CENTRE FOR ECONOMIC POLICY RESEARCH

CEPR PRESS

Edited by Ilan Goldfajn and Eduardo Levy Yeyati

# Latin America: The Post-Pandemic Decade

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**CEPR PRESS**

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# Foreword

The devastating effects of the Covid-19 pandemic impacted countries worldwide, yet for governments in the Latin America region, the crisis has compounded a series of pre-existing social, economic and health issues which has heaped further pressure on already strained governmental systems. Poverty alleviation and progress towards reducing inequality have stagnated in recent years, as social expectations have become increasingly harder to meet.

As a result, the Covid economic downturn has been more pronounced in the region, and long-run damage – such as that interconnected with education deprivation or job destruction – will likely be larger and more persistent. The pandemic has also highlighted acute regional deficits, including poor state capacity and labour exclusion and informality, which have contributed towards a poor economic recovery from the pandemic. These underlying issues, when added to a feeling of general mismanagement during the pandemic, have aggravated societies across the region, revealing dissatisfaction which could hamper the implementation of future economic policies.

This timely eBook brings together leading Latin American researchers and policymakers to discuss the sizeable challenges ahead and map out policy options for a sustainable, equitable and stable future for the region. Chapters discuss how, without the requisite policy responses, the pandemic will continue to drive excess mortality through disrupted health services and will worsen economic instability and deepen existing inequalities. The contributors discuss what lessons can be learned for future crisis management, suggest reforms for endurable growth, and highlight the impact of social challenges in the region. Without policies that put the general interest first in providing goods and services that are essential to the public at the heart of the post-pandemic landscape, societal problems will only worsen.

CEPR is grateful to Ilan Goldfajn and Eduardo Levy Yeyati for their expert editorship of the eBook. Our thanks also go to Anil Shamdasani for his skilled handling of its production.

CEPR, which takes no institutional positions on economic policy matters, is delighted to provide a platform for an exchange of views on this important topic.

Tessa Ogden
Chief Executive Officer, CEPR
December 2021

# Introduction

**Ilan Goldfajn and Eduardo Levy Yeyati**
Credit Suisse Brazil and CDPP; Universidad Torcuato Di Tella



**The impact of the Covid-19 pandemic on world GDP growth was massive. For Latin America, it represented a moment of reckoning. Taking into account the differences across countries, it highlighted long-standing fiscal and social deficits, overstretched public sector resources and deepened a growing discontent with the economic status quo, the political system and, to some extent, with liberal democracies in the region. As a result, the consequences of the pandemic limit the economic and political spaces to deal with all these challenges in the future.**

Against this backdrop, this volume collects a series of conversations with distinguished Latin American researchers and policymakers aimed at trying to map a possible future for Latin America. We start with a brief review of the effect of the pandemic and then summarise our conversations in four sections that focus on avoiding the next crisis, policies for sustainable growth, social challenges and the future of democracy.

Section I, "Avoiding the next crisis", brings together contributions from Laura Alfaro, Roberto Chang, José de Gregorio and Federico Sturzenegger. The section centres on crisis management: what are the lessons learned from the Covid crisis, and what should we do to avoid the next one?

The most pressing issues are related to the fiscal and debt fronts. Although everybody recognises that the upfront response to the pandemic was necessary and desirable, the question remains whether this has created a long-term fiscal imbalance. Overall, the majority conclude that public debt may increase even further in the years to come, with the risk of debt overhang and financing difficulties. Naturally, the analysis depends on country-specific characteristics and on the institutional capacity to resist political pressures to maintain spending without any compensating adjustment, at a time where there is no additional fiscal space. The answers in the section are rich enough to explore the diversity of cases and their particularities. Going forward, fiscal policy, if faced with a similar situation in the future, would need to be better calibrated and focused, reducing unnecessary and useless public good expenditures during the crisis. Regarding future episodes, the contributors argue that policymakers would need to react in an overall more reasoned way – faster and avoiding policy overreaction.

Most interviewees believe that monetary institutions in the region should maintain their focus on price and financial stability. They reject the view that monetary policy could somehow be thought of as unconstrained, and there is still no convincing argument in favour of monetary financing of fiscal policy in emerging economies. Given the past history of inflation in the region, central bankers will be less willing to believe in easy

monetary solutions. The dialogues in this section contemplate the possibility of higher global interest rates in the near future and their dire consequences for the region, but the probability of such an adverse scenario is still far from consensus. That said, policymakers cannot ignore the fact that a combination of higher levels of debt and interest rates could make macroeconomic and financial management much more challenging in the future. This is a time for effective policymaking.

Several other interesting issues are addressed in the section, including the need for more inclusion as a way to prepare the next crisis – inclusive societies would not have avoided Covid but would have been able to respond to it in a more organised and effective fashion – and the recognition that as equality, in a broad sense, is legitimately at the core of popular demands, there is a need to avoid returning to the old Latin American populism. On this, success is not guaranteed.

Section II, "Policies for sustainable growth", includes dialogues with Marcela Eslava, Ricardo Hausmann, Rodrigo Valdés and Alejandro Werner.

Returning to sustained growth is a key challenge for Latin American economies. This section discusses the causes of the dismal performance of Latin America and the post-Covid policies needed to change this reality. Contributors in this section suggest that the region will witness important rebounds during 2021-2022. The recovery that started in the second half of 2020 gained strength as the economies gradually reopened following rising vaccination rates. Some countries will be reaching 2019 GDP levels in 2021; others, in 2022. However, the concern is that these recoveries will be short-lived. And if global financial conditions become less supportive, the next decade could be quite demanding.

In the medium term, Latin America is expected to exhibit significant scars from Covid, as growth is expected to be permanently below the levels anticipated before the pandemic. But the severe problem of the limited growth potential of the region predates the crisis. And, even for countries that grew more than the Latin American average, the post-pandemic future looks bleaker. The contributors highlight several reasons behind this modest performance. The first and the most commonly cited is macroeconomic mismanagement (high inflation, financial fragility leading to balance-of-payments crises). However, even countries that successfully achieved macroeconomic stabilisation failed to achieve sustained growth. It follows that the forces behind low growth are more complex: the business environment has been feeble; there is a lack of appropriate governance; the natural resource curse applies in some countries, with weak institutions and short-sighted governments with the perception that there is no need for further effort; there are social, political and institutional factors that complicate the building of a consensus around an economic policy framework that sets the foundations for medium-term inclusive growth. In addition, relatively slow technological progress widens the region's technological gap with the advanced world. Moreover, while the lack of social progress cannot be solved merely with a redistributive strategy, the region's regressive income distribution and structural poverty are detrimental to growth through their

impact on the expected sustainability of economic regimes, as well as, on occasions, pure expropriation risk arising from social tensions. In the meantime, local talent remains undiscovered and undernourished for lack of opportunities.

Most doubt the possibility of implementing successful industrial policies in the region, sceptical that Latin American policymakers could efficiently substitute for the right market signals and incentives, and propose that the development strategy should be largely based on horizontal policies. But some see a role for the state to address the many unexploited externalities, arguing that public goods do not possess the market's invisible hand to signal where the information about what is needed, the incentives to provide these public goods, and the allocation of resources would come from. According to this view, policymakers should fulfil these tasks.

In Section III, "Social challenges ahead", Francisco Ferreira, Nora Lustig and Eric Parrado focus on the social aspects of the Covid crisis, its impact and challenges.

They argue that the pandemic increased inequality along several dimensions, as well as poverty, as those living in poorer areas, informal workers and minorities suffered the most from the pandemic. Despite these unequalising forces, governments could – and some actually did – make a real difference in mitigating the social impact of the crisis. Reflecting on poverty, some argue that the substantial number of households transitioning into poverty showed the importance of transitory poverty in the determination of coverage for social programmes in crises. And if the main objective is poverty reduction, replacing existing, targeted programmes with universal income programmes would have left the poor worse off.

The impact from the pandemic will ultimately prove temporary, but many of its consequences may affect people's lives for a long time. The contributors coincide on education losses potentially being Latin America's greatest and longest-lasting scar from Covid-19, given the long school closures and the fact that in-person learning proved hard to replace. Looking ahead, some argue that the pandemic has not fundamentally altered Latin America's key policy challenges and priorities but has made them more urgent by (most likely) worsening inequality, exposing the low quality of public services and highlighting the negative consequences of pervasive informality. The private sector has a tremendously important role, since public investment may be constrained in the coming years as countries grapple with the need for higher social spending when many will need to pursue fiscal consolidation to bring debt levels down. The interviewees agree that the reigning in of fiscal deficits will need to be implemented in a socially responsible way: under a comprehensive vision that considers all taxes and social spending.

Finally, in Section IV, "The future of democracy in Latin America", Edmar Bacha, Armínio Fraga, Andrea Repetto and Andres Velasco reflect on the protests and social discontent in the region, the noisy and unstable political environments (and what to do about them) and, more generally, on whether and to what extent this aspect may become a relevant driver and a binding constraint in the Latin American post-pandemic landscape.

Some argue that the macroeconomic indicators of the last 30 years – even in countries like Chile with high growth, an impressive fall in poverty and a reduction in inequality – do not capture the essential dimensions of inequality and the perceptions surrounding it. Others emphasise that the tolerance for income inequality and unfairness changes in the course of development, and the frustration with the present, and disillusion about the future, comes after a bout of improvements that have recently stalled. This has eroded trust in the leadership, leading people to believe that institutions are flawed – or worse, that they are working to further the interests of people in power, against ordinary citizens – and fuelling anger and protests. They argue that dissatisfaction with contemporary democracy should not come as a surprise, as almost every human endeavour has changed beyond recognition in the past 250 years – except democracy. Societies are experiencing radical political fractures, and social networks are part of this new radicalisation. Latin American countries are no exception to this overall picture given their long tradition of economic populism, and patrimonialism makes the problem more acute: the combination of a fixed-term executive presidency and a proportional electoral system in the region is prone to instability.

What can be done about this? Some forecast that we will end up reinventing social democracy in a way that addresses the key issues of our time: growth that is sustainable in all senses of the word (financially, environmentally and socially), although success is far from assured. That said, most argue that political and economic reforms that put the general interest first in providing goods and services that are essential to the public are badly needed to repair these problems. These reforms should get the macroeconomy back on track, allow for a much-needed change in spending priorities and – with the exception of Argentina and Brazil, countries with OECD-level tax burdens – allow the state to increase tax revenues and finance better social benefits without compromising stability and growth.

## ABOUT THE AUTHORS

Eduardo Levy Yeyati is the Dean of School of Government at Universidad Torcuato Di Tella in Buenos Aires, and the Founding Director of its Center for Evidence-based Policy (CEPE). He is also Principal Researcher at Argentina's (CONICET), non-resident Senior Fellow at Brookings, and affiliate to Harvard's CID. In the past, Eduardo was senior adviser to the Office of the Chief of Staff in Argentina, Head of Latin American Research and Emerging Markets Strategy at Barclays Capital, Senior Financial Sector Adviser for LAC at the World Bank, and Chief Economist at the Central Bank of Argentina. He holds a PhD in Economics from the University of Pennsylvania and a BA in Engineering from Universidad de Buenos Aires.

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# The Latin American pandemic

**Ilan Goldfajn and Eduardo Levy Yeyati**
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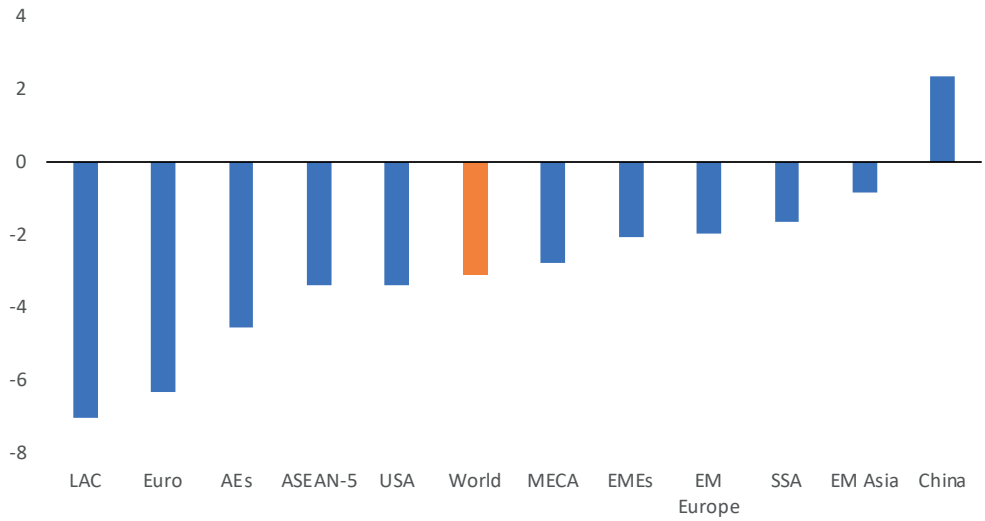
The Covid-19 recession was the deepest since the end of World War II. The world contracted by 3.12% in 2020 according to the IMF's October 2021 *World Economic Outlook*, a 6.5 point loss relative to the 3.4% growth forecast back in October 2019. But the impact was unequal. While virtually every country posted negative growth in 2020, the downturn was more pronounced in the poorest parts of the world (Figure 1). Moreover, long-run damage associated with education losses or job destruction will likely be larger and more persistent for developing countries.

**FIGURE 1 GLOBAL GDP GROWTH 2020**

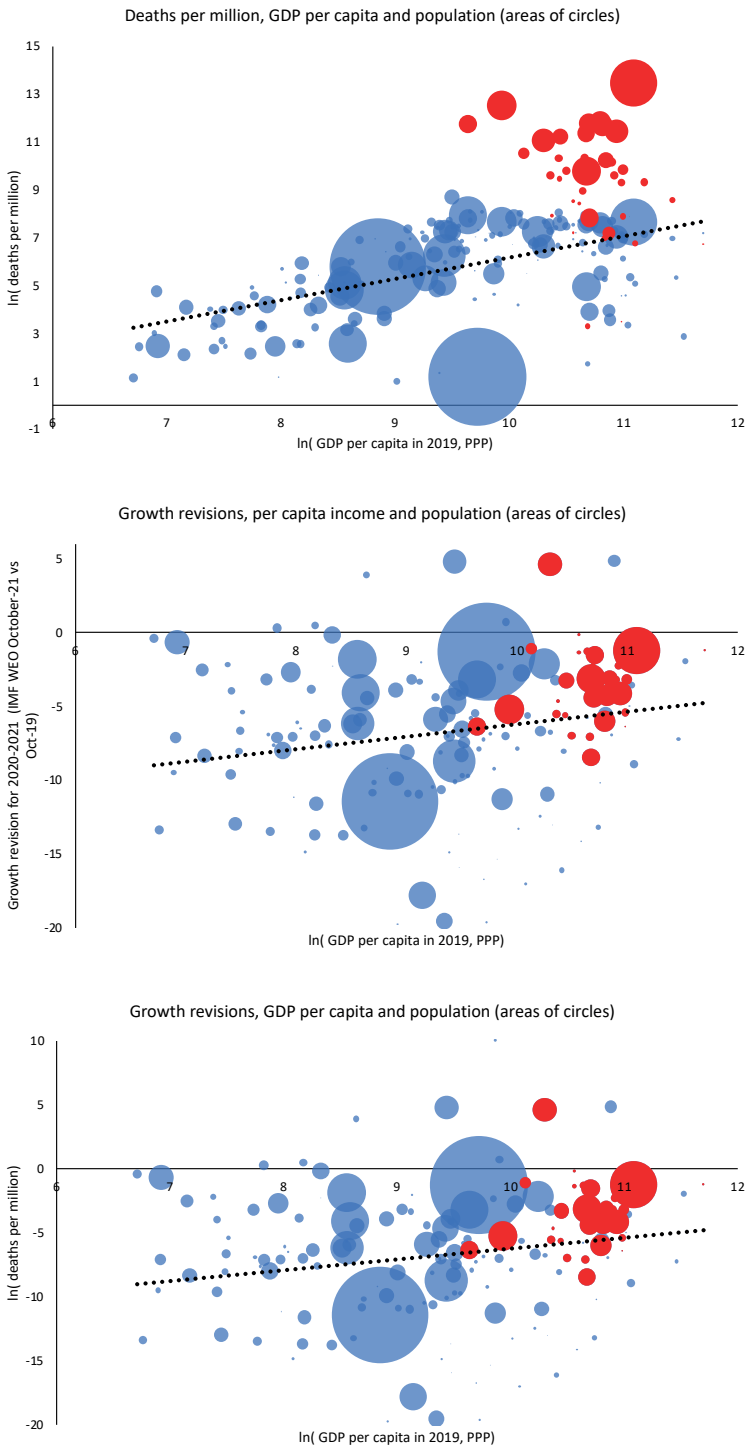



Source: Filippini and Levy Yeyati (2021a), based on the October 2021 *World Economic Outlook*.

Note: AE = advanced economies; EM Asia= emerging and developing Asia excluding China; EM Europe = emerging and developing Europe; LAC = Latin America and the Caribbean; MECA = Middle East and Central Asia; SSA = sub-Saharan Africa

Indeed, despite the fact that the size of the shock – imperfectly measured by the numbers of deaths per million – was on average larger in the advanced world, the sensitivity to the shock was larger in developing economies, leading to an overall downward revision of growth forecasts for the pandemic period (2020–21) that was inversely proportional to per capita income (Figure 2).

**FIGURE 2 THE COVID SHOCK, GROWTH REVISIONS (2020-21) AND PER CAPITA INCOME**

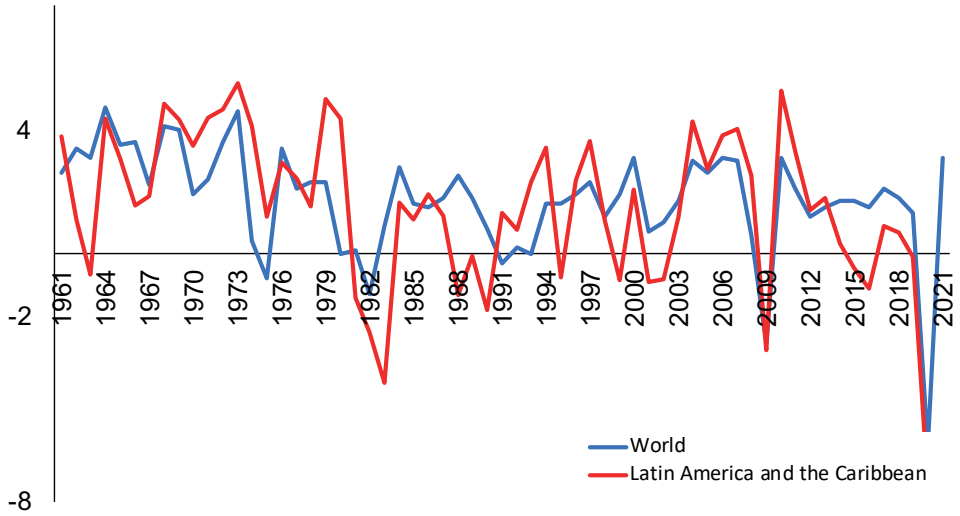



Source: Filippini and Levy Yeyati (2021b), based on October 2021 *World Economic Outlook* and Our World in Data.
Note: Red bubbles correspond to OECD countries. Trends in dotted lines. Deaths per million as of 1 October 2021.

The reasons are several: the relative fiscal space (to support the economy and to postpone the unwinding of the stimulus), the level of firm and labour informality, the generally more limited state capacity to mitigate the effects of the lockdowns on economic activity and on essential public services such as education. Contrary to what initial estimates suggested (Deaton 2021), the pandemic will likely widen global inequalities. Latin America will not be an exception to this pattern: Covid-19 probably contributed to deepening Latin American underperformance in economic growth – and, possibly, human development – and there is a risk of this persisting in the years to come.

**For Latin America, the pandemic came at an inconvenient time**. Not only did it hit the region after years of mostly lacklustre growth compared with global averages (Figure 3), at a time when the gains in terms of poverty and inequality had been tapering off and governments were finding social expectations increasingly harder to meet; it also flagged two long-standing but often overlooked regional deficits: poor state capacity, and labour exclusion and precariousness. These two features, which help explain both the welfare cost of the pandemic and the underperformance in the recovery, were likely behind the region's growing indifference with political regimes (Latinobarómetro 2021), and the dissatisfaction expressed, before and after the pandemic, in episodes of social outbursts in Colombia (2021), Chile (2019), Ecuador (2019) and, earlier, Brazil (2016). They also highlight a sometimes overlooked dimension: as the resistance and ultimate reversal of the Colombian tax package exemplifies, social dissent can severely condition economic policy looking forward.

**FIGURE 3 GLOBAL AND LATIN AMERICAN GROWTH FROM A HISTORICAL PERSPECTIVE**

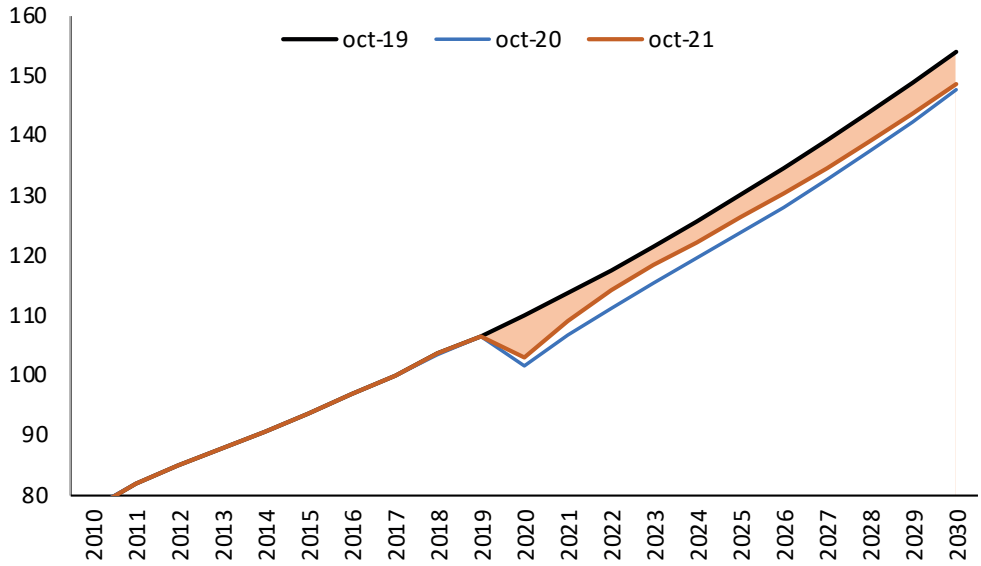



Source: Bolt et al. (2018); Kose et al. (2019, 2020); October 2021 *World Economic Outlook*; World Bank World Development Indicators.

Note: Data for 2021 are forecasts.

**The impact of the shock is likely to be long-lasting**. While the global economy is already recovering, indeed at a faster pace than originally predicted (as Figure 4 illustrates, forecasts were revised upward, particularly for advanced economies), the level of global output at the end of 2021 is projected to remain below the pre-virus baseline. Moreover, this global outlook masks important cross-country differences. Updating the methodology used in OMS (2021) to the latest growth revisions, a back-of-the-envelope estimate based on the IMF's pre-Covid and latest *World Economic Outlook* projections shows the expected output loss in Latin America to be roughly 76% of 2019 GDP, or nearly 70% larger than the global average (Table 1).

**FIGURE 4 GLOBAL GDP PROJECTIONS (CONSTANT USD, INDEX 2017=100)**




Sources: IMF *World Economic Outlook* October 2019, October 2020 and October 2021.

**TABLE 1 ESTIMATED COVID-RELATED OUTPUT LOSS (AS A PERCENTAGE OF 2019 GDP)**

| | World | AEs | EMEs | LIDCs | LatAm |
|---|---|---|---|---|---|
| Lost 2020 global GDP from Covid-19 | 6.5% | 6.3% | 6.8% | 4.8% | 8.8% |
| Lost 2021-30 global GDP from Covid-19 *(discounted at 0%)* | *40.1%* | *-3.6%* | *77.2%* | *101.4%* | *68.8%* |
| **Total GDP loss 2020-30 (discounted at 0%)** | **46.6%** | **2.7%** | **84.0%** | **106.2%** | **77.5%** |

There are additional, hard-to-quantify, non-linear channels influencing the realised and future Covid-related losses that are not incorporated in the GDP forecasts. In particular, we need to address the 15% of GDP global fiscal stimulus, without which the output loss in 2020 would have been much steeper. How much of this stimulus should be regarded as a cost? This is a non-trivial exercise since, according to the IMF Fiscal Monitor, almost half of the stimulus was below the line (loans, equity stakes, guarantees), with a cost that is contingent on the speed and composition of economic recovery in each country.[1]

As many of the contributors to this book emphasise, besides near-term output losses, there were many other deleterious consequences of the pandemic that include, most notably, significant education losses – a central point in the discussion in Section III. School closures posed a serious risk to human capital accumulation across the world, both in terms of effective hours of schooling and retention ratios (the increase in dropouts). More to the point of this book, these costs were highly regressive as they were more pronounced for low- and middle-income households and countries for two reasons: (i) they were ill-equipped to cope with distancing restrictions, and (ii) they had difficulties with home schooling (OECD 2020). In addition, a comprehensive calculation of the economic cost of the pandemic cannot ignore the value of the excess in deaths due –directly, or indirectly through health externalities – to Covid-19.[2] The same may be said about job and firm destruction (with its concomitant loss of job-specific human capital and firms' social capital and knowhow), untreated or un-diagnosed illnesses, the psychological toll of social distancing, and other sources of loss that can be only conjectured at this point. At any rate, the estimated output loss in Table 1 is probably a conservative lower bound.

## THE RESPONSE

**Unlike the global financial crisis, when monetary policy bore the greatest share of the burden, the Covid shock triggered an unprecedented (and heterogeneous) fiscal response from governments across the globe**. The fiscal stimulus was almost three times the amount observed during the global financial crisis (IMF 2020b), reaching nearly $16 trillion (around 15% of global GDP) at a global scale in 2020. This fiscal support included, most notably, salary subsidies; relief from contractual and financial obligations; liquidity support through equity injections and loans and loan guarantees (some governments encouraged banks to make use of available capital and liquidity buffers to support lending even at the risk of preserving nonviable 'zombie' firms); a sharp reduction of monetary policy rates and sustained quantitative easing by central banks to relax borrowing conditions in financial markets; and income support measures (mainly

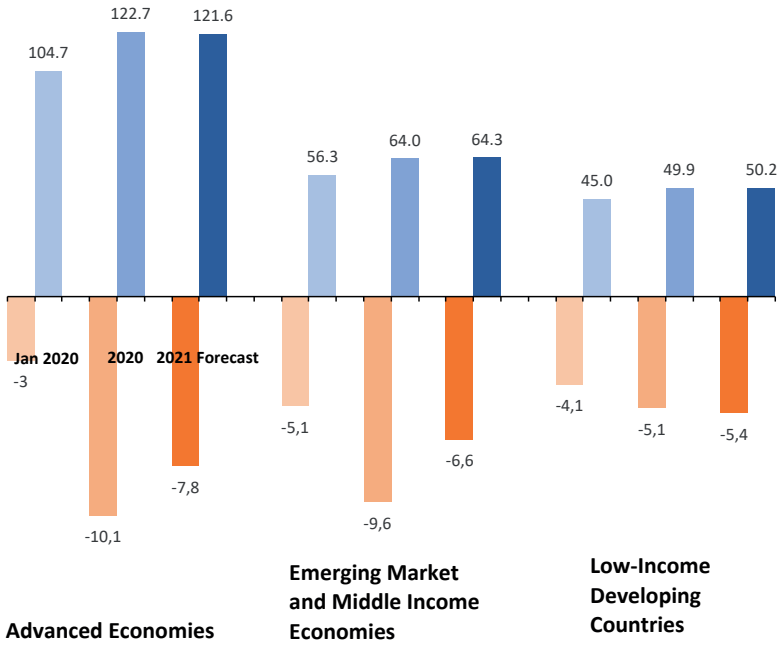
1 The economic impact of fiscal stimuli is also hard to appraise, since it depends on the ineffable fiscal multiplier, which in turn varies with the nature of the economic depression and the quality and composition of the package. However, for the purpose of our cost calculation, we can ignore the counterfactual (output losses in the absence of fiscal stimulus).

2 This is a broad estimate, as education losses have persistent consequences that will only be apparent in the long term. For example, Hanushek and Woessmann (2020) estimated the cost equivalent to a half academic year loss to be a 2.2% lower annual GDP for the remainder of the century, which, depending on the discount rate, could yield a larger total than the one we use in our exercise.

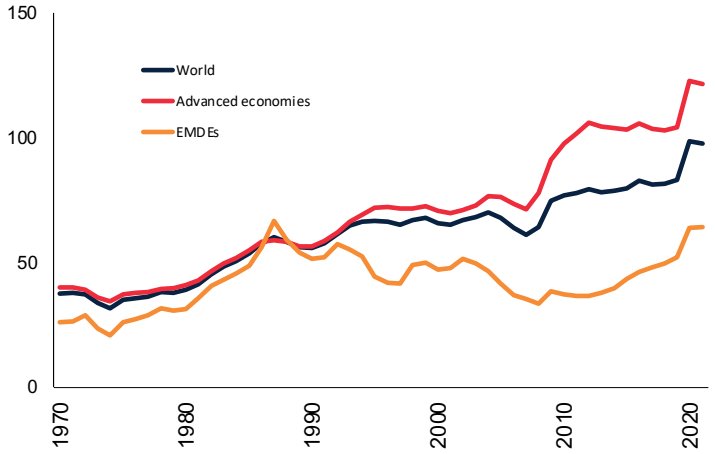
through cash transfers), which were particularly relevant in developing economies with a large degree of informal and self-employed workers without access to finance and outside of the labour support net.

**FIGURE 5 FISCAL RESPONSE (AS A PERCENTAGE OF GDP)**

a) Forecasts for general government gross debt and fiscal balances (as a percentage of GDP)




b) Government debt (as a percentage of GDP)




Source: Source: World Bank January 2021 *World Economic Prospects* and October 2021 *World Economic Prospects*. Data for 2021 is estimated.

Note: EMDEs = emerging market and developing economies. Aggregates calculated using current GDP in US dollars as weights.

**The fiscal dimension was, and will remain, crucial to analyse the differential impact of the crisis across regions**. Fiscal stimuli were originally calibrated under the assumption that this would be a one-off shock and were adjusted, by the time of the second and third waves of the pandemic, in proportion to countries' individual fiscal capacities. Ultimately, the increase in the fiscal deficit in advanced economies was double that in emerging and middle-income countries, and was five times larger than that in lower-income economies (Figure 5a). The sizable discretionary fiscal support, along with the contraction in output and fiscal revenues, led to an increase in government debts (Figure 5b).[3]

**In fact, the pandemic triggered a fiscal response that was unprecedented in terms of its speed and magnitude**. But while the fiscal response in some Latin American countries was on a par with OECD countries (for example, nearly 20% of GDP in Brazil and Peru, including above- and below-the-line items), the support was on average more modest (closer to 10%) than in advanced economies.

**And the effectiveness of this unprecedent fiscal stimulus is still not clear**. Some countries were not able to mitigate the impact of the decline in GDP; others did not offer protection to the most vulnerable part of their population. There was, as noted, a lack of capacity to focus on the most affected portions of the population, leading to waste of resources or the need for ever-larger emergency help packages. In fiscally constrained Latin America, this is a luxury that is not affordable.

**Overall, the capacity of countries to implement emergency measures varied significantly**. Three dimensions, already relevant prior to the pandemic, come up again and again in the dialogues to account for this heterogeneity:

- **Fiscal space**. The capacity to support household and firms largely depends on fiscal space to spend from the budget and/or access to financing, either domestically or in international financial markets. Several Latin America countries suffered from a lack of fiscal capacity. The result is that they either did not implement the needed fiscal stimulus or they will inherit debts and difficult fiscal situations going forward.
- **The capacity of the state to reach affected populations**. Fast and efficient implementation of policies to support households and firms requires information and 'capillarity' of institutions, organised and up-to-date databases on lower-income individuals and those in poverty, and good tracking of the people that fall into poverty and need help as a result of the shock. The latter – individuals who are vulnerable to large shocks like the Covid pandemic – is often closely related to informality, which is pervasive in Latin America. In addition to targeting capacity, channelling resources to these vulnerable individuals in a timely and organised manner demands logistics that are often missing in the region – hence cases like

3 Corporate indebtedness will also likely increase as firms are facing an abrupt reduction in sales, particularly in the developing world.

Peru, where well-funded programmes remained under-executed. In some cases, countries used their tax and social transfer systems; in others, existing public banks and their agencies, or privately owned financial systems. In a good part of the region, the lack of capacity to distribute the support, rather than the fiscal space to fund it, was the binding constraint.

- **Labour market informality**. The region suffers relatively more than others from informality. These workers either depend on face-to-face interactions or had significant difficulties adopting remote working. This meant that a large share of informal workers were immediately thrown into poverty, with limited capacity of the state to reach them. The result was high levels of poverty and inequality due to the crisis.

**Interestingly, monetary policy took the back seat to fiscal policy this time around**. In the global financial crisis, monetary reaction was crucial for developing economies – and to Latin American economies in particular. This time around, success in reacting to the pandemic shock depended more on the fiscal, political and social institutions, as argued above. This is not to say that there was no role for monetary policy. Monetary policy reacted successfully both with lower interest rates and with the provision of liquidity. In general, where financial markets existed, they continue to function properly. Central banks offered ample liquidity and financial institutions had no major immediate issues. This notwithstanding, financing was, again, hard to channel to those firms that needed it the most as financial institutions were shy to lend due to concerns regarding borrowers' capacity to pay, given the crisis, and a large share of micro and small enterprises with limited track record or a history of informality remained outside the lending net. This disconnect was hard to overcome, given the scarcity of collateral capital and the fact that governments' ability to provide guarantees, a contingent sovereign obligation, depended also on their fiscal space. As a result, lending to the small firms that are pervasive in the region was significantly affected, limiting financial assistance to basically renewing existing loans and lengthening grace periods and loan maturities.

## THE POLITICS

**The political dimension was, and will remain, another key to understanding the scope for individual governments to mitigate the impact of the pandemic**. For example, the effectiveness of both lockdowns and the fiscal response were conditioned by political factors. On the one hand, many countries came from a period of increased civil unrest that reduced the government's ability to restrict mobility; on the other hand, besides the predictable economic toll of a protracted lockdown, lack of political cohesion made it difficult to communicate and implement restrictions that inevitably led to lockdown fatigue, linked to diminished socialisation and mobility and stressed mental

health. The lack of a unified political message led to varying degrees of compliance with protocols and restrictions, which helps to explain the heterogeneous efficacy of the fiscal response.[4]

On top of that, in many countries in Latin America, as noted, the social and political underpinnings of the pandemic response interacted with a background of civil discontent, or already ongoing recessions with important welfare costs. As the contributors highlight in these dialogues, socio-political factors will play a critical role post-pandemic and will likely inform and limit the economic decision set. While there seems to be a poor correlation between human development indicators and civil unrest, the indelible scars of the pandemic are likely to stir social demands, adding a sense of urgency to governments with weak popular support. Is the region entering a middle-income trap (Levy Yeyati 2021) at a time when economic resources are most limited?

**Polarisation in politics, and society in general, seems to be a relevant barrier to addressing the challenging economic environment going forward**. Elections in Latin America have become increasingly disputed and won by polarised candidates. The centre has lost ground and with it the hope for an easier political cohesion to pass reforms and tackle the many difficult choices ahead. In many cases, tough decisions must be taken in the present to address the fiscal and social challenges. In others, the political and economic situation requires a clear definition of priorities – not an easy task in politically antagonistic societies.

**Why has polarisation hit hard in so many Latin American countries?** For starters, there is the perception that social improvements have stalled and the future looks worse than originally expected – a context of diminished expectations that is blamed on current and past governments, politicians and leaders in general pushing the trust in leadership and institutions to record lows. But we have to acknowledge that polarisation is a more widespread phenomenon that goes beyond Latin America and requires a more global – or at least a more nuanced – explanation. The emergence and success of social media is an important element to be incorporated in the mix; recent strikes and protests in Latin America were often organised on social media, sometimes without a clear leadership for governments to negotiate with. More importantly, communication in closed groups and 'social bubbles' lacking exposure to divergent opinions tends to confirm and reinforce individual views, sometimes compounding the feelings of distrust, frustration and anger. In (mostly) vocal and plural liberal democracies of Latin America, this 'echo chamber' effect can promote discontent and intolerance of diverse views, favouring political leaders – and ultimately, governments – who are averse to the negotiations and compromises needed to face the non-trivial political challenges ahead. While it is still too early to generalise, if this recent political reality becomes a trend, it could impair governments' capacity to avert a new lost decade for the region.

4 See Levy Yeyati and Sartorio (2021) on the determinants of lockdown compliance and Goldstein et al. (2021) on the dynamics of lockdown fatigue.

## THE DAY AFTER

**The pandemic left us with three monetary/financial risk fronts of future concern**: (i) non-performing loans (NPLs) when borrowers have to repay their Covid-related loans or catch up with loan extensions; (ii) potential pressures to engineer seemingly easy monetary solutions to hard fiscal problems, either by monetising deficits or by using financial repression to channel scarce resources to meet government needs; and (iii) a reversal of easy monetary policy – locally and globally – in a context of persistently higher inflation.

Loan performance in Latin America will likely depend on the pace of GDP recovery, which in turn should depend on the control of the pandemic (most notably, though extensive vaccination) and on the Covid-related and structural constraints to growth – some of which may have been deepened in the past two years (as is discussed in Section II of this book).

**Higher inflation, in turn, is a major immediate concern, leading to a relevant constraint going forward**. Inflation could be temporary or more persistent. On the one hand, the asymmetric recovery during the phasing out of the pandemic has led to disruptions in global supply chains as well as changes in the composition of global demand (reverting from the service-intensive consumption during lockdowns back to a larger share of industrial goods), leading to selective overheating and global inflation. Also, in the United States, changes in workers' behaviour in the aftermath of the pandemic, including lower participation and higher turnover of low-skilled workers, may have generated some localised wage inflation. All these factors have probably translated into temporary (albeit more persistent than usual) shocks to inflation. More worryingly, unprecedented fiscal and monetary stimuli could have led to a permanent, or at least very persistent, inflation push, both globally and locally in the region – something that could become apparent from a generalised pressure on wages coming from tight labour markets.

The consequences for Latin America are very different depending on whether higher inflation, which is already showing its face in the region (Table 2), is revealed to be temporary or permanent. A more troublesome inflation outlook would generate tighter monetary policy in advanced economies, putting pressure on Latin American economies with weaker exchanges rates and higher interest rates. The ultimate consequence, in this scenario, would be the loss of monetary policy as a macro tool to smooth out the transition out of the fiscal stimulus in the region, tightening the fiscal constraint – and the political trade-off – even further.

TABLE 2 INFLATION IN LATIN AMERICA

| Country/economy | Inflation Realised and Bloomberg 12-month forecast | | |
|---|---|---|---|
| | 2019 | 2020 | 2021e |
| Argentina | 53.8 | 36.1 | 48.2 |
| Brazil | 4.3 | 4.5 | 8.2 |
| Chile | 3.0 | 2.9 | 4.3 |
| Colombia | 3.8 | 1.6 | 3.5 |
| Ecuador | -0.1 | -0.9 | 1.1 |
| Mexico | 2.8 | 3.2 | 5.6 |
| Peru | 1.9 | 2.0 | 3.9 |

**In sum, we can say that the combination of pre-existing conditions and the impact of a large unprecedent shock, in a context of polarised political societies, poses a complex set of challenges to Latin American policymakers and politicians**. These include, but are not restricted to:

- **Economic and political constraints on fiscal policy**. The combination of higher debts and more financing needs, at a time when there is still a need to provide stimulus to the ongoing growth recovery and support to make up for the losses of a large share of the population, certainly creates a thorny political dilemma. This complicated fiscal trade-off and the need to contain the primary deficit will surely fuel the debate on the size of public sector, pointing to the need to scale it down through spending cuts where it is needed (most notably, in Argentina and Brazil) or to scale it up through tax hikes for the rich – and more realistically, albeit tougher, the middle classes – pretty much everywhere else in the region.

- **Populist temptations in economic policy**. The scarcity of resources coupled with an abundance of needs could lead to economic populism. This narrative – that there are no objective constraints on the use of fiscal resources – is not new in Latin American. Similarly, populism may propose monetary financing as an easy and sustainable solution to the fiscal dilemma. Polarised societies and political segmentation magnify the risk of populist temptations.

- **Asymmetric consequences of the pandemic**. As the shock affected different groups asymmetrically – informal more than formal workers; lower-middle-income households more than the middle and upper classes; women more than men; contact-based, bricks-and-mortar activities more than digital services – social

cohesion will be challenging. In particular, policies during the recovery from the crisis should not be neutral; special attention should be assigned to the groups most affected by the pandemic.







## IS LATIN AMERICA DOOMED TO ANOTHER LOST DECADE?

We believe it is too early to tell. But we hope not. There is still time for a change. Politicians could still address many of the perils and challenges outlined in this book; voters could still react by delegating power to politicians and policymakers that could address their legitimate frustrations and disappointments. Indeed, this is the time to change. The difficulties ahead call for a reaction; the proposed solutions cannot be seen as a repackaging of the old formulas that brought us here. The region has suffered from design weaknesses and from a development strategy that fell short of addressing social development and income distribution for society as a whole, and often disregarded education as an essential social mobility tool and a key ingredient of long-run growth. The list is long: corruption and security, transportation and habitat, and environmental issues – these 'third-generation demands' call for third-generation reforms and policies. Otherwise, the accumulation of social drawbacks and frustrations that is currently limiting the capacity to react to the large pandemic shock will continue to fuel civil discontent and to hinder public policies in negative feedback for years.

There is also a risk that current tensions could lead to the undoing of past improvements. Most Latin American economies (with a few important exceptions) put in place policies that led to better balance-of-payments and inflation environments, achieving a stability that looked a long shot in the 1980s and 1990s. It is politically tempting to politicise and opportunistically disregard the benefits of running responsible monetary and fiscal policies, or the relevance of a focus on productivity, innovation and competitiveness as pillars of sustainable progress. The reality is that these policies, if not sufficient, are certainly necessary as building blocks for a new regime that combines macroeconomic stability with inclusive and sustainable growth in a more equal society.

People's willingness to engage in reforms depends on their perceived fairness. This perception requires effective communication, as well as a true commitment by the region's established and new leaders. Given the complex task and numerous constraints outlined above, and discussed in detail in these dialogues, there is a clear danger that voters and politicians will yield to easy, near-term shortcuts that would ultimately lead to loss of income, higher inequality and poverty – a major detraction from welfare in the long-term. Latin America is at a crossroads: whether or not we avoid another lost decade will depend on the choices the region makes today.

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# SECTION I

# AVOIDING THE NEXT CRISIS

# "The pandemic can be used as a cover for wasteful spending"



**Laura Alfaro**
Harvard Business School and CEPR

*What is your assessment of the fiscal situation of Latin American countries after Covid? Do you agree that, in some countries, the unprecedented fiscal expansion to respond to the pandemic has generated too large a debt that calls for a fiscal response?*

Latin American countries display great heterogeneity – from fiscal space to institutional capabilities – in their ability to efficiently and equitably allocate resources. Economic structures also differ. In general, however, in the last decades they have all underperformed in terms of growth due to low productivity and poor investments in infrastructure and human capital (Alfaro and Kanczuk 2020). Informality, which is prevalent in the region, accounts for over 50% of the labour force (Alfaro et al. 2020). In this context, further characterised by high poverty and inequality, Covid-19 has had devastating consequences, albeit uneven across segments of the population and across sectors.

Given the nature of the Covid-19 shock – one that combined supply and demand effects under high uncertainty – discussion has centred on how best to act, as fiscal expansion can negatively affect debt sustainability. In the short run, an upfront response to the pandemic was necessary. But the optimal amount depends on each country's fiscal space and institutional capacity; there is no 'one size fits all' in the region.

For countries with strong pre-pandemic positions, borrowing should not considerably weaken their fiscal sustainability positions. In fact, for these countries, such as Chile, the international debt markets have provided funds to smooth the costs of responding to the pandemic. The countries in the region that had lost private market access before the crisis, such as Ecuador, have turned to multilateral funding. For a third set of countries – such as Costa Rica, where the government was running unsustainable fiscal deficits before Covid and has displayed little capacity to spend well and respond effectively – the external private market has been substituted by multilateral lending.

In all countries, priorities must be carefully established, as the pandemic can be used as a cover for wasteful spending. Attention should be given to limiting excessive spending that may endanger medium- and longer-term debt sustainability. Misused funds and corruption are not costless; they undermine the legitimacy of institutions and, more generally, of the democratic system. Both transparency and accountability are crucial. The fiscal response to the pandemic should be transitory and debt-financed, if possible. It is well documented that, in many countries in the region, the short-lived transitory

spending that was required during the global financial crisis later became permanent. That spending, overall, did not increase productivity, improve education and infrastructure or substantially address social needs and inequality.





*If so, is this higher debt capable of generating debt crisis and default? Is this higher debt potentially a debt overhang that is going to hamper growth in the region in the short, medium and long run? How should indebted countries in Latin America avoid a future debt crisis or debt overhang problem for growth?*

Many countries in the region have recently enacted fiscal rules. Fiscal rules allow spending in the short term while maintaining a steady commitment to debt sustainability. Standard economic theory holds that fiscal policy should be countercyclical (Barro 1979). Many countries, possibly owing to limited access to credit markets (Bauducco and Caprioli 2014) or distorted political incentives (Alesina and Tabellini 2008), follow procyclical fiscal policies that tend to exacerbate already pronounced cycles (Kaminsky et al. 2005, Vegh and Vuletin 2012). In practice, that is, governments tend to over-borrow in good times and often resort to defaulting on their debt in bad times. Fiscal rules are a potentially useful commitment technology to solve this problem. The prevalent and increased use of fiscal rules is suggestive of the desire to correct incentives to overspend.

This is precisely the time to respect those fiscal rules that, when well-designed, incorporate negative shocks and business cycle fluctuations. Indeed, the gains from an optimal fiscal rule could be economically relevant (Alfaro and Kanczuk 2019). A question remains as to whether fiscal or debt rules are easier to enforce. However, a simple, easily contractible threshold rule can generate virtually as high gains as the optimal rule. The credibility of adhering to fiscal rules allows access to external funds at favourable terms – an important consideration in an environment of potential looming increases in international interest rates.

The first choice, then, to deal in the medium term with the fiscal implications of the pandemic and the worsening debt sustainability outlook is to reallocate funds away from regressive and inefficient spending. Note also that in some countries in the region, the tax burden is high (e.g. Brazil) and highly distortive of the formal labour market (e.g. Costa Rica). In such cases, fiscal reform should aim to foster the formal economy and private investment. The need to reduce barriers to formal jobs, which generally imply access to safety nets, is imperative in the aftermath of the pandemic.

*There is an increasing belief in some corners that monetary financing of government spending and debt is harmless. After all, quantitative easing (QE) is a recognised tool in advanced economies, and some even believe in Modern Monetary Theory, at the risk of understating or neglecting a hard-won nominal instability. What is your position on that front? Should economists reclaim the narrative of inflation policies in the region?*





Inflation targeting and flexible exchange rates have served the region well (for example, in Mexico, Chile and Brazil; see BIS 2021). This is a time for effective policymaking. Countries did not further impose capital controls this time around – a great sign of improved effective crisis management gained in the region.

Most countries in Latin America have plenty of space to implement traditional monetary policy (i.e. through interest rates) and that is what should be done. The region has been at the forefront of dealing with inflationary pressures emerging worldwide. Adhering to fiscal rules should afford them the space to manage potential changes in the international environment and avoid fiscal dominance. It is worth highlighting that QE has not been implemented effectively by countries with chronic histories of sovereign risk and default and where potential risks remain. For example, QE may distort the pricing of sovereign risk, with investors expressing this risk in the exchange rate, causing large depreciation. The aim should be to hedge, dampen and eliminate risks, not disguise them.

*The next crisis could also be epidemiologic. How could we prepare for a prolonged Covid crisis or a similar pandemic crisis? Moreover, an important characteristic of the Covid shock was its asymmetric impact on specific sectors: vulnerable social groups through labour access, women through growing demands for home care, children through the loss of education. All consequences that appear to be quite persistent. How can we prepare Latin American countries to restore the balance?*

Indeed, an ongoing debate relates to how best to tackle the challenges posed as we adjust to Covid-19 not as an outbreak, but as an endemic. In addition to the need to further improve and invest in health systems and the corresponding infrastructure, the region will face a severe education crisis due to the longer disruption of in-person classes. The potential to bring about another lost generation, as the debt crisis did in the 1980s, is real. Latin America should refocus efforts to the task of helping all the students whose education was disrupted.

The Covid-19 outbreak, furthermore, has highlighted the importance of digital connectivity for societies: people, companies, and governments. Information and communication technology (ICT) has made it possible to reduce the negative impacts of the crisis. The pandemic, however, has also highlighted the persistent digital divide in Latin America, with many businesses and individuals lacking access. Many of these changes, likely to be permanent, can also help in the fight against global climate change. Policies should aim to further invest in maths, science and technology. The region also has a great opportunity

to turn to green investment afforded by our biodiversity and ample solar, wind and hydro resources, among others, in addition to investing in mitigation and adaptation. The private and public sectors should work together to tackle all these challenges.

The pandemic is not over, given the high costs for many countries in the region of containment strategies based mainly – or even solely – on long-term lockdowns (Alfaro et al. 2020). At this point, the most effective alternative is to quickly scale up vaccinations; Latin America is slowly catching up in terms of vaccinations. While efforts to increase supply and vaccine production capabilities have started to materialise (for example, in Brazil), it will remain an onerous uphill task. But the cost in terms of lives and livelihoods dwarfs those hurdles.

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# "QE in advanced economies does not provide a convincing argument for monetary financing in emerging ones"



**Roberto Chang**
Rutgers University

*What is your assessment of the fiscal situation of Latin America after Covid? Do you agree that, in some countries, the unprecedented fiscal expansion to respond to the pandemic has generated levels of indebtedness that call for a fiscal consolidation? Alternatively, are these higher debt levels, if left unattended, capable of generating debt crises and defaults? And last but not least, to what extent could these higher debt ratios potentially result in a debt overhang that, in the medium term, hampers further an already poor growth record in the region?*

The most notable aspect of the fiscal outlook is the heterogeneity across countries. The onset of Covid found Latin American countries in very different positions with respect to debt levels, fiscal deficits and access to international credit. At one extreme, the public debts of Chile and Peru were less than 30% of their respective GDPs, and their fiscal deficits were low. Correspondingly, they could borrow internationally at very low costs. At the other end, Argentina was grappling with a fiscal crisis and default, while Brazil's public debt reached 75% of its GDP, with a fiscal deficit of 6% of GDP at the onset of the crisis. In the middle, a group of countries, including Colombia and Mexico, had debts of about 50% of GDP and relatively low fiscal deficits.

The 2020 fiscal response to Covid did not alter this pattern, but instead it may have exacerbated it. As expected for countries with the most fiscal space, Chile and Peru ran relatively large fiscal deficits, approaching 10% of GDP, to pay for Covid adjustment programmes. But the largest deficit by far was in Brazil, at more than 14% percent of GDP, increasing its debt to almost 90% of GDP.

Fiscal heterogeneity suggests at least three things. First, Latin American countries currently differ greatly in their debt burdens. Second, while Covid resulted in debt increases in all of Latin America, the existence and urgency of a debt problem for each country is largely the result of longer-term, pre-pandemic dynamics. Third, whether a country's debt is too large going forward will depend on how much the Covid crisis has disrupted those previous dynamics.

Taken together, these observations indicate that change is most urgently needed in Brazil. As seen, Brazil's fiscal dynamics were hardly sustainable even before Covid. Doubts about sustainability and the prospects for a fiscal correction have become even larger with the Covid response, which has generated demands for social assistance programmes to

be made permanent, as well as for tax reductions for lower income classes. Without a correction, there is grave danger of an eventual debt crisis. Such a crisis would be very costly for Brazil, but I do not think that it would contaminate the whole region. I believe that financial market participants would recognise the differences across countries that I mentioned before, and credit flows would adjust accordingly.

Optimism is also justified by the prevailing low global interest rates. In spite of probably higher Federal Funds rates in the near future, international interest rates remain strikingly low, even for very long-term debt. One consequence of low rates is that, while Latin American debt levels have increased, the cost of servicing that debt has barely moved, even for Brazil. This makes current levels of debt less alarming, giving Latin American countries more time to put their fiscal houses in order. However, the interest rate environment can reverse quickly, so that extra time should not be wasted.

*How should indebted Latin American countries avoid a 1980s-style loop whereby debt overhang hinders investment and growth, in turn raising debt ratios further?*

In the immediate future, it is essential to avoid the creation of long-term fiscal imbalances when dealing with Covid, which will (hopefully) be a short-term problem. As an example of the potential pitfalls, consider cash transfer programmes. Most of us welcomed them in 2020 as an emergency measure to alleviate that impact of lockdowns on households. But now there is significant pressure for transfers to be extended and even to become permanent, adding a long-lasting drain on fiscal resources.

In the medium term, several Latin American governments need to raise more revenues. Observe that government revenues are more than one third of GDP in advanced economies, but only one fourth of GDP or even less in several of the Latin American economies. A hard question is how to raise revenues without hurting incentives for investment and growth. There is considerable space in many cases. For example, we do know that the informal sector is very large – most notably in Peru, Colombia and Mexico. Reforms to bring informal actors to formal status would presumably add those actors to the taxpayer base, helping on the fiscal revenue side. In this case, one would hope that economic growth would benefit.

On the expenditure side, in some cases a redistribution of fiscal spending towards productive infrastructure, both of the physical kind and also the 'human infrastructure' currently emphasised in the United States, could help stabilise public finances. An emphasis on infrastructure would boost medium-term growth, eventually reducing the debt-to-GDP ratio and, at the same time, increasing employment and hopefully alleviating poverty and inequality.

In some instances, a key challenge is to prevent inefficient government spending or the dissipation of public funds through populist initiatives, plain mismanagement, or worse, corruption and theft. This task is most apparent for exporters of commodities whose prices remain at historically high levels. Peru is a prime example where a new

leftist government has been peddling old recipes (for example, renegotiation of contracts with mining companies under the threat of nationalisation and expropriation). These companies note, correctly, that not only do they already pay a substantial amount of taxes, but also, in the past ten years, these revenues have been squandered on white elephant projects or simply have not been used. So, it is fair to ask if the government is going to levy more duties on the mining sector, whether there is a credible plan to utilise those resources for the public good. Without such a plan, I believe that raising more money from mining companies, rather than benefiting the population at large, will likely become an invitation for more corruption.





*Even if fiscal problems are not apparent in some countries, governments have become accustomed to low interest rates and low funding costs in the last few years. Are they ready for higher interest rates in the future? How should governments prepare today?*

Latin American governments should avoid the danger of leaving the Covid episode with larger entitlement programmes and other unwarranted permanent commitments. Also, as I mentioned, they should reduce the structural fiscal gap via tax reforms, increased fiscal revenues and more efficient government spending.

The current low interest rate environment could be advantageous in other various ways. The government could try to extend the maturity of its debt, and perhaps shift its composition towards local currency sources. This seems quite feasible. Last November, for instance, Peru sold a 100-year bond with a 3.24% yield. And this happened in the middle of a constitutional crisis during which Peru had three presidents in less than two weeks.

Similarly, low interest costs may justify the accumulation of international reserves. One could regard the financial costs of reserves accumulation as insurance against the event of a sudden, disruptive increase in world interest rates.

A more difficult issue is whether a sudden increase in interest rates would trigger less visible imbalances, for example on the balance sheets of corporates and financial intermediaries. In many countries, corporates, banks and non-bank intermediaries benefited from emergency credit assistance during the Covid crisis. As Covid subsides and the credit assistance programmes are brought to an end, many of these indebted agents will be vulnerable to increased interest rates. In this sense, governments could prepare for higher interest rates by ending the credit subsidies as soon as it is feasible given the trajectory of Covid, and by anticipating weaknesses in the net worth position of private agents as the economy exits the Covid period.

In the medium run, Latin American governments would also be affected by new institutional reforms, or the fate of previous ones (for example, those related to social security systems, which have recently come under attack particularly in Chile and Peru). Needless to say, how this pressure is resolved could have huge implications for fiscal sustainability.

Finally, for commodity exporters that benefit from world price windfalls, the creation of Norwegian-style sovereign wealth funds should be on the agenda. Such funds would take care of some of the social demands that lead to pro cyclical fiscal policy in Latin America, and also, one hopes, would diminish the possibility of corruption and rent dissipation.





*Sometimes, excess debts and financing problems lead not to crisis but to higher inflation in Latin America. Do you believe inflation will be back in the region after the Covid? In Latin America, fiscal expansion with low real interest rates tend to generate future inflation. Is this time different? What would you recommend central banks do going forward?*

I remain cautiously optimistic in this regard, especially about countries that have adopted independent central banks and inflation targeting as their monetary frameworks. Latin America has indeed changed, and more markedly so since the turn of the century. With few exceptions (Venezuela, Argentina), our countries seem to have learned that monetary financing of a budget deficit can easily be conducive to inflation in the double or triple digits, if not more. Inflation fell in most of the region, even in countries that adopted fiscal policies that might be considered populist, such as Bolivia. In recent times, our central banks have largely kept inflation under control, which reflects well on them.

That being said, I see some important risks. While we economists have long recognised that low inflation is necessary but not sufficient for development and growth, recent political trends, especially the ascendance of populism from the right and the left, blame central banks for not doing more to fix social problems such as wealth and income inequality, pensions or climate change. As a result, some challenging questions arise. Since central banks have access to policy tools that can be deployed quite quickly, without the need for a political consensus-building process, why not use those policy tools to reduce the unemployment of specific minority groups, or to boost interest income for retirees?

Central bankers need to come up with convincing answers in order not to undermine and even destroy their institutional foundations, including their independence, which would lead to the loss of credibility and reputation that has been accumulated over decades.

Perhaps the best way for central banks to solidify their position is to educate the public about the importance of sound central bank policy, and how much of a difference this has made in the past. In this regard, the Covid crisis may represent an excellent opportunity in many countries where central banks played a crucial role in stabilising credit and ensuring the stability of the financial system. The average citizen should be reminded that, as bad as the Covid period was, it would have been much worse without sound central bank actions. At the same time, a central bank should explain clearly and firmly its objectives and targets. There are good reasons why many central banks are committed to targeting only a few objectives, and in most cases only one – inflation. Those reasons should be communicated to the public.

*More extreme, do we face the risks of fiscal dominance? Could central banks even control inflation if it occurs? The challenge of controlling inflation with fiscal problems and in the midst of social challenges could impair central bank work. Could central bank independence be at risk after Covid? How can we preserve the monetary institutions in the region?*





The combination of rising inflation, fiscal imbalances and social demands indeed imperils the independence of our central banks and forces them to engage in a delicate balancing act. Perhaps the clearest illustrations come from Chile and Peru, whose macroeconomic records have been impressive for decades. In both cases, central banks were given independence and inflation targeting became the monetary policy framework. The result was robust growth, relative stability and low inflation.

Things started to change just before Covid, although these changes accelerated with it. In Chile, a popular revolt resulted in the creation of a recently elected Assembly charged with rewriting the Constitution. This would have resulted in social reforms and moves in favour of more redistribution even without Covid. But the Covid response included a strong deficit-financed fiscal impulse, as well as early withdrawals from retirement pension accounts. This combination has generated overheating, with inflation increasing well above the official target, causing the central bank to increase the policy interest rate. In this environment, politicians of different stripes have found various reasons to complain and accuse the central bank of ignoring the impact of the tightening on their respective constituencies. And these politicians have not shied away from questioning the independence of the central bank altogether.

In Peru, social and political cleavages intensified with the pandemic and, after a series of political crises, a radical left government led by a former teachers' union leader, Pedro Castillo, came to power last July. At this point, it is unclear what Castillo wants to do, or will be able to do, given the political fragmentation and his lack of a majority in Congress. But during his presidential campaign Castillo promised to rewrite the Constitution, with an emphasis on its economic chapters, which might have resulted in a reform of the central bank charter. This and other positions, such as the threat of forced contract renegotiations or increased taxation in the mining sector, have generated heightened uncertainty and a steep depreciation of the Peruvian sol.

Market doubts were exacerbated by a long delay in choosing the central bank president. While Julio Velarde, the Central Reserve Bank of Peru´s long-time and well-respected president, was ultimately reappointed, the process revealed intense political infighting, with Castillo signalling that he is not fully committed to existing institutions. Fears remain, then, that Castillo and his political allies may attempt to ditch the independence of the central bank before long.

Again, central banks and their supporters could do a better job of educating the population about the crucial role of central bank policy and how its fundamental institutions, including its independence, are designed to maximise the quality of policy. Also, in many

cases, central banks should resist attempts at 'mission creep' and affirm that its role is limited to managing a few instruments to attain a few goals – chiefly, low inflation, smoothing business cycles and financial stability.





*There is an increasing belief in some corners that monetary financing of government spending and debt is harmless. After all, QE is a recognised tool in advanced economies and some even believe in Modern Monetary Theory. Do you believe that? If not, how can economists regain the narrative?*

There are several issues here. A most basic one is: do governments have budget constraints? My answer is yes, of course, which means that government spending has limits, and public debts can become unsustainable. I do not see much controversy on this point (except perhaps from MMT proponents, but I do not think that MMT deserves to be called a theory, or modern, or even monetary).

But the more relevant and difficult question is: what is the range of public debts and fiscal deficits that can place an economy in a position where monetary financing becomes necessary, and runaway inflation a real threat? The answer depends crucially on the expected future path of real interest rates, which have dropped substantially in recent times.

Note that world interest rates that stood at about 4% around 2000 are now essentially zero. Clearly, if interest rates were to remain at zero for a long time, it would be sustainable for our governments to issue and service substantially larger public debts than we are used to. Unfortunately, there is no convincing evidence yet that interest rates will either remain low or return to the 4% range. While long-term interest rates seem to indicate a path of very gradual increases over the next ten years, there is quite a lot of uncertainty around that reference point. Because of that, we need to anticipate the possibility of much faster increases in the not-too-distant future. In this light, my position would be that many Latin American countries still enjoy substantial room to issue more debt in the near future, but should avoid long-term fiscal commitments, especially entitlements, that may result in permanent increases in their fiscal deficits.

Since you mention it in your question, let me stress that the impact of quantitative easing in advanced economies does not yet provide (at least from my perspective) a convincing argument in favour of monetary financing of fiscal policy in emerging economies. First, I do not agree that the existing evidence in advanced economies indicate that QE has been that effective. Arguably, it had significant effects in the United States in the immediate aftermath of the Lehman bankruptcy. But in Europe, where QE was implemented somewhat later, economic activity remained very weak for years. Second, QE in advanced economies entailed exchanging some existing financial assets for safe and liquid ones, such as bank reserves. But the latter could be freely created by central banks in advanced countries, including the Federal Reserve or the ECB, which can print dollars or euros at no cost. The central banks of many, if not all, Latin American countries do not have

the power to create safe assets freely; they can only issue domestic currency assets. The consequence is that QE and other unconventional central bank policies in Latin America have a tight link to the question of dollarisation and reserves accumulation. I have explored this issue in ongoing work with Luis Céspedes and Andrés Velasco (Céspedes et al. 2017). We have made good progress, but many questions remain.





*Do you believe Covid brought a reversal of globalisation trends? Would this mean more difficulties generating current account surpluses and/or balance-of-payments financing going forward?*

In the short run, Covid impaired international trade, as we know, especially via the disruption of global supply chains and international travel. These impacts are likely to subside relatively quickly, in my view.

For the longer term, I would rather emphasise some positive news. The most striking is that the global financial system has performed quite well during the Covid period. This deserves much more emphasis that it has received, because at the beginning, in early 2020, there was much speculation that there would be a replay of the global financial crisis of the late 2000s. Having experienced several crises in my lifetime, my view was that the pandemic did not need to lead to a financial meltdown, which would have multiplied the economic costs. But it could have, especially in the absence of appropriate policy responses. Fortunately, central banks and international financial institutions around the world reacted appropriately, forcefully and in a coordinated fashion. In particular, the Federal Reserve and other advanced central banks made it clear that they were committed to providing whatever international liquidity was required to preserve the functioning of the international financial system.

These developments already suggest that balance-of-payments financing may, in fact, be smoother going forward. But I think, or hope, that there is more there than meets the eye. The Covid episode has been a truly universal phenomenon; no country was left untouched. The magnitude and global nature of the pandemic impressed on national governments the need to find coordinated, global solutions. As mentioned, central banks and international financial institutions were the quickest to develop a multilateral policy response, but current attempts at global policymaking go beyond the financial realm. We see similar efforts in health policy, most obviously. Indeed, the awareness of the centrality of international linkages may have affected, for example, recent negotiations to impose a minimum corporate tax rate, and has clearly provided a boost for climate change reform efforts.

*In some countries, the financial system has become accustomed to low interest rates, so hiking interest rates can be destabilising. In your view, is there a risk of financial crisis or turbulence if inflation comes back and interest rates rise? If so, how can we avoid a future financial crisis?*

The answer depends, in my view, on the specific scenario that would lead to increases in interest rates. When financial turmoil is associated with a central bank raising interest rates, it is often not caused by the higher rates but, rather, by more fundamental underlying problems. In the past, for example, when a central bank monetised fiscal deficits, the resulting increases in inflation forced the central bank to raise rates to prevent the real interest rate becoming too negative. Sometimes the increase was insufficient, allowing inflation to accelerate; other times, the increase led to a drastic contraction in economic activity. In both cases, and not too surprisingly, financial turbulence occurred, but it would be improper to blame interest rates for this.

On occasion, the central bank may raise rates in an attempt to prevent steep currency depreciation, which may be behind inflation, in a context of a fragile financial system. This effort to shore up the currency may lead to the depletion of international reserves, ultimately forcing the central bank to either stop acting as a lender of last resort or to allow the currency to float. In this scenario, which Andrés Velasco and I modelled years ago (Chang and Velasco 2000), central banks have in practice tried to delay the time of reckoning by raising interest rates, with little success. In those episodes, higher interest rates would not be the culprits of a financial crisis, which would reflect an inconsistent policy, namely, an attempt by the central bank to both serve as lender of last resort and stabilise the currency with insufficient reserves.

A third scenario, which may be the most relevant one in the medium term, is when a central bank has to raise interest rates to respond to an increase in world interest rates. In such a case, financial volatility would be responding primarily to the world interest rate, not to higher domestic rates.

If you identify the applicable scenario, the needed preparations become more apparent. In the cases mentioned, I would emphasise that (1) fiscal discipline is paramount; (2) fixed exchange rates are quite dangerous; (3) governments should anticipate the possibility of sudden increases in world interest rates; and (4) building international reserves and securing international lines of credit is advisable as a prudential strategy.

*Latin American countries depend on capital flows and external financing. In a post-Covid world, with more uncertainty and higher debts and interest rates in advanced economies, do you believe there is a balance-of-payments crisis on the horizon? How could Latin American countries and international organisations prepare for that?*



At the local level, several Latin American countries are vulnerable, for different reasons. Fiscal imbalances, for example, place Brazil on a potentially unstable financial trajectory, despite the large accumulated international reserves. Also, Argentina that has been struggling with debt and attempts at fiscal consolidation. In these and other cases, a quick increase in the cost of external financing might create financial pressures.

These vulnerabilities can lead to a balance-of-payments crisis if world interest rates increase significantly and suddenly. So a key question is: how likely is such an event? At this point, inflation around the world has increased, and there is considerable speculation that the Federal Reserve will start increasing interest rates sooner than anticipated. On the other hand, I agree with Paul Krugman and others that worldwide inflation is largely driven by supply disruptions that are surely transitory, so that the current surge in inflation should not be permanent. I also expect that central banks in advanced economies will show patience and wait for more data to arrive before switching monetary policy to a less expansionary gear. Financial markets seem to agree with this expectation: measures of expected inflation and interest rates for five- to ten-year horizons reflect that the current bump in inflation will not last beyond a couple of years. In sum, while we should anticipate policy rates to increase next year, the increases are unlikely to be large and lasting.

Other risks come from the fiscal side. A main one is the political situation in the United States, where deep division in Congress and a virtually total lack of cooperation between Democrats and Republicans has made the prospect of a default on the US government debt a not-unthinkable event. Although not likely, a US default would be catastrophic for world financial markets.

A related source of fiscal uncertainty is the infrastructure and social fiscal packages that Democrats have been negotiating in Congress. Depending on the final cost of these packages, and of the accompanying tax measures to help finance them, the impact on the US fiscal deficit could be substantial, resulting in lower prices for US government debt and higher interest costs for everyone. This being said, at this point political infighting within the Democratic Party will probably prevent an outcome that would lead to excessive fiscal imbalances.

While my view is that a scenario of a sudden run up in interest costs and a rush to the US dollar is not very likely, Latin American countries and international institutions should be making appropriate plans in case it materialises. Our governments should be gathering information about which agents (firms, banks) would be in need of assistance in such an event. In some countries, it may be feasible to induce or require those agents to

shore up their financial positions, via reducing leverage or raising equity. In turn, the IMF and other international financial institutions could prepare lines of credit to be made available to Latin American countries in case adjustment is required.





*The next crisis could also be epidemiologic. How can we prepare for a prolonged Covid crisis or a similar pandemic in the future?*

The Covid crisis brought to the surface the weakness of national safety nets, especially in terms of health systems. Years of underinvestment in hospitals, medical posts, training of doctors and nurses, and distribution systems for medicines and supplies resulted in huge costs in terms of human suffering, contagion and death. So, the first order of business before the next pandemic would be revamping investment in the health system – redirecting public expenditures towards the health sector, with the objective of a drastic expansion of its infrastructure and reach, as well as of its human capital and organisation.

A related issue in many countries is the prevalence of informality and marginalisation, in the general sense that vast sectors of the population remain disconnected from the formal economy as well as the government and the state. Those sectors live excluded from government services and the social safety net, a situation that was tolerated or ignored in normal times but became central during Covid. During the pandemic, many Latin American governments found themselves incapable of reaching and delivering assistance to informal and marginalised populations. Correspondingly, those governments had little power to impose public health mandates such as lockdowns or social distancing. More recently, vaccination campaigns, already a challenge, were hampered by the difficulty of reaching informal and marginalised sectors. Last but not least, popular support for some mandates, including mask usage and social distancing, may have been weakened by the social fracture, which implied that enforcement was bound to be far from uniform.

Therefore, a key word in preparing for the next pandemic is 'inclusion'. Inclusive societies would not have avoided Covid but would have been able to respond to it in a more organised and effective fashion. Their governments would have been able to deliver assistance much more widely and, in return, would have been in a much better position to monitor the implementation of health mandates. And when vaccines became available, an inclusive society would have distributed them in a much faster fashion to larger swaths of the population.

*An important characteristic of the post-Covid world is the asymmetric impact of the crisis on sectors, social groups, genders, and others. How can we prepare Latin American countries to restore the balance?*

From a macroeconomic perspective, the most urgent objective is a return to sustained growth. The pandemic caused a drastic increase in poverty indices, in some cases undoing decades of progress. A key challenge will then be to restore employment to pre-Covid levels, and to create new job opportunities.

To the extent that employment recovers, the previous gains against poverty will be hopefully preserved.

Here again I come back to the importance of reducing informality. There should be an emphasis on job creation in the formal sector. Not only are these jobs better paid than informal ones, but they also help integrate workers into public safety nets and the state in general. A country with less informality will also be more resilient and able to respond to future shocks.

This being said, I think that the impact of Covid on asymmetries – inequality, fairness, and the like – is less important and more transient than the underlying trends in this direction that were becoming apparent before Covid. Chile's case, which I mentioned earlier, is the leading example, but you will find that similar forces were gaining strength in other Latin American countries prior to 2020. It is too early to see where these processes will take us, as they are basically social and political ones, not economic ones. So, there is not much that economists can (or should, for that matter) say or do to 'restore the balance'. My preference would be to adopt a wait-and-see attitude, keeping in mind the need to speak up if the basic foundations of liberal democracy become at risk. But, ultimately, that is my role as a citizen rather than as an economist.

*Peru has opened its economy, invested more, and was able to provide a stable monetary and fiscal environment in the last several years. But politically, noise and uncertainty now dominate. Are the achievements at risk? Could Peru plunge into a crisis in the future?*

Unfortunately, the answers are yes and yes. For three decades, the Peruvian economy enjoyed astonishing financial stability, low inflation and sustained growth. This remarkable performance was the result of sound monetary and fiscal policies which, in turn, were designed and implemented by appropriate institutions, chiefly an independent central bank committed to inflation targeting. Macroeconomic success was surprisingly resilient, and continued even during periods of political turmoil, to the point that, until this year, financial markets seemed to believe that the Peruvian economy was independent of politics.

The outlook has changed dramatically after the victory of the Marxist left in the 2021 presidential elections. Newly elected president Castillo ran on a platform promising radical redistribution and reform measures, including changing the country's Constitution. And Castillo's party, Peru Libre, had elaborated a government plan which reads, well, like a communist pamphlet from the 1970s. An optimist might say that those documents and declarations were just empty talk to win the election, and that upon taking power, Castillo would prove to be a reasonable and skilled policymaker, with a social conscience on top. But since his inauguration last July, Castillo has proven to be indecisive and ineffective, failing to answer the question of who has the real power.

Some prospective scenarios are quite adverse. In particular, Castillo and Peru Libre may attempt to call for a special election of an assembly charged with rewriting the Constitution, as has occurred in Chile. Such an attempt would be opposed by the Peruvian Congress, forcing a constitutional crisis with unpredictable consequences.

Other scenarios are less dramatic, and indeed I will be very happy if events prove me wrong. But, unfortunately, the young Castillo administration has already met serious conflict and the possibility of impeachment by Congress. In addition, the administration has questioned a number of basic liberties, such as freedom of the press. So, the early signals are far from reassuring.

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# "Even moderate increases in interest rates may be a cause of concern for fiscal sustainability"



**José de Gregorio**
Universidad de Chile and PIIE

*What is your assessment of the fiscal situation of Latin American countries after Covid? Do you agree that, in some countries, the unprecedented fiscal expansion to respond to the pandemic has generated too large a debt that calls for a fiscal response? If so, is this higher debt capable of generating debt crisis and default? Is this higher debt potentially a debt overhang that is going to hamper growth in the region in the short, medium and long run?*

Indeed, the fiscal response in Latin America was quite significant, as it was almost everywhere in the world. However, the response has been heterogenous on the magnitude and timing dimensions. While expansions in advanced economies will lead to an increase in public debt about 20 percentage points of GDP between 2019 and 2021, in emerging market economies, as well as in Latin America, this increase will be about 10 percentage points of GDP – smaller than in advanced economies, but still quite significant by historical standards. The fiscal expansions have also been heterogenous within the region, with Brazil, Chile and Peru ranking at the top, and Mexico and Uruguay at the bottom. In the case of Chile, there was a delayed response and most of the fiscal effort came in 2021.

Although Latin America was able to implement a relevant fiscal expansion, countercyclical fiscal policies are relatively new in the region. They started during the global financial crisis (and continued during the Covid-19 pandemic) and the fiscal space has been narrowing since then. The intended transitory fiscal stimulus implemented during the global financial crisis was not completely withdrawn, as a result of only partial reductions of government expenditure to pre-crisis levels after the financial stress was over. This is the *fiscal inertia* (De Gregorio 2014) that I am afraid will also apply to the Covid-19 aftermath. There will be political pressures to maintain social transfers, without any compensating adjustment, additionally reducing the fiscal space. I believe this is a serious cause of concern post-pandemic.

In that case, public debt may increase even further in the years to come, with the risk of debt overhang and financing difficulties that will be detrimental to growth and to the implementation of social policies. This was the story of Latin America before the fiscal progress achieved in the early 2000s. Will there be a debt crisis or a default? I do not think these outcomes are likely in the short run. But difficulties to finance the budget and a need for more drastic adjustments may come soon. Sooner rather than later, we may see countries seeking IMF support.

*You mention the risk of financial stress and, perhaps more likely, the risk that the debt hangover impairs the post-pandemic recovery. How should indebted countries in Latin America prepare to mitigate those risks?*

On the fiscal front, there is no option other than fiscal consolidation – a combination of tax increases and expenditure rationalisation. This should be enough to avoid a debt overhang, in particular if global interest rates increase, which would limit the ability of governments to borrow. Note that in the event of a delayed fiscal adjustment, there will be detrimental repercussions on the cost and the ability to borrow of both the public and the private sector. The debt overhang may reduce the capacity to grow, which further burdens the budget and makes it more difficult to stabilise debt-to-GDP ratios.

Regarding tax reforms, they must be progressive, without jeopardising economic growth. Many countries in the region are characterised by high levels of tax evasion and informality. In any fiscal reform, reducing these should be a priority in order to increase the tax base. In addition, given the urgency to face climate change, green taxes are also an option to explore. But all these efforts put together may not be enough to avoid a deterioration of public finances.

*Even if fiscal problems are not apparent in some countries, governments have become accustomed to low interest rates and low funding costs in the last few years. Are they ready for higher interest rates in the future? How should governments prepare for higher rates?*

The strength of fiscal positions depends on the level of interest rates, and it is unlikely that interest rates would reach levels that could cause global financial instability – but we cannot rule that out. An event of such magnitude could have very negative consequences not only in Latin America but in the whole world. As I noted, this could also have a negative impact on the non-financial corporate sector, as corporations have borrowed significantly in global financial markets during the years of low rates and high liquidity.

Even moderate increases in interest rates may be a cause of concern from a fiscal sustainability viewpoint, particularly in economies that started the Covid-19 crisis in a weak position, as was the case for several Latin American countries. Higher interest rates only make fiscal consolidation even more urgent.

*Sometimes excess debts and financing problems lead not to crisis but to higher inflation in Latin America. Do you believe inflation will be back in the region after Covid? In in Latin America, fiscal expansion with low real interest rates tends to generate future*

*inflation. Is this time different? What would you recommend central banks do going forward? More extreme, do we face the risk of fiscal dominance? Could central banks even control inflation if it occurs?*

In most Latin American countries, with the exception of Argentina and Venezuela, independent central banks cannot finance the government, and this has been a game changer. It is more likely that countries request an IMF programme than rely on monetary finance from their central banks. This could create a problem for the IMF, as its support would not be needed for financing external imbalances, but rather public sector ones. And the demands for assistance could be more than what is envisaged in the existing programmes. Perhaps the IMF should rethink its role, adding the responsibility of global fiscal stabiliser for emerging market economies. It does not make a big difference to its actual workings since currently lending for balance-of-payments purposes to the government is already done and IMF programmes already include fiscal objectives.

However, this does not rule out fiscal dominance, which could create serious problems for monetary policy and its role of controlling inflation. Fiscal dominance can take different forms, but in essence it limits the ability of central banks to focus on inflation and economic stability. What we may observe in Latin America is that increases in domestic interest rates could depreciate the currencies, contrary to what one normally would expect, due to the increase cost of foreign debt and prospects of financing difficulties (Blanchard 2004). The depreciation of the currency would add to the burden of external debt. In this case, the ability of the central bank to conduct monetary policy could be seriously impaired; a monetary tightening could sow the seeds of a fiscal crisis. Monetary policy becomes dominated by the fiscal position of the country, and its stabilisation role undermined.

In addition, when there is fiscal dominance there is also the fear of floating of the exchange rate, precisely because of the destabilising effects of currency fluctuations. I have not seen a situation like this recently, with the possible exception of Argentina in 2018. But, given currents trends in some countries, we may get there sooner rather than later.

*The task of controlling inflation with fiscal problems, in the midst of social challenges, could impair central bank work. Could central bank independence be at risk after Covid? How can we preserve the monetary institutions in the region?*

There is a need to increase social expenditure in the region, but this is a challenge in the context of relevant limits to public finance. The recent history of inflation control in most Latin American economies has been a solid foundation for central bank independence. Of course, there will be the temptation to eliminate central bank independence to allow for monetary financing of the budget. Fiscal dominance may occur even with central bank independence. However, it seems unlikely to me that there would be political support for eliminating central bank independence in democratic countries through the region; there is still significant fear of inflation.

Overall, central banks have done a very good job during the Covid-19 crisis (Cespedes and De Gregorio 2021). They have not only delivered very expansionary monetary policies, but also contributed to the flow of credit to the private sector when it was most needed (i.e. the periods of generalised lockdown). Given the bad inflationary experiences of the distant past in the region and the good performance during the last crisis, it is hard to envisage political support for monetary financing of the budget. However, as populism takes centre stage, limiting central bank independence remains a risk.

The best way to preserve the monetary institutions in the region is by maintaining their job focused on price and financial stability. Moving away from this, including by embracing quasi-fiscal policy, may undermine the nature of central bank policy and, as a result, its independence, opening the door to requests to fulfil new tasks.

*There is increasing belief in some corners that monetary financing of government spending and debt is harmless. After all, QE is a recognised tool in advanced economies and some even believe in Modern Monetary Theory. Do you believe that? If not, how can economists regain the narrative?*

QE is a useful monetary policy tool at the zero lower bound. Since short-term rates cannot fall further, monetary policy seeks to reduce long rates by exchanging bank reserves for bonds. By reducing interest rates, it reduces the cost of borrowing by the government, opening space for expansionary fiscal policy.

The temptation for fiscal authorities that are unable to borrow is to issue debt purchased by the central bank, in an indirect monetisation of the budget, as we learned from the unpleasant monetary arithmetic argument. This is the reason why central banks should be allowed to buy only government debt in the secondary market. Independent central banks should be forbidden from buying primary issues, as a way to separate monetary operations from government financing.

MMT, however, goes beyond this and presumes that fiscal deficit can be financed through money creation with no effects on inflation. This could be a reasonable assumption in the context of a liquidity trap, where fiscal and monetary expansions have an impact on activity without affecting interest rates and inflation. But, for a healthy separation of monetary and fiscal policy, the budget should be financed in the market and not directly through the central bank. When the economy is operating away from the ZLB, and in particular close to full employment, fiscal expansions cause inflation and crowding out and have small effects on activity. MMT is a mirage; it assumes that fiscal expansions financed by money creation have no costs – like a free lunch. MMT is particularly useless in Latin America, where the long history of high inflation caused by fiscal imbalances was very costly in terms of growth and progress (De Gregorio 1992) . The shortcomings of MMT have been thoroughly documented by Edwards (2019). It is very unlikely that any serious Latin American scholar would argue in favour of MMT.

*Do you believe Covid brought a reversal of globalisation trends? Would this mean more difficulties generating current account surpluses and/or balance-of-payments financing going forward?*

The Covid-19 crisis is unrelated to trade and financial globalisation frictions. Of course, recent tensions in the trade system could reduce the incentives for global value chains. However, I do not think there will be a reversal in globalisation. Since the global financial crisis, financial integration has proceeded at a slower pace, and this is a natural consequence of previous financial excesses and the need for tighter regulation. However, globalisation will not recede. Moreover, the incipient developments on crypto and digital assets will make it much more difficult to control cross-border flows.

*In some countries, where the financial system got used to low interest rates, raising interest rates could be destabilising. What's your view? Is there a risk of a financial crisis or turbulence if inflation is back and interest rates increase? How can we avoid a future crisis?*

It is true that an environment of low interest rates induces more borrowing and risk-taking in a search for yields. Nevertheless, for this to be a destabilising factor for a financial system, borrowing must have been too risky – for example, allowing for unhedged foreign currency borrowing in emerging market economies. We have also witnessed important fluctuations in capital inflows, with periods of severe tightening of financial conditions, and the financial systems in Latin America proved able to accommodate those events well.

Since the global financial crisis, exchange rates in emerging markets have gone through periods of high volatility and sharp depreciations, and their financial systems have not been destabilised despite large foreign exchange borrowings incentivised by low interest rates. To the extent that the evidence suggests that recent borrowing was done to hold liquid assets for future investment, there is no reason to fear the presence of widespread risky currency mismatches (De Gregorio and Jara 2021).

At any rate, to avoid financial problems, central banks and financial authorities should have in place sound prudential regulation and they should constantly evaluate the health of balance sheets under scenarios of severe stress. This is the appropriate way to anticipate potential problems, and this is currently being done in major economies in the region.

*Latin American countries depend on capital flows and external financing. In a post-Covid world, with more uncertainty and higher debts and interest rates in advanced economies, do you believe there is a balance-of-payments crisis on the horizon? How could Latin American countries and international organisations prepare for that?*

Never say never. There are always situations in which external financing problems could arise. However, during the global financial crisis, facing perhaps the most severe financial distress in the global economy, most Latin American countries did not have problems

of external financing. At the core of this has been the flexibility of exchange rates. Most external financing problems have been caused by exchange rate misalignments that have induced financial fragility and unsustainable current account imbalances.

Financial systems across Latin America have stood up well in the last 20 years, despite being subject to great financial shocks coming from the world economy. Despite high volatility of capital flows, we have not seen problems of external financing. Flexibility of exchange rates, which does not promote one-sided speculation against domestic currencies, and relatively well-regulated financial systems have been the cornerstone of this performance. Nevertheless, high levels of debt and interest rates can make macroeconomic and financial management more challenging in the future.

*An important characteristic of the post-Covid world is the asymmetric impact of the crisis on sectors, social groups, genders, and others. How can we prepare Latin American countries to restore the balance? The next crisis could also be epidemiologic. How could we prepare for a prolonged Covid crisis or a similar pandemic crisis?*

This is very important challenge for policymakers. Covid-19 brought important changes in the way we work, interact and relate with the rest of the world, among others. The effects have been quite asymmetric across sectors and social groups. Public policy should help the transformation of the economy. There are many productivity-enhancing activities for the future, and many opportunities to improve the quality of life of the population. A basic case has been online work, which has allowed many people to save time on travel and facilities to work more productively. This is particularly relevant in Latin America, where public transportation is quite deficient. But there are also groups of the population that are falling behind, especially those whose jobs depend on social interactions. This will be the big theme of public policy in the coming years. There are many opportunities to improve quality of life, but also many risks of barking up the wrong tree.

We are still in the Covid-19 crisis, and perhaps we are two or three years away from returning to normality. It is time to strengthen health systems and accommodate the economy to conditions that, for at least a couple of years, will be very different to those of the pre-pandemic world.

*Chile was the poster child for stability in the region for decades. Nevertheless, social unrest and protests have knocked on the door recently and a new Constitution is in the making. Will Chile look more like a classic Latin American economy going forward, with more challenges? Is there a risk of future crisis?*

There are many causes for the social unrest and the ensuing political crisis. However, equality, in a broad sense, has become a central demand of the people. A new Constitution is being drafted, and presidential and Congressional elections are coming before the end of the year. In the middle of this political crisis and institutional redrawing, there has been a rise of populism, in the sense of proposals that may be popular in the short run

but with little effects in terms of improved wellbeing in the long run. At the same time, the number of spending promises in a scenario of a needed fiscal tightening is a threat to the fiscal prudence that has historically characterised the country. There are many risks, but I am confident that the people and authorities will see the need to continue the good policies that the country implemented in the last decades and that generated important deep changes. We must avoid returning to the old Latin American populism, but success is not guaranteed.



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# "Good results are the best guarantee of central bank independence"





**Federico Sturzenegger**
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*What is your assessment of the fiscal situation of Latin American countries after Covid? Do you agree that, in some countries, the unprecedented fiscal expansion to respond to the pandemic has generated too large a debt that calls for a fiscal response? If so, is this higher debt capable of generating debt crisis and default? Is this higher debt potentially a debt overhang that is going to hamper growth in the region in the short, medium and long run?*

I think we don't have a debt sustainability problem at hand. The fiscal situation has deteriorated throughout the region, though not to a tipping point that makes debt unsustainable. I have estimated that the primary surpluses needed to ensure debt sustainability in 2022 are on average, for Latin American countries, 1.6% higher than those expected for 2021 by the April 2021 *World Economic Outlook*. Therefore, some effort is required for debt sustainability. But some of that adjustment will come naturally from phasing out some Covid-related expenses. Also, the required surpluses for 2022 are smaller than those of 2019, before the crisis, and smaller than the historical primary surpluses these countries have attained recently. Part of this benevolent scenario results from expectations of lower rates, but the bottom line is that the extra fiscal effort needed to ensure sustainability is small and not unfeasible by historical standards.

There are important lessons from the recent fiscal experience, though. The most important is that a significant chunk of the fiscal spending of 2020 and 2021 was to a great extent useless. I think we need to acknowledge that. It is beyond question that vulnerable groups and workers deserved support; the same goes for firms that were forced to shut their doors for a while. But fiscal multipliers are low, particularly if people cannot spend, and a significant amount of spending was used to provide income to people that were not poor, had steady income flows, at a time when they could not consume. The result was that the deficit financed an increase in private savings, in many cases, of the well-off, such as public employees. In the case of Argentina, for example, public employees did not go to work for more than a year during which they were fully compensated, even though during this period, their consumption possibilities were also strongly curtailed.

It makes no sense to bring forward income to a moment when consumption is unfeasible.

To put it more bluntly, to increase the public debt so that some people can save more is sheer madness!

*How should indebted countries in Latin America avoid a future debt crisis or debt overhang problem for growth in future pandemics?*

Fiscal policy, if faced with a similar situation in the future, needs to be thought out very differently. It must be better calibrated and more focused, reducing unnecessary and useless public good expenditures during the pandemic state.

We could also prepare budget rules that provide future flexibility. For example, budgets rules could include: "If in a particular year the OMS declares a world pandemic, which has such and such impact on the local health situation (to be defined) which, in turn, requires lockdowns, ...then the authorities will be entitled to adjust public sector wages (or spending) accordingly." The same goes for interest payments. New clauses in private and multilateral lending could state that in a global pandemic, debt service could be reduced or postponed. This procedure would be transparent, not subject to moral hazard problems, and would help alleviate the debt costs during a future pandemic episode. I see no reason to not include these clauses in multilateral and private bond issues.

*Even if fiscal problems are not apparent in some countries, governments have become accustomed to low interest rates and low funding costs in the last few years. Are they ready for higher interest rates in the future? How should governments prepare for higher interest rates?*

Higher interest rates would be a problem, although I think the situation is different for dollar debt and for local-denominated debt. If US inflation spikes, dollar interest rates would increase – no doubt about it. But the impact on real rates is yet to be seen. Martin Uribe has recently shown that permanent increases in inflation have come along with lower real rates, while transitory inflation spikes are associated with increases in the real rate. Which one it will be this time is still unclear. But even if real rates increase because of the Fed's attempt to taper inflation, the increased cost applies only to new debt issues, while the stock of debt benefits from debt dilution. This means that US inflation will probably relieve the pain of foreign currency-denominated debt, which tends to be longer term and have fixed coupons.

The analysis is slightly more difficult with domestic debt. Inflation still dilutes debt, but it is more likely that local rates will catch up faster to inflation in the event of a negative shock. This is partly due to shorter terms on domestic debt and also because central banks in the region are likely to be more proactive to avoid a de-anchoring of expectations. This issue can be illustrated by what is happening today in Brazil, where ex-ante rates on domestic debt have already become positive.

A good step would be to make debt more contingent. The IMF could also lend in a more contingent way, profiting from its ability to hedge across countries and across time. Real exchange rates are negatively correlated across countries and should provide a hedging space.

*Sometimes excess debts and financing problems lead not to crisis but to higher inflation in Latin America. Do you believe inflation will be back in the region after Covid? In Latin America, fiscal expansion with low real interest rates tend to generate future inflation. Is this time different? What would you recommend central banks do going forward?*





Much as I do not see an impending debt crisis, I do not see inflation spiralling out of control in Latin America. Over recent years, central banks have managed to control inflation and assert their independence in the region. This has been the case even with governments for which one could have been suspicious of their inflation intentions, such as Mexico's AMLO or Peru's Castillo goverment. The fact that Castillo made clear that the Reserve Bank of Peru would remain independent is a wonderful metaphor for this coming of age.

During a pandemic, lower consumption works to depress interest rates. At the same time there is a tendency to increase the demand for money. So, the role of the central bank should be to keep an attentive eye on liquidity conditions, making sure that it satisfies the demand for money and avoiding that the money market becomes an additional source of disruption. Beyond that, it is not clear to me that the central bank should play any other role in a pandemic.

I believe central banks should stick to their mandates. They should not focus on anything else beyond their mandate for price stability, even in extraordinary circumstances. Otherwise, in the future there will be pressure to expand the definition of an extraordinary circumstance, to accommodate other objectives.

*More extreme, do we face the risk of fiscal dominance? Could central banks even control inflation if it occurs?*

The region has moved from a regime of fiscal dominance in the 1970s and 1980s, where central banks were used to finance fiscal policy, to a regime of monetary dominance from the 1990s onwards in which central banks are mostly independent. In this new regime, the treasury understands that it must balance its intertemporal budget constraint without use of central bank resources. We need to preserve this framework even if things get rough and fiscal policy becomes unsustainable. I think inflation is the worst solution to a debt-sustainability problem. If the 'shit hits the fan', so to say, I would let fiscal policy creditors fix their problems with the government but not knock on the door of the central bank.

*The task of controlling inflation with fiscal problems, in the midst of social challenges, could impair central bank work. Could central bank independence be at risk after Covid? How can we preserve the monetary institutions in the region?*

I think that the best way to preserve monetary institutions is by having central banks focus on their job. Good results are the best guarantee of their independence. When Lula came to power, the previous success of the central bank compelled him to name Meirelles as governor. Once you've got to this point, it is a question of delivering a minimum standard of results to ensure that no government tries to mess up.

Of course, there are exceptions. In Argentina, for example, the consensus is that the central bank needs to coordinate policies, whatever that means. I guess it means it has to finance the treasury. But this approach does not allow the central bank to build credibility and takes you non-stop to the current 50% inflation rate. So, if someone doubts about the need for independence of the central bank, you can always point in the direction of Argentina.

*Argentina had formal independence in 2001, and yet the Alianza government managed to displace the central bank governor and place a substitute more in line with the Minister of Economics. This happened, again, in 2007 under a Peronist government. How should formal independence be implemented in practice to avoid this de facto dominance?*

Absolutely true, formal independence is not a sufficient condition. But it sure is a necessary one. Always, if shocks are large enough, institutions may get reversed. Even the United States violated gold contracts at some point. But formal institutions increase the cost of that reversal. So, the stronger they are, the less likely they are to get reversed. And if you survive repeated shocks and are successful in bringing down inflation, then the institution becomes perceived as important, and you enter a virtuous loop. Marcel and Velarde have recently been re-appointed as central bank governors in Chile and Peru, and are two good examples.

*There is increasing belief in some corners that monetary financing of government spending and debt is harmless. After all, QE is a recognised tool in advanced economies and some even believe in Modern Monetary Theory. Do you believe that? If not, how can economists regain the narrative?*

Very respectable economists, some of the best in fact, argue that in advanced economies, because $r < g$, government expenditure can expand without bound and without cost. I like Robert Barro's argument for why this is technically wrong. The $r$ that needs to be considered in this computation is the return of equities or real assets, not the risk-free government bond that is offered in net zero supply. If government debt holdings were to persist indefinitely (technically, the present value of debt in the infinite future is positive),

it means that someone holds those assets forever, violating the zero net supply assumption that underpins the low rate. In another words, try to push debt far into the future and you'll see higher interest rates quickly. In Latin America, all this is old hat.

When you acknowledge Barro's logic, it means that the budget constraint of the government is well defined and that debts today imply higher taxes tomorrow. No escape from that. In Latin American countries, this constraint is all too evident. This is the reason why building up debt so that some rich people can save more in the pandemic seems like a terrible mistake.

The same goes for MMT. The flattening of the Phillips curve in the United States has rekindled the idea that the demand for money is infinitely elastic. I find all these ideas pure nonsense. Fortunately, given our past history of inflation, I think they have less relevance in the region. We are lucky that our central bankers have their feet on the ground.

*Do you believe Covid brought a reversal of globalisation trends? Would this mean more difficulties generating current account surpluses and/or balance-of-payments financing going forward?*

Obviously, the reductions in transportation costs achieved in the second half of the 20th century have been hindered during the pandemic by increased health protocols, but these costs probably will be contained or reverted quickly. Also, as GDP becomes more digital, the scope for globalisation increases. Today a young person in Colombia can sell his or her time to chat with an elder person in Kansas, something unthinkable only a few years ago. As work becomes remote, location becomes less important. In a world where all work is done digitally, it would be a truly global labour market. And I think we are going in that direction. So, if you press me to take a position, I would say that Covid will probably accelerate the process of globalisation.

*In some countries, the financial system has become accustomed to low interest rates, so raising interest rates can be destabilising. What's your view? Is there a risk of financial crisis or turbulence if inflation is back and interest rates rise? If so, how can we avoid a future financial crisis?*

This takes us to the issue of financial sector regulation. My sense is that financial sector regulation has improved dramatically in the last few decades, maybe even with a bit of an overkill in terms of capital and liquidity requirements after 2008. In general terms I see a sound environment, to which low inflation is perhaps the most important input, but which also rests on rules like non-related parties lending, credit limits and borrower diversification that have become ubiquitous.

While Argentina is probably not a good example of anything in macroeconomics, in terms of financial regulation it has done a good job. In fact, while I was governor of the central bank, I never lost sleep over the soundness of the financial sector. Argentina in the early 2000s implemented an innovation that I think makes a lot of sense: in order to avoid risks

arising from FX jumps, it not only required banks to have a low exposure to exchange rate changes in its net worth (something pretty standard), it also required banks to worry about the FX exposure of the *recipients* of the loans. In particular, no company can take a dollar loan if its income stream is not dollarised, thus avoiding a currency mismatch by the borrower. This has worked extraordinarily well in contexts of extreme dollar volatility.

I think the biggest challenge banks face in coming years is the phasing out of transactional deposits that typically reduce the average cost of lending for banks. If transactional deposits migrate to a central bank digital account, for example, then the bottom line of financial institutions will change dramatically. I think a lot of the debate will occur in this dimension in the future.

*Latin American countries depend on capital flows and external financing. In a post-Covid world, with more uncertainty and higher debts and interest rates in advanced economies. do you believe there is a balance-of-payments crisis on the horizon? How could Latin American countries and international organisations prepare for that?*

Balance-of-payments crises don't happen out of the blue; they occur when macro policies are unsustainable, and governments in the region have moved a long way to achieve that sustainability. So, I don't see this as a major concern.

*An important characteristic of the post-Covid world is the asymmetric impact of the crisis on sectors, social groups, gender, and others. How can we prepare Latin American countries to restore the balance?*

Some countries are more status-quo biased. Argentina, for example, is a country where no activity can be threatened without generating an uproar. As an illustration, I can mention that the City of Buenos Aires has sustained a long and exhausting fight against Uber, concerned about how it would affect traditional cabs. And I am speaking about the most innovative local government in Argentina, so imagine the scenario elsewhere in the country. When societies have this degree of rigidity, any asymmetric shock will be more difficult to handle. The temptation is to think that the government must do something about this, but honestly, I am sceptical about training programmes and initiatives of that sort. The inability of society to cope with shocks is a problem that, in many cases, is created by the government itself, mostly through its legislative and regulatory excesses. And I am sceptical of the solutions provided by whoever got me in the mess in the first place. The focus should be on reducing these rigidities, that is, providing more flexibility.

*The next crisis could also be epidemiologic. How can we prepare for a prolonged Covid crisis or a similar pandemic crisis?*

Even if the next crisis is epidemiologic, we don't know what characteristics it will have. What will be the transmission mechanism? What age group will it affect? Will it be more geographically contained?

If the transmission is airborne, like Covid, then I guess we have learnt a lot and we will be quite quick to respond both at the public and private level. But if the transmission is through surfaces, water, or any other new mechanism, it will impose a new set of challenges. And then there is the age issue. This pandemic affected the elderly, with a smaller impact on children and the working-age population. If a new pandemic affects the youngest, the whole approach will have to be redesigned. And then there is the issue of how lethal it may be. Imagine a pandemic where contagion means death. That is a totally different scenario.





Having said that, I think what comes out of this pandemic are two things. First, societies around the world will react more quickly, in line with the faster response to Covid in East Asia, which had previously been chastened by the avian influenza and SARS. Second, the response has been, on some occasions, an overreaction, and I think this will lead to a more reasoned response to future episodes.

*Argentina had struggled with macroeconomic stability long before Covid. Has the pandemic made it more difficult to find a route to stability? What are the key aspects that need to be addressed to allow Argentina to breathe more macroeconomic stability going forward?*

Argentina's problems with macroeconomic stability have been around for a while. They certainly have to do with a political configuration in which very strong interest groups combine with a conservative electorate biased towards preserving the status quo. These interest groups are all those that receive a cheque from the state, that receive protection from the state – among which we have a big chunk of the business community – and the unions, of course. These interest groups mobilise against change, and change becomes impossible because those who benefit from it will show up in the future, while those that transitorily may have something at stake are around today. This means that reformist governments are easy prey for those interest groups. Pressure from the interest groups quickly erodes political support, leading to weak fiscal results and weak institutions. Unless these interest groups are removed from the stage, reform and stability will remain elusive.

## ABOUT FEDERICO STURZENEGGER

Federico Sturzenegger is full Professor at Universidad de San Andrés, Visiting Professor of Public Policy, Harvard Kennedy School and Emeritus Professor at HEC, Paris. He holds a PhD in Economics from MIT (1991), was Assistant Professor of Economics at UCLA (1991-1995), Chief Economist of YPF (1995-1998), Dean of the Business School at Di Tella (1998-2000/2002-2005), Secretary of Economic Policy of the Republic of Argentina (2001), Visiting Professor of Public Policy at the Kennedy School of Government, Harvard University (2005-2007), President of Banco Ciudad de Buenos Aires (2008-2013), Member of Parliament, House of Representatives (2013-2015) and Governor, Central Bank of

Argentina (2015-2018). He has written or edited nine books, and has published extensively in the area of international finance and macroeconomics. In 2005 the World Economic Forum of Davos selected him as Young Global Leader. In 2006 he received the Konex award for his contributions to economic theory. In October 2021 he published *Advanced Macroeconomics, An Easy Guide,* co-authored with Filipe Campante and Andres Velasco.

# SECTION II

# POLICIES FOR SUSTAINABLE GROWTH

# "Social discontent can be easily mobilised to immobilise public policy"

**Marcela Eslava**
Universidad de Los Andes

*What would you say is the most likely growth scenario for the Latin America region as a whole, and in your country in particular: a quick take-off, a new lost decade, a mixed bag?*

It all depends on whether (and which) Latin American countries purposedly embark on a decided strategy that at the same time rebuilds lost capacities and addresses some of the hurdles to inclusive growth that, having haunted the region for decades, became most apparent with the pandemic. They have been busy dealing with the health emergency and putting patches on the wounds inflicted on the economy: subsidies to those whose incomes were badly hit and to firms who are struggling to stay alive. But it is by now clear that that the activism was not enough and is not sustainable – it could not have been, with limited fiscal spaces and the impossibility for the state to sustain the full complex web of relationships that the economy is, within a country and with others. Some of those wounds will become permanent scars. Attenuating their depth will demand deep reforms that were already needed before the pandemic and became more pressing with it. Passing those reforms, in turn, requires political will and support that look difficult to achieve in the current climate of political division. Positive leadership will be a must in the immediate future.

Why was the region more badly hit and why does it need reforms to get out of the hole? Part of it has to do with fiscal constraints, both to supporting those affected and to moving forward more rapidly in the adoption of the technologies needed to fight Covid (mainly vaccinations at the time). But a whole lot more has to do with the risks associated with the region's economic structure. Social security and employment protection schemes, as well as remote working, protected millions around the world from losing their incomes. But, as I show in research with Laura Alfaro and Oscar Becerra, a very large fraction of workers in the region could not rely on these options, either because they held informal jobs or they were in occupations not fit for remote working. In the recovery, however, informal jobs have been most easily recovered. The bias towards informality in the recovery implies an impoverishment of average working conditions, including earnings and stability. Formal jobs, when lost, are difficult to recover given their high costs to the employer and their reliance on high organisational capital. Reforms that address the underlying segmentation of costs between formal and informal jobs are necessary for a recovery that would make up for the many months of lost growth. Further addressing other reasons for the low coverage and unequal nature of social security systems in the region will also be necessary for that growth to be inclusive.

Another reason why the danger of permanent losses is larger in Latin America is the horrendous loss of education and of acquisition of soft skills of children and youngsters in the region. School closures were more extended and unconditional in the region than they were in most advanced economies – all this in a context where millions of students had no connectivity and had home environments that do not foster their learning process. We already see a high prevalence of irreversible consequences, such as youngsters who left school for work and teenage pregnancies, many involving domestic sexual violence. We have yet to assess the full extent of the damage to formal learning and social capabilities of the generations of children who should have been in the classroom, but we already see increasing reports of learning gaps and mental health effects. All this implies a permanent reduction of human talent for the future, perhaps the most crucial ingredient of inclusive growth looking to the next decades.

*With a few exceptions, within the developing world Latin America has been exhibiting lacklustre growth in recent years. Even exceptions such as Chile or Colombia seem to be facing worse growth outlooks than in the past decade. What do you think are the main reasons for this?*

The region has spent decades without being able to reduce its per-capita income gap with respect to advanced economies. Of course, there is no single origin to this problem. But since you ask for the main reason, I'll point to what I believe is the main underlying factor: the weakness of Latin American states and its many manifestations, which are conducive to low aggregate productivity and, in many cases, deep inequality and social segmentation. In terms of growth, the most worrisome of these manifestations are (1) inflexible regulations coupled with the inability to enforce them; (2) social security and labour protection systems that are at the same time unable to provide broad coverage, extremely generous to a few, and frequently financed by businesses through taxes on labour; (3) poor public good provision; (4) ineffective public administrations; and (5) corruption.

The first two aspects segment Latin American businesses and workers into informal and formal classes. It is in informality where most of the productivity gap – and the growth gap vis-à-vis the developed world – is concentrated, and also where the poor and vulnerable workers mostly are. But all five factors provide a weak environment for productive activities, innovation and more general value addition and productivity growth. They all impose high costs on productive activities. Those costs are largely independent of how productive or innovative the activity or business is, thus weakening the link between the relative success of an activity and its relative productivity, and ultimately disincentivising not only what should be the natural concentration of workers in occupations, firms and sectors that generate the highest value, but also the efforts to innovate and stay competitive.

*Macroeconomists have long thought of growth from a macro perspective: fiscal balance and economic stability, access to finance, investment in physical and human capital. More recently, the discussion about growth has been enriched with what we could call micro elements that were previously implicit or understated – equity and fairness, labour segmentation and precarity, insufficient or inadequate education, fiscal fatigue and civil unrest, etc. – all of which often impose limits on the speed and nature of macro reforms and pro-growth policies. Ultimately, do you think they represent additional growth hurdles for an already slow-growing region?*

These phenomena not only impose constraints on policies; they clearly impose constrains on growth itself. Take, for instance, the formal/informal segmentation of the labour market mentioned in your question – a distinguishing feature of Latin American economies.

Informality, loosely understood as lack of compliance with rules, is an expression of the concurrence of low productivity, low enforcement capabilities of the state, and rules that are too costly to comply with given that low productivity. These three elements, and informality itself, are at the root of low per-capita income levels in the region. Low productivity is the main ingredient of such poor performance. The high costs of formality generate disincentives for firms and individuals to engage in investments that lead to growth and exceptional performance, as activities such as exporting or patenting are incompatible with remaining 'off the record'. Poor enforcement also implies poor average product and service standards, and an inability to compete for the most sophisticated costumers. Finally, informality itself is a cause – not only a consequence – of low productivity. Businesses that are informal do not adjust the quality of their products to comply with minimum regulatory standards, or to trade with the government or other highly demanding formal costumers of providers. As a result, they do not benefit from positive spillovers on productivity or organisational capabilities from belonging to sophisticated production or distribution networks.

Having said that, it is also the case that these microeconomic factors affect the feasible set of policies and the political process to approve them, through their influence on the architecture of society and public sentiment. Let's stay with the example of labour segmentation and its underlying drivers. Most of the labour regulations that generate exclusion from formality by making formal employment costly are there to protect workers: social security contributions to fund employee benefits, or minimum wages well above the actual earnings of large fractions of workers. Labour market segmentation also segments interests: formal workers who benefit from these regulations and informal ones who are excluded from these benefits by how generous they are, but who also have hopes of eventually accessing them. The growth agenda thus requires some degree of redistribution from formal workers, who may be better off than their informal counterparts but are far from being high-income, to those who are currently most vulnerable. Of course, the hope and intention is that they bring enough growth to make everyone better off then they currently are in absolute terms, but the agenda asks the middle class to trade off current certainties for uncertain future benefits. All of this while this middle class also

sees a giant income gap to a very thin layer of truly high-income individuals – of whom our current tax systems ask very little effort – and demands redistribution from that privileged layer towards them.





*Some observers have argued that Latin America is either stuck in, or getting into, a middle-income trap, with roots that are not only economic but also social and political. These include a growing discontent with the system's institutions and a feeling of unfairness that, in turn, fuel spending demands on governments that, because of the pandemic, have exhausted their fiscal space. Do you believe Latin America is in a middle-income trap? What would be the economic strategy to escape it?*

One outstanding feature of Latin American economies in the current global economy is the combination of middle income and high inequality. Only Africa exhibits similar levels of inequality, but it does so at much lower levels of income. The region's inability to couple growth with inclusion has fuelled discontent among millions of Latin Americans whose aspirations to a certain level of comfort (reasonable in a middle-income context) are not matched by their realities or those of their close ones. In a context where popular protest thrives thanks to technology that has reduced to a minimum the costs of popular organisation, and where polarisation has increased the appetite for populist politics, such discontent can be easily mobilised to immobilise the public policy that is necessary to overcome the hurdles to growth. Paradoxically, it can also become the obstacle for the most important redistributive public policies.

An effective economic strategy to address lacklustre growth must therefore also address the lack of inclusion in economic gains that Latin Americans are used to. The good news is that, as I said before, the main obstacles to growth in the region are also at the basis of its deep inequality problem. But the agenda to solve them has no easy way forward. By its very nature, this growth agenda implies redistribution: some will benefit much more than others, and some may even lose. Among those who may feel threatened are not only the people who can be considered rich (frequently less than 3–4% of adults in the region), but also an important fraction of people with middle levels of income and wealth, who have become increasingly important politically. As I mentioned above, much of the redistribution in the region should be from formal to informal workers, that is, not only from high-income to low-income, but also involving transfers from the middle class. Although traditional vote buying and clientelism are unlikely to go away, politicians in the region are increasingly being forced to mobilise support from these middle-income groups, who gained voice through the recent waves of organised popular protest in the region. The 'trap' you refer to, in my view, is the difficulty to devise reforms and ways to explain them that address these clashes of interests.

The way out of the (hopefully apparent) trap requires positive leadership able to gather people around the common purpose of shared prosperity, with stronger states and social security systems. The political polarisation and populism that have dominated the recent political debate in the region have, instead, emphasised divisive discourses around a presumed trade-off between growth and equality that, in the region, is a fallacy.





*The need to reduce commodity dependence has been a common concern in the region for decades, yet the diversification never materialised. Do we need to diversify? Has the meaning of diversification changed over the years?*

The need to diversify away from resource extraction in the region is more important today than ever. We have discussed it for decades in relation to concerns over the macroeconomic volatility implied by the dependence on commodities with fluctuating prices in foreign currency. In the era of climate change, the dependence of many countries in the region on the extraction of fossil fuels brings additional reasons for concern. It contributes to what is already an environmental disaster with health and welfare costs that these countries are not immune to. It also puts those countries in the line of fire with an international community that is (hopefully) increasingly committed to stopping demand for those fuels.

Highly concentrated production and export baskets also imply we miss productivity gains from dense production networks, which generate welfare gains not only – and not mainly – from an ability to produce greater volumes thanks to externalities in those networks (better inputs, knowledge about technology from input consumption and from competition), but more importantly from diversification itself. Consumers gain from diversified consumption baskets, which also implies firms can thrive through innovation that appeals to those consumers, and individuals can have diverse life projects. Diversification today not only means reducing the share of income, production and employment from resource extraction; it means primarily increasing the variety of goods and, importantly, services that are produced and provided, adapting them to the diverse and changing needs and life plans of individuals and societies.

*Industrial policy as a way to develop and generate growth has long been at the heart of the public debate in Latin America. Are manufactures the way to develop from a rural economy to a mature, services-based one? Whereas economists such as Dany Rodrik see traditional industries as a stepping-stone for inclusive development and warn about premature de-industrialisation (or a premature jump to a service economy), others praise services (or 'industries without smokestacks' such as tourism) as a shortcut to the inclusion of a large informal unskilled workforce currently employed in subsistence agriculture or precarious marginal activities in big cities. What is your view on this*

*debate in the context of the technological advances promoted by the pandemic? In particular, and going back to your previous comments, where do you think the 'good' jobs needed for inclusive growth will mostly come from?*

I have a very hard time seeing that the promising path to development in Latin America could come from developing cheaper ways to manufacture certain products. Manufacturing has been seen as a stepping-stone for development based on the idea that it is more prone to technical change and tradable than services. The IT revolution has proven that this was not immutable. Profound technical change in services has materialised that allows services to trade over IT platforms, form dense production networks, and massively absorb low-skill workers. And, for both manufacturing and services, high-value technical change is less and less about producing cheaply and more and more about producing diversely.

For better or for worse, Latin America did not industrialise heavily at the stage of development at which this was expected. Now, facing a global economy and a technological frontier that are mostly services-based, I have little doubt that it is in services where jobs will continue to be created looking forward. Whether this is good or bad news for the speed and inclusion potential of future growth will depend not on *whether* but on *how* the region grows in services: high- or low-complexity services, services where it has or can create advantages.

Natural and cultural diversity provides advantages for tourism and creative industries. This is not minor – tourism is already the main income generator among services exports in many countries in the region, and it is a sector with potential for large contributions to GDP. But tourism can be largely informal, environmentally harmful and of low complexity – or the opposite. Much will depend on the will of governments to regulate the industry in an effective way to align it with the objectives of inclusion, environmental sustainability and diversification.

*During the pandemic there was a revived role for the public sector (supporting jobs, firms and low-income households; adopting emergency laws; leading the quest for the vaccine and the vaccine roll out), not only as a regulator but also as an active participant. What is your view on the role of the public sector? Has the pandemic changed your views about this role? Do you think the popular perception of the role of the public sector has changed to the point of inhibiting the retrenchment and fiscal consolidation due post-pandemic?*

Very early in the pandemic, we learned that Latin American governments were able to quickly design and operationalise systems capable of reaching out to specific groups of people and firms. This came as a surprise in a region where millions of people and firms are off the radar of the authorities – unreachable to tax authorities, the pension and health system, law enforcement. In the early days of the pandemic, many Latin American

governments seized technology and partnered with private corporations to integrate existing registries into databases usable to identify those in greatest need and transfer them cash. They also partnered with the banking sector to get to firms.

I believe that the realisation of the potential that technology and public–private collaboration have to boost state capacities in the region will change, or at least should change, our traditional poor-man's approach to public administration. And this can be a game changer for a region where weak state capacity has been at the heart of the development problem.

Of course, the pandemic also changed the role of Latin American governments in the narrower sense of engaging more actively in subsidising people and activities most in trouble. This was natural and appropriate at the height of the crisis. As we progress into the recovery phase, the involvement should evolve towards efforts to get people into formal jobs, get them to adapt their skills for the post-pandemic economy. Latin Americans learned, I hope, that widespread subsidies are a possibility, but also that they have limited effectiveness. Positive leadership should reinforce this message.

*Are so-called vertical pro-growth policies (targeting specific activities or value chains) still a viable option for Latin America? If so, what sectors would you favour post-pandemic, and how?*

It is the 'how' question that really matters. Governments in the region de facto target sectors and they frequently do it with total disregard for the concerns of those who oppose targeting, simply finding ways to make business more favourable for targeted sectors. I believe this is in part a result of an overly simplistic debate that often focuses only on whether or not to target – a false black-and-white dilemma that forgets that in reality such targeting comes in infinitely varied shades of grey.

It is valid for governments to make well-grounded strategic bets for their economy. For instance, betting on sectors where private investment is likely to be insufficient for the needs of the economy as a whole is crucial. The key question is what targeting actually means, and how it is done. Take the example of tourism that I mentioned above. Why could there be underinvestment in tourism, and in particular in those high-linkage, nature- and culture-friendly types of tourism that I argued present a good opportunity for the region? Lack of appropriate infrastructure, low-capability local tourism bureaus and low enforcement of regulation for adventure tourism are all frequent in the region, representing effective barriers to the development of this industry despite the potential for it. Similarly, if we think of high-complexity services, we would find poor IT infrastructure and legal constraints as important barriers. Those barriers arise from poor provision of sector-specific public goods that only governments can provide. In choosing how to prioritise scarce resources for the provision of these goods, going for strategic sectors is a valid north.

I am much less positive, however, about providing targeted high-powered incentives such as tax benefits to specific sectors. These generate much more severe distortions against untargeted sectors, potentially leading to serious misallocation. These types of incentives must be restricted to targets of extreme priority; incentives for 'green' activities would be one example. Any such policy design must be subject to prior careful examination of the costs to those negatively affected, adopted only if the expected benefits are clearly above those costs, accompanied by compensation mechanisms if necessary, and subject to sunset clauses.

There is one bet in which all governments in the globe should be engaging: environmentally friendly sectors and modes of production. Latin American countries have added reasons to embrace this strategy. For one, they are more heavily involved in the extraction of fossil fuels than other countries, and are therefore at greater risk from a fall in external demand. On a positive line, they also enjoy privileged access to natural resources that puts them at an advantage in the provision of eco-systemic services.

## ABOUT MARCELA ESLAVA

Marcela Eslava is Professor and Dean of Economics at Universidad de Los Andes, Bogotá; a Fellow of the Econometric Society; and Vice-President 2022-2023 (President 2024-2025) of The Latin American and the Caribbean Economic Association (LACEA). Professor Eslava holds a PhD in Economics from the University of Maryland at College Park. Her current research interests revolve around the lack of inclusive growth in Latin America, with a focus on firm dynamics and productivity, as well as informality. Professor Eslava's research has been published in leading academic journals, such as the *American Economic Review*, the *Journal of Development Economics*, the *Review of Economics and Statistics* and the *Journal of Public Economics*. She has been involved in multiple initiatives, research projects and missions led by multilateral organisations and the Colombian government to contribute to the understanding of the origins of the deficit of inclusive growth in the region and to devise solutions to it.

# "Lack of progress cannot be solved by a redistributive strategy"



**Ricardo Hausmann**
Harvard University

*What would you say is the most likely growth scenario for the region as a whole and in your country in particular?*

My guess is that the recovery from the Covid-19 recession of 2020–21 is likely to be mediocre. First, the pandemic itself is likely to linger as an economic disruptor, as new variants of the virus emerge and as the protection offered by vaccines erodes faster than the region can vaccinate. Second, the economy will be impacted by the need for fiscal consolidation, which will temper the recovery of demand. On the positive side, terms-of-trade improvements and the fast recovery of the US economy are likely to stimulate the recovery. Third, international financial markets have been supportive, with even lower-rated countries maintaining access to funds at reasonable rates. This may change as the United States and the European Union end quantitative easing and start tightening monetary policy, accelerating the needed pace of fiscal consolidation and threatening macro stability. Finally, accommodative monetary policy in Latin America is unlikely to be very effective as both banks and firms will face equity shortages which will limit credit growth. The IMF's World Economic Outlook current GDP projections for 2024 are between 8% and 10% below what they had projected for 2024 back in October 2019, before the pandemic. This contrasts with the numbers for the United States, where current projections are slightly above what was expected for 2024 back in October 2019. The pandemic is likely to have a very durable effect on the income gap between Latin America and the United States.

For Venezuela, I am particularly pessimistic. GDP has fallen by about 80% since 2013, the largest collapse ever recorded outside of war and one that is much larger and longer than the ones caused by many wars, including the First and Second World Wars and the Spanish Civil War. The destruction of the productive capacity of the oil industry has been so complete, the bankruptcy of the state oil company PDVSA so messy that it is unlikely to recover in a world were financial markets fear funding assets that may be stranded by the efforts to contain climate change. In this respect, Venezuela's oil is particularly heavy and sour, and hence would be more heavily taxed if carbon taxes are ever implemented. The country has seen over 6 million of its citizens migrate, especially those with higher skills, and if the political status quo remains in place, they are unlikely to either go back or be able to substantially engage. I would not expect to see Venezuela return to pre-2013 levels of income in my lifetime.

*Within the developing world, Latin America has been exhibiting lacklustre growth in recent years. Even exceptions such as Chile or Colombia seem to be facing worse growth outlooks than in the past decade. What do you think are the main reasons for this?*

Over the past 60 years, the region has not shown a capacity to narrow the huge income gap it has with the advanced countries, except in short periods of unusually favourable international conditions. The region's income per capita at market prices is less than 1/7th that of the United States, 1/4th when adjusted for purchasing power parity. The gains achieved during the 2004–14 commodity super-cycle have all been given back.

This lack of progress in closing the income gap is surprising in light of the fact that gaps in education, health, life expectancy, infant mortality, urbanisation, fertility rates and female labour force participation have narrowed dramatically or even reversed, while gaps in investment effort are either small or negative. All this means that the gaps in physical and human capital have narrowed substantially. Policies have also become more market friendly: inflation is way down in the single digits (except in Venezuela and Argentina), credit ratings have improved, trade has been liberalised, public enterprises have been privatised and many other indicators of market-friendly structural policies have all been moving in the right direction, suggesting that the productivity with which physical and human capital are used should have improved, causing a convergence of income that should be even faster than the convergence in factors of production. And yet, we see no such narrowing of the income gap. Standard income or growth show a significant worsening of the productivity gap across the board, including in relatively good performers such as Chile, Peru, Colombia and Panama.

My interpretation of this state of affairs is that there is a growing technology gap: Latin America is particularly bad at adopting and adapting technology. Paul Romer got his Nobel prize in economics for the notion that the secret of growth is the growth of ideas, which creates increasing returns to scale at the social level. Moreover, those ideas are public goods: they are non-rivalrous and non-excludable. As a consequence, growth at the technological frontier is inefficiently slow because of the public-good distortions in the market for 'ideas'. But this would make it easier for middle-income countries to catch up, as they can free ride on the 'ideas' that others have developed. We do not observe this convergence in the real world in most places outside of East Asia and Eastern Europe. In my opinion, this is because technology adoption requires adaptation to local conditions, and this requires the production of other 'ideas' and the acquisition of missing knowhow.

*How would you measure this 'quality' of technology adaptation?*

One indication of efforts at the creation of productive ideas is investment in R&D and patenting. The OECD puts together statistics for R&D investment for its member countries and a few others. Fortunately, there are three Latin American OECD members. Unfortunately, these three countries – Colombia, Chile and Mexico – have the lowest reported rates of R&D spending in the OECD.

With patents, the numbers are even starker. For the region as a whole, the rate of patenting is 1/70th that of the United States, with the best performers – Brazil and Chile – at about 1/40th of US levels. This is not a typical feature of middle-income countries: China's patenting rate per capita is higher than the United States and Korea holds the world patenting record per capita, while Turkey, Eastern Europe and the former Soviet Union dwarf the best Latin American performers. Moreover, Latin America's patenting rate is incredibly low when compared to the very large size of its university system and the rate at which it publishes scientific papers. While Latin America's patenting rates average 1.5% of US per capita levels, its scientific publications average 13% of US levels, meaning that Latin America's patenting rate is nine times smaller than would be expected given its scientific publications.

A final piece of evidence is the dearth of new exports in Latin America: while the export basket of fast-growing countries in East Asia and Easter Europe shows rapid diversification and sophistication – from garments, to electronics, to cars, to machinery, to chemicals and beyond – Latin America has been stuck in a narrow set of exports. Even Latin America's own positive deviance – blueberries, soybeans, avocadoes and other fruits – speak about technological developments adapted to local conditions that allowed the region to deploy physical and human capital into new 'ideas'.

In short, the income gap with the technological frontier does not narrow because of a widening technological gap and this is the consequence of the fact that the world develops new technologies at a rate that is faster than what Latin America can adapt to, due to the dearth of its R&D efforts and other activities associated with technology adoption and adaptation.

*Some observers, including myself, have argued that Latin America is either stuck in, or getting into, a middle-income trap, with roots that are not only economic but also social and political. These include a growing discontent with the system's institutions and a feeling of unfairness that, in turn, fuel spending demands on governments that, because of the pandemic, have exhausted their fiscal space. The pandemic – which hit precarious workers harder, increasing inequality – may have strengthened these demands. Do you believe Latin America is in a middle-income trap? To what extent would you agree with the argument above, or with the broader view that growth shortcomings reflect non-economic hurdles? What would be the economic strategy to tackle them?*

I think that I would essentially reverse the causality that is implied by your question. I believe that the middle-income trap is related to problems with the growth process and the discontent you allude to is really the consequence of lacklustre progress rather than its cause. Had the technological gap not widened, the region's income would have substantially converged towards US levels and the middle-income trap would not have appeared. I believe there has been a fundamental flaw in the growth strategy of the region, including Chile's. The region trusted that market-friendly policies would be enough to

cause income convergence: making the world safe for investors and making regulations as seamless as possible would deliver investment and growth. If technology was needed, it would naturally flow in, especially if trade barriers are kept low.

To attract the needed capital, taxation rates on corporate capital income were lowered and taxation on personal capital income has been kept lower than the rate on formal labour income. This has limited fiscal resources and reduced the redistributive effects of fiscal policy.

More importantly, too little has been done to create an innovation ecosystem and very little attention was given to the fact that, even according to Romer's theory, at the core of the growth process is a fundamental market failure: the public good nature of 'ideas'. Just compare the attitude of Latin American economic authorities regarding R&D strategies with those of Israel, Singapore or Korea. Compare the government demands for productive upgrading of Japanese, Korean or even Turkish conglomerates vis-à-vis the cosy attitude taken towards Latin American conglomerates, all focused mainly on non-tradable services such as retail and banking.

Clearly, lack of progress cannot be solved by a redistributive strategy, as Argentina and Venezuela show. It can get countries into a redistributive trap, where the threat of explicit or implicit expropriation drives away the agents of change that might help narrow the technology gap.

*The need to reduce commodity dependence and exposure to real shocks and increase access to foreign exchange from net exports has been a common theme in the region for decades, yet the export diversification never fully materialised. Do we need to diversify? Why? Has the meaning of diversification changed over the years? How does the pandemic's expected boost to service globalisation, in contrast with goods de-globalisation and reshoring, affect the region's trade prospects and diversification strategy?*

I do not see diversification as something that is needed to reduce macroeconomic risks such as terms-of-trade shocks in the way diversification reduces the volatility in the returns of a portfolio. Diversification is really the other side of the coin of specialisation. When individuals specialise, the city diversifies. When doctors specialise, hospitals diversify. Technological progress naturally involves new products and processes. This naturally creates a trend towards doing more things. Exports allow firms to amortise their costs in technology adaptation and product development over a larger market. So, the diversification of exports is a consequence of healthy technology adoption and adaptation. I see the diversification and increased complexity of exports as a symptom of progress rather than a goal.

Regarding the post-Covid-19 world, I do not think that de-globalisation and re-shoring are going to be significant. More importantly is going to be teleworking. Covid-19 taught us that many of the things that we used to do in the office can be done from home. But anything that can be done from home can be done from abroad. This means that there

will be an acceleration of trade in tasks. Some of this will be mediated by freelancers who connect through websites such as Upwork or Torre, as Richard Baldwin has pointed out. Other industries will be disrupted by the possibility of using white-collar workers in the South for activities in the North, but will be intermediated through firms like Wipro, Accenture and PwC. I hope this will create new growth opportunities and export opportunities for people in Latin America. Another area that may benefit Latin America is 'nearshoring': to the extent that the US separates from China, it may want to assure that its value chains are located closer to itself, both geographically and politically. We have seen anecdotal evidence of this trend, but have yet to see how large it will become and which countries will be able to tap into it. My guess is that it will be important for countries like Mexico. If Colombia and Central America play their cards well, they may also reap benefits from this trend. It would be harder to see how the Southern Cone will capture much of this relocation, given the competition from other, better located alternatives.

*Macroeconomists have long thought of growth from a macro perspective: fiscal balance and economic stability, access to finance, investment in physical and human capital. More recently, the discussion about growth has been enriched with what we could call micro or 'social' ingredients that were previously implicit or understated – equity and fairness, labour segmentation and precarity, insufficient or inadequate education ('human capital formation'), fiscal fatigue and civil unrest, etc. – all of which often impose limits on the speed and nature of macro reforms and pro-growth policies. Do you think these factors represent additional hurdles for an already slow-growing region?*

Latin America is the poster child for the confusion between macro and growth. I am an example of that confusion. I finished my PhD in 1981, just in time for the Latin American debt crisis. The lost decade that ensued was characterised by high inflation, recession, multiple exchange rates, price controls, banking crises and defaults. I belong to a generation of economists that thought that fixing these macro problems was not only very important, but that it would lead to growth. The macro policy agenda succeeded beyond belief: inflation disappeared, countries became investment grade, exchange and price controls were abolished, banking systems were made sound. And yet, Latin America did not converge, except very temporarily due to the commodity super-cycle, as I mentioned above. The question is not macro or social: it is technological and unless we solve this issue, we are not going to make the progress that our societies aspire to. Macro, social and so-called 'structural' policies such as those captured by the Doing Business Indicators have little to do with technology adoption and adaptation, which is really the secret of growth.

*One aspect that has been emphasised in most studies about the economic costs of the pandemic has been the dual nature of Latin American labour markets. More than half of the active workers have informal or independent occupations (a condition that they share with most of the developing world) unprotected by* kurzarbeit*-type job support schemes,*

*which resulted in differential losses in terms of hours and labour income, and widening inequality, that were only partially reversed in the past quarters. This precarisation trend, if persistent, may translate into greater social spending and lower revenues from taxes and contributions to social security – besides feeding the already mentioned growing discontent. What is behind this labour precarity?*

One of the predictions Karl Marx made about the future of capitalism did not pan out. He was living in a world dominated by independent craftsmen that were being displaced by manufacturing. He posited that, in the future, independent craftsmen who owned their means of production would be substituted by larger capitalist firms that owned those means and would transform craftsmen into dependent salaried workers. This happened to a very large extent in advanced countries. But, for some reason that we have yet to explain, the process in Latin America petered out when salaried employment reached about 50% of the labour force. What we call the informal sector is what Marx would have called independent craftsmen. To me, the puzzle has to do with problems of technology adoption and adaptation.

The reason why modern production takes the form of larger firms is in order to exploit the benefits from the division of knowledge. A modern firm has people who know about accounting, finance, production, operations management, human resource management, taxes, contracts, design, marketing, branding, sales, distribution and so much more. The knowledge needed to implement the technologies that firms use to organise and execute production and sales does not fit into a micro-firm. These larger organisations should be more productive and hence should be able to displace traditional production by paying workers more. In the United States, about 90% of the labour force works for a wage and the country is suffering from labour shortages. Why are modern firms employing only half of Latin Americans who want to work?

In my mind, it is because they have failed to adopt and adapt enough technology to produce enough to exhaust the labour force. We see this in the differential rates of informal employment by regions within countries. While in Monterrey informality represents a third of employment, it represents over 80% of employment in Chiapas.

Modern firms can provide some of the protections that workers need. But even the advance of the gig economy in the United States suggests that forms of social protection should be less tied to the firm and more tied to public services. This may be the way forward.

*Industrial policy as a way to develop and generate growth has long been at the heart of the public debate in Latin America. Are manufactures the way to develop from a rural economy to a mature, services-based one? Whereas economist such as Dany Rodrik see traditional industries as a stepping stone for inclusive development and warn about premature de-industrialisation (or a premature jump to a service economy), others praise services (or 'industries without smokestacks' such as tourism) as a shortcut to the*

*inclusion of a large, informal, unskilled workforce currently employed in subsistence agriculture or precarious marginal activities in big cities. Do you believe in industrial policy?*

All technologies require a combination of inputs that can be purchased in markets and inputs that cannot. Cars need roads, traffic lights, rules and cops. Cell phones need a dedicated electromagnetic spectrum and property rights on it. The cars and handsets are private goods that can be purchased in markets. Roads, traffic lights and property rights on the spectrum are public goods. Private goods benefit from the invisible hand of the market. They have prices that provide information. Suppliers aspire to earn profits which are based on the price difference between inputs and outputs, but are also an incentive to respond to the information contained in prices. They have capital markets that allocate resources to those that are expected to be profitable, which are those seen as adequately responding to the information contained in prices. Hence, the provision of private goods could potentially take care of itself, because the invisible hand provides information, incentives and resource allocation.

Public goods do not possess that invisible hand. They do not have prices, they are not provided with a profit motive and they do not benefit from capital markets allocating resources. So, it is not clear where the information about what is needed, the incentives to provide them and the allocation of resources would come from. This is where so-called 'industrial policies' come in. It is a policy process dedicated to identifying the missing public inputs and to search for solutions for their provision. It is rife with coordination failures caused by the complementarity between technologies: a missing technology can prevent others from being adopted. And it has to deal with the fact that knowhow may be missing and hard to move. 'Industrial policy' should be about the exploration of the space of possibilities of new products and processes and the identification and provision of the non-market components of the productive process. I cannot see how a country can grow without doing a good job at these tasks.

*During the pandemic there was a revived role for the public sector (supporting jobs, firms and low-income households, adopting emergency laws, leading the quest for the vaccine and the vaccine roll out), not only as a regulator but also as an active participant. What is your view on the role of the public sector? Has the pandemic changed your views about this role?*

The public sector is what society creates to address our collective challenges and aspirations and to empower us with security, freedom, rights, rules, dispute resolution, infrastructure and so much more. It has a central role to play in the adoption and adaptation of technology. It should maximise its complementarity with the things that society can do on its own rather than compete in those spaces. The pandemic is just one more example of this reality. The Latin American discussion has been dominated by views, both on the left and the right, that emphasise substitution between public and private rather than enhance their complementarity. Developing a strong public sector is

very hard, if not impossible, unless the society possesses a strong 'sense of us' that sees public service as morally commendable and serving others as a meaningful and respected activity. The pandemic has not changed my views; it has reaffirmed them.





*It looks like, finally, the climate change debate is here to stay, and it includes potential restrictions for a region where exports are intensive in non-renewable natural resources, transgenics and beef, and where traditional industries are struggling to survive. How does the green agenda affect the revision of what we see as a viable growth strategy for the region?*

For countries like Venezuela or Colombia, the green agenda will impact their main exports by making long-term investments in fossil fuels harder to finance and by potentially causing a decline in the after-carbon-tax price. But this is the negative side of the green agenda. I see a positive side to that agenda and it is based on the simple fact that much of the renewable energy we have – solar, wind and hydro – is less transportable than oil.

Oil is particularly energy dense, meaning that transporting it is cheap and energy- poor countries like Korea can specialise in energy-intensive industries like steel production by importing oil from far away. In a world where energy is less transportable, energy-intensive activities will have to move to places abundant in green energy. We already see it with aluminium in Canada and Iceland. This may open new avenues for growth for countries with high green energy potential, like Venezuela and Chile.

Materialising the potential will require the ability to compensate those affected by green energy projects, a social ability whose scarcity has limited hydro and mining investments in countries like Peru, Chile and Colombia. It will also be affected by the ability to get into new technologies and the value chains that can be supported by green energy such as green versions of hydrogen, ammonia, fertilizers, plastics, cement, steel and even hydrocarbons. But this will require an effort to master emerging technologies in these fields. Chile has the Atacama Desert which makes it into a Saudi Arabia of solar. It is starting to push a green hydrogen agenda. Colombia has plenty of untapped hydro resources. Patagonia is very windy. Venezuela has the Caroni River, the best hydro-electric river in the world, and could easily extract 35 GWH from it with the investments it has already made and very little more. Beyond that, it has the Caura River, which remains untouched. From the 1970s, the Caroni powered a steel and aluminium industry that was green when the world did not pay any premium for that. Those industries have collapsed due to the regime's expropriations and mismanagement. But they could potentially recover and attract major green investments.

Countries should develop strategies not just to reduce their carbon footprint but to help the rest of the world reduce theirs by moving global production towards their green energy sources.

*You have frequently emphasised the centrality of knowhow in successful growth episodes. There is a growing consensus that, with a few exceptions, the region has been lagging other middle-income developing economies in terms of educational achievement and job creation. Do you think there is a connection between the two concepts that helps explain the subpar growth outcomes?*





To me, knowhow and education are very different ideas. K-12 education generates some skills that are common like reading, writing and maths. It is mostly conceptual and can be tested in standardised exams, like PISA and TIMMS, that measure how much of the same thing students learn. My reading of the data is that Latin America has made enormous progress in education. As I mentioned before, the data suggest a major narrowing of educational gaps.

Knowhow is very different. To begin with, it is tacit. It is the ability of the brain to perform a task such as walking, playing the violin or knowing how to drive around a particular city without a map or WAZE. It is not in the pre-frontal cortex, so we have no conscious access to it. We do not teach our babies to walk by explaining anything to them. Knowhow gets there through a long process of repetition, imitation and feedback, mostly on the job. Together with machines and manuals, it is fundamental in implementing technology in the real world. But it is highly differentiated between individuals. This differentiation allows for the division of knowhow, and this allows for the growth of knowhow at the collective level. A society knows more not mainly because its individuals know more but because its individuals know different.

Knowhow explains why firms care about the experience of potential employees. It is about the things that they have learned outside of the classroom. But you cannot have experience in activities that do not exist. You cannot become a watchmaker in a place that does not make watches. And you cannot develop a watchmaking industry without watchmakers. This fundamental chicken-and-egg problem complicates technology adoption and adaptation. It cannot be solved by improving K-12 education or by hiring workers with experience in bakeries or in firefighting.

Knowhow is acquired through a very slow process: Malcolm Gladwell says that it takes 10,000 hours of practice to become good at something. This in part explains why we need to put different bits of knowhow in different brains: your dentist tends not to be your lawyer. Implementing a technology requires that you have available all the different bits of knowhow that the technology requires, just like making a film requires an author, actors, directors, photographers, sound specialists, video editors, soundtrack composers, etc. A missing skill can destroy the film.

*What types of policies would you recommend to enhance the knowhow pool of Latin American countries?*

While it is hard to move knowhow into brains, it is much, much easier to move brains. Worker mobility between firms, cities and countries is fundamental for the diffusion of technology. This has been demonstrated by studies of the impact of the harsher non-compete clauses in Boston vis-à-vis Silicon Valley; in Steven Klepper's description of how start-ups are formed from experienced workers from incumbent firms; in studies of the role of West-to-East migration in the re-industrialisation of East Germany post-unification (by Frank Neffke and myself); and in the studies of the role of migration in export diversification (by Hillel Rapoport and Dany Bahar), in science (by Petra Moser) and in patenting (Crescenzi and Neffke). With Michele Coscia and Frank Neffke, we have even documented the importance of business travel from countries with knowhow in the growth of employment, productivity and exports in the receiving countries.

So, it is important to focus an agenda of increasing knowhow on the extensive margin – the things that a society does not know how to do – and on the mobility of knowhow between firms. Recently, we convinced the Saudi government to allow ex-pats to move between firms rather than having to leave the country if they separate from their jobs.

For the most part, Latin America is closed to immigration, with a special bias against high-skilled immigration. There are limits to the number of foreigners per firm and there are obstacles to the accreditation of professionals. In a country like Panama, foreigners are limited to 10% of the payroll and 26 professions are reserved for citizens. Public employees, including public university professors, must be citizens.

The Venezuelan catastrophe constitutes a sad natural experiment of these constraints. In most countries (Colombia excepted), they cannot get even temporary status. Venezuelan doctors tend to migrate to Chile and Spain because those are the only places where a path to professional accreditation exists. In many countries, engineers drive for Uber because they cannot validate their degrees. Most universities in the region did not exploit the opportunity of hiring Venezuelan professors that were leaving the country in droves, because their hiring practices are not geared to attracting foreign talent.

The accumulation of knowhow is strongly impacted by human mobility. In the United States, 14% of the population is foreign born, but foreigners represent 29% of entrepreneurs nationwide and 54% of STEM workers in Silicon Valley. Mind you, the other 46% are not mainly Californians (only 18% are), even though at 40 million, the state has a population that is comparable to that of Argentina and Colombia and larger than that of Chile, Peru and all of Central America. The same can be said about Hollywood. In the 2015 Colombian census, foreigners represented only 1 out of every 350 people living in the country. The Venezuelan exodus has been their first large immigration experience.

A strategy of knowhow accumulation must involve an agenda for the attraction of foreign talent. It can also involve the mobilisation of a country's diaspora abroad. Many countries have significant numbers of their citizens living in other countries. Venezuelans abroad number over 6 million, Colombians over 5 million. There are 35 million Mexicans and their descendants in the United States. The diaspora know two worlds and are exposed to opportunities to acquire knowhow in activities that do not exist in their country of origin. They can help close technological gaps. This has been demonstrated in work by Hillel Rapoport and Dany Bahar both in a cross-country setting and in an interesting case study of the former Yugoslavia and its German diaspora, and by Ljubica Nedelkoska and me for Albania and its Greek diaspora. The government of Colombia has recently published the results of its Internationalization Commission (which I chaired), and it involves a strategy for both the attraction of foreign talent and a deeper engagement with the diaspora. They are already implementing some of our recommendations.

*If you were named Economic Minister of Venezuela, what would be the first few measures or reforms that you would propose once the pandemic constraints are released?*

This is a difficult question. Venezuela, as I mentioned before, is in very dire straits. The Venezuelan catastrophe is not just the consequence of excessive spending during the 2004–14 oil boom, although that did happen on a massive scale. In the election year of 2012, with the price of oil comfortably over $100 a barrel, the country ran a public sector deficit in excess of 18% of GDP. The external public debt went up by a factor of six during the boom to a level in excess of $150,000. The country lost market access years before the price of oil declined in 2014. So, it was really in a very vulnerable state to absorb the oil price decline, leading to hyper-inflation and collapse.

But this relatively common macro mismanagement story was, to some extent, a supporting actor. The central figure of the drama was the assault on property rights and the adoption of a policy regime that disempowered society. Expropriation and confiscation became standard practice with banks, telecoms, steel, cement, food, shipping, propane gas distribution and millions of hectares of farmland ending up in state hands and all driven to the ground. Despite the plethora of dollars, the country maintained during the boom a multiple exchange rate regime with import and price controls. Exports of a large swath of products were prohibited in order to prevent smuggling of goods that benefited from a highly subsidised exchange rate. Some 20,000 experienced oil workers and managers – out of a total of 35,000 – were fired following the 2002–03 oil strike, causing a collapse in the human capital and the corporate routines of PDVSA.

Agriculture and manufacturing peaked in 2007, seven years before the official start of the recession, but the decline was compensated by a huge increase in imports, funded by the boom in oil prices and external borrowing. When these imports were no longer financeable, domestic supply imploded. The rationing of foreign exchange when oil revenues and borrowing declined meant that there too few dollars to import raw materials, intermediate inputs, spare parts, medicines, seeds, fertilizers and agrochemicals, leading

to the collapse in output. Hyper-inflation caused the banking system to go from over $70 billion in assets to less than a billion. At present, pensions and public wages average less than $10 a month. Mass migration and the collapse in health, education, power and water services have made progress impossible, while the country has devolved into an archipelago of local warlords.

In this context, a strategy needs to include the following elements. First and foremost, Venezuelans need to have their rights restored: the right to property, so that they can become empowered economic agents able to plan, act and take risks; the right to speak, so that they can have a civilised debate about the way forward; the right to elect a government of their choosing, especially when things are not going well. If the country is to recover, it will be because 30 million Venezuelans feel empowered to contribute to the reconstruction. For that, they need their rights restored.

Second, the state must be able to perform its basic functions, while drastically curtailing the monetary financing of the fiscal deficit. This will require that the government focus its spending priorities but that it fully pays for the cost of providing essential services, such as education, health and security. You cannot run a university system where full professors earn $10 a month. We probably have some 4 million pensioners, but they earn $4 a month. Electricity has collapsed and is essentially free – two highly correlated observations. A (re)privatisation agenda will have to be part of the equation, but this will take time. The recovery of Venezuela will require an increase in spending and a reduction of the unfunded deficit, in order to stop hyper-inflation. This will be made easier if the international community provides ample financial support for the recovery.

To make this financial support feasible, the country will need to re-establish its solvency. This will require the recovery of the oil industry and the renegotiation of the external debt. Juan Szabo and Luis Pacheco, two very senior former PDVSA executives, have designed a plan that would cost over $170 billion over ten years and would recover oil production from its current level of around 500,000 barrels per day to something closer to 2.7 million. It is impossible for PDVSA to execute anything like this plan. It has destroyed its human and organisational capital and is financially bankrupt beyond repair. It will be mired in legal proceedings for a very long time. The only way forward is to open oil production to private investment. A reform of the hydrocarbons law in the direction of recent reforms in Colombia, Mexico and Brazil is a must.

The debt will have to be renegotiated with a huge haircut. This will be the only way in which new money can flow into the country to finance the recovery. The current debt of $150 billion was already too high for the country in 2013, when it had a GDP close to $300 billion and exports of $60 billion. It is impossible for a country with a GDP of $60 billion and exports of less than $8 billion. A 90% haircut would still leave the country with a foreign public debt equivalent to 25% of GDP or 200% of exports. If the economy were miraculously to bounce back, legacy creditors could participate through a more equity-like value recovery instrument.

All of this presumes a state that can have something like a monopoly on the legitimate use of violence, as states are supposed to have, but Venezuela does not. Getting there will be a difficult and costly task.



## ABOUT RICARDO HAUSMANN

Ricardo Hausmann has been at Harvard University since 2000, where he is the Rafik Hariri Professor of the Practice of International Political Economy and the Founding Director of the Growth Lab at the Harvard Kennedy School, which is a group of over 40 full time researchers and a network of faculty that does academic research on growth, applied research on national, regional and urban growth strategies and digital online tools such as the Atlas of Economic Complexity and Metroverse. From 2005 to 2019 he also served as the Director of the Center for International Development at Harvard University. Since 2009 he is also an External Faculty at the Santa Fe Institute. Previously he served as Chief Economist of the Inter-American Development Bank where he founded the Research Department. In the early 1990s he served as the Minister of Planning and a member of the board of the Central Bank of Venezuela. His academic research with co-authors has introduced new concepts into economics such as original sin, dark matter, self-discovery, growth diagnostics, economic complexity and the product space. In his applied work he has worked on over 40 countries and regions in all continents and has chaired senior advisory councils for South Africa and Colombia. He holds a PhD in Economics from Cornell University.

# "I have strong doubts about the possibility of having successful industrial policies in the region"



**Rodrigo Valdés**
Catholic University of Chile

*What would you say is the most likely growth scenario for the region as a whole and in your country in particular: a quick take-off, a new lost decade, a mixed bag?*

So far, there has been heterogeneity across the region on the growth front. Depending on the strength and coherence of the macroeconomic policy reaction, and on the progress on the vaccination process, some countries are recovering very quickly (for example, Chile, Brazil and Colombia already bounced back to their pre-Covid GDP levels in 2021, or will do so in early 2022) whereas Argentina, at the other extreme, may not return to its initial GDP level until 2024. Of course, this is just the recovery; the medium-term growth prospects of these economies remain an open question.

In Chile, growth has been buoyant in the last few quarters to the point that our macroeconomic discussion transitioned to overheating concerns. The policy reaction has been immense, with monetary policy interest rates at the technical minimum of 0.5% for several months, coupled with a late and humongous fiscal expansion. In addition, in the second half of 2021, the government is distributing cheques to 90% of households, spending to the tune of 1% of annual GDP every month. Altogether, fiscal policies will increase government spending by about 30% year-on-year in 2021. In addition, there have been three massive resource withdrawals from the pension system, each one of about 5–6% of GDP. I honestly do not remember a Keynesian expansion of this size in an emerging market, at least not in peace times. In this light, the new pressing macroeconomic risk is inflation and, related to that, the difficulties to wind down government spending. Although the government has proposed a deeply contractionary budget for 2022, our fiscal homework is far from over.

But this is just the short run. Potential output prospects for the medium run are dismal almost everywhere in the region. For instance, the IMF five-year GDP growth forecast for several large and medium-sized countries is only around 2%. In the case of Chile, potential output growth is at most 2.5% and could be well below that, whereas it was closer to 5% a few years back.

In sum, once the Covid recovery is completed, reality will come back to haunt the region. Indeed, economies with faster recoveries may end up looking like what Lula Da Silva called '*voos da galinha*' (hen flights). And if global financial conditions become less supportive, we could face a nasty decade, considering that public debt ratios are significantly higher than a few years ago.





*With a few exceptions, Latin America has been exhibiting lacklustre growth in recent years. You already mentioned that even successful exceptions such as Chile (and, I would add, Colombia) seem to be facing a worse growth outlook than in the past decade. What do you think are the main reasons for this?*

There are different hypotheses, of course, but let me offer one that applies to Chile.

Potential growth has declined relentlessly in the last 20 years. Part of this was normalisation (it was extraordinarily high at some moment) and convergence (as you become more prosperous, you grow less). But what happened is much more intense than what these considerations can explain. In 1999, the IMF estimated Chile would grow by 7% in 2004 (five years out); in 2005, it expected 5% for 2009; currently, it predicts just 2% for 2025. It is not (only) that the current and previous governments may have made mistakes or face unexpected shocks.

Among the different macroeconomic drivers, only one has suffered a true sudden stop in the past couple of decades: the volume of exports. In per capita terms, exports increased fast until 1997 and have remained flat since 2008. From 1984 to 2000, Chilean exports consistently grew above world trade, and the opposite happened after 2006 (and this negative divergence has only increased).

One possibility is that natural resource-based exports eventually do hit some ceiling. This appears to be the story at the micro level, as different industries show a similar pattern: birth, slow growth, take-off, consolidation. Of course, it is possible to discover new natural resources-based exporting initiatives, but it seems more promising to look to other areas. Export services, for example, seem to have been an essential step up in the growth trajectory of small open economies that reached developed status.

In sum, our development strategy worked well for a while, but, at least for smaller countries, it now looks insufficient. How to transit to a new one is an unknown path full of perils.

*Some observers, including myself, have argued that Latin America is either stuck in, or getting into, a middle-income trap, with roots that are not only economic but also social and political, including a growing discontent with the system's institutions and a feeling of unfairness that, in turn, fuel spending demands on governments that, because of the*

*pandemic, have exhausted their fiscal space. The pandemic may have strengthened these demands. To what extent would you agree with the view that growth shortcomings reflect non-economic hurdles? What would be the economic strategy to tackle them?*

Indeed, there is a severe problem with the limited growth potential of the region, which reduces the prospects for any country to become a developed one (however we define that) in the next few years. We know from cross-country comparisons that Latin America lacks savings and thus investment, while productivity growth is meagre. What is behind this dismal context? While the relative importance of the different factors is not evident, let me offer two 'exogenous' elements that could help build an exploratory answer.

First, the business environment has been feeble almost everywhere and, where it did work, it has been deteriorating, usually following poor, ill-advised politics. Although I would not be able to prove it, I am increasingly sceptical of our presidential system when combined with an electoral arrangement that produces too many parties and makes it harder and more costly to build a governing majority. Besides the usual fiscal or sovereign debt risks, I think the private sector fears – because, in many cases, it has experienced them – changing rules, short-termism and the possibility of expropriation. Of course, these problems reflect faulty politics as well as our persistent income distribution and segregation problems. Perhaps we need a different political system altogether. Practically all countries that serve as a model to us have parliamentarian regimes.

Second, to some extent, the old paper by Sachs and Warner on the natural resources curse applies. With weak institutions, having natural resources has promoted the perception that we are already rich and merely have to discuss how to distribute our wealth. Whereas growth (including jobs and wages) is rarely a winning political platform, a redistribution agenda often scores well with voters.

*The need to diversify exports has been a common theme in the region for decades, yet the diversification never fully materialised. Do we need to diversify? Has the meaning of diversification changed over the years? Has the pandemic affected the region's trade prospects and diversification strategy?*

Diversification has undoubtedly been a theme for quite some time, but I am afraid rarely fully understood. Even worse, it has not produced a well-designed and consistent set of policies. Some diversification has happened. Take the example of Chile, where copper represented almost 90% of total exports in the 1960s and is currently at 50%. Some may find this an example of too little diversification, but the question is then: would the country be better off without copper and copper exports? What would you have done differently?

Instead of tweaking tariffs or credit markets, I think the main problem is that the proceeds from our exports should have been better reinvested, perhaps in education, perhaps in health. Exports fuelled too much current spending and limited efforts to build a new,

modern economy. Of course, this is easier said than done, as it is far from evident that political and market forces, by themselves, would have produced what you need to limit countries' reliance on natural resources.

On the pandemic, it is unclear yet how Covid will change previous trends. So far, the rebound from the recession has produced a significant expansion of trade in goods, while social distancing has kept the services sector at bay (with the apparent exception of Zoom and other platforms). Covid may even hinder tourism-related activities for an extended period. But overall, I would say that the jury is still out on whether this will produce long-lasting effects.

*Macroeconomists have long thought of growth from a macro perspective: fiscal balance and economic stability, access to finance, investment in physical and human capital. More recently, the discussion about growth has been enriched with what we could call micro or 'social' ingredients that were previously implicit or understated – equity and fairness, labour segmentation and precarity, insufficient or inadequate education, fiscal fatigue and civil unrest, etc. – all of which often impose limits on the speed and nature of macro reforms and pro-growth policies. Do you think these new constraints were deepened by the pandemic? Do you think they represent additional growth hurdles for an already slow-growing region?*

It seems clear that Latin America's endemic problem with income distribution, segregation and power concentration is detrimental to growth. You can pick your favourite transmission channel – e.g. regime sustainability and expropriation risk, or talents that remain undiscovered – but the fact is that there is no industrialised country with our social disparities.

What is less obvious, or at least less of a typical pattern across all countries, is whether this social fabric (or lack thereof) will be even more frayed after Covid. On the negative side, we have seen a much deeper income drop in the services sector, which for staters often pays lower wages. The same has happened with women with children at home – their labour participation rate has declined more. These drops could become relevant drags for both growth and equity.

At the same time, however, with Covid vaccinations, countries rediscovered the critical importance of an effective state, which may serve as a new focal point for policies. The same has happened with the health system. In Chile, for instance, where we have an utterly fractured system – one for affluent families and another one for the rest – the state took control of the entire system and learned to better integrate the two previously disjointed parts. This development may be the beginning of a process of deep reform. Also, in a few places (for example, in Chile or Brazil), the government distributed so many cheques to families that the handout may become the first step of a universal basic income (with all the fiscal risks that this entails).

So it is true that, at least in the short run, the crisis produced tremendous disparities. But that is only the direct effect. Some countries cushioned part of this problem with social policies. More importantly, they experimented with new ways to organise the safety net that may ultimately become the seeds of a more integrated society.



*One aspect that has been emphasised in most studies on the economic costs of the pandemic has been the dual nature of Latin American labour markets. More than half of the active workers have informal or independent occupations (a condition that they share with most of the developing world) unprotected by* kurzarbeit-*type job support schemes, which resulted in differential losses in terms of hours and labour income, and widening inequality, that were only partially reversed in the past quarters. In addition, there is considerable evidence that the recent technological advances are not skill-neutral, and that they threaten middle- and low-skill tasks that are central to the occupations of the region's employed workforce. How do you think labour market and innovation policies should be integrated into the post-pandemic growth agenda?*

Covid reaffirmed that several Latin American countries have significant informality, and uncovered more duality than expected in others. It wasn't easy to deliver economic aid to several groups, including informal and self-employed workers and immigrants. These same groups have recovered more slowly than others and represent the most important pockets of unemployment. It seems, indeed, that this is one of the critical problems explaining low productivity growth, and it even explains the very low density of social security contributions in several countries.

What to do? Before working on direct labour and innovation policies, it is essential to provide strong incentives in social and tax policies to reverse the logic that it is not profitable to become formal. If formality is too expensive for the typical informal worker, it is essential to reverse that. One way would be to have enhanced social policies for those who take steps towards formalisation – precisely the opposite to what we see around in many countries these days. Of course, labour policy should also adapt; I'm afraid this is not happening either. Policies directed to small and medium-sized firms (and to large firms in terms of their outsourcing conditions) is another area where forbearance may be both politically and economically convenient in the short run, but very costly in the long run. An obvious case is what happens with pension contributions and tax avoidance, usually split between employer and employee.

*Industrial policy as a way to generate growth has been at the heart of the public debate for a long time in Latin America. Whereas economists such as Dany Rodrik see traditional industries as a stepping-stone for inclusive development and warn about premature de-industrialisation (or a premature jump to a service economy), others praise services (or 'industries without smokestacks' such as tourism) as a shortcut to the inclusion of a large informal unskilled workforce currently employed in subsistence agriculture or precarious marginal activities in big cities. Do you believe in industrial policy? What is*

*your view about this debate in the context of the technological advances promoted by the pandemic? In particular, and going back to the previous question, where do you think the jobs needed for inclusive growth will mostly come from?*

I have strong doubts about the possibility of having successful industrial policies in the region. As an economist, I am sceptical about substituting market signals and incentives for the decisions of a group of bureaucrats. It is not easy to defend the idea that a group of people without skin in the game will decide well. Of course, there are industries where externalities matter a lot, as I will explain.

However, my most significant doubt arises from the lack of appropriate governance, the risk of capture and corruption. With the poor quality of our institutions, I doubt that countries will be able to do industrial policies effectively, even if they are a priori a good idea.

But there are areas like tourism where there is a more straightforward case for government coordination, from preparing human capital to subsidising first-comers that will trigger the entry of complementary businesses. Although services like this one may not produce continuous productivity growth, they are a quantum leap from informal services, so I believe it is a worthwhile strategy for the region. The same argument for the state as facilitator applies to areas like agribusiness, where the production chain requires significant coordination (think of ports, transportation, water, etc.).

At the same time, the old-school logic of subsidising new industries to facilitate their growth at early stages is much less appealing. If there were a visible benign effect from state participation, we would see strong growth trends in Mercosur countries or in those economies with large, influential development banks.

*During the pandemic there was a revived role for the public sector (supporting jobs, firms and low-income households; adopting emergency laws; leading the quest for the vaccine and the vaccine roll out), not only as a regulator but also as an active participant. What is your view on the role of the public sector? Do you think the popular perception of the role of the public sector has changed to the point of inhibiting the retrenchment and fiscal consolidation due post-pandemic?*

The pandemic is like a war. The public sector is, without doubt, at centre stage and in the driver's seat. However, that does not mean that discovering that governments can be more effective than previously thought (in certain extreme circumstances) should flip upside down the growth and development strategy. Rudi Dornbusch's saying that "free markets, sound money, and a bit of luck" are needed to achieve growth continues to be a helpful guide as a first pass.

But Covid did show that government effectiveness can make a tremendous difference. The outcomes in Chile and Uruguay in comparison to, for example, Brazil and Argentina is a clear demonstration that investing in a better public sector is hugely profitable. I

would also add that the pandemic also served as a new experience for our economic elite. We were used to buying several public goods and social rights out of pocket in the open market. Education, security, health services, etc. were in several countries in the region of two types: massive and sub-standard, provided by the state; or good quality, privately provided for a few. The battle against Covid brought society closer together, and I believe the episode will give a helpful example that we can be better off with more integration. As I mentioned before, when the Chilean government decided to take considerable control over the private health system, the experience was much less traumatic than expected. Indeed, I think it is possible to bring the two health systems closer together.

A different issue altogether is the fiscal side, and the scars that Covid will leave on this front. My take here is that we need to consolidate quickly, as the region has exhausted almost all its fiscal space. Debt levels are much higher than three years ago, and structural deficits are more significant. It is unclear how this problem will play out, but the risk of having almost the entire region below investment grade at a time of withdrawing global liquidity and higher interest rates is real. The IMF may have a lot more work to do in a few years.

*If you were named economic minister in your country of origin, what would be the first few measures or reforms that you would propose once the pandemic constraints are released?*

Saying 'no'. I already did my service tour as minister of finance.

*It looks like, finally, the climate change debate is here to stay, and it includes potential restrictions for a region where exports are intensive in non-renewable natural resources, transgenics and beef, and where traditional industries are struggling to survive. How does the green agenda affect the revision of what we see as a viable growth strategy for the region?*

I am not sure how damaging the climate change agenda will be for the region's development strategy; perhaps it will allow triggering changes that otherwise would not have happened. One example is what has been happening with green mining, which uses solar energy and green hydrogen, among other aspects. However, the sign of the effect seems evident: it will be yet another restriction to the system that will dampen growth in comparison to a scenario without climate change. In other words, strictly from a growth perspective, it would be better not to have the climate challenges we face. That said, is too early to evaluate the size of the effect, and perhaps it is not even productive to do it; there is no alternative but to act.

*Chile was until recently a regional success story. Political stability, qualified technical personnel with shared views about the value of stability and institutions, a broad coalition with considerable support, a two-party system with overlap in key economic positions. Right before the Covid shock, it turned into a powder keg on the brink of explosion. How*

*did this evolve during the pandemic? Do you think this civil discontent is here for the long run? Will it limit the policy options moving forward? Did you see this as a potential pattern in the region, or rather as an isolated phenomenon due to local factors?*

On this question, we could write an entire book. Covid has delayed for almost a year the institutional process that followed up our Chilean Spring in October 2019. At the same time, after more than a year and a half of curfews and the new Constitution process underway, protests have been less intense.

Things are moving now. The Constitutional Convention was elected in May 2021, started working in July, and agreed on its by-laws by end-September. It is now discussing Constitutional contents. My baseline scenario is that the Convention will not end up with a 'Chavez-type' Constitution despite the left having a solid representation. Most likely, we will have something close to the Colombian Constitution, with its peace dividends and fiscal woes. I'm not convinced that social discontent will abate fully with the new Constitution, but the latter will undoubtedly be helpful to contain it.

Congress is perhaps the institution that remains most clearly in crisis or panic mode, approving unconstitutional laws and doubling down on populist measures to get re-election. The costs will be dire, to be paid in the future.

As a reaction to protests and to stop Congress from sanctioning wilder measures, the government has delivered an untimely massive fiscal expansion. Fiscal policy was a bit too shy during the first year of the pandemic, but, in 2021, it went all out. Government spending increased a modest 10% annually in 2020 and a whopping 32% in 2021 (all in real terms). During the second half of 2021 – when the economy was already booming and in overheating territory – the executive launched almost universal monthly cheques of US$900 per family of four. In sum, there is significant fiscal homework to be done; debt dynamics could become nasty if this is not addressed correctly.

Is this a preview of what could happen elsewhere in Latin America? Colombia's protests have a lot in common with Chile's. But perhaps it is simply a more global phenomenon, only exacerbated in Latin America like so many things usually are, as García Márquez once wonderfully wrote.

## ABOUT RODRIGO VALDÉS

Rodrigo Valdés is an Associate Professor at the School of Government of the Catholic University of Chile. He was Minister of Finance of Chile in 2015-17. Previously, he had experience in both the private and public sectors. He worked at Barclays Capital in New York and BTG Pactual in Santiago. He was Deputy Director for the European and the Western Hemisphere departments at the IMF. Before, he was the Director of Research and Chief Economist of the Central Bank of Chile. He holds a BA in Economics from Universidad de Chile and a PhD in Economics from MIT.

# "The international financial community should rethink its risk tolerance"



**Alejandro Werner**
Georgetown Americas Institute and PIIE

*What would you say is the most likely growth scenario for the region as a whole and in your country in particular: a quick take-off, a new lost decade, a mixed bag?*

After being the region that suffered the largest deceleration and the one that contracted at the fastest pace in 2020, Latin America is set to experience an important rebound during 2021–22. This recovery started in the second half of 2020, driven first by an important bounce back in exports and followed by a consumption recovery that gained strength as the economy gradually reopened and as vaccination rates rose. Some countries will be reaching 2019 GDP levels in 2021 and others in 2022. However, together with the rest of the emerging markets, Latin America is expected to exhibit significant scars in the medium term, with GDP for 2025 and beyond projected to be permanently below the levels anticipated before the pandemic. Potential growth is expected to return to pre-covid levels, with countries that deployed more aggressive macroeconomic policies expected to exhibit lower levels of irreversible damage.

The expectations of permanent losses and their relation to the size of the macro response, the eventual withdrawal of this stimulus, and the new estimates of potential growth are subject to a larger than normal degree of uncertainty given the lack of understanding that forecasters and economists have of the dynamics of the Covid disruption and the determinants of the healing process. Therefore, we need much more research to educate our views of how this process is going to play out. Consider Chile and Mexico as the two extremes of the policy response. In Chile, we have seen a very large fiscal stimulus coupled with pension withdrawals. The total amount of the fiscal expansion plus the pension resources surpassed 30% of GDP. On the other hand, Mexico implemented a meagre policy response as government expenditure in real terms was basically flat in 2020. Predictably, these two countries are at the extreme of the cumulative growth forecasts for the 2020-2021 period: whereas Chile will experience a cumulative expansion of 5%, Mexico will show a cumulative contraction of 2% during the same period. Both policy responses were flawed – the former for favouring excessive and non-targeted stimulus that led to overheating and an irresponsible use of the fiscal space; the latter for prioritising debt sustainability at the expense of citizens' welfare.

Mexico's economy experienced one of the largest economic contractions among the large economies in Latin America, and it is expected to be among the last economies to recover to 2019 levels of GDP. This is explained by the fact that the positive spillovers that it received from exports to the United States and the strong dynamism of remittances in

the second half of 2021 were not enough to compensate for the impact of the lockdowns in the context of a very timid policy response. Growth is expected to be strong in 2021 and part of 2022 as the re-opening is completed. After 2022, Mexico is expected to converge from above towards a paltry potential rate of growth that will most likely be below 2% per year, dragged by low investment and productivity, as well as high microeconomic policy uncertainty.

It is also important to highlight the impact of the pandemic on the Caribbean, the region that experienced the deepest economic contraction because of its high dependence on international tourism. Median GDP for the region fell by 9.5% in 2020 and in 2021 it is still expected to be 9% below the level registered in 2019.

*With a few exceptions, within the developing world Latin America has exhibited a poor growth record in recent years. Even exceptions, such as Chile or Colombia, seem to be facing worse growth outlooks than in the past decade. What do you think are the main reasons for this?*

It is true that, except for the decade from 2004 to 2014, when many countries in Latin America benefitted from what has been called the commodity supercycle, growth in the region has been modest by developing and emerging market standards. At one point, many economists thought that the key driving force of this lacklustre outcome was macroeconomic mismanagement (i.e. high inflation, recurrent debt, financial and balance of payment crises, etc). However, as many countries successfully achieved macroeconomic stabilisation, we realised that the forces behind low growth were more complex.

On the structural side, low human capital and the still high levels of protection, coupled with significant concentration in key sectors of the economy, lead to low investment, high costs and low productivity. The weakness of the region's institutions and its judicial systems create a weak rule of law environment in which rates of return to investments in human and physical capital are more uncertain. On the social front, the high levels of poverty and one of the worst income distributions in the world generate the urgent need to resolve these social demands in the context of relatively weak governments, which in many cases leads to the implementation of unsustainable macroeconomic policies that end poorly or in highly interventionist regulations in the labour and product markets that deter investment. This social dimension is complemented by inequities in other areas such as race and gender that, put together, have contributed to the perception among large segments of the population that the socioeconomic equilibrium is unfair. Finally, the previous elements, coupled with weak democratic institutions, have generated a political cycle that presents wide swings in economic policy, leading to even more uncertainty.

*Some observers, including myself, have argued that Latin America is either stuck in, or getting into, a middle-income trap, with roots that are not only economic but also social and political. These include a growing discontent with the system's institutions and a feeling of unfairness that, in turn, fuel spending demands on governments that, because*

*of the pandemic, have exhausted their fiscal space. The pandemic, which hit precarious workers harder, increasing inequality, may have strengthened these demands. Do you believe Latin America is in a middle-income trap? To what extent would you agree with the argument that growth shortcomings also reflect non-economic hurdles, some of which you touched on in the previous answer? What would be the economic strategy to tackle them?*





I totally agree that there are many social, political and institutional factors, some of which I described before, that complicate the building of a consensus around an economic policy framework that sets the foundations for medium-term inclusive growth. This situation has fostered a political environment in which a false dichotomy exists between proposals that focus on growth and those that prioritise redistribution. The long lags between the implementation of policies and their effects on growth and welfare and the short length of the political cycle also generate a bias towards shortcuts and impatience by the population, feeding into an already uncertain economic cycle. This debate will intensify in the region once we start to leave the pandemic behind and begin looking towards a very heavy electoral calendar for late 2021 and 2022.

As Latin America's economies exit the recession, they will experience significant economic, fiscal, social and political gaps. The economic gap will complete another lost decade for Latin America, as the combination of the adjustment to the 2014 decline in the terms of trade and the pandemic shock would lead to a situation in which the region's average per-capita GDP in 2025 will most likely be at 2015 levels. Regarding the fiscal gaps, the region will have to deal with significantly higher debt ratios and primary deficits. Additionally, on the social side, the pandemic erased the gains in poverty reduction and improvements in income distribution of the last five to seven years. Finally, on the political front, polarisation, antagonism and the sense of a lack of legitimacy of the social and economic equilibria has significantly deteriorated political stability in the region.

The economic strategy should rely on a three-pillar social pact. The first component should be a strengthening of the state, focused on developing solid education, health and pension systems, together with antitrust, consumer protection and anticorruption institutions. For those countries in the region that already have a very generous welfare state, the challenge will be to make it more efficient and better targeted. Second, a solid fiscal system that can sustainably fund this expansion of the state and implement the required adjustments to bring debt back to a sustainable path will be needed. Finally, economic opening – internal and external – and structural reforms in key sectors are primordial to generate more competition and private-sector investment. This is a very ambitious agenda, but it is proportional to the challenge that the region faces.

*The need to reduce commodity dependence has been a common theme in the region for decades, yet the desired diversification never fully materialised. Do we need to diversify? Has the meaning of diversification changed over the years? How does the pandemic's expected boost to service globalisation, in contrast with goods de-globalisation and re-shoring, affect the region's trade prospects and diversification strategy?*

Should diversification be an explicit objective of policy or the result of a well-functioning dynamic economy as it progresses through the different stages of the development process? Between two of the most open economies in Latin America, the least diversified, Chile, has done much better in the past 25 years than Mexico, which is significantly more diversified. The examples of advanced open commodity exporters, such as Australia and New Zealand, also point towards caution in the way we address this question.

However, there are many good macro and micro policies that, if implemented, especially in commodity dependent countries, should be conducive to a healthy diversification. First, commodity exporters should follow macro policies that smooth out the effects of the swings in commodity prices on the economy through very countercyclical fiscal policy, implemented through a stabilisation fund or countercyclical debt ratios. In addition, using the proceeds from commodities to invest in education and infrastructure should provide a boost to overall competitiveness, leading to higher economic growth and a more diversified export base.

The previous argument ignores static and dynamic externalities as well as coordination problems that might be present in building a robust and diversified export sector. Externalities generated by on-the-job learning in some specialised sectors and those that exist in developing a skill hub that might attract producers in more advanced segments of the product ladder might provide the rationale for some type of policy intervention to jump start those businesses. Providing the needed infrastructure, such as efficient ports, roads, railroads, and reliable energy, is key for many industrial activities to develop and there is a clear policy role to provide them. Finally, coordinating regulation at the different levels of government for some sectors to develop, and in some cases investing public equity in these sectors to show that a government entity will be seated at the table in difficult situations throughout their development, might also be relevant.

As we exit the pandemic and we continue to face important supply bottlenecks, many of them in transportation, and the geopolitics become more polarised, there will be a trend away from just-in-time and towards just-in-case. In this environment, some Latin American countries may benefit from the re-shoring of firms that want to be closer to their consumption markets and avoid the ramifications of trade and investment protection tensions that might flare up in other parts of the world.

*One aspect that has been emphasised in most studies about the economic costs of the pandemic has been the dual nature of Latin American labour markets. More than half of the active workers have informal or independent occupations (a condition that they share*

*with most of the developing world) unprotected by kurzarbeit-type job support schemes. This precarisation trend, if persistent, may translate into greater social spending and lower revenues from taxes and contributions to social security – besides feeding the already mentioned growing discontent. How do you think labour market and innovation policies should be integrated into the post-pandemic growth agenda?*





The pandemic's toll on employment has been massive. Latin America has a larger share of contact-intensive sectors and large service sectors compared with other emerging markets and developing economies. In addition, the large degree of informality, where labour hoarding was not an alternative during the second quarter of 2020, led to a particularly severe decline in employment that was concentrated in lower-income workers, especially women and youth. The employment challenge will also be impacted as automatisation and other types of skill-biased technological change increase. As I mentioned previously, increasing the size and coverage of an earned income tax credit (EIC), or implementing one in countries that do not have it, would foster low-skilled jobs. From a medium-term perspective, it will be very important to strengthen the education system to support continuous education. Finally, labour legislation reform should be aimed at accommodating a more dynamic labour market with new forms of employment.

*Industrial policy as a way to develop and generate growth has been at the heart of the public debate for a long time in Latin America. Are manufactures the way to develop from a rural economy to a mature, services-based one? Whereas economists such as Dany Rodrik see traditional industries as a stepping-stone for inclusive development and warn about premature de-industrialisation (or a premature jump to a service economy), others praise services (or 'industries without smokestacks' such as tourism) as a shortcut to the inclusion of a large informal unskilled workforce currently employed in subsistence agriculture or precarious marginal activities in big cities. Do you believe in industrial policy? What is you view about this debate in the context of the technological advances promoted by the pandemic? In particular, and going back to the previous question, where do you think the jobs needed for inclusive growth will mostly come from?*

I do not believe in industrial policy as the key instrument for development and growth in the region, but I do see a role for non-traditional or sectoral policies to complement the main development strategy that should be based on horizontal policies.

Industrial policies were tried in the past in Latin America with mostly poor results. The lack of a strong technical staff to identify the right interventions and the weakness of the political system to limit lobbying efforts to extend the duration of potentially good other policies or support the wrong ones has been a constant throughout the region when these experiments were undertaken. I do not think that the institutional framework has changed sufficiently to avoid capture by the private sector, nor have I observed a build-up of state capacity to design these policies better. Therefore, if governments in the region

were to think of introducing elements of sectoral industrial policies, the first order of business would be to identify the relevant externality, derive what the intervention is, and decide whether it is politically viable.

In addition, I think that the region still has much work to do to strengthen its growth fundamentals, such as the rule of law, reducing high effective rates of protection, making its energy supply more efficient, improving its education, simplifying its tax structure and developing an R&D policy.

Although not a central part of the development strategy, some elements of industrial policy can play a role in the design or adjustment of legislation and regulation to technological changes, to accommodate the development of production and business strategies hindered by them, or to provide public infrastructure for key sectors to develop.

*During the pandemic there was a revived role for the public sector (supporting jobs, firms, and low-income households, adopting emergency laws, leading the quest for the vaccine and the vaccine roll out), not only as a regulator but also as an active participant. What is your view on the role of the public sector? Has the pandemic changed your views about this role? Do you think the popular perception of the role of the public sector has changed to the point of inhibiting the retrenchment and fiscal consolidation due post-pandemic?*

I think the political economy of fiscal adjustment has become significantly more difficult as the social and economic gaps that I mentioned earlier have become even more demanding and urgent. It is also true that the pandemic laid open the huge inequities in our education and health systems that need to be corrected. Therefore, there is an urgent need in many Latin American countries to increase the size of the social safety net. This should be financed with changes to the tax system that make it more progressive and by opening our economies more to the private sector to promote investment and job creation. I think that the pandemic reinforces the need for the public sector to provide better health and education, and to establish better social risk-sharing systems. The difficult part might be that given the large liquidity provision undertaken by advance economies, a higher tolerance to debt might have developed that would further complicate the approval of the tax reforms that would be needed to fund these programmes.

*If you were named economic minister in your country of origin, what would be the first few measures or reforms that you would propose once the pandemic constraints are released?*

In the case of Mexico, which clearly has fiscal space, I would follow a two-pronged strategy.

First, I would immediately launch actions to address some of the deepest scars from the pandemic. I would propose a large programme of remedial education targeted at compensating the losses in days of schooling that took place during 2020–21 and mitigating school dropout rates. I would also increase the size and coverage of the EIC to stimulate the creation of low-wage jobs in the formal sector and a public expenditure

effort to upgrade medical facilities. Finally, in this immediate set of actions, I would design some tax incentives and financial support from development banks for the creation of new SMEs, as they are also key for job creation.

The second pillar of the strategy would be to relaunch the government's economic programme with the aim to better align it with a social democratic model. This agenda should be developed along three dimensions. The first dimension is to strengthen the role of the state as a provider of public goods and social risk-sharing mechanisms. On this front, I would set in motion processes to improve the quality and effective coverage of the public health system and create incentives to improve the quality of education. I would redesign the cash transfer, universal pension and other social and anti-poverty programmes to improve their targeting, make them more progressive and transparent and reduce their overlap. In addition, I would propose an unemployment insurance mechanism. I would also initiate the design of the tax reform needed to fund these efforts with a view to making the tax system more efficient and more progressive and modify the fiscal rule to make it more countercyclical. The second dimension should focus on opening as many sectors as possible to private sector participation and to provide the legal and regulatory certainty for all private sector activities needed for them to thrive. This should be a horizontal effort that covers every sector of the economy, but particular focus should be given to the energy and infrastructure sectors, where the country has digressed into more state intervention. The third dimension should be to build institutions on the anti-trust, consumer protection and anti-corruption front. This institutional pillar should have a strong emphasis on building a fair, efficient and honest judicial system.

*It looks like, finally, the climate change debate is here to stay, and it includes potential restrictions for a region where exports are intensive in non-renewable natural resources, transgenics and beef, and where traditional industries are struggling to survive. How does the green agenda affect the revision of what we see as a viable growth strategy for the region?*

I think the region needs to develop its strategy based on its own needs and the opportunities presented by the emphasis that this agenda has gathered around the world and its contribution to the global problem. Based on this regional strategy, the regional leaders must speak with one voice in the international debate.

*In the pandemic crisis, contrary to what was expected, countries drew only a fraction of the IMF's available funds, mostly in the form of unconditional liquidity facilities such as the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL) and the Rapid Financing Instrument (RFI). Despite the severe real contraction and fiscal expansion, there was no (and there is no sign of impending) financial crisis beyond those already in*

*the making prior to the Covid shock. How was this seen from the Fund? Does this mean that we should rethink the IMF's role and lending menu? Have macroeconomic crisis changed in nature in the new millennium?*

Although emerging and developing economies were able to implement support policies of larger magnitude than what was originally thought, they were significantly smaller than those recorded in advanced economies. This, amongst other factors, lies behind the divergent nature of the recovery, where advanced economies are expected to reach their pre-pandemic GDP path and emerging markets and developing economies will show permanent marks. Many emerging markets and developing economies had substantial access to market financing and official assistance. However, even under this benign financing environment, fiscal support measures in emerging markets and low-income countries were approximately between 25% and 15% of those implemented in advanced economies. Therefore, an important question is if there was space to do more. In some instances, it was a clear policy decision in countries that had fiscal space but decided not to use it, as was the case of Mexico, or the many nations that received the emergency financing of the IMF but decided not to engage in negotiations towards larger programmes with conditionality. But let me give a quick summary of what the international financial institutions did and try to answer the question of whether the international community could have done more.

During the pandemic, the IMF Board approved programmes for more than 85 countries of approximately $117 billion, of which at least 50% has been disbursed. It is important to highlight that Latin America was the region of the world that took most advantage of this, as more than $60 billion of this total went to countries in the region and the whole gamut of instruments was used by them: Stand-By Arrangements (SBAs), the Extended Fund Facility (EFF), the PLL, the FCL and the RFI. It is also true that the international community, through the IMF, deployed more than $275 billion to emerging markets and developing economies through the Special Drawing Right (SDR) allocation. The World Bank was able to increase its lending portfolio by approximately $20 billion (of which more than $6 billion went to the region) and the International Development Association (IDA) by approximately $20 billion, while the Inter-American Development Bank (IDB) also expanded its exposure to the region by approximately $10 billion. In summary, the international community used the instruments it has at its disposal in a relatively aggressive fashion. However, it clearly lacks a large light-conditionality instrument to finance fiscal expansions during global recessions (although the current version of the SDR allocation is moving in that direction).

I think the international financial community should rethink its risk tolerance. Having approximately $700 billion in fire power at the IMF, there is a case to be made for stretching the support that the institution can deploy during global crises. Additionally, the multiple multilateral development bank (MDB) balance sheet expansions could have been much larger. We should ask ourselves if it would have made sense to expand the balance sheets of these institutions much more, even at the risk of losing their AAA credit

rating – especially in an environment in which real rates of interest were coming down and in many cases were negative. Definitively, the benefit of additional MDB financing was much greater during 2020 than in the past. In my view, even within the current framework, there was a lot of additional space at the IMF and the MDBs to do more.

Regarding the lack of a major debt, financial or balance-of-payments crisis generated by the pandemic, I think we should realise that our traditional crisis frameworks were designed for idiosyncratic emerging market crises, and the current pandemic crisis – as was the case with the previous financial crisis – is a global crisis. In these cases, we should incorporate in our analysis of emerging market crisis management the large countercyclical monetary and financial response from advanced economies and the resulting opening of additional fiscal room for emerging markets.

## ABOUT ALEJANDRO WERNER

Alejandro Werner is the Director of Georgetown Americas Institute and a Non-resident Senior Fellow at the Peterson Institute. He was previously Director of the Western Hemisphere Department of the International Monetary Fund (IMF), Undersecretary of Finance and Public Credit (December 2006–August 2010), Director of Economic Policy and Chief of Staff at the Finance Ministry of Mexico, Director of Economic Studies at the Bank of Mexico and Head of Corporate and Investment Banking at BBVA-Bancomer. He has taught at Instituto Tecnológico Autónomo de México (ITAM), Instituto de Empresa, and Yale University. Werner was named Young Global Leader by the WEF and has a PhD from MIT and BA from ITAM (Mexico).

# SECTION III

# SOCIAL CHALLENGES AHEAD

# "The pandemic packed a triple inequality-increasing punch"





**Francisco Ferreira**
London School of Economics

*Many studies of the distributional consequences of the Covid crisis in developing economies have highlighted its regressive impact on several fronts, from the modest income support for independent and informal workers to the unequal cost of school closures or connectivity coverage. What do we know about the effects of the pandemic on the different social groups? What was the impact on inequality? How persistent do you think this impact will be?*

I think the answer really depends on the nature and magnitude of the policy response. In the absence of any policy response, the pandemic packed a triple inequality-increasing punch. First, there is now plenty of evidence that mortality from Covid was itself unequally distributed, both in Latin America and elsewhere. Those living in more crowded urban settlements where sanitation conditions are lacking – such as our slums, *favelas* and *villas miseria* – were at considerably greater risk. So were poorer self-employed workers who – again, in the absence of a policy response – had little alternative but to return to work after a while so they could feed their families, thereby placing themselves at greater risk of infection and death. There's also a racial dimension: given the region's pre-existing racial disparities, Afro-descendants and indigenous peoples are over-represented in both those slums and in the informal sector, and thus suffered higher mortality from Covid.

Second, the pandemic had an impact on the distribution of incomes, both by creating new inequalities and by exacerbating old ones. We know that any large recession tends to dampen the earnings of those who are forced to enter the labour market at that time, and this one won't have been any different, generating gaps between a particular cohort of young people and those just older and just younger than them. More importantly, a key inequality during the pandemic is that between those who could continue to work (and earn) while isolating at home and those whose jobs required in-presence personal contact. The latter suffered much more from the negative demand shock. Although the association is not perfect, the ability to work from home is highly correlated with education, and thus with pre-pandemic income. This was a key mechanism through which the pandemic exacerbated old inequalities.

Finally, you are absolutely right that school closures and attempts to conduct learning remotely, either online or – in some cases – via classes on TV, have had a huge and highly unequal impact. Private schools attended by children from richer families have vastly superior resources – both human and financial – and were able to move to digital learning much faster and more effectively than the bulk of (mostly) public schools attended

by children from poorer families. In addition, the pivot to learning at home placed a greater onus on parents – particularly mothers – as educators, so that the children of better-educated parents were once again better protected. Unfortunately, the currently available estimates of these educational effects suggest that they are both substantial and, potentially, very long lasting (e.g. Neidhöfer et al. 2021).

*How do you evaluate the policy responses in Latin America? What should have been done differently? Were there better and worse responses? What did we learn in 2020 that can help improve policy today, at a time when the pandemic has reduced its lethality due to the vaccine rollout but uncertainty about new variants remains high?*

Yes, the overall impact of the pandemic on inequality very much depended on the policy response. Despite the unequalising forces mentioned above, governments could – and some did – make a real difference. Obviously, the first broad policy area where government effectiveness mattered a great deal was public health policy, including things like testing, contact-tracing, isolation policies and the management of lockdowns. Globally, we certainly have some examples of success, such as Australia, New Zealand, South Korea and, after an initial phase of denial, China.

In Latin America, sadly, I think we had a situation in which public health policy responses did vary a great deal between countries, but the final outcomes did not. Take Brazil and Peru, for example. The Bolsonaro government in Brazil took an essentially ideological line that Covid was not a serious health crisis and implemented no national lockdown, although local governments did introduce them to some extent. Peru, on the other hand, imposed an early and – at least on paper – rather draconian national lockdown. Ex post, when we look at mortality rates in 2020, both countries have among the highest rates in the world. We did have some early examples of success, such as Chile's rapid testing roll out and Uruguay's contact tracing system. But my understanding is that both of those countries were also ultimately severely hit by the pandemic.

Separately from the public health response and the management of lockdowns, the region also experienced a wide variety of social protection responses, ranging from essentially no change in benefits in Mexico to the very generous *Auxílio Emergencial* payments in Brazil. As a result, according to early estimates by Lustig et al. (2021), both poverty and inequality increased quite sharply in Mexico and – under one of the scenarios they explore – may actually have fallen in Brazil! Argentina and Colombia had intermediate responses, and so intermediate results, but inequality is alto estimated to have risen in both countries. The decline in inequality in Brazil during Covid – at least up until September 2020 – has also been documented by Reis and Costa (2021) using the PNAD-Covid19 data, which were collected monthly through telephone interviews during the pandemic. (Of course, one irony in these comparisons is that Mexico, which took a very fiscally austere position in its response, has a left-wing government, whereas Brazil, which is governed by the extreme right and had a terrible public health response, was rather generous with its cash transfers…)

*How are the social consequences of the pandemic, and the lockdowns associated with it, different in the developing world? How are they different in Latin America relative to other developing countries? How do these differences influence the policy recipe? Should policy interventions be different in the region?*



I think the central difference between the developing world and richer countries as far as lockdowns are concerned can be summarised in one word: informality. The labour market response in many European countries relied crucially on furlough schemes, through which the state effectively subsidised the wage bill of formal firms. Workers typically earned less than before but were able to stick it out at home. Firms received substantial support with a key part of their variable costs and were able to retain workers they would have otherwise fired. In the United States, assistance took the form of extensions in unemployment insurance and substantial support for firms.

None of this works very well if half your labour force and a very large number of (typically smaller) firms are informal. The 'pipes' through which the government can channel support to workers are simply not there. This meant that the Latin American governments that chose to support people financially did so predominantly through unconditional cash transfers, typically in an 'emergency' fashion. But where they did not do that, or where support was too little, a large share of the labour force was forced to choose – after their meagre savings were exhausted – between obeying lockdown rules or feeding themselves and their families. I suspect this lies behind the failure, for example, of Peru's well-intentioned lockdown in early to mid-2020. Informal sector workers, who have always lain at the margin of many regulations in any case, had no choice but to ignore the lockdown as well. An additional problem in much of Latin America was the lack of fiscal space, which forced a number of governments to be more circumspect about increasing transfers than they might have liked. The combination of limited fiscal space and large informal sectors was a bane for most of the region.

*A January 2021 piece by Angus Deaton argued that, because of the more intense virus circulation in many developed economies, the 2020 output loss tended to narrow global cross-country income inequality, something of a silver lining in an otherwise dismal scenario. However, other studies that look at losses over a longer time window find that, because of the faster recovery and a more muted impact in terms of education losses, the total Covid toll would still be higher for developing economies. Has the Covid crisis altered the evolution of global inequality?*

Angus Deaton's findings in that paper are nuanced. He does show that declines in GDP and Covid mortality rates in 2020 were both positively associated with pre-pandemic GDP per capita. As my co-authors and I have shown (Decerf et al. 2021), the higher mortality rate in richer countries was due to the age-selectivity of Covid-19, and the fact that richer countries have older populations. But yes, this did lead to an additional decline in inter-country inequality.

Two important words there: 'additional', because inter-country inequality has been declining since at least the turn of the millennium; and 'inter-country', to emphasise that this uses countries as the unit. In the same paper, Deaton shows that 'international' inequality – when countries are weighted by population – actually rose during 2020. This was a trend reversal, since that concept of inequality had also been falling for two decades or so, and it was entirely due to India, which suffered a massive decline in GDP per capita in 2020. Exclude India, Angus shows, and that measure also continues to decline.

What about 'global' inequality, which is yet a third concept? Global inequality, as typically described nowadays, is not calculated between countries – whether or not weighted by population – but between individuals or households. It is the only one of the three concepts to include within-country inequality. Well, it is simply too early to know what happened to global inequality during the pandemic, or even just in its first year, 2020. The necessary survey and/or administrative data are simply not yet available for many countries. In a short piece I did for *Finance and Development* (Ferreira 2021), I speculated that it probably rose in 2020. When measured by the 'right' indices, global inequality is a weighted sum of between- and within-country inequality, where the between-country component is given exactly by what I have called 'international' or population-weighted inequality above. We know from Deaton's paper that this has risen. So it would be enough for within-country inequality to have risen 'on average' for global inequality to also have gone up. Although there are places like Brazil – but also France, Germany, Italy and Spain, according to Clark et al. (2021) – where the social protection response was sufficient to lower inequality. On the whole, one expects the unequalising market forces that I described earlier to have prevailed in most countries, leading to rising inequality. If that is so – which, I repeat, we won't know for sure for a while – then global inequality would have risen during the pandemic.

*What are the social and physical investments needed in Latin American economies to tackle the post-Covid social challenges? How can these efforts be funded while the government is faced with the need to reduce the 2020 fiscal impulse? Do you see any role for the private sector in this agenda?*

In a sense, the pandemic merely exacerbated – rather than radically changed – the social and economic challenges facing Latin America. Although of course there is heterogeneity across countries, it is probably still fair to characterise it in broad strokes as a highly unequal, economically sluggish region. Those are its perennial twin challenges: persistent inequality and secular stagnation marked by very low rates of productivity growth. From having living standards that were not that far off those in Southern Europe in the 1960s, the region has since increasingly become a laggard, and has been overtaken by one Asian country after another, now culminating with China.

To a first order of approximation, and again overlooking important national specificities, solutions require a different level of effectiveness in our investment in human capital and infrastructure. It is in this sense that the pandemic merely underscored deep-seated problems we have long suffered from. It shone a stark light on the inadequacy of Latin American hospitals, schools and, in some cases, entire public management systems.





While of course the private sector is fundamental, I believe it mostly has to stick to its core function of spotting profitable opportunities and investing to exploit them. It will also have a role in providing training for firm-specific skills. But the bulk of general human capital provision – from early childhood to university – needs to be either directly provided or subsidised by the state (except for the rich). The same is true of much basic infrastructure like ports, roads and railroads. Decades of hype about public–private partnerships in infrastructure have clearly not delivered the necessary amounts of investment.

The region falls into two categories in terms of how this highly needed additional public investment should be financed. In many countries – including Mexico, Peru and a number of Central American countries – fiscal effort (the overall tax/GDP ratio) is still either very or relatively low and there is considerable scope for raising additional revenue, which should be done in as progressive a manner as possible. Other countries, notably Brazil and Argentina, already have large public sectors and tax takes around 30% of GDP – almost at OECD levels – but deliver public services of much lower quality than OECD countries. In these cases, a very fundamental reform of the state is needed. But these diagnoses have been around for a long time. Because they are opposed by powerful corporatist interests, very little gets done and the cycle of stagnation and inequality continues, largely as a result of these captured state apparatuses.

*Poverty has worsened due to the Covid crisis. Do you think this is a temporary or a permanent deterioration? How could this be reversed or mitigated?*

Except for Brazil, as already discussed and as far as I know, the current estimates are indeed that poverty has risen across Latin America – as indeed in most of the world. This is not surprising: in 2020, global GDP per capita is estimated to have fallen by 5.3%, with negative growth rates observed in 172 of the 182 countries for which data were available to the World Bank (2021). Using differentiated poverty lines for low-income, lower-middle-income, upper-middle-income and high-income countries, we estimate that some 300 million additional people fell into poverty in 2020 alone (Ferreira et al. 2021) This was a very deep recession, and it is now increasingly understood that the Sustainable Development Goals of poverty eradication by 2030 – even in their more modest, World Bank version of 3% by 2030 – will not be reached.

That said, poverty – unlike inequality – does almost always respond to persistent growth. As the vaccine rollouts and rebounding economies substantially raise growth forecasts for 2021 around the world, we can expect to see some poverty declines. In that aggregate sense, the poverty increases from the pandemic will ultimately prove temporary. There

are, however, persistent and durable effects at the level of those families and individuals who were pushed into poverty over the last two years. Where nutritional outcomes worsened, permanent damage will have been done to children's cognitive skills. Those who were out of school for too long and, as a result, dropped out prematurely will likely have lower earnings and opportunities for the rest of their lives. Even if higher poverty – measured by counting people living under a poverty line – proves temporary, many of its sequels are highly durable, and scar people's lives for a long time.

*We have seen a burst of social protests and demands, from Colombia to Chile, demanding more opportunities, social mobility and equality. Are protests related to (or strengthened by) the increase in poverty and the growing inequality due to the crisis, or are they reflecting something else? Latin American politicians have responded by expanding social programmes, and even scheduled a constitutional reform in Chile. Are these the right answers?*

Some of these protests – including the massive Chilean demonstrations of 2019, which ultimately led to the current constitutional reform process – preceded the pandemic. In Colombia, of course, there were big protests both before and during the pandemic. I have argued elsewhere (Ferreira and Schoch 2020) that the common attribution of the 2019 protests to 'rising inequality' could not be right, since inequality had in fact been falling in both Colombia and Chile in the years immediately preceding the protests.

A second hypothesis – that the protests arose from a slowdown in the growth of the middle classes after the end of the commodity boom – does not fare much better. Countries that did see a decline in the size of their middle class late in the last decade – like Brazil and Argentina – did not see large protests. In Colombia and Chile, conversely, the middle class had kept expanding. Chile, in fact, had the fastest expansion up to 2017 and the largest middle class in the region, as a share of the population (55% of Chileans lived in households with per capita incomes between US$11 and $70 in 2017).

Marta Schoch and I argued that unlike the protests we currently observe in Lebanon – a country experiencing systemic collapse – those in Chile and Colombia in 2019 are best explained by recourse to the so-called Tocqueville paradox. In *Democracy in America*, written in 1840, Alexis de Tocqueville wrote that "it is natural that the love of equality should constantly increase together with equality itself, and that it should grow by what it feeds on". The Wikipedia entry on the Tocqueville effect summarises it as follows: "as social conditions and opportunities improve, social frustration grows more quickly". Of the various candidate explanations for the social eruptions in some of the region's most successful countries just before the pandemic, this seems the least at odds with the data – they were protests brought about by (possibly severely) incomplete success, rather than outright failure.

*There is an ongoing debate about the relevance of the empirical approach to policy in the region, in particular regarding the relevance (particularly the economic size and persistence, including between generations) of the findings from randomised control trials for policy interventions. To what extent should policymakers follow the results of RCTs to guide social policies in Latin America going forward?*





Randomised control trials are a hugely valuable 'new' tool in the applied economist's toolkit. When we are interested in studying the effects of policies that can be assigned exclusively to certain individuals or groups – like a conditional cash transfer or deworming medicine, and unlike a monetary policy expansion or a change in the exchange rate regime – RCTs provide the cleanest, surest possible way to identify the causal effect of the policy from other confounding changes. I don't think one can – or should – argue with that.

Of course, as already intimated in the above paragraph, they cannot be used to study everything. In addition, their results are valid in the context of the actual experiment as conducted. In a different context – say, when instead of a small experiment run by highly motivated team of researchers or volunteers, the policy is implemented at scale by 'regular' civil servants – the same results may not hold. (This is, of course, the distinction between internal and external validity.)

I think this is all fairly well understood by now, so the debate can seem a little sterile at times. Basically, if the problem you have is a nail, then by all means use a hammer. If the problem requires a saw or a drill instead, well, then, of course, the hammer won't work. That's why there are many tools in the toolkit, and RCTs are just one kind.

*Among the many debates energised by the pandemic, one of the most controversial is the one about who should 'pay' for the fiscal impulse during the crisis, in particular whether the fiscal unwinding should be buffered by higher taxes on the rich. How should we evaluate this argument in the context of slow-growing, fiscally fragile Latin American economies? Do you believe that the pandemic has exacerbated the savings glut of the rich in the region? Do they need to be taxed more, or to be induced to invest and spend more to help reignite economic activity? More generally, how has the equity versus growth debate changed with the recent crisis?*

Although I emphasised low (total factor) productivity growth as the main cause of the region's disappointing long-term growth performance earlier, it is true that in many countries investment rates are also too low. I am not an expert on growth but, looking at a country like my own – Brazil – I have the impression that more public and private investment are *both* needed, and are likely to be quite complementary. After all, better ports and highways, reliable electricity supply and telecommunications would all lower the so-called *Custo Brasil*, and presumably encourage private investment.

What we need less of is public consumption – basically a polite name for all kinds of wasteful public expenditure that, as I suggested earlier, leave us with an OECD tax rate and Central American public services. Once we fix that – again, much easier said than done – then the state will have earned the right to ask for additional tax revenues – if those are needed.

As I noted earlier, Brazil is probably an extreme case of a bloated public sector in Latin America, perhaps followed by Argentina and Uruguay. The latest OECD revenue statistics for Latin America put Brazil's overall tax-to-GDP ratio at 33.1% in 2019, just below the OECD average (33.8%) and well above the LAC average (22.9%). Even in Brazil, of course, taxation can still be made more progressive. Elsewhere, there is a likely a case for both raising taxes in aggregate – hopefully all of it coming from the rich – *and* making public spending more efficient.

*Covid may not end abruptly. It may take several months or even years for the pandemic to wane. How should governments revise or change the policy responses to mitigate the consequences over such a long period? What reforms – in labour, education, social policy, housing – are more urgent once we consider this scenario?*

As I have already suggested, I don't think the pandemic has fundamentally altered Latin America's key policy challenges and priorities. It has exacerbated them by most likely worsening inequality, exposing the low quality of our public services and highlighting the negative consequences of pervasive informality.

In terms of reform, I have emphasised the need for a systematic reform of the public sector in countries like Brazil and Argentina, where public workers actually serving the public – from teachers to garbage collectors – are often paid too little, while an elite class of bureaucrats earn outrageous salaries for adding very little value (to be polite). If and when we succeed in making our public sectors more efficient and effective, I think the pandemic has made us look closely at our public health systems and infrastructure, the low-quality end of our school systems and at the factors in our tax, labour market and social security systems that discourage formality. Those reforms should keep our governments busy for a while…

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# "Replacing existing targeted programmes with a UBI would leave the poor worse off"



**Nora Lustig**
Tulane University

*Many studies of the distributional consequences of the Covid-19 crisis in developing economies have highlighted its regressive impact on several fronts, from the modest income support for independent and informal workers to the unequal cost of school closures or connectivity coverage. What do we know about the effects of the pandemic on the different social groups? What was the impact on inequality and poverty? How persistent do you think this impact will be?*

In the last 25 years, Latin America experienced progress in reducing inequality and poverty, and their intergenerational persistence (e.g. López-Calva and Lustig 2010, Neidhöfer et al. 2018, Neidhöfer 2019, Lustig 2020). While this progress had stalled in the years prior to the pandemic, Covid-19 will trigger even more significant reversals. By the end of 2020, Argentina, Brazil, Colombia, Mexico and Peru were among the top ten countries in terms of infections. Brazil, Mexico and Peru were also among the top ten in terms of deaths per hundred thousand inhabitants. To contain the spread of the virus, governments implemented lockdown policies of various degrees. In addition, as individuals took their own precautions to avoid contagion, demand for many goods and services fell. Compounded by the fall in exports, tourism and capital inflows, these dislocations in domestic demand and supply caused sharp reductions in output, employment, and income.

Compared to their pre-shock income, households across the entire income distribution were hit. Somewhat surprisingly perhaps, the relative losses might have been higher for the moderate poor, the nonpoor vulnerable and the middle class, rather than the poorest. This perhaps unexpected result is the consequence of the targeted cash transfers programmes that were implemented in most Latin American countries over the past 25 years. These programmes essentially put a 'floor' for the incomes of the poorest. However, the short-term impact on inequality and poverty in the end depended on the government's response in the social protection front (e.g. Alkire et al. 2020, Brussevich et al. 2020, Busso and Messina 2020, INEGI 2020, OPHI-UNDP 2020, Bottan et al. 2021, Egger et al. 2021, IBERO 2021, Lustig and Pabón 2021, Lustig et al. 2021). This response has been quite heterogeneous. Some countries significantly expanded social assistance and were able to mitigate the brunt of the negative effects – Brazil and Chile stand out. At the other extreme is Mexico, where the social assistance response was close to nil. As a result, inequality and poverty in the short run did not rise in Brazil (it might

have even declined) whereas Mexico experienced one of the largest increases in poverty compared to pre-pandemic levels (Lustig et al. 2020). As the economies recover, incomes are likely to bounce back. However, long-lasting effects on poverty and inequality may occur because some households get trapped in their new circumstances. In particular, the negative impact on the human capital (cognitive skills, educational achievements, health, and nutrition) of poor children could negatively affect their earnings prospects permanently. Of the various channels by which the current situation is going to impact the future, education is one of the most important ones.

*How do you evaluate the policy responses in Latin America? What should have been done differently? Were there better and worse responses?*

Covid-19 has indeed resulted in sharp increases in inequality and poverty in Latin America. However, some countries were more effective in mitigating the effects (Blofield et al. 2021). Looking at the four largest countries, Argentina and Brazil stand out in terms of resources and coverage of vulnerable populations. In Colombia, on the other hand, such efforts have been more limited, and in Mexico they are downright puny.

Social protection measures were the broadest and most sufficient in Argentina and Brazil (Blofield et al. 2020). Both countries established demand-driven mechanisms to reach the informal population. Households could self-identify and apply for transfers designed to meet basic needs, under relatively inclusive eligibility criteria. This enabled both countries to reach a large share of households not covered by existing social protection schemes. By June 2020, new programmes reached 9 million recipients in Argentina and nearly one-third of Brazilians. Thanks to these responses, the number of additional poor was cut to a third (and more in Brazil). Neither response has been cheap (in absolute terms and given fiscal difficulties both countries face): by mid-year, they amounted to around 2% of GDP in Brazil and over 1% in Argentina.

In Colombia, the coverage and generosity of the expanded safety net was much more limited, and thus the number of new poor was only cut by 8%. Finally, in Mexico, there was no national-level expansion of existing cash transfer assistance nor introduction of new cash transfer programmes. As a result, around an additional 9 million individuals are likely to have fallen into poverty, probably the largest number in the region.

*The few studies that attempted to estimate the long-term economic costs resulting from school closures yielded dismal numbers, of the same order of magnitude as expected output losses. To that we need to add the already-mentioned distributional aspects, including the widening of the gap between rich and poor students. What can we say of the*

*differential impacts of the pandemic on educational outcomes? How long will they last? To what extent can they be attenuated? What should be done as soon as possible to stop the human capital haemorrhage?*

Education may be Latin America's most lasting scar from Covid-19. Our research suggests that the likelihood of today's students completing secondary education may drop from a regional average of 61% to 46% (Neidhöfer et al. 2021). This average, however, hides striking differences across socioeconomic groups. While schools shut their doors to children of all backgrounds, their ability to continue learning depended on their parents' income and educational level. Children in low-parental education households found it difficult, if not impossible, to continue their education at home due to lack of adequate equipment, connectivity and – above all – one-on-one coaching. Just as an example of such inequalities, the internet coverage for households whose head has less than secondary school in Bolivia, El Salvador, Honduras and Nicaragua is around 30%, while it is above 90% in families headed by adults with more than secondary education.

The probability of completing secondary school for children in low-parental education households could fall by almost 20 percentage points, from 52% to 32%. This low level of educational attainment for children of disadvantaged families was last reported for cohorts born in the 1960s (!). In contrast, children from highly educated families will be hardly affected. The growing educational gap will damage social mobility and equality of opportunity for years to come unless we take the warning signs seriously and act fast. There will be a need to make up for the losses by increasing both the amount and quality of learning time. School systems will need to contemplate extended schedules, summer and after-school programmes, and more personalised instruction. Efforts should also be geared to developing online and offline resources available for free and expanding connectivity. The remedial actions and rescue operations will require resources, especially financial resources. One key recommendation is for governments not to cut education spending when they face the inevitable need to reign in fiscal deficits (deficits that were not only acceptable but encouraged during the pandemic). In fact, if anything, fiscal resources devoted to education may need to rise. However, more spending without quality-enhancing reforms may not end up helping. The challenge is so daunting that help will be needed from nonstate actors as well. Private philanthropy, the for-profit sector and community-based organisations, together with governments, should launch a crusade to save the next generation of vulnerable children from falling behind.

*In the early 2000s, Latin America saw a reduction of inequality mostly driven by a narrowing of wage dispersion, while recent work on inequality has highlighted what looks like a potential reversion. Are we indeed witnessing the beginning of a period of widening wage premiums and inequality? Do you think the regressive impact of today's education losses will further contribute to this reversion in the medium term?*

Inequality is a distinctive feature of Latin America due to its high level and persistence. After rising in the 1990s, however, income inequality in the 2000s unambiguously declined in almost all the countries. Research shows that there were two underlying factors: (i) a fall in the relative returns to workers with secondary and tertiary education versus workers with primary education (the skill premium); and (ii) higher and more progressive government transfers (López-Calva and Lustig 2010). The fall in the skill premium, in turn, could be attributed to changes in the composition of demand and supply of labour by skill (markets) and institutional factors such as rising minimum wages and unionisation (state action). On the supply of labour side, the 1990s were marked by an accelerated expansion of basic education. This changed the composition of the labour force by educational level, with low-skilled workers becoming relatively less abundant. As a result, relative returns to education, particularly for secondary and higher education vis-à-vis workers without schooling or incomplete primary education, fell. Depending on the scale of the effect on educational gaps, the Covid-19 pandemic could set in motion a process in reverse. If children of poorer households drop out of school in large numbers or if their ability to catch up on lost learning is pervasively limited, low-skilled workers would become relatively more abundant and their relative wages would decline. The impact of automation on the demand side could increase the wage gap even further. Labour income inequality and, thus, overall inequality could rise as a result. Hence the importance of implementing remedial actions to contain the fallout of school closures on the educational levels of disadvantaged children.

*The UN Economic Commission for Latin America and the Caribbean (ECLAC) and others have suggested that the recent expansion of cash transfers as a response to Covid-19 could be made permanent as a step towards a universal basic income (UBI). Would such a cash-transfer policy successfully lift people out of poverty, and what unintended consequences might it have in the region? What would a UBI system look like in Latin America and the Caribbean?*

As a response to the pandemic, countries expanded cash transfer programmes to protect those hurt by Covid's economic fallout. Whether to convert this into a permanent change is a different matter. A UBI can provide a broad-based safety net in the face of a reduction in income (such as during the current pandemic). However, if the main objective is poverty reduction, replacing existing targeted programmes with a UBI would leave the poor worse off (Enami et al. 2021). If the aim is to both reduce poverty and create a social protection floor, a UBI should be high enough, at the minimum, for the poor to be no worse off than under current programmes. Beyond undesired work disincentives,

achieving this in a budget-neutral manner would require an increase in taxation that may create political resistance from the middle classes. Thus, there is a trade-off between size (i.e. the impact on poverty reduction) and efficiency of the universal basic income floor. The higher the floor, the larger the potential losses in efficiency due to higher taxes; the lower the floor, the smaller the ability of a UBI to act as a genuine safety net. In the end, whether or not to introduce a UBI will depend on the country. What cannot wait is implementing a universal registry that includes informal workers and the self-employed. In the absence of such a registry, expanding the coverage of transfers quickly enough is difficult. A second matter that cannot wait is to keep track of spending on cash transfers. Accurate information is not available; ECLAC discontinued reporting these data some time ago.



*Covid may not end abruptly. It may take several months or even years for the pandemic to wane. How should governments revise or change the policy responses to mitigate the consequences over such a long period? What reforms – in labour, education, social policy, tax policy, housing – are more urgent once we consider this scenario?*

The pandemic revealed two major holes: the large share of workers and households not covered by existing social protection systems, and the tremendous inequity on multiple fronts caused by unequal access to connectivity. Hence, implementing a counter-cyclical social protection system with universal coverage in terms of registries and universal internet coverage should be top priorities.

In addition, the reigning in of fiscal deficits will need to be implemented in a socially responsible way. This means that spending on the poor and vulnerable on social assistance, education, health and infrastructure should be protected from cuts as much as possible. At the same time, taxes should be reformed in such a way to make the richer echelons of society pay more. Addressing how to tax undistributed profits so that this does not continue to be how the rich protect themselves from being taxed will be key. One major challenge will be how to cushion the middle classes from further blows. The cut in subsidies and emergency social assistance that reached the middle classes during the pandemic is inevitable; the middle classes may also have to pay more in taxes. Both will fuel further discontent and could result in self-defeating politics and policy dynamics.

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# "The pandemic showed the importance of transitory poverty in the determination of coverage for social programmes"



**Eric Parrado**

Inter-American Development Bank

*Many studies of the distributional consequences of the Covid crisis in developing economies have highlighted its regressive impact on several fronts, from the modest income support for independent and informal workers to the unequal cost of school closures or connectivity coverage. What do we know about the effects of the pandemic on the different social groups? What was the impact on inequality? How persistent do you think this impact will be?*

There is no doubt that the economic and social impact of the Covid-19 crisis falls largely on the poor and the middle class. In April 2020, we conducted a large-scale online survey in 17 countries in Latin America and the Caribbean, reaching almost a quarter of a million households (Bottan et al. 2020). The impacts of the Covid-19 crisis were large and unequal, with the major impacts experienced by the lowest-income households. Overall, 45% of respondents reported that a household member lost their job and among households owning small businesses, 59% of respondents reported that they had closed their business. The damage was greater among the households with the lowest income prior to the pandemic: 71% of respondents reported that a household member lost their job and 61% of households owning a small business reported that they had closed their business.

These labour market disruptions led to severe declines in income, partially reversing years of progress on poverty. Overall, we found that 71% of respondents expected declines in their household income in April 2020, relative to January 2020. Although the poorest households experienced greater labour market disruptions, the pandemic also showed the vulnerability of the middle class. Among respondents whose pre-pandemic income was above the lowest income category, proxied by the national monthly minimum wage, 56% expected their income to fall into the lowest income category. The pandemic threatened other dimensions of inequality also. Women had to worry about contributing to bringing food to the table and about taking care of children or the elderly.

More recently, a forthcoming IDB study concludes that inequality has increased in Latin America during the pandemic (Acevedo et al. 2021). So, the Covid-19 crisis not only had a negative effect immediately in the income distribution, but also after several months. We observed that 2020 saw a reversal in the trend towards poverty reduction and greater

equality that started 20 years ago. In particular, the inequality reduction dynamic that started in our region in 2002 was broken in 2020, which saw a 2% increase in the value of the Gini index.

Although several countries have lifted the lockdowns and mobility restrictions, some sectors such as services or tourism have yet to come back to normal. Some displaced workers may have migrated from the formal to the informal sector.

The pandemic brought a new policy challenge: how to ensure that this transition into poverty was only transitory? Encouraging the adoption of digital technologies may enable businesses in the service sectors to keep operating and even to expand their customer base. In the case of women with children, access to childcare directly or indirectly through the safe opening of schools can enable them to fully reintegrate into the labour force. Even when jobs and income streams are restored, governments may need to deal with the pervasive consequences of the crisis. For example, our survey revealed that households that experienced the loss of their livelihoods were 13 percentage points more likely to have suffered hunger and 8 percentage points more likely to experience declines in the quality of their diet.

*How do you evaluate the policy responses in Latin America? What should have been done differently? Were there better and worse responses? What did we learn in 2020 that can help improve policy today, at a time when the pandemic has reduced its lethality due to the vaccine rollout but uncertainty about new variants remains high?*

In general, the governments in the region responded rapidly during the first months of the pandemic. However, the region is quite heterogeneous and countries with different situations have implemented different policy responses. The governments in the Latin American region showed that innovation in the public sector is possible, particularly in the case of social protection. Governments rapidly expanded their social safety nets or, in some cases, created them from scratch. For example, some countries relied on their already well-developed social registries, others collected applications online, still others relied on non-traditional data sources such as utility expenses to identify beneficiaries.

In the region, governments faced constraints on designing their response; they needed to respond with very limited resources and in a short period of time. There is a lot of merit to those quick responses. However, there are still important lessons to be learned; expanding social safety nets at unprecedented speed led, unsurprisingly, to some implementation issues. These lessons are not only important because we are still fighting the pandemic, but because other crises such as those related to natural disasters and climate change are ever more probable.

One key lesson is the importance of having well-stablished social protection programmes (e.g. Gallego et al. 2021). Our research shows how beneficiaries of pre-existing programmes were able to attenuate the impacts of the labour disruptions induced by the pandemic, even though these programmes were not necessarily designed to tackle systemic crises.

There are countries such as Brazil and Chile, which displayed social support during the pandemic that was extraordinary and, by the same token, not sustainable at that pace. The challenge in the future is to expand these safety nets to those that fell through the cracks in a sustainable way.





We also learned the importance of investing in social registries with broad coverage. Several countries used their social registries to identify potential beneficiaries almost in real time. In contrast, some countries had to figure out how to identify beneficiaries for emergency social programmes, while others had to provide the much more expensive (and less sustainable) option of near-universal benefits.

There are also important implementation lessons. Some countries were able to use the expansion of digital services to improve efficiency and improve the delivery of benefits from social programmes. In some countries, beneficiaries of social programmes had to agglomerate to cash out their benefits. In contrast, other countries had already a way to electronically disburse benefits while others partnered with the private sector to bank millions of beneficiaries. In the case of the latter, these new social programmes are likely to deliver important positive impacts that will persist beyond the pandemic, such as banking previously unbanked households, increasing their use of digital accounts and digital payments.

*How are the social consequences of the pandemic, and the lockdowns associated with it, different in the developing world? How are they different in Latin America relative to other developing countries? How do these differences influence the policy recipe? Should policy interventions be different in the region?*

Latin America differs from the most developed countries in several ways that affected the economic impacts of the pandemic.

First, labour market informality is more prevalent in the region relative to the most developed countries. Comparing across 17 countries in Latin America and the Caribbean, we find greater labour market disruptions in countries with a greater share of self-employed workers, which we consider a proxy for labour market informality. In Latin America and the Caribbean, we find that among households that owned a small business, 58% closed their business. In comparison, in the United States, another survey found that 43% of businesses closed temporarily (Bottan et al. 2020).

Second, teleworking and digital services played a crucial role in allowing many individuals to continue working and businesses to continue operating. Differences in the ability to transition to teleworking – for example, differences in technology skills, high-speed internet connections, the lack of widespread use of digital payments and the nature of work – allowed some countries, regions, industries, businesses and individuals to adapt their economic activities more quickly to the pandemic.

Third, in developed countries safety nets are much deeper, matured and well structured. This, together with much more ample fiscal space than we had in Latin America and the Caribbean, allowed developed nations to quicky channel resources appropriately so as to quickly insulate vulnerable populations from the economic shock. In addition, this rapid response facilitated the effectiveness of the lockdowns in controlling the spread of the virus.

Thinking of the hopefully prompt return to normalcy, countries need to invest in making sure that the digital transformation is accessible to most citizens.

*The few studies that attempted to estimate the long-term economic costs resulting from school closures yielded dismal numbers, of the same order of magnitude as expected output losses. To that we need to add the already mentioned distributional aspects, including the widening of the gap between rich and poor students. What can we say about the differential impacts of the pandemic on educational outcomes? How long will they last? To what extent can they be attenuated? What should be done as soon as possible to stop the human capital deterioration? What would be, in your view, a realistic medium-term program to address the education shock in Latin America?*

The region arrived at the pandemic with large learning gaps across socioeconomic status of students and a serious problem of school dropout among teenagers. The two problems will likely be severely exacerbated after the pandemic. School closures required an unplanned (and in many instances, improvised) transition to remote learning. This was a difficult transition even in very developed areas of the world. In Latin America, the complexity of the transition to remote learning was even more challenging because many families had limited connectivity, limited monetary resources or limited time to help children with school activities.

This is a problem for which evidence is scarce. However, some initial studies in the region suggest two types of effects. First, we have experienced large learning losses. Second, school dropout increased dramatically. The long-run impact of these negative effects of the pandemic on schooling outcomes will depend critically on how much remediation school systems can deploy. With little or no remediation, it is likely that the negative effects will be somewhat permanent. We have some indirect evidence that suggests that learning losses during periods of school inactivity have long-lasting effects on subsequent student learning and wages once these students access the labour market. Hence, remedial education should be an absolute priority of governments in the region. The good news is that over the last decades, we have collected a lot of evidence on what works and what does not to attain these two goals. The SkillsBank[5] reviews this evidence in depth. It is time to put this evidence to work.

5 https://skillsbank.iadb.org

There are many challenges to reopening schools safely, but experts agree that in-person learning is important. When thinking about the educational sector, it is also important to consider all the other services it provides to students in addition to learning. Schools often provide health services, nutrition through school meals and social services. Returning to in-person schooling will allow children to access these additional support services that can improve learning and wellbeing.





Once schools reopen, it is important that they do not return to business as usual. To make up for lost learning, schools can embrace accelerated learning strategies, non-linear curricula and adaptive instruction. Adaptive instruction, such as Teaching at the Right Level (TaRL), individually targets instruction to each student's level and can help to reduce gaps between students. Technology can help to tailor support to each students' needs. These measures will help reduce the permanent effect of the pandemic on education.

There are some promising approaches to mitigate the impacts of the pandemic on learning. Last year, Peru implemented a learning platform that uses computer-assisted instruction to teach maths skills aligned with the public school curriculum. Before the pandemic, an IDB study showed that this tool could engage children and improve learning in Chile (Arias Ortiz et al. 2020). We are hopeful that this and similar initiatives can mitigate the negative effects of the pandemic.

What are the social and physical investments needed in Latin American economies to tackle the post-Covid social challenges? Due to their different nature, these investments tend to fall in the ranking of policy priorities. How can these efforts be funded while governments are faced with the need to reduce the 2020 fiscal impulse? Do you see any role for the private sector in this agenda?

The region faced many social challenges before the Covid crisis and as the pandemic recedes (new cases and deaths are falling in most countries but not all) these challenges are even greater. The crisis reversed the progress the region had been making to reduce poverty and inequality. There is an urgent need to improve both the quantity and quality of investment in the region, particularly in infrastructure.

Unfortunately, investment (both public and private) in infrastructure had been falling and was just 2.8% of GDP in the decade leading up to the Covid crisis. During the crisis it fell further. In our recent 2020 flagship report on infrastructure (Cavallo et al. 2020), we analyse this situation in detail. There are major opportunities to improve the quality of such investments, from the project planning and selection process through to the building and operation phase. There are many inefficiencies in these processes to date and it is estimated as much as 35% of the resources spent may have been accounted for by delays and cost-overruns. Whether infrastructure is provided through public or through private financing, that framework needs to work efficiently.

At the same time, the quantity of investment also needs to rise. In fact, quality and quantity go together, as private investment will not be attracted if the investment framework is poor. This is even more critical today. Public investment may be constrained in the coming months and years as countries grapple with the need for higher social spending and many need to pursue a fiscal consolidation to bring debt levels down. There is, though, ample space to attract more private financing to infrastructure. At present, most private investment in infrastructure is provided by commercial banks; pension and other funds appear to invest very little in such assets. There is, then, an opportunity to boost investment, particularly from these types of investors, by selecting and planning good projects and by designing the right financial instruments.

The private sector has a tremendously important role in the recovery post-pandemic. In addition to its involvement in infrastructure, the private sector is key in creating highly productive formal jobs that the region so badly needs in the recovery. Economies in the region are populated by many small, unproductive, informal establishments which exist in part because it is costly for productive firms to create jobs. There are some economic relief measures that are not as costly in terms of fiscal resources that can foster formal job creation – for instance, the temporary reduction of severance payment or payroll taxes for newly created jobs so that wages paid to employees are similar to the actual cost of employing that person.

Also, the private sector is an engine for innovation. This innovation matters not only for growth but also for social policies. The use of digital tools in education is a good example. We have evidence from Latin America and from the rest of the world that, when properly done, the use of technologies in and outside the classroom can lead to learning gains (which could compensate some of the learning losses that we discussed before). Another aspect of digitalisation is that, during the pandemic, industries with intense online activities have been much more resilient than industries with in-person activities. Moreover, we have seen a substantial increase of online transactions of firms because of the pandemic. So now, we need to create the right incentives – through regulations – to continue with that process.

*Poverty has worsened due to the Covid crisis. Do you think this is a temporary or a permanent deterioration? How could this be reversed or mitigated?*

The length of the impacts on poverty will be partially determined by the effectiveness of government policies. But a key priority is to reignite growth. We know from the experience in the 2000s that growth in that decade was crucial for poverty reduction. The region was able to reduce poverty almost 20 percentage points between 2002 and 2012. Up to two-thirds of the reduction of poverty during that period was due to growth which translated into improvements in employment opportunities: higher wages, higher employment and higher labour market participation of people (mostly women) who were not working before and joined the labour force. The other third of the reduction in poverty was due to redistribution, like the expansion of conditional and unconditional cash transfer

programmes and non-contributory pension programmes. There is very little fiscal space to replicate such an expansion now – that's why the role of the private sector in spurring job creation is key.

Countries in Latin America reacted quickly to the Covid-19 crisis by introducing emergency social transfers. We now have results from rigorous impact evaluations showing that these programmes delivered much-needed resources at an unprecedented speed and attenuated the negative impacts of the pandemic not only on income but also on consumption. The damage induced by the pandemic was huge, but it could have been worse. There are some contrasts, however. For households in the first quintile of the income distribution, the coverage and replacement rates of labour market income were high, but these rates are much lower for households in the second and third quintiles of the income distribution. Thus, it takes more to mitigate the impacts of crises on middle-income households. Prior to the pandemic, these households earned nearly all their income through labour, and they didn't have enough wealth to build sufficient resilience to labour market shocks. In contrast, lower-income households receive around a quarter of their income from social programmes, which is protected from labour market shocks. Sustainably expanding benefits to the lower-middle-income households is a challenge for the future.

The reversal, of course, goes beyond social benefits. Public health policies and vaccinations are crucial. However, once we defeat the virus, it is possible that the structure of the economy will be different. Some sectors were hard-hit while others thrived, and the increased use of digital technologies may have also changed the nature of work and accelerated automation. A successful reversal will require policies that enable workers to quickly adapt to the new challenges of labour markets.

*We have seen a burst of social protests and demands, from Colombia to Chile, demanding more opportunities, social mobility and equality. Are the protests related to (or strengthened by) the increase in poverty and the growing inequality due to the crisis, or do they reflect something else? Latin American politicians have responded by expanding social programmes, and even scheduling a constitutional reform (in Chile). Are these the right answers?*

The social discontent pre-dated Covid-19, but these issues were exacerbated during the pandemic. They were related to the lack of equality of opportunities but also to a general mistrust in governments. We know, from previous research, that the levels of trust among Latin Americans are low when compared to trust levels in more developed countries, and we also know that a vast majority in the region perceive that the distribution of income is unfair. Given this context, last year we published an entire report documenting the pervasiveness of inequality in the region both in terms of income but also inequalities based on race, gender and regions within countries (Busso and Messina 2020). One stylised fact is that despite sharp declines in poverty in the region during the past 20

years, income inequality had barely been reduced. There are of course no one-size-fits-all policies. Inequality is a common symptom but how each country got there may entail different economic and political paths.

The reaction of politicians around the regions has been to listen to those demands and try to accommodate them as much as possible within both very stringent political and economic constraints. The current fiscal space leaves very little room to manoeuvre. So, fiscal reforms are necessary and timely. But political leaders must understand that increases in public expenditures, given social demands, have to have a correlation with public revenues. Fiscal management is complex, especially when debt levels are increasing, but Latin American countries need to propose a course for fiscal policy and a clear strategy to exit the pandemic.

The political economy of tax reforms has always been important, but now even more so in societies that demand greater opportunities, more inclusion and more equality.

*There is an ongoing debate about the relevance of the empirical approach to policy in the region, in particular regarding the relevance (particularly, the economic size and persistence, including between generations) of the findings from randomised control trials for policy interventions. To what extent should policymakers follow the results of RCTs to guide social policies in Latin America going forward?*

Randomised controlled trials are the gold standard in science. We learned first-hand about the value of the evidence produced by RCTs in the testing of the efficacy of Covid-19 vaccines. In many cases, we should also require the same about many policy interventions. Why spend scarce fiscal resources on programmes for which we do not know their effectiveness? If anything, we need more RCTs on a variety of government programmes, in different settings, for different populations and at different scales. The implementation of RCTs should also be done in close coordination with the government so that programmes can be tweaked and fine-tuned to increase their effectiveness.

The results of RCTs have high internal validity but they may lack external validity. The results of an RCT may be highly context-dependent and what works in one situation may not work in another. While RCTs may teach us about what works and what does not, understanding the context behind the results is very important. At IDB, there are multiple initiatives to systematise the lessons from rigorous impact evaluations so that policymakers can look at the broad range of impacts of similar interventions and understand how they vary across countries.

Further, many RCTs are designed to determine whether a specific intervention is effective, but not to provide clear evidence on questions such as why the intervention did or did not achieve its goals, how it might be tweaked to improve outcomes, or whether it would be effective in a different context. Because in many RCTs it not possible to guarantee treatment compliance, there is little understanding about who chooses to receive the intervention and why. In response, many RCTs are now closely linked to economic theory or structural

models that allow researchers to address some of these additional questions. Likewise, policymakers and researchers need to acknowledge that scaling up interventions may be much more challenging than implementing pilots. This is precisely why it is important to work alongside the people in charge of operations and implementing agencies; a practice that is central to research at IDB.





Now, there are some policies that cannot be guided by RCTs because no RCT can be designed; monetary policy comes to mind or banking regulations. That's fair enough. There are other principles or tools that can be used to guide policymakers when randomised controlled trials are an impossibility.

*Among the many debates energised by the pandemic, one of the most controversial is the one about who should 'pay' for the fiscal impulse during the crisis, in particular whether the fiscal unwinding should be buffered by higher taxes on the rich. How should we evaluate this argument in the context of slow-growing, fiscally fragile Latin American economies? Do you believe that the pandemic has exacerbated the savings glut of the rich in the region? Do they need to be taxed more, or induced to invest and spend more to help reignite economic activity? More generally, how has the equity versus growth debate changed with the recent crisis?*

As I mentioned in an op ed on Project Syndicate (Parrado 2021), the most important and urgent challenge is related to the need for fiscal consolidation. Tax collection in Latin America and the Caribbean (LAC) is only 22% of GDP, while it is over 35% in the OECD. But there is substantial heterogeneity across the region, so this calls for very different policies depending on whether taxation is high or low.

In the case of high-taxation countries in LAC, efforts to be more expenditure efficient are in order. Boosting tax effort – the percentage of effective tax collection relative to its potential – could make a significant difference relative to raising tax rates. Tax effort in the region is about 60%, compared to 77% in advanced economies. If LAC could catch up to advanced economies, it could increase tax collection by about 7% of GDP. Informality is one of the key reasons for the low tax effort, and it should be addressed through programmes that reward formal employment, particularly for low-income groups.

For countries with low taxation revenues, raising the tax bases as recovery gains momentum and ultimately increasing tax rates are available options. However, they should be carried out in a way that does not damage growth and inequality, which are crucial for poverty reduction, as argued above. Options for increasing tax collection and lessening inequality include reducing overarching exemptions for value-added taxes (VAT) on specific goods such as food, drugs and housing, while using a well-targeted system of compensating transfers to the poor. Among income taxes, there is less scope for raising either the personal income tax (PIT) rate or the corporate income tax (CIT) rate. PIT rates are already at similar levels to advanced economies. CIT rates, at 27% on average in LAC, are higher than in advanced economies (22.6% on average). With CIT tax

rates falling across the globe, increasing them is not an option, but there is room to lower CIT exemptions and to push for formalisation of informal firms to increase income tax collection. Yet another option includes increasing property taxation. The region collects only about 0.4% of GDP, roughly half the amount collected in other developing countries and one-sixth that in the OECD.

For both groups, reducing tax evasion and tax avoidance would be a key component in a fiscal consolidation strategy. In addition, countries should think of imposing carbon taxes to combat climate change could be beneficial. LAC countries have ample room to increase fuel taxes and/or diminish subsidies. Digital services must also be taxed to ensure that taxes are fairly applied across sectors. These services have experienced a surge in demand, yet their taxation is low.

Finally, wealth taxes, other than property taxes, are instruments that can increase the redistributive impact of tax systems. However, in practice their impact can be very limited if not properly designed and managed. In fact, most of the countries that implemented wealth taxes observed low levels of collection, a consequence of high evasion or aggressive tax planning by taxpayers to evade the tax. These low levels of collection, together with concerns about efficiency losses in the economy, have led several countries to eliminate this tax. In the OECD, 12 countries had a personal wealth tax in 1990; currently only three countries (Spain, Switzerland and Norway) have one. In our region, only three countries (Argentina, Colombia and Uruguay) had such a tax before the crisis generated by the Covid pandemic. In both regions, the collection of this tax is low. In OECD countries, the average collection of wealth tax in 2018 represented 0.56% of GDP, while in LAC this figure was 0.06% of GDP. Therefore, to increase the impact of fiscal policy in LAC, it is important that countries adopt a comprehensive vision, considering all taxes and social spending.

*Covid may not end abruptly. It may take several months or even years for the pandemic to wane. How should governments revise or change the policy responses to mitigate the consequences over such a long period? What reforms – in labour, education, social policy, housing – are more urgent once we consider this scenario?*

The region needs to grow. In that process, it needs to ameliorate the negative shock to human capital by implementing quick remediation policies. But in the short term, the best thing that we can do at this point to limit the economic and health impacts of the pandemic is to increase vaccination rates and address vaccine inequities.

Beyond that, policies to encourage labour market formalisation, such as the negative income tax (NIT) or the earned income tax credit (EITC) programmes, and to include informal workers in social safety nets should be considered. There is suggestive evidence that labour market informality increased labour market disruptions. Labour market informality may also have magnified the negative impacts of these disruptions on

household wellbeing, since informal workers typically have less access to social safety nets. Through both channels, labour market informality may have played a significant role in exacerbating inequality in the region.

Teleworking and the expansion of digital services and tools can help economies adapt. We found that higher-income respondents were more likely to be able to telework, helping them to preserve their jobs and also protecting them from exposure to Covid-19. This was not the case for lower-income households, those who tend to obtain most of their income through informal jobs or small businesses. Indeed, we found that the impacts were more devastating in countries with a larger informal sector.

Beyond teleworking, digital tools and services can help governments and businesses deliver services. For example, digital transfers can help recipients access their transfers. Some workers may now have access to digital platforms that expand their markets, while others may simply benefit from not having to stand in line for hours to conduct basic transactions.

In the education sector, the region could also take advantage of this opportunity to embrace new ways of teaching that recognise that students learn at different paces and require different support at different levels. The pandemic also paved the way for an increase in the use of technology and digital tools to assist education.

The pandemic exposed the vulnerability of the middle class. The substantial number of households transitioning into poverty showed the importance of transitory poverty in the determination of coverage for social programmes during crises.

We need to use these lessons to better prepare for future, unanticipated crises by designing more dynamic and flexible social safety nets. The end of this pandemic may be around the corner, but the increasing threat of other health crises, natural disasters and other crises is knocking on our doors.

*Has the Covid crisis, and its estimated consequences in Latin America, changed the priorities of a regional development bank like the IDB? In particular, in light of the traditional focus of IDB lending, is there a greater focus on social spending as opposed to infrastructure and private?*

The Covid crisis has highlighted the weak health infrastructure in the region. While the region has only 8% of the global population, it had more than 30% of the deaths due to Covid in the world. Moreover, as detailed in the 2021 Latin American and Caribbean Macroeconomic report (Cavallo and Powell 2021), there was no real trade-off between the health and the economic outcomes. Countries in the world that did well in terms of few Covid deaths tended to suffer smaller declines in GDP, while countries that suffered greater deaths also had larger recessions. So, the first priority from both a health and

an economic perspective should be to ensure adequate vaccination rates and mask and social distancing policies, especially among those that remain unvaccinated, to ensure a speedy recovery.

Apart from the obvious and necessary focus on health, the Covid crisis has accentuated the challenges that the region was already facing, including high poverty rates and high inequality, poor education outcomes and weak infrastructure provision. As we argued in the 2020 report (Nuguer and Powell 2020), there are a set of policies that could be adopted that would boost inclusive growth, in other words, that would increase growth and at the same time reduce poverty or inequality. Examples are found in both fiscal reforms, monetary policy, other structural reforms, and through the judicious choice of infrastructure projects. Countries should focus on these win-win policies.

In addition, the region is facing two challenges which are also tremendous opportunities. The first is the technological revolution. Digitalisation and other technologies are reforming almost every sector, including infrastructure. Technology is revolutionising the provision of infrastructure services. But it is critical to ensure that the right policies are in place. With the right policies, this revolution can assist in enhancing the affordability and the quality of services.

The second challenge is climate change. On the one hand, higher temperatures, higher sea levels and the increased frequency of floods, droughts and fires and strength of storms implies that countries need to invest more in becoming more resilient. On the other hand, countries need to invest in the transition to zero net emissions going beyond current plans in many cases. But such plans and the required associated investments can be affected to boost economic activity and jobs. Technology is also helping, as the cost of the transition to net zero emissions has become much more economically feasible today. There are, then, huge opportunities to push towards a cleaner and a more inclusive economic environment taking advantage of the technological advances that are here and are going to be coming in the near future.

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# SECTION IV

# THE FUTURE OF DEMOCRACY IN LATIN AMERICA

# "Societies are experiencing radical political fractures; Latin American countries are no exception"





**Edmar Bacha**
Casa das Garças Institute of Economic Policy Studies

*Some leaders in the region (including your country, Brazil) have embarked on a behaviour (or at least a rhetoric) that seems to endanger the very institutions that sustain democracy (justice, elections, etc.). Is this a real threat? What could we do about it?*

Yes, it is a real threat. As public intellectuals, we need to be vocal about the dangers to democracy that populist leaders represent, both from the right and the left. As academic economists, we need to introduce political economy considerations more seriously into our theoretical and empirical analyses.

*Following episodes in Brazil, Chile and Colombia in the past ten years, many experts, including economists, have started to consider whether liberal democracies in Latin America are in danger, and whether and how they should adapt to address what looks like a slowly boiling social discontent. What are your views on that?*

Democratic institutions are fragile constructs, particularly in large heterogeneous societies. Authoritarianism is on the rise worldwide, after a relatively tranquil period following the downfall of the Soviet empire in the early 1990s. The rise of China is particularly problematic for, contrary to expectations, economic progress did not reduce the dominance of the Chinese Communist Party there – much to the contrary. Russia under Putin is another threat to democracy both domestically and in neighbouring countries. Rich, democratic Western societies are experiencing radical political fractures that seemed to be long gone. Social networks are part of this new radicalisation. Latin American countries are no exception to this overall picture, with their own peculiarities which make the problem more acute, namely, a long tradition of economic populism and patrimonialism.

*While these manifestations preceded the pandemic, there is a feeling that the crisis may have given them a new impulse. How has the pandemic affected these conflicts?*

Difficult to say. On one hand, there are the loss of income, increase in inequalities and the rise of public debts. On the other, there are the heightened conscience of the importance of externalities and the need for social compacts to deal with them.

*When we read of protests in Chile and Colombia, the first reaction is to look at a deterioration of social indicators. These two cases, however, are success stories in terms of the recent evolution of social statistics. What, then, are the concrete sources of this dissatisfaction? Do you think they are justified?*

To focus on the rise of inequalities does not seem to me to be the right way to go about such questions. Think of the Civil Rights movement in the United States in the 1960s. It was the relative wellbeing of African Americans in the North that permitted them to get organised to fight apartheid in the South. I do not see any paradox in this. Improvement in material conditions is a condition for social movements to fructify. Let's be clear that we're talking about middle- and high-income countries where at least a modicum of wellbeing is present; low-income countries and failed states play a different, sadder ball game, as illustrated by Haiti presently.

*Economist often think in terms of benign dictators with an extraordinary capacity for secondary redistribution. While the distribution hurdles have been addressed by the economic literature, the political aspects (the response in terms of support and votes, unrest and exit) of economic policy, while not ignored, are sometimes minimised. Certain policies may yield the results predicted by the model, but lose track due to political resistance. Is democracy a new constraint to thinking about economic policies?*

No, I do not think so. Resistance to change comes from established interest groups. Lack of democracy and transparency is at play. Think about the resistance to overcoming a bloated public sector or to increasing productivity in the private sector through opening to world trade. They reflect capture of the state by public corporations, in one case, and by private interests, in the other. Democracy is not at fault.

*One could conjecture that the current discontent is flagging the need for 'third generation' reforms – rather than income in the pocket, 'access' to public goods and services (quality education, health, transportation, finance, habitat). At the same time, this access uses resources from the same budget that funds social transfers. Has the trade-off between money in the pocket and money in the street changed in a post-pandemic scenario of fragile liberal democracies?*

I totally disagree. Bolsa Familia only costs 0.5% of GDP. Supporting the poor is not costly. Costly are the salaries and pensions of public sector employees. Costly are the subsidies and tariffs that protect inefficient incumbents in the private sector. Get these out of the way, then there will be enough space in the budget for the government to invest in both social and physical infrastructure.

*We could include social security within social spending. Indeed, there is some evidence that Latin American countries – Brazil, in particular – spend proportionally more than other regions on their elderly, at the expense of insufficient investment in (non-voting) children and youths (infant care, public education, health). Would you agree on the need to change the age distribution of the public spending? Is this politically viable?*





Population ageing and the already very large share of total income going into pensions make social security reforms imperative. There are two dimensions to this. The first is reducing the privileges of public sector employees, to make their pension systems on a par with those of private sector employees. The second is making sure that retirement ages are consistent with population ageing, so as to maintain the system in financial balance without ever-increasing contributions from those at work. These reforms would liberate resources for increasing funding of social benefits to children and youths. At the margin, without affecting those already receiving pensions, these reforms seem to me to be politically viable.

## ABOUT EDMAR BACHA

Edmar Bacha is Director of the Casa das Garças Institute of Economic Policy Studies, a think-tank in Rio de Janeiro, She was Senior Adviser to the Minister of Finance for the 1994 real stabilisation plan in Brazil and is former President of Brazil's National Development Bank and member of the World Bank Growth Commission. A recollection of his academic work is available in "On the economics of development: a view from Latin America" (*PSL Quarterly Review*, 2018). He holds a PhD from Yale University.

# "My bold prediction is that we will end up reinventing social democracy"



**Armínio Fraga**
Gávea Investimentos, IEPS and IMDS

*Following episodes in Brazil, Chile and Colombia in the past ten years, many experts, including economists, have started to consider whether liberal democracies in Latin America are in danger, and whether and how they should adapt to address what looks like a slowly boiling social discontent. While episodes of social unrest are by no means new in the region, the current debate has gone beyond what is strictly economic and even social and moral (equity and fairness). There are aspects related to technology and behaviour (the incidence of social networks in driving and feeding massive public responses), among others. What are your views on that? Are we at the doorstep of a persistent fracture that demands more than cosmetic changes in public policy, or rather a temporary and localised phenomenon?*

It has been a long time since Latin America last looked as bad as it looks now. Slow growth, inequality, corruption and dissatisfaction with the quality of public services have all contributed to the popular perception that governments are not doing their part. People have made that abundantly clear in all possible ways. I do fear for democracy in the region, but more in the 21st century version, where death or disability comes slowly, rather than in the classic and more sudden coup form.

Technology has played more than one role in the plot. First, it allowed for the massive spreading of ideas and news – often fake news. This creates parallel universes, devoid of the filters that prevent the necessary foundation for effective public debate and action. Second, it represents a threat to employment, in what is seen as a perverse form of leapfrogging.

My bold prediction, based mainly on what I see in Brazil, the country I know best, is that we will end up reinventing social democracy, in a way that addresses the key issues of our time: growth that is sustainable in all senses of the word (financially, environmentally and socially). Success is far from assured, as Venezuela has shockingly demonstrated.

*While these manifestations preceded the pandemic, there is a feeling that the crisis may have given them a new impulse, or at least new reasons. I am thinking, in addition to the economic and social costs, of the rise in inequality and the loss of education.*

As a friend of mine likes to say, "we are all in the same storm, but in different boats". The pandemic has exacerbated inequality. The health- and education-related losses will take a long time to be reverted, possibly never for the poorest. No short-term fiscal effort can offset the loss, particularly for children of school age.

*How are these social episodes related to the global discontent with 'the system', reflected in a movement towards extreme ideological positions and the appeal of political outsiders with populist agendas? To what extent is this change in attitude global or local?*

I can only speculate here. I see both global and local dimensions. On the one hand, to the extent that information flows around the globe in an instant, one can think of an epidemic of discontent. On the other hand, massive and inexpensive information flows swamp people's processing capabilities, making it hard to distinguish between truth and falsehood and between signal and noise. Therefore, radical views proliferate easily in self-contained groups.

These groups can be very large and have a life of their own, it seems often going beyond the original intentions of their creators. Jonathan Rauch's recent book, *The Constitution of Knowledge*, discusses these issues and how formal and informal institutions can (try to) protect democracy. When the legislative and judiciary are under the heavy hand of populist/authoritarian leaders, democracy is left to depend on a free and competent press (conventional and digital), on academia (science is out of fashion in parts of the region), not-for-profit entities and even the world culture (with its creative ways of conveying messages and emotions).

*From a strictly political perspective, it appears that the indictment of social democracy has widened the dispersion of the electoral menu, with a gradual hollowing out of the centre in favour of outsiders that place themselves at the corners of the political spectrum. How real do you think is the threat of this dispersion to (the perception of) policy continuity, a critical input for investment and economic activity in all growth success stories in the region?*

In Brazil, the pendulum seems to have become a wrecking ball. Policy continuity is certainly under question. I don't think in Latin America one can repeat the phrase often heard about Italy that "governing is not impossible, it is irrelevant". Right now, the picture in most of Latin America is ugly. For example, I am not sure Peru can withstand so much instability for much longer.

*The beginning of this book discusses fiscal sustainability post-pandemic, so we may as well redress the issue in relation to the institutions and their connection with socioeconomic outcomes. Perhaps more than the mythic Moncloa pact, the transition between Fernando Henrique Cardoso and Luiz Inácio Lula da Silva, as well as Lula's actual compliance with the promised continuity, is often seen as a model of how continuity could help tame*

*the worst fears arising from political polarisation. You were a privileged witness to this period. How do you see the clash between Bolsonaro and Lula in this light? Do you think that a failed transition to the next government in 2022 may trigger a financial crisis?*

The transition I witnessed close hand took place with an underlying economic situation that was manageable. The panic was caused by fear of Lula and his Partido dos Trabalhadores (PT). Things calmed down when Lula himself made it clear he was not going to implement his party's programme, but rather that he would stick to reasonable and disciplined macro policies. It was a simple as that.

Now, we have a heavily indebted Brazil that has run a primary fiscal deficit since 2014. Moreover, the country exhibits a high government spending-to-GDP ratio, where nearly 80% of the spending goes to payroll and social security, and where overall government investment is a paltry 1.4% of GDP, mostly done by state and local governments.

Major reforms will have to take place to get the macroeconomy back on track and to allow for a much-needed change in spending priorities. True, there is plenty of room for improvement, but it will have to be well planned and implemented – not an easy task any way you look at it, be it from a policy design angle, or from the political viability of it all.

*Judging from the case of Colombia, attempts to unwind the pandemic fiscal impulse through a reform of the tax system that affects the middle class may be ultimately derailed by fierce social resistance. To what extent does the balancing act between a progressive fiscal adjustment and the growing demands for fairness make fiscal accounts post-pandemic look more fragile?*

Again, let me elaborate on the Brazilian case. There is no doubt Brazil's tax system is not progressive. There is much to be done. For starters, the government ought to go after the numerous tax breaks and subsidies available to those with high incomes. This is a classic case of rent seeking and the worst kind of lobbying. These distortions must be eliminated so the government can acquire the moral authority necessary to move forward with an urgent reform of the income tax and VAT systems. There is also some room for higher marginal rates. Finally, as indicated above, there is ample room for redirecting government spending towards areas such as the social safety net, health, infrastructure and education, all capable of great impact on poverty, inequality and social mobility.

*Economists often think in terms of benign dictators with an extraordinary capacity for secondary redistribution. Certain policies may yield the results predicted by the model, but get lost in the political struggle. Should we incorporate democracy as a new constraint when we think of economic policies?*

I don't believe in benign dictators. This sounds more like an empty set. Democracies have here and there fallen prey to populism, but their success in terms of quality of life is unequivocal: the most prosperous nations in the planet are all democracies. We must not forget that.

*One could conjecture that the current discontent is flagging the need for 'third generation' reforms – rather than income in the pocket, 'access' to public goods and services (quality education, health, transportation, finance, habitat). At the same time, this access uses resources from the same budget that funds social transfers. Has the trade-off between money in the pocket and money in the street changed in a post-pandemic scenario of fragile liberal democracies?*

It is misleading to treat Latin America as a homogeneous entity. Some countries have large states, like Brazil and Argentina, others have smaller states, such as Chile and Mexico.

As I have mentioned above, in Brazil, in addition to moving back to a primary surplus, it will be necessary to cut spending on regressive subsidies, payroll and social security, so as to allow more spending on the key areas mentioned above. This would not be doable overnight and would require a long-overdue reform of the state. It is my strong conviction that such a move would be growth-enhancing. This conjecture becomes more plausible once its impact as a vaccine against populism is taken into account.

## ABOUT ARMÍNIO FRAGA

Armínio Fraga is an economist, founder and chair of Gávea Investimentos, the Institute for Health Policy Studies (IEPS) and the Social Mobility and Development Institute (IMDS). He is a member of the Group of Thirty and the Council on Foreign Relations. He is former President of the Central Bank of Brazil (1999-2002), Chairman of B3, and Managing Director of Soros Fund Management. He holds bachelor's and master's degrees from PUC-Rio and a PhD from Princeton University, where he served as a Trustee. He has taught at PUC-Rio, EPGE-FGV, SIPA-Columbia and the Wharton School.

# "In Chile, the middle class is 'too rich for the state and too poor for the market'"





**Andrea Repetto**
Universidad Adolfo Ibáñez

*We are witnessing several episodes of social unrest and protests. What are the causes and prospects in your view?*

The excellent macroeconomic indicators of the last 30 years – high growth, an impressive fall in poverty and a reduction in inequality – do not capture essential dimensions of inequality and the perceptions surrounding it. First, inequality in Chile remains high. The Gini and the fraction of income taken by the richest are extremely high by international standards, even for countries with similar development levels. Ninety percent of Chileans consider inequality to be excessive, according to a UNDP survey (UNDP 2017).

Second, social mobility is low. The opportunities to which people have access depend strongly on factors beyond their control, such as family background, gender, race and neighbourhood. Education and health are highly segregated. As a study by Seth Zimmerman of Yale University shows, the top jobs are available to only a few, usually men from wealthy families, regardless of effort and ability (Zimmerman 2016).

Third, there is much economic vulnerability: more than 20% of workers are informal, while one-third of private wage earners have temporary jobs and rotate from one firm to another. Pensions and unemployment insurance benefits depend on the ability to save and to maintain stable formal employment. Therefore, they provide little protection. Out-of-pocket health spending and drugs prices are high compared with OECD and other countries in the region.

Fourth, people feel mistreated, in the streets, at work, and in public services. In the median, a person receiving care in the public sector waits about 400 days for surgery. Some 28,000 people die a year waiting for that surgery, about the same number of people who died from Covid in the first year of the pandemic. For more than a decade, the demand for equal dignity has appeared in citizen accounts collected by sociologists and anthropologists in Chile (UNDP 2012) .

Finally, there is a perception of abuse, both by the private sector and in politics. While most pensions are low, fund managers' owners have become rich. At the same time, cases of collusion, insider trading, corporate abuse, corruption and illegal electoral financing receive weak sanctions.

There is a high agreement in Chile on the need to repair these problems. However, the political system has been unable to move forward with substantive reforms. It seems trapped, and this adds to the frustration and distrust of the citizenry.





*Following episodes in Chile and Colombia in the past ten years, many experts, including economists, have started to consider whether liberal democracies in Latin America are in danger, and whether and how they should adapt to address what looks like a slowly boiling social discontent. Are we at the doorstep of a persistent fracture that demands more than cosmetic changes in public policy, or rather a temporary and localised phenomenon?*

Chileans believe in democracy. According to Latinobarómetro measurements, the preference for democracy has been rising over the last decade. Seventy-four percent of those surveyed in 2020 say that democracy is the best system, even if it has problems. However, we must fix our democracy to make it work. Seventy-six percent of those surveyed by Latinobarómetro in 2020 say they are dissatisfied with Chile's democracy.

I believe that at the heart of Chile's problems is a hyper-presidential government regime that coexists with a fragmented party system. Successive governments are minority governments. They face various oppositions in Congress and have difficulty governing. The oppositions have no incentives to pass the proposed laws and use their oversight powers to obstruct the government. The leaning of the government, whether right-wing or left-wing, does not matter.

Since 2017, two different governments have proposed four or five projects to improve current and future pensions. Nevertheless, even though this is a heartfelt demand at the centre of citizen protests, the political system does not reach substantive agreements. The same has happened with reforms to health care, daycare provision, occupational training and the police. This inability to respond to citizens' demands is an essential source of frustration and discontent.

*A follow-up question, if I may? Interestingly, in Argentina analysts have highlighted the convenience of a strong opposition in Congress to keep populist presidents in check. Don't you think that the combination of a hyper-president coupled with a parliamentary majority could pave the way for more policy uncertainty in a context of increasingly popular political extremes?*

Governments in Chile in the last 30 years have not been at the extremes; they have been centre-right or centre-left. None has proposed populist policies that have required a majority to stop them. Still, their bills usually have no support in Congress and do not even reach agreements to be amended and move forward.

*Are these episodes of social unrest related with the global discontent with 'the system', in turn reflected in a centrifugal movement towards extreme ideological positions and political outsiders with populist agendas?*

No country is free from the risk of populism. Anger and frustration with living conditions are an invitation to populism, especially if the political system does not respond to people's demands.

Although Chile does not seem to have been very tolerant of populism throughout its history, it does experience it occasionally. For the first time since the return to democracy, if I am not mistaken, the current Congress has used subterfuge to circumvent constitutional restrictions. Faced with the government's slowness in delivering support to families in the pandemic, it allowed workers and retirees to withdraw funds from their individual pension accounts. Since then, it has legislated two more withdrawals and is now discussing a fourth. Current social supports and the solid economic recovery do not justify these withdrawals, especially if pensions are low and additional resources are needed to improve them. However, this is an election year, and that seems to prevail. The withdrawals are popular, and the pensions system is not.

*Chile and Colombia are success stories in terms of the recent evolution of social statistics, at least based on traditional measures of poverty and inequality. Are these demonstrations a manifestation of the Tocqueville paradox, namely, that social demands feed on their success? Specifically, are they about disabused middle classes that have more income but are not less poor in terms of public services?*

When countries develop, people demand more and better public goods. Chile has not been able to deliver this because it has a relatively small state, which has not grown in 30 years. A small state has no choice but to focus its support on the poorest groups or deliver low-quality services. Quality health and education are very expensive, inaccessible to the vast majority. In Chile, it is said that the middle class is "too rich for the state and too poor for the market".

Also, Chile's state has not been able to deliver because it has privatised public provision subject to rules that do not always have the common interest at their core. The private sector is heavily involved in providing public goods and services such as health, education and pensions. Moreover, it has been allowed to discriminate for reasons beyond the control of individuals. For example, *Instituciones de Salud Previsional* (Isapres) – private companies that sell mandatory health plans – can discriminate based on age, gender and pre-existing conditions. Private schools, which are publicly financed and serve about 60% of school children, could discriminate based on religious beliefs or socioeconomic status until recently.

Reforms are needed so that the state can collect and finance better social benefits. Also, reforms that put the general interest first in providing goods and services that are essentially public.

*While these manifestations preceded the pandemic, there is a feeling that the crisis may have given them a new impulse. I am thinking, in addition to the economic and social costs, of the rise in inequality or the loss of education, particularly for low-income families. How has the pandemic affected the social discontent?*

The pandemic has reinforced the social and political crisis. It exposed many of the deprivations and vulnerabilities in the country: the weak protection of the unemployment insurance system; overcrowded housing; limited access to the internet, which was crucial for working and attending school in the pandemic. It also made evident the zeal with which the state delivers social support in Chile. The government initially faced the pandemic using the same model it regularly uses: narrow targeting, insignificant benefits, the obligation to apply and demonstrate need, and the fulfilment of conditions.

Chile has the relevant infrastructure to provide immediate support to families, and the government did not take advantage of it. On the one hand, it has the *Registro Social de Hogares*. This extensive database brings together the administrative records of households and allows the state to know the social situation of families in great detail. On the other hand, Cuenta RUT, a product offered by the state bank, has banked vast segments of the population, including the most vulnerable and migrants.

The government's response was at first slow and insufficient. Today it is delivering social support on an unprecedented scale (just over one point of GDP per month) despite the rapid recovery of the economy and employment and the fact that it is fiscally unsustainable. This large-scale spending is only justified because Chile is in an electoral year. It will be challenging to withdraw these very substantial supports amid citizens' demands for better living conditions and a call for better state protection. It will be essential to find a workable middle ground.

*The case of Colombia is particularly telling, in that the trigger was an attempt to unwind the fiscal impulse through a mix of tax hikes and lifting of VAT exemptions, which was later replaced by a more modest package centred on corporates. The contemporaneous trade-off between equity and growth immediately comes to mind. How can the progressivity of the fiscal adjustment be balanced with legitimate demands for fairness?*

In my opinion, the starting point is critical. In Chile, the state collects a little more than 20 points of GDP, a fraction that has not changed in 30 years despite the significant development that the country has experienced. The composition of fiscal revenues also needs to be revised. The system relies too much on VAT and too little on income taxes by international standards. Several taxes have high rates, but due to loopholes, they yield too little. The personal income tax is one example; the inheritance tax is another. According to Fairfield and Jorratt de Luis's (2016) estimates, the wealthiest 1% pay an average income tax rate that is several points lower than they should pay according to the tax scheme. Moreover, the top 0.01% pay proportionally less than the top 0.1%, who pay proportionally less than the top 1%. In other words, the system is regressive at the very top.

At the same time, Chile's Internal Revenue Service (*Servicio de Impuestos Internos*, or SII) has little enforcement capacity to deal with tax evasion compared to both the OECD and other countries in the region. For example, the SII must request judicial authorisation to access general information on bank accounts with high balances. Tax administrations do not need judicial approval to access this information in the United States, the United Kingdom, Spain, Argentina, Brazil and Mexico.





All this suggests that there is room for the higher income group to pay more without significant effects on economic efficiency in Chile.

*Economist often think of policy in terms of a benign dictator with an extraordinary capacity for secondary redistribution. The political aspects (the response in terms of support and votes, unrest and exit) of economic policy, while not ignored, are sometimes minimised. Is the political struggle typical of a liberal democracy a new constraint on thinking about economic policies?*

Political systems can be a constraint even when there is broad agreement on the need for specific reforms. This is the case of Chile, as described above. For example, despite the urgency of pension reform, the political system seems unable to build agreements.

The pensions reform proposed by the Bachelet government in 2017 (a centre-left government) was rejected by the right (as well as part of the left) in Congress. When the Piñera government (a right-wing government) amended its 2018 reform and proposed to Congress in early 2021 something along the lines of what Bachelet laid out, it was the centre-left that rejected it. The content of a bill does not matter, only who proposes it. Understanding the codes of politics is very important to understand the feasibility of reforms and their likely effects.

*Simplifying, one could conjecture that the current discontent is flagging the need for 'third generation' reforms – rather than income in the pocket, 'access' to public goods and services (quality education, health, transportation, finance, habitat). At the same time, this access uses resources from the same budget that funds social transfers. Has the trade-off between money in the pocket and money in the street changes in a post-pandemic scenario of fragile liberal democracies?*

Cash transfers are virtually non-existent in Chile. Chile typically spends less than half a point of GDP per year on cash transfers, excluding pandemic benefits and pensions and medical leave subsidies. In addition to being small and highly targeted, the benefits require compliance with conditions that the most vulnerable generally find difficult to meet due to their living conditions. At the same time, spending on health, education and housing has significantly expanded within the fiscal budget, but this has not been reflected in timely access or high quality.

At least in the case of Chile, the problem is not one of a trade-off between types of benefits. On the contrary, the problem is a small state that should take a more relevant role in providing public goods and services and economic security.





*From a strictly political perspective, it appears that the indictment of social democracy has widened the dispersion of the electoral menu, with a gradual hollowing out of the centre in favour of outsiders that place themselves at the corners of the political spectrum. How real do you think is the threat that this dispersion may detract from the perception policy continuity, a critical input for investment and economic activity in all growth success stories in the region?*

Chilean democracy has not been one of extremes. Its limited political volatility has not translated into volatile policies and laws. Hopefully, it will remain this way.

From a broader perspective, Chile's case seems particularly interesting today. The constitutional reform that a citizen-elected convention will propose will show whether key economic institutions are entrenched, whether they will stay protected from the electoral cycle. Thus, for example, it would be a good sign if the autonomy of the central bank, enshrined in the current constitution, were to remain. Also, it would be good if the greater decentralisation of power at the territorial level that is likely to be agreed upon does not affect the incentives of those who manage public finances. The same concern arises with the definition of guarantees to social benefits: whether the judges will order their satisfaction or whether the government and future congresses will be in charge and take fiscal sustainability into account.

*How do you think the constitutional reform will reshape Chilean institutions?*

The constitutional convention is Chile's tool for addressing its political problems. Chile needs the convention to do it very well. Despite the difficulty in reaching agreements I described earlier, the political system does react when the country is on the edge of the abyss. The political deal to move forward with a constitutional reform process, which has shown high citizen support, is an example of this.

I imagine that the convention will make relevant changes. First, it will grant guarantees to several economic, social and cultural rights that the current constitution does not. It only guarantees the right to choose who provides these rights, not the right in itself. I do not think the private provision is in question; its ability to discriminate is. At the same time, the state will have a more significant role in the responsibility for this provision.

As I said, I also imagine that the territories will have a more significant say in some local decisions and that Chile's hyper-presidential system will be attenuated. In short, I imagine a constitution that resembles European ones, combining economic freedom with social rights and leaving many decisions on how to implement things to the law.

Finally, I hope – this is a wish, not a prediction – that the convention will agree on a political regime and an electoral system that promote stable coalitions and favour agreements to respond to citizens' demands effectively.



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# "Colombia, Peru and Chile are entering a populist phase from which it will not be easy to escape"





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*We are witnessing several episodes of social unrest and protests in Latin America. When we read of protests in Chile and Colombia, the first reaction is to look at a deterioration of social indicators. These two cases, however, are success stories in terms of the recent evolution of social statistics, at least based on traditional measures of poverty and inequality. What are the true causes in your view?*

It helps to start by discarding the explanations that are not true. Consider the unrest in Chile in late 2019. The most common explanation is that a 3% increase in metro fares caused public indignation at rising prices and high inequality to boil over. At some level that must be true – people with sufficient income who feel they are treated fairly do not loot and riot. But as an explanation on which to base policy changes, the standard account risks being simplistic.

Take price increases. Yes, Chile has a history of inflation. And, yes, because it is more prosperous, Santiago is more expensive than most Latin American cities. Yet Chilean inflation in the 12 months to September was barely 2.1%, and the central bank has been cutting interest rates because inflation is below its target.

Or take income inequality. Yes, for an upper-middle-income country, Chile is very unequal, with a Gini coefficient (most economists' preferred measure of income disparity) at a high level of 46.6 in 2017 (100 represents absolute inequality). Yet according to the World Bank, the coefficient has fallen from an eye-popping 57.2 when Chile returned to democracy in 1990.[6] The notion that *rising* income inequality is behind citizen discontent does not fit reality.

Chile is not unique in this respect. Across Latin America, inequality was dropping fast during precisely the same years it rose in the United States and the United Kingdom. According to the World Bank, between 2007 and 2017 the Gini coefficient fell in every Latin American country which has recently erupted in protests – including by a massive eight points or more in Bolivia and Ecuador. At the very least one needs an account of why the tolerance for income inequality changes in the course of development. Alberto Hirschman wrote an illuminating essay with precisely that title in 1973.

6 https://datos.bancomundial.org/indicador/SI.POV.GINI?locations=CL

*Are these demonstrations a manifestation of the de Tocqueville paradox, namely, that social unrest occurs precisely after long periods of prosperity and rising living standards? Does success carry the seeds of its own demise?*

Alex de Tocqueville was not the only one to make that point. Marx and Engels, recall, marvelled at capitalism's "constant revolutionising of production", but noted that this meant "uninterrupted disturbance of all social conditions, everlasting uncertainty and agitation".

In many emerging economies – Brazil, Chile and Ecuador among them, but also Turkey, Lebanon and Hong Kong – university enrolment has soared in recent decades. With the supply of skilled labour growing more quickly than demand, the gap between the earnings of the university-educated and the rest narrowed. As a result, different measures of income inequality fell.

What's not to like? Not much, unless you belong to the generation caught in the transition. Young people who went to university in the last quarter-century – often to new institutions whose standards were not exactly Ivy League, but which charged high fees nonetheless – ended up earning less than they expected. The result has been a generation of educated, indebted and often irate young men and women.

Surges in access to higher education, coming on the heels of prolonged periods of peace and prosperity, have often coincided with mass street protest. Education attunes you to injustice, and prosperity means that protesting does not jeopardise your livelihood. It happened in the 1960s in Europe and the United States. It is now happening worldwide, faster and more intensely than ever, thanks to mobile devices and social media.

Competition policy is a third example of the Marxian dictum that capitalist success begets its own failures. Economists Daron Acemoglu, Philippe Aghion and Fabrizio Zilibotti sketched the cycle in an influential 2006 paper (Acemoglu et al. 2006). When a country is relatively poor, allowing firms some monopoly rents accelerates capital accumulation without harming innovation, because firms simply adopt technologies imported from more advanced economies. But once a country prospers and reaches the world technology frontier, further growth requires innovation, which in turn requires competition.

Bottom line: successful emerging economies should adopt aggressive anti-monopoly policies if they wish to remain successful. Many, including Mexico and Chile, have. But here's the rub: the new, more stringent standards will reveal unending collusion scandals, which will fill the headlines and ignite public anger long before more competition produces the innovation and higher incomes to placate that anger. The price of success in fighting monopoly may be more, not fewer, street demonstrations.

*Those are economic and social factors that could be causing public dissatisfaction. What about political factors? Are there political forces at work also?*

To understand the causes of a social phenomenon, one must ask: Why here? Why now? If citizen discontent has spiked in a country like Chile, some other causal factor must also have spiked so as to explain the change. What changed dramatically in Chile over the last few years that might explain massive citizen anger? Here is a possible answer: Chileans lost trust in most institutions in their country.

Development is always a race between frustration and trust. In a not-quite-developed nation with much inequality and large pockets of poverty, many people lead harsh lives. Their income and consumption fall far short of their needs; they have difficulty paying their bills at the end of the month; they worry about losing their job or getting sick; they receive mediocre public services. All of this causes anxiety, frustration and, yes, anger.

But people control their anger as long as they believe that things will get better for them and their children. And crucially, that institutions - the government, parliament, judges, prosecutors, the police, the military, labour unions, big business – are working to make that improved future possible (or at least are not working to impede it). But if trust suddenly collapses, and people come to believe that institutions are not working – or, worse, that they are working to further the interests of people in power, not of ordinary citizens – then frustration and anger will boil over and quite possibly turn violent.

That is what seems to have happened in Chile and the region. According to Latinobarómetro, interpersonal trust has been very low and on a downward trend for the last 15 years. So has trust in most institutions: government, parliament, political parties and the judiciary, among many others. By late 2019, if you believe Latinobarómetro and other pollsters in Chile, trust in these institutions was in the single digits. That was an important factor behind the unrest.

*While in several countries the unrest preceded the pandemic, there is a feeling that the crisis may have given it a new impulse, or at least new reasons. How has the pandemic affected these conflicts?*

Some of the benign trends, like a slowly improving income distribution, began to change with the end of the commodity boom in the middle of the previous decade, and then went into full reverse during the pandemic. Preliminary evidence suggests that poverty increased and inequality rose during the past 18 months in the region, and that cannot come as a surprise.

What remains to be seen is how these reversals will be processed and interpreted politically. Crisis can bring countries together or they can pull them apart. Consider the global financial crisis of a decade ago. As many voters saw it, Wall Street got a bailout while Main Street got only unemployment and home foreclosures. In some countries, the

recovery was slow; in others, like Greece, the crisis dragged on for nearly a decade. We are not in this together, people concluded. Elites look out only for themselves. Let's drain the swamp.

The alternative answer dates back to 1945. From the rubble and devastation of war, durable social trust emerged. In the United Kingdom and the United States, the rich kid from Oxford or Yale had fought shoulder-to-shoulder with the coal miner's son from North Yorkshire or Hazard, Kentucky. Private businesses, large and small, had mobilised for a public purpose: the war effort. And politicians had delivered on the ultimate common good: victory. The suffering and loss of life had been horrific. But in many countries, citizens could plausibly conclude that we are in this together, and together we will build a better tomorrow.

So, which one will it be, 2010 or 1945? One cannot be too sure, but it is looking more and more like 2010.

*The case of Colombia is particularly telling, in that the trigger was an attempt to unwind the fiscal impulse through a mix of tax hikes and lifting of VAT exemptions, which was later replaced by a more modest package centred on corporates. The contemporaneous trade-off between equity and growth immediately comes to mind. How can the progressivity of the fiscal adjustment be balanced with legitimate demands for fairness? To what extent does this balancing act make post-pandemic fiscal accounts in the region look more fragile?*

The pandemic weakened fiscal accounts in the region in an obvious way: large fiscal deficits –fully justified in this mother of all emergencies – were financed with debt, both external and internal. Some countries, like Brazil and Argentina, have very high debt-to-GDP ratios, nearly on a European scale. Others, like Peru and Chile, are still below 50%, but how debt-to-GDP ratios will be stabilised remains unclear.

Above and beyond that obvious link between the pandemic and fiscal fragility, there is a deeper political economy challenge at work. Argentina and Brazil have high tax-to-GDP ratios already. In many other countries in the region, including Mexico, Colombia, Peru and Chile, there is room – and a need – for those ratios to rise. The question is who will foot the higher tax bill. High-income earners should pay quite a bit more, via higher taxation of capital incomes and more stringent control of personal income tax evasion. But taxing the rich is not enough. Many other important taxes – on hydrocarbon consumption and on residential real estate and other forms of property, for instance – remain low, and hard-to-justify tax breaks to all kinds of businesses remain common. Put differently: middle-class households and businesses will also have to foot part of the bill. But in the current political environment, that looks pretty unlikely. No wonder, then, that debt sustainability is becoming a concern, and could become a much bigger concern if world interest rates rise.

*Following episodes in Brazil, Chile and Colombia in the past ten years, many experts, including economists, have started to consider whether liberal democracies in Latin America are in danger, and whether and how they should adapt to address what looks like a slowly boiling social discontent. What are your views on that? Are we at the doorstep of a persistent fracture that demands more than cosmetic changes in public policy, or rather a temporary and localised phenomenon?*





According to the most recent Pew Global Attitudes Survey (Wike et al. 2019), in the mean country of 27 surveyed, 51% of citizens report being dissatisfied with democracy, while 45% are satisfied. If that 51% does not seem all that high to you, note that the figure is 55% in Britain, 56% in Japan, 58% in the United States, 60% in Nigeria, 63% in Argentina, 64% in South Africa, 70% in Italy, 81% in Spain, 83% in Brazil and 85% in Mexico. Being dissatisfied with democracy is not unique to one social group. Men and women, young and old, rich and poor, highly educated and not so – all report being disappointed by democratic performance.

Dissatisfaction with contemporary democracy should not come as a surprise. In the past 250 years, almost every human endeavour has changed beyond recognition – except democracy. We elect large groups of peoples known as parliamentarians, who meet in ornate chambers and, following arcane rules, lengthily and with great showmanship discuss subjects they understand only superficially. Sparks fly, yet little illumination occurs. Many social and economic problems remain unaddressed. Four or five years later the cycle starts all over again.

Now, the rules of democracy matter. But the participants in democracy matter just as much – and they are also thoroughly discredited. In the same Pew report, across the 27 countries surveyed, 54% think politicians in their country are corrupt and only 35% think that elected officials care what ordinary people think. Some of those politicians are discredited because their sins are all too evident. Writing in the *Washington Post* in 2018, Fernando Henrique Cardoso of Brazil reminded us that "[o]f the four presidents elected after the 1988 Constitution took effect, two were impeached, one is in jail for corruption and the other is me".

But the problem is bigger than just a few bad apples. In "Politics as a Vocation", his famous lecture of a century ago, Max Weber warned that a key risk for modern democracy was that a political class would arise, disconnected from voters and the common people (Weber 1918). Well, that political class did arise. Now the people are revolting against it. Political parties are a case in point. Once upon a time they had roots in society. Conservative parties were linked to the various churches, neighbourhood clubs and associations of businesses, large and small. Socialist parties had their base in the trade unions and what

was once called the industrial proletariat. Today those institutions are fewer and weaker and so are political parties. One political scientist has called modern parties 'hydroponic' – floating above society but with no roots in it.[7]





*So the problem is global, but it seems to be particularly acute in Latin America. Two or three decades ago, Latin Americans were proud of their just-recovered democracies. Today they are disappointed and distrustful. What happened?*

The rules of South American democracy (Mexico is different) promote political fragmentation and divided government. The type of regime (presidential or parliamentary) and electoral system (majoritarian or proportional) define a country's politics. The combination of parliamentary governance and proportional representation has yielded model democracies in Scandinavia. The parliamentary first-past-the-post formula of the Westminster system, copied by Canada and other Commonwealth countries, also works well. American exceptionalism shows up in the coupling of presidential and majoritarian arrangements (single-seat districts in the House, two seats per state in the Senate). Donald Trump notwithstanding, this combination has sustained nearly 250 years of stable democracy.

And then there is the oddball combination of presidentialism and proportional electoral systems, which exists only in Latin America. Presidents are elected for a fixed term of office and remain regardless of whether they enjoy a parliamentary majority. And proportional systems, which allocate seats according to a party's vote share, deliver the kinds of fragmented parliaments Peruvians and Ecuadorians have just elected and countries like Brazil, Colombia and Chile have had to endure in recent years.

With two-round presidential elections now enshrined in most Latin American constitutions, the final winner can claim a vigorous mandate, from which all manner of deep and important reforms will follow. That vow, typically delivered in solemn tones on election night, vanishes under the harsh light of dawn. The strong majority of the runoff quickly turns into a weak minority in the legislature. Some presidents, like Sebastián Piñera in Chile, end up caving in to the whims of ever-shifting parliamentary coalitions. Others, like Jair Bolsonaro in Brazil, are forced to rely on the votes of groups (the so-called *Centrão*) with which they share few if any ideas; the result is volatile and unpredictable policymaking. Others, like Fujimori's father, Alberto, simply close down parliament and assume quasi-dictatorial powers – as Pedro Castillo has threatened to do if Peru's legislature does not do his bidding.

7 https://www.latercera.com/noticia/latinobarometro-brasil-y-chile-lideran-desafeccion-ciudadana-con-partidos-politicos/ (in Spanish).

The combination of a fixed-term executive presidency and a proportional electoral system was never a great idea. It has been made worse by the decline of another crucial democratic institution: political parties. Many Latin American countries never had strong and stable parties. In the few that did – Colombia, Costa Rica, Chile and Uruguay – parties are a shadow of their former selves.





*How are these social episodes related to the global discontent with 'the system' reflected in a centrifugal movement towards extreme ideological positions and the appeal of political outsiders with populist agendas? To what extent is this change in attitude global or local? Do these manifestations of discontent have common drivers, or are they connected only epidermically by a common thread of discontent?*

The teens were the decade of populism. In Europe, Asia and the Americas, demagogues of both the left and the right have come to power with simplistic solutions to policy dilemmas, using authoritarian methods to achieve their ends. Until recently, nearly 330 million Americans were governed by Donald Trump. By one count, 170 million Europeans live under governments with at least one populist in the cabinet. Add Brazil, with 210 million people and a newly elected populist president who makes Trump look like an apprentice. Add the Philippines, a country of over 100 million. And Turkey, with nearly 80 million. And you can keep adding.

The new populism is often blamed on a generation or more of stagnant median wages. In countries like the United States and the United Kingdom, the distribution of income has worsened and the top 1% are reaping the lion's share of gains from economic growth. The 2008 global financial crisis not only caused much pain, it also reinforced the conviction that Wall Street is Main Street's enemy. No wonder politics has become confrontational. If this story is right, the policy conclusion is simple: throw out the rascals who did the bankers' bidding, tax the rich, and redistribute income more aggressively. Populism will then eventually fade away.

But, however politically appealing this standard account – call it the economic insecurity hypothesis – may be, it is a poor description of reality. It does not fit the facts in emerging markets, and it may not apply even to the United States and the United Kingdom. Populism has taken root in nations like Poland, India or Turkey, where pre-pandemic growth was strong, so that in many cases the populists seem to be the offspring of economic gain, not pain. And there is one final prickly fact to consider: if surging populism reflected a demand for redistribution, we would expect the surge to be on the left, not the right. Yes, populists on the left have done well in Greece, Mexico and Peru, but it is right-wing populism that has been on the ascent throughout much of the world.

Because populists like Trump and Bolsonaro mishandled the pandemic so badly, some people hope their divisive style of politics will come out weakened. But before liberal democrats begin celebrating, they should remember that the crisis will also sow plenty of divisions: between the lucky professionals who can work from home and the factory

workers who cannot; between the elderly who for health reasons cannot go outside and the young who could but are being kept inside by government; between formal workers who can receive wage subsidies and the self-employed who have lost all income.

I doubt the pandemic will be the beginning of the end for populism. On the contrary, it could well be just the end of the beginning. Several countries in our region, including Colombia, Peru and Chile, are entering a populist phase from which it will not be easy to escape.





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CENTRE FOR ECONOMIC POLICY RESEARCH

The impact of the pandemic in Latin America should not be underestimated. It highlighted the challenge of long-standing fiscal and social deficits in a context of overstretched public sector resources. And it deepened a growing discontent with the economic status quo and the political system. Its seems that even though the impact from the pandemic will ultimately prove temporary, many of its consequences may mark people's lives for a long time. As a result, the pandemic may frame the next decade in the region.

But it is too early to predict another lost decade. The difficulties ahead may still prompt a reaction. The proposed solutions need to address social frustration, cannot disregard the benefits of running responsible monetary and fiscal policies, and should focus on productivity, innovation and competitiveness as pillars of sustainable progress.

People's willingness to engage in reforms, however, depends on their perceived fairness. This perception requires effective communication, as well as a true commitment by the region´s established and new leaders. The risk is that voters and politicians yield to easy near-term shortcuts that would ultimately lead to loss of stability and income, higher inequality and poverty – a major departure from welfare objectives in the long term.

In trying to map this post-pandemic decade in Latin America, this book starts with a review of the effect of the pandemic in the region and then engages in a series of both entertaining and substantive conversations with distinguished and well-known Latin American researchers and policymakers. The focus is on avoiding the next crisis, the policies for sustainable growth, the social challenges in the region and the future of its democracy. Given the complex task and numerous constraints discussed in detail in these dialogues, Latin America emerges at a crossroads. The policy choices made today will largely define its next decade.

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