External Factors, Macro Policies and Growth in LAC: Is Performance that Good?

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Emerging Powers in Global Governance Conference
Paris, July 6, 2007
(based on work with Ernesto Talvi)
I. The External Environment: The Stars are Aligned

II. Activity Performance: Great or Average?

III. Macroeconomic Policies: Are They What They Seem?

II. Final Remarks
Economic Boom in LAC: Strong World Output Growth
(Real annual GDP growth)

Source: WEO
*Estimation
**Forecast
Economic Boom in LAC: High Commodity Prices
(1991-1997 Average = 100)

LAC-7 Terms of Trade
(1997.II = 100)

*excluding Venezuela
Economic Boom in LAC: Exceptional External Financial Conditions for EMs

(EMBI+, bps)

* Assuming an 11% coupon and 10-year maturity
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Business Cycle in Latin America: Here we go again?
(LAC-7 GDP, real annual growth rate)

Source: WEO
The Role of External Factors in LAC Business Cycle: *Simulations*

**Growth Dynamics**
(GDP LAC-7, year on year growth rate)

**Growth Contribution**
(LAC-7, average 2003 - 2006)

*Predicted growth with external factors at 2002q4 levels
Growth in Emerging Markets: A Comparative Perspective
(GDP per capita, constant PPP, 1974 = 100)

Source: Own calculations based on Angus Maddison
Growth in Emerging Regions: A Comparative Perspective
(Real GDP, 2003-2006 annual growth)

Emerging Asia: 8%
Ex USSR: 7%
Middle East: 6%
Emerging Europe: 5%
Africa: 4%
Latin America: 3%

World: 4.8%
Latin America: Investment & Productivity

Investment
(LAC-7, s.a. GFKF, Quarter 0 = 100)

<table>
<thead>
<tr>
<th>Year</th>
<th>1998</th>
<th>2006</th>
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<tbody>
<tr>
<td>% of GDP</td>
<td>22%</td>
<td>20%</td>
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<tr>
<td>Current Prices</td>
<td>22%</td>
<td>23%</td>
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<td>Constant Prices</td>
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Total Factor Productivity
(LAC, Year 0 = 100)

Source: IMF
OUTLINE

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Latin America: Inflation

Inflation
(LAC-7, CPI annual variation)

- Average 91.I-95.II: 20.3%
- Russian Crisis
- Average 98.II-02.IV: 6.2%
- Average 03.I-06.IV: 5.0%
- Median 2006: 4.1%

Incidence of High Inflation
(Latin America, % of countries with inflation over 10% for the last 5 consecutive years)

- 1989: 82%
- 1997: 27%
- 2002: 16%
- 2006: 5%

*Median
Latin America: International Reserves
(billions of US dollars and % of M2)

- **Reserves / M2**
  - Russian Crisis
  - Average 1991.I-1998.II: 45.6%
  - Average 1998.II-2002.IV: 40.3%
  - Average 2002.IV-2006.III: 48.3%

- **M2** = Currency outside banks + demand deposits + time, savings and foreign currency deposits of resident sectors

- **Source:** IFS and own calculations
Latin America External Balance: A Different Perspective*
(LAC-7, current account, in millions of USD and % of GDP)

Current Dilemmas of Monetary & Exchange Rate Policy

Downward Pressure on the Real Exchange Rate

Monetary and Exchange Rate Policy Options

No FX Intervention

Appreciation
Current Dilemmas of Monetary & Exchange Rate Policy

Downward Pressure on the Real Exchange Rate

Monetary and Exchange Rate Policy Options

- No FX Intervention
  - Appreciation

- FX Intervention
  - Inflation
Current Dilemmas of Monetary & Exchange Rate Policy

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- Appreciation

FX Intervention
- Inflation

Dilemma
Real Exchange Rate Policies: Leaning Against the Wind or Growth Oriented Policy?

- “Leaning against the wind policies” are short or medium-term in nature, and therefore could be manageable.

- But growth oriented policies are in principle longer-term and may carry some difficult choices.
Real Exchange Rate Policies: Costs

- Targeting the RER away from equilibrium may be a loosing battle with inflationary consequences (Calvo et al 1994).
- Alternatively, RER depreciation beyond equilibrium will require sterilization policies to fight inflation.
- Quasi-fiscal costs of sterilization.
- Latin America is not China:
  - Closed vs. open capital account
  - Quasifiscal surplus vs. deficit
Real Exchange Rate Policies: Is it the tool?

• Studies do not control for Sudden Stop-type crises: Large RER depreciation coincides with later recovery at high growth rates (Calvo, Izquierdo & Talvi, 2006)

• If diversification is related to the provision of specific factors (Hausmann et al, 2006), it is not clear that across the board policies in tradable sectors are desirable

• In particular, if accompanied by export taxes (the case of Argentina), most subsidies go to import substitution activities

• To the extent that the fisc depends on these taxes to obtain its primary surplus, then risks to debt sustainability increase
Federal Government: the Effect of New Taxes on the Primary Surplus

**Revenues & Primary Expenditures**
(Central Government, % GDP)

- Observed Revenues
- Primary Expenditures
- Revenues Excluding New Taxes*

**Primary Surplus**
(Central Government, % GDP)

- Observed Primary Surplus
- Primary Surplus Excluding New Taxes*
- New Taxes*

* Export Taxes and Financial Transactions Tax
Current Dilemmas of Monetary & Exchange Rate Policy

Downward Pressure on the Real Exchange Rate

Monetary and Exchange Rate Policy Options

No FX Intervention
- Appreciation
  - The Fisc looses (lower export tariffs)

FX Intervention
- Inflation
  - The Central Bank looses (sterilization)

Dilemma
Current Dilemmas of Monetary & Exchange Rate Policy

Downward Pressure on the Real Exchange Rate

Monetary and Exchange Rate Policy Options

No FX Intervention

- Appreciation
  - The Fisc loses (lower export tariffs)

FX Intervention

- Price Controls
  - Capital Controls
  - The Central Bank loses (sterilization)
- Inflation
Latin America: Fiscal Balance
(LAC-7, % of GDP)

Average 1992-1998: -0.9%
Average 1999-2002: -2.8%
Average 2003-2006: -0.2%

Russian Crisis
Chile: Structural Fiscal Balance*

**Fiscal Revenues and Expenditures**
(Fiscal Revenues, Mar-91 = 100)

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<tr>
<th>Year</th>
<th>Russian Crisis</th>
<th>Beginning of Current Boom</th>
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**Fiscal Balance**
(% of GDP)

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* *Talvi, Ernesto (2007), “If Latin America Were Chile: A Note on Structural Fiscal Balances”.*
Latin America: Structural Fiscal Balance*

Fiscal Revenues and Expenditures
(LAC, Fiscal Revenues, Mar-91 = 100)

Fiscal Balance
(LAC-7, % of GDP)

*Excluding Venezuela

*Talvi, Ernesto (2007), “If Latin America Were Chile: A Note on Structural Fiscal Balances”
Latin America: Public Debt Dollarization

(LAC-7, foreign currency debt, % of total debt)

Average 97-02: 59.1%
Average 03-06: 48.9%

Source: Cowan, Levy, Panizza, Sturzenegger (2006) and own calculations based on official data.
Debt Mutation: An Illustration*
(Public debt composition, % of total debt)

<table>
<thead>
<tr>
<th>Pre-October 2002 Election Debt Composition</th>
<th>Current Debt Composition</th>
<th>Pre-Asian Crises Debt Composition</th>
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<tbody>
<tr>
<td>83%</td>
<td>55%</td>
<td>61%</td>
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<td>15%</td>
<td>43%</td>
<td>28%</td>
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<td>Selic-linked + FX-linked + Repo</td>
<td>Fixed rate</td>
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Pre-Devaluation Debt Mutation*
(Debt dollarization + Selic-linked in % of total debt, and exchange rate, R$ per US dollar)

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The current bonanza and macroeconomic fundamentals in Latin America are largely supported by an exceptionally favorable external environment.

There have been policy improvements (more flexible exchange rate regimes, better monetary policy, dedollarization).

However, the current bonanza may be masking fragilities: macroeconomic indicators that look good today may worsen quickly if the external environment deteriorates.

And if it doesn’t? What if higher terms of trade and benign financial conditions are here to stay? Are we using the good times to strengthen vulnerabilities? Are we making use of this bonanza for much needed long-term investments?
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