USAID
Economic Analysis
and Data Services

EADS Economic Trends Report
South America

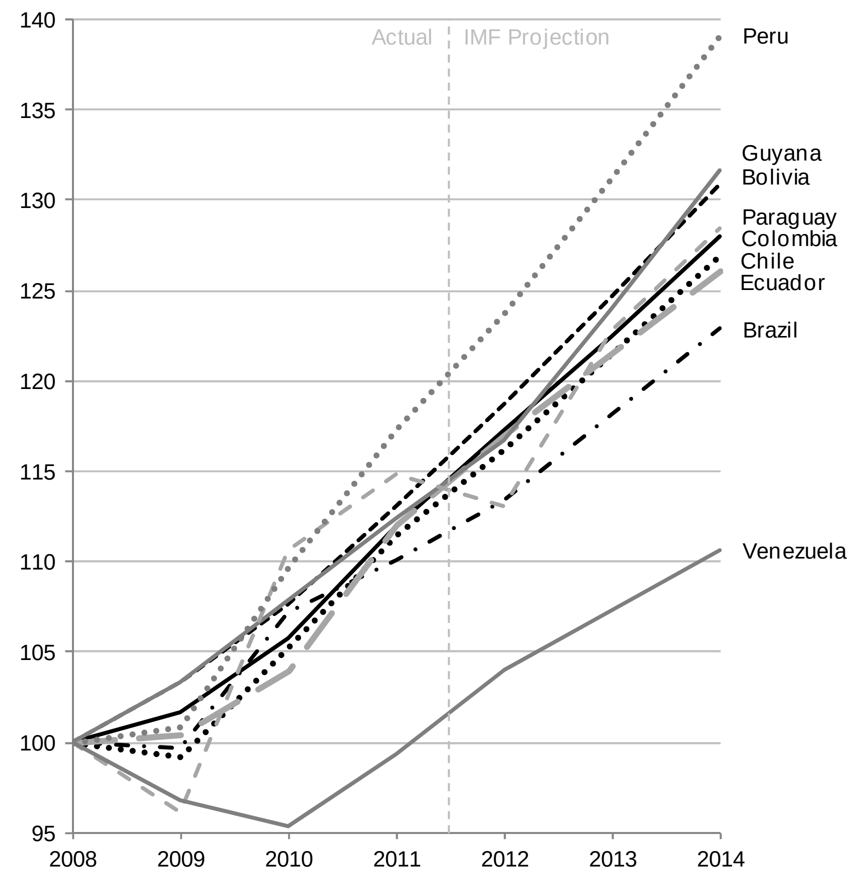
May 2012

Economic Overview

Strong economic growth in South America in 2011, at a 4.8 percent pace, was buoyed by resilient domestic demand, positive external financing conditions, and high commodity prices. However, there are significant risks that negative spillovers from the euro area sovereign debt crisis will dampen growth in several of South America's financially integrated economies.

Peru has demonstrated robust growth rates driven mainly by domestic demand in the telecom, utility, and financial sectors. President Ollanta Humala, elected in June 2011, has so far pursued a centrist economic policy. Humala's administration faces several challenges, including battling increasing cultivation of coca. Peru surpassed Colombia in 2011 to become the world's top producer of pure cocaine, according to the U.S. Drug Enforcement Agency.

Real GDP (2008=100)



SOURCE: IMF, *World Economic Outlook*, April 2012.

Brazil has implemented monetary and fiscal policy tightening in order to prevent the economy from overheating. The result has been a moderation in Brazil's GDP growth and domestic demand, which has helped to cool inflationary pressures; however, elevated credit rates and continued growth in imports suggest that risks of overheating remain. On the other hand, Brazil is expected to maintain solid foreign investment levels through 2014 thanks to confidence in the government's commitment to keeping a balanced budget and the commitment of the Central Bank to respond to changing economic conditions, Brazil's natural mineral and oil wealth, and enthusiasm related to the 2014 FIFA World Cup and 2016 Olympic Games.

Colombia is among the region's strong performers due to robust growth in the country's banking, infrastructure, mining, and hydrocarbons sectors; however, its economy faces risks of overheating as evidenced by elevated foreign investment flows, rising housing prices, and accelerating inflation rates. While part of Colombia's recent economic growth is related to improved security and stability, allegations of corruption, high crime rates

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

and weak state presence in many areas of the country continue to present severe risks to recent economic and social gains.

The Venezuelan economy is beginning to recover from a protracted recession from 2008 to 2010 thanks in part to high oil prices (Venezuela is the world's fifth largest producer of crude oil) and aggressive monetary stimulus. However, the sustainability of the recovery will be tested by political and economic uncertainty surrounding the October 2012 presidential elections.

Fiscal Policy

The IMF recommends that South American countries take advantage of favorable external conditions, including high commodity prices and low global interest rates, to build up fiscal buffers.

Despite strong revenues, the IMF predicts that Brazil will have the region's largest gross government debt in 2012 at 65.0 percent of GDP, slightly down from 66.2 percent in 2011. Former President Lula initiated several large public spending programs designed to address severe inequality that will be difficult to unwind. In addition, the highly inefficient tax collection system poses a further challenge to the efforts of the Brazilian government to reduce fiscal deficits. These challenges, combined with slower global growth and the need to secure capital investment in preparation for the 2014 FIFA Soccer World Cup and the 2016 Summer Olympics, will make it difficult for the current administration of Dilma Roussef to fulfill promises of fiscal consolidation.

Ecuador had the highest government expenditures as a percent of GDP in South America in 2011 at 42.0 percent, but is predicted to gradually decrease its rate of expenditure over the next two years, falling behind Venezuela where government expenditures are expected to reach 42.4 percent of GDP in 2012. As a result of the dollarization of the Ecuadorian economy, the government depends mainly on fiscal policies rather than monetary policy to stimulate the economy. One of the main social spending programs in Ecuador includes the *bono de la vivienda* program that is designed to expand access to housing finance through a combination of grants and loans targeted for low-income and senior citizen groups. The total amount of *bono de la vivienda* program loans from the government increased from nearly $600 million in 2009 to $770 million in 2011. Expenditures have been financed mainly by windfalls from oil exports.

Chile posted a strong fiscal surplus of 1.3 percent of GDP in 2011 thanks to growing tax and mining revenue. However, protests against President Sebastián Piñera could push the government to increase spending in anticipation of the 2013 presidential election, leading to a fiscal deficit in 2012, especially if global copper prices begin to moderate.

The Business Monitor International (BMI) reports predict that Guyana's fiscal deficit will narrow between 2011 and 2012 as a result of rising revenue and slowing expenditure rates. However, persistent fiscal deficits will keep the country dependent on external financing. According to IMF projections, Guyana's total government debt as a percent of GDP is expected to expand from 61.6 percent in 2011 to 64.6 percent in 2014.

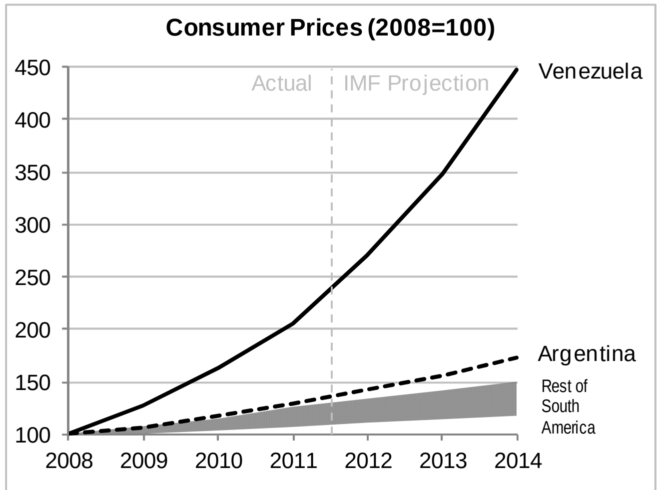
Monetary Policy

Given the pervasive uncertainty in global markets many South American countries have opted to pursue a largely neutral monetary policy, attempting to balance inflation and mitigate potential external shocks, such as spillovers of financial stress from Europe. In 2011, Brazil, Chile and Peru reduced or kept nominal policy rates unchanged. Following tightening of monetary policies in the beginning of 2011, Brazil began loosening monetary policy late in 2011 as inflationary pressures subsided. Chile has also begun to loosen monetary policies by decreasing the policy rate by 25 basis points to 5.0 percent in January 2012. According to March 2012 Business Monitor International (BMI) reports, Peru is expected to maintain a policy rate of 4.25 percent in 2012, allowing inflation to increase slightly with the hope of combating an appreciation of the currency. In contrast, Colombia, Uruguay, and Paraguay continued monetary tightening in 2011 in reaction to high domestic demand and expected inflationary pressures. The Central Bank of Paraguay raised reserve requirements and increased policy rates in 2011 in order to strengthen the financial system and contain inflation.

Real GDP Growth, 2012 (IMF Projections)	South America 3.9%	Central America 3.8%	Mexico 3.6%	Caribbean 2.5%

Inflation

Governments in several South American countries are concerned with preventing overheating and rising inflation related to substantial capital inflows and high global food and fuel prices. South America has the highest projected inflation rate for 2012 compared to other sub-regions in Latin America and the Caribbean (LAC); however, this average is skewed by the exceedingly high expected inflation rates for one country: Venezuela. The majority of South American countries have implemented effective policies designed to maintain inflation within targeted ranges. Venezuela and Argentina are the exceptions.



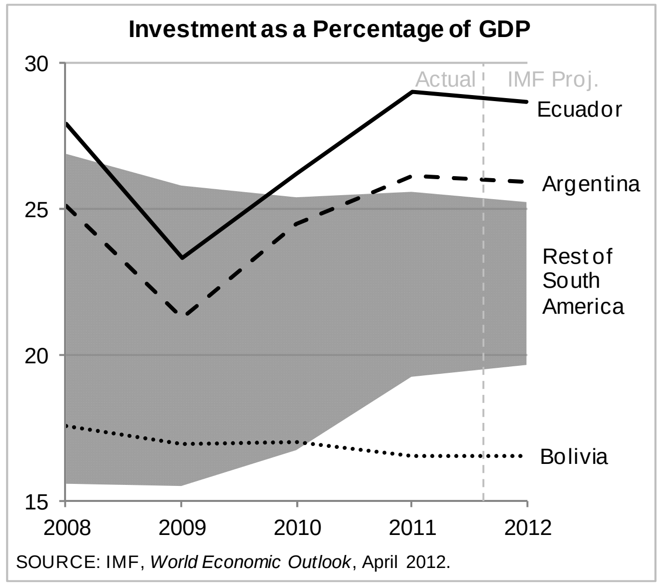
SOURCE: IMF, *World Economic Outlook*, April 2012.

The Venezuelan government's pursuit of expansionary monetary policies and refusal to take action to counter declines in the country's productive capacity are aggravating inflationary pressures. In order to protect consumers from rising prices, the government subsidizes goods, enforces price controls, and has lifted minimum wages. However, these policies to not address the causes of inflation and are contributing to an unsustainable situation, especially if oil prices begin to decline and the government is no longer able to finance its subsidy programs. There are severe risks of hyperinflation, a flight from the currency (the bolívar), and the shutdown of the retail sector.

While less acute than Venezuela, Argentina's current expansionary monetary policies are also contributing to unstable levels of inflation above 20 percent. Of further concern is the poor quality of official inflation data from Argentine authorities. In February 2012, the IMF Executive Board released a statement reflecting a disapproval of the absence of progress in aligning Argentina's Consumer Price Index reporting with international statistical guidelines and calling for reforms to improve data quality compliance.

CPI Inflation, 2012 (IMF Projections)	South America 7.7%	Central America 5.4%	Caribbean 4.1%	Mexico 3.9%

Investment



Capital inflows and investment in South America have remained strong; however, volatility and heightened global risk aversion are factors dampening forecasts for investment in 2012.

Ecuador is leading the region with its rapid growth in investment rates. High oil prices and an expansion in consumer credit in Ecuador have fueled investment in infrastructure and residential construction. Ecuador has also benefited from increasing foreign investment by Chinese banks and firms. For example, in October 2011, the Export-Import Bank of China signed a loan contract to help finance the development of hydroelectric power plants in Ecuador. On the other hand, President Rafael Correa has run into stiff opposition by indigenous Amazonian Shaur Indians against plans to open pit mines to access copper and other mineral wealth. In addition, Ecuador's weak investment climate and barriers to accessing financing are significant risks that threaten the investment growth trajectory. Finally, Ecuador's dependence on oil revenues creates a potential vulnerability should global oil prices begin to decline.

In Argentina, President Cristina Fernández has adopted interventionist policies to spur investment, including forced repatriation of export revenues, higher import duties, and the nationalization of the YPF energy company. These policies have infuriated Spain, Argentina's largest foreign investor, and will most likely lead to a dramatic drop in foreign direct investment (FDI) flows in the future.

In Bolivia, President Evo Morales has similarly adopted interventionist policies that repel rather than attract foreign investment. In May 2012, President Morales signed a decree to nationalize assets of Spain's Red Electrica Corporación, giving the government control over the country's power grid. This expansion of state control pushes Bolivia a step closer to resembling President Chavez's Venezuela in which large sectors of the economy are now under state control. Venezuela's economy has been dragged down by frequent shortages of electricity following the nationalization of the power industry. Bolivia and Venezuela rank among the worst countries globally for ease of doing business, at 153rd and 177th, respectively, out of 183 countries in the 2012 World Bank Doing Business Survey.

In contrast, Chile, Colombia and Peru rank in the top 50 for overall ease of doing business according to the 2012 Doing Business surveys. These three countries stand out in the region for their strong institutions, infrastructure, and business-friendly regulatory environments. Colombia ranked in the top ten countries globally for economies that improved the most across three or more areas measured by Doing Business from 2010 to 2011, making significant reforms in the following areas; starting a business, paying taxes, and resolving insolvency. Colombia's economy benefited from strong FDI inflows in 2011 in the mining, petroleum, and infrastructure sectors.

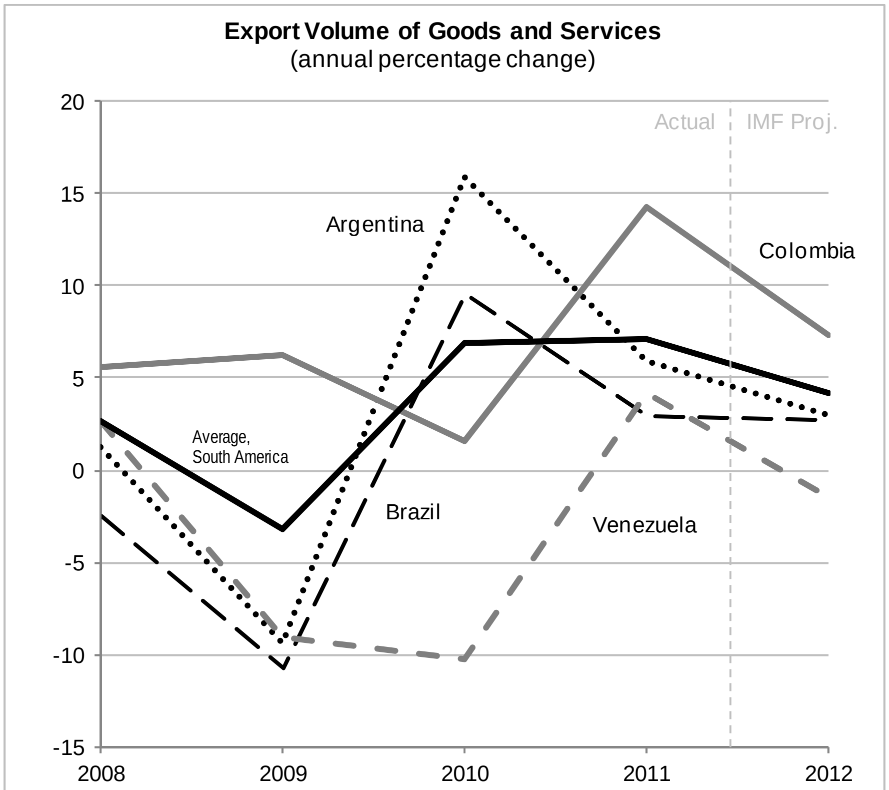
Investment as a percent of GDP in Paraguay has been increasing steadily since a major decline in 2009 related to the negative impacts of a severe drought and the global financial crisis in that year. The government of Paraguay is going to receive a generous loan of over $200 million USD from the Japanese government in 2012 to help fund critical road construction linking centers of trade and manufacturing in the eastern areas of Paraguay. Investment in infrastructure has been highlighted by the IMF as critical to maintaining a long-run growth trajectory in Paraguay of around 5 percent.

Total Investment, 2012 (as a percentage of GDP) (IMF Projections)	Caribbean 27.8%	Mexico 25.0%	Central America 22.7%	South America 22.6%

Trade

Commodity and fuel exporters have benefited from high global prices and demand in 2011 which are expected to moderate in 2012. There are concerns about weakened export demand from Europe if conditions related to the sovereign debt crisis worsen. According to the World Bank's Global Economic Prospects 2012, exports to the euro area comprise 20 percent of total exports from Brazil and Chile and almost 15 percent from Argentina and Peru.

In addition, southern cone countries (Argentina, Bolivia, Chile, Paraguay, and Uruguay) are likely to be negatively impacted by the marked slowdown in Brazil's GDP growth trajectory compared to Andean countries that have less trade linkages with Brazil.



SOURCE: IMF, *World Economic Outlook*, April 2012.

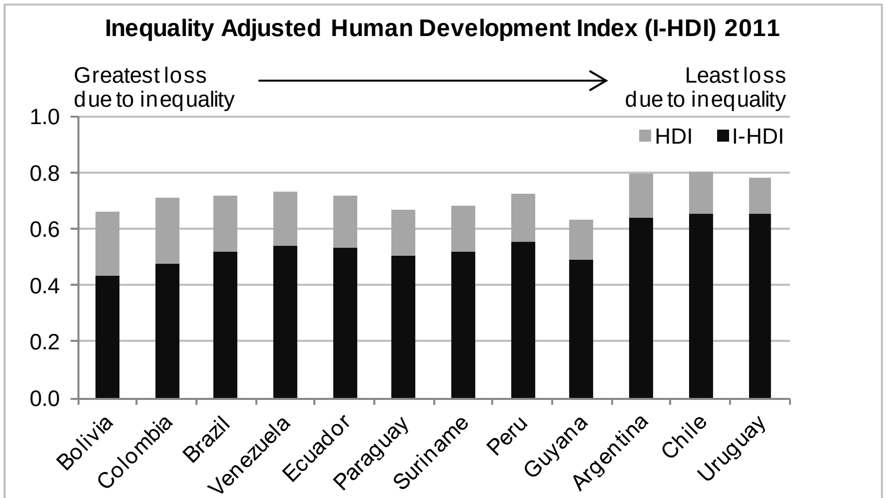
Colombia has made significant progress in promoting trade and export growth. Relations between Colombia and neighboring trade partner Venezuela have improved recently as evidenced by a trade agreement on partial customs preferences signed by Venezuelan President Chávez and Colombian President Juan Manuel Santos in November 2011. In addition, after being stalled for five years, a free-trade agreement (FTA) between Colombia and the U.S. was approved by the U.S. Congress in October 2011. On the other hand, there are rising trade tensions between Colombia and Argentina. In April 2012, Colombia sent a letter to the WTO protesting import restrictions imposed by Argentina on Colombian products.

Trade relations between South American countries and China have significantly expanded over the past decade. According to the *Latin American Economic Outlook 2012* by the OECD/ECLAC, exports to China over the past ten years have increased from 2 to 13 percent of total exports from Brazil, from 5 to 23 percent from Chile and, from 6 to 15 percent from Peru. While increased trade with China has helped South America remain resilient to the financial crisis in the U.S. and Europe, it also leaves the region vulnerable to negative external shocks related to a potential slowdown in Chinese economic growth.

Export Volume of Goods and Services, 2012 (annual percentage change) (IMF Projections)	Mexico 12.8%	Caribbean 5.8%	Central America 4.7%	South America 4.2%

Poverty Reduction and Sustainable Development

According to the UNDP *2011 Human Development Report* (HDR), there has been improvement in reducing inequality in health and education, especially in Argentina, Brazil and Peru; however, Latin America still remains the region with the world's highest levels of income inequality. Economic growth alone does not guarantee a reduction in poverty if there are structural or social factors that cause some groups to be left behind. Studies by the UNDP highlight the following factors that contribute to the persistence of inequality:



SOURCE: UNDP *Human Development Report* 2011.
NOTE: The I-HDI is the Human Development Index (HDI) value adjusted for inequalities in the three basic dimensions of human development.

- continued gaps in the quality of services and human security
- institutional and regulatory challenges, including insecure property rights and poor access to justice
- lack of opportunity for decent work.

In addition to high rates of inequality, the 2011 HDR report also finds that Latin America has the highest rate of loss of forest cover in the world from 1990–2010. Fortunately, several countries are taking steps to reduce deforestation rates. Brazil has made great progress in slowing the rate of deforestation in the Amazon and Chile is among seven developing countries globally that have recently transitioned from deforesting to reforesting.

With the Rio+20 earth summit set to take place in Brazil in June 2012, issues of sustainable development and poverty eradication in South America and around the world will be taking center stage in global discussions. One of the goals of the summit is to develop a system of global governance for sustainable development, including global institutions in charge of developing, monitoring, and implementing policies on sustainable social, environmental, and economic development.

Additional Information

For questions or more information, please contact statsunit@devtechsys.com.

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/), the *Global Economic Prospects* and *Doing Business Reports* from the World Bank (http://www.worldbank.org/), the UNDP *Human Development Report 2011* (http://hdr.undp.org/en/reports/global/hdr2011/), and Business Monitor International Business Forecast Reports (http://www.businessmonitor.com/).