LATIN AMERICA IN A GLOBAL WORLD: CHALLENGES AHEAD

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Latin American economies have benefited from globalization, but there are areas where potential gains remain unexploited. Latin America should take advantage of this opportunity to accelerate their development and narrow their gaps with developed countries. Reaping the benefits involves reinforcing open markets, improving and completing structural reforms started after the debt crisis, and strengthening political and economic institutions.

Monetary policy has also been affected by globalization. Transmission mechanisms have been altered by weaker links between domestic demand and output, and larger trade and financial integration. Macroeconomic discipline has become imperative.

However, Latin America needs to go beyond the basic requirements —of stability, openness, market competition, and modern institutions— and get involved head-on in technological innovation, better education, and improved training of the labor force. Attaining political consensus and involving the civil society into policy making must be part of the reform process, to achieve political legitimacy and minimize the likelihood of costly policy reversals.

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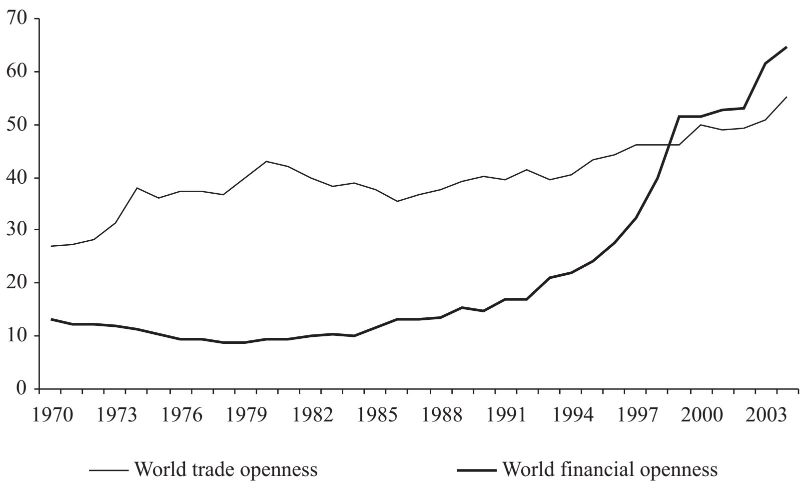
I. Introduction

Globalization, understood as increasing interdependence of countries reflected in greater and smoother flows of goods, services, capital, and even labor (although to a lower degree) across national borders has been a growing phenomenon in the world economy during the past three decades. The phenomenon is not new, but it now seems unstoppable. In recent years, world trade —imports plus exports— has risen much faster than world output, as have cross-border capital flows (Figure 1). Globalization has been fostered by a remarkable reduction in transport, information and telecommunication costs that has gone along with the information and communications revolution (Figure 2) and by policy shifts in various countries that have resulted in a major reduction in barriers to the movements of goods and services and to capital flows. The most dramatic policy shift has swept three major economic regions —China, South Asia, and the former Soviet states— that have adopted market policies and have overcome their

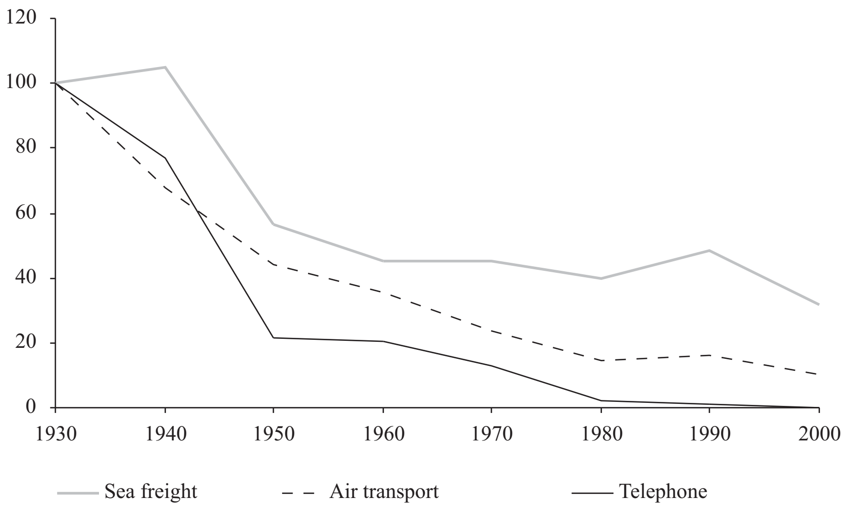
FIGURE Nº 1: FINANCIAL AND TRADE INTEGRATION (% GDP)



Note: Trade openness measured as the sum of exports and imports in percent of GDP. Financial openness measured as the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment in percent of GDP.

Sources: World Development Indicators, World Bank (2007); International Financial Statistics, IMF (2007); Lane, Philip and Milesi-Ferretti (2006).

FIGURE Nº 2: TRANSPORT AND COMMUNICATION COSTS
(Index 1930 = 100)



Note: Sea freight considers the average ocean freight and port charges per short ton of import and export cargo. Air transport is the average cost of air transport per pasenger mile, and telephone is the cost of a 3-minute telephone call from New York to London.

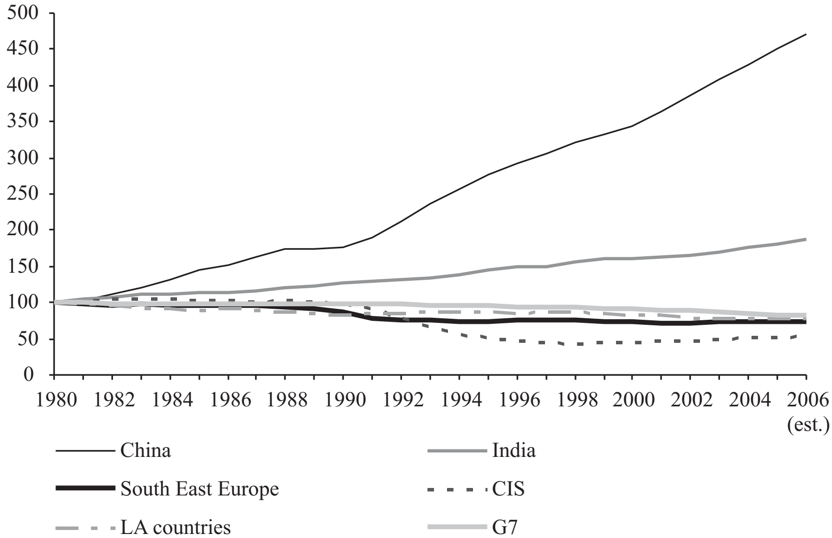
Source: Busse (2003).

atavistic fear of integrating to the world economy. Previously, these regions were essentially closed to —or at least heavily insulated from— the global trading system, and have shown impressive growth as they have embraced integration[1] (Figure 3).

However, the globalization phenomenon is more encompassing. Countries have recognized that market-friendly economic systems, open to international competition, provide a unique opportunity to increase their citizens' well-being. Governments, firms and consumers have worked to become part of the new world order. Countries that integrated with robust policies based on strong institutional settings have reaped important benefits

[1] In effect, China's share in the world's total GDP based on purchasing-power-parity (PPP) ballooned in 1980-2006 with a 371% increase, and India increased its participation by 87% during the same time.

FIGURE Nº 3: EVOLUTION OF GDP-BASED PPP SHARE OF WORLD TOTAL
(Index, 1980 = 100)



Source: Own calculation based on World Economic Outlook, IMF (April 2007).

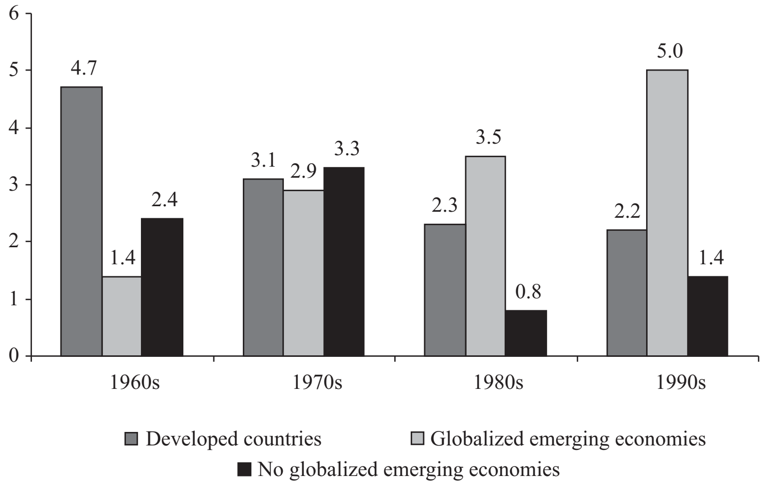
from the globalization process. Growth has accelerated and the standards of living of their population have improved substantially (Figures 4 and 5).

Production has shifted to more cost-effective locations around the globe, and the gained access to wider markets has allowed efficiency gains by producing larger volumes of goods. Competitiveness has been enhanced by increasing competition, a wider range of imported intermediate goods, with improved quality of final products at lower cost, as well as from technology transfers and absorption and productive processes that are at the international frontier.

Governments' changed orientation towards open markets set the basis for greater integration; however, consumers and investors must seize the opportunity. Consumers benefiting from improved quality, wider variety and lower costs of available goods and services, and investors seeking higher returns on investment, have the incentives and are the main promoters of growth in cross-border trade and financial transactions.

In fact, among the most striking aspects of the recent trade expansion are growth in services and the closer integration of global financial markets.

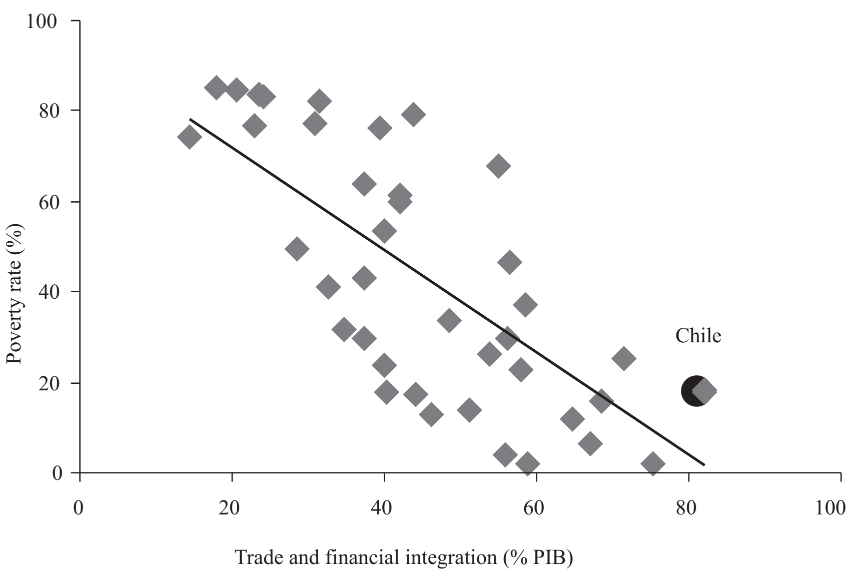
FIGURE Nº 4: ECONOMIC GROWTH AND INTEGRATION BY MAJOR REGIONS
(Average in indicated decade, %)



Note: Globalized emerging economies considers 24 countries that have experienced important trade openness since 1980.

Source: Dollar and Kraay (2001).

FIGURE Nº 5: INTEGRATION AND POVERTY (2002)



Source: Own estimation.

Profitable projects are now financed with foreign savings, enabling investment that otherwise would not occur due to lack of domestic funding. National income fluctuations are smoothened within the business cycle, flattening household consumption and investment patterns. This intertemporal softening of consumption is crucial, and particularly important for Latin American countries whose export prices are highly volatile. Financial integration also increases opportunities for diversifying portfolio asset risks.

Globalization also entails costs, so prudent policies and appropriate institutions are required to mitigate them. Exposure to international markets' conditions is higher. Domestic output and consumption are now more dependent on foreign supply and demand conditions. In addition, growing access to global capital markets has tightened the link of long-term interest rates with international interest rates and lessened that with short-term domestic rates. Thus, abrupt commodity prices and/or interest rate fluctuations or capital drainage (sudden stops) have a greater impact on domestic markets, increasing their vulnerability to external shocks. The other side of the coin of this greater exposure to international conditions is that economies become less vulnerable to idiosyncratic shocks. More open economies use the external sector as a buffer for domestic shocks. Thus, the move towards more flexible exchange rate systems and a highly diversified product and trade composition, allow non-generalized shocks to be absorbed less traumatically.

Another important aspect of globalization has to do with the consequences of the impressive increase in the supply of low-waged workforce that comes with the integration of huge Asian countries. Large numbers of new workers flooding the global economy might lead to a rise in the relative return to capital, and probably put downward pressure on the compensation of low-skilled workers in the rest of the world with respect to more skilled workers. However, as their very low wages reflect unproductive jobs created by extremely rigid economic and political systems, the opening to greater trade, technology, competition and incentives should boost their productivity as they acquire physical capital, new production methods and skills, resulting in higher wages and reducing the pressure on their peers around the world.

As a consequence of globalization, redistributive effects are bound to appear. There are winners and losers from globalization; the challenge is to design policy interventions to support the losers. This is important also for its feasibility. Overall benefits may be dwarfed by protests from those hurt in

the process (typically import-competing industries). Preserving the political viability of a reform process towards freer trade requires paying special attention to those in pain and facilitating their adaptation to the new world order with flexible markets and training, outplacement and relocation opportunities, so they can share the benefits of the open market orientation.

Finally, and given a professional bias towards these issues, it is important to realize that globalization has reshaped monetary policy. Developed and emerging economies alike have seen reduced inflationary pressures due to import penetration and allocation of production in lower-cost countries. This has resulted in a decline in the relative prices of imported and import-competing goods, at least in the short and medium term, due to increased competition and gradual integration of low-cost economies into world markets. This, together with the increasing share of tradable goods in domestic output with prices set internationally and growing financial integration, may have flattened the Phillips Curve (IMF, 2006; World Economic Outlook, April, chapter 3), thus changing the transmission channel of monetary policy to inflation and the conduct of monetary policy.

Globalization, a complex concept with many facets, presents a challenge and an opportunity that can be made profitable with a good mix of policies and institutions. Latin American countries should seize this opportunity to take a leap in their development processes and narrow their gaps with developed countries. Major benefits from globalization have already been harvested, but some gains are still waiting to be exploited. Important progress has been done, but it has been incomplete and, in some areas, too shallow. Further work is required and, while each country is different in terms of main weaknesses and political legitimacy, today's rare historical juncture is propitious for undertaking the needed structural reforms to enhance economic performance and take full advantage of the new opportunities available.

II. Latin American process to globalization

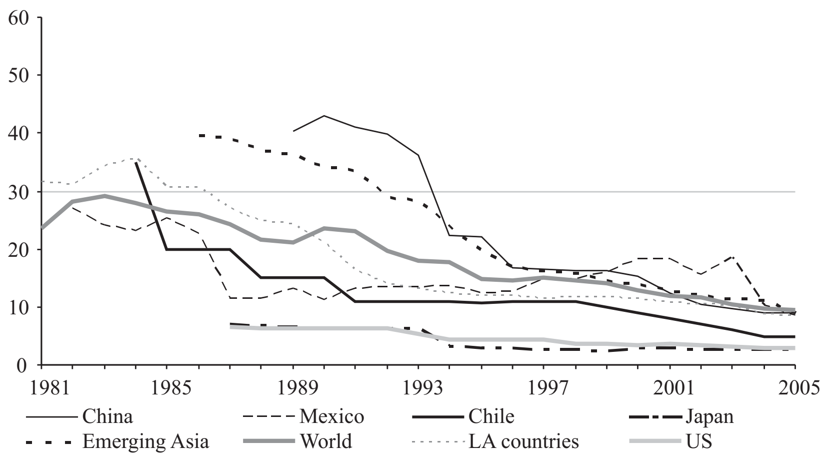
The presence of Latin America as a global player is not new. Most Latin American countries began the process of integration into this new global order soon after the debt crisis of the early 1980s. Until then, the development strategy depended mainly on import substitution and high government involvement. However, the debt crisis uncovered structural

problems and severe macroeconomic imbalances in the region, triggering the much needed macroeconomic reforms, where priority was given to fiscal consolidation, trade integration and financial liberalization. Chile's reform process had started almost a decade earlier.

With the new trade policies, countries began reducing both the level and the dispersion of trade tariffs, while lifting other non-tariff barriers to trade and unifying multiple exchange rate systems (Figure 6). Trade integration took two forms: Unilateral tariff reductions (e.g., Chile in the period 1974-2003) and/or preferential trade agreements and the establishment of trade areas within the region, such as Mercosur. In addition, tax reforms were implemented, where VAT was introduced (Chile introduced VAT in 1975) and some taxes were raised to compensate for the reductions in trade tariffs.

In the financial sector, reforms included lifting restrictions on credit allocation, abolishing ceilings on interest rates, and reducing reserve requirements on banks (Figure 7). Latin America increased financial integration notably. The correlation between saving and investment fell from

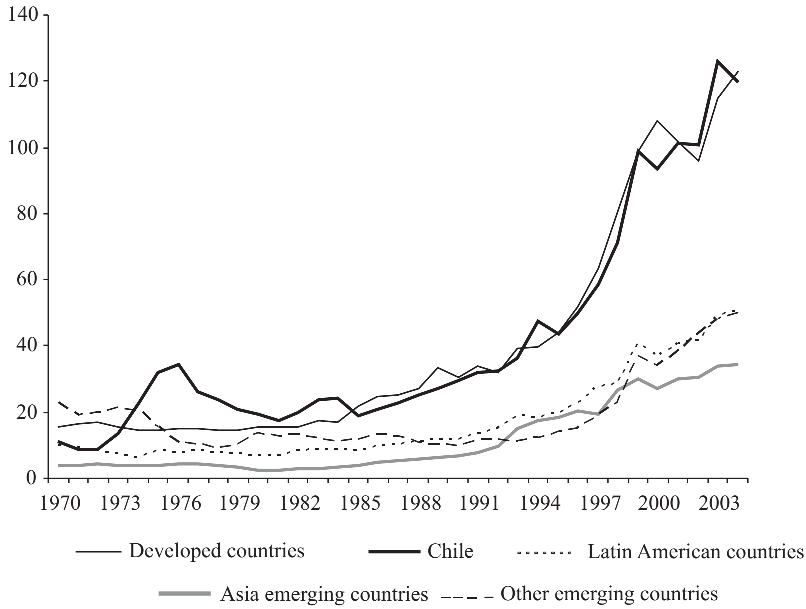
FIGURE Nº 6: AVERAGE APPLIED TARIFF RATES (%)



Note: All tariff rates are based on unweighted averages for all goods in *ad valorem rates*, or applied rates, or applied rates, or Most Favored Nation (MFN) rates, whichever data is available for a longer period.

Source: Data on Trade and Import Barriers, World Bank (2007).

FIGURE Nº 7: FINANCIAL OPENNESS (% GDP, 1970-2004)



Note: Measured as the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment in percent of GDP.

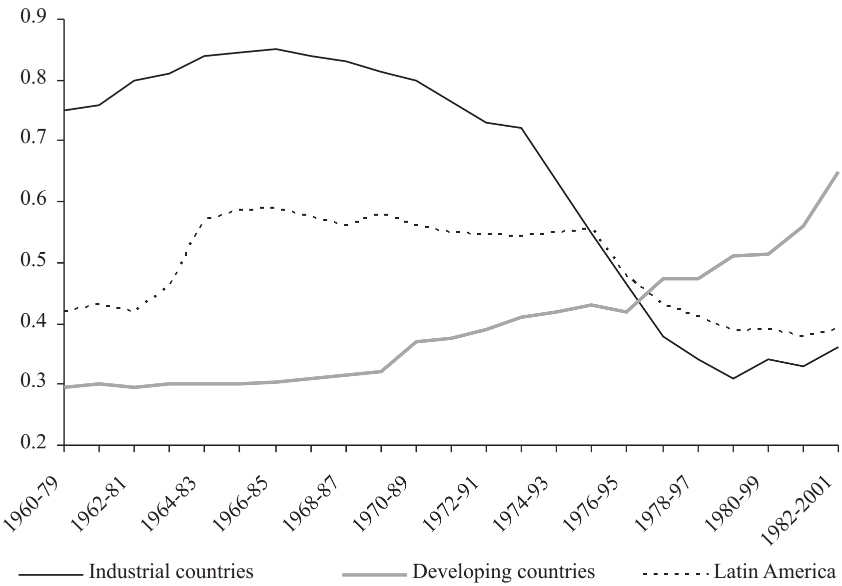
Sources: Lane, Philip and Milesi-Ferretti (2006); International Financial Statistics, IMF (2007).

a peak of 0.59 in 1966-85 to 0.38 in 1981-2000 (Calderón and Schmidt-Hebbel, 2003) (Figure 8), while domestic real interest rates converged to international rates.

Despite the reform efforts, the growth response has been disappointing: growth in LA has been slow and volatile in comparison with other emerging countries, especially in East Asia (Figure 9). In the 1990s, growth resumed in the region but remained below pre-debt-crisis rates, at about 5% per year from 1950-80.[2] Income gaps with respect to G-7, which remained large and even widened in some countries; recurrent

[2] Growth in LA countries averaged 2.5% during 1991-97, compared to –0.1 during the 1980s.

FIGURE Nº 8: SAVING-INVESTMENT CORRELATIONS (1960-2001)



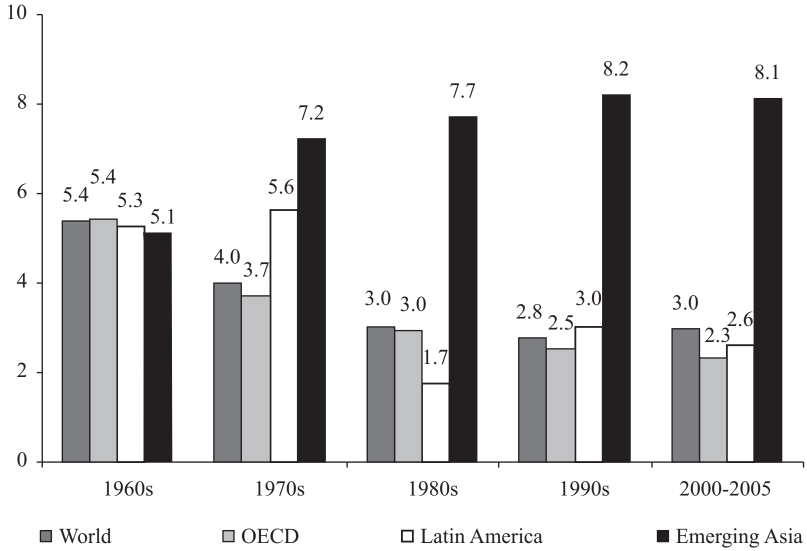
Note: Measured as 20-year rolling correlations.
Source: Calderón and Schmidt-Hebbel (2003).

macroeconomic crises; modest poverty alleviation and worsening income inequality generated barriers to sustainable growth (Figure 10). Although recently declining, poverty rates in Latin America have shown only slow improvement over the decades, and income inequality —as measured by Gini coefficients— has been generally higher than in Asia. This polarization of economic well-being in some countries has contributed to polarization in the political sphere which, in turn, has made it more difficult to build a lasting consensus for reform in the region.

Macroeconomic stability was not fully achieved. Inflation rates are still high in some countries (Table I) although region-wide there has been significant progress. In addition, most Latin American economies adopted pro-cyclical fiscal policies in the 1990s, especially in countries with high budgetary rigidities like Argentina, Brazil, Colombia, Uruguay and Venezuela[3]

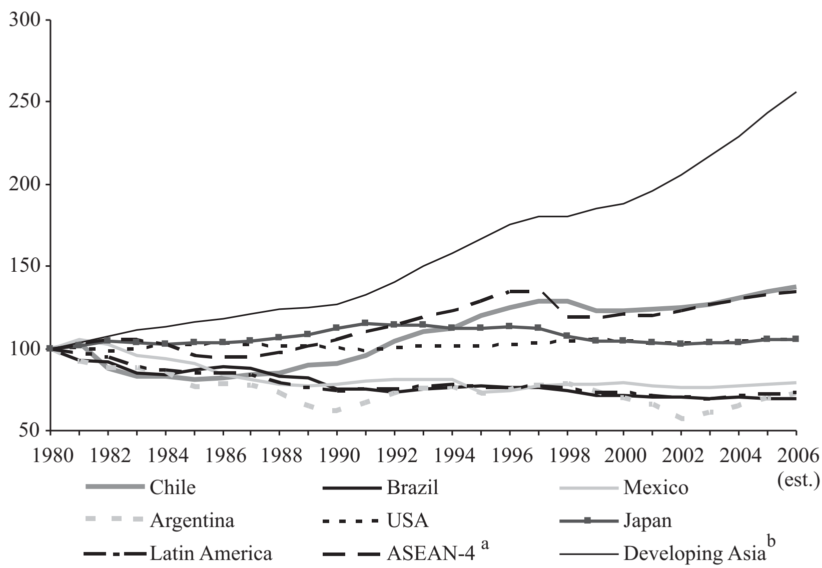
[3] In Asia, only Philippines and Thailand seem to have had pro-cyclical fiscal policies during the 1990s.

FIGURE Nº 9: ECONOMIC GROWTH
(Average in indicated period, %)



Source: World Development Indicators, World Bank (2007).

FIGURE Nº 10: RELATIVE PER CAPITA OUTPUT
(Per capita GDP over per capita GDP of G-7, PPA, 1980 = 100)



[a] Considers Malaysia, Indonesia, Thailand and the Philippines.
[b] Includes China and India.

Source: Own calculation based on World Economic Outlook, IMF (April 2007).

TABLE N° 1: INFLATION (%, YEAR ON YEAR)

	1980-84	1985-89	1990-94	1995-99	2000-05	2006 (est.)
Argentina	268.1	863.2	506.7	0.8	8.6	10.9
Bolivia	351.9	2.413.7	13.6	7.4	3.4	4.3
Brazil	132.4	532.2	1.690.2	19.4	8.4	4.2
Chile	22.4	20.4	17.5	6.0	2.8	3.4
Colombia	22.7	24.0	26.3	18.0	6.9	4.3
Ecuador	25.1	42.9	44.8	33.2	26.5	3.3
El Salvador	13.7	23.3	15.9	5.4	3.1	4.6
Mexico	56.1	82.0	16.3	24.5	5.7	3.6
Peru	84.1	878.5	1.607.4	8.4	2.3	2.0
Uruguay	44.2	71.0	76.4	21.4	9.4	6.4
Venezuela	13.1	33.0	41.0	53.8	20.0	13.6
Average LAC	88.5	213.4	265.0	17.1	7.7	5.4
Asean- 4[a]	12.3	6.1	7.7	11.3	5.2	8.2
G7	7.8	3.2	3.4	1.8	1.9	2.3
World	14.6	16.3	29.3	7.8	3.8	3.8

[a] Considers Malaysia, Indonesia, Thailand and the Philippines.

Source: World Economic Outlook, IMF (April 2007).

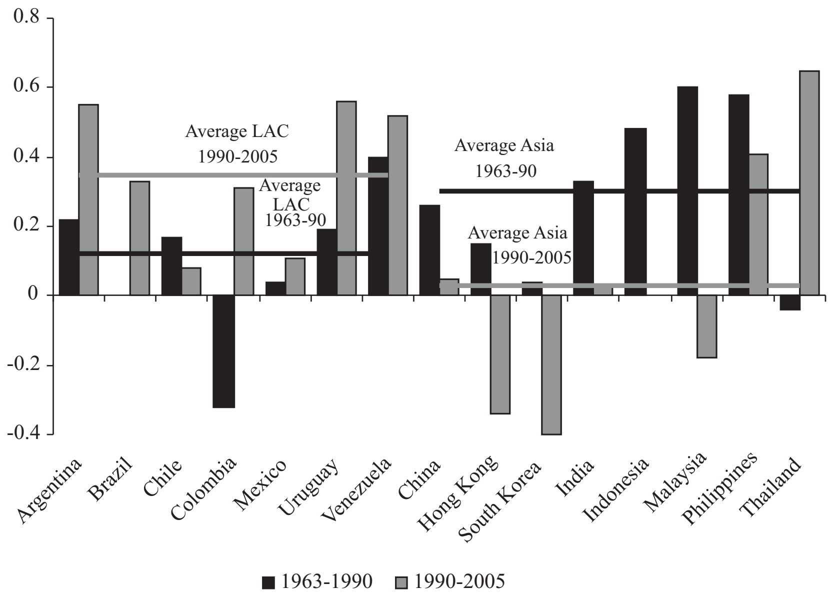
(Figure 11). Furthermore, fiscal weakness led to high levels of public borrowing in many countries with an average public debt to GDP ratio of 55%, countries like Argentina and Brazil with levels above 60%, and Bolivia and Uruguay, above 70% (Figure 12).

In recent years, the favorable terms of trade shocks have been administered more prudently. Primary fiscal balances had surpluses in most countries. In addition, the implementation of prudent monetary policy with flexible exchange rates helped macroeconomic stability. In many LA countries, inflation-targeting monetary policy regimes were introduced with an impressive decline in inflation. All this was accompanied by a favorable external environment with high commodity prices, strong global growth and significantly reduced financial costs, allowing countries to build foreign reserves and improve their debt structures.

Overall, trade barriers still prevailed and import tariffs were high, hence trade openness was incomplete (Figure 13). Even in countries with low barriers to trade volume was still very modest as impediments of other sorts were still present (related to rule of law, confidence in the system, corruption).

Trade openness in LA has remained below world average and far behind Asian emerging economies (Figure 14). The Latin American region accounted for around 5% of world trade in 2005, quite low compared to Asian

FIGURE N° 11: PROCYCLICALITY OF FISCAL POLICY



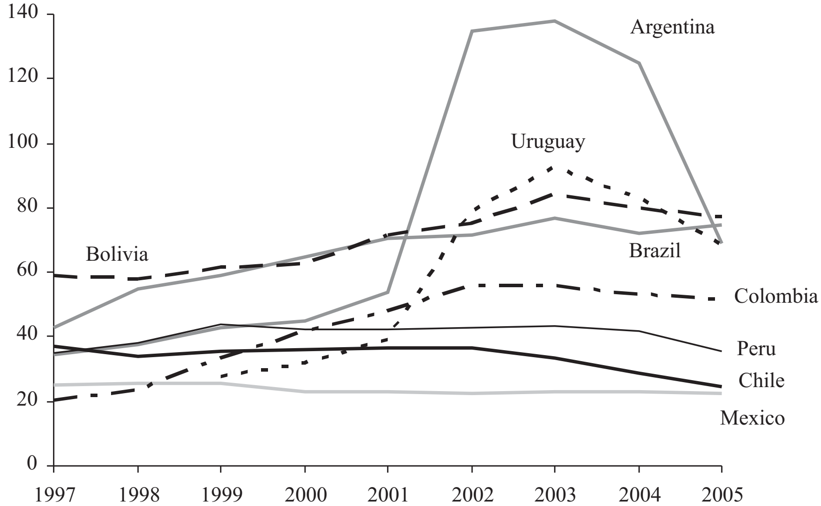
Note: Measured as the correlation between cyclical componets (based on the Hodrick-Prescott filter) of real government spending (Central Government expediture deflated by the GDP deflator) and GDP growth. A positive correlation is evidence of a pro-cyclical fiscal policy.

Source: Cerisola and Singh (2006).

countries with 11% (with China nearly 7%) and emerging Europe with 7%. Despite the reforms, the situation has not changed much since the 1980s. Furthermore, the share of Latin America went down by 30% in the 1980s. As percent of GDP, merchandise trade represents approximately 44% of GDP in 2005, compared to Asia with 75% (China 64%) and emerging Europe with 69% (Figure 15).

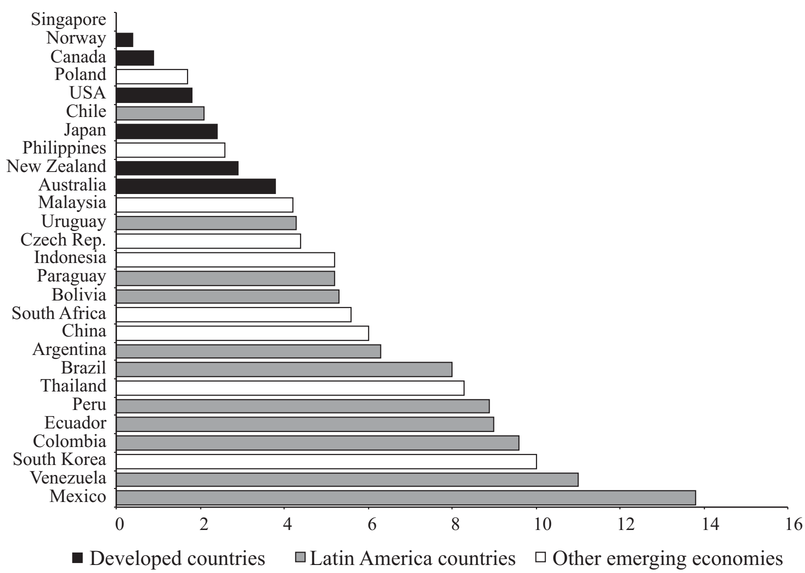
International financial integration, measured as financial openness, increased in the region, especially since the 1990s, and is high compared to other emerging countries, including Asian economies. This, despite the inadequacy of the regulatory, supervisory and institutional framework that often accompanied the process (Figures 16-17). Overall, LA countries have benefited from capital flows. Nevertheless, financial crises (e.g., Mexico, Asia,

FIGURE N° 12: PUBLIC DEBT IN LATIN AMERICA
(General government's debt, % GDP)



Source: Moody's Country Credit Statistical Handbook (2006); Chile's Ministry of Finance (2006).

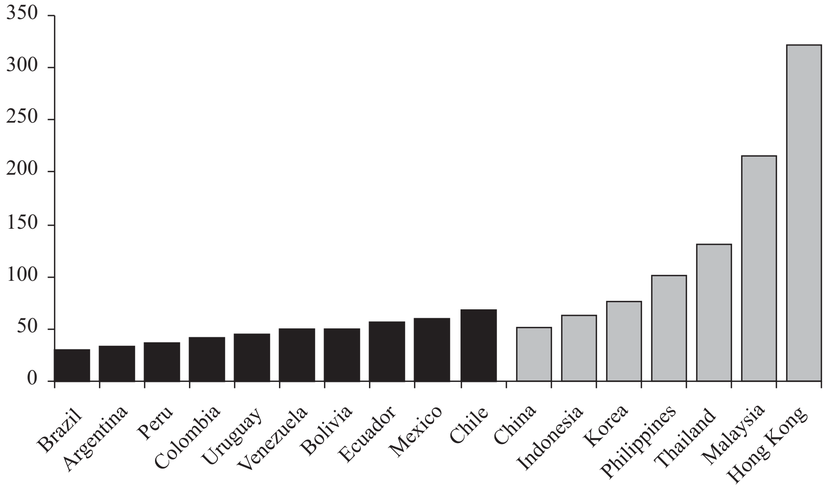
FIGURE N° 13: WEIGHTED MEAN IMPORT TARIFFS BY MAJOR REGIONS (%)



Note: Weighted mean tariff is the average of effectively applied rates or most favored nation rates weigthed by the product import shares corresponding to each partner country. Most recent country data available for countries varies between 2003 and 2004.

Source: World Development Indicators, World Bank (2006).

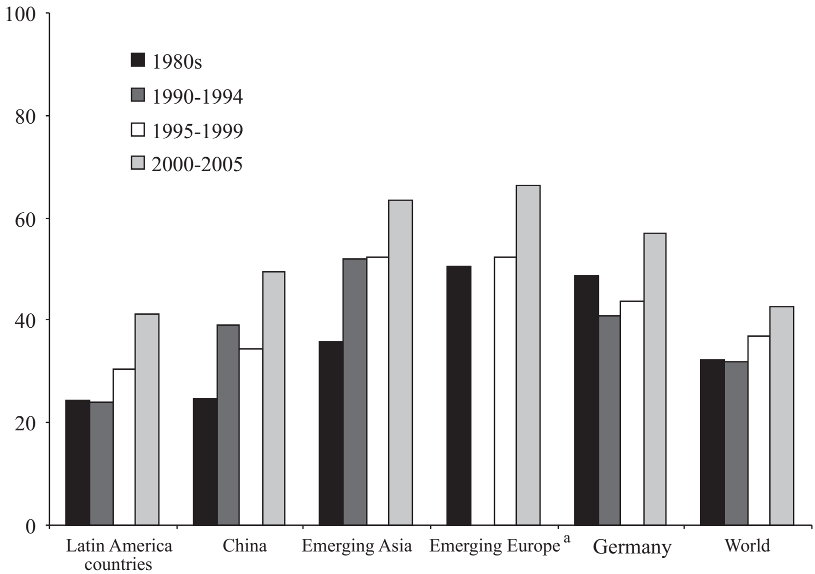
FIGURE N° 14: TRADE 2000-2005
(Average, % GDP)



Note: Considers exports and imports of goods and services and GDP at current prices in US$ dollars.

Source: World Development Indicators, World Bank (2007).

FIGURE N° 15: MERCHANDISE TRADE (% of GDP)

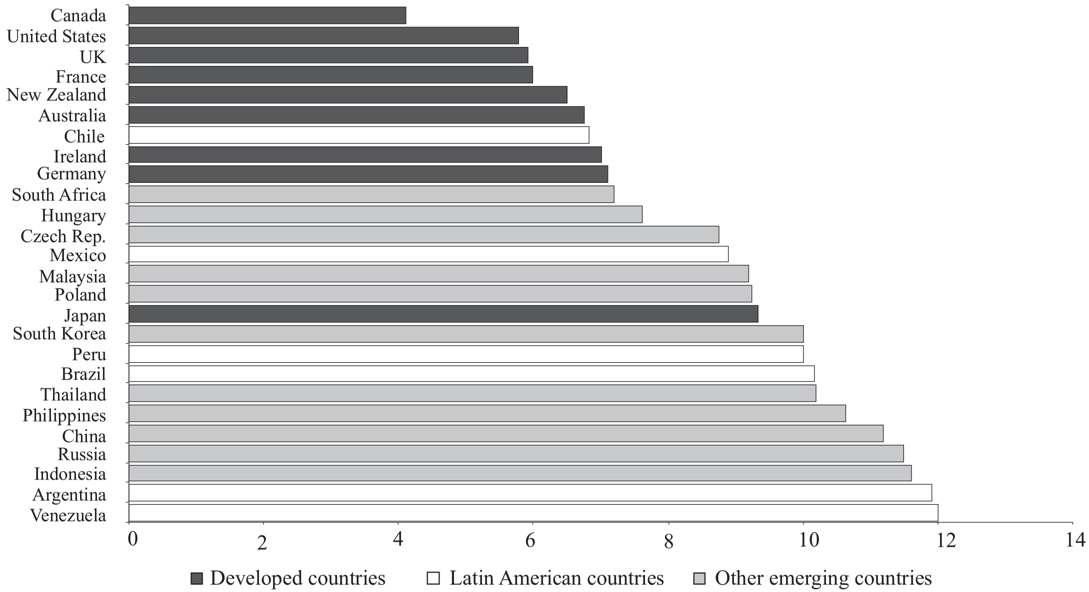


[a] Data are not available for 1990-1993 period.

Note: Exports and imports of goods and GDP at current prices in US$ dollars. Emerging Asia includes China.

Source: World Development Indicators, World Bank (2007).

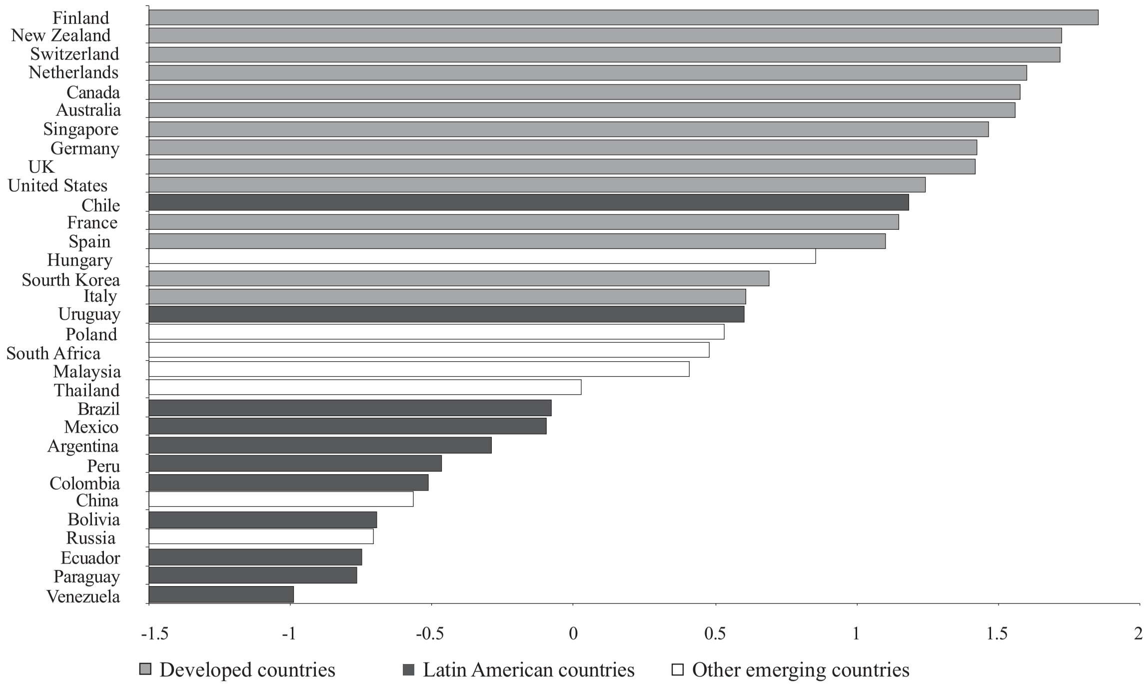
FIGURE N° 16: BANKING SYSTEM STRENGTH (Index, 2006)



Note: It is quantified on a scale from 1 to 13. The index measures the likelihood that a bank will require assistance from third parties such as its owners, its industry group, or official institutions. Factors considered in the assignment of Bank Financial Strength Rating include bank-specific elements such as financial fundamentals, franchise value, business and asset diversification, and risk factors in the bank's operating environment such as the strength and prospective performance of the economy, the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Source: Central Bank of Chile based on Moody's Financial Strength Ranking (December 2006).

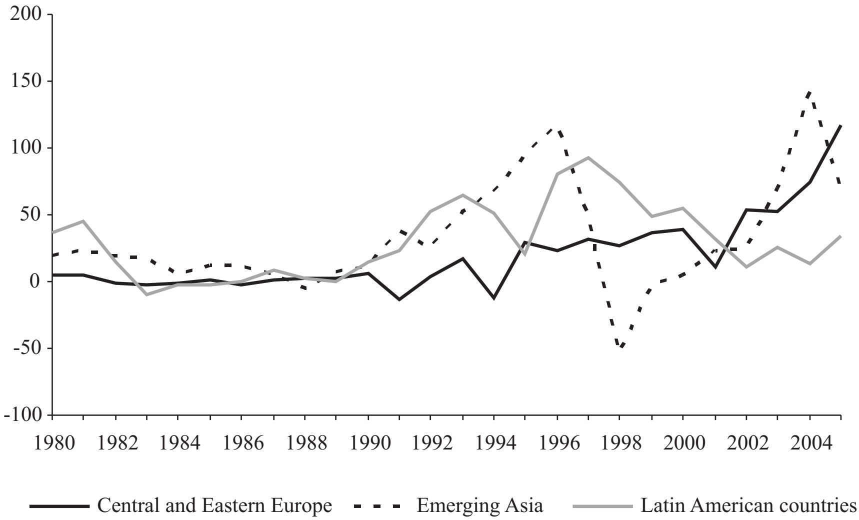
FIGURE N° 17: QUALITY OF INSTITUTIONS (Index, 2005)



Note: Average of six indexes: Rule of law, corruption control, political stability, quality of regulations, government effectiveness, and accountability.

Source: Worldwide Governance Indicators: 1996-2005, World Bank (2006).

FIGURE N° 18: PRIVATE CAPITAL FLOWS, NET
(US$ billions)



Note: Net private capital flows is the sum of net direct investment, net portfolio flows and net other private capital flows. Emerging Asia includes India and China and newly industrialized Asian economies: Hong Kong, South Korea, Singapore, and Taiwan.

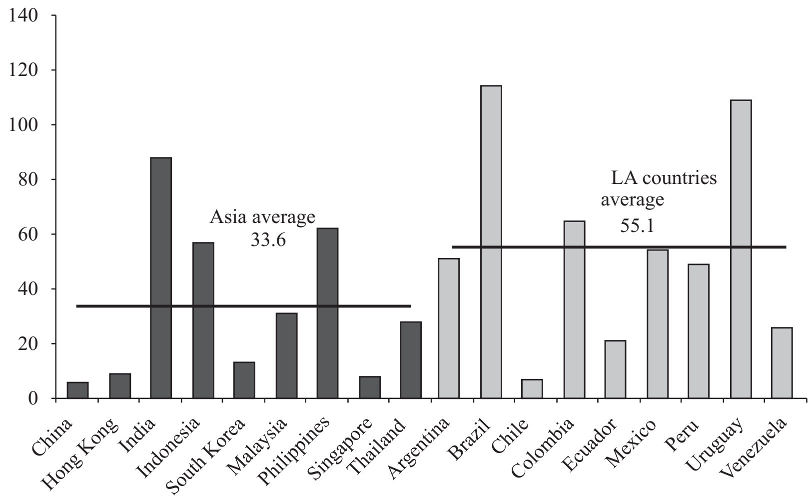
Fuente: World Economic Outlook, IMF (April 2007).

Brazil, Russia and Argentina) have been painful, causing important declines in capital inflows that have returned to the region only modestly (Figure 18).

III. Reaping the benefits of globalization: The pending agenda

Overall, Latin American economies have benefited from globalization, but there are still areas where gains remain unexploited. Here lies the challenge, and the timing could not be better. Latin American countries must continue in the process of further integration, through reducing import tariffs and removing other non-trade barriers, prompting a more open economy, not only *de jure,* but also *de facto.* Isolation is not a possibility in a global world. Maintaining open economies, especially on the trade account, ensures that

FIGURE N° 19: MACROECONOMIC ENVIRONMENT
(Ranking, 2006)



Note: Considers the place in the ranking. The variable is an average of eight indexes: Government balance, national saving rate, inflation, interest rate spread, government debt, real effective excahange rate, recession expectations, and country credit rating.

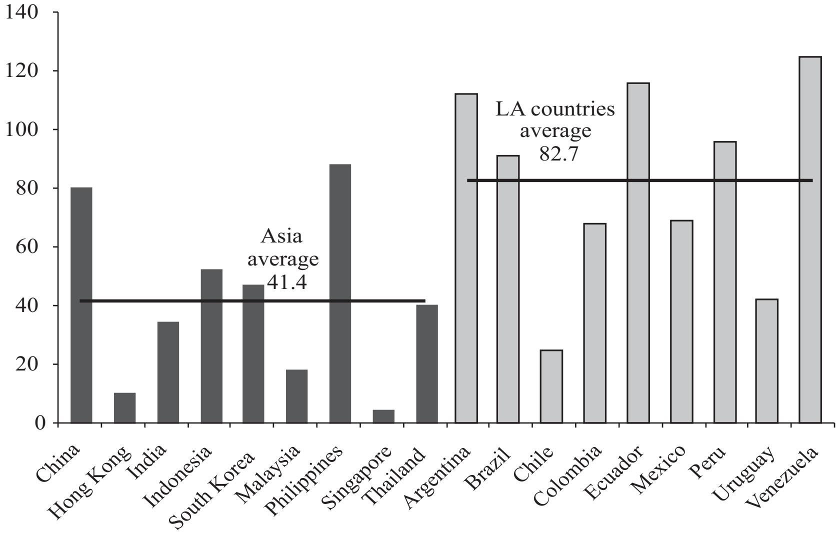
Source: Global Competitiveness Report 2006-2007, World Bank (September 2006).

competitive price signals are transmitted to domestic economies promoting efficient resource allocation, a basic element for sustained growth.

A key aspect for taking advantage of the new opportunities opened by access to world goods and services markets is macroeconomic stability conducive to attracting and sustaining domestic and foreign investment. This has much to do with the conduct of monetary and fiscal policies and their impact on public borrowing and financial stability. A lot has been achieved in this front, but many times assisted by extremely favorable terms of trade. Macroeconomic stability is yet to be consolidated in cyclical adjusted forms (Figure 19) and based on solid institutional framework (Figure 20).

A reduction in inflation and its volatility can still contribute more to stability with further commitment of authorities with monetary policy regimes oriented toward pricelevel stability. Increased accountability and credibility

FIGURE N° 20: INSTITUTIONS
(Ranking, 2006)



Note: Considers the place in the ranking. The variable measures the quality of public and private institutions of an average of twenty nine indexes: property rights, diversion of public funds, public trust of politicians, judicial independence, favoritism in decisions of government officials, wastefulness of government spending, burden of government regulation, business costs of terrorism, reliability of police services, business costs of crime and violence, organized crime, ethical behavior of firms, efficacy of corporate boards, protection of minority shareholders' interests, strength of auditing and accounting standards, effectiveness of law-making bodies, quality of information regarding changes in policies and regulation, pervasiveness of illegal donations to political parties, impact of legal contributions to political parties on public policy, centralization of economic policymaking, freedom of press, irregular payments in exports and imports, irregular payments in public utilities, tax collection, public contracts and judicial decisions, bribes for influencing laws, policies, regulations or decrees, business cost of corruption, and impact on nepotism.

Source: Global Competitiveness Report 2006-2007, World Bank (September 2006).

of the monetary authority will result in a controlled inflationary environment, a crucial element for entrepreneurs to make better resource allocation decisions. Countries like Chile, Brazil, Colombia and Peru that have complemented the inflation-targeting scheme with a floating exchange rate have made significant advances in the macroeconomic front.

On the fiscal side, the public debt remains high in many countries. A revision of debt levels is essential to reduce vulnerability and facilitate the use of countercyclical fiscal policy. There is room for improvement in the composition and quality of spending, especially in countries with rigid budgets and meager fiscal revenues. Efficiency in tax collection can be boosted, and pension systems —which are increasingly in need for public funding in our aging societies— should be revised to be made more fiscally sustainable.

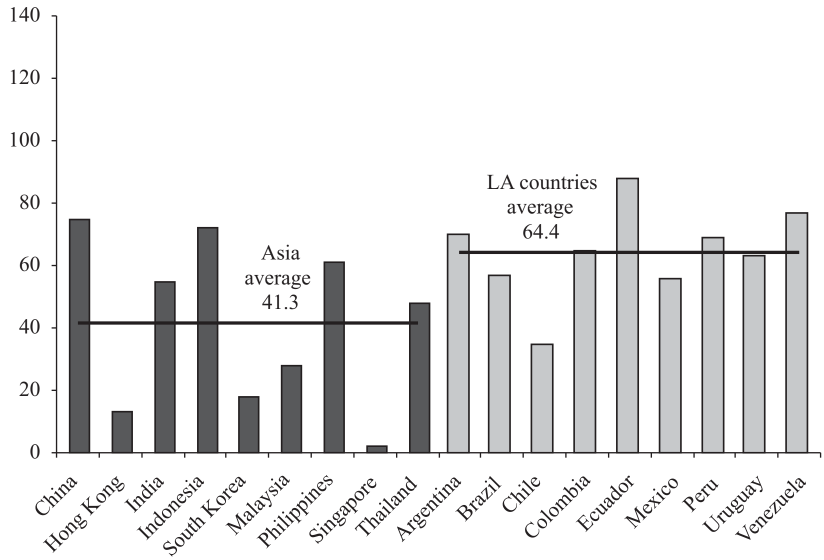
The second challenge lies in creating solid institutional frameworks. The quality of institutions still lags behind that of developed countries, and although changing them is costly as they tend to be largely inertial, there are many examples of the great benefits it yields when done successfully (WEF 2005). Strong institutions, especially efficient bureaucracies, together with an enabling business environment, all induce better appropriation of the opportunities offered by the integrated world.

Strengthening of the financial system through better regulation and supervision is required to induce an efficient flow of resources. A strong banking system needs to be complemented by a predictable and efficient justice system. A business climate that encourages investment, innovation and job creation is also a must. Better governance, improved infrastructure and a reduction in regulatory barriers are all steps in the right direction.

The significance of trade openness, structural reforms and macroeconomic stability to improve growth has been confirmed by several studies. On average, macroeconomic stability and structural reforms have contributed 1.8 percentage points to the 1990s relative to the 1980s' growth performance. If only the best performers in reforms and macroeconomic stability are considered,[4] the average increases to 2.9 percentage points (Loayza, Fajnzylber and Calderón, 2004). Compared to East Asian countries, differences with respect to inflation performance, openness, and institutional quality can account for about 2.2 percentage points of the approximately 2.5-point gap in average annual TFP growth during 1970-1999 between those regions (Blyde and Fernández-Arias, 2004). Along the same lines, if Latin American economies are compared to Asian countries by their differences in government consumption, rule of law, inflation, democracy, and trade openness, 1.6 percentage points are explained by these factors considering the period 1970-2000, of which 0.6 percentage point is due to differences in openness (De Gregorio and Lee, 2003).

[4] Specifically: Argentina, Bolivia, Chile, Colombia, El Salvador, Nicaragua, Panama, Peru and Uruguay.

FIGURE N° 21: TECHNOLOGICAL READINESS
(Ranking, 2006)



Note: Considers the place in the ranking. The variable measures the agility with which an economy adopts existing technologies to enhance the productivity of its industries and is the average of fifteen indexes: technological readiness, firm-level technology absorption, laws relating to information and communications technologies (ICT), FDI and technology transfer, cellular telephones, internet and personal computers users, prevalence of foreign technology licensing, government priorization of ICT, government success in ICT promotion, quality of competition in the internet service provider sector, extent of business internet use, internet access in schools, impact of rules on FDI, and internet hosts.

Source: Global Competitiveness Report 2006-2007, World Bank (September 2006).

The third challenge lies in the appropriation of technological progress that is still modest in most of the region. Adoption, diffusion and head-on involvement in technological processes are critical elements to extract higher profits offered by the developed world to less developed countries (Figure 21). To enhance the process and drive innovation, further opening to competition is needed. This also requires a very highly skilled labor force and flexible labor markets.

Latin American countries have significantly increased the quantity of education provided to their population, but the quality leaves much to be

desired when contrasted with that of developed countries and even emerging countries with similar per capita income. Radical reforms in educational systems that improve the quality of early education cycles are required together with continuous training processes, in order to succeed in an evolving economic environment. Moreover, a labor market that incorporates the necessary provisions for a rotating labor force will benefit the creation of a more mobile and adaptable productive factor, willing to incorporate state-of-the-art technology and increase productivity substantially.

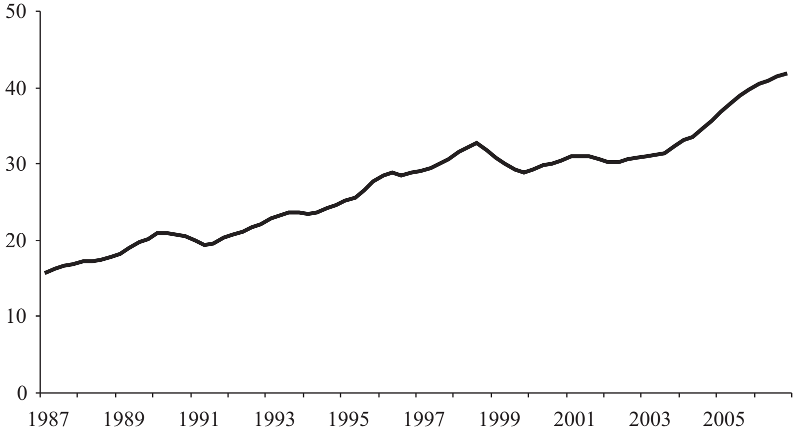
Responding to most of these challenges will be costly to the country and to some specific groups of society. A careful design of the reform process that informs of the long-run overall revenues, with immediate palliative measures to those most hurt is imperative to generate consensus within the civil society, increasing the political feasibility of the changes and the chances of success.

The implementation of policies and structural reforms also depends on the characteristics and developmental stage of each country. A popular view argues that reforms in LAC have failed not because they have not gone far enough, but because they have missed the point. Indeed, growth policies must be defined at the country level, as critical constraints to higher growth are not necessarily the same in every country and reforms need to be tailored to country circumstances. Countries differ in the timing, political legitimacy and delivery of reforms as well.

IV. Globalization, inflation and monetary policy

Globalization has affected the conduct of monetary policy by way of its impact on price dynamics and effectiveness of monetary policy. With respect to price dynamics, increasing deviation of production towards lower-cost countries has resulted in a large and persistent decline in relative prices of importable and import-competing goods. This direct effect on CPI inflation has risen over time as the import share of household spending has increased (Figure 22). On the other hand, the impressive growth of the newly opened emerging economies has put big pressure on the price of energy and primary commodities, countering the disinflationary bias of continuously introducing cheaper imported oods in the domestic consumer basket. In the last five years, China alone accounted for nearly one third of the growth in oil consumption in the world, positioning itself as the second largest oil consumer. In refined copper, China has become the largest consumer, and its increasing demand explaing more than 60% of the growth in the 2001-2005

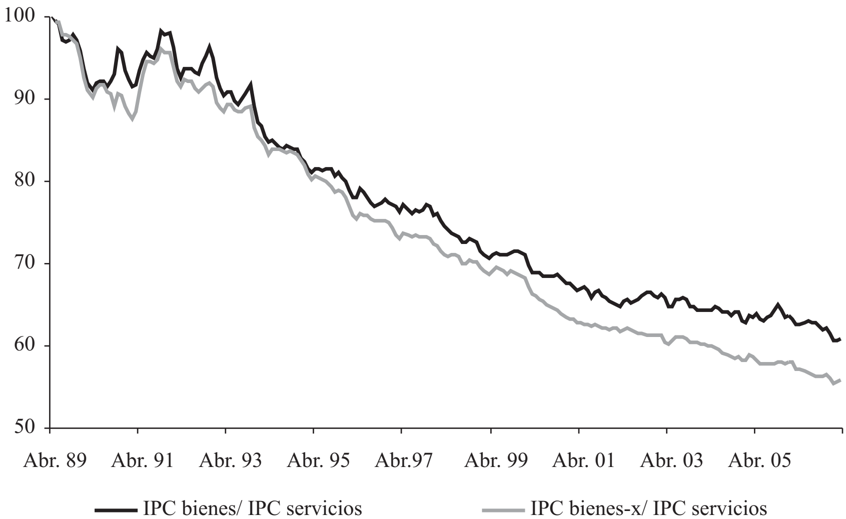
FIGURE N° 22: CHILE: IMPORTS OF GOODS AND SERVICES
(% GDP)



Note: Considers annual moving average of quarterly data on imports of goods and services and GDP at constant prices of 2003.

Source: Central Bank of Chile.

FIGURE N° 23: CHILE: CPI INFLATION FOR GOODS AND SERVICES
(Index, April 1989=100)



Note: CPI goods-x excludes oil and perishables.

Sources: Central Bank of Chile and National Bureau of Statistics.

period. Of course, the weight of each countering force in the CPI will vary across countries depending on their consumption structures. The Chilean case, even including energy prices in the price index for goods, depicts a downward sloping trend for the relative price of goods in terms of services, although smaller than that of the rest of the goods (Figure 23).

Globalization has also reinforced the disinflationary process in import-competing goods' prices by intensifying the competitive pressures, squeezing profit margins and intensifying productivity-enhancing activities. However, not only imported and import competing goods have lived the disinflationary process: Widespread availability of cheaper imported inputs and equipment have reduced production costs, indirectly restraining price increases for most domestically produced goods and services. Furthermore, the entry of millions of new low-wage workers to the global markets has restrained wage pressures, holding down domestic prices in many sectors and not just in those competing with goods from abroad.

As a result, globalization has altered the inflation process. The question of interest is whether these changes are transitory or permanent. Pressures on commodity prices and imported goods prices will not go on forever; however, there is a long way to go in increasing world trade and financial integration. Thus, the direct and indirect effects mentioned earlier will be with us for a while. Nevertheless, even with increasing import penetration, prices need not continue falling. In fact, for the case of Chile, decomposing the 15.6% annual growth in Chinese penetration identifies only a quantity penetration of 0.8% due to price changes, 10.2% due to quality improvements, and 4.1% due to increases in the number of varieties (Alvarez and Claro, 2006). A similar argument points towards limited restraining forces on wages as the unproductive low-wage workers entering the global labor markets start acquiring skills and tools to increase their productivity and wages. Hence, even with increasing integration, it is plausible that the restricted inflationary pressures may last only for a limited time. While they do, if everything else stays unchanged, monetary policy may be loosened to allow for higher non-traded inflation in order to keep inflation levels at comfortable ranges (or target in inflation-targeting frameworks), and not below them. However, since the monetary policy adjustment may take time both to realize the changing price pressures and to affect the market once implemented, inflation may be affected in the meantime.

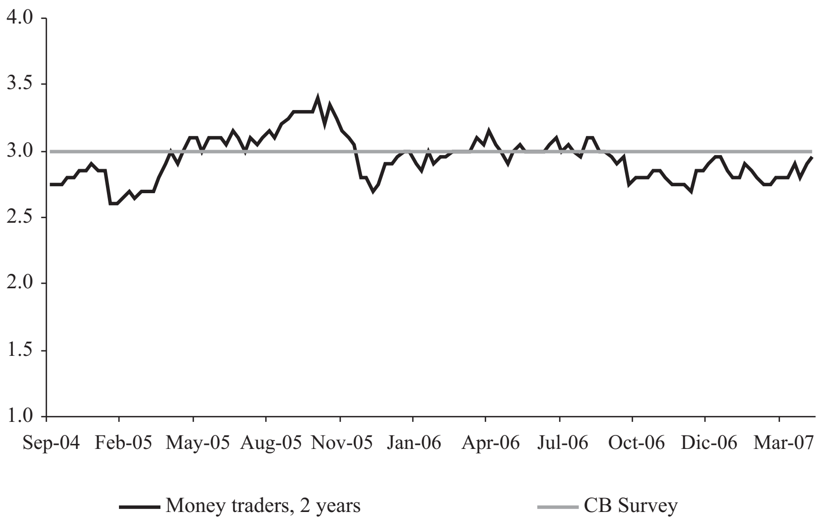
In the long run, inflation is ultimately a monetary phenomenon; therefore, as long as the incentives and objectives of monetary policy do not

change with globalization, long-run inflation remains unaltered. However, incentives may change: countries with a hight target might take advantage of the opportunity to reduce it, thus having a longer-run effect on inflation.

Notwithstanding the transitory nature of the direct and indirect price effects, globalization has long lasting consequences in the price process as it incorporates important international determinants not considered in earlier days and because monetary policy channels of transmission and/or effectiveness may be altered. Economies today are more exposed to international market conditions affecting both the amount of information the policy maker must analyze to forecast inflation and the way its policy instrument is transmitted to the market, prices and output. On the first line, the increasing need to closely monitor international events implies having a highly specialized working team to look at global markets, hold frequent meetings with international institutions and authorities, and overall use more resources to gauge what is happening outside our frontiers. It is not surprising that this process also involves a growing level o funcertaintly as our countries' evolution will now depend on many other factors outside of our own policy domain. On the second line, trade openness and the increasing share of tradable goods, with prices determined internationally and growing financial integration, have brought about an augmented link of long-term interest rates to international interest rates and, to a lesser extent, to short-term domestic rates. Moreover, globalization allows greater dissociation of domestic demand and output: today a booming demand may be satisfied in foreign markets generating less pressure in domestic prices. Therefore, access o international goods and services markets has reduced the sensitivity of inflation to domestic output gap fluctuations, and the Phillips curve has become flatter as a result. Consequently, it has become more costly to reduce inflation, because larger changes in the monetary policy interest rate are necessary to affect long-term market rates. This may also affect incentives to use tradeoff between output and inflation influencing the medium-and short-term inflation dynamics.

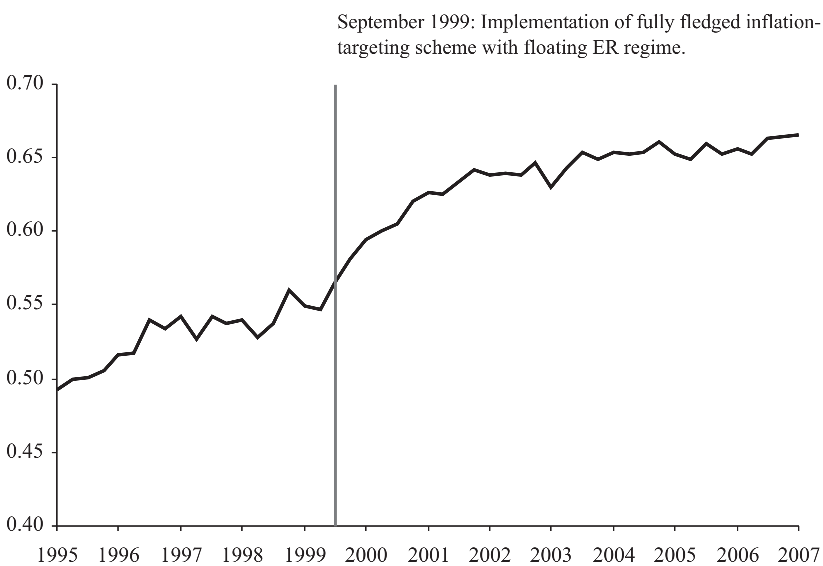
Finally, another lasting result of globalization is that monetary discipline has become a very valuable asset (Figure 24-25). Increasing interdependence of markets, with resources flowing constantly back and forth, has increased the need to show investors good behavior in many aspects of the economic activity, especially on monetary and fiscal policy. If international standards are not met, the cost may be extremely high as resources escape and international risk ratings soar, visibly branding us as

FIGURE N° 24: INFLATION EXPECTATIONS (%)



Source: Central Bank of Chile.

FIGURE N° 25: EXPECTED INFLATION COEFFICIENT



Note: This chart shows the coefficient of inflation expectations in a standard Phillips curve equation, where the sample begins in 1985 and ends in the indicated year.

Source: Central Bank of Chile.

unattractive to investors. Additionally, as the domestic output gap channel narrows, the anchoring of inflation expectations gains importance as a mechanism that facilitates the convergence of inflation to the target.

V. Conclusion

Latin America must take advantage of the opportunities at hand and move towards greater integration into global markets. This open-market strategy will surely be profitable for the country as a whole. Reaping the benefits and mitigating the costs of greater commercial and financial integration involves reinforcing the open-market economy orientation of policies, continuing, improving and completing the structural reform process started after the debt crisis in Latin America and installing a strong institutional setting. Regulation and supervision of financial systems must conform to international standards, to ensure appropriate management of financial institutions.

To take a major leap in closing the income gap with developed economies, Latin American countries need to go beyond the basic requirements (stability, openness, competition and institutions), and get involved head-on in technological innovation, education and training of the labor force. Furthermore, creating consensus and incorporating the civil society must be part of the reform process, to create political legitimacy and bound reversal possibilities.

Globalization has brought about new challenges upon monetary policy. The way monetary policy is done has changed as the transmission mechanism has been altered, the impact of international events has increased and the link between domestic demand and output has been diffused. Macroeconomic discipline has become imperative: credibility helps counteract the decreased transmission of domestic rates into markets, and deviations from best practices are penalized with economic and political consequences.

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