

## LATIN AMERICA AND THE GLOBAL CRISIS OCTOBER 8, 2008

### *Sharp deterioration of the external front*

Since our previous outlook for Latin America and the Caribbean (LAC) in April 2008, the external environment has deteriorated significantly. Three inter-related global shocks are hitting the world economy: the financial crisis, the slowdown in growth, and changes in international relative prices (notably, a weakening of commodity prices). These shocks are becoming larger, increasingly reinforcing each other and spreading rapidly around the world, although their relative importance for different countries continues to evolve. The global crisis is already hitting the LAC region even as uncertainty about how the crisis will unfold mounts.

In particular, the world is facing a financial crisis of unprecedented dimensions that is reshaping the global financial landscape and eliciting government interventions of unparalleled scope and magnitude. The crisis was triggered by sub-prime lending excesses in the U.S. housing market but has spread relentlessly to other financial markets within the U.S. and overseas. A string of failures of major financial institutions and deep disruptions in credit markets have contributed to a sense of panic, fueled by the “*fear of the unknown*.” As a result, financial intermediaries and investors have shifted out of riskier assets into cash and cash-like assets, and this has been associated with a freezing of credit lines. Things have recently taken a turn for the worse as the financial crisis has spread to other systems, notably in Europe but also Hong Kong and Russia, which have also witnessed bank failures, steep equity price drops, and runs on deposit and deposit-like instruments. There are, as a result, increasing concerns on the effects that the financial meltdown will have on the real economy. Most worrisome, risk aversion continues to rise, bank runs to intensify, and the credit crunch to stiffen despite escalating efforts by the government of rich countries to pump liquidity into the system and use public funds to rescue financial institutions that are too important to fail, guarantee deposits and money market funds, protect socially-sensitive debtors, and support key credit markets.

As the global financial crisis worsens so have the forecasts and downside risks to world-wide growth. Many advanced and emerging market economies have been revising their growth projections downwards. Growth in the US for 2009 is expected to fall between +1.0 and -0.2 percent—led by a substantial deceleration in consumption and private investment and despite strong export performance. Growth forecasts for Europe and Japan in 2009 are also being revised downward, to between 0.1 and 1.2 percent in the former and between 0.4 and 1.3 percent in the latter. All this has also raised concerns about a possibly greater deceleration of growth in China, estimated to range between 7.0 and 8.5 percent in 2009 (down from 9.8 percent in 2008 and 11.9 percent in 2007), although this country is believed to have substantial means to stimulate its domestic economy.

**The global slowdown is already weakening commodity prices.** Slower growth implies less demand for oil, industrial metals, and grains and this has been reflected in significant declines in commodity prices over the past months. For instance, international energy prices declined more than 20 percent during the third quarter of 2008, while international prices for food and metals and minerals decreased by more than 15 and 10 percent, respectively. Much uncertainty remains, however, about the level of commodity prices in the medium and long term.

### *The global crisis is spreading to Latin America through various transmission channels*

The following channels of transmission are of particular relevance to the region:

- a) Financial contagion
- b) External demand
- c) Changes in relative prices

### *Financial contagion has already reached the LAC economies*

**Financial markets in the LAC region are already experiencing the effects of the global crisis.** Latin America has witnessed a slowdown in portfolio flows, large declines in stock price indexes, and significant currency adjustments—with the latter in large part associated with the unwinding of previous speculative short-run positions (the so-called “carry trades”). External borrowing costs have increased sharply, particularly for Latin firms but also for Latin sovereigns. The average EMBI spreads for Latin corporates and sovereigns rose to 578 and 603 basis points, respectively, as of October 7, 2008. Note, however, that this deterioration in risk premiums takes place from a historically low level of spreads, high equity prices, appreciated currencies, and record capital inflows. Moreover, these effects have not been particularly more pronounced in Latin America than in other emerging regions. Perhaps more importantly, other key financial indicators do not appear to have worsened yet: FDI inflows to the region have remained high according to the latest estimates and local currency debt and interbank markets have remained relatively well behaved across most countries. Nevertheless, given the continuing unfolding of the global crisis, local financial conditions need to be closely monitored. In particular, firms that generally tap international markets for financing might have to switch to domestic sources of funding, pushing up borrowing local costs and possibly crowding out smaller firms that have nowhere else to go for their financing needs. In addition, the global reduction in credit risk exposures and flight to cash may induce the international banks operating in the region and/or the local banks that rely heavily on their foreign bank correspondents to recoil sharply in their local lending activity.

### *Rising concerns on the cyclical impacts of the global slowdown*

**The likely stagnation of growth in the rich countries and sharp deceleration in emerging Asia will adversely affect LAC growth.** The main channel will be the decline in the world’s demand for LAC exports. Falling remittances, weakening commodity prices, higher borrowing costs, and the lagged impact of the tight monetary policy that LAC countries have hitherto been pursuing to tame inflationary pressures will exacerbate the situation. Thus, the cyclical downturn

in LAC is now envisaged to be more pronounced and subject to a widening of downside risks. In particular, growth in LAC is expected to slow down from 5.6 percent in 2007 to an estimated 4.6 percent in 2008 and to between 2.5 and 3.5 percent in 2009. Although the slowdown in LAC will be greater than previously expected, the deceleration will occur from a relatively high growth trend achieved in recent years. Of course, countries that are tightly linked to the U.S. economy (due to trade links and remittances, among others)—such as Mexico and Central American countries—are already feeling the impact. Countries that are relatively more linked to other regions—such as Argentina, Peru, and Brazil—will see a somewhat mitigated and delayed impact, as long as China’s growth remains robust. Moreover, the ability of LAC countries to bounce back to a high growth trend after the global slowdown passes is quite heterogeneous. The countries that are likely to perform better will be those that have in the past years managed to reduce macro-financial vulnerabilities, increase investment rates, diversify export markets, and restore productivity growth.

### *Commodity prices changes have markedly asymmetric effects across LAC countries*

**The softening of commodity prices arising from the slowdown of the global economy will deteriorate the terms of trade of the region as a whole.** Latin America is a net commodity exporter. Over 90 percent of the region’s GDP and population reside in net commodity exporting countries, which will be adversely affected by the decrease in commodity prices. This, of course, comes after a prolonged period where the same countries benefited significantly from the commodity price boom. Meanwhile, approximately half the countries in the region, mainly located in Central America and the Caribbean, are net commodity importers. For them, the recent downturn in the international prices of fuels, industrial metals, and cereals will provide some relief. Unfortunately, in many cases, this relief is offset by falling remittances inflows and stagnating economic growth. At the same time, the fall in international prices of foods and fuels is helping reduce the inflation pressures to which they formerly contributed.

### *The region is better positioned this time...*

**Considering the severity of the global shocks, LAC economies are, on average, weathering the crisis significantly better than in the past.** This is the result of notable improvements in macroeconomic and financial policies as well as a reduced net dependency on external capital inflows. In particular, over the past 5 years or so LAC has registered:

- a) A major reduction of currency and rollover risks in the governments’ debt portfolios and a simultaneous deepening of local currency debt markets
- b) A substantial increase foreign exchange liquidity buffers
- c) An increased flexibility in exchange rates, as part of more robust and credible monetary policy frameworks
- d) Much lower net public sector borrowing requirements.
- e) A shift to external current account surpluses or significantly lower deficits.
- f) The freeing of fiscal space for and a higher weight given in fiscal spending to education, health, and social protection.

Despite these overall improvements, the ability to manage the current crisis differs notably across countries in the region.

*...yet the global shocks are much larger and the global outlook is significantly bleaker now*

**While there is great uncertainty on the ultimate consequences of the global shocks on the LAC region, downside risks have widened, forcing a reconfiguration of policy challenges and priorities.** In particular, the threat of inflation, previously a great policy concern in LAC, has arguably subsided. Inflation expectations have in fact begun to decline and the rate of inflation to decelerate in several countries, not least because of the tightening of monetary policy that took place in past months but also due to weaker commodity prices and lower growth prospects. At the same time, policy concerns with the financial turmoil and growth deceleration have moved to center stage. The ability of LAC countries to respond to these deteriorating circumstances will depend on the extent of their financial and real vulnerabilities. On the monetary front, authorities will be faced with the decision of whether and when to ease. The answer will depend in part on how much inflation has been tamed and the degree of stress in financial systems and currencies. On the fiscal front, authorities in many a Latin American country will have to weather a contraction in revenues, associated with falling commodity prices and/or lower economic activity. The ability to cope with this fiscal challenge while maintaining key social and investment spending—and thus avoid an unnecessary increase in poverty and inequality—will depend on the availability of self-insurance buffers (which some countries like Chile prudently built during the good times), the degree of expenditure rigidity, and the room to borrow prudently. On the regulatory side, the current redrawing of the financial industry in Europe and the U.S. will prompt policymakers to discuss how to draw lessons, reformulate appropriately prudential regulations, and prepare for potential (yet hopefully unlikely) crisis management and resolution. For private sector financing, authorities may need to use wisely their access to multilateral lending to offset at least in part the potential of an internationally-driven credit crunch.