Macroeconomic Policy Challenges for (most) Latin America

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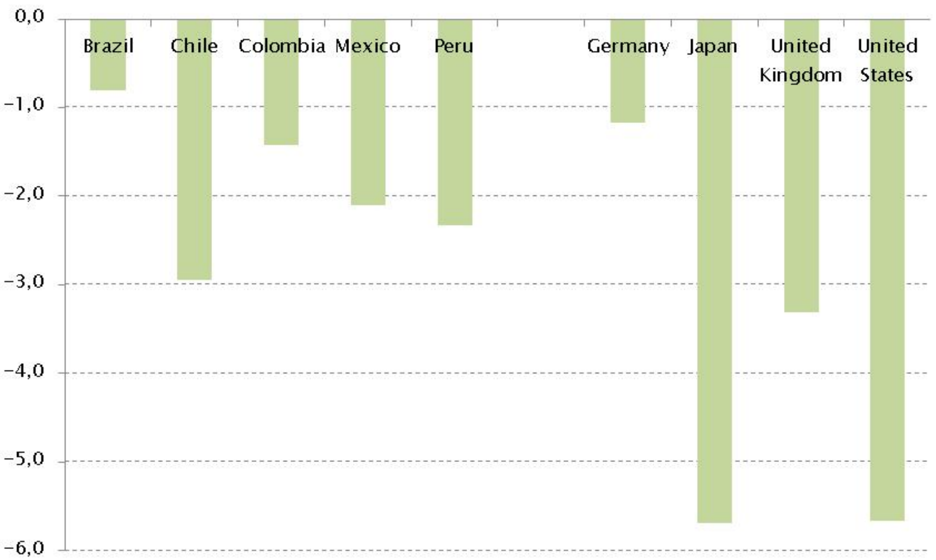
Main issues

- What is behind the strong recovery in LATAM?
- What policy dilemmas has set this particular type of recovery for LATAM Policy Makers?
- What have been the policy responses?

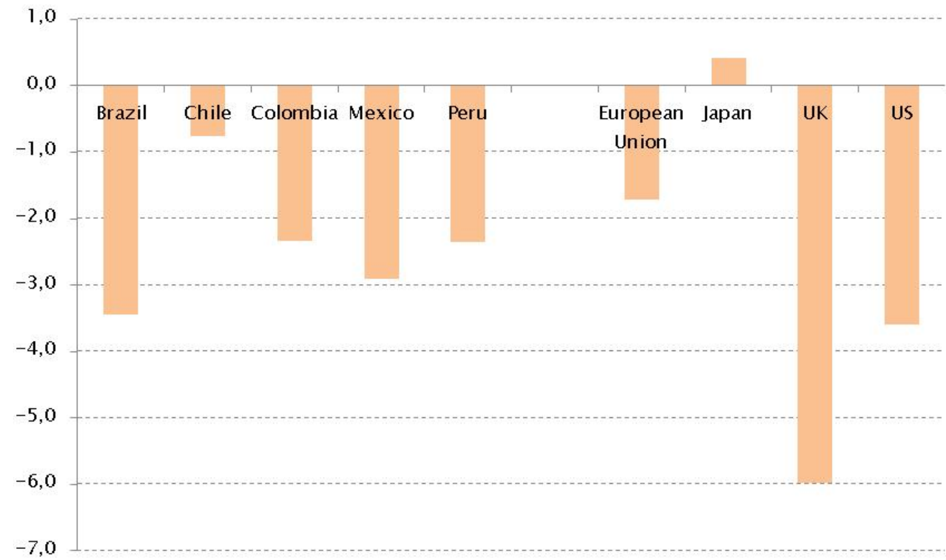
The 2008-09 crisis moved Governments and Central Banks to introduce large Fiscal and Monetary stimulus

Changes in Structural Balances 2010-07 (*)
(% potential GDP)



(*) SB estimates do not correct for ToT deviations from trend. 2013 information is estimated .
Source: International Monetary Fund. World Economic Outlook Database, April 2013.

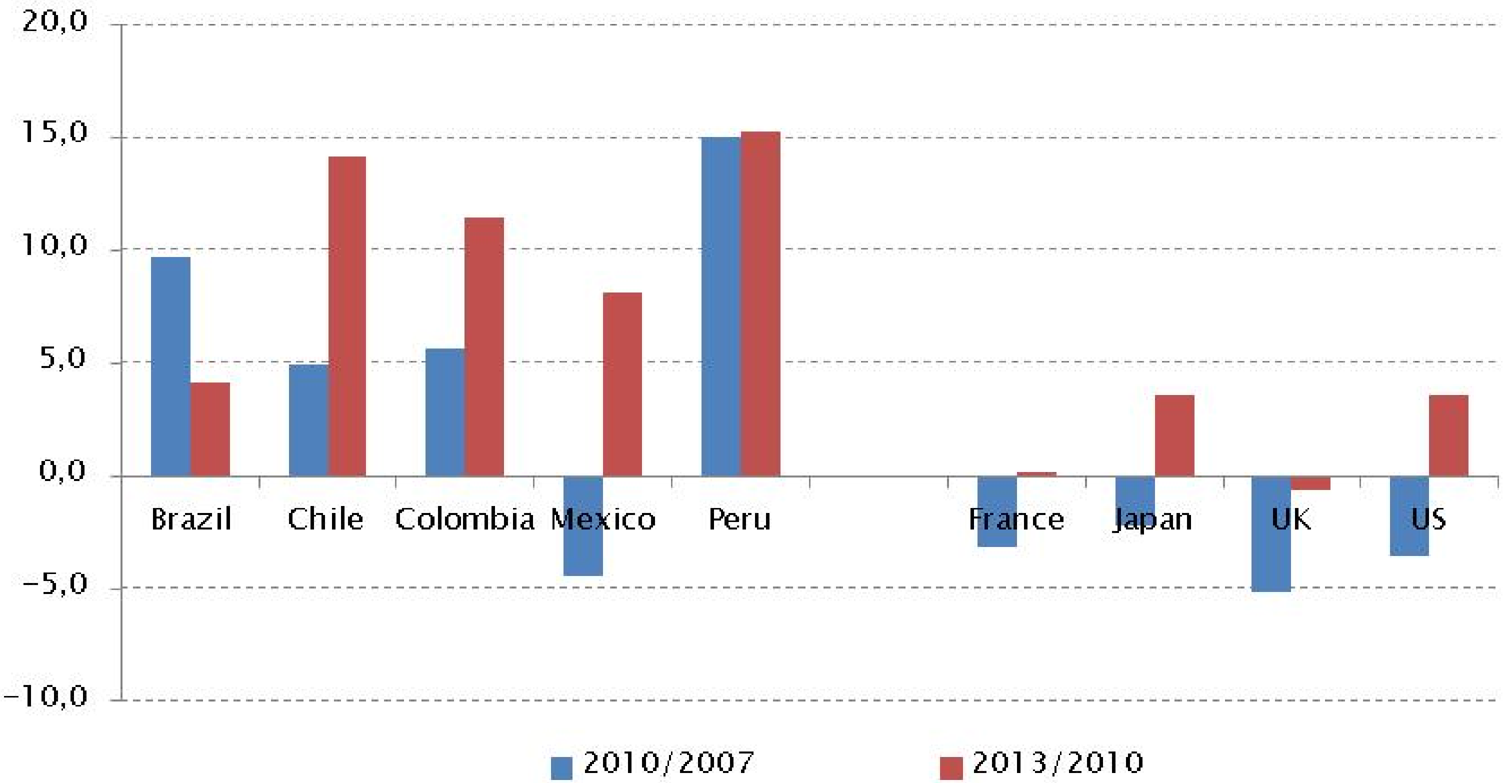
Changes in Monetary Policy rates 2010-07
(Inflation adjusted, %)



Source: Own estimates on the basis of Central Bank data

While LATAM shows a clear recovery after 2010, most of the Advanced Economies remained bogged down in recession or slow recovery.

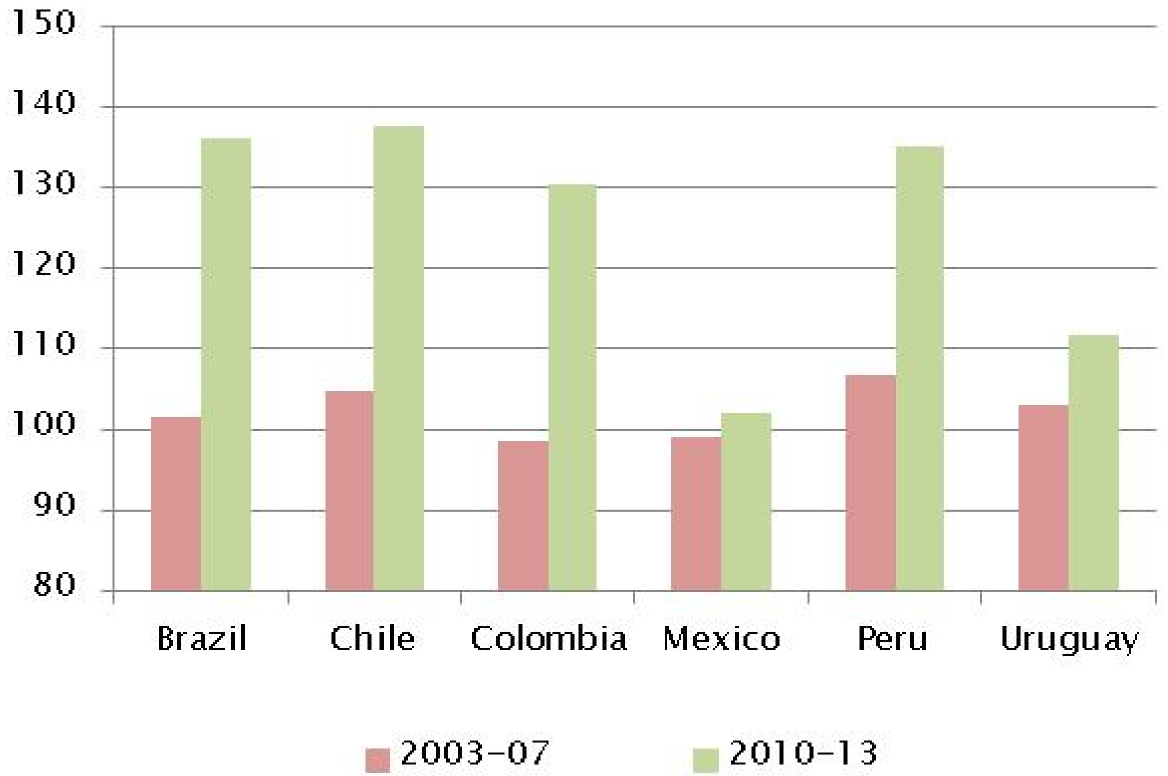
Accumulated changes in Per Capita GDP during the crisis and recovery phases
(%)



(*) 2013 information is estimated .
Source: International Monetary Fund. World Economic Outlook Database, April 2013.

Terms of trade recovered quite fast (in some cases they did not fall) supported by Developing Asia's demand for commodities.

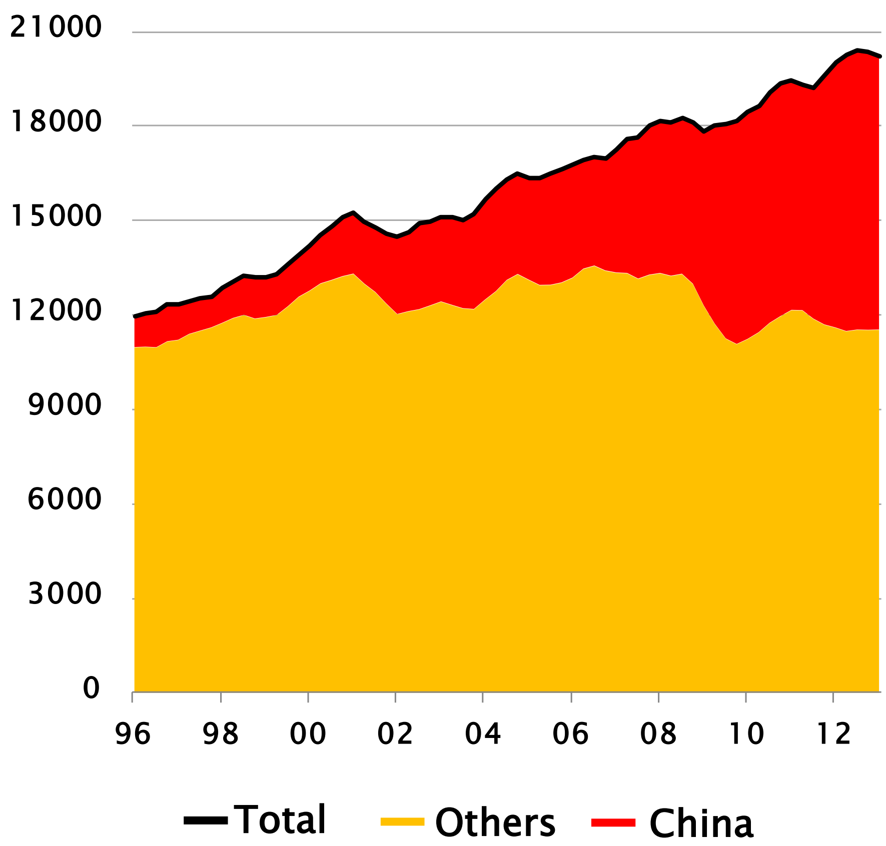
Terms of Trade for selected countries in LATAM
(Period averages, 2005 = 100)



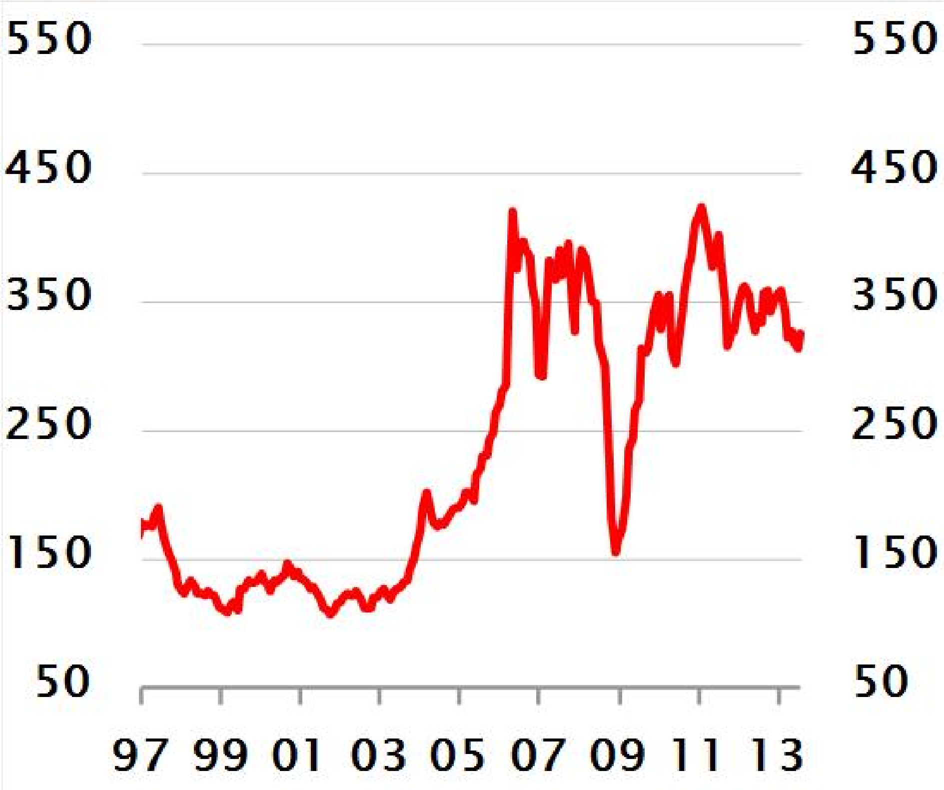
Source: ECLAC Statistical Database.

The case of copper: global demand kept rising in spite of the Great Recession due to Chinese demand.

Refined copper consumption
(thousand metric tonnes)



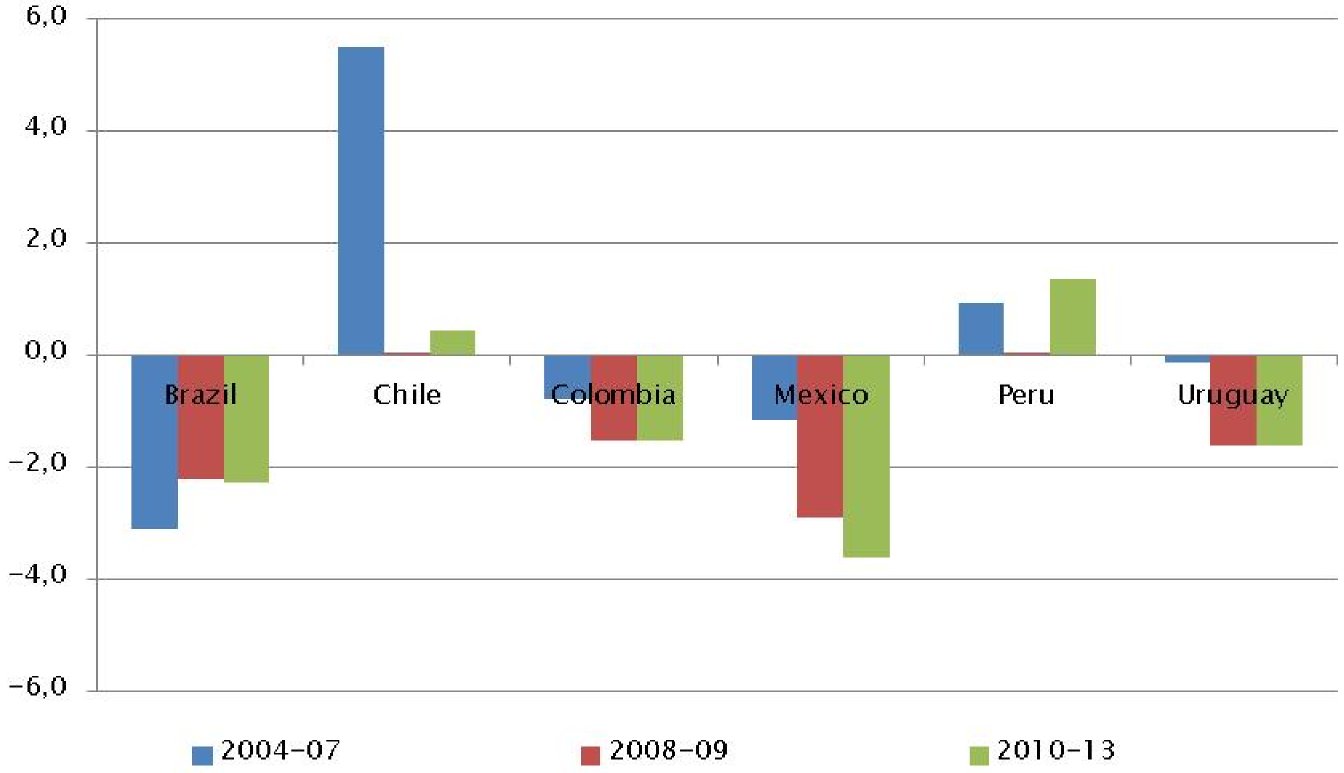
Copper price
(USD cents per pound)



Sources: Bloomberg and Central Bank of Chile.

Most countries in the region, and especially Chile and Peru, saved a large fraction of the Cyclical Windfall from high commodity prices

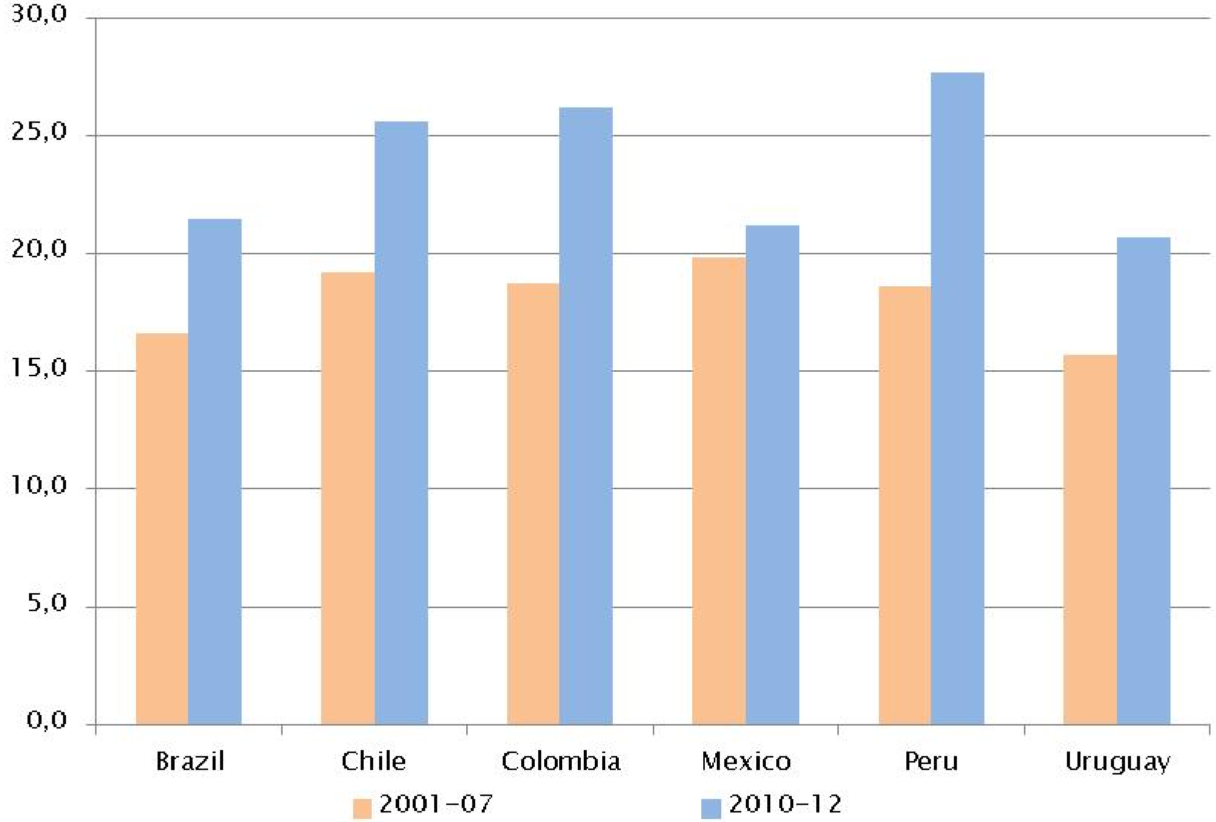
Accumulated fiscal surpluses over different periods
(annual averages, percent of GDP)



Source: IMF, WEO 2013 Database.

But as a result of the ToT positive shock, there has also been a "Real Shock" in private, resource-led investment

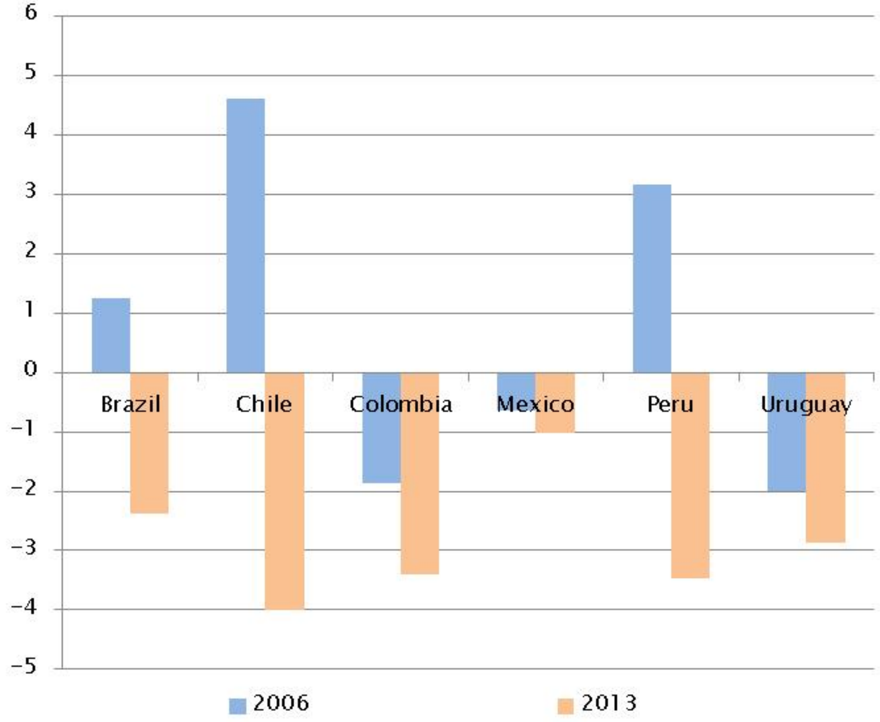
Gross Fixed Investment before and after the Big Recession
(Percent of GDP, constant USD 2005)



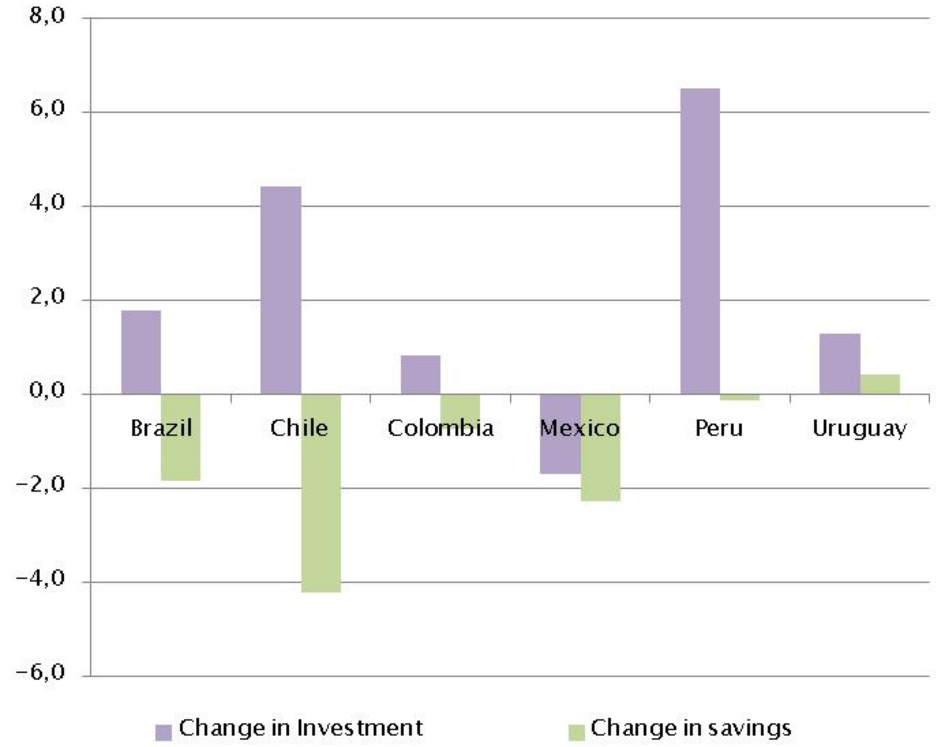
Source: World Bank, WDI database.

Current accounts worsened, even before the correction in commodity prices, reflecting excess domestic demand growth over GDP

Current Accounts 2006 and 2013(*)
(% GDP)



Decomposition of changes in Current Accounts 2013-06
(% GDP)



(*) 2013 information is estimated .
Source: International Monetary Fund. World Economic Outlook Database, April 2013.

The Central Banks Dilemma in 2012

- Domestic demand was growing strongly

- Current Accounts deficits were widening

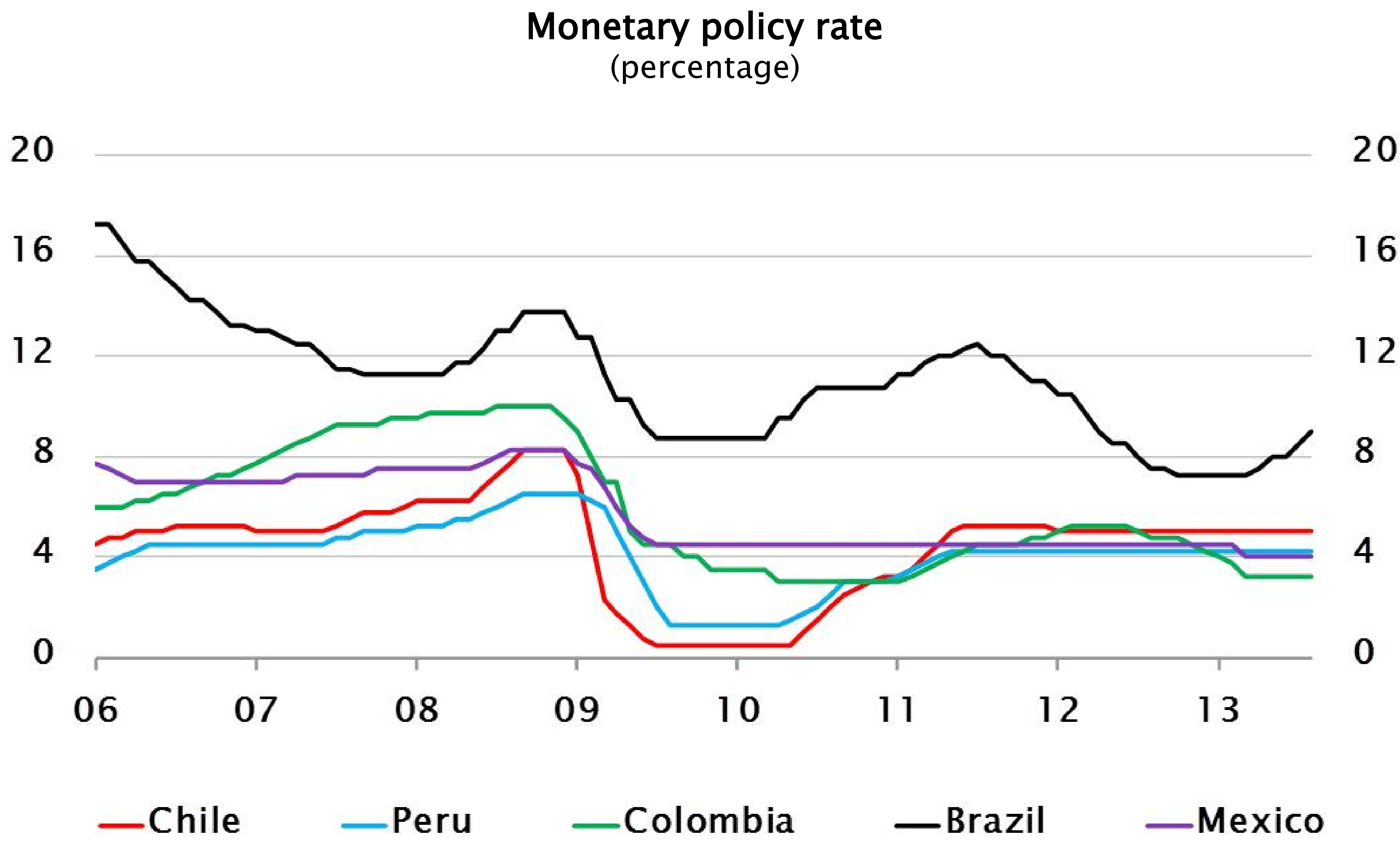
- However inflation remained close to targets

- Foreign funding was available and very cheap (In addition to large FDI inflows)

- Fiscal Policy was not available (unless there was a major emergency)

- There was a wide gap between domestic policy rates and the Fed Funds rate and significant pressures for LATAM currencies to appreciate.

Most countries kept or made modest cuts in Monetary Policy rates, with the exception of Brazil



 Source: Central Bank of Chile and Bloomberg.

Searching for new instruments

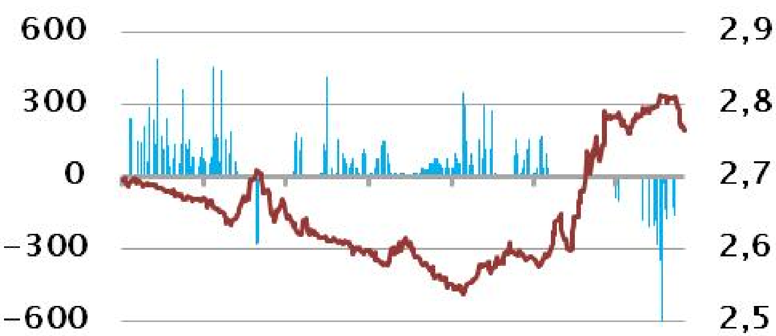
- Most countries used less conventional instruments, such as increases in reserve requirements.
- Most countries also intervened in the FX market.
- Chile has been an outlier: Did not use non-conventional measures.

	2011 – 2012	2013
Brazil	• Bought about US$15 bn. through FX *swaps* • Accumulated US$65 bn. International Reserves • Raised up to 6% the tax rates on short term financial operations and to loans up to 5 years maturity	• Sold about US$60 bn. Through FX *swaps* • Sold ~US$3bn. of International Reserves • Elliminated the 6% tax on foreign purchases of Brazilian debt and the 1% tax on derivatives transactions
Colombia	• Instated daily purchases of US$20 mill. accumulating US$3,7 bn.	• The program remains in place
Mexico	• Daily auction of up to US$400 mill. at depreciated currency rates (2%) wrt previous day.	•Suspended in April
Peru	• Bought about US$7 bn. In the spot market	• Sold US$3,3 bn. since July
	• Changes in Reserve requirements in FX deposits: marginal remained at 55%. Average rose 275 bps	• Changes in Reserve requirements in FX deposits: marginal fell to 50%. Average rose 250 bps with a cap at 45%
	• Changes in Reserve requirements in PEN deposits: marginal rose from 25% to 30%. Average rose 275 bps	• Changes in Reserve requirements in PEN deposits: marginal fell from 30% to 20%. Average rose 25 bps with a cap at 17%
	• The Treasury announced purchases of US $ 4 bn.	• Raised the limit for foreign investments of AFPs from 30% to 36% of total assets under management.

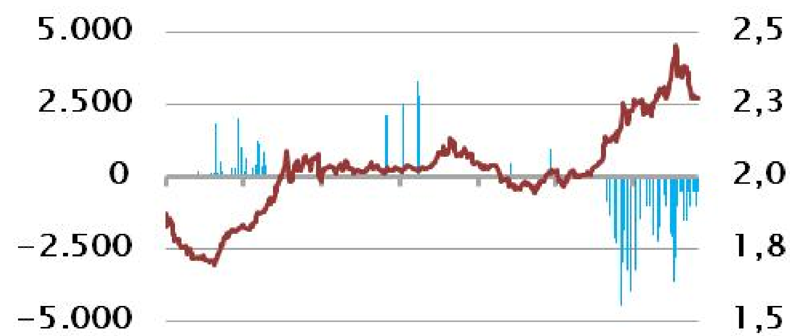
FX interventions probably helped to dampen currency appreciations in several countries.

Interventions in FX markets and exchange rates (*)
(January 2012, September 2013)

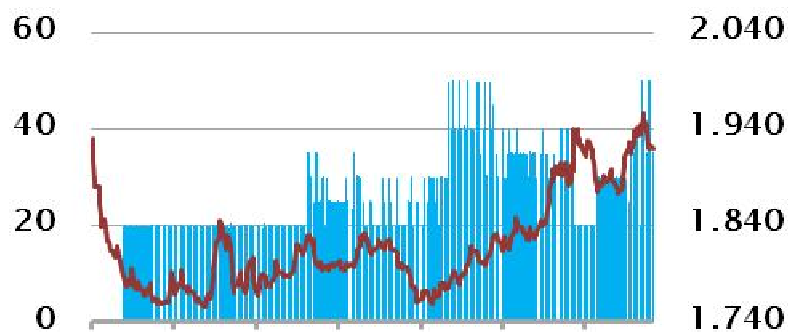
Peru



Brazil



Colombia

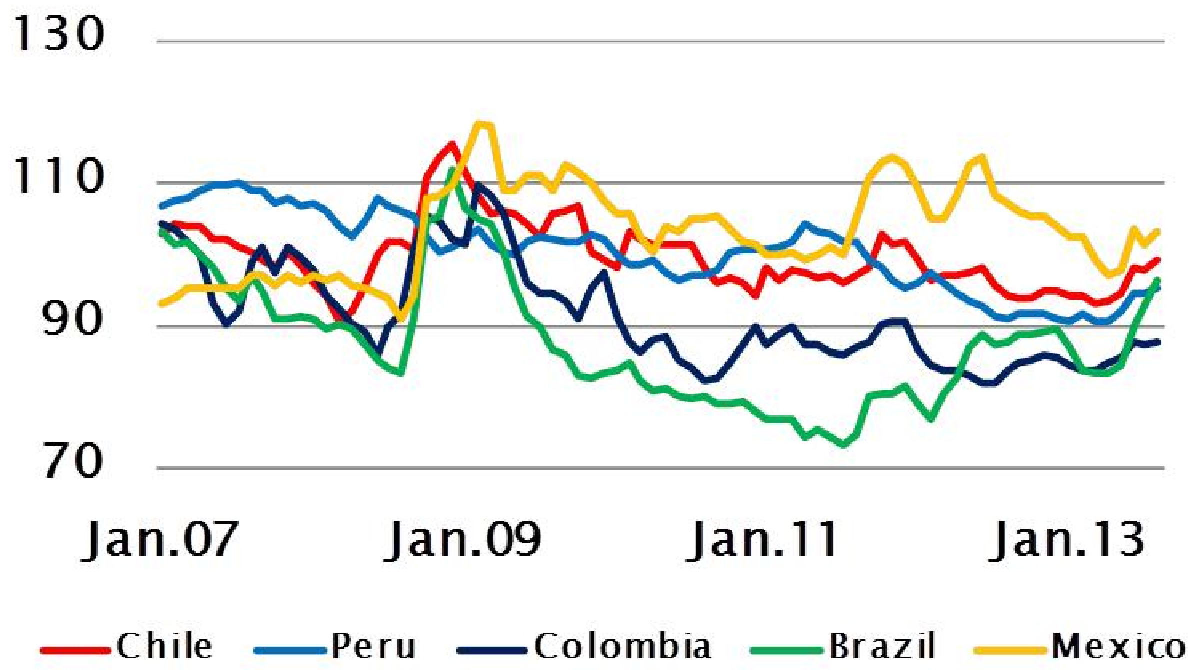


(*) Left hand axis: size of interventions (millions of USD); Right-hand axis:, exchange rate (local currency/USD)

Source: Central Bank of Chile and Bloomberg.

However, deviations from trend for the Chilean peso have been similar to those currencies of countries with more activist policies

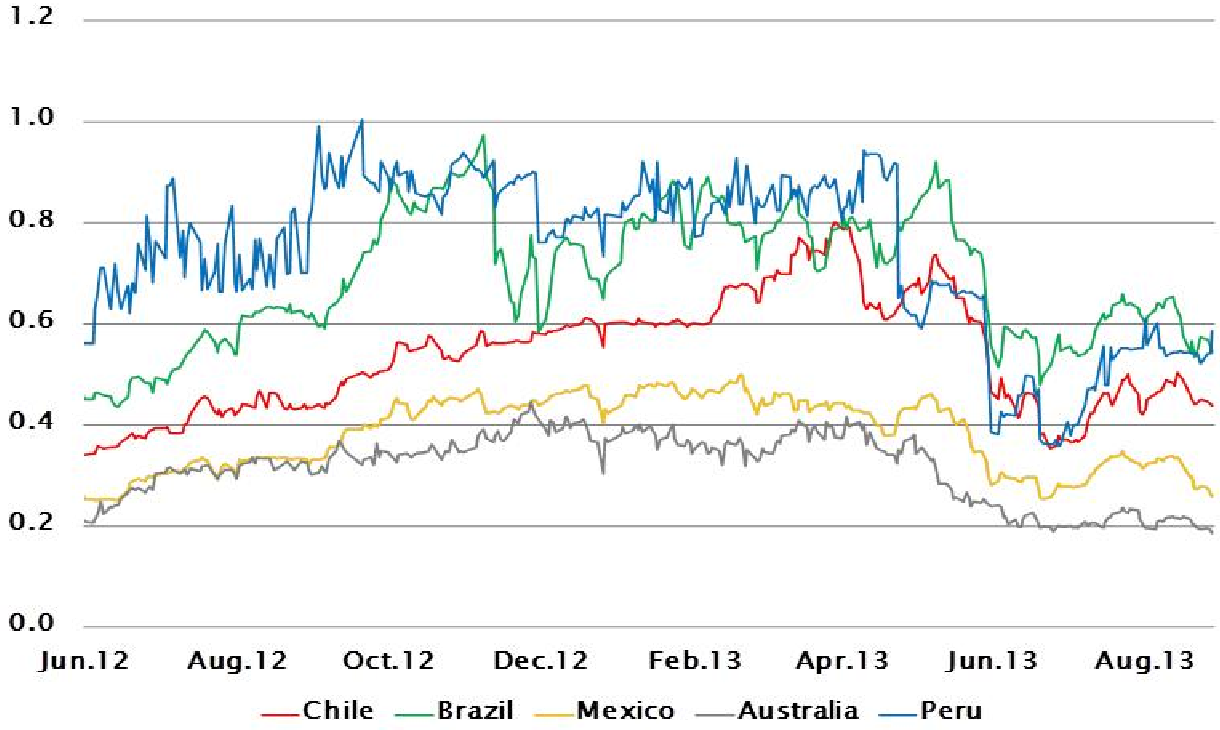
Exchange rate deviations from trend for selected countries



Note: Deviation from average real parity January 1995 – June 2013

Free floating and FX volatility has helped reduce incentives for arbitrage in Chile.

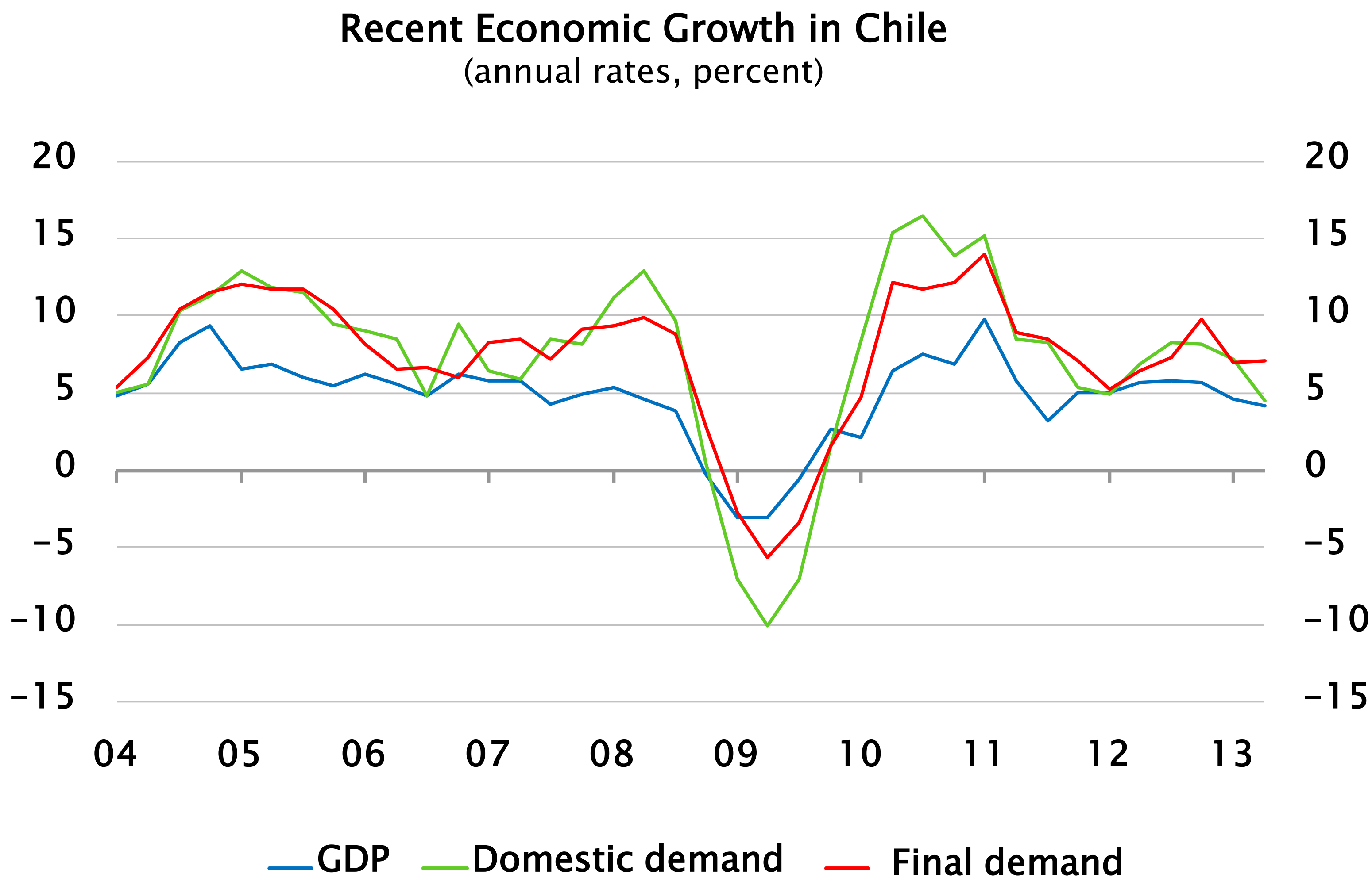
Carry to risk ratio for selected countries



$$Carry\ to\ risk\ ratio = \frac{i_{3\,months}^{active} - i_{3\,months}^{passive}}{options\_implicit\_volatility\_3months\ active / passive}$$

i_{active}: 3 month deposit rate in local currency.
$i_{passive}$: 3 month deposit rate in USD.

We are seeing growth slowdowns everywhere. In Chile we are seeing a gradual convergence of GDP and Domestic Demand growth to trend rates



Source: Central Bank of Chile.

Final remarks

• The disconnection – perhaps temporary – of the domestic cycle in LATAM relative to the Advanced Economies has made more difficult the task of Central Banks.

•While some countries have succeeded using aggressive FX intervention and non-conventional monetary instruments to limit credit expansion.

• Chile has achieved similar results with more orthodox monetary policies and allowing for free EXR flotation, in an environment of high ToT volatility.

• The expectation of a slowdown of the QE in the USA has alleviated pressures for appreciation. There has been an outflow of short-term capital.

• How much of the slowdown in countries like Brazil or Peru is due to the use of macro prudential policies? This is an open question

• There is little doubt that the overall macroeconomic management in (most of) LATAM has improved dramatically.

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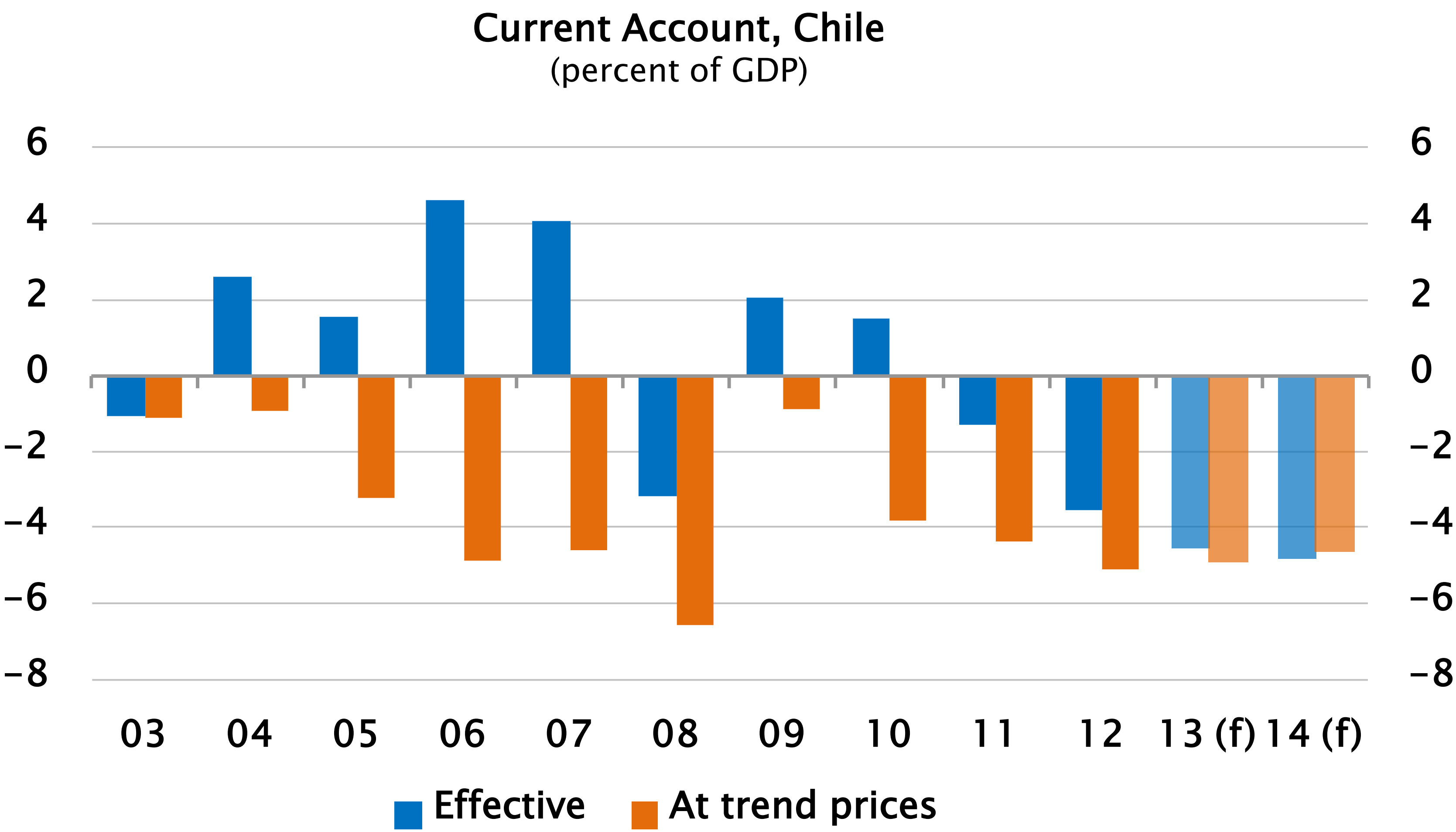
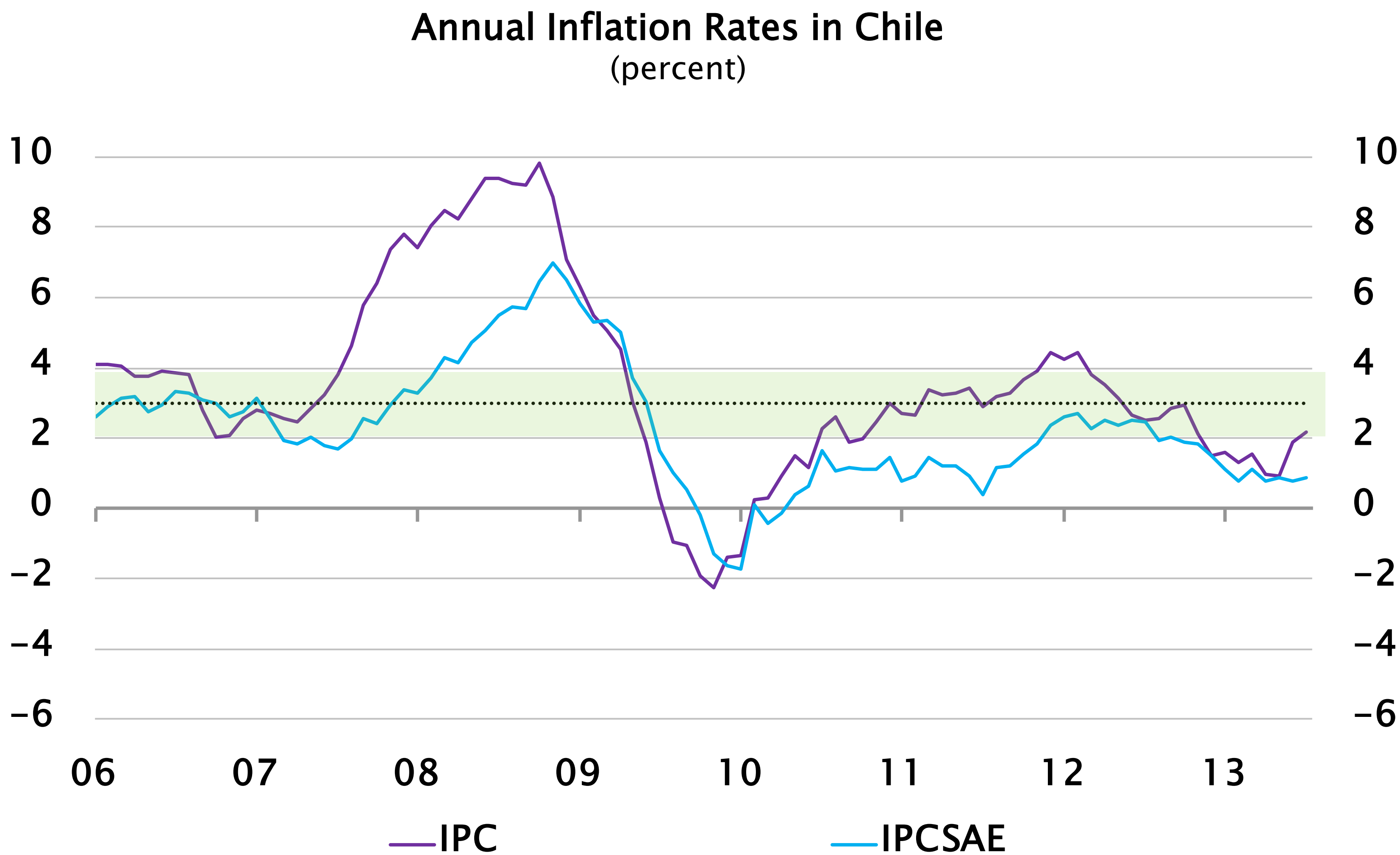
In Chile the current account deficit (measured at trend prices for copper and oil) has stabilized



Source: Central Bank of Chile.

While inflation has remained subdued throughout this process



Source: Central Bank of Chile.