Latin America's Deceleration and the Exchange Rate Buffer

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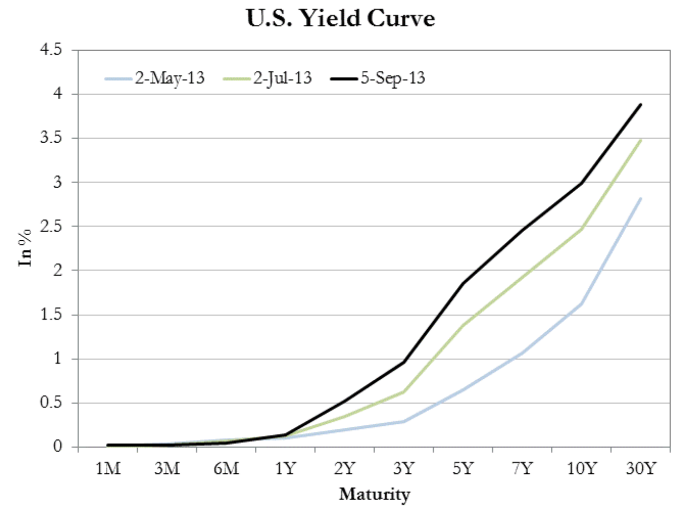
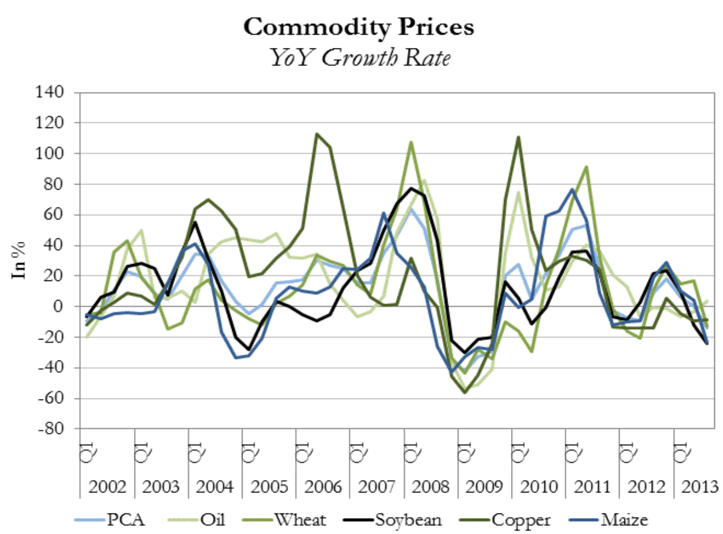
Chief Economist Office
Latin America and the Caribbean Region
The World Bank

The punch line

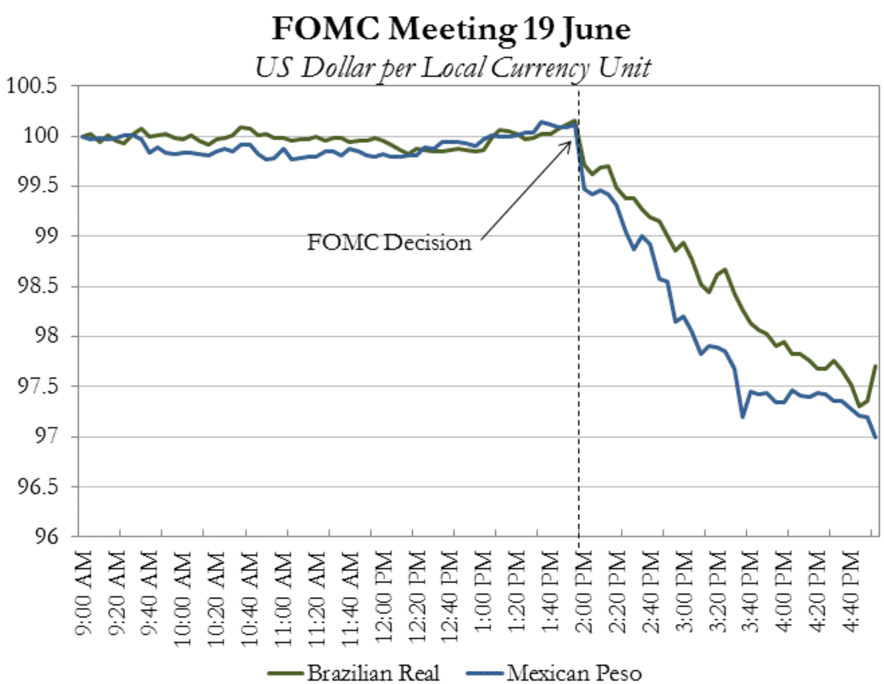
- The current wave of economic pessimism about LAC is exaggerated…
- …because fundamental macro-financial improvements have largely dispelled the fear of 1990s-style financial distress…
- …not least because exchange rate depreciations can, for a first time in history, be a full part of the counter-cyclical toolkit
  - Depreciations cannot of themselves remove the structural impediments to higher growth over the trend

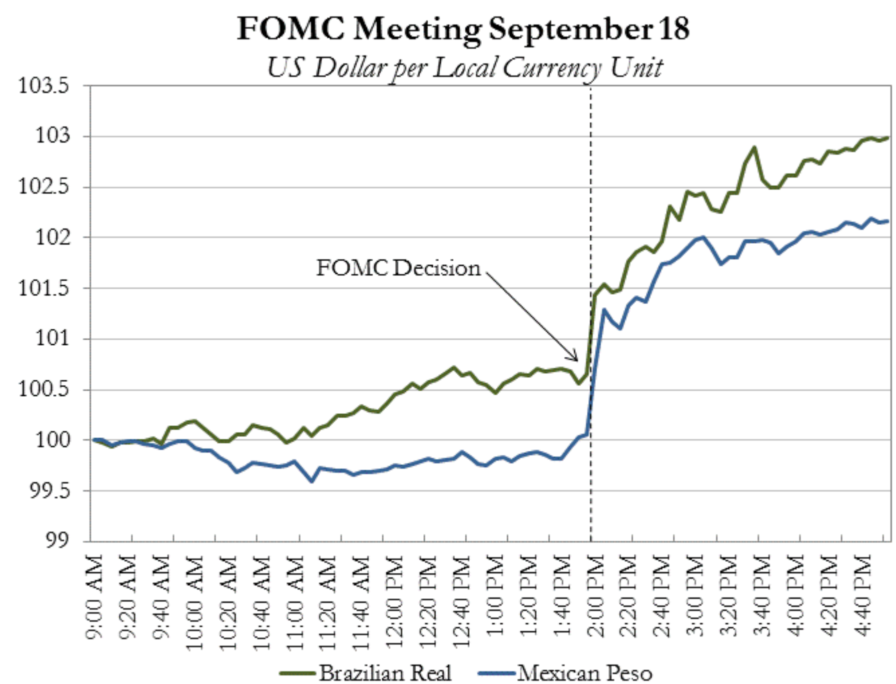
The obvious worries: receding global tailwinds,…





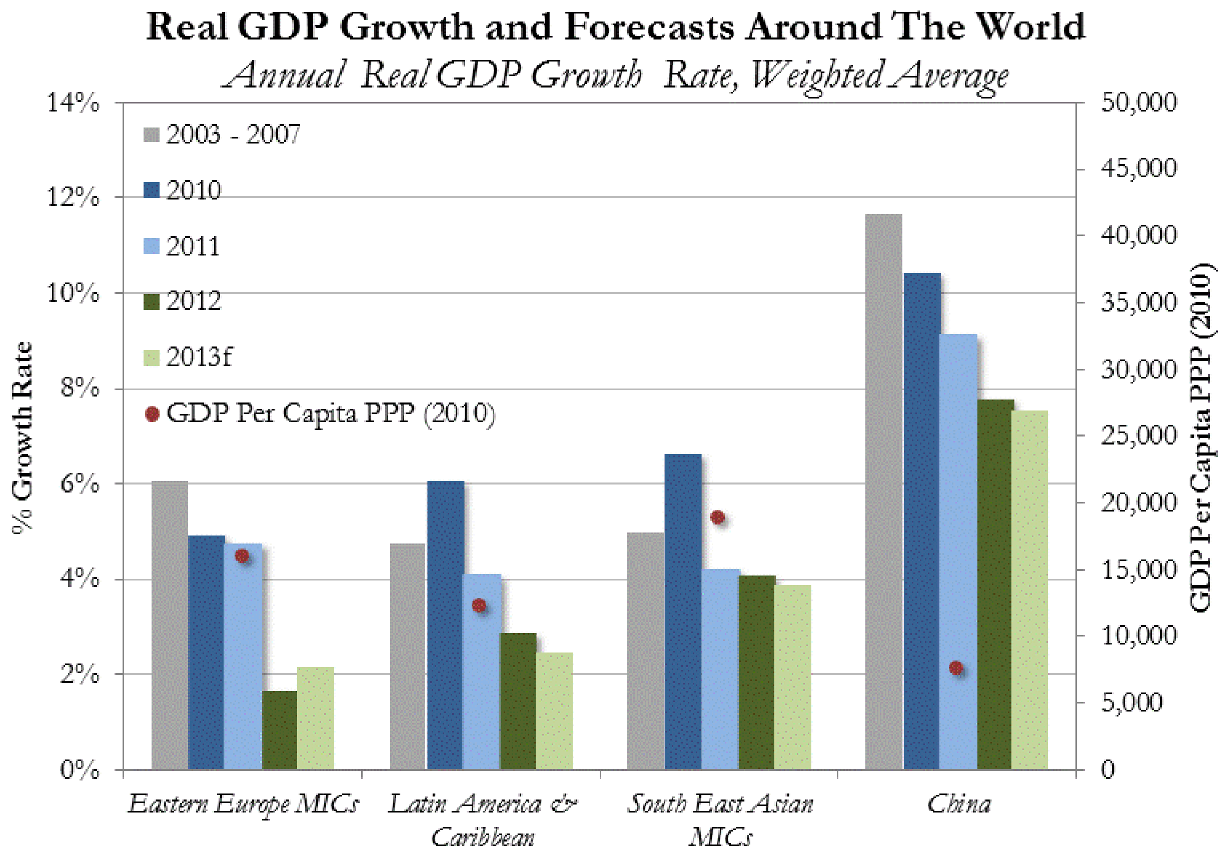
…nervous market overreactions to QE tapper talks…





Source: Bloomberg

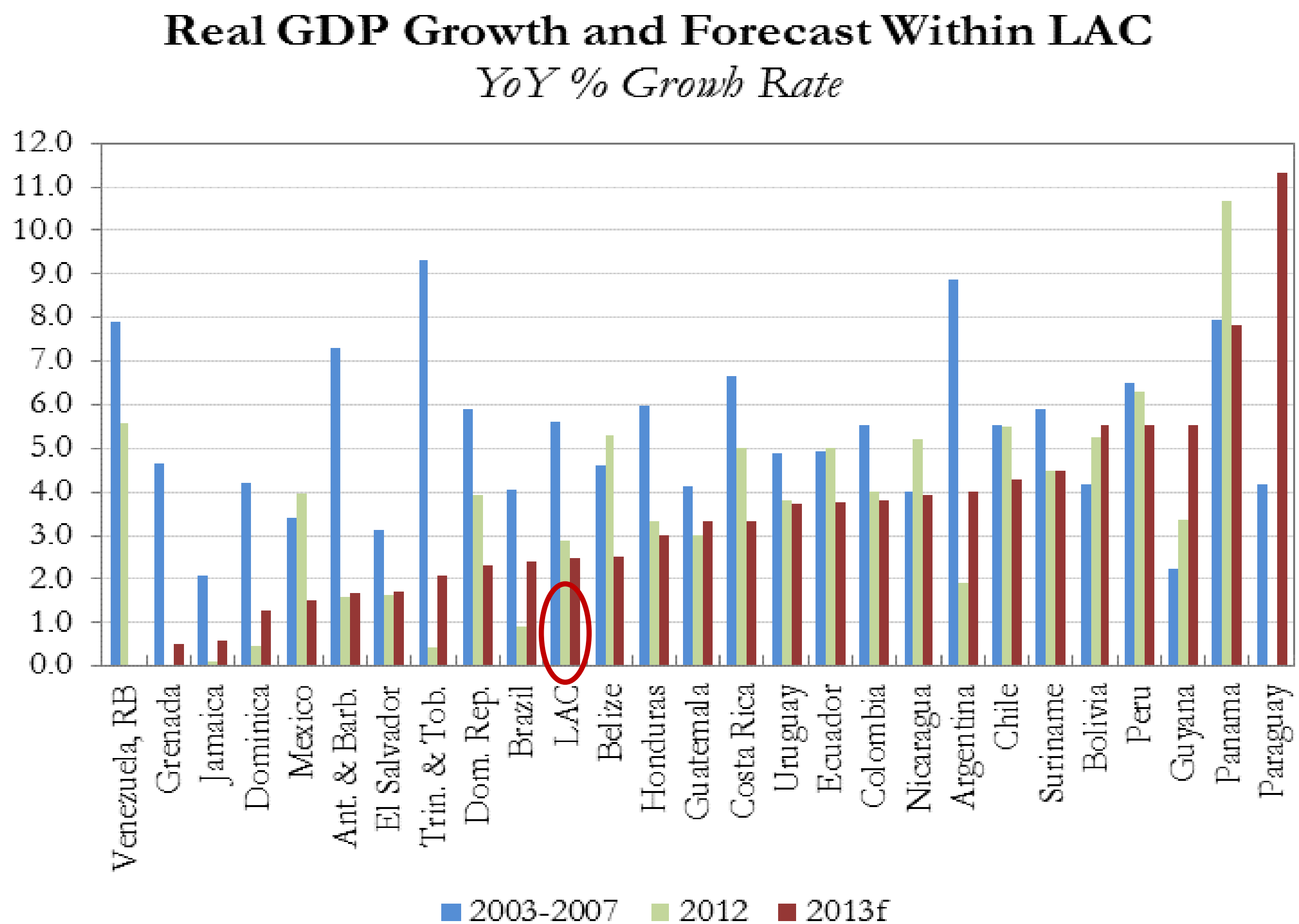
…in the context of a synchronized deceleration in EMs...



Synchronized deceleration in EMs: a 3-4 percentage point fall in growth rates from their 2010 (rebounding) peaks

Sources: Consensus Forecasts (September 2013), Bloomberg, Haver, WEO (April 2013)

…with the predictable heterogeneity within the region



Sources: Consensus Forecasts (September 2013), & WEO (April 2013)

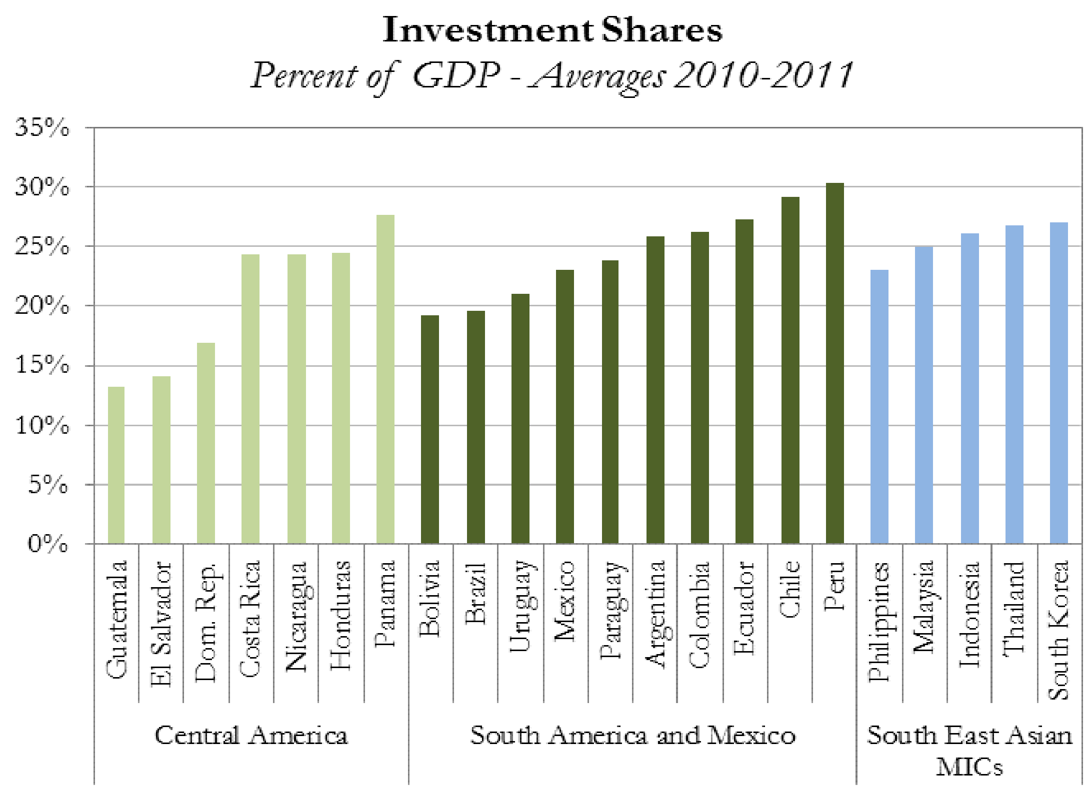
The “this-time-is-not-different” pessimists

- Pessimistic headlines are in vogue
  - “Submerging economies”, now that “the party is over”, are “entering a lost decade”

- This pessimism confounds two different claims
  1. That past growth had feet of clay and was a wasted opportunity
  2. That the current souring of external conditions will lead to a 1990s-style instability, where internal fragilities amplified external shocks

- Is this assessment warranted?
  - Partially “yes”, with respect to 1
  - Definitely “no”, with respect to 2

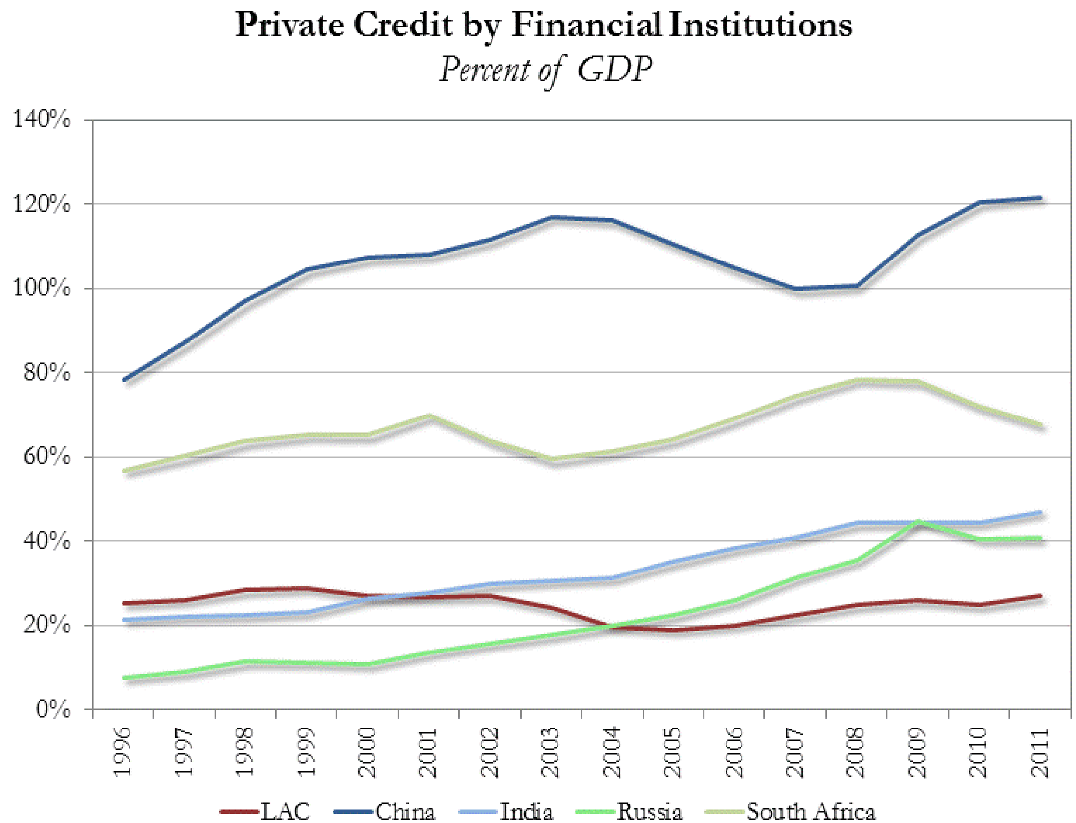
LAC's past growth was not a pure consumption story – investment rates closed the gap with those in East Asia…



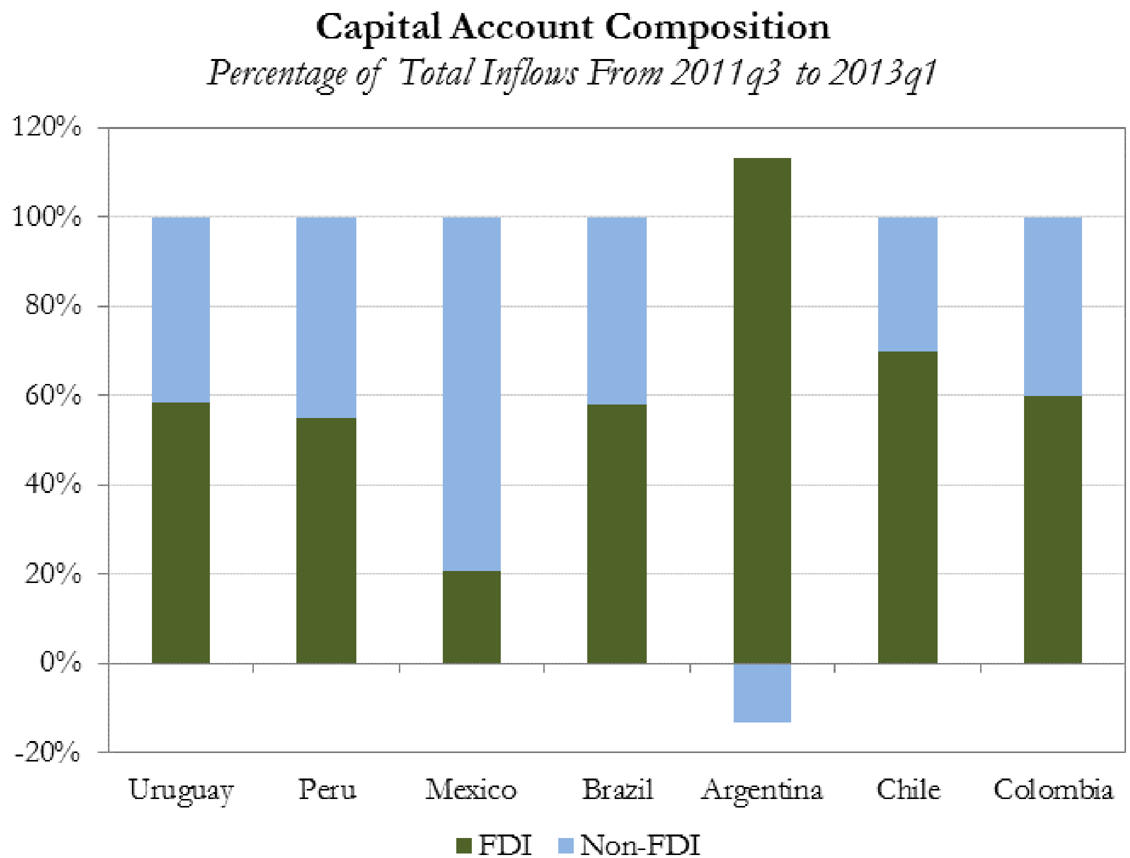
The efficiency and sustainability of investment are different issues that cannot be taken cavalierly and remain a source of concern

Sources: LCRCE and UN Statistics

…credit growth was comparatively mild and closely monitored by strict supervisory authorities…



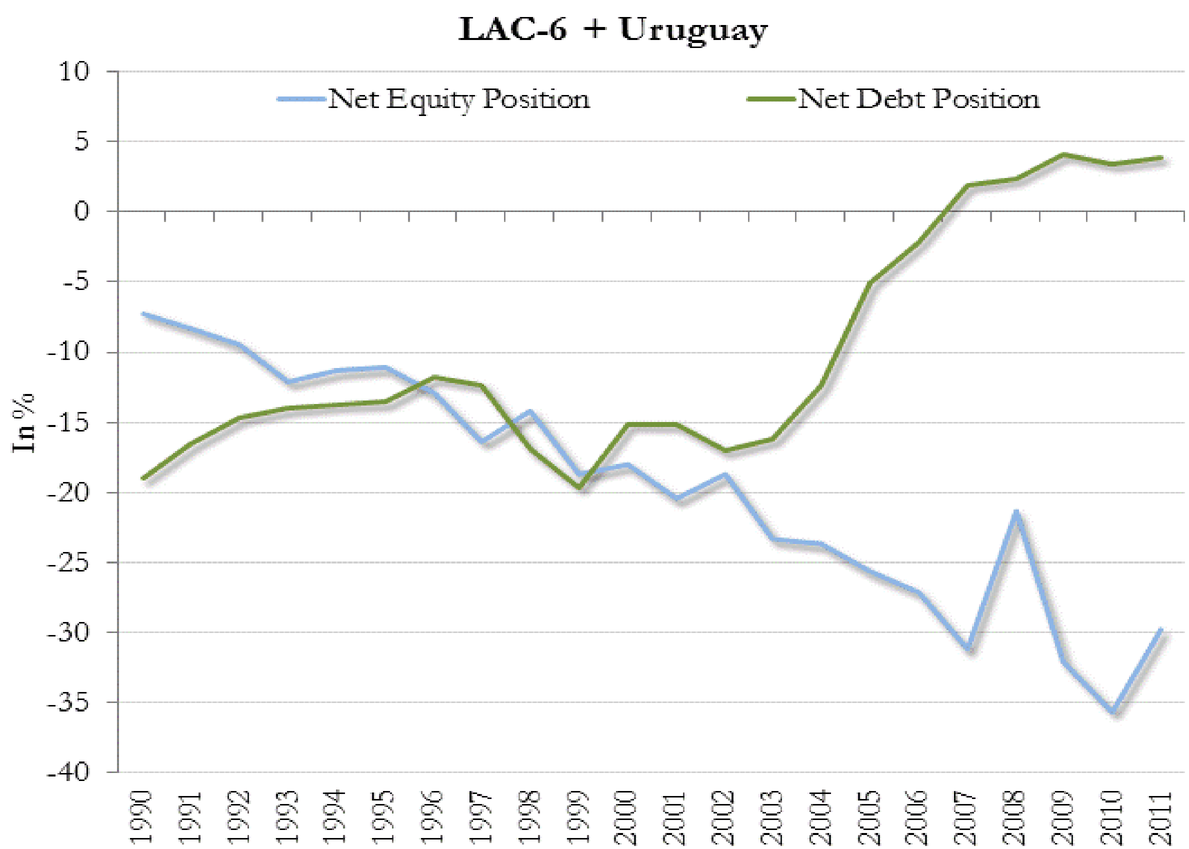
… and current account deficits have been mainly financed by FDI…



FDI inflows in LAC are larger and more stable than non-FDI inflows…
…and not necessarily concentrated in extractive activities

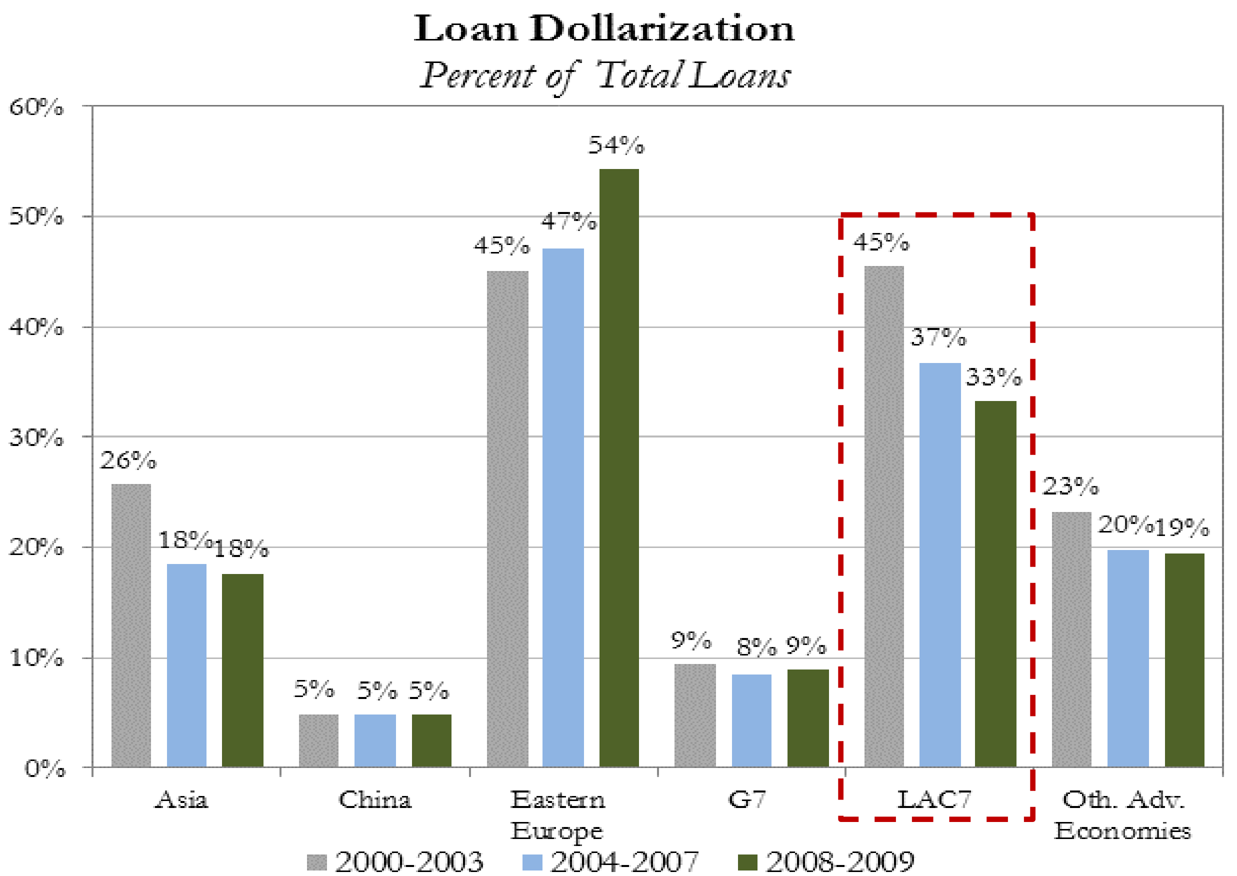
Sources: LCRCE and IFS.

Moreover, the *fear of depreciation* has been largely dispelled in the region due to net deleveraging…



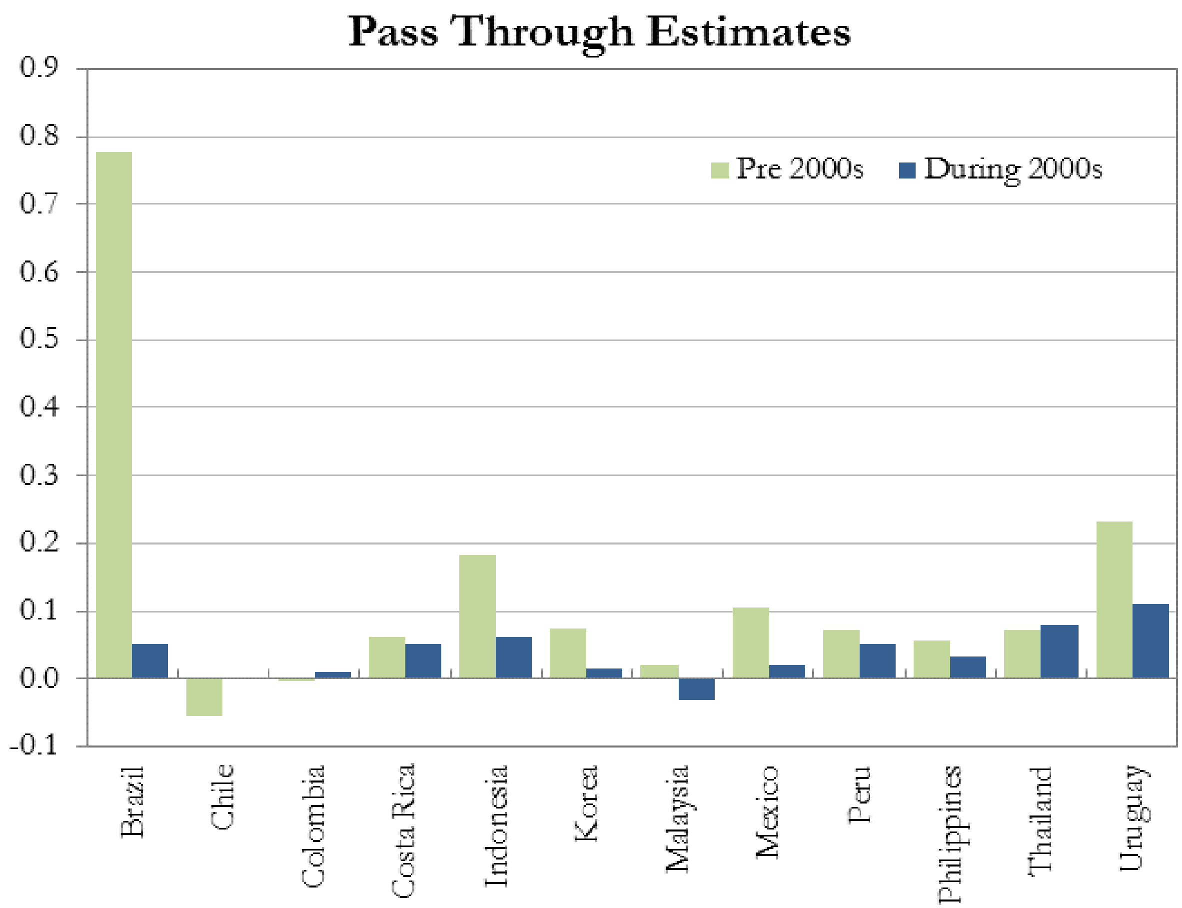
Sources: Milessi-Ferreti (2011)

… financial de-dollarization …



Sources: De la Torre, Ize & Schmukler (2011).

… and a much lower pass-trough

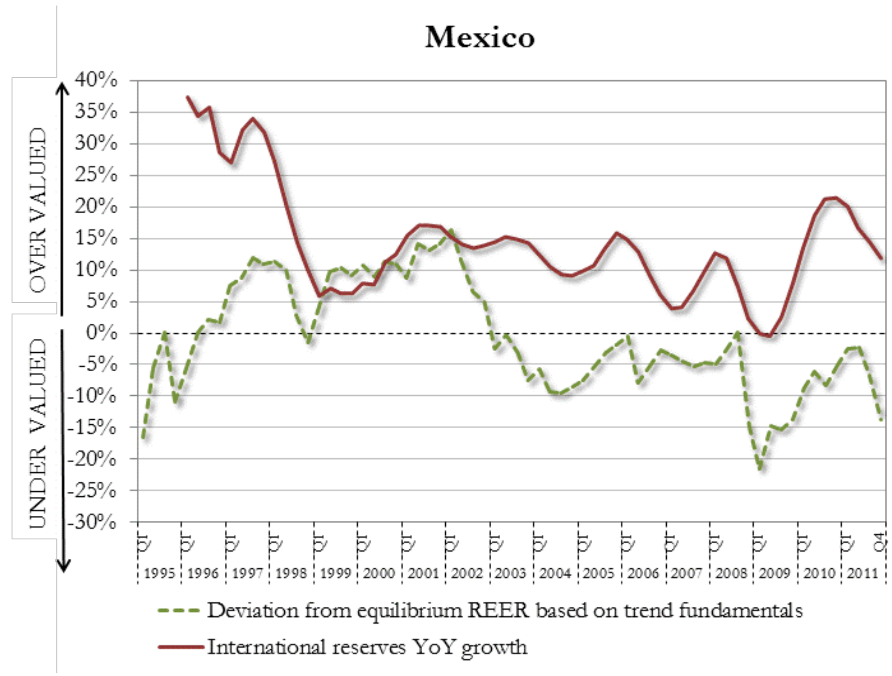


Sources: Authors calculations from BIS & Bloomberg..

Thus, for much of LAC, depreciations are not a problem but part of the solution

- Several LAC countries can rely on exchange rate flexibility to conduct countercyclical monetary policy...
- ...and, for the first time in their monetary history, they can savor the full range of benefits of a depreciation...
  - Achieve external adjustment (lower imports) while stimulating output and employment (higher production for foreign & domestic markets)
  - Mitigate the outflow of capital—curving speculation and boosting the appeal of local assets relative to foreign assets
- ... which could not be had in 2009 due to the global downturn
- LAC countries are moving towards run-of-the-mill business cycles, typical of advanced economies

In this light, it is high time to reappraise exchange rate interventions…



No longer defending the indefensible,
but mitigating excess volatility around the equilibrium

Source: Authors calculation from Daude et al. (2013) and IFS.

…and the concerns about quasi-fiscal costs of intervention

Cost of Central Bank Intervention for Selected Emerging Economies
Total 2005-2012, Percent of 2012 GDP

Country	Net Flow Profits	Net Valuation Profits	Net Total Profits
Peru	-3.0%	-0.3%	-3.3%
Israel	-1.9%	-1.1%	-3.0%
Russia	-6.7%	4.5%	-2.1%
Brazil	-5.3%	3.6%	-1.6%
LAC	**-2.5%**	**0.9%**	**-1.6%**
Colombia	-1.5%	0.0%	-1.5%
Chile	-1.6%	0.3%	-1.2%
South Korea	-1.4%	0.5%	-1.0%
Argentina	-2.9%	2.5%	-0.4%
Mexico	-1.4%	1.0%	-0.4%
Indonesia	-1.8%	1.5%	-0.3%
India	-2.7%	3.7%	1.0%

Source: Authors calculation from Levy-Yeyati (2010).

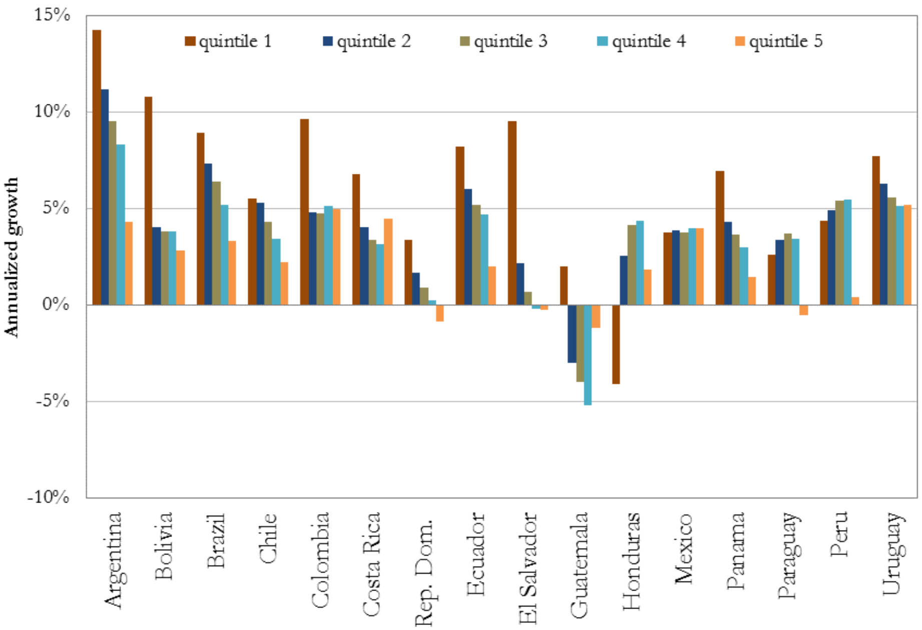
Short-run business cycle management vs. long-run growth

- The exchange rate in much of LAC is no longer a shock amplifier, but a shock absorber that enables counter-cyclical monetary policy
- But for several LAC countries counter-cyclical monetary policy is out of reach
  - Most Central American and Caribbean countries are too small and open to be able realistically to develop an independent monetary policy
  - Other financially globalized LAC countries are dollarized or have not developed the institutional frameworks to support inflation targeting
  - Other less financially globalized South American countries are insulated in other ways—via fiscal buffers built during the bonanza period
- The improved macro-financial immune system can help cushion the cyclical component of the downturn and normalization of US monetary policy …
- …but it cannot solve the structural impediments to a higher growth path
  - Absent productivity enhancing reforms, LAC social progress would stall and the economy could fall into a low savings-low productivity-low growth trap

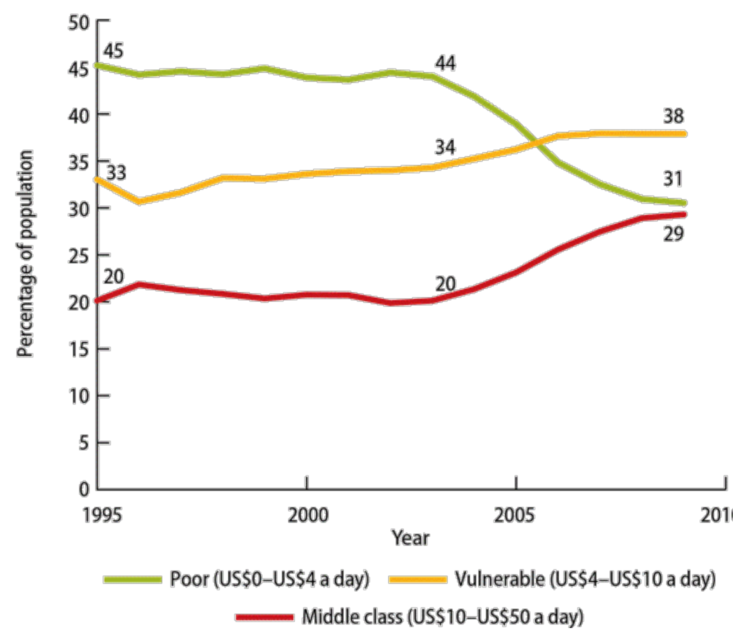
Thank you

Absent a 1990s-style crisis, social progress may stall going forward if growth is low but is unlikely to be reversed

Income Growth Across Quintiles in LAC
Early 2000s - Late 2000s



Middle class, vulnerability, and poverty trends in LAC
1995–2009



Sources: LCSPP and LCRCE from SEDLAC