



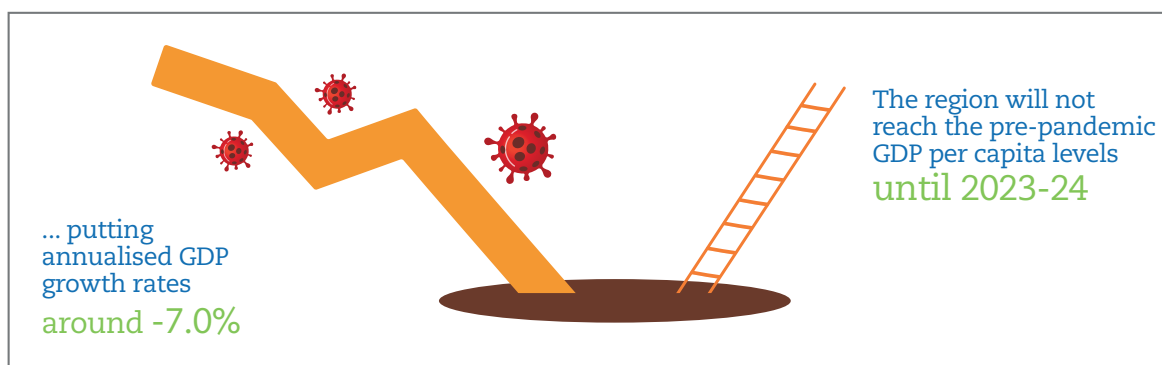
Chapter 1

Structural macro perspective and the path to recovery

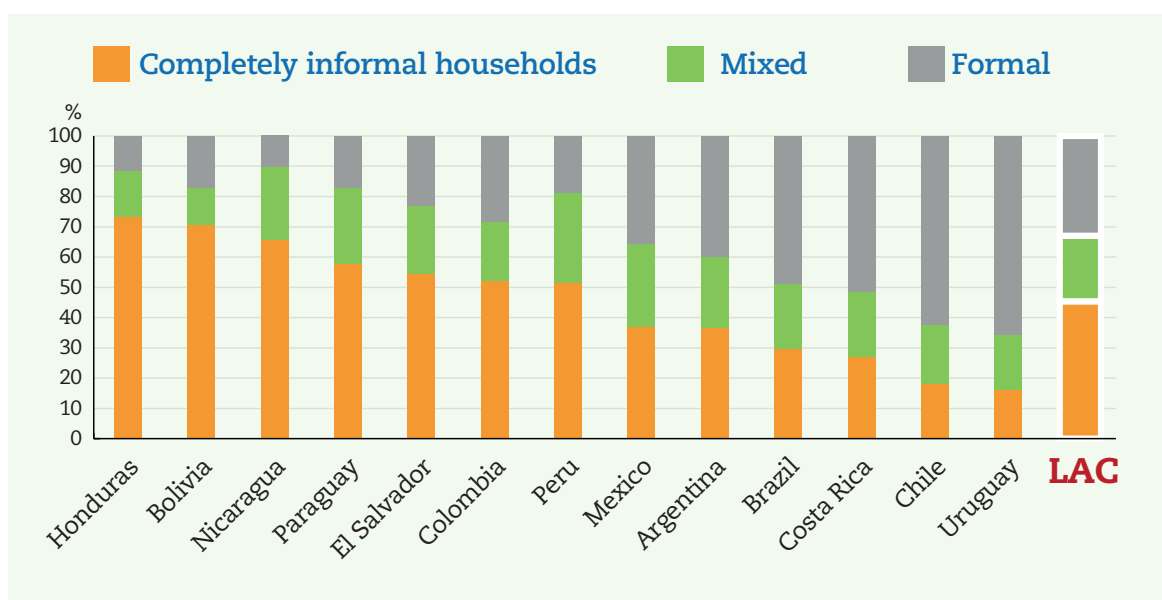
The socio-economic impacts of the coronavirus (COVID-19) crisis have been dramatic in terms of income and social conditions. Although positive growth is expected for 2021, pre-crisis GDP per capita levels are not expected to be reached before 2023-24. In the short run, demand-side policies should continue to play a central role to ensure a strong and inclusive recovery. After summarising the international context the region faces, this chapter presents the economic performance and key factors affecting the pace and shape of the recovery in LAC. In particular, it focuses on the importance of fiscal policy actions. It also highlights the social consequences of the crisis and the importance of financing conditions to protect the most vulnerable populations and of targeting policies based on key dimensions, including informality at the household level.

The effects of the Covid-19 crisis in Latin America and the Caribbean

In the LAC region, 2020 ended with the greatest economic downturn of the past two centuries due to the Covid-19 crisis...



Informal households are the most affected by the COVID-19 crisis, facing loss of employment and labour income



Introduction

As a consequence of the coronavirus (COVID-19) pandemic, Latin America and the Caribbean (LAC) ended 2020 with the greatest economic downturn of the last two centuries, putting annualised gross domestic product (GDP) growth at rates around -7.0% (ECLAC, 2021^[1]; CAF, 2021^[2]), with immediate damages to the economic and social fabric and considerable risks of long-term scarring. Social costs are drastic in terms of inequalities and poverty, as the impact of the COVID-19 crisis has particularly affected the most vulnerable groups.

LAC economies should regain some ground in 2021, but uncertainty remains regarding the strength of the recovery. The recovery will likely be protracted, mainly explained by a statistical carry-over effect that will moderate in 2022, and with heterogeneity across and within countries.

The main threats to the recovery are increased contagions or a slow vaccine rollout that delays the normalisation of economic activity. Potential upsides include a larger than expected boost in global demand due to more robust recoveries in key partners for the region, including the European Union, the People's Republic of China (hereafter "China") or the United States. Similarly, the driving forces or tailwinds of growth will affect countries differently, but on average, pre-crisis per capita GDP levels are projected to be reached by 2023-24.

At the international level, the surge in some commodity prices and the recovery of global trade and industrial production should be favourable to LAC exports. Nonetheless, the region's external trade contraction during 2020 severely affected the economy, revealing existing trade fragmentations, especially regarding intraregional trade. In order to support a strong and more inclusive recovery while enhancing competitiveness and protecting against future exogenous shocks, it will be crucial to support stronger integration within and beyond LAC (Chapter 3) (ECLAC, 2021^[3]). Development-oriented trade policies, coupled with competition and consumer policies, will also play an important part in the recovery and should contribute to achieving the United Nations 2030 Agenda for Sustainable Development, as well as to continued economic resilience (UNCTAD, 2020^[4]).

While in 2020 LAC governments, in common with those of other emerging and developing economies, were capable of tapping capital markets with favourable financing conditions (OECD, 2021^[5]), uncertainty remains regarding the international liquidity conditions for emerging markets. Moreover, some countries should remain without access to global capital markets, making them highly dependent on multilateral banks and public creditors to finance their recovery.

At the domestic level, policy makers in the region will face challenges in backing internal demand. Countries must overcome the health crisis in a race between new contagions and the vaccine rollout. The longer it takes to attain herd immunity through vaccination, the more likely uncertainty and stop-and-go policies will be, with increased likelihood of some permanent scarring to the economy.

Fiscal policy will have to continue to play a supportive role to ensure a strong and inclusive recovery but should be implemented in a holistic and sequenced manner. The use of tax and spending policies and the design of fiscal reforms, including actions such as strengthening the tax administration, should be co-ordinated and sequenced to offset the impact of the COVID-19 crisis on households and firms and to bolster public healthcare systems. Furthermore, there is a growing need for a holistic approach in terms of fiscal policy for the region that takes into account the political economy of fiscal reform, tax

morale and the complex socio-economic conditions that resulted from the crisis. The proper use of fiscal resources could increase the level of satisfaction with public services, increase tax morale, strengthen trust and escape the “institutional trap” affecting many countries in the region (OECD et al., 2019^[6]).

Governments must also manoeuvre between keeping fiscal stimulus going to cement the recovery and avoiding unsustainable fiscal positions. The premature withdrawal of the fiscal stimulus could derail the recovery and dent longer-term growth. Fiscal policy is therefore crucial to mitigate the immediate consequences of the crisis but also avoid the permanent scarring of the economy. It is key to design and finance well-targeted measures for the most vulnerable households and firms. Macroeconomic conditions are heterogeneous across the region, implying that the policy space is more limited for countries that are highly indebted or where anchoring inflation is becoming more difficult. This raises the need to adapt and tailor expenditure, taxation and debt management approaches to each country’s context. Some of these actions require further co-operation and co-ordination at the international level (Chapter 5).

This chapter first examines the global context, with a focus on key partners of the region and the global financial and commodity markets. Then, it presents the economic performance in LAC, highlighting the region’s heterogeneity, external accounts and the role of demand-side policies in sustaining the recovery. Third, it focuses on the key role of fiscal policy for the recovery and the need to build consensus and establish favourable sequencing of fiscal actions. Fourth, it highlights the social consequences of the crisis, the underlying conditions of informality at the household level and the need to finance the well-targeted social protection systems adopted during the pandemic. The chapter concludes with main policy messages.

Navigating a challenging international context

Global recovery gradual and uneven

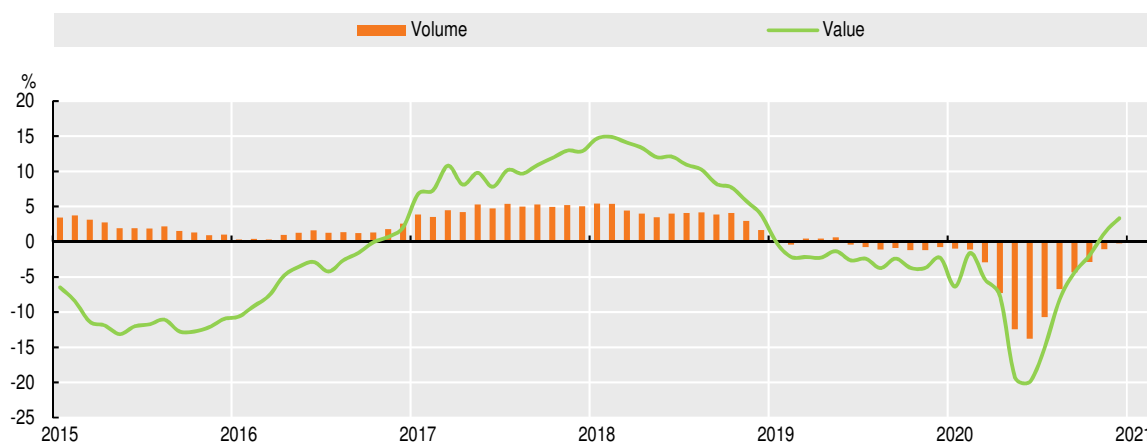
The global economic recovery is underway but still depends on the vaccine rollout. Global activity contracted dramatically in 2020, with GDP falling by 3.4% (OECD, 2021^[7]). By 2021, thanks to the gradual deployment of effective vaccines, additional fiscal support and successful measures in most countries to cope with the virus, economic prospects have improved markedly, and global GDP growth is projected to be 5.7% in 2021 and 4.5% in 2022. World output has now surpassed its pre-pandemic level, but output and employment gaps remain in many countries, particularly in economies where vaccination rates are low (OECD, 2021^[7]).


The global recovery improved international trade, but trade will not reach pre-crisis levels for all goods and services in 2021. World trade is projected to strengthen in 2021, with an estimated 8.2% increase of trade volumes, after falling by 8.5% in 2020 (OECD, 2021^[8]). For 2021, the gradual recovery of the global economy, combined with changes in consumption patterns (increased demand for medical items and technology for remote work, for example), has allowed merchandise trade to recover steadily; nevertheless, trade in services, notably tourism, will remain subdued as long as the pandemic requires sanitary restrictions and undermines travellers’ confidence (OECD, 2021^[8]) (Figure 1.1).

There are marked divergences across countries in terms of dealing with the health crisis and the recovery. The United States leads growth among advanced economies, boosted by the accelerated advance in the vaccination process and the Biden administration’s sizeable stimulus package (OECD, 2021^[7]). This will generate positive spillover in key trading

partners, including LAC economies. In Europe, continued containment measures in the first half of 2021, a more limited fiscal support and the still-complicated epidemiological situation are delaying activity normalisation. Growth in the Euro Area will be in particular driven by private consumption (OECD, 2021^[7]). Among emerging economies, China has caught up with its previous growth path and is set to stay on this trajectory in 2021 and 2022. Other emerging economies may continue to have large shortfalls in GDP relative to pre-pandemic expectations and are projected to grow at robust rates only once the impact of the virus fades (OECD, 2021^[8]).

Figure 1.1. Global merchandise trade (% change y-o-y, 3-month moving average)



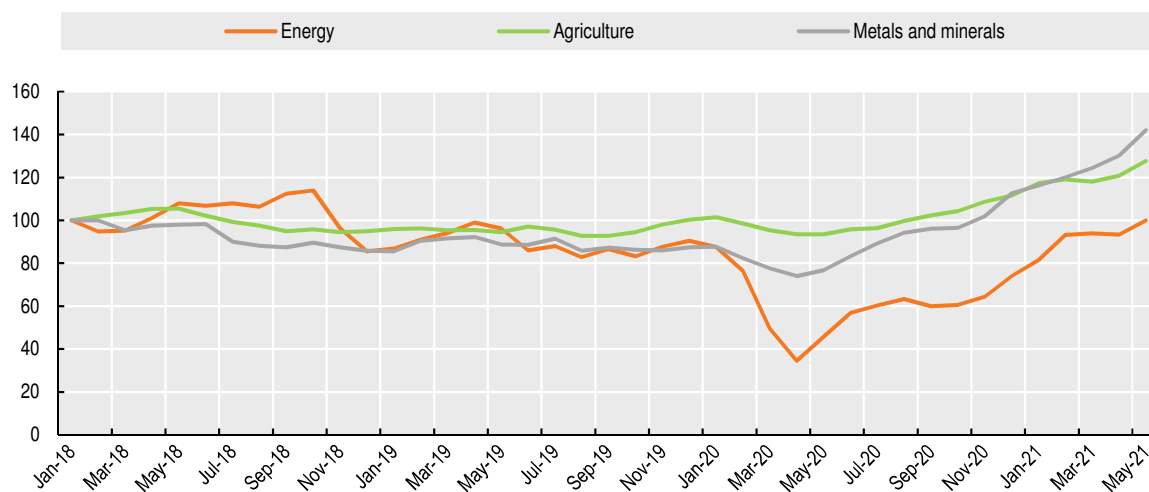
Source: OECD/ECLAC/CAF/EU based on CBP Netherlands Bureau of Economic Analysis; and WTO Short-Term Indicators.
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Commodity prices are on an upward trend

Most commodity prices have increased to above pre-pandemic levels (Figure 1.2). The COVID-19 crisis caused a sharp fall in commodity prices, but this trend has reversed as of May 2020. In 2021, the recovery in the global economy, production bottlenecks and changes in consumption patterns have continued to push commodity prices up. Energy prices, whose recovery lagged compared to other commodities, have risen rapidly since the end of 2020. These changes signal a recovery from last year's historical plunge but not necessarily the beginning of a new commodity supercycle. Commodity prices should stabilise once supply bottlenecks and the strong rebound in demand, particularly in China and to a lesser extent in the United States, ease and growth converges to potential. Moreover, looking forward, international action to tackle the climate emergency and the commitments to decarbonisation and reducing dependency on fossil fuels could cap oil prices while being positive for some metals. The shift to a more environmentally sustainable consumption model, mainly in developed countries, will increase the demand for some base metals necessary for components and batteries (e.g. copper and lithium), as seen with increases in electric vehicles.

Some of the drivers behind the last commodity supercycle – the rapid industrialisation of China and robust global trade – are less vigorous today. Moreover, globalisation was stalling even before the pandemic, which could increase the reshoring and fragmentation of some value chains, weakening the impulse of world trade. Therefore, as the world economy returns to previous growth trends, global trade, particularly commodity trade, will hardly play a substantial role in driving LAC economies' growth compared to before the 2008 financial crisis.

Figure 1.2. **Commodity prices (international commodity prices, January 2018 to May 2021; January 2018 = 100)**



Source: OECD/ECLAC/CAF/EU based on World Bank Commodity Markets.
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Easing financial conditions but with volatility and uncertainty

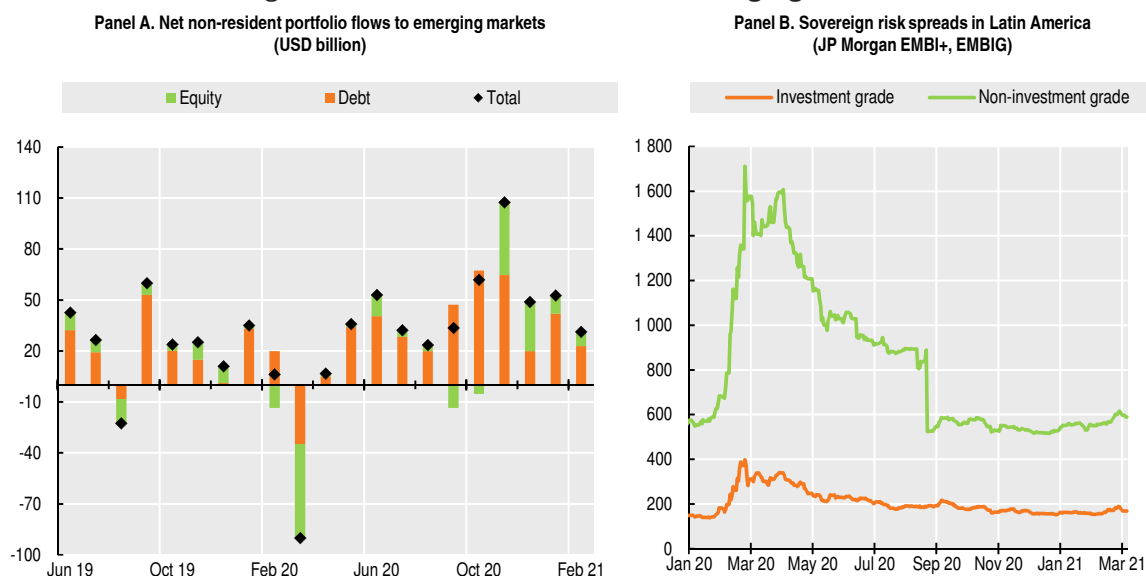
Financial conditions have continued to ease since the sudden stop in capital flows in March 2020. Risk appetite resumed, and capital flows returned to emerging markets. In contrast to previous international crises, the COVID-19 crisis was favourably accompanied with ample international liquidity thanks to the strong and co-ordinated monetary policy responses in major advanced economies. While interest rates will probably remain relatively low in advanced economies, the long end of the yield curve remains slightly subdued. In the case of the United States, and similar to the previous case of the “taper tantrum”, rising US bond yields and a strong US recovery could trigger a reversal in capital flows and raise exchange-rate volatility (OECD, 2021^[8]). The increase in yields since the beginning of 2021 indicates that markets expect a rise in medium-term inflation, in line with the economic recovery. However, financial conditions are not tight yet, since real interest rates remain near zero or negative.

Rising headline inflation should push central banks with inflation-targeting regimes to switch to a less expansionary policy stance. In many economies, headline inflation has been rising as energy and food prices are increasing, and currencies depreciate. These pressures are likely to trigger a sustained rise in wages and other costs, forcing central banks to switch to a less expansionary policy stance. Nonetheless, as long as output gaps remain negative, the overall slack in labour markets persists and expectations stay anchored, inflationary pressures should be transitory. In emerging economies where expectations are not so firmly anchored, central banks could take more neutral stances. However, exchange-rate depreciation pass-through, higher energy costs and increased food prices may lift inflation expectations and elicit interest rate hikes, particularly in countries where fiscal sustainability is on the line.

Access to external financing has not been a binding constraint for most LAC countries in the short term, although credit access remains differentiated. The appetite for debt securities in foreign currency has remained since the second half of 2020 and has been greater than for stocks (Figure 1.3, Panel A), allowing significant Eurobond issuance at relatively low rates by emerging markets. In Latin America, investment-grade issuers did not face significant obstacles issuing debt in the markets at low interest rates since April 2020 (e.g. Chile, Colombia,¹ Mexico, Panama, Paraguay, Peru, Uruguay). Other

countries were in the process of debt restructuring without access to markets (Argentina and Ecuador), and for some others, credit has rapidly become more costly (e.g. Bolivia, Costa Rica, Trinidad and Tobago). Following debt restructuring in Argentina, the gap of sovereign bond spreads between non-investment and investment grade countries has remained high at close to 400 basis points (Figure 1.3, Panel B) (see section on debt management below). The recent increase in US yields prompted a rise in the cost of borrowing in local currency in domestic markets (IIF, 2021^[9]; IMF, 2021^[10]).

Figure 1.3. Financial conditions in emerging markets and LAC



Source: OECD/ECLAC/CAF/EU based on Bloomberg and (IIF, 2021^[9]); Weak economic performance in the region
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Insufficient growth for LAC in 2021, with high uncertainty

The LAC region was the hardest hit by the pandemic in the developing and developed world, registering one of the world's deepest contractions (Figure 1.4, Panel A). The recovery is likely to be more protracted than in other regions owing to the pandemic second wave's hefty toll and the slow return to normality.

Importantly, following the commodities bust in 2014, the COVID-19 shock represents the second shock to the LAC region in the last decade. Since 2014, the region has experienced little to no growth, which represents an additional threat, with some predictions that the region will not reach the pre-pandemic GDP per capita levels until 2023-24. Moving towards a recovery from the crisis, the danger of another lost decade must be kept in mind. Therefore, it is crucial to adopt a long-term view in terms of the structural reforms needed to achieve long-term and sustainable growth. For instance, productivity growth is the core engine of sustained economic progress, but in LAC aggregate labour productivity shows reduced and persistently low growth, with decreases since the 1960s relative to the OECD countries (Figure 1.4, Panel B).

Resuming steady growth will remain a daunting task for LAC economies until the health crisis has passed. In 2020, the pandemic induced economic crisis saw GDP on average fell by almost 7% (ECLAC, 2021^[3]; CAF, 2021^[2]). The effects of the pandemic continue to be felt in the first quarter of 2021, forcing further mobility restrictions that have weighed on activity. The impact of second-wave restrictions in LAC economies was not as severe as experienced in the second quarter of 2020. However, initially progress in vaccination has been slow except in few countries, in particular Chile and Uruguay.

Vaccination campaigns accelerated during the second semester in several countries, including Ecuador, Paraguay, Argentina, Colombia, Panama, the Dominican Republic and Brazil, as supply bottlenecks eased and vaccines availability increased. LAC faced obstacles to acquiring the vaccines – due to the unequal global distribution of vaccines across regions, bottlenecks in global production, little international co-ordination or financial restrictions in some cases. Beyond these challenges, most LAC countries face difficulties related to poor domestic logistics and limited local capacities to implement immunisation campaigns. Both aspects (vaccine accessibility and vaccination rollout strategies) could delay the normalisation of activities in most countries and thus hinder growth. The longer it takes to recover, the more pervasive the scarring and the more permanent the damage to the already low potential growth.

Figure 1.4. GDP per capita and labour productivity in LAC



Source: OECD/ECLAC/CAF/EU based on (IMF, 2021^[10]), World Economic Outlook, <https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021>.

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Average growth around 6% is expected for 2021 in the region followed by a projected deceleration in 2022 (ECLAC, 2021^[1]; CAF, 2021^[2]; IMF, 2021^[11]). Growth in 2021 is mainly attributed to the low basis of comparison – after the 2020 strong drop – along with the positive effects arising from external demand and the rise in the price of the commodities that the region exports, as well as to increases in aggregate demand (ECLAC, 2021^[1]; ECLAC, 2021^[3]). The scenario for the remainder of 2021 and for 2022 is subject to the evolution of the pandemic, and the surge of the Delta variant, the vaccine rollout and public discontent that has translated into social protests in some countries. The main driver of growth in the short term will be domestic demand, particularly consumption, as mobility restrictions are lifted, allowing services to resume. In addition, a packed political cycle in the region, with presidential and/or legislative elections between the second half of 2021 and end of 2022 in Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador,

El Salvador, Mexico and Peru, will weigh on expectations and could keep investment subdued. Finally, social unrest remains a key factor affecting economic stability. Recent social protests highlight the need to achieve a more inclusive growth model, improve citizens' well-being (see below and Chapter 2) and build consensus across citizens in a renewed social contract (Chapter 4).

The recovery will be uneven across the region. It will depend on countries' exposure to hard-hit service sectors, access to financing, carry-over effects and policy space to support demand. For instance, countries heavily exposed to tourism, as Caribbean economies, will exhibit weaker expansions, since tourism will probably lag in the recovery (Chapter 6). Panama and Peru, which experienced double-digit contractions in 2020, will be among the fastest-growing economies this year. In Chile and Peru (and, to a lesser extent, Colombia), public investment in infrastructure will underpin demand.

Back to the usual current account deficits in LAC

Current account balances in most LAC countries should come back to the usual deficits in 2021, mirroring structural challenges in the region. In contrast to previous years, the 2020 LAC average exhibited a narrow current account surplus as a result of considerable decreases in imports (ECLAC, 2021^[11]). Current account balances should deteriorate further as domestic demand picks up. However, for 2021, deficits should not soar, as the increase in imports will not be large enough to override the improvement in exports. Foreign direct investment (FDI) continues to be key to finance these deficits. The implementation of a more interconnected market in LAC would provide substantial protection from future exogenous shocks while enhancing competitiveness (Chapter 3) (ECLAC, 2021^[12]).

Net FDI fell by 35% in 2020, reaching 2.5% of GDP, the lowest value in the last decade (ECLAC, 2021^[13]). The region needs to diversify the sources of FDI to promote further market competition and economic diversification, key dimensions to overcome the “productivity trap” described in (OECD et al., 2019^[6]) (Chapter 3). Diversification also means attracting quality FDI, which can contribute to increase productivity and deliver a more job-rich and sustainable recovery (Box 1.1).

Box 1.1. FDI and sustainable development

Foreign direct investment (FDI) can make important contributions to sustainable development well beyond the capital invested by the affiliates of foreign multinationals. Foreign investors are often thought to have access to better technology and know-how than their domestic peers as a result of ties to their multinational parent firms. These technological advantages can be transferred to the host economy through supply chain linkages and market interactions with domestic firms. Consequently, FDI can enhance growth and innovation, create quality jobs, develop human capital and improve living standards and environmental sustainability. The OECD FDI Qualities Indicators seek to shed light on the extent to which FDI contributes to sustainable development, focusing on productivity and innovation, job quality and skills, gender equality and the low-carbon transition (OECD, 2019^[14]). The forthcoming OECD FDI Qualities Policy Toolkit will further support governments in identifying policies and institutional arrangements to improve FDI impacts on sustainable development (OECD, 2021^[15]).

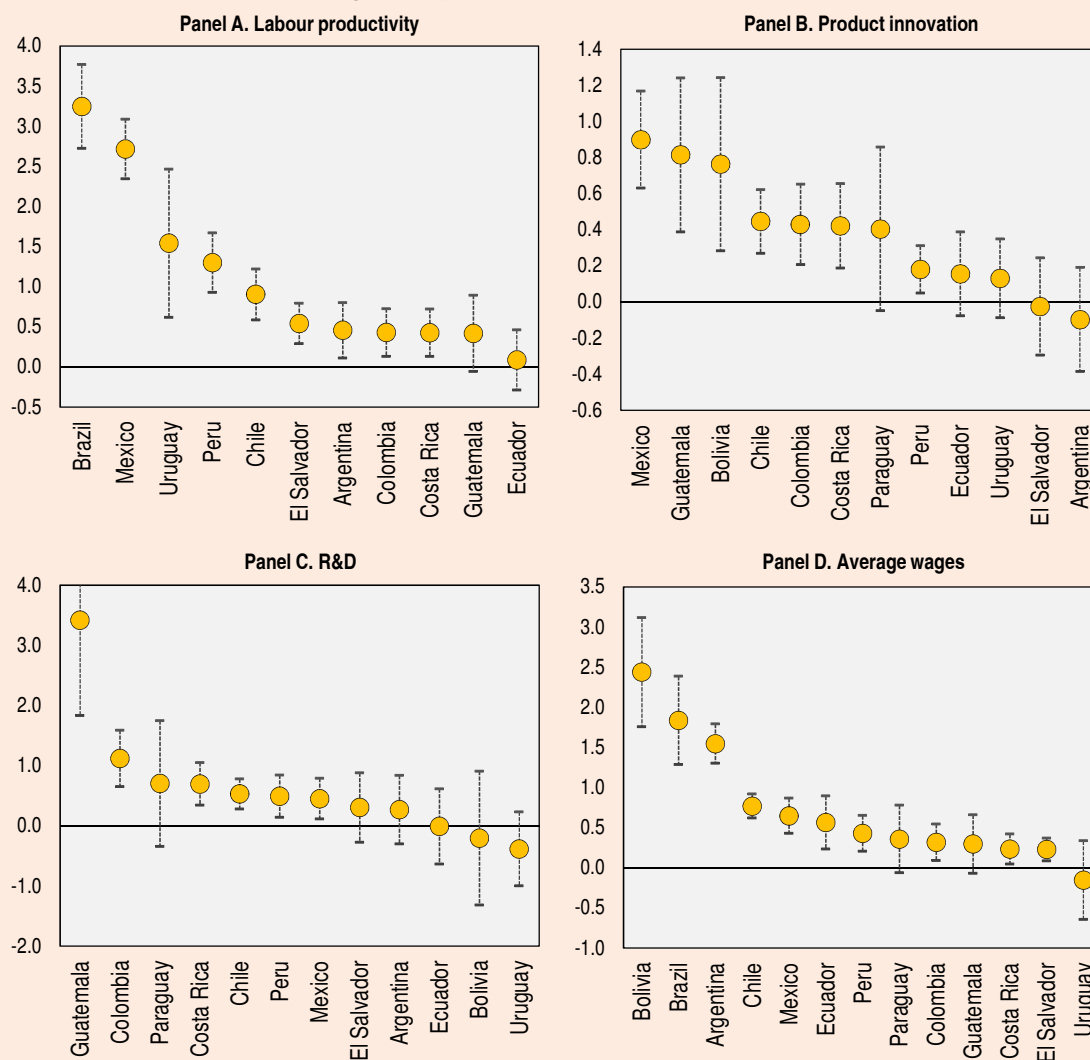
In the case of Latin America, the OECD FDI Qualities Indicators show that, across most countries for which data are available, foreign investors are more productive and more likely to introduce product innovation or invest in research and development (R&D) than domestic firms (Figure 1.5, Panels A-C). This productivity and innovation gap suggests that there is potential for knowledge

Box 1.1. FDI and sustainable development (cont.)

and technology spillovers from foreign to domestic firms. Foreign firms also tend to offer higher average wages, suggesting that the productivity premium they enjoy is at least in part transferred to employees (Figure 1.5, Panel D). At the same time, in the majority of Latin American countries considered, compared to domestic peers, foreign firms tend to employ a higher proportion of unskilled workers and are significantly more likely to offer training opportunities (Figure 1.5, Panels E and F). This evidence suggests that foreign investors are an important source of employment for low-skilled workers in Latin America and can make a significant contribution to upgrading their skills and increasing their opportunities for future employment. In order to enhance FDI's contribution to inclusive and sustainable development further, investment promotion efforts in the region should be aligned with well-defined production strategies that promote economic diversification.

Figure 1.5. OECD FDI Qualities Indicators for selected Latin American countries

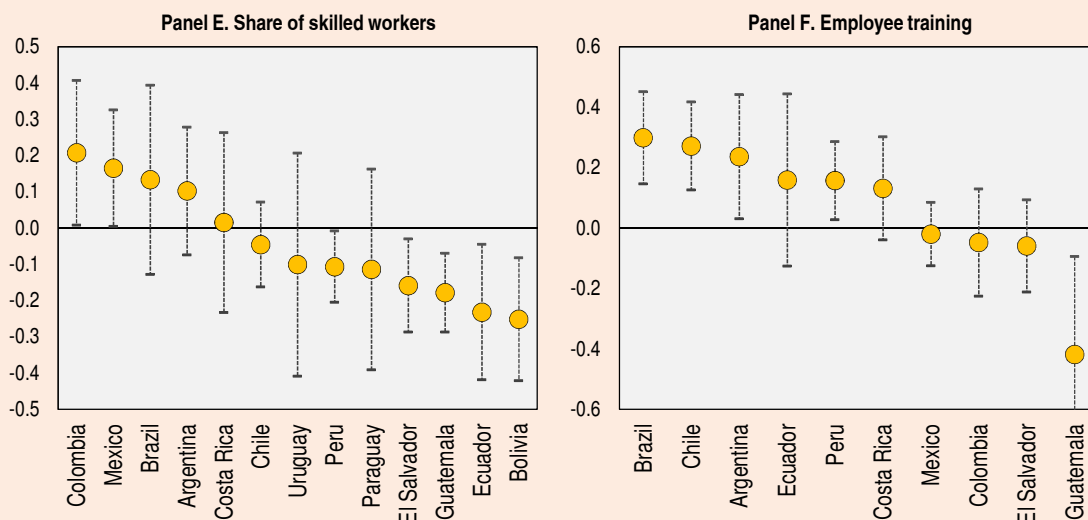
Foreign firms perform better than domestic firms if value > 0



Box 1.1. FDI and sustainable development (cont.)

Figure 1.5. OECD FDI Qualities Indicators for selected Latin American countries (cont.)

Foreign firms perform better than domestic firms if value > 0



Note: Data circa 2017 except for Brazil, Mexico Chile and Costa Rica (circa 2010).

Source: Based on (OECD, 2019^[14]), for methodological details, <https://www.oecd.org/fr/investissement/fdi-qualities-indicators.htm>.

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Limited capacity on the monetary front in most countries: Towards a hawkish policy

The space to stimulate activity during the transition to normality will depend on the policy space before the crisis and how much of that space countries have already used up. Monetary policy responses were uneven in LAC during 2020. Central banks in countries with credible monetary regimes (e.g. independent central banks with inflation targeting regimes) and well-anchored inflation expectations deployed countercyclical policies, cutting nominal interest rates to historical lows and even resorting to quantitative easing, for the first time in these countries' history. These measures were effective in avoiding disruptions in the payment systems and to prevent collapse in domestic credit. Admittedly, the slump in demand depressed prices in most countries, enabling such extraordinary measures while keeping inflation under control.

The recent pickup in inflation related to currency depreciation and energy prices should affect monetary policy but, overall, should not imply a strong change of its stimulative stance. Central banks with inflation-targeting regimes will closely monitor second-round effects that could drift expectations away from targets. Most central banks should be able to support the recovery by keeping interest rates low, as inflation remains under control and easy financial conditions persist. However, central banks will have less margin of manoeuvre because inflation expectations are already slightly above target and they have larger balance sheets (Cavallo and Powell, 2021^[16]). In fact, several countries started to move towards a more neutral stance, including Brazil, Mexico, Chile and Peru.

Resource mobilisation to mitigate the crisis and ignite the recovery

Fiscal policy has been an essential instrument to mitigate the impact of the COVID-19 crisis on families and firms and to bolster public healthcare systems (ECLAC, 2021^[3]; ECLAC, 2021^[17]; ECLAC, 2021^[18]). Across the region, a combination of tax relief measures, budget reallocations, additional expenditures and concessional lending have been adopted as a response to the health and socio-economic challenges posed by the pandemic, especially for the most vulnerable. As a result, the region mobilised an unprecedented amount of resources. Amounts varied by country, depending on the impact of the pandemic, their initial fiscal position and their financing opportunities. This mobilisation of fiscal resources, coupled with the decline in economic activity, has put a strain on the region's fiscal position.

Fiscal policy will continue to be at the core of the response to the crisis and will be essential to ensure a strong and inclusive recovery. Going forward, the crisis-mitigation part of the fiscal response will have to become more targeted, focusing on those sectors (e.g. tourism), firms (e.g. SMEs) and vulnerable population groups that continue to face the greatest hurdles, including those due to the impact of school closures in 2020-21. The fiscal response will also have to address the structural vulnerabilities that the pandemic has exposed, with a view to strengthening the basis of the recovery and building forward better.

Fiscal policy can be essential to drive the needed productive transformation that generates quality formal employment, fully leverages the digital transformation and prioritises the environment. This means increasing investment in human and physical capital (including infrastructure), targeting spending to the most vulnerable populations, improving the effectiveness of public spending and the quality of public services and coherently addressing the development and climate objectives. To finance these investments, there needs to be greater resource mobilisation at both the national and international levels in most LAC countries, which in turn implies greater progressivity of the taxation system and better tax administration and debt management. Similarly, further efforts are needed to eliminate the possibility of gender biases historically present in the current schemes. Current taxation systems place additional burdens on households' secondary earners (traditionally women) and discourage their participation in the labour market (ECLAC, 2021^[17]). Ensuring fiscal sustainability will be instrumental to the success of these efforts, along with strengthening citizens' trust in government to overcome the institutional trap, which many countries were experiencing even before the COVID-19 crisis (OECD et al., 2019^[6]).

Going forward, for fiscal policy to be effective, it must take into account the current complex context through well-defined sequencing of actions. It also needs to be backed by a broad consensus built through national dialogue and clear communication (Chapter 4). The political economy of fiscal policy is more important than ever. Additionally, there is no unique approach or solution to ensuring that fiscal policy translates into a robust, inclusive and sustainable recovery. The context-specific socio-economic characteristics of each country, coupled with the heterogeneous impacts of the crisis, call for a tailored approach. However, some overarching considerations can help LAC countries get their "policy menu" right and achieve a good balance between public spending, tax policy and public debt management.

Tax revenues in times of crisis

The region's tax revenues do little to reduce inequalities and in most LAC countries, they remain insufficient to finance the region's development agenda. Tax revenues remain

low, as the average tax-to-GDP ratio in the LAC region was 22.9% in 2019, considerably below the OECD average of 33.8%, and fell on average by around 3% in 2020. There is strong heterogeneity among LAC countries in revenue collection as a percentage of GDP, ranging from Cuba (42.0%) and Barbados and Brazil (both 33.1%) to Paraguay (13.9%), Dominican Republic (13.5%) and Guatemala (13.1%). Furthermore, in contrast to most OECD economies, tax structures in LAC are more dependent on indirect than on direct taxes. Taxes on goods and services – mainly value added tax (VAT) and sales taxes – accounted for 49.8% of total tax revenues, compared to 32.7% in the OECD. In addition, while taxes on corporate income accounted for 15.5% of total tax revenues in LAC in 2018, the personal income tax (PIT) only represented 9.1%. In contrast to LAC, PIT accounts for a larger share of taxes in OECD economies (23.5% of total tax revenues), compared to corporate income taxes (CIT) (10.0% of total tax revenues) (OECD et al., 2021^[19]).

The combination of tax reliefs to address the COVID-19 pandemic and severe contraction in economic activity caused a significant decline in public revenues in LAC. Value added tax (VAT) revenues, a principal source of tax revenues for LAC, fell especially strongly in many countries, with year-on-year declines in real terms of 40% in May 2020. This was higher in Antigua and Barbuda, Chile, Costa Rica, Ecuador, Grenada, Honduras and Jamaica. Income tax revenues also registered significant declines in the first half of 2020, principally owing to the extension of tax relief measures as the liquidation of 2019 tax liabilities was deferred and advance tax payments were suspended. In some cases, forgone revenues were more than 1% of GDP. In Chile, it is estimated that revenues fell by 1.4% of GDP (DIPRES, 2020^[20]), similar to Peru (1.5% of GDP) (MEF, 2020^[21]). The effectiveness of tax relief was hampered, however, by the region's outsized informal sector and the limited participation of individuals and small and medium-sized enterprises (SMEs) in the tax and social security systems (OECD et al., 2021^[19]).

Tax measures were mainly aimed at strengthening health systems and supporting households, self-employed workers and firms. The region's underdeveloped health systems quickly became overwhelmed by the COVID-19 pandemic (OECD/The World Bank, 2020^[22]), and governments enacted measures to support them, primarily by aiming to reduce the cost of importing crucial medical goods. Because of the region's dependence on external suppliers, many countries applied temporary exemptions or zero ratings to medical supplies to respond to equipment shortages (e.g. of alcohol, laboratory items, gloves, disinfectant, equipment and other health supplies). In some cases, these measures were accompanied by the exemption of medical goods from VAT, for instance in Colombia, or by temporary deductions for PIT to incentivise direct donations to health systems.

Governments implemented tax reliefs to compensate for the decrease in income of households and among the self-employed. The most common of these tax measures were deferrals, suspensions of advanced payments and the creation of favourable tax payment facilities of the VAT and PIT, such as instalment plans with no interest or penalties. Several countries, including Chile, Colombia, Peru and Trinidad and Tobago, also implemented accelerated PIT refunds to provide further support. In some countries, including Argentina, Colombia, Costa Rica, Dominica, Guyana, Honduras and Saint Vincent and the Grenadines, households were also supported by VAT exemptions on essential medical supplies, products from the basic basket of consumption goods, and services such as electricity. In Colombia, a VAT refund scheme targeting 1 million families living in poverty was implemented, extending five payments of COP 75 000 (Colombian peso) during the year (OECD et al., 2021^[19]).

Similarly, tax relief for firms mainly consisted of temporary measures to bolster cash flow, especially in the early months of the crisis, through deferrals and suspension of

advance payments of VAT and CIT. VAT relief in particular played an important role in the region, especially for micro, small and medium-sized companies (MSMEs). In several cases, tax relief was targeted at MSMEs or sectors particularly affected by the crisis, such as construction, tourism and personal services. Countries also extended relief to firms by modifications to social contribution schemes, such as the *Programa de Asistencia de Emergencia al Trabajo y la Producción* in Argentina, which introduced a reduction of up to 95% of employer contributions to the Integrated Social Security System. In Brazil, payments to the Unemployment Insurance Fund were suspended, and contributions to the *Sistema S* system, which finances technical and vocational education, were reduced by 50% (OECD et al., 2021^[19]).

Looking forward, a set of tax policy options could increase revenues without compromising the economic recovery or well-being of citizens, but the sequencing of these policies, backed by a national consensus, will define its success (Mora, Nieto-Parra and Orozco, 2021^[23]). These include measures to reduce tax evasion and avoidance which cost Latin America around 6.1% of GDP in revenue, mainly in PIT, CIT and VAT receipts (ECLAC, 2021^[17]). Other options include policies to increase tax compliance, strengthen tax administration and eliminate tax expenditure that brings low benefits in terms of equity or job creation (overall tax expenditures averaged 3.7% of GDP in Latin America from 2015 to 2019) (OECD et al., 2021^[19]). Coupled with international measures to avoid tax base erosion and profit shifting by multinational enterprises (e.g. through the implementation of the OECD/G20 Base Erosion and Profit Shifting project), these measures have an additional benefit: they improve fiscal morale and therefore the credibility of institutions. The digital economy, and tackling the challenges it brings, is another key international tax challenge for the region (OECD et al., 2020^[24]; Mora, Nieto-Parra and Orozco, 2021^[23]).

Countries may need to consider additional ways of raising revenues to address structural shortfalls (OECD et al., 2021^[19]; Mora, Nieto-Parra and Orozco, 2021^[23]). The timing, speed and shape of these policies should be adapted to each country and closely linked to citizen consensus. While in OECD economies taxes and transfers contribute to the reduction of the Gini coefficient by approximately 16 percentage points, the comparable reduction in LAC is below 3 percentage points, on average (OECD, 2020^[25]; OECD et al., 2019^[6]). However, in most countries, once the recovery is underway, actions to broaden the PIT base, and specific actions among top deciles should be considered. PIT is the principal factor behind the tax gap between LAC and the OECD, limiting not only potential revenues but also the redistributive power of the tax system (OECD et al., 2021^[19]). Further action on specific taxes, including taxation of immovable property (Izquierdo and Pessino, 2021^[26]) and of individuals' capital gains, should contribute to increasing revenues to finance the recovery and improve the progressivity of the taxation system. Other measures include wealth and inheritance taxes (OECD, 2021^[27]), where their effective implementation requires improving the capacity of tax and statistics administrations (Mora, Nieto-Parra and Orozco, 2021^[23]). The international tax reform, backed by 130 countries (23 LAC countries), will provide needed revenues. The reform will ensure a fairer distribution of profits and taxing rights among countries with respect to the largest multinational enterprises, including digital companies, and put a floor on competition over CIT through the introduction of a global minimum corporate tax rate, which countries can use to protect their tax bases (minimum rate of at least 15%) (OECD, 2021^[28]).

As the recovery advances, there are tax policies the region has not fully explored. These include corrective taxes, such as environmental taxes. In LAC, on average, revenues from environment-related taxes amounted to 1.2% of GDP in 2019 (mainly energy taxes, most commonly from diesel and petrol), a lower level than the OECD average of 2.1% of GDP (OECD et al., 2021^[19]). Public health-related taxes, such as on consumption of tobacco, alcohol, sugar and beverages, can play a key role in shaping incentives for economic actors

to promote healthier diets, ultimately generating better health outcomes and reducing health-related costs. Measures to improve VAT efficiency by reducing the number and scope of exemptions and compensating the most vulnerable populations could be envisaged (OECD et al., 2021^[19]). The COVID-19 crisis presents an opportunity to rethink traditional taxation policy in LAC, focusing on long-standing gender biases in taxation schemes. For instance, tax systems generally do not account for how women take on a larger share of unpaid work, making the tax burden disproportionate at the household level. Tax reliefs for male-dominated economic sectors is another example of gender bias in fiscal policy (ECLAC, 2021^[17]).

Public spending should be countercyclical and with a long-term view enabled by capital expenditure

Public spending in the LAC region before the pandemic showed modest growth, with social spending and debt services on the rise. Public expenditure increased from 20.1% of GDP in 2010 to 21.5% of GDP in 2019. Overall, increases in public spending had been small, as many countries adopted fiscal consolidation policies to control a rise in public debt and there is low flexibility (OECD, 2020^[29]). The main changes occurred in the composition of expenditure and were mainly driven by the increase in debt services that followed the rise of public debt and in current expenditure, which reflects the growth in social expenditure. To offset the increases in debt services and current spending, capital expenditure fell, increasing the investment gap between LAC and other economies (ECLAC, 2021^[17]) and hampering productivity growth.

As a response to the COVID-19 pandemic, global current public spending increased significantly in 2020 to support public health systems, families and firms. In 2020, total central government spending in Latin America reached 24.7% of GDP, its highest level since the 1980s in the midst of the debt crisis. However, there remain significant differences across regions regarding the capacity to react to the crisis as the LAC region has, on average, adopted smaller-scale measures, compared to emerging Asia or advanced economies (IMF, 2020^[30]). This can be in partly explained by weak automatic stabilisers and a large vulnerable populations with no safety nets or social protection systems to fall back on once the crisis hit. There is strong heterogeneity across LAC countries: while Argentina, Brazil, Dominican Republic and El Salvador saw their central government primary expenditure rise by more than 20% in the first nine months of 2020, Costa Rica, Ecuador, Honduras and Mexico continued their fiscal consolidation and reduced public spending. The heterogeneity of responses to the crisis encompasses countries' policy choices, impact of the COVID-19 pandemic, previous fiscal stance, capacity to tap domestic and global financial markets, multilateral lending institutions and capacity of central banks. The majority of the increases in public expenditure (70%) were focused on current transfers as relief measures and social benefits.

Expenditure measures were particularly important and focused on health systems, households and small enterprises. To support the health system, many countries reallocated or increased expenditure to buy medical supplies, hire additional personnel or expand infrastructure. Measures to support household income included the design of new programmes – or the strengthening of existing programmes – of transfers targeted to unemployed informal workers and vulnerable groups (OECD, 2020^[31]). Examples of newly created transfers include *Ingreso Familiar de Emergencia* in Argentina, *Auxilio Emergencial* in Brazil, *Ingreso Familiar de Emergencia* in Chile, *Ingreso Solidario* in Colombia, *Bono Proteger* in Costa Rica (OECD, 2020^[29]), *Subsidio Pytyvõ* in Paraguay and *Bono Familiar Universal* and *Bono Independiente* in Peru (OECD, 2020^[25]). Transfers were also directed to formal-sector workers, as with the *Programa de Asistencia de Emergencia al Trabajo y la Producción* in Argentina (Chapter 2). Countries also expanded or complemented social

protection systems by expanding unemployment insurance (e.g. in Brazil, Chile, Ecuador, Mexico and Uruguay) and social security benefits, such as pensions (e.g. in Argentina, Colombia, Guatemala, Mexico and Paraguay). To support low-income households directly, in-kind support in the form of food packages and subsidies to cover the cost of basic household services (electricity, gas and water) were included.

In LAC, public spending was also directed to preserve productive capacity, with a special focus on MSMEs. The measures, subsidies and financing were mainly aimed to preserve employment and ensure that companies had sufficient liquidity, given the frequency of demand and supply shocks. Chile, Colombia, Peru and Uruguay adopted payroll subsidy programmes to protect employment. For example, Colombia established the *Programa de Apoyo al Empleo Formal* to provide a monthly subsidy, equivalent to 40% of the minimum wage, to assist with payroll costs for firms that could prove they suffered a 20% decline in revenues between February and March 2020. In Guatemala, Mexico and Panama, business subsidies were established to offset operation expenses related to the purchase of supplies needed in the agricultural sector. Some countries also used below-the-lines measures, such as the provision of special lines of credit and the capitalisation of state-owned financial institutions, to ensure that firms had access to necessary liquidity. For instance, Brazil expanded the Brazilian Development Bank's (the BNDES's) financing programmes. Chile made a large capital injection into the *Fondo de Garantía de Pequeños Empresarios*. In Colombia, Bancoldex launched new credit lines. The *Reactivate Ecuador* programme provided credit to MSMEs at a preferential rate. Peru established a new programme as part of the *Reactiva Perú*, where treasury-guaranteed credits were supported by a contribution by the central bank. Some countries, for instance Argentina and Peru, implemented productivity support programmes by financing R&D projects, promoting digitisation and entrepreneurship.

To avoid putting lives at risk and to ensure a strong and inclusive recovery, public expenditure must be implemented efficiently through a well-defined sequencing of actions (Mora, Nieto-Parra and Orozco, 2021^[23]). As resources are scarce, the region must seek to reallocate expenditure from inefficient to efficient uses, for instance addressing leakages in social transfers or fraud, corruption and waste in government procurement (Cavallo and Powell, 2021^[16]; OECD, 2020^[32]) or increasing the share of government spending subject to public procurement (OECD, 2020^[29]). In the short term, and as long as the pandemic continues to put lives at risk, the priority should continue to be to protect people, support the most vulnerable families and save firms and jobs. Vaccination is key to secure an exit from the pandemic and reduce the uncertainty of stop-and-go confinement measures. Additionally, countries should continue to support social assistance, aiming to design mechanisms that promote long-term economic effects. For instance, there is evidence that targeted cash transfers, especially conditional, can spur investment in child schooling (OECD, 2019^[33]). Similarly, public spending should continue to support human and productive capacity development and protect viable MSMEs. It remains crucial to be aware of the gender-differentiated impacts of the crisis, as well as the lack of gender neutrality of traditional fiscal policy. Identifying and eliminating present biases that hamper non-discrimination and tackling the root causes of gender discrimination would support a more inclusive recovery (ECLAC, 2021^[17]).

Once the pandemic begins to be under control, the focus of public spending should gradually shift. Public spending should gradually be reallocated from general to targeted support – with a focus on the sectors that need it the most – and from current to capital expenditure (Mora, Nieto-Parra and Orozco, 2021^[23]). Traditionally, 80% of public spending in LAC is concentrated in current expenditure, and just 20% in capital expenditure (OECD et al., 2019^[6]). As a result, the region lags behind other regions in terms of gross capital formation. Before entering the COVID-19 crisis, the gap was 4 percentage

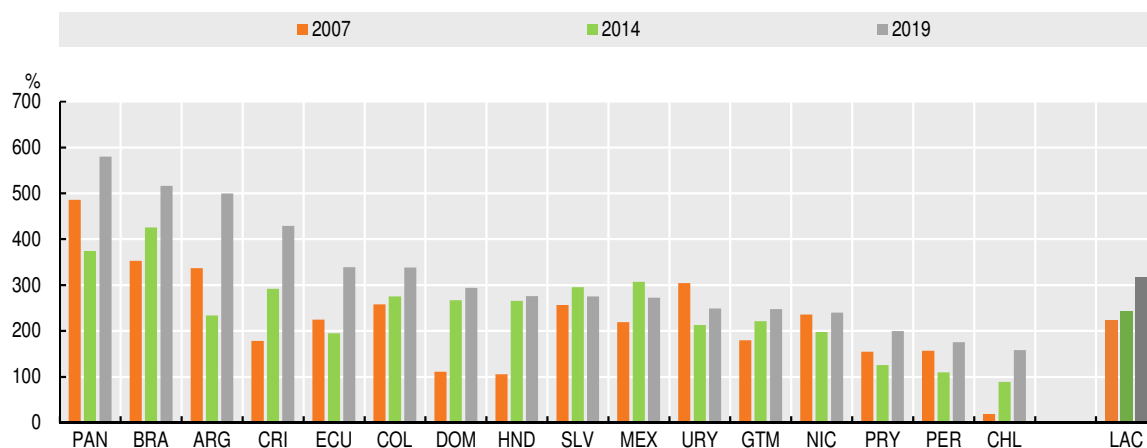
points of GDP vis-à-vis advanced economies and more than 21 percentage points of GDP against emerging and developing Asian countries (IMF, 2021^[10]). More and better capital expenditure is fundamental to a robust recovery and to drive the infrastructure investments (including in digital and green technologies) needed to promote quality jobs and a production transformation that has the environment at its centre. Furthermore, especially concerning infrastructure, capital expenditure has a high multiplier effect (as high as two) in both economic activity and employment (Izquierdo and Pessino, 2021^[26]). Last, LAC must gradually return to fiscal frameworks, including fiscal rules to safeguard investment; ensure clarity, efficiency and equity of expenditure; and add adequate escape clauses for exceptional events (Mora, Nieto-Parra and Orozco, 2021^[23]).

Debt management and increasing available resources without compromising tomorrow: The role of international co-operation

The COVID-19 crisis has adversely affected the already vulnerable fiscal position of LAC countries. In 2020, the average overall deficit in Latin America reached almost -7% of GDP (ECLAC, 2021^[17]). This is considerably higher than the 2019 average deficit of -4% of GDP or the 2009 average fiscal deficit of -3.6% of GDP that resulted from the global financial crisis. The historically high fiscal deficits in the region are mainly linked with the fall in tax revenues due to lower economic activity and the tax measures to confront the pandemic, combined with the implementation of expenditure packages, including current transfers to support families and firms. This fiscal strain arrived at a time when LAC economies were already undergoing fiscal adjustments, and growth was anaemic at best (OECD, 2020^[25]; IMF, 2020^[30]).

Deep fiscal deficits have resulted in a strong increase in public debt and debt service, accentuating an already existing trend. In 2020, central government gross public debt averaged 56.3% of GDP, an increase of 10.7 percentage points over 2019 (ECLAC, 2021^[17]). The public debt-to-tax ratios, a proxy indicator of countries' financial capacity to pay for the public debt, also increased in most countries, leaving them in a weaker position to face the COVID-19 crisis than they were in 2007, before the 2008 financial crisis (Figure 1.6). The debt-to-tax ratio is expected to increase considerably in 2021, given the fall in tax revenues and the increase in public debt, leaving the region in an even weaker position to face future shocks (ECLAC, 2021^[17]).

Figure 1.6. Gross public debt-to-tax ratio in selected Latin American countries



Source: OECD/ECLAC/CAF/EU based on official data (2019); and (OECD et al., 2021^[19]).
 StatLink <https://doi.org/10.1787/888934286350>

Strong debt increases in 2020 illustrate how, despite the global crisis, financing opportunities have remained available for the region. Sovereign debt issuance in international markets rose by 45% in the first ten months of 2020, as some countries were able to tap international markets, often on favourable terms, to cover their increased financing needs and, in some cases, pre-finance their 2021 budgets. Most of the debt issuance came from the public sector (ECLAC, 2020^[34]). This has been possible as emerging markets have benefited from the monetary policy responses and the subsequent liquidity expansion carried out by major central banks in developed countries. In particular, financing costs have substantially fallen in Colombia and Mexico, with yields on ten-year benchmark bonds dropping by 1.55 and 1.16 percentage points respectively, between December 2019 and December 2020. Those were larger decreases than those experienced in OECD countries (OECD, 2021^[5]). In a context of ample liquidity and low global interest rates, LAC central banks have been able to lower their policy rates as an alternative response to fiscal policy to sustain aggregate demand. Additionally, thanks to the global liquidity expansion, financing costs remained low in many LAC countries. Emergency financing from international financial institutions (IFIs) was also significant, especially for countries with little to no access to international financial markets. IFIs extended USD 47.8 billion in new credit, while also redirecting existing credit lines (ECLAC, 2021^[1]).

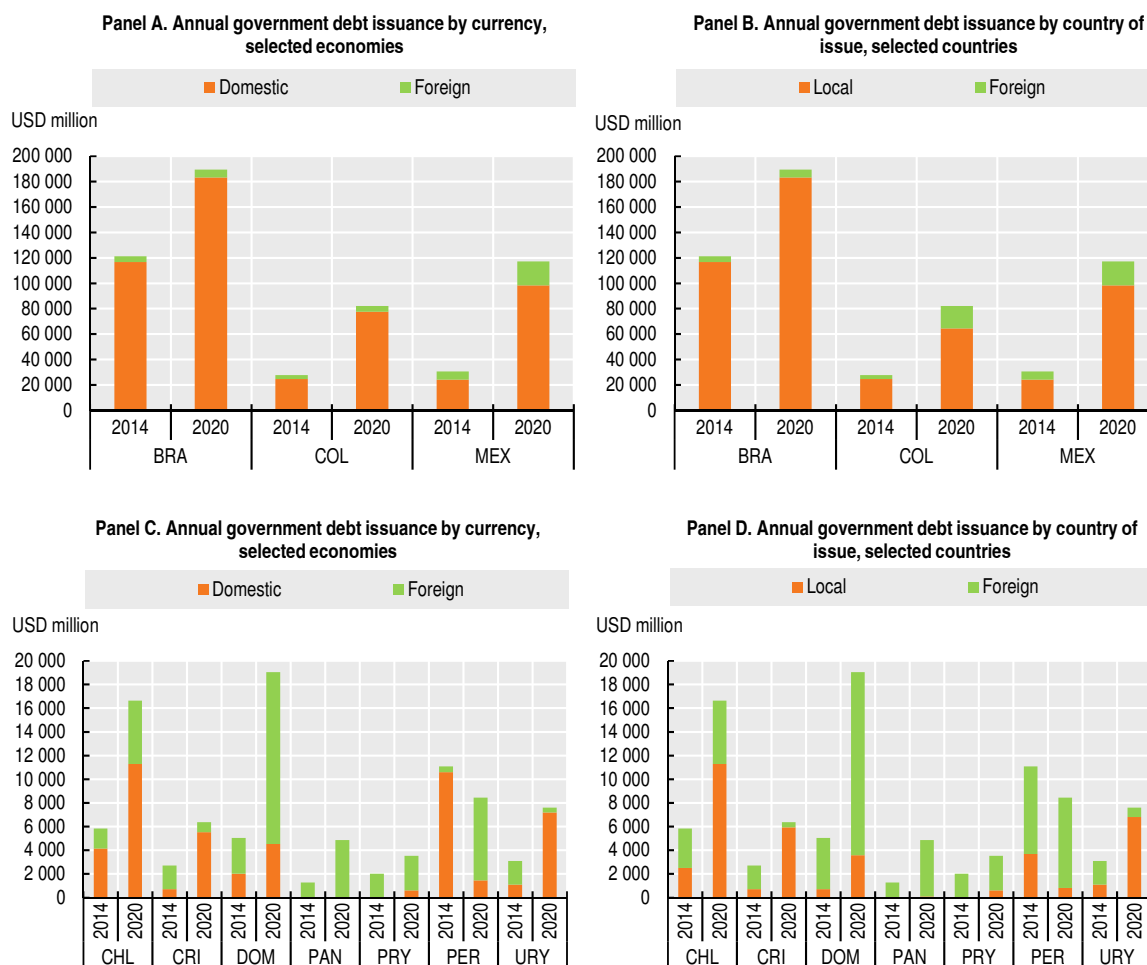
While the increase in debt issuance in 2020 is common to most LAC countries able to finance their expenditure through the issuance of bonds, differences persist in their relative capacity and conditions to secure financing. Interestingly, given the persistent liquidity in global financial markets and investors' increased appetite for risk, LAC countries have also been able to make greater use of their own currencies and markets to issue bonds. In particular, LAC countries that issue bonds mostly in domestic currency have been able to use local markets for their debt issuance (e.g. Brazil, Chile, Colombia, Costa Rica, Mexico and Uruguay). This greatly reduces the risk of debt sustainability crises and enables the possibility of raising more resources as the policy options to resolve domestic debt issues are more varied than those that deal with external debt (Kose et al., 2021^[35]). Other countries issue debt mostly in foreign currency and in foreign markets (e.g. Panama, Paraguay and Peru) (Figure 1.7). These heterogeneities in debt issuance mechanisms will prove important in determining potential future risks, especially as countries' needs for resources to finance the recovery increase.

In the medium term, debt ratios in LAC should stabilise, but at higher levels than before the crisis. With abundant liquidity, international capital markets seem more willing to admit larger debt ratios at this point, and there is still access to capital flows. However, conditions may change rapidly in the medium term if, following large stimulus packages, monetary policy normalises in advanced economies. Additionally, in this uncertain context, risks of a sudden stop – an abrupt reduction of net capital inflows – remain. Important determinants of systemic sudden stops are domestic liability dollarisation, fiscal deficits and current account deficits. The first two have gravely deteriorated owing to the COVID-19 shock, and the third is expected to widen with the recovery. If this were to happen, debt sustainability could be affected, a situation that could lead to debt crises in the face of issuer or creditor inaction, making the global scenario even more complicated and highlighting the importance of globally co-ordinated debt management (OECD, 2020^[25]; Nieto-Parra and Orozco, 2020^[35]).

Given the global implications of the pandemic and as the financial resources needed to address its consequences increase, global co-ordination of public debt management should be a priority to avoid or address possible debt sustainability issues (OECD, 2020^[25]). The compounded nature of the COVID-19 shock can raise the risk of public debt and currency crises, which threatens plans to respond to the crisis and to build back better. The recovery will depend on continued policy support; therefore, this might be the time

for the international community to innovate regarding foreign debt instruments (Breuer and Cohen, 2020^[36]), especially given the investments needed to pursue the Sustainable Development Goals (SDGs) and the 2030 Agenda (UNCTAD, 2020^[37]).

Figure 1.7. Annual government debt issuance in selected LAC countries by currency and by country of issue



Note: Annual government debt issuance refers to total active government bond issuances including re-openings.

Source: OECD/ECLAC/CAF/EU based on Refinitiv.

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There is no unique solution to ensure the necessary funds to fuel the recovery or to ensure against possible debt sustainability issues in LAC, but in many cases the economic recovery will require supportive international co-ordination, enabling debtor countries' continued ability to conduct countercyclical macroeconomic policies to respond to the crisis (UNCTAD, 2020^[4]). Possible solutions to financing challenges will depend on countries' initial characteristics and their access to markets; however, these solutions must target restoring the region's capacity to service debt through investment, output and export growth rather than through expenditure, income and import contraction (UNCTAD, 2020^[4]). Historical examples provide lessons for facing today's public finance challenges, for instance the outcome of the long 1980 debt crisis resolution process in the region (Box 1.2).

Box 1.2. Waves of debt crises: A historical perspective

The history of world economic crises confirms that economic recovery is never uniform. A historical case of unequal recovery from an economic downturn is the one observed during the 1980s. For Latin America, this decade exhibited sluggish economic growth, higher inequality and rising poverty (Székely and Montes, 2006^[48]). It followed a period of upsurge in economic growth that had lasted at least a couple of decades. During the late 1970s, governments in poor countries had increased their level of public indebtedness. This debt stemmed mainly from loans granted by Western commercial banks, with interest rates that varied according to the interbank rates in the main creditor countries. In 1979, the Federal Reserve increased its interest rate to face mounting levels of inflation in the United States. A declining rate of economic growth in developed countries during the early 1980s was then accompanied by a fall in the prices of oil and other commodities, triggering a fall in export revenues in developing countries and a general rise in the cost of governments' debt service.

For some scholars, the severe economic and social costs that followed could have been averted if management of the crisis had been different (Diaz-Alejandro, Krugman and Sachs, 1984^[49]). Several governments in developing countries restructured debts and adhered to adjustment programmes, while banks granted new loans through additional, albeit involuntary, lending to support the adjustment efforts (Devlin, 1989^[50]). These short-term solutions, framed to face a liquidity rather than a solvency crisis, were followed by successive rounds of restructuring between 1984 and 1986 (Vasquez, 1996^[51]). After 1985, as economic growth continued to struggle owing to deteriorating terms of trade and a decline in public expenditure, rescheduling and renewed financing began to be formally linked to economic growth in borrowing countries as part of what became known as the Baker Plan. Accordingly, access to a new loan package from banks and from multilateral and bilateral lenders was made contingent on the evolution of oil prices (in the case of Mexico) and a pre-fixed targeted economic growth rate, which had to be attained through liberalising economic reforms.

The outcome of lengthy negotiations and lack of debt relief is illustrated by the evolution of the ratios between total interest payments and exports, which remained relatively high during the first years of the crisis. The average for Latin America was 41% in 1982 and only slightly declined to 35% in 1985. A certain amount of debt relief was granted only after 1989 with the implementation of the Brady Plan.

The Brady Plan sought to reduce commercial bank debt while providing banks with the possibility of increasing or reducing their exposure to each debtor. This “menu” approach included the exchange of loans with newly issued bonds, with a change of face value, according to new capital provision and risk taking. One option included the conversion of loans to bonds securitised by US Treasury Bonds and financed by Mexico's own reserves and by loans from international financial organisations. Successive Brady deals differed in terms of debt reduction and new money provisions and were adopted by 18 countries. According to (Cline, 1995^[52]), the typical deal led to 30% to 35% forgiveness of a country's debt.

There is strong disagreement among scholars regarding the benefits of the Brady Plan and whether the debt relief granted was sufficient to guarantee a healthy growth process and to raise the creditworthiness of each country. For (Rogoff, 1993^[53]), plans such as the Brady Plan were more beneficial to the banks, as they raised the value of the remaining debt in their portfolios. While the Brady plan effectively reduced the indebtedness ratio for all countries, it increased thereafter. According to (Cline, 1995^[52]), economic performance in the post-Brady years was better in terms of price stability, economic growth and lower interest rates. In fact, the plan allowed firms and governments to return to the market, most of the time under favourable terms (Buckley, 1998^[54]).

For countries with little to no access to capital markets, it remains important that official support be directed towards them. So far, and to ease financial pressures, the G20 has supported low-income countries by suspending their debt service payments on bilateral government loans until December 2021. The International Monetary Fund (IMF) has also provided financial assistance and debt service relief for numerous countries thanks to, for instance, increases in rapid credit facilities, rapid financing instruments and flexible credit lines across income levels. These welcome measures have offered a temporary respite for more than 100 countries during the pandemic.

However, much-needed support for middle-income countries (MICs), many of which belong to the LAC region, remains largely missing in the international agenda. Even though MICs will benefit from the recent Special Drawing Rights (SDR) issuance agreement, that so a historic allocation equivalent to USD 650 billion (about SDR 456 billion), from which which SDR 193 billion (about USD 275 billion) will go to emerging markets and developing countries. Access to further multilateral financing is important for MICs, as the risk of decline in international private financing remains (Ocampo, 2021^[38]). Among ideas proposed in this framework is to offer extraordinary liquidity to developing countries through the creation of liquidity funds. One example is the proposed Fund to Alleviate COVID-19 Economics, which would be capitalised with funds from developed countries channelled through multilateral institutions (ECLAC, 2021^[17]).

For countries that might have access to capital markets but still face high debt costs due to potential downgrades in credit ratings or low future growth expectations, there are several policy options, including debt standstill/moratorium, debt relief, lengthening of maturities to limit short-term refinancing risk (OECD, 2021^[5]), creation of a special vehicle to finance the crisis or pay the debt, and greater use of SDRs. In particular, either a new issue of SDRs or a reallocation of existing SDRs could be a vehicle to increase liquidity in an efficient manner, both in LAC and in developing economies, without increasing debt (ECLAC, 2021^[17]). However, a long-term view – beyond the COVID-19 crisis – is important. SDRs remain underutilised as international community instruments, which calls for a discussion on their fundamental frameworks and traditional allocation (Ocampo, 2021^[38]). The former require international co-operation, involving multilateral banks, developed countries or private creditors (OECD et al., 2020^[24]; Nieto-Parra and Orozco, 2020^[35]; Bolton et al., 2020^[39]). So far, private creditors have remained uninvolved, and some countries have decided not to participate in international programmes to avoid possible downgrades in their credit ratings (OECD, 2021^[8]).

Last, countries that already enjoyed ample fiscal sustainability must retain access to capital markets with low-risk premiums that allow them to raise funds needed to respond to the crisis. For countries in the region to reinforce their debt management capacities, accurate debt transparency, as well as technical assistance, should also be pursued at the international level (OECD, 2021^[8]; Subacchi, 2020^[40]).

Regarding debt restructuring mechanisms, strong co-ordination with bondholders and capital market stakeholders is crucial to minimise reputational risk (i.e. future access to capital markets). Recent debt restructuring experiences in Argentina and Ecuador show the importance of including Collective Action Clauses in sovereign bond contracts (OECD et al., 2020^[24]). Even though the use of existing mechanisms is welcome, going forward, it is important to rethink international sovereign debt restructuring procedures to go beyond Collective Action Clauses (Ocampo, 2021^[38]).

To facilitate a strong and inclusive recovery, LAC economies can use innovative policy options with social or environmental scope to meet their financing needs. For instance, debt-to-COVID, debt-to-SDG, debt for climate or debt for nature swaps could be implemented. Debtor governments and lenders, including private creditors, would benefit

as debtor countries channel planned debt service payments into national COVID-19 mitigation measures, SDGs or climate- or nature-related investments (UN/DESA, 2020^[41]; Steele and Patel, 2020^[42]). Likewise, the implementation of social and environmental sustainability-linked “green” bonds would tie sustainable foreign financing with SDG commitments. This would allow countries to raise much-needed financial resources to deal with the COVID-19 crisis while also committing to the achievement of the SDGs (Caputo Silva and Stewart, 2021^[43]). Mexico recently became the first country in LAC to issue a bond linked to the fulfilment of the SDGs: EUR 750 million at an interest rate of 1.35% (ECLAC, 2021^[17]).

Countries vulnerable to climate change (as are most LAC countries) are associated with unfavourable credit ratings and are deemed by lenders to have a higher debt default probability than countries that are more resilient to climate change. In a time when the region must pursue a sustainable recovery from the COVID-19 crisis, LAC countries with limited fiscal space may benefit from alternative policy instruments that deploy resources to fight climate change while reducing debt burdens, debt costs and pressure on fiscal balances (Cevik and Tovar Jalles, 2021^[44]). Last, future debt instruments that include “insurance-like” clauses while rearranging payouts to creditors conditioned on the debtor country’s economic performance would provide some relief (Breuer and Cohen, 2020^[36]; OECD, et al.^[24]). Namely, in the Caribbean, where countries are highly exposed to natural disaster risks, hurricane clauses should become the norm in order to improve debt repayment capacity. In Grenada, the implementation of such clauses has reduced debt levels (ECLAC, 2021^[17]).

In the case of economies such as those of the Caribbean, the recurrent exposure to natural hazards and their devastating social and economic effects can worsen the financial situation and lead to debt distress. Hurricane clauses enable the deferral of principal and interest payments or the possibility of fast-tracking debt restructuring operations in the event of a hurricane (or other insured natural disaster).

LAC economies must gradually return to their fiscal frameworks and undertake the necessary steps to ensure clarity and efficiency of expenditure. Fiscal rules, a key component of fiscal frameworks, are essential to reduce or reverse a LAC characteristic of procyclical behaviour of fiscal policy (Vegh and Vuletin, 2014^[45]; Alberola et al., 2016^[46]) and to protect public investment. As an exceptional measure, many countries in the region suspended their rules in order to undertake strong fiscal expansions. As the pandemic recedes and countries reduce public spending, and to avoid a long-term impact in future fiscal consolidations, returning to their fiscal frameworks or implementing fiscal rules can be a useful tool to protect public investment, boost investor confidence and thus add a growth-enhancing dimension (Ardanaz et al., 2021^[47]). These fiscal rules must be clear and transparent and ensure escape clauses for exceptional measures.

Social effects of the COVID-19 crisis. Protecting businesses, jobs and livelihoods in LAC

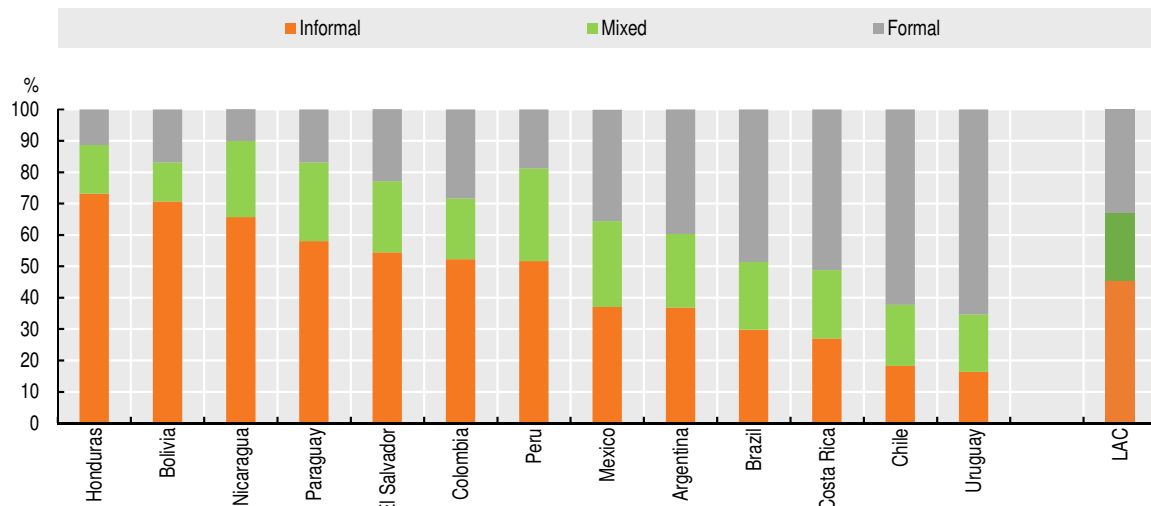
Income losses translated into worsening living conditions, as well as substantial increases in unemployment, poverty and inequality (ECLAC, 2021^[18]). The dramatic drop in income in the LAC region concentrates among the most vulnerable sectors. The informal economy, for example, is the primary source of job losses across all LAC economies. Households dependent on informal income or on sectors with lower labour income were unprotected from losses due to confinements, restrictions and other interventions.

The crisis triggered the closure of thousands of businesses, destroying millions of jobs, especially in the informal sector

Latin American labour markets have traditionally been informal, fragile and exclusive. More than half of LAC workers hold informal jobs (OECD, 2020^[25]). “Informal households” – those depending on the informal economy for their earnings – are the most affected by the COVID-19 crisis, facing loss of employment and labour income. On average, almost half (45%) of the LAC population live in households that depend solely on informal employment, 22% live in mixed households and 33% live in completely formal households (OECD, forthcoming^[56]). Still, according to the OECD Development Centre Key Indicators of Informality Based on Individuals and their Households (KIIBIH), informality levels in LAC countries exhibit wide heterogeneity, from less than 20% in Chile and Uruguay to more than 60% in Bolivia, Honduras and Nicaragua (Figure 1.8).

Figure 1.8. More than half of Latin Americans live in completely informal or mixed households

Distribution of overall population by degree of informality of households (%), 2018 or latest available year



Note: Using the classification by the (OECD/ILO, 2019^[56]) individuals are assigned to one of three categories according to the degree of informality of their household. Formal households: all working members are formally employed. Informal households: all working members have informal employment. Mixed households: some working members of the household have formal jobs and others have informal jobs.

Source: (OECD, forthcoming^[56]), *Labour Informality and Households' Vulnerabilities in Latin America* (provisional title).
StatLink <https://doi.org/10.1787/888934286388>

Programmes targeted to those most affected need to consider the overall household dimension. The well-being of individuals living in households that are completely in the informal economy differs, sometimes significantly, from those in “mixed-status” or entirely in the formal economy. There is segmentation at the household level and it highlights the relevance of distinguishing “informal households that depend entirely on the informal sector” and “mixed” households with a mix of formal and informal revenues, when designing policy interventions. Both informal and mixed households represent an important share of the population.

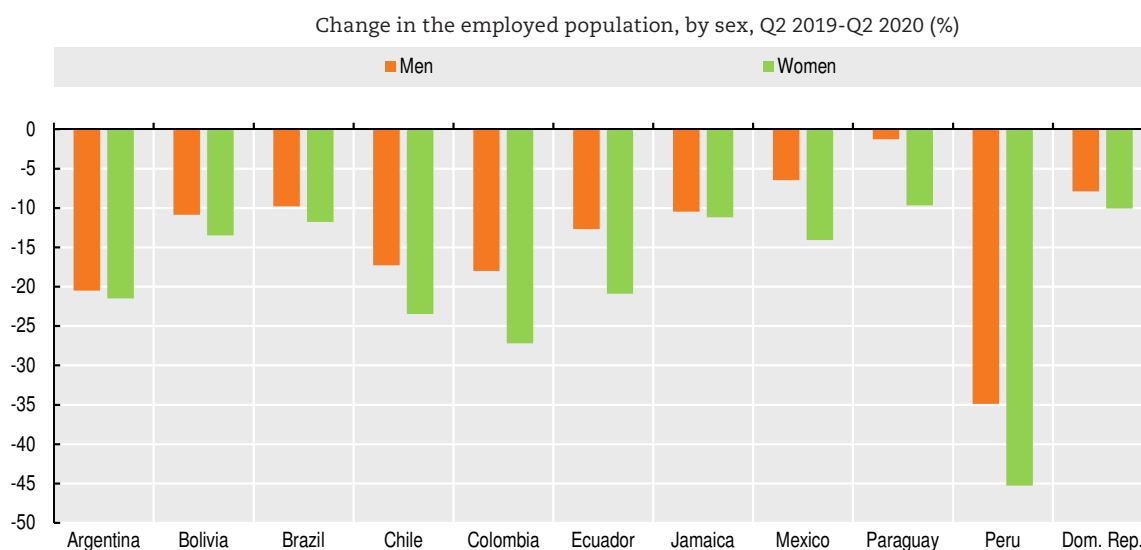
A household perspective on informality is needed to capture the level of income poverty and income insecurity among informal workers, measure the capacity to pay for social protection, identify the possibility of accessing social protection through household members working in the formal economy, and assess the extent to which informal workers' vulnerability is passed on to their dependants (OECD, forthcoming^[56]).

Owing to the lack of social protection or better labour conditions, informal workers are trapped in a vicious cycle, which keeps them vulnerable. In countries such as Bolivia, Ecuador, Paraguay and Peru, the differences between informal and formal workers living in poverty or vulnerability are significant. Informal workers not only have less or inadequate access to social protection, but their income instability prevents them from investing in human capital and moving into higher productivity jobs (OECD et al., 2019^[6]).

The pandemic and its consequences led to significant setbacks in several labour indicators, including employment contraction (ECLAC, 2021^[3]). The most affected were women and young people who, in addition to being highly affected by job losses, had to dedicate intensive time to unpaid care work given the limited functioning of education facilities and care services for dependent populations (Figure 1.9). In addition, the most vulnerable populations in the region, such as Afrodescendants, indigenous peoples, migrants and people with lower education levels, often work in the informal sector, which came to an almost complete halt during the confinements.

Pre-existing structural challenges, such as the digital divide and unequal access to finance, also affect informality levels and increase inequality. The digital divide has exacerbated inequality in the region, disproportionately affecting informal workers. Inequality arising from the pandemic is first and foremost evident in the ability to work from home, which is correlated with level of income. Lack of digital skills and infrastructure impede informal workers from working from home and from the overall benefits of the digital transformation (OECD et al., 2020^[24]). Similarly, informal households may lack access to the financial system, impeding them from obtaining a loan to invest or to smooth consumption. In fact, lack of access to financial system services (loan, banking account) can hold back growth for informal enterprises and could hinder formalisation (OECD/ILO, 2019^[56]).

Figure 1.9. COVID-19 job losses are substantial across the LAC region, affecting women more than men



Note: Data for Argentina include only 31 urban agglomerations. Data for Bolivia include only urban areas. Data for Ecuador are for June 2019 to May/June 2020. Data for Jamaica are for July 2020. Data for Mexico are for May 2020.

Source: (ECLAC, 2021^[18]), *Social Panorama of Latin America 2020*, www.cepal.org/es/publicaciones/46687-panorama-social-america-latina-2020.

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Millions of vulnerable Latin Americans have fallen into poverty and extreme poverty, while inequality gaps continue to widen in the region

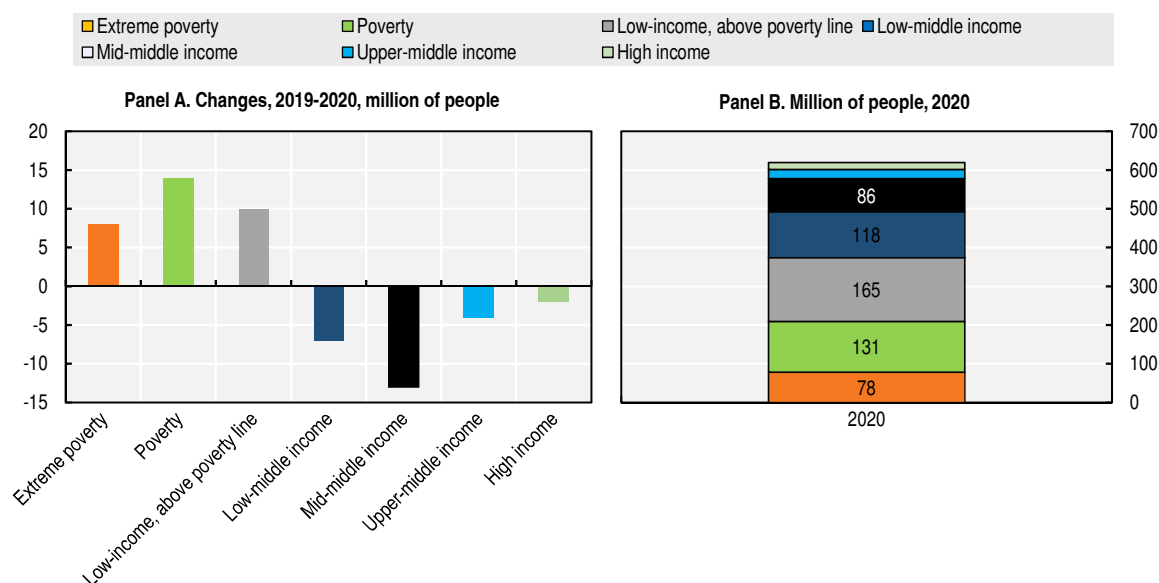
The COVID-19 crisis has shattered some of the last decade's progress in eradicating poverty and inequality. Over the past few decades, governments in LAC have considerably reduced poverty, lifting around 42 million people out of poverty between 2004 and 2019. Before the crisis, around 30.5% of the total LAC population were living in poverty (187 million people), and 11.3% were living in extreme poverty (70 million people). As a result of the COVID-19 crisis, the extreme poverty rate in 2020 reached 12.5% and the poverty rate 33.7%. These poverty levels have not been seen for the past 12 years – 20 years in the case of extreme poverty (ECLAC, 2021^[18]).

The crisis affected vulnerable groups, reducing jobs and income. The job and consequent income losses resulting from the COVID-19 pandemic have led to increases in poverty, a reduction of the middle class and an increase in inequality. Those most affected by job losses were in the first quintile, as the proportion of those workers who stopped earning labour income (based on 2019 incomes) increased by 5.7 percentage points, a value that decreases considerably in subsequent quintiles. In the richest quintile, the increase is 0.7 percentage points. Similarly, for those who retained their jobs, loss of income represents an estimated 15% contraction in the average labour income. For workers in the first quintile, for 2019, the estimated reduction is 42%, while for those in the fifth quintile, it is about 7% (ECLAC, 2021^[18]).

Negative job and income dynamics have reduced the middle class and threaten to deepen existing social and economic gaps in an already highly unequal region. The number of people living on low incomes (vulnerable, poor and extremely poor) has grown dramatically, with 32 million more people than before the crisis. By contrast, people earning lower-middle income decreased by 7 million people, those with mid-middle income by 13 million (13.1%), those with upper-middle income by 4 million (14.2%), and those with high income by 2 million (10.5%) (Figure 1.10).

To sum up, informal households are the most affected by the COVID-19 crisis, facing employment losses and labour income drops. The pandemic effects led to significant setbacks in several labour indicators, including employment contraction. The most affected groups are women and the region's most vulnerable populations, such as Afrodescendants, indigenous peoples, migrants and people with lower education levels. Structural challenges, such as the digital divide and unequal access to the financial market also affect inclusion in the labour markets.

Figure 1.10. The COVID-19 crisis has increased the number of people living on low incomes and shrunk the middle and upper classes



Note: Includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. Data refer to the definition of income strata, as specified by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC, 2021), Social Panorama of Latin America 2020 and (ECLAC, 2019), Social Panorama of Latin America 2019. The extreme poverty line represents the level of income that enables each household to meet the basic needs of all its members. The basic basket for measuring poverty is formed from a selection of food items, including the goods required to meet the nutritional needs, taking into account food prices in each country and geographical area. The amount required by households to satisfy basic non-food needs is then added to define the poverty line. Low-income non-poor are those households with per capita income of up to 1.8 times the poverty line; the low-middle stratum, the mid-middle stratum, the upper-middle stratum are defined as having, respectively, a per capita income of up to 3, 6 and 10 times the poverty line. The high-income stratum is defined as above 10 times the poverty line.

Source: Economic Commission for Latin America and the Caribbean based on Banco de Datos de Encuestas de Hogares (BADEHOG). Figures adjusted to United Nations population projections, *World Population Prospects 2019*, <https://population.un.org/wpp/> and estimates of poverty trends for countries whose measurements are not available for the years indicated. StatLink <https://doi.org/10.1787/888934286426>

Weak social protection mechanisms in the region failed to prevent the deep social crisis caused by the pandemic

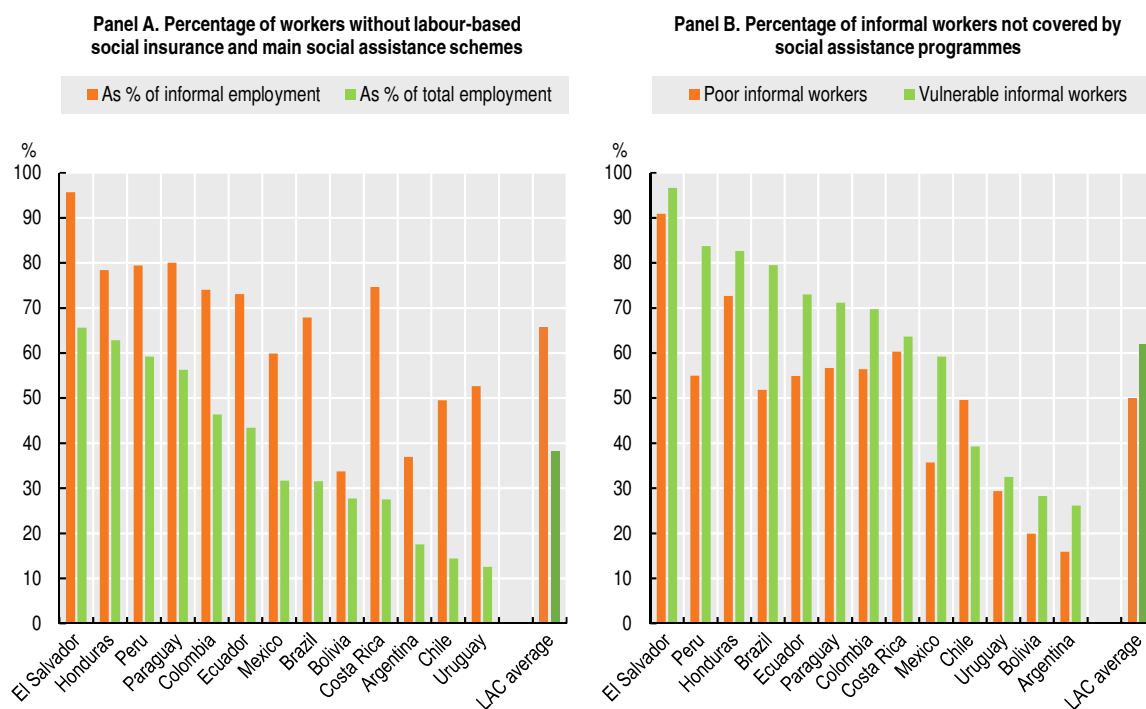
Owing to the lack of robust social protection mechanisms in LAC, millions of families working in the informal economy experienced a dramatic drop in income during the confinements. Following the contagion-containment strategy worldwide, LAC countries shut down their economies (OECD, 2020^[25]). However, while predominantly formal OECD countries provided unemployment insurance to their populations and supported enterprises to avoid job losses, LAC countries entered the pandemic with millions of families and businesses unprotected by social security mechanisms. On average, in the LAC region, more than 60% of economically vulnerable and informal workers do not benefit from labour-based social protection or a social assistance programme [such as conditional cash transfers (CCTs); Figure 1.11, Panel A].

The LAC region has a long history with social assistance programmes, starting with exemplary cases such as *Bolsa Família* in Brazil or Mexico's CCT programme (*Oportunidades* and, before being discontinued, *Prospera*). However, even though social assistance programmes are widespread and have been of great help to many families, around 50% of poor informal workers do not benefit from social assistance (Figure 1.11, Panel B).

Moreover, the heterogeneity of uncovered families across countries is substantial, ranging from 97% of poor workers in El Salvador to 26% in Argentina.

Social protection in LAC needs to move towards strengthening financing mechanisms, making social contributions more flexible with a mix of non-contributory, contributory and voluntary programmes. Social security contributions as a percentage of labour costs are relatively high in the region. LAC countries' averages are similar to those of OECD countries and exceptionally high for the lowest deciles (OECD/IDB/CIAT, 2016^[57]). Reducing non-wage labour costs could encourage formal job creation, especially in the SME sector, thus supporting entrepreneurship. Similarly, shifting part of the tax burden from social security contributions to property taxes could also prove useful to reduce informality (OECD, 2020^[29]). However, a clear productive strategy is key to support those policies (Chapter 3). It could also improve citizens' perception of state social protection, thus strengthening incentives for formalisation and tax payment (OECD et al., 2019^[6]). Creating a social safety net decoupled from formal employment and financed through general taxation is one way to achieve this objective.

Figure 1.11. Due to the lack of social protection, informal workers face a much higher risk of falling into poverty in the face of adverse shocks than their formal peers



Notes: Regional average is an unweighted average. Informality definition is based on (OECD/ILO, 2019^[56]). The main social assistance programmes refer only to main CCT programmes and non-contributory social pensions, although the availability of data of beneficiaries in household surveys varies by country, which may result in non-comparable data that the harmonisation process cannot fully solve. In the case of Argentina and Brazil, these percentages are estimated based on social programme focalisation conditions. Owing to the systematic approach to produce internationally comparable data and the use of household surveys different from labour force surveys, informality estimates may differ from the estimates presented in other sources, including national statistics. These figures are subject to updates. Economic vulnerability refers to per capita income (PPP) USD 5.5-13 per day. Poverty refers to PPP lower than USD 5.5 per day.

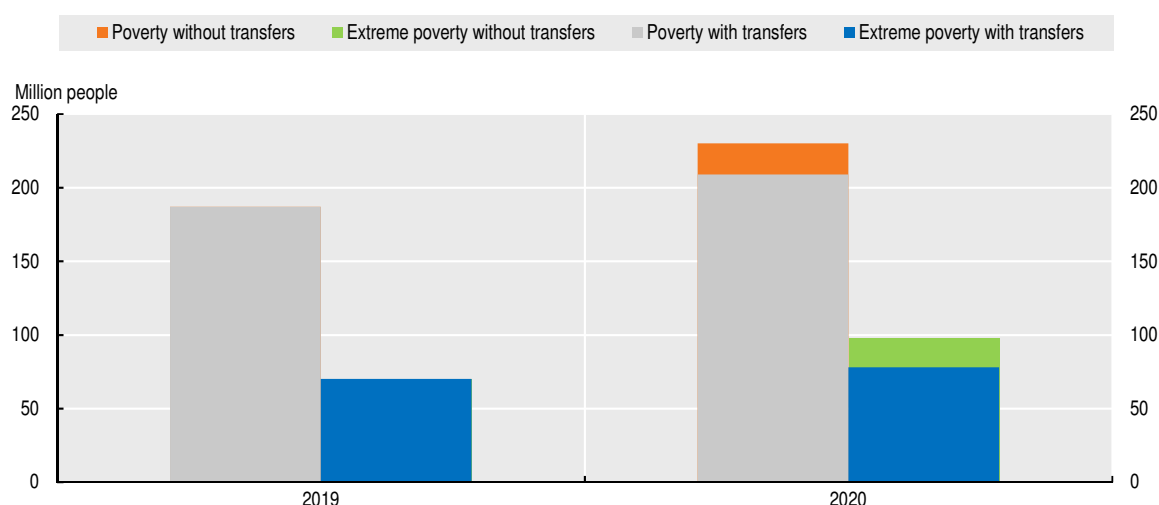
Source: Authors' calculations based on household surveys: Argentina: EPH 2018. Bolivia: Encuesta de hogares 2018. Brazil: PNAD 2015. Chile: CASEN 2017. Colombia: ENCV 2017. Costa Rica: ENH 2018. El Salvador: EHPM 2017. Ecuador: ENEMDU 2018. Honduras: EHPM 2014. Mexico: ENH 2018. Paraguay: EPH 2018. Peru: ENH 2018. Uruguay: ECH 2018.

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Without rapid and efficient policy actions, it could have been worse

Policy actions to support workers, households and firms helped reduce the negative effects of the COVID-19 crisis on poverty and inequality. Latin American countries implemented rapid, effective and well-targeted policies for the most vulnerable groups (see fiscal policy section above and Chapter 2). For instance, cash transfers helped reduce the effects of poverty; without them, it is estimated that the number of people living in poverty would have been 21 million more (up to 230 million people) and 20 million more in extreme poverty (up to 98 million) (Figure 1.12). Similarly, without government transfers to mitigate the loss of labour income, the Gini Index would have increased by 5.6% – higher than the recorded in 2019; instead of 2.9%.

Figure 1.12. Selected social indicators with and without cash transfers to address the COVID-19 crisis in 2020



Source: Authors' calculations based on (ECLAC, 2021^[18])
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Policy responses to the COVID-19 crisis provide the basis to move towards universal comprehensive and sustainable social protection systems. To respond to the crisis, governments reacted rapidly by adopting social assistance support targeted to vulnerable populations not covered by traditional social programmes or social protection mechanisms. Continuing to target vulnerable populations after the crisis and providing social protection are key conditions of a welfare state (Chapter 2).

Conclusions

The COVID-19 pandemic has exacerbated what was an already complicated scenario in the LAC region. The region entered the pandemic with persistent structural challenges (i.e. low productivity growth, vulnerable middle class, labour informality, weak institutions) and limited space for expansionary policies both on the monetary and fiscal front. Nevertheless, and despite the complications and challenges brought on by the pandemic, the crisis and its recovery have provided momentum and opportunity that could be propitious for undertaking the structural changes that will ensure a sustainable and inclusive development path for the region.

The economic recession has translated into worsening living conditions and substantial increases in unemployment, poverty and inequality, with the most vulnerable paying a

heavy toll. Informal workers have been the most affected, as lack of social protection or poorer labour conditions leave them more exposed. The crisis highlighted the need and opportunity to increase the coverage and quality of social protection systems.

So far, demand policies have been at the core of the response, supporting public health systems, households and firms, and fiscal policy will play a crucial role for the recovery. In some countries and despite price increases, monetary policy should still continue to be supportive. However, its capacity remains limited and fiscal policy should play a larger role for a strong, inclusive and sustainable recovery.

To achieve this, co-ordinated actions on the fiscal front are essential. In particular, measures related to public spending, taxation and public debt management should be co-ordinated under a well-defined sequence of policies that can be adapted to the different stages of the recovery. Public spending should target most vulnerable populations and gradually be reallocated from current to capital expenditure, by taking into consideration the benefits of the digital transformation and by investing in the transition to a low-carbon economy. Mobilising the necessary resources will require a fiscal strategy that combines improvements in the structure of the taxation system, tax evasion and avoidance, and policies to increase tax compliance and to strengthen tax administration. In addition, new and innovative fiscal frameworks, including fiscal rules, should be implemented to ensure long-term fiscal sustainability. They should be clear, transparent and protect investment, with adequate escape clauses. Finally, national responses are not enough; the nature of this crisis and the interlinkages across countries require further co-ordination and co-operation at the international level. This is in particular evident in terms of public debt management.

Overall, there needs to be a consensus and national dialogue surrounding the timing and dimensions of required public actions. To achieve any structural changes, the political economy is more important than ever. Any structural reform must be done with the current context in mind and with a well-defined sequencing of actions. It also needs to be backed by a broad consensus built through national dialogue and clear communication (Chapter 4). However, some actions can be undertaken in the short term and can be highly effective, such as measures to reduce tax evasion and avoidance.

Box 1.3. Key policy messages

There is no unique approach or solution to ensuring that policies translate into a strong and inclusive recovery from the coronavirus (COVID-19) for Latin America and the Caribbean (LAC). The context-specific socio-economic characteristics of each country, coupled with the different impacts of the crisis, call for a tailored approach. However, some overarching considerations can help countries get their “policy menu” right and achieve a good balance between policies.

1. Implement effective and equitable vaccination strategies as a key element for recovery in the short term.
 - Ensure fast, effective and equitable vaccine rollout to enable the normalisation of economic activity at the national level.
 - Promote regional integration and international co-operation to foster research, development and production capabilities for vaccines and medicines in LAC.
2. Fiscal policy is at the core of the response to the ongoing crisis and will in large part determine how inclusive and strong the recovery will be. Despite highly varied national contexts, countries should consider some common factors and fiscal measures on the road to recovery.

Box 1.3. Key policy messages (cont.)

- A holistic fiscal response should make use of all fiscal policy tools. There are arguments for “bundling” reforms into a comprehensive package to build fiscal legitimacy in the region. Bundling reduces political constraints for fundamental reforms and addresses distributional issues.
 - Fiscal measures should be co-ordinated under a well-defined sequence of policies that can be adapted to the various stages of the recovery.
 - There needs to be a consensus and national dialogue surrounding the timing and dimensions of required public spending and taxes. A consensus can help renew the social contract.
 - Well-focused actions in terms of both expenditure and income should promote further progressivity and sustainable formal job creation.
 - New and innovative fiscal frameworks, including fiscal rules, should be implemented to ensure long-term fiscal sustainability. They should be clear and transparent and safeguard investment, with adequate escape clauses.
 - National responses are not enough. The nature of this crisis and the linkages across countries require further co-ordination and co-operation at the international level.
3. If possible, continue with an accommodative stance for monetary policy to support the recovery.
- Continue with the stimulative stance for monetary policy. If inflation remains under control and easy financial conditions persist, most central banks should be able to support the recovery by keeping interest rates low, although with less space.
 - Central banks with inflation-targeting regimes should closely monitor second-round effects that could drift expectations away from targets.
 - Continue to support, monitor and supervise the financial system.
4. Attract quality foreign direct investment (FDI), as it can spur inclusive and sustainable growth.
- Quality FDI can make important contributions to sustainable development by increasing productivity and innovation, creating quality jobs, developing human capital and improving living standards. Better and higher FDI should be part of a broader productive strategy.
5. Protecting the most vulnerable populations, in particular informal households, requires well-designed policies.
- Programmes targeted to those most affected by the crisis need to consider the household dimension. Segmentation at the household level highlights the relevance of distinguishing between completely informal and mixed households when designing policy interventions.
 - A household perspective on informality is needed to capture the level of income poverty and income insecurity among informal workers, measure the capacity to pay for social protection, identify the possibility of accessing social protection through household members working in the formal economy, and assess the extent to which informal workers’ vulnerability is passed on to their dependants.
 - Adopt policy actions that go beyond the social dimension to support formalisation. These include: i) promoting higher levels of financial inclusion, in particular of informal workers who do not have a bank account or cannot obtain a loan; ii) reducing the digital divide and increasing digital skills to make the most of new technologies;

Box 1.3. Key policy messages (cont.)

iii) improving government services; and iv) increasing the fiscal space to provide further targeted support to informal workers.

6. Finance social protection mechanisms while promoting job formalisation.

- Reduce non-wage labour costs to encourage formalisation, especially for low-income earners. Contributions to social security programmes are too costly relative to informal workers' incomes, especially for those at the lower end of the income distribution.
- Make use of the general taxation system to finance the expansion of social protection mechanisms.

Note

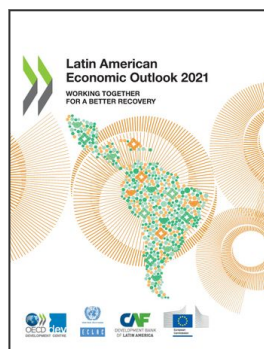
1. S&P reduced Chile's long-term issuance rating in March 2021 but maintained its investment-grade rating, and cut Colombia's sovereign rating to below the investment grade in May 2021 (OECD, 2021^[8]).

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