The Global Financial and Economic Storm: How Bad is the Weather in LAC?

Spring Meetings
April, 2009

Chief Economist Office
Latin America and the Caribbean Region
The World Bank

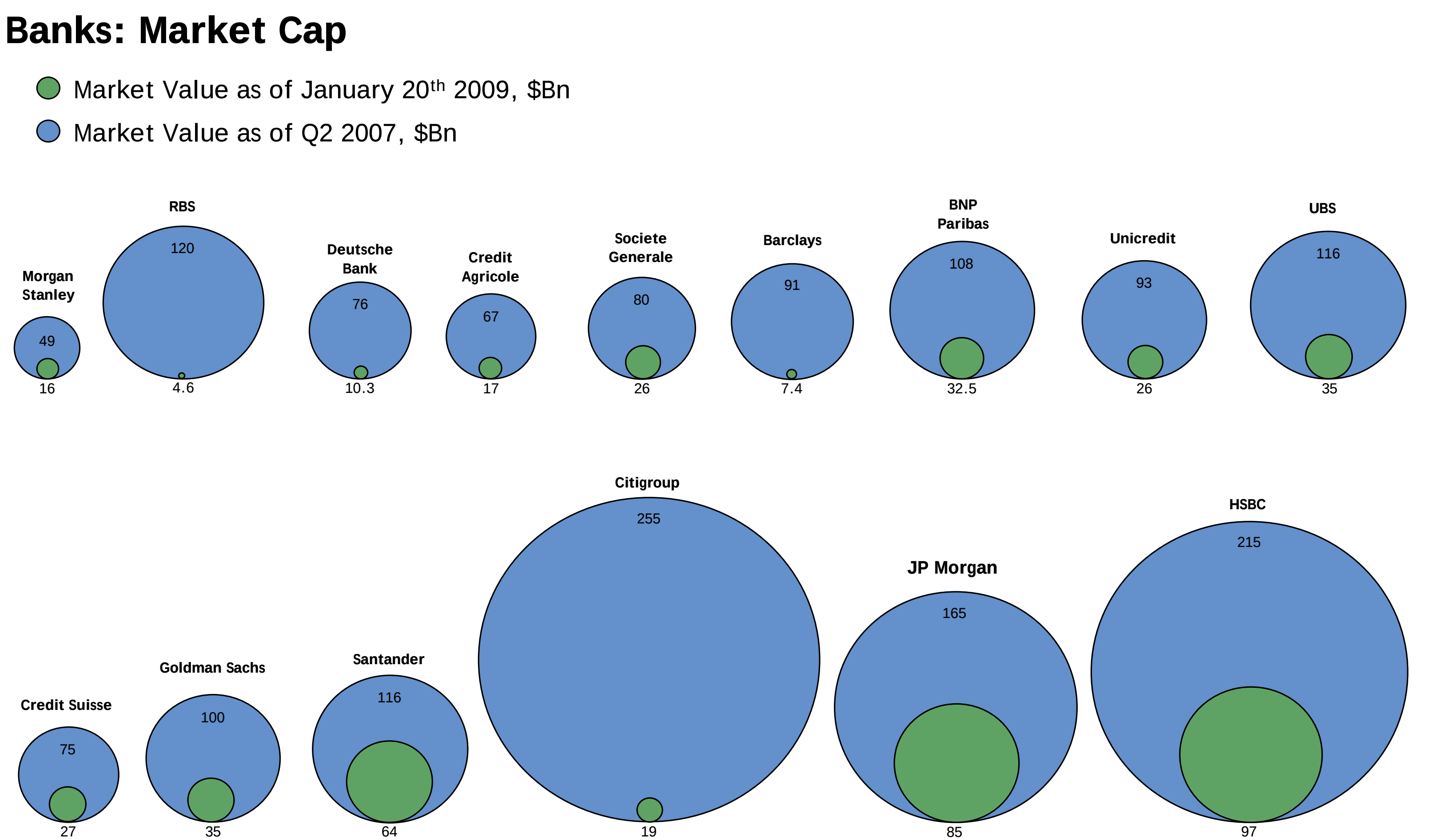
World Bank
Latin America and the Caribbean Region

Outline

- The eye of the storm is in the center…
- … but very bad weather is spreading to the periphery
- Desirable responses are restricted in practice
- LAC is less vulnerable compared to its own past…
- …and, in some respects, compared to other regions
- LAC is likely to avert a systemic financial crisis, but will inevitably endure a recession
- LAC is relatively more vulnerably in the social arena
- What is LAC’s room for countercyclical policy?
- Summing up

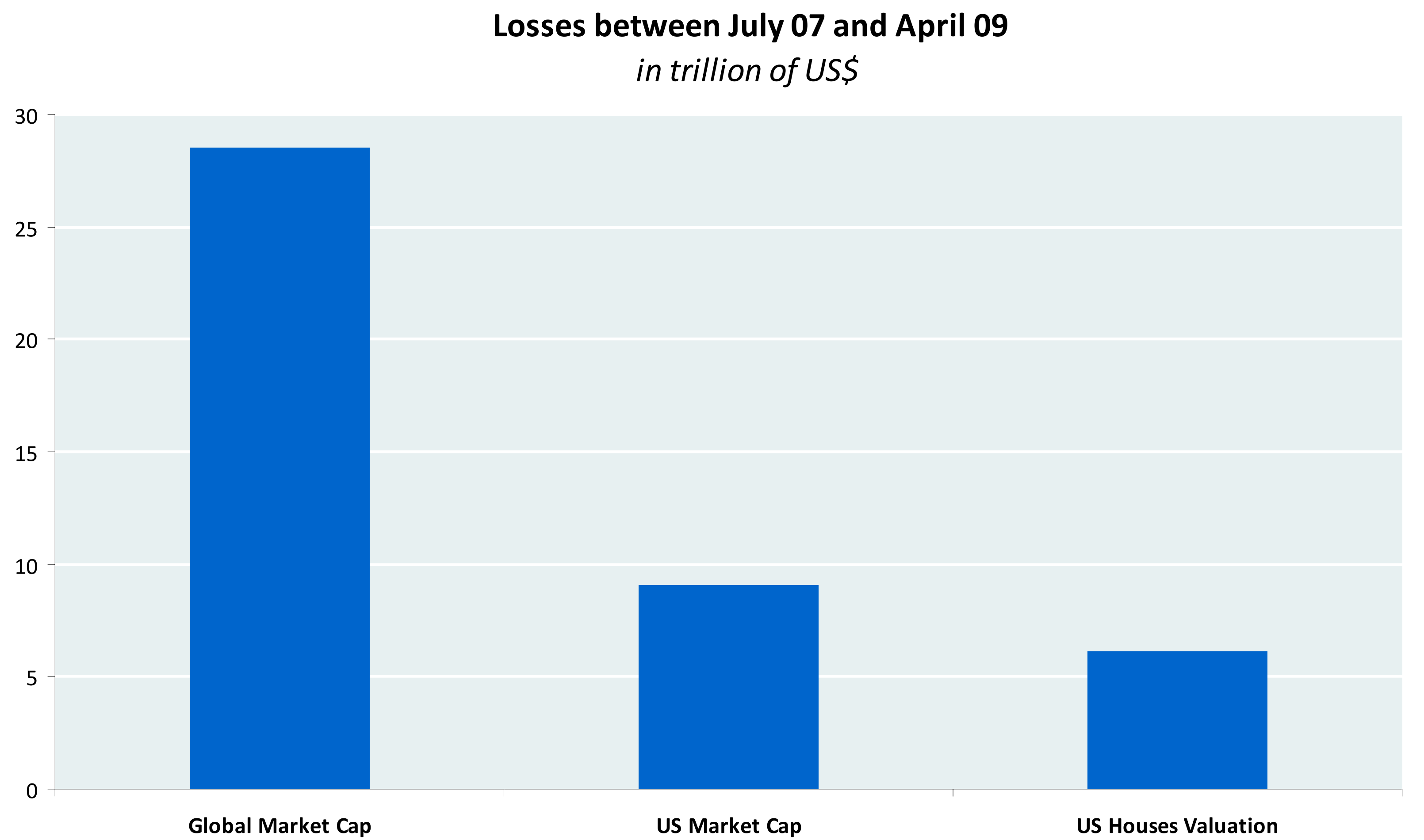
The eye of the storm is in the economies of the center…

Financial crisis has resulted in an unprecedented destruction of banks' net worth…



Source: Bloomberg, Jan 20th 2009

… and of assets values more generally

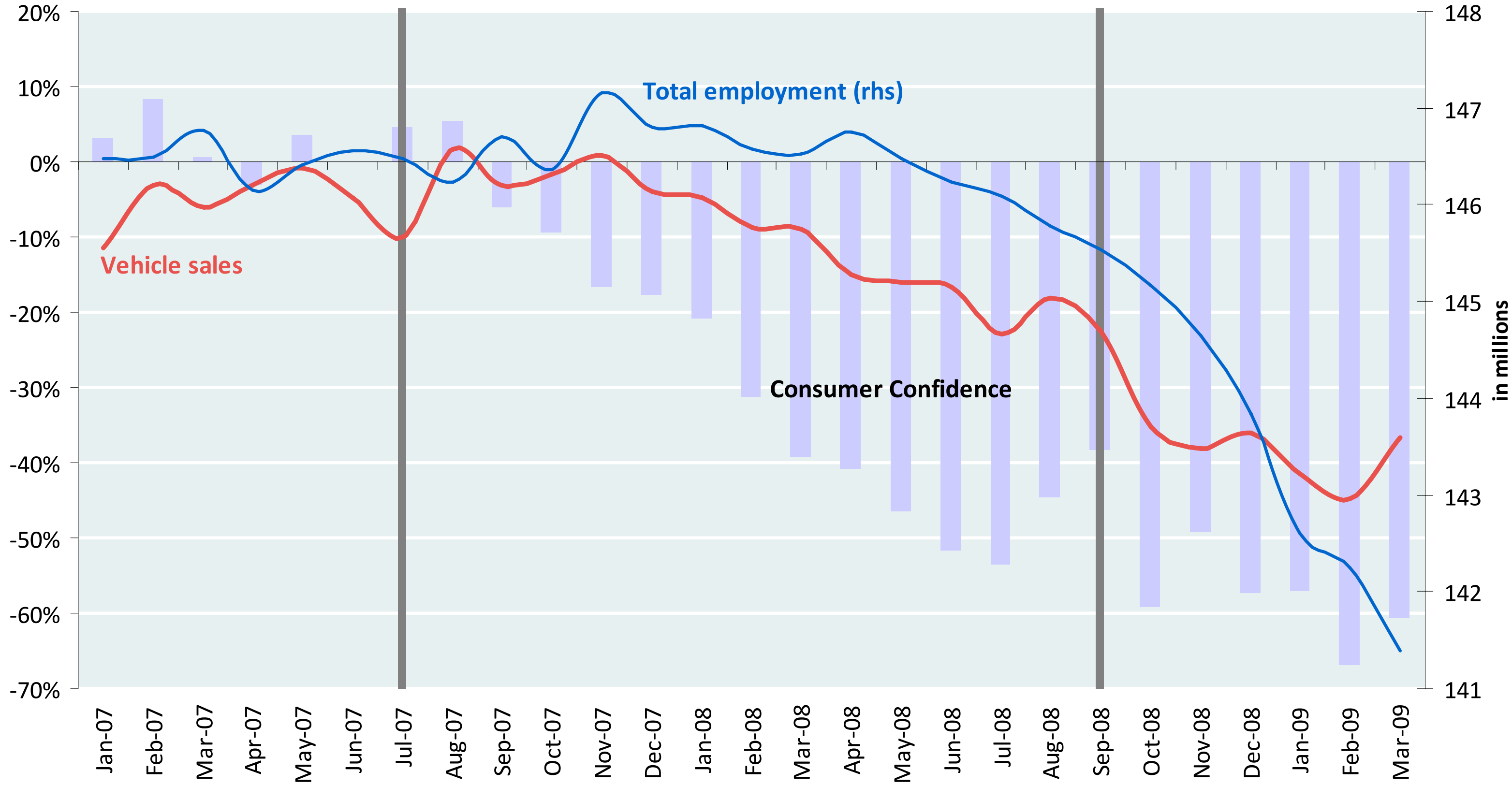


Source: Bloomberg

The U.S. economy is in a major recession, but perhaps no longer in a free fall

U.S. Economic Indicators

Total Employment and YoY variation of Consumer Confidence and Vehicle Sales

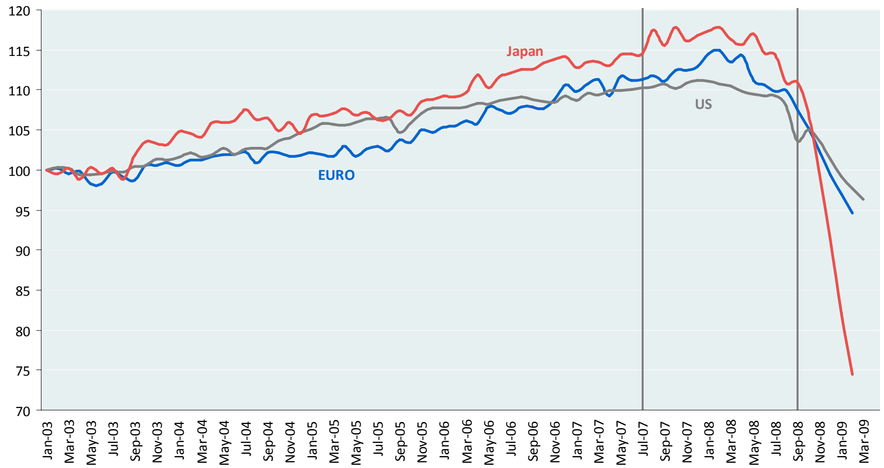


Source: Bloomberg

Economic activity in all rich countries is shrinking significantly, with Japan hardest hit

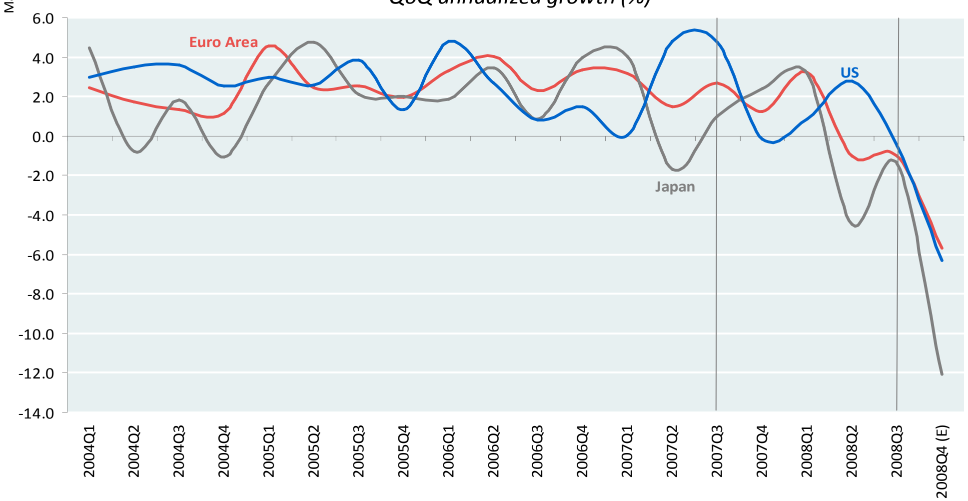
Industrial Production Indexes

Index number - Jan-03=100



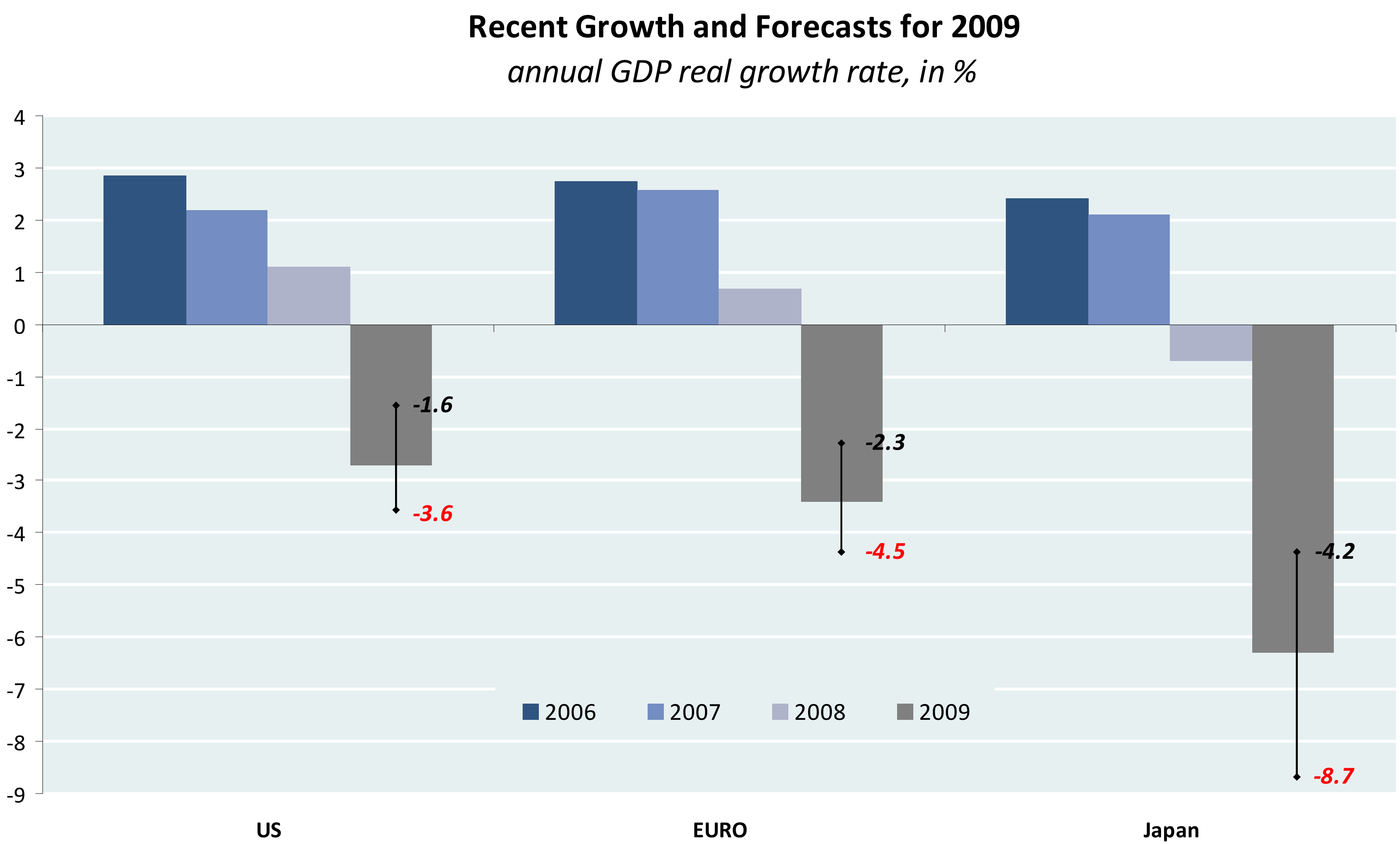
Real GDP Growth in Advanced Countries

QoQ annualized growth (%)



Source: Bloomberg

2009 forecasts for the center are grim and clouded by high uncertainty



Source: Consensus Forecasts (April-09)

… but very bad weather is spreading to the periphery

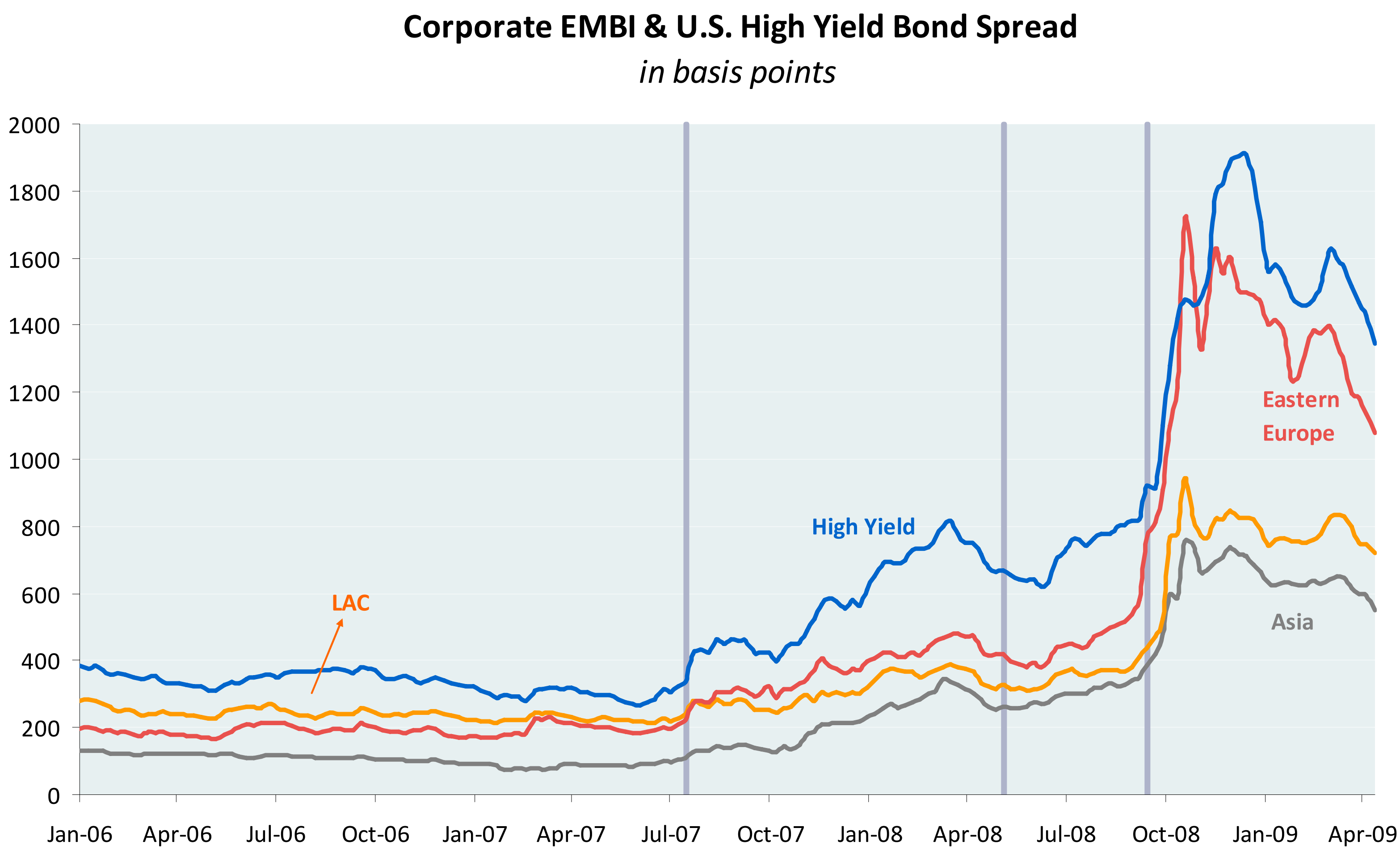
Multiple transmission channels are activated, with September 2008 marking an inflexion point

- Transmission channels to EMs
  - Financial effects: cost and access
  - Commodity prices
  - Remittances
  - External demand

Interrelated

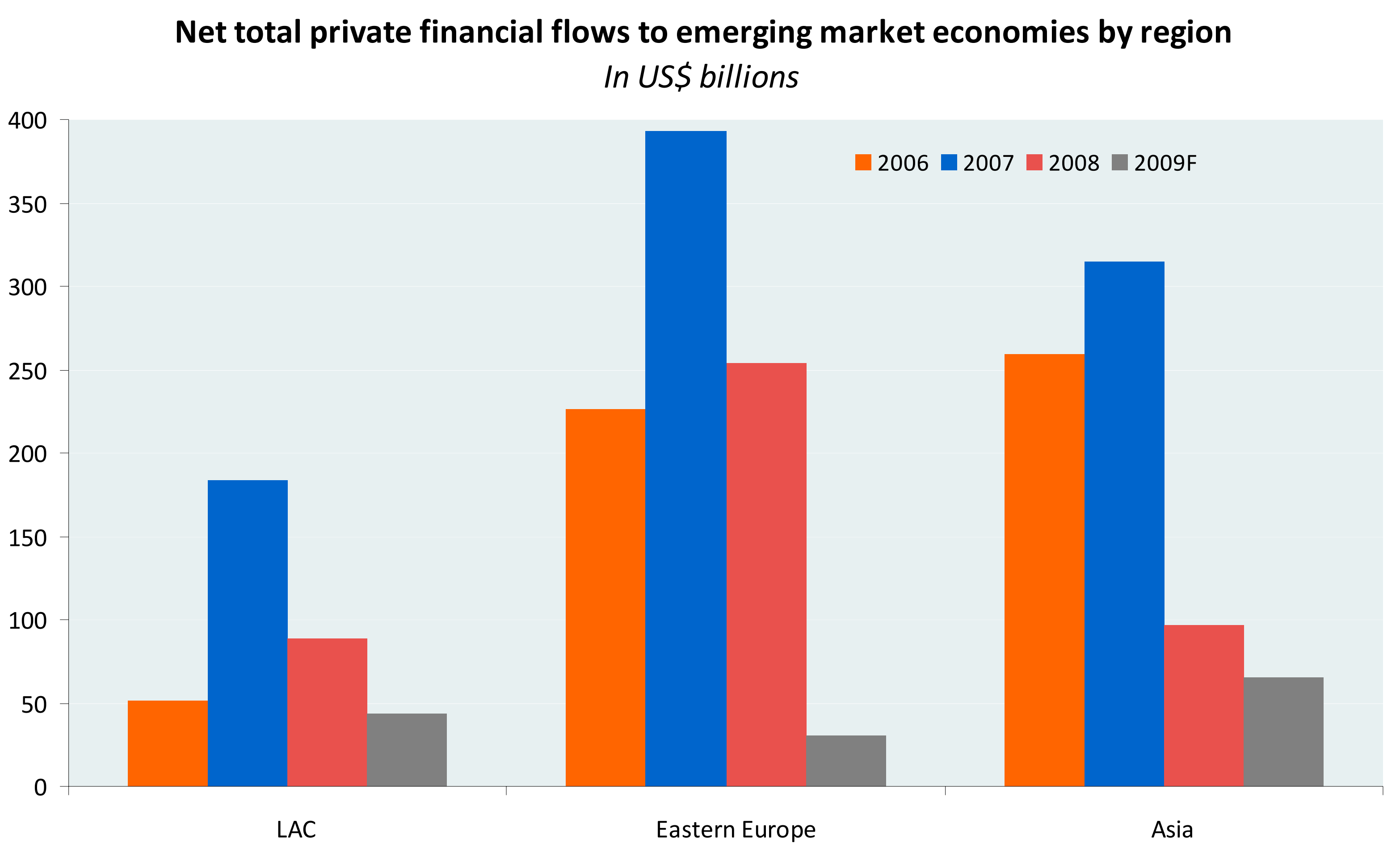
- Stages of the transmission to LAC
  - Decoupling stage (Aug 07 – May 08)
    - Rise in commodities decoupled from financial crisis
  - Re-coupling stages (begins May 08, accelerates Oct 08)
    - Commodity collapse, Lehman effect, and real side downturn

Financial effects: sharp increase of FX borrowing costs for EM firms



Source: Bloomberg – US Credit Suisse High Yield Spread, JP Morgan CEMBI Global: Corporate Emerging Markets Bond Index.

Financial effects: portfolio flows to EMs on a steep decline



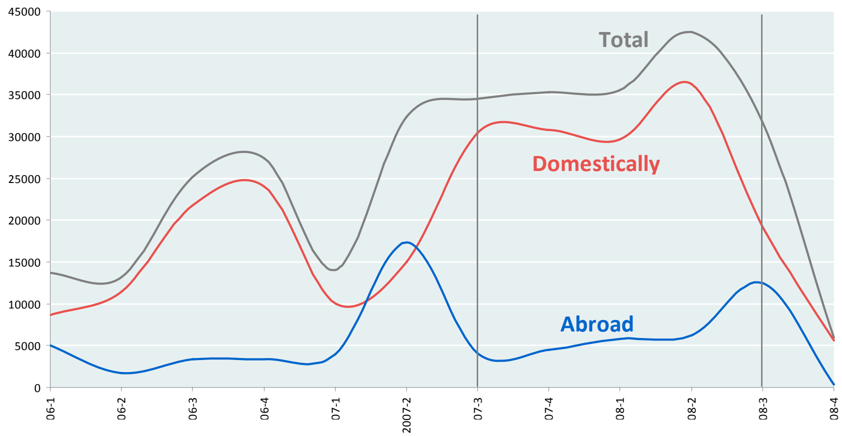
Source: IIF

Financial effects: corporate issues virtually stopped, in local & foreign markets

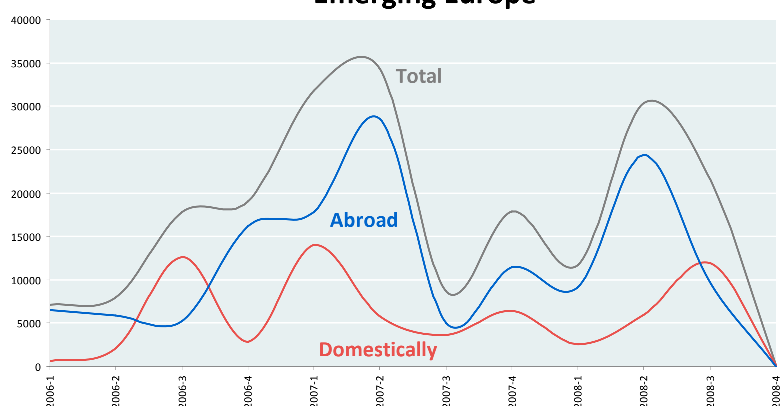
Capital Raising Activity

Corporate issues, in US$ millions

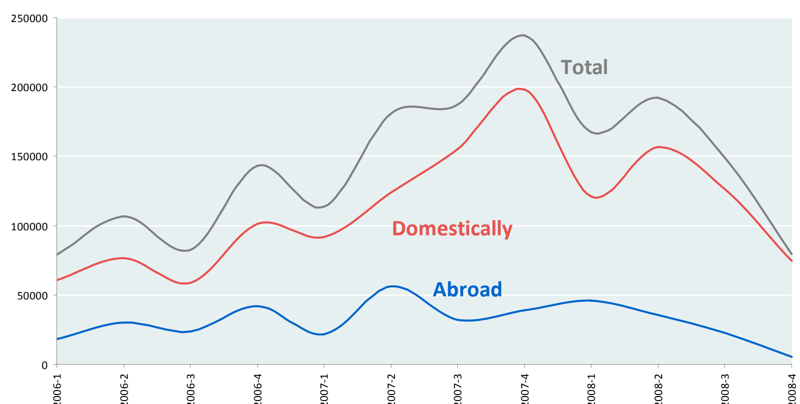
LAC-7



Emerging Europe



South-East Asia



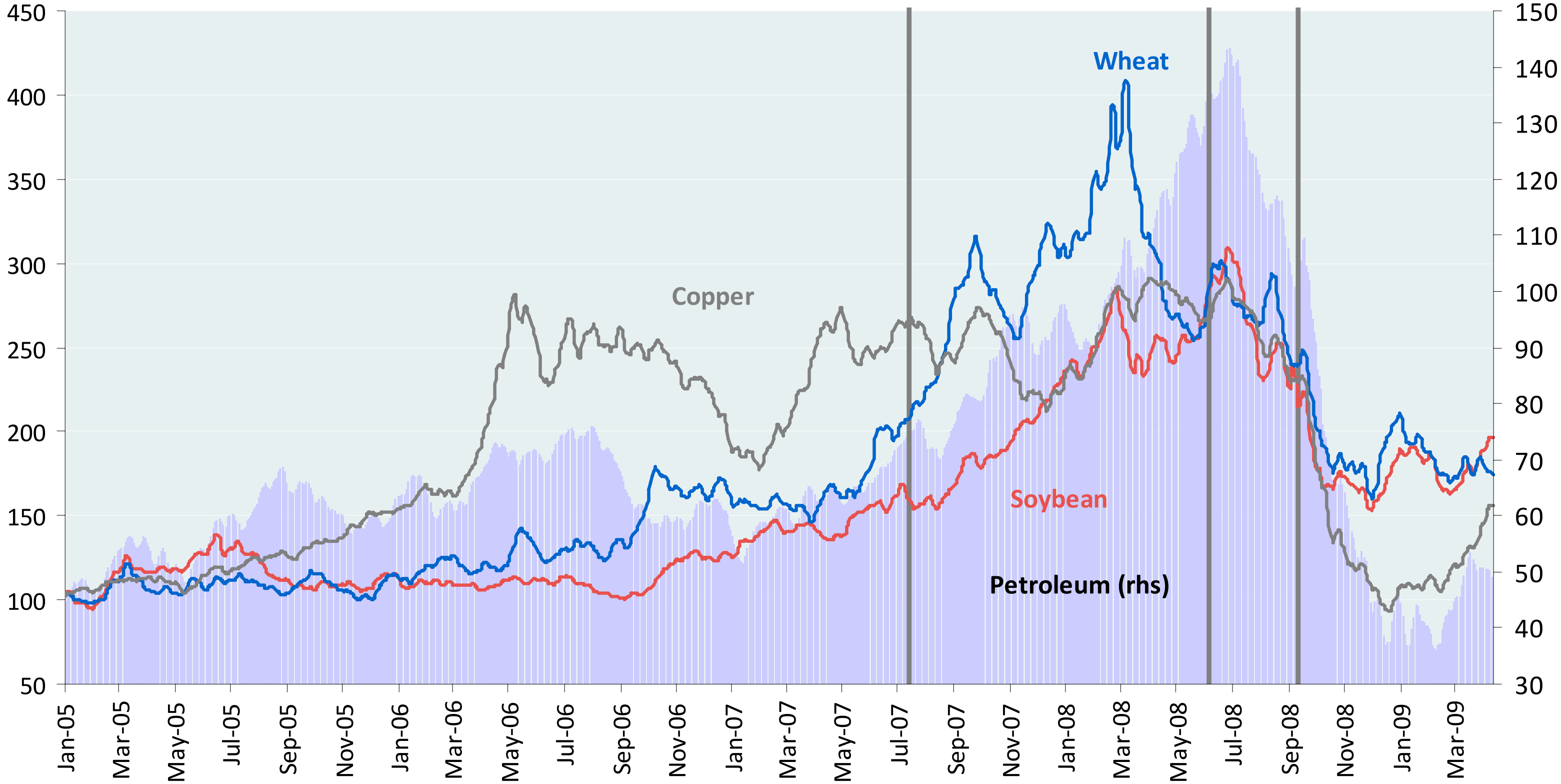
New issues of debt and equity securities in international markets. Source: STC Thomson

Commodity prices collapsed from their mid-2008 peaks and have stabilized at low levels

Commodity Prices (5-day Moving Average)

Oil WTI in current US$, Wheat,

Copper and Soybean are Index numbers: 1/01/05=100

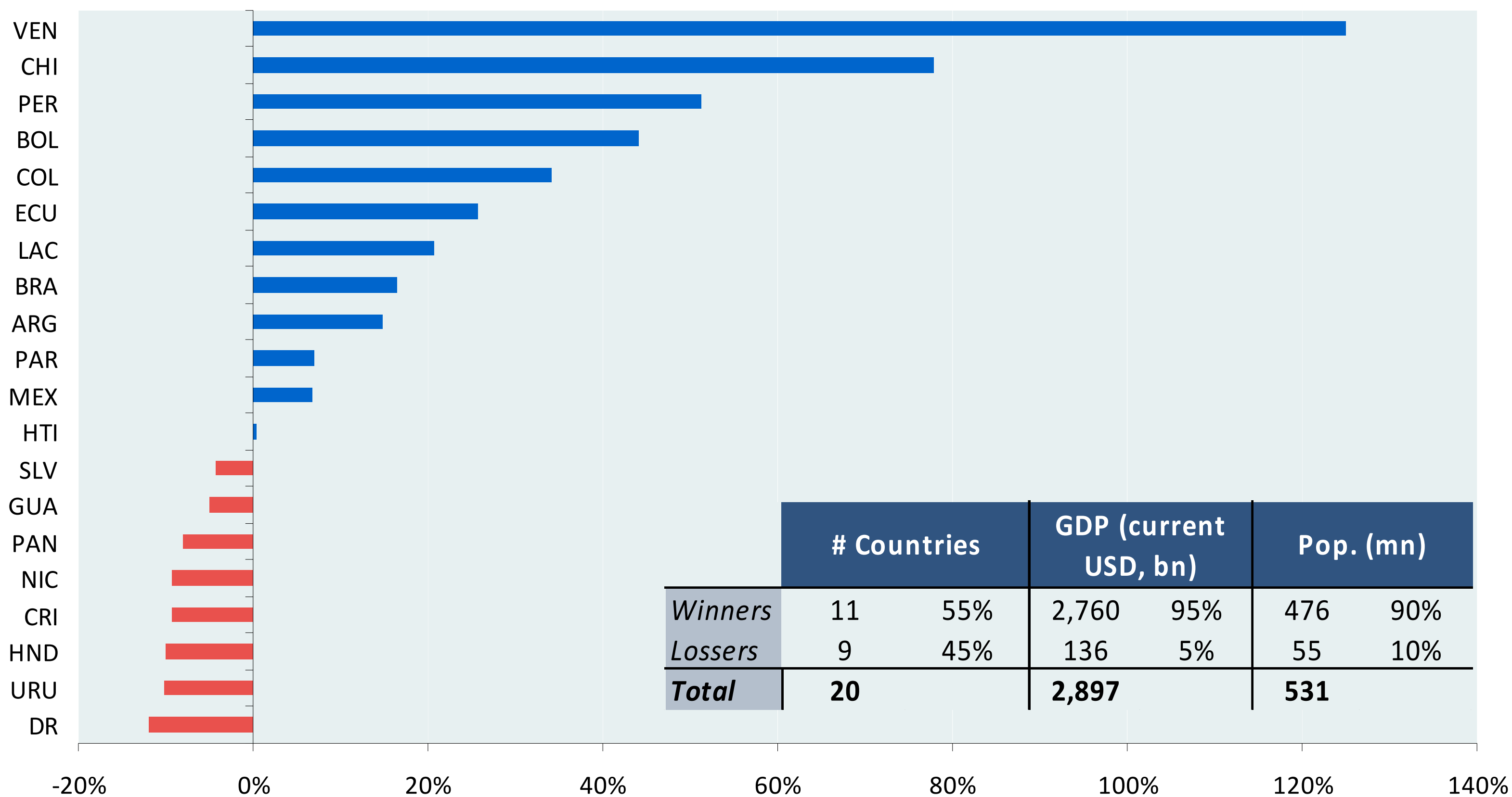


Source: Bloomberg

Commodity prices have asymmetric effects across LAC countries

Terms of Trade

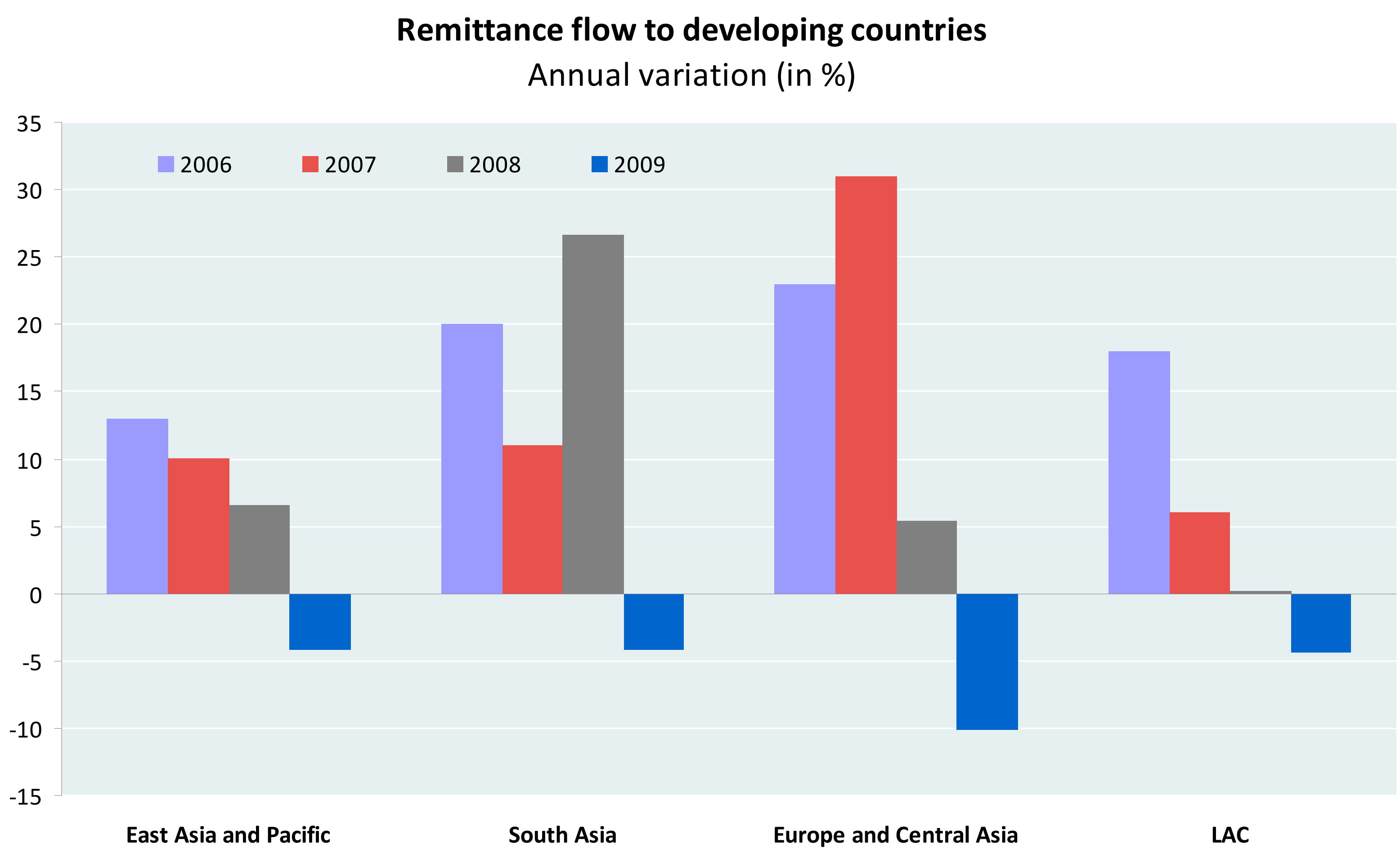
cumulative percent change from 2002 to 2007



	# Countries		GDP (current USD, bn)		Pop. (mn)	
Winners	11	55%	2,760	95%	476	90%
Lossers	9	45%	136	5%	55	10%
Total	**20**		**2,897**		**531**	

LCRCE staff calculations. We use 2006 GDP (current US$) and population figures. Source: ECLAC.

Remittances are contracting all around the world

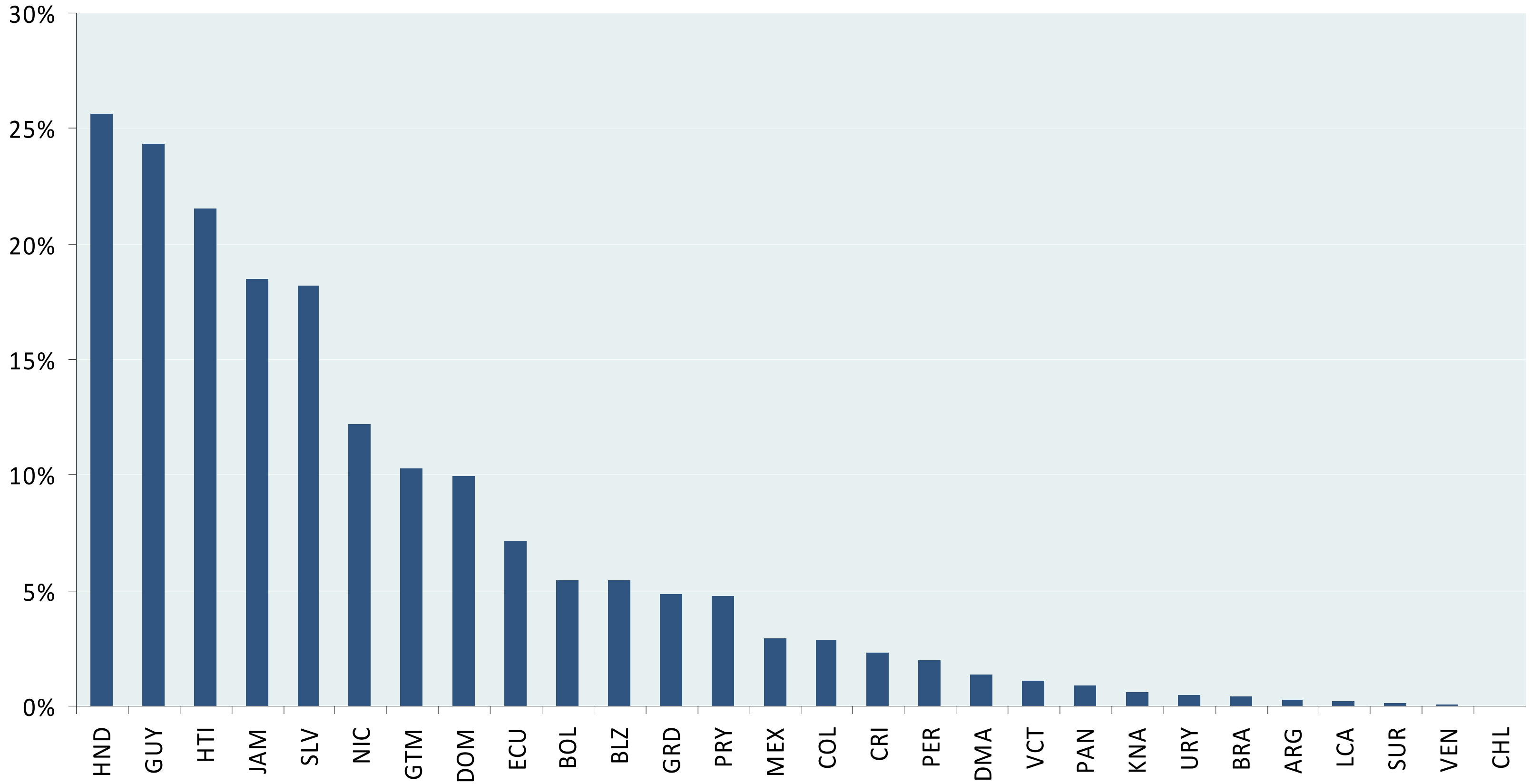


Source: Migration and Remittances. Factbook 2008 – World Bank

Remittances that are important for the region

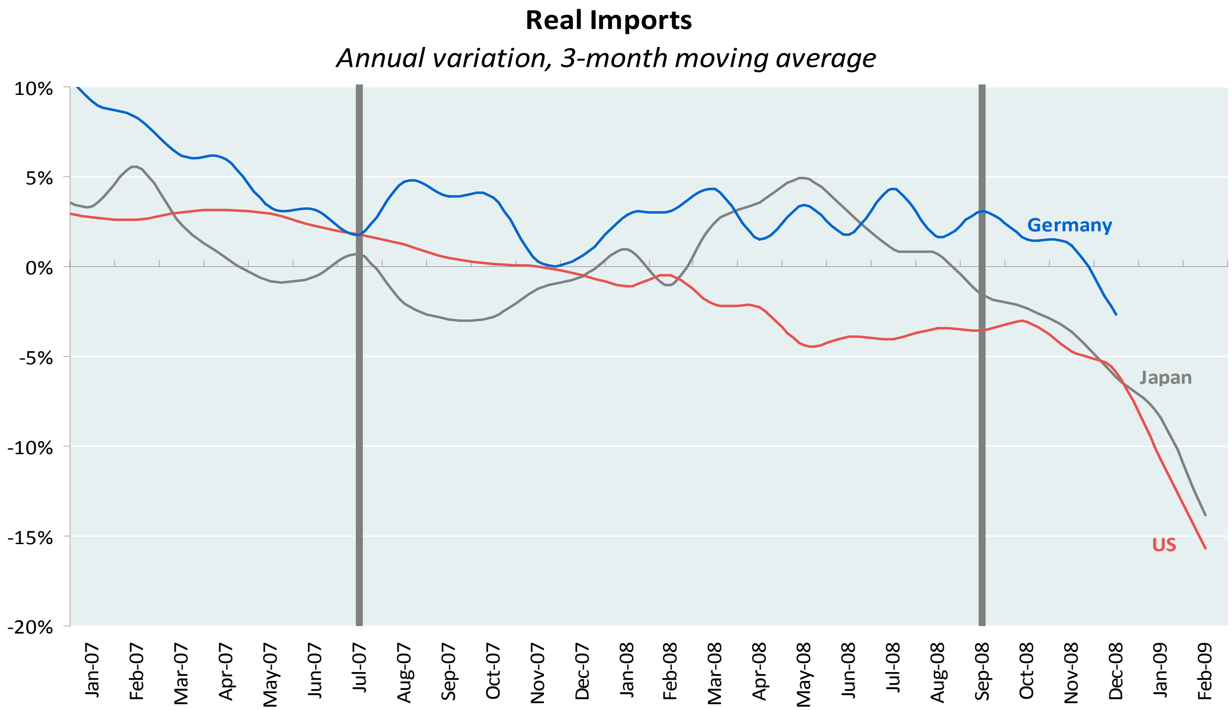
Remittances to LAC in 2006

(Remittances inflows as % GDP)



LCRCE calculations. Source: Migration and Remittances. Factbook 2008 – World Bank

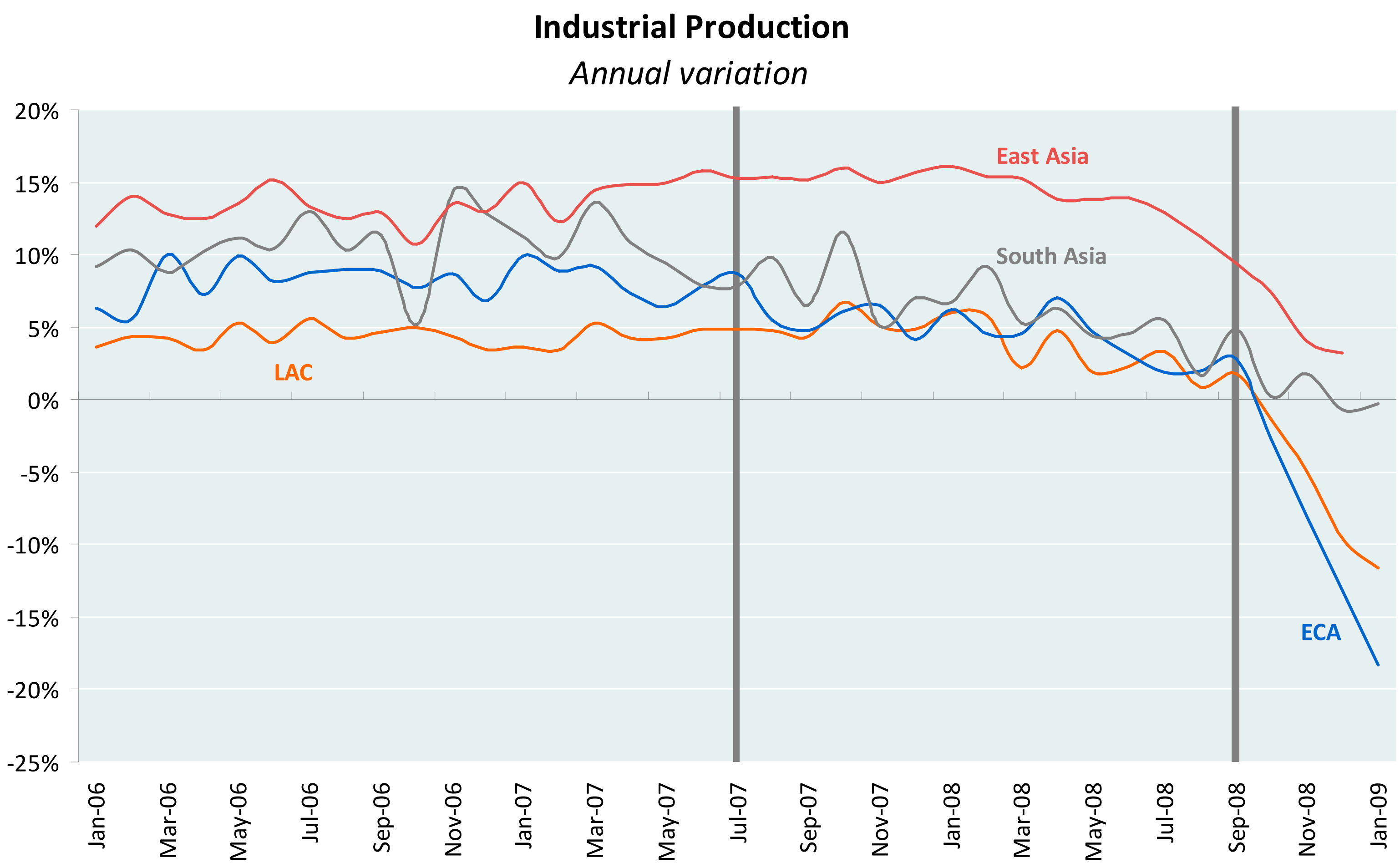
External demand: imports by rich countries are on a contracting path...



- **Global trade is declining for the first time in 25 years**
- **ILO: world unemployment could rise to 38 million workers, from 14 million in 2008**

Source: DECPG World Bank

… leading to a marked slowdown in industrial production across emerging markets



Regional aggregates are calculated as weighted averages. Source: World Bank DECPG

Desirable policy responses are restricted in practice

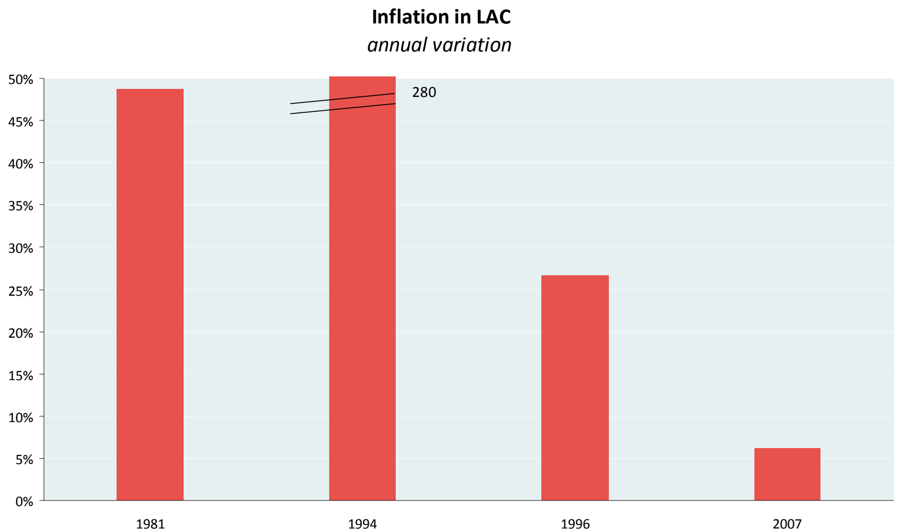
- *In principle*, the situation calls for timely responses:
  - Countercyclical macroeconomic policy
  - Scaling up of social protection and basis infrastructure
  - Significant real exchange rate depreciations

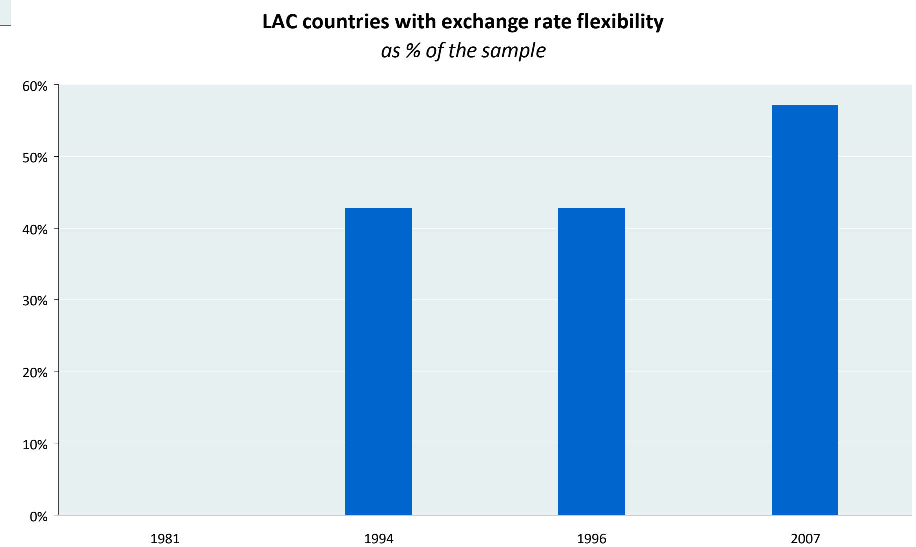
- *In practice*, impact and response capacity depends on:
  - Extent of pre-existing macro-financial weaknesses
  - Extent of poverty, inequality and social conflict
  - Structural factors: trade diversification, integration into global production chain, sectoral allocation of labor

Pre-existing weaknesses?

LAC is less vulnerable compared to its past

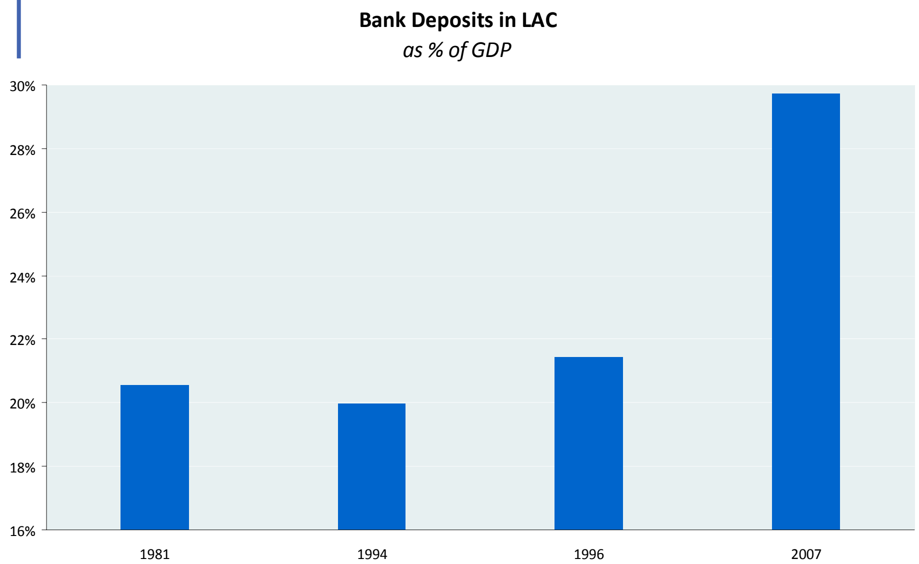
Sounder money – low, stable inflation coexisting with flexible e-rates ➔ deeper LC debt markets

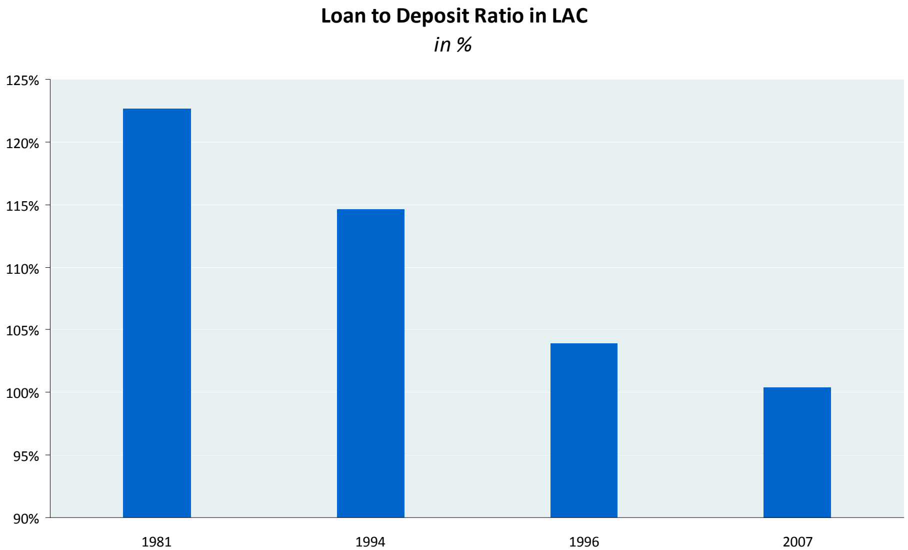




LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

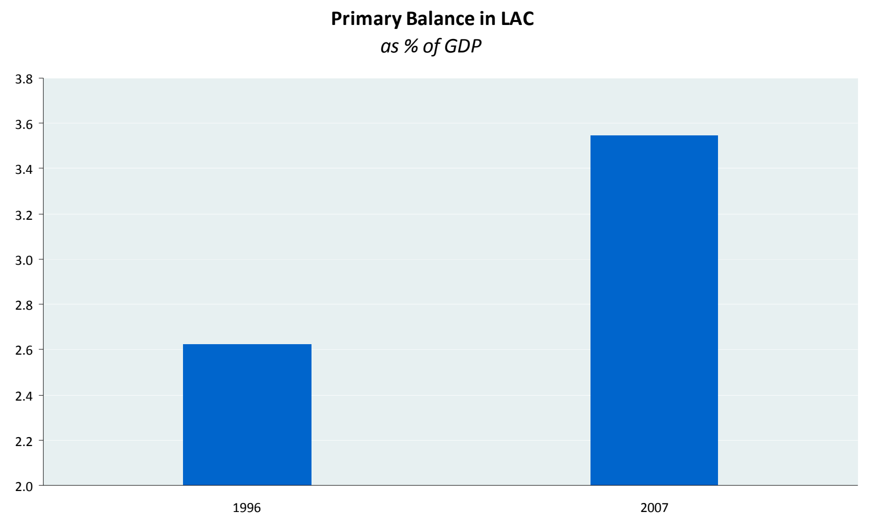
Financial systems – stronger and deeper

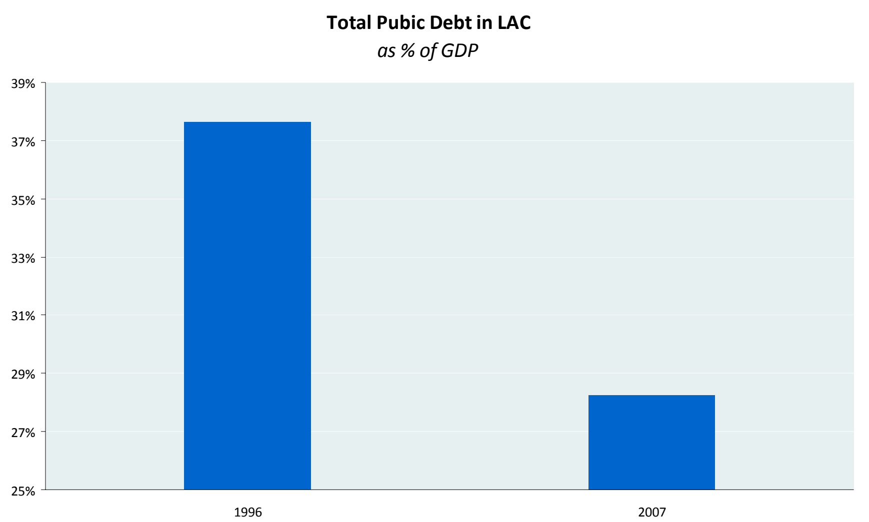


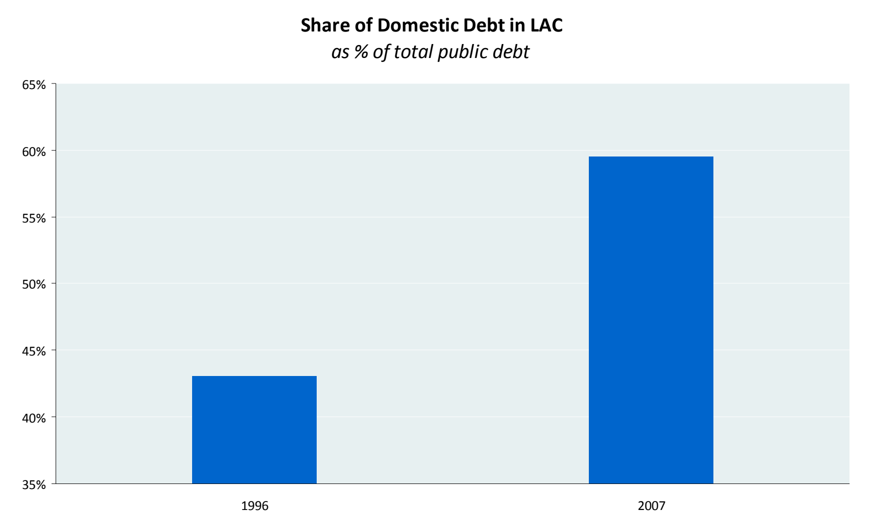


LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Public finances – more viable

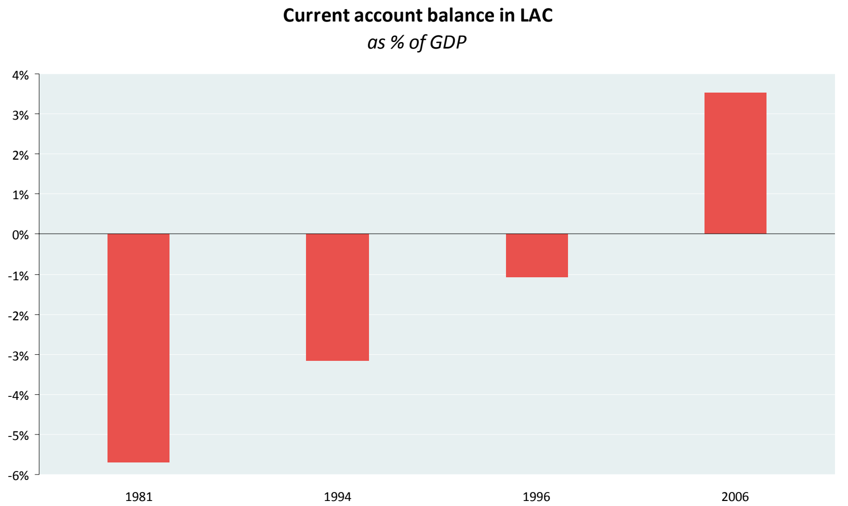


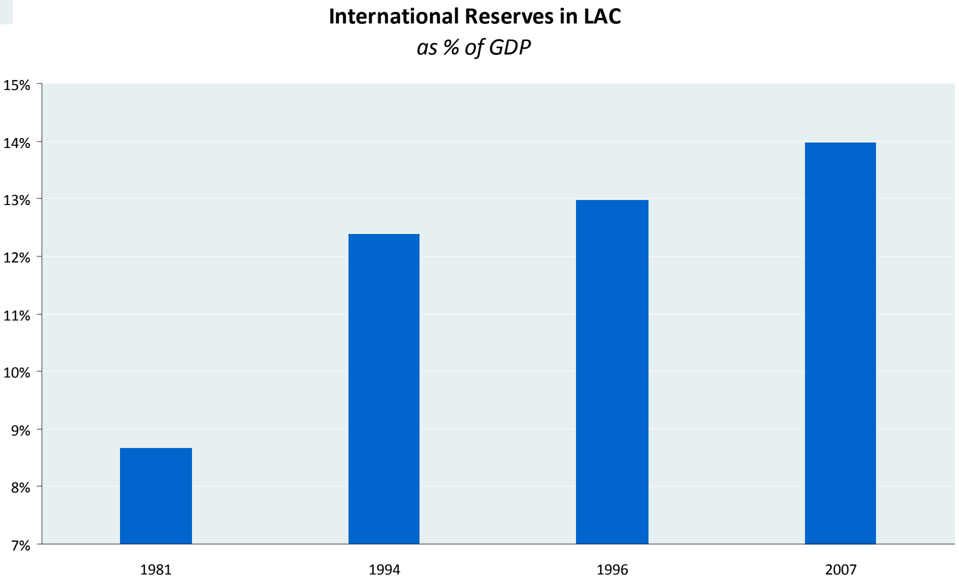




LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

External position – stronger



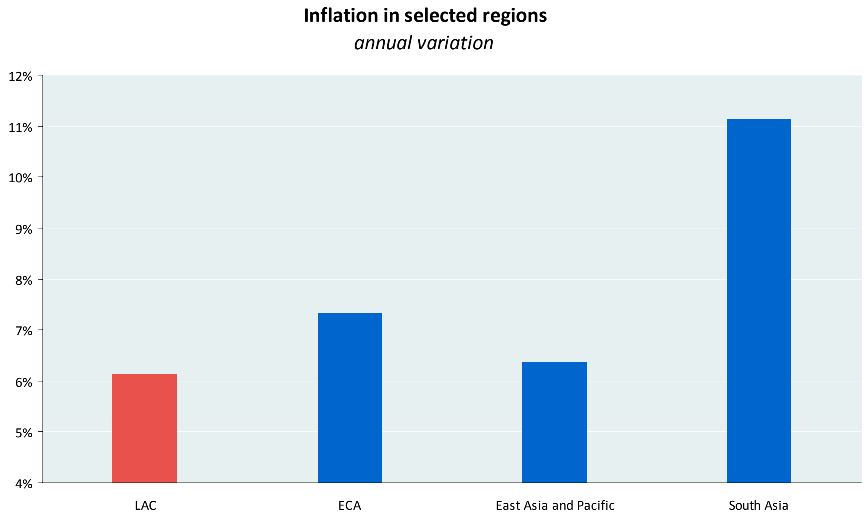


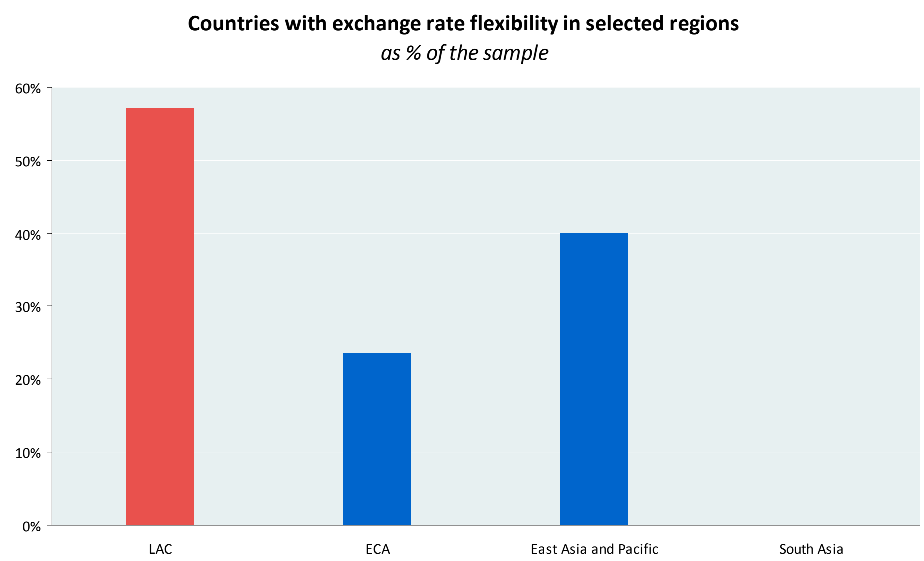
LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Pre-existing weaknesses?

LAC less vulnerable than other regions?

Monetary policy frameworks

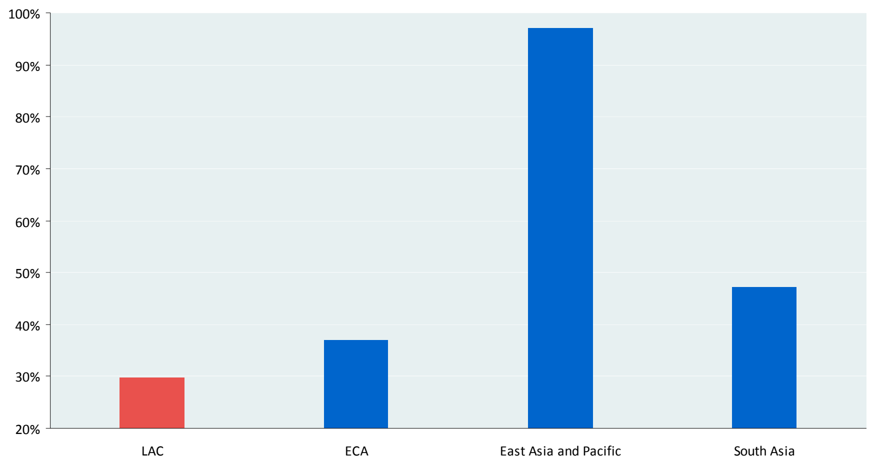




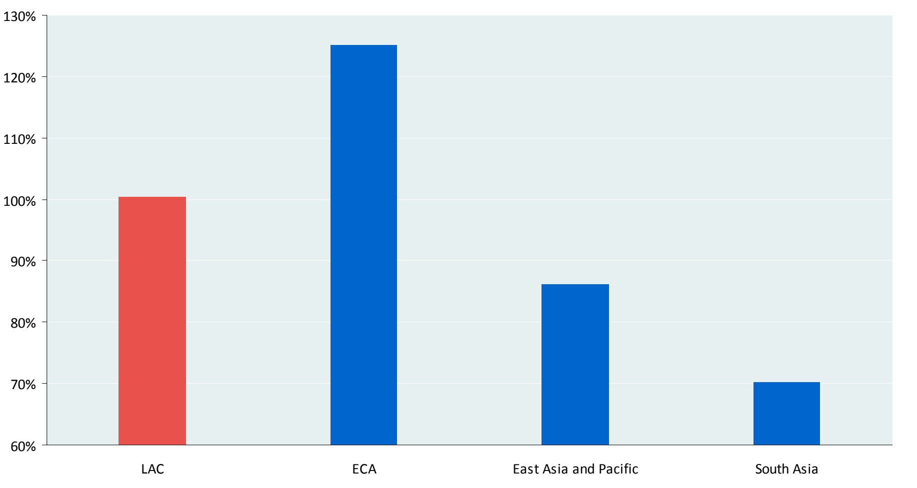
Regional aggregates are calculated as simple averages for 2007. LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Financial systems

Bank Deposits in selected regions
as % of GDP



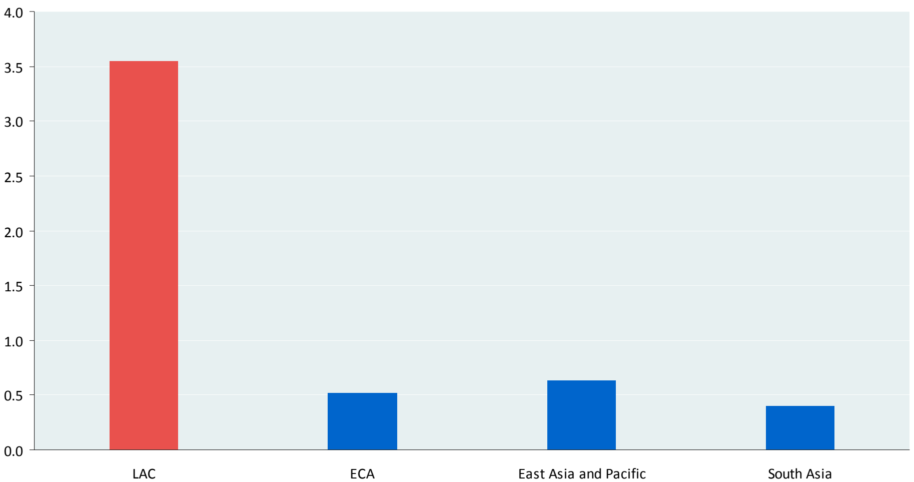
Loan to deposit ratio in selected regions
in %



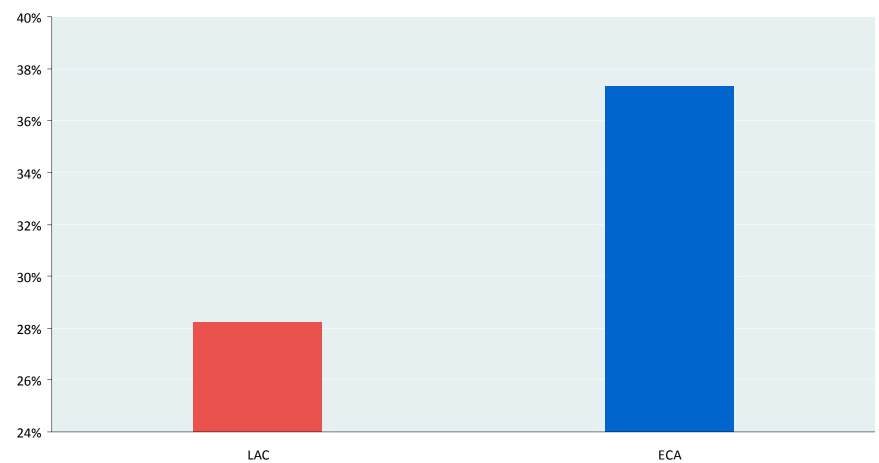
Regional aggregates are calculated as simple averages for 2007. LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Public finances

Primary Balance in selected regions
as % of GDP

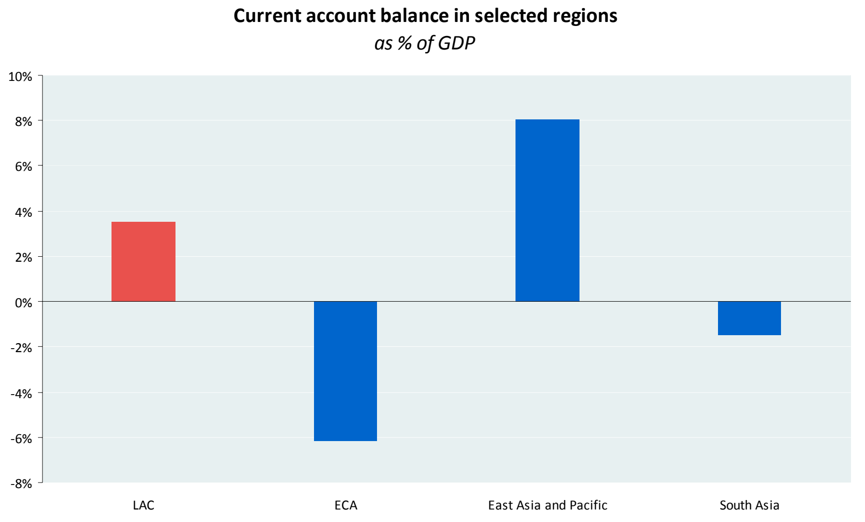


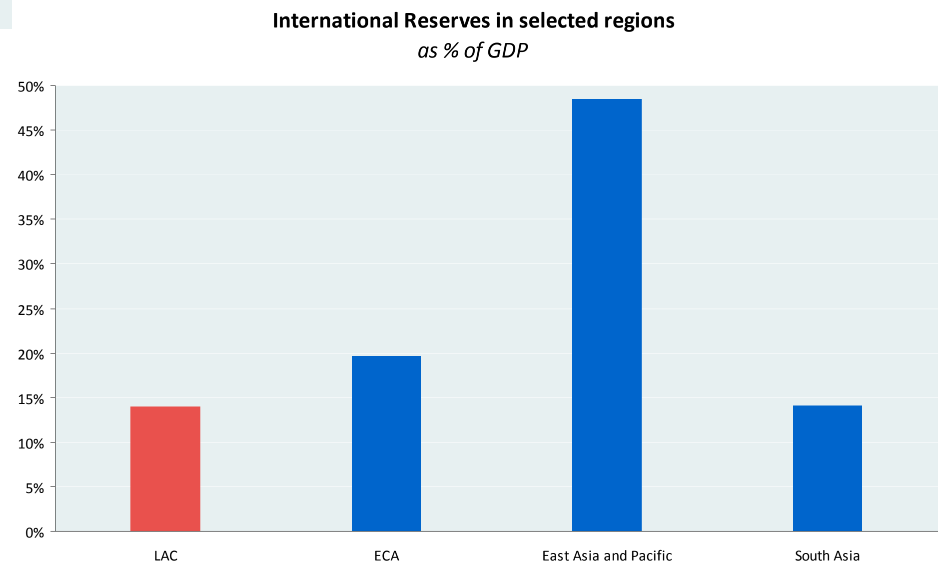
Public debt in selected regions
as % of GDP



Regional aggregates are calculated as simple averages for 2007. LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

External positions





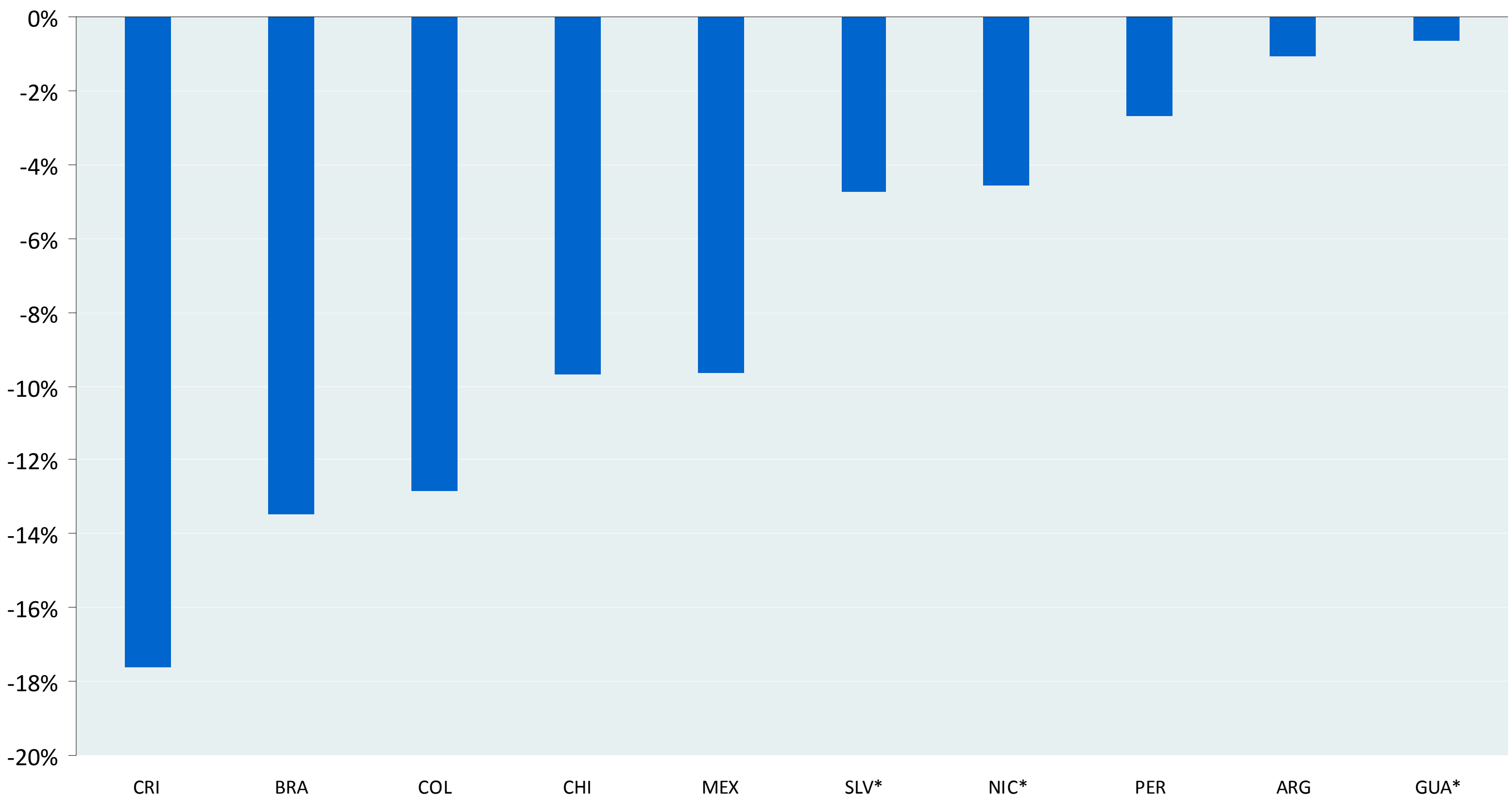
Regional aggregates are calculated as simple averages for 2007. LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Hence, LAC is likely to avert systemic financial crises, but will inevitably endure a recession

A marked economic slowdown is sweeping through LAC since 2008-Q4

Industrial Production in LAC

Annual variation, last available figure

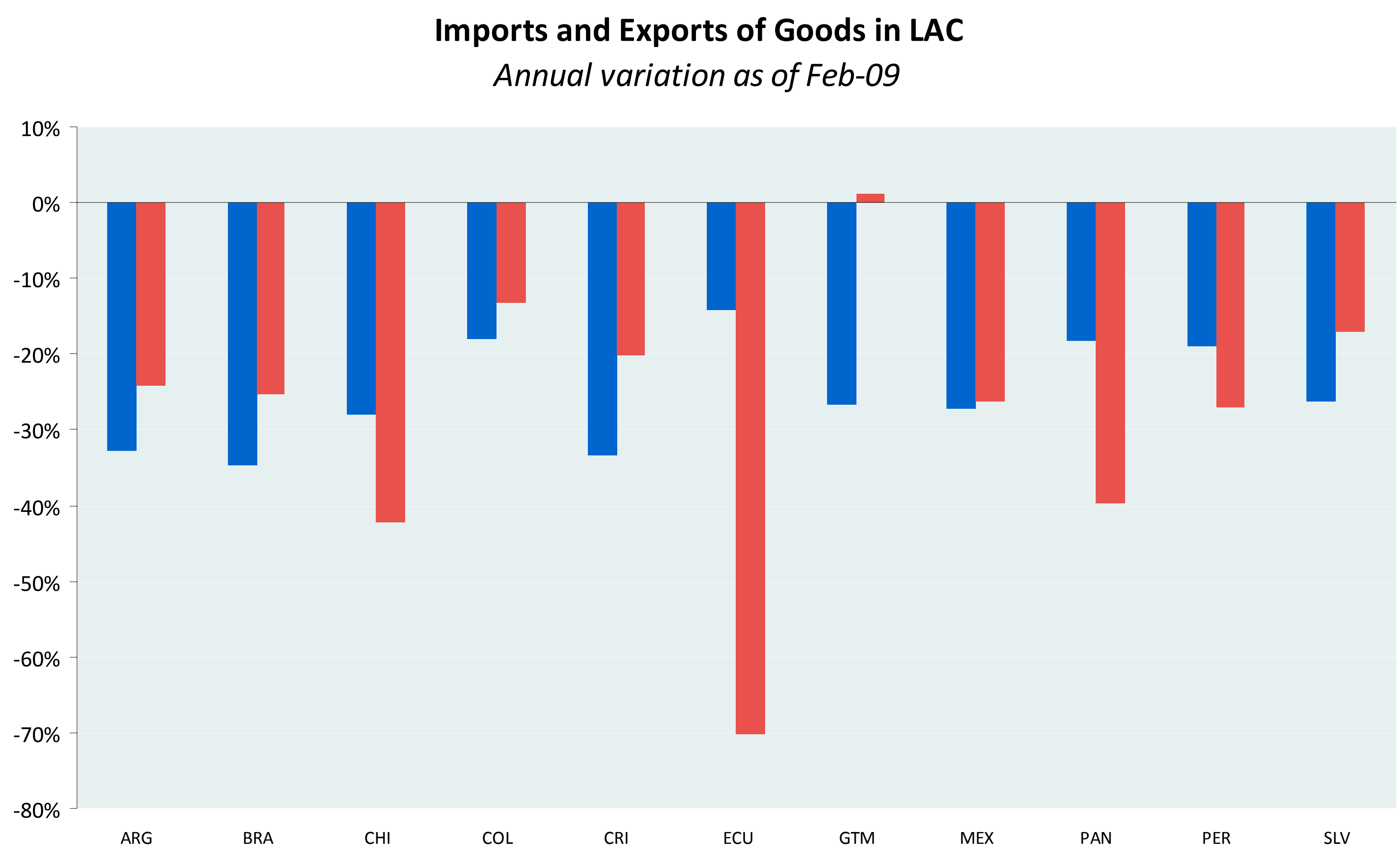


**Data corresponds to the Index of Economic Activity. Source: Haver Analytics and National Authorities*

Exports *and* imports collapsed in the 4th quarter of 2008 for LAC as a whole…

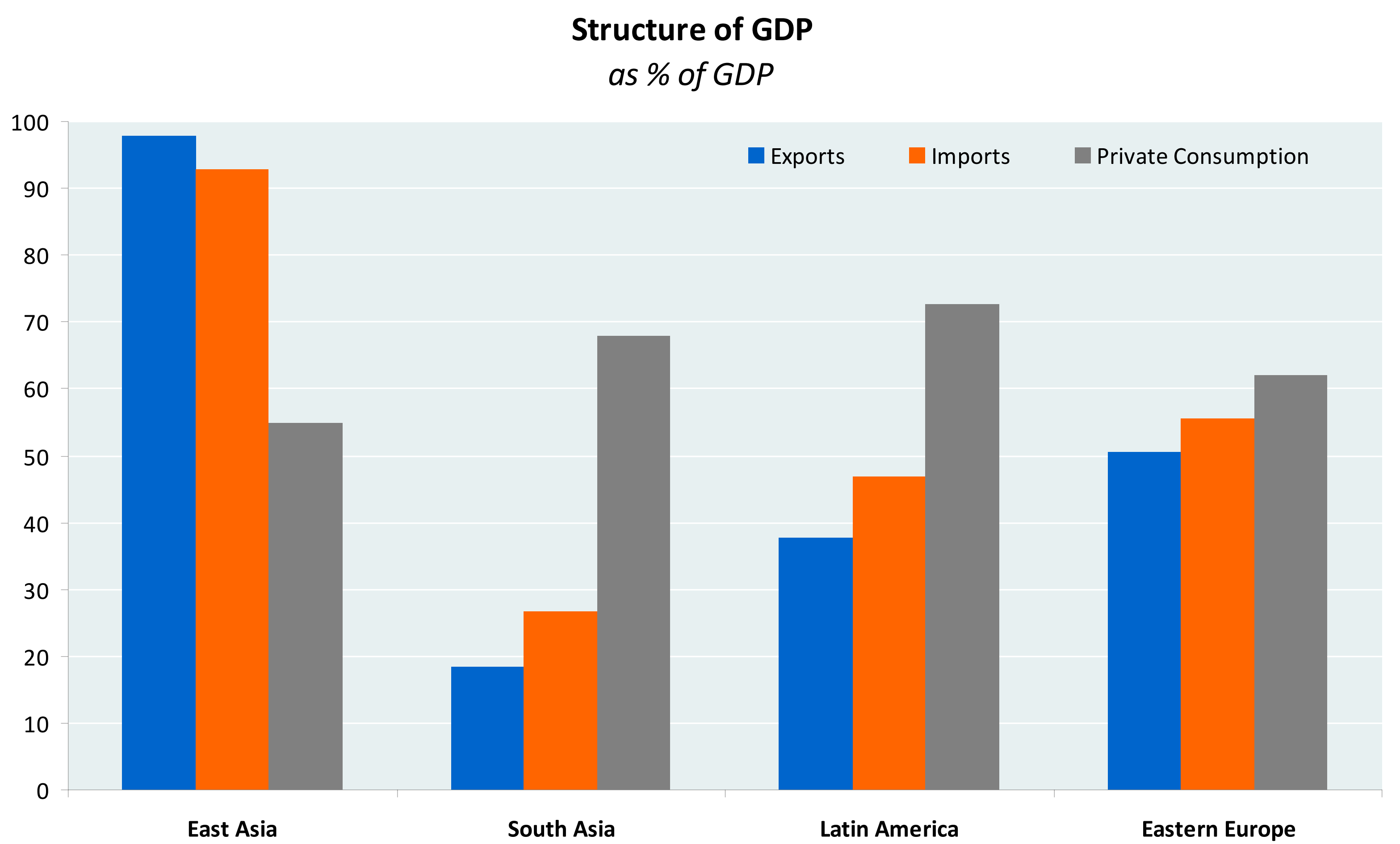
LAC: Argentina, Brazil, Chile, Mexico and Peru. Source: Bloomberg

… with significant variation across LAC countries



Source: Haver Analytics and National Authorities

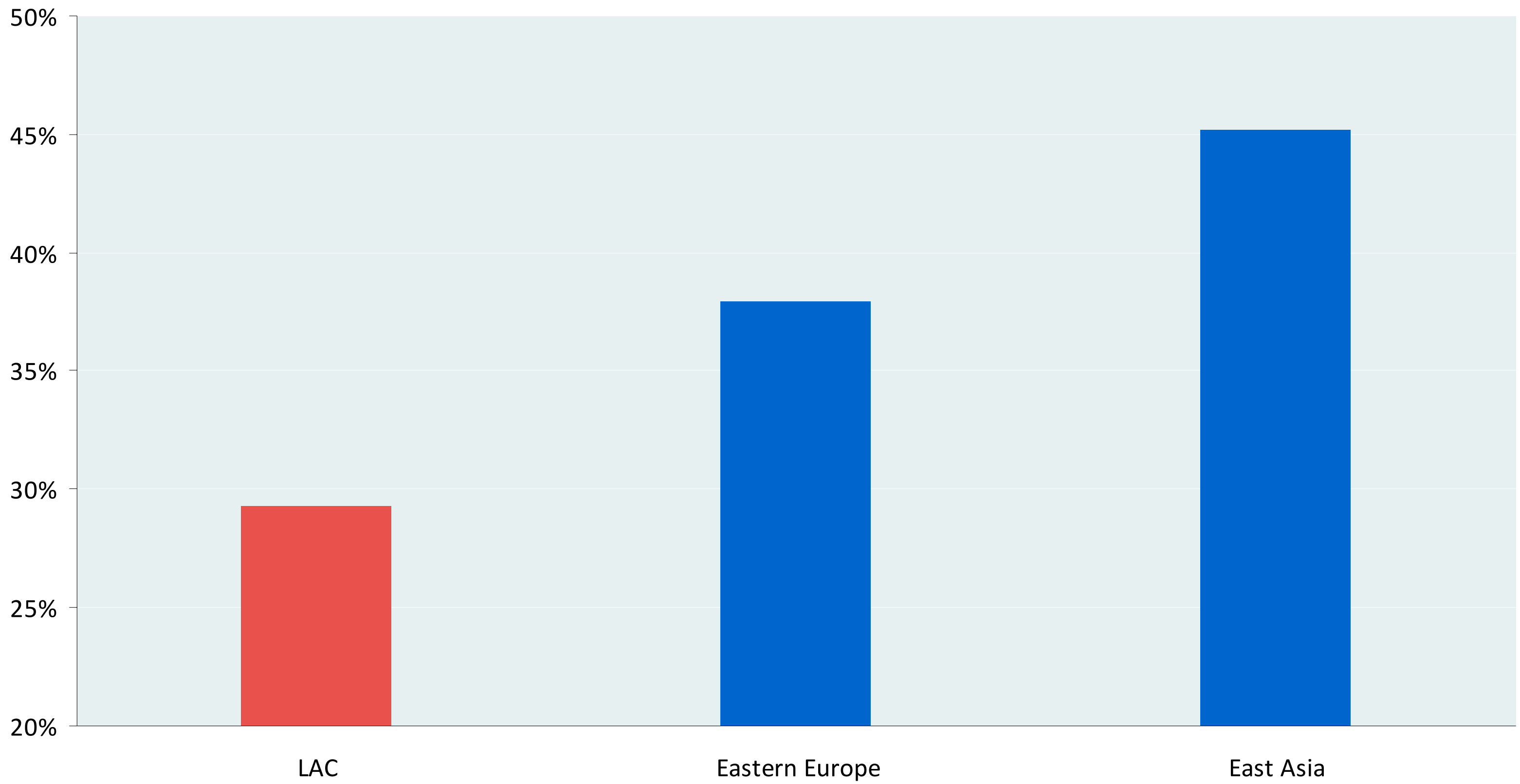
Structural factors matter – relative size of tradable and non-tradable sectors



Regional aggregates are calculated as simple averages. Source: LCRCE Office calculations based on EIU

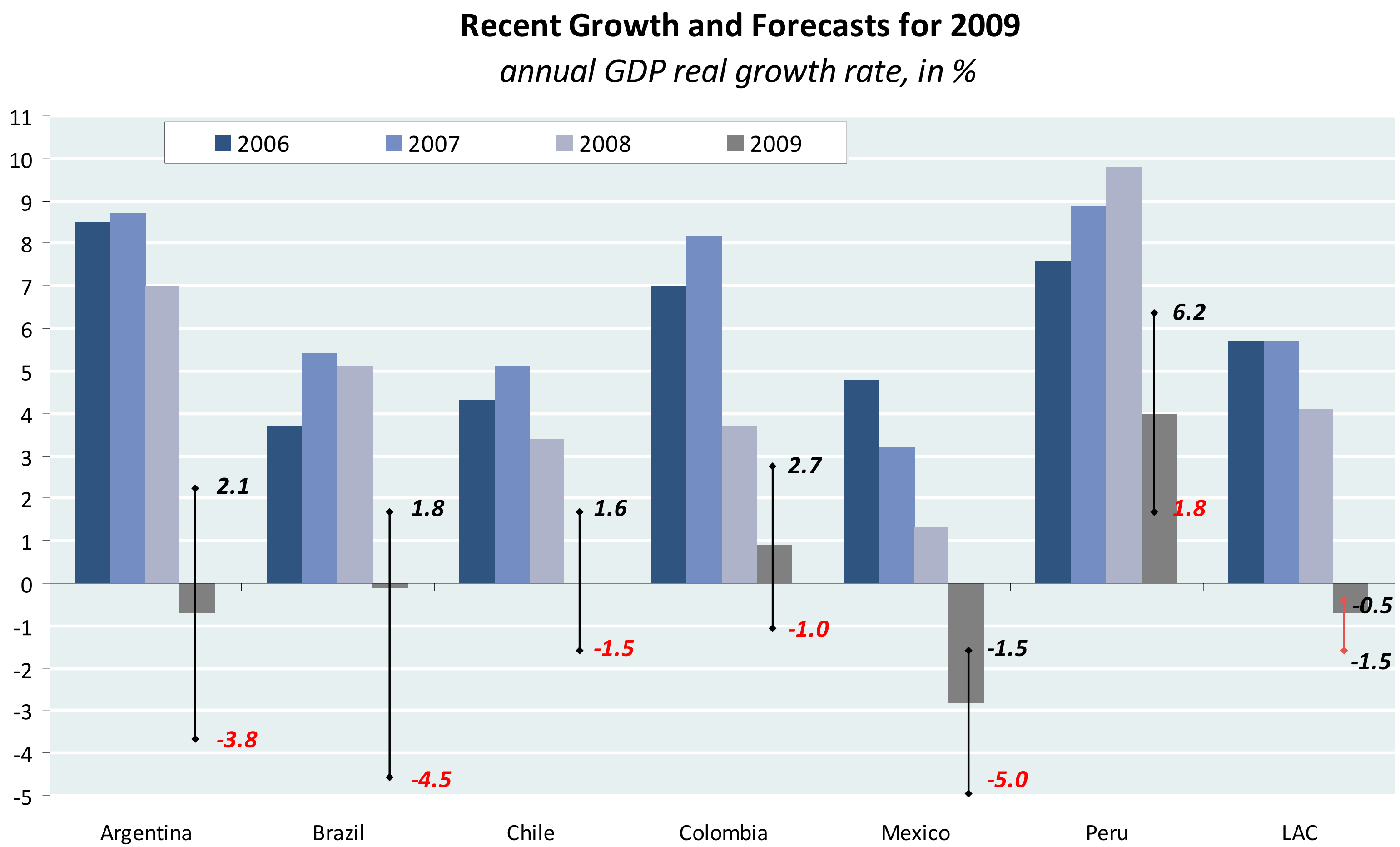
Structural factors matter – the sectoral distribution of employment

Labor Force in the tradable sector in selected Regions
as % of total labor force - as of 2006



Regional aggregates are calculated as simple averages. Source: LCRCE Office calculations based on ILO

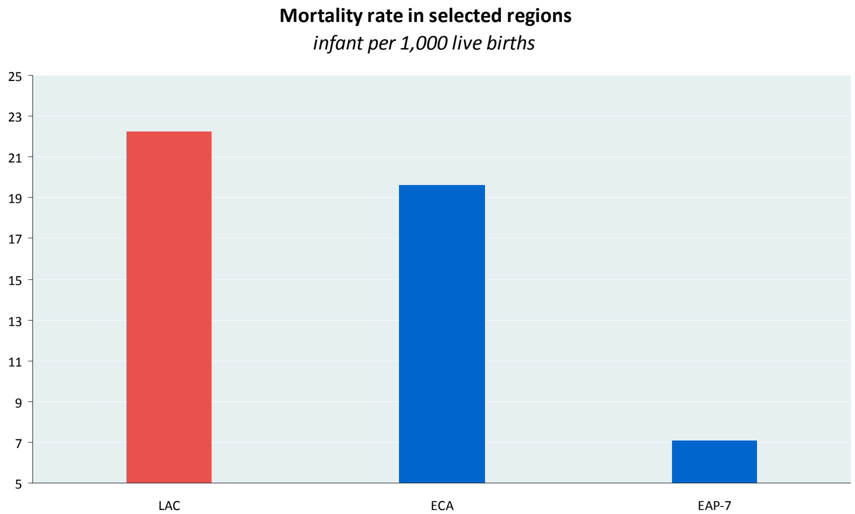
In all, LAC is in for a recession in 2009

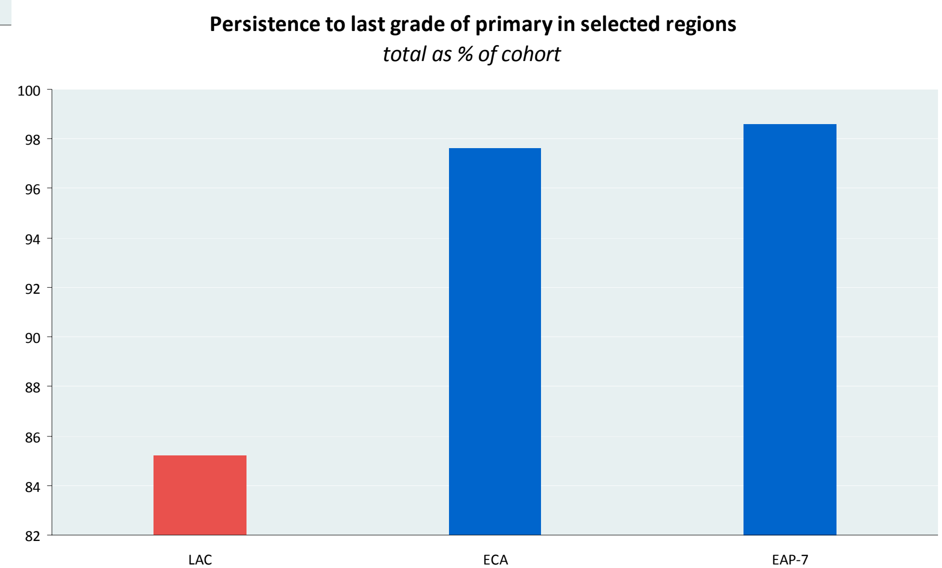


Sources: Consensus Forecasts (as of March 09), ECLAC and World Bank. LAC growth range is based on LCRCE Estimations

The risk of reversal of social gains can be highly problematic for LAC

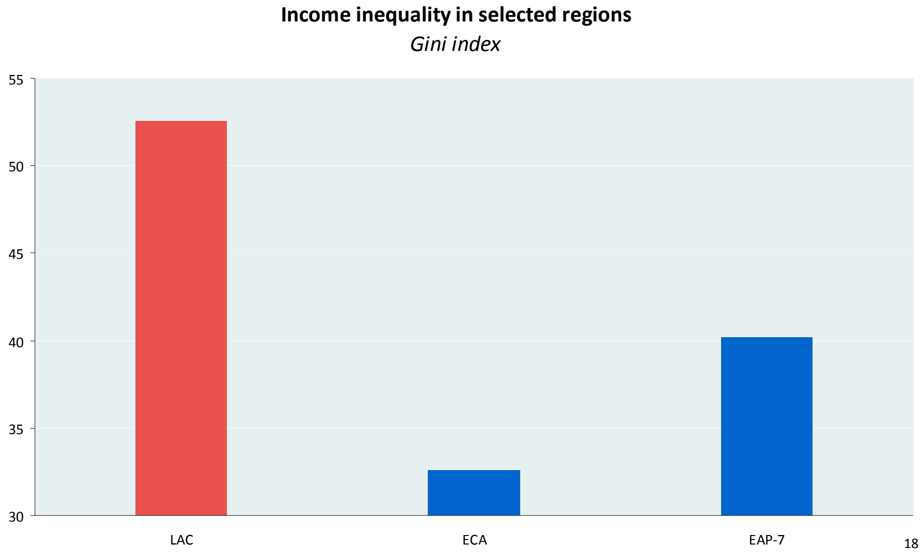
LAC lags other emerging regions in social indicators

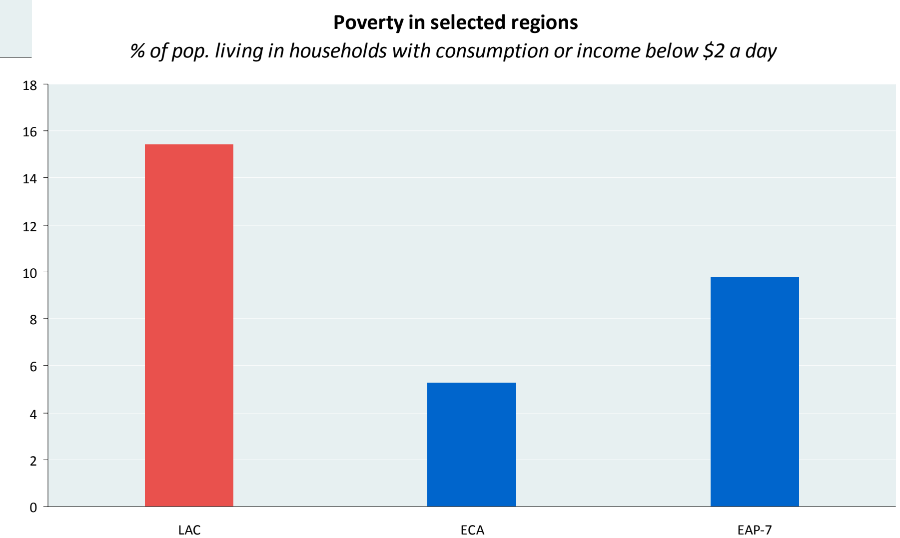




Regional aggregates are calculated as simple averages for 2005. LAC figures usually calculated using data of LAC-7 countries. Source: WDI.

LAC lags other emerging regions in social indicators (cont.)





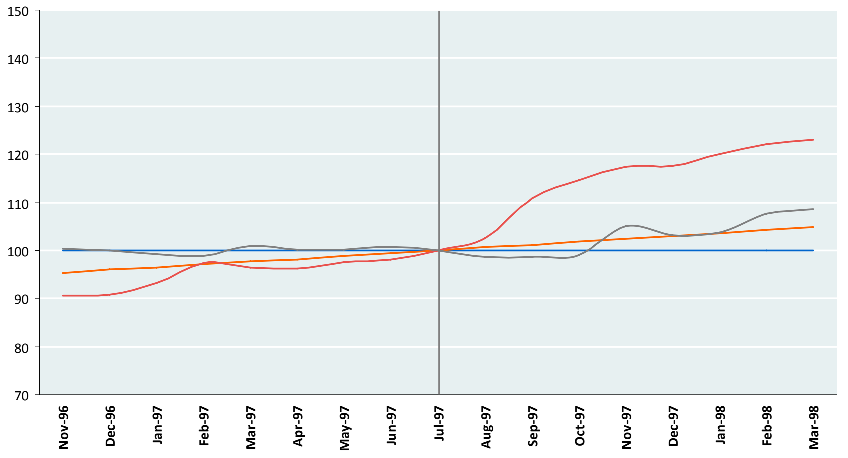
Regional aggregates are calculated as simple averages for 2005. LAC figures usually calculated using data of LAC-7 countries. Source: WDI.

LAC: how much room for policy maneuver?

Flexible exchange rates are shock absorbers now

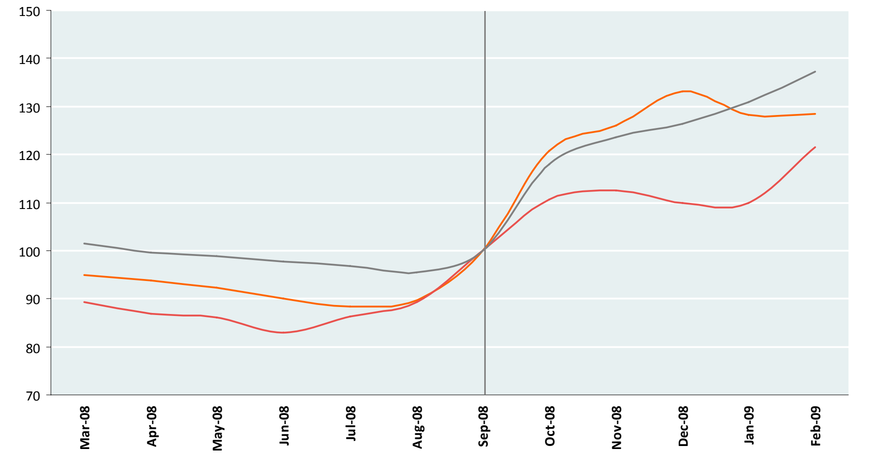
Exchange Rates in selected LAC countries

Jul-97=100



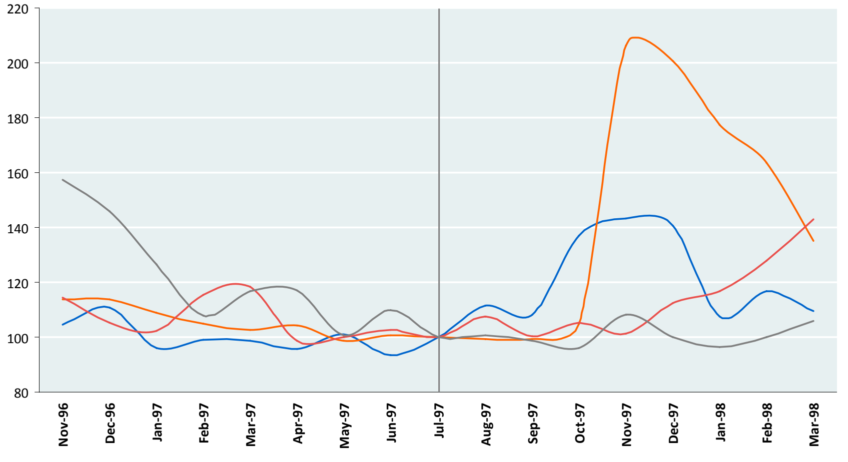
Exchange Rates in selected LAC countries

Sep-08=100



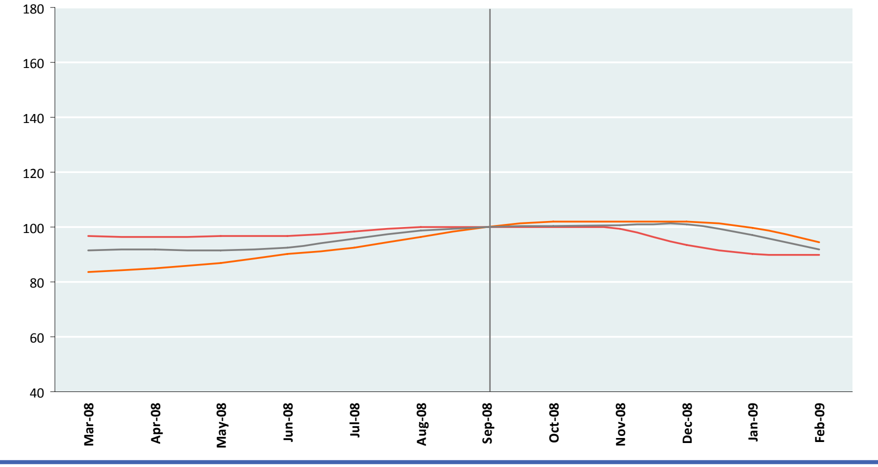
Interest Rates in selected LAC countries

Jul-97=100



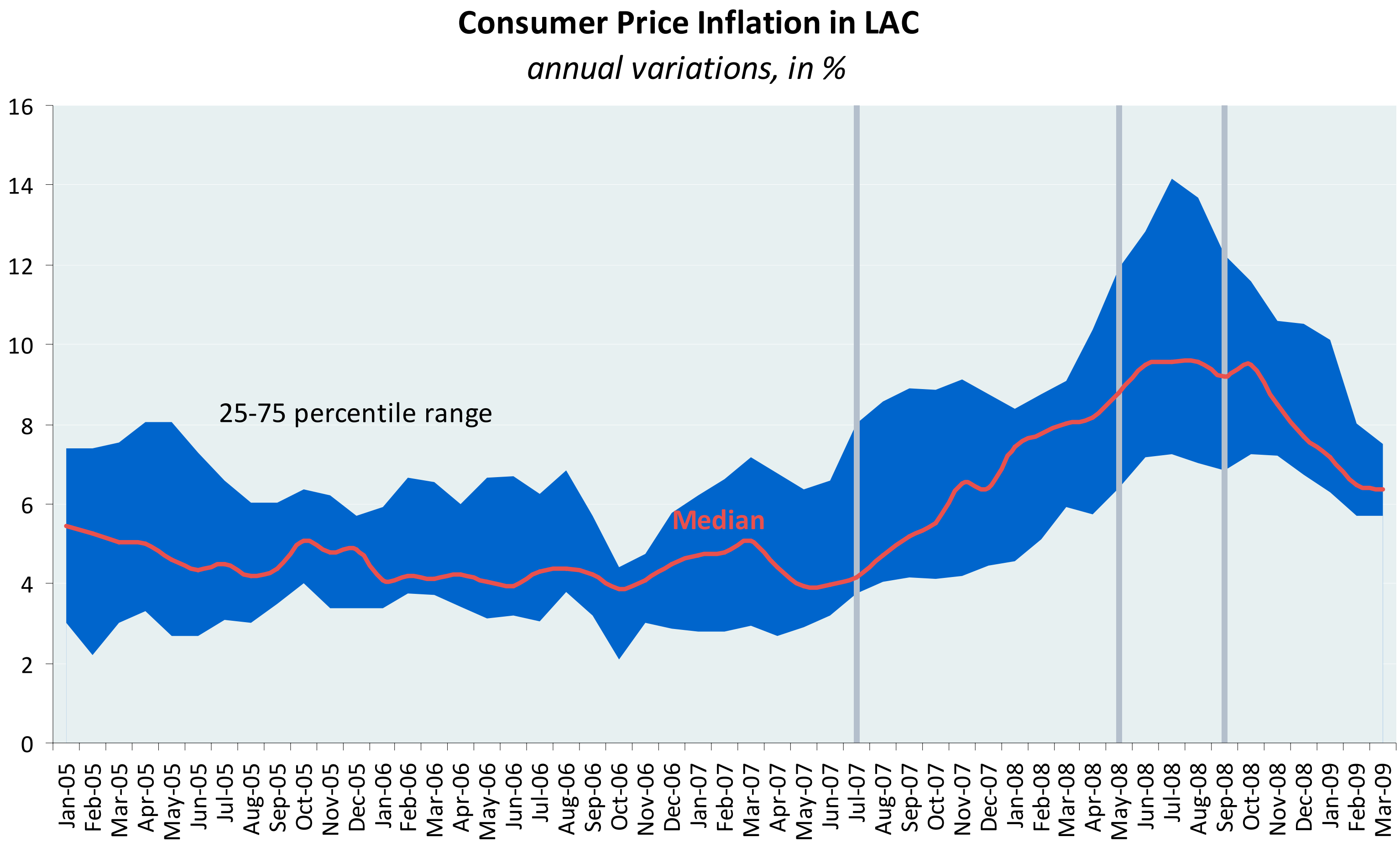
Interest Rates in selected LAC countries

Sep-08=100



Regional aggregates are calculated as simple averages. Source: WDI and IFS

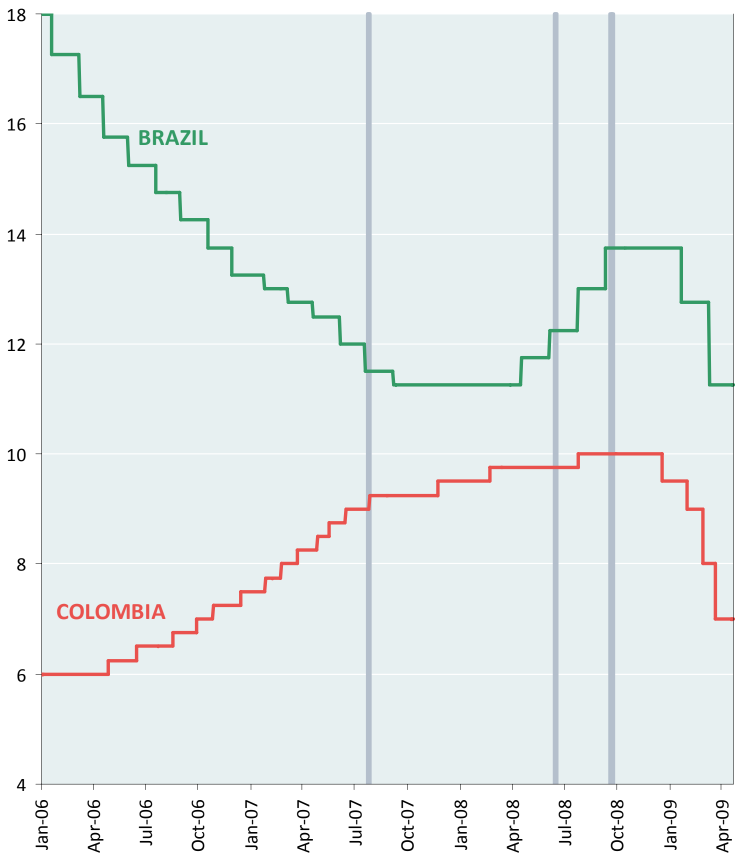
And with inflation concerns rapidly disappearing…



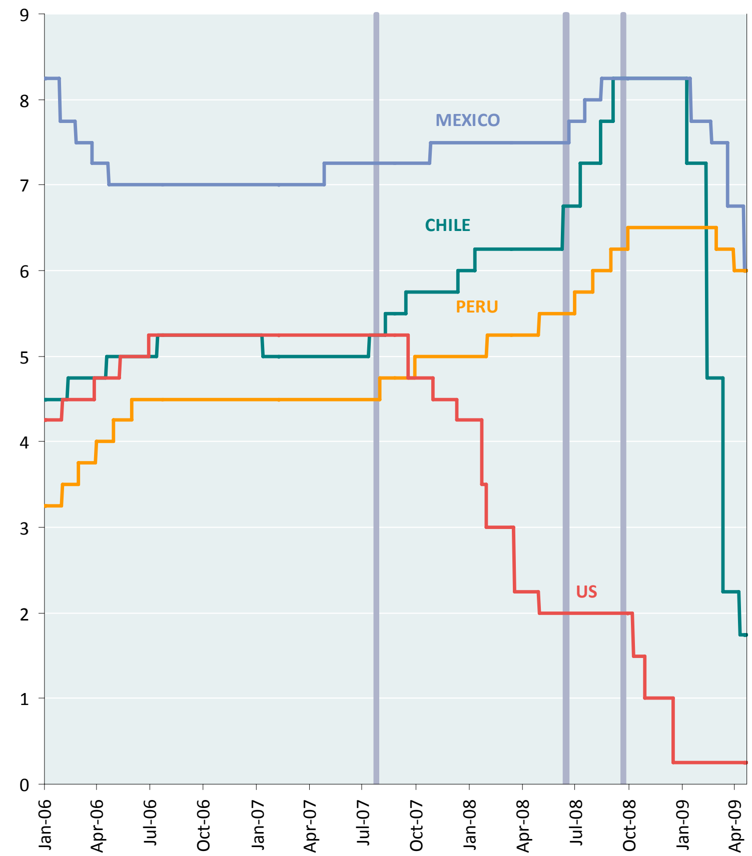
LAC: Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Mexico, Panama, Peru, Trinidad y Tobago, Uruguay and Venezuela
LCRCE staff calculations. Source: National data sources and Bloomberg.

… LAC inflation targeters have (and are using the) room for countercyclical monetary policy

Monetary Policy Rates
in %

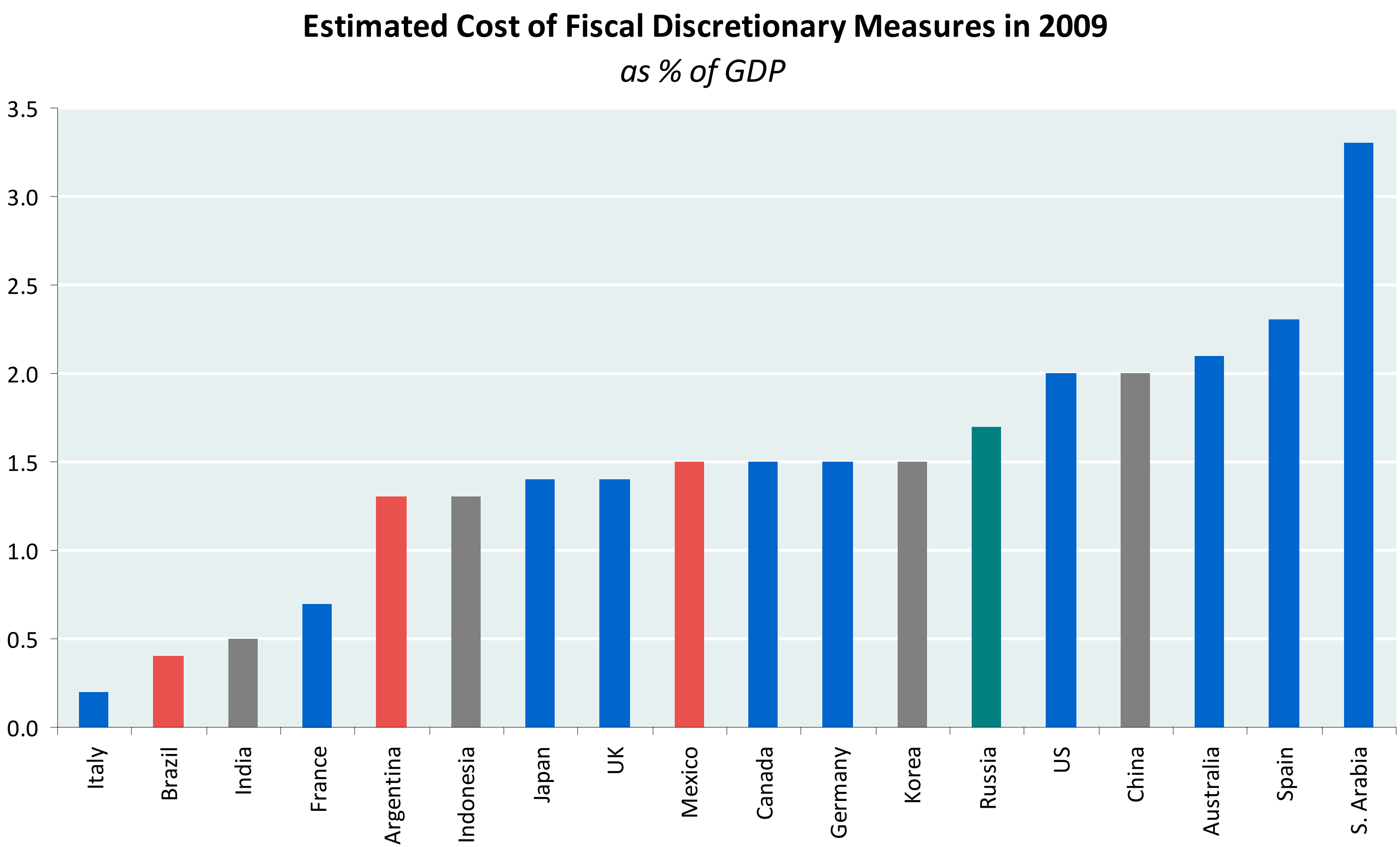


Monetary Policy Rates
in %



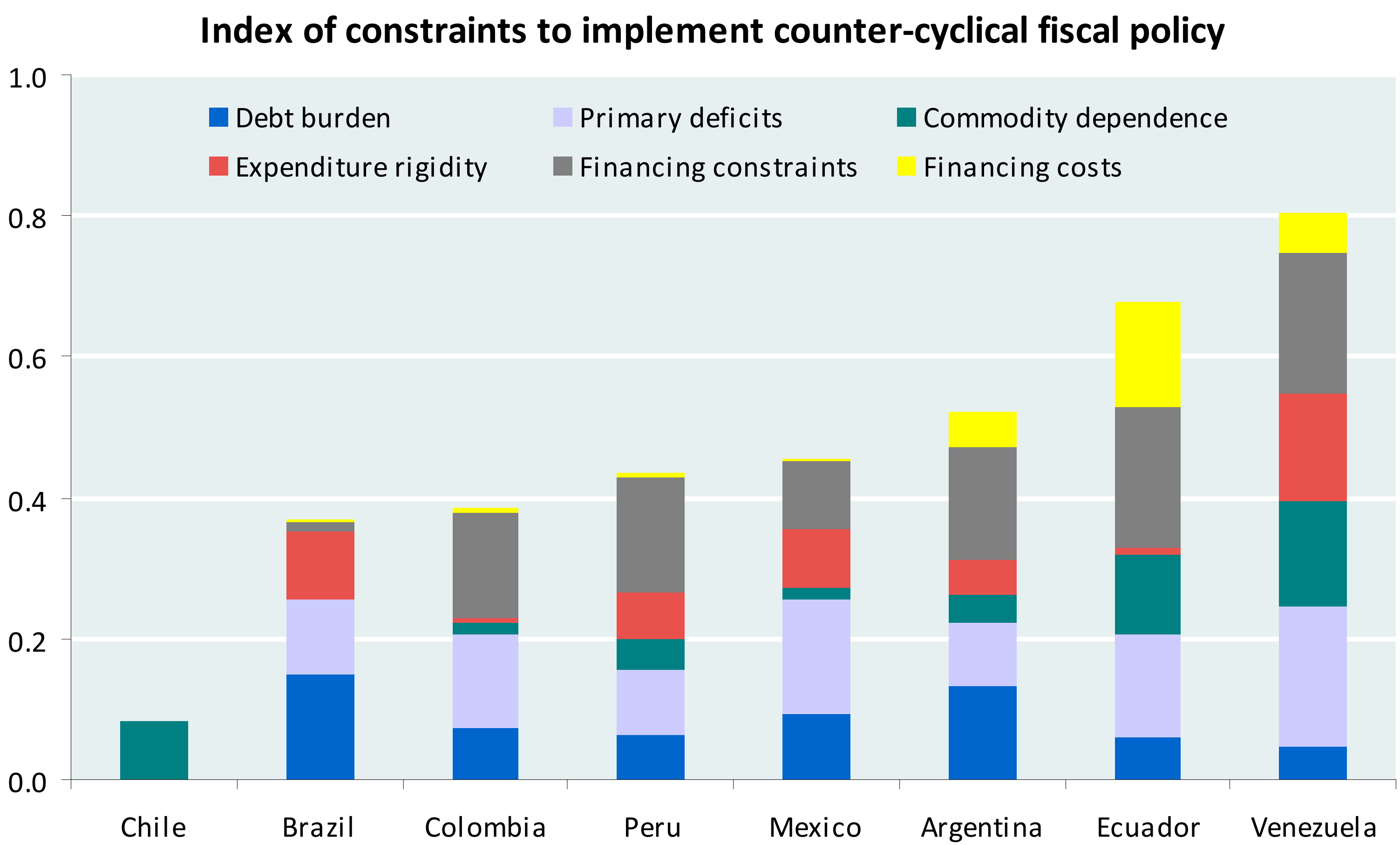
Source: Bloomberg – National Authorities

LAC countries are joining governments across the world in designing fiscal stimulus packages



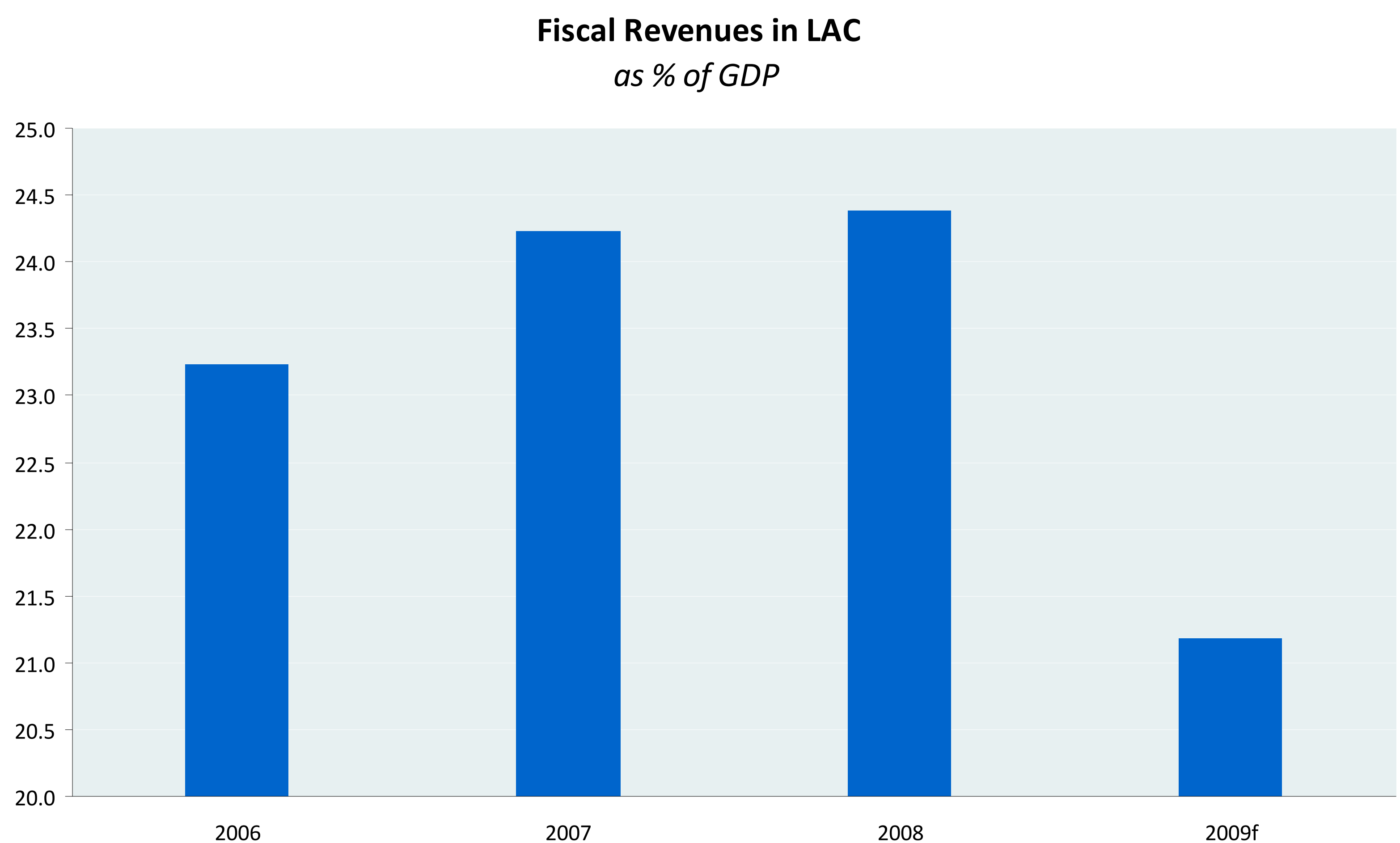
Source: IMF

But fiscal maneuvering room varies significantly across LAC countries…



This index is the weighted average of the relative score of the six different categories. The index as well as each category take values between 0 and 1. Higher values indicate higher contraints to create room for counter-cyclical fiscal police. Source: LCRCE Office calculations based on National Authorities

… which complicates matters given the expected large fall in fiscal revenues across LAC countries



Source: EIU

Final thoughts

- The world is gripped by the broadest, deepest, and most complex crisis since the Great Depression
- Economic prospects depend on the success of fiscal stimulus and financial packages in the US and other rich countries
  - The jury is still out regarding the packages' effectiveness
  - Even if effective, they may have adverse short-term consequences
    - Crowding out
    - Ring fencing of high-grade assets
    - *Risk of protectionism*
- Heterogeneity across EM regions is significant
  - Degree of openness and integration to the global production chain
  - Asymmetries in commodity dependence
  - Differences in macro-financial vulnerability

Final thoughts

- LAC has an edge over other emerging regions
  - LAC's monetary and fiscal policy frameworks and its local financial systems are not—for a change—independent sources of trouble
    - Some LAC countries have recovered space for countercyclical policy
    - But the scope for countercyclical fiscal policy is quite constrained
  - LAC's is relatively less integrated to the global production chain, which mitigates the *initial* effect of the current global slowdown
- The risk of reversal of social gains can be highly problematic for EMs, especially for democratic-but-unequal LAC
- Financial resources from multilaterals can and should help

Thank you