Growth and Exchange Rates in Developing Countries

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Outline

1. Promoting Growth

2. The Role of Exchange Rates

3. The World Economy

Promoting Growth

- It is urgent to resume growth to consolidate reforms and to avoid costly shortcuts.
- What to do? There are many factors, but from the macro-policy point of view:
- Institutions.
- Openness.
- Macroeconomic Stability: inflation - currency crisis.

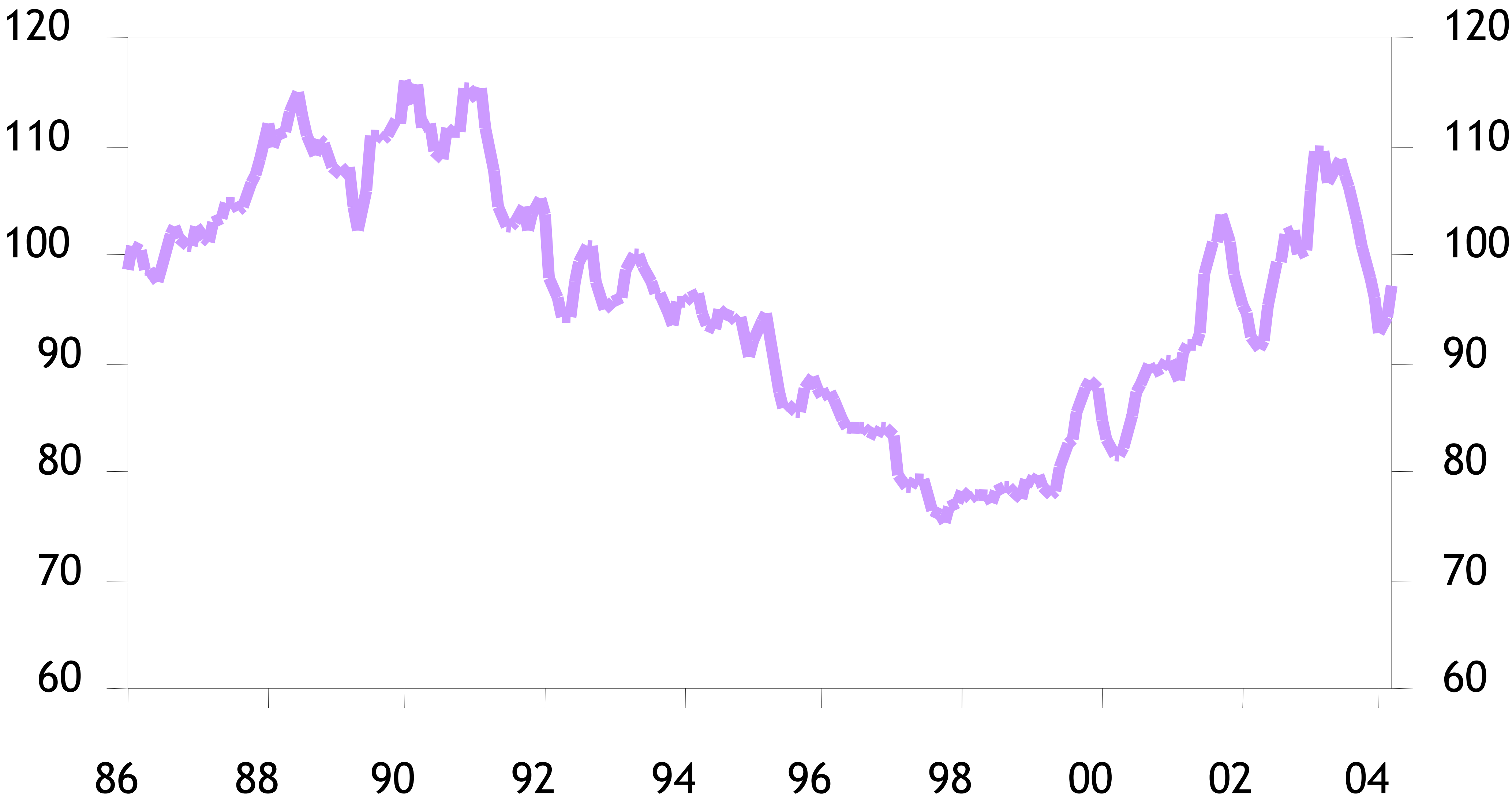
Promoting Growth

- Currency crisis are costly: in a five-year period reduce output by 9%, if in addition comes with banking crisis the cost is doubled.
- Business Cycle: fluctuations are larger and more persistent, and exacerbated by pro-cyclical policies (fiscal, exchange rates, current account).
- Strong institutions pre-requisite for successful stabilization.

The Role of Exchange Rates

- Must promote stability. Acting timely as shock absorber.
- Need for flexibility: small open economies subject to a variety of shocks that need to be accommodated.
- Attempts to lean against the wind via aggressive reserve accumulation may encourage speculation and increase capital inflows.
- Capital controls: effectiveness it is not clear, specially when domestic financial markets are well-developed. Could be advisable for countries without strong macro institutions, but not as substitute for building them.

Real Exchange Rate
(average 1986=100)

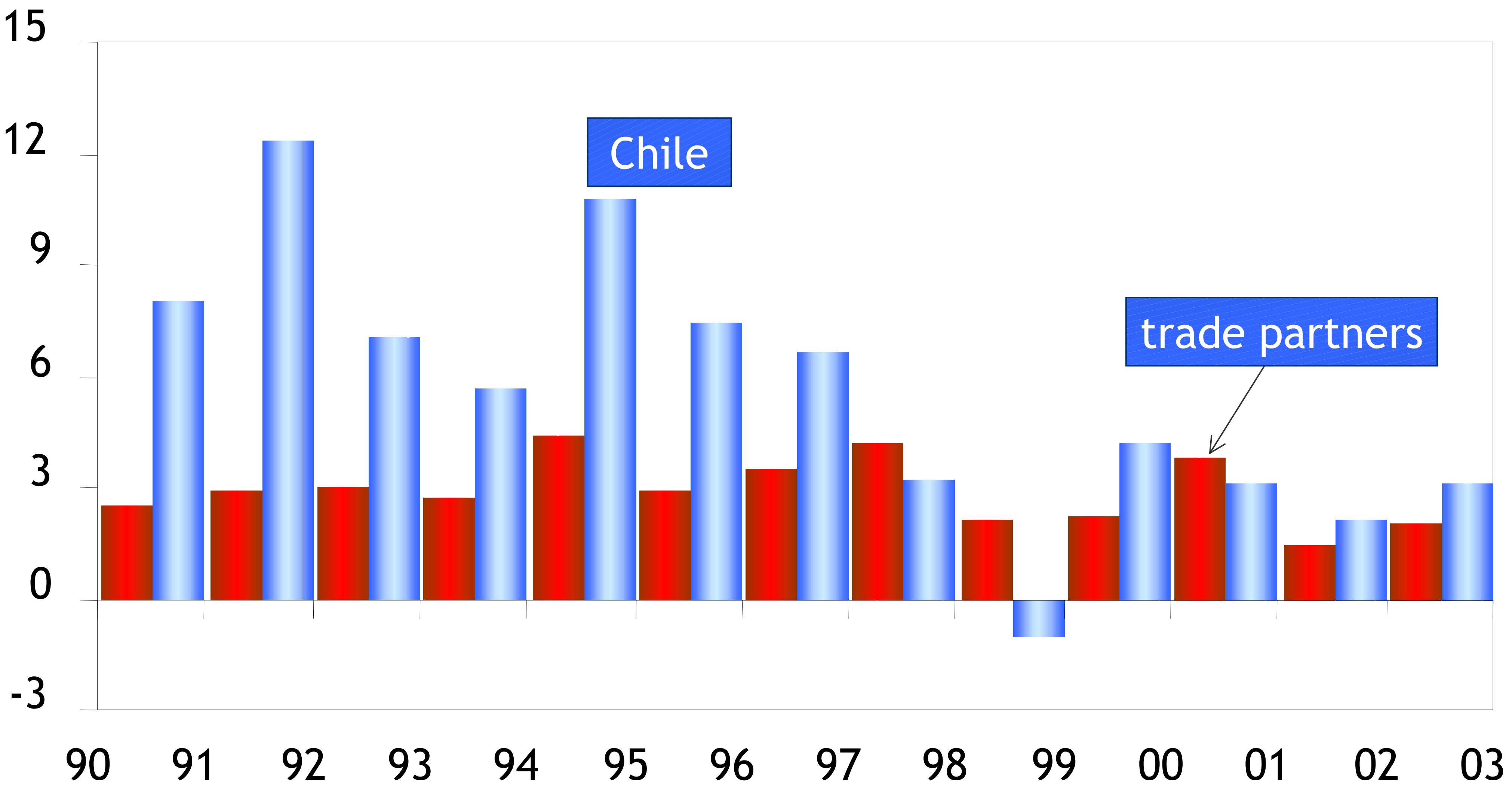


World Ouput Growth

	2003	2004f	2005f
World	3.5	4.7	4.2
USA	3.1	4.8	3.9
Europe	0.9	2.3	2.3
Japan	2.4	2.6	2.0
Rest of Asia	7.0	7.6	7.1
Latin Amercia	1.0	4.0	3.3
Chile´s trade partners	2.6	4.2	3.6

Source: Consensus Forecast and Investment Banks.

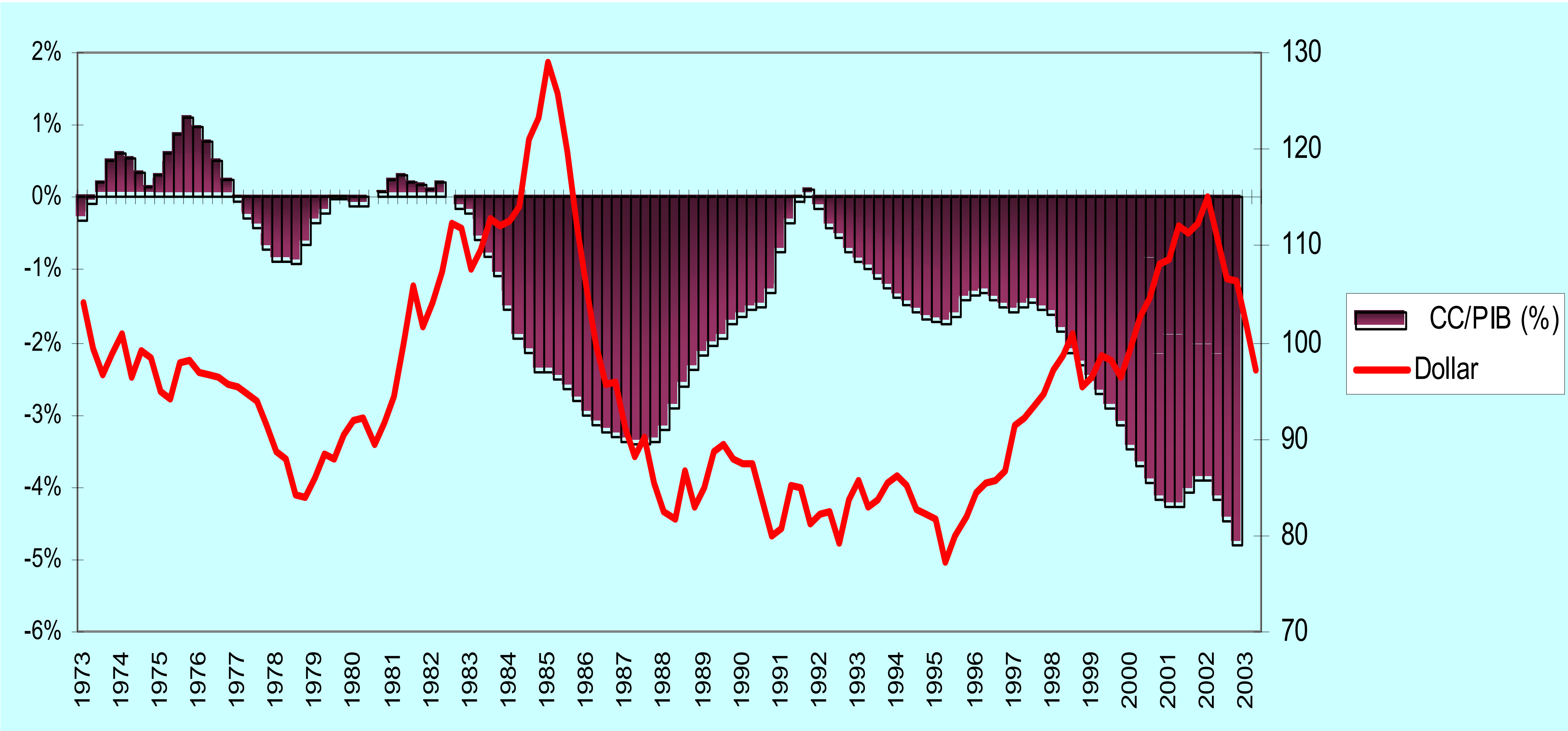
World Growth (%)



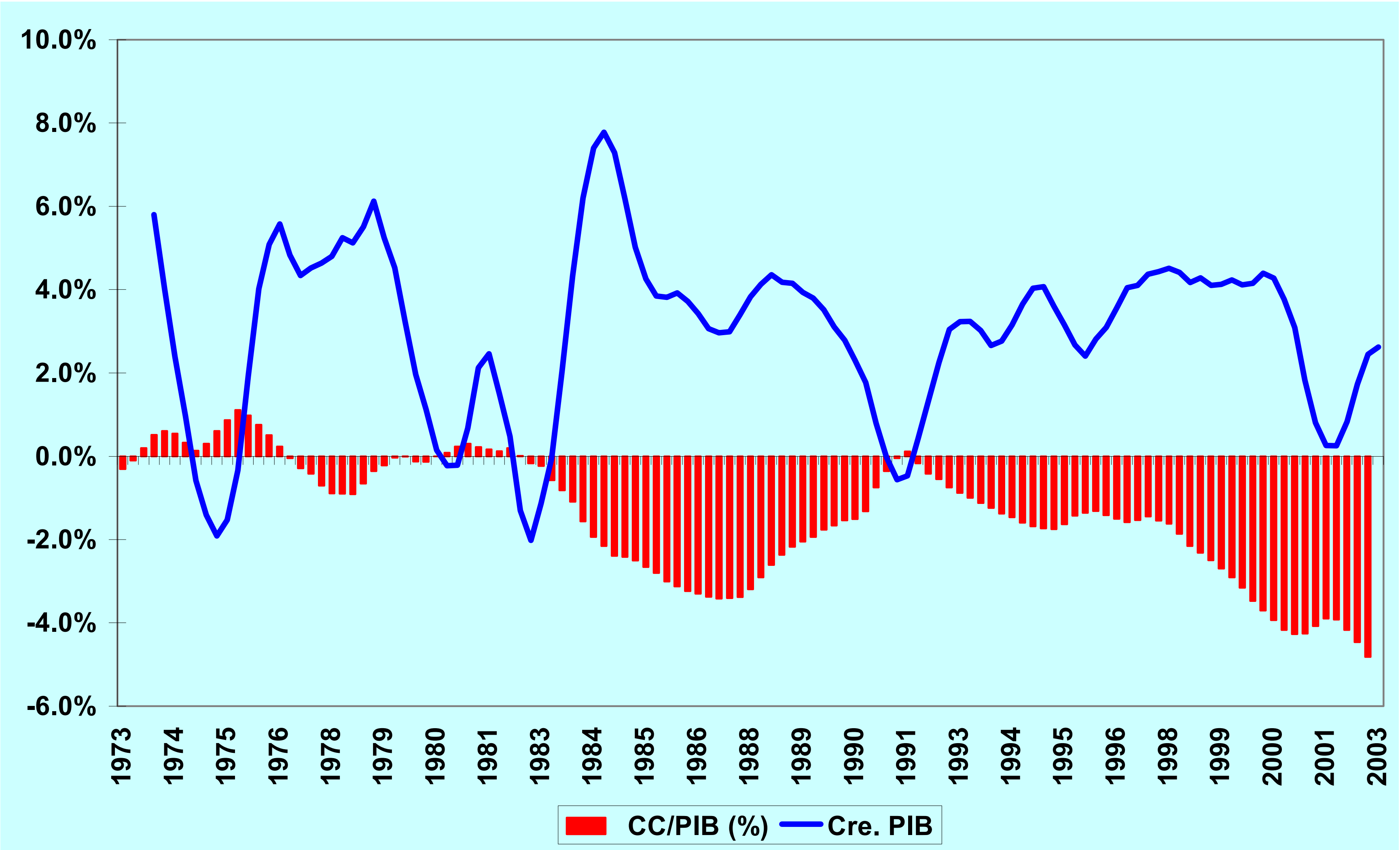
Main issues and risks in the global economy. Consequences for emerging markets

- Twin deficit in the US: Fiscal imbalances and current account deficit.
- Exchange and interest rates pressures..

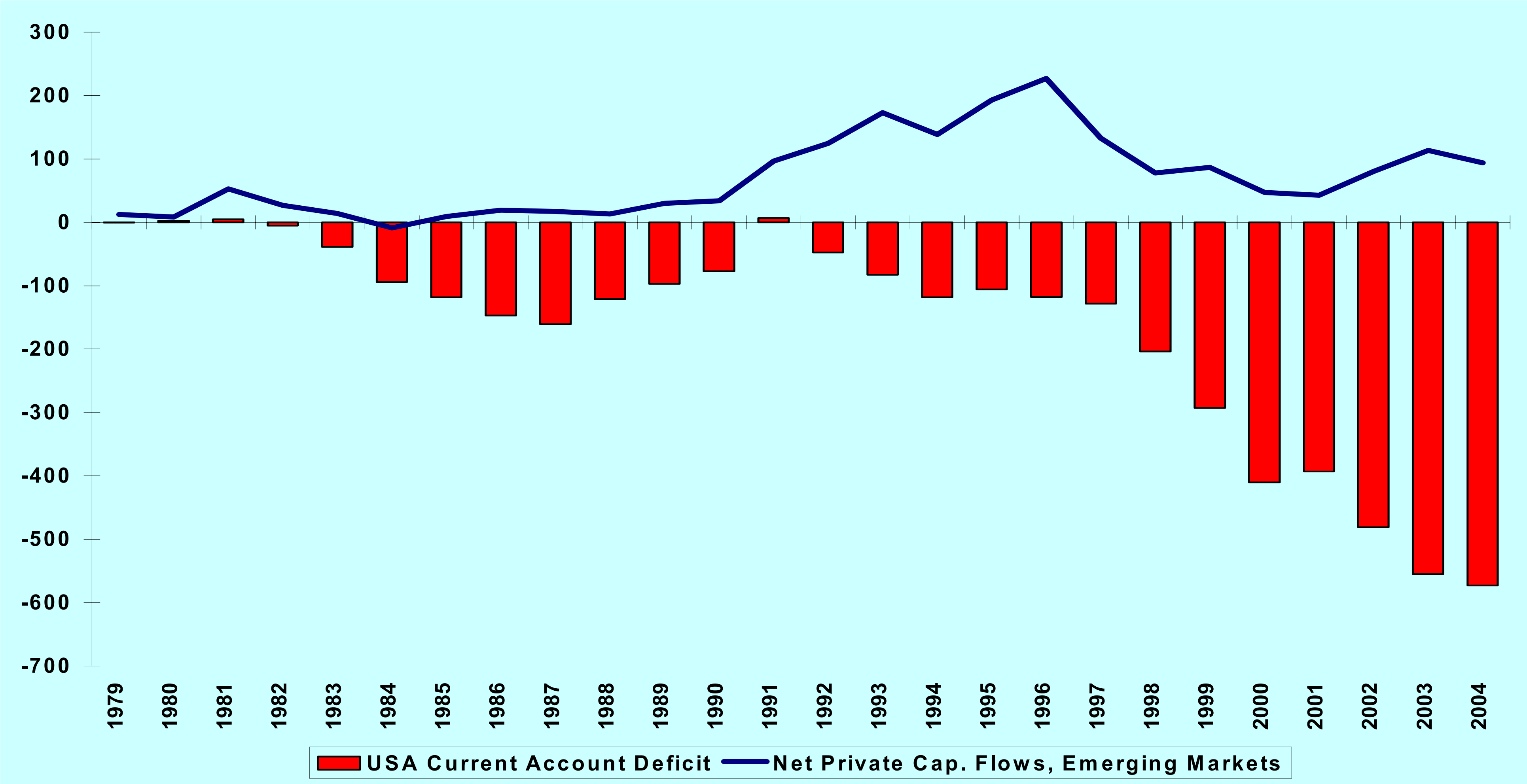
US Current Account and the Dollar



US: Current Account and GDP Growth



US Current Account Deficit and Capital Inflows to Emerging Markets (billion $)



Consequences of the Adjustment

- Increase in the availability of capital flows to emerging markets.
- Weakening of the US dollar and pressures in emerging markets competitiveness.
- Slowdown of growth in the USA.
- Interest rate risk, very bad news for highly indebted countries, serious risks on fiscal side.
- When? By 2005 and beyond. Its timing and intensity are uncertain.

Implications of the depreciation of the dollar

- Pressures on developing countries currencies, and appreciation may undermine resumption of growth.
- Higher international inflation in US dollars, although low domestic impact due to low pass-through.
- Increase in the price of commodities, good news for developing countries.
- Overall: the adjustment in the US is necessary, and if smooth is good news for the world economy. The main risk is on interest rates and slowdown.