

Latin America in a globalized world: challenges ahead

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Outline

1. Introduction
2. Latin American process to globalization
3. Reaping the benefits of globalization: The pending agenda
4. Globalization, inflation and monetary policy
5. Concluding remarks



1. Introduction

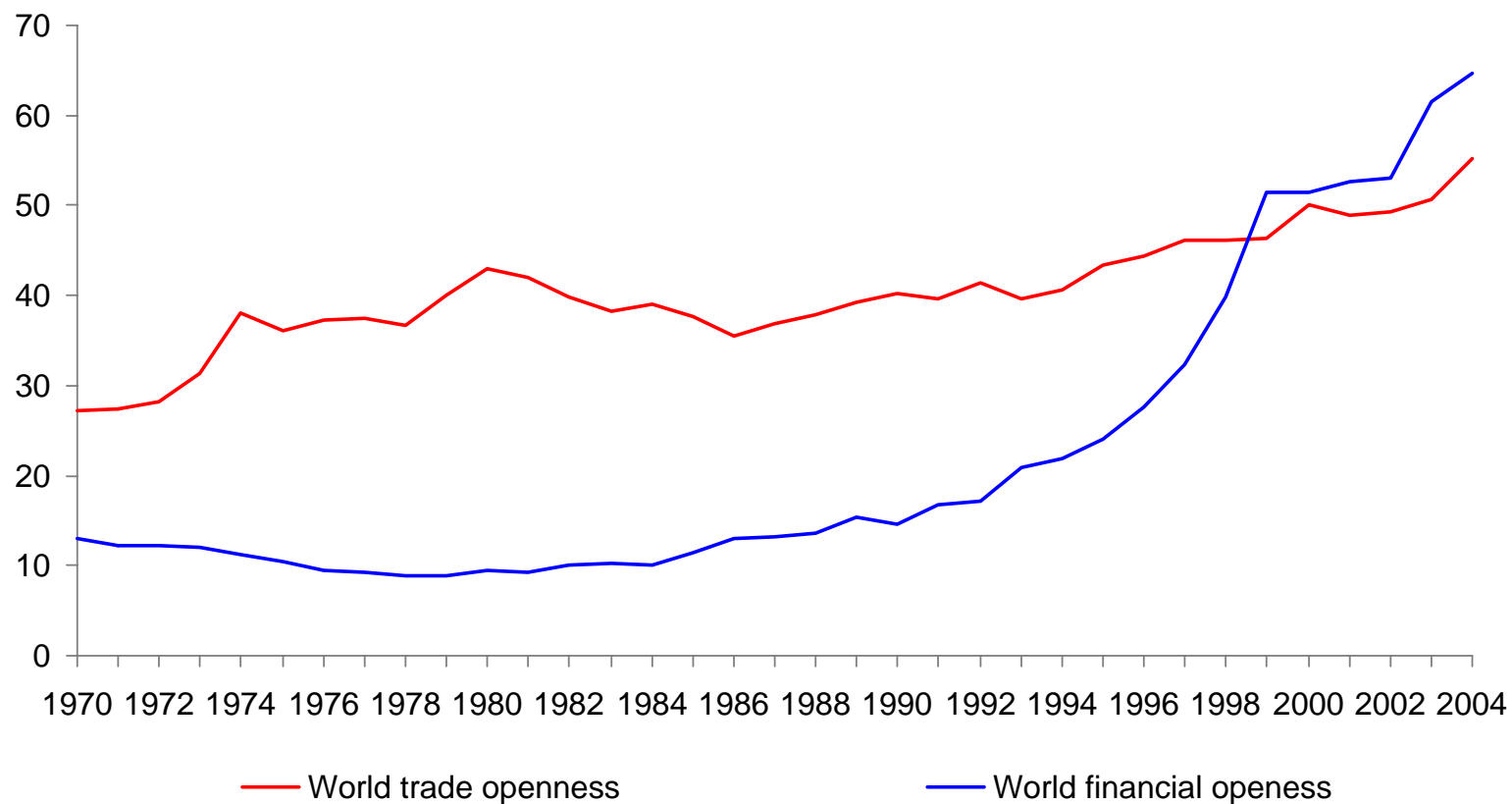


Globalization

- Dominant phenomenon in the last three decades (not new, however increasing).
 - Commercial and financial integration;
- Globalization has been facilitated by:
 - Information and communication revolution with reduction in transport, information and telecommunication costs;
 - Policy shifts in various countries:
 - Integration into world economy of other emerging economies (China, South Asia and former Soviet-bloc states).
- Globalization has enabled countries to accelerate growth and improve standard of living.



World financial and trade openness (% GDP)



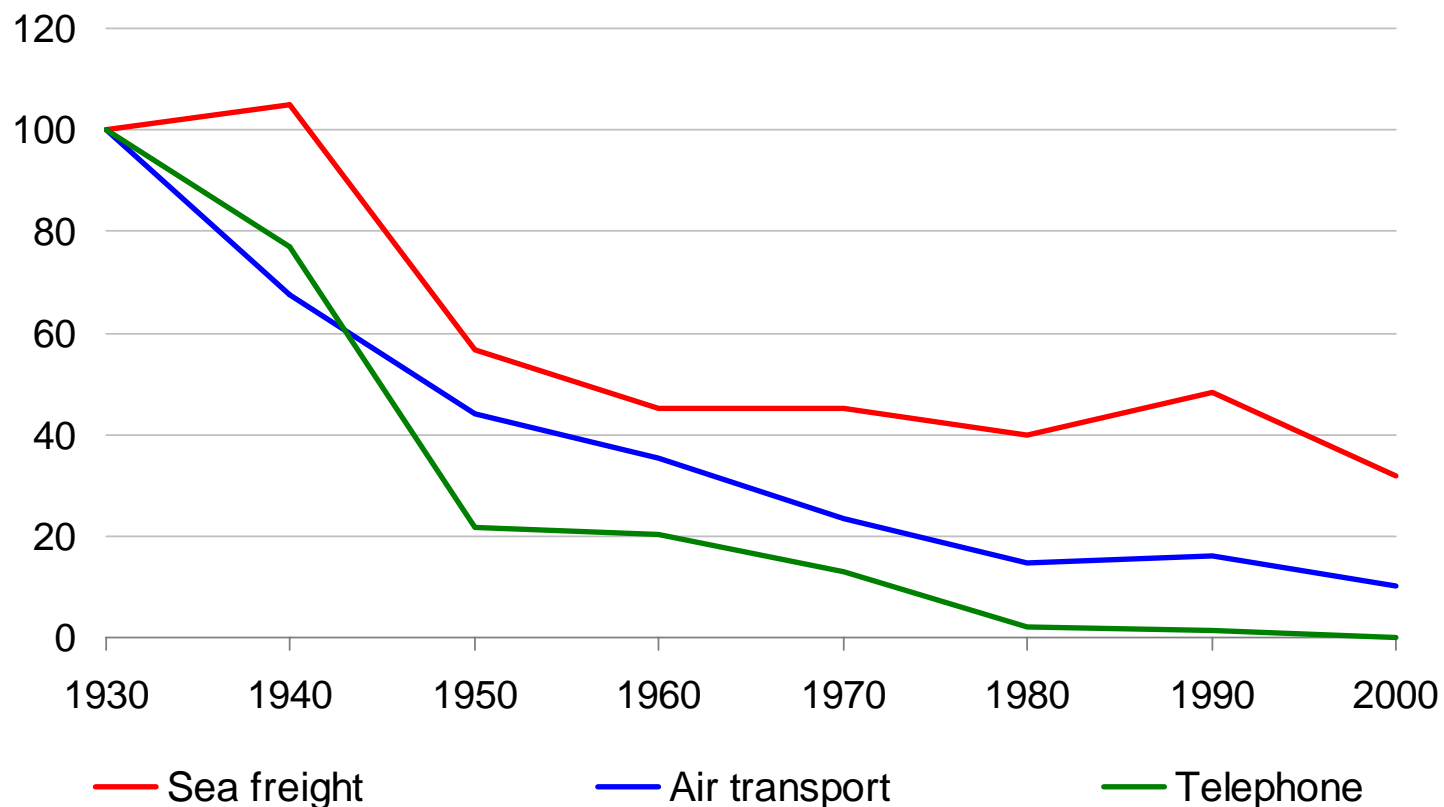
Note: Trade openness measured as the sum of exports and imports in percent of GDP. Financial openness measured as the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment in percent of GDP.

Sources: *World Bank*, *IMF*, Lane, Philip and Gian Maria Milesi-Ferretti (2006).



Transport and communication costs

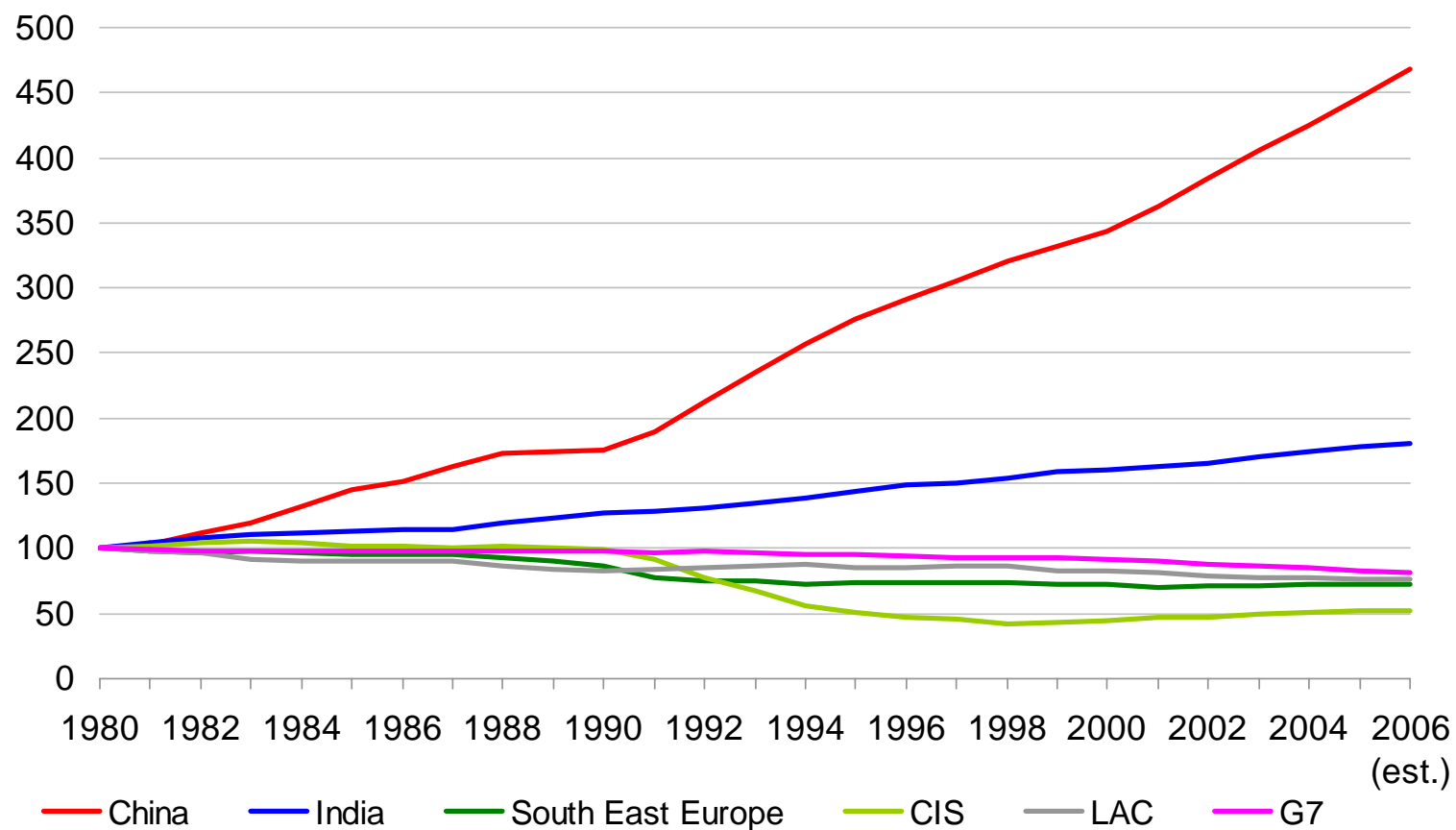
(index 1930 = 100)



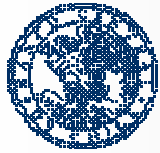
Note: Sea freight considers the average ocean freight and port charges per short ton of import and export cargo. Air transport is the average cost of air transport per passenger mile and telephone is the cost of a 3 minute telephone call New York to London. Source: Busse (2003).



GDP based PPP share of world total (1980=100)

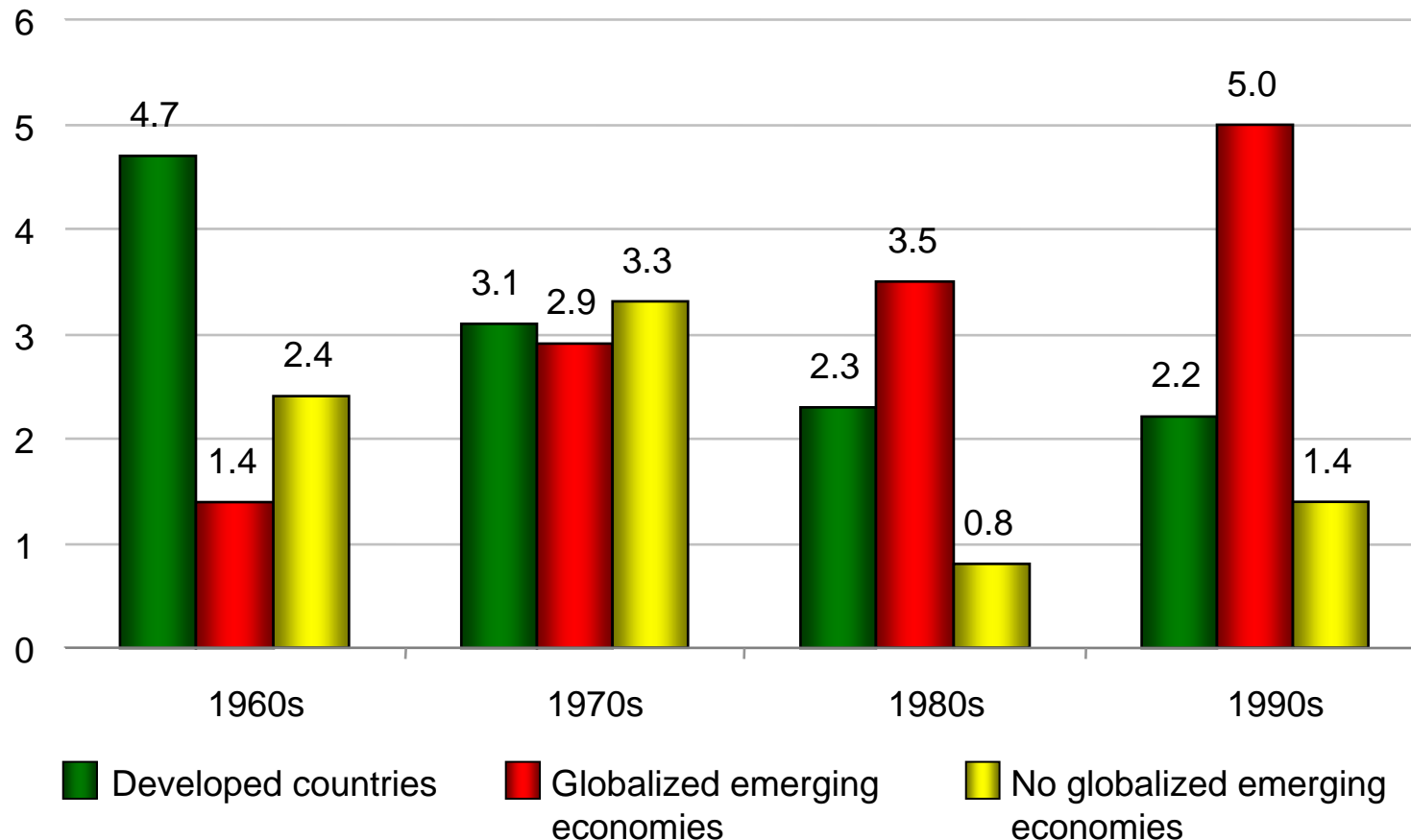


Source: WEO (2006).



Economic growth and integration

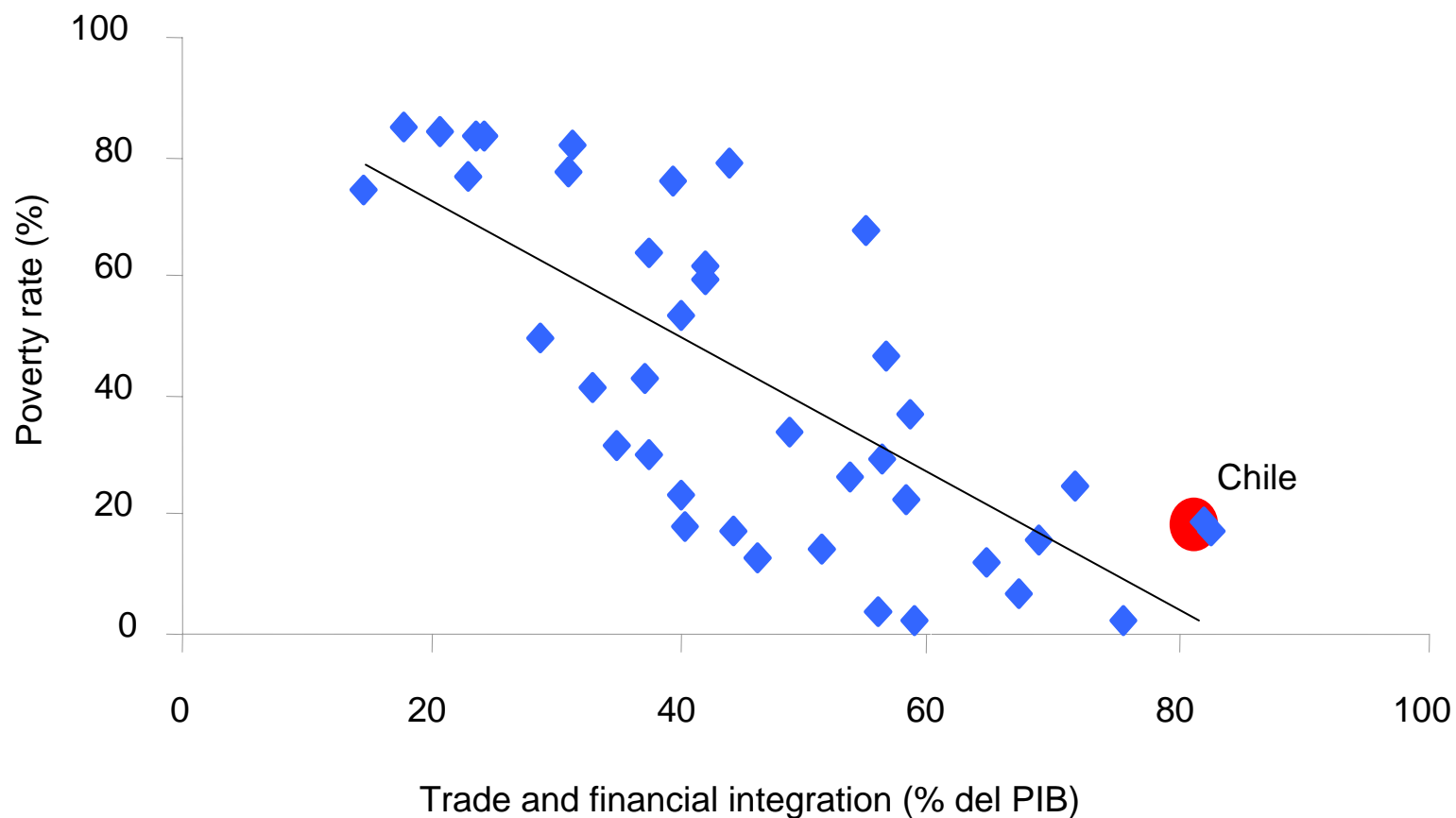
(average on indicated period,%)



Note: Globalized emerging economies consider 24 countries that have experienced an important trade openness since 1980. Source: Dollar (2004).



Integration and poverty (2002)

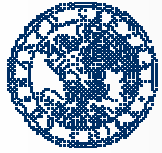


Source: Own estimation.



Benefits and cost of globalization

- Globalization allows a more efficient resource allocation, technology transfer, investment financing, smoothing of national income fluctuations and diversification of portfolio assets risk, among others.
- In turn a larger exposure to international market conditions results in:
 - Domestic output and consumption more dependent on foreign supply and demand conditions;
 - Increased link between long-term domestic interest rates and international interest rates.



Benefits and cost of globalization

- Thus, commodity price fluctuations, international interest rates movements or sudden stops of capital flows have greater impact on domestic markets, increasing the exposure to external shocks;
 - Prudent policies and appropriate institutions are required to mitigate them.

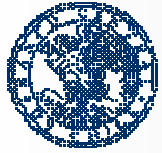


Other features of globalization

- Technological innovation and increased entrance of new labor force has put downward pressure on compensation of low-skilled workers.
- Transmission channel of monetary policy to inflation has changed, affecting the way MP is conducted.
- Redistributive effects has to be considered and managed.



2. Latin American process to globalization



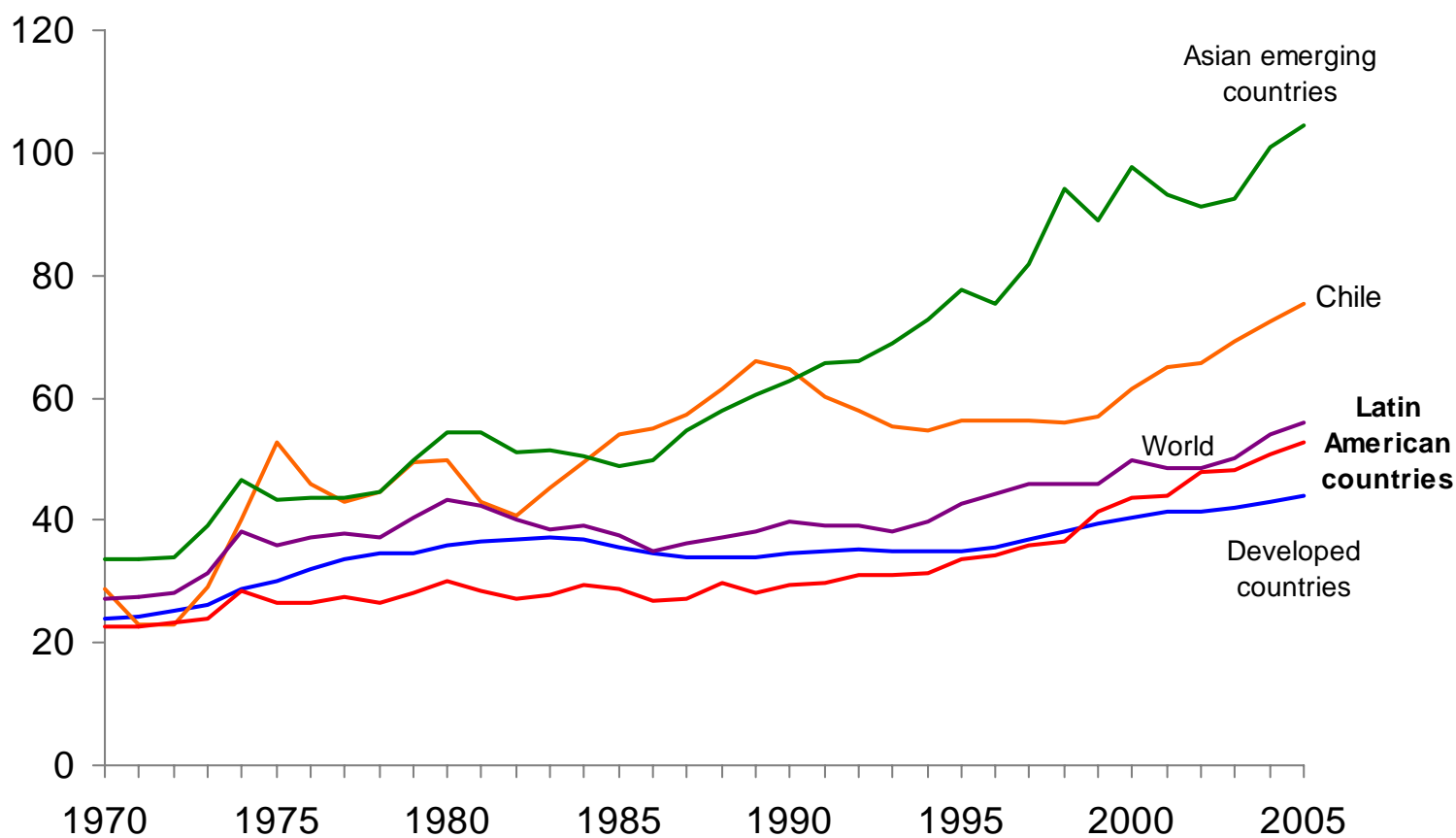
Macroeconomic reforms of 1980s

- Latin America as a player in the global world is not new:
 - Integration process took place after 1980 debt crisis;
 - Complemented by structural reforms.
- Priority was given to trade integration and financial liberalization.
- Saving-investment correlation decreased and domestic real interest rates converged to international rates.



Trade openness

(% GDP, 1970-2005)

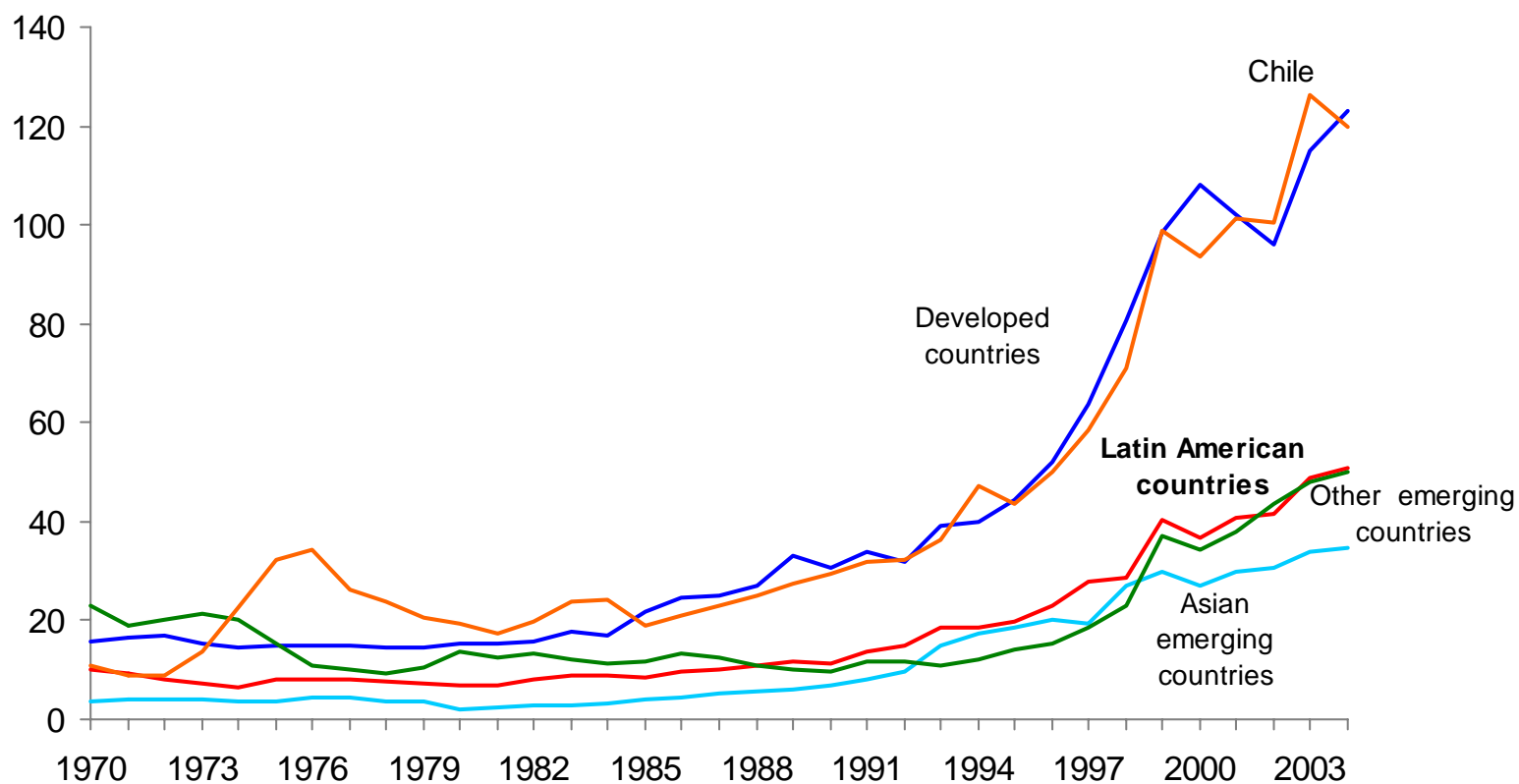


Note: Measured as the sum of exports and imports in percent of GDP.

Sources: World Bank and IMF.



Financial openness (% GDP, 1970-2004)

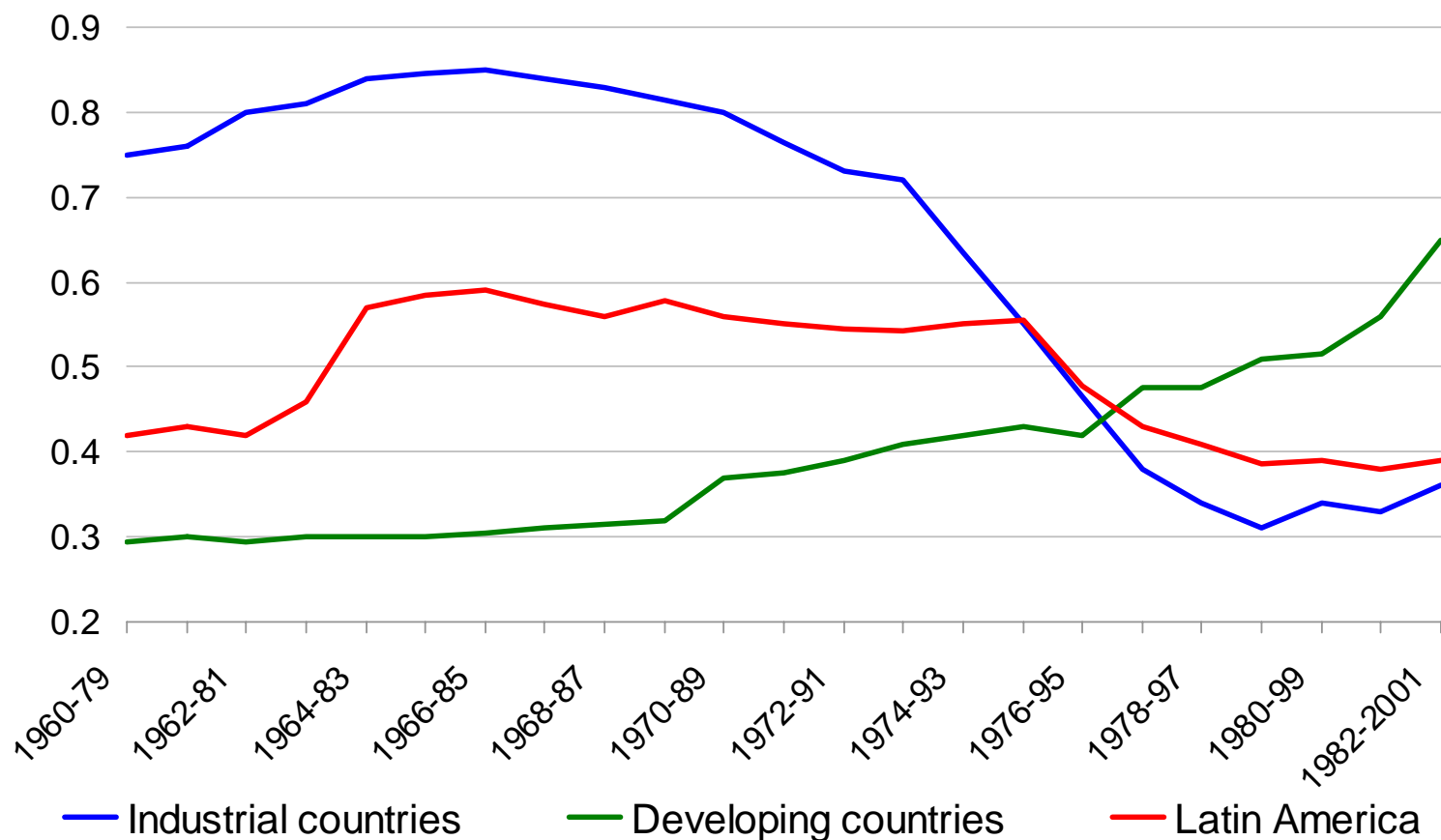


Note: Measured as the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment in percent of GDP.

Sources: Lane, Philip and Gian Maria Milesi-Ferretti (2006) and IMF.

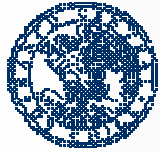


Saving-Investment correlations (1960-2001)



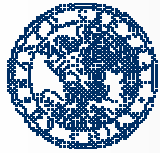
Note: Measured as 20-year rolling correlations.

Source: Calderón and Schmidt-Hebbel (2003).

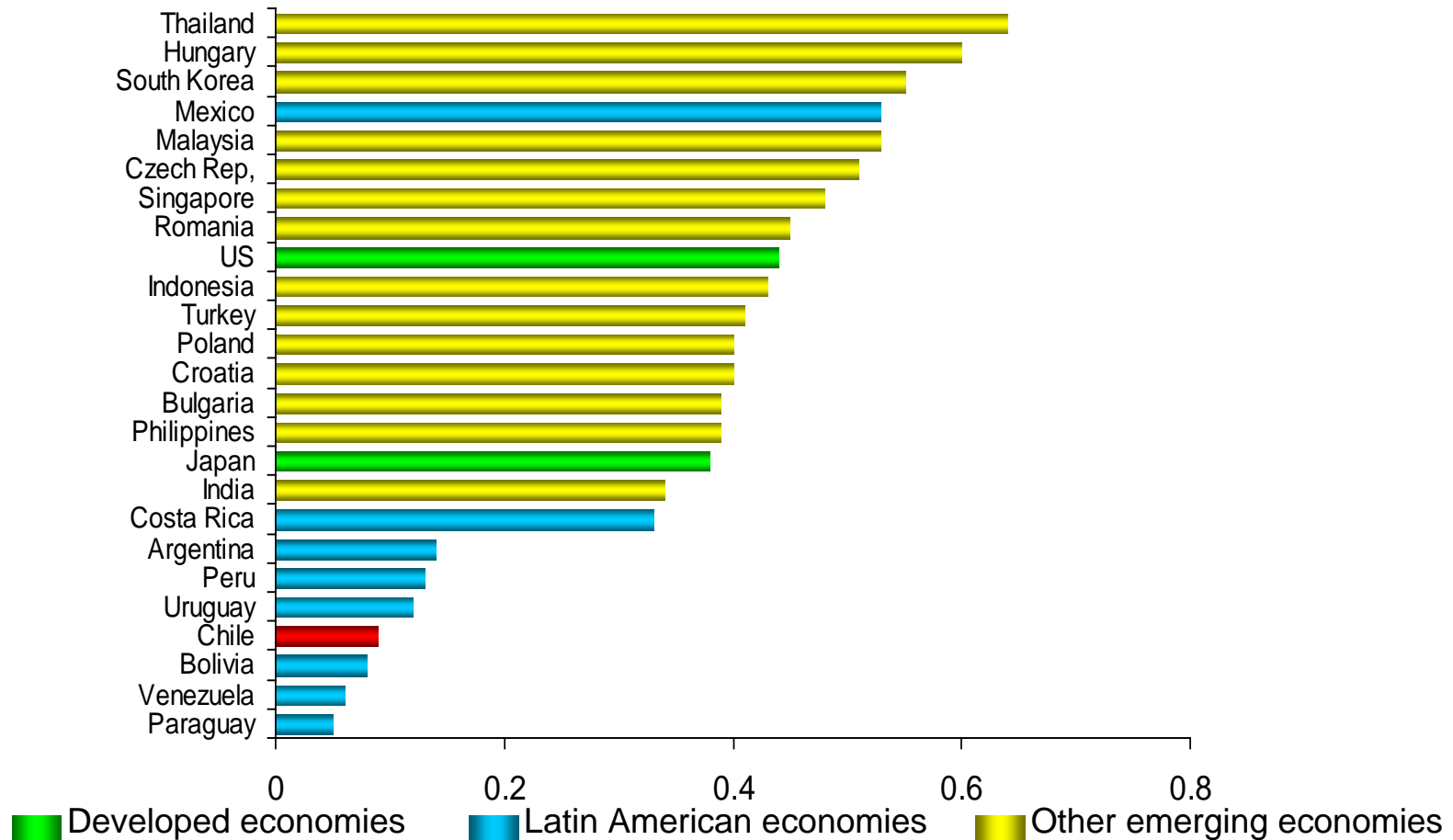


Trade competition effect

- One of the concerns of the integration strategy and the entrance of China and India into world markets is the impact of trade competition with Latin American exports.
- However, trade competition is mild:
 - Except for Mexico, with a very similar trade structure.
 - But, its export structure could change: Singapore and South Korea are already changing their exporting structure, reducing their exports of manufactured goods, machinery and transport equipment.
 - Mexico also has been adjusting and has a structural competitive advantage: its geographical closeness to the U.S.



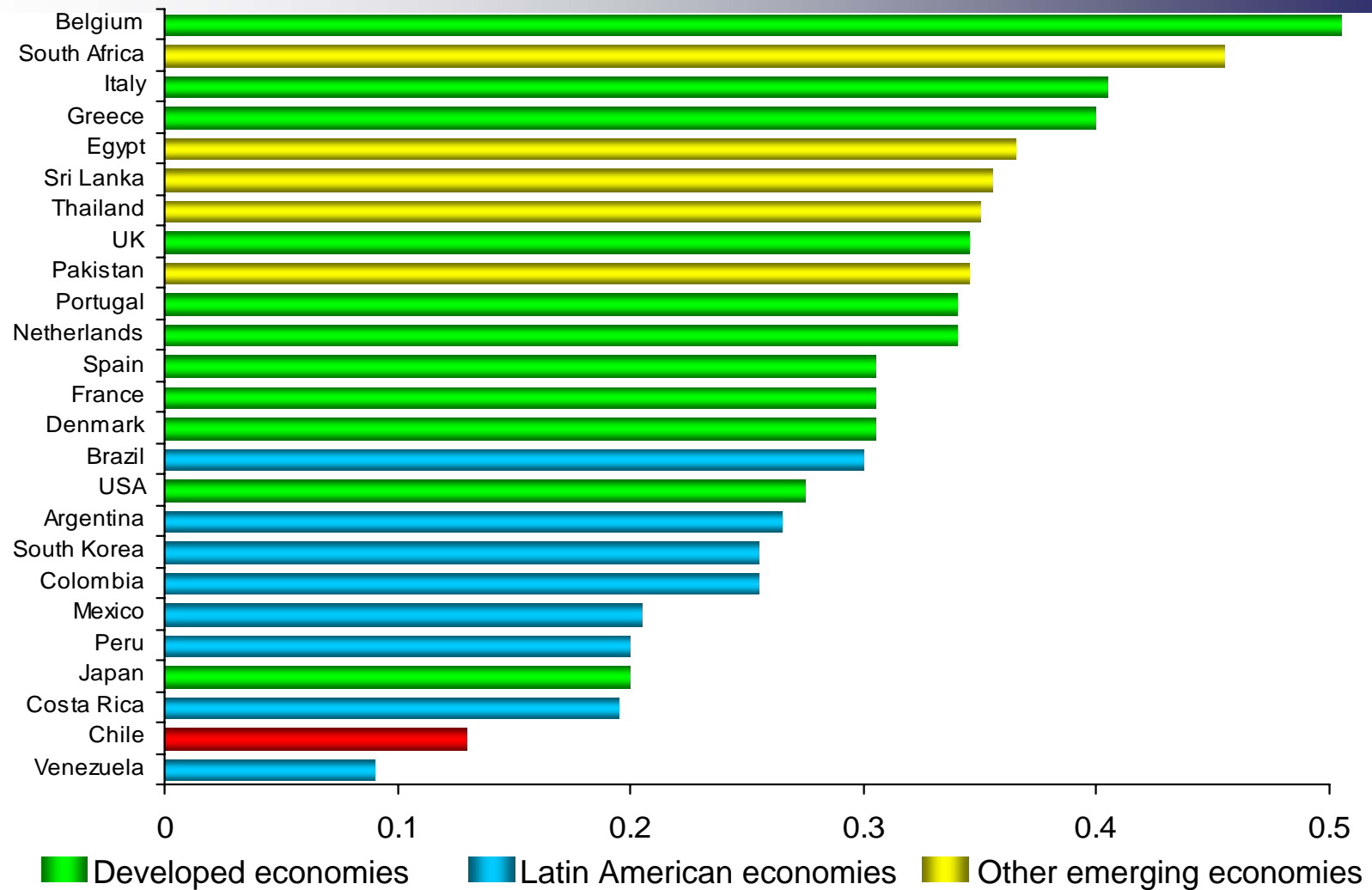
Chinese Trade Competition Index



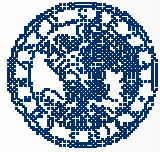
Note: Comparizon of exporting and importing structures of 34 countries (15 in Latin America) during 1998-2004. Index of 1 means that the country has an equal export structure compared with China, thus facing great competition. Source: Blazquez-Lidoy, Rodriguez and Santiso (2006).



Indian Trade Competition Index



Source: Qureshi and Wan (2006).

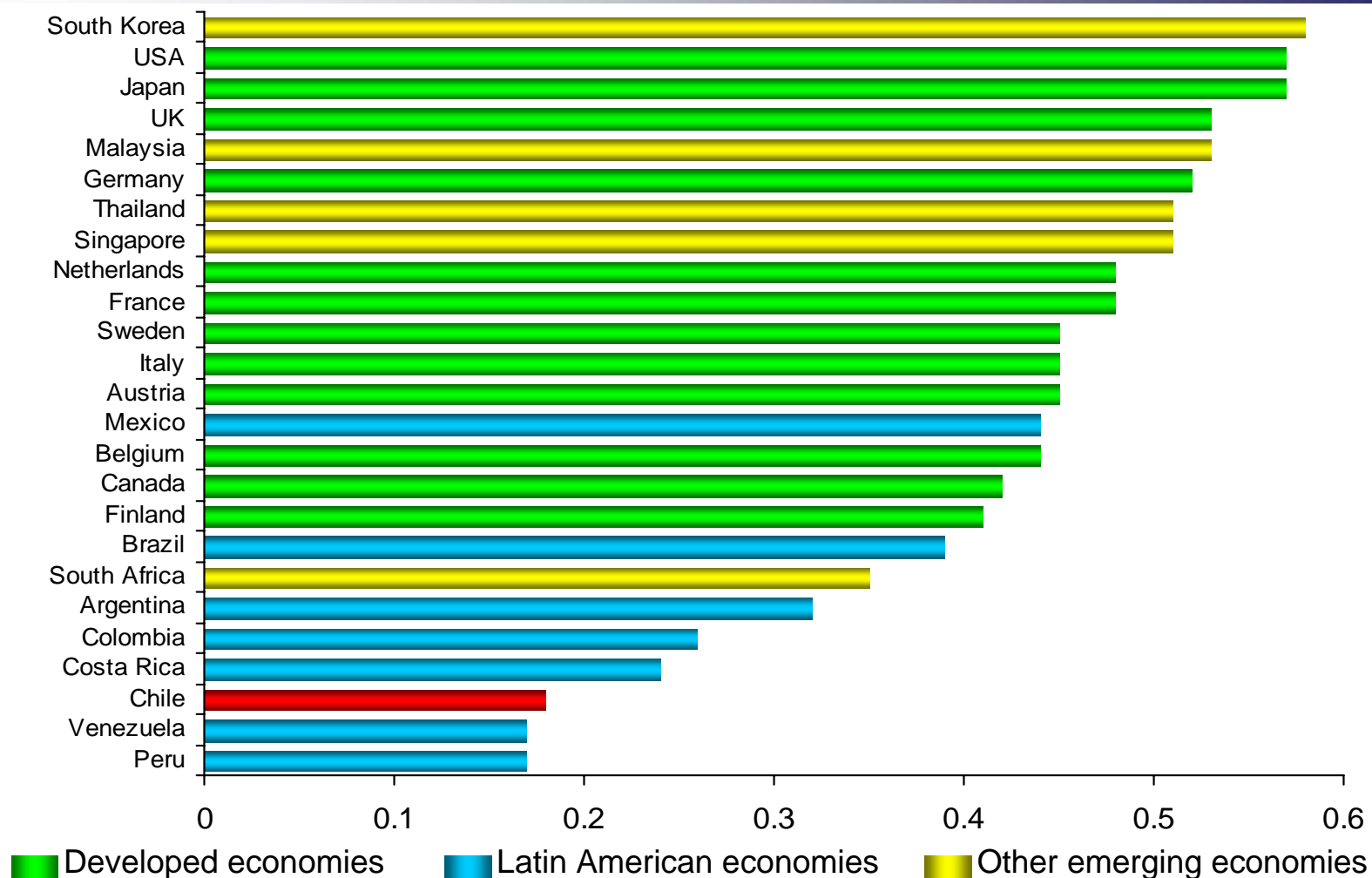


Potential trade gains

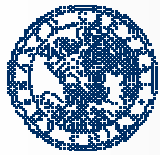
- Commodities exporters face low competition since China and India are net importers of raw materials.
- In 2005, China was the world's largest importer of cotton, copper and soybean, and the third largest importer of oil.
- Great opportunity for Latin American countries because of its potential exporting market.
- However, measured trade complementarities and potential trade gains are also low.



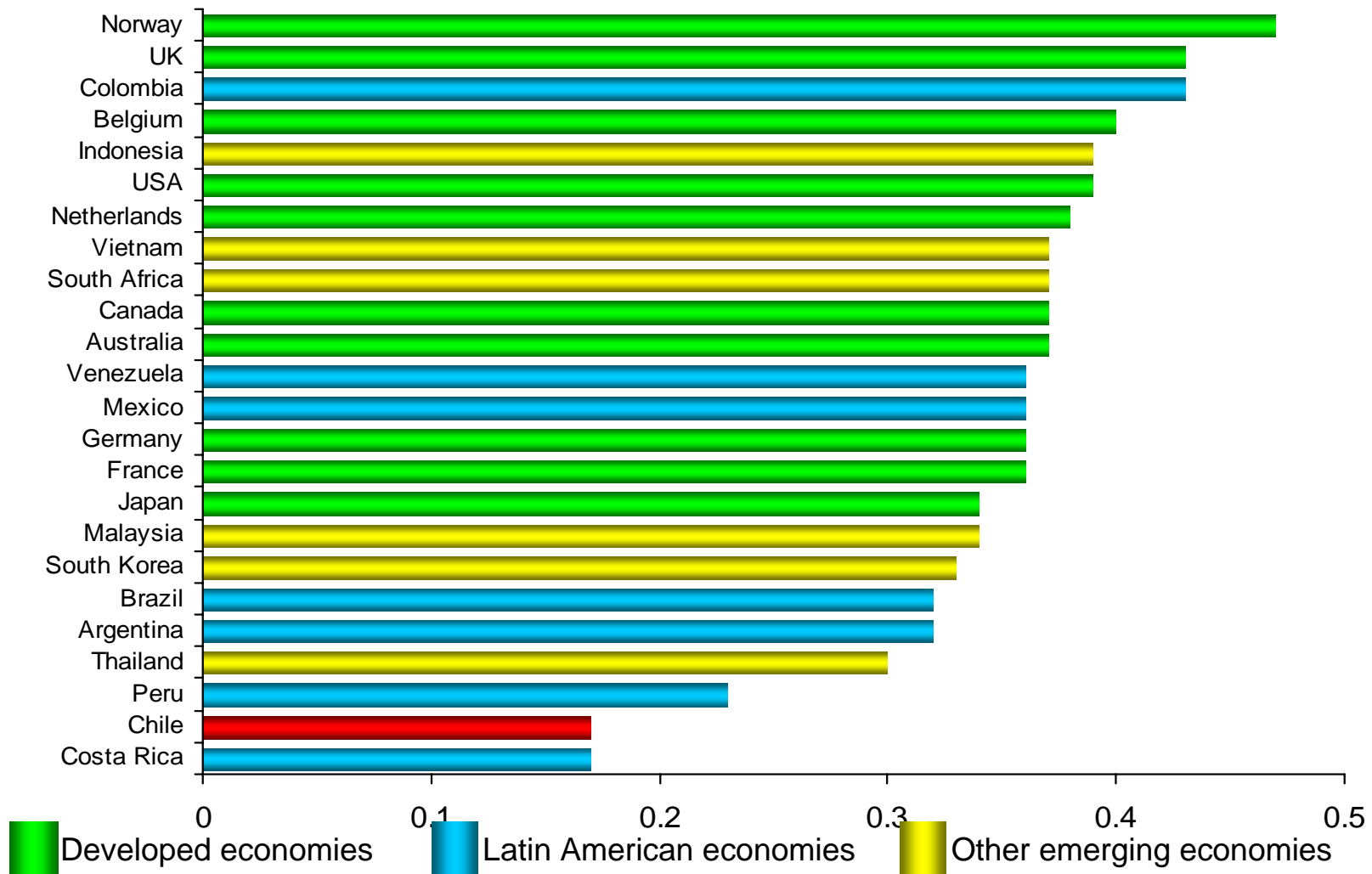
Chinese Trade Complementarity Index



Source: Qureshi and Wan (2006).



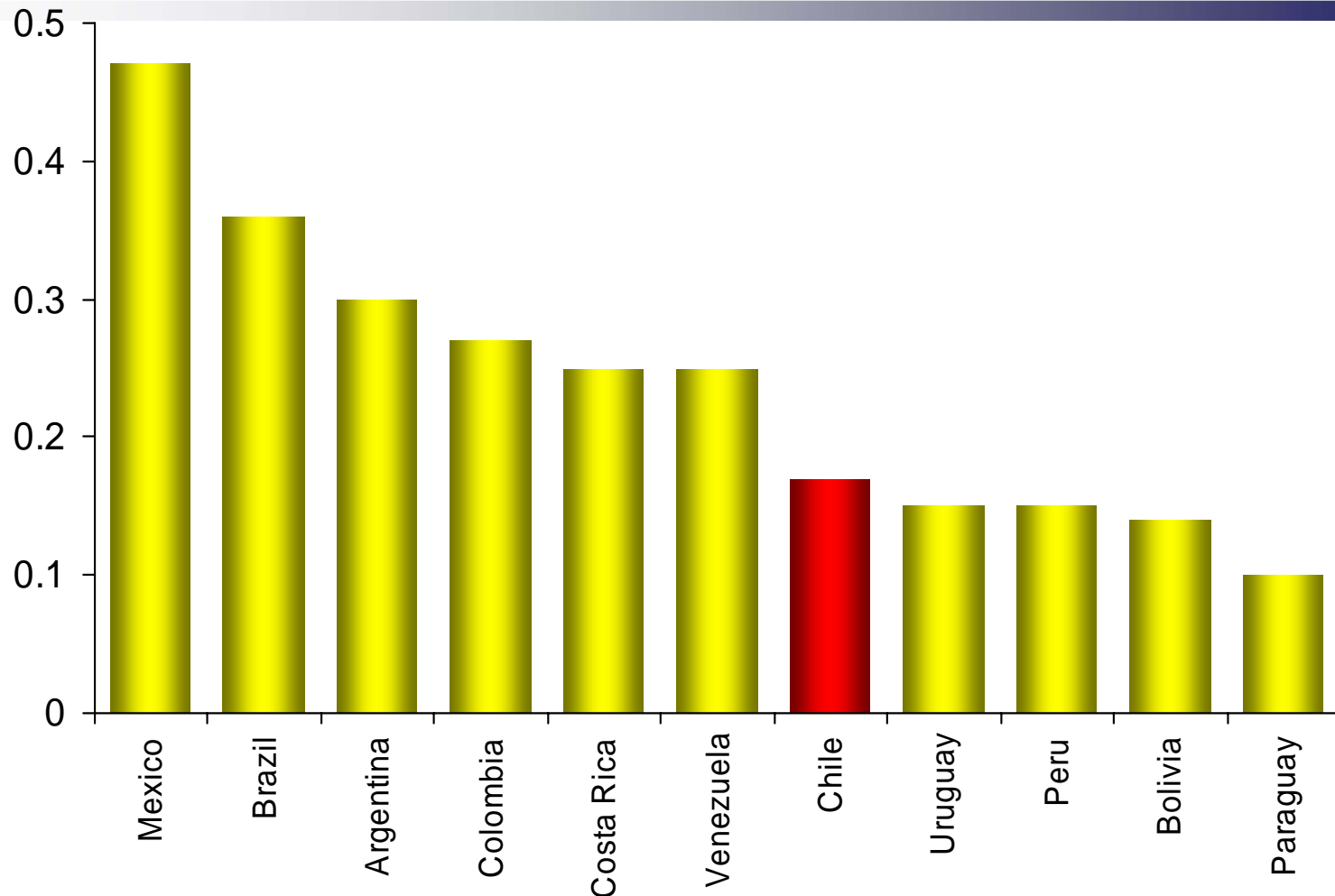
Indian Trade Complementarity Index



Source: Qureshi and Wan (2006).



Latin America's Potential Trade Gains



Source: Santiso (2006). Index of potential trade gains compares export structure of Latin American economies with import structure of China. The index is zero when no goods are exported by one country or imported by the other and 1 when the export and import shares are a perfect match.



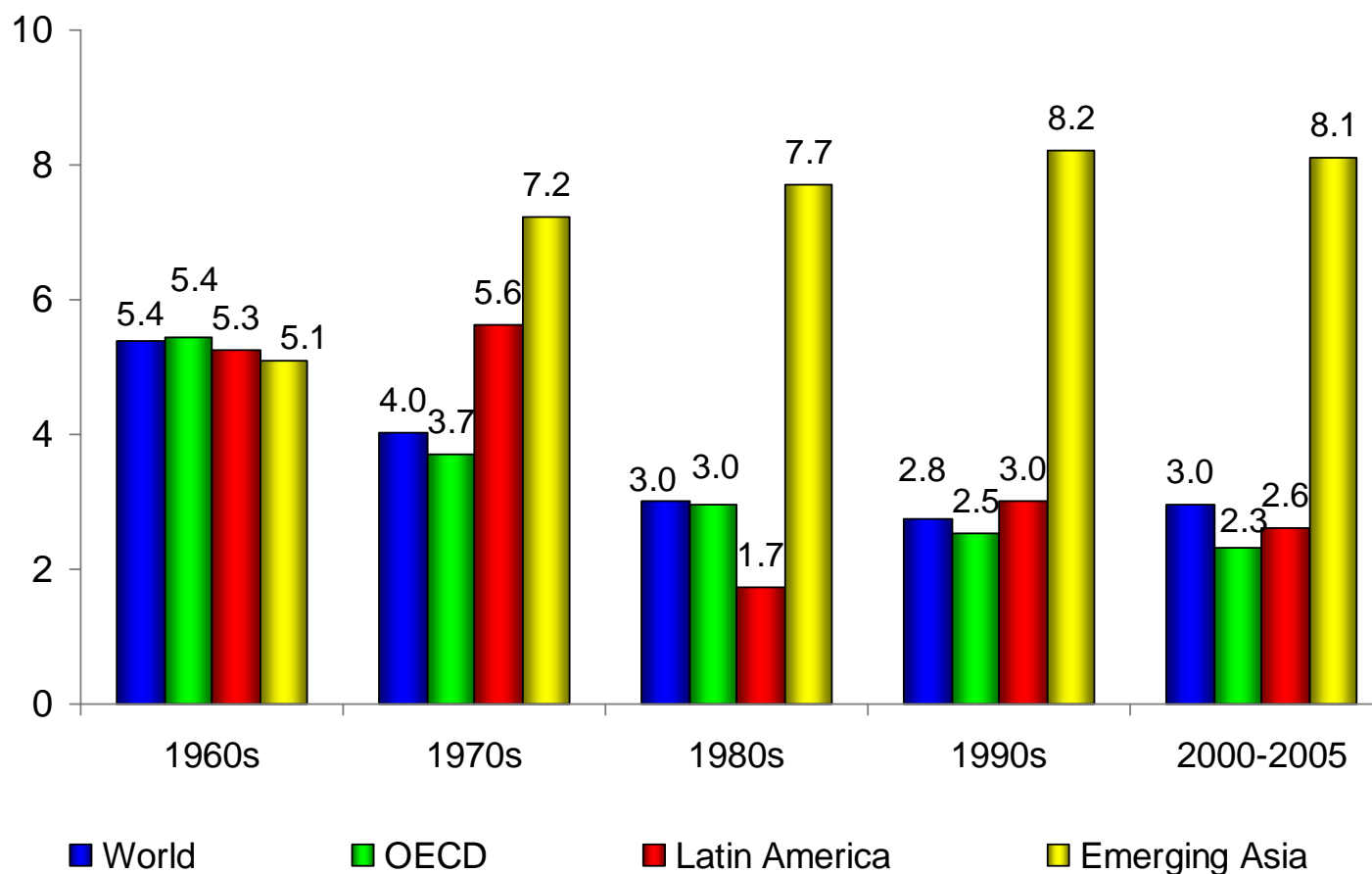
Disappointing results

- Despite reforms, results were disappointing:
 - Growth remained low and volatile, specially compared to East Asia.
 - Widening income gaps with G-7, macroeconomic crises, modest poverty alleviation and worsening income inequality.
- Macroeconomic stability was not fully achieved:
 - Inflation still high in some countries;
 - Pro-cyclical fiscal policy especially in countries with high budget rigidities;
 - Fiscal weakness led to high debt ratios.



Economic growth

(average on indicated period, %)

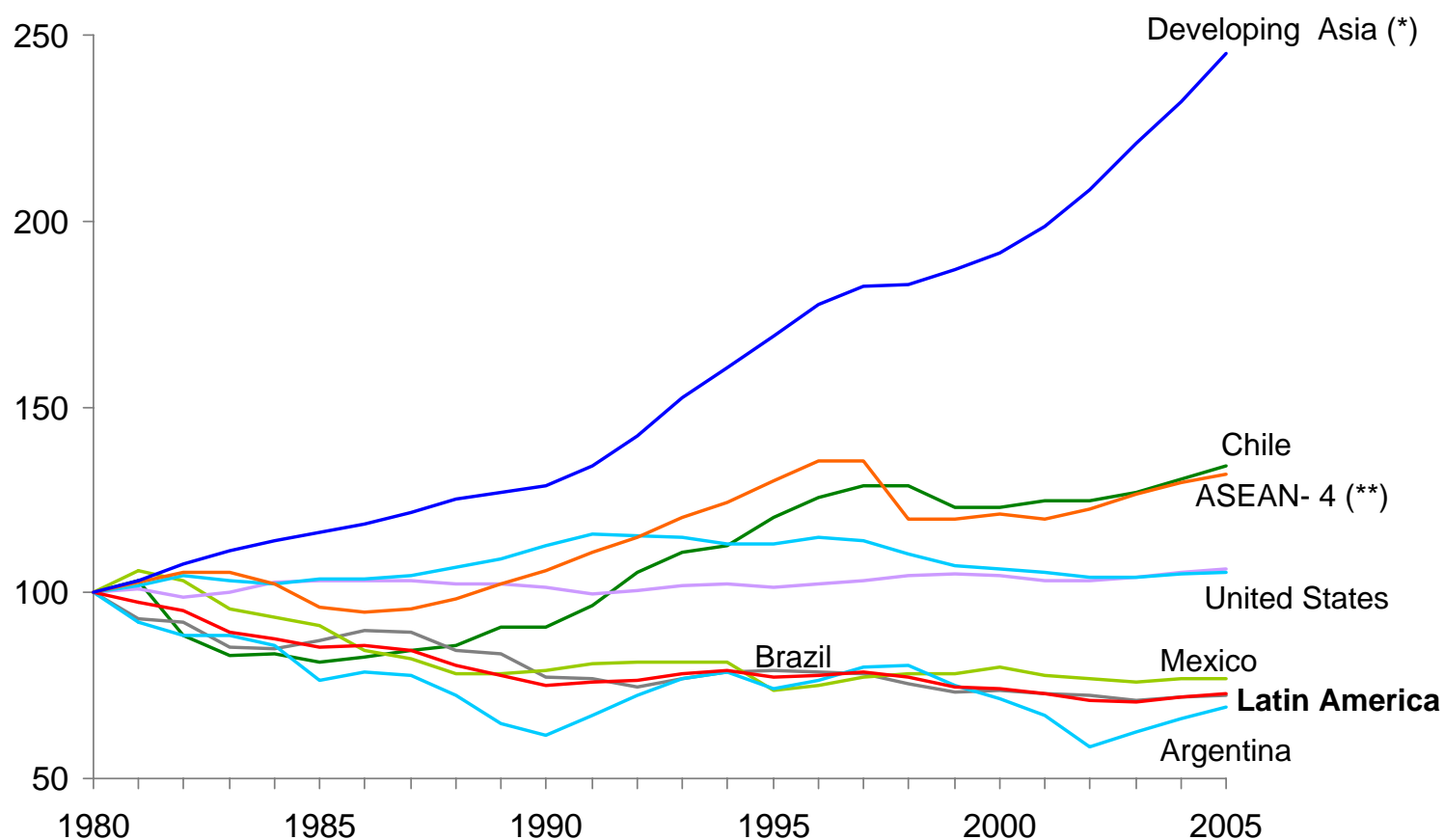


Source: Word Bank.



Relative Per Capita Output

(per capita GDP over per capita GDP of G-7, PPP; 1980=100)



(*) Includes China and India (**) Considers Malaysia, Indonesia, Thailand and Philippines.

Source: Own calculation.



Inflation

(%)

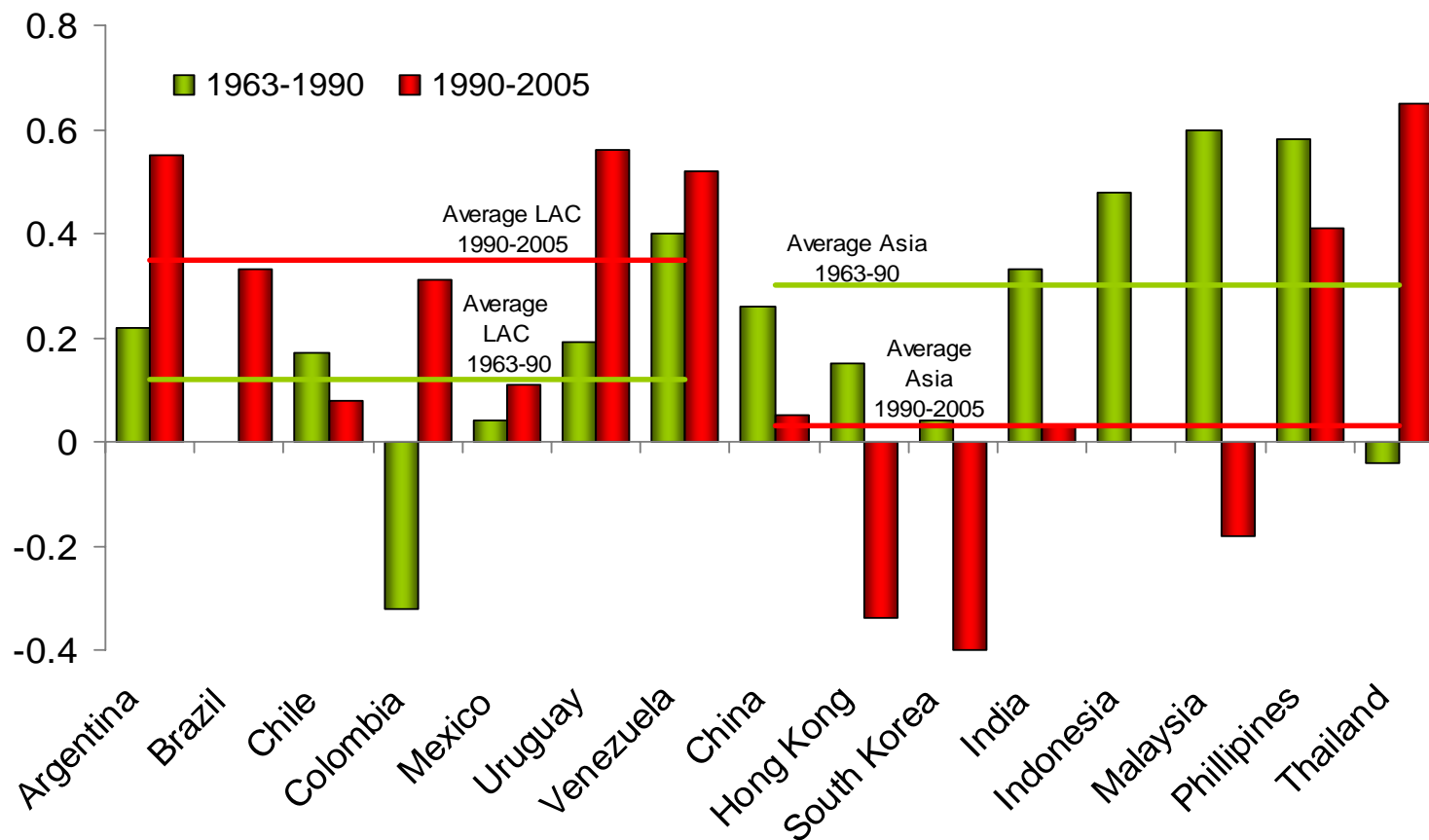
	1980-84	1985-89	1990-94	1995-99	2000-05	2006 (est.)
Argentina	268.1	863.2	505.0	0.8	8.6	12.3
Bolivia	351.9	2413.7	13.6	7.4	3.4	4.1
Brazil	132.4	532.2	1690.2	19.4	8.4	4.5
Chile	22.4	20.4	17.5	6.0	2.8	3.5
Colombia	22.7	24.0	26.3	18.0	6.9	4.7
Ecuador	25.1	42.9	44.8	33.2	26.5	3.2
El Salvador	13.7	23.3	15.9	5.4	3.1	4.1
Mexico	56.1	82.0	16.3	24.5	5.7	3.5
Peru	84.1	878.5	1607.4	8.4	2.3	2.4
Uruguay	44.2	71.0	76.4	21.4	9.4	5.9
Venezuela	13.1	33.0	41.0	53.8	20.0	12.1
Average LAC	88.3	213.1	264.2	17.1	7.6	5.6
ASEAN- 4 (*)	12.3	6.1	7.7	11.6	5.4	8.6
G7	7.8	3.2	3.4	1.8	1.9	2.6
World	14.5	16.2	29.2	7.9	3.8	3.8

(*) Indonesia, Malaysia, Philippines and Thailand.

Source: IMF.



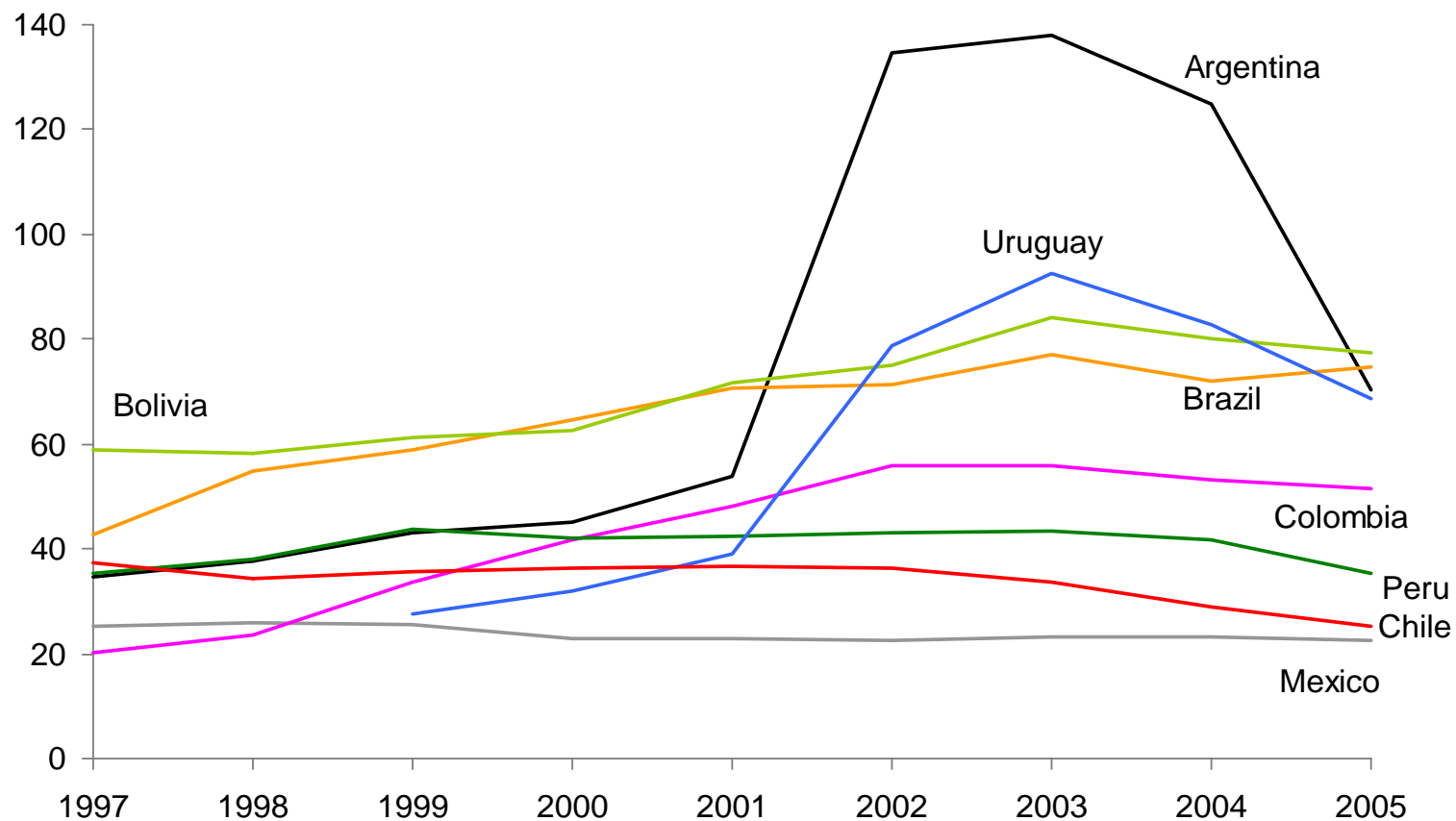
Procyclicality of Fiscal Policy



Note: Measured as the correlation between cyclical components (based on the Hodrick-Prescott filter) of real government spending (Central Government expenditure deflated by the GDP deflator) and GDP growth. A positive correlation is evidence of a pro-cyclical fiscal policy. Source: Singh and Cerisola (2006).

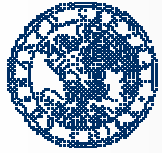


Public debt in Latin America (% GDP)



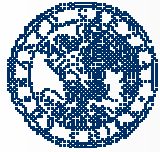
Note: Considers General Government Debt.

Sources: *Moody's* and Central Bank of Chile.



Progress to macro stability

- Only in recent years, macroeconomic stability has improved:
 - Balanced primary fiscal surplus;
 - More flexible exchange rate systems;
 - Implementation of IT monetary policy regimes, with declining inflation.
- The favorable financing environment enhanced the process and was used to prefinance external needs, improving debt structures and accumulating reserves.

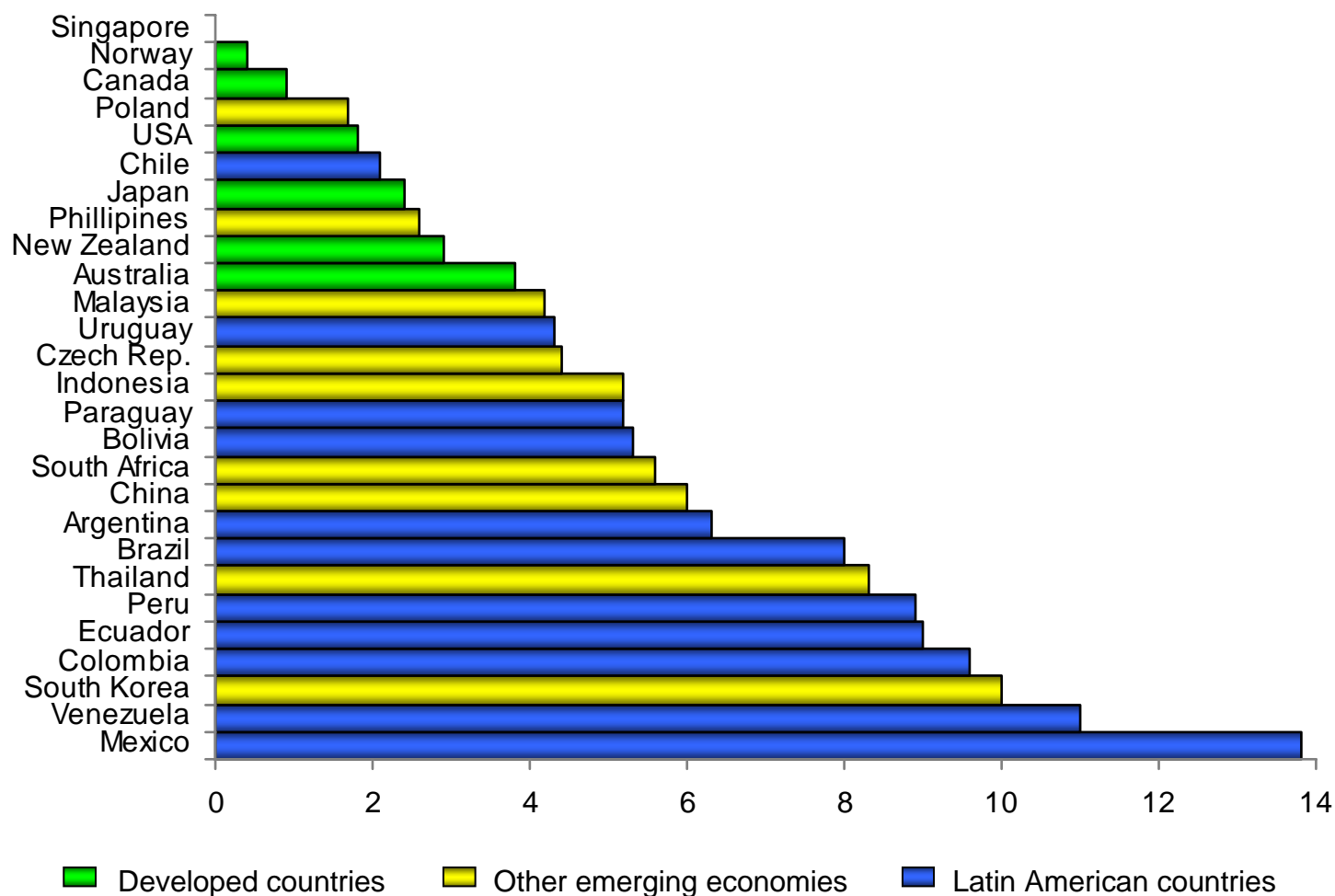


Incomplete integration

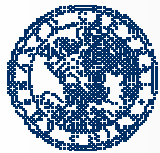
- But still trade openness is incomplete :
 - Trade barriers prevail and import tariffs are high;
 - Trade openness has been below world average and far behind Asia emerging countries.
- Financial liberalization was based on inadequate regulatory, supervisory and institutional framework.
 - Financial crisis have been painful, and capital has only modestly returned after the crises.



Average import tariff (%)

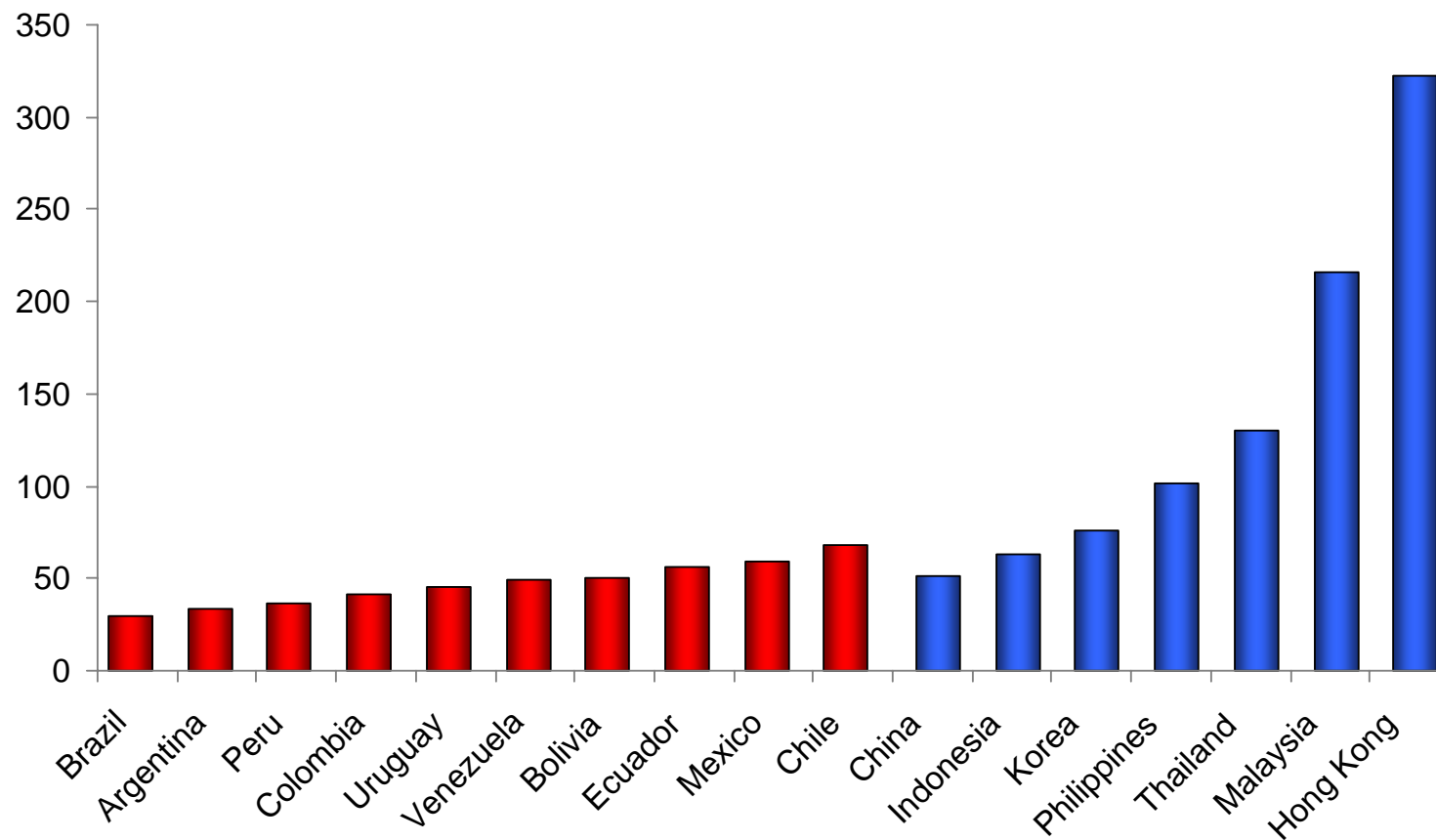


Source: World Bank (2005).



Trade

(average 2000-2005, % GDP)

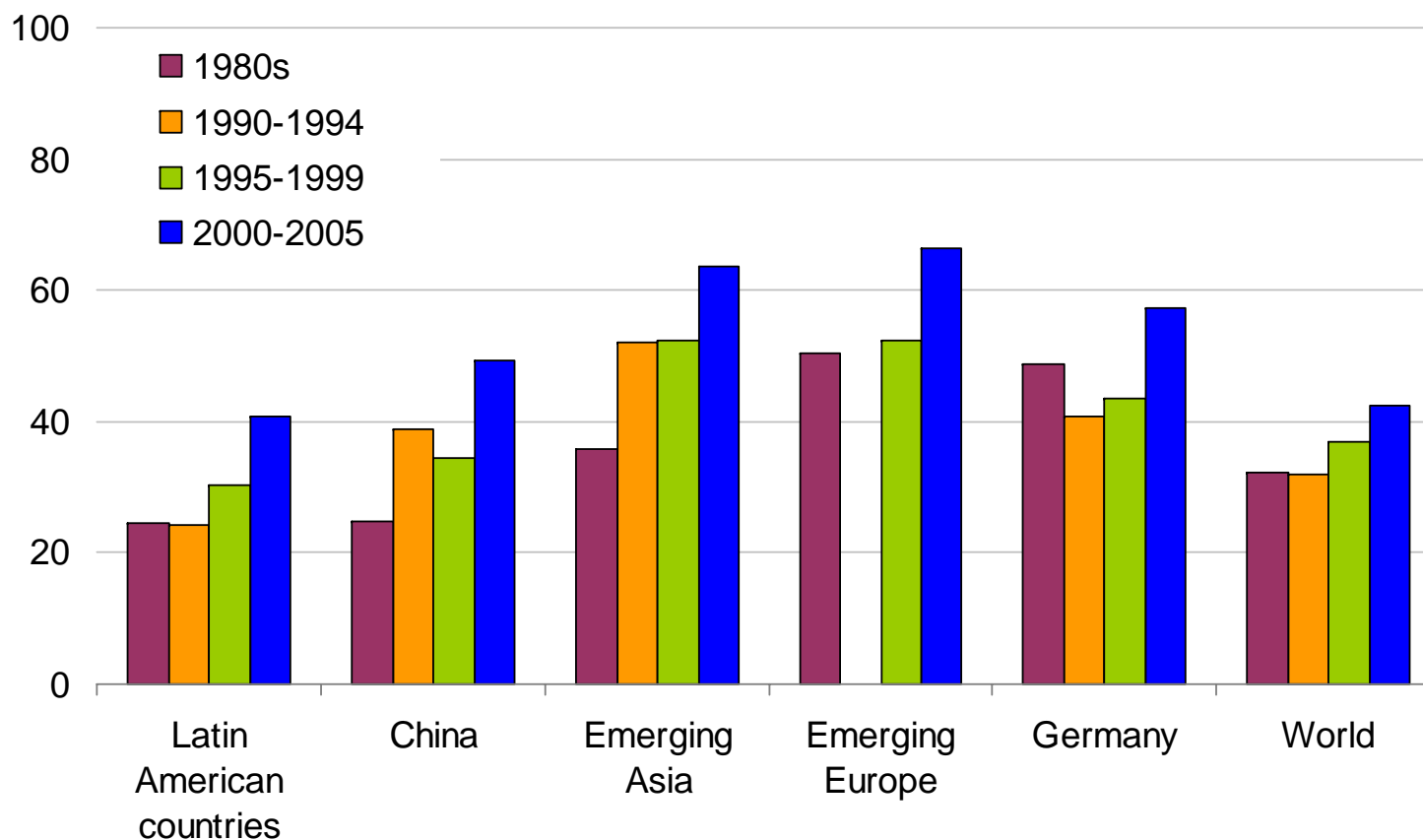


Note: Measured as the sum of exports and imports in percent of GDP.

Sources: World Bank.



Merchandise trade (% of GDP)

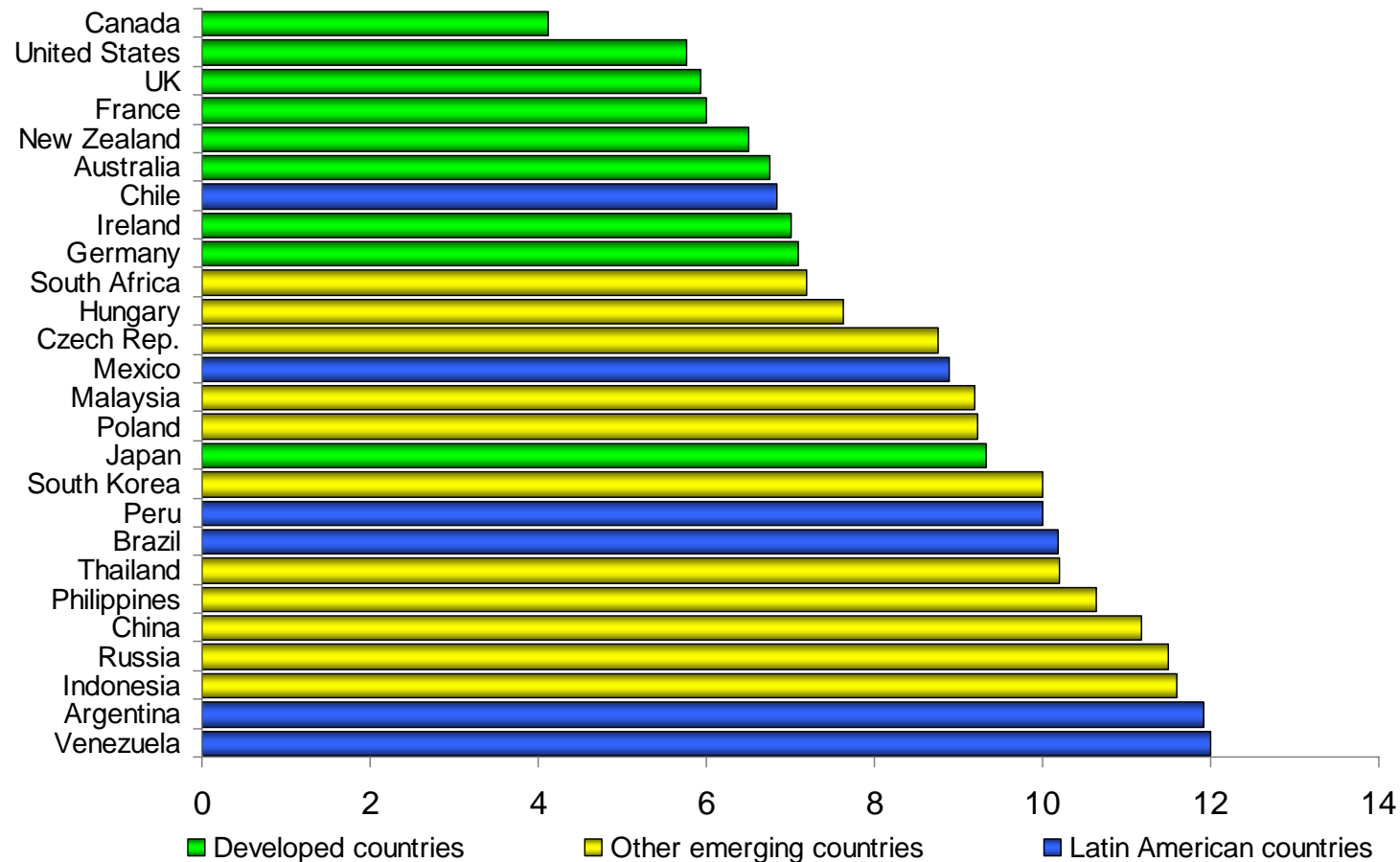


Note: Emerging Asia includes China.

Source: World Bank.



Banking system strength (index, 2006)

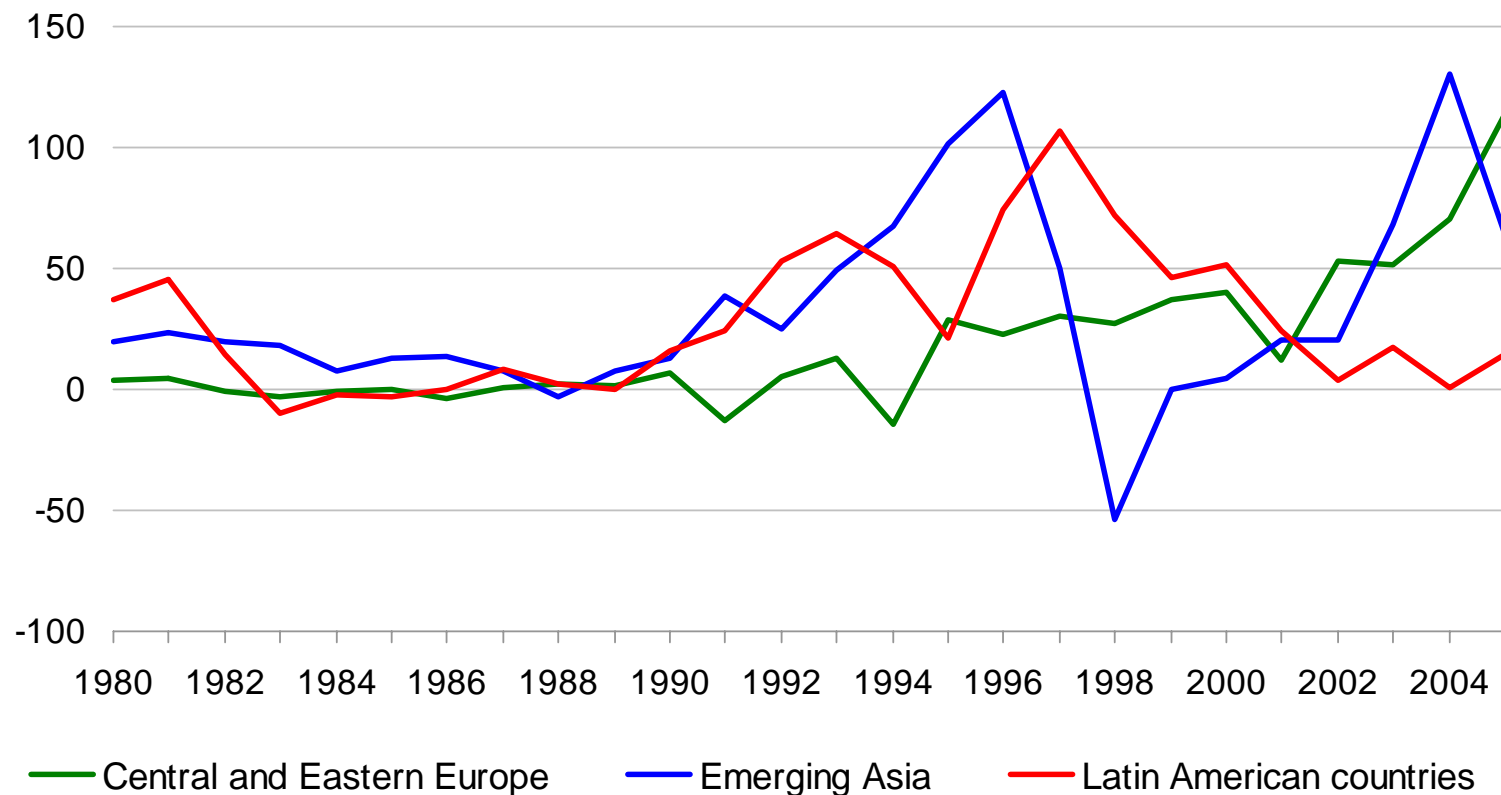


Note: It is quantified in a scale from 1 to 13.

Source: Central Bank of Chile, based on Moody's Financial Strength Ranking (December 2006).



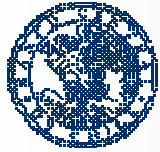
Private capital flows, net (US\$ billions)



Note: Net private capital flows is the sum of net direct investment, net portfolio flows and net other private capital flows. Emerging Asia includes India and China and newly industrialized Asian economies: Hong Kong, Korea, Singapore, and Taiwan. Source: IMF.



3. Reaping the benefits of globalization: The pending agenda

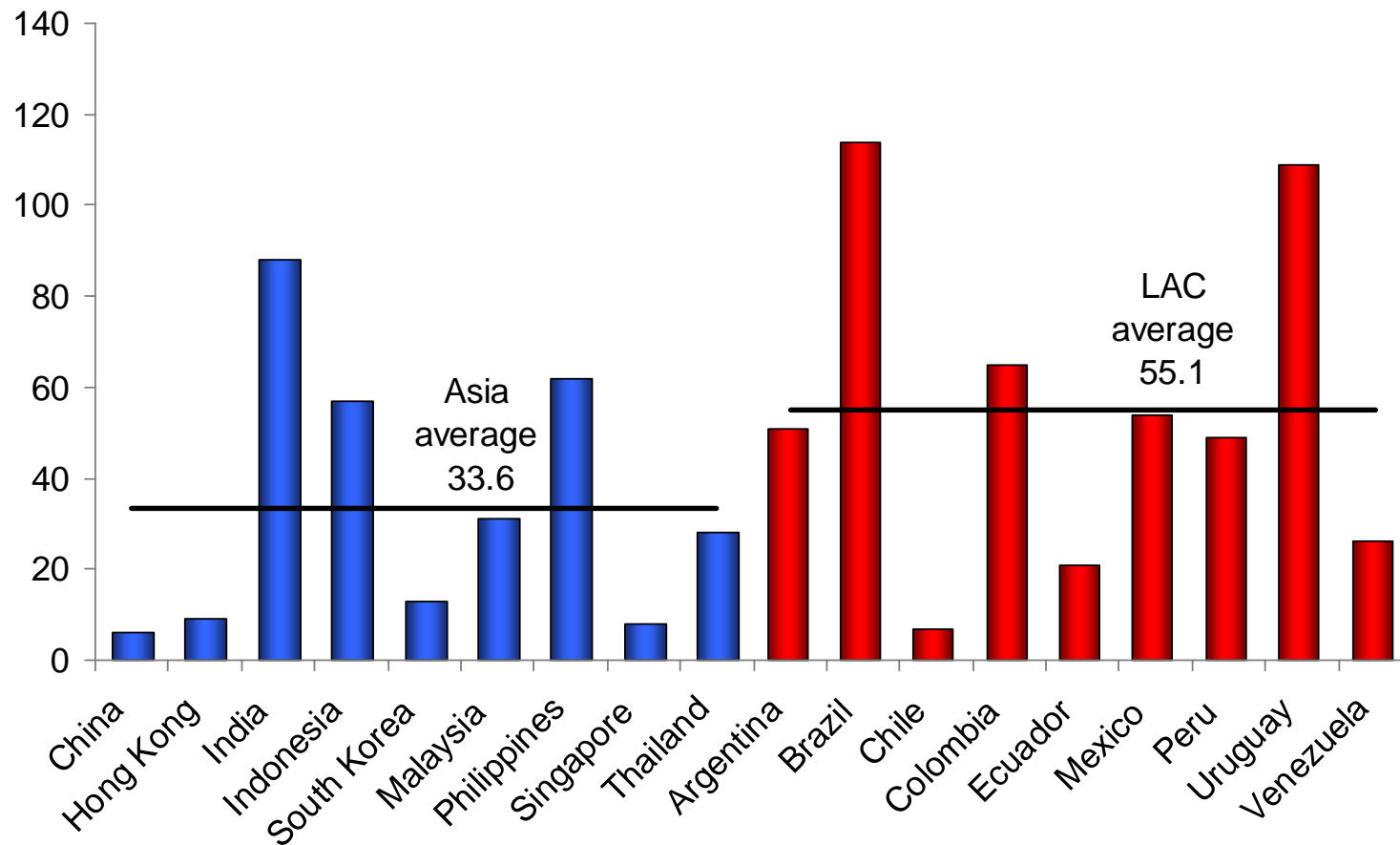


Reaping benefits of globalization

- To reap the benefits of globalization, further trade integration is required, isolation is not a possibility:
 - Reduce import tariffs and remove other non-trade barriers, not only “de jure” but also “de facto”.
- Consolidate macroeconomic stability based on solid institutional framework:
 - Advance in orienting MP in terms of inflation reduction;
 - Revise public debt structures:
 - Composition and quality of spending, add flexibility to budget and increase public revenue;
 - Improve efficiency in tax collection;
 - Revise pension systems.



Macroeconomic environment (ranking, 2006)

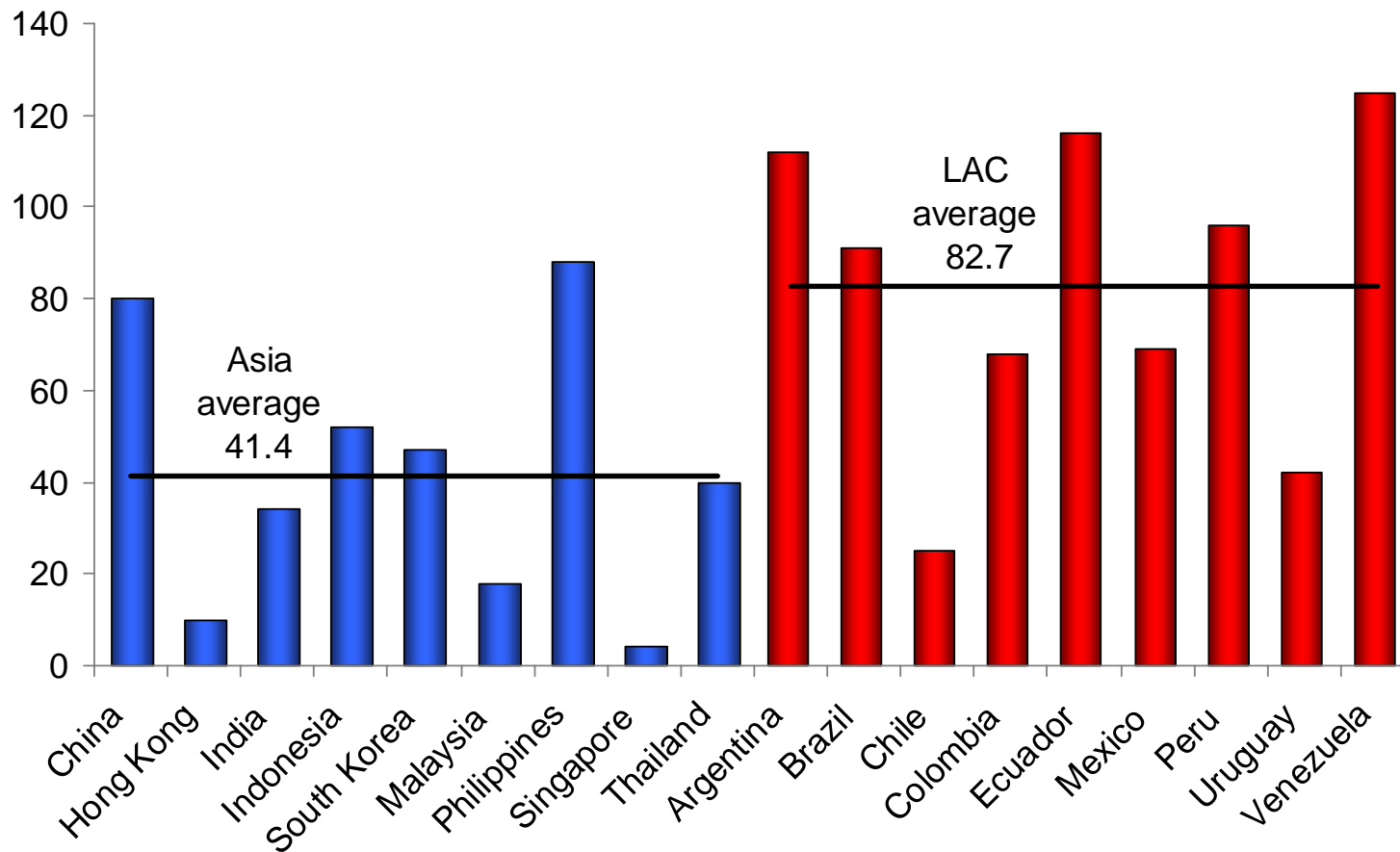


Note: Considers the place in the ranking.

Source: World Economic Forum (September 2006).

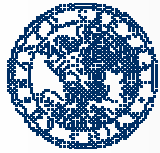


Public institution (ranking, 2006)



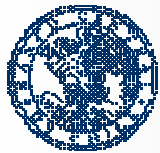
Note: Considers the place in the ranking.

Source: World Economic Forum (September 2006).

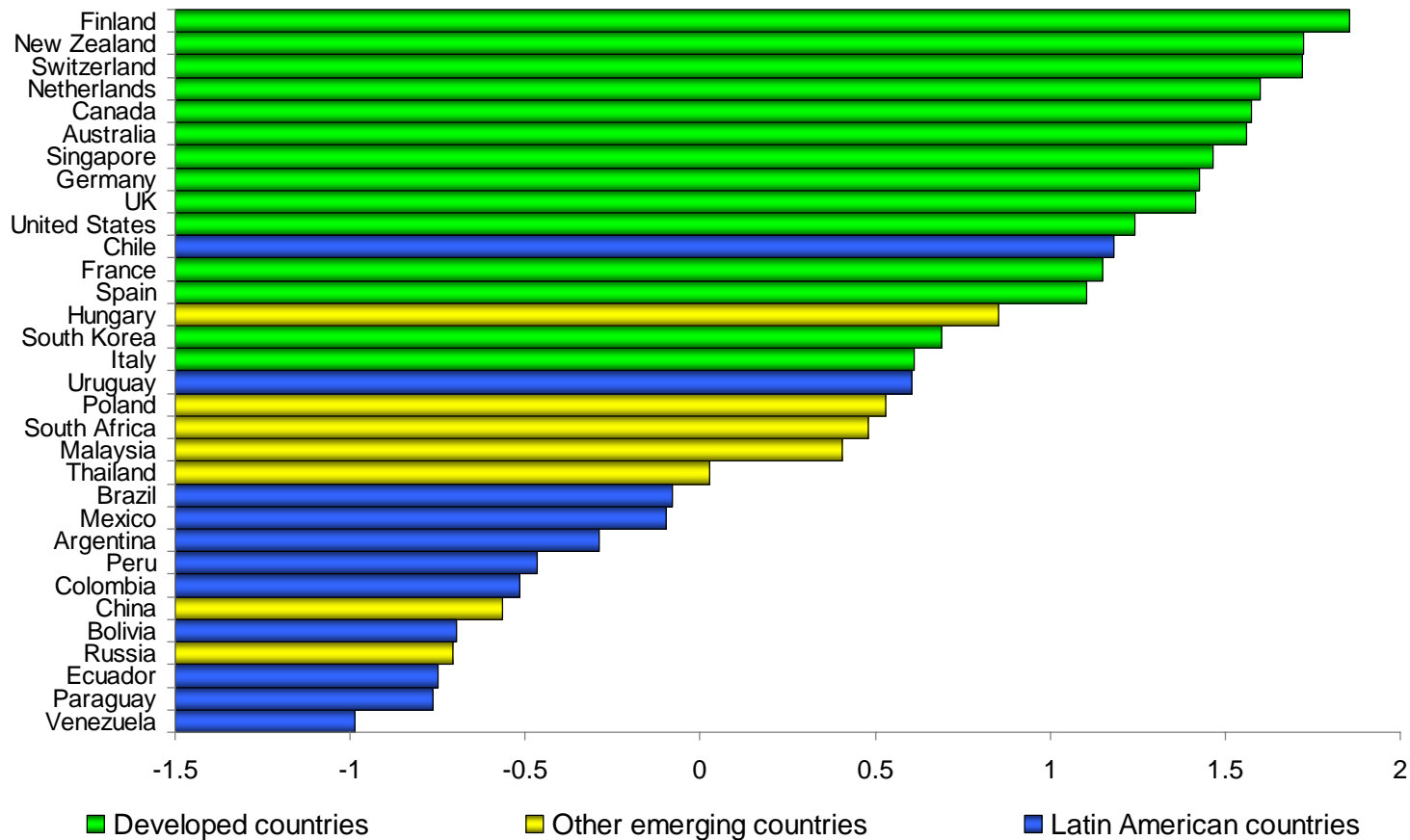


Reaping benefits of globalization

- Improve quality of institutions:
 - What is required are strong institutions with efficient bureaucracies and an enabling business environment.
- Strengthen financial systems through better regulation and supervision:
 - Complemented by a predictable and efficient judicial sector;
 - Create better business climate;
 - Improve infrastructure and reduce regulatory barriers.



Quality of institutions (index, 2005)



Note: Average of six indexes: rule of law, corruption control, political stability, quality of regulations, government effectiveness, and accountability.

Source: World Bank (September 2006).

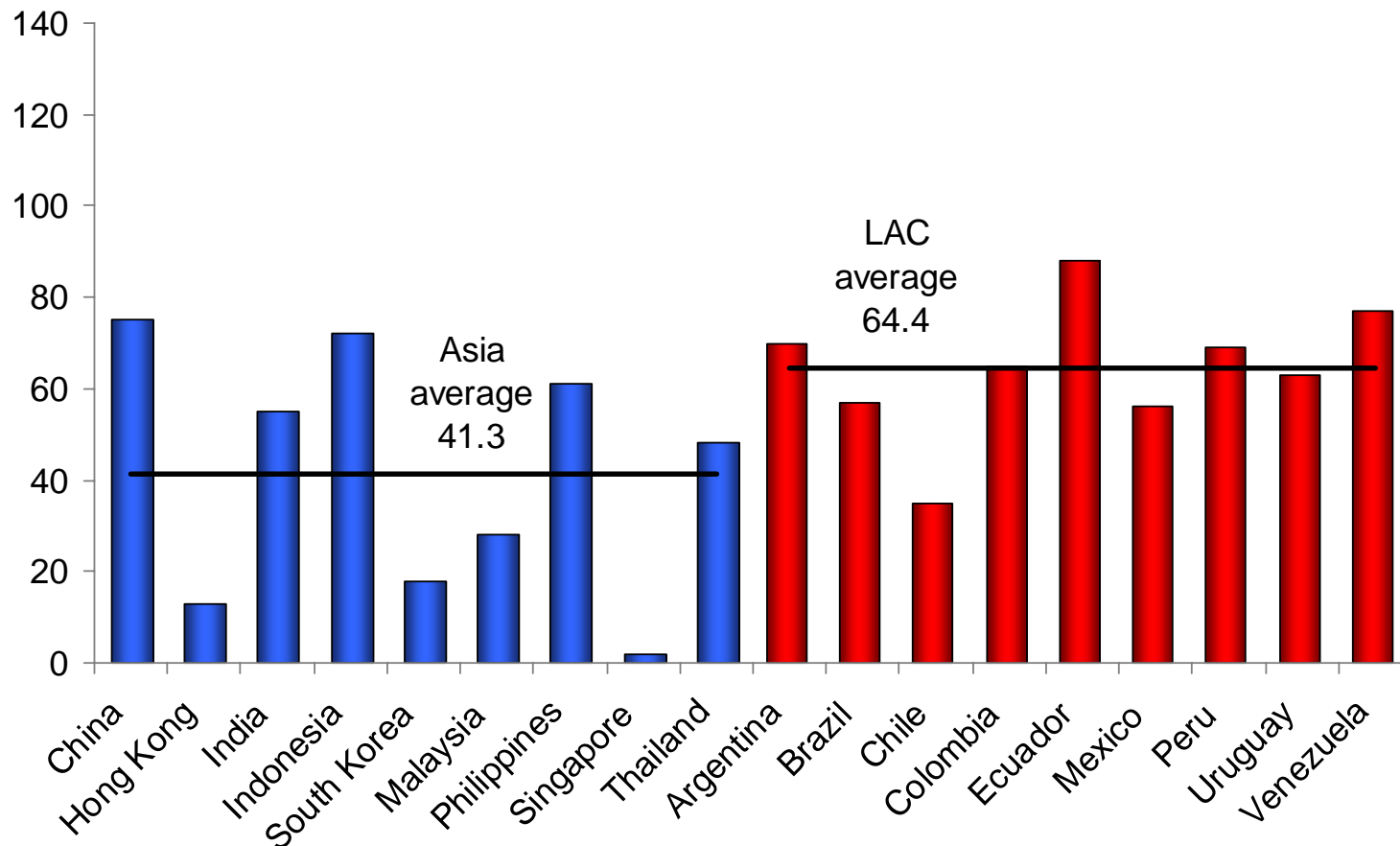


Reaping benefits of globalization

- Adoption, diffusion and head-on involvement in technology help reap the benefits.
 - Increased competition, further flexibility of labor markets and very high-skilled labor force is needed.
- Generate consensus within the civil society increases the political feasibility of the changes and chances of success.
- Policy and structural reforms need to be defined at the country level. Countries differ in:
 - Timing;
 - Delivery;
 - Political legitimacy.



Technology (ranking, 2006)



Note: Considers the place in the ranking.

Source: World Economic Forum (September 2006).



5. Globalization, inflation and monetary policy

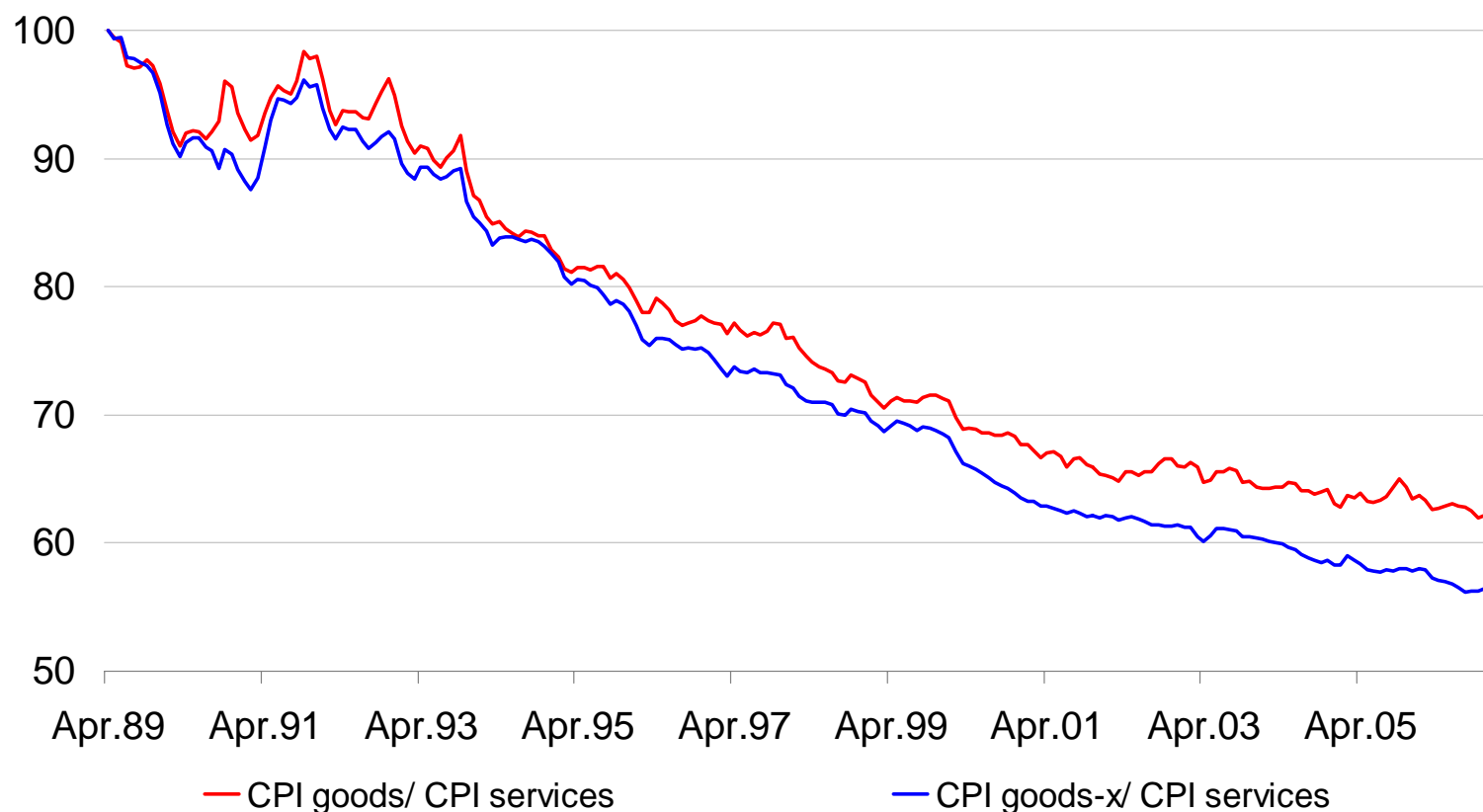


Globalization and monetary policy

- Globalization has affected the way monetary policy is conducted:
 - Large and persistent decline in relative prices of imported and import-competing goods, due to allocation of production in lower-cost countries and increasing import shares.
 - Competitive pressures (squeezing profit margins), intensified productivity-enhancing activities, and reduced production cost (wider availability of cheaper imported inputs) have reinforced disinflation pressures.
 - Technological innovation and entrance of new low-wage workers has restrained wage rise, holding down domestic prices.
 - Counteracting force of increasing commodity prices due to growing demand.

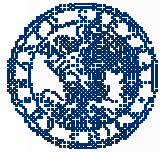


CPI Inflation for goods and services (index April 1989=100)



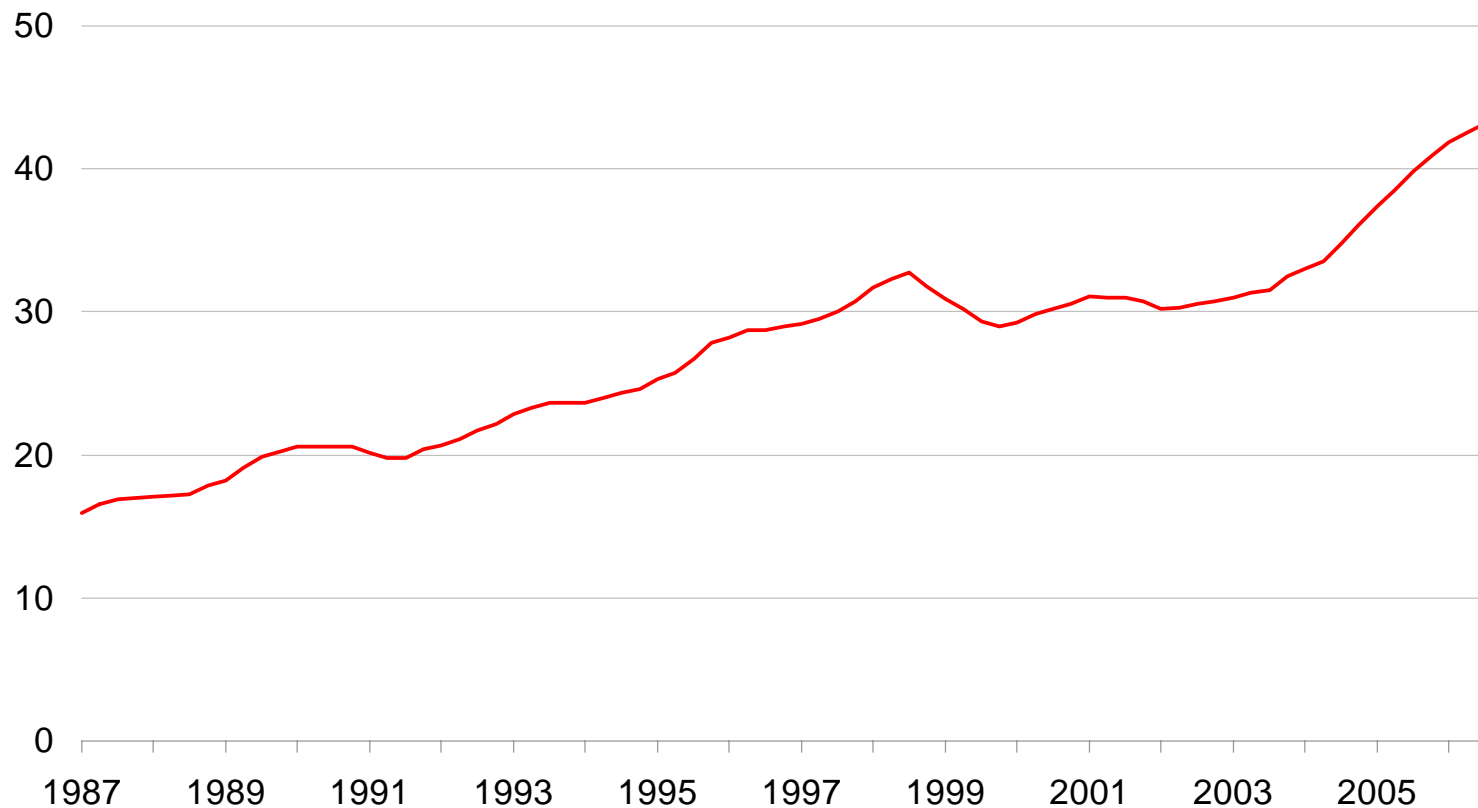
Note: CPI goods-x excludes oil and perishables.

Sources: Central Bank of Chile and National Bureau of Statistics.



Imports to GDP ratio in Chile

(annual moving average, %)



Note: Annual moving average on quarterly data.

Source: Central Bank of Chile.



Globalization and monetary policy

- Relevant external prices for MP has changed:
 - Transitory or permanent ?
 - Price versus quality effect.
 - Productivity rise in opening labor markets, reducing wage deflationary pressures.



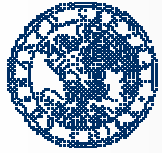
Globalization and monetary policy

- Globalization has increased the need to closely monitor international events:
 - Highly specialized working teams on global markets;
 - Frequent meetings with international institutions and authorities (e.g. IMF, BIS);
 - Increased use of resources to follow what is happening outside frontiers.



MP transmission channel

- The transmission channel of monetary policy has changed:
 - Augmented link of long-term and international interest rates and to a lesser extend to short-term domestic rates;
 - Greater dissociation of domestic demand and output: growing demand is satisfied by foreign markets generating less pressure in domestic prices;
 - Increased access to international markets has reduced inflation sensitivity to domestic output gap fluctuations. As a result, Phillips curve has become flatter.

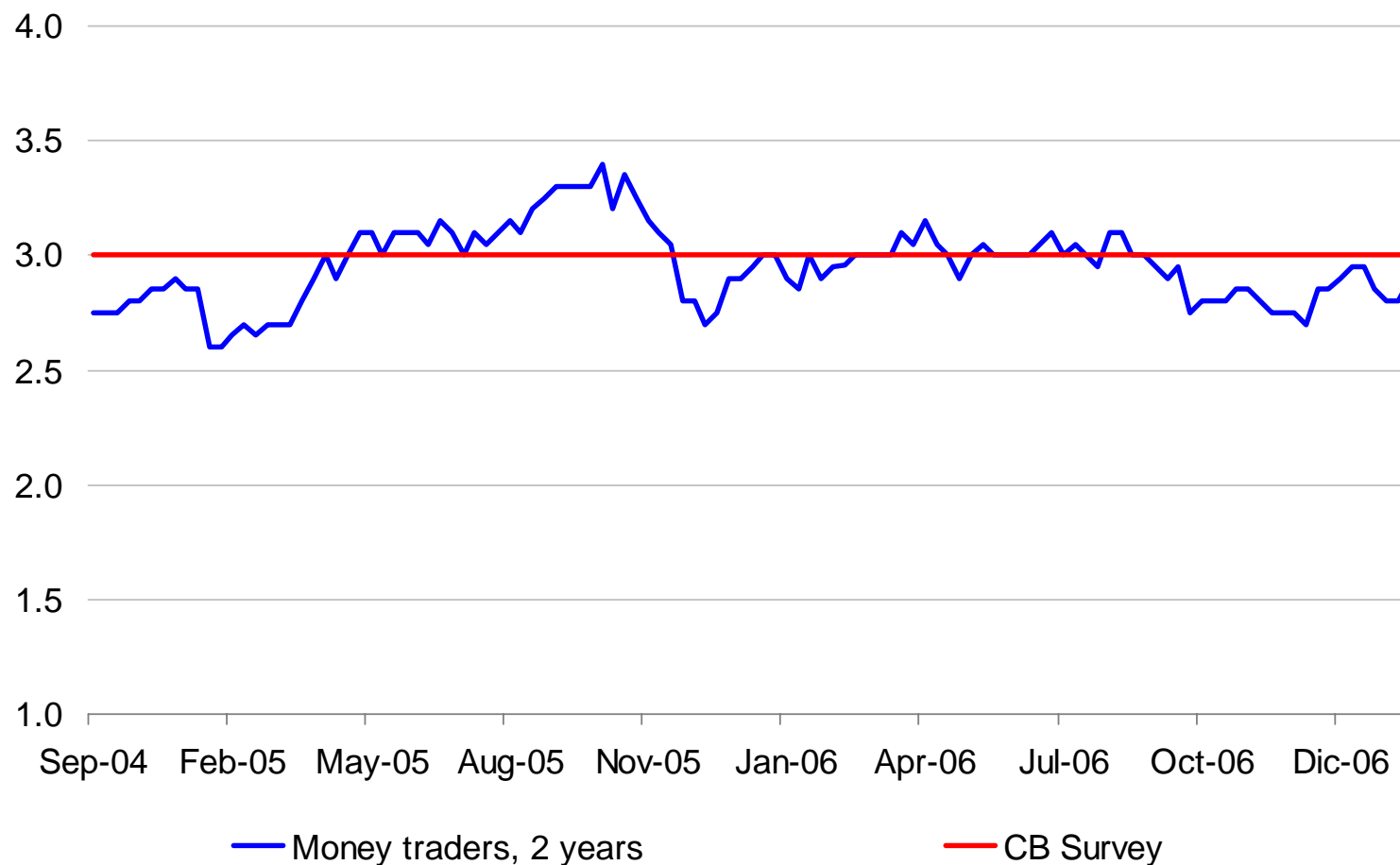


MP transmission channel

- Inflation reduction has become more costly; larger changes in the MPR are needed to affect long-term market rates.
- Inflation expectations are the driving force for inflation control. Thus, credibility of monetary policy has become an increasingly valuable asset.



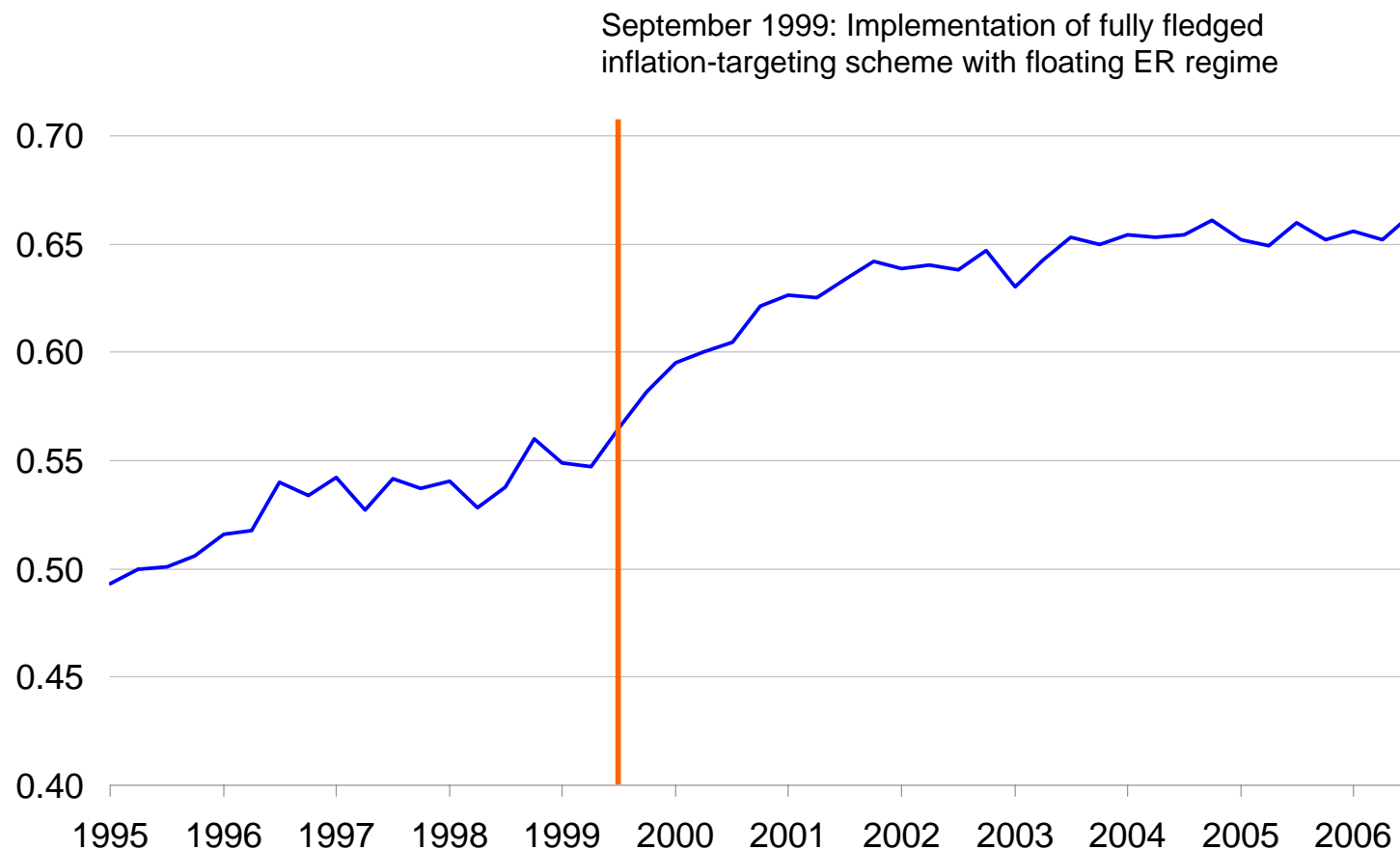
Inflation expectation (%)



Source: Central Bank of Chile.



Expected inflation coefficient

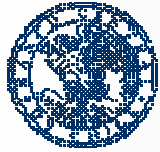


Note: This chart shows the coefficient of inflation expectations in a standard Phillips curve equation, where the sample begins in 1985 and ends in the indicated date.

Source: Central Bank of Chile.

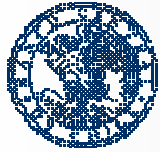


6. Concluding remarks



Challenges for Latin America

- To cease the opportunities brought by globalization, necessary steps towards more integration must be taken.
- Reaping benefits and mitigating costs of greater integration involves reinforcing policies to open-market orientation; completing structural reform process; and installing a strong institutional setting.
- Regulation and supervision of financial system must be conforming to international standards, to ensure the appropriate management of financial institutions.



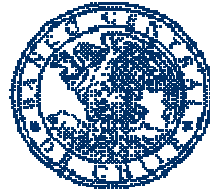
Challenges for Latin America

- To close the income gap, it is necessary to go beyond basic requirements (stability, openness, competition and institutions), and get a head-on involvement in technological innovation, education and training of labor force.
- Furthermore, the creation of consensus and incorporation of the civil society is essential to the reform process, increasing political legitimacy and bounding reversal possibilities.
- Moreover, today's rare historical juncture is very good for undertaking the needed structural reforms to enhance economic performance.



Implication for Monetary Policy

- Globalization has brought about new challenges upon monetary policy.
- Macroeconomic discipline has become imperative:
 - Inflation expectations are the driving force of inflation control.
 - Credibility helps counter the decreased transmission of domestic rates into markets.
 - Deviations from best practices are punished with economic and political consequences.



Latin America in a globalized world: challenges ahead

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