LAC Success Put to the Test

Presentation at Central Bank of Peru

Lima, August 15, 2011

Chief Economist Office
Latin America and the Caribbean
The World Bank

World Bank LAC
opportunities for all

Structure of the presentation

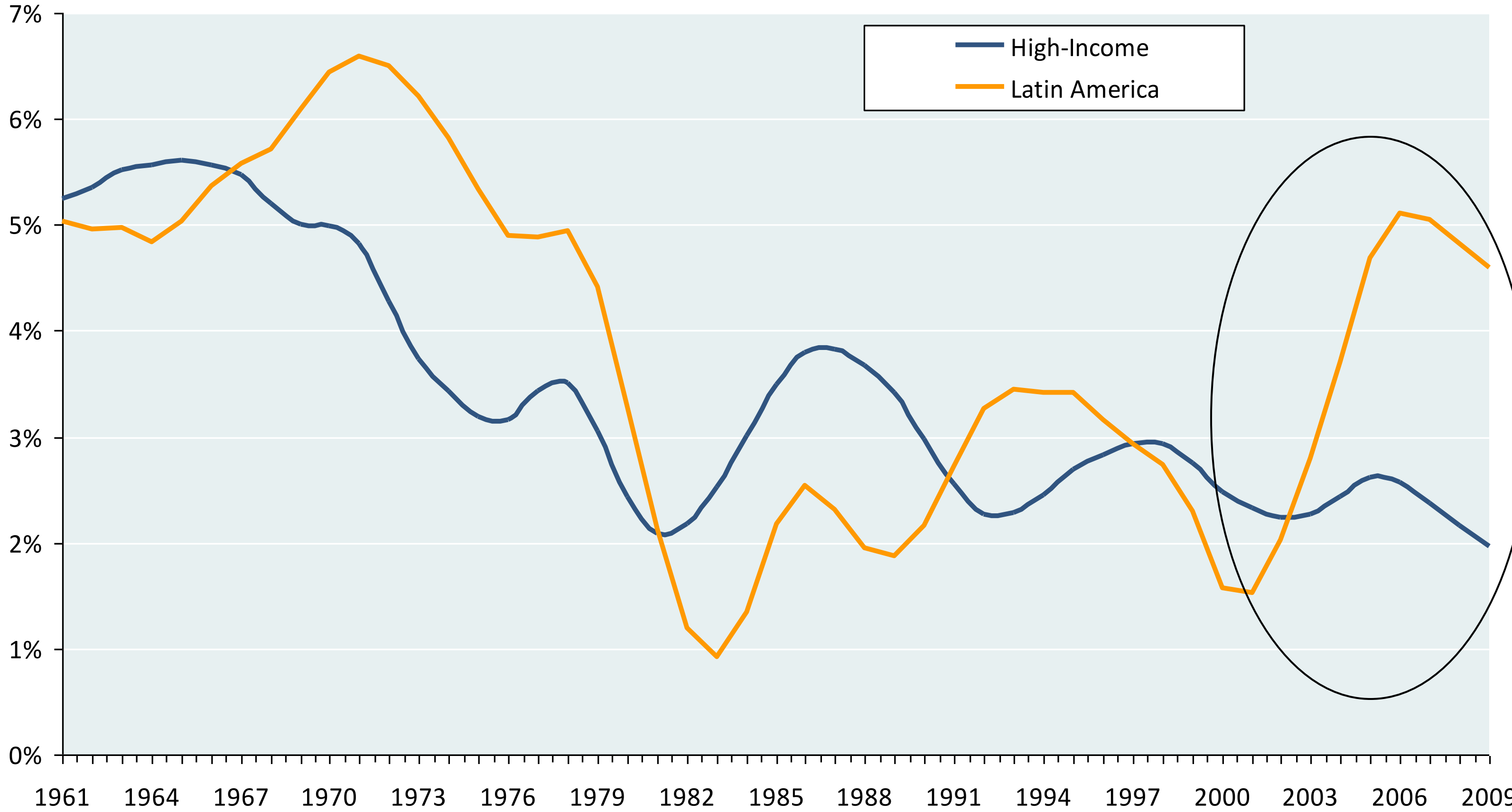
- LAC's success and the maturing recovery – real decoupling
  - The new face of LAC after a good decade
  - Maturing (decoupled) recovery cycle
  - Domestic policy tensions
- Rising global uncertainty and risks – financial coupling
  - European ailments: are sovereign debt troubles reaching the core?
  - U.S. downgraded: is a double-dip in the horizon?
  - China: how hard a landing?
- Whither LAC?
  - Can LAC avoid the traditional boom-bust pattern and achieve a high trend growth (real trend decoupling)?
  - How resistant is LAC macro-financial immune system to a potential downward cyclical re-coupling on a global scale?

LAC’s Success and the Maturing Recovery

LAC's success
Non-inflationary growth decoupling from rich countries

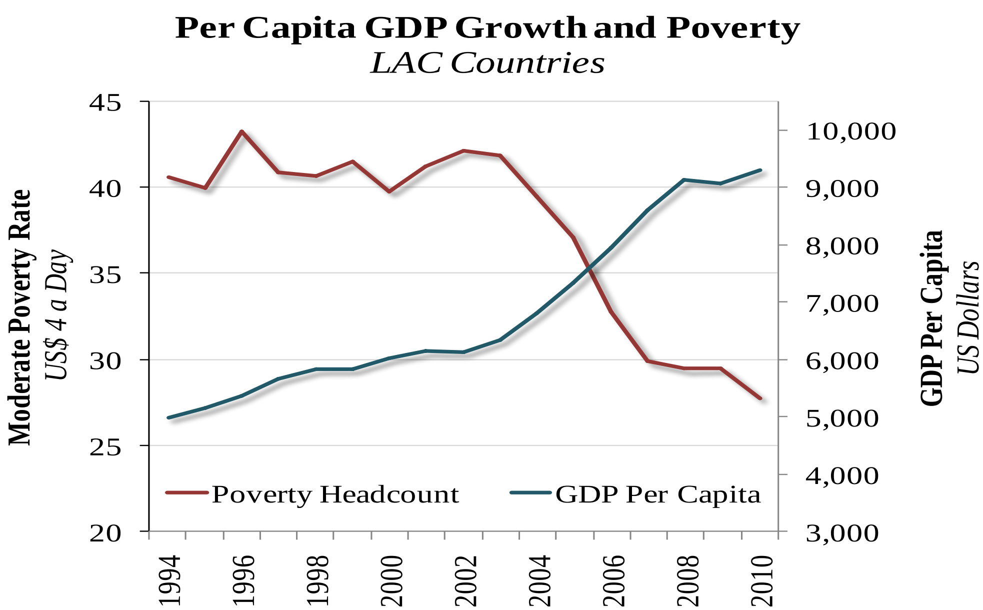
Cyclical-adjusted Growth in Latin America and High-Income Countries

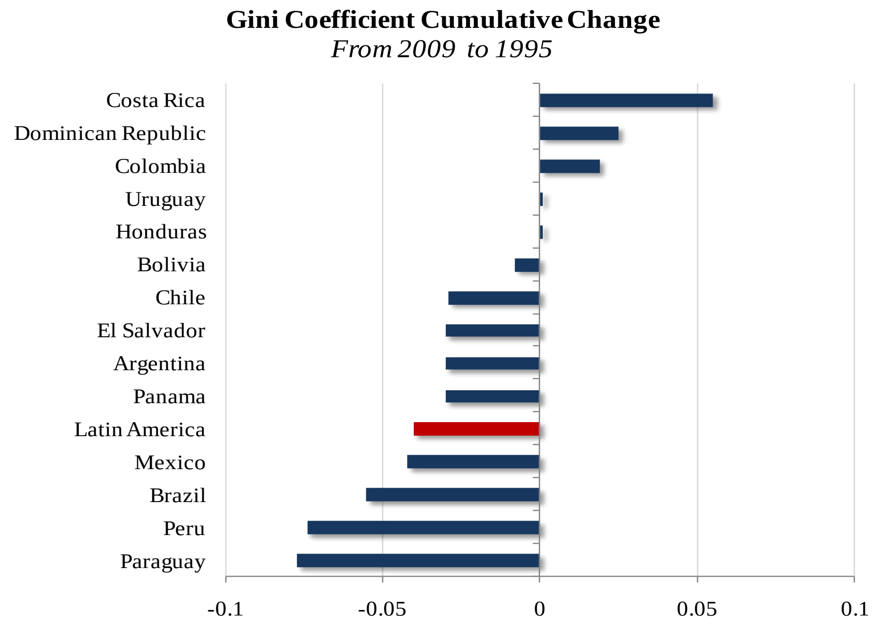
Trend growth computed using the band-pass filter



The trend growth of real GDP growth is computed using the band-pass filter (Baxter and King, 1999). LCRCE staff calculations. Source: WDI – World Bank; National Authorities.

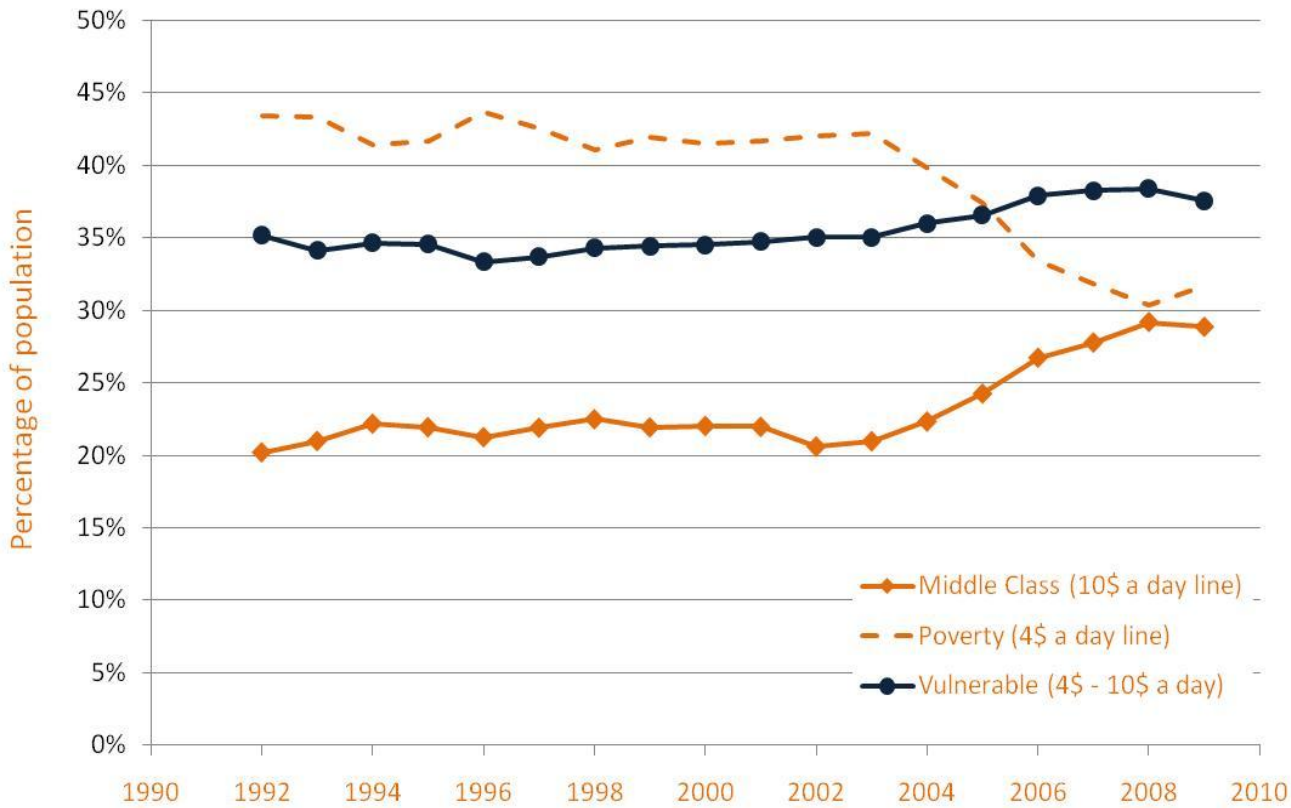
LAC's success
Reduction in poverty and income inequality





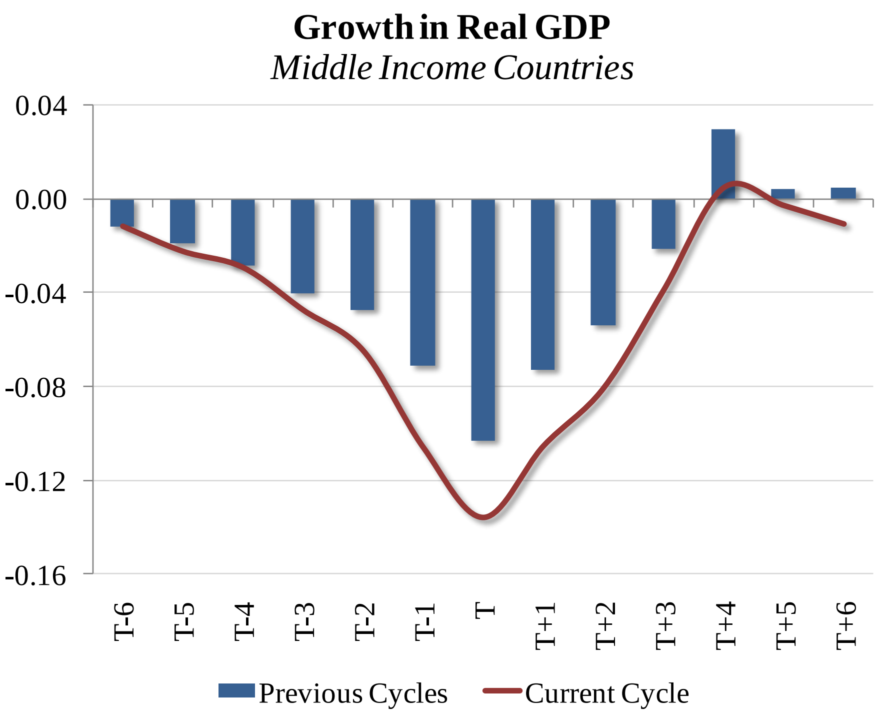
Source: LCSPP based on Socio-Economic Database for Latin America and the Caribbean (CEDLAS and The World Bank).

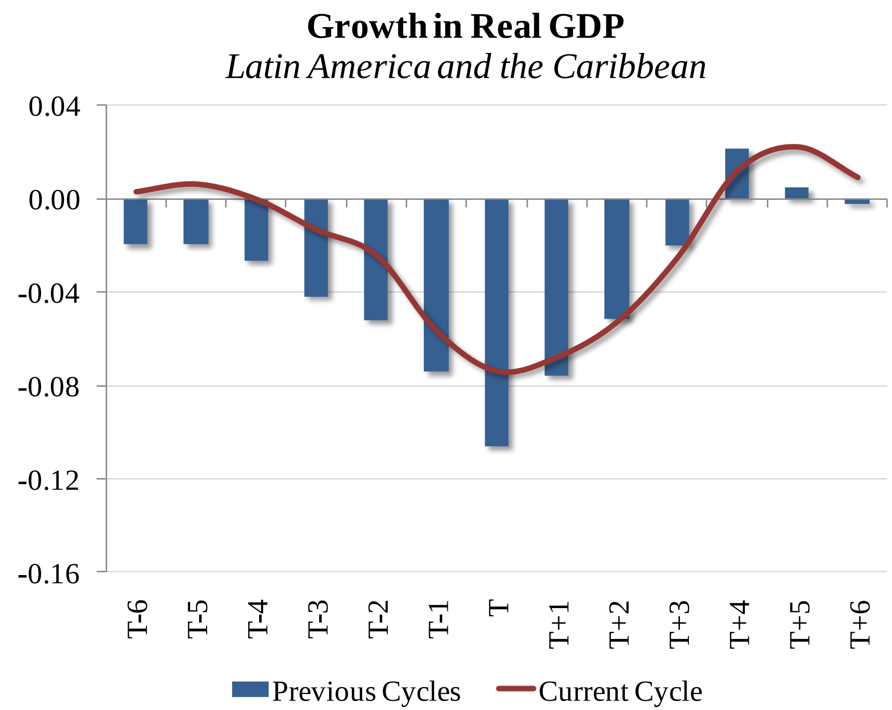
LAC's success
An expanding middle class



Source: *LAC Chief Economist Office, World Bank.*

LAC's success
Stellar performance during the 2009 global downturn

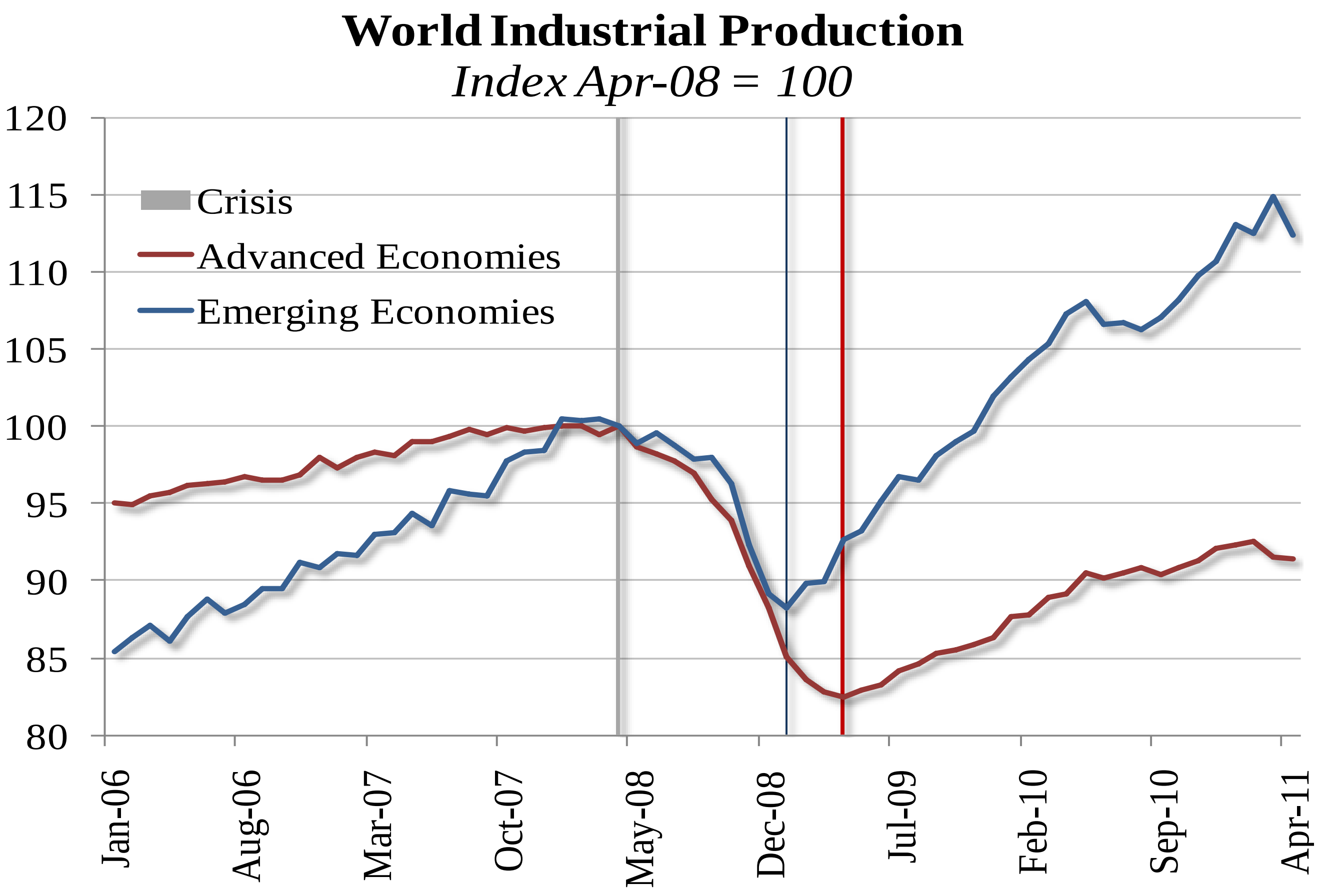




LAC came out of the global crisis without balance sheet damage

Notes: The figures represent the deviations from regional/group trend growth in real GDP on 13-quarter windows centered on previous and current troughs on real GDP. This figure depicts the behavior of real GDP in previous and current recession-recovery cycles. Sources: IMF's International Financial Statistics – IFS, National Statistical Institutes and Central Banks, Haver Analytics.

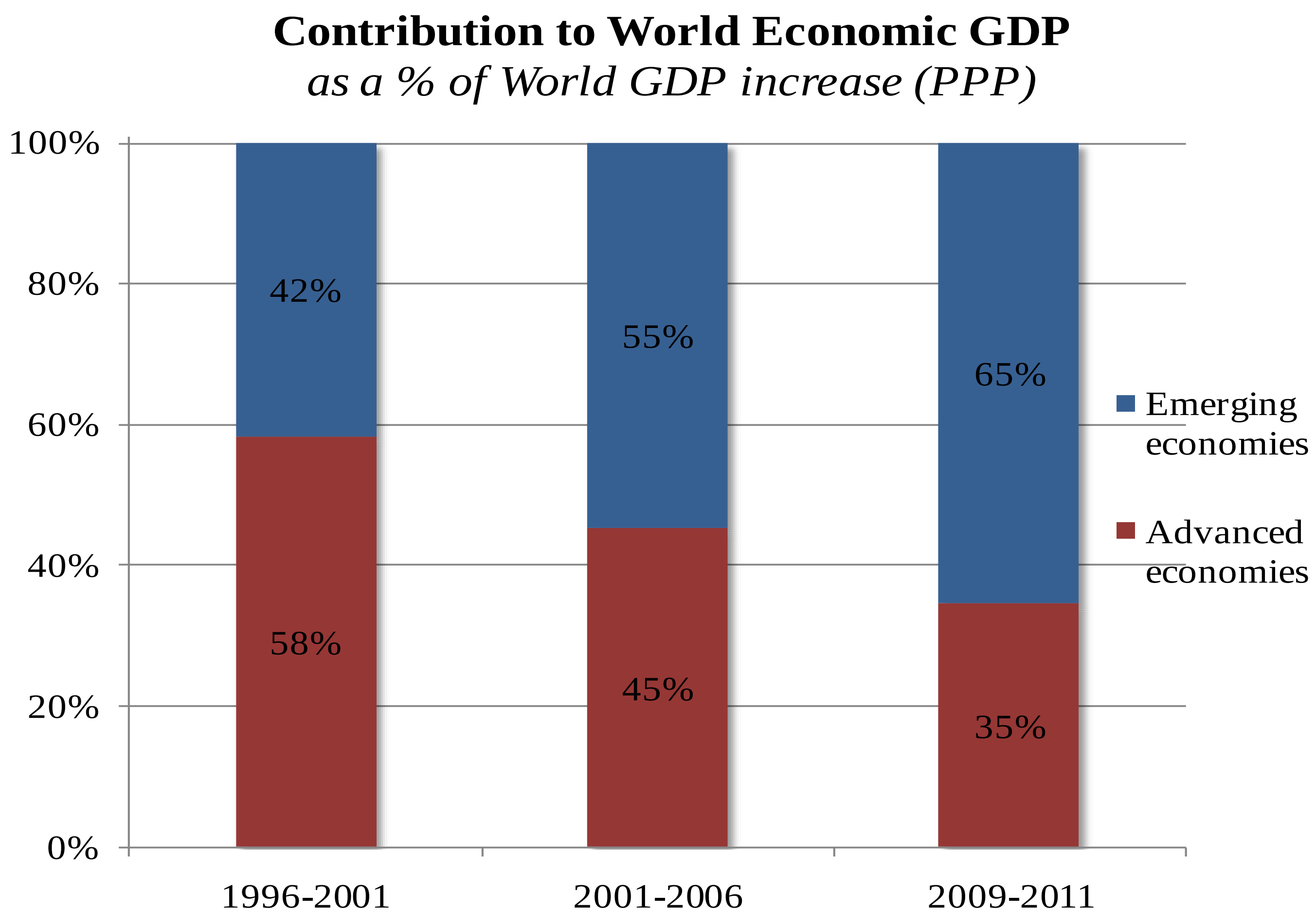
LAC's success
Joining the dynamic EMs in the recovery phase



- *Emerging economies with strongest recoveries include Brazil, China, India, Korea, Malaysia, Philippines and Thailand*
- *They represent 52% of emerging economies' GDP*

Note: The group of developed countries refers to OECD countries excluding Turkey, Mexico, Republic of Korea, and Central European countries. Source: CPB (Netherlands Bureau for Economic Policy Analysis).

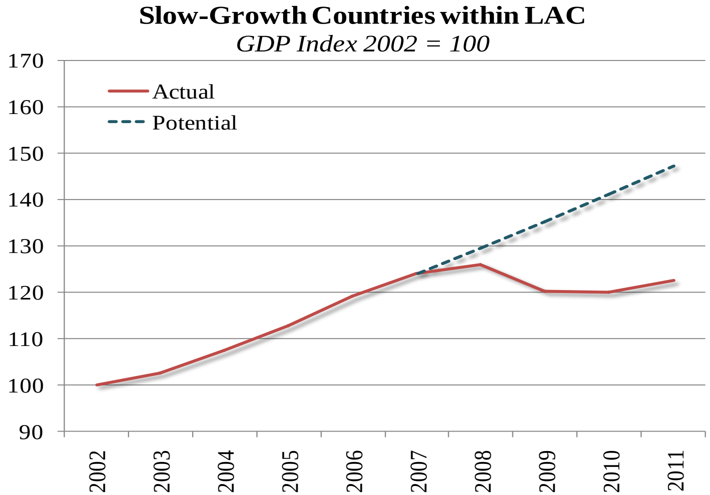
LAC's success
Joining the dynamic EMs in the recovery phase

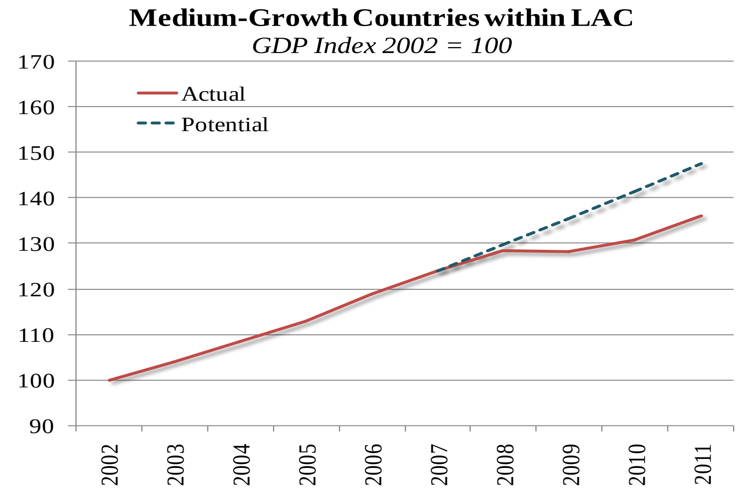


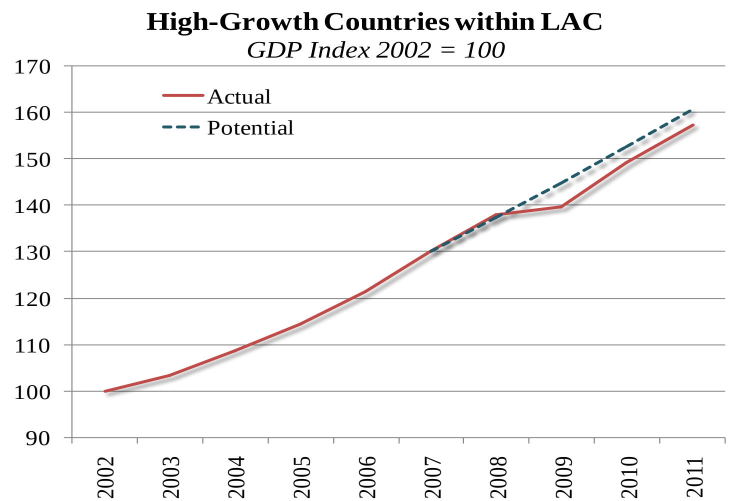
Note: This graph use the WEO definition of Emerging Economies and Advanced Economies. For the "2009-2011" window we use the last WEO's forecast (April – 2011)

LAC's uneven success

Mutating regional heterogeneity







Sources: Potential GPD is computed as the average rate of growth between 2007 and 2003. Simple averages are used to construct the composite. The categorization of each group is as follow: Slow-growth are those countries that showed a less than 3.5% in their 2011-2008 GDP real growth rate; Medium-growth are those between 3.5% and 10%: High-growth are those with 10% or more. For 2011 we used the last available forecast (Consensus Forecast June-2011). Sources: Consensus Forecast (June – 2011); WEO (April – 2011).

LAC's uneven success

Where you are matters less than to whom you are connected

	Number of countries	Mean growth 2003-2007*	Mean Growth 2003-2011	Mean Growth 2008-2011**	Cumulative Max. 2008-2011	Cumulative Min. 2008-2011
Low growth	13	4.4%	2.3%	-0.3%	3.3%	-12.3%
Medium growth	7	4.4%	3.5%	2.4%	7.9%	4.1%
High growth	12	5.4%	5.2%	4.9%	18.8%	10.0%
Total	**32**	**4.8%**	**3.7%**	**2.2%**	**18.8%**	**-12.3%**

** This is the measure used to construct the "Potential GDP"*

*** This is the measure used to define the classification as "Low", "Medium" and "High".*

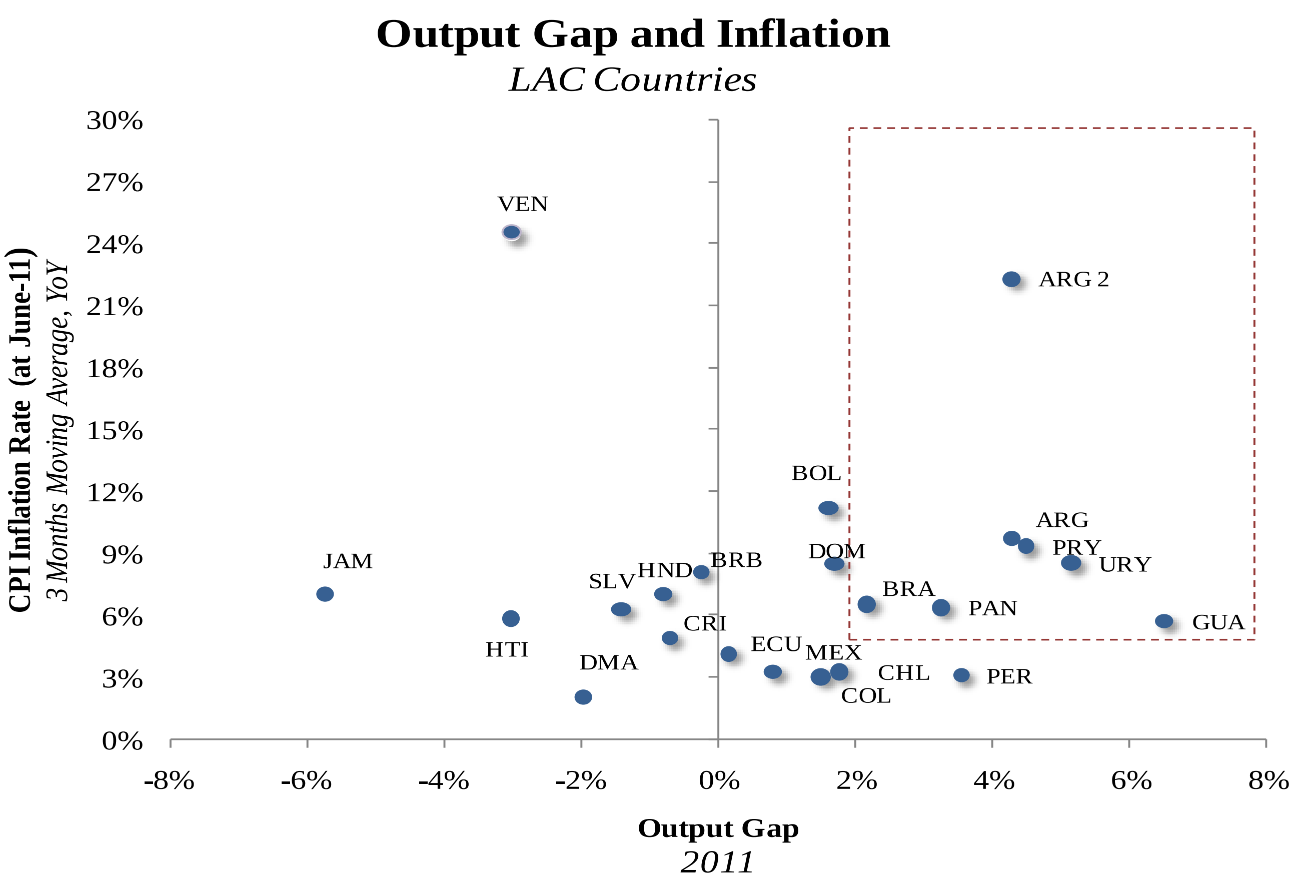
Low growth (<4%): St. Kitts and Nevis, Antigua and Barbuda, Grenada, Barbados, Jamaica, Bahamas, Venezuela, Trinidad and Tobago, St. Vincent and the Grenadines, El Salvador, St. Lucia, Dominica and Mexico

Medium growth (4%-10%): Honduras, Belize, Haiti, Nicaragua, Guatemala, Costa Rica and Ecuador

High growth (>10%): Chile, Colombia, Brazil, Guyana, Bolivia, Suriname, Paraguay, Dominican Republic, Peru, Argentina, Uruguay and Panama

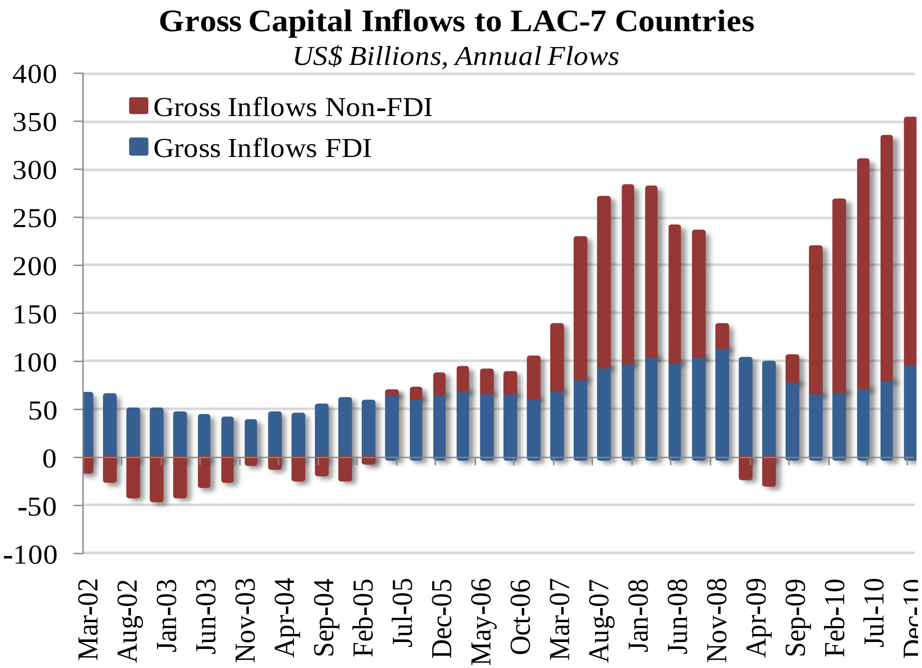
Sources: World Bank's World Development Indicators – WDI (December 2010), IMF's World Economic Outlook – WEO (April 2011), and Consensus Forecasts (June 2011) – Latest available forecasts. Potential GDP is calculated computing the annual average real growth rate for the 2002-2007 to 2007 GDP. Weighted averages (2007 Nominal GDP in USD Billions).

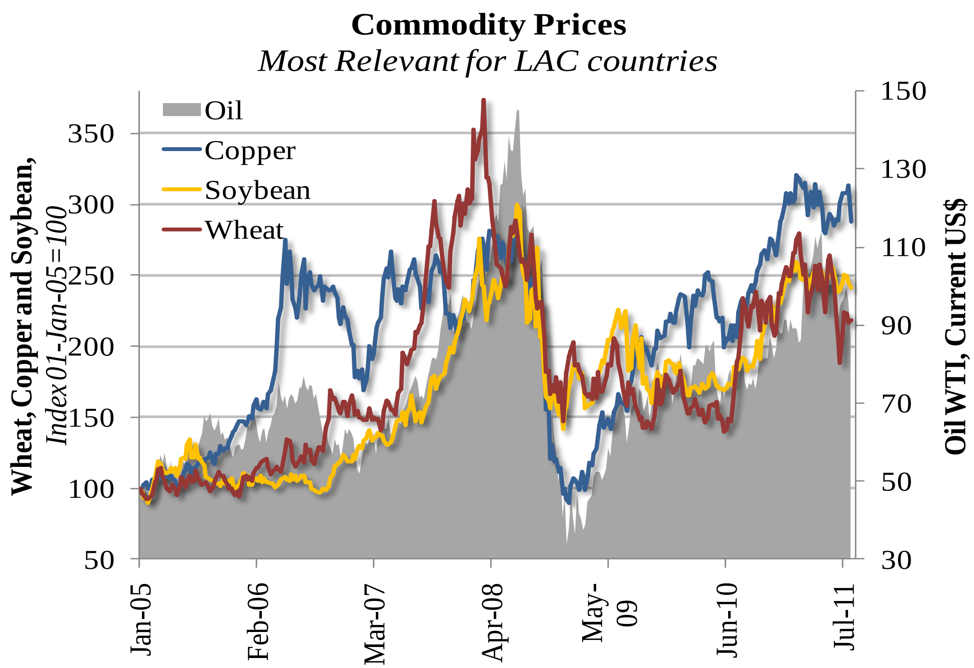
LAC's maturing cyclical recovery
Overheating and *endogenous* inflationary pressures



Notes: The area inside the box represents the range between the lowest and highest midpoints among inflation targeting countries. Sources: National Statistical Institutes and Central Banks, Haver Analytics.

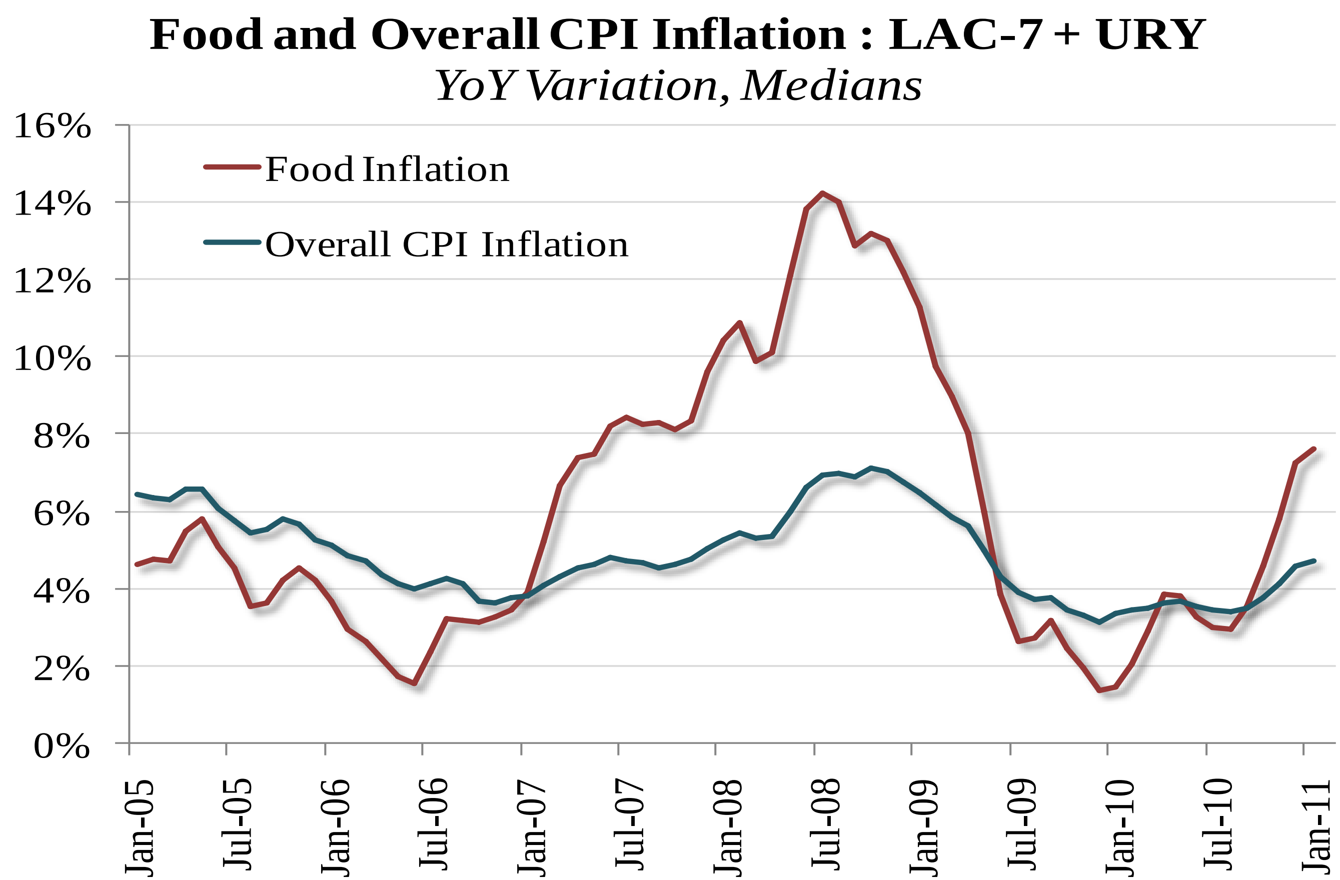
LAC's maturing cyclical recovery
Double tail spin push: commodity prices & capital inflows





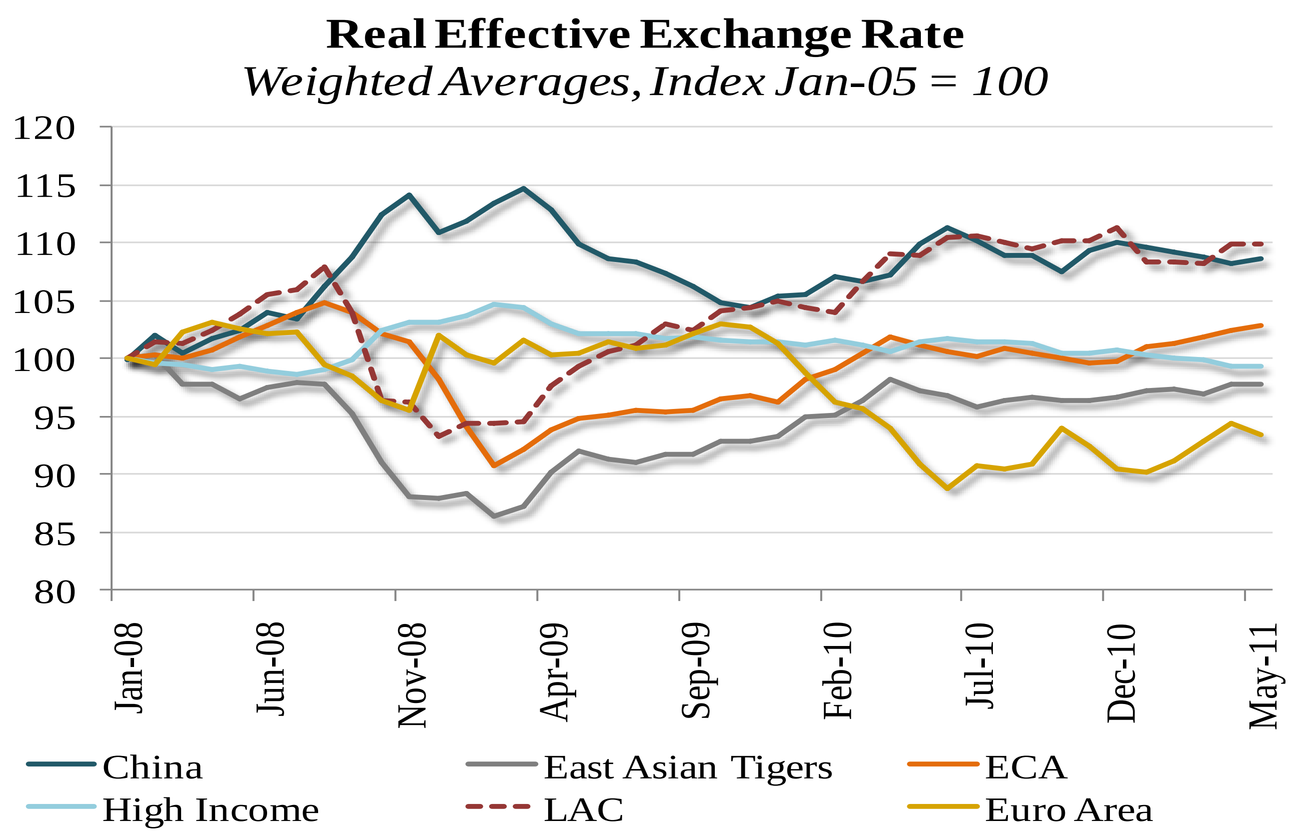
Notes: Annualized capital inflows to LAC-7. Sources: IMF's Balance of Payments Statistics, National Statistical Institutes, and Central Banks.

Demands on domestic macro-financial policy
Maintain inflation expectations well anchored



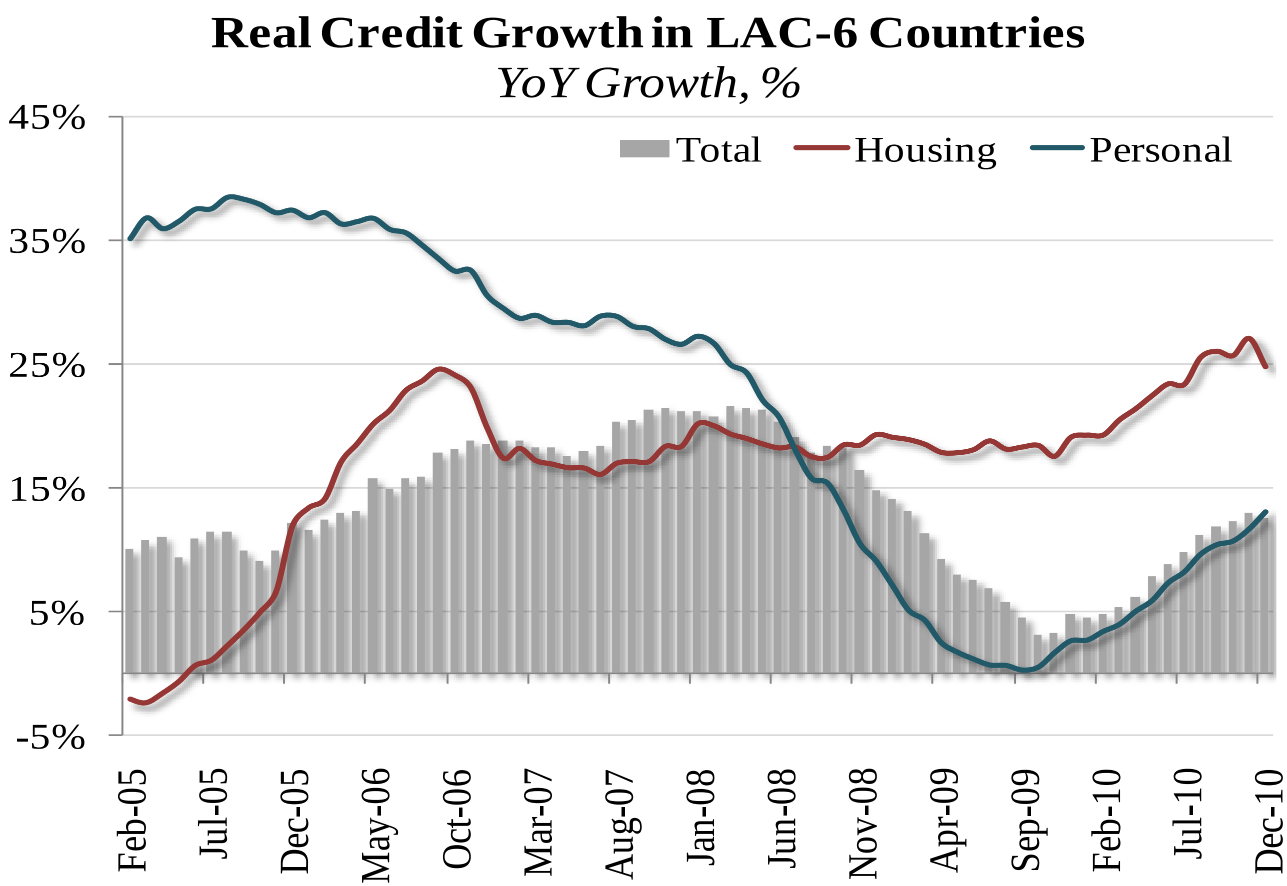
Notes: There is a change in the methodology of calculation for both food and overall PCI index for Chile since January 2009. For the figure on the right, we used the latest available figure for each country. Weighted averages (2007 Nominal GDP in USD Billions) were used in the case of the regional numbers. Sources: Bloomberg, Instituto Nacional de Estadísticas de Chile – INE, and Food and Agriculture Organization – FAO (2010) and IMF's World Economic Outlook – WEO (October 2010).

Demands on domestic macro-financial policy
Avoid “excessive” currency appreciation



Notes: Weighted averages were calculated using the 2007 nominal GDP in USD Billions. An increase means an appreciation of the REER. Sources: IMF’s International Financial Statistics – IFS and IMF's World Economic Outlook – WEO (April 2011).

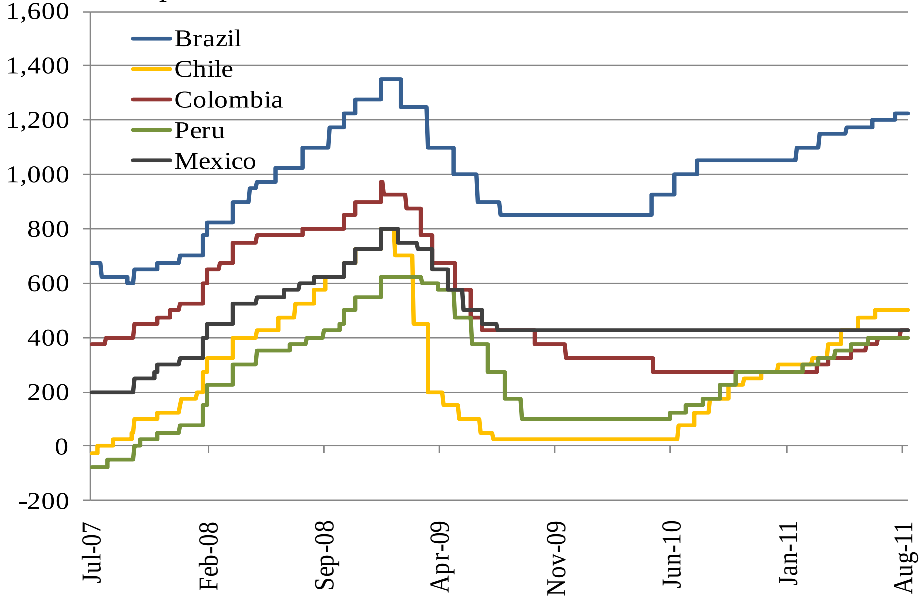
Demands on domestic macro-financial policy
Curb systemic risk buildup (financial excesses)



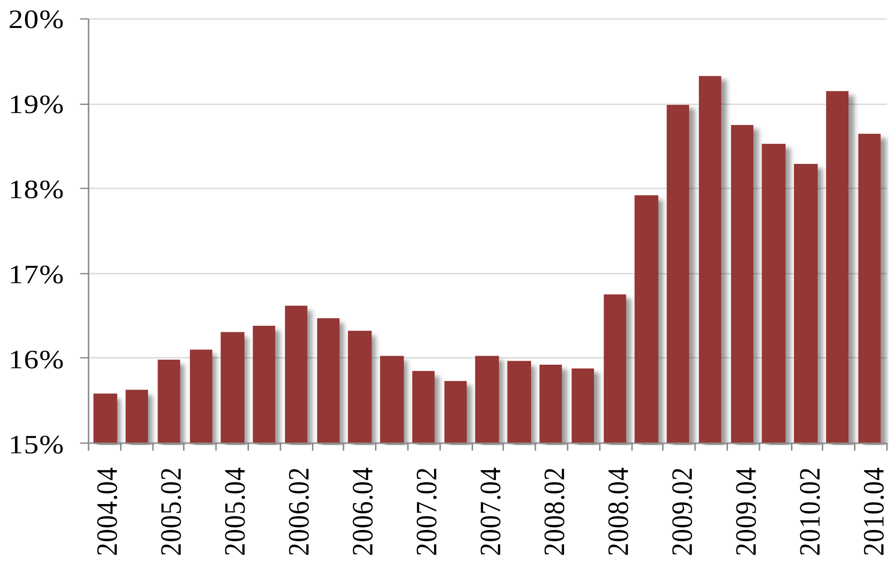
Notes: The figure depicts the (PPP-GDP) weighted average of the growth rates of (total, personal and housing) credit to the private sector for the six largest LAC countries (Argentina, Brazil, Chile, Colombia, Mexico, and Peru). Sources: National Statistical Institutes, Central Banks, and Superintendence of Banking.

Adjusting the macro-financial policy response
The need to rebalance the monetary-fiscal policy mix

Monetary Policy Interest Rate Differential
Spread w.r.t FED Funds Rate, In Basis Points



Primary Expenditure
% of GDP, LAC-6 Countries



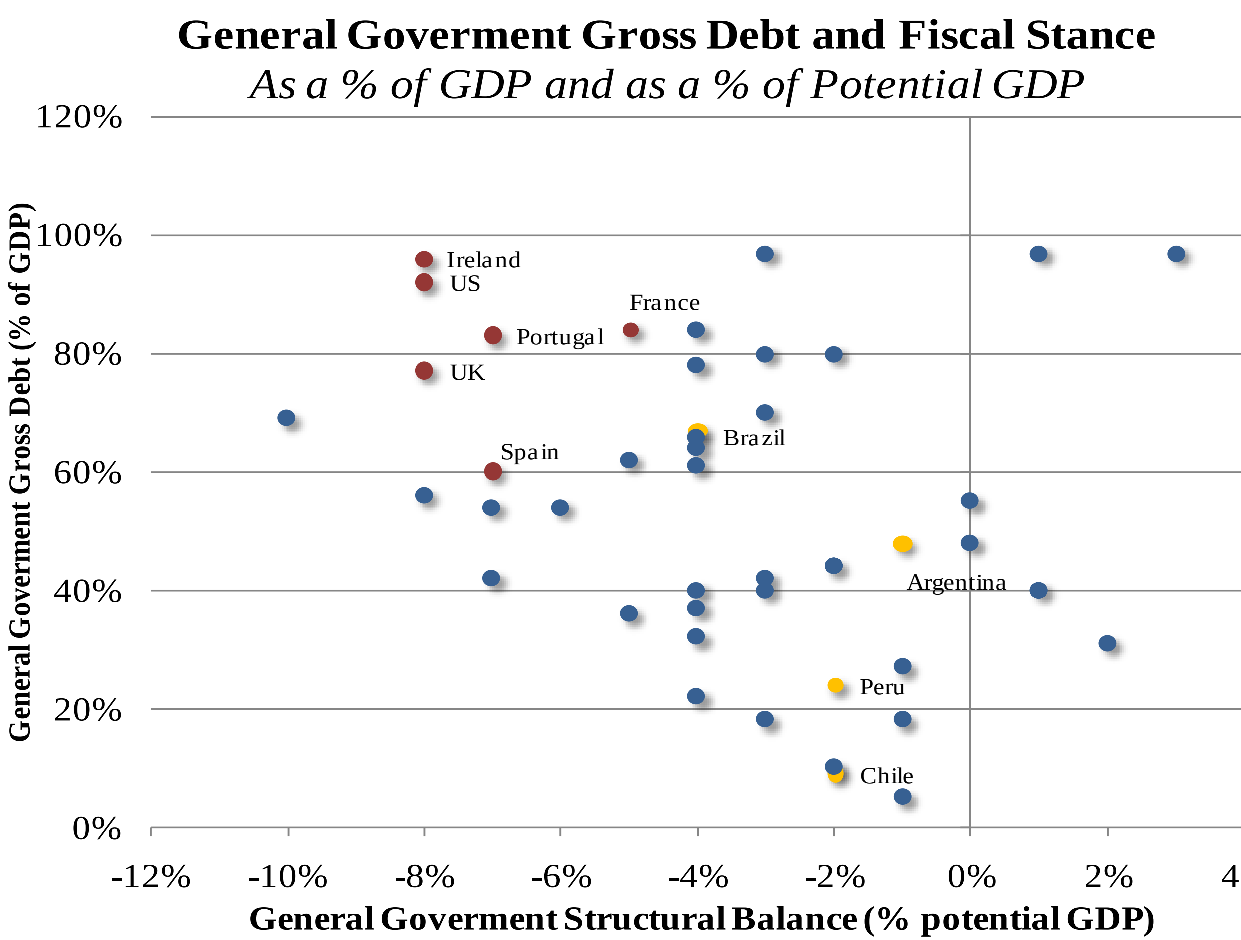
Notes: The figures in Panels B is the cyclically-adjusted primary expenditure and primary balance for the major six LAC countries (Argentina, Brazil, Chile, Colombia, Mexico, and Peru). Sources: Bloomberg, Haver Analytics, National Statistical Institutes, and Central Banks.

Domestic macro-financial policy
The need to hone the macro prudential policy agenda

- Avoid contributing to amplification – don't rock the boat
  - Remove pro-cyclicality in macro and *traditional* regulatory policy
  - Allow prudential buffers to be true buffers – i.e., to be used without penalty during downswings (Goodhart, 2010; Hellwig, 2010)
  - Remove deeper pro-cyclical factors, such as currency mismatches and social moral hazard (expectation of bailouts or "Greenspan put")
- Enhance financial system resiliency to cycle – build a better boat
  - Add more, systemically-oriented buffers (liquidity and solvency)
- Dampen the cycle – tame the (excess) amplitude of the waves
  - Incorporate an explicit dampening function into MMP design
- Nip the gestation of adverse financial amplifications in the bud
  - Induce the internalization of externalities and prevent buildup of exuberance (Pigovian taxes, approval protocols for innovations)

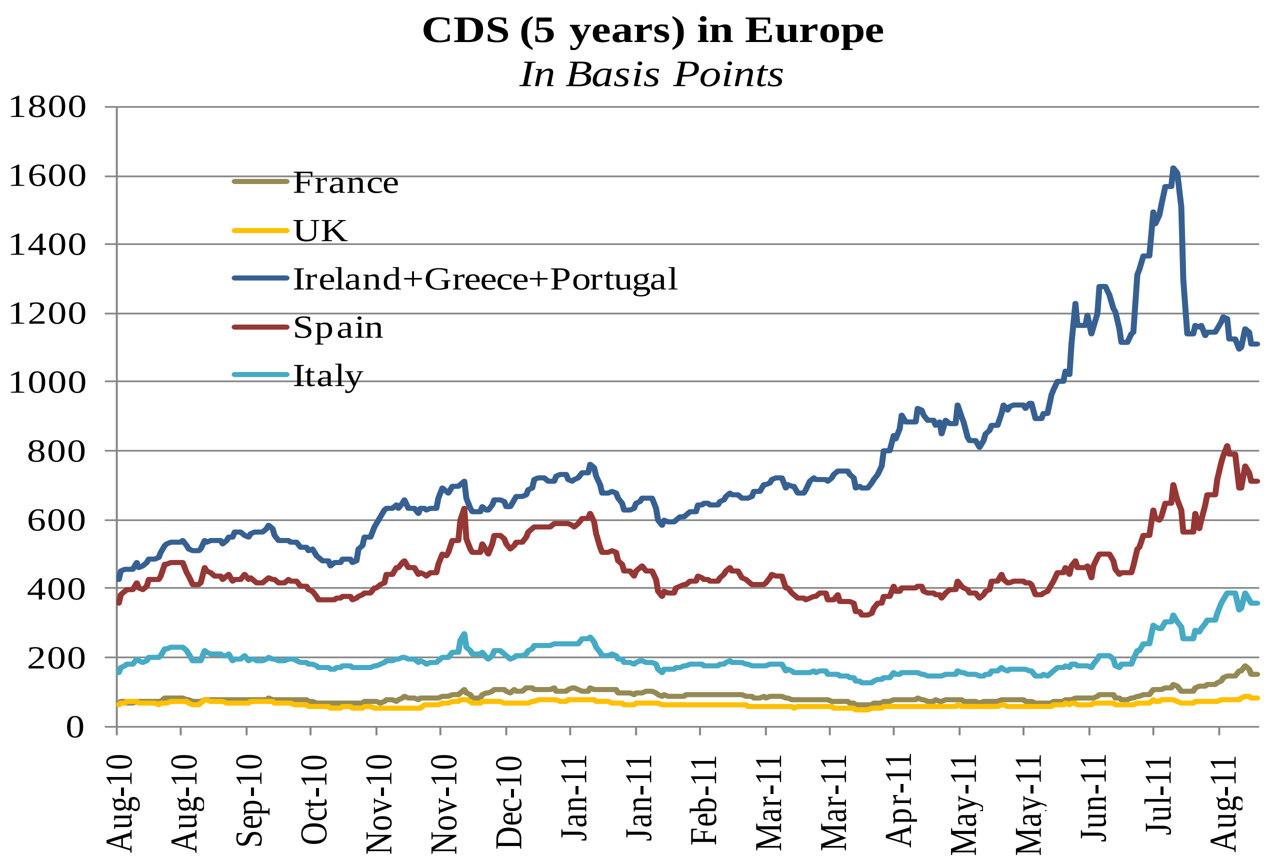
Rising Global Uncertainty and Risks

The European Epicenter
Deeper and broader concerns about debt viability



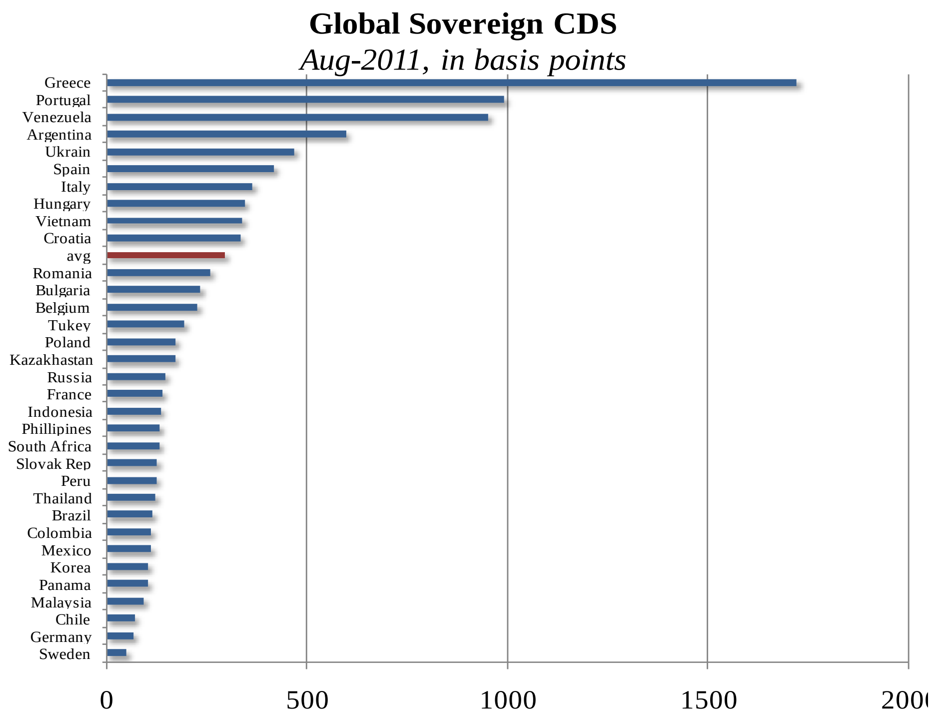
Source: IMF WEO (April – 2011)

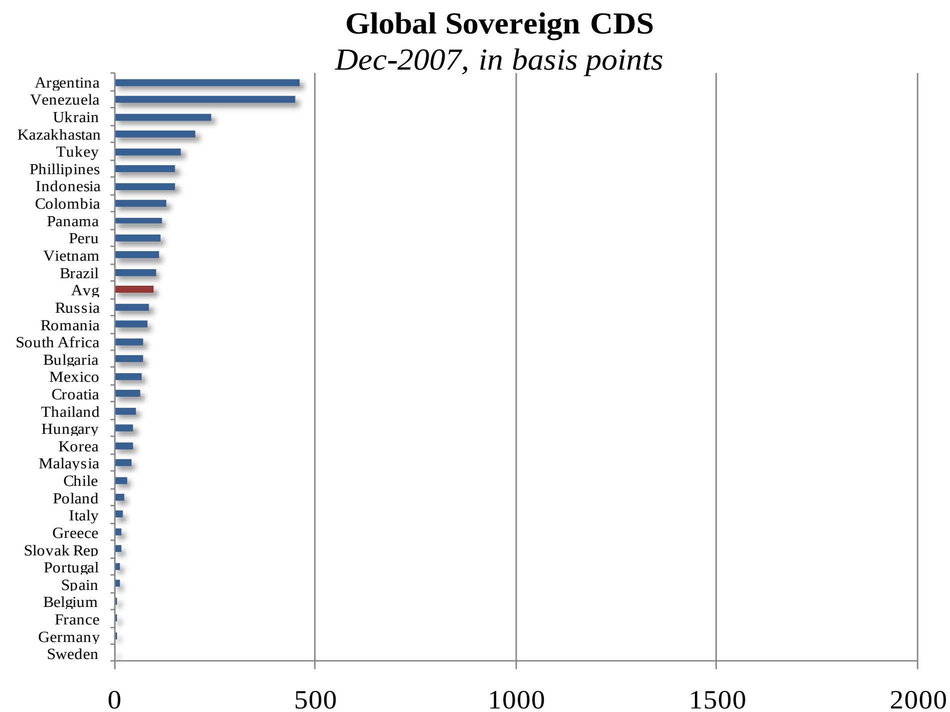
The European Epicenter
From drama to trauma



Note: The average CDS is computed for Ireland, Greece and Portugal. Source: Bloomberg

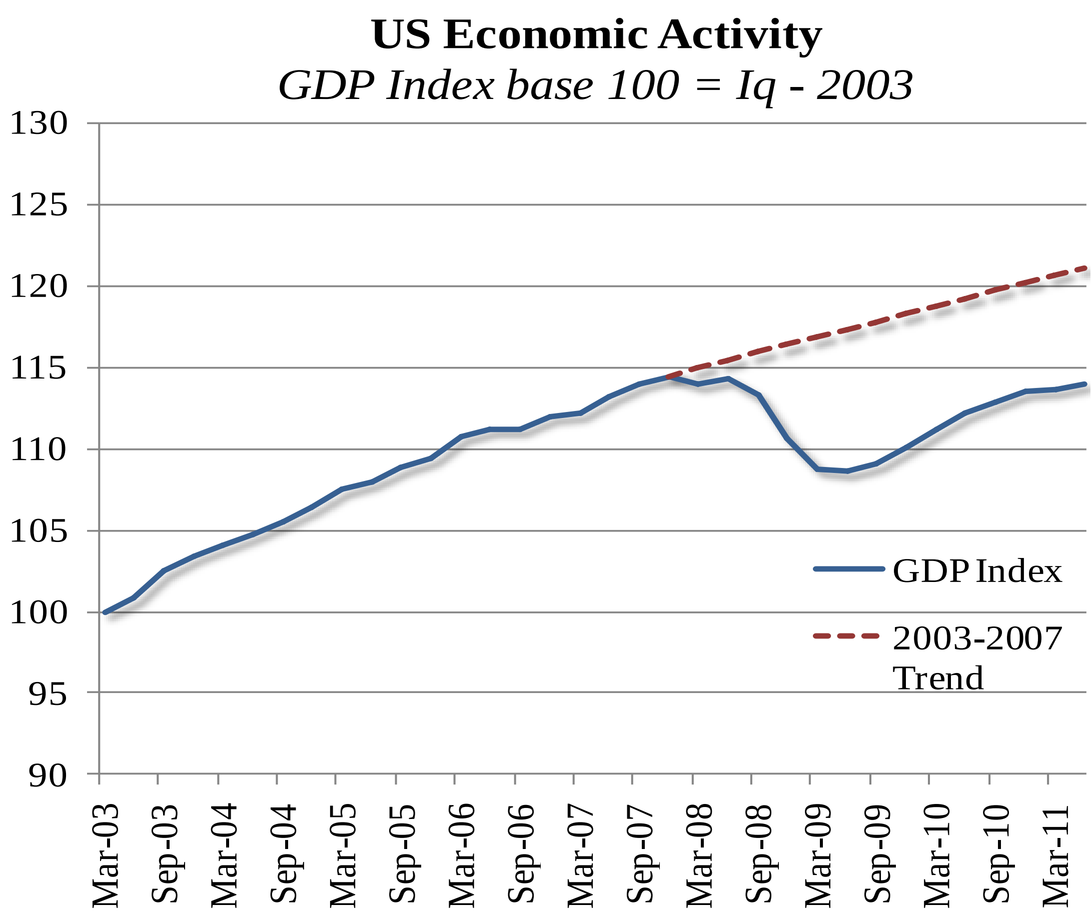
The European Epicenter
Reversal of fortune





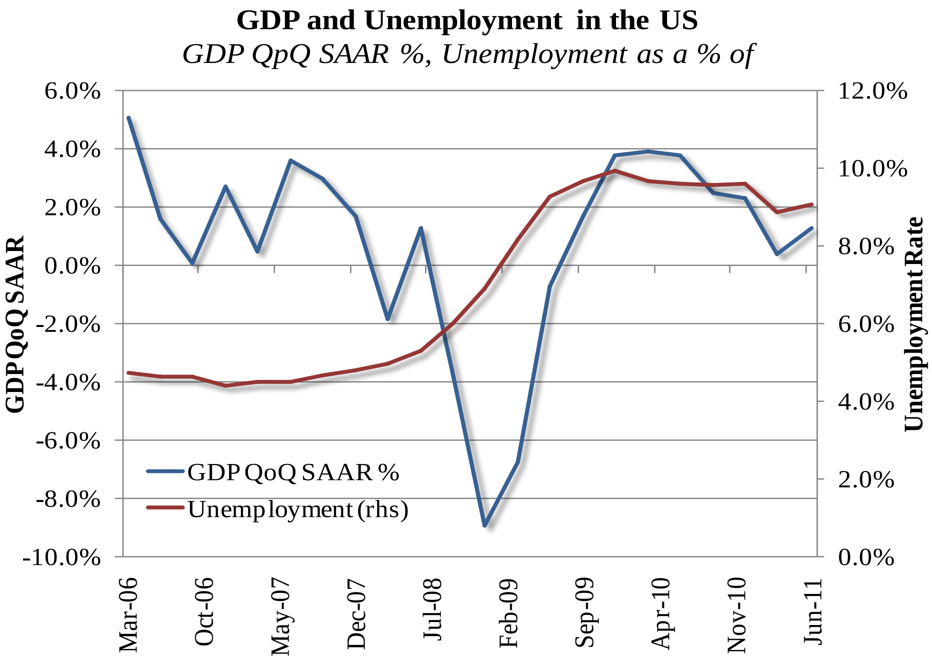
Source: Own calculation based on Bloomberg

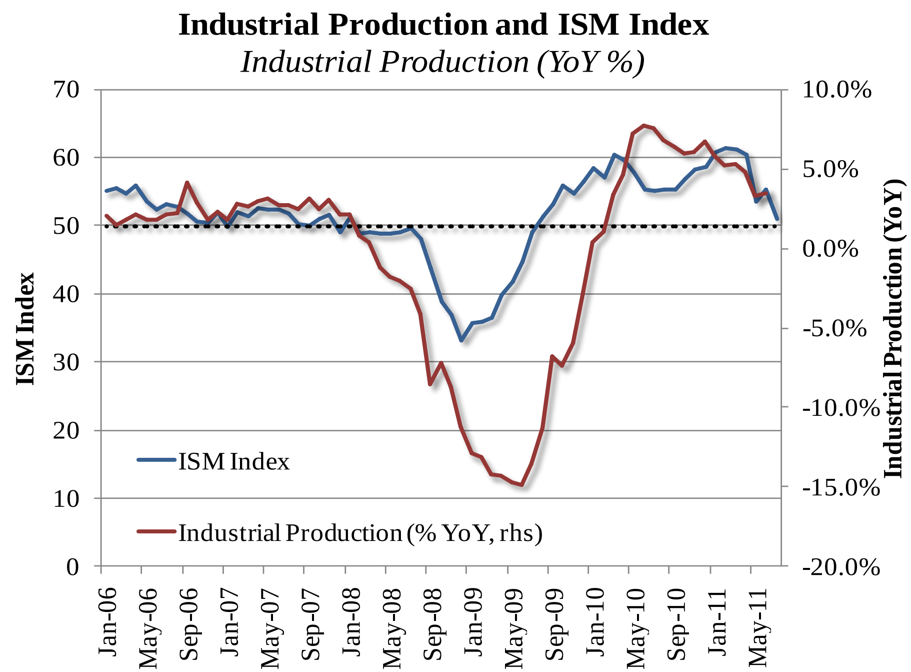
The U.S. Epicenter
Still well below potential



Source: National sources

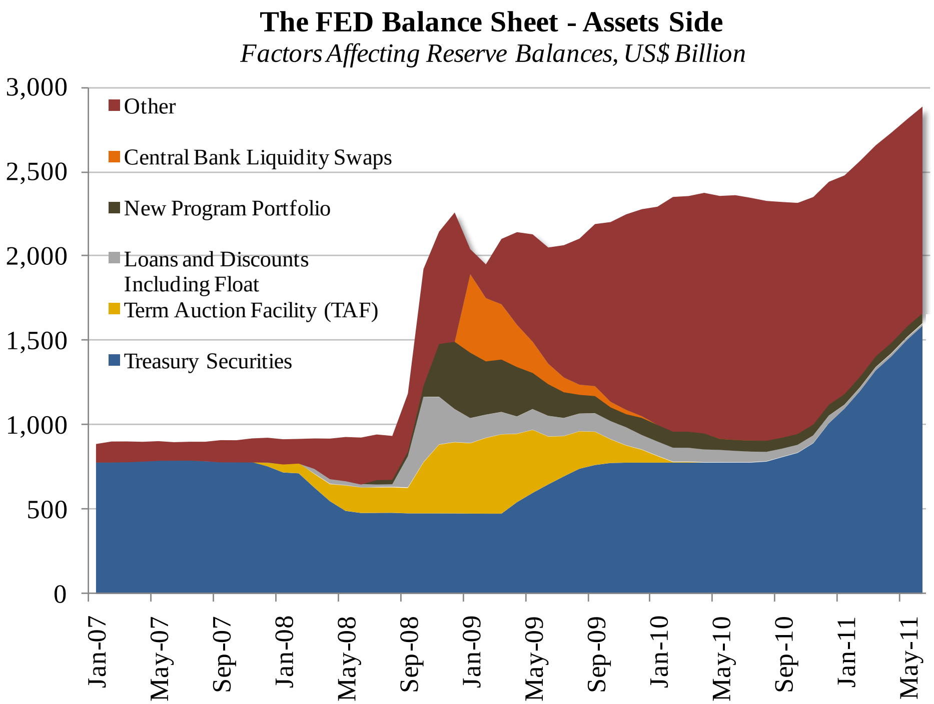
The U.S. Epicenter
A threat of a double dip?

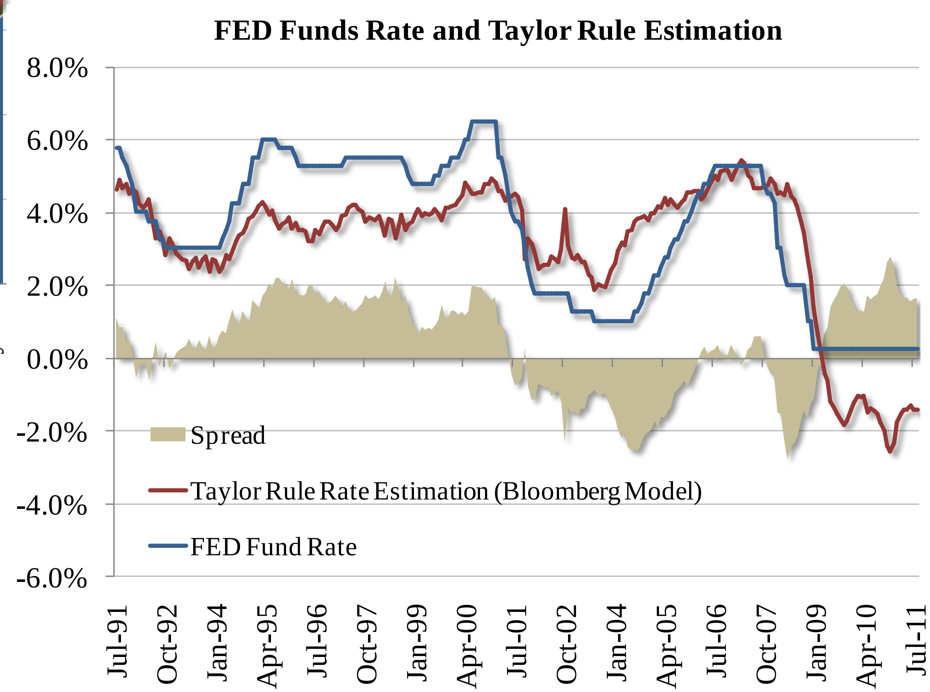




Source: National sources.

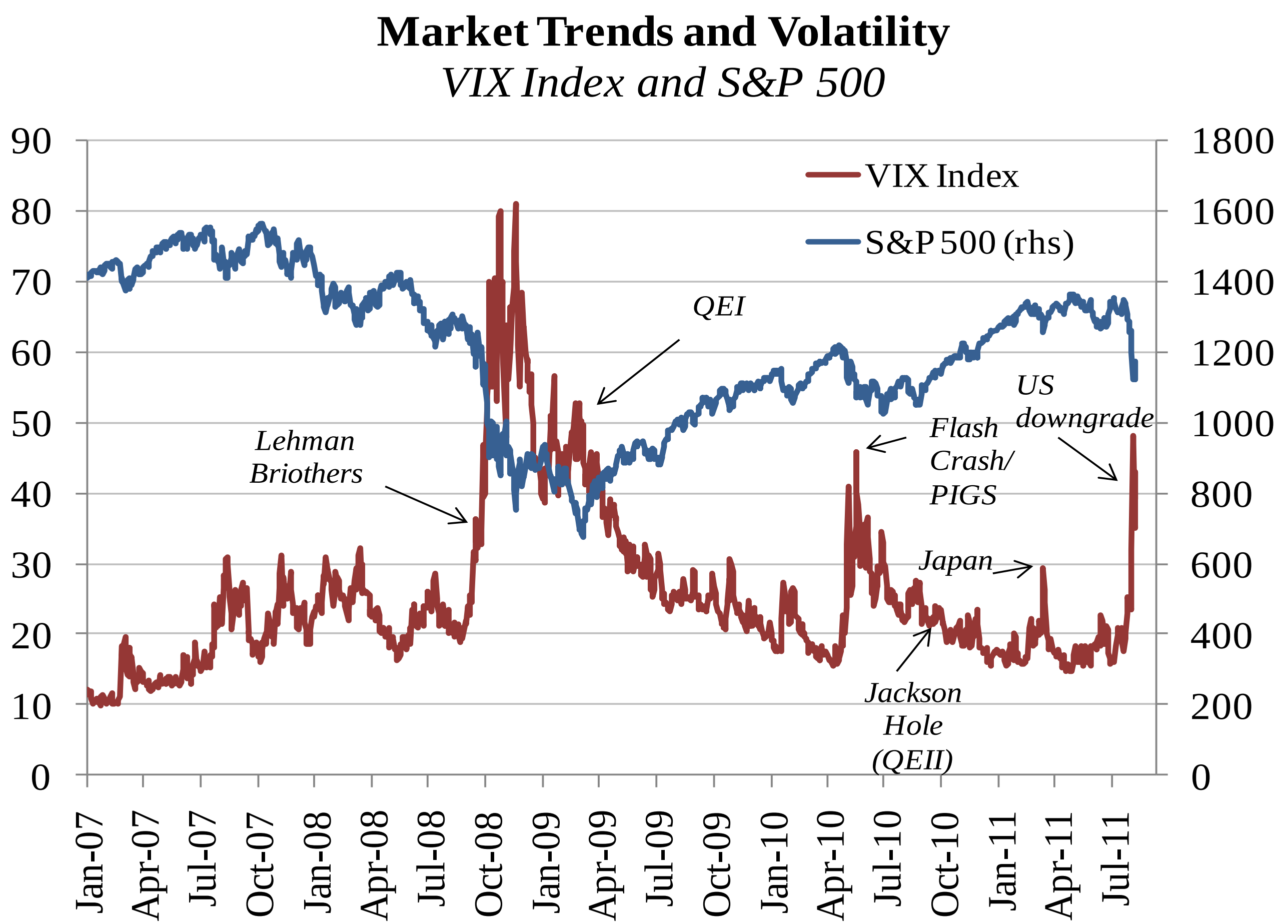
The U.S. Epicenter
Narrowing room for policy maneuvering





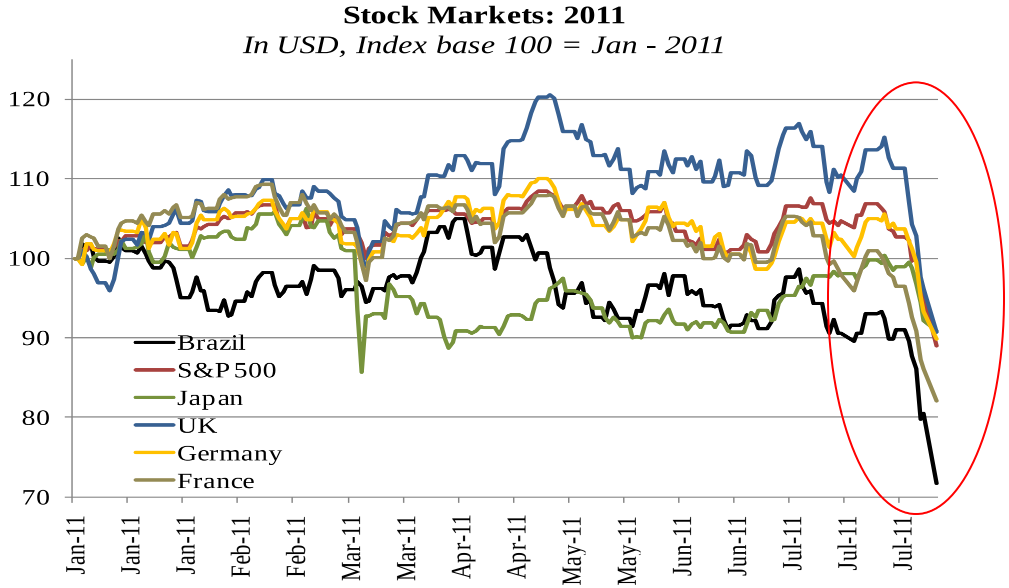
Source: National sources.

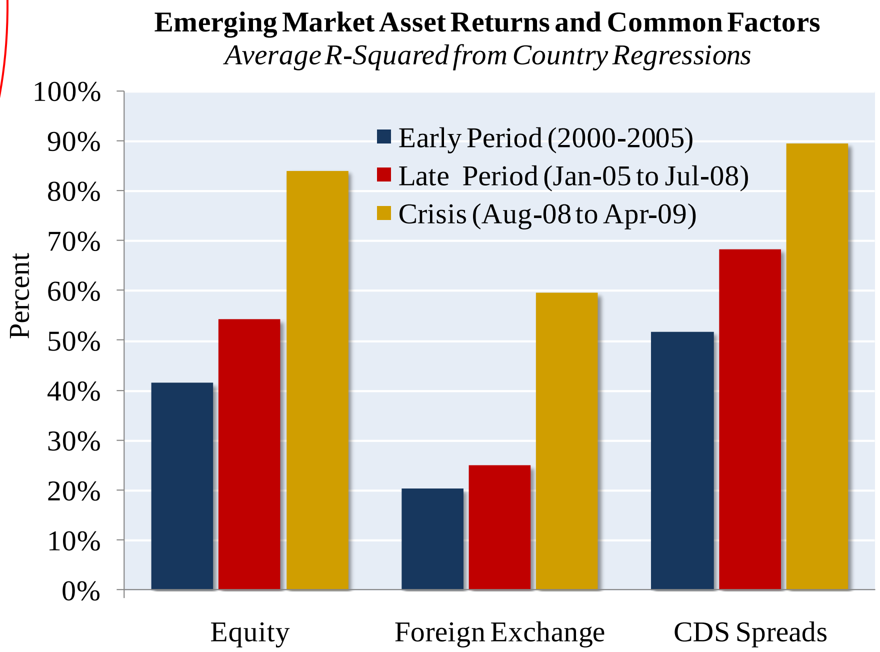
The U.S. Epicenter
The downgrade and the swing in market sentiment



Source: Bloomberg

The U.S. Epicenter
The downgrade and global financial coupling

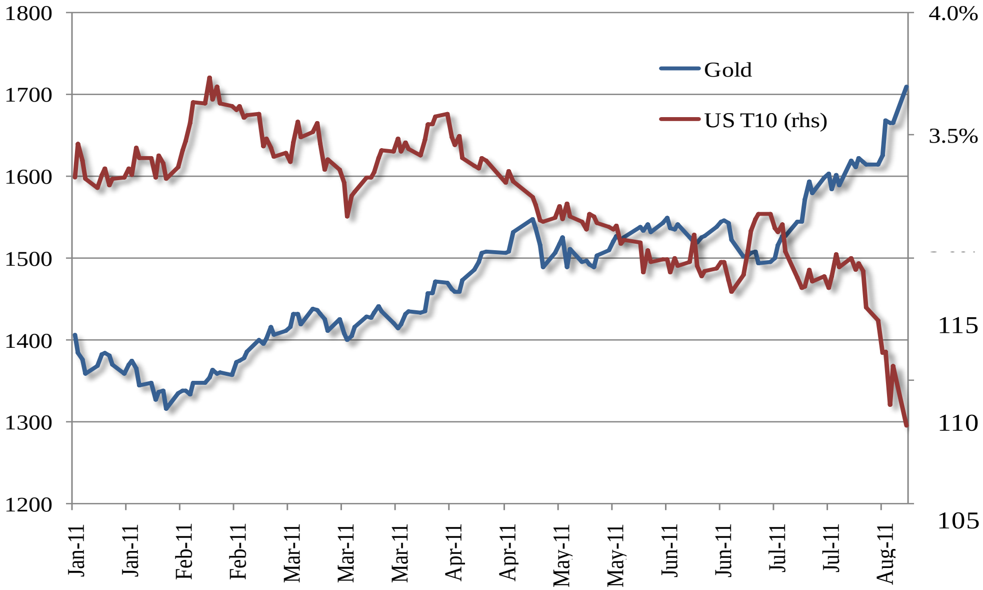




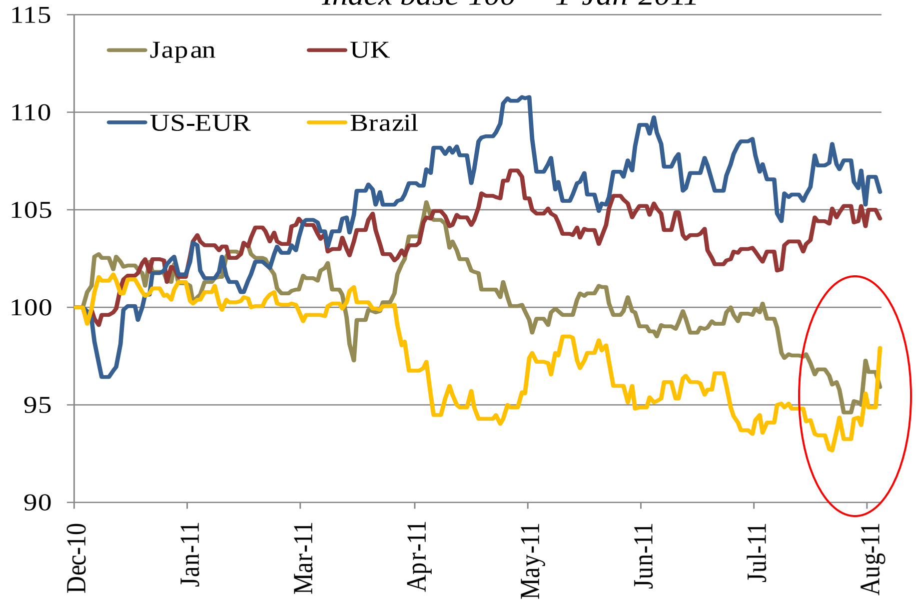
Source: Bloomberg

The U.S. Epicenter
Downgraded but still the safe haven

Gold and US T10
2011



Currencies: 2011
Index base 100 = 1-Jan-2011



Source: Bloomberg

The China Epicenter
Danger of an abrupt adjustment?

Source: National sources.

Whither LAC?

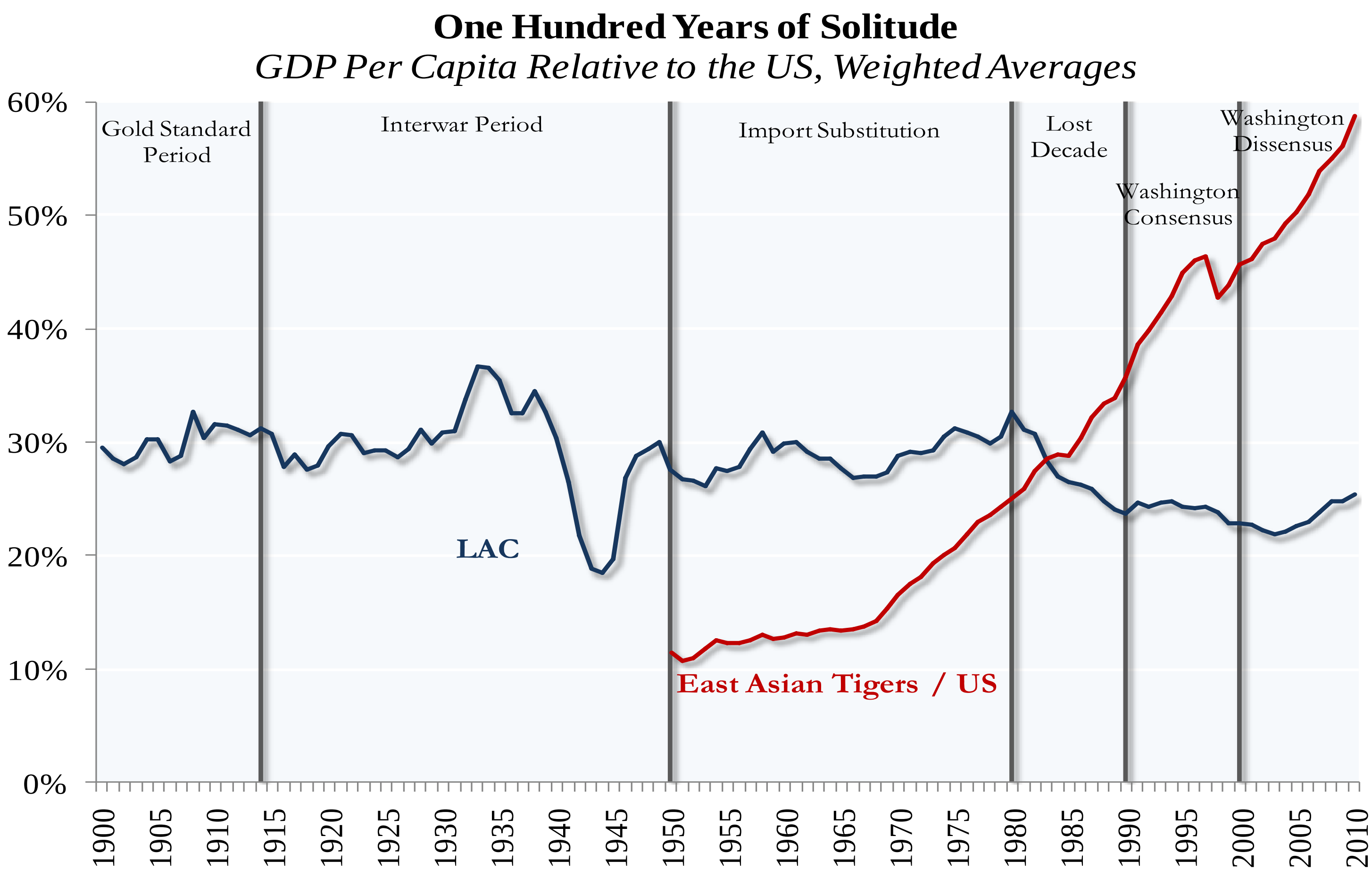
Benign scenario: real decoupling continues
Can LAC turn cyclical recovery into higher trend growth?

- Successful management of the cycle is essential to break free from the historical boom-bust pattern

- LAC bumps against *structural speed limits* at comparatively low growth rates
  - Productive capacity in LAC lacks the efficiency and flexibility to accommodate robust long-run growth rates

- Could the region turn natural resources into a blessing?
  - Saving – for stabilization and asset building
  - Diversification – avoiding the “enclave” syndrome
  - Institutions – avoiding corrosive effects of rent-seeking

LAC has experienced 100 years of growth solitude



Note: The group of East Asian tigers includes Hong Kong (China), Indonesia, Malaysia, Republic of Korea, Singapore, Thailand, and Taiwan (China). Maddison (2007-2009) was used from 1900 to 2006. We used the Real Per Capita GDP growth from WDI to calculate the levels from 2006 to 2010.
Source: LCRCE Staff calculations based on Maddison (2007, 2009) and WDI

Bad scenario: global downward re-coupling
How much can LAC's new "immune system" resist?

- Robust monetary policy frameworks in LAC, mostly
  - Shock absorption via e-rate flexibility/monetary policy independence
- How good are LAC's fiscal buffers?
  - Comfortable public debt situation but insufficient fiscal flexibility
- How good are LAC's financial system buffers?
  - Strong capital and liquidity positions
  - Have systemic risks been brewing in the past year or so?
- How good are LAC's social safety nets?
  - Ability to scale up social assistance programs vary widely in the region
  - Social insurance frameworks are the weak link

Thank you