Outline

1. Global and US Outlook
2. Latin America and the Caribbean (LAC)
   A. Outlook and Policy Stance
   B. External Risks to the Regional Outlook
3. Policy Challenges Facing LAC
4. The Evolving Role of the Fund
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Global growth is running above 5 percent...

Real GDP

(Percent change from four quarters earlier)

Emerging markets

World

Advanced economies

...but the balance of risks is increasingly slanted to the downside
The sources of global growth are widening, but remain dependent on the United States (and China).
Productivity growth remains close to its high 10-year average and corporate profits are at a record high...
...while corporate risk spreads remain low

Bond spread over U.S. Treasuries
(In basis points)

U.S. outlook
Although unit labor costs have been rising, inflation expectations remain well contained.
The flattening yield curve does not necessarily herald a recession, as real rates remain low...
...but the risk of a “substantial correction” in housing markets could weigh on activity...
...in part by slowing wealth appreciation, which may dampen consumption
Risks to the Global Outlook

- Impact of global monetary tightening
- High and volatile oil prices
- Global imbalances
Synchronized tightening by the major central banks has usually been followed by a global slowdown.

**World real GDP**
(Annual percent change)

Short-term interest rates increase in **each** G-3 currency area.
Crude oil prices have fallen but remain high and volatile.
Global imbalances remain a pressing policy challenge

Current Account Balance
(In percent of World GDP)

United States

China

Oil Exporters

Japan

Global risks
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Growth in LAC remains strong, although it is expected to moderate in 2007.
Inflation has generally remained subdued (with exceptions) and is projected to decline further.
The recovery has contributed to falling unemployment rates
Financial markets have largely recovered from the spring turbulence and spreads are back close to historical lows.
Strong global demand for commodities has supported the regional expansion and improved current accounts...
...but the benefits of commodity price increases have been unequally distributed across countries.
High remittances have bolstered living standards and current account positions

Remittances, 2001-03, 2004-06
(% of GDP, average)

- Central America
- Caribbean
- LAC

2001-2003
2004-2006
Compared to previous recoveries, this expansion is generally solid

- Balanced contributions from external and domestic demand
- Higher reserves and exchange rate flexibility
- Improved monetary institutions
- Primary fiscal surpluses
Domestic demand is playing an increasingly important role for the recovery

**Contributions to Growth**
(In percent, per annum)

- Consumption
- Investment
- Net Exports

2002-05:
- Consumption: ~0%
- Investment: ~0%
- Net Exports: ~0%

2006-07:
- Consumption: ~4%
- Investment: ~1.5%
- Net Exports: ~0.5%
Reserves have increased and exchange rates have strengthened without harming competitiveness.

Exchange Rates and Reserves

- Real effective exchange rate
- Nominal effective exchange rate
- Total reserves (RHS)

Average Export Share

- Export share to industrialized countries
- Export share to all countries

Index January 2002 = 100
Billions of U.S. Dollars
Monetary policy institutions have improved, allowing for lower inflation

Targets and Outturns in IT countries
(cross country averages)

Inflation

Average gap
(absolute value)

(includes: Brazil, Chile, Colombia, Mexico, and Peru)
Higher revenues have strengthened fiscal positions across the region (but with high cyclical components).
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A sharper-than-expected slowdown in the U.S. could significantly affect demand for the region’s exports.
Primary fiscal surpluses would be halved by falling commodity prices

Stress Tests of Fiscal Balances
(percent of GDP)

Baseline

Commodity revenues at 2004 level

Combined

Spending growth at 2005-06 average

External risks
Some countries face trade pressures

- **Caribbean**: erosion of preferential access for sugar and banana exports in EU markets
- **Central America**: competitive pressure in textiles following the phasing out of MFA quotas
- **Andean Region**: expiration of trade preferences under the ATPDEA

**Graph:** Share of Total Exports Affected by Expiration of ATPDEA Trade Preferences (In percent)

- **Bolivia**
- **Colombia**
- **Ecuador**
- **Peru**

External risks
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The overriding challenge in Latin America today is to raise investment and productivity on a sustained basis.

Even during the ongoing expansion, growth and investment in Latin America lags other regions.
Addressing this challenge requires policies that entrench and extend recent achievements

- Entrenching macroeconomic stability
- Improving equity and reducing poverty
- Removing structural impediments to growth

**Basic Message**

There are strong complementarities between the polices that can achieve these objectives
To reduce risk premia and raise investment, the region needs to entrench its recent macroeconomic stability

*This requires:*

- Further lowering public debt
- Containing and better targeting public expenditures
- Making budgets less rigid
- Expanding revenue bases
- Deepening the credibility of monetary policy institutions and further financial sector reforms
- Monitoring rapid credit growth
While public debt is projected to decline, it remains generally high.

The chart shows the total public debt (% of GDP) for different countries over the years 2004, 2005, and 2006. The debt levels are compared to the 1996 LAC average. Argentina (ARG) had the highest debt in 2004 at 132%. The chart indicates trends and variations in public debt across the region.
However, primary expenditure growth has accelerated...
...as the underlying fiscal stance in many countries is turning expansionary
More flexible budgets would allow fiscal policy to better respond to shocks and improve spending efficiency.

Policy challenges

Budget Rigidity
(percent of primary revenue)

- Combined rigidity
- Expenditure rigidity
- Revenue earmarking

Argentina Brazil Chile Ecuador
Broader tax bases and higher revenues could create room for more public investment.
Strong monetary and financial sector institutions help achieve low and stable real interest rates
The rapid expansion of domestic credit (from a low base) will require continued close monitoring.
Reducing inequality would have positive effects on growth and macroeconomic stability...

There are policy levers to promote equity

- Tax reform
- Reallocation of government expenditures
- Reduction of budget rigidities
- Reforms of labor markets, government services, and credit markets

...but entrenching macroeconomic stability would also have a salutary effect on equity
While some obstacles to growth are country-specific, Latin American countries suffer from common problems.
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The Fund’s role in the LAC region is evolving

- The need for direct financial support to the region has diminished
- The focus of the Fund involvement is shifting in response to country needs
- The Fund is currently reshaping its role
  - Improved country and global surveillance
  - Improved lending instruments
  - Improved governance