



All That Glitters May Not Be Gold

**Assessing Latin America's
Recent Macroeconomic Performance**

XLIX Annual Meeting of the Board of Governors of the IADB - April 4, 2008

**Research Department
Inter-American Development Bank**

OUTLINE

- I. Current Perceptions on Macroeconomic Performance in LAC: “This Time Is Different”**
- II. Beyond Perceptions:
All that Glitters May Not Be Gold**
- III. Is the Current Subprime Crisis a Measure of the Region’s Strength?**
- IV. Taking Advantage of the Current Bonanza: A Tentative Set of Policy Topics for Discussion**

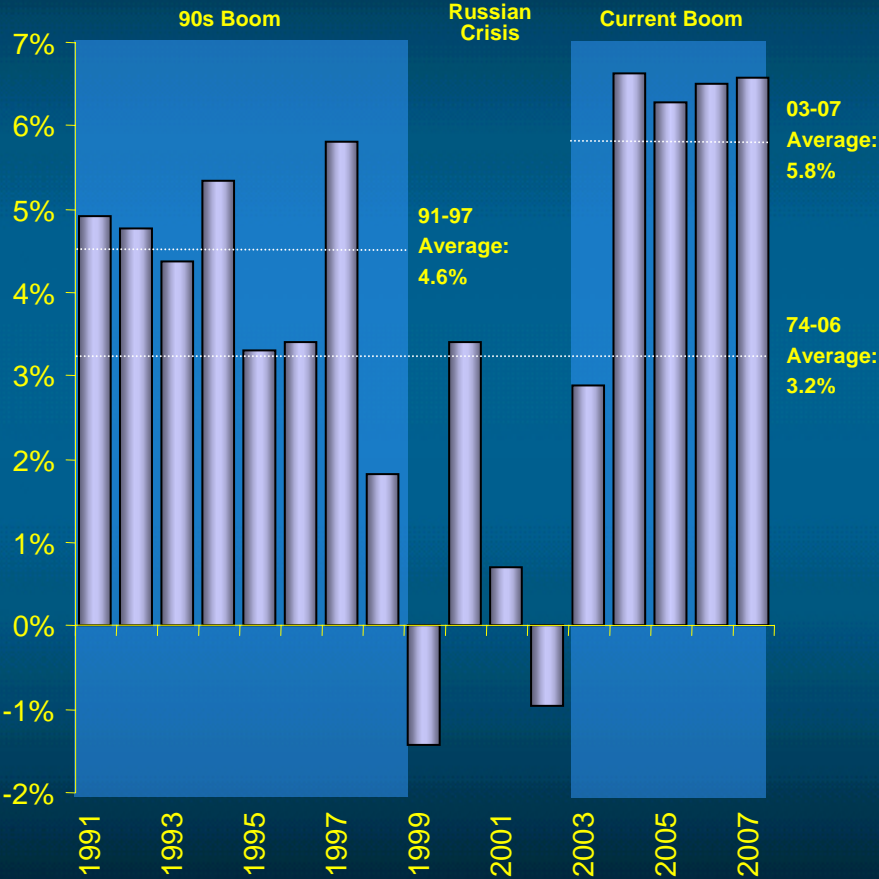
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Latin America Recent Macroeconomic Performance

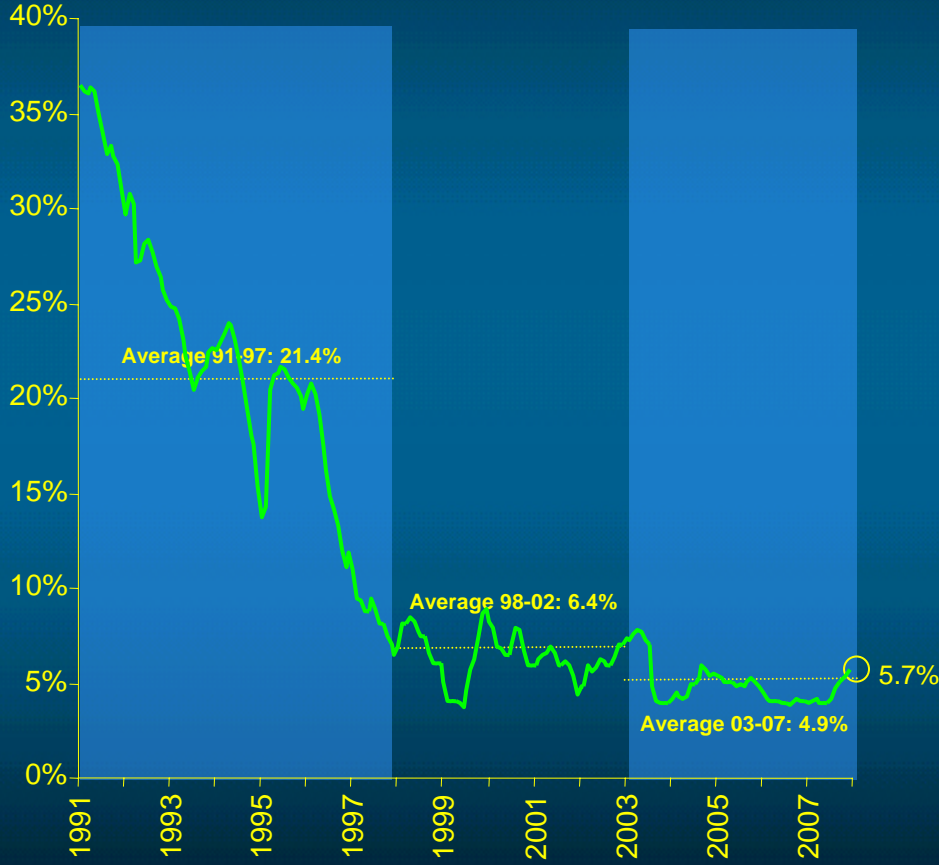
Economic Activity

(LAC-7, GDP Annual Growth)



Inflation

(LAC-7 median, CPI Annual Variation)

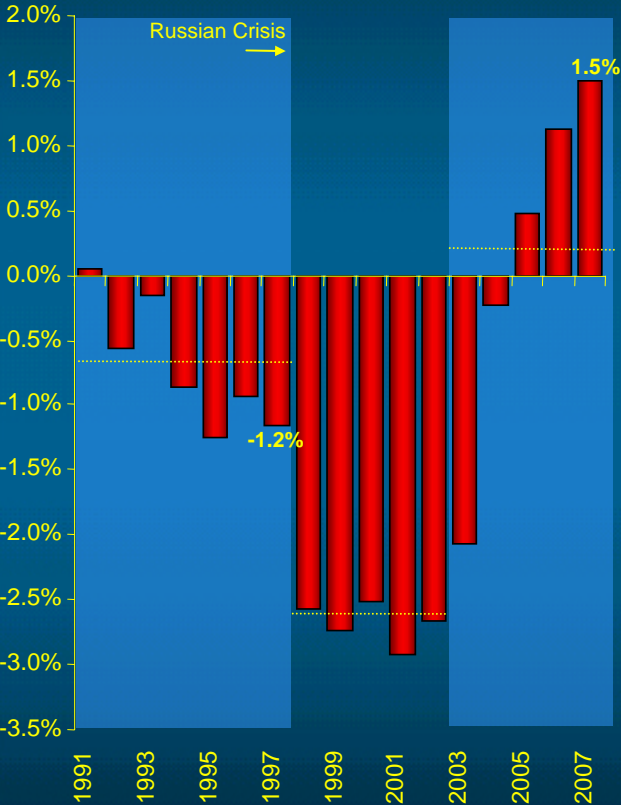


LAC-7 is the simple average of the seven major Latin American countries, namely Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. These countries represent 91% of Latin America's GDP.

Latin America Recent Macroeconomic Performance

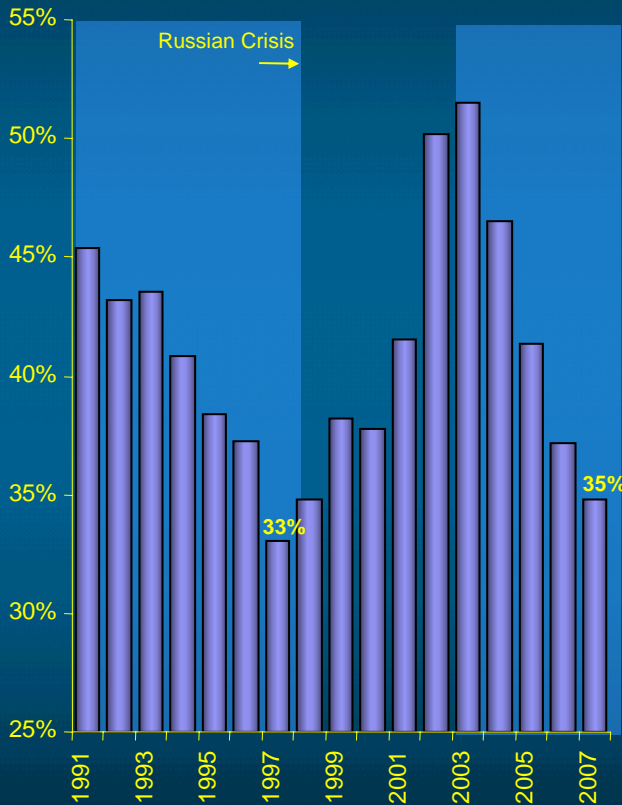
Fiscal Balance

(LAC-7, % of GDP)



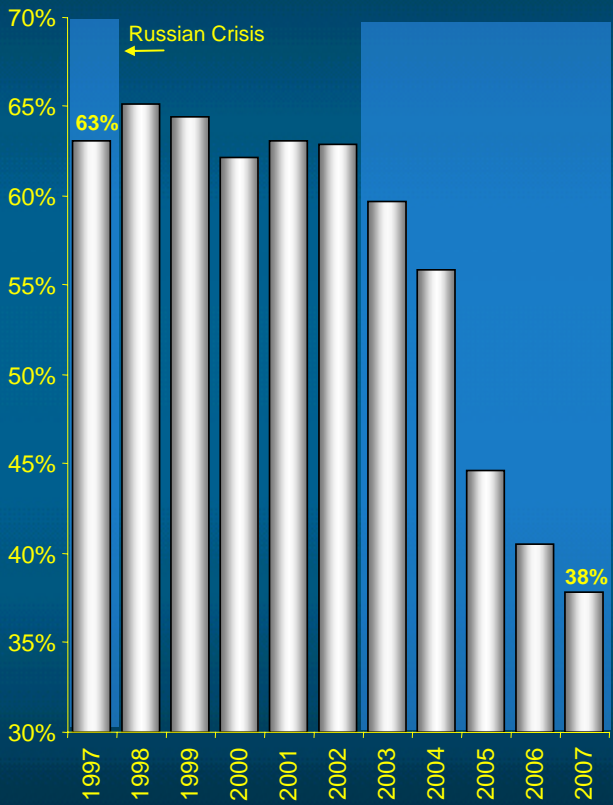
Public Debt*

(LAC-7, % of GDP)



Debt Composition

(LAC-7, Foreign Currency Debt, % of Total Debt)



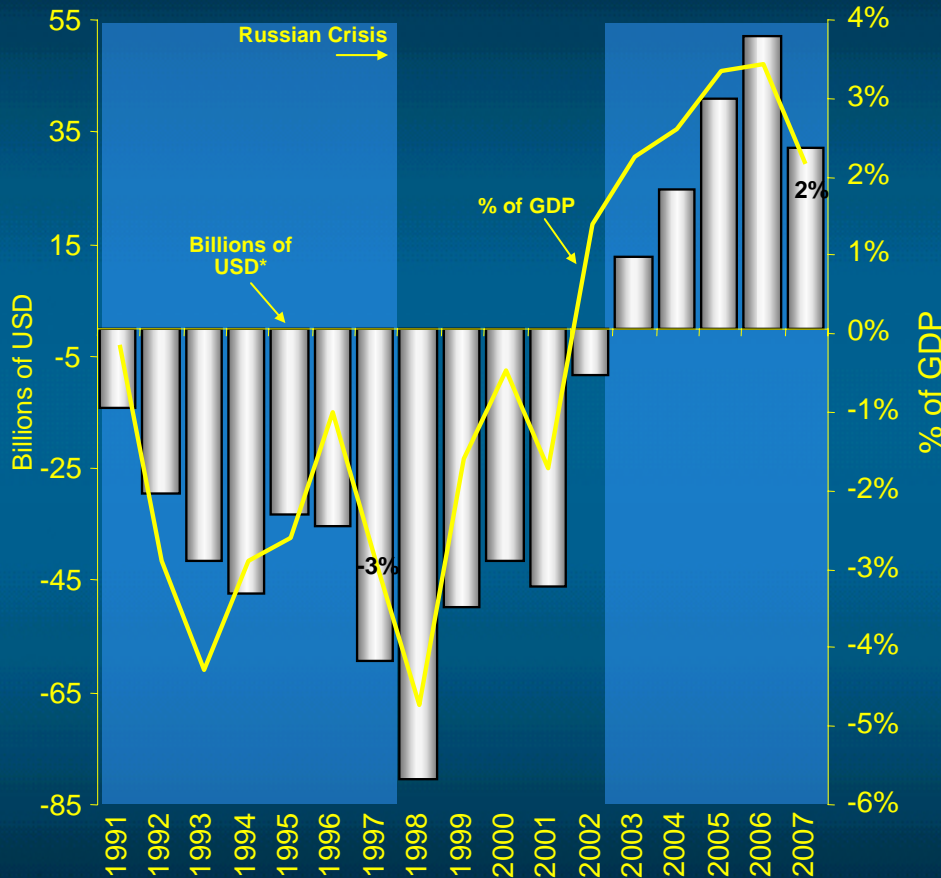
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*Adjusted by Argentina's debt exchange.

Latin America Recent Macroeconomic Performance

Current Account

(LAC-7, Billions of US Dollars and % of GDP)



International Reserves*

(LAC-7, Billions of US Dollars)

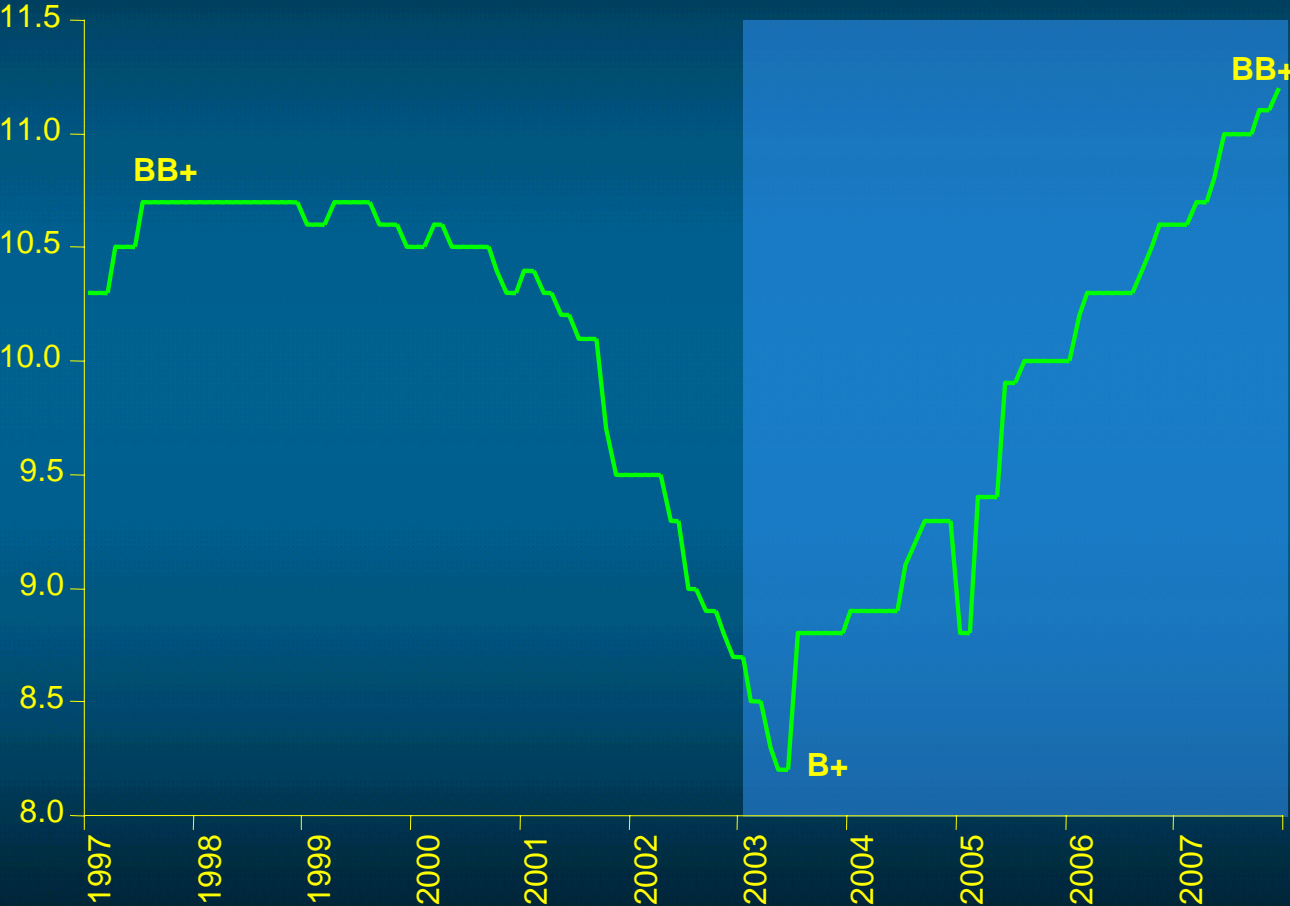


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*LAC-7 is computed as the sum of Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

Latin America Recent Macroeconomic Performance

Credit Ratings*
(Latin America)



Numerical Transformation of Credit Ratings

AAA	21	} Investment Grade
AA+	20	
AA	19	
AA-	18	
A+	17	
A	16	
A-	15	
BBB+	14	
BBB	13	
BBB-	12	
BB+	11	
BB	10	
BB-	9	
B+	8	
B	7	
B-	6	
CCC+	5	
CCC	4	
CCC-	3	
CC	2	
SD	1	

*Latin American countries included in the EMBI Index with data availability since 1997.
Average of numerical scale transformation of S&P credit ratings; see Powell and Martínez (2008).

The “This Time is Different” View

- Exceptional macroeconomic outcomes and strong fundamentals:
 - Place the region in a privileged position to engage in sustained growth
 - Make the region less vulnerable to adverse changes in external conditions
- Recent turmoil in US financial markets was met with a relatively subdued reaction in LAC-7 bond markets, an apparently powerful testimony to the region’s new-found strength

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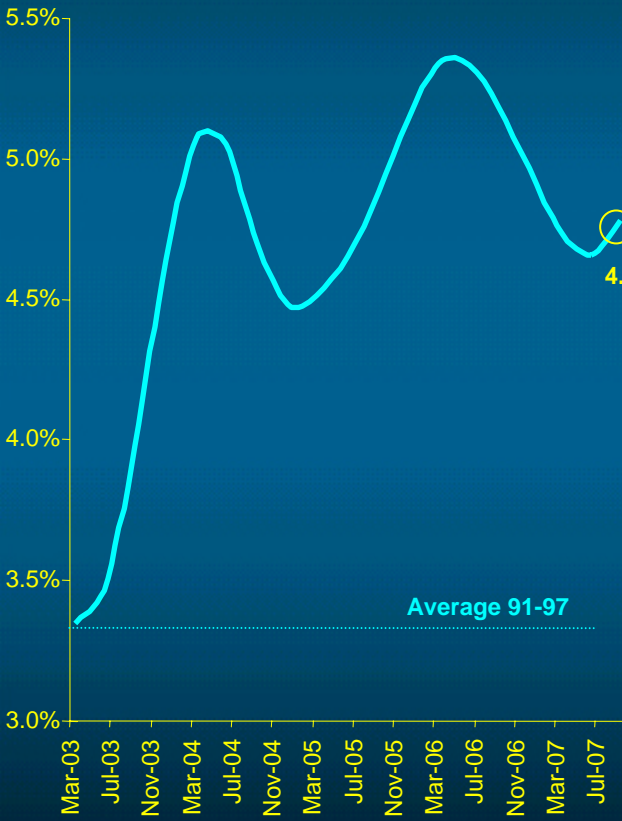
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External Conditions for Latin America

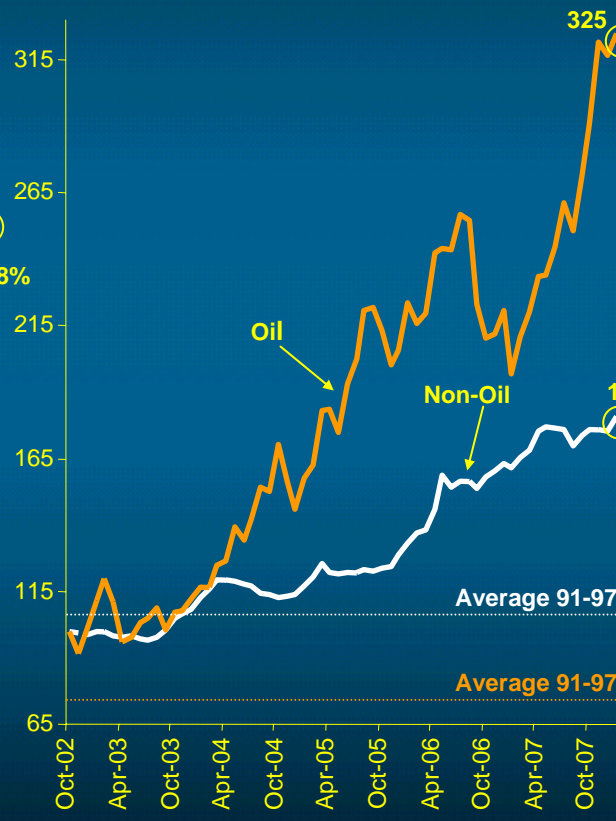
World Production

(World-7 GDP Index, Annual Variation, Weighted by PPP adjusted GDP*)



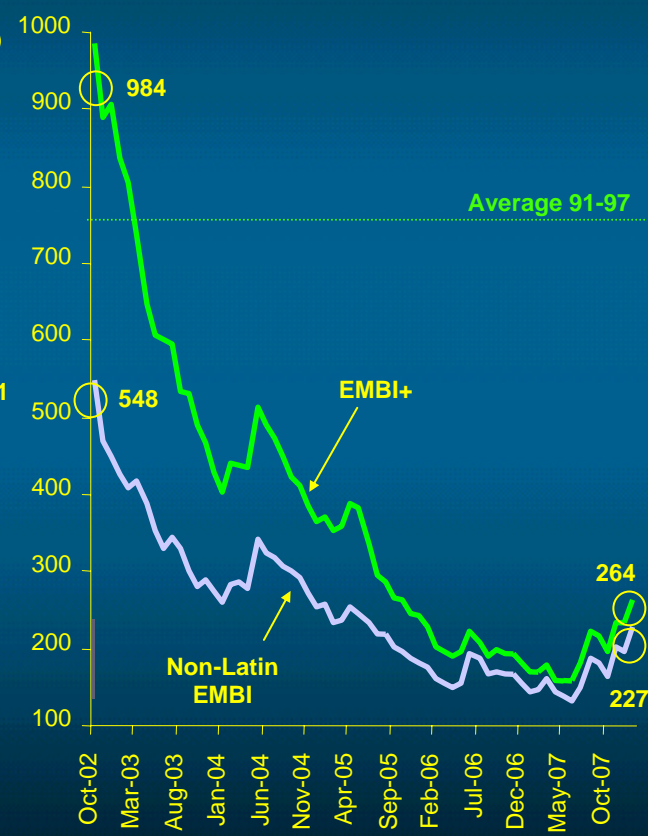
Commodity Prices

(Index of Oil and Non-Oil Commodities, Oct-02=100)



External Financial Conditions

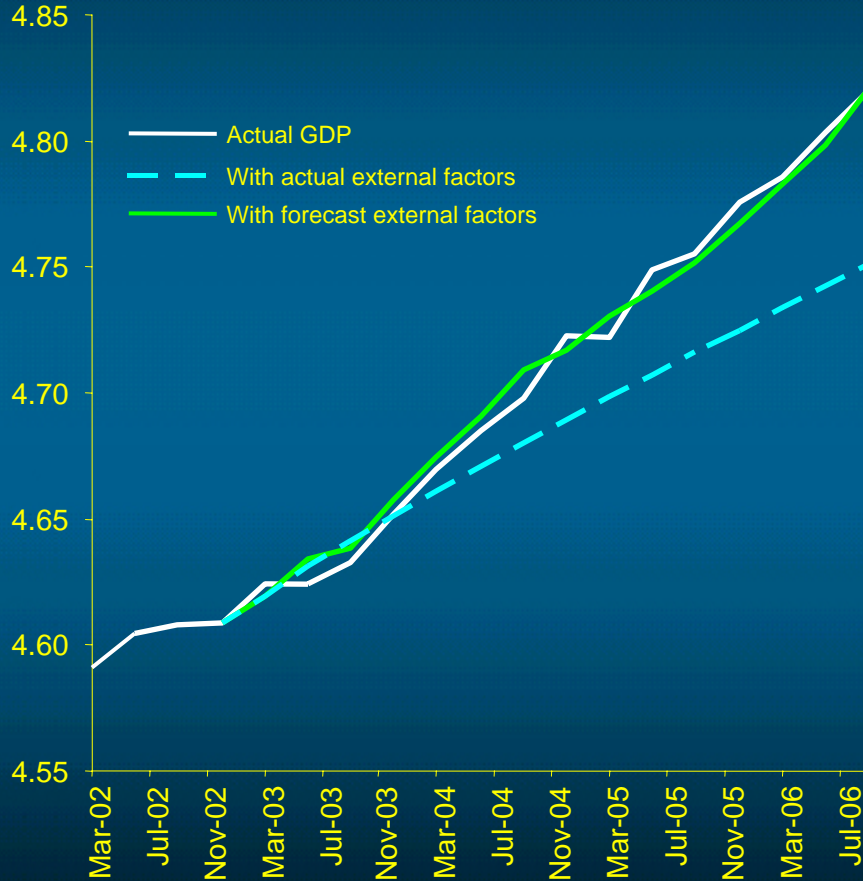
(EMBI spread, basis points)



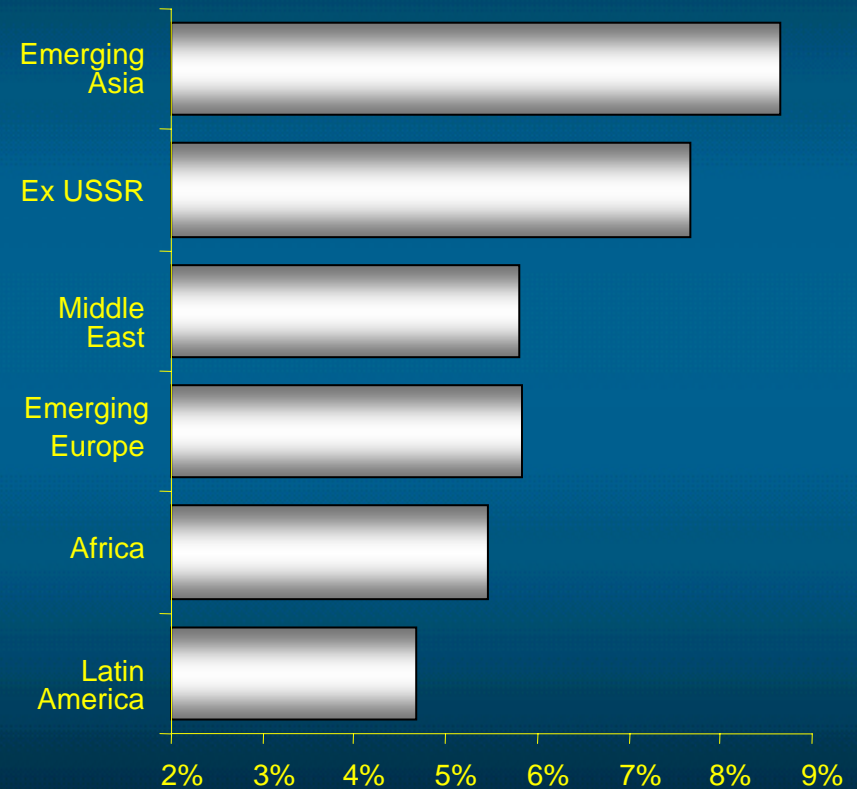
*World-7 includes G-3 (EU-15, Japan and USA) and EM-4 (China, India, Korea and Russia)

Growth Performance in Latin America

GDP Forecast Conditional on External Variables*
(LAC-7, values expressed in logs)



Growth in Emerging Markets: A comparative Perspective
(Real GDP, 2003 – 2007 Annual Growth)



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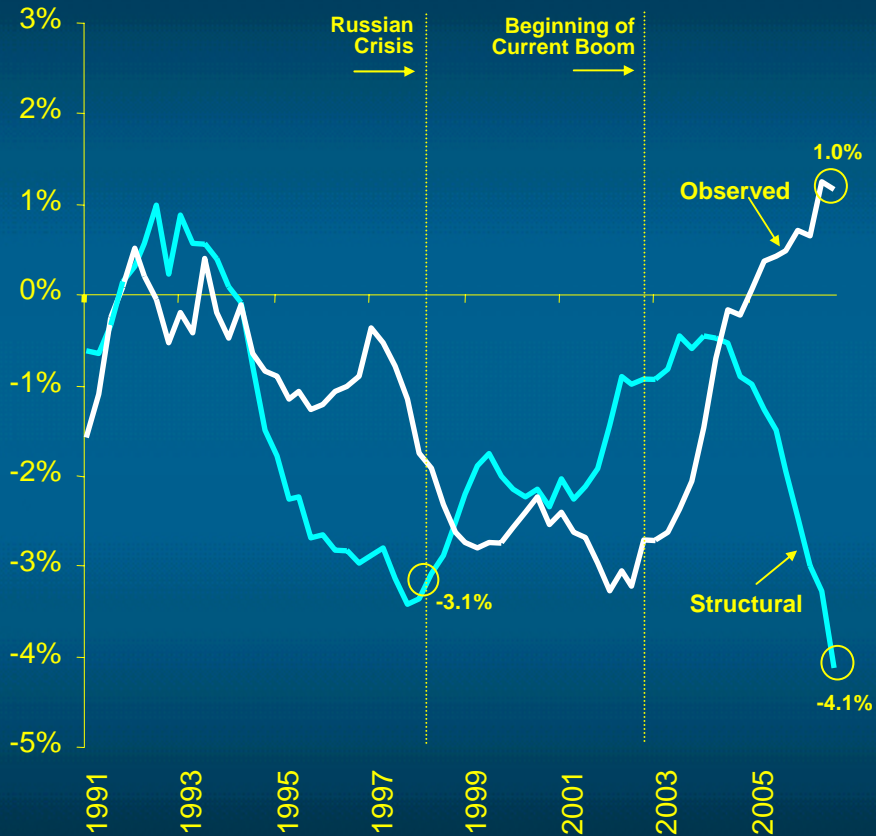
*Izquierdo, Romero and Talvi (2007)

Observed and Structural Fiscal Balances*

(Structural balances computed by applying the “Chilean Fiscal Rule” to other LAC-7 countries)

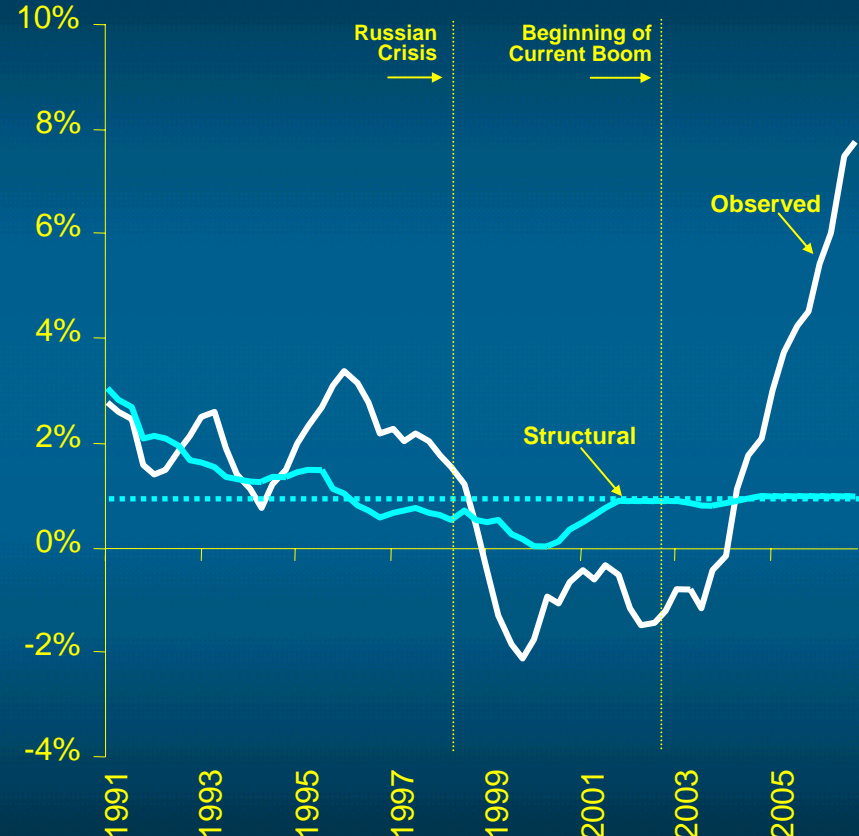
Latin America

(LAC-7, % of GDP)



Chile

(% of GDP)



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Fiscal balances include: Public Sector (Mexico), Non-Financial Public Sector (Argentina, Colombia, Peru), General Government (Brazil), Central Government (Chile, Venezuela).

*Izquierdo, Ottonello and Talvi (forthcoming).

Fiscal Balances by Country

(Dec-06, in % of GDP)

	Observed Fiscal Balance	Structural Fiscal Balance	
		Traditional HP Filter*	“Chilean” Fiscal Rule**
Argentina	1,8%	0,6%	-2,2%
Brazil	-3,0%	-3,3%	-4,9%
Colombia	-0,5%	-1,2%	-0,1%
Mexico	0,1%	-0,5%	-4,5%
Peru	2,1%	0,6%	-1,8%
Venezuela	-0,2%	-2,0%	-16,0%
LAC-6	0,0%	-1,0%	-4,9%
Chile	7,7%	6,1%	1,0%
LAC-7	1,1%	0,0%	-4,1%

LAC-6 is the simple average of Argentina, Brazil, Colombia, Mexico, Peru and Venezuela. LAC-7 is the simple average of the seven major Latin American countries, namely Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. These countries represent 91% of Latin America's GDP.

Fiscal balances include: Public Sector (Mexico), Non-Financial Public Sector (Argentina, Colombia, Peru), General Government (Brazil), Central Government (Chile, Venezuela).

*HP = Hodrick Prescott; lambda = 1600 (quarterly data).

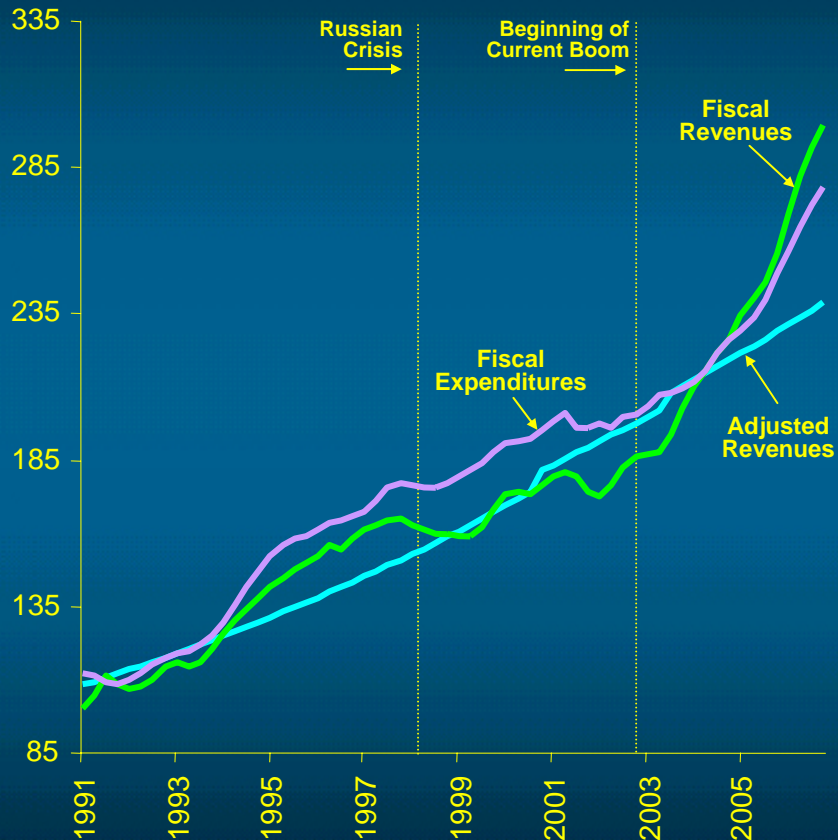
**Izquierdo, Ottonello and Talvi (forthcoming).

Fiscal Revenues and Expenditures*

(Adjusted revenues computed by applying the “Chilean Fiscal Rule” to other LAC-7 countries)

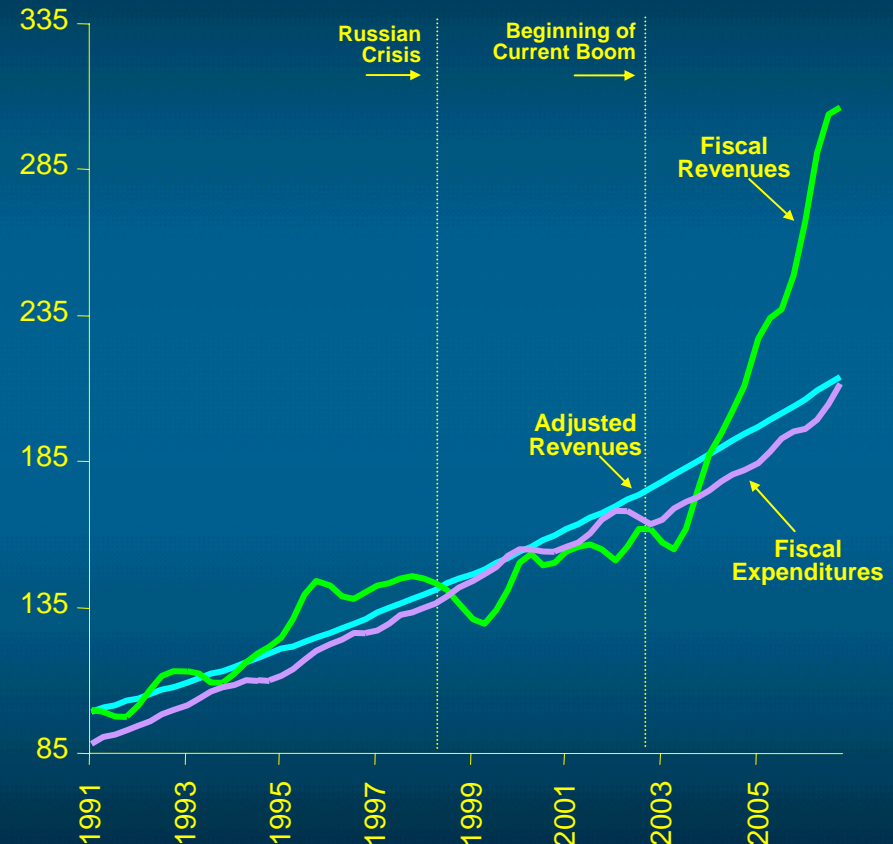
Latin America

(LAC-7, Fiscal Revenues, Mar-91 = 100)



Chile

(Fiscal Revenues, Mar-91 = 100)



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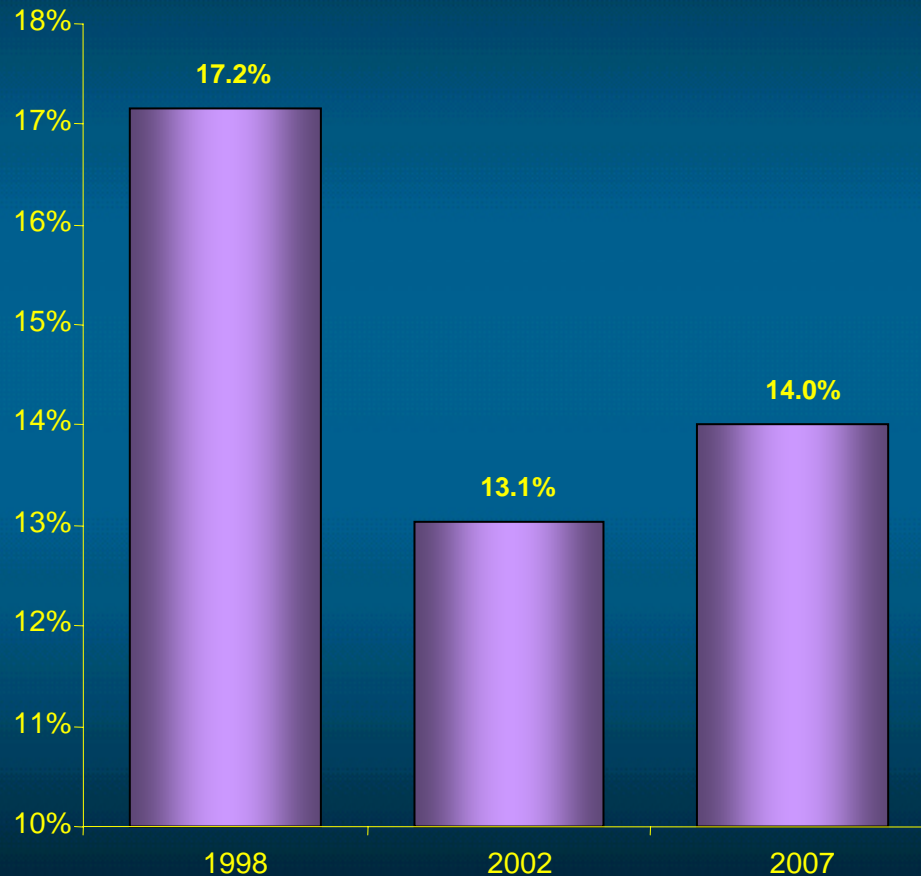
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Public Expenditure Composition in Latin America

Public Investment Expenditure

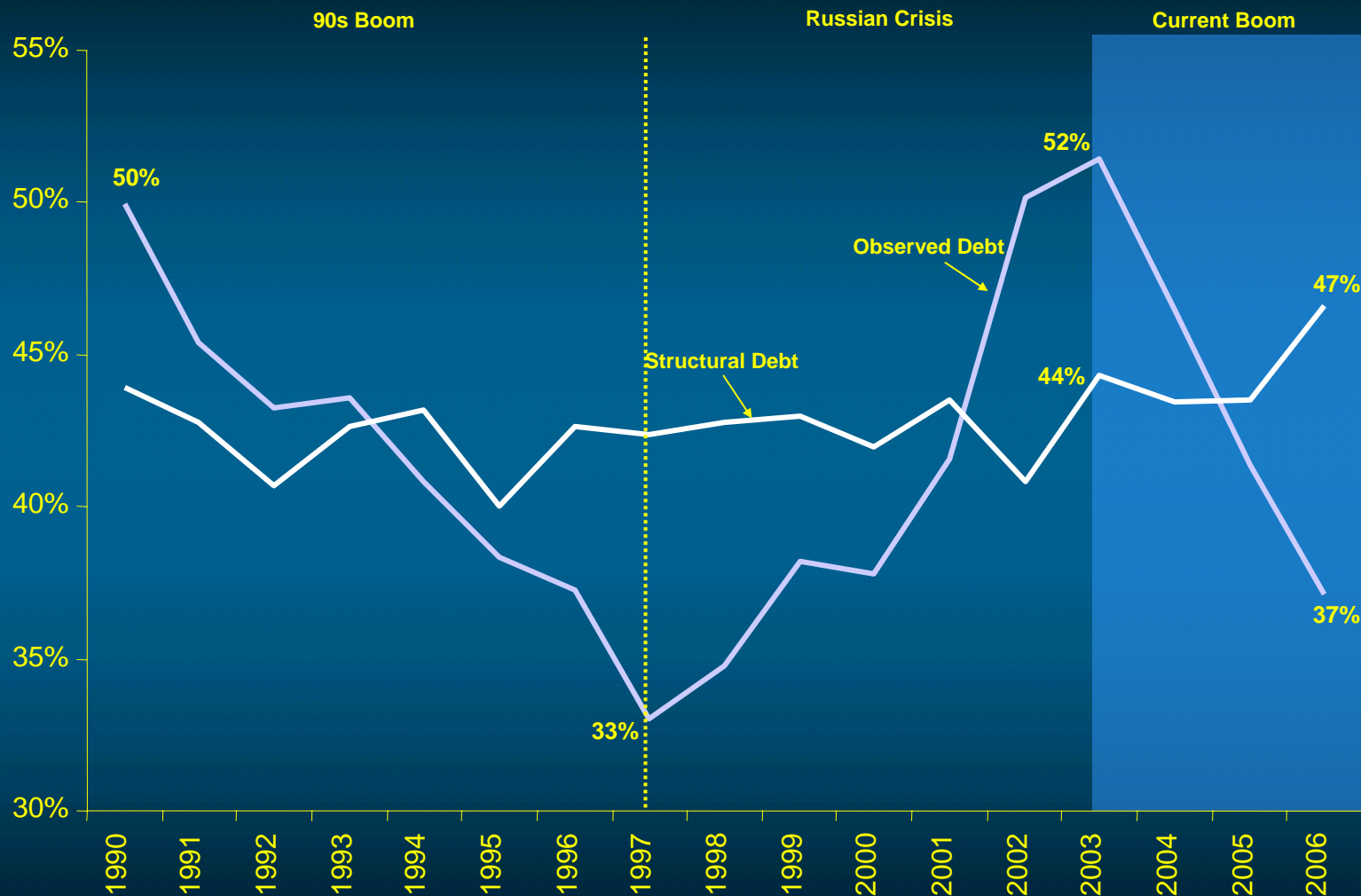
(LAC-7, in % of Primary Expenditure)



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Observed and Structural Public Debt*

(LAC-7, in % of GDP)



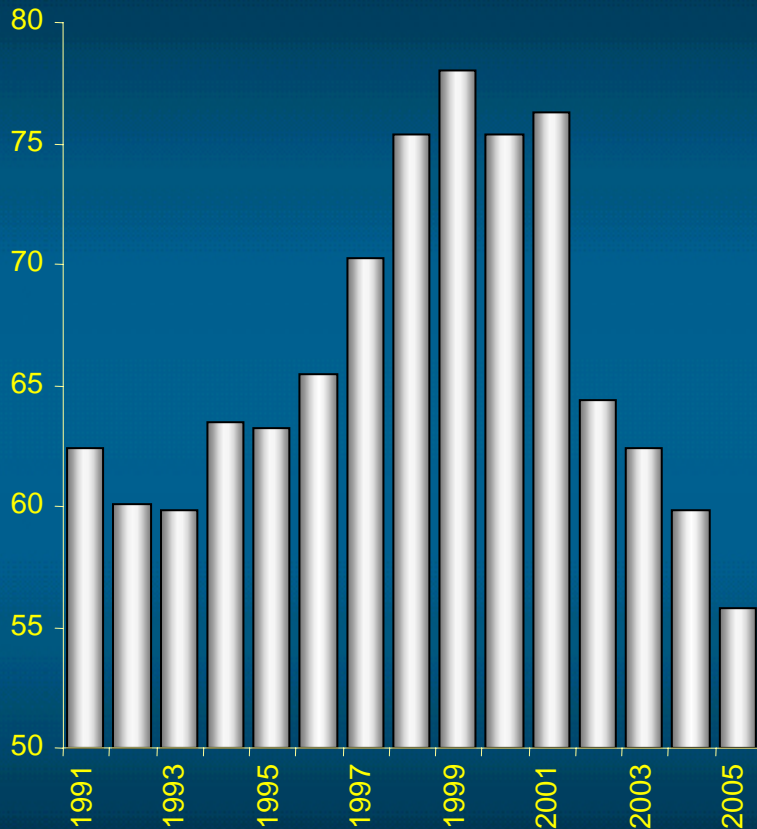
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Debt Riskiness: “The Mutation Factor”

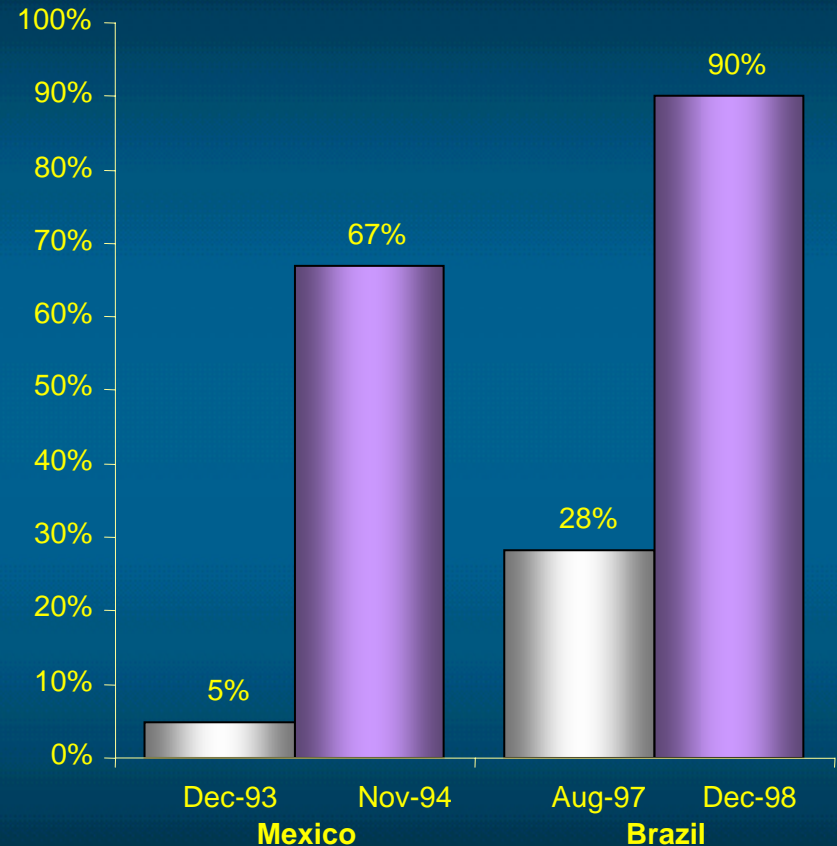
Debt Riskiness

(LAC-7, Risky Debt in % of Total Domestic Debt*)



Debt Riskiness: Two Revealing Examples

(Risky Debt in % of Total Domestic Debt**)



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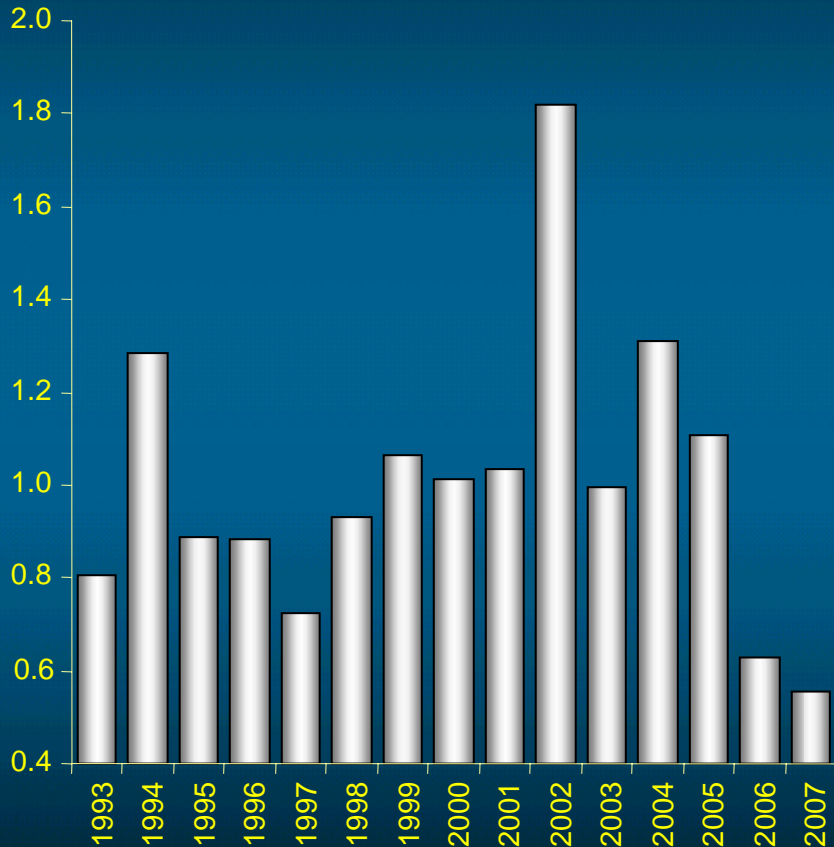
*Risky debt includes foreign-currency debt, short-term debt and variable interest rate debt. LAC-7 excludes Peru.

**For Mexico, risky debt is computed by taking the ratio of Tesobonos (denominated in US dollars) to total domestic public debt. The latter includes Cetes, Bondes Ajusta Bonos and Tesobonos. For Brazil, risky debt is constructed by taking the ratio of the sum of domestic public debt indexed to the Selic plus exchange-rate-indexed debt over total domestic public debt.

Liquidity Risk Ratios: “The Mutation Factor”

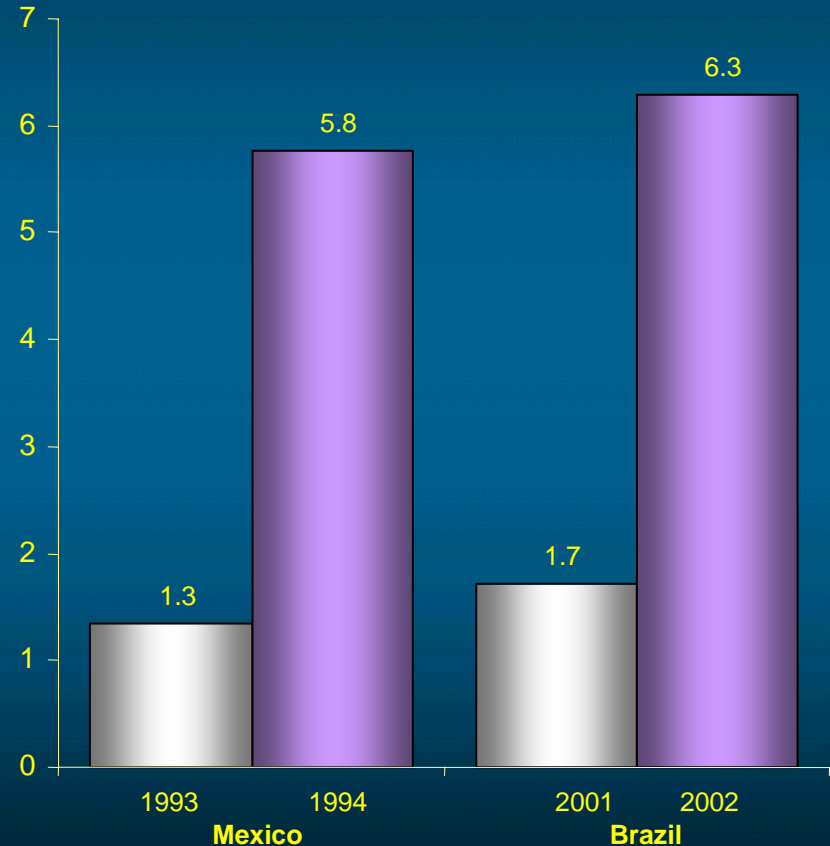
Liquidity Risk Ratios

(LAC-7, ratio of external public debt amortizations in the next 12 months to international reserves*)



Liquidity Risk Ratios: Two Revealing Examples

(LAC-7, ratio of external public debt amortizations in the next 12 months to international reserves*)



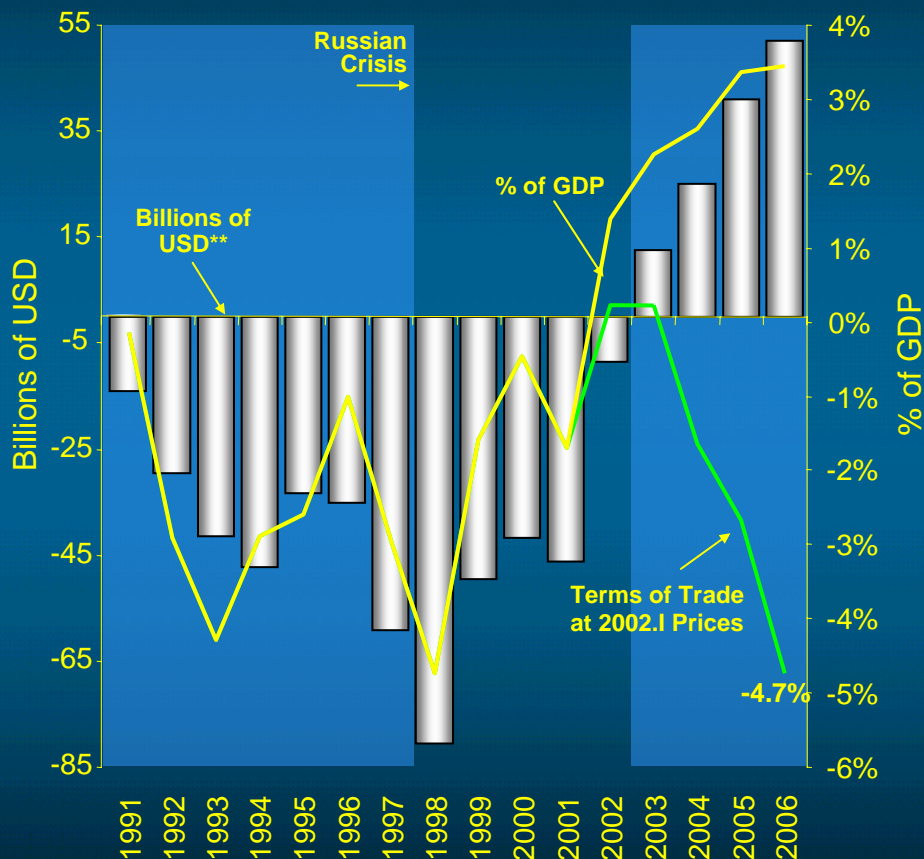
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*International reserves net of Central Bank short-term liabilities.

Latin America's External Position*

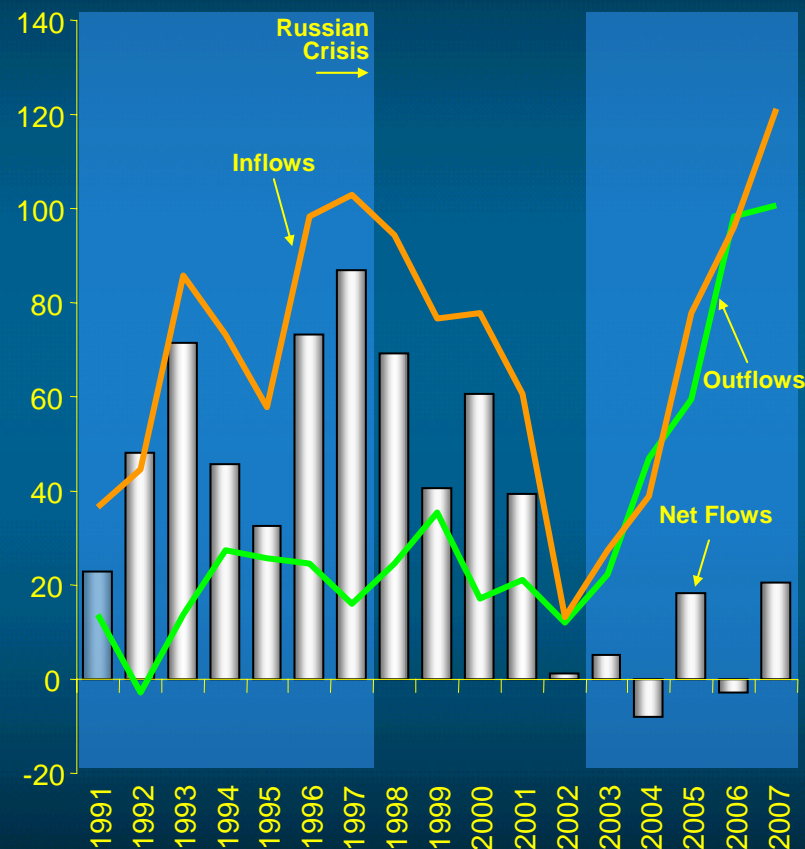
Observed and Adjusted Current Account

(LAC-7, Billions of US Dollars** and % of GDP)



Capital Flows

(LAC-7, Billions of US Dollars**)



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* Calvo and Talvi (2007).

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International Reserves to M2 Ratios

Standard Ratio



Adjusted by M2 volatility Ratio



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 EA-5 is the simple average of Indonesia, Korea, Malaysia, Philippines and Thailand.

Taking Stock

- Removing the veil of external bonanza uncovers vulnerabilities in performance and fundamentals that are not immediately apparent
- Although credit ratings have improved dramatically since 2003, they are not higher than prior to the Russian crisis as they should be expected to be if in spite of apparently higher fundamental

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Taking Stock

- None of the vulnerabilities above is in and of itself a destabilizing factor...
- ...but when put together, they call for a reevaluation of the region's stance
- This does not lessen relevant progress in macroeconomic management made by the region
- It is precisely because these achievements need to be sustained that this reevaluation is necessary

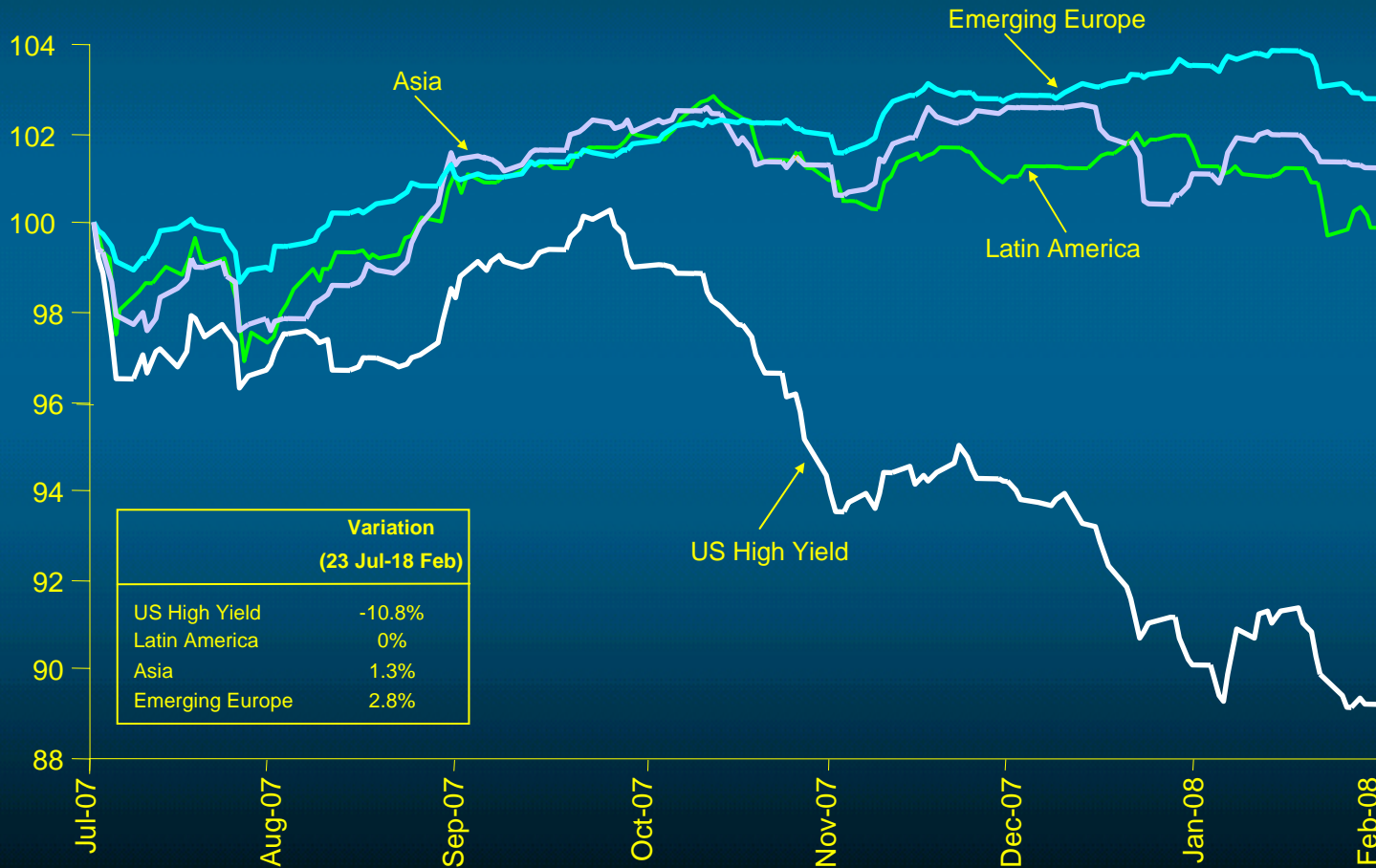
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Emerging Markets' Reaction to US Subprime Crisis

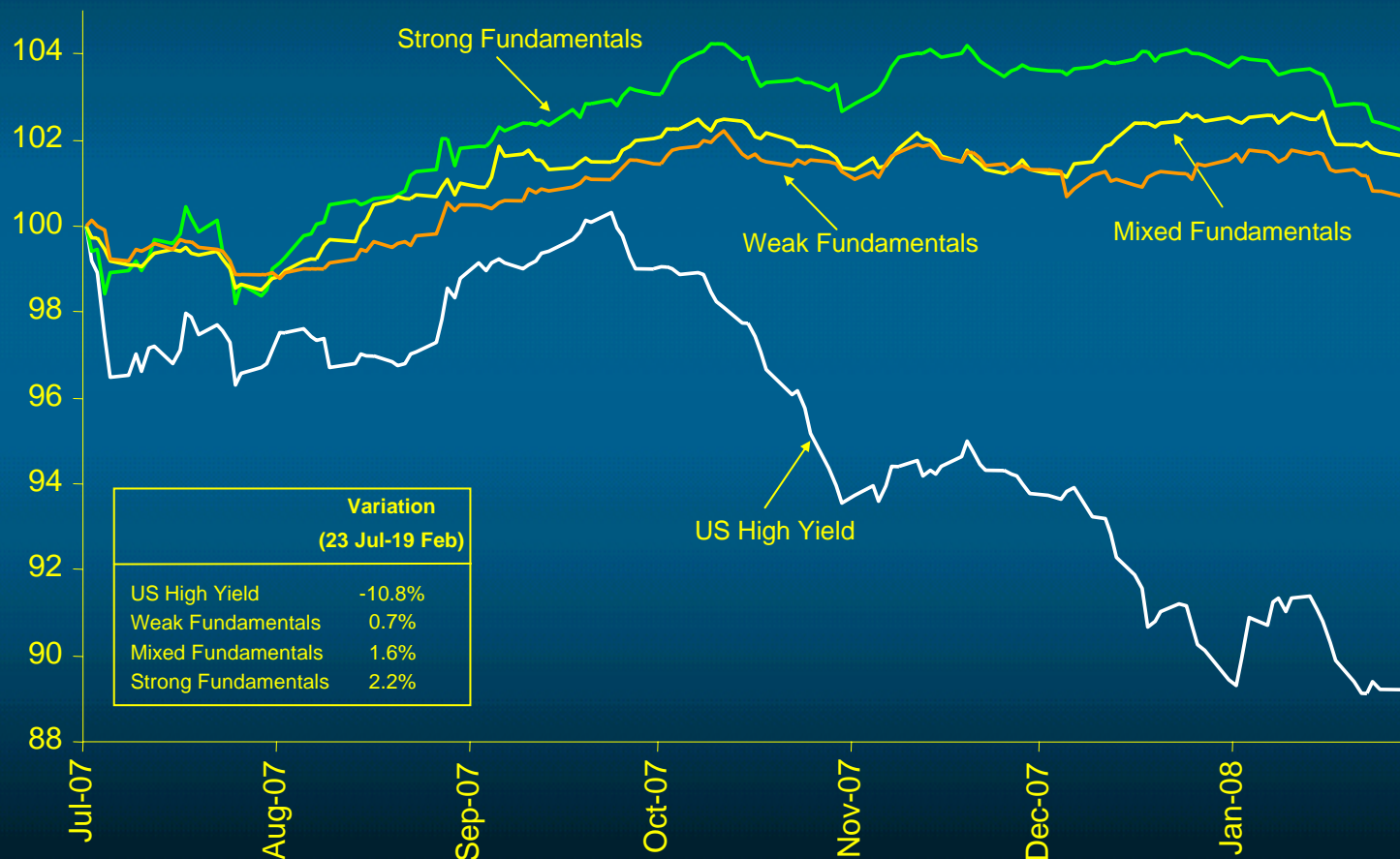
Bond Prices by Region

(US High Yield, Latin EMBI, Asia EMBI and Europe EMBI, Bond Price Equivalent, 23-Jul-07 = 100)



Emerging Markets' Reaction to US Subprime Crisis

Bond Prices in Emerging Countries with Strong, Mixed and Weak Fundamentals*
 (US High Yield and EMBI Bond Price Equivalent, 23-Jul-07 = 100)



* A country with strong fundamentals is defined as a country that displays both a current account and a fiscal surplus; a country with weak fundamentals is a country that displays both a current account and a fiscal deficit; and a country with mixed fundamentals is a country that has a surplus in one dimension and a deficit in the other.

Reasons for Financial Decoupling Now (but not Then)

- The source of the crisis: Subprime turmoil detonated at the center
- This prompted massive intervention by the Federal Reserve, helping isolate the crisis and prevent contagion into other asset markets
- This decoupling stands in stark contrast with the behavior of the 1998 financial crisis, which detonated in the periphery
- Liquidity provision by the Fed was not nearly as aggressive, as US financial markets remained largely unscathed

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Taking Advantage of the Bonanza: Policy Topics

Resist the temptation of taking comfort in favorable tailwinds, and work towards:

- Strengthening fiscal policy

Adopting structural fiscal rules consistent with the reduction of structural debt-to-GDP ratios to prudent levels

Ensuring adequate shares of investment in primary expenditure

- Strengthening regulation and supervision

Enforcing capital ratios and provisions that are pro-cyclical

In fast credit growth sectors, ensuring that competition does not weaken the risk management process

Taking Advantage of the Bonanza: Policy Topics

- Generating a genuine build-up of international reserves → Ensuring that financing for reserve accumulation does not weaken their insurance value
- Creating conditions conducive to long-lasting growth → Using favorable times to foster a business climate that stimulates private investment and productivity growth

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THANK YOU