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# Shockwaves from the North: Latin America and the External Deterioration

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Annual Meetings of the IMF and World Bank  
Washington, DC  
October 2008

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



# Outline

- Global shocks – a perfect storm?
  - Worsening and spreading of U.S. financial crisis, weakening commodity prices, sharper economic slowdown
    - Big uncertainty: transmission around the world
- Transmission channels
  - Financial contagion
  - Remittances
  - Commodity prices
  - External demand

} Interrelated
- LAC perspective and policy challenges

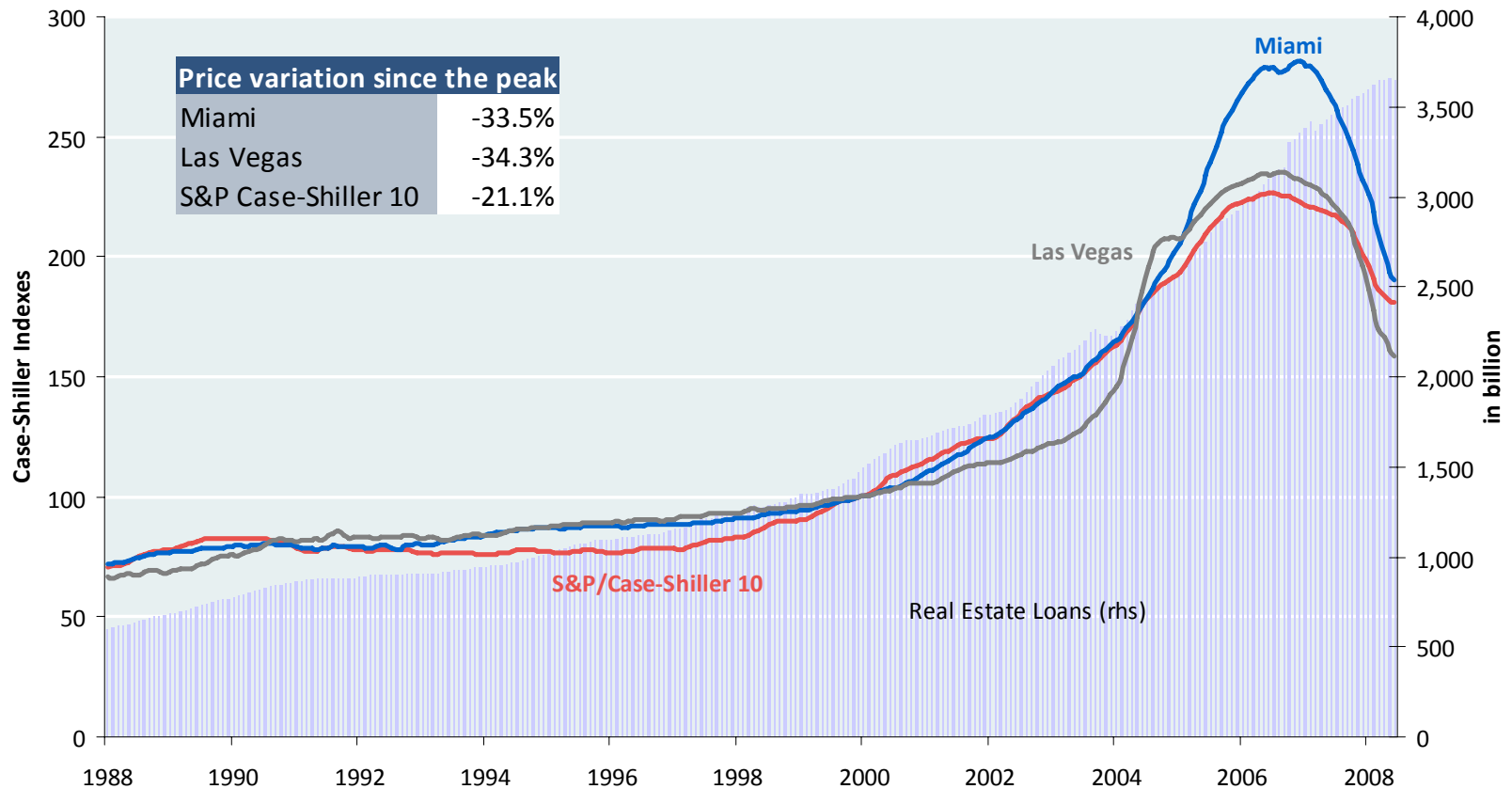
# *The deteriorating external environment*

# The trigger of the U.S. financial crisis

## *Toxic subprime loans, imploding housing markets*

### US House Prices and Real Estate Loans

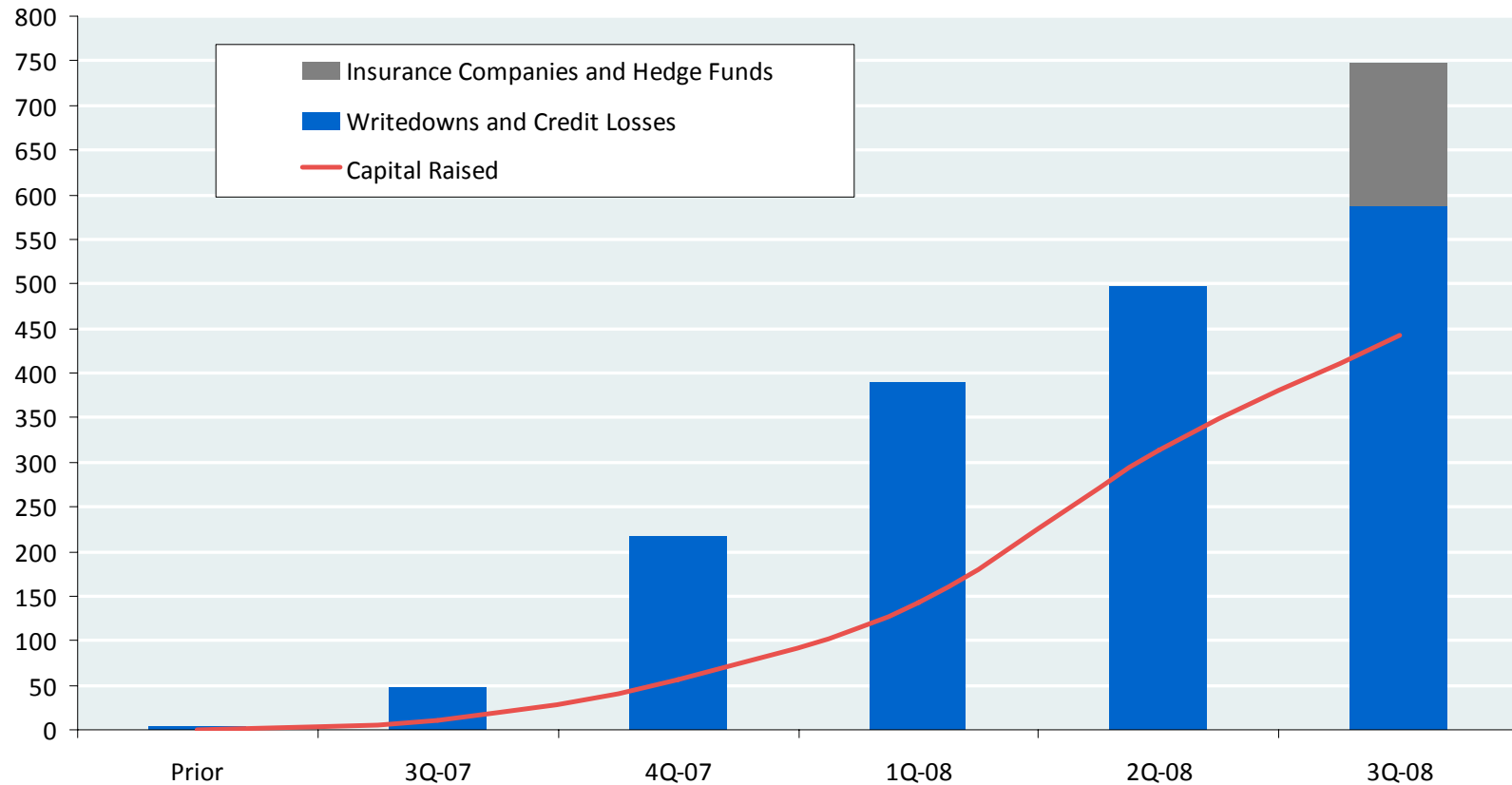
*S&P/Case-Shiller Indices and Stock of Real Estate Loans*



# The severity of the U.S. financial crisis

## *Colossal accumulation of credit losses, and counting...*

**Cumulative Bank Writedowns and Credit Losses vs. Capital Raised**  
*in billions of U.S. dollars*



Note: The figures reported above do not include Freddie Mac and Fannie Mae. Source: Bloomberg.

# The severity of the U.S. financial crisis

*Assets of failed institutions represent 40% of GDP, so far*

## Closed Institutions                      Assets (in billion of dollars)

Ameribank	0.1
ANB Financial	2.1
Douglass National Bank	0.1
First Heritage Bank	0.3
First Integrity Bank	0.1
First National Bank of Nevada	3.4
First Priority Bank	0.3
Hume Bank	0.0
IndyMac Bank	32.0
Integrity Bank	1.1
Lehman Brothers	691.0
Silver State Bank	2.0
The Columbian Bank and Trust	0.8
Washington Mutual	307.0
<b>Total</b>	<b>1,040.1</b>

## Intervened Institutions                      Assets (in billion of dollars)

AIG	1,060.0
Fannie Mae	882.0
Freddie Mac	794.0
Merrill Lynch	1,020.0
Wachovia	782.0
<b>Total</b>	<b>4,538.0</b>

= 40% of US 2007 GDP

# The intractability of the U.S. financial crisis

## *Confidence erosion despite massive government support*

### Liquidity and Solvency Interventions



#### **LoLR**

*Liquidity Injections (USD 145 bn)\**

*FED doubled its cash auctions to banks to up to USD 900 bn*

#### **Solvency and Quasi-Solvency Support**

*Deposit Insurance Fund use (USD 7.2 bn)*

*Bear Stearns bad asset purchase (USD 30 bn)*

*Freddie and Fannie conservatorship (?)*

*AIG long-term loan (USD 85 bn)*

*Guarantee on money market funds (USD 50 bn)*

*TARP (USD 700 bn)*

*Fund to purchase commercial paper (?)*

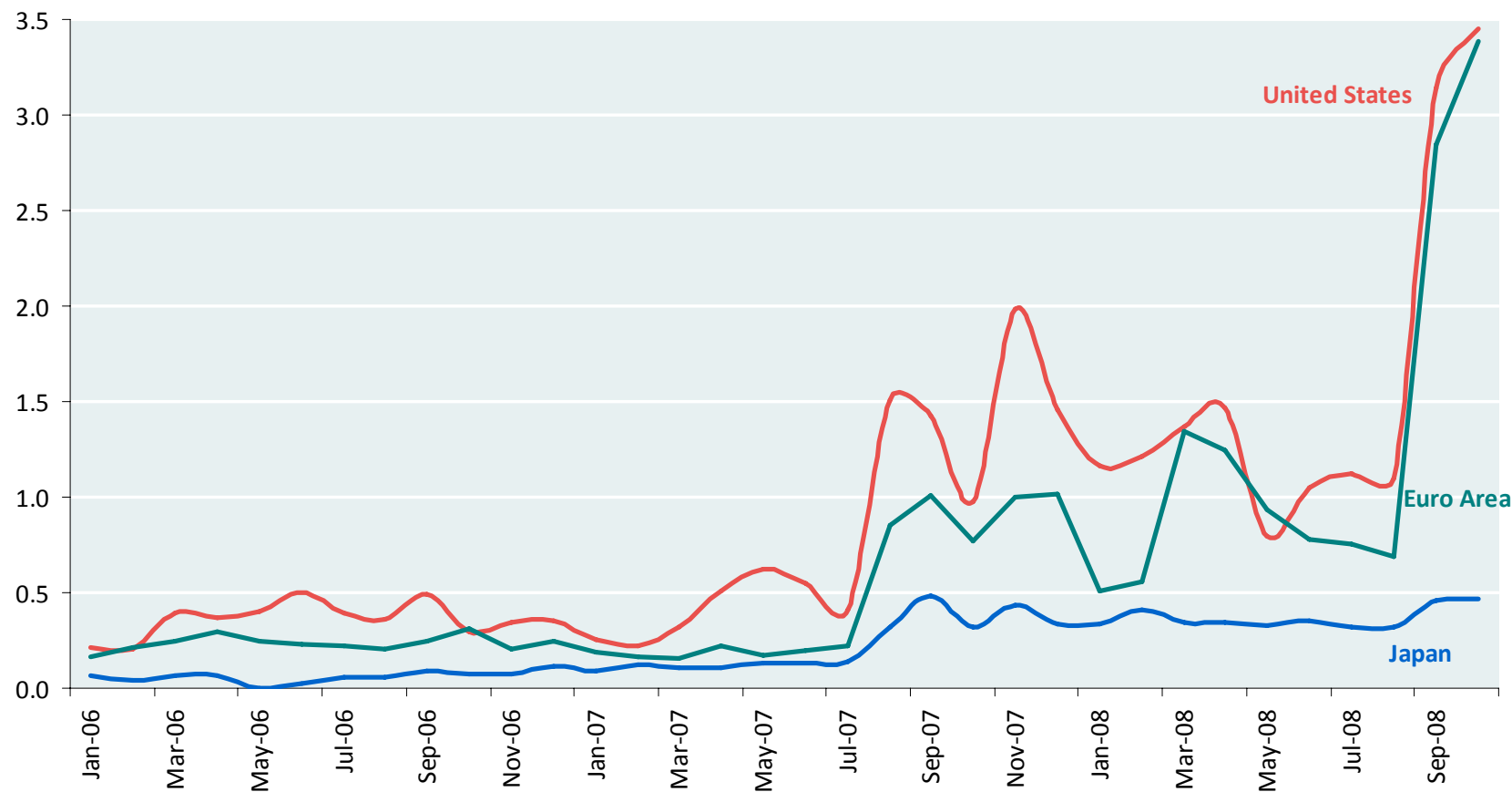
*\*Net interbank liabilities to monetary authority Q2.2008*

# The intractability of a spreading credit crisis

## *Unyielding money markets dislocation in the U.S. & Europe*

### Interbank Markets

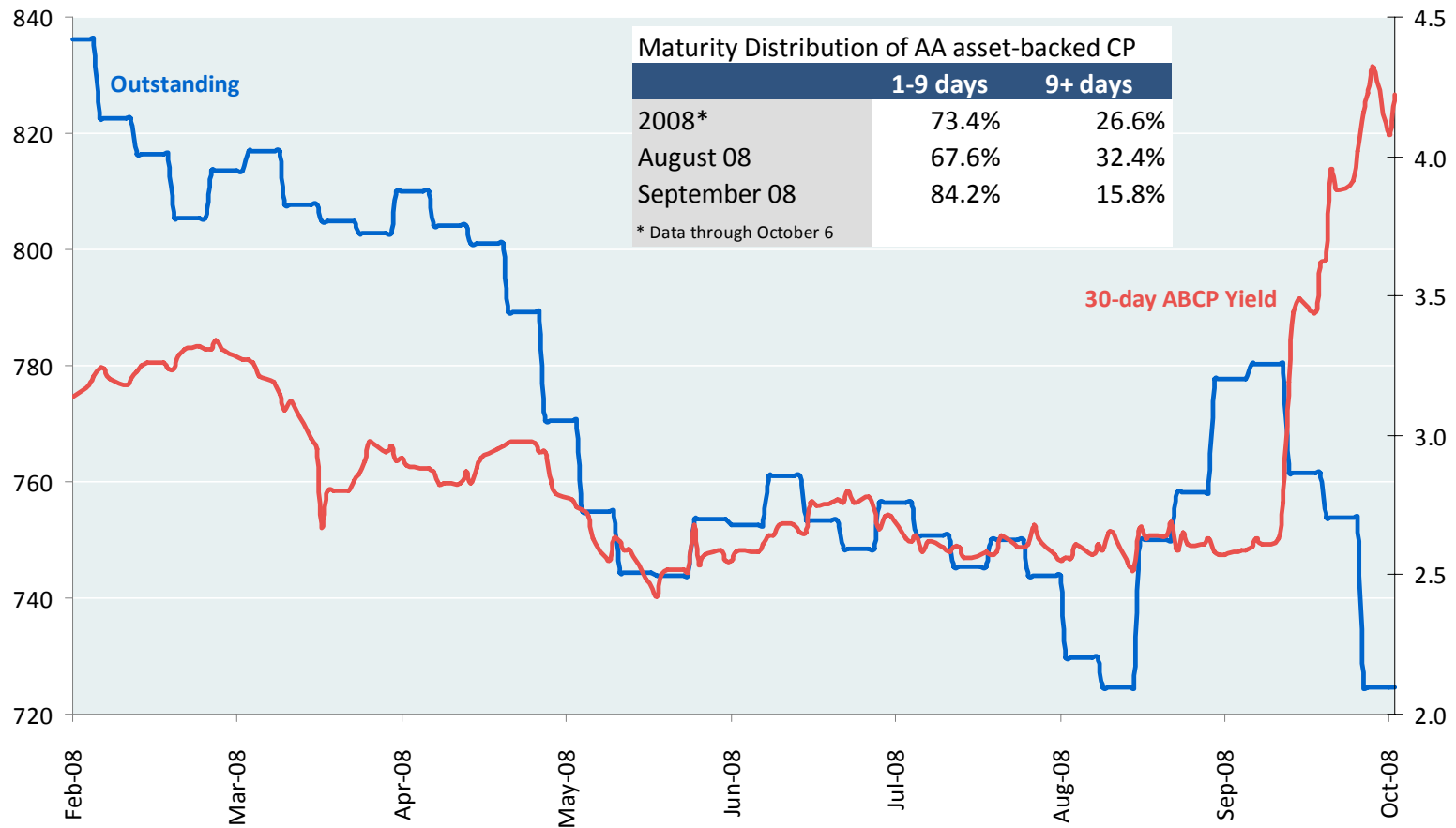
*TED spread, in percentage points*



# The intractability of the U.S. credit crisis

## *Virtual freezing of commercial paper market*

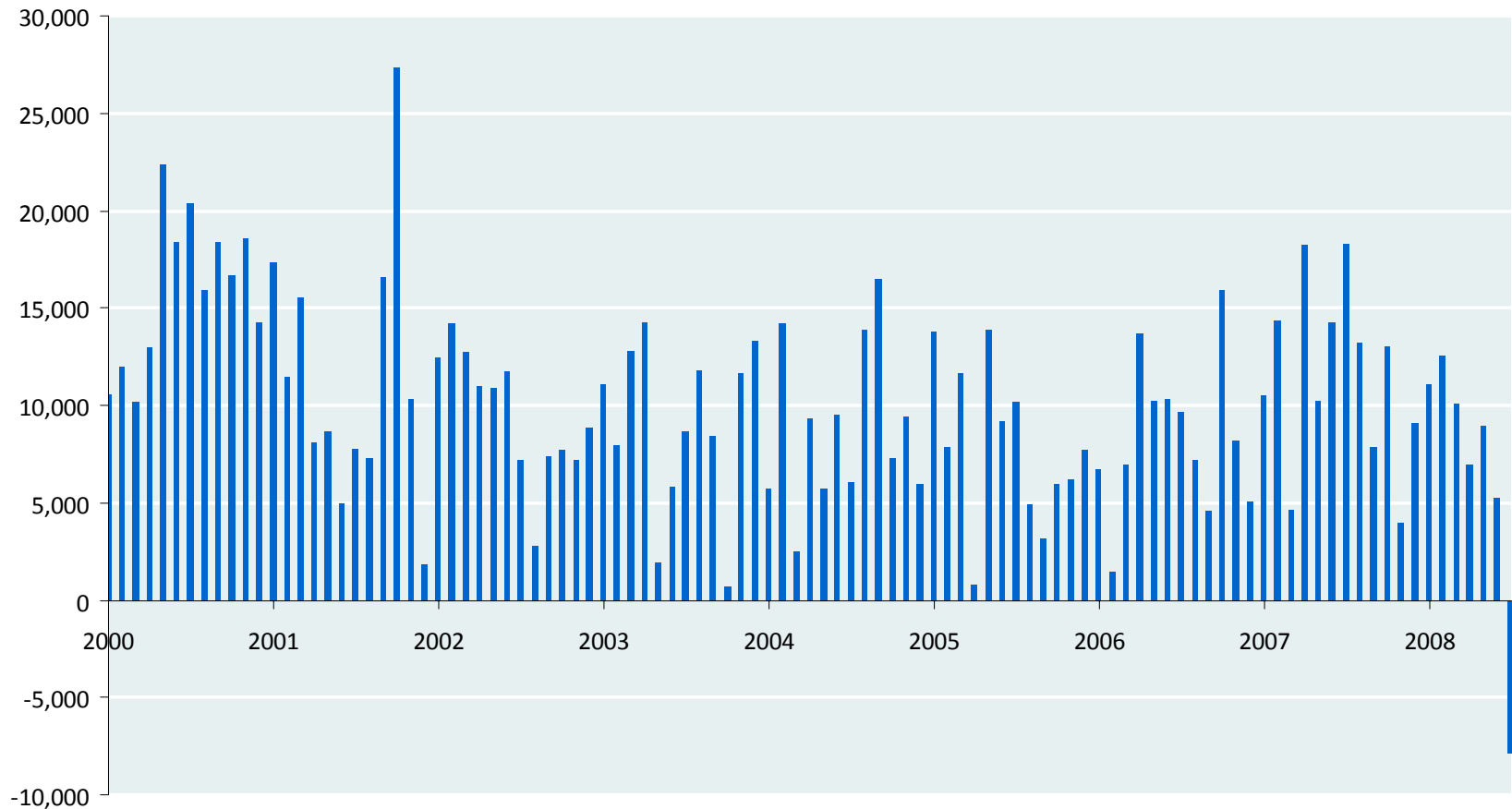
**Asset Backed Commercial Paper Outstanding and 30-day ABCP Yield**  
*CP in billion of US\$ and rates in percentage points*



# The intractability of the U.S. financial crisis

## *Unprecedented contraction in consumer credit*

**Total Consumer Loans Owned and Securitized**  
*Monthly variation in million of dollars, seasonally adjusted*

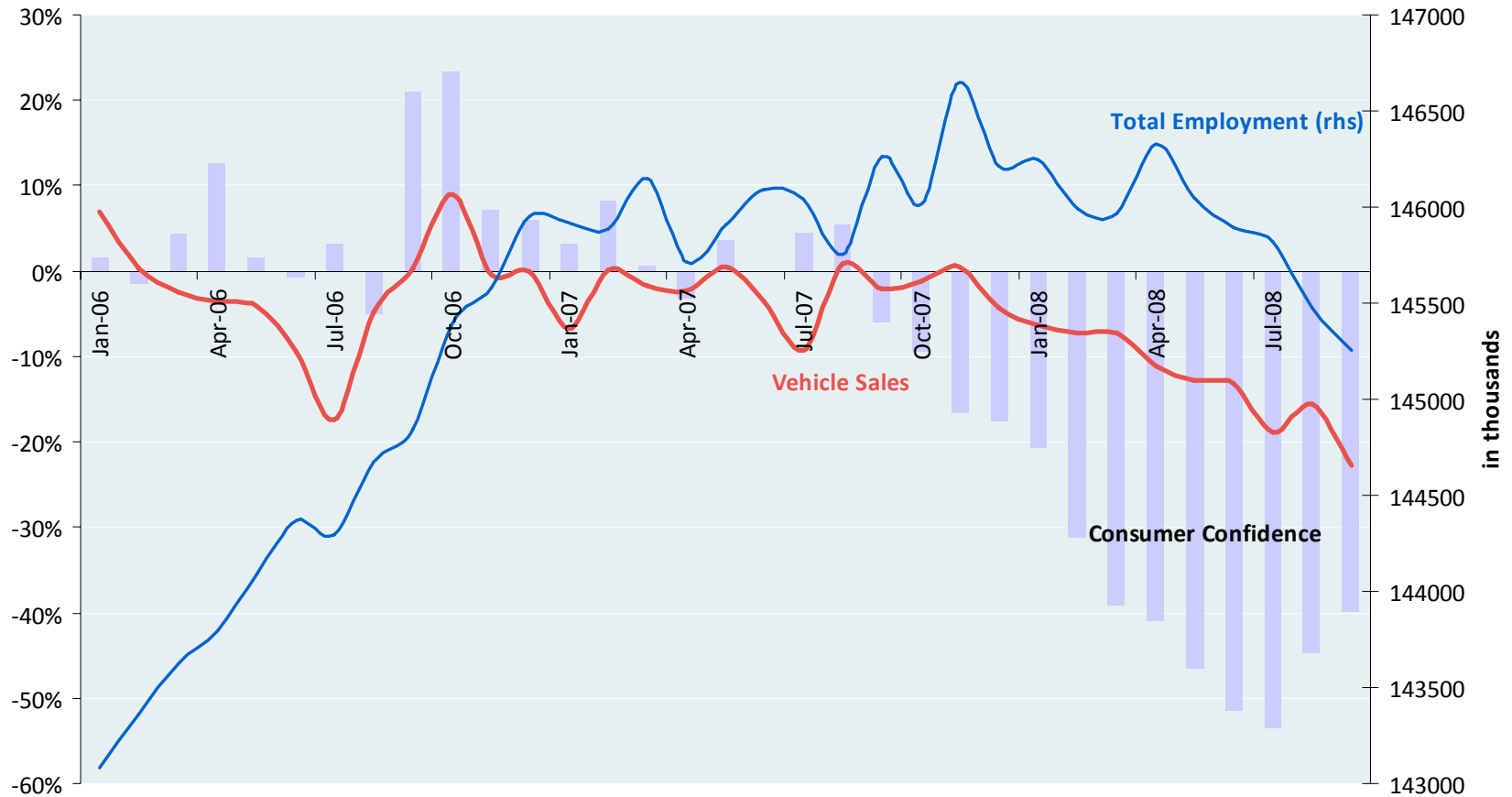


# The perniciousness of the U.S. financial crisis

*It is infecting the real economy in the USA...*

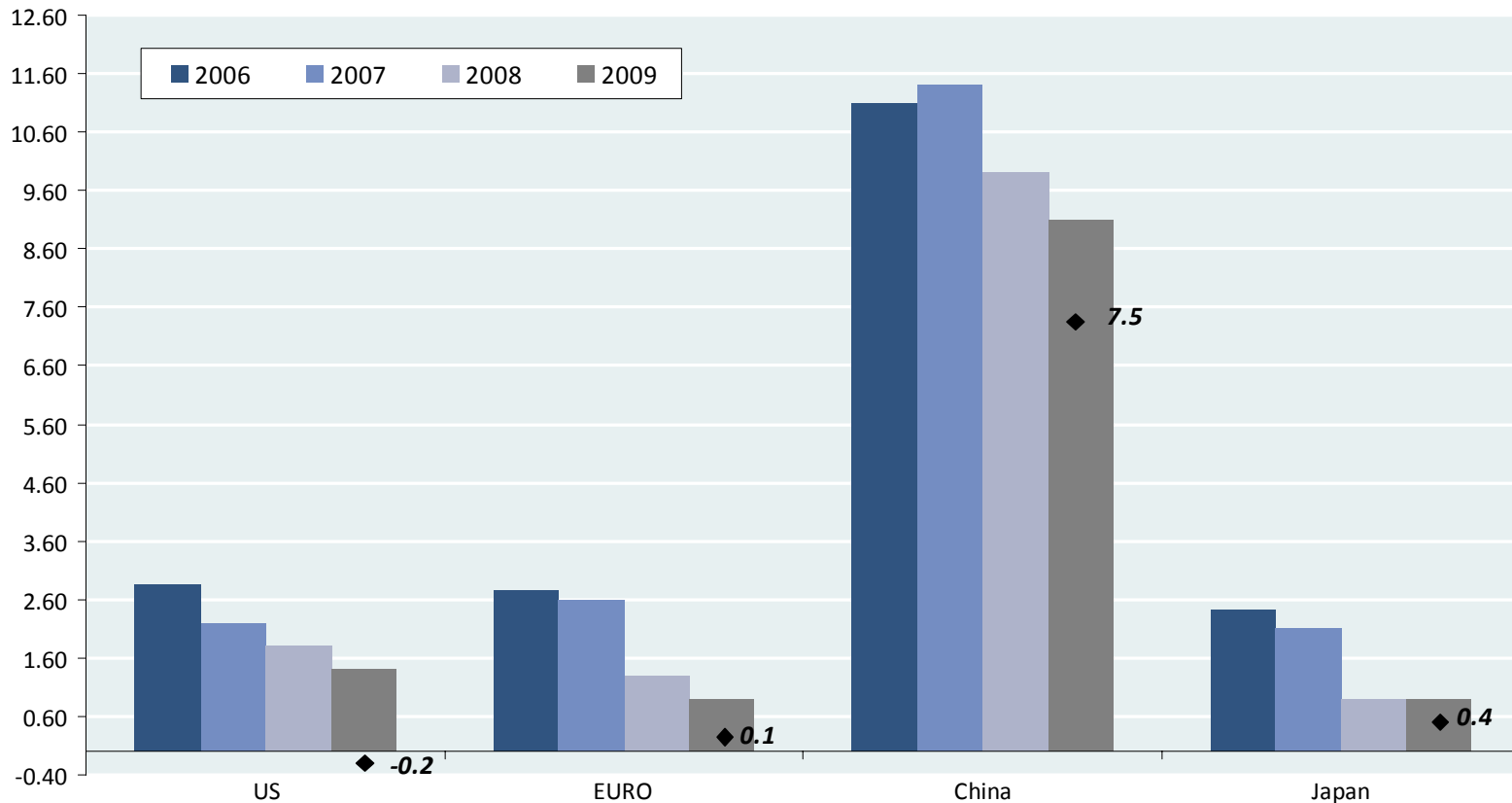
## U.S. Economic Indicators

Total Employment and YoY variation of Consumer Confidence and Vehicle Sales



# Amidst rising uncertainty, a sharper global slowdown is now envisaged

**Recent Growth and Forecast for 2008 and 2009**  
*annual GDP real growth rate, in %*

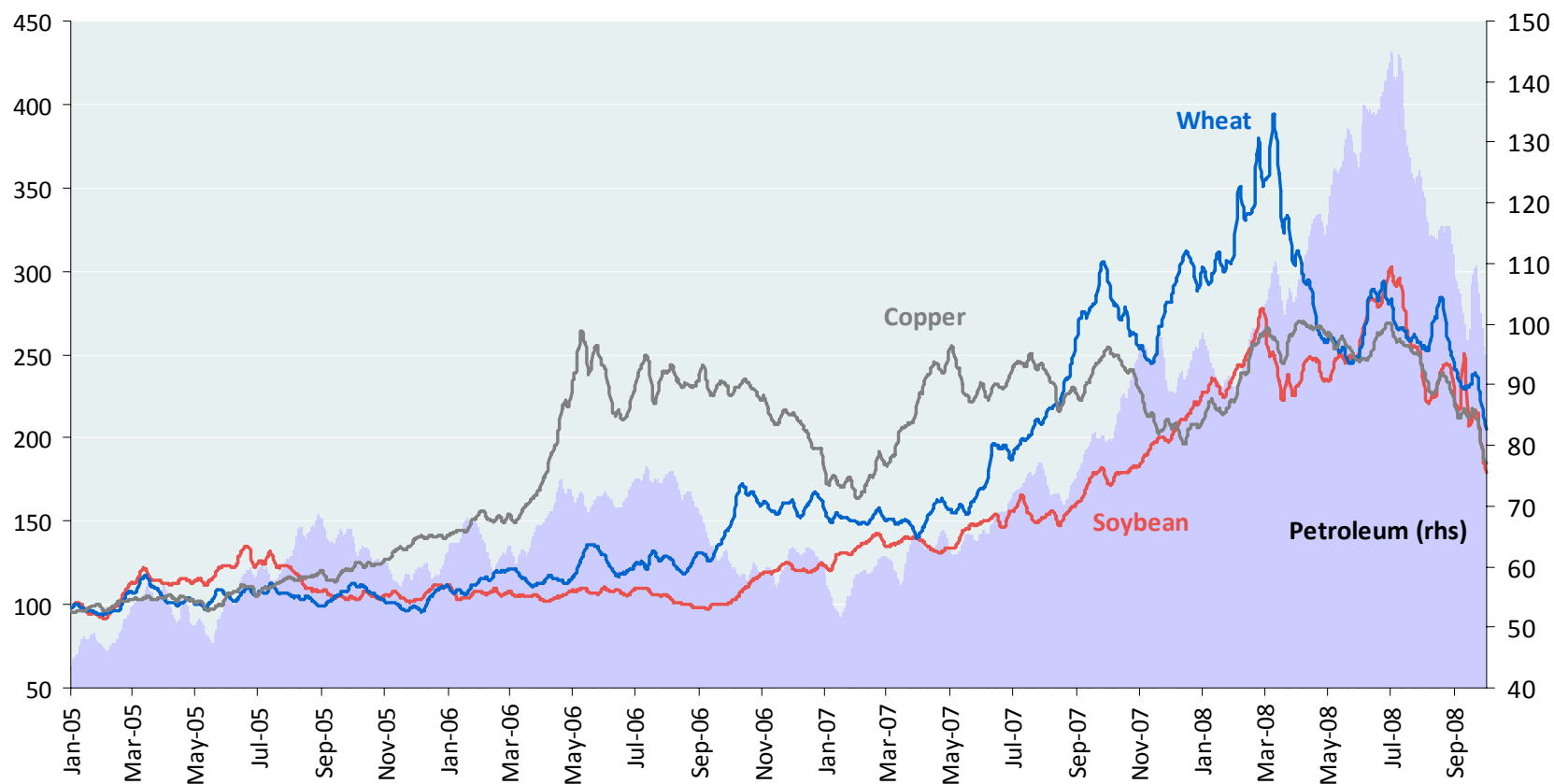


# Commodity prices are moving now in the same direction as finance and growth, downward

## Commodity Prices

Oil WTI in current US\$

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



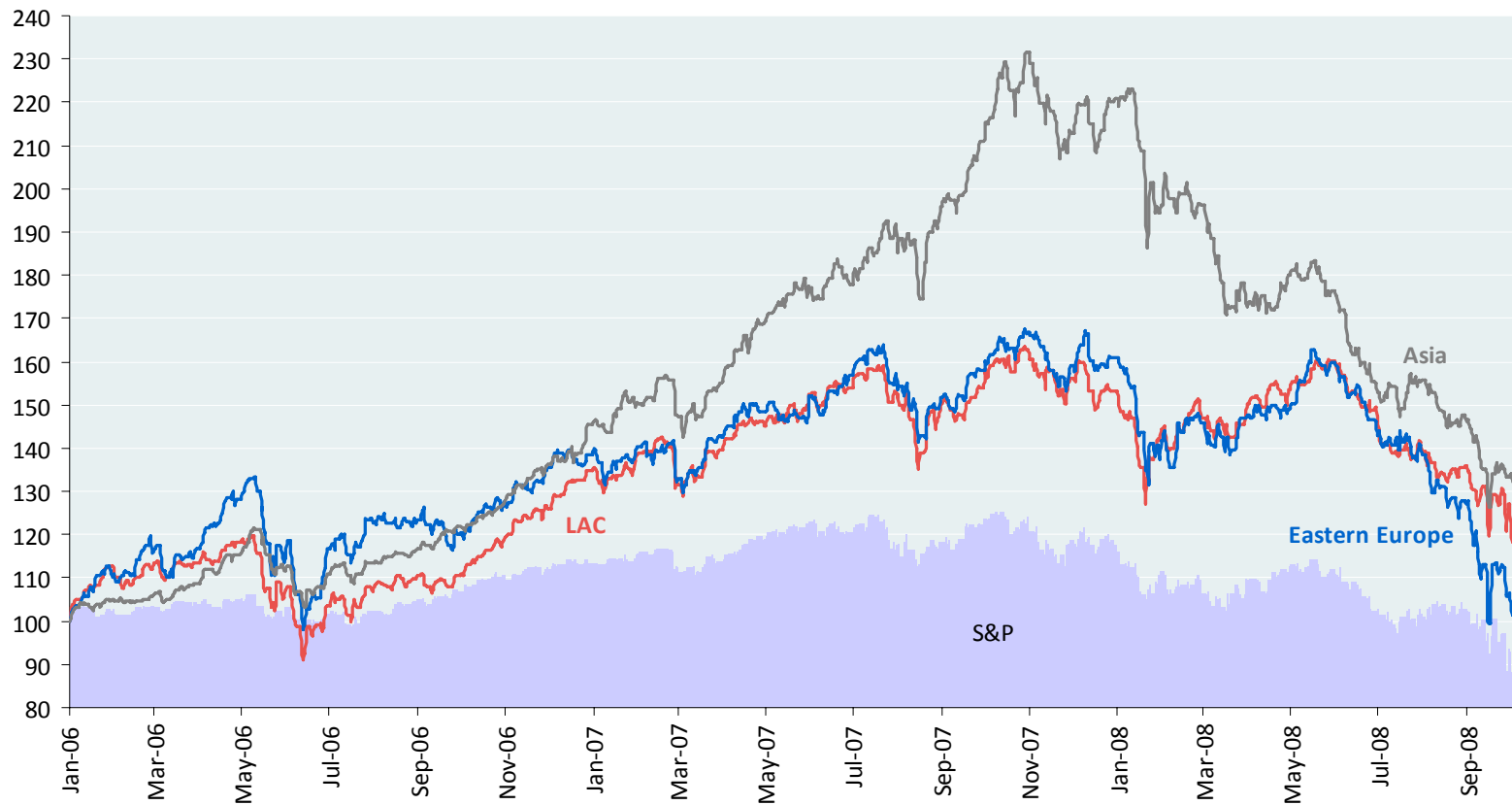
# *Financial contagion effects*

# LAC has been caught in the global selloff of stocks

*But fall is less pronounced than in Asia and Eastern Europe*

## Stocks in Emerging Markets

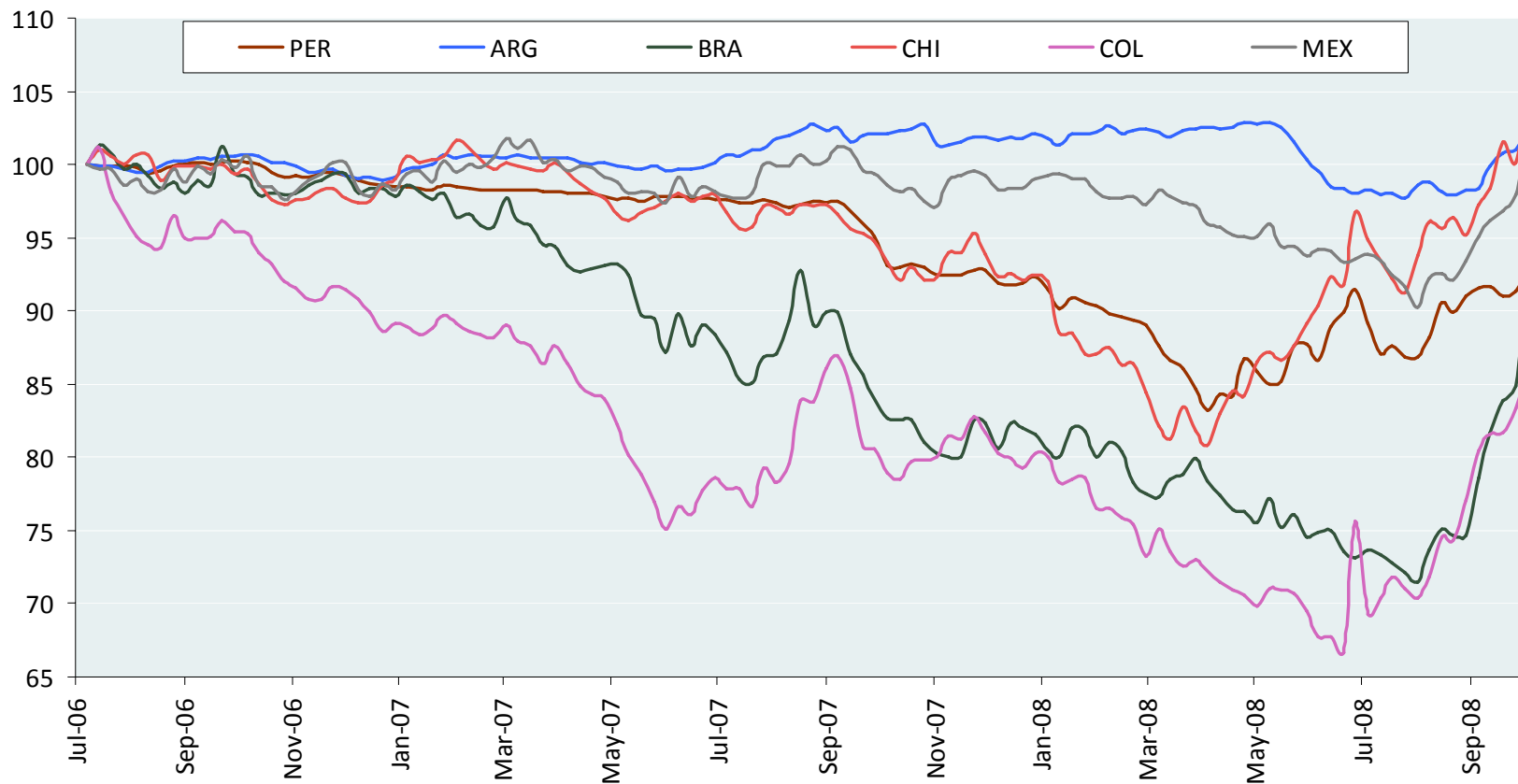
Index number - Jan 06=100



LAC: Argentina, Brazil, Colombia, Chile, Mexico. Eastern Europe: Czech Republic, Hungary, Poland and Russia. Asia: China, Hong Kong, India, Indonesia, Malaysia, Philippines and Thailand.  
Source: Bloomberg

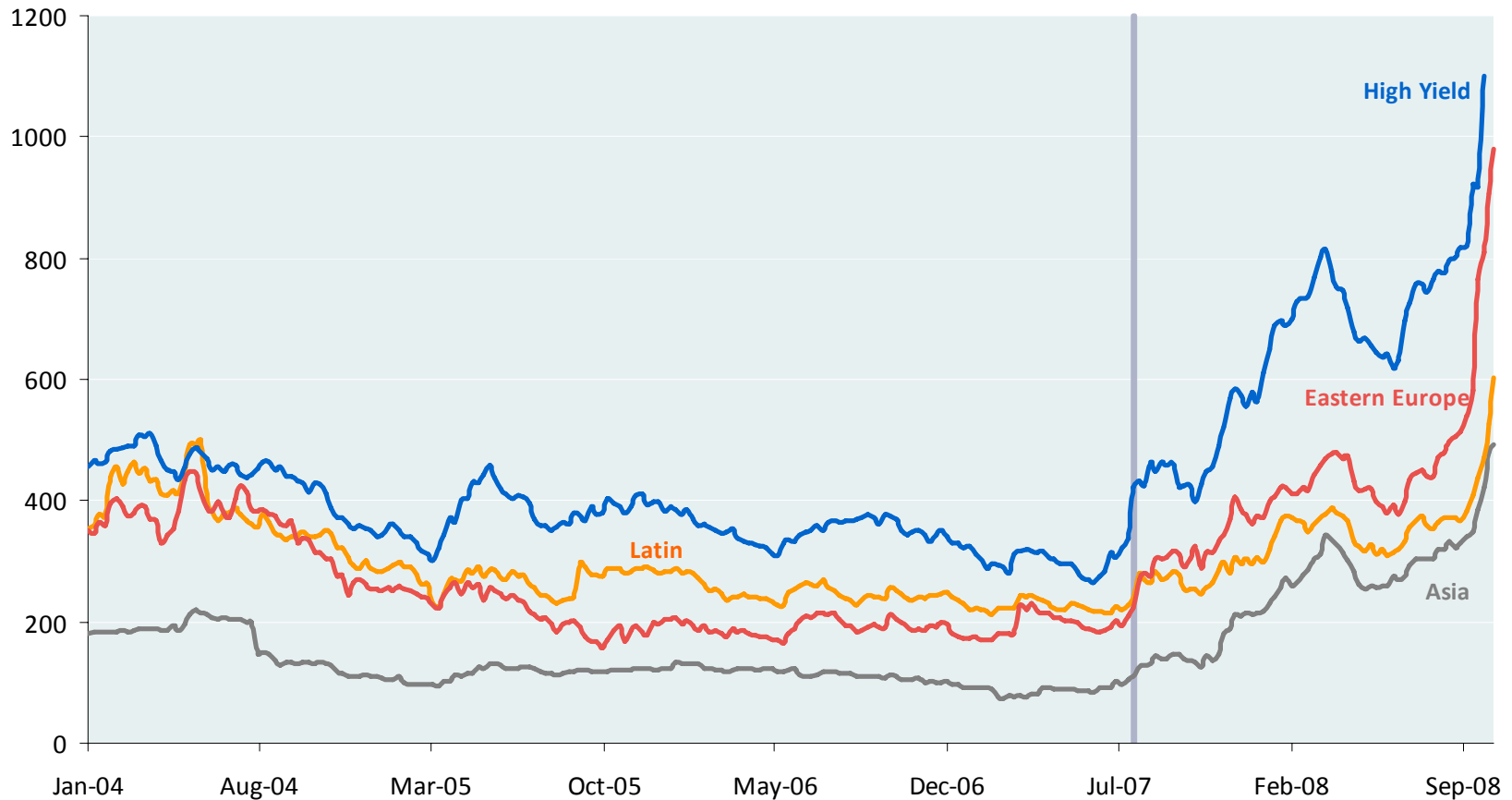
# Latin currencies are adjusting sharply, following a prolonged period of appreciation

**Performance of Selected LAC Currencies**  
Unit of local currencies vis-a-vis US dollar.  
Index 100=Jul2006



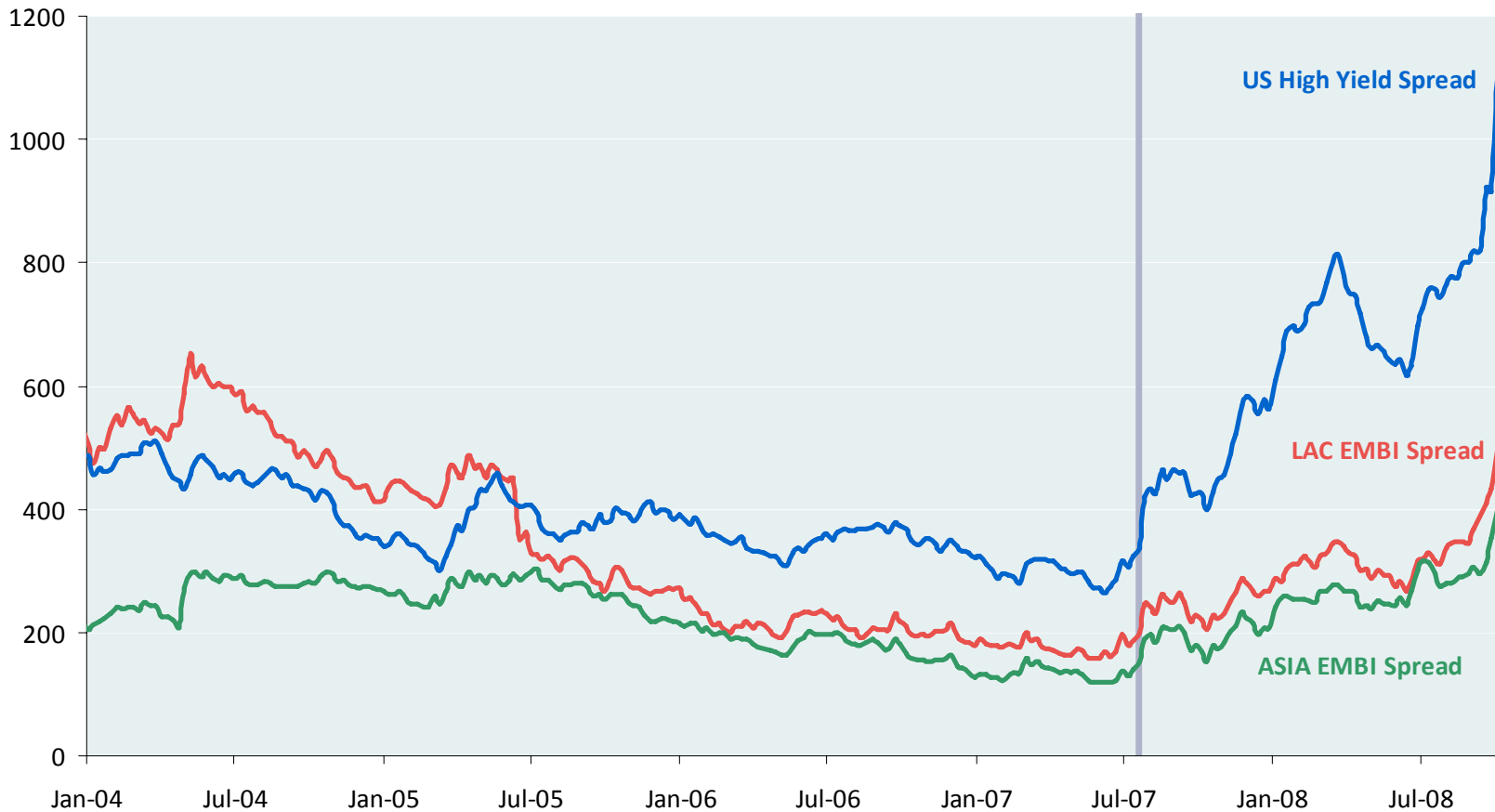
# Latin firms are facing a steep rise in FX borrowing costs, though less than firms in Eastern Europe

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



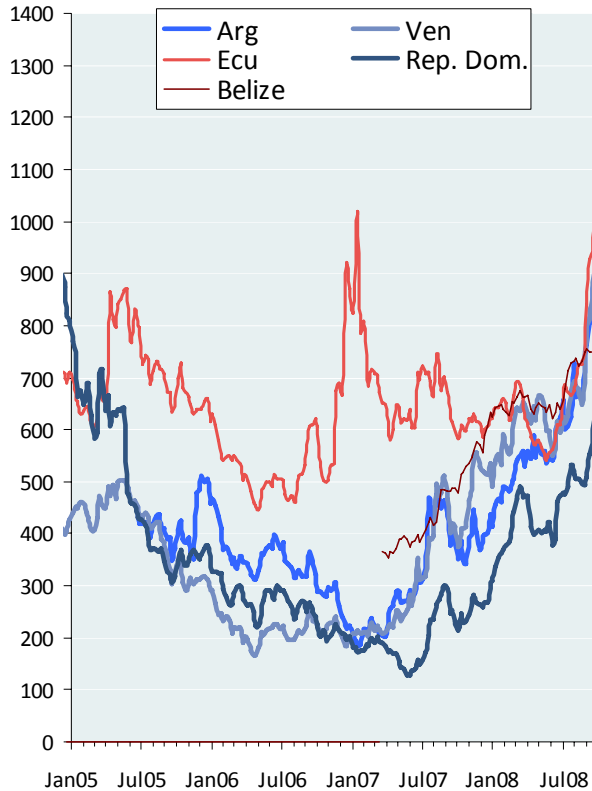
Risk premiums for Latin sovereigns have risen but have remained well below “junk bond” spread (level & volatility)

**Latin America EMBI & U.S. High Yield Spreads**  
*in basis points*

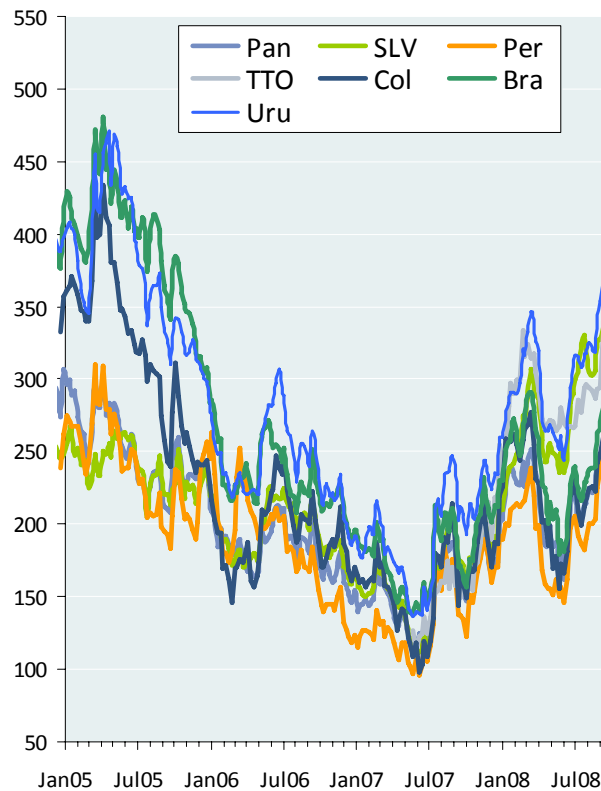


# Behind the Latin EMBI average, countries can be classified into three groups ...

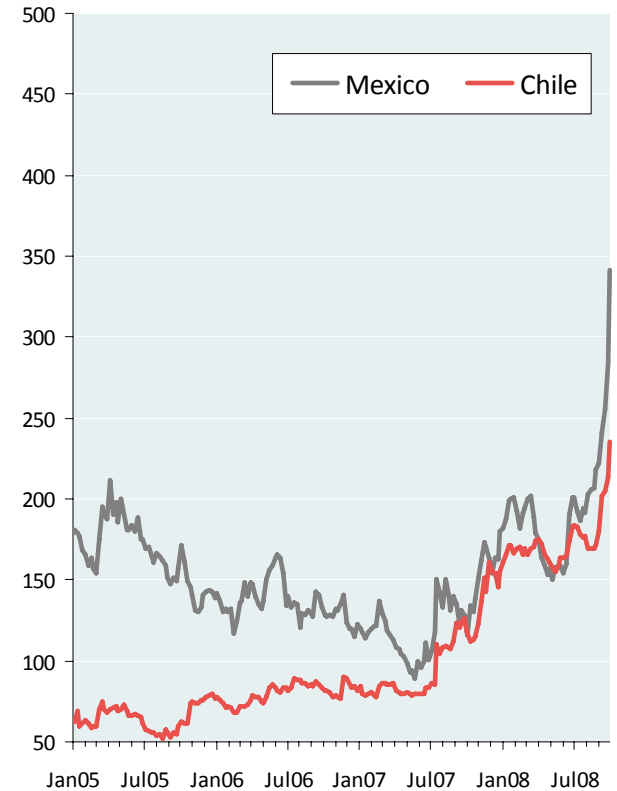
**High EMBI Spread LAC countries**  
*in basis points*



**Medium EMBI Spread LAC countries**  
*in basis points*

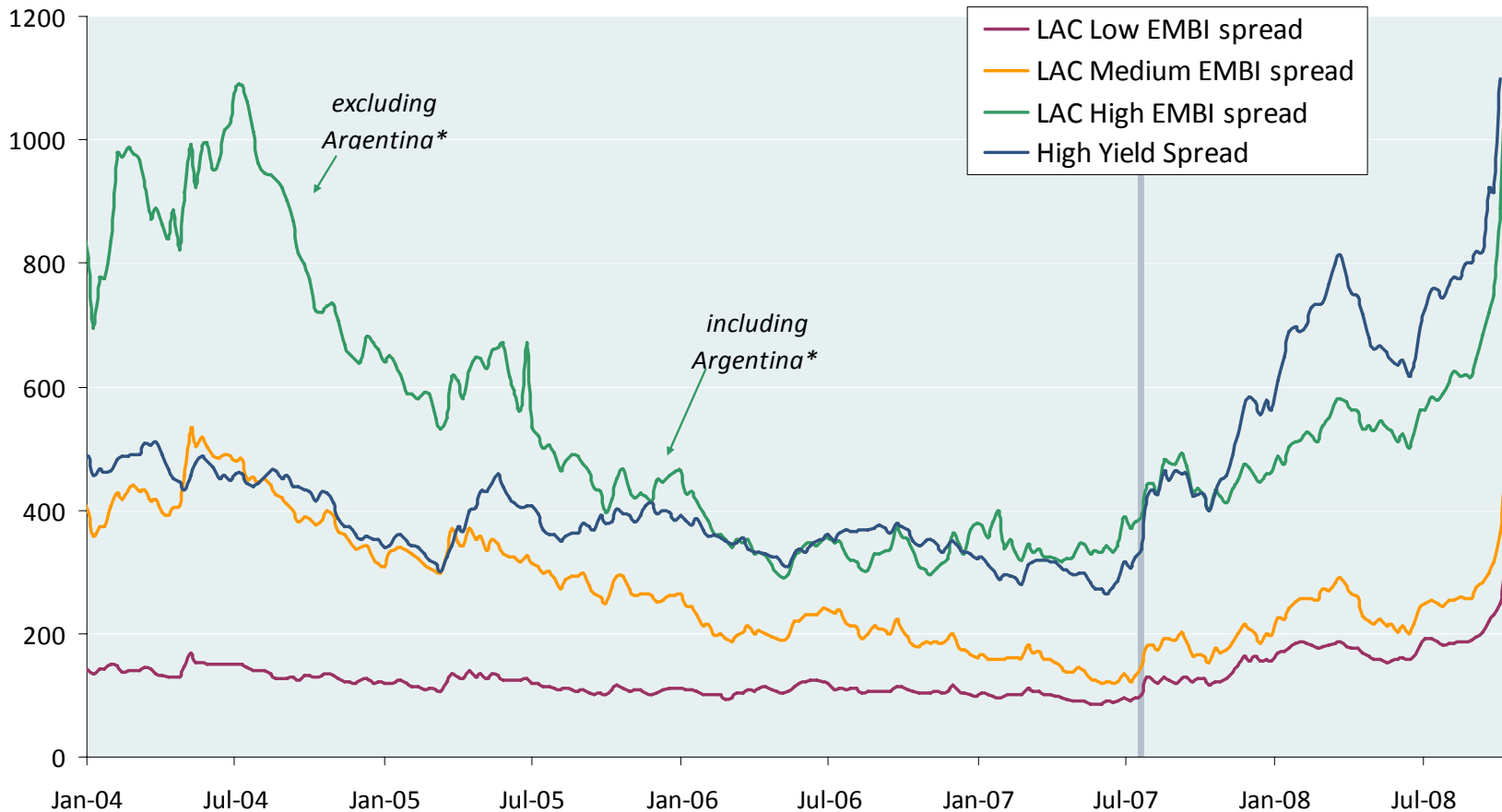


**Low EMBI Spread LAC countries**  
*in basis points*



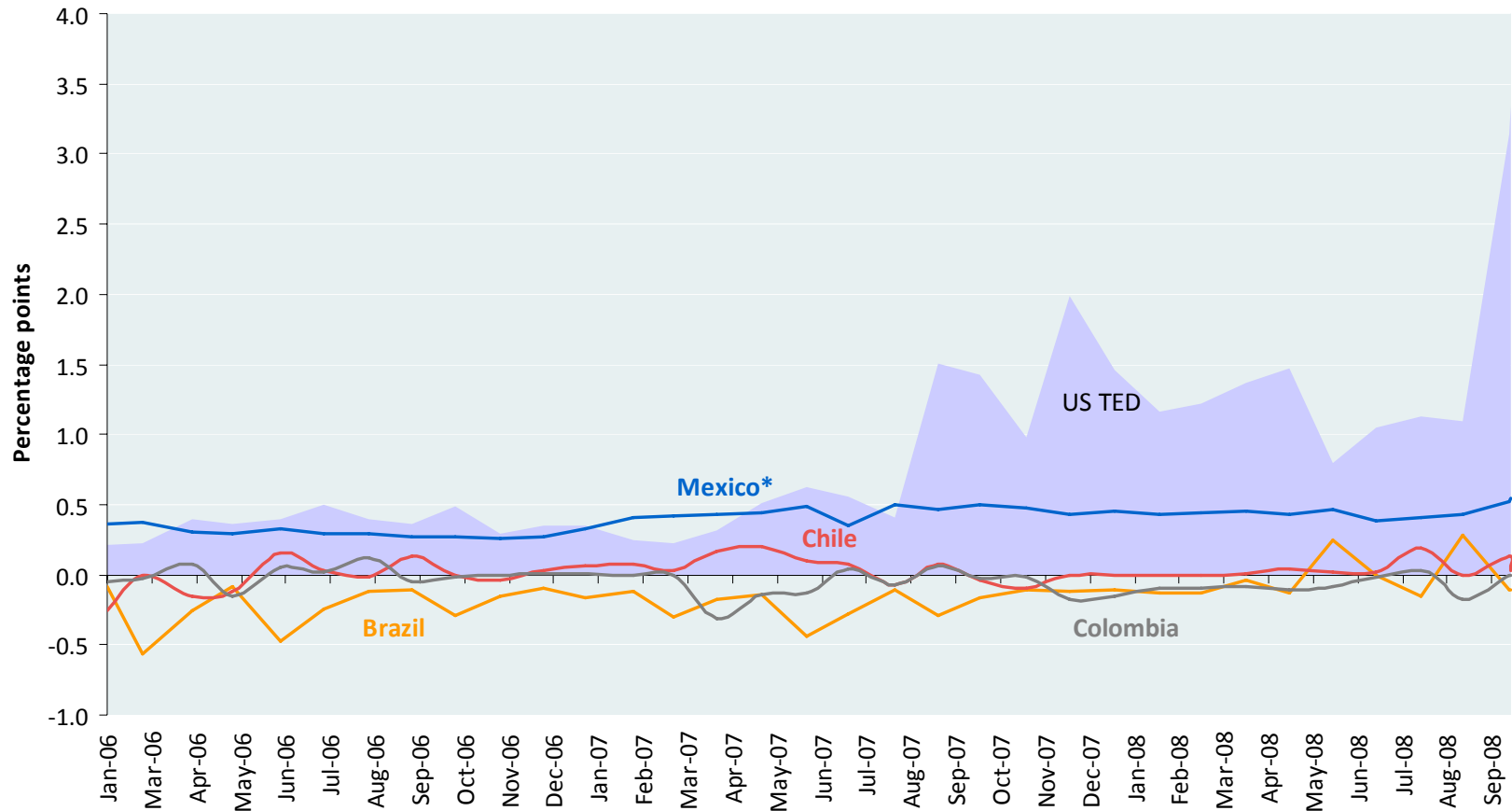
# ... depending on the behavior of their EMBIs relative to the spreads of U.S. high yield bonds

**Latin EMBI & U.S. High Yield Spreads**  
*in basis points*



# Local interbank markets in LAC remain well behaved, so far

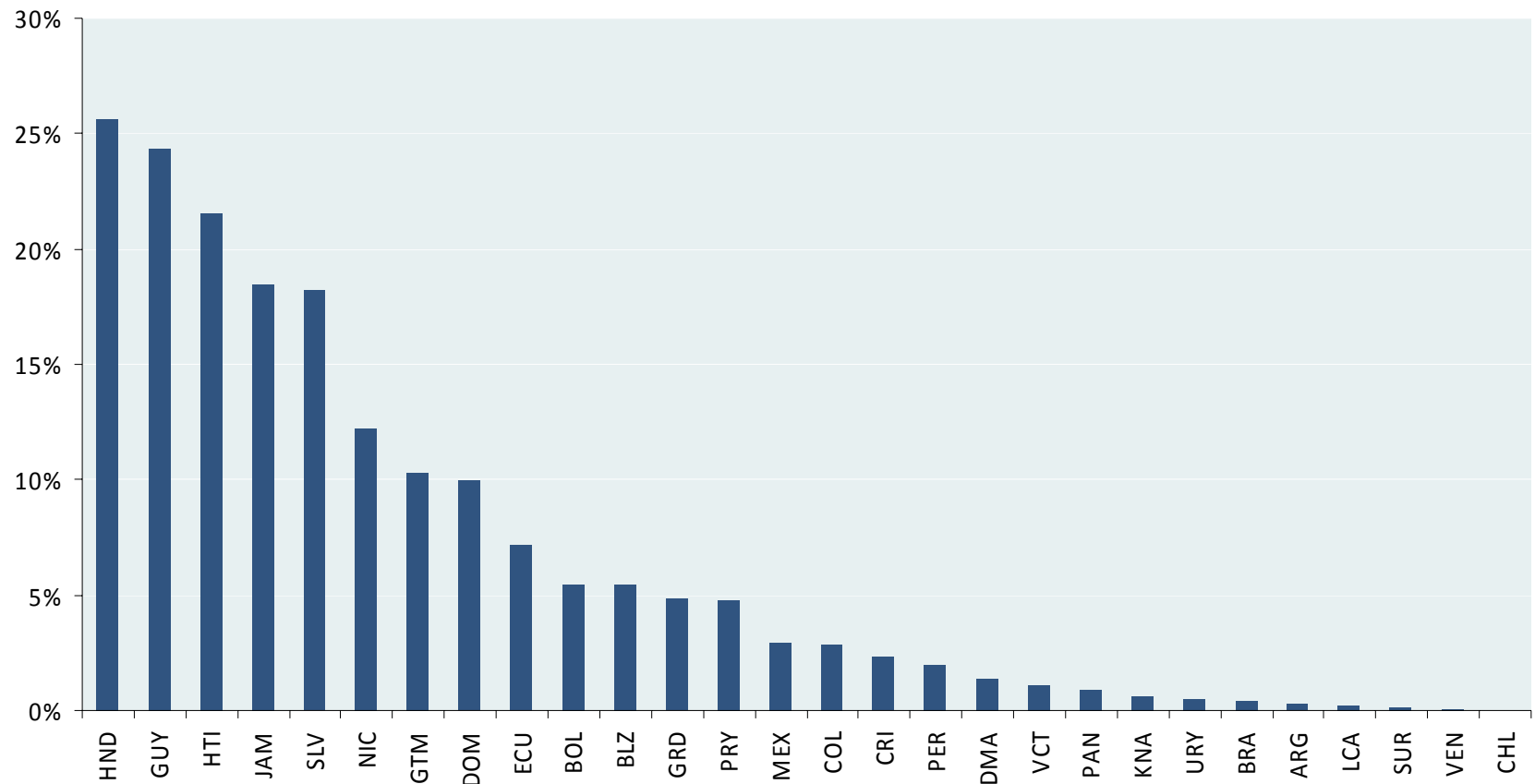
**Interbanks Markets in Selected LAC Countries**  
Spread between 1-month Interbank rate and Policy Rate



# *Remittances*

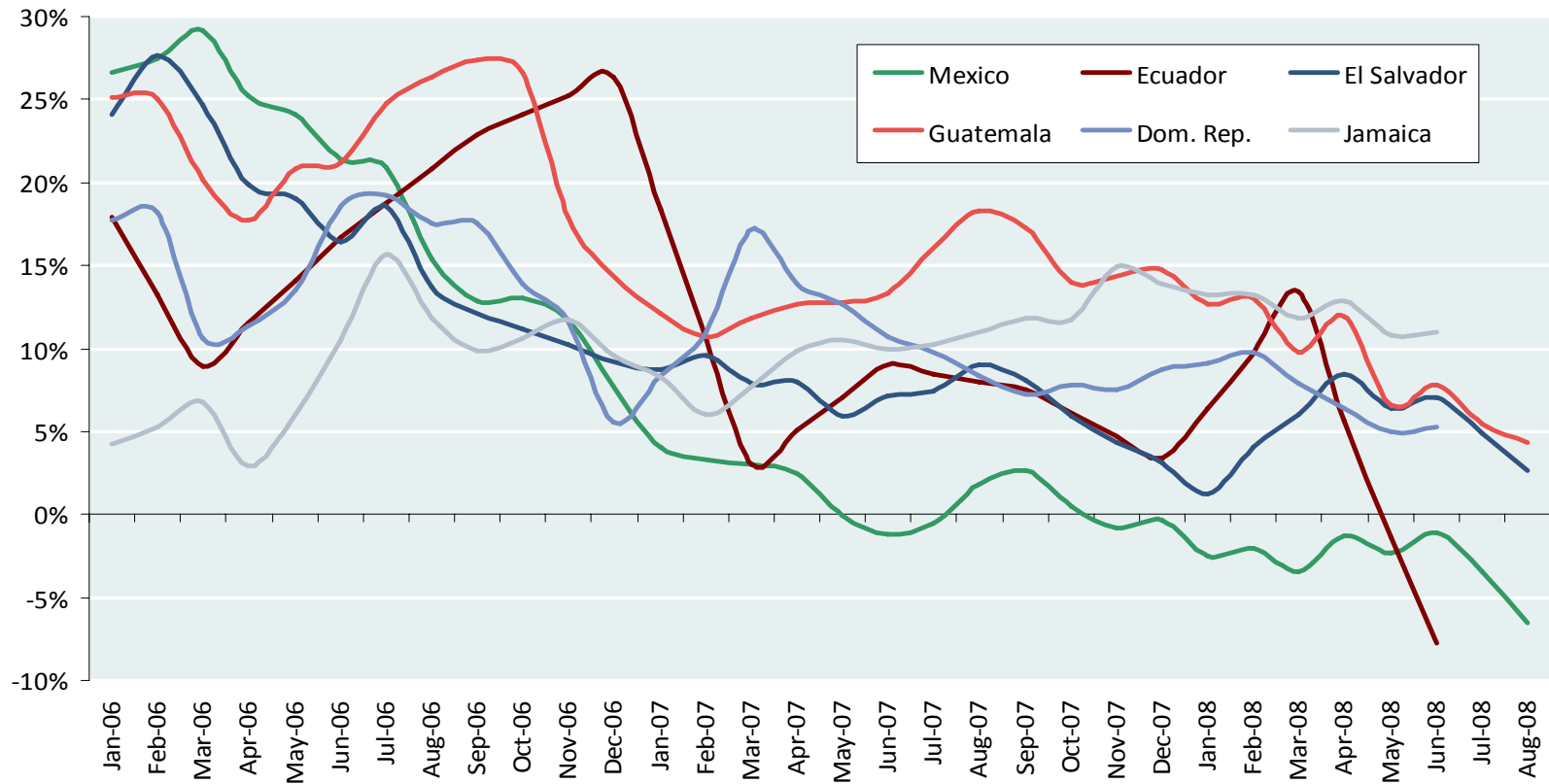
# Remittances represent 10-20 percent of GDP in 8 Caribbean and Central American countries

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



# Troubles in originating countries have led to a sharp fall in the growth rate of remittances to the region

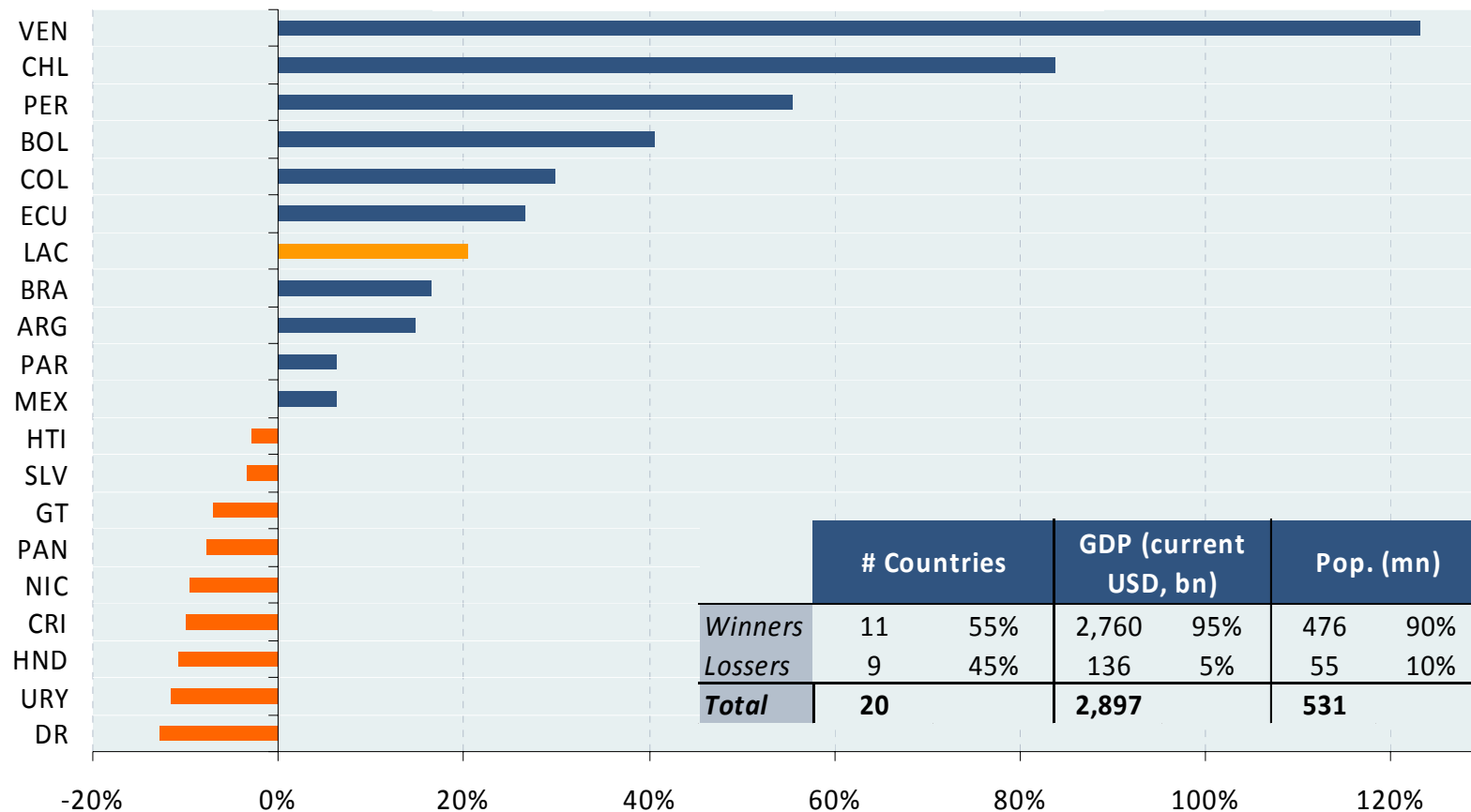
**Remittances to Latin America**  
*annual variation, 3 month moving average*



# *Commodity prices and inflation*

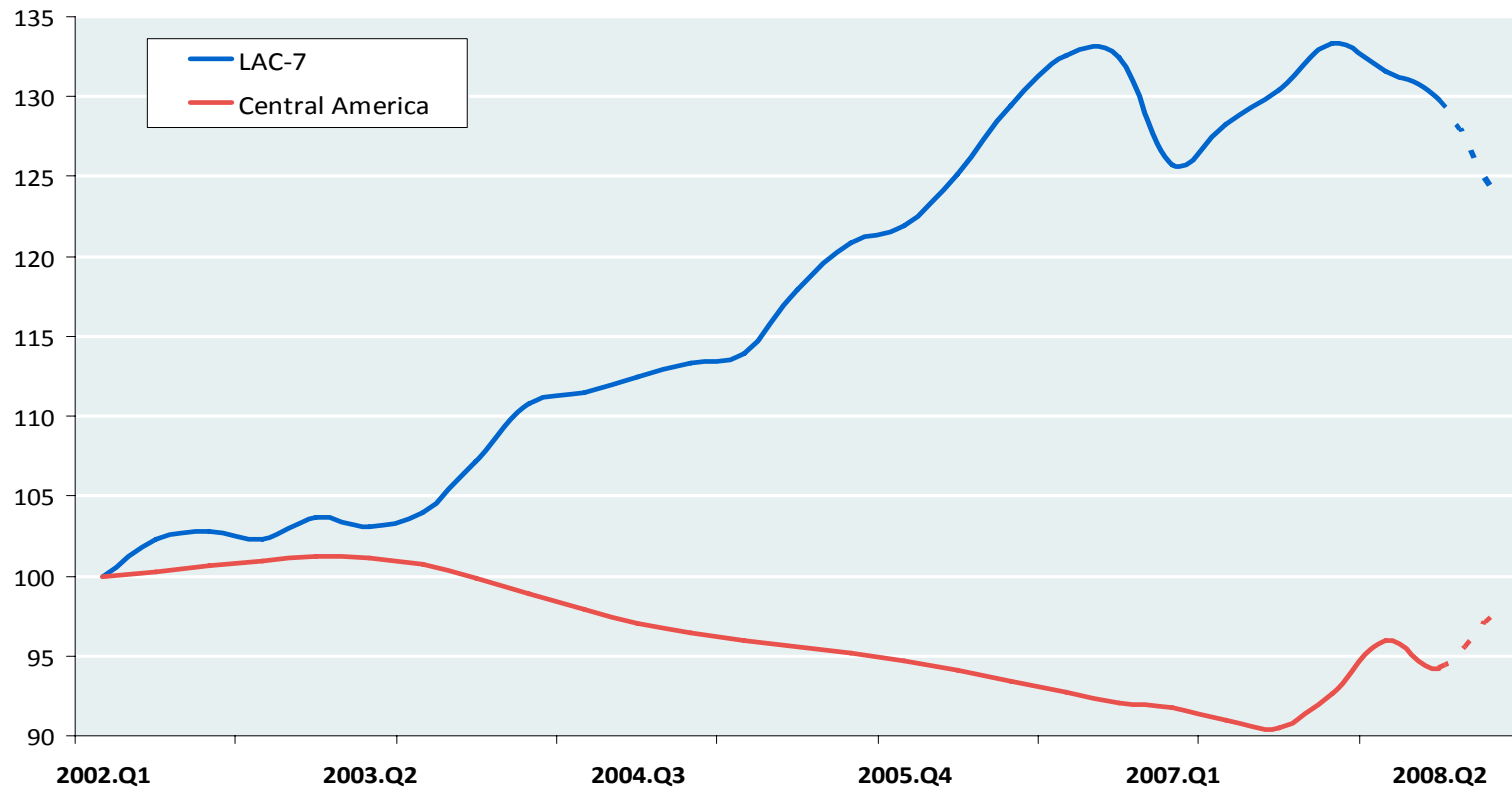
# Despite marked asymmetries in TOT effects across countries, gains have dominated until recently...

**Terms of Trade for Selected LAC countries**  
change between 2002-2007 - in %



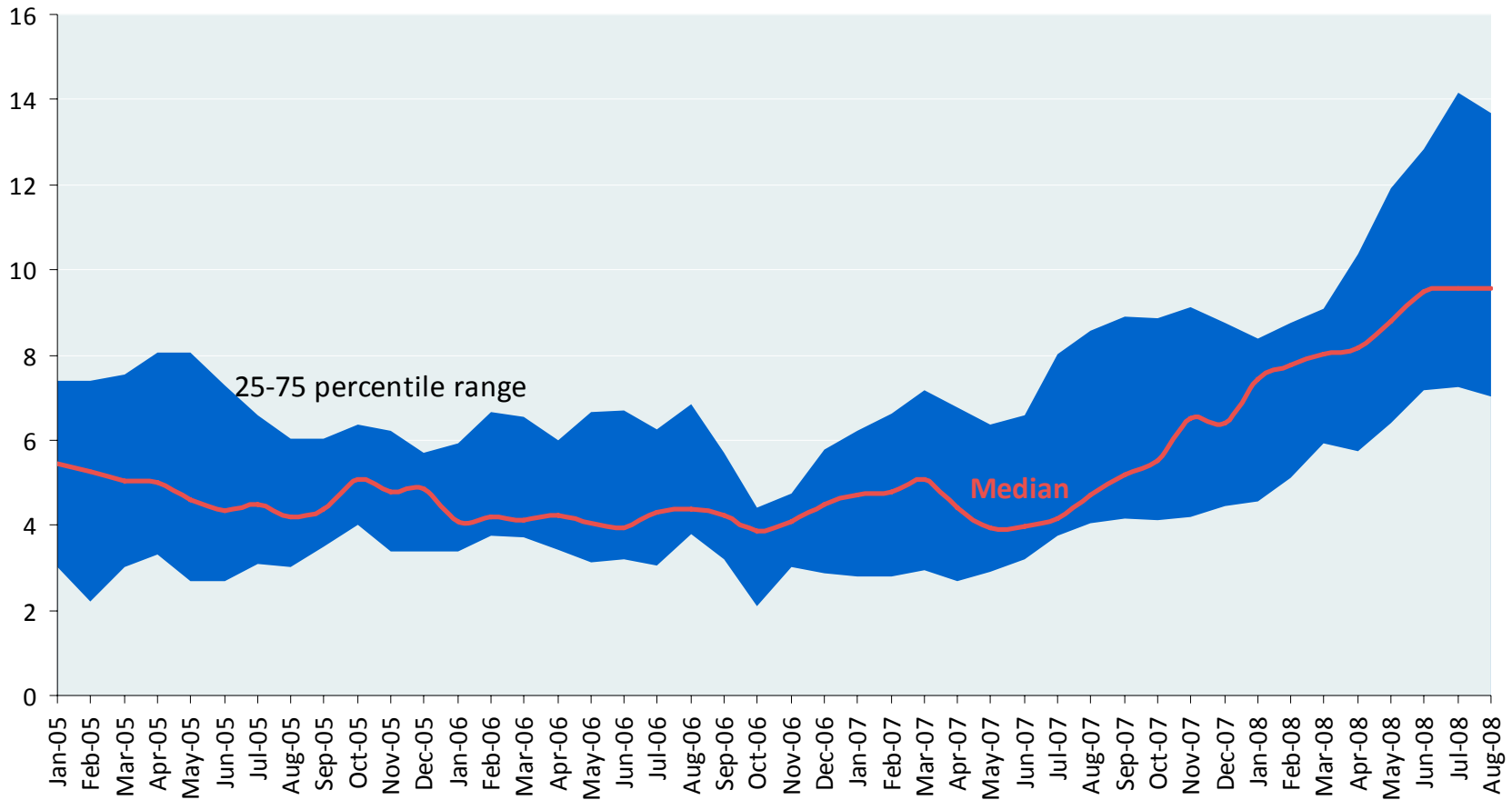
But terms of trade effects seem to be turning the corner, reversing winning and losing sides...

**Terms of Trade**  
2002.Q1=100



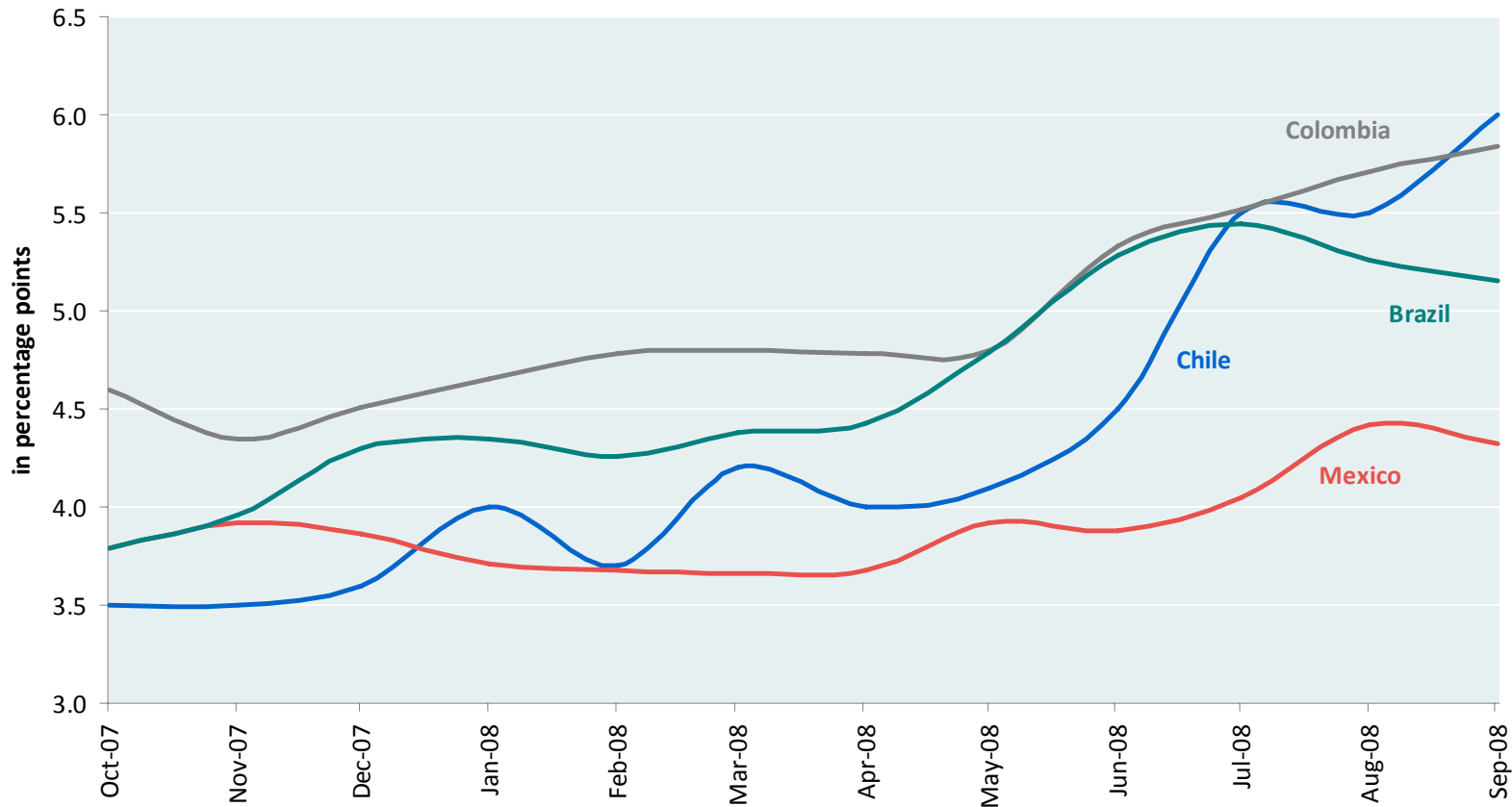
Reflecting the previous sharp rise in food & fuel prices, inflation rose in the region but not evenly across countries

**Consumer Price Inflation in LAC**  
*annual variations, in %*



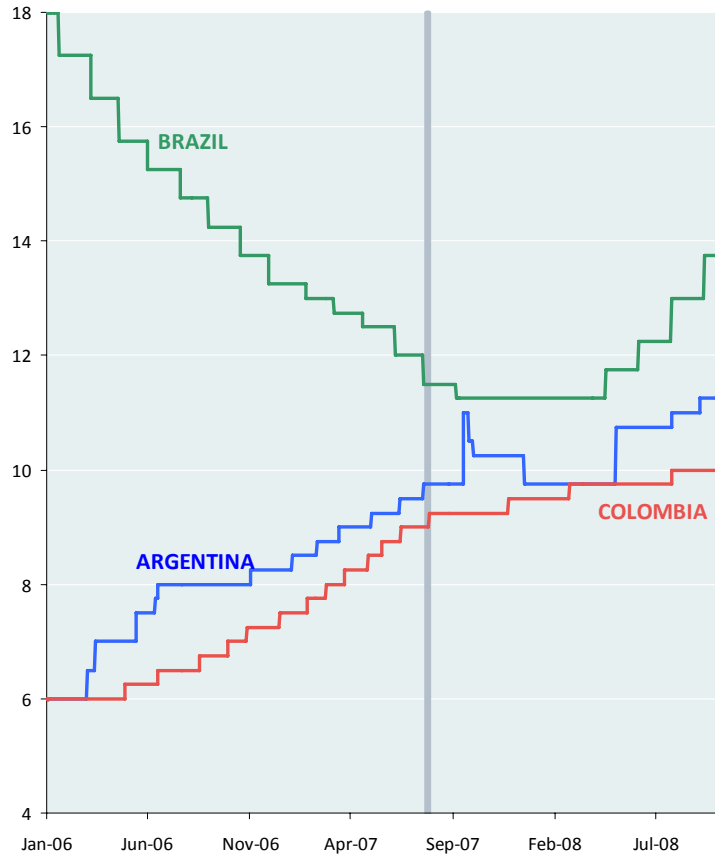
# The good news is that inflation expectations have begun to yield in several countries...

**Expected Inflation**  
*for the next 12 months*

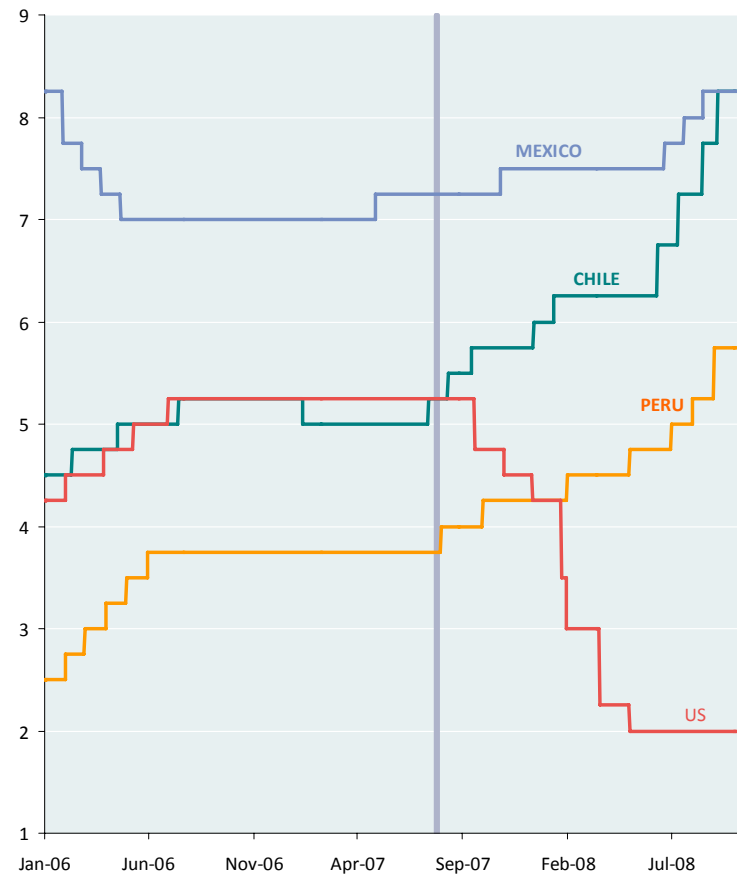


... not least because of tight monetary policy, but also due to weaker commodity prices and lower growth prospects

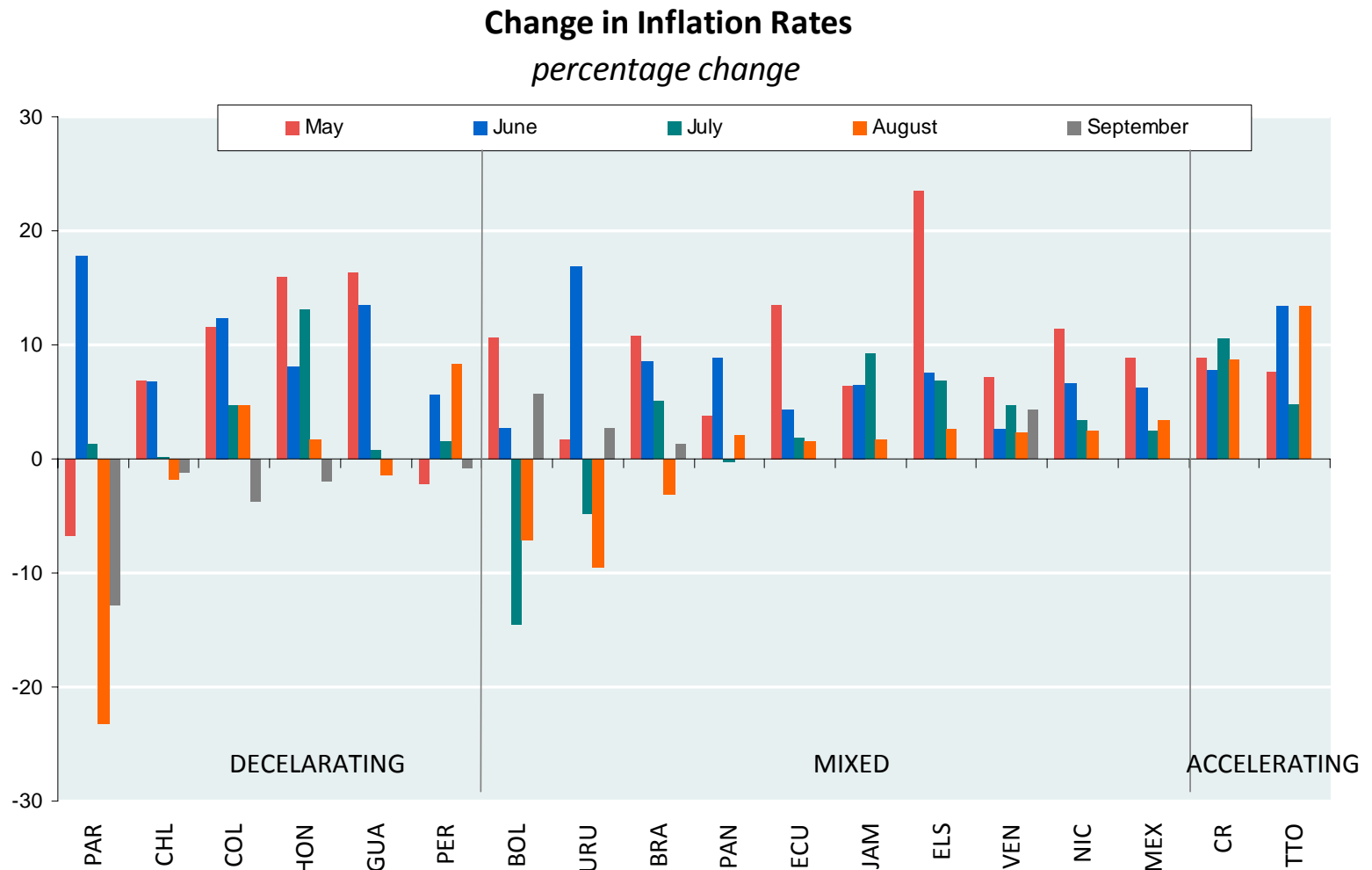
Monetary Policy Rates  
in %



Monetary Policy Rates  
in %



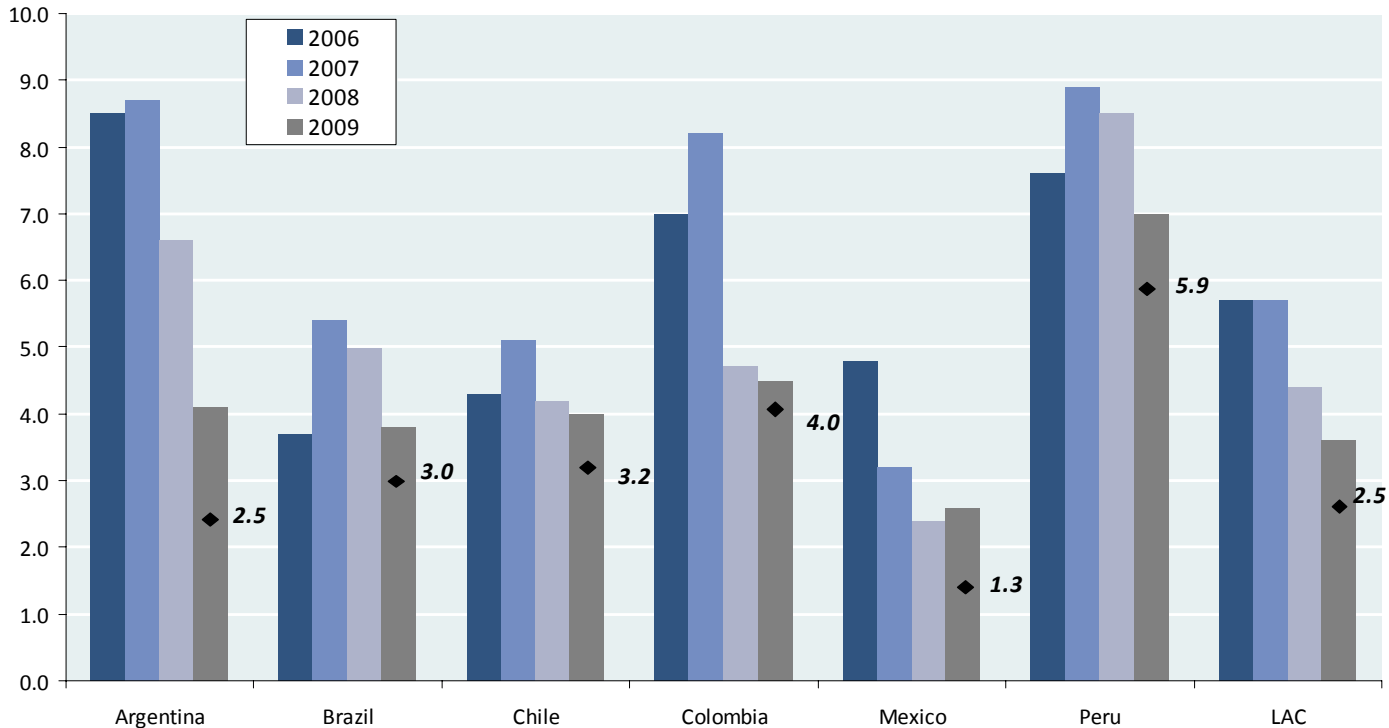
# However, the taming of inflation is proceeding unevenly across Latin countries



# *External demand effects*

# Latin countries can hardly break free from the cyclical deceleration in global growth

Recent Growth and Forecast for 2008 and 2009  
annual GDP real growth rate, in %

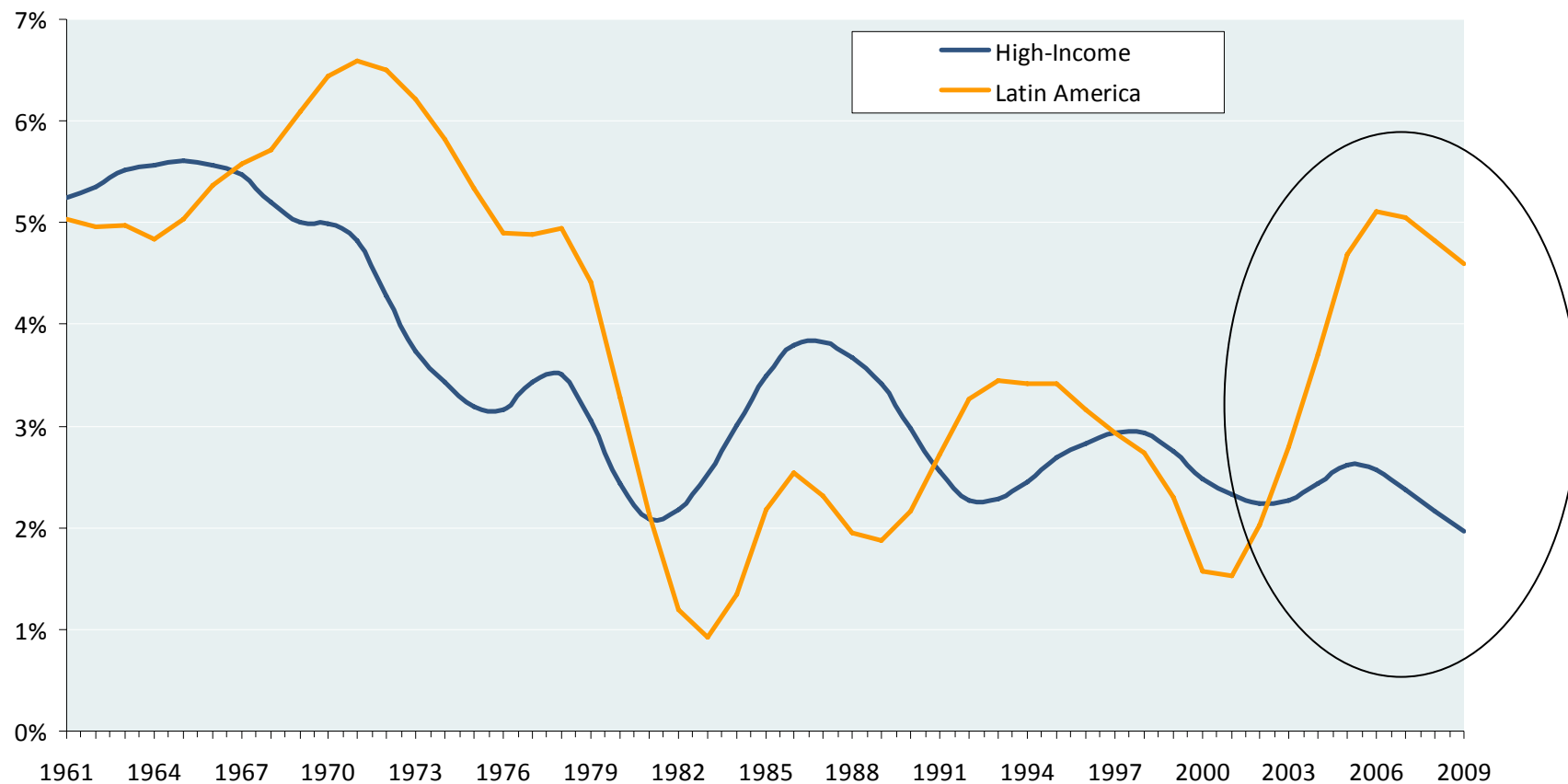


*The global slowdown, higher costs of finance, weaker commodity prices, and the lagged effect of monetary tightening – all point to a sharper deceleration*

# Fortunately, Latin America as a whole is decelerating from a relatively high trend growth...

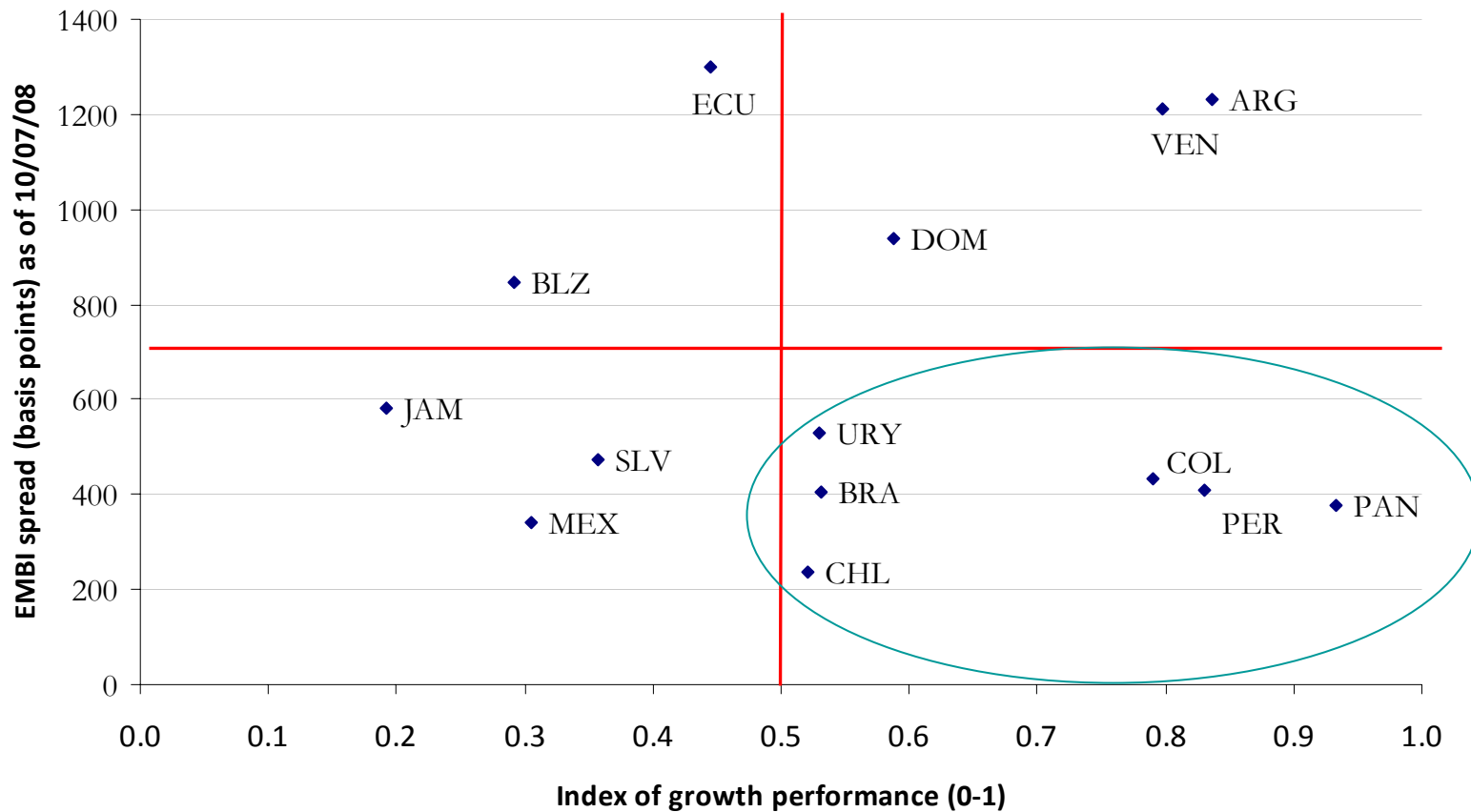
## Cyclical-adjusted Growth in Latin America and High-Income Countries

*Trend growth computed using the band-pass filter*



*The trend growth of real GDP growth is computed using the band-pass filter (Baxter and King, 1999). LCRCE staff calculations. Source: WDI – World Bank; National Authorities.*

# ...yet growth *vulnerability* varies considerably across Latin countries



# LAC perspective and policy challenges

# LAC: a better-built boat facing a nastier storm

- Overall, LAC is less vulnerable to macro-financial shocks than before and this is due to fundamental improvements...
- ... but vulnerability to shocks varies considerably across countries in the region
- LAC enters the cyclical downturn from a higher trend growth...
- ... but growth vulnerability is heterogeneous across countries
- The fall in commodity prices hurts LAC, a net commodity exporter...
- ... but it is a relief for the small Central American and Caribbean countries which are nonetheless hurt by lower remittances

# Key policy challenges for the short-run

- *Monetary policy*: whether and when to ease
  - Will depend on having truly tamed the inflation threat and on the degree of financial stress
- *Fiscal policy*: weathering the revenue contraction
  - Will depend on availability of self-insurance buffers, degree of expenditure rigidity, and room to borrow prudently
- *Financial policy*: learning from the U.S. financial crisis
  - Will depend on institutional strength, leadership and coordinating capacity of relevant agencies

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Thank you

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