The Global Context and Regional Outlook for Latin America and the Caribbean

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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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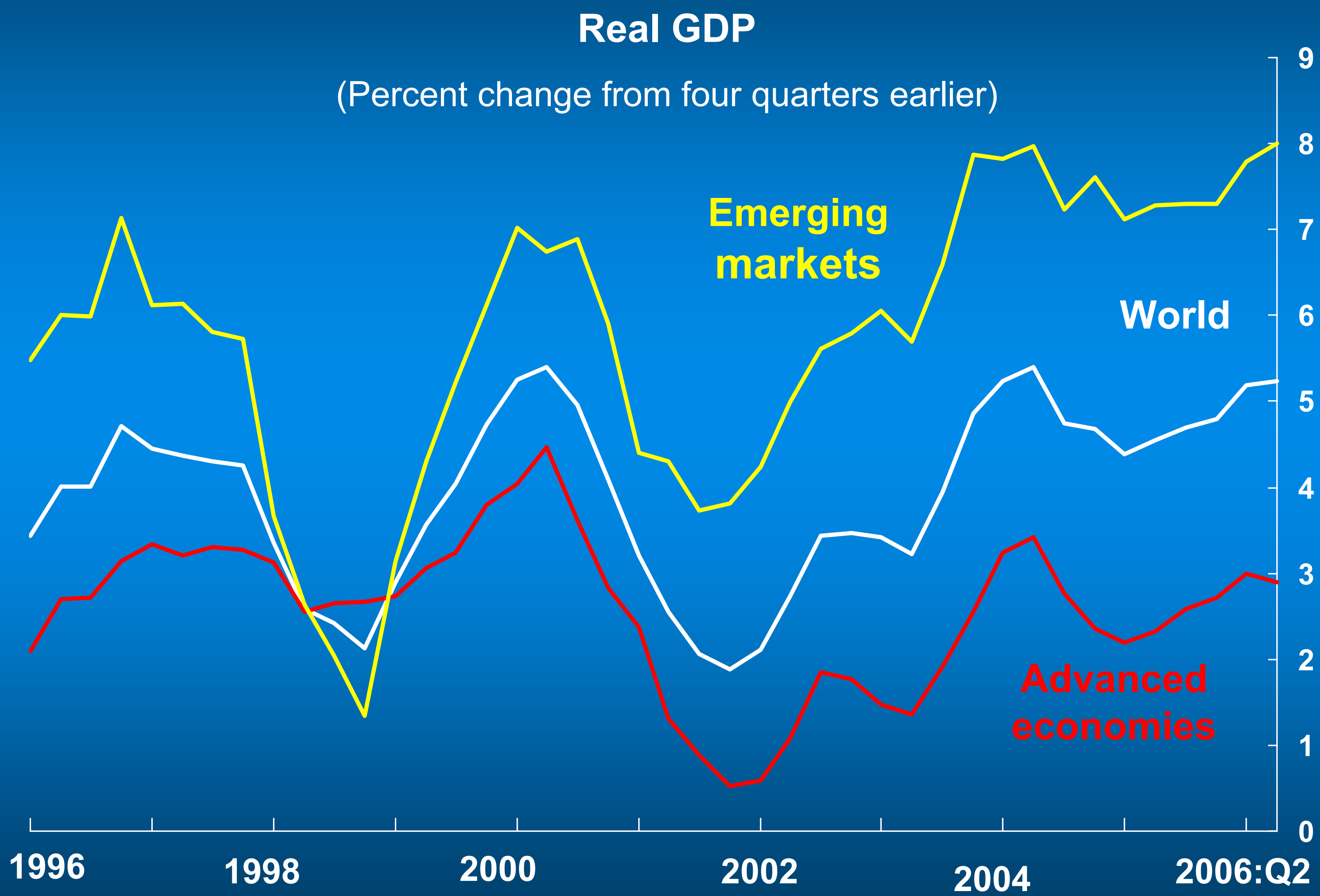
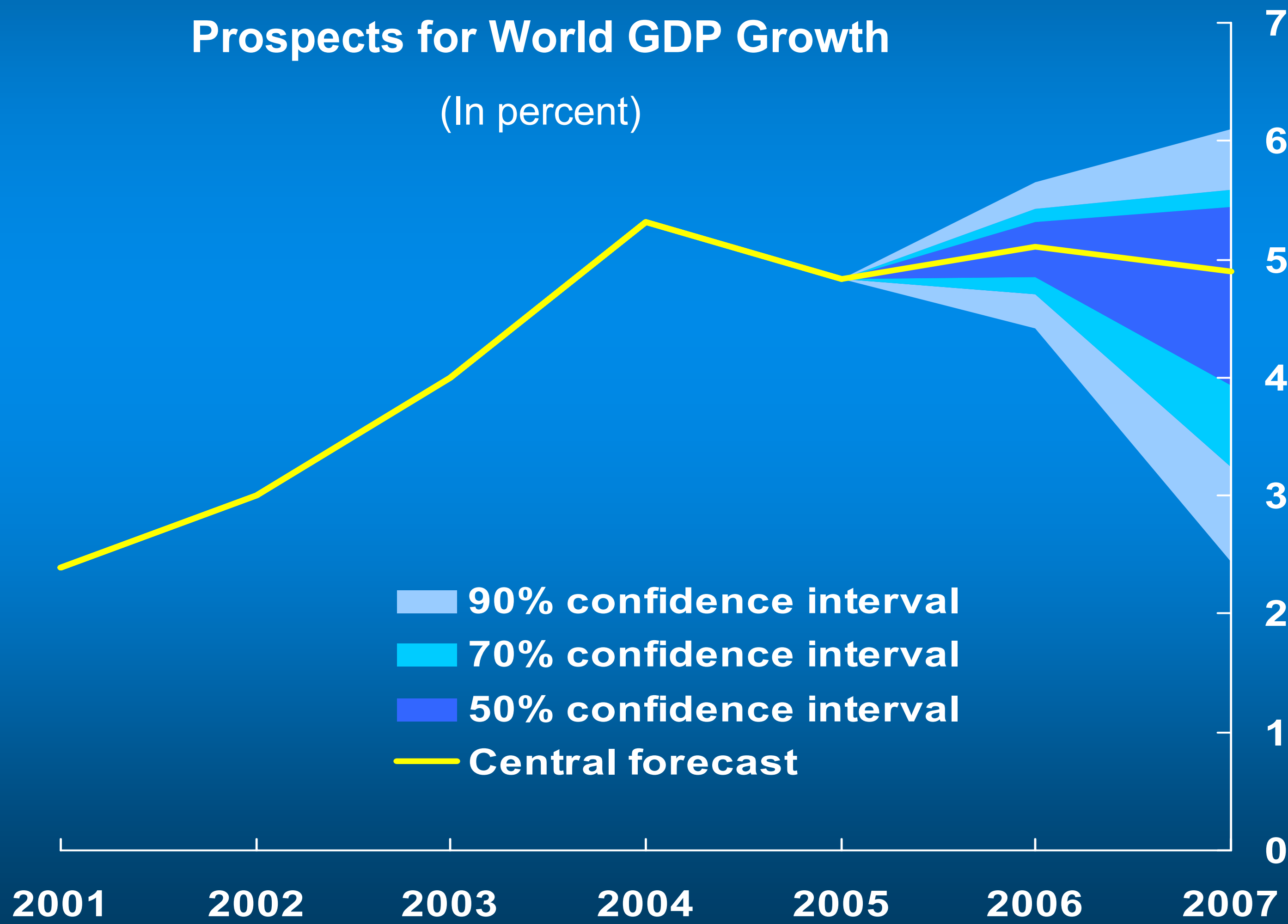
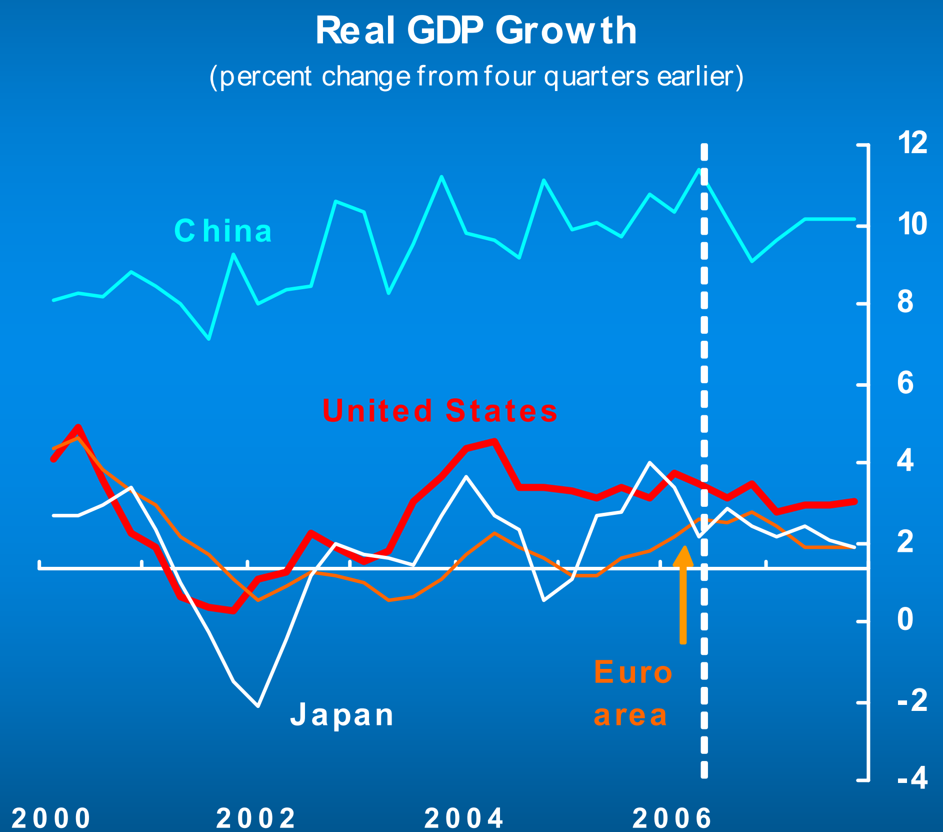
Global growth is running above 5 percent...

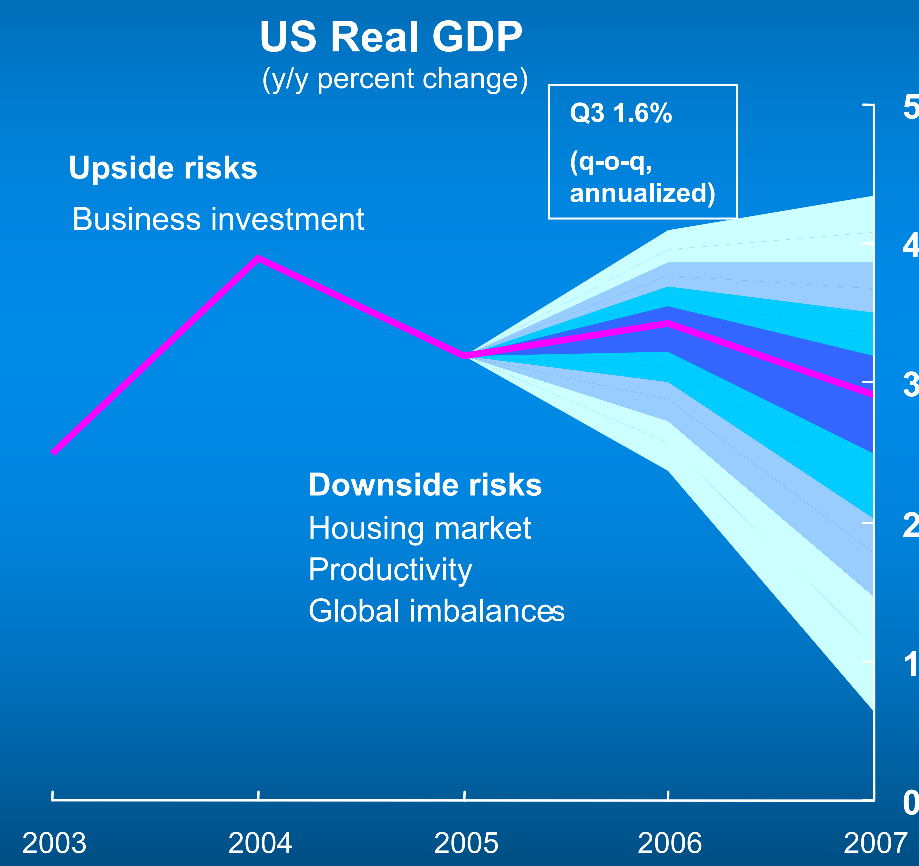


...but the balance of risks is increasingly slanted to the downside

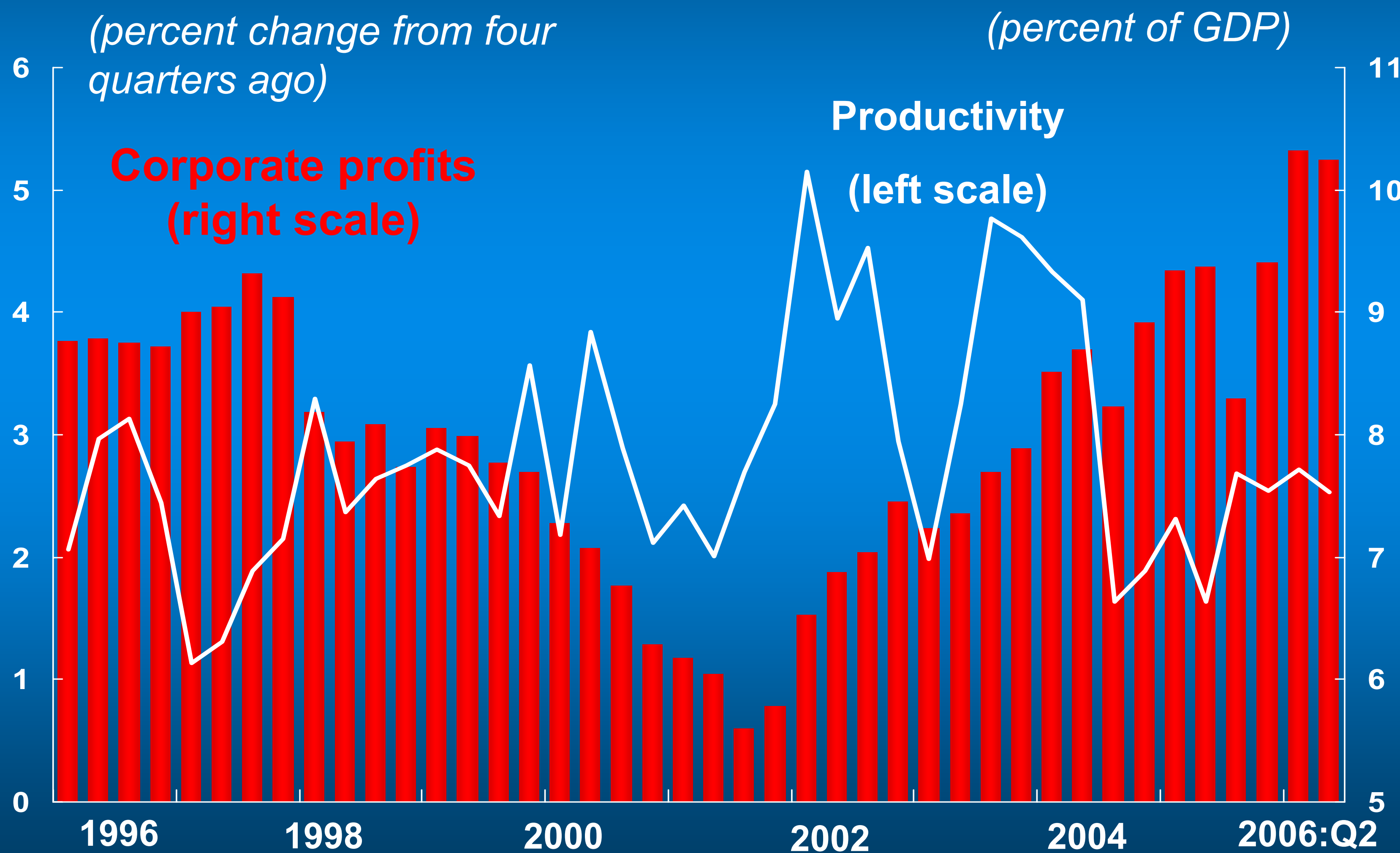


The sources of global growth are widening, but remain dependent on the United States (and China)

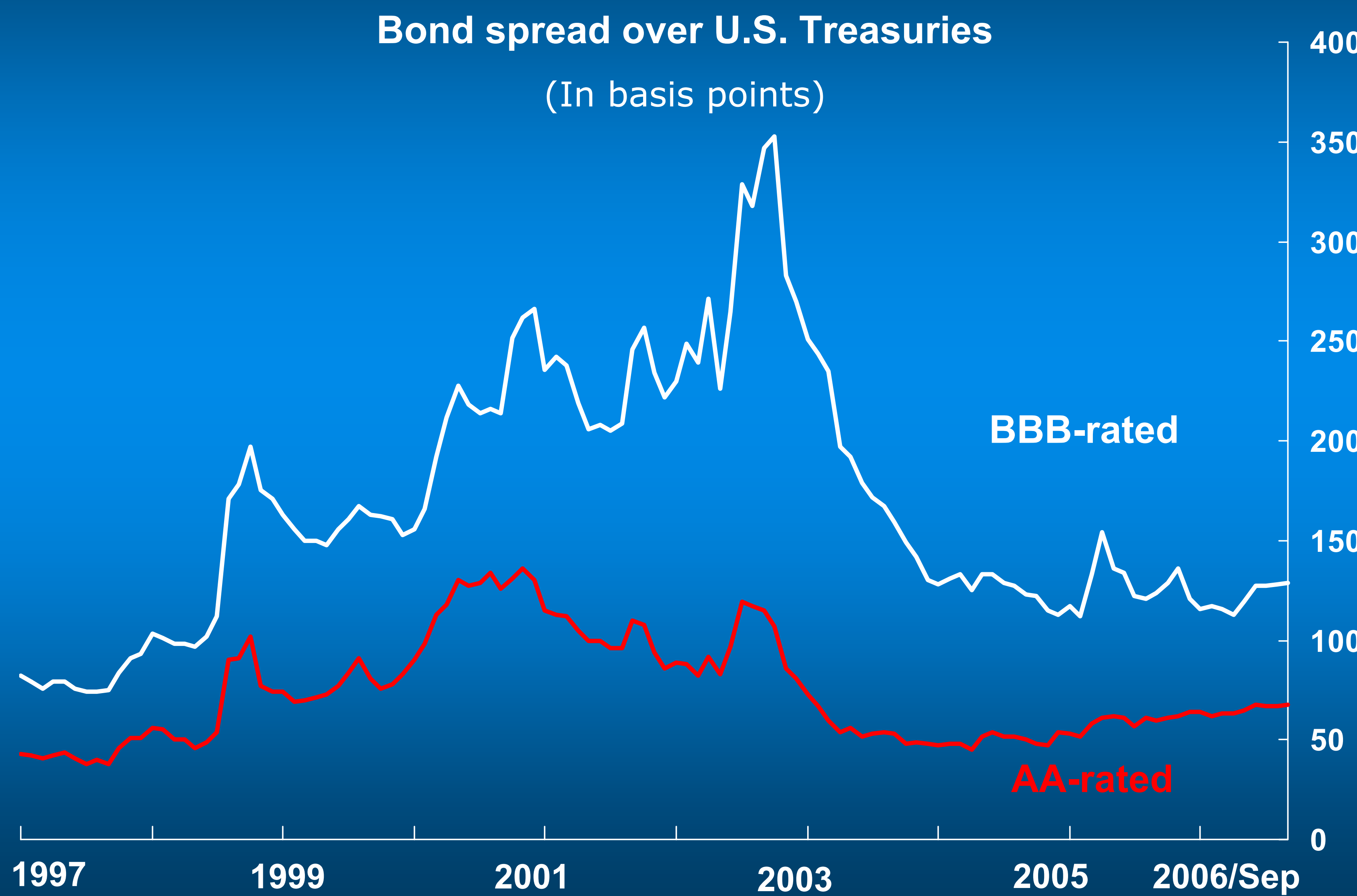




Productivity growth remains close to its high 10-year average and corporate profits are at a record high...

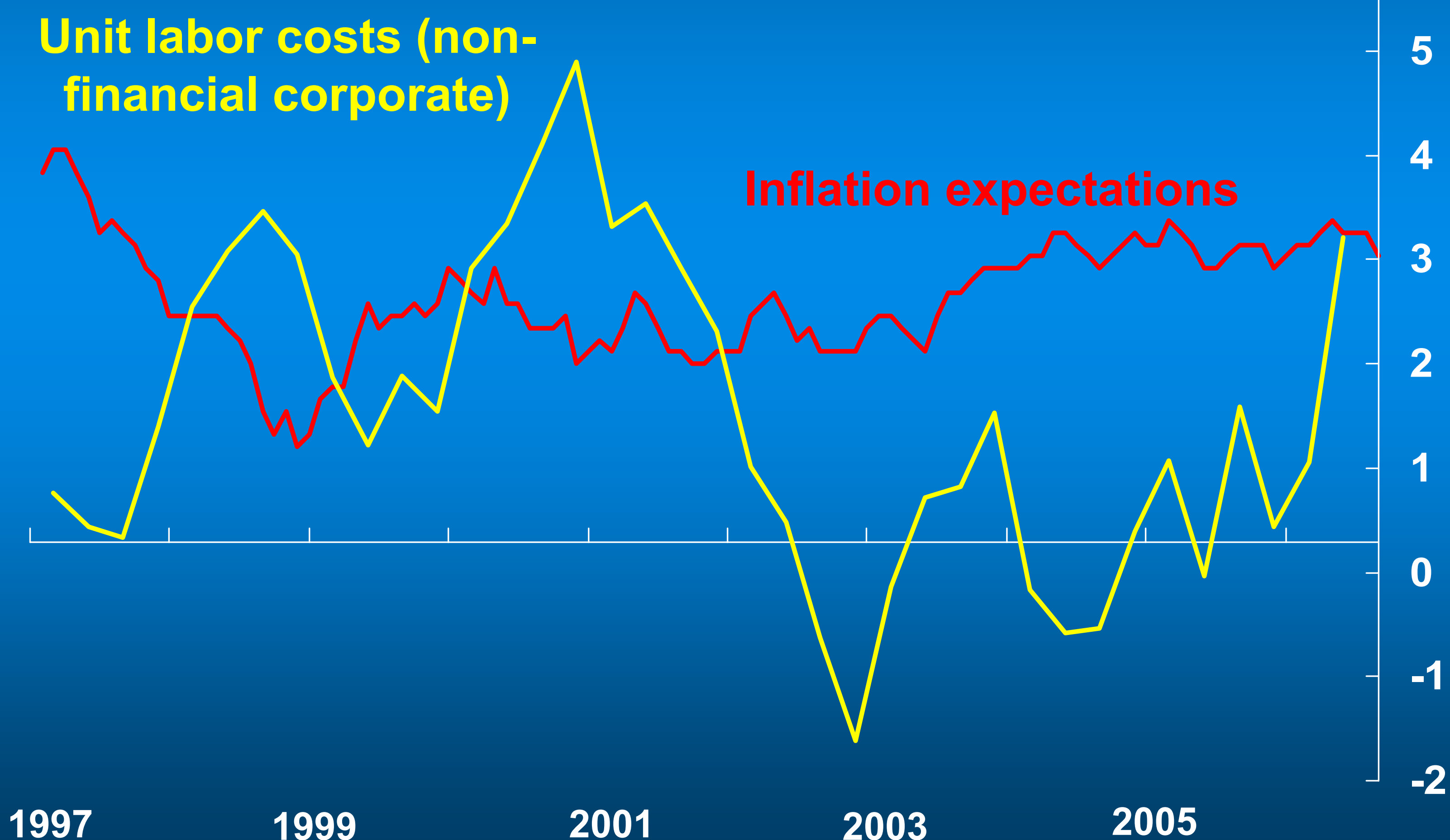


...while corporate risk spreads remain low

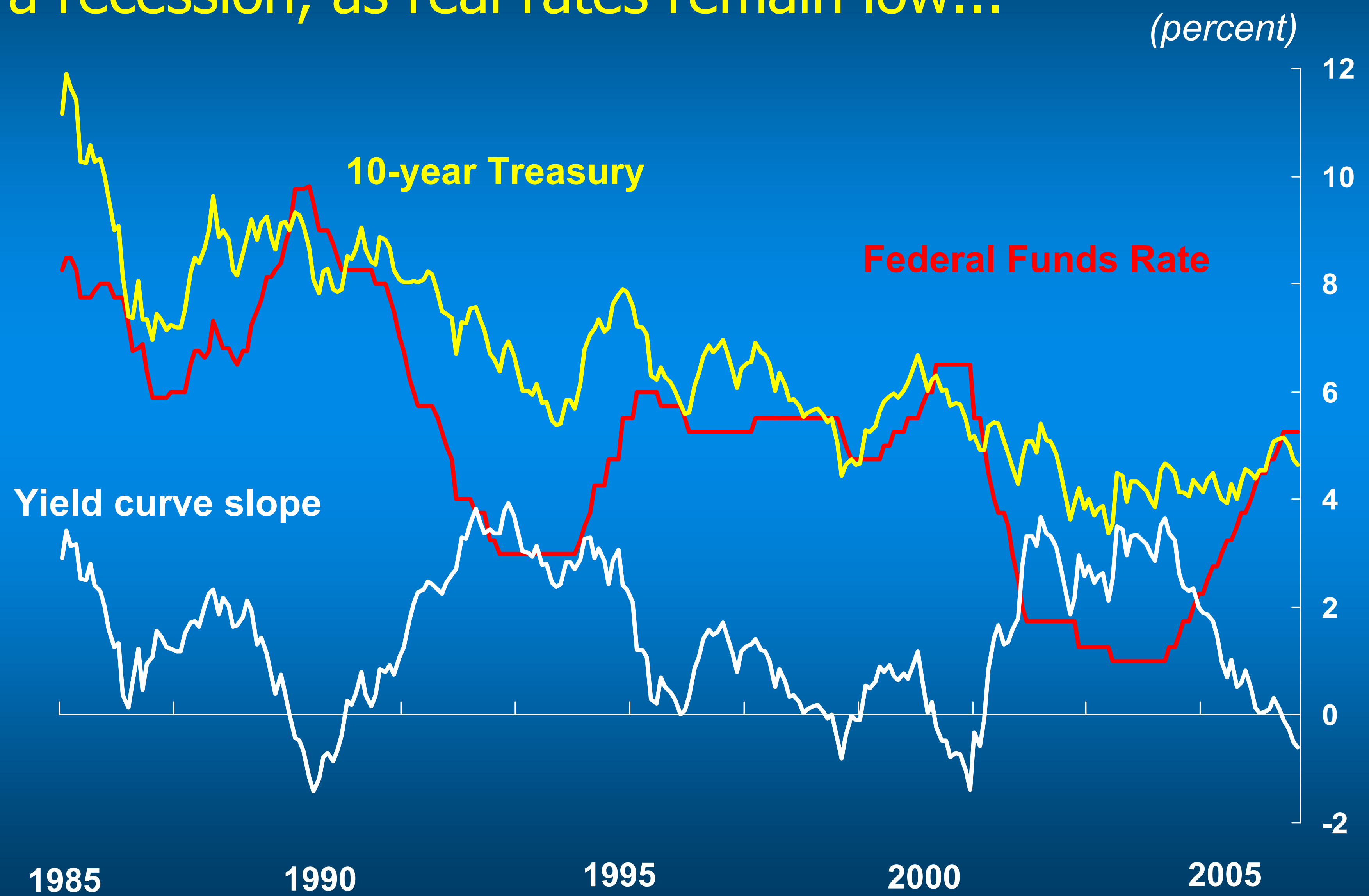


Although unit labor costs have been rising, inflation expectations remain well contained

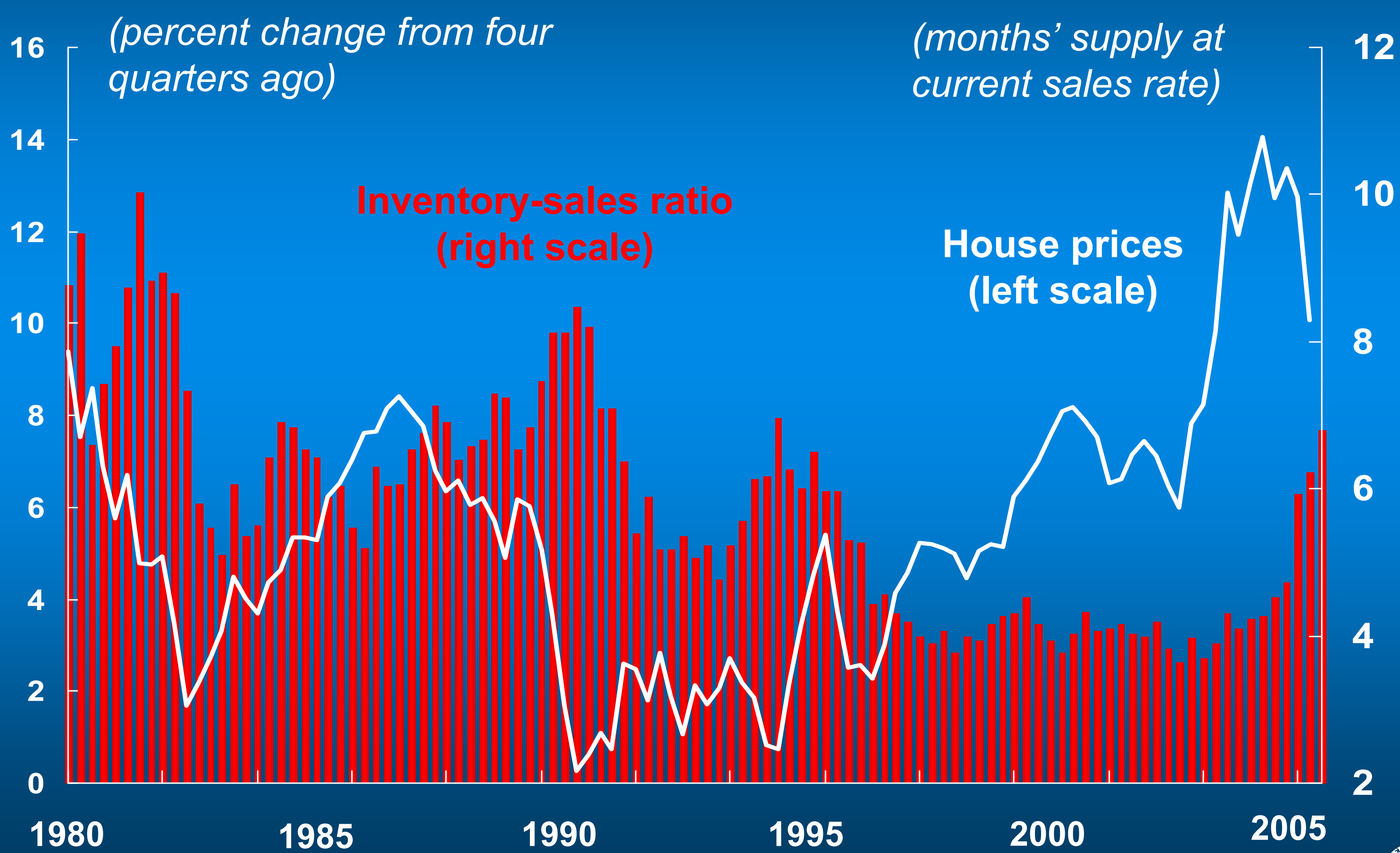
(percent change from twelve months ago)



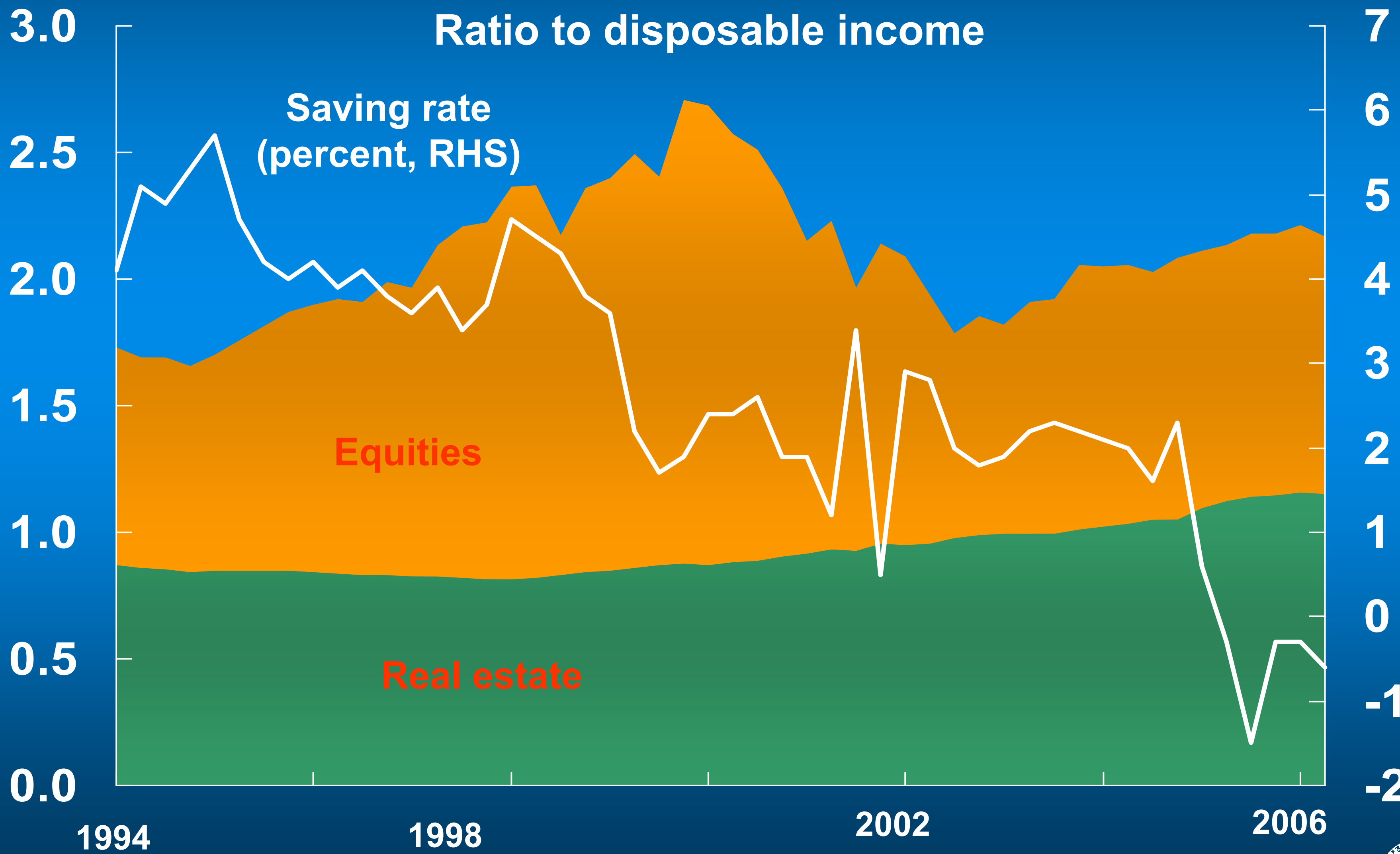
The flattening yield curve does not necessarily herald a recession, as real rates remain low...



...but the risk of a "substantial correction" in housing markets could weigh on activity...



...in part by slowing wealth appreciation, which may dampen consumption

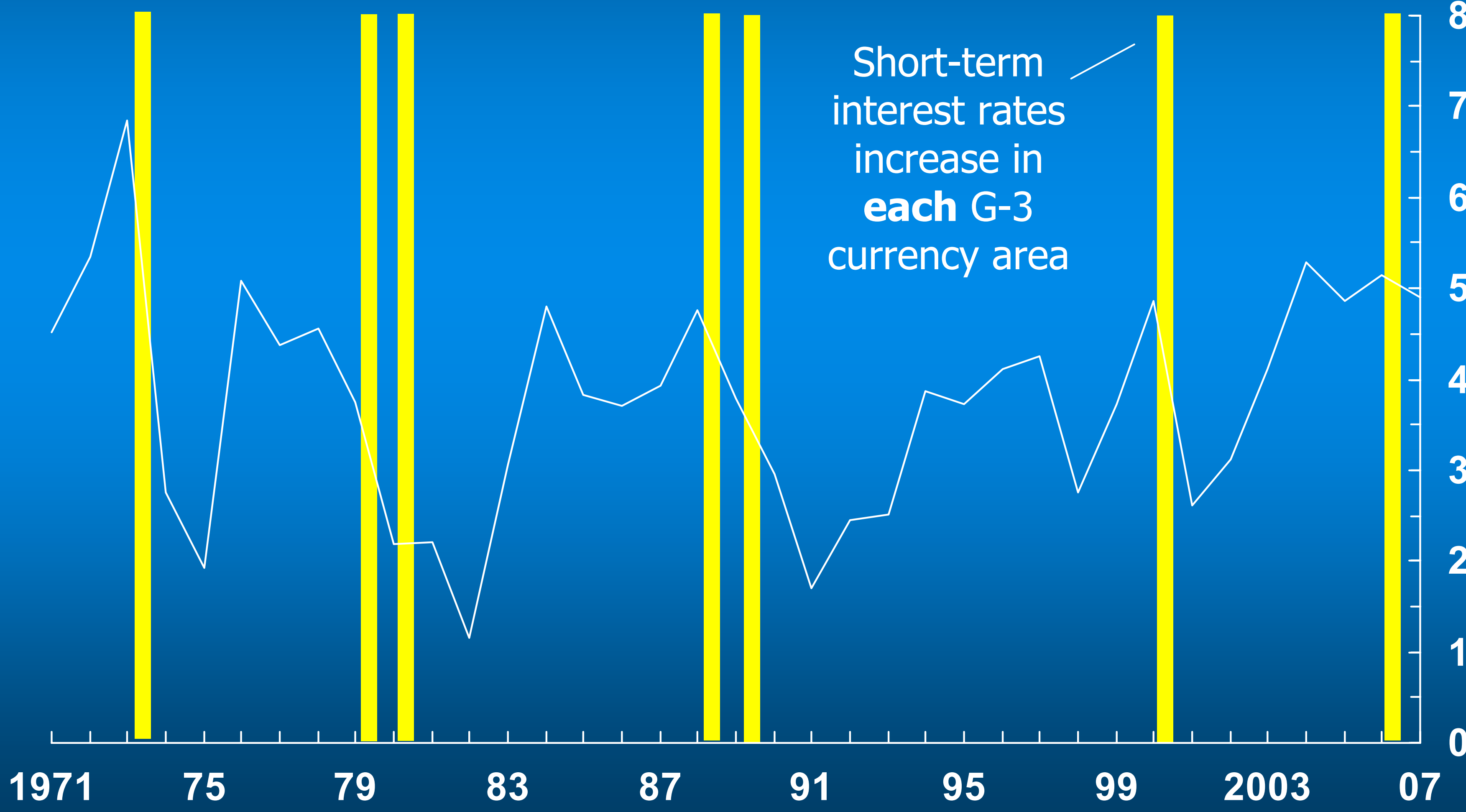


Risks to the Global Outlook

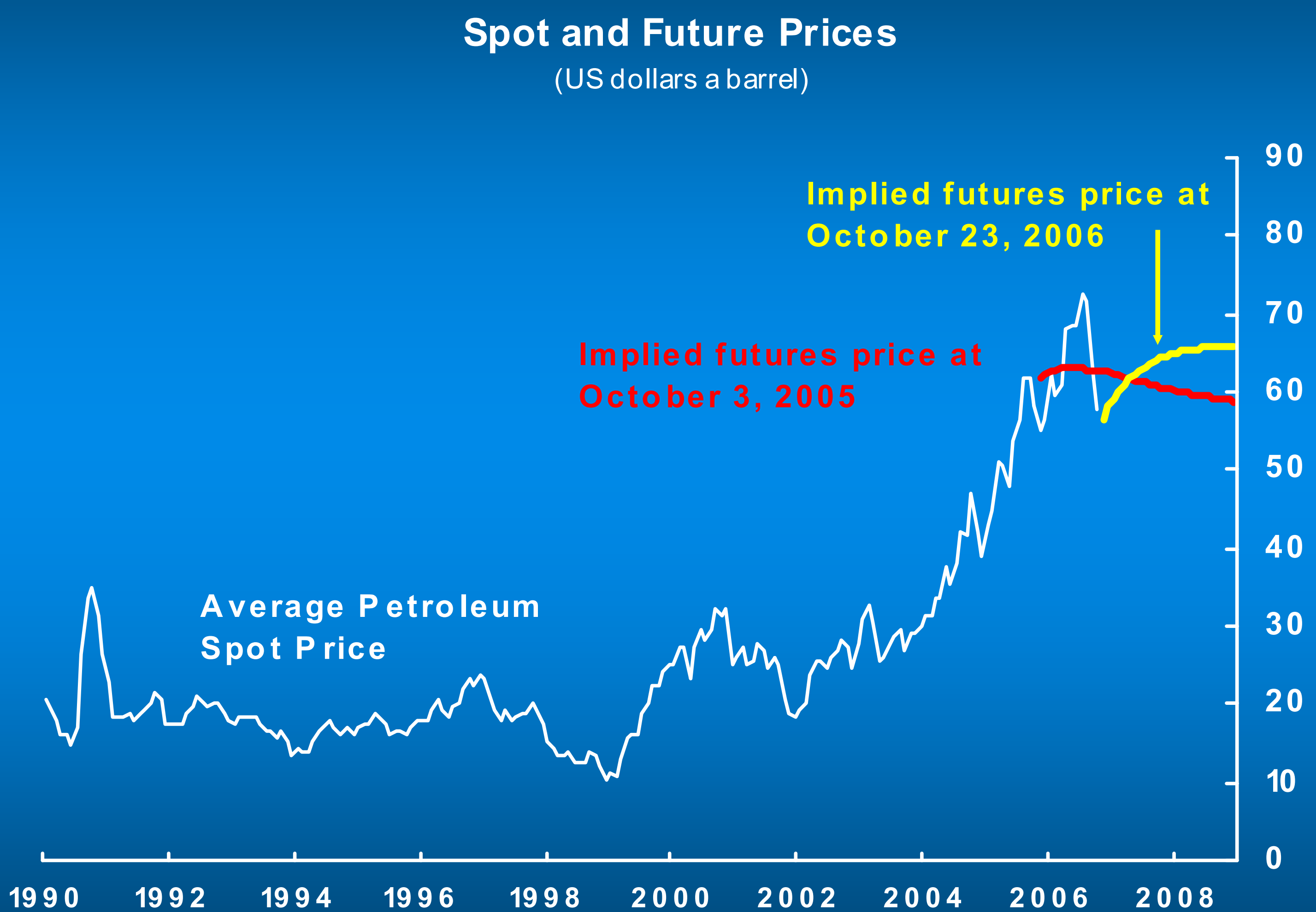
- Impact of global monetary tightening
- High and volatile oil prices
- Global imbalances

Synchronized tightening by the major central banks has usually been followed by a global slowdown

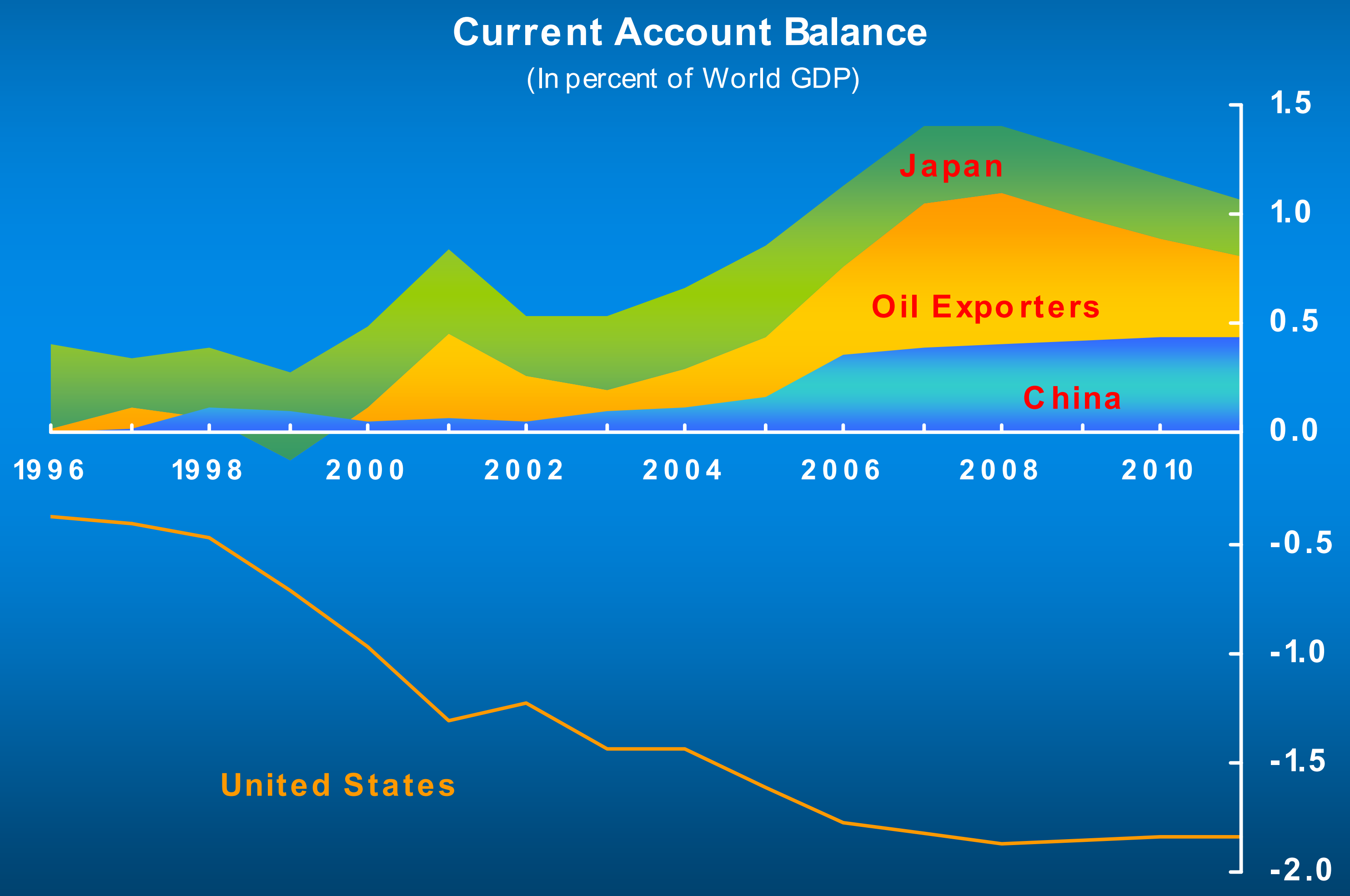
World real GDP
(Annual percent change)



Crude oil prices have fallen but remain high and volatile



Global imbalances remain a pressing policy challenge



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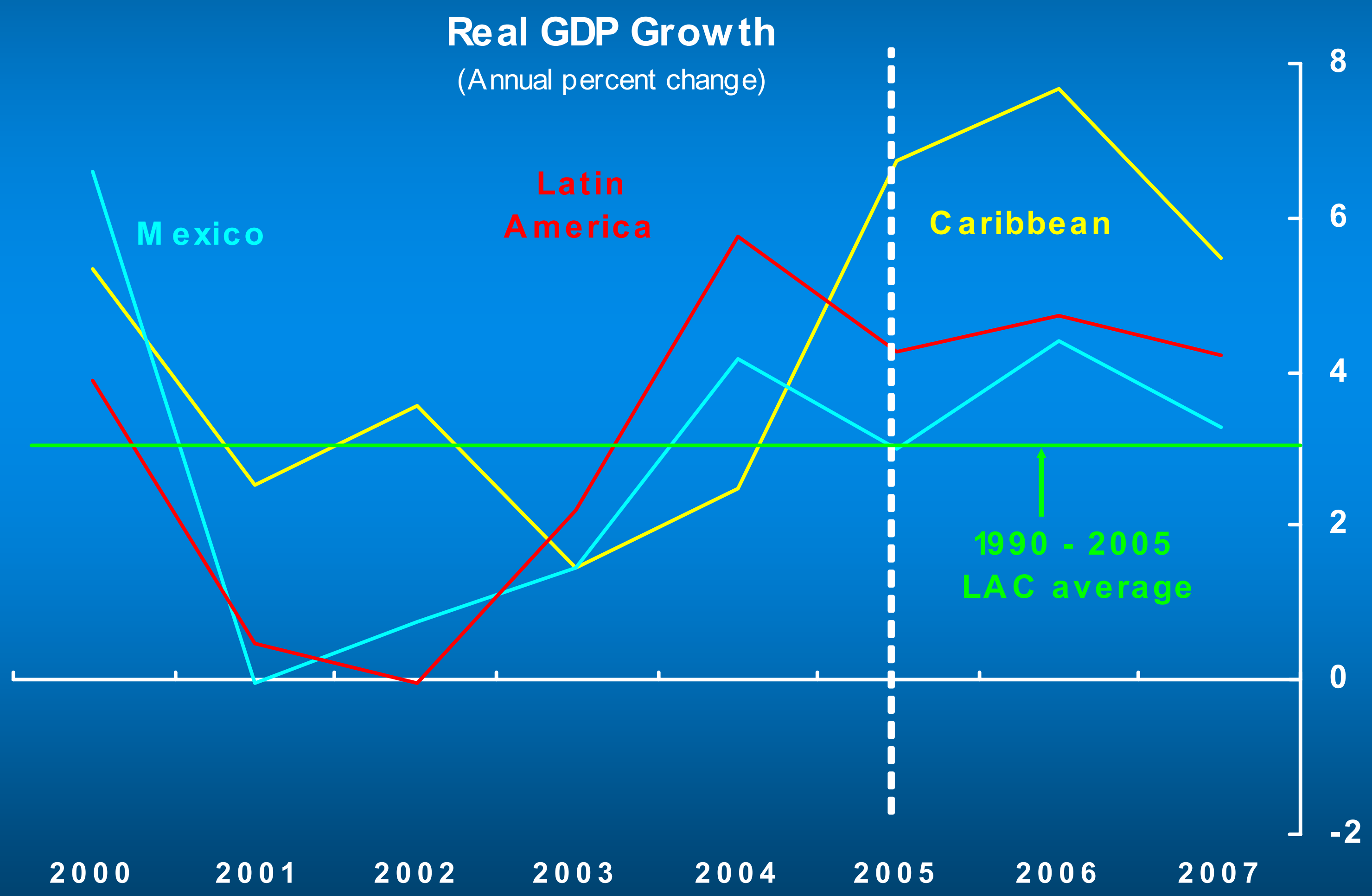
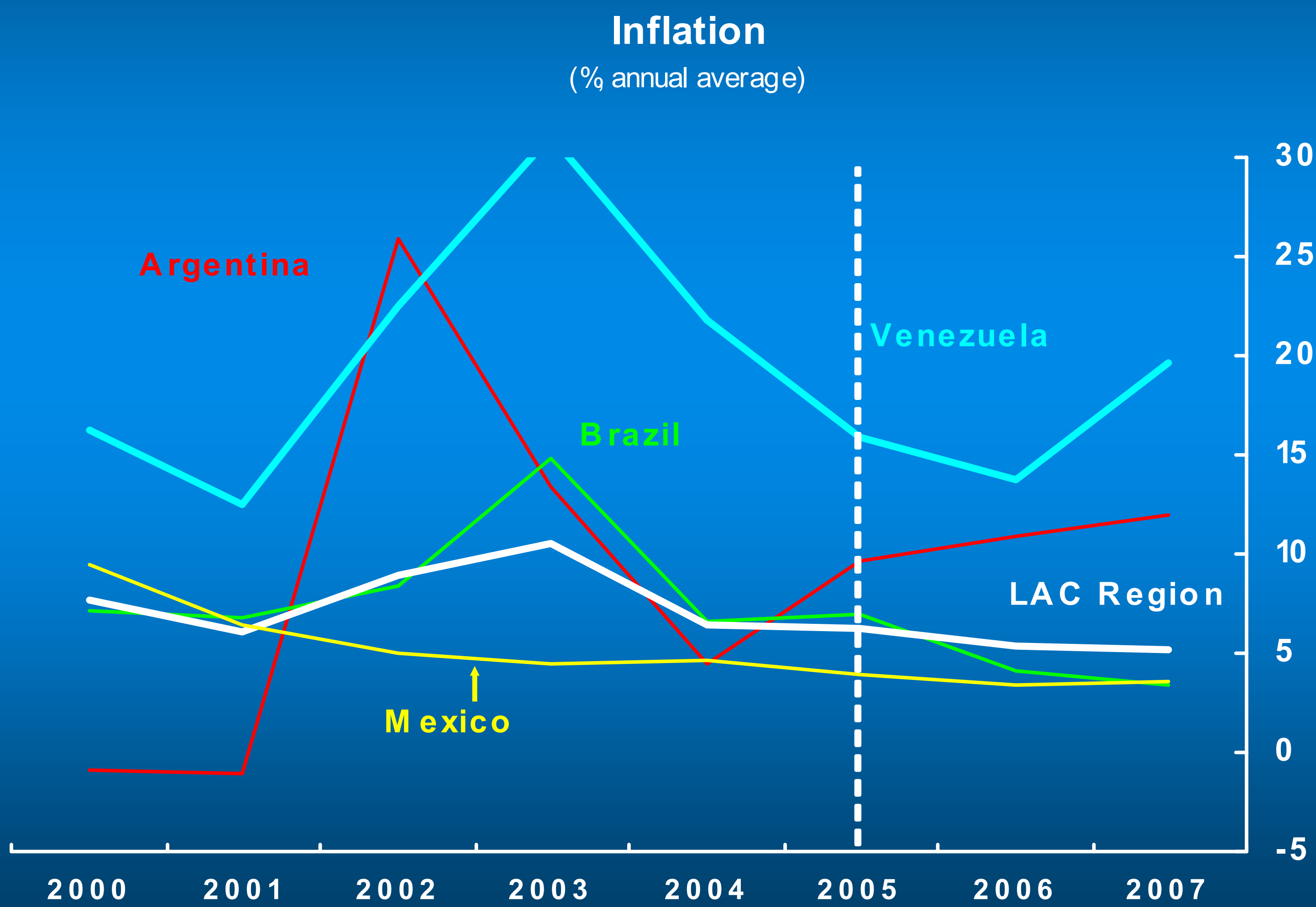
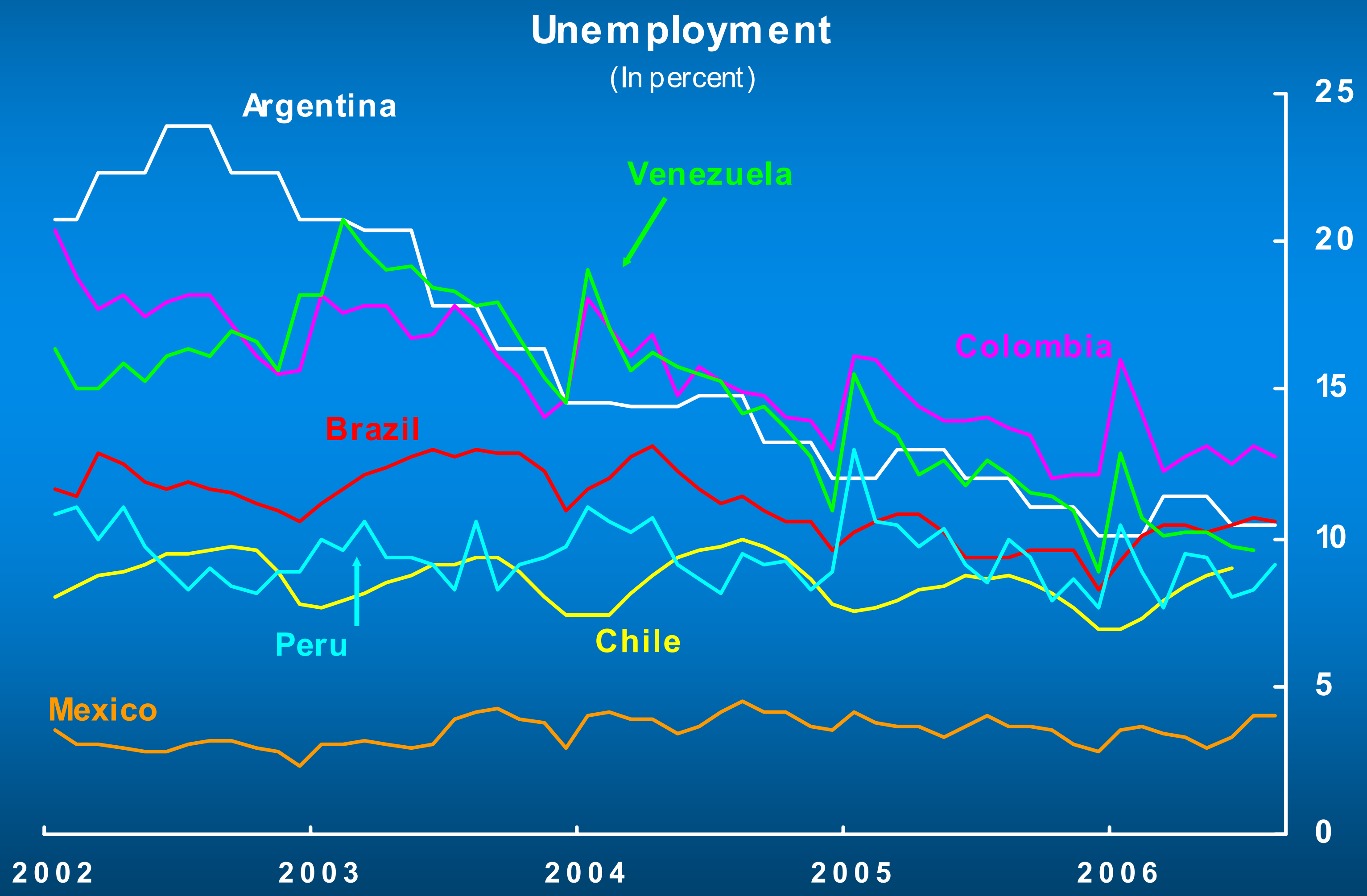
Growth in LAC remains strong, although it is expected to moderate in 2007



Inflation has generally remained subdued (with exceptions) and is projected to decline further

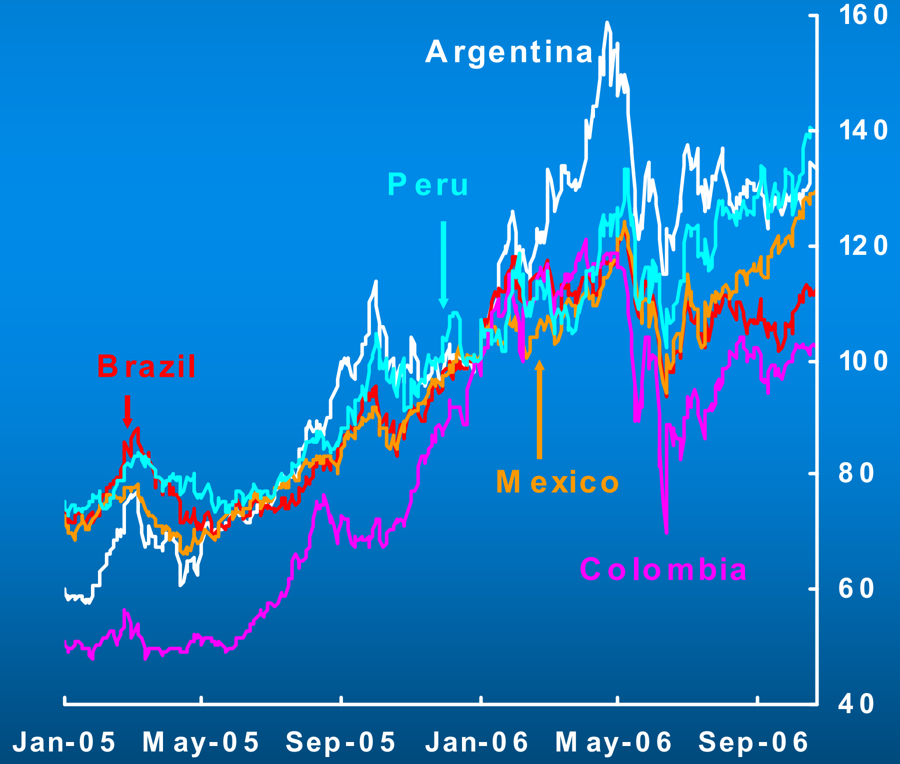


The recovery has contributed to falling unemployment rates

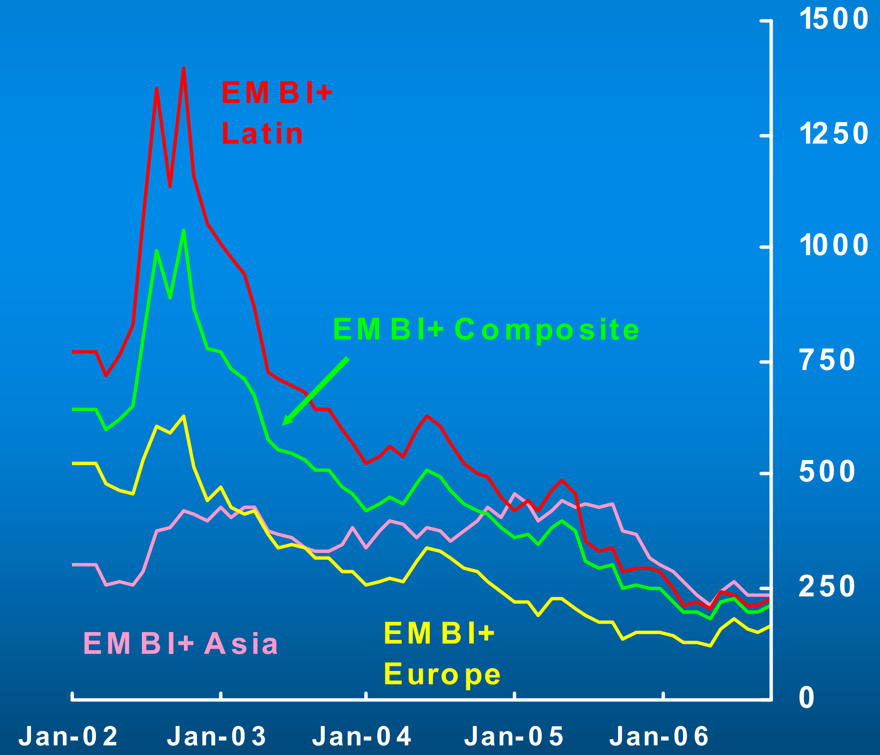


Financial markets have largely recovered from the spring turbulence and spreads are back close to historical lows

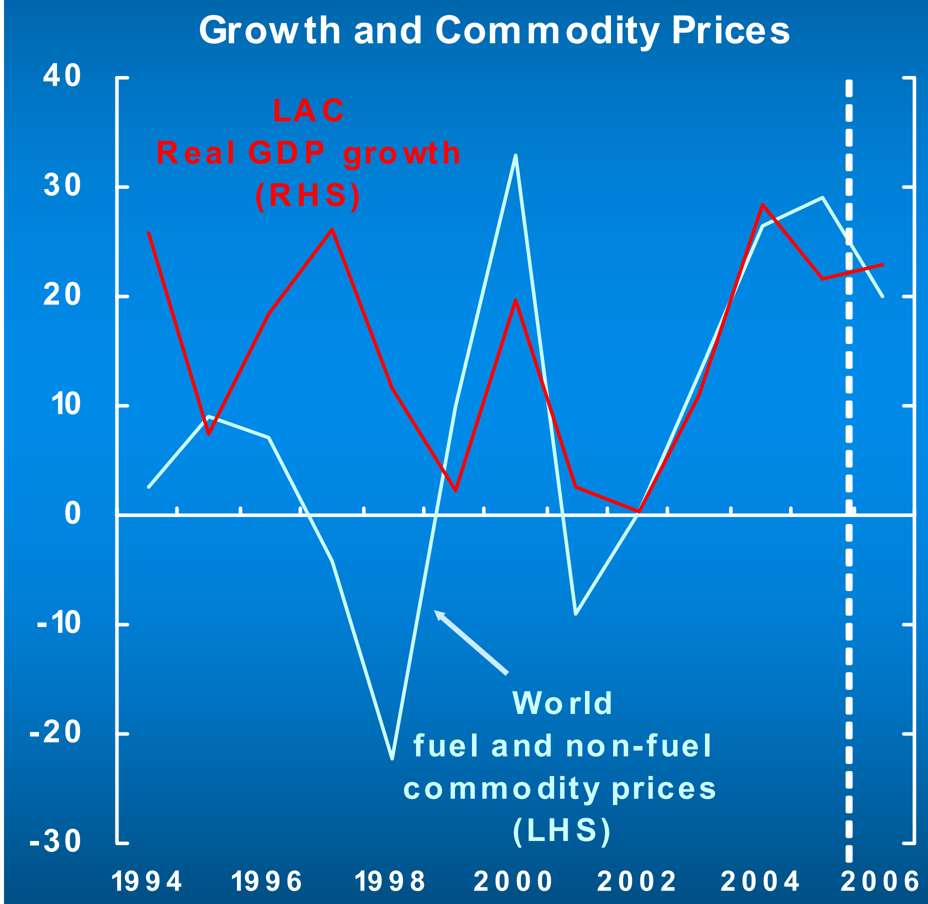
Equity Market Developments
(December, 2005 = 100)

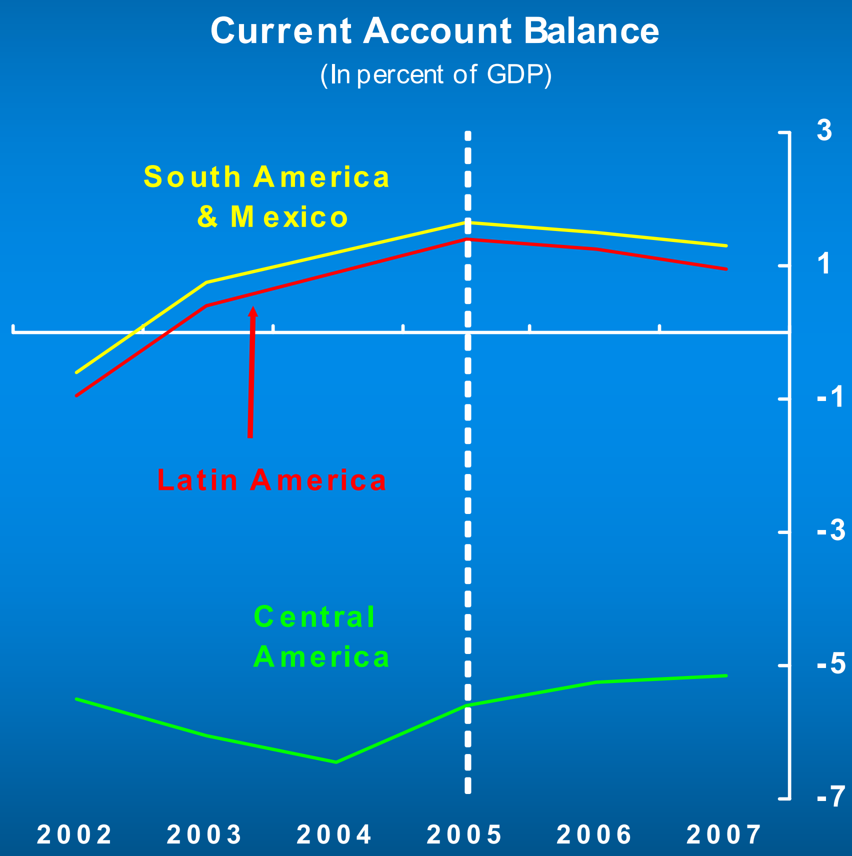


Emerging market sovereign spreads
(Basis points)

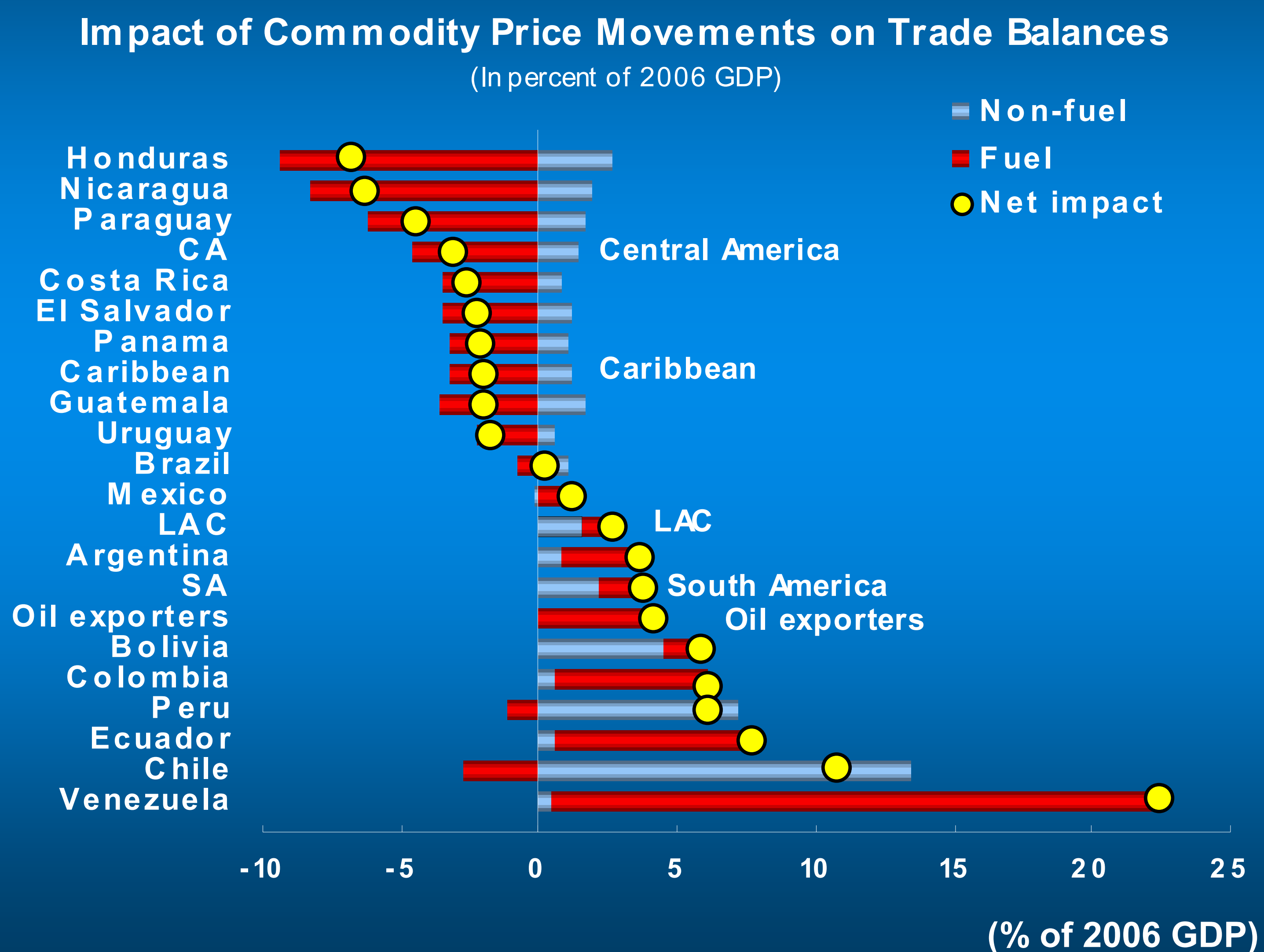


Strong global demand for commodities has supported the regional expansion and improved current accounts...

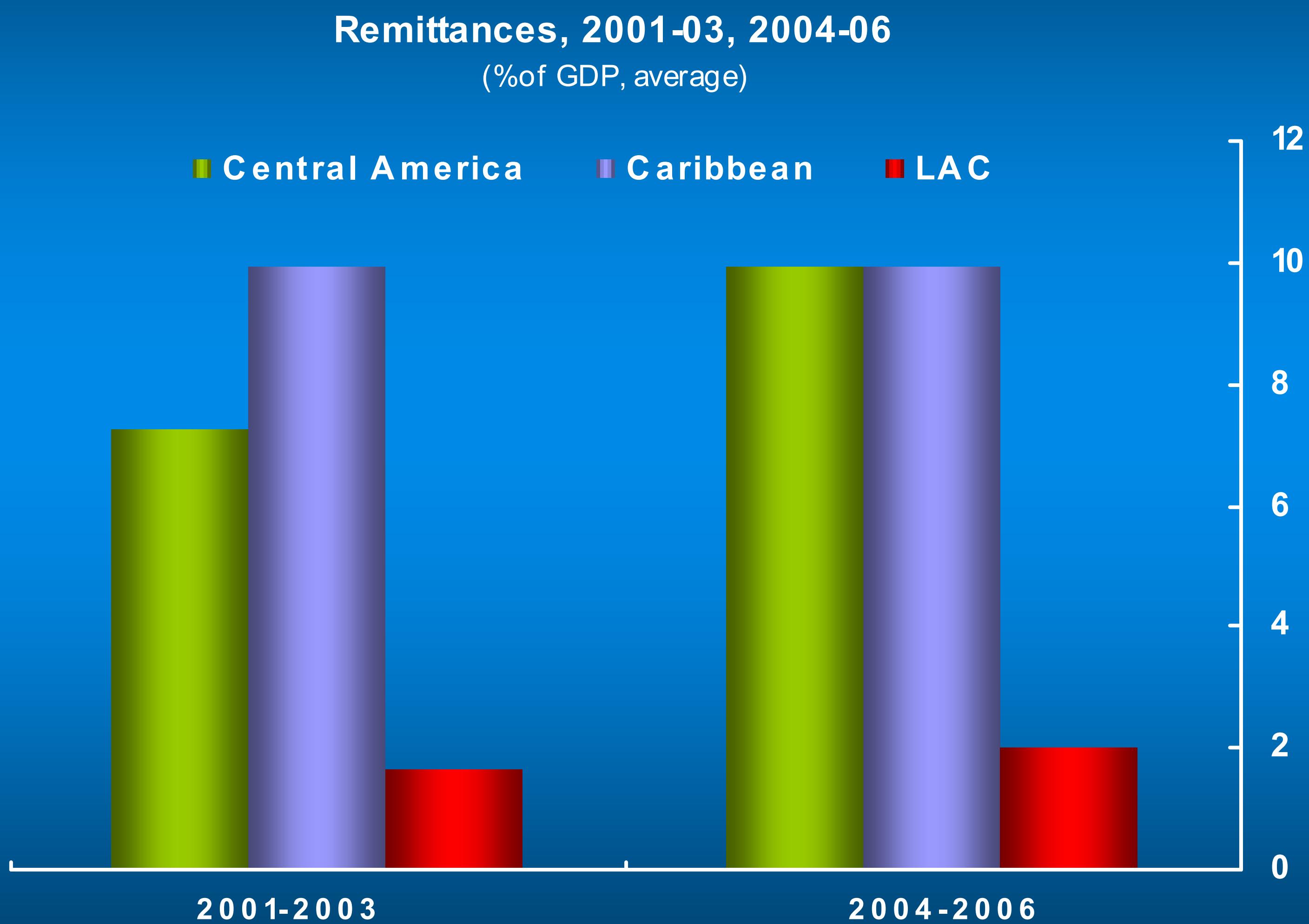




...but the benefits of commodity price increases have been unequally distributed across countries



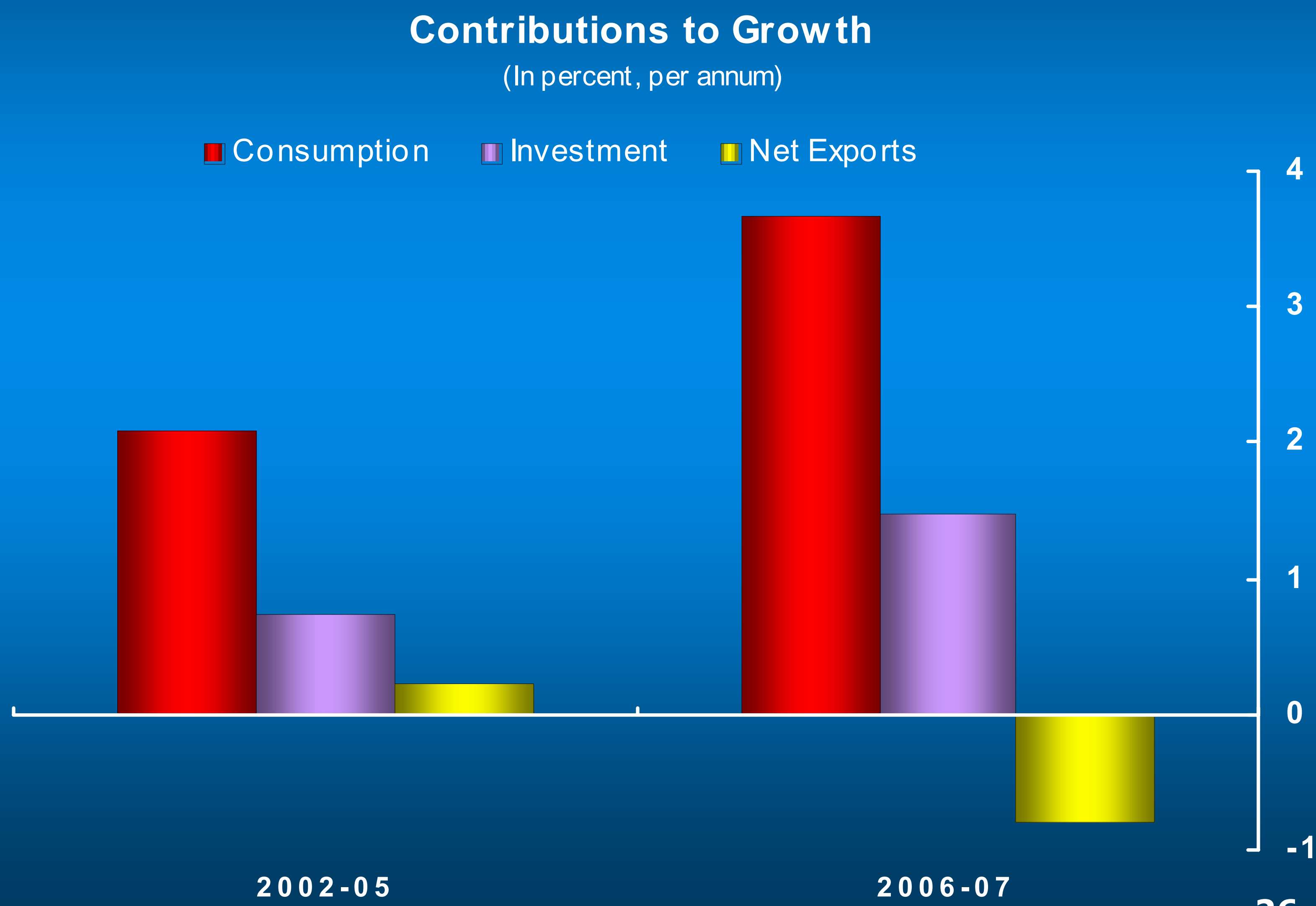
High remittances have bolstered living standards and current account positions



Compared to previous recoveries, this expansion is generally solid

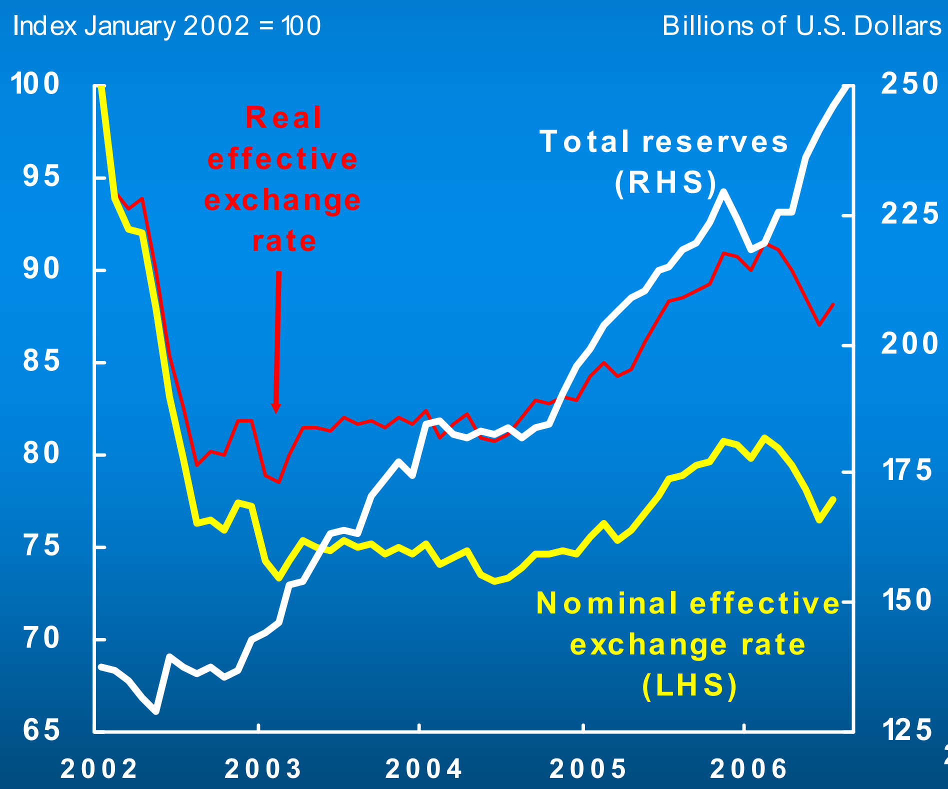
- Balanced contributions from external and domestic demand
- Higher reserves and exchange rate flexibility
- Improved monetary institutions
- Primary fiscal surpluses

Domestic demand is playing an increasingly important role for the recovery



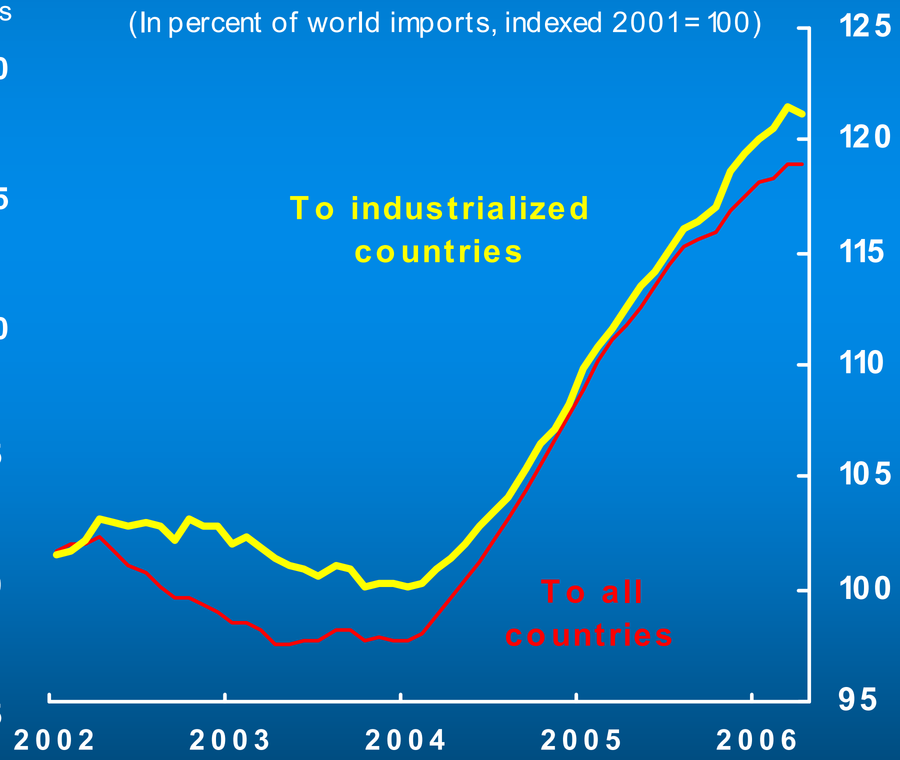
Reserves have increased and exchange rates have strengthened without harming competitiveness

Exchange Rates and Reserves

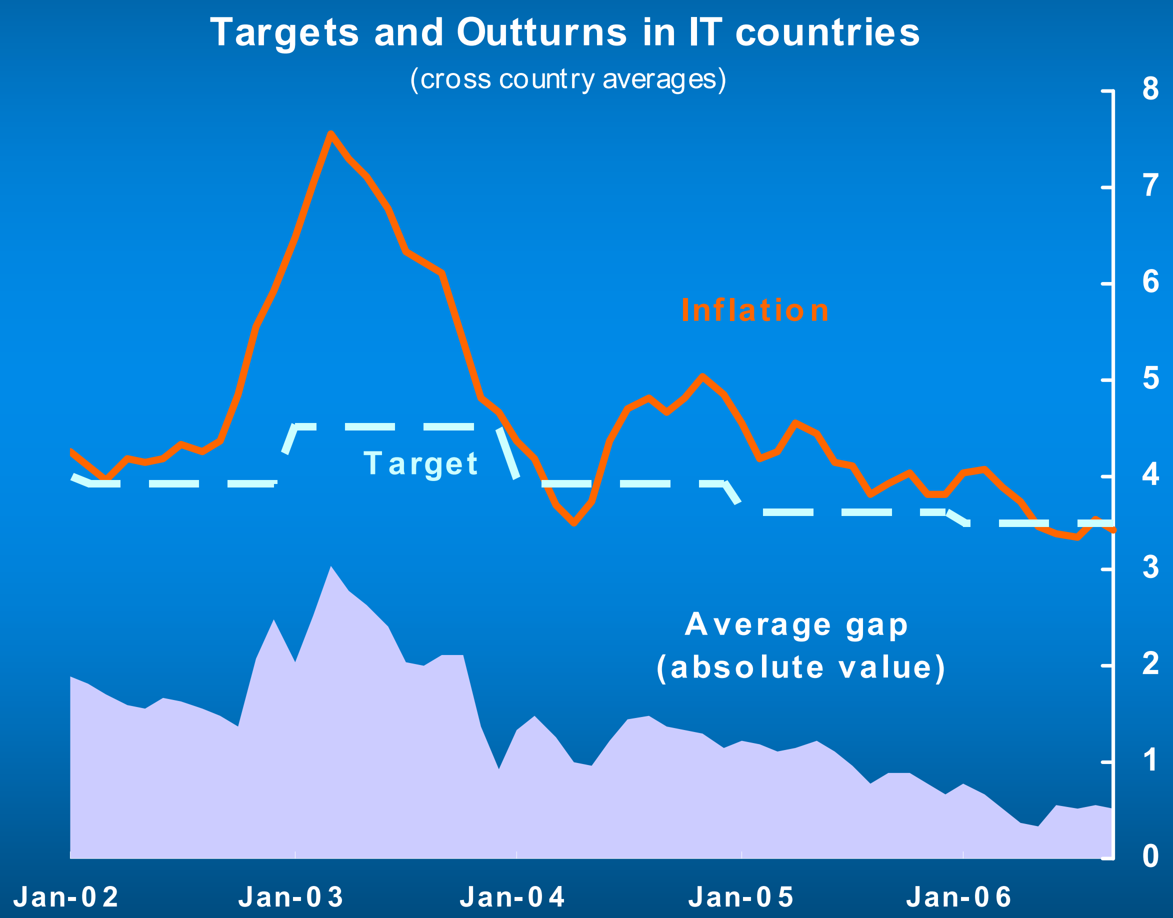


Average Export Share

(In percent of world imports, indexed 2001=100)

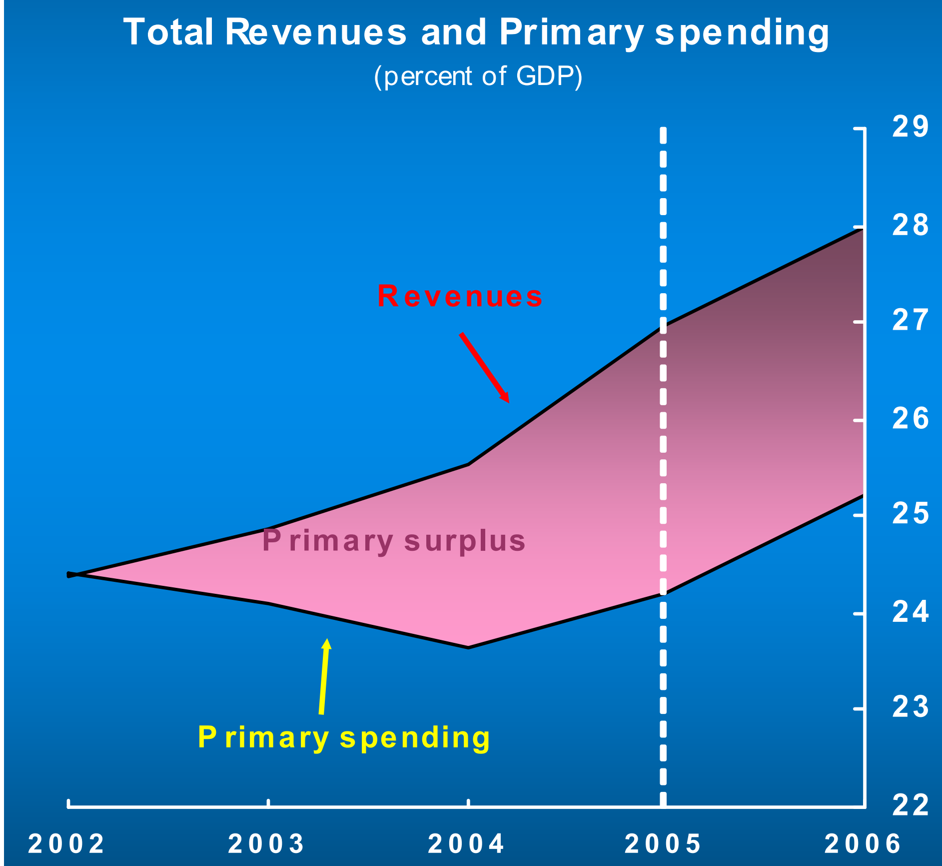


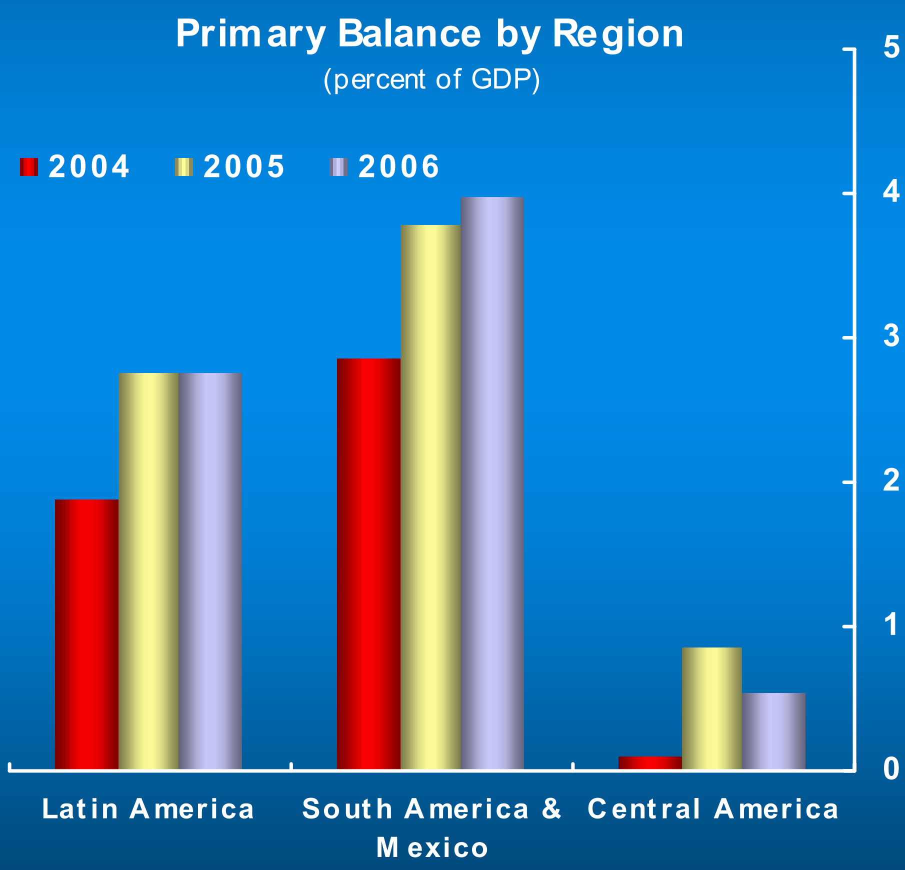
Monetary policy institutions have improved, allowing for lower inflation



(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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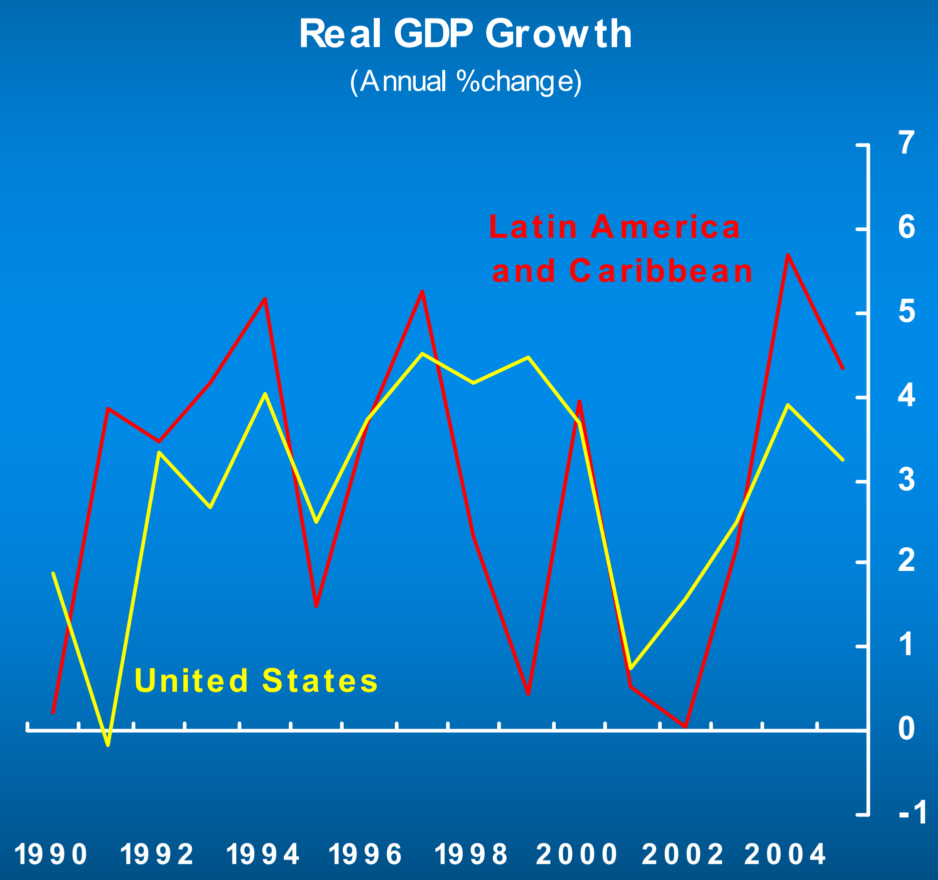
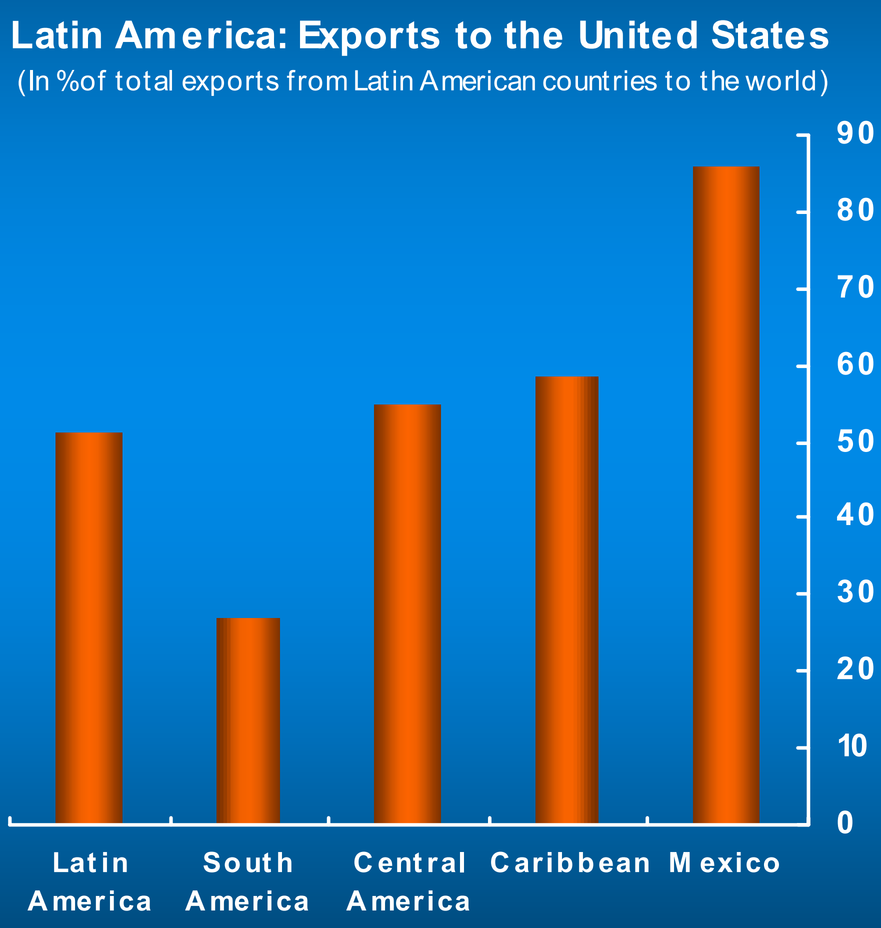
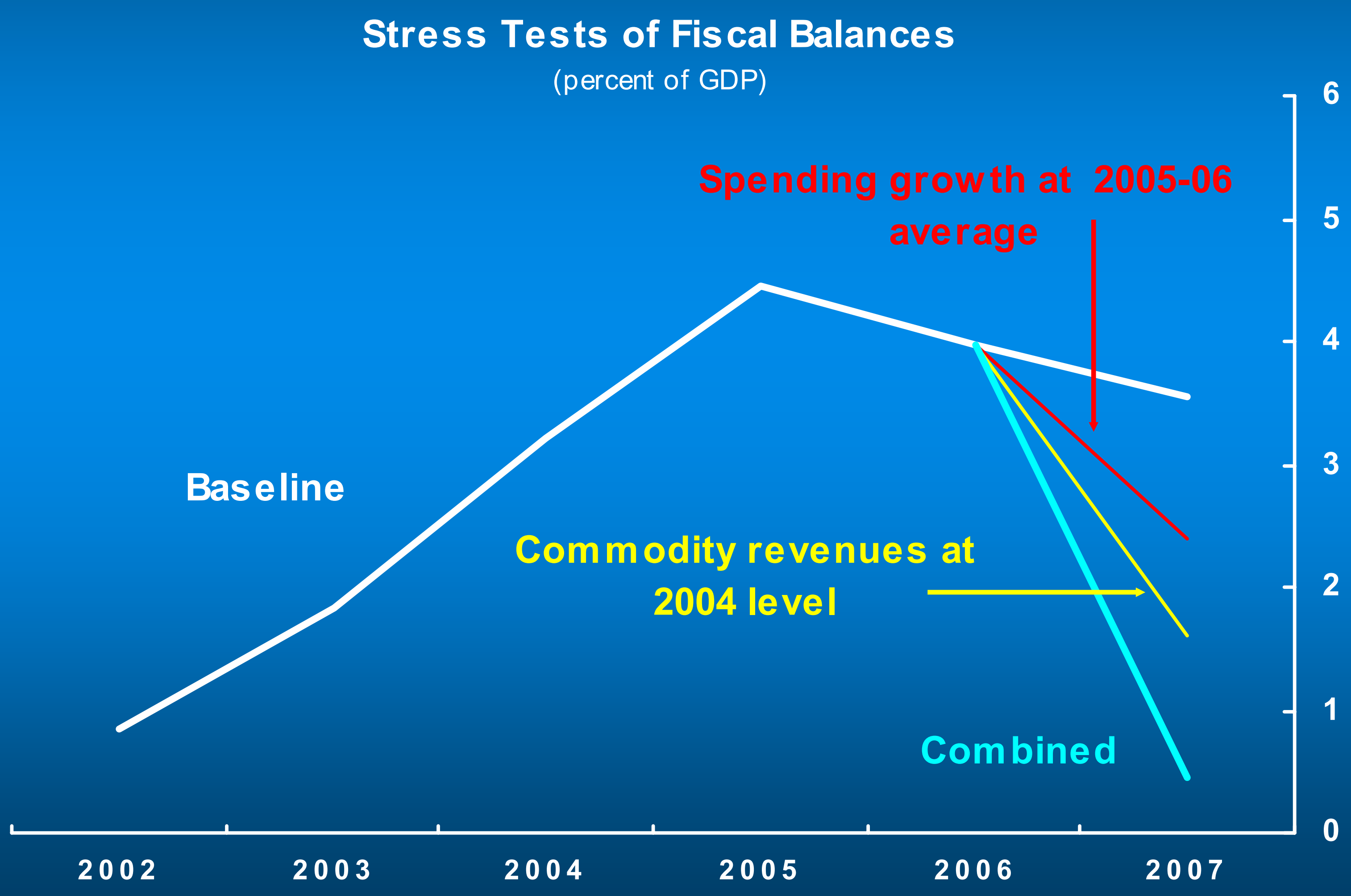
A sharper-than-expected slowdown in the U.S. could significantly affect demand for the region's exports





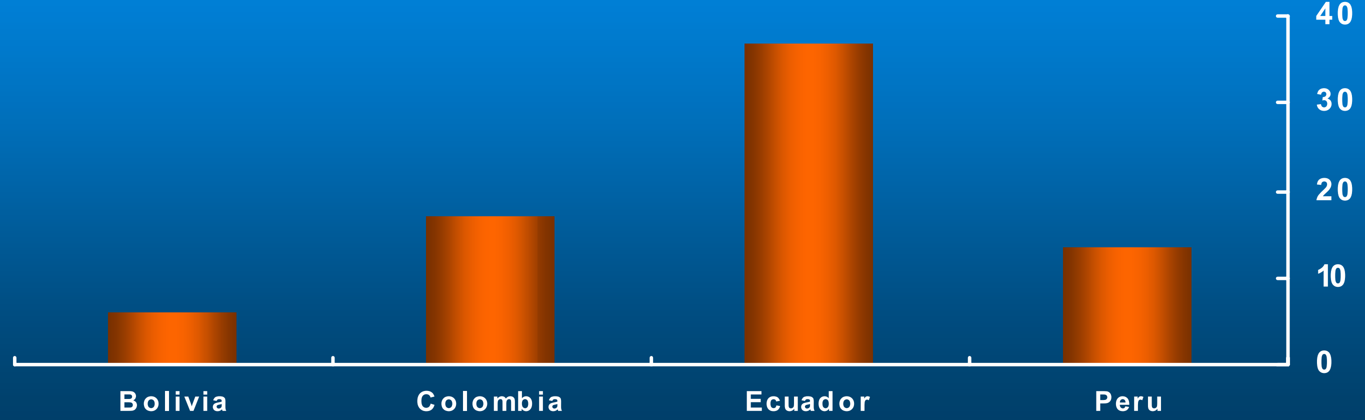
Primary fiscal surpluses would be halved by falling commodity prices



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

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



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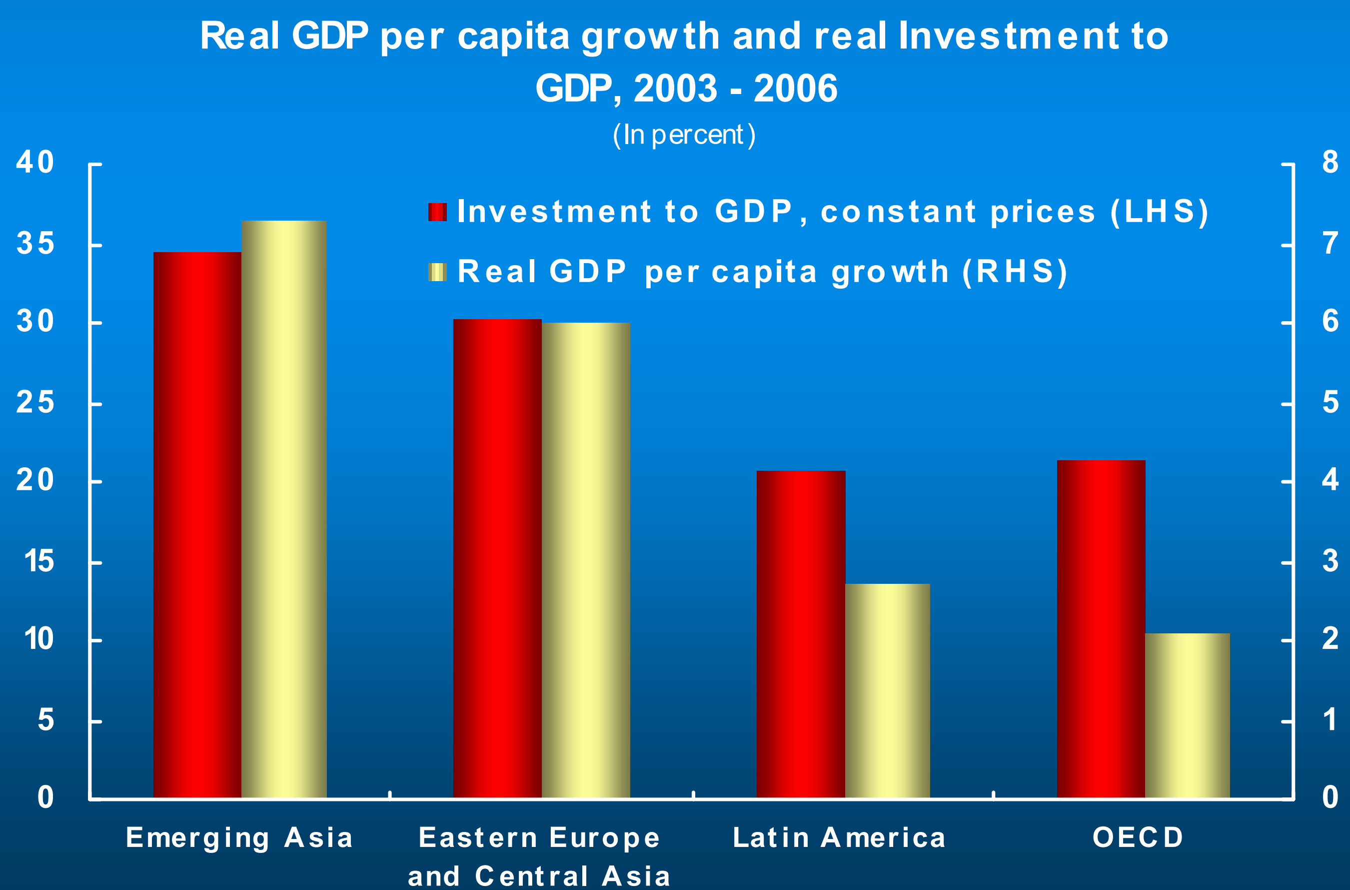
The overriding challenge in Latin America today is to raise investment and productivity on a sustained basis

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

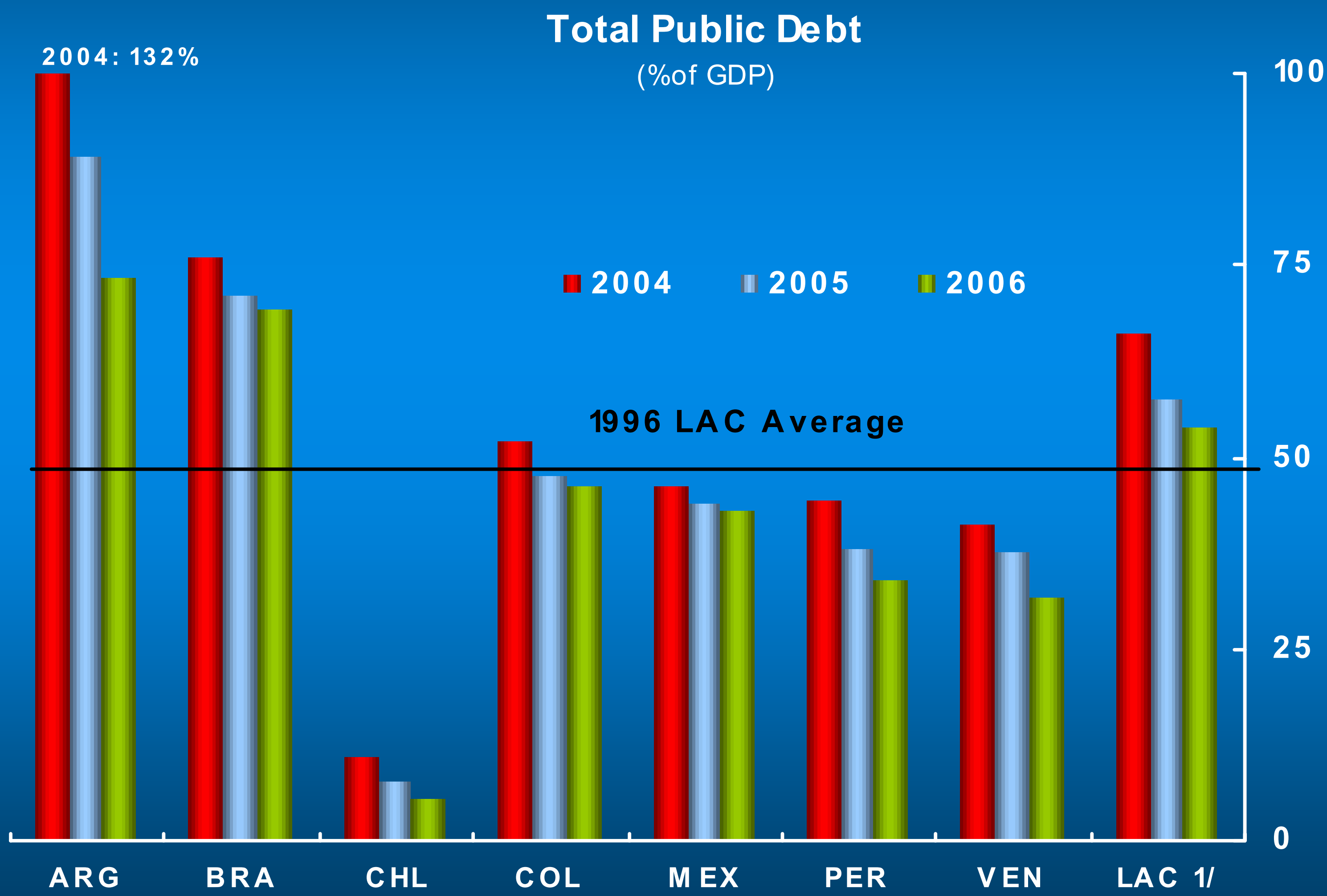
There are strong complementarities between the polices that can achieve these objectives

To reduce risk premia and raise investment, the region needs to entrench its recent macroeconomic stability

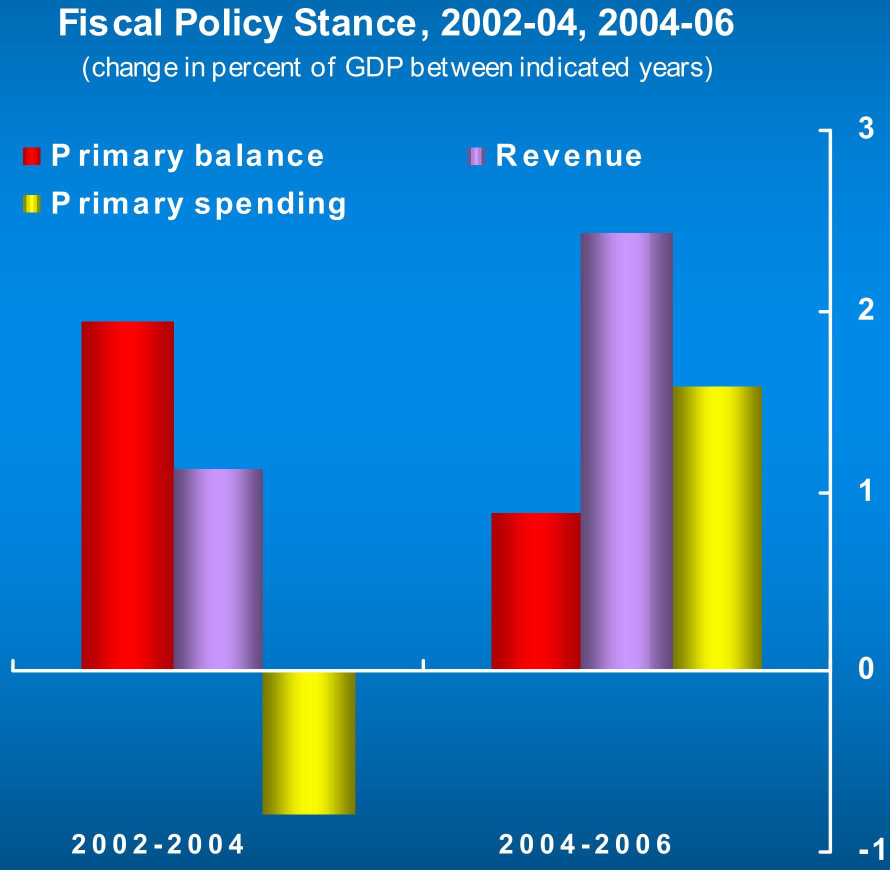
This requires:

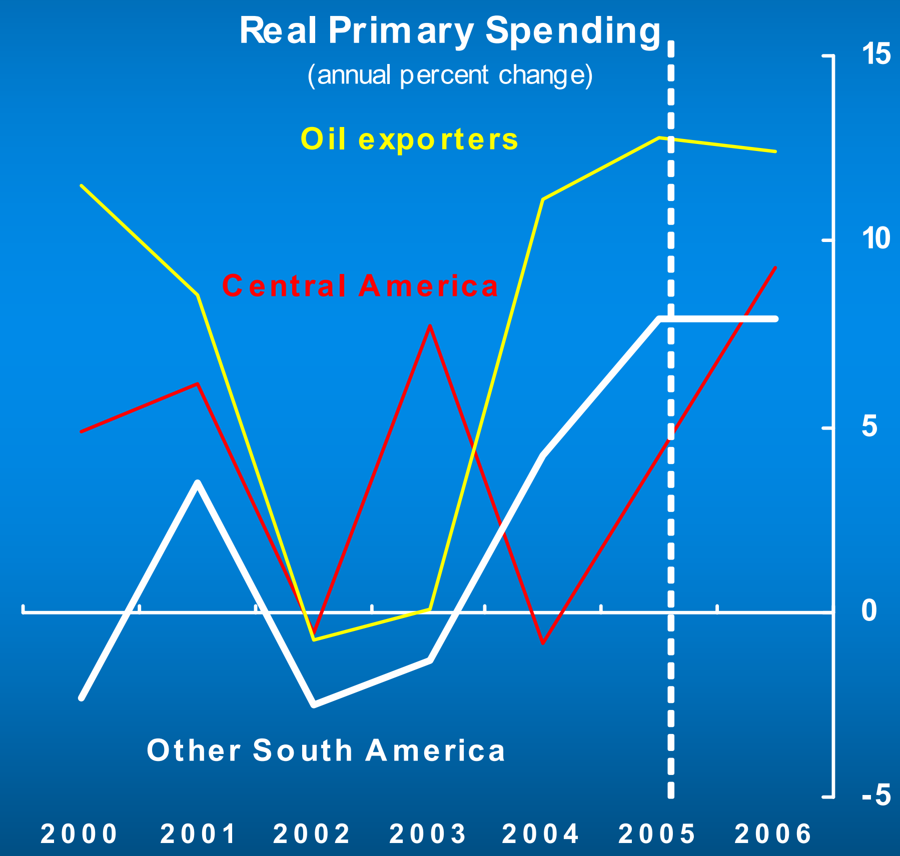
- Further lowering public debt
- Containing and better targeting public expenditures
- Making budgets less rigid
- Expanding revenue bases
- Deepening the credibility of monetary policy institutions and further financial sector reforms
- Monitoring rapid credit growth

While public debt is projected to decline, it remains generally high

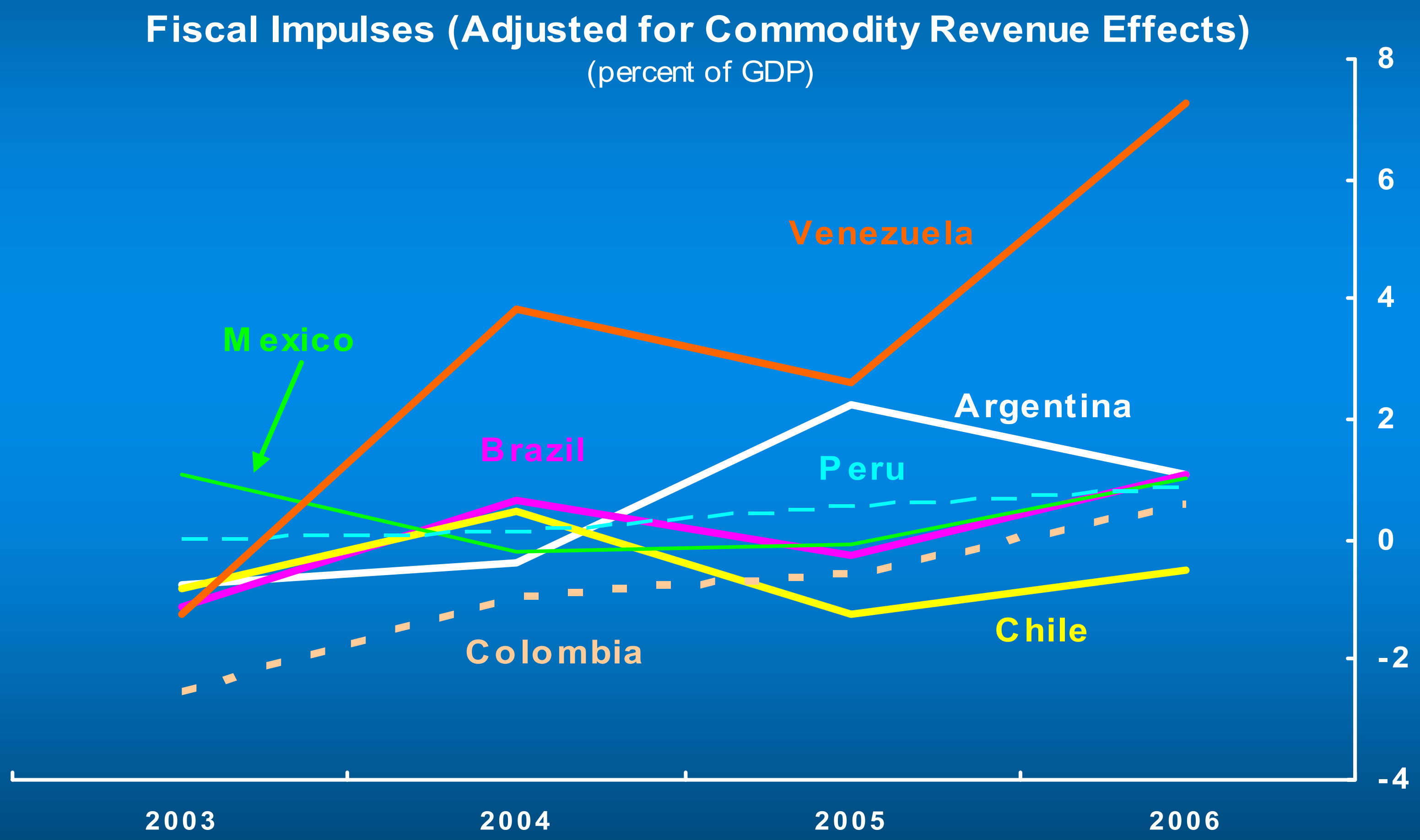


However, primary expenditure growth has accelerated...

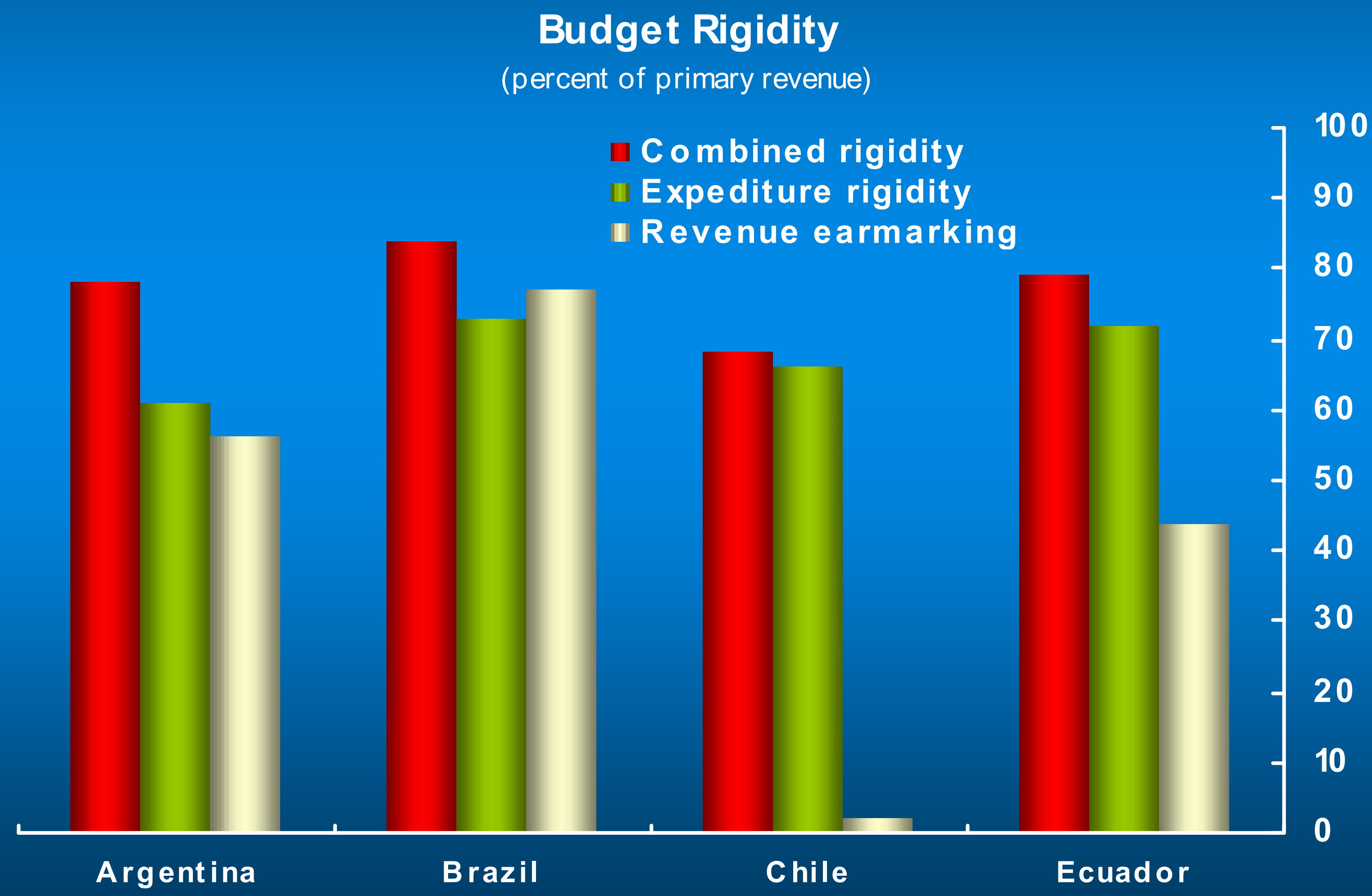




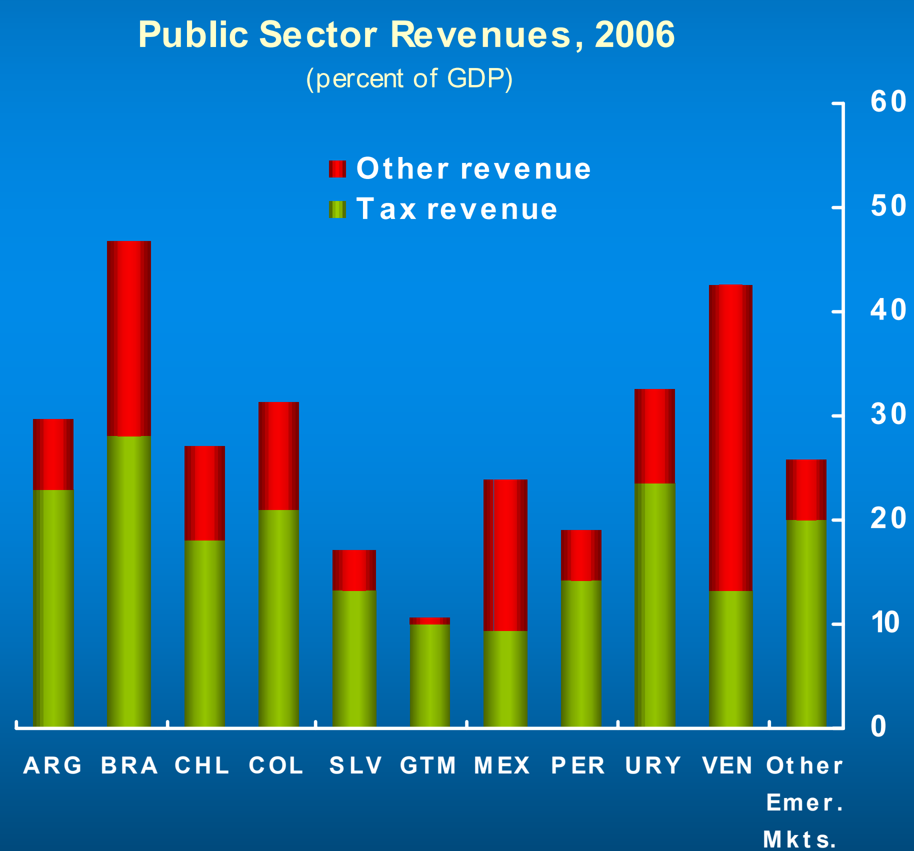
...as the underlying fiscal stance in many countries is turning expansionary

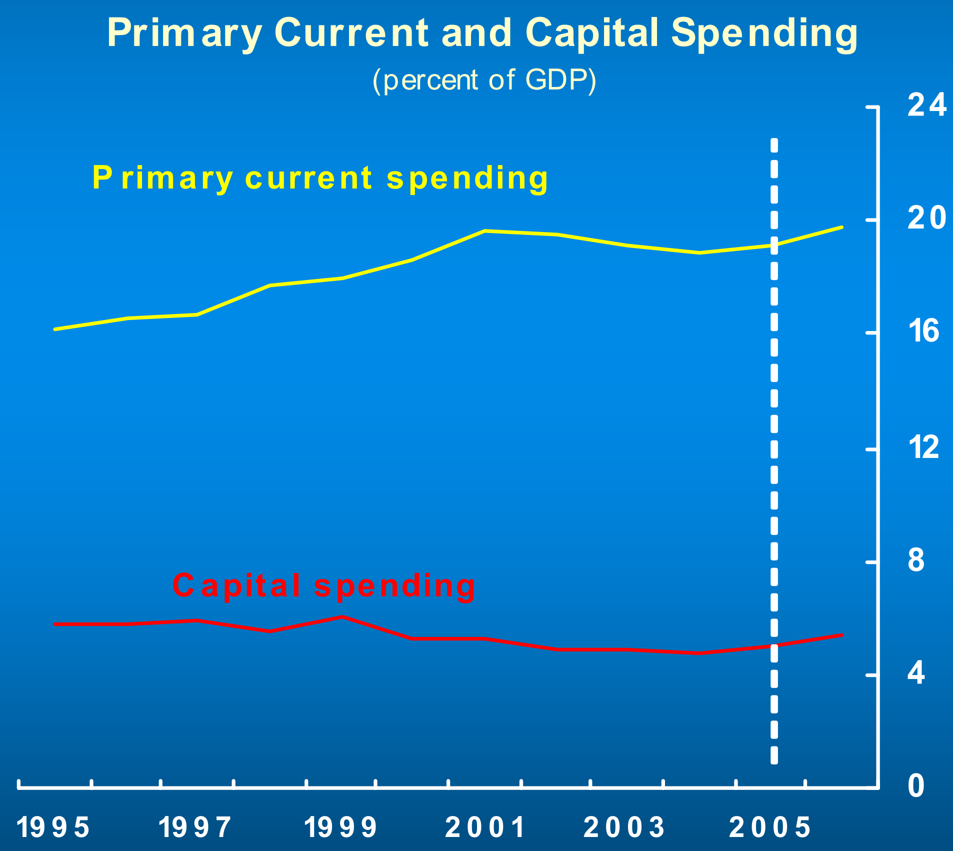


More flexible budgets would allow fiscal policy to better respond to shocks and improve spending efficiency

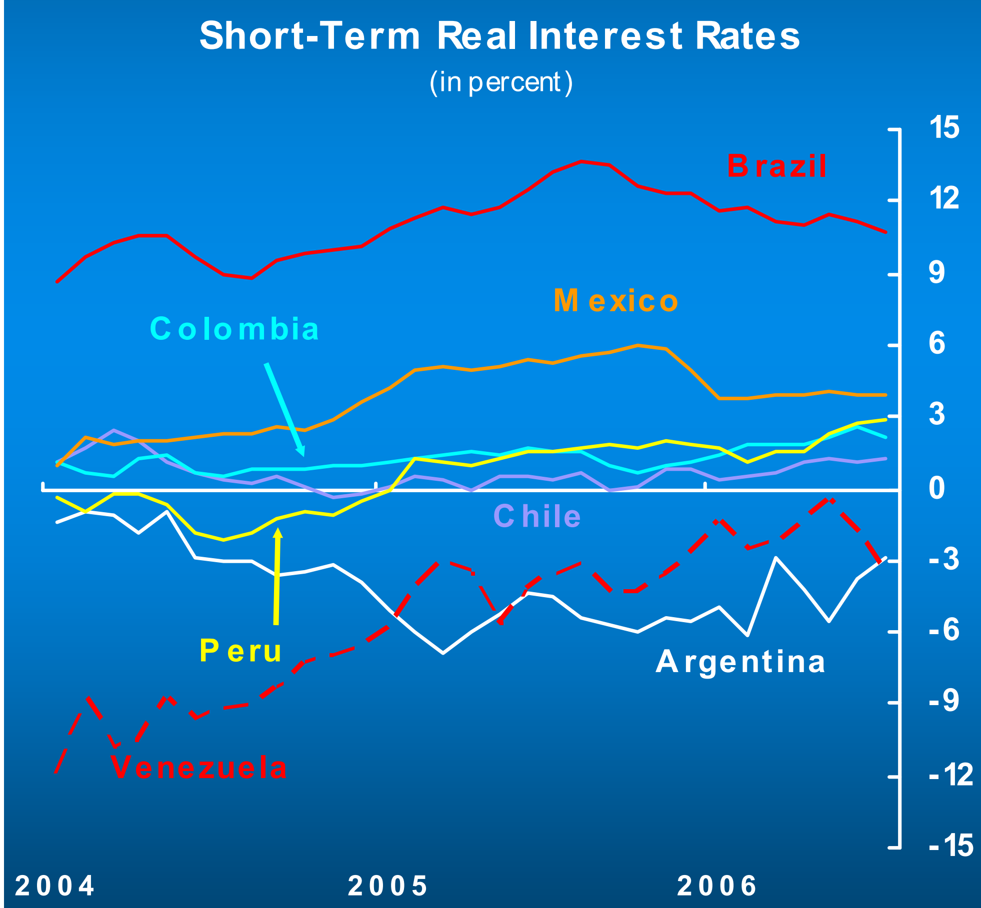


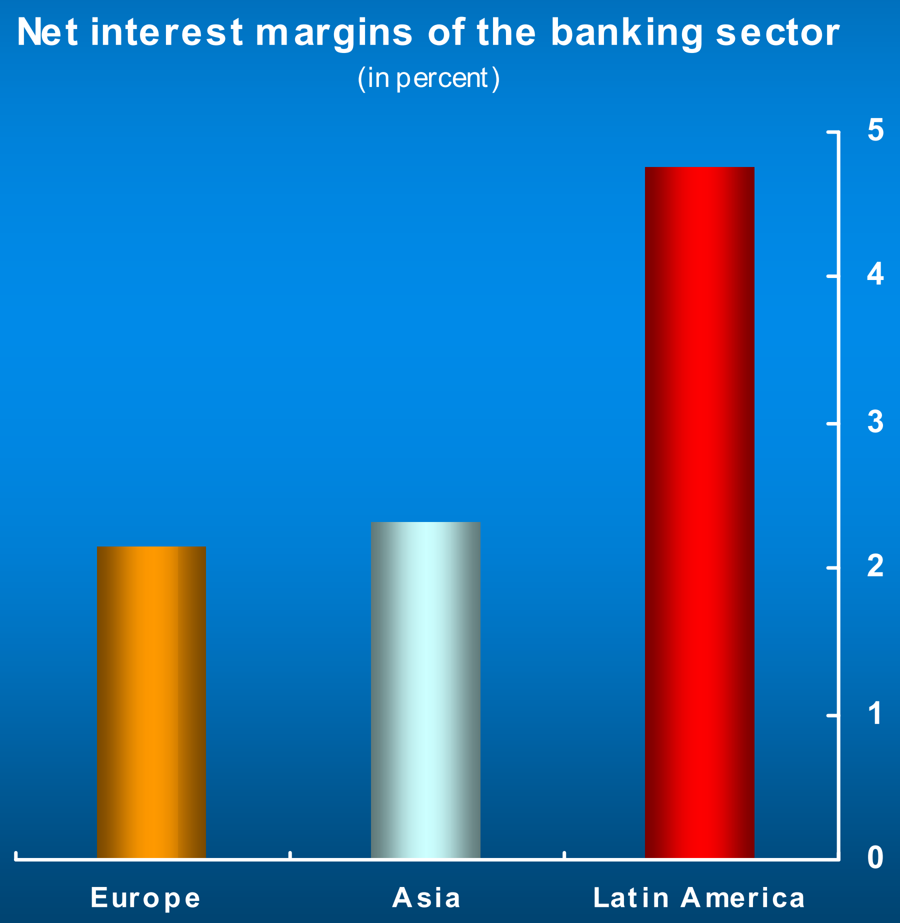
Broader tax bases and higher revenues could create room for more public investment



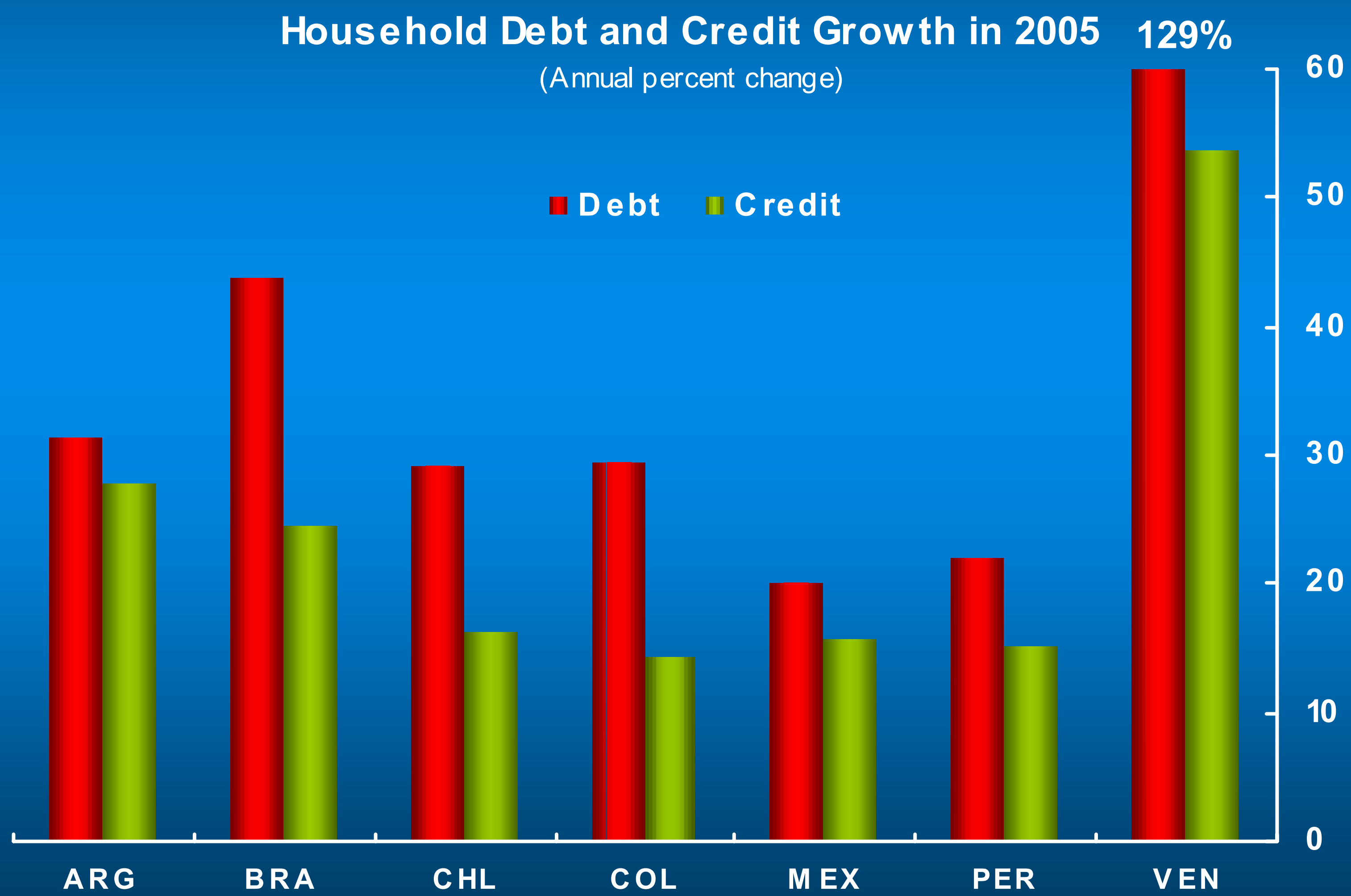


Strong monetary and financial sector institutions help achieve low and stable real interest rates

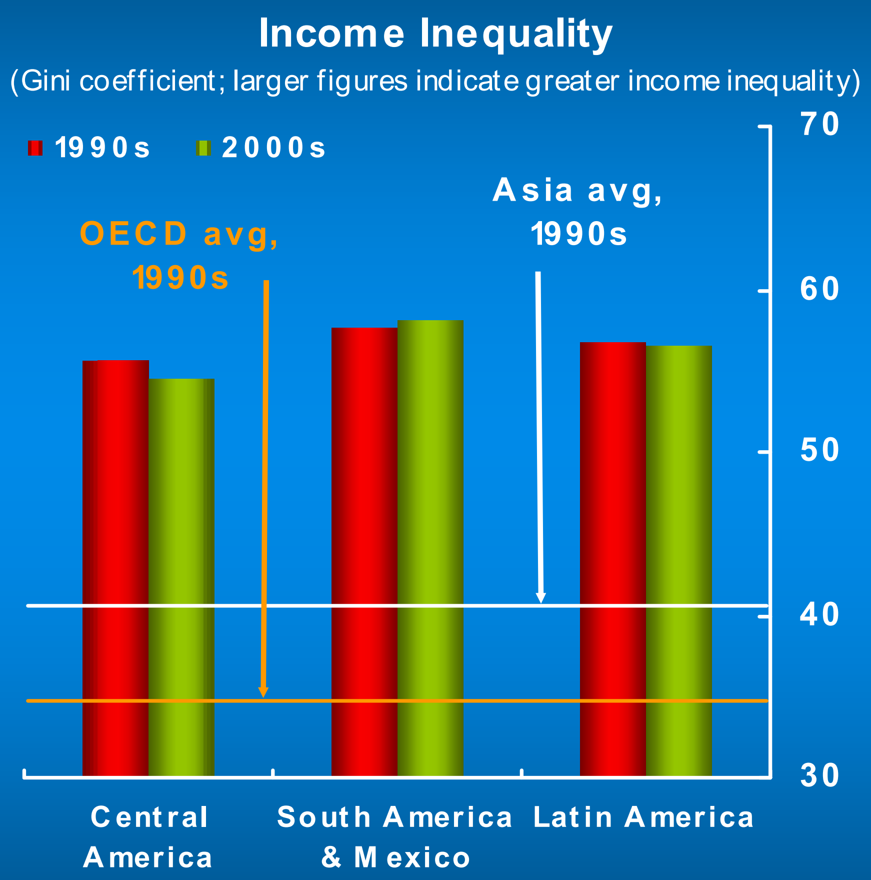




The rapid expansion of domestic credit (from a low base) will require continued close monitoring



Reducing inequality would have positive effects on growth and macroeconomic stability...

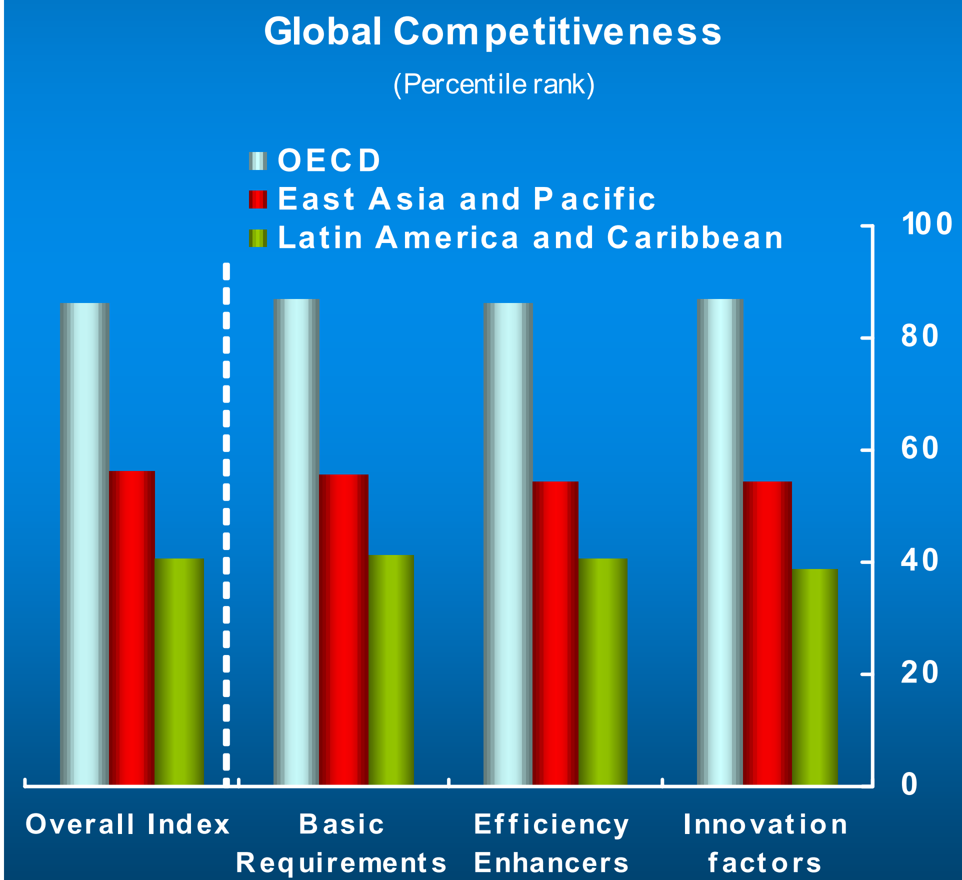


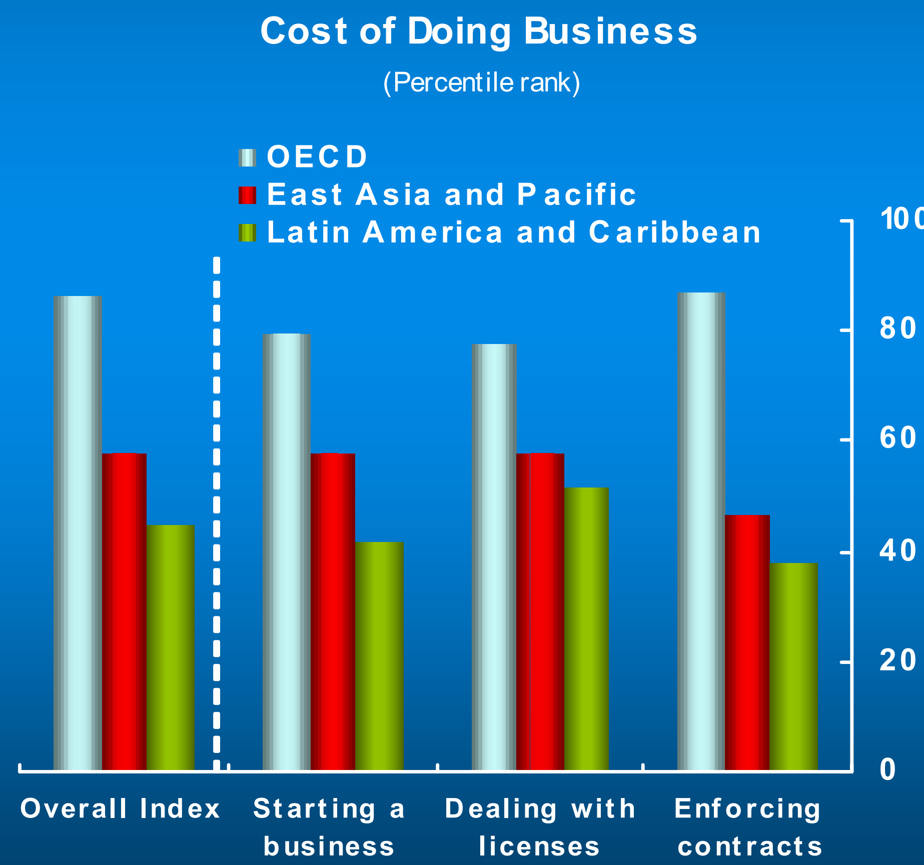
There are policy levers to promote equity

- 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