

**SLOUCHING TOWARD
RECOVERY,
OR GLOBAL
MALAISE?**

**GLOBAL ECONOMIC RISKS AND
OPPORTUNITIES IN 2011**

Santiago, December 10, 2010

A DIVIDED WORLD

- Continuing weakness in US
- Strong growth in Asia
- Opportunity—on shaky footing—for Latin America.



PROSPECTS FOR U.S AND EUROPE: A JAPANESE-STYLE MALAISE

- Continuing weaknesses in Europe and the U.S.
- Growth too slow to create enough jobs for new entrants to labor force
 - Exacerbating already high levels of unemployment
- Underlying problem: lack of aggregate demand
 - Before crisis US economy was fueled by unsustainable housing bubble
 - Breaking of bubble left in its wake legacy of excess capacity and debt



WHY PROSPECTS OF US RECOVERY ARE SO DIM

- Consumption likely to remain weak, given overhang of debt, high unemployment, weak wages
- Investment likely to remain weak, given excess capacity, overhang from excess investment in real estate during boom years
 - Small businesses cannot get access to credit
 - Source of job creation
 - Banking system—especially that part engaged in lending—remains weak
 - Most borrowing is collateral based; collateral real estate; real estate prices down markedly
- Exports uncertain, given weaknesses in global economy
 - US lost capacity for exporting in many industries



WEAK PROSPECTS FOR US

- ▶ End of stimulus implies fiscal contraction
 - Stimulus worked, but was too small and not well designed
 - Administration underestimated depth and duration of downturn
 - Thought that the underlying problem was *just* a banking crisis; repair the banks and the economy will be repaired
 - Even if banks were working perfectly, economy would be weak
- ▶ Exacerbated by declines in state revenues
 - States have balanced budget frameworks



WHAT US NEEDS – AND WHAT WE ARE LIKELY TO GET

- Large second round of stimulus
 - Likely only to get 2 year extension of Bush tax cuts
 - Likely to stimulate economy only a little
 - But will probably increase deficit substantially: bang for buck low
 - Can the U.S. afford stimulus?
 - Can't afford not to
 - Long-term fiscal position will be improved if government spends on investments, e.g. in infrastructure, technology, education



WHAT US NEEDS AND WHAT WE ARE LIKELY TO GET

- ▶ Restructuring mortgages
 - ¼ of all mortgages underwater
 - Nothing likely to happen
- ▶ Inducing banks to lend at affordable interest rates
 - Money went disproportionately to banks that were not engaged in SME lending
 - Restructuring of banking system led to less competition, increased gap between lending rate and deposit rate
 - Dodd-Frank bill did little to redirect attention of banks towards lending
 - Securitization model for housing has not be repaired—and not likely to be—implying increased reliance on banks
 - Government has been buying all mortgages—not a sustainable policy
 - Deficit reduction pressure likely to highlight tax preferences for real estate, leverage



MONETARY POLICY LIKELY TO BE RELATIVELY INEFFECTIVE

- Quantitative easing has considerable risks, few benefits
- Short-term interest rate already near zero, small change in LT interest rates not likely to have much effect
 - Large firms awash with capital
 - Banks unlikely to increase significantly lending to SME's at more favorable terms
 - Other channels quantitatively small (except possibly competitive devaluation)
- Costs
 - Expected capital loss by government
 - Lower income to older individuals relying on government interest rates
 - Increased uncertainty—
 - Bubbles
 - Inflation
 - Future conduct of monetary policy
 - Responses of competitors to competitive devaluation—likely fragmentation of global financial markets



EUROPE IS EQUALLY FRAIL

- ▶ Some countries in particularly bad fiscal position
- ▶ But even those that are not (such as UK) are engaging in austerity
 - We were all Keynesians, but for a moment
 - Austerity will slow growth markedly
- ▶ Uncertainty in Euro area
 - Took away interest rate and exchange rate mechanisms for adjustment, put nothing in place
 - Bailout measures only temporary palliative
 - Political issue: will they be able to create more permanent institutions (“solidarity fund for stabilization”)
 - Uncertainty will cast pallor over Europe and global economy
 - Banking crisis in Ireland, “Cajas” in Spain



STRONG GROWTH IN ASIA

- Asia is different
 - Had learned lessons from previous crises—need for good financial regulation
 - Strong public finances provided them resources to respond to crisis
 - Adopted effective Keynesian policies—and they worked
 - Strong infrastructure investment will simultaneously provide basis for long term economic growth



STRONG GROWTH IN ASIA

- Helping other developing countries (Latin America, Africa)
- But Asia is still too small to restore growth in advanced industrial countries
 - Partial decoupling



STRONG GROWTH IN ASIA

- Big Question: Can it sustain growth with Europe and America in malaise?
 - Likely answer: **YES**—huge domestic markets to be developed
 - Will need to continue restructuring away from export-led growth
 - Green investments will be important

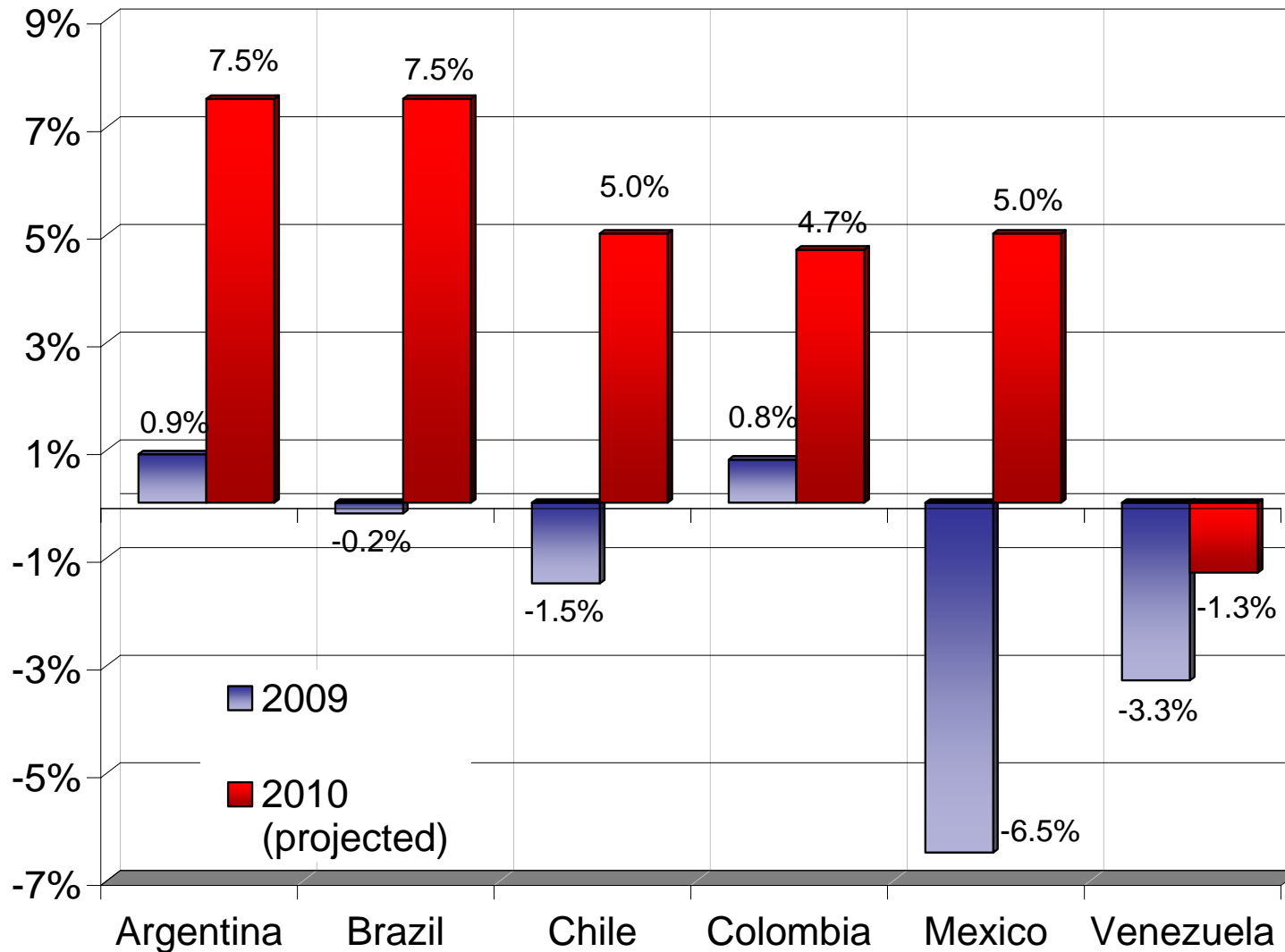


LATIN AMERICA: OPPORTUNITIES AND HAZARDS

- After recession, growth has resumed in the region, more strongly than in North America
 - 5.2% projected for 2010 (EIU)
- But growth varies highly across region, not as high as it could be.
 - For example, Brazil predicted to grow 7.5% in 2010; Mexico only 5% after weathering 6.8% contraction in 2009 (see next slide)



Latin America GDP Growth 2009, 2010



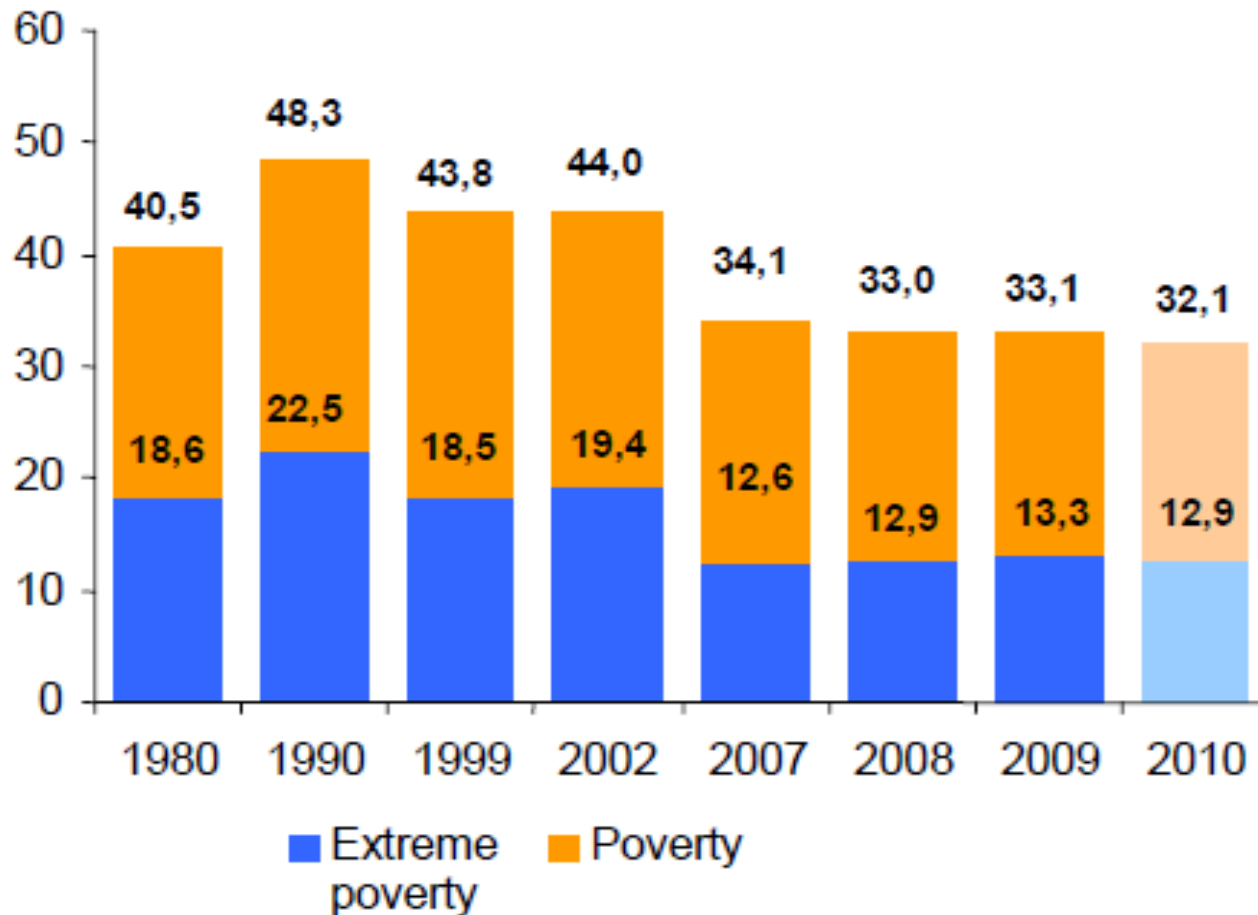
LATIN AMERICA: OPPORTUNITIES AND HAZARDS

- Other indicators also shaky
 - Poverty and inequality remain persistent problems (13% of people still in extreme poverty)
 - Headway against poverty lost steam as a result of recession
 - Unemployment increased to 8.2% in 2009 from 7.3% in 2010 (average Latin-America)
 - Mitigated to some extent by Latin American countries' fiscal stimulus, something they are more capable of now than in the past. Public debt fell to 30% GDP from above 50% GDP in 2002-03 (sovereign spreads also fell)
 - Fiscal stimulus mostly government spending (and transitory tax cuts in some countries, around .8% of GDP in Brazil and Chile) reflected in a reduction of 2.2% GDP of primary surplus from 2008 to 2009 (simple average Latin America)



Poverty and inequality remain persistent problems

- Latin-America Poverty (% of people)



Source: ECLAC (UN), Nov 2010

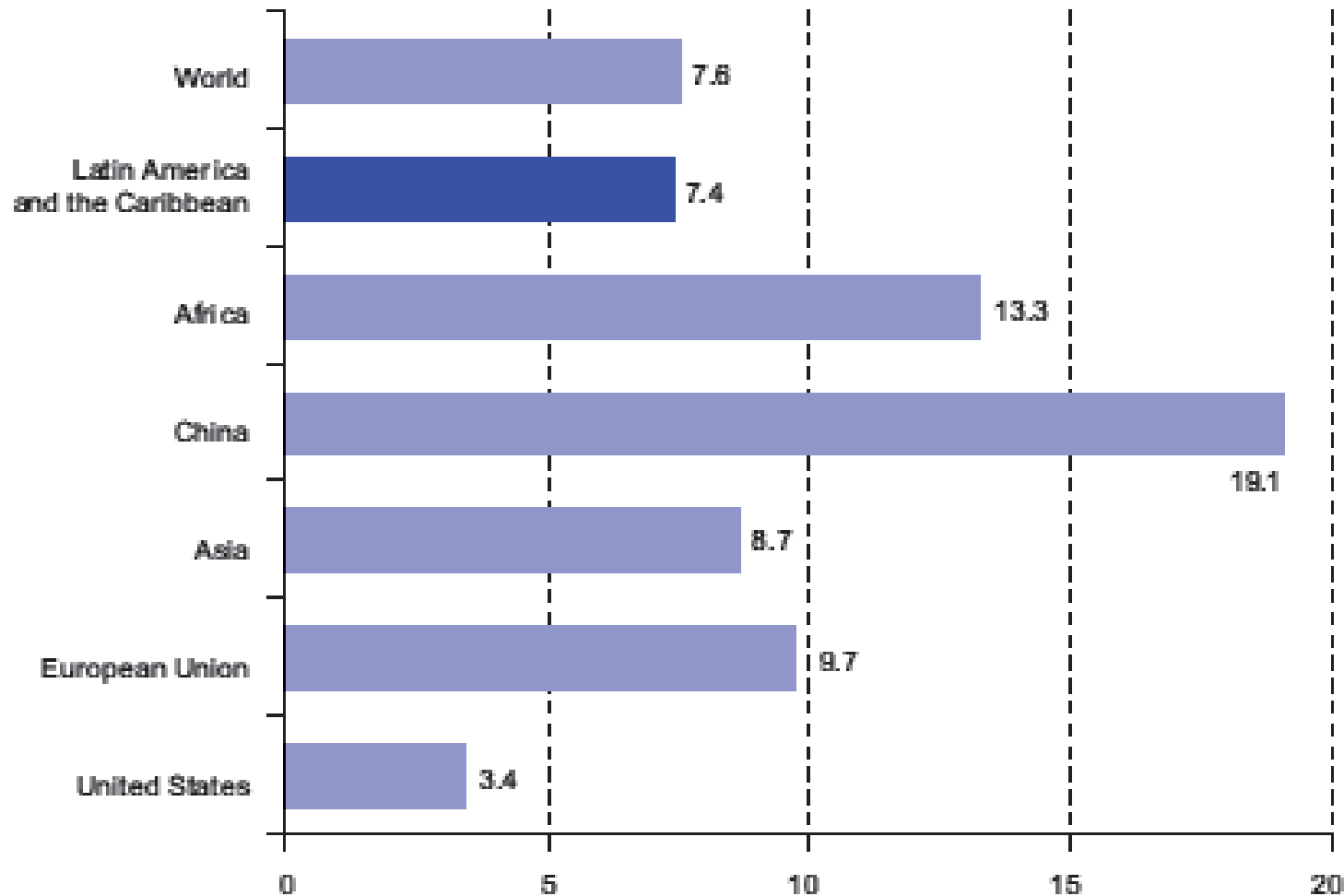
LATIN AMERICA: OPPORTUNITIES AND HAZARDS

- Opportunity: If Asia growth continues strong, commodity prices are likely to remain strong
- Continuing to shift export basis towards Asia
- In the longer run, need to restructure away from commodity dependence
- Fraction of raw materials in exports of goods up from 27% in 1999 to 38% in 2009



LATIN AMERICA: OPPORTUNITIES AND HAZARDS

- Latam export growth (goods, average% 2000-09)



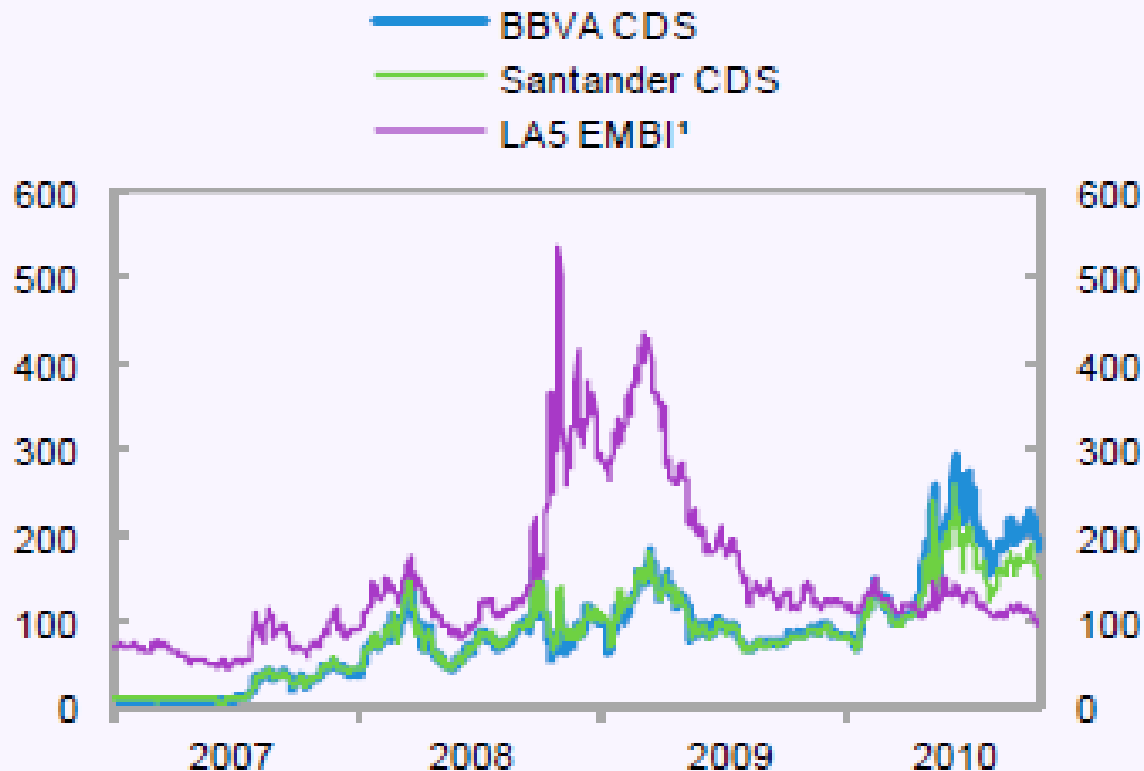
Source: ECLAC (UN), July 2010

Latin America has been resilient to European Crisis

- o Sovereign spreads in the region little affected by European debt crisis episodes

Bond Spreads of Latin American Sovereigns and Selected Spanish Bank CDS Spreads

(Basis points)



Sources: Bloomberg; and IMF staff calculations

¹ Average for Brazil, Chile, Colombia, Mexico, and Peru.

LATIN AMERICA: OPPORTUNITIES AND HAZARDS

- Transition to more flexible exchange rates to accommodate external shocks
- Risk of short term speculative inflows (asset price bubbles/ credit booms)
 - some countries taking measures to discourage them.
- Important: improving social safety nets, promoting high-return investment
 - Keys to stability in long-term growth
 - Latin America should NOT be tempted to follow European austerity measures



GLOBAL PERSPECTIVE

- Political gridlock in US combined with new enthusiasm for austerity likely to prolong recovery
- Underlying problems in US not being addressed
- In world of globalization, what matters is global aggregate demand; underlying weaknesses due to
 - Growing inequality
 - Precautionary savings—build up of reserves—in aftermath of East Asia crisis
 - Crisis may have exacerbated problems, not reduced them
- With end of fiscal policy, ineffectiveness of monetary policy, attention will switch to trade —protectionism and competitive devaluations
 - Heightening tensions, uncertainty



CURRENCY WAR

- ▶ Beggar thy neighbor policies won't lead to global recovery
- ▶ Worry about asset bubbles (especially in emerging markets) is leading to currency interventions, capital controls, taxes, etc
- ▶ Global imbalances are a major source of worry
 - Didn't cause the last crisis
 - But could cause the next
 - Moderate changes in exchange rates not likely to affect global imbalances significantly
 - But large changes in exchange rate could contribute to global instability and impair recovery



WHAT IS NEEDED: A GROWTH COMPACT

- If US, Europe reignite growth, currency realignment would be much easier
- Both China and US need to increase wages, reduce inequality
- Both China and US need economic restructuring
 - US: away from consumption, away from sectors in which they have lost global comparative advantage; need to repair dysfunctional financial sector
 - China: away from dependency on exports, toward service sectors; recycle savings in a way that is more productive



WHAT IS NEEDED: A GROWTH COMPACT

- Both China and US need to improve energy efficiency, respond to challenge of global warming
- Infrastructure and real estate investments to “retrofit” economies all over the world to changing economic circumstances and environmental demands could be crucial element in pulling the global economy out of its current malaise
 - And ensuring growth in Asia is sustainable



CONCLUDING COMMENTS

- We have pulled back from the brink of disaster
- But the world faces important uncertainties
 - Most likely prospect remains Europe and US mired in a slow and unsteady recovery
 - Financial system slow recovery
 - Strong growth only in Asia
 - Not just “more consumption”: the planet will not survive if everyone attempts to imitate US profligate style
 - But more investment
 - And growth over next decade likely to be somewhat slower, less resource intensive
- Latin America should take advantage of current situation to restructure economy to place growth on a more sustainable basis

