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Taking Advantage of Tailwinds

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Preface

This May 2010 issue of the *Regional Economic Outlook: Western Hemisphere* (REO) was prepared by a team led by Steven Phillips and Ana Corbacho under the direction of Rodrigo Valdés and Nicolás Eyzaguirre. This report reflects developments as of April 15, 2010. The team included Jorge Iván Canales-Kriljenko, Herman Kamil, Kornélia Krajnyák, Leandro Medina, Rafael Romeu, Bennett Sutton, and Secil Topak. Charles Kramer contributed Chapter 1, Gabriel Di Bella made contributions to Chapter 2, and Nicolás Magud, Aurelie Martin, Stephanie Medina Cas, Aditya Narain, and Sebastián Sosa contributed boxes. Patricia Attix, Lucía Castro, María S. Gutierrez, Leandro Medina, Breno Oliveira, Bennett Sutton, and Secil Topak provided research and production assistance. Martha Bonilla and Joanne Blake of the External Relations Department edited the manuscript and coordinated the production.

Executive Summary

A multispeed global recovery is under way, with some emerging markets in the lead and the major advanced economies growing more slowly. The fragile recovery in most advanced economies is still dependent on extraordinary policy stimulus. In the United States, the drag from the global crisis will linger for some time, as the ongoing repair of balance sheets of households and the financial sector, coupled with continued weak labor markets, keep demand growth low. Risks to the U.S. growth outlook appear broadly balanced in 2010, but they are tilted downwards in 2011 as fiscal stimulus winds down.

The current macroeconomic setting already has favored a return to easy global financing conditions and high commodity prices—a situation that is likely to be sustained, but unlikely to be permanent. Policy interest rates of advanced economies will remain low for some time. With global financial markets already having recovered their appetite for risk, many emerging market countries will be facing very low borrowing costs. At the same time, the stronger growth of emerging market economies, particularly in Asia, will continue to support commodity prices.

The recovery in Latin America and the Caribbean is advancing faster than anticipated, but at different speeds across countries. Higher growth is projected in many of the commodity exporting countries that are most integrated with global financial markets. Elsewhere, the upswing is less vibrant, particularly where the drag from the slow recovery in advanced economies is protracted, as in tourism intensive economies. In some countries, slower projected growth reflects sectoral bottlenecks and other supply-side constraints, with trend output in some cases contracting.

For the commodity exporters with stronger ties to global financial markets, the challenge is to best manage the upswing of the business cycle amid favorable external conditions. This includes the need for resetting macroeconomic policies toward neutral ground, a task that is more immediate in countries where growth is on stronger footing. It will be especially important to phase out previous fiscal stimulus, to take some of the burden off monetary policy, allowing interest rates to move toward a neutral level more gradually than otherwise. For some of the other commodity exporting countries, policy challenges will be more structural, including avoiding the perils of fiscal procyclicality, anchoring macroeconomic policies, and regaining access to financial markets.

The weak recovery in the tourism intensive, commodity importing countries will pose a great challenge to policymakers, as elevated debt levels and limited access to financing impose difficult policy tradeoffs. Efforts to protect vulnerable groups and unlock growth potential through structural reforms should be priorities in the policy agenda. Other commodity importing countries are gradually recovering, boosted by higher exports, but inflows from remittances continue to contract. In many of these countries, the room for macroeconomic stimulus has been almost depleted and should be prudently saved for downside risk scenarios.

This Regional Economic Outlook *discusses policy priorities for Latin America and the Caribbean region during the upswing*. Chapter 1 analyzes the global background and the outlook for the United States and Canada in particular, emphasizing the implications for the other countries of the region. Chapter 2 focuses on the outlook for Latin America and the Caribbean.

Chapter 3 looks in depth at the challenges associated with easy external financial conditions—such conditions are a favorable development, but also bring risks. At the same time that it creates opportunities for deft public debt management and the financing of investment at less cost, cheap external financing raises the risk of a boom-bust cycle, potentially leading to surges in domestic demand, asset prices and credit, as well as current account deficits. The prospect for rising commodity export prices could add further to demand overheating. Whether these risks materialize will depend critically on policy responses: allowing significant exchange rate flexibility is important, as are fiscal discipline and macroprudential policies. Other types of policy responses, such as taxes on capital inflows, may help in complementing these approaches, though they have important limitations.

1. Global, U.S., and Canadian Outlook

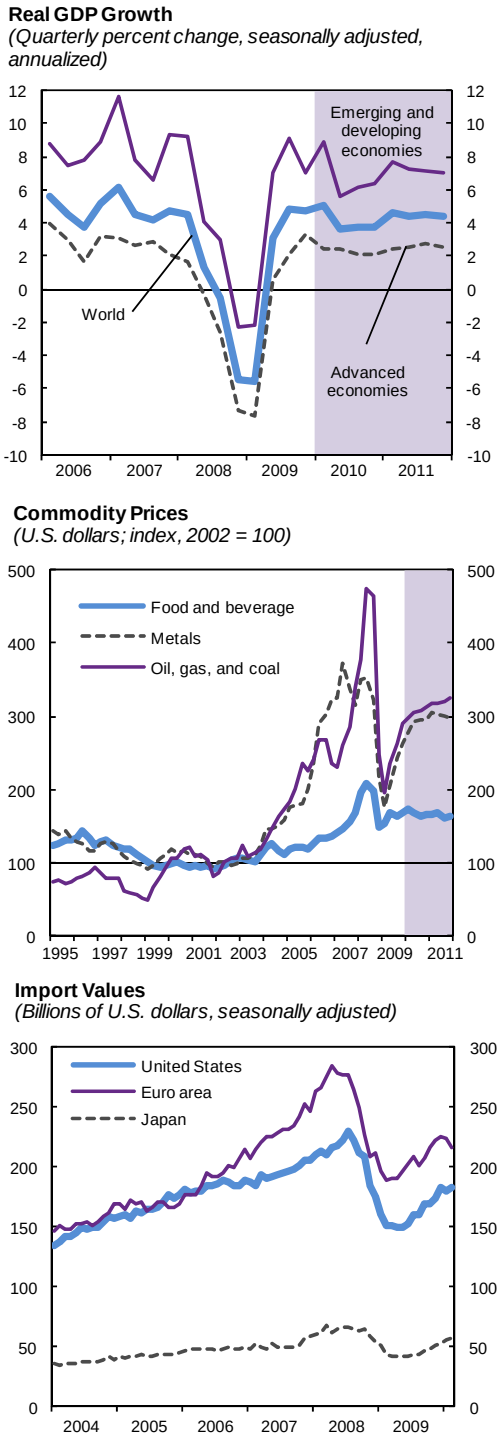
The economic recovery is under way, with upward revisions to global growth as financial markets normalized faster than expected and policy stimulus took effect. The upswing in advanced economies is still muted and dependent on policy support. In contrast, many emerging markets are experiencing a more vigorous upswing amid easy financing conditions and rising commodity prices.

The Global Backdrop—A Recovery with Uneven Speed

Extraordinary levels of fiscal and monetary stimulus are supporting a global recovery from the severe recession that followed the financial crisis. Fiscal expansions in the major countries—averaging about 2 percent of GDP in 2009 in the advanced G20 countries, and about 2½ percent of GDP in the emerging G20 countries—launched in the first part of 2009 began to have their full effects in the second half of the year. Highly expansionary monetary policies—with policy interest rates at their minimum and unconventional easing—that were deployed in a number of countries during the crisis have since supported both demand and financial stability. With confidence improving and financial conditions easing, global trade and manufacturing production recovered strongly, and commodity prices rebounded since their nadir early 2009 (Figure 1.1). Commodity prices are projected to remain high in 2010–11 on limited excess capacity in the sector and on the strong cyclical position of some key emerging markets. Nevertheless, potential inflationary pressures should not derail the recovery.

At the same time, signs of a self-sustaining recovery in private demand in the major economies remain scant. Consumption growth generally remained muted into 2010, notwithstanding substantial improvements in household confidence

Figure 1.1. A global recovery is under way, with trade and commodity prices rebounding.

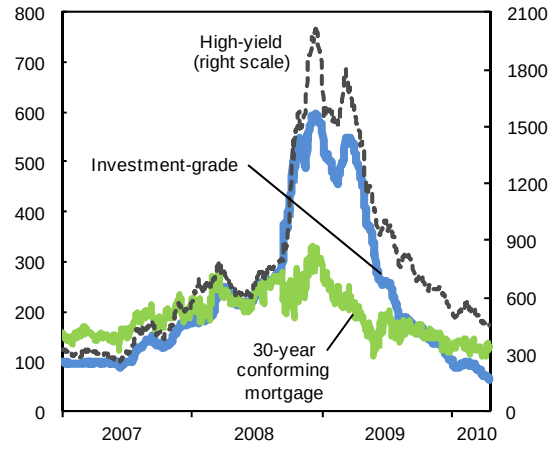


Sources: Haver Analytics; Bloomberg, L.P.; and IMF staff calculations.

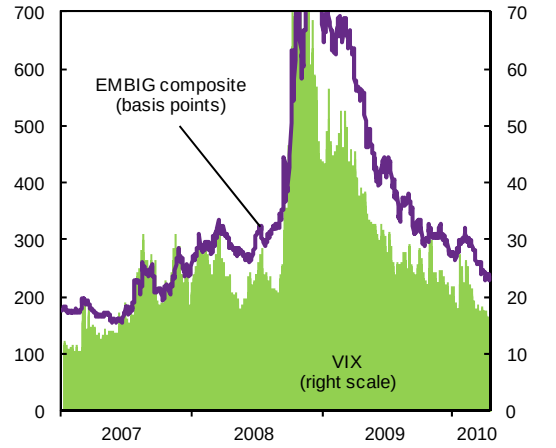
Note: This chapter was prepared by Charles Kramer.

Figure 1.2. Financial market conditions improved faster than expected and on several metrics have recovered to precrisis levels.

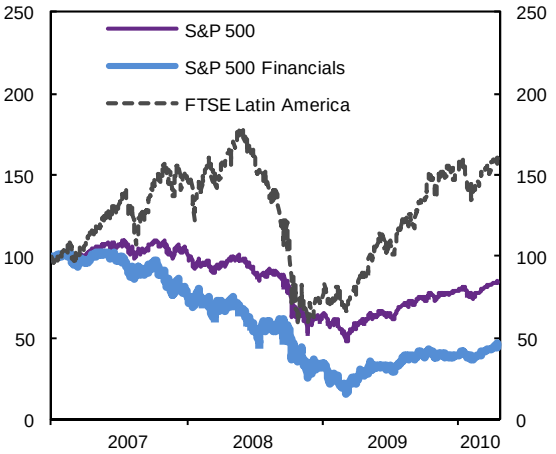
United States: Selected Spreads
(Spread to 10-year Treasury bills; basis points)



Global Risk Aversion and EM Spreads



Equity Prices
(January 4, 2007 = 100)



Sources: Bloomberg, L.P.; and IMF staff calculations.

and tentative signs that the deterioration in labor markets is ending. Investment activity started to pick up in late 2009, but with financial intermediation not fully restored and excess capacity still high, prospects are poor for a sustained investment boom that would lead the recovery. Indeed, much of the recent strength in advanced economy demand reflected a sharp turn in the inventory cycle, reflecting the overshooting that deepened the recession when stock levels were slashed. Advanced economies are expected to register 2 percent growth in 2010, following a contraction of 3¼ percent in 2009—the slow recovery showing the persistent drag from consumer and bank balance sheet repairs and weak labor markets. Over the medium term, some permanent output loss is expected as the legacy of the crisis.

But an increasing number of emerging and developing countries are showing signs of strength in early 2010. During the recession, most of these countries avoided domestic financial instability and, where possible within domestic constraints, deployed their own stimulus to support activity. From mid-2009, growth in emerging and developing countries has been spurred by the sharp turnaround in global trade, and some countries have benefited from the recovery in global commodities prices, particularly for energy and metals. Emerging and developing economies are anticipated to post 6 percent growth in 2010, up from about 2 percent in 2009, led by strong growth in developing Asia.

Meanwhile, global financial conditions eased since the height of the global crisis but remain challenging in some segments—particularly for bank lending in advanced economies (Figure 1.2). Money markets have stabilized and the tightening in bank lending standards has moderated. That said, bank balance sheets remain under strain, with capitalization still weak and credit losses continuing to mount. Most financial intermediaries continue to deleverage, and borrowers without access to capital markets (consumers and SMEs) face credit constraints. On the other hand, capital markets have been buoyant, and investment grade borrowers—including emerging market sovereigns—were able

by early 2010 to issue bonds at close to precrisis rates. Work is progressing with drawing regulatory lessons in the aftermath of the crisis (Box 1.1).

Global liquidity is ample, and risk aversion has declined from its crisis highs, easing conditions for emerging markets. With emerging market growth prospects improving, some emerging market economies have experienced sizable inflows since mid-2009, along with upward pressures on their currencies in some cases. Key asset valuations for advanced emerging markets have recovered to precrisis levels. However, fragile risk appetite and risks in selected countries could yet spur a retrenchment from risk-taking (as appears to have occurred earlier this year amid market concerns about Greece), dampening capital inflows to emerging and developing countries.

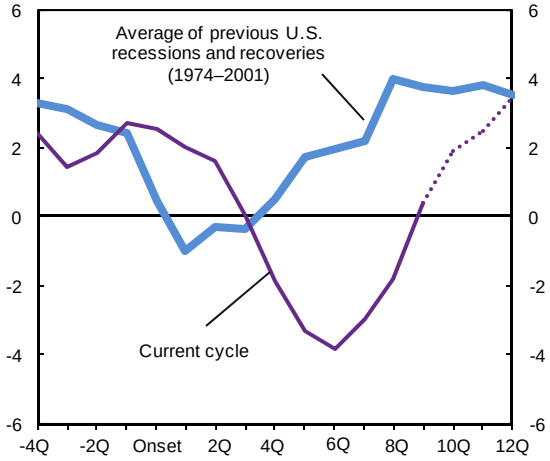
The "multispeed" recovery calls for country-specific adjustments to policy settings. In major economies, output gaps are large and the shift from public to private support to growth is still ongoing. At the same time, some emerging markets have already staged a private-demand driven recovery, are operating close to capacity, and are attracting capital inflows. The different challenges clearly call for variation in the speed and sequencing of postcrisis exit from supportive policies. In major advanced economies, exit will remain slow, their low monetary policy rates contributing to easy financing for emerging markets for some time. Over the medium term, exit policies—including gradual fiscal adjustment in the United States—should also contribute to slowly reducing policy shortcomings that gave rise to global imbalances (Box 1.2).

United States—Recovery Is Still Policy Driven

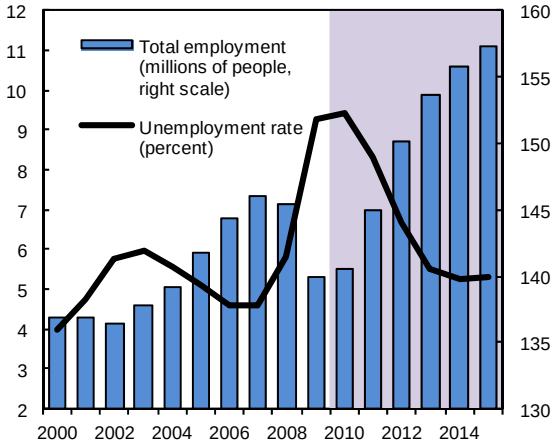
Policy stimulus and the inventory cycle have propelled a recovery in U.S. economic activity (Figure 1.3). GDP rose by 5.6 percent (seasonally adjusted annual rate) in the fourth quarter of 2009, reflecting acceleration in investment and a slowdown in inventory destocking (the latter of

Figure 1.3. A muted recovery is under way, with balance sheet adjustment weighing on consumers.

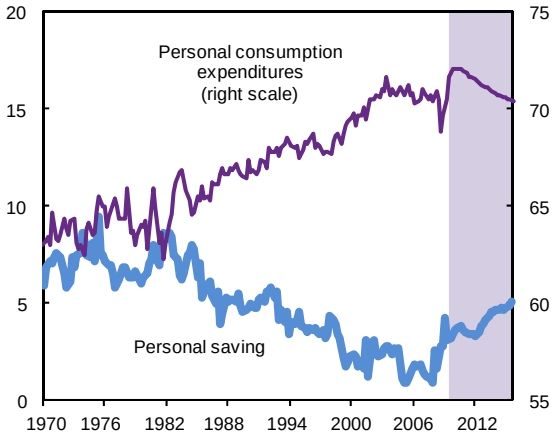
United States: Recovery Compared with Previous Cycles
(Four quarter percent change)



United States: Employment Outlook



United States: Personal Consumption and Saving
(Percent of GDP)



Sources: U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics; Haver Analytics; and IMF staff calculations.

Box 1.1. Recent Developments in Financial Regulation Reforms

The ongoing financial regulatory reform process—spearheaded by the G20—is aimed at addressing the inadequacies in the regulatory framework that the crisis has revealed. The process is gradually yielding recommendations at both the national level and internationally, which is generating some regulatory uncertainty for the financial sector.

Proposals are most advanced in the area of strengthening bank capital. Enhancements to the Basel II capital framework—specifying higher capital requirements for banks' trading books and some securitizations—were announced in mid-2009, and are to be implemented by end-2010.

Other reform proposals (announced in December 2009) focusing on bank capital and liquidity are yet to be finalized, with the final calibration for capital requirements announced by end-2010 and implementation by end-2012. The proposals target:

- Improving the quality of bank capital (by increasing the share of common equity in Tier 1 capital; harmonizing the definition of Tier 2 capital internationally; and enhancing the risk coverage of the capital framework, for example, with respect to counterparty risk).
- Supplementing risk-based capital requirements with a leverage ratio, with details yet to be worked out.
- Dampening procyclicality (by conservative adjustments to capital adequacy to reflect stressed periods; forward-looking provisioning; building up target capital buffers; and upward adjustment of capital buffers after a period of rapid credit growth). Work on the details of the proposals is ongoing.
- Addressing systemic risk and interconnectedness (through a better-calibrated asset value correlation factor in internal ratings that would imply higher capital requirements for exposures to large regulated financial firms or to unregulated leveraged entities such as hedge funds).
- Reducing the reliance on external ratings in the capital adequacy framework.
- Introducing internationally common standards of minimum high quality liquidity buffers, with the dual aim of (i) being able to meet liquidity outflows over a 30-day stress period; and (ii) matching liability and asset profiles over a 1-year horizon.

Recommendations in other areas are less advanced. The framework for macroprudential supervision is still evolving, with a view to alleviating credit cycles and interconnectedness risks. Discussions on issues related to systemic risk and systemically important institutions are complicated by, among other things, political and legal issues. On the agenda are extending the regulatory perimeter, introducing differential prudential regulations for systemically important institutions, possibly creating a systemic risk regulator, setting up a resolution framework for systemically important institutions, and rethinking regulator issues in the OTC derivative and securitization market.

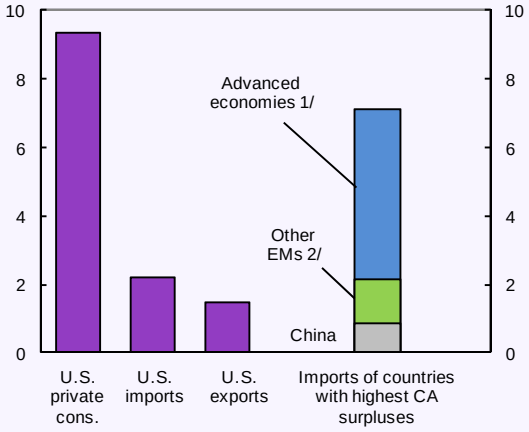
Of course, these proposals do not cover all areas where improvements would be needed to strengthen financial stability. Ensuring adequate supervisory responses, improving risk management and governance in the financial sector, and leveling the playing field internationally (by proper and consistent implementation of prudential standards) and across sectors (by stepping up lagging reforms in the insurance sector and securities markets) remain outstanding tasks.

Note: This box was prepared by Aditya Narain and Kornélia Krajnyák.

Box 1.2. Rebalancing Global Demand: What Will Take Up the Baton from the U.S. Consumer?

What could take up the slack in global demand left by lower U.S. consumption as U.S. households strengthen their balance sheets in coming years? The task of filling that gap is nontrivial: U.S. private consumption is among the largest quanta in the global economy, amounting to $9.3 trillion in 2006—the last full precrisis year (see figure, upper panel). Suppose that this level is permanently lower by 10 percent—roughly corresponding to the percentage difference between staff's projected consumption over the medium term versus the level that would have prevailed if consumption had continued to grow at precrisis rates from 2007 forward. What type of adjustment in other quanta—say, U.S. exports and (the counterpart) imports of partner countries—would be necessary to fill that gap? (Of course, making up for a permanently lower growth rate of consumption would pose still larger challenges—but for simplicity, let us deal with levels rather than growth rates.)

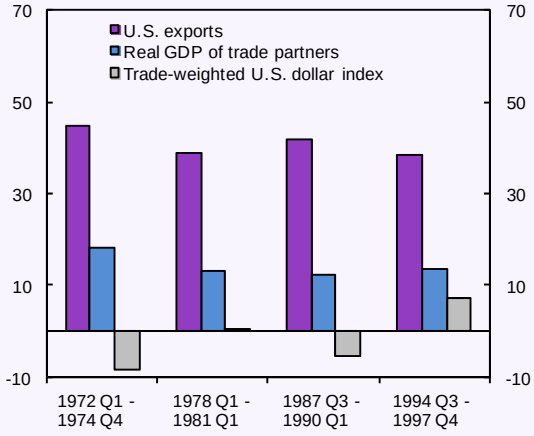
United States: Consumption, Exports, and Imports of Countries with Highest Current Account Surpluses, 2006
(Billions of U.S. dollars)



Sources: IMF, *Direction of Trade Statistics;* and IMF staff calculations.
1/ Sum of top 15 performers.
2/ Sum of top 7 performers that are emerging market economies, excluding China.

One part of the adjustment would occur through lower imports, though the effect might not be very large. In particular, lower consumer spending would mean reduced imports of consumer goods—but about 70 percent of consumption is services, and consumer goods imports are modest in comparison. In 2006, imports of consumer goods totaled about $446 billion, against nominal private consumption of about $9.3 trillion (comparing NIPA-basis numbers). To be sure, this understates the importance of imports considerably, as it excludes automotive products ($256 billion including parts), as well as intermediate inputs that are transformed into consumer goods (for example, oil). Nevertheless, the comparatively low overall volume implies a modest impact even if consumer goods imports are sensitive (say, with an elasticity of 2) to consumption compression.

United States: Exports and External Conditions during U.S. Export Surges
(Cumulative percent change)



Sources: Haver Analytics; and IMF staff calculations.

If the remaining adjustment fell on exports, it would require a very large increase—given exports of about $1.4 trillion, an increase of about 60 percent. Historical increases in U.S. exports have typically been somewhat smaller (see figure, lower panel). The largest trough-to-peak cumulative surges in real U.S. exports totaled about 40–45 percent, occurring over several years. In two of four instances, they coincided with a significant depreciation of the U.S. dollar. And in two episodes, they also coincided with (or came in the wake of) significant policy initiatives—the end of Bretton Woods in the early 1970s and the Plaza/Louvre period in

Note: This box was prepared by Charles Kramer and Kornélia Krajnyák.

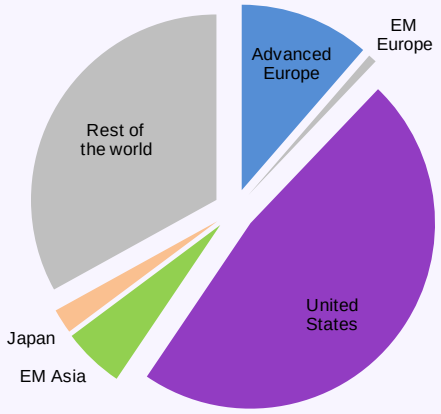
Box 1.2 (*concluded*)

the 1980s. Finally, export surges also were accompanied by periods of substantial partner country growth (cumulative growth of up to 15 percent). In short, surrounding circumstances were quite favorable to exports—and perhaps unusually favorable.

Of course, a counterpart increase in other countries' total imports from the United States of the same magnitude would also be required. For example, the adjustment relative to the overall imports (from all countries) of the 15 countries with the largest external surpluses would be nontrivial, but not huge—12 percent. But U.S. exports are disproportionately bound for G7 countries—some US$400 billion go to the G7, almost twice that for Latin America and the Caribbean or Asia. Given the relatively modest share of U.S. exports that presently go to emerging market economies, if the adjustment fell on the top seven emerging market surplus economies, their imports would need to increase by about 45 percent; and if (for the sake of illustration) the adjustment fell solely on China, its overall imports would need to increase by about 100 percent. Using a rule of thumb for the elasticity of imports with respect to domestic demand of 2, this would imply increases in domestic demand in those countries of about half those magnitudes.

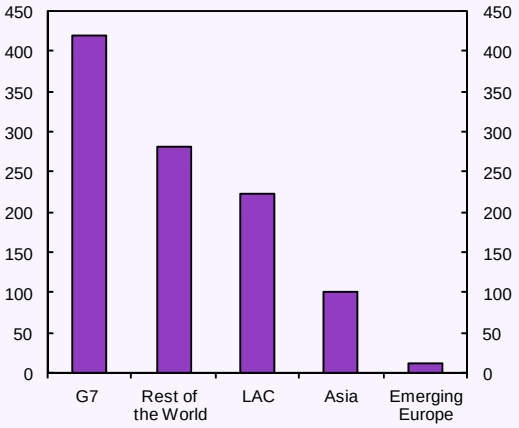
All these elements, and more, would likely need to come together to gradually fill in the U.S. consumption gap. U.S. exports and imports are quite small compared with private consumption, and they would need to adjust together to generate the required quantities. Relatedly, should a real depreciation in the U.S. dollar occur, the switch away from imports and toward exports may be better incentivized. And finally, domestic demand overseas would need to increase—as counterpart demand to the higher supply of U.S. exports.

Latin American Export Shares, 2006
(Millions of U.S. dollars)



Sources: IMF, *Direction of Trade Statistics;* and IMF staff calculations.

United States: Exports to World Regions, 2006
(Billions of U.S. dollars)



Sources: IMF, *Direction of Trade Statistics;* and IMF staff calculations.

which contributed more than half of GDP growth). The contribution of net exports swung from negative to positive, as export growth picked up amid the revival of global demand, while import growth eased.

Although the free fall of housing investment ended in mid-2009, it remained depressed through the year despite support from the Federal Reserve's mortgage-backed securities purchase program and tax credits. Meanwhile, investment

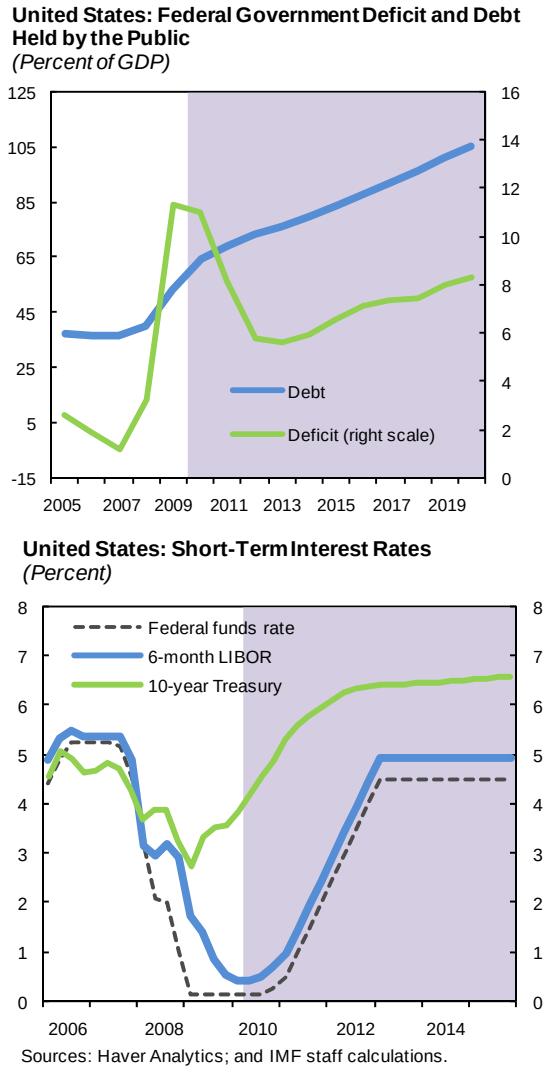
in nonresidential structures continued to contract sharply in the second half of 2009 owing to the ongoing deterioration in the commercial real estate market. Private consumption growth ticked down by late 2009, as spending on durables faded with the ending of the "cash for clunkers" program.

Labor market conditions have begun to stabilize but remain grim. In March 2010, the unemployment rate stood at 9.7 percent—still 2 percentage points above levels a year ago, and about 25-year highs. Long-term unemployment and labor underutilization (including discouraged workers) similarly remain elevated and are close to historical highs. Moreover, labor market conditions are much worse in sectors such as construction—which remains under pressure despite coming off its lows—and for Hispanic workers, for which March unemployment rates were 24.9 percent and 12.6 percent, respectively.

Despite upward revisions to growth projections, prospects remain for a muted recovery. The IMF forecasts growth of 3.1 percent in 2010—significantly stronger than the 1.5 percent projected in the 2009 October *World Economic Outlook*, but still weaker than in previous recessions. Growth would decelerate to 2.4 percent in 2011, as the output gap narrows, the inventory cycle matures, and the fiscal stimulus fades. The unemployment rate would decline gradually, lagging the recovery in activity (as is typical historically). Inflationary pressures would remain contained, with substantial excess capacity in labor and product markets. Overall, the profile of the recovery would be consistent with an economy pushing against the twin headwinds of weaknesses in household and financial institution balance sheets.

Risks are relatively balanced in 2010, but tilted to the downside for 2011. In the near term, residential housing and commercial real estate pose downside risks to growth. However, these are broadly counterbalanced by a stronger than expected inventory cycle. But beyond the very near term, downside risks predominate, including the risks of a worse outcome in the real estate markets with higher-than-anticipated foreclosure rates. Over the medium term, risks associated with higher interest rates are growing owing to concern over fiscal balances.

Figure 1.4. Macroeconomic policy settings are to stay supportive for some time.



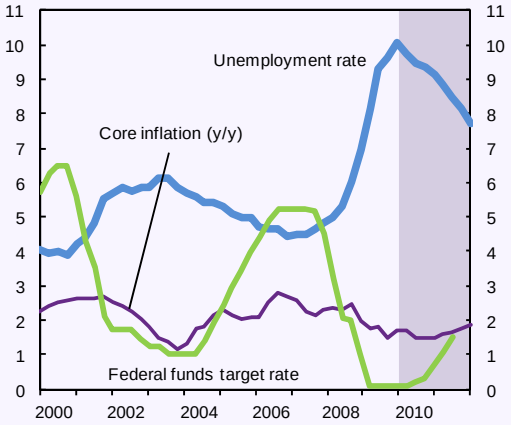
Sources: Haver Analytics; and IMF staff calculations.

In this context, U.S. macroeconomic policy is likely to maintain a highly supportive tilt for the future (Figure 1.4). Although the U.S. Federal Reserve has continued to elaborate its exit strategy and wind down emergency liquidity facilities, it has also continued to signal that the policy rate is set to remain at exceptionally low levels for an extended period (see Box 1.3). Consistent with this, futures

Box 1.3. U.S. Monetary Policy: How Low for How Long?

An unprecedented easing of monetary policy has been a central element of the U.S. policy response to the crisis. The Federal Reserve has deployed unconventional monetary policy measures—a variety of innovative liquidity facilities along with "credit easing" measures to support financial market functioning. As financial strains faded, many of these facilities have wound down, particularly those aimed at liquidity conditions. Asset purchases continued through end-March but at a decreasing pace. As the crisis broke, the Federal Reserve successively cut rates (from 5¼ percent), bringing the target to 0–25 basis points by December 2008, an all-time low.

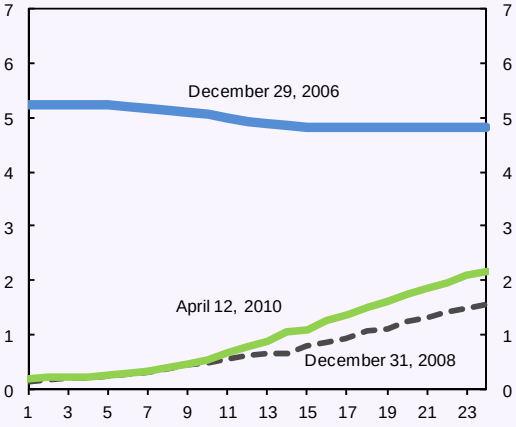
United States: Inflation, Unemployment, and the Federal Funds Rate
(Percent)



Sources: Blue Chip Financial Forecasts; and IMF staff calculations.

How soon would the Federal Reserve be likely to reverse its easing cycle? Incoming data and the outlook suggest a highly accommodative stance for some time. Economic slack remains high: the unemployment rate has ticked down from the 26-year high of 10 percent, but it is still elevated and likely to decline only gradually. Meanwhile, core inflation has continued to soften, and long-term inflation expectations have remained stable. And although financial conditions have considerably improved, they remain on the tight side.

Federal Funds Futures Yield
(Percent; x-axis reflects months to maturity)



Source: Bloomberg, L.P.

Market data are consistent with expectations that the Federal Reserve would remain highly accommodative in the near term. Market analysts also predict a gradual tightening. At end-2006, the federal funds futures curve priced in a policy rate at about 5 percent over the coming 24 months. (Federal funds futures prices should be read with care. Contracts are somewhat illiquid, particularly at longer tenors, and may include a term premium.) By end-2008—with the Federal Reserve target at an all-time low—the curve had collapsed, showing rates persisting at low levels. Since then, the federal funds curve has steepened, now pricing in an implied policy rate of about 2 percent in two years—still a low level. The Blue Chip panel of forecasters predicts a path broadly consistent with the federal funds futures market. Some analysts, particularly those with more bullish economic forecasts, predict faster tightening. But others—notably those at two large investment banks—see no Federal Reserve tightening until mid-2011.

In summary, although "how low" and "how long" can be debated, the consensus is that U.S. monetary policy will remain highly accommodative for a long time. Indeed, the latest Federal Open Market Committee statement again noted that "the Committee … continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." Accordingly, U.S. monetary policy is likely to tilt global financial conditions—including for capital flows to emerging market countries—to the easy side for some time to come.

Note: This box was prepared by Charles Kramer.

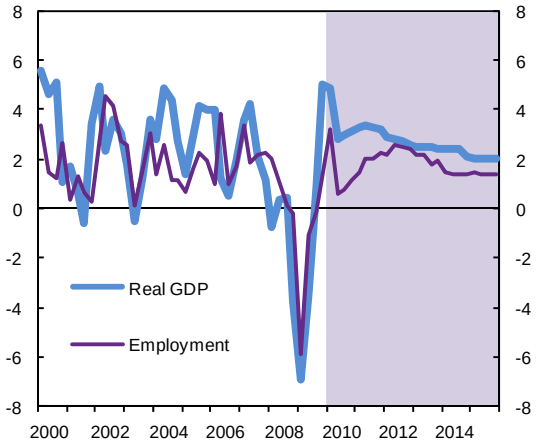
markets and private forecasters expect no significant tightening in Federal Reserve policy during 2010, with some expecting the Federal Reserve to remain on hold through mid-2011. Fiscal policy is stimulative in 2010—including through recent initiatives to extend support to the jobless and the labor market—and the 2011 budget proposal includes additional short-term support to the economy and jobs. But beyond the near term, the main macroeconomic policy challenge for the United States is getting its fiscal imbalances under control. Although the recent health care reform will increase coverage and modestly help reduce medium-term deficits, determined further fiscal adjustment (including steps to raise revenues and control medical costs) will be key for the medium-term fiscal outlook. Absent adjustment, staff project public debt to rise above 100 percent of GDP over the next decade—with growing risks associated with higher interest rates resulting from fiscal concerns.

Canada—Recovery Is Getting Entrenched

By contrast with the United States, domestic demand has remained relatively resilient in Canada. Canada was significantly affected by the global recession, with a sizable drop in output amid the worldwide collapse in trade and commodity prices (Figure 1.5). Nevertheless, Canada's financial sector remained relatively unscathed through the recession, thanks to rigorous regulation and prudent bank practices. Domestic demand also remained resilient—steady consumption growth reappeared in the second half of 2009, and the housing market was robust, with construction activity and housing prices posting gains. In labor markets, the unemployment rate rose during the crisis, but trended below U.S. rates—for the first time in several decades—although employment tended to post positive growth since mid-2009 (compared with continued, albeit narrowing, declines in U.S. employment). Meanwhile, financial conditions are favorable, reflecting low funding costs and the absence of financial system strains evident in some other countries.

Figure 1.5. In Canada, growth has recovered and employment growth has restarted.

Canada: GDP Growth and Employment
(Quarterly percent change, annualized)

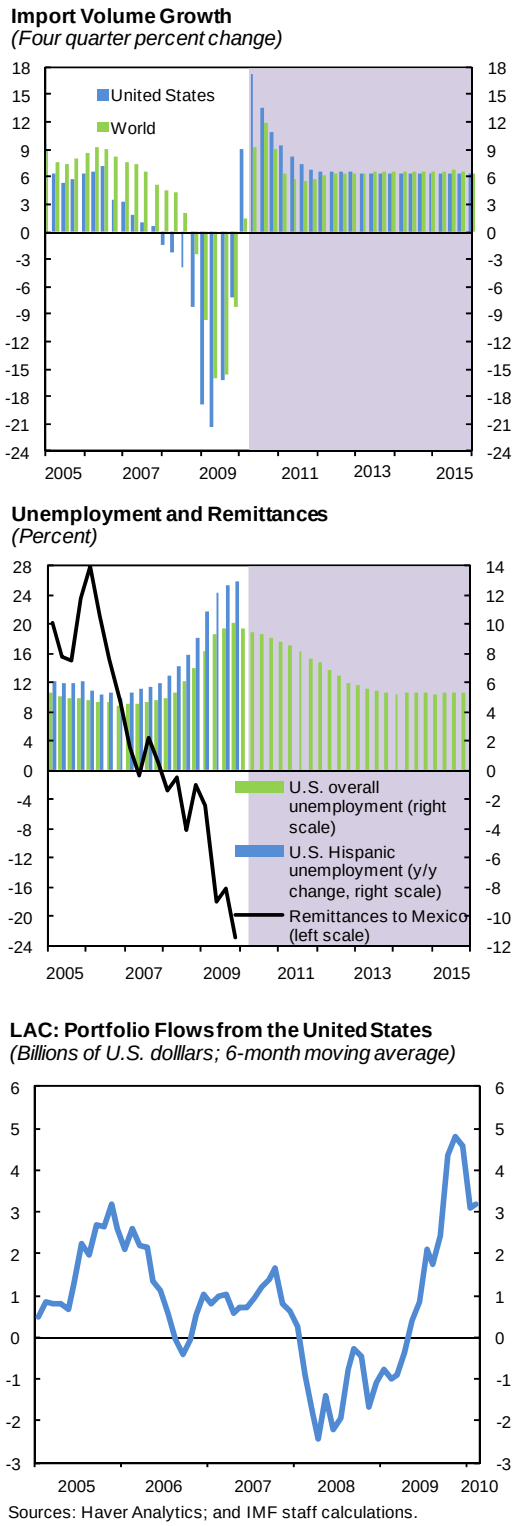


Sources: Haver Analytics; and IMF staff calculations.

The strengthening Canadian dollar, however, has taken the edge off the support to external demand from the recovery in global economic activity. On the back of the rebound in commodity prices and the unwinding of the "flight to quality" trade in the U.S. dollar, the loonie (Canadian dollar) has strengthened vis-à-vis the U.S. dollar and since last October has been close to parity versus the U.S. dollar. Reflecting the strengthening of the currency, Canada's export recovery has been muted, and the current account continues to show deficits.

Well-tuned macroeconomic policies have been instrumental in supporting Canada's resilience, and growth is expected at about 3 percent both in 2010 and 2011. A fiscal stimulus of 2 percent of GDP in both 2009 and 2010 is helping to bolster demand, but has not challenged Canada's fiscal credibility, the legacy of over a decade of consolidation prior to the crisis. Similarly, extraordinary monetary easing, with the policy rate at its effective lower bound and a conditional commitment to maintain the rate at its low, along with ample provision of liquidity, has underpinned both demand and financial stability. At the same time, medium-term inflation expectations have remained well anchored at about the Bank of Canada's 2 percent inflation objective, testament to the credibility of the inflation-targeting framework.

Figure 1.6. U.S. macroeconomic conditions carry some drag, but the United States contributes to financial push in Latin America.



Sources: Haver Analytics; and IMF staff calculations.

Implications for the Latin American and Caribbean Region

The global recovery is spurring exports from Latin America, with further buoyancy added for commodities exporters. After the earlier collapse of global trade, trade flows started to pick up in mid-2009, but volumes are still significantly below precrisis levels. The continued recovery of global trade in 2010–11 and a normalization of crossborder production linkages will remain a significant pull factor for the region's exporters. At the same time, strong growth in emerging Asia should continue supporting commodity prices and favoring LAC commodity exporters, primarily by stimulating domestic demand.

Amid the global upturn, some drag will be associated with macroeconomic conditions in the United States, particularly in 2011 when U.S. growth slows (Figure 1.6). Persistent softness in U.S. consumption as households adjust their balance sheets and build up their savings over the next few years will weigh on demand for consumer imports. Slow improvements in the labor market situation will further restrain the recovery in tourism—causing a delayed start to the upswing in tourism-dependent economies in the LAC region. At the same time, weakness in the U.S. housing market and tepid construction activity suggest that construction employment will remain subdued. Given the sector's strong links with workers' remittances to Latin America, this clouds prospects for a quick rebound in remittances, which for many countries are 10 percent or more below precrisis levels.

In contrast, the United States will likely contribute to the ongoing financial push that a number of countries in the region face. Over the past quarters, ample global liquidity, recovery in risk appetite and improving growth prospects have directed capital flows toward some emerging regions, including Latin America. Given prospective developments in U.S. monetary policy—with supportive monetary conditions for a sustained period—and financial markets, this trend is likely to continue. A low federal funds rate, weak domestic

credit demand in the United States, and further improving risk appetite—combined with the attractive risk profile of some Latin American markets—could continue to drive capital flows to selected markets and put upward pressure on asset prices in the region. With these financial push and pull factors sustained, easy external financing conditions and pressures from capital flows are expected to remain a feature of the regional landscape for a sustained period.

2. Outlook for Latin America and the Caribbean

The Latin America and Caribbean region is recovering from the crisis somewhat faster than previously anticipated. However, the speed of recovery and the associated policy challenges differ markedly across countries. For some of the larger commodity exporters, a favorable external environment and a strong rebound in domestic demand are boosting growth. Challenges ahead include managing the upswing of the economic cycle and adjusting to easy external financial conditions. In contrast, for some of the smaller commodity importers, challenges will likely be shaped by continued sluggish activity, particularly in countries more reliant on tourism and constrained by high debt levels.

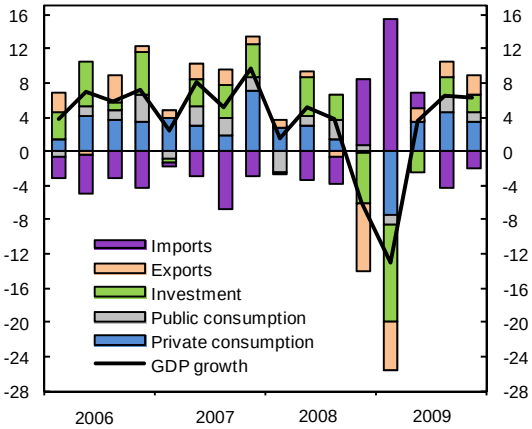
Growth Is Gaining Momentum

The economic recovery in the Latin America and Caribbean (LAC) region as a whole is advancing faster than previously anticipated. Following a steep decline at the end of 2008 and early 2009, regional growth, in purchasing-power-parity-weighted terms, resumed in the second half of 2009. The recovery is being driven by a strong rebound in private consumption. Investment collapsed at the peak of the crisis, but is expected to accelerate in the coming periods (Figure 2.1).

For 2010, regional GDP is expected to grow by 4 percent—good performance by historical standards.[1] This represents an upward revision of about 1 percentage point compared with our forecast in the October 2009 *Regional Economic Outlook: Western Hemisphere*. Better prospects for commodity exports

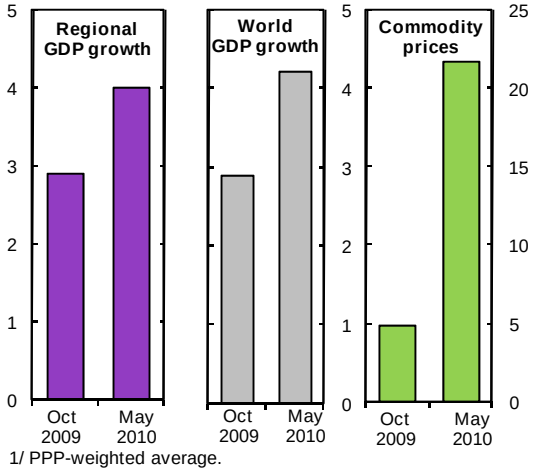
Figure 2.1. A rebound in consumption and better external conditions are supporting the recovery.

LAC: Contribution to GDP Growth 1/
(Quarterly percent change, seasonally adjusted at annual rate; GDP-PPP-weighted averages)



1/ Includes Argentina, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, and Venezuela.

LAC: Forecasts for 2010 1/
(Annual percent change)



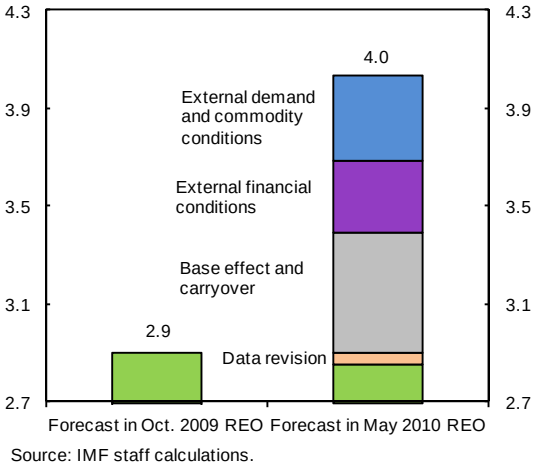
1/ PPP-weighted average.

Source: IMF staff calculations.

Note: This chapter was prepared by Ana Corbacho and Rafael Romeu, with inputs from Jorge Iván Canales-Kriljenko, Gabriel Di Bella, Herman Kamil, Kornelia Krajnyak, Leandro Medina, Ben Sutton, and Secil Topak.

[1] Regional growth has averaged 2.5 percent since the 1980s, before accelerating to more than 5 percent during the boom period 2004–07.

Figure 2.2. Better external conditions explain about 60 percent of the forecast revision in 2010 growth.



Source: IMF staff calculations.

help to explain about 30 percent of the growth forecast revision, cheaper external financial conditions about 30 percent, and changes in historical data and the base effect from higher growth in the second half of 2009 explain the remaining 40 percent (Figure 2.2).[2]

There are risks to the outlook on both sides. As discussed in Chapter 1, our baseline scenario assumes that external financial conditions remain relatively easy for some time. Improvements in financial market sentiment would entail upside risks to growth in those emerging markets in the region with brighter growth prospects and stronger ties to international capital markets. Commodity prices could also rally further if Asia's rebound proves faster than currently anticipated. This would bring good news to the region's major commodity exporters. Careful macroeconomic management will be critical to mitigate risks of a potential boom/bust cycle fueled by favorable external conditions.

Downside risks are still present, being more pronounced in 2011 and beyond. Growth in advanced economies remains highly dependent on public support, with uncertainty mounting as stimulus winds down after 2010. Slow progress in repairing financial sector balance sheets, or concerns over fiscal sustainability, could undermine confidence in the world recovery and heighten global risk aversion. The spike in government bond spreads in Greece in January 2010, and the spillovers to Portugal, Spain, and other advanced economies with important fiscal challenges, have underscored continuing fragilities. Real linkages with the LAC region are limited, but the region could be affected if tail risks materialize (Box 2.1). A weaker recovery in advanced economies would also bring with it weaker employment and consumption, posing downside risks for those economies in the LAC region more dependent on income from tourism and workers' remittances.

Different Speed of Recovery—Different Policy Challenges

Stronger growth prospects for the LAC region as a whole mask some important differences across countries. The multispeed global recovery is exposing the region to a heterogeneous external environment, leading to a multispeed recovery also within the LAC region. As in past editions of the *Regional Economic Outlook: Western Hemisphere*, we divide the region into four analytical country groupings, aiming to capture differences in their exposure to external shocks (Box 2.2 and Panel 2.1).[3]

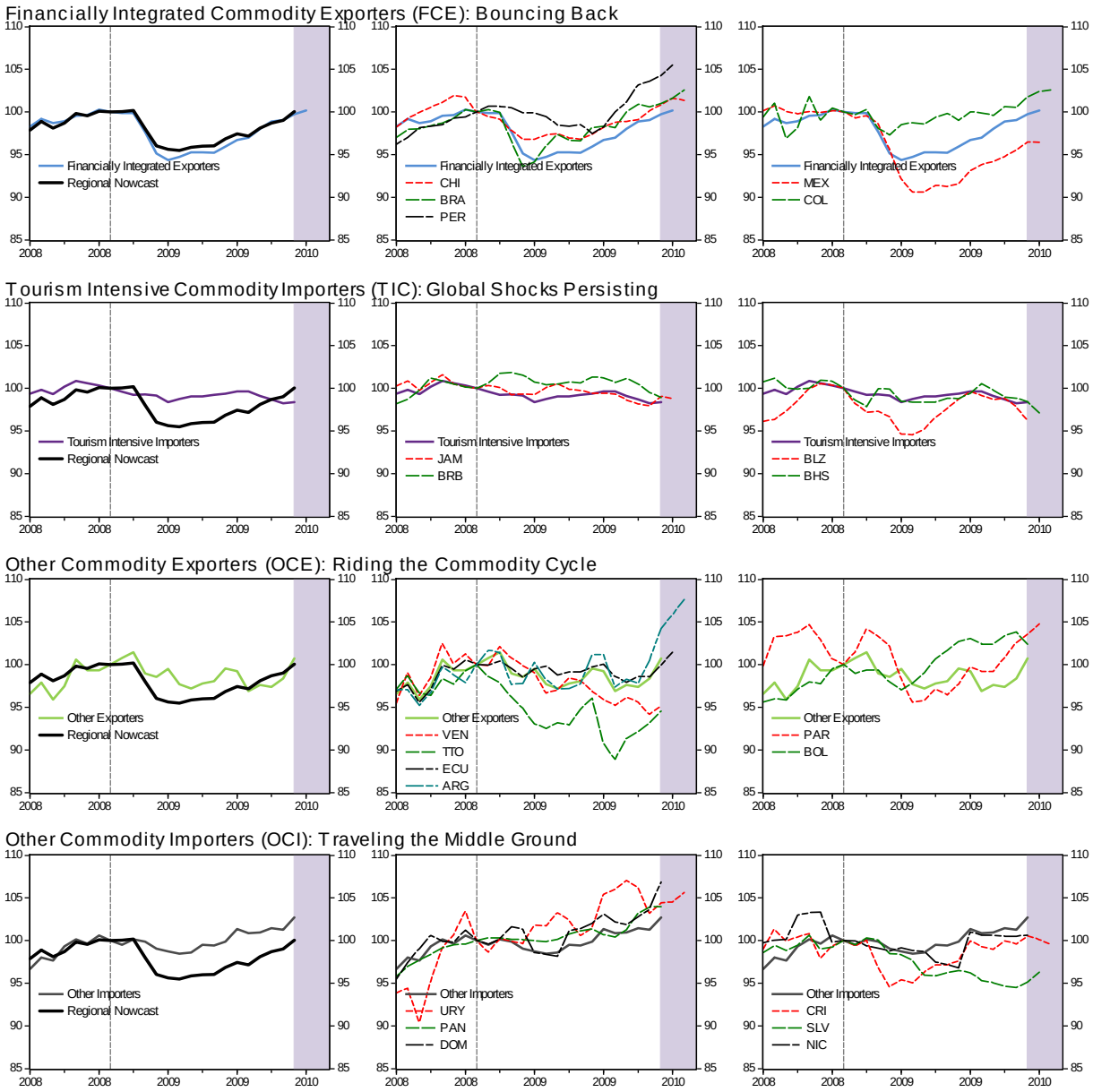
The rebound in growth is expected to be strongest for the financially integrated commodity exporting countries (Figure 2.3). Their outlook is being supported by favorable external conditions. Commodity prices have risen strongly from the troughs in late 2008, and in the cases of metals and energy, are expected to trend slightly upward in 2010–11 (see Chapter 1). Demand for these

[2] These estimates are derived from the IMF's BVAR regional model for Latin America, comparing the forecast under different scenarios: (i) the one prevailing in the October 2009 *Regional Economic Outlook*; (ii) a scenario that incorporates historical data revisions; (iii) a scenario that incorporates actual outcomes in the second half of 2009; and (iv) the current scenario that incorporates the latest forecasts for the external environment.

[3] The analytical groupings aim to capture structural differences across the economies and do not imply country rankings.

Panel 2.1. LAC: Monthly "Nowcast" of Real Economic Activity[1]

While both groups of commodity exporters are showing signs of a rebound, the financially integrated exporters have recovered to precrisis levels, owing in part to a favorable external environment and a strong rebound in domestic demand. For some of the smaller commodity importers, activity continues to be sluggish, particularly for those reliant on tourism and constrained by high debt levels.



Sources: Country authorities; CMC; CTO; Haver Analytics; IFS; WDI; and IMF staff estimates.

[1] The monthly "nowcast" of real economic activity is constructed on the basis of monthly indicators of real activity, such as real currency in circulation, capital imports, sales of retail and industrial/intermediate goods, electricity/energy consumption, industrial production, aggregate activity indicators, and others. The monthly GDP "nowcast" index is normalized to each country's August 2008 level. The PPP-weighted regional average is shown in the left column (solid) against averages for the four country LAC analytical groupings. Each group average is then shown in the middle and right columns (solid) against the individual country indices. Shaded area corresponds to periods of "nowcasting."

Box 2.1. Potential Spillovers from GIPS to Latin America

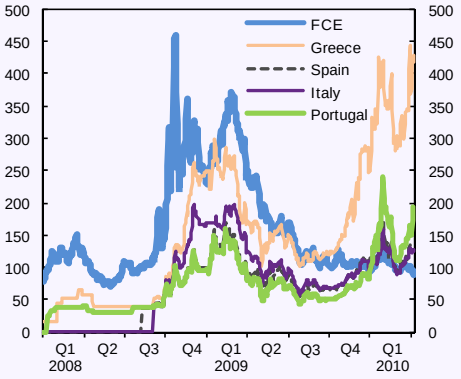
The global slowdown has heightened underlying fiscal vulnerabilities in advanced economies, triggering a confidence crisis in Southern Europe in early 2010. Greece has been at the epicenter. Spreads for Greek government bonds started to diverge markedly from other European countries in October 2009. Sovereign spreads in Portugal, Spain, and Italy have been the most affected. Indeed, since late last year, Greece, Italy, Portugal, and Spain (GIPS) have been the largest contributors to intersovereign contagion in the Euro zone (*Global Financial Stability Report*, 2010).

Real linkages with the LAC region are limited, but there could be financial spillovers should tail risks materialize. Exports to GIPS account for less than 5 percent of total exports of the LAC region, limiting contagion through real channels. However, in an extreme scenario, a sovereign debt crisis in Southern Europe could have spillovers through market confidence effects. Our analysis suggests that sovereign CDS spreads in the LAC region do not react much to movements in Greek CDS spreads, but are relatively more sensitive to global risk aversion, proxied by the implied volatility in the S&P 500 (VIX). The VIX suddenly jumping in January 2010 and again in April, along with Greek spreads. But it has remained relatively low by historical standards.

Spanish banks operating in the LAC region represent a direct transmission channel, although there are sources of resilience. Sovereign funding pressures could crowd out private lending and prompt global banks to withdraw from crossborder activities. However, global banks in the LAC region, including Spanish banks, have relied primarily on subsidiaries funded by local deposits rather than crossborder flows. This has proven to be a source of resilience during the global crisis (see Chapter 4 in the May 2009 *Regional Economic Outlook*). Moreover, Spanish banks operating in the region remain well capitalized and have sizable provisions, thanks to regulations that take into account the economic cycle. Some authorities are considering tightening limits to related party lending to mitigate any potential risks.

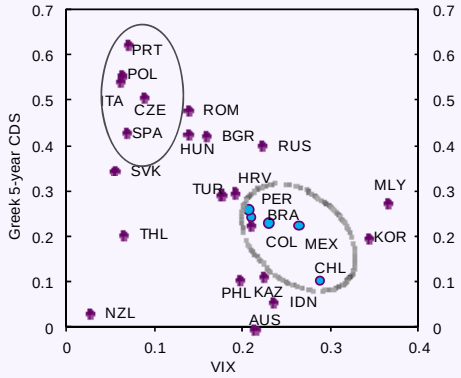
Note: This box was prepared by Ana Corbacho and Secil Topak.

CDS Spreads in FCE and GIPS



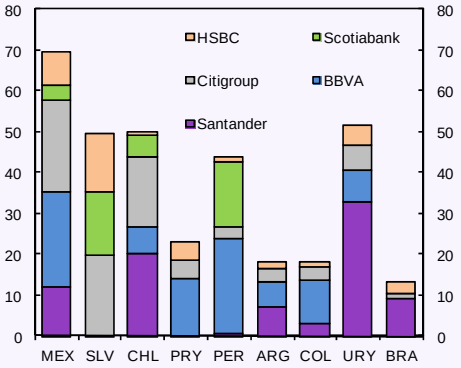
Source: Bloomberg, L.P.

Sensitivity of Sovereign CDS Spreads to Greek Spreads and Global Volatility 1/
(Percent)



Source: IMF staff calculations.
1/ Based on country by country regressions of weekly percent changes in Greek CDS spreads and the VIX during October 2009 to February 2010.

Share of Banking Assets Held in Subsidiaries or Branches of Global Foreign Banks 1/
(Percent of total banking system assets, end-2009)



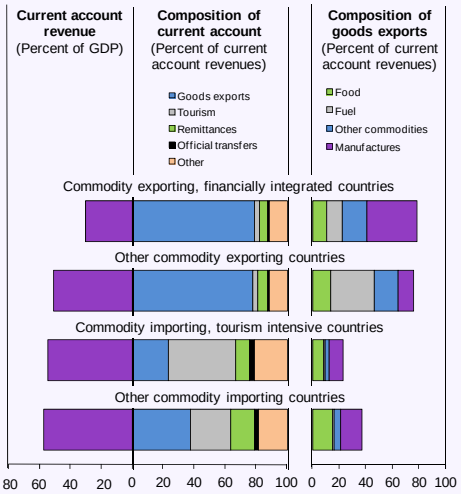
Sources: National authorities; Bankscope; and IMF staff calculations.
1/ Included in the calculations are the five main foreign banks with global presence. In some countries, the actual share of foreign bank ownership of assets could be higher owing to the presence of other international or regional banks.

Box 2.2. LAC Country Analytical Groupings

In analyzing the outlook, we split LAC countries into four groups designed to capture their different exposures to key external shocks. To reflect the greatly varying impact of external terms-of-trade shocks, a first distinction is made between net commodity exporters and net commodity importers. Among the net commodity exporters, we further distinguish between countries that have full access to international financial markets and those that are relatively less financially integrated. Among the net commodity importers, we further distinguish countries with predominant tourism sectors from the rest.

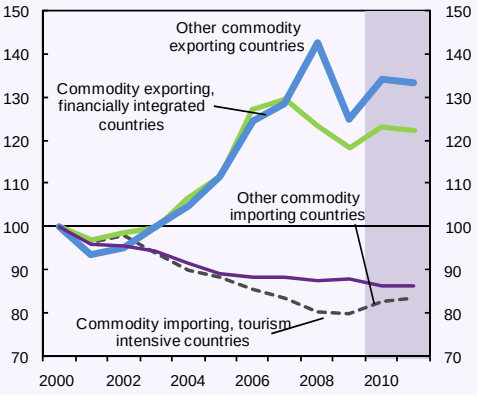
- **Net commodity exporting countries with full access to international financial markets**. For brevity, these are called *commodity exporting, financially integrated countries*. This group comprises five countries that account for two-thirds of the region's GDP (Brazil, Chile, Colombia, Mexico, and Peru). They are the most linked to global financial markets and have access to those markets on relatively favorable terms, with investment grade credit ratings (except Colombia). They also tend to have more developed domestic capital markets. These countries share other characteristics. They are inflation targeters, with the highest degree of exchange rate flexibility, and more generally follow rules-based macroeconomic policies. Terms of trade for these countries have usually moved with world commodity prices.
- **Other net commodity exporting countries**. This group comprises Argentina, Bolivia, Ecuador, Paraguay, Suriname, Trinidad and Tobago, and Venezuela. In general, these countries are currently less integrated with global financial markets. On average, they have experienced the most significant terms-of-trade gains.

Current Account Revenue Structure



Sources: IMF, *Balance of Payments Statistics;* Comtrade; and IMF staff calculations.

Terms of Trade
(Index, 2000 = 100; simple average within groups)

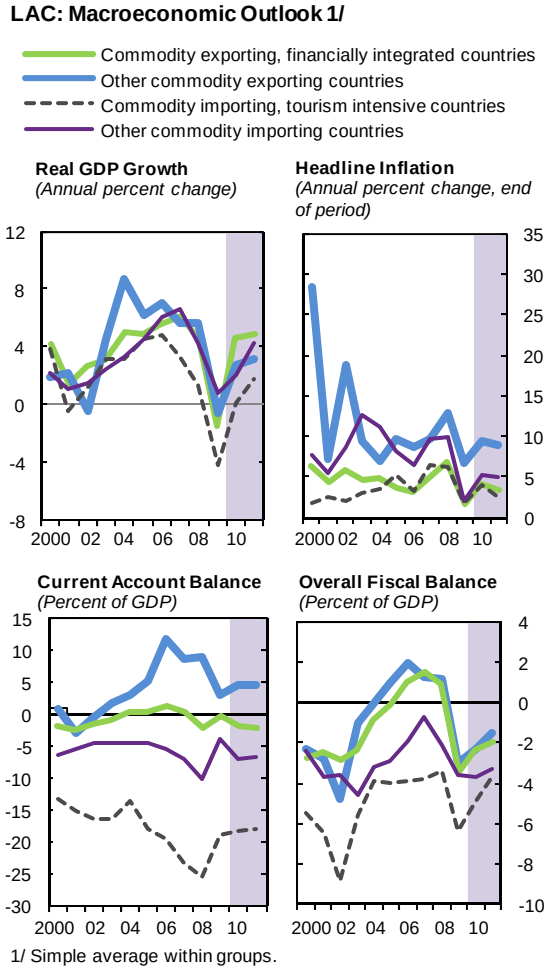


Source: IMF staff calculations.

- **Net commodity importing countries with large tourism sectors**. For simplicity, these will be referred to as *commodity importing, tourism intensive countries*. This group comprises Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. These countries depend primarily on tourism for their current account revenues. In general, they have high external debt burdens but otherwise are not closely integrated with external financial markets. They experienced sizable terms-of-trade losses during 2000–08, given their limited goods exports base and their reliance on imported fuels.
- **Other commodity importing countries**. This group comprises Costa Rica, Dominican Republic, El Salvador, Guatemala, Guyana, Haiti, Honduras, Nicaragua, Panama, and Uruguay. Many of these countries rely heavily on remittances. Some of these countries have sizable commodity exports but still experienced terms-of-trade losses in 2000–08 given their large fuel imports.

Note: This box was prepared by Jorge Iván Canales-Kriljenko and Ana Corbacho.

Figure 2.3. There is considerable heterogeneity in the outlook within the region.



Source: IMF staff calculations.

countries' exports is also growing faster than previously forecasted, and access to foreign capital is resuming on relatively easy terms. Finally, substantial policy stimulus implemented during 2009 is still bearing fruit.

At the other end of the spectrum, growth in the commodity importing tourism intensive countries has been marked down and is expected to perform worse in the current cycle than in previous episodes of global stress. The relevant external conditions are less benign for these countries. Reflecting strong links to weak employment in advanced economies, shocks to tourism have not fully reversed, and elevated commodity import prices are weighing on activity. Moreover, in some of these countries, high levels of debt constrain the room for policy maneuver. Although some countries managed to implement countercyclical fiscal policy in 2009, the payoff in growth was limited, probably reflecting small multipliers. And fiscal stimulus efforts may be short-lived, given financing constraints in forthcoming periods.

Policy challenges in the coming years will correspondingly vary across countries. For many of the financially integrated commodity exporters, the challenge will be managing the upswing of the business cycle. A main theme will be the timing and sequence of exit from the macroeconomic stimulus implemented in 2009, and the adjustment to a more benign external environment. In turn, for many of the tourism intensive commodity importers, the sluggish recovery, coupled with high external and fiscal imbalances, will require difficult policy choices.

The recovery in other countries in the region is traveling a middle ground, but with striking differences. Other commodity exporting countries are starting to ride another commodity cycle, especially the energy exporters. Policy challenges will include avoiding the perils of procyclicality that have been common in the past, anchoring macroeconomic policies, and regaining credibility and access to financial markets. In contrast to many countries around the world that are battling with

weak demand, some of the other commodity exporters are struggling with supply constraints. In these countries, improving the business climate will be critical to attract private sector investment and support potential growth.

Other commodity importing countries are gradually recovering. Higher exports are supporting growth, but inflows from remittances, closely linked to the still weak labor market in the United States, continue to contract. Possible downside risks in global growth down the road may require more fiscal austerity than warranted by the current stage of the economic cycle to replenish fiscal buffers depleted during the crisis. Within the other commodity importers, Haiti faces an especially challenging outlook, as the devastating earthquake will require major efforts to improve social conditions and rebuild the economic infrastructure (Box 2.3).

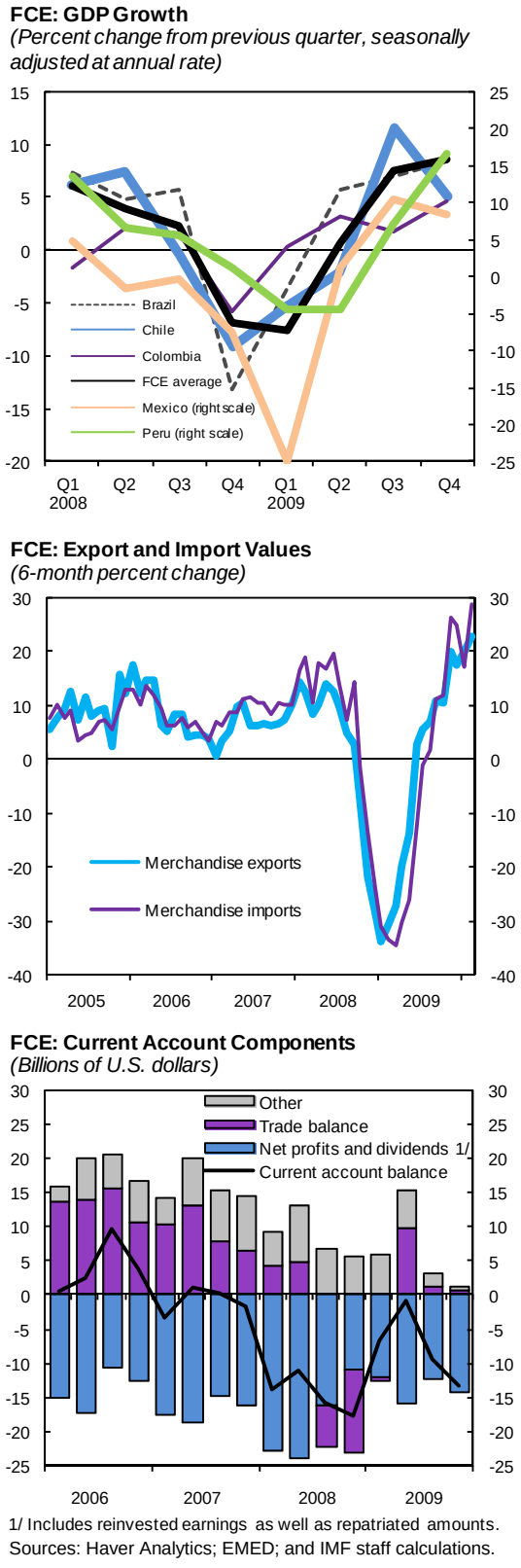
Financially Integrated Commodity Exporters (FCE)

Bouncing Back

Economic activity regained strength in the second half of 2009 in the financially integrated commodity exporters (Figure 2.4). Quarter on quarter growth turned positive in all countries by September 2009, and gained momentum in the most recent months. Strong domestic consumption and the inventory cycle have been the main drivers. In Colombia, growth resumed as early as the first quarter of 2009, but lost some steam later in the year on account of lower exports to Venezuela. In Chile, the recent earthquake may slow down the strong ongoing recovery. In 2010, real GDP in the financially integrated exporters is expected to grow by about 4.5 percent, following a decline of about 1.5 percent in 2009. Upside risks to the growth outlook prevail in the near term.

Social indicators have no doubt been affected by the global financial crisis. But in contrast to past experience, the significant gains made over the last decade will not be undone (Box 2.4). In the financially integrated exporters, employment losses

Figure 2.4. Growth turned positive in the second half of 2009, with a decline in external balances amid rising imports.



1/ Includes reinvested earnings as well as repatriated amounts.
Sources: Haver Analytics; EMED; and IMF staff calculations.

Box 2.3. Impact of the Earthquake on Haiti and the Role of the IMF

A powerful earthquake of magnitude 7.0 struck Haiti on January 12, 2010. The Port-au-Prince area (80 percent of GDP) suffered extensive damage to transportation, communication infrastructure, and housing. Most public buildings were damaged or destroyed, including the tax and customs office and the central bank. The payments system was impaired and the banking system temporarily shut down. The Post Disaster Needs Assessment (PDNA) conducted by the United Nations and the World Bank estimated damages and losses at about US$8 billion dollars, equivalent to about 120 percent of 2009 GDP. More than 225,000 people died, and one million still require shelter.

The macroeconomic outlook for 2010 is challenging. The earthquake represents a major setback for Haiti, after several years of significant progress in maintaining macroeconomic stability. GDP is projected to fall by 8.5 percent in FY2010, despite a projected recovery in the second half of the year. This recovery is expected to be led by reconstruction activity, a good agricultural harvest, and manufacturing growth. Inflation is expected to remain at single digit levels, despite some increases in construction materials and housing prices.

- **A collapse in fiscal revenue is causing a fiscal gap of US$250–350 million**. Tax collections are estimated to fall by about half during this fiscal year, as businesses have suffered damages from the hurricane and the tax administration agency has been weakened by the destruction of part of its infrastructure.
- **The authorities are seeking to secure budget support disbursements from donors to close this gap**. Securing such support will be critical in helping to avoid the inflationary risks that would be associated with a significant increase in central bank financing of the budget.
- **To help restart bank credit to the economy, the Central Bank is working toward the establishment of a Partial Credit Guarantee fund**. Uncertainty as to the value of collateral and financial status of banks' clients has led to a credit crunch. This fund would support viable enterprises and thus employment and economic activity. It would also help to address the impaired assets of the banking system, which is well capitalized and generally sound.

Over the medium term, large expected inflows of foreign aid and higher remittances will need to be managed carefully. A challenge will be to avoid the emergence of Dutch disease effects and to ensure that appropriate conditions are in place to spur exports and private sector economic growth. The government's reconstruction plan represents a unique opportunity to implement a new development model for Haiti based on the creation of viable poles of economic activity outside the capital, boost infrastructure, and improve social conditions. To that effect, the reconstruction plan will need to include an ambitious program of structural reforms as well as sustained donor support and technical assistance in the coming years.

The IMF has moved quickly to provide emergency support to Haiti and stands ready to support the authorities' medium-term reconstruction plans. Within two weeks of the earthquake, the IMF approved the sixth review under the Extended Credit Facility (ECF) and an augmentation of access of 80 percent of quota. A disbursement of US$114 million was made at end-January. The authorities used these additional resources to ensure that there was no shortage of cash in circulation, boost reserves, and finance critical imports for reconstruction. The IMF is also providing technical assistance in the financial and fiscal sectors to support the authorities' post-earthquake needs and revised medium-term priorities. The IMF will continue to support the authorities' reconstruction and growth strategy and, in that context, discussions for a new ECF program are expected to start in May 2010.

Note: This box was prepared by Aurelie Martin and Stephanie Medina Cas.

Box 2.4. The Global Crisis and Social Outcomes

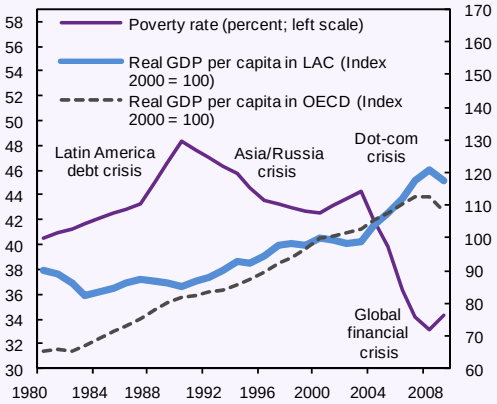
Economic crises in the LAC region have set back poverty reduction efforts in a significant manner in the past. During the three previous crises, poverty in the region fluctuated significantly, reaching its peak at 48.3 percent in 1990. It took the region twenty-four years to undo the increase in poverty since the 1980s debt crisis, when the income gap relative to the Organisation for Economic Co-operation and Development (OECD) widened sharply. Significant strides have been made in the most recent years. From 2003 to 2008, poverty declined steadily to a historical low of 33.2 percent.

The poverty impact of the current global financial crisis may be smaller than what could have been expected given the severity of external shocks. Despite the large drop in output, the current crisis is expected to have a relatively small impact on the poverty rate of about 1.1 percentage point in 2009 (ECLAC, 2009), thanks to the progressive commitment of countries to allocate public funds to social policies since 1990. Social public spending, per person, almost doubled during the 2006–07 period, compared with 1990–91, and increased by 18 percent, compared with 2004–05. However, there are significant disparities between countries. Namely, the least developed countries cannot implement countercyclical measures during economic downturns given their budget constraints. Hence, poverty remains a major problem in the least developed countries.

Employment losses in the financially integrated commodity exporters have been more subdued. This is in contrast to the United States and other advanced economies (Spring 2010 *World Economic Outlook*, Ch. 3). The sound banking system in the LAC region is complementing the strong domestic demand, which promises a relatively speedy economic recovery.

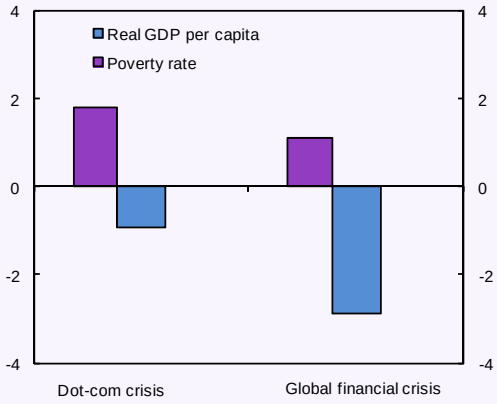
Active social safety nets to cushion the most vulnerable have been at play. Cash transfers to households have increased the income of 40 percent of the poorest households (ECLAC, 2009). Among the different types of transfers, retirement benefits and pensions stand out with their contribution to poverty reduction in the region. Welfare transfers have played an important role in raising the living standards of the poorest segments of society, raising per capita income for the poorest by 15 percent.

LAC: Poverty and GDP per Capita



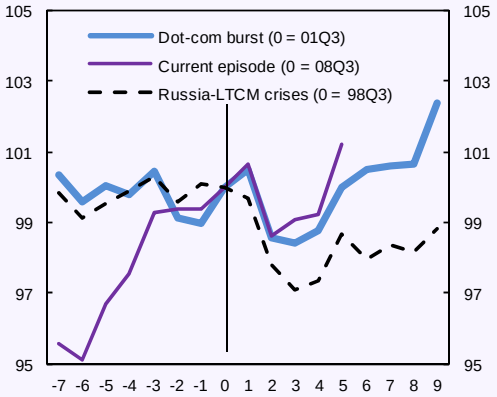
Sources: ECLAC; and IMF staff calculations.

LAC: Change in Real Per Capita GDP and Poverty Rate in Crisis Periods
(Percent, simple averages)



Sources: ECLAC; and IMF staff calculations.

FCE: Employment Before and After Crisis Episodes
(Quarterly index, simple average within group, crisis start = 100)

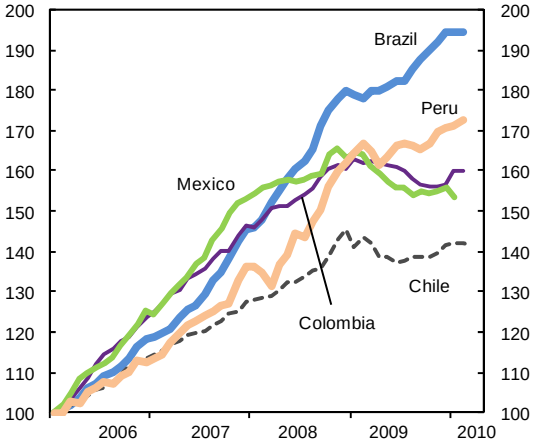


Sources: Haver Analytics; EMED Emerging Americas; and IMF staff calculations.

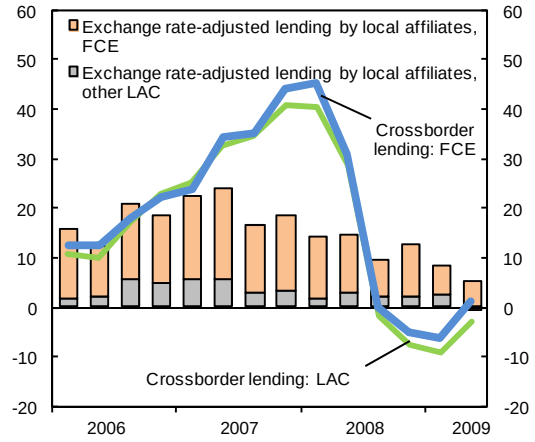
Note: This box was prepared by Secil Topak.

Figure 2.5. Sluggish bank credit in some countries contrasts with the improvement in nonbank external financing.

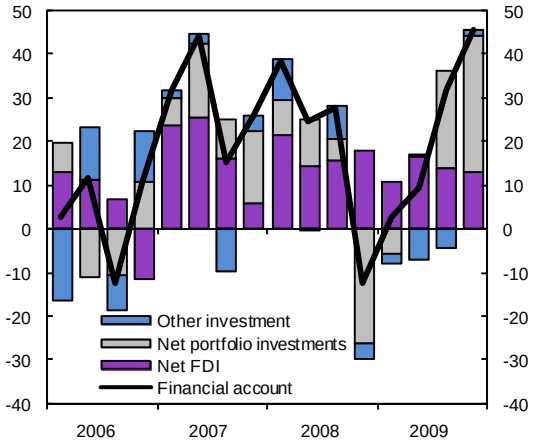
FCE: Real Credit
(January 2006 = 100; deflated by national CPI)



LAC: Foreign Banks' Lending
(Annual percent change in U.S. dollar value)



FCE: Financial Account Components
(Billions of U.S. dollars)



Sources: Bank for International Settlements; Haver Analytics; EMED; and IMF staff calculations.

were more subdued in comparison with previous crises (and also with recent employment dynamics in the United States). This is noteworthy given the much more severe external shocks at play this time around. This is testament to active countercyclical policy responses and the avoidance of domestic financial crises that would have amplified the impact of global shocks.

The gradual improvement in external current accounts came to a halt in the third quarter of 2009, driven by shrinking trade balances as imports firmed. Still, external current account deficits are expected to widen only moderately in 2010, as high commodity prices and the recovery in external demand are expected to sustain exports.

Domestic credit to the private sector is turning around, following the sharp deceleration in late 2008 and early 2009 (Figure 2.5). Credit growth has been strongest in Brazil, supported by buoyant lending from public institutions.[4] In Mexico, public banks have also stepped up activities, but from a much lower base.[5] In general, credit from private institutions is restarting, but only timidly. Nevertheless, with domestic financial conditions normalizing, support from extraordinary liquidity facilities is being phased out.[6]

Overall, the crisis had a limited impact on the stability of the financial sectors. Stronger policy frameworks, including financial and regulatory reforms implemented over the last decade, and the buildup of buffers were critical in this respect.[7]

[4] Quasi-fiscal stimulus from public banks in Brazil is estimated at more than 3 percent of GDP in 2009, higher than fiscal stimulus channeled through the budget.
[5] While credit to the private sector from public sector institutions accounts for about 40 percent of total credit in Brazil, it represents less than 10 percent of total credit in Mexico.
[6] For example, Brazil has now unwound almost all of the emergency foreign exchange liquidity facilities implemented during the crisis. These included direct U.S. dollar loans against collateral, U.S. dollar swap lines to exporters, and the sale of U.S. dollar futures.
[7] See the May 2009 *Regional Economic Outlook: Western Hemisphere*, Chapter 3.

The sharp deceleration in foreign banks' lending appears to be bottoming out. In the third quarter of 2009, total foreign bank lending to the LAC region grew by 3 percent with respect to the second quarter, with Brazil at the lead. Notably, cross-border lending to the region stopped declining, in contrast with continued withdrawal by foreign banks in other emerging market regions.

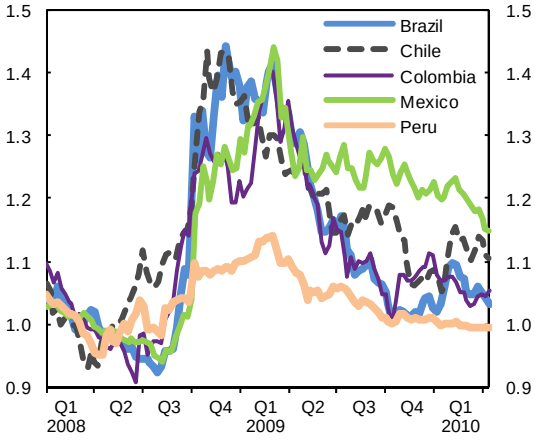
Access to nonbank external financing has improved markedly. As anticipated in our last edition, the financially integrated commodity exporters have become an attractive destination for foreign investors. Capital inflows have gone back to precrisis levels, with record volumes in portfolio investments at the end of 2009. More recent data on external issuances suggest these trends have continued in early 2010. Even high yield firms, which were rationed out during the peak of the crisis, have been able to tap international markets. Still, anecdotal evidence suggests that small and medium-size firms continue to face constraints in access to finance.

With inflows resuming, and global risk aversion declining, asset prices have recovered the losses experienced during the crisis (Figure 2.6). Equity markets have bounced back, notably ahead of the U.S. market. In most countries in the region, price earnings ratios remain within historical averages. In Brazil and Colombia, however, stock market valuations appear now stronger than historical averages. (See also the Spring 2010 *Global Financial Stability Report*).

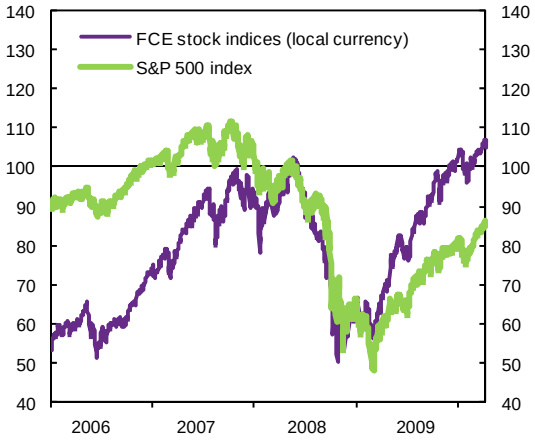
Since March 2009, exchange rates have strengthened across the board to precrisis levels in most countries, in both nominal and real effective terms. Currency appreciation has helped to stem pressures from foreign inflows. In addition, authorities have accumulated foreign exchange reserves, strengthened macroprudential regulations, raised reserve requirements, and in the case of Brazil, reintroduced capital controls (Box 2.5).

Figure 2.6. Asset prices have generally recovered to precrisis levels.

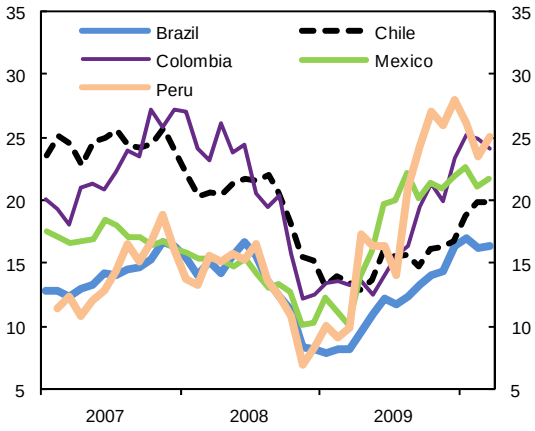
FCE: Exchange Rates
(National currency/U.S. dollar; H1 2008 = 100)



Equity Markets: FCE vs. S&P 500
(May 2008 = 100)



FCE: Price / Earnings Ratios



Sources: Haver Analytics; and IMF staff calculations.

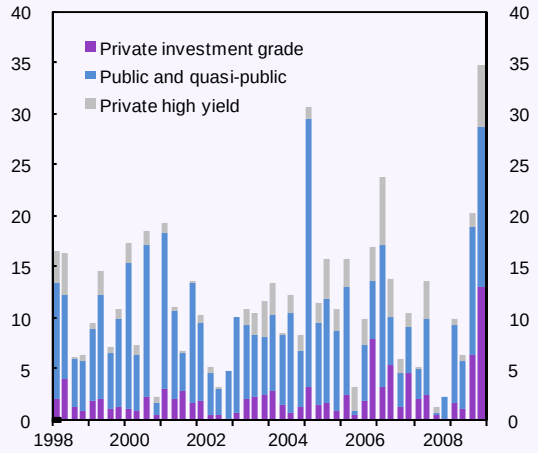
Box 2.5. Capital Inflows—An Aspect of "Good Times"

The recovery in global capital markets has been faster than anticipated, contributing to a positive short-term growth surprise in advanced economies, and easing external financing conditions for emerging markets. External bond issuance by emerging market sovereigns and corporations picked up in the second half of 2009, suggesting that access to international capital markets has normalized, and on several metrics (for example, EMBI spreads, market volatility), market conditions for emerging markets are close to or as easy as before the crisis. Amid very low U.S. Treasury base rates, on the one hand, the cost of external bond financing (as measured by yields) has dropped to near-record lows for stronger-rated emerging markets. On the other hand, the recovery of crossborder bank lending remains slow, as global banks continue to repair balance sheets.

At the current juncture, both "push" and "pull" factors spur capital flows toward emerging economies with attractive risk profiles.

- "Push" factors arise from financial market developments—returning appetite for risk, ample global liquidity, and low interest rates in major economies.
- Besides structural factors, the multispeed global recovery also generates "pull" incentives for this capital flow pattern; emerging markets with good structural growth prospects and more advanced and broader-based cyclical recoveries are benefiting.

LAC: External Bond Issuance
(Billions of U.S. dollars)



Sources: Dealogic; and IMF staff calculations.

Indeed, portfolio and equity flows to several regions have recovered. Flows have picked up particularly to countries with good structural growth prospects in Asia and Latin America and to commodity exporters; Brazil has been particularly attractive, with net inflows of US$70 billion in 2009. At the same time, capital flows to Emerging Europe remain anemic.

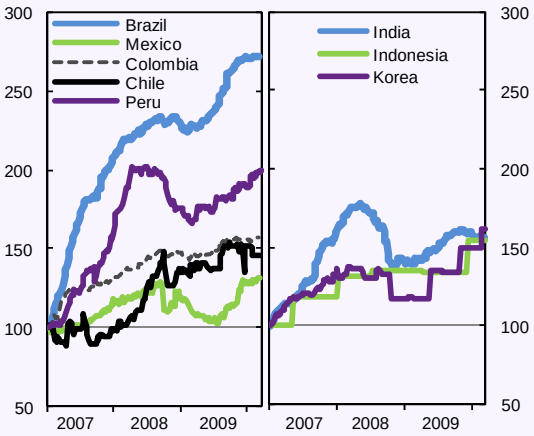
The low cost of external financing and the possibility of accelerated capital inflows may pose some challenges, particularly in countries that are cyclically advanced. These include smoothing the foreign exchange and financial market volatility associated with inflows, avoiding an excessive appreciation of the exchange rate, reducing the probability of asset bubbles and credit booms, and avoiding potential overheating associated with "easy money" conditions. The latter two considerations are especially important for economies already close to operating at full potential (such as Brazil and Peru), but give less immediate reason to be concerned for countries with large economic slack (such as Mexico).

Emerging market countries around the world have resorted to a variety of instruments to reduce risks associated with capital inflows.

Note: This box was prepared by Kornélia Krajnyák.

- *Exchange rates and reserves.* Most emerging markets—including major Latin American economies—responded with a combination of exchange rate appreciation (which reduces incentives for capital inflows) and reserve accumulation (which strengthens buffers and can reduce volatility). Among the FCE, Brazil experienced the strongest increase in reserves—US$35 billion since capital flows picked up in mid-2009, against an increase of US$60 billion in the first half of 2007, even as the exchange rate in both episodes appreciated by about 10 percent. In Peru, reserves increased by US$4 billion since mid-2009—similar to the amount in the first half of 2007. However, the currency has appreciated about 5 percent in recent months, although it remained broadly stable in early 2007. In Colombia, the exchange rate appreciated about 10 percent with broadly unchanged reserves in recent months. The currencies of several major Asian economies (for example, India, Indonesia, and Korea) also appreciated since mid-2009 in real effective terms, even as these countries accumulated similar or smaller amounts of reserves than in the 2007 capital inflow episode.

International Reserves
(January 4, 2007 = 100)



Sources: ECLAC; and Haver Analytics.

- *Prudential regulations.* These instruments target slowing asset price or credit booms; and strengthening the financial sector's resilience. For example, Hong Kong, Korea, and Singapore have recently taken steps to cool down the housing market, and China has raised reserve requirements and introduced measures to strengthen risk management in the banking sector. Among the financially integrated exporters, Peru has increased reserve requirements on short-term (less than 2 years) external loans, and Brazil announced it will raise reserve requirements on deposits after having lowered them during the crisis. In Mexico, pension fund regulations have been revised to increase flexibility in episodes of high volatility.

- *Capital controls.* Restricting inflows or reducing restrictions on outflows may help manage the situation (for example, Chile relaxed limits on foreign investments and foreign exchange hedging requirements for pension funds), although the effectiveness of some control measures may be lower in countries with substantially open capital accounts. Brazil has recently introduced a 2 percent tax on fixed income and equity inflows. On the other hand, Colombia has not reverted to its precrisis capital control measures that included unremunerated reserve requirements and minimum stay rules for FDI.

- *Macroeconomic policy mix.* So far, countries are still in recession-averting mode. But the speed of exit from supportive policies should vary significantly. Countries that are more cyclically advanced may need to withdraw fiscal stimulus faster than anticipated, and ahead of monetary stimulus, to manage possible risks from capital inflows.

Policy Challenges: Managing Good Times

With favorable external conditions and the economic recovery advancing faster than anticipated, the main policy challenge for the financially integrated commodity exporters will be managing the upswing of the economic cycle. The resumption of capital inflows and easy external financial conditions more broadly add further complexity to policy challenges in the years ahead.

Varying starting conditions will shape the needed pace of stimulus withdrawal. Output gaps are expected to nearly close in Brazil and Peru in 2010, but remain sizable in Mexico. In turn, economic slack may increase somewhat in Colombia, given idiosyncratic shocks (Figure 2.7).

Inflation gaps—the difference between expected and target inflation—are also projected to close in 2010. Inflation started to increase in recent months, partly reflecting a slow rise in food and fuel prices in line with higher world commodity prices. Headline inflation is expected to reach the midpoint of the inflation targeting bands by the end of 2010. In Mexico, one off effects from changes in taxes and administered prices will lead to a temporary increase in inflation above the midpoint of the band in 2010, before converging by 2011. In Colombia, disruptions arising from El Niño could bring inflation to the upper part of the target range.

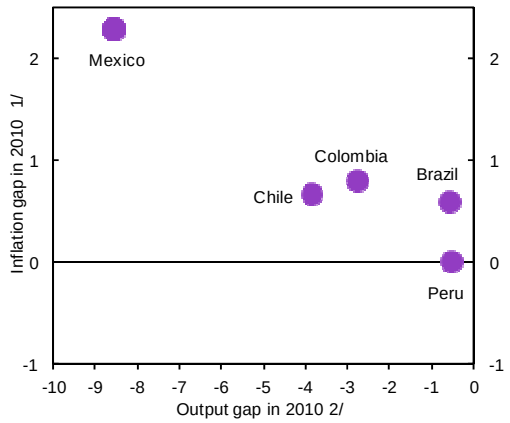
Monetary policy remains highly stimulative. Following significant cuts in monetary policy rates during the crisis, central banks have kept rates unchanged, remaining below neutral levels in all financially integrated exporters. Markets are already pricing in rate increases in 2010.

The fiscal impulse implemented during the crisis is not expected to be fully withdrawn in 2010.[8] As described in our last edition, the financially integrated commodity exporters were able to run countercyclical fiscal policies during this crisis, in marked contrast with previous episodes of global stress. In 2010, fiscal stimulus will be only partially reversed, except in Brazil and Mexico.[9] In Chile, spending related to reconstruction would have an expansionary effect on fiscal policy. With fiscal revenues growing again, overall fiscal balances in the financially integrated commodity exporters are expected to improve, allowing a moderate reduction in debt (Figure 2.8).[10]

As economic activity recovers, and inflation and output gaps close, the stance of macroeconomic policies will need to return to neutral. As discussed in our earlier edition, given that the recovery in the region does not depend exclusively on public support, risks from withdrawing stimulus too early are not as severe as in the advanced economies. The

Figure 2.7. Inflation gaps are expected to close in 2010.

FCE: Cycle in 2010
(Percent)



Source: IMF staff calculations.
1/ Projected inflation at end-2010 minus inflation target for end-2010. In Mexico and Colombia, idiosyncratic shocks account for temporary higher inflation in 2010. See main text for details.
2/ GDP in 2010 minus potential GDP, in percent of potential GDP.

[8] The fiscal impulse is defined as the change in the *domestic* cyclically adjusted fiscal balance (that is, excluding commodity-related fiscal revenues and foreign grants), and measures the impact of discretionary fiscal policy on domestic demand. See the October 2009 *Regional Economic Outlook: Western Hemisphere*, Chapter 4, for further details.

[9] In Mexico, the withdrawal of fiscal stimulus in 2010 reflects the authorities' goal to ensure medium-term sustainability given an expected structural decline in oil revenues.

[10] In Colombia, revenues as a percent of GDP are expected to fall in 2010, owing to lower oil-related revenues linked to low international fuel prices in 2009.

faster recovery currently being forecasted reinforces this notion. Countries where output gaps are closing more rapidly will need to move to a tightening mode ahead of others. In general, fiscal stimulus should be withdrawn ahead of monetary stimulus.[11]

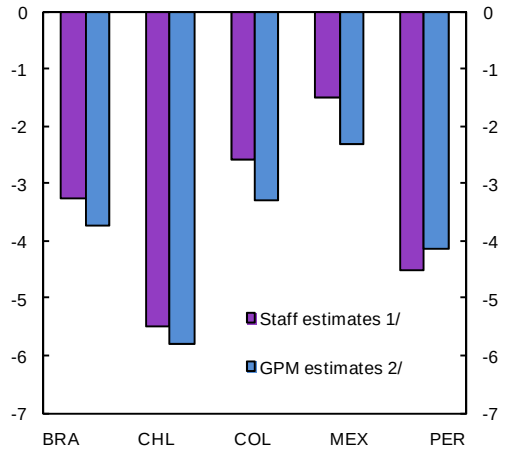
Easy external financial conditions pose additional challenges. As analyzed in more detail in Chapter 3, sustained periods of easy external financial conditions can lead to currency appreciation and loss of competitiveness, but that is only part of a broader picture. Perhaps more important risks of such conditions are that they can also lead to overheating, triggering and then fueling booms in domestic demand and credit, along with widening current account deficits. If not well managed, these trends could in time lead to the accumulation of significant vulnerabilities and risks.

Given the still sluggish recovery in bank credit in most countries, the risk of a credit boom may not be imminent, but growth of domestic demand is already robust in some countries. Policymakers need to plan ahead, as the current episode of easy external financial conditions may persist for some time, with effects that do not play out immediately, but can be very significant for the financially integrated exporting countries.

Although concerns over currency appreciation tend to be the most visible and politically charged, policymakers will need to focus beyond that one issue. Policies should be framed to address the broader risks from a demand boom, given the potentially damaging consequences. A macroeconomic policy mix favoring a tighter fiscal stance would be appropriate, helping also to stem appreciation pressures. In the context of bold stimulus policies during the crisis in 2009, policy mixes can be adjusted by reversing temporary fiscal impulse, creating room for monetary policy to be tightened somewhat more slowly than otherwise. Macroprudential policies should play an important complementary role in moderating the cycle and influencing risk-taking behavior in firms and households (see Chapter 3). Controls on capital inflows and foreign exchange intervention to resist currency appreciation can be

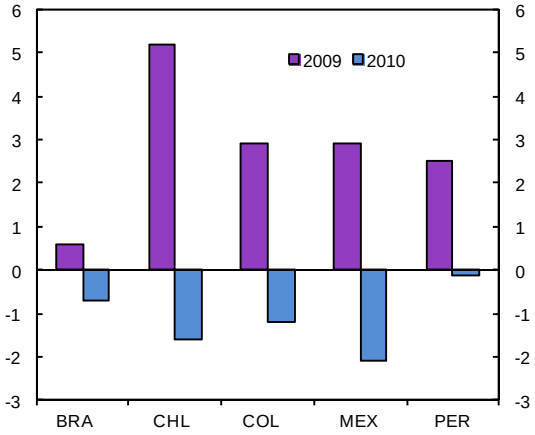
Figure 2.8. Monetary policy remains stimulative, whereas fiscal impulse will be partially withdrawn.

FCE: Monetary Stimulus in 2010
(Difference between current monetary policy rate and neutral policy rate in percentage points)



1/ Neutral policy rates based on potential GDP growth and inflation target.
2/ Neutral policy rates based on Global Projection Model. See Chapter 3, October 2008 *Regional Economic Outlook: Western Hemisphere.*

FCE: Fiscal Impulse in 2009 and 2010
(Percent of GDP)



Source: IMF staff calculations.

[11] The general recommendation is that fiscal policy should return to a neutral or passive role in the management of the demand cycle, also facilitating the conduct of monetary policy.

part of the toolkit, but policymakers need to be mindful of their limitations—including that some approaches may backfire and attract more capital inflows.[12]

Easy external financial conditions also bring some opportunities. Access to cheap foreign money can help fill investment gaps and alleviate infrastructure bottlenecks. Easy external financial conditions also provide attractive options for deft public debt management. For example, Colombia recently issued an 11-year global treasury bond denominated in domestic currency—the first such sovereign issue since the onset of the global crisis.

Further Strengthening Policy Frameworks

The forthcoming good times provide an opportunity to solidify credibility and further strengthen policy frameworks.

On the fiscal front, rising fiscal revenues on account of the favorable commodity and economic cycle will test authorities' resolve to implement countercyclical fiscal policy in good times. A fundamental goal should be to save revenue windfalls and rebuild buffers. This would ease fiscal constraints in future bad times. Second, fiscal frameworks could be refined to explicitly consider countercyclical provisions. Targeting cyclically adjusted fiscal balances is one option. Simpler expenditure rules may also work. Finally, there is a need to strengthen automatic stabilizers on the expenditure side. Improving the targeting, efficiency, and speed of additional spending during recessions is critical in this respect.

Flexible exchange rates proved an invaluable instrument to absorb the impact of recent external shocks. Further improvements in balance sheets would allow additional space for exchange rate swings without destabilizing effects, particularly in the more dollarized economies.

Gains in credibility allowed monetary policy easing during the crisis without undue risks to inflation expectations. But there are still open questions posed by the inflation performance of the financially integrated exporters in the run up to the global crisis, with fairly high inertia in some countries and a strong pass through from supply shocks in others. Higher world commodity prices and closing output gaps will likely start pressuring inflation. Ensuring that inflation expectations remain anchored would lower sacrifice ratios and reduce the need for significant tightening.

On macroprudential frameworks, important progress has been made. Challenges ahead remain concentrated in five areas in line with undergoing global initiatives (see Box 1.3): (i) broadening the perimeter of regulation to cover all systemically important institutions; (ii) strengthening the mandate for financial stability; (iii) improving consolidated supervision; (iv) reducing procyclicality; and (v) disclosing information and systemic risks with high transparency standards. [13]

Tourism Intensive Commodity Importers (TIC)

Global Shocks Persisting

The severity of the crisis impact and the outlook for the tourism intensive, commodity importing countries diverges markedly from the pace of recovery projected for the rest of the region (Figure 2.9). While output in the rest of the LAC region declined by about 0.2 percent in 2009, it fell by more than 4 percent in these countries.[14]

[12] Heavy intervention in the foreign exchange market to stem *nominal* appreciation may have the unintended consequence of attracting more capital inflows, by stirring expectations for further appreciation and reducing the volatility of the exchange rate as authorities lean against the wind. This can exacerbate the ensuing credit and domestic demand boom, resulting in overheating and an increase vulnerabilities in the financial sector. Notwithstanding initial efforts to mitigate appreciation and protect the export sector, domestic inflation will pressure the *real* exchange rate.

[13] For a detailed assessment of the current state and challenges in financial regulation, see Rennhack and others (2009).

[14] Simple average across countries.

With the economy still contracting, average inflation moderated to below 2 percent by end-2009, helped in part by collapsing food and energy import prices. The average current account deficit narrowed to roughly 20 percent of GDP (from around 25 percent in 2008), notwithstanding the acute shock to tourism revenues and indirect appreciation from exchange rates pegged to a strengthening U.S. dollar.

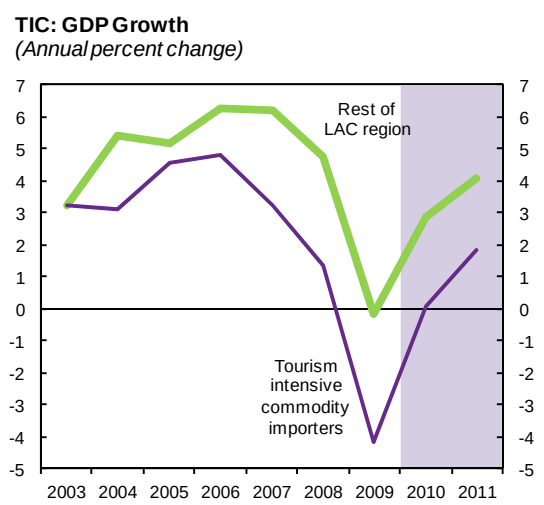
The global financial downturn spread to the tourism intensive economies through their tight links with advanced economies, and in particular, through Organisation for Economic Co-operation and Development (OECD) unemployment increases not seen in nearly three decades. Unemployment increased both in the United States and Europe. In contrast, Canada provided a welcome boost to regional tourist arrivals owing to its stronger economic performance during the crisis (see Chapter 1). The forecast in the October 2009 *Regional Economic Outlook* for year over year declines in tourism arrivals materialized at the lower end of the 10–15 percent range, albeit with significant heterogeneity. Tourist arrivals declined by double-digit rates in most countries, and as much as by 25 percent in St. Kitts and Nevis, but increased in Jamaica.[15]

Estimates of tourist arrivals to the tourism intensive commodity importers suggest that the impact of a 1 percent increase in OECD unemployment implies a contemporaneous decline of 4 percent in arrivals, on average (Box 2.6). For the current downturn, the approximate 3 percentage point increase in U.S. unemployment squares with the average 10 percent decline in Caribbean tourism.

Longer-term investments in the form of vacation real estate and other forms of tourism fell concomitantly with short-term vacation arrivals, as household wealth declined in the aftermath of the financial crisis. This is particularly costly for the tourism intensive importing countries, as median FDI (in percent of GDP) had tripled, from below 4 percent in 1996 to more than 16 percent of GDP by 2008. The importance can be observed in the concurrent declines in median unemployment in the region, from more than 16 percent in 1996 to single digits in the most recent years. With the onset of the crisis, FDI fell sharply to 10 percent of GDP in 2009.

Employment in advanced economies is expected to improve only gradually, with weak prospects for tourism in the coming years.[16] This *Regional Economic Outlook* projects a modest increase in arrivals of

Figure 2.9. Growth and inflation decelerated sharply.



Inflation Deceleration in the Tourism Intensive Commodity Importers
(Annual percent change, end of period)

	2008	2009	Difference
Antigua and Barbuda	0.7	2.4	1.7
Bahamas	4.5	1.3	-3.2
Barbados	7.2	3.2	-4.0
Dominica	2.1	3.2	1.0
Grenada	5.2	-2.4	-7.5
Belize	4.4	-0.4	-4.8
Jamaica	16.8	10.2	-6.6
St. Kitts and St. Nevis	7.6	1.0	-6.6
St. Lucia	3.8	1.0	-2.7
St. Vincent and Grenadines	8.7	-1.5	-10.3
Average	6.1	1.8	-4.3

Source: IMF staff calculations.

[15] See Box 2.3 of the October 2009 *Regional Economic Outlook*.

[16] The recovery from recessions led by financial crises tends to be slow (see Chapter 3 of the April 2010 *World Economic Outlook*). Unemployment in the United States—by far the largest client country in the Caribbean—is projected to remain above 9 percent for the current year.

Box 2.6. The Impact of Employment Conditions on Tourism, and Tourism on Output

The crisis in OECD economies is transmitted to tourism intensive commodity importing countries in part through higher unemployment rates that reduce tourist arrivals. In principle, tourist arrivals are the result of individual decisions by OECD consumers that depend on factors such as employment conditions, savings rates, consumer confidence, and wage growth. Bilateral regressions of tourist arrivals and OECD unemployment suggest a heterogeneous impact within the tourism intensive importers. The weighted average elasticity for the tourism intensive importers is -4.5, which implies that an increase in the home country unemployment rate of 1 percent leads to a decline of approximately 4 percent in arrivals (see Romeu, IMF Working Paper, forthcoming). For example, the unemployment rate for the United States (the dominant OECD economy for the Caribbean) increased by 3.4 points from 5.8 percent in 2008 to 9.2 percent in 2009, implying a regional tourist decline of 13 percent, which is broadly in line with the observed decline.

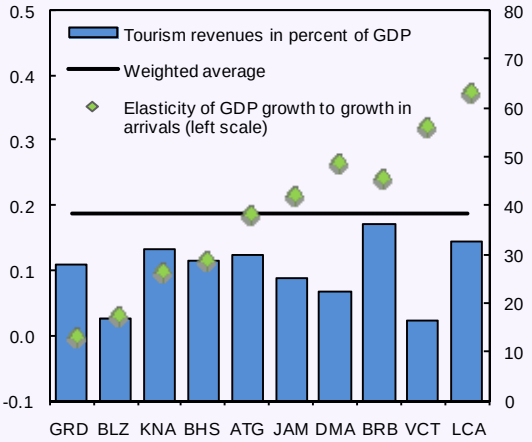
The impact of declines in tourist arrivals on output growth varies within the region. Bilateral estimates are shown for the region (with the weighted average of these indicated by the horizontal line—see figures). After controlling for storms, output growth in OECD economies, and other factors such as the price of oil or changes in the value of the U.S. dollar, the elasticity of output with respect to arrivals is (in weighted average) 0.2. This implies that a decline in arrivals of 10 percent in a given year leads to a fall in GDP growth of -2 percent, all other things equal. These estimates suggest that falling tourist arrivals from the OECD contributed 2–2½ percentage points of the roughly 4 percent regional output decline observed in 2009. Panel estimation, which pools data across tourism intensive importing countries to find a joint estimate of the impact of deteriorating OECD employment, broadly confirms these results. The panel estimation suggests that arrivals drop by approximately 3 percent per unit increase in the OECD unemployment rate, whereas GDP contracts by approximately 1 percent for each 10 percent

TIC: Growth in Tourist Arrivals and Output, 2009

	Arrivals	GDP
Antigua and Barbuda	-11.8	-7.0
Bahamas, The	-9.3	-5.0
Barbados	-8.6	-5.3
Belize	-5.2	-1.1
Jamaica	3.6	-2.8
St. Lucia	-5.8	-5.2
St. Vincent and the Grenadines	-11.2	-1.9
St. Kitts and Nevis	-25.6	-5.5
Grenada	-10.4	-7.7
Dominica	-9.7	-0.3
Simple Average	-9.4	-4.2
Simple Average Excl. Jamaica	-10.9	-4.3

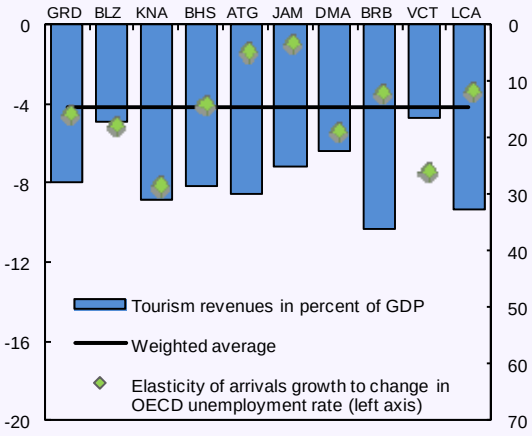
Sources: Country authorities; Caribbean Tourism Organization; and IMF staff estimates.

Impact of Tourist Arrivals on GDP



Sources: Caribbean Tourism Organization; and IMF staff calculations.

Impact of Unemployment on Tourist Arrivals



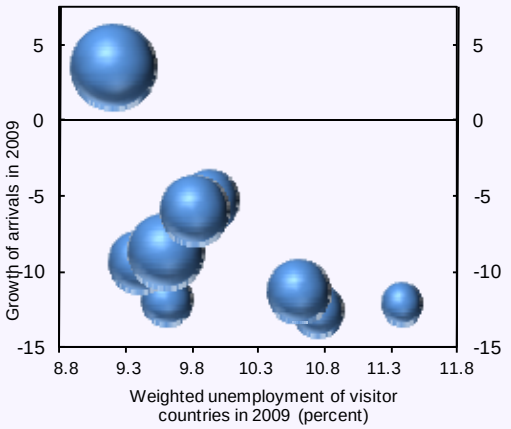
Sources: Caribbean Tourism Organization; and IMF staff calculations.

Note: This box was prepared by Rafael Romeu.

decline in arrivals. Jointly, these estimates suggest that roughly half of the decline in GDP in 2009 stemmed from increasing unemployment rates in the OECD.[1]

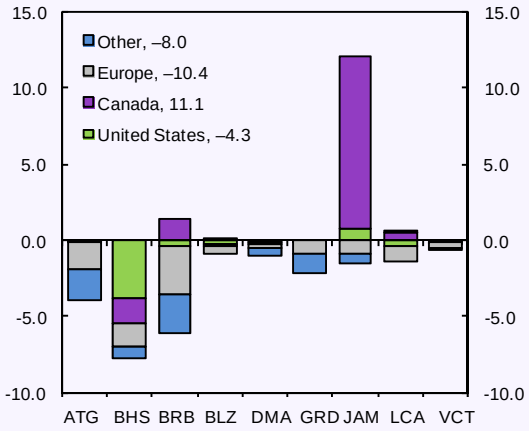
Differences in economic conditions in the originating countries can help to further explain developments in tourism in the region. The four groups of OECD visitors to the tourism intensive importers used here are Canada, the United States, Europe, and the rest (labeled "other"), which in many of the tourism intensive importers largely reflects visiting expatriates living in the OECD. Canada's relatively strong performance (see Chapter 1) during the crisis, and in particular, the strength of its labor market, led to positive growth in tourism in 2009. This was an important countercyclical flow for some of the tourism intensive economies; and countries among the tourism intensive importers (as well as within the broader Caribbean) that were positioned to receive Canadian tourism fared much better in terms of arrivals during this crisis. For example, in Jamaica, Canada was the major driver of growth for arrivals in 2009.

Unemployment and Growth of Arrivals in 2009 1/



Sources: Caribbean Tourism Organization; U.S. Census Bureau; and IMF staff calculations.
1/ Bubbles scaled by percent of Canadian arrivals in 2008.

Contribution to Growth of Caribbean Arrivals, by OECD Visitors 1/
(Annual percent change in tourists)

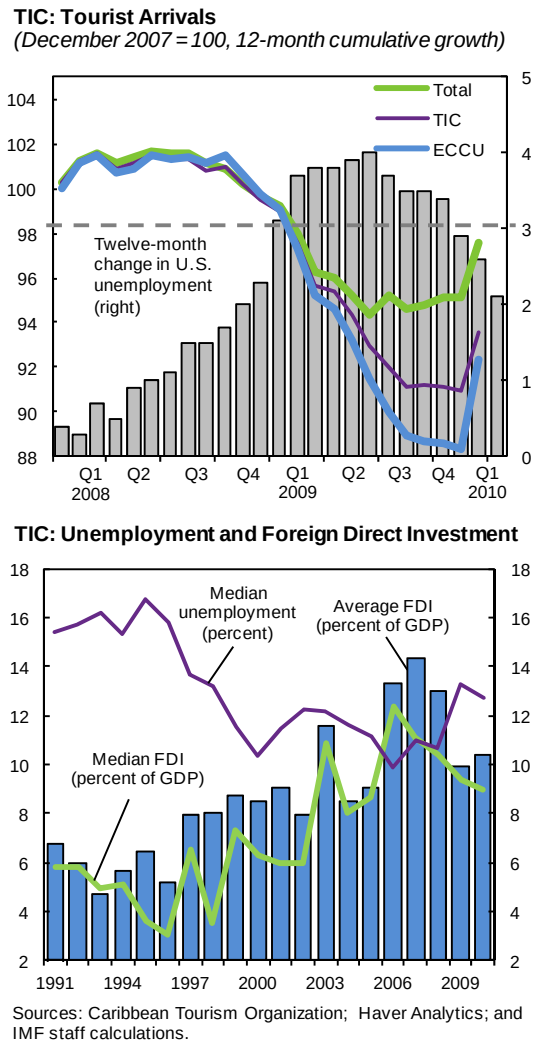


Sources: National authorities; Caribbean Tourism Organization; and IMF staff calculations.
1/ Adding colors horizontally yields OECD arrivals percent growth in 2009.

Tourism from European economies declined across the board during the crisis, owing in part to slightly larger increases in unemployment compared with Canada. In the future, this could represent a vulnerability for the region, as tourism from Europe during this crisis declined by more than 1 percent on average for individual economies—more than twice the rate of U.S. declines to the region (see lower figure) despite a larger observed increase in U.S. unemployment—and Europe as a region did not increase its arrivals to any tourism intensive economy in 2009. U.S. arrivals to the region declined as a whole, but increased to some destinations, including Jamaica. Finally, regarding visits from the residual category of "other" OECD countries, more detailed arrival statistics (where available) and anecdotal evidence suggest that a significant part of these visits are conducted by expatriates of the tourism intensive countries. One unemployment proxy for this subgroup is the U.S. unemployment rate for Hispanics. Despite showing the largest increases in unemployment of the four subgroups (and double that of Canada and Europe), "other" arrivals to the tourism intensive countries recorded the lowest declines in arrivals in 2009, owing in part to the strong links to these economies.

[1] System estimation, which controls for the endogeneity of shocks across arrivals and GDP from exogenous factors—such as natural disasters that would both lower arrivals and lower output growth but are unrelated to OECD unemployment—confirms further the robustness of these results.

Figure 2.10. Tourism and FDI remain depressed.



Sources: Caribbean Tourism Organization; Haver Analytics; and IMF staff calculations.

approximately 5 percent in 2010. This, alongside weak FDI, implies a sluggish recovery for 2010 to virtually no output growth in the tourism intensive importers in the region, with unemployment hovering around present levels of 13 percent. Arrivals to more European dependent destinations will take longer to increase, given the expected delayed recovery relative to the United States. Should downside risks to the OECD materialize, the recovery in the tourism intensive importers could be delayed further (Figure 2.10).

Financial sectors in these countries have felt substantial pressure from both internal and external shocks. Externally, regional offshore financial sectors have come under greater international scrutiny as the fallout from the global financial crisis combined with greater pressure to close regulatory loopholes and, in some cases, outright fraud. Offshore Financial Centers (OFCs) have been required to comply with increasingly tighter international standards (spearheaded by the G20) in the fiscal/tax and financial/regulatory areas. In the future, country regulators and financial market participants will need to adapt to remain classified as countries meeting the minimum international standards. While costly, these initiatives will strengthen the existing OFCs in the long term, hence maintaining their beneficial impacts on the domestic tourism intensive economies, including (moderate) fiscal revenues and associated tourism.

In addition to this external pressure, the tourism intensive countries have faced financial shocks emanating from within the region:

- The January 2009 collapse of the Trinidad and Tobago-based CL Financial Group sent shock waves throughout the Caribbean that are continuing to reverberate. Low debt and high reserves permitted Trinidad and Tobago to bail out three domestic subsidiaries at a cost of US$850 million (about 3.8 percent of GDP). However, higher exposure combined with high debt levels in several countries in the rest of the Caribbean pose significant challenges in dealing with the problems created by the group's insurance subsidiaries, the Colonial Life Insurance Company (CLICO) and the British American Insurance Company (BAICO). Estimates of exposure to the two companies range as high as 17 percent of the Eastern Caribbean's combined GDP. The extent of the subsidiaries' financial distress varies across the region, with ECCU countries particularly vulnerable as funding gaps in that area account for larger shares of GDP.
- The Caribbean has also experienced an episode of Ponzi schemes. In February of 2009, the U.S. Securities and Exchange Commission charged Robert Allen Stanford and three of his companies for orchestrating a fraudulent,

multibillion dollar investment scheme. This scheme is at the center of the collapse of the Stanford Financial Group in Antigua and Barbuda and the intervention of the Bank of Antigua.

Both experiences point to the need to improve financial regulation and crossborder cooperation.

Policy Challenges: Ensuring Fiscal Sustainability amid Low Growth

The slow expected recovery in the tourism intensive commodity importers will test the resolve of policymakers, as existing vulnerabilities—combined with particularly elevated debt levels and limited financing—will impose strong constraints on policies despite prolonged recessionary conditions (Figure 2.11).

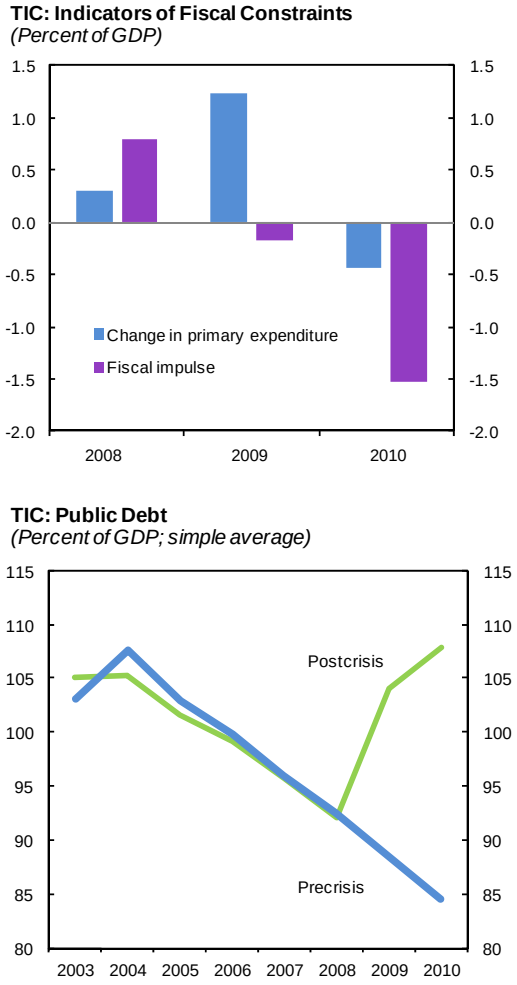
The foremost challenge for authorities will be to manage fiscal policy in 2010, including in some cases a further withdrawing of fiscal stimulus, despite the difficult economic environment. Cuts in average primary expenditure are expected to be in the order of 0.5 percent of GDP in 2010, with a withdrawal of fiscal impulse of about 1.5 percent of GDP on average for tourism intensive importers. Hence, although some limited fiscal relief was available in 2009, binding resource constraints will likely force a withdrawal of this stimulus in the future.

Given limited borrowing opportunities constraining fiscal policy, and fixed exchange rates limiting monetary policy, it is imperative to continue with structural reforms that unlock potential growth through higher productivity, as well as strengthen social safety nets that protect the most vulnerable and explore options for diversifying sources of growth.

The balance of risks faced by the tourism intensive commodity importers include a potential rebound in commodity prices, the dependence on bilateral concessional assistance from Venezuela's PetroCaribe, and further real shocks in 2011.[17] A high dependence on energy imports would put added pressures on external accounts, as higher oil and other commodity prices outweigh benefits from regional exports (such as sugar, bauxite, and bananas). PetroCaribe has helped finance part of the oil imports, and hence, any potential altering of the program's terms could open a new regional vulnerability.

Finally, the risk of further real shocks in 2010 is low, but could increase in 2011 as the stimulus is wound down in advanced economies. Knock-on increases in sovereign yields from the near doubling of OECD national debts in the coming years could generate renewed financial pressure on the tourism intensive importers. International investors are increasingly focusing on long-term debt sustainability

Figure 2.11. The global crisis has further inflated debt levels.



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

[17] For details on PetroCaribe, see Box 2.8 in the October 2008 *Regional Economic Outlook: Western Hemisphere*.

(see Box 2.1), and high debt levels in the tourism intensive commodity importers, where some of the world's historically most indebted countries reside, pose important challenges.[18] Furthermore, with weakening access to international sources of financing, recourse to domestic banks has accentuated existing vulnerabilities and hampered the prospects for a swift debt resolution process in some of the tourism intensive countries.

In this difficult environment, countries have engaged the IMF in new programs. The recent program in Jamaica is illustrative of the substantial support provided by the IMF in response to the global financial crisis.[19] Dominica, St. Lucia, and St. Vincent and the Grenadines also received IMF financial support through the IMF's exogenous shock facility, in response to the deteriorating external environment and its impact on tourism and GDP. In Grenada, the IMF recently approved a successor Extended Credit Facility program; and in St. Kitts and Nevis, the IMF has provided support through its Emergency Assistance for Natural Disasters facility. IMF staff also reached agreement on a program with the Antiguan authorities through a Stand-By Arrangement. Finally, the IMF's Caribbean Regional Technical Assistance Centre (CARTAC) launched a Financial Literacy Public Education program in response to the worldwide economic crisis. The ECCU has also stepped up crisis efforts, including the recently announced eight point transition program to stabilize the region, while efforts by the Caribbean Community (CARICOM) are ongoing to establish a College of Regulators to enhance regional financial surveillance.

[18] See IMF (2005) on debt in the Caribbean.

[19] Jamaica's 27-month Stand-By Arrangement (SBA) is for US$1.3 billion, half of which was disbursed upfront and earmarked for the Financial Sector Fund. This fund was established to provide liquidity support to financial institutions in the event of problems directly related to Jamaica's debt exchange. The debt exchange achieved a 99.2 percent participation rate, and led to interest savings of 3.5 percent of GDP and a 65 percent reduction in maturing debt payments over the next three years. The SBA paved the way for US$1.1 billion in financing from other multilaterals over the next two years.

Other Commodity Exporters (OCE)

Riding the Commodity Cycle

Higher commodity prices and the rebound in global trade are supporting the recovery in many of the other commodity exporting countries. Alongside these direct effects, indirect spillovers from the strong economic performance in one of the major regional economies—Brazil—are further helping growth among neighboring countries, including in Argentina, Bolivia, and Paraguay.[20] Hence, in considering the role of policies during the recent downturn, it is also important to recognize auspicious exogenous factors in the future.

As noted in the October 2009 *Regional Economic Outlook*, some of the countries in this group weathered the global crisis relatively well, while others suffered significant declines in activity and trend growth. For 2010, average growth for the group is expected to recover to 2.7 percent, after a decline of 0.6 percent in 2009. Nevertheless, a fast recovery in Bolivia and Paraguay contrasts markedly with still-contracting economic activity expected in Venezuela.

For 2010, average inflation for the group is expected to increase to 9.5 percent (from about 6.5 percent in 2009). In Bolivia, Paraguay, and to some extent Suriname, inflation could become a concern as demand picks up and growth gains momentum. The potential for resurging inflation is also underscored by double digit real increases in measures of domestic liquidity over the last twelve months, particularly in Bolivia and Paraguay. Moreover, although output gaps in these three countries remain negative, they are small on average. Importantly, while trend growth declined by about 1.2 percent since 2007 on average for the whole group—or double the decline in the rest of the LAC region—it remained broadly stable and robust in Bolivia, Paraguay, and Suriname, where

[20] The spillovers are also visible in Uruguay, which is discussed in the next section.

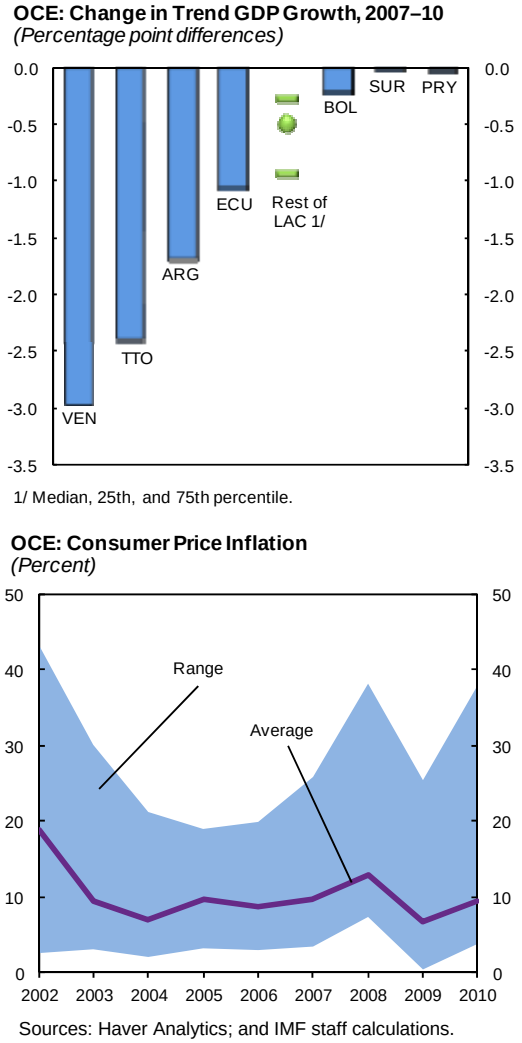
positive prospects are likely to fuel FDI in key sectors (Figure 2.12).[21]

In some countries in the other commodity exporters group, a deteriorating private sector investment climate has further aggravated supply constraints, while accelerating inflation. Should recent declines in trend output growth continue ahead, as supply expands slowly, some of these countries will face either stagflation or high inflation under even moderate output growth. In addition, some of these countries recently conceded investment opportunities to foreign firms while at the same time nationalizing foreign production assets. The higher premiums required to do business in volatile investment environments are likely to continue constraining growth and pushing up prices. Hence, for those affected countries, the need to enact structural reforms aimed at fostering and diversifying economic growth is increasing.

Policy Challenges: Avoiding the Perils of Procyclicality

Fiscal policy responses differed markedly during the crisis. On average, the group of other commodity exporters had a procyclical fiscal stance, with a negative fiscal impulse of about 1 percent of GDP. Some countries managed to implement countercyclical policies to help cushion the impact of the crisis.[22] But some of the other commodity exporters resorted to procyclical budget cuts to weather declines in public sector revenue exceeding 10 percent of GDP in 2009. In some countries, significant expenditure increases during commodity booms exhausted the possibility of smoothing the external shocks during the crisis (Box 2.7). In the future, effective demand management and long-term fiscal consolidation will be essential to avoid the procyclicality that has marred economic performance in the past.

Figure 2.12. Losses in trend output and inflation pressures differ markedly across other exporters.



Without conventional stabilizing policy options, some economies resorted to unorthodox measures, such as reserves transfers from central banks, nationalizations (of banks, pension funds, and private sector companies), and devaluation combined with multiple exchange rates to adjust to declining commodity revenues. Crisis management continued to reflect long-standing and predictable issues owing to the absence of a macroeconomic anchor or a cycle dampening policy framework.

[21] Estimates of trend output were obtained by setting the smoothing parameter of a Hodrick-Prescott (HP) filter at different values (6, 10, 100, and 250). To avoid the end-of-period bias, the filter was applied to series that include forecasts through 2011. See Chapter 4 of the October 2009 *Regional Economic Outlook: Western Hemisphere*.

[22] For instance, the fiscal impulse in Paraguay and Suriname exceeded 2 percent of GDP, and in Bolivia, sustained growth justified maintaining their prudent fiscal stance.

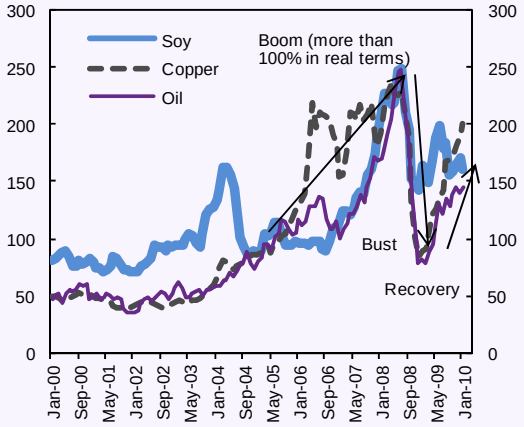
Box 2.7. Fiscal Performance and Commodity Cycles: Not a Standard Amusement Ride

Commodity prices are firming up, and countries with sizable commodity exports could receive significant windfalls. These windfalls can be temporary. Some countries in the region, however, have had a pervasive behavior of fiscal spending reacting strongly to commodity shocks.

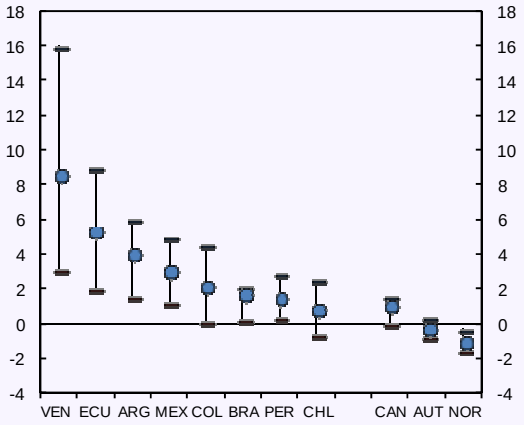
In this box, we assess the dynamic response of fiscal indicators to commodity price swings in the major commodity exporters of the LAC region and in some advanced commodity exporters. We estimated VARs based on quarterly data for the period 1994–2008.[1] We find that total revenues do not respond very differently across countries to commodity price shocks. However, estimates of primary expenditure responses suggest that, although some Latin American countries behave in a similar fashion to those high-income countries that have cemented fiscal prudence, others react strongly to commodity price shocks. At one end of the spectrum is Chile, which behaves similarly to the high-income commodity exporting countries, such as Australia, Canada, and Norway. At the other end of the spectrum is Venezuela, where expenditures rise even more than proportionally to revenues when faced with a commodity price shock.

The current crisis has shown that countries that had secured enough political consensus for the application of more prudent fiscal frameworks entered the crisis better prepared, in particular owing to the accumulation of large fiscal buffers during good times. This is particularly important for countries with a large proportion of commodity-related revenues in total revenues, as fiscal revenues in such countries tend to be more unpredictable, with commodity price gaps not necessarily coinciding with domestic output gaps.

Commodity Prices Boom, Bust, and Recovery 1/
(U.S. dollar; index 2005 = 100)



Primary Expenditure Response to Commodity Price Shocks 2/
(One year cumulative response to a 1 standard deviation commodity price shock)



Source: IMF staff calculations.
1/ Soy: Chicago soybean futures contract; Copper: LME spot price; and Oil: crude oil simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh.
2/ A standard deviation price shock goes from 8 percent for Brazil to 16 percent for Venezuela. Lines stand for 1 standard deviation confidence intervals.

Note: This box was prepared by Leandro Medina.

[1] Latin America: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Venezuela; high-income countries: Australia, Canada, and Norway. See Medina (2010).

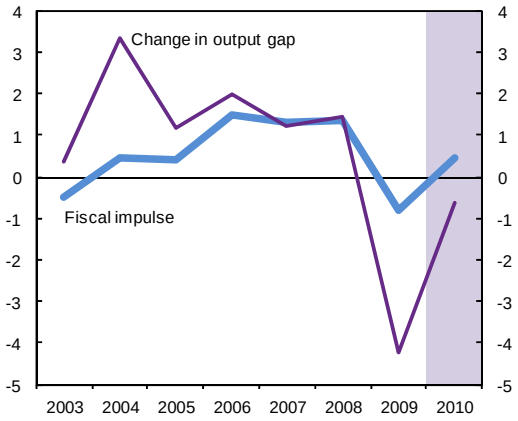
Going Back to Financial Markets?

The need to manage foreign exchange will be important in some of the other commodity exporters that currently have lesser access to external financial markets (Figure 2.13). The average current account balance for the whole group is expected to recover from 2.9 percent of GDP in 2009 to about 4.5 percent in 2010—an important source of external financing. Nevertheless, large amortization payments are coming due, in particular for Ecuador (more than 25 percent of existing reserves in 2010 and again in 2011).[23] In Venezuela, although amortization needs are smaller, foreign exchange pressures could arise from the continuing sizable capital outflows, which in 2009 exceeded US$20 billion, and is equivalent to two-thirds of central bank reserves or 40 percent of oil exports.

So far, foreign exchange management in some countries has included import restrictions, export taxes, financing from the Corporación Andina de Fomento (CAF), the Inter-American Development Bank (IADB) and other multilateral funds, and bilateral over-the-counter East Asian loans largely tied to natural resource exploitation. Nevertheless, some of the other commodity exporting economies will need traditional capital market inflows in the medium term. In some of these countries, tapping external markets may prove costly and difficult, as average sovereign spreads exceeded 600 basis points in 2009. Furthermore, potential sources of credit are limited because of outstanding disputes over past debt defaults.[24] In some countries, completion of the regular Article IV policy consultation with the IMF could facilitate access to international financial markets.[25]

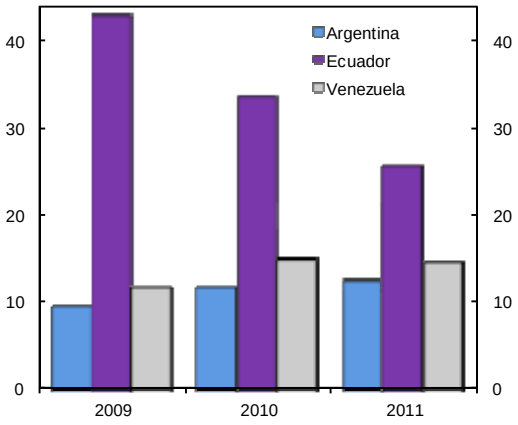
Figure 2.13. Procyclicality and external financing pressures pose important challenges.

OCE: Fiscal Impulse and Changes in Output Gap 1/
(Percent of GDP)

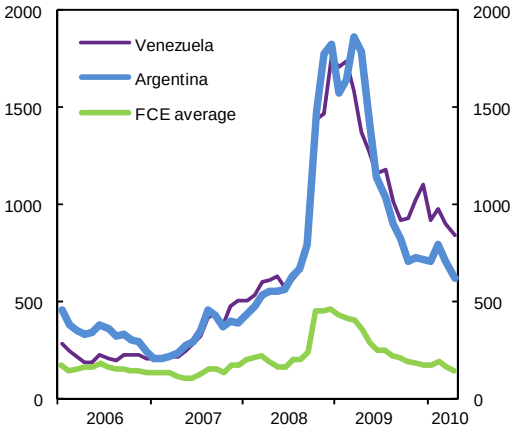


1/ Simple averages within group.

OCE: Amortization of Public Sector External Debt
(Percent of 2009 international reserves)



OCE: EMBI Spreads
(Basis points)



Sources: Bloomberg, L.P.; national authorities; and IMF staff calculations.

[23] Close to one-half of Ecuador's 2009 amortization consisted of buybacks of defaulted external debt.
[24] The Congress of Argentina reopened the debt restructuring process, and an offer has been made for bond holdouts.
[25] Policy consultations between the IMF and each member are set forth in Article IV of the IMF Articles of Agreement. Currently, there are only four nonprogram member countries that have not had an Article IV consultation with the IMF within the regular period: Argentina, Ecuador, Somalia, and Venezuela.

Other Commodity Importers (OCI)

Traveling the Middle Ground

Not without some heterogeneity, a gradual recovery is under way in the other commodity importers. Economic activity seems to have bottomed out by the end of 2009, with growth picking up most strongly in the Dominican Republic, Panama, and Uruguay. In El Salvador and Honduras, economic activity finally stopped contracting (Figure 2.14). In Haiti, the powerful earthquake had devastating effects, with sizable human and economic losses (see Box 2.3). In 2010, average growth in the whole group is expected to rise to about 2 percent, from 0.8 percent in 2009.[26]

The external environment for other commodity importing countries remains mixed. Faster than previously forecasted U.S. growth is providing some impetus to exports. However, workers' remittances continue to post significant declines on an annual basis, reflecting weak employment in the U.S., particularly for Hispanics and in the construction sector. The pickup in commodity prices is also a negative shock for these countries, with energy import bills starting to rise. All these factors combined are projected to widen the average external current account deficit to 7 percent of GDP in 2010, from about 4 percent of GDP in 2009.

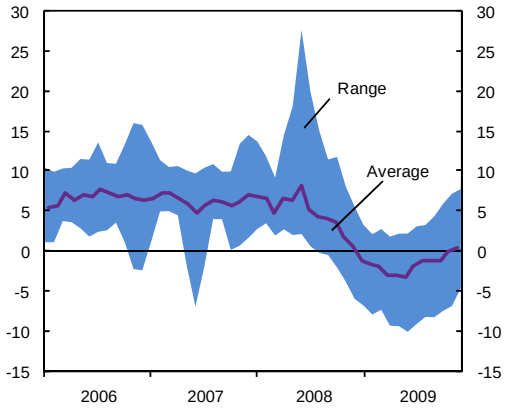
Credit growth has been sluggish. Bank deposits keep growing, and lending rates have declined, signaling continued normalization in domestic financial markets. Credit, however, is picking up modestly and only in a few countries (for example, Dominican Republic and Uruguay). Moreover, cross-border bank lending continued to contract through the third quarter of 2009.

Notwithstanding the sharp deceleration in growth, financial systems in other importing

[26] Economic indicators for Haiti are not averaged with the rest of the other commodity importers, given the sizable impact of the earthquake.

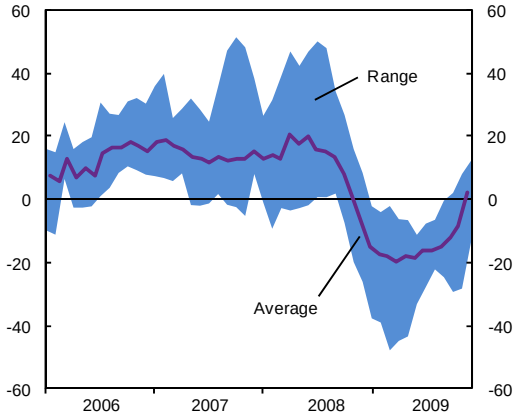
Figure 2.14. A gradual recovery is under way amid a mixed external environment.

OCI: Economic Activity Measures 1/
(12-month percent change in 3-month moving average)



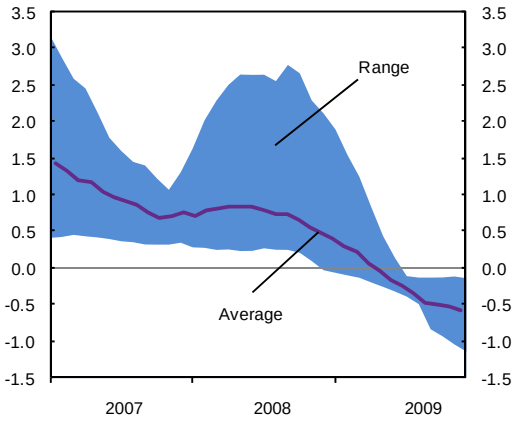
1/ Economic activity index for Costa Rica, Dominican Republic, El Salvador, Guatemala, Hondouras, Nicaragua, and Panama; manufacturing production for Uruguay; no indicator available for Guyana and Haiti.

OCI: Export Values 1/
(12-month percent change in 3-month moving average)



1/ Excludes Guyana and Haiti.

OCI: Remittances 1/
(Percent of GDP; rolling 12-month sum)



1/ Excludes Guyana, Haiti, and Uruguay.

Sources: National authorities; and IMF staff calculations.

countries weathered the global crisis relatively well overall. Financial soundness indicators point to some deterioration in credit quality, but banks' capital adequacy ratios remain at comfortable levels.

Policy Challenges: Replenishing Buffers

Downside risks in the global recovery in 2011 and beyond call for prudent macroeconomic policies in the other commodity importing countries, even if growth does not recover at the same pace as in some other countries in the region.

In many countries, fiscal policy provided needed support to economic activity during the peak of the crisis (Figure 2.15). On average, other commodity importers implemented a fiscal impulse of about 1 percent of GDP in 2009.[27] But buffers have been mostly depleted. In most countries, public debt levels are not alarmingly high, but limited financing possibilities constrain options for substantial further stimulus in 2010. Any remaining fiscal space would be more appropriately saved in case downside risks to global growth materialize down the road. Countries where growth is already on strong footing (for example, Uruguay) would benefit from a tighter fiscal stance.

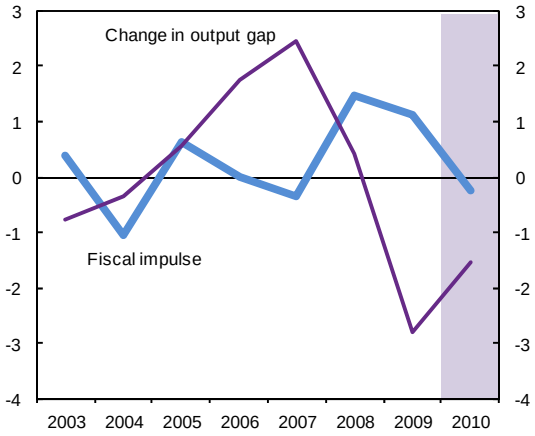
Substantial economic slack and low commodity prices contained inflationary pressures during 2009. However, inflation has started to pick up in recent months. In many cases, the pickup in inflation is being driven by high food and fuel prices, whereas core inflation has been stable. In Uruguay, however, inflation expectations and core inflation are edging above the inflation target range.

For 2010, inflation is projected to increase to about 5 percent on average. However, the pass-

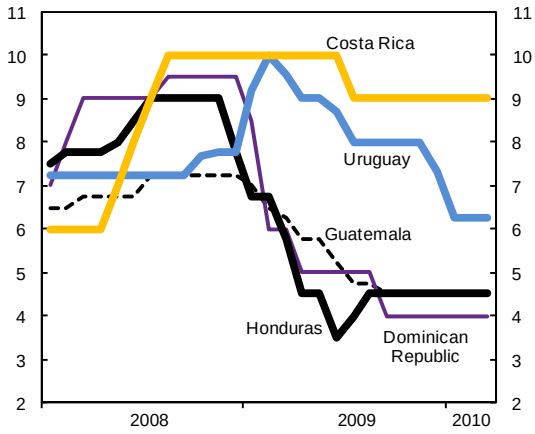
[27] There were significant differences, with a fiscal impulse of more than 3 percent of GDP in Costa Rica and a negligible one in Nicaragua.

Figure 2.15. Policy buffers need to be replenished given global downside risks in 2011 and beyond.

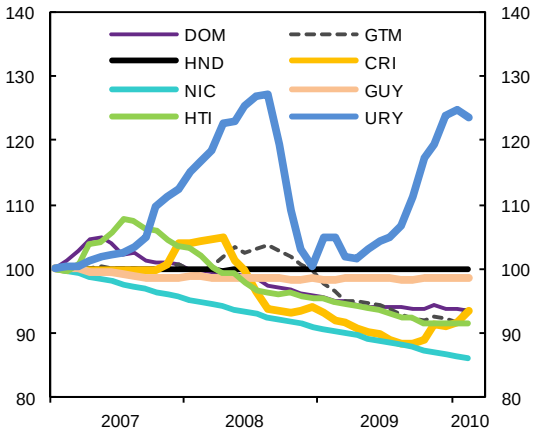
OCI: Fiscal Impulse and Changes in Output Gap
(Percent of GDP; simple average within groups)



OCI: Monetary Policy Rates
(Percent)



OCI: U.S. Dollar Exchange Rate Indices 1/
(January 2007 = 100)



1/ Increase denotes appreciation.
Sources: National authorities; and IMF staff calculations.

through from commodity prices was significant in the past. With commodity prices recovering, there could be upside risks to inflation, particularly in those countries where domestic demand is growing relatively fast.

Moving toward more flexible exchange rates, where possible, would serve as a cushion against potential future external shocks. In some countries, limited exchange rate flexibility constrained the room for more aggressive cuts in monetary policy rates during the crisis.

The IMF continues to engage fully in the region. In Costa Rica, El Salvador, and Guatemala, high access Stand-By Arrangements have bolstered international confidence during the global crisis. The Dominican Republic also signed a high access Stand-By Arrangement to support reserves, countercyclical fiscal stimulus, and social safety nets. In Honduras, the IMF has reengaged in discussions after the international community recognized the newly elected president, and is also continuing work with Nicaragua on its Extended Credit Facility. The IMF also made substantial efforts in working with Haitian authorities after the devastating earthquake in January (Box 2.3).

Concluding Remarks

The LAC region is recovering from the global financial crisis somewhat faster than anticipated. Still, there is considerable heterogeneity across countries. While growth in many of the region's commodity exporters is gaining momentum, it is proceeding at a weak pace for other countries in the region, especially those more reliant on tourism from advanced economies.

For many of the financially integrated commodity exporters, the challenge in coming years will be managing the upswing of the business cycle. Countries where output gaps are closing more rapidly will need to move to a tightening mode ahead of others. Easy external financial conditions and the resumption of capital inflows pose additional challenges. Careful macroeconomic management will be critical to mitigate risks of boom/bust cycles. In this context, a policy mix favoring a tighter fiscal stance would be appropriate, helping to mitigate risks from overheating while also stemming currency appreciation pressures.

The weak recovery in the tourism intensive commodity importing countries will test the resolve of policymakers, as elevated debt levels and limited access to financing will impose difficult policy tradeoffs. Efforts to protect vulnerable groups and unlock growth potential through structural reforms should be priorities in the policy agenda.

For some of the other commodity exporting countries, policy challenges will include avoiding the perils of procyclicality, anchoring macroeconomic policies, and regaining access to financial markets. Other commodity importing countries are gradually recovering, boosted by higher exports, but inflows from remittances continue to contract. In many of these countries, the room for macroeconomic stimulus has been almost depleted and should be prudently saved for downside risk scenarios.

The LAC region has continued to benefit from the IMF's lending facilities. By April 2010, the IMF had committed 42 billion SDRs to countries in the region, an increase of 2 billion since the last edition of the *Regional Economic Outlook: Western Hemisphere*. This represents more than 35 percent of IMF total commitments to its members around the world, in large part reflecting access under the IMF's new Flexible Credit Line (FCL) received by Colombia and Mexico.[28] Owing to strong external positions, most countries in the LAC region have not drawn on their IMF loans, but treated them as precautionary to boost international confidence throughout the global crisis and the ongoing recovery.

[28] The FCL provides large and up-front financing without ex post conditions to members with very strong fundamentals and policies. For details, see Box 2.2 of the October 2009 *Regional Economic Outlook: Western Hemisphere*.

3. Challenges Arising from Easy External Financial Conditions

Although easy external financial conditions are overall good news for emerging markets, they come with risks that need to be managed. Past episodes of easy conditions often have led to sustained accelerations of domestic demand and significant real appreciation in emerging market countries, sometimes also accompanied by fast credit growth. Importantly, responses to easy conditions have varied in degree, reflecting differences in policies as well as structural features. With interest rates of major advanced economies and global risk aversion both likely to remain low for a sustained period, the challenge for policymakers is to conduct macroeconomic and prudential policies that make the most out of the enhanced financing possibilities while reducing the likelihood of boom-bust cycles. Policies on many fronts will be relevant, with exchange rate flexibility, fiscal policy, and macroeconomic prudential regulation being among the most important in insulating against unwanted demand and credit booms.

What Are the Concerns?

External financial conditions for emerging market economies with strong fundamentals are likely to be "easy" for some time, with low interest rates, low spreads, and ready market access. As discussed in Chapter 1, the expected subpar recovery of advanced economies points to an extended period of loose monetary policy, and financial markets expect that G3 policy interest rates will increase only gradually. Long-term interest rates on G3 risk-free government securities also are likely to remain low, unless fiscal risks gain new importance in the eyes of investors.

At the same time, with effects of the global financial crisis subsiding, global risk aversion has fallen back sharply, and the spreads charged on "risky" assets already have returned to near their historic lows, at least for investment grade assets. As perceptions of risk decline, investors facing low returns in advanced economies will naturally look for yield in emerging markets.

This chapter examines the diverse set of macroeconomic and financial concerns that arise during a prolonged period of easy external financial conditions. The issues and risks are wide-ranging and interrelated, and critically contingent on policy responses.

These various concerns, analyzed over the course of this chapter, can be summarized as follows.

Easy external financial conditions have a strong potential to trigger accelerated growth of domestic demand. Low external interest rates and greater access to foreign finance can directly stimulate both consumption and investment. The boost to demand will be reinforced if foreign investors bid up asset prices in emerging markets, increasing their residents' wealth. In turn, growth of domestic demand—in excess of output growth—will drive a widening current account deficit and an appreciation of the real exchange rate (other things constant). These forces result in large inflows of foreign capital—readily available at low cost, but not forever—that create their own set of macroeconomic issues and prudential risks, especially if accompanied by a parallel boom in domestic credit. Booming demand and credit could lead to dynamics that end in recession or even crisis. This fate is not inevitable, of course, as policies can be decisive as to whether such risks build or stay contained.

Among the issues raised by easy external financial conditions, implications for economic growth are often on the minds of policymakers. The potential concern is that real appreciation will reduce the profitability of the traded goods sector and eventually also the volume of net exports—in turn with negative implications for growth. Of course, in the particular

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Note: This chapter was prepared by Jorge Iván Canales-Kriljenko with significant contributions to the empirical analysis from Herman Kamil, Leandro Medina, and Bennett Sutton.

context of booming domestic demand, contractions in net exports need not necessarily affect the overall level of activity.[29] A very different concern relates to the supply side: real appreciation, though temporary, could damage a country's economic growth trend in the longer term, if the sectors that lose some of their profitability play a special role in productivity growth. This concern is akin to "Dutch disease."

This chapter sheds light on the relevance of these risks by analyzing the experiences of a group of Latin American countries—compared with other countries—and by surveying the relevant literature. In light of the lessons from these past experiences, the chapter concludes with a review of policy options to manage the risks that would emerge in the expected new episode of sustained easy external financial conditions.

A central message of this chapter is that policies can act either to mitigate or to amplify the risks arising from episodes of easy external financial conditions. For example, flexible exchange rates can serve to choke off foreign inflows, whereas systematic efforts to limit (nominal) appreciation can stimulate capital inflows and the expansion of credit. Fiscal policy is also relevant, as governments can choose to partially offset surging private demand—or instead choose to accelerate their own expenditure amid easy financing opportunities and booming tax bases. Macroprudential and other policies can also play important roles.

The empirical investigations here, using several methods, focus especially on the experiences of two groups of countries. One is the "FCE" group of financially integrated commodity exporting countries identified in Chapter 2: Brazil, Chile, Colombia, Mexico, and Peru. The second is a comparator group of relatively small advanced economies that are also commodity exporters: Australia, Canada, New Zealand, and Norway, or "ACE4," all of which permit a very high degree of exchange rate flexibility—and which have been relatively successful in managing episodes of easy external financial conditions. Reference is also made to experiences of countries in Asia, and in Eastern and Central Europe.

Booming Domestic Demand . . .

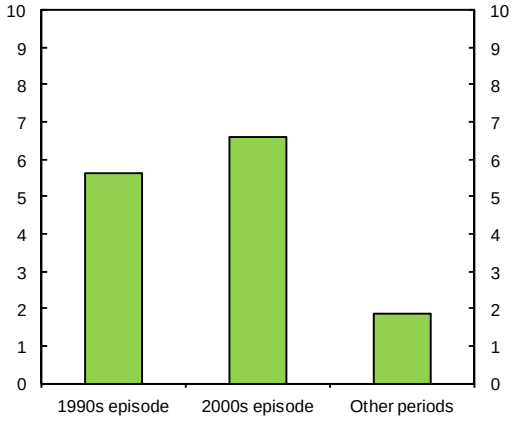
Looking over the last twenty-five years, the two episodes of easy external financial conditions (Box 3.1) coincided with accelerated demand growth. FCE domestic demand grew on average 4 percentage points per year faster than in other periods (Figure 3.1). This pickup was somewhat greater in the 2000s episode (when FCE domestic demand also got a boost from rising commodity export income—see below).

Although this boom in FCE domestic demand was also associated with a marked pickup in GDP growth, even beyond trend, demand outstripped production in both episodes, and therefore real imports surged. The biggest acceleration of demand was in fixed capital formation (by 7 percentage points), while private consumption picked up by 3 points and government consumption by 2 points.

On average across the two episodes of easy conditions, domestic demand in FCE picked up

Figure 3.1. Domestic demand in the FCE countries grew faster during earlier periods of easy external financial conditions.

FCE: Domestic Demand Growth under Easy External Financial Conditions
(Annual percent change, average over the period)



Source: IMF staff calculations.

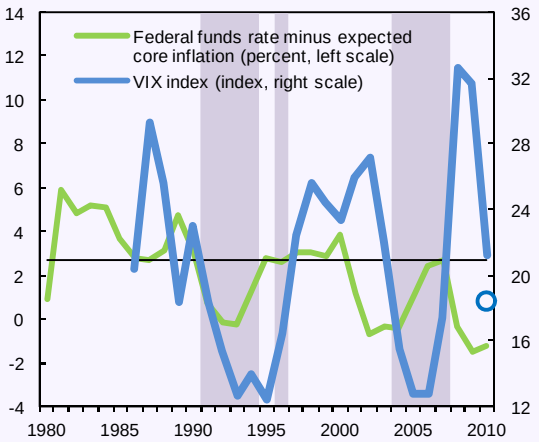
[29] Depending on the monetary policy framework, adjustments of policy interest rates could help offset concerns about full employment. Moreover, in inflation targeting regimes, policy interest rates may need to be cut amid the downward effect of currency appreciation on inflation.

Box 3.1. When Are Financial Conditions "Easy"?

Easy external financial conditions are here defined as years of simultaneously low real short-term interest rates and global risk aversion. Real interest rates are measured as the U.S. federal funds rate less expected core U.S. inflation. The indicator of global risk aversion is proxied by the Chicago Board of Options Exchange Volatility Index (VIX), with low values of the VIX usually associated with lower spreads. These two indicators are considered low when below their median annual values computed over the last twenty-four years (1986–2009).

According to these joint criteria, external financial conditions were "easy" during two multiyear episodes: 1991–96 (excluding 1995) and 2004–07. Real interest rates and global risk aversion were both broadly equal across the two episodes, on average. In the second episode, however, commodity prices increased considerably, and world growth was much faster than in the 1990s episode. At mid-April 2010 values of real interest rates and the VIX, external financial conditions were easy again.

Episodes of Easy External Financial Conditions 1/
(In percent and index)



Source: Haver Analytics.
1/ Shaded areas show periods when low real interest rates coincide with low global risk aversion. The black line represents medians over 1986–2009. Data for 2010 are averages through February (mid-April VIX values are lower, about 18, blue circle).

Note: This box was prepared by Jorge Iván Canales-Kriljenko.

more than in emerging market economies of other regions, and also more than in the ACE4 group of advanced commodity exporters. A closer look at each period, however, shows also marked pickups of demand in Asian countries in the 1990s episode, and in both European and ACE4 countries in the 2000s episode (Table 3.1).

A multivariate VAR analysis confirms that FCE's domestic demand has systematically responded, positively and considerably, to lower external real interest rates and greater risk tolerance in global financial markets. (Importantly, this result holds after controlling for the positive effects of external demand and commodity prices.)

In this VAR analysis, these two indicators of external financial conditions together explain about 35 percent of FCE domestic demand fluctuations over a year. For the ACE4 countries, this sensitivity also exists, but the corresponding share is only about 20 percent. Figure 3.2 shows that FCE's demand response to shocks of a given size is greater than for the ACE4, for both of these aspects of financial conditions.

This greater sensitivity of FCE to external financial conditions could reflect a variety of reasons. These countries may have more prevalent financing constraints, both at the household and firm level, that loosen at times of easy financial conditions. Declines in global risk aversion may expand financial possibilities to a greater degree in Latin American countries, as these are considered more risky than those in the ACE4.

Finally, policy frameworks and policy responses are relevant. For example, government spending in the ACE4 countries has been much less responsive to easy conditions than in FCE, where a pickup of public spending contributed to the expansion of overall domestic demand. In the same vein, exchange rates have been more flexible in the ACE4, as will be discussed later.

Table 3.1. Emerging Markets: Selected GDP Components under Easy External Financial Conditions 1/2/
(Percent a year, period average)

	Easy External FC Subperiods		Mean	Difference in Means (Statistical significance)		
	1990s (A)	2000s (B)	Other years (C)	(A-C)	(B-C)	(A-B)
Real demand growth						
FCE	5.6	6.6	1.9	**	**	
Asia	6.8	5.9	4.2	**	**	
Europe (flexible)	0.3	5.3	1.7		**	**
Europe (fixed) 3/	…	11.0	2.2	…	**	…
Middle East and Africa	5.6	5.4	3.2		**	
ACE4	1.9	4.8	2.8		**	**
Real private consumption growth						
FCE	4.6	5.7	2.1	**	**	*
Asia	6.2	5.5	4.2	**	**	
Europe (flexible)	1.3	5.2	1.8		**	**
Europe (fixed) 3/	…	10.8	1.6	…	**	…
Middle East and Africa	6.6	5.0	3.8		*	
ACE4	2.3	4.4	2.7		**	**
Real fixed capital formation growth						
FCE	6.0	12.4	1.7	**	**	**
Asia	5.5	7.4	2.7	**	**	
Europe (flexible)	-0.7	9.8	1.0	*	**	**
Europe (fixed) 3/	…	16.4	5.2	…	**	…
Middle East and Africa	1.2	5.0	0.6		**	**
ACE4	2.7	8.0	2.8		**	**
Real government consumption growth						
FCE	5.4	4.4	3.0	*	*	
Asia	4.9	5.6	4.4		*	
Europe (flexible)	1.9	2.6	2.0			
Europe (fixed) 3/	…	3.2	1.6	…		…
Middle East and Africa	4.6	3.1	3.7			
ACE4	1.8	3.0	3.0	**		**
Memorandum items:						
Real import growth						
FCE	16.1	13.8	2.7	**	**	
Asia	12.0	11.4	6.2	**	**	
Europe (flexible)	22.1	11.9	5.3		**	
Europe (fixed) 3/	…	14.6	3.9	…	**	…
Middle East and Africa	5.6	10.7	4.0		**	*
ACE4	5.5	8.1	4.3		**	**
Real GDP growth						
FCE	4.6	5.4	2.2	**	**	
Asia	6.6	6.1	4.8	**	**	
Europe (flexible)	-0.4	4.7	1.8	**	**	**
Europe (fixed) 3/	…	8.3	2.2	…	**	…
Middle East and Africa	5.2	5.4	3.4		**	
ACE4	2.8	3.1	2.6		**	

Source: IMF staff calculations.

** Significant under a standardized normal statistic at 5 percent probability; * significant at 10 percent probability.

1/ Based on annual data 1986–2008. Easy liquidity conditions are defined as those with low VIX and federal funds rates. The years are 1991–94, 1996, and and 2004–07.

2/ Countries include Brazil, Chile, Colombia, Mexico, and Peru in Latin America; India, Indonesia, Korea, Malaysia, Philippines, and Thailand in Asia; Czech Republic, Hungary, Poland, and Turkey in Europe (flexible); Bulgaria, Estonia, Latvia, and Lithuania in Europe (fixed); Egypt, Israel, Lebanon, Pakistan, South Africa, and Tunisia in the Middle East and Africa; and Australia, Canada, New Zealand, and Norway, among advanced commodity exporters.

3/ Only the 2000s epidose, owing to data availability.

. . . And Currency Appreciation . . .

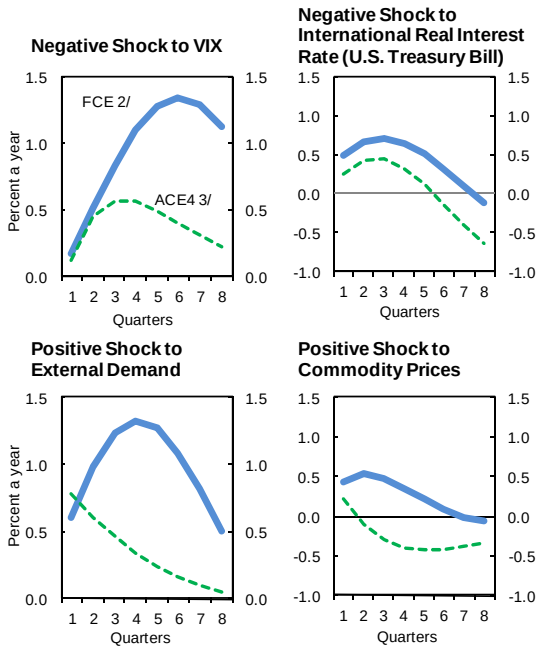
Significant real appreciation took place in Latin America during earlier episodes of easy external financial conditions (Figure 3.3). The appreciation for the FCE was on average 4 percentage points a year higher than in other periods (more in the second episode). Real appreciation was also prevalent in the ACE4 and in the other emerging market economies, particularly in the 2000s episode.

Econometric analysis confirms that the real exchange rate responds to external financial conditions, even after controlling for the effect of commodity prices (Figure 3.4). Both lower VIX and lower international interest rates tend to appreciate the REER. Moreover, the reaction appears to be larger in the FCE countries than in the ACE4 countries. Episode analysis is consistent with this observation. For example, during the 2000s episode, currency appreciation in the FCE averaged 4.8 percent, whereas in the ACE4 it averaged 3.4 percent. This difference in behavior of real exchange rates likely reflects the greater sensitivity of FCE to external financial conditions rather than exchange rate policy (on the whole, the ACE4 have practiced less foreign exchange market intervention than the FCE have).

The joint occurrence of domestic demand booms and real appreciation during episodes of easy external conditions is not surprising. Both respond to a similar set of factors. Moreover, an expansion of domestic demand (in excess of potential output growth) will bid up the relative price of nontradable goods, leading to a real exchange rate appreciation. In the other direction, currency appreciation may boost domestic demand through financial wealth effects. Currency appreciation could further boost domestic demand if it shifted income from firms' profits to the wages of workers with a higher propensity to spend.

Previous literature has confirmed the importance of domestic demand as a determinant of the REER by identifying the effects of government consumption in particular. A typical finding is that an increase in such expenditure by 1 percentage

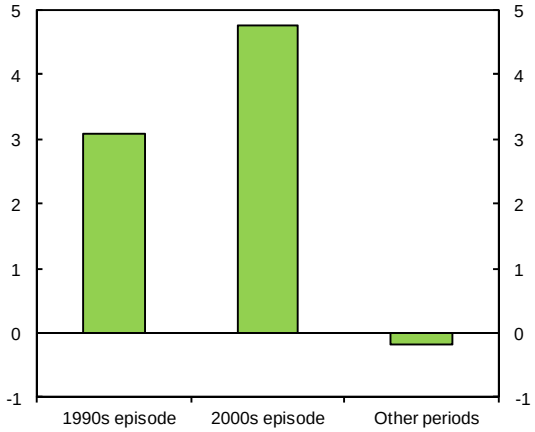
Figure 3.2. The systematic response of domestic demand to external conditions has been stronger in the FCE countries than in the ACE4 countries.1/



Sources: Haver Analytics; and IMF staff calculations.
1/ Each chart shows the dynamic response of domestic private demand (expressed in percentage change, year over year) to a 1-standard deviation shock to the VIX and real interest rates (expressed in percent per year) and 1-standard deviation shock to external demand and commodity prices expressed in percentage change, year over year). The impulse response function is based on a vector autoregression model, estimated over the period 1994Q2 and 2009Q2, which includes external domestic demand, VIX, interest rates, commodity prices, and private domestic demand.
2/ Simple average of Brazil, Chile, Colombia, Mexico, and Peru.
3/ Simple average of Australia, Canada, New Zealand, and Norway.

Figure 3.3. Earlier episodes of easy money also coincided with significant real appreciation in the FCE countries.

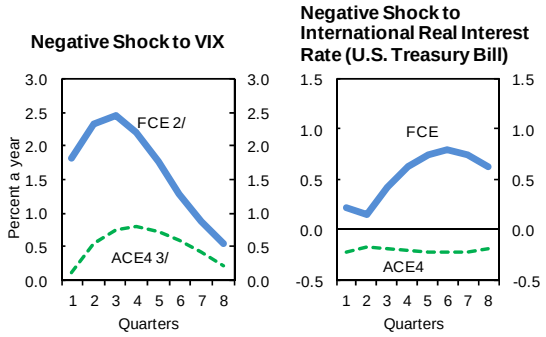
FCE: Currency Appreciation Under Easy External Financial Conditions 1/
(Annual percent change, average over the period)



Source: IMF staff calculations.
1/ Both increases are statistically significant.

Figure 3.4. Real exchange rates respond more to external financial shocks in the FCE than in the ACE4 countries.

Response of Real Exchange Rate to Global Financial Conditions 1/



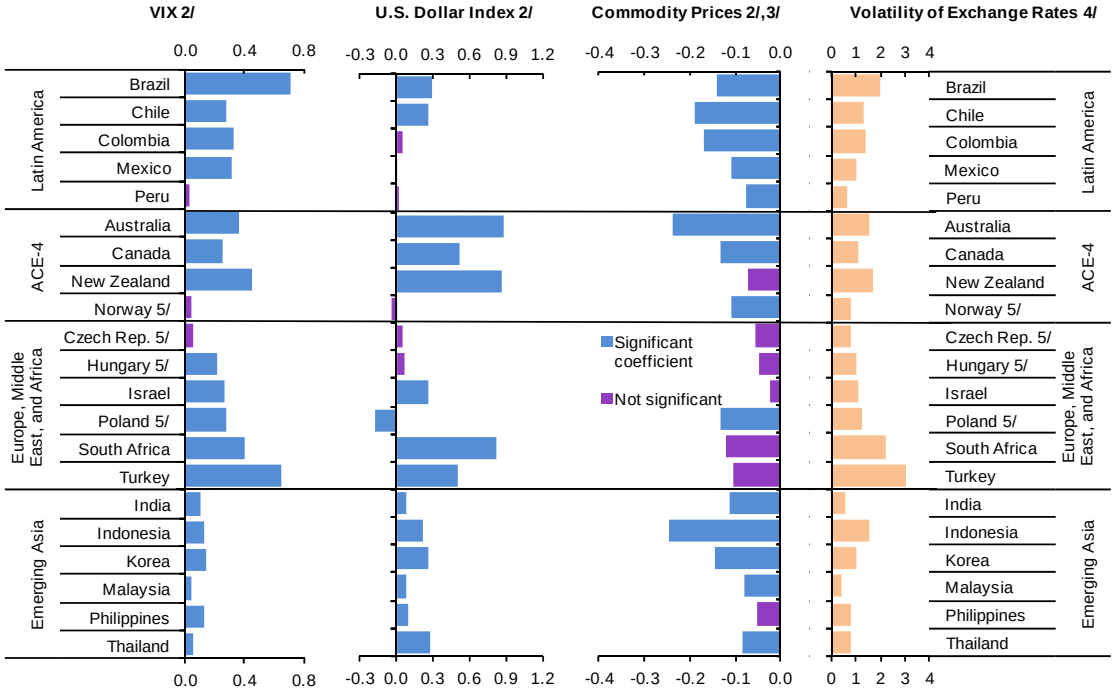
Sources: IMF, *International Financial Statistics*; Bloomberg, L.P.; Haver Analytics; and IMF staff calculations.
1/ The figure shows the dynamic response of the real effective exchange rate to a 1 standard deviation shock to the VIX and real interest rates (expressed in percent per year). The impulse response function is based on a vector autoregression model, estimated over the period 1994Q2 and 2009Q2, which includes external domestic demand, VIX, interest rates, commodity prices, private domestic demand, and the real exchange rate.
2/ Simple average of Brazil, Chile, Colombia, Mexico, and Peru.
3/ Simple average of Australia, Canada, New Zealand, and Norway.

point of GDP is associated with appreciation of the real exchange rate of about 2½ percent (Isard and Faruqee, 1998; and Lee and others, 2008).

Sensitivity to global financial conditions is also apparent in how *nominal* exchange rates respond to short-run movements of the VIX. Currencies of many emerging markets—and also of some smaller advanced economies—tend to appreciate when the VIX declines. Many currencies also tend to appreciate when certain commodity prices rise; for example, this is clearly the case for most currencies of the FCE and ACE4 countries, reflecting the importance of commodity exports to their economies (Figure 3.5). Studies of the longer-run determinants of *real* exchange rates have confirmed the importance of the commodity terms of trade for many countries.

Figure 3.5. Nominal exchange rates systematically react to information contained in the VIX index (as a proxy for global risk aversion) and commodity prices, after controlling for the value of the U.S. dollar.

FCE and Other Regions: Sensitivity of Exchange Rates to Global Shocks 1/



Sources: Bloomberg, L.P.; and IMF staff calculations.
1/ Regressions of weekly changes (Friday over Friday), from January 2000 to January 2010, excluding the period September 1, 2008 to May 31, 2009. Exchange rate increases (decreases) denote depreciation (appreciation).
2/ Country-specific coefficient times 1 standard deviation of either the VIX, U.S. dollar index, or commodity prices. Standard deviations expressed as log changes times 100.
3/ Change in exchange rates regressed on changes in the VIX, U.S. dollar index, and each of an overall commodity price index, a metals price index, food price index, and the WTI oil price index. Commodity price index for each country selected as the specification with the highest R-squared: composite index for Brazil, Colombia, India, Indonesia, Israel, Korea, Malaysia, Mexico, New Zealand, and the Philippines; metals index for Australia, Peru, South Africa, Thailand, and Turkey; copper price for Chile; oil price index for Candad, Czech Republic, Hungary, Norway, and Poland.
4/ Standard deviation of weekly log change in local currency per U.S. dollar exchange rate, times 100.
5/ Dependent variable defined as local currency per euro.

. . . May Lead to Vulnerabilities . . .

Large increases in domestic demand could end badly if the economy is forced to adjust abruptly. The increases in demand are often partly financed by capital inflows and lead to current account deficits. The associated dangers include financial crises triggered by sudden stops and current account reversals, whose effects may be aggravated by excessive financial risks that may be taken during the demand upswing.

An extensive literature on "early warning indicators" and determinants of crises highlights current account deteriorations, large credit growth, and exchange rate misalignment, among the most important developments that should trigger alarm. Balance-sheet exposures of the corporate and financial sectors, such as currency or maturity mismatches, could aggravate the impact (Table 3.2).

Some well-known financial crises have occurred after periods of easy external financial conditions, as was the case, for example, in the Latin American crisis that followed the easy episode that ended in the 1982 financial crisis, the Asian crisis that followed the 1990s episode, and those in many European countries that followed the 2000s episode. In contrast, the FCE countries analyzed here escaped a financial crisis following this last episode—an unsurprising outcome in light of their stronger vulnerability indicators.

How did vulnerability indicators evolve during the earlier two episodes of easy financial conditions?

- In both episodes, the region experienced rising capital inflows. In particular, the increase in crossborder liabilities in FCE was faster than at other times, including through foreign direct investment (FDI) and portfolio flows. The latter, however, were notably smaller on average in the 2000s episode. At the same time, FCE also tended to accumulate crossborder assets during these episodes, particularly in the 2000s episode. Thus, on net, the increase in capital inflows was relatively smaller in the second episode than in the first episode (Box 3.2).
- Somewhat surprisingly, current account/GDP ratios in FCE did not worsen significantly despite the noted pickups of domestic demand and import volumes (Table 3.3). Although the current account deficit worsened slightly during the first episode, the current account balance actually improved during the episode of the 2000s, which is explained by the good fortune of large terms-of-trade gains. The real exchange

Table 3.2. A Glimpse at the Literature on Early Warning Indicators, Sudden Stops, and Current Account Reversals

Authors	Main Messages
Milesi-Ferretti and Razin (1998)	Low reserves and unfavorable terms of trade can trigger current account reversals and currency crises.
Kaminsky, Lizondo, and Reinhart (1998)	Some indicators can warn in advance on the possibility of a currency crisis. Early warning indicators include current account deficits, overvaluation, high credit growth, reserve losses, low export growth, and reserves to broad money (levels and growth rate), among others.
Berg, Borensztein, Milesi-Ferretti, and Pattillo (1999)	Short-term debt/reserves are also early warning indicators of currency crises. Authors focus on overvaluation, current account deficits, reserve losses, and low export growth as other early warning indicators.
Frankel and Cavallo (2004)	The probability of a sudden stops increases with the size of the initial current account deficit to GDP. It decreases with the openness of the country.
Edwards (2005)	The current account deficit is a key determinant of reversals.
Mendoza and Terrones (2008)	All emerging market crises have been associated with credit booms, although not all credit booms end up in a crisis.

Table 3.3. Selected Balance of Payments Accounts under Easy External Financial Conditions 1/2/
(Percent of previous year GDP, period average)

	Easy External FC		Other	Difference in Means (Statistical significance)		
	1990s	2000s	years			
	(A)	(B)	(C)	(A-C)	(B-C)	(A-B)
FCE						
Net private capital inflows	**5.6**	**2.6**	**1.5**	**	**	**
Of which:						
Private crossborder liabilities	6.3	7.0	2.6	**	**	
Private crossborder assets	-0.8	-4.4	-1.1		**	**
Other inflows (net)	0.1	-1.1	1.9			
Net international reserve accumulation	**2.3**	**2.3**	**0.5**	**	**	
Current account balance	-3.4	0.8	-2.9	**	**	**

Sources: IMF, *International Financial Statistics;* and IMF staff calculations.
* significant at the 10 percent probability
** Significant under a standardized normal statistic at 5 percent probability.
1/ Based on annual data 1986–2008. Easy external financial conditions years are identified as 1991–94, 1996, and 2004–07.
2/ Brazil, Chile, Colombia, Mexico, and Peru.

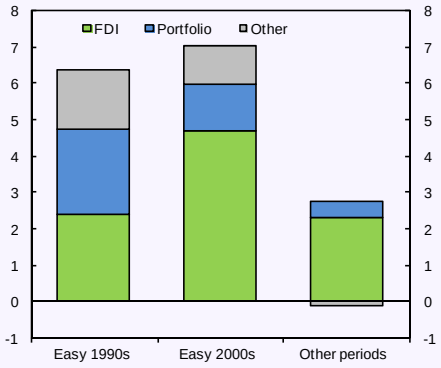
Box 3.2. Capital Inflows when External Financial Conditions Are Easy

Private capital inflows (gross and net) increased substantially in past episodes of easy external financial conditions. In both episodes, Latin American crossborder liabilities rose at roughly the same rate (about 6½ percent of previous year GDP on average). Nevertheless, crossborder assets of Latin American residents rose significantly faster during the second episode. As a result, net capital inflows were larger in the first episode (5.6 percent of GDP) than in the second (2.6 percent of GDP).

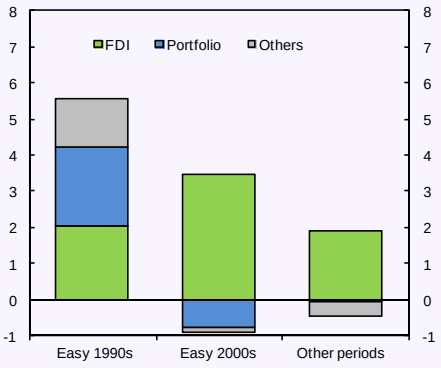
The composition of the crossborder assets and liabilities changed from one episode to the other. On the crossborder liability side, the share of foreign direct investment (FDI) in Latin America rose, and that of nonresident portfolio investments in the region fell, during the 2000s compared with the 1990s episode. On the crossborder asset side, portfolio investments rose much faster than FDI abroad and even exceeded the increase in crossborder portfolio liabilities. Given this, the region arguably faced lower risks of sudden stops during the second episode than during the first episode because FDI in the region is typically more stable than portfolio flows, and portfolio assets are more liquid than FDI.[1]

How did these flows compare with other regions? All regions experienced a large increase in inflows during the episodes of easy external financial conditions.[2] The net increase, however, was significantly higher during the 1990s in Latin America and Asia and during the 2000s in Emerging Europe. The ACE4 countries actually experienced net outflows. Gross inflows, however, increased markedly during the second episode across the board, which is consistent with the increased financial globalization observed during the last decade. The ACE4 experienced the largest increase in gross inflows during the second episode, but even higher gross outflows. As in the FCE region, gross FDI inflows increased across the board. In contrast to the experience of FCE, however, gross portfolio inflows increased markedly elsewhere during the second episode.

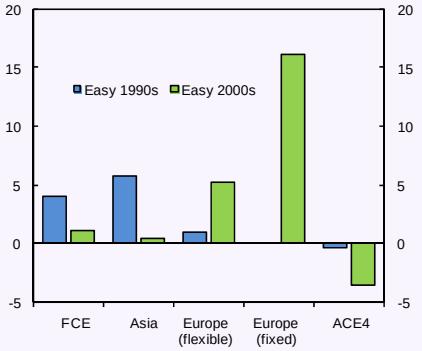
FCE: Gross Capital Inflows: Increase in Crossborder Liabilities with Nonresidents 1/
(Percent of previous year GDP)



FCE: Net Capital Inflows: Crossborder Liabilities Minus Crossborder Assets
(Percent of previous year GDP)



Emerging Markets: Net Capital Inflows Under Easy External Financial Conditions
(Percent of previous year GDP, increase relative to other periods)



Source: IMF, *Balance of Payment Statistics*.
1/ Increase relative to periods in which external financial conditions were not easy.

Note: This box was prepared by Jorge Iván Canales-Kriljenko.

[1] For a review of Latin America's experience with FDI, see the October 2009 *Regional Economic Outlook: Western Hemisphere* (Box 2.4).

[2] Over the period 1990–2009, Vera-Martin (forthcoming) identifies 31 episodes in which individual countries experienced large capital inflows. The frequency of these episodes peaks during the periods identified by this chapter as easy external financial conditions.

ratio appreciation during both periods also raised these ratios' U.S. dollar GDP denominator.[30]

- The credit-to-GDP ratio increased in Latin America by about 2 percentage points of GDP every year, in both episodes of easy conditions. In other years, this ratio declined slightly. In other regions, credit-to-GDP ratios sometimes were affected strongly as well, notably in Asia in the 1990s episode and in Europe in the 2000s episode (Figure 3.6). Especially striking was the surge in credit growth in the European countries with fixed exchange rate regimes, suggesting that exchange rate regimes matter, an issue explored later in the chapter. Banking indicators in Latin America did not change much, with nonperforming loans and capital adequacy virtually unchanged.

In sum, Latin America experienced a sharp pickup in gross inflows during periods of easy external financial conditions, although net of outflows, they were notably smaller during the most recent episode. Yet, the current account ratios remained well contained (helped by rising commodity export prices), although credit growth notably increased.

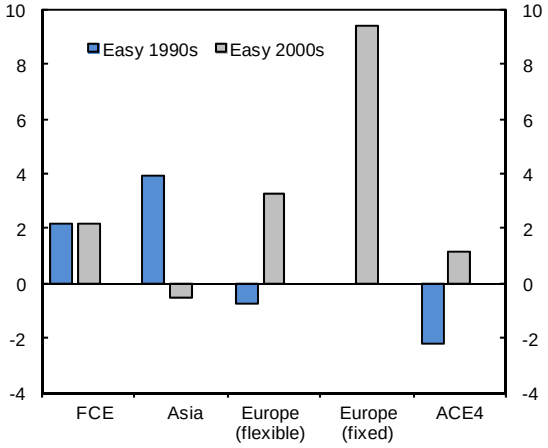
. . . And Hinder Competitiveness and Possibly Growth

Currency appreciation can trigger two distinct concerns about economic activity. First, appreciation may damage activity in the short term, through a contractionary effect on aggregate demand. Second, it is often suggested that appreciation, if prolonged, could hurt growth through effects on the economy's supply side. Concerns of the latter type are variations on a "Dutch disease" issue. At the center of most of these fears is the belief that certain sectors—traded goods, or exports, or industrial sectors that are associated with exporting—are in some way special in terms of being conductive to economy-wide growth.

Therefore, the first empirical question is to what extent—and when—has appreciation been associated with reduced exports?

Figure 3.6. Credit growth responses have varied by region, growing fast in Asia in the 1990s and in Europe in the 2000s.

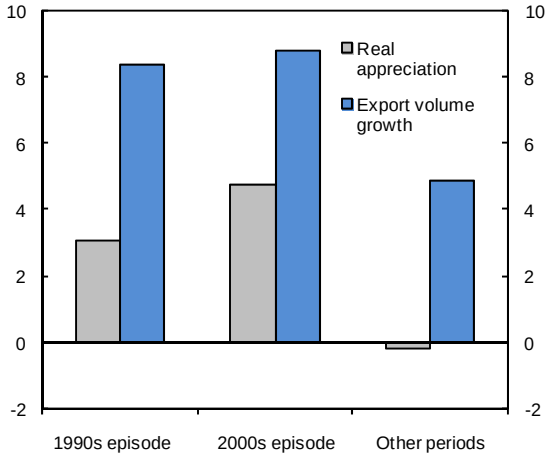
Emerging Markets: Credit Growth Under Easy External Financial Conditions 1/
(Percent increase over other periods)



Sources: IMF, *International Financial Statistics*; and IMF staff calculations.
1/ Increase relative to periods in which external financial conditions were not easy.

Figure 3.7. Despite the real appreciation, export volumes actually increased during the earlier episodes of easy money.

FCE: Real Appreciation and Export Growth During Episodes of Easy External Financial Conditions
(Annual percent change, increase in means during episodes)



Source: IMF, *Information Notice System.*

[30] The ACE4 countries experienced similar gains in their terms of trade, averaging about 6 percent each year, in that episode. Luckily, the higher export revenue in the FCE and ACE4 regions partly offset the effect of the rising domestic demand on the current account balance, which otherwise could have been more problematic.

This is not an easy question to answer, as so many factors are involved in export performance, and in determining the level of the exchange rate. No tight association exists simply between real appreciation and weaker export volumes. Looking at episodes of easy external financial conditions illustrates the problem: FCE export volume growth actually picked up, despite fairly strong real appreciation at the same time (Figure 3.7).

This joint occurrence of appreciation and faster export growth could reflect developments that can induce both real appreciation and growth of exports, such as the rise in commodity prices (if it leads to expansion of commodity production), higher demand volume, or productivity growth in the export sector. Adverse effects of appreciation may also take time to materialize.

Econometric exercises on the dynamic relationship between appreciation and export growth—taking into account other factors—help detect the relationships involved, but are often inconclusive when applied to emerging market countries. System estimation with annual data suggests that export volumes in Latin America respond somewhat to growth in advanced economies and China, as well as to changes in the real exchange rate and export prices.[31] Estimation of standard types of "trade equations" also suggests some short-term negative effect of real appreciation on FCE export volumes, when controlling for external demand and commodity prices.[32]

Regarding the sensitivity of imports, an association between appreciation and import volumes can be detected much more clearly. In addition to the direct, expenditure-switching effect of appreciation on import volume, this association likely reflects also an indirect channel: to the extent that appreciation stimulates overall domestic demand, this additional demand will fall partly on imported goods.

Taken together, these points do not provide much support for the concern over contractionary behavior of aggregate demand at times of easy external financial conditions. Although appreciation itself will have some negative impact on net exports, this impact has been more than offset by the strong growth of *domestic* demand. Expenditure-switching effects on the side of exports seem limited as the price elasticity of exports in Latin America may be smaller than in other countries given the larger weights of commodities in their total exports. The effects involved on the side of import substitution appear larger, but the surge in domestic demand seems strong enough to offset them.

Thus, concern about growth effects of exchange rate appreciation probably should turn more to supply-side effects. However, the existing literature does not settle the issue of whether currency appreciation—either temporary or permanent—hurts growth in the long term, or of how likely or large such an effect might be. The classic theory on Dutch disease is ambiguous about its effects, and the evidence is inconclusive. A new literature exploring the long-run effects of alternative exchange rate levels on growth has provided some evidence, but its interpretation remains controversial and its relevance unclear. This new literature does not address effects of temporary real appreciation but rather the consequences of an exchange rate level that is sustained—by some means[33]—for many years, as part of an ongoing development strategy that favors the profitability of certain sectors (Box 3.3).

[31] The response of export volumes to export prices is likely to be higher for noncommodity exports.

[32] However, a long-term cointegrating relationship between export prices, real exchange rates, and export volumes is difficult to detect for most countries.

[33] Rodrik (2008) recognizes that the real exchange rate is not a policy instrument but rather an endogenous variable. Moreover, policies to influence its level on a sustained basis would need to affect "real" variables, for example, policies that promote a higher level of national saving.

Box 3.3. Real Appreciation and Trend Growth: An Overview on Dutch Disease and Related Concerns

Concerns about sustained adverse growth effects of real appreciation have been explored for many years, going back to the "Dutch disease" literature of the early 1980s. The debate continues today—including with a related new literature that proposes further links from the real exchange rate to growth—but is still far from resolved. While the logic of some of the theoretical arguments for this link is clearly established, these arguments lean heavily on special assumptions about the nature of economic growth. And the evidence seems insufficient: to date, while there are a few exceptions, empirical studies of Dutch disease have focused mainly on how shocks that cause real appreciation may affect the level of traded goods production—rather on whether this sector has a special role in economic growth, or on whether it is permanently damaged by temporary episodes of real appreciation.

Theory

In its original form, Dutch disease results from an increase in the price of (or discovery of) an exportable natural resource, which lowers the relative price of tradable goods. This reallocates factors of production into the extraction of the natural resource and nontradable goods and away from the other tradable goods (Corden, 1981). From this, at least two distinct concerns are raised. On the one hand, the change in relative prices may hamper the development of an infant manufacturing export industry, which may have been getting stronger by learning by doing. This may decrease overall growth in the long term (Van Wijnbergen, 1984). However, this effect will not be permanent if learning by doing takes place in both the tradable and nontradable goods sectors (Torvik, 2001; Adam and Bevan, 2004). Second, with economies of scale, deindustrialization would occur if the appreciation persists for a long time or is too large (Krugman, 1987). If increasing returns to scale exist in the nontradable goods sector, the appreciation would actually increase growth (Sachs and Warner, 1999). However, if the real appreciation is an equilibrium response to the shock, there might be no disease after all (Edwards and Aoki, 1983; Harberger, 1983).

The new literature addressing the linkages between the level of real exchange rate and growth, still in its infancy, identifies several channels through which they could operate. First, the exchange rate may affect growth through externalities associated with export-linked activities, particularly from the manufacturing tradable sector (Prasad and others, 2007; Rodrik, 2008). Second, an "overvalued" exchange rate may hinder growth through a reduction in domestic saving. Dooley, Folkerts-Landau, and Garber (2004) argue that an appreciated real exchange rate tends to shift demand away from nontradable goods into tradable goods, which requires a reduction in real interest rates to maintain internal equilibrium, reducing domestic saving rates. Finally, an overvalued real exchange rate may be associated with higher real wages, leading firms to lower investment as well as saving rates required to finance that investment (Levy-Yeyati and Sturzenegger, 2007).

Evidence

The evidence from the empirical literature on Dutch disease is mixed. This literature mostly focuses on the effect on the real exchange rate arising from a series of shock events (linked to natural resources, remittances, foreign aid, or capital inflows) and the reallocation of resources between the tradable and nontradable sectors. Whether or not such reallocation has a permanent effect on growth is usually not examined empirically. Regarding remittances, most studies find that there are Dutch disease effects—real appreciation and a decrease in the tradable to nontradable output ratio (Lartey and others, 2008; Acosta and others, 2009; Amuedo-Dorantes and Pozo, 2004). Rajan and Subramanian (2005), in contrast, find evidence

Note: This box was prepared by Nicolás Magud and Sebastián Sosa. It draws on a more extensive literature review and discussion by the same authors (Magud and Sosa, forthcoming).

Box 3.3 (*concluded*)

that remittances do not create such effects. Studies about the effects of an increase in foreign aid are inconclusive. Some find that aid inflows lead to real exchange rate appreciation and deindustrialization (Rajan and Subramanian, 2005 and 2009; Adenauer and Vagassky, 1998), but others show that Dutch disease is not an inexorable consequence (Amuedo-Dorantes and Pozo, 2004; IMF, 2005; McKinley, 2005). Furthermore, it is unlikely that a sustained increase in aid would, through Dutch disease effects, hurt long-term growth (Barder, 2006).

While there is some evidence suggesting that sustained overvaluation of the exchange rate level hinders growth and that undervaluation stimulates it, the evidence is still insufficient (Hausmann, Pritchett and Rodrik, 2004; Prasad and others, 2007, Levy-Yeyati and Sturzenegger, 2007; Rodrik, 2008; Eichengreen, 2008). There is little systematic evidence on externalities that may foster growth. Similarly, while some studies try to document positive spillover effects from manufacturing, the evidence is inconclusive (Eichengreen, 2008).

Finally, on the hypothesis linking exchange rate levels and saving rates, Montiel and Servén (2008) argue that the hypothesized causal link from the real exchange rate to saving is empirically weak.

In short, fears about the adverse impact of currency appreciation on growth can be valid in principle, but it is difficult to gauge their practical relevance. In the absence of clear evidence on the size or permanence of any such effects, policymakers still must rely on judgment and perhaps focus relatively more on the booming consequences of easy conditions (which by itself would exacerbate the competiveness issue).

Policy Matters

Policy frameworks and policy responses can influence the degree of risks associated with easy financial conditions—either mitigating or compounding those risks.

To inform future policymaking, it is useful to first review the typical responses of policies to such conditions.

. . . In the Past . . .

Macroeconomic and financial policies of FCE countries have improved markedly over the years, and thus differed significantly across the two earlier episodes of easy external financial conditions. One major achievement was the reduction in inflation in the context of a significant revamping of monetary policy frameworks that allowed increased exchange rate flexibility. Critical for this increased flexibility has been the establishment of a credible nominal anchor—the inflation target—which has lessened the effects of exchange rates on inflation and thus helped reduce the "fear of floating." Even in the context of much more flexible exchange rates, however, some FCE central banks at times have purchased large amounts of foreign exchange, particularly in 2006–07, amid large capital inflows and a spike in revenues from commodity exports.[34]

Fiscal policy and public debt management also have improved significantly, and systems of financial regulation and supervision saw major improvements (see the May 2009 *Regional Economic Outlook: Western Hemisphere).*

Have these fundamental changes of policy frameworks made a difference in how FCE economies respond to changes in external financial

[34] During the first episode of easy financial conditions, fairly high inflation often meant high nominal exchange rate movements. By the time of the second episode, these countries had much lower inflation, and most were allowing a significant degree of nominal exchange rate flexibility, including in the short term, and in both directions. Still there were differences, with Chile and Mexico abstaining from discretionary purchases and sales of foreign exchange for long periods.

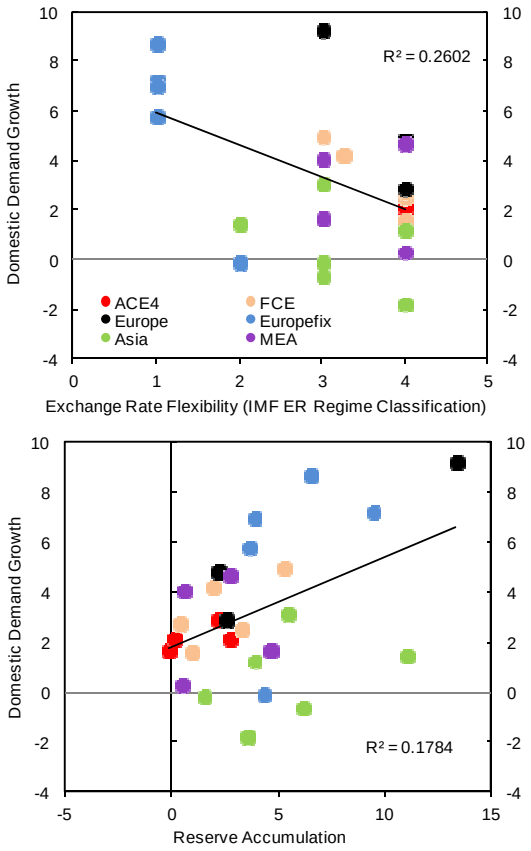
conditions? Further evidence from the VAR-based econometric approach mentioned earlier suggests that something has changed. In particular, sensitivities to the VIX and also to U.S. real interest rates seem to have been larger and faster in the past than more recently.[35]

Did **exchange rate flexibility** matter? In moving toward greater exchange rate flexibility, the region has lowered the likelihood of currency crises and the likely adverse impact on economic activities associated with interest rate increases to defend an exchange rate when external financial conditions tighten. The increased flexibility—including in the short term—also played a role in reducing the sustained attractiveness of ongoing portfolio investment inflows (as noted earlier, these were smaller during the 2000s episode). Notably, the shift to allowing higher nominal exchange rate flexibility was not associated with larger real appreciation during the second episode, as might have been expected given the terms-of-trade gains experienced then.

Looking at a wider range of country experiences suggests that monetary policy frameworks and exchange rate regimes are important. It is helpful to look at a broader sample because the FCE and ACE4 countries in general now follow broadly similar regimes and monetary frameworks. Although substantial cross-country variation exists across regimes, simple cross-country scatterplots of data during the 2000s episode of easy conditions suggest that countries with more flexible exchange rate regimes tended to have lower domestic demand growth in excess of their trend growth rate, which leads to smaller current account deficits. Because more flexible exchange rate regimes tended also to accumulate less international reserves, a positive association between reserves and domestic demand growth is also apparent (Figure 3.8).[36]

Figure 3.8. Countries with more flexible exchange rate regimes and less reserve accumulation tended to experience lower surges in domestic demand.

Emerging Markets: Exchange Rate Regimes and Domestic Demand Growth: 2004–07



Source: IMF International Financial Statistics, Information Notice System, and World Economic Outlook databases.
1/ Demand growth is percent change less average GDP growth over the last 10 years.

For example, a number of European countries with strong fixed exchange rate regimes provide a sharper contrast to those following inflation targeting regimes in the FCE and ACE4 country groups. Within Emerging Europe, those countries with more flexible exchange rates had a much less pronounced credit boom, smaller current account deficits, and lower inflation—despite allowing substantial nominal appreciation—than did other countries (Bakker and Gulde, forthcoming). The earlier Table 3.1 also shows that European countries with fixed pegs experienced much larger increases in domestic demand. Looking at a broader country

[35] Thus when the model is estimated over the period 1994–2002, impulse responses for shocks to these variables turn out to be larger than when estimated using a sample that includes also the 2000s. This is indirect evidence that policies (or other economic structure) changed over the years.
[36] Admittedly, the experience of exchange rate fixers in Europe is important for the result seen in this particular episode.

sample, the Spring 2010 *Global Financial Stability Report* finds that the link from global liquidity to "receiving country" asset valuations is weaker for countries with greater degrees of exchange rate flexibility (IMF, 2010).

Accumulation of international reserves in FCE countries was also faster during the earlier two episodes of easy external conditions than during other periods. This suggests that policies of reserve accumulation have responded to low real interest rates or to global risk aversion or both—a pattern which is verified in an econometric analysis that controls for other variables. According to that estimated relationship, a decrease of 1 standard deviation in the VIX increased the growth rate of international reserves by about 4 percentage points within one year, whereas an analogous decrease in real interest rates increased reserves growth by an additional 2.5 percentage points.[37]

Such a policy pattern of building reserve holdings faster at times of easy global financial conditions—despite the lower returns earned at the time on reserve holdings—suggests that purchases of foreign exchange often were timed to lean against pressures for currency appreciation, in part owing to fear of eventual contractionary effects of a firmer currency. Central banks also may have been motivated to accumulate reserves more rapidly in those times for prudential reasons, seeking to self insure against the risk of a sudden reversal of easy external financial conditions. Having an ample stock of reserves available could limit the effects of a potentially large currency depreciation that could occur when those easy conditions end. Indeed, reserve levels are key vulnerability indicators and there is some evidence that they are factored into emerging market borrowing costs (see Baldacci and others, 2008; Rojas and Jaque, 2003; and Rowland, 2004). Reserve accumulation may also result from intervention that is motivated by a type of "industrial policy"; that is, as countries try to defend their export sectors from a deterioration in competitiveness.

Conversely, because reserve accumulation can easily reduce (actual or perceived) exchange rate flexibility, it may encourage domestic demand growth and capital inflows, increasing the risk faced by the country during a sudden stop. In containing currency appreciation, reserve accumulation may allow expectations of further appreciation to persist for some time while keeping asset prices attractive. In contrast, a fast, upfront appreciation would increase the expected financial cost of external financing by generating expectations of future depreciation, and, at the same time make domestic assets less attractive for foreigners, damping the effect of easy external financial conditions on domestic demand.

In sum, exchange rate flexibility can play a crucial role in containing the risks that may build during periods of easy external financial conditions. Yet, it requires having a strong alternative nominal anchor in the form of a credible objective for inflation as well as prudential regulations that discourage large currency exposures. In turn, reserve accumulation can help central banks play a supportive role later, in the event of a subsequent sudden stop.

Credit in FCE was allowed to grow significantly faster in both episodes of easy external financing, as noted earlier. Explicit policies for curtailing credit growth were in general isolated (other than increases in interest rates that were called for under the monetary framework to contain inflation). The pickup of credit, however, was not as much as in other regions, especially Emerging Europe. Some countries, however, took notable specific steps, particularly during the final boom years before the global crisis hit. In particular, measures adopted by countries in the FCE region, for example in Brazil, Colombia, and Peru, included tightening reserve requirements on some financial instruments, prudential regulations on exchange rate risks, and reinforcing dynamic provisioning requirements, among others.

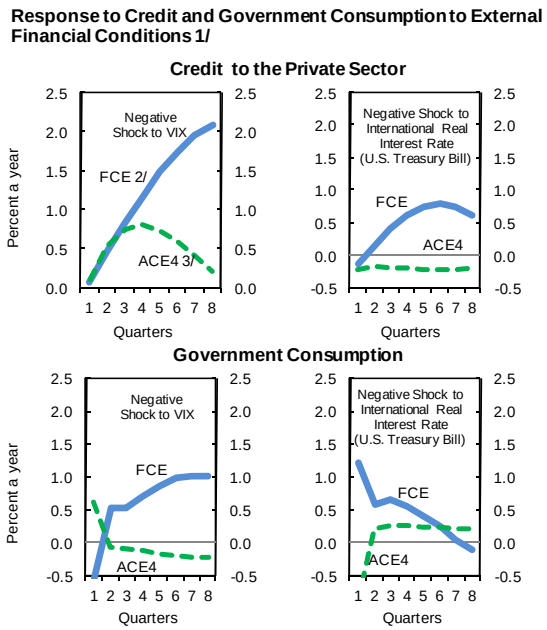
[37] A positive shock to commodity prices increased reserves growth by about 1 percentage point, with a lag of about one year. An effect of external demand growth on reserves was difficult to detect in this exercise.

Regarding **fiscal policy responses**, FCE governments expanded their spending at somewhat faster rates during both periods of easy external conditions than at other times (Medina, forthcoming). That pickup, however, was much smaller than that seen in private domestic demand, and also smaller than that of GDP. Amid such accelerated growth of the bases for income tax and VAT revenue, and with commodity-based revenues also surging in the second episode, the pickup of government expenditure could be seen as relatively modest, particularly in the second episode.[38] Still, expenditure policy was by no means acyclical. Estimated impulse responses confirm that FCE spending tended to increase under easier external financial conditions and more favorable external demand. By way of comparison, estimated responses for ACE4 governments' expenditure were much smaller, and may not be statistically significant (Figure 3.9).

How have these policies interacted with external developments in determining outcomes? In particular, how much of the approximate 4 percentage point pickup in domestic demand in the first episode and of the approximate 5 percent increase in the second episode could be attributed to external financial conditions? Panel system estimation of the key relationships discussed in this chapter may provide some hints. This system attempts to provide a first approximation at how domestic demand growth, real appreciation, export growth, and export prices relate to easy external financial conditions and world demand (Table 3.4).[39]

The estimated relationship for domestic demand suggests, taking as a given the policy responses over the period studied, that about 3 percentage points of its increase was associated with external financial conditions during both episodes, whereas about 1 additional percentage point in the second episode was associated with the increase in commodity prices. Government consumption and credit growth explained most of the rest, suggesting that they also contributed to the boom and real appreciation.

Figure 3.9. The systematic responses of credit and government consumption have been stronger in FCE countries.



Sources: Bloomberg, L.P.; Haver Analytics; and IMF staff calculations.
1/ Each panel shows the dynamic response of financial sector credit and government spending (expressed in percentage change, year over year) from a 1 standard deviation shock to the VIX and real interest rates (expressed in percent per year). The impulse response function is based on a vector autoregression model, estimated over the period 1994Q2 and 2009Q2, which includes external domestic demand, VIX, interest rates, commodity prices, private domestic demand, and each of the two variables alternatively.
2/ Simple average of Brazil, Chile, Colombia, Mexico, and Peru.
3/ Simple average of Australia, Canada, New Zealand, and Norway.

. . . And in the Future, when an Array of Policy Options Need to Be on the Table

In a situation of sustained easy external financial conditions, concerns are broad, and policy objectives may conflict with each other. This chapter has argued that reducing the likelihood of undesirable booms in domestic demand and credit and their consequences is an overarching objective.

[38] That said, government expenditure did accelerate amid these favorable environments for revenue growth, indicating a degree of procyclicality of fiscal policy to revenue. Procyclicality of FCE fiscal policy is generally considered to have declined over time—for example, with Chile's introduction of an essentially acyclical rule in 2001. See also the October 2009 *Regional Economic Outlook: Western Hemisphere*.

[39] System estimation may be required to address indirect interactions among variables giving rise to problems of simultaneity and identification.

Table 3.4. FCE: System Estimation of Domestic Demand Growth, Real Appreciation, Export Price, and Real Export Growth 1/ 2/

Domestic demand growth		
CBOE's VIX index (lagged 1 year)	-0.25	**
Fed funds, real	-0.49	**
Government consumption growth	0.17	**
Credit growth	0.04	**
Real export price growth	0.12	**
Real currency appreciation		
CBOE's VIX index	-0.46	**
Real export price growth	0.04	**
Reserve accumulation	-0.54	**
Export price growth		
CBOE's VIX index	-0.54	**
Fed funds, real	-0.79	**
Advanced economies demand growth	3.88	**
Advanced economies demand growth (lagged 1 year)	-4.27	**
Export growth		
Real export price growth	0.1	**
Real appreciation	-0.1	**
Advanced economies' demand growth	1.3	**
Chinese economy's demand growth	0.4	**

Sources: IMF, *International Financial Statistics;* Bloomberg, L.P.; Haver Analytics; and IMF staff estimates.
1/ System estimation by seemingly unrelated regressions using annual data for 1986–2008. To present a representative number for the FCE, the parameters have been assumed to be the same for Brazil, Chile, Colombia, Mexico, and Peru. Individual country regressions reveal differences in country parameters, and that not all coefficients are significant in all countries. The system also captures the interaction between the real Fed funds rate, the VIX, and demand growth in advanced economies in China. Results do not change qualitatively when the recent global financial crisis is excluded.
2/ Constants vary by country. ** significant at the 5 percent level.

The risks to stability and growth associated with boom-bust cycles in demand and credit are clear, and focusing exclusively on trying to avoid currency appreciation would miss them. Reduced growth from episodes of temporary real appreciation itself is also an important concern, although it is more difficult to confirm and evaluate. In any case, in situations where policymakers are concerned by appreciation itself, policies for controlling domestic demand growth again will be relevant, as these are also important for containing *real* appreciation.

Against the wide range of concerns, an array of policies will need to be considered during times of sustained easy global financial conditions. No single policy can counter all risks. Moreover, in practice, all the relevant policy options will have their own limitations—including in terms of political and administrative feasibility—as well as in their effectiveness, and their potential for adverse side effects. No solution will be perfect, but acting with moderation on multiple fronts seems more prudent.

Recognizing that no easy fix will be available, the experience of past episodes and policy approaches suggests priorities for certain policies and some guidelines for the sequencing and conditions in which various policies should be considered.

To meet the challenges posed by episodes of easy external financial conditions, theory and experience both suggest that maintaining exchange rate flexibility is key to help contain demand and credit booms. Put another way, efforts to lean against the wind of nominal appreciation can actually exacerbate such booms, maximizing the transmission of easy external financial conditions. Still, it is difficult for even the purest exchange rate float to deliver complete insulation, and a possibly large currency appreciation can create its own concerns. For instance, sustained appreciation could lead to bankruptcies in the export and import-competing sectors, with potential long-lasting effects on economic activity.

Consideration should be given to shifting the macroeconomic policy mix—with a tighter fiscal and a relatively looser monetary stance. A firmer fiscal position can open space for a monetary stance that is looser than would otherwise be possible. Lower policy interest rates will reduce incentives for "carry trade" inflows especially. Consideration will need to be given to removing any domestic financial market distortions that may be encouraging carry trade. The case for early action on the fiscal policy front is especially strong when domestic demand is growing significantly faster than potential output and economies are approaching or already above full employment. A tighter fiscal stance is directly relevant for containing domestic demand growth and the widening of the current account deficit, and at the same time helping to reduce real appreciation. As noted, studies suggest this fiscal tool can be quite

powerful in this context,[40] with maximum effect when concentrated on cuts in spending on nontraded goods.[41] Of course, fiscal tightening may encounter political resistance and take time to develop and to have its full impact; this argues for planning ahead and not delaying.

Prudential policies should play an important role in limiting the risks that may arise and grow during times of easy external financing. Prudential policies can help contain rapid credit growth that may facilitate a boom in domestic demand. In particular, they can provide incentives to smooth credit growth over the cycle, for example, through dynamic provisions and cyclically adjusted reserve requirements. Prudential regulations can also head off excessive risk-taking in private financial and corporate sectors' balance sheets during good times, particularly those related to currency exposure, including through financial derivatives and off-balance sheet instruments.

Further regulatory and supervisory steps should be considered in the region to more thoroughly contain systemic risks that may develop during the upswing. This may involve widening the perimeter of prudential regulation and financial supervision, which should cover all systemically important financial institutions, whether banks or nonbanks. Most countries in the region need to advance further in strengthening consolidated supervision to better detect and correct in time systemic risks, to avoid "blind spots," and to use supervisory methods that internalize macroeconomic dynamics. Enhancements of supervision may involve legal modifications that set guidelines for dealing with cases of systemic risk, perhaps clarifying the resolution framework that would apply to these cases, and separate capital requirements for systemically important institutions. In addition, further developments in prudential regulation and supervision in advanced economies will affect foreign banks operating in the region and set new standards that could be adapted to Latin American financial institutions, particularly as the region proceeds in the process of gradually implementing the Basle II recommendations (see Chapter 1, Box 1.1).

Enhanced policies on these fronts may take time to design and implement, as they often involve changes in legislation that must go through the political process. Laws and regulations to improve policy frameworks should be reviewed frequently, as the goal is to have policies in place before they are more obviously needed. In the meantime, there is always scope for further refinement in essential supervisory tasks, which include monitoring liquidity, market risk, and credit risks, as well as oversight over risk-taking through proprietary trading by institutions considered too big to fail.

As acknowledged earlier, appreciation of the nominal exchange rate could create problems of its own. In considering policies aimed at limiting currency appreciation directly, pragmatism calls for a combination of policies that take into account country characteristics. These include the current state of financial regulation and supervision, the effectiveness of bureaucratic procedures, the sophistication of the investor base, and the level of international reserves. The focus of policy responses in this direction should be greater if a country is already experiencing a domestic demand boom and has a fairly large current account deficit, and when other policy options have already been deployed to the extent possible.

In such a context, controls (taxes) on capital inflows could play a role, but it is important to keep in mind their limitations. Careful attention should be given to their design and the ability to enforce them. They need to be applied to the widest possible spectrum of inflows to lessen circumvention. Their implementation requires substantial administrative

[40] See also the October 2008 *World Economic Outlook* for an analysis of the effect of countercyclical fiscal policies in advanced and emerging markets.

[41] Although the signal of fiscal responsibility could attract larger capital inflows at the margin, this effect is likely to be small compared with the direct effect of fiscal adjustment on demand. The effect is likely to be especially limited for countries, such as those of the FCE, whose creditworthiness is already viewed favorably, with sovereign spreads already quite low.

capabilities that cannot be developed overnight. To moderate distortions, price-based mechanisms are generally more appropriate. Because the effect of controls tends to wear off over time, and because controls may have undesired side effects, they cannot substitute for more fundamental adjustments, but can be a potentially useful transitory tool (Ostry and others, 2010).

Intervention in the foreign exchange market can be an appropriate tool as well. Because it is relatively easy to implement quickly with seemingly immediate effects on the nominal exchange rate, however, intervention is perhaps often used too quickly and too extensively. Sterilized intervention cannot substitute for action on more fundamental fronts, as it cannot by itself control growth of domestic demand or even credit. Before intervening, it should be verified first that the currency is not currently undervalued for fundamental reasons. This requires taking account of the latest developments in productivity and the terms of trade, as these may be affecting the equilibrium real exchange rate. Here, the outlook for prices of Latin America's commodity exports is particularly relevant.

Before resorting to market intervention and implementing capital controls, it is generally advisable to allow a nonnegligible amount of currency appreciation. Deploying these tools too early risks being self-defeating, by continuing market expectations of future appreciation. Moreover, policymakers need to be wary that efforts to smooth or moderate the path of appreciation over an extended time could also backfire, by stimulating further capital inflows. Similarly, efforts to ensure adequacy of international reserves, which are clearly important, need to be carried out in ways that do not attract more inflows.

The issue of the appropriate level of international reserves to protect the country against sudden stops, external liquidity shortages, and current account reversals is in principle separate from exchange rate flexibility and foreign exchange intervention. For example, international reserves could be built by official long-term borrowing without any official intervention in the foreign exchange market (or by purchases of foreign exchange that are executed relatively smoothly, rather than timed to react to short-term market fluctuations). The appropriate level of self insurance by building reserves needs to balance two factors: the cost of holding reserves and the likelihood and severity of the possible adverse event (which may increase with the size of inflows). These factors are likely to differ across regions depending on country characteristics, which include, among others, the degree of financial dollarization in the economy (which can limit the desirability of allowing wide exchange rate flexibility).[42] The need for self insurance through reserves diminishes with the reliability of other forms of insurance that allow countries to better pool these risks, including those designed through multilateral arrangements.

In conclusion, financially integrated countries in Latin America may face a sustained period of easy external financial conditions—with associated risks that are amply illustrated by past experience. In many respects, these countries are now better equipped than in the past to face these challenges, but none are immune. Economies that have already returned to full employment, amid strong demand growth, face the most immediate challenge. But policymakers in other countries also will need to look ahead and concern themselves with a broad range of issues and risks—going beyond the question of currency appreciation alone, focusing especially on demand and credit booms—even though these will not fully develop immediately. Policymakers will want to be ready to pursue multiple policies from within their toolkits.

[42] Gulde and others (2004) note that financially dollarized economies hold higher international reserves to insure against financial risks, including those arising from corporate and financial balance-sheet exposures.

Western Hemisphere

Main Economic Indicators

	Output Growth (Percent)							Inflation (End-of-period, percent) 1/							External Current Account Balance (Percent of GDP)						
	1996-2005 Avg.	2006	2007	2008	2009	2010 Proj.	2011 Proj.	1996-2005 Avg.	2006	2007	2008	2009	2010 Proj.	2011 Proj.	1996-2005 Avg.	2006	2007	2008	2009	2010 Proj.	2011 Proj.
Latin America and the Caribbean																					
PPP-GDP-weighted average	**3.0**	**5.6**	**5.8**	**4.3**	**-1.8**	**4.0**	**4.0**	**9.8**	**5.1**	**6.3**	**8.2**	**5.0**	**7.0**	**5.9**	**-1.5**	**1.6**	**0.4**	**-0.6**	**-0.5**	**-1.0**	**-1.2**
Simple average	**3.2**	**5.8**	**5.3**	**3.7**	**-1.4**	**2.0**	**3.3**	**8.4**	**5.5**	**7.9**	**8.9**	**2.9**	**5.6**	**4.8**	**-6.6**	**-5.0**	**-7.5**	**-9.5**	**-6.5**	**-7.2**	**-7.1**
Commodity exporting, financially integrated countries 2/	**3.2**	**5.6**	**6.1**	**4.5**	**-1.5**	**4.6**	**4.9**	**7.3**	**3.1**	**5.1**	**6.8**	**1.8**	**4.0**	**3.3**	**-2.0**	**1.4**	**0.4**	**-2.2**	**-0.3**	**-1.7**	**-2.2**
Other commodity exporting countries 2/	**3.4**	**7.1**	**5.7**	**5.6**	**-0.5**	**2.8**	**3.1**	**16.3**	**8.7**	**9.7**	**12.9**	**6.6**	**9.5**	**8.8**	**-1.2**	**11.6**	**8.8**	**9.1**	**2.9**	**4.6**	**4.5**
Commodity importing, tourism intensive countries 2/	**3.1**	**4.8**	**3.2**	**1.3**	**-4.2**	**0.1**	**1.8**	**2.9**	**3.3**	**6.4**	**6.1**	**1.8**	**4.0**	**2.5**	**-14.1**	**-19.4**	**-23.4**	**-25.6**	**-18.9**	**-18.3**	**-18.0**
Other commodity importing countries 2/	**3.3**	**6.0**	**6.6**	**4.3**	**0.8**	**2.1**	**4.3**	**9.0**	**6.5**	**9.6**	**10.0**	**2.0**	**5.3**	**5.0**	**-5.1**	**-5.4**	**-6.9**	**-10.2**	**-3.9**	**-7.0**	**-6.6**
North America																					
Canada	3.3	2.9	2.5	0.4	-2.6	3.1	3.2	2.1	1.4	2.5	1.9	0.8	1.8	2.0	1.0	1.4	1.0	0.5	-2.7	-2.6	-2.5
Mexico	3.7	4.9	3.3	1.5	-6.5	4.2	4.5	10.6	4.1	3.8	6.5	3.6	5.3	3.0	-1.9	-0.5	-0.8	-1.5	-0.6	-1.1	-1.4
United States	3.4	2.7	2.1	0.4	-2.4	3.1	2.6	2.6	2.2	4.1	0.7	2.0	1.7	1.9	-3.7	-6.0	-5.2	-4.9	-2.9	-3.3	-3.4
Central America																					
Costa Rica	4.5	8.8	7.9	2.8	-1.1	3.5	4.2	11.6	9.4	10.8	13.9	4.0	5.5	5.0	-4.1	-4.5	-6.3	-9.2	-2.2	-4.3	-4.6
El Salvador	2.7	4.2	4.3	2.4	-3.5	1.0	2.5	3.3	4.9	4.9	5.5	-0.2	1.5	2.8	-2.5	-4.2	-6.0	-7.6	-1.8	-2.7	-2.8
Guatemala	3.3	5.4	6.3	3.3	0.6	2.5	3.5	7.8	5.8	8.7	9.4	-0.3	4.3	4.0	-5.2	-5.0	-5.2	-4.5	-0.6	-3.3	-3.7
Honduras	3.9	6.6	6.2	4.0	-1.9	2.0	2.0	11.5	5.3	8.9	10.8	3.0	6.5	6.5	-4.6	-3.7	-9.0	-12.9	-3.2	-6.1	-6.7
Nicaragua	4.1	4.2	3.1	2.8	-1.5	1.8	2.5	8.3	9.4	16.9	13.8	0.9	7.0	7.0	-19.7	-13.4	-17.6	-23.8	-15.0	-18.1	-17.4
Panama	5.0	8.5	12.1	10.7	2.4	5.0	6.3	1.2	2.2	6.4	6.8	1.9	3.0	2.7	-5.2	-3.1	-7.2	-11.6	0.0	-8.5	-8.9
South America																					
Argentina 3/	2.5	8.5	8.7	6.8	0.9	3.5	3.0	6.0	9.8	8.5	7.2	7.7	9.7	9.7	-0.1	3.2	2.3	1.5	2.8	2.8	2.0
Bolivia	3.3	4.8	4.6	6.1	3.3	4.0	4.0	4.2	4.9	11.7	11.8	0.3	4.0	3.5	-2.7	11.3	12.0	12.1	3.5	2.6	2.0
Brazil	2.4	4.0	6.1	5.1	-0.2	5.5	4.1	7.4	3.1	4.5	5.9	4.3	5.3	4.8	-2.0	1.3	0.1	-1.7	-1.5	-2.9	-2.9
Chile	4.3	4.6	4.6	3.7	-1.5	4.7	6.0	3.7	2.6	7.8	7.1	-1.4	3.7	3.0	-1.5	4.9	4.4	-1.5	2.2	-0.8	-2.1
Colombia	2.4	6.9	7.5	2.4	0.1	2.2	4.0	10.5	4.5	5.7	7.7	2.0	3.8	3.4	-1.8	-1.8	-2.8	-2.8	-1.8	-3.1	-2.9
Ecuador	3.3	4.7	2.0	7.2	0.4	2.5	2.3	29.4	2.9	3.3	8.8	4.3	3.7	3.2	-1.2	3.9	3.6	2.2	-1.1	-0.6	-1.6
Guyana	1.6	5.1	7.0	2.0	3.3	4.4	4.9	5.4	4.2	14.0	6.4	3.6	4.0	4.0	-7.6	-13.1	-11.1	-13.2	-8.5	-10.0	-9.4
Paraguay	1.2	4.3	6.8	5.8	-3.8	6.0	5.0	8.8	12.5	5.9	7.5	1.9	4.0	3.5	-1.6	1.4	1.7	-2.4	-0.2	-1.5	-1.2
Peru	3.4	7.7	8.9	9.8	0.9	6.3	6.0	4.0	1.1	3.9	6.7	0.2	2.0	2.0	-2.8	3.1	1.3	-3.7	0.2	-0.7	-1.8
Suriname	3.4	3.8	5.2	6.0	2.5	4.0	4.7	30.3	4.7	8.4	9.3	5.7	5.5	4.9	-14.6	7.5	7.5	3.9	-2.0	-5.7	-4.4
Uruguay	1.3	4.3	7.5	8.5	2.9	5.7	3.9	11.0	6.4	8.5	9.2	5.9	6.5	5.5	-0.9	-2.0	-0.9	-4.8	0.8	-1.0	-0.9
Venezuela	2.0	9.9	8.2	4.8	-3.3	-2.6	0.4	30.8	17.0	22.5	30.9	25.1	34.3	32.0	8.0	14.7	8.8	12.3	2.5	10.5	10.8
The Caribbean																					
The Bahamas	3.2	4.3	0.7	-1.7	-5.0	-0.5	2.0	1.7	2.3	2.9	4.5	1.3	1.7	1.2	-9.3	-18.9	-17.5	-15.4	-11.4	-14.4	-13.6
Barbados	2.4	3.2	3.4	0.2	-5.3	-0.5	3.0	2.8	5.7	4.8	7.2	3.2	7.3	2.2	-5.5	-8.4	-5.4	-10.5	-5.1	-5.7	-5.5
Belize	5.8	4.7	1.2	3.8	-1.1	1.0	2.0	1.9	2.9	4.1	4.4	-0.4	3.5	2.5	-12.7	-2.1	-4.0	-10.1	-7.0	-6.2	-5.2
Dominican Republic	5.2	10.7	8.5	5.3	3.5	3.5	6.0	12.8	5.0	8.9	4.5	5.8	6.0	4.0	-0.8	-3.6	-5.3	-9.9	-5.0	-6.1	-5.5
Haiti 4/	1.0	2.2	3.3	0.8	2.9	-8.5	7.0	16.8	12.4	7.9	19.8	-4.7	8.5	8.0	-0.7	-1.4	-0.3	-4.5	-3.2	-9.5	-6.0
Jamaica	0.7	2.7	1.5	-0.9	-2.8	-0.3	1.5	10.2	5.7	16.8	16.8	10.2	13.2	6.1	-6.1	-9.9	-16.3	-18.1	-11.7	-9.1	-7.5
Trinidad and Tobago	7.9	13.5	4.6	2.3	-3.5	2.1	2.3	4.6	9.1	7.6	14.5	1.3	5.0	5.0	3.7	39.6	25.7	33.8	14.5	24.0	23.7
ECCU 5/	3.0	6.6	5.6	1.9	-6.1	-0.3	1.5	1.5	2.8	5.8	4.2	0.7	2.1	2.2	-17.5	-30.9	-35.4	-36.9	-26.8	-25.7	-22.7

Source: IMF staff calculations.

1/ End-of-period rates, i.e., December on December. These will generally differ from period average inflation rates reported in the IMF, *World Economic Outlook* , although both are based on identical underlying projections.

2/ Simple averages.

3/ Private analysts estimate that consumer price index inflation has been considerably higher. The authorities have created a board of academic advisors to assess these issues. Private analysts are also of the view that real GDP growth has been significantly lower than the official reports since the last quarter of 2008.

4/ Fiscal year data.

5/ The Eastern Caribbean Currency Union includes Anguilla, Antigua and Barbuda, Dominica, Grenada, Monseratt, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines.

Latin America and the Caribbean

Main Fiscal Indicators 1/

	Public Sector Revenue (Percent of GDP)						Public Sector Primary (Percent of GDP)						Public Sector Overall Balance (Percent of GDP)						Public Sector Primary Balance (Percent of GDP)					
	2006	2007	2008	2009	2010 Proj.	2011 Proj.	2006	2007	2008	2009	2010 Proj.	2011 Proj.	2006	2007	2008	2009	2010 Proj.	2011 Proj.	2006	2007	2008	2009	2010 Proj.	2011 Proj.
Latin America and the Caribbean																								
PPP GDP–weighted average	**28.8**	**28.7**	**29.6**	**28.7**	**29.3**	**29.3**	**25.9**	**26.1**	**27.1**	**29.0**	**28.5**	**28.4**	**-1.3**	**-1.2**	**-0.9**	**-3.9**	**-2.3**	**-2.4**	**2.9**	**2.7**	**2.5**	**-0.3**	**0.8**	**1.0**
Simple average	**26.9**	**27.4**	**27.6**	**26.7**	**26.8**	**27.6**	**24.4**	**24.9**	**26.2**	**28.3**	**28.8**	**29.2**	**-0.7**	**-0.3**	**-1.0**	**-4.0**	**-3.4**	**-2.6**	**2.4**	**2.6**	**1.6**	**-1.1**	**-0.7**	**0.0**
Commodity exporting, financially integrated countries 2/	**27.6**	**27.9**	**28.2**	**26.3**	**26.3**	**26.4**	**23.4**	**23.5**	**24.6**	**27.1**	**26.1**	**25.8**	**1.0**	**1.5**	**0.9**	**-3.4**	**-2.3**	**-2.0**	**4.1**	**4.5**	**3.6**	**-0.8**	**0.2**	**0.5**
Other commodity exporting countries 2/	**25.9**	**25.9**	**26.6**	**25.3**	**26.5**	**26.2**	**22.9**	**23.6**	**24.7**	**25.9**	**26.7**	**26.2**	**1.9**	**1.3**	**1.2**	**-3.0**	**-2.3**	**-1.6**	**4.4**	**3.5**	**2.8**	**-1.0**	**-0.5**	**0.1**
Commodity importing, tourism intensive countries 2/	**26.7**	**27.7**	**27.4**	**26.4**	**26.6**	**27.2**	**24.2**	**25.4**	**26.0**	**26.8**	**26.2**	**25.6**	**-3.4**	**-3.3**	**-3.7**	**-6.3**	**-5.0**	**-3.3**	**1.4**	**1.5**	**0.8**	**-0.7**	**0.2**	**1.4**
Other commodity importing countries 2/	**23.0**	**23.8**	**23.7**	**23.7**	**23.4**	**25.3**	**22.6**	**22.6**	**24.6**	**27.0**	**28.6**	**30.7**	**-2.0**	**-0.7**	**-2.1**	**-3.6**	**-3.7**	**-3.3**	**0.4**	**1.4**	**-0.2**	**-1.7**	**-1.7**	**-1.3**
North America																								
Mexico	21.4	21.4	22.9	22.4	21.7	21.5	19.6	20.1	21.8	24.4	22.5	22.0	-1.0	-1.4	-1.5	-4.7	-3.4	-3.0	1.8	1.3	1.1	-2.0	-0.8	-0.5
Central America																								
Costa Rica	21.2	22.8	23.1	22.1	22.8	24.0	18.4	18.7	20.9	23.8	24.9	25.3	-0.7	1.2	0.1	-3.9	-4.5	-3.4	2.8	4.1	2.2	-1.7	-2.1	-1.3
El Salvador	17.1	17.1	16.9	16.1	17.8	18.7	17.6	16.6	17.6	19.1	19.6	19.1	-2.9	-1.9	-3.1	-5.6	-4.8	-3.6	-0.5	0.5	-0.7	-3.0	-1.8	-0.5
Guatemala	12.7	12.8	12.0	11.2	11.7	11.8	13.3	12.8	12.3	12.9	12.9	12.9	-1.9	-1.4	-1.6	-3.2	-2.8	-2.8	-0.6	0.0	-0.3	-1.7	-1.1	-1.1
Honduras	24.1	24.4	26.3	24.8	25.0	25.0	25.0	25.3	27.3	28.7	28.7	28.8	-1.9	-1.6	-1.7	-4.6	-4.8	-5.3	-0.9	-0.9	-1.0	-3.9	-3.7	-3.7
Nicaragua	29.7	30.5	29.4	29.6	32.6	34.2	27.5	28.0	29.1	32.1	34.5	35.6	0.2	1.0	-1.5	-3.9	-3.3	-2.9	2.2	2.5	0.3	-2.5	-1.8	-1.4
Panama	24.9	27.8	25.9	24.8	25.4	26.2	20.1	20.9	22.4	22.9	24.1	24.5	0.5	3.4	0.4	-1.0	-1.4	-0.8	4.8	6.9	3.5	1.8	1.3	1.6
South America																								
Argentina 3/	29.9	31.5	33.4	33.9	33.8	33.9	25.9	29.1	30.6	33.8	34.6	34.6	-1.1	-2.1	-0.3	-3.9	-3.5	-3.6	4.0	2.4	2.7	0.2	-0.8	-0.6
Bolivia	34.3	34.5	38.9	32.5	34.3	34.7	27.3	30.1	34.5	30.5	32.5	32.6	4.5	1.9	2.8	0.1	-0.3	0.2	7.0	4.4	4.7	2.2	1.9	2.3
Brazil	36.1	35.7	36.5	36.2	36.6	36.8	32.8	32.3	32.5	34.2	33.3	33.5	-3.5	-2.7	-1.4	-3.3	-1.5	-2.0	3.2	3.4	4.0	2.1	3.3	3.3
Chile	27.7	29.4	28.4	22.2	24.1	23.9	19.2	19.9	22.6	26.0	25.5	24.6	7.9	8.9	5.3	-4.4	-1.8	-0.9	8.5	9.5	5.8	-3.9	-1.4	-0.6
Colombia	27.3	27.1	26.6	27.0	24.7	25.5	24.3	24.1	23.0	26.4	24.8	25.2	-0.7	-0.7	-0.1	-2.8	-3.5	-3.0	2.9	3.2	3.2	0.6	-0.1	0.2
Ecuador	27.4	28.8	33.4	29.7	31.3	31.0	21.6	24.8	33.0	32.6	34.2	33.9	3.7	2.2	-0.9	-3.6	-3.8	-3.8	5.8	4.1	0.4	-2.8	-2.9	-2.9
Guyana	29.3	27.5	25.9	28.8	29.2	29.2	34.1	30.6	29.0	30.4	30.8	31.0	-7.2	-4.9	-4.7	-3.3	-3.2	-3.2	-4.8	-3.1	-3.1	-1.7	-1.5	-1.8
Paraguay	24.6	23.1	22.1	24.0	21.8	22.4	22.2	20.1	18.3	22.5	22.6	22.0	0.8	1.5	2.7	0.7	-1.6	-0.3	2.4	3.0	3.8	1.5	-0.8	0.5
Peru	25.4	25.8	26.6	23.7	24.2	24.1	21.3	20.9	22.9	24.4	24.4	23.8	2.2	3.1	2.1	-2.0	-1.5	-1.0	4.1	4.9	3.7	-0.7	-0.2	0.3
Suriname 4/	27.4	30.5	27.5	31.2	27.8	26.0	26.7	26.9	24.9	31.7	29.8	26.2	1.1	3.0	2.0	-1.8	-2.9	-1.2	2.9	4.4	2.7	-0.5	-1.9	-0.2
Uruguay 5/	29.6	28.4	28.1	29.0	29.3	29.4	26.0	26.0	26.2	27.7	27.5	27.8	-0.9	-1.5	-1.1	-1.6	-0.9	-1.0	3.3	2.2	1.8	1.2	1.7	1.5
Venezuela	37.4	33.0	30.8	25.9	36.5	34.9	36.9	34.2	31.9	30.3	33.6	34.1	-1.6	-2.8	-2.6	-6.1	1.3	-0.5	0.5	-1.2	-1.2	-4.4	3.0	0.9
The Caribbean																								
The Bahamas 6/	17.4	18.1	18.9	17.8	17.0	17.6	17.2	18.9	19.0	20.6	20.4	20.0	-1.5	-2.5	-2.0	-4.9	-5.9	-4.8	0.2	-0.8	-0.1	-2.8	-3.5	-2.4
Barbados 7/	44.1	45.5	43.2	40.9	42.2	44.4	39.5	43.9	43.0	43.3	43.4	42.9	-5.3	-8.0	-7.6	-8.6	-7.2	-5.1	-1.5	-3.4	-3.4	-3.8	-2.5	0.0
Belize 8/	25.3	27.7	28.4	27.2	27.8	27.7	21.5	23.8	24.1	25.2	26.0	25.6	-2.0	-1.5	0.4	-2.0	-2.6	-2.6	3.8	3.9	4.3	2.0	1.8	2.2
Dominican Republic	16.1	17.2	15.8	13.6	14.3	15.3	16.4	15.3	17.1	15.6	14.3	14.7	-1.6	0.3	-3.0	-3.9	-2.2	-1.5	-0.2	1.9	-1.3	-2.0	0.0	0.6
Jamaica 8/	26.1	27.1	26.5	27.9	26.7	26.7	18.4	19.4	21.1	22.0	20.1	19.4	-4.5	-4.0	-6.5	-10.4	-6.1	-2.4	7.7	7.7	5.4	6.0	6.6	7.3
Trinidad and Tobago 8/	33.8	33.5	31.9	29.3	27.9	29.9	25.5	26.1	25.6	32.5	30.3	28.9	6.1	5.3	4.4	-6.1	-5.4	-1.8	8.3	7.4	6.3	-3.2	-2.3	1.0
ECCU 9/	31.2	30.6	31.5	30.8	31.9	31.5	32.5	31.1	31.6	34.4	33.3	30.8	-5.1	-4.0	-3.6	-8.4	-5.8	-3.6	-1.2	-0.4	-0.2	-3.6	-1.4	0.7

Source: IMF staff calculations.

1/ Figures for overall public sector, including general government and public enterprises. Definitions of public sector accounts vary by country, depending on country-specific institutional differences, including on what constitutes the appropriate coverage from a fiscal policy perspective, as defined by IMF staff.

2/ Simple averages.

3/ Federal government and provinces. Includes interest payments on accrual basis.

4/ Central government accounts only. Differences between the primary balance and revenues less primary expenditures are the result of statistical discrepancies.

5/ General government accounts only.

6/ Central government accounts only; reported on fiscal year basis.

7/ Central government accounts only. Overall and primary balances include off-budget and public-private partnership activities. Revenue and expenditure components of these items are not available and not included in the revenue and primary expenditure estimates.

8/ Central government accounts only.

9/ Eastern Caribbean Currency Union includes Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. Central government accounts only.

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