´Tale of two cities´

Lessons from the recent commodity price cycle

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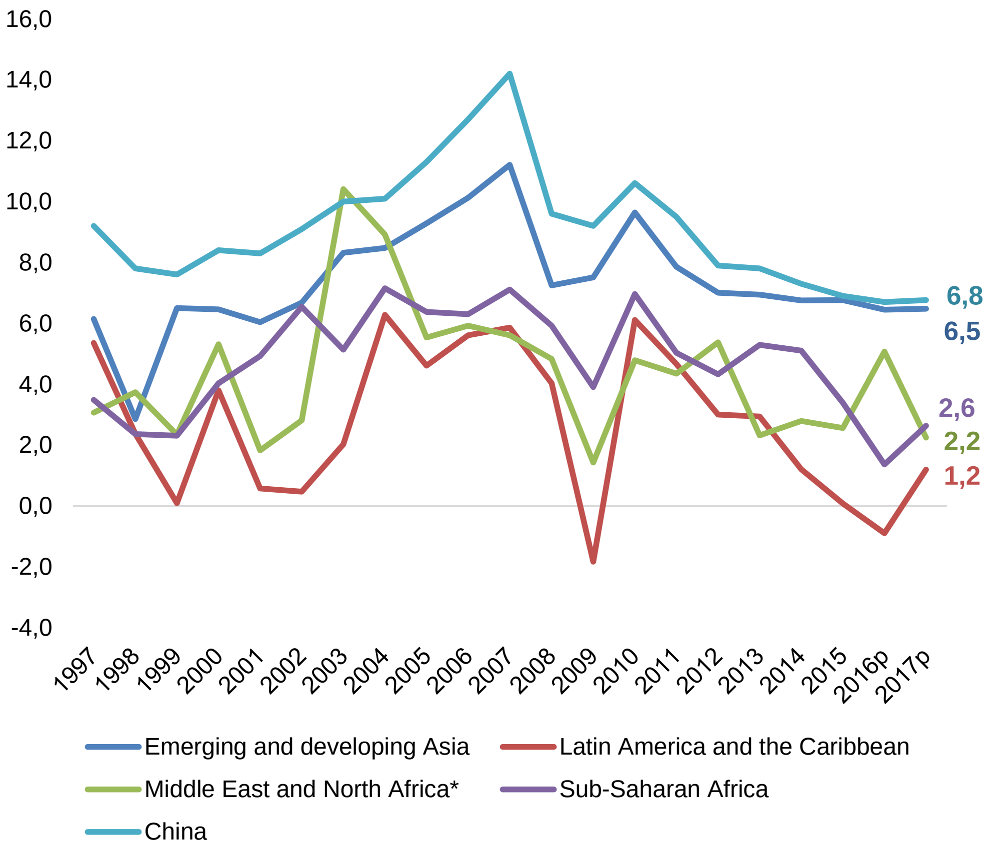
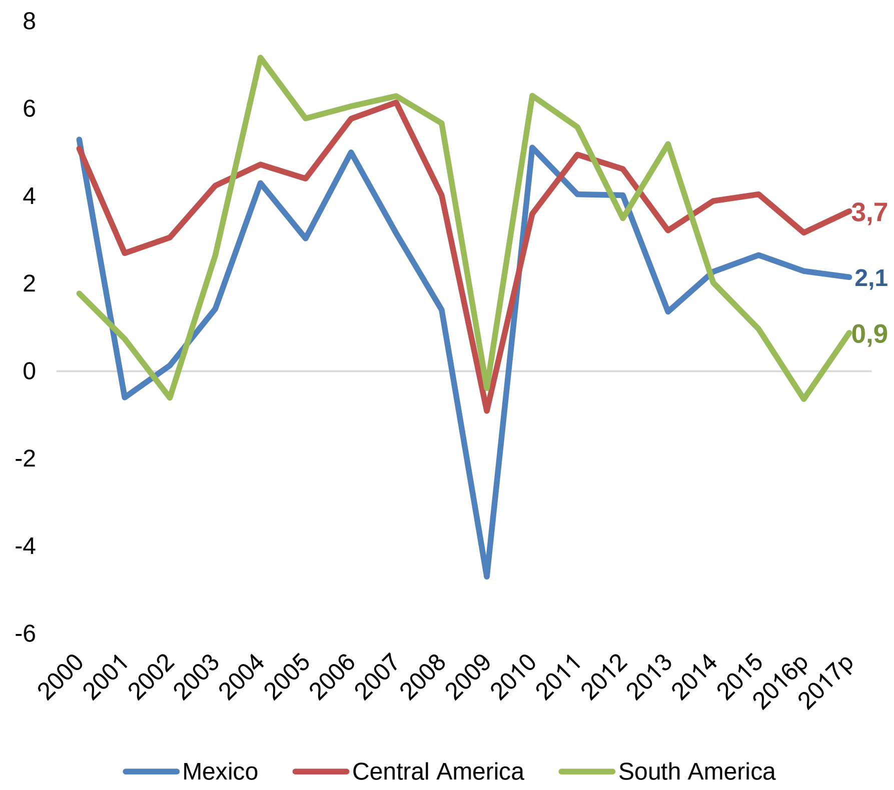
´All happy families are alike;
each unhappy family is unhappy in its own way´

Ana Karenina, Leon Tolstoi.

Recent economic slowdown in all developing regions, especially in South America and, less so, in Mexico

GDP growth rate (%)

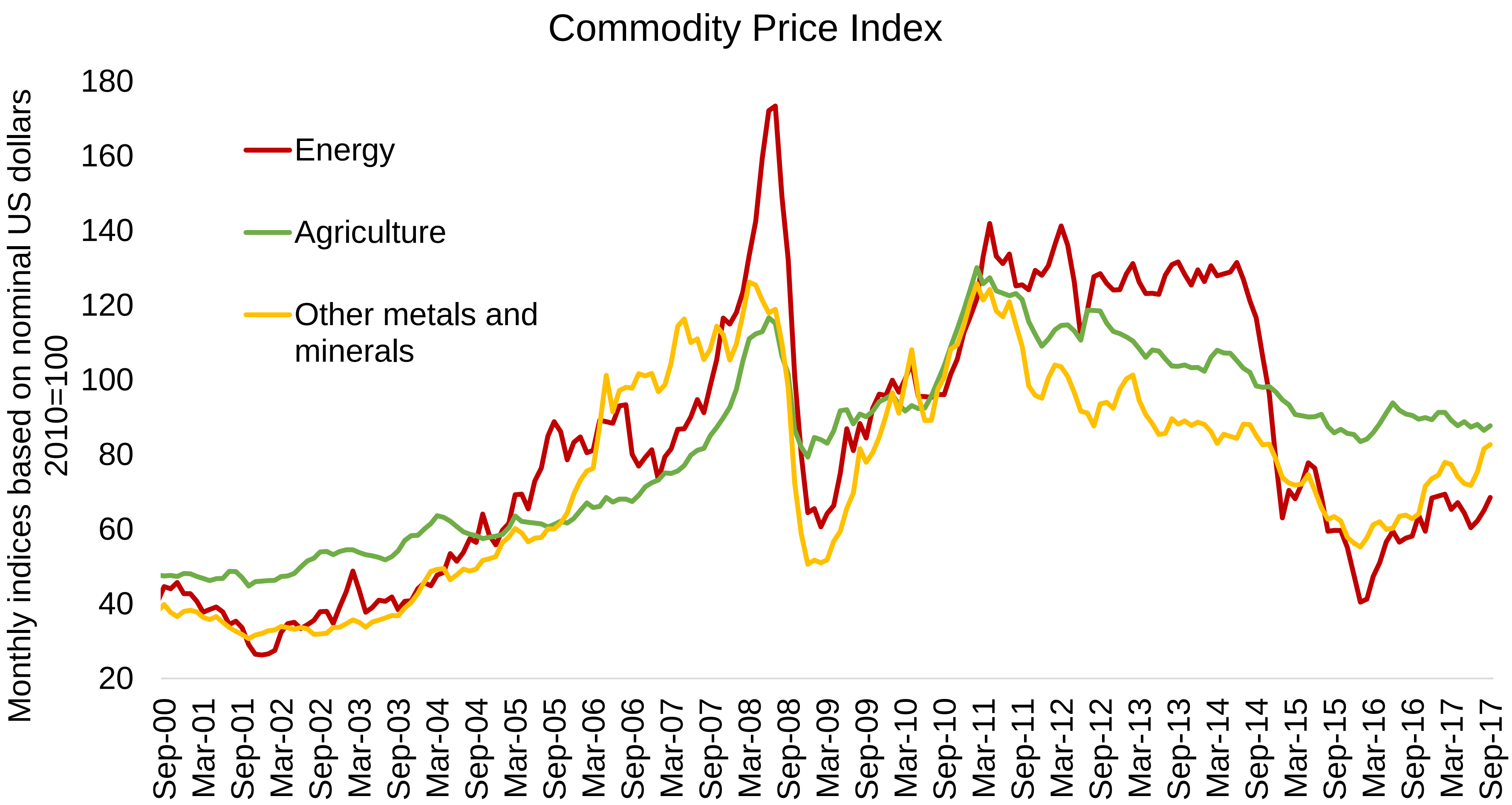




*Also includes Afghanistan and Pakistan

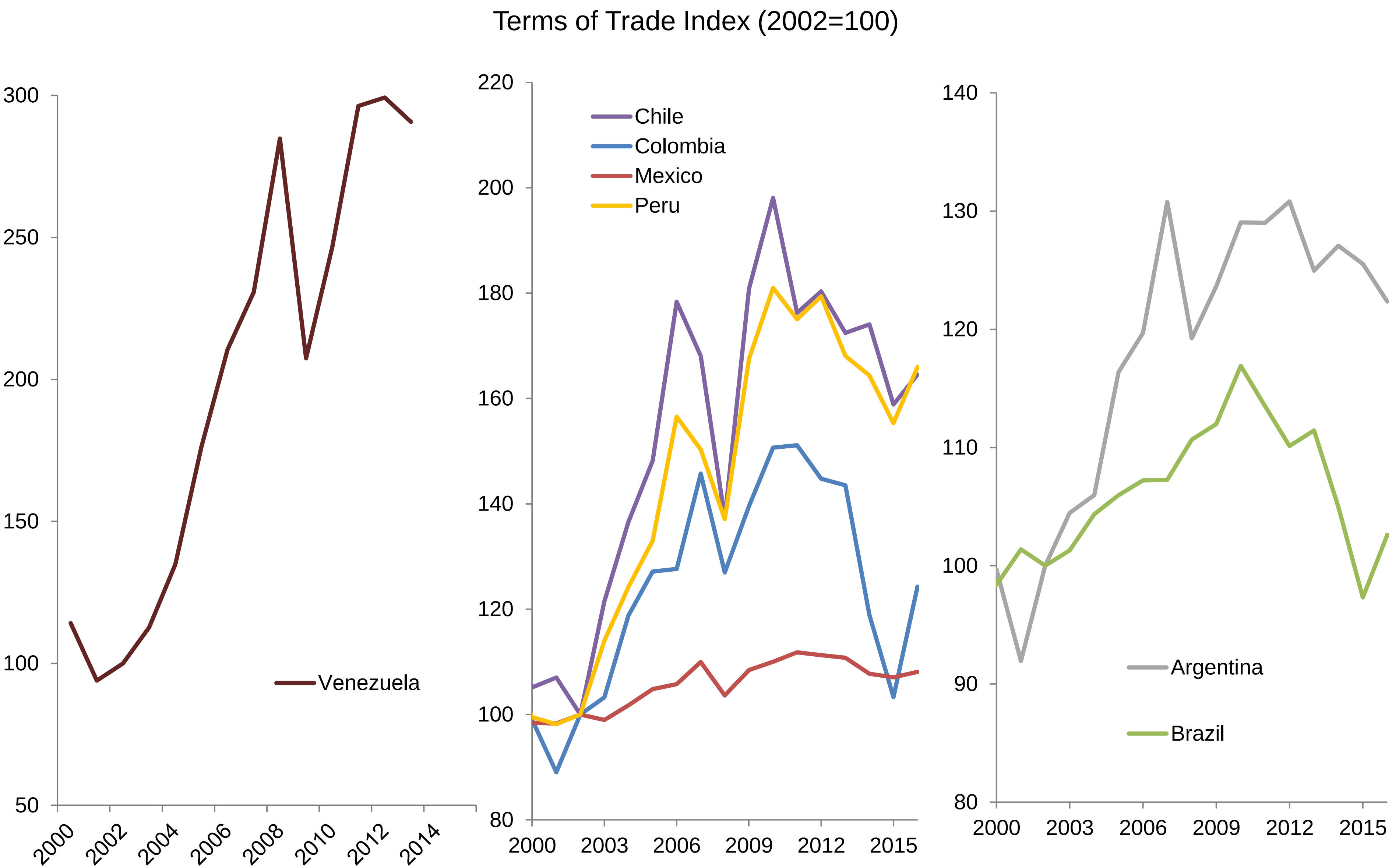
Source: World Economic Outlook database, IMF projections, WEO October 2017

Mainly explained by the slump in commodity prices, after a long boom since 2003



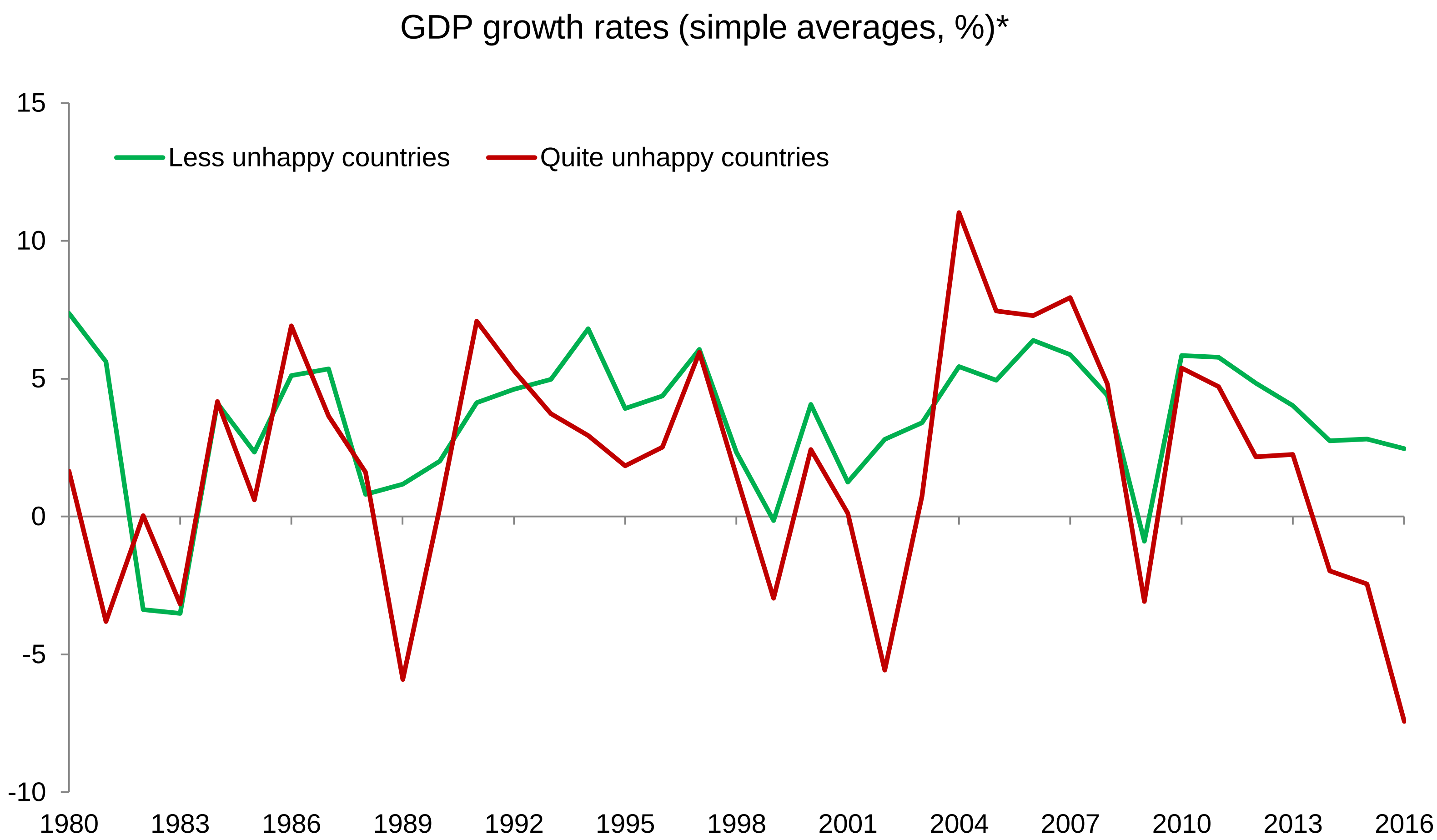
Source: World Bank

That led to a boom and bust in Terms of Trade



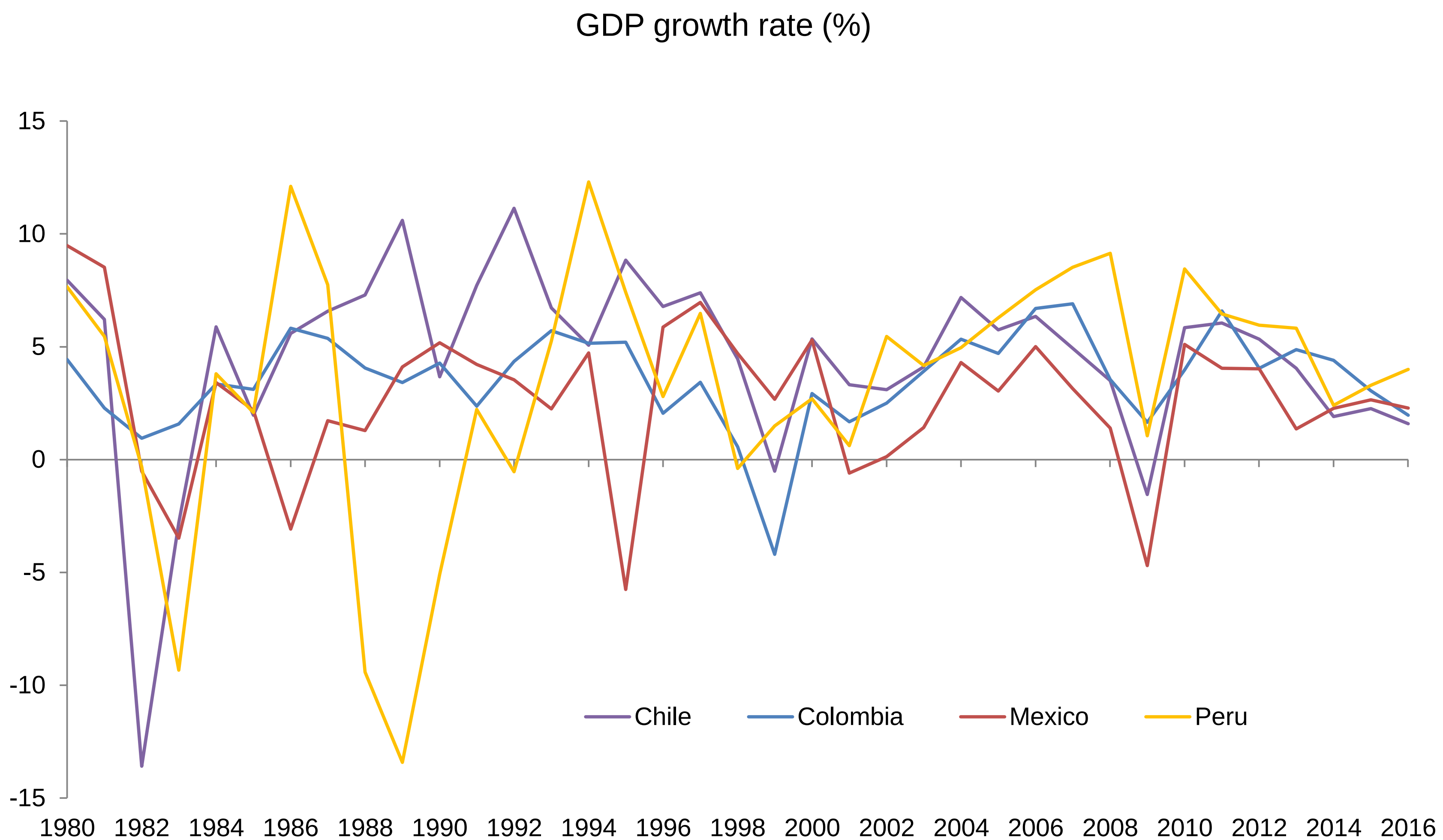
Source: Citi Bank.

We see today quite unhappy and less unhappy countries: differences are not fully explained by TOT



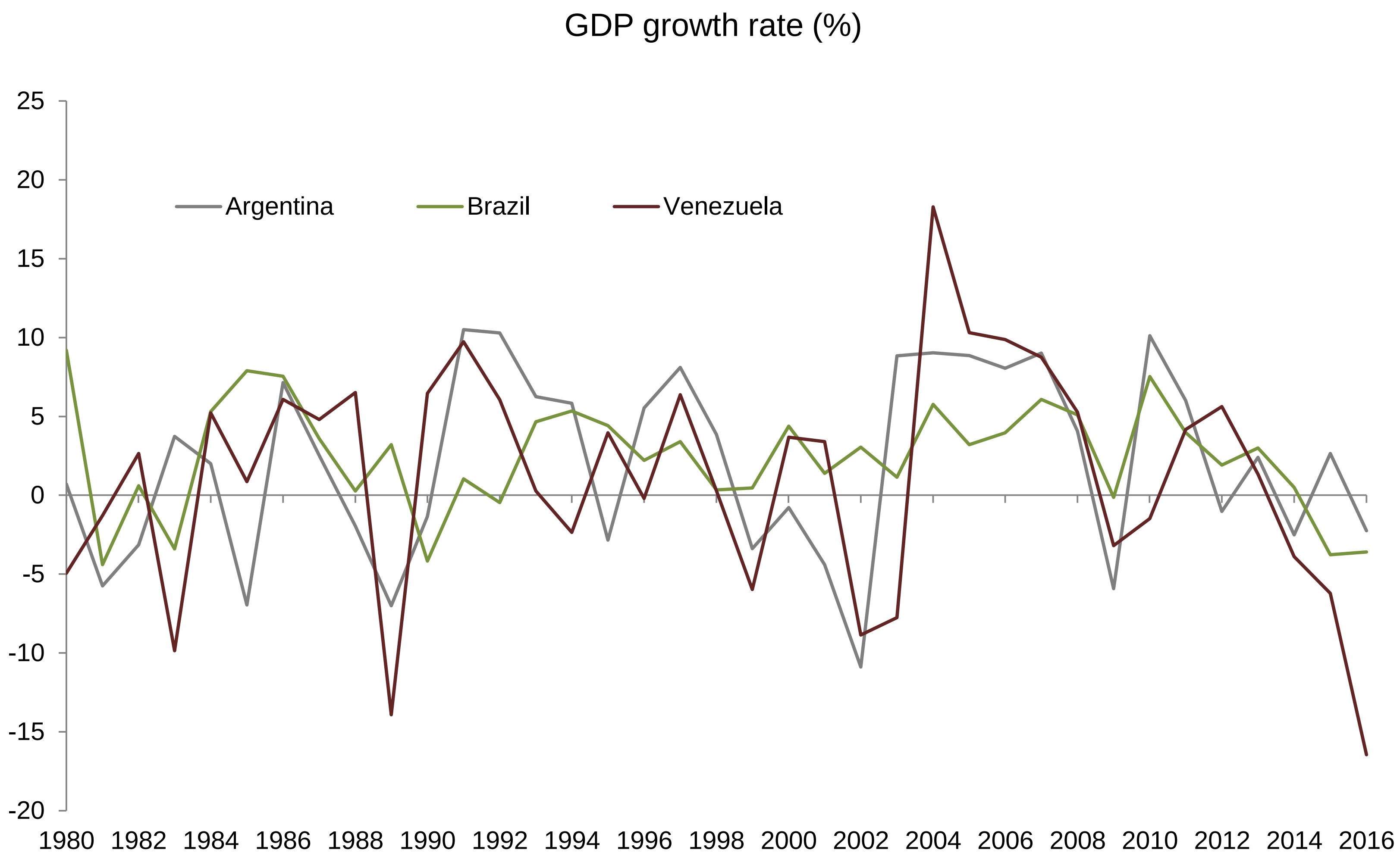
*Less unhappy: Chile, Colombia, Mexico and Peru; Quite unhappy: Argentina, Brazil and Venezuela
Source: World Economic Outlook database, IMF projections, WEO October 2017

GDP growth: The less unhappy ones look quite alike



Source: World Economic Outlook database, IMF projections, WEO October 2017

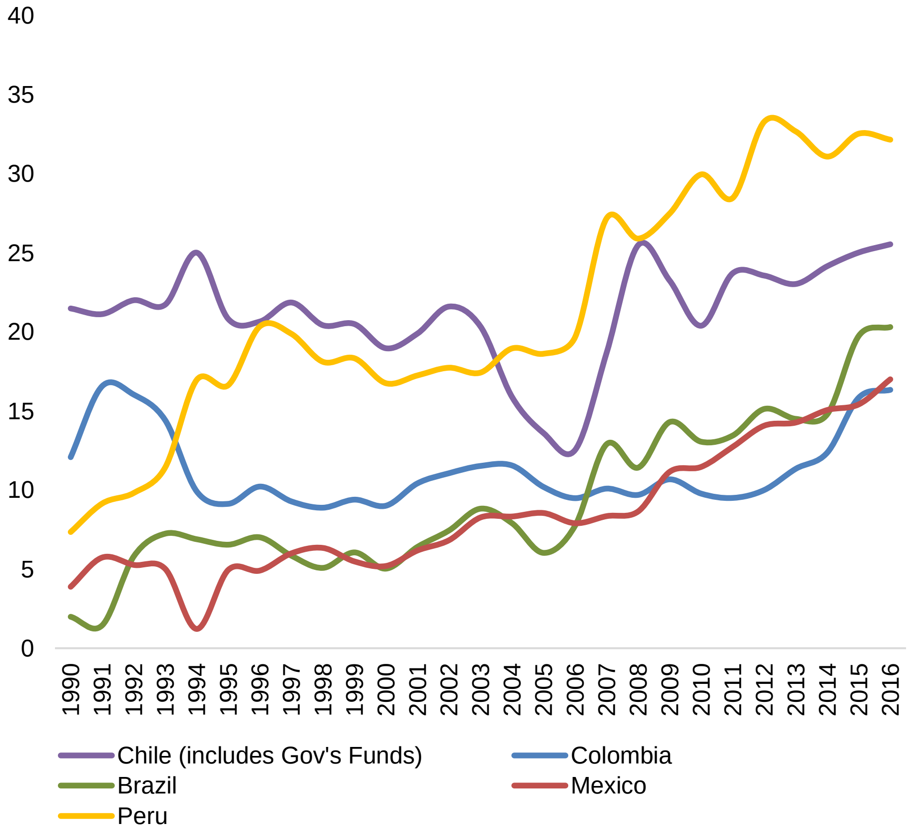
GDP growth: The more unhappy ones look much less alike

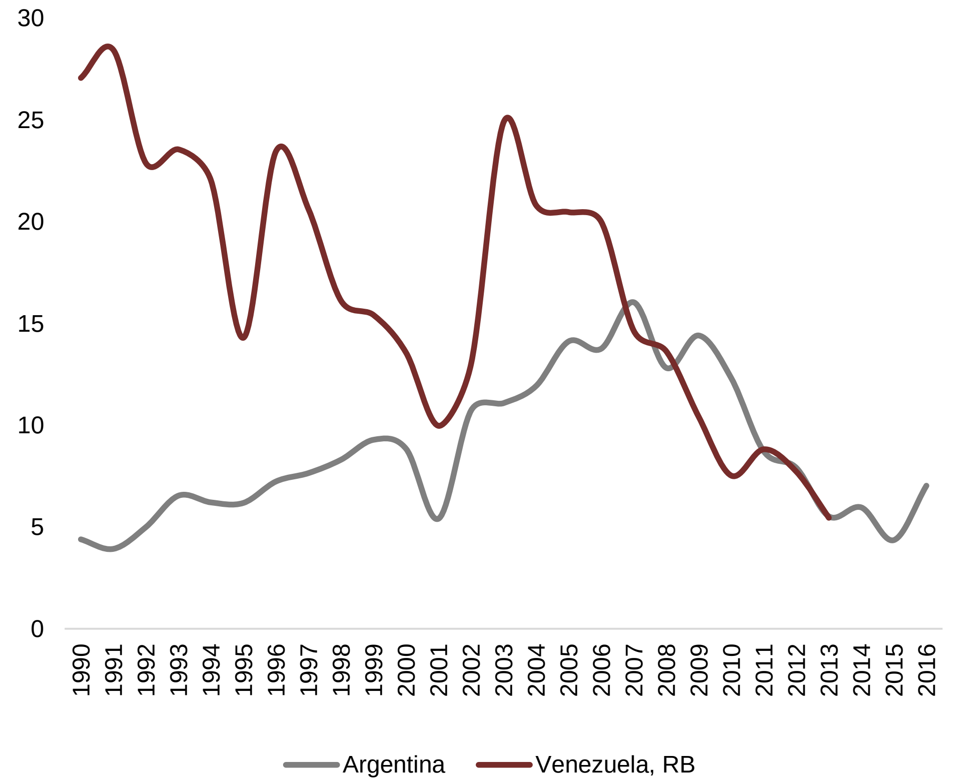


Source: World Economic Outlook database, IMF projections, WEO October 2017

An early symptom of unhappiness in Venezuela and Argentina: loss of reserves

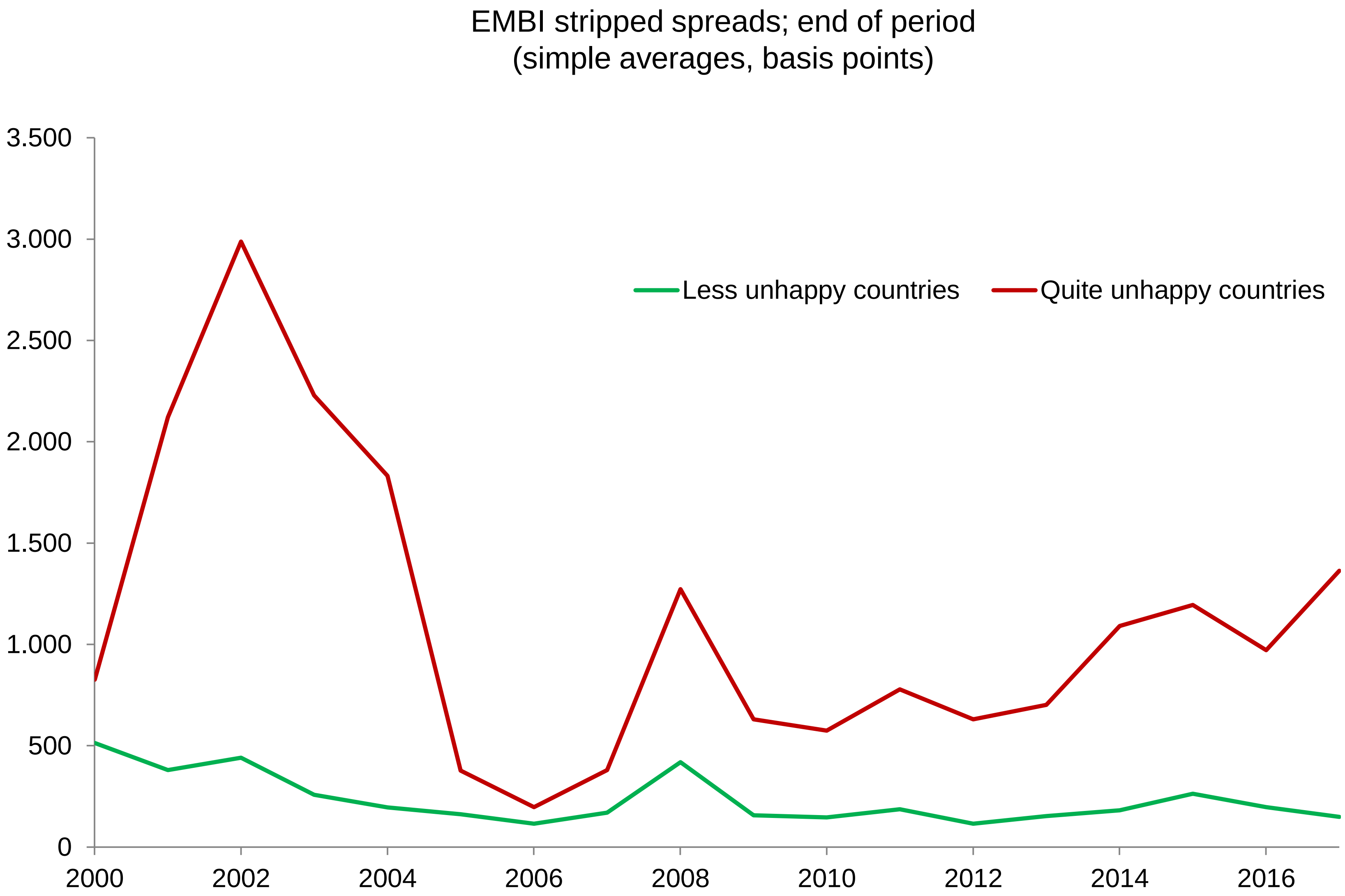
International Reserves (includes gold, % of GDP)





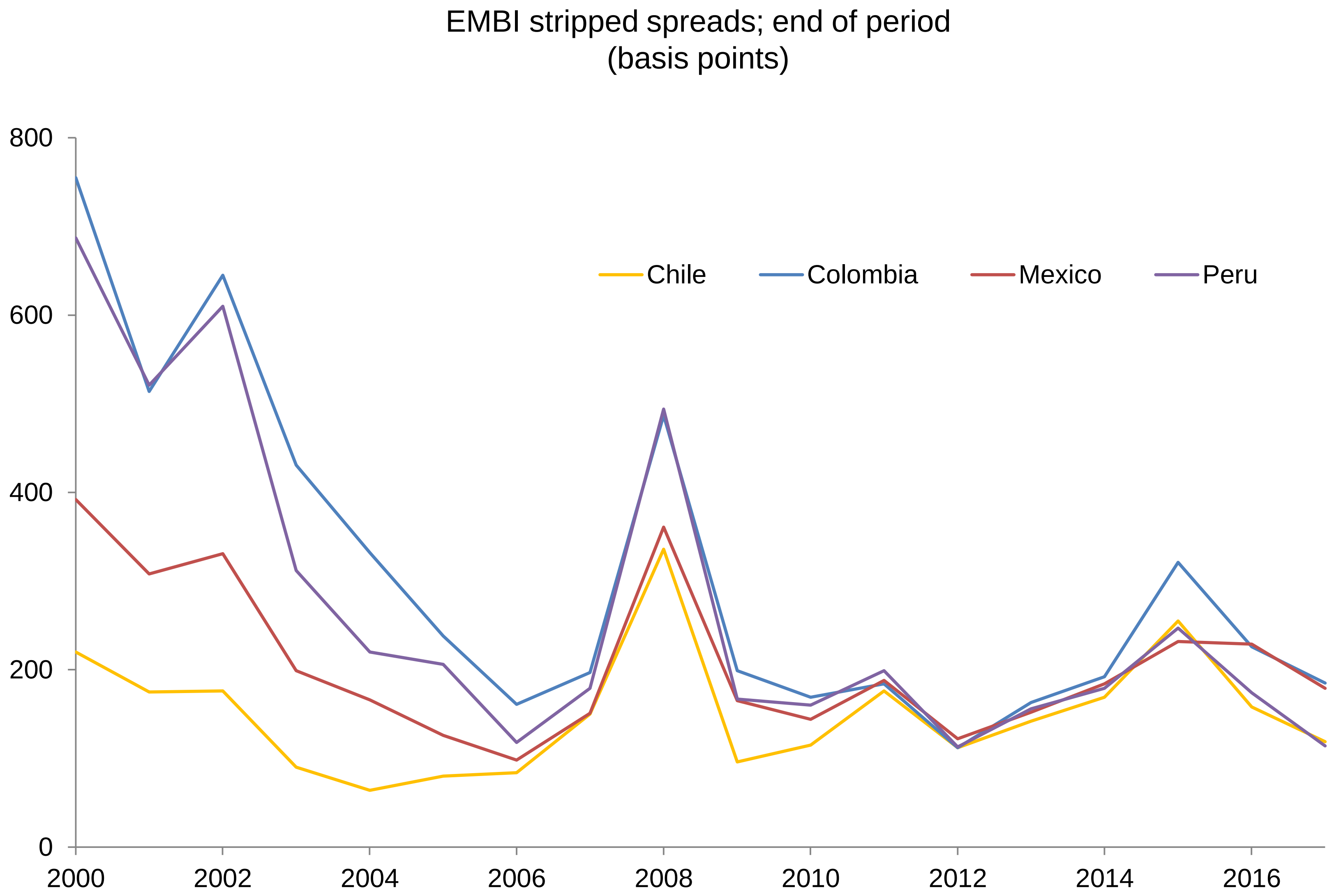
Source: World Development indicators, World Bank, Ministry of Finance of Chile

And sovereign risk hikes



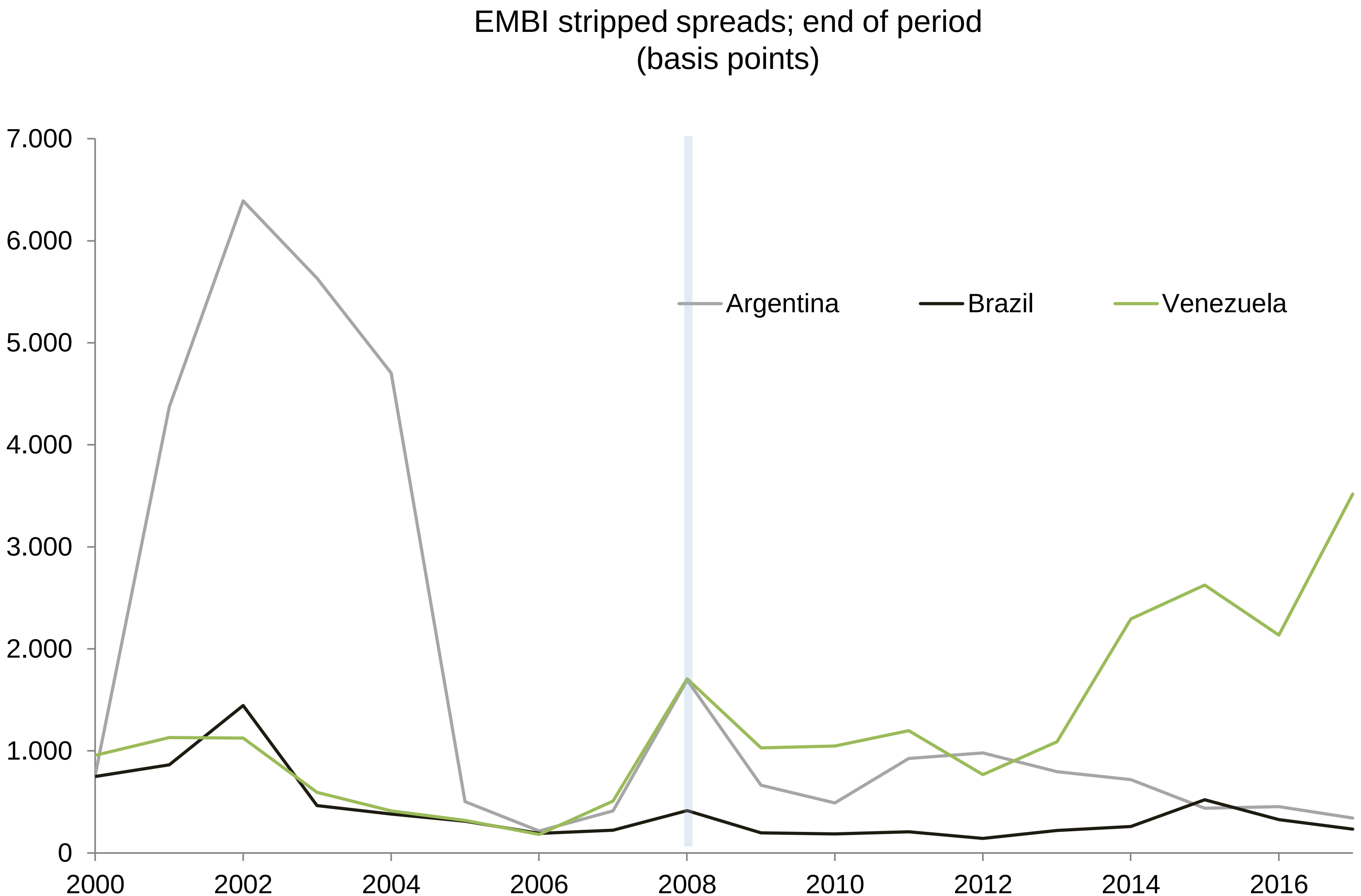
Source: Bloomberg, JP Morgan

Spreads: The less unhappy bunch look again quite alike



Source: Bloomberg, JP Morgan

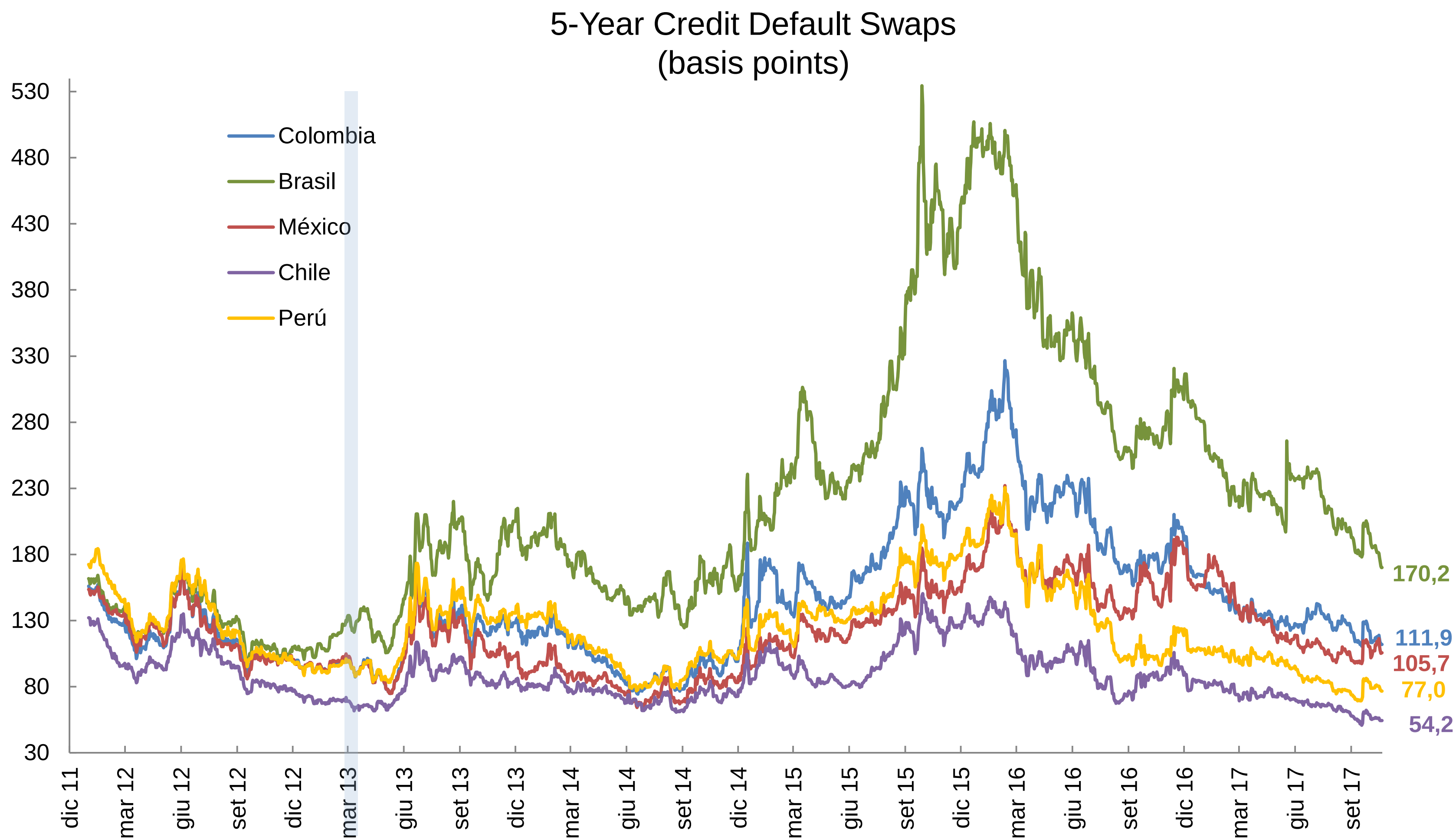
Spreads: The very unhappy ones again look less alike



Source: Bloomberg, JP Morgan

A closer look to the less unhappy bunch and Brazil:

Credit Default Swaps

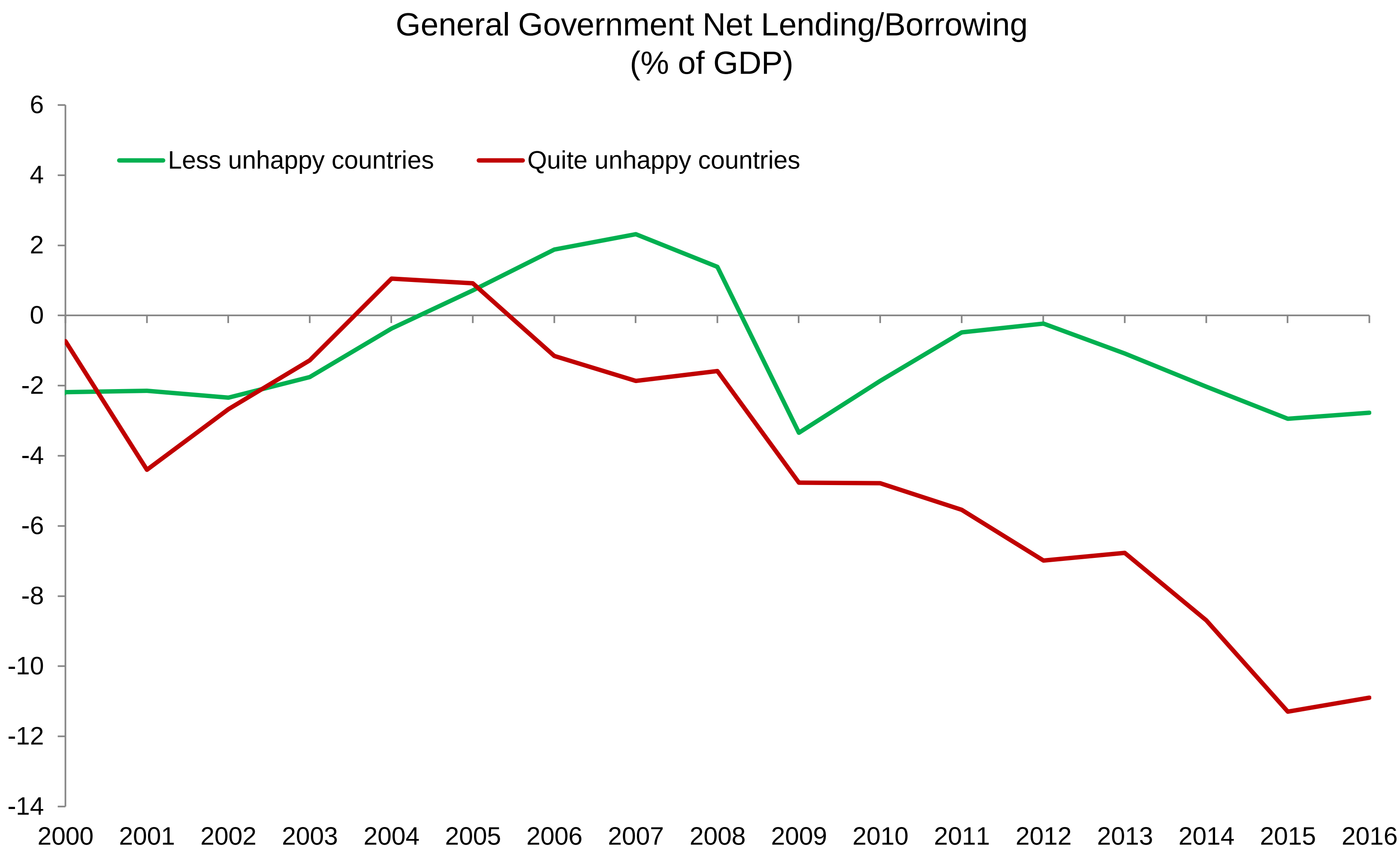


Source: Bloomberg

Two factors behind differences in unhappiness
(in addition to micro-policies and politics):

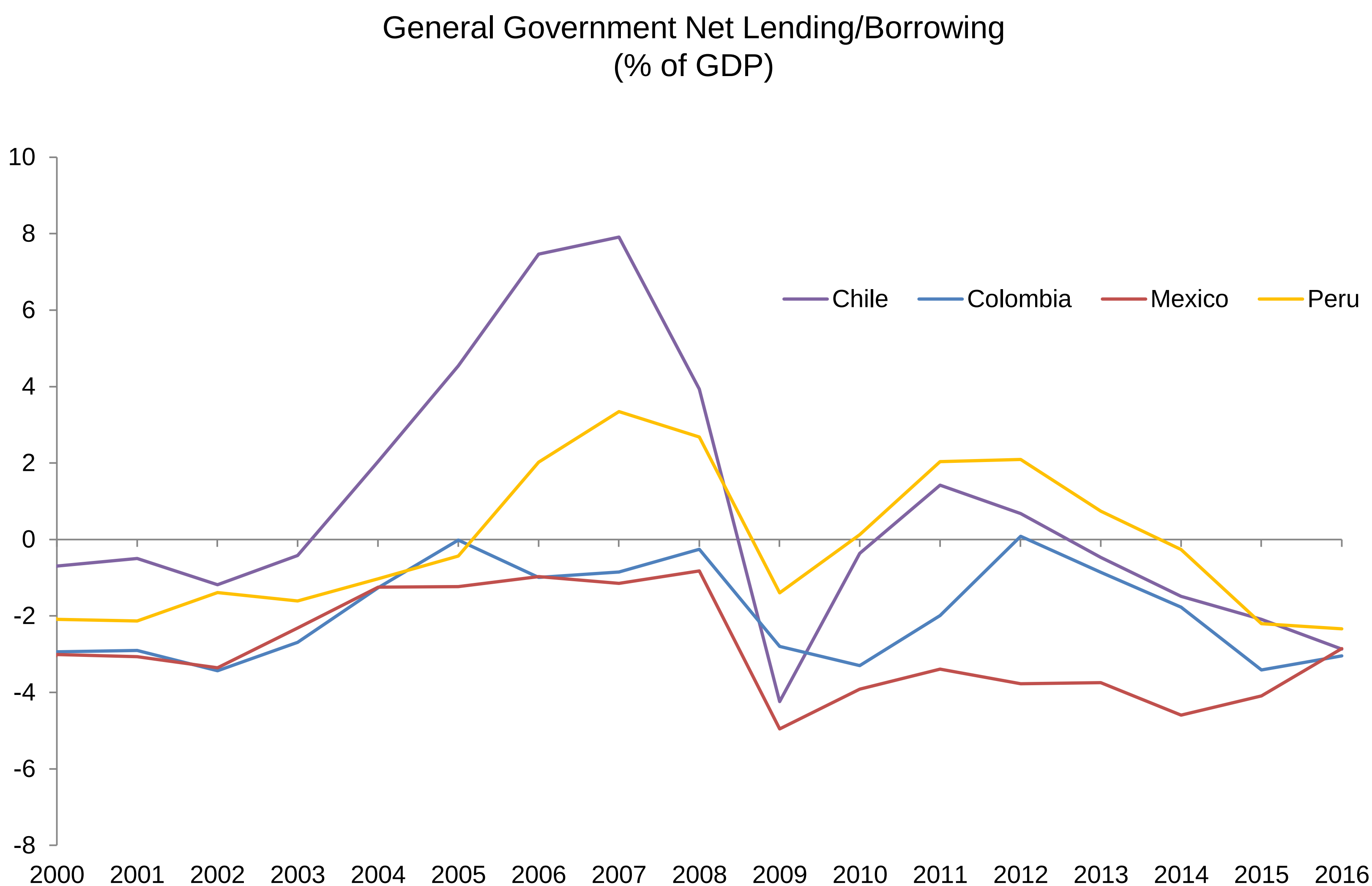
Fiscal deficits and
exchange rate regimes and interventions

Behind deep unhappiness: fiscal deficits



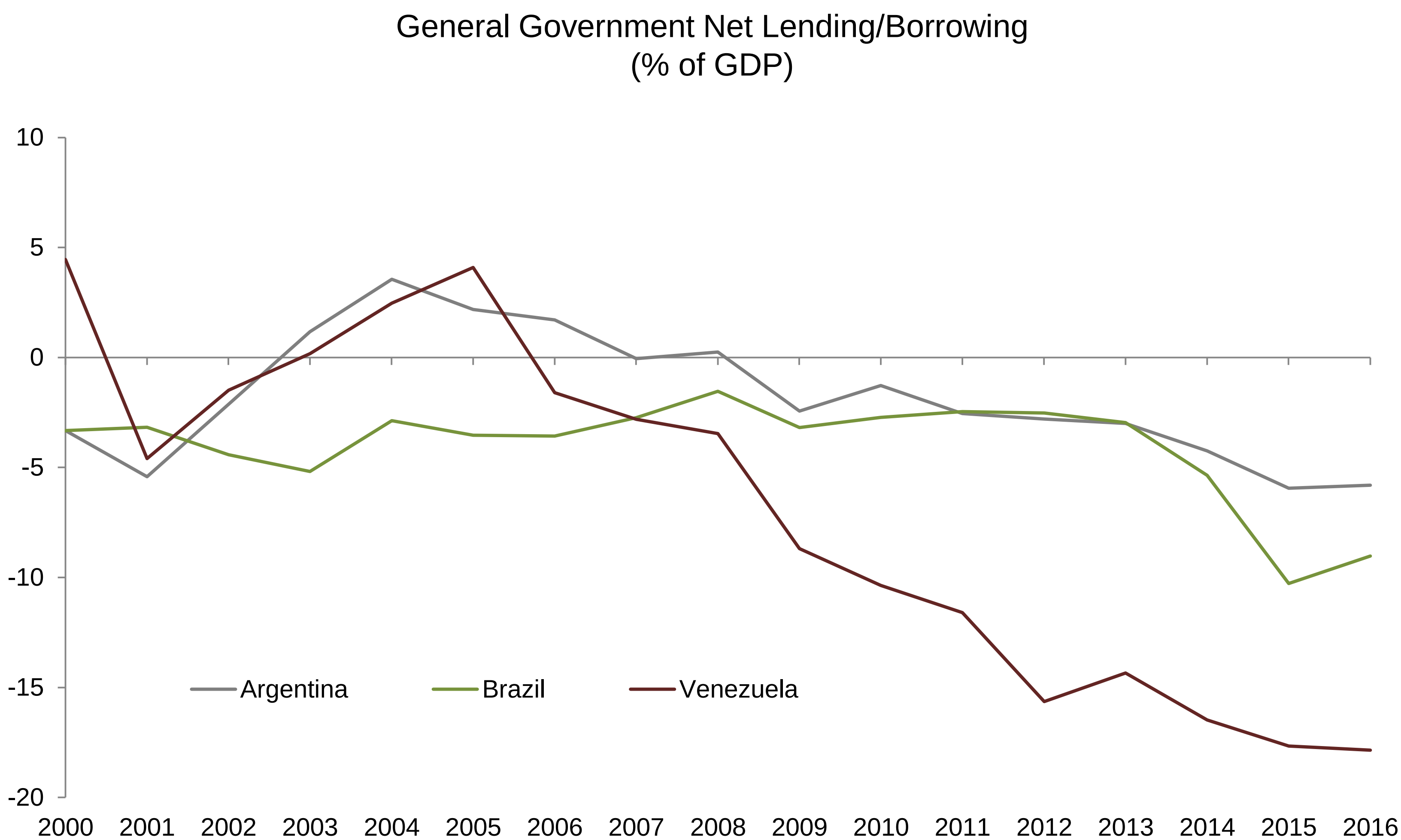
Source: World Economic Outlook database, IMF projections, WEO October 2017

Some differences in fiscal deficits among the less unhappy



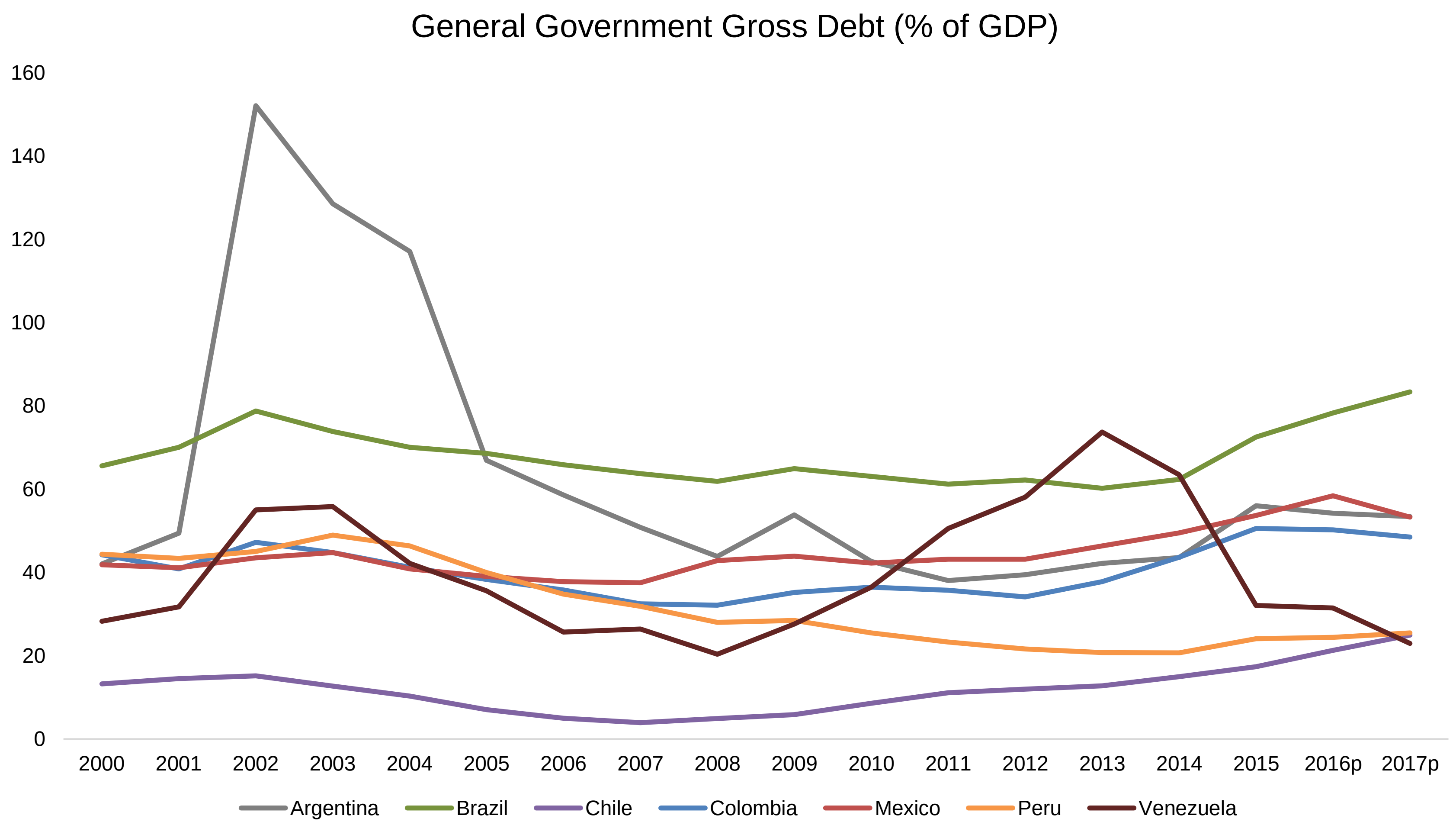
Source: World Economic Outlook database, IMF projections, WEO October 2017

Wider fiscal deficits and differences among the very unhappy



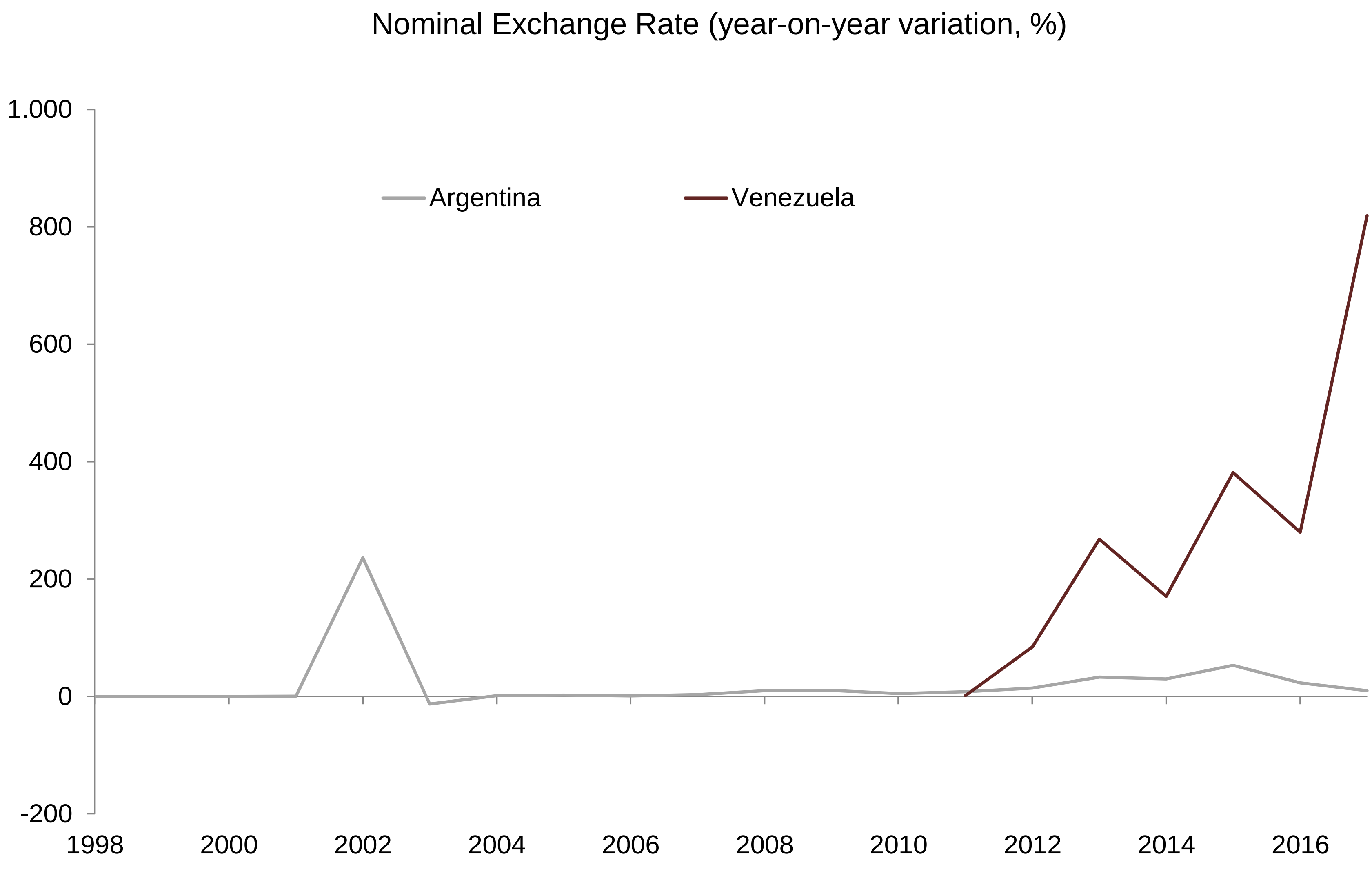
Source: World Economic Outlook database, IMF projections, WEO October 2017

Sovereign debt levels are also a concern in Brazil



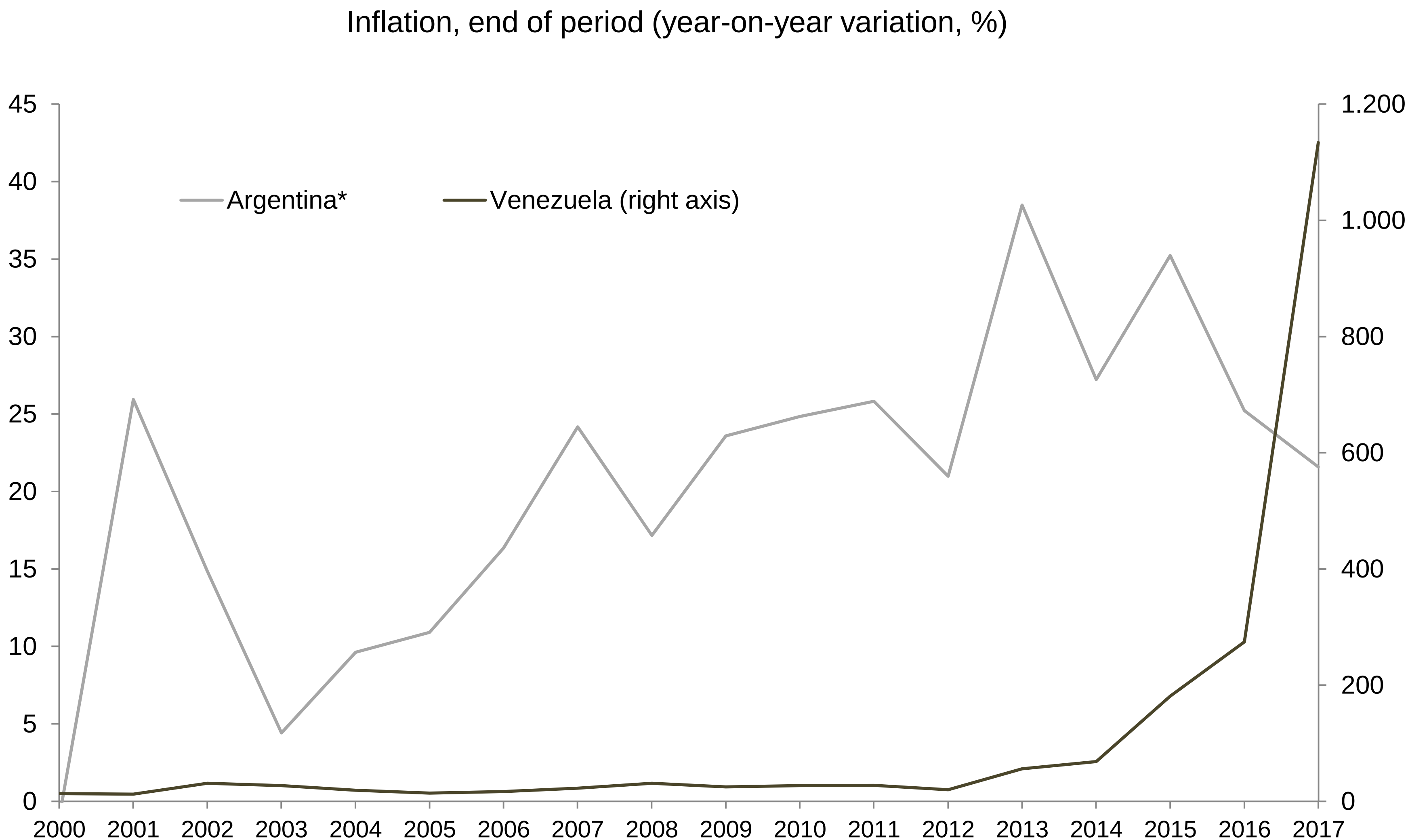
Source: World Economic Outlook database, IMF projections, WEO October 2017

Argentina and Venezuela attempted to keep nominal exchange rates constant but had sharp recent devaluations



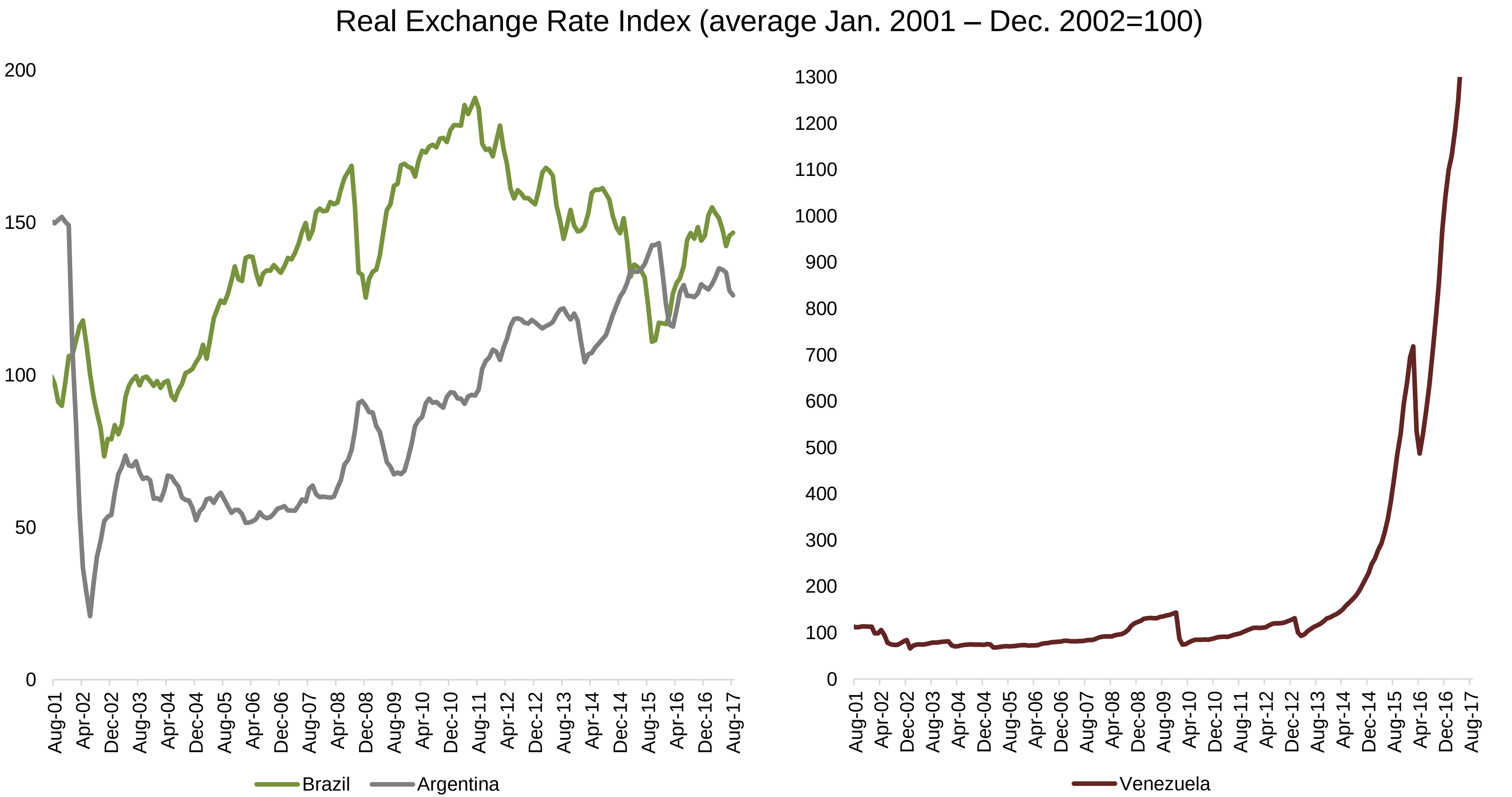
Source: Banco de Bogotá, author’s calculations

Both had inflationary pressures since the beginning of the boom; Venezuela has hyperinflation now



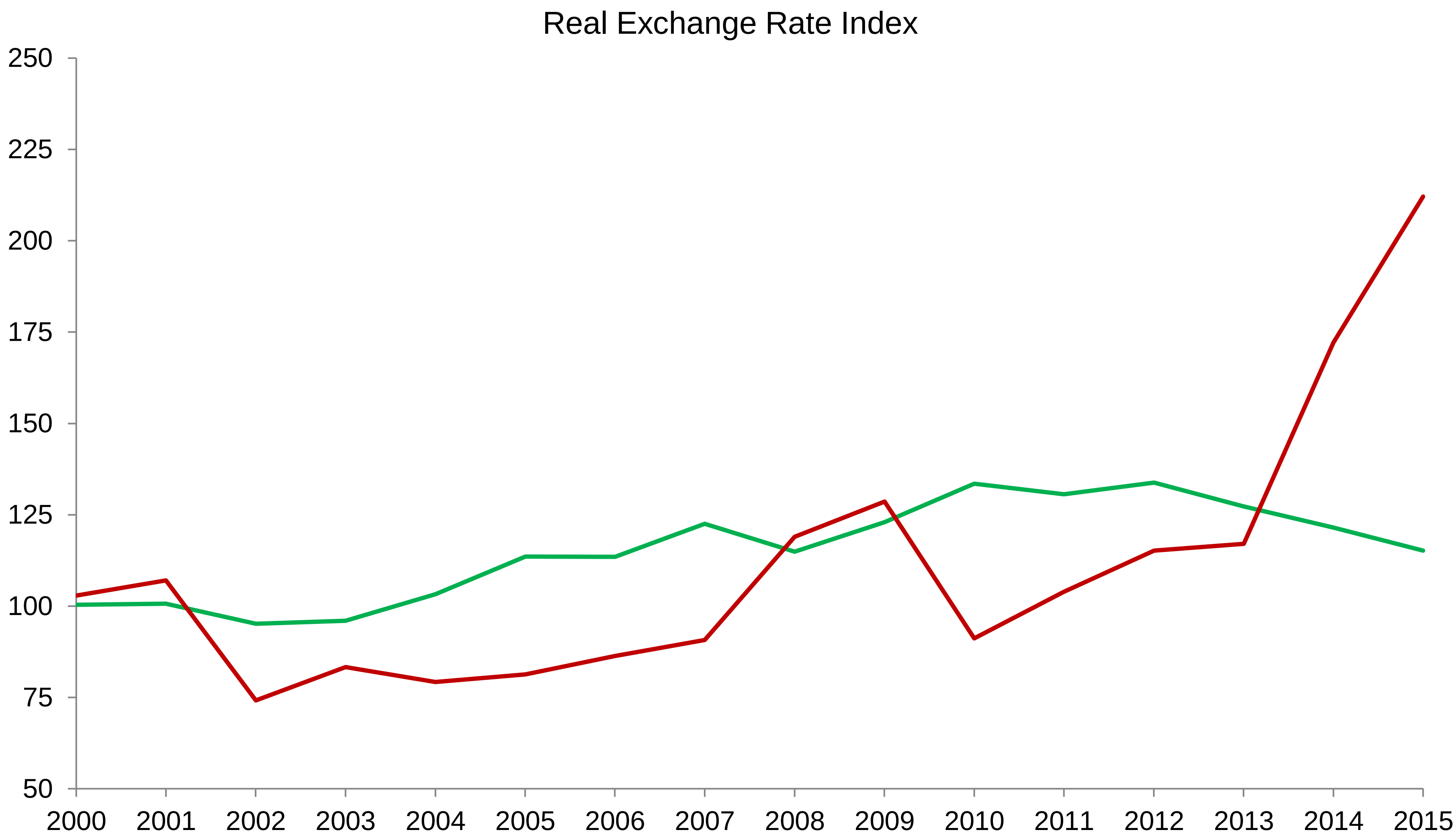
Source: Bloomberg. *Data for Argentina is extracted from independent sources

Their Real Exchange Rates did not appreciate much during the early boom but showed significant appreciation latter, even during the bust.



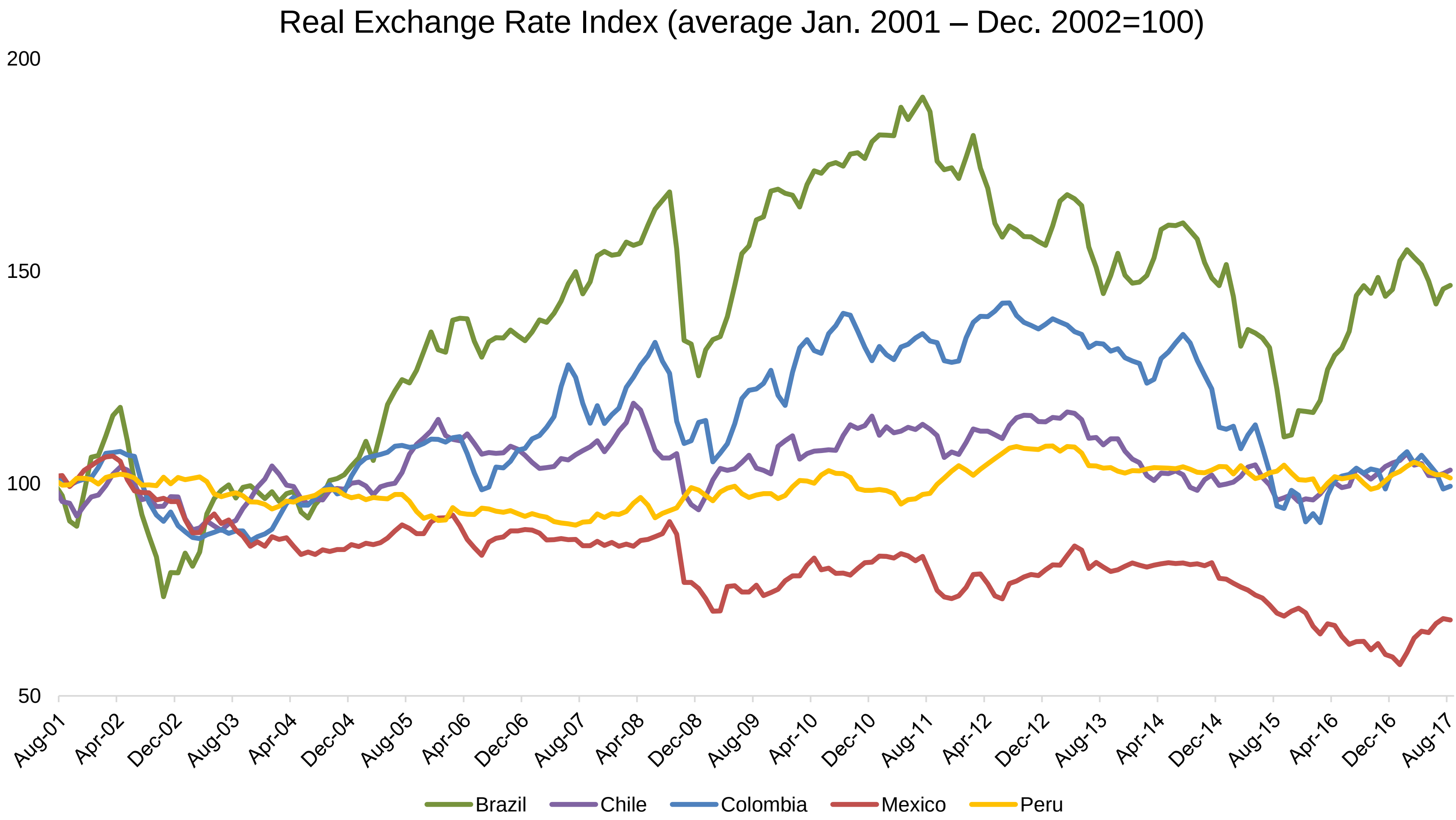
Source: BIS, Central Bank of Argentina, author's calculations.

Major differences in Real Exchange Rate performance between Inflation Targetting and non-IT countries



*Less unhappy: Brazil, Chile, Colombia, Mexico and Peru; Quite unhappy: Argentina and Venezuela
Source: Banco de Bogotá, author's calculations

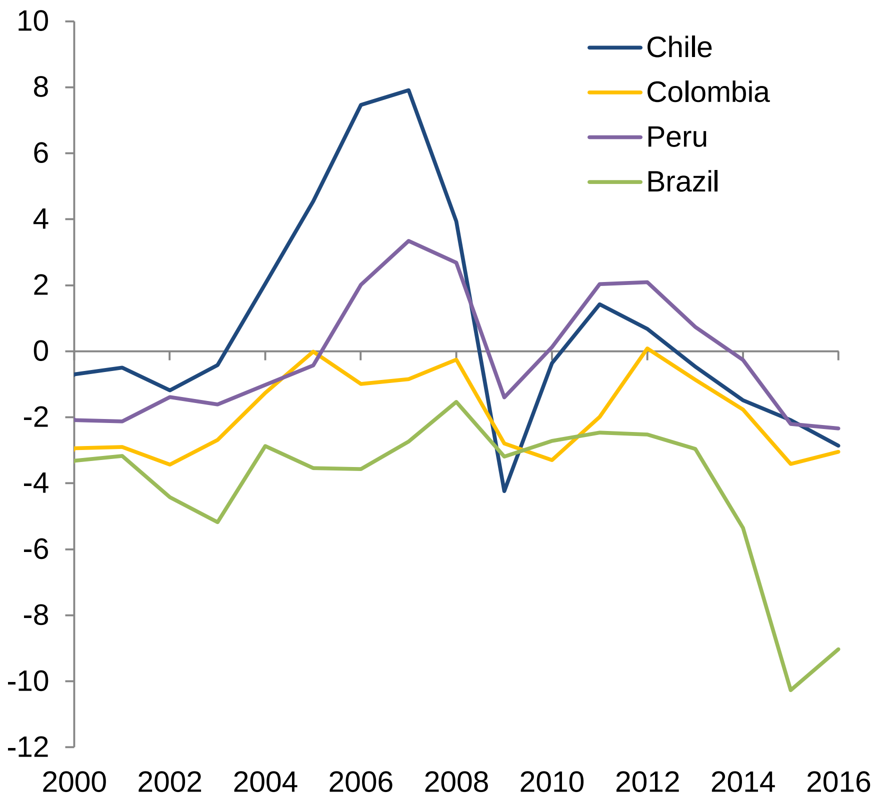
Some differences in Real Exchange Rate performance among IT countries: Chile and Peru appreciated less than Brazil and Colombia during the *boom*, in spite of higher TOT gains.



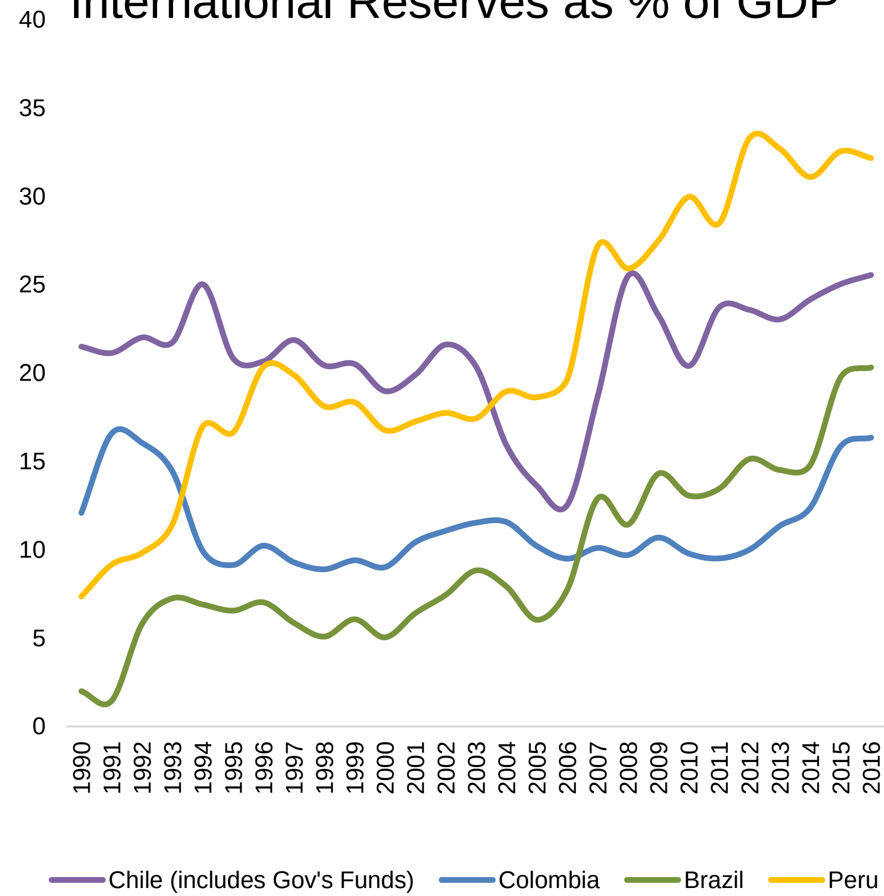
Source: BIS, author's calculations.

Due to the fact that Perú and Chile had both fiscal surpluses and higher accumulation of reserves

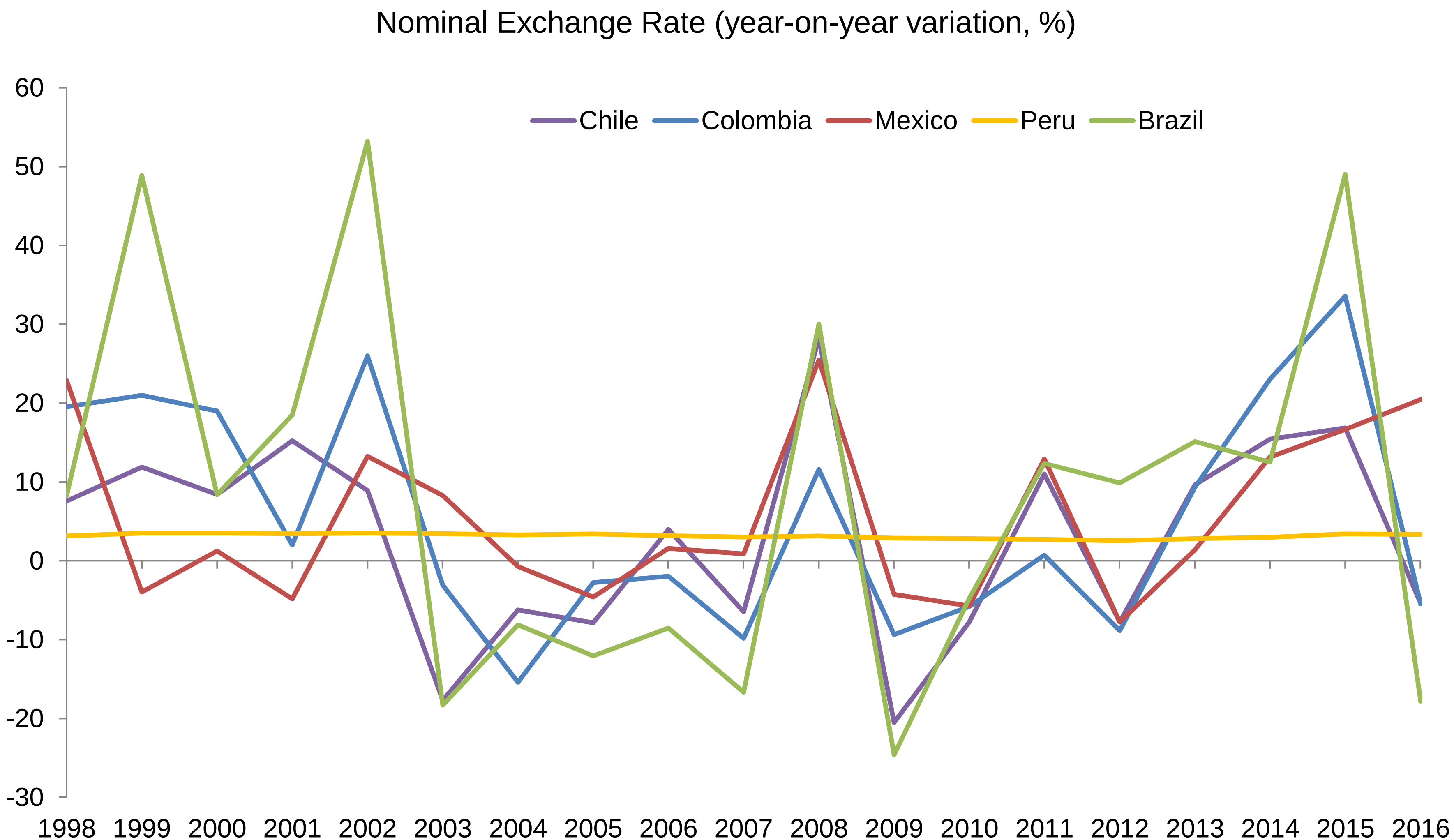
General Government Net Lending (% of GDP)



International Reserves as % of GDP

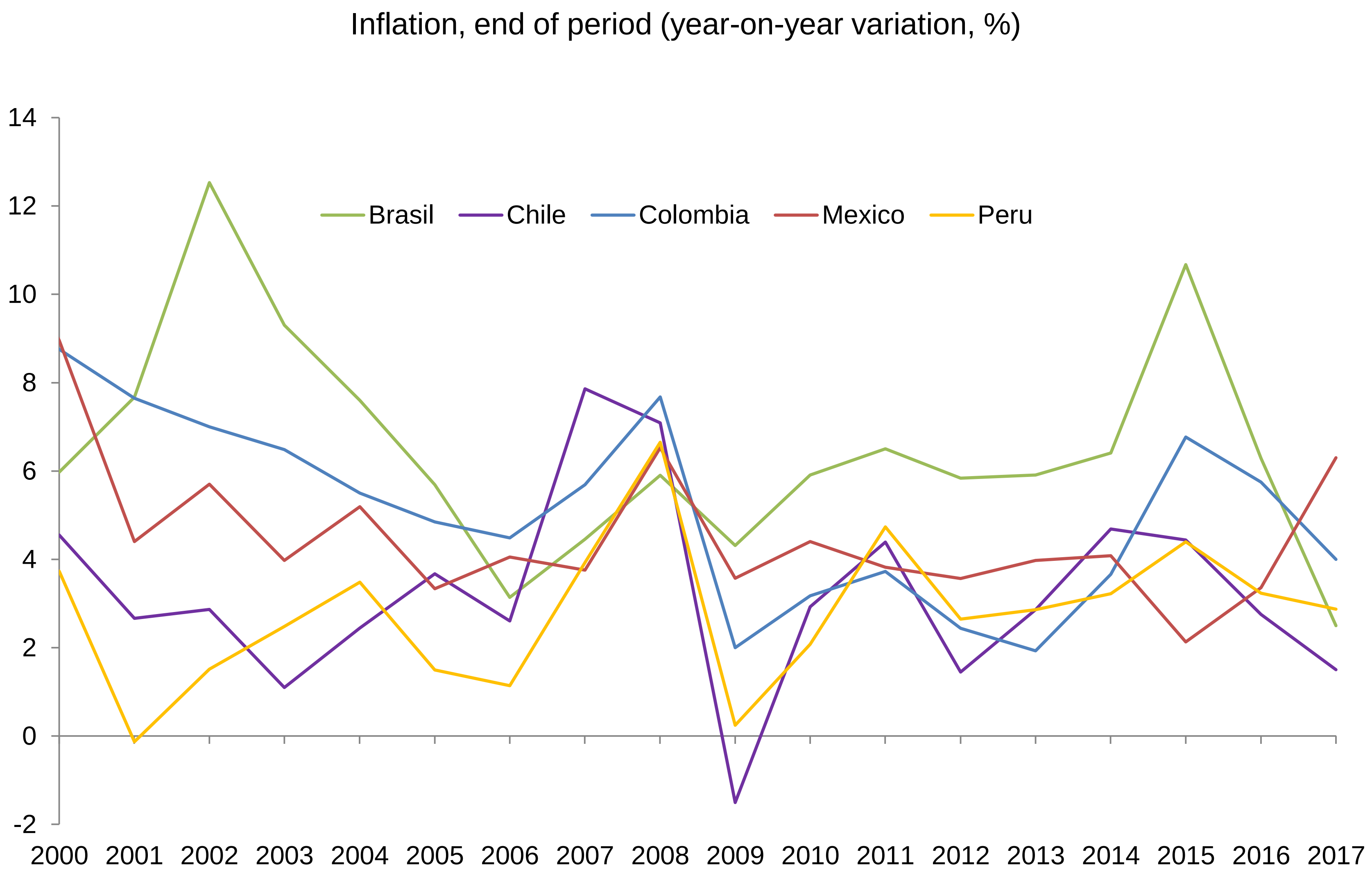


As a consequence, there were sharper recent compensatory nominal devaluations in Brazil and Colombia



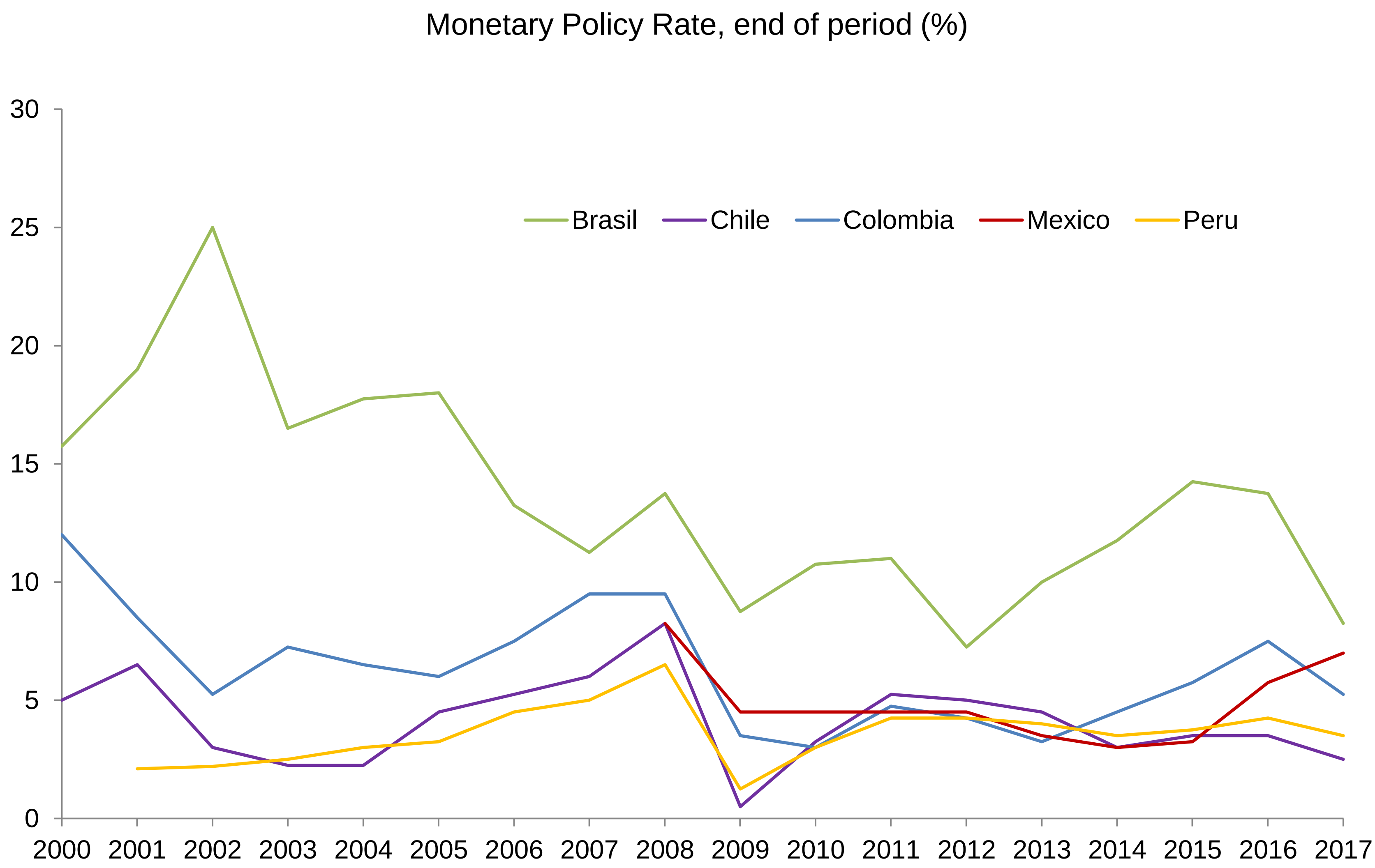
Source: Banco de Bogotá, author's calculations

That contributed to recent inflationary pressures



Source: Bloomberg

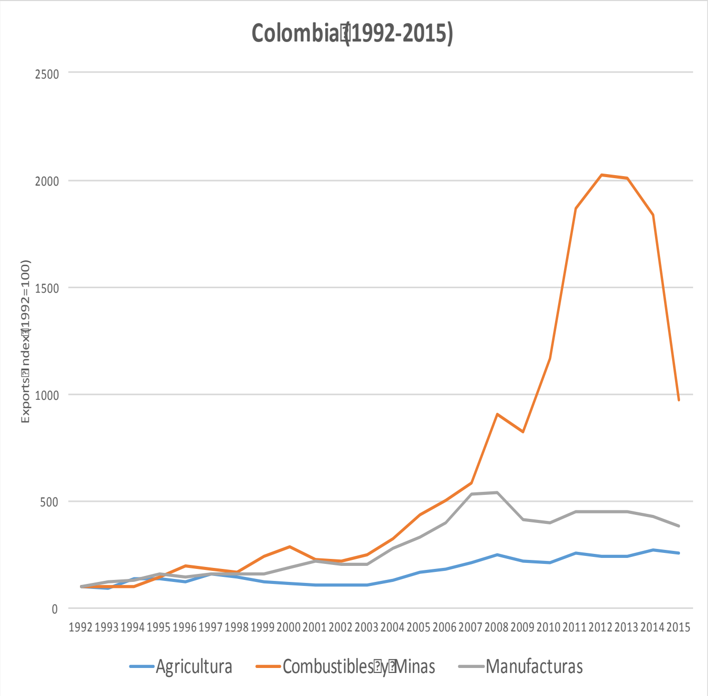
And led Brazil's and (less so) Colombia's Central Banks to adopt pro cyclical interest rate hikes (Mexico in 2016: Trump effect)

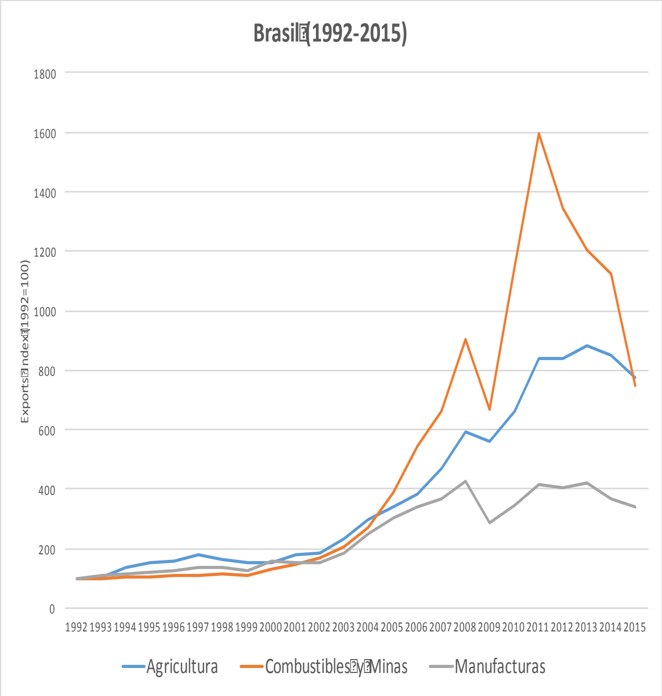


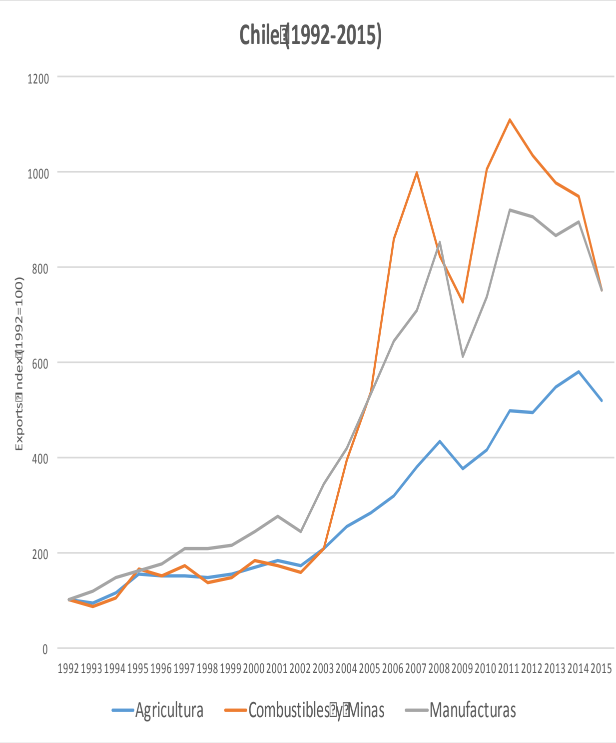
Source: Bloomberg

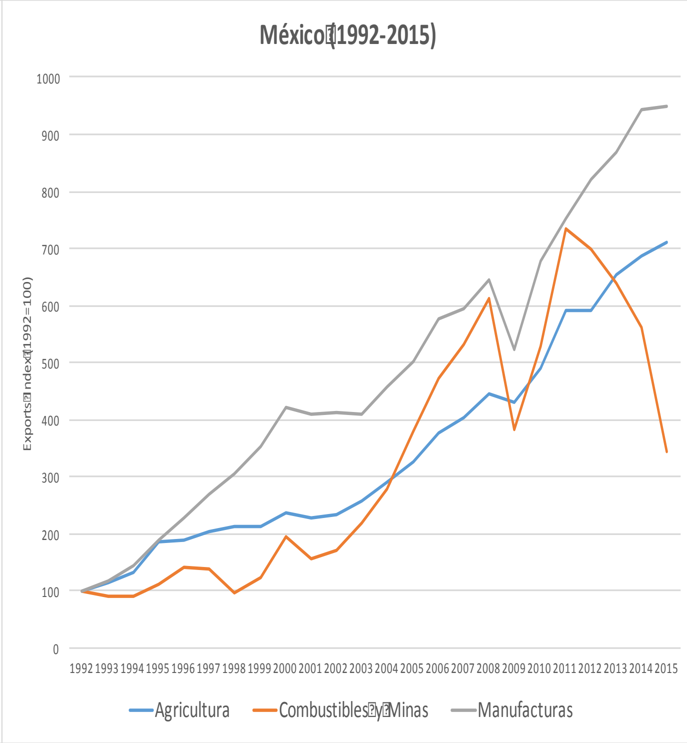
Not surprisingly DUTCH DISEASE symptoms were higher in COLOMBIA and BRAZIL than in PERU and CHILE: Exports

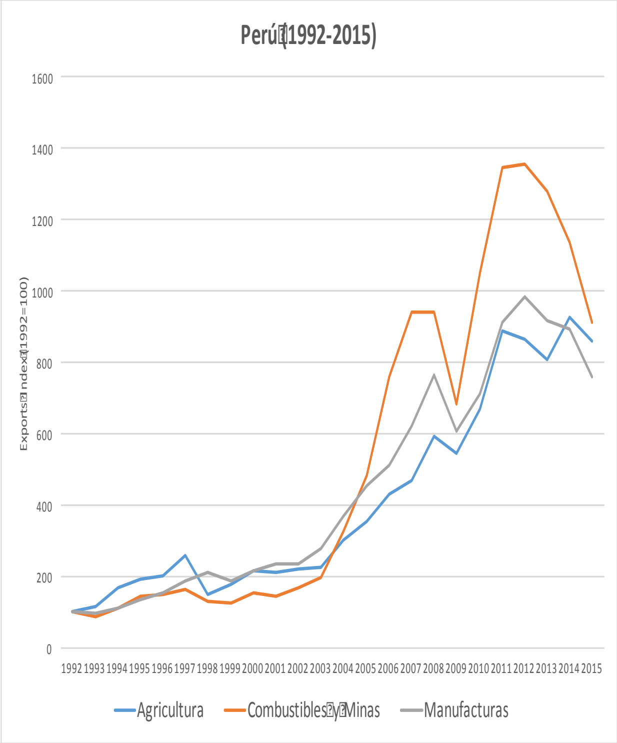
Fuente: WTO; cálculos propios





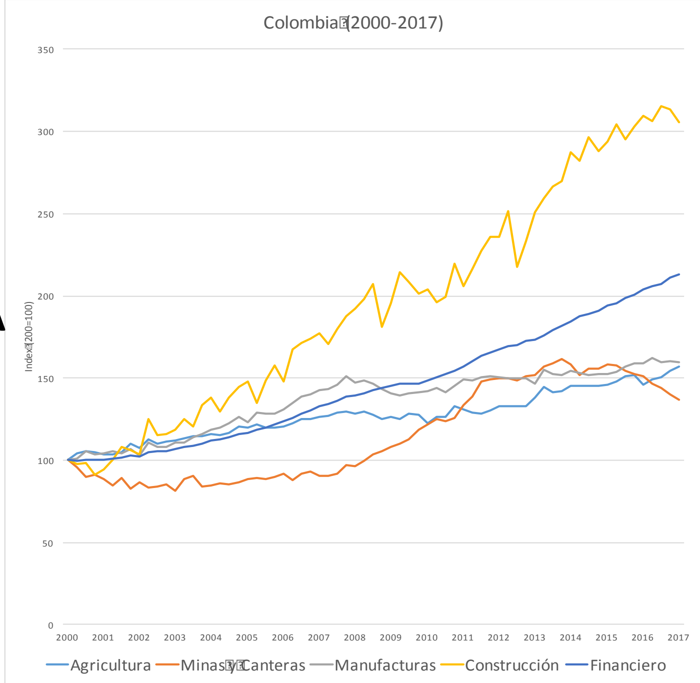


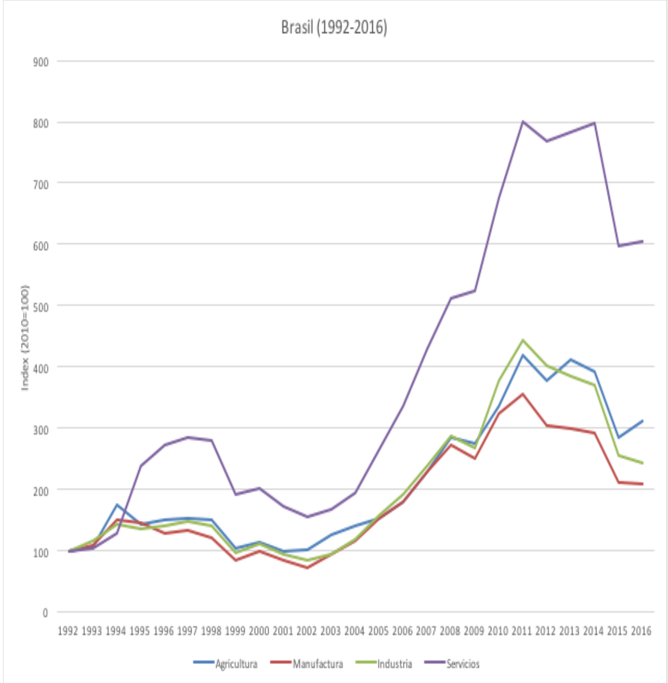


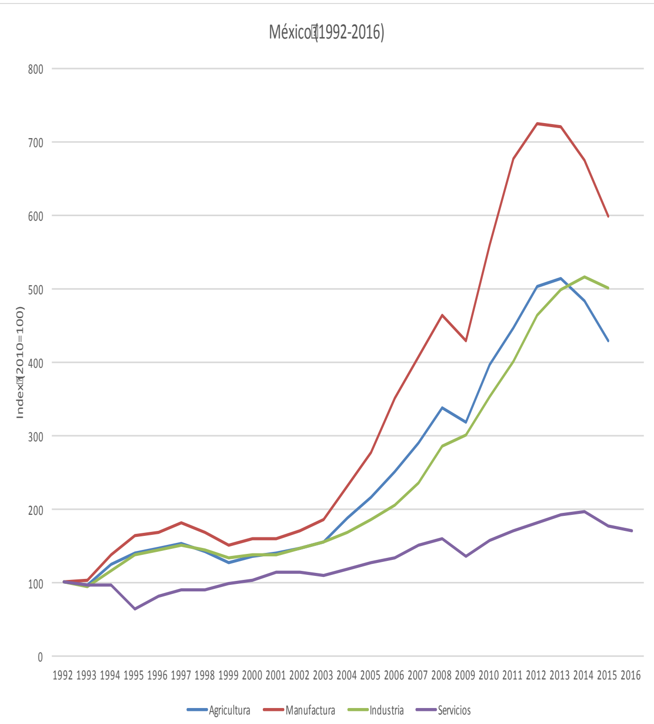


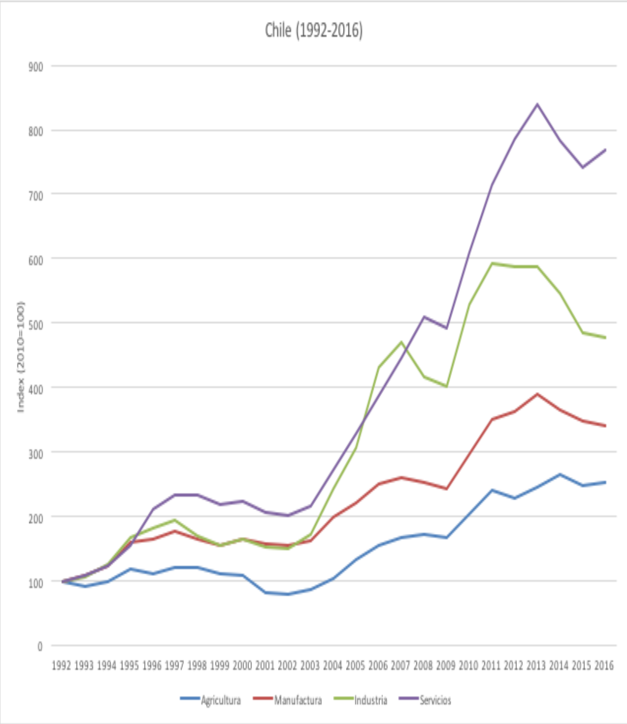
Not surprisingly DUTCH DISEASE symptoms were higher in COLOMBIA and BRAZIL than in PERU and CHILE : Production

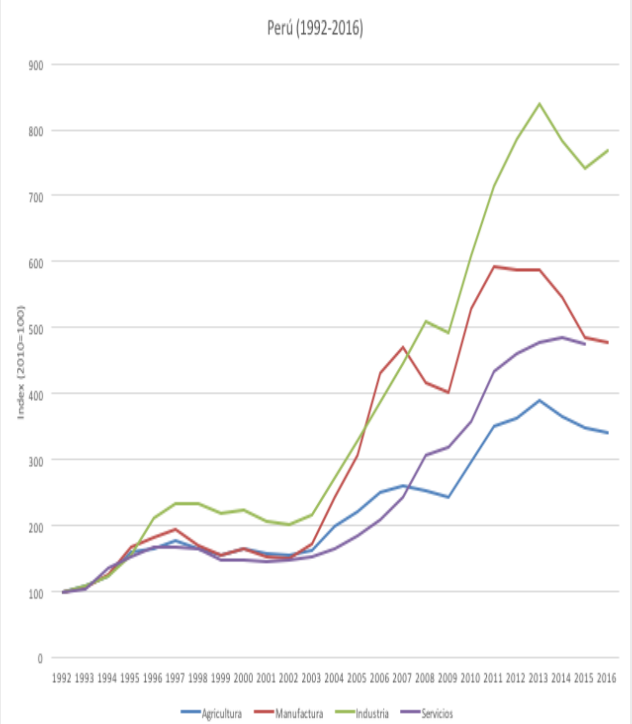
Fuente: WDI, World Bank; cálculos propios y Banco de la República de Colombia











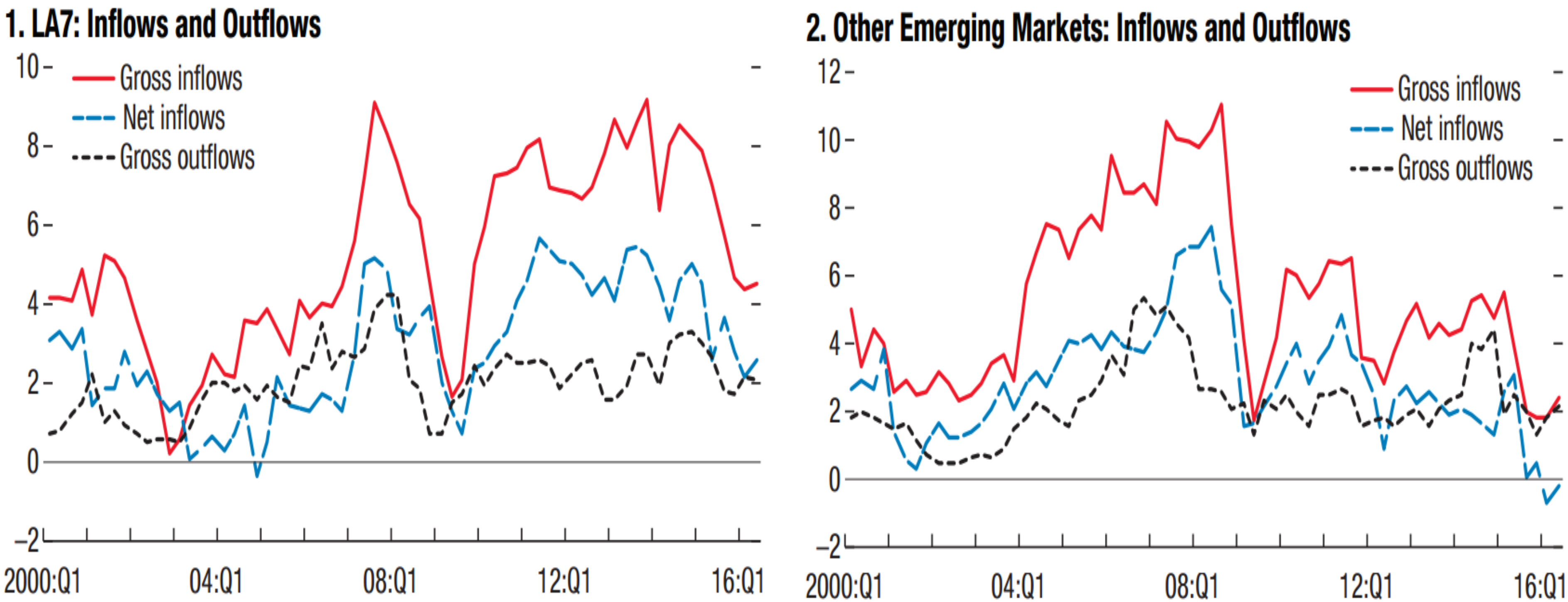
The key lessons

- As expected, flexible exchange rate regimes operated as important shock absorbers. Countries with fixed exchange rate regimes (Argentina and Venezuela) had higher variability of growth and inflation
- But significant Real Exchange Rate appreciations and depreciations created serious Dutch Disease, adjustment and inflationary costs during the commodity price cycle in Brazil and Colombia.
- Perú and Chile that mitigated them through a combination of counter cyclical fiscal and monetary policies and ´against the wind´ exchange market interventions by central banks (´dirty´ floating) encountered less problems

Vulnerabilities to potential external shocks

FED interest rate hikes will impose threats to capital flows to Emerging Markets, with high external and fiscal vulnerabilities

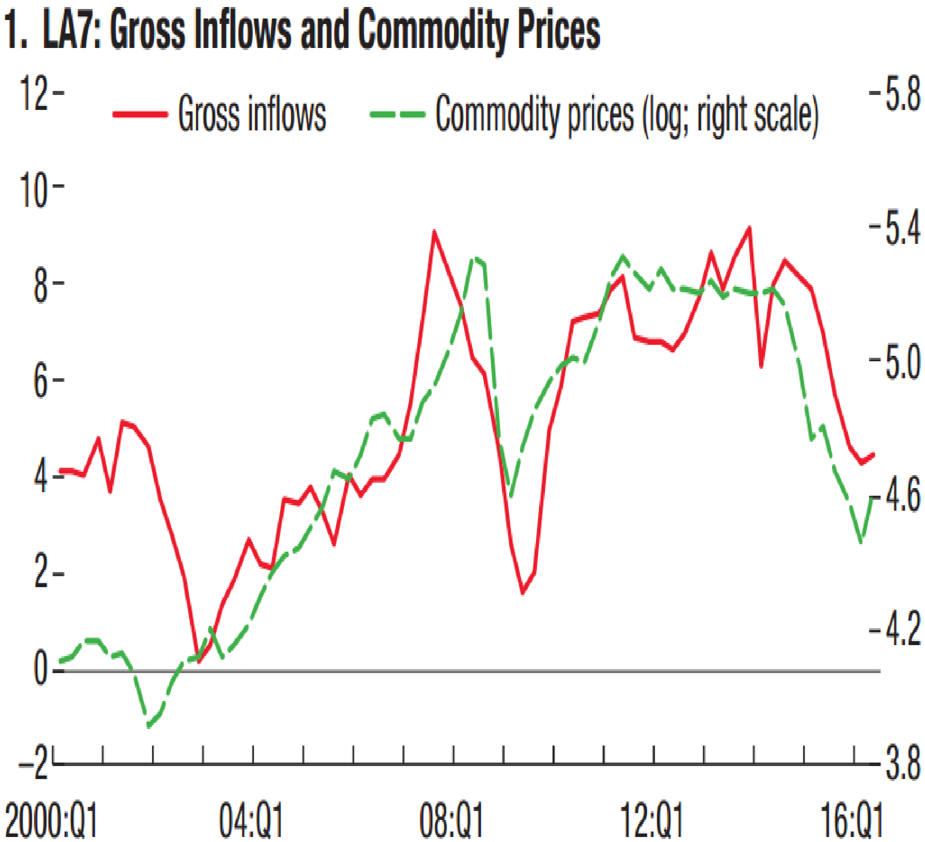
Capital Flows in Emerging Markets (percent of trend GDP; median)

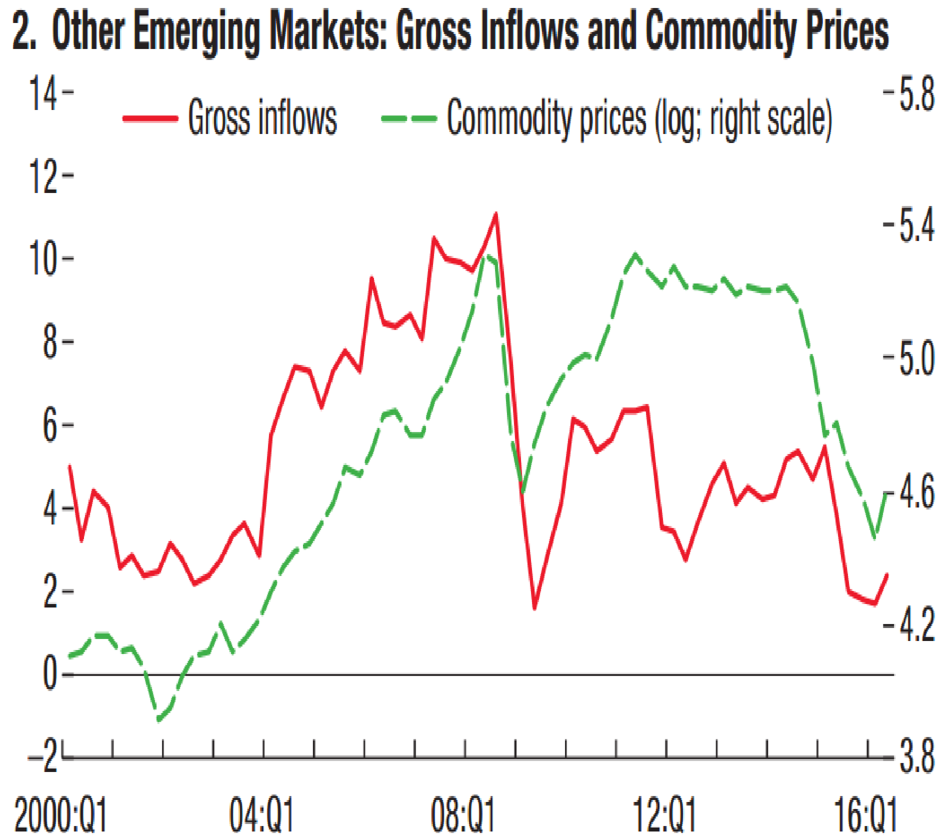


Source: IMF, REO April 2017

Though gross capital inflows are highly correlated with commodity prices in South America : a China hard landing would impose huge risks.

Gross Inflows and Commodity Prices (percent of trend GDP; median)

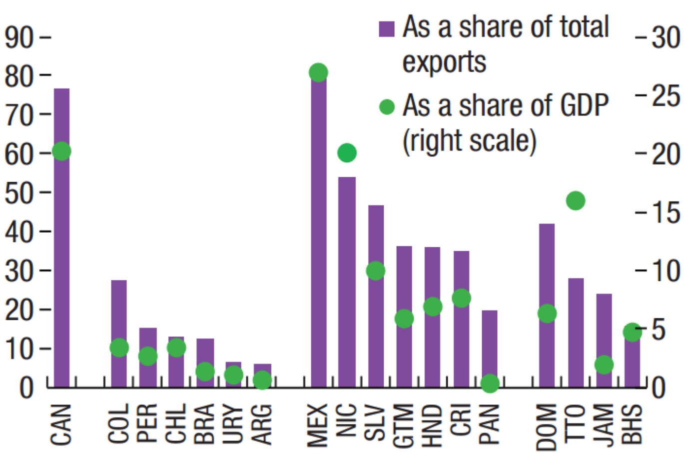




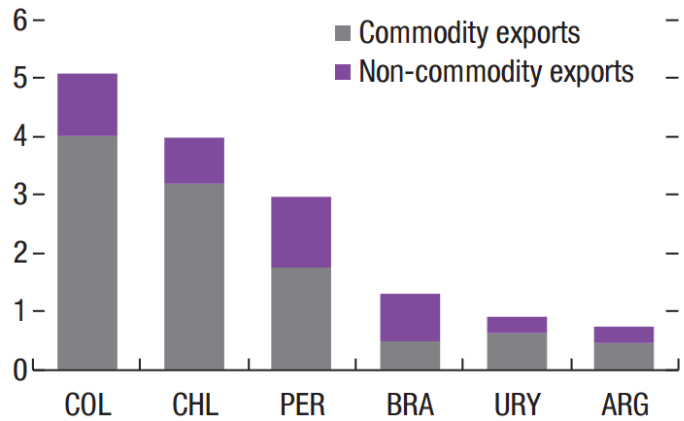
Source: IMF, REO April 2017

Protectionist policies in the US would affect countries with high trade links: Mexico and Central A merica

1. Goods Exports to the United States, 2015 (Percent)

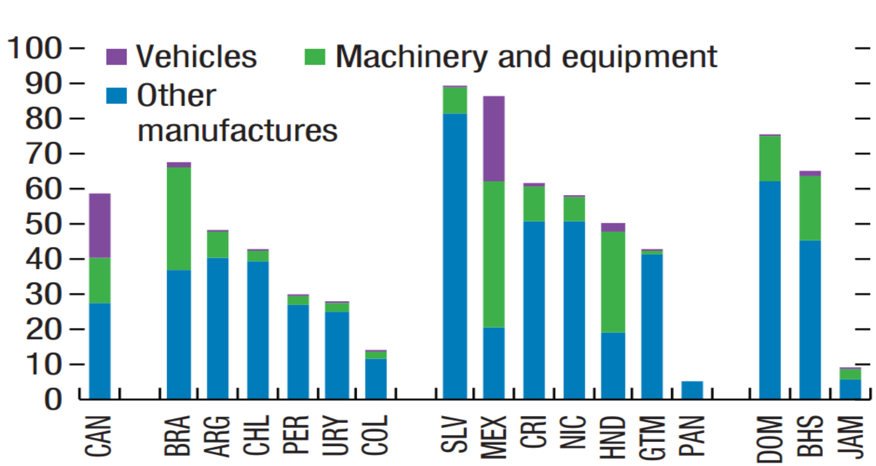


2. South America: Composition of Exports to the United States, Average over 2013–15[1] (Percent of GDP)



South America has lower exposure to the US –mostly through commodities-, compared with **Central America** and **Mexico**

3. Manufactured Exports to the United States, 2015[2] (Percent of total exports of goods to the U.S.)

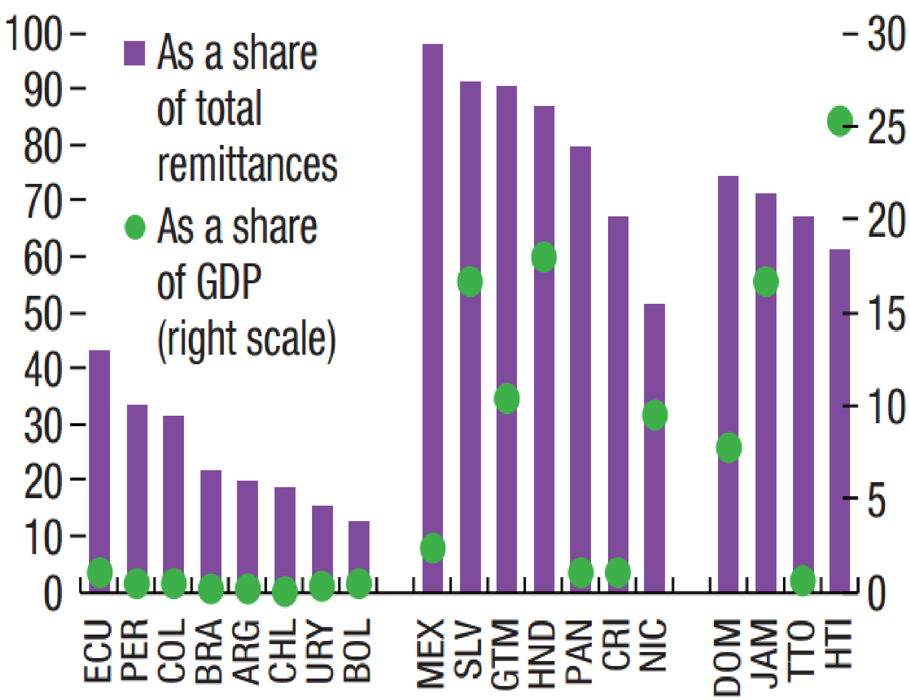


Brazil, **Argentina** and **Chile** export more manufactured goods to the US, compared to Peru and Colombia

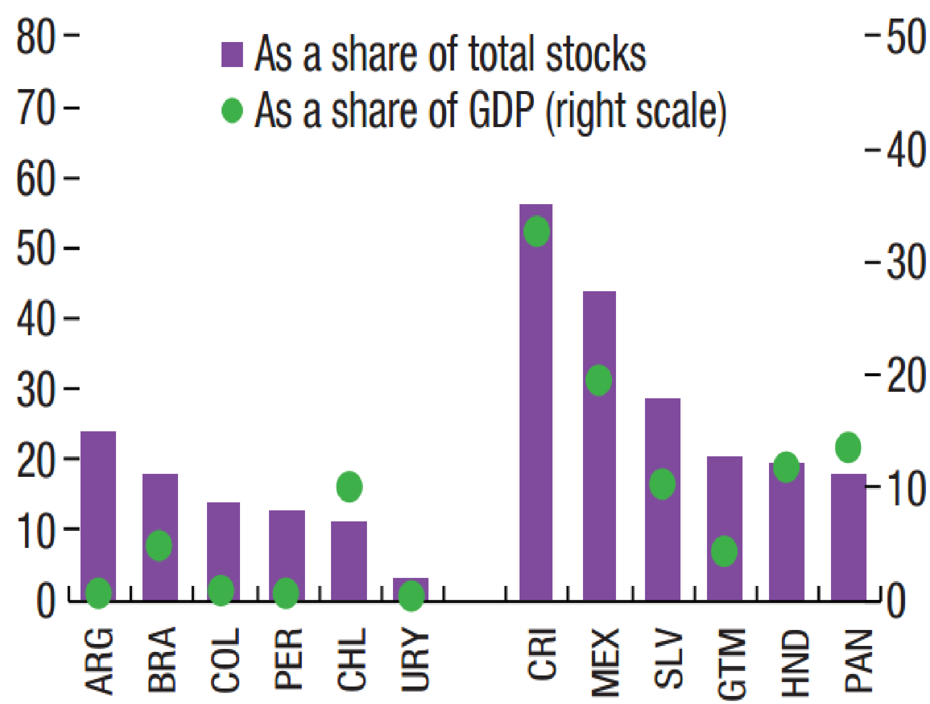
Source: IMF, REO April 201

Remittances and Direct Investment from the US are also quite high, especially to Mexico

4. Remittances from the United States to Latin America and the Caribbean (Percent)

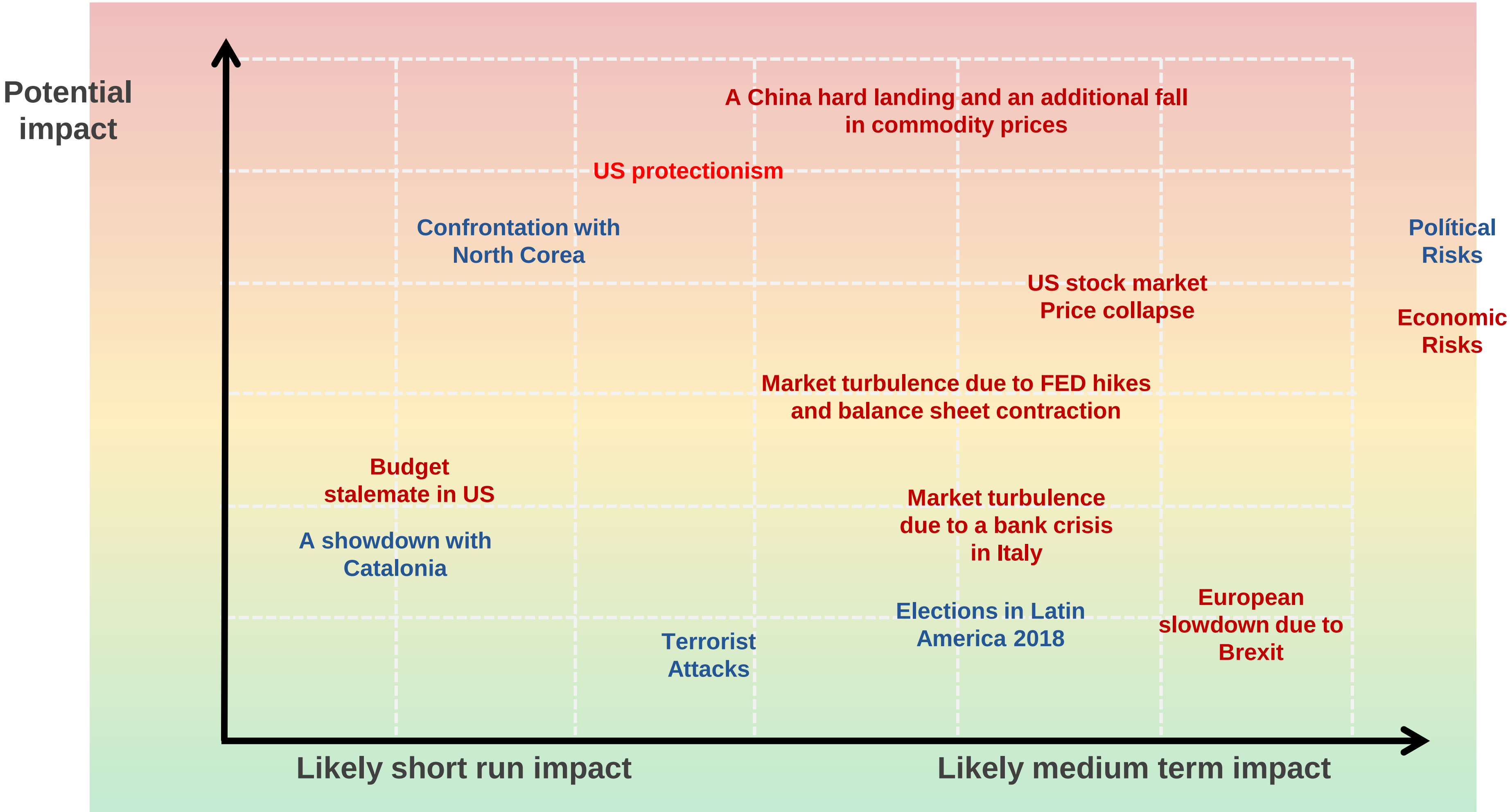


6. Direct Investment from the United States, 2015 (Percent)



Source: IMF, REO April 2017

A matrix of global risks for Latin American Countries



Sources: Deutsche Bank, Bank of América, own estimates.

The key challenge going forward:

productivity growth

The key long term challenge: closing the productivity gap

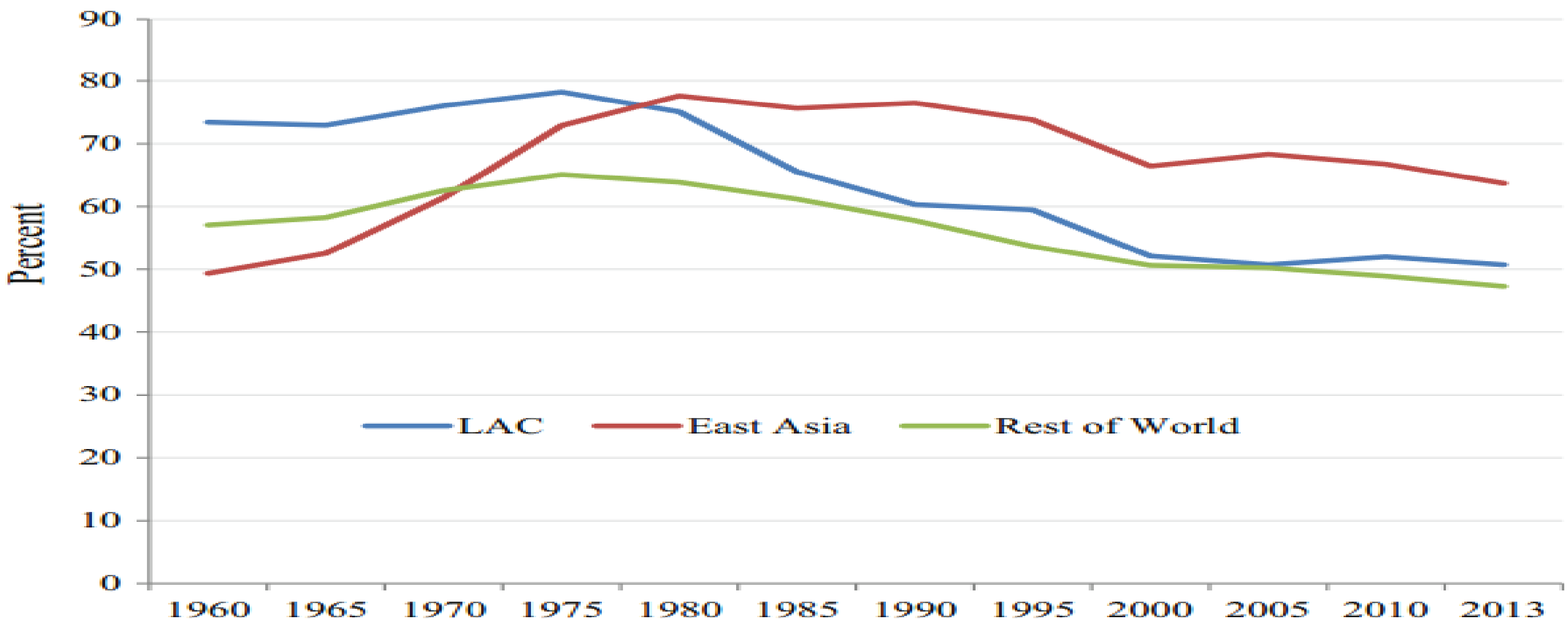
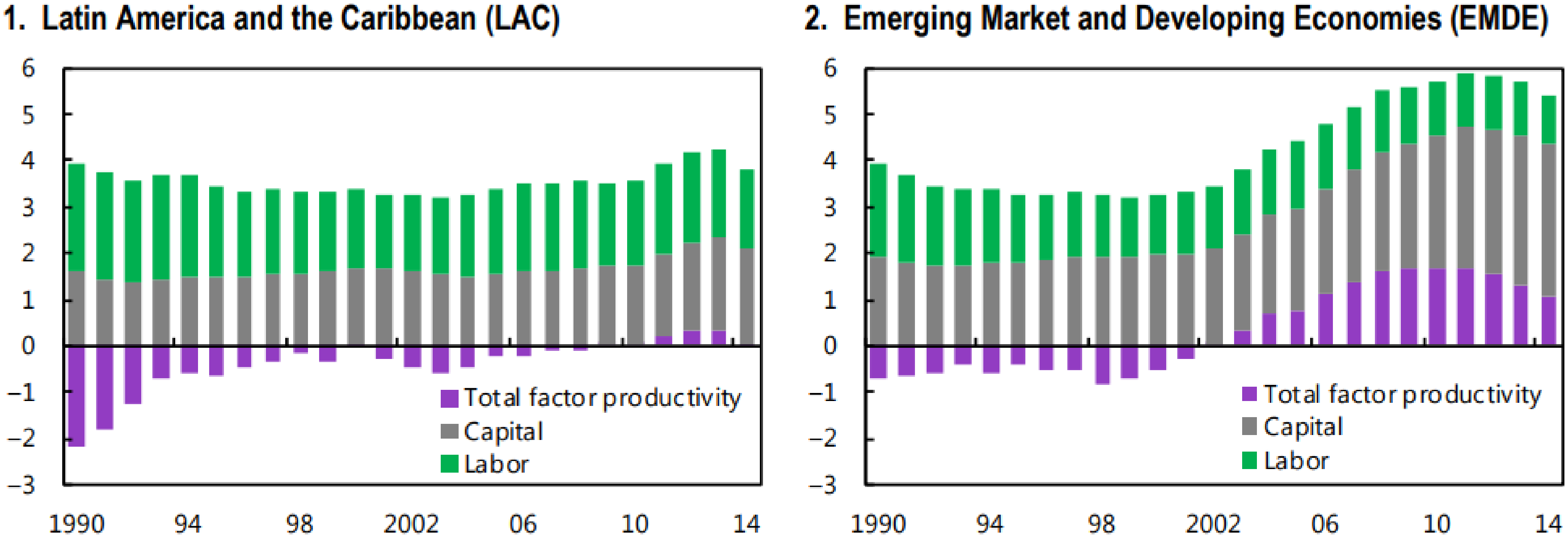


Fig. 1.1 TFP relative to the United States (1960–2013) (*Source*: Fernández-Arias 2014)

Source: Grazzi, M. & Pietrobelli, C., "Firm Innovation and Productivity in Latin America and the Caribbean", IDB, June 2016

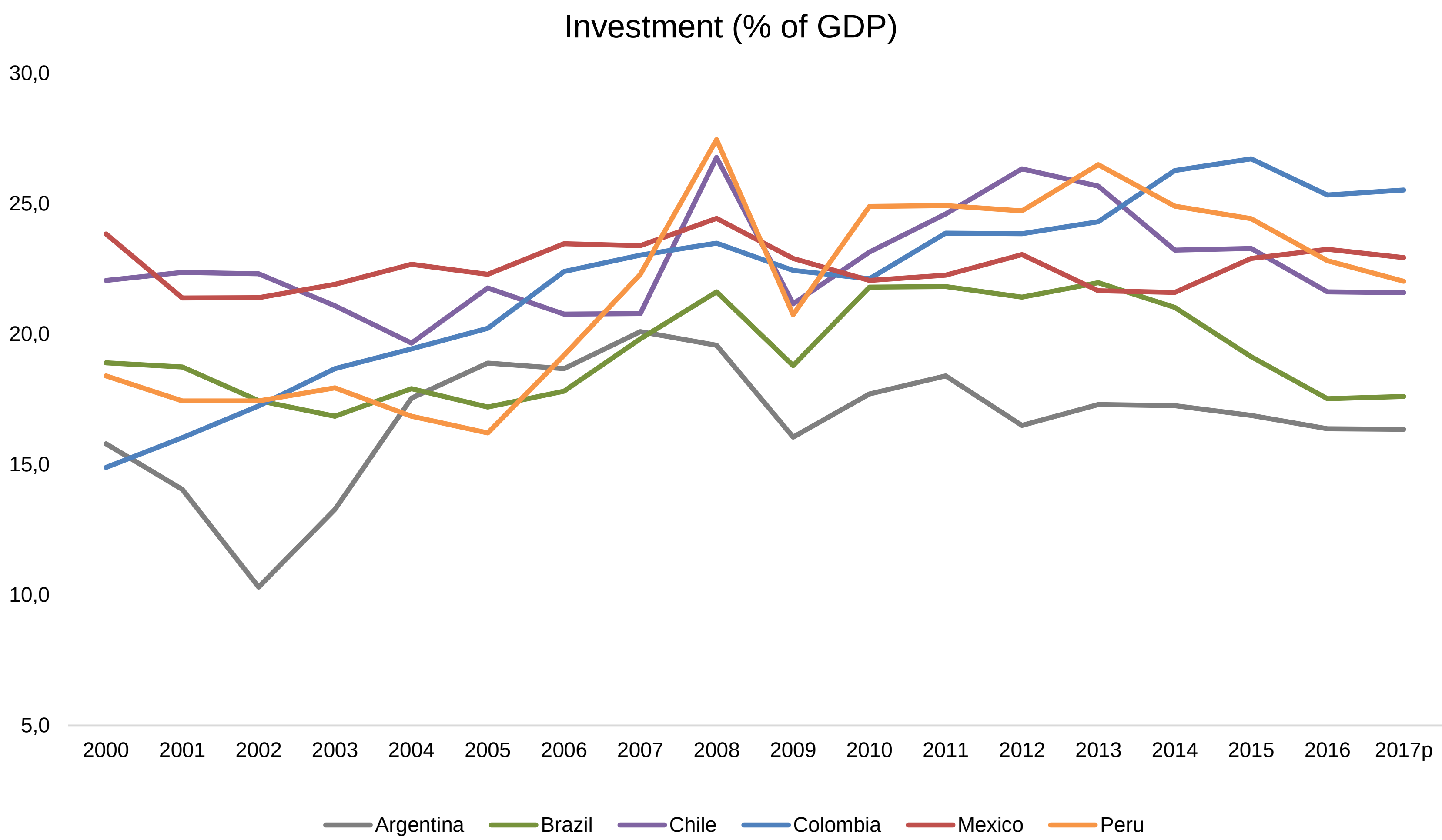
Growth in Latin America has been driven by capital and labor growth, not by total factor productivity growth

Figure 1.2. Decomposition of Economic Growth in LAC and EMDE
(Percent)



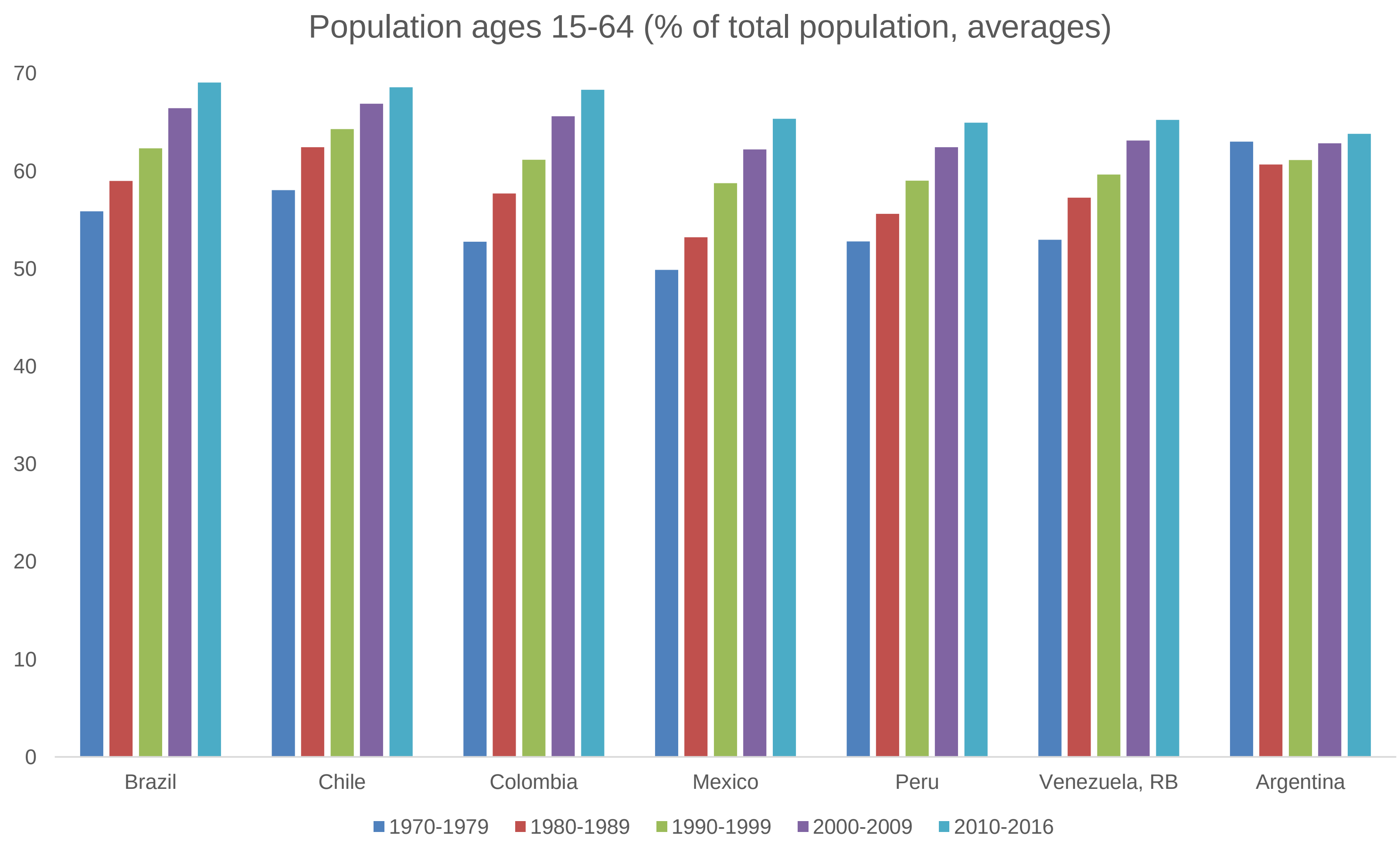
Sources: Penn World Tables (PWT) 9.0; and IMF staff calculations.
Note: Ten-year rolling average of purchasing-power-parity GDP-weighted average across countries; growth rates in constant price national currency units. Total factor productivity is calculated based on the translog production function, time-varying labor shares. Labor includes number employed, years of schooling, and returns to education, as published in the PWT 9.0.

This will have to change: as investment rates are already high in several countries..



Source: World Economic Outlook database, IMF projections, WEO October 2017

And the demographic bonus will soon be over



Source: World Development Indicators, World Bank

Summing Up

1. The growth boom and posterior slowdown in most Latin American countries is basically explained by the cycle of commodity prices (*plus high international liquidity and low international interest rates*).

2. Countries that saved more in the boom (*fiscal surplus and reserve accumulation*), like Chile and Peru, had lower symptoms of Dutch Disease, have had to engage in less painful fiscal and monetary pro cyclical adjustments in the bust and have now lower vulnerabilities to additional shocks.

3. Venezuela and Argentina engaged in unsustainable macro policies (*and anti private sector micro policies*) and lost access to international capital markets (*and had sharp reserve losses*) well before the fall in commodity prices. Venezuela is in full implosion while the new regime in Argentina is trying to cope.

4. Brazil problems began after 2013 (*fiscal relaxation and temper tantrum*) and were then aggravated by the political crisis.

5. The key going forward are increases in productivity: *no tale winds in the horizon and lower capital and labour growth!*