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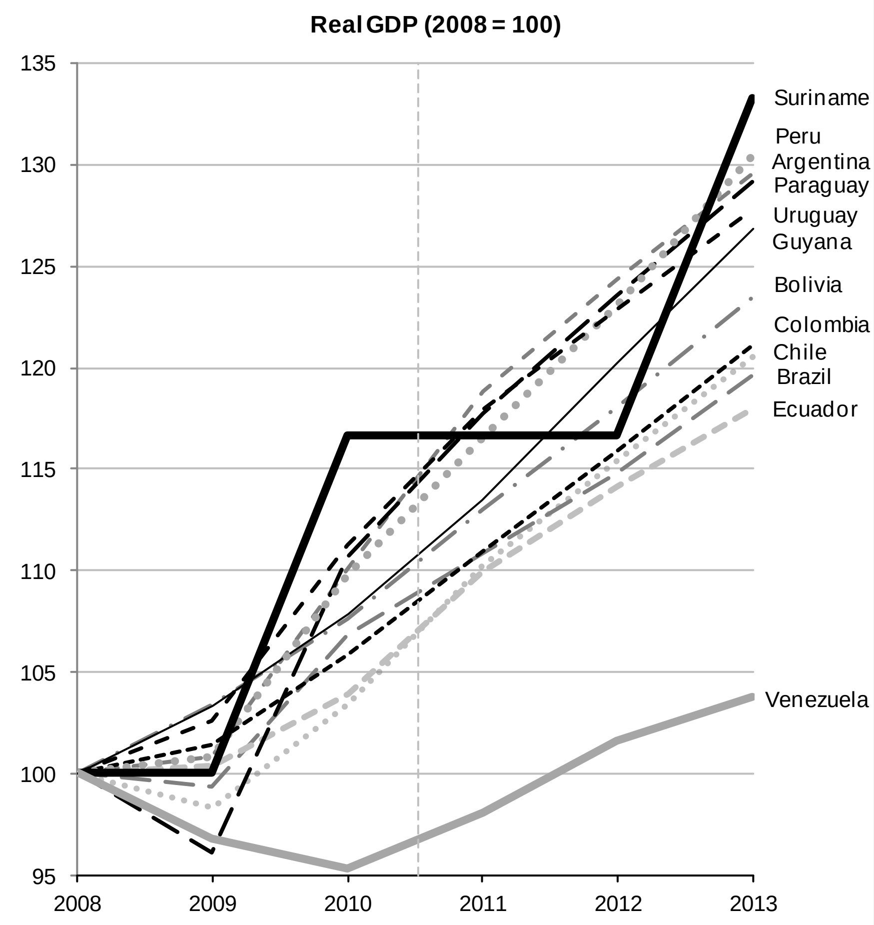
EADS Economic Trends Report
South America

September 2011

Economic Overview

Economic growth in the South American region bounced back sharply in 2010 after a small contraction in 2009. Growth rates this year and in the next several years are projected to be at or above four percent for the region as a whole.



SOURCE: IMF, *World Economic Outlook*, September 2011.

The relatively brisk pace of GDP growth in South America is led by the five countries known as the "Financially integrated commodity exporters (FICE)"—Brazil, Chile, Colombia, Peru, and Uruguay.

Prior to the economic slump in 2009, the South American region had achieved a long run of relatively strong income growth. Based on per capita GDP in local currency and constant prices, ten of the South American countries boosted income levels by an average 27 percent in a decade. Peru led the pack with a 44 percent rise in income. Only Paraguay's three percent gain over the 1999–2009 period was sluggish.

Many countries throughout the region are faced with the possibility of overheating and inflationary risks. Strong exports and capital inflows have also put upward pressure on many of the currencies. The financial and stock markets in the region, particularly in Brazil, Chile, and Peru, have proven to be relatively sturdy and able to recover from the travails elsewhere in the world.

Investment-to-GDP ratios in the region took a hit when the world economy slowed in 2008, but the region has recovered. World Bank forecasts call for relatively strong levels of investment going forward. The economies in the region are riding a surge of demand for their commodities, particularly from China. The current account balances are also being affected by rising imports, as consumers in the region use some of their rising incomes to buy consumer goods.

Countries covered in this report include Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Suriname, Uruguay, and Venezuela. Due to data limits, not all countries are represented in every graph or analytical section.

As was true throughout the world, poverty rates rose in the South American region in the wake of the world economic downturn in 2008. However, the scale of the increases was lower than in other crises and the resumption of economic growth has contributed to a stabilization of poverty rates in the Andean region. According to an October 2010 World Bank report (*Did Latin America Learn to Shield Its Poor from Economic Shocks?*), the typical pattern of slower growth and higher poverty did not hold consistently in South America this time. Economic growth slowed in Chile, for example, but poverty fell slightly. In Peru and Paraguay, the unemployment rates dropped. Data for 2008 and 2009 from Brazil indicate that all households registered increases in income, with "poor and lower-middle class households had higher income growth than wealthy households."

Fiscal Policy

Because Ecuador has boosted its oil production during a period of higher prices, the government's revenues from the energy sector have risen sharply and partly covered large increases in public spending. Fiscal policy will be expansionary over the next several years, with deficits rising towards 4 percent of GDP. Expenditures have already reached much higher levels as a percent of GDP than they were as recently as 2000. Public debt relative to the economy has risen and will continue to rise over the next several years.

World Bank Income Groups

Of 12 South American countries, all are in the Middle Income group by World Bank standards. Three (Bolivia, Guyana, and Paraguay) are Lower-Middle Income countries. The others are Upper Middle Income countries, including Ecuador which moved up to that category in 2011.

Peru's stated fiscal policy objective is the rule of structural balance, or keeping the balance within plus or minus one percent of GDP. Peru's government is expected to run a small surplus in 2011 and then a small deficit in 2012.

Colombia has recently adopted a new structural fiscal rule which is expected to put the deficit on a gradually declining course over the next few years. For this year, the deficit will widen, partly due to increased infrastructure spending in the wake of recent flood damage. The expected reduction in Colombia's fiscal deficit will be partly due to better management of oil and mining royalties and partly due to the elimination of some tax exemptions. In addition, the expansion of formal sector employment is broadening the tax base.

Bolivia's recent construction of a gas pipeline to Argentina has significantly increased the revenue flow for the government. Even with strong revenue growth this year and next, Bolivia's spending increases will inject a fiscal stimulus to the economy. One risk to the Bolivian fiscal outlook is that the government is heavily dependent on revenues from the nationalized energy sector, leaving the fiscal balance vulnerable to a downturn in commodity prices.

In Guyana, strong revenue growth in 2011 has pushed the overall fiscal surplus even higher. The government has cut the excise tax on fuels several times, but the reduction in revenue from that source is being more than made up for by higher VAT, personal income, and customs duties revenues.

In Paraguay, where the public debt burden is relatively light, the fiscal balance is expected to move from a small surplus in 2010 to a small deficit this year. The government is attempting to reform the tax code to reduce its reliance on indirect taxes and to increase revenue generally, but political opposition is stalling reforms.

Monetary Policy

Peru is pursuing a steady monetary policy, the benchmark interest rate holding at 4.25 percent, as inflationary pressures have weakened. The policy rate might rise over the next year or so, but is not expected to become restrictive. If the world economy slows more than expected, the Peruvian central bank does have the flexibility to cut the policy rate to encourage domestic demand.

The Colombian exchange rate has appreciated over the past year, raising concerns about export competitiveness. Nevertheless, the central bank is expected to sustain recent interest rate hikes in order to meet its inflation targets. Since January 2011, the main policy rate has been boosted by 150 basis points to 4.5 percent.

The central bank in Bolivia left the policy rate unchanged from 2008 until May of this year, when it raised the rate to 4.5 percent. Despite continuing price pressures, further interest rate hikes are not likely as the government seeks to expand bank lending to stoke the economy. The main tool to keep inflation in line will be exchange rate policy.

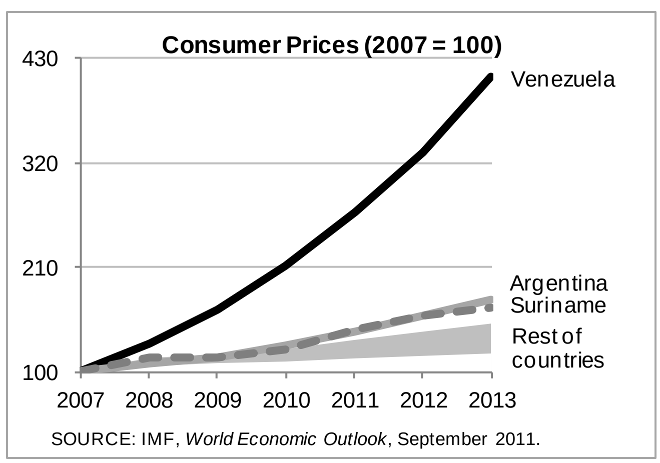
Paraguay's monetary policy committee imposed a sharp interest rate hike in May 2011, in the wake of rising inflation. Although a stronger currency tempered inflation in tradeable goods, continued price pressures in non-tradeables prompted another interest hike in August. Paraguay's tighter policy stance should cut the growth rate of credit to the private sector and bring annual inflation back down to the five percent annual target.

Brazil's central bank left interest rates unchanged during the second half of 2010, but resumed its tightening of monetary policy in 2011. The monetary authorities have raised the Selic rate and increased the reserve requirements on bank deposits.

Real GDP Growth Rates, 2010	**South America 6.2%**	Mexico 5.5%	Central America 3.7%	Caribbean 3.4%

Inflation

Overheated economies and rising inflation are increasingly seen as risks to the region. Inflation has been running at about ten percent in Argentina and nearly thirty percent in Venezuela. Although the current and projected inflation rates in most other South American countries remain relatively low, nearly all show higher inflation this year and next.



Stronger exports and capital inflows have boosted exchange rates in many South American countries. Brazil's real has recently risen vis-à-vis the U.S. dollar as investors have reacted to stronger commodity prices. In those South American countries where the currency has faced relatively less upward pressure and monetary policies have remained expansionary, the IMF (April 2011) recommends a policy shift to stay ahead of the curve and thwart overheating.

Inflation Trends

Low inflation: During 2000–2010, three South American countries kept annual inflation below ten percent each year: Chile, Colombia, and Peru.

High inflation: Nine countries had at least one year of double-digit inflation during 2000–2010. Venezuela, Uruguay, and Argentina have had it most often.

Consumer Price Inflation, 2011 (projected)	**South America 8.8%**	Caribbean 7.7%	Central America 5.4%	Mexico 3.6%

Banking and Financial Sector

The improvement in terms of trade and strong capital inflows have resulted in higher asset prices and more bank credit in many South American countries. As the IMF's Regional Economic Outlook noted, the possibility of an asset bubble or a credit boom cannot be ruled out. Corporate and consumer credit posted the largest growth rate declines during the crisis, but are rebounding quickly. Mortgage credit in the largest South American economies did not decline significantly during the crisis and is continuing to grow rapidly—particularly in Brazil, Colombia, and Peru. In those three countries, the mortgage market is still relatively small (less than 4 percent of GDP, versus 20 percent in Chile). There are plenty of positives to consider. The IMF notes that banks in the region are generally sound and have operating ratios which are improving from already comfortable levels. Stock prices in Brazil, Chile, and Peru have recovered sharply from the downturn in 2008.

South America demonstrated a measure of resiliency to the recent global financial crisis. Two thirds of the countries avoided a decline in their domestic credit (as a percentage of GDP) in the wake of the crisis. Despite their relatively strong performance, South American countries need to continue to strengthen their financial monitoring and supervision. The IMF also advises countries in the region to step up their regulation of nonbank intermediaries.

Investment

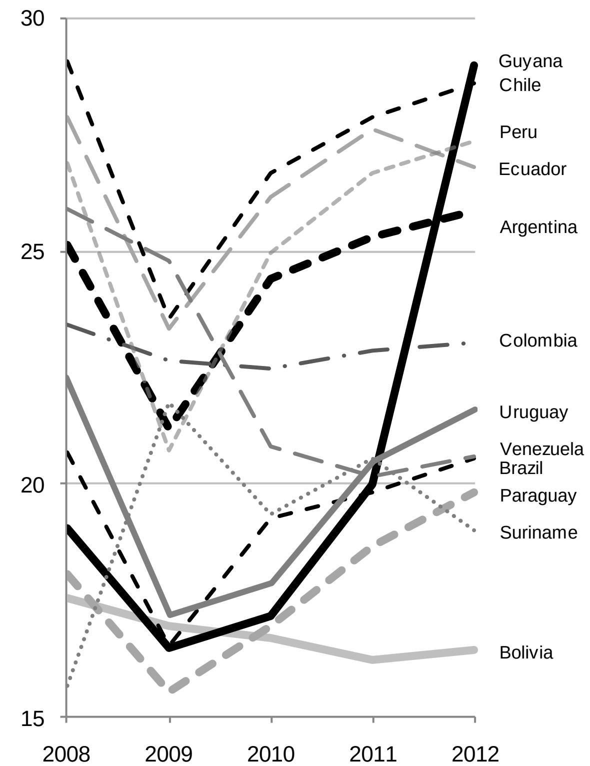
As was the case in other regions of the world, the South American region suffered a decline in its investment-to-GDP ratios in the wake of the financial crisis. Investment declined in nearly all the countries in 2009, but most saw a rebound in 2010. The ability to recover varies by country. According to IMF projections, in 2012 half of the countries will have an investment-to-GDP ratio below their 2008 peak. Even with its robust growth, Brazil is projected to need until 2013 to get back to pre-crisis levels.

In Guyana, the investment ratio is being pushed higher by large projects in the energy and transportation sectors. Brazilian investors are key drivers of Guyanese economic growth at the moment.

Colombia's investment ratio puts it in the middle of the pack among South American countries, but the country did minimize its 2009 investment decline. Continued investment is supported by brisk orders for industrial goods and heavy demand for construction in Colombia.

South America's ability to attract private capital inflows from foreign investors should be sustained. Net private inflows of equity and debt are forecast by the IMF to remain above 4 percent of GDP for 2011–2013.

Investment as Percent of GDP



SOURCE: IMF, *World Economic Outlook*, September 2011.

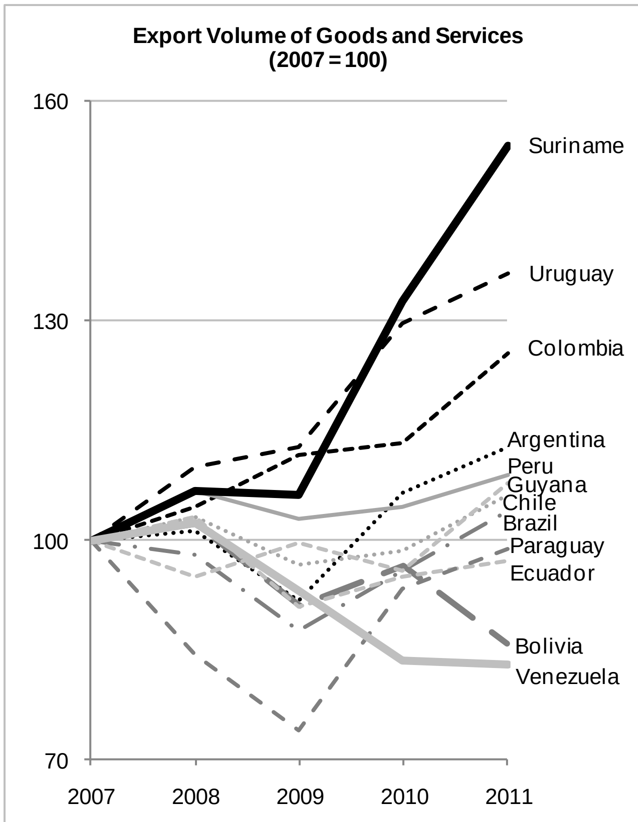
Investment as a Percent of GDP, 2010	Mexico 25.7%	**South America 21.0%**	Central America 19.8%	Caribbean 17.7%

Trade

Commodity exporters are continuing to benefit from brisk demand for their products, particularly from China. In addition, those South American countries with relatively greater degrees of financial integration (Brazil, Chile, Colombia, Peru, and Uruguay) will also gain from access to external finance. In addition, countries in the region with strong trade links to Brazil (Argentina, Bolivia, Paraguay, and Uruguay) will continue to benefit from the rapid economic growth in the region's biggest economy.

The two main trade blocs in South America are moving in opposite directions. The Mercosur countries (Argentina, Brazil, Paraguay, and Uruguay) have increased their share of trade since 2002, led by import demand from Brazil. The Andean Community (Colombia, Bolivia, Ecuador, and Peru) has seen its share of trade decrease. (IMF, Regional Economic Outlook, April 2011.)

Suriname has had the fastest export expansion in the region since 2009. In recent years, donor support has expanded capacity in the bauxite, gold, and alumina sectors. As international demand has picked up in the last two years, Suriname has been well placed to take advantage.

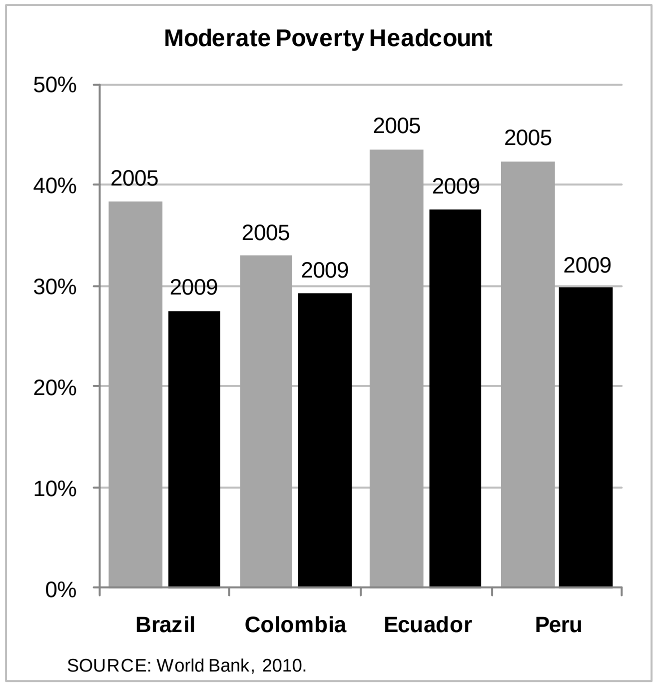


SOURCE: IMF, *World Economic Outlook*, September 2011.
NOTE: 2011 values are projections.

Percentage Change in Export Volume of Goods and Services, 2010	Mexico 14.2%	**South America 8.5%**	Central America 7.4%	Caribbean 5.5%

Poverty Reduction

The world economic slowdown during the past several years increased the number of poor in South America, as in most regions of the world. The World Bank estimates (April 2011) that South American economic growth in 2010 and this year will lower the incidence of poverty back to pre-crisis levels in most countries.



Most notably, the scale of the increases in poverty was lower than in other crises and the resumption of economic growth has contributed to a stabilization of poverty rates in the Andean region. In some countries, the typical pattern of less economic growth and more poverty did not hold consistently. In Chile, for example, poverty declined slightly even as growth slowed. Data for 2008 and 2009 from Brazil indicate that all households registered increases in income, but the pattern of gains was pro-poor. In 2009 alone, income distribution was less unequal in Colombia, Ecuador, and Argentina despite slower economic growth.

The weakened association between economic contraction and poverty increases is partly explained by the steady rise in social spending throughout South America in the decade before this latest slump. Higher spending on a per capita basis, social expenditures (which include education, health, and social protection) increased in every South American country. In only two countries (Bolivia and Paraguay) per capita social expenditures increased by less than 20 percent from 2000 to 2008. In half of the countries, the increase was greater than 36 percent. (World Bank, October 2010)

Progress on Human Development

Two-thirds of the South American countries are rated as achieving "High Human Development" in the latest Human Development Index (UNDP). The other four – Bolivia, Guyana, Suriname, and Paraguay – are rated as "Medium Human Development."

Additional Information

For country-specific data and additional information about the countries covered in this report, please visit the EADS Country Portal at http://esdb.eads.usaidallnet.gov/query/do?_program=/eads/esdb/countryPortal.

Sources used in compiling this report include the semi-annual World Economic Outlook from the International Monetary Fund (http://www.imf.org/) and the Global Economic Prospects from the World Bank (http://www.worldbank.org/).