The global context and its implications for Latin America

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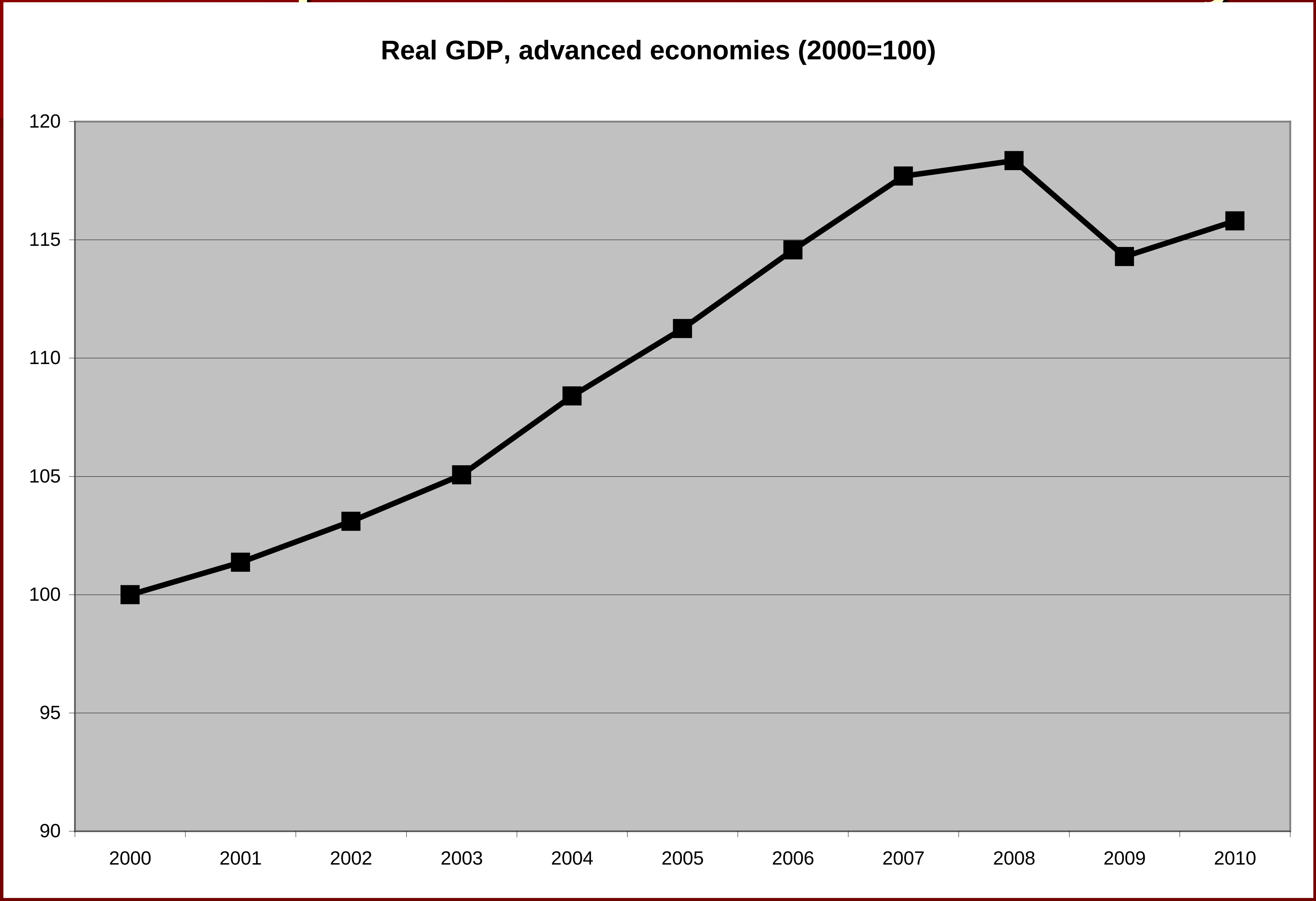
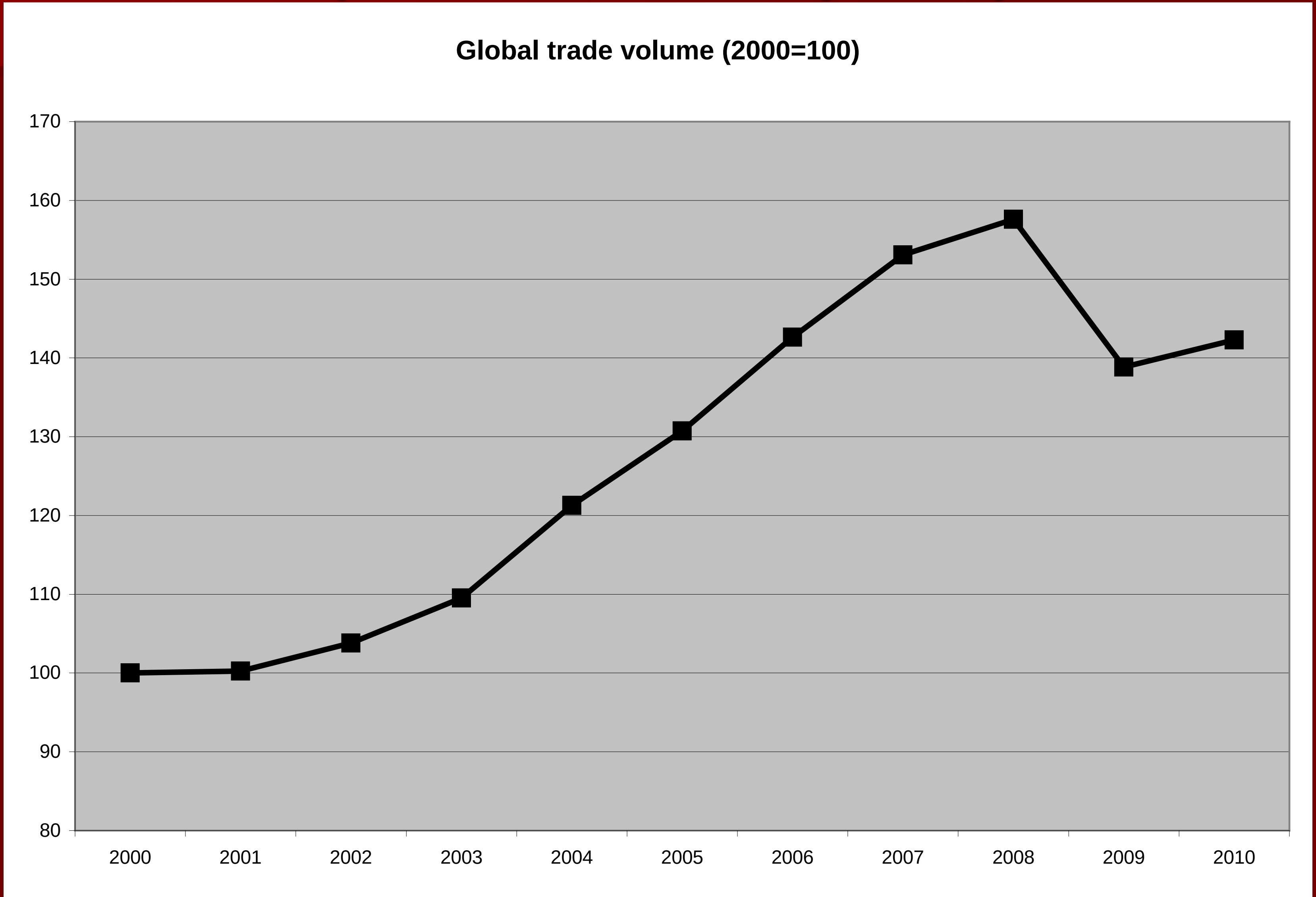
The setting

- Financial stability is being restored in the advanced countries eventually
- Recovery is taking place, but economic growth in the advanced economies is likely to fall short from pre-crisis levels
  - sizable wealth destruction + burden of public debt => slow consumption growth
  - European crisis will exert continuing drag at best
- Political constituency for “economic openness” will remain weak at best in the advanced countries
  - Significant strains on world trade regime is likely
- So the pace of economic globalization is likely to slow down
  - Domestic markets and domestic growth strategies will become more important for the health of tradable industries

Incomplete economic recovery



Global trade unlikely to recover its previous buoyancy



Protectionist clouds on the horizon

- China's surpluses and global macro imbalances
  - Even some distinguished free traders now favor punitive tariffs on China
- Excess capacity in many sectors
  - Steel: 19% global overcapacity in 2008 (MGI)
- Renewed emphasis of the role of government in the economy
  - Market fundamentalism is dead
- WTO and the multilateral trade regime in trouble for some time
  - Problems of over-reach and legitimacy

The good, the bad, and the ugly

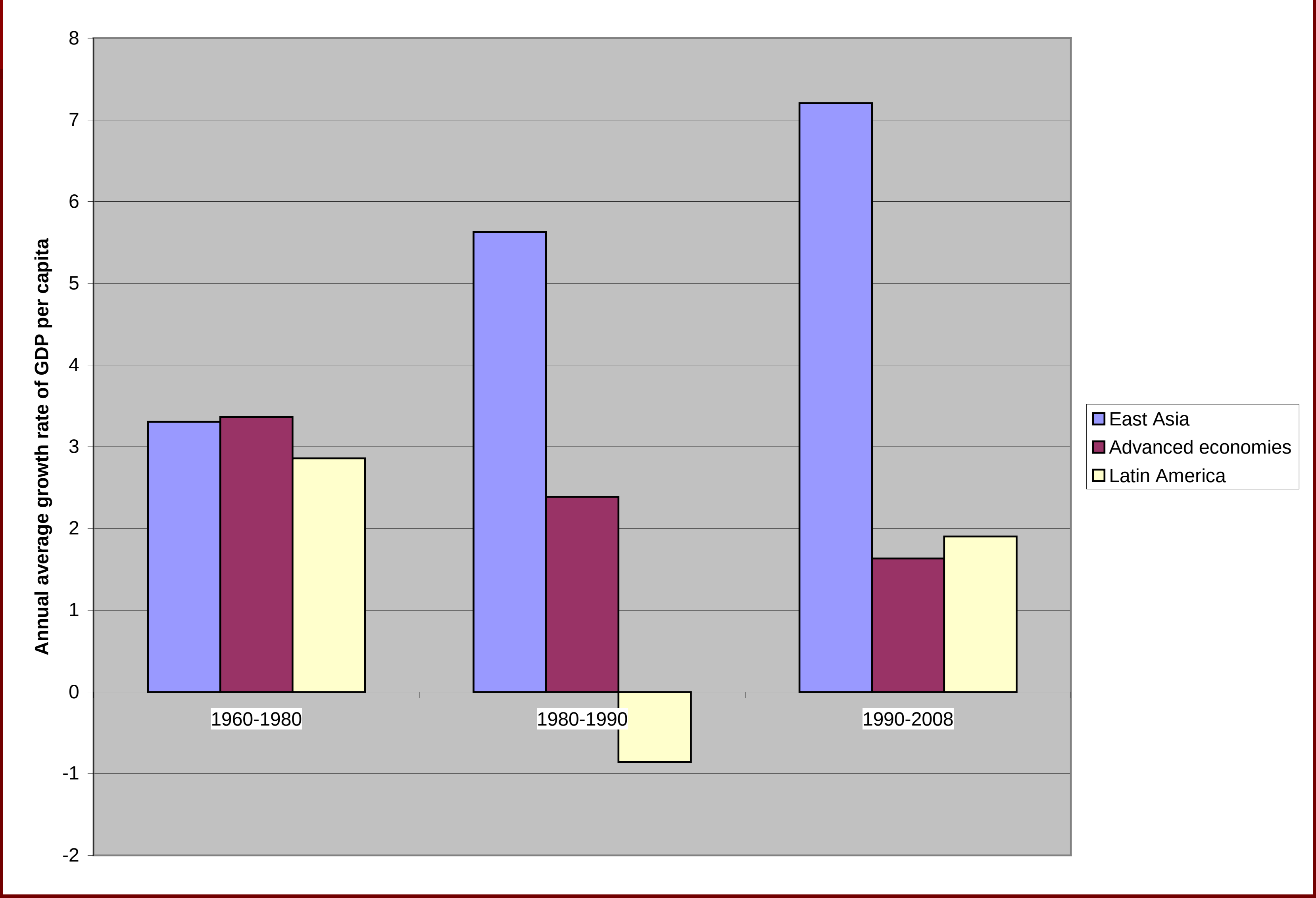
1. Managed globalization
   – Better balance between the prerogative of nation states and international rules
2. Business as usual
   – Continued reliance on (necessarily inadequate) improvements in global governance and coordination
3. Return to the 1930s
   – Protectionist free-for-all

- The first option is the only practical and sustainable remedy for the world economy

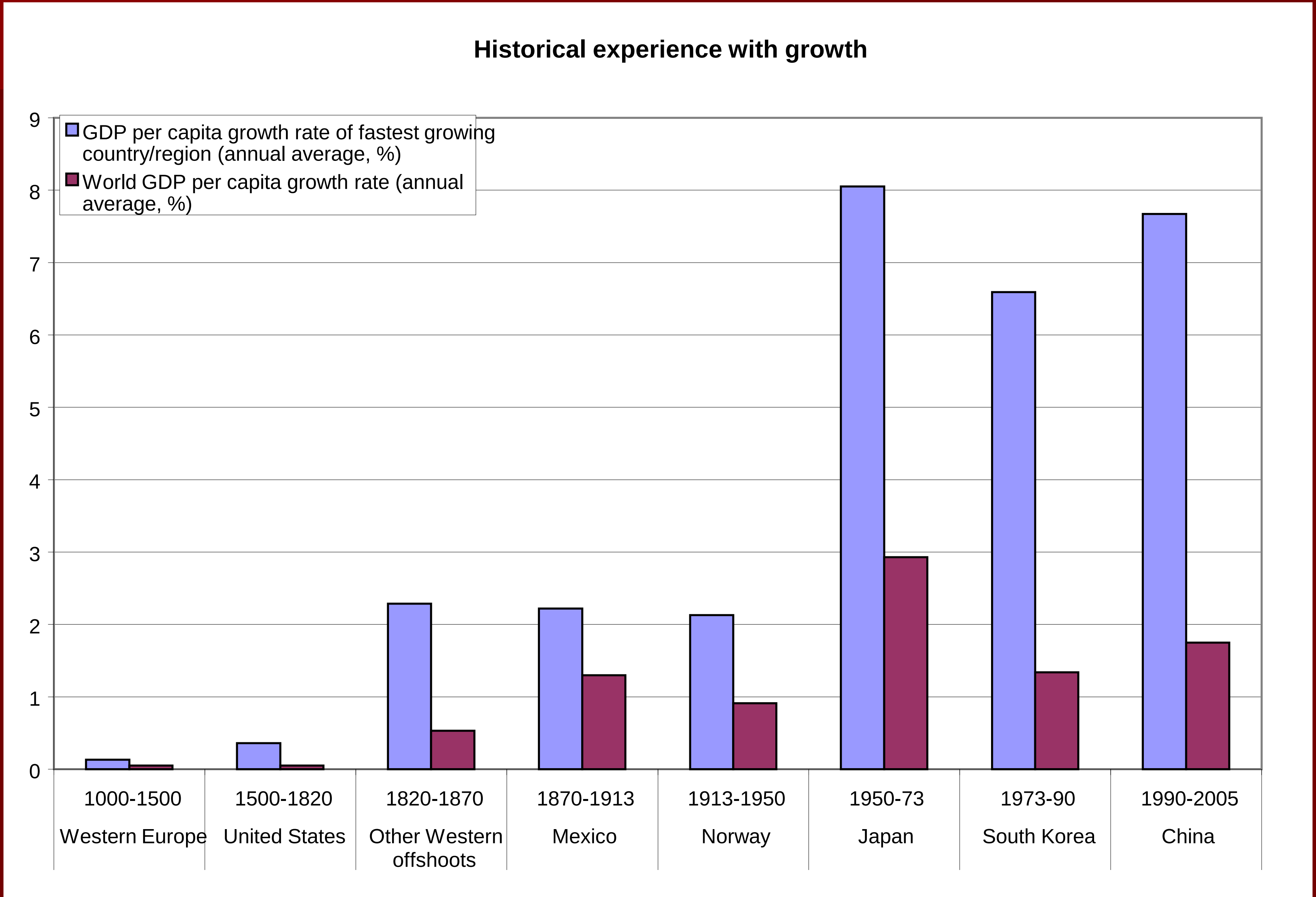
A slower pace of globalization is not necessarily bad news

- Growth comes from convergence with the productivity level (the "technology") that prevails in the rich countries
  - The stock of *ideas* and *knowledge* that constitutes "technology" does not disappear or dissipate when rich countries grow more slowly or when world trade is less buoyant.
- Countries of the Latin American region grew more rapidly prior to the 1980s than they have since
- For countries with large domestic/regional markets domestic market growth can sustain rapid increase in output in tradables

Comparative economic performance of Latin America by periods



The long view on economic growth: what's globalization's contribution?



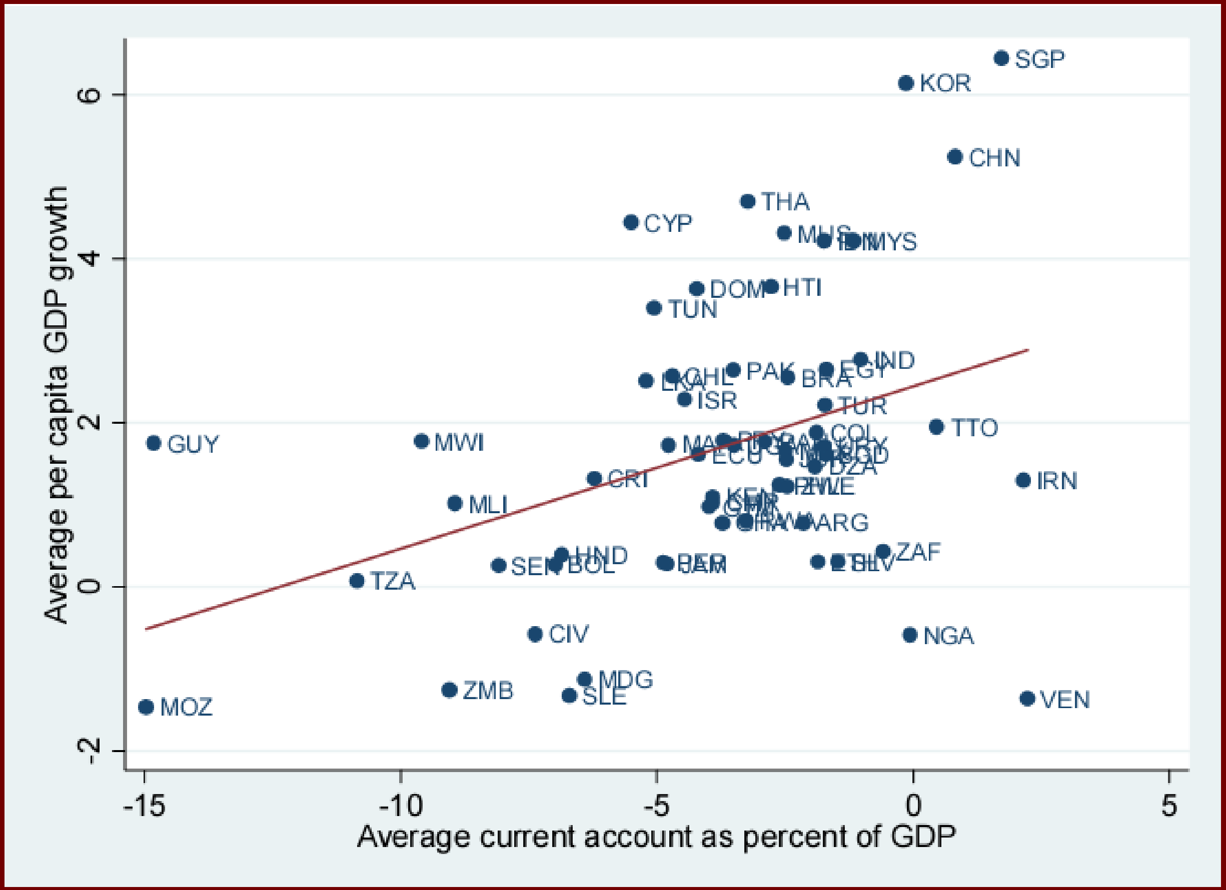
What drives growth in developing countries?

Three models of growth:

1. Foreign borrowing-led growth
   - countries in the periphery of EU in 1990s, LA in 1970s, ...
2. Commodity booms
   - 19th century, many African countries in the last decade
3. Structural transformation-led growth
   - From low-productivity traditional products to modern, mostly manufacturing activities (and lately increasingly into tradable services)
   - Based not on (static) comparative advantage, but on producing what richer countries produce

Only the last has been a sustained source of convergence (Japan, S. Korea, China)

Countries that rely *less* on external resources grow faster in the longer term



Source: Prasad, Rajan, and Subramanian (2006).

Can Latin America return to rapid growth? Pluses

- Growth potential, as measured by “convergence gap” with advanced countries, larger than ever since the early 1970s
- Significant capacity to absorb (and generate) new technologies
- Much greater integration in international trade and production networks
- Better macroeconomic management
- Improved governance and institutions

Can Latin America return to rapid growth? Minuses

- Endemic tendency for high real interest rates
  - A consequence of history of fiscal imprudence and macroeconomic instability
- Much greater integration in global finance
  - Sudden stops and financial whiplash
  - Currency overvaluation as soon as optimism sets in
- Much greater conflict between “productivist” and finance-centered policies
  - Should monetary policy target purely inflation or take into account competitiveness and employment too?
  - Should capital inflows be allowed to lead to currency appreciation or result in sterilization and capital controls?
  - Is there a role for industrial policies?

What has worked in East Asia: "productivist" policies

- Sound "fundamentals"
  - Market-friendly policies
  - Macro stability
- But also:
  - Industrial policies in support of new economic activities
  - Undervalued currencies to promote tradables
  - (The more a country relies on industrial policies, the less the need for currency undervaluation, and vice versa)
  - A certain degree of repression of finance, to enable:
    - Development banking
    - Subsidized credit
    - Undervaluation

… combined with an enabling external environment

- Permissive with regard to industrial policies
  - At least under GATT and
  - Until recently
- Willing to absorb excess supply of tradables
  - U.S. attitude of benign neglect towards current account deficits
    - Bretton Woods I and II
  - Unconcerned with undervaluation in developing countries
    - Again, until recently

Latin America cannot duplicate Asia

- History of macroeconomic instability
- Financial globalization
- Global trade rules

But it can internalize the main lessons

- Economic transformation requires strategic collaboration between the private sector and the government
  - Instead of a hands-off approach
  - Important role for “industrial policies”
- Currency volatility and overvaluation is very harmful to economic development
  - Role of capital controls
- Only high levels of domestic saving can reduce the economy’s reliance on capital inflows without hurting investment and growth
  - Role of strong fiscal policy