



From Rapid Recovery to Slowdown: Why Recent Economic Growth in Latin America Has Been Slow

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Latin America's recent economic performance has been disappointing. After a strong recovery from the Great Recession, the region's economy has slowed dramatically (figure 1). Growth in 2014 was significantly below expectations, and prospects for 2015 are dim.

In 2010 recovery was solid, except in Mexico (where the economy was damaged by the crisis in the United States) and Venezuela (which contracted after years of economic mismanagement and dependence on oil). After strong growth in 2010, Brazil slowed significantly, although recovery remained strong in Chile, Colombia, and Peru. By 2014, however, growth had stalled, except in Colombia, and prospects for 2015 dimmed. Among the seven largest economies in the region (LAC7), output is expected to contract in Argentina, Brazil, and Venezuela, and Chile, Colombia, Mexico, and Peru are projected to grow by only about 3 percent. Figure 1 shows that performance has been broadly much worse than expected two years ago.

This slowdown differs from other similar episodes in the region, in that it does not result from adverse external factors. Indeed, international financial conditions have been favorable. The decline was mostly cyclical in nature and a result of low productivity.

Although monetary and fiscal policies may still have roles in supporting demand within inflation targeting regimes and prudent fiscal rules, the main problem in the region is not a lack of demand but low productivity growth. Efforts must be made to foster productivity. Institutional weakness must be addressed and inequality reduced if sustainable high growth is to resume.

This *Policy Brief* first discusses the most relevant aspects of the global economy for the region, namely commodity prices and prospects of tightening monetary policy in the United States. The next section analyzes the factors that caused the slowdown, emphasizing the role of the business cycle, in which a rapid recovery is normally followed by a slowdown. Latin America, and most emerging-market economies, were not used to such a fast recovery, which makes it particularly difficult to forecast turning points in the business cycle. Uncertainty about long-term growth potential has led to optimistic forecasts and expectations that past good performance would be permanent. In addition, the evidence—inflationary pressures in some countries and stable unemployment despite the deceleration—would support the proposition that potential output growth is below what was experienced at the beginning of this decade, and previous assessments were optimistic. The slowdown started before commodity prices started declining, and terms of trade were not significantly low. Therefore it is difficult to blame external factors for the slowdown.

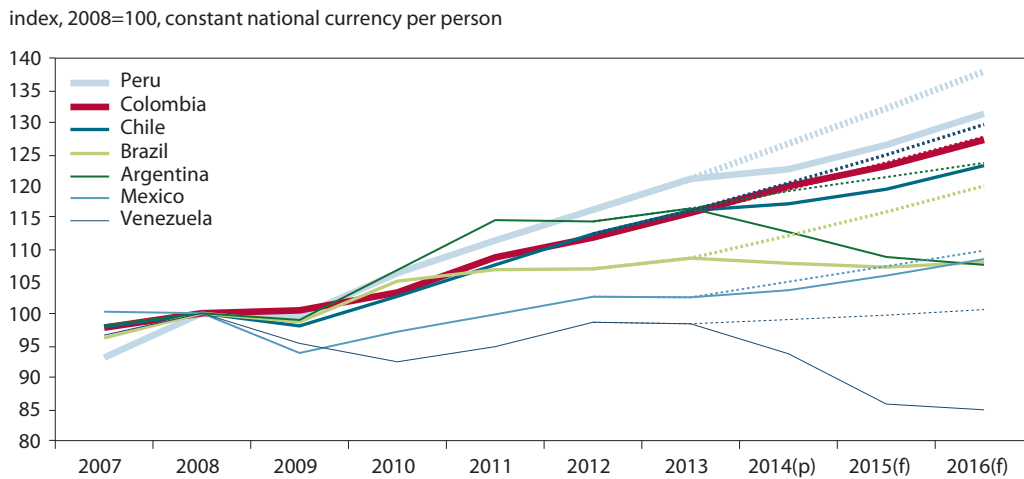
However, prospects of lower commodity prices will exacerbate the drag on economic growth. The commodity price boom's impact led to income growth and, even more, to an investment boom. The *Policy Brief* later discusses the scope for expansionary policies and expectations in the near future.

In general the *Policy Brief* focuses on LAC7 countries. Because, Argentina and Venezuela have followed different paths in terms of policies and performance and have less reliable statistics, this paper concentrates more on LAC5 countries.

THE GLOBAL ENVIRONMENT

End of the Commodity Supercycle

Emerging-market economies, in particular China, have led growth in the world economy since recovery from the crisis. The surge of these markets raised commodity prices, because

Figure 1 Per capita GDP in LAC7, 2007–16

p = provisional; f = forecast

Note: The dotted lines show the IMF's April 2013 forecast for the path of per capita GDP.

Source: IMF, *World Economic Outlook Database*, series NGDPRPC.

emerging and developing economies' demand for commodities is more intense than demand by advanced economies. As Latin American countries are commodity exporters, they benefited from these developments.

Now that growth in emerging and developing economies is slowing, commodity prices are declining. In addition, growth in the United States led to a global rise in the value of the US dollar, which further weakened commodity prices.

The slowing of economic growth in China, which accounts for 10 percent of Latin America's exports, has added to the problems of the region's export-dependent economies. (Kotschwar 2014). The least exposed country is Mexico, which trades largely with the United States. The most exposed country is Chile, which sells about 24 percent of its exports to China and 42 percent to Asia as a whole (figure 2). Only about half of its exports to China are commodities (in the other countries, noncommodity exports to China are small). Argentina is the only country with significant intraregional trade; its main export destination is Brazil. In 2011 Brazil, Chile, and Peru ran trade surpluses with China. They are therefore vulnerable to deceleration in China.

The decline in commodity prices has been uneven, in timing and magnitude (figure 3). At the beginning of 2014, the prices of most commodities were somewhat below the average of the previous years. An exception was coffee, which started the year at a very low price.

Compared with the average during 2011–13 (a period of relatively high commodity prices), the largest price decline was in oil and iron ore. Oil prices fell about 50 percent from the highest in mid-2014 to mid-April 2015. Prices of copper, soybeans, and most foodstuffs fell by about half as much as

the price of oil. Copper was more stable for most of 2014, but a sharper decline was observed in late 2014 and early 2015. Coffee is the only commodity relevant for Latin America whose price increased sharply (as a result of the severe drought in Brazil, which disrupted supply).

A better way to examine the evolution of external prices for Latin America is to look at the terms of trade (figure 4), which shows the ratio between price of exports and price of imports. Data from different sources are not entirely consistent, but they show similar trends.

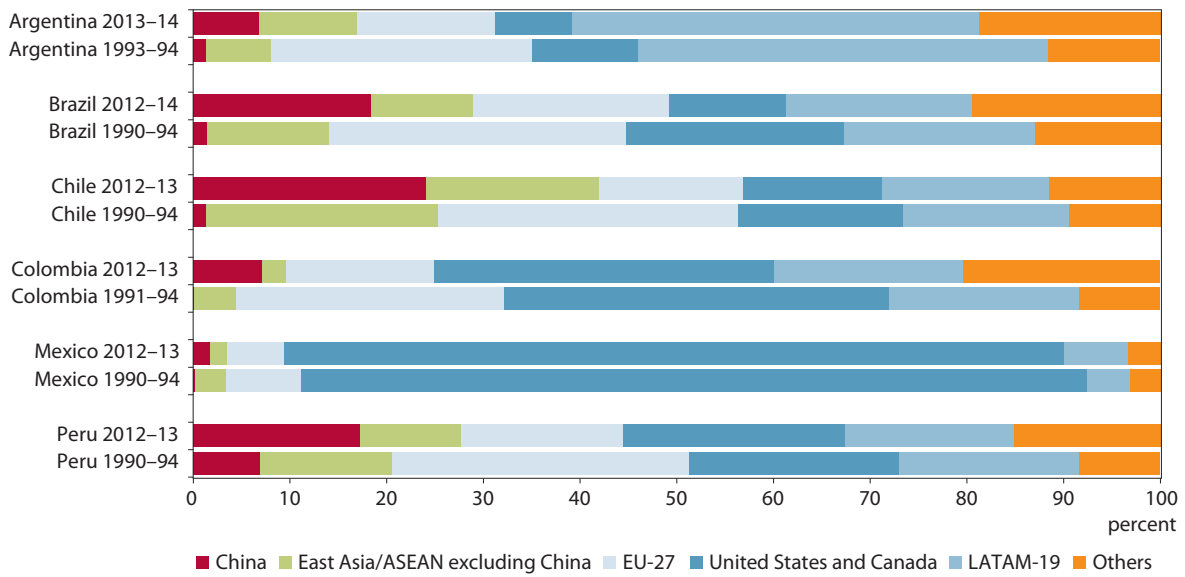
Commodity prices were high after the global financial crisis, particularly in Chile, Peru, and Colombia. The terms of trade in the region declined after 2011, but not by enough to explain the growth deceleration that started in mid-2013.¹

One factor that could blur the domestic effects of the terms of trade is that although commodity prices remain high with respect to the low levels of a decade ago, production costs are much higher. The combination of lower prices and higher production costs reduces profitability, which is related to the commodity investment cycle discussed in the next section.

The most significant development in the commodities market is the decline in the price of oil. It affects different governments' budgets in different ways. In Mexico about a third of revenues come from oil, but the one-year ahead price is fully hedged. Moreover, the low price of oil could allow the government to phase out price subsidies, reducing pressure on the budget. In addition, Mexico as a whole is a net importer.

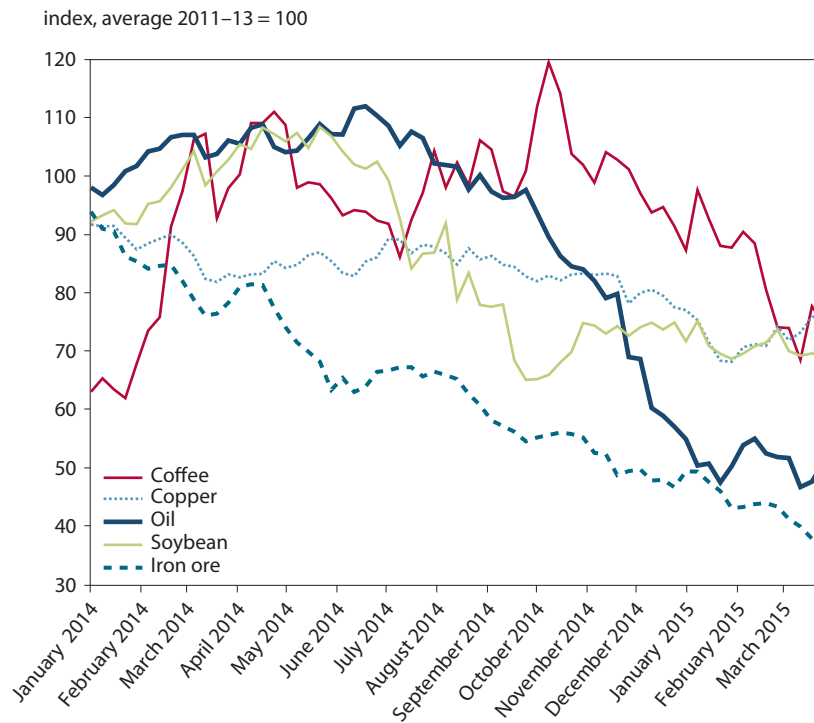
1. There are no data for Venezuela, but other sources, such as United Nations Economic Commission for Latin America and the Caribbean (ECLAC), show that the increase in the terms of trade was much larger there than in other LAC7 countries.

Figure 2 Export destinations of Latin American countries



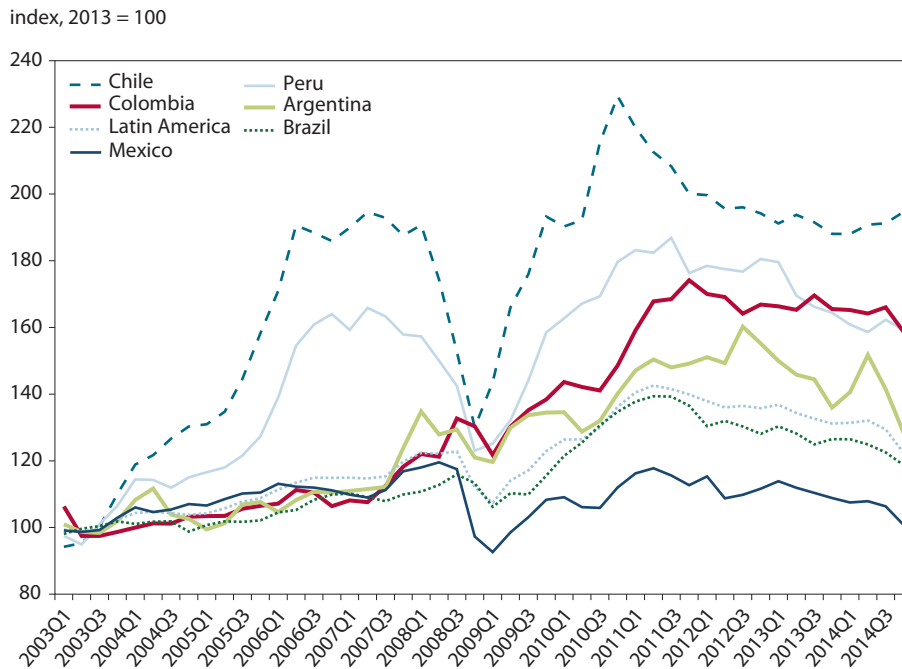
ASEAN = Association of Southeast Asian Nations; LATAM = Latin America
 Source: UN Comtrade Database.

Figure 3 Commodity prices, 2014 to March 2015



Source: Bloomberg.

Figure 4 Terms of trade, 2003Q1–2014Q4



Source: Haver Analytics.

In Brazil, Chile, and Peru—all net importers of oil—the drop in oil prices has been beneficial. The largest effects have been in Chile, where the decline in energy costs should improve productivity and slow inflation.²

Venezuela, where oil exports accounted for more than 90 percent of total exports and 30 percent of GDP in 2014, is by far the most exposed to oil prices. (Ecuador and Colombia also suffer, but their exposure is less than a third that of Venezuela [Werner 2015]). The International Monetary Fund (IMF) forecasts that Venezuela’s GDP will contract about 7 percent in 2015. The downturn will require severe domestic adjustments. Gasoline is virtually free in Venezuela, costing 2–6 cents a liter, depending on the exchange rate used to convert domestic prices. The government will have to increase the price of gasoline, but adjustments will not be large, because of fear of riots and violence. Venezuela’s generous financing of Petrocaribe (an initiative through which Venezuela subsidizes oil to Central America and the Caribbean) will probably be adjusted. However, as most beneficiaries of this initiative are large net importers of oil, the improvement in the terms of trade should mitigate, if not outweigh, the adjustments.

Overall, the decline in oil prices is good news for the region and the world (albeit not for oil-producing countries), but it

will not create a boom. Moreover, the sharp decline could cause some tensions in adjustment, especially in economies that were managed as if oil prices would remain high for a long time.

US Monetary Normalization, Trilemmas, and Dilemmas

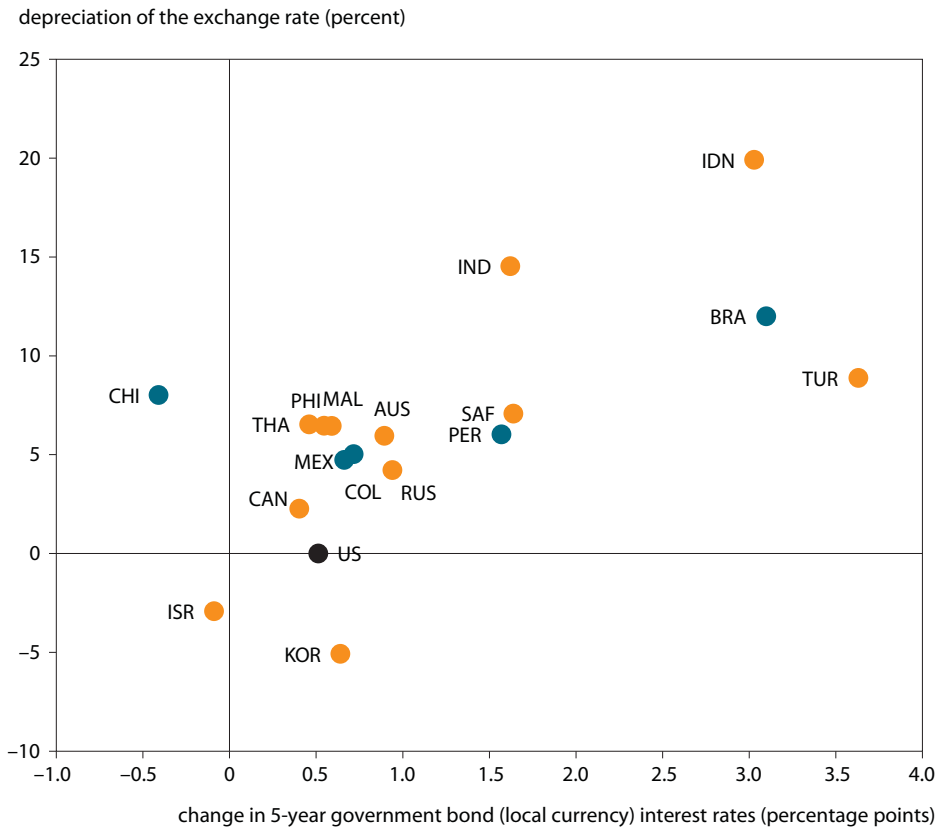
The other major development in the world economy is the likely monetary policy tightening and quantitative easing in Japan and Europe. The change in domestic financial conditions as a result of changes in US monetary policy is a potential source of turbulence. Concerns are heightened by the financial links and spillovers from the center economy, the United States, on emerging-market economies. Since Mundell-Fleming, it has been argued that financially open economies cannot manage the exchange rate, be financially integrated, and have independent monetary policy. This is the well-known trilemma in international finance. For this reason flexible exchange rates are needed for monetary autonomy.

However, Rey (2013) has gone further, arguing that in an integrated world in which capital is mobile, the policy trilemma is reduced to a dilemma, because regardless of the exchange rate regime, countries cannot adopt independent monetary policies. The global credit cycle spreads in the global economy and cannot be addressed by monetary policy alone.

Hence, the argument on the dilemma goes, small open economies that are financially integrated with the rest of the

2. The impact on inflation varies from country to country. It depends on the structure of taxes and subsidies to gasoline.

Figure 5 Change in 5-year rates and exchange rate depreciation after tapering announcement (6-month changes)



AUS = Australia, BRA = Brazil, CAN = Canada, CHI = Chile, COL = Colombia, IND = India, IDN = Indonesia, ISR = Israel, MAL = Malaysia, MEX = Mexico, PER = Peru, PHI = Philippines, RUS = Russia, SAF = South Africa, KOR = South Korea, THA = Thailand, TUR = Turkey, US = United States
 Note: The comparison is between the third week of November 2013 and second week of May 2014. The announcement was made May 22.
 Source: Bloomberg.

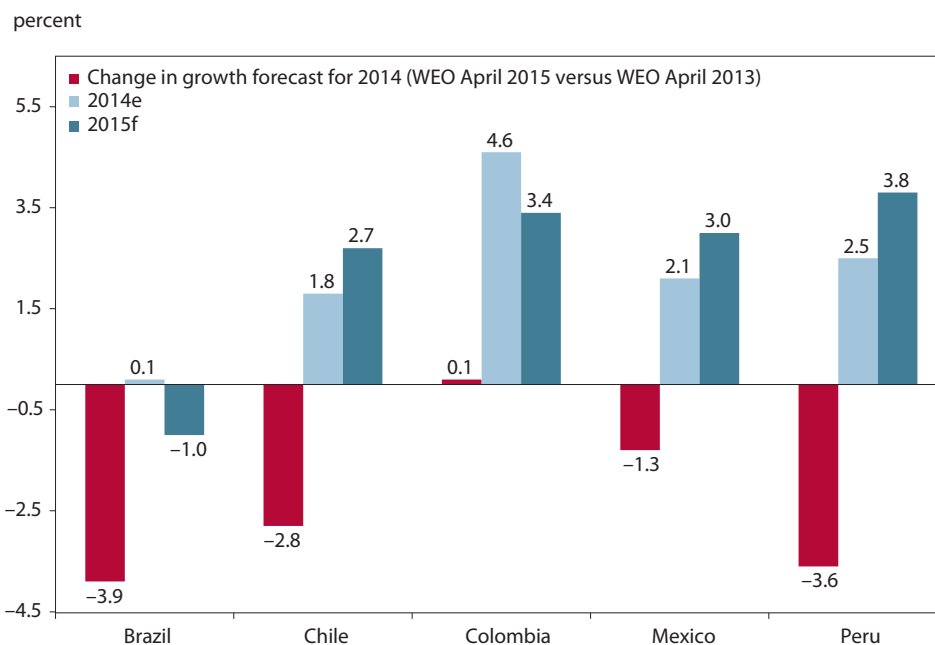
world economy have less monetary independence and must compensate with additional tools, such as macroprudential policies. If domestic conditions require loosening monetary policy but center countries (basically the United States) tighten their monetary policies, domestic financial conditions will tighten, too, even if the exchange rate floats. The practical implication for today's world economy is that if the United States tightens, emerging markets may also suffer from the tightening without the ability to compensate for with monetary policy.

How relevant the dilemma is remains unsettled. Obstfeld (2014) shows that economies with flexible exchange rates are better prepared to mitigate changes in global monetary and financial conditions. Countries with flexible exchange rates retain the ability to maintain long-term rates that differ from rates in the United States and other major economic powers. This notion is consistent with evidence that economies that allowed their currencies to float performed better during the global financial

crisis than countries with fixed exchange rates (Tsangarides 2012, Alvarez and De Gregorio 2014). Indeed, most emerging-market economies used expansionary monetary policy to mitigate the worst financial crisis and tightening since the Great Depression, especially when exchange rates were allowed to adjust.

An important example of rapid transmission of international financial conditions occurred during the so-called taper tantrum of 2013. After the Federal Reserve announced, in May 2013, that it would start to taper quantitative easing, asset prices fluctuated significantly. The rise in long-term rates in the United States was transmitted to most of the world. Most currencies depreciated against the US dollar, as demand for safety increased (figure 5). Six months after the shock, currencies were weaker and rates higher. The only exceptions were Chile, where the depreciation was accompanied by a fall in rates, and Israel and South Korea, whose currencies appreciated.

This financial shock did not translate entirely into tighter

Figure 6 Growth forecast (2014–15) and deceleration (2014) in LAC5

e = estimate; f = forecast

Source: IMF, *World Economic Outlook* (WEO), April 2013 and April 2015.

economic conditions, because exchange rates were allowed to float. The tightening effects of the increase in interest rates were partly offset by the expansionary effects of depreciation. If currencies had not been allowed to weaken, the impact on interest rates would have been much larger.

It is difficult to know what determines the response of asset prices to global shocks. Floating rates certainly help absorb shocks. Chile had the lowest participation of foreign investors in the local debt market. It was therefore less affected by increases in risk aversion and the flight to safety. Local investors, most of them institutional, tend to stay at home. This observation is at odds with the long-held view of “original sin” (Eichengreen, Hausmann, and Panizza 2005), which holds that emerging markets are at a disadvantage because holdings of domestic currency-denominated debt by foreigners are low. Although this feature can be beneficial in normal times, it may exacerbate fluctuations to global shocks and limit the scope of monetary policy in times of turmoil. Having a large base of domestic investors should help countries maintain more independent monetary and financial conditions.

FACTORS CONTRIBUTING TO THE SLOWDOWN

In 2013 forecasters predicted that growth in Latin America would increase between 2013 and 2014. It did not (figure 6). Peru, which had been projected to grow 6.1 percent, is now estimated to have grown just 2.5 percent. Brazil, which had been

projected to grow 4 percent, hardly grew. The deceleration was even worse in Argentina and Venezuela (not shown in figure 6). Only Colombia performed better than projected—but growth will probably slow there, too, in 2015. This pattern is also seen in consensus forecast estimates as well as those of other private sector analysts. Markets also had a similar view to that of the IMF.

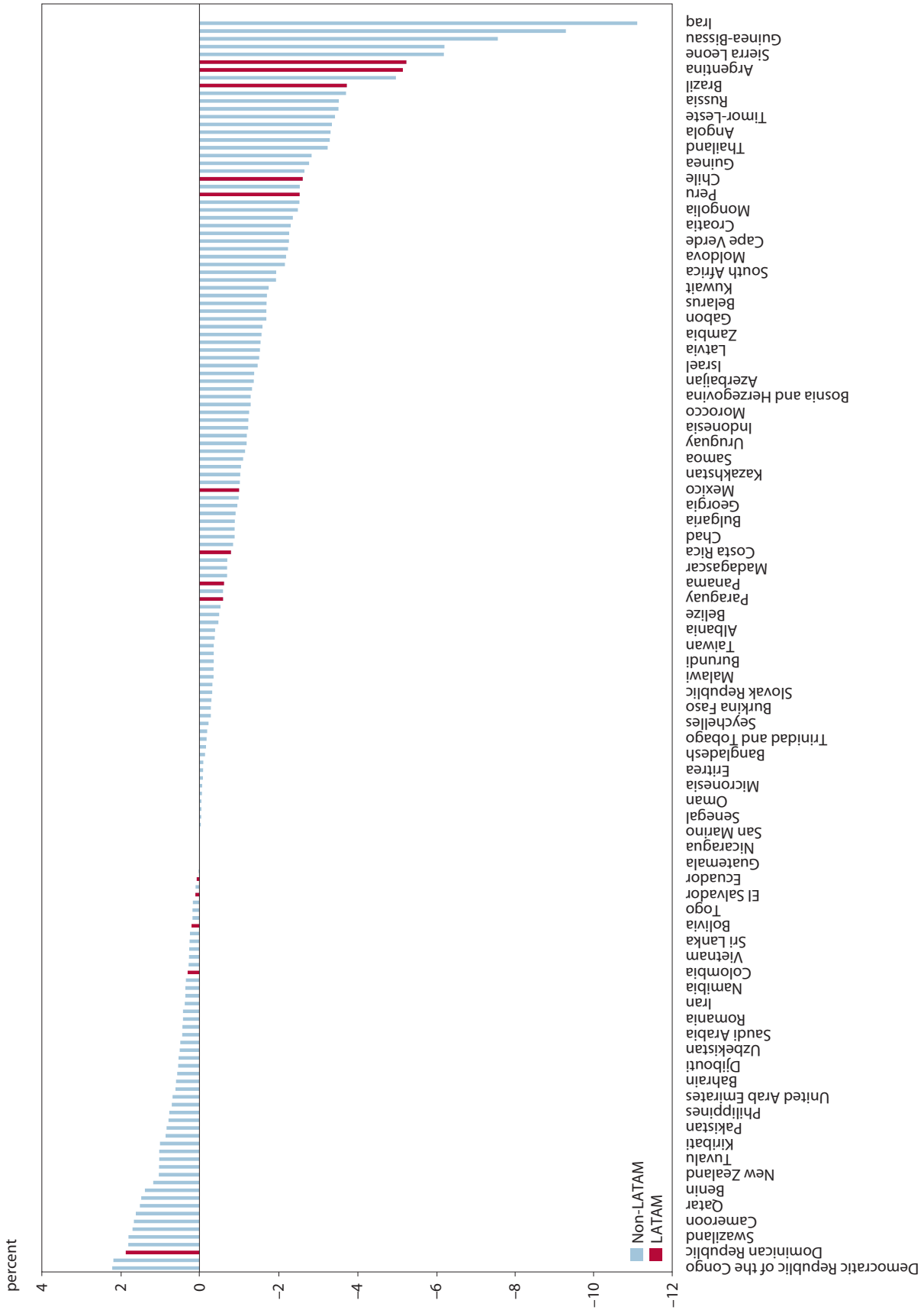
It is tempting, but unwarranted, to blame external causes for the slowdown. The deceleration started in the second half of 2013. In 2014 it became obvious that forecasts had been too optimistic. The decline in commodity prices came later. If global conditions had been responsible for the deceleration, prospects for 2015 would probably have been even worse than current forecasts indicate. The evidence on the terms of trade (see figure 4) does not show an extreme decline. In addition, Latin American countries have been able to tap international capital markets at good terms; firms have issued large amounts of debt.

Forecasts across emerging markets were also optimistic (figure 7). They failed to predict normal business cycle fluctuations, the commodity investment boom in Chile and Peru, the true long-term growth rates, and idiosyncratic domestic factors.

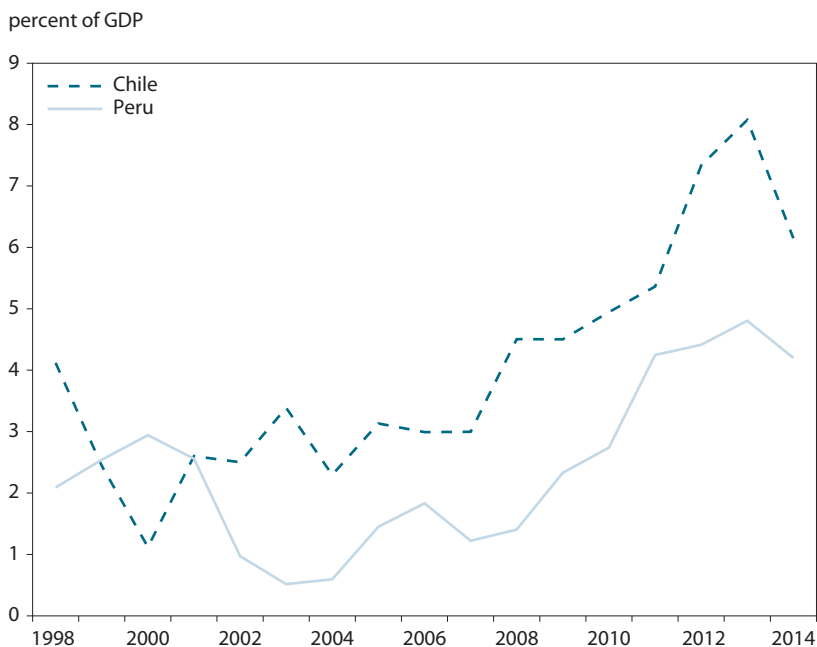
The Business Cycle and Long-Term Growth

Forecasts are not good at predicting turning points (Ahir and Loungani 2014) or identifying long-term trends (Ho and Mauro 2014). Forecasting is particularly difficult in Latin America, which has not experienced regular business cycles. In the past,

Figure 7 Change in growth forecast for emerging and developing economies for 2014



LATAM = Latin America
 Source: IMF, *World Economic Outlook*, April 2013 and October 2014.

Figure 8 Investment in mining, Chile and Peru, 1998–2014

Source: Chile: Central Bank of Chile and Cochilco; Peru: Ministerio de Energía y Minas and Sociedad Nacional de Minería, Petróleo y Energía, and Fornero, Kirchner, and Yani (2014).

recessions were very deep, recoveries slow, and dependence on international conditions significant. In the recent crisis, when Latin American countries aggressively adopted conventional macroeconomic policies for the first time in many years, the contraction was limited, given the size of the shocks, and the recovery rapid.

Forecast errors occur not only because the cycle is difficult to predict but also because there may be overoptimism about long-term trends, in particular the rate of growth at full capacity. High growth tends to create the impression that it will persist. But growth takeoffs do not last forever; after the first push from initial reforms, especially macroeconomic consolidation, growth normalizes.³ An early example in the region is Chile, where growth took off rapidly in the late 1980s before returning to normal rates after the Asian crisis. Peru grew at an average annual rate of 6.6 percent between 2005 and 2013—certainly not its long-run rate of growth.

Long-term growth predictions were farthest off the mark in Brazil. Between the successful stabilization of the early 2000s and 2008, annual growth averaged 4.8 percent. After a mild recession in 2009, when output contracted 0.3 percent, Brazil recovered strongly, growing 7.5 percent in 2010. Since 2011

annual growth has averaged 1.6 percent and is expected to be negative in 2015. Still, in late 2013 long-term growth was forecast at 3.5 percent (Kaufman and Garcia-Escribano 2013).

Colombia is the only country among the LAC7 where growth remained robust in 2014. Strong performance may reflect the country's aggressive infrastructure program, which offset a decline in private investment. Such spending cannot be a source of permanent growth, however. Indeed, the leveling off of this spending, along with the decline in the price of oil, has dimmed growth prospects. In 2014 Colombia was forecast to grow about 4.5 percent in 2015; current estimates are closer to 3 percent.

The Copper Investment Boom in Chile and Peru

From the mid-2000s to 2013, investment in mining in Chile and Peru increased by 3–4 percent of GDP (figure 8). In 2014 it declined by about 2 percent of GDP in Chile. The decline in mining investment was smaller in Peru, about 1 percent of GDP. A continued decline in investment in mining will hold back growth.

Commodity price booms increase income, government revenue, and demand, thereby boosting output. An appropriate macroeconomic framework can dampen the effect of an income-induced commodity price boom: fiscal policy that saves

3. For a review of the evidence in the context of China's growth prospects, see Pritchett and Summers (2014).

in good times to spend in bad times, a flexible exchange rate that acts as a shock absorber, and a credible monetary policy can limit the effects of commodity prices.⁴

Because foreign investors and the government own much of the copper in Chile and Peru, the cycle can be mitigated by managing windfalls. Traditional income effects are more likely to be felt in agricultural commodities, where benefits are widespread and domestic demand booms when commodity prices increase.

Although the decline in the terms of trade has not been large enough to explain a large share of the slowdown through income effects, a commodity price boom can induce a cycle through its effects on investment. When investors perceive a long-lasting rise in commodity prices, they have incentives to invest. Copper is very capital intensive; investment in the initial phases is significant and spills over to many other sectors, such as construction. The investment process increases aggregate demand, which induces a boom. When all projects have been developed, investment declines, even if prices have not declined significantly.

Fornero, Kirchner, and Yani (2014) investigate the investment accelerator effect of commodity booms.⁵ Their empirical results show that rising commodity prices have an important effect on investment in mining, with spillovers to the rest of the economy. According to them, commodity prices induced most of the above-average investment during the boom in Chile. During the crisis, the investment boom mitigated its effects. Thus, instead of commodities having a multiplier effect on demand and activity, their effects are much closer to an investment accelerator.

Gruss (2014a) finds that “even if [commodity] prices were to remain stable at the relatively high levels observed in 2013, the annual output growth rate over the medium term (2014–19) would be almost 1 percentage point lower than in 2012–13.” Although the mechanism is not explicit, the pattern he describes is consistent with the investment cycle. The effects are large for Peru; average for Argentina, Chile, Colombia, and Venezuela; and small for Brazil.

Investment cycles associated with commodity prices also affect the current account balance. When commodity prices are high, the rise in domestic investment can widen a current account deficit, despite high export prices. A decline in commodity prices may be offset by a fall in investment and a consequent narrowing of the current account deficit.

4. Indeed, this seems to be the case of copper in Chile, as De Gregorio and Labbé (2011) discuss.

5. I am grateful to the authors for sharing their data on investment in mining.

Country-Specific Issues

The deceleration in Brazil, Chile, Mexico, and Peru has been significant, and these countries will probably not be able to grow at the rates experienced during the commodity price boom. Colombia grew strongly in 2014, but deceleration is also expected there. Different idiosyncratic factors held back growth in 2014 in different countries.

Brazil. Since late 2013, Brazil has suffered one of the most devastating droughts in decades—a costly calamity in a country where 70 percent of power generation is hydroelectric. The drought increased energy prices and is likely to force electricity rationing and cause water shortages. It was also responsible for the increase in the price of coffee, following destruction of much of the crop.

Brazil has also been affected by the decline in the oil price. It has one of the world’s largest deepwater reservoirs of oil, but exploiting them may be unprofitable at current oil prices. The massive corruption scandal at Petrobras, the public partner in these projects, further undermined investment prospects and is having serious spillovers onto economic performance and the political climate.

Brazil has one the lowest growth potentials among LAC5 countries. Despite low growth, the central bank, which follows an inflation target, has been tightening monetary policy—an indication that Brazil’s economy is close to full capacity.

To boost growth, Brazil needs to increase productivity. Removing severe distortions in the allocation of credit, opening up the economy, rationalizing a distortionary and high tax burden, and, above all, addressing widespread corruption should be high on the agenda. Demand policies are not the solution.

Chile. Chile once had the region’s most pro-growth environment. Recent reforms to improve equity introduced uncertainty, however, and made the business climate less attractive to investors. The source of the reforms was the mandate given to the incoming administration to increase social inclusion. Chile’s experience is important, because other countries in the region may go a similar route, as discontent over inequality mounts. Social reforms during the 1990s and the previous decade were rightly geared toward increasing coverage of social services. For example, enrollment in tertiary education increased significantly, with the private sector supplying the education services. But fees were high and quality low, which triggered massive demonstrations in 2011. In some respects, one can argue that Chilean social policies “were behind the curve,” at least behind public expectations. Many demands are justified (in health and education, for example), but they were not addressed in time, so the pendulum swung the other way. No government would have been able to sidestep these demands.

As a first step in the social reforms, the government introduced tax reform to fund social needs. The reform, which will

raise revenues by 3 percent of GDP, will be implemented gradually between 2015 and 2018. Central government expenditure will rise from about 22 percent to 25 percent of GDP. This reform was followed by educational reform, electoral reform, and proposals for labor market reform.

Despite the need and broad support for reforms, legislation has been contrived, and in some cases inappropriate; it has created uncertainty and undermined investors' confidence. Adjustments will probably have to be made in the future. Uncertainty will diminish as the full extent and actual implementation of the reforms become clearer.

The fundamentals of Chile's success—free markets, an open economy, independent central bank, strong fiscal policy, and a sound financial system—remain in place. Moreover, if the reforms are effective, they should allow growth with social cohesion. However, the transition is complex and adjustment may be required in order for them to be effective.

Mexico. Since late 2013 Mexico has amended its constitution and enacted legislation to open oil investment to the private sector in joint ventures with PEMEX, the national oil company. It also introduced energy reform that should allow private sector participation in a sector that needs investment. The reforms increased confidence, but the recent decline in oil prices has not been good news. The growth gains originally estimated to have resulted from reform (of about 0.5 percentage points of GDP) will decline as incentives to invest fall as oil prices decline.

Peru. Peru has faced problems in mining and fishing, two of its most important sectors. As a result of climate change, fishing output fell about 25 percent in 2014 (in 2013 it had been projected to increase 7 percent). The decline also affected manufacturers associated with the fishing sector. Mining also declined, as discussed above. Although conditions in 2015 seem more promising, it is extremely unlikely that Peru will return to growth of 6 percent a year (indeed, forecasts project growth of about half that rate).

THE ROAD AHEAD

Prospects for Latin American growth are modest at best, as figure 6 indicates. Chile, Colombia, Mexico, and Peru are likely to grow about 3 percent in 2015, and Brazil's economy is likely to contract by as much as 1 percent. Argentina and Venezuela may suffer even larger declines.

Countries in the region must address two main challenges. First, they need to craft macroeconomic policies that reflect lower growth and support stability. Second, they need to spur productivity growth. The fact that unemployment has been stable is a clear indication that productivity is growing slowly,

and I show the evidence below. In addition, a key issue in the region is inequality, which has to be tackled effectively to improve productivity, necessitating institutional reforms and avoiding the historical cycle of populism and stagnation.

Macroeconomic Policies and Exchange Rates

The global financial crisis witnessed a significant loosening of monetary policy, a key factor in speeding the recovery (figure 9). After the recovery, monetary policies started a process of normalization (except in Mexico, which has not raised interest rates since the global financial crisis started).

The normalization process continued until 2011–12, when, with the decline in actual and projected inflation (figure 10), there was more systematic loosening in Chile, Colombia, Mexico, and Peru. More expansionary monetary policy continued until recently (except in Colombia, where monetary policy has been gradually tightening. This trend may soon change, as the Colombian economy has started to weaken.)

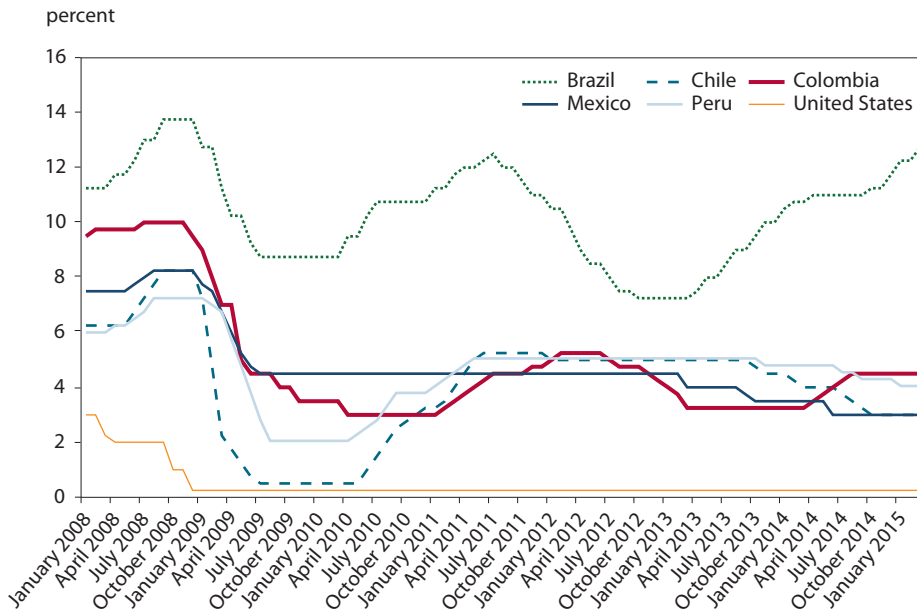
Inflation rising was a serious concern in most countries in 2014. It increased significantly in Chile, primarily as a result of the pass-through of a significant depreciation to domestic prices. Although in principle depreciation should not have significant persistent effects on inflation, especially when the economy is decelerating, room for further loosening is limited. The sharp fall in oil prices and low growth should alleviate inflationary pressures, but they are not enough to warrant monetary loosening. Indeed, because of current exchange rate developments most inflation rates are running higher than current targets.

A key factor allowing more expansionary monetary policy is an increase in excess capacity. However, excess capacity depends not only on the current rate of growth but also on the expansion of potential output (i.e., full capacity output). It is not clear that excess capacity is increasing, as potential growth has probably fallen. Significant monetary loosening is therefore unlikely. In addition, the uncertainty about the impact of US monetary policy tightening on the global economy will tend to make monetary policymakers await the Federal Reserve's move before changing their monetary policy stances.

Brazil's monetary policy is special, for several reasons. First, its central bank follows an inflation target, which it usually overshoots. In a credible inflation targeting regime, inflation usually rises when the economy is operating above full capacity, when the monetary policy response is to tighten. Rising inflation is the first indication that despite low growth, Brazil has hit the full capacity limit. To grow faster, it needs to increase productivity. Demand policies will not help in a lasting way.

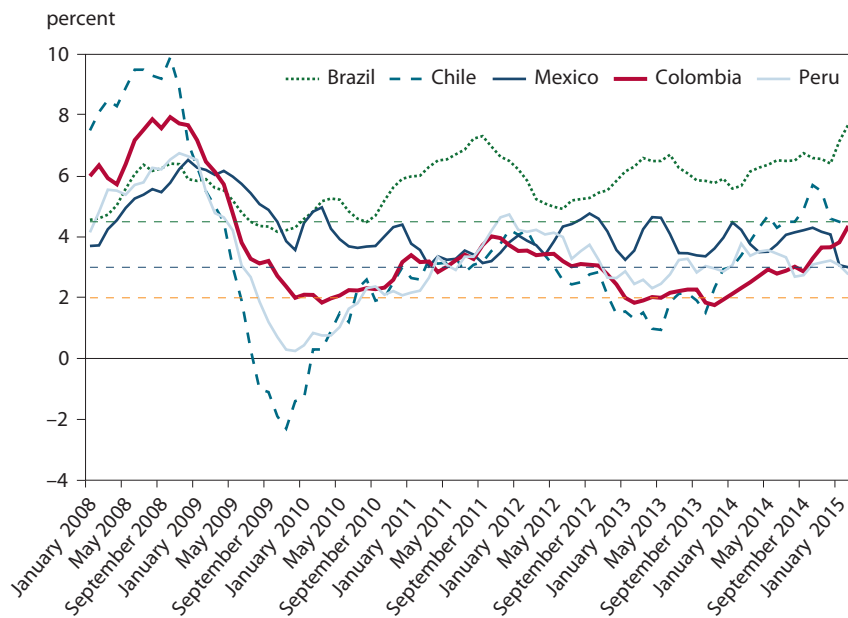
Second, with its Selic (monetary policy) rate at 12.75 percent and inflation running at 7.7 percent, Brazil has perhaps

Figure 9 Monetary policy rates, 2008 to March 2015



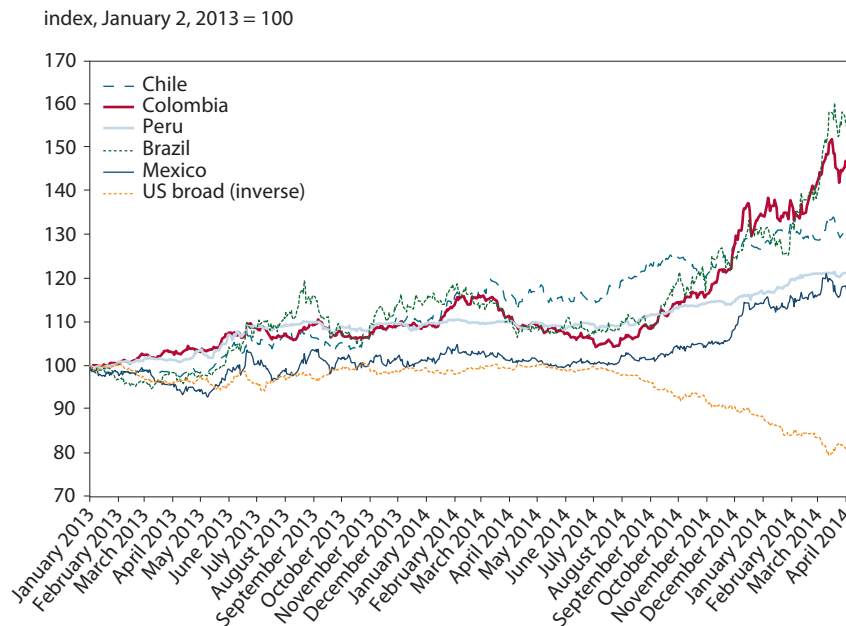
Source: Bloomberg.

Figure 10 Inflation rates in LAC5, 2008 to February 2015



Note: Dashed lines correspond to current inflation target. Brazil is 4.5 percent; Chile, Colombia, and Mexico, 3 percent; and Peru, 2 percent.

Source: Bloomberg.

Figure 11 Exchange rates in LAC5, 2013 to March 2014

Note: Exchange rates are measured as domestic currency per US dollar, so an increase represents a depreciation. The dollar is a broad index (Bloomberg inverse of DXI index) measure as unit of US dollars per foreign basket of currencies, and hence the decline is an appreciation.

Source: Bloomberg.

the highest real (ex post) monetary policy interest rate in the world. It has been able to grow with very high Selic rates for many years. One reason why this is the case is that development banks—which account for about half of new lending—charge much lower rates. These lower rates dampen the effect of monetary policy. However, many small and medium businesses, as well as most consumer credit, lie outside the scope of development banks.

Third, the exchange rate is a key transmission mechanism of monetary policy in Brazil. For this reason, the Brazilian authorities are more concerned about sharp fluctuations in the exchange rate than are authorities in Chile, Colombia, or Mexico. They raised the issue of currency wars and accumulated reserves and introduced capital controls when the real appreciated. However, when Brazil was doing well in 2010, bond yields were above 10 percent and, hence, incentives for carry trade were significant. This was the reason for the appreciation of the real some years ago. It was not a currency war.

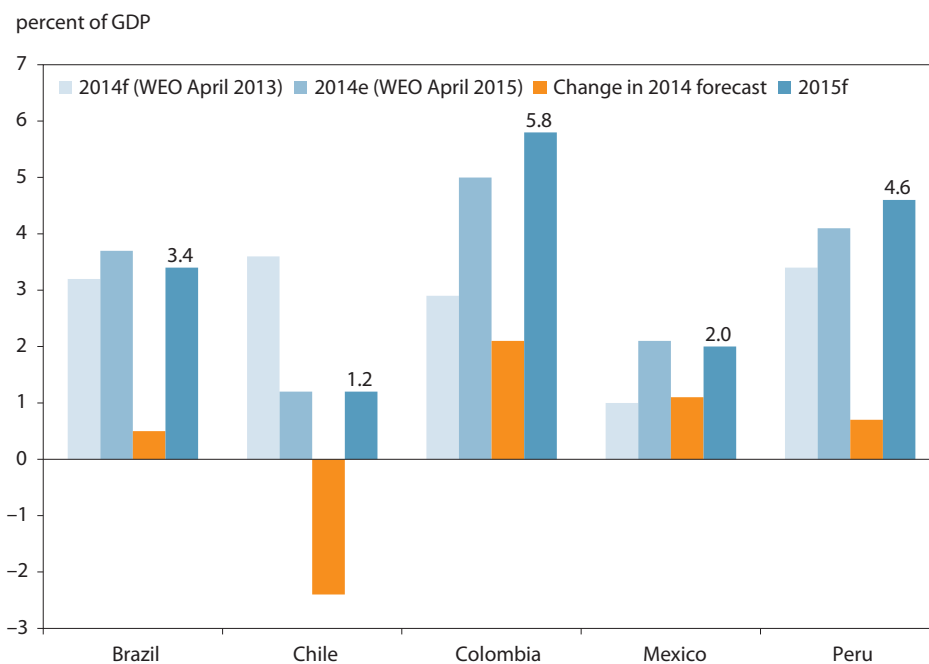
When emerging-market currencies started depreciating, the Brazilian authorities removed capital controls and intervened in the foreign exchange market to impede the depreciation. As the pass-through from exchange rate to prices has declined in most emerging markets as currencies float and inflation declines (Mihajek and Klau 2008), this channel requires stronger responses of monetary policy and the exchange rate. Indeed, the tightening of monetary policy in Brazil during the

latest cycle started in March 2013, before taper tantrum, when the Brazilian real started depreciating at a steady and relevant pace (figure 11).

Recent announcements to reduce transfers to development banks for three years should help rationalize the operation of the financial system, but they will severely tighten credit conditions if no other changes are implemented. Brazil could afford to reduce the Selic significantly, but only if development banks increase their lending rates. However, the transition and political implementation is complex.

With commodity prices weakening, domestic activity slowing down, and external financial conditions tightening, exchange rates must depreciate if they are to act as shock absorbers. They did so in LAC5 countries (figure 11): The Brazilian real and the Colombian peso depreciated about 50 percent between early 2013 and April 2015. The Chilean peso, which started depreciating earlier, fell about 30 percent. The Peruvian Nuevo Sol depreciated more gradually and by less, despite suffering a shock similar to that of Chile. The high degree of dollarization in Peru results in somewhat greater fear of floating, as authorities allow adjustments to take place gradually. But further depreciation is needed to resume growth. The case of Mexico is different, because its currency is more closely tied to the US dollar.

The weakening of LAC5 currencies with respect to the US dollar coincided with a global strengthening of the dollar, measured on the basis of a wide currency basket. The magnitudes

Figure 12 Current account deficit and forecast adjustment in LAC5

e = estimate; f = forecast

Note: A positive number is a deficit. The difference is the change in the forecast between April 2013 and April 2015. A positive figure is a widening of the deficit.

Source: IMF, *World Economic Outlook* (WEO), April 2013 and April 2015.

of the gains in competitiveness were therefore smaller than reflected in figure 11, as the real depreciations, measured by some real effective exchange rate measure, were smaller.

As the exchange rate should facilitate external adjustment, the current account balance should improve. Progress in this area has been limited. Figure 12 shows the evolution of the IMF's forecast of the current account deficit for 2014 (a positive number is a deficit). The third bar represents the change in the forecast between April 2013 and April 2015. It implicitly measures the impact of the deceleration plus the depreciation on the current account.⁶ Chile is the only country for which the most recent forecast shows a decline in the current account deficit. The forecast fell from almost 4 percent of GDP to about 2 percent. In this case, most of the adjustment came from a fall in imports, especially imports of capital goods related to the decline in investment, rather than an increase in exports.

The lack of current account adjustments could reflect lags with which depreciation affects net exports, changes in the terms of trade, or lack of adjustment of aggregate demand. However, forecasts for 2015 show that there is still no reversal, with the balance in 2015 expected to be similar to the balance in 2014.

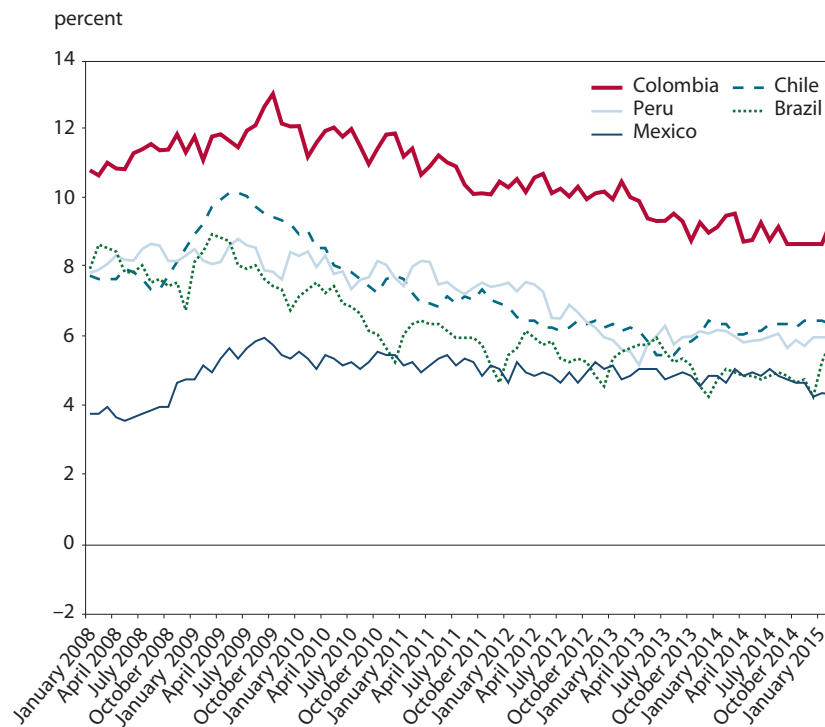
6. IMF estimates of the current account deficit show some inertia in the face of large exchange rate changes (see Cline 2013).

The impact of exchange rate fluctuations on inflation decreased substantially over time, as low inflation was maintained and currencies allowed to float. If domestic prices react less to the exchange rates, relative prices could be more stable, thereby limiting expenditure switching. However, in a world of local currency pricing there will still be gains in competitiveness on the exports side (De Gregorio 2014).

Government expenditures that expanded during the crisis were not completely pulled back when economies recovered. This "fiscal stickiness" was evident in most emerging-market economies (De Gregorio 2014). The problem of lingering government stimulus is that it limits the ability of governments to undertake future countercyclical fiscal expansions when they are needed in downturns, especially in countries facing doubts about debt sustainability. A better approach is to rely on more automatic stabilizers, especially on the expenditure side. Fiscal expansions do not always lead to economic expansions in any case (Alvarez and De Gregorio 2014).

Long-Term Growth and Unemploymentless Slowdown

The slowdown in the LAC5 countries has come without a significant increase in the unemployment rate (figure 13). Not surprisingly, in Colombia, where the economy continued to grow,

Figure 13 Unemployment rates in LAC5, 2008 to February 2015

Source: Brazil, Colombia, and Peru: Bloomberg. Chile and Mexico: OECD, harmonized unemployment rates. Data for Colombia and Peru were adjusted for seasonality. Latest data available are from December for Chile and from January for Mexico. Data until February were extrapolated using official statistics.

unemployment declined in 2014. But in Brazil, Chile, Mexico, and Peru, where growth was tepid, unemployment was stable or declined slightly.⁷ These unemployment figures have provided some relief to domestic authorities, helping to reelect Dilma Rouseff in Brazil, for example. Employment growth in Brazil decelerated significantly in recent quarters, but it was compensated for by changes in the labor force that resulted in relative stability of the unemployment rates.⁸

This evidence seems to be at odds with a standard application of Okun's law, which holds that when countries are growing below potential, unemployment goes up. For advanced economies the effect is about 30 to 40 basis points increase in unemployment for 100 basis points lower growth with respect to potential (Ball et al. 2013). Recent data for the region are difficult to reconcile with standard Okun's law, unless we take

this as an indication that potential, or long-term, growth has declined.⁹ Indeed, had these economies grown at rates close to potential, unemployment rates would have been stable.

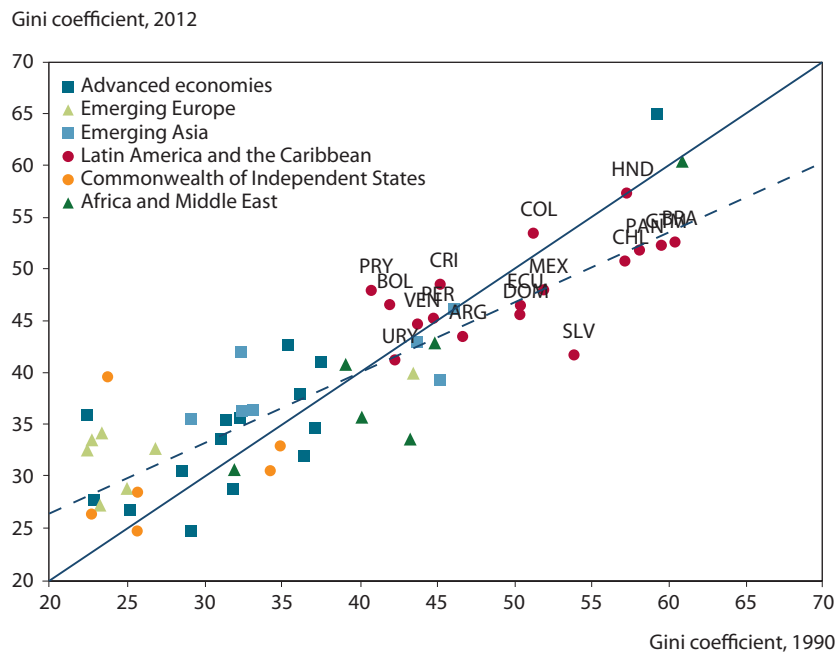
Other factors may explain why this slowdown was not accompanied by a dramatic rise in unemployment. It is possible that the composition of unemployment has changed. In Chile the proportion of self-employed people has increased. Informality usually rises with low growth. It may be that employment is adjusting on the intensive margin (hours) rather than the extensive one. People who lose their jobs may also be quitting the labor force. Lags in unemployment adjustment could also have lengthened. However, this evidence shows that productivity has not been growing, and long-term growth is lower than anticipated some years ago. Therefore, to resume growth, efforts should be made to increase productivity.

7. Unemployment in Chile increased from 5.7 percent in December 2013 to 6.0 percent in December 2014, while growth fell by 2.4 percentage points, according to official figures. Figures for Chile and Mexico are from the OECD's harmonized statistics. There are many alternative series of unemployment across countries, but all tell roughly the same story.

8. Brazil's unemployment rate began to rise at the beginning of 2015. The increase cannot be blamed on lags, as growth in Brazil has been low since 2011. The most likely explanation is that Brazil is in a recession with output falling.

9. Gruss (2014b) presents Okun's law estimates for Latin American countries and the coefficients are smaller than those found in advanced economies.

Figure 14 Evolution of income inequality, 1990 and 2012



ARG = Argentina, BOL = Bolivia, BRA = Brazil, COL = Colombia, CHI = Chile, CRI = Costa Rica, DOM = Dominican Republic, ECU = Ecuador, GTM = Guatemala, HND = Honduras, MEX = Mexico, PRY = Paraguay, PAN = Panama, PER = Peru, SLV = El Salvador, URY = Uruguay, VEN = Venezuela
 Note: A Gini index of 0 represents perfect equality, while an index of 100 implies perfect inequality.
 Source: World Bank, Development Research Group, <http://iresearch.worldbank.org/PovcalNet/index.htm>.

Perils of Inequality

Institutional weaknesses are high on the list of obstacles to growth. Corruption and crime not only hamper growth but also directly affect the quality of life in the region. Crime is high in Latin America, particularly in Guatemala, Venezuela, and El Salvador. The mass killings in Iguala, Mexico; the murder of a government prosecutor in Argentina; the corruption scandal at Petrobras, which may extend to several other companies and sectors of the Brazilian economy; and the political crises in Chile and Peru all indicate the need for institutional reforms.

Many factors explain weak institutions, corruption, populism, and macroeconomic imbalances in the region. Some of them can be traced to the high levels of inequality. However, causality also runs in the other direction: Poor institutions weaken the scope to reduce inequality.

Figure 14 plots the Gini coefficient for selected regions in 1990 and 2012.¹⁰ Inequality increased (decreased) in countries above (below) the diagonal line. The dotted regression line shows that this measure increased in countries in which

inequality was initially high and decreased in countries in which inequality was lower.

The figure shows that between-country inequality declined between 1990 and 2012. It also indicates that Latin America is one of the most unequal regions in the world but that inequality declined in most countries in the region.

As a rule, when growth recovers, inequality is not a serious concern. This typically happens after macroeconomic stabilization and implementation of the first set of reforms. Only after several years of economic progress and growth of household income and consumption do new demands for a more equal distribution of wealth and income arise, along with an insistence on greater social inclusion and fairness. Policymakers often ignore these concerns, because they can fuel demands for more public spending, derailing sound macroeconomic policies. Moreover, to pay for higher social spending, for example, taxes may need to be increased, stifling economic growth. Without social inclusion, however, it is very difficult for the region to sustain growth and maintain sound economic policies. Chile now faces the problem of balancing these pressures.

10. The Gini coefficient is a measure of income distribution in which a coefficient of 0 indicates perfect equality and 1 indicates perfect inequality.

FINAL REMARKS

Macroeconomic policies have improved in many countries in Latin America. The adoption of sound monetary policies that seek to maintain price stability and the consolidation of fiscal policy have rid the region of the double- and triple-digit inflation that plagued its economies decades ago. Letting the exchange rate float and allowing it to act as a shock absorber has been key to creating a more integrated global economy, as demonstrated during the global financial crisis.

Some tensions may lie ahead, as the United States starts ending its unprecedented monetary stimulus. But LAC5 econo-

mies are prepared to face significant currency adjustments. The share of public debt denominated in dollars is small, and financial systems are resilient to currency fluctuations.

The risk of populism and derailment of good macroeconomics cannot be disregarded, because of the negative consequences for the entire population. But quick fixes should be avoided and may again lead to bad policies. The road is not easy. Change affects vested interests and there is impatience, but without social inclusion it is very difficult for the region to sustain growth. Current problems in the region also reveal the need to improve institutions, which are essential to spur productivity growth.

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