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Andean Anomalies: Fast Growth in a Slowing Global Economy

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Several Andean economies are basking in fast growth, even as the rest of the world sees a slower economic pace. This brings upward pressure on output, and inflation could lead to tighter fiscal and monetary policies.

Colombia, Chile and Peru are growing faster than expected, making them anomalies in a slowing global economy. Each country benefits from strong mining exports, investment in mining industries and spending driven by local expansions.

Mining companies are responding to sustained high demand in China by expanding production in the Andes, which also creates demand for capital goods from the US and elsewhere. It's a demonstration of the global supply chain at work, in this case creating an anomalous corner of unexpected growth—and inflation risk.

Surging Exports in Both Colombia and Peru

Chile is a special case, because of the added inflationary impact of earthquake reconstruction efforts. Both Colombia (**Display 1**) and Peru, meanwhile, are benefiting from surging exports, which in Colombia mean shipments of petroleum and related products, coal and nickel. Coffee is also included among traditional exports, which have jumped 53% in 2010 through June compared with the same

period last year—largely due to higher prices.

Peru is enjoying strong mining exports of oil, copper, zinc, lead and iron. Peru's traditional exports, which include fishing and agricultural products, are up 41% year to date through June (**Display 2**), again mostly due to higher prices. By comparison, exports of non-manufactured goods are growing, but not to the same extent.

Fiscal Policies May Be Tightened

The high prices of metals attract investment in mining, mostly in the form of direct investment by foreign companies. And both Colombia and Peru have seen economic expansions driven by fiscal spending that provided support in the wake of the global financial crisis.

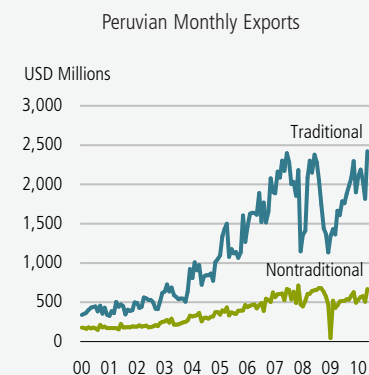
Both economies are booming. Peru's monthly gross domestic product (GDP) data point to annualized second-quarter growth of over 12%, stronger even than China's. Although monthly GDP isn't available for Colombia and the evidence is more fragmented, early indications imply

Display 1
Weak Non-Commodity Exports



As of June 30, 2010
Source: Departamento Administrativo Nacional de Estadísticas and Haver Analytics

Display 2
Reaching New Heights



As of June 30, 2010
Source: Bloomberg

solid growth, as the country overcomes a collapse in its exports to Venezuela. Both Peru's and Colombia's official growth expectations are rising: to 6% in Peru (we estimate that over 8% is possible) and to 4.5% in Colombia.

While fiscal policies have fueled strong growth, they may be tightened gradually going forward. Colombia's central-government fiscal deficit reached 4.9%, in part because of stimulus measures at the behest of the international community and spending by local politicians in the run-up to this year's election. Depending on the treatment of Ecopetrol, the country's largest oil company, other public-sector deficits vary in size.

In Peru, the public-sector balance swung from a 2.1% surplus in 2008 to a 1.9% deficit in 2009. Despite strong economic growth, Peru's deficit may actually widen in 2010, a sign that spending is growing even faster than surging taxes on higher commodity exports.

Colombia plans to enact a new fiscal rule to encourage a long-term framework to public-spending decisions, which should help tame sizable deficits. Such a rule can avoid the costs of shortsighted policies that expand inflation-inducing spending during booms, only to be forced to cut spending and raise taxes in a recession. It can also facilitate the accumulation of

offshore funds from a planned expansion of commodity exports in the next few years, which should eventually counterbalance upward pressure on the currency. By 2011, this rule should begin affecting fiscal policy, and should help stabilize expectations even sooner.

Strong Growth Expectations Push Inflation Up

In both countries, expectations of strong economic growth have boosted inflation rates. Colombia's inflation report predicts that inflation will rise to 3% by early 2011, up from 2.2% in July, and Peru's report sees inflation rising to 2.5% over the same time frame, up from 1.8% in July.

Of particular concern in Peru is the heavy weighting of food in the consumer price index (CPI) basket and how it could be impacted by higher wheat prices; to counter the risk of higher inflation, rates might be raised significantly. For Peru, this "neutral" real interest rate could be around 2% in excess of inflation, so precautionary policies could push official rates up to between 4.5% and 5%.

Colombia's 3% official rate is reasonably close to neutral territory; Peru, which until recently had an official rate of 0.75%, wasn't close. This explains the relatively aggressive path of rate hikes in Peru, including the surprisingly large 0.5% August hike, which raised rates to 2.5%.

Capital Flows in—but Not to Bonds

The substantial differences among interest rates globally have created numerous opportunities for carry trades—borrowing in low-interest-rate currencies to invest in higher-interest-rate currencies. Currencies with higher interest rates, or expectations of higher rates, often attract capital inflows, because investors expect others to follow them into a currency in which rates are expected to rise.

But investors are not as likely to favor bonds in these countries, because rising rates create more risk for fixed-income investments. This aversion is especially true when the ultimate ending of a cycle of interest-rate hikes is unsettled. So, while both the Colombian peso and Peruvian sol have been driven upward by global investors, the capital they invest is more often headed for short-term deposits than longer-term debt instruments.

The anomaly of exceptional growth in the Andean region owes itself to mining revenues, investment spending and stubborn fiscal deficits. As a result, these booming area economies can find themselves under sustained upward pressure. Any unexpected accidents in managing inflation would likely lead to further, perhaps unexpected, tightening measures that will be felt mostly in rising currency values. ■

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