

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)***



LatinMacroWatch

OUTLINE

I. The External Environment: The Stars are Aligned

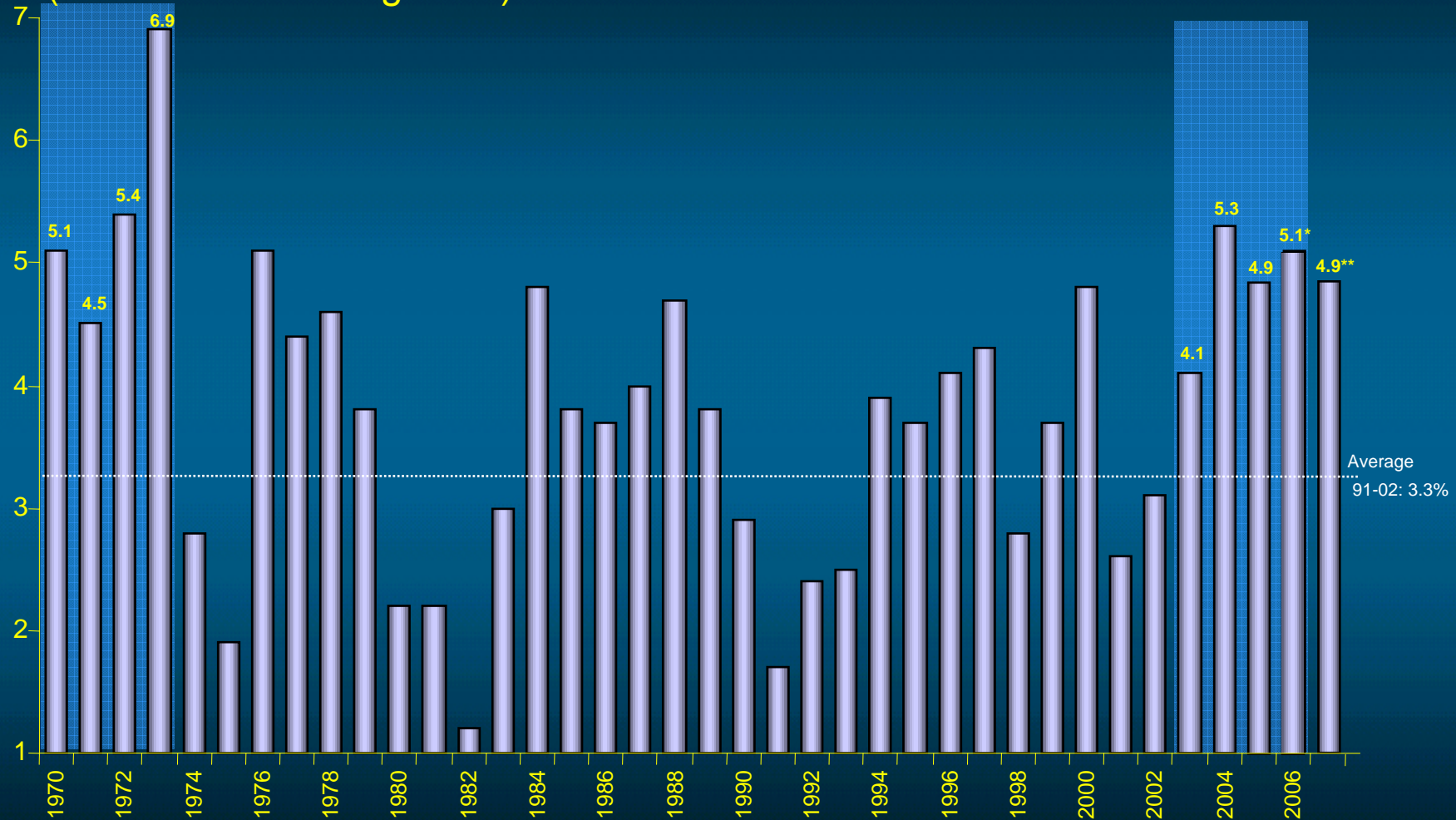
II. Activity Performance: Great or Average?

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



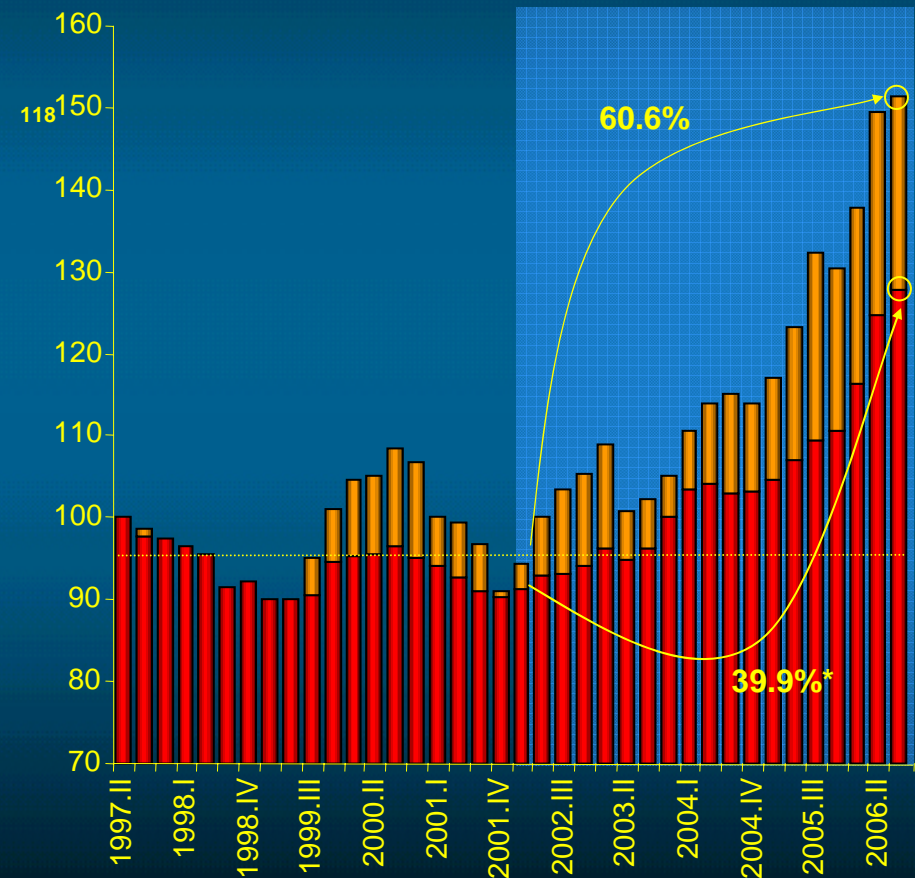
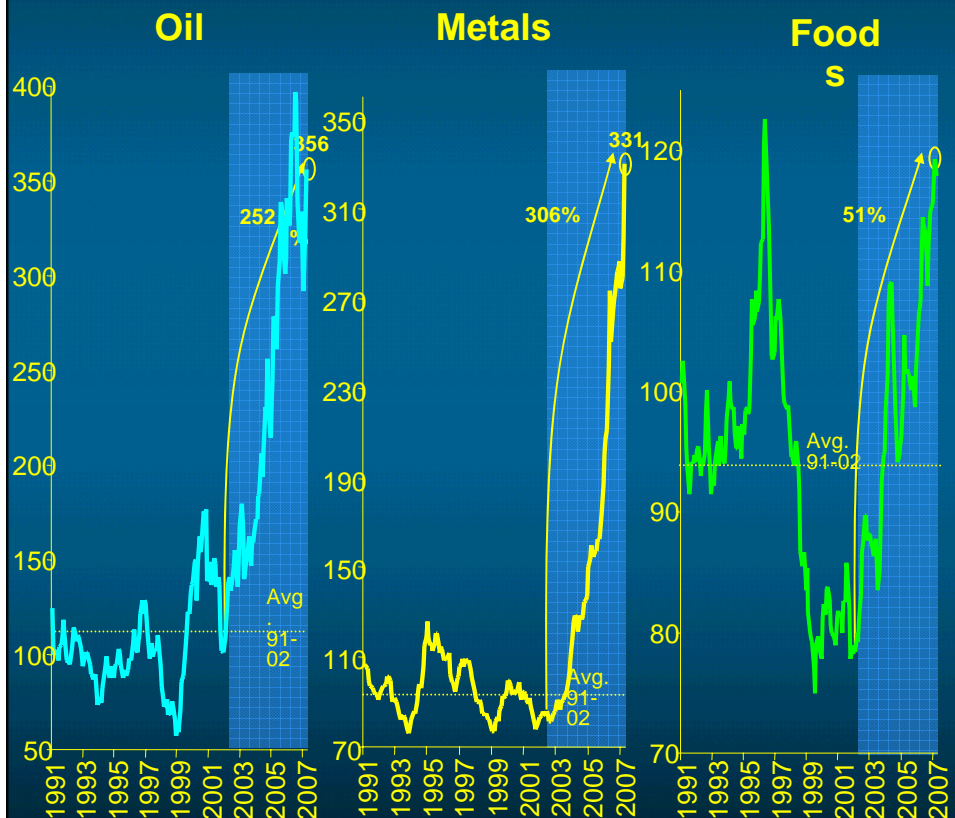
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Economic Boom in LAC: High Commodity Prices

(1991-1997 Average = 100)

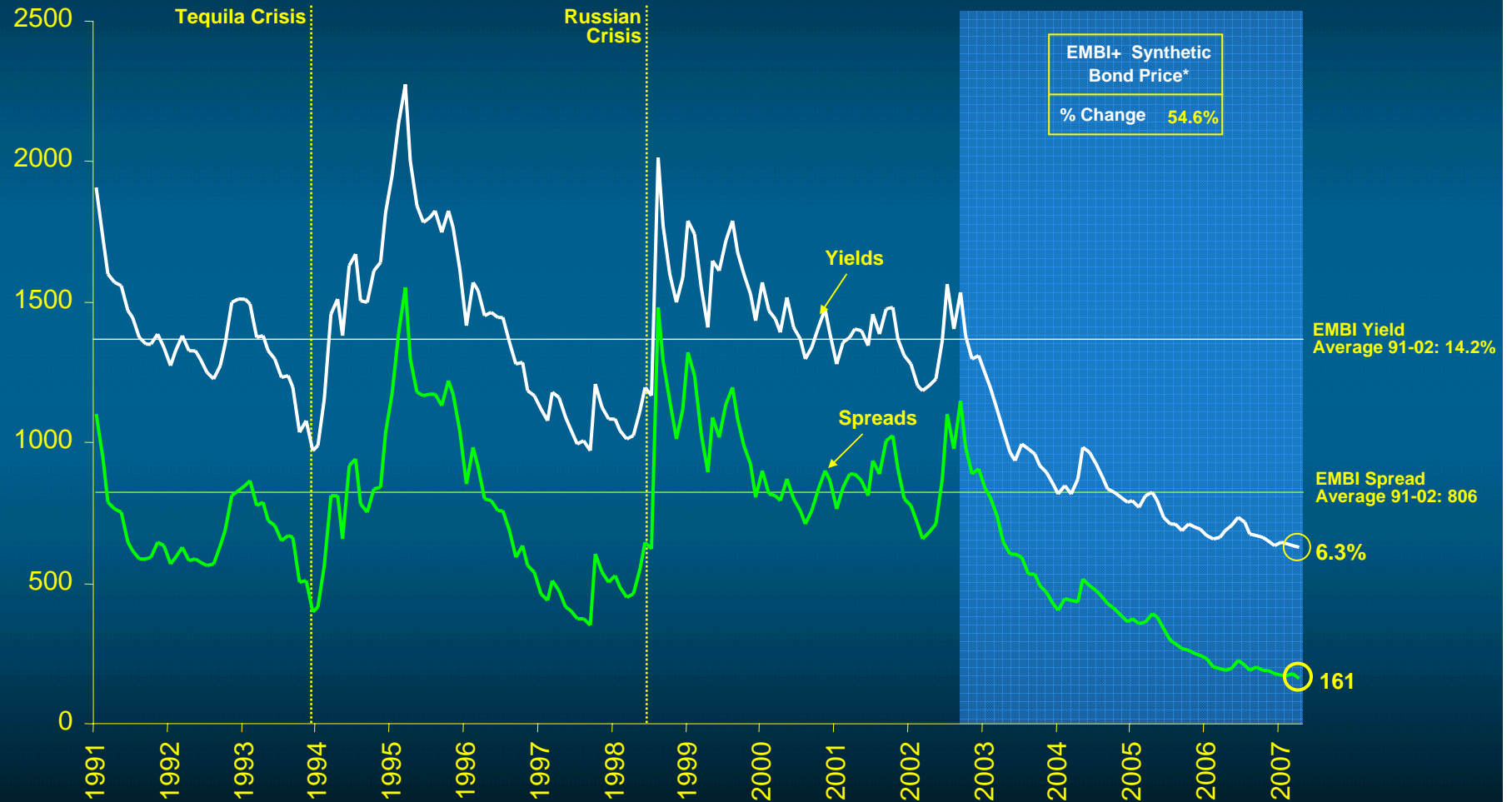
LAC-7 Terms of Trade

(1997.II = 100)



Economic Boom in LAC: Exceptional External Financial Conditions for EMs

(EMBI+, bps)



* Assuming an 11% coupon and 10-year maturity

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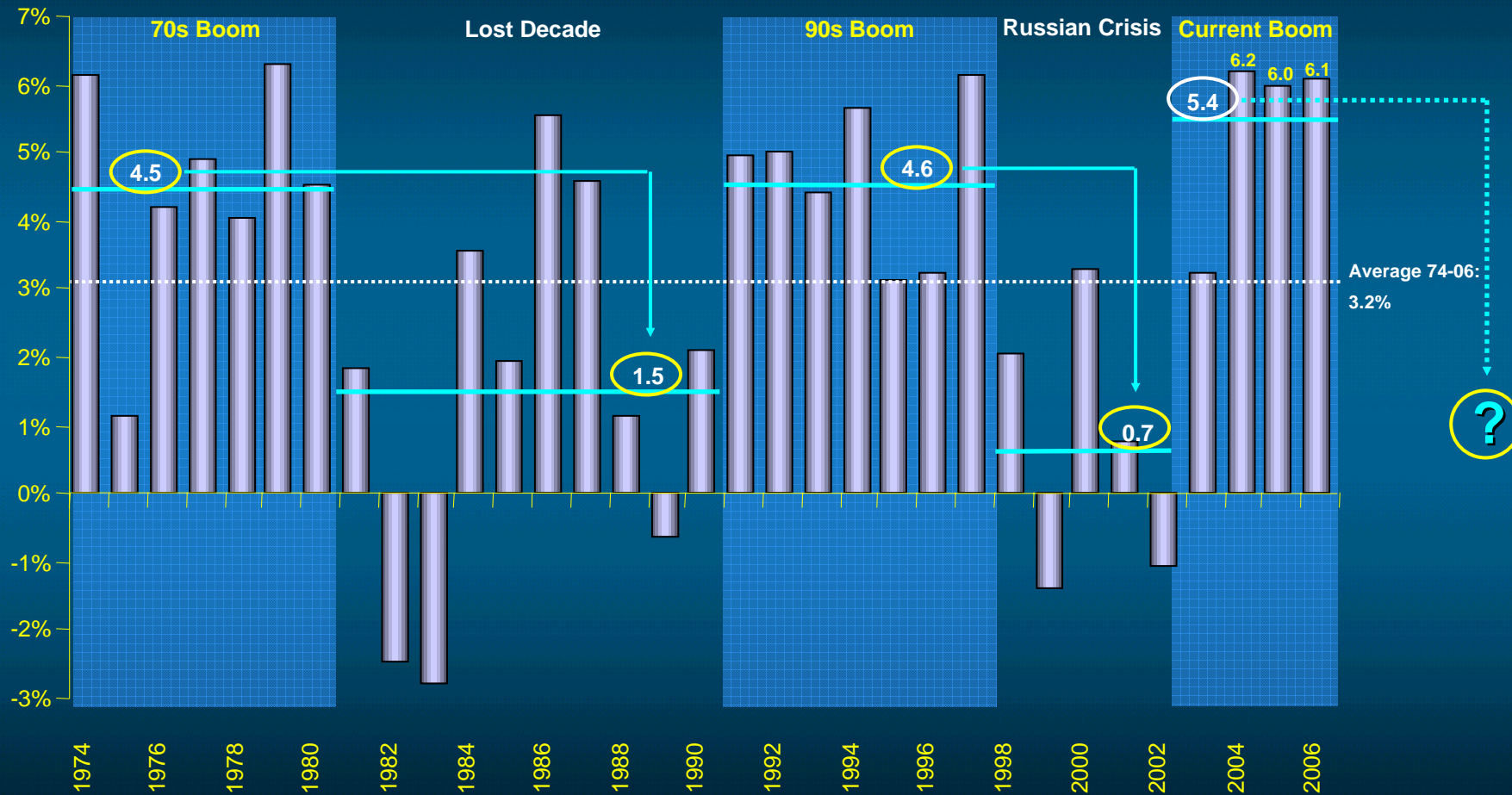
III. Macroeconomic Policies: Are They What They Seem?

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Business Cycle in Latin America: Here we go again?

(LAC-7 GDP, real annual growth rate)



Source: WEO

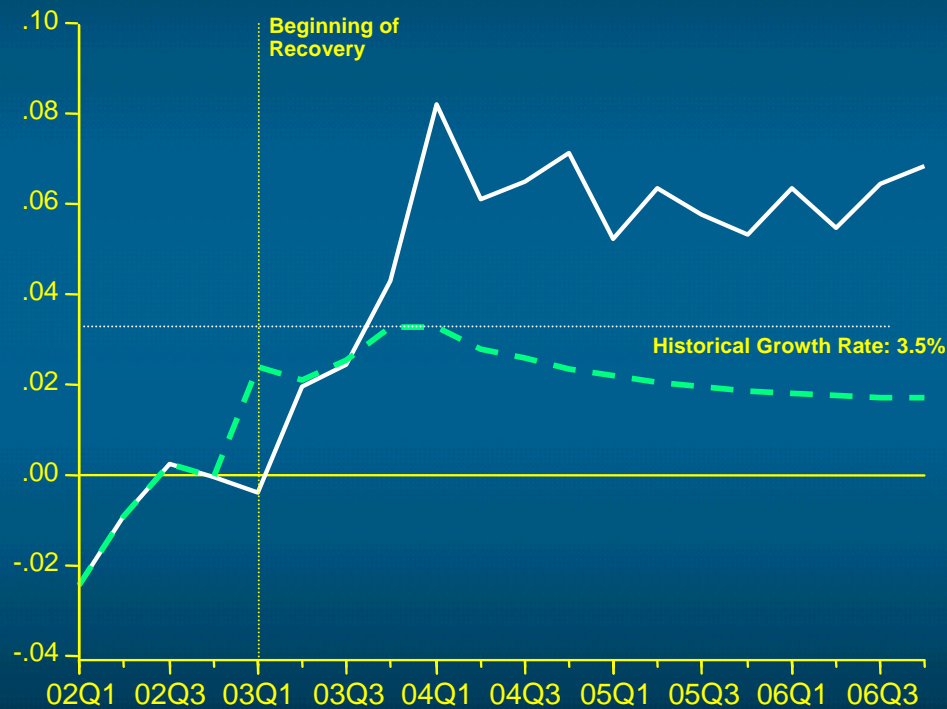


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The Role of External Factors in LAC Business Cycle: *Simulations**

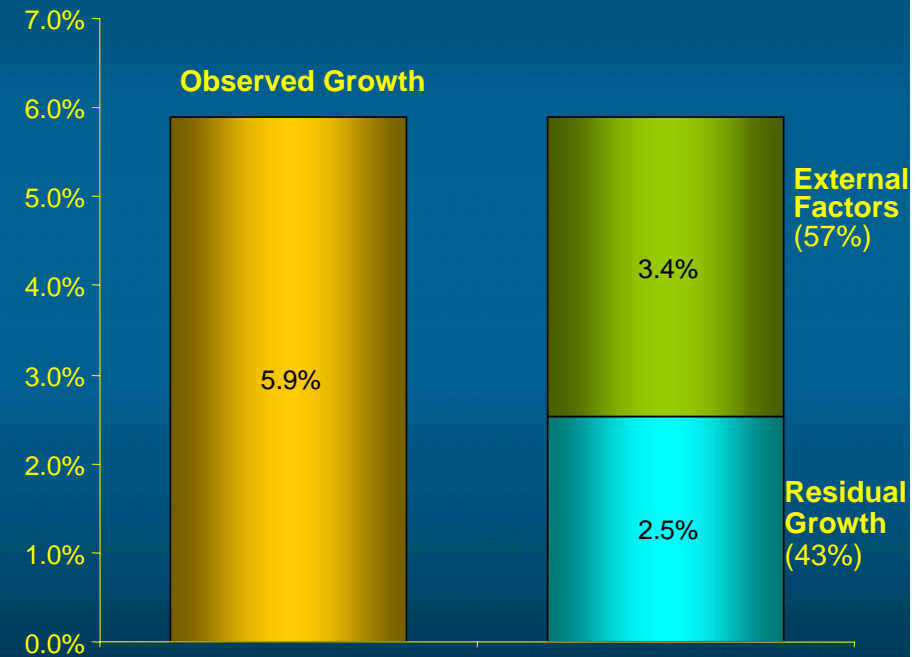
Growth Dynamics

(GDP LAC-7, year on year growth rate)



Growth Contribution

(LAC-7, average 2003 - 2006)

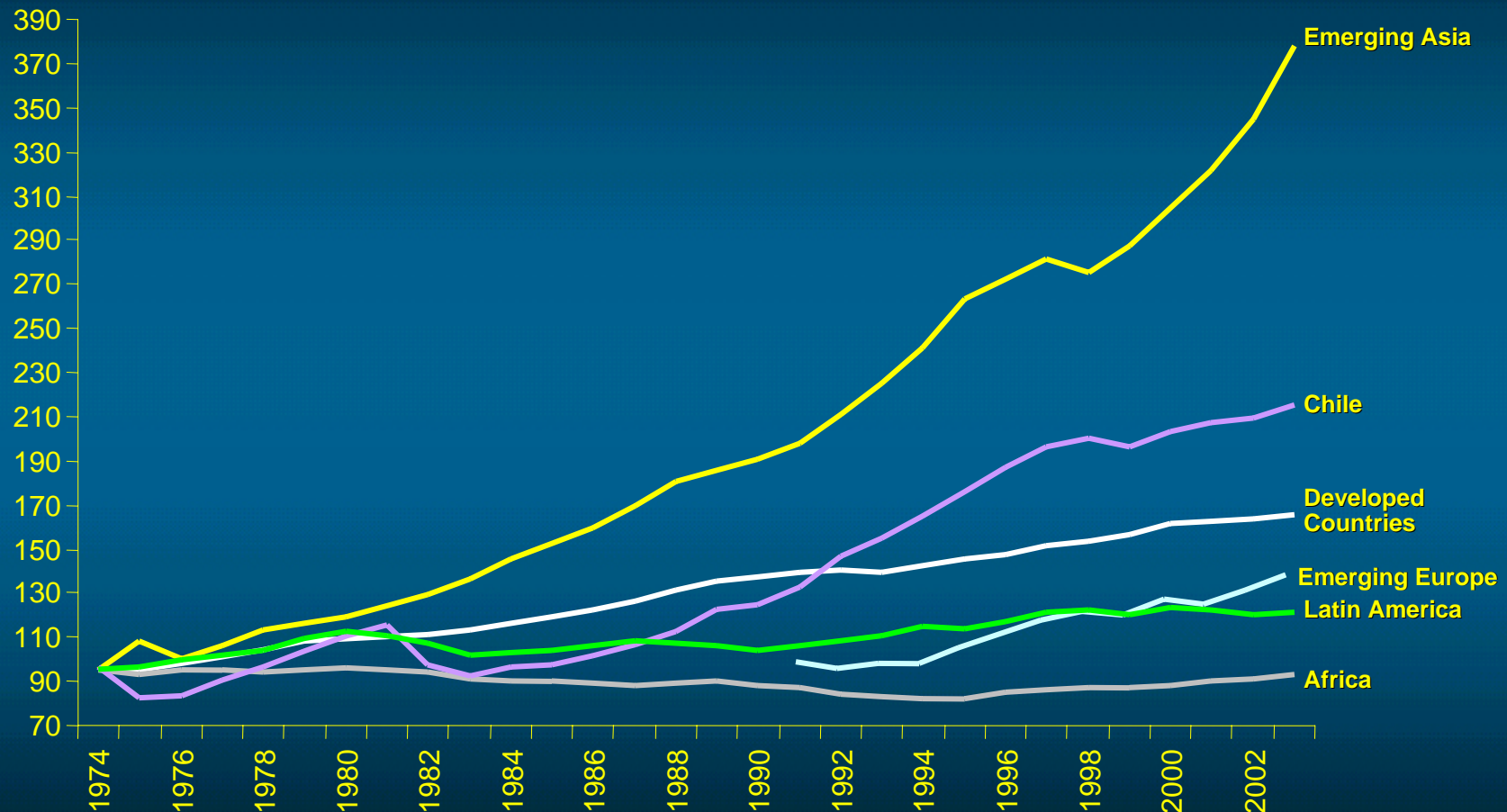


*Predicted growth with external factors at 2002q4 levels

*A. Izquierdo, R. Romero and E.Talvi (2006,2007), "The Role of External Factors on Growth in Latin America".

Growth in Emerging Markets: A Comparative Perspective

(GDP per capita, constant PPP, 1974 = 100)



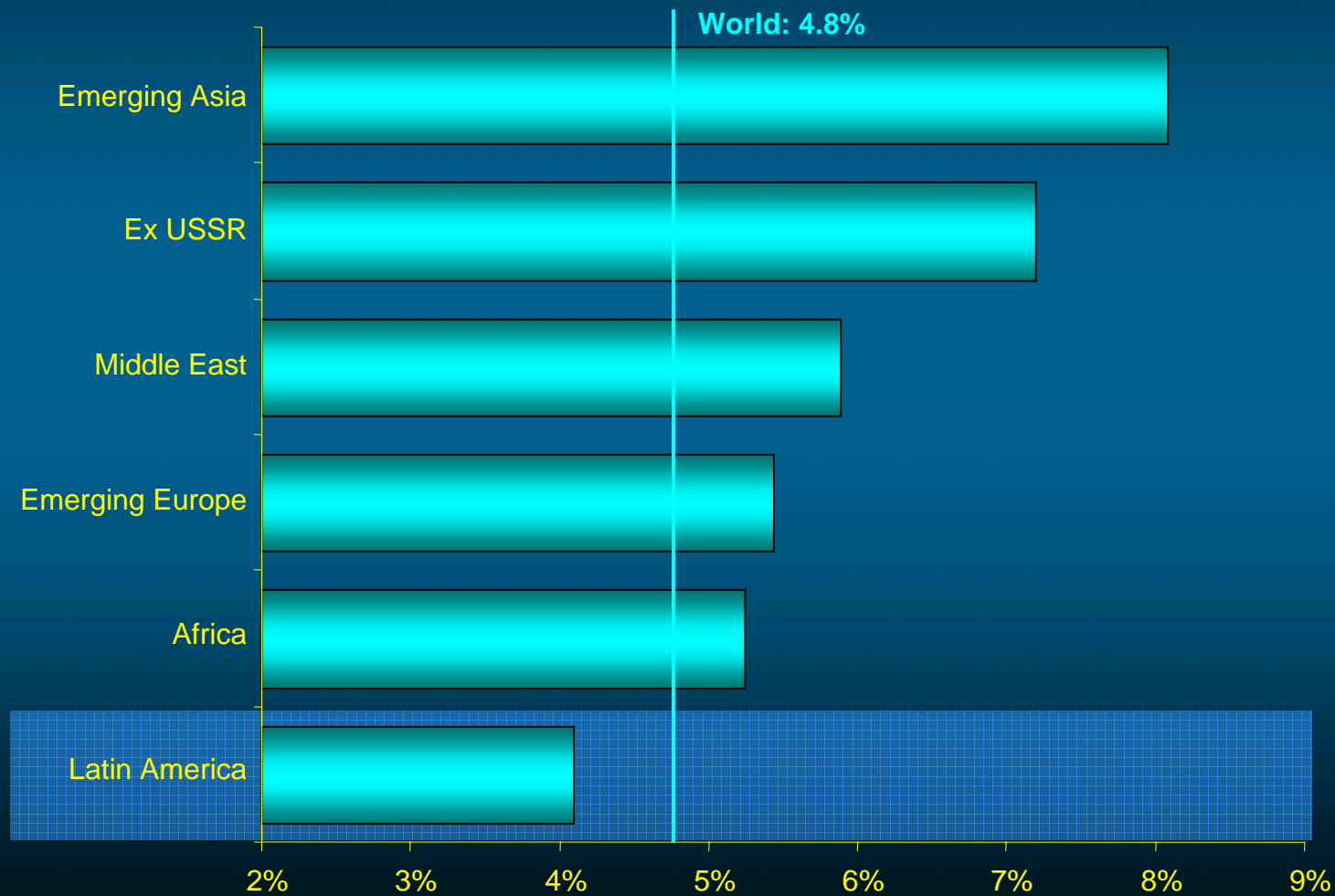
Source: Own calculations based on Angus Maddison



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Growth in Emerging Regions: A Comparative Perspective

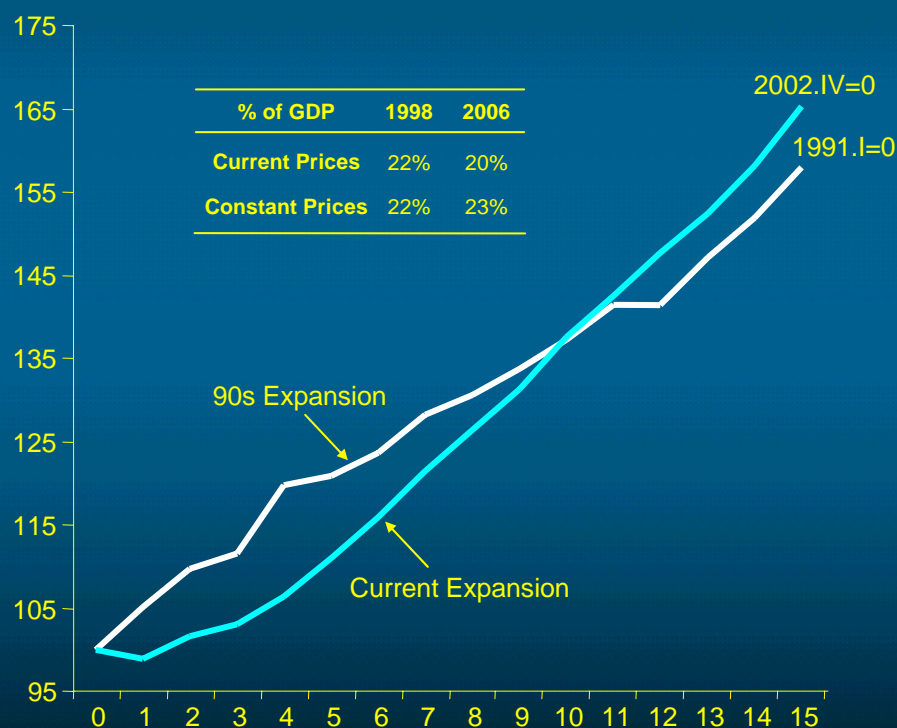
(Real GDP, 2003-2006 annual growth)



Latin America: Investment & Productivity

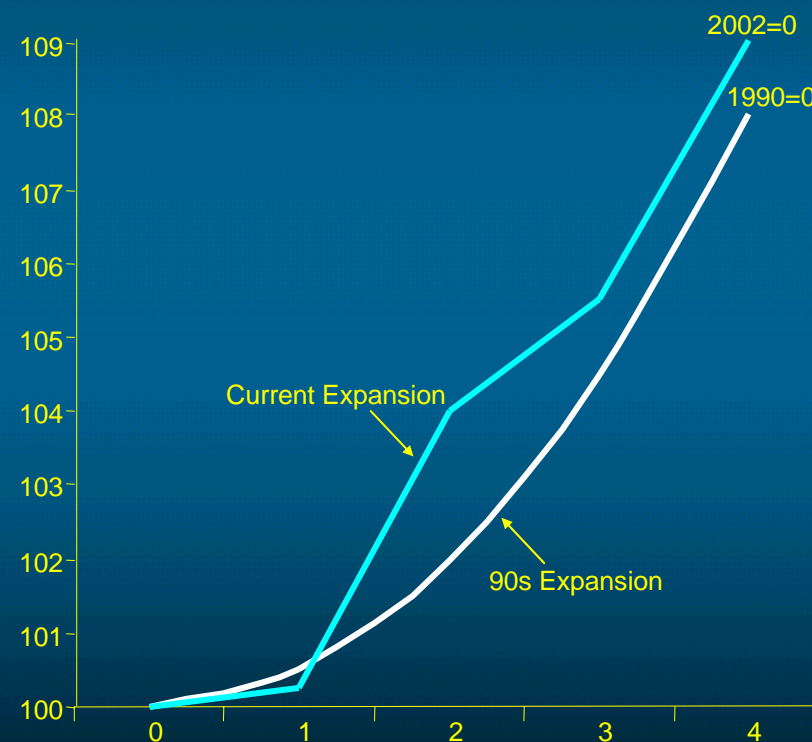
Investment

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



Total Factor Productivity

(LAC, Year 0 = 100)



Source: IMF



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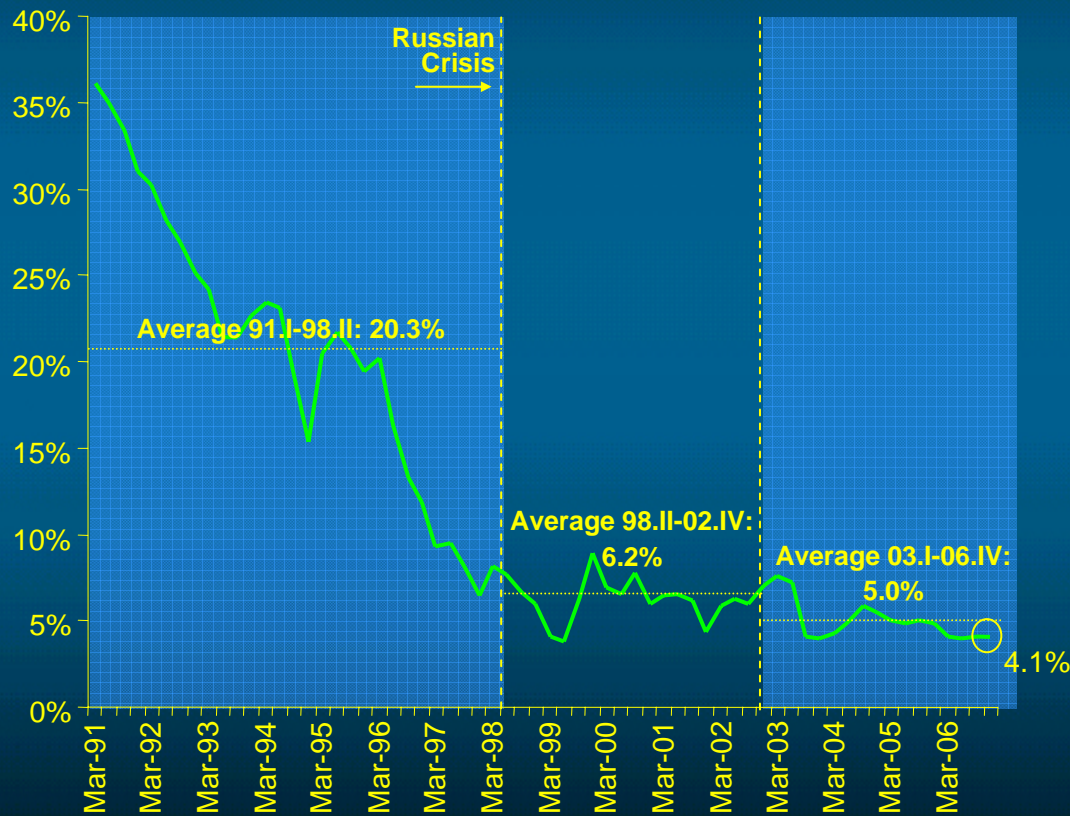
II. Final Remarks



Latin America: Inflation

Inflation

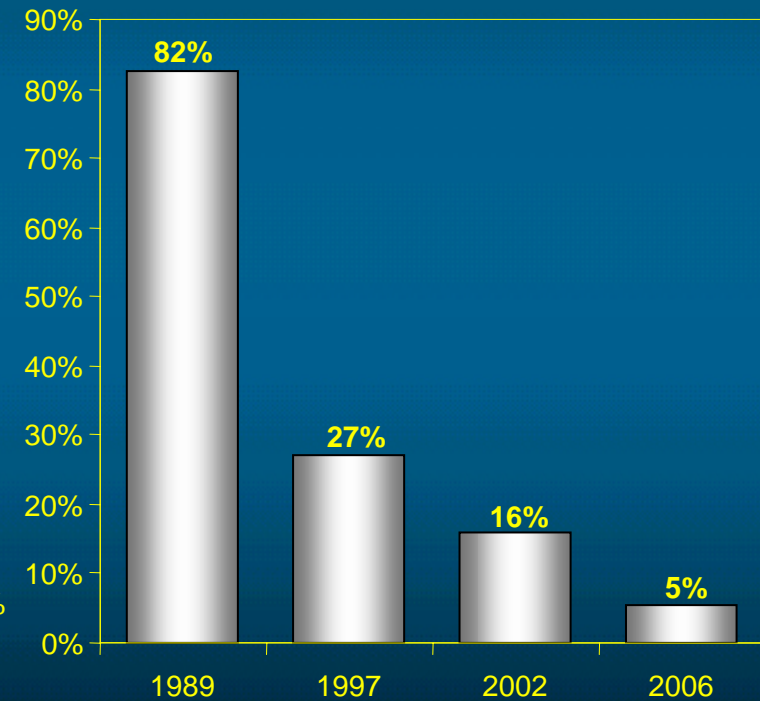
(LAC-7, CPI annual variation)



*Median

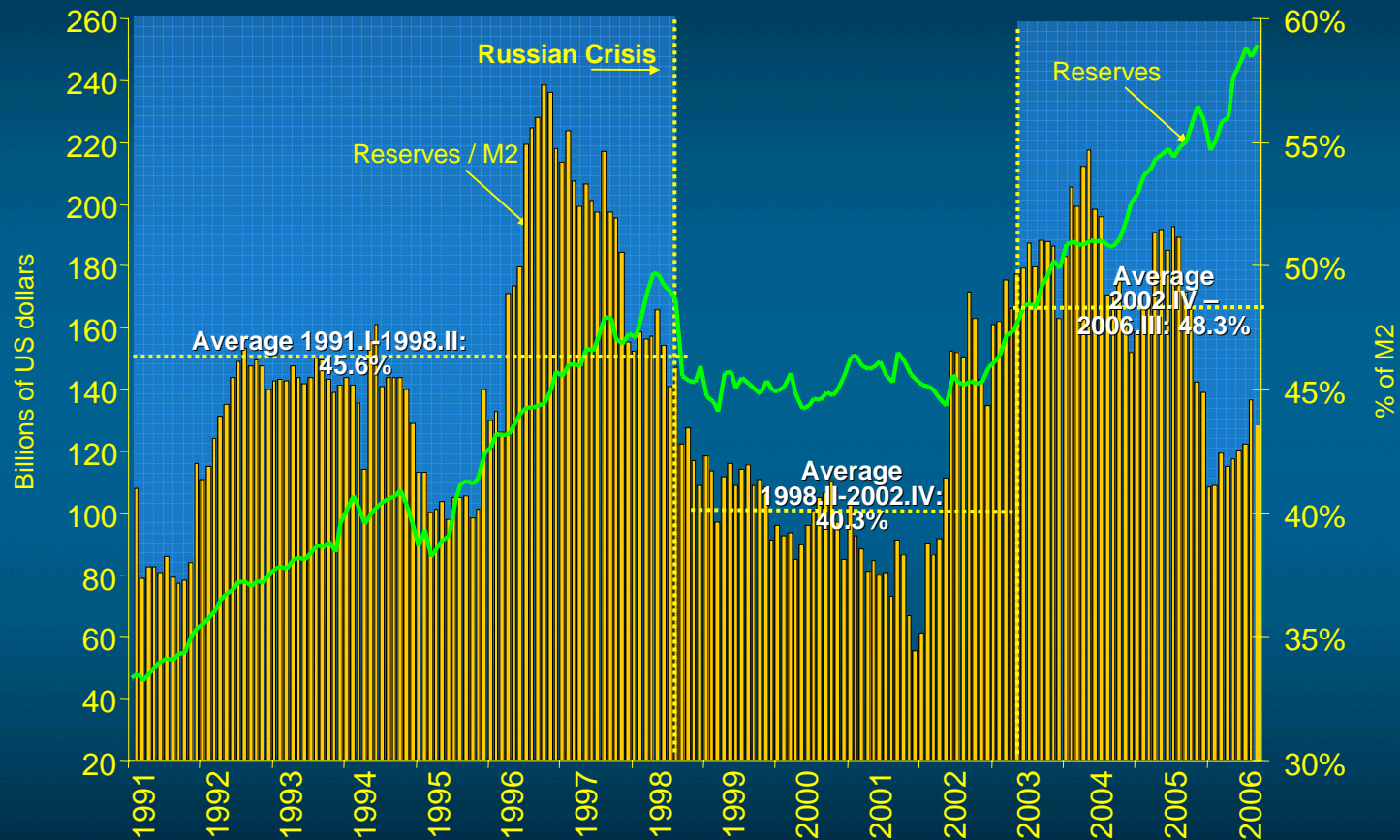
Incidence of High Inflation

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



Latin America: International Reserves

(billions of US dollars and % of M2)

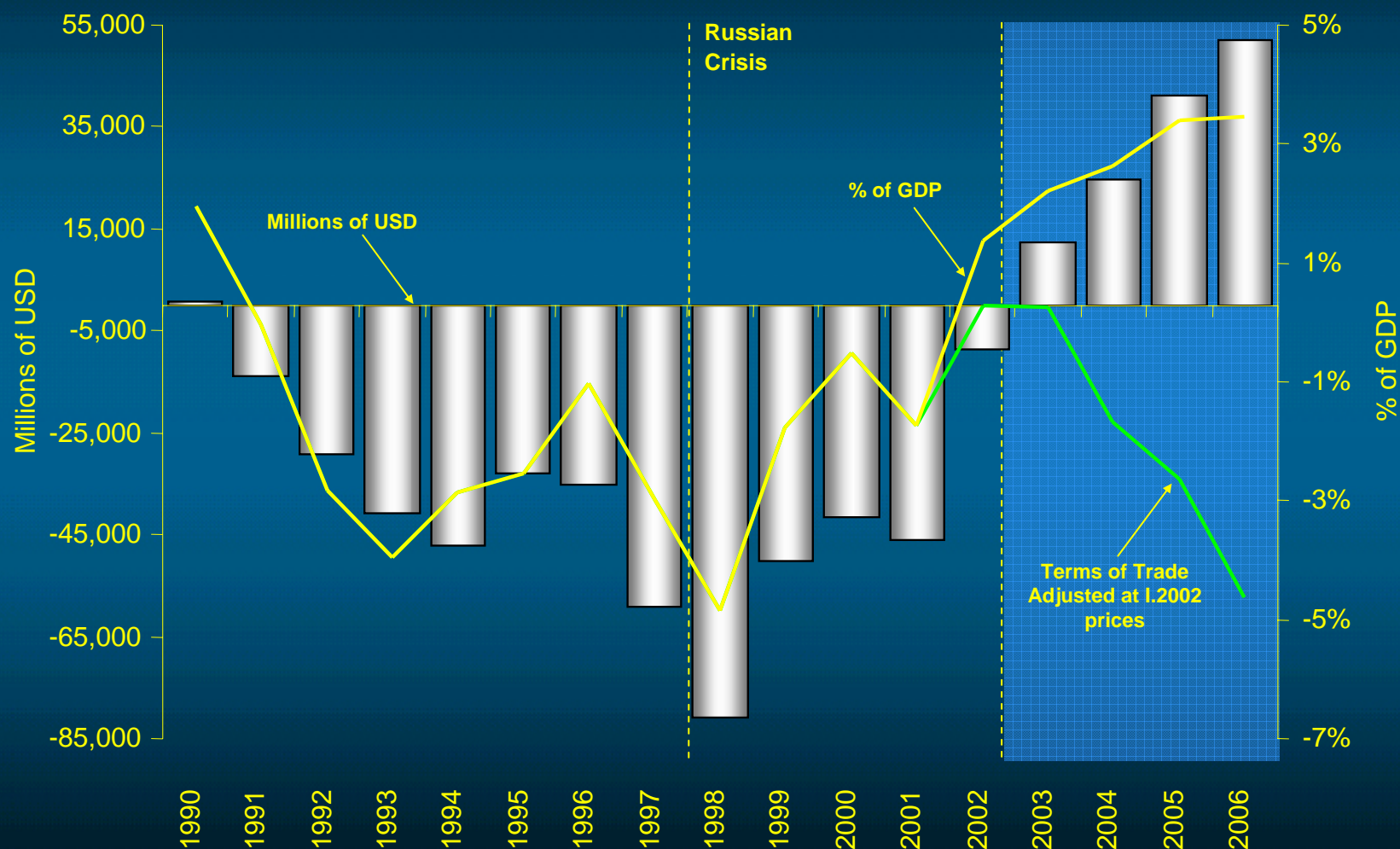


M2 = Currency outside banks + demand deposits + time, savings and foreign currency deposits of resident sectors

Source: IFS and own calculations

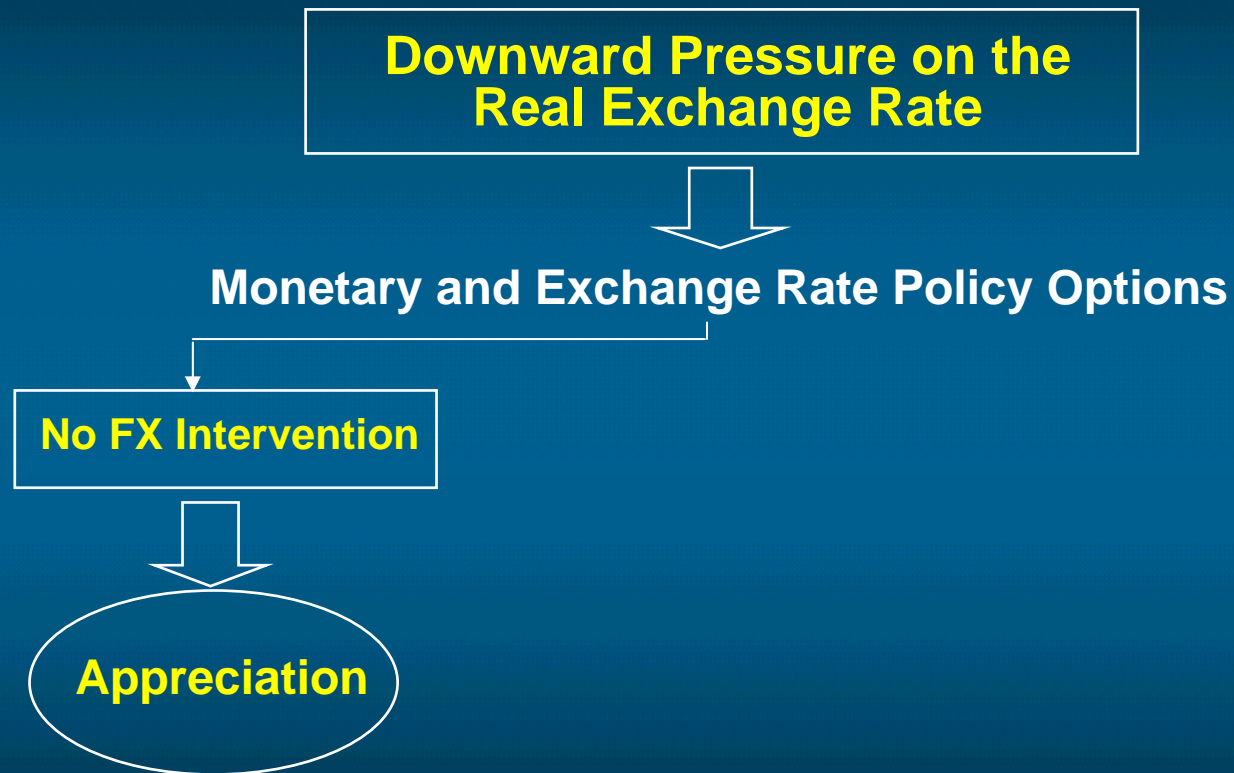
Latin America External Balance: A Different Perspective*

(LAC-7, current account, in millions of USD and % of GDP)

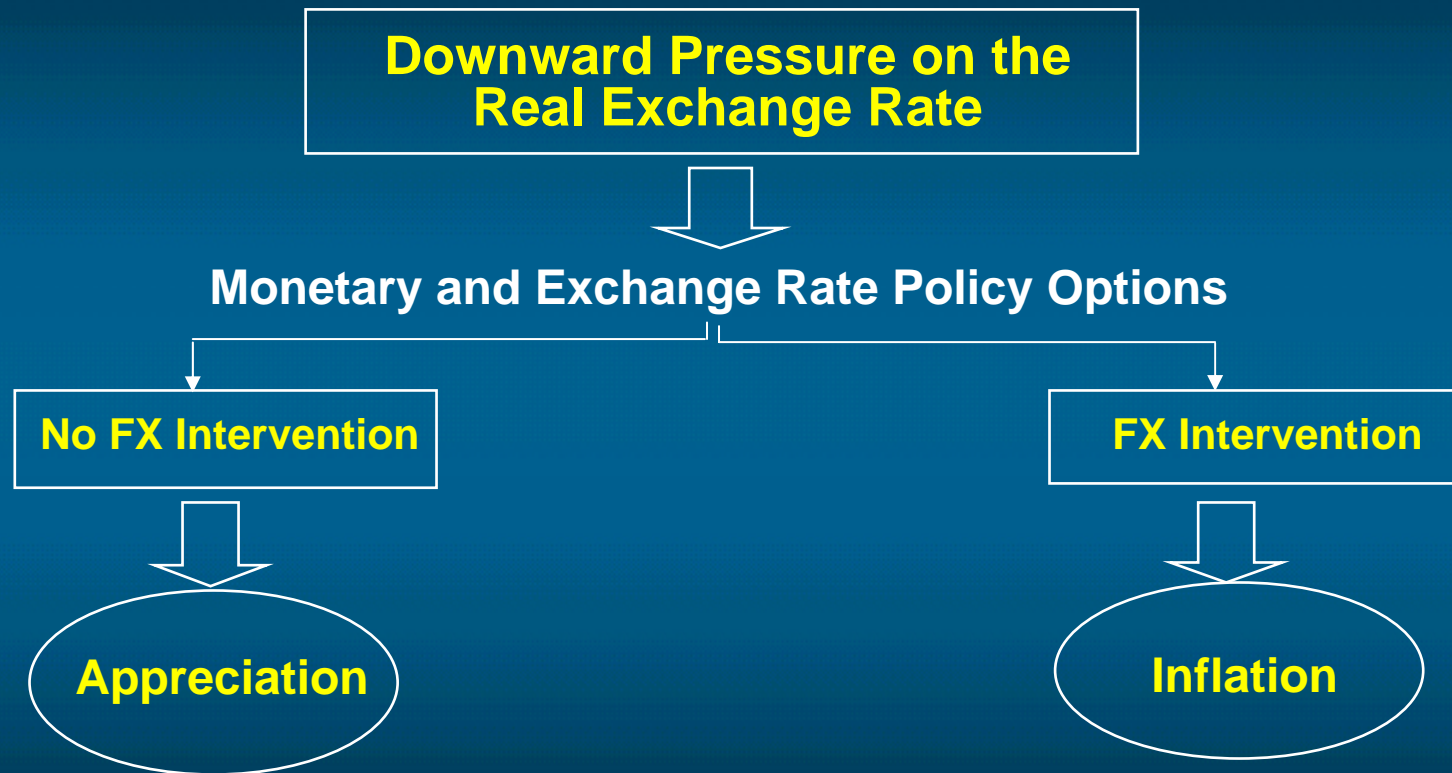


* Calvo and Talvi (2007): "Current Account Surplus in Latin America: Recipe Against Capital Market Crises?"; www.rgemonitor.com (forthcoming)

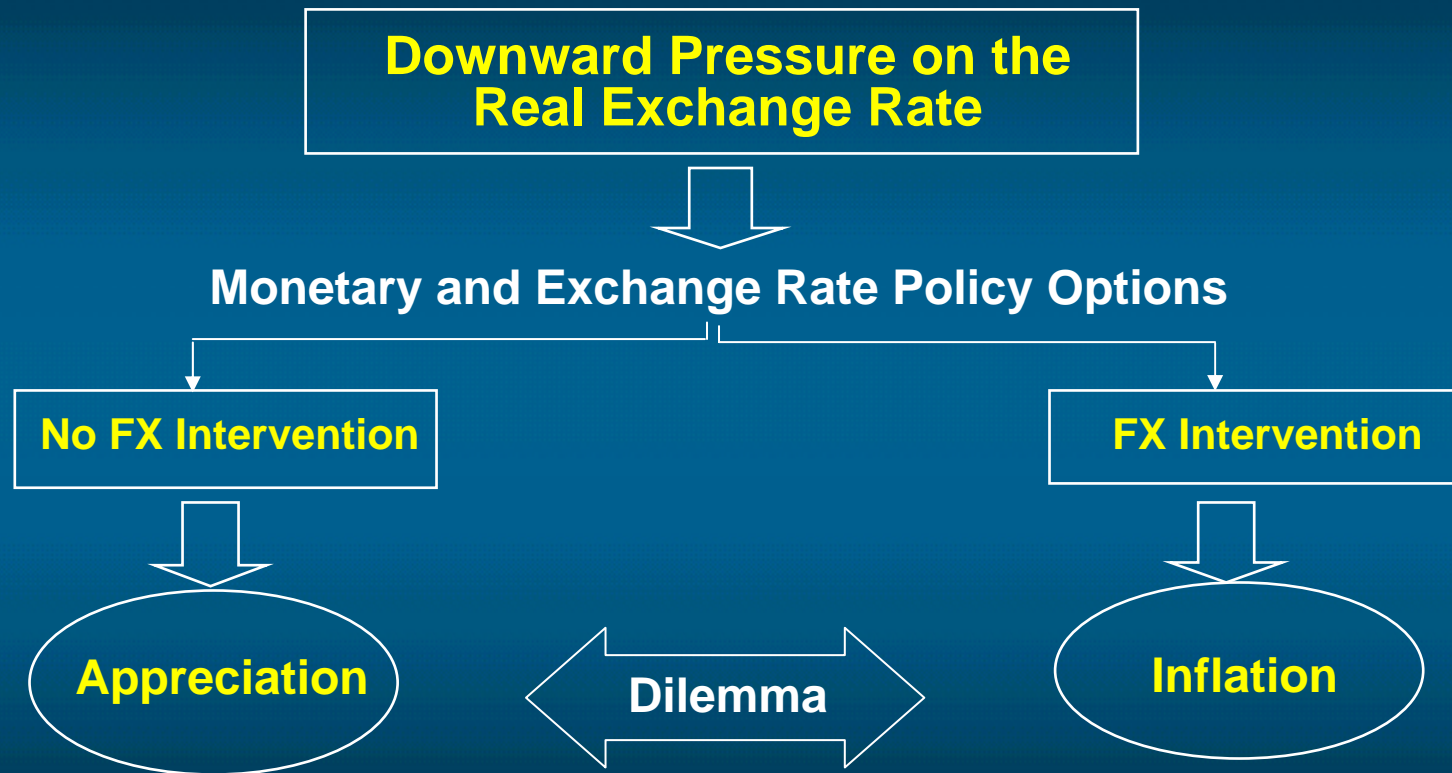
Current Dilemmas of Monetary & Exchange Rate Policy



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Current Dilemmas of Monetary & Exchange Rate Policy



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 losing battle with inflationary consequences (Calvo et al 1994).
- Alternatively, RER depreciation beyond equilibrium will require sterilization policies to fight inflation
- Cuasi-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?

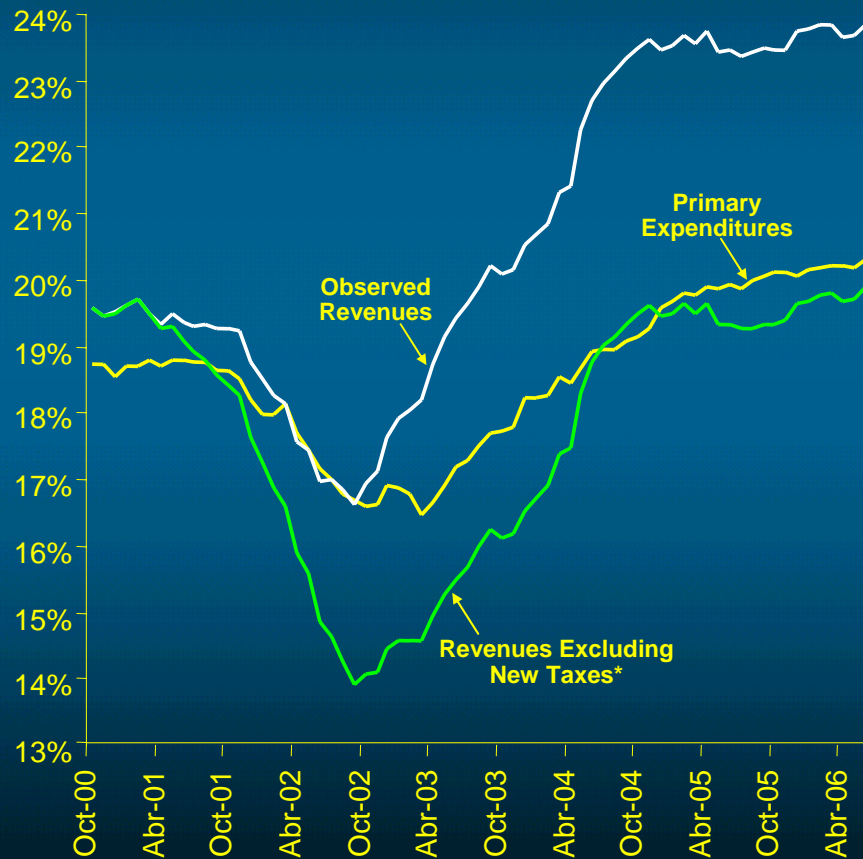
- Studies do not control for Sudden Stop-type crises: Large RER depreciation coincides with later recovery at high growth rates (Calvo, Izquierdo & Talvi, 2006)
- If diversification is related to the provision of specific factors (Hausmann et al, 2006), it is not clear that across the board policies 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)



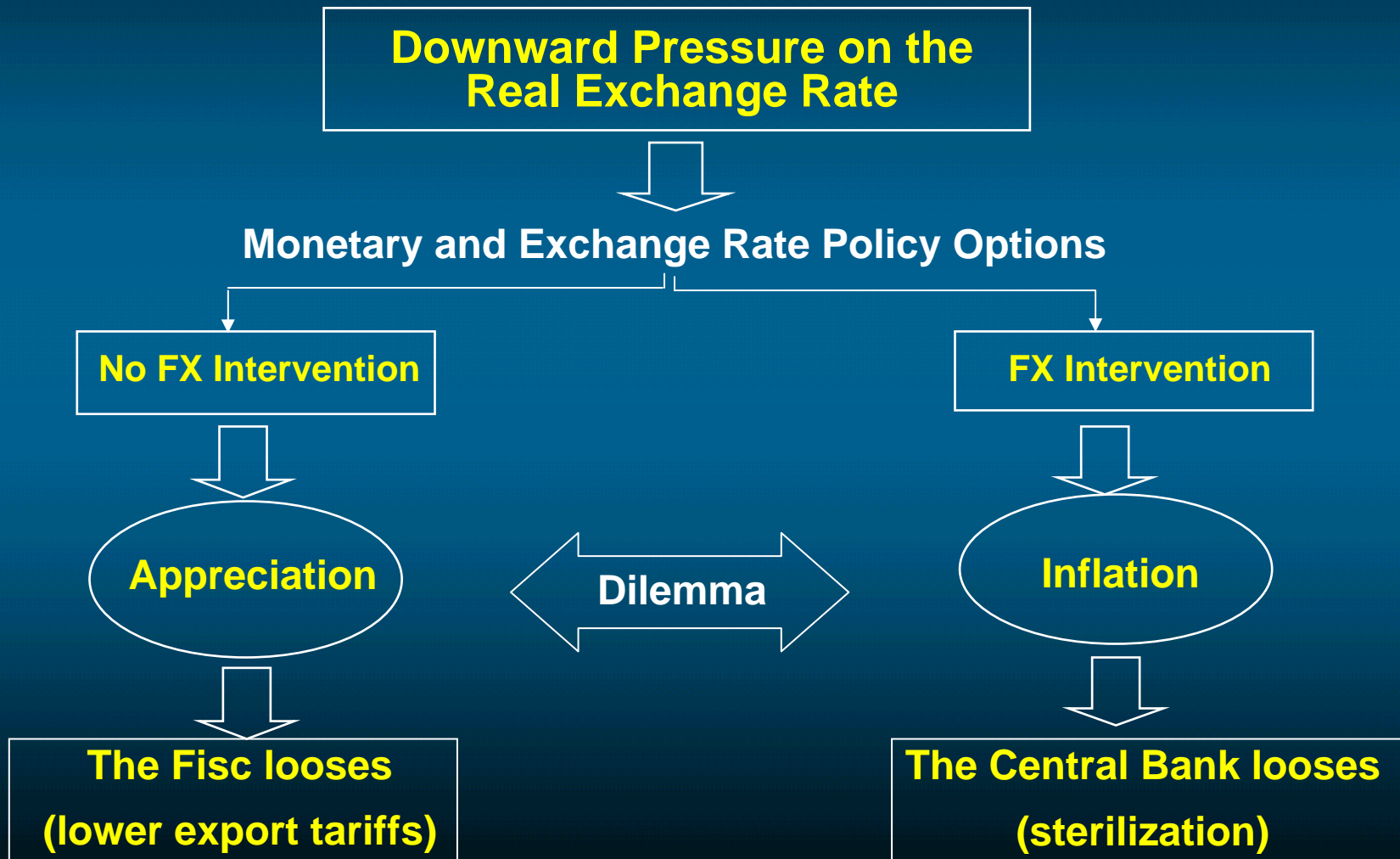
Primary Surplus (Central Government, % GDP)



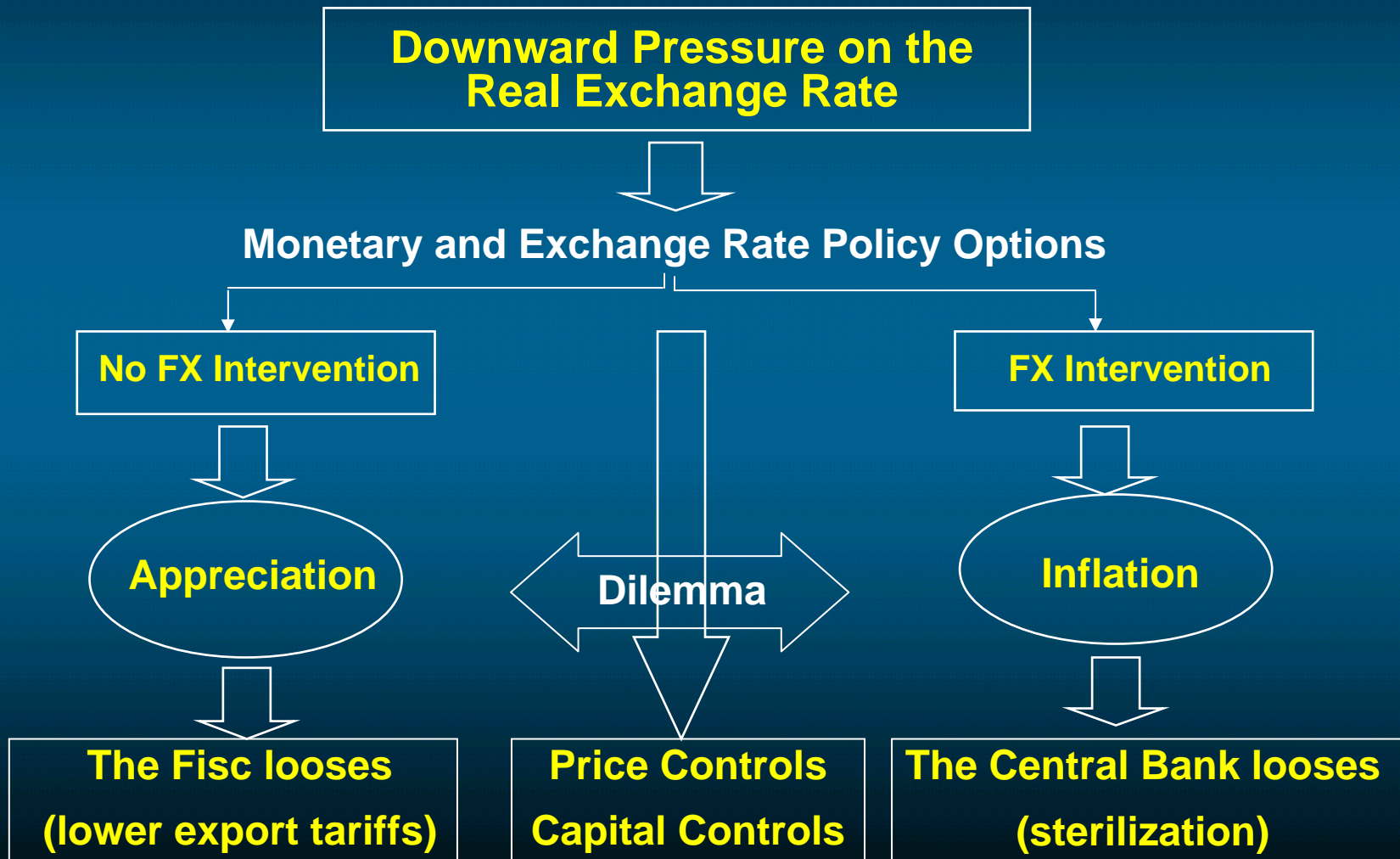
* Export Taxes and Financial Transactions Tax



Current Dilemmas of Monetary & Exchange Rate Policy

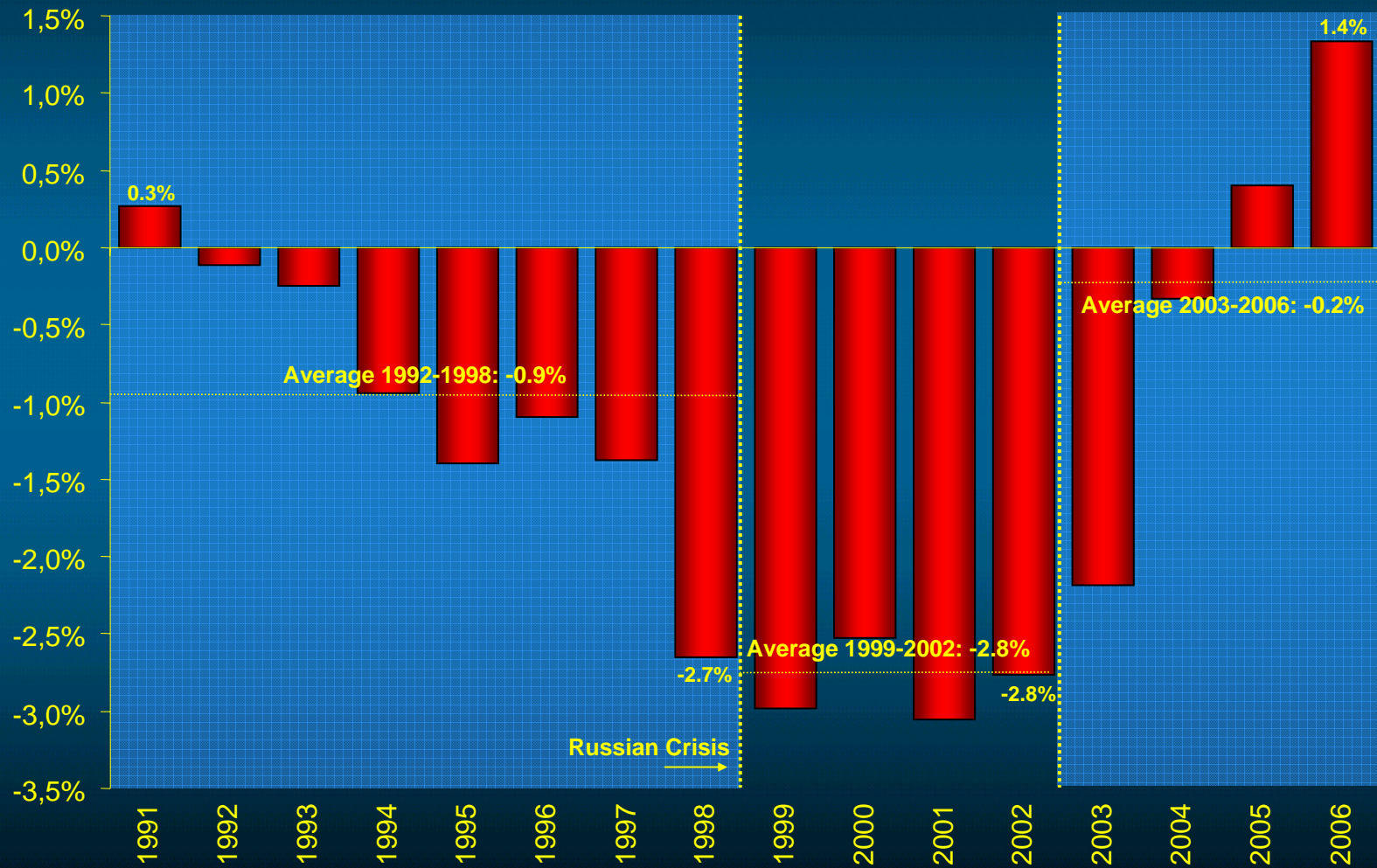


Current Dilemmas of Monetary & Exchange Rate Policy



Latin America: Fiscal Balance

(LAC-7, % of GDP)

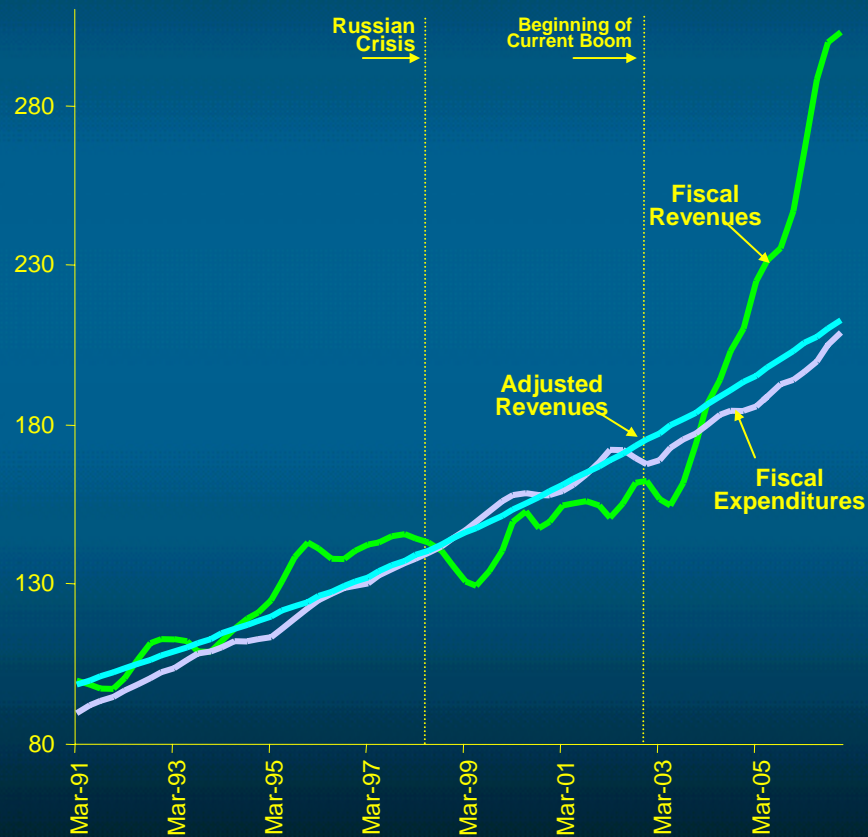




Chile: Structural Fiscal Balance*

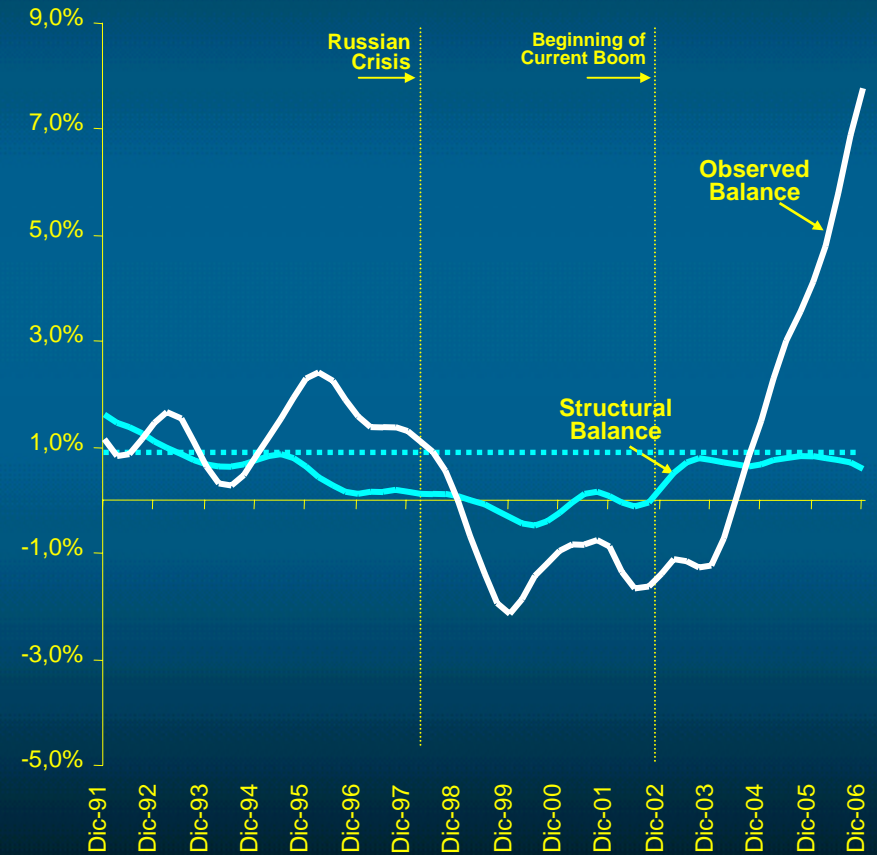
Fiscal Revenues and Expenditures

(Fiscal Revenues, Mar-91 = 100)



Fiscal Balance

(% of GDP)



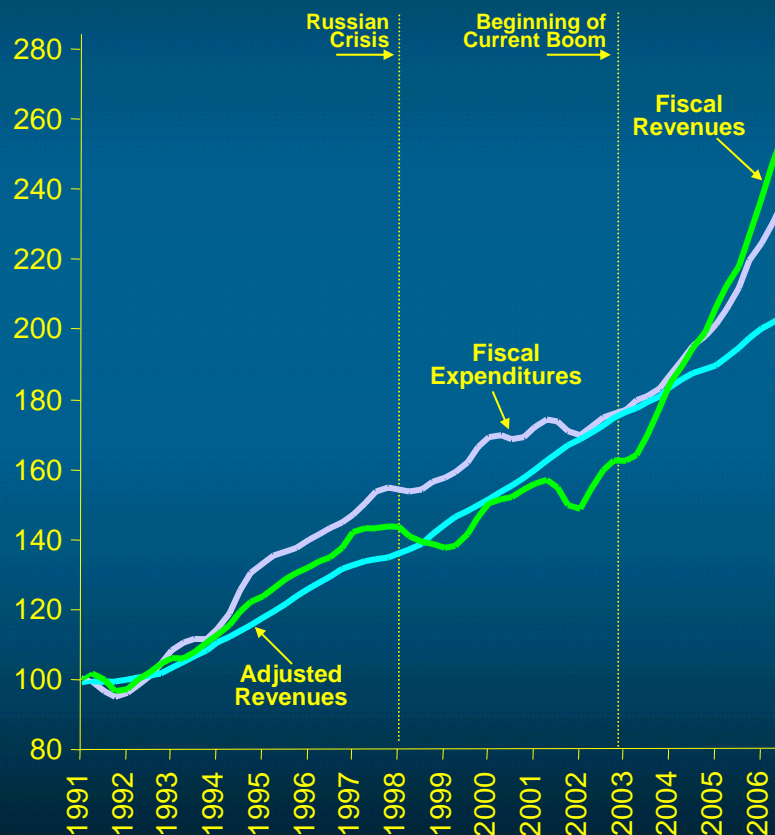
*Talvi, Ernesto (2007), "If Latin America Were Chile: A Note on Structural Fiscal Balances".



Latin America: Structural Fiscal Balance*

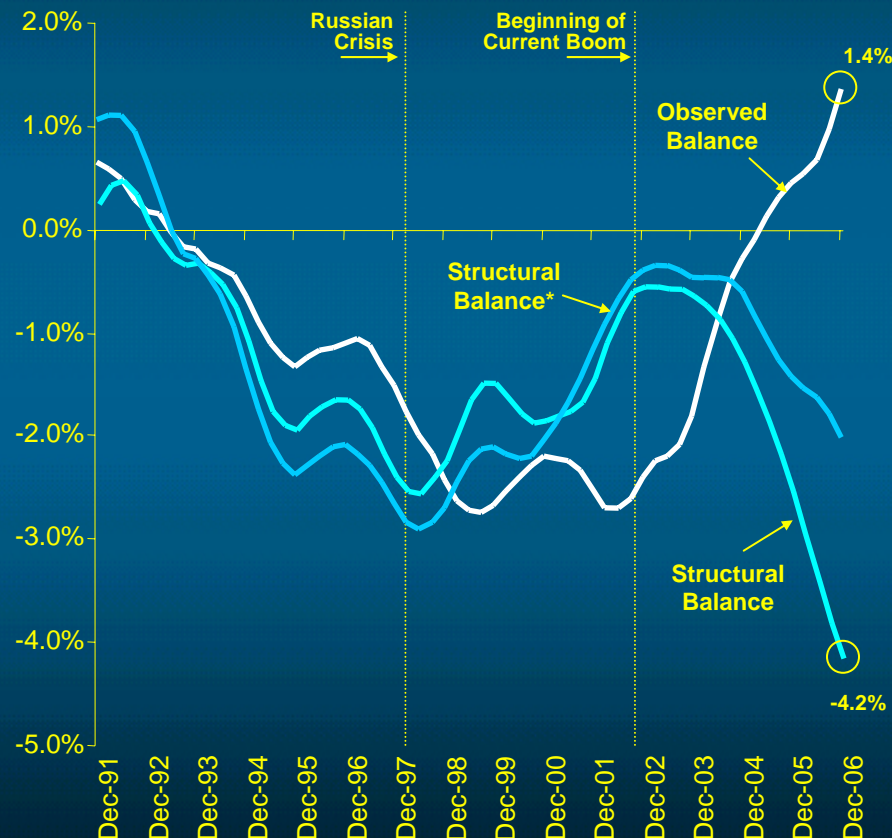
Fiscal Revenues and Expenditures

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



Fiscal Balance

(LAC-7, % of GDP)

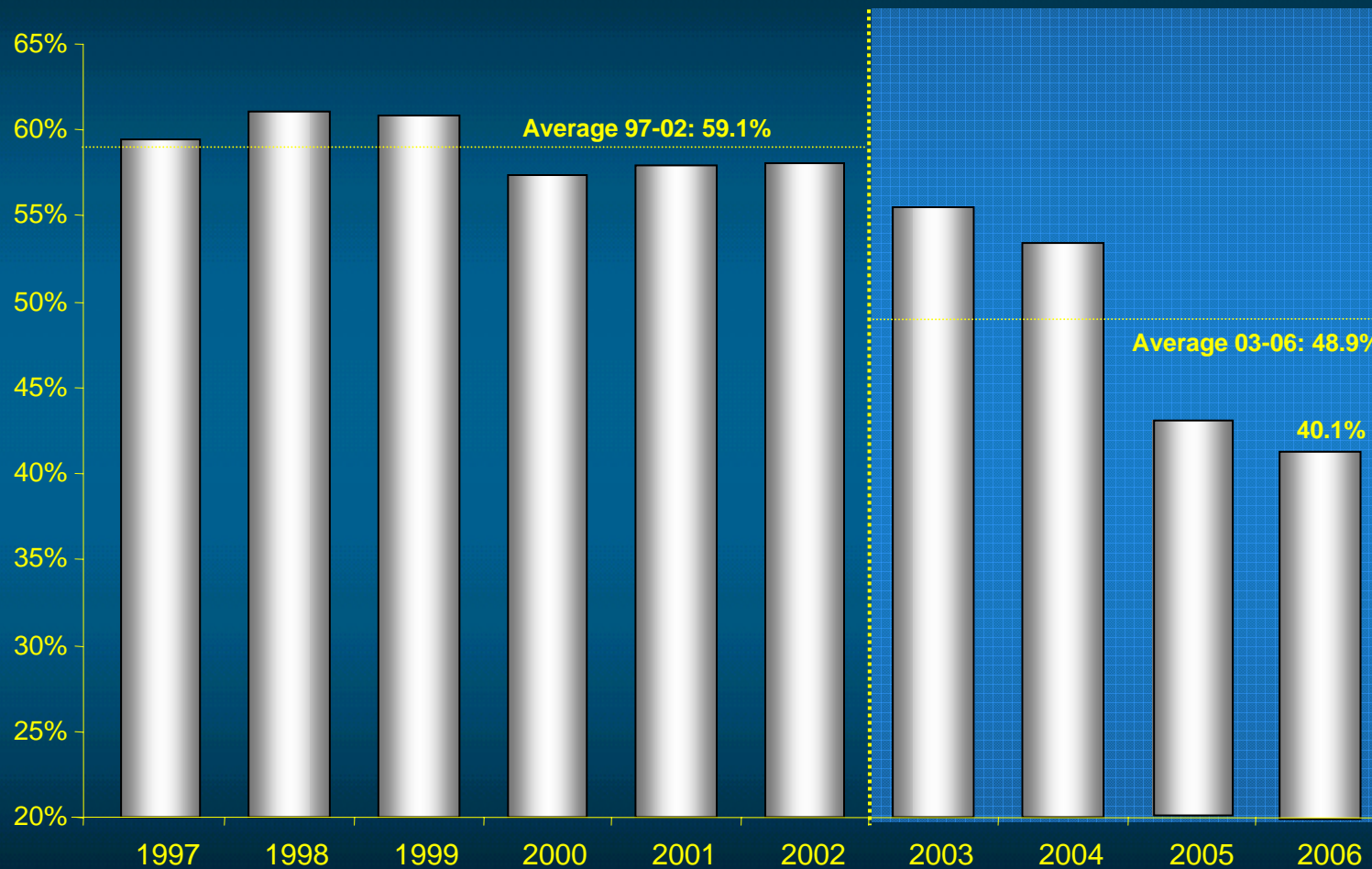


*Excluding Venezuela

*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)



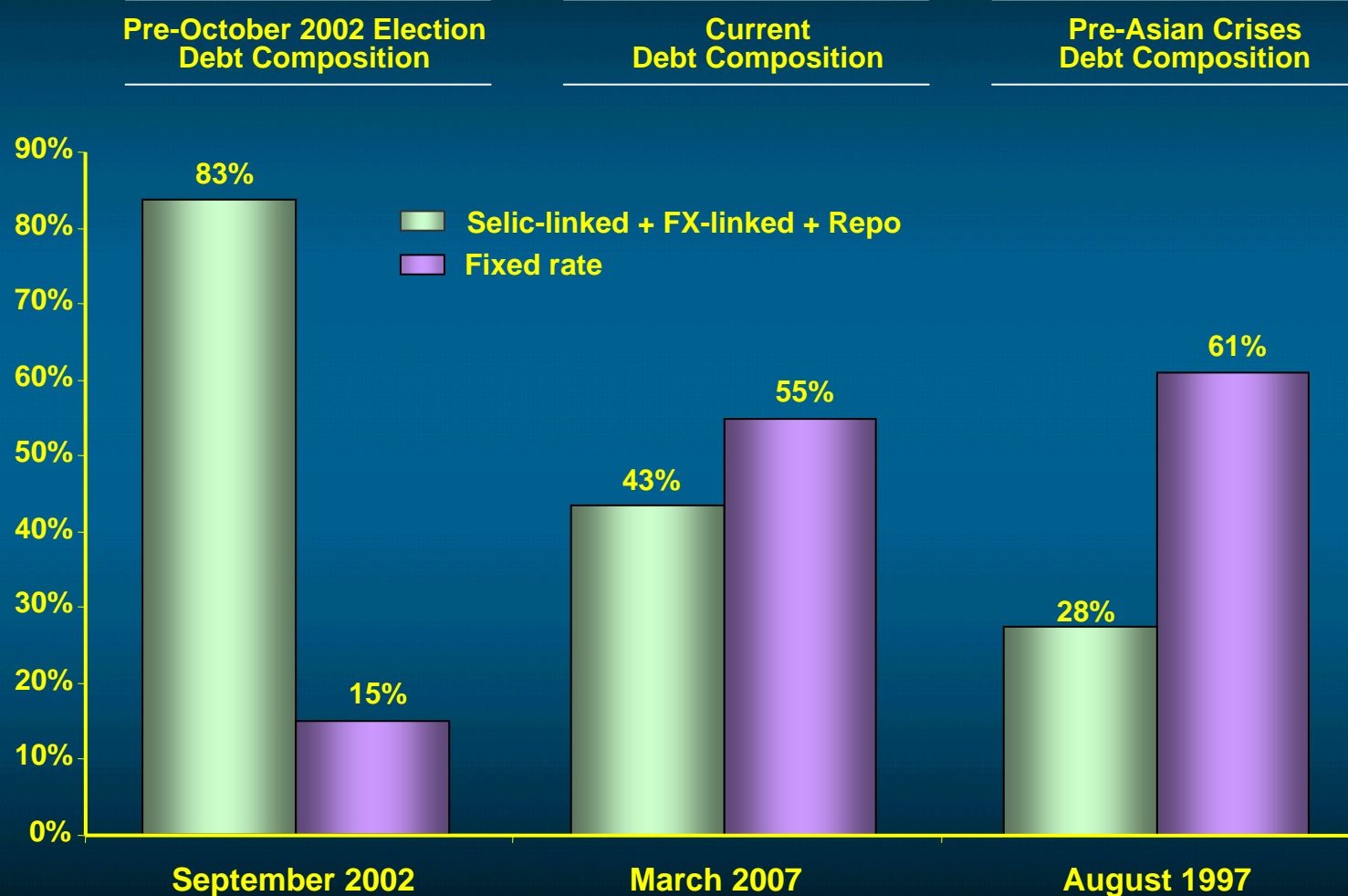
Source: Cowan, Levy, Panizza, Sturzenegger (2006) and own calculations based on official data.





Debt Mutation: An Illustration*

(Public debt composition, % of total debt)



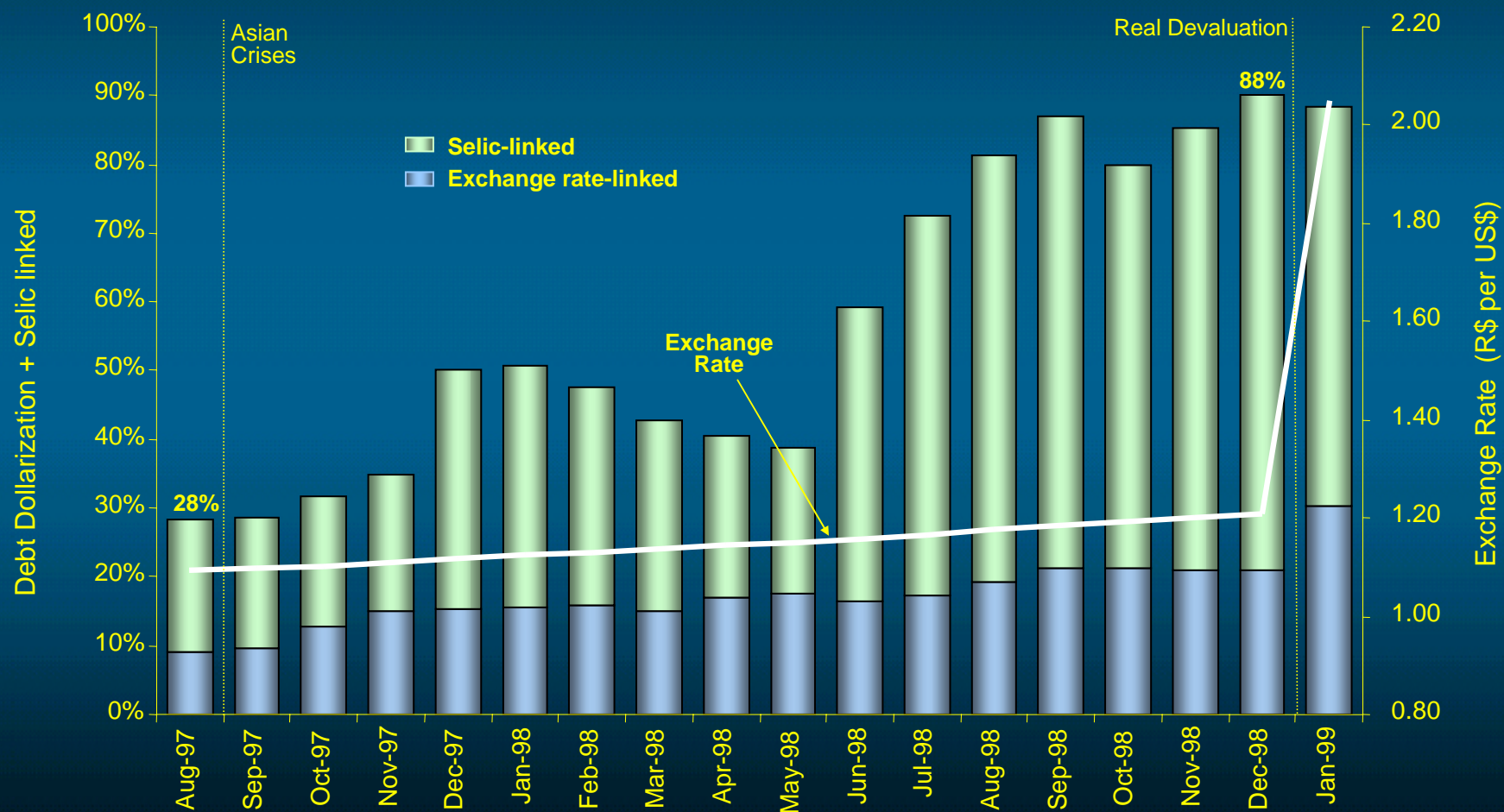
* A. Izquierdo and E. Talvi (2007), "External Financial Conditions and Debt Composition: the Mutation Factor" (in progress)





Pre-Devaluation Debt Mutation*

(Debt dollarization + Selic-linked in % of total debt, and exchange rate, R\$ per US dollar)



* A. Izquierdo and E. Talvi (2007), "External Financial Conditions and Debt Composition: the Mutation Factor" (in progress).



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FINAL REMARKS

- 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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