

Financial crisis, slowdown, price pressures: *Latin America in a Changing External Environment*

FundForum Latin America 2008

Sao Paulo, Brazil

4 September 2008



Augusto de la Torre
Chief Economist for Latin America and the Caribbean
The World Bank



Outline

- External shocks
 - Financial crisis, global slowdown, price pressures
- How is Latin America faring?
 - Financial contagion? – decoupling so far
 - Lower relative riskiness amidst rising risk aversion
 - Commodity price effects
 - Terms of trade – net aggregate gains & cross country asymmetries
 - Inflationary pressures – a major test for the new monetary policy
 - Distributional pressures – a significant fiscal policy challenge
 - Growth prospects
 - Cyclical coupling and “trend” decoupling?



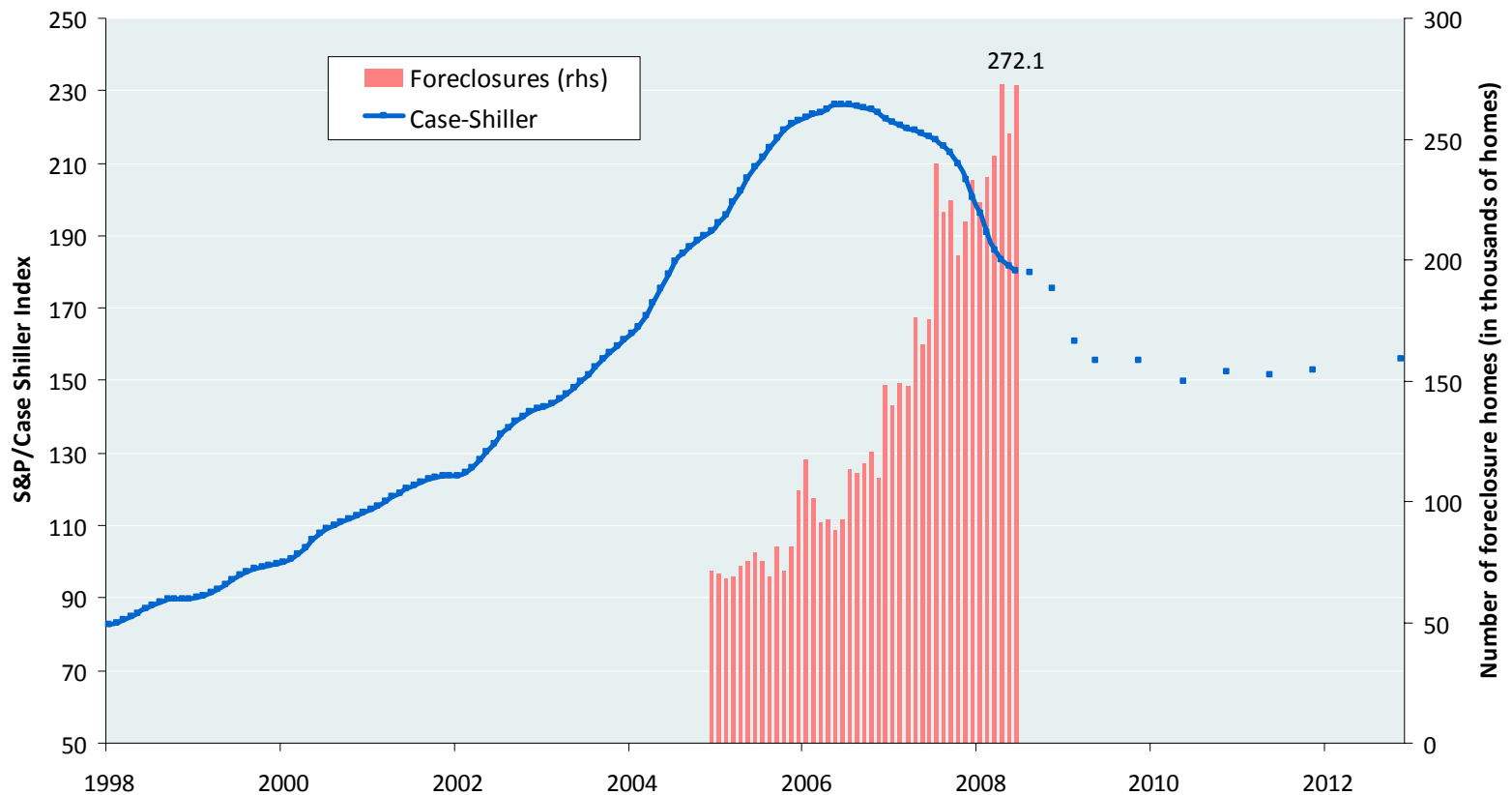
The worrisome external environment

U.S. Financial Crisis

Imploding mortgage markets

US House Prices and Foreclosures

S&P/Case-Shiller 10 Index and number of foreclosure homes



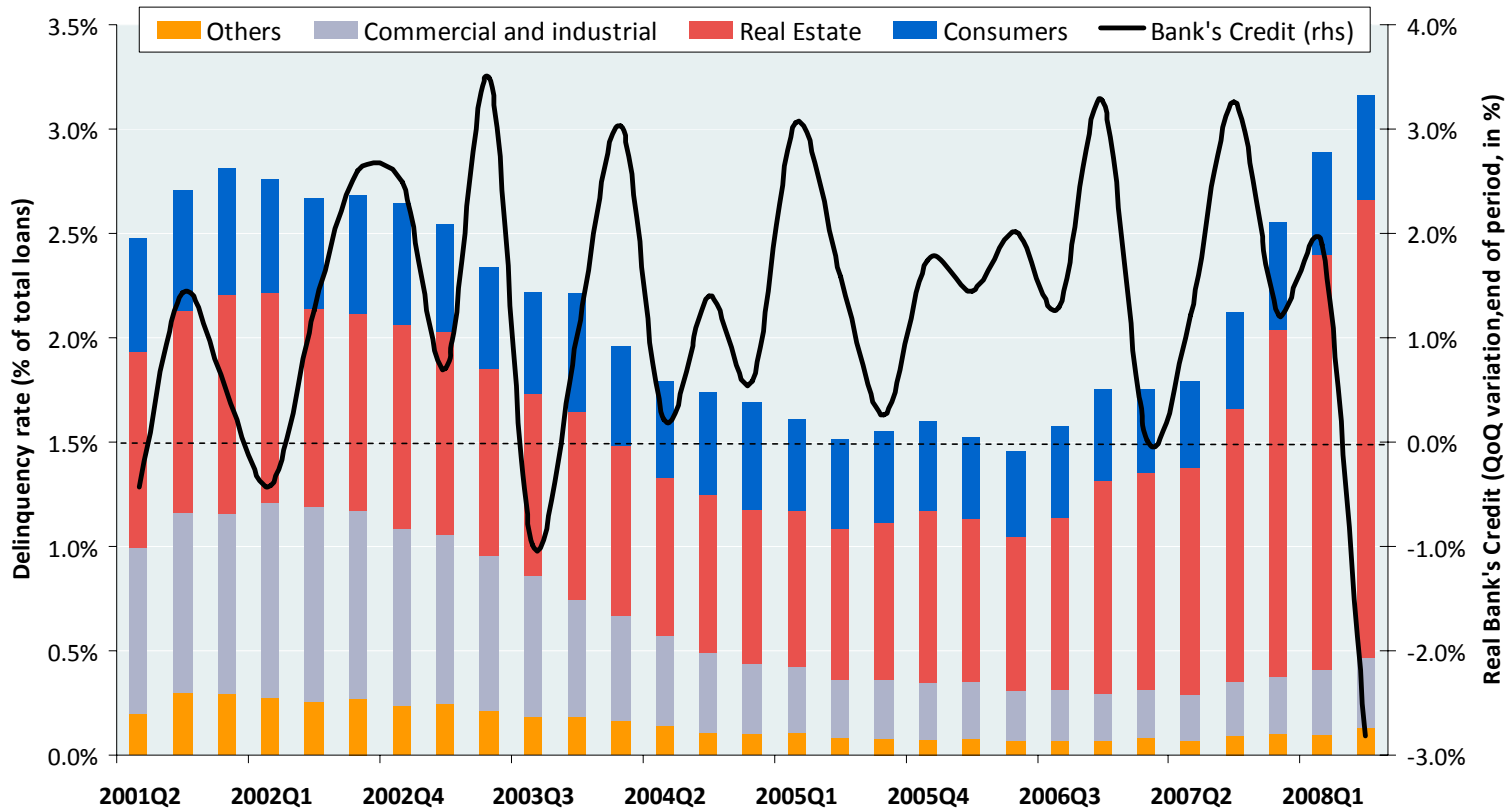
The S&P/Case-Shiller 10 index is a composite index of housing prices in 10 U.S. metropolitan areas. Source: Bloomberg.

U.S. Financial Crisis

Credit contraction and loan quality decay

Real Bank's Credit Growth and Delinquency Rate - All Commercial Banks

Credit growth and Delinquency rates

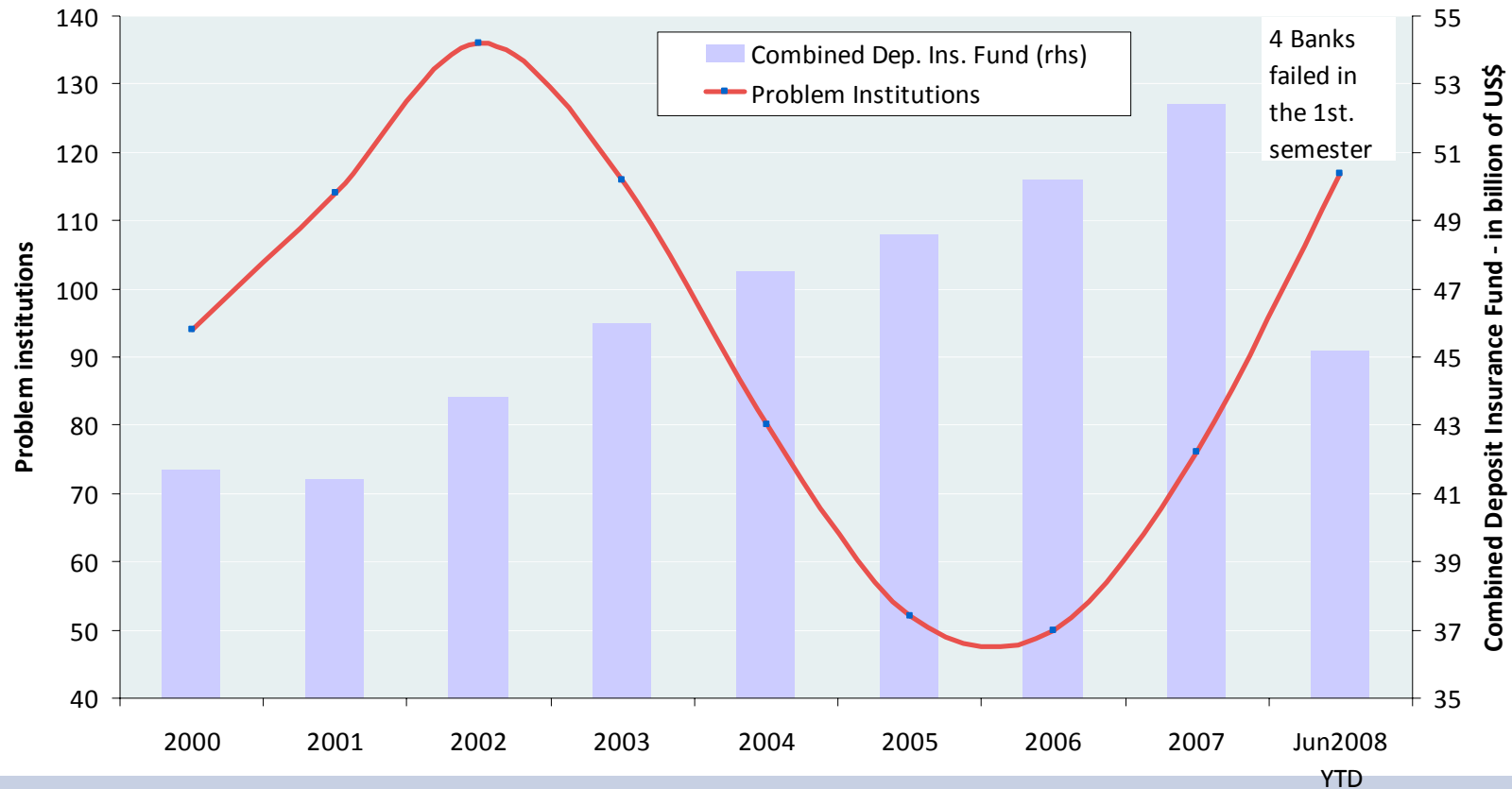


LCRCE staff calculations. Delinquent loans are those past due thirty days or more and still accruing interest as well as those in nonaccrual status. Bank's Credit is nominal credit deflated by CPI. Source: Federal Reserve

U.S. Financial Crisis

Problem and failing financial institutions

Deposit Insurance Fund and "Problem" Institutions
in billions of US\$

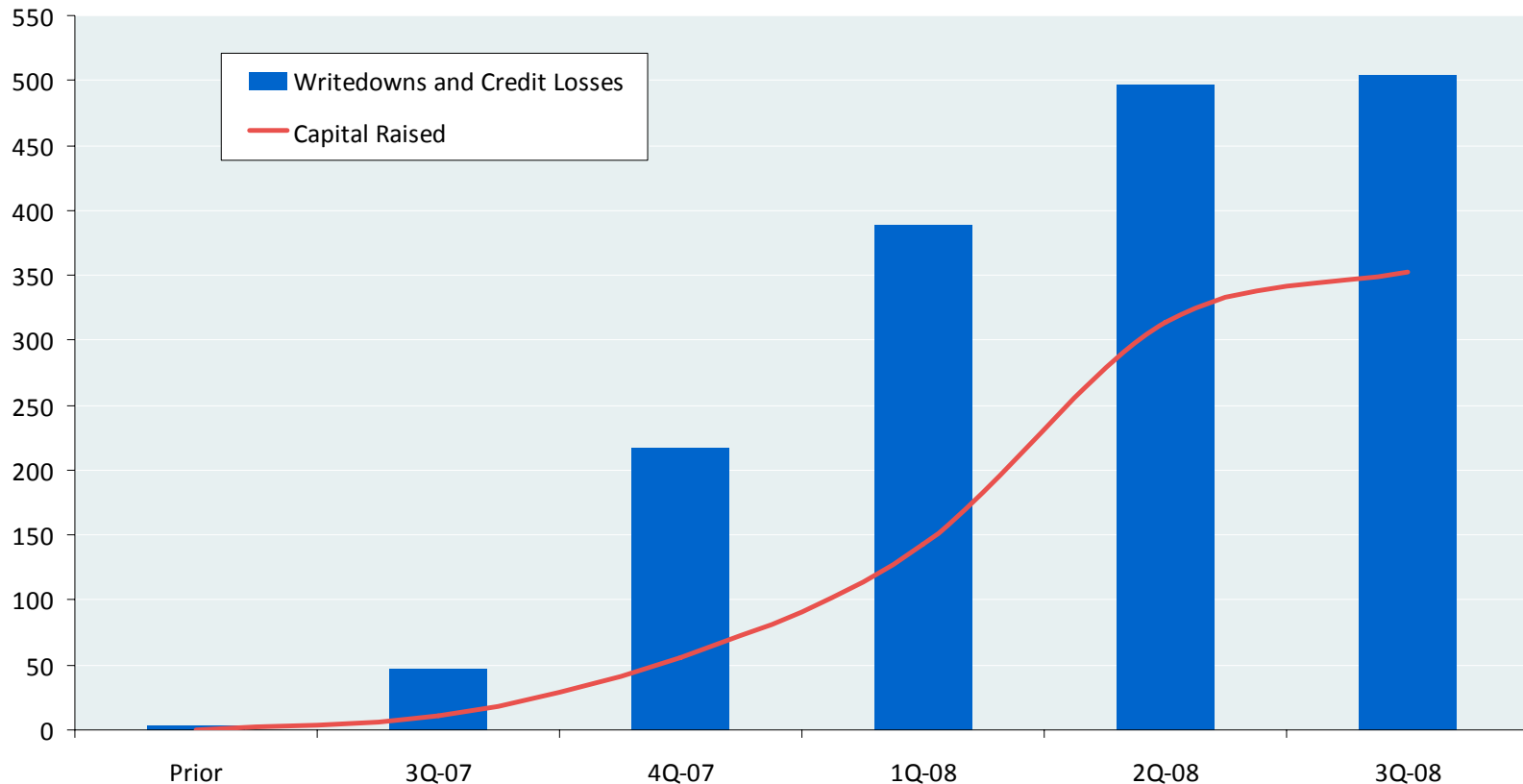


"Problem" institutions are those institutions with financial, operational, or managerial weakness that threaten their continued financial viability based on FDIC composite ratings. Source: FDIC

U.S. Financial Crisis

Capital catch up – a moving target

Cumulative Bank Writedowns and Credit Losses vs. Capital Raised
in billions of U.S. dollars

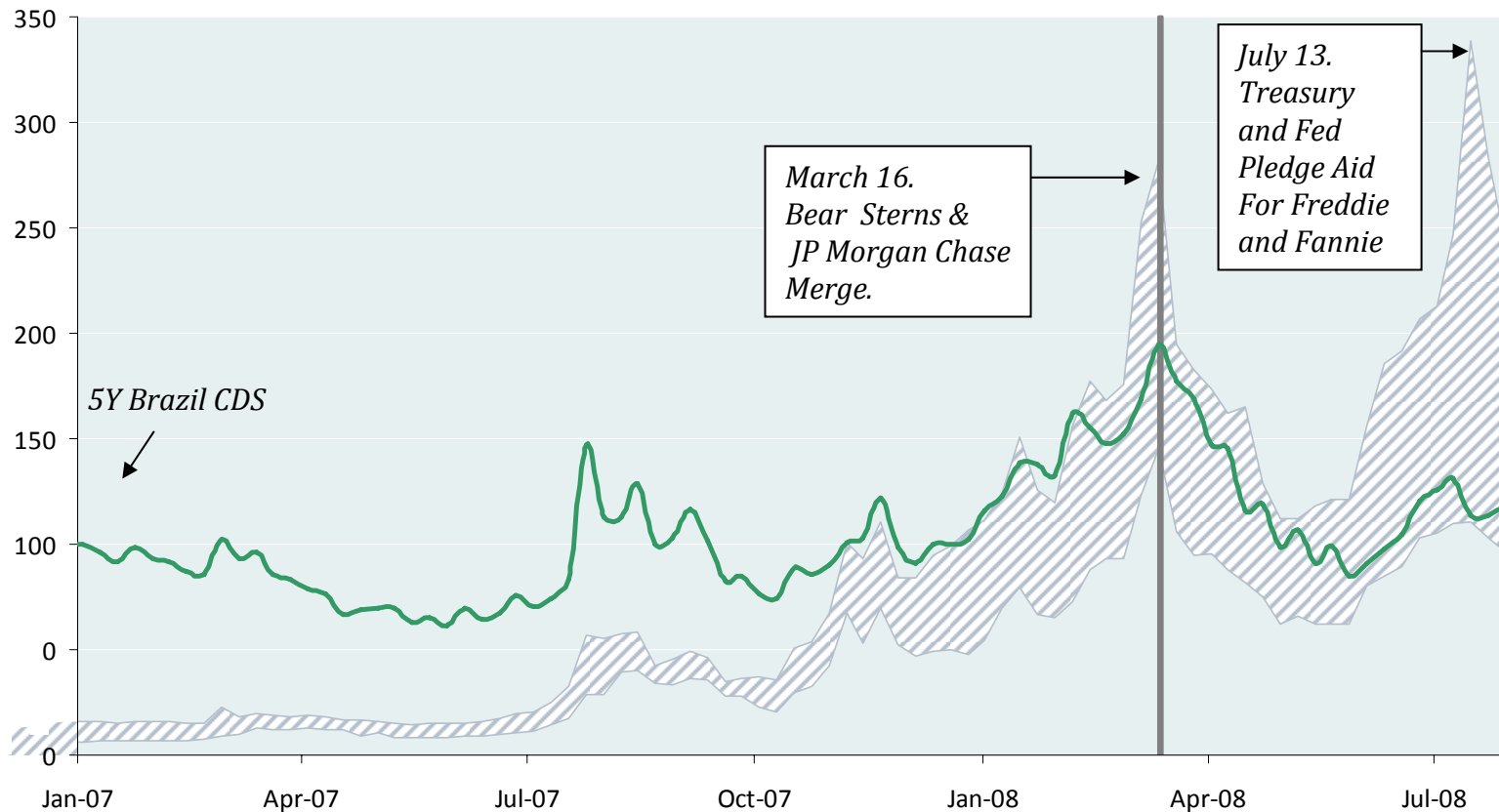


Note: The figures reported above do not include Freddie Mac and Fannie Mae. Source: Bloomberg.

U.S. Financial Crisis

Major banks under risk scrutiny

CDS of the 5 biggest Banks in U.S.
5 years CDS, in basis points

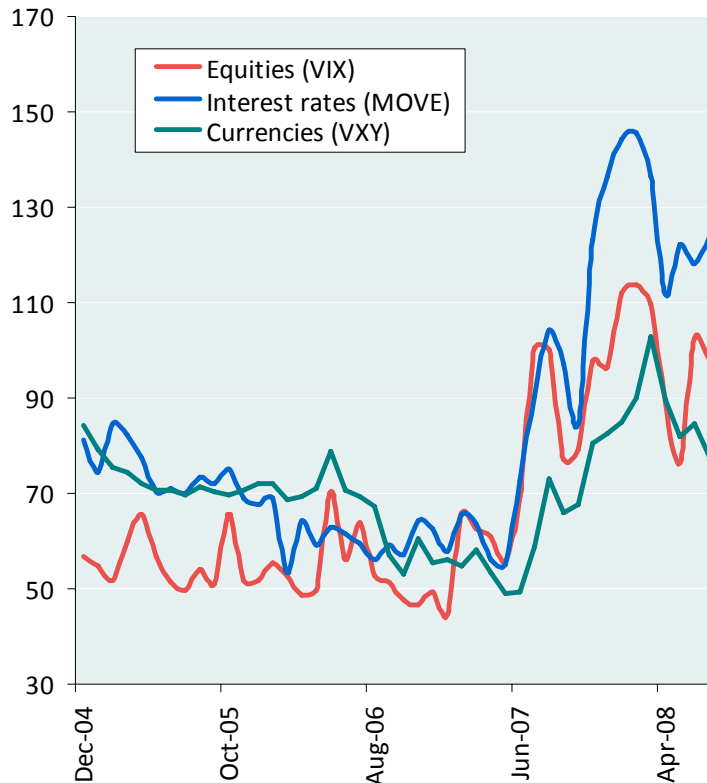


U.S. Financial Crisis

Uncertainty high; money markets dislocated

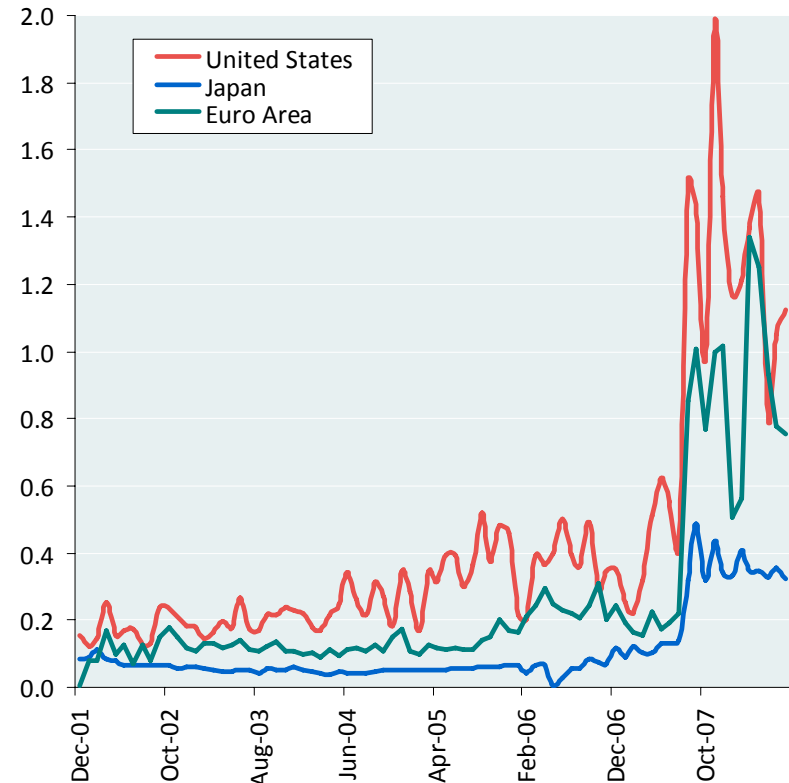
Market Pricing of Volatility

Index Jan-00=100



Interbank Markets

3-Month LIBOR minus T-bill rate, in %

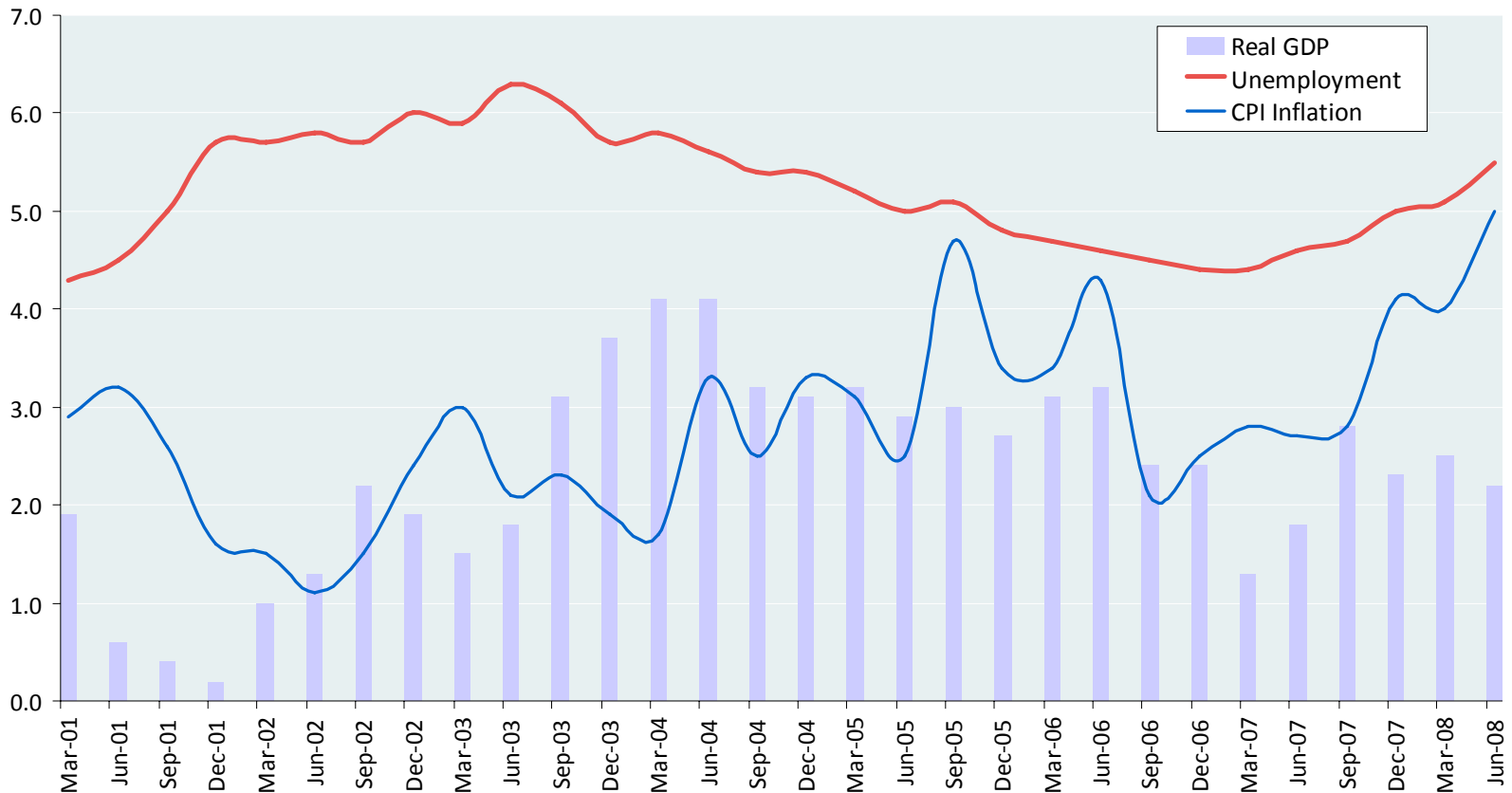


Note: The Chicago Board Options Exchange SPX Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes. Merrill Option Volatility Estimate (MOVE) is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30. JPMorgan Volatility index (VXY) is calculated based on currency 3 month ATMF vols, which are combined with a set of fixed weights to produce the daily result. Source: Bloomberg

U.S. Real Economy

Sluggish domestic demand and price pressures

U.S. Economic Indicators
annual variations, in %

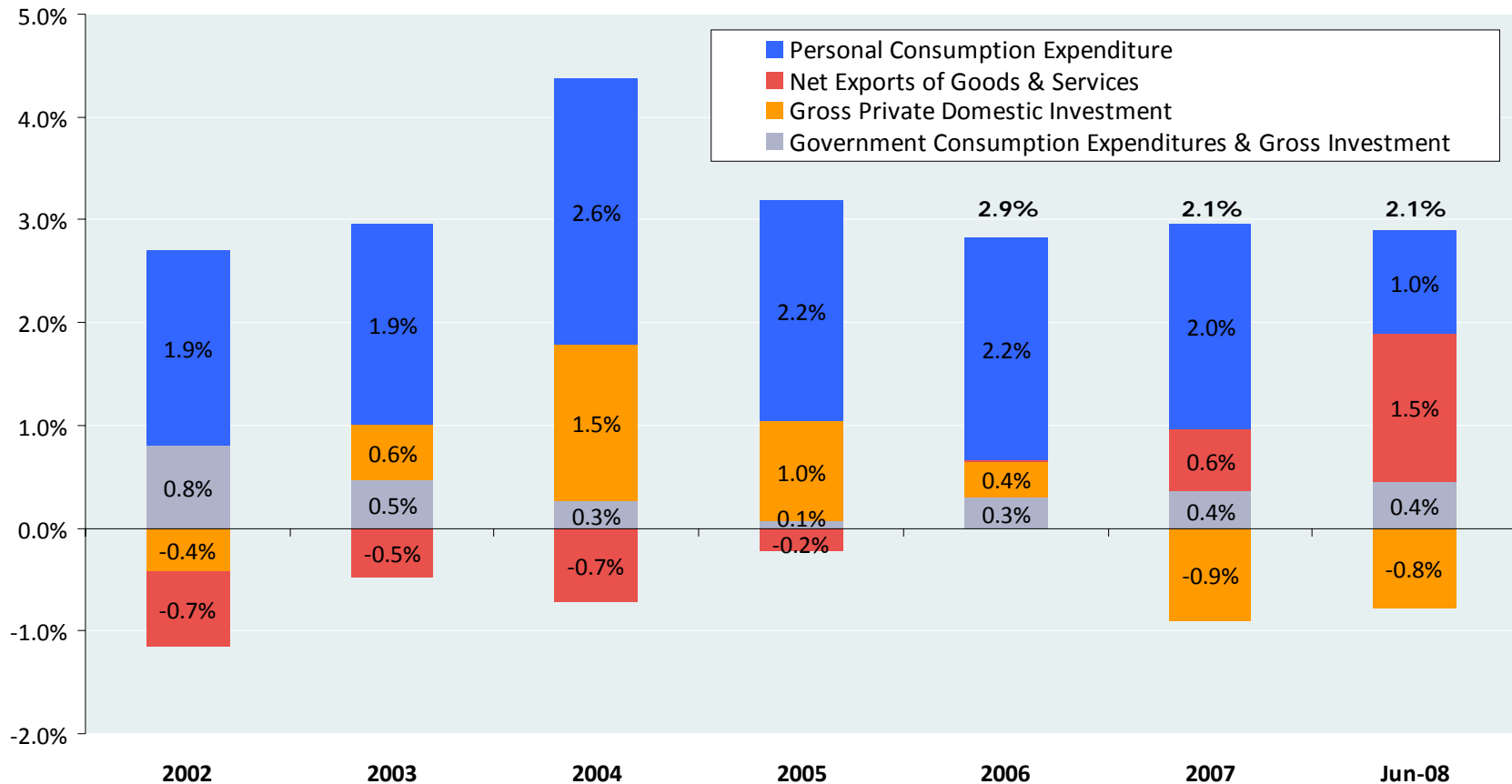


U.S. Real Economy

Exports (and the exchange rate) to the rescue

U.S. Sources of Growth Decomposition

Real GDP - 2000 US dollars

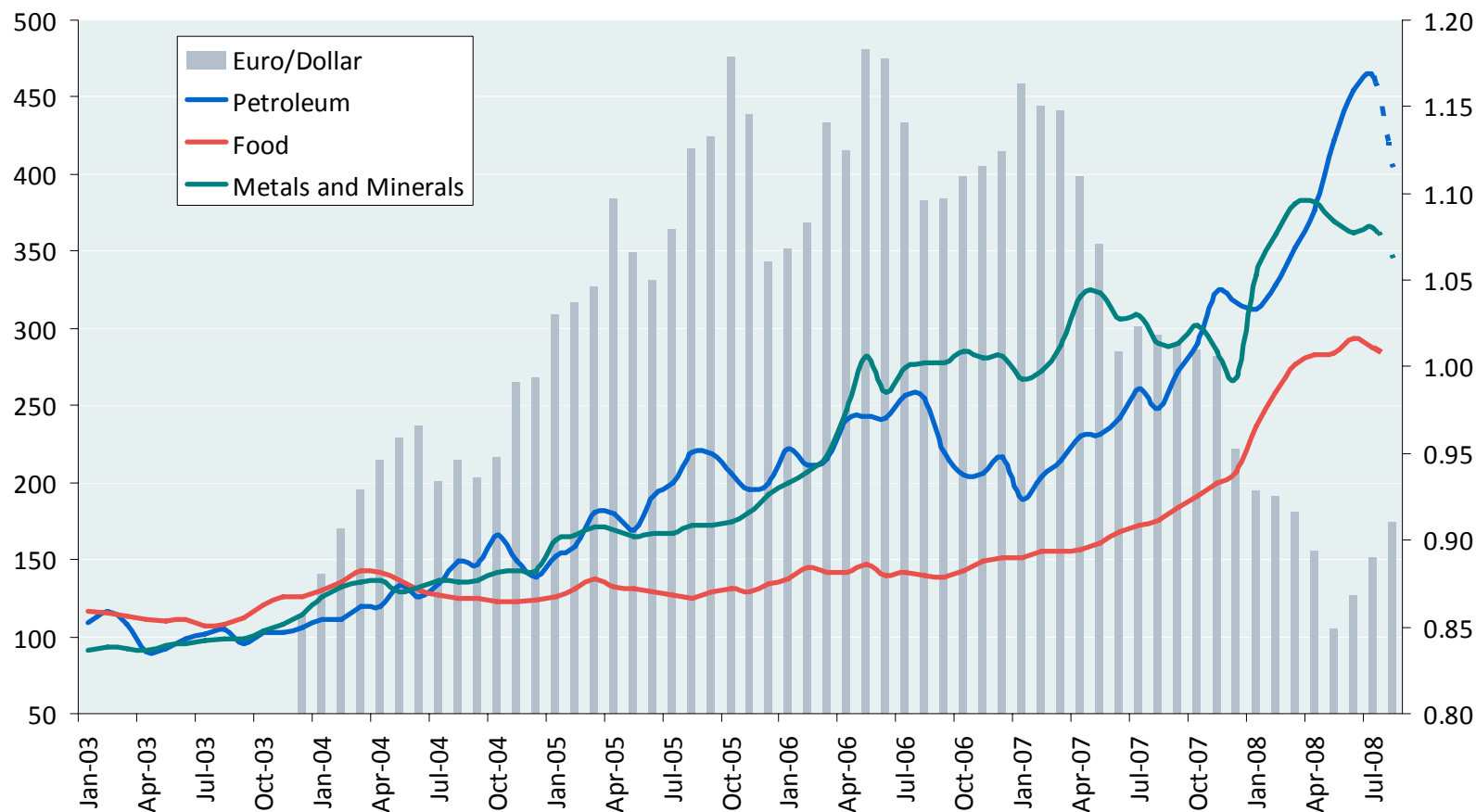


LCRCE staff calculations. Contribution of GDP demand components to growth. Gross private domestic investment includes changes in private inventories. *2008: 1st semester YoY variation SA. Source: St. Louis FED

Is the recent escalation in commodity prices ...

Commodity Prices

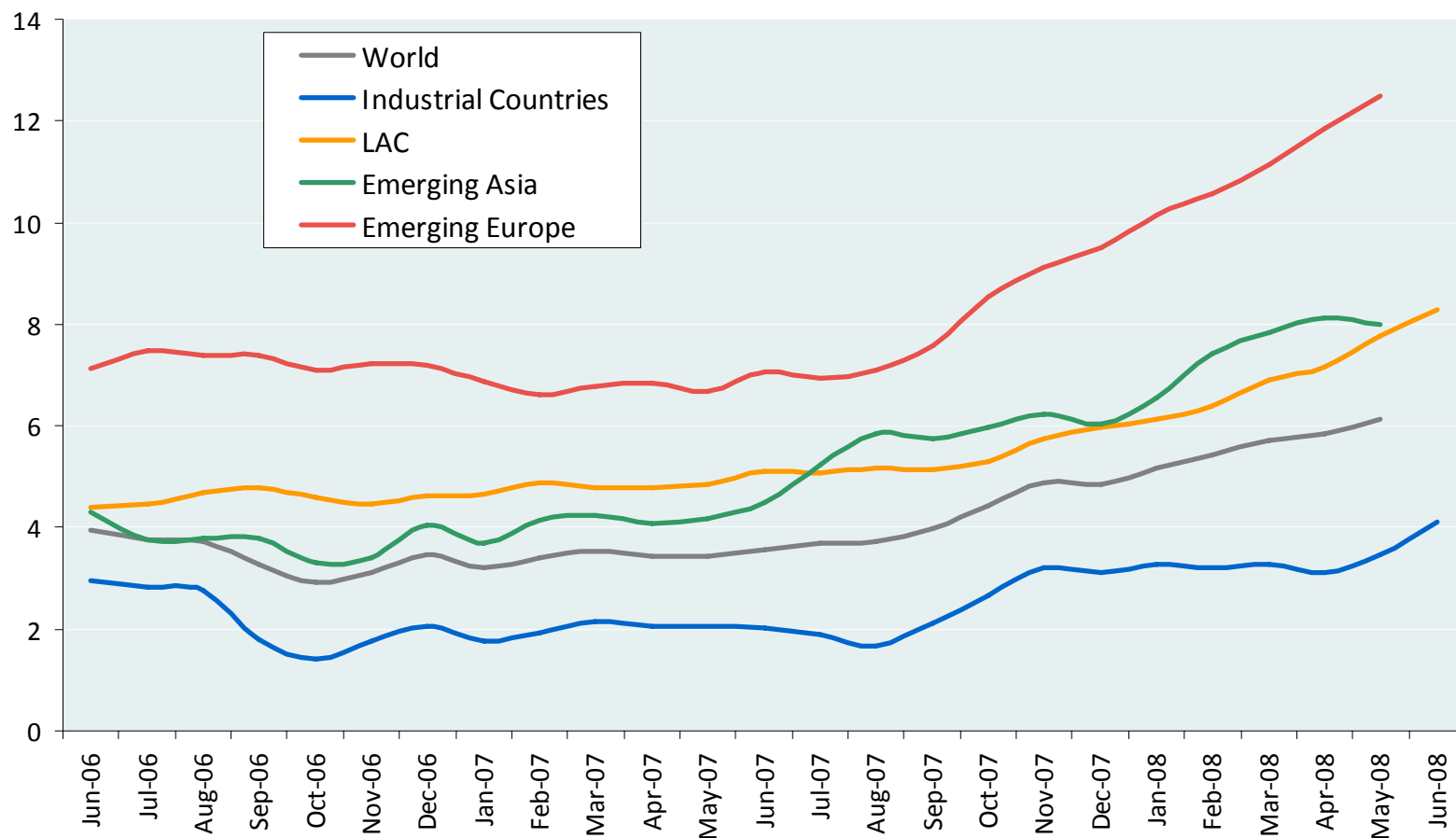
World Bank Commodity Price Index (2000=100) - in current US\$



The World Bank's Commodity Price Index measures prices of primary commodities exported by developing countries. Prices series used in the index are export (f.o.b.) market prices in US dollars. Source: World Bank.

... leading to a world-wide wave of inflation?

Consumer Price Inflation
annual variations, in %

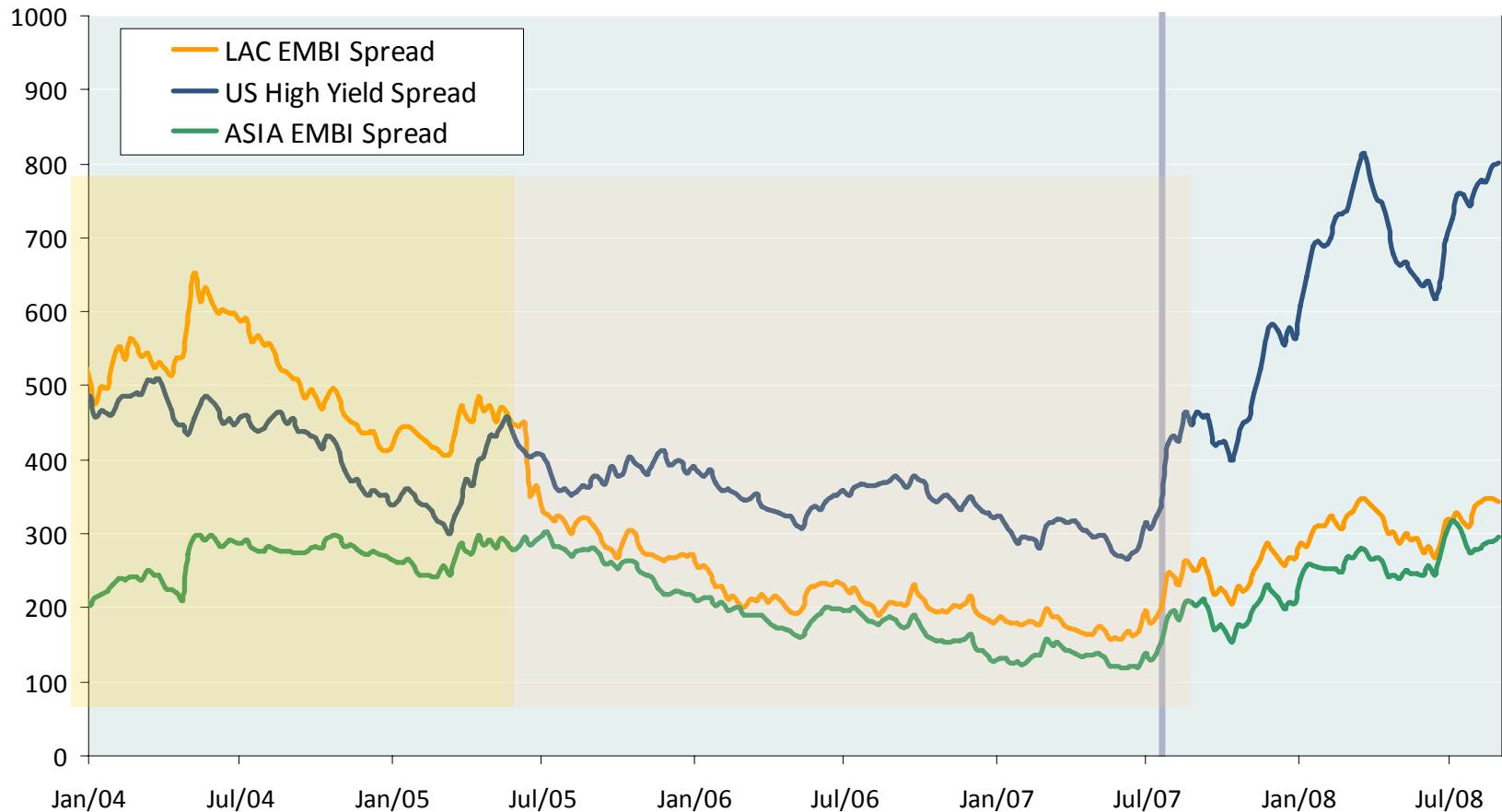


The World Bank's Commodity Price Index measures prices of primary commodities exported by developing countries. Prices series used in the index are export (f.o.b.) market prices in US dollars. Source: World Bank.

Financial contagion – decoupling?

Latin America – volatile but “junk bond no more”

Latin America EMBI & U.S. High Yield Spreads
in basis points

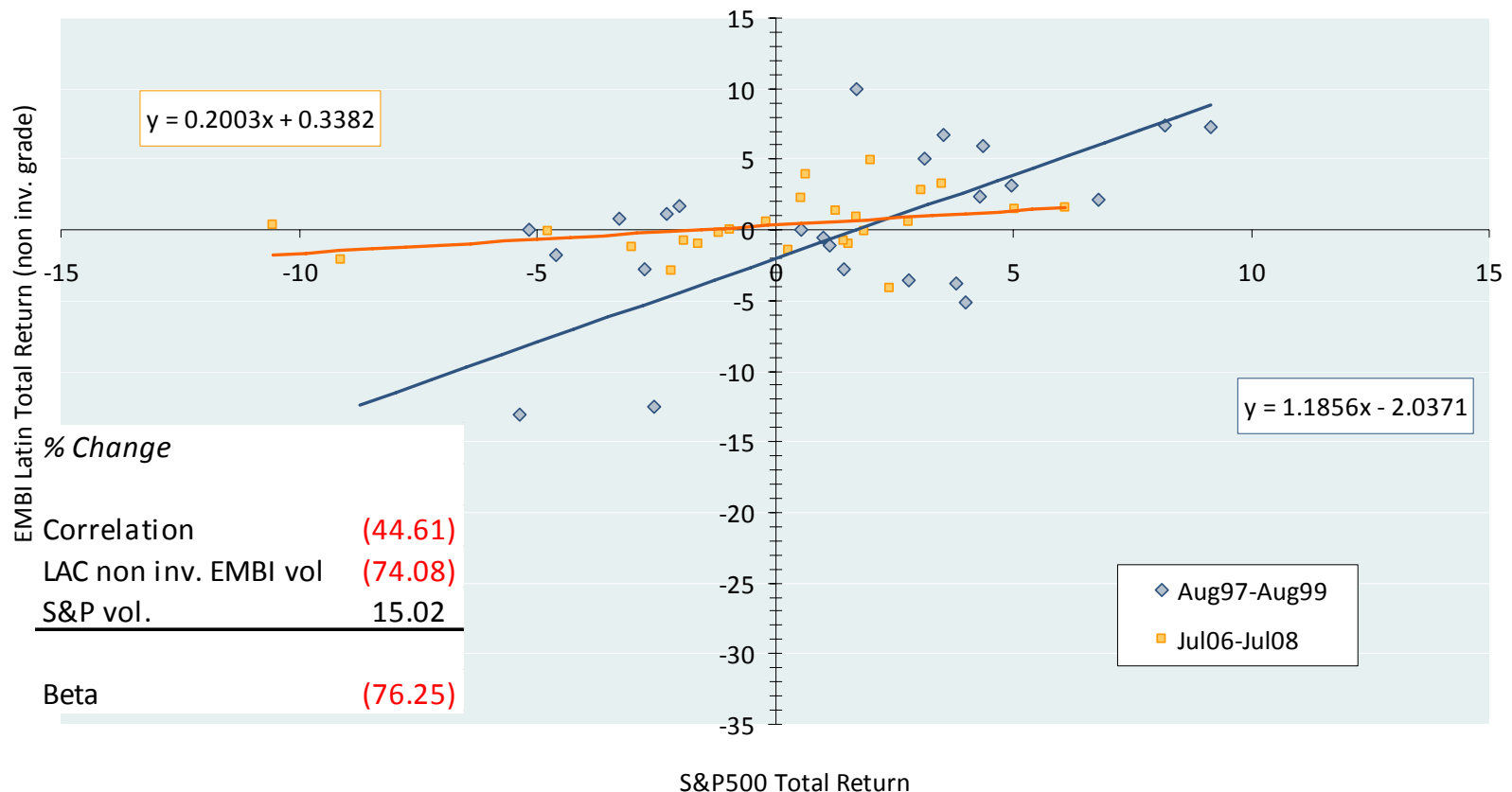


Source: Bloomberg – US Credit Suisse High Yield Spread, Latin America JP Morgan EMBI Global.

The lower “beta” for Latin bonds generates diversification benefits

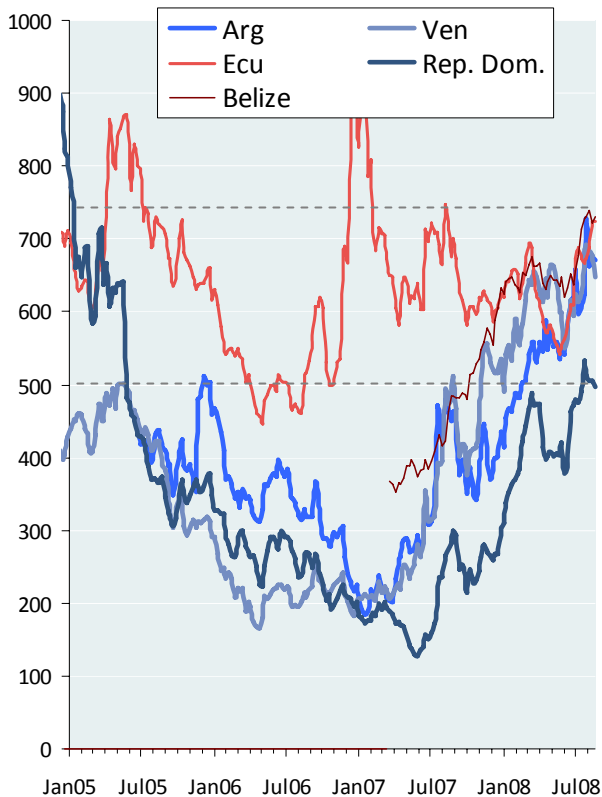
Beta of LAC EMBI w.r.t. US Stock Market Portfolio

variables in axes in %

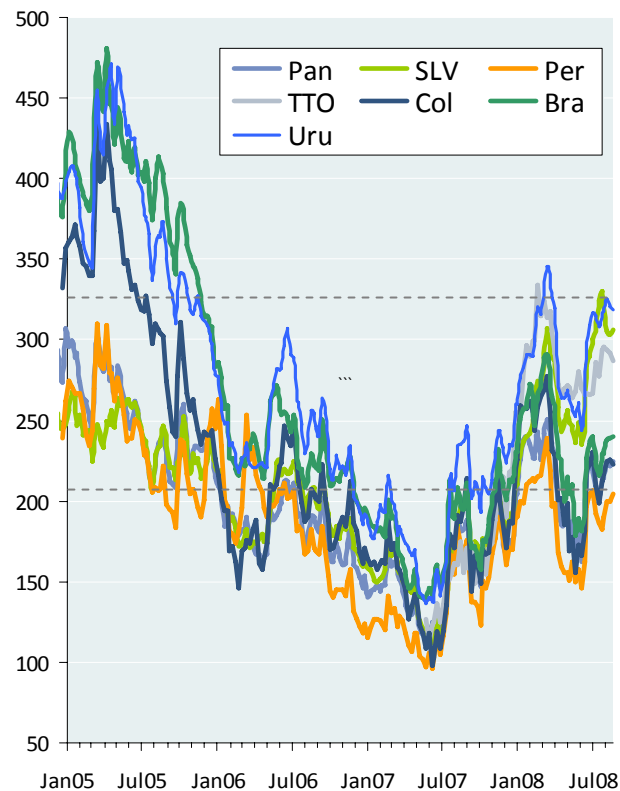


Behind the Latin EMBI average, countries can be classified into three groups ...

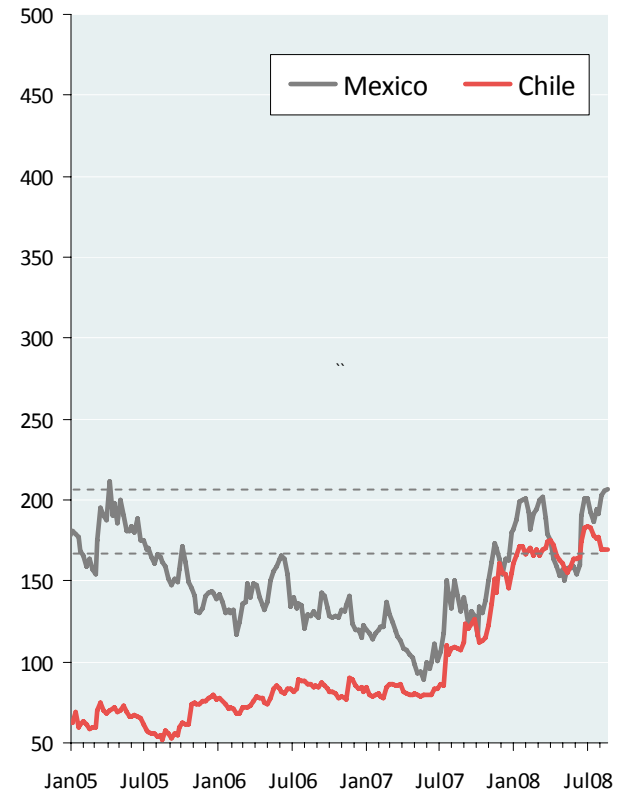
High EMBI Spread LAC countries
in basis points



Medium EMBI Spread LAC countries
in basis points

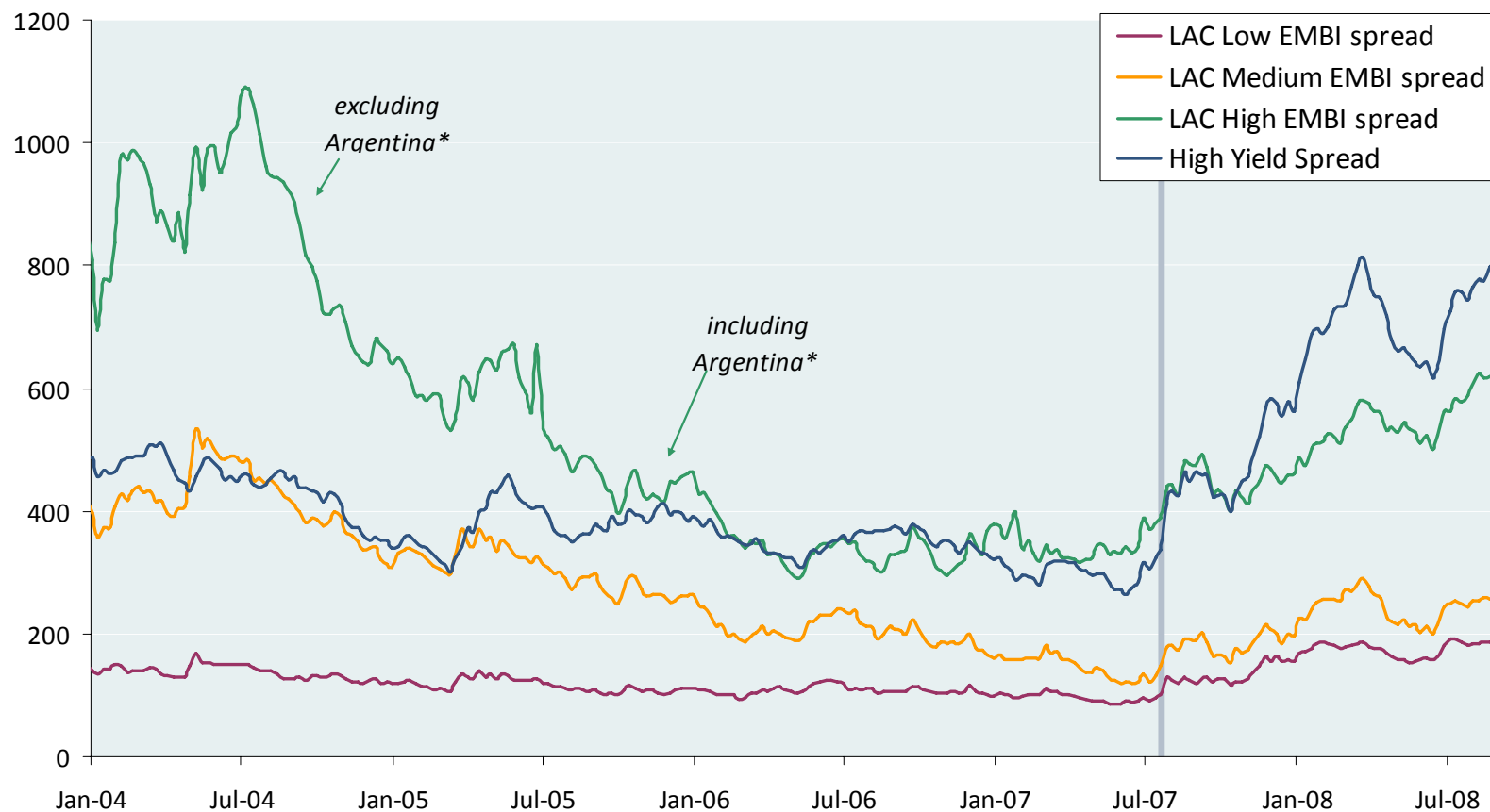


Low EMBI Spread LAC countries
in basis points



... depending on the behavior of EMBIs relative to the risk premium of the U.S. high yield bonds

Latin EMBI & U.S. High Yield Spreads
in basis points

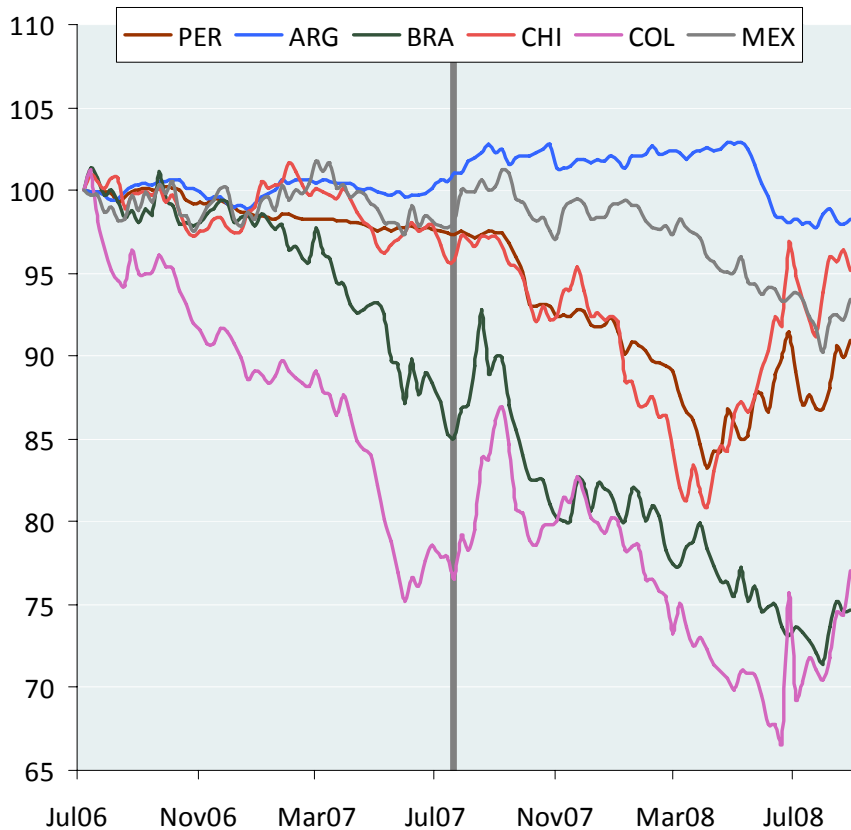


Source: Bloomberg – US Credit Suisse High Yield Spread, Latin America JP Morgan EMBI Global.

Latin currencies and international reserves are not under attack...

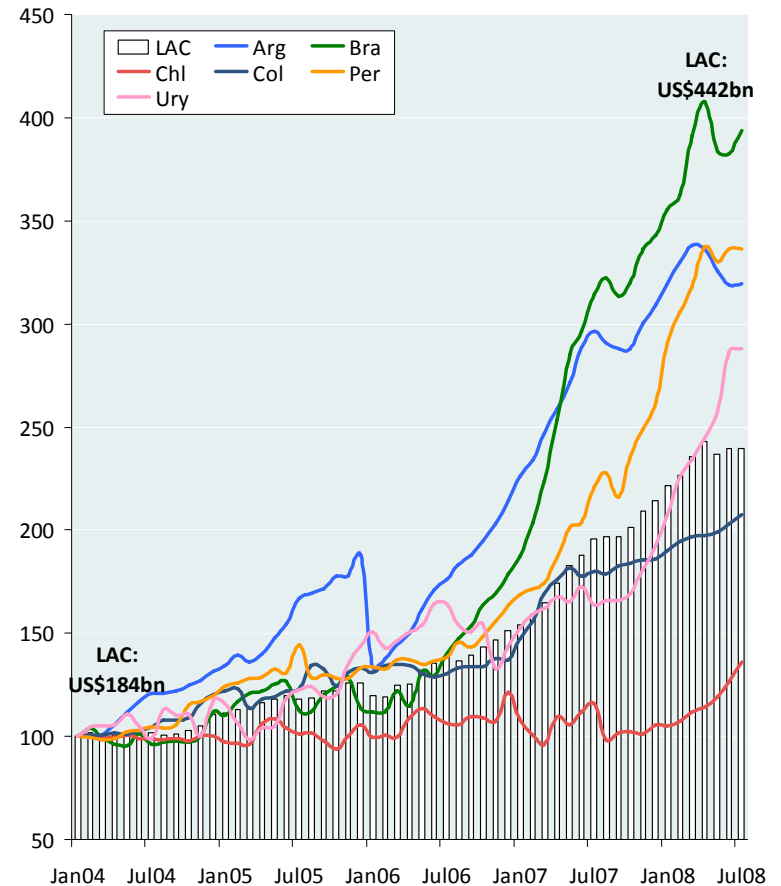
Performance of Selected LAC Currencies

Unit of local currencies bis-a-bis US dollars. Index
100=Jul2006



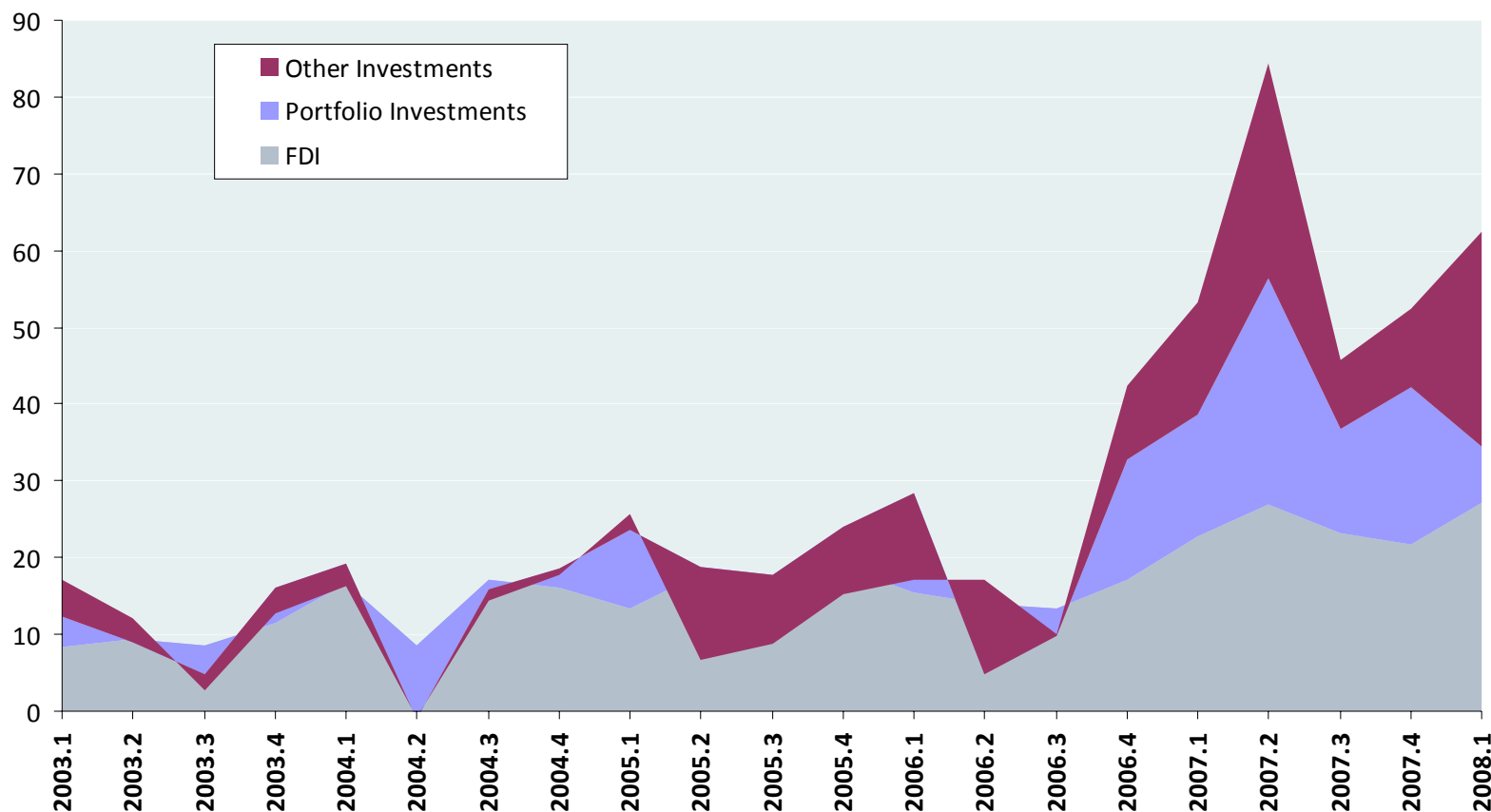
International Reserves for Selected LAC countries

Index: Jan2004=100



... and capital inflows to Latin America, particularly FDI, have remained strong

Gross capital inflows to LAC7
(12 months cumulative - in US\$ billions)



LAC7 = Argentina, Brazil, Chile, Colombia, Mexico, Peru y Venezuela. Other investments: Bank and trade-related lending (trade credits, loans, currency and deposits, and other liabilities). Source: IMF's Balance of Payments Statistics and National sources

Lower vulnerability reflects fundamental gains

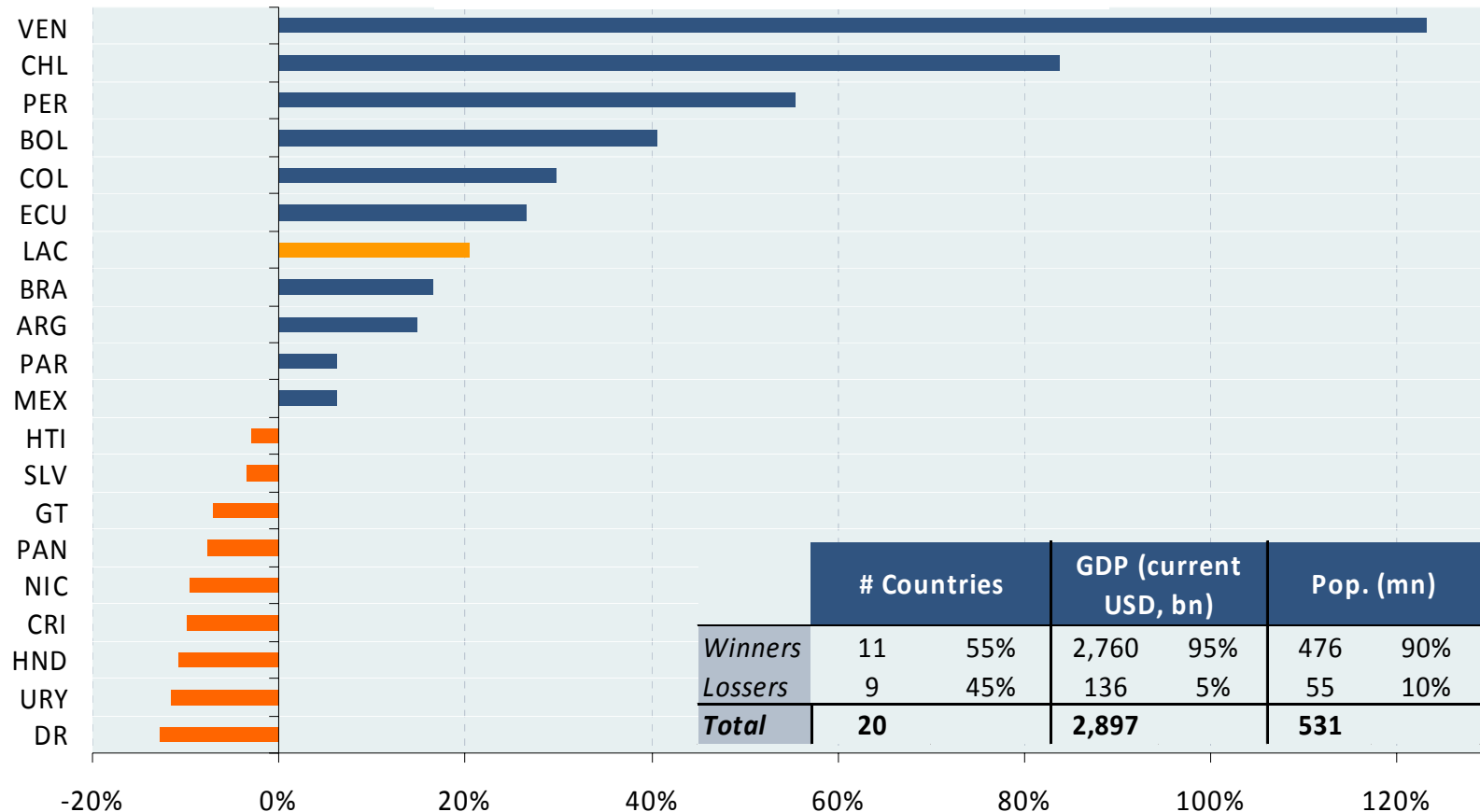
- Good luck is only part of the story
- Mutually reinforcing achievements ...
 - Enhanced independence and credibility of central banks
 - Exchange rate flexibility cum inflation targeting
 - Deeper local currency debt markets
- have reduced currency mismatches (a traditionally lethal source of vulnerability)
- Fiscal policy – not stellar but not unsupportive

Commodity price effects

Despite the marked asymmetries in terms of trade effects between countries, gains dominate...

Terms of Trade for Selected LAC countries

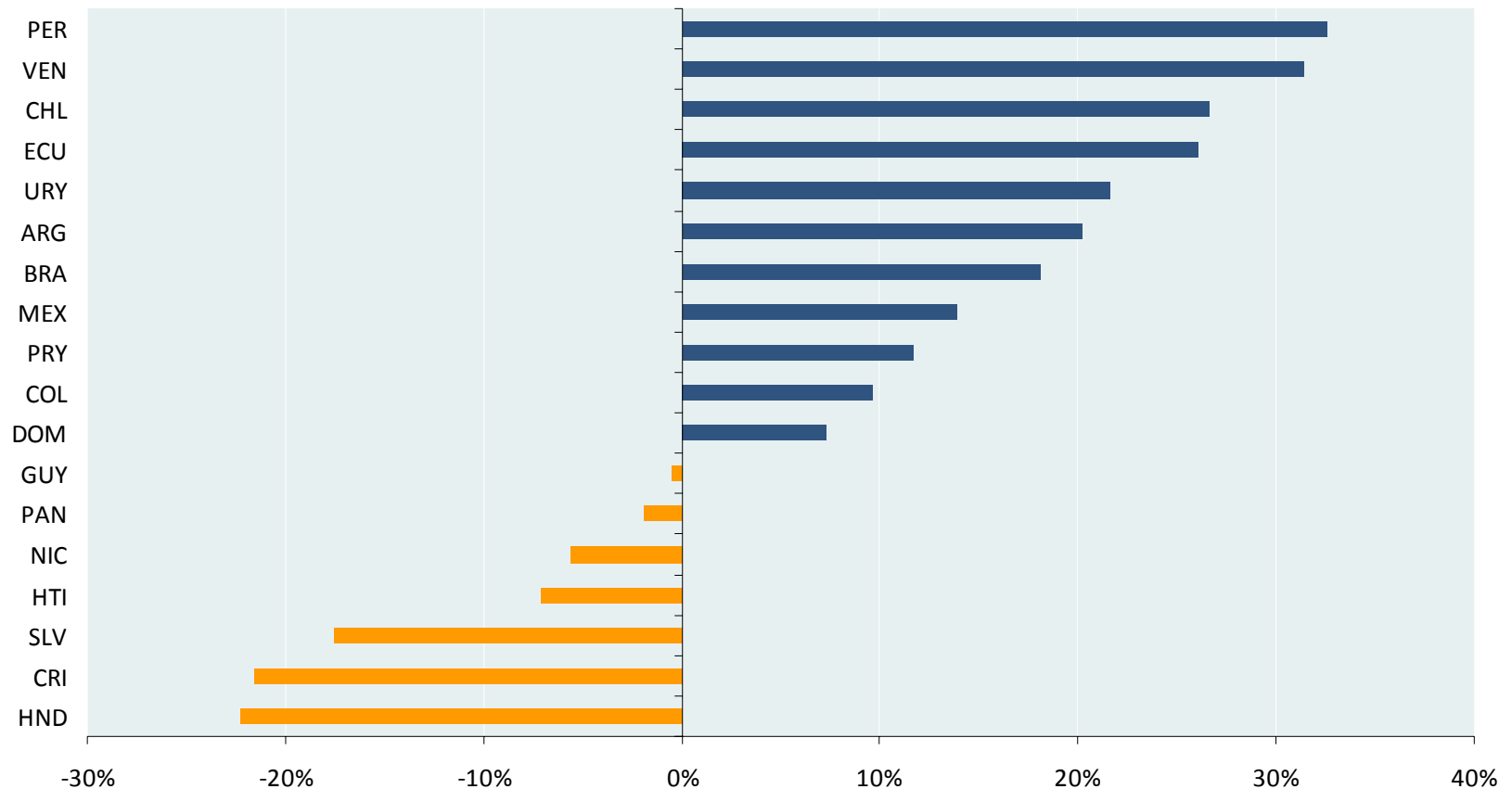
change between 2002-2007 - in %



... raising significantly the purchasing power of income for many Latin countries

Terms of Trade Adjustment

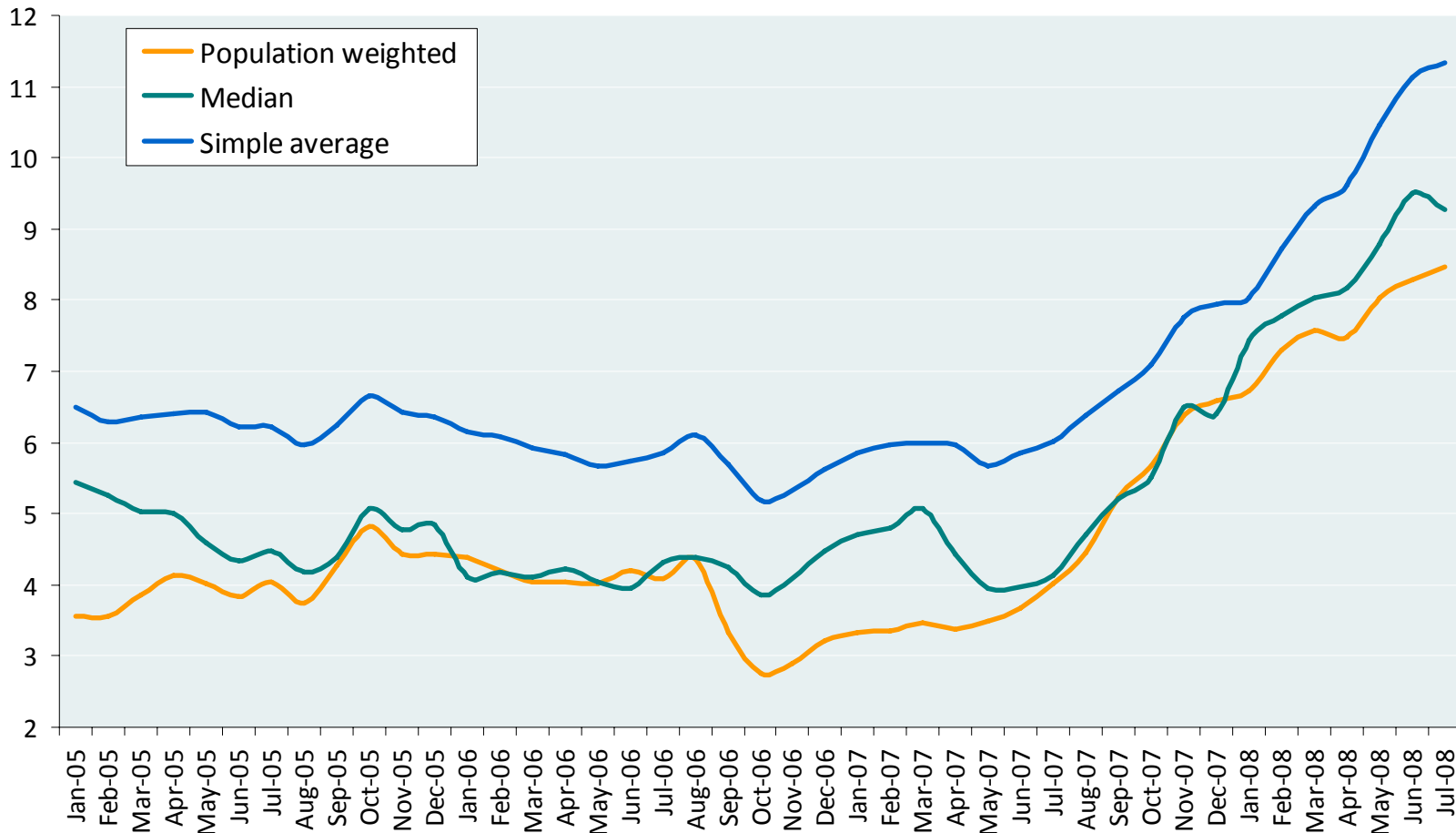
(cumulative gains or losses in 2002-7 as % of real GDP of 2007)



Inflationary pressures

Inflation has picked up in the region as a whole...

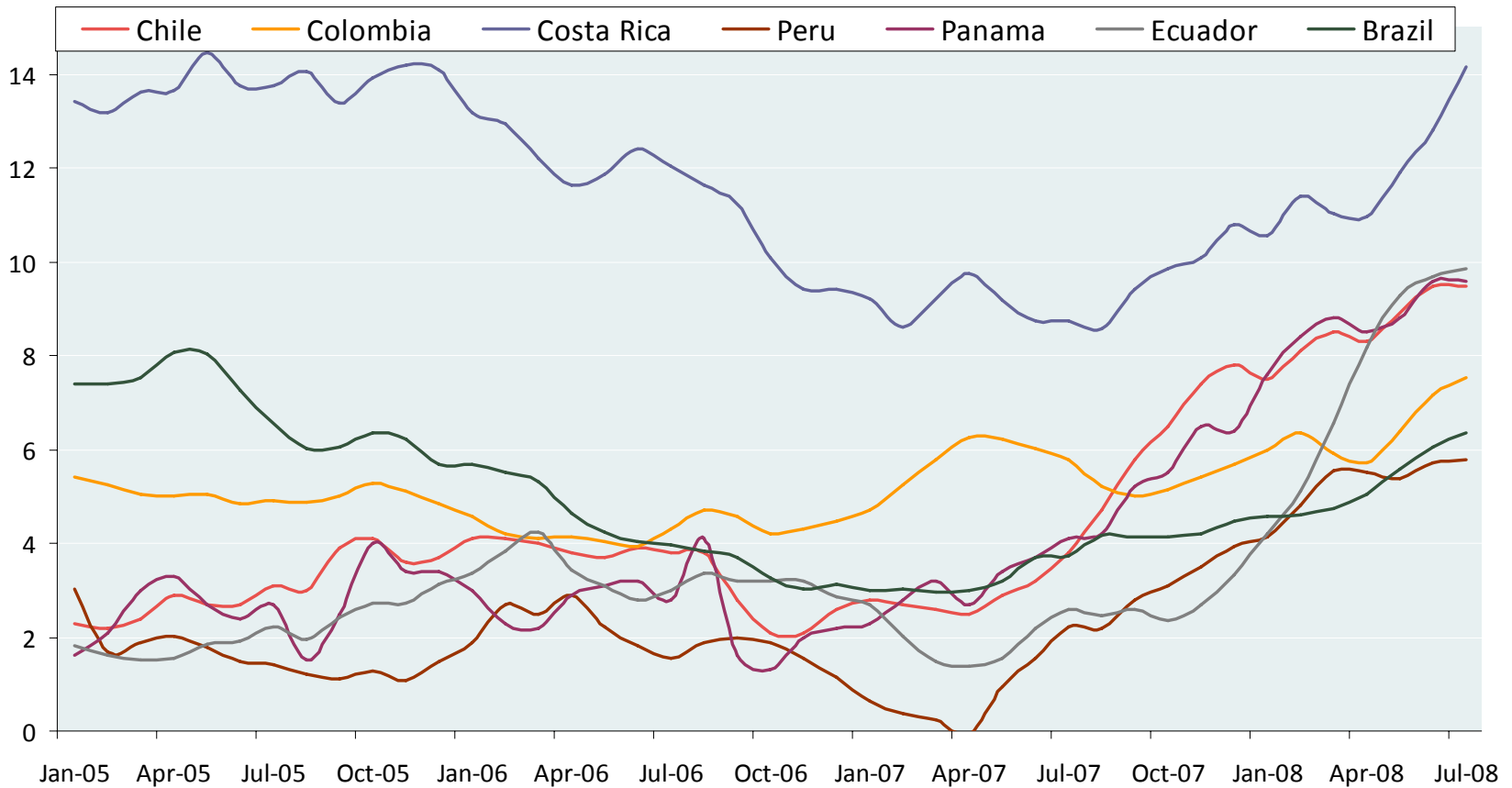
Consumer Price Inflation in LAC
annual variations, in %



LAC: Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Mexico, Panama, Peru, Trinidad y Tobago, Uruguay and Venezuela
LCRCE staff calculations. Source: National data sources and Bloomberg.

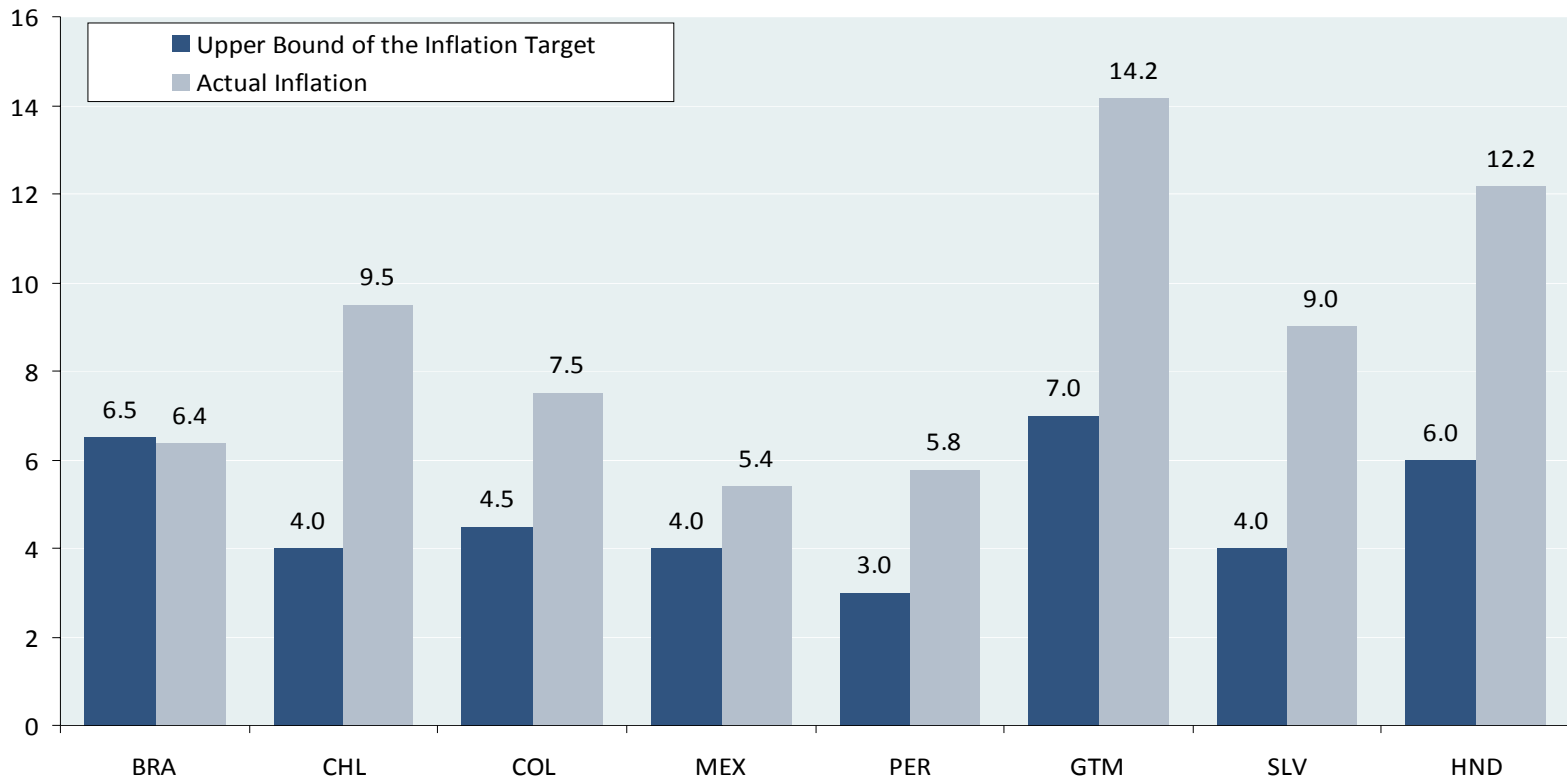
... and is quite generalized across countries, as a common external factor is at work

Consumer Price Inflation
annual variations, in %



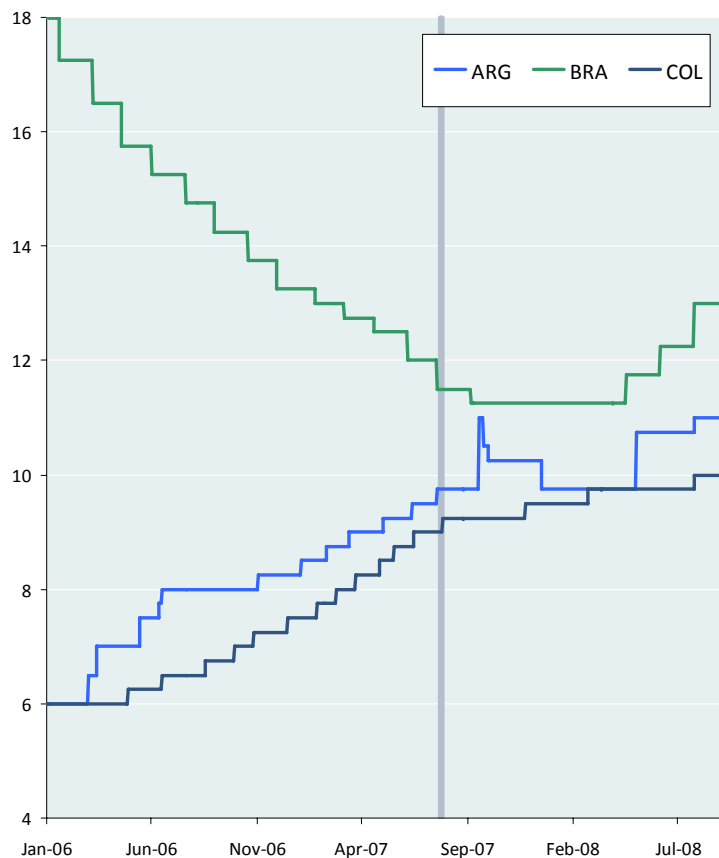
... and many inflation targeting (and near-targeting) countries have overshoot their targets

Inflation Target and Actual Inflation for Selected LAC countries
as of July 2008 - in % YoY

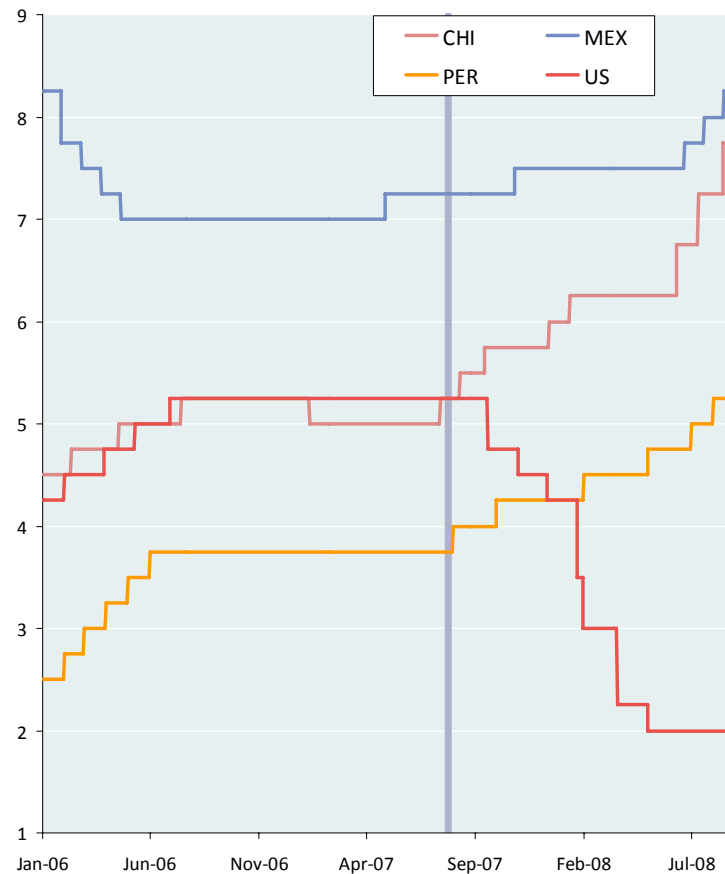


Most countries in the region have tightened monetary policy significantly ...

Monetary Policy Rates
in %



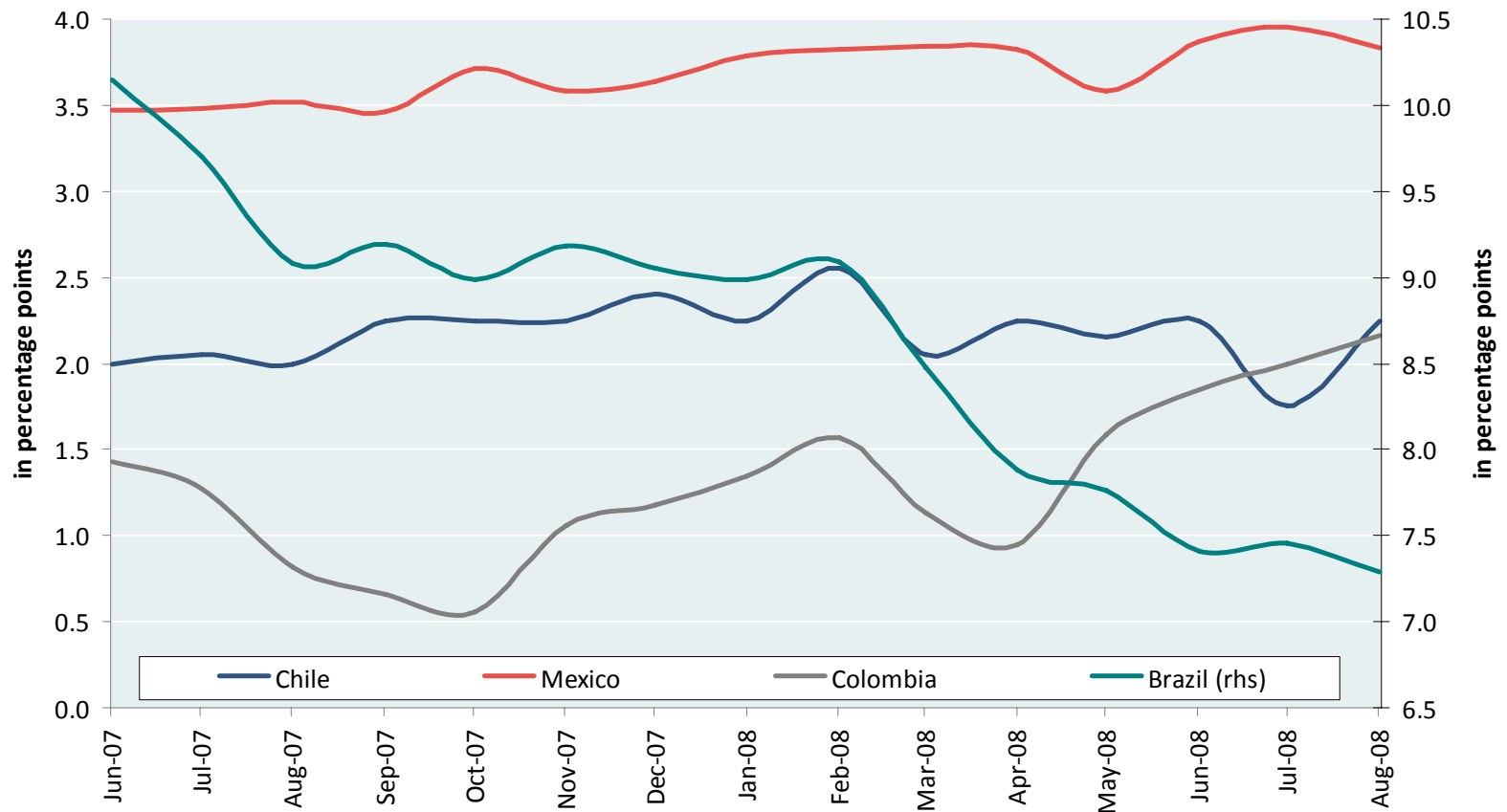
Monetary Policy Rates
in %



... to curb 2nd round effects of food & fuel price rises and anchor inflationary expectations

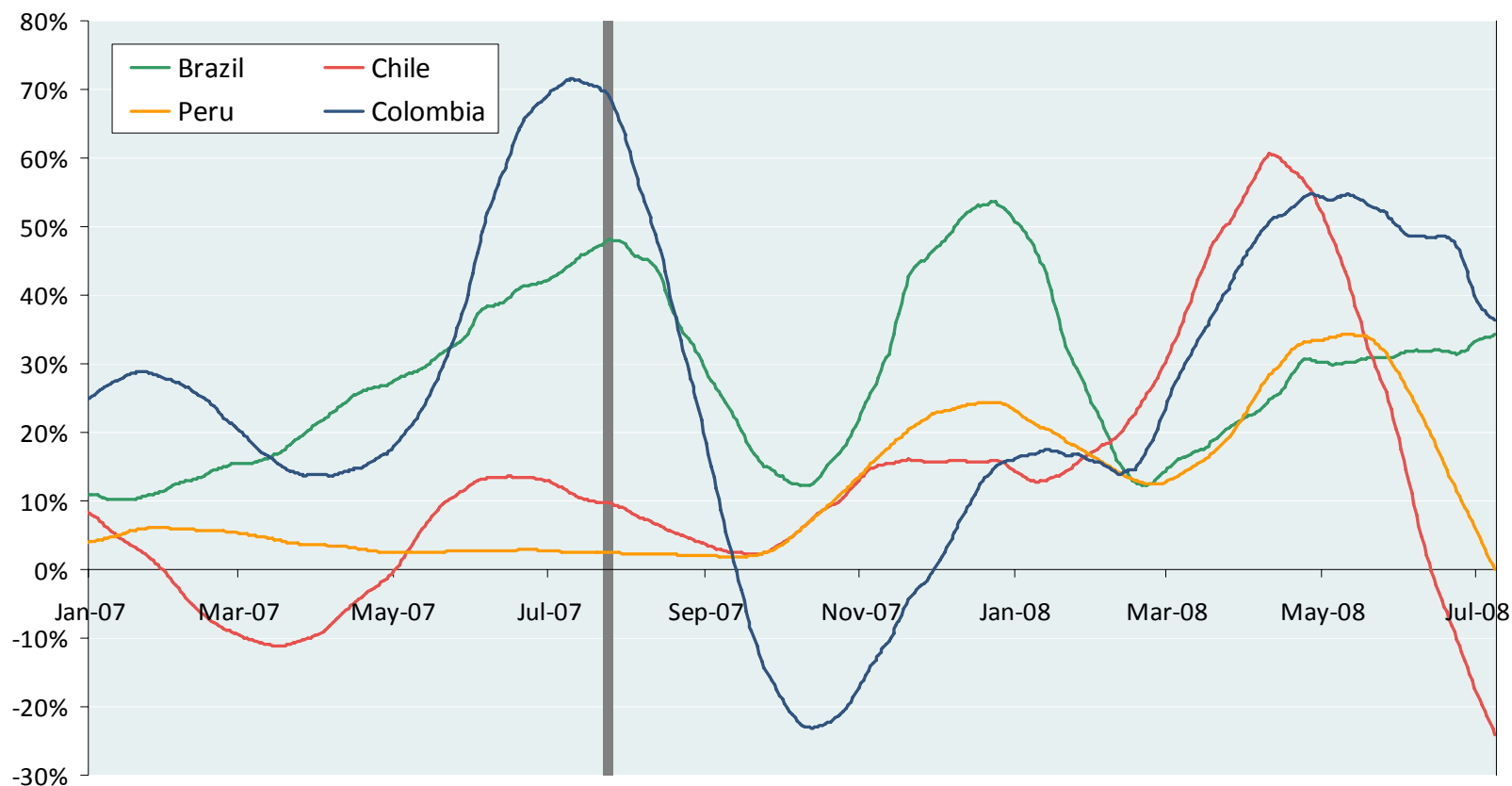
Real Policy Rate

Policy rate minus expected inflation for the next 12 months



... but this has exacerbated the strong currencies phenomenon in some of the countries

Realized Returns of the Carry Trade for Selected LAC countries
annual returns in dollar terms - 3M moving averages



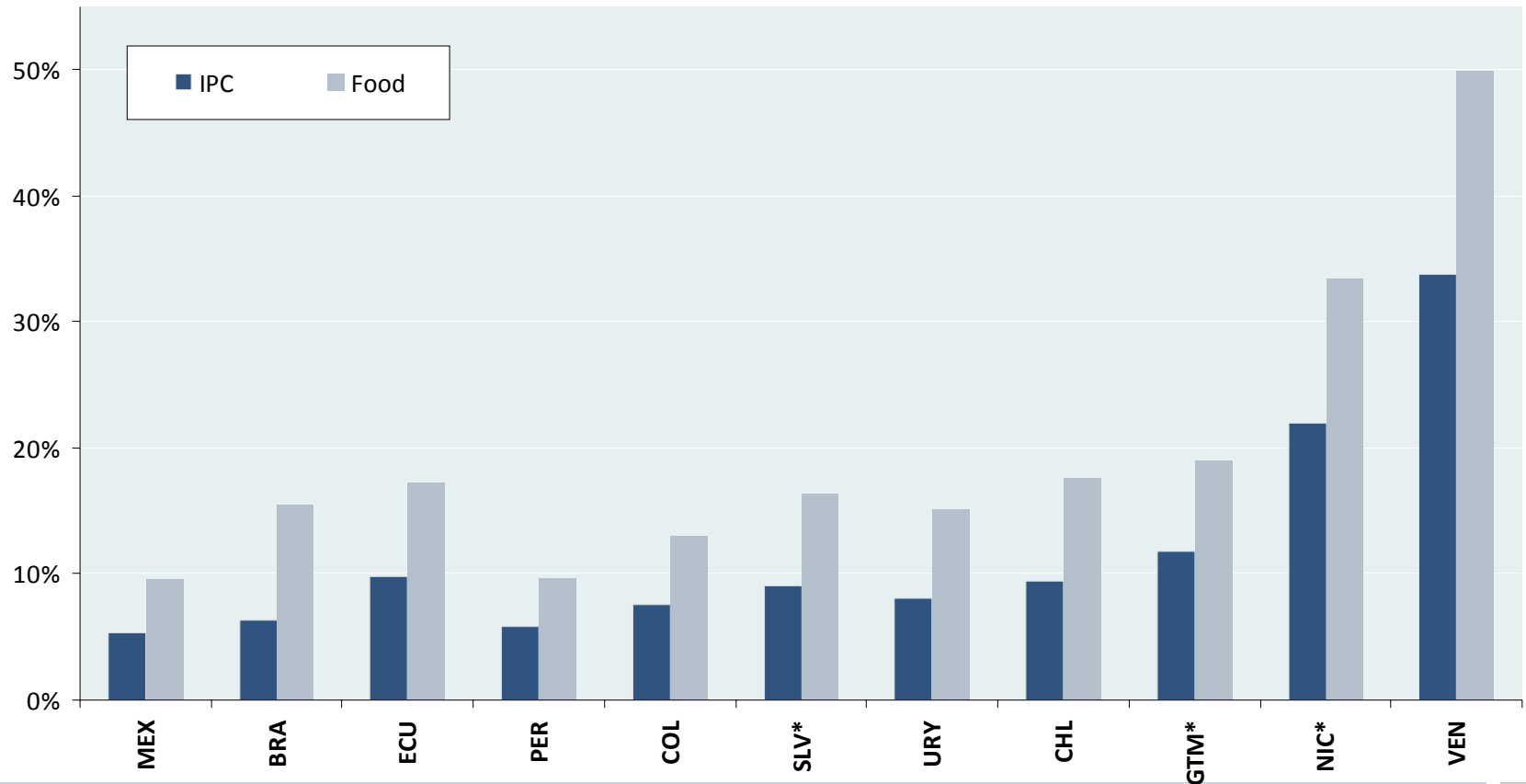
The complexity of the monetary policy challenges varies significantly between countries

		<i>Economic Activity</i>			
		HEATING		COOLING	
<i>Terms of Trade</i> (% change between 2002-2007)	> 0	ARG BRA	COL PER	CHL BOL	MEX
	< 0	CRI HND PAN	URY PAR	JAM NIC DR GTM	

Distributional tensions

The pass-through involves socially sensitive prices (foods and fuels)

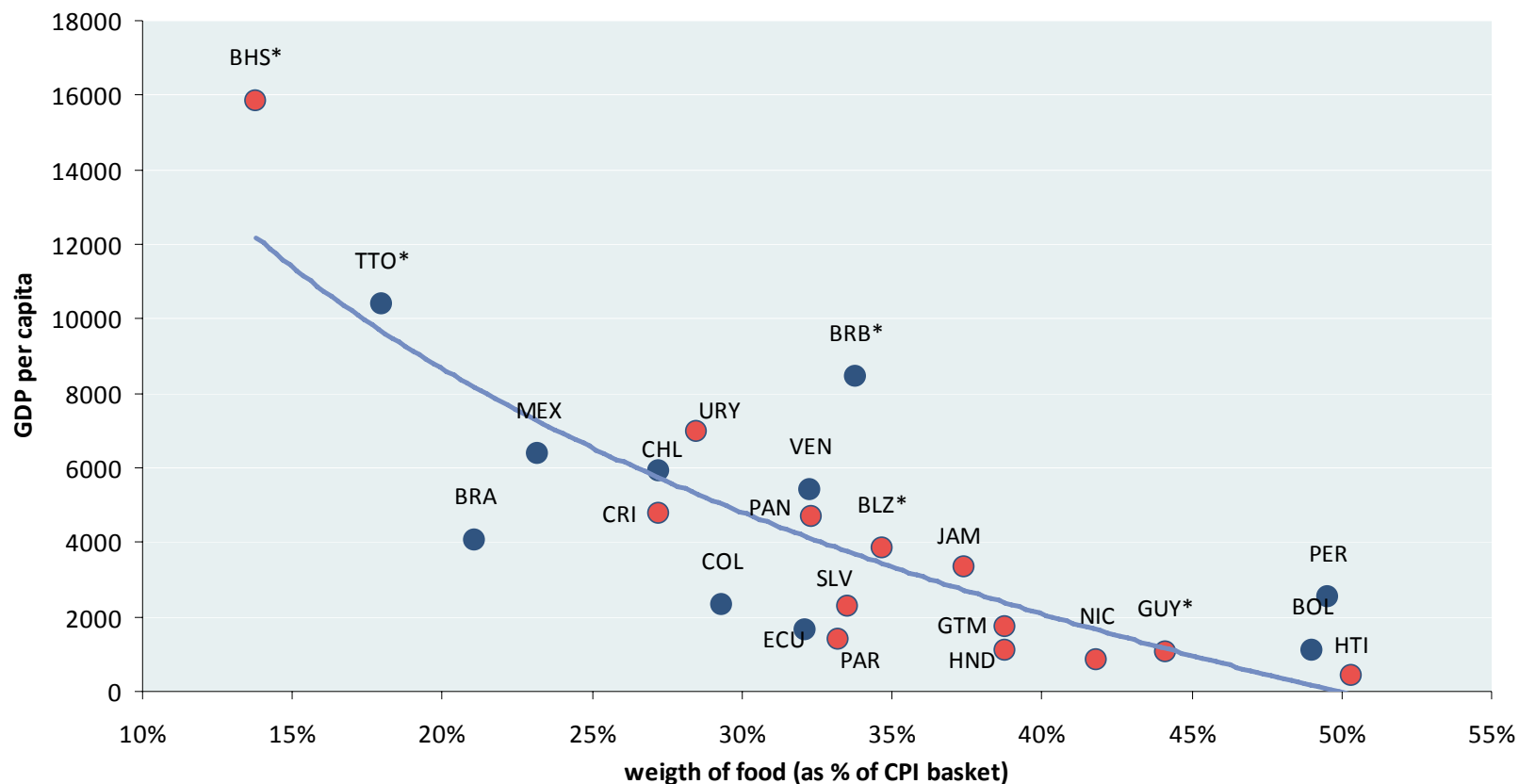
Consumer & Food Prices in Latin America
annual variation, in % - as of July 2008



Source: National data sources. *countries where the inflation index is available only up to June 2008

High food prices hit the poor harder in countries with low income and terms of trade losses

Weight of Food on the CPI basket
against GDP per capita as of 2006, at 2000 US\$



Source: World Bank staff (LCRCE) calculations - National data sources. *countries where the inflation index is available only up to December 2007. Countries highlighted in red have had negative terms of trade changes in 2002-2006.

Some Latin American countries significantly subsidize internal fuel prices

Latin countries tend to subsidize domestic oil prices

Country	Oil Subsidy	Who bears the cost of the subsidy	Has the subsidy risen in the past 12-18 Mo?	Are plans to reduce the subsidy?	Domestic prices of gasoline USD/liter
Net Oil Exporters					
Argentina	Yes	Private companies	Yes	No	0.80
Colombia	Yes	State oil company	Yes	Yes, reduction under way	1.07
Ecuador	Yes	State oil company	Yes	No	0.38
Mexico	Yes	Government	Yes, significantly	Yes	0.71
Venezuela	Yes	State oil company	-	No definite plans	0.04
Net Oil Importers					
Brazil	Yes	State oil company	Yes	No	1.53
Chile	Yes	State oil company	Yes	No	1.20
Peru	Yes	Stabilization fund	Yes	Yes	0.87

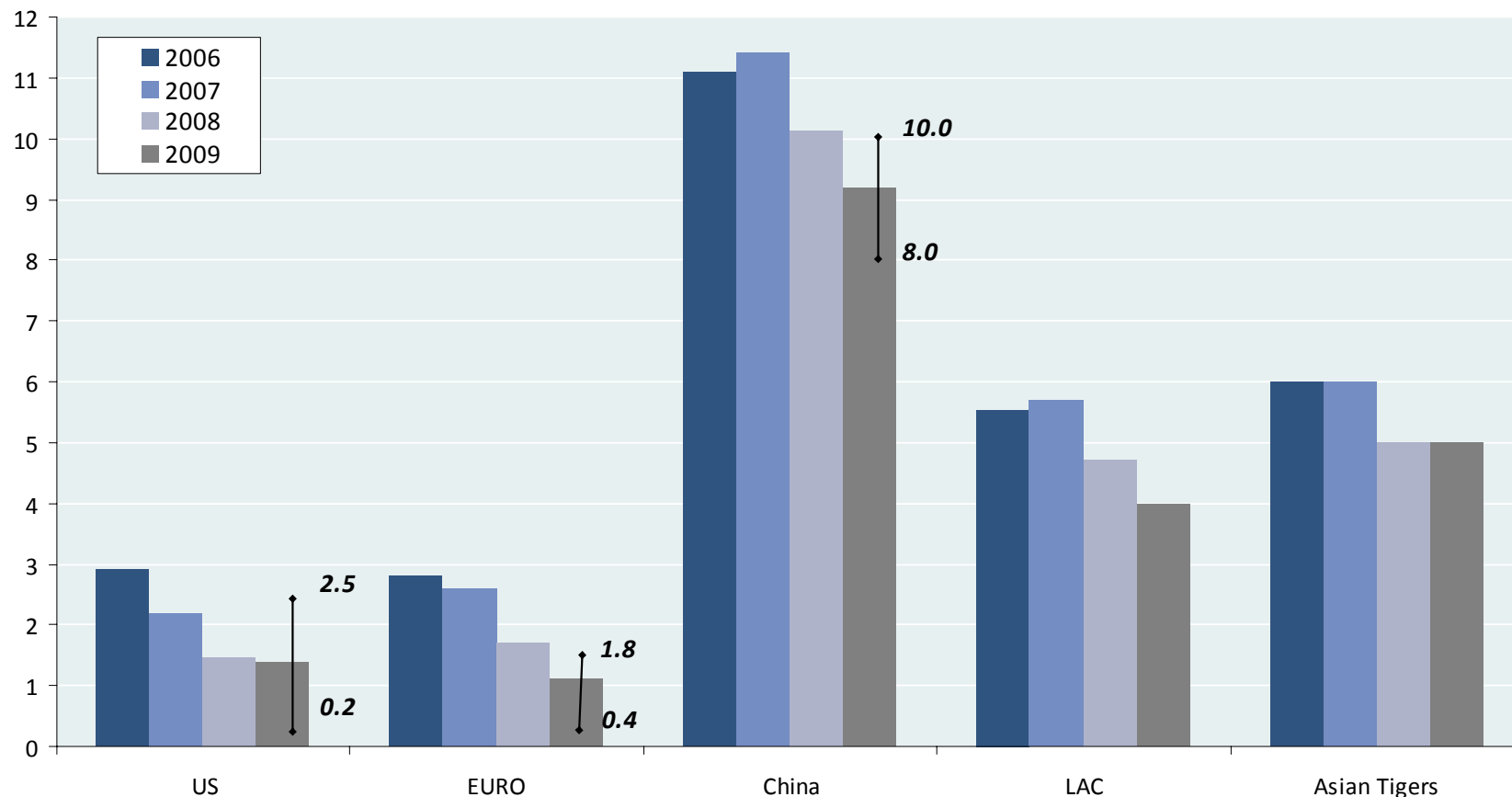
Tensions are more difficult to address in countries with terms of trade losses and lack of fiscal maneuvering room

		<i>Fiscal maneuvering margin</i>		
		Yes	Perhaps	No
<i>Terms of Trade</i> <i>(% change between 2002-2007)</i>	<i>GAINS</i>	CHL MEX VEN ECU PER	BOL COL? BRA?	ARG JM PAN
	<i>LOSSES</i>	SLV GTM	CRI DR	URU

Growth prospects

A process of global economic deceleration is underway ...

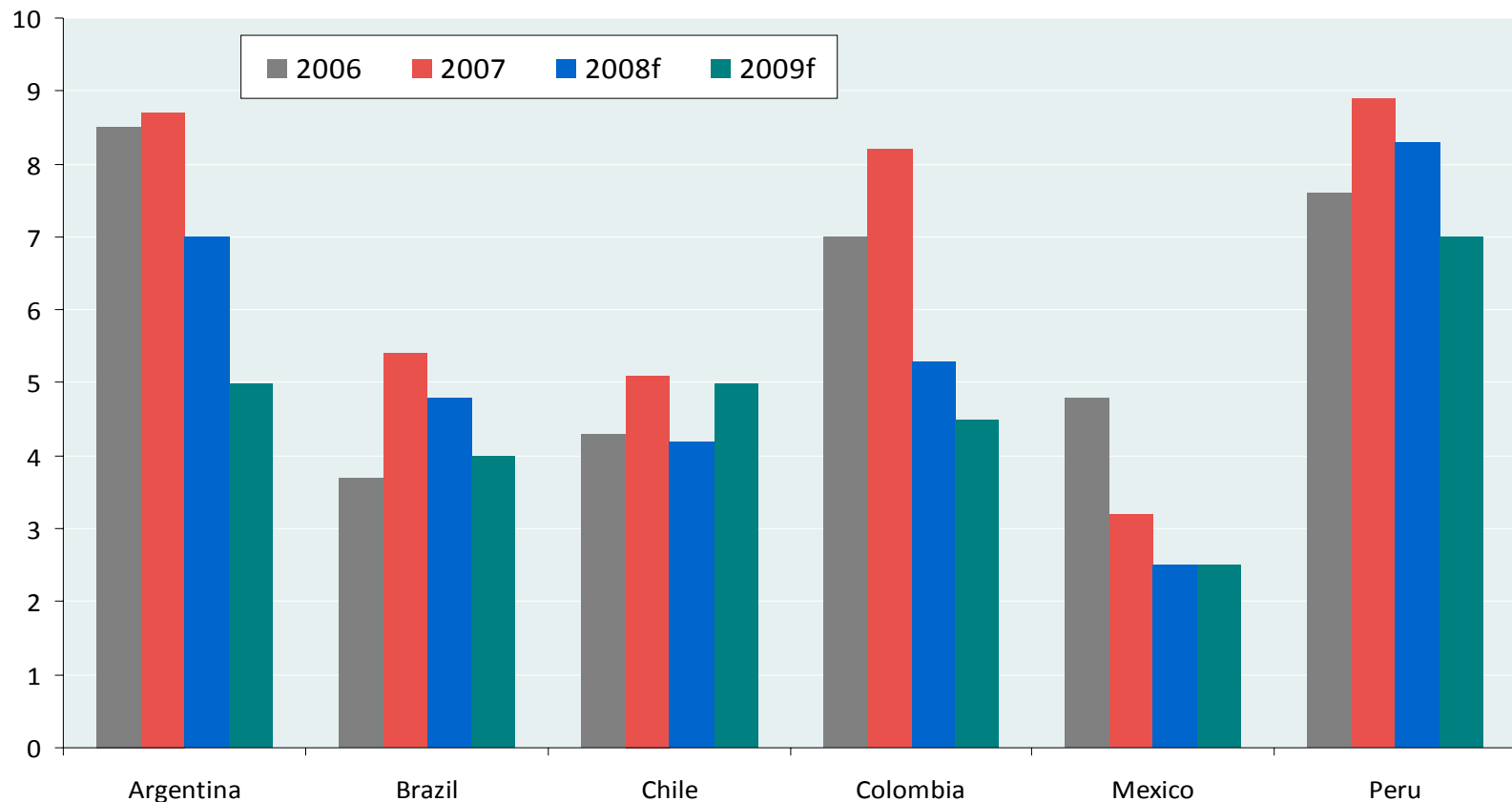
Recent Growth and Forecast for 2008 and 2009
annual GDP real growth rate, in %



Latin countries can hardly break free from the cyclical deceleration in global growth

LAC-7: Real GDP Growth and Forecasts (ECLAC)

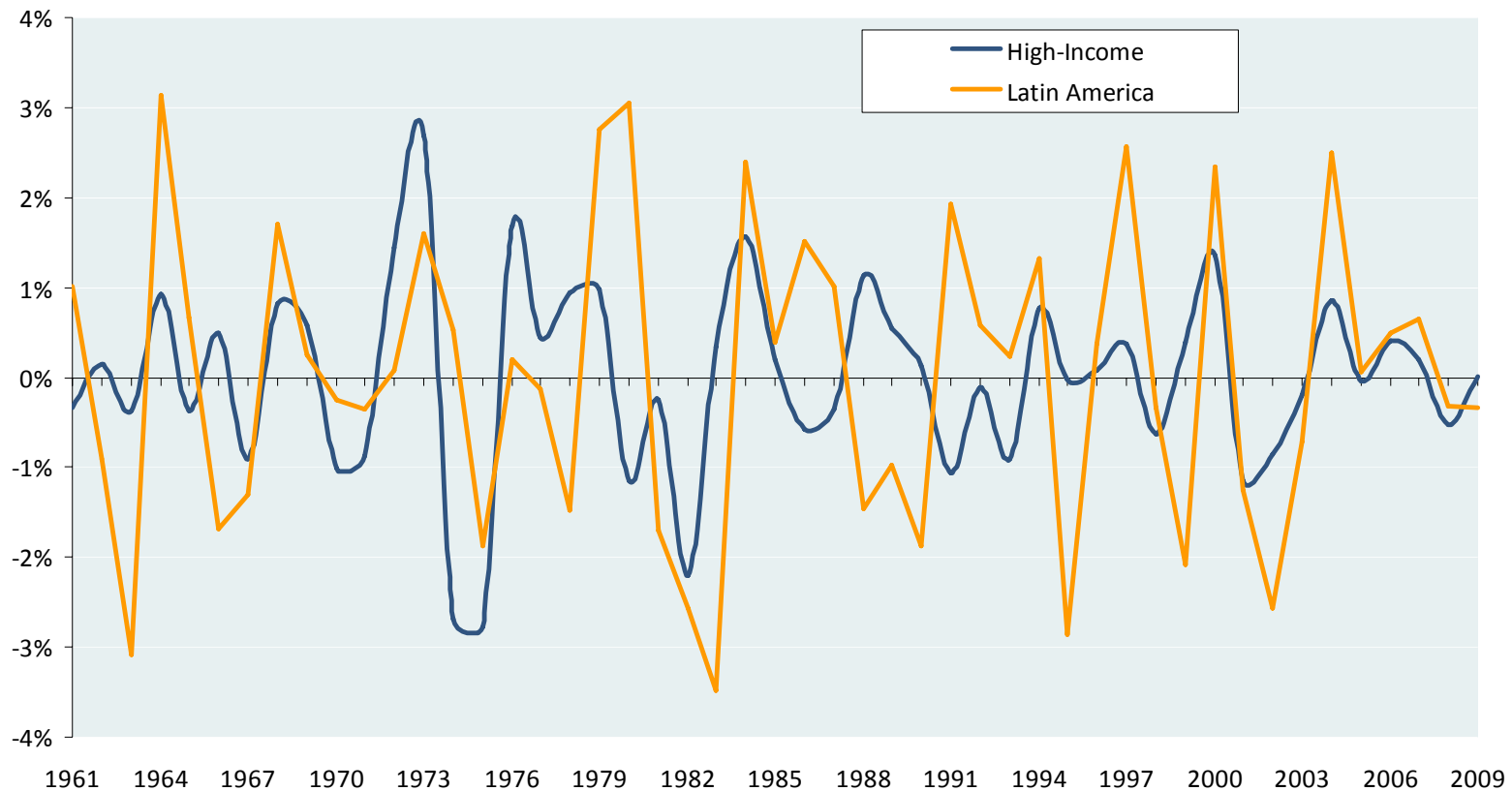
annual variation, in %



In effect, the cyclical components of Latin and rich countries' growth are clearly synchronized ...

Cyclical component of Growth in LAC and High-Income Countries

Cyclical component of GDP annual growth computed using the band-pass filter

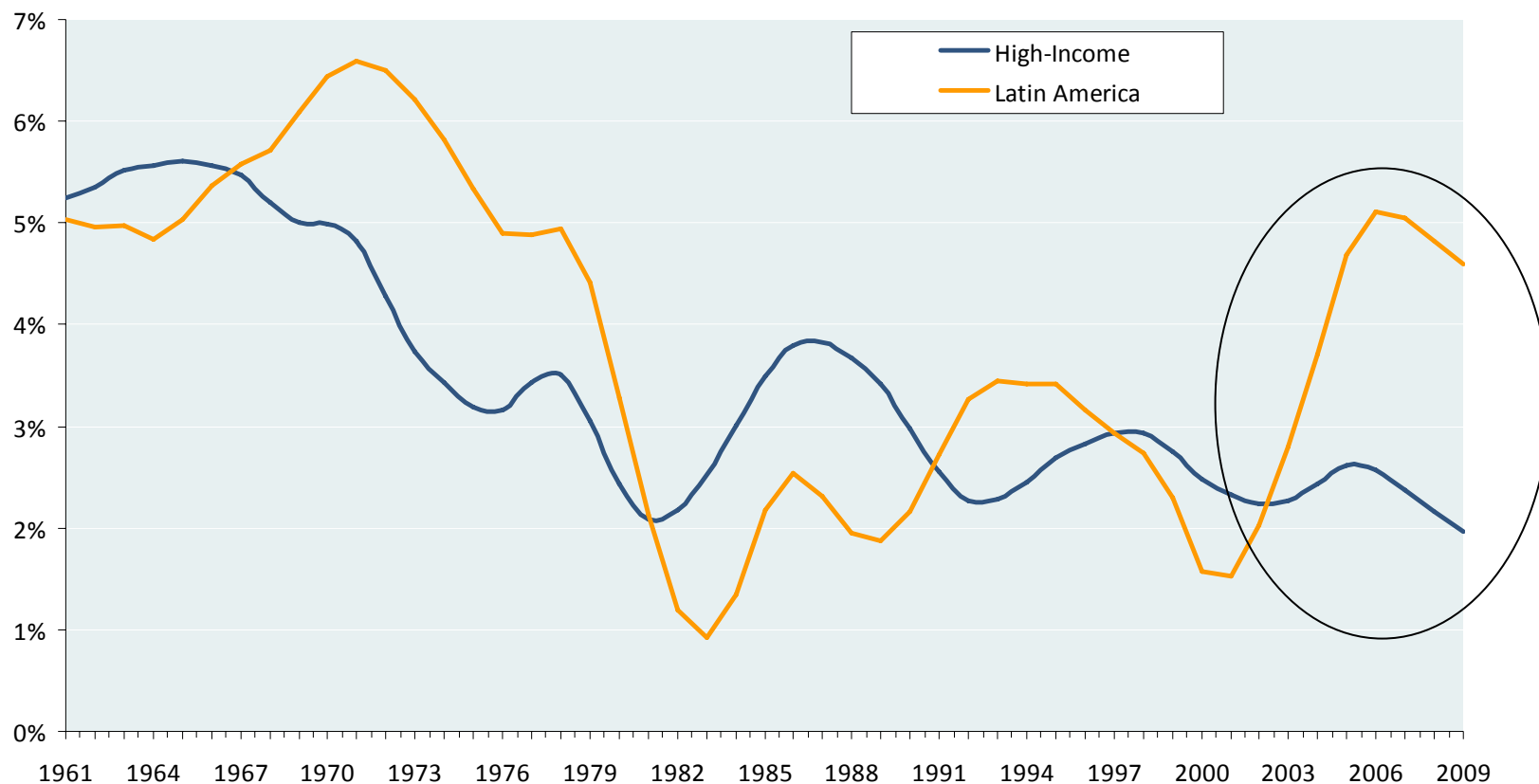


The cyclical component of real GDP growth is computed using the band-pass filter (Baxter and King, 1999). LCRCE staff calculations.
Source: WDI – World Bank; National Authorities.

... but, is there a decoupling of Latin American cyclically-adjusted growth vis-à-vis rich countries?

Cyclical-adjusted Growth in Latin America and High-Income Countries

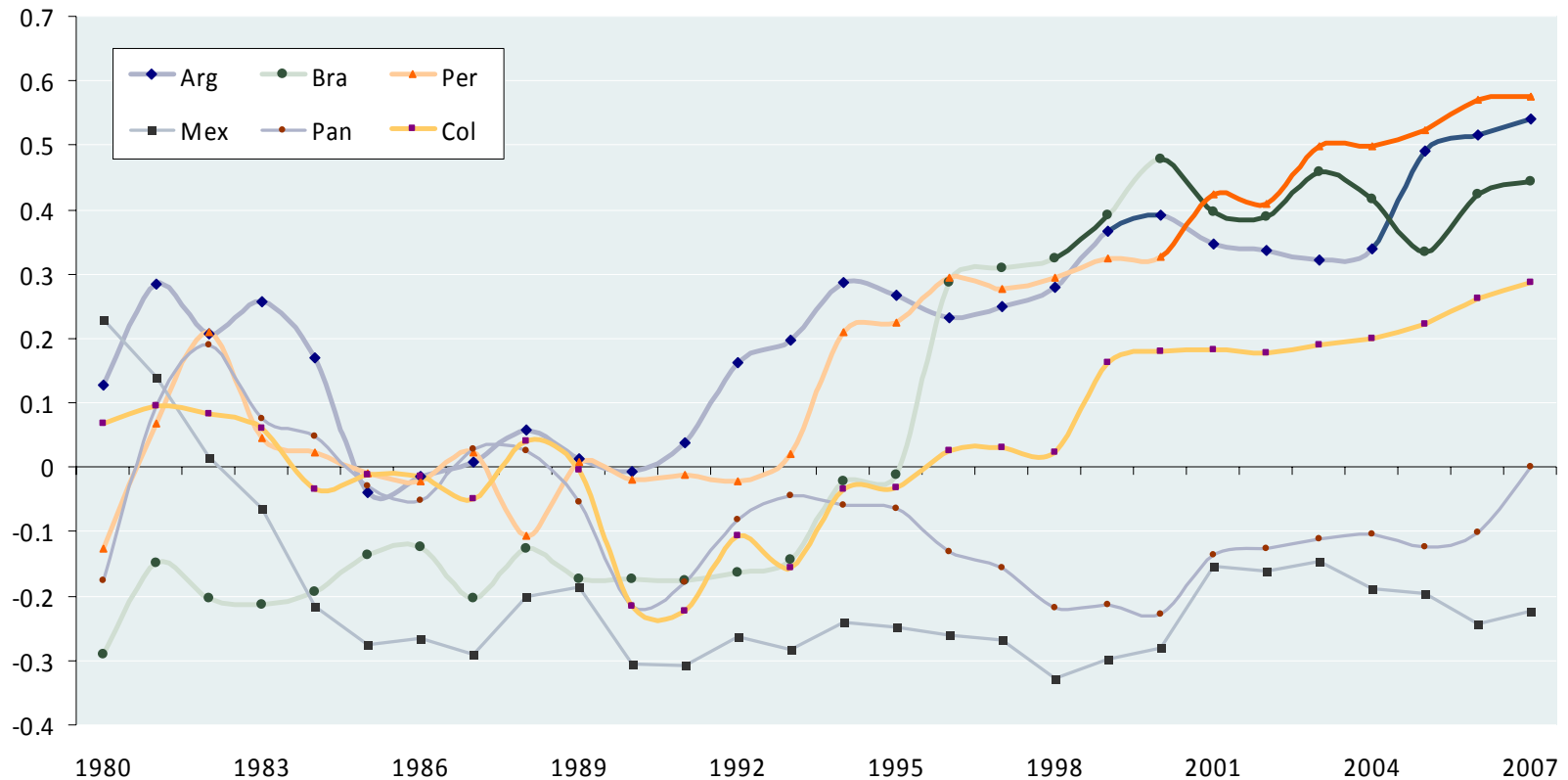
Trend growth computed using the band-pass filter



The trend growth of real GDP growth is computed using the band-pass filter (Baxter and King, 1999). LCRCE staff calculations. Source: WDI – World Bank; National Authorities.

The growth co-movement of Latin America and China has increased ...

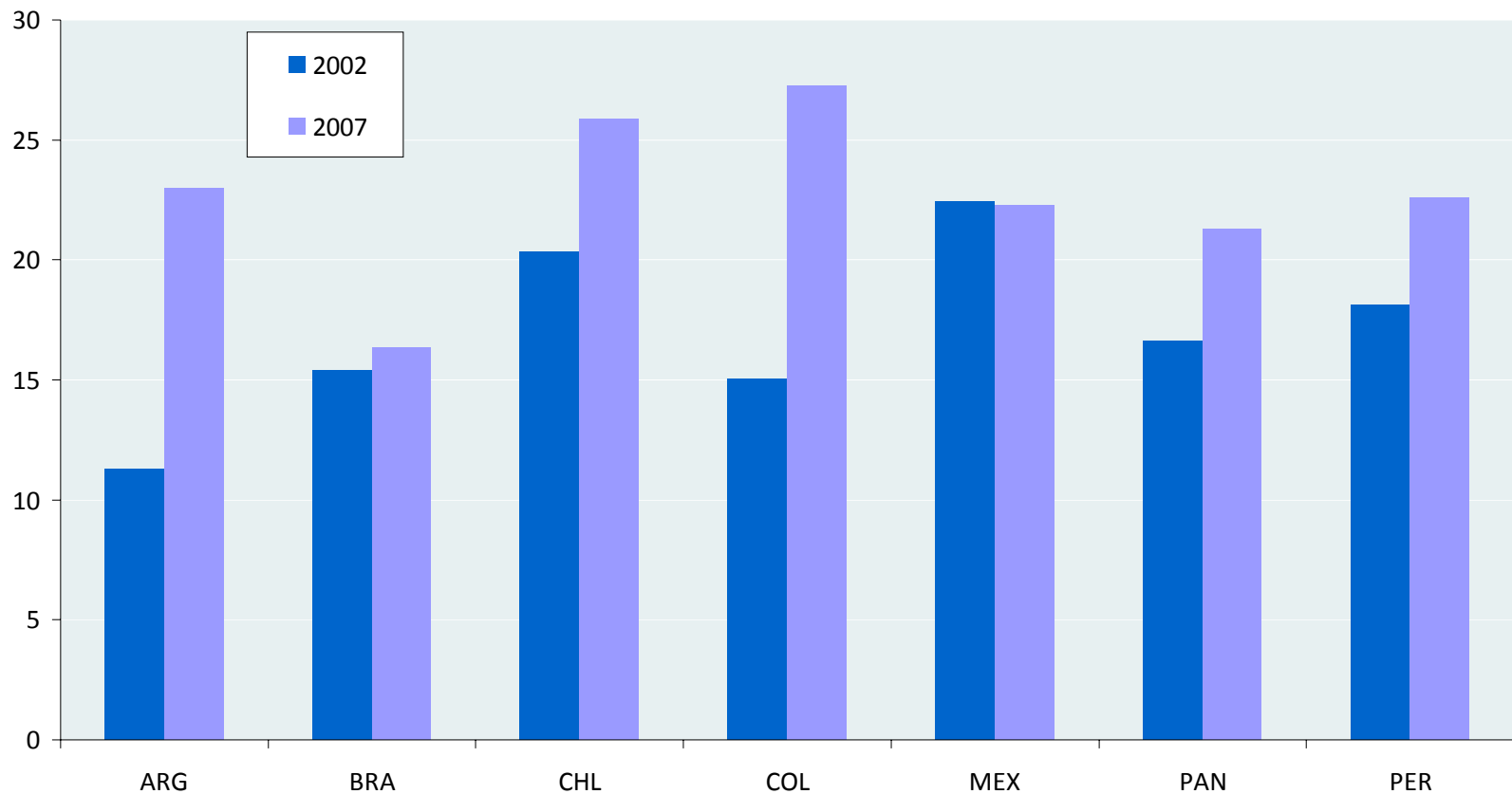
Output Co-Movement between LAC and China
20 years rolling correlation of the Real GDP growth



Note: Solid colours reflect statistically significant correlations with and confidence interval of 10%. LCRCE calculations. Source: National Authorities.

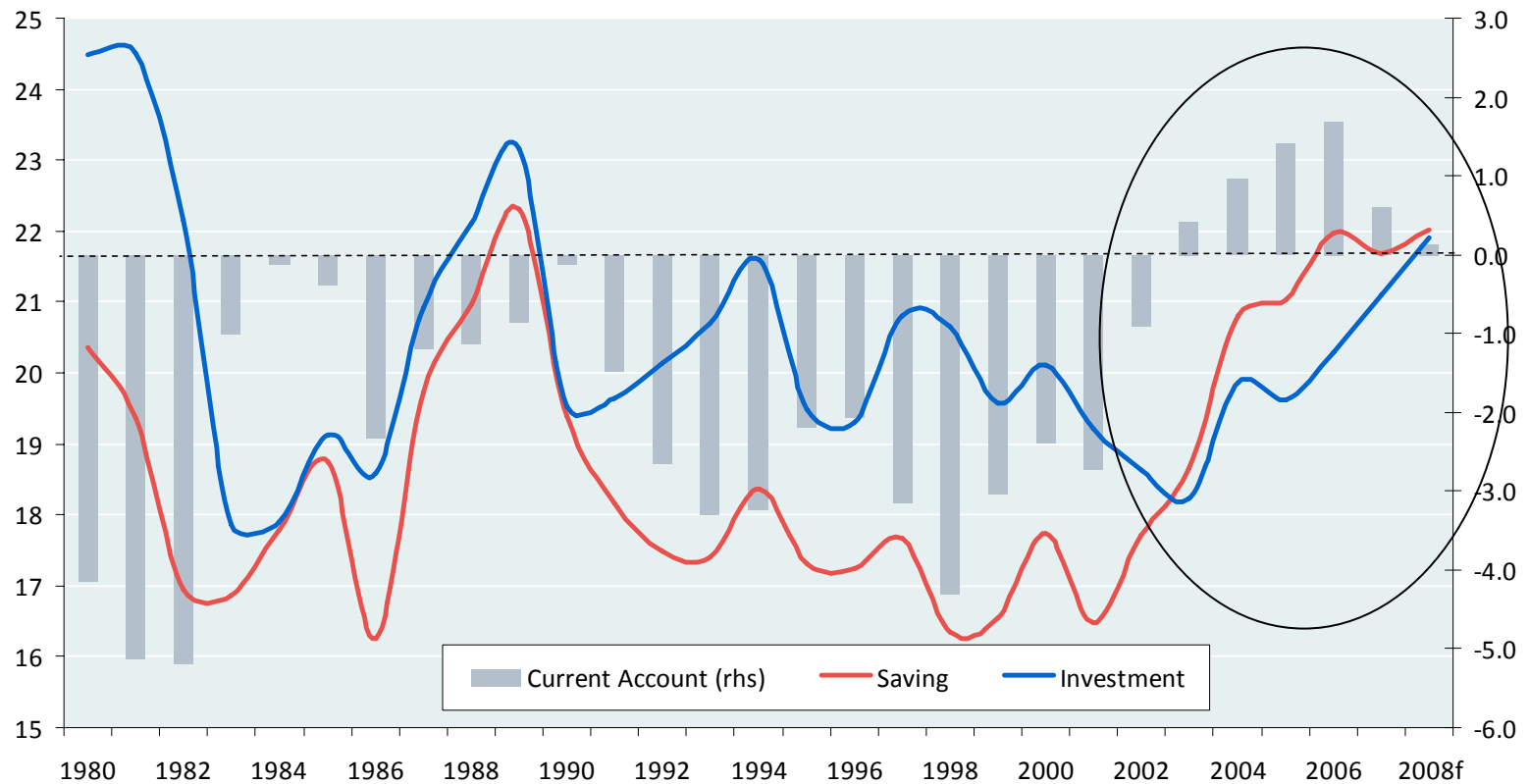
Investment rates have risen in many Latin countries...

Gross Capital Formation in selected LAC countries
(as % of GDP)



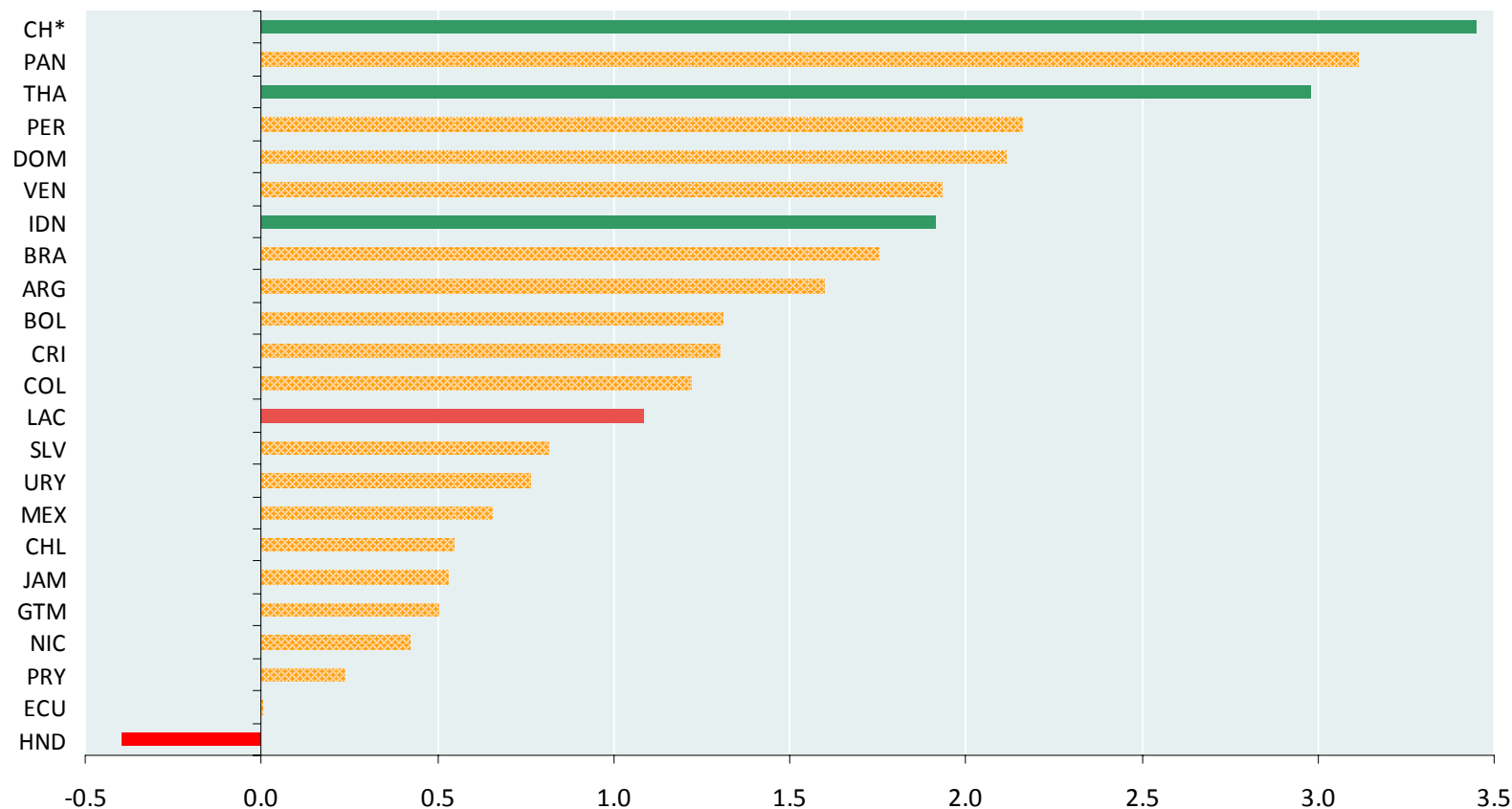
... largely financed by domestic savings

Saving, Investment and the Current Account in LAC
as percentage of GDP



And there are (finally!) signs of a pick up in productivity growth in some Latin countries

Total factor productivity growth in LAC and East Asia
(average annual trend-growth in TFP during 2000-7, in %)



* Chile average annual trend-growth in TFP during 1990-7. Trend GDP growth is computed using the band-pass filter. LCRCE staff calculations.
Source: PWT, DECPG

Will LAC return to a high trend growth after the cyclical deceleration?

- A lower vulnerability to shocks is necessary to sustain growth for the good performers...
- ... but it is not sufficient
- It will also be necessary to closer major gaps
 - Human capital
 - Infrastructure
 - Innovation

END