LatAm—2003-07 Extraordinary External Adjustment Major Source of Macro Resilience

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BCRP-WB Conference "*The Global Rise in Food Prices and the US Slowdown: Issues and Challenges in Monetary Policy*"

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2003-07: Major Reduction in External Vulnerabilities … but Amid Subpar Growth/Inv. Performance.

➔ Accumulated Resilience to Deal With External Shocks (e.g. Increase in Risk Aversion; Decline in Commodity Prices; Lower Global Growth)

<u>Going Forward</u>: Broad Financial/Macro Stability. Unique Opportunity to Push Forward With Needed Reforms and Elevate Growth Potential.

LatAm: Benefited From Extraordinarily Supportive External Backdrop During 2003-1H2007

- **Since 2003 LatAm has benefited from rarely seen constellation of uniquely and concurrently favorable external factors ➔ Allowed region to post above-trend growth rates, considerably strengthen the external accounts, improve fiscal balances and debt ratios, accumulate a significant amount of foreign reserves, and therefore, visibly reduce the perennial vulnerability to external shocks and excessive dependence on international capital flows.**

- **Such favorable external tail winds contributed decisively to strengthen most regional currencies, improve the balance sheet of both sovereigns and corporates, and reduce hard currency debt spreads to new lows. The significant reduction in external vulnerabilities was recognized by rating agencies through a host of sovereign rating upgrades.**

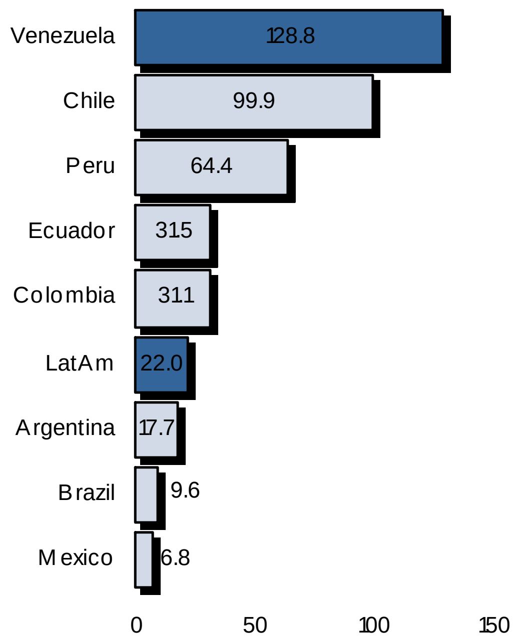
- **The onus is now on the regional policy makers to capitalize on this unique opportunity to leave decisively behind the lost decade of the 1980s and the sub-par performance of the 1990s.**

Significant Terms of Trade Gains Since 2003

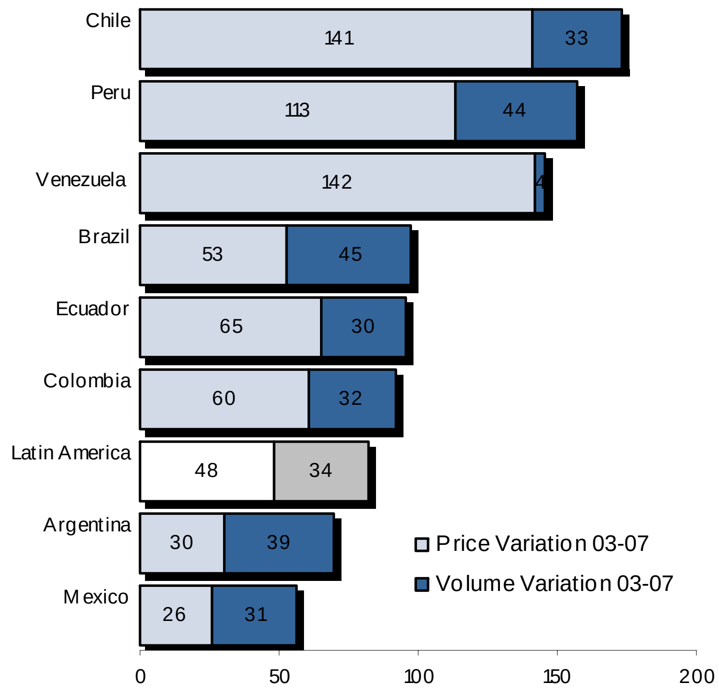
- **The external adjustment initiated in 2003 took place on the back of a major rally in commodity prices.**

- **However, beyond the favorable price developments there was also robust export volume growth.**

Variation in Terms of Trade from 2003 to 2007

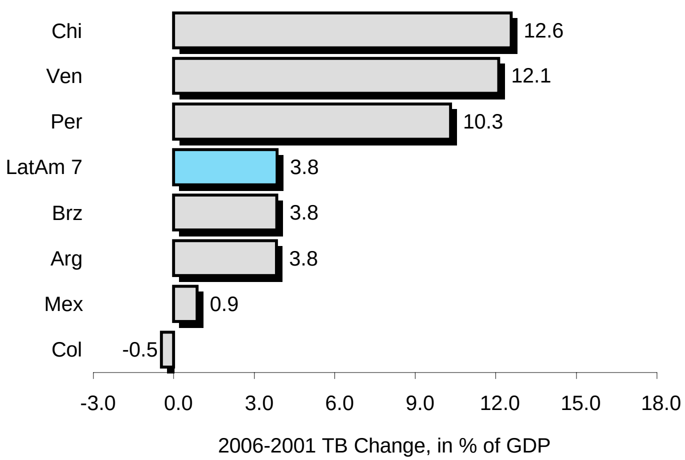


Export Growth 2003-07
(Price and Volume Decomposition**)**



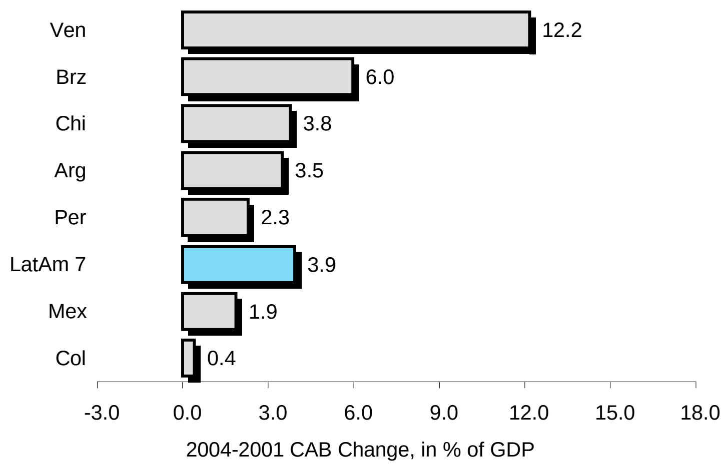
Oil and Metal Exporters the Main Beneficiaries

Trade Balance Improved Across The Region



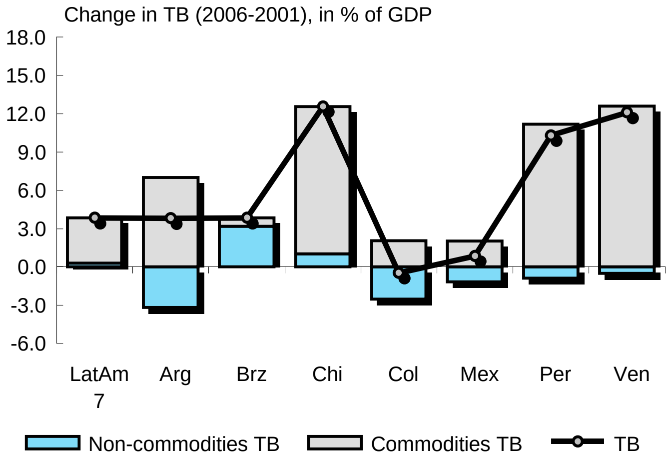
Source: Goldman Sachs estimates.

Current Account Balance Improved Almost Everywhere



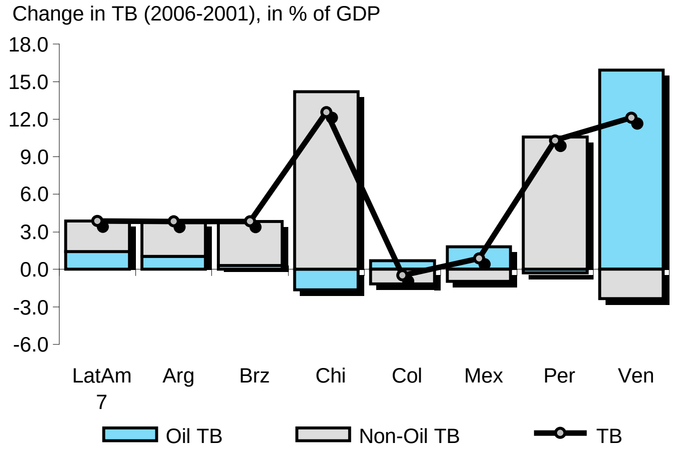
Source: Goldman Sachs estimates.

Primary Goods Exports Explain 98% of TB Shift



Source: Goldman Sachs estimates.

Oil Explains 42% of Trade Balance Shift



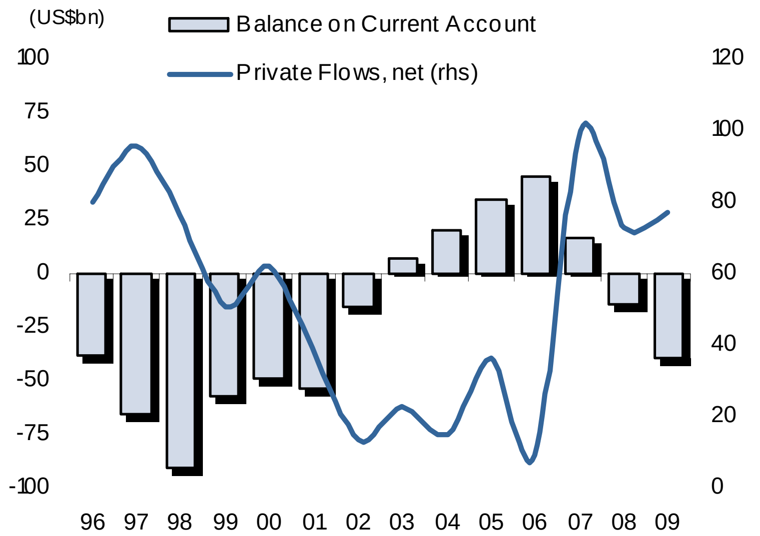
Source: Goldman Sachs estimates.

Major Turnaround in the External Accounts

- **The current account shifted into a small surplus in 2003—the first in over 35 years—and continued to improve every year until 2006.**

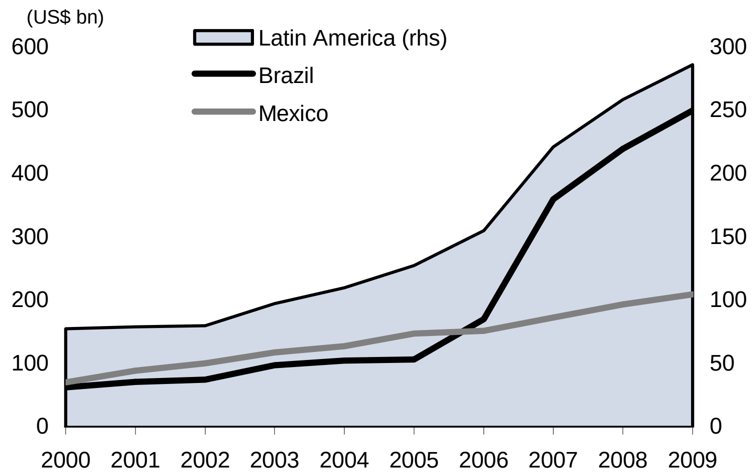
- **The swing in the current account was driven by a shift in the trade balance to a surplus of close to US$100bn in 2006, up from a US$10bn deficit in 2001. In addition, the volume of labor remittances increased from US$26 billion in 2001 to US$55 billion in 2006.**

LatAm Exporting Savings (Curr Acc Surplus)



Source: IMF WEO.

Significant Accumulation of International Reserves



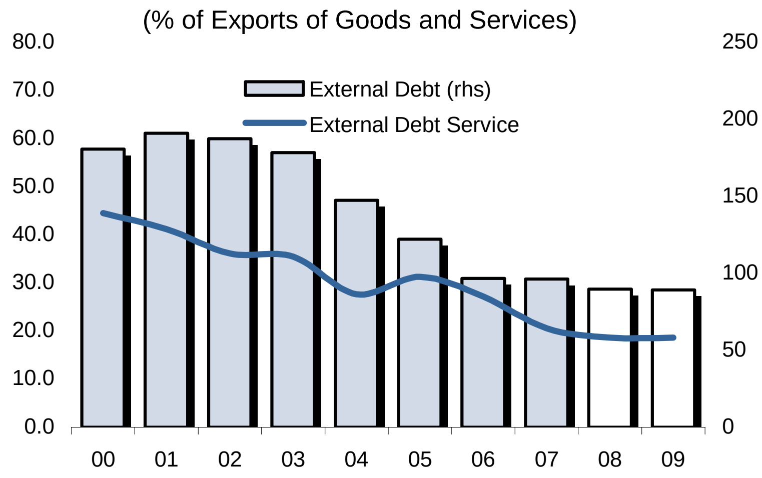
Source: IMF WEO.

External Debt Service Capacity Improving and Inflation Under Control

- **The external debt servicing capacity indicators of the region have improved markedly.**

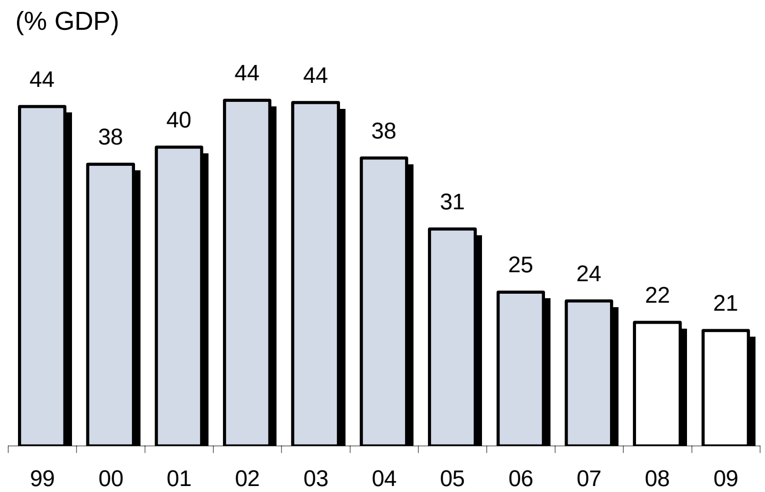
- **This reflects the boom in exports, higher international reserve levels and, smoother debt servicing profiles achieved through liability management.**

External Debt Service Capacity Improving



Source: IMF WEO.

Total External Debt Declining



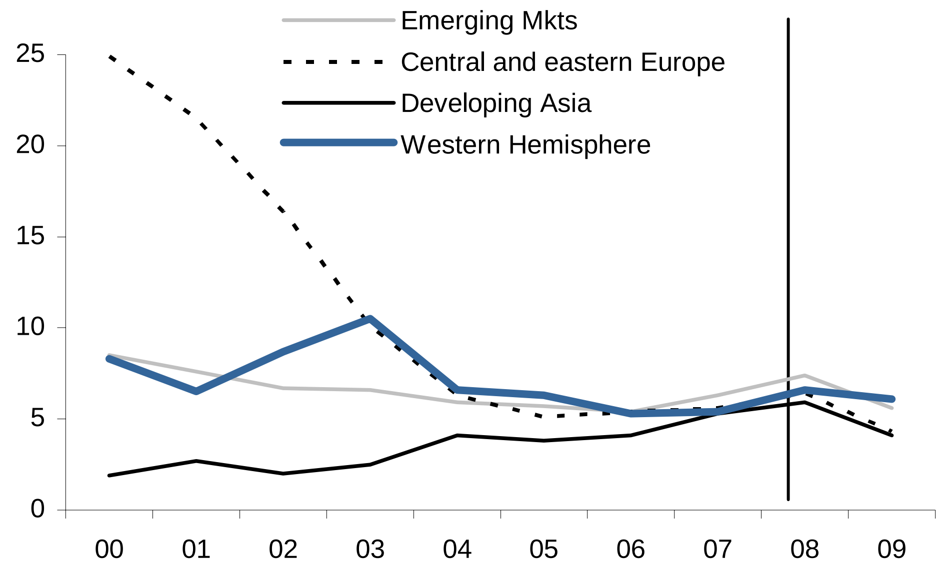
Source: IMF, WEO.

Inflation Turning into Main Macro Policy Challenge

2003-2006: (1) Inflation inertia conquered, and (2) the happy combination of declining inflation and growth revival was reflected in the buoyant performance of local markets (equities and fixed income).

2007-08: since 2H2007 inflation has accelerated almost across the board driven in part by food-fuel supply price shocks but also with a few exceptions accommodative monetary conditions amid solid domestic demand growth also played a key role.

Inflation Dynamics Under Control



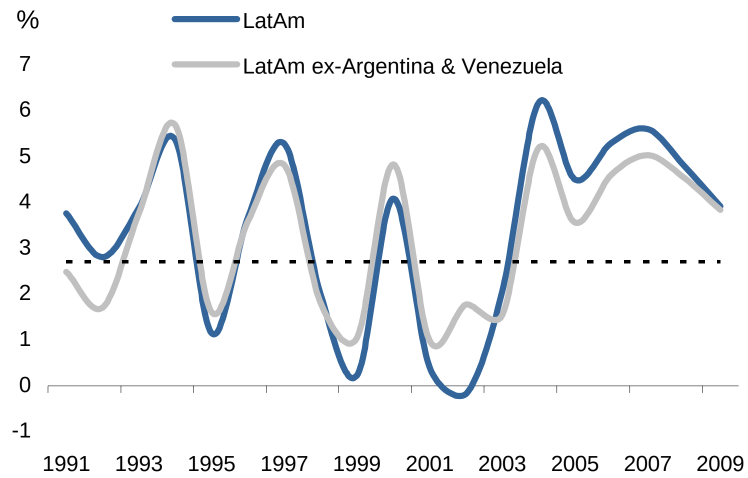
Source: IMF WEO.

LatAm: Above-Par Real GDP Growth During 2004-06

- **The economic history of LatAm is populated by boom-bust cycles amid mediocre growth on average.**

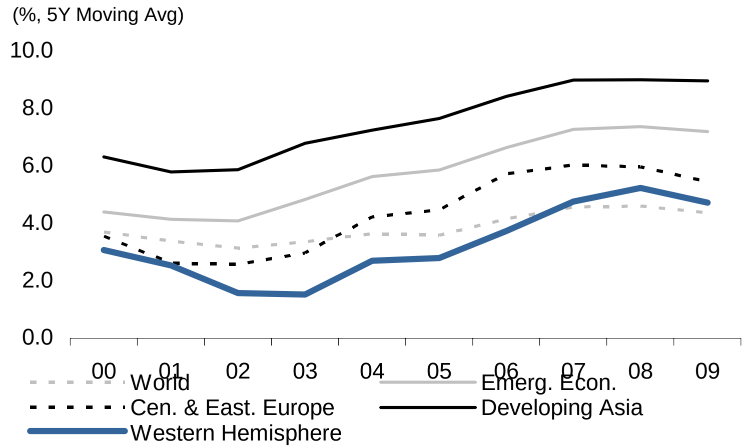
- **The growth performance during 2004-06 (4.9% average) was higher than 2.7% average of the past two decades, but it was unfortunately still considerably below the average of emerging market economies (7.5%) and pales when compared against the performance posted by Emerging Asia (8.8%).**

Above-Par Real GDP Growth During 2004-07



Source: Goldman Sachs

Disappointing Real GDP Growth Performance

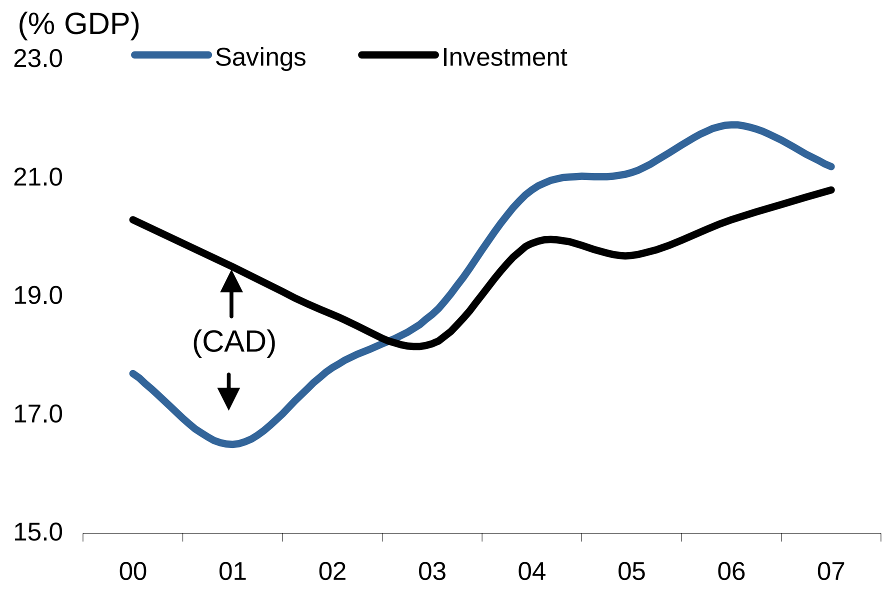


Source: IMF WEO.

Investment Ratio Lagging Increase in Savings

- **The significant wealth transfer observed via terms of trade gains led to an increase in the domestic savings ratio by 4.9 percentage points of GDP since 2001.**
- **However, increase in savings led to only minor increase in the investment to GDP ratio (up 1.0% of GDP) with the rest being channeled abroad (i.e. exporting national savings as the current account moved into a surplus).**

Latin America Savings and Investment



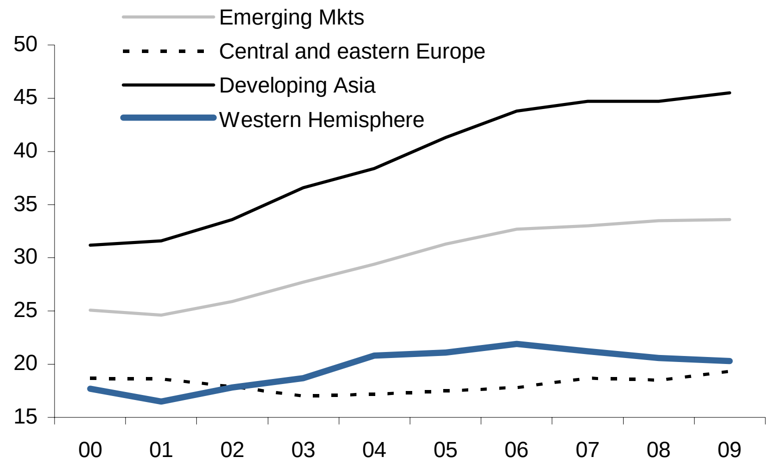
Source: IMF WEO.

Very Low Investment and Savings Ratios

- **Unfortunately, 21% of GDP investment ratio is still the lowest of any region, particularly when compared with other emerging markets (e.g. Asia at 36% of GDP, and emerging Europe at 25% of GDP).**

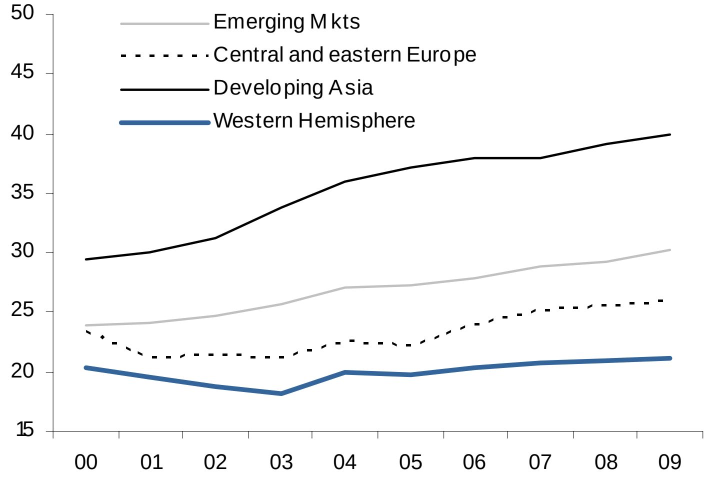
- **Hence, no surprise that despite the recent acceleration, economic growth in the region continues to lag that of other more dynamic regions in the globe.**

Very Low Domestic Savings Ratio



Source: IMF WEO.

Very Low Investment Ratio

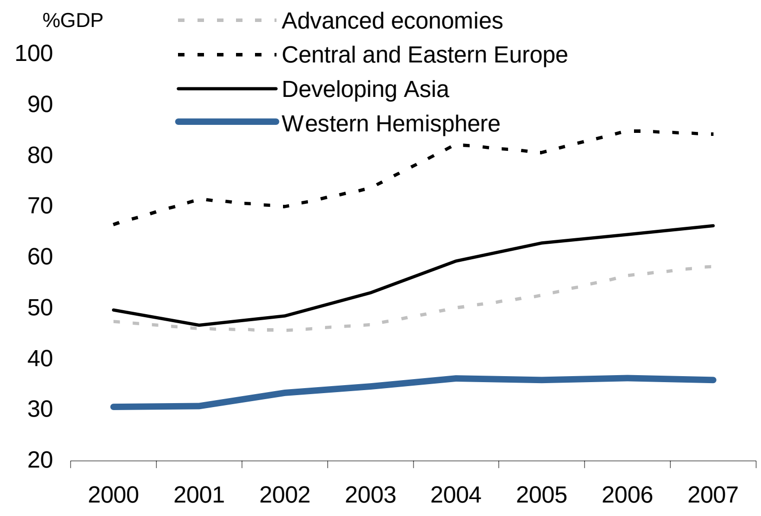


Source: IMF WEO.

LatAm Still Very Closed to Trade

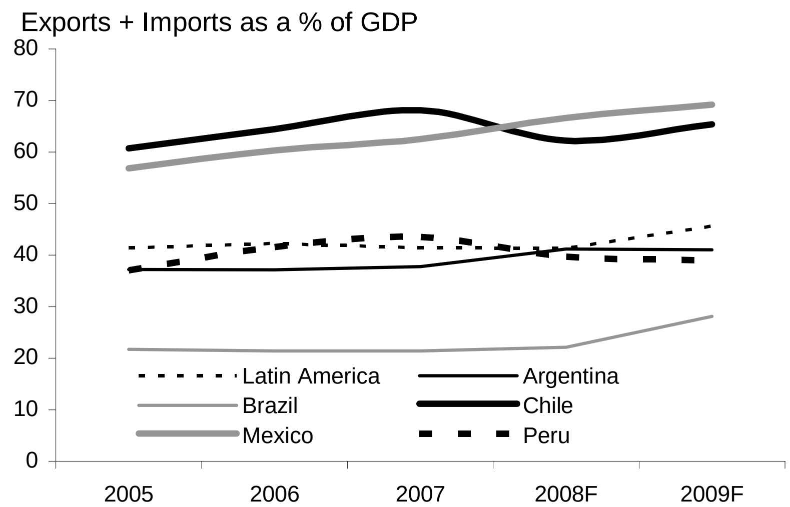
- Opening to trade, by reducing still high levels of protection within clearly inefficient regional trade arrangements, would also contribute to give a technological/productivity shock to economies that need to elevate investment levels and attract foreign capital to leverage their development.
- Imperative to continue to invest in education to enhance the level of human capital and create knowledge based societies.
- A more educated population also less susceptible to populist proposals and experimental-heterodox policy platforms (that have and continue to hinder the development of the region)

LatAm Still Very Closed to Trade



Source: IMF WEO.

Brazil Exceptionally Closed to Trade



Source: Goldman Sachs estimates.

LatAm Navigated Quite Well Recent International Market Jitters

How did Latin America react to the sub-prime crisis?

Quite well (even Mexico) due to the massive reduction in external vulnerabilities observed during 2003-07. Many sovereigns are now net external creditors. Growth remains solid and many central banks are implementing monetary policy counter-cyclically versus the US.

How would a slowdown in U.S. and global economic activity affect the region?

It affects the region but given how close these economies are and the small share of non-commodity exports the spillovers from the downshift in activity in the US and globally via the trade balance are quite limited (except for Mexico). As long as commodity prices hold the region should do well.

Is the commodity-driven expansion in LAC a source of fragility?

Yes and No. Yes, since commodities represent a large share of exports and a major source of fiscal income and current account receipts… but not necessarily a source of fragility if govt's implement counter-cyclical savings funds (e.g. Chile, Norway) and save part of the revenue windfall (i.e. smooth inter-temporally the commodity revenue windfall).

Real Rather Than Financial Shocks Will Dominate the Future

What are other sources of real/financial fragility in the region?

With a few exceptions there are no main financial fragilities but on the real side the quest is still to diversify the sources of growth and create conditions to increase investment and elevate potential growth. I.e. structural productivity enhancing reforms still a must to elevate TFP.

Will real shocks matter more than financial shocks in the future?

Probably real shocks will turn more relevant as the financial vulnerabilities that used to magnify/amplify financial shocks have been to a great extent addressed.

Going Forward Sizeable Opportunities but Also Significant Policy Challenges

What are the main challenges that LAC policymakers face in the current environment?

Strengthen the policy mix. Now that we have reduce perennial vulnerabilities we need to increase the efficiency in public spending, invest more, improve human capital levels, reduce poverty, and embrace trade.

What are the challenges they are like to face when monetary conditions tighten in the US?

Not a big deal. The challenges ahead will not be that different from the challenges these govt's face today. They still need to pursue investment/market friendly policies to attract needed foreign capital and encourage local capital to stay engaged domestically.

Commodity Prices

Selected Commodity Prices

	Units	Current Price	2008 YTD	Spot Price Changes (in %) Past Performance 1-Wk	1-Mth	3-Mth	12-Mth	Forecasts 3-Mth	6-Mth	12-Mth
Energy										
WTI Crude Oil	$/bbl.	136.7	43.1	7.5	10.9	26.3	102.1	138.0	149.0	145.0
Industrial Metals										
Aluminum	$/lb.	1.32	23.1	2.2	-1.9	-4.6	8.3	1.3	1.3	1.3
Copper	$/lb.	3.62	18.1	0.0	-5.4	-6.2	5.8	3.7	3.9	4.2
Precious Metals										
Gold	$/oz.	869.2	4.1	-0.4	-1.4	-13.2	33.4	860	840	800
Agricultural										
CBT Wheat	¢/bu.	851.0	-1.9	10.5	12.5	-27.2	40.3	900	900	900
Soybeans	¢/bu.	1536.5	24.6	4.2	12.2	11.8	85.7	1400	1530	1420

Source: Goldman Sachs Commodities Group.

LatAm: Selected Economic Indicators

Consolidated Latin America Aggregate Selected Economic Indicators

	2005	2006	2007F	2008F	2009F
I. Economic Activity and Prices					
Nominal GDP (US$bn)	2396	2794	3260	4002	4227
Real GDP growth (% yoy) 1/	4.4	5.3	5.6	4.7	3.8
CPI Inflation (% yoy)	5.6	4.8	6.1	7.5	5.7
II. External Sector					
Current Account (US$bn)	39.8	52.1	22.9	-17.7	-56.7
Trade Balance (US$bn)	95.2	112.8	89.2	62.8	33.7
Gross International Reserves (US$bn)	235.3	283.8	416.2	462.8	487.0
Change in Reserves (US$bn)	51.5	48.5	132.5	46.6	24.2
III. Public Finance and Indebtness					
Overall Fiscal Balance (%GDP)	-0.8	-0.5	-0.2	-0.1	-0.6
Total External Debt (%GDP)	27.4	22.3	20.9	17.4	16.6

1/ Calculated using nominal GDP weights

Source: National Authorities and Goldman Sachs estimates and forecasts.

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Global Outlook

Global Macroeconomic Framework

	2006F	2007F	2008F	2009F	07Q1	07Q2	07Q3F	07Q4F	08Q1F	08Q2F	08Q3F	08Q4F
Real GDP Growth (%, yoy)												
United States	2.9	2.2	1.5	1.1	1.5	1.9	2.8	2.5	2.5	1.6	0.9	1.0
Euroland	2.9	2.6	1.7	1.6	3.2	2.5	2.7	2.2	2.2	1.9	1.4	1.4
Japan	2.4	2.1	1.4	1.5	3.2	1.8	1.7	1.7	1.0	1.7	1.6	1.2
World Economy	5.0	4.8	3.9	3.7	4.7	4.8	5.0	4.8	4.4	3.9	3.5	3.5
CPI Inflation (%, yoy)												
United States	3.2	2.9	4.1	3.2	2.4	2.6	2.4	4.0	4.2	3.9	4.5	4.0
Euroland	2.2	2.1	3.5	2.4	1.9	1.9	1.9	2.9	3.4	3.5	3.7	3.4
Japan	0.1	0.0	1.6	1.0	-0.1	-0.1	-0.1	0.4	1.0	1.4	1.8	1.9
Interest rates (%, e.o.p)												
Fed Funds	5.25	4.25	2.00	2.00	5.25	5.25	4.75	4.25	2.25	2.00	2.00	2.00
UST 10-Year	4.71	4.03	3.91	4.20	4.65	5.03	4.58	4.03	3.43	3.70	3.80	3.90
Euro yield 10-year	3.95	4.33	4.12	4.30	4.07	4.57	4.32	4.33	3.90	4.00	4.00	3.90
Exchange Rates (e.o.p)												
US$/EUR	1.27	1.38	1.51	1.40	1.32	1.34	1.39	1.46	1.55	1.51	1.51	1.45
JPY/US$	117	117	103	110	117	123	115	112	101	102	102	106

Source: Goldman Sachs Economic Research Group.

GS vs. Consensus

GDP Growth: GS vs Consensus

% yoy	2006	2007	2008 GS	2008 Consensus*	2009 GS	2009 Consensus*
US	2.9	2.2	**1.5**	1.5	**1.1**	1.7
Japan	2.4	2.1	**1.4**	1.3	**1.5**	1.5
Euroland	2.9	2.6	**1.7**	1.5	**1.6**	1.6
UK	2.9	3.0	**1.6**	1.7	**1.6**	1.3
Europe	3.2	2.9	**2.0**	1.9	**1.8**	1.8
Switzerland	3.2	3.1	**2.2**	2.1	**1.5**	1.5
China	11.6	11.9	**10.5**	10.1	**10.0**	9.4
India	9.6	9.0	**7.8**	7.6	**8.2**	8.1
BRICs	10.0	10.3	**9.1**	8.8	**8.7**	8.4
Advanced Economies	3.1	2.7	**1.9**	1.8	**1.7**	1.9
World	5.0	4.8	**3.9**	3.8	**3.7**	3.7

* Consensus Economics May 2007

Inflation: GS vs Consensus

% yoy	2006	2007	2008 GS	2008 Consensus*	2009 GS	2009 Consensus*
US	3.2	2.9	**4.1**	4.0	**3.2**	2.5
Japan	0.1	0.0	**1.6**	1.1	**1.0**	0.8
Euroland	2.2	2.1	**3.5**	3.1	**2.4**	2.1
UK	2.3	2.3	**3.2**	3.1	**1.8**	2.4
Europe	2.2	2.2	**3.6**	3.0	**2.5**	2.2
Switzerland	1.1	0.7	**2.2**	2.3	**1.6**	1.4
China	1.5	4.8	**6.8**	7.0	**3.0**	4.5
India	5.5	4.5	**7.0**	7.1	**4.7**	5.9
BRICs	3.6	5.0	**6.8**	7.3	**4.6**	5.3
Advanced Economies	2.3	2.2	**3.5**	3.3	**2.6**	2.2
World	3.3	3.4	**5.0**	4.8	**3.7**	3.5

* Consensus Economics May 2007

Thank You!

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