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Latin America and the Caribbean: economic situation and outlook, 2010-2011

Summary

Following the drop experienced in 2009, the gross domestic product (GDP) of Latin America and the Caribbean returned to growth in 2010, increasing by 6.1%. Although growth was observed essentially throughout the region, it reached 6.8% in South America and 4.9% in Mexico and Central America, but only increased by 0.5% in the English- and Dutch-speaking Caribbean. This growth was driven to a great extent by the countercyclical measures deployed by many countries, in addition to the recovery of the global economy that began in the first half of 2010. Greater economic growth had a positive impact on employment demand, pushing the regional unemployment rate down to 7.5%.

A number of external factors, such as fuel and food prices, pushed inflation up to 6.7% in 2010, although core inflation increased only slightly. The early months of 2011 saw a change in the situation, with some countries experiencing pressure on core inflation. A further impact of the higher prices for these commodities was that the exporting countries enjoyed better terms of trade and greater value of their exports. The scenario in the second half of 2010 was less optimistic, brought about by exhaustion of idle production capacity, public spending cuts and strong appreciation of the currencies of some countries of the region.

As a result, growth in 2011 is projected to reach 4.2%. The South American economies are expected to continue posting growth rates higher than the rest of the region, although lower than in 2010 because of the withdrawal of public policy efforts to spur demand, including tighter monetary policy to counter inflationary pressure and a slowdown in global growth.

* E/2011/100.

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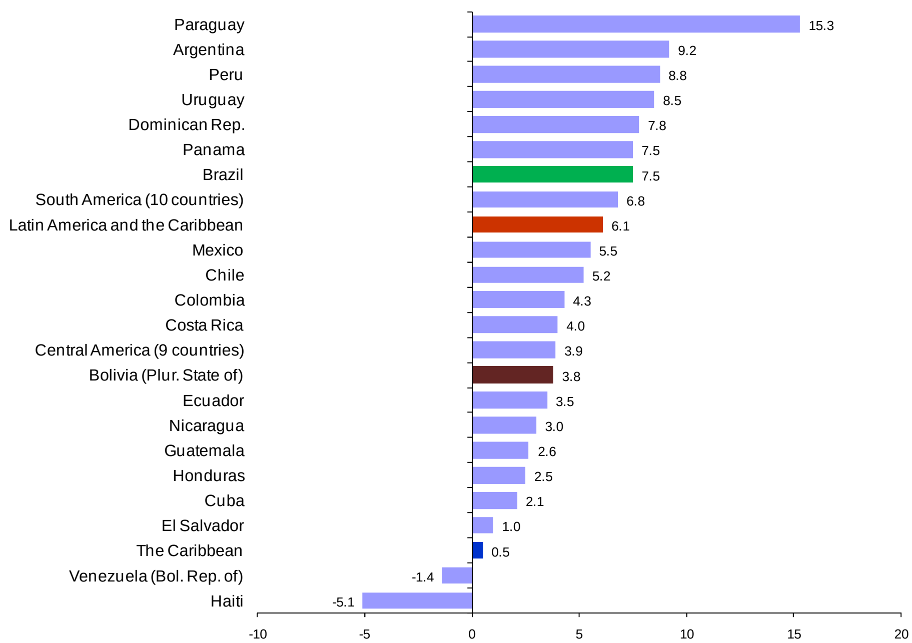
I. Introduction

1. Latin America and the Caribbean grew 6.1% in 2010, equivalent to 4.8% growth in per capita gross domestic product (GDP); this is the highest rate of growth since 2004. Although growth was observed essentially throughout the region, performance across subregions was uneven. While in South America GDP grew by 6.8%, in Central America it grew by 3.9%, in Mexico by 5.5% and in the English- and Dutch-speaking Caribbean by 0.5% (see figure I).

2. Growth in 2010 consolidated the recovery that had begun in most of the economies of the region in the second half of 2009, boosted by the countercyclical measures deployed by many countries. Unlike similar scenarios in the past, the expanded macroeconomic space in many countries of the region provided unprecedented scope for implementing policies geared towards weathering the crisis. Measures for counteracting the impact of the global crisis dovetailed with the rapid recovery of the global economy in the first half of 2010 to help sustain the improved performance of the economies of Latin America and the Caribbean.

Figure I
Latin America and the Caribbean: growth rates, 2010
(Percentages)



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

3. Greater economic growth drove employment demand up (the region-wide unemployment rate is estimated to have fallen to approximately 7.5%) and helped to improve the quality of the jobs created. Rapid growth was accompanied by a slight uptick in inflation, which went from 4.7% in 2009 to an estimated 6.7% in 2010, owing above all to the behaviour of international prices for commodities such as

food and fuel. Although that uptick did not affect core inflation in 2010, the early months of 2011 did see a slight increase in this index.

4. This evolution of labour market indicators, plus expanding credit and the general improvement in expectations, helped to spur private consumption. These factors, along with a substantial rise in investment in machinery and equipment, were the main drivers of the rise in demand.

5. For the region as a whole, the favourable external scenario translated into higher export volume and value, although imports rose even more. The international context resulted in widely differing impacts according to each country's position in the market for goods and services.[1] The terms of trade for the countries that export commodities (agricultural products, minerals and hydrocarbons) improved, and the value of their exports climbed.

6. Most of the countries of Central America and the Caribbean, however, were hit again by the rising value of their imports, leading to net losses and further worsening their external balance. These negative impacts were offset in part by a certain degree of recovery in tourism and in remittances sent from developed countries by emigrant workers. Mexico benefited from a nascent recovery in the United States of America (Mexico's principal export market), which had experienced a severe crisis the year before.

7. Nevertheless, several factors emerging in the second half of 2010 hinted at a less optimistic scenario for the global economy. Along with slowing demand from public spending and the exhaustion of idle production capacity, these factors were behind the general slowdown of growth that is constraining the economies of Latin America and the Caribbean in 2011.

8. The Economic Commission for Latin America and the Caribbean (ECLAC) thus projects that growth in the region will slow to 4.2% in 2011, equivalent to GDP per capita growth in the area of 3%. In South America, GDP is expected to grow by 4.5%, while projections are for 3.9% growth in Central America and 2.2% growth in the Caribbean.

II. Recent trends in the Latin American and Caribbean economies

9. The external context for the region in 2010 showed signs of an incipient global economic recovery but was still marked by turmoil in the wake of the 2008 international financial crisis. Following a 2.0% global contraction of GDP in 2009, the forecast is for growth of 3.6% in 2010. While the recovery has come sooner than expected, developed economies and emerging economies are growing at substantially different rates, giving rise to some uncertainty as to the future sustainability of growth.

10. In such a scenario, some countries of Latin America could still benefit from growing demand for commodities and rising nominal prices owing to global depreciation of the dollar and the resulting appreciation of their own currencies;

[1] Commodity prices also reflected events in international financial markets, in particular the performance of the United States dollar and increased global liquidity.

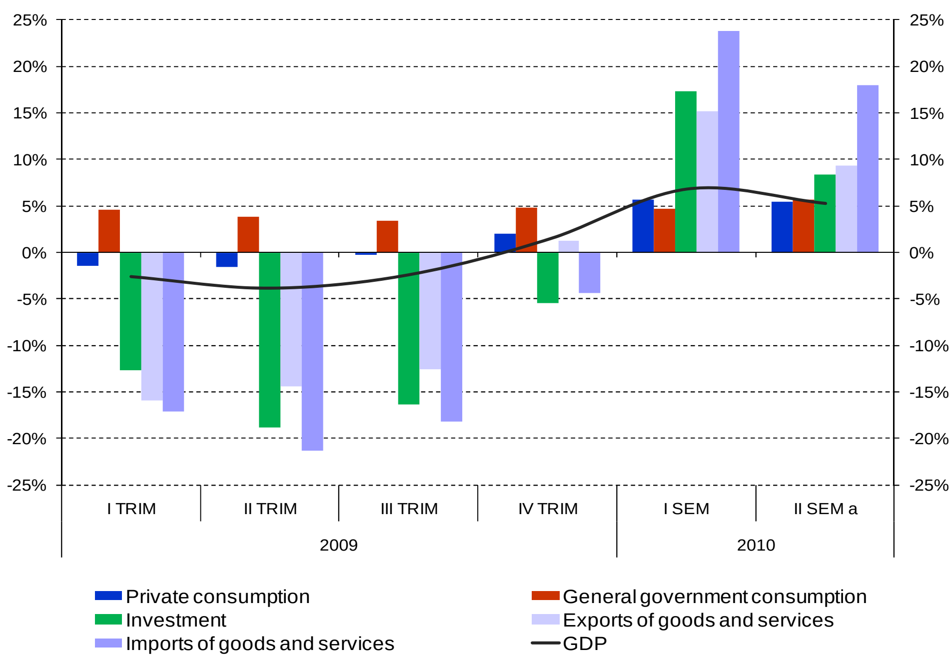
those factors would impact positively on terms of trade and on control of inflation through the import component. Nevertheless, these countries run the risk of discouraging other exports as it becomes harder for the region's tradable sectors to compete in external and domestic markets. This issue will be further discussed below.

A. Internal factors

11. The strong countercyclical measures deployed by the governments of most of the countries of the region enabled economic activity to recover quickly and, in most cases, to top pre-crisis levels. These factors were reflected in the evolution of the macroeconomic aggregates, with public consumption at the forefront of aggregate demand, especially in the first half of 2009 as can be seen in figure II.

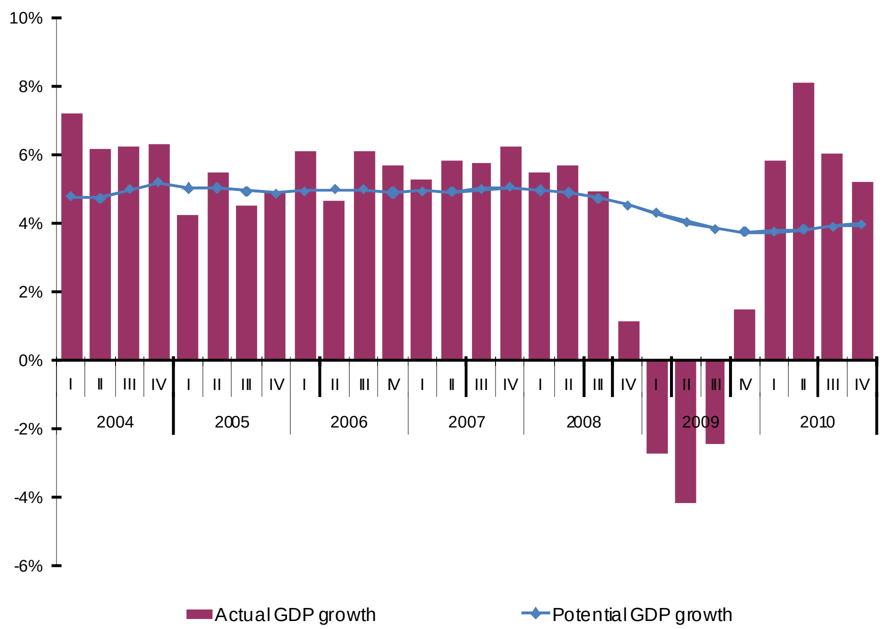
12. Investment and private consumption picked up by late 2009 and gained intensity in the first half of 2010. Rising demand led to high growth rates that in many cases topped potential GDP growth, as emerges from figure III.

Figure II
Latin America: year-on-year rates of variation in supply and demand, 2009-2010
(Percentages in dollars at constant 2000 prices)



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

Figure III
Latin America (nine countries): actual and potential GDP growth, year-on-year quarterly rates of variation, 2004-2010
(Percentages)



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

13. The depletion of idle capacity owing to the pick-up in activity amid expanding availability of credit and lessening uncertainty as to the evolution of the economies of the region helped to spur investment, especially in machinery and equipment, and inventory restocking.

14. Likewise, rising expectations, increasing consumer credit and, in some cases, measures geared towards sustaining spending by the poorest segments of the population drove private consumption up. As the recovery progressed, these impacts began to feed back into improving labour indicators, with falling unemployment and improving job quality and real wages.

15. This crisis had surprisingly little relative impact on the labour markets of the region compared with past episodes and with what happened, for example, in the United States economy. Indeed, in the four cases reviewed (Brazil, Chile, Mexico and Peru), the impact of specific policies on the labour markets and the effect of monetary and fiscal policies on employment demand not only dampened the initial impact but also allowed a rapid recovery (Mexico might be an exception).

16. Job creation during the economic recovery brought the unemployment rate down from 8.2% to 7.5% despite the significant rise in labour participation (see figure IV). Most job creation took place in the formal sector; the resulting improvement in employment quality in many countries contributed to a quantitative improvement in labour market indicators. In addition, as the employment rate rose

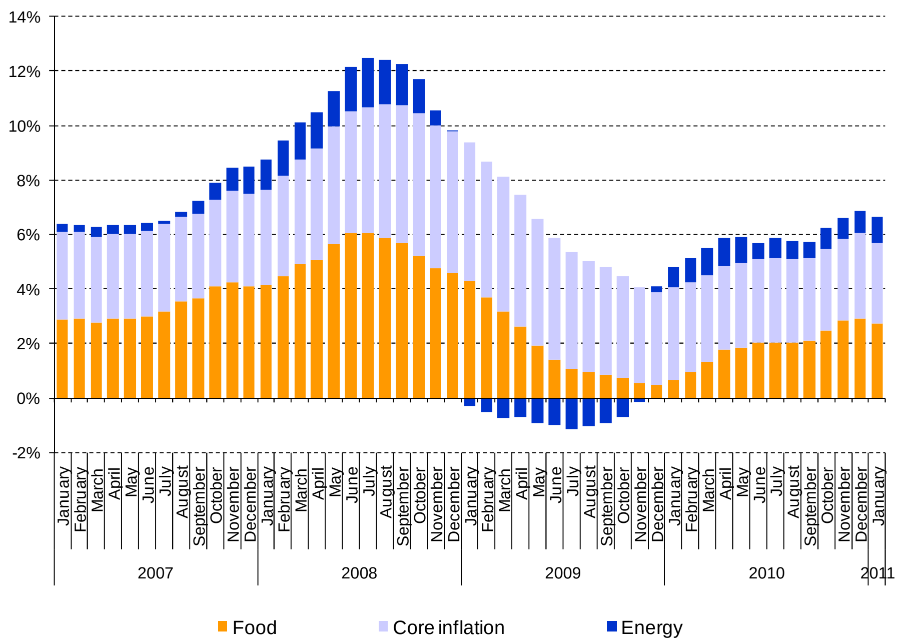
more among women than among men, the strong increase in the female labour supply did not trigger greater unemployment among women. In fact, unemployment at the regional level dropped by similar proportions for men and women, although in the countries experiencing higher unemployment in 2010 (Bolivarian Republic of Venezuela, Honduras and Jamaica) the increase was greater among women than among men.

Figure IV
Latin America: employment and unemployment, 2000-2011
(Percentages)

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Estimate.
[b] Projection.

17. Falling unemployment and improving employment quality were accompanied by an increase in real wages that was somewhat smaller than in 2009 (although greater than the annual increases during the rest of the decade), owing to a jump in inflation — from 4.7% to 6.7% — and greater enforcement of minimum wage policies. The main factor behind the higher inflation rate was the increase in food prices and, to a lesser extent, fuel prices, although, as can be seen in figure V, these rises did not transfer to core inflation (although the initial months of 2011 did see an increase in core inflation). The current political situation in various countries of North Africa may trigger additional hikes in fuel prices and, as a result, additional upward pressure on inflation.

Figure V
Latin America (simple average): inflation by component, January 2007-January 2011
(Percentages)



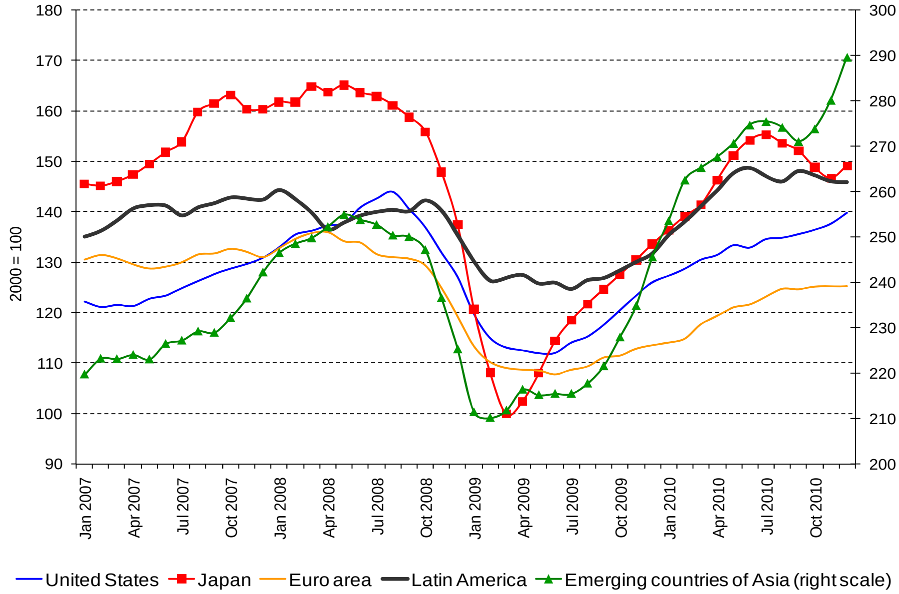
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

18. Overall, this combination of factors led to a decrease in the poverty rate, which is estimated to have fallen from 33.1% in 2009 to 32.1% in 2010, and a somewhat smaller decline in indigence, from 13.3% in 2009 to 12.9% in 2010, thanks to the behaviour of food prices.

B. External factors

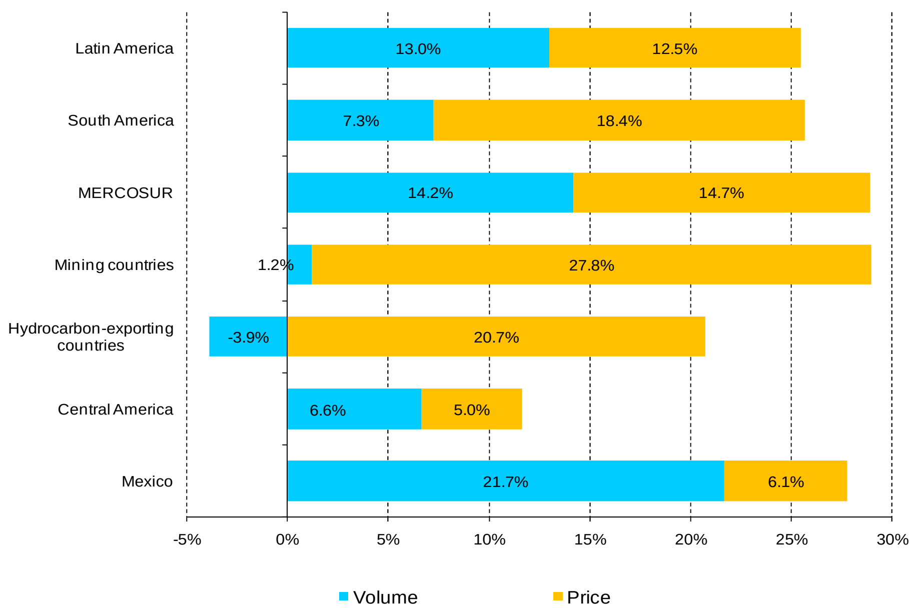
19. The region's export volumes began to rise significantly in late 2009 and, in the second quarter of 2010, exceeded pre-crisis levels (see figure VI). By subregion, the best export performance in volume terms was posted by Mexico and the countries of the Southern Common Market (MERCOSUR), in contrast to the countries of Central America and the countries that export mining products and hydrocarbons (see figure VII).

Figure VI
World exports by region (three-month moving average), 2007-2010
(Index: 2000=100)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of figures from the Netherlands Bureau for Economic Policy Analysis (CPB).

Figure VII
Latin America: export variation by volume and price, 2010
(Percentages)



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

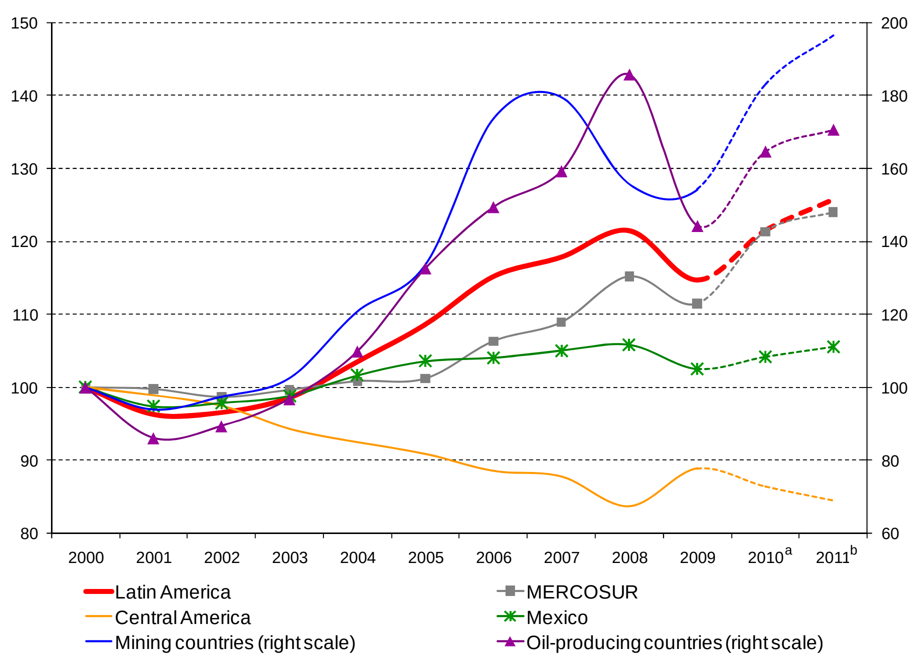
20. The rise in export volume was accompanied by an increase in the price of commodities (which account for a significant portion of the export basket, especially for the countries of South America). Although commodity prices are highly volatile because of the financial status that these markets have acquired and general asset market turmoil since mid-2007, these prices have resumed their pre-crisis positive trend and, in the case of food, have approached the peaks recorded in mid-2008; some items, such as copper and gold, are currently at all-time highs.

21. As a result, the average terms of trade for the region improved in 2010, although the benefits of this were essentially confined to the countries of South America as net commodity exporters. The opposite happened in Central America, which is a net commodity importer: the pre-crisis downward trend resumed. There were opposing effects on Mexico's terms of trade. Despite being an oil exporter, the prices of the country's exports of manufactured goods to the United States suffered because of competition from China in that market. As figure VIII shows, the terms of trade have, generally speaking, returned to their pre-crisis trends.

Figure VIII

Latin America and the Caribbean: variation in terms of trade, 2000-2011

(Index 2000=100)



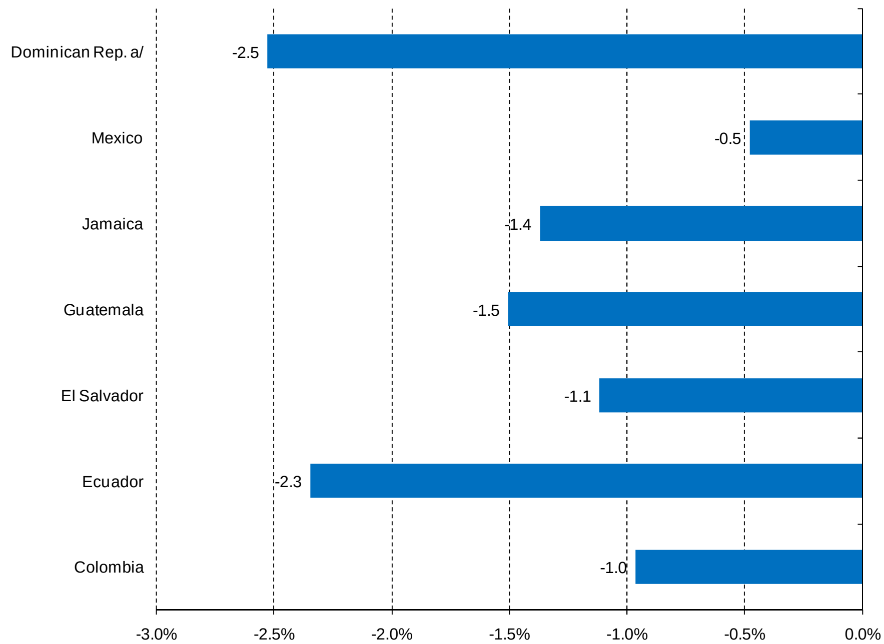
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] Estimate.

[b] Projection.

22. Remittances recovered throughout 2010 but were not able to offset the sharp contraction that in some cases had begun in late 2008 and generally extended throughout 2009. For some of the recipient countries, this has meant a substantial loss of revenue compared with the pre-crisis levels, with drops ranging between 0.5% and 2.5% of GDP (see figure IX).

Figure IX
Latin America and the Caribbean (selected countries): variation in remittance revenue before and after the crisis[a]
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Difference between remittance revenue for 2010 and the average for the period 2004-2007.

23. Despite climbing exports, the rapid recovery of the economies of the region — accompanied in most instances by appreciating real exchange rates — has led to an even greater rise in imports, especially in terms of volume. The region's goods trade balance has therefore returned to the downward trend that was interrupted by the crisis.

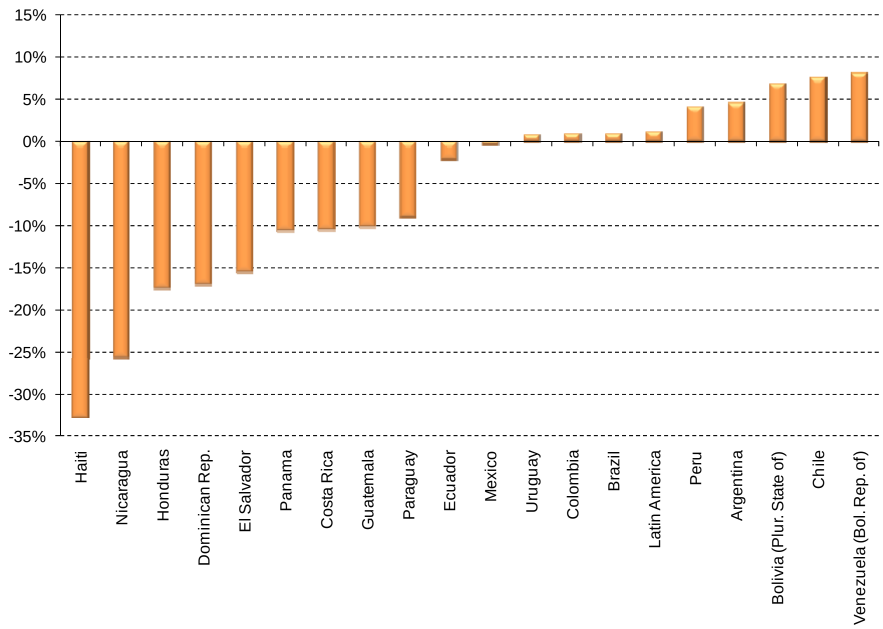
24. The worsening trade balance is exacerbated when real services (which traditionally run a deficit) are also taken into account, leading to a balance — according to ECLAC estimates — of 0.1% of GDP, the worst level recorded since 2001 (see figure X). The income balance deficit has grown as well, owing above all to larger profit remittances to companies associated with the exploitation of natural resources and which offset the increase in worker remittances. The region would thus have a current account deficit equivalent to 1.1% of GDP; so even if growth resumed in the region, it would not be accompanied by an external surplus as it had been in the years prior to the crisis. Moreover, some of the components of this trend are expected to deepen. As noted below, a larger current account deficit is therefore projected for 2011.

25. The current account deficit does not threaten the growth of Latin America and the Caribbean in the short term because financial resources are flowing to the region from a variety of sources in an amount that will not only finance the current account gap but will even allow the accumulation of international reserves. The region has

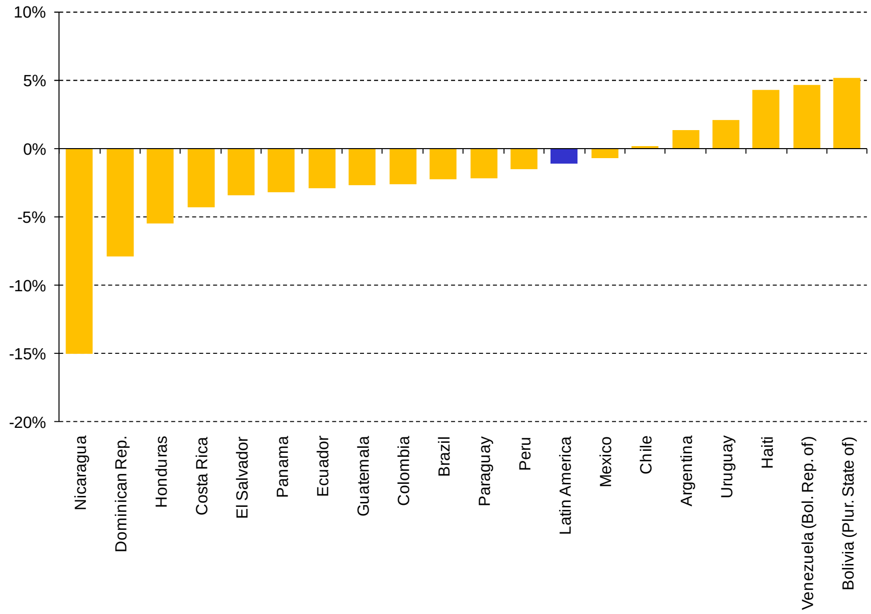
returned to the international markets, and the debt instruments of almost all the countries have been upgraded and their sovereign risk premiums have improved substantially (although they are not yet back at pre-crisis levels). Nevertheless, as will be discussed below, some of the scenarios that can be projected on the basis of this situation are cause for future concern.

Figure X
Latin America and the Caribbean: trade balance and current account balance, 2010
(Percentages of GDP)

A. Trade balance



B. Current account balance



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

III. Macroeconomic policy

26. After a year like 2009, in which countries deployed massive countercyclical policy efforts to address the impacts of the crisis, the strategy for 2010 was a general pull-back of public policies targeting demand, albeit with marked differences between countries. To a certain extent (especially in the second half of the year), macroeconomic policies began to reflect the growing concern about currency appreciation in the region stemming from the sharp increase in liquidity in the global financial markets.

A. Fiscal policy

27. Revenue behaviour was the main determinant of fiscal performance in Latin America and the Caribbean in 2010. The principal contributing factors were the upturn in activity and (in countries specializing in producing and exporting natural resource-intensive goods) commodity price recovery.[2] In most cases, fiscal stimulus policies remained partially in place in 2010. As a result, public account balances in all of the countries of the region either improved or held relatively steady; the exceptions were Costa Rica and the Plurinational State of Bolivia (see figure XI).

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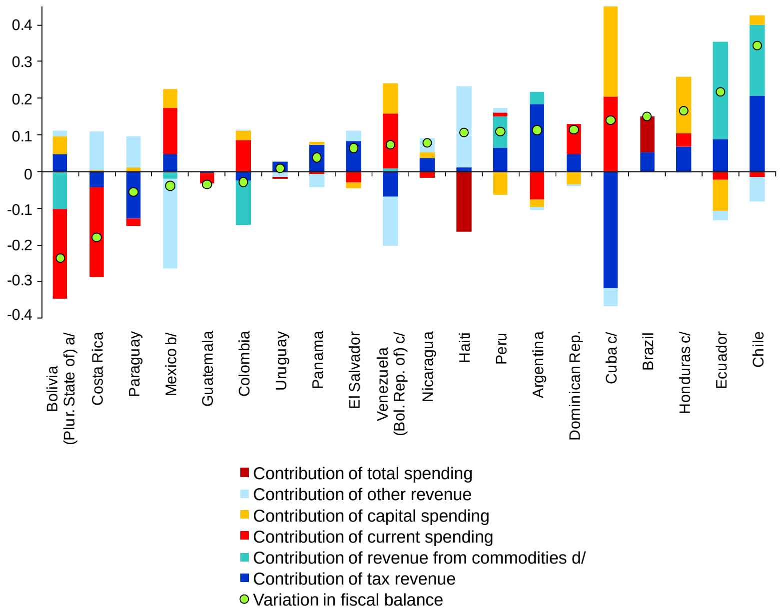
[2] But some countries (such as Colombia and the Plurinational State of Bolivia) lagged behind; the price drop of 2009 was still reflected in lower fiscal revenue from hydrocarbons in 2010.

Figure XI
Latin America: contribution of income and expenditure variations to fiscal balance variation, 2009-2010

(Percentages of GDP)



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

[a] General government.

[b] Public sector.

[c] Total expenditure does not include net lending.

28. Latin America's central governments ended 2010 with a primary fiscal deficit of 0.6% of GDP, as a simple average, compared with a deficit of 1.1% of GDP in 2009. The overall balance (including public debt service payments) was a deficit that went from 2.9% of GDP to 2.4% of GDP.

29. After the increase in public debt balance in 2009 as a consequence of the crisis, in 2010 most countries of the region reduced their level of public debt in GDP terms, thus leading to a drop in regional indebtedness. Underlying the improvement in the debt-to-GDP ratio in 2010 were the strong recovery of economic activity and a lower fiscal deficit. However, although the average ratio dropped, such an average conceals very divergent realities: for instance, Chile had a debt-to-GDP ratio below 10%; Argentina, Nicaragua and Panama had a ratio above 40%; and some countries of the Caribbean had ratios exceeding 100% of GDP.

30. Estimates taking account of national budgets in the region point to continued fiscal account improvement in 2011, with a primary deficit of 0.2% of GDP and a global deficit of 2% of GDP. All in all, the countries of the region are, thanks to rising fiscal revenues, slowly rebuilding their public accounts after the fiscal deterioration in 2009 triggered by the crisis.

31. Recouping pre-crisis degrees of fiscal space after the ground lost in 2008-2009 will require efforts that will vary in nature and magnitude among the countries of

the region because of their differing macroeconomic positions, fiscal revenue products and price elasticities and the measures put in place. In some cases the effort should centre on increasing fiscal revenues. Others will require a firmer effort to moderate the increase in primary public spending (especially current spending), which in many cases has far outstripped the GDP trend growth rate. In some countries, attention should be paid to the repercussions of quasi-fiscal activities. Countries whose debt position is more fragile could seize the abundant liquidity on the global markets as an opportunity to reduce their vulnerability by means of active debt management (lengthening terms, lowering cost).

B. Monetary and exchange-rate policy

32. In the first quarter of 2010, some of the countries of the region began to roll out more restrictive monetary policies as the economic recovery gained traction and concerns grew regarding inflation rate evolution. Among the countries setting inflation rate targets, Brazil, Chile and Peru increased their monetary policy rate. Colombia and Mexico did not, focusing instead on stimulating economic growth.

33. Among the countries with no explicit inflation targets, the Dominican Republic and Uruguay increased rates (albeit later and to a lesser degree), while Paraguay curbed monetary aggregate growth. Argentina and Costa Rica implemented more expansionary policies.

34. A noteworthy development in 2010 was the significant expansion of credit in various countries. Between November 2009 and November 2010, credit grew in real terms in Colombia (16.1%), Peru (15.1%) and Brazil (14.5%); it also grew in Chile but only by 7%, owing to a progressively more restrictive policy (see figure XII). Private credit propelled this rise in total credit except in Brazil,[3] where public bank credit was the main driver of growth.

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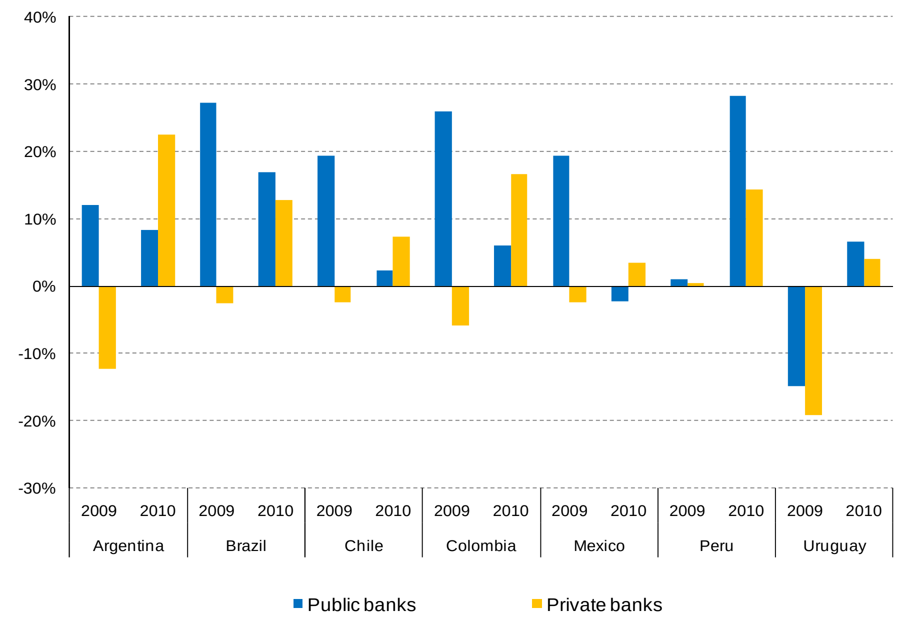
[3] Although Peru showed high growth in public bank credit, the weight of the public bank sector there is relatively lower; it was thus the private banks that were behind the credit expansion in that country.

Figure XII
Latin America (selected countries): real credit growth, November 2009-November 2010

(Percentages)



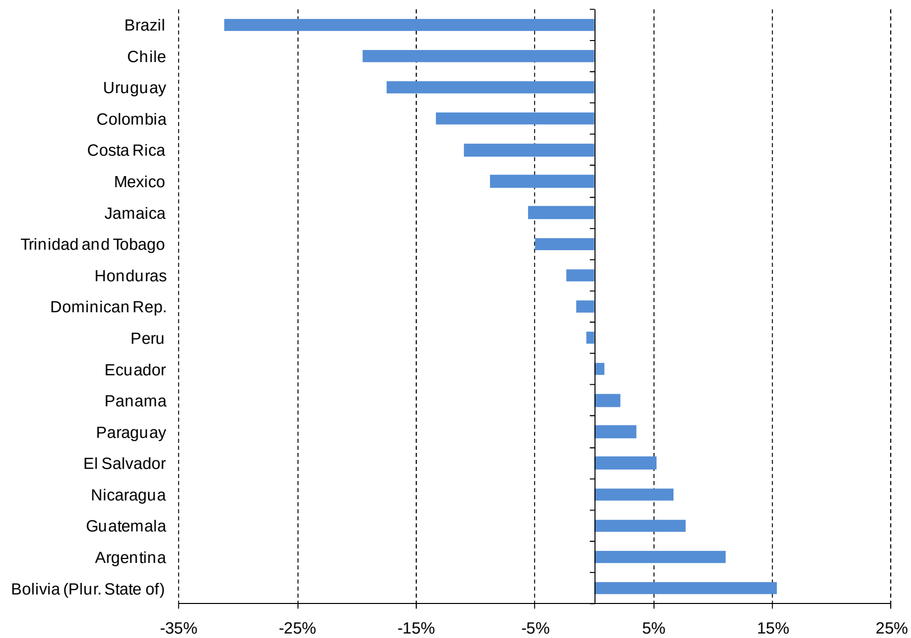
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

35. Looking ahead, some countries may deploy measures to slow the rapid expansion of credit that is putting pressure on currency appreciation in the region — given the excessive international liquidity that spurred capital flows to markets of the region. For example, in early 2011 Peru raised its reserve requirements, among other steps.

36. In 2010 (annual average compared with average for 2009), currency appreciation was highest in Brazil (12%), Colombia (12%), Uruguay (11.2%), Chile (8.8%) and Costa Rica (8.3%). To moderate exchange-rate volatility and appreciation, especially in situations of historically low effective rates of exchange, some countries deployed measures that included reserve accumulation (Argentina, Brazil, Colombia, Costa Rica, Guatemala, Mexico and Peru) and sought to stem capital inflows (by means of taxes and restrictions in Brazil, which increased the financial transaction tax on foreign investment in fixed-income instruments — first to 4% and then, in October, to 6%) and increased outflows (Chile and Peru raised the overall limit on pension fund investments abroad).

37. In real terms, these movements were even more pronounced. As can be seen in figure XIII, real exchange-rate appreciation was fairly widespread and led to real exchange-rate parities below pre-crisis levels. In several countries, real effective exchange rates were therefore substantially below the historical average for the past 20 years. Four countries were more than 20% below their historical averages: Brazil (25.8%), Bolivarian Republic of Venezuela (25.4%), Trinidad and Tobago (24.5%) and Colombia (21.1%).

Figure XIII
Latin America and the Caribbean: variation in real effective exchange rate, December 2008-December 2010
(Percentages)



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

IV. Prospects for 2011 and macroeconomic challenges beyond the short term

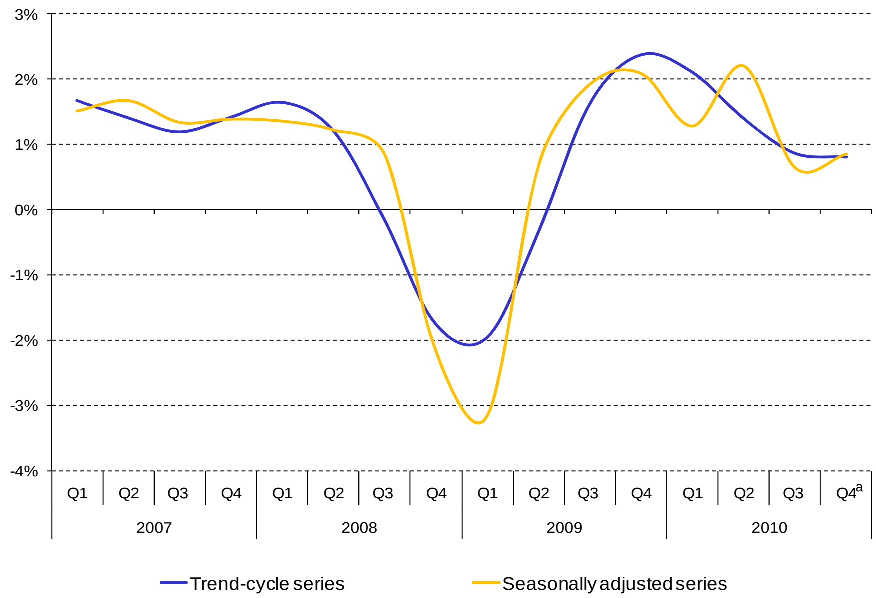
38. ECLAC estimates that the region will continue to grow in 2011, although at a slower pace than in 2010. With the pull-back of public policy efforts to spur demand, the region's economic growth is expected to slacken as idle production capacity is exhausted and the global economy slows, with the resulting effect on trade flows. As figure XIV shows, the pace of growth already began to fall off in the third quarter of 2010.

39. The projected growth rate for Latin America and the Caribbean in 2011 is 4.2%, with per capita GDP rising by 3%. The pace of growth in South America is expected to continue to be slightly above the regional average, at 4.5% (see figure XV). Slower growth is projected for Central America (including Mexico), at 3.9%, and the countries of the Caribbean, at 2.2%.

40. Since job creation will slow as growth slacks off, the unemployment rate will creep down to just over 7% for the year. At the same time, monetary policy issues loom on the horizon and could thwart efforts to control inflation and thus have a negative impact on real wages.

Figure XIV
Latin America (seven countries): quarter-on-quarter real GDP variation, 2007-2010

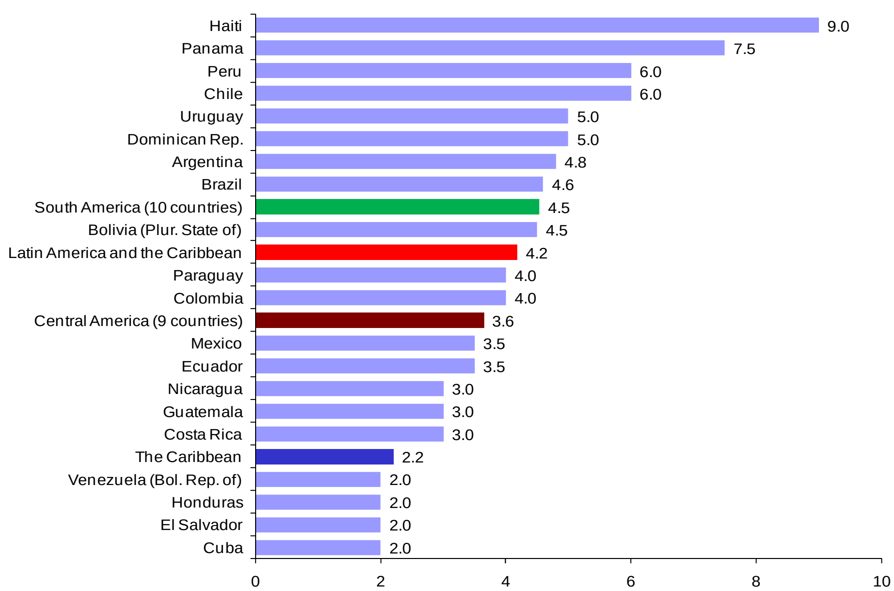
(Percentages)



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

[a] Estimate.

Figure XV
Latin America and the Caribbean: GDP growth, 2011



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

41. Concerning the evolution of external-account indicators, the region's terms of trade should continue to improve despite volatility in the global financial markets that could affect price movements for many of the region's principal export products.

42. Good prospects for the region's terms of trade could benefit most of the economies of South America, but rising commodity prices could mean lower revenue in real terms for the countries of Central America and the Caribbean (with the exception of Jamaica, Suriname and Trinidad and Tobago). For Mexico — which exports manufactured goods principally to the United States — the impact will be quite limited even though it is an oil exporter, due to price competition in manufactured goods from China. Although average prices will improve in the region, the trade balance is expected to deteriorate further in 2011, with the current account deficit rising to 1.5% of regional GDP.

43. The space for implementation of the public policies that enabled the economies of the region to recover swiftly will be affected not only by the need to rebuild countercyclical response capabilities in certain cases, but also by concerns arising from excess global liquidity that could result from monetary policy in the United States. This will be a key monetary and fiscal policy factor for the countries of the region that are potential receivers of capital inflows over the short term.

44. Because of the need to rebuild pre-crisis fiscal space and the desire to keep an expansionary strategy from increasing pressure on the financial and currency markets, fiscal efforts are expected to pull back from the levels seen over the past few years.

45. The search for high returns and low risk that many of the financial assets of Latin America and the Caribbean can offer could channel more short-term capital flows towards the region. This could be a source of instability that would shape monetary and exchange-rate policy.

46. First, it could lead to exchange-rate imbalances and currency over-appreciation in the countries of the region if the economic authorities elect not to intervene in their exchange markets. Another possibility is that it could lead to a monetary imbalance that, with narrowing idle production capacity margins, could set off inflationary pressures (as is currently occurring in some countries of the region) were central banks to intervene by buying currency to defend nominal and real parity as much as possible. Between the two extreme alternatives for intervening in the foreign exchange markets there exists a range of possibilities combining the two but sterilizing the resulting monetary expansion, at least in part, by raising interest rates to continue to encourage capital inflows, thus rendering less effective the efforts to defend real parity. This is indeed a dilemma with significant implications beyond the short term, as will be discussed below.

47. Greater global liquidity will most likely help to deepen the trend towards real appreciation of most of the currencies of the region already seen in 2010, regardless of efforts by the monetary authorities of the region to control the channels through which resources flow towards their economies. A drop in the real exchange rate would affect the production of tradable goods, that is, both exportable products and those that compete with imports. This, combined with the projected slowdown of the global economy (especially in the developed countries), would impact the external component of the demand for goods. Central America and Mexico, whose trade is

more oriented towards the United States market, would feel the impact the most, although it would likely ripple through all of the economies of the region.

48. This would have a negative impact on external accounts but would not endanger growth, at least in the short run. On the contrary, the region is expected to continue to grow in 2011, albeit at a pace that is closer to potential GDP growth, helped by internal demand as credit becomes more available. In South America, this could be boosted by external demand from the Asian economies (although the recent earthquake in Japan could have a temporary impact on this situation) as they continue to grow at a rapid pace.

49. This is not the first time that the Latin American and Caribbean region has seen a massive inflow of short-term capital towards its asset markets and the resulting appreciation of real exchange rates. As seen in similar situations, capital inflows are expected to support steady growth in domestic demand. The downside could be a gradually worsening trade balance, although currency appreciation could help check inflationary pressures caused by rising commodity prices.

50. This economic scenario could have a positive effect on poverty indicators to the extent that a large proportion of consumption among the poorer strata is in tradable goods whose relative price is expected to fall along with the real exchange rate. Income distribution might even improve, at least in the short run, provided that the increase in relative income for the poorest strata does not come with deteriorating labour market indicators. Even so, these improvements could be cancelled out by higher prices for foodstuffs and transport.

51. Beyond the short term, though, the impact of the trends towards exchange rate appreciation could be very negative. The region has already been the stage for many stories with unhappy endings when growth came with unsustainably low (appreciated) real exchange rates.

52. A scenario like the one that could be starting to take shape in the second half of 2010 (with high global liquidity exerting downward pressure on real exchange rates and upward pressure on commodity prices) could lead to (a) increased production of non-tradable goods to the detriment of tradable goods, with the consequent negative impact on external accounts, and (b) overspecialization in the production and export of primary goods. This could be exacerbated if China, as a source of demand for commodities that also competes on the manufactured products markets, were to appreciate its currency more slowly than the countries of Latin America and the Caribbean.

53. Such specialization would make the economies of the region more vulnerable to external shocks and add to the volatility of domestic macroeconomic aggregates such as investment, thus hobbling the economies' capacity to grow, generate productive employment and reduce inequality. And that would be only the effects on the real sector.

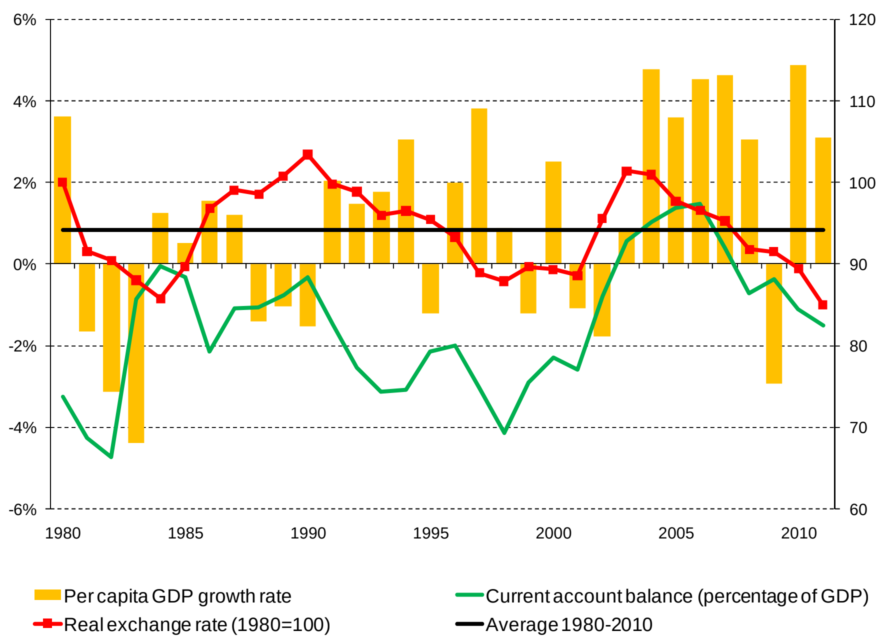
54. But the impacts generated by the financial markets are usually swifter and more devastating. Economic growth accompanied by further external account deterioration could make the economies of the region more dependent on external savings to fund expansion, unlike what happened in the period 2003-2008.

55. During that period, growth came with rising domestic saving rates and an external account surplus. This enabled the economies of the region to deflect the

crisis, because they did not need to turn to the financial markets when these markets had serious problems (to a certain extent, they still do). Quite the opposite: the countries of the region (albeit with differences between them) built up a capacity to act countercyclically that quickly put them back on the road to growth.

56. The region's economic history over the past 40 years is full of examples of how processes involving excessive capital inflows can lead to growth based on domestic demand, but with a gradual deterioration of external accounts (see figure XVI). Such deterioration is due to excess domestic spending in relation to productive capacity and to a relative price shift associated with falling real exchange rates, thus discouraging exports and making imports relatively cheaper.

Figure XVI
Latin America and the Caribbean: per capita GDP growth[a] and current account balance,[b] 1950-2011
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Annual variation rates, in 2000 dollars.
[b] In percentages of GDP.

57. Initially, the balance-of-payments current account deficit can be financed in part with long-term capital inflows associated with foreign direct investment flows, as is happening to a large extent at present, or with the reserves that the countries of the region have built up over the years. However, at some point this will drive external indebtedness up, not only making the economies of the region more vulnerable to terms-of-trade shocks because of their increasing specialization in commodities, but also increasing their vulnerability to financial shocks to the extent that growth would become more and more external finance-intensive. In this

environment, a sudden reversal of capital flows could set off an external financial crisis that would halt growth and give rise to a painful adjustment period, as the Latin American and Caribbean region, unfortunately, knows all too well.

58. So, what can the countries of the region do to defend themselves against this exogenous situation? Several countries have put in place or strengthened mechanisms for regulating the entry of short-term capital in order to ease pressure on the foreign exchange markets. This is a step in the right direction, but restrictions like this might not be enough in the face of such potentially large increases in the supply of foreign exchange.

59. For this reason, the central banks have in many cases elected to make currency purchases to sustain demand and try to prevent or at least slow appreciation. This strategy is not without its problems and limitations, but it could at least ease the transition while reserves are built up to strengthen the external position of the economy.

60. Such measures should be complemented by a countercyclical strategy encompassing, to the extent possible, both the fiscal and the financial spheres and geared towards easing pressure on domestic demand and preventing an excessive increase in the credit supply, as another way to relieve pressure on the foreign exchange markets. Another possibility is productive policy measures seeking to make tradable goods-producing sectors more profitable; this might require redirecting some items of public spending or making some changes to the tax structure.

61. Any lasting solution will most likely call for more coordinated strategies on the international level to narrow global imbalances, although at present this would seem to be a far-off goal. That said, preparations should be made for a period of low growth and external imbalances in countries that specialize in trade with developed countries and/or are net commodity importers, and for a pick-up in growth for commodity exporters at the price of deteriorating external accounts. This calls for measures to deal with the potential reversal of capital flows in the future with the least possible damage to growth and employment.

V. Conclusion

62. To recap, it is not an exaggeration to say that in 2010 Latin America and the Caribbean as a whole saw a consolidation of the recovery following the global financial crisis. While there were differences between countries, the economies of the region generally exhibited levels of activity that topped pre-crisis levels while maintaining a solid external position. This was possible because they had earlier built space for countercyclical policy action and benefited from an external environment that, although highly variable and uncertain, was generally favourable for recovery. Recovery was thus swifter than expected and cushioned the social effects of the crisis.

63. However, the post-crisis situation holds new challenges that the region should prepare for. This task will be harder for those countries that benefited the least from the high commodity price cycle in the period 2003-2008, and which resumed in 2010.

64. First, a significant portion of countercyclical capacities had to be drawn on to deal with the crisis. Although public finances are relatively balanced and public debt

levels are, in general, low, there is little margin for facing any drop in external demand or counteracting the poor external performance that is expected in the light of slow growth in the developed economies. This is even truer for some countries of Central America and the Caribbean with relatively higher levels of public debt and/or very low tax burdens.

65. The need for sustainable public finance is one of the painful lessons to be drawn from the Latin American experience with instability in decades past. The consequences of a lack of moderation in this sphere were reflected in acute inflation followed by severe adjustments that lowered the standard of living, had a concentrating effect on distribution, exacerbated poverty and did not create conditions conducive to growth.

66. During the next few years, the external environment is likely to be turbulent as some developed countries face the challenge of restoring solvency to their financial systems and redirecting their public finances towards realistically sustainable paths. The earthquake in Japan and the political events of West Asia and North Africa will also have an impact on economic performance in the region. Moreover, rebuilding global balances between the developed and emerging economies as needed for post-crisis recovery will pose substantial macroeconomic challenges for the region, in the form of fluctuating export prices, external demand and real currency parities, along with the danger of even more specialized productive patterns that are not necessarily conducive to high economic growth and a more equitable distribution of the benefits.

67. In short, the macroeconomic challenge for the region is to rebuild its capacity to act countercyclically while continuing to create conditions for productive development that is not based solely on commodity exports.

68. Rebuilding the space for countercyclical action as part of a development strategy for dealing with development challenges is a multidimensional public policy exercise that centres on getting back on track to greater public spending that is consistent with social demands, with the expected evolution of the medium- to long-term determinants of public revenues and with debt levels that can be managed without major policy shifts. This calls for a new social accord, a new fiscal pact on how to progressively meet development needs and on the level and mix of the tax burden for sustaining spending programmes.

69. Fiscal policy plays a key role in dealing with the dangers of an external environment characterized by high global liquidity that, while leading to high nominal prices for some of the commodities that the region exports, exerts upward pressure towards real currency appreciation and undermines tradable sector competitiveness. Although the factors behind the trend towards appreciation of the currencies of the region are exogenous, these pressures are magnified by national savings rates that are insufficient in relation to investment and scant financial development.

70. Beyond the tools that the countries of the region use to discourage excessive capital inflows, over the medium to long term it will be necessary to increase national savings (by, among other things, enhancing the medium-term fiscal balance and bringing public debt down to moderate levels that do not put excessive pressure on the local markets) and to promote financial systems that increase the capacity to generate domestic savings to support investment.

71. In conclusion, the economies of the region should invest more if they are to increase their capacity to grow. Despite the progress made in the years before the crisis, the countries of Latin America and the Caribbean are, in general, still far from the investment levels of the 1970s. The challenge is to base the needed step-up in investment on an increase in national savings that will make it possible to better defend currency parities and thus shape a pattern of productive specialization that is more in line with the region's development needs.