Executive Summary

The outlook for the Western Hemisphere remains broadly favorable. For the United States, annual growth is now forecast to come close to 2¼ percent for 2007 and to recover to just under 3 percent in 2008. After an exceptionally strong year in which real output rose by 5½ percent, growth in Latin America and the Caribbean (LAC) is expected to ease to just under 5 percent in 2007 and 4¼ percent in 2008, reflecting a deceleration from historically high rates in some countries, the slowdown in the United States, and lower prices for some commodities. Inflation is expected to pick up slightly, but will remain contained.

The LAC region has made impressive economic progress in recent years, and 2007 is likely to become the fifth year of what is already the most vigorous period of recovery and expansion since the 1970s. Although there remain significant differences across countries, the past year again witnessed record current account and primary fiscal surpluses, lower inflation, lower public debt, and further improvements in debt structures. Stability was maintained and growth increased, including in countries that experienced critical political transitions. Unemployment and poverty rates continued to fall, and regional inequality is falling for the first time in several decades.

However, there are clear signs that some economic safety margins are beginning to erode, while popular impatience about social outcomes continues. Significant declines in external and fiscal surpluses are projected for this year and the next as a result of high public expenditure growth rates, continued high growth of imports, and lower commodity prices. Credit—particularly to households—has also been growing rapidly. In light of still low aggregate credit rates, this is not unwelcome; but it will require careful monitoring—as will inflation risks in some countries.

This issue of the Regional Economic Outlook: Western Hemisphere *(henceforth,* Regional Economic Outlook*) takes a close look at the sensitivity of Latin American growth to the external environment*, which has been exceptionally benign in recent years. Though much-improved balance sheets and policy frameworks have made Latin America more resilient than it was a decade ago, the region remains sensitive to shocks to world growth, commodity prices, and financing conditions. While moderate changes in these factors can be accommodated, slower world growth combined with sharply tighter financing, or sharply lower commodity prices, could bring about a significant growth decline. Reducing Latin America's vulnerability to such shocks even further requires additional efforts to lower public debt, make budgets and exchange rates more flexible, strengthen financial systems, and diversify its export structure.

Looking to the medium term, Latin America's challenge remains to raise growth, make it more sustained, and share its benefits more equitably. This report shows that significant increases in investment and—more importantly—in productivity growth would be needed to raise per capita incomes substantially over the next two decades, and illustrates the effects of two particular policies: improvements in education and labor reforms. Drawing on recent research, the

Regional Economic Outlook also asks whether Latin America has now succeeded in breaking with its history of periodic growth reversals. Several determinants of sustained growth—including political institutions and trade regimes—have improved significantly in the last two decades, and macroeconomic volatility has declined significantly in recent years. However, efforts to create more equitable and less divided societies—which are better positioned to avoid drastic growth reversals in the future—are still at an early stage in many countries. Progress in this area will take time and require fiscal, education, labor, and financial sector reforms. In the meantime, macroeconomic policies will need to remain vigilant, to ensure that the region can grasp the continued opportunity presented by the benign global economic environment to entrench growth and raise it on a sustained basis.