SUSTAINED RECOVERY IN THE ASIA PACIFIC

Overcoming the Global Crisis in South America

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Summary and Main Conclusions

- Study four PECC-Latin America countries: Chile, Colombia, Ecuador, & Peru.

- Five simple conclusions:

  (a) this crisis was externally driven

  (b) countries had good preconditions and policy space to whether the crisis and used it reasonably well (except for Ecuador)

  (c) recovery is underway and faster than in more advanced economies (North America and Europe)

  (d) countries too small to determine its own macroeconomic prospects

  (e) policies implemented to weather the crisis though necessary are not those needed for sustained recovery or long run growth

Snapshot of LA-PECC countries pre-crisis

- Small, dynamic, open economies

	GDP in 2008 US$ Billions	US$ GDP per-capita	Annual GDP growth 2004-08 (%)	Foreign Trade % of GDP
Chile	170	10,100	4.8	91
Colombia	242	5,180	5.5	36
Ecuador	53	3,180	5.4	79
Peru	127	4,540	7.7	55
LAC	**4,266**	**4,693**	**5.4**	**20**

- PPP based GDP?: add 40%

- Brazil and Mexico

Crisis was external

- First time ever
    - No financial crash (no toxic assets, good regulation)
    - No balance of payment crisis or currency collapses (trade heavily affected, massive reserves, floating exchange rates)
    - Solid initial conditions (except Ecuador)
        - External buoyancy
        - Macroeconomic stability (low inflation finally, CB independence)
        - Fiscal discipline (rules)

Crisis and Vulnerability

- Policy makers initially believed countries were "invulnerable"

- Two forms of "vulnerability"

Vulnerability Type I	*My Son (5)*	*Open, integrated, full of shocks, quick recovery, little scars, relapses unusual*
Vulnerability Type II	*My Father (85)*	*Closed, unintegrated, few shocks, slow recoveries, lasting effects, relapses fatal*

- Solid initial conditions do not prevent shocks from occurring, but make crisis less damaging and recovery faster and more sustainable.

Policies I: Policy Space to Respond to Crisis ("Never Better")

- **External balances (never better)**
  - *5 years of trade surpluses and current account surpluses*
  - *High remittances and foreign reserves*
  - *Low external debt, mostly private sector (unused borrowing capacity)*

- **Fiscal space (never better)**
  - *Fiscal balance or surplus.*
  - *Low internal debt (unused borrowing capacity)*
  - *Substantial fiscal discipline*

- **Financial and monetary space (never better)**
  - *Low inflation, successful targeting and substantial credibility*
  - *Low risk of currency and maturity mismatch in financial sector*

Policies II: Policy responses

- **Similar to the rest of the (reasonable) world**

- **Monetary policy**
  - *Lowering interest rates*
  - *Provision of liquidity in foreign and domestic currency*
  - *Issuing long-term public debt in local currency*

- **Financial market intervention**
  - *Flexibility of reserve requirements for financial institutions.*
  - *Elimination of capital controls on portfolio and foreign direct investment.*
  - *State support for loan restructuring (collateral, but no guarantees for deposits)*

- **Fiscal Policies**

  - *Lowering taxes for SMEs and corporations*
  - *Increased and new (targeted) subsidies and new tax benefits.*

  - *Fiscal stimulus plan announced*

    - *Sizable: around 3% of GDP*
    - *Prioritizing public expenditure*
      - *Infrastructure (roads franchising, housing, water and sanitation, irrigation)*
      - *Social programs (health, education)*
      - *Support for small businesses (employment)*
      - *Several sectoral stimulus measures*

Recovery

- Short-term recovery well on its way
  - Stock market booms, country risk declines, exchage rate appreciation
  - Housing and investment growing steady
  - Confidence levels up

Long-run growth and economic development

- Small open economies depend on fate of developed economies.
- Implementing the correct domestic policies do not.
    - How are countries going to dismantle “crisis support measures”?
    - What are the key policies for long-term growth?

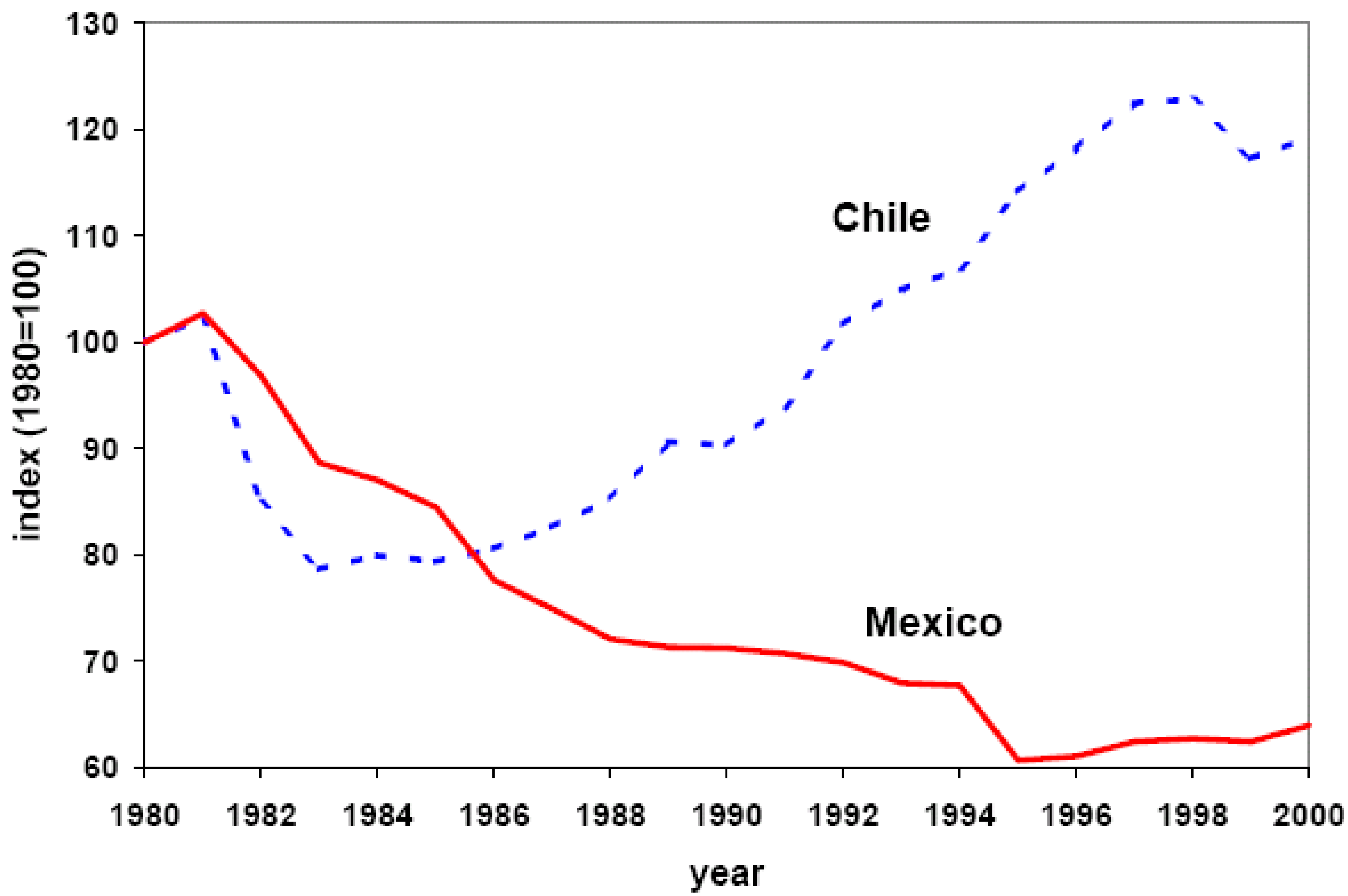
Learning from a “true” crisis (Mexico and Chile in the 1980s)

- Similar crises in 1981-1983 (more severe in Chile than in Mexico)

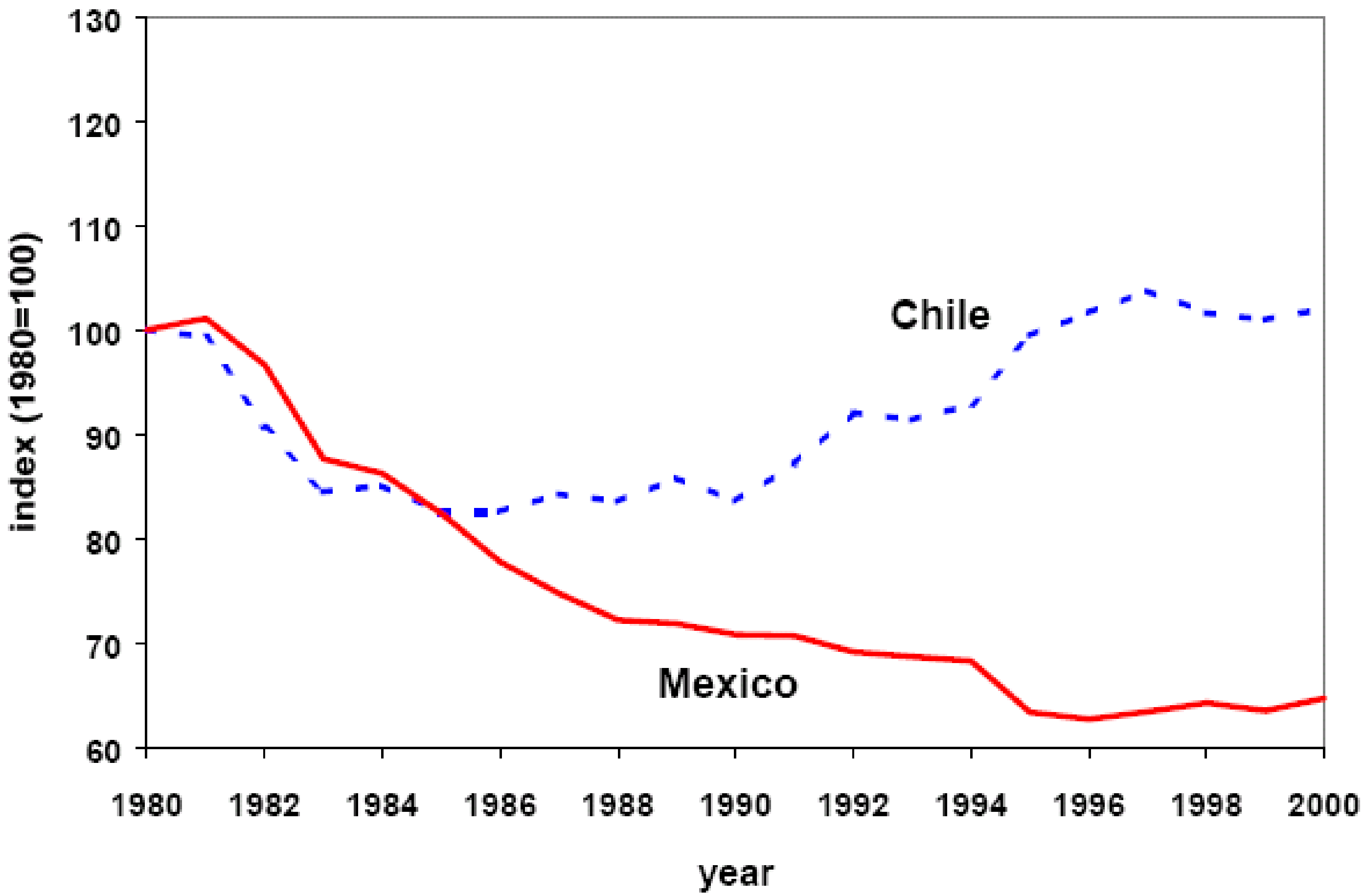
- Different recoveries (much faster in Chile than in Mexico)

- Why the different pattern?

Real GDP per working-age (15-64) person in Chile and Mexico, detrended by 2% per year.



Total factor productivity in Chile and Mexico, detrended by 1.4% per year



Similar Initial conditions in 1982

- large foreign debt
- appreciating real exchange rate
- large trade deficit
- banking problems.

Similar foreign shocks

- jump in world interest rate
- plummet in copper and oil prices
- cutoff in foreign lending.

Why different recoveries?

- **Different monetary policies?**
  Tighter monetary policy in Chile
- **Export boom based growth (RER depreciation + lower wages)?**
  Higher depreciation and lower wages in Mexico
- **Debt overhang?**
  Higher debt in Chile
- **Structural reforms?**
  Chile reaped benefits of reform long before Mexico
- **Tax Reforms?**
  Very similar in both countries

- **Trade reforms?**
  - *Chile: before crisis all quantitative restrictions eliminated and uniform tariff of 10 percent. Transitory tariff hikes quickly eliminated*
  - *Mexico: in 1985, 100% of domestic production protected by import licenses, nontariff barriers and dual exchange rates (until NAFTA)*

- **Privatization?**
  - *Chile: major privatizations 1974-1979, no reversal during or after crisis*
  - *Mexico: nationalization in 1982, expropriated banks' holdings of private companies and government controlled 60-80 percent of GDP (until 1989)*

- **Banking?**
  - *Chile: took over failed banks in 1982, but let market-determined interest rates, lowered reserve requirements, reprivatize at high cost*
  - *Mexico: 1982 and after nationalized all banks, government set low deposit rates, 75% of loans either to or directed by government*

- **Bankruptcy laws**
  - Chile reformed the administration of its bankruptcy procedures in 1978.

- Mexico reformed its bankruptcy procedures in a similar way only in 2000.