

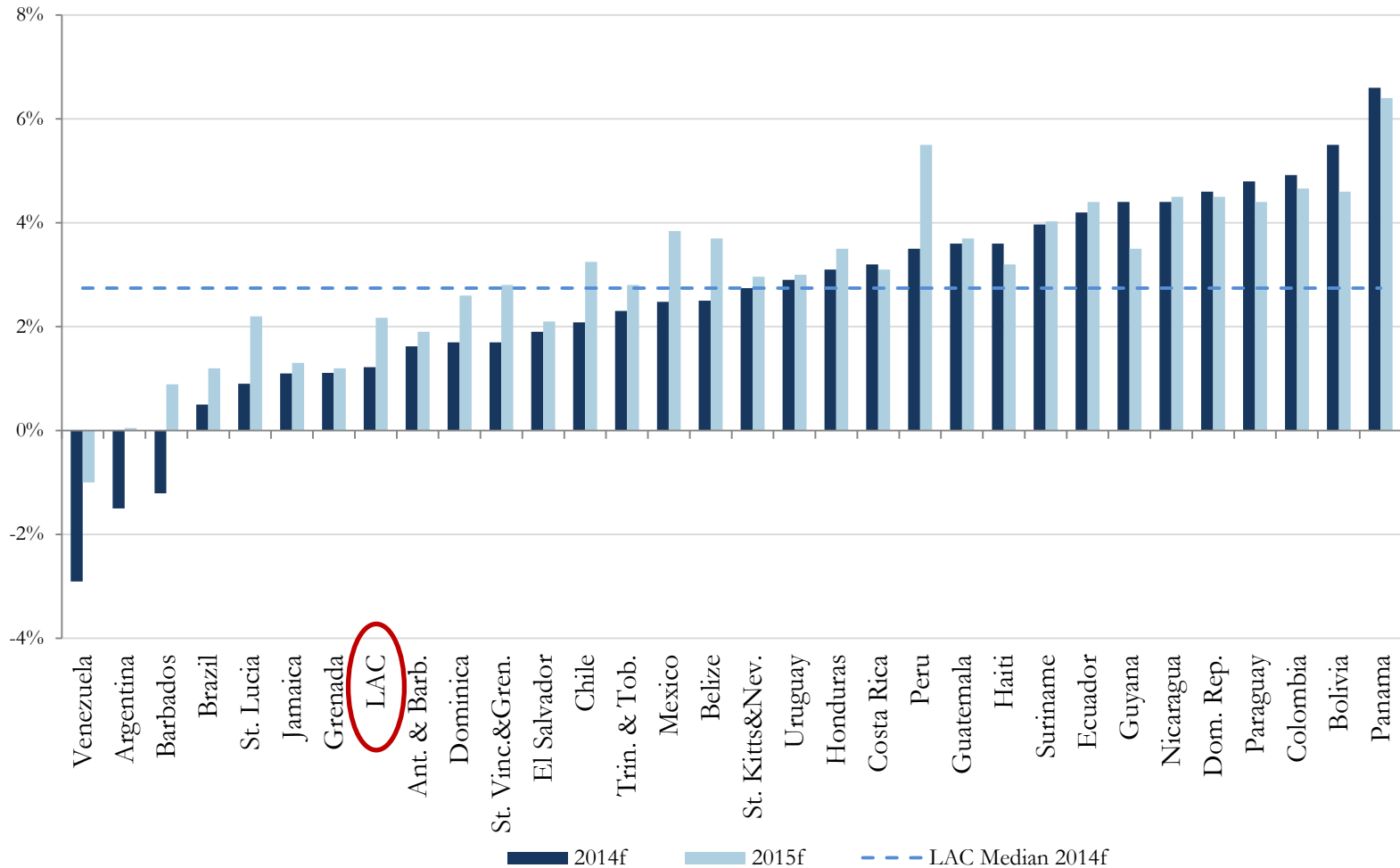
INEQUALITY IN A LOWER GROWTH LATIN AMERICA



The Great Deceleration

Low growth in LAC in 2014 is driven by few of the region's larger countries

LAC: Real GDP Growth Forecasts

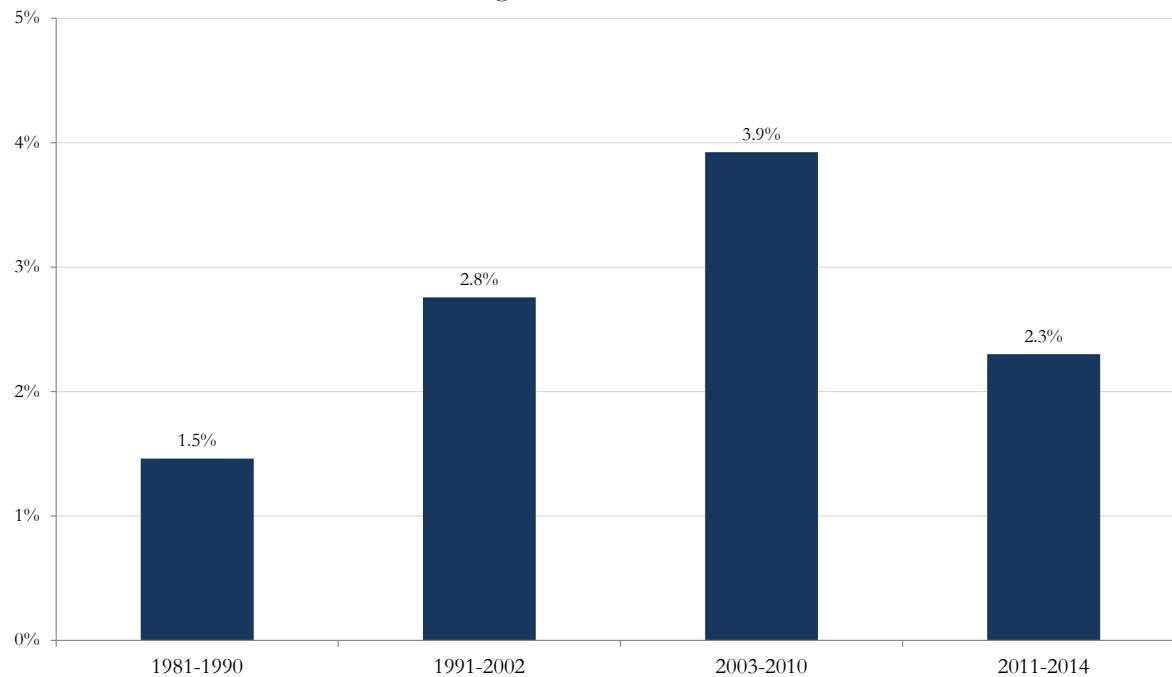


Growth in the last three years is reminiscent of growth in the 1980s and 1990s

Average growth for 2011-2014 (2.3%) is not much below that in 1990-2010 (3.2%) and not much above that in the 1980s (1.5%)

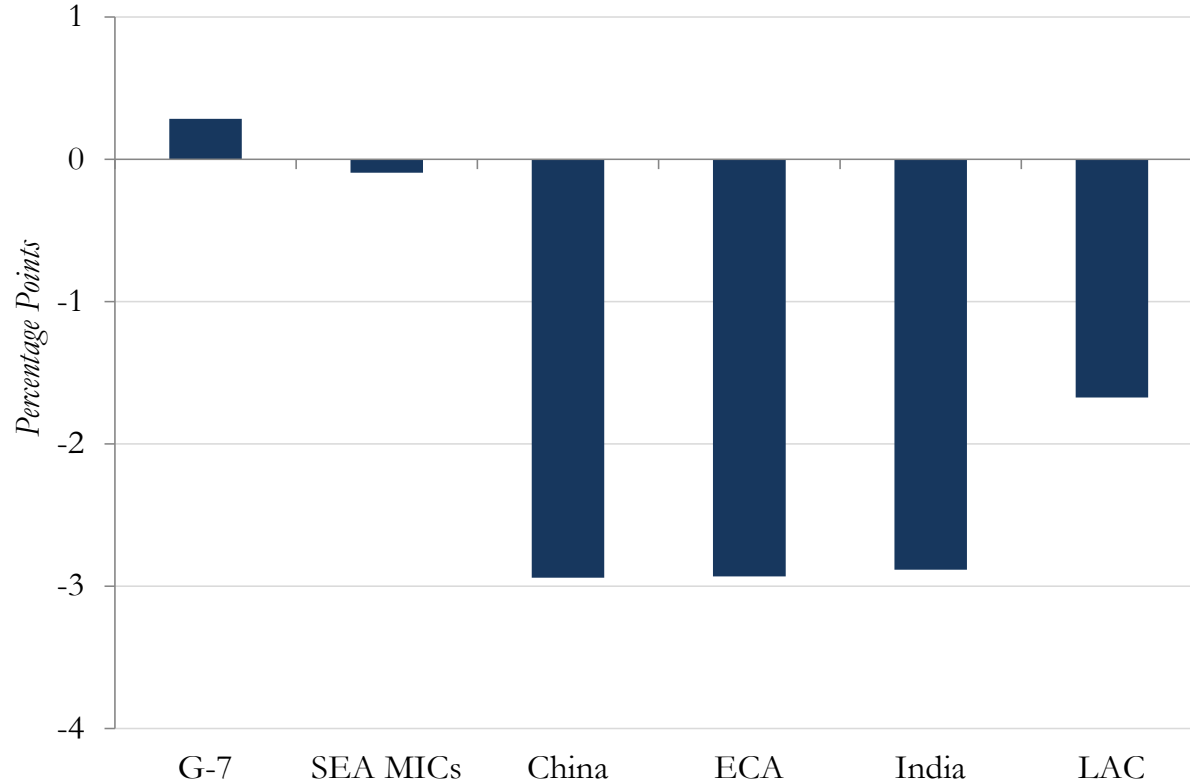
Latin America and the Caribbean

Average Real GDP Growth Rate



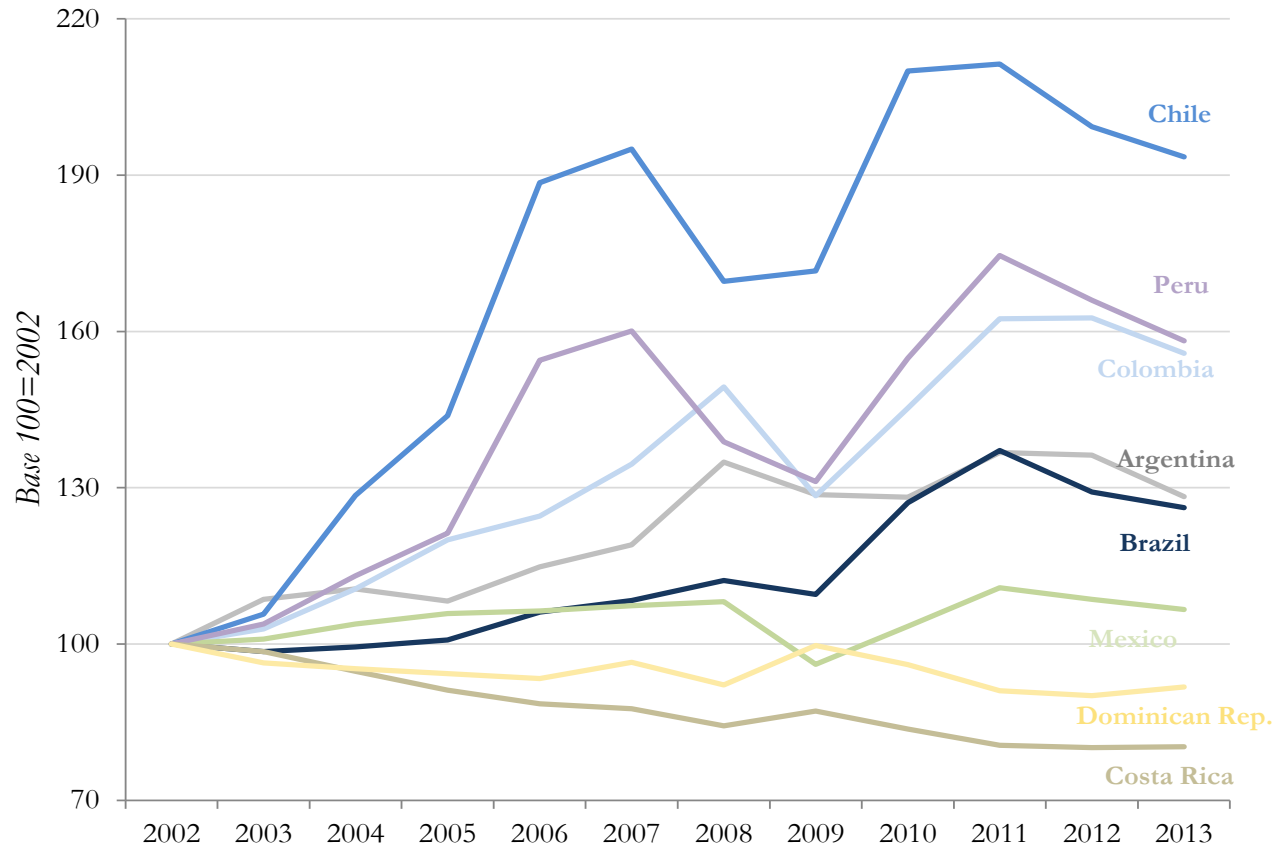
But LAC is not alone – it is part of the “great EM deceleration”

Average Rate of Growth in 2011-2014 minus 2003-2010, by Region



Indeed, global factors are at work – especially developments in China and softening terms of trade

Terms of Trade for the LAC-6



Where is LAC in the cycle? What will the “new normal” (trend growth) be?

- It is not clear whether LAC is already at the bottom of the business cycle, but it is clear that it is not a crisis-type bust
- It is even less clear what the “new normal” (non-inflationary trend) will be...
 - The external tail winds that blew strongly in favor of LAC will not be replayed
- ... but it will surely not be the rate of growth of the “golden years”
 - The non-inflationary growth rate seems to vary significantly across countries in the region: e.g., Brazil vs. Colombia
- How serious a risk is the growth slowdown to the viability of further shared prosperity?
 - Understanding what lies behind the inequality patterns observed in the past may help us understand the risks and opportunities ahead

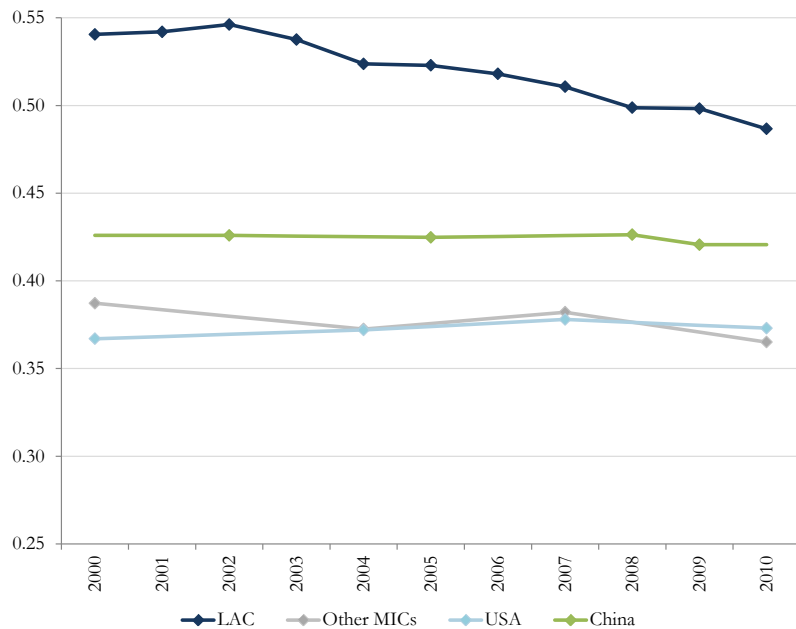


Our Inequality Story:
Does it Depend on the Choice of Measure?

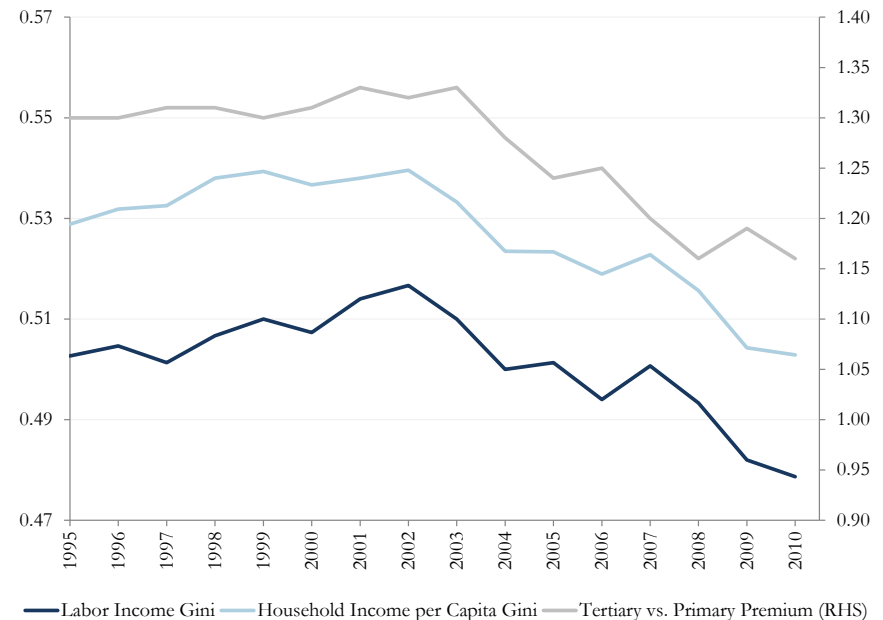
The inequality story we have been telling for LAC

The decline in household income inequality was unique in the world. It was driven by lower labor income inequality, which reflected declining returns to education

Income Inequality Across Regions



LAC: Labor and Total Income Gini and the Education Premium



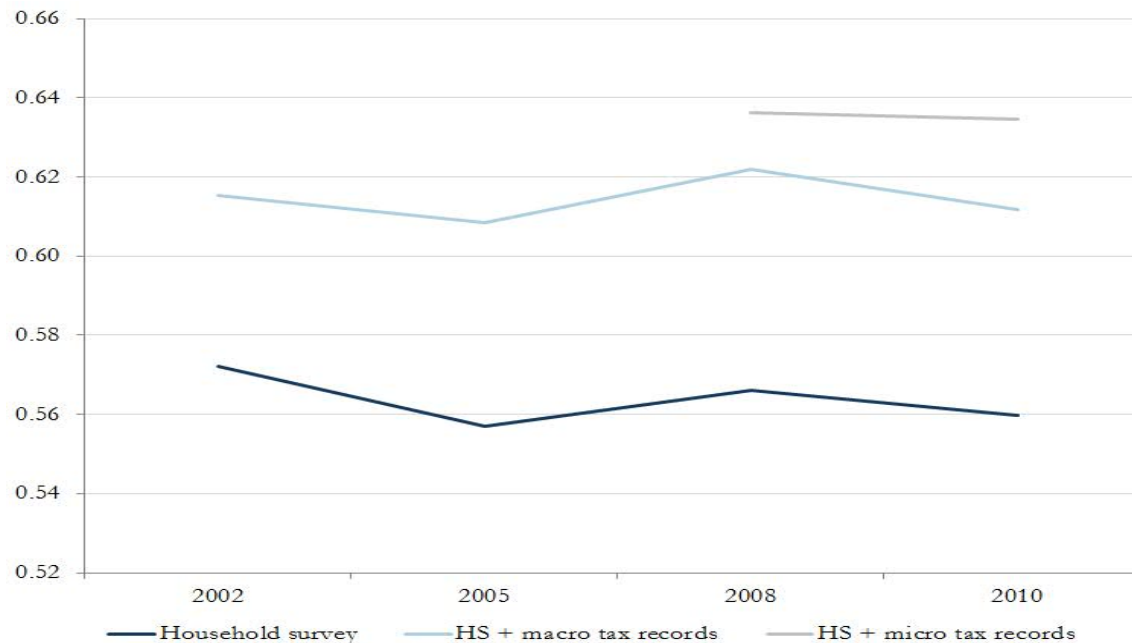
Is the story a function of how we measure inequality?

- Limitations of using household income surveys, the LAC way
 - Comparability: most other regions use consumption surveys
 - Top earners have a higher than average non-response rate
 - Capital income is hardly captured
 - By being a measure of nominal income inequality, the Gini assumes that the consumption basket is the same for all income groups
- What do we do in this report?
 - Complement household surveys with tax-based records
 - Analyze the shares of GDP going to labor—after adjusting for the income of self-employed workers
 - Estimate the inequality of *purchasing power* by correcting for decile-specific inflation rates
- Bottom line: the LAC inequality story holds, but with some caveats

Adding the top earners changes the level but not the direction of change over time

Case study - Colombia: we supplement household survey data with the World Top Incomes Database (macro-tax records) and micro-tax records

Colombia: Basic and Augmented Gini Index



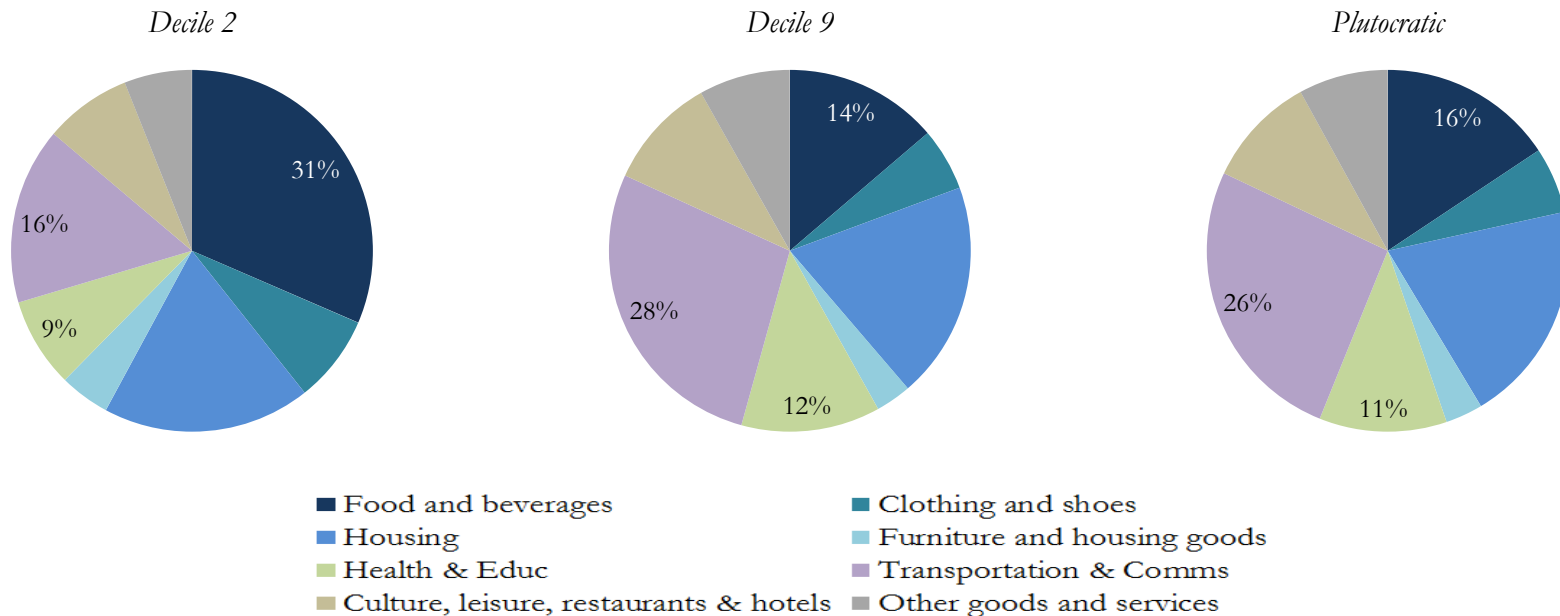
The share of labor in national income shows only part of the distributional picture

- We check for consistency between the evolution of the labor share in national income and that of the survey-based Gini
 - The expectation is that, since capital income is concentrated at the top, as the labor share declines inequality should increase
- We find that the decline in labor shares (which in LAC was milder than elsewhere) was associated with a rise in income at the top 1%...
- ...but that there is no systematic association with changes in the Gini
 - Labor shares don't tell us how labor income is divided
- Bottom line: changes in labor shares are a good proxy for changes of income at the top but not for changes in the distribution elsewhere

Nominal vs. purchasing power inequality : why are they different?

- *The consumption basket of the rich and the poor are very different*
- *Inflation rates across products are different: e.g. food prices*
- *The basket used to calculate the CPI is biased toward the rich*

Consumption Basket Across the Expenditure Distribution: Brazil - 2009

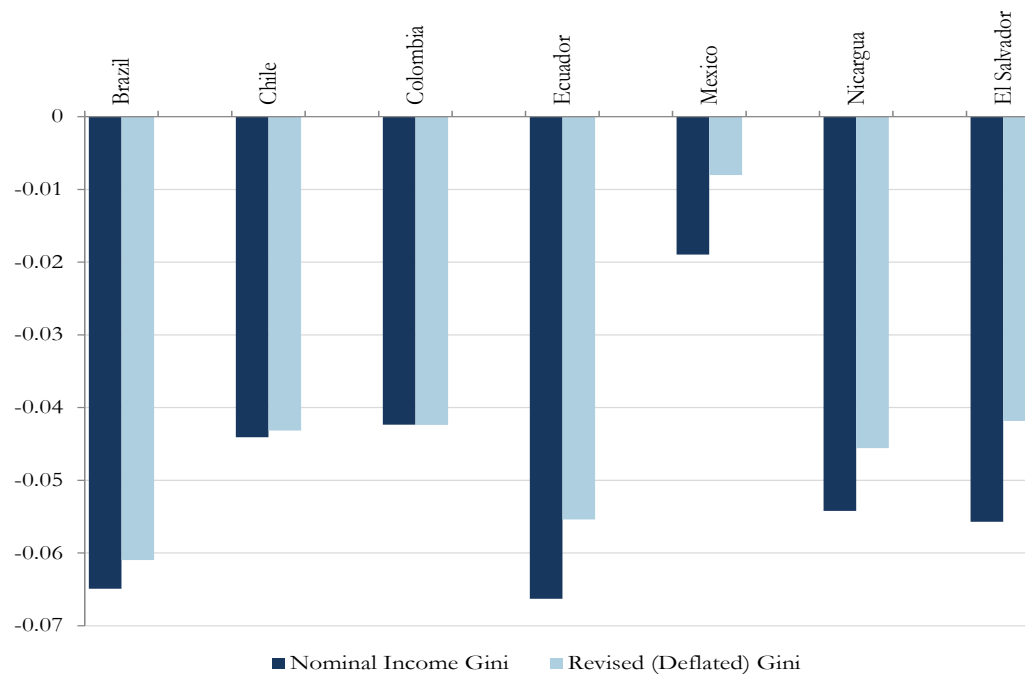


Nominal vs. purchasing power inequality : similar movie, less action

- *Inflation rates across the income distribution can be very different*
- *We deflate nominal incomes with decile-specific inflation rates*

Change in Nominal and Deflated Gini for Selected LAC Countries

circa 2001 - 2012



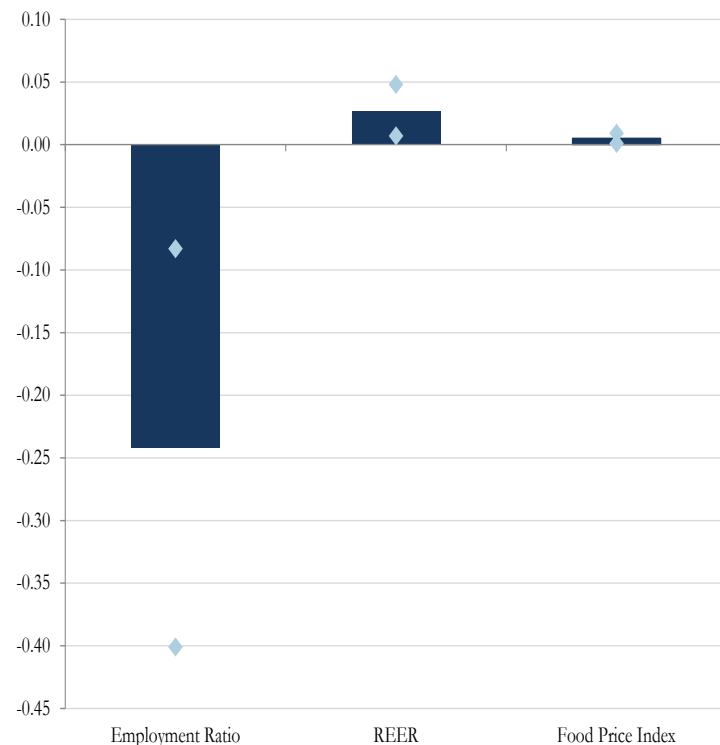


What has driven the changes in inequality?

The macro drivers

- It is the changes in employment, and not changes in growth per se, that matter most for inequality...
 - Not surprising: given of limited or no unemployment insurance and limited access to financial savings
- ... but changes in real wages, hence in the exchange rate and tradable prices, also affect inequality, but less forcibly
 - Tradable foodstuffs weigh more in the consumption basket of the poor
- ... hence, social equity objectives favor employment stability over real wage (exchange rate) stability
- Non-crisis cyclical downturn and flexible exchange rates are now more supportive of employment

Elasticities of the Gini Index





The micro drivers

- What is behind the puzzle of the decline in the (still high) returns to education? Supply and demand factors
- Possible supply side factors leading to wage compression
 - Expansion of lower quality education coverage towards the poor – can lower average wages for a given level of education...
 - ... compounded by a drop in the average quality of tertiary education associated with its rapid expansion
- More research is needed (forthcoming Regional Study)



Policy Discussion

Policy tensions and policy maneuvering room (1)

- Growth slowing down but social equity expectations remain high – tensions likely to arise due to pressures on labor incomes and fiscal revenues
- Room for counter-cyclical policy varies widely
 - Counter-cyclical policy cannot fix the problem of low trend growth
- Initial conditions matter
 - Countries with room to borrow, well-behaved fiscal, *and* no inflation pressures can support employment via e-rate depreciation and borrow prudently
 - Countries with high debt *or* over-committed fiscal *or* facing inflation pressures should create maneuvering room the hard way – tighter fiscal, looser monetary
 - Quality fiscal adjustment: not at the expense of social policy objectives.
- However, conditions may favor the easy (but long-run costly) way out
 - Keep aggregate (consumption) demand and social spending high...
 - ...and borrow in international markets that are avid to lend

Borrowing stance across LAC countries

Public Debt and Sovereign Ratings



Policy tensions and policy maneuvering room (2)

- Inequality gains are not likely to reverse ...
 - Flexible exchange rates should help maintain employment levels, thus avoiding spikes in inequality
 - LAC's new macro immune system will have less regressive adjustments
- ... but, inequality gains are likely to flatten
 - Effect of expanding education coverage is tapering off
- LAC has two important agendas—productivity and equity-friendly employment—that are not automatically linked
 - Success in the productivity agenda may lead to a technology-driven widening of the skill premium (hence, increasing inequality)...
 - ... which puts a premium on equalizing opportunities, especially wide access to a high quality education regardless of socio economic background

THANK YOU



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