PREPARING THE MACROECONOMIC TERRAIN
for Renewed Growth

Coordinated by
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Latin America and the Caribbean needs to address a triple challenge—three complex, interconnected macroeconomic issues—to achieve its population’s aspirations for development and welfare.

First, the region faces a social challenge. With nearly 18% of the population living on less than US$3.1 per day, poverty levels exceed those of a decade ago. While some correction has taken place, the pandemic increased poverty overall, and recently, Russia’s war in Ukraine has made it even more difficult to reclaim lost gains. In addition to poverty, inequality is also on the rise.

Second, the region faces a fiscal challenge. The COVID pandemic stressed fiscal resources and expenditures. As a result, after the crisis, sovereign debt reached over 70% of GDP, and while fiscal consolidation is still possible, many risks remain.

Third, the region faces a growth challenge. Productivity growth and, consequently, long-term economic growth is currently estimated at only around 2%—too low to meet the development goals of most countries in the region.

In addition to these specific issues, the region also faces the cross-cutting challenges of dealing with climate change, advancing diversity, inclusion, and equity, and strengthening the institutional context and the rule of law for a better business environment.

None of these challenges can be addressed separately since they all feed into each other. The current global scenario carries risks that can increase the depth of these issues. To illustrate their interconnectedness, consider inflation. High inflation, particularly in food prices, exacerbates poverty and threatens food security which in turn impacts human capital and long-term productivity growth. Simultaneously, it leads to higher interest rates, placing additional pressure on fiscal accounts. With tight fiscal accounts, governments are hard-pressed to find the public sector resources for interventions that reduce poverty and inequality or enhance productivity.

The macroeconomic dynamics of recent years have complicated this triple challenge. Since 2020, the global economy has been hit by a series of severe shocks. First, the COVID-19 pandemic pushed most countries into deep recession. Then, while still recovering in early 2022, the Russian invasion of Ukraine again disrupted the world order. In Latin America and the Caribbean, the pandemic led to a 7% contraction of GDP in 2020. Record levels of fiscal spending accompanied that contraction to mitigate its impacts, leading to fiscal deficits of 7.4% of GDP and sovereign debt levels of 74% of GDP in the median country of
the region. However, as countries recovered from the pandemic and adjusted their fiscal balances, the region grew by 7% in 2021.

Global economic recovery came with stronger aggregate demand that, in late 2021, started to push commodity prices and inflation upwards. This global trend intensified in 2022 with Russia’s war in Ukraine. As a result, major shifts in commodity prices exerted additional pressure on prices. The predominant role of Russia and Belarus in the global market for fertilizers caused their prices to increase swiftly, generating additional pressure on food prices throughout the planet.

Latin American and Caribbean countries were no exception to global price trends. Inflation, particularly food inflation, reached its highest level in over 20 years. As in the rest of the world, central banks in the region reacted strongly to contain the inflationary outburst. Interest rates rose, and as a result, inflation has been curbed in many countries, and capital flows have been largely contained. Despite higher interest rates, most countries were able to maintain a fiscal consolidation trend in 2022; the positive commodity shock helped offset the negative growth shock, adding revenue to fiscal accounts while higher inflation helped dilute a portion of the debt.

As the world adjusts to the consequences of higher inflation, many risks have appeared on the region’s economic horizon. Lower global growth and high financing costs are part of the outlook that policymakers will need to navigate in 2023 and possibly beyond. This outlook may lead to an increase in the ratio of debt to GDP from 2023 onward, signaling the urgent need for policies aimed at consolidating fiscal accounts.

A major source of uncertainty is the lack of an end game to the war in Ukraine. However, even in a status quo scenario, risks are associated with lower-than-expected global growth and higher-than-expected financing costs. Learning how to navigate such a world is critical for policymakers to avoid transforming the year of global adjustment into one of intense economic pressure for the region. Authorities can implement policies to contain global shocks and set the stage for faster and better recovery when global conditions normalize.

This year’s Latin American and Caribbean Macroeconomic Report explores the main challenges the region will face in 2023 on the monetary, fiscal, labor market, and financial fronts. Chapter 1 sets the stage and presents risk scenarios for the global economy and our region. Chapter 2 discusses inflation, the reaction of monetary policy, and the difficulties in returning to the region’s inflation targets. Chapter 3 explores fiscal issues and complements the recent IDB flagship report, *Dealing with Debt*, by discussing how to maintain the region’s fiscal consolidation trend. Chapter 4 focuses on the evolution of poverty and inequality, reviews the main drivers of labor market dynamics, and lays out the key risks ahead, particularly following strong contractionary policies in 2022. Chapter 5 analyzes the risks faced in financial markets, both external and domestic, and suggests ways to deal with potential financial fragilities. Finally, Chapter 6 summarizes the main
policy recommendations presented throughout the report. Each chapter focuses on the main challenges faced in each area and discusses potential policy actions to face current uncertainties, reduce the risks of deepening the region’s triple challenge, and set the stage for addressing these specific issues and the critical cross-cutting ones in the medium term.

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After bouncing back strongly in 2021 from the deep recession induced by the 2020 COVID-19 pandemic, growth in Latin America and the Caribbean was expected to fall back gradually to longer-term averages. However, the Russian invasion of Ukraine sent shock waves across the world. Commodity prices soared, global growth expectations plummeted, and central banks increased interest rates and warned they would have to stay elevated for a prolonged period. As a result, growth in 2022 was higher than expected. Initial forecasts in April suggested the region would grow 2.5%; actual figures will be closer to 3.9%. The growth prospects for 2023 for the region appear less promising than the 2021 and 2022 recovery period. As a result, gaps related to the region’s triple challenge of improving social conditions, strengthening fiscal accounts, and promoting long-term growth may increase. Growth in 2024 is then expected to return to close to medium-term averages, although there is considerable uncertainty. This chapter reviews global and regional growth prospects, considers the risks facing the region, and outlines growth scenarios.

A Risk-Filled Global Context

World growth has been slowing. While it rebounded to 6.1% in 2021, it slipped back to 3.4% in 2022, and is expected to be 2.9% for 2023. Private forecasts are more conservative at 2.1% for 2023. The United States grew by just 1.6% in 2022 and private forecasters now expect growth to be 1.3% in 2023. The Eurozone grew 3.1% in 2022 and private forecasters expect growth to be zero this year. Growth in China was just 3.2% in 2022, well below the high rates above 5% in recent years, which in turn were well below the 2002-2012 average of 10% per annum. Still, China is now expected to recover with private forecasters projecting 5.0% for 2023.

The Russian invasion of Ukraine unleashed significant impacts through several channels. First, the decline in demand was a direct economic impact. Second, the sharp rise in energy and other commodity prices further impacted growth and inflation negatively. Third, the

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1 IMF, World Economic Outlook, January 2023.
3 The IMF projects 1.4% growth in its January 2023 World Economic Outlook.
increase in inflation provoked tighter monetary policy from central banks across the world, depressing growth prospects further. Finally, stock markets fell, wiping out billions of dollars in firm valuations. All of these impacts spread across the world, affecting virtually all countries, but especially small, open economies such as those in Latin America and the Caribbean.

Since the first months of the war, other developments have provoked a decline in commodity prices from their peak levels (Figure 1.1). China implemented a strict zero-COVID policy, which reduced demand from the world’s second largest economy. The United States released petroleum from its strategic reserve. Recently, some commodity prices picked up again with the reopening of China and optimism about increased demand.

The United States has suffered a combination of lower growth and higher inflation that have sparked fears of stagflation. After realizing that inflation would not be strictly temporary, the Federal Reserve increased the policy interest rate seven times to a target range of 4.25% to 4.5% after its last meeting in 2022—the highest level since 2007. Policymakers emphasized that rates have to be raised further and must remain elevated for a considerable period of time to ensure that inflation recedes to around the 2% target. Considering the minutes from the last meeting and the so-called dots plot, members of the Federal Open Market Committee (FOMC) expect interest rates to reach 5.1% this year and then start to decline in 2024 to 4.1%, and then 3.5% in 2025.4 On February 1, 2023, the Federal Reserve increased the Federal Funds target rate an additional 25 basis points

4 The minutes of the December FOMC meeting are available at: The Fed — December 13–14, 2022, FOMC Meeting (federalreserve.gov).
and the Federal Reserve chairperson warned that rates may have to surpass the 5.1% figure, although he acknowledged the progress being made in bringing down inflation.\(^5\)

The market appears to have been somewhat at odds with the view of the Federal Reserve. As revealed by the Chicago Mercantile Exchange Group’s FedWatch Tool, market expectations envision the policy rate rising, and peaking above 5% before the Federal Reserve begins to reduce rates this year.\(^6\) One interpretation is that the market might simply believe that inflation has already peaked and will start to come down fairly quickly; thus, the Federal Reserve has no reason to maintain higher rates for an extended period. A less benign view is that the market thinks the United States will enter a recession and the remarkably low unemployment rate will begin to rise. According to this logic, the market may then be reasoning that the Federal Reserve will start to lower rates to pursue its full employment as well as its inflation objective, even if inflation remains above the 2% target.

These are potential interpretations of the current market data. However, there are also risks. One significant risk is that growth in the United States decelerates more than expected and unemployment begins to rise, even as inflation remains above the 2% target. The Federal Reserve has stated that the costs of bringing down inflation by keeping rates elevated is likely much lower than bringing rates down too quickly. If under these circumstances the Federal Reserve keeps rates higher, then market expectations would need to be revised and almost surely provoke another sharp correction in equity prices and impact longer-term interest rates as well.

The world economy faces many other risks as well. The International Monetary Fund (IMF) notes that while risks are tilted to the downside, there are also upside risks, such as stronger than expected demand (from pent-up demand given high savings during the pandemic) and a swift decline in inflation. However, the list of downside risks is longer and likely more potent if they materialize.

In China, the zero-COVID policy is now being lifted and the economy is regaining momentum. However, that raises the risk that the number of new cases will mount and new strains may emerge. Immunity to COVID remains relatively low in China and new strains may further weaken the effectiveness of vaccines, presenting a risk for China as well as the rest of the world. Some countries are already imposing travel restrictions on Chinese visitors. A second risk stems from high levels of debt, particularly in the real estate sector. At the same time, China has a high level of reserves and many tools to intervene. The challenge is to contain any problems that emerge and prevent them from provoking more widespread economic malaise.

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\(^5\) See, for example, “Fed’s Powell says could raise rates beyond December, gives nod to disinflation” from Reuters.

An additional risk is an escalation of the Russian war in Ukraine. This conflict continues with no clear endgame in sight. The resistance against the invasion has been remarkable and the Ukrainian army has even made advances against Russian forces. This defiance has been met with barrages of missiles, apparently aimed at the energy and transport infrastructure. The deployment of patriot missiles, and German and U.S. tanks, may help Ukraine defend current positions and regain further territory. However, Russia may also interpret these actions as a further escalation of the conflict. On the one hand, the West appears willing to provide whatever is required to prevent Russia from annexing all of Ukraine. On the other hand, regaining all the territory taken by Russia appears ambitious, and raises the chilling specter that a more comprehensive defeat of Russian forces on the ground might prompt the use of nuclear weapons. And that then poses the question, what would be the response from the West? An elevated risk of escalation along these lines would severely impact commodity and financial markets and economies across the world.

Tethered to a Volatile World:
Developments in Latin America and the Caribbean

Developments across the world have impacted Latin America and the Caribbean. The region bounced back strongly after the 2020 recession with 2022 growth expected to be close to 3.9%, but growth is projected to fall in 2023. The IMF’s growth forecast for Latin America and the Caribbean in 2023 was downgraded from 2.5% in April 2022 to 1.7% in October and upgraded slightly in January 2023 to 1.8%. Projections from private forecasters are considerably lower at just under 1%. Growth forecasts for 2024 indicate a recovery to over 2%.

Growth forecasts for the region are impacted by global projections and particularly those for the United States. In the April 2022 World Economic Outlook, the IMF indicated U.S. growth would be 2.3% in 2023, but downgraded that forecast to 1.0% in October of 2022. The IMF upgraded 2023 growth to 1.4% in January and recent figures from private forecasters suggest it will reach 1.3%.

Inflation increased strongly in the region through 2021 and 2022, reaching a maximum of 9.6% in the median country. As discussed further in Chapter 2, central banks acted aggressively by raising policy interest rates which, coupled with the fall in commodity prices and the slowdown in growth, allowed inflation to fall back from the peak in several countries in late 2022 or early 2023.

Global capital markets have remained open for most countries in Latin America and the Caribbean which surely helped countries through the pandemic. For example, governments issued almost US$220 billion of bonds in 2020—almost four times the issuance in 2019. Interestingly, government bond issuance has been extremely strong in the first
weeks of 2023, reaching over 30% of the total 2022 issuance before the end of January 2023, indicating most countries still have access to external markets.\(^7\)

At the same time, financial conditions have tightened for both governments and the private sector, given both the rise in global interest rates and developments at home. Average yields on external bonds issued by governments in the region increased from around 5.3% in 2021 to over 9% in late 2022. Early 2023 has brought some decline in yields but they remain over 8%. Through 2021 and the early part of 2022, higher yields were due almost exclusively to the rise in yields of U.S. treasuries. However, after April 2022, bond spreads over U.S. treasuries also increased for the region. Figure 1.2 illustrates the upward movement in bond yields, decomposing the yield into the spread and the corresponding U.S. treasury yield.

The rise in bond spreads reflects both changes in global risk aversion and domestic developments. While debt ratios fell from high levels given strong growth in 2021, they were roughly stable in 2022 and projections suggest only a gradual decline over the next 10 years, with considerable risks attached to that scenario.\(^8\) Uncertainty regarding fiscal plans and continued elevated levels of debt in the current global context have likely put upward pressure on spreads (see Powell and Valencia, 2023, and Chapter 3).

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\(^7\) Figures from Bloomberg. Refer to Cavallo et al. (2022) for further analysis of access to external financing through the pandemic.

\(^8\) Ruiz-Arranz et al. (2023) show that the increase in the Emerging Market Bond Index (EMBI) in several Latin American and Caribbean countries is related to an emerging markets’ common factor that is highly correlated to the global risk aversion measured by the VIX.
Regional Growth Scenarios

The risks highlighted above, particularly for the U.S. economy, carry significant risks for Latin America and the Caribbean. To investigate these risks, a statistical model of the global economy is employed to consider the impacts of particular shocks on Latin America and the Caribbean.9

The baseline for this analysis is considered to be the average expectations of private analysts. These projections indicate that growth in the United States will fall in 2023 and that inflation will come down reasonably quickly, in accordance with average private sector analysts. The average private forecaster expects growth to be about 1.0% for the region in 2023. This low growth projection reflects, among other factors, lower world growth, higher interest rates, continued restrictive monetary policy in the world and the region (discussed in Chapter 2), gradual fiscal consolidation, and relatively high debt levels (see Powell and Valencia, 2023, and Chapter 3).

Still, this baseline scenario carries considerable risks. Consider the case of lower-than-expected U.S. growth; in particular, assume a one standard deviation shock to U.S. growth spread over four quarters, starting in the first quarter of 2023. At the same time, suppose inflation does not come down swiftly and remains substantially above the Federal Reserve’s 2% target through 2023. That would likely provoke additional interest rate hikes over and above those currently expected by market analysts as well as a correction in equity prices. Consider that the correction in equity prices is one standard deviation of a broad U.S. equity index. The financial shock and the growth shock interact to provoke a significant recession in the U.S. economy, with growth dipping to –0.9% in 2023 and growth remaining negative in 2024 (–0.2%). The United States returns to positive growth in 2025 (+2.0%). The baseline and this negative scenario for the U.S. economy are illustrated in Figure 1.3.

Shocks to U.S. growth carry significant implications for growth in Latin America and the Caribbean. The shocks outlined above on growth and financial markets in the United States provoke a recession in Latin America and the Caribbean, with growth of –1.5% in 2023. The region would also have negative growth (–0.5%) in 2024 and would only return to positive growth in 2025 (+2.0%). Figure 1.4 illustrates the results for Latin America and the Caribbean.

The impact of the shocks stemming from the United States are felt most acutely in Mexico, given the close trade and other links between the two countries; Mexico loses an average of 2.1% of GDP each year for three years (2023 to 2025 inclusive) relative to the baseline. Brazil, which is a larger economy and more diversified in terms of its external

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9 The model is a global vector autoregression or G-VAR. Please refer to Cesa-Bianchi et al. (2012) and Powell (2012) for further details of the model. For the purposes of this analysis, Latin America and the Caribbean includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Jamaica, Mexico, Nicaragua, Paraguay, Peru, and Trinidad and Tobago.
linkages, is the least affected, with a loss of 1.3% of GDP on average for each of the three years. The GDP losses resulting from the shocks emanating from the United States relative to the baseline are detailed in Table 1.1.
As expected, given the pattern of GDP losses, Mexico also suffers the most in terms of growth; in the negative scenario, Mexico suffers a recession, with –2% growth in 2023. Brazil also endures a recession in 2023, but of smaller magnitude (~0.9% growth). All subregions would record negative growth in 2023 and all would return to positive growth in 2025. The growth rates under both the baseline and the negative scenario are detailed in Table 1.2.

Tourism-dependent economies suffered more than others during the pandemic given the travel restrictions and have not fully recovered. Given the uncertain demand conditions for tourism, especially from advanced economies, they may once again be particularly impacted. This specific transmission channel may not be fully captured in the statistical model. Box 1.1 details the potential effects on tourism-dependent countries.

### TABLE 1.1 Estimated Annual Losses in GDP (2023–2025) Relative to Baseline

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America and the Caribbean</td>
<td>1.7</td>
<td>-0.8</td>
<td>-0.9</td>
<td>-1.7</td>
</tr>
<tr>
<td>Southern Cone except Brazil</td>
<td>1.9</td>
<td>-1.0</td>
<td>-0.9</td>
<td>-1.8</td>
</tr>
<tr>
<td>Central America and the Caribbean</td>
<td>2.2</td>
<td>-0.7</td>
<td>-0.7</td>
<td>-1.4</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.6</td>
<td>-0.6</td>
<td>-0.7</td>
<td>-1.3</td>
</tr>
<tr>
<td>Mexico</td>
<td>1.7</td>
<td>-1.0</td>
<td>-1.1</td>
<td>-2.1</td>
</tr>
</tbody>
</table>

Source: IDB staff calculations.

Note: Scenarios are generated using a Global Vector Auto-Regression Model (G-VAR). The shock to United States GDP is 1.6% while the shock to the U.S. financial sector is 16.1%. Southern Cone except Brazil includes Argentina, Bolivia, Chile, Colombia, Ecuador, Paraguay, and Peru. Central America and the Caribbean corresponds to Costa Rica, El Salvador, Jamaica, Nicaragua, and Trinidad and Tobago. Latin America and the Caribbean includes the two groups, Brazil, and Mexico.

### TABLE 1.2 Growth Rates in the Baseline and Negative Scenario

<table>
<thead>
<tr>
<th>Region and Country</th>
<th>2022 Baseline</th>
<th>2023 Baseline</th>
<th>Negative scenario</th>
<th>2024 Baseline</th>
<th>Negative scenario</th>
<th>2025 Baseline</th>
<th>Negative scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America and the Caribbean</td>
<td>3.5</td>
<td>1.0</td>
<td>-1.5</td>
<td>1.9</td>
<td>-0.5</td>
<td>2.3</td>
<td>2.0</td>
</tr>
<tr>
<td>Southern Cone except Brazil</td>
<td>4.6</td>
<td>1.0</td>
<td>-1.6</td>
<td>2.0</td>
<td>-0.5</td>
<td>2.6</td>
<td>2.3</td>
</tr>
<tr>
<td>Central America and the Caribbean</td>
<td>2.4</td>
<td>1.9</td>
<td>-0.4</td>
<td>2.1</td>
<td>0.3</td>
<td>2.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Brazil</td>
<td>3.0</td>
<td>0.9</td>
<td>-0.9</td>
<td>1.8</td>
<td>-1.1</td>
<td>2.0</td>
<td>1.8</td>
</tr>
<tr>
<td>Mexico</td>
<td>2.9</td>
<td>1.1</td>
<td>-2.0</td>
<td>1.8</td>
<td>-1.1</td>
<td>2.1</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Source: IDB staff calculations.

Note: Scenarios are generated using a Global Vector Auto-Regression Model (G-VAR). The shock to United States GDP is 1.6% while the shock to the U.S. financial sector is 16.1%. Southern Cone except Brazil includes Argentina, Bolivia, Chile, Colombia, Ecuador, Paraguay, and Peru. Central America and the Caribbean corresponds to Costa Rica, El Salvador, Jamaica, Nicaragua, and Trinidad and Tobago. Latin America and the Caribbean includes the two groups, Brazil, and Mexico.
The increasingly uncertain and challenging global economic outlook casts a shadow on advanced economy demand for travel and tourism over the next 12 to 24 months. The latest survey of the UNWTO’s Panel of Tourism Experts highlights that while industry participants remain optimistic about the sector’s global prospects in 2023, confidence dampened somewhat over the last quarter of 2022, in line with deteriorating economic conditions. Regardless of outcomes, both regional and global economies face headwinds and the prospects for travel and tourism demand are not likely to improve. Policymakers from tourism-dependent economies should prepare to address concerns emanating from this crucial sector, which is again vulnerable to rapidly evolving external forces.

Many Latin American and Caribbean countries rank among the most dependent on tourism. The Tourism Dependency Index (TDI) developed by Mooney et al. (2020), based on the relative contribution of the sector to GDP, exports, and employment, suggests that Latin American and Caribbean countries are arguably the world’s most tourism-dependent (Figure 1.1.1). The TDI ranks 175 countries globally across all regions and finds that about half of the 20 most tourism-intensive economies on earth are in the Caribbean.

While these Caribbean economies tend to be relatively small in size and population, tourism is significant for some of the largest countries as well. From 2017 to 2021, it is estimated that tourism accounted for an average of over 16% of both economic output and employment in Mexico, and about 10% of both GDP and total employment for Uruguay, Argentina, and Chile. In Brazil, it is estimated that tourism contributed about 8% of both output and employment. In aggregate, about 28 million Latin American and Caribbean citizens depended on the tourism

![Tourism Dependency Index](image_url)
Navigating the Difficult Road Ahead

2022 turned out to be a better-than-expected year for Latin America and the Caribbean. In April, the IMF forecasted the year’s growth at 2.5%. In October, it was upgraded to 3.5% and estimates now suggest that growth reached 3.9%. This improvement was driven mostly by the impact of high commodity prices and positive terms of trade fluctuations in many economies in the region. A repeat of this pattern is not expected in 2023. Global growth prospects are now bleaker and because central banks across the world have needed to tame inflation, global interest rates are now higher.

Latin American and Caribbean countries face a year in which global demand may be depressed—compensated partially by the reopening of China following its strict COVID-related shutdowns—and high financing costs. In some countries still struggling to stabilize inflation, financing costs may continue to rise. Against this backdrop, countries in the region still have policy room to maneuver and avoid deeper than needed economic contractions that could further derail them in closing the social, fiscal, and growth gaps that constitute their triple challenge.

Monetary and fiscal policies are clear examples of areas in which the region needs adjustments to not only avoid a hard landing, but also set up the conditions for a faster recovery following the perils of 2023. On the monetary front (see Chapter 2), countries still need to maintain, or in some cases tighten, their monetary policy stance to ensure that inflation returns to its targets by 2024. All policy playbooks throughout the region should give this priority.

Fiscal policy needs to accompany monetary policy by accelerating fiscal consolidation. Fiscal consolidation is crucial to lower risk premia, reduce financing costs and the neutral monetary policy interest rate, and generate fiscal space to support much needed policies to promote economic and social development. Fiscal consolidation faces risks (see Chapter 3), but policymakers have a number of policy instruments, such as strengthening fiscal institutions and restoring the use of fiscal rules, that can allow them to advance on the fiscal front.

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**BOX 1.1 • Out of Its Hands:**
Prospects for the World’s Most Tourism-Dependent Region (continued)

sector for some part of their incomes and livelihoods in 2018 (the last year for which final data are available).c

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b Only IDB member countries are shown in Figure 1.1.1, but Aruba, Antigua and Barbuda, St. Lucia, Dominica, and Grenada are also among the top 20 most tourism-dependent economies by this measure.
c Note that these data reflect travel and tourism’s total contribution to employment (World Bank WDI and WTTC), driven by both direct and indirect economic activity. Direct contribution refers to jobs specifically linked to tourism-facing sectors, including hotels and restaurants, while indirect contributions include support services and other upstream inputs to the sector (e.g., agricultural inputs, construction, sector maintenance services, etc.).
The economic slowdown that the region may face in 2023 raises the grave specter of a deterioration in poverty and inequality. Many of the hard-earned social gains the region chalked up in the first decade of the century have been reverted. Avoiding further retrenchment and generating the conditions to recover and exceed past gains is a priority. How labor markets respond to the restrictive policies implemented through 2022 to curtail inflation (see Chapter 4) may leave additional scars that affect the future adjustment of labor markets. Policies must be designed with the poor in mind and include focalized fiscal policies to address the needs of the most vulnerable to monetary and financial shocks. Labor markets in the region still need to increase their levels of formality to better contribute to development needs.

Despite higher global financing costs, financial markets in the region have been resilient. Access to global financing has remained open, though its cost has increased significantly. As financial dollarization expands in several countries, authorities must develop strategies to contain it to avoid a potential financial shock that leads to balance sheet vulnerabilities that increase financial stress. Despite pressure in financial markets (see Chapter 5), the region’s financial systems remain relatively robust. Maintaining them this way, by ensuring that all tools—including stress tests—are used properly, should be the target of authorities throughout Latin America and the Caribbean.
CHAPTER 2

A Balancing Act: Monetary Policy in Turbulent Times

Inflation in the region reached its highest level in 14 years in 2022, but by the end of the year, signs pointed to a slowdown in the increase in prices. Still, forecasters do not expect inflation to return to central bank targets until at least the end of 2024. To fight the spike in inflation and a possible de-anchoring of inflation expectations, central banks in the region increased interest rates. Policy rates will likely remain above their neutral level in 2023 and prompt a slowdown in economic growth. Inflation above targets combined with expected low growth will complicate finding the correct mix of monetary and fiscal policy needed to return to a sustained economic growth path.

This chapter describes recent trends in inflation, monetary policy interest rates, and central bank balance sheets in Latin American and Caribbean countries. It also discusses the global component of inflation, and central banks’ reaction. The chapter also addresses the challenges of coordinating monetary and fiscal policies in the year ahead.

Dissecting the Surge: Inflation in 2022

In 2022, Russia’s invasion of Ukraine together with an economic recovery and fiscal stimulus during the pandemic put pressure on prices, especially of energy and food. Inflation in Latin America and the Caribbean reached its highest level since the 2008 financial crisis (see Figure 2.1). The annual inflation rate for the median country in the region peaked at 9.6% in July 2022 versus 6.3% in 2021 (highest value of that year).

Inflation increased in countries whose monetary policy regimes ran the gamut. Even in countries with fixed exchange rates, and in dollarized economies, annual inflation climbed above 6%. As in 2021, inflation was driven mainly by real factors—the adjustment in global commodity prices, supply side restrictions related to Russia’s war in Ukraine and remnants of the COVID-19 crisis—rather than monetary factors (see Cavallo et al., 2022).

The increase in prices was a global, not local, phenomenon. The principal component of inflation in the region since the beginning of the pandemic explains 83% of the variation in overall inflation rates, compared to only 57% when estimating with data since 2005 (see Box 2.1). The principal components of inflation in all countries regardless of
their monetary regime are highly correlated after March 2020 (see Figure 2.2., Panel A). Moreover, the principal component of inflation in the region is highly correlated with the principal component of inflation in the G7 countries, in other emerging economies, and with commodity prices (see Figure 2.2, Panel B). The commonality of these patterns suggests that the surge in inflation in 2022 was driven by global factors. In fact, the rise in inflation and inflation expectations was driven mostly by a rise in fuel, food, and other commodity prices, which in turn was driven by global supply shocks caused by the pandemic and the war in Ukraine (Box 2.2).

Food inflation rose 30% between February 2020 and December 2022 in response to both the COVID-19 pandemic and the war in Ukraine, while the consumer price index (CPI) increased 18% (see Figure 2.3). In 2022, food inflation for the median country reached 14%, total CPI inflation 9%, and core inflation 7%. The fact that food prices increased more than overall consumer and core prices reflects the relatively stronger impact of supply restrictions on food prices, which exert greater pressure on poorer households that spend

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1 See Ayres et al. (2023) for more details. Ruiz-Arranz et al. (2023) show that, in Central America, more than half of the non-food inflation is explained by a common factor highly correlated with oil prices, and that food inflation is highly correlated with the price of corn and wheat.

2 See IMF (2022b) for a discussion.
The principal component is simply the linear combination of 19 inflation series of countries in Latin America and the Caribbean that explains most of the overall variation in inflation in the data. Ayres et al. (2023) perform a principal component analysis of the inflation dynamics in Latin America and the Caribbean to assess the recent surge in inflation across the region. The principal component accounts for 57% of the variation in inflation in the last 17 years, and is highly correlated with the principal components of inflation of country groups outside the region, especially post-COVID-19. Global factors such as U.S. inflation, commodity prices, and international shipping costs account for at least one-third of the variation of the principal component. The analysis implies that external factors are major drivers of the surge in inflation in the region after the pandemic lockdowns.

Figure 2.1.1 shows the principal component and the inflation series of the 19 countries in the region. The principal component captures the widespread increase in inflation around 2008–2009, during the global financial crisis, and in the most recent period, post-COVID-19. Moreover, the computation of the principal component illustrates its share of the variance in inflation in the sample. This share is the ratio of the largest eigenvalue to the sum of all eigenvalues of the variance-covariance matrix. The principal component alone accounts for 57% of the variation in inflation. And the principal component for the sub-period post-March 2020—the beginning of the pandemic—accounts for 83% of the variation. This indicates that a common factor accounts for most of the inflation variation in the sample, particularly in the post-COVID-19 subperiod.

Source: IDB staff calculations based on central bank data and Haver Analytics.
Note: Countries with high inflation periods and missing data are excluded to avoid problems in the principal component estimation. The figures include data for The Bahamas, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Jamaica, Mexico, Panama, Paraguay, Peru, Trinidad and Tobago, and Uruguay.
**FIGURE 2.2 ● The Principal Component of Inflation for Different Groups**

A. Latin America and the Caribbean, grouped by monetary regimes

B. Latin America and the Caribbean, other economies, and the commodity index

Source: IDB staff calculations based on central bank data, Haver Analytics, and IMF’s Commodities Database.

Note: Countries with high inflation periods and missing data are excluded to avoid problems in the principal component estimation. IT stands for inflation targeting. IT pioneers include Brazil, Chile, Colombia, Mexico, and Peru. More recent IT incorporates Costa Rica, Dominican Republic, Guatemala, Jamaica, Paraguay, and Uruguay; Intermediate covers Bolivia, Guyana, Honduras, and Trinidad and Tobago; Fixers encompass The Bahamas, Ecuador, El Salvador, and Panama. Other EMEs are the same emerging market economies as covered by the EMBI index but excluding the countries of Latin America and the Caribbean. Consequently, the group includes: Armenia, China, Cote d’Ivoire, Croatia, Egypt, Georgia, Hungary, India, Indonesia, Kenya, Latvia, Lithuania, Malaysia, Namibia, Nigeria, Oman, Pakistan, Philippines, Poland, Romania, Russia, Senegal, Slovakia, South Africa, Tunisia, and Zambia. The members of the G7 group are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. The figure uses the aggregate commodity price index of IMF’s Commodities Database.

**BOX 2.2 ● Understanding the Roots of Inflation**

Galindo and Nuguer (2023) estimate the impact of fuel price shocks on inflation and inflation expectations in Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Mexico, Paraguay, and Peru. These countries have inflation-targeting frameworks. To quantify the impacts of global fuel price shocks they use Bayesian-VAR (structural vector autoregressive) models. The models include the exogenous fluctuation of the global price of fuel commodities as well as domestic variables: headline inflation, inflation expectations, and the nominal exchange rate depreciation.

In all cases, inflation and inflation expectations respond significantly and rapidly to a shock in fuel prices. The size and duration of the impact varies across countries. A key feature of these countries is the existence of some type of fiscally supported mechanism to reduce the impact of global fuel prices on domestic fuel prices. The most likely transmission channel may be through the increase in the cost of imported goods and services. The size of the impact and the persistence and dynamics of the transmission may relate to the idiosyncratic functioning of each gasoline price smoothing mechanism.

(continued on next page)
**BOX 2.2 • Understanding the Roots of Inflation** (continued)

The main drivers of inflation from January 2005 through October 2022 were fuel price shocks, except in Brazil (see Figure 2.2.1). Fuel price shocks explain more than 70% of the exogenous variation of inflation estimated by the models in the last quarter of the sample. In the cases of the Dominican Republic and Paraguay, fuel price shocks explain more than 90% of the variation.

**FIGURE 2.2.1 • Historical Decomposition of Inflation**

A. Brazil

B. Chile

C. Colombia

D. Costa Rica

E. Dominican Republic

F. Mexico

- Δ Fuel
- Inflation
- Δ Exchange Rate
- Inflation Expectations
- Stochastic component
Overall, these findings suggest that the external dynamics in fuel prices have been the main driver of CPI inflation in Latin America and the Caribbean.

In line with inflation, fuel price shocks played a key role in shaping inflation expectations (see Figure 2.2.2), which is a key signal for policymakers to communicate to the public their views about the nature of fuel price shocks (e.g., about the perceived persistence or not of key market shocks).\(^*\)
**BOX 2.2 • Understanding the Roots of Inflation (continued)**

**FIGURE 2.2.2 • Historical Decomposition of 12-month Inflation Expectation**

C. Colombia

D. Costa Rica

E. Dominican Republic

F. Mexico

G. Paraguay

H. Peru

Source: IDB staff calculations based on Haver Analytics and central bank data.

Note: The figures depict the decomposition of inflation for each country explained by the B-VAR model estimated in Galindo and Nuguer (2023). The solid line corresponds to the stochastic component of inflation, while the different area colors correspond to each of the shocks in the B-VAR model.
FIGURE 2.3  • Alternative Measures of Consumer Price Index

[Graph showing alternative measures of consumer price index with median inflation rates for a group of countries for which food and core inflation rates are available.]

Source: IDB staff calculations based on central banks, department of statistics, and Haver Analytics.
Note: This figure shows median inflation rates for a group of countries for which food and core inflation rates are available. The countries included are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, El Salvador, and Trinidad and Tobago.

a larger portion of their income on food (see Cavallo and Powell, 2021, and Nuguer and Powell, 2020). Even though prices increased globally, large subsidies to energy prices in the region limited the passthrough to domestic prices. Nonetheless, the rise in global energy prices boosted both transportation costs and the price of imported goods, which then fed into general price increases and domestic food price inflation. Again, poorer households suffered relatively more since they depend to a greater extent on their labor income, which is heavily affected by inflation (Chapter 4).

The Monetary Policy Reaction

To counteract the sharp increase in inflation, central banks in the region raised interest rates and reduced their balance sheets to curb aggregate demand and anchor inflation expectations. These actions, together with lower commodity prices, prompted a slowdown in inflation in the fourth quarter of 2022. In 2023, the initial effect of the price hikes in 2022 will begin to ease, while monetary policy will continue to act through conventional demand channels to tame inflationary pressures; thus, inflation will likely continue to slow down.

Subsidies differ and may vary across products. For agriculture, for example, diesel is especially important, so if its price was not subsidized, the main mechanism of adjustment could have been a rise in the cost of that input to agriculture.
Even if the main drivers of the inflation surge were external, the decisive response of central banks reveals their concern for de-anchoring inflation expectations. Most likely, their policies were aimed at avoiding this from happening and risking the perpetuation of inflation. Since global commodity prices also shape inflation expectations (Box 2.1), the policy response was warranted.  

**Monetary Policy Reference Interest Rates**

The median monetary policy reference interest rate was 5.5 percentage points higher in 2022 than at the end of 2021, but varied widely across countries: Guatemala increased only 2 percentage points, while Colombia and Chile increased 9 and 7.25 percentage points, respectively. At least 10 central banks in the region increased their monetary policy interest rates significantly (see Figure 2.4). The central banks of inflation target pioneers, on average, raised interest rates more than recent inflation targeters, even though their inflation rates were similar. This is probably due to the fact that countries with consolidated

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4 The fuel price shock impacts inflation expectations through fiscal accounts. Estimates suggest that the fiscal costs of stabilizing domestic fuel prices can add up to 1.4% of GDP. If that fiscal cost eventually ends up weakening fiscal accounts and endangering fiscal sustainability, it may end up fueling inflation, either through the need of monetary financing or through exchange rate depreciations. This makes a case for an aggressive reaction of countries to curb the inflation spike.
inflation targeting regimes have more experience and knowledge about how monetary policy transmission mechanisms work in practice and about how trade-offs with growth are actually smaller than expected. Moreover, in these countries, the stakes of losing credibility may be higher. Fiscal strength, the behavior of financial and currency markets, and other economic dimensions may also explain differences in policy responses.

If central banks believed the inflationary surge was going to be short-lived or was coming fully from external factors, their reaction should have been null (if monetary policy worked efficiently) or very little (because they could still impact inflation expectations). However, their decisive reaction reveals their belief that inflation was going to be more persistent, and that their policy could prevent inflation expectations from de-anchoring.

The magnitude of the reactions of Latin American and Caribbean central banks contrasts with the responses of central banks in the G7 group of countries. The latter also increased rates, but at a slower pace.

In the next 12 months, inflation among regional inflation targeters is expected to be above their target band in all countries except Paraguay (see Table 2.1, in which countries are ranked by their de-anchoring of 12-month inflation expectations). The largest discrepancies are in Jamaica and Mexico, where inflation expectations are 5.6 and 4.4 percentage points above their respective band’s upper-bound. However, medium-run inflation expectations remain well anchored: all countries expect inflation to be within their target band or less than 1 percentage point above their upper bound in the next 24 months.

**TABLE 2.1 • Inflation Expectations among Inflation Targeters**

<table>
<thead>
<tr>
<th>Country</th>
<th>Interest rate</th>
<th>December 2022 inflation</th>
<th>Inflation target band</th>
<th>12-m inflation expectations</th>
<th>24-m inflation expectations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jamaica</td>
<td>7</td>
<td>10.3</td>
<td>4-6</td>
<td>11.6</td>
<td>—</td>
</tr>
<tr>
<td>Mexico</td>
<td>10.5</td>
<td>7.8</td>
<td>2-4</td>
<td>8.4</td>
<td>5</td>
</tr>
<tr>
<td>Colombia</td>
<td>12</td>
<td>13.2</td>
<td>2-4</td>
<td>7.7</td>
<td>4.7</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>9</td>
<td>7.9</td>
<td>2-4</td>
<td>5.8</td>
<td>4</td>
</tr>
<tr>
<td>Peru</td>
<td>7.5</td>
<td>8.5</td>
<td>1-3</td>
<td>4.7</td>
<td>3.5</td>
</tr>
<tr>
<td>Uruguay</td>
<td>11.5</td>
<td>8.3</td>
<td>3-6</td>
<td>7.4</td>
<td>6.8</td>
</tr>
<tr>
<td>Guatemala</td>
<td>3.75</td>
<td>9.2</td>
<td>3-5</td>
<td>6.3</td>
<td>4.8</td>
</tr>
<tr>
<td>Chile</td>
<td>11.3</td>
<td>12.8</td>
<td>2-4</td>
<td>5.3</td>
<td>3.5</td>
</tr>
<tr>
<td>Brazil</td>
<td>13.8</td>
<td>5.9</td>
<td>1.75-4.75</td>
<td>5.4</td>
<td>4.2</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>8.5</td>
<td>7.6</td>
<td>3-5</td>
<td>5.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Paraguay</td>
<td>8.5</td>
<td>8.1</td>
<td>2-6</td>
<td>5</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: IDB staff calculations based on central bank data and Haver Analytics.

Note: Data as of December 2022. Latest Inflation corresponds to the 12-month percentage variation in the consumer price index. Brazil, Mexico, Paraguay, and Peru’s 12- and 24-month inflation expectations correspond to the annual inflation expectations for December 2023 and December 2024, respectively; Chile, Colombia, Costa Rica, Dominican Republic, Guatemala, Jamaica, and Uruguay’s inflation expectations correspond to the annual inflation expected for the following 12 and 24 months. There is no 24-month inflation expectations data for Jamaica.
The convergence of inflation expectations to targets is good news and implies continued credibility in the central banks’ policies. For this reason, central banks reacted strongly in 2022 to fend off the rise in inflation. Current measurements of 24-month expectations suggest that this response has been appropriate; inflation is falling, and expectations remain well anchored.

**Beyond Interest Rates**

To control inflation, interest rate policy was accompanied by adjustments to central banks’ balance sheets. After the large increase in their balance sheets during the pandemic, all central banks started or continued the contractionary process that began in 2021 (see Cavallo and Powell, 2021, and Ayres, Neumeyer, and Powell, 2021). Table 2.2 presents the evolution of central bank balance sheets in a group of Latin American and Caribbean countries and ranks them according to the difference between the overall cumulative variation since the beginning of the pandemic (Panel A) and from their peak expansion during the COVID-19 pandemic (Panel B).

Countries vary widely in their general behavior. Chile expanded assets with a cumulative variation of 13.4% (see Table 2.2, Panel A). Brazil and Uruguay contracted assets by a cumulative total of –5.7% and –0.2%, respectively.

Chile expanded net credit to banks (14.1% cumulative variation) and sterilized most of it (12.2% total cumulative variation). The movement in the foreign exchange market of the central bank has been slight given that it follows an inflation targeting regime with a flexible exchange rate.

Brazil increased and then reined in net credit to the government more than any country. At the beginning of the pandemic, the government drew down its deposits at the central bank to finance its COVID-related policies; those funds were sterilized as the government spent them. The government was able to replenish its deposits by resuming bond issuances and transferring profits from the central bank due to the exchange rate devaluation effect on the foreign reserves.

The peak expansion for most countries was in 2020 or in 2021. Since then, balance sheets in all countries have contracted (see Table 2.2, Panel B). Brazil, Peru, Chile, and Uruguay reached their peak in early 2021 and since then have contracted the most. Except for Chile, net credit to the government decreased in all countries. In Brazil and Peru, the policy actions were followed by a decline in net bank assets. Chile adjusted net credit to foreigners, reducing the monetary base.

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5 See Mariscal et al. (2018).
6 The cumulative change in central bank balance sheets is computed as the variation in total assets or liabilities (net of foreign exchange valuation effects) divided by 2019 GDP.
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.
# TABLE 2.2 Cumulative Variation in Central Bank Balance Sheets

## A. Expansion in central bank balance sheets through the latest available data (% of 2019 GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
<th>(8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>-1.1</td>
<td>14.1</td>
<td>0.4</td>
<td>2.7</td>
<td>12.2</td>
<td>-1.5</td>
<td>13.4</td>
<td>Dec-22</td>
</tr>
<tr>
<td>Bolivia*</td>
<td>-7.2</td>
<td>3.5</td>
<td>16.9</td>
<td>11.1</td>
<td>0.0</td>
<td>2.1</td>
<td>13.2</td>
<td>Dec-22</td>
</tr>
<tr>
<td>Jamaica</td>
<td>6.3</td>
<td>-0.8</td>
<td>1.3</td>
<td>4.0</td>
<td>3.8</td>
<td>-1.1</td>
<td>6.8</td>
<td>Dec-22</td>
</tr>
<tr>
<td>Colombia</td>
<td>2.1</td>
<td>-0.1</td>
<td>2.6</td>
<td>4.2</td>
<td>0.4</td>
<td>-0.1</td>
<td>4.6</td>
<td>Dec-22</td>
</tr>
<tr>
<td>Peru</td>
<td>6.5</td>
<td>2.2</td>
<td>-5.3</td>
<td>3.8</td>
<td>0.1</td>
<td>-0.5</td>
<td>3.4</td>
<td>Dec-22</td>
</tr>
<tr>
<td>Paraguay</td>
<td>5.0</td>
<td>-0.9</td>
<td>-1.5</td>
<td>2.2</td>
<td>1.7</td>
<td>-1.2</td>
<td>2.7</td>
<td>Dec-22</td>
</tr>
<tr>
<td>Mexico</td>
<td>1.3</td>
<td>-0.3</td>
<td>1.2</td>
<td>3.9</td>
<td>-1.5</td>
<td>-0.2</td>
<td>2.2</td>
<td>Dec-22</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>-2.0</td>
<td>2.2</td>
<td>-0.2</td>
<td>2.6</td>
<td>-1.5</td>
<td>-1.1</td>
<td>0.0</td>
<td>Dec-22</td>
</tr>
<tr>
<td>Uruguay</td>
<td>4.7</td>
<td>-0.7</td>
<td>-4.1</td>
<td>0.3</td>
<td>3.9</td>
<td>-4.4</td>
<td>-0.2</td>
<td>Dec-22</td>
</tr>
<tr>
<td>Brazil</td>
<td>-3.4</td>
<td>-1.5</td>
<td>-0.9</td>
<td>1.4</td>
<td>-0.2</td>
<td>-6.9</td>
<td>-5.7</td>
<td>Dec-22</td>
</tr>
</tbody>
</table>

Source: IDB staff calculations based on IMF and central bank data.
Note: * corresponds to data from the International Financial Statistics (IFS) of the IMF.

(continued on next page)
### TABLE 2.2  Cumulative Variation in Central Bank Balance Sheets (continued)

**B. Expansion in central bank balance sheets from their peak during the pandemic through the latest available data (% of 2019 GDP)**

<table>
<thead>
<tr>
<th>Country</th>
<th>Net credit to foreigners (Net of FX valuation)</th>
<th>Net credit to banks</th>
<th>Net credit to government</th>
<th>Monetary base</th>
<th>Sterilization liabilities</th>
<th>Other net liabilities</th>
<th>Total assets = liabilities</th>
<th>Last observation — peak</th>
<th>Expansion between Dec 2019 and peak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>-3.2</td>
<td>-2.6</td>
<td>-9.3</td>
<td>-0.1</td>
<td>-7.7</td>
<td>-7.2</td>
<td>-15.0</td>
<td>Dec 2022–Jul 2020</td>
<td>4.0</td>
</tr>
<tr>
<td>Peru</td>
<td>-0.9</td>
<td>-4.0</td>
<td>-4.3</td>
<td>0.6</td>
<td>-8.0</td>
<td>-1.7</td>
<td>-9.2</td>
<td>Dec 2022–Jan 2021</td>
<td>13.2</td>
</tr>
<tr>
<td>Chile</td>
<td>-6.5</td>
<td>-1.3</td>
<td>0.0</td>
<td>-3.1</td>
<td>-1.6</td>
<td>-3.2</td>
<td>-7.8</td>
<td>Dec 2022–Nov 2021</td>
<td>3.3</td>
</tr>
<tr>
<td>Uruguay</td>
<td>-1.3</td>
<td>-0.2</td>
<td>-4.7</td>
<td>-2.2</td>
<td>-0.5</td>
<td>-3.5</td>
<td>-6.2</td>
<td>Dec 2022–Mar 2021</td>
<td>3.0</td>
</tr>
<tr>
<td>Jamaica</td>
<td>0.1</td>
<td>-0.2</td>
<td>-1.7</td>
<td>-0.3</td>
<td>-0.2</td>
<td>-1.4</td>
<td>-1.8</td>
<td>Dec 2022–Oct 2021</td>
<td>1.4</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>-2.6</td>
<td>2.2</td>
<td>-1.0</td>
<td>2.4</td>
<td>-1.1</td>
<td>-2.8</td>
<td>-1.4</td>
<td>Dec 2022–Jun 2020</td>
<td>8.6</td>
</tr>
<tr>
<td>Mexico</td>
<td>-1.0</td>
<td>-0.2</td>
<td>0.1</td>
<td>1.6</td>
<td>-0.3</td>
<td>-2.4</td>
<td>-0.8</td>
<td>Dec 2022–Feb 2022</td>
<td>4.4</td>
</tr>
<tr>
<td>Paraguay</td>
<td>1.0</td>
<td>-1.8</td>
<td>0.1</td>
<td>1.6</td>
<td>-0.4</td>
<td>-1.8</td>
<td>-0.6</td>
<td>Dec 2022–Dec 2020</td>
<td>21.2</td>
</tr>
<tr>
<td>Bolivia*</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>Dec 2022–Dec 2022</td>
<td>12.6</td>
</tr>
<tr>
<td>Colombia</td>
<td>0.0</td>
<td>-0.2</td>
<td>0.8</td>
<td>0.9</td>
<td>0.3</td>
<td>-0.6</td>
<td>0.6</td>
<td>Dec 2022–Dec 2021</td>
<td>9.3</td>
</tr>
</tbody>
</table>

Source: IDB staff calculations based on IMF and central bank data.

Note: * corresponds to data from the International Financial Statistics (IFS) of the IMF.
The increase in U.S. interest rates also impacted the balance sheets of central banks as a result of the lower value of reserves, and a lower price of foreign assets denominated in U.S. dollars. All countries in the sample, except for Paraguay, reduced net credit to foreigners. Chapter 5 discusses the latest financial account trends and overall changes in reserves for the region.

The average monetary policy interest rate in the region for inflation targeting countries was 4.25 percentage points higher than the Federal Reserve Board’s stance in December 2022. This may impact capital flows into the region, the so called “carry trade” motive, which was a concerning issue at the beginning of 2022. In principle, higher interest rates might attract foreign investors to borrow in U.S. dollars to invest in the region, especially short-term investments. The inflow of short-term foreign capital might create pressure towards currency appreciation or might smooth depreciation pressures on the domestic currency, thereby limiting competitiveness and growth. However, in 2022, the behavior of domestic currencies varied vis-à-vis the U.S. dollar, with idiosyncratic factors playing a key role. More details regarding the capital flows behavior are presented in Chapter 5.

Closing the Gaps

In the next few months, central banks will probably maintain their contractionary monetary policy stance at least while inflationary pressures persist. Even if inflation continues to recede, inflation expectations must remain anchored. The commitment of central banks to fight inflation and anchor inflation expectations is key to ease monetary policy either by the end of 2023 or in 2024. To do so, key gaps need to be closed.

In 2022, economic activity and inflation peaked with respect to the last 10 years. Because of this, both the output and inflation gaps were close to five points higher than in 2020 (see Figure 2.5); the difference between the output projected for 2022 and its long-term trend, and the difference between the inflation level and its target, for each inflation targeter in the region, were, on average, positive and higher than two years ago. This suggests that many economies in the region were over-heating given the sharp growth rebound and continued supply restrictions.

In 2023, the gaps are expected to close relative to 2022 thanks to the reaction of central banks, easing global trends in commodity prices, and relatively high global interest rates. On the one hand, inflation expectations are now approaching central bank targets in most countries, continuing the trend in 2022. Economic activity, on the other hand, varies. For most countries, it is expected to return to its long-term potential level, but for Mexico and Guatemala, for example, it is expected to remain below potential, and even lower than

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8 Their communication strategy must continue to be extremely careful and explain the shocks hitting economies and the interest rate path and other policies that central banks might carry out.
in 2022. Mexico’s and Guatemala’s performance may reflect these countries’ correlation with U.S. growth. The slowdown in inflation and economic activity across the region are explained by the effect of currently high interest rates and the end of the post-pandemic rebound.

The “Correct” Policy Mix

Inflation has begun to recede in the region. However, even if commodity prices have fallen from their peaks and helped inflation decline, it will probably remain above target until 2024. Monetary policy interest rates will remain high until inflation returns to target. Avoiding de-anchoring of inflation expectations is crucial for central banks. Reducing inflation and keeping expectations in line is necessary; if they de-anchor, re-anchoring them again in the future may be costly. In addition, it could imply trade-offs in terms of slowing economic activity and disrupting labor markets (see Chapter 4). To reduce the trade-offs, monetary policy must be coordinated with fiscal and other relevant economic policies.

Coordination with fiscal policy is critical. To continue reducing inflation given a positive inflation gap amid supply restrictions, and to prevent the need for even higher interest rates to keep expectations anchored, fiscal policy should be consistent with monetary objectives. Lower fiscal deficits and a corresponding reduction in sovereign credit risk
are necessary to enhance the efficiency of monetary policy. Lower risk spreads reduce the neutral interest rates used by central banks in their monetary policy functions.\(^9\) As the neutral interest rate falls, central banks have more space to reduce their policy rates. In turn, as fiscal accounts consolidate, the risks of monetary financing of fiscal deficits decline and inflation expectations adjust faster. However, consolidating fiscal accounts is challenging (see Chapter 3). While some countries have benefited from higher fiscal revenues associated with rising commodity prices, many countries maintain expansionary fiscal policies that put pressure on demand and limit the speed at which inflation declines. This complicates central banks’ ability to sustain an independent monetary policy as central bank financing of fiscal expenditure takes priority over achieving inflation objectives. Ensuring a sustainable path for government finances to complement a credible monetary framework and maintaining price stability continue to be critical in the months ahead.

Coordination is a two-way street. As central banks reduce their policy rates, other rates should follow, including those paid by government bonds, if sovereign risk is also falling. Lower interest payments help fiscal consolidation, which in turn eases the task of monetary policy. In this sense, the success of an anti-inflationary policy benefits both fiscal and monetary accounts when both authorities move in the same direction.

However, coordination must go beyond fiscal policy. Negotiating several types of contracts is also crucial to ensure the success of monetary policy. A key example is the negotiation of public sector and minimum wages (see Chapter 4). How much of past inflation translates into future wage adjustments also affects how central banks adjust their policies. The risks of updating firms’ pricing decisions and wage increases with 2022 peak inflation is that a price spiral allows inflation to persist. High indexation leads to higher inflation expectations, and hence reduces the space available to central banks to ease their monetary policies, which delays any potential impact on economic activity and labor market tightness.

Inflation is expected to fall thanks to policies adopted by central banks since the inflation surge of 2022. Risks to this outlook include how global commodity prices react to the reopening of China following strict COVID-19 lockdowns, and developments in the war in Ukraine. How potential trade-offs materialize depends on how well monetary policy is coordinated with other key economic policies.

\(^9\) Spreads could also be reduced as fiscal institutions improve.
Many Challenges, Many Options: Fiscal Policy in the Face of Shocks

Fiscal balances have improved since the pandemic despite rising interest rates following Russia’s invasion of Ukraine and the global fight against inflation. However, there is still a long road ahead to consolidate public accounts and stabilize the public debt. Forward-looking scenarios suggest that the declining trend in debt may be reversed in 2023. The possibility of interest rates moving yet higher or growth being lower than anticipated poses risks to fiscal policy. Pressures to increase spending are significant and, in some cases, justified. Still, for many countries, any increases aimed at specific groups or sectors should be offset by lower spending elsewhere or higher revenues to contain risks and should be clearly communicated as part of a medium-term fiscal plan. In countries with relatively high spending and revenue levels, the gains from improving efficiency in spending and tax systems are substantial. Countries can follow different paths to fiscal consolidation and minimize negative impacts on growth or even improve growth prospects; the specific route depends on individual country characteristics (Powell and Valencia, 2023).

This chapter describes recent trends in fiscal consolidation and debt trajectories, discusses significant issues associated with how inflation and the policy response to it have affected fiscal policies, and explores fiscal scenarios in the years ahead in response to global issues. Despite significant challenges, countries have several policy options depending on their current fiscal structures and debt position.

Getting Back on Track: Fiscal Consolidation in the Region

Fiscal consolidation is proceeding in Latin America and the Caribbean, with fiscal balances in 2022 returning to pre-pandemic levels. In the average economy (Figure 3.1, Panel A), the primary deficit reached 0.4% of GDP in 2022, up 4.4 percentage points since the COVID-19 crisis and 0.6 percentage points less than the 2019 deficit. Similarly, the 2022 total balance increased 1.6 percentage points from 2021, reaching −3.2% of GDP, and was 0.2 percentage points above 2019 (see Figure 3.1, Panel B). Still, low projected growth for 2023 and increasing interest rates leave no room for complacency.
More than three-quarters of the countries in the region improved their fiscal balances in 2022. Some countries adjusted more than others (see Figure 3.2). Overall, progress in public finances has been driven mainly by an average decline in total spending of 1.5 percentage points of GDP. In turn, the main driver of this decline has been current spending, which fell by 1.5 percentage points of GDP on average, with most countries in the region ending the fiscal stimulus implemented during the pandemic.

Notably, this occurred at a time of pressure for fiscal expansion. In 2022, 84% of the region’s countries adopted or expanded measures to compensate for the decline in purchasing power due to high inflation in the poorest population. On average, support in the region to the most vulnerable households reached 0.6 percentage points. The repertoire

**FIGURE 3.1 • Fiscal Balances in Latin America and the Caribbean**

A. Primary balance

B. Total balance

Source: IDB staff calculations based on IMF (2022b).
Note: The figures include data for all IDB borrowing countries except Venezuela.
of measures includes targeted cash transfers, subsidies to specific producers such as the agricultural sector, and in some cases, price freezes on energy and fuels.¹

Capital expenditures have varied more. Half of the region increased capital expenditure by 0.4 percentage points; in the other half, it declined by 0.7 percentage points of GDP (see Figure 3.2). Fiscal revenues increased on average, but not as much as output in the post-pandemic economic recovery. In the average country in the region, revenues increased by only 0.2 percentage points of GDP. In 11 countries, revenues declined between 0.1 and 3.4 percentage points.

¹ See IMF (2022b).
Public debt is adjusting gradually after pre-pandemic increases and the spike in 2020. In the average country, it fell from 67% in 2021 to 64% of GDP in 2022 (Figure 3.3, Panel A). However, there is still a significant gap before returning to the relatively low pre-pandemic levels. Higher economic growth, high inflation rates, and the fiscal consolidation process were the main drivers of the reduction in indebtedness. However, sharp currency depreciations and higher interest payments have offset the gains, and the latter pose a

FIGURE 3.3 Public Debt Dynamics in Latin America and the Caribbean

A. Gross debt

<table>
<thead>
<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>% of GDP</td>
<td>57</td>
<td>71</td>
<td>67</td>
<td>64</td>
<td>70</td>
<td>65</td>
<td>62</td>
<td>59</td>
<td>56</td>
<td>54</td>
<td>52</td>
</tr>
</tbody>
</table>

B. 2021-2022 Debt change decomposition

Source: IDB staff calculations based on IMF (2022b).
Note: Latin America and the Caribbean includes 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. Diversified economies include Argentina, Brazil, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, and Trinidad and Tobago.

For a discussion of how these factors affect debt-to-GDP ratios, see Powell and Valencia (2023).
particularly high risk to further consolidation. In the context of rising inflationary pressures, inflation-indexed debt representing about 9% of total debt generated an increase in public indebtedness of between 0.4 and 0.9 percentage points of GDP (Figure 3.3, Panel B). While the share of inflation-indexed debt has fallen, the composition of debt has shifted towards more foreign-currency and floating-rate debt. The weight of foreign-currency debt increased by 1.7 percentage points in 2021 relative to 2018, with commodity-dependent countries registering the biggest increase (12.7 percentage points). In addition, debt with a floating rate had inched up slightly (0.5 percentage points) by 2021 relative to 2018, driven mainly by the increase in tourism-dependent economies.

Although debt as a share of GDP has been decreasing, interest payments as a percentage of fiscal revenues (referred to as the burden of interest payments) have increased and exceed a threshold level indicating higher fiscal risk (see Figure 3.4). Interest rates started to increase around 2014 after the collapse in commodity prices, which prompted a rise in country risk premia. This did not change before the pandemic hit in 2020. Spreads and yields rose swiftly in 2020, but then declined as financial fears related to the pandemic subsided. The world was shocked again by the Russian invasion of Ukraine, and inflation, which had been creeping up gradually, increased sharply, leading to substantial hikes in policy interest rates (see Chapters 1 and 2). Initially, spreads in the region remained stable,

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**FIGURE 3.4  • Burden of Interest Payments**

![Chart showing burden of interest payments from 2007 to 2022](image)

Source: IDB staff estimates based on IMF (2022b).

Note: The figure includes all IDB borrowing countries except Venezuela. The threshold represents the level of debt affordability over which the likelihood of facing fiscal stress increases. To see methodological details of the threshold calculations see Valencia et al. (2022).

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3 See Powell and Valencia (2023) and Valencia et al. (2022) for technical details.
but the rise in U.S. interest rates fed through to higher yields on external debt, and domestic yield curves rose. This sequence of shocks has negative implications for debt affordability.

With the rise of interest rates during 2022, yield curves on government debt have shifted upwards. Thus, new debt issuances carry higher interest costs, thereby increasing debt service payments. In addition, due to higher inflation expectations and liquidity risk perceptions, yield curves have flattened (e.g., in Colombia and Peru). In some cases, such as Mexico, yield curves have inverted (Figure 3.5). Flattening or inverted yield curves may signal an expected slowdown in economic activity in the region. Usually, when long-term interest rates exceed short-term rates, they indicate a lack of confidence in the economy’s future growth.

Source: IDB staff calculations based on DataStream.
Note: The x-axis corresponds to years to maturity.
The total burden of debt includes interest payments and debt amortization. In Latin America and the Caribbean, the burden of debt has increased not only because of higher interest rates but also due to the increase in projected amortizations.\(^4\) Seven countries face debt service of more than 5% of GDP in 2023, while six others face debt service between 2.5% and 5% of GDP (Figure 3.6, Panel A). For the median country in the region, debt service accounts for nearly 15% of fiscal revenues in 2023 and is expected to fall to about 9% by 2027 (Figure 3.6, Panel B).\(^5\) Brazil and Mexico account for more than 75% of the region’s debt service maturing in 2023.

Higher interest rate payments and concentrated amortizations are risks to future fiscal consolidation. Despite strengthening their fiscal positions in 2022, uncertainty about growth dynamics and the behavior of interest rates in 2023 raise questions about how firmly the region will continue to advance in consolidation. Given the rise in interest payments, authorities will need to find additional space to lengthen maturities and limit the growth of expenditures. This task may be challenging in the face of pressure to compensate for high prices with greater spending. Fiscal forecasts until 2026 point to improved primary balances that are partially offset by higher interest payments, leading to modest increases in debt ratios from 64% in 2022 to 67% of GDP in 2026. However, risks may alter these forecasts.

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\(^4\) See Powell and Valencia (2023) for a detailed discussion.

\(^5\) These figures do not include the roll-over of short-term debt.
Fiscal Scenarios

Figure 3.7 shows the projected trajectories of the debt-to-GDP ratio for the average country in Latin America and the Caribbean and the different groups of countries. The baseline scenario assumes paths for growth, inflation, interest rates, and commodity prices that are consistent with the baseline presented in Chapter 1. The stressed scenario incorporates lower economic growth, higher U.S. policy interest rates, higher inflation, and lower commodity prices in line with the negative scenario of Chapter 1.

Continued fiscal consolidation in 2022 reduced financing needs and contributed to a lower debt-to-GDP ratio of 64% of GDP (Figure 3.7, Panel A). The projections in the baseline scenario show that for the average Latin American and Caribbean country, debt rises and then stabilizes at around 67% of GDP, given higher financing costs and lower growth rates. In the stressed scenario, due to persistently tighter financial conditions, new macro-fiscal shocks increase debt ratios. For the typical country, debt reaches 72% of GDP in 2026, which is 5 percentage points above the baseline scenario.

Estimated debt-to-GDP trajectories for country groups reflect a similar pattern to that of the average country, but debt levels vary depending on starting positions. The debt ratios of tourism-dependent countries, which ran significant average primary surpluses before the pandemic (1% of GDP, 2015–2019), stabilize in the medium term at around 71% of GDP (Figure 3.7, Panel B). In commodity-exporting countries, additional fiscal revenues from higher commodity prices partially mitigate the effects of higher financing costs, and their debt converges to 60% of GDP in 2026 (Figure 3.7, Panel C). On the other hand, the debt-to-GDP ratio in diversified economies increases to 69% in 2026 due to greater spending pressure (Figure 3.7, Panel D). As for the stressed scenario, the additional shocks result in estimated debt ratios between 3 and 7 percentage points of GDP above the baseline scenario, depending on the country group.

The projections of primary fiscal balances in the baseline scenario suggest a convergence to fiscal balance by 2026, explained by the continued withdrawal of fiscal stimulus and a recovery of growth in 2024 and beyond (Figure 3.8, Panel A). However, in the stressed scenario, the path of fiscal adjustment is slower. Given lower growth rates and higher inflation, primary deficits are estimated to be close to one percentage point of GDP higher than in the baseline in 2023. However, this difference will narrow gradually in the medium term, and the primary balance will converge to −0.3%.

The dynamics of fiscal adjustment in tourism-dependent and commodity-exporting countries resemble those of the regional average. The tourism-dependent group, on the one hand, would converge towards a primary surplus of 1.1% of GDP in the baseline scenario and 0.8% of GDP in the stressed scenario, which is feasible given the historical capacity of these countries to make rapid fiscal corrections and generate positive primary balances (Figure 3.8, Panel B). On the other hand, supported by the additional fiscal revenue from
high commodity prices, the group of commodity-exporting countries could increase their primary balances to fiscal balance by 2026 in the baseline and to a deficit of 0.6% of GDP in the case of additional macroeconomic stress (Figure 3.8, Panel C). The primary balance of the diversified group would worsen, falling to –0.8% of GDP in the baseline and to –1.1% in the stressed scenario (Figure 3.8, Panel D).

As Powell and Valencia (2023) argue, reducing debt to prudent levels creates room for further growth and mitigates the risks of other adverse macro-fiscal shocks. Figure 3.9 shows the additional fiscal effort that country groups must make on average per year to converge to their prudent debt levels in both the baseline and stressed scenarios. The effort

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6 The prudent level of debt is one that ensures debt remains sustainable, even if a wide set of adverse shocks were to arise. It is estimated as the level of debt that, with a given probability, remains below the maximum sustainable debt level.
surpasses an average fiscal reform in Latin America and the Caribbean that generates between 0.7 and 1 percentage point of GDP of additional fiscal revenues. Countries need to generate adjustments that can exceed one and a half or two fiscal reforms to converge to prudent levels. Countries have several policy options to converge to prudent debt levels.

Fiscal forecasts can change, among other things, depending on how past inflation leads to adjustments of fiscal expenditures and revenues. Given high inflation and interest rates (see Chapter 2), understanding how they may affect fiscal accounts is a crucial question. Due to the rise in interest rates to combat inflation, interest payments have increased, generating future fiscal pressure. However, higher inflation affects future fiscal balances through other channels as well. Inflation impacts tax collection in several ways. It also impacts different dimensions of expenditure and revenue (see Box 3.1). Limiting channels through which past inflation affects future fiscal balances is critical to avoid reversing the region’s fiscal consolidation trends.
Policy Options

Although fiscal balances have already returned to pre-pandemic levels, debt in many countries has yet to reach an estimated prudent level. Despite the continuation of fiscal consolidation in most countries in 2022, risks are rising. Moreover, simulated scenarios suggest that debt could return to a growing path, signaling the urgent need for policies aimed at adjusting fiscal accounts. There is no one-size-fits-all policy to reduce debt, and fiscal strategies to achieve fiscal consolidation depend on country-specific characteristics. However, some standard features in several countries—increasing the efficiency of expenditure and tax revenue collection, enhancing fiscal institutions, and improving the composition of debt—can guide policy in that direction.7

Improving expenditure efficiency and tax collection should top policymakers’ agendas everywhere.8 Greater targeting of transfer payments9 and enhancing the quality of public investment in all stages of project cycles10 are pending tasks that could save over 4% of

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7 For a deeper discussion, refer to Powell and Valencia (2023).
8 For a discussion of policies to promote fiscal consolidation, see Cavallo and Powell (2021) and Cavallo et al. (2022).
9 Targeted subsidies that replace blanket subsidies can be an efficiency gaining approach. For example, adopting subsidies for vulnerable populations to use mass transportation can be more efficient than providing blanket fuel subsidies that may even be regressive.
10 Improvements in public investment frameworks would also improve fiscal multipliers.
**BOX 3.1 • Inflation and Fiscal Accounts**

**Past Inflation and Expenditure**

The effects of inflation on government spending are diverse and depend on various factors: the level of indexation of spending components; the policy response in terms of the targeting mechanisms used to compensate for the loss of purchasing power of the most vulnerable (Premchand, 1989); and the increased cost of government purchases.

Salaries and personnel costs have annual revision mechanisms that correct for the loss of purchasing power due to inflation. Between 2017 and 2019, workers’ compensation accounted for about 29% of public spending—higher than in OECD countries (24%). Also, social security spending, which accounts for nearly 20% of total expenditure, depends on wage growth and is directly indexed to inflation. Through this mechanism, a rise in past inflation automatically leads to an increase in expenditure.

Finally, government purchases of goods and services also adjust with inflation due to the rapid adjustment of prices by the private sector, which supplies them. Therefore, at least 60% of public spending can be expected to be adjusted for inflation (Figure 3.1.1).

**FIGURE 3.1.1 • Fiscal Expenditure and Inflation**

<table>
<thead>
<tr>
<th>% of public expenditures</th>
<th>Indexed to inflation to preserve purchasing power</th>
<th>Indexed to inflation or wage increases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflationary linked expenditure</td>
<td>60.2</td>
<td>28.6</td>
</tr>
<tr>
<td>Wages</td>
<td>28.6</td>
<td>19.0</td>
</tr>
<tr>
<td>Pensions</td>
<td>19.0</td>
<td>12.6</td>
</tr>
<tr>
<td>Purchases of goods and services</td>
<td>12.6</td>
<td>12.6</td>
</tr>
</tbody>
</table>

Source: IDB staff calculations based on World Bank and Arenas de Mesa (2020).

Note: The figure includes data for Argentina, Brazil, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Peru, Trinidad and Tobago, and Uruguay.

Because of indexation, past inflation can lead to future expenditure growth. An additional problem occurs when inflation-indexed spending is inflexible, as in the case of wages, transfers, and interest payments on debt. In those cases, the effects of high inflation not only translate into the following year’s fiscal accounts, but also have a persistent impact. In many countries, inflexible public spending accounts for over 50% of total expenditures (see Figure 3.1.2). In that context, rising inflation also increases the future inflexibility of public spending, posing a challenge for fiscal consolidation.

**Inflation and Fiscal Revenue**

The impact of inflation on fiscal revenue is uncertain. On the one hand, if the inflation rate is higher than the rate at which tax brackets are adjusted, individuals and businesses may be pushed into higher tax brackets, resulting in greater tax revenue for the government.

*(continued on next page)*
Inflation and Fiscal Accounts (continued)

On the other hand, if inflation decreases purchasing power, people have less disposable income to pay taxes, which results in lower tax revenue. Inflation also affects the value of tax deductions and credits, thereby increasing or decreasing the amount of taxes owed.

The timing of transactions is critical to assess the impact of inflation on the tax base and the real value of tax liabilities. To calculate the tax base, many transactions carried out at various times must be considered. Depending on the timing of these transactions, the real tax base increases or decreases, affecting the tax liabilities generated. The tax base is also affected by deductions or limits that are determined in local currency. As for actual tax liabilities, the difference between the time the liability is generated and the time the tax is paid erodes the real value of the tax burden; the longer these delays, the greater the erosion. Additionally, if tax credits are set in nominal terms, their future use reduces their real value, thereby increasing the tax burden.

Many countries have implemented measures to limit price increases to domestic consumers. Among the policies implemented are tax reductions, especially on energy and food items. More than half of the countries in the region use tax reduction, averaging 0.27% of GDP. Also, one-third of the countries have announced temporary cuts or suspended tariffs on food and container imports to curb the rise in shipping costs (IMF 2022).

Additionally, high inflation creates uncertainty and disrupts economic activity, which negatively impacts tax collection. Overall, the effect of inflation on tax collection is complex and depends on many factors.

\[ \text{Source: IDB staff’s calculations based on IMF.} \]
\[ \text{Note: The vertical line corresponds to the average of the sample.} \]

FIGURE 3.1.2 • Inflexible Public Expenditure

- Colombia
- Peru
- Mexico
- Chile
- Brazil
- Uruguay
- Argentina
- Nicaragua
- Guatemala
- El Salvador
- Paraguay
- Costa Rica
- Honduras
- Dominican Republic
- The Bahamas
- Jamaica
- Belize

Source: IDB staff’s calculations based on IMF.
Note: The vertical line corresponds to the average of the sample.

On the other hand, if inflation decreases purchasing power, people have less disposable income to pay taxes, which results in lower tax revenue. Inflation also affects the value of tax deductions and credits, thereby increasing or decreasing the amount of taxes owed.

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Additionally, high inflation creates uncertainty and disrupts economic activity, which negatively impacts tax collection. Overall, the effect of inflation on tax collection is complex and depends on many factors.

\[ \text{See Izquierdo, Pessino, and Vuletin (2018) and Arenas de Mesa (2020).} \]
\[ \text{b This estimate accounts for data available in 2018 for Argentina, Brazil, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Peru, Trinidad and Tobago, and Uruguay.} \]
\[ \text{c This effect can also work to the detriment of the taxpayer. Sometimes the government must refund taxpayers. If these refunds are delayed over time, the value of the refund may also be eroded.} \]
GDP, according to IDB estimates. These measures are essential for countries with high public expenditure and where increasing revenues can be politically unfeasible.

Given high inflation, authorities, specifically in countries where wages take a large share of total expenditure, should be aware of the risks of perpetuating permanent increases in inflexible expenditure via wage indexation. Therefore, wage adjustments should rely more on measures of future inflation expectation and less on realized past inflation.

In countries with lower fiscal revenues, enhancing tax revenues can effectively consolidate fiscal accounts. Moreover, tax reforms can be progressive if they are adequately designed and promote higher formality. Such reforms seek to increase revenues not only through higher rates but by strategically focusing on expanding the tax base, promoting mechanisms that reduce evasion and tax avoidance, and limiting exemptions when unnecessary. In 2022, one-third of the region’s countries submitted plans to carry out tax reforms in the next three years that aimed to achieve an average revenue increase of 1% of GDP.

Reducing debt to prudent levels depends critically on strengthening fiscal institutions. Well-designed, debt-anchored fiscal rules are a crucial tool to enhance the credibility of medium-term fiscal plans. Where these are in place, market participants tolerate higher debt ratios and risk premia tend to be lower. Fiscal rules perform even better when combined with independent fiscal committees that monitor and produce key parameters that feed the rules. During the COVID-19 pandemic, many countries suspended the use of their fiscal rules. The region must now resume compliance promptly (Box 3.2).

The composition of debt matters as much as its level. Active debt management practices may also be required, given the rise in interest rates and the expected burden of debt service in the years ahead. Strategies to improve the profile and composition of debt that allow smooth debt service over time may be required. These strategies include designing mechanisms to exchange high-cost short-term debt for longer-term instruments at lower costs. Multilateral development banks can play a crucial role in achieving this shift.

Institutional strengthening is essential to converge towards prudent levels. Many countries in the region have created units dedicated to debt management. Active coordination with macro-fiscal planning actions is necessary, given the complexity of debt operations. Several countries in the region have created fiscal rules with debt anchors. Still, the debt strategy needs to be coupled with medium-term fiscal frameworks to achieve a robust fiscal strategy in the face of current uncertainty.

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12 For example, the adoption of negative income taxes can be helpful not only to promote a more efficient management of taxes and subsidies but may also contribute to combat the high levels of informality that characterize the region. See Cavallo et al. (2022) for a discussion.
13 Due to the large countercyclical fiscal policy observed in 2020, many countries temporarily eased fiscal rules to smooth fiscal consolidation over time and lessen the negative effect on growth.
14 See Powell and Valencia (2023) for further discussion.
BOX 3.2 • Escape Clauses, Flexibility, and the Return to Fiscal Rule Compliance

Fiscal rules are instruments for fiscal sustainability that represent a long-lasting constraint over selected macroeconomic aggregates. One of the shortcomings of rule-based frameworks is that they need more space to accommodate unforeseen shocks. Over time, fiscal rules have included escape clauses for exceptional events, which allow some flexibility for specific cases such as natural disasters or severe economic contractions. The health emergency triggered by COVID-19 in 2020 severely tested fiscal rules, flexibility, and ability to accommodate a countercyclical response.

In those countries that implemented fiscal rules, they represented a severe constraint to dealing with the crisis. Nevertheless, most rules included escape clauses in their design. In need of fiscal space to deal with the shock, 14 of 16 countries in Latin America and the Caribbean used their escape clauses in 2020 given the size of the negative shock. Among the countries that changed the rule, six chose to modify the numerical targets set for the fiscal year, and four decided to suspend the rule for at least one fiscal year.

Although most rules were back in force in 2022, the return to compliance has varied across countries. Three scenarios are observed:

1. 28% of the countries tried to comply with the rule before the pandemic without activating the escape clause.
2. 36% of the countries decided to modify the targets without invoking the escape clause, allowing a convergence period to the initial targets.
3. 36% of the countries used the escape clause to either suspend or modify the initial targets.

Consequently, the fiscal adjustments made by countries after the pandemic are linked to the way they chose to comply with fiscal rules enacted in 2020.

In 2023, with new and difficult macroeconomic conditions, countries face a new challenge to meet the objectives initially laid out in the fiscal rules. In some countries, the design of escape clauses has facilitated this task. Overall, following the analysis of compliance with fiscal rules proposed by Ulloa-Suarez and Valencia (2022), respect for the objectives set out in the rules improves when accounting for the flexibility incorporated in the escape clauses. Indeed, the compliance rate increased from 33% to 40% in 2020 and from 63% to 70% in 2021.\(^a\)

Since the frequent use of escape clauses is associated with discretionary actions, activating them must be accompanied by gradually returning to the objectives. Although the considerable uncertainty and size of shocks often complicate the design of a return plan to ensure subsequent compliance with the rule, this feature would help accommodate the shock’s transitory effects and maintain fiscal discipline.

\(^a\) Preliminary results.

Moreover, fiscal and monetary policies require strong coordination. Only by working in tandem will they achieve their maximum results at a minimum cost. Easing increases in interest rates alleviates fiscal pressure. But stronger fiscal positions, in turn, are necessary to give central banks room to relax monetary policy. As fiscal consolidation continues, risk premia should come down. As a result, the neutral interest rate that determines monetary policy interest rates can decline, allowing central banks to soften their monetary policy stance. Coordination is always important, but is now critical to avoid consequences that threaten the economic and social gains after the worst of the pandemic.
Poverty and inequality levels in Latin America and the Caribbean have improved since the initial impact of the pandemic. Labor markets performed well after the massive vaccination campaigns and the normalization of most economic sectors. Unfortunately, the economic and social recovery is under threat from an expected slowdown in economic activity associated with higher interest rates and inflation.

This chapter presents recent trends in social and labor market indicators and insights on the impact of inflation and disinflationary policies on them. It also discusses policies to mitigate the potentially negative social impacts of macroeconomic stabilization policies. Synchronizing social policies with fiscal consolidation and contractionary monetary policies present many challenges. The region can avoid reversing the gains in employment, poverty, and inequality achieved during the COVID shock recovery. The key is to correct labor market distortions and allocate resources in a more efficient and productive manner that avoids incentives to informality.

Poverty in 2022

The first 15 years of the 21st century generated optimism about attaining continuous reductions in poverty and inequality in Latin America and the Caribbean. Between 2000 and 2015, the population living on less than US$5 a day fell from 48% to 26% (see Figure 4.1, Panel A). The share living on less than US$3.10 a day dropped from 30% to 13% during the same period. The Gini coefficient decreased from 0.53 to 0.49 (see Figure 4.1, Panel B). Rapid growth in wages among the poorest populations drove this improvement in poverty and income distribution, aided by notable progress in implementing targeted social assistance transfers to the same population segment.1

As growth stalled, the positive trends in poverty and inequality started to revert. By 2019, the percentage of people living on less than US$5 and US$3.10 a day reached 28% and 16%, respectively. The Gini coefficient increased to 0.52. As expected, the pandemic

1 See Messina and Silva (2019) and Busso and Messina (2020) for a discussion.
exacerbated the deteriorating trends. In 2020, despite significant policy efforts to contain the impacts of the pandemic, social indicators deteriorated. The share of people earning less than US$5 a day rose further to 34%, and those earning less than US$3.10 reached 20%. The Gini coefficient ended 2020 at a decade high of 0.52.

Employment dynamics explain much of the increase in poverty and inequality during the COVID years. Employment fell by 14% on average at the beginning of the pandemic, and unlike the past when informality acted as a buffer, informal activity shrunk more than formal employment due to lockdowns and other containment measures.

The economic recovery of 2021 and 2022 returned poverty numbers to their pre-COVID trends but still left the region on a deteriorating path in leading social indicators. Consistent with lower growth, estimates suggest that poverty in 2022 is marginally higher than in 2021 despite variations among countries.

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2 See Azuara et al. (2021), Cavallo and Powell (2021), and Cavallo et al. (2022).
3 Azuara et al. (2021).
Strong and persistent growth would undoubtedly help reverse the trends. Still, given that such a growth scenario is unlikely in the short term, policy efforts need to focus on targeting the poorest to, at a minimum, avoid any further deterioration.

**Getting Back on Track: Labor Market Trends in 2022**

The flip side of poverty figures since the pandemic has been the dynamics of labor markets. The poverty and inequality reductions enjoyed in 2021 and 2022, compared to the numbers at the beginning of the pandemic, reflect improved employment in the region. During 2022, the growth in employment in Latin America and the Caribbean continued. After a slow recovery process, by September 2022, employment had surpassed its pre-pandemic levels. Employment grew 4% on a year-to-year basis in the second quarter of 2022, equivalent to an increase of more than 8 million jobs (see Figure 4.2, Panel A). This recovery was uneven across countries and economic groups.\(^4\) Labor force participation,

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**FIGURE 4.2 • Labor Market Trends**

**A. Evolution of employment**

<table>
<thead>
<tr>
<th>% of employed in February 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Feb-20</td>
</tr>
<tr>
<td>-16</td>
</tr>
</tbody>
</table>

**B. Evolution of labor force participation**

<table>
<thead>
<tr>
<th>% of labor force participation in March 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar-20</td>
</tr>
<tr>
<td>-14</td>
</tr>
</tbody>
</table>

Source: IDB staff calculations based on IDB Labor Market Observatory.
Note: Estimates use data from Argentina, Barbados, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Jamaica, Mexico, Nicaragua, Paraguay, Peru (Metropolitan Lima), and Uruguay.

\(^4\) See Observatorio Laboral (2022).
which also contracted significantly during the pandemic, surpassed its pre-COVID level in the final quarter of 2021. As economies decelerated in 2022, labor market participation retrenched (see Figure 4.2, Panel B).

Contrary to the experience in previous economic crises, during the COVID-19 pandemic, informal employment did not serve as a cushion for households and actually fell more than formal employment.\(^5\) During the recovery, formal employment has also recovered faster than the informal sector (see Figure 4.3). This slowdown in informality coincides with a strong economic recovery, boosted partly by high commodity prices caused by the pandemic recovery and the war in Ukraine.

Commodity price booms impact labor markets and poverty in various, often conflicting, ways. On the one hand, they may be passed on to consumer prices, which, as discussed below, increase poverty by reducing real incomes. On the other hand, employers—at least commodity exporters—may boost demand for low-skilled workers, thereby increasing earnings in that segment of the distribution. Which effect dominates is an empirical question and may depend, among other factors, on the size of the commodity price boom and the passthrough to consumer prices. Despite the possible counteracting factors, until mid-2022, labor markets were recovering in tandem with poverty and inequality figures in the region. However, as expected for 2023, a slowdown in economic activity could halt this positive development.

\(^5\) Azuara et al. (2022) and Cavallo et al. (2022).
Female employment suffered relatively more than male employment during the pandemic, but also grew slightly faster during most of 2022 (see Figure 4.4). While employment remains biased towards male employment, growth figures suggest that Latin America and the Caribbean has returned to its pre-COVID levels. The critical question is whether these gains will prevail as inflation and uncertainty about economic perspectives remain elevated.

**The Inflation Threat to Poverty and Labor Markets**

The current macroeconomic context of high inflation and interest rates raises concerns about the future dynamics of labor markets, poverty, and inequality. Returning poverty trends to their favorable performance at the beginning of the century and sustaining the improvement in employment trends is challenging given high interest rates. An alternative high-inflation scenario could be even worse for employment and poverty.

Inflation is a regressive tax. A sustained increase in prices, particularly of food and energy, increases poverty through at least two channels. Inflation reduces disposable incomes as well as real wages when nominal wages grow at a slower rate than prices (Cardoso, 1992). When inflation rises, if nominal income remains constant, the ability to purchase goods and services falls. Income may also decline during inflationary bursts in response to adjustments in labor markets. When real household income declines, people
may have to work more hours to maintain the same level of consumption. The most vulnerable groups are the most susceptible to these shifts.

Without policy interventions to compensate for the effect of higher food prices on household consumption, the inflation rates witnessed throughout Latin America and the Caribbean in 2022 could increase poverty by 2.4%, and extreme poverty by 2.5% (see Figure 4.5). These numbers imply sending nearly 13.8 and 14.0 million people into poverty and extreme poverty, respectively.

These numbers assume that many other factors affecting poverty remain constant and are thus only indicative. However, they provide a clear signal of the vulnerability faced by the poorest when dealing with inflationary outbursts. Analyzing the impact of inflation on real labor income reveals a similar effect on poverty. Azuara and Torres (2022) build a poverty index based on labor income. This index measures the percentage of households whose average member receives less than their country-specific purchasing-power-parity-adjusted threshold of US$1.90 daily in real labor income. They show that this measure of monetary poverty increased with the pandemic in a sample of countries in Latin America and the Caribbean, reached a maximum in the second quarter of 2020 at the peak of pandemic-induced shutdowns, and decreased afterwards (see Figure 4.6). The case of

![Increase in Poverty due to Food Inflation](image-url)
Peru stands out: from 2021 to 2022-Q3, average labor income poverty was 4.6 percentage points above what it was prior to the pandemic. In Costa Rica, the increase was 3.5 percentage points, while in Chile it was 3.3 percentage points. Bolivia’s labor income poverty inched up only 0.2 percentage points thanks to the lowest rate of inflation in the region.

Labor income poverty levels are associated with different macroeconomic factors that affect—directly or indirectly—the income generated by members of households. This poverty measure increased during employment recovery, as noted previously, ruling out the hypothesis that an unemployment spur is driving it. Prices and wages are among the other factors explaining the rise in labor income poverty. Various price and wage indices contribute to understanding the dynamics of poverty (Figure 4.7). Since 2019, poverty increases are strongly associated with price increases in the general price index and energy prices (Panels A and B) and much less correlated with changes in minimum wages during the same period (Panel C). However, the decline in real wages due to inflation shows the highest correlation. In other words, wage adjustments have been insufficient to overcome the effect of inflation.

Behind all correlations usually lies great heterogeneity. The way in which salaries adjust and how much of inflation they compensate for is critical for labor market and poverty dynamics. The high inflation in the last year has increased the levels of labor poverty and households are probably working more and longer hours to, at least, maintain their levels of consumption.

Methodological details are available in Arias et al. (2022).
Inflation and Wage Adjustment

The effectiveness of monetary policy in an inflation-targeting regime depends partly on how successfully central banks use their policies and announcements to affect inflation expectations (see Chapter 2). A key in determining how the policy can curb inflation is how wages adjust. Since labor is an input in any production function, how much wages adjust may define the path of inflation. Wages might be indexed to past inflation, meaning they are adjusted based on past inflation. When this happens, a mechanism to perpetuate high levels of inflation is built into the economy, making it difficult to adjust most prices downward or at a lower rate than previous inflation. In Latin American and Caribbean countries, nominal wages increased rapidly in 2022: up to the third quarter they had increased 11% in the average country, following closely CPI inflation (Figure 4.8).

An additional hurdle in the presence of high indexation is that labor markets take more time to adjust to a new equilibrium following changes in inflation. For example, suppose...
wages in one period are fixed based on last year’s inflation rate, and inflation turns out to be lower in the following period. In that case, the real wage (that is the nominal wage deflated by the price level) may remain higher than the equilibrium wage for some time and therefore, unemployment may rise. While indexation protects the purchasing power of the employed, the risk is that some people may slip into unemployment because wages fail to adjust in line with prices.

In Latin America and the Caribbean, formal and minimum wages are strongly indexed to past inflation. Data for the 2010–2021 period show that average per-capita household labor income increases about 90% of the previous year’s inflation, while the minimum wage is set on average at 120% of the rate of past inflation (Figure 4.9). Notably, labor income of informal workers does not adjust with inflation.

Indexation will play a role at the current juncture. As authorities continue to battle inflation, labor market developments will be critical not only to determine how fast inflation will converge to its target, but also to determine how employment may adjust throughout the process.

**A Two-Edged Sword: Monetary Policy and Labor Market Dynamics**

Containing inflation is crucial for many reasons, among them, its negative impact on poverty and labor market functioning. But containing inflation also comes at a price: in the short term, it may worsen labor markets. Usually, inflationary outbursts are followed
by strict contractionary monetary policies. These policies aim at returning inflation to a desired long-term level while avoiding cutting into income and increasing poverty in the medium and long run. However, they inevitably slow down the economy and likely increase unemployment. Brazil, Colombia, and Mexico went through inflationary outbursts in the 2010s. In response to high inflation, policy rates increased, inflation adjusted downwards, but unemployment suffered a significant, though short-lived, increase (see Table 4.1).

<table>
<thead>
<tr>
<th>Table 4.1: Previous Disinflationary Episodes, Selected Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
</tr>
<tr>
<td>Monetary policy rate</td>
</tr>
<tr>
<td>2012-Q4</td>
</tr>
<tr>
<td>7.25</td>
</tr>
<tr>
<td>Inflation rate</td>
</tr>
<tr>
<td>2015-Q4</td>
</tr>
<tr>
<td>10.40</td>
</tr>
<tr>
<td>Unemployment rate</td>
</tr>
<tr>
<td>2013-Q4</td>
</tr>
<tr>
<td>6.30</td>
</tr>
</tbody>
</table>

Source: IDB staff calculations based on data from Haver Analytics.
Higher interest rates, through credit and wealth channels, seek to curb consumption and investment and restrain aggregate demand to limit price increases. Similarly, through exchange rate channels, they help curb external demand from domestic agents. On the flip side, as demand contracts, labor markets need to adjust to a new equilibrium that usually implies less demand for labor. This, in turn, causes a higher level of unemployment during the disinflation process.

Recent empirical evidence shows that while income declines for all workers during disinflation, the impact of a contractionary monetary policy varies for each type of worker. In countries with high informality, a monetary contraction reduces the income of informal workers more than formal ones. At the same time, the monetary shock leads to a shift from formality towards informality. The variation in the income response also depends on the income level of the worker. While income shrinks for all workers, formal and informal, workers in the lowest segment of informality suffer relatively more than their formal counterparts.7

**Adjustment with an Eye on the Poor**

In recent years, labor markets have improved compared to pandemic levels. The improvement in labor markets has been accompanied by lower poverty and inequality as compared to the peaks reached at the height of the COVID-19 crisis. However, returning to pre-COVID trends is an unsatisfactory goal. Latin American and Caribbean countries need to resume a declining trend in poverty and inequality. Unfortunately, doing so is not an immediate term goal. The macroeconomic policies needed to bring down inflation will most likely delay a return to that track.

What can be done to avoid losing the gains in poverty and inequality of the post-pandemic years while the region resumes a sustainable growth trend? Now more than ever, fiscal policy must focus on reaching the poorest populations to compensate for the impact of adjustment on them, while making sure the overall fiscal consolidation is consistent with the monetary adjustment. There is no way to sugar coat the complexity of this balancing act. But it needs to and can be done.8

Targeting energy and food subsidies is needed to address poverty and inequality concerns in the presence of commodity price shocks. Stimulating investment in infrastructure, particularly by mobilizing private sector resources through public investment, is also a key policy to reduce poverty and inequality when fiscal constraints are present. Evidence shows that investment in infrastructure, particularly when accompanied by mechanisms to increase efficiency, has a differential and larger impact on the income of the poorest.9

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7 See Gomes et al. (2023) for an analysis of these dynamics in the case of Brazil.
8 Horizontal expansions (more beneficiaries) can be complemented with vertical expansions that increase the value of the monetary transfers to guarantee basic food consumption (need more income).
9 See Cavallo et al. (2020) and Cavallo and Powell (2019).
Policies to improve the functioning of labor markets are also needed. Reducing incentives for informality are crucial.\textsuperscript{10} There is no unique set of interventions; each country must define the best combination of policies for its own reality. These include: policies that delink social security benefits from the labor market status of workers;\textsuperscript{11} incentives to find better job searches, particularly policies to stimulate aggregate demand and use public information; productive development policies that focus on incentivizing innovation and developing new firms and better labor and social security policies that promote successful career paths for all workers over the course of their lives, including retirement, and thereby contribute to productivity and equity.

\textsuperscript{10} See, for example, Cavallo et al. (2022).

\textsuperscript{11} See Levy and Cruces (2021).
Financial markets have been under stress since the onset of the COVID-19 pandemic. While access to foreign credit was available throughout most of the pandemic, credit supplied by domestic financial systems slowed during 2021. In 2020, savings increased, foreign finance was widely available, and many governments and financial and nonfinancial firms used them to build liquidity buffers. From mid-2021 through the second quarter of 2022, both external and domestic finance showed stronger growth dynamics. However, this trend took a turn for the worse as inflation increased, international and domestic interest rates rose, high debt ratios materialized, and financial markets became more volatile.

This chapter discusses the major challenges and potential risks faced by Latin American and Caribbean countries in international and domestic financial markets. Despite repeated shocks, financial markets remain strong. However, both international and domestic finance are confronting increasing vulnerabilities and authorities need to be vigilant to avoid significant disruptions.

Threats to External Financing

Global developments associated with the war in Ukraine, global inflation, and rising interest rates combined to increase financing needs in Latin American and Caribbean countries. The current account deficit in the median country widened from 2.3% in 2021 to 3.7% of GDP in the third quarter of 2022 (Figure 5.1). Current account deficits expanded in most countries in the region, although the size of the deficits varied.¹ The case of commodity exporters is notable; despite the growth in commodity exports, the current account deficit expanded. This increase may reflect rising import prices associated with higher global fuel and food prices, increasing transport costs, and higher interest payments due to the global response to the inflationary outburst (see Chapter 2).²

¹ Guyana is excluded from all the analyses in this section due to its recent oil discoveries and the resulting structural transformation.
² Simultaneously, the demand for liquidity increased significantly.
Growing current account deficits in the median country have been accompanied by deteriorating trade balances. The behavior of the trade balance, however, varies more than that of the current account. In particular, the trade balance deteriorated in tourism-dependent countries during 2021 and 2022 (coinciding with the 25th percentile in Figure 5.2), while commodity exporting countries enjoyed positive trade balances in the same period (coinciding with the 75th percentile in Figure 5.2).

As the year progressed, so did the strain on current accounts, which worsened for the entire region in 2022. Russia’s invasion of Ukraine substantially changed the prospects for current accounts; deficits were projected to increase on average 1.5 percentage points of GDP during the year, especially among oil importers, because of the war’s impact on energy and food prices (Figure 5.3). Forecasts were adjusted upwards an additional half a percentage point later in the year due to the impact of higher interest rates. The larger and longer-than-expected shock to inflation in advanced and emerging economies led to tighter monetary policies, reduced global liquidity, and greater financing needs even among net commodity exporters.

As economic activity slows down in 2023 and global inflation declines, pressure on interest rates may diminish, and current account deficits could contract. The size of this contraction may depend on macroeconomic policies. If fiscal policy helps reduce risk spreads, country-specific interest rates may fall in tandem with global rates, easing fiscal and external pressures.
FIGURE 5.2  ● Trade Balance

Source: IDB staff calculations based on IMF Balance of Payments Statistics (BOPS) and central banks.
Note: Data include all IDB borrowing countries except for Barbados and Venezuela due to data availability and Guyana due to the structural break in the series.

FIGURE 5.3  ● Change in 2022 Current Account Deficit Forecast

Source: IDB staff calculations based on IMF (2022a) and IMF (2022b).
Note: Data include all IDB borrowing countries except for Barbados, Haiti, Trinidad and Tobago, and Venezuela due to data availability, and Guyana due to the structural break in the series. The figure shows the change in the current account deficit forecasts the IMF estimates twice a year for their World Economic Outlook (WEO). The dark-colored column indicates the difference between the April 2022 vintage forecast and that in October 2021. The light-colored column shows the change in the October 2022 forecast with respect to that in April 2022.
As the counterpart of the current account deficit, the financial account surplus in third quarter 2022 reached its highest level since 2015. The median surplus was 3.7% of GDP (see Figure 5.4). Notably, despite tight global financial conditions and higher risk spreads, financial markets remained open for the region. In fact, average sovereign yields increased about 3 percentage points during 2022 (see Figure 1.2).

In 2023, external financing needs are expected to decline in line with the expected contraction of the current account. Nonetheless, to maintain access to external financing, strengthening fiscal consolidation should remain a policy priority (see Chapter 3).

The region’s main source of external finance is foreign direct investment (FDI). The greater stability of FDI compared to portfolio or other investment flows, and its resilience in times of global stress is a strength for the region in 2023. However, even these relatively stable flows are subject to much volatility, particularly in commodity-producing countries in which FDI is associated with commodity production sectors and follow commodity prices closely. If commodity prices remain volatile, FDI will most likely follow suit.

Still, external financing needs generally exceed expected FDI inflows (Figure 5.5, Panel A). While FDI will remain an important source of external financing, representing 2% of GDP in the median country, several countries are expected to rely on other types

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3 Financing needs may be higher depending on the debt amortization schedules of countries or the realization of higher investments in specific countries that require higher external finance.

4 See Cavallo et al. (2022).
of flows. According to IMF estimates,\textsuperscript{5} multilateral debt will be a key source of financing for several countries. Given the slowdown in economic activity in the region, and the traditionally counter-cyclical behavior of this type of lending,\textsuperscript{6} multilateral debt is expected to cover part of the anticipated decline in private capital flows (multilateral debt falls under the other investment category in Figure 5.5, Panel B). Other sources of finance may remain relatively scarce and volatile. Portfolio investment in the region, for example, has suffered a steep decline since 2021, following the consolidation of fiscal accounts (see Chapter 3).

\textsuperscript{5} See IMF (2022b).
\textsuperscript{6} See Powell and Valencia (2023).
Prepared for a Sudden Stop?

High global rates, and risk premia imply more volatility than usual in capital flows and, hence, risks for the financing of the current account. The key question is if, as in the past, periods of high inflation and global interest rates will be followed by episodes of financial stress 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 avoided sudden stops in capital flows thanks to their strong fundamentals. Table 5.1 presents key domestic indicators identified by the literature as determinants of the likelihood of sudden stops: fiscal balances and the current account, the degree of liability dollarization, and the availability of foreign reserves. To assess the region’s vulnerability to sudden stops in 2023, its position vis-à-vis these key variables in 2022 are compared to its situation in 2007 and 2019.

On the one hand, Table 5.1 shows that the region has a weaker fiscal position compared to previous distress episodes, as seen in Chapter 3. Similarly, current account balances are now larger, implying that external financing needs are greater as well. While weaker fiscal accounts are common across countries regardless of their monetary regime, with respect to the current account balance, the patterns differ. The external balances for inflation targeting pioneers have tightened (0.5 percentage points of GDP since 2019) while they have remained the same or widened for all other countries.

On the other hand, liability dollarization has not changed significantly in the region. Before the pandemic, the trend was to reduce liability dollarization; that trend has changed

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**TABLE 5.1 Sudden Stop Leading Macroeconomic Indicators for Latin America and the Caribbean**

<table>
<thead>
<tr>
<th>(%) of GDP</th>
<th>Fiscal balance</th>
<th>Current account balance</th>
<th>Liability dollarization*</th>
<th>Reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT pioneers</td>
<td>-0.8</td>
<td>-2.7</td>
<td>-3.8</td>
<td>0.0</td>
</tr>
<tr>
<td>More recent IT</td>
<td>0.0</td>
<td>-2.5</td>
<td>-3.2</td>
<td>-5.0</td>
</tr>
<tr>
<td>Intermediate</td>
<td>1.3</td>
<td>-3.7</td>
<td>-3.2</td>
<td>2.1</td>
</tr>
<tr>
<td>Fixers</td>
<td>-0.2</td>
<td>-3.1</td>
<td>-4.0</td>
<td>-7.2</td>
</tr>
<tr>
<td>Regional median</td>
<td>0.1</td>
<td>-2.9</td>
<td>-3.5</td>
<td>-0.9</td>
</tr>
</tbody>
</table>

Source: IDB staff calculations based on IMF (2022b), IFS, and national sources.
Note: All reported values are medians. Excludes Guyana, Barbados, and Venezuela in all cases. IT (inflation targeting) pioneers include Brazil, Chile, Colombia, Mexico, and Peru; Most recent IT corresponds to Costa Rica, Dominican Republic, Guatemala, Jamaica, Paraguay, and Uruguay; Intermediate group is composed of Argentina, Bolivia, Haiti, Honduras, Nicaragua, Suriname, and Trinidad and Tobago; the group Fixers is The Bahamas, Barbados, Belize, Ecuador, El Salvador, and Panama. Liability dollarization data are available for Argentina, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Suriname, Trinidad and Tobago, and Uruguay.

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7 See Calvo, Izquierdo, and Loo-Kung (2012) for a discussion.
in recent years. Levels of dollarization have grown in countries that have recently adopted inflation targeting regimes—a matter that authorities should monitor closely. Additionally, international reserves have increased in all monetary groups with respect to 2019, as have savings prompted by the pandemic uncertainty. However, even though reserves exceed their 2019 levels, the ratio of international reserves to GDP decreased in most countries with respect to 2021 (see Figure 5.6). For the median country, the factors explaining this decrease include a 0.4 percentage point decline in the valuation of reserves, a 1 percentage point decrease due to exchange rate devaluation, a 0.6 percentage point reduction explained by the fall in real economic growth, and a slight 0.34 percentage point increase in the actual quantity of reserves, consistent with a robust demand for savings.

FIGURE 5.6 Contributors to Change in the International Reserves-to-GDP Ratio between 2021 and 2022

Source: IDB staff calculations based on IMF (2022b) and central banks.
Note: Barbados, Trinidad and Tobago, and Venezuela are excluded due to data availability and Guyana due to the structural break in the series. Valuation of reserves is derived implicitly as the difference between change in reserves and the actual change in dollar stocks of international reserves. Deflator and exchange rate effect is derived from the difference between U.S. dollar GDP and real GDP growth.
Overall, external risks are growing in many countries due to the combination of higher external needs and larger fiscal deficits that must be financed. In countries where liabilities in foreign currencies are growing, this needs to be monitored, and where they do not exist, measures to avoid currency mismatches in the balance sheets of financial institutions and firms should be enacted. Consolidating fiscal accounts is a key step toward strengthening the external position of the region given prevailing global uncertainty.

In Slow Motion: Credit and the Domestic Financial Sector

Despite access to foreign finance during the years of the pandemic, domestic financial credit growth diminished, likely due to high liquidity buffers and savings. Credit is a key pillar to support sustainable medium- and long-term growth. Firms and households need a healthy financial system to help them navigate through times of economic distress. During COVID, credit growth to the nonfinancial private sector in Latin America and the Caribbean, supplied by the domestic financial system, decelerated. The real growth rate of credit fell from average levels of around 4.2% between 2016 and the first quarter of 2020, to negative rates in the first two quarters of 2021. Since September 2021, real credit has recovered slowly at an average growth rate of 1.6% (see Figure 5.7). In nominal terms, credit also registered a significant slowdown during the COVID-19 pandemic from average annual growth rates of nearly 8% in the pre-pandemic years, to only 4.7% in 2020 and 2021. Starting in the last quarter of 2021, nominal credit resumed growth rates above 10%, a trend that continued during most of 2022. In the third quarter, as inflation and interest rates picked up, credit began to decelerate.

While credit supplied by the domestic financial sector kept flowing after the peak of the pandemic, cross border loans, or credit supplied by foreign financial institutions to firms and households in the region did not. Both in nominal and real terms, this type of financing contracted severely during the worst of the COVID-19 pandemic and has continued declining at a slower rate since 2021 (Figure 5.8). As rising global uncertainty and interest rates combined with increasing sovereign debt spreads, the growth rates of foreign loans stagnated at negative levels. As a result of the decline in foreign loans, firms and households in the region had less credit compared to the pre-pandemic years.

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8. The links between finance and economic growth are extensive. Levine (2005) and Buera, Kaboski, and Shin (2011) provide surveys of the literature and a recent discussion for emerging markets can be found in García-Escribano, Han, and Cuevas (2015), who find a positive relationship between bank credit and growth and explore in detail the channels through which different types of credit (commercial or consumer) affect growth. Discussions on limits on the amount of finance and growth can be found, among others, in Arcand, Berkes, and Panizza (2015).

9. A real credit contraction of 1.1% was reported in the first half of 2021. Not even during the global financial crisis of 2008–2009 did credit contract in real terms in the sample of countries plotted.
FIGURE 5.7 • Claims of Depositary Institutions on the Nonfinancial Private Sector

Source: IDB staff calculations based on IMF’s International Financial Statistics and Haver Analytics.
Note: The sample includes Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Mexico, Nicaragua, Paraguay, Peru, Suriname, Trinidad and Tobago, and Uruguay. The figure reports the median values of economy-wide aggregates across the countries included in the sample.

FIGURE 5.8 • Cross-Border Loans to Nonfinancial Corporations

Source: IDB staff calculations based on BIS Locational Banking Statistics.
Note: The sample includes Argentina, The Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Trinidad and Tobago, and Uruguay. The figure reports the median values of economy-wide aggregates across the countries included in the sample.
Ensuring a stable and healthy financial system is crucial to avoid a slowdown in economic activity. The current elevated level of domestic and global interest rates has the potential to cause financial distress and a corresponding economic contraction. In contrast to past episodes, banking systems in Latin America and the Caribbean seem to be well positioned to weather the upcoming shocks. The profitability of banks, which had fallen substantially during the peak of COVID, but that notably remained in positive territory, is now back to pre-COVID levels (Figure 5.9, Panel A). Capital adequacy ratios, a measure of available buffers to
deal with unexpected losses, remain above regulatory requirements (Figure 5.9, Panel B). As economies in the region have slowed down, nonperforming loans are now rising (Figure 5.9, Panel C). This behavior is natural since credit risk tends to follow the real business cycle. An increase in nonperforming loans was not recorded during the COVID pandemic due to regulatory forbearance measures that aimed to prevent the pandemic from having a more damaging effect on financial stability. Nonetheless, during the worst of the COVID years, banks raised their levels of provisions to deal with the pandemic’s potentially permanent impact on credit quality. As economies recovered, loan-loss provisions returned to their pre-pandemic levels.

A distinctive feature of bank balance sheets when the COVID-19 pandemic started was a swift shift towards holdings of public sector assets. This led to a reduction in risk-weighted assets as government bonds carry low or zero regulatory risk weight, and to an increase in the share of public sector claims in banks’ total claims (Figure 5.9, Panel D). As economies recovered in 2021 and 2022, the share of public-sector assets to total assets declined and correspondingly risk-weighted assets increased. This pattern is consistent with more dynamic credit to the private sector (Figure 5.7). However, the fact that risk-weighted assets are growing faster than public sector assets are decreasing may suggest that risk perceptions of private credit are now higher, a feature compatible with the expected slowdown in economic activity. To complement the view derived from balance sheet indicators, Box 5.1 presents an alternative estimation of risk based on market valuations.10

**BOX 5.1  ● Estimating Capital Shortages**

An additional estimate of underlying banking risks can be inferred from the market valuation of banks. Market prices are a useful mechanism to construct real-time indicators of banking system risk. These measures came under scrutiny in the aftermath of the global financial crisis, as they failed to respond enough to the fast-moving impact of the risk of nontransparent, structured products and derivative transactions. Arguably, they are more suited to the current situation, whose potential risks stem more from slower moving credit problems. Using equity-based risk models that draw on option pricing theory, Perraudin, Powell, and Yang (forthcoming) estimate the probability of bank capital shortages for a subset of large, listed banks in the region. The estimate assumes a bank would default when its ratio of assets to liabilities reaches a certain threshold.

To compute the probability of capital shortages, the estimate requires data on the market capitalization of banks and its volatility, the value of liabilities of the bank that are assumed constant at the level of the last balance sheet reported, interest rates, and a specified time horizon for possible default. Using a sample of 1,122 banks in 87 countries, assuming a threshold of 97% under which the value of assets to liabilities would trigger a default, and a five-year horizon, Figure 5.1.1 reports the average probability of capital deficiencies for banks grouped by regions of the world in Panel A, and for Latin America and the Caribbean by bank size in Panel B.

(continued on next page)

10 Loan moratoria and reprofiling of loan policies adopted at the beginning of the COVID-19 pandemic have expired in almost all countries in the region. However, where extended, balance sheet indicators may mask the true level of risk underlying financial activity.
Higher Risk and Lower Investment in the Corporate Sector

The corporate sector in Latin America and the Caribbean emerged from the pandemic with high debt levels compared to historical averages and other emerging economies (Figure 5.10, Panel A). Indeed, during the first half of 2022, the median firm in Latin America...
and the Caribbean held a total debt-to-assets ratio of 28%, which is around 12 percentage points larger than the median firm in other emerging economies. This trend is consistent with credit growth figures for the private sector (Figure 5.7). The scenario is worrisome given the tightening financial conditions faced by the region in 2022 and the slowdown in economic activity expected for 2023.

The elevated level of uncertainty at the onset of the pandemic led firms to accumulate unprecedented amounts of liquid assets as a precautionary move (see Figure 5.10, Panel B) at the expense of investment in physical capital (see Figure 5.10, Panel C). In addition

**FIGURE 5.10  Building Up Balance Sheet Vulnerabilities in the Nonfinancial Corporate Sector**

A. Leverage: Total debt/assets

B. Cash and short-term investment/assets

C. Gross investment/assets

D. Distance to default

Source: IDB staff calculations based on data from Refinitiv.
Note: The figures display the median value of the respective variable across firms in five countries in Latin America and the Caribbean: Brazil, Chile, Colombia, Mexico, and Peru. All figures are in % of total assets and calculated as moving averages over four quarters. Total debt in Panel A encompasses only debt obligations with interest-bearing debt outstanding, while cash in Panel B includes cash on hand and short-term investments. The investment rate in Panel C is measured as gross capital expenditures over total assets. Panel D illustrates the number of standard deviations from bankruptcy; distance to default is a measure of corporate risk using the framework by Merton (1974). The sample period is 2002Q1–2022Q2.
TABLE 5.2  • Firm Fundamentals in Latin America and other Emerging Economies

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<th>Pre-crisis</th>
<th>Covid</th>
<th>Post-crisis</th>
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<td>2018Q4–2019Q3</td>
<td>2020Q1–2020Q4</td>
<td>2021Q3–2022Q2</td>
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<td>Return on assets</td>
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<tr>
<td>Latin America and the Caribbean-5</td>
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<td>2.4</td>
<td>4.6</td>
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<tr>
<td>Other emerging economies</td>
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<td>2.9</td>
<td>3.5</td>
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<tr>
<td>Leverage</td>
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<td>Distance to default</td>
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<td>Latin America and the Caribbean-5</td>
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<tr>
<td>Other emerging economies</td>
<td>3.1</td>
<td>3.1</td>
<td>3.7</td>
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</tbody>
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Source: IDB staff calculations based on data from Refinitiv.
Note: First, the median value per quarter is computed and then, a simple mean of medians is drawn over periods. Latin America and the Caribbean-5 corresponds to Brazil, Chile, Colombia, Mexico, and Peru, while Other emerging economies corresponds to other emerging countries excluding Latin America and the Caribbean. Return on assets is net income to assets. Leverage is total debt to assets. Distance to default is a measure of corporate risk using the framework by Merton (1974).

to this preventive behavior, governments supported the significant spike in the cash-to-assets ratio by deploying large fiscal packages to sustain firms’ finances and avoid large bankruptcies during the pandemic (see Cavallo and Powell, 2021).

Even though the region’s corporate sector is still highly indebted and facing elevated risks, the return on assets of the median listed firm in Latin America and the Caribbean has recovered and exceeded its pre-pandemic levels in 2022 (see Table 5.2). Also, average profits in Latin America and the Caribbean have grown since the COVID-19 pandemic, while they have stagnated in other emerging economy corporate sectors. Corporate profits grew in all five countries in the sample, with Peru’s corporate sector enjoying a notable 1.8 percentage-point jump relative to pre-COVID-19. In part, the resilience in profit rates is owing to the recovery in economic activity and aggregate demand during 2022.

On the risk side, firms’ leverage (total debt over assets ratio) is higher than before the pandemic (in contrast to other emerging economies) and higher than in other emerging economies (28.5% vs. 17.8%). High leverage creates more challenges for corporates as it tends to harm investment through a debt overhang effect (see Powell and Valencia, 2023), which may only worsen given the higher borrowing costs following the spike in worldwide interest rates.

Additionally, firms in the region face a higher risk of default than other emerging economies, and higher than in their pre-crisis period.11 This elevated level of risk is generalized

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11 The distance to default measure is defined by Merton (1974) and a higher number indicates a greater distance to default, while a number closer to zero indicates that firms are closer to default.
across economic sectors. The median firm in all industries, except mining, faces a higher risk of defaulting on debt than before the pandemic. The specter of default is another factor holding back physical investment in the region. Mining’s recovery is likely related to the increase in international commodity prices.

Recent developments in the Latin American and Caribbean corporate sector show that the high levels of debt and risk that firms built up during the pandemic have yet to recede. Investment fell sharply at the beginning of the pandemic, and the recovery process has been slow. Despite many signs of slow and incomplete recovery, with the distance to default decreasing and leverage increasing, the positive news is that the return-to-assets of listed companies has started to rise. However, the global outlook for 2023, including the high cost of borrowing and the possibility of a slowdown in worldwide economic activity, might delay the recovery of private investment.12

Policy Recommendations

The rise in global inflation, the subsequent hike in interest rates, and a shift towards more risk-averse portfolio management in the context of intense geopolitical uncertainty strained financial markets in emerging economies. While foreign capital continued to flow in, its cost increased notably. The region’s EMBI yields rose from 5.5% to 8.5% during 2022. As economies worldwide decelerate, financing needs in Latin American and Caribbean countries may diminish, reducing the vulnerability to sudden stops in capital markets. However, to reduce vulnerabilities, countries need to consolidate their fiscal positions.

One source of concern is the growing trend in liability dollarization in some countries. While this may reflect expanding capital markets with all the potential benefits to productivity growth that this expansion entails, close monitoring is needed to avoid currency mismatches, which can hurt financial and nonfinancial firms when exchange rates fluctuate. Prudential regulation should be in place to mitigate this concern.

The recovery of credit in the region has been fragile, as is clearly noted in the financial stability reports of central banks.13 Authorities understand that risks associated with external forces are mounting. Financial stability reports highlight that these risks could affect the cost of credit, economic activity, and the solvency of creditors, particularly in consumer credit, mortgages, and the smaller corporate segments; however, they also suggest that financial institutions are well capitalized and well provisioned to weather the risks safely.

12 A key question is if firms will be able to rebuild their capital stocks. Overall, firms’ fixed assets are lower as firms did not invest much during the pandemic, but there is heterogeneity between sectors (see Powell and Rojas-Suarez, 2022). While all firms now have a lower level of fixed assets, those that suffered less from the negative shock, specially via their revenues, have a much better chance of being able to rebuild their investment.
13 See, for example, Banco Central do Brasil (2022), Banco Central de Chile (2022), Banco de la República (2022), Banco de México (2022), and Banco Central de Reserva del Perú (2022).
A challenge for the region is how to increase the access of small and medium-sized enterprises to credit. Despite low levels of debt, access to credit for this segment is notably constrained.\textsuperscript{14} Authorities should design programs that discriminate better and promote the recovery of pre-COVID fixed asset levels and investment in the new technologies needed to adapt to digitalization. Additionally, they should consider a wider set of financing options.\textsuperscript{15}

Maintaining the overall stability of the financial sector to ensure that potential problems arising from weak banks do not lead to systemic problems is critical. Authorities need to be alert to the full gamut of potential risks. Uncertainty remains high and potential risks are lurking. Traditional balance sheet indicators may not provide an accurate assessment of risk (see Box 5.1). Under these circumstances, stress testing systems at the individual bank level are a valuable supervisory tool. While many countries implement stress testing to anticipate macroeconomic and systemic events, stress testing can also help identify institutions facing unusual circumstances and allow supervisors to design specific plans to overcome situations of distress or, when necessary, devise a robust recovery strategy.\textsuperscript{16} Providing more information regarding these plans to complement current balance sheet indicators may also boost confidence among investors and other agents seeking more credible information in these uncertain times.

\textsuperscript{14} See Powell and Valencia (2023) and Cavalcanti et al. (2021).
\textsuperscript{15} See Powell and Rojas-Suarez (2022) for a discussion.
\textsuperscript{16} Basel II’s Pillar 2 (encapsulated in Basel III) allows supervisors to request additional capital depending on the results of stress tests.
CHAPTER 6

Challenges and Opportunities

When the region was still recovering from the COVID-19 pandemic, Russia’s war in Ukraine disrupted several markets and brought new challenges. With the war, regional and global growth perspectives plummeted, and financing costs rose. Even so, 2022 was a better-than-expected year for Latin America and the Caribbean. In April 2022, the IMF forecasted growth at 2.5% for the year. It subsequently upgraded its projection to 3.5% in October, and current estimates suggest that growth was 3.9%.

Inflation rose everywhere in 2022, and the region was no exception. The median annual inflation rate in Latin America and the Caribbean reached 9.6% in July 2022, the highest since the global financial crisis in 2008. And this was the pattern for all Latin American and Caribbean countries, regardless of their monetary policy regimes. This price behavior reflected increased commodity prices, fertilizer prices, supply chain constraints, and pent-up demand from the COVID-19 crisis. As a result, central banks increased rates by more than 500 basis points in only one year.

Poverty and inequality levels returned to pre-pandemic levels as labor market conditions improved. By September 2022, employment had surpassed its pre-pandemic levels. A critical question is whether these gains will prevail as inflation and uncertainty about economic perspectives remain elevated. Since economic growth is the primary determinant of poverty reduction, policymakers should focus on measures to avoid contractions in the short term, and reforms to boost productivity growth in the medium and long run.

The fiscal consolidation process in the region continued in 2022, with fiscal balances returning to their pre-pandemic levels. As a result, the primary deficit in 2022 is estimated at only 0.4% of GDP, reaching 4.8% of GDP in 2020 and 1% in 2019. Additionally, gross debt decreased from 71% of GDP in 2020 to 64% by the end of 2022; however, it is still higher than before the pandemic (57% of GDP) and estimated prudent debt levels (54% of GDP). Moving forward, the declining trend is expected to revert slightly as interest rates rise and growth slows; by 2026, debt ratios may reach 67% of GDP. Therefore, policies to strengthen fiscal consolidation are recommended.

1 See Powell and Valencia (2023).
Since the worst part of the pandemic, most countries have enjoyed good access to external financing from private and multilateral sources. However, the second quarter of 2022 ushered in a turn for the worse as inflation increased, international and domestic interest rates rose, high debt ratios materialized, and financial markets became more volatile. As a result, in 2022, the region’s EMBI yields rose from 5.5% to 8.5%. Still, in the first month of 2023, regional governments engaged in exceptional bond issuance. As economies decelerate and current accounts contract, financing needs in Latin American and Caribbean countries may diminish, reducing exposure to sudden stops in capital markets. However, governments must consolidate their fiscal positions and tackle liability dollarization to minimize vulnerabilities.

The perspectives for 2023 present challenges and opportunities. World growth prospects are weaker and, given the need of central banks across the world to tame inflation, global interest rates are higher. As a result, Latin American and Caribbean countries face a year of depressed global demand—compensated in part by China’s reopening following its very strict COVID-related shutdowns—and high financing costs. Moreover, financing costs may continue to rise in some countries struggling to stabilize inflation. This combination may contribute to a slowdown in growth. The future may look even bleaker if growth is lower than expected and interest rates rise even more. However, against this backdrop, countries in the region still have policy room to maneuver and avoid deep economic contractions.

Inflation, in most countries, has started to show signs of slowing down. However, it will remain above target until at least 2024, and monetary policy interest rates will stay above neutral levels. Central banks will struggle to maintain inflation expectations anchored and keep a tight monetary stance until expectations align with targets. A de-anchoring of expectations would be very costly in the future. Though monetary policy rates have had a much larger impact on reducing inflation than hurting growth and labor markets, a trade-off still exists. To mitigate the potential effects, monetary policy needs to rely on consistent fiscal and economic policies. In this context, the independence of central banks is crucial and is a priority to control inflation.

Fiscal policy needs to consolidate and reach lower deficits and debt ratios. Not only is this necessary in itself, but it is also crucial to enhance the efficiency of monetary policy. Improving fiscal institutions helps reduce sovereign credit risk, which leads to reductions in the neutral interest rate. It also provides central banks with additional space to ease monetary policy interest rates and limit the trade-offs in terms of economic activity. Fiscal consolidation also helps diminish pressure on aggregate demand. Through these channels, it helps align inflation and inflation expectations with their targets. However, consolidating fiscal accounts is challenging and implies implementing complex policies. Reducing

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2 See Powell (2016).
monetary policy rates also brings down government bond rates if sovereign risk does not increase, thus contributing to fiscal consolidation.

Strengthening fiscal positions and reducing debt to prudent levels demands a combination of actions that vary according to each country's specific situation and characteristics. However, most countries need policies to increase the efficiency of expenditure and tax revenue collection, improve fiscal institutions, and adequately manage debt.

Expenditure efficiency can be attained through improved targeting of transfers and subsidies and strategies to enhance the quality of public investment. These policies also promote a progressive use of public expenditure, which helps provide a safety net for the poor, and contributes to long-term growth via productivity enhancements. Furthermore, at the current juncture of high inflation, wage adjustments should follow expected inflation rather than observed inflation to reduce the risk of future increases in inflexible spending.

On the revenue side, many countries are planning tax reforms in the coming two or three years. When considering a reform, the focus should be on expanding the tax base and reducing tax evasion and tax avoidance. Additionally, promoting the progressivity of the tax structure is critical. A negative income tax, for example, allows for more efficient management of taxes and subsidies and also contributes to combating high levels of informality.

Strong fiscal institutions are crucial for fiscal consolidation. Debt-anchored fiscal rules and independent committees that support them enhance market confidence that fiscal accounts will remain around medium-run targets compatible with macroeconomic and financial stability. Having these institutions in place contributes to lower debt and also allows for a more gradual transition to a lower level of debt.

Active debt management practices that smooth the debt service burden over time may help consolidation. Exchanges of expensive short-term debt for long-term debt at lower costs would benefit many countries, and multilateral institutions can play a vital role in this process.

Coordination among policies must go beyond the fiscal and the monetary arenas. A key example is the negotiation of public sector wages and, where relevant, minimum wages. Wages should be set considering expected future, rather than past, inflation to avoid the persistence of inflation and the buildup of additional public expenditure inflexibilities. In addition, labor market policies should promote formality and reduce the gender gap. Policies that grant access to social security benefits regardless of the labor market status of workers are part of the solution. Better labor and social security policies that support successful career paths for all workers improve productivity and equity.

Boosting selected, high-quality infrastructure can crowd in private sector investment, improve labor market dynamics, and help reduce inequality and poverty. Accompanied by mechanisms to increase the efficiency of expenditure, this can lead to a reduction in poverty figures.
The region has benefited from a solid financial sector. However, rising global financing costs and lower economic activity may stress financial markets and institutions. Even though external markets have been open, financing costs have increased substantially, and vulnerability to stress episodes is growing as financial dollarization increases and fiscal positions remain weak. Therefore, prudential measures that limit the exposure of financial and nonfinancial firms to exchange rate risks are advisable. Similarly, financial supervisors should enhance the use of stress tests as a policy tool to address specific weaknesses in financial institutions and produce detailed plans to manage them. Providing more information on such plans also boosts confidence among investors and other agents seeking more credible information in these uncertain times. In addition, adjusting prudential regulation and supervision is increasingly becoming necessary to address the risks of climate change in the balance sheet of financial entities in the region. Doing so may also signal greater confidence about how the region manages its financial risks.

Overall, 2023 will be challenging for Latin America and the Caribbean, given the complexity of the global scenario and its significant uncertainties. As a highly integrated region, particularly in financial terms, the global cycle will influence the region. The magnitude of the impact of external fluctuations will depend on the region’s strengths and weaknesses. A more robust current policy framework is therefore critical. Latin America and the Caribbean has the tools to address its triple challenge of improving social conditions, strengthening fiscal accounts, and promoting long-term growth. By harnessing these tools, the region’s policymakers can prepare the macroeconomic terrain for renewed growth.
References


