

# How Is the Slowdown Affecting Households in Latin America and the Caribbean?

*Oscar Calvo-González*  
*R. Andrés Castañeda*  
*Maria Gabriela Farfán*  
*Germán Reyes*  
*Liliana D. Sousa*



**WORLD BANK GROUP**

Poverty and Equity Global Practice Group

January 2017

## Abstract

This paper shows evidence that suggests the economic slowdown in Latin America and the Caribbean has already translated into slowing social gains, including decelerating poverty reduction, stagnating growth of the middle class, and lower income growth. The countries of South America outperformed Mexico, Central America, and the Caribbean in poverty reduction during the decade up to 2012. But since then, a new story has emerged. In recent years, poverty reduction has been disappointing across the entire region, which seems to be converging toward low growth with slow

poverty reduction and stagnant inequality. However, this apparent convergence in poverty reduction is driven by diverging labor market patterns. In a reversal of the trends seen during the commodity boom, real wages have been falling in South America and rising in Mexico, Central America, and the Caribbean. As lower economic growth is likely, the new normal will pose challenges for policy makers, in protecting the gains achieved and for societies as they face a mismatch between expectations and actual social mobility.

---

This paper is a product of the Poverty and Equity Global Practice Group. It is part of a larger effort by the World Bank to provide open access to its research and make a contribution to development policy discussions around the world. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The authors may be contacted at [ocalvogonzalez@worldbank.org](mailto:ocalvogonzalez@worldbank.org).

*The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be cited accordingly. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the views of the International Bank for Reconstruction and Development/World Bank and its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent.*

# How Is the Slowdown Affecting Households in Latin America and the Caribbean?\*

Oscar Calvo-González<sup>†</sup>, R. Andrés Castañeda<sup>‡</sup>, Maria Gabriela Farfán<sup>§</sup>,

Germán Reyes<sup>\*\*</sup>, Liliana D. Sousa<sup>††</sup>

JEL Classification: I3, D63, J6, N36

Keywords: Latin America and the Caribbean, Economic slowdown, Poverty, Inequality.

---

\* The authors would like to thank the members of the Regional Management Team of the Latin America and the Caribbean region of the World Bank as well as participants of the seminar organized by the Poverty and Equity Global Practice, World Bank, for comments and suggestions.

<sup>†</sup> Practice Manager, Poverty and Equity Global Practice, World Bank. E-mail: ocalvogonzalez@worldbank.org

<sup>‡</sup> Research Analyst, Poverty and Equity Global Practice, World Bank. E-mail: acastaneda@worldbank.org

<sup>§</sup> Young Professional, Poverty and Equity Global Practice, World Bank. E-mail: gfarfan@worldbank.org

<sup>\*\*</sup> Research Analyst, Poverty and Equity Global Practice, World Bank. E-mail: greyes2@worldbank.org

<sup>††</sup> Economist, Poverty and Equity Global Practice, World Bank. E-mail: lsousa@worldbank.org

## **1. Introduction**

After a decade of unparalleled social gains, the years since 2011 have been marked by a protracted economic slowdown in Latin America and the Caribbean (LAC). For five consecutive years, growth trended downwards and even culminated in a contraction in regional economic activity in 2015 (de la Torre et al., 2015, 2016). In the decade or so after 2003 that coincided with the commodity boom time, the region had been characterized by sharp reductions in poverty and inequality and moved towards becoming a middle class region as increasingly large proportions of the population moved into the middle class. In the recent context, however, the question is how much of the achievements of the previous decade are being put at risk because of this protracted slowdown?

The aim of this paper is to describe through a set of stylized facts how the slowdown is affecting households in the region. The paper is organized around two central questions: what is happening with poverty and inequality and what is behind these trends? The first section documents how the slowdown is manifesting in key welfare indicators and presents new emerging trends in the region. The second section further describes what is behind recent trends by looking at the main channels through which the impact of the slowdown is manifesting. Lastly, the paper concludes with a discussion of some of the main implications and challenges that the new scenario poses to policy makers in the region. It does so from the perspective that the lower economic growth in the region is likely the reflection of a “new normal,” driven in turn by the bursting of the commodity price boom and lower growth in China. If that is the case, the future pace of social gains in the region is also likely to be affected and this is likely to pose challenges for policy makers to protect the social gains achieved. In addition, to the extent that the rapid pace of social gains seen in previous years may have been internalized by the population at large and created expectations for future gains, the new normal may result in societies facing a mismatch between expectations and actual social gains and mobility.

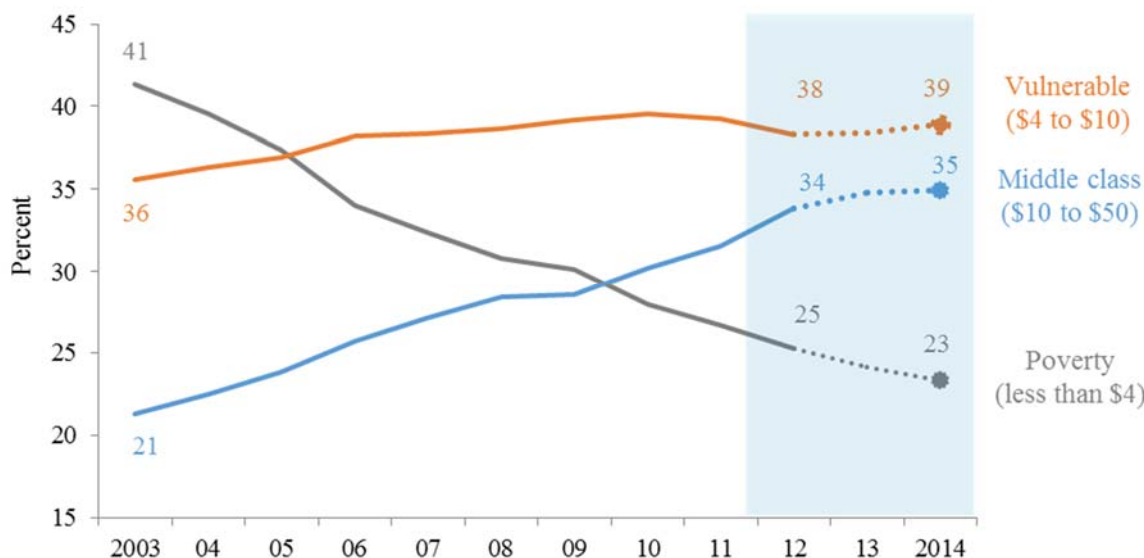
## **2. How is the slowdown affecting poverty and inequality?**

As economic growth slows in the region, a particular concern is that it may translate into a slowdown—or even a reversal—of the social gains achieved during the recent period of sustained high growth. Indeed, we find evidence that the slowdown has already translated into a slower pace of poverty reduction and a stagnation of the growth of the middle class (Figure 1).<sup>7</sup>

---

<sup>7</sup> The numbers presented in this brief are based on comparable household and labor force surveys in the SEDLAC and LABLAC databases. See Annex 1 for more details about the data and the definitions of the different economic groups. All poverty rates are calculated based on international poverty lines, in particular, \$4 per day adjusted for 2005 purchasing power parity (PPP).

Figure 1: Poverty continued to decline through 2014 but the middle class stopped growing



Source: LAC Equity Lab tabulations using SEDLAC data (CEDLAS and the World Bank).

Figure 1 shows the evolution of the share of the population that is poor, vulnerable, or middle class in LAC.<sup>8</sup> There are three immediate findings from visually inspecting this figure. *First*, poverty continued to fall in 2014 but it did so at a slower pace than in previous years.<sup>9</sup> Between 2004 and 2012, LAC reduced poverty at a rate of almost two percentage points per year; while in the 2012-14 period the rate of poverty reduction halved. *Second*, the middle class stopped growing in 2014 (growth fell to an average of 0.5 percentage points per year since 2012, down from 1.4 percentage points per year between 2004 and 2012). *Third*, as mobility into the middle class has stalled, the decrease in poverty is leading to an increase in the vulnerable population, defined as those whose level of income puts them at greater risk of falling back into poverty (Ferreira et al., 2012). As a result, the vulnerable remain the largest economic group in the region. In fact, if growth rates prior to the slowdown had persisted, the middle class would have become the largest economic group in 2016—surpassing the population vulnerable to falling into poverty.

At the same time, LAC has seen a slowdown in the reduction of inequality as measured by the Gini coefficient since the beginning of the 2010s (Figure 2a).<sup>10</sup> In 2004, the region’s Gini coefficient was 0.55, making LAC the most unequal region in the world.<sup>11</sup> Between 2004 and

<sup>8</sup> See Annex 1 for more details on the definitions of the different economic groups.

<sup>9</sup> 2014 is the last year for which comparable poverty rates are available.

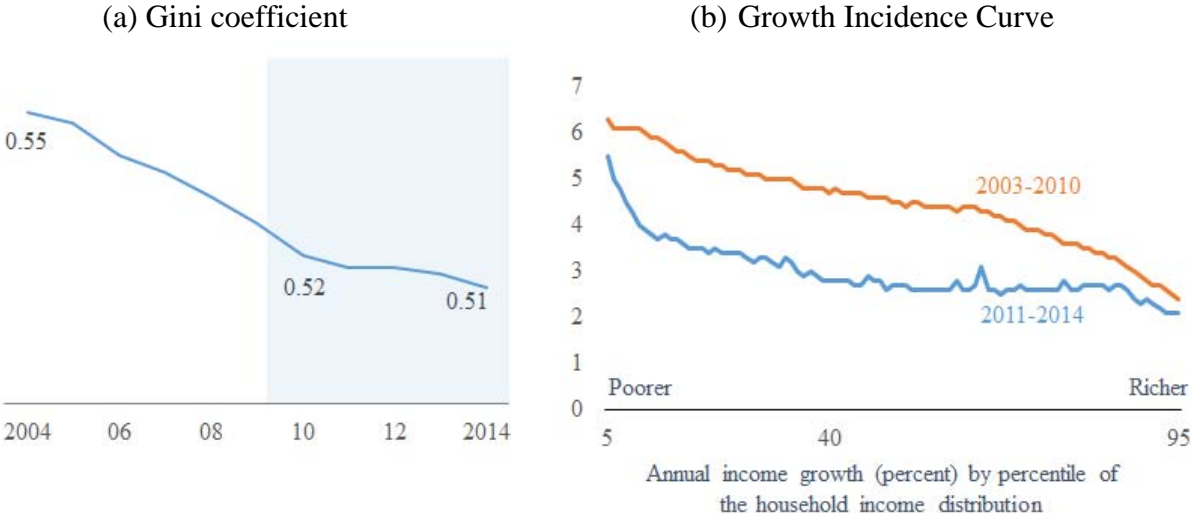
<sup>10</sup> See also Cord et al. (2016) and Gasparini, Cruces and Tornarolli (2016).

<sup>11</sup> Most countries in the LAC region use income-based rather than consumption-based welfare aggregates, while most countries in other regions use consumption-based welfare aggregates. Inequality of income is typically higher than inequality of consumption. While inequality is high in LAC, it may not be directly comparable to inequality in other regions.

2010, the Gini coefficient fell at an annualized rate of 0.9 percent, while in the 2010-14 period it fell from 0.52 to 0.51, the equivalent of an annualized reduction of 0.3 percentage points. After years of income inequality reduction, the region remains highly unequal: as of 2014, the poorest 40 percent of the population received only 11.6 percent of the region’s total income.

The slower pace of inequality reduction is due to slowing income growth in the middle of the income distribution. Figure 2b shows the growth incidence curves (i.e., the annualized growth rate of the per capita household income for every percentile of the income distribution) for two periods. Compared to the 2003-10 period, the 2011-14 period not only shows a substantial decline in the growth rate along the distribution, but it also shows a flatter growth incidence curve. A flattening of the growth incidence curve from a downward sloping curve shows that growth became less pro-poor. In fact, the decline in the growth rate between both periods (i.e., the gap between the two lines) is almost two percentage points per year.

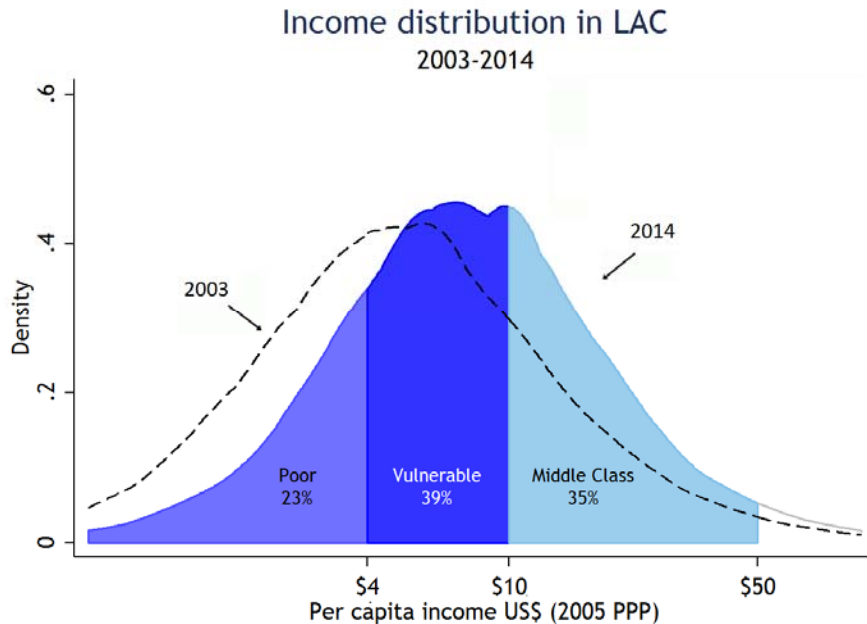
*Figure 2: Inequality reduction has stagnated and the income growth of the poorest 40 percent has slowed*



Source: LAC Equity Lab tabulations using SEDLAC data (World Bank and CEDLAS). Note: The growth incidence curves are calculated using pooled harmonized data from LAC-17.

Even though there are signs of slowing social gains, there is also evidence that the region may be able to withstand the economic slowdown without erasing its social gains in terms of poverty reduction. The growth of household income moved many households further from the poverty line over the past decade, providing them with more of a cushion against negative income shocks that would have otherwise pushed them back into poverty. In other words, this figure suggests that the region has become more resilient to poverty increases. This is shown in the change in distribution of per capita household income between 2003 and 2014 (Figure 3).

Figure 3: A 'near middle class' region



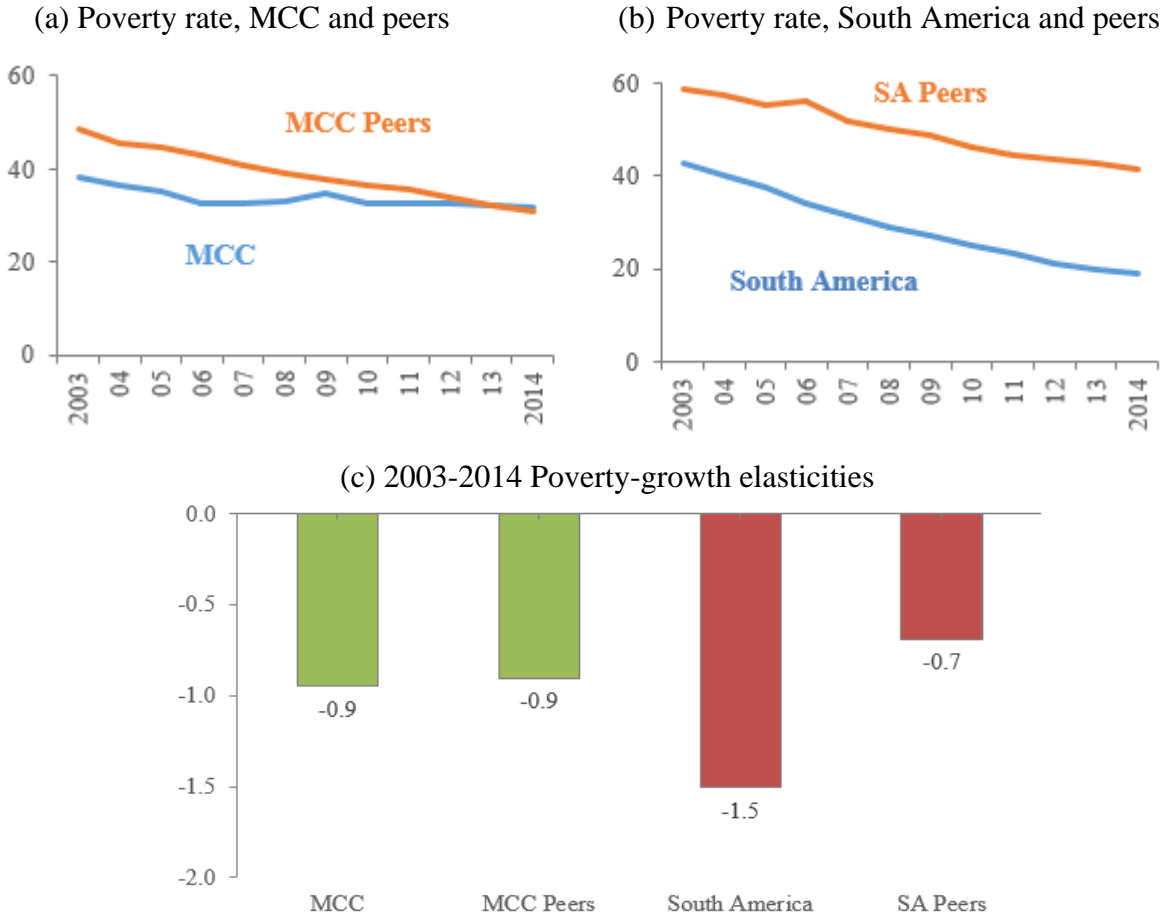
Source: Authors' calculations using SEDLAC data (World Bank and CEDLAS).

Two main messages emerge from Figure 3. First, the income distribution of the region shifted to the right, reflecting higher average standards of living. Second, there is a large concentration of population near the middle class threshold. As noted above, the shift of the income distribution to the right reflects increased resilience to poverty as households have a more robust income cushion to help keep them from falling below the poverty line. At the same time, those living in poverty have higher incomes and are closer to exceeding the \$4 per day threshold. The second message suggests a second, less obvious, implication: the largest economic group of the region, “the vulnerable,” has experienced economic mobility that has suddenly stagnated. These households are no longer poor, but have been unable to make the jump into the relative economic security of the middle class. Not yet a middle class region, LAC finds itself as a *near* middle class region.

Yet, behind this regional story there is an important caveat in how the earlier period of high growth and the recent slowdown has played out in the different parts of the region. While the commodity exporters of South America—countries like Brazil, Argentina, Ecuador, and Peru—led growth in the region during the pre-slowdown period, it is these countries who are now leading the economic slowdown as China’s growth decelerated and commodity prices fell (de la Torre et al., 2015). Whether these economies are able to sustain growth will depend on how they adjust to the “new normal of low commodity prices and slower growth in China” (de la Torre et al., 2016:23). At the same time, Mexico and many of the countries of Central America and the Caribbean (MCC), which had been more adversely affected by the 2008-09 global crisis, have seen increasing terms of trade and gains from the US economic recovery. This pattern continued in 2016 with positive growth in the countries of MCC and recessions in some South American countries (de la Torre et al., 2016).

This difference is reflected in the heterogeneous performance in poverty reduction before and after the slowdown. Figure 4 shows the evolution of the poverty rate in the two sub-regions of LAC: Mexico, Central America, and the Caribbean in panel (a), and South America in panel (b).<sup>12</sup>

*Figure 4: South America was able to translate growth into poverty reduction better than Mexico, Central American, and Caribbean – both in absolute terms and when compared to peer countries that faced similar external conditions*



Source: Authors’ calculations using World Development Indicators (WDI), Macro Poverty Outlook (MPO), and LAC Equity Lab tabulations using SEDLAC data (World Bank and CEDLAS).

Note: MCC refers to Mexico, Central America, and the Caribbean. Peer countries as per de la Torre et al. (2016). South America Peers includes Ghana, Indonesia, Nigeria, Russian Federation, South Africa, and Uzbekistan. MCC Peers includes Bangladesh, Malaysia, Pakistan, Philippines, Thailand, and Turkey. For Russia and Turkey, we use the \$5 a day poverty line, for the rest of non-LAC countries the poverty line is \$3.10 a day. Poverty data of Malaysia and Uzbekistan comes from World Development Indicators (WDI), while for the rest of the peers they come from the Macro Outlook Poverty (MPO). LAC data comes from LAC Equity Lab. When data from a country-year was missing, we applied an arithmetic linear interpolation in order to analyze the same set of countries every year.

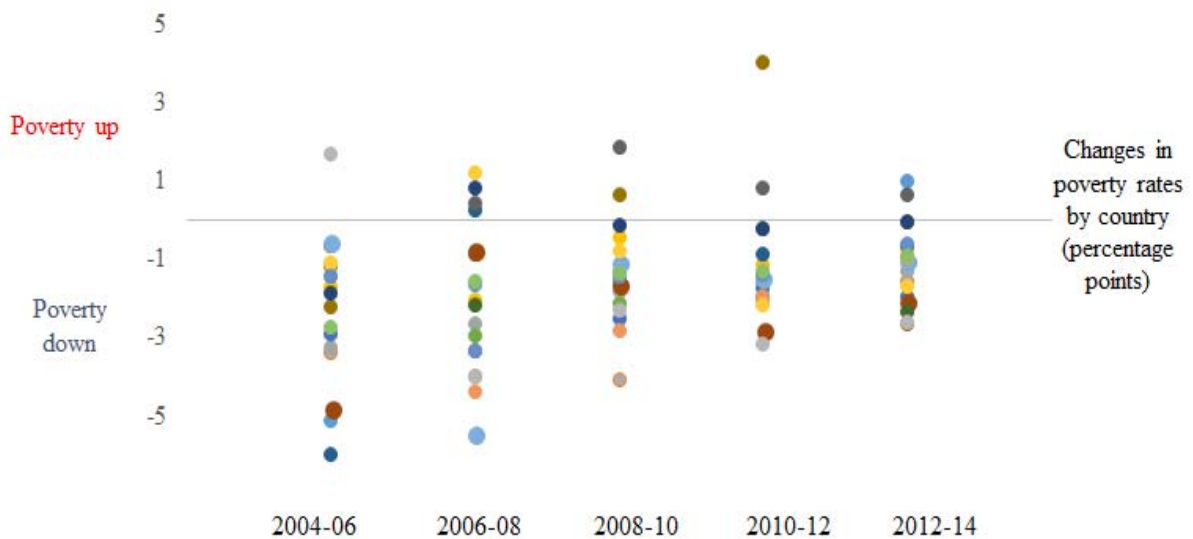
<sup>12</sup> Due to data limitations, only data for the LAC-17 are used (see Annex 1). Though the LAC-17 represents the large majority of LACs population, it excludes several countries, including the Bolivarian Republic of Venezuela, Cuba, Haiti, and the Dutch/English-speaking countries of the Caribbean.



As is immediately apparent from the figure, the performance of both regions in terms of poverty reduction was markedly different during the 2000s. While poverty in MCC has remained relatively constant during the past decade, South America experienced large declines in its poverty rate. This is also shown in Figure 4c, which reports the elasticity of poverty to growth of GDP per capita. Between 2003 and 2014, a 1 percent change in GDP per capita was associated with a 1.5 percent decrease in the poverty in South America compared to 0.9 in MCC. That is, it was not only that South America's growth was higher that resulted in steeper poverty reduction, but rather South America was able to translate its growth more effectively into poverty reduction.

In addition, Figure 4 shows that these two sub-regions also differ in how they have performed relative to international peers. Building on the important role that differences in the structure of trade have played in the growth patterns of MCC and SA before and during the slowdown, these peers are other middle-income countries selected based on similar changes in terms of trade since 2000 (see de la Torre et al., 2016). While MCC's poverty rates remained largely unchanged, its peers saw modest declines.<sup>13</sup> South America, on the other hand, outperformed its peer group in poverty reduction.

Figure 5: Convergence in poverty reduction rates

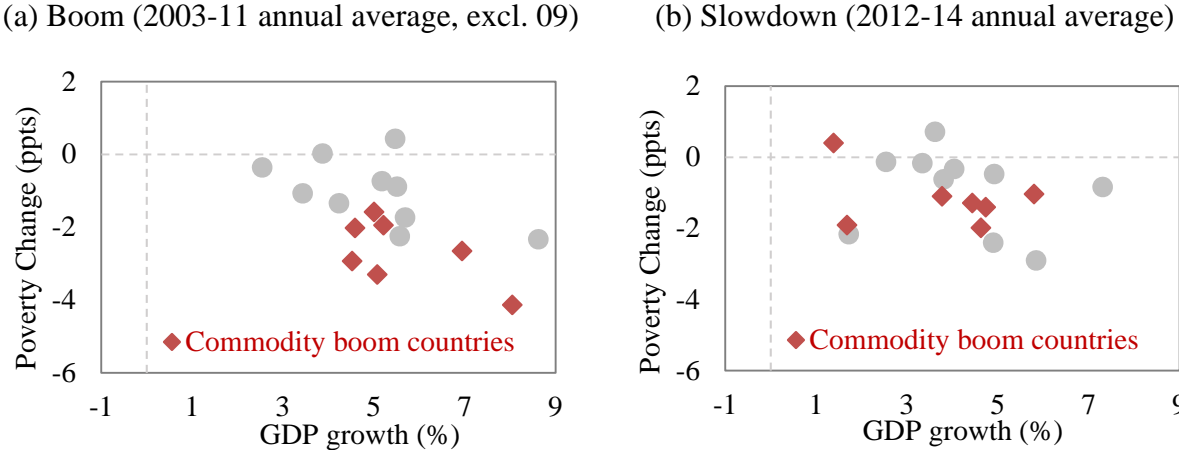


Source: LAC Equity Lab tabulation using SEDLAC data (World Bank and CEDLAS). Note: Each dot represents the average annual poverty reduction per country in each period. Each color reflects the same country over time.

<sup>13</sup> Note that while poverty is measured in LAC using income data, it is measured using consumption for most peer countries. These two methods of measuring poverty do not yield comparable estimates and, in particular, the income-based rates are expected to overestimate extreme poverty. In addition, poverty is measured using different lines across LAC and the peer countries. While these differences imply that poverty levels are not comparable, the *trends* in poverty reduction remain informative.

During the slowdown, in contrast, the marked differences in poverty reduction observed across MCC and SA countries seem to be disappearing. A new story of convergence emerges if we look at the evolution of changes in poverty reduction across the region. Each dot in Figure 6 represents two-year average annual changes in poverty rates—as percentage points—for each country over the 2004-14 period. Dots above the horizontal line reflect an increase in poverty, whereas dots below the line refer to a decrease in poverty. The further away the dot is from the horizontal line, the greater is the poverty change in absolute value. Figure 5, then, presents some interesting findings. First, though most countries in the region continued to reduce poverty over time, the pace of poverty reduction has slowed. Second, this slowing of poverty reduction across the countries of LAC suggests that the region as a whole may be converging to the same place, in contrast to the recent decade of “two regions” within LAC. Third, if this convergence towards low poverty reduction continues, we are likely to find poverty reduction in the region continue to flatten in the near future, or even begin to see an increase in poverty rates.

*Figure 6: The convergence in poverty reduction rates is due to ‘commodity boom countries’ now looking more like the rest of LAC*

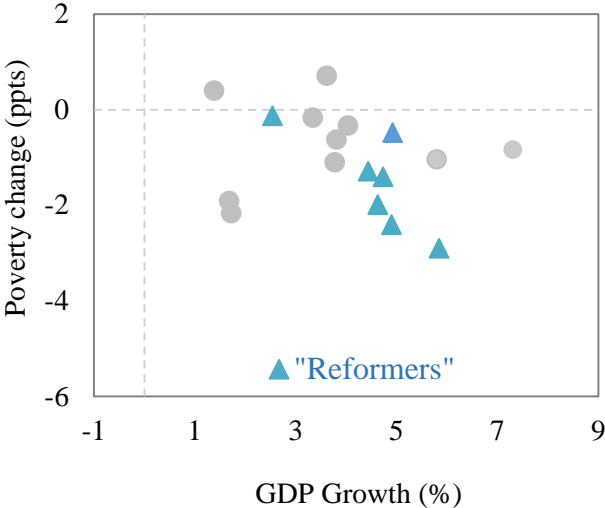


Source: LAC Equity Lab tabulations using SEDLAC data (World Bank and CEDLAS). Note: Commodity-boom countries are identified as those whose terms of trade grew by more than two percent in annualized terms between 2003 and 2013 as defined in World Bank (2015). Commodity boom countries are Chile, Bolivia, Colombia, Peru, Ecuador, Brazil, and Argentina; the other countries included are Dominican Republic, Guatemala, Honduras, Mexico, Paraguay, Uruguay, and El Salvador. Since growth rates in 2009 are significant outliers, they are excluded from the first period.

This convergence in poverty reduction is largely explained by the change in growth performance among countries that benefited from the commodity boom. Figure 6 shows the relationship between poverty change and economic growth during the commodity boom period (2003-11) and the slowdown (2012-14). The best performers in each period are those countries in the bottom right of the figure. Commodity-boom countries have jointly moved to the upper left during the slowdown period, reducing the poverty reduction gap with the non-commodity countries.

This apparent convergence, however, might be transitory. Figure 7 shows the same scatterplot during the slowdown period but with a different classification of countries: “the Reformers”. These are countries for which the Global Competitiveness Index (published by the World Economic Forum) has increased at a faster pace than the worldwide average increase from 2010 to 2015. Under this definition, the reformers have become more competitive by improving a set of institutions, policies, and factors (e.g., infrastructure, health, and education; macroeconomic stability; and well-functioning labor, financial, and human capital) that determine the level of productivity in their economies (WEF 2016). These reformers appear to have achieved larger poverty gains that non-reformers during 2012-14. This classification suggests a new split in the region that is worthy of analysis, and leaves behind the old “commodity”–“non-commodity” classification.

Figure 7: Is there a new split in the region in terms of poverty performance?  
Slowdown (2012-14 annual average)



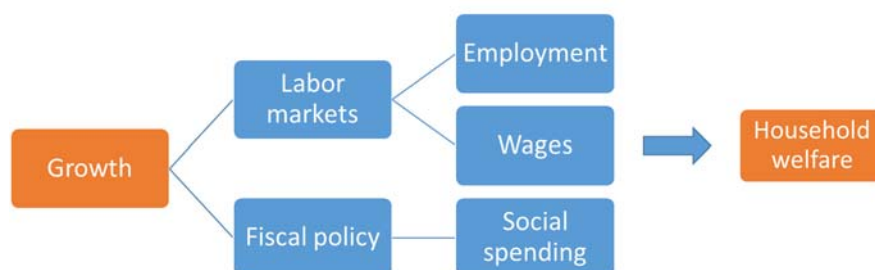
Source: LAC Equity Lab tabulation using SEDLAC data (World Bank and CEDLAS). “Reformers” are defined as countries which saw their Global Competitiveness Index (World Economic Forum 2015) increase at a faster pace than the worldwide average from 2010 to 2015. The countries identified as reformers are Colombia, Dominican Republic, Ecuador, Mexico, Nicaragua, Peru, and Paraguay.

### 3. What is behind recent trends?

While the previous section focused on exploring what has been happening with poverty and inequality in LAC since the beginning of the slowdown, this section explores some of the drivers behind these trends. How does slowing economic growth impact household welfare? The labor market and fiscal policy are the two key transmission channels between economic growth and household income (Figure 8). The labor market, the most important channel of transmission due to the important role of labor income in household budgets, reflects the interaction between firms and employees through wages (prices) and employment (quantities). These two components are

determined by labor supply and demand, and hence highly influenced by domestic and international market dynamics, demographics, institutions, and policies. On the other hand, a significant share of the non-labor component of household welfare comes from public social spending.<sup>14</sup> The policies and programs put in place to help lower-income households, including tax policy and public spending initiatives, can play a role in reducing poverty and inequality.<sup>15</sup>

*Figure 8: Key channels of transmission from slowing growth to slowing social gains*



Labor income has served as the principal channel through which economic growth has led to poverty reduction in LAC. Figure 9 presents the region’s poverty reduction decomposed in two ways: panel (a) presents the growth and redistribution components of the change in poverty, whereas panel (b) decomposes the change in poverty between changes in the labor and non-labor components.<sup>16</sup> While the first decomposition establishes the importance of growth relative to income redistribution in explaining poverty reduction, the second establishes the importance of labor income among household income sources.

Even during the period of ‘pro-poor’ growth, which resulted in faster income growth for low income households, economic growth on its own remained a critical driver of poverty reduction (Figure 9, panel a). That is, under a scenario of neutral growth across the income distribution, the region would still have achieved significant poverty reduction between 2003 and 2008; on its own, growth accounted for about two-thirds of the poverty reduction during this period.<sup>17</sup> Falling inequality, or the “redistribution” component associated with pro-poor growth, accounted for the remaining one-third of poverty reduction. During the slowdown, annual poverty reduction has fallen dramatically – even so, the relative contributions of the growth and redistribution components in the poverty reduction of both periods remain fairly constant.

<sup>14</sup> Other household income sources, such as remittances, pensions, and other private transfers, could be included in this framework through either channel but are omitted to simplify the framework and because they are relatively small sources of income.

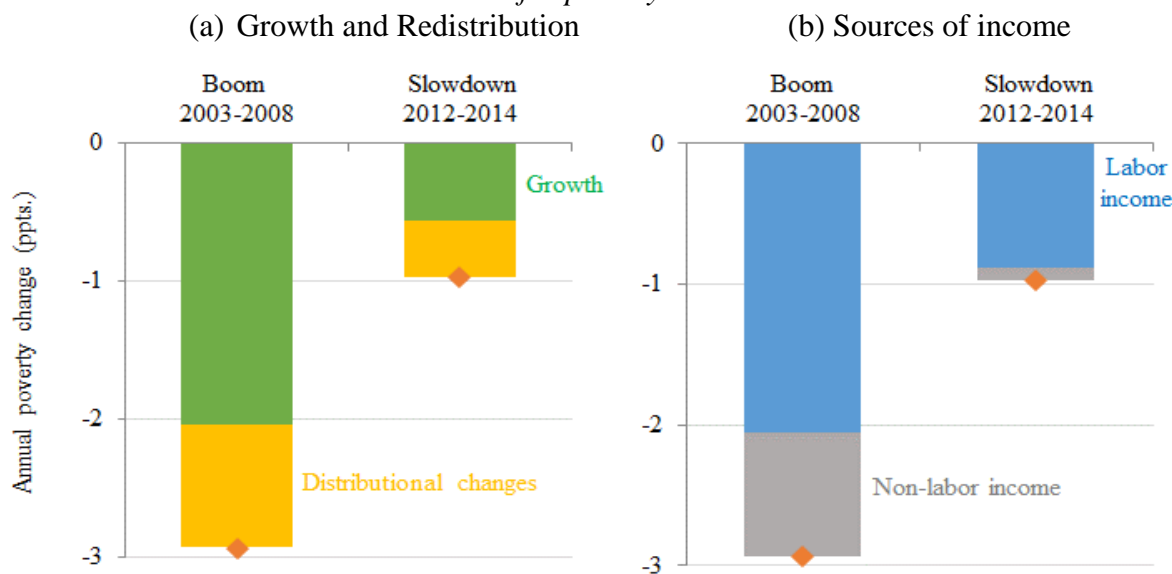
<sup>15</sup> For example, see Lustig, Pessino, and Scott (2014) for an overview of the role that fiscal policy has on poverty and inequality in Argentina, Bolivia, Brazil, Mexico, Peru, and Uruguay.

<sup>16</sup> The decomposition of poverty changes between growth and inequality is based on the methodology of Datt and Ravallion (1992); the decomposition by household components is based on Azevedo, Sanfelice, and Nguyen (2012), which is an adaption of Paes de Barros et al. (2006).

<sup>17</sup> The growth component measures the change in poverty due to a change in the mean per capita household income. The redistribution component measures the change in poverty due to a change in the income distribution.

Compared to other sources of household income, labor income has been the leading driver of poverty reduction in LAC, only growing in importance during the slowdown (Figure 9, panel b). During the boom period, growth in labor income translated into more than 2 percentage points of poverty reduction per year. Growth in all other income sources, including public transfers, accounted for less than 1 percentage point per year. During the slowdown, continued yet slowing growth in labor income accounts for practically all poverty reduction.<sup>18</sup> The key takeaway is that, while labor income growth has slowed, its importance to poverty reduction has grown.

Figure 9: Compared to the boom the contribution of labor income has halved yet it is more critical for poverty reduction



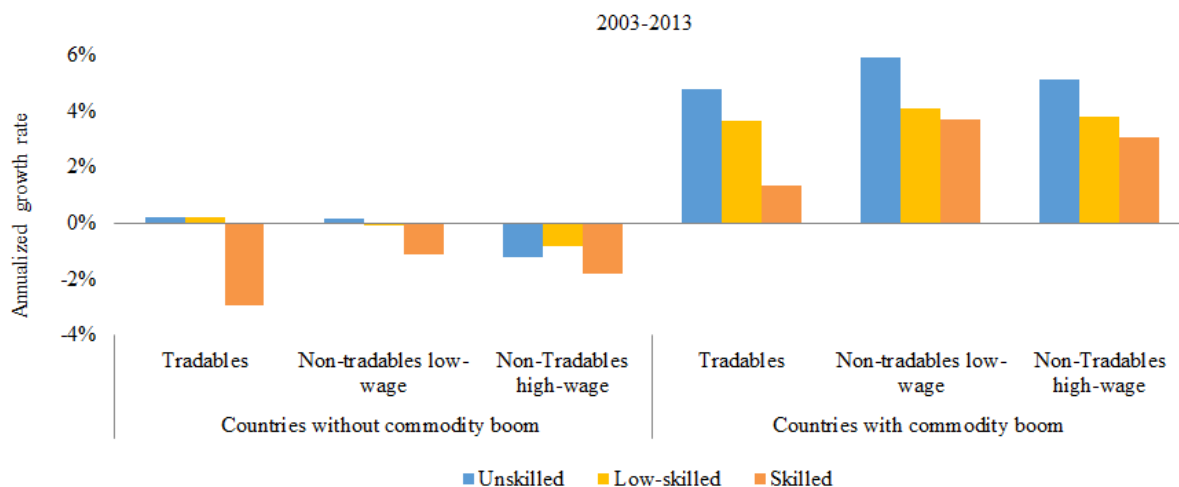
Source: LAC Equity Lab tabulations using SEDLAC data (CEDLAS and the World Bank). Note: Panel (a) reports the results of a decomposition of poverty changes between growth and inequality, based on the methodology of Datt and Ravallion (1992); Panel (b) reports the decomposition of poverty changes based on the methodology of Azevedo, Sanfelice, and Nguyen (2012) which is an adaptation of Paes de Barros et al (2006).

Given the critical role that labor earnings have played—and are expected to continue to play—in poverty reduction, in the remainder of this section we consider how the slowdown has affected its two components: wages and employment. Through 2013, wage growth was markedly different across countries that benefited from the commodity boom of the 2000s and those that did not. Figure 10 shows that the impressive poverty reduction experienced by commodity boom countries was fueled by widespread real wage growth (World Bank, 2015). Positive wage growth extended

<sup>18</sup> The small contribution of non-labor income to poverty reduction during the slowdown does not imply that social spending has been suddenly slashed in the region. If this were the case, the decomposition would show that non-labor income had a poverty increasing impact. Rather, the decomposition is of changes in income by source, hence if non-labor income does not grow enough to close the poverty gap or to cover more of the population living in poverty, it will not contribute to changes in poverty rates. A possible explanation for the declining importance of non-labor income is that income sources such as public transfers and remittances expanded during the boom years but have stopped expanding during the slowdown.

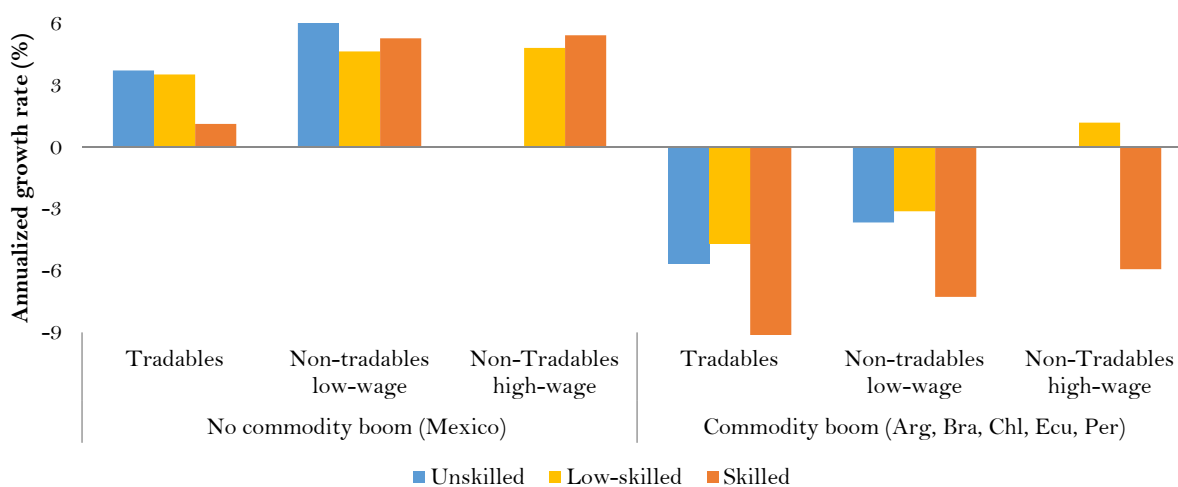
across all sectors—tradable and non-tradable, as well as across all skill levels. Wage growth was particularly high among the least skilled. In contrast, non-boom countries experienced wage contraction or stagnation across all sectors and all skill levels during this period.

*Figure 10: Poverty reduction through 2013 was fueled by high wage growth, especially for unskilled labor*



Source: World Bank (2015). Commodity boom and non-commodity countries defined as in Figure 7. The tradable sector includes primary activities, mining, and manufacturing. Non-tradable low-wage sector includes construction, wholesale and retail trade, hotels and restaurants, public administration, and domestic work. Non-tradable high-wage sector includes electricity and gas, transport and communications, financial, real estate, education and health, and extraterritorial organizations. Skill levels are based on highest level of schooling achieved. Unskilled includes those without complete primary education; low-skilled includes primary complete; skilled includes completed secondary and above.

*Figure 11: The adjustment of wages in 2014-2015 reflects almost a mirror image from developments in the previous decade*



Source: Authors' calculations using LABLAC (the World Bank and CEDLAS). Skill groups and sector types as in Figure 10. Due to data limitations only the six countries listed on the x-axis are included. Due to small sample size, the wage growth of unskilled workers in non-tradable high wage sectors is not reported.

These patterns, however, have undergone a notable reversal since 2013. Figure 11 above shows that, between 2014 and 2015, non-boom countries saw positive real wage growth while commodity-boom countries experienced negative wage growth.<sup>19</sup> While workers in Mexico are seeing wage growth following the lasting impact of the 2008/09 crisis, workers in the commodity exporters of South America are seeing negative real wage growth. Importantly, this reversal is not due solely to the particularly difficult economic situation faced by Brazil in 2015 (see Annex 2).

Employment and unemployment trends also suggest that differences are emerging across the region (Figure 12). However, in contrast to the case of wages, this may be driven more by the recent events in Brazil. Employment rates in Brazil have been on a downward trend since 2008, and unemployment rates have increased substantially for the last three consecutive years and in particular in 2015. The rest of South America does not present marked signs of labor market deterioration. Employment rates may have started to go down in 2015, but it is not clear yet whether that represents a change in trend. Within this group of countries, however, Ecuador did experience an important rise in unemployment in 2015; between 2014 and 2015 unemployment increased from 4.12 percent to 5.19 percent.<sup>20</sup>

Figure 12: Large differences in labor market outcomes are emerging across the region



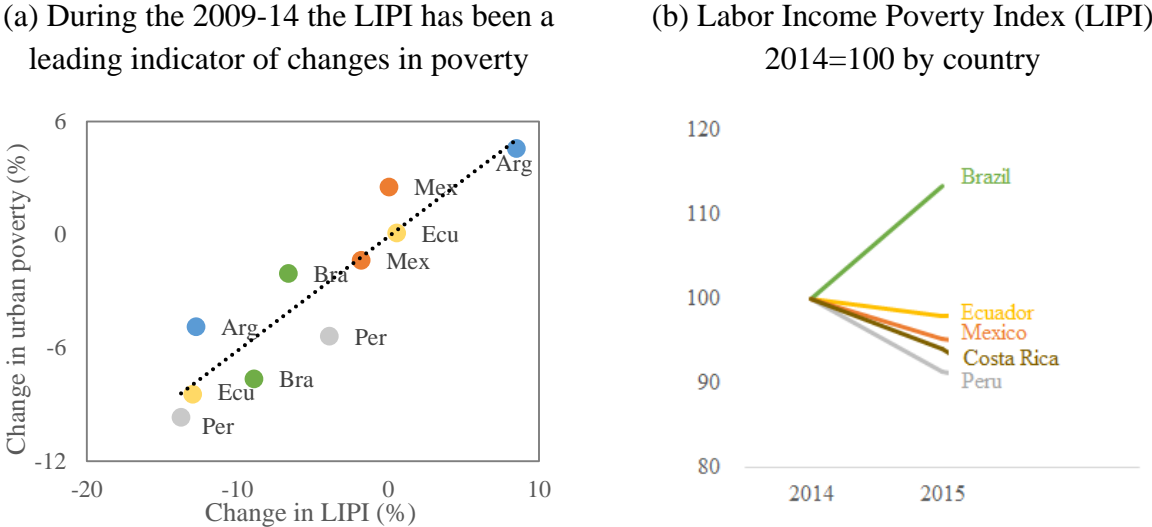
Source: Authors’ calculations using LABLAC (the World Bank and CEDLAS).

Put together, changes in wage and unemployment trends have implications for poverty outcomes. This can be seen in recent trends in the Labor Income Poverty Index (LIPI), which is a leading indicator of urban poverty changes. The LIPI measures the evolution of the share of the population

<sup>19</sup> This graph is limited to six economies in the region because 2015 data from the other countries are not yet available.  
<sup>20</sup> It should be noted that the Bolivarian Republic of Venezuela is excluded from this analysis due to lack of data. If data were available, the analysis would likely show increasing unemployment.

living in households whose per-capita labor income is below the poverty line relative to a reference year. Based on labor force surveys, which are usually available earlier and on a more frequent basis than Living Standards Household Surveys, the LIPI was developed by Mexico’s CONEVAL to have more up-to-date poverty estimates. As shown in the left panel of Figure 13, changes in the LIPI track changes in urban poverty very closely.<sup>21</sup> A look at the change in this indicator for the most recent year (2014-15) suggests marked differences in trends across countries. The share of households without enough labor income in Brazil increased substantially as the index increased 13 percent. In Peru, Ecuador, Mexico and Costa Rica, however, the LIPI decreased though at very different rates.

Figure 13: The share of households with insufficient labor income is diverging across countries



Source: Authors’ calculations using LABLAC (the World Bank and CEDLAS).

All in all, the analysis of the labor market suggests that, while the region is converging in terms of poverty reduction rates, the labor market drivers behind this convergence differ substantially. The labor market indicators suggest that the observed convergence may only be the manifestation of countries starting from different places and moving on different paths, and a new regional typology might soon emerge. While the years of commodity-fueled high growth helped South America achieve impressive social gains, going forward poverty reduction may be led by countries that have undertaken the necessary reforms to reduce inequality and poverty in sustainable manners. For example, through investing in universal public education and labor market reforms that strengthen inclusion through these key institutions.

<sup>21</sup> Labor force surveys are typically limited to urban areas so the comparison to poverty trends is limited to urban areas.



#### **4. Some challenges ahead**

A new normal of lower economic growth and slower social gains is bound to create a number of challenges for policy makers and more broadly for societies at large in the region. These challenges are likely to manifest themselves in a variety of areas, including fiscal policy trade-offs, prospects for long-term growth, and societal demands.

In terms of fiscal policy, decision-makers are likely to face a difficult trade-off between efforts of fiscal consolidation and preserving social expenditures. While this trade-off is nothing new, it is likely to be more difficult than before. After a decade or so of successful poverty reduction there still remained a large number of chronic poor. Following Vakis et al. (2016) by chronic poor we simply mean those households that were poor both in 2004 and in 2012. Those that remained poor during the boom are likely to need specific policy efforts. The falling importance of non-labor income in poverty reduction is probably a reflection of the difficulty of lifting the “harder to reach” out of poverty in recent years. Put simply, those that had better chances of escaping poverty already did so—in part thanks to both public and private transfers—making it more difficult to have an impact at the margin. This suggests that, even in the absence of a growth slowdown, prospects for further poverty reduction among the chronically poor would be weaker going forward.

At the same time, the vulnerable, which remain the largest socioeconomic group in the region, will now be more likely to experience downward economic mobility and increased risk of falling into poverty. Combined the poor and vulnerable account for around two-thirds of Latin Americans. But these two groups may benefit most from different types of interventions and expenditures. In this context, fiscal consolidation will benefit from better understanding what public programs can do for the different groups and where there may be efficiency gains.

As shown in this paper, performance across the region in terms of poverty reduction is no longer correlated with the benefits of a commodity boom. Moreover, there is some emerging evidence that countries’ overall policies, as captured by such a broad measure as improvements in the Global Competitiveness Index, may help to explain some of the differential performance in both growth and poverty reduction across the continent. In short, the hypothesis is that as the super cycle of the commodity boom comes to its end, the old country taxonomy based on commodity prices might be replaced with a taxonomy based on the progress made to increase economy-wide productivity and competitiveness as well the efficiency of spending, led by those countries in the region that are taking the necessary reforms. Further analysis of this hypothesis could help identify how reforming countries can “do more with less” in terms of poverty reduction as growth shifts to a new normal.

The growth agenda will be critical for the social agenda. Decompositions show that during the boom more than two-thirds of poverty reduction in the region was due to growth rather than to changes in the distribution of income. Adjusting to changes in global demand with an eye towards increasing economic growth in a changing environment will be key for continuing social gains.

This requires reforms and investments aimed at boosting the creation of better jobs and increasing firm efficiency and labor productivity.

The region faces an important challenge if it is to avoid falling back into a low growth equilibrium. Falling wages might have long-lasting consequences for the region. Faced with a new economic reality, households may adjust their behavior and engage in alternative coping strategies based on the type of shock being faced and its perceived duration. These adjustments often have an impact on investment decisions – both in physical assets as well as human capital, which feed back into growth (Figure 14).<sup>22</sup> Will the slowdown imply, for example, that the region’s growing educational attainment is under threat? If so, what does this imply for the future of Latin America’s productivity growth?

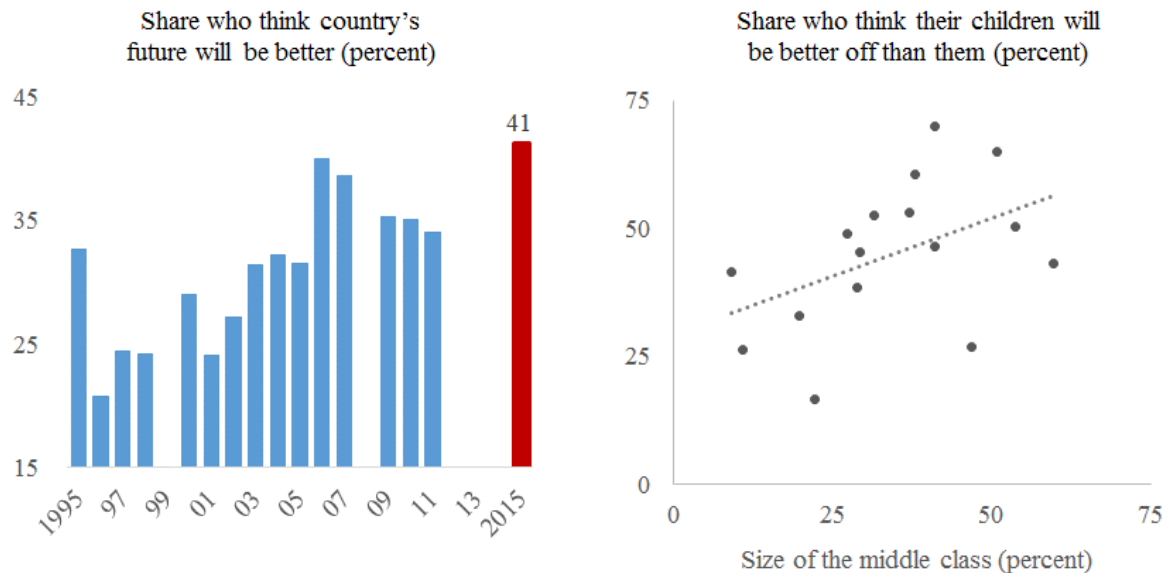
*Figure 14: How households react to the slowdown will affect the long-term growth prospects*



Finally, the new normal of lower growth and slower social gains may unveil a mismatch between society’s expectations about social mobility and the reality. The decade of fast social gains had in fact been accompanied by an increase in the share of people across the region that were optimistic about the future – as shown in the left panel of Figure 15. While the year to year readings of this variable are relatively volatile, it is noteworthy that 2015 had the highest share of the population expressing the view that the country’s future will be better.

<sup>22</sup> Research has shown that catastrophic events have led to drops in household consumption per capita, compelling individuals to decrease calorie consumption, sell vital assets, work longer hours and pull children out of school (for example, Baez et al. 2015). See Perry et al. (2006) for a review of the evidence and channels through which poverty might lead to lower growth, among which are: low accumulation of human capital (education and health), lower accumulation of physical capital, and lower rates of innovation. Economic cycles affect human capital outcomes: in poorer countries, infant mortality, school enrollment and nutrition are pro-cyclical; in middle-income countries of Latin America health outcomes are generally pro-cyclical and education outcomes countercyclical (Ferreira and Schady, 2009).

Figure 15: Unmet expectations?



Source: Latinobarómetro (several years) and SEDLAC (the World Bank and CEDLAS).

Note: Questions from Latinobarómetro are as follows: “How do you think the country's economic situation will be in three years' time?” (left panel) and “Imagine a staircase with 10 steps where the poorest people are on the first step and the richest on the tenth step. ... Where do you think your children will be on this staircase?” (right panel). Data on the size of the middle class and on the share who think their children will be better off than them in the right panel refer to 2013.

The growth of the middle class during the decade after 2003 may have increased expectations that households have about the chances that their children would enjoy upward social mobility. In the new economic reality, these expectations may prove more difficult to materialize. If households' expectations somehow adjust with a lag to the realities of social mobility, it may well be that the decade during the boom represented a unique circumstance where social mobility was not only high but also exceeded expectations. In contrast, going forward the region may not only see slower social gains but also gains that fall short of society's expectations.

## References

- Azevedo, J.P., V. Sanfelice, and M.C. Nguyen (2012). “Shapley Decomposition by Components of a Welfare Measure.” Washington, DC: World Bank.
- Baez, J., M.E. Genoni, L. Lucchetti, and M. Salazar (2015). “Gone with the Storm: Rainfall Shocks and Household Well-Being in Guatemala.” Washington, DC. World Bank.
- Cord, L., O. Barriga-Cabanillas, L. Lucchetti, C. Rodríguez-Castelán, L. D. Sousa, and D. Valderrama (2016). “Inequality Stagnation in Latin America in the Aftermath of the Global Financial Crisis.” *Review of Development Economics*. doi:10.1111/rode.12260
- Datt, Gaurav and Martin Ravallion (1992). “Growth and Redistribution Components of Changes in Poverty Measures: A Decomposition with Applications to Brazil and India in the 1980s.” *Journal of Development Economics* 38(2): 275–95. doi:10.1016/0304-3878(92)90001-P.
- Gasparini, L., G. Cruces, and L. Tornarolli (2016). “Chronicle of a Deceleration Foretold: Income inequality in Latin America in the 2010s.” *Revista de Economía Mundial* 43: 25-46.
- de la Torre, A., F. Filippini, and A. Ize (2016). “The Commodity Cycle in Latin America: Mirages and Dilemmas”. LAC Semiannual Report (April); Washington, DC: World Bank.
- de la Torre, A., A. Ize, and S. Pienknagura (2015). “Latin America Treads a Narrow Path to Growth: The Slowdown and its Macroeconomic Challenges” LAC Semiannual Report, World Bank, Washington, DC.
- de la Torre, A., D. Lederman, A. Ize, F. Bennet, and M. Sasson (2016). “The Big Switch in Latin America: Restoring Growth through Trade”. LAC Semiannual Report; Washington, DC: World Bank.
- Ferreira, F., J. Messina, J. Rigolini, M. Lugo, R. Vakis, and L. López-Calva. 2012. “Economic Mobility and the Rise of the Latin American Middle Class.” Washington, DC: World Bank.
- Ferreira, F. and N. Schady (2009). “Aggregate Economic Shocks, Child Schooling, and Child Health.” *The World Bank Research Observer* 24(2): 147-181.
- Lustig, N., C. Pessino, and J. Scott (2014). “The Impact of Taxes and Social Spending on Inequality and Poverty in Argentina, Bolivia, Brazil, Mexico, Peru, and Uruguay: Introduction to the Special Issue.” *Public Finance Review* 42(3): 287-303.
- Paes de Barros, M. Carvalho, S. Franco, and R. Mendoça (2006). “Uma Análise das Principais Causas da Queda Recente na Desigualdade de Renda Brasileira.” *Revista Economica* 8(1): 117-147.

Perry, G., O. Arias, J.H. Lopez, W. Maloney, and L. Serven (2006). *Poverty Reduction and Growth: Virtuous and Vicious Circles*. World Bank Latin American and Caribbean Studies; World Bank.

Vakis, R., J. Rigolini, and L. Lucchetti (2016). *Left Behind. Chronic Poverty in Latin America and the Caribbean*. Latin America Development Forum; Washington, DC: World Bank.

World Bank (2015). “Working to End Poverty in Latin America and the Caribbean: Workers, Jobs, and Wages.” Poverty and Labor Brief; Washington, DC: World Bank.

World Economic Forum (2016). *The Global Competitiveness Report, 2015*. Switzerland: World Economic Forum.

## **Annex 1. About the data**

The numbers presented in this brief are based on two regional data harmonization efforts known as SEDLAC and LABLAC, joint efforts of the World Bank and CEDLAS at the National University of La Plata in Argentina. They increase cross-country comparability of selected findings from official household and labor surveys. For that reason, the numbers discussed here may be different from official statistics reported by governments and national offices of statistics. Such differences should not be interpreted in any way as a claim of methodological superiority, as both sets of numbers serve the same important objectives: regional comparability and the best possible representation of the facts of individual countries.

Unless otherwise noted, indicators for LAC are calculated using data from Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, and Uruguay (LAC-17). In order to analyze the same set of countries every year, interpolation was applied when country data were not available for a given year.

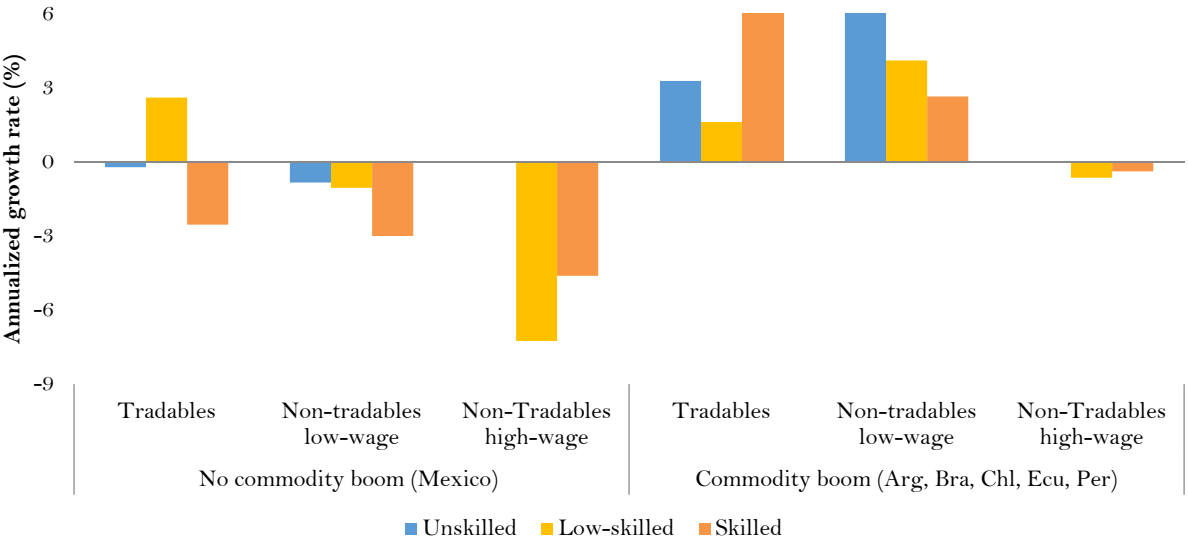
The welfare indicator used in this report is the total household per capita income. Since October 2015, the basic World Bank indicator for measuring extreme poverty globally is the percentage of people living on less than \$1.90 a day in 2011 purchasing parity power (PPP). But the level of economic development in the LAC region has led analysts to use poverty lines that are higher: \$2.50 a day extreme and \$4 a day overall poverty lines. Unless otherwise noted, poverty lines and welfare measures in this brief are in 2005 US\$ (PPP) per day. We follow Ferreira et al. (2012) who defined four economic groups based on the concept of economic security: (i) the poor who are those individuals with a per capita income below \$4 a day; (ii) the vulnerable who are with high risk of falling back into poverty and have incomes between \$4 to \$10 a day; (iii) the middle class who are those individuals living with incomes between \$10 and \$50 a day; and (iv) the rich who are those with incomes above \$50 (all in 2005 US\$ PPP per day).

The Gini coefficient measures income inequality, using values between zero for perfect equality and one for perfect inequality. Since the coefficient does not satisfy group decomposability, the regional Gini coefficient is computed based on pooled country-specific data previously collapsed into 8,000 quantiles. As a result, this measure captures the income inequality between the region's population, and thus differs from measures based on country-specific indicators. In order to analyze the same set of countries every year, interpolation was applied when country data were not available for a given year. Inequality measures include households with zero incomes. Results are similar with the exclusion of these households.

## Annex 2. How robust is the result that wage growth patterns have flipped between commodity exporters and the rest of the region?

While data limitations make it difficult to draw definitive conclusions about the extent to which wage growth patterns have changed in the most recent past, this annex explores a number of data sources to explore this finding and assess its robustness. In the main text above, Figure 10 is based on household surveys from the SEDLAC project while Figure 11 is based on urban samples from labor force surveys in LABLAC. As a result, Figure 10 includes more countries and both urban and rural wages. As a robustness check, we reproduce Figure 10 using the same sample of countries and data source as in Figure 11 to look at wage growth before the beginning of the slowdown. As shown in Figure A1, the wage pattern shown in 2003-2013 largely holds for this smaller set of countries in the year 2012-13.<sup>23</sup> Mexico’s wages were falling for most groups while the wages of most sectors in the commodity exporters were increasing. At this point, however, wages in the non-tradable high-wage sectors were already showing signs of falling.

Figure A1. The year before the slowdown began (2012-13), commodity exporters continued to experience high wage growth for most worker and sector groups

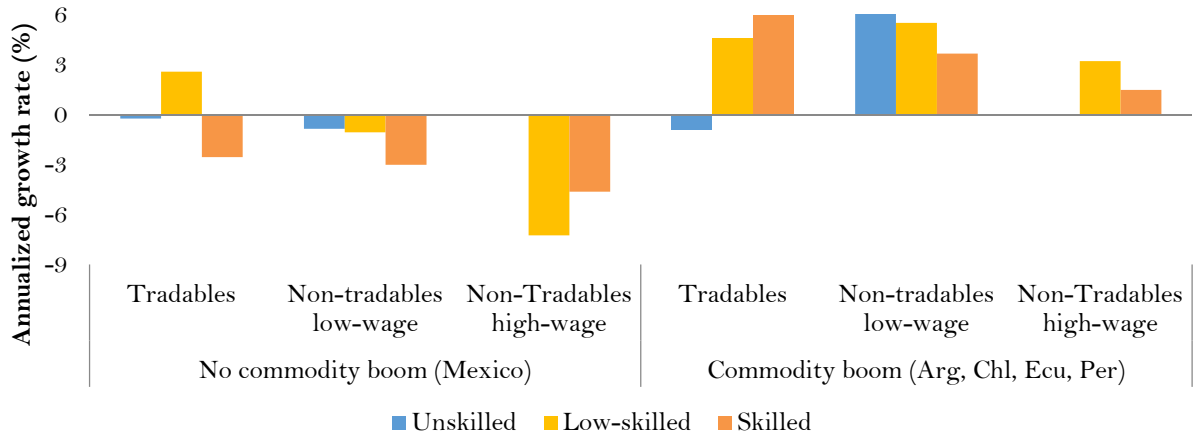


Source: Authors’ calculations using LABLAC (the World Bank and CEDLAS). Skill groups and sector types are defined as in Figure 10. Due to data limitations only the six countries listed on x-axis are included. Due to small sample size, the wage growth of unskilled workers in non-tradable high wage sectors is excluded.

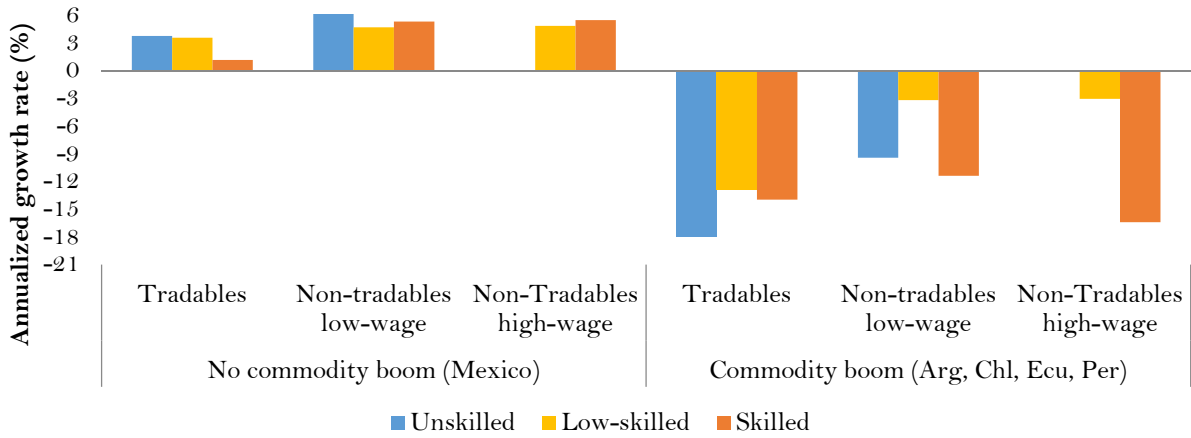
These results are robust to the exclusion of Brazil, the region’s largest economy, which has seen particularly important changes in its economic growth and employment performance. The two figures below show that excluding Brazil from the commodity boom group does not change the general patterns of wage growth of this group of countries.

<sup>23</sup> This analysis cannot be replicated for the full 2003-13 period because LABLAC data are not available that far back for most countries.

Figure A2. The patterns from Figures 12 and A1 are robust to the exclusion of Brazil  
 (a) Wage growth by sector and skill group, 2012-2013



(b) Wage growth by sector and skill group, 2014-2015



Source: Authors' calculations using LABLAC (the World Bank and CEDLAS). Skill groups and sector types are defined as in Figure 10. Due to data limitations only the six countries listed on x-axis are included. Due to small sample size, the wage growth of unskilled workers in non-tradable high wage sectors is excluded.