

Latin American challenges in the present environment

Guillermo Perry

LACEA/LAMES

México, November 2006



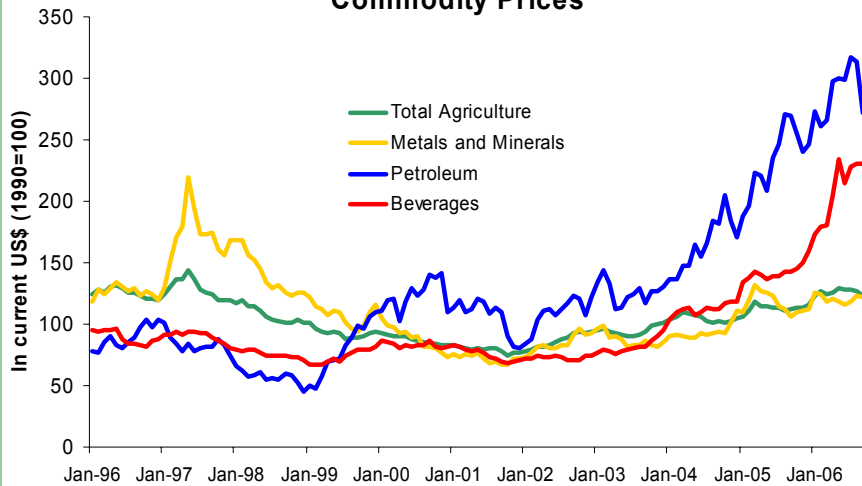
Office of the Chief Economist
Latin America & the Caribbean Region
The World Bank

Structure of the Presentation

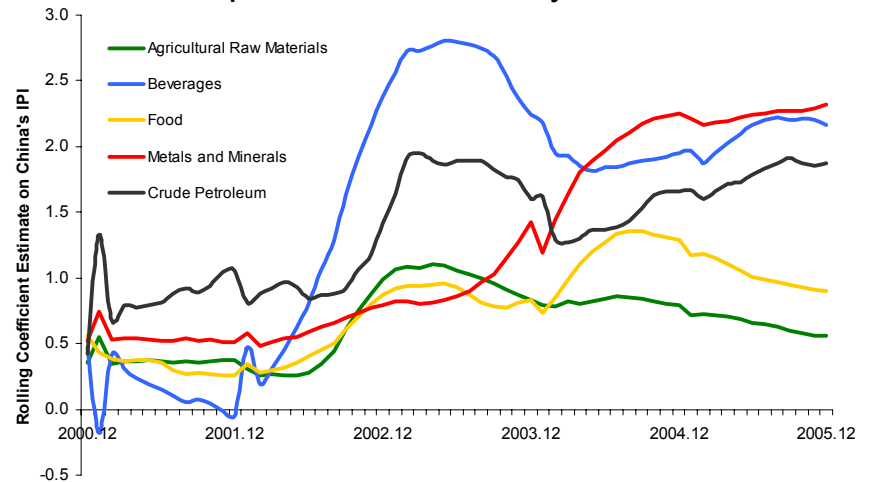
- Macro challenges:
 - A favorable external environment, with a few downside risks
 - Further Reducing Vulnerabilities
- Competitiveness challenges:
 - The effect of the growth of China and India in the World Economy
 - LAC response

A favorable external environment: Commodity prices likely to remain high

Commodity Prices

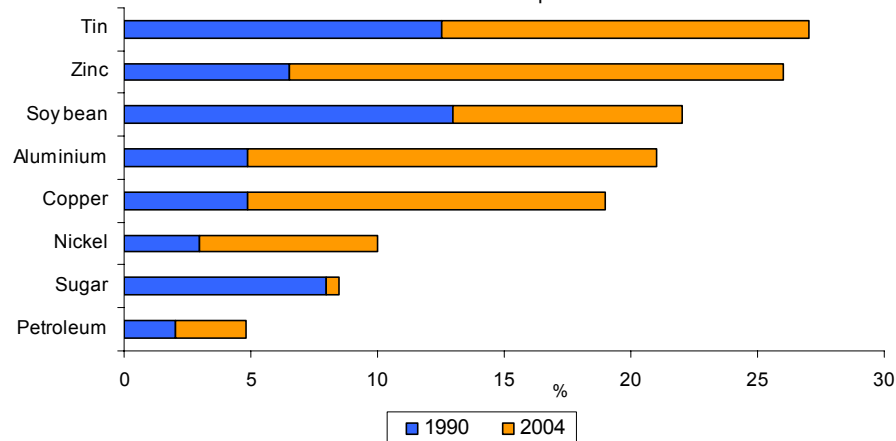


Impact of China on Commodity Prices

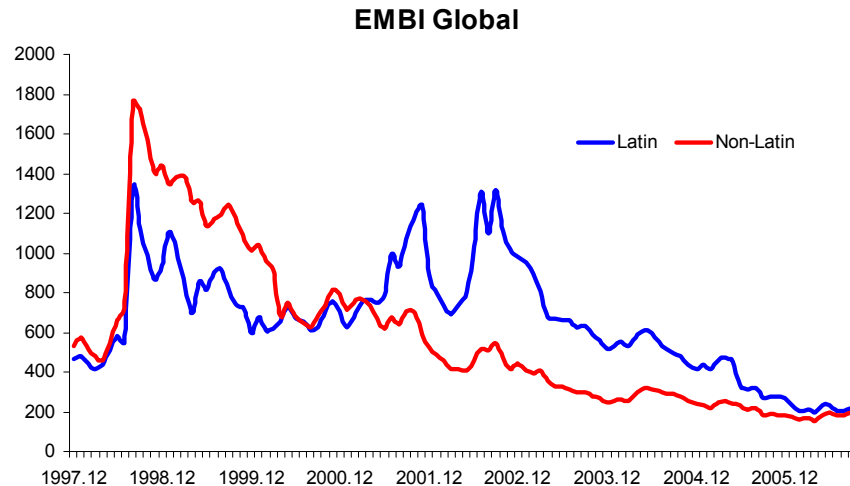
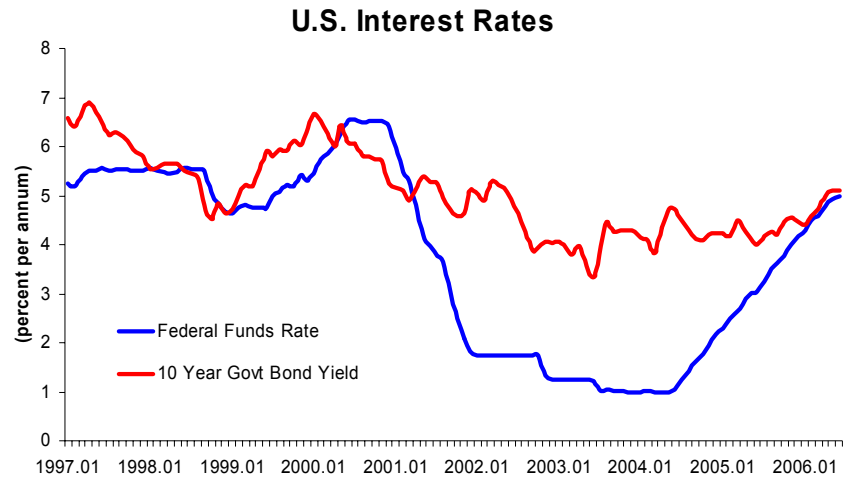
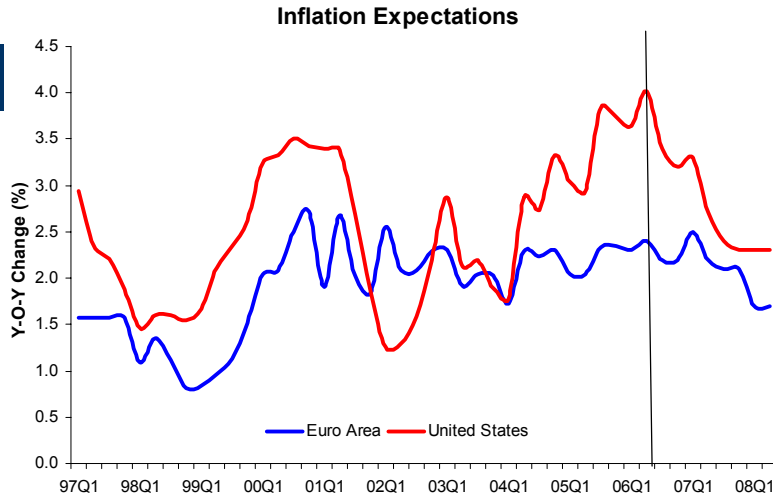


The growing Chinese appetite for Commodities

Share in world consumption



A favorable external environment: liquidity is likely to remain high



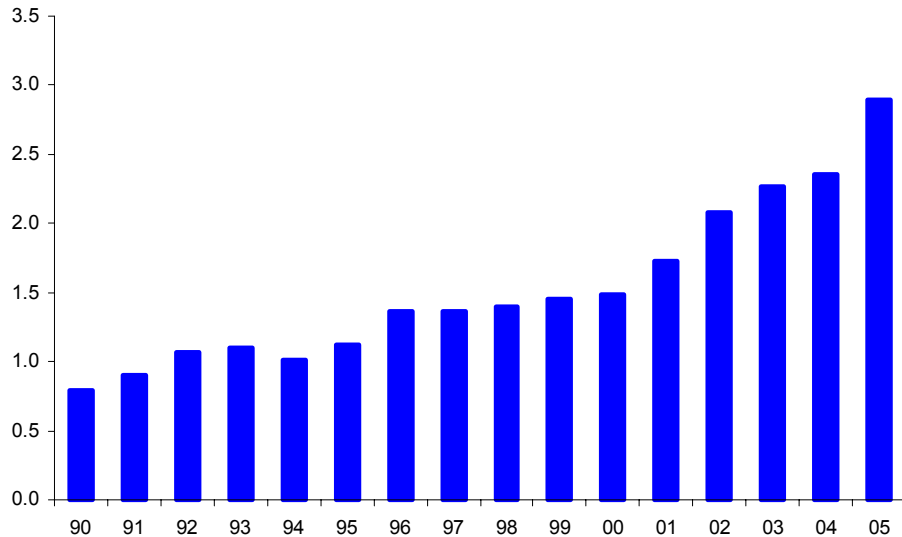
A favorable external environment, with a few downside risks

- Current Account Imbalances (CAI): much ado about just dark matter, or a real threat?
- Risks of a fast US slowdown:
 - Housing and consumer spending
 - Industrial Production
 - These might prompt a fast correction of the CAI
- A further Oil Price Hike:
 - Vulnerability to supply shocks (low excess capacity)
 - So far, little inflationary pass through and modest real effects

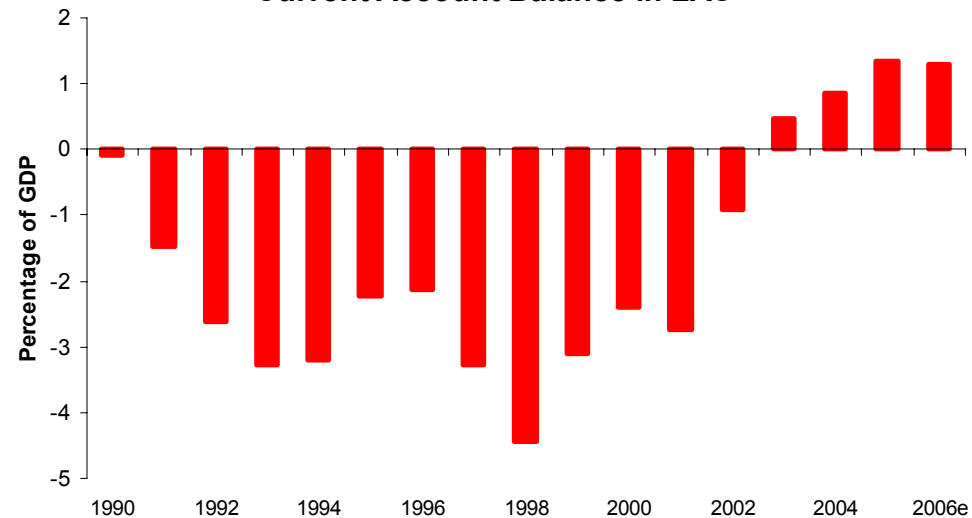
Bottom Line: good times don't last forever!

Further Reducing Vulnerabilities: Liquidity Risks

Reserves / Short-Term Debt



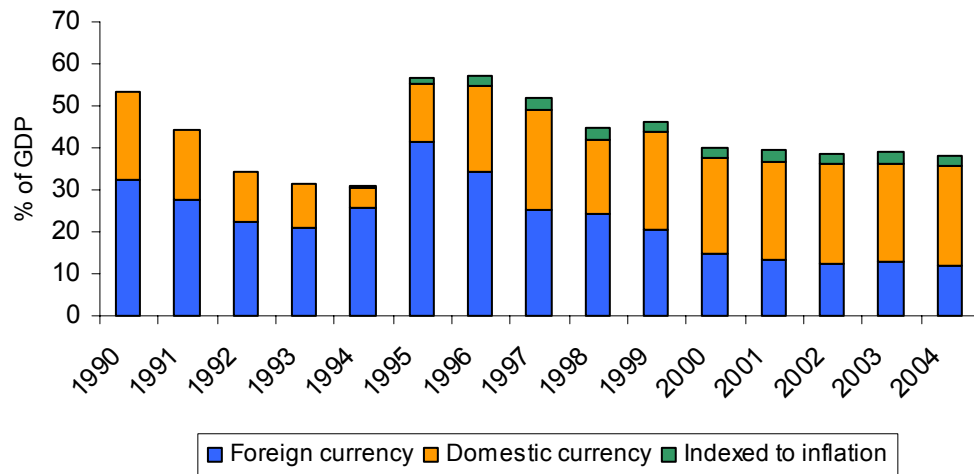
Current Account Balance in LAC



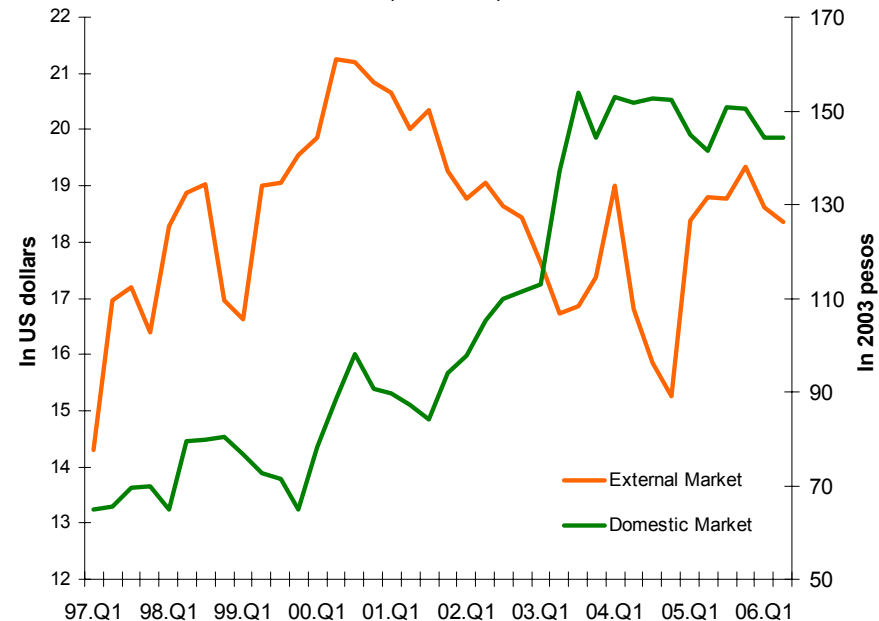
Further Reducing Vulnerabilities: Currency Risks

The case of Mexico

Currency composition - Public debt



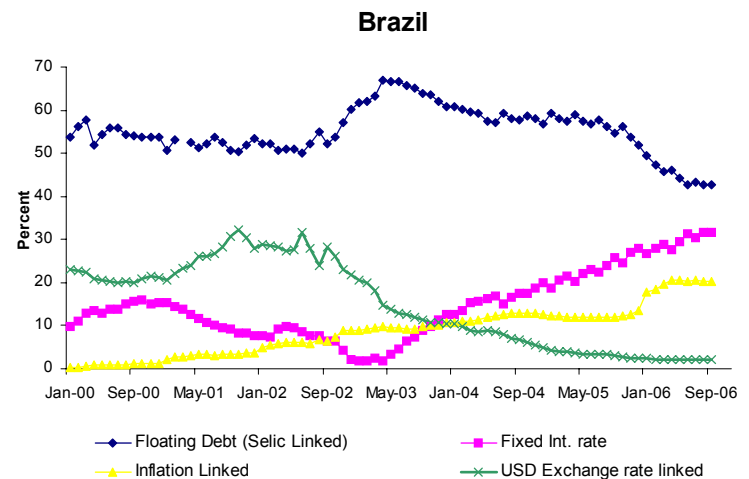
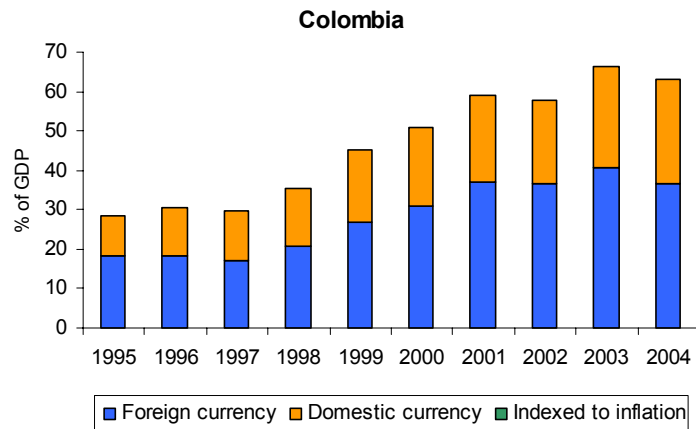
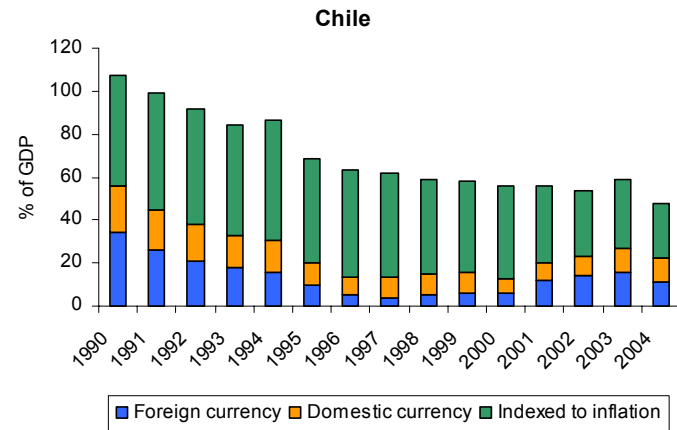
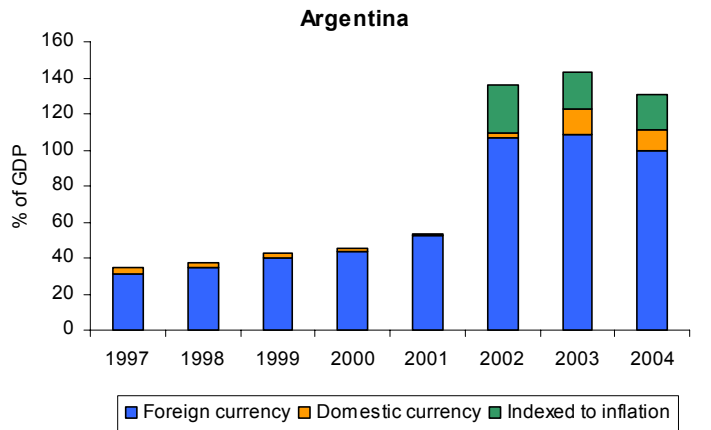
Private Bond Issuance
(in billions)



Source: Cowan et. Al. 2006 and Bank of Mexico

Further Reducing Vulnerabilities: Currency Risks

Public debt – Currency composition

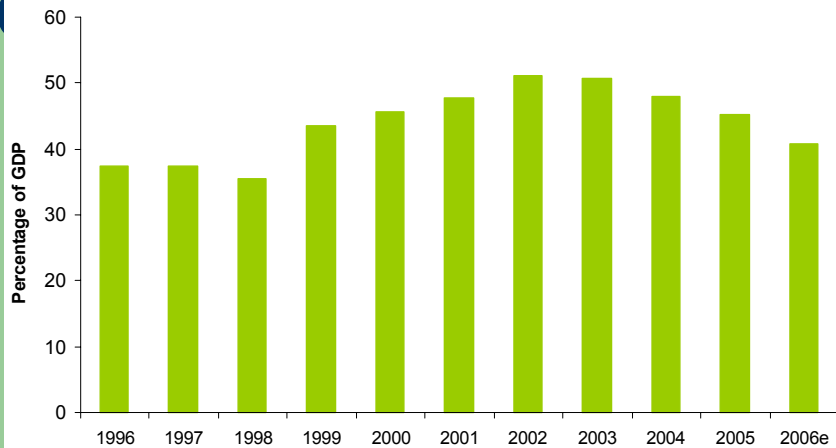


Further Reducing Vulnerabilities: Currency Risks

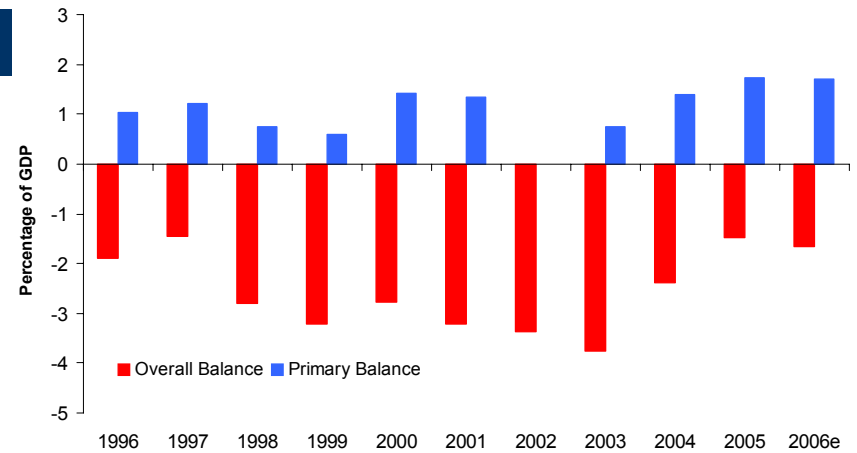
- How fast can countries dedollarize liabilities?
- Challenges in building a stable/competitive long term domestic currency market:
 - Short termism: why not use more IPC indexed bonds?
 - Regulatory Challenges
- A more difficult task for economies with financial dollarization?
- Is there a role for IFI's?
 - Borrowing/lending in domestic currencies
 - Currency Swaps

Further Reducing Vulnerabilities: Solvency Risks

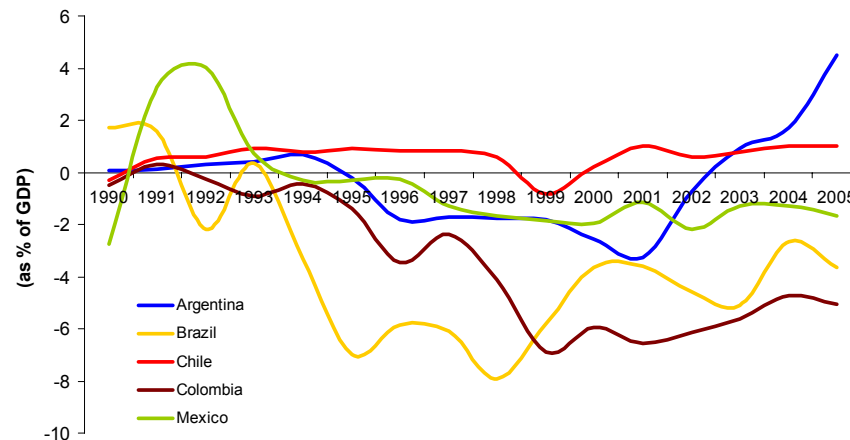
Public Debt



Fiscal Balance / GDP



Structural Overall Balances in LAC, 1990-2005



Further Reducing Vulnerabilities: Solvency Risks

- Adopting Structurally Adjusted Assessments and Rules:
 - Overcoming fiscal illusions
 - Overcoming pro cyclical
- Towards Inter temporal Fiscal Sustainability Analysis:
 - Fiscal Adjustment was done at the expense of Infrastructure Investment
 - Overcoming the Anti Investment Bias
- A missing item in current IMF Reform?

The effect of China and India on LAC: Pain in some industries and countries

- Exports of some LAC manufacturing industries (textiles/apparel, electronics, electrical machinery)
- Exports of some services (business support services)
- FDI inflows in manufacturing in some countries
- Mexico and Central America more affected

The effect of China and India on LAC: Net effects on LAC Exports: findings

Net Aggregate Effect: **LAC Exports would be 2% lower if China and India home market had grown at just world average rates**

- Large and Fast Growing Markets

But also,

- Effects on Global Growth
- Increased competitiveness through use of cheap intermediate inputs
- Both substitution and complementary effects of China and India export growth.
- Huge effects on Demand for and Prices of Commodities

Trade: evidence of complementarities in third markets with China, some substitutability with India

Growth in LAC exports to third markets associated with China and India's above average growth in world markets (as a share of LAC exports in 2004)

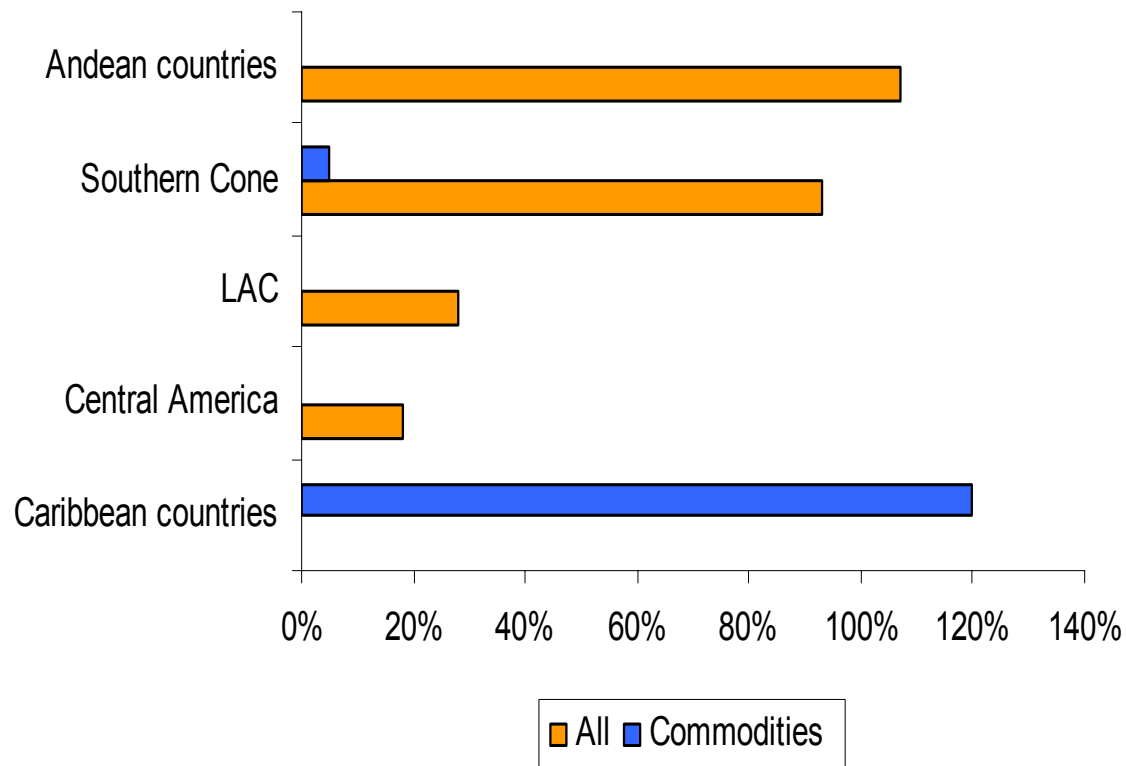
LAC	China	India
China/India exports to third countries	15%	3%
China/India imports from third countries	0%	-2%
China/India exports to LAC	4%	-3%
China/India imports from LAC	4%	1%

The effect of China and India on LAC: Other Aggregate Effects: Findings

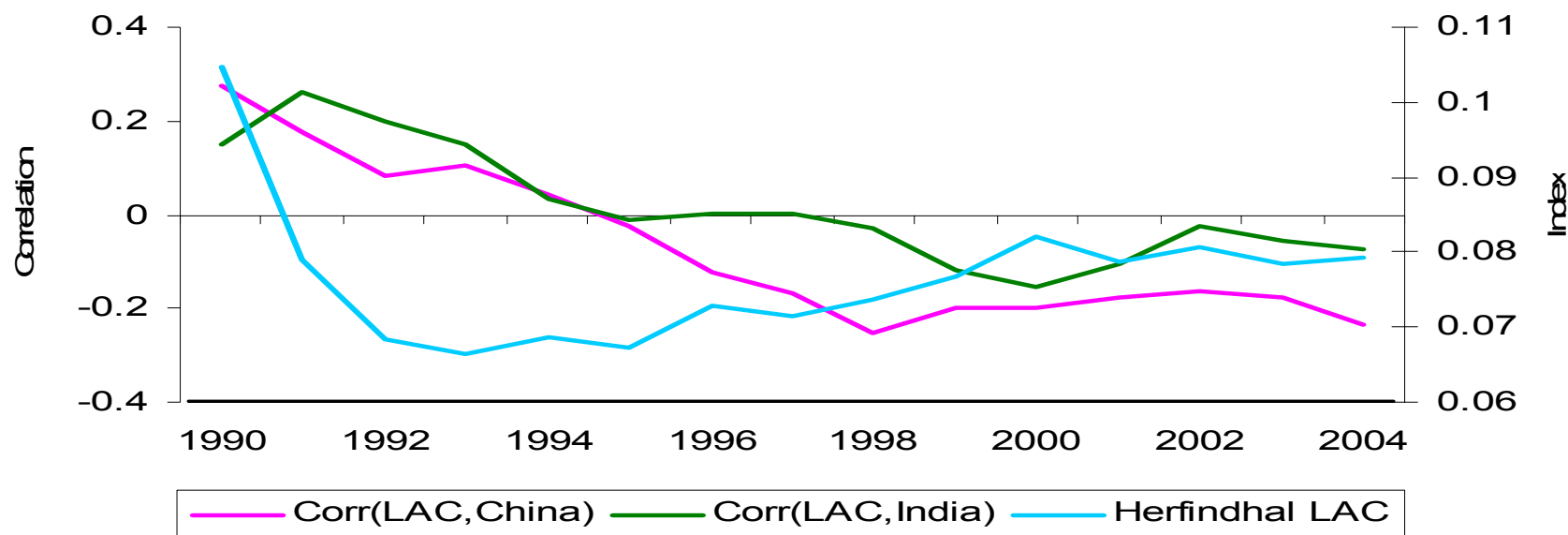
- No evidence of crowding out on FDI flows
- Positive indirect effect through lower international interest rates
- No evidence of crowding out on innovation: some complementarities with India

Though opportunities have not been fully tapped

Unsatisfied Chinese demand for LAC products, as share of bilateral LAC exports



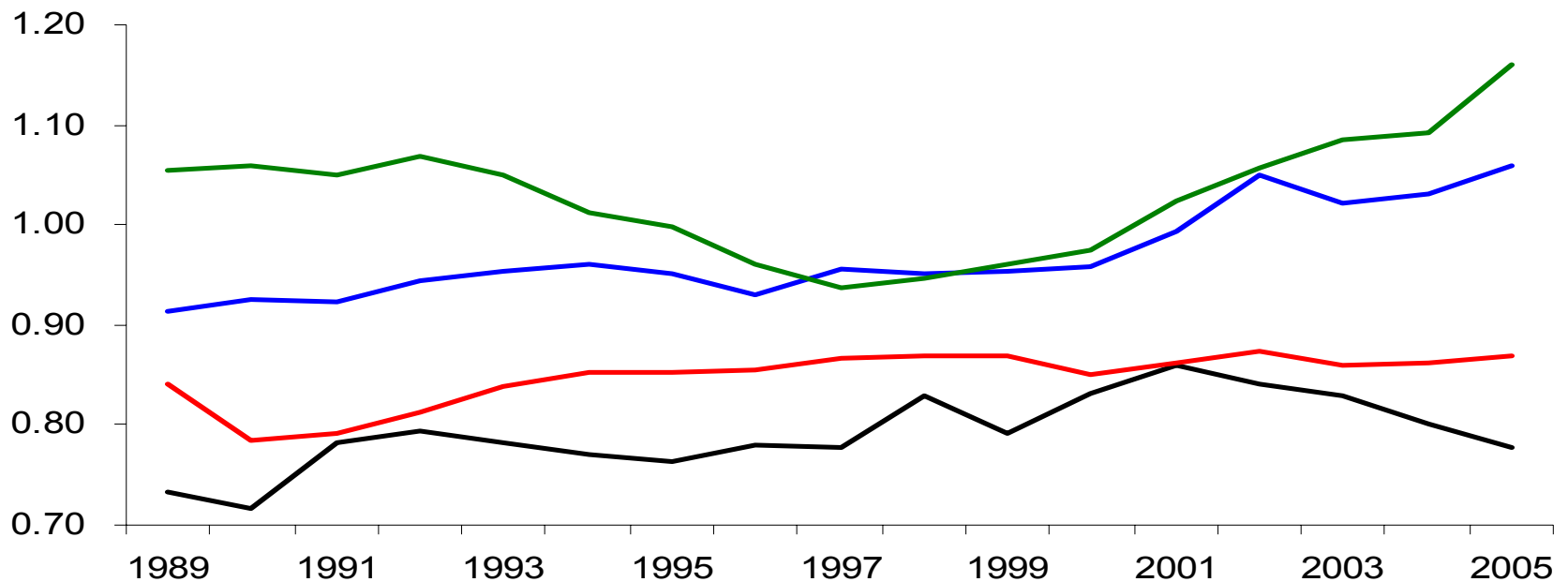
LAC response: LAC has been moving away from China and India's comparative advantage



- ❑ Specialization has been diverging, except for Mexico
- ❑ LAC specialization is shifting towards natural resources and scientific knowledge intensive products

Lac's Response: Different industry adjustments in different countries

Relative exports prices of apparel, 1989-2004



— Haiti + Nicaragua

— Honduras + Guatemala + El Salvador

— Costa Rica + Dominican Rep

— Mexico

Policy implications

- Promote bilateral trade, FDI and innovations flows with China and India
- Shift of LAC comparative advantage towards natural resources and scientific knowledge should be facilitated by:
 - Better natural resource management and rural development policies
 - Strengthening of policies and institutions for the promotion of skills and innovation (patentable or not)
- Protectionist forces should be resisted:
 - Governments should give more weight to consumers and users of imported intermediate goods in their trade policy formation

Policy implications

- FDI
 - LAC has been quite successful in attracting FDI
 - But, beware of recent reversal in FDI policies in some LAC countries Services
- Services:
 - Improve Telecommunication infrastructure and competition and Internet access
 - Beware of misaligned exchange rates
- Employment
 - Adjustment assistance for workers displaced (both skilled and unskilled) by direct competition from China and India