



LATIN AMERICA'S NEW IMMUNE SYSTEM: HOW IS IT COPING WITH THE CHANGING EXTERNAL ENVIRONMENT?

The worrisome external front...

The U.S. financial turmoil and its effect the real economy can negatively alter what has been hitherto a benign external environment for Latin America. Triggered by losses in U.S. sub-prime mortgages, the financial crisis has spread rapidly to other credit markets (including in developed markets outside the U.S.). Monetary authorities in the U.S. and other developed countries have responded with massive lender-of-last resort support and an unprecedented extension of the safety net beyond the traditional limits of deposit-taking institutions. U.S. fiscal authorities, for their part, appear willing to commit significant resources to support consumer demand and assist distressed debtors. Despite these bold actions, the U.S. economy is suffering adverse consequences, with markets perceiving a 70 percent probability of a recession in 2008. However, given the high uncertainty, the depth, length, and global impact of a U.S. recession are as much a matter of concern as of debate.

Rising food and fuel prices in international markets add a major complication. The prices of internationally-traded food commodities have risen by about 50 percent when measured in terms of Latin American currencies since January 2006. Demand for food products is outpacing supply partly due to the secular rise in the standards of living in China and other emerging markets (leading to relatively greater consumption of meat and, hence, rising demand for grains and animal feed products). High petroleum prices also exert upward pressure on food prices, particularly through their effect on the cost of fertilizer. Food price increases are exacerbated by the production of bio-fuels, boosted by generous subsidies and other support policies. Thus, almost all the increase in global maize production from 2004 to 2007 went for bio-fuels production in the U.S. (Mitchel 2008). The current wave of rising food prices arguably reflects a medium-term phenomenon. The World Bank forecasts food prices to remain high in 2008-09 and then begin to decline, but remaining above the 2004 levels through 2015.

... can prove disturbing to Latin America in various ways

These external changes can affect Latin economies through at least four channels:

- a) Financial contagion
- b) Contraction of external demand for Latin exports
- c) Fall in remittances
- d) Asymmetric effects of rising commodity prices across and within countries

But financial contagion does not seem to be one of them

The news is good so far with respect to the threat of financial contagion—unlike past episodes, investors are not “shorting” Latin America. The phenomenon of a sudden stop in capital flows to Latin America, which characterized previous crises (Tequila, Russia, and LTC), has

not been observed this time. Not only have investors not shorted Latin assets but capital has continued to flow into the region, contributing to the strengthening of Latin currencies and international reserve positions. On average, Latin American assets have become more attractive (less risky) relative to other asset classes. Thus, in the midst of the U.S. credit crisis, the Latin Emerging Market Bond Index (EMBI) spread has remained below and displayed less volatility than the spread on U.S. high yield (“junk”) bonds. More precisely, as their “beta” declines, Latin assets are providing greater risk diversification benefits to a portfolio of U.S. debt and equity securities. Concerns cannot be fully dispelled, however, given that Latin financial intermediaries are increasingly connected to their counterparts in the U.S. and elsewhere, including through risk-hedging trades. Also, there is evidence of tightening conditions in international markets for Latin American corporate bonds.

The improvement in the relative attractiveness of Latin assets as a whole conceals important differences within the region. The evolution of EMBI spreads since the outset of the U.S. sub-prime crisis, points to a clustering of Latin countries into three groups:

- a) Low EMBI spreads countries (Chile, Mexico). Their spreads—currently at less than 200 basis points over U.S. Treasuries—have been the lowest and least volatile relative to U.S. “junk” bonds spreads.
- b) Medium EMBI spreads countries (e.g., Brazil, Colombia, El Salvador, Panama, Peru, Trinidad & Tobago, Uruguay). Their spreads—currently between 200 and 350 basis points over U.S. Treasuries—have been converging towards the level and volatility of the EMBI spreads of the former group of countries.
- c) High EMBI spreads countries (e.g., Argentina, Belize, Ecuador, Dominican Republic, Venezuela). Their spreads—currently well above 350 basis points over Treasuries—have been closer to the level and volatility of U.S. “junk” bond spreads.

A U.S. recession is an important concern, but less so if China maintains high growth

How badly will the contraction in external demand drag down Latin growth? It will depend on the depth and duration of the U.S. slowdown and on what happens with growth in Europe and Asia (particularly China). The historically tight synchronization of economic downturns between the U.S. and Latin America has been loosened in recent years by a number of factors, including the rising importance of China to Latin American trade and growth. This helps explain why, despite the ongoing deterioration of U.S. growth forecasts, the growth forecasts for most Latin countries (with the notable exceptions of Mexico and Chile) have remained high and, in some cases, even increased following the eruption of the sub-prime crisis. The evidence suggests that, while Latin growth is cyclically coupled with the growth in high-income countries, its trend growth might be decoupling to an extent. The most recent consensus forecast puts Latin American weighted average growth at 4.3 percent for 2008 (compared to an achieved growth rate of about 5.5 percent in 2007). Behind this forecast is the perception that, even under pessimistic global scenarios, growth in China is envisaged to remain strong (above 9 percent) in 2008 and, therefore, commodity prices high.

In any case, a U.S. downturn will affect Latin countries differently. Two groups can be distinguished, depending on the magnitude and nature of the impact:

- a) Countries where the impact is mainly direct (due to tight trade links with the U.S.) and from the outset—such as Mexico and most Central American countries.
- b) Countries where the impact is mainly indirect (via lower growth in Europe and Asia) and thus somewhat delayed—such as Argentina and Brazil.

The U.S. slowdown is already undermining remittances flows

A fall in remittances hurts a well-defined set of Latin countries. Remittances represent between 10 and 20 of GDP in eight Caribbean and Central American countries (Honduras, Guyana, Haiti, Jamaica, El Salvador, Nicaragua, Guatemala, and the Dominican Republic) and between 3 to 10 percent of GDP in seven additional countries (Ecuador, Bolivia, Belize, Granada, Paraguay, Mexico, and Colombia). While countercyclical with respect to growth in the recipient country, remittances are pro-cyclical with respect to growth in the sending country. Latin migrants in the U.S. live mainly in states (California, Texas, Florida, and New York) and work in economic sectors (construction, services) that are hit hard by the current slowdown. As a result, remittances to Latin America have decelerated and are beginning to contract for some countries (Mexico, Dominican Republic). The fall in the dollar further magnifies this decline when measured in pesos. The decline in remittances would increase the total poverty rate in Latin America only marginally, but it would significantly raise the poverty rate among recipient households.

Rising commodity prices have asymmetric effects, across and within countries

The terms of trade effects associated with rising commodity prices differ widely across Latin countries. In broad terms, the boom in commodity prices implies significant terms of trade gains for South America but terms of trade losses for Central America and the Caribbean (with the salient exception of Trinidad & Tobago). High petroleum prices are particularly damaging for small and low-income countries in Central America and the Caribbean (e.g., Guyana, Honduras, Belize, Jamaica, Nicaragua). High prices of agricultural commodities are especially harmful to certain middle-income countries in the Caribbean (e.g., St. Lucia, St. Kitts, Barbados, Dominica, Jamaica).

Particularly sensitive among commodities are foods and fuels—their rising prices are causing stress within countries due to their uneven distributional effects. As food products are comparatively more important in the consumption basket of lower income households, rising food prices mean that the inflation that is relevant to them is significantly higher than overall inflation. Other things equal, this would lead to lower consumption and lower purchasing power of the income of poor families that are not net producers of foodstuffs. And this may translate into higher poverty in urban areas (relative to rural areas). Although more important in the consumption basket of the non-poor, fuel prices too are highly sensitive, not least because of their widespread effects on the structure of costs. Not only the Latin American countries that are net importers of foods and fuels, but also the net exporters, must deal with the distributional pains of the pass-through to domestic prices of higher international prices. But net exporting countries have a clear advantage—their governments can capture the terms of trade gains and use them to finance targeted income transfers to the poor.

The region is better positioned this time...

On average, Latin America has strengthened its immune system vis-à-vis adverse external shocks. This is the result of interactions between a favorable external environment and policy improvements. The improved immune system features:

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

...but political and external factors are constraining the room for policy maneuvering

Political economy constraints can lead to sub-optimal policy responses to rising international prices of foods and fuels. The political tensions associated with higher food and fuel prices help explain recent measures taken by several Latin governments (price controls, import subsidies, export taxes, export bans, etc.), applied to sensitive consumables and intended to drive a wedge between the international and domestic prices of these products. (This excludes measures taken with the sole purpose of raising fiscal revenues by taxing commodity rent windfalls.) While offering short run relief, these measures may not be sustainable in the medium-term because they prevent price signals from reflecting the changed relative scarcities in the world economy. As a result, they induce a misallocation of productive resources and hinder suitable changes in consumption, postponing the necessary adjustment in supply and demand to what is arguably medium-term trend in commodity markets. Price distorting measures, furthermore, are often untargeted and can thus have, contrary to their intention, regressive distributional effects. Finally, from a global point of view, exaggerated food export impediments can be seen as a “beggar thy neighbor” policy, lowering domestic prices at the expense of higher prices for food importing countries and hindering the global supply response. Policies to facilitate that supply response through productivity increases, along with targeted income transfers to vulnerable groups, would induce fewer distortions and be more sustainable.

And external factors confront monetary authorities with a complex dilemma. The coexistence of falling international interest rates, a sliding dollar, and rising food prices creates difficult trade-offs for Latin central bankers. Lower international interest rates and a weakening dollar increase the returns on “carry trade,” thereby boosting speculative capital inflows and exacerbating the appreciation of Latin currencies that are already uncomfortably strong. In the absence of upward pressures on inflation, Latin central bankers could mitigate this problem by following foreign central banks with domestic interest rates cuts of their own. But this option is all too risky given the rise in food and fuel prices, which rather compel monetary authorities to maintain or increase interest rates, particularly in countries where the economy is overheating. There is no easy way out of this dilemma in an environment of unfettered capital mobility. It is thus not surprising that the option to throw “sand in the wheels”—via some form of Chilean-style taxes on short-term capital *inflows*—is being discussed again in Latin policy circles, although many doubt that this type of measure could curb *total* capital inflows beyond the short-run.