

Latin America in Today's Global Economy

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Lima, Peru

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Agenda

- I. LA and the US Credit Crisis/Economic Slowdown
- II. LA and the Commodity Price Shock
- III. LA and Global Stagflation
- IV. LA Challenges and Outlook



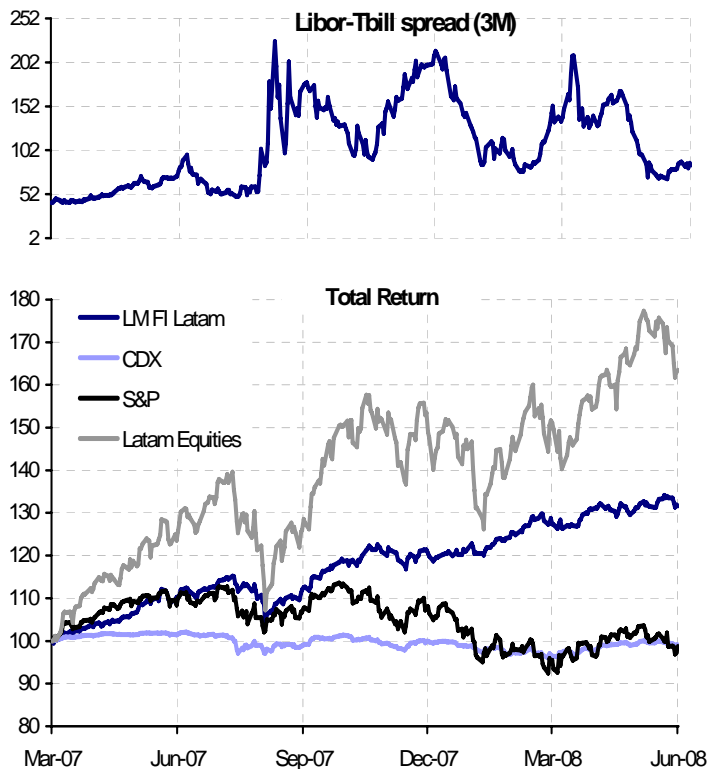
I. LA and the US Credit Crisis/Slowdown



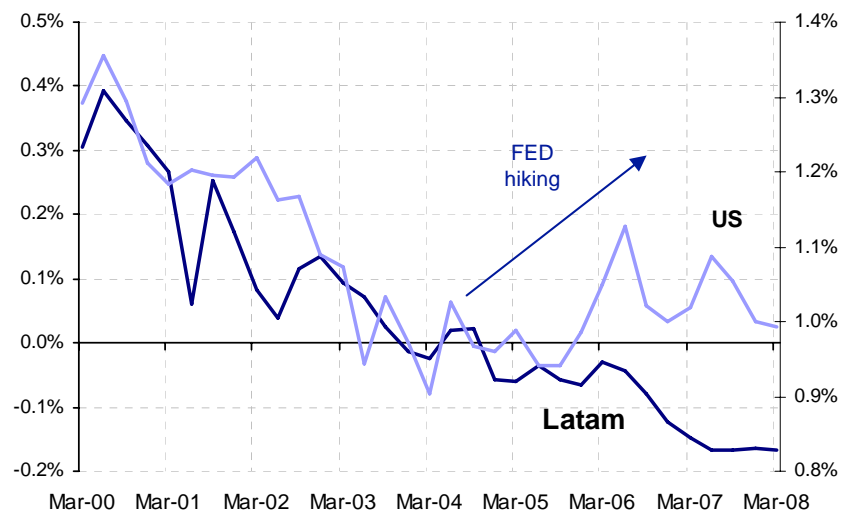


Comparative Shock

Asset price indicators

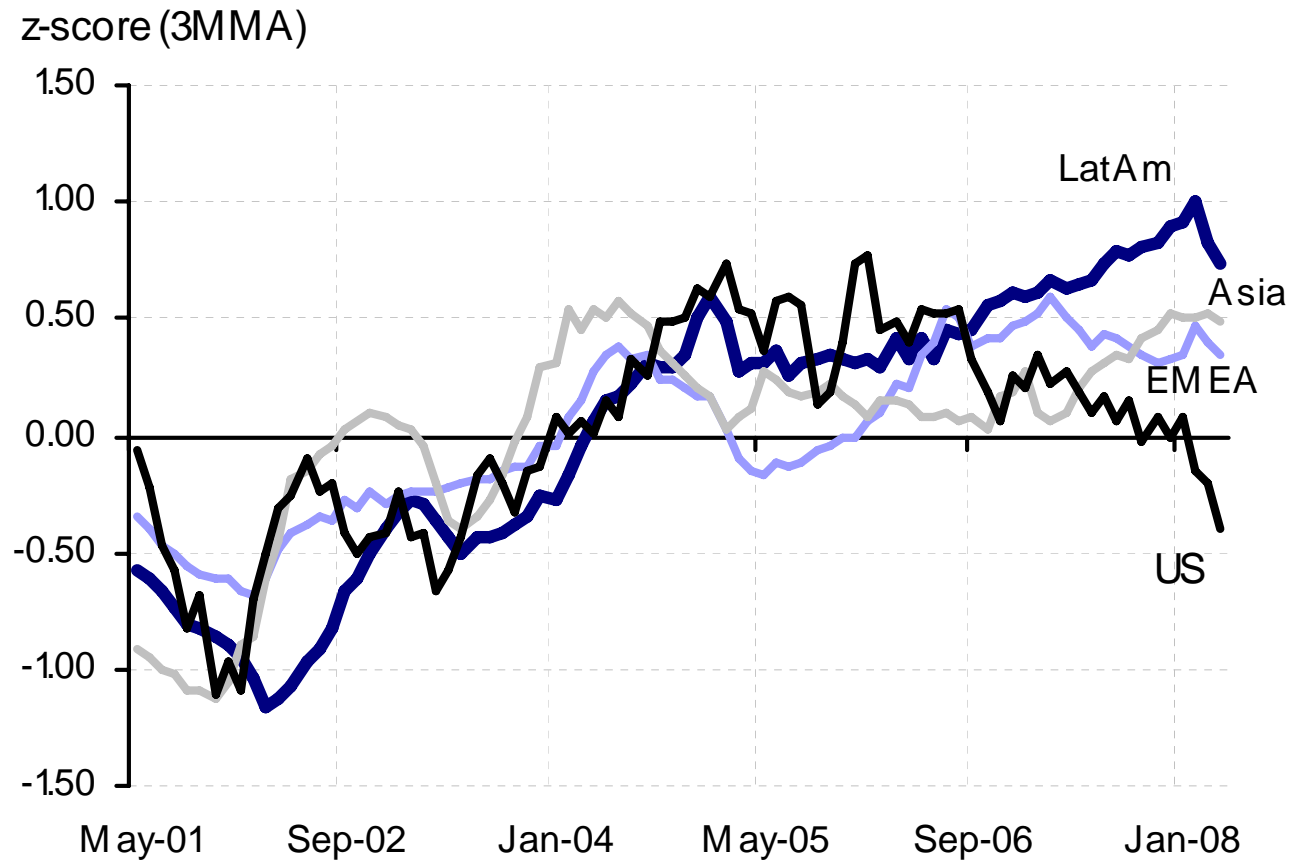


Financial condition indicators



Comparative Performance

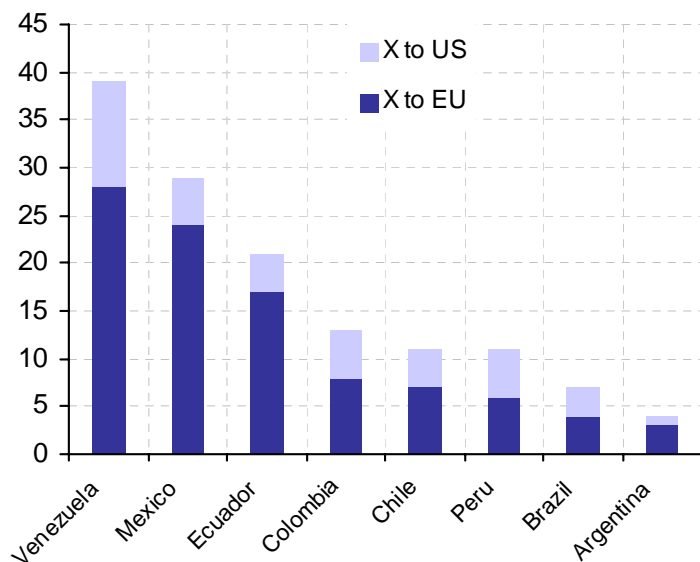
Momentum activity indicators



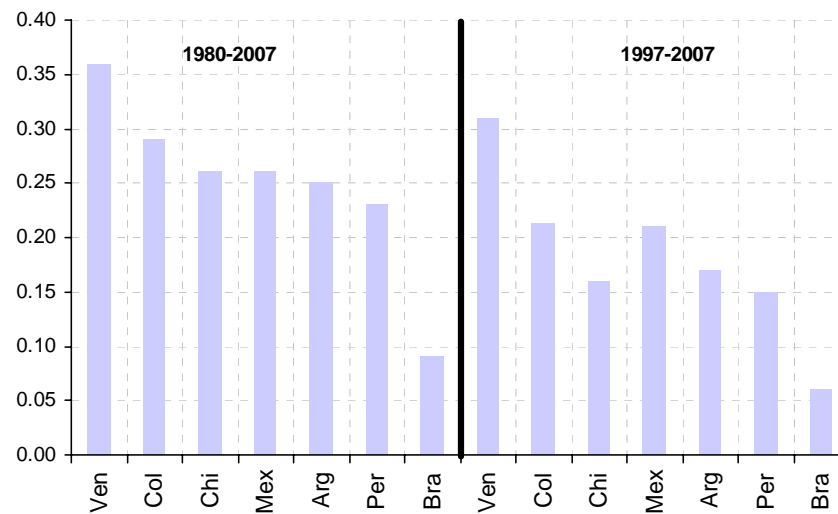


Fundamental Grounds

Exports to US and EU (% of GDP)



Growth correlation with US & EU

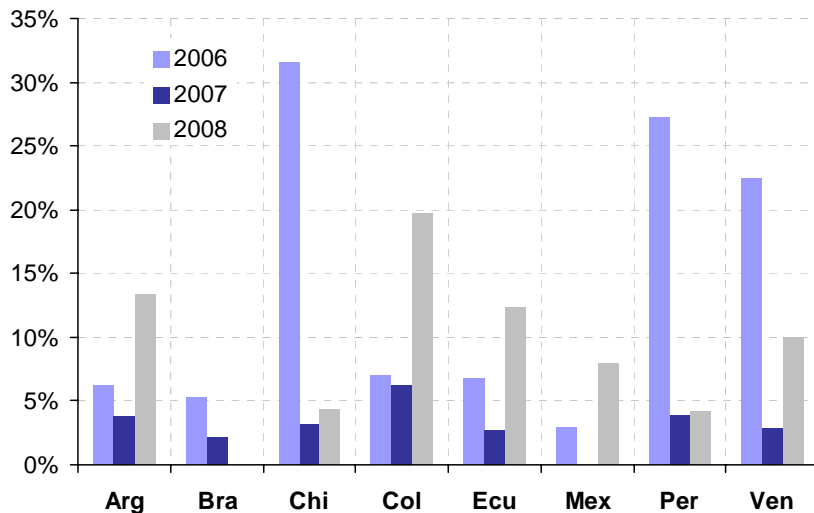


II. LA and the Commodity Price Shock



Measuring the Commodity Shock - Benefits

Change in terms of trade, YoY%



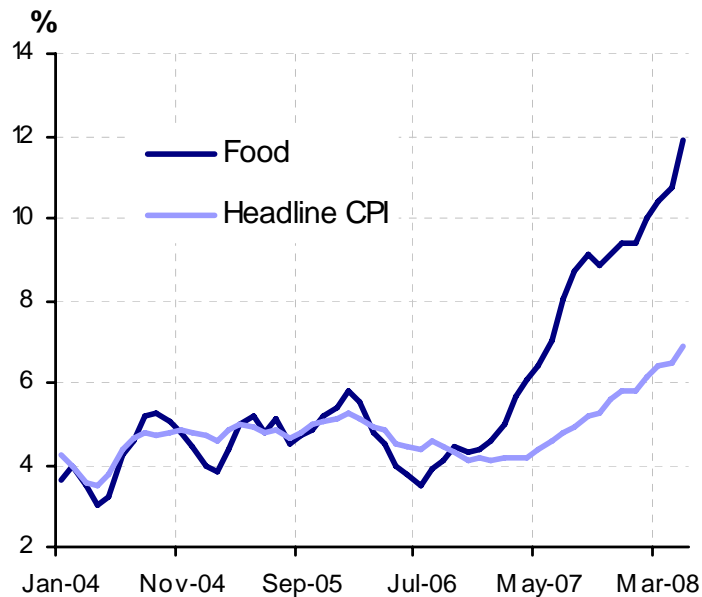
Commodities and fundamentals, %GDP

| | Commodity Participation in | |
|------------------|----------------------------|-----------------|
| | Exports | Fiscal Revenues |
| Argentina | 12.9 | 3.9 |
| Brazil | 4.1 | 0.8 |
| Chile | 27.0 | 8.3 |
| Colombia | 7.8 | 3.4 |
| Ecuador | 17.9 | 9.4 |
| Mexico | 3.9 | 4.2 |
| Peru | 18.0 | 3.1 |
| Venezuela | 30.3 | 24.0 |



Measuring the Commodity Shock - Costs

Food vs headline inflation

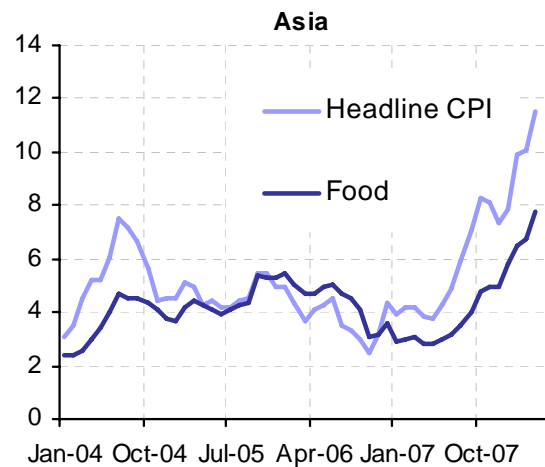
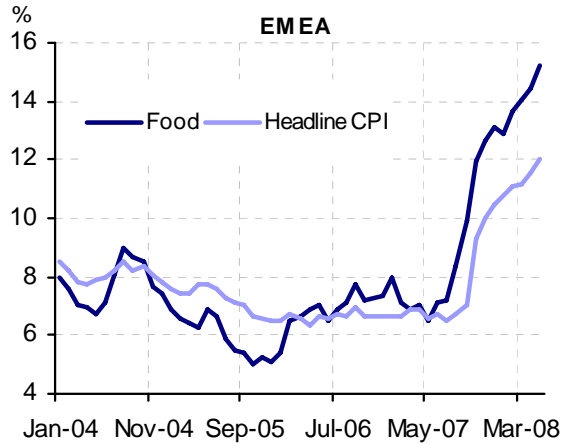


Commodity price shock by country

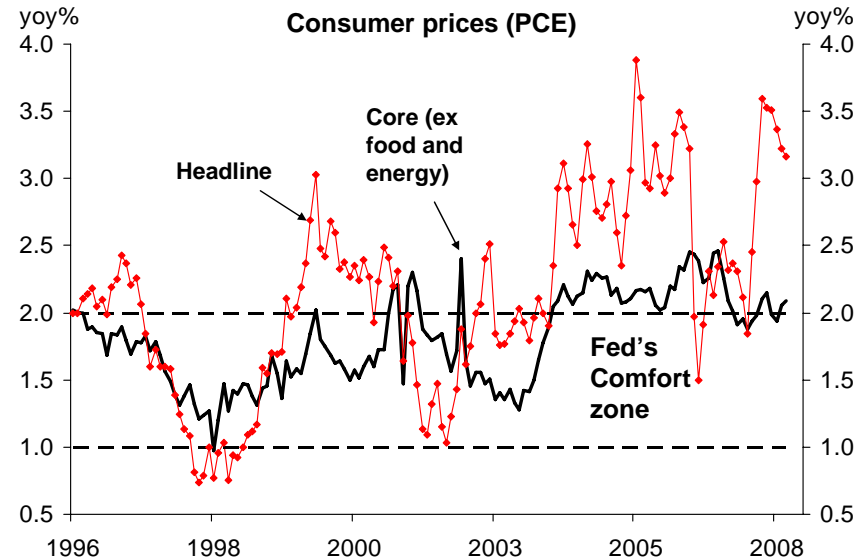
| | 2006 | 2007 | YTD |
|-------------------------|--------|--------|--------|
| Commodity Food | 10.49% | 15.24% | 38.47% |
| Commodity Energy | 20.49% | 11.28% | 64.32% |
| Arg | | | |
| CPI Headline | 10.92% | 8.84% | 8.49% |
| CPI ex food and energy | 11.23% | 7.23% | 7.68% |
| Bra | | | |
| CPI Headline | 3.27% | 4.08% | 5.43% |
| CPI ex food and energy | 4.32% | 3.30% | 3.21% |
| Chi | | | |
| CPI Headline | 3.40% | 4.40% | 8.02% |
| CPI ex food and energy | 1.92% | 1.56% | 2.88% |
| Col | | | |
| CPI Headline | 4.30% | 5.54% | 6.09% |
| CPI ex food and energy | 3.12% | 4.12% | 4.15% |
| Mex | | | |
| CPI Headline | 3.63% | 3.97% | 3.89% |
| CPI ex food and energy | 3.43% | 3.48% | 3.61% |
| Per | | | |
| CPI Headline | 2.00% | 1.78% | 4.84% |
| CPI ex food and energy | 1.22% | 1.69% | 2.02% |

Comparative Performance

Better than in EMEA or Emerging ASIA



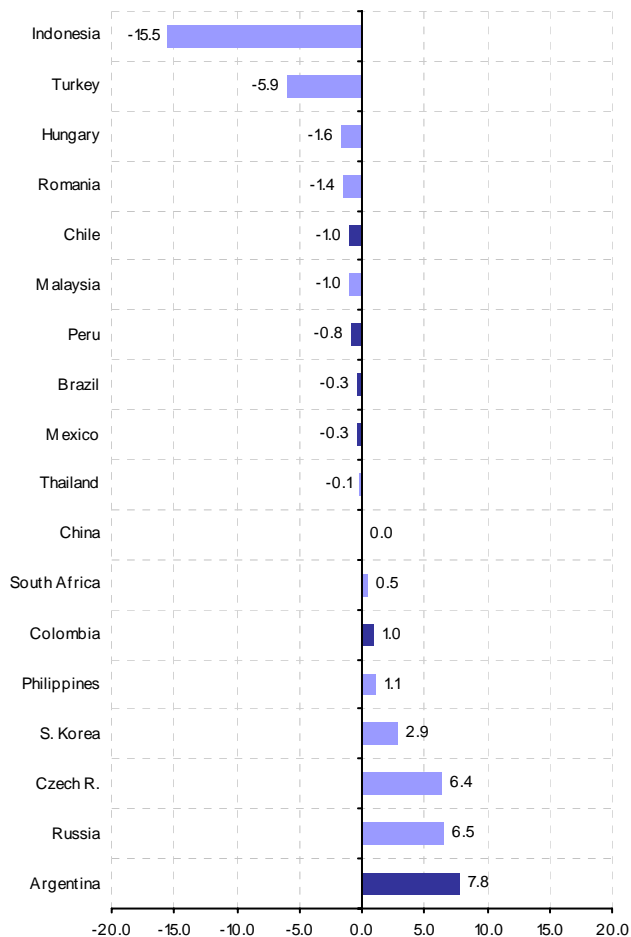
US PCE: Headline running well above comfort zone and core at the edge



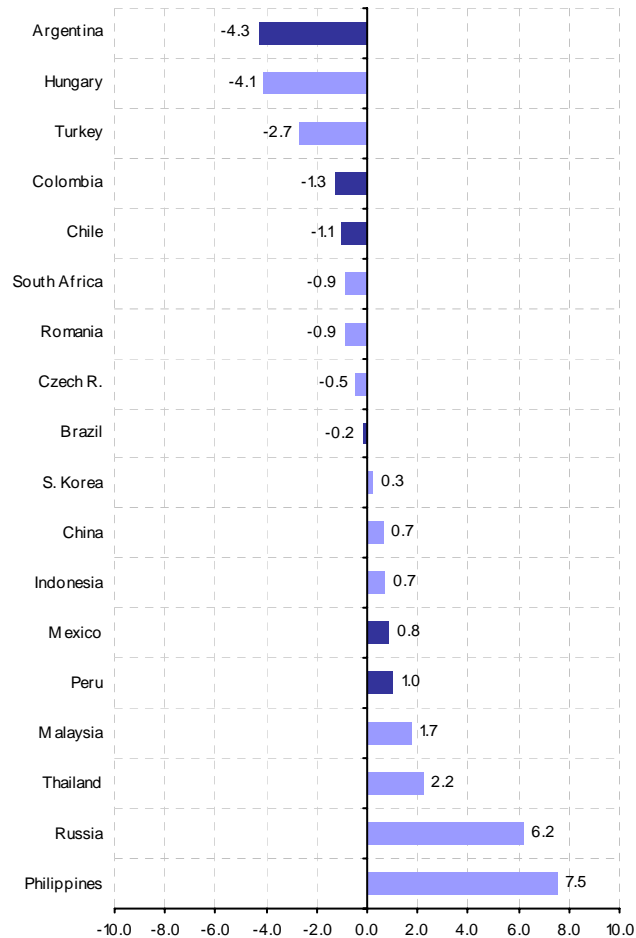


Comparative Performance - continued

12M Food commodity non-food/energy pass-through



12M Energy commodity non-food/energy pass-through

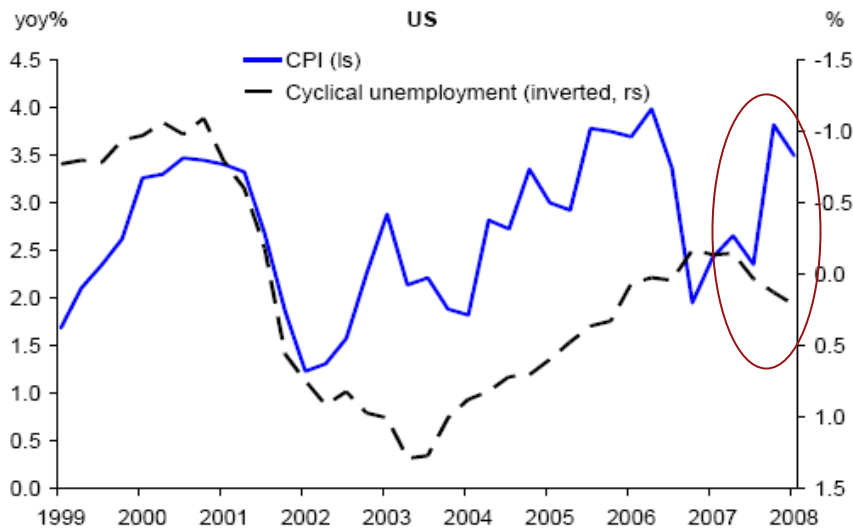


III. LA and Global Stagflation

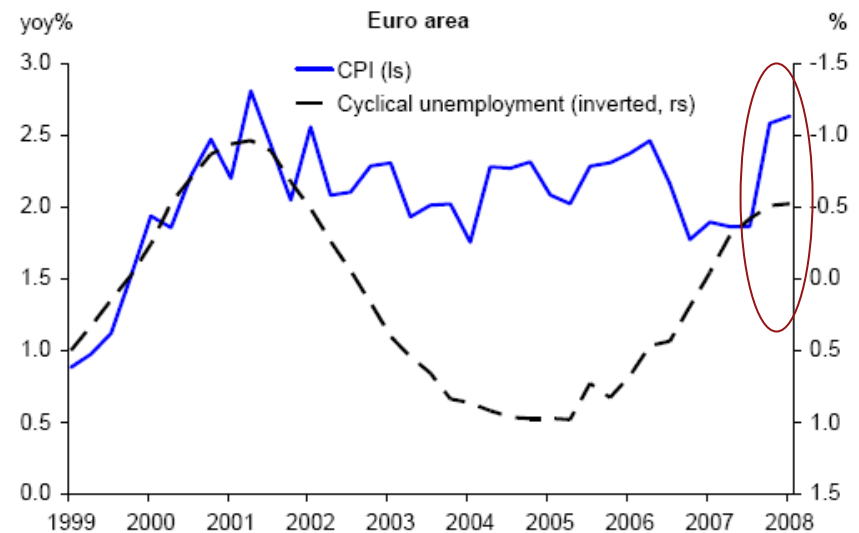


Global Stagflation – The Worsening Trade-off

Inflation and cyclical unemployment in the US



Inflation and cyclical unemployment in the Euro area



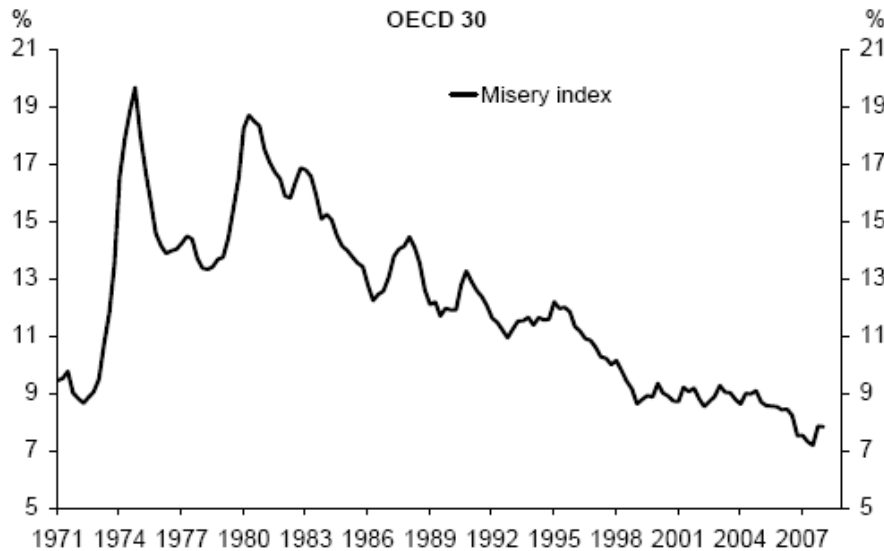
FED targeting comfort zone for core (1.5%-2.0%) would have to push unemployment up by 50bps. ECB achieving 2% headline could cost between 150bps-200bps in additional unemployment





Global Stagflation – Still Not That Bad But...

The misery index (inflation + unemployment) in OECD 30



Drivers of stagflation (according with our US economists)

Setting the stage

- US credit-financed expansion
- Supply-side price shocks

Macro policies

- Lax fiscal policy
- Politically dependent central bank
- Exchange rate peg to USD
- Monetary policy not committed to price stability
- Liquid banking sector

Competition/openness

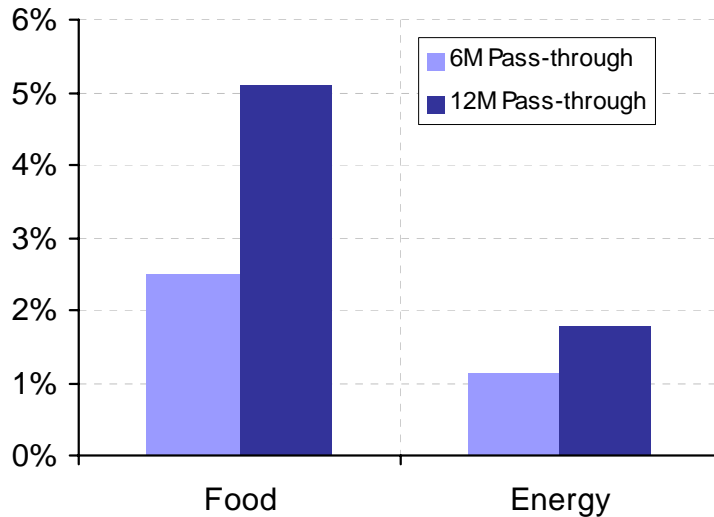
- Rigid labour markets / strong unions
- Monopolies in product markets
- Trade protection and market intervention

Factors causing stagflation

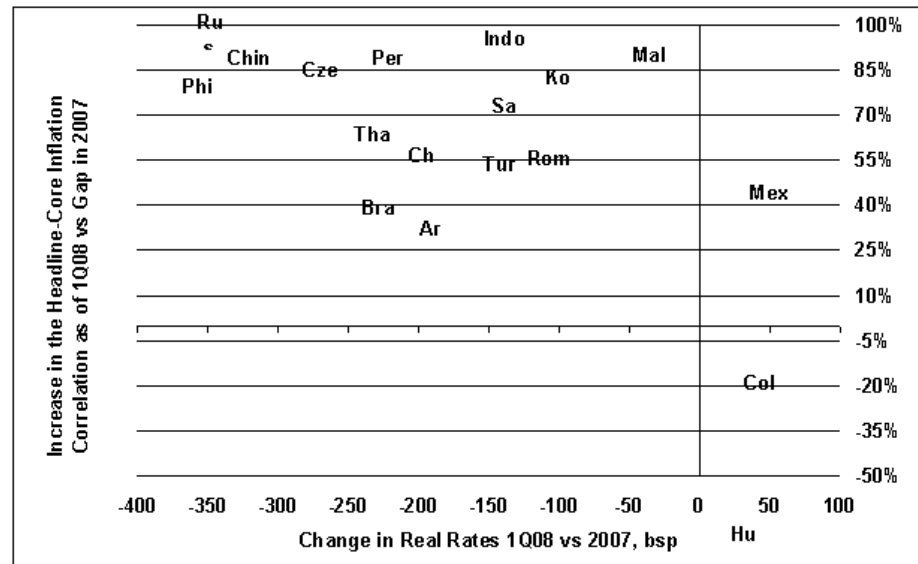
| | Industrial countries | Developing countries |
|--|----------------------|----------------------|
| Setting the stage | | |
| US credit-financed expansion | + | + |
| Supply-side price shocks | + | + |
| Macro policies | | |
| Lax fiscal policy | - | - |
| Politically dependent central bank | - | + |
| Exchange rate peg to USD | - | + |
| Monetary policy not committed to price stability | - | + |
| Liquid banking sector | - | + |
| Competition/openness | | |
| Rigid labour markets / strong unions | - | - |
| Monopolies in product markets | - | + |
| Trade protection and market intervention | - | + |

LA and (Still) Global Inflation – Lags and Late Reaction!

Path of food and energy pass-through (median) anticipates more inflation to come

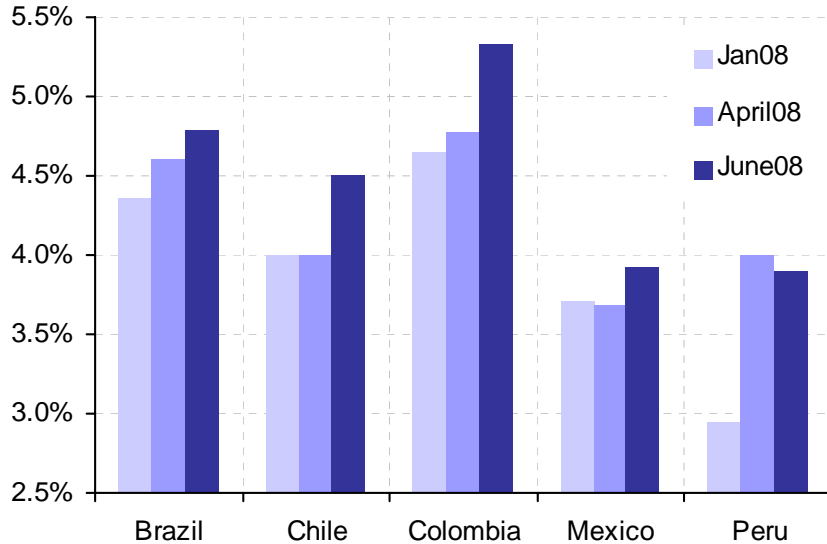


Monetary policy had barely reacted to potential inflation contamination by end of April



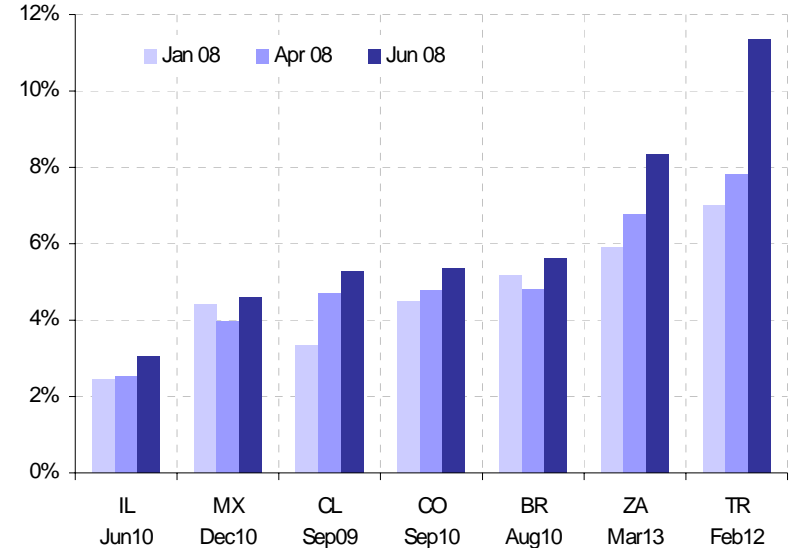
LA and Global Inflation – Local Inflation Is on the Rise

Analysts inflation projections are also increasing (12 month ahead)



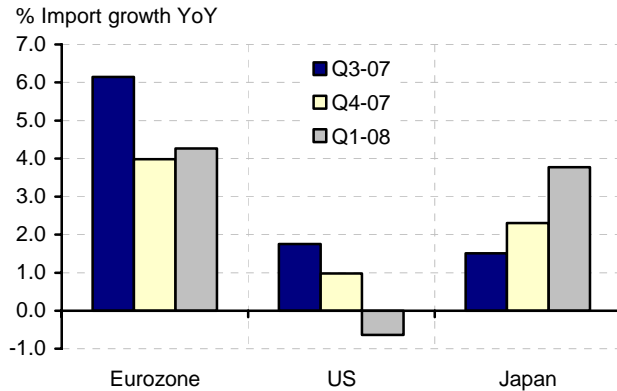
Breakeven inflation is increasing across EM

Breakeven inflation implied by EM inflation-linked bonds

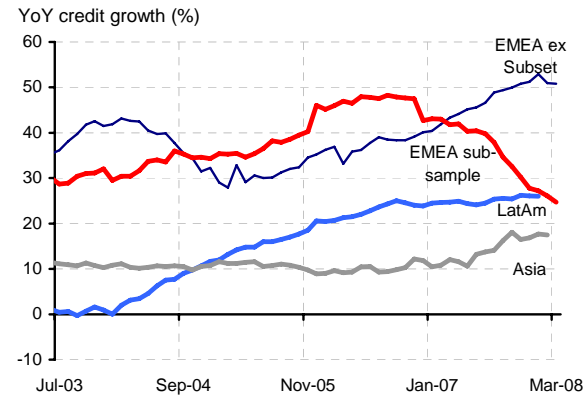


LA and Global Stagflation – Decoupling?

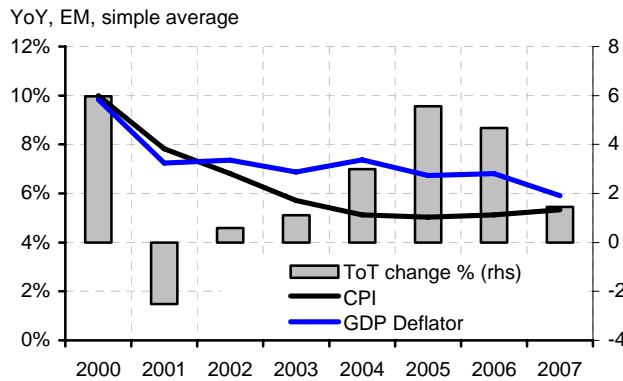
Demand for foreign goods- on US collapsing



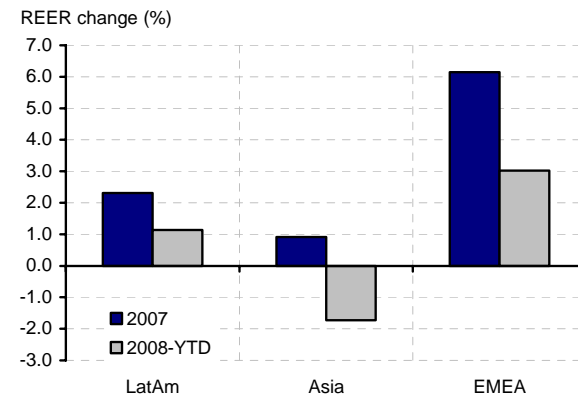
Credit growth sustaining consumption + investment



ToT gains are boosting real income growth

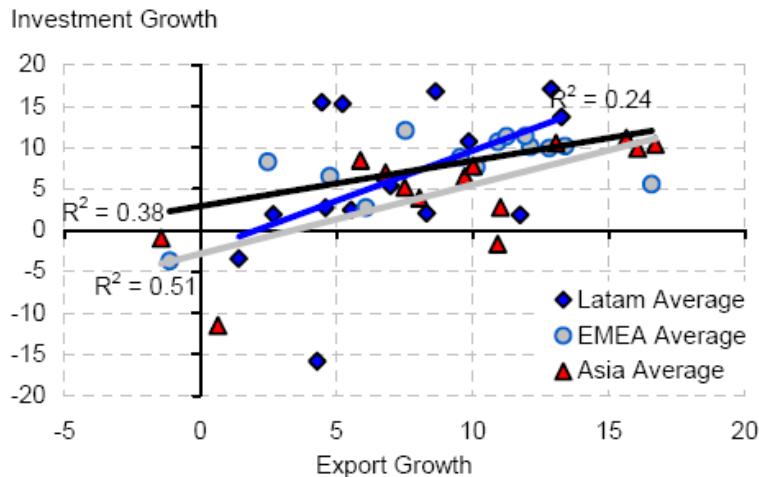


Asian growth benefiting from weaker currencies

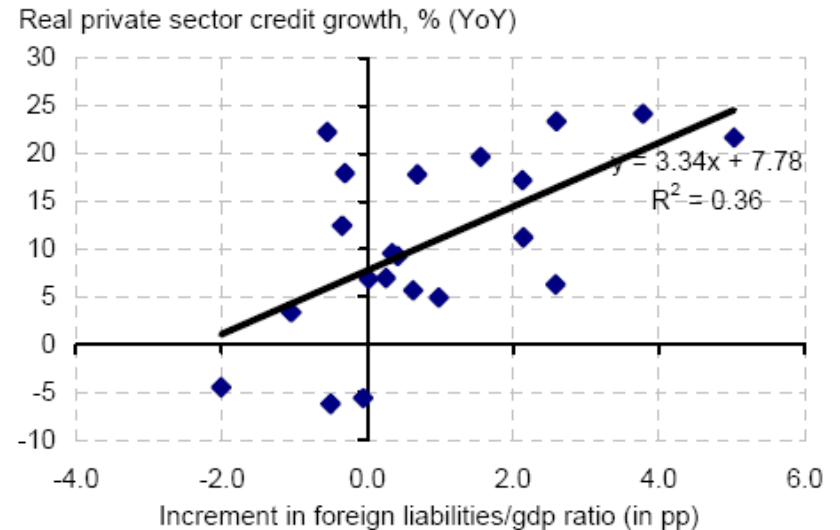


LA and Global Stagflation – Domestic Led Decoupling?

Export growth explains a significant part of EM investment growth



...which in turn is heavily influenced by the ability to borrow abroad



But the biggest BRICs seem to enjoy a solid domestic demand led growth. They represent roughly half of Emerging Economies. But raising inflation in China might not be a minor disruption. Protectionism is another real and serious threat.




IV. LA Challenge/Risk and Outlook

From Great Moderation to Shock Brutality



LA Challenge/Risk – Major C. Banks Should Care about Inflation and Coordinate Policy

Global

Deutsche Bank 

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Emerging Markets Monthly

Are Central Banks Behind the Curve?

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Dovish FED, Weak dollar, Strong Commodities, Higher Inflation for Everyone

**Weak dollar = strong commodities.
Fed Dallas, Jef Frankel, World GDP in USD, etc.**



SOURCES: Energy Information Administration; Federal Reserve Board; authors' calculations.

ECB is influenced by strong Germany, the rest of the members are simply suffering

Commodities bet is functional with accommodative FED. FED eases and the global economy recovers at the cost of inflation (scenario bullish commodities, even without recovery!)





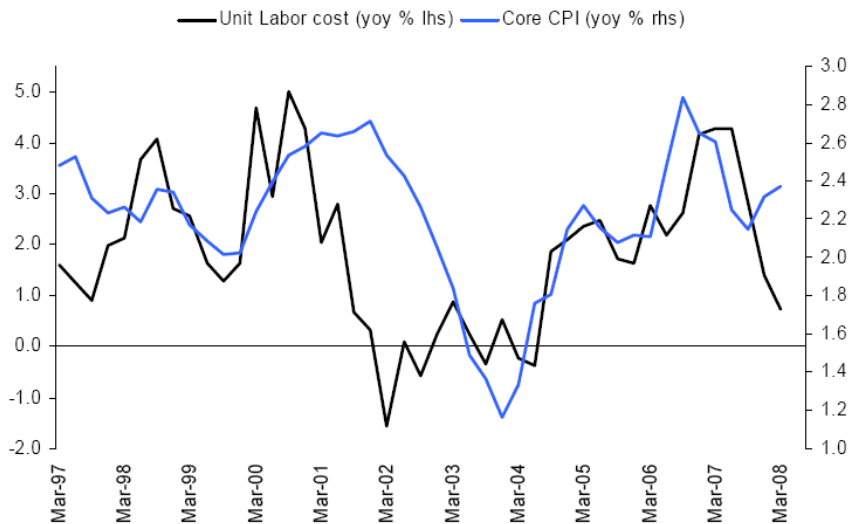
The (Even) Impossible Single Goal of Monetary Policy

- Facing an average supply shock (great moderation), monetary policy ideal response would be to avoid second round effects and accommodate relative price adjustments. Target sticky prices.
- In front of a large shock (brutality), more than 50% in food and 100% in energy in the last three years accumulated, this could imply a long deviation from inflation targets.
- True is, monetary policy institutions should help (i.e. see inflation response to previous shocks). However, under a sizeable shock, monetary policy becomes history and circumstances determined, balancing risk management and long term costs.
- Nothing worse than a large shock confronted with a policy mix that seems to exacerbate it. Thus the need for monetary coordination, fiscal policy, subsidies, market practices, etc, etc.
- Anyway, this would likely demand a monetary policy that would have to be tighter and for a more prolonged period of time than initially thought or even imagined.

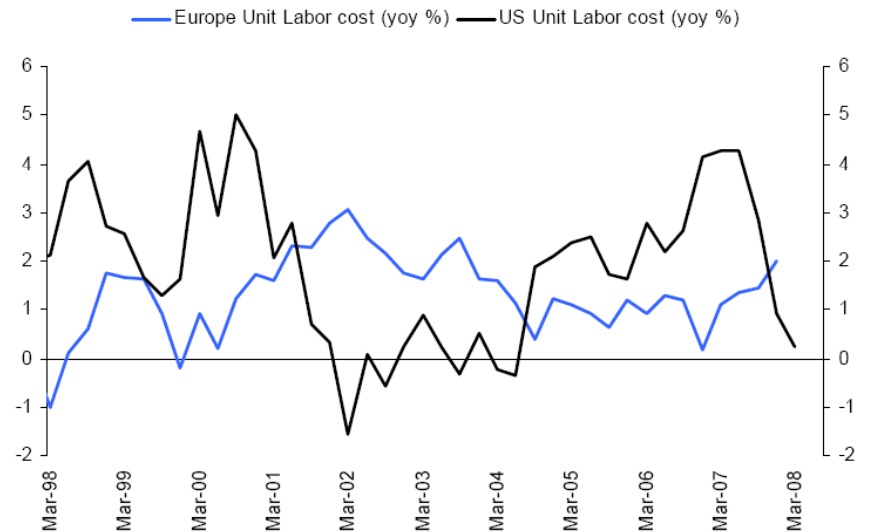


Has the FED Been on Denial? No, Risk Managing!

ULC growth (in the US) is pointing to declines in core inflation

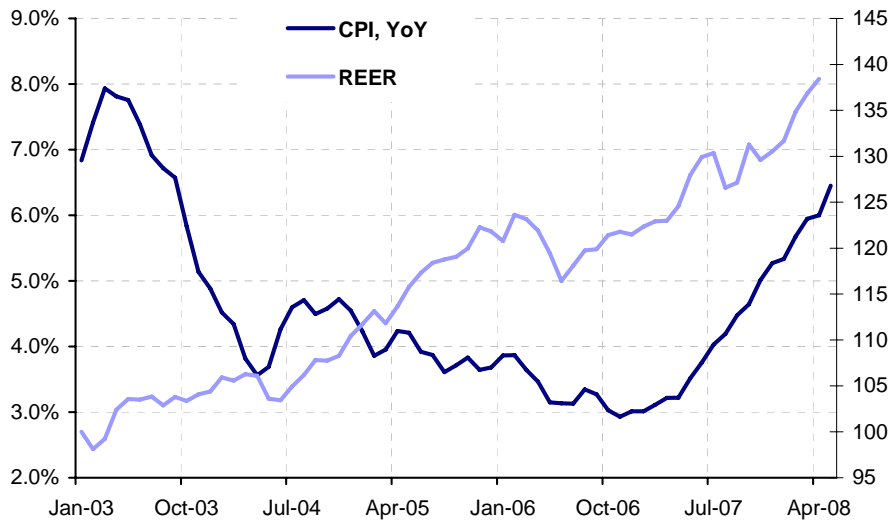


While ULC growth has fallen in the US, it has been rising in the Euro area

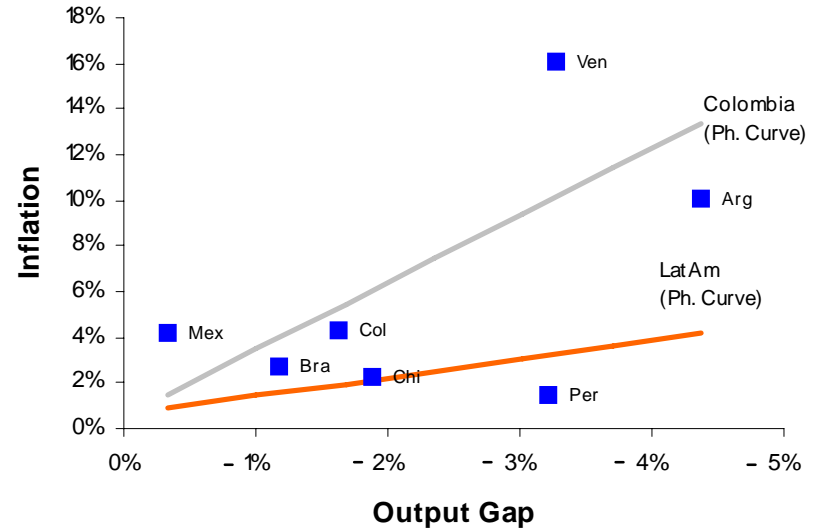


Cutting Inflation on Our Own Will Not Be Easy Otherwise

LA: Inflation vs real effective exchange rate (a help factor that could soon experience some constraints)



Regional Phillips curve and country trade-off, may anticipate a serious sacrifice ratio



So Far So Good for LATAM

Domestic rates and equities under pressure as EM Central Banks are forced to respond to inflation

EM market performance indicators (9-May – 11-June)

| | FX | Dom. Rates | CDS | Equities |
|-------|-------|------------|-----|----------|
| LatAm | +0.6% | +56 | -26 | -2.1% |
| EMEA | +0.7% | +69 | +10 | -3.3% |
| Asia | -2.0% | +94 | +22 | -9.1% |

Note: The above performance indicators represents the simple average change across a broad range of EM countries in each region. FX: is the performance of EM currencies relative to the corresponding major cross for each country; Domestic Rates is the change in 5Y swaps, or closest equivalent instrument; CDS is 5Y sovereign CDS and Equities is the local currency performance of the major domestic equity index.



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