Latin America: Managing Abundance

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Presentation Outline

1. **Global baseline**

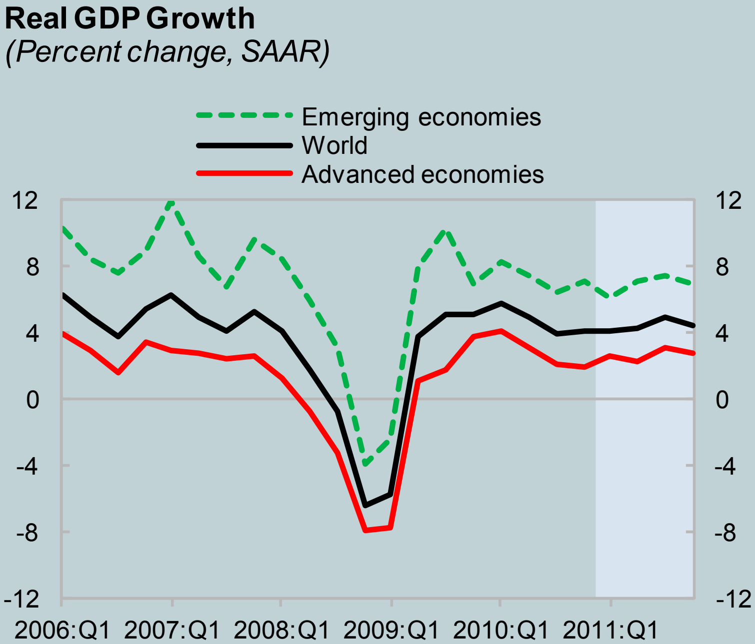
2. **Risks to global outlook**

3. **Implications for Latin America.** How is Latin America different from other Emerging Market Economies?

4. What are the policy options? Importance of initial conditions and country-specific circumstances

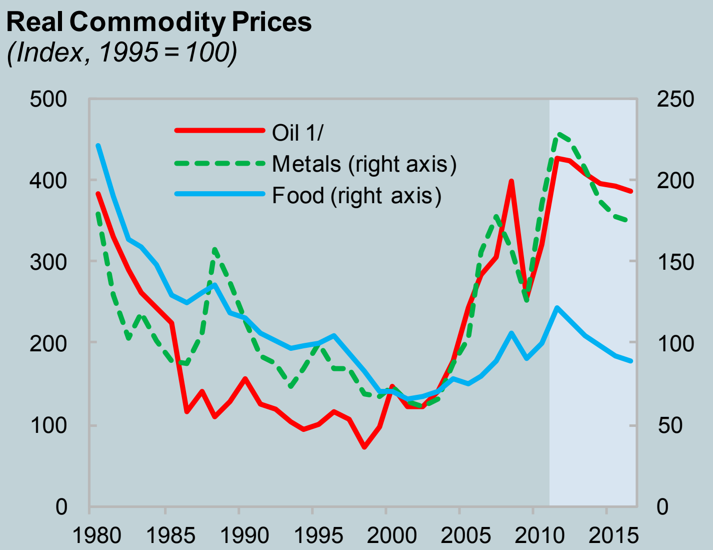
1. Global baseline: High commodity prices and …

Strong growth in emerging economies, particularly in Asia …



Source: IMF World Economic Outlook.

… should keep commodity prices high for an extended period

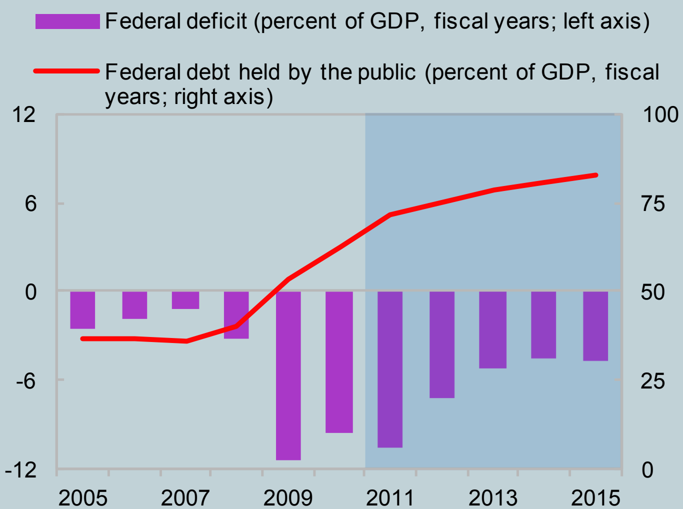


Source: IMF, Global Assumptions.
1/ Simple average of spot prices of U.K. Brent, Dubai Fateh, and West Texas Intermediate crude oil.

… easy financing conditions for an extended period

Weak U.S. recovery and need for fiscal consolidation …

United States: Federal Deficits and Debt

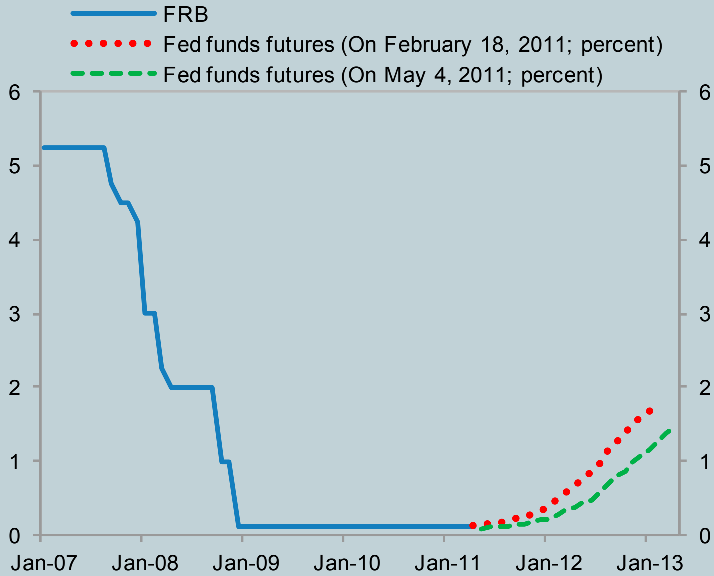


Note: Projections assume full implementation of policies under Staff's macroeconomic assumptions.

Source: Office of Management and Budget and Fund staff calculations.

… should keep monetary policy rates low for some time

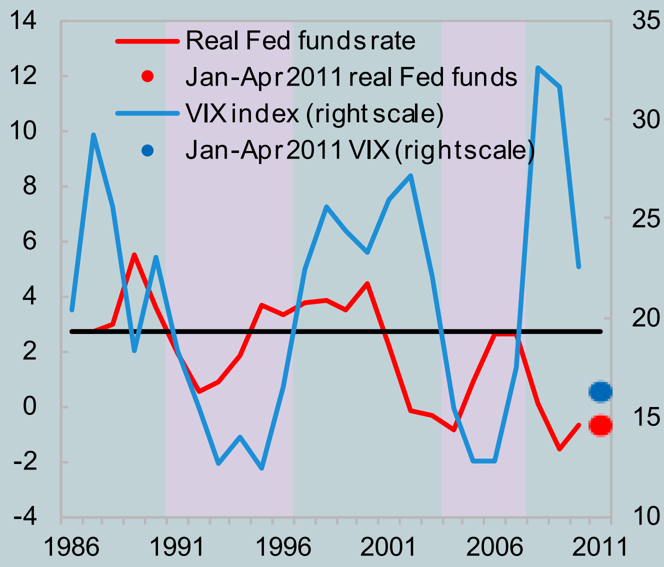
United States: Federal Funds Rate
(in percent) 1/



Source: Bloomberg, LP.
1/ Projections implied by futures contracts

Unusually easy conditions and improved prospects in EMs are leading to a surge in capital flows

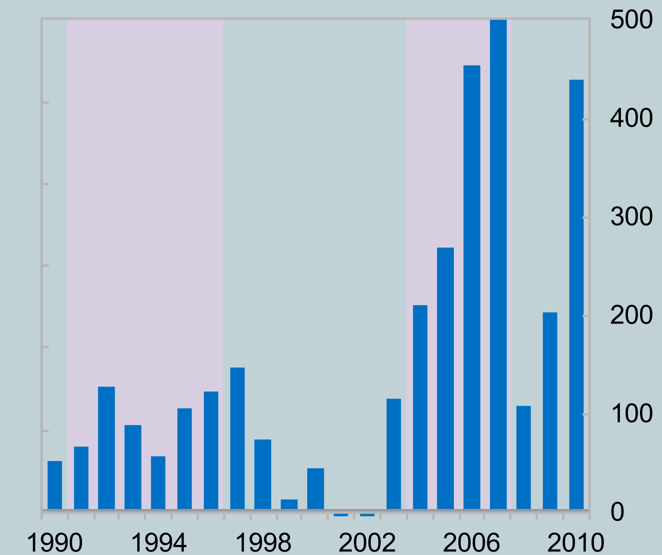
Episodes of Easy External Financial Conditions



Source: Haver Analytics.

Non-FDI Capital Inflows to Emerging Market Economies

(Billions of U.S. dollars)



Source: IMF staff calculations.
Note: 2007 value exceeded US$ 1000 billion.

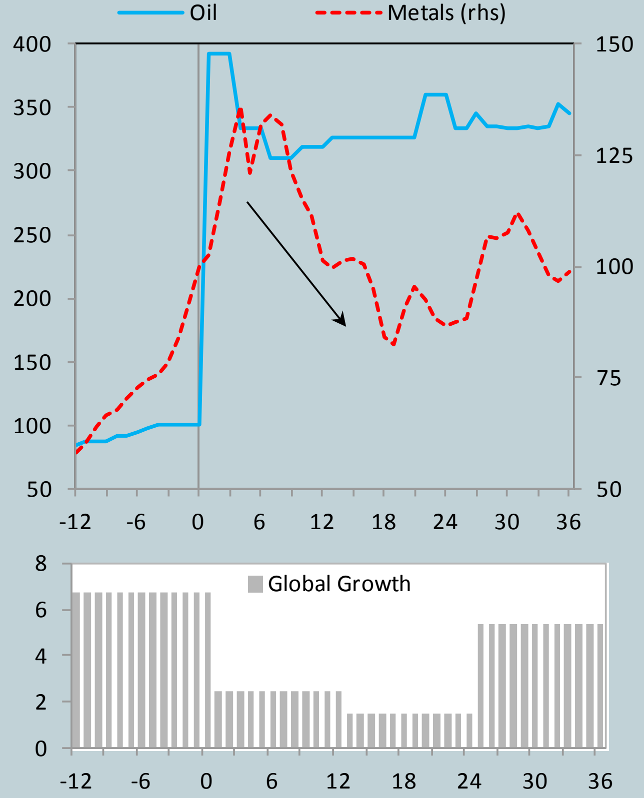
2. Alternative scenarios: *New tail risks have emerged*

- **Prolonged oil shock** with impact on global growth and price of other commodities

- **Early tightening of global financial conditions:** U.S. political deadlock on fiscal consolidation coupled with strong recovery in private demand

<u>Scenario A</u>. **Deep and prolonged oil shock:** *would lower global growth as well as the price of other commodities*

First Oil Crisis
(December 1972=100)

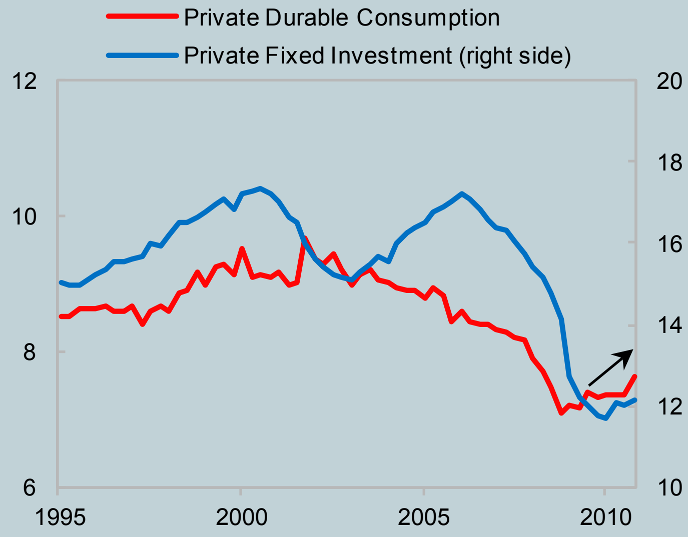


number of months
Source: World Economic Outlook and Fund staff estimates.

***Scenario B*. Earlier tightening of U.S. monetary policy**: *stronger recovery of U.S. private demand and lack of fiscal consolidation*

There is still lots of pent-up private demand

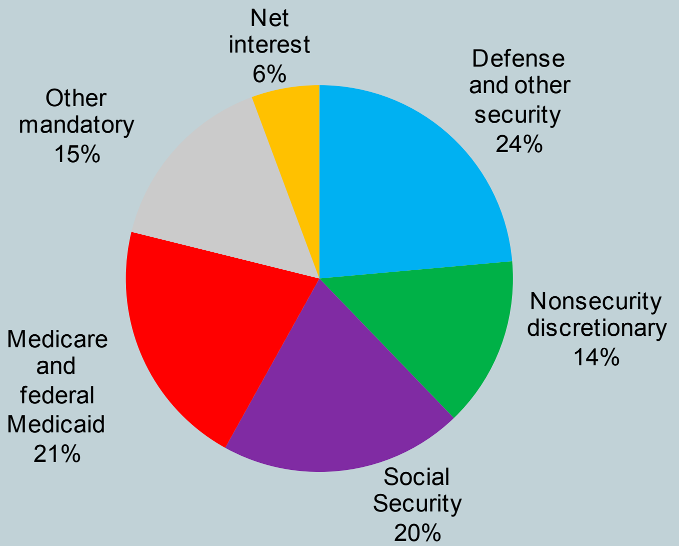
United States: Private Investment and Durable Goods Consumption (in percent of GDP)



Source: BEA and Fund staff calculations.

Reaching political consensus on fiscal consolidation will be challenging

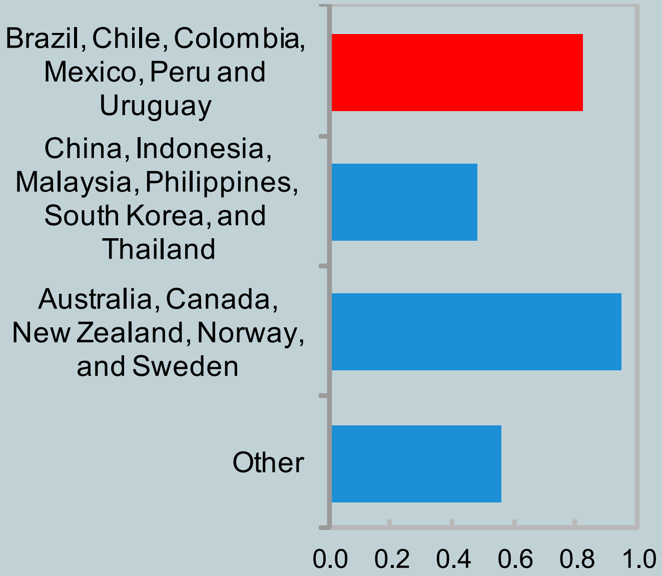
Composition of Federal Spending



Sources: U.S. Office of Management and Budget; and IMF staff calculations.

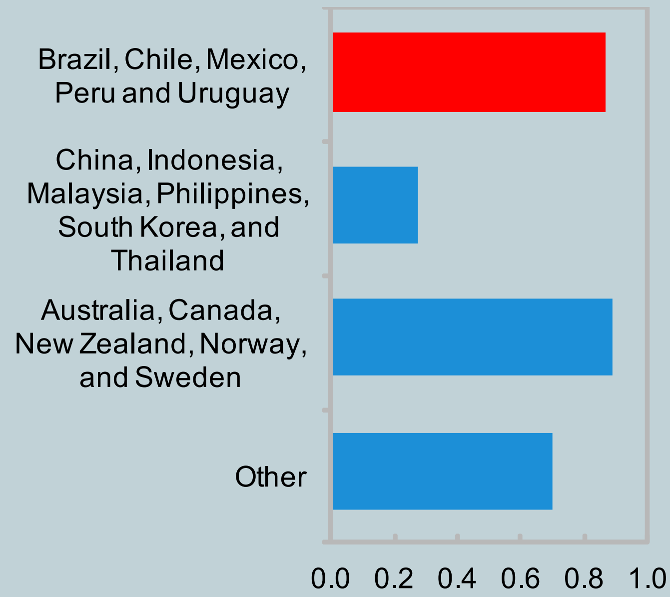
3. Implications for Latin America: *Capital accounts are significantly more open than in other emerging market economies …*

Chinn & Ito Index, 2008
(Means, higher indicates greater openness)



Source: Chinn & Ito, 2009.

Schindler Index, 2005
(Means, higher indicates greater openness)

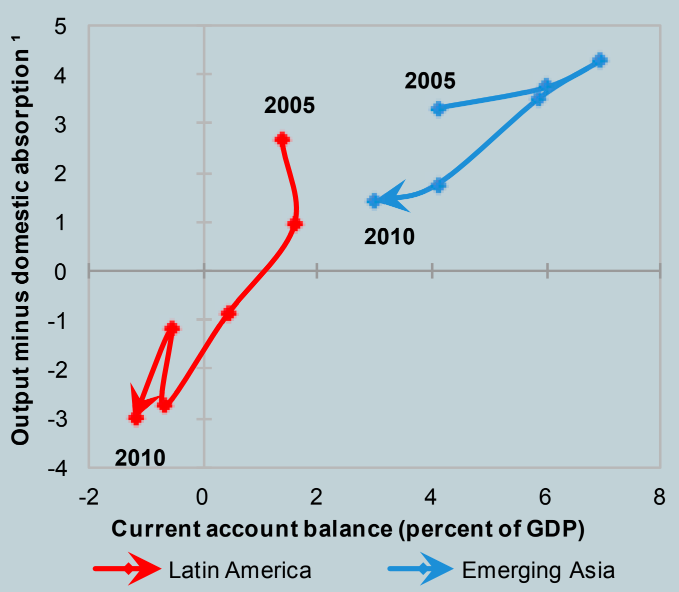


Source: Schindler, 2009.

… current accounts are in deficit and currencies are flexible

Current accounts are in deficit, and widening

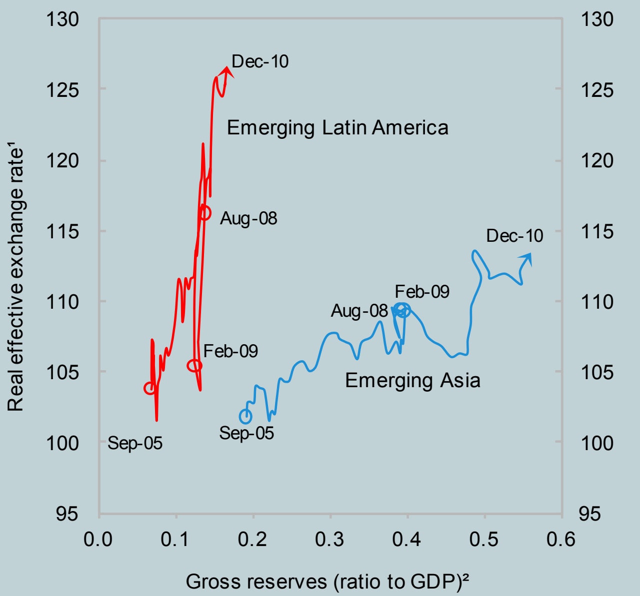
External Balances in Emerging Market Economies, 2005–10



¹ Output minus domestic absorption in percent of output, at constant (2005) prices.

Currencies are more flexible and reserves are smaller

Emerging Latin America and Asia: Real Exchange Rates and Reserves, 2005–10

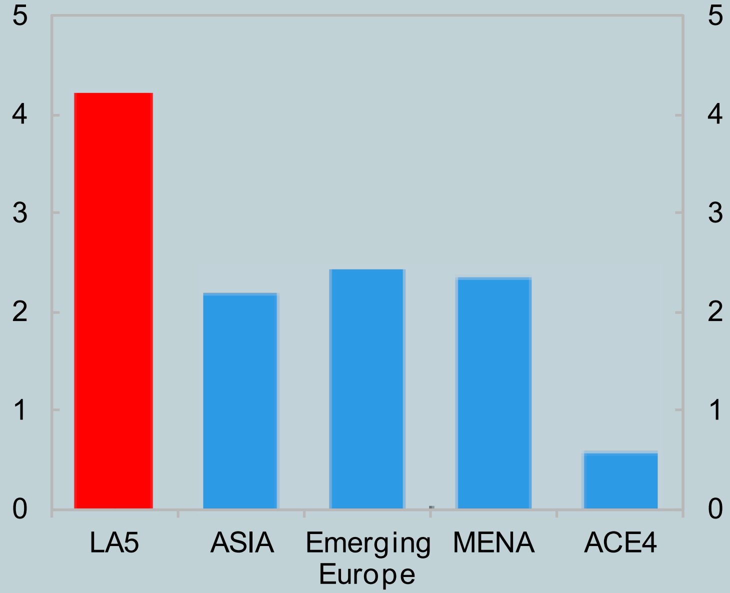


Note: Weighted averages of 15 Latin American and 10 Asian economies.
¹Index 2005=100.
²Gross international reserves as a share of 2006–08 average GDP.

Latin America has historically been more ***sensitive to changes in external financing conditions*** *…*

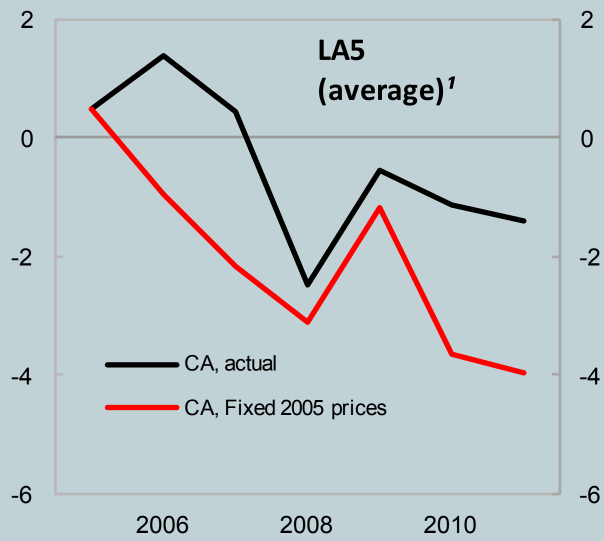
Domestic Demand Growth in Episodes of Easy External Financing

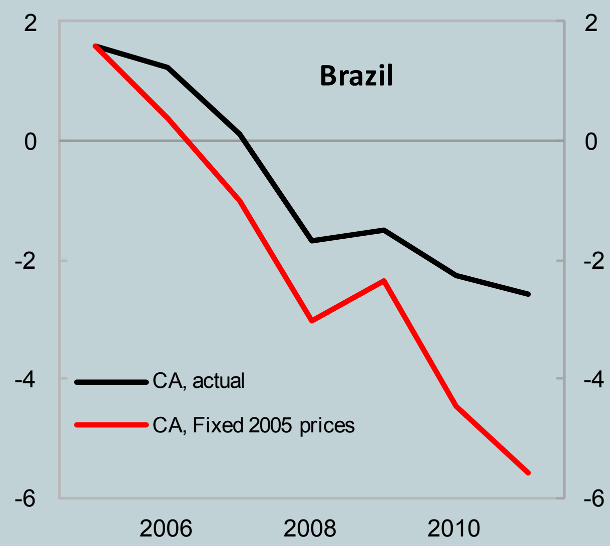
(Difference of growth rates relative to non-episode years)



… and fluctuations in commodity prices

Current Account Balance at Current and Constant 2005 Prices
(percent in GDP)[1]





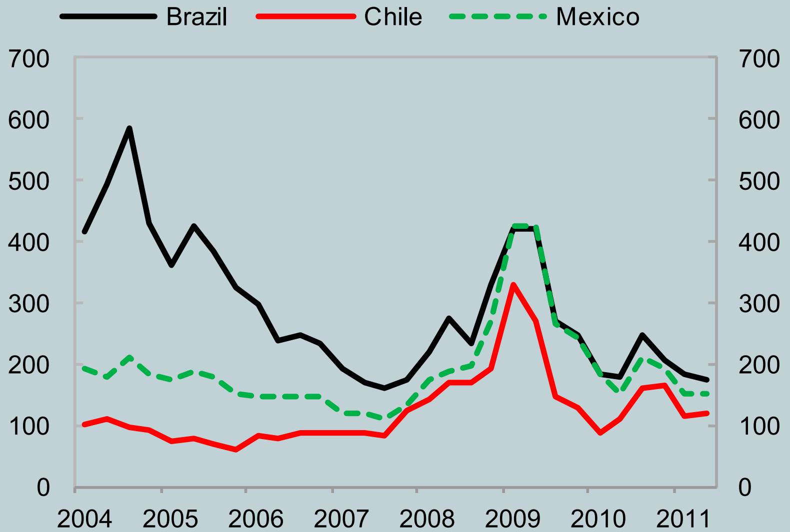
[1] Simple average for Brazil, Chile, Colombia, Mexico and Peru.
[2] Keeping terms of trade constant at 2005 levels and controling for the sensitivity of repatriation of profits and dividends to commodity prices.

Brazil *is likely more sensitive than others in the region*

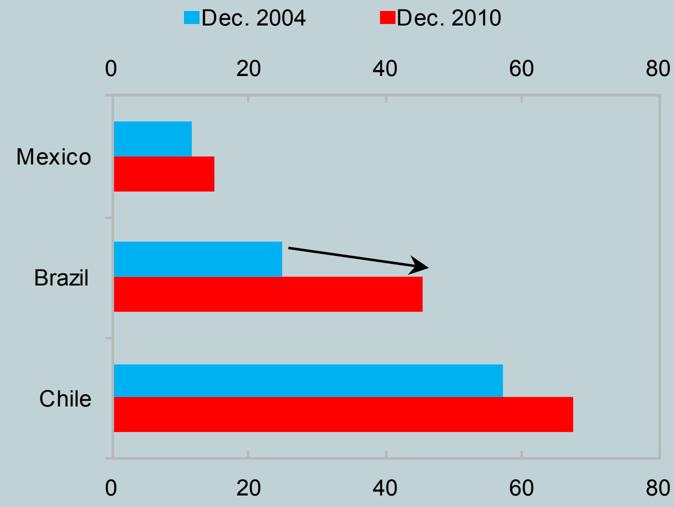
Brazil's spreads have contracted far more since 2004

Bank credit started from a fairly low base

EMBI Global Bond Spreads
(basis points)



Private Sector Credit
(Percent of GDP)

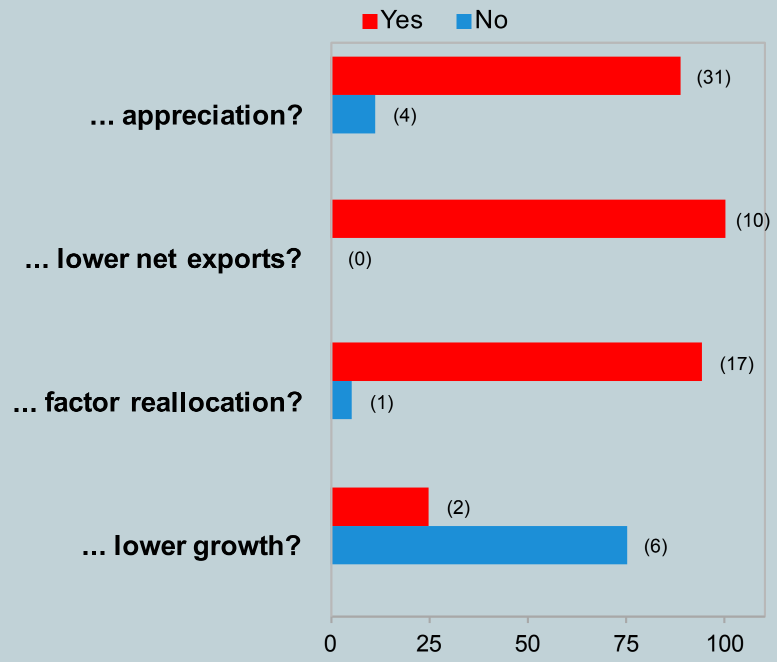


Source: National authorities and Fund staff estimates.

What is key risk/concern for Latin America?

- **Domestic demand boom**
- **Buildup of financial risks and excesses (credit boom, mismatches)**
- **How about risks to growth?**
  - ➢ Unlikely that currency appreciation could bring a demand shortfall, recession
  - ➢ Dutch disease? conceptually, a relevant concern… but empirical evidence is weak

Do natural resources/capital inflows shocks cause...
(Percent of total observations; number of observation in parenthesis)

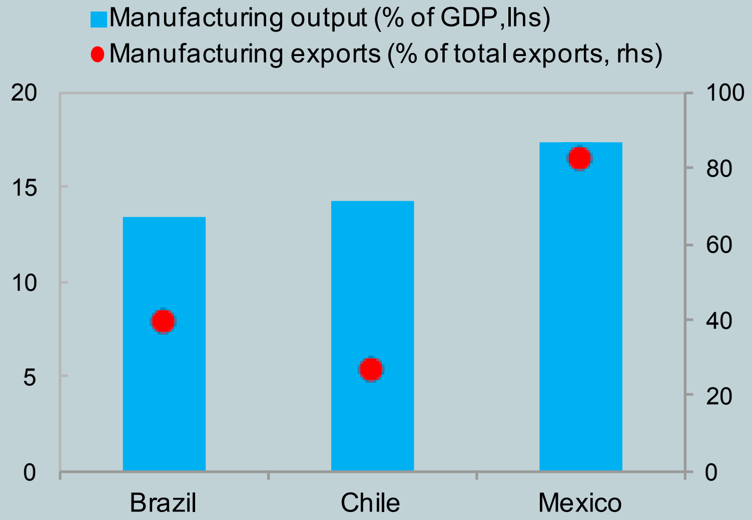


Source: Magud & Sosa (2010).

Impact of currency appreciation may depend on the relative size of the manufacturing sector (open question)

The share of Brazil's manufacturing exports is larger than Chile's (though smaller than Mexico's)

Relative Importance of Manufacturing Sector, 2010



Source: Haver Analytics, and IMF World Economic Outlook.

4. Policy Response

Need Action on multiple fronts (and at the same time):

- Shift macro policy to neutral or contractionary mode
- Protect exchange rate flexibility
  - FX intervention? Not too early.
- Macro-prudential policies (more work)
- Capital controls can be part of toolkit
- Tackle information gaps (corporate and housing sectors)

Fiscal and exchange rate policy

Don't let fiscal policy feed the boom

- Bring fiscal stance to neutral gear (reverse previous stimuli)
- Limit spending growth to match *structural* revenue gains, not boom gains
  - ✓ Requires enhancing fiscal policy targets
- Reign in policy lending

Take advantage of greater currency flexibility

- Demand booms are smaller where flexibility is greater
- Net K inflows are not predetermined, but respond to domestic policies
  - ✓ Some currency "overshooting" is part of the solution
  - ✓ Don't intervene prematurely; intervention is more effective in countries with closed capital account (i.e. Asia).

Complementing toolkit

Strengthen macro-prudential policies

- Continue working fast and build on earlier experience
- Need broad oversight *and* targeted interventions
- Open issues: calibration (trial and error required); effectiveness (circumvention); consistency (with traditional policies).

Consider capital controls (if macro and financial policies are insufficient to contain risks)

- Controls should be on the table, given high openness and exceptional global setting
- For effectiveness, be comprehensive (not selective)

5. Key Takeaways

- Demand booms and financial excesses—not currency appreciation per se—are the main risks.
- Take advantage of exchange rate flexibility to mitigate inflows—avoid intervening prematurely.
- Enhance fiscal policy targets: simple nominal targets on fiscal balances guarantee procyclical responses.
- Strengthen and develop new macroprudential policies.
- Marginal/temporary reductions in openness can be justified in some cases.