
Latin America's New Immune System: Coping with the Changing External Environment

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Latin America and the Caribbean
World Bank

Structure of presentation

- The worrisome external environment
 - A financial crisis-driven recession in the U.S.
 - Rising food and fuel prices
- The financial channel: decoupling, so far
- The real channels: cyclical coupling, trend decoupling?
 - External demand
 - Remittances
 - Commodity prices
- The region's capacity to respond

The worrisome external environment

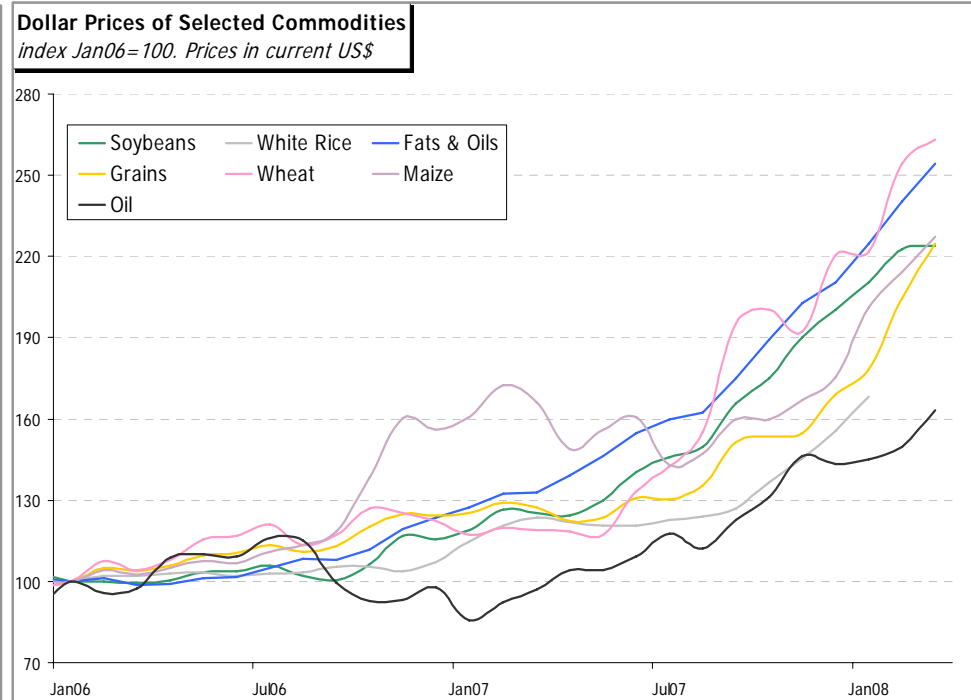
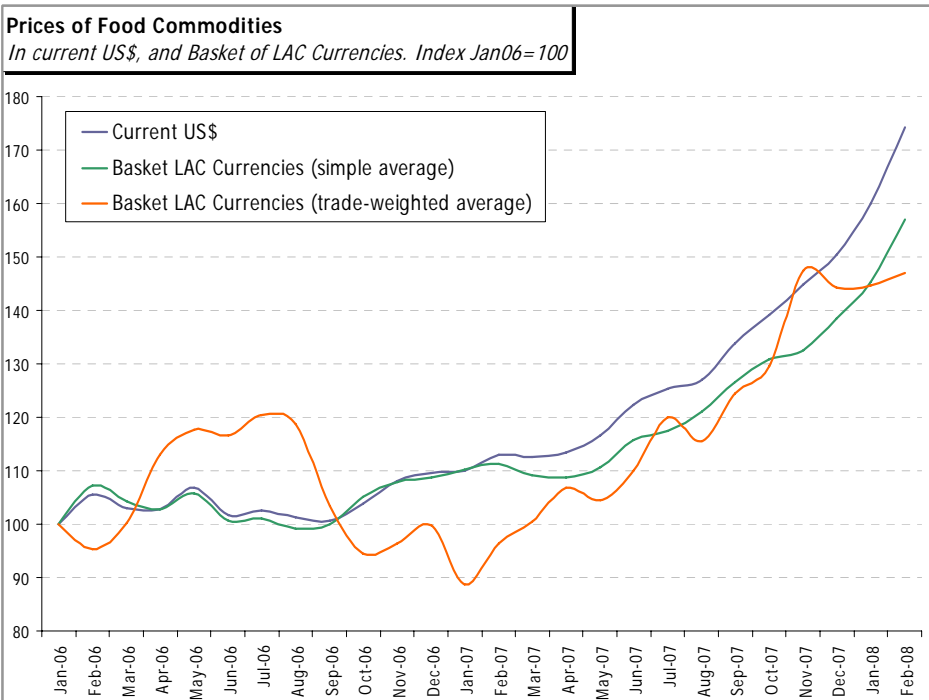
A financial crisis-driven recession in the U.S.
and
Rising international prices of foods and fuels

As credit problems infect U.S. financial markets, the conviction of a recession rises



Source: Intrade.com. The Price of the contract reflects the probability that will pay if the US economy goes into a recession during 2008.

International prices of foods and fuels have been rising steeply



The financial channel

The region is less vulnerable to financial contagion than in the past – *this time, investors are not shorting Latin America*

Exhibit 1: Following the sub-prime crisis, Latin EMBI spreads have risen less than U.S. junk bonds spreads

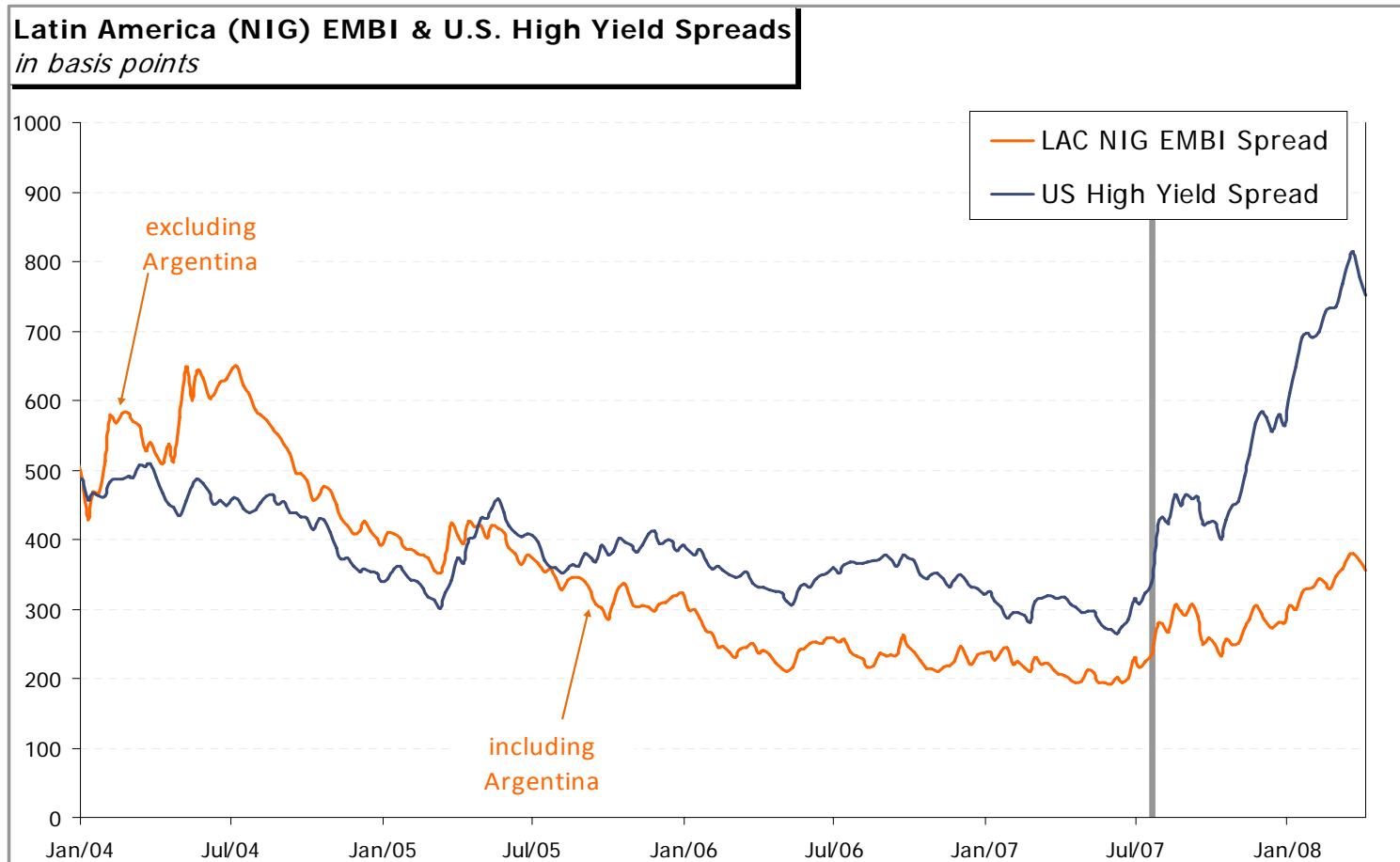


Exhibit 2: As volatility in Latin bonds fall, they add diversification benefits to a U.S. stock market portfolio

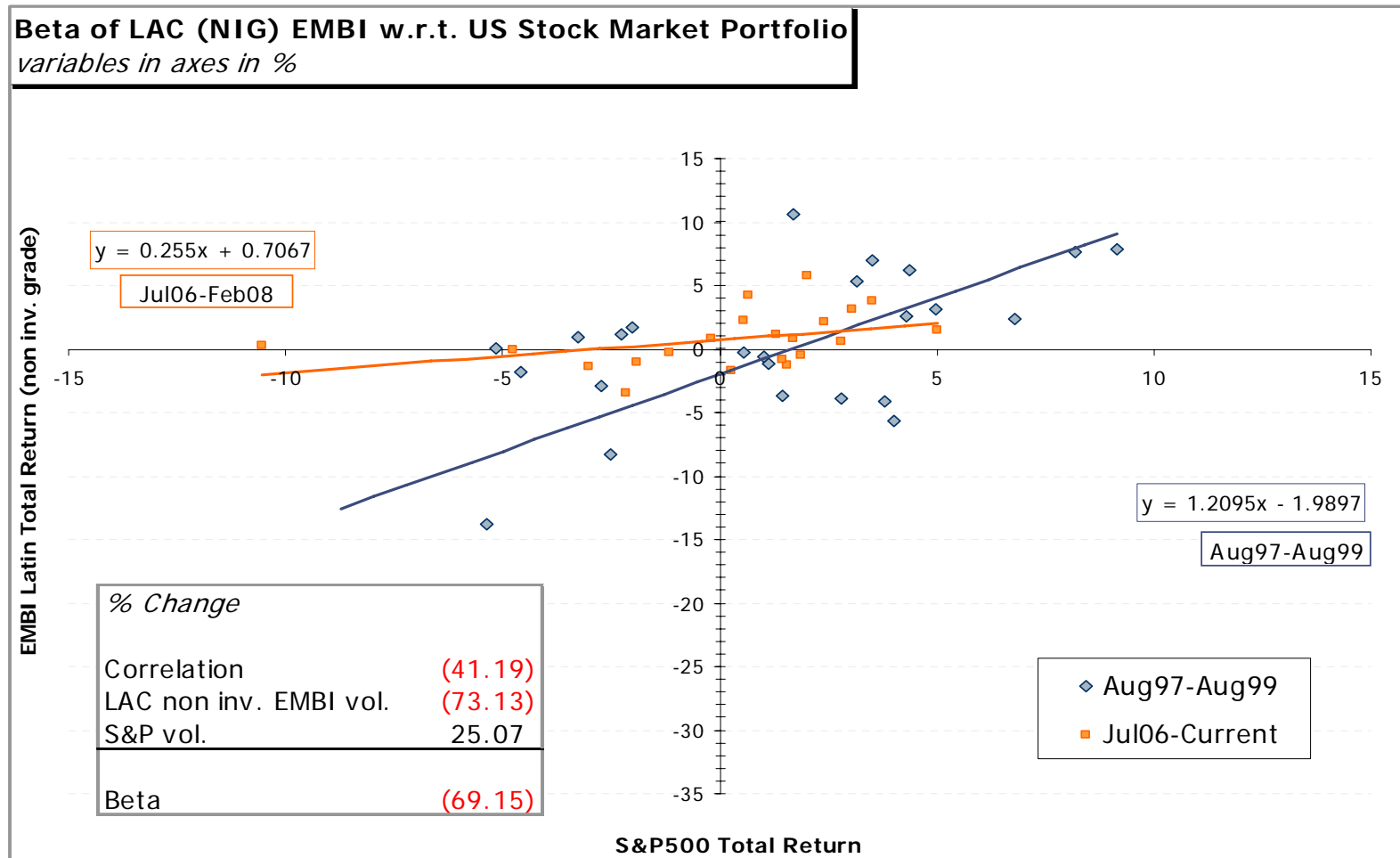
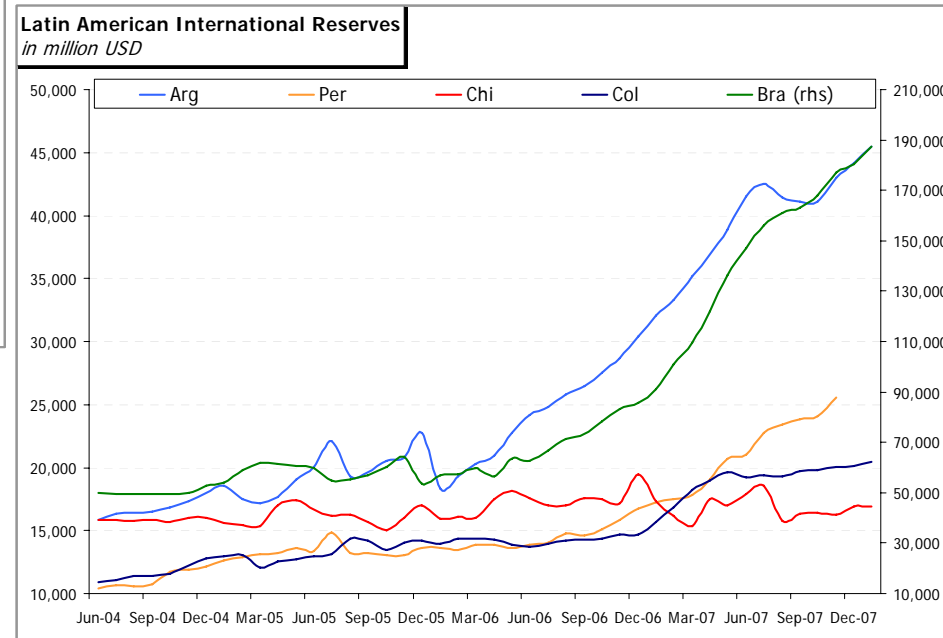
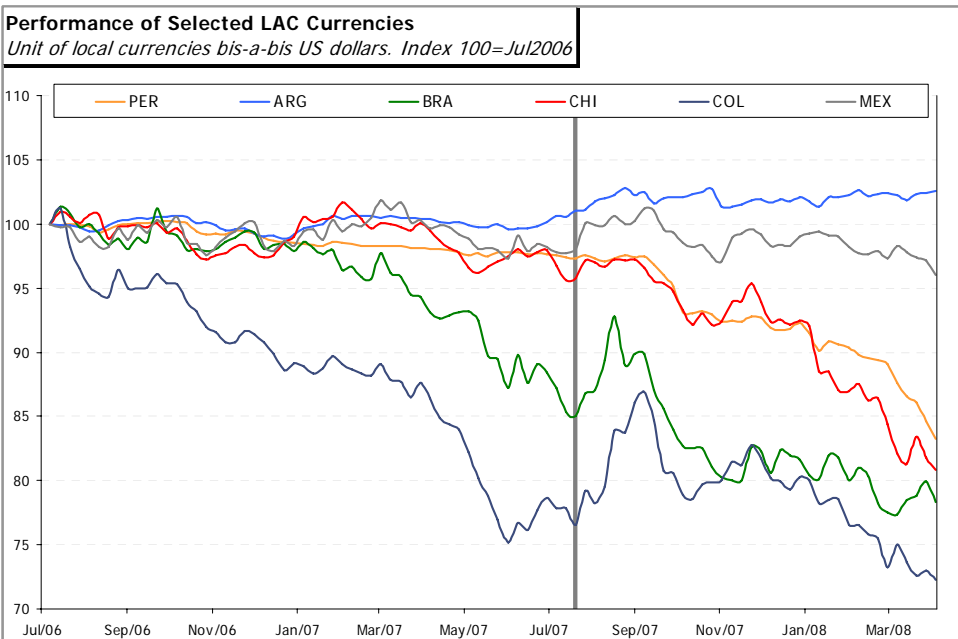
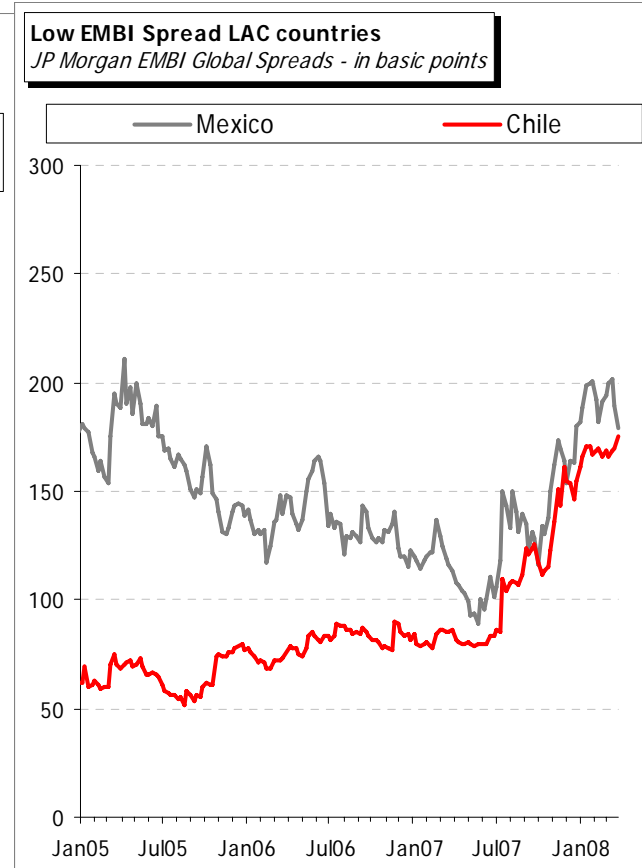
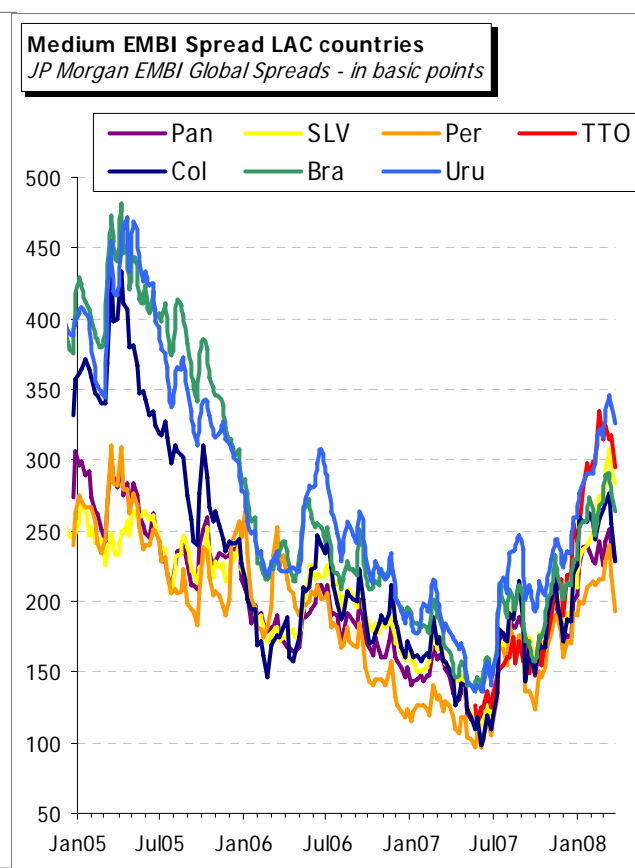
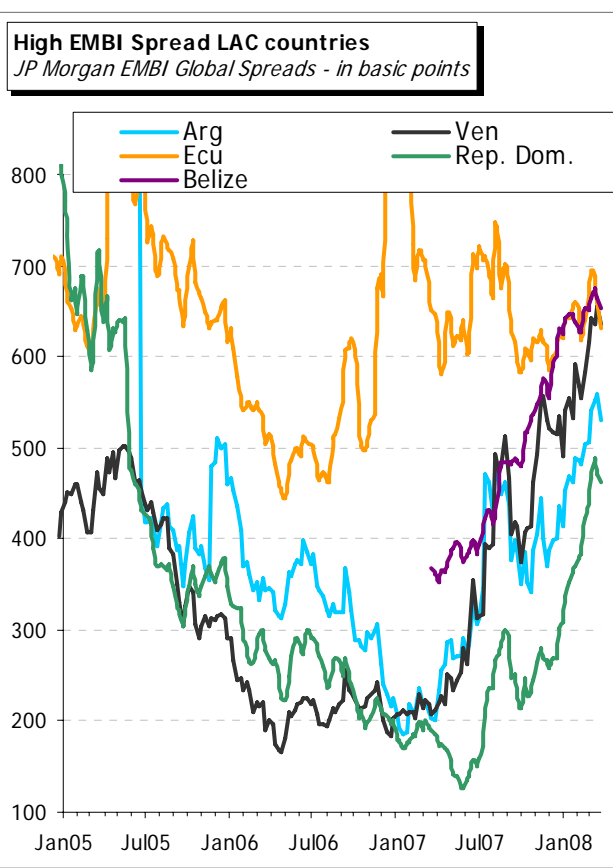


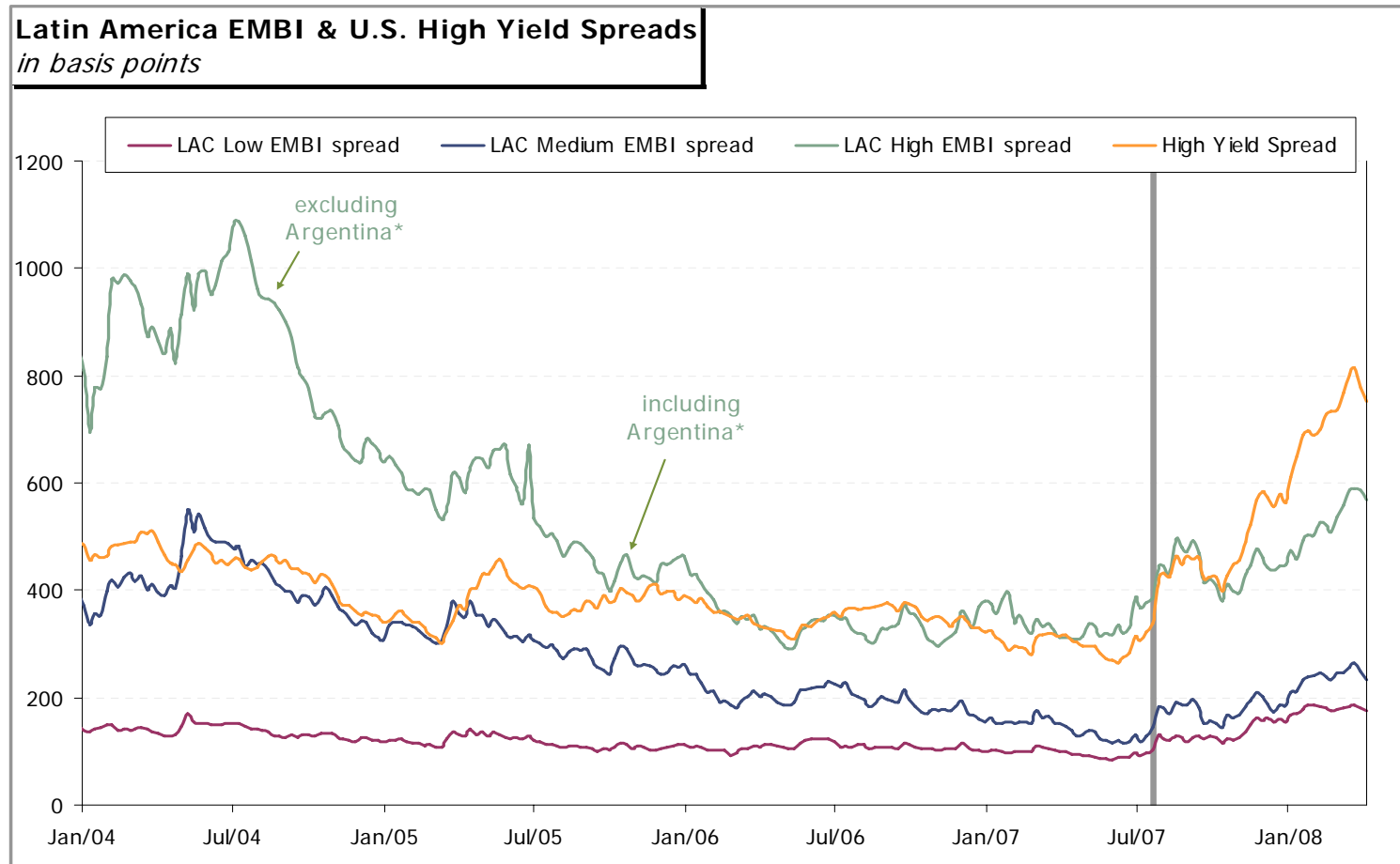
Exhibit 3: Latin currencies are not under attack; they are under appreciation pressures



Behind the average Latin EMBI, countries seem to be clustering into three groups...



... depending on the behavior of their EMBI spreads relative to high-yield U.S. bond spreads



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

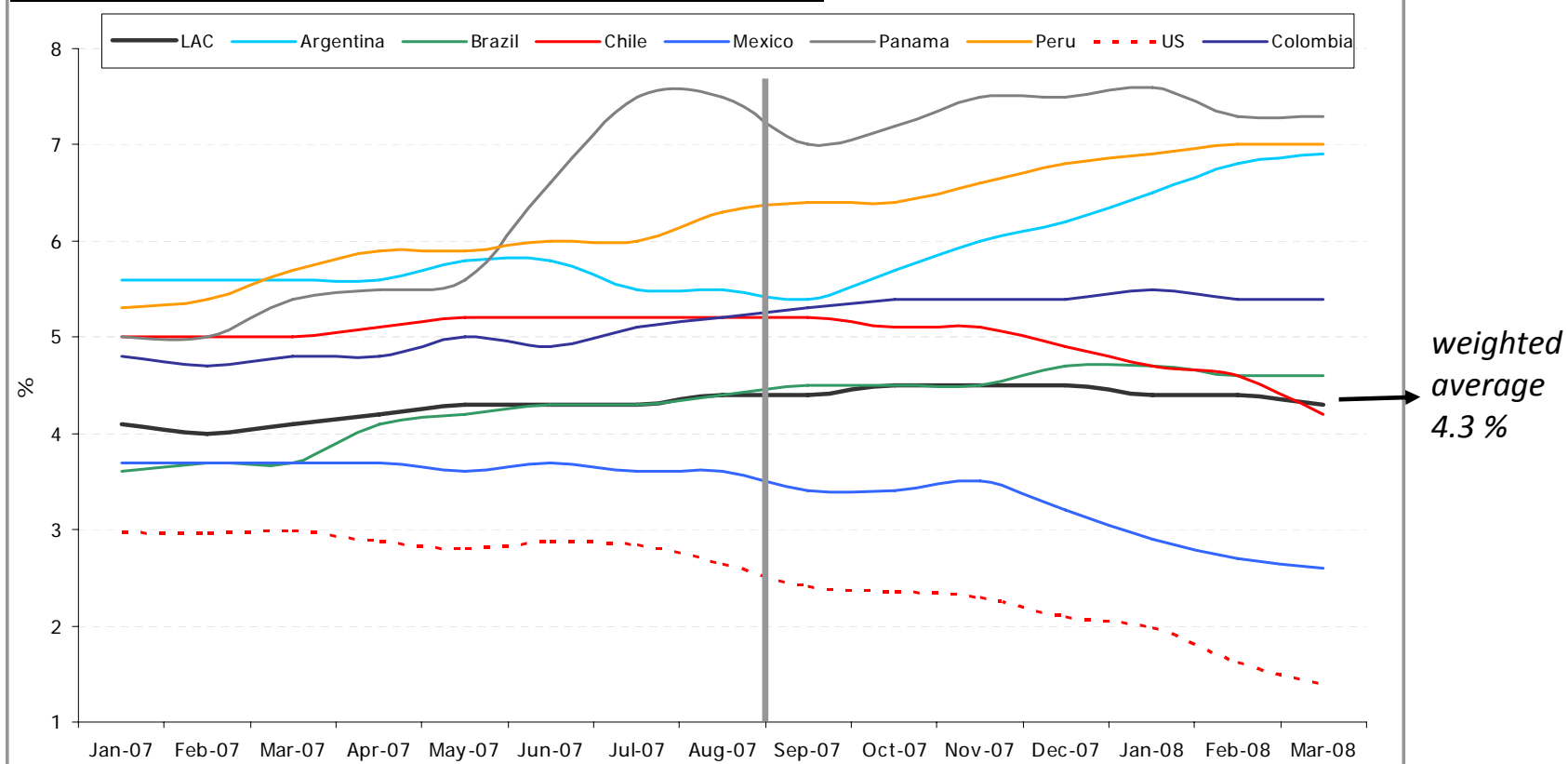
* The Latin EMBI excludes Argentina until Oct2005, because it was an outlier during the 2001-05 period.

The real channels

External demand – a U.S. recession is an important concern, but less so if China maintains high growth

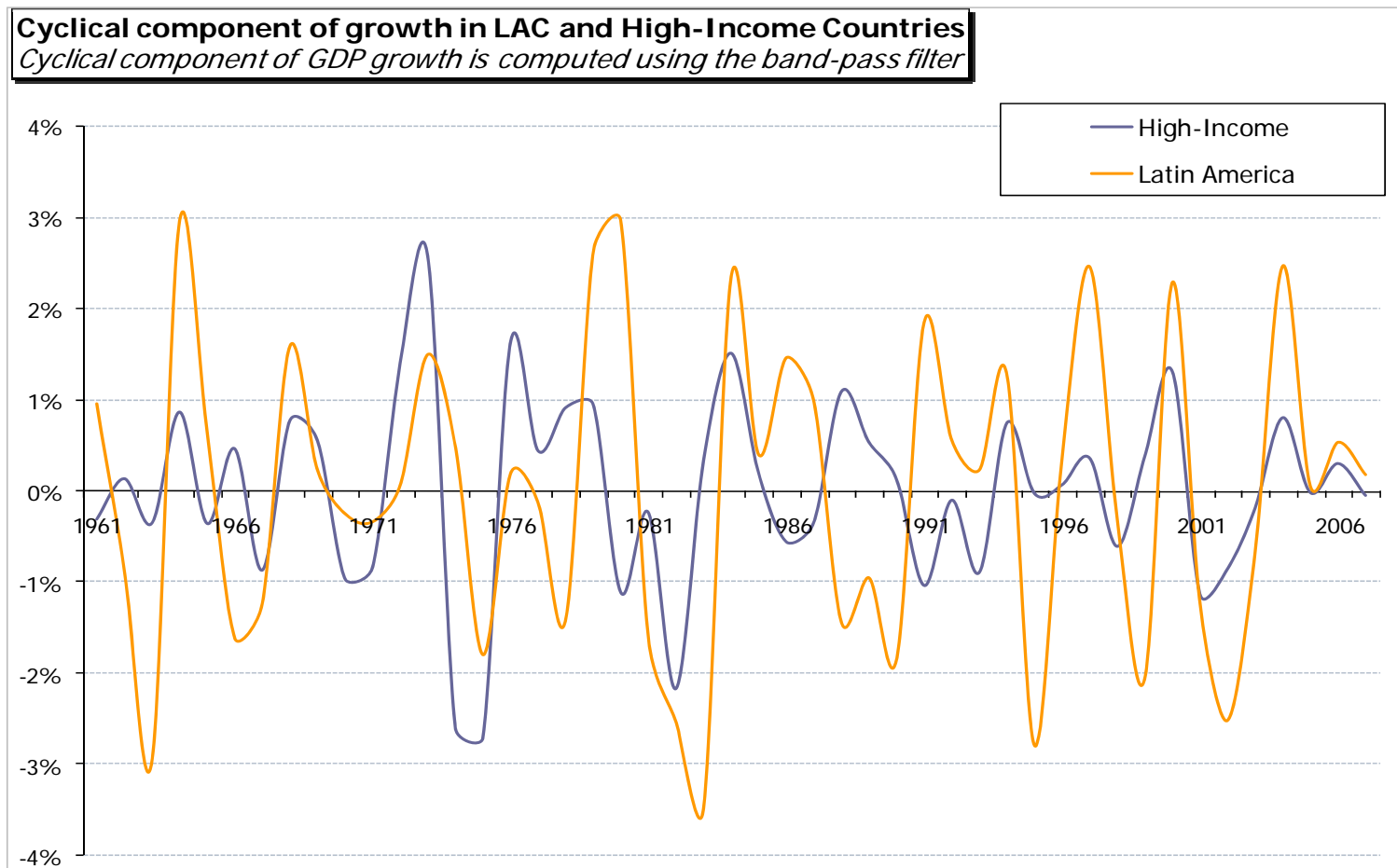
Latin growth forecasts have remained high even as U.S. growth projections fall

2008 GDP Growth Forecast for Selected LAC countries
consensus forecasts

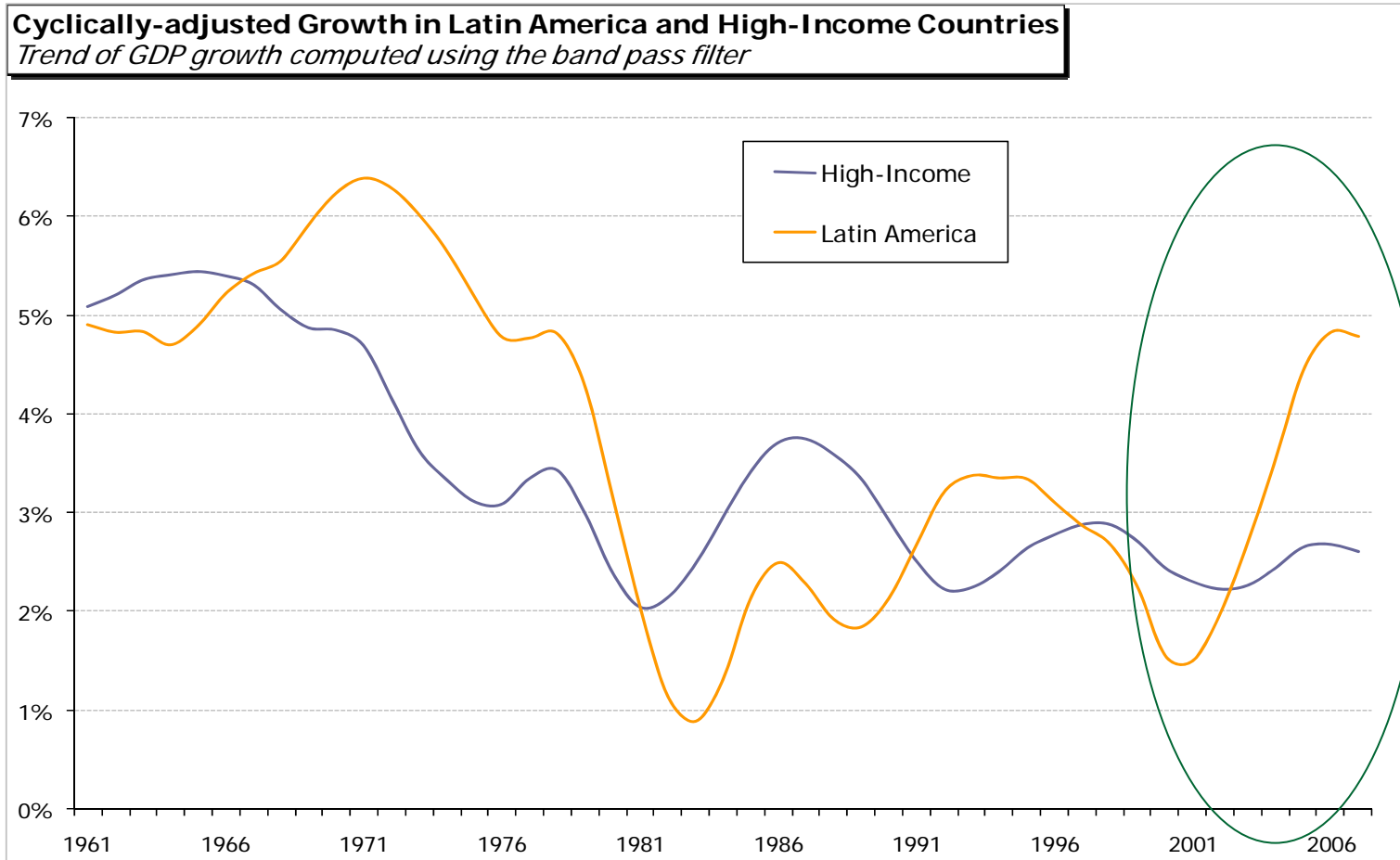


Source: Consensus Forecasts. Forecast computed as the mean of the forecast surveyed by private agencies.

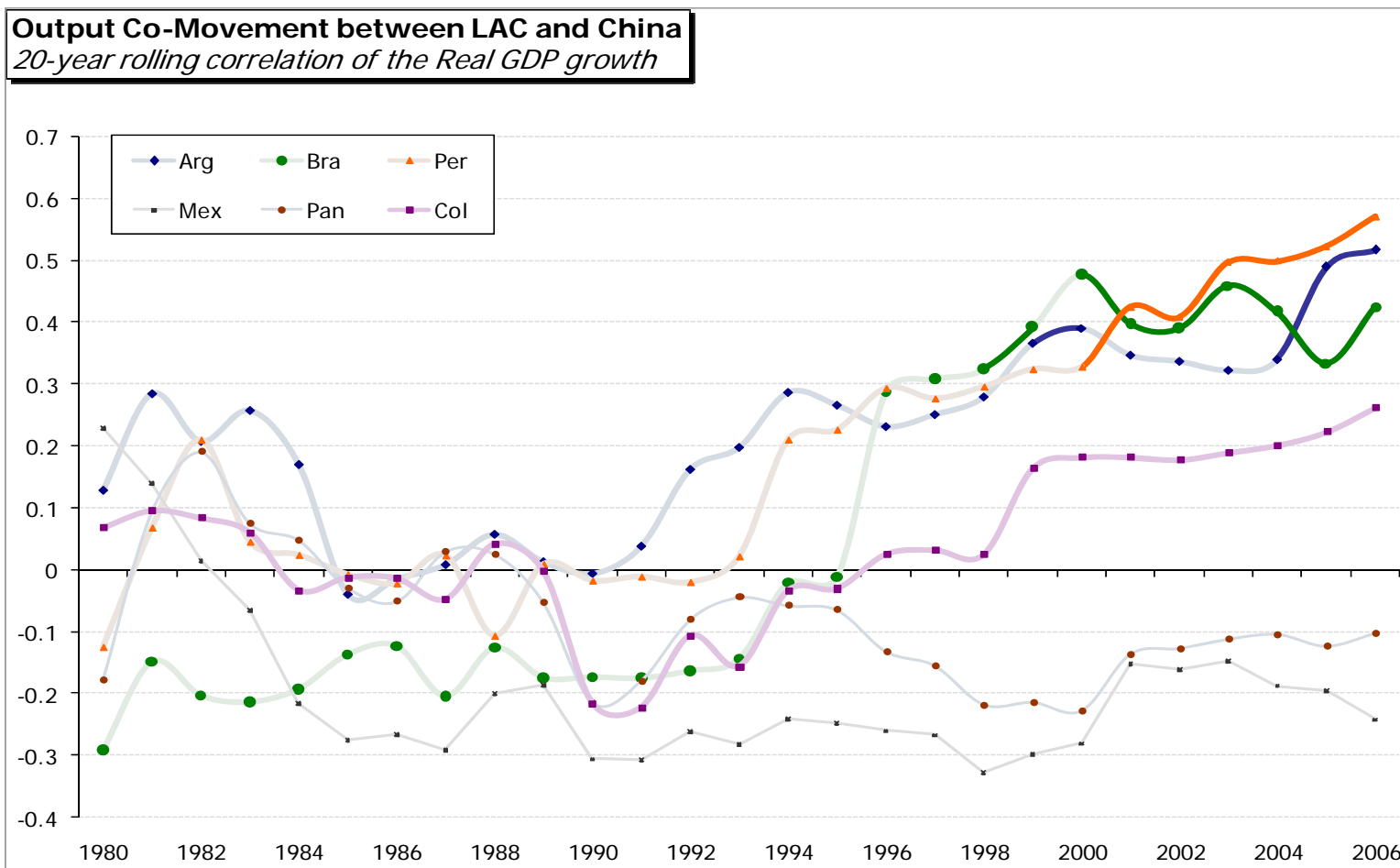
The *cyclical* components of growth in LatAm and high-income countries are clearly coupled...



... but do cyclically-adjusted growth paths suggest the beginning of *trend* decoupling?



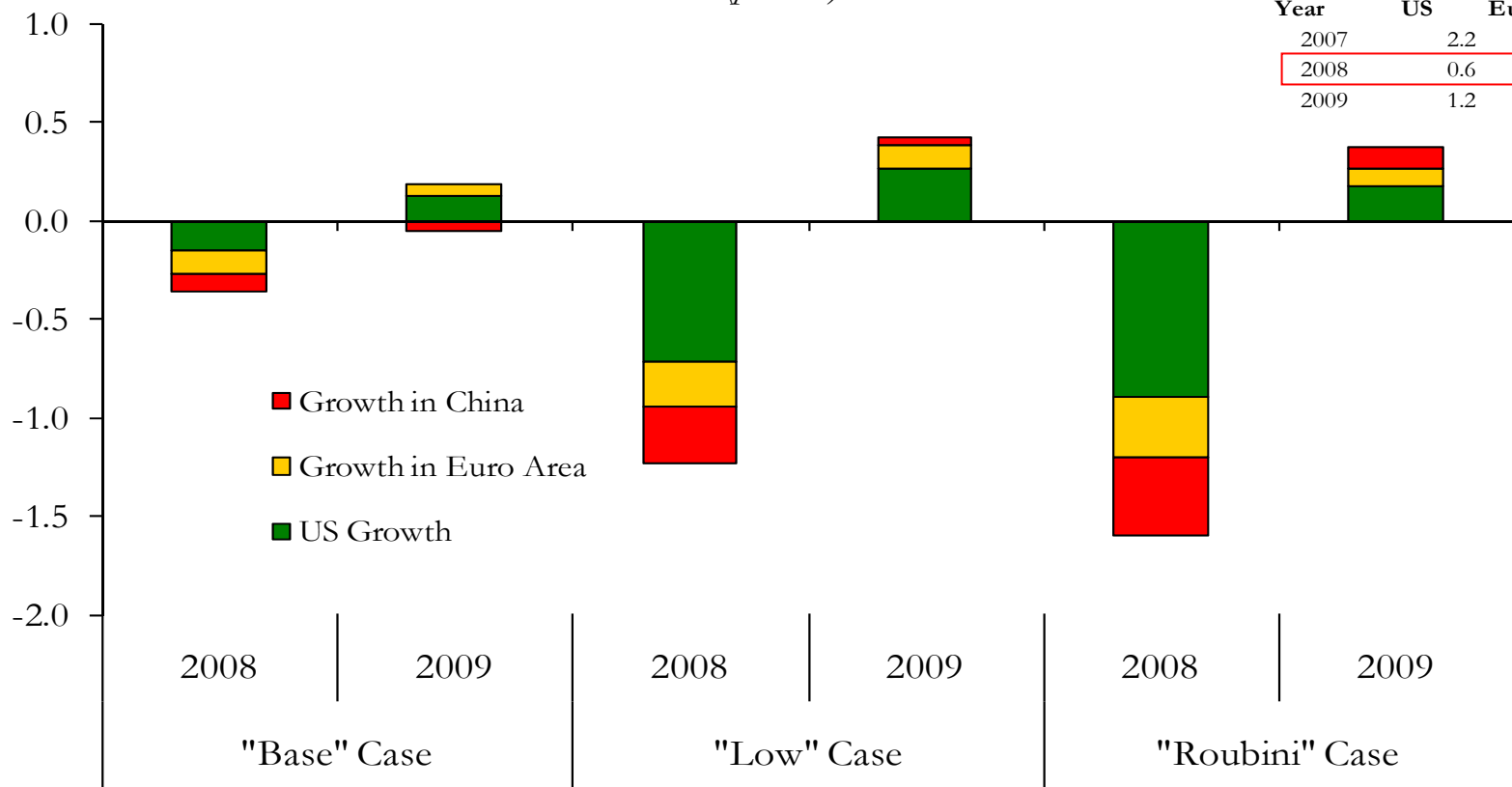
The co-movement of growth between Latin America and China has been on the rise...



Source: National Authorities. Note: Solid colors reflect correlation values significant at a 10% confidence interval.

Much of the cyclical effect on LatAm will depend on growth in China and Europe

Impact of US, Euro Area and China growth on LAC
(percent)



"BASE" Case

Year	US	Euro Area	China
2007	2.2	2.7	11.3
2008	1.9	2.1	10.8
2009	2.3	2.4	10.5

"LOW" Case

Year	US	Euro Area	China
2007	2.2	2.7	11.3
2008	0.9	1.6	9.8
2009	1.8	2.1	10.0

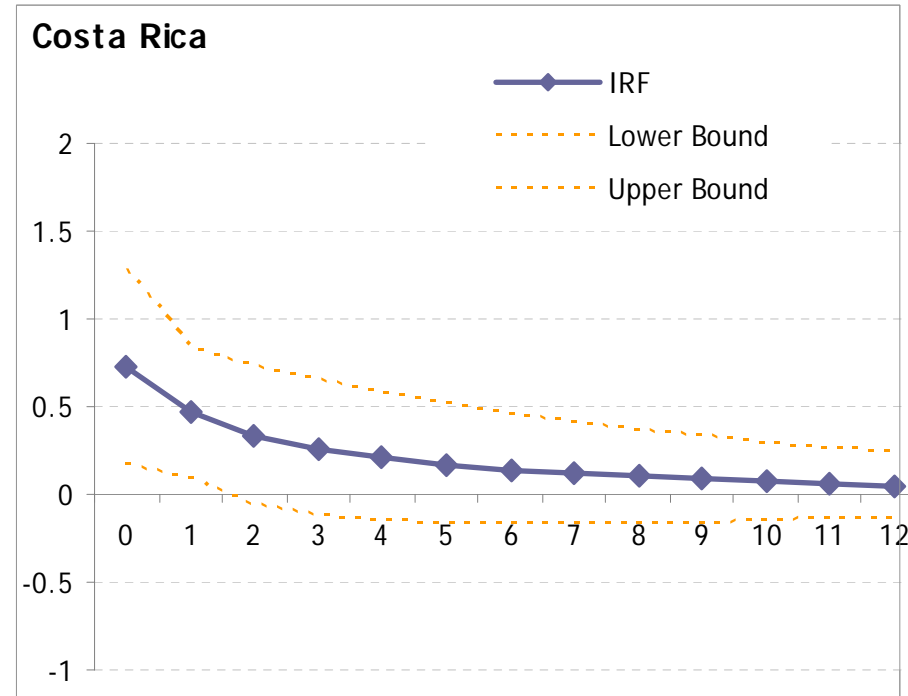
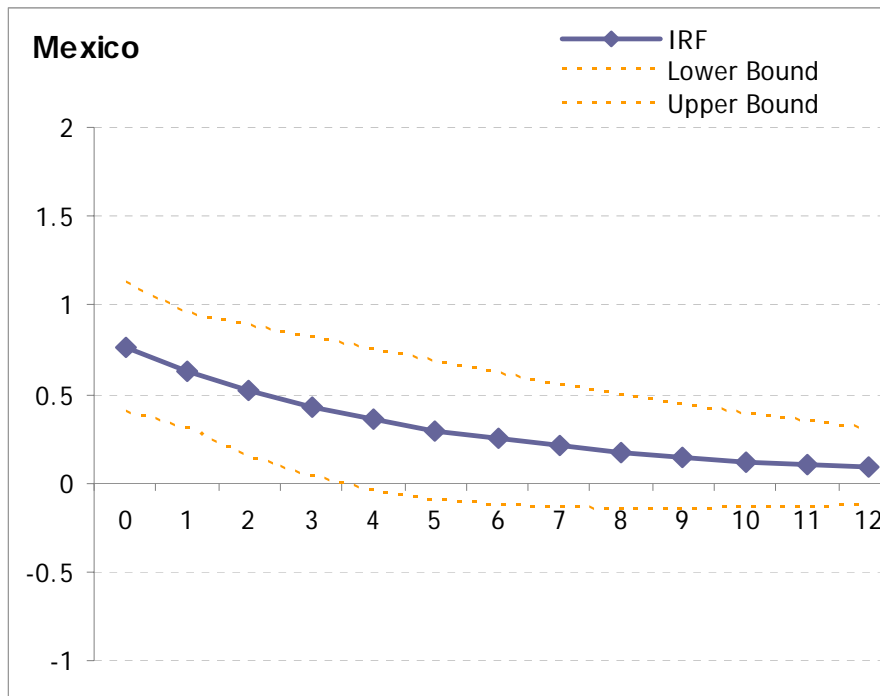
"Roubini's" Case

Year	US	Euro Area	China
2007	2.2	2.7	11.3
2008	0.6	1.2	9.2
2009	1.2	1.6	9.8

Heterogeneous impact of U.S. slowdown across countries – VAR approach

Direct effects dominate in countries tightly linked to the U.S. ...

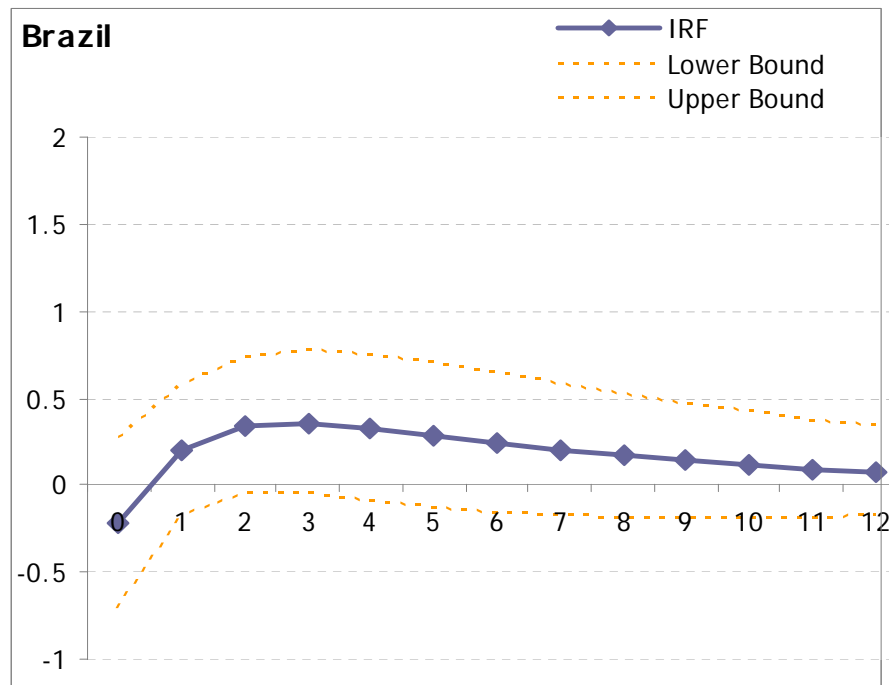
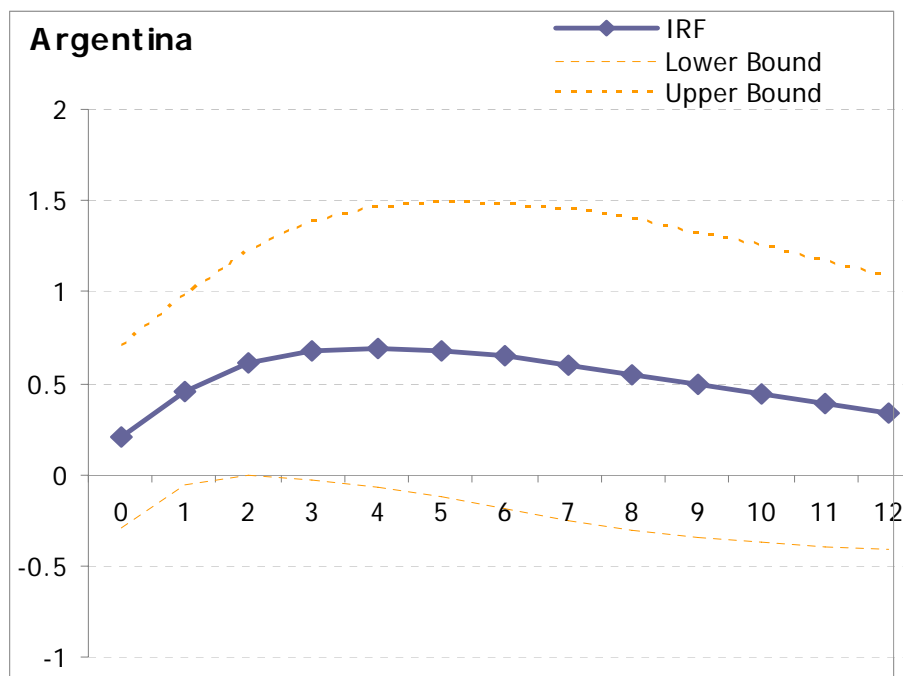
Impulse response function of a one standard deviation in the U.S. growth rate



Uneven impact of a U.S. slowdown – VAR approach

... and indirect effects in countries with diversified export markets

Impulse response function of a one standard deviation in the U.S. growth rate



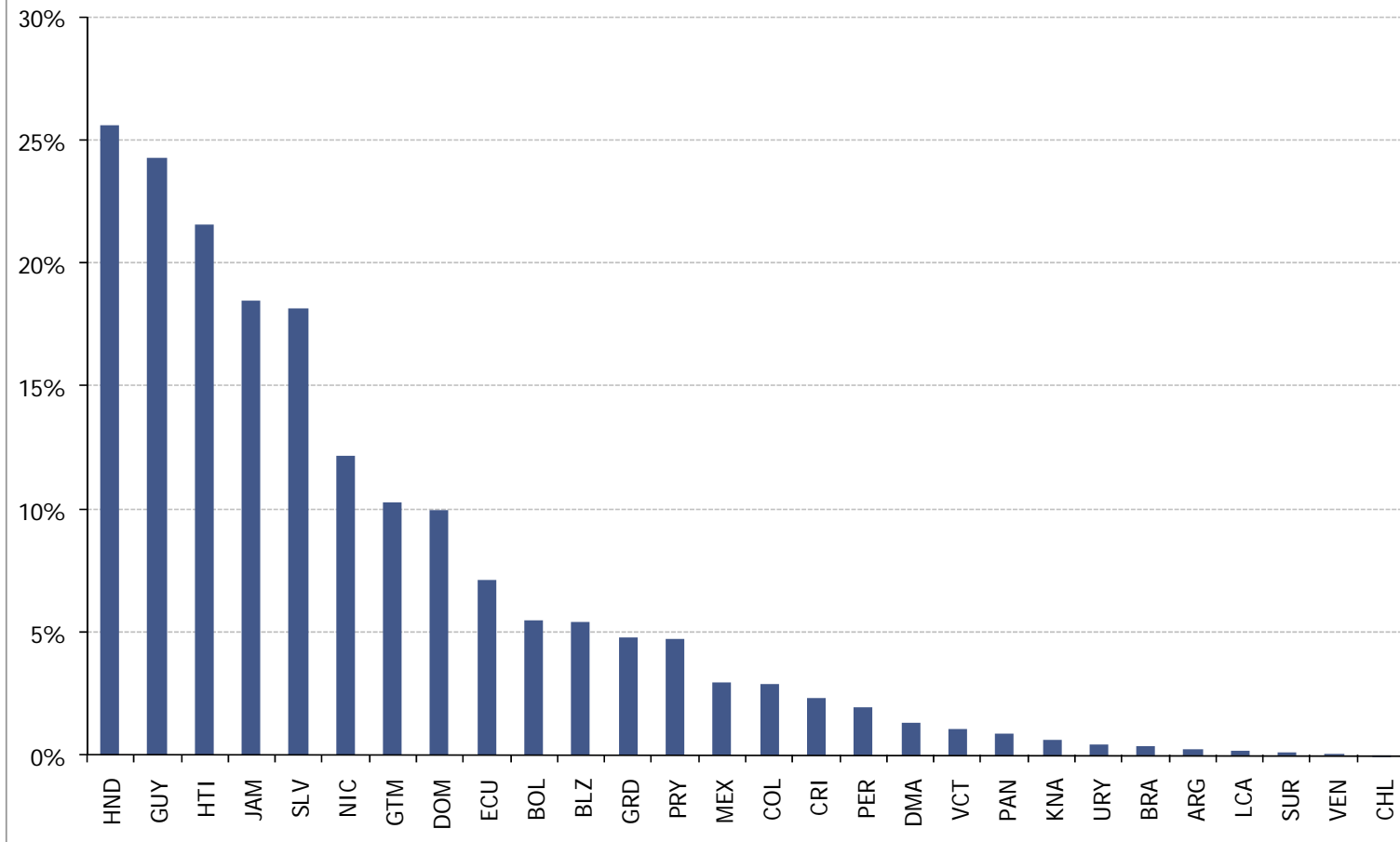
Note: VAR computed using a quarterly sample from 1994q1-2007q4. The VAR system states four separated equations, modeling the GDP growth for U.S., Europe, China and the specific country of LAC. The model contains the change in the terms of trade, the change in the real exchange rate, the real international interest rate, the local inflation, and specific country dummies. Source: Bloomberg, Haver, National Authorities. Elaborated by the LAC Chief Economist Office, WB

The real channels

Remittances – their decline hurts a well-defined set of Latin countries

Remittances represent 10-20 percent of GDP in eight Caribbean and Central American countries

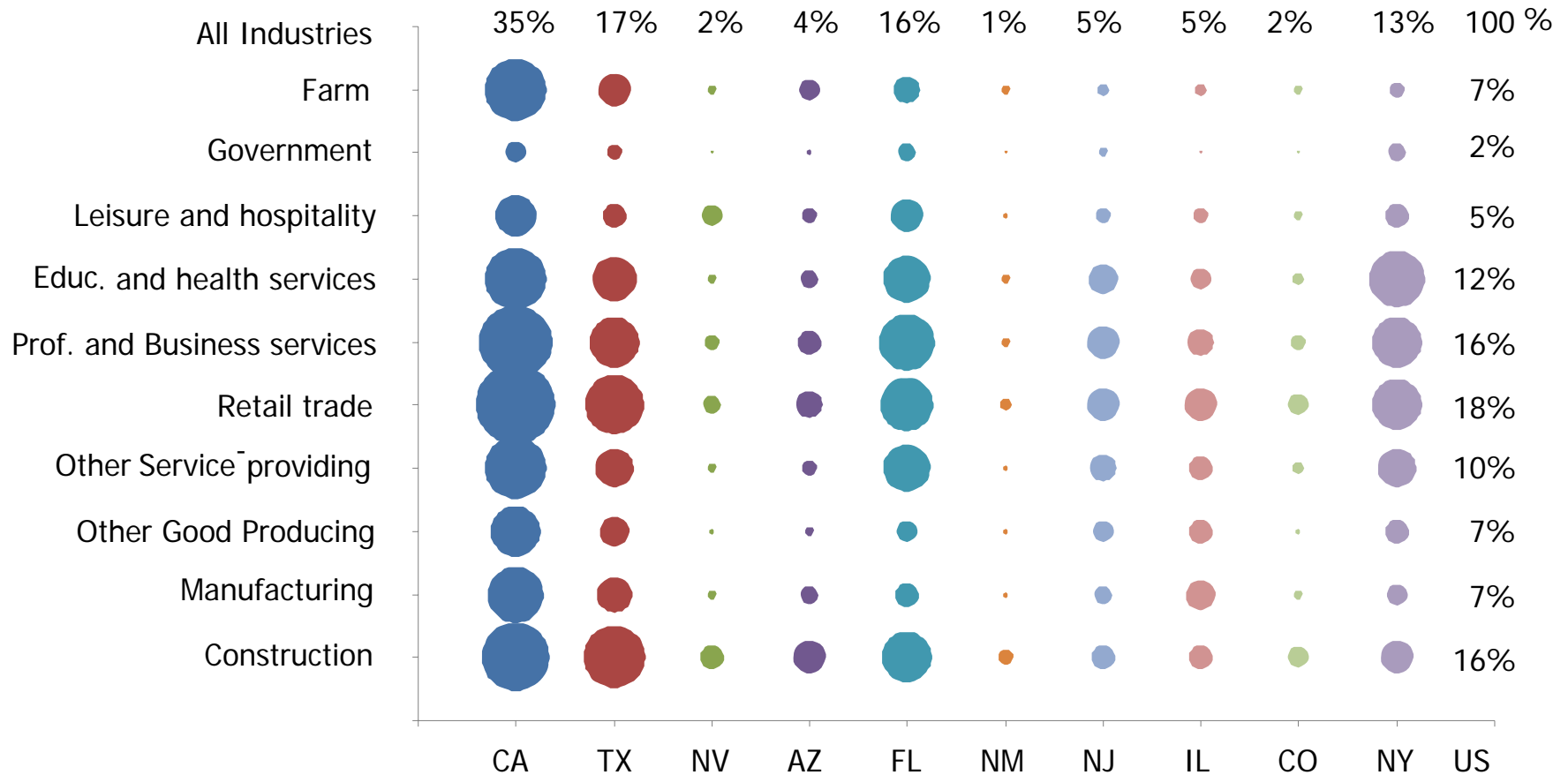
Remittances to LAC in 2006
(Remittances inflows as % GDP)



Latin migrants in the U.S. work in states and economic sectors that are hit hard by current crisis

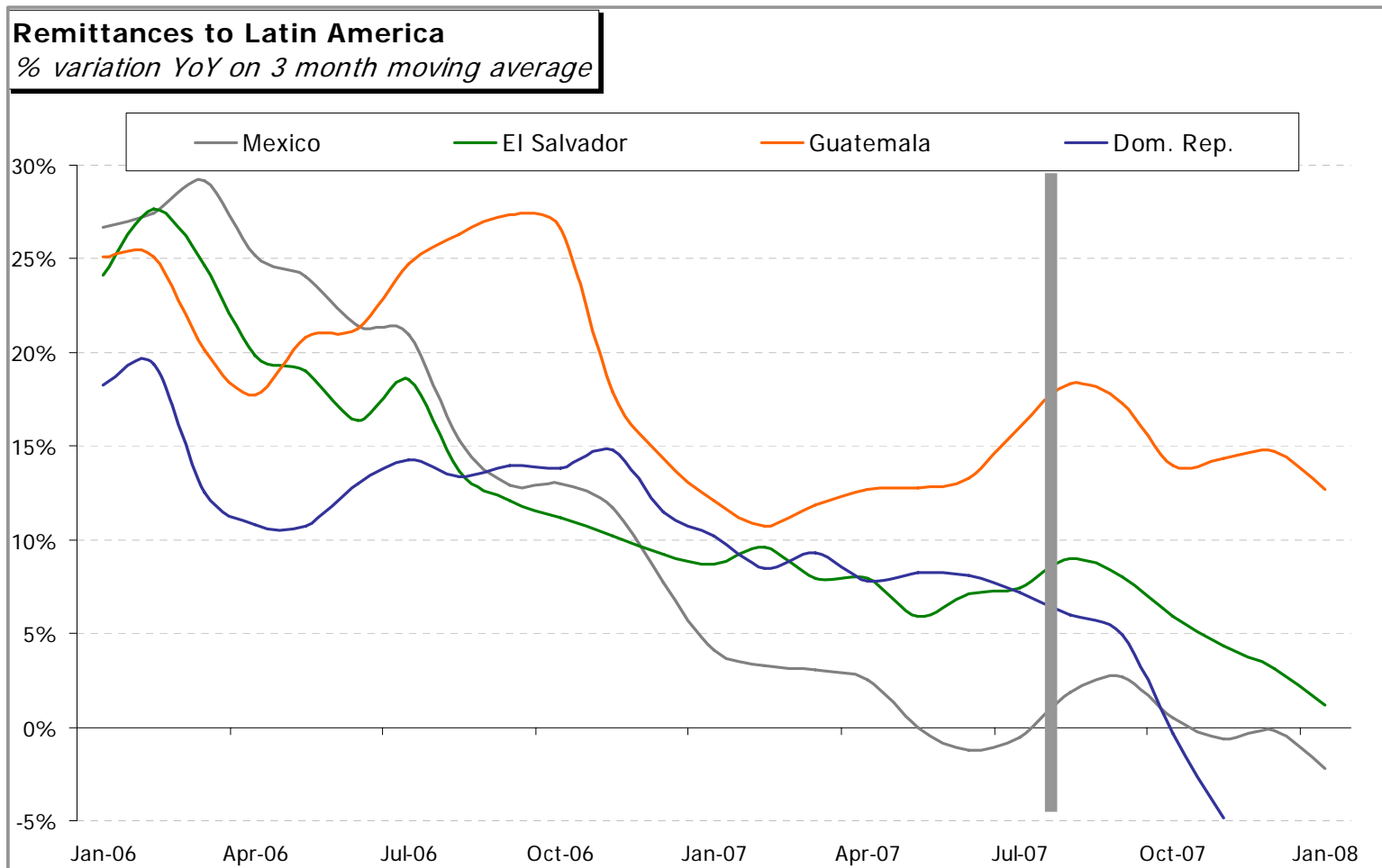
Latin Americans inmigrnats in the US
by states of residence and industry sector

(15 million)



Source: IPUMS – 2006 census. US Pop. filtered by birthplace. States shown account for 80% of the total. Size of bubbles represent immigrant population size.

It is thus not surprising that the growth rate in remittances to LatAm has been decelerating



A U.S. recession would significantly increase poverty among recipients, but only modestly nationwide

Poverty rates would increase by 17% among remittance recipients:

$$\begin{array}{rcl} \Delta(R / GDP) & \hat{\alpha} & = \% \Delta P^{LAC} \\ (2.66) & \text{Elasticity of recipient poverty w.r.t. (R/GDP)} & \\ & (6.6) & = 17.5 \end{array}$$

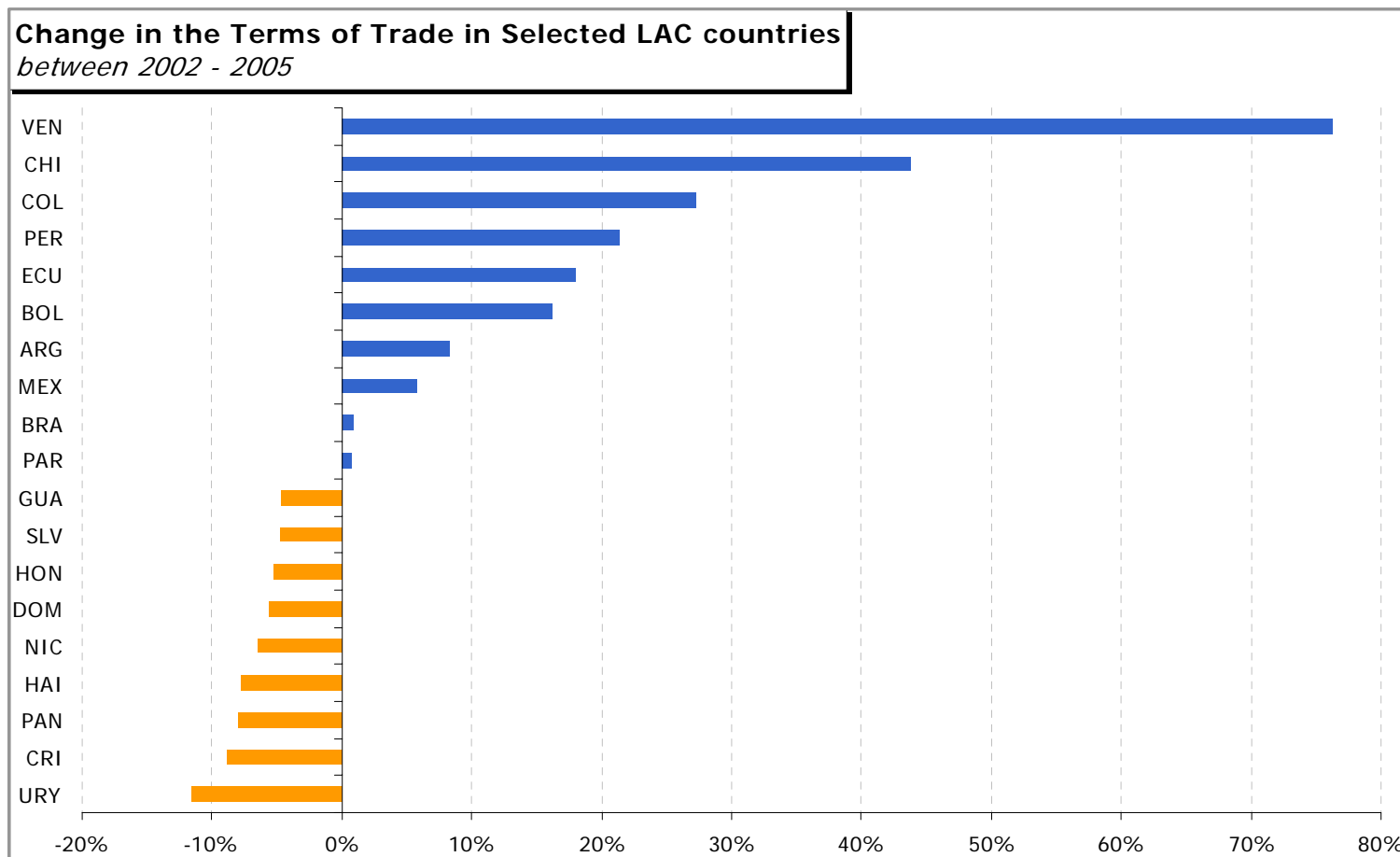
Poverty would increase by only 1% at the national level:

$$\begin{array}{rcl} \Delta(R / GDP) & \hat{\delta} & = \% \Delta P^{LAC} \\ (2.66) & \text{Elasticity of poverty w.r.t. (R/GDP)} & \\ & (0.39) & = 1.04 \end{array}$$

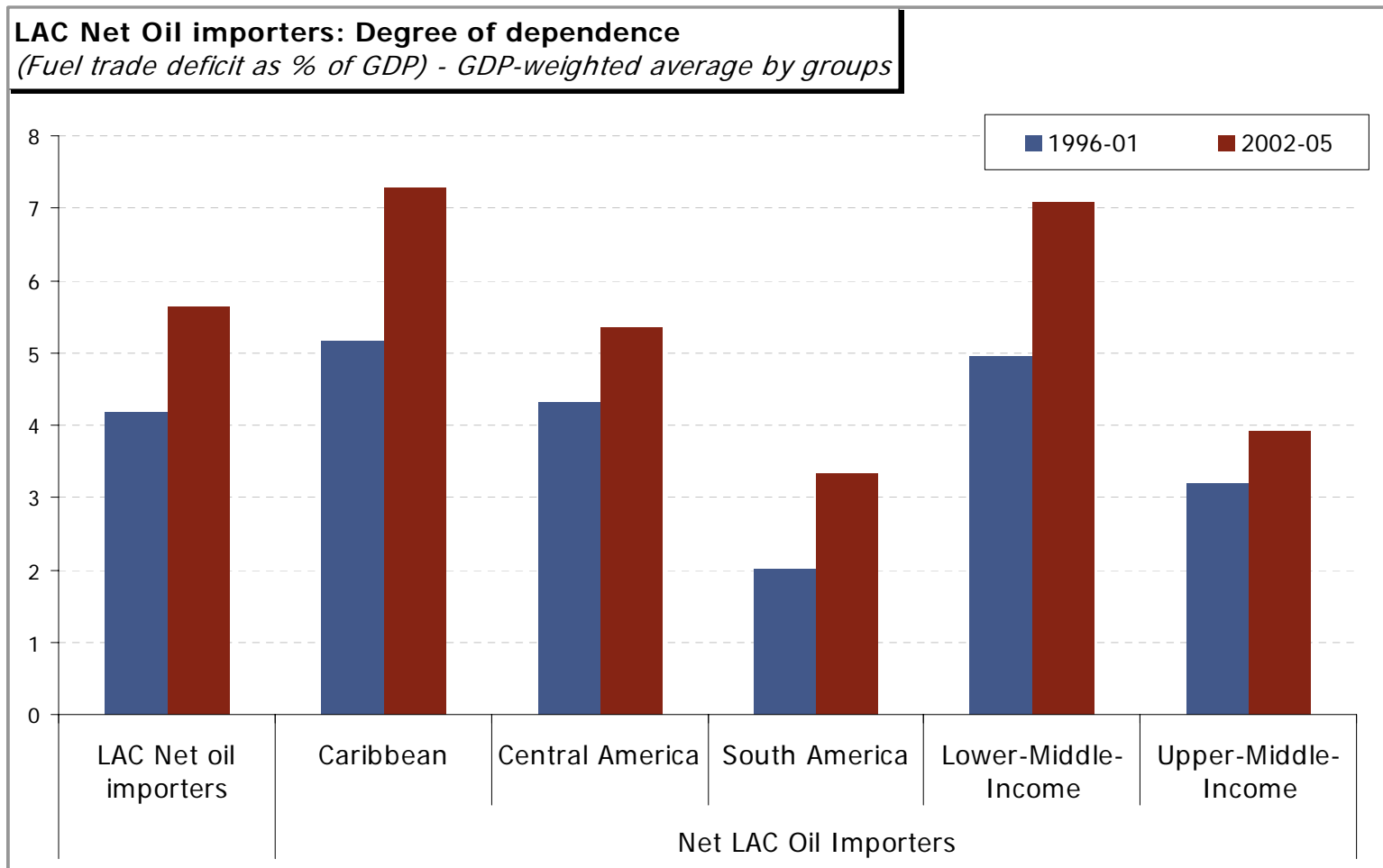
The real channels

Commodity price increases – asymmetric effects
across and within Latin countries

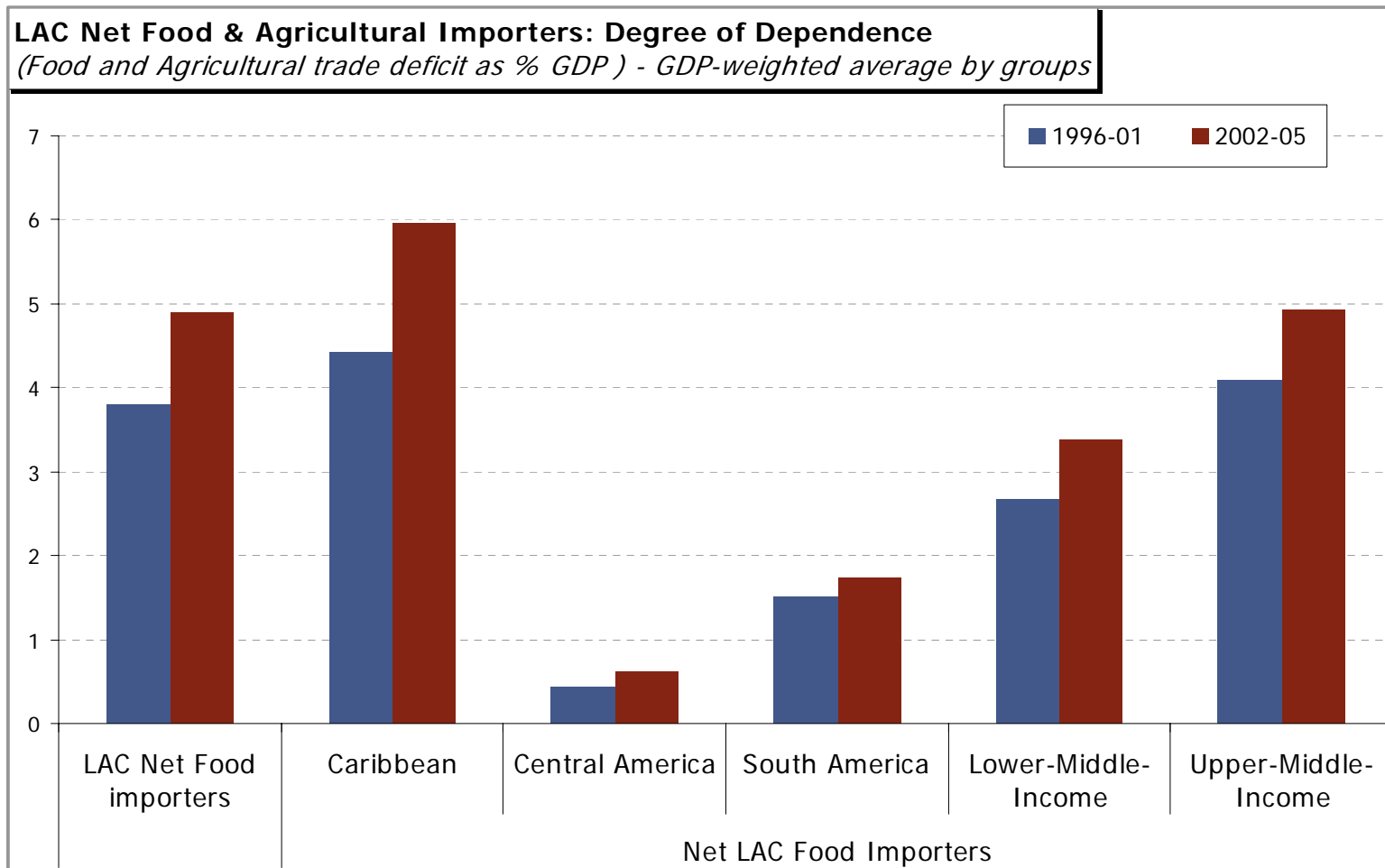
Changes in commodity prices have a highly heterogeneous effect on Latin economies



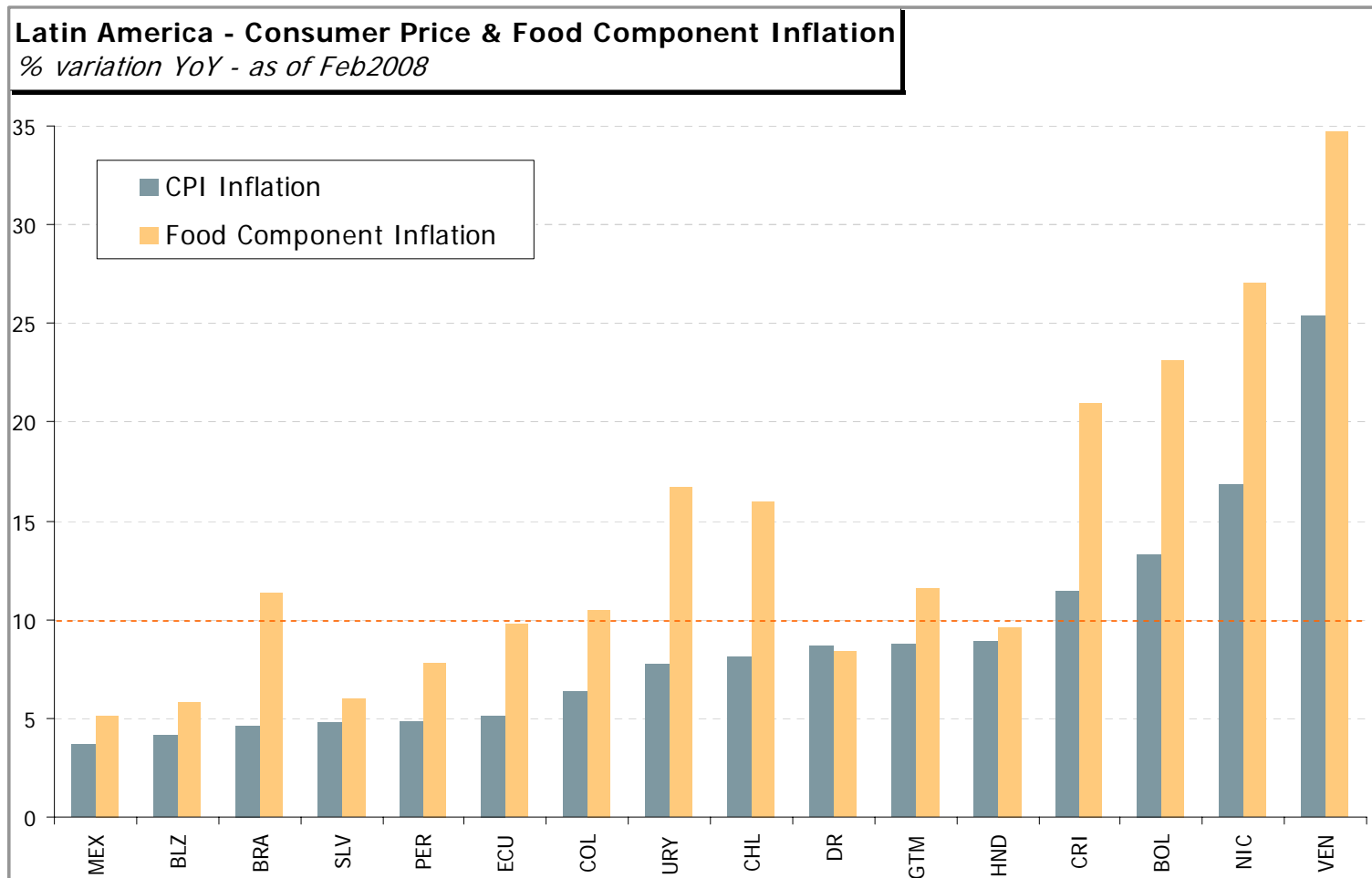
High oil prices hurt mainly the small and low-income countries in Central American & Caribbean...



High agricultural commodity prices hurt mainly middle-income Caribbean & South American countries



The pass-through of rising international food prices has uneven distributional impacts within countries



The region's capacity to respond

Latin America is better positioned this time, but some factors restrict the scope for countercyclical policies

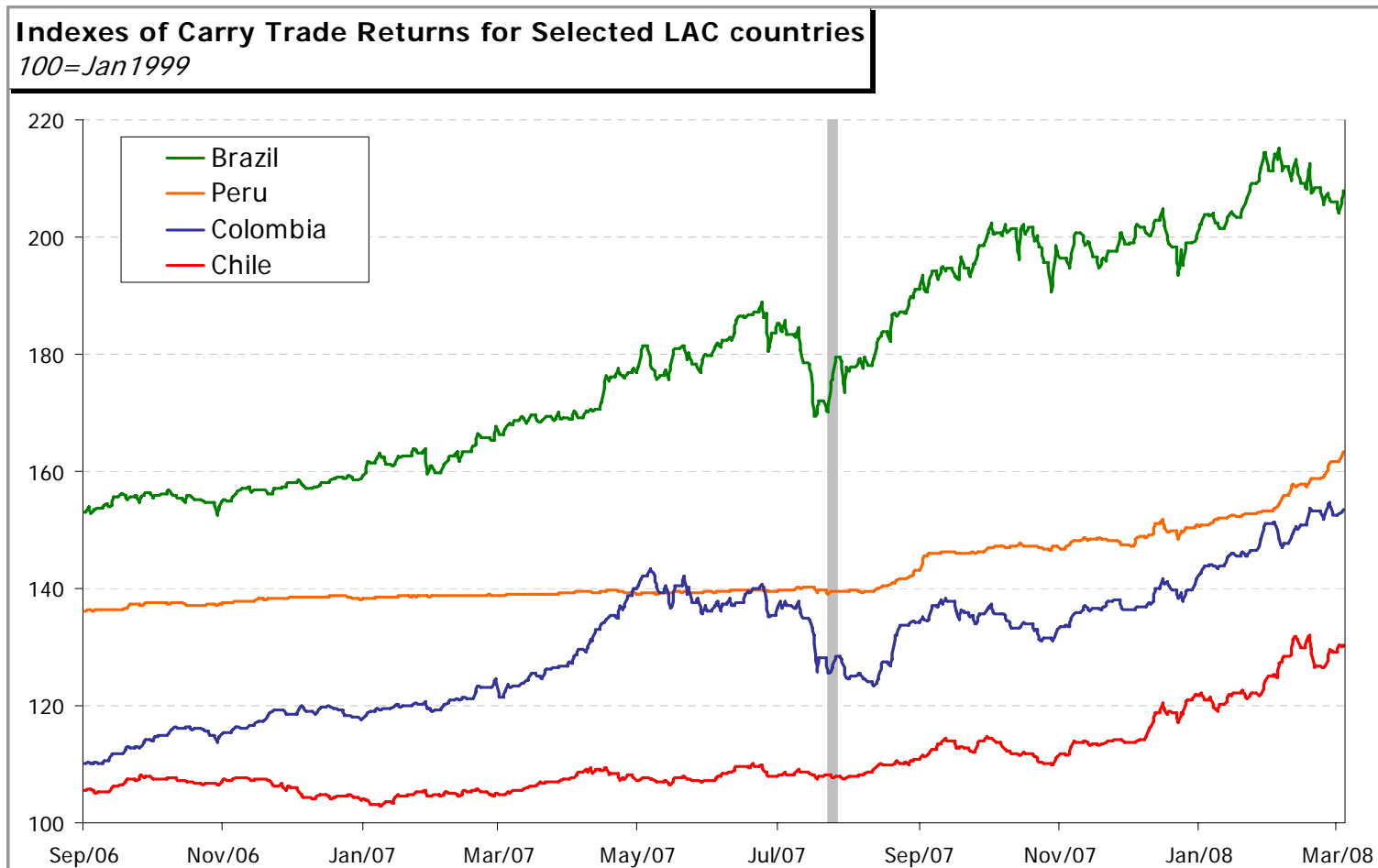
Latin American vulnerability to sudden stops has fallen considerably...

- A stronger immune system, associated with...
 - Higher FX liquidity cushions
 - Lower public sector and external borrowing requirements
 - Exchange rate flexibility
 - Lower exposure to currency, interest rate, and rollover risks in public sector debt portfolios
 - Significant increase in local currency-denominated loanable funds in domestic markets
- ... has reduced the *beta* of the region, on average

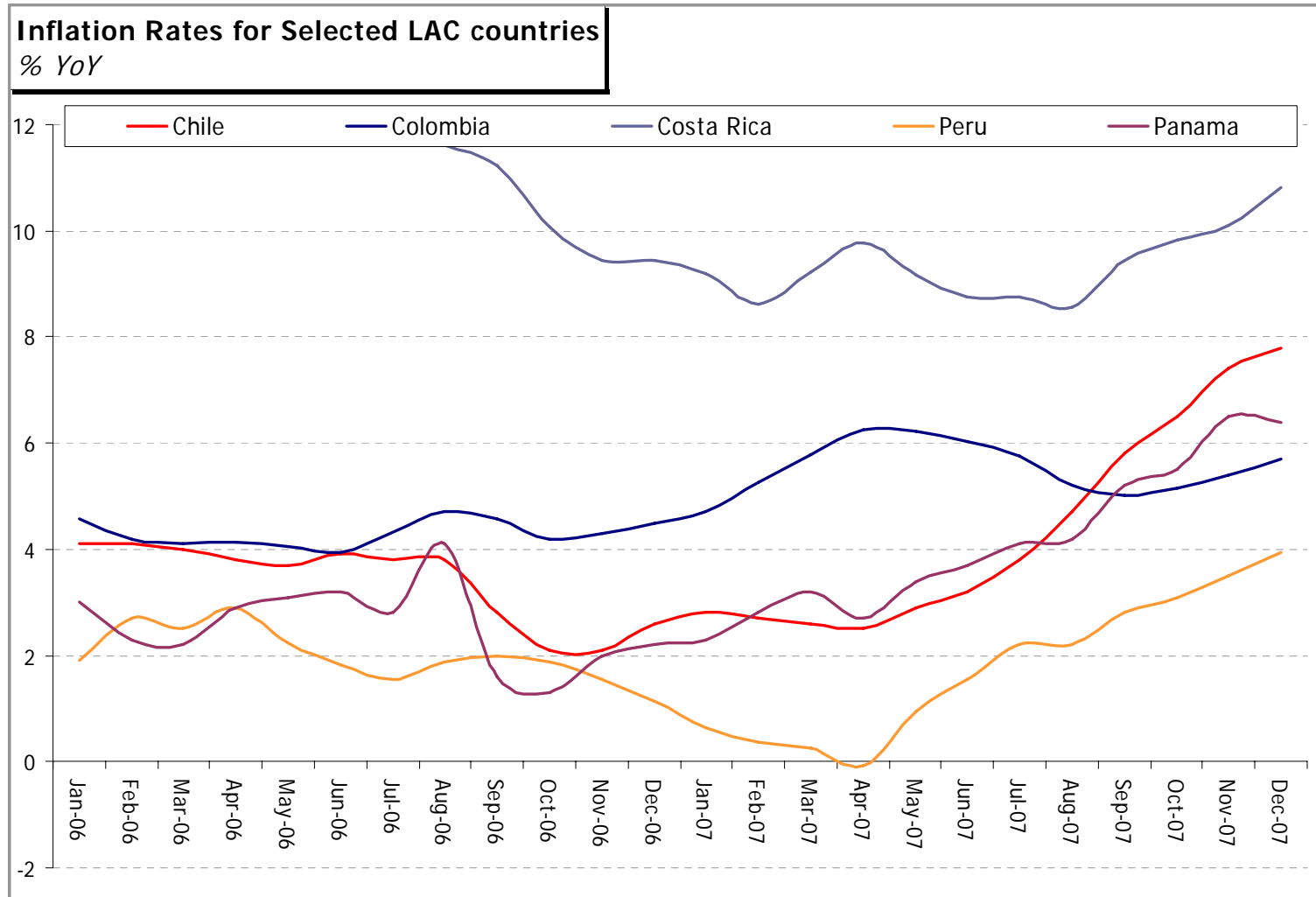
... but there are constraining factors to the scope for policy maneuvering

- Dealing with the distributional implications of the pass-through of international to domestic prices
- Monetary policy facing a difficult dilemma

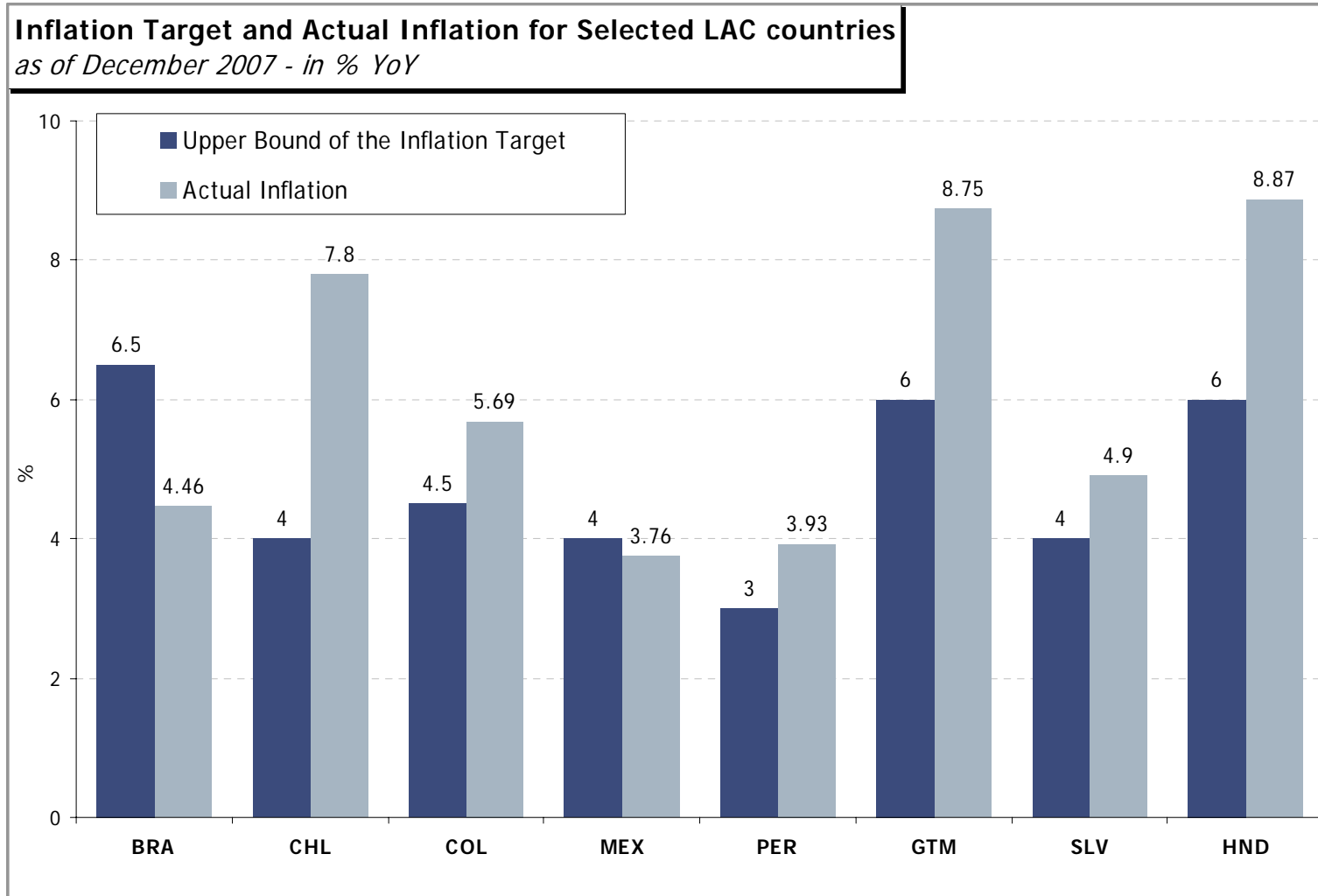
Monetary policy faces a dilemma: currency appreciation exacerbated by “carry trades” ...



... and the recent pick up in domestic inflation...



... running above target in many Latin countries



END