demand for reserve currency to purchase capital goods, as most of these are imported. The question must be, then, what role the region is going to create for itself in a world characterized, first, by reduced economic dynamism in developed countries and greater participation by developing countries in global growth and, second, by financial systems subject to stricter regulation and oversight, less dynamic lending markets and higher interest rates.

It is not the purpose of this paper to give an exhaustive response to these questions, which ultimately turn on the need to achieve sustained economic growth based on higher productivity and greater distributional equity. All that is proposed here is to offer some suggestions for macroeconomic policy design that may help to consolidate the link, traditionally an uncertain one in Latin America, between growth and equity.

Macroeconomic stability is a necessary condition for the region to enhance growth and improve its distribution, but stabilization needs to be understood broadly as a goal that goes beyond low and stable inflation. This is unquestionably a central objective of macroeconomic policy, but the economic history of Latin America shows many examples of the high costs that real-term instability can entail. This highlights the importance of sustainable macroeconomic management, guided by expected trends in the main variables that can provide a benchmark for decision-making whose horizons extend beyond the short term.

It is crucial for macroeconomic policies to be designed to cope with the fluctuations associated with economic cycles, but this capability needs to be developed at times of economic expansion for use in recessionary phases, thereby avoiding excessive fluctuations both in the level of public service provision

<sup>24</sup> It is estimated that to sustain growth of 6% a year, the region would require an average investment rate of between 24% and 27% of GDP. See ECLAC (2006).

<sup>25</sup> See Rogoff (2009).

and in the real exchange rate and interest rates. This is an important lesson that has been emerging from the crisis, as the benefits to the region of the countercyclical policies which various countries implemented, to different degrees, have become apparent.

This has not always been so, however. On the contrary, a comparative review of the past 30 years shows that fiscal policy has been procyclical in most Latin American countries, by contrast with the developed countries, where it has been countercyclical or at worst acyclical.<sup>26</sup> Despite the recent improvement, the region still displays very high levels of real volatility that entail large costs in terms of welfare.<sup>27</sup>

The implementation of countercyclical policies is obviously not without its strains and conflicts, largely because of the difficulty of identifying the long-term trend in many of the region's economies, although they can also derive from the conflicting preferences of different economic agents in specific situations. Thus, sectors with the capacity to save or with access to financing are very likely to differ in their interests from the poorer sections of society, whose spending is highly constrained because they lack the capacity to save and have only very limited access to the financial market.<sup>28</sup> Countercyclical macroeconomic management is particularly important for the less well-off, and therefore policy measures are important, from the distributional point of view, during phases of expansion to build up the capacity needed to cope with the downswing of the cycle.

Broadly speaking, macroeconomic policy affects growth and distribution by the way it balances the management of variables that are at least partially under the control of the economic authorities, such as the amount and type of taxes collected, the level and composition of public spending, interest rates and the exchange rate. The way these instruments are used influences production and accumulation decisions and the incomes of different groups or sectors. The set of instruments available and the nature and strength of their effects depend on the structure of the economy, its institutional configuration (the ownership of natural resources, for example) and its history (experiences that may affect demand for domestic assets and financial system depth, for example).

<sup>26</sup> See López-Monti (2009b) for a comparative analysis of the cyclicity of fiscal policy in Latin America and the developed countries.

<sup>27</sup> See López-Monti (2009a) for estimates of the welfare cost of cyclical fluctuations in Latin America using different models.

<sup>28</sup> See Krusell and Smith (2002).

In Latin America, the tax burden is too low in most countries to fund the spending demands made on the State. Not only does the region collect little, however, but it collects it badly.<sup>29</sup> Particular problems are the low share accounted for by income taxes and the fact that the taxation structure is based mainly on regressive indirect taxes.<sup>30</sup> The region's tax systems are among the factors keeping income distribution unequal and thereby perpetuating poverty and indigence, since taxation policy has placed other goals ahead of that of improving distributional equity. The great challenge in this area is not only to increase the amount of resources collected but also to improve their impact on income distribution by increasing the burden on the sectors that can best afford it.

Where spending is concerned, there can hardly be an area of the public budget that is not being reformulated in some way, which shows how dissatisfied society is with the scale and approach of government intervention.<sup>31</sup> Where social spending in particular is concerned, reforms must be expected to play a central role in the construction of more cohesive societies while at the same time enhancing the legitimacy of public policies and thus of the taxation required to pay for them. However, demands for more public spending are not confined to the social area but include, for example, public investment in infrastructure which, over and above its impact on activity in other sectors and its role as an economic catalyst, has a very substantial effect in raising competitiveness and shaping the production profile.<sup>32</sup>

The objective, then, is to secure sustainable financing for a range of different types of State provision that are required in pursuit of higher and more inclusive growth. While this need directly involves different aspects of fiscal policy, it also transcends it to become the basis for a new fiscal covenant, an issue that will only be touched on here, as a proper discussion would require it to be given an article to itself.

Monetary policy, meanwhile, should aim to achieve the lowest and most stable inflation rate possible; there is a high degree of consensus on this

<sup>29</sup> On this point, see Cetrángolo and Gómez Sabaini (2007).

<sup>30</sup> This could also influence the effectiveness of automatic stabilizers. See Sescún (2007).

<sup>31</sup> See Cruces, Rovner and Schijman (2007) for an assessment of how social plans are perceived in Argentina. An interesting conclusion of this study is the need to consider issues associated with the flow of information on programme content and evaluations, as a way of enhancing their legitimacy.

<sup>32</sup> On this subject, see Lucioni (2009).

in a region that has passed through some very difficult periods as a result of very high inflation. It must not be forgotten, however, that the choice of monetary and exchange-rate regime determines a crucial variable, the exchange rate. The real-term volatility characteristic of Latin American economies is closely associated with excessive real exchange-rate variability, and this negatively affects investment, especially in internationally tradable goods, which means that preventing large and sudden oscillations in the real exchange rate ought to be a goal of macroeconomic policy, irrespective of whether the nominal price of currencies fluctuates according to market conditions or is set by the economic authority.<sup>33</sup>

The difficulties involved in reducing exchange-rate volatility in a region exposed to strong external shocks are not trivial, but it is clear that the low prices for tradable goods resulting from excessive appreciation tend to create a production and investment profile which is an impediment to export diversification and growth.<sup>34</sup> Again, these relative prices give rise to mistaken perceptions of spending capacity (measured in foreign currency), ultimately leading to large external imbalances and unsustainable borrowing levels.

Consequently, economic policy, and central banks in particular, should make it their “second objective” to maintain a stable and competitive real exchange rate. The tools available for this may range from direct interventions and “dissuasion” to restrictions on short-term capital inflows when these are large. Of course, more active monetary policies to support the real exchange rate need to be matched by greater fiscal discipline. However, maintaining the real exchange rate at any cost can give rise to inflationary pressures in certain circumstances, thus militating against the main objective of monetary policy.

In any event, the difficulties this can create need to be resolved by strengthening policy coordination arrangements to make it possible to assess the costs and benefits associated with any trade-offs the economic authorities have to make between target variables. Given the importance of the real exchange rate as a macroeconomic signal for production, investment, demand and financing decisions, it does not seem

advisable to treat this as a “residual” variable for economic policy purposes.<sup>35</sup>

In these paragraphs we have sought to identify some factors that ought to be taken into account in the design of a macroeconomic policy oriented towards mitigating volatility. The multiplicity of objectives this might entail means there is a need to create independent instruments, something that in turn involves acting on the structural constraints limiting policy autonomy: institutions, the availability of tax resources and the quality of the State machinery.

Economic development is a complex enterprise that entails far more than just quantitative shifts and step changes in scale, and that needs to be seen as a process of continuous transformation in production and social structures. The difficulty faced by economies like those of Latin America here stems from the absence of certain markets (like those for long-term local-currency lending), the imperfect competition characterizing others, the asymmetrical distribution of information (in credit and technology markets, for example, and in relation to investment opportunities) and failures of coordination. All this highlights the importance of a State presence, which means that creating and expanding opportunities for public policy implementation by developing instruments and enhancing different coordination arrangements are essential tasks from the standpoint of growth and development.

The need to achieve sustained economic expansion based on higher productivity and greater equity highlights the importance of reducing volatility to enhance growth, generate more employment and reduce the vulnerability of the least protected segments of the population. To sum up, as Prebisch pointed out 60 years ago: “Anti-cyclical policies must be included in any programmes of economic development if there is to be an attempt, from a social point of view, to raise real income. The spread of the cyclical fluctuations of the large centres to the Latin-American periphery means a considerable loss of income to these countries. If this could be avoided, it would simplify the problem of capital formation. Attempts have been made to evolve an anti-cyclical policy, but it must be admitted that, as yet, but little light has been thrown on this subject” (Prebisch, 1950).

*(Original: Spanish)*

<sup>33</sup> Bastourre and Carrera (2004) find a negative relationship between exchange-rate policy flexibility and real volatility.

<sup>34</sup> Aghion and others (2006) show that currency volatility has a negative effect on growth in economies with underdeveloped financial systems, like those of Latin America.

<sup>35</sup> See Eichengreen (2008), Rodrik (2007) and, from a Latin American perspective, Barbosa-Filho (2006) and Frenkel (2009) on the importance of the exchange-rate instrument for emerging economies.

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