FROM RECOVERY TO RENAISSANCE

Turning Crisis into Opportunity

Coordinated by

Eduardo Cavallo
Arturo Galindo
Victoria Nuguer
Andrew Powell

IDB

2022 Latin American and Caribbean Macroeconomic Report

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Preface

Following a severe economic recession in 2020, Latin America and the Caribbean grew strongly in 2021. Because of the COVID-19 pandemic, the region suffered a triple sudden stop: capital flows ceased, mobility halted, and trade collapsed. As reviewed in the 2021 Latin American and Caribbean Macroeconomic Report, governments reacted rapidly and decisively with fiscal support as well as active monetary and financial policies to mitigate the crisis. While the loss in GDP was the largest in a single year in recorded history, these policies, together with successes in fighting the virus, set the stage for faster recovery.

In the months before the Russia-Ukraine war, GDP was rebounding, while employment was lagging. Job losses had been particularly acute for women, workers in the informal sector, and those with less education. As a result, poverty and inequality had grown. Evidence was also emerging of persistent job losses in the sectors most vulnerable to automation. Apparently, the crisis accelerated the trend towards adopting new technology, which impacted labor markets. At the same time, the region was emerging from the COVID-19 crisis with more debt, less fiscal space, and higher inflation.

In early 2022, growth rates were faltering, and policymakers were already facing complex challenges. Against this backdrop, the Russian invasion of Ukraine had a strong impact on the global economy, and thus the region. As a result, uncertainty increased, preexisting challenges were heightened, and new challenges arose. The 2022 edition of the IDB Latin American and Caribbean Macroeconomic Report analyzes the challenges, outlines the opportunities, and provides recommendations to boost stronger, inclusive, and sustainable growth in this context. Enhanced fiscal and labor market architectures are required for a faster recovery and reduced inequality.

The outlook is challenging on account of both external and domestic factors. The global economy presents several risks. Inflationary pressures are increasing across the world, leading major central banks to raise interest rates and unwind expansionary monetary policies. In the past, tighter global financial conditions proved to be challenging for the region. In addition, geopolitical security risks have grown given the Russia-Ukraine conflict and could pose a significant threat to the global recovery, as well as trigger volatility in financial markets and increase inflationary pressures. Russia and Ukraine are significant exporters and importers. They are closely linked to the global economy, and the conflict could have unpredictable consequences. Fortunately, the region's direct trade links with

Russia are relatively small, with a few exceptions, such as meat from Paraguay, inorganic chemicals from Jamaica, or fruit from Ecuador. Likewise, and except for fertilizers, the region imports little from Russia. In the case of fertilizers, imports from Russia represent close to 20% of imports for the average country in the region. Substituting these markets, both for exports and imports, is a crucial task for the region. These and other risks require close monitoring and evaluation.

Chapter 1 employs a statistical model of the world economy to analyze the impacts of specific risks for Latin America and the Caribbean. Those risks and new, emerging ones may impact the growth outlook and have implications on social indicators. The chapter reviews the most recent trends in poverty and inequality.

This economic outlook and the associated risks have significant implications for policymaking in the region. Chapter 2 on fiscal policies argues that a new fiscal architecture is required, and the crisis may provide a window of opportunity to enact meaningful reforms. It also outlines policies to improve efficiency to support both growth and equity. At the same time, most countries need to pare back expansionary fiscal stances and are planning to do so. How this transition is designed and executed will be critical to ensure macroeconomic stability, and improvements in the fiscal architecture could boost development.

Chapter 3 considers monetary policies. Central banks took exceptional steps to support economies through the crisis, but with demand surging and inflation on the rise, the landscape is now vastly different. The chapter focuses on how monetary policies should be crafted in this phase and highlights the importance of coordination between fiscal and monetary policies.

One of the remarkable aspects of the crisis was the adjustment in the external accounts of the region; both exports and imports fell, and most countries retained fluid access to capital markets, aided by exceptional monetary policies in advanced economies. Chapter 4 reviews the current state of both the current account (of goods, services, and remittances) and the financial account (capital flows). Current high commodity prices are benefitting several countries across the region. There are considerable opportunities to boost exports given the reconfiguration of global value chains. Ensuring access to capital markets for firms will be key to boost investment and exports, and requires good macroeconomic fundamentals with highly credible fiscal and monetary policy regimes.

Credit has been scarce in the region throughout the pandemic, though financial sectors have shown resilience. Many countries adopted financial policies designed to contain the impact of the pandemic. While these policies were useful to avoid costly loan defaults, they may mask higher-than-reported levels of credit risk. Regulators and supervisors should work with banks to account for and address these risks through regular stress testing exercises. To ensure a sustainable economic recovery, credit to the private sector needs to resume and balance sheets must rebalance away from low-risk-rated government securities. Strengthening financial stability becomes even more important in the context

of war, given that while the direct and indirect links of Latin American and Caribbean financial systems with Russia are limited, cross-sanctions may affect global financial flows.

The pandemic hit the labor market hard, causing extensive job losses that have not been fully recovered. Chapter 5 examines the labor market and argues that this crisis differed from previous ones given the composition of the job losses and the expected reallocation effects. At the same time, opportunities exist to create a new labor market by putting in place incentives to reduce informality and create more productive and higher-wage jobs. In addition, new technologies and digitalization offer other opportunities. The chapter suggests that with the right policy framework, the region could make significant advances in productivity and growth.

Chapter 6 draws together the conclusions and various policy recommendations outlined in this report.

For all the difficulties created by the pandemic, the war in Ukraine, and the risks and challenges ahead, the crisis has also opened a unique window of opportunity to implement fundamental changes that improve wellbeing. At the time of this writing, there is great uncertainty about how the pandemic and, especially, the war will unfold. This year's Latin American and Caribbean Macroeconomic Report presents ideas and actionable policies to advance on multiple fronts focusing on policies that are within countries' control and that can be implemented even under adverse scenarios. We should not let the window of opportunity close. The region deserves better.

Eric Parrado
Chief Economist

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CHAPTER 1

After COVID: New Risks and New Policy Frameworks

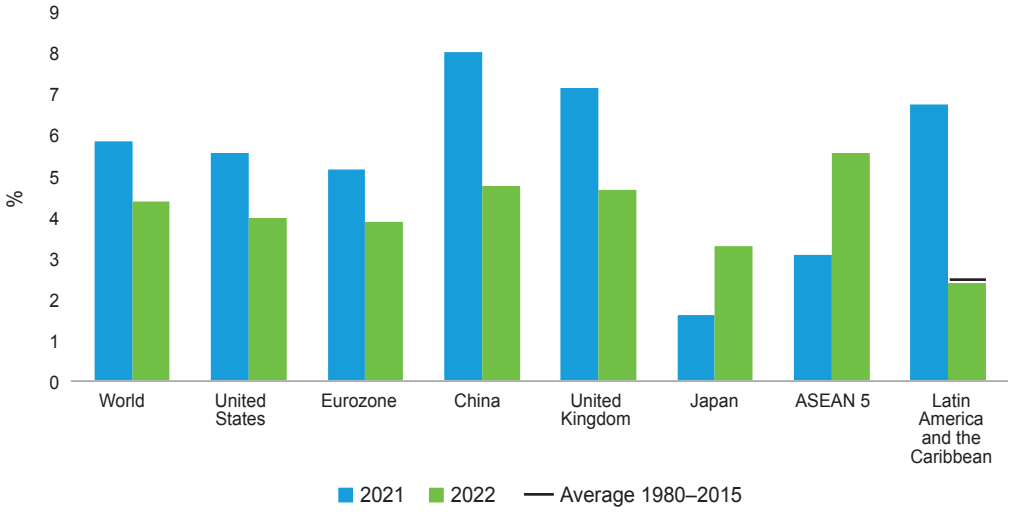
While global and regional economies recovered strongly in 2021, headwinds have strengthened. Growth for Latin America and the Caribbean was expected to wane in 2022 and converge to average long-term values. However, the Russia-Ukraine conflict, together with policy normalization in advanced economies and the possibility of new coronavirus variants, has brought changes to this pre-war scenario. The war will depress world growth and boost commodity prices. On balance, growth in the region could be below pre-war expected levels. In a scenario that combines the impacts of the war with stronger than anticipated monetary policy actions in advanced economies to counter high inflation, the region could be pushed into recession despite higher commodity prices. Poverty and inequality increased during the crisis and are unlikely to resume the declining trend enjoyed during the 2003–2013 commodity boom. Significant measures are required to boost economic performance and address many pressing demands. Crises often provide a window of opportunity for more fundamental change. This chapter considers global and regional economic prospects, the risks facing the region, and the recent data on poverty and inequality. It sets the scene for the remaining chapters to provide more detailed policy recommendations on resetting policy frameworks in critical areas.

Prospects for the Global Economy

The global economy recovered strongly in 2021 at an estimated 5.9%, some 0.4% higher than anticipated in January of that year. In January 2022, before the Russia-Ukraine conflict began, projections for 2022 global growth at 4.4% remained above average values (see Figure 1.1).[1] As 2021 ended, the rapid spread of the omicron variant through southern Africa, Europe, the United States, and elsewhere sparked a new wave of economic uncertainty. This new, highly transmissible variant has made it clearer that the COVID-19 virus will likely

[1] While less than the 4.9% projected in October 2021, this remains a percentage point above the 1980–2019 average global growth rate of 3.4% (calculations sourced from IMF [2021c]). Baseline projections illustrated in this chapter are consistent with IMF (2022).

FIGURE 1.1 • Pre-War Growth Projections



Source: IDB staff calculations based on IMF (2022).
Note: ASEAN 5 refers to Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Eurozone refers to the 19 countries that use the Euro as their currency.

be around for the medium or long haul and will need to be managed for the foreseeable future, rather than assuming it can be eradicated. New variants may also arise and could be even more transmissible than the original omicron. Worse yet, they could mutate in such a way as to evade the benefits of vaccines or fast acting therapeutics.

At the same time, even as omicron cases soared, confidence grew that this variant and others can be managed, at least to limit severe disease and deaths, given current vaccines, new platforms for developing targeted vaccines rapidly, and new therapeutic treatments for those who suffer severe effects. This confidence allowed global stock markets to reach record levels and may support growth projections. Still, a coordinated global response is required to ensure new mutations do not continually surface and new outbreaks are contained. While the economic impacts of the health crisis appeared to be fading, the war between Russia and Ukraine has now complicated the outlook for global growth and elevated the security and economic risks.

The U.S. economy bounced back from the 3.5% recession in 2020, with 5.6% growth in 2021; 4% was projected for 2022 in January of that year. Monetary policy was highly accommodating through 2021 with the policy interest rate remaining close to zero and the Federal Reserve continuing to purchase assets. On the fiscal front, the initial US$2.5 trillion package in 2020 was followed by a stimulus of US$900 billion and a further US$1.9 trillion package focused on infrastructure spending.

The rise in demand coupled with supply chain problems in some sectors pushed inflation higher, with an annual rate of 7.5% reported in January 2022, substantially above

the Federal Reserve's medium-term 2% target. There was optimism that the inflation spike would be temporary, as pent-up demand waned and supply constraints loosened. However, it has proved to be more persistent than expected; the Russia-Ukraine conflict with its effects on commodity prices will further impact inflation.

The impact on labor markets has been exacerbated by what has become known as the "great resignation," with over two million workers reportedly choosing to leave the labor market. The impacts on labor participation have been especially acute in the contact sectors, particularly retail, health, and education.[2]

In view of the rise in inflation, the Federal Open Market Committee (FOMC) meeting of December 2021 indicated a change in monetary policy (U.S. Federal Reserve, 2021); the Federal Reserve announced that asset purchases would be tapered and at that time the median member of the FOMC expected three hikes of 25 basis points each in the policy interest rate through 2022. The reaction in the bond market following the meeting and the press release was muted; the ten-year treasury bond remained at a yield of around 1.5% and the stock market rose on the announcement.

The war between Russia and the Ukraine, coupled with persistently high inflation, has now pushed the Federal Reserve to become considerably more hawkish. In its March meeting, the policy interest rate was raised by a highly anticipated 25 basis points (some market participants had thought this first hike might be 50 basis points) and the press conference and subsequent remarks by the FOMC Chair highlighted the need and the willingness to act to bring down inflation.[3] FOMC members altered their outlook for future monetary policy, such that the expectation of the median member of the FOMC became 6 hikes of 25 basis points by the end of 2022.

The Federal Open Market Committee also announced it will phase out net asset purchases by March 2022 and released a set of principles on how it will then reduce the size of its balance sheet of US$8 trillion of United States Treasuries and Mortgage-Backed Securities (MBS). According to these guidelines, asset sales will be predictable and focus on allowing some portion of the maturing assets to run off the balance sheet without reinvesting the principal payments on assets coming due. Since in the medium term the intention is to hold only United States Treasuries on the balance sheet, this policy may focus on the MBS coming due. These principles were aimed at limiting the uncertainty surrounding how the Federal Reserve might reduce its extensive balance sheet. By the same token, any unexpected deviations from the path for balance sheet normalization

[2] See the News Economic Release from the U.S. Bureau of Labor Statistics from January 7, available at https://www.bls.gov/news.release/empsit.nr0.htm.

[3] The meeting was on March 15 and 16, and the press conference is available at https://www.federalreserve.gov/monetarypolicy/fomcpresconf20220316.htm. In addition, see the speech at the National Association for Business Economics on March 21 available here: https://www.federalreserve.gov/newsevents/speech/powell20220321a.htm.

now expected by investors could significantly impact longer-term yields, including on emerging economy bonds.

Growth projections for 2022 for the United States have been falling from around September of last year and the outbreak of the Russia-Ukraine conflict only accentuated that trend. The median of the Bloomberg survey of professional forecasters indicated 3.5% growth for 2022 as of March 24.[4]

Growth in Eurozone economies also bounced back from a recession of 6% in 2020 to 5.2% growth in 2021; growth of 3.9% is projected for 2022. The rapid spread of the omicron variant provoked new restrictions on mobility in some countries and dampened growth prospects for this year. The European Central Bank (ECB) also adopted an extremely accommodating policy stance with low policy interest rates and a strong program of asset purchases.[5] Inflation had risen in several countries in the Eurozone even before the war and reached 5.0% in December 2021 across the 19 economies. The war is pushing prices higher and may even provoke shortages of some key goods, including energy-related products.

Given the impacts of lower trade with Russia and Ukraine, the prospect of potential shortages of key goods and inflationary pressures, and the potential policy response, growth prospects have also been falling in the Eurozone. The median of the survey of Bloomberg professional forecasters for 2022 was 3.3% on March 24.[6]

China was the first of the world's largest economies to recover from the COVID crisis. Strict lockdown policies in cities where outbreaks occurred helped limit the impacts of the virus. Recovery began in the latter half of 2020 and continued through 2021. China posted positive growth of 2.3% in 2020 and the economy grew by 8.1% in 2021. This strong performance helped boost commodity prices even as global demand weakened due to the pandemic. Growth waned in the second half of 2021 and is expected to be 4.8% in 2022. This projection indicates not only that the days of double-digit growth have long gone but also the likelihood of regaining growth rates of around 6% is now very low. Moreover, these projections carry risks. China has adopted a policy of strict lockdowns in cities that suffer even small outbreaks of COVID, and while this has helped contain any new surge in the virus, it may impact economic activity and spill over to supply shortages for some critical components in the West. The highly transmissible nature of omicron may yet test this policy as the country opens its borders further. In addition, the high debt levels of some companies and municipalities continue to present a challenge for policymakers. The recent troubles of Evergrande highlight the issues. This real estate company had over

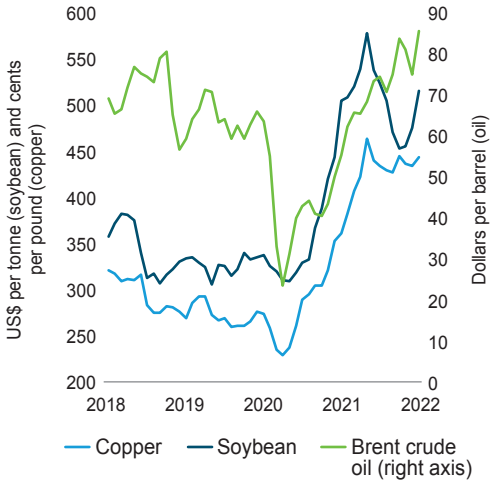
[4] The OECD suggested a loss in GDP of over 0.8% of GDP for the United States in the first full year as a result of the war (OECD, 2022).

[5] The ECB sets a series of interest rates. The Main Refinancing Operation rate is currently set at 0% and the rate paid by the ECB on deposits of banks is –0.5%. See ECB (2021).

[6] The OECD indicated a potential loss of 1.4% for Eurozone GDP in the first full year after the war (OECD, 2022).

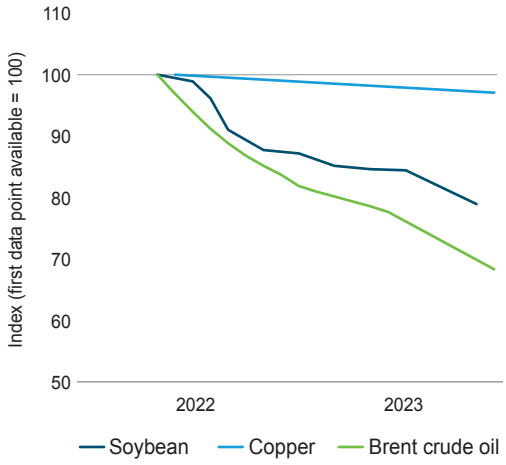
FIGURE 1.2 ● Developments in Commodity Prices

A. Commodity prices



Source: IDB staff calculations and Bloomberg.
Note: Monthly commodity prices in different units as indicated on the axes of the figure. The last data point is the price on February 28, 2022 rather than the February average.

B. Commodity futures curves



Source: IDB staff calculations, International Commodity Exchange (for Brent crude oil futures), London Metal Exchange "official prices" (for copper futures) and Chicago Mercantile Exchange (for soybean futures). The data were sampled on February 28, 2022.

US$300 billion in financial liabilities. While China has ample resources to deal with such a problem, the underlying issue is how to resolve the problem for such companies without creating incentives for reckless borrowing. As growth trends down, more such cases are likely to crop up and overall debt levels are significant, constituting a risk to monitor closely in the months and years ahead.

The resurgence in global demand pushed commodity prices to higher levels, and many prices surpassed pre-pandemic levels (see Figure 1.2, Panel A). The Russia-Ukraine conflict then provoked another sharp rise in the prices of commodities including crude oil and soybeans. The future course of commodity prices will depend critically on how the conflict develops. At the same time, the futures curves for most commodities are in backwardation (meaning that futures prices are below spot prices). Figure 1.2, Panel B illustrates the futures prices at different expiry dates for oil, copper, and soybeans, three critical commodities for the region. When a commodity futures curve is in backwardation (strictly speaking when the futures price is below the spot price plus storage costs and the interest rate, known as the "full carry"), this normally implies a temporary disruption to supply and the average expectation among traders is that the spot price will fall over time. As oil and soybean prices soared, steeper backwardations developed. Still, prices are expected to be significantly above pre-war levels for many months ahead.

The anticipated rise in short-term interest rates may push up longer-term yields and emerging market bond yields. It may also lead to less liquidity in global financial markets and hence reduce capital flows to the region. The impacts would be even more serious if inflation in the United States does not fall as anticipated as this may prompt the Federal Reserve to take actions that are beyond the expectations of most market participants. Such actions could include more aggressive interest rate hikes than expected or significant quantitative tightening (QT)—in other words, the Federal Reserve system selling mortgage-backed securities or even U.S. Treasury bonds to tighten liquidity and increase pressure on longer-term interest rates.

In addition to the risks outlined, the ongoing conflict between Russia and Ukraine could have further impacts on the global economy. Energy prices have risen strongly, and supply chains may face greater disruption. Russia is a significant exporter of oil, gas, grains, fertilizers, and other products, so, at a minimum, these markets are likely to be affected. Global financial markets may also be impacted, particularly since a portion of Russia's central bank reserves have been frozen and it is unclear how Russia will make payments on instruments outstanding. There could also be contagion through the international banking system. Financial asset valuations and commodity prices will likely remain volatile until relations between Russia and NATO countries become clearer.

In Chapter 4, the trade links between Russia, Ukraine, and the rest of the world are analyzed, with a focus on the role Latin America and the Caribbean could play in mitigating supply disruptions and limiting the impact on global inflation. Chapter 4 also considers the cross-border links through banking systems and the macroeconomic fundamentals that are important in resisting sudden stops in capital flows given volatility and elevated levels of risk in international capital markets.

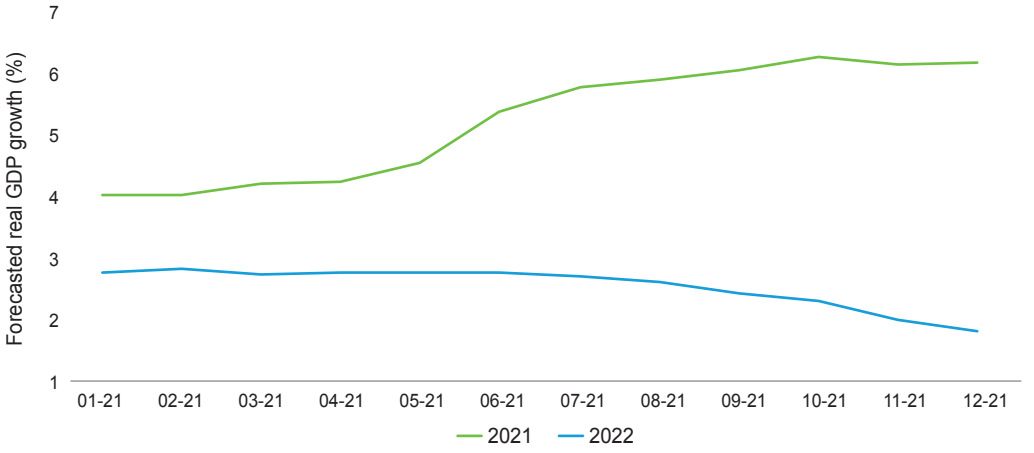
Prospects for Latin America and the Caribbean

As detailed in the 2021 Latin American and Caribbean Macroeconomic Report (Cavallo and Powell, 2021), the 7% loss in GDP in 2020 was the worst single-year recession suffered by the region since the struggles for independence in the first half of the 19th century.[7] By contrast, 2021 has brought strong growth—stronger than was generally anticipated. An average of private forecasters suggested in January 2021 that growth would be less than 4.5% for the year, but that figure increased substantially through the year to almost 7% (see Figure 1.3).[8] The IMF increased its growth projections for 2021 to 6.3% by October 2021 and by January 2022, the estimate for 2021 growth had reached 6.8% (see Figure 1.1). These substantial revisions to the growth projections highlight the difficulty in forecasting growth, given the currently high levels of uncertainty.

[7] See Cavallo and Powell (2021).

[8] This is based on the survey conducted and reported by Bloomberg of professional forecasters.

FIGURE 1.3 ● Growth Prospects for Latin America and the Caribbean



Source: IDB staff calculations from central bank surveys of growth projections as published in the IDB's Revela interactive tool, available at https://www.iadb.org/en/research-and-data/revela.
Note: The figure illustrates projections for 2021 growth and for 2022 growth made in each month of 2021.

Interestingly, as growth projections improved for 2021, as illustrated in Figure 1.3, they declined for 2022. While this reflected a stronger rebound than expected in 2021, it indicated that the rebound was expected to be temporary, and the region was expected to return to a longer-term average growth rate of around 2.5%.[9]

Still, despite a mixed record on the speed of vaccinations, many countries reported successes in dealing with the pandemic.[10] High commodity prices boosted prospects for exporters and the highly accommodating monetary policy in advanced economies allowed sovereigns and firms to tap capital markets. Meanwhile, expansionary fiscal and monetary policy continued in many countries. Despite recent interest rate hikes, real short-term interest rates remain negative, and central bank balance sheets have not yet shrunk to their pre-crisis size in most countries, after unprecedented expansions as a response to the crisis.

The strength of financial systems in Latin America and the Caribbean was an important asset through the COVID-19 crisis. The high capital and liquidity ratios, assisted by government programs to support credit, and central bank actions to provide additional liquidity and regulatory flexibility, allowed banks to maintain and even boost credit in some countries. As economies recovered, loan moratoria and guarantee programs were phased out, although reprogrammed and guaranteed loans have not all expired. Bank provisioning

[9] The 1980–2019 average growth rate was 2.5%, as was the 2000–2019 average growth rate (sourced from IMF [2021c]).

[10] For information on vaccinations and other aspects of the pandemic in Latin America and the Caribbean, please visit the IDB's Coronavirus portal and select the current situation here: https://www.iadb.org/en/coronavirus/current-situation-pandemic.

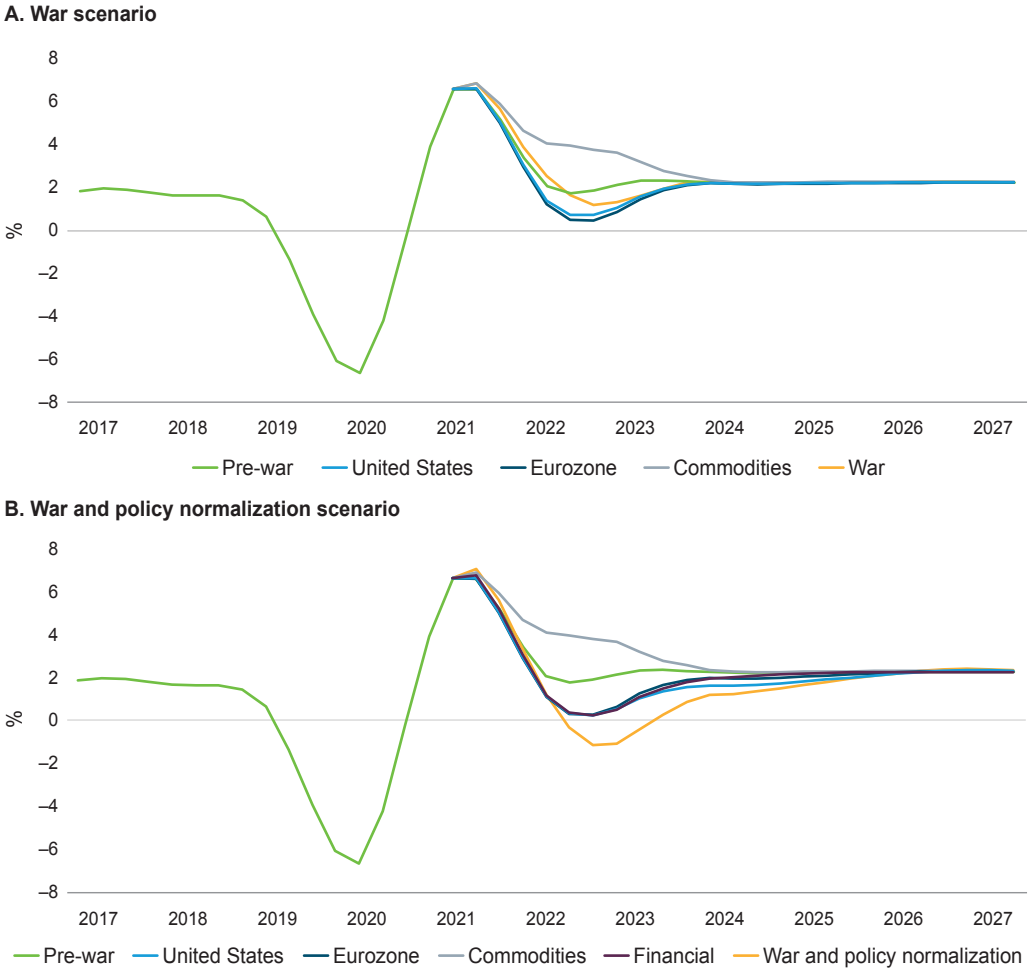
for nonperforming loans has risen and nonperforming loans have started to rise. The final levels of impaired assets remain uncertain. Current capital ratios and traditional credit quality indicators are difficult to interpret given the change in the composition of assets towards government bonds (that have a zero risk-weight for regulatory capital calculations) and the changes in regulations. Market measures of risk, harnessing balance sheet measures of liabilities, stock market valuations, and volatility measures, suggest that the probability of capital levels falling below regulatory minima remains higher than before the pandemic.[11] At the same time, banking systems are highly interconnected across borders. Thus, the war raises concern over contagion due to direct exposure or the exposure of international banks that are also active in the region. As detailed in Chapter 4, these links appear to be modest, thereby limiting the risks of contagion through this channel. Given the unique challenges facing financial systems that likely impact individual institutions in different ways, policymakers may wish to enhance the use of stress testing to assess banks' strengths and weaknesses and as a technique to reveal more information to the public regarding how each institution is expected to perform given its level of provisioning and likely developments in terms of nonperforming assets.

Now, policymakers must also consider the impacts of both the Russia-Ukraine war and policy normalization in advanced economies to develop an appropriate policy stance in the coming months. This is no easy task as multiple shocks have pulled in different directions. The two scenarios presented below are designed as an aid in this thought process. A Global Vector Auto-Regression (G-VAR) statistical model of the world economy including several countries in Latin America and the Caribbean is then employed to analyze the implications for the region.

The first scenario considers specific shocks to the global economy due to the war between Russia and Ukraine. The scenario combines negative shocks to growth in the Eurozone and the United States with a positive shock to commodity prices. These shocks are understood to be in relation to the pre-war scenario as outlined in the IMF's January World Economic Outlook (IMF, 2022). The negative shock to Eurozone GDP is assumed to be 1.4% while the loss of U.S. GDP is fixed at 1%. The shock to commodity prices is in line with the rise in oil prices, from the (average) January 2022 Brent crude spot price, to the Brent futures curve as of mid-March 2022. This implies a near 30% increase in the spot oil price in the second quarter of 2022 that then gradually falls in line with the futures curve through 2024. Other commodity prices are left to be determined by the model but, given the high correlation between commodities, also rise significantly. In this scenario, no additional financial shock is included, but financial markets react to the other shocks and equity markets fall across the globe.

[11] For further analysis of financial systems and the disconnect between traditional and market measures of risk please, refer to Galindo and Powell (forthcoming).

FIGURE 1.4 ● Growth Scenarios for Latin America and the Caribbean



Source: IDB staff calculations based on IMF (2022) and Goldfajn, Ivanova, and Roldos (2022).
Note: The pre-war scenario is taken from IMF projections as of January 2022 (IMF, 2022). Scenarios are generated using a Global Vector Auto-Regression Model (G-VAR). In the war scenario, the shock to Eurozone and United States GDP is 1.4% and 1.0% respectively. The commodity shock is the difference from the average spot price of Brent crude oil in January 2022 to prices indicated by the Brent futures curve from the London Commodity Exchange as of mid-March 2022. The war and policy normalization scenario has deeper growth shocks for the United States and the Eurozone, the same commodity shock and a one standard deviation fall in stock market values in the United States, the United Kingdom, and Germany, labeled as the financial shock. For further details on the G-VAR, see Cesa-Bianchi et al. (2012) and Powell (2012). Latin America and the Caribbean includes Argentina, Bolivia, Brazil, Chile, Costa Rica, Colombia, Ecuador, El Salvador, Jamaica, Mexico, Nicaragua, Paraguay, Peru, and Trinidad and Tobago.

As can be seen in Figure 1.4, Panel A, the commodity price shock is favorable for the region while the two negative growth shocks each depress growth below the pre-war scenario. Given the dynamics in this empirical analysis, which results from estimating the model over the last 20 years, the impact of the commodity shocks is relatively fast and results in higher growth in 2022 than in the pre-war scenario. However, the negative growth shocks then outweigh the impacts of higher commodity prices that ultimately

fade out. The net result is a negative scenario for the region in 2023 and overall, relative to the pre-war scenario. There are some differences across subregions with larger losses relative to the baseline for Central America and the Caribbean, and Mexico. Mexico is hit harder by lower growth in the United States, and Central America and the Caribbean is also hit by the combination of that shock and higher oil prices. The losses in GDP relative to the pre-war scenario are detailed in Table 1.1 and the actual annual growth rates are provided in Table 1.2.

The war is exacerbating the problem of higher and more persistent inflation in advanced economies. In order to explore the risks to the region of policy normalization, a second negative scenario is developed. The potential problems from a more complicated policy normalization than that anticipated by the market is based on a scenario developed in the IMF's October 2021 World Economic Outlook (IMF, 2021c), which includes a more complex reversion of the highly accommodating monetary policies in advanced economies, particularly the United States.[12] More specifically, the assumptions for growth in the United States and Europe are taken from the IMF's scenario; then, a financial shock is added which is intended to reflect a market correction in the valuation of financial asset values given a significant rise in U.S. interest rates.[13] The negative growth shocks operate in the period 2022–2024. The financial shock is front-loaded relative to the growth shocks and is assumed to take place through 2022 only. These shocks are then added to the shocks in the war scenario to create a scenario that is labeled "War and policy normalization." It should be noted, however, that this represents a significantly more complicated policy normalization than currently envisaged by the market: policy interest rates may be raised beyond current expectations or significant quantitative tightening (bond sales by the Federal Reserve) may be considered necessary to reduce liquidity and boost longer-term rates. The impacts on growth in Latin America and the Caribbean are then illustrated in Figure 1.4, Panel B.

In Panel B, the shocks to U.S. and Eurozone growth are deeper than in Panel A and consequently have a larger impact on the region. The commodity shock is the same as in Panel A and thus has the same positive effect on growth.

The financial market shock is also highly significant for the region. The combined effect (aggregating the growth, commodity, and financial shocks) is to reduce growth substantially from the pre-war scenario with the region only recovering towards the end of 2023 and into 2024. The combined shock shaves off 1.5% of GDP on average each year from 2022 to 2024, from the average baseline growth of 2.2% per year. Mexico is hardest hit among the countries and regions analyzed, given its close links to the United States,

[12] See IMF (2021c), Chapter 1, Scenario Box 1, p. 23 for further details.

[13] The financial shock is calibrated to be one standard deviation of stock market returns for the United States, the United Kingdom, and Germany, which is roughly a correction of 7% to 9%, depending on the market.

TABLE 1.1 ● GDP Losses Relative to the Pre-War Scenario (annual average 2022–2024)

Region	Pre-war	War	War and policy normalization
Latin America and the Caribbean	**2.2**	**–0.1**	**–1.5**
Southern Cone	2.1	0.0	–1.3
Central America, Caribbean, and Mexico	2.5	–0.3	–2.0
Andean countries	3.5	0.1	–1.1

Source: IDB staff calculations.
Note: The pre-war scenario is based on IMF (2022). The war scenario includes an increase in spot Brent crude oil prices from the January 2022 average to prices following the futures curve as of March 2022, which implies a 30% increase in the price for the second quarter of 2022, and negative shocks to growth in the Eurozone of 1.4% of GDP and in the United States of 1.0% of GDP. The war plus policy normalization scenario is based on an interpretation of the IMF's negative scenario in IMF (2021c) with larger than anticipated hikes in interest rates and/or asset sales plus deeper shocks in U.S. and Eurozone growth.

TABLE 1.2 ● Annual Growth Rates in the Pre–War and Negative Scenarios

A. War scenario

	2021	2022		2023		2024	
Region		**Pre–war**	**War**	**Pre–war**	**War**	**Pre–war**	**War**
Latin America and the Caribbean	**6.7**	**2.1**	**2.6**	**2.4**	**1.7**	**2.2**	**2.3**
Southern Cone	7.3	1.8	2.4	2.2	1.6	2.3	2.4
Central America, Caribbean, and Mexico	5.2	2.9	2.9	2.7	1.8	2.0	2.0
Andean countries	9.7	3.8	4.0	3.3	3.1	3.3	3.6

B. War and policy normalization scenario

	2021	2022		2023		2024	
Region		**Pre–war**	**War and policy normalization**	**Pre–war**	**War and policy normalization**	**Pre–war**	**War and policy normalization**
Latin America and the Caribbean	**6.7**	**2.1**	**1.2**	**2.4**	**–0.4**	**2.2**	**1.3**
Southern Cone	7.3	1.8	1.2	2.2	–0.3	2.3	1.4
Central America, Caribbean, and Mexico	5.2	2.9	1.3	2.7	–0.6	2.0	0.9
Andean countries	9.7	3.8	2.8	3.3	1.5	3.3	2.9

Source: IDB staff calculations.
Note: The pre-war scenario is based on IMF (2022). The war scenario includes an increase in spot Brent crude oil prices from the January 2022 average to prices following the futures curve as of March 2022, which implies a 30% increase in the price for the second quarter of 2022, and negative shocks to growth in the Eurozone of 1.4% of GDP and in the United States of 1.0% of GDP. The war plus policy normalization scenario is based on an interpretation of the IMF's negative scenario in IMF (2021c) with larger than anticipated hikes in interest rates and/or asset sales plus deeper shocks in U.S. and Eurozone growth.

with a loss of 2.1% of GDP per year on average for the three years 2022–2024 (see Table 1.1). Brazil is the least affected given its greater links to Europe relative to the United States, the benefits of the commodity shock, and somewhat lesser dependence on international

capital markets. Still, the shock reduces growth by 1% per annum from 2022 to 2024 in that country relative to the pre-war scenario.

In this second and more negative scenario, growth would be reduced from 2.1% to 1.2% in 2022 and in 2023, growth in the region would be negative (-0.4%). The region recovers in 2024 to 1.3% and thereafter converges back to longer-term growth. Growth rates in the pre-war and negative scenarios are detailed in Table 1.2.[14]

The negative scenarios demonstrate the current risks to the region of the war and a more aggressive monetary policy normalization than is currently anticipated. Tremendous uncertainty surrounds both the war and its economic impacts and the need for more aggressive policy normalization. These scenarios are only indicative and depend critically on the underlying assumptions. Other assumptions would lead to different results. Moreover, the underlying statistical model is a necessary simplification of a very complex set of interactions in the global economy.

To give greater context and detail regarding these interactions, Chapter 4 includes a discussion of the direct trade links between Russia and Ukraine and Latin America and the Caribbean. Russia is an important market for several exports from Latin America and the Caribbean, including dairy products and meat (almost 20% and 8%, respectively, of total exports of those products from the Southern Cone, excluding Brazil), and tobacco (about 8% of Brazil's total tobacco exports). In terms of imports, about 20% of the region's total imports of fertilizers come from Russia, as do over 5% of total imports of iron and steel. The elevated price of oil and grains will benefit exporters, but importers, particularly in Central America and the Caribbean, are facing higher prices. For all countries, higher global oil prices will feed into higher inflation levels, as discussed in Chapter 3. Chapter 4 also explores potential links through banking systems.

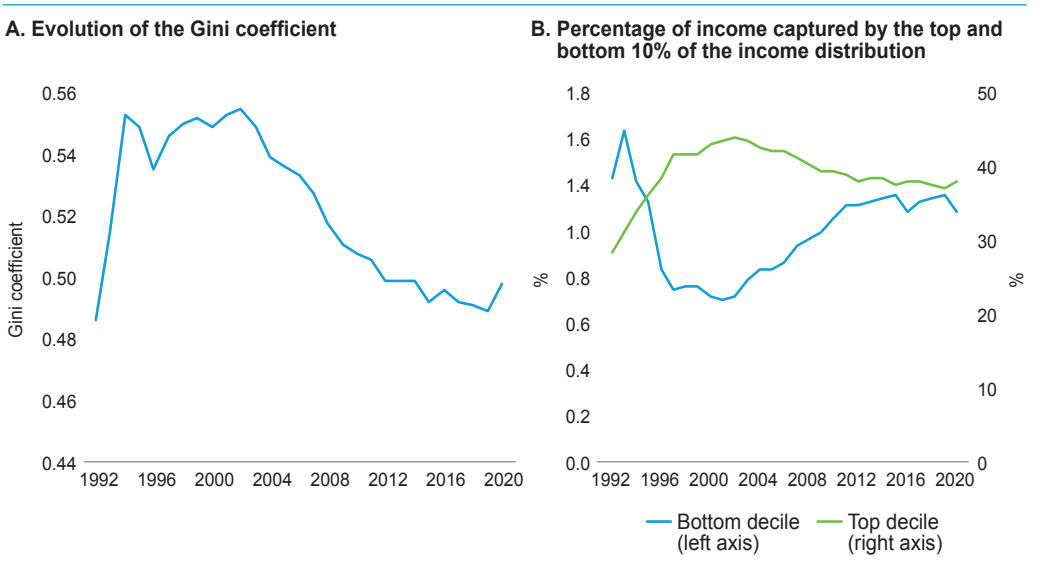
While higher commodity prices are generally associated with lower poverty and inequality in the region, lower growth and higher inflation will likely reduce the real income of poorer households. The next section presents a brief review of developments in both inequality and poverty and the prospects for the future.

Tracking Inequality and Poverty in Latin America and the Caribbean

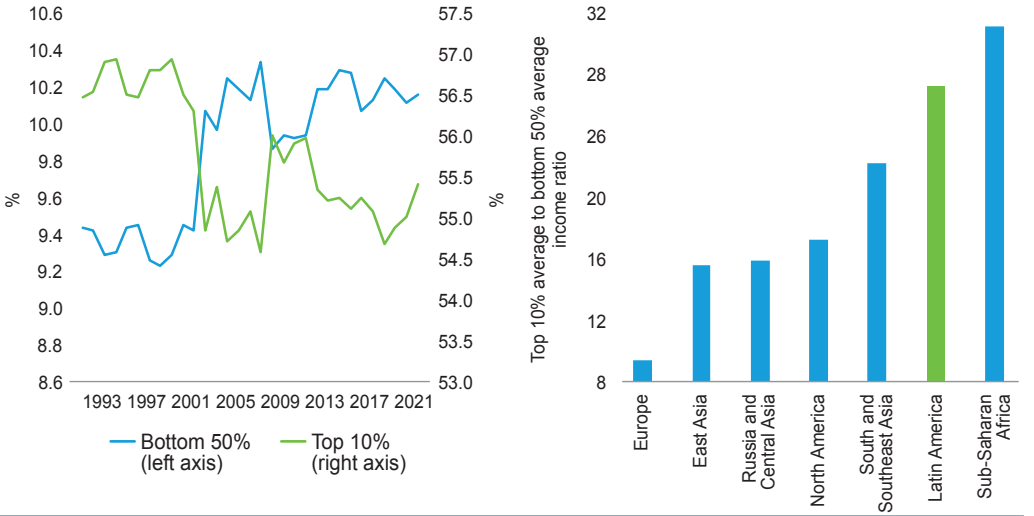
The stronger than expected economic rebound in 2021 helped limit the rise in inequality as a result of the COVID crisis. However, a return to the mediocre growth rates of the pre-COVID years will likely prevent the region from resuming the trend of falling inequality that prevailed prior to COVID, especially through the post-2003 commodity boom. Figure 1.5, Panel A illustrates the evolution of the Gini coefficient in ten Latin American countries.

[14] Note that baseline growth in this modeling exercise differs from the baseline projections for the Latin American and Caribbean region, as not all countries are included in the regional aggregate.

FIGURE 1.5 ● Trends in Inequality



Source: Acevedo, Castellani, Cota et al. (2021).
Note: Figures include Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Mexico, and Peru.



Source: Chancel et al. (2021).

While this measure of inequality fell strongly between 2003 and 2013 and then stabilized, the Gini coefficient grew by a full percentage point in 2020.

The increase in inequality was driven mainly by the dynamics at the bottom and the top of the income distribution. Figure 1.5, Panel B plots the share of income captured by

the top 10% in the household surveys. While the income share of the wealthy had been falling since 2003, it increased by almost one percentage point in 2020. At the same time, the share of income captured by the bottom 10% declined in 2020 after nearly 20 years of continuous growth.

Interestingly, the income captured by the bottom half of the income distribution did not change as much in 2020, indicating that the extremes of the income distribution account for the dynamics of inequality (see Figure 1.5, Panel C). The region continues to have one of the largest income gaps in the world in 2021 (see Figure 1.5, Panel D). The bottom 50% earn 27 times less than the top 10% in Latin America and the Caribbean, compared to 9 times less in Europe.

The improvement in inequality before the COVID crisis was driven by changes in the labor markets, particularly by rapid wage growth at the lower end of the distribution.[15] About 56% of the reduction in the Gini coefficient between 2003 and 2018 was explained by the wage structure alone. In addition, the growth in employment and changes in nonlabor income, primarily driven by the generalization of targeted social assistance government transfers, contributed to the decline in inequality.[16]

If wages were the main driver of inequality reductions before the pandemic, employment was the key driver of the increase in inequality as COVID-19 surged through the region. Social distancing measures and shelter-at-home orders halted virtually all nonessential economic activity. Employment fell by 17% on average between February and June 2020, according to evidence from household surveys (see Chapter 5). In contrast to previous crises, when informality acted as a buffer, employment in the informal sector fell more than it did for formal workers. Indeed, formal employment, defined as those workers who contribute to pension systems, fell by 8%. However, since June 2020, informal employment has rebounded strongly and has now surpassed the level of February 2020.

Employment losses through 2020 were greater for workers with lower levels of education, as shown in Figure 1.6 for Chile, Colombia, and Peru.[17] The trajectories for female versus male employment rates also varied significantly.[18] More women lost their jobs than men and the recovery has been slower for female employment. As of September 2021, despite the strong economic recovery, the jobs deficit was an estimated 6% for women compared to just 1% for men. The impacts on labor markets are reviewed further in Chapter 5. The pattern of job losses across formal and informal workers, education levels, and gender are closely related to the rise in inequality as well as increased levels of poverty.

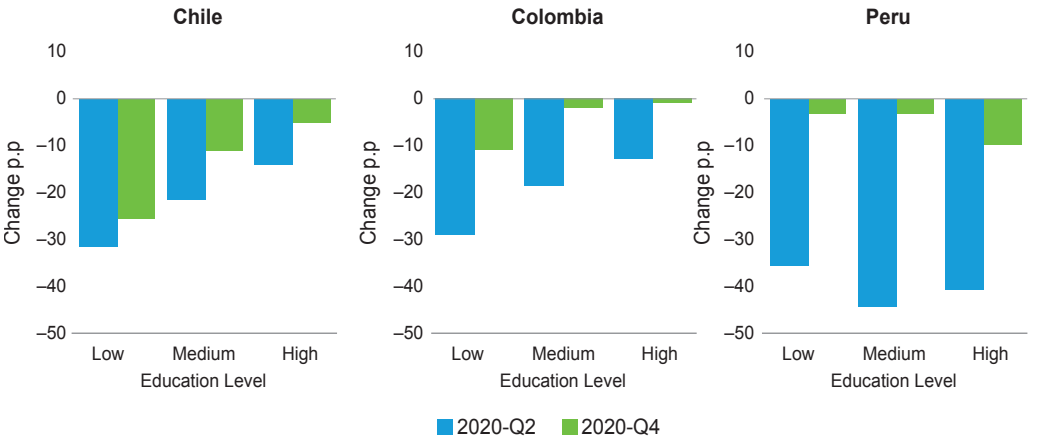
[15] See also Messina and Silva (2019).

[16] See also Busso and Messina (2020).

[17] See Bottan, Hoffmann, and Vera-Cossio (2020).

[18] The employment rate is employment relative to the labor force including those that are employed and those looking for work.

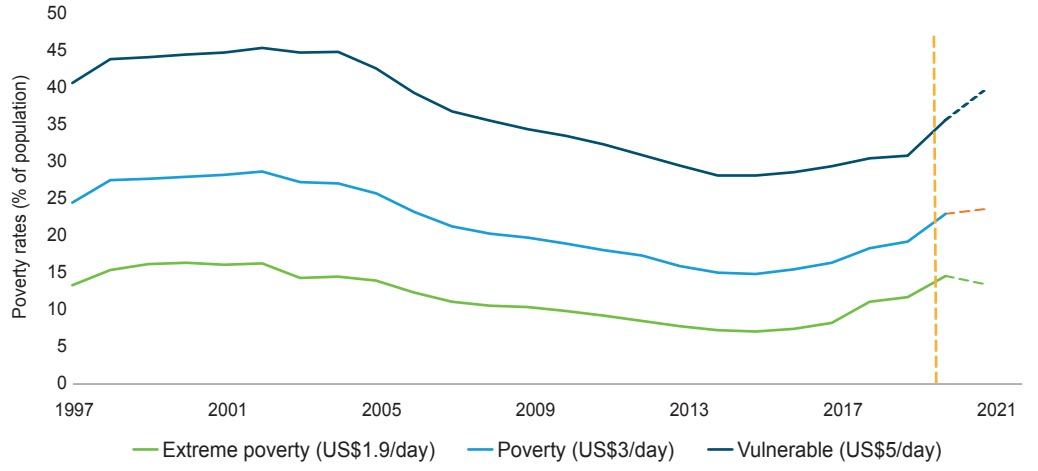
FIGURE 1.6 ● Employment Losses by Level of Education



Source: Álvarez and Pizzinelli (2021).
Note: The figure illustrates the loss of employment in percentage points. For education, the "low" group includes those with primary school level education or less, "medium" are those with secondary schooling, and "high" are those with post-secondary including tertiary level education.

Poverty has increased in tandem with the rise in inequality. Figure 1.7 illustrates the rise in the percentage of the population living in extreme poverty, poverty, and vulnerability (i.e., with incomes below US$1.9, US$3.1, and US$5 a day, respectively). The COVID-19 crisis has exacerbated the trend of gradually increasing poverty post 2013 and undone

FIGURE 1.7 ● Poverty and the COVID-19 Crisis



Source: IDB staff calculations based on Stampini et al. (2021).
Note: Poverty rates are measured as the percentage of the population living in households with a per capita income below US$1.9, US$3.1, and US$5 a day, measured in real terms and adjusted by Purchasing Power Parity (PPP) exchange rates. Each line shows the simple regional average of 18 countries with regular household surveys. For 2021, household data were used for a subset of countries while predictions were used when survey data were unavailable. The predictions were based on a regression model. The vertical dashed line approximates the beginning of the COVID-19 crisis.

more of the reduction in poverty attained during the 2003–2013 commodity boom. In 2020, the percentage of the population with incomes below US$3.1 per day increased by almost 20%, implying 26 million more people living below that level. Extreme poverty (people living with at most US$1.9 per day) increased 25%. Such poverty levels have not been recorded since the early 2000s.

Government programs mitigated the impact of the crisis on both inequality and poverty but were insufficient to completely insulate more vulnerable populations.[19] Governments rapidly put in place almost 200 income support policies (the majority cash transfer programs) to help poorer households and to complement existing programs (see Cejudo, Michel, and Ramirez [2021]). However, the existing safety net had been designed to deal with structural poverty and not with transitory shocks that affected vulnerable households above the poverty line. The COVID-19 crisis pushed many of these families back into poverty (Busso et al., 2021). In part because of the limited coverage of the transfers and the relatively short duration of the response, the expansion of income-support policies is estimated to have reduced the incidence of poverty (and extreme poverty) by two percentage points (Stampini et al., 2021). While recent data suggest extreme poverty may have begun to fall, other measures of poverty remain elevated and above pre-crisis levels.

The economic recovery in the region after the first year of the pandemic was accompanied by an increase in commodity prices, reinforced by the war between Russia and Ukraine. Commodity booms trigger opposing effects on poverty in the region. On the one hand, as the increase in commodity prices is passed through food and gas retail prices to inflation, poverty tends to increase because poor households spend a large share of their budgets on those items. On the other hand, commodity booms have been accompanied by an increase in the demand for low-skilled workers, thereby increasing earnings in the bottom tail of the income distribution. In addition, depending on the context, commodity booms tend to open up fiscal space and allow governments to expand transfers to the poor and spend more on energy subsidies, which offset price increases (see Busso and Messina [2020]). In the recent past, these counteracting effects have allowed poverty rates to decline in economies that are net commodity exporters (Balakrishnan et al., 2021). As the impacts are ambiguous, policymakers will wish to monitor this area carefully.

Risks and New Challenges

The region faces considerable challenges. New global coronavirus variants, such as omicron and subvariants, may spread rapidly through the region. Countries will need to find effective ways to manage the health and economic impacts. The reality now is that the coronavirus is unlikely to be eradicated; rather, it will need to be managed through

[19] See Bottan, Hoffmann, and Vera-Cossio (2021) and Acevedo, Castellani, Cota et al. (2021).

a strategy of vaccinations, preventative measures, and therapeutics for those with more severe symptoms. Preventative measures may impact economic activity, but the hope is that the types of lockdowns or severe restrictions on mobility seen in many countries in 2020 will not be needed.

Growth recovered strongly in 2021, but the war between Russia and Ukraine poses new risks and challenges. Higher commodity prices will be positive for investment and growth in commodity exporting countries, but higher oil prices will be a considerable burden for Central America and some countries in the Caribbean. High prices for primary products are also pushing inflation yet higher across the world, complicating the need to normalize monetary policy in advanced economies. In a war scenario, growth may be lower in the region than in the pre-war scenario, depending critically on the growth impacts in Europe and the United States which may offset the benefits of higher commodity prices. In a scenario that also includes a more complicated policy normalization in advanced economies—one in which monetary policy must be more aggressive than anticipated to bring down inflation—the region might be pushed into a recession in 2023.

This economic outlook and the associated risks have significant implications for policymaking in the region. Policymakers will need to take bold steps to boost growth, make sure fiscal and monetary policies are consistent, and ensure public policies are designed efficiently and improve both equity and growth. The chapters that follow draw out policy recommendations in key areas including fiscal and monetary policy, the external sector, and labor markets. A final chapter summarizes the main recommendations.

CHAPTER 2

Towards a New Fiscal Architecture

Country authorities implemented fiscal measures to help households and firms during 2020 and in 2021. As a result, fiscal deficits and debt levels increased across the region. Countries now face the challenge of managing the transition out of the pandemic in the context of the war in Ukraine. While there may be different fiscal implications depending on the characteristics of each country, the entire region shares three priorities: reducing spending levels; reducing debt levels; and maintaining fiscal sustainability while supporting economic recovery and protecting the most vulnerable.

This chapter reviews recent fiscal developments, assesses the main risks involved, and evaluates policy options for countries to ensure a stronger and more equitable recovery. Given the complexity of the challenges, isolated and disjointed changes to existing frameworks will not be sufficient. The current environment provides a window of opportunity for significant reforms to improve the efficiency of public spending and the tax systems. It is time to create a new fiscal architecture with strategies to improve equity, boost fiscal sustainability, and increase growth.

A Reduced Fiscal Stimulus

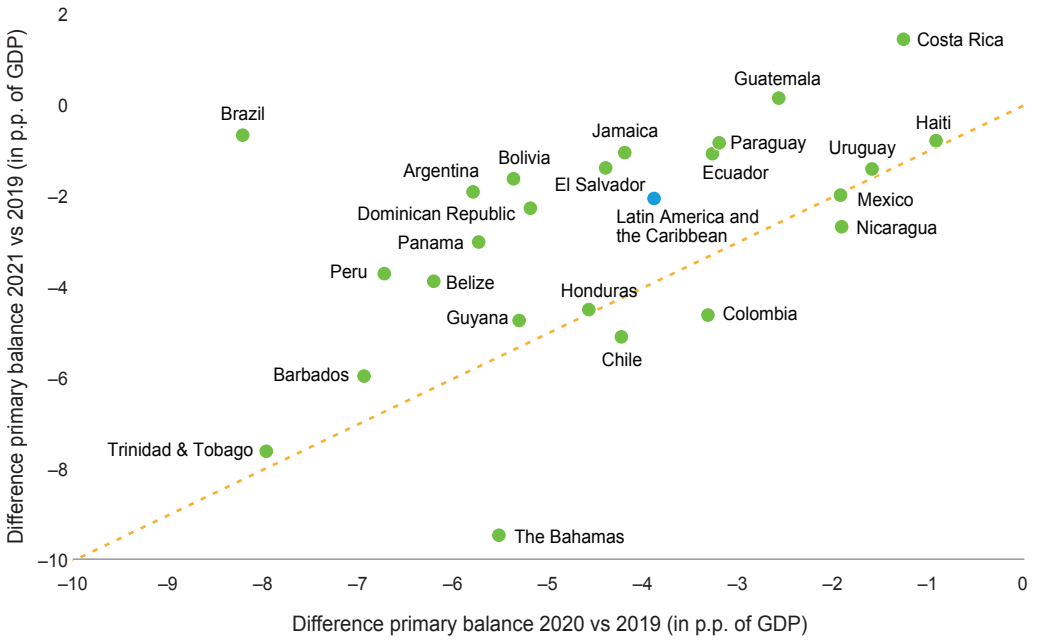
In 2021, the fiscal stimulus in Latin America and the Caribbean was reduced but not eliminated. Fiscal stimulus as measured by the increase in the primary fiscal deficit, averaged 2.1 p.p. of GDP in 2021 compared to 3.9 p.p. of GDP in 2020 (see Figure 2.1).[1] Despite the reduction, the fiscal stimulus in 2021 was still higher than the one implemented in response to the global financial crisis. In the two years from 2008 to 2010, the primary fiscal deficit increased about 2 p.p. of GDP.

As vaccination rates increased, governments began to phase out emergency measures, and economic activity recovered, leading to higher fiscal revenues. Greater economic dynamism led to a rise of 0.4% of GDP in total tax revenues compared to 2020 (see Figure 2.2).

Total public spending decreased by 1.5 p.p. of GDP on average compared to 2020, primarily due to reductions in current spending (1.6 p.p.). The enforcement of targeted

[1] Fiscal stimulus measured by the change in the primary fiscal balance may be impacted by changes in the denominator. An alternative measure that uses changes in structural primary balances shows similar results but is available for fewer countries.

FIGURE 2.1 ● Fiscal Stimulus



Source: IDB staff calculations based on IMF (2021c) and Goldman Sachs (2022).
Note: Fiscal stimulus is measured as the difference between the primary balance in 2021 or 2020 vs 2019 as a percentage of GDP.

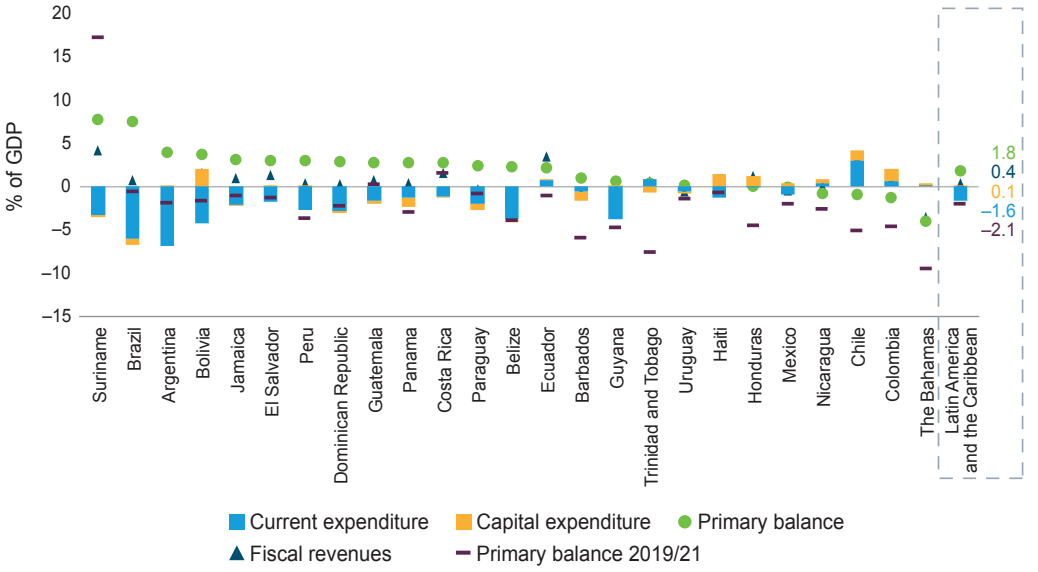
spending policies and a reduction in emergency transfers to households and firms were the main drivers of the decline in spending. However, current spending remained 1.3 p.p. of GDP higher than in 2019, suggesting there is still a way to go in unwinding supportive fiscal policies (see Figure 2.2).

In contrast, in terms of capital spending, the response varied: half of the countries in the region increased public investment (by 0.7 p.p. of GDP), while the remaining countries decreased capital spending (by around 0.5 p.p. of GDP).[2] On average, capital spending remained almost flat. Still, the decline in current expenditures and the increase in capital expenditures were below the amounts budgeted at the beginning of the year, reinforcing the trend whereby spending on investment, including infrastructure, loses out relative to current spending in times of stress, and then usually does not rebound as much as anticipated during the recovery phase.[3]

[2] For example, Colombia passed a Social Investment Law, which includes a public investment plan for the next 10 years and the creation of formal jobs (Ministry of Finance and Public Credit of Colombia, 2021) while Chile expanded the social protection network, strengthened the health system, and made significant progress in public investment (Ministry of Finance of Chile, 2021). Ecuador also expanded social programs during 2021 (see IMF [2021a]).

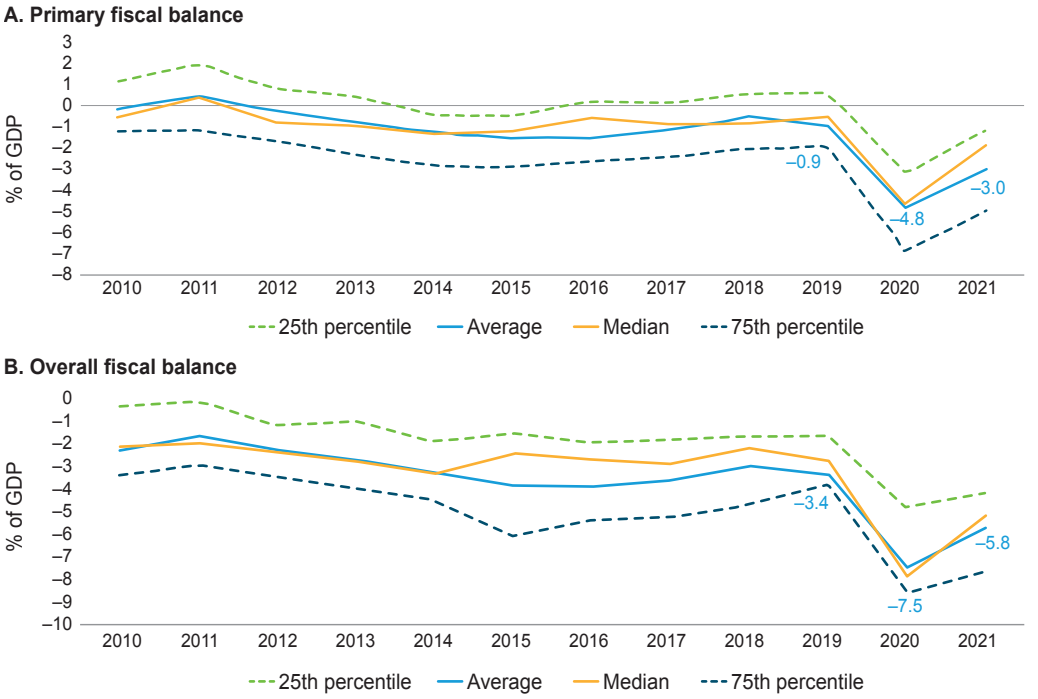
[3] See Izquierdo, Pessino, and Vuletin (2018) and Cavallo and Powell (2021).

FIGURE 2.2 ● Explaining the Changes in Primary Balances in 2021



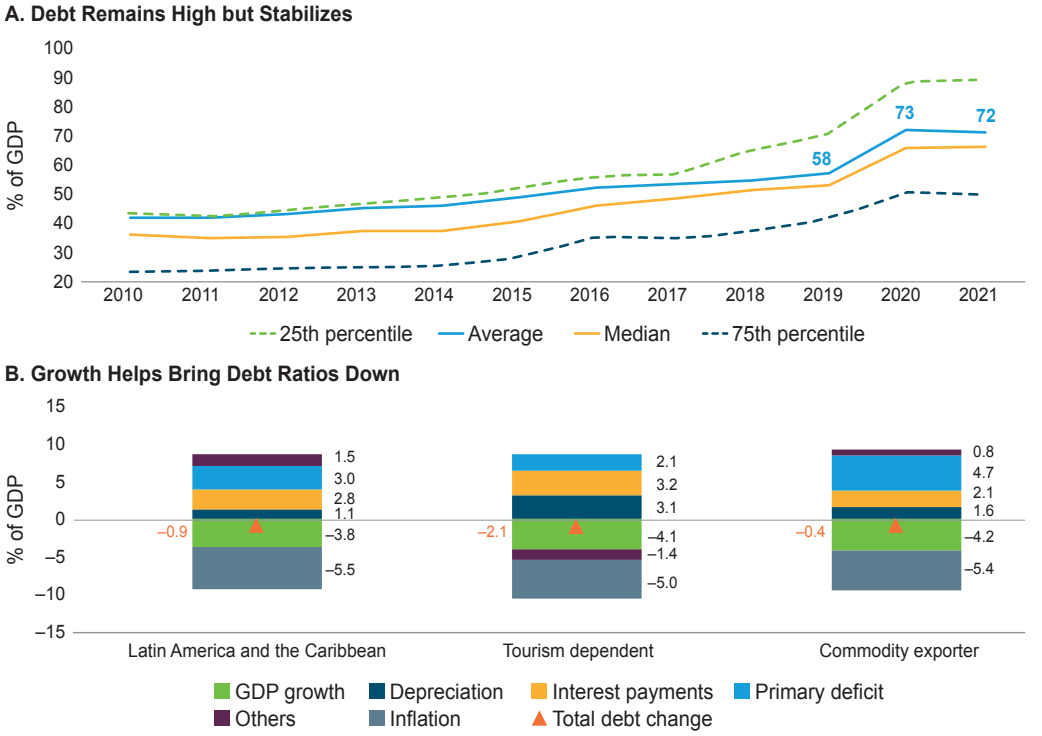
Source: IDB staff calculations based on IMF (2021c), Focus Economics (2022), and Goldman Sachs (2022).
Note: All changes in 2021 vis-à-vis 2020, except for primary balance, for which the variation between 2021 and 2019 is also reported. Countries in the Caribbean region have fiscal years that differ from the calendar year and that may impact the calculations.

FIGURE 2.3 ● The Partial Recovery in Fiscal Balances



Source: IDB staff calculations based on IMF (2021c), Focus Economics (2022), and Goldman Sachs (2022).
Notes: Includes all IDB borrowing countries except Venezuela.

FIGURE 2.4 ● Tracking and Explaining the Movement in Debt Ratios



Source: IDB staff calculations based on IMF (2021c), Focus Economics (2022), and Goldman Sachs (2022).
Note: Latin America and the Caribbean include all IDB borrowing countries except Venezuela. Tourism-dependent countries include The Bahamas, Barbados, Belize, Dominican Republic, Haiti, Jamaica, Panama, and Uruguay. Commodity-dependent countries include Bolivia, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, and Suriname. Panel B shows the accounting decomposition of public debt accumulation as a percentage of GDP.

Despite the fiscal deficits, debt ratios did not increase in 2021. Given the stronger than expected recovery in GDP, the average debt ratio actually decreased 0.9 p.p. of GDP, from 72.6% in 2020 to 71.7% in 2021 (Figure 2.4, Panel A). The fiscal deficit and currency depreciation contributed 3 p.p. and 1.1 p.p. of GDP to increasing debt, respectively. Interest payments added 2.8 p.p. of GDP to debt ratios. On the flip side, the economic rebound and rising (albeit moderate) inflation offset these factors. Jointly, they reduced the average debt-to-GDP ratio by 9.3 p.p. Debt to GDP fell by 2.1 p.p. of GDP in tourism-dependent economies and 0.4 p.p. of GDP in commodity-dependent countries, as they maintained higher primary fiscal deficits (see Figure 2.4, Panel B).

Fiscal Impact of the War between Russia and Ukraine

The future trajectory of the debt-to-GDP ratio will hinge on the speed of economic recovery, the pace of fiscal adjustment, interest rates, and commodity prices. This section

uses a general equilibrium model to determine the probable paths for the debt-to-GDP ratio under alternative scenarios.[4]

The scenarios adopt the assumptions for growth of the pre-war scenario described in IMF (2022). In addition, two alternative scenarios related to the war and possible complications in the normalization of monetary policy in advanced countries are considered (see Chapter 1). The model is then used to estimate the trajectory of debt ratios and fiscal variables, assuming similar relationships between them as in the past.

Debt service, which includes interest payments and debt amortizations, is projected to decline from an estimated 5% of GDP in 2021 to just below 4% of GDP for 2022–2024 in the average country in the region.[5] Still, the cost of servicing debt, computed as the ratio of interest payments to fiscal revenues, is projected to increase to 13.1% by 2024, up from 12.3% in 2021 and less than 10% before the pandemic. To put the figures into perspective, the same ratio is expected to remain stable at 2.3% in advanced economies and increase moderately from 9.5% to 9.9% in other emerging countries between 2021 and 2024.[6]

The pre-war scenario anticipated a gradual withdrawal of fiscal stimulus and a possible deterioration in financing conditions for Latin America and the Caribbean as a result of gradually tighter monetary policies around the world. Economic recovery was driving a gradual fiscal adjustment from a primary deficit of 4.8% of GDP in 2020 to a balanced fiscal budget by 2024 in the average country. Within the region, both commodity exporters and tourism-dependent countries were expected to reduce primary fiscal deficits gradually, with deficits turning into surpluses for tourism-dependent countries by 2024 (see Figure 2.5).

After falling in 2021, the debt-to-GDP ratio was expected to hit 73% of GDP for the average country by 2024 as growth waned and higher interest rates increased financing costs. Among commodity exporters, debt-to-GDP was expected to stabilize at 66%. In contrast, and given the higher initial level, the debt-to-GDP ratio was expected to stabilize at 82% in tourism-dependent countries (see Figure 2.6).

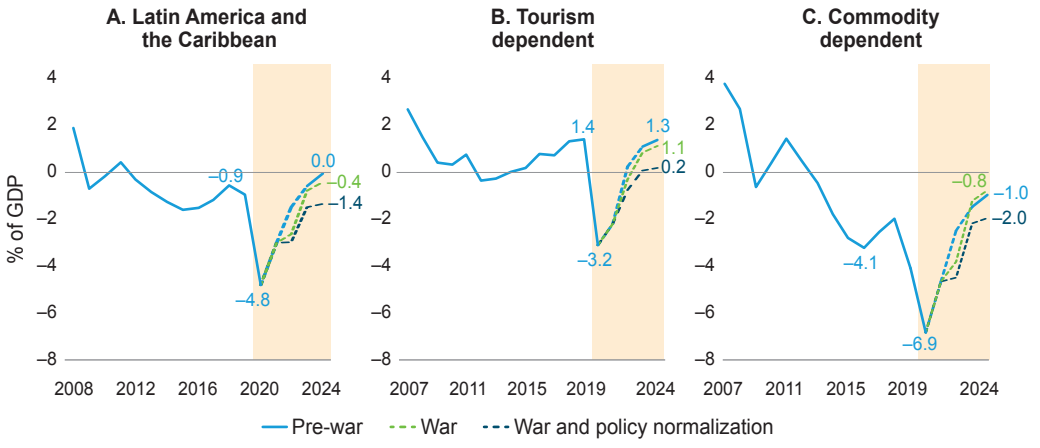
However, these projections are subject to uncertainty. The Federal Reserve could raise interest rates more than anticipated in response to further inflationary pressures. This could lead to capital outflows from the region that would entail currency depreciation, tighter financing conditions, and lower commodity prices. During 2021, higher international demand pushed commodity prices higher, allowing for gains in fiscal revenues

[4] For further details of the model and assumptions, see Valencia (2021).

[5] These are likely underestimates as the figures reflect the amortization schedules of debt issued; this analysis does not contemplate the roll-over of liabilities within the period.

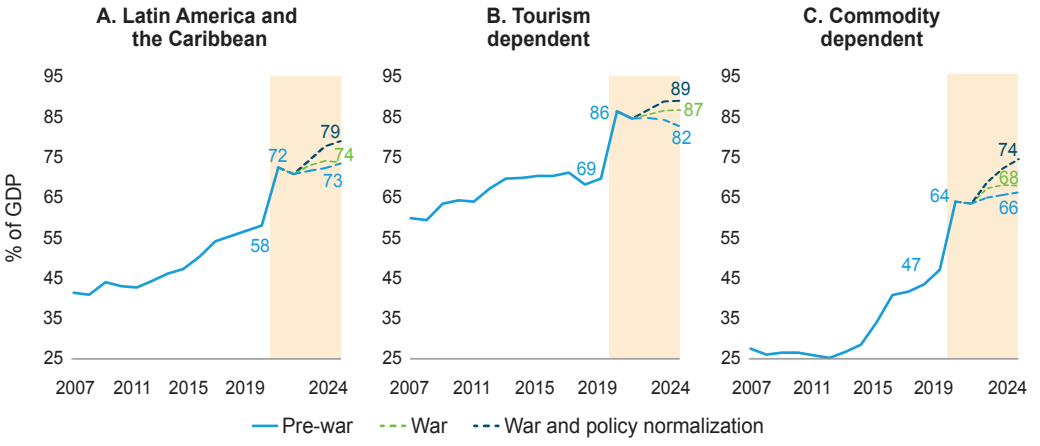
[6] The ratio of interest payments to fiscal revenues was 2.6%, 7.8%, and 9.7% in advanced economies, emerging economies, and Latin America and the Caribbean, respectively, prior to the pandemic.

FIGURE 2.5 ● The Outlook for Primary Balances



Source: IDB staff scenarios and calculations based on IMF (2021c), Focus Economics (2022), and Goldman Sachs (2022).
Note: The shaded area indicates the COVID-19 crisis and future scenarios (2020–2024). Latin America and the Caribbean countries include all IDB borrowing countries.

FIGURE 2.6 ● Scenarios for Debt-to-GDP Ratios



Source: IDB staff scenarios and calculations based on IMF (2021c), Focus Economics (2022), and Goldman Sachs (2022).
Note: The shaded area indicates the COVID-19 crisis and future scenarios (2020–2024). Latin America and the Caribbean countries include all IDB borrowing countries.

in commodity-exporting countries. But higher interest rates, weaker global demand, and the resolution of supply bottlenecks could drive prices lower.

These projections have been impacted by the war in Ukraine, which has raised uncertainty. The war has resulted in increases in commodity prices, impacting fiscal balances, and in turn, increasing domestic and global inflationary pressures. In response, the Federal Reserve could raise interest rates more than expected. This could generate capital outflows from the region, a depreciation of currencies, and a further deterioration

of financing conditions. The war is also expected to have a negative impact on growth in the United States and Europe.

The war scenario combines negative shocks to growth in the Eurozone and the United States with a positive shock to commodity prices. The impact of these shocks is compared with the pre-war scenario. In a second scenario, a more complicated and less gradual normalization of monetary policy in advanced countries than expected by the market is envisaged. In addition, a financial shock is included in the war scenario, which attempts to capture the market's reaction to the steeper interest rate hike in the United States through a fall in the value of financial assets. It also incorporates more negative shocks to growth in the United States and the Eurozone (see Chapter 1).

In the war scenario, projected fiscal deficits decline less than in the prewar scenario. The increase in fiscal revenues from the commodity price shock has a positive impact on fiscal balances, but with a lag.[7] Meanwhile, the impact of the negative growth shock and the increase in spending (mainly through the impact on energy subsidies) keep the 2022 deficit at levels similar to those of 2021 in the average country. Commodity-exporting countries will benefit from higher commodity prices, especially in 2023, and will be able to use the associated revenues to slightly reduce their primary fiscal deficits by 2024 relative to the pre-war scenario. In contrast, in tourism-dependent countries, the progressive fiscal adjustment of the primary deficit slows down, and the fiscal balance remains below the pre-war scenario. The higher projected fiscal deficit in the period 2022–24, together with higher inflationary pressures and increased cost of financing, could lead to an increase in the debt-to-GDP ratio for the average country of up to 74% by 2024. For tourism-dependent countries and commodity exporters, the debt-to-GDP ratio could reach 87% and 68%, respectively (see figures 2.5 and 2.6).

In the war and policy normalization scenario, the impact of shocks results in the interruption of the fiscal adjustment process, so that the primary deficit in the typical country remains the same in 2022. Although the fiscal adjustment resumes in 2023 in a gradual manner, the fiscal balance for the average country remains at a primary deficit of around 1.5% of GDP by 2024. As a result, debt levels rise to 79% of GDP in the average country, 89% in tourism-dependent countries and 74% in commodity-exporting countries.

Short-Term Policy Priorities: Designing Fiscal Consolidation Plans

The baseline fiscal projections assume a gradual improvement in primary balances, but do not contemplate active fiscal policy changes. All scenarios in the above exercise result in an increasing debt path, which could grow even further if downside risks materialize.

[7] In line with the fiscal framework relevant to companies in the extractive sector, and in line with the way public companies in the sector distribute dividends, most commodity exporting economies receive the additional fiscal revenues (tax and capital) in the year following the price increase.

To mitigate risks, countries could reduce fiscal deficits faster. And beyond debt sustainability issues, a key concern for policymakers is to design fiscal consolidation plans that are growth friendly and equitable.

Previous IDB reports have discussed design flaws in tax structures that affect economic efficiency and income distribution, including the proliferation of exemptions and reduced rates in the value-added tax for certain goods, narrow personal and corporate income tax bases, and poorly focalized tax deductions and incentives.[8] The implications are that in many countries, revenue mobilization efforts aimed at eliminating inefficiencies and streamlining tax expenditures (discussed in more detail in the next section) could enhance progressivity while minimizing output costs.

On the expenditure side, a key concern is how to allocate budget cuts between public consumption (current expenditures) and investment (capital expenditures) during fiscal consolidation, given the different multipliers on spending components.[9] New empirical analysis assesses the output responses to fiscal adjustments in the composition of expenditures or, more specifically, the mix between public investment and public consumption in a sample of 70 countries, including 17 Latin American and Caribbean countries.[10]

Results show that while average public investment cuts (3.2% of GDP) are more than twice as large as public consumption cuts (1.3% of GDP) during the typical fiscal adjustment, they vary widely across countries and over time.[11] The analysis explores these variations to distinguish episodes of public investment protection and penalization during fiscal consolidation and estimates their respective impacts on economic activity.[12]

When public investment is penalized relative to public consumption (i.e., the share of capital outlays in public expenditures decreases) a consolidation of 1 percent of GDP reduces output by 0.7 percent within three years. In contrast, safeguarding public investment from budget cuts vis-a-vis public consumption can neutralize the contractionary effects of fiscal adjustments and can even spur output growth over the medium term (see Figure 2.7).[13]

[8] See Cavallo and Powell (2018, 2021).

[9] See Izquierdo et al. (2019), Cavallo and Powell (2018), and Izquierdo, Pessino, and Vuletin (2018).

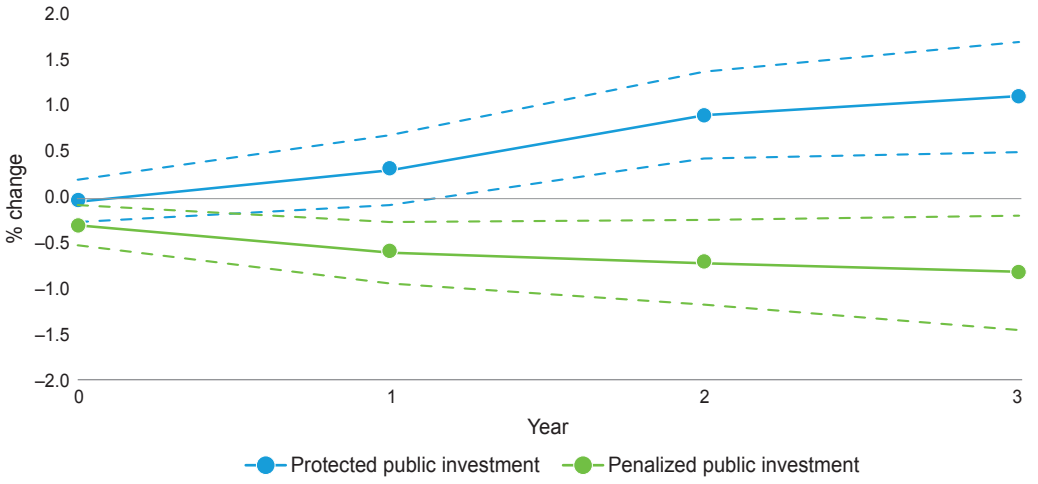
[10] See Ardanaz et al. (2021b).

[11] Point estimates of a regression of the growth rate in real public investment and public consumption (as a % of GDP) against a variable capturing the size of fiscal adjustment are –3.2 for public investment (90% confidence interval: –2.1 and –4.2) and –1.3 for public consumption (90% confidence interval: –0.9 and –1.8). See Ardanaz et al. (2021b).

[12] Public investment is protected (penalized) when the share of public investment in total spending increases (decreases) after the consolidation episode ends, compared to before it began.

[13] A logical extension of this analysis is to look at debt dynamics under different fiscal adjustment strategies. Results show that when public investment is protected vis-a-vis public consumption, the debt-to-GDP ratio *decreases* significantly. In contrast, when public investment is penalized, the effects of consolidations on the debt-to-GDP ratio are not significant. Part of this difference can be explained by the effects of these types of adjustments on the denominator of the debt-to-GDP ratio.

FIGURE 2.7 ● GDP Response to Changing the Form of Adjustment



Source: Ardanaz et al. (2021b).
Note: Year = 0 denotes the year of a fiscal consolidation. Protected (penalized) public investment denotes a situation in which a positive (negative) change in the public investment to public consumption ratio is observed as a result of fiscal adjustment. Dotted lines indicate 90% confidence interval.

The GDP component most sensitive to changes in the spending mix is private investment, which remains subdued when public investment loses ground relative to public consumption and grows strongly when the public investment share is protected. This finding suggests that the positive crowding-in effects of public investment on private investment are a key in explaining the variation in the output responses to alternative fiscal adjustment plans.

In the current environment, many countries will have to design fiscal consolidation plans to restore debt sustainability. While fiscal adjustments may be inevitable, expenditure policy can dampen their negative effects on output. In particular, safeguarding the public investment to public consumption expenditure ratio during the consolidation can help avoid deep and prolonged contractionary effects of austerity, and can even generate expansionary benefits over the medium term. Moreover, it can have positive impacts on income distribution, because public investment affects the price and quality of services that account for a larger share of the spending of the poor than of the rich.[14]

However, protecting public investment is not always straightforward, as there are always many competing priorities. And institutional frameworks supporting investment decisions vary across the region. To safeguard productive public investment from budget cuts, countries should consider, for example, fiscal rules that complement deficit or debt targets with flexible design features that address spending composition, and/or medium-term fiscal frameworks that ensure predictable capital spending levels over time.[15] Still, the political economy of fiscal

[14] See Cavallo, Powell, and Serebrisky (2020).

[15] On the role of fiscal rules design in addressing the bias against public investment in a large sample of countries, see Ardanaz et al. (2021a).

adjustments is not easy. Incumbents may postpone reforms until they have no other choice, as organized groups may be able to prevent budget cuts that affect their interests, or for fear of incurring electoral costs.[16] Carefully designed fiscal adjustment plans are more likely to succeed.[17] The instruments governments use for these consolidations matter too as voters are likely to prefer expenditure-led over tax-led fiscal consolidations.[18] Success depends on how confident citizens are that the government will fulfill their commitment to carry out policies that are best for society. Gaining and maintaining public support for fiscal consolidations requires a two-pronged approach. One is to inform and empower. Telling people what the government is going to do, doing it, and informing it has been done, increases the chances that people will support the government. The other is to increase trustworthiness. Keeping promises, providing evidence that the government is taking people's opinion into account, and increasing participation make the citizenry more likely to support government actions. Showcasing successes and communicating the effectiveness of specific policies in achieving specified objectives can also help harness support.[19]

More generally, improvements in fiscal institutions can produce rapid and significant benefits in particular when facing a period of fiscal adjustment to attempt to reduce debt levels. Improved institutions can enhance credibility, which then allows for a more gradual adjustment with lower interest rates. This, in turn, reduces the amount of adjustment required and the financial cost of the adjustment.

In the end, all available instruments must be combined to place public finances on a sustainable path, while protecting economic growth and ensuring a healthy recovery. The good news is that such reforms are feasible, even when initial conditions are challenging. Jamaica's noteworthy shift from one of the most indebted countries in the world to among the best performers in terms of fiscal outcomes had a lot to do with the improvement in its fiscal institutions (see Box 2.1).

The Pillars of a New Fiscal Architecture

Spending and tax reforms should focus on redesigning inefficient and unequal public expenditure programs while enacting measures to reduce tax evasion and exemptions. Less tax evasion and fewer exemptions would expand the tax base and allow tax rates to be reduced, in particular those taxes that are most harmful for growth. At the same

[16] The probability of fiscal adjustment in general, and tax reform in particular, is significantly curtailed during electoral years across Latin America. In contrast, deep recessions tend to trigger fiscal adjustments. See Ardanaz, Hallerberg, and Scartascini (2020) and Hallerberg and Scartascini (2017).

[17] Ardanaz, Hallerberg, and Scartascini (2020) uncover significant differences in the electoral effects of tax- versus expenditure-based fiscal consolidations in Latin America, Voters are more likely to prefer expenditure cuts than tax hikes. Opposition to tax increases is most prevalent among the most vulnerable. See Furceri et al. (2021).

[18] See Ardanaz, Hallerberg, and Scartascini (2020).

[19] See Keefer and Scartascini (2022).

BOX 2.1 • Importance of Robust Fiscal Institutions: The Case of Jamaica

Jamaica has long suffered from macroeconomic volatility and unsustainable debt burdens. Before 2010, debt had risen sharply, and financing costs had soared. A first restructuring of domestic debt in 2010 was accompanied by incipient fiscal reforms. But debt levels did not fall, and the debt-to-GDP ratio reached a peak of about 149% in 2012–13—behind only Japan and Greece (Mooney and Zegarra, 2020). Against the backdrop of another IMF-supported program, in coordination with the IDB, Jamaica's debt ratio declined by about a third after revising and fully implementing a Fiscal Responsibility Framework (FRF) and related reforms in 2014. Jamaica's fiscal effort (primary fiscal surplus of about 7% per year on average, from 2015 to 2019) has exceeded that of all other Latin American and Caribbean countries, on average, ranking in the top five globally.

Jamaica's FRF includes two rules: a balanced budget rule and debt rule. In 2014, a floor was set on the overall balance of the covered public sector, with the objective of reducing public debt to 60% of GDP, initially targeted for 2026. The FRF also includes a well-designed escape clause, and an automatic correction mechanism. Specifically, the FRF's targets were initially designed to be amendable on the grounds of national security, national emergency, or other exceptional grounds, as determined by the Minister of Finance and Public Service. Key features of the correction mechanism include the stipulation that deviations be recorded, with the expectation that future fiscal adjustments will be made to return the trajectory of fiscal aggregates to a path consistent with public debt targets. Jamaica's FRF also includes a ceiling for the public wage bill to contain the increase of current expenditures.

Jamaica's fiscal performance up to and through the COVID-19 crisis illustrates the benefits of such a rule-based regime.[a] The pandemic provided a significant external test of Jamaica's FRF. Jamaica's real GDP contracted by about 10% in 2020, owing largely to its dependence on tourism. In line with the built-in flexibility, in May of 2020, amendments to the FRF were approved, allowing the shock to be accommodated, while continuing to adhere to a transparent consolidation path. The Minister of Finance and the Public Service extended the FRF target date for reducing public debt to 60% of GDP from 2026 to 2028, as permitted under the framework,[b] allowing the primary fiscal balance target to be trimmed from 6.5% to 3.5% of GDP for FY2020–21, without compromising credibility. Credit rating agencies and investors have welcomed the government's pre-crisis fiscal efforts guided by the FRF and cited its flexible and fluid operation during the crisis as factors supporting positive ratings and a minimal deterioration of risk premia on sovereign debt,[c] despite the worst single-year GDP contraction in Jamaica's history.

[a] See Mooney and Zegarra (2020) for a detailed analysis of tourism dependence across Latin America and the Caribbean, and the pandemic's unprecedented shock to economies.
[b] The legislation was also amended to update the qualifying conditions for the suspension of the FRF, by specifically referring to "health-related shocks."
[c] By end-2021, real yields on Jamaica's external debt had rebounded to near pre-crisis levels, following a temporary deterioration during 2020.

time, better fiscal policies to address climate change and provide incentives to reduce emissions, together with policies to boost tax collection from the digitalization revolution, should be part of the new fiscal architecture.

Making progress on all these fronts would improve fiscal sustainability while pursuing inclusive growth. While priorities will hinge on country specific circumstances, countries should consider several key reform pillars.

Diminish Spending Inefficiencies

A first step would be to decrease widespread spending inefficiencies. Reducing "technical inefficiencies" in spending by levelling off public and private salaries, limiting leakages in public transfers with better targeting, and eliminating overpricing in purchases could save the region 4.4% of GDP per year on average. Those savings could be reallocated to productive physical and human capital investments, thereby increasing their share of total spending.[20]

Another source of overspending in the region comes from pension systems, which cost much more than in advanced economies adjusting for age differences in the populations but cover only the richest portion of the population. In many countries, pension systems are already unsustainable, before factoring in the pressure of an aging population.[21]

Combat Tax Evasion, Exemptions, and Distortionary Taxes

Reducing rampant tax evasion, costly exemptions, and distortionary taxes constitute another priority in many countries. Given the need for fiscal consolidation in the post-pandemic period, policymakers can try to increase revenues with comprehensive and progressive reforms, tailored to country-specific circumstances.[22] Raising taxes may not be advisable, especially in countries with high taxation levels and tax evasion because, especially when the tax base is small, it can hamper growth and increase inequality. Tax evasion tends to be inefficient and highly unequal.[23]

Address New Challenges: The Digital Economy and Climate Change

The world has changed; digital technologies are expanding and changing the way we work, communicate, and relate to others. It is also changing the way in which taxation is collected and raising questions about how and where firms should declare their profits. Multinational firms have always had the potential to provide services in one or multiple locations but declare profits and be taxed in another. However, the digital economy has arguably accentuated this problem. Box 2.2 provides a discussion of the current proposals

[20] See Izquierdo, Pessino, and Vuletin (2018).

[21] This structural issue has been aggravated, even in the case of defined contribution systems, due to lower long-term interest rates and lost contributions during the pandemic. Thus, fiscal risks stemming from guaranteed minimum pensions have increased and overall sustainability has been threatened even for capitalized systems. See Pessino and Ter-Minassian (2021) and Cont and Pessino (forthcoming).

[22] A long-term challenge in Latin America is that at 22.4% of GDP, tax collection is far below that in advanced economies (i.e., in the OECD it is 34.3%). Collection is not easy to increase without causing collateral damage to growth, inequality or both.

[23] Studies found that in developed countries, high rates of tax evasion concentrate at the top: the 0.01% richest households evade about 25% of their taxes (Alstadsæter, Johannesen, and Zucman, 2019).

BOX 2.2 • The New Global Tax Deal

The digitalization of the economy has challenged century-old conventions about jurisdiction to tax economic activities carried out by nonresident taxpayers. As of today, countries adhere to the brick-and-mortar concept of permanent establishment, disregarding the fact that the Internet supplies the infrastructure to conduct business in a foreign territory, and that this infrastructure is exponentially more effective than tangible assets. Thanks to the Internet, Multinational Enterprises (MNEs) carry out businesses in market jurisdictions with minimum assets—or without any tangible asset at all—in what has been dubbed *scale without mass*. At the same time, it has been generally acknowledged that the 15 Base erosion and profit shifting (BEPS) Actions, despite significant time and effort, failed to put an end to profit shifting.

The OECD, though the BEPS Project and the Inclusive Framework, is proposing a multilaterally agreed policy response. To the *scale without mass* problem, the proposal is to allocate 25% of the residual profits of the largest multinationals to market jurisdictions. To the profit shifting issue, the response is a 15% global minimum tax. On October 10, 2021, government authorities of more than 140 countries agreed to an ambitious timeline to implement the system on January 1, 2023. Latin American and Caribbean countries must now decide the extent to which they want to be part of the new system and how this will shape their tax policies for foreign trade and investment.

Pillar 1 is a tax that affects barely 100 companies in the world (those with sales above EUR 20 billion and profitability above 10%) and may reallocate, at best, EUR 125 billion to market jurisdictions.[a] It is difficult to estimate the portion of profit that will accrue to Latin American and Caribbean countries; data from these companies would be required, but assuming it will be commensurate with GDP, then the region may expect to tax 3.4% of the global amount under Pillar 1. On the positive side, countries would receive this revenue with minimal administrative effort. On the negative side, they would commit to eliminate/nonproliferate unilateral measures such as digital services taxes (DSTs), accept mandatory and binding arbitration, and adopt a fixed margin for baseline distribution activities.

The scope of Pillar 2 is broader, affecting multinationals above EUR 750 million. They will be liable to a top-up tax on profits booked on foreign jurisdictions and taxed below 15% (effective tax rate). This is expected to generate about US$150 billion of revenue per year globally, but Latin America and the Caribbean may not collect much of it, as the tax will be paid by the MNEs to the country where they are headquartered. Only Latin American and Caribbean countries housing multinationals, and instances where two subsidiary rules are applied (the Undertaxed Payments Rule and the Subject to Tax Rule), will receive revenue from Pillar 2 in the region.

In this context, Latin American and Caribbean countries need to update their tax policies. For Pillar 1, the choice is basically between the OECD-IF package and unilateral measures. The problem is that the threshold is so high that most MNEs will *fly below the radar*. Imposing unilateral DSTs may be more effective to achieve the policy goal of taxing *scale without mass* but may have adverse effects as a foreign investment policy, as unilateral measures impose compliance and certainty costs. An intermediate solution may be to renegotiate treaties using article 12 of the UN Model. In terms of Pillar 2, the challenge for Latin American and Caribbean countries is to retain the tax base in their jurisdiction. This calls for reconsidering tax incentive policies and, probably, enacting national minimum taxes of 15% (since it will be taxed anyway, better tax it at source). Equally important, countries should take steps to ensure robust implementation of transfer pricing legislation and other anti-avoidance rules.

[a] See https://www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm.

to tax such companies. These proposals have significant implications for all countries. More generally, tax authorities may need to adapt the way in which taxes are collected. Most income tax is remitted through firms (corporate income taxes and where the individual is an employee) but as the so-called Uber economy expands, more individuals may switch to self-employment creating greater challenges for collection. Still, digital information and new tools provide mechanisms to collect taxes more efficiently, as discussed below to confront the problem of informality.

At the same time, climate change is advancing and negatively impacting the world and the region. Latin America and the Caribbean, while facing the challenges of adapting to climate change, has made commitments in the context of the Paris Agreement that require urgent action, including in fiscal policy. Box 2.3 discusses green fiscal policies that would help the region adapt to the challenges of climate change while meeting its commitments and maintaining fiscal responsibility.

Tax Reform in Countries with Lower Taxation and Informality

In countries with high levels of spending efficiency, low informality, and low tax rates, that require additional adjustments, increases in tax rates may be considered. In general, increasing taxes has negative multipliers on the economy; however, the negative impact of raising taxes is lower when tax rates are low.[24] Higher taxation to finance expenditures should only be considered when it can be demonstrated that the additional expenditure will boost growth and/or equity in an efficient manner.

Still, high levels of informality can hamper even the best designed tax reforms. As much as (negative) tax multipliers are smaller when the tax level is lower, high informality has the opposite effect. In fact, informality hurt fiscal consolidation in Greece and Italy, countries with the highest informality rates in Europe.[25] The problem is that informality is closely intertwined with tax evasion. The high degree of informality prevalent in the region could limit the effectiveness of tax reforms and cloud the prospects for reducing tax evasion

Reduce Informality to Increase Fiscal Efficiency

Labor informality affects 58% of the workforce in Latin America and the Caribbean on average and has been persistent. It pervades the entire spectrum of the income distribution; although highest in the poorest quintile reaching 80%, more than 40% of workers in the richest quintile are also employed in the informal economy. Although this problem has

[24] See Gunter et al. (2021).

[25] See Dellas et al. (2017) and Pappa, Sajedi, and Vella (2015).

BOX 2.3 ● The Strategic Role of Finance Ministries for Tackling the Climate Crisis[a]

Latin American and Caribbean countries face growing fiscal and economic challenges from the physical impacts of climate change and transition risks as the world seeks to decarbonize. This transition also offers economic gains and opportunities for job creation if fiscal policies are successfully harnessed.

The region is one of the world's most vulnerable to the impacts of climate change. These impacts include more intense and frequent floods, droughts, and hurricanes that can take their toll in human losses, economic damages, and financial pressure on fiscal accounts. Evidence shows that, in the region, the occurrence of at least one extreme event per year is associated with an increase in the fiscal deficit of 0.8% of GDP for lower middle-income countries and 0.9 percent of GDP for the low-income group.

Despite high oil prices, which partly reflect temporary supply constraints, the region faces transition risks to more decarbonized economies as it seeks to meet the challenges of climate change. Risks must be mitigated and managed to minimize fiscal impacts. For example, the increased production of renewable energy and growth in the use of electric vehicles will reduce demand for fossil fuels from regional exporters. To achieve the 1.5-degree goal of the Paris Agreement, Latin American oil production needs to fall to less than 4 million barrels per day by 2035—60% below pre-pandemic levels. Regional oil exporters could lose up to US$2.6 trillion in fiscal revenue by 2035 if that strong global climate action materializes. Governments also need to be wary of fossil fuel assets becoming stranded,[b] which would imply additional costs for public finances.

There are three key areas of intervention where finance ministries can strengthen public finances while supporting economic transformation:

1. To manage the economic and fiscal risks related to extreme weather events and decarbonization, finance ministries can strengthen public investment systems to ensure all new infrastructure is resilient to climate impacts, design fiscal strategies to anticipate lower fossil fuel revenues, and identify and manage the risks of stranded assets.
2. To plan for a just transition, finance ministries must design policies that consider and address the distributional impacts on affected economic sectors and workers through proper fiscal, tax, public investment, and spending management while encouraging new sources of employment in sectors such as renewable energy and plant-based food production.
3. To enhance access to financing, finance ministries can attract private investment by establishing incentive frameworks, proposing public investments, and implementing regulatory reforms to help reduce barriers to private investment. They can also contribute to the development of new markets such as green bonds, which are a growing instrument in the region that have been issued by firms and by Chile and Colombia's governments. Promoting market depth and a platform for transparency are key instruments for the success of this market.

Taken together, these efforts, if effectively delivered, will translate into financial flows that are far more consistent with the objectives of the Paris Agreement than is currently observed and will put countries on a much better footing to deliver meaningful results under their own climate goals.

[a] For more details, see Delgado, Eguino and Lopes (2021).
[b] Stranded assets include oil, gas, and coal fields that remain untapped due to the energy transition, as well as exploitation, transportation, processing, and utilization of infrastructure (IDB, 2021a).

existed for decades in the region, the pandemic greatly complicated it, because the large drop in employment is mainly being filled with informal jobs (see Chapter 5).[26]

Informality not only precludes the increase in tax rates necessary to achieve consolidation, it also inhibits the government's ability to target social transfers and combat tax evasion—two of the largest sources of inefficiency in fiscal policy. Informality operates through several channels to create inefficiencies in fiscal policy.[27] Given the nature of informality, governments lack reliable data on taxpayers' actual incomes; also, social and tax registers do not have sufficient, up-to-date information to collect payments, or target transfers, generating spending leakages and tax evasion. Governments have tried to correct the information asymmetry using "proxy means testing" procedures based on old censuses and self-declarations that only capture about 60% of the variability in real incomes.[28]

The information asymmetry is lower for formal workers because firms must register wages. Authorities can, therefore, obtain and verify third-party records, which improve the accuracy of income tax filings, thereby reducing evasion. In the United States, for example, the evasion for self-employed workers (for whom income verification through third-party information is more difficult) reaches 63% versus only 1% for formal wages and salaries.[29] In Latin America and the Caribbean, where the proportion of self-employed and informal workers (58%) is much higher than in the United States (around 15%), informality's contribution to tax evasion is likely much higher. Not surprisingly, income tax evasion is at least four times higher in Latin America and the Caribbean. Lack of records increases evasion of other taxes as well. About 80% of the evasion of value added taxes accrues in the last stage of the tax, corresponding to final sales, where the automatic cross-checking of credits is nonexistent, due largely to the lack of data from third parties to detect noncompliance.[30] The same argument can be applied to the Simplified Tax Regime. Using third party data provided by the electronic invoice, the state of Piaui in Brazil was able to detect 64% of tax evasion in the regime. Notifying taxpayers increased compliance significantly.[31]

The bottom line is that even the best designed fiscal reforms can fail if informality is not reduced. On the flip side, there is ample room to increase revenues and lower tax evasion by reducing labor informality with fiscal policy.[32] Some of these policies are outlined below.

[26] See also ILO (2020), IMF (2020), and Altamirano Montoya and Azuara (2021).

[27] In Latin America and the Caribbean, public spending has large leakages to the non-poor in social assistance, energy subsidies, and tax expenditure in VAT that add up to 1.7% of GDP. Tax evasion has persisted despite stronger tax administrations in many countries. Corporate and personal Income tax evasion is about 4.7% of GDP on average. VAT evasion is close to 30% of potential tax collection, or 2.6% of GDP. See Izquierdo, Pessino, and Vuletin (2018).

[28] See Robles, Rubio, and Stampini (2015).

[29] See Slemrod (2019).

[30] See Pomeranz (2015).

[31] See Bando et al. (2021).

[32] See Pessino, Pineda, and Rasteletti (forthcoming).

Digitalization of Records and Transactions

Digital Fiscal Ecosystems would tackle the problem of incomplete, asymmetric, and obsolete information triggered by high informality levels. This type of system, which must safeguard the privacy and confidentiality of contributors, allows the government to gather "objective" information about the income and basic needs of households to improve the efficacy of its fiscal and social functions. The automatic collection of individual information from social, income, wealth, property, and consumption data combined with unique identification and digital authentication of individuals and firms, provides the government access to information to better target cash transfers to the poor, including energy subsidies, and to reduce tax evasion.

A version of this system was implemented in Argentina in the late 1990s and has yielded at least US$120 million annually in saved resources and decreased tax evasion.[33] A similar system was used in 2018 to implement a "social utility tariff" that produced savings of about 1% of GDP in energy subsidies. During the pandemic, Panama implemented an emergency cash program called "Vale Digital." Without a digital fiscal ecosystem in place and without reliable records, payments were initially targeted according to a self-declaration of needs. However, as people claimed the transfer, the government began to collect administrative data and use them to check inclusion and exclusion restrictions for eligibility. This cross-checking would not be feasible relying on proxy mean tested systems that are not, and cannot be, updated regularly. The estimated savings through targeting of the Vale Digital added up to about 0.6% of GDP, or US$300 million.[34]

Just as the digital fiscal ecosystem helps ministries in charge of spending allocation to improve spending targeting, it also helps Tax Administrations (TAs) with real-time third-party data to decrease tax evasion. These efforts complement the digital transformation of TAs in the region and provides even greater control over taxpayers.[35] An example of the benefits of this transformation is the more than 10% decline in tax evasion achieved with the Electronic Invoice in Latin America supported by the IDB through the program PROFISCO to the states of Brazil.[36]

Negative Income Tax

Three main factors drive high informality in the region. First, high non-wage formal labor costs, with payroll taxes of around 27.3% of wages on average, discourage employers

[33] See Pessino and Fenochietto (2007) and Pessino (2017).

[34] The pilot digital fiscal ecosystem generated those savings because it used exclusion data such as formal work suspensions, whether the employee was in the public sector, whether she had properties above certain value, etc. The IDB is currently advising Panama on how to build a mature and solid digital fiscal ecosystem for the wellbeing of Panamanians.

[35] See OECD (2016), CIAT (2020), and Reyes-Tagle, Roca, and Barraza (2021).

[36] The IDB supported Colombia, Ecuador, El Salvador, Honduras, Peru, Mexico, and several other countries in the digitalization of tax administration and the provision of Electronic Invoice. See Martinez Frischer et al. (2022).

from hiring workers legally.[37] Second, social welfare programs available only for workers in the informal sector had good intentions and were effective in reducing poverty and inequality but had a negative impact on labor formality because if program beneficiaries accept a formal job, they must surrender 100% of the transfer. This informality subsidy occurs because these cash programs are paid out only if people do not work or work informally.[38] The third driver of informality is the low level and poor quality of education, especially in lower-income countries, making it difficult for workers to acquire the skills to enter the formal labor market.

Fiscal policy can help address the root causes of informality. For example, the informality subsidy can be diminished by programs that provide transfers to low-wage workers, as long as they receive them only if they work in the formal sector. For this, it is necessary to implement policies with the least possible disincentive to formality, maintaining the highest and most efficient level of social protection. The negative income tax (NIT), or tax credits like the Earned Income Tax Credit (EITC) in the United States, are good examples. These programs reward formality since payments (credits) are not reduced to zero if the worker opts to work formally; rather, the benefit is reduced gradually, ensuring that the reward of working formally (formal salary plus transfer or credit) is always greater than working informally. Microsimulations of implementing one possible specification of a hypothetical NIT in Latin America and the Caribbean show that the formalization rate could reach 58% among informal wage earners in the second quintile of the income distribution alone (Figure 2.8).[39]

A popular alternative to the NIT is the Universal Basic Income (UBI). UBI gives a unique transfer to all individuals independent of their income. However, the NIT by virtue of being targeted would be less expensive, making it more attractive under tight fiscal constraints.[40] An additional benefit of an NIT is that it achieves better distributive outcomes than UBI because tax credits make the personal income tax (PIT) more progressive and redistributive. The high income inequality prevalent in Latin America and the Caribbean implies that most of the PIT is borne by the highest income decile, making it a progressive tax; however, given the small tax base (evasion is high), it is not highly redistributive.[41] By refunding the PIT to the poorest through a negative tax (or tax credit), the gradient of the whole system would become steeper,

[37] One of the clearest examples is the tax reform introduced in 2012 in Colombia that lowered payroll taxes by almost 50 % and that managed to increase formal employment by 18% (Fernandez and Villar, 2017).

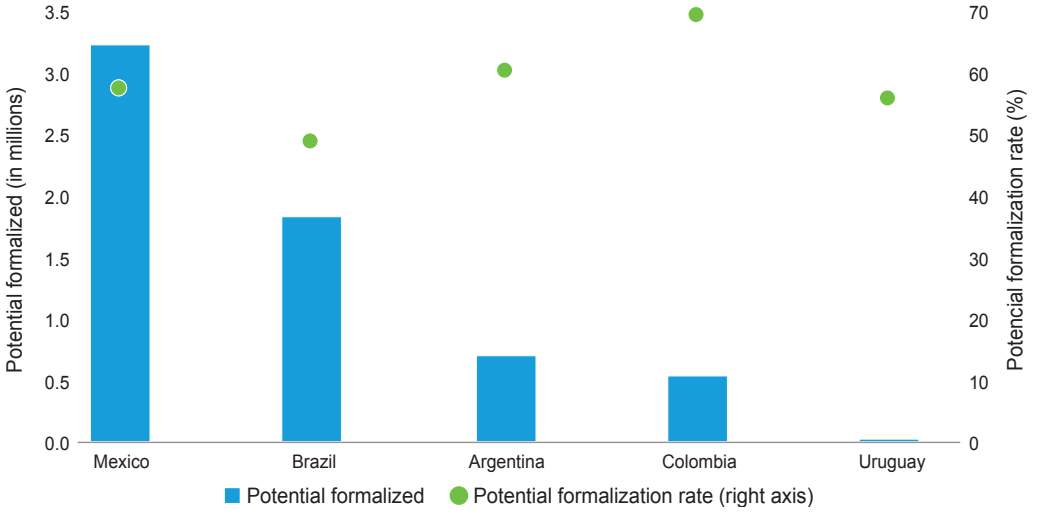
[38] See, for example, Bergolo and Cruces (2021).

[39] See Pessino, Pineda, and Alarcon (2021).

[40] In Latin America and the Caribbean (population: 650 million), a UBI of US$3.2 per day (covering the poverty line of low middle-income countries) or US$96 per month would cost around US$748 billion yearly, or about 60% of total federal public spending, or 24% of GDP. Instead of granting everybody US$96 per month, an NIT program with a 50% tax rate would provide the same transfer to the poor and to people whose monthly earnings were under US$192, at only a fraction of the UBI cost.

[41] See Engel, Galetovic, and Raddatz (1999).

FIGURE 2.8 ● Potential Formalization Rate for Workers in Quintile 2



Source: IDB staff calculations based on microsimulations.
Note: These microsimulations replace the countries' conditional cash transfer programs with one possible specification of an NIT in the second quintile of the income distribution. The first quintile continues to receive the conditional transfer, but the second quintile instead receives an NIT with a 50% rate. For all countries, a budget of 0.5% of GDP was considered.

thereby compensating the unequal income distribution beginning with the first deciles. And as informality begins to decrease, less tax evasion would also enlarge the tax base.

Refund of a Generalized VAT to the Poor

Refunding value-added taxes (VAT) to the poor, instead of exempting food or other essential products, would improve the progressivity of tax systems while creating incentives to reduce evasion and informality.[42] However, this would be feasible only if the purchases are formal transactions that generate a tax record. The prospects of getting a refund on certain transactions would encourage consumers to request invoices and to use digital means of payment, thus reducing the opportunities for tax evasion and informality.[43]

A generalization of VAT would also facilitate tax administration. One of the most important benefits of VAT refund policies would be to reduce tax expenditures that add up to 1.6% of GDP.[44] This would increase revenues and the progressivity of the tax system at the same time, because VAT tax expenditures are mostly pro-rich.[45] Between a third and a half of tax expenditures benefit the richest 20% of the population, while

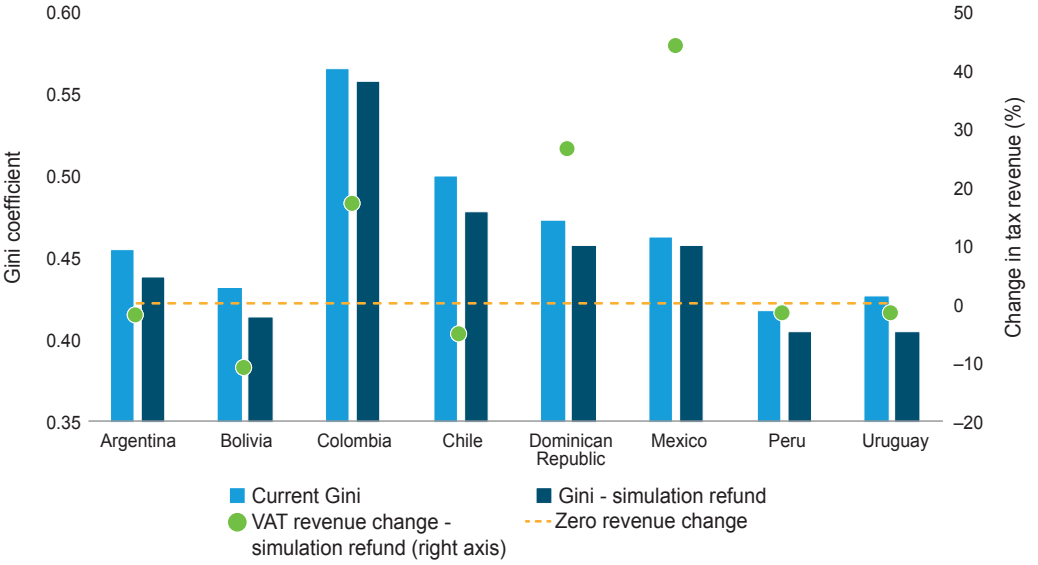
[42] VAT reimbursement policies for low-income households must contain limits on the amounts to be reimbursed to avoid reimbursement requests for purchases made by or for third parties.

[43] Some proposals compensate low-income households based on an estimate of the VAT normally paid by targeted beneficiaries. In this case, no incentives exist to formalize transactions.

[44] See Rasteletti and Saravia (2022).

[45] While exemptions reduce the tax burden on all consumers, richer households benefit the most.

FIGURE 2.9 ● Microsimulation of Lifting Tax Exemptions and Refunding VAT to the Poor



Source: IDB (2022).

the poorest 20% receive less than 10% of the benefits.[46] VAT reimbursement programs for the poor may be key to the viability of policy reforms that reduce VAT tax-expenditures. They put a visible mechanism in place to compensate the poor for eliminating tax exemptions on food and other goods, thus reducing social and political opposition to this type of reform.

Figure 2.9 shows results of a microsimulation of generalizing VAT—eliminating all exemptions—and reimbursing the full VAT payments to households in the first three income deciles. In this scenario, VAT paid by the poor is reimbursed and inequality measured by the Gini coefficient decreases because the poor are more generously reimbursed, and the rich are not reimbursed. In most countries, net tax revenue would increase or stay the same, except in countries with relatively low current tax expenditures.

A Window of Opportunity to Improve Fiscal Outcomes

Fiscal dynamics in the third year of the pandemic have been shaken by the Russian invasion to Ukraine. Oil and gas prices have soared and remain volatile since then. Agricultural prices have also risen. For commodity-exporting countries in the region, higher prices can generate greater revenues that should be saved to create buffers and raise productive investments, or applied to reduce high debt levels, given the temporary nature of

[46] See IDB (2022).

the shock.[47] Ultimately, net additional resources may be limited due to the rising cost of energy subsidies and higher transfers to reduce the impacts of rising food prices to the poor. Among commodity importers in the region, the fiscal shock of the war is clearly negative. Across the region, the current crisis opens a window of opportunity for meaningful reforms to improve the efficiency of spending and tax systems. Ad-hoc changes are not useful. What is needed is a careful diagnosis and well-crafted reforms.

Fiscal policy to boost efficiency, equity, and long-term sustainability can be supported by institutions that have proven to be effective in other countries but are still uncommon in the region. For example, an Expenditure and Tax Quality Unit can evaluate and coordinate national action to eliminate leakages, reduce corruption, and periodically evaluate the technical and allocative efficiency and equity of taxes and spending. Eventually, this unit could evolve into an Independent Evaluation and Productivity Council that conducts objective studies that promote greater efficiency and equity without political pressure. In general, reallocating spending away from consumption towards greater productive investment would improve efficiency in many countries.

A stronger institutional framework combined with novel instruments like digital fiscal ecosystems and the digital transformation of the tax administration are key ingredients of a more efficient fiscal architecture.

Credible fiscal institutions that guarantee efficiency, equity, and sustainability would be a critical asset for the region today. Greater equity would help alleviate social tensions. Greater efficiency would reduce required financing. And credibility would help maintain low interest rates, which would allow for a more gradual transition in the post-COVID world and provide greater capacity to deal with the challenges imposed by the Russia-Ukraine war. While these reforms may seem to have a lower priority as they are sometimes labelled "medium term," nothing could be farther from the truth. While changes made today may have lasting benefits, those benefits start to accrue today. The region cannot afford to let this window of opportunity close.

[47] For developing countries in particular, the conventional advice of managing the windfall to smooth consumption over time should be modified to address two prevalent market imperfections: the inability to access capital markets at low costs, and the high domestic interest rates due to the premium faced on high levels of debt. See van der Ploeg and Venables (2011).

CHAPTER 3

Putting the Genie Back in the Bottle: Monetary Policies for the Fight against Inflation

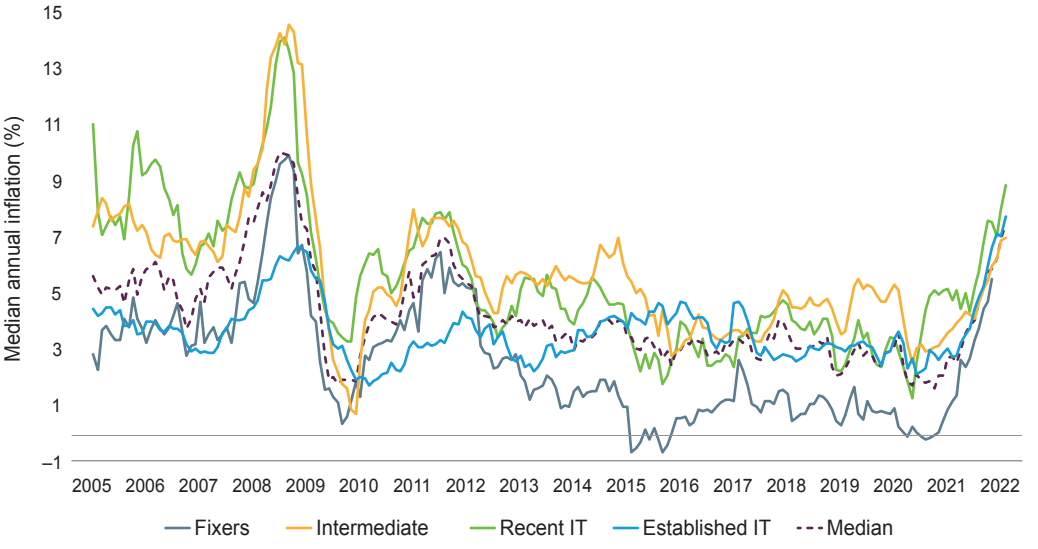
During the pandemic, the slump in economic activity and low inflation rates allowed central banks to implement exceptional monetary policy responses to the crisis without threatening price stability.[1] But as demand picked up and supply problems emerged, inflation started to rise. While in 2020, central banks reduced policy interest rates to an effective lower bound and expanded balance sheets, in 2021 they began to reverse these policies. However, economic activity has not fully recovered, and a persistent job deficit remains. An increase in policy interest rates may slow economic recovery, but should help contain the rise in inflation, which unduly impacts poorer households. Looking forward, central banks face the challenges of how to reduce liquidity support and contain inflation without stifling economic activity, all while maintaining credibility in monetary regimes, despite the rise in public sector debt. In addition, monetary tightening in the United States and other advanced economies, with potential implications for capital flows and financing costs, might complicate the landscape ahead. Inflation has been driven higher by the increase in commodity prices brought on by the war between Russia and Ukraine. The exceptional actions of central banks, accompanying the fiscal packages during the pandemic, helped assuage the economic impacts of the pandemic. As the effects of the pandemic subside, inflation is rising as a result of the war. Now the challenge for central banks is to put the genie of monetary policy back in the bottle.

Inflation on the Rise

In 2020, inflation in the region reached its lowest levels in 15 years. However, inflation rose as economies recovered, especially in the second half of 2021, and irrespective of the monetary policy regime in place (see Figure 3.1). The median annual inflation rate in the region was 4.6% in 2021 versus 2.4% in 2020.

[1] See Cavallo and Powell (2021) and Ayres, Neumeyer, and Powell (2021).

FIGURE 3.1 ● Inflation Rate across Monetary Regimes



Source: IDB staff calculations based on central bank data and Haver Analytics.
Note: This figure depicts median inflation rates for different exchange regimes. Established inflation targeters (IT): Brazil, Chile, Colombia, Mexico, and Peru; Recent IT: Costa Rica, Dominican Republic, Guatemala, Jamaica, Paraguay, and Uruguay; Intermediate: Argentina, Bolivia, Haiti, Honduras, Nicaragua, and Trinidad and Tobago; Fixers: The Bahamas, Barbados, Belize, Ecuador, El Salvador, Guyana, Panama, and Suriname.

The fiscal and monetary support implemented by governments and central banks through 2020 and 2021 to fight the consequences of the COVID-19 pandemic, together with an effort to vaccinate populations, aided in the recovery in economic activity in 2021. However, output levels remain below their pre-pandemic values in most of the region. Still, the increase in demand, coupled with supply chain disruptions and higher international energy prices, compounded by the Russia-Ukraine war, exacerbated the impact on prices, which will continue to rise in the coming months.

Additionally, exchange rates in the region depreciated during the pandemic, notwithstanding the rise in commodity prices, as discussed in Chapter 1. As the pandemic took hold in January to March 2020, bilateral dollar exchange rates depreciated 7% alongside strong portfolio capital outflows.[2] After this initial period, currencies across the region stabilized and even appreciated slightly—by 3% from March 2020 to December 2020. But exchange rates further depreciated in 2021 as local currencies lost an additional 8% in value by January 2022. In 2021, the unusual combination of higher commodity prices and declines in the value of currencies in the region increased the price of imports, putting additional pressure on domestic prices. Through 2021, much of the increase in inflation

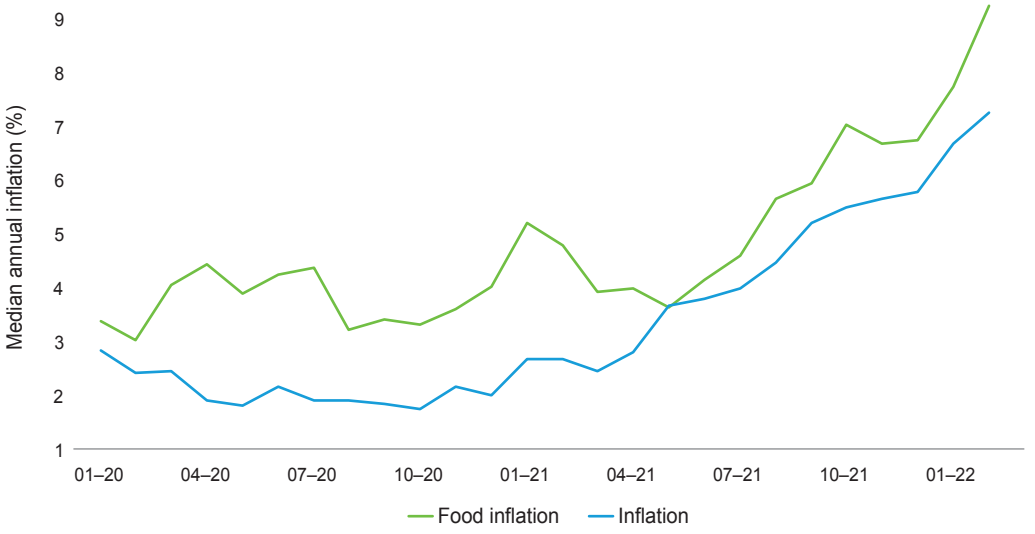
[2] The sample includes end-of-the-month exchange rates from Haver Analytics data for Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Guatemala, Haiti, Honduras, Jamaica, Mexico, Paraguay, Peru, and Uruguay.

appeared to be explained by specific factors such as the rise in food, energy, or other products. Poorer households spend more of their income on food and other products that posted price increases and had to shift yet more of their income to cover these expenses; thus, the real purchasing power of this segment of the population was particularly impacted (see Cavallo and Powell [2021]).

Inflation in 2021 was higher in almost every country in the region than in 2020. Countries with fixed exchange rates and fully dollarized economies suffered similar increases in inflation as those with flexible exchange rates and established inflation targeting regimes (see Figure 3.1). Arguably, this suggests that higher inflation was driven primarily by real factors (the increase in demand coupled with supply constraints) rather than monetary considerations. Still, the more recent inflation targeters suffered the highest inflation rates, with the median reaching 7.6% in October 2021.

Rising inflation is a global phenomenon that is clearly reflected in food prices. These, in turn, are directly impacted by Russia's invasion of Ukraine: first, through the price of energy; second, more directly through the increase in the price of grains that both countries export; and third, through the price of fertilizers that will affect agriculture and livestock farming in the region (see Chapter 4). These combined effects led to an increase in the price of commodities and, therefore, of food, which has surpassed the levels previously observed during the pandemic (see Figure 3.2). The same effect is apparent across all

FIGURE 3.2 ● Headline Inflation and Food Inflation



Source: IDB staff calculations based on central bank data and Haver Analytics.
Note: This graph shows median inflation rates for a group of countries for which food inflation rates are available. The countries included are: Argentina, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guyana, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Trinidad and Tobago, and Uruguay.

monetary regimes: median food inflation is higher than median headline inflation. Median food inflation reached 9.3% versus 7.3% for headline inflation in February 2022.

Whether the rise in inflation is a transitory or persistent phenomenon is the focus of much recent debate. Initial optimism that temporary supply constraints and the impacts of pent-up demand would diminish has given way to the view that the shocks to inflation may be more persistent. The danger is that if inflation expectations drift upwards and are then reflected in firms' pricing policies and wage negotiations, then higher inflation will become entrenched. Several central banks in the region have moved aggressively, pushing up policy interest rates to ensure that inflation expectations stay anchored, and the inflation target remains credible. Central banks may well consider the costs to be asymmetric: it may be more costly to bring inflation back down if it is consistently above the target and expectations become de-anchored, than it is to maintain a credible anchor ex-ante. As reviewed in Chapter 1, the Federal Reserve has also signaled that it will continue raising policy rates in the months ahead.

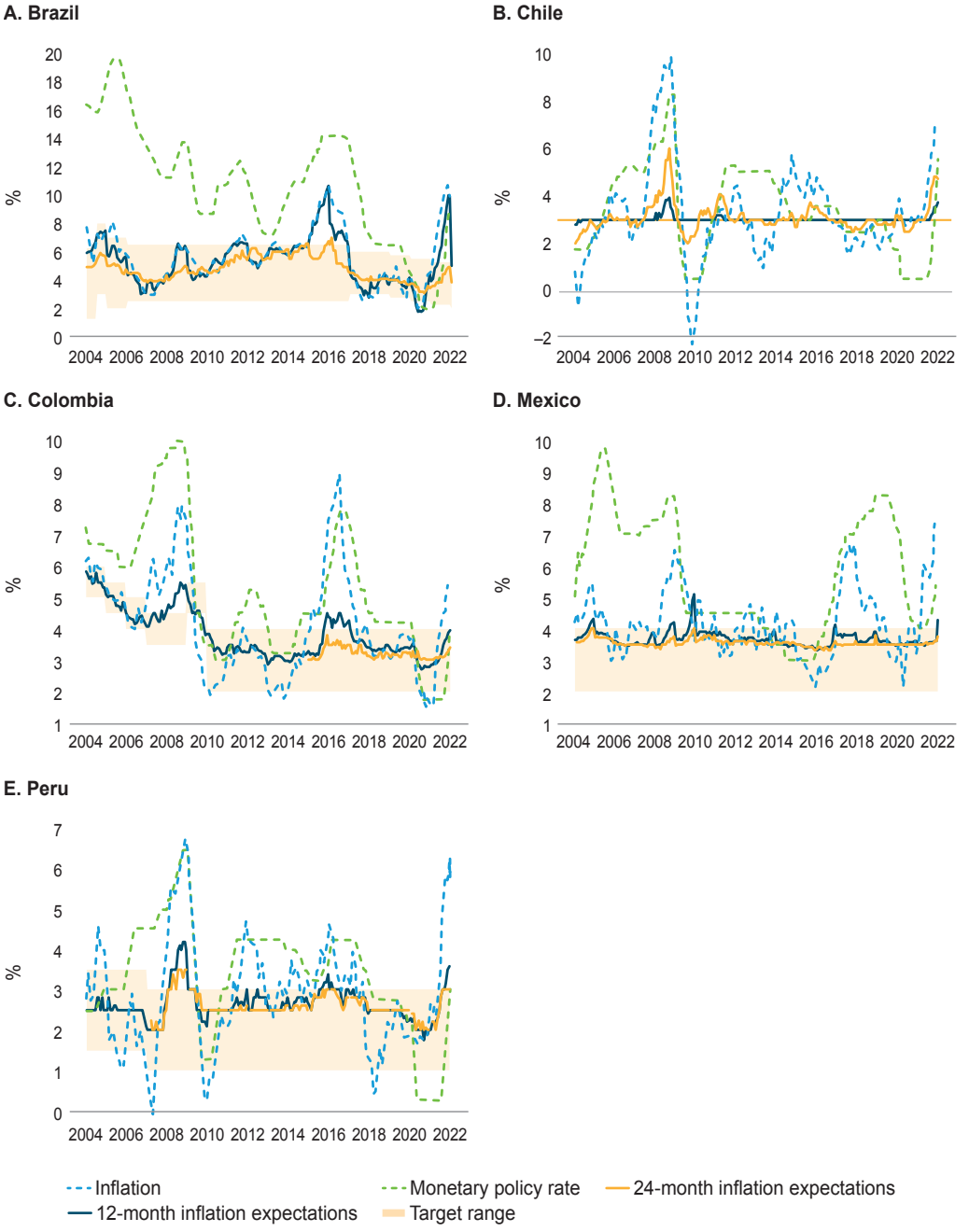
Inflation expectations have already moved upward in some inflation-targeting economies, following the movements in actual inflation (see Figure 3.3). Brazilian inflation expectations for the end of 2021 began to climb in February of that year, increasing from 3.5% to 4% in less than a month, while inflation expectations for 2022 went from 3.6% to 3.8% in April 2021. By December 31, 2021, inflation for 2021 was estimated at 10%, while for the end of 2022, expectations were at 5%. The increase in inflation expectations coincided with the increase in actually observed inflation. As of March 2021, inflation reached 6%—above the target band. For Chile, the situation is similar. Twelve-month inflation expectations jumped from 3% in May 2021 to 4.8% in November 2021 and stayed at 4.7% in January 2022; the 24-month expectation for inflation rose to 3.5% in November 2021, after sitting at 3% for more than 10 years. Inflation was 4.5% in July 2021, surpassing the target. In these two cases as well as in Mexico and Peru, shorter-term inflation expectations exceeded the upper level of the relevant target bands, but medium-term inflation expectations remained inside the target. The central banks of Brazil, Chile, and Peru tightened policy interest rates. Inflation expectations in Colombia remained anchored.

Higher inflation may exacerbate the already increasing inequality in the region. The rebound in economic activity has not yet produced a similar recovery in jobs and wages, particularly in the lower part of the wage distribution (see Chapters 1 and 5). Moreover, the poorest households are the income group most negatively affected by food inflation, putting more pressure on their expenses (see Cavallo and Powell [2021] and Nuguer and Powell [2020a]).

Interest Rates to Control Inflation

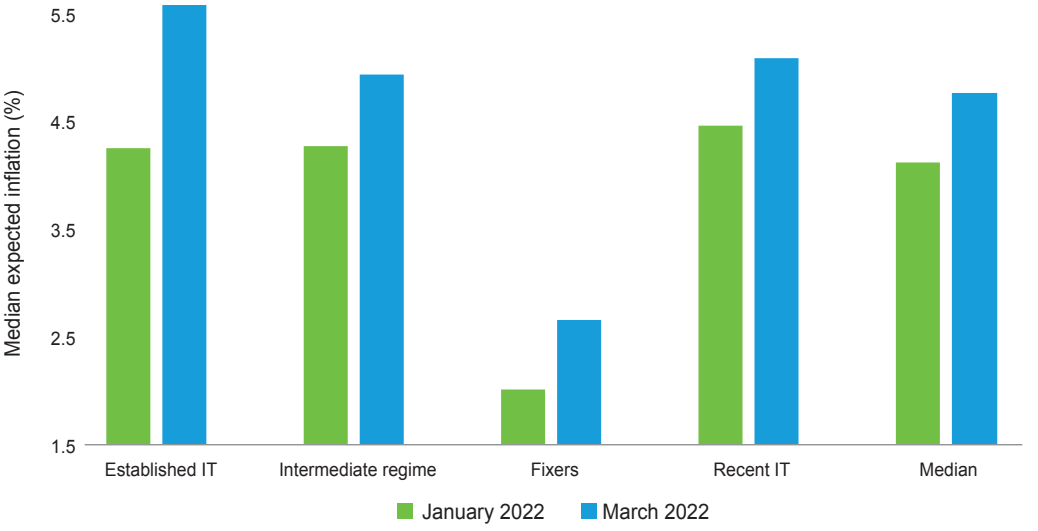
Given the increase in commodity prices due to the conflict between Russia and Ukraine, it is not surprising that inflation expectations for the end of 2022 have increased for all monetary

FIGURE 3.3 ● Inflation and Inflation Expectations for Selected Countries



Source: IDB staff calculations based on central bank data and Haver Analytics.
Note: In the case of Brazil, Mexico, and Peru, 12- and 24-month inflation expectations correspond to the inflation expectations at the end of the current year, and the end of the subsequent year. Inflation expectations for Brazil correspond to the last business day of each month.

FIGURE 3.4 ● Changes in Inflation Expectations by the Year-End 2022



Source: IDB staff calculations based on data from Focus Economics (2022).
Note: The graph includes median inflation expectations for the different monetary regimes. Countries with established inflation target: Brazil, Chile, Colombia, Mexico, and Peru. Countries with recent inflation target: Costa Rica, Dominican Republic, Guatemala, Jamaica, Paraguay, and Uruguay. Countries with intermediate regimes: Argentina, Bolivia, Haiti, Honduras, Nicaragua, and Trinidad and Tobago. Countries with fixed exchange rates: Belize, Ecuador, El Salvador, and Panama.

regimes from January to March 2022 (see Figure 3.4). The median country in the region recorded an increase in inflation expectations for 2022 of 0.7 points in just two months.

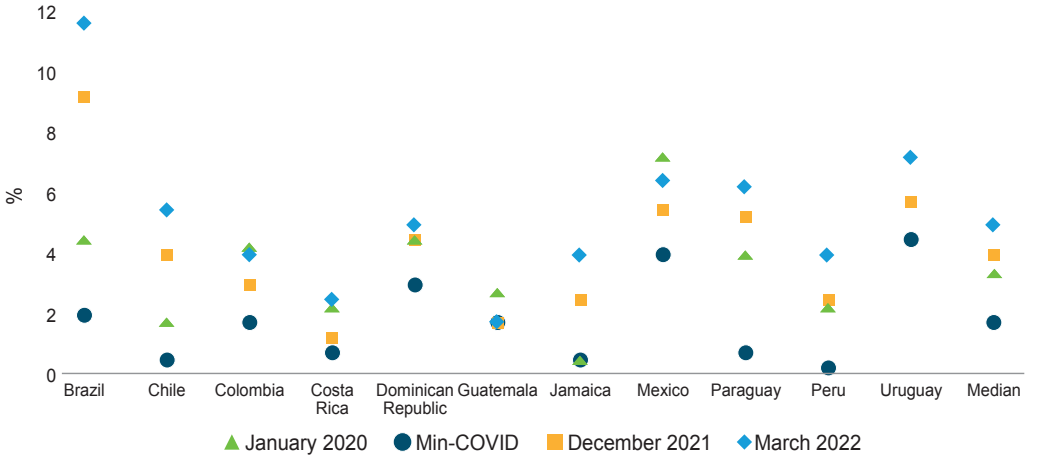
Those countries with established inflation targeting regimes suffered the most marked increase in inflation expectations. Analysts have raised their expectations by 1.3 points, putting median inflation expectations for this group 2 points above the average of the inflation target range. Inflation expectations were in danger of becoming de-anchored, provoking central banks to take action. As of March 2022, expected inflation in countries with recent inflation targeting was still within the central banks' target range, but above the average of that band. At the same time, economic activity was below potential, and is very likely to remain there at least until 2023.

Central banks are facing a trade-off: hiking policy interest rates too much may stifle the recovery and slow the pace at which economies are recovering; however, keeping policy interest rates low may not prevent inflation expectations from becoming de-anchored and inflation may increase further.[3] This conundrum sharpens the inflation versus growth dilemma and may test central bank credibility.

Central banks were highly active in fighting the pandemic. They used both conventional (or sometimes referred to as indirect) monetary policy tools, such as the

[3] This dilemma is exacerbated in a scenario of complications in monetary policy normalization such as the one discussed in Chapter 1.

FIGURE 3.5 ● Monetary Policy Interest Rates



Source: IDB staff calculations based on central bank data and Haver Analytics.
Note: Min-COVID corresponds to the lowest monetary policy rate since March 2020. The month with the lowest policy rate was August 2020 for Brazil, March 2020 for Chile, September 2020 for Colombia, June 2020 for Costa Rica, September 2020 for Dominican Republic, June 2020 for Guatemala, March 2020 for Jamaica, February 2021 for Mexico, June 2020 for Paraguay, April 2020 for Peru, and September 2020 for Uruguay. Uruguay explicitly adopted the interest rate as the monetary policy instrument in September 2020, hence the rate for January 2020 is not included.

policy interest rate, and direct policy levers (sometimes referred to as unconventional monetary policies), such as reducing reserve requirements or expanding balance sheets by providing credit via loans, buying bonds, or through repurchase operations.[4] In terms of the monetary policy rate, during the pandemic, central banks reached historically low levels, promoting credit flows and easing financial conditions. All the inflation targeters in the region reduced policy interest rates with respect to the beginning of the pandemic (see Figure 3.5); the only exception is Jamaica, where the policy rate was already low, at 0.5 percent. By year-end 2021, most central banks had begun to tighten monetary policy, and half had pushed policy rate levels above those at the beginning of the pandemic. Interestingly, the two countries with the largest central bank balance sheet expansions (Brazil and Chile) were the first to raise interest rates. Inflation expectations also moved up more significantly in these two cases. While interest rate hikes may slow the trajectory of the recovery, the primary objective of central banks is to keep inflation expectations anchored and reduce the likelihood of even more costly adjustments in the future.

In the monetary policy committee meetings in the first quarter of 2022, central banks in almost all countries accelerated monetary policy tightening. On average, interest rates went up by 1.25 basis points.

[4] Most central banks in the region are highly constrained in such activities (see Ayres, Neumeyer and Powell [2021] for a discussion).

The rise in policy interest rates across the region implies that so called "carry trade" motives may impact capital flows. The region may attract portfolio flows seeking to benefit from the higher short-term interest rates offered by banks or firms. Investors are likely leveraging by borrowing at lower rates in dollars, or another relatively low interest rate currency. Attracting such short-term flows can provoke an appreciation of the local currency which may improve measured debt-to- GDP ratios (especially if substantial debt is denominated in foreign currency) and bring domestic inflation down (by reducing the prices paid for imports); however, it may limit competitiveness and growth. It may also have implications for financial stability as collateral values may be inflated given an over-valued exchange rate, and complicate monetary policy decisions. If carry-trade motivated portfolio flows become significant, then other "macro prudential" actions may be needed to complement traditional monetary policy actions. Capital flows are discussed in further detail in Chapter 4.

Central Bank Balance Sheet Challenges

Besides reducing policy interest rates and reserve requirements, central banks also injected liquidity directly into economies by purchasing government and private debt securities, extending credit to banks, and making exceptional transfers of profits to governments. Overall, the result was a significant expansion of central bank balance sheets in many countries.[5] Table 3.1 ranks a group of Latin American and Caribbean countries by the cumulative change in central bank balance sheets, computed as the cumulative variation in total assets/liabilities (net of foreign exchange valuation effects on foreign reserves) divided by 2019 GDP, from the start of the pandemic. The largest peak expansions were in Chile, Peru, Bolivia, and Brazil (21.2%, 12.6%, 11.6%, and 9.3% of 2019 GDP, respectively).[6] Large central bank balance sheet expansions may raise concerns about potential inflationary pressures. As economic uncertainty subsides and the strong demand for liquidity abates, central banks will want to reduce the size of their balance sheets accordingly, especially if stronger demand persists due to the economic recovery and continuing supply bottlenecks.

Many central banks began to reverse balance sheet expansions during 2021. The peak expansion was in 2020 or at the beginning of 2021 for most countries (see Table 3.1, Panel A). However, the peak expansion occurred later in 2021 in some countries, suggesting that their expansionary policies persisted even as economic activity recovered. Panel B of Table 3.1 compares the most recent data available for the expansion of each

[5] See Cavallo and Powell (2021) and Ayres, Neumeyer, and Powell (2021).

[6] That expansion is even larger if the valuation of their foreign reserves due to exchange rate depreciations is considered. In this case, the expansions are 22%, 15%, 14.5%, and 11.6% for Chile, Brazil, Peru, and Bolivia, respectively.

TABLE 3.1 ● Cumulative Variation in Central Bank Balance Sheets

A. Maximum Expansion in Central Bank Balance Sheets (% of 2019 GDP)

	ASSETS			LIABILITIES				
	Net foreign assets (net of FX valuation)	Net bank assets	Net government assets	Monetary base	Sterilization liabilities	Other net liabilities	Total assets = liabilities	Expansion peak
Country	(1)	(2)	(3)	(4)	(5)	(6)	(7)=(1)+(2)+(3)	(8)
Chile	5.4	15.4	0.4	5.7	13.7	1.7	21.2	Nov 2021
Peru	7.3	6.2	–0.9	3.2	8.2	1.2	12.6	Jan 2021
Bolivia	–4.2	2.9	12.8	9.5	–0.1	2.1	11.6	Dec 2021
Brazil	–0.2	1.1	8.4	1.5	7.5	0.3	9.3	Jul 2020
Jamaica	2.6	–0.6	6.3	3.7	4.2	0.4	8.3	Jul 2021
Uruguay	5.5	–0.1	–0.9	1.8	4.0	–1.4	4.4	Mar 2021
Colombia	2.1	0.1	1.8	3.3	0.1	0.5	4.0	Dec 2021
Paraguay	4.0	0.9	–1.6	0.6	2.0	0.7	3.3	Dec 2020
Mexico	2.3	–0.2	0.9	2.8	–0.8	1.0	3.0	Feb 2022
Costa Rica	0.6	0.0	0.8	0.1	–0.3	1.5	1.4	Jun 2020

Source: IDB staff calculations based on central bank data.

B. Expansion in Central Bank Balance Sheets Until the Last Available Date (% of 2019 GDP)

	ASSETS			LIABILITIES				
	Net foreign assets (net of FX valuation)	Net bank assets	Net government assets	Monetary base	Sterilization liabilities	Other net liabilities	Total assets = liabilities	Last observation
Country	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Chile	3.3	16.6	0.3	4.3	15.3	0.6	20.2	Feb 2022
Peru	8.1	4.5	–5.7	3.8	2.5	0.6	6.9	Feb 2022
Bolivia	–4.8	2.4	12.6	7.7	–0.1	2.5	10.1	Jan 2022
Brazil	–1.0	0.6	–3.7	1.2	–0.4	–4.9	–4.1	Feb 2022
Jamaica	3.8	–0.7	3.9	3.3	4.6	–1.0	6.9	Feb 2022
Uruguay	4.6	–0.2	–5.9	0.5	1.7	–3.7	–1.5	Feb 2022
Colombia	2.1	0.0	0.5	2.7	–0.5	0.4	2.6	Feb 2022
Paraguay	3.5	0.2	–1.9	1.1	1.3	–0.6	1.8	Feb 2022
Mexico	2.3	–0.2	0.9	2.8	–0.8	1.0	3.0	Feb 2022
Costa Rica	–3.8	2.2	1.2	1.0	–1.8	0.4	–0.4	Feb 2022

Source: IDB staff calculations based on central bank data.

central bank balance sheet to their respective peak expansion in Panel A. In the cases of Brazil, Colombia, and Uruguay, the latest cumulative expansions are significantly lower than the peak and, for the first two, even show a reduction relative to 2019. For these

countries, net government assets fell considerably and were followed by a decline in net bank assets.[7]

In Brazil, for example, the peak expansion occurred in July 2020 with a sharp increase in net government assets as the government drew down its deposits at the central bank to finance fiscal expenditures to bolster the economy during the pandemic. Given the interest rate target set by the central bank, which works as a floor, most of that liquidity injection returned to the balance sheet of the central bank as (repo) sterilization liabilities (see the discussion in Ayres, Neumeyer, and Powell [2021]). In that month, the balance sheet of the Central Bank of Brazil expanded 9.3% of 2019 GDP. After that, the government resumed debt issuance and used the proceeds to replenish its deposits at the monetary authority, thereby reversing the expansion. By February 2022, the balance sheet was already lower than in December 2019. Similarly, Colombia's Central Bank injected liquidity by increasing net bank and government assets. That has also been reversed, due largely to a decrease in net government assets with the increase in government deposits at the central bank.

Chile and Peru are two countries where net bank assets increased significantly during this period. In the case of Chile, the central bank bought bonds issued by banks. In the case of Peru, a large, public guarantee scheme supported credit to firms. Banks provided government-guaranteed loans to firms that were used as collateral in long-term repo operations with the central bank, from which they obtained the necessary funds. By February 2022, net bank assets were still sizable in Chile, as most of these operations are yet to mature. As they do, liquid assets in the economy will decline as banks transfer funds back to the central bank. At the same time, assuming the uncertainty surrounding the pandemic subsides, demand for liquidity will recede. If these two developments cancel out, then no further action should be necessary. However, if one dominates, then the central bank may choose to compensate by buying or selling sterilization liabilities, unless other action is deemed necessary to maintain the inflation target.

Central banks also intervened in foreign exchange markets. Governments issued abroad and used the proceeds to finance domestic fiscal operations, which then entails selling dollars and purchasing domestic currency. This may result in a rise in international reserves on the asset side of the central bank and, as the domestic interventions are then sterilized, an increase in (short-term) sterilization liabilities. In some other cases, domestic injections were essentially financed with reserves. In other words, dollars were sold by the central bank to purchase domestic currency and credit was extended to the government to finance fiscal operations. Thus, one asset was depleted (international reserves) for the benefit of another asset (net government assets). Table 3.1 illustrates this pattern in the case of Bolivia, which operates an exchange rate peg and harnessed reserves to finance fiscal operations.

[7] Net government assets include government debt securities held by the central bank (and direct loans to the central government and state-owned enterprises in the case of Bolivia), net of government deposits.

Governments and central banks worked together for a coordinated response to the pandemic. In the recovery phase, greater tensions might arise.[8] In a positive scenario, demand for liquidity should abate. Inflation should also decline as the supply bottlenecks that emerged during the pandemic, and the impact of pent-up demand for goods and services, should subside. In this context, central banks would be able to reduce the size of balance sheets, and policy interest rates should return to more normal levels. Fiscal authorities should also be able to pare back fiscal stimulus and start to reduce high debt levels (see Chapter 2). However, the scenario has changed over the past few months because of the war between Russia and Ukraine and the possibility that the normalization of monetary policy in the United States may be more complicated than expected (see Chapter 1). In this scenario, additional inflationary pressures could coexist with low economic growth and consistently high inflation rates. Depending on how export-oriented a country is, and how the fiscal authorities use the commodity price boom (see Chapter 2), this new situation could lead to tensions between fiscal and monetary policy. Central banks could come under increasing pressure: on the one hand, to limit interest rate hikes, which would increase financing costs; on the other hand, to finance fiscal deficits with monetary measures. The monetary and fiscal history of the region speaks clearly to the danger of falling into the trap of financial repression and the monetary financing of persistent fiscal deficits.[9] The region has progressed markedly in terms of central bank independence and the design of monetary policy frameworks, but those advances may be tested in the months ahead. It will be critical to maintain autonomy,[10] credible monetary policy regimes, and consistency between monetary and fiscal policies in order to ensure price stability and sustainable recovery.

In Search of a Balanced Fiscal and Monetary Policy Mix

During the COVID-19 pandemic, both monetary and fiscal authorities reacted strongly to mitigate the impact on economic activity. At the onset of the pandemic, central banks had significant room to intervene, not only by reducing the monetary policy rate but also through balance sheet expansions. On average, the established inflation targeters reduced interest rates by 230 basis points in 2020 and expanded their balance sheet by almost 10% of GDP. As discussed in Chapter 2, governments also implemented fiscal measures, depending on the available fiscal space. On average, the established inflation targeters increased their fiscal deficit by 4.9% of GDP, pushing the average gross debt up to 57.3% of GDP by the end of 2021, considerably lower than the regional average of 73%.[11]

[8] See Ayres, Neumeyer, and Powell (2021) for a discussion.

[9] See Kehoe and Nicolini (2021).

[10] See Parrado and Powell (2021) for a discussion of the importance of central bank autonomy.

[11] The regional average corresponds to average annual inflation rates for all IDB borrowing countries except Argentina and Venezuela.

However, the scope for policies to support economic recovery has changed significantly in 2021 and 2022. While economic activity was slowly returning to normal levels, the shock generated by the war in Ukraine, together with the normalization of monetary policy in the United States, is likely to create new challenges for many countries in the region (see Chapter 1). The combination of higher aggregate demand and supply shortages had fueled inflationary pressures in the region. Rising commodity prices due to the war will continue to intensify it. This has triggered rapid increases in monetary policy interest rates. Public debt will be impacted by how governments manage additional external resources, domestic energy subsidies and potentially higher financing costs (see Chapter 2).

The close coordination between fiscal and monetary policies will be critical in the months ahead. Higher inflation rates could reduce the size of the debt in real terms but also require central banks to increase interest rates, which would raise the cost of domestic financing. Additionally, higher interest rates could slow down economic activity and increase debt-to-GDP ratios. If fiscal policy remains expansionary, inflation may be pushed higher; however, this scenario would lead to increases in interest rates, which would act against the fiscal expansion slowing the economy. Thus, the gains from expansionary fiscal policy would be reduced.

Complex Policy Challenges in the Months Ahead

The region will face higher levels of inflation in the coming months. The combination of resurging demand, supply constraints, and elevated commodity prices will continue pushing inflation higher. If inflation is allowed to continue above targets, then a danger is that inflation expectations may become de-anchored and those expectations may feed into firms' pricing decisions and wage negotiations. Then, central banks may find that reducing inflation requires a more costly loss in output than ensuring that expectations remain anchored today. Making sure that inflation converges back to targets would also assist in moderating the impacts of higher inflation on poorer households.

Monetary policy tends to be more effective when central banks and inflation targets retain high credibility. In general, the required increase in interest rates, or changes in other policy levers, to bring down inflation (or keep inflation expectations anchored) will be less with higher credibility. Also, higher credibility minimizes the pass-through of exchange rates to inflation. Central banks are then able to allow exchange rates to fluctuate without needing to respond with changes in the policy rate. Credibility is promoted by central bank independence and a clear communications strategy. These two factors also help minimize the costs to the economy from the process of shrinking the central bank's balance sheet.

A consistent fiscal policy with lower fiscal deficits will preserve the efficiency of monetary policy in the medium term in the current context. While some countries are benefiting from higher revenues associated with rising commodity prices, maintaining a

more expansionary fiscal policy will likely lead to higher inflation and hence higher interest rates. Close coordination between monetary and fiscal policies are required to maximize efficiency during the recovery phase. A further danger is that, if fiscal policy remains too expansionary and debt continues to rise, conditions for fiscal dominance may arise. If debt is too high, it may then be impossible to sustain an independent monetary policy as central bank financing of fiscal expenditure takes priority over realizing any inflation objective. Ensuring a sustainable path for government finances to complement a credible monetary framework and ensure price stability will then become critical in the months ahead.

CHAPTER 4

Risks to External Accounts

During 2020 and 2021, current accounts in the region swung from deficit to balance or surplus as imports fell more than exports, remittances remained strong, and countries issued foreign debt, which boosted capital inflows and reserves. But just as the post-pandemic recovery kicked in, so too did the Russia-Ukraine war. This development raises several questions regarding the region's external accounts. How will it affect countries' current accounts? What is the risk to capital flows? What impact will it have on tourism? Can Latin America and the Caribbean help the world by exporting more of the products whose supply has decreased due to the war between Russia and Ukraine? Given changing global trade patterns, can the region strengthen its external accounts?

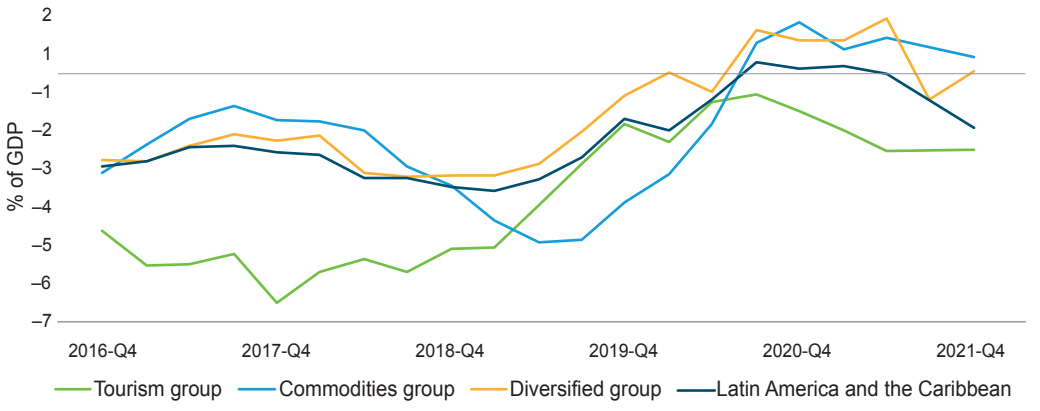
During 2020, the current account of the countries of the region shifted from average negative values close to –2.5% of GDP between 2016 and 2019 to a surplus of 0.6% at the end of 2020 (see Figure 4.1). The median value of both imports and exports in U.S. dollars contracted by about 18%. Remittance flows grew by 7.2%, allowing the current account balance to improve. In 2021, as the recovery gained momentum, the current account balance fell again into negative territory.

Within Latin America and the Caribbean, external account performance varies considerably across countries. The composition of exports, the weight of tourism in economic activity, and the reliance on remittances are key factors that differentiate the dynamics of the current account in the countries of the region and that, in turn, shape the nature of the external risks they will face in the years ahead. These factors are critical in determining how the impacts of the war between Russia and Ukraine will play out in the region.

Countries are classified in three groups: those that rely largely on commodity exports, those dependent on tourism, and diversified countries whose exports are not concentrated in either commodities or tourism. While the current account balance improved in the commodities and diversified groups in 2020, switching from deficit to surplus, in the tourism-dependent group, it remained negative (see Figure 4.1). In 2021, as imports picked up throughout the region, the surpluses in the diversified and commodities groups shrank, and the deficit in the tourism-dependent economies widened.[1]

[1] For recent outlooks on tourism, see IMF (2021c) and Giordano et al. (2021).

FIGURE 4.1 ● Current Account Balance



Source: IDB staff calculations based on data from the Balance of Payments Statistics (BOPS) database of the IMF and national sources.
Note: Includes countries for which data are available. Values are medians. Potential GDP is used. The latest data for 2021 are the value of the current account balance from the World Economic Outlook (IMF, 2021c). Tourism group includes: The Bahamas, Belize, Dominican Republic, Jamaica, Haiti, Panama, and Uruguay. Commodities group includes: Bolivia, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, and Suriname. Diversified group includes: Argentina, Brazil, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, and Trinidad and Tobago.

The War's Impact on Current Accounts: A Tale of Two Regions

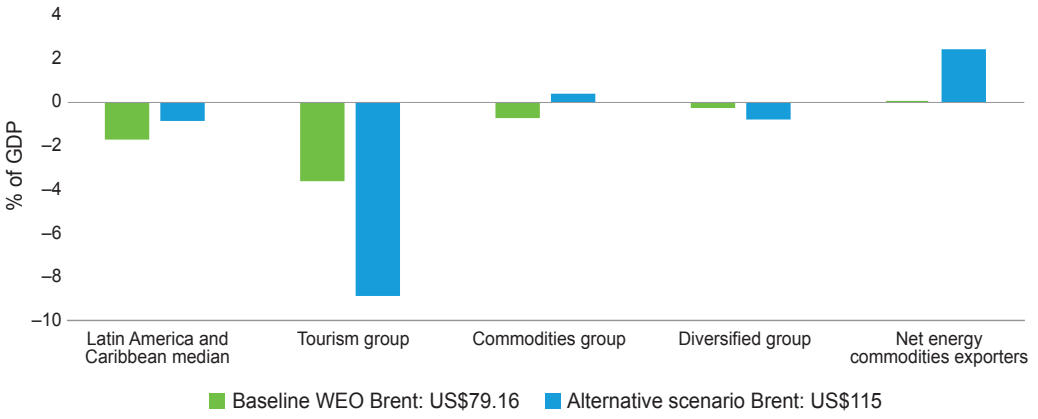
One of the global impacts of the Russian-Ukrainian war was the sharp increase in prices of commodities, particularly oil and its derivatives, as well as other mining and energy products whose prices fluctuate with oil (see Chapter 1). Several countries in the region are net exporters of raw materials. The rise in oil prices improves the trade accounts of net energy exporters and worsens those of net energy importers (Figure 4.2). Given higher energy prices, the current account deficit is now expected to contract to around half of the pre-war estimate for the median country. This relative "improvement" in the current account at the regional level conceals a significant improvement by more than two percentage points of GDP in the median energy-exporting country and a sharp deterioration in importing countries, many of which are also dependent on tourism revenues.

Exports of Goods: Support for Current Account Balances

The region enjoyed strong external demand for goods in 2021, propelling median export volumes by 8.4% and values by 22.5% in 2021 (see Figure 4.3, Panel A). Strong global demand for imports primarily from the United States, and to a lesser extent Europe, underpinned the increase in volumes while higher commodity prices buoyed the increase in values. In the case of the United States, imports grew in tandem with the rise in personal consumption of durable goods, which spiked above its longer-term trend (see Figure 4.3, Panel B). After contracting sharply in March and April of 2020, demand for durable consumer

goods[2] returned to the pre-COVID trend by June 2020, and kept growing, ending 2021 some 20% higher than its pre-pandemic level.

FIGURE 4.2 ● Current Account Balance Scenarios for 2022

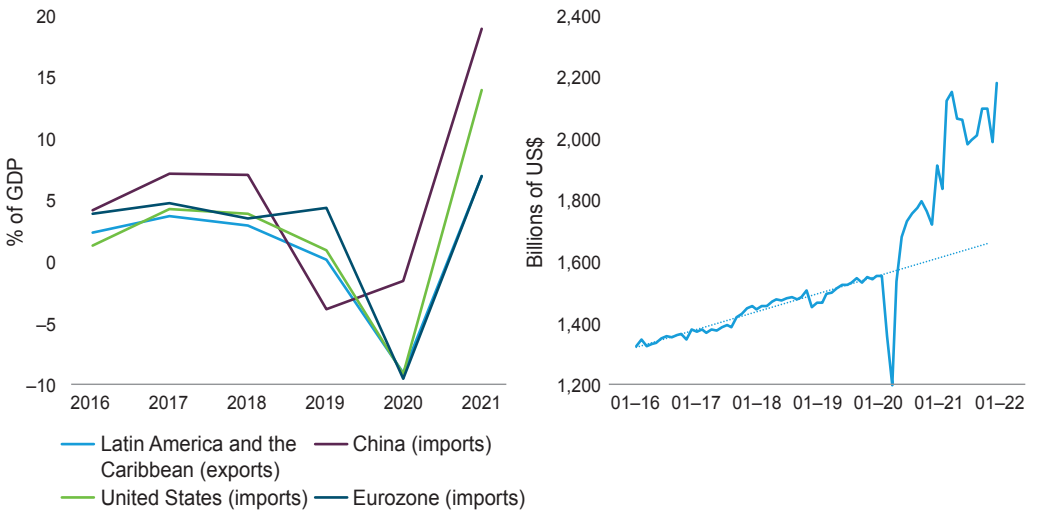


Source: IDB staff calculations based on IMF data (2021c) and the Comtrade monthly data from the United Nations.
Note: The base forecast comes from the IMF (2021c), with a projected average price of US$79.16 per barrel of Brent oil in 2022. The alternative scenario assumes an average price of US$115 per barrel of Brent oil in 2022. The new price's impact on the current account is determined using the energy commodities trade balance for 2019, from the Comtrade database. See the note on Figure 4.1 for a description of the countries included in each group.

FIGURE 4.3 ● External Demand for Goods from Latin America and the Caribbean

A. Goods and services export volume

B. United States: Consumer spending on durable goods



Source: IDB staff calculations based on IMF (2021c), and the Federal Reserve Economic Data.

[2] According to the Bureau of Economic Analysis, the durable consumer goods category includes goods that have an average useful life of at least three years.

Future export trends will depend on how countries react to changes in commodity prices and the war's impacts on the growth of large importers. Chapter 1 showed that the war could cause the economies of the United States and Europe—the region's main trading partners—to contract. This could reduce their imports. However, as noted above, in some cases, higher prices are likely to offset lower volumes.

The war could also have direct impacts on the region's exports (see Box 4.1). Some countries export a significant portion of certain products to Russia. Assuming that this market is now closed, exporters will have to find alternative destinations, and there may be negative impacts during the transition. Meanwhile, there are products that Russia and Ukraine export that Latin America and the Caribbean also export, and so the region can assist in ameliorating global supply restrictions (see Box 4.2). The presence of exporters from the region in these markets could mitigate the global inflationary effects of the fall in the global supply of specific products.

BOX 4.1 • Reallocation of Global Imports: Did Latin America and the Caribbean Gain Market Share?

The war between Russia and Ukraine has raised serious concerns about how it will impact trade in the rest of the world. The countries of Latin America and the Caribbean are no exception. Although the aggregate trade of the two countries does not account for a high percentage of global trade, the prices of some raw materials could be impacted by the participation of Russia and Ukraine in their supply chains, as is the case for wheat, corn, fertilizers, natural gas, and oil, among other products.

Latin American and Caribbean countries export little to Russia, with the exceptions of Ecuador, Jamaica, and Paraguay. In 2019, only 0.3% of the exports of the median country in the region went to Russia (see Table 4.1.1).

Although the region's trade exposure to Russia is generally low in terms of exports, for some specific products, Russia accounts for a meaningful portion. For example, in 2019 Russia received 33% of Paraguayan beef exports, worth US$335 million. What's more, these exports accounted for 4.3% of Paraguay's total exports (see Figure 4.1.1)— a significant portion. Based on this analysis, beef in Paraguay, fruits in Ecuador, seeds for oil production in Paraguay, and inorganic chemicals in Jamaica are the sectors that will be most impacted by an interruption in trade with Russia.

The picture is similar for imports of Russian products to Latin America and the Caribbean, which account for only 0.3% of total imports for the median country of the region (see Table 4.1.2).

Although no Russian product represents a large proportion of the total imports of the countries in the region, fertilizers are especially significant since countries like Brazil, Ecuador, Nicaragua, Peru, and Suriname import at least 30% of their fertilizers from Russia. (see Figure 4.1.2). This is particularly important given agricultural products' weight in the export basket of many countries in the region.

The war will raise the price of fertilizers given Russia's dominance in global trade of this product. Without question, this Russian dominance will impact all the countries in the region, especially Brazil. The South American giant is the largest net importer of fertilizers in the region, exports significant quantities of agricultural products, and makes intensive use of fertilizers in its production process. Brazil imports about 30% of its fertilizers from Russia, although it is more diversified than other countries (see Figure 4.1.3).

(*continued on next page*)

BOX 4.1 • Reallocation of Global Imports: Did Latin America and the Caribbean Gain Market Share? (*continued*)

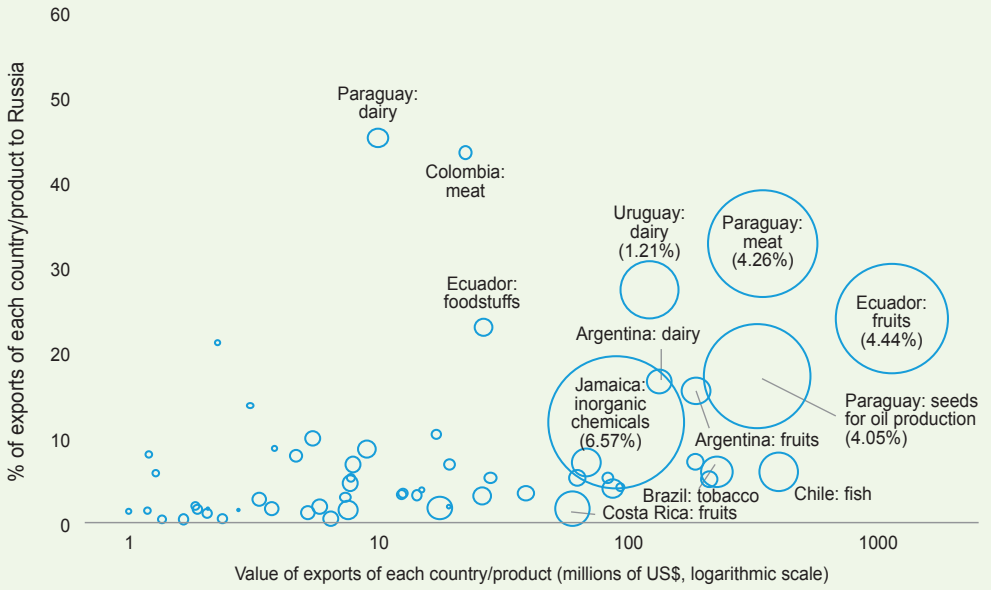
Clearly, the origin of fertilizer imports varies widely in the region. The median Latin American and Caribbean country imports 18% of its fertilizers from Russia and 22% from the United States. The portion of fertilizer imports from China is substantially smaller, accounting for 8% of median country imports. Countries highly dependent on Russian fertilizer will have to work harder to rebuild their basket of imports.

TABLE 4.1.1 • Exports to Russia

Country	Portion of total exports to Russia (%)
Paraguay	8.5
Jamaica	6.6
Ecuador	5.3
Uruguay	1.8
Argentina	1.3
Chile	1.2
Median of remaining countries	0.2
Median for Latin America and the Caribbean	0.3

Source: IDB staff calculations based on data from the Comtrade database of the United Nations.
Note: The calculations were carried out using data from 2019, as the COVID crisis years are considered atypical.

FIGURE 4.1.1 • Exports to Russia from Latin America and the Caribbean



Source: IDB staff calculations based on data from the Comtrade database from the United Nations.
Note: The calculations were carried out using data from 2019, as the COVID crisis years can be considered atypical. The vertical axis measures the importance of exports to Russia per country by product category in each country. The horizontal axis measures the value of each country's exports to Russia by product category. The size of the bubbles represents the weight of a country's product exports to Russia as a percentage of the country's total exports. In selected cases, this value is reported in parentheses.

(*continued on next page*)

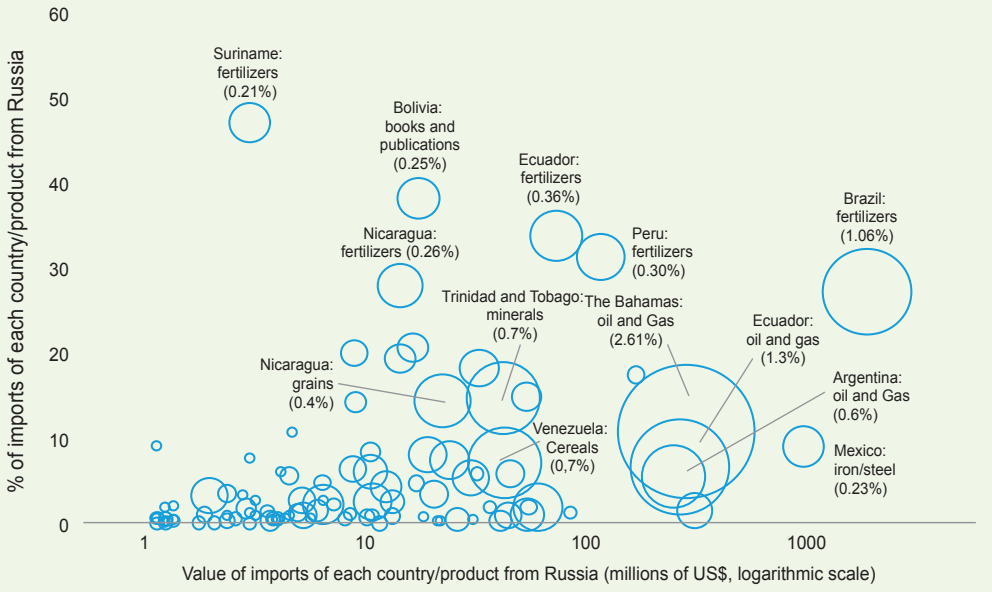
BOX 4.1 • Reallocation of Global Imports: Did Latin America and the Caribbean Gain Market Share? (*continued*)

TABLE 4.1.2 • Imports from Russia

Country	Portion of total imports from Russia (%)
Bahamas	2.6
Ecuador	2.0
Venezuela	1.7
Brazil	1.4
Nicaragua	1.0
Trinidad and Tobago	0.8
Median of remaining countries	0.3
Median for Latin America and the Caribbean	0.3

Source: IDB staff calculations based on data from the Comtrade database of the United Nations.
Note: The calculations are carried out using data from 2019, as the COVID crisis years are considered atypical.

FIGURE 4.1.2 • Imports to Latin America and the Caribbean from Russia



Source: IDB staff calculations based on data from the Comtrade database of the United Nations.
Note: The calculations were carried out using data from 2019, as the COVID crisis years are considered atypical. The vertical axis measures the importance of imports from Russia per country by product category in each country. The horizontal axis measures the value of each country's imports from Russia by product category. The size of the bubbles represents the weight of a country's product imports from Russia as a percentage of the country's total imports. In selected cases, this value is reported in parentheses.

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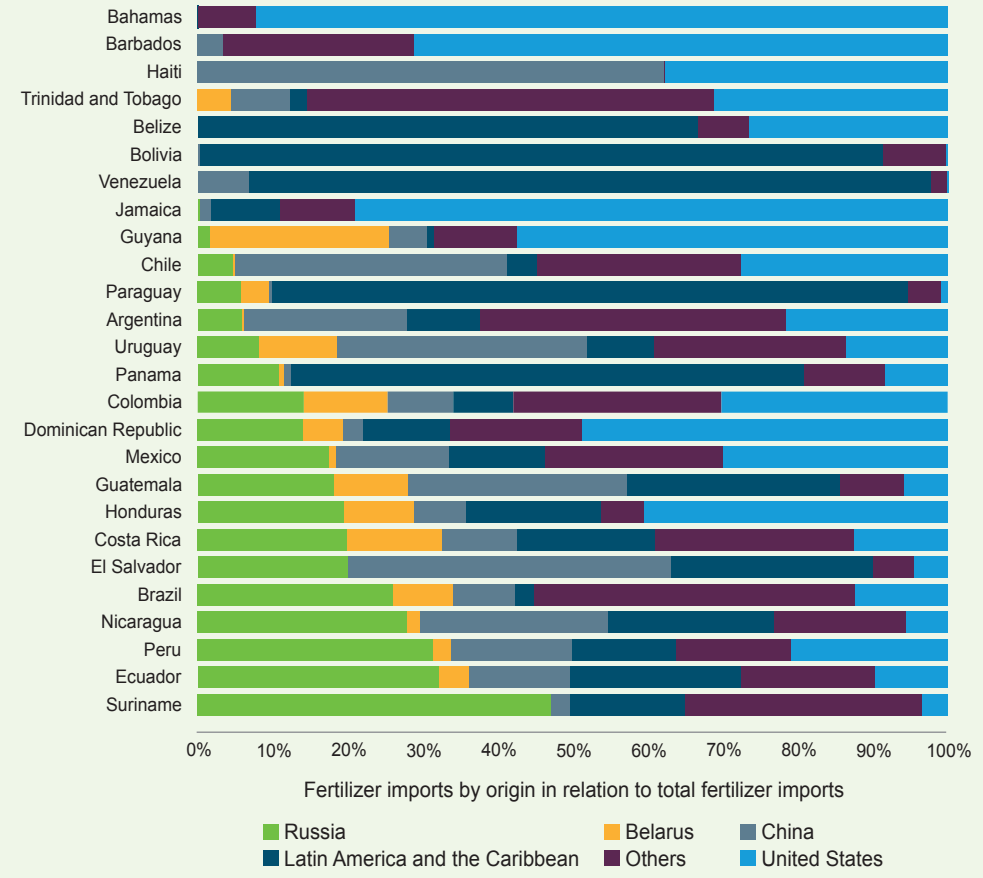
BOX 4.1 • Reallocation of Global Imports: Did Latin America and the Caribbean Gain Market Share? (*continued*)

FIGURE 4.1.3 Composition of Fertilizer Imports in Latin America and the Caribbean



Source: IDB staff calculations based on data from the Comtrade database of the United Nations.
Note: The calculations were carried out using data from 2019, as the COVID crisis years are considered atypical.

Tourism: A Partial Recovery

Tourism suffered greatly during the COVID-19 crisis with tourism exports falling a staggering 45%. International tourist arrivals indicate a slow and bumpy recovery and remain below pre-pandemic levels (see Figure 4.4, Panel A). However, in this area too country experiences vary. For example, Figure 4.4, Panel B shows a reversal in international tourist arrivals to The Bahamas in August of 2021, when COVID cases surged and stricter measures were enforced for both residents and tourists. The country's relatively low vaccination rate (Figure 4.4, Panel C) may well explain the vulnerability to a new surge.

Varying vaccination rates, the latent risk of new strains of the coronavirus, and the consequences of the war in Ukraine could slow the tourism recovery.

BOX 4.2 • How Latin America and the Caribbean Can Help Mitigate the Impacts of the War

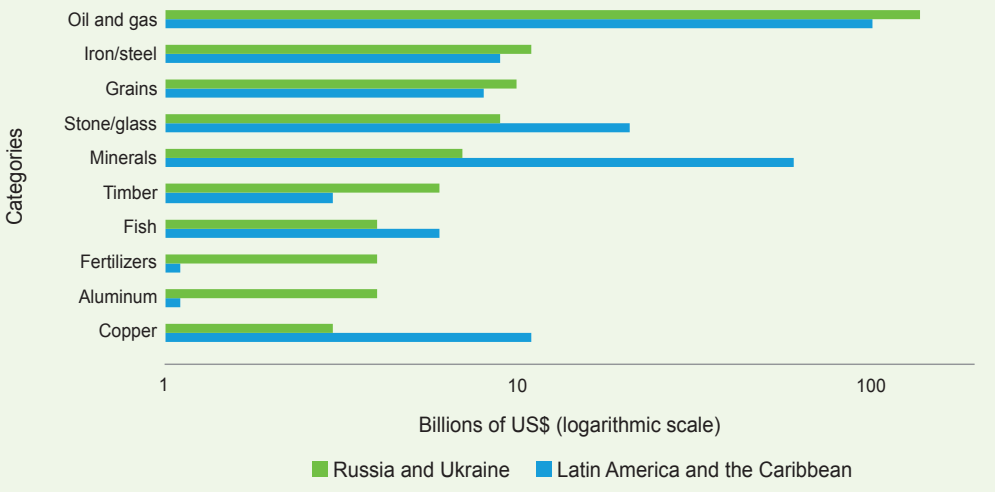
The war between Russia and Ukraine will have a significant global impact. Much of it will come from the contraction in the global supply of commodities—along with some essential intermediates—in different value chains. In certain markets, Latin America and the Caribbean is well placed to mitigate the adverse effects of a possible supply squeeze and the potential inflationary pressure resulting from the war (see Figure 4.2.1).

Grains offer a good example. Russia and Ukraine export grains, as do several countries in the region. Some of these exports end up in the same markets. If those markets want to replace their current imports from Russia and Ukraine, Latin American and Caribbean countries could meet part of that demand. Moreover, the region already has proven experience exporting these specific products to these markets, thus facilitating the establishment of business relationships with clients there. Also, Latin America and the Caribbean has a market share comparable to—and in some cases greater than—that of Russia and Ukraine, reflecting their comparative or competitive advantages in these products.

However, there are obstacles. For example, during the pandemic, the region underwent the reconfiguration of global supply chains in a context of weak export networks, deficient logistics, and persistent barriers to trade integration. These factors restricted the ability to take full advantage of the opportunities offered by the reshuffling of global trade at that time.

The region's chances of mitigating the war's global impacts depend on which markets it can supply and their global relevance. In the case of grains, fertilizers, and iron and steel, Russia and Ukraine account for 28%, 20%, and 20%, respectively, of the markets in which they and the countries

FIGURE 4.2.1 • Markets Served by Latin America and the Caribbean, Russia, and Ukraine



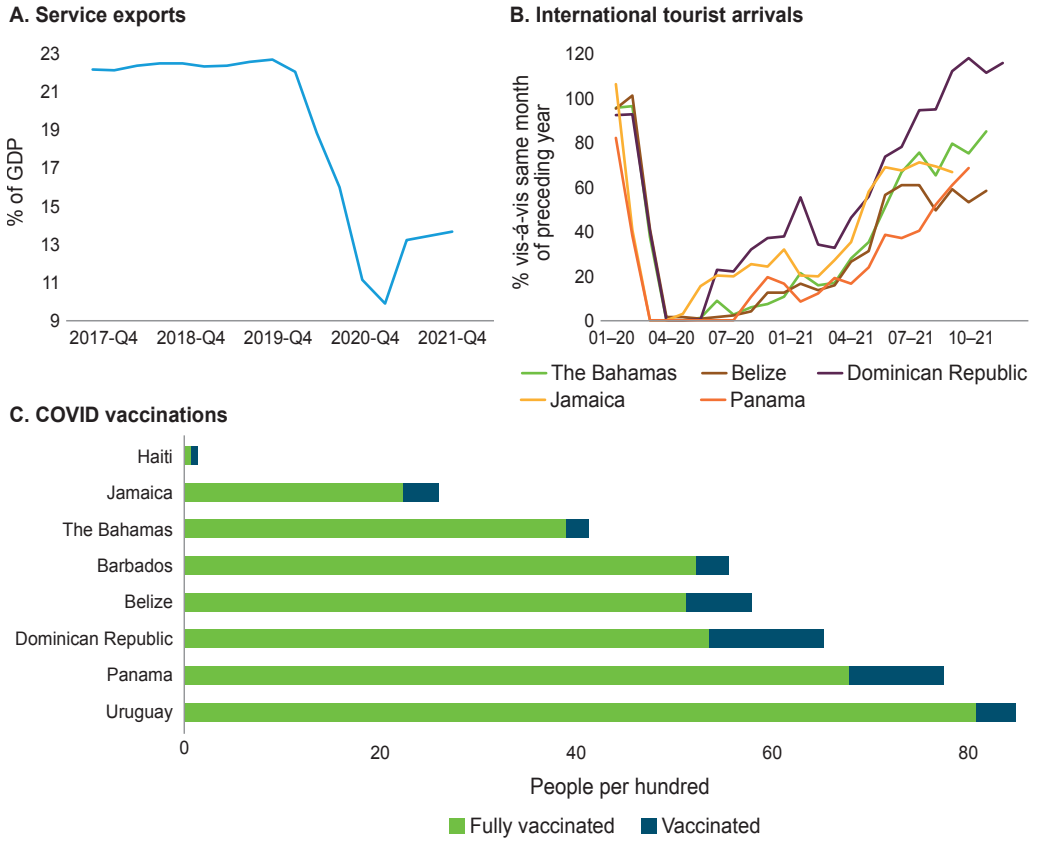
Source: IDB staff calculations based on data from the Comtrade database of the United Nations.
Note: The calculations were carried out using data from 2019, as the COVID crisis years are considered atypical. The exercise shown in the above figure is based on an analysis of countries that import more than 6,000 products from both Russia and Ukraine, and Latin America and the Caribbean. Once it is established that both groups of countries are involved in trade for each product, the products are grouped into a series of broad categories. The figure shows, in descending order, the 10 categories that are most relevant for Russia and Ukraine.

(*continued on next page*)

BOX 4.2 • How Latin America and the Caribbean Can Help Mitigate the Impacts of the War (*continued*)

of Latin America and the Caribbean participate. These shares are equivalent to 12%, 6%, and 6% of the global market for these products. The region could play an important role in the markets for these products, as well as in the oil and gas markets. However, any adjustment is not likely to be immediate given the nature of the production processes for different goods and the restrictions on the supply and exploitation of natural resources. Still, these markets must be explored in order for the region to play an active role in mitigating the major trade disruption being caused by the war.

FIGURE 4.4 • Tourism Statistics

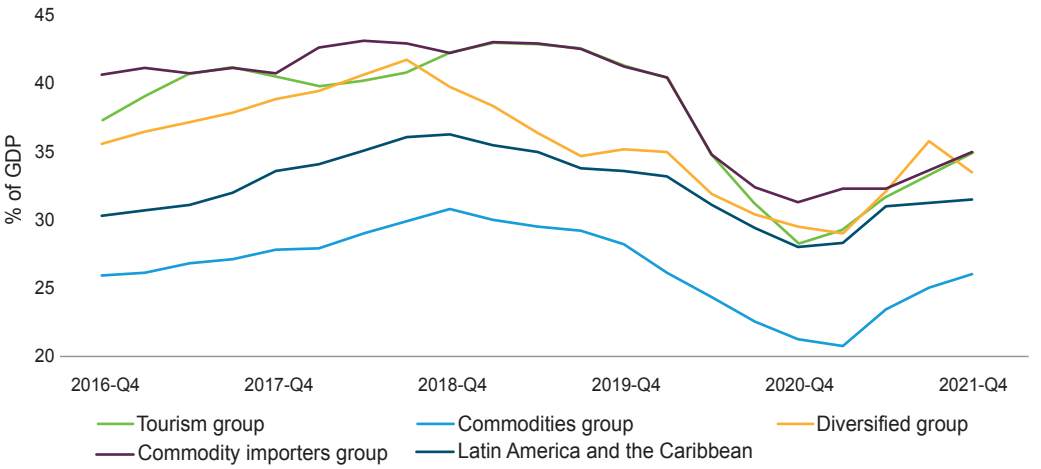


Source: IDB staff calculations based on the IMF Balance of Payments Statistics (BOPS) database and IMF (2021c), UNWTO Global Tourism Dashboard, national sources, and Our World in Data Database.
Note: Includes countries for which data are available. See Figure 4.1 for a description of the countries included in the group. In Panel A, potential GDP was used. The latest data for 2021 are the value of service exports from the World Economic Outlook (IMF, 2021c).

Completing the Current Account Picture: Imports and Remittances

In 2020, given the depth of the recession and the shocks to demand and supply chains, imports contracted significantly (see Figure 4.5). Imports rose by 3.5 percentage points

FIGURE 4.5 ● Imports of Goods and Services



Source: IDB staff calculations based on data from the Balance of Payments Statistics (BOPS) database from the IMF, IMF (2021c) and national sources.
Note: Includes countries for which data are available. Values are medians. Potential GDP is used. The latest data for 2021 are the value of goods and services imports from the World Economic Outlook (IMF, 2021c). Commodity Importers Group includes: Belize, The Bahamas, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Nicaragua, and Trinidad and Tobago. See the note on Figure 4.1 for a description of the countries included in the remaining groups.

of GDP in 2021 for the median country to return to prepandemic levels. However, going forward the picture is more uncertain.

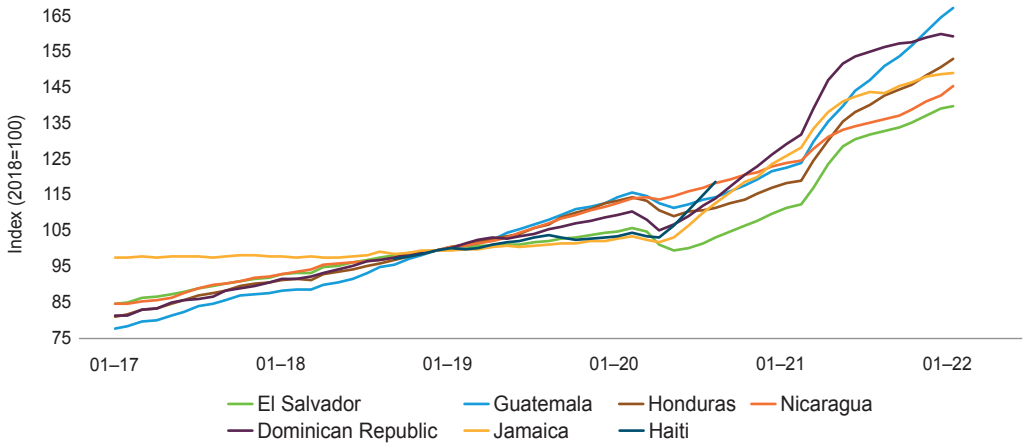
The dynamics of imports in 2022 and beyond will depend on how prices develop, especially commodity prices, and how the war impacts the world economy and, in turn, the countries of the region.

Remittances are an important source of foreign currency for several economies in the region. Figure 4.6 shows the evolution of remittance flows in countries that rely heavily on them. After an initial drop at the beginning of the pandemic, remittances rebounded rapidly, explained both by the stimulus policies in the United States and other source countries, and the increase in demand in destination countries. Remittances provided an additional 5% of GDP in hard currency flows to these countries in 2020, crucially helping them smooth the pandemic shock. In 2021, the median growth rate was a still buoyant 26.7%. Going forward, the flow of remittances may be impacted by a slowdown in U.S. growth due to the impact of the war between Russia and Ukraine, as well as complications in the normalization of U.S. monetary policy to slow inflation (see Chapter 1).

The Financial Account Takes Center Stage, Again

The uncertainty surrounding the future dynamics of the current account highlights the role of the financial account. The impact of COVID on financial flows in 2020 was not

FIGURE 4.6 ● Remittance Flows



Source: IDB team calculations based on data from the Consejo Monetario Centroamericano, the Central Bank of Jamaica, and the Central Bank of Haiti.
Note: Total flow of the 12 months of 2018 in U.S.$ for each country is assigned to 100. For each month, the flow of the last 12 months is compared with that of 2018 for the same country.

as severe as initially feared. Most countries' financing flows recovered quickly in the second semester of the year. Mirroring current account developments, median financial account flows fell the most for the commodities group (-4.8% of GDP) while for diversified economies they fell only 2.0% of GDP, and for the tourism group grew 0.8% of GDP. Direct investment was resilient, falling only about 0.8% of GDP across all countries in 2020 and recovering quickly in 2021. The difference between the country groups was due to differences in portfolio and other investment flows,[3] which grew for tourism economies and fell for the commodities group.

However, focusing on the median economy in each group may ignore specific financing flow dynamics. Interestingly, most countries in the region avoided any type of sudden stop in capital flows.[4] While portfolio outflows were substantial in the early part of the crisis, many countries were able to tap international bond markets (see Box 4.3), borrow from official creditors and, in some cases, residents repatriated capital, thereby avoiding sudden stops in net capital flows that would have had a significant impact on current accounts. The few cases of sudden stops were largely driven by capital flight (residents moving capital offshore) and were concentrated in countries that had been suffering some type of exchange rate pressure before 2020. One of the defining characteristics of the crisis brought on by the pandemic compared to many previous crises suffered by the

[3] In balance-of-payments jargon, "other investment" includes mostly private bank loans, government and multilateral credit, and foreign exchange and deposits.
[4] See Cavallo and Powell (2021).

BOX 4.3 • Sovereign External Bond Issuance during the COVID Crisis

The unprecedented contraction in economic activity generated by the COVID-19 pandemic plus the urgent need to assist both households and firms, forced governments to tap all their financing sources. Several governments in the region issued sovereign bonds in international markets in 2020 and 2021, which was critical for many economies to avoid a Sudden Stop event (Cavallo et al., 2022).

Table 4.3.1 shows the sovereign external bond issuances of Latin American and Caribbean countries, both in their dollar amount and as a percentage of GDP for 2020 and 2021. In the year the pandemic started, economies in the region issued bonds worth US$61.5 billion at face value, with the median issuance to GDP ratio among the 14 issuing sovereigns reaching 2.5%.

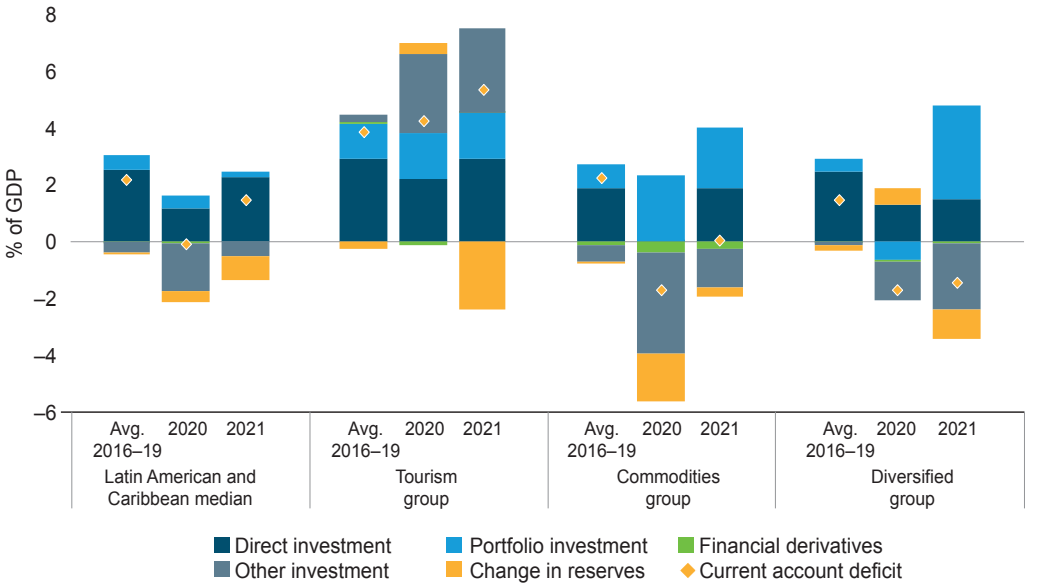
All 10 sovereigns that issued in 2021 had also done it in 2020, but the converse was not true. Total issuance was US$48.6 billion, and the median issuance to GDP ratio was 1.8%. Since the onset of the COVID-19 crisis, 16 of 23 countries in the region that had a sovereign issuer rating have seen it downgraded by at least one of the three major rating agencies.

TABLE 4.3.1 • Sovereign External Bond Issuance and Credit Ratings

	Sovereign external issuance				Credit ratings Dec 2021 (S&P/Moody's/Fitch)	
	2020		2021			
Country	Millions of US$	GDP %	Millions of US$	GDP %	Credit rating	Outlook
Brazil	5,250	0.3	1,500	0.1	BB-/Ba2/BB-	STA/STA/NEG
Chile	4,501	1.5	17,064	5.4	A/A1/A-	STA/NEG/STA
Colombia	5,583	1.8	4,300	1.4	BB+/Baa2/BB+	STA/STA/STA
Dominican Republic	8,266	9.5	2,116	2.3	BB-/Ba3/BB-	STA/STA/STA
El Salvador	1,000	3.7			B-/Caa1/B-	NEG/NEG/NEG
Guatemala	500	0.6	1,000	1.2	BB-/Ba1/BB-	STA/NEG/STA
Honduras	600	2.4			BB-/B1/NA	STA/STA/NA
Mexico	18,105	1.5	10,777	0.8	BBB/Baa1/BBB-	NEG/NEG/STA
Panama	5,000	8.1	1,250	2.0	BBB/Baa2/BBB-	NEG/STA/STA
Paraguay	1,000	2.7	600	1.6	BB/Ba1/BB+	STA/STA/STA
Peru	8,750	3.9	8,337	3.7	BBB+/Baa1/BBB	NEG/STA/STA
The Bahamas	825	7.1			B+/Ba3/NA	STA/NEG/NA
Trinidad and Tobago	500	2.2			BBB-/Ba2/NA	NEG/STA/NA
Uruguay	1,628	2.7	1,610	2.6	BBB/Baa2/BBB-	STA/STA/STA
Total	61,509		48,554			
Median	3,065	2.5	1,863	1.8		

Source: Eikon-Thomson Reuters Datastream and IMF (2021c).
Note: External issuances are defined by jurisdiction. Debt restructuring issuance from Argentina and Ecuador is omitted. In 2020, Argentina, Belize, Bolivia, Costa Rica, Guyana, Jamaica, Haiti, Nicaragua, and Suriname did not issue. In 2021, Argentina, The Bahamas, Barbados, Belize, Bolivia, Costa Rica, Ecuador, Honduras, El Salvador, Jamaica, Nicaragua, Suriname, and Trinidad and Tobago did not issue. NA: Not Available. POS: Positive. STA: Stable. NEG: Negative. Potential GDP is used.

FIGURE 4.7 ● Sources of External Financing



Source: IDB staff calculations based on the IMF Balance of Payments Statistics (BOPS) database and IMF (2021c).
Note: Includes countries for which data are available. Values for Latin America and the Caribbean are medians, while for the other groups they are averages. See the note on Figure 4.1 for a description of the countries included in each group.

region was the access to international capital markets at reasonable costs, aided by the exceptional monetary policies in advanced economies.[5]

However, while net capital flows recovered in 2021 after the contraction in 2020, they remained below 2019 levels and risks remain. Moreover, not all financing sources returned at the same pace. The rebound is uneven when disaggregating financial flows for different groups of countries and by type of flow, as shown in Figure 4.7. Foreign direct investment (FDI) was relatively stable in the diversified and tourism groups, while highly volatile in the commodities group: It dropped sharply in 2020, then recovered quickly.

The war and the dynamics of the monetary policy adjustment in the United States raise new questions about the stability of capital flows to emerging markets. In October 2021, the IMF forecasted that on average, FDI would be enough to cover current account deficits for the economies in the region. The exception was countries in the tourism-dependent group, which received a significant amount of "other investment flows" (which include multilateral and bilateral lending) to finance their current account deficits in 2020 and 2021. The increase in the prices of raw materials could reduce the financing needs of some countries but increase them in others. Any of these dynamics could take place in a

[5] See Cavallo et al. (2022) for a more detailed analysis of the changes in the financial account and an explanation of the lack of sudden stops during COVID.

world where capital flow volatility could increase due to uncertainty about the impacts of the war and economic sanctions on Russia.

Risks to External Financing

High volatility in capital flows implies risks for current account financing. Economies in the commodities group have volatile FDI flows, often driven by investment in extractives, which tend to follow commodity prices. As long as these prices remain high, foreign investment flows may follow, particularly if the price boom is accompanied by a robust fiscal policy (see Chapter 2).

For the diversified group, moderate current account deficits are expected, reducing net borrowing vis-a-vis the rest of the world absent restrictions due to supply factors. This outlook relies on exports maintaining a higher growth rate than in the years before the pandemic. If that perspective fails to materialize because growth cools in advanced economies, durable goods demand sags, or commodity prices increase further, the expected surpluses could become deficits, in which case these countries would require substantial external financing as well.

The tourism-dependent group will require substantial external financing in addition to the FDI expected in the next couple of years. Thus, this group may be particularly vulnerable to a sharp retraction in global liquidity.

A key question is whether going forward, countries will continue to benefit from the strengths that allowed them to avoid significant external crises, or whether they could face a greater risk of sudden stops in capital flows. In the past, higher interest rates in advanced economies frequently caused disruptions to capital flows in emerging markets.

The answer lies in the strength of macroeconomic fundamentals. During the Global Financial Crisis of 2008, and more recently during the COVID crisis, Latin American and Caribbean countries were able to avoid sudden stops. In both cases, the key was sound economic fundamentals, which enabled continuous access to external financing.[6] Table 4.1 presents key domestic indicators identified by the literature as relevant determinants of the likelihood of sudden stops: the current account and fiscal balances, liability dollarization, and the availability of foreign reserves.[7] To assess the vulnerability to sudden stops in 2022, projected values for these variables are compared to those observed in 2007 and 2019.

[6] See Cavallo and Powell (2021) and Cavallo et al. (2022) on the behavior of capital flows during the COVID period, and Cavallo, Izquierdo, and León-Díaz (2020) on the behavior of capital flows during other episodes of financing stress.

[7] See Calvo, Izquierdo, and Loo-Kung (2012).

TABLE 4.1 ● Leading Macroeconomic Determinants of a Sudden Stop

	Fiscal balance			Current account balance			Liability dollarization[a]			Reserves		
(% of GDP)	2007	2019	2021	2007	2019	2021	2007	2019	2021	2007	2019	2021
Tourism group	0.7	–2.7	–4.3	1.8	–0.7	–0.6	27.9	22.9	27.9	13.5	15.1	21.1
Commodities group	–0.8	–3.5	–6.4	–2.9	–2.1	–2.8	20.0	18.1	21.3	12.9	16.4	20.7
Diversified group	0.8	–2.7	–4.5	–5.1	–1.3	–1.6	16.3	19.8	22.0	14.1	14.6	19.3
Latin America and Caribbean	–0.2	–2.8	–5.4	–3.5	–1.3	–1.6	19.7	19.0	21.6	13.8	15.7	20.7

Source: IDB staff calculations based on IMF (2021c).
Note: All reported values are medians. Excludes information for Guyana and Venezuela. See Figure 4.1 for a description of the countries included in each group.
[a] Data for Argentina, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, and Uruguay.

Table 4.1 suggests that currently the main source of vulnerability is on the fiscal side. Fiscal balances in the region uniformly deteriorated with the pandemic. In 2021, the median fiscal deficit was still higher than in 2019, which was in turn larger than in 2007. In terms of the other indicators, the diversified group appears stronger; in particular, the current account deficit in 2021 is less than half the level in 2007, and about the same as in 2019. Throughout the region, liability dollarization has declined and reserves have increased. During 2020, the median reserves holdings-to-GDP ratio increased 4.7% due to higher current account balances, external pre-financing operations undertaken by some countries, and IMF rapid credit disbursements. In 2021, current account deficits returned and pre-financing slowed, thereby reducing reserve accumulation; however, the decline in reserves was offset by the allocation of IMF's Special Drawing Rights (SDRs). The median SDR allocation among Latin American and Caribbean economies is 1.4 percentage points of GDP.

The bottom line is that a key goal for Latin American and Caribbean economies should be to rebuild their fiscal space sooner rather than later, not only on the grounds of fiscal sustainability per se (Chapter 2) but also to prevent sudden stops in net capital flows that have proven costly to the region in the past. Given the volatility that could be caused by the war in Ukraine and the normalization of monetary policy in the United States, moving in that direction is crucial for the region.

Weighing the Risks

The recovery of economies in the region has been accompanied by a widening of current account deficits. In most countries, a significant fraction of the current account deficit is

financed by relatively stable capital flows in the form of FDI. However, risks to the outlook are tilted downwards.

The emergence of new COVID variants could cause tourism flows to dip and the current account deficit in several countries to further widen. The possibility of lockdowns, quarantines, and other measures in both destination and origin countries may affect travelers' decisions. That makes vaccination and COVID management particularly important for tourism-dependent economies.

Commodity prices have risen substantially due to the Russia-Ukraine war. Specifically, oil and soybean prices are expected to remain high for many months. Remittances seem to have peaked and are poised to return to their long-term levels.

Still, the recovery in developed economies combined with the shift in demand strained supply chains worldwide and sparked inflation in advanced economies. That prompted central banks to withdraw liquidity and reverse balance sheet expansions to curb inflationary pressures. In addition, the Russia-Ukraine war has altered the risks. A significant risk is that capital flows may be interrupted. At the beginning of the war, some economic indicators that usually reflect the markets' perception of emerging economy risk increased, including the emerging countries bond index (EMBI) spreads and the options exchange volatility index (VIX). Towards the end of March, these indicators had already returned to their pre-war levels, indicating that the markets did not anticipate major disruptions to capital markets. This is consistent with the apparent lack of obvious channels for transmitting financial instability from Russia to other countries around the world (see Box 4.4). However, it is still too early to assess whether emerging market capital markets will remain calm, especially in the event of a steady increase in interest rates in the United States.

Although mitigating the risks to the financial account is no easy task, rebuilding buffers should be a priority. Moving to strengthen fiscal accounts and reduce sovereign debt will help preserve the access to external credit markets that may be essential, if such risks were to materialize, to prevent sudden stop episodes.

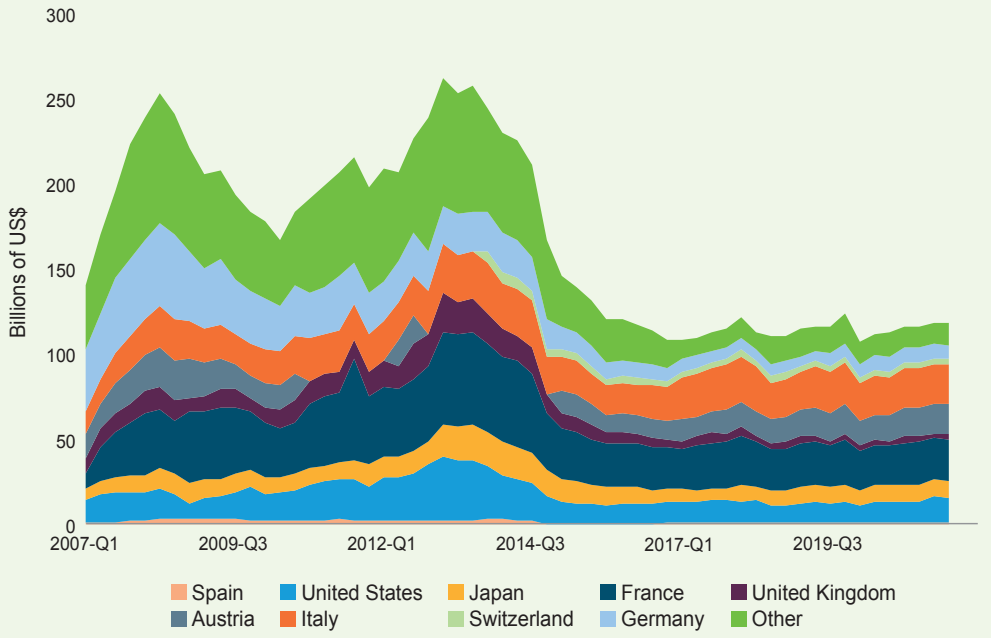
BOX 4.4 • How Exposed Are Latin American and Caribbean Banking Systems to Russia?

Foreign banks active in Russia and Latin America and the Caribbean could represent a channel of instability for the region. If these banks face significant losses in Russia, or if their assets are tied up and they are unable to transact, they may have to contract their operations in different parts of the world to offset the related capital loss. This could cause further instability. However, this risk appears to be contained. Lending by foreign banks to Russian counterparts has contracted sharply since the first decade of the 21st century (Figure 4.4.1) and now accounts for about half of what it was at the end of the first decade of the century. Currently it represents around US$120 billion, less than 12% of total lending to the private sector by the Russian banking sector. The countries with the greatest exposure to Russia are Austria, the United States, France, Italy, and Japan.

Although high, these exposures are not systemically relevant for most countries. Banking systems' exposure to Russia is only significant in the case of Austria, where it is equivalent to almost 20% of the capital of Austrian banks. In the case of French, Italian, American, and Japanese banks, the figures are 3.9%, 8.5%, 0.6%, and 2.3%, respectively. Although these proportions are not significant at the aggregate level, they could be relevant for individual banks.

With the exception of the United States, foreign banks that are highly exposed to Russia have low exposure to Latin America and the Caribbean (see Figure 4.4.2). Consequently, shocks to the Russian banking market are not expected to impact the countries of the region. More indirect impacts are possible through the cross-exposure of Spanish banks—which have a strong

FIGURE 4.4.1 • Loans from International Banks to Russia, by Origin



Source: IDB team calculations based on consolidated banking statistics from the Bank for International Settlements.
Note: The measurement is of the exposure of domestic banks to the banks, public sector, and non-financial private sector in Russia.

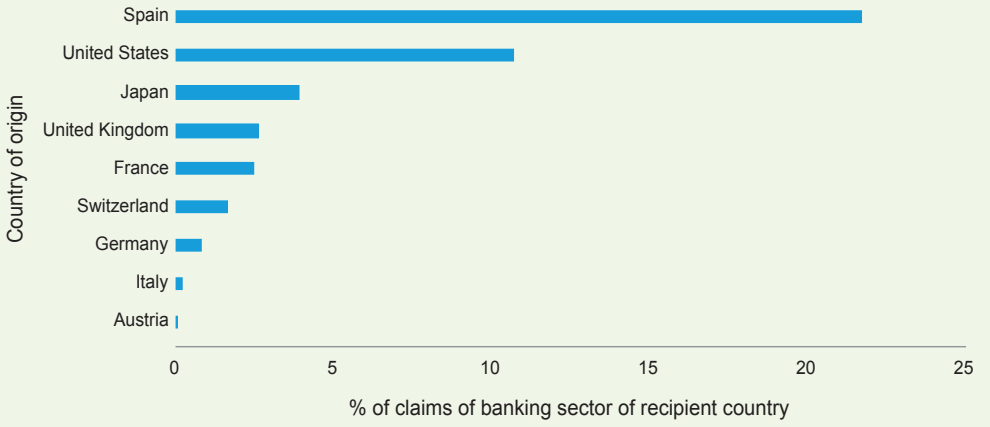
(*continued on next page*)

BOX 4.4 • How Exposed Are Latin American and Caribbean Banking Systems to Russia? (*continued*)

presence in Latin America and the Caribbean—to countries with significant exposure to Russia, such as Austria. However, even these effects are only second order.

In any case, financial volatility can be transmitted via multiple channels. This is just one of them, which is why monetary and financial authorities must remain vigilant.

FIGURE 4.4.2 • Lending from Foreign Banks to Latin America and the Caribbean



Source: IDB team calculations based on consolidated banking statistics from the Bank for International Settlements and Latin American and Caribbean central banks and financial regulators.
Note: The measurement is of the exposure of domestic banks to the banks, public sector, and nonfinancial private sector in the recipient country, normalized by recipient country bank lending to the same sectors.

CHAPTER 5

Opportunities for a Great Transformation of Labor Markets

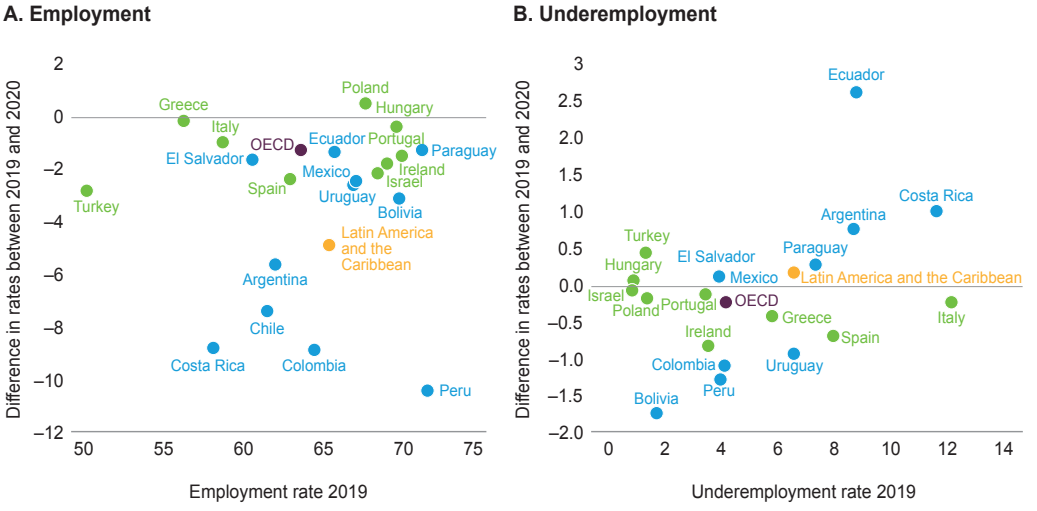
The COVID-19 crisis and the current conflict between Russia and Ukraine pose challenges and opportunities for labor market transformation in Latin America and the Caribbean. The region was hard hit by the COVID shock; employment rates fell dramatically and unemployment rates spiked. Importantly, the effects on the labor market have differed from previous crises, with informal workers bearing the brunt of the shock. Women and youth have been severely impacted while some sectors suffered more than others.

While employment has risen with the recovery from the COVID crisis, it has still not reached pre-pandemic levels. The Russia-Ukraine war brings more uncertainty to the recovery of the region and its labor markets. Given the potential impacts, accelerating job growth is a priority. At the same time, the region still faces the longstanding challenges of high informality, low productivity, and low wages. And digitalization and automation may have additional profound effects on labor markets in the coming years. This chapter presents key elements to build a new labor market architecture, complementing the fiscal reforms discussed in Chapter 2, to reduce informality, stimulate more and better jobs, and take advantage of new technologies. Latin America and the Caribbean has an opportunity to not only recover from the COVID shock to employment, but correct the labor market distortions of the past and prepare for a more efficient, productive future benefitting workers, in particular women and those in the informal sector.

The Impact of COVID-19 on Labor Markets

In 2020, Latin America and the Caribbean suffered the most significant contraction in GDP and employment of any region—advanced or developing—in the world (see Chapter 1). Employment and underemployment rates were significantly harder hit in Latin America and the Caribbean than in a group of OECD countries (see Figure 5.1). In Chile, Colombia, Mexico, and Peru, employment contracted by an unprecedented 14.5% in the first and second quarters of 2020, and unemployment rates rose to

FIGURE 5.1 ● Average Employment and Underemployment in Latin America and the Caribbean and Selected OECD Countries



Source: IDB staff calculations based on data from COVID-19 Labor Market Observatory and OECD Employment and Labor Market Statistics.
Note: The figure contains the average annual difference in employment and underemployment rates for each country. For Latin American and Caribbean countries, underemployment is defined as the employed workers who work for 30 hours a week or less and are willing to work longer. For OECD countries, underemployment is defined as the share of persons who declared they worked part-time because they could not find a full-time job. The sample of OECD countries inludes Greece, Hungary, Ireland, Israel, Italy, Poland, Portugal, Spain, and Turkey.

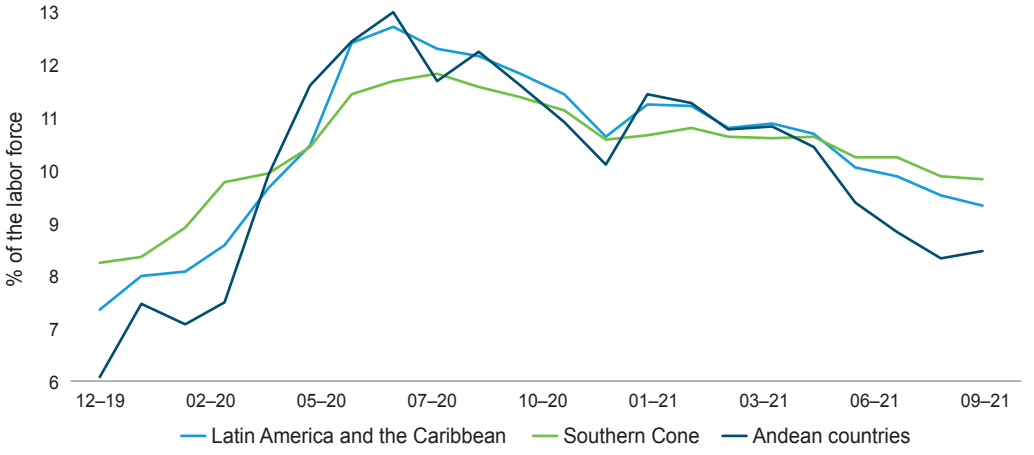
historically high levels.[1] After peaking in July 2020, unemployment began a slow descent that was relatively uniform across the region (see Figure 5.2). Critically, the COVID-19 crisis led to a significant contraction in labor force participation rates, a dramatic rise in closures of micro and small businesses, and a remarkable reduction in informal employment.[2]

The impacts on labor markets differed substantially from previous crises in many ways. The deeper contraction in informal employment was unique to the COVID-19 recession. Typically, informal employment has reacted countercyclically and risen during previous downturns in the region.[3] With the COVID crisis, however, total employment (including formal and informal employment from household surveys) fell more than formal employment (as measured by administrative records on pension contributors) (see Figure 5.3).

The contraction in informal employment is particularly relevant since informal workers—both salaried and self-employed—tend to have more volatile incomes. Average

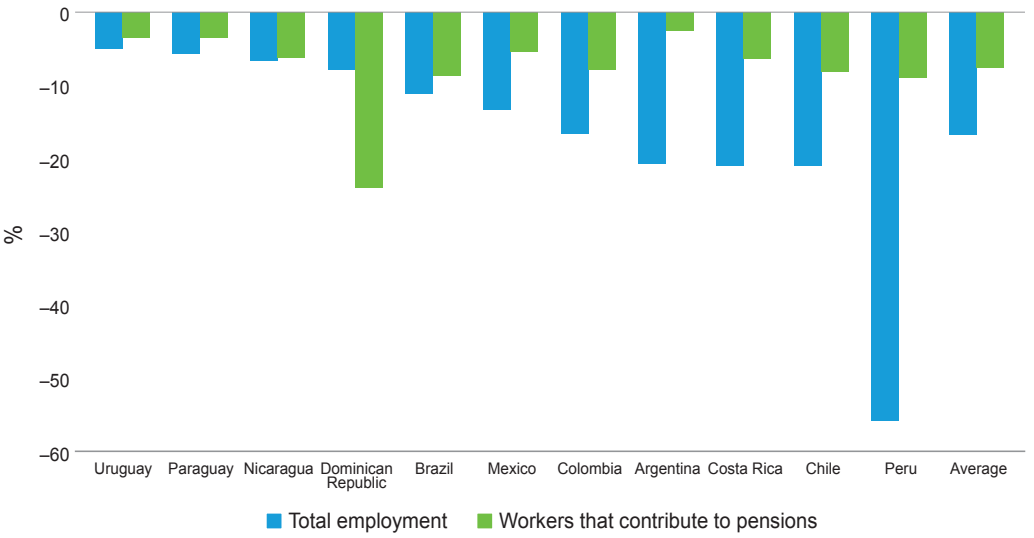
[1] Unemployment rates vary depending on the selected period, the choice of countries, simple or regional average and whether it is a moving quarterly average or an estimated monthly change.
[2] See ECLAC (2020a) and Azuara et al. (2020).
[3] See Leyva and Urrutía (2021) and Álvarez et al. (2021).

FIGURE 5.2 ● Unemployment Rate



Source: IDB staff calculations based on data from COVID-19 Labor Market Observatory.
Note: Southern Cone countries include Argentina, Brazil, Chile, Paraguay, and Uruguay; Andean countries include Bolivia, Colombia, Ecuador, and Peru.

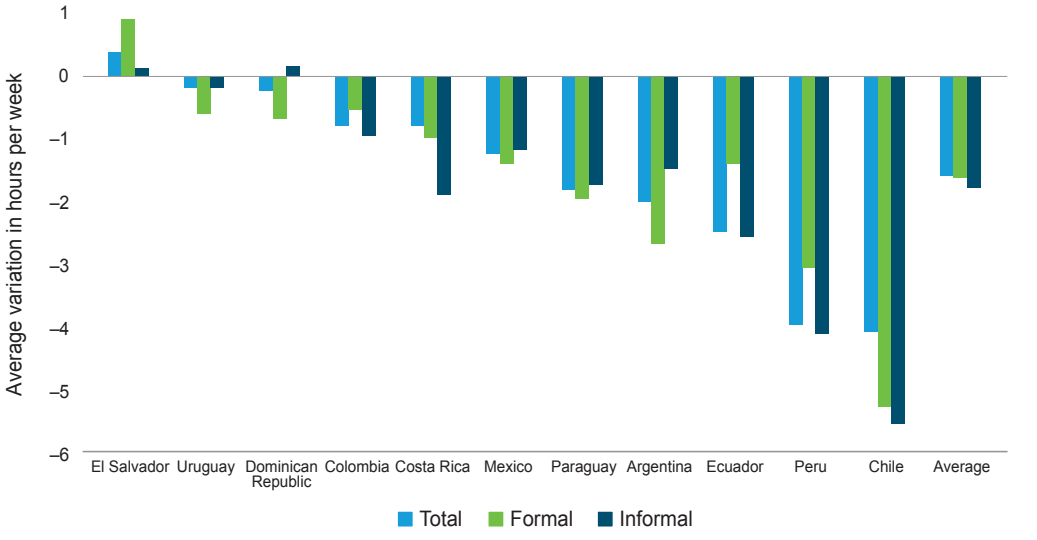
FIGURE 5.3 ● The Decline in Total and Formal Employment from February to June 2020



Source: IDB staff calculations based on data from COVID-19 Labor Market Observatory.
Note: The figure plots the percentage change in the two variables. The data on total employment is sourced from household surveys while the data on workers that contribute to pensions (proxy for formal employment) come from administrative records. When data on total employment were unavailable from February, March data were used.

monthly income fell in 2020 with significant variations across countries. Peru, for example, registered a 24.5% decrease in the average income of employed individuals. The COVID shock, coupled with extended lockdowns, also reduced incomes in Colombia and Ecuador

FIGURE 5.4 ● Hours Lost per Week: Formal versus Informal Sector, 2019–2020



Source: IDB staff calculations based on data from COVID-19 Labor Market Observatory.

by 13.1% and 11.1%, respectively. However, average monthly income increased for Chile and El Salvador 13% and 9%, respectively.[4]

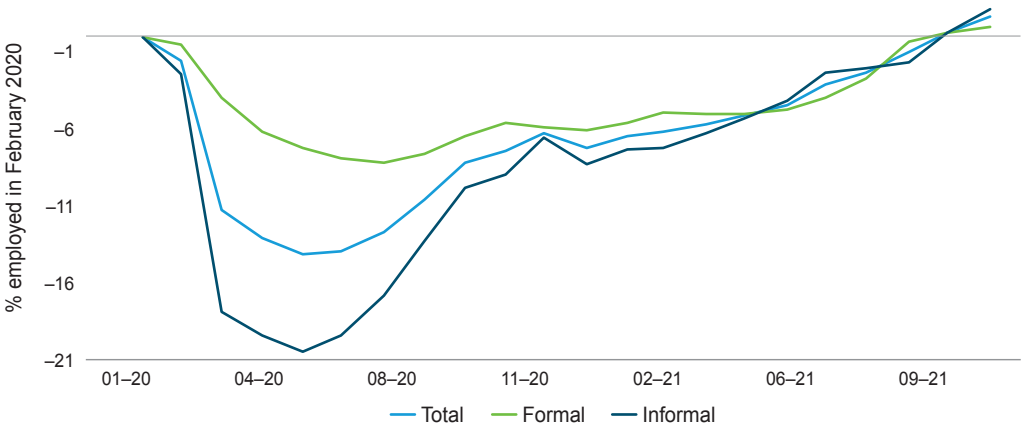
The number of hours worked among the employed population also declined. The average time worked per week fell by 1.6 hours in Latin America and the Caribbean between 2019 and 2020. Chile, Mexico, and Ecuador recorded the most significant declines with 4.1, 4, and 2.5 hours, respectively (see Figure 5.4). In general, the declines have been greater among informal workers. For example, in Ecuador, informal workers lost 1.2 hours per work more than formal workers, on par with Peru (1 hour) and Costa Rica (0.9 hours). However, in some countries, the formal sector suffered larger adjustments; in Argentina, formal workers lost 1.2 hours more than informal workers, as they did in Uruguay (0.4 hours) and Paraguay (0.3 hours).

Countries in the region have not yet fully recovered from the initial impact of COVID-19. Labor markets continue to show significant problems despite the rebound in economic activity. Informal employment has picked up faster (Figure 5.5). The percentage change in employment from September 2020 to September 2021 was nearly identical for formal and informal work. Nevertheless, informality rates may increase in the medium term as people return to the workforce but are unable to find formal jobs.[5] The recovery might also be jeopardized by the uncertainty in economic activity prompted by the Russia-Ukraine war.

[4] Data sourced from IDB Harmonized Household Surveys 2019, 2020.

[5] See Acevedo, Castellani, Lotti et al. (2021).

FIGURE 5.5 ● Evolution of Formal and Informal Employment, 2020–2021

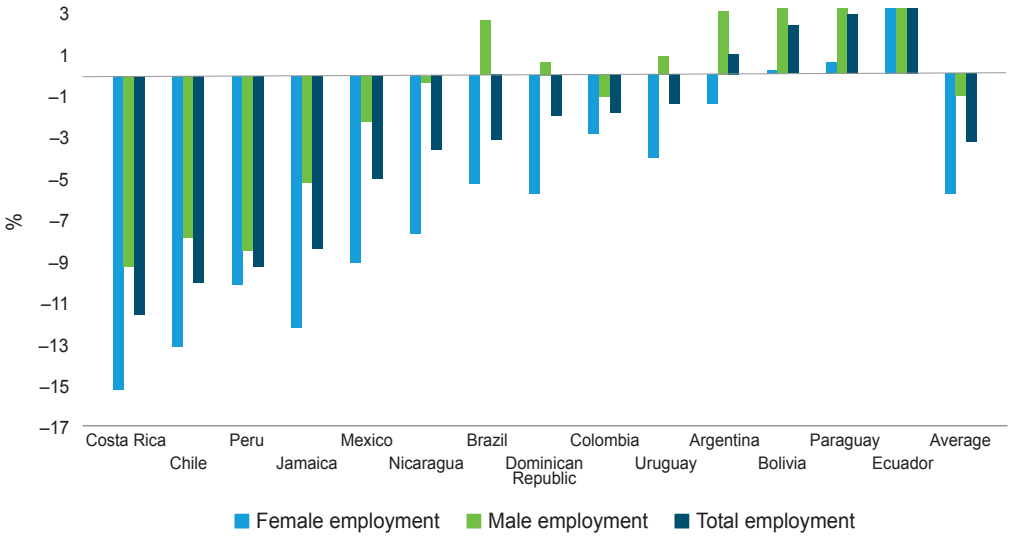


Source: IDB staff calculations based on data from COVID-19 Labor Market Observatory.
Note: Average Latin America and the Caribbean estimate for 13 countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Mexico, Paraguay, Peru (Lima Metropolitana), and Uruguay.

The total number of jobs lost and recovered underestimates the magnitude of the pandemic's effect on employment. Under normal conditions, total employment should increase over time due to population growth. To better estimate the loss, the rate of job growth is extrapolated from the previous year for each country. Figure 5.6 compares the evolution of employment after the start of the pandemic with pre-existing trends. Average employment decreased from February 2020 through September 2021 by 1%. However, considering the pre-crisis employment trends by country, the estimated employment deficit was 3% in September 2021 (see Figure 5.6). This employment deficit varies considerably across countries ranging from 11.6% in Costa Rica to near zero in Argentina, Bolivia, Paraguay, and Ecuador where employment had fully recovered to its pre-pandemic levels.

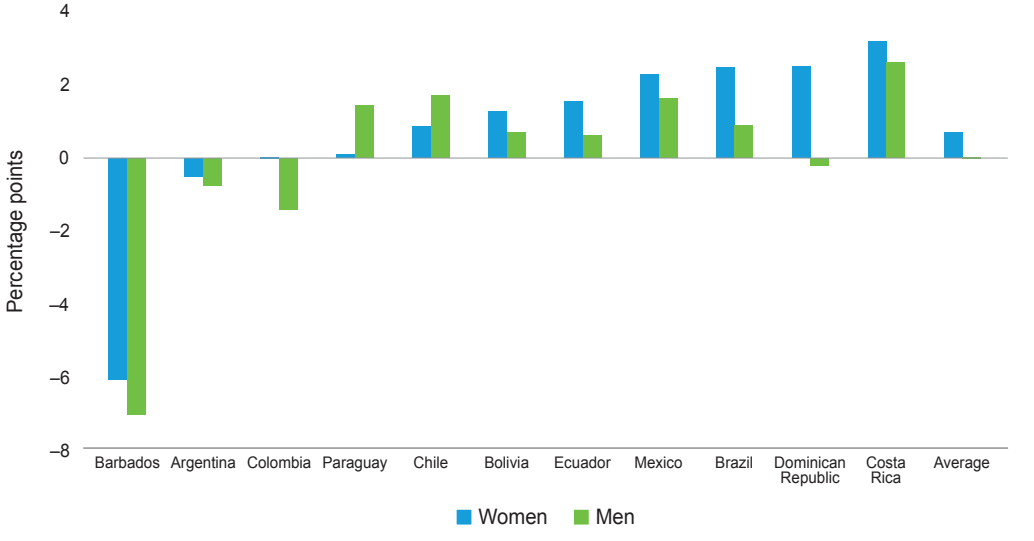
The negative impact of the crisis on employment is almost entirely due to a reduction in female employment. The crisis erased many of the gains achieved in recent decades in narrowing gender gaps. Between February 2018 and February 2020, the percentage increase in female employment outstripped that in male employment: On average, employment rose 5% among women compared to 2% among men. However, between February 2020 and September 2021, female employment fell 3% while male employment did not change. The average deficit of female employment (the difference between actual employment in September 2021 and projected employment based on the pre-crisis trends) was 6% while it was only 1% for male employment (see Figure 5.6). In other words, female unemployment rates reinforce the message that women have suffered disproportionately during the crisis.

FIGURE 5.6 • Total and Projected Employment by Gender



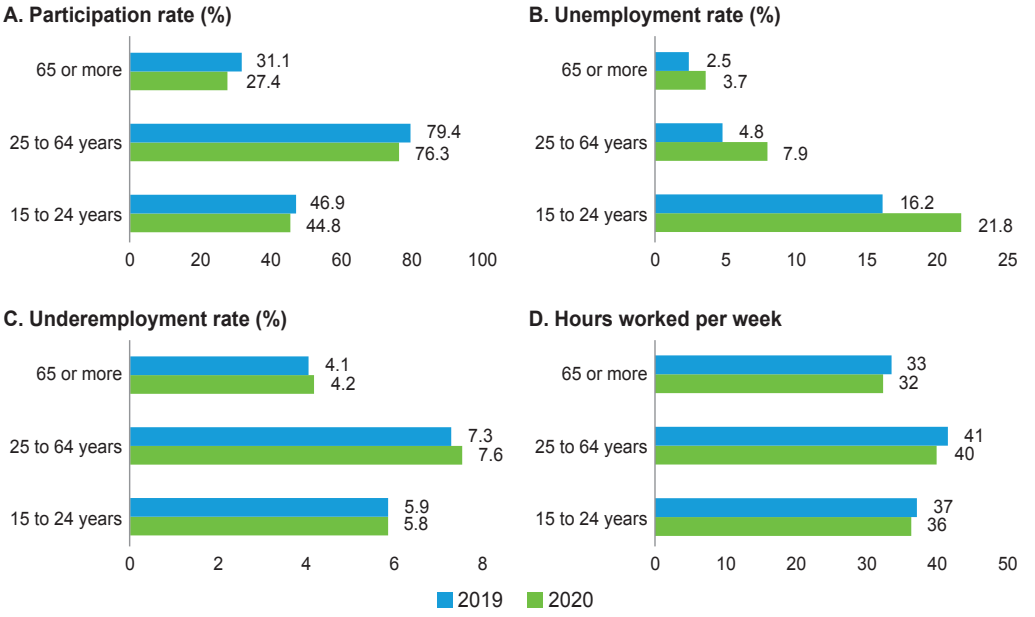
Source: IDB staff calculations based on data from COVID-19 Labor Market Observatory.
Note: The figure measures the difference between total employment in September 2021 and projected employment using the trend from February 2018 through February 2020. The data on total employment are sourced from household surveys. When February data on total employment were unavailable, March data were used. For Nicaragua, total employment is an estimate based on population rates and demographic data.

FIGURE 5.7 • Change in the Unemployment Rate by Gender



Source: IDB staff calculations based on data from COVID-19 Labor Market Observatory.
Note: The figure shows the change in unemployment rate between December 2019 and September 2021.

FIGURE 5.8 ● Labor Outcomes by Age



Source: IDB staff calculations based on data from COVID-19 Labor Market Observatory.

The change in female and male unemployment rates also illustrates the disproportionately large effect of the crisis on women. From December 2019 to September 2021, male unemployment rates were basically unchanged, while female unemployment rates increased 0.7 percentage points (see Figure 5.7). The change in the unemployment rate was larger for women in 9 of the 11 countries analyzed.

The crisis also affected young people more, even though they already had the worst employment indicators before the pandemic. The most striking statistic is youth unemployment, which increased from 16.2% in 2019 to 21.8% in 2020 (see Figure 5.8). Reasons explaining this variation include tenure in the job, experience, human capital investments, and firing costs.[6]

Policies to Reshape the Labor Market

The pandemic profoundly impacted labor markets. When the crisis hit, labor markets in the region suffered from high levels of informality, low wages reflecting low productivity, and volatility characterized by high turnover and limited incentives for workers to gain better skills. The shock of the pandemic further exposed the vulnerability of a large

[6] See Becker (1993), Autor et al. (2014), and Autor, Katz, and Kearney (2006).

portion of the labor force and eroded the small gains achieved in previous decades. Against this backdrop, the pandemic provides an opportunity to consider interventions that promote a new structure for labor markets in the region with better quality, higher productivity jobs.

Chapter 2 discussed fiscal policies that countries can implement to reduce labor informality. To complement them, this chapter focuses on labor market policies aimed at (i) reactivating labor markets, (ii) improving workers' skills, and (iii) correcting structural problems in labor markets that predate the pandemic. Governments in the region face the triple challenge of designing policies to recover from the shock, improving the quality of labor, and dealing with the traditional deficiencies of the region's labor markets. Not surprisingly, the policies are all intertwined.[7] Faster and inclusive recovery of labor markets will depend partly on the combination of policies and their results.

Accelerating the Recovery of Employment

Policies to protect income and employment (such as transfers to workers or providing liquidity to firms) will remain relevant during the recovery. They should be complemented with new measures to stimulate employment creation. The region should facilitate the transition of workers and firms to emerging sectors that are creating jobs, provide incentives for effective training that can be used in multiple industries, and support firms' innovation and digital transformation to take advantage of opportunities in a post-war world.

In terms of support to workers, informal employees and their families have benefited during COVID lockdowns from emergency social assistance programs, but these have had limited effect. The programs partially mitigated consumption losses and prevented increases in extreme poverty, but did not reach the majority of informal workers who were not poor, many of whom became unemployed or left the labor force due to the crisis.[8] Countries are opting for Temporary Work Programs (TWP) because they can help mitigate the shock's effects, support income and consumption levels, and act as unemployment insurance for informal workers. However, evidence for both developed countries and the region suggests that these programs do not improve workers' employability at the end of the intervention.[9] Therefore, countries face intertemporal trade-offs as short-term mitigation policies are unlikely to address long-term structural needs. In the future, programs

[7] The combination of policies is not unique, and their effect depends on each country's specific characteristics—demographic, economic, fiscal, institutional, and political.

[8] The coverage and replacement rates of labor income are high among the first quintile of the population but low in the second and third quintiles (Busso and Messina, 2020).

[9] See Gasparini, Haimovich, and Olivieri (2007), Hernani-Limarino, Villegas, and Yáñez (2011), Kluve (2006), and Del Ninno, Subbarao, and Milazzo (2009).

should combine transfers with Active Labor Market Policies (ALMPs) that can help workers' future employability.[10]

To support firms, short-time work (STW) schemes (subsidies for reducing the hours worked in firms affected by temporary shocks) are especially helpful. The cost of these programs, however, is high.[11] Chile used financial resources from its unemployment insurance accounts to finance temporary layoffs or reduced work hours to prevent permanent job losses. However, for many Latin American and Caribbean countries, coverage is limited by high informality. The costs may be beyond the reach of many nations given current fiscal constraints (see Chapter 2 and Box 5.1).

BOX 5.1 • Policies to Promote Labor Market Recovery: Quantifying the Costs

Multiple policies aimed to revamp labor markets after the COVID-19 crisis. A particular focus was on creating formal jobs that will likely be lacking in the near future. The cost-effectiveness of each policy depends on the coverage, benefits, and strategic behavior of firms and individuals. In addition, the initial conditions of informality, sectoral composition, and institutional capacity should shape their implementation in each country.

The maximum and minimum cost of three selected policies was estimated as follows:

i. Combining transfers with Active Labor Market Policies (ALMPs). Transfers to formal workers equivalent to 25% or 75% of a minimum wage in a period of 12 months.
ii. Short-time work (STW) schemes. Reducing the working time of formal workers between 12% and 40% (from 5 hours to 2 days per week) in order to bring more people into the labor force. The estimate was made holding constant their average income per hour. The reduction in effective hours was compensated by hiring additional workers, assuming unitary elasticity, zero searching costs, and zero transaction costs.
iii. Hiring Credits. A subsidy between 20% and 50% of social security contributions per formal worker for 12 months is assumed.

The estimates are annualized and expressed in percentage points of GDP for a sample of countries.[a] In the case of ALMPs, the average cost is estimated between 1.6% and 4.8% of GDP. In

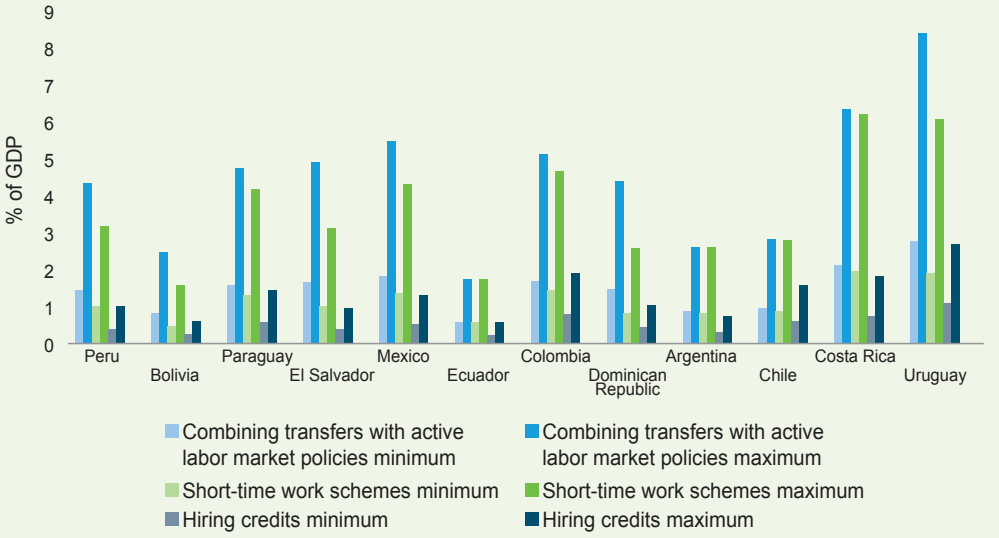
(*continued on next page*)

[10] A meta-analysis of ALMPs found labor intermediation programs to be cost-effective (Card, Kluve, and Weber, 2010). For example, labor intermediation shortens the duration of unemployment and increases the rate of rehiring (Davis et al., 2013; Forslund, Fredriksson, and Vikström, 2011). In the region, an evaluation of Colombia found that intermediation was beneficial for finding formal work (Pignatti Morano, 2016). Evidence from Bolivia shows that the PAE (*Programa de Apoyo al Empleo*), a job intermediation and wage subsidy program, substantially increases employment, formality, and earnings (Novella and Valencia, 2019).

[11] STW schemes help employers with economic difficulties retain formal employment (Giupponi and Landais, 2020). They also limit losses of intangible capital between workers and companies, allowing economic recovery to accelerate (Cahuc, Kramarz, and Nevoux, 2018; Kopp and Siegenthaler, 2021; Giupponi and Landais, 2018; Bruhn, 2020). These schemes also help preserve workers' health insurance, their experience, and firm-specific human capital (Davis and von Wachter, 2011; Schmieder, von Wachter, and Heining, 2018).

BOX 5.1 • Policies to Promote Labor Market Recovery: Quantifying the Costs (*continued*)

FIGURE 5.1.1 • Cost of Policies to Reactivate Labor Markets



Source: IDB staff calculations based on IMF (2021b), the IDB Labor Markets and Social Security Information System, and Alaimo et al. (2017).

TABLE 5.1.1 • Cost of Policies to Reactivate Labor Markets by Level of Formality (% GDP)

	Combining transfers with active labor market policies		Short-time work schemes		Hiring credits	
	Minimum	Maximum	Minimum	Maximum	Minimum	Maximum
High informality	2.9	4.4	1.2	3.2	0.4	1.0
Low informality	3.4	5.2	1.8	4.7	0.8	1.9
Average	1.6	4.8	1.2	3.9	0.6	1.5

Source: IDB staff calculations based on IMF (2021b), the IDB Labor Markets and Social Security Information System, and Alaimo et al. (2017).

the case of reducing working hours, the average cost is between 1.2% and 3.9% of GDP. This cost varies by the level of informality: in less formal countries, the average cost is between 1.2% and 3.2% of GDP, while in more formal ones the cost is between 1.8% and 4.7% of GDP. Finally, the credit policy of social security contributions has an average cost between 0.6% and 1.5% of GDP. Similarly, this policy costs between 0.8% and 1.9% of GDP for countries with the highest formality rates, and between 0.4% and 1% of GDP in countries with the lowest formality rates. Besides considering their costs, a complete evaluation of these policies requires that their benefits be quantified as well.

[a] These countries are Argentina, Bolivia, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Mexico, Paraguay, and Peru.

Credit guarantees are a less expensive option than STW programs.[12] Hiring credits, in the form of reduced labor costs (i.e., wages, payroll taxes, and training), can also spur employment creation and would complement fiscal measures like the Negative Income Tax (see Chapter 2). Evidence from the United States suggests that hiring credits are more effective in recessions when applied broadly, rather than just to disadvantaged groups.[13] In the region, they can improve the employability and formality of workers,[14] particularly where high minimum wages or other pressures prevent wages from adjusting downward when labor demand sinks.[15] Evidence from the United States indicates that these credits could be more cost-effective per net job created than a general stimulus measure[16] and can help beneficiaries improve their job opportunities in the medium term.[17] However, although they cost less than other options, hiring credits are still expensive. Subsidizing half of the non-salaried costs for minimum wage workers making up 10% of the employed population for one year could cost an estimated 0.2% of GDP in Latin America and the Caribbean, on average.

Firms may also require support to help make the digital transformation. Firms in the region need to adapt to the post-pandemic era—an adjustment that includes digital transformation and incorporating remote and hybrid types of work into management practices. Policies that promote greater digital adoption among firms improve their productivity profiles, which bolsters GDP, labor income, and the share of formal employment. By improving the investment climate, thereby encouraging the entry of more firms in the economy, these policies also exert downward pressure on the unemployment rate, despite a decline in total employment (see Box 5.2).

Finally, labor-market policies are not the only policies that affect employment. Countercyclical macroeconomic policies that accelerate economic recovery also translate into a quicker labor-market recovery. For example, expenditure switching policies (see Chapter 2) allocate a higher share of spending to public investment. By investing US$1 billion in water and sanitation, energy, and transportation infrastructure, the region can create at least 35,000 new direct jobs plus another 64,000 indirect jobs, for a total of close to 100,000 jobs.[18]

Improving the Skills of the Labor Force

The second set of labor policies aims to design and implement upskilling and reskilling programs—public or private—that help update workers' skills. These policies are designed

[12] See Izquierdo et al. (2020).
[13] See Neumark and Grijalva (2013).
[14] See Novella and Valencia (2019) and Galasso, Ravallion, and Salvia (2004).
[15] See Pagés (2017).
[16] See Neumark and Grijalva (2013).
[17] See Cockx, Goebel, and Robin (2013) and Gerfin, Lechner, and Steiger (2002).
[18] See Pastor et al. (2020).

BOX 5.2 • Digital Adoption, Automation, and Labor Market Recovery: New Firm Entry and Job Creation

Prior to the pandemic, both firms and households across the region steadily increased their use of digital systems; roughly 70 percent of the population in the region used the internet and a growing share of the population was making and receiving digital payments. The pace of digital adoption and usage by businesses rose dramatically with the pandemic, partly as a response to the economic contraction in high-contact sectors.[a]

The pandemic accelerated the adoption of new forms of work. Many people engaged in teleworking for the first time during the last two years. Whether people work remotely largely depends on the economic sector and individual characteristics including gender and skills. An estimated 10% to 35% of the labor force teleworked during the pandemic (Azuara et al., 2020). At the peak of the pandemic, between 20% and 40% of the employed were teleworkers in Chile, Mexico, and Uruguay.[b]

Governments across the region either adopted, or have considered adopting, specific policies aimed at further bolstering digital use as a way to counteract the recession.[c] These policies have numerous objectives, principally to reduce firms' entry barriers and to expand their ability to adopt digital technologies in order to support economic activity, employment, and productivity growth.[d] The COVID crisis offers a unique opportunity to reshape the productivity profile of firms in the region.

Economic models are useful to gauge the impact of policies to promote digitalization. Finkelstein Shapiro and Mandelman (2021) adopt such a model, which incorporates key features of labor markets in the region. Firms can choose to adopt information and communication technologies (ICT), which have a differential effect on various labor market segments—formal and informal workers, those with fixed salaries and those with variable-pay etc. The model is calibrated to Mexico and explains key features of the labor market including the collapse in employment in the second

TABLE 5.2.1 • Long-Run Response to a 1% of GDP Digitalization Subsidy

Variable	Percent change relative
Total output	0.58
Consumption	0.39
Total employment	–1.62
Formal wages	3.29
Informal wages	2.48
Total labor income	0.23
Salaried firms using ICT	35.74
Number of salaried firms	32.5
Average firm productivity	0.13
	Percentage–pt. change
Unemployment rate	–0.10
Formal employment share	0.66
Share of firms using ICT	1.01

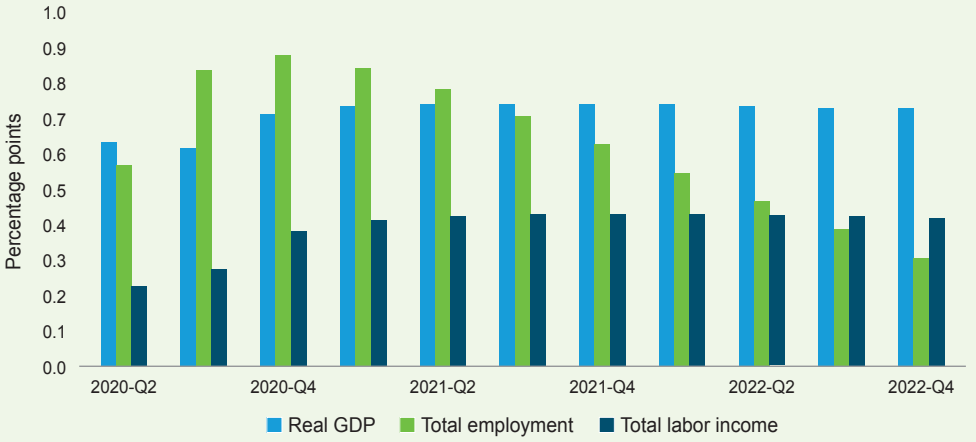
Note: The figures in the table refer to changes in the steady state of the model and are expressed in real terms relative to the baseline.

(*continued on next page*)

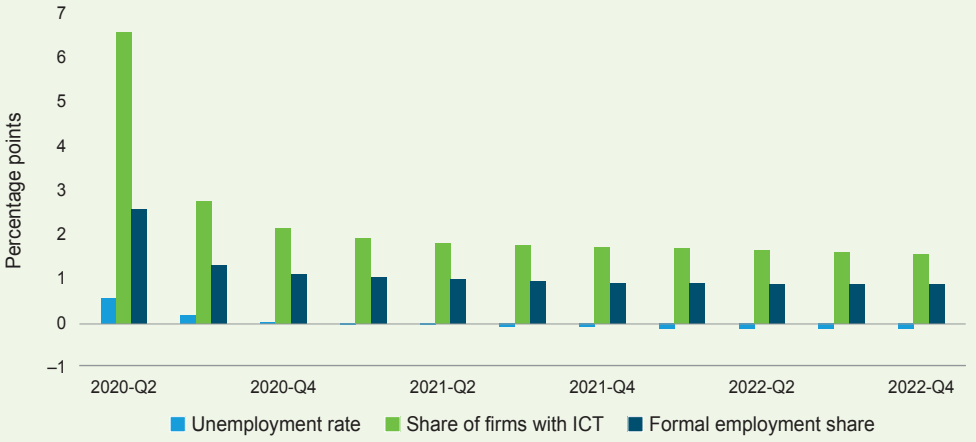
BOX 5.2 • Digital Adoption, Automation, and Labor Market Recovery: New Firm Entry and Job Creation (*continued*)

FIGURE 5.2.1 • Short-Run Policy Impact of a Subsidy to Digitalization Relative to the Baseline

A. Real GDP, total employment and total labor income



B. Unemployment rate, share of firms using ICT, and informal employment share



Note: The figures show the short-run response to a 1% of GDP subsidy to adopt ICT technoliogy in each variable relative to the baseline. The latest available datapoint for Mexico is 2021-Q3. Therefore, the results after 2021-Q3 should be interpreted as model predictions conditional on the absence of additional shocks after 2021-Q3.

quarter of 2020 and the subsequent recovery. The model also indicates that firms should have accelerated their use of ICT, which was indeed the case.[e]

Suppose the government provides a one-time subsidy for the cost of digital adoption.[f] This can be thought of as an investment in digital infrastructure that lowers the cost of adoption for any firm wishing to digitalize. The fiscal cost of the policy is assumed to be about 1% of GDP. In terms of long-run effects, as shown in Table 5.2.1, this policy increases the share of firms that use

(*continued on next page*)

BOX 5.2 • Digital Adoption, Automation, and Labor Market Recovery: New Firm Entry and Job Creation (*continued*)

ICT an additional 1 percentage point, and raises GDP, real wages (both formal and informal), total labor income, and average firm productivity, although total employment contracts in the long run (because overall labor force participation contracts). The policy increases the share of formal employment by two-thirds of a percentage point because greater digital adoption improves the average productivity profile of firms and, thus, expands the share of formal employment. The change in the composition of total employment, coupled with the positive effects of the policy on real wages, result in greater overall labor income.

In addition to the long-run response, the model also captures short-run dynamics; the impacts on key variables in each quarter after the policy is implemented are plotted in Figures 5.2.1A and 6.2.1B. The digitalization subsidy mitigates the contraction in GDP. Interestingly, total employment increases strongly in the short run, in contrast to the long-run effect, and the composition of total employment shifts towards formal employment. As shown in Figure 5.2.1B, the policy buttresses a sharp expansion in the share of firms that use ICT, which then demand more labor. The digitalization adoption rate, however, converges swiftly to the long-run trend after the shock (Table 5.2.1). Finally, the policy induces an initial increase in unemployment, as it takes time for the larger share of firms using ICT to absorb the individuals who lost their jobs at the onset of the COVID-19 shock. Over time, however, this changes and employment expands.

These results should also consider other phenomena occurring in the world before and during the pandemic. The adoption of robots in different industries across regions is changing the production and delivery of many goods and services (McKinsey, 2021). International trade is a channel through which automation affects labor markets in general as companies are vertically and horizontally integrated (Ripani et al., 2020). Automation affects all production and logistics processes around the world. Once the transitory effects of the pandemic are resolved, industries will have incentives to adjust their production processes. The adoption and use of technology will be an important factor in this reconfiguration. Previous trends indicate that the balance favors robots over workers, given that they cannot be infected with viruses. Automation favors those who are best prepared to adopt technology in the production process (Acemoglu and Restrepo, 2018). People who perform the most routine and easily "codable" tasks are the ones who suffer most directly from automation-related job loss.

[a] As documented in Díaz de Astarloa et al. (2021) and others, e-commerce expansion and penetration accelerated dramatically during 2020. This was reflected in a sharp increase in the registration of new sellers in Mercado Libre—the largest online marketplace in the region—as well as an expansion in online sales and new business websites.
[b] From the report "What is the effect of COVID-19 on employment" of the COVID-19 Labor Market Observatory.
[c] These policies included, among others, assistance to improve small and medium enterprises' digital presence, payments, and sales; free access to online marketplaces, as well as government-backed partnerships between banks and businesses to facilitate online interactions and transactions.
[d] For the purposes of transparency, all shocks (aggregate productivity, labor force participation, job destruction and the salaried labor market matching process, and the productivity of the ICT composite) take place once, in the first period, with no additional shocks thereafter. The post-shock evolution of the economy is determined by the persistence of a subset of shocks but, more importantly, the economy's firm and employment structure (that is, the frictions that permeate the labor market and the firm entry-exit process).
[e] For example, of 18 Latin American and Caribbean countries, at least half had updated or implemented strategies to bolster e-commerce and telecom accessibility and affordability (ECLAC, 2020b; Díaz de Astarloa et al., 2021).
[f] When considering the post-pandemic dynamics as shocks subside and the economy recovers, it is assumed that this policy is put in place, in full, during the quarter when the shocks first hit.

for individuals who have lost their jobs or were forced to change jobs because the pandemic transformed their working sector. Therefore, upskilling and reskilling programs should seek to provide the skills relevant to the most demanded jobs in the economy, including skills for the green and digital economies. They should also provide advice and information for employers and job seekers to meet so as to ensure that placements are in quality jobs.

Combining skills-development interventions with demand-side interventions, such as technical assistance or extension services, multiplies productivity and employment. Technical assistance (TA) to small and medium-sized enterprises (SME) provides high-quality information to companies on how to improve management practices, increase sales, lower costs, and structure products or services. This, in turn, creates needs for skills development.[19] Estimates indicate that investing in TA to SMEs has a present value of 5.4 times program costs through higher-productivity growth and more employment creation.[20] Evidence for the region shows that TA creates a significant number of jobs in Argentina, Brazil, and Mexico and can improve the performance of small businesses.[21,22] Workforce development interventions in companies can achieve even better results when they target both managers and workers.[23]

A lesson from the COVID-19 pandemic is that the income-protection mechanisms were insufficient to help all workers smooth their consumption despite the region's best efforts. Some countries authorized extensive withdrawals from pension accounts, which may have a substantial long-term impact on the sustainability of pension systems. The lesson, then, is that trying to institute mechanisms to protect people who lose their jobs when the crisis hits is not feasible. The region should begin to construct safety nets, including robust unemployment insurance schemes, so they are already in place when the next crisis hits.

Towards a New Architecture for Labor Markets

Before the COVID-19 crisis, job creation in Latin America and the Caribbean was sluggish. More than half of workers had informal jobs and pension systems suffered from numerous problems: low coverage and high rotation in and out of jobs that contribute to pensions (low contribution densities); large gender gaps, and; workers lacking the information and skills needed to find and maintain good jobs.[24]

[19] See Bloom et al. (2013) and McKenzie and Woodruff (2015).

[20] See Bartik (2018), Jarmin (1999), and Bloom et al. (2013) for the effects on higher-productivity growth and Piza et al. (2016) for the effects on employment creation.

[21] See Castillo et al. (2010), Cravo, Becker, and Gourlay (2015), and Bruhn, Karlan, and Schoar (2018) for evidence for Argentina, Brazil, and Mexico, respectively.

[22] See Calderón, Cunha, and De Giorgi (2020).

[23] See Prada, Rucci, and Urzúa (2019).

[24] This section contains a summary of some of the key issues in the Labor Sector Framework Document of the Inter-American Development Bank (IDB, 2021b).

As the world faces new challenges that may continue shocking labor markets, countries in the region should also address pre-existing issues. To confront the problem of high informality and low coverage of pension systems, social security reforms could make certain benefits universal and independent of an individual's labor-market status and finance these benefits with general taxation instead of labor taxes. These reforms would promote formal work by reducing its cost.[25] The 2012 Colombian tax reform, which reduced the extent to which labor taxes are used to finance health care and increased corporate taxes to ensure that total financing was not reduced, is an example of how a change in the financing of social security benefits can promote formal employment. Countries should also strengthen their capacity to enforce social security obligations.

Gender gaps could be reduced by making sure that girls and women acquire the skills demanded by growing sectors. Simlarly, universal systems to care for children, elderly people, and others in need of care can help women enter the labor market because the burden of caregiving disproportionately falls on women.[26]

To provide information and skills to people searching for jobs, labor intermediation programs are a cost-effective mechanism that shortens the duration of unemployment and/or promotes formal work, especially for those with weaker job-market prospects. In this regard, public employment services (PES) play a crucial role in returning the unemployed to work and helping firms find the right talent. Strengthening the capacity of PES to perform their primary functions is critical.

A well-functioning skills-development system, combined with policies to promote employee training in firms, are critical levers for increasing productivity and formal employment. Because skills accumulate over the life cycle, prosperous countries invest in improving skills acquisition at each stage of life by strengthening the capacity of crucial skills development institutions. Adapting the skills of the labor force is particularly relevant to transition rapidly to remote or hybrid work, adapt to potential changes in the business environment, and adjust to new modalities of work in the region. The critical elements for effective skills-development systems include:

i. Developing continuous feedback loops among stakeholders at all levels to identify productive sector needs and align training to the demand for socioemotional, digital, and advanced cognitive skills.

[25] Levy and Cruces (2021) document the distortions created by social security systems in which benefits for formal workers are financed by labor taxes while similar benefits are offered to informal workers and financed through general taxation. Offering these benefits to everyone irrespective of their labor status and financing them through general taxation would lower the cost of hiring formal workers, increase productivity, and reduce informality.

[26] Significant gender gaps existed before the pandemic: women in the region devoted more than twice the number of hours to nonremunerated domestic and caregiving responsibilities than their male peers (Bustelo, Suaya, and Vezza, 2021).

ii. Developing effective curricula and instruction while investing in high quality teachers and instructors.
iii. Establishing performance-based quality and relevance standards that allow for rapid adaptation to a fast-changing environment.
iv. Supporting adequate financing including incentives to employers to invest in training.

Taking Advantage of the Moment

The pandemic caused turmoil in the world's labor markets, particularly in Latin America and the Caribbean. While the informal labor market served as a buffer in previous crises, this time informal employment fell more than formal employment. Labor incomes also suffered during the crisis and pre-pandemic gains in terms of reducing gender gaps were lost. Women and young people suffered disproportionately during the crisis, particularly in terms of unemployment. However, the most important result is that even though labor markets have been improving since the worst of the pandemic, they are still far from full employment. The labor-market effects of the pandemic are likely to last for many years.

The region's labor markets suffered from significant structural problems prior to the crisis. To achieve well-functioning labor markets in the medium term, countercyclical policies must be implemented for years to come—ideally until labor markets fully recover from the crisis.

Governments will also face challenges in the recovery due to the high inflation expected over the coming months because of the war in Ukraine. On the one hand, commodity importers will face a slower economic recovery as they race to implement the necessary changes in their labor markets. On the other hand, commodity exporters will see economic activity recovering faster than expected. However, this should be no reason to delay labor markets reforms. Economic recovery from commodity exports will be temporary, while reforms can bring long-lasting benefits.

Countries should address pre-existing structural issues by changing the basic structure of social security systems and modernizing labor codes to allow for greater employee flexibility. Latin America and the Caribbean has an opportunity to transform labor markets, modernize labor market institutions, improve labor intermediation, and prepare the human capital of the region. The shock of the pandemic and looming challenges related to the Russia-Ukraine war call for urgent and concerted action to carry out this transformation for the benefit of current and future generations. Reforming labor markets will strengthen the region's ability to deal with future shocks by avoiding their devastating impact on the most vulnerable.

CHAPTER 6

Conclusions and Policy Suggestions

The worst part of the COVID-19 pandemic may already be in the rearview window as vaccines have become more widely available, better information about how the virus is transmitted has emerged, and countries have begun to adapt to living with the virus. However, the global economy now faces new challenges stemming from the Russia-Ukraine war with its multiple implications.

Latin America and the Caribbean was the hardest hit region in 2020, with GDP growth declining by 7%—the largest one-year decline on record since the struggles for independence in the XIX century. Poverty and inequality increased significantly, erasing some of the hard-fought gains of the preceding decades. Fiscal deficits and debt levels rose as countries responded to the unprecedented challenges with fiscal support to families and firms that was smaller in size compared to advanced economies but larger than the stimulus provided during previous crises. Many countries now face the triple challenge of continuing to provide support where needed, while at the same time maintaining fiscal sustainability and price stability.

Governments and central banks worked closely together to provide liquidity and support credit during the worst part of the pandemic. Central banks reduced policy interest rates to an effective zero lower bound, brought down reserve requirements, and expanded their balance sheets, thereby providing resources to banks and governments as their restrictive charters allowed. As the crisis recedes, the challenge now is to reverse these exceptional interventions, support the recovery process, and closely coordinate fiscal and monetary policies.

Countries were able to access external financing from private and multilateral sources and thus, largely avoided sudden stops in capital flows. Governments and corporates in most countries were able to tap international markets at reasonable rates to help finance the fiscal support measures and face the unprecedented demands for liquidity. The international community supported countries through lending and via the allocation of IMF's Special Drawing Rights (SDRs), which enlarged international reserves. However, countries depleted other buffers—especially fiscal—and thus increased vulnerability to a reversal of capital flows in the future.

During 2021, the recovery phase gained strength. GDP in the region rebounded by 6.8%. Fiscal deficits declined from 7.5% of GDP in 2020 to 5.8% of GDP as countries pared down (but did not eliminate) fiscal expansion. Debt service, which includes interest payments and debt amortizations, reached an estimated 5% of GDP in 2021 and is expected to remain close to 4% of GDP in 2022 and 2023. Despite the still high fiscal deficits, average debt-to-GDP ratios stabilized and declined marginally from 72.6% in 2020 to 71.6% of GDP in 2021 due to stronger than expected growth.

Still, the recovery and the Russia-Ukraine war have brought new challenges. Resurgent demand combined with higher commodity prices and supply disruptions have increased inflationary pressures. Central banks have reacted by raising policy interest rates to ensure that inflation expectations remain anchored, and some have started to reverse the expansions of their balance sheets. Higher demand also resulted in widening current account deficits that require additional external financing at a time when external financing conditions could become tighter.

The pandemic led to large job losses that have not fully recovered despite the rebound in economic growth. As of September 2021, employment remained 3.3% below the levels projected if the crisis had not occurred but with a wide variation across countries. In four countries analyzed, that deficit remained above 8%. Notably, female employment explains most of the persistent loss in jobs. While in previous crises, the informal sector acted as a buffer, during the pandemic, informal employment suffered comparatively more given the prevalence of informality in high-contact sectors impacted by lockdowns and behavioral responses. The recovery has prompted a strong come-back for the informal sector in many countries and preexisting structural problems in labor markets have returned to the fore.

The Russia-Ukraine conflict is having significant effects on the global economy and, in turn, Latin America and the Caribbean. Pre-war growth projections for the region were 2.4% for 2022. The war has increased uncertainty and will have competing impacts. On the one hand, higher commodity prices will be positive for growth and for fiscal revenues in commodity exporters. On the other hand, lower world growth, in particular in Europe and the United States, will dampen growth projections. In a war scenario outlined in Chapter 1, growth in 2022 may be somewhat below the pre-war projections. In addition, if monetary policy normalization in the United States proves to be complicated and the Federal Reserve needs to raise interest rates or sell assets more aggressively than anticipated to bring down inflation, then the region could suffer yet lower growth and even be pushed into recession.

Sometimes, economists frame policies as being either short-term or medium-term. This approach is frequently misguided. The medium-term or structural issues hang over the region and are impacting economic prospects this year. The longer-term and the shorter-term challenges are intertwined. This report provides recommendations to help

policymakers navigate through the challenges. In particular, the report calls for meaningful reforms to develop new architectures for both fiscal and labor markets. Substantial improvements in these areas could have significant effects on growth and equality this year and beyond. Moreover, the health crisis and the war may provide a window of opportunity to pursue such reforms.

Fiscal frameworks remain inefficient in many countries, as policy changes could enhance growth and reduce inequality. In the past, piecemeal actions have led to dysfunctional structures. Substantial and well-crafted changes to eliminate waste, reduce inefficient spending, lower tax evasion, expand the tax base, and boost public investment could yield significant benefits. As countries' starting positions vary widely, the right package and sequence of reforms will be country-dependent and will need to consider the relevant political economy constraints. Still, a new fiscal architecture could lead to both lower inequality and higher growth.

Most countries are pursuing some type of fiscal consolidation to reduce fiscal deficits, prevent the cost of servicing debts from rising, and lower debt levels. The temporary windfall from higher commodity prices for some countries may assist in this process and is not a reason to delay. However, the form of that consolidation may be as important as the headline deficit reduction. Expenditure switching policies that protect productive public investments, for example in infrastructure, and investments in health and skills building can reduce the negative impacts of fiscal consolidation on output and reduce income inequality. They can even be expansionary a few years out as they stimulate complementary productive private investments. More generally, credible fiscal institutions are vital to guarantee medium-term fiscal planning and instill high confidence in fiscal sustainability. Critical to those efforts is to reduce labor informality, which is behind the high tax evasion that plagues the region and, in turn, both limits the effectiveness of fiscal policies and undermines reforms.

Labor markets were hit hard during the pandemic. The region now faces both challenges and opportunities. First, active policies are needed to accelerate the recovery of employment and include: (i) programs that combine transfers to unemployed workers with other interventions that increase workers' future employability (e.g., labor intermediation policies that improve the quality and efficiency of matching workers to jobs and training); (ii) hiring credits in the form of reduced labor costs (e.g., wages, payroll taxes, and training), that help spur employment creation while improving employability and encouraging formalization, and; (iii) policies that encourage firms to adopt digital systems to support transactions such as targeted subsidies.

Second, given the resurgence in informality, policies to address this problem are needed now more than ever. Informality provides only low-paid, insecure, and unproductive jobs. In addition, it shrinks the tax base and explains much of the poor coverage of pension systems in the region. Addressing informality requires a concerted effort on several

fronts. Reforms to social security systems to make benefits universal and independent of an individual's labor-market status with financing from general taxation rather than labor taxes would promote formal work. High labor taxes provide strong disincentives for firms to formalize or for formal firms to hire formal workers.

Fiscal policies should complement labor market interventions to boost more productive, higher-wage formal jobs. For example, digitalizing tax records and transactions would help tackle the problem of incomplete, asymmetric, and obsolete information, which breeds tax evasion and informality. A negative income tax (NIT), or tax credits akin to the Earned Income Tax Credit (EITC) in the United States, would reward formality by ensuring that the payoff for working formally (formal net salary plus any additional transfers) is always greater than working informally. And refunding value-added taxes (VAT) to poorer households, instead of exempting food or other essential products that all households consume, would improve the progressivity of tax systems while creating incentives to reduce evasion and informality.

Third, the gender gap, now accentuated by the crisis, demands a serious policy response. Girls and women should be given opportunities to acquire the skills demanded by the most dynamic sectors. In addition, since the burden of caregiving falls disproportionately on women, universal systems to care for children, the elderly, and others in need of care would help more women enter the labor market.

Fourth, in many countries in the region, there are significant opportunities to improve information systems to make job search and skill matching more efficient. Labor intermediation programs have been shown to be cost effective by shortening the duration of unemployment and/or promoting formal work, especially for those with weaker job prospects. Moreover, harnessing the information gathered may help both the public and private sectors see which skills are most in demand to then create appropriate training programs.

Fifth, the crisis has accelerated the trend towards digitalization and automation, which may have profound impacts on labor markets. Evidence is already emerging that in the recovery, job losses are continuing in professions most vulnerable to automation. Outsourcing may become more and more common and fundamentally impact the organization of firms. While these trends present a challenge, they also create opportunities. Policymakers will need to stay abreast of how rapid technological changes affect the labor market. Regulations in different areas may need to adapt for countries to take full advantage of the opportunities. Tax authorities may find that firms remit less in taxes, but authorities can also harness the digital tools to monitor transactions. Digitalization and automation will both create and destroy jobs. The net impacts remain controversial and may depend on the type of innovation and government policies. As these are global and fundamental trends, simply attempting to resist technological change is likely to be a losing strategy. The challenge is to craft policies that maximize the creation of new, productive jobs and help those who may lose out to gain skills and transition to the new economy.

Accelerating job growth, reducing informality, addressing the gender gap, and finding paths to benefit from digitalization and automation could significantly improve labor market outcomes in the region. In turn, since unemployment and low wages are strongly associated with poverty and inequality, higher employment and wages could serve to markedly improve these social indicators. While reducing poverty and inequality is a top priority, it may also help promote social cohesion and diminish the risk of unrest.

Fiscal and monetary policy must also be closely coordinated. A critical question for those countries fortunate enough to export and tax commodities is, what to do with the temporary windfall revenues? The additional income provides an excellent opportunity to reduce debt ratios and minimize the interest cost of carrying higher debts. As inflation has risen and is well above inflation targets in many cases, additional spending, which might prompt central banks to raise policy interest rates even further, could be highly inefficient. Any additional spending should be specific and well-targeted to address higher poverty or boost supply through, for example, high quality and well-chosen infrastructure investments. Oil importers will have the additional burden of the cost of oil imports and the higher costs of energy subsidies, which may also impact exporters by reducing or even eliminating the additional revenues in net terms. Refining energy subsidy policies to ensure they are targeted to assist only poorer households or key sectors for specific purposes would be valuable in this context. More generally, close coordination and consistency between fiscal and monetary policies will be critical in the months ahead.

A danger in countries that face the need for fiscal consolidation and are not enjoying additional revenues is that central banks might be pressured towards monetary financing of deficits which would weaken the credibility of monetary regimes and threaten central bank independence. This road would lead to higher inflation and weaker economic performance, which would be counterproductive in terms of delivering better living standards, especially for the most vulnerable. Instead, fiscal and monetary policy should work together to sustain the recovery but also ensure the credibility of the monetary regime. This requires independent central banks that can take the action necessary to anchor inflation expectations. If inflation expectations become de-anchored, the costs of reducing inflation and restoring credibility tend to be greater than the cost of maintaining credibility ex-ante.

One remarkable achievement during the pandemic was that the region was able to avoid balance of payment crises. Despite the initial volatility in financial markets, most countries were able to access financing from international capital markets and multilateral sources. A key question is how the rise in global monetary policy interest rates may impact capital flows and access to, or the cost of, financing. The muted impact on emerging market spreads in recent weeks, despite the advent of the Russia-Ukraine war, and as the policy interest rate in the United States was raised in March, indicates some cautious optimism may be in order. However, if unanticipated additional action on interest rates is required, or asset sales become necessary (quantitative tightening), to bring

down inflation and ensure inflation expectations are anchored, then emerging market spreads and domestic interest rates in the region may rise further. It is also hoped that if Russia or Ukraine fall into arrears with creditors or need to restructure their debts, then the market would differentiate such cases from general emerging economy debt and financial contagion can be averted. Still, countries in the region should maintain strong macroeconomic fundamentals to ensure continued access to capital markets at reasonable cost during this period. Countries should work to rebuild fiscal buffers and ensure consistent macroeconomic policy frameworks.

The pandemic has also disrupted global supply chains, presenting the region with significant opportunities. Shortages and bottlenecks have induced firms in advanced economies to reconfigure their suppliers in favor of sources closer to their operations and create supplier-redundancy to hedge against disruptions in supply chains. This trend is likely to increase as the Russia-Ukraine conflict unfolds, given that Russia is a significant exporter of oil, gas, grains, and fertilizers, so, at a minimum, these markets are likely to be affected during the conflict. While supply bottlenecks and demand shifts may be temporary, global trade links are persistent, which means the region may be able to increase its share in global trade. As prices for some key products that the region already exports have soared and pushed global inflation higher, Latin America and the Caribbean may be well-placed to limit the volatility in these markets and help the world contain global inflationary pressures. If the region could increase exports of oil and gas, certain minerals, and grains (products exported by Russia and/or Ukraine), this could limit the price movements in these important global markets. Still, a careful analysis of the required investments and time horizons would be required. Current futures price curves suggest prices will stay elevated for many months but any early resolution to the war would likely cause prices to fall sharply. Hedging techniques to lock in prices would be valuable in this context. Multilateral development banks, such as the IDB, are able to advise and assist countries in these types of operations. More generally, trade policies going forward should seek to strengthen export networks through better infrastructure and logistics, and fortify institutions that can promote trade and provide useful information to exporters. In addition, much work remains to be done to ensure that the many trade agreements already signed are consistent with each other, and to finish constructing the web of trade agreements across the region and with the rest of the world where there are missing links.[1]

The region benefitted from a strong financial sector as the pandemic hit. Moreover, early evidence suggests that the direct and even indirect links between banking systems in the region and Russia and Ukraine are limited. Financial policies adopted in many countries to contain the pandemic were useful to avoid costly loan defaults. Some policies,

[1] See Powell (2017) and Mesquita Moreira and Stein (2019) for a discussion.

however, may be hiding higher than reported levels of credit risk. Given loan moratoria and associated reporting standards, traditional balance sheet indicators of risk may not reflect the actual situation of banks. Moreover, bank balance sheets have shifted in favor of public sector assets that attract very low risk ratings. As these policies are phased out, and as credit to the private sector grows, regulators and supervisors should work with banks to ensure traditional balance-sheet indicators properly reflect the risks. A useful additional tool in this environment would be regular stress-testing exercises that reveal the risks associated with individual banks and indicate the need, if any, for greater capital over time as economies recover. While many countries employ stress tests as a tool to analyze systemic financial stability, given the uncertainty and the issues with traditional balance sheet indicators, using this additional tool for supervisory purposes may be valuable.

The pandemic has posed many serious challenges for the region. They may now be compounded by the conflict between Russia and Ukraine given its implications for the global economy. Still, the region's resilience in the face of adversity creates reasons for optimism. The crisis provides a window of opportunity to work towards new policy architectures in critical areas to improve both equity and efficiency. Greater equity would help reduce social tensions and facilitate the implementation of growth enhancing reforms. Greater efficiency would improve fiscal outlooks, help reduce debt levels, and cement the basis for faster, more equitable post-pandemic growth.

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