Guido di Tella Memorial Lecture: Economic Challenges to Latin America from the Pandemic

Talk given by

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The views are not necessarily those of the Bank of England or the Monetary Policy Committee. I would like to thank.

Introduction

Many thanks for the invitation. It is an honour to give the Guido Di Tella Memorial Lecture at the University of Oxford's Latin American Centre.

I had planned to give this lecture in person last year, before the arrival of the pandemic in the UK made that impossible. I am grateful that technology can still allow us to get together and remember the generosity of Guido Di Tella's contribution to public policy and his lasting legacy to political ideas, research and education.

Guido Di Tella was an extraordinary figure, and a role model for economists. He showed an unwavering commitment to public service, grounded on lucid scholarship and a deep understanding of the social, political and economic challenges that Argentina entailed. He understood better than anyone, that for Argentina to prosper, it was – and it still is – key to heal divisions and work through a road of consensus and cooperation, both within the country and with the rest of the world.

My talk today will focus on the current pandemic, more as a kick-off of a conversation than as a conclusive take on any of its complex dimensions. Latin America has been hit particularly hard by Covid-19, in terms of both health and economic outcomes. And limited capacity to use fiscal policy in many Latin American countries will make it hard to support the fast recovery that we're now expecting to see in advanced economies. That makes it even more important to use policy as effectively as possible.

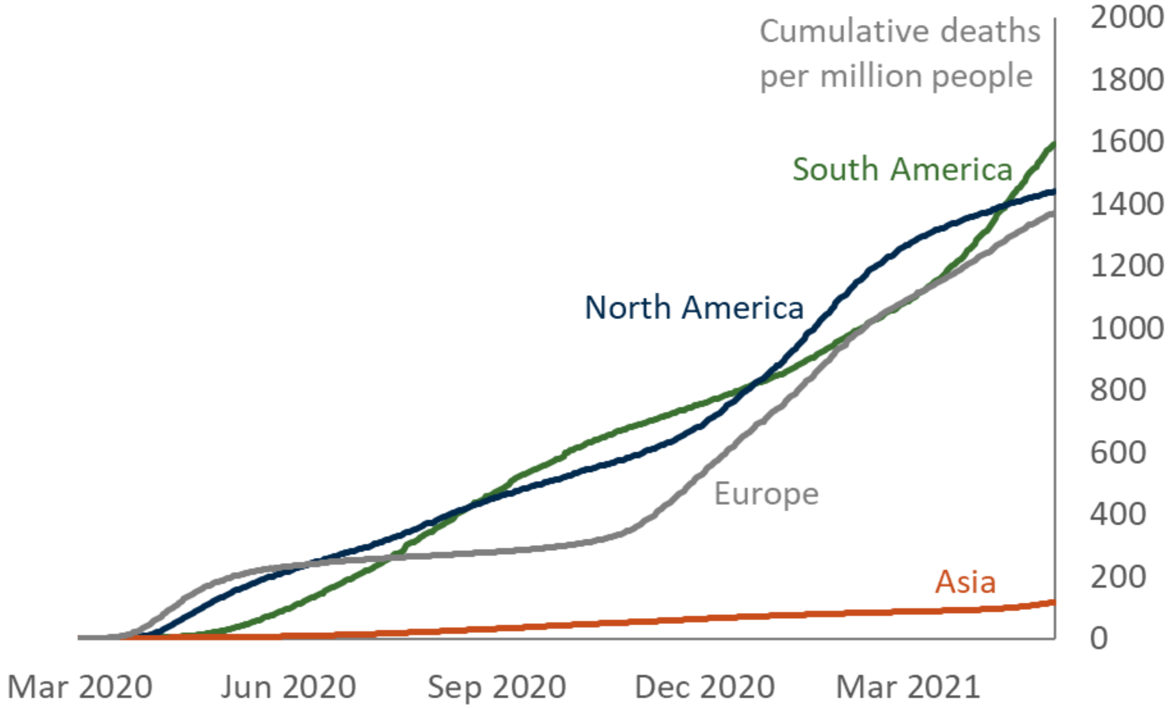
In that context, I want to make two points today. First, the key long-term challenge for policymakers everywhere at the moment is to minimise longer-term or permanent damage arising from Covid. This is imperative in Latin American economies, where that damage is likely to lead to higher levels of poverty. A key area – and one that was particularly close to Guido di Tella's heart – is education. While children across the world globe have suffered from lost educational opportunities during the pandemic, schools in many Latin American countries have been closed for more than most, hitting particularly hard those children from disadvantaged backgrounds that often don't have easy access to online education.

Second, monetary policy remains an important and powerful tool to stabilise Latin American economies, both in general and in the context of the recovery from the Covid-19 pandemic. Some countries have difficult inflation problems to solve. But many other Latin American countries have already built credible inflation targeting regimes. These countries can now reap the benefits of this institutional investment: Where inflation expectations are firmly anchored because monetary policy is credibly committed to price stability, economies are less likely to be derailed by spiralling inflation, and central banks have the discretion to use their tools in support of the economic recovery from the pandemic.

1 Looking back, the pandemic has hit Latin America particularly hard

Let me start by putting Latin America's experience since the start of the pandemic into a global context. The timing of different waves of the virus has differed across continents and across countries, but over the course of 2020 Covid-19's death toll has been broadly similar in North America, Europe and Latin America (**Chart 1**). Most Asian countries fared better, but the current wave in India may of course change that picture.

Chart 1: Covid-19 mortality has been high in Latin American countries

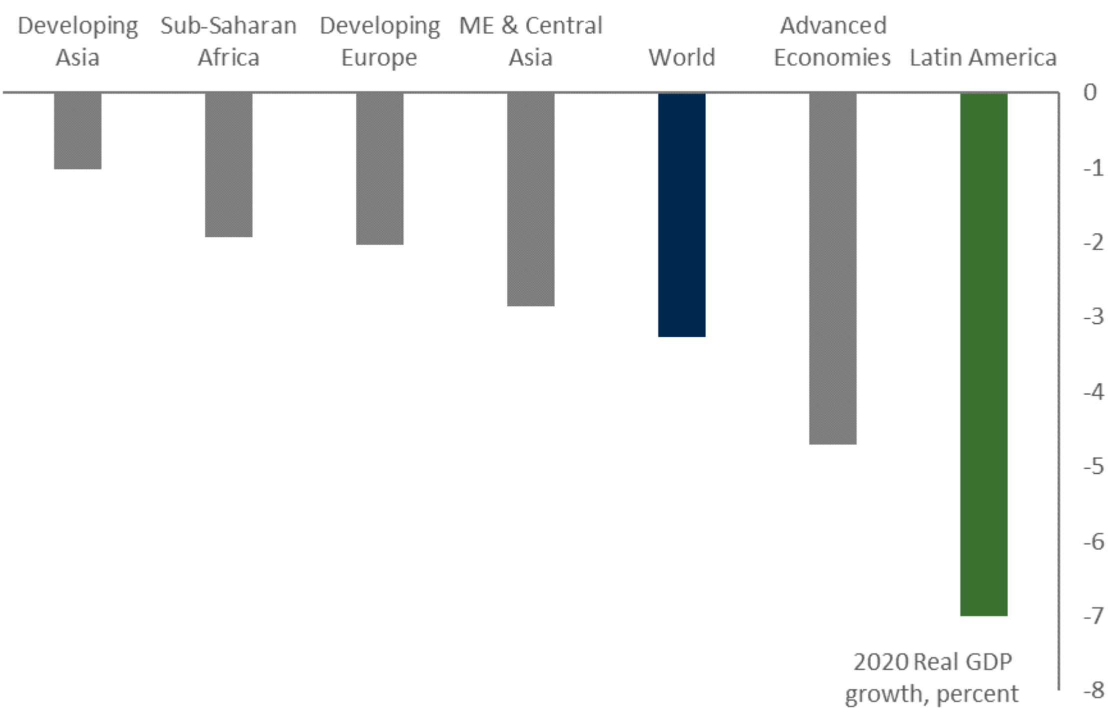


Source: Our World in Data. The regional breakdown provided by *Our World in Data* is for South America rather than Latin America, but a Latin America line would not look materially different given Mexico's death toll at around 1,680 per million is in-line with the South American average.

Since the start of 2021 new Covid-19 cases and deaths have slowed down in advanced economies, first in the US and UK, and increasingly also in continental Europe, owing in part to renewed restrictions to combat emerging virus variants, but in large part because of successful vaccine rollouts. Latin American countries, meanwhile, reached new peaks of infections in May. The region now sadly has the greatest number of cumulative Covid-19 related deaths (**Chart 1**), and looks set to continue posting higher death rates than most advanced economies in the near-term.

As well as its tragic consequences for human health, the Covid-19 pandemic and the restrictions on economic activity – both official and voluntary – that it triggered in response resulted in an enormous economic shock, from which the global economy is still attempting to fully recover. As **Chart 2** shows, Latin America has not only seen the largest loss of human life due to the pandemic, it has also suffered the largest economic loss, with real gross domestic product (GDP) contracting by around 7% in 2020, compared to under 5% in advanced economies and a bit over 3% globally. And of course, any given economic shock is likely to have more damaging consequences in Latin America than in advanced countries, given higher levels of poverty and inequality.

Chart 2: Latin American economies have been hit hard by the pandemic



Source: IMF April 2021 WEO.

The large drop in economic output was accompanied by an even larger drop in employment. Total employment in large Latin American countries fell by about 30 percent on average between January and May 2020, significantly more than in other emerging markets and in advanced economies.[2]
A range of factors can help explain Latin America's comparatively poor economic performance during the pandemic.

First, a pandemic is naturally harder to cope with in developing economies. Firms and households in developing countries have smaller financial buffers than those in advanced economies, and many

[2] See e.g. IMF (2020). Falling employment in advanced economies tended to show up as increasing unemployment, whereas job losses in Latin America resulted mainly in large declines in labour force participation, mainly due to the large informal economy.

more live in or are threatened by poverty. This leaves less room to deal with a large shock to incomes, forcing firms out of business and households to restrict non-essential consumption more quickly. Weaker health care systems can force developing countries to lock down more quickly, or to accept higher death tolls. At the margin, the timing of the pandemic also didn't help: growth in many Latin American countries had fallen in the pre-pandemic years, with the unwind of the super-commodity cycle. Meanwhile, Europe and the US had experienced several years of fairly stable and positive growth before Covid-19.

A second source of the Latin American disadvantage is that a relatively large share of jobs cannot be done from home. This limits the extent to which economic activity can continue safely under pandemic conditions. Of course even in advanced economies like the UK, many services jobs require direct interpersonal contact, and most manufacturing jobs have to be done on-site. But still, estimates by the IMF suggest that over 50 percent of all jobs can in principle be done remotely in some advanced economies, compared to 30 to 50 percent in emerging markets in Asia and Europe and less than 20 percent in most Latin American countries.[3] And even where Latin American jobs could in principle be done from home, a weaker digital infrastructure than in advanced economies makes this more challenging.[4]

Third, the fiscal response to the pandemic was larger in advanced economies than in Latin America (**Chart 3**). Advanced economy governments tend to have deeper pockets than emerging economy governments, so they can more easily afford large fiscal expansions. And that difference becomes starker in times of crisis. For the US, as well as for countries like the UK and Germany, government bond yields typically fall when there is a crisis because global investors are looking for safety and want to buy these governments' debt. In contrast, emerging economies frequently face rising interest rates on government debt as global investors withdraw capital when risks or fears rise.

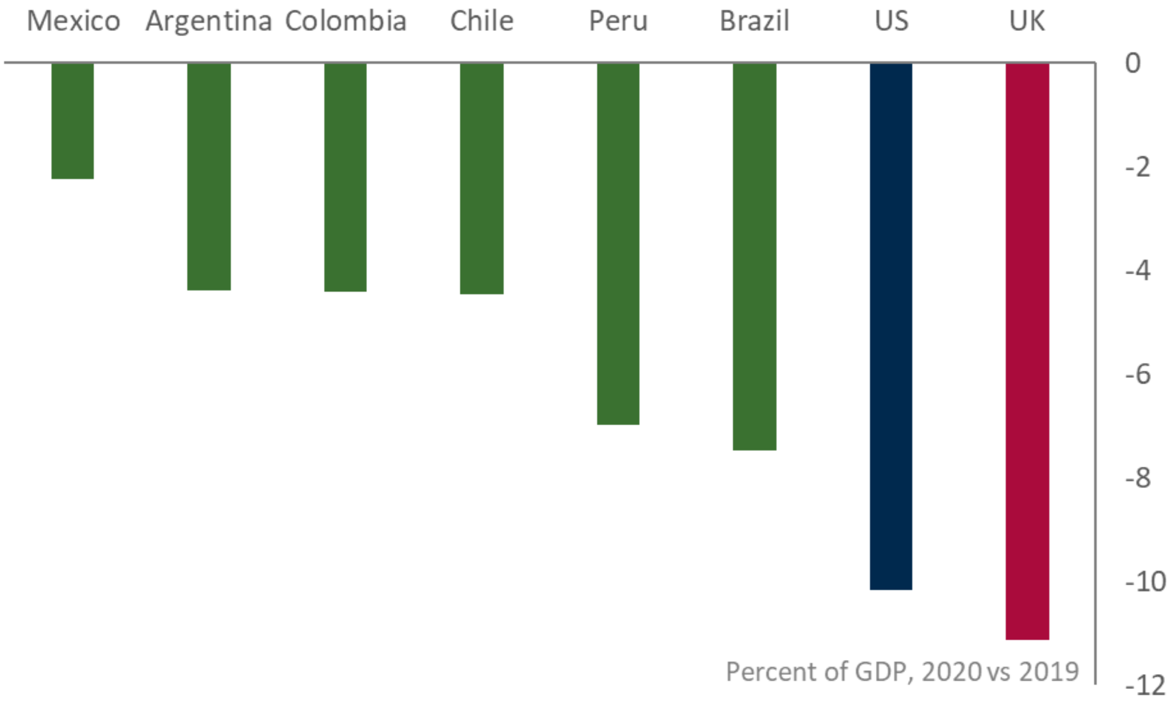
These mechanisms were also at play in 2020. As the pandemic hit, global investors temporarily withdrew funds from emerging markets and Latin America in particular. These pressures were not large enough to prevent Latin American governments from pursuing expansionary fiscal policy in response to the pandemic. But they do highlight that developing economies' governments have to work within tighter fiscal constraints, limiting the extent to which governments can stabilise economies in the face of large shocks. This makes it even more important that fiscal policy is well targeted and funds are used efficiently.

Looking beyond sheer size, a more nuanced point regarding fiscal policy is that the nature of the support measures taken differed materially across countries, with still highly uncertain implications for the longer-term performance of our economies. In Europe, employment support schemes such as the UK government's furlough scheme mean that governments temporarily take over wage bills to avoid

[3] Dingel and Neimann (2020), IMF (2020).
[4] E.g. Garrote-Sanchez et al (2020).

mass unemployment. This protects existing matches between workers and firms, effectively freezing the economy to make sure it can reopen smoothly post-pandemic. In the US, the pandemic was allowed to flow through the labour market to a larger extent, accepting the loss of many jobs.[5] US fiscal policy has instead sought to protect household incomes via enhanced unemployment benefits and stimulus checks.

Chart 3: Change in government net lending/borrowing



Source: IMF, Bank calculations. Recently announced US fiscal measures in 2021 will make the US's overall fiscal response to Covid-19 materially larger than the UK response.

It remains an open question the extent to which these different approaches could lead to different persistent effects on output and employment. From a policy design perspective, there are tradeoffs involved in the choice of support scheme: a furlough system protects the job match, facilitating a return to normality once health risks subside; on the other hand, enhanced unemployment benefits may offer more flexibility to relocate workers if there are significant structural changes

The extent to which large falls in employment during the crisis will have permanent adverse effects on potential output and employment will also matter greatly for Latin America, given the very large number of job losses that we have seen.

To be clear, all of the large Latin American countries have implemented some form of wage subsidy and loan scheme to support job retention. In Brazil, for example, more than 25% of formal private sector workers benefited from a wage-subsidy program. But given the large share of informal jobs,

[5] For a more detailed discussion of US and UK fiscal policy during Covid-19, see Tenreyro (2021).

this only accounts for about 10% of total jobs in the country, so the reach of such programmes is always going to be more limited compared to advanced economy job retention programmes, such as the UK government's furlough scheme.

The fact that these schemes do not reach the large group of informal workers, which tend to be much more vulnerable to poverty and more likely to lose their job due to Covid,[6] meant that other complementary income support tools were needed.

In Brazil, the Emergency Aid programme provided temporary, means-tested cash transfers equal to roughly 40 percent of the pre-Covid median labour income. This programme provided aid to around 70 percent of households in the poorest decile. The IMF estimates that these transfers mitigated the negative impact of the pandemic on poverty and inequality. Their figures suggest that without the programme, the share of Brazilians below the national poverty line would have more than doubled, from around 7% to 15%. With it, the poverty headcount ratio actually fell slightly.

Although efforts to shield the most economically vulnerable from the immediate impact of Covid-19 are important, the total impact on poverty and inequality will depend crucially on what happens during the recovery phase, both to the labour market and to key areassuch as education, which I'll come on to in more detail. And looking at Latin America as a whole, poverty and inequality have already increased significantly. Various estimates put the pandemic-induced increase in poverty headcount (below $5.50 per capita per day) in Latin America in a range from 18 million to 44 million people, while the World Bank projects an increase in extreme poverty (below $1.90 per capita per day) of 14.7 million people.[7]

2 In the near term, Latin America will likely recover more slowly than advanced economies

Looking ahead, the global economy is expected to recover over the next couple of years. But as the IMF highlights in its recent World Economic Outlook, the path of recovery is likely to diverge materially between advanced economies on the one side and emerging economies on the other. Led by the US, and fuelled by a very large US fiscal expansion, advanced economies are expected to grow rapidly in 2021 and 2022. Emerging and developing economies, meanwhile, are expected to recover more gradually.

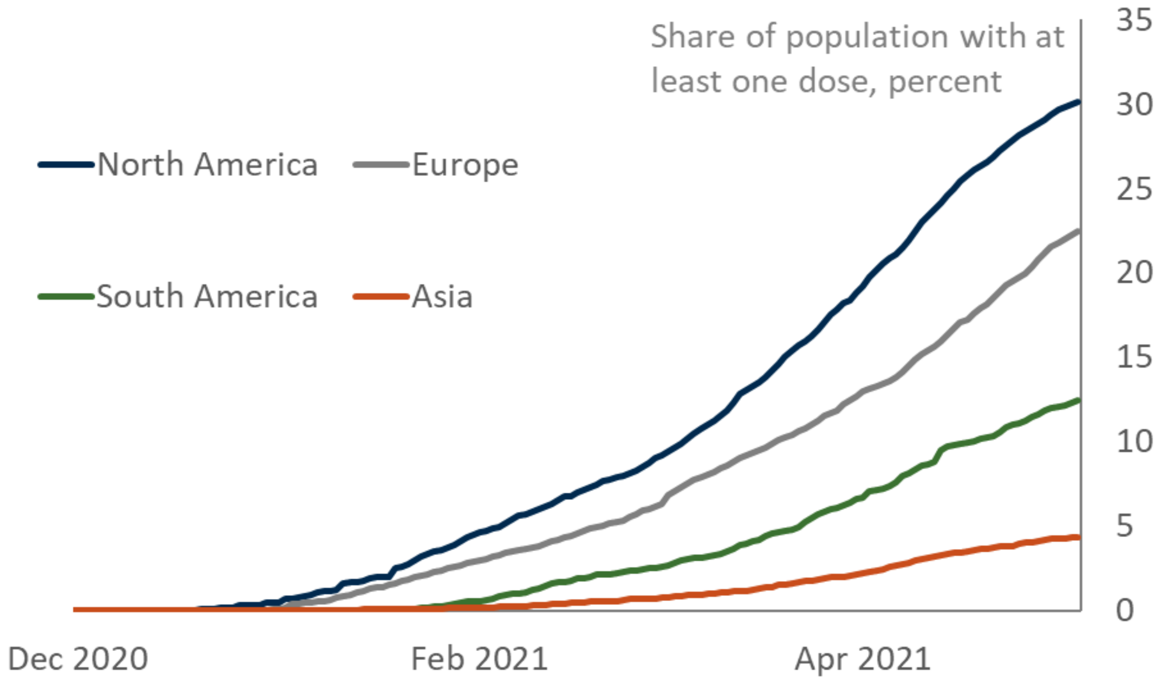
A key driver of the difference in recovery speed is of course the different pace of vaccine rollouts. In the UK, 33% of the population are now fully vaccinated and over 56% partially vaccinated. These numbers look similar in the US, and while initially proceeding at a slower pace, many continental

[6] See e.g. Busso et al (2020), Bottan et al (2020).
[7] World Bank (2020), ECLAC (2020), Lustig et al (2020).

European countries have been catching up in recent weeks. This has allowed these countries to start reopening their economies, and public and economic life are expected to return more or less to normal before the end of the year.

While ahead of many emerging countries in Asia (where, overall, the pandemic has not hit as hard), Latin American vaccine rollouts have proceeded more slowly than in advanced economies so far (**Chart 4**), with the notable exception of Chile and Uruguay. That means it will take longer until health concerns fade and full reopening is possible, so the pandemic will weigh on the economy for longer.

Chart 4: Latin America's vaccine rollout is lagging advanced economies



Source: Our World in Data. Again, Mexico's vaccine rollout is broadly in line with the South American average.

A second reason to expect a slower recovery in Latin America is that households and firms in these economies have typically seen larger hits to their balance sheets, given a bigger fall in incomes during the crisis and less fiscal support. There was also less scope to accumulate savings while consumption was restricted by lockdowns, as a higher share of income is spent on essential goods. Weaker household and firm balance sheets are hence likely to weigh on demand in the near term. This contrasts sharply with strong household balance sheets in advanced economies, where catch-up demand out of excess savings accumulated during the pandemic are expected to contribute to fast recoveries to some extent.

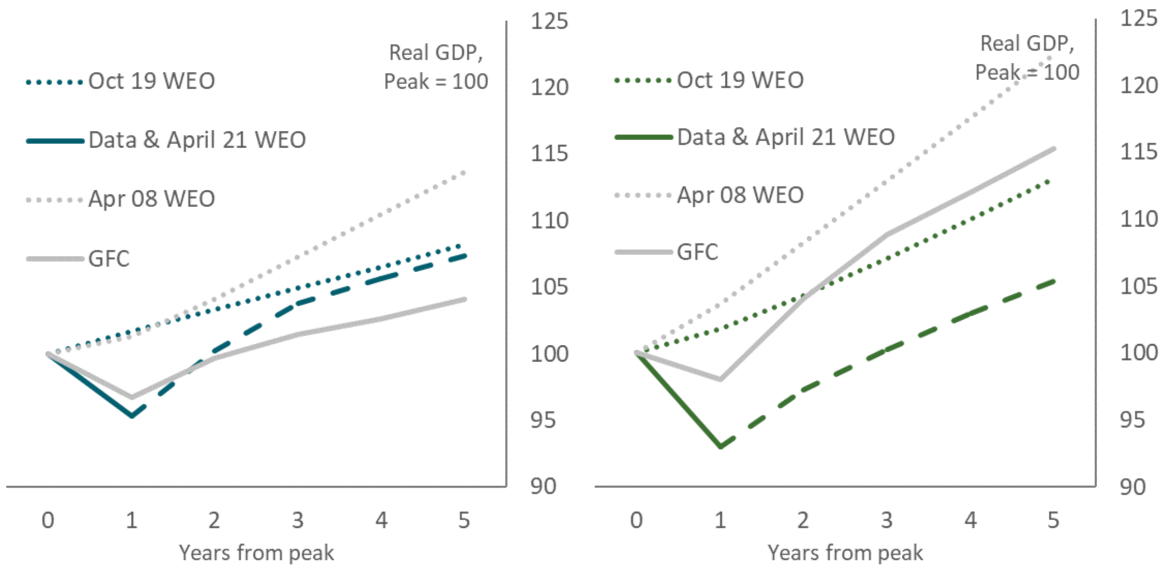
Another important reason for the slower expected recovery is that fiscal policy will in all likelihood tighten more quickly in Latin America than in advanced economies with both higher taxes and a reduction in spending. In contrast, US fiscal policy is expected to stay highly accommodative over the course of 2021 and beyond, given the $1.9trn stimulus package announced in March and large infrastructure investments currently being debated. European governments are expected to reduce fiscal support more quickly than the US, but nevertheless support schemes to households and firms are generally still in place and expected to be withdrawn only gradually as economic conditions normalise. Given tighter market-imposed borrowing constraints, it is less likely fiscal policy will provide as much support in Latin America. This quicker reversal of fiscal policy will reduce aggregate demand, contributing to a slower recovery.

3 In the medium term, Latin America is likely to experience more scarring than advanced economies

Apart from the near-term outlook for growth and employment, a key question for policy makers is whether the pandemic would leave economies with permanent scars, by which I mean a reduction in the longer-term path for economic output. **Chart 5** might help to clarify the concept.

Chart 5: More scarring expected in Latin America than in advanced economies

Panel A: Advanced Economies **Panel B: Latin America**



Source: IMF and Bank calculations. Source: IMF and Bank calculations.

After the global financial crisis in 2008/09, advanced economies experienced very slow recoveries, as can be seen in **Panel A**. The dotted grey line shows the IMF's forecast for advanced economies in early 2008. The solid grey line shows what actually happened from 2008 to 2013. Advanced economies did not make up for the lost growth during the crisis, leaving a permanent wedge between the two grey lines. That is, the global financial crisis (GFC) has left us with permanently lower output. What's more, the rate of economic growth also slowed down, which you can see from the fact that the slope of the solid grey line is smaller than the slope of the dotted grey line, leading to a widening gap between our pre-crisis expectation for the path of output and subsequently realised output.

The cause for this slowdown in advanced economies' economic growth rates after the GFC, often referred to as the "productivity puzzle", remains a hotly contested topic in the economic literature.[8] But even without productivity puzzle, that is, even if growth rates had recovered to pre-crisis levels, the GFC still would have left output permanently below the pre-crisis path. This permanently lower level of GDP after a crisis is often called "scarring": The economy's potential to produce goods and services has been permanently reduced.

Scarring can occur when a crisis leads to firm failures, and high start-up costs or regulatory barriers to entry prevent new firms from taking their place, leaving some industries permanently less competitive. Scarring can also be the result of skill depreciation or lost labour-market matches: Hiring is a costly and time-consuming process for firms, in particular in the formal economy. So following a wave of lay-offs in a recession, it can take a while for firms to re-fill their ranks. Workers also build up job-specific and firm-specific skills through on-the-job experience over time, which do not carry over seamlessly to new jobs and firms. That is why large shocks to the labour market can reduce overall productivity and leave unemployment elevated for long periods of time.

As the blue lines in **Panel A** suggest, the IMF expects neither a productivity slowdown nor any significant permanent scarring in advanced economies after the Covid-19 pandemic. Advanced economies are expected to grow rapidly over the next couple of years and more or less catch up to the path for output that was expected before the pandemic.

Meanwhile, the green lines in **Panel B** show that the IMF expects a significant amount of scarring in Latin America. Growth rates are expected to get back to pre-Covid levels, but there's much less catch-up, so the level of output would remain permanently below the path expected before the pandemic. Why is that?

One reason to expect more scarring in Latin America follows naturally from my previous discussion of labour market developments and policies during the pandemic. Covid-19 led to a much larger reduction in employment than in advanced economies, which naturally leaves more room for labour market scarring. The fact that the economic recovery is projected to proceed more slowly than in advanced economies only compounds the issue.[9] And the crisis has pushed millions of people back into poverty and extreme poverty, both of which are notoriously hard to escape. So it is unsurprising that many are anticipating more labour market scarring in Latin America than in other regions.

[8] See e.g. Haldane (2018), Tenreyro (2018) and Castle et al (2020) on the UK productivity puzzle.

[9] One counter-argument is that many of the lost jobs were informal, which might mitigate scarring to some extent. Hiring costs may be lower in the informal economy, making it easier to re-establish matches between workers and firms and to find new ones.

Relatedly, past recessions and subsequent recoveries have sometimes been associated with replacement of some jobs by automation.[10] A relatively large share of jobs in Latin America are routine and hence potentially vulnerable to automation, particularly so for women.[11] Job automation has generally proceeded more slowly in emerging economies than in advanced economies so far, and currently high uncertainty may reduce the attractiveness of large investments in automation for many firms.[12] On the other hand, automation might be encouraged as a way to increase social distancing in work settings. The possibility that a large number of routine jobs might ultimately disappear could put even more strain on Latin American labour markets in the transition to the longer term. This reinforces the need to address a second key source of scarring, which is the strain that Covid-19 has put on education systems.

School closures have been part of lockdown strategies throughout the world, but they have been most extreme in Latin America. According to UNICEF, 168 million children globally had their school shut for almost an entire year since March 2020, and 98 million of these children live in Latin America.[13] That's nearly 60% of all Latin American school children, compared to 22% in South Asia, 15% in East Asia and few if any in advanced economies. The World Bank estimates that school closures could increase the share of Latin American children in lower secondary education that do not meet minimum proficiency levels as measured by PISA test scores from 55 percent to 71 percent, the largest deterioration worldwide.[14] Learning poverty could increase by 20 percent, meaning 7.6 million more children that are unable to read or understand age-adequate texts.

In advanced economies, including the UK, schools were typically the last institutions to be shut and the first ones to reopen when case numbers fell. Prioritising schools reflected an acknowledgement of the fundamental importance of education, both in its own right and as a crucial investment in human capital and the economy's future production capacity. In many Latin American countries, schools remained shut longer than some other parts of the economy.

While hitting everyone, school closures tend to have larger adverse effects on children from poorer and disadvantaged educational backgrounds. These children are less likely to have access to online education. Their schools are more likely to have been financially stretched even before the pandemic, making it harder to adapt quickly and offer alternative forms of learning. And their parents are less likely to be able to – or have the time to – take over teaching duties.

This unequal impact of school closures on children from different backgrounds has been a feature of the pandemic in many advanced economies. But it is magnified further in Latin America, where poverty and inequality are significantly higher. In many advanced economies, online learning tools

[10] See e.g. Cores et al (2020), Jaimovic and Siu (2020).
[11] See e.g. Beylis et al (2020), Brusssevich et al (2019).
[12] See e.g. IMF (2020).
[13] See UNICEF press release here.
[14] World Bank (2021).

were eventually available to most children, albeit in some cases with substantial delays. Meanwhile, many disadvantaged children in Latin America did not have any access to online teaching throughout the pandemic. For instance, although 92% of students in the South region of Brazil were taking part in remote learning in 2020, this was only 52% in the poorest North-West region.[15]

Teaching children to read, write and count is obviously important. But as UNESCO, UNICEF, and the World Bank have all highlighted, schools do much more than that, in particular in poor areas.[16] School meals are the most reliable source of food for 10 million students in Latin America.[17] Schools are also often essential providers of health and hygiene services and mental health support. And schools drastically reduce the risk that children experience violence, abuse, and early pregnancies.

Keeping schools shut for long periods of time may have smaller economic and fiscal costs in the near term than closing other parts of the economy. But the longer-term costs of school closures are likely to be much larger, and contribute significantly to economic scarring. Learning deficits will make it harder for affected children to enter and advance in the workforce. Drop-outs in particular may never reach the minimum thresholds for literacy and numeracy that are essential for virtually all jobs in the formal economy, and early estimates do point to a significant increase in drop-outs due to the pandemic.[18] This could hamper further progress towards formalisation and persistently swell the ranks of the poor.

4 Invest in Education to reduce Scarring and use Monetary Policy to help along Recovery

As I have highlighted, Latin America is at risk of bearing larger permanent economic scars from the pandemic than other parts of the world. And those scars are likely to affect mainly the poorest households. So minimising scarring is likely to impact both aggregate income and its distribution.

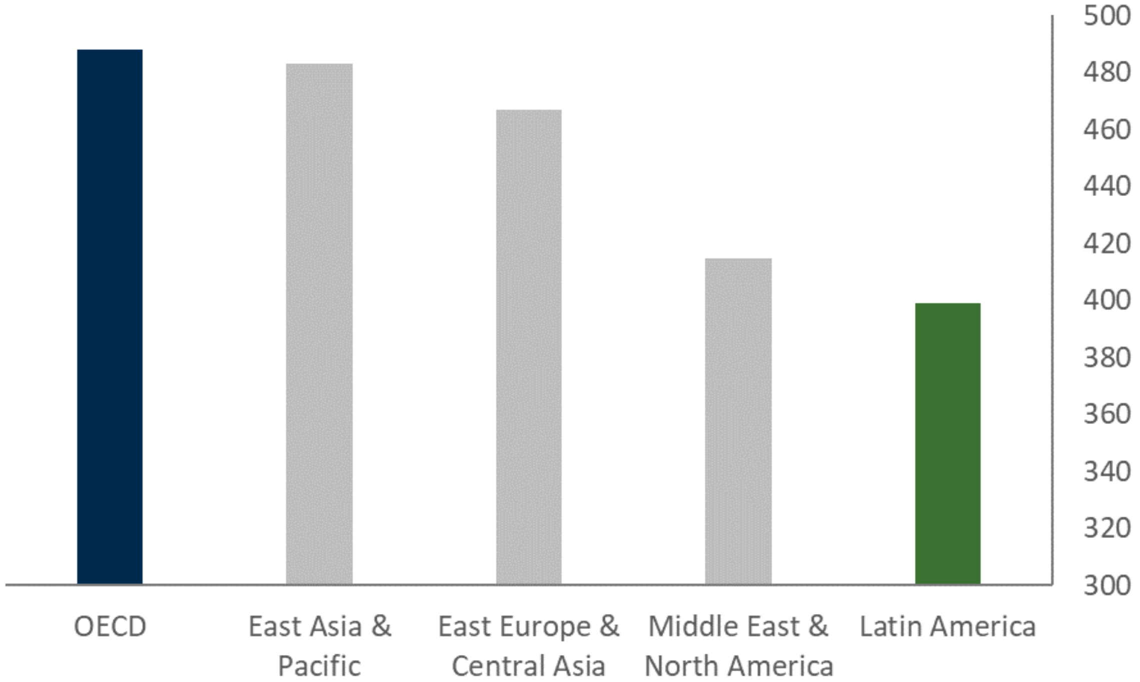
What I've also highlighted is that Latin American fiscal policy makers operate within tighter constraints than advanced economies do. The US approach, which is to ensure a swift recovery and fend off the risk of scarring through overwhelming fiscal force, is less open to emerging market policy makers. That creates more challenging trade-offs for policymakers, who may have stark choices between policies that support the economy during the pandemic and over the longer-term. On the latter, policies that support education should be be an effective way to minimise longer-term scarring.

In this context, it should be noted that Latin America did not only experience a large hit to education during the pandemic. Even beforehand, education systems performed relatively poorly in international

[15] Fundacao Lemann (2020), World Bank (2021).
[16] E.g. the Framework for reopening schools (April 2020).
[17] World Bank (2021).
[18] E.g. Zoido et al (2020), Cerdan-Infantes et al (2020).

comparisons, as evidenced by low aggregate PISA scores and inequity in student access to quality education in the world (**Chart 6**).[19]

Chart 6: Average PISA Scores at Age 15



Source: World Bank, 2018 PISA Scores for reading, math and science.

A large body of empirical research finds very large social returns on investment in education, in particular when targeted at young children from disadvantaged backgrounds.[20] [21]

Returns to education remain high in primary and secondary school, in particular again for children from disadvantaged backgrounds. Early in life, a key role of schooling is to encourage the development of cognitive skills and teach children to engage in effortful thinking for sustained periods

[19] World Bank (2021).
[20] E.g. Heckman and Karapakula (2019).
[21] In the 1960s, US researchers conducted what is now known as the “Perry Project”. Disadvantaged preschool children were randomly divided into two groups, only one of which entered a high-quality preschool program. The near-term impact on cognitive and educational achievement was significant: At age 5, 67% of pre-schooled children had an IQ in excess of 90, compared to only 28% in the control group. And 77% of the treatment group graduated high school, compared to 60% in the control group. Half a century later, we can now see the longer-term impact of the program. 60% of those in the treatment group earned more than $20,000 at age 40, compared to 40% of the control group. The program was particularly effective at reducing crime amongst men: 30% of men in the control group had at least one conviction for a violent felony by age 50, compared to 7% in the preschool group.

of time.[22] Later in life, primary and secondary schools in disadvantaged areas help keep children safe and reduce the likelihood that they encounter violence, abuse and other ills.[23]

Overall, if the goal of policymakers is to limit scarring, investment in education should be a particularly effective way to achieve this in Latin America. Given the long lags involved in building human capital, many of the returns are not likely to be visible immediately, so it is also a policy choice that requires taking a longer-term perspective. To sum, in my view, education –and making up for the educational losses during the pandemic—should be a priority.

Now, let me turn from the real to the monetary side of the economy. Central banks have little to contribute to education reform or to human capital, but they can play an important role in supporting the recovery from the pandemic more broadly. In many Latin American countries, central banks are now in a good position to keep inflation under control while helping along the economic recovery.

Flexible exchange rates and credible inflation targeting central banks have long been key institutions in advanced economies. Theory and evidence on emerging and developing economies, including work I've done with Thomas Drechsel and Michael McLeay, suggest they can also be effective tools for Latin American countries to stabilise their economies and to provide support to firms and households in downturns and recoveries.[1] Fortunately, many Latin American countries have now built credible inflation targeting regimes, which puts these countries in a better position, when compared to previous crises. With stable inflation expectations and credible, independent central banks, economies are much less likely to be derailed by spiralling inflation. And monetary policy makers have more freedom to use interest rates and other monetary policy tools to help their economies recover faster. Some countries, like Argentina and Venezuela are in a more difficult position, with a challenging inflation dynamics to solve, and they need to make the investment into building a credible monetary-policy framework. But for many other Latin American countries, previous investments into stronger monetary institutions should now start paying off. Monetary policy should be part of the solution.

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[22] For instance, a recent field study among Indian primary school students (Kaur et al 2021) finds that encouraging cognitive endurance is an important channel through which schooling builds human. capital.
[23] Unicef (2020), World Bank (2021).
[1] E.g. Drechsel et al (2019).

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