
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



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 vulnerable in the social arena
- What is LAC's room for countercyclical policy?
- Summing up

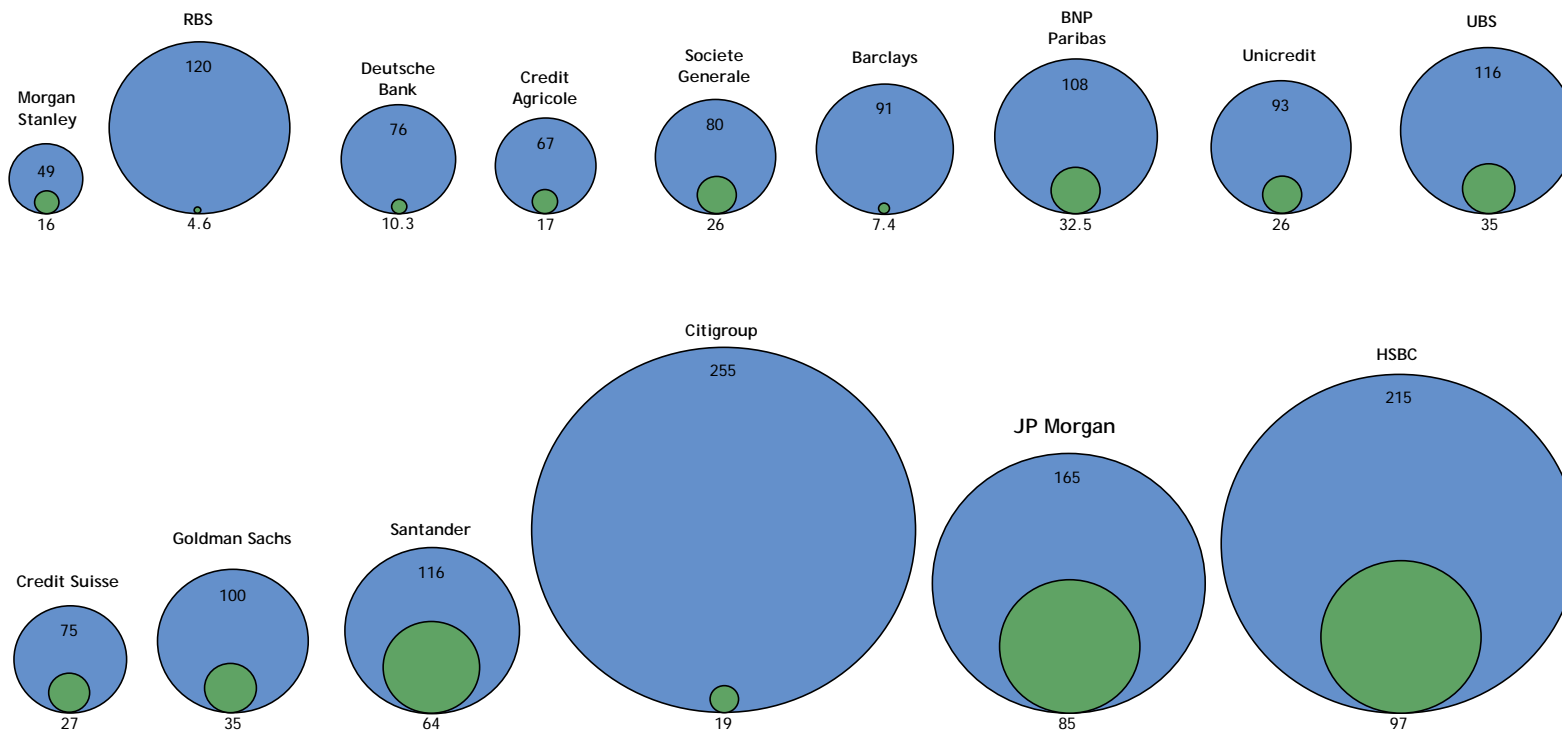
*The eye of the storm is in the economies
of the center...*

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

Banks: Market Cap

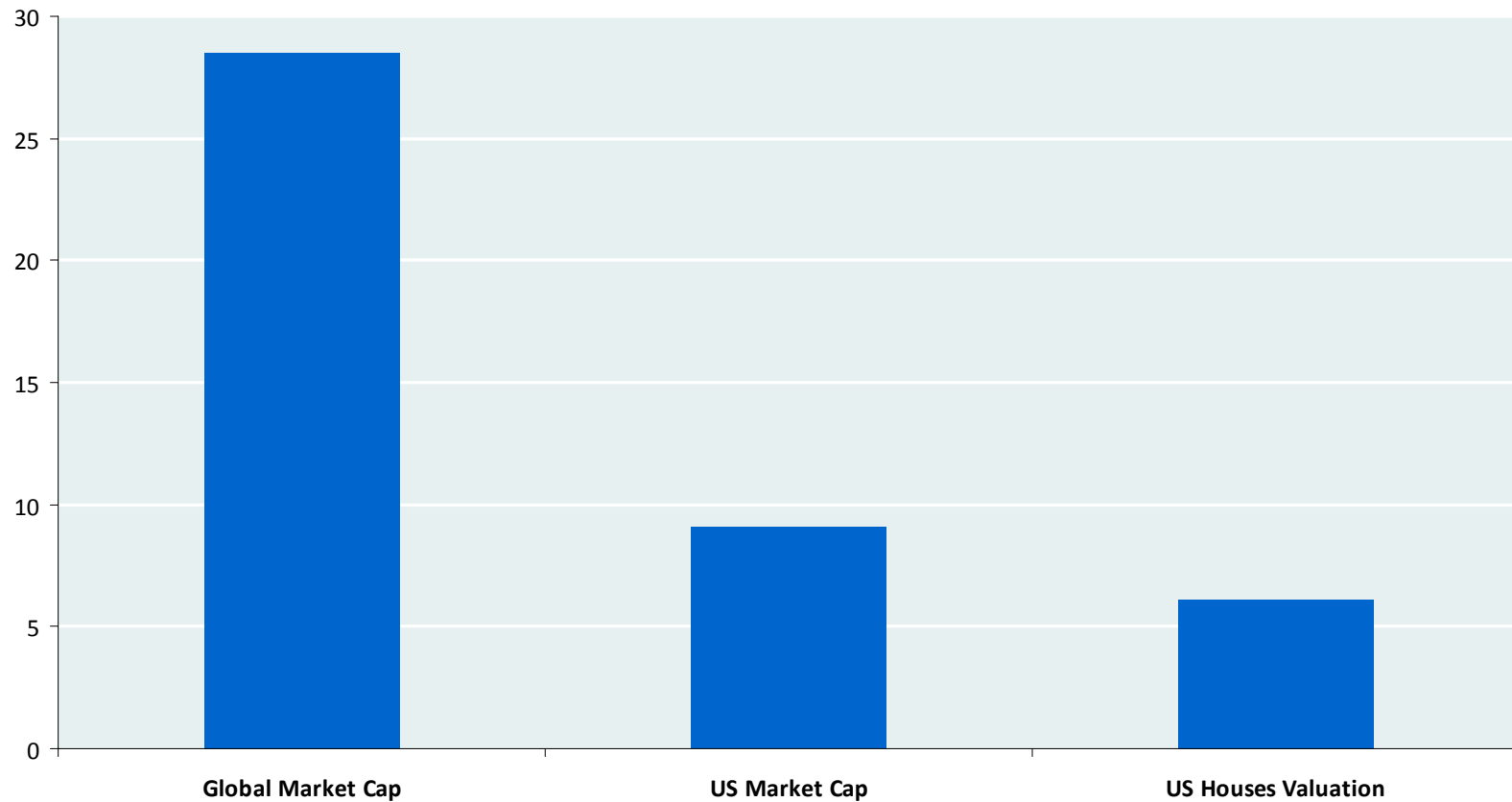
● Market Value as of January 20th 2009, \$Bn

● Market Value as of Q2 2007, \$Bn

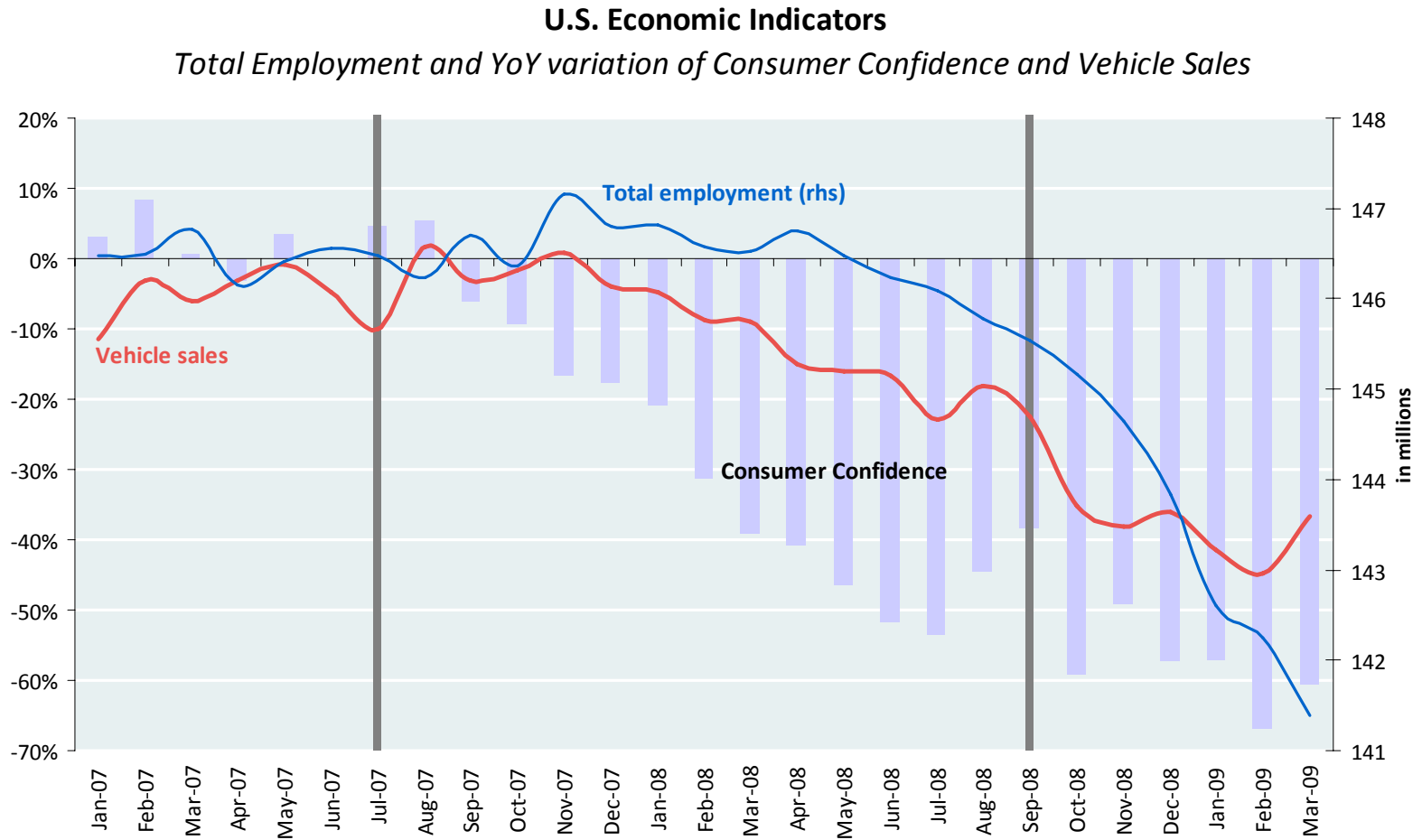


... and of assets values more generally

Losses between July 07 and April 09
in trillion of US\$

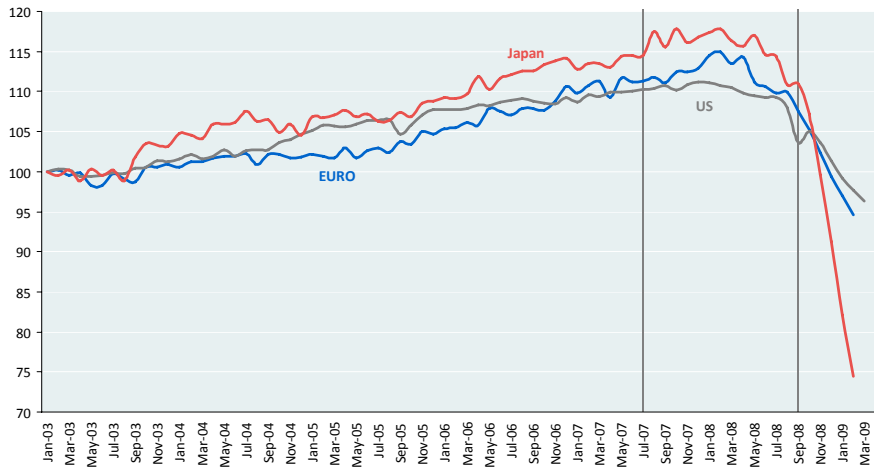


The U.S. economy is in a major recession, but perhaps no longer in a free fall

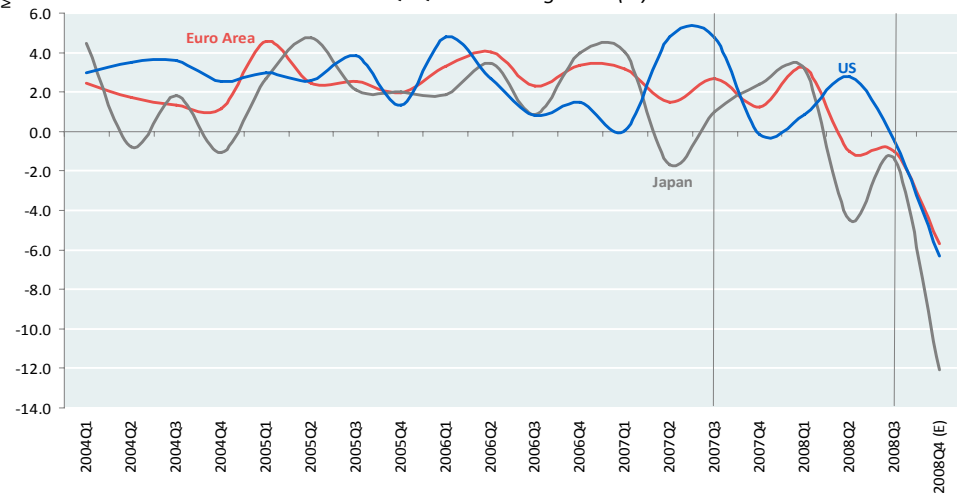


Economic activity in all rich countries is shrinking significantly, with Japan hardest hit

Industrial Production Indexes
Index number - Jan-03=100

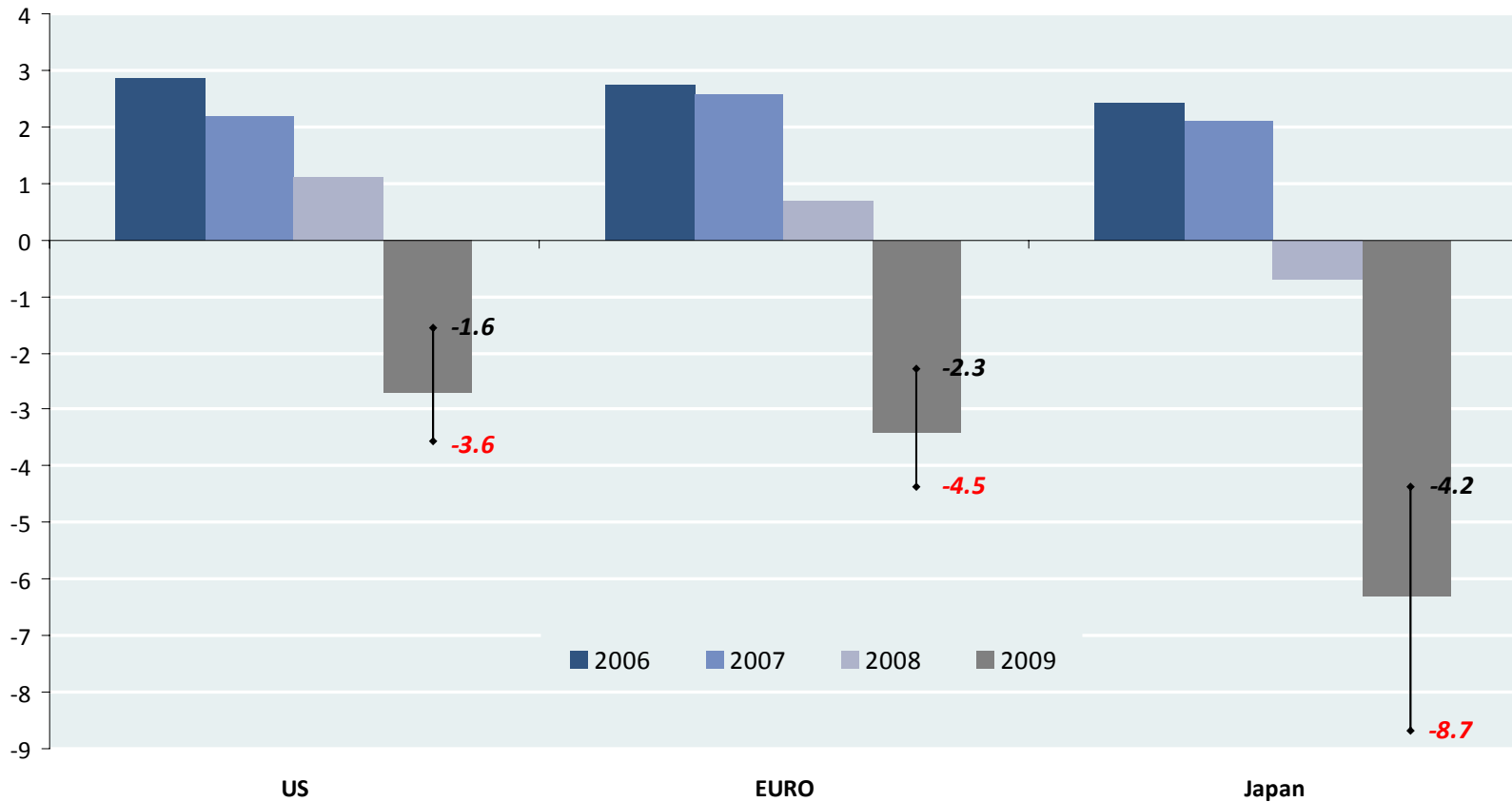


Real GDP Growth in Advanced Countries
QoQ annualized growth (%)



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

Recent Growth and Forecasts for 2009
annual GDP real growth rate, in %



*... 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

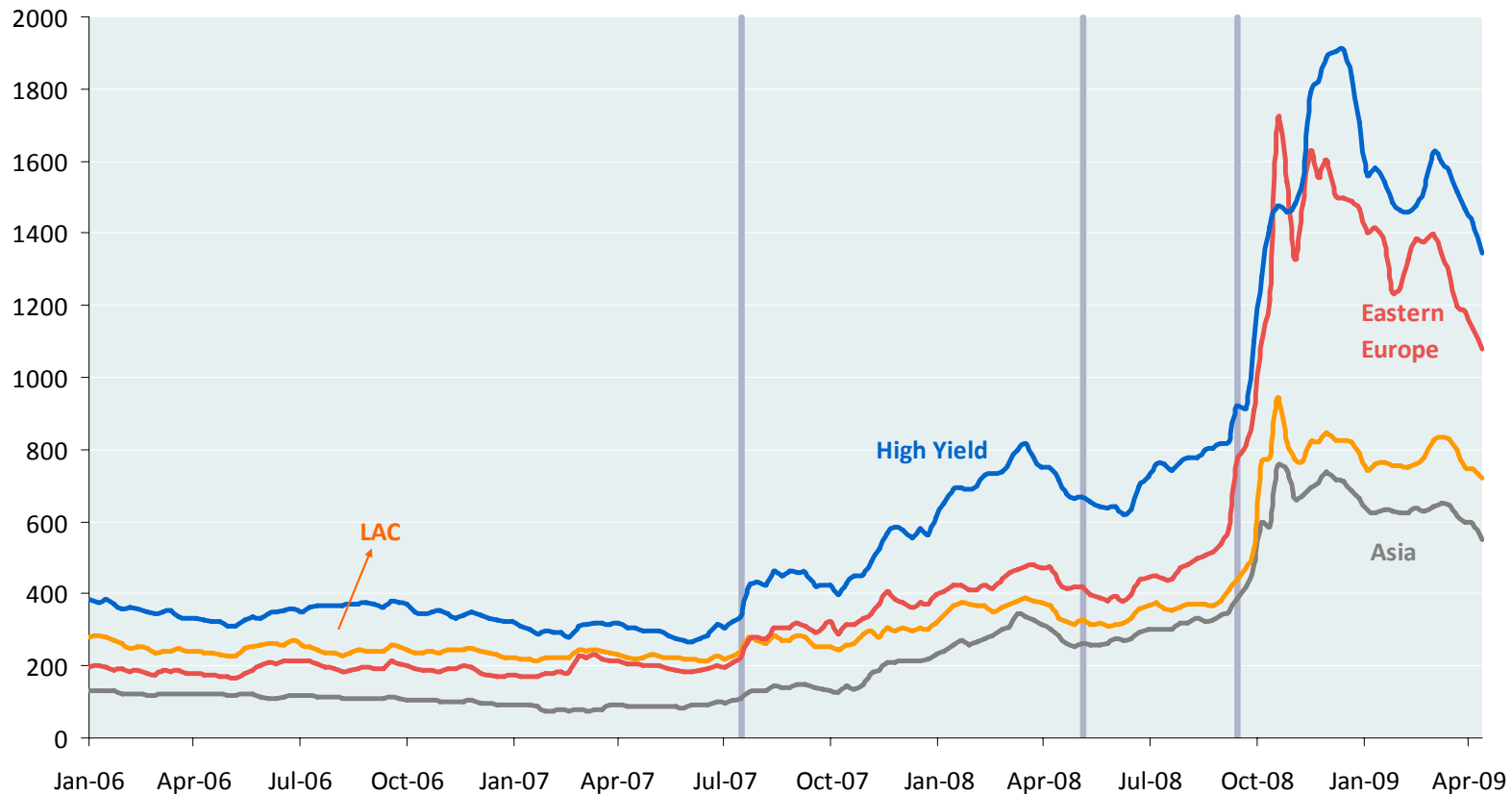
} Interrelated

■ 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

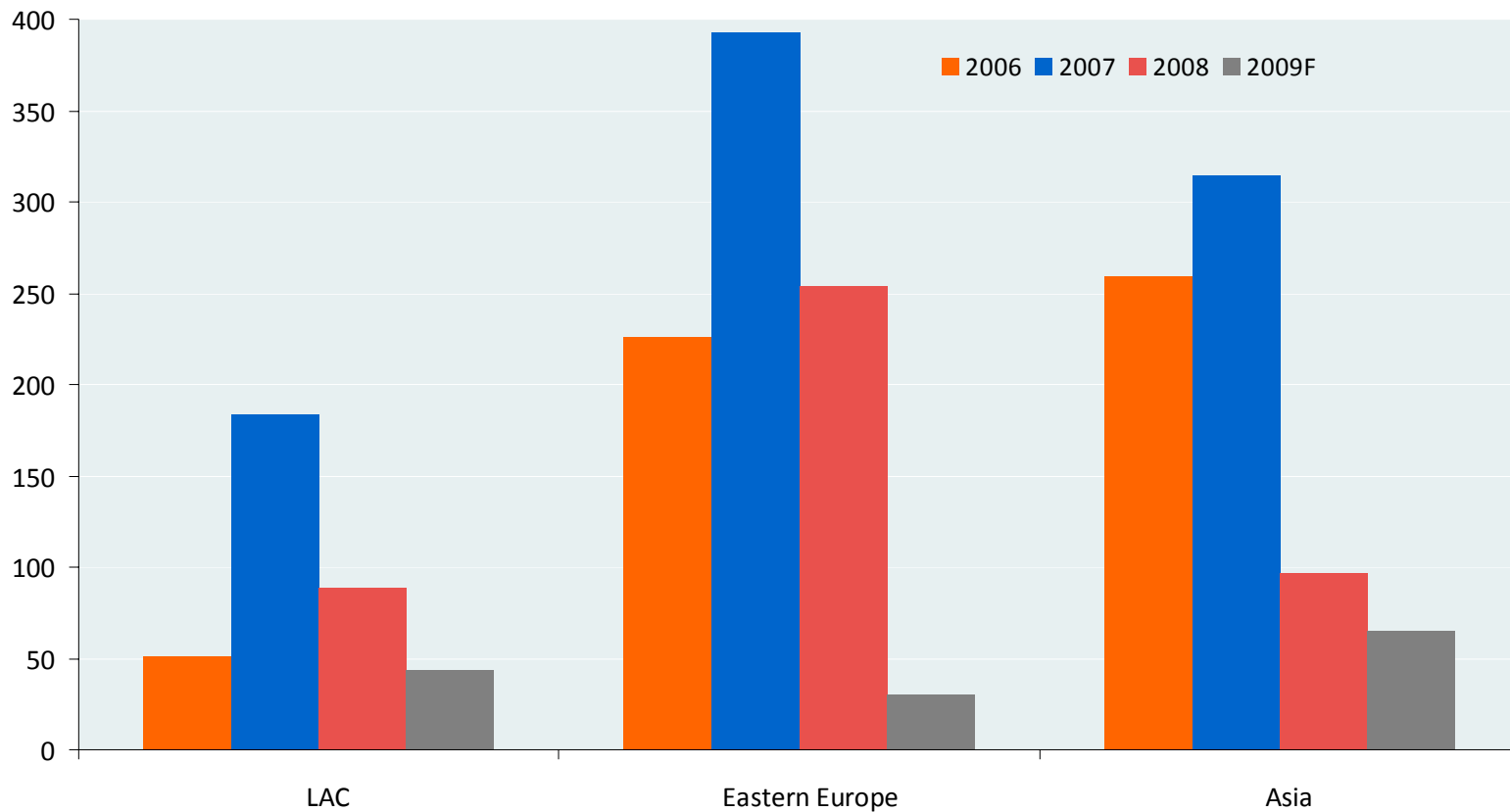
Corporate EMBI & U.S. High Yield Bond Spread
in basis points



Financial effects: portfolio flows to EMs on a steep decline

Net total private financial flows to emerging market economies by region

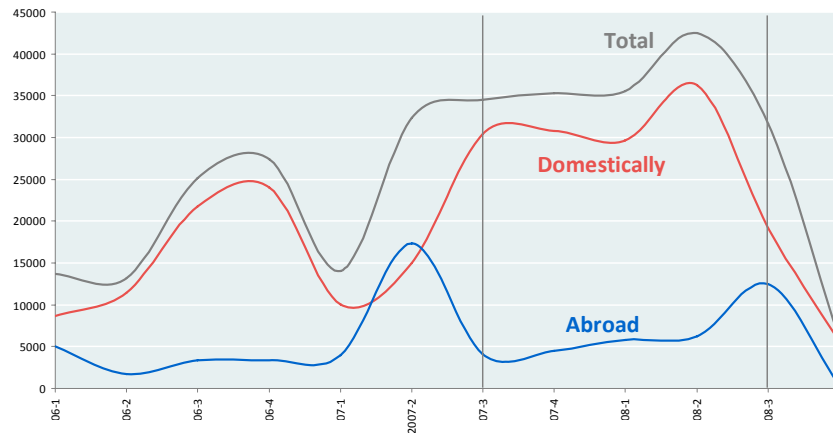
In US\$ billions



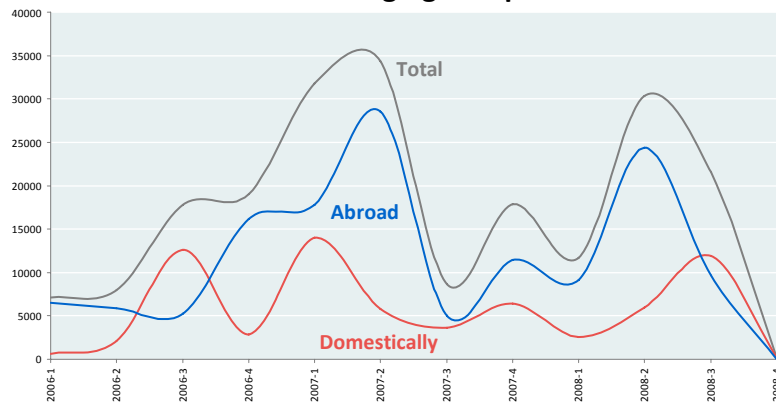
Financial effects: corporate issues virtually stopped, in local & foreign markets

Capital Raising Activity
Corporate issues. in US\$ millions

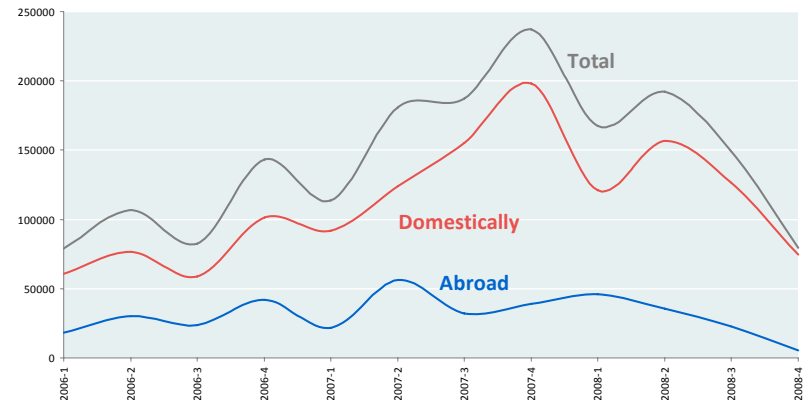
LAC-7



Emerging Europe

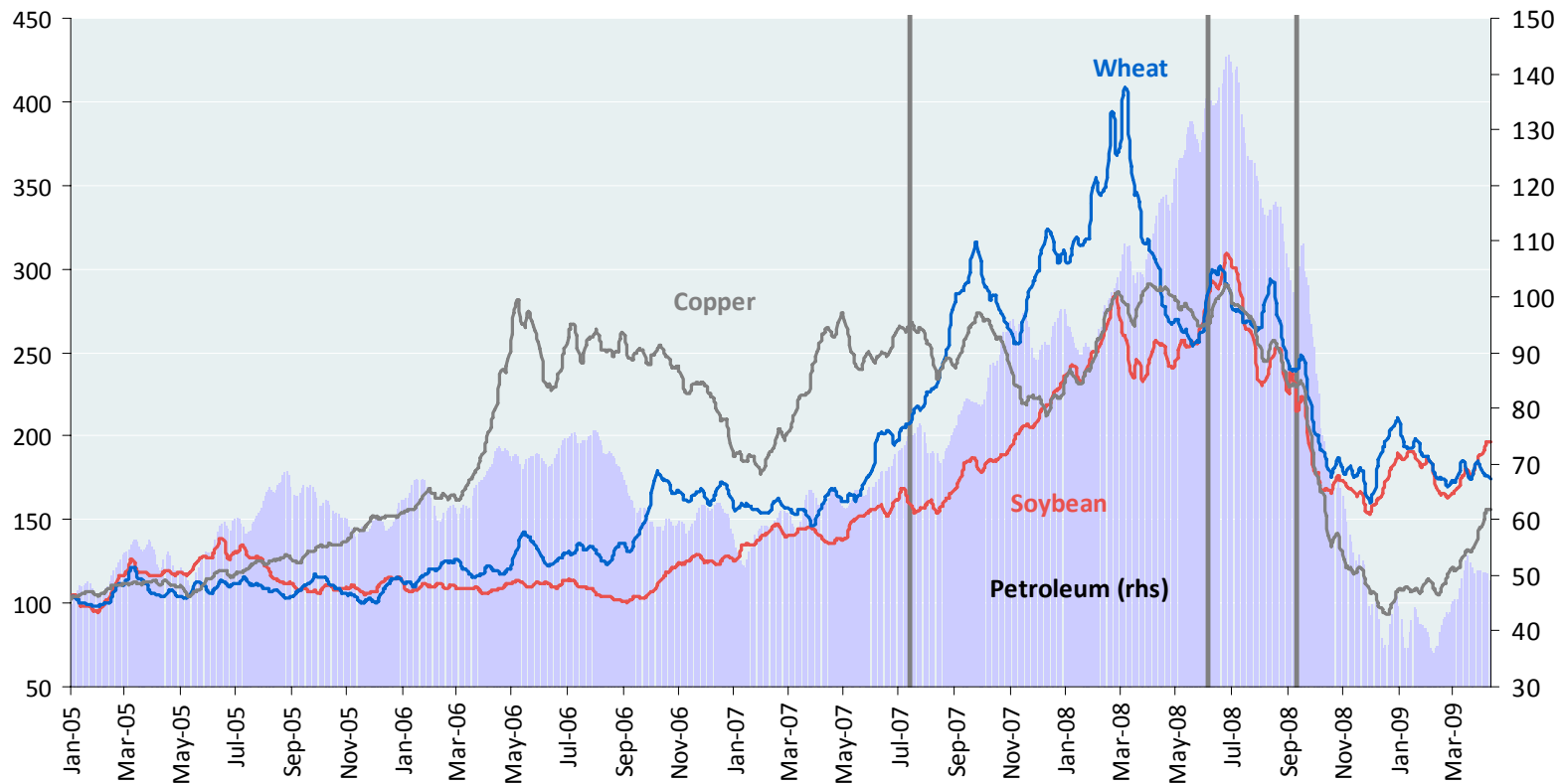


South-East Asia



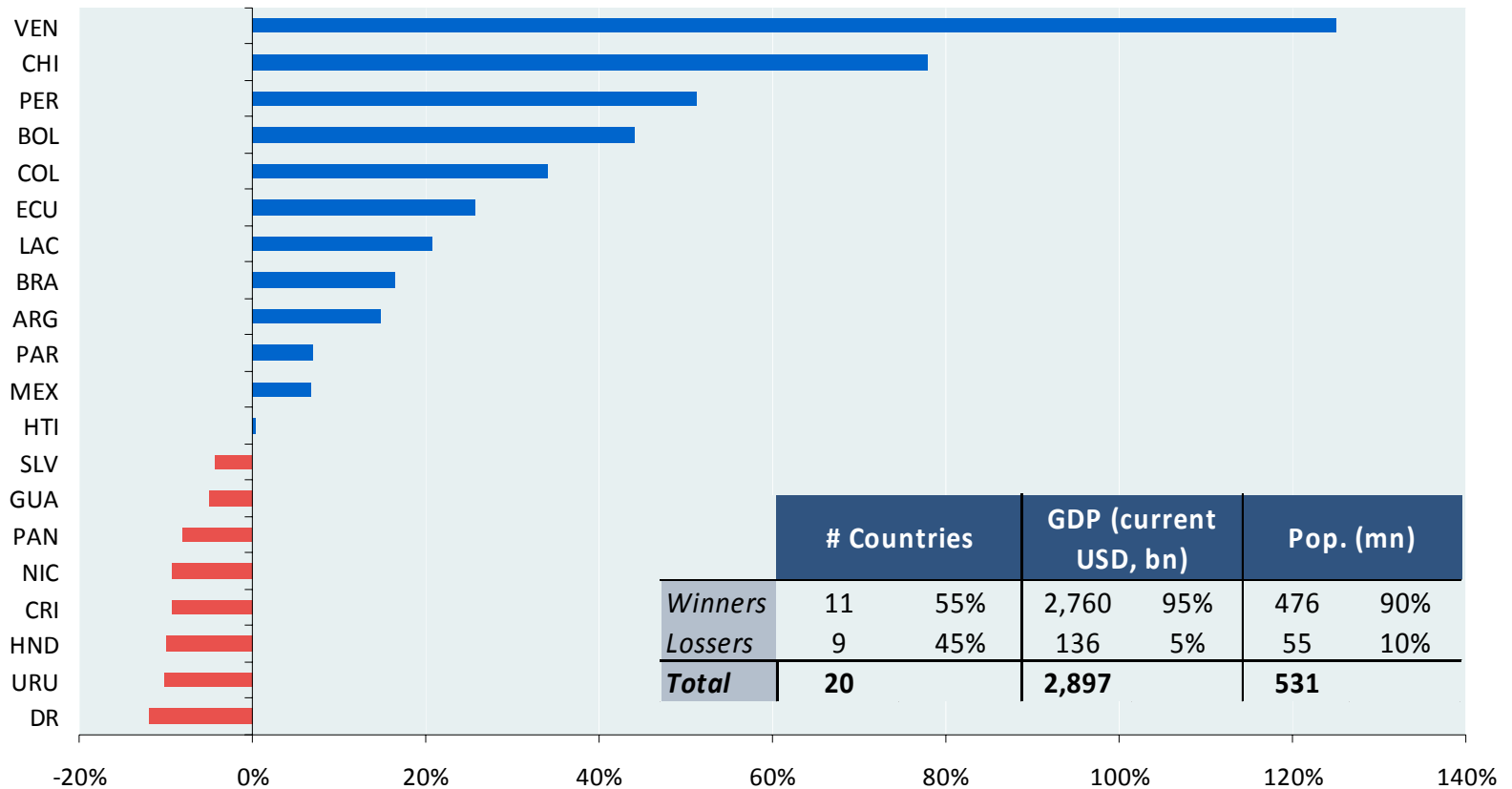
Commodity prices collapsed from their mid-2008 peaks and have stabilized at low levels

Commodity Prices (5-day Moving Average)
*Oil WTI in current US\$, Wheat,
Copper and Soybean are Index numbers: 1/01/05=100*



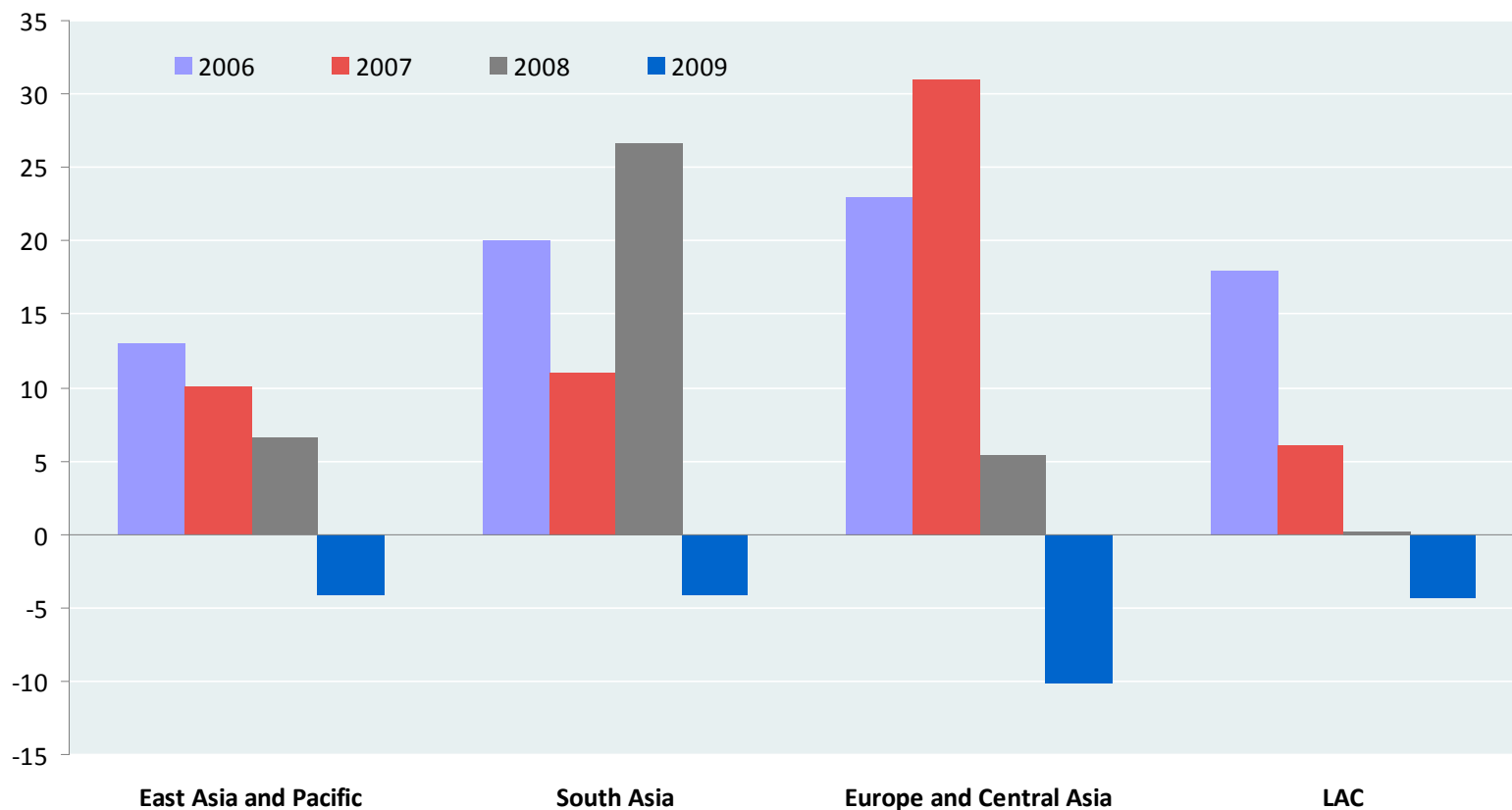
Commodity prices have asymmetric effects across LAC countries

Terms of Trade
cumulative percent change from 2002 to 2007



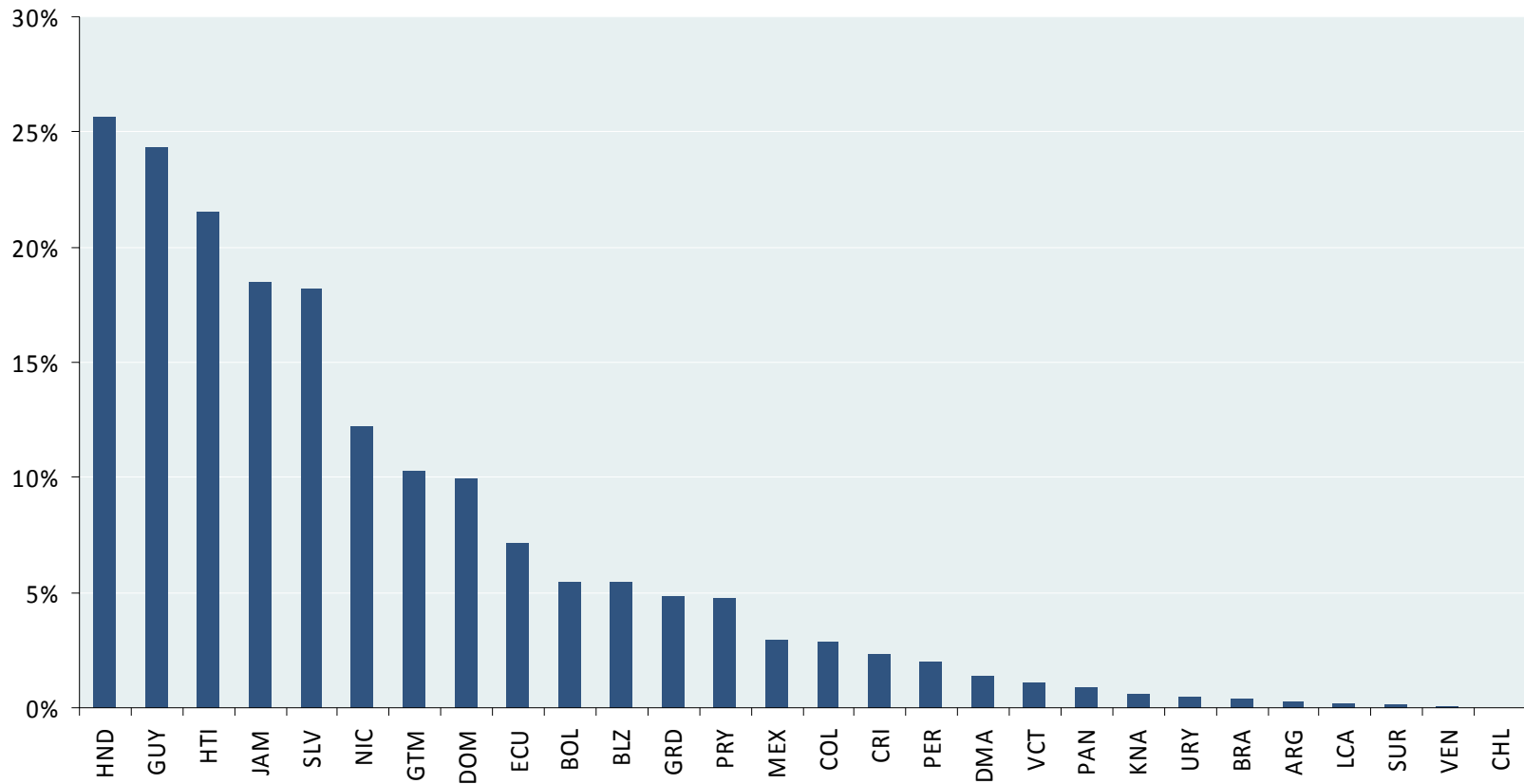
Remittances are contracting all around the world

Remittance flow to developing countries
Annual variation (in %)

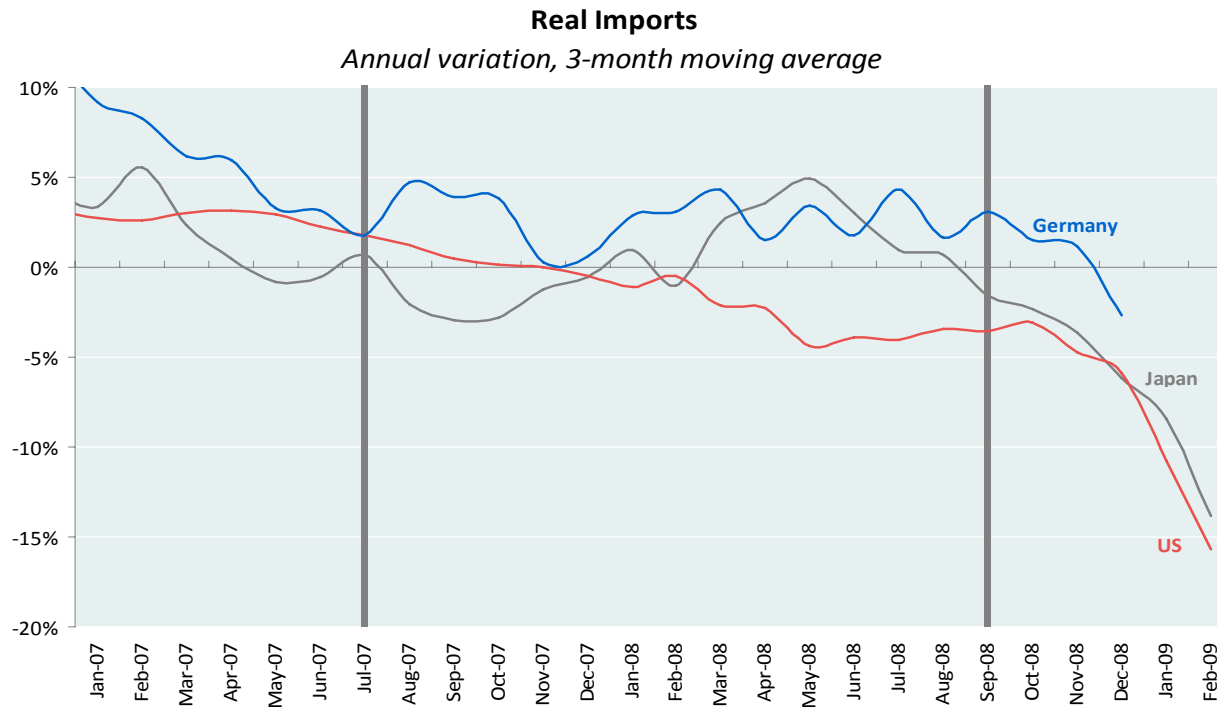


Remittances that are important for the region

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

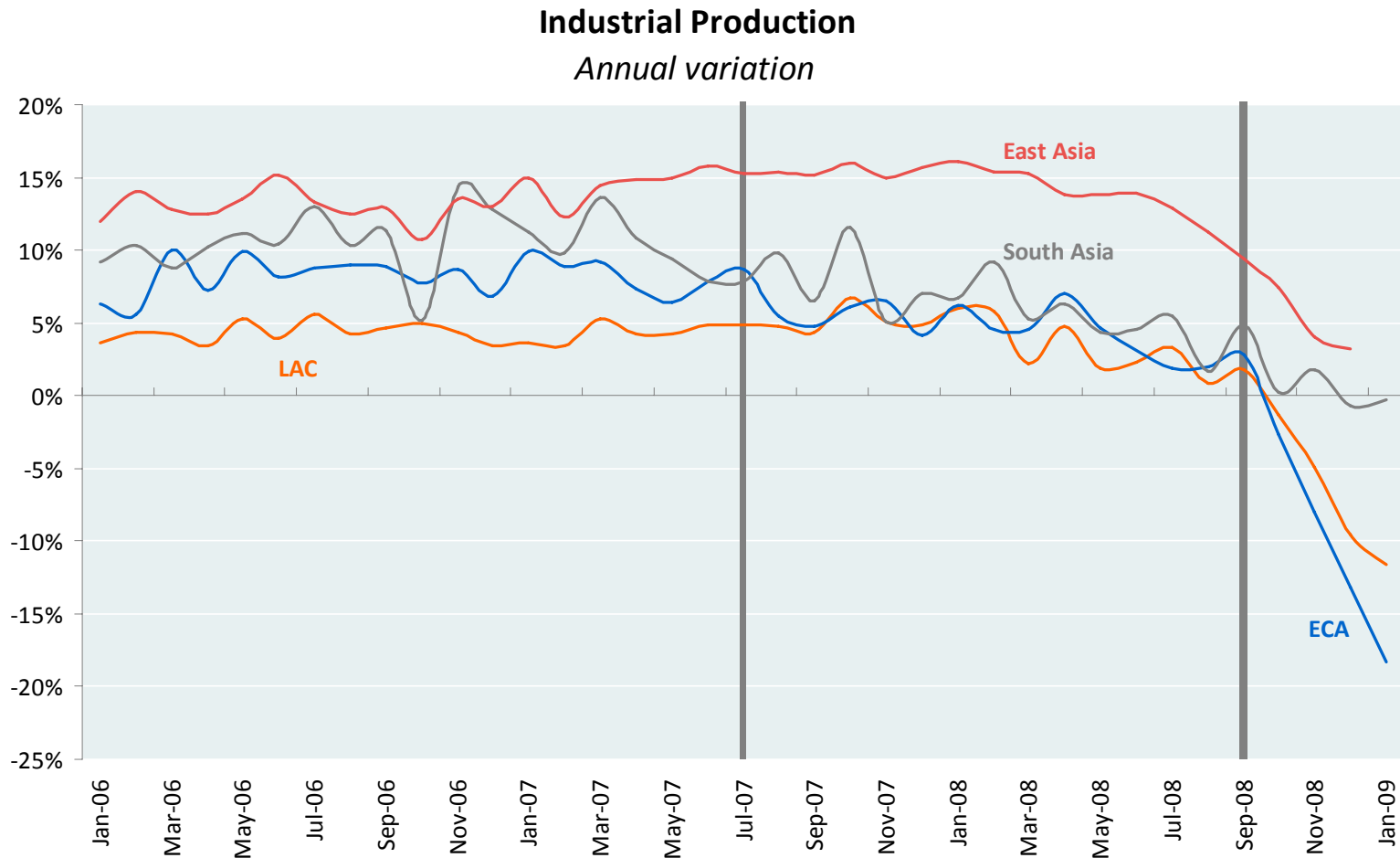


External demand: imports by rich countries are on a contracting path...



- 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

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



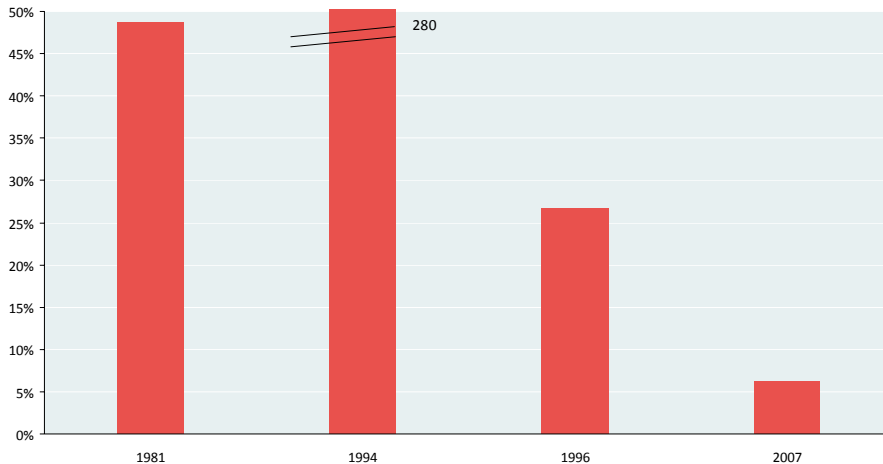
Desirable policy responses are restricted in practice

- *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

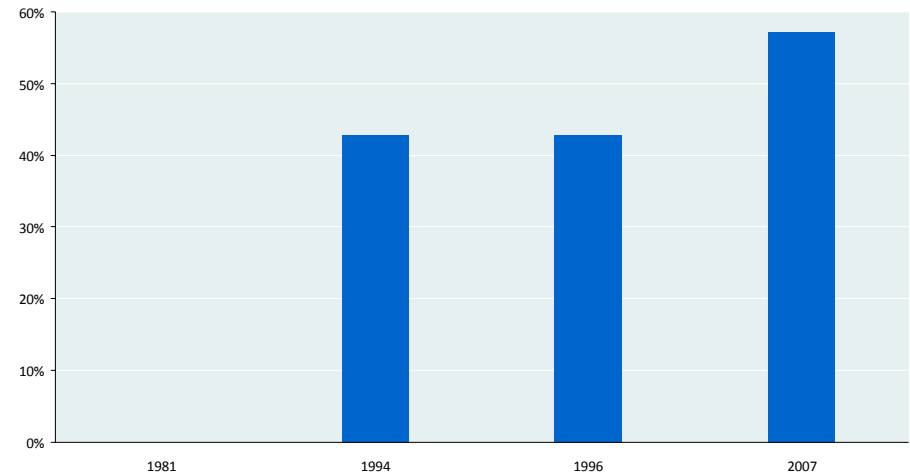
Pre-existing weaknesses?
LAC is less vulnerable compared to its past

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

Inflation in LAC
annual variation

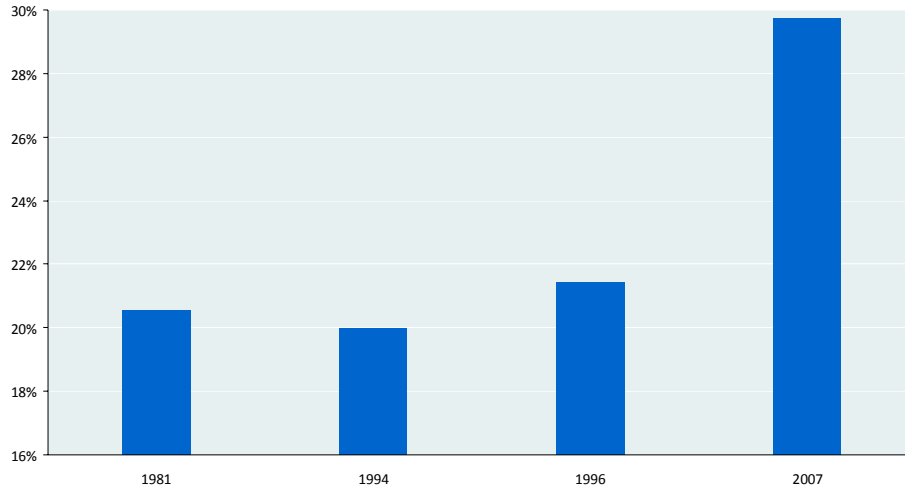


LAC countries with exchange rate flexibility
as % of the sample

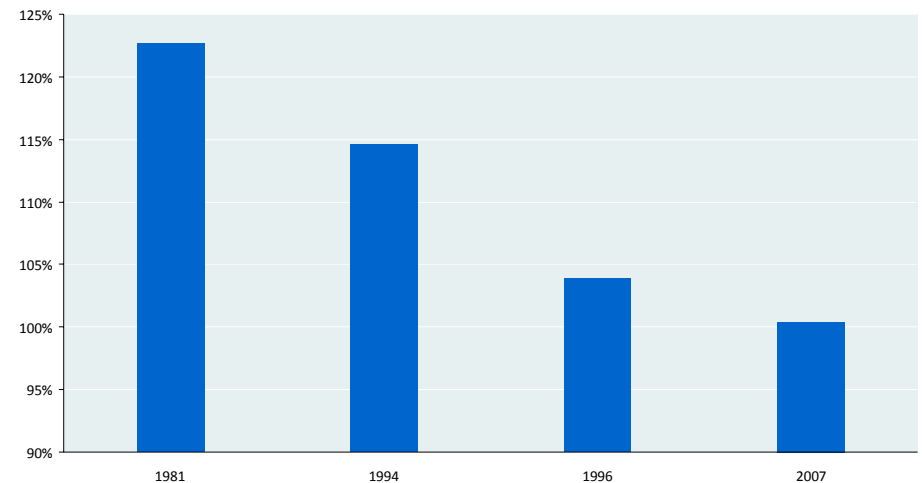


Financial systems – stronger and deeper

Bank Deposits in LAC
as % of GDP

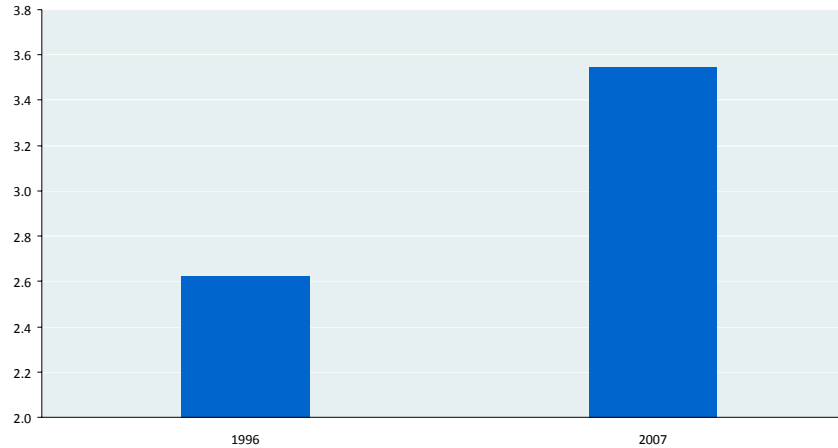


Loan to Deposit Ratio in LAC
in %

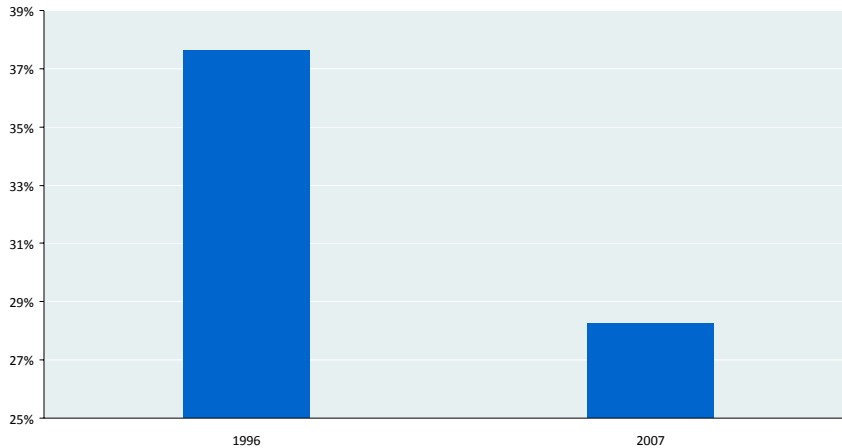


Public finances – more viable

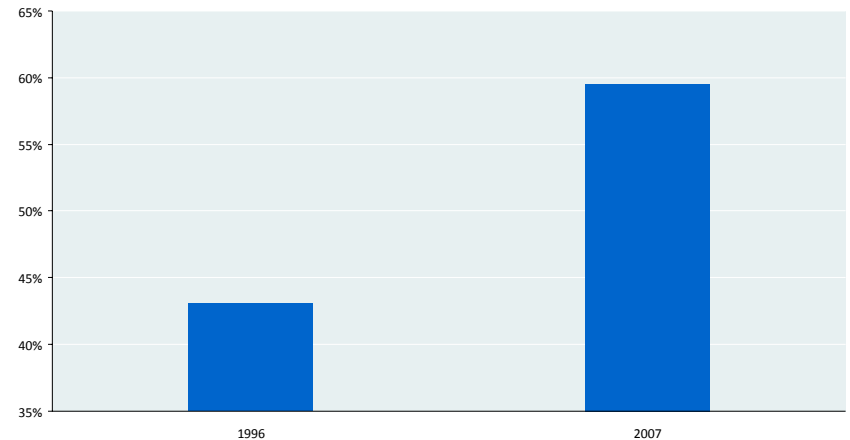
Primary Balance in LAC
as % of GDP



Total Public Debt in LAC
as % of GDP

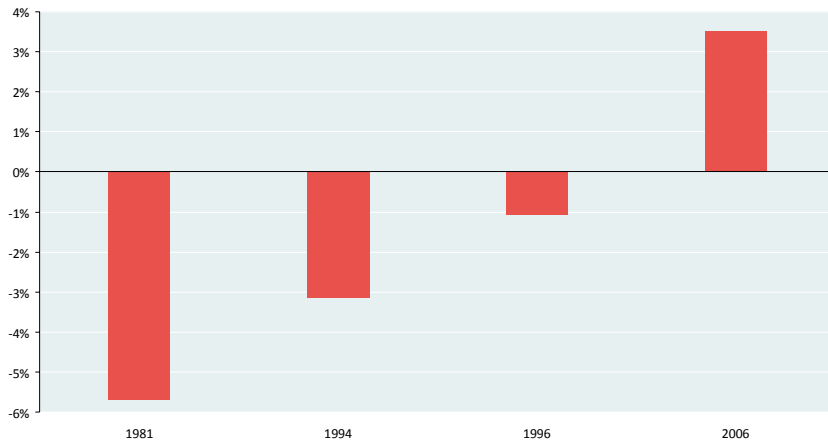


Share of Domestic Debt in LAC
as % of total public debt

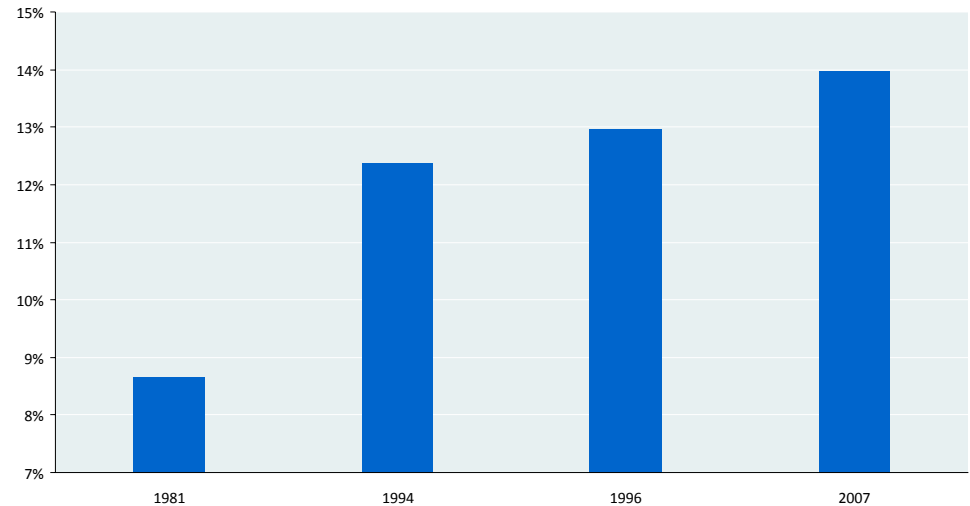


External position – stronger

Current account balance in LAC
as % of GDP



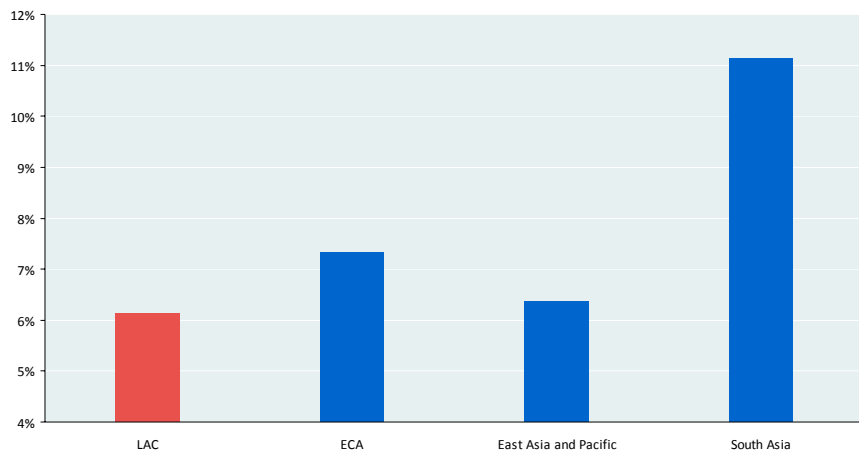
International Reserves in LAC
as % of GDP



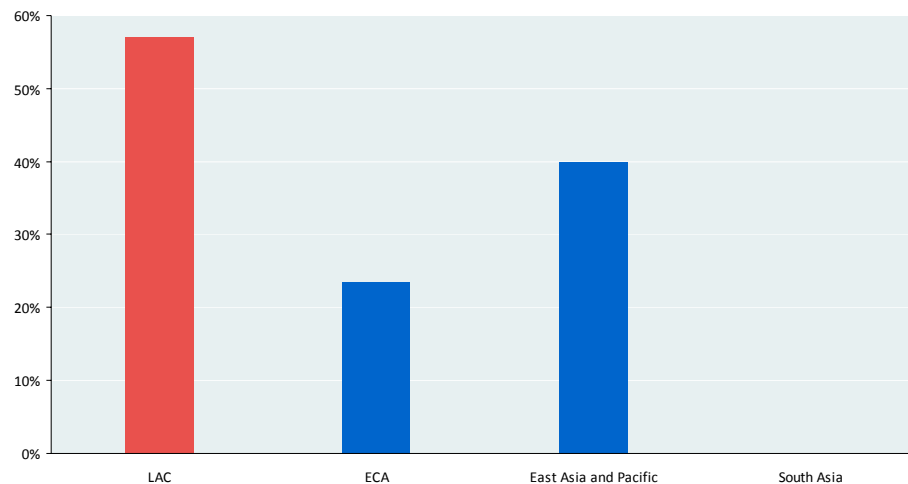
*Pre-existing weaknesses?
LAC less vulnerable than other regions?*

Monetary policy frameworks

Inflation in selected regions
annual variation

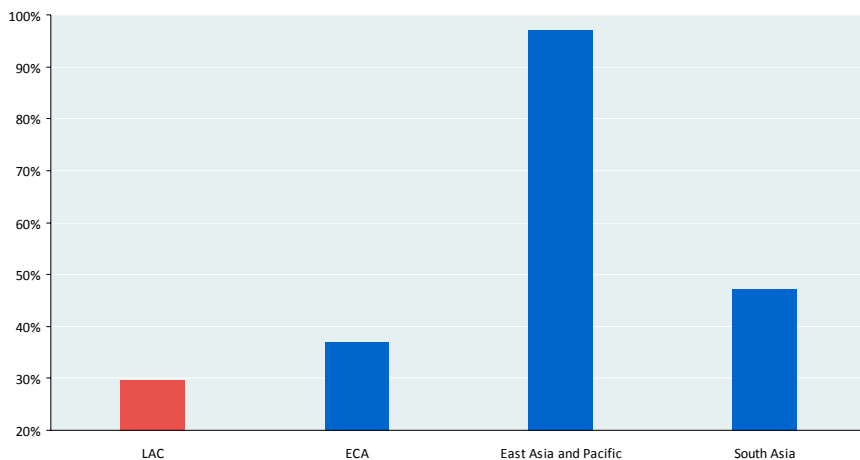


Countries with exchange rate flexibility in selected regions
as % of the sample

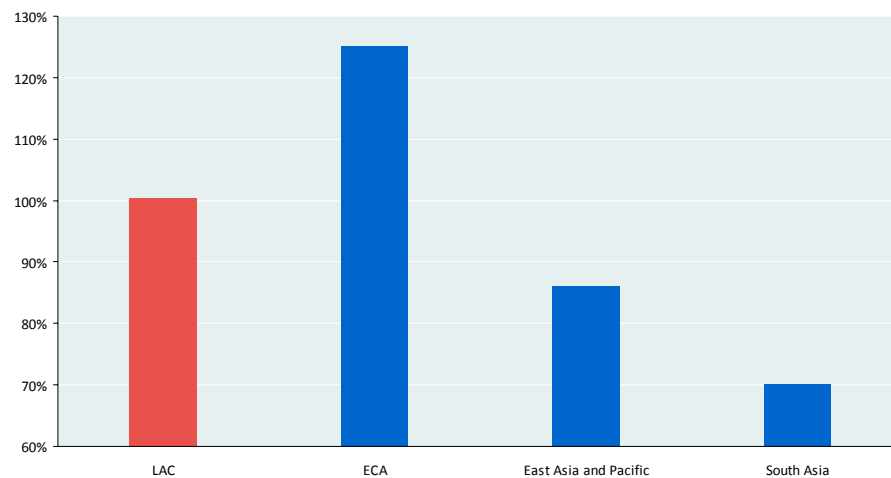


Financial systems

Bank Deposits in selected regions
as % of GDP

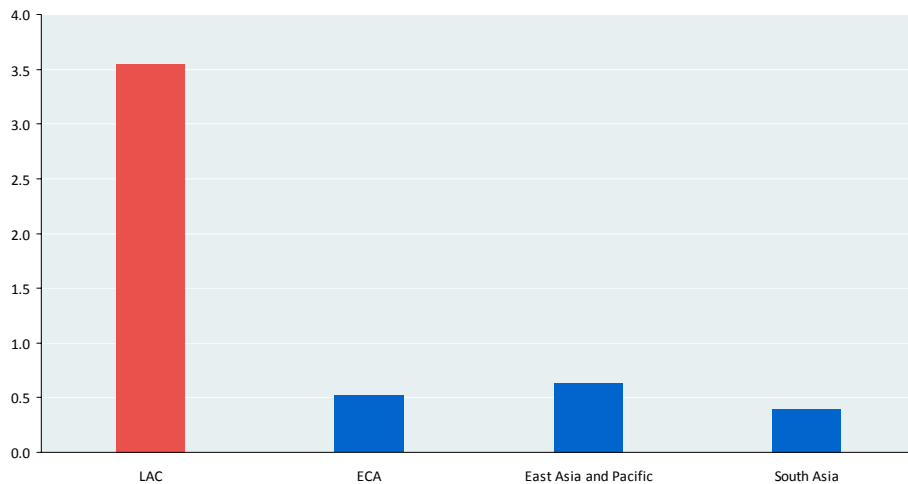


Loan to deposit ratio in selected regions
in %

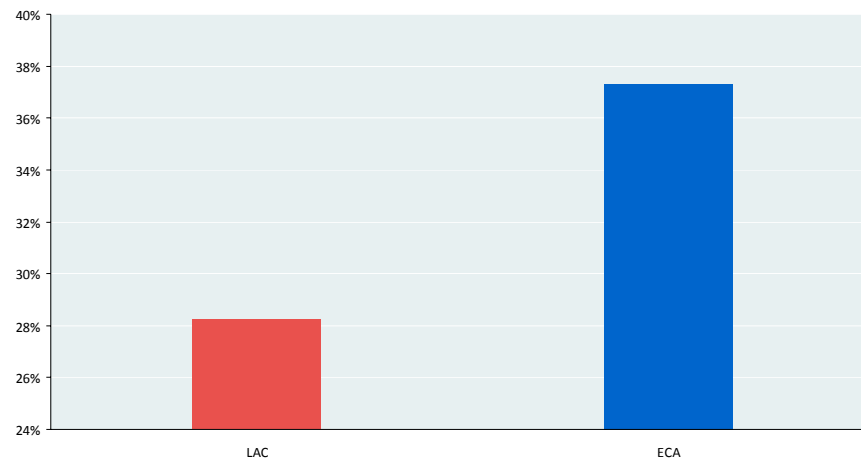


Public finances

Primary Balance in selected regions
as % of GDP

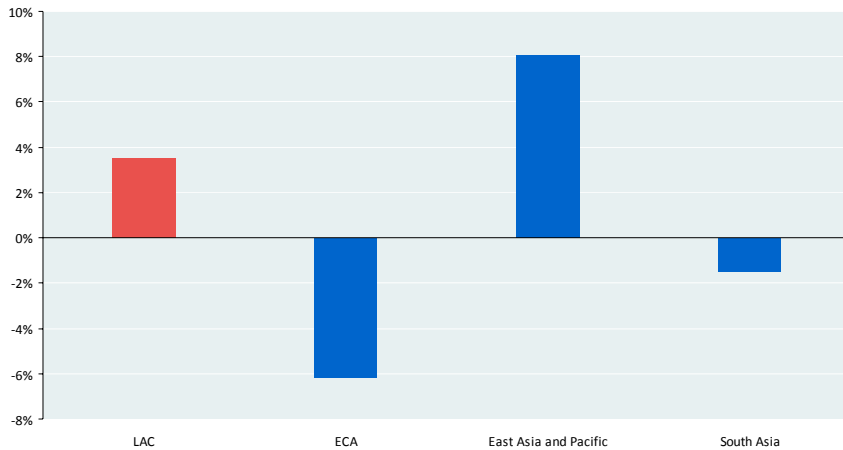


Public debt in selected regions
as % of GDP

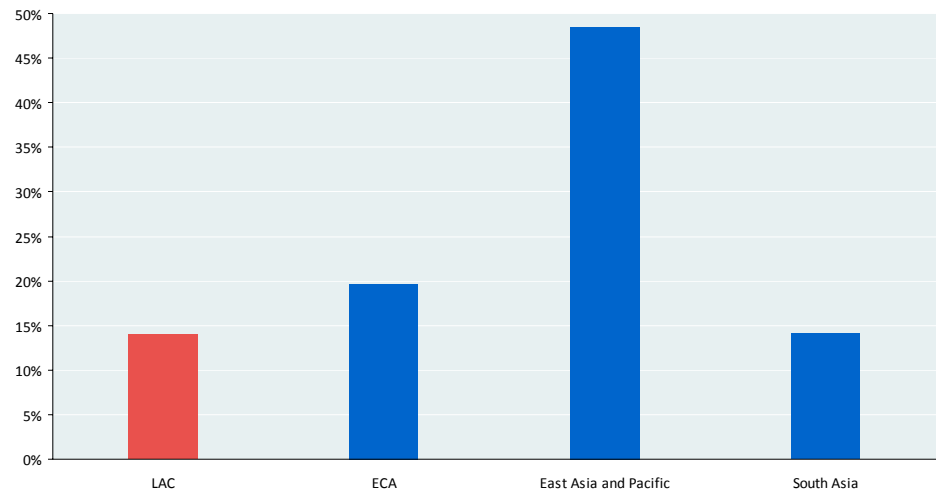


External positions

Current account balance in selected regions
as % of GDP



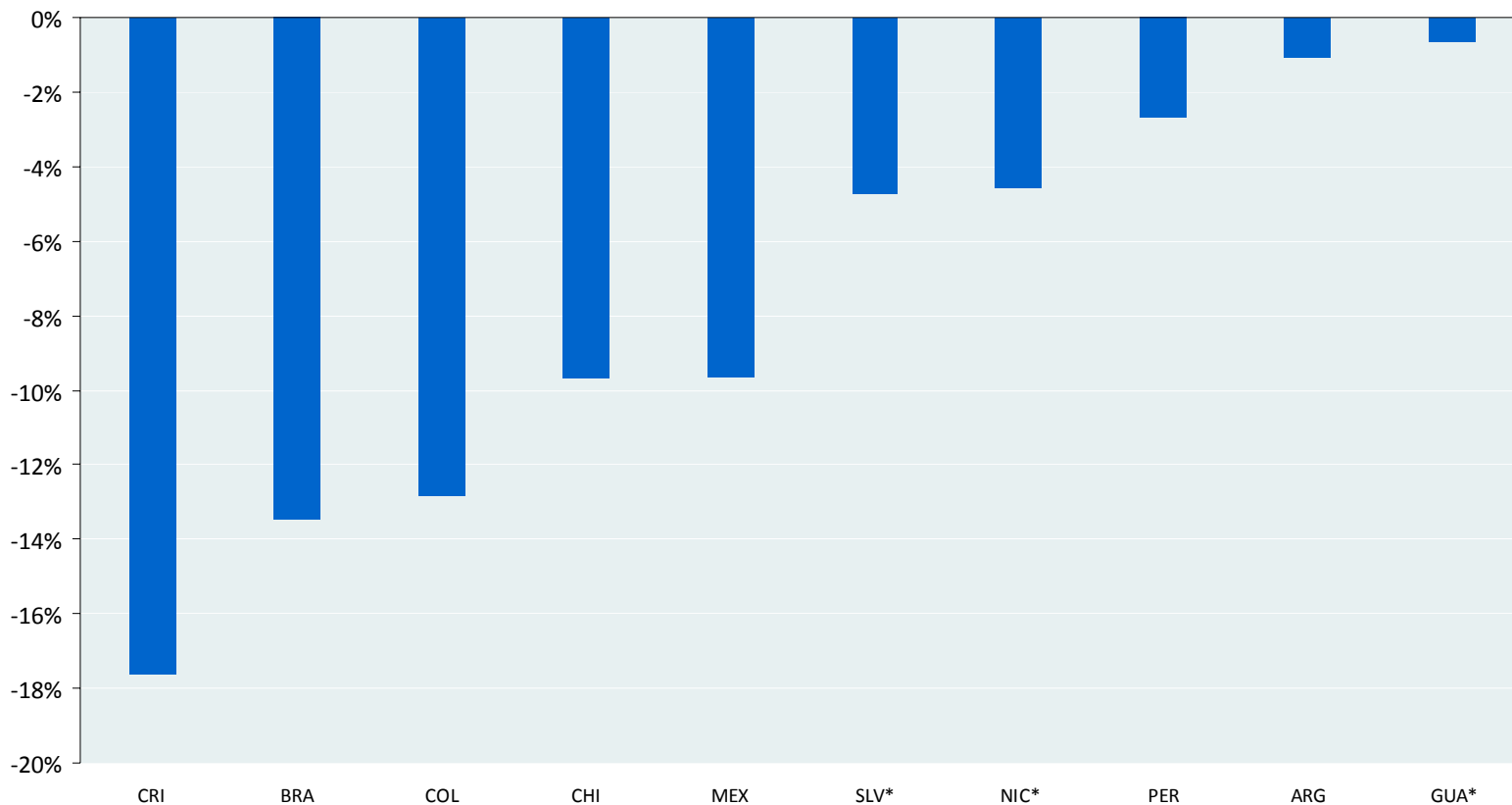
International Reserves in selected regions
as % of GDP



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

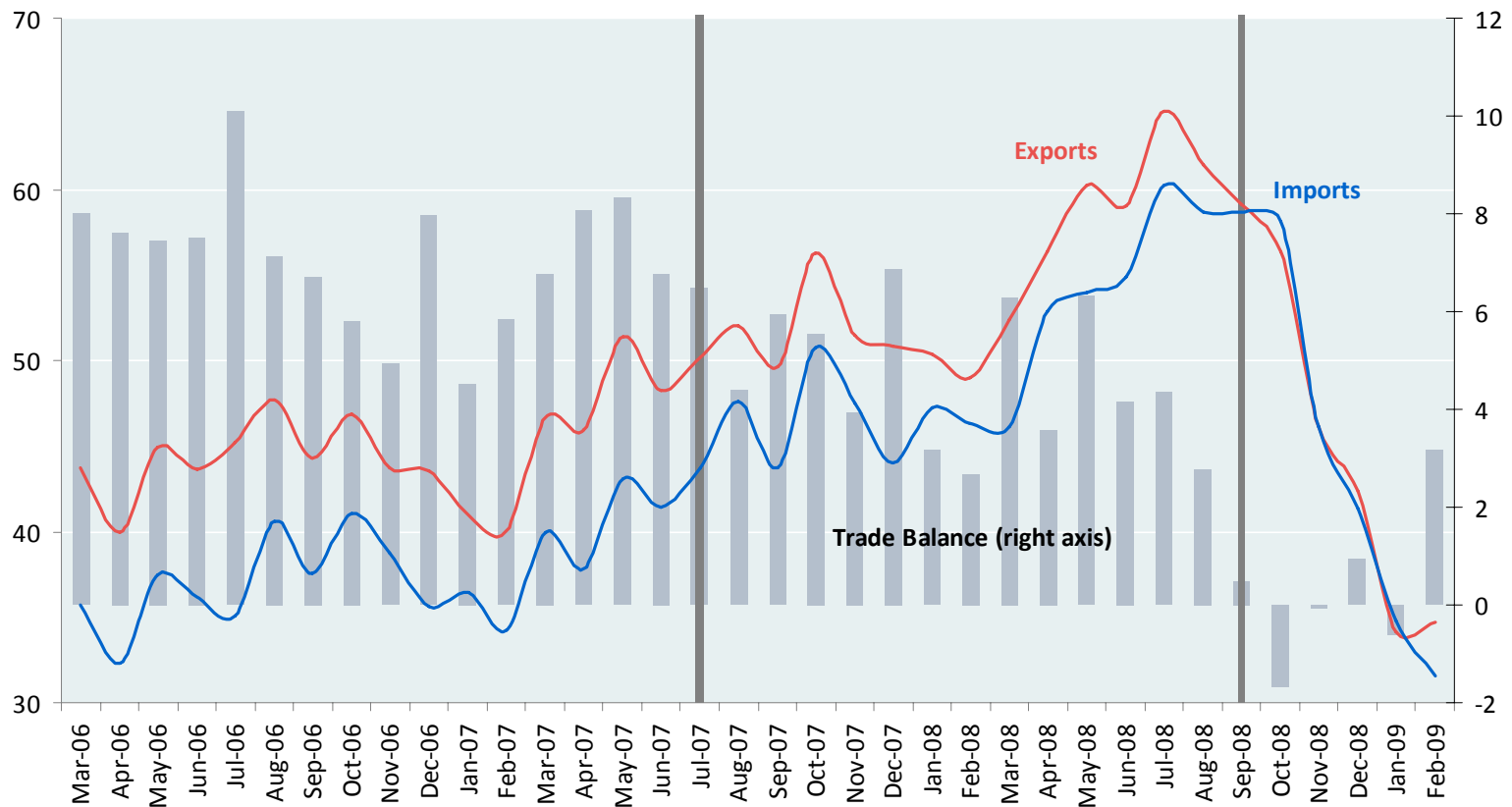


**Data corresponds to the Index of Economic Activity. Source: Haver Analytics and National Authorities*

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

Imports and Exports in selected LAC countries

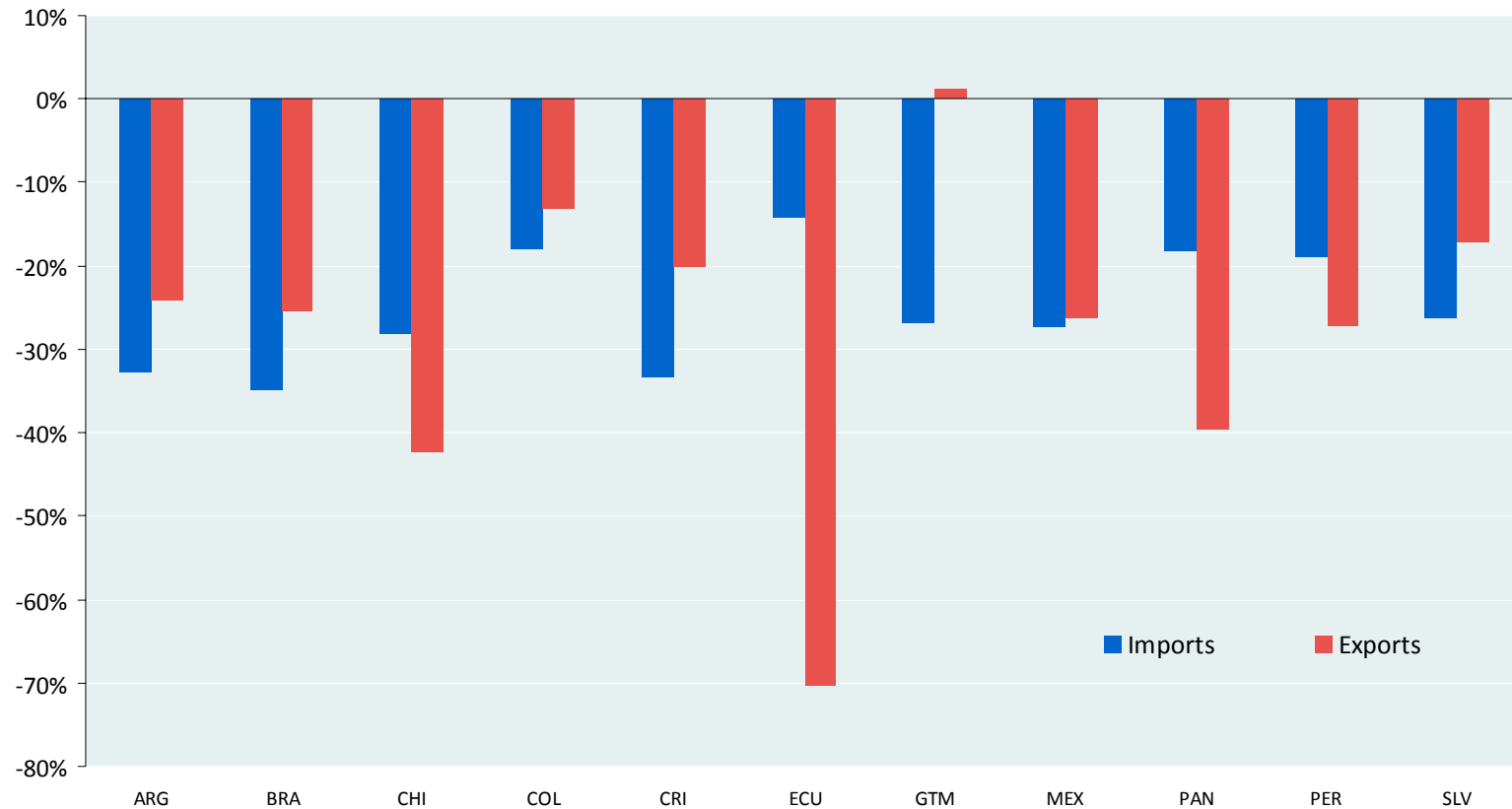
In billions of US\$



... with significant variation across LAC countries

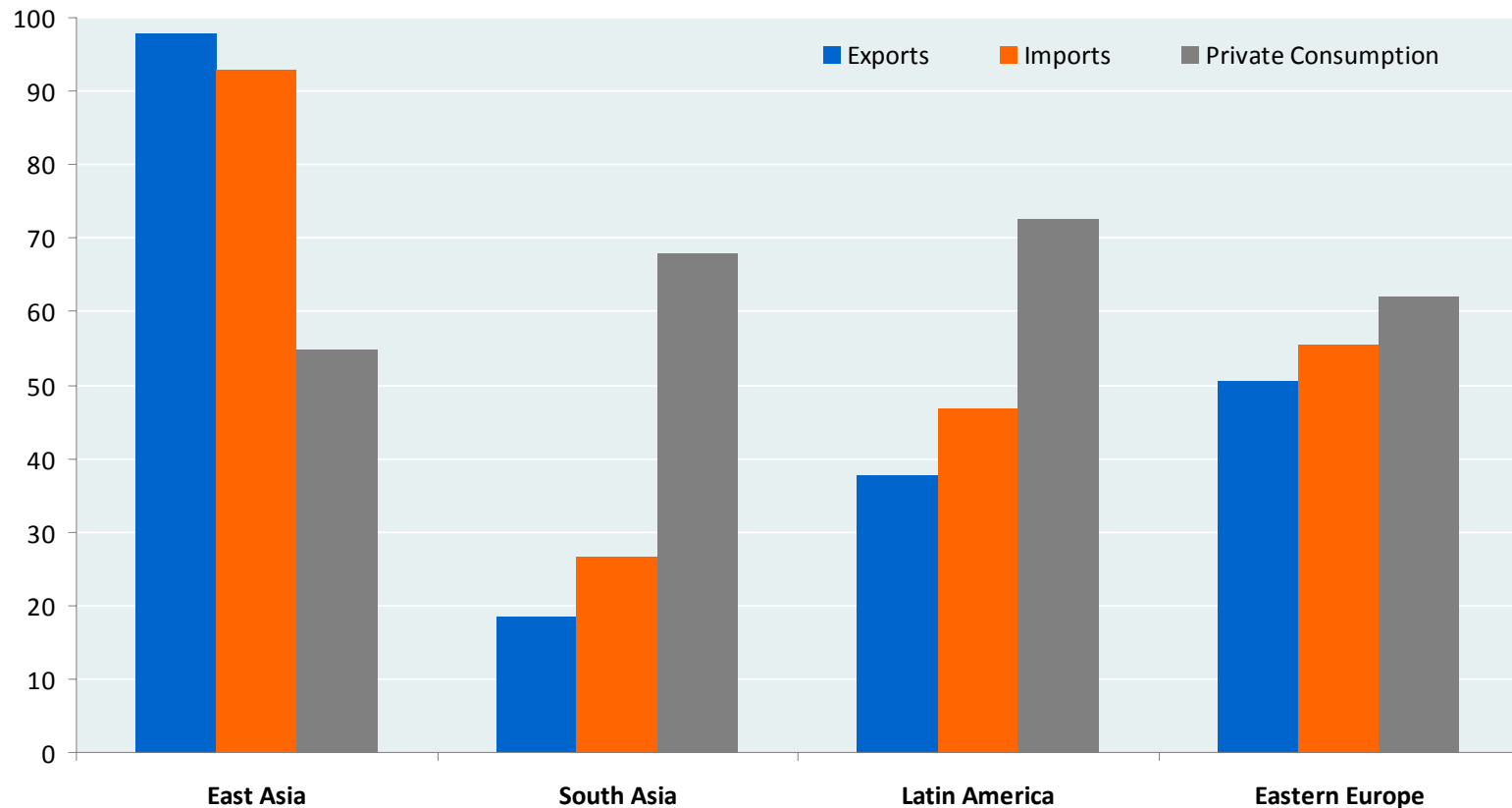
Imports and Exports of Goods in LAC

Annual variation as of Feb-09



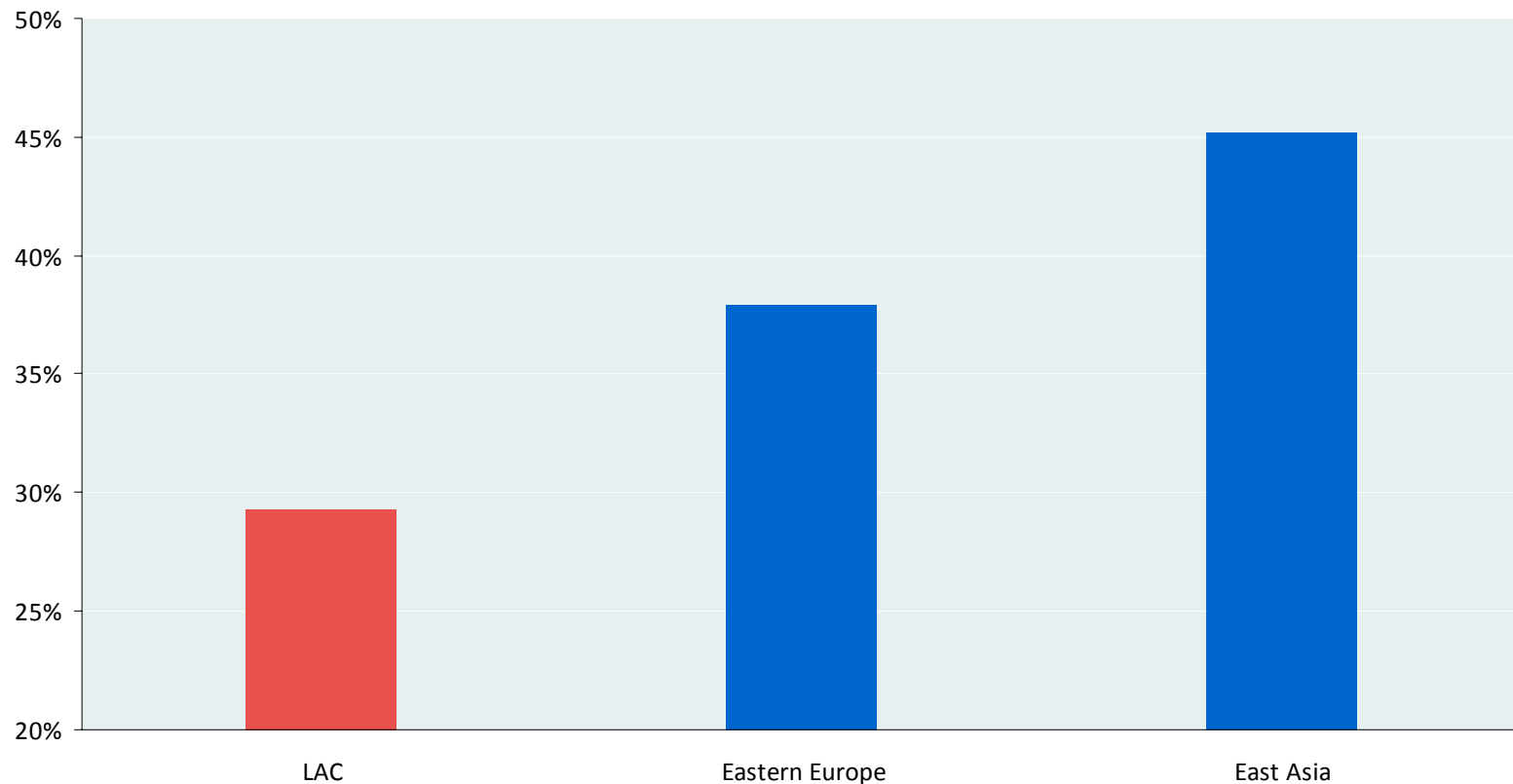
Structural factors matter – relative size of tradable and non-tradable sectors

Structure of GDP
as % of GDP



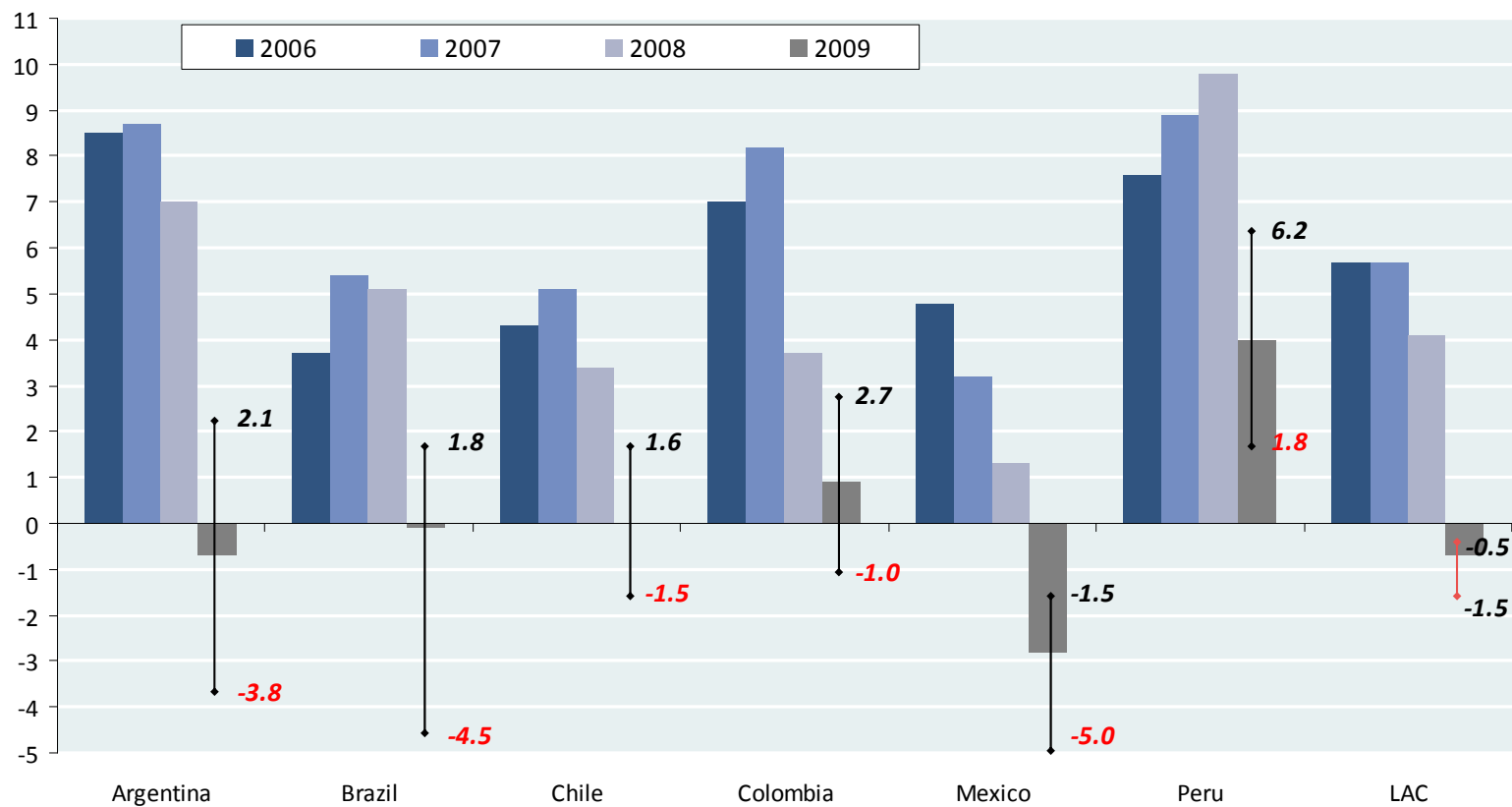
Structural factors matter – the sectoral distribution of employment

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



In all, LAC is in for a recession in 2009

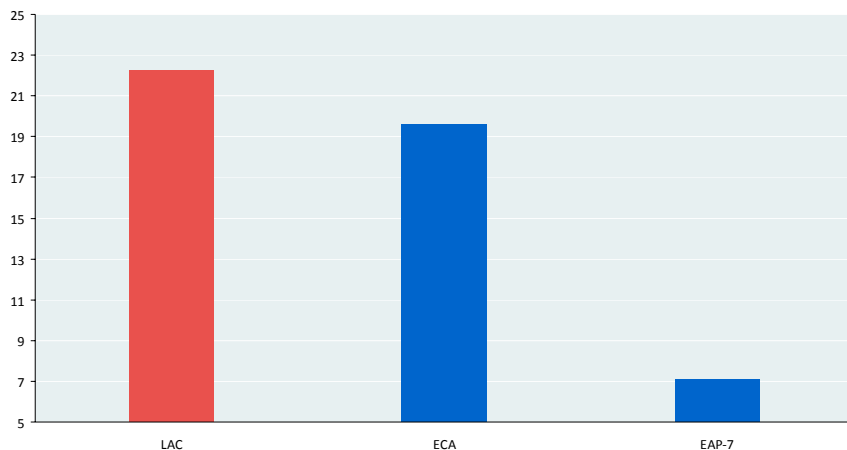
Recent Growth and Forecasts for 2009
annual GDP real growth rate, in %



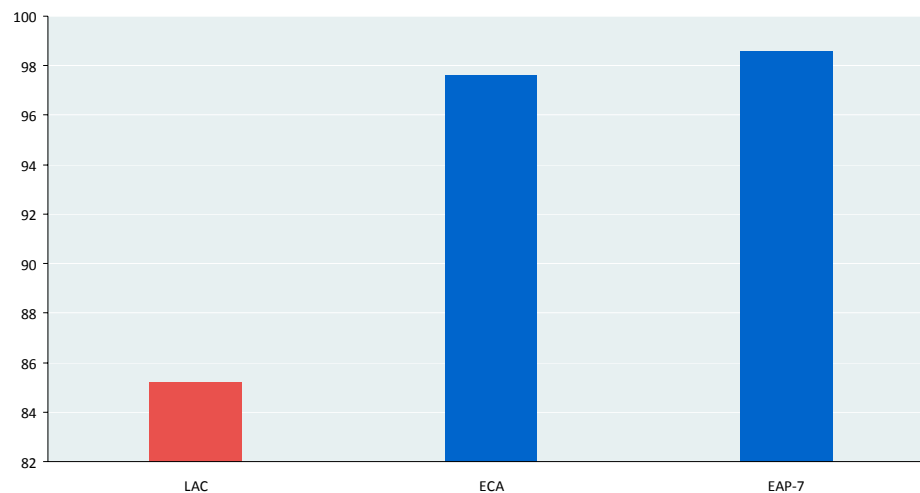
The risk of reversal of social gains can be highly problematic for LAC

LAC lags other emerging regions in social indicators

Mortality rate in selected regions
infant per 1,000 live births

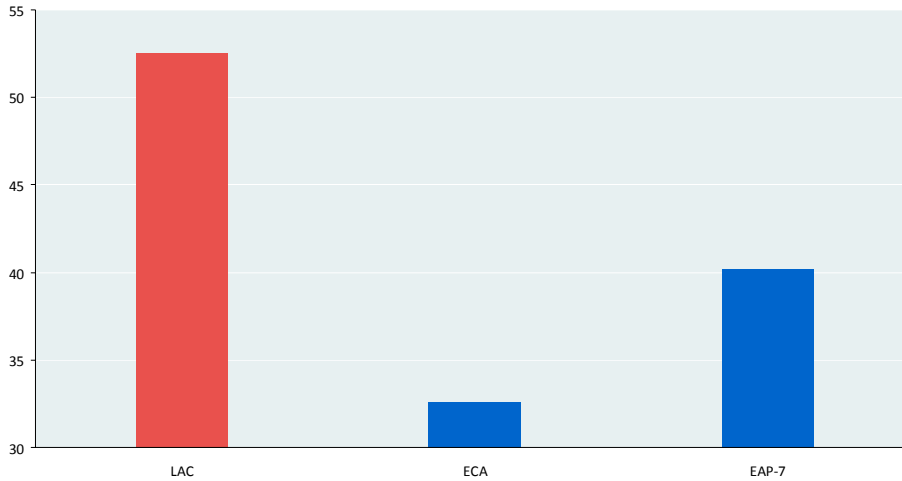


Persistence to last grade of primary in selected regions
total as % of cohort

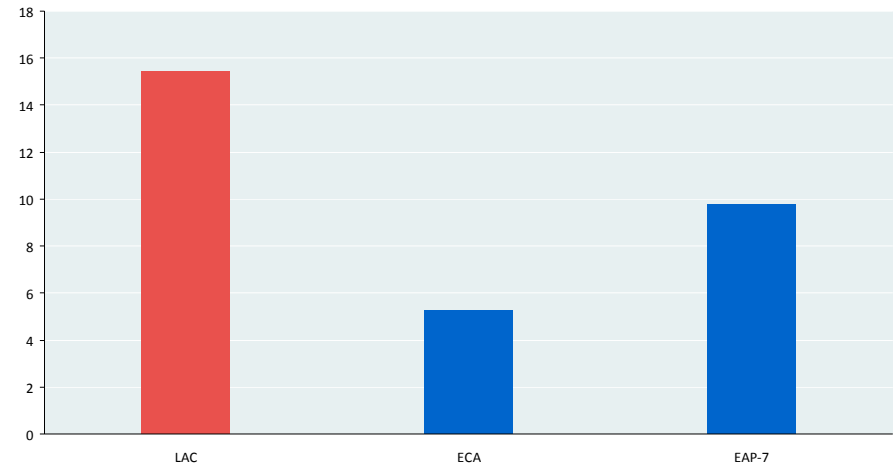


LAC lags other emerging regions in social indicators (cont.)

Income inequality in selected regions
Gini index



Poverty in selected regions
% of pop. living in households with consumption or income below \$2 a day

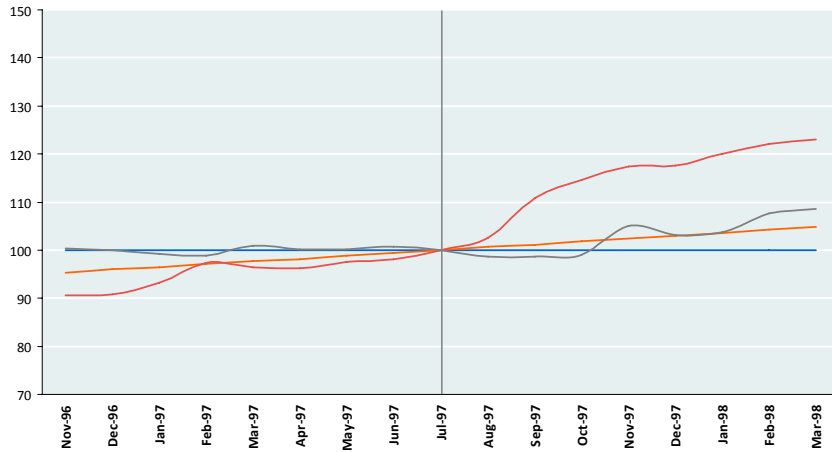


LAC: how much room for policy maneuver?

Flexible exchange rates are shock absorbers now

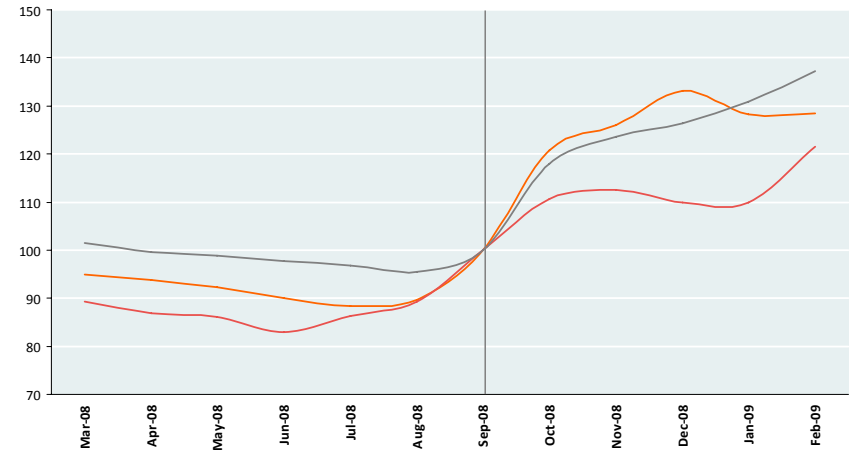
Exchange Rates in selected LAC countries

Jul-97=100



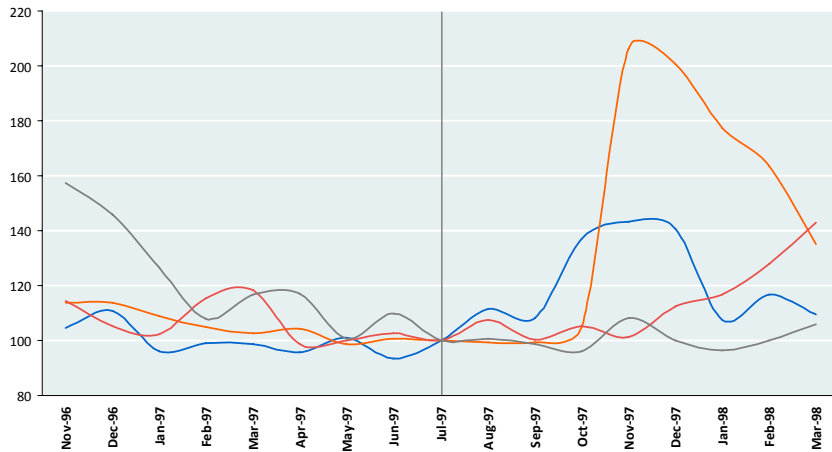
Exchange Rates in selected LAC countries

Sep-08=100



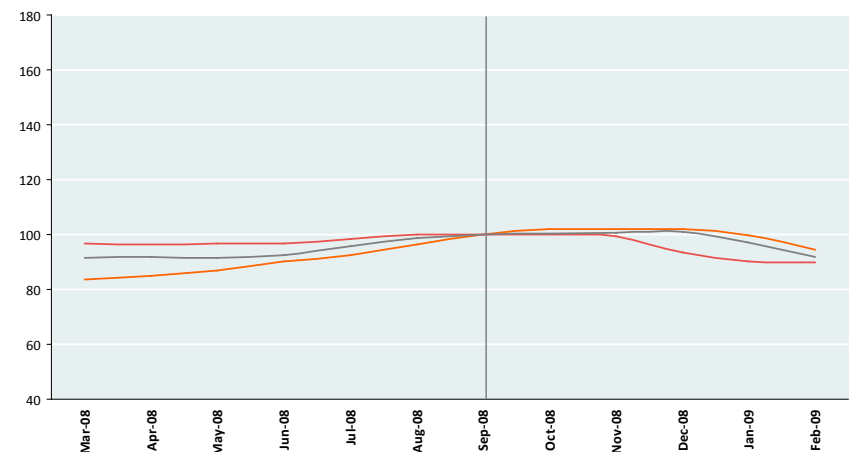
Interest Rates in selected LAC countries

Jul-97=100



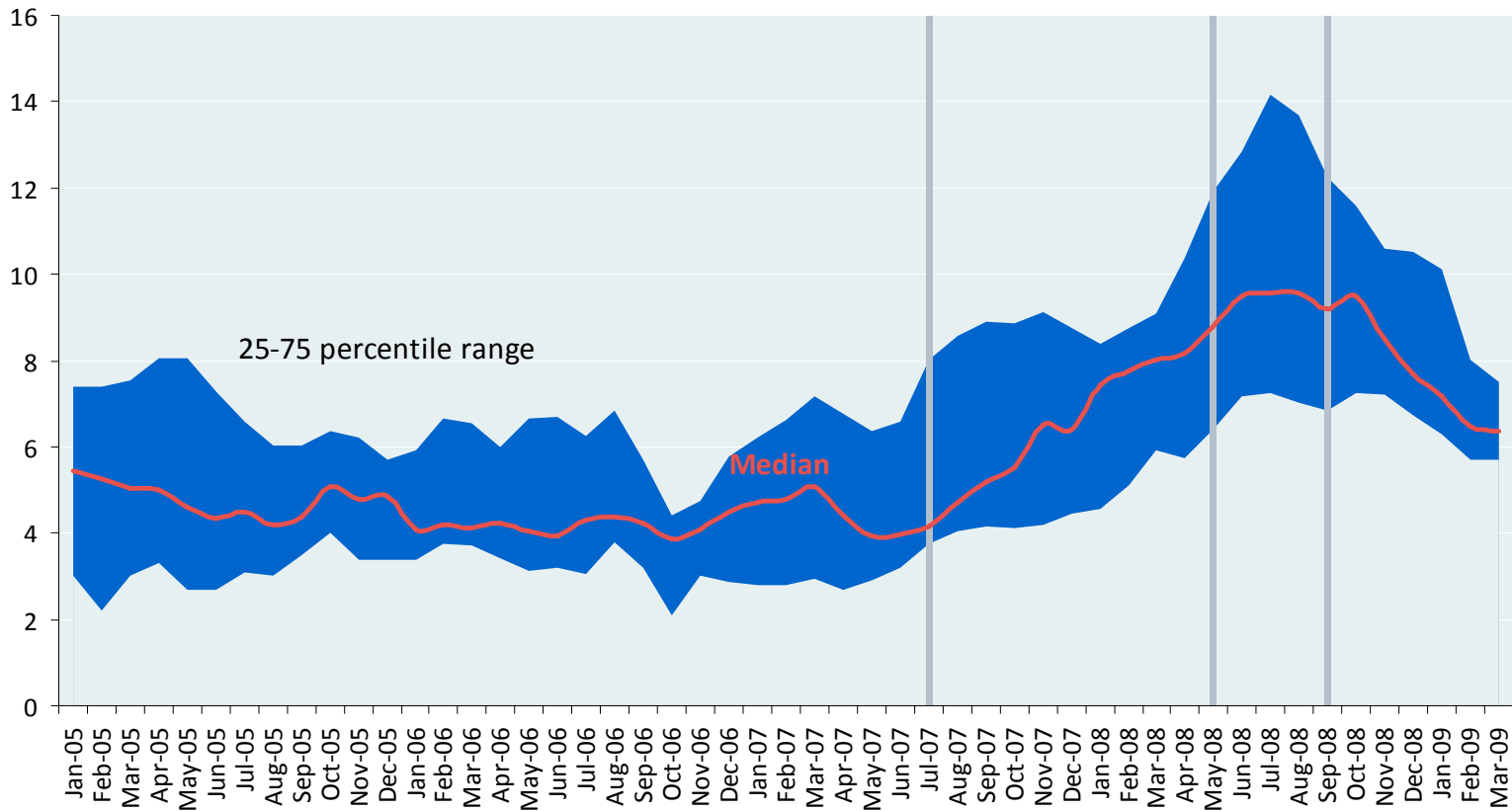
Interest Rates in selected LAC countries

Sep-08=100



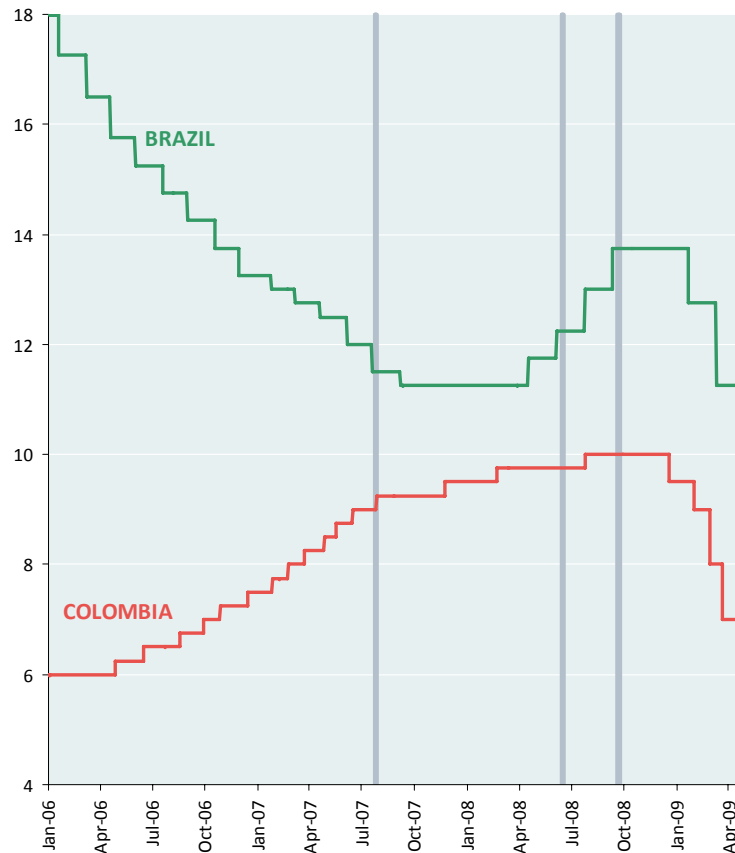
And with inflation concerns rapidly disappearing...

Consumer Price Inflation in LAC
annual variations, in %

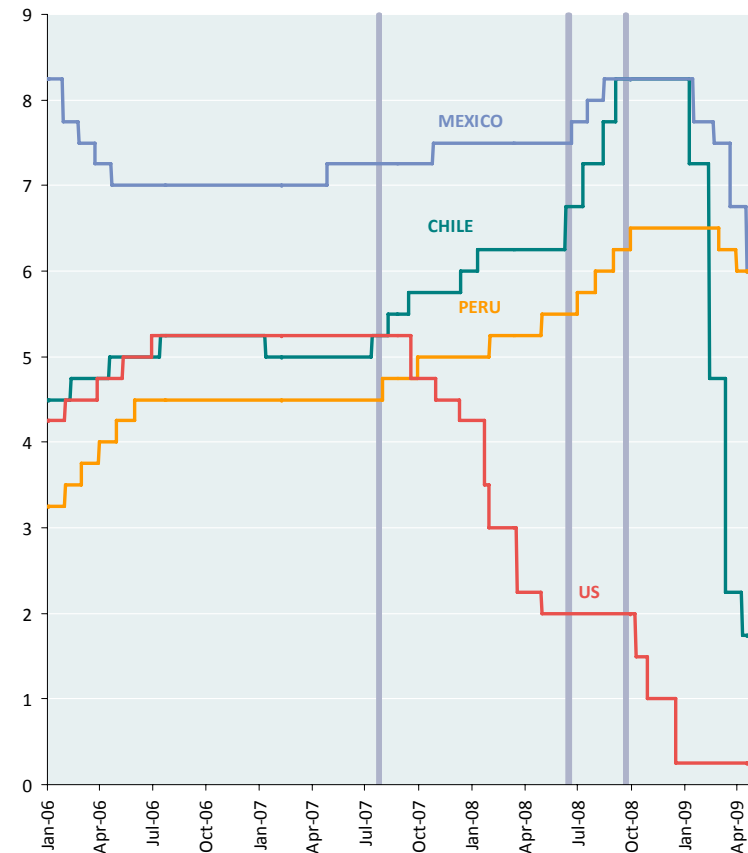


... LAC inflation targeters have (and are using the) room for countercyclical monetary policy

Monetary Policy Rates
in %

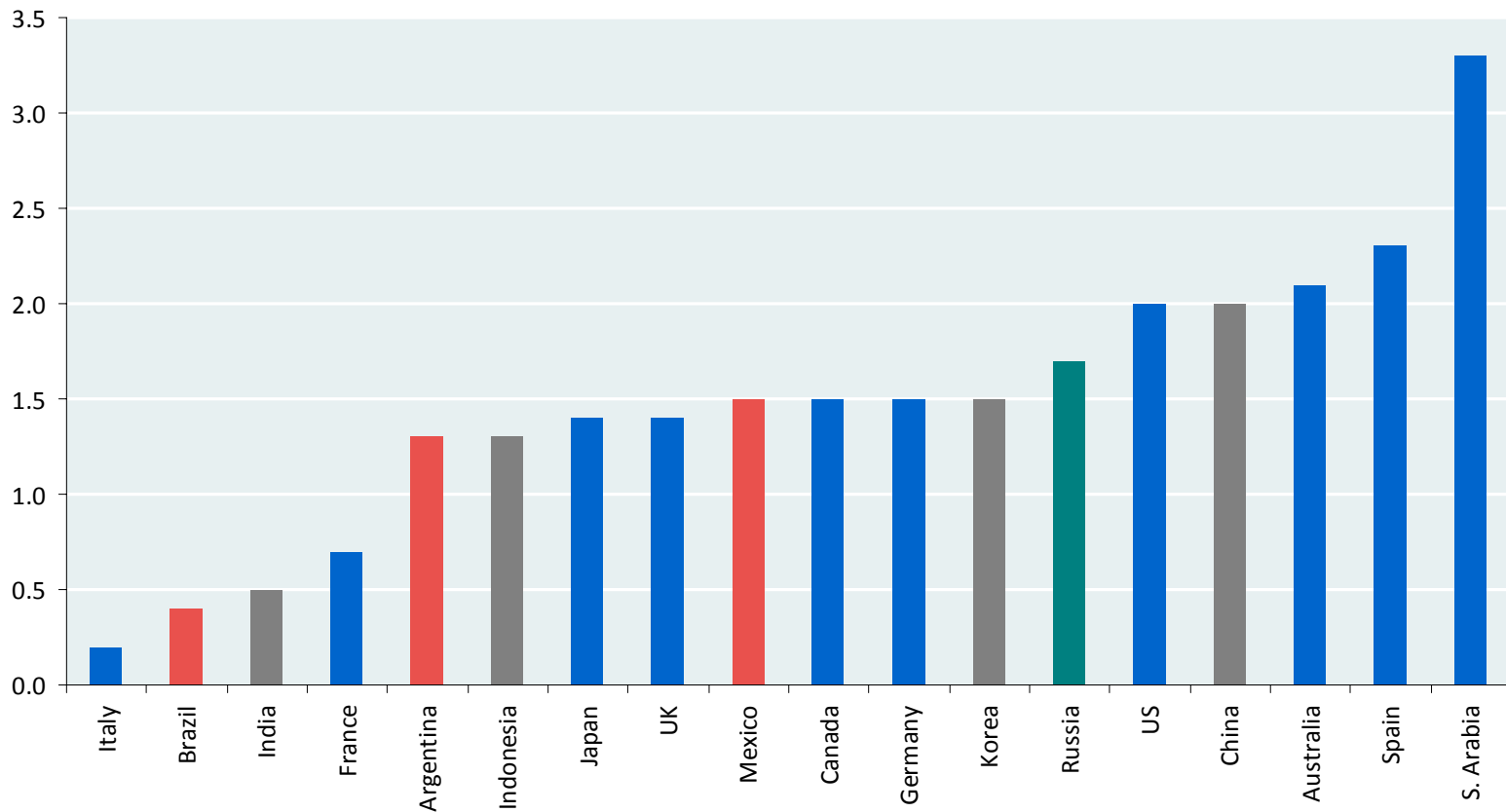


Monetary Policy Rates
in %



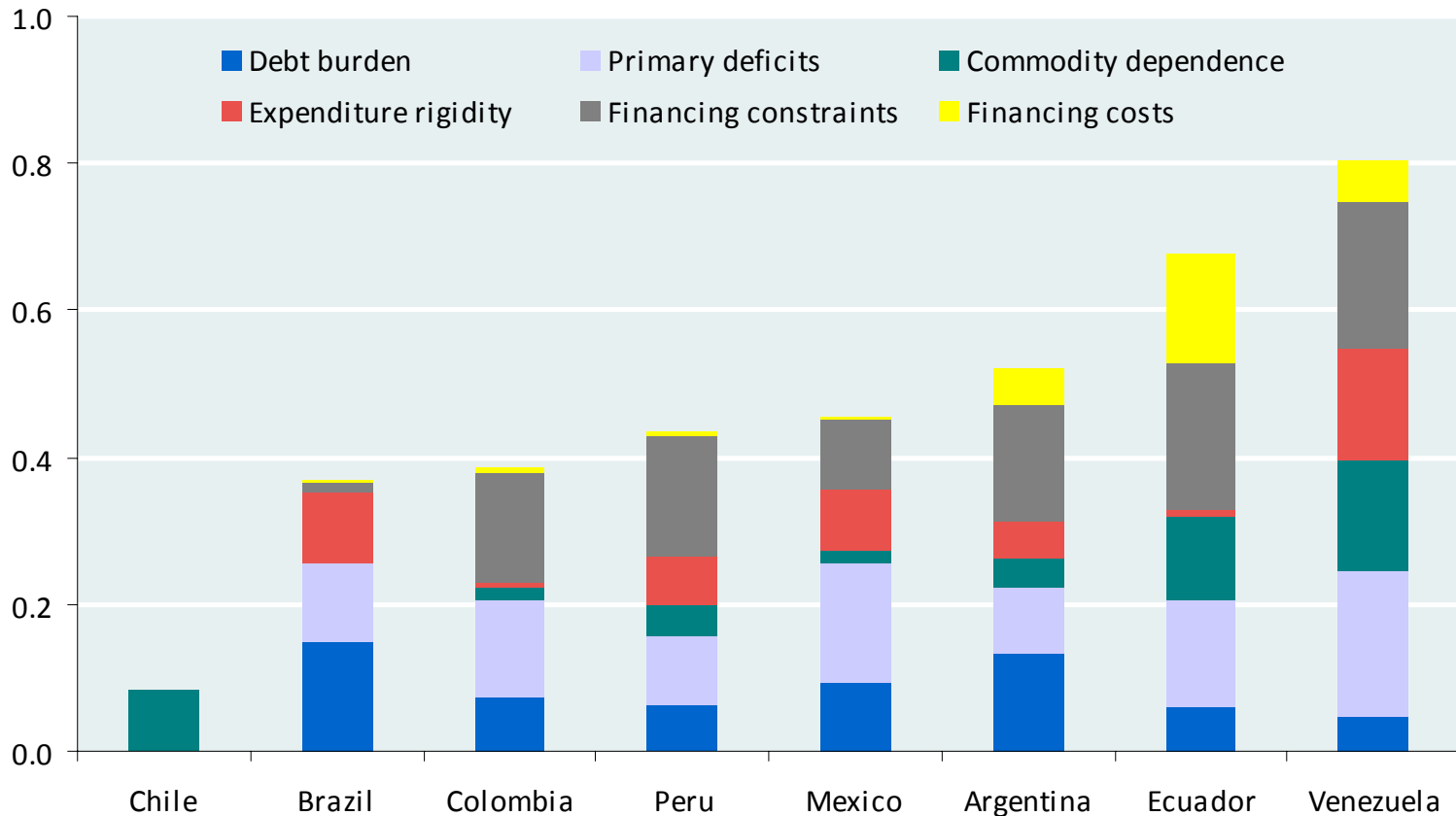
LAC countries are joining governments across the world in designing fiscal stimulus packages

Estimated Cost of Fiscal Discretionary Measures in 2009
as % of GDP



But fiscal maneuvering room varies significantly across LAC countries...

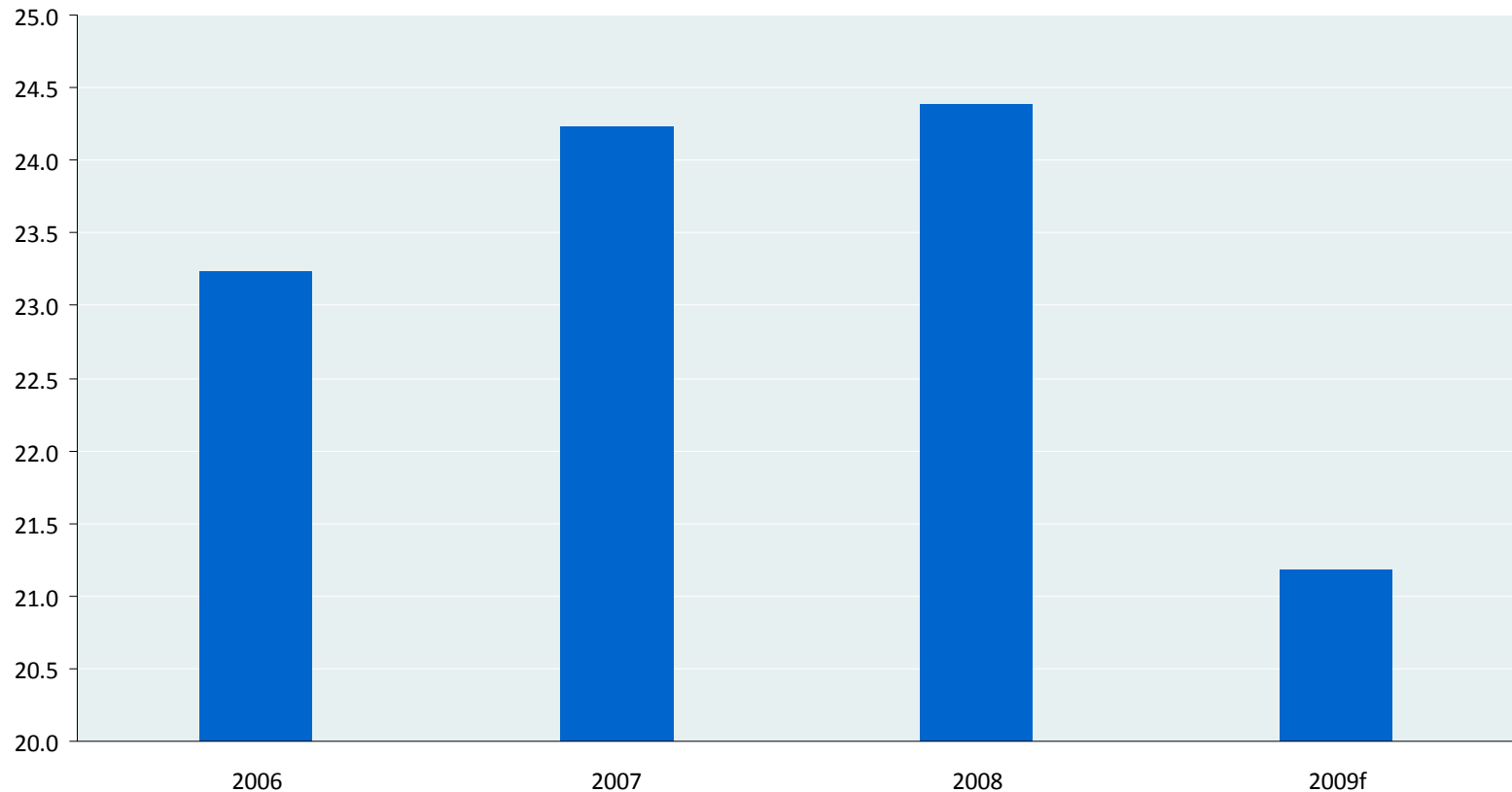
Index of constraints to implement counter-cyclical fiscal policy



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 constraints 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

Fiscal Revenues in LAC
as % of GDP



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
