Shockwaves from the North: Latin America and the External Deterioration

Annual Meetings of the IMF and World Bank
Washington, DC
October 11, 2008

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

Outline

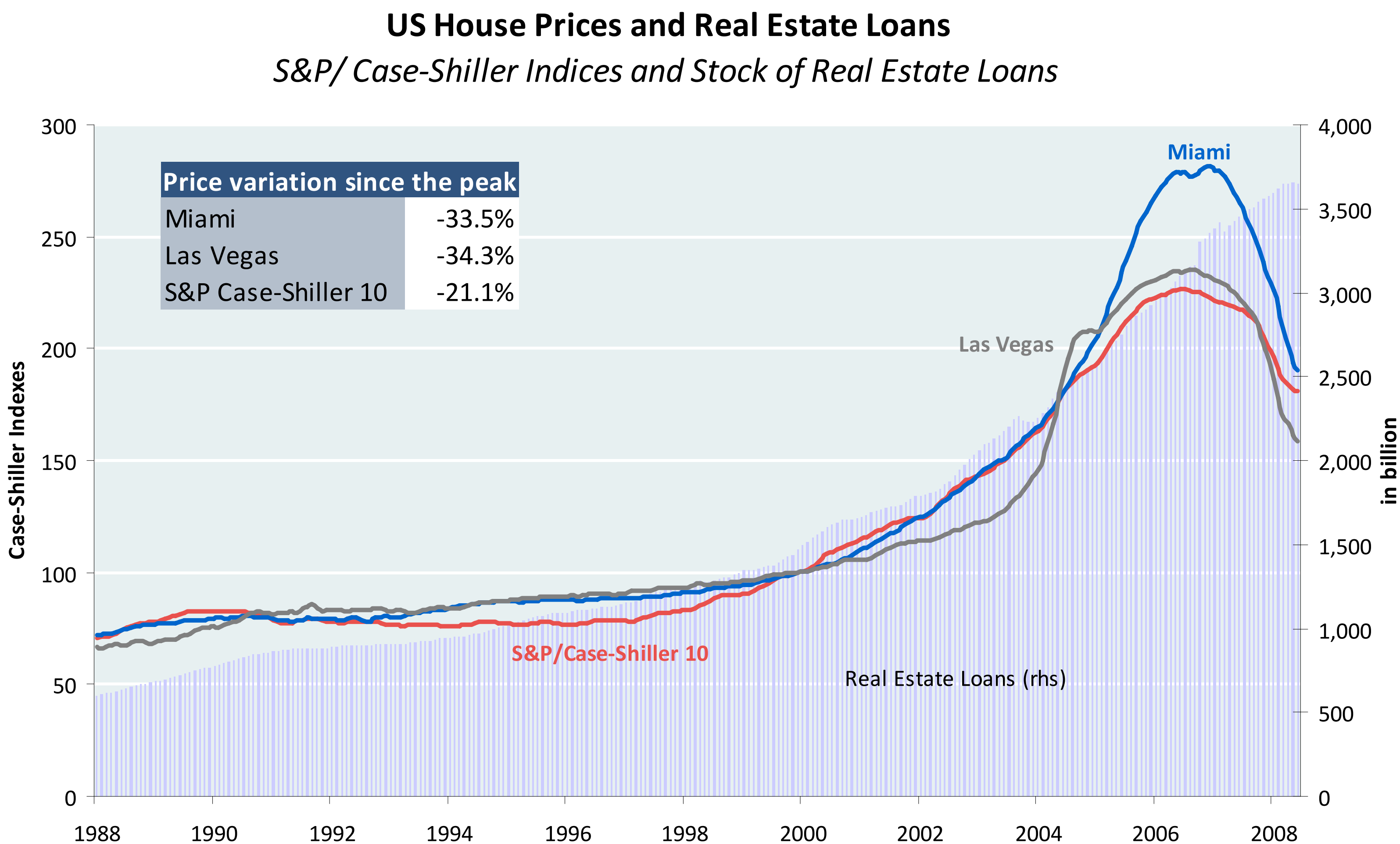
- Global shocks – a perfect storm
  - Worsening and spreading of U.S. financial crisis, weakening commodity prices, sharper economic slowdown
    - Big uncertainty: transmission around the world
- Transmission channels
  - Financial contagion
  - Remittances
  - Commodity prices
  - External demand

  Interrelated
- LAC perspective and policy challenges

The deteriorating external environment

The trigger of the U.S. financial crisis

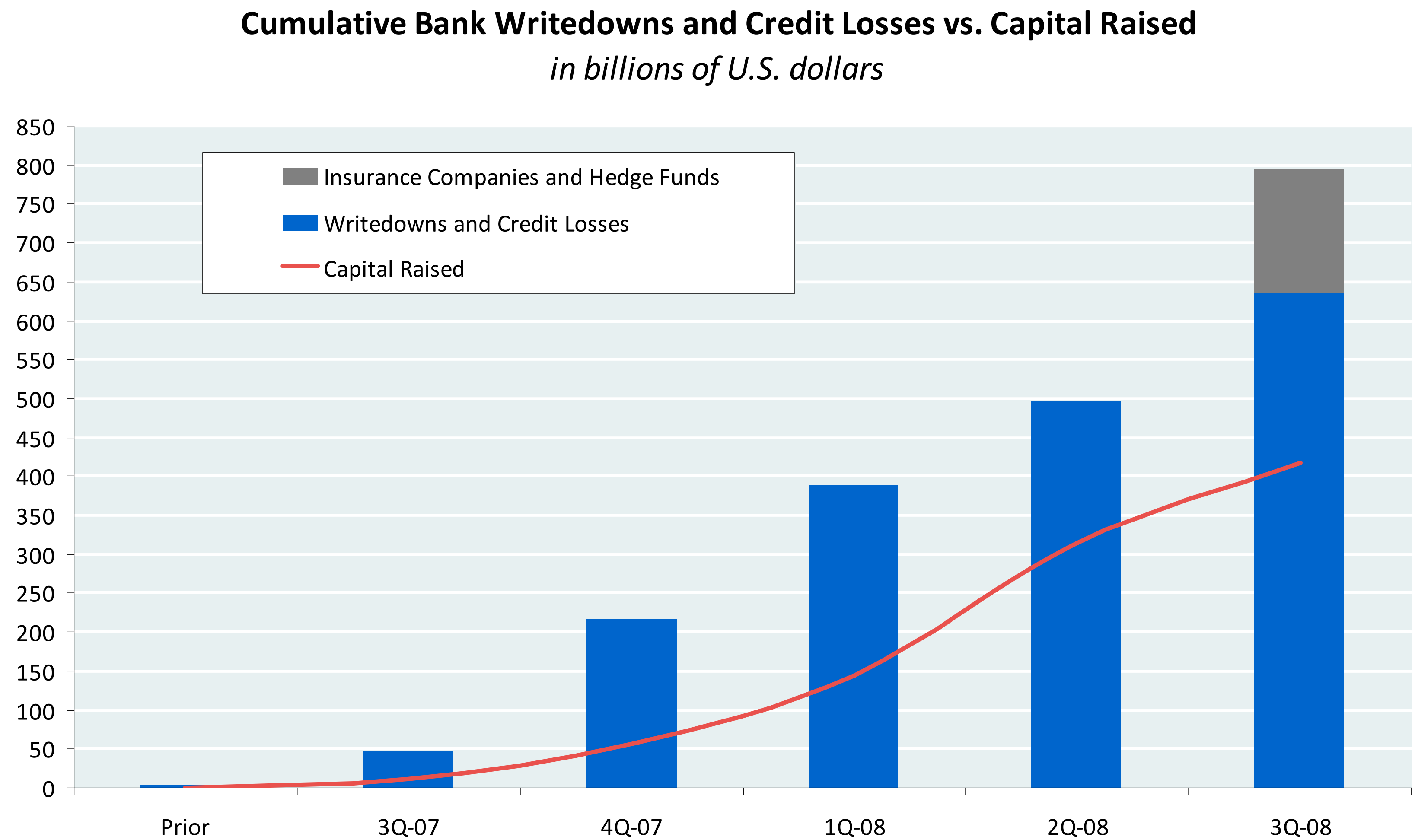
Toxic subprime loans, imploding housing markets



The S&P/Case-Shiller 10 index is a composite index of housing prices in 10 U.S. metropolitan areas. Source: Bloomberg.

The severity of the U.S. financial crisis

Colossal accumulation of credit losses, and counting…



Note: The figures reported above do not include Freddie Mac an 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
Total	**1,040.1**

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
Total	**4,538.0**

= 40% of US 2007 GDP

The intractability of the U.S. financial crisis

Confidence erosion despite massive government support

Liquidity and Solvency Interventions

LoLR

Massive Liquidity Injections

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 + USD 37.8 bn)

Guarantee on money market funds (USD 50 bn)

TARP (USD 700 bn)

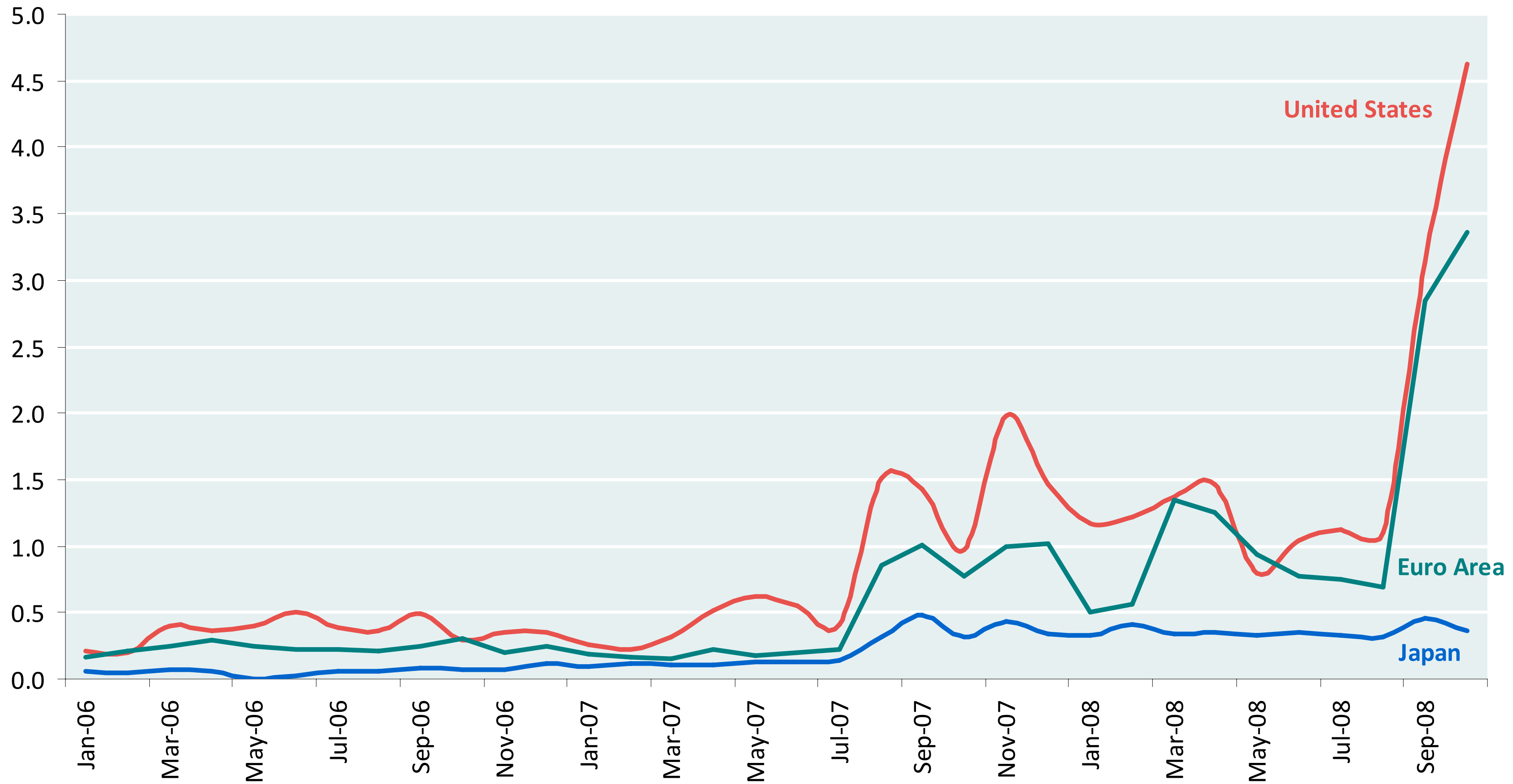
Fund to purchase commercial paper (?)

The intractability of a spreading credit crisis

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

Interbank Markets

TED spread, in percentage points



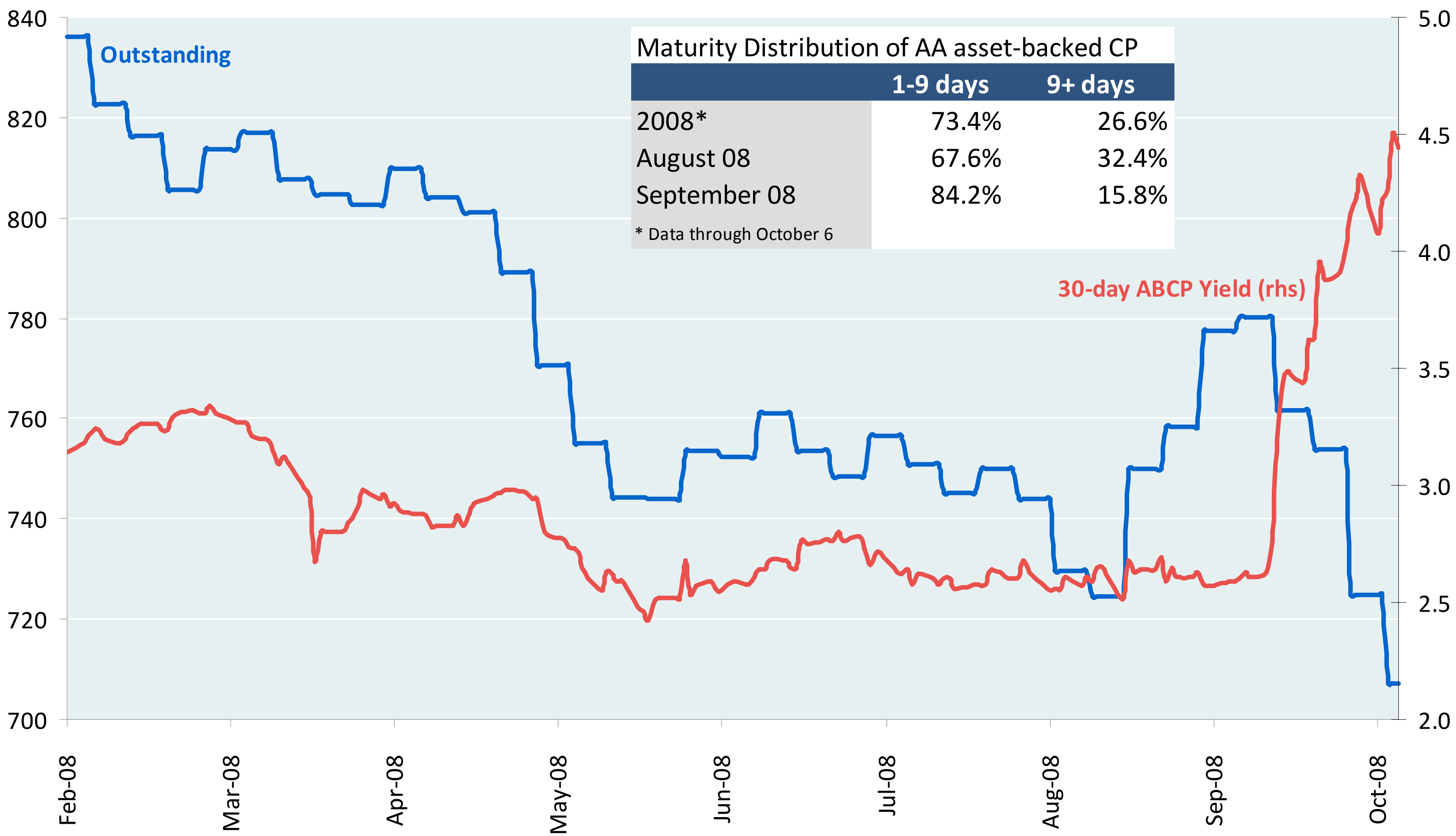
TED Spread: 3-Month LIBOR minus T-bill rate. Source: Bloomberg

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



Maturity Distribution of AA asset-backed CP

	1-9 days	9+ days
2008*	73.4%	26.6%
August 08	67.6%	32.4%
September 08	84.2%	15.8%

* Data through October 6

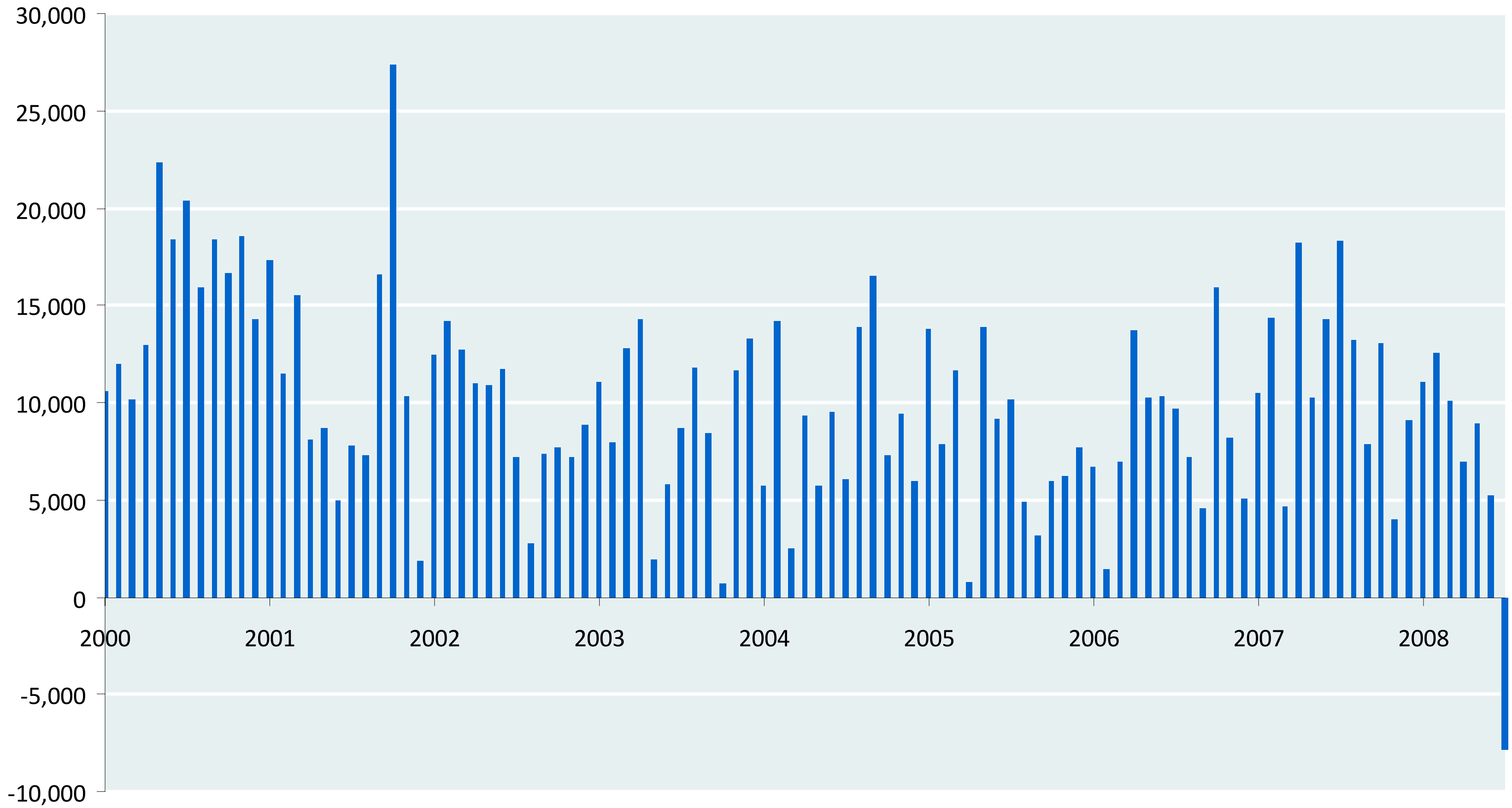
Source: Bloomberg and Federal Reserve

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



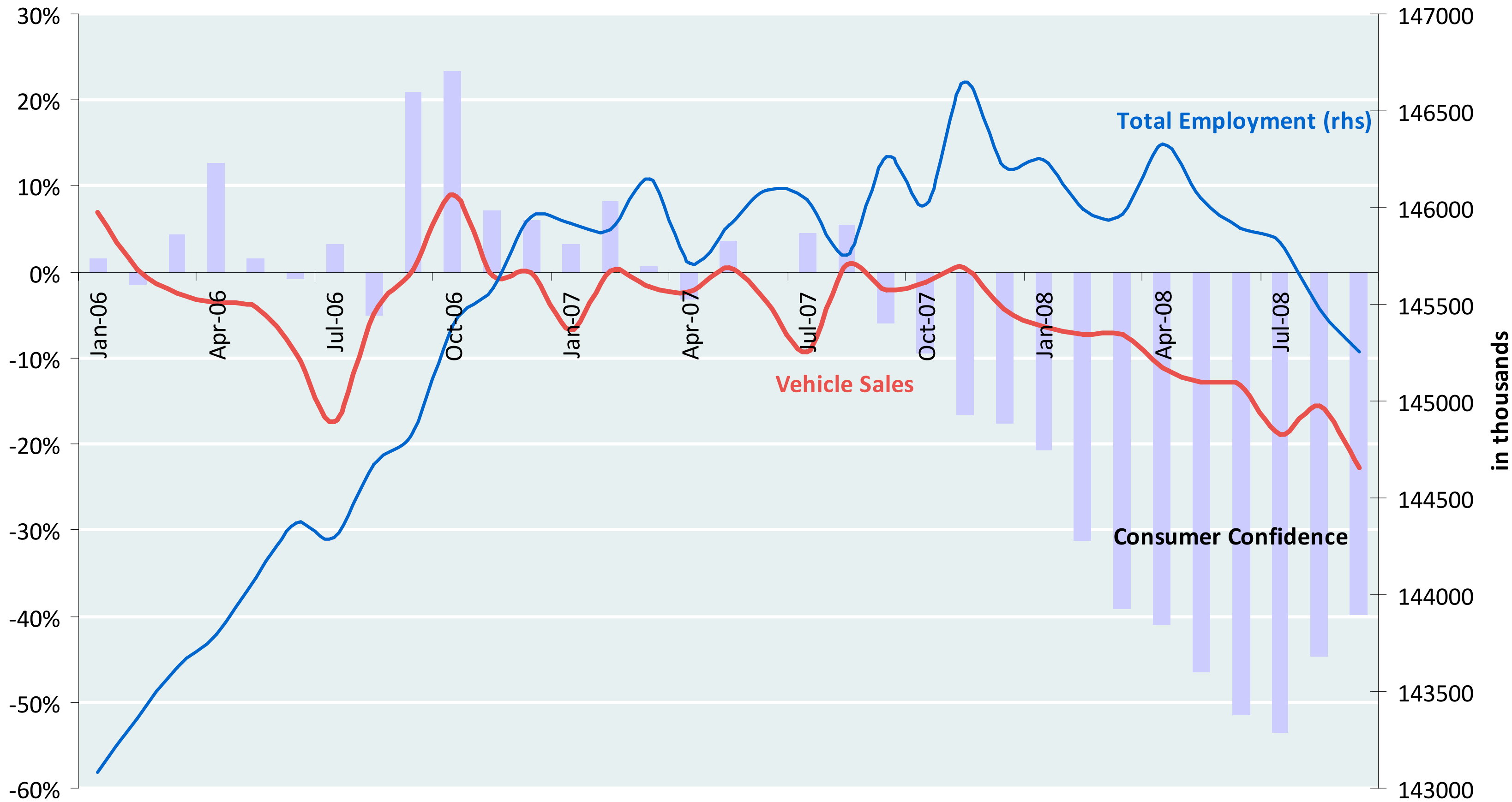
Source: Bloomberg and Federal Reserve

The perniciousness of the U.S. financial crisis

It is infecting the real economy in the USA…

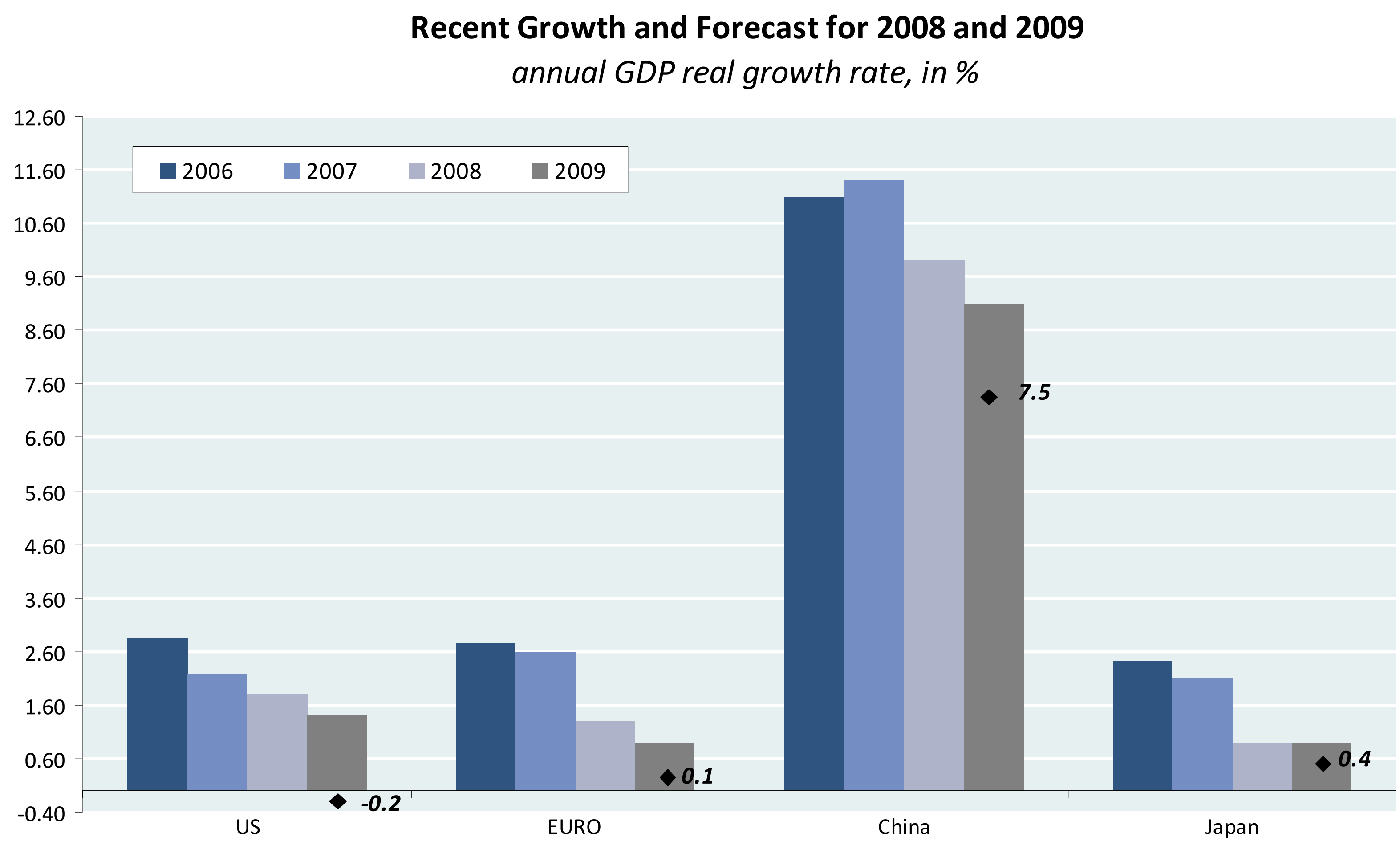
U.S. Economic Indicators

Total Employment and YoY variation of Consumer Confidence and Vehicle Sales



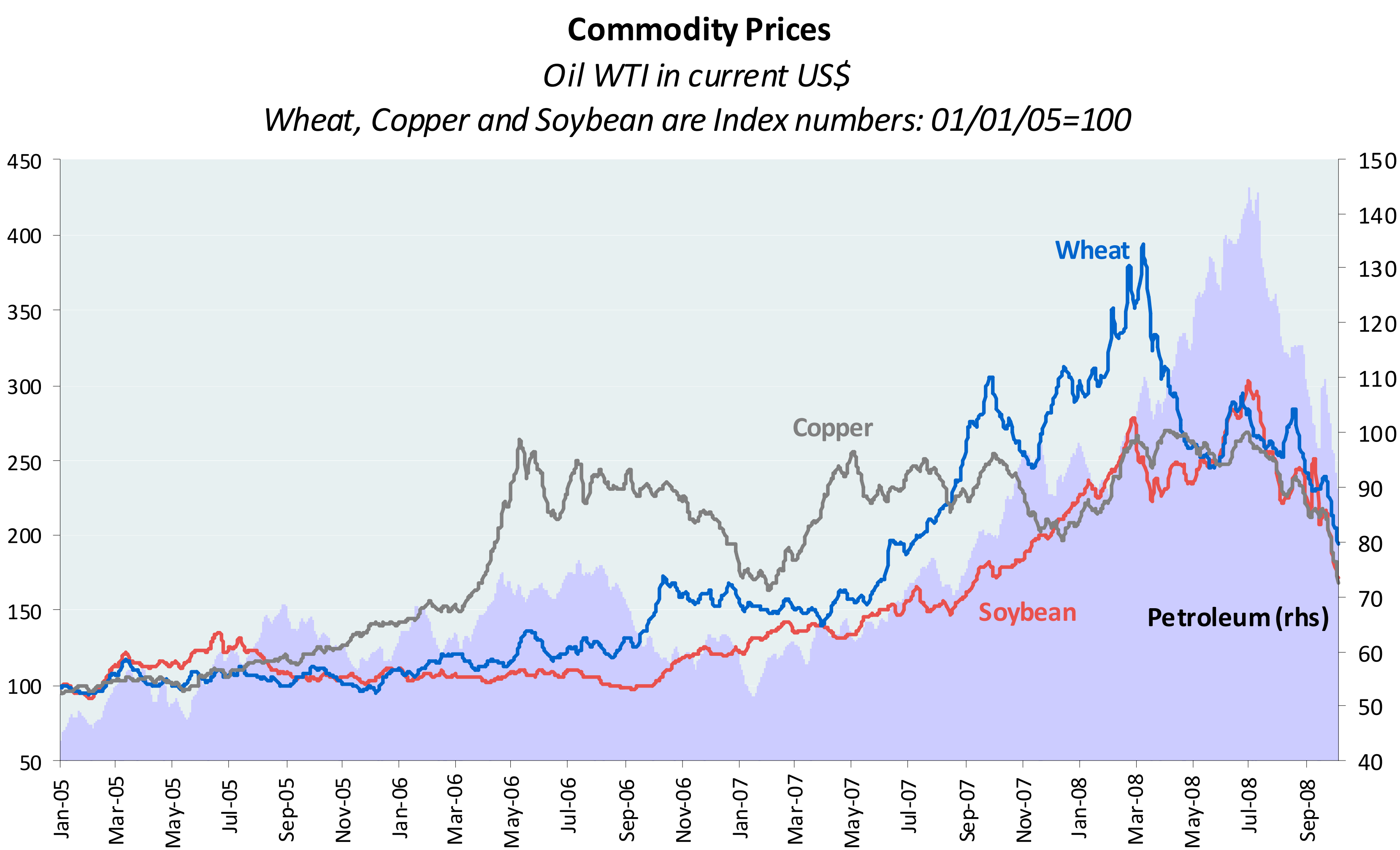
Source: Bloomberg

Amidst rising uncertainty, a sharper global slowdown is now envisaged



Lowest forecasts for 2009 (in black dots) are taken from Consensus Forecasts. Source: Consensus Forecasts

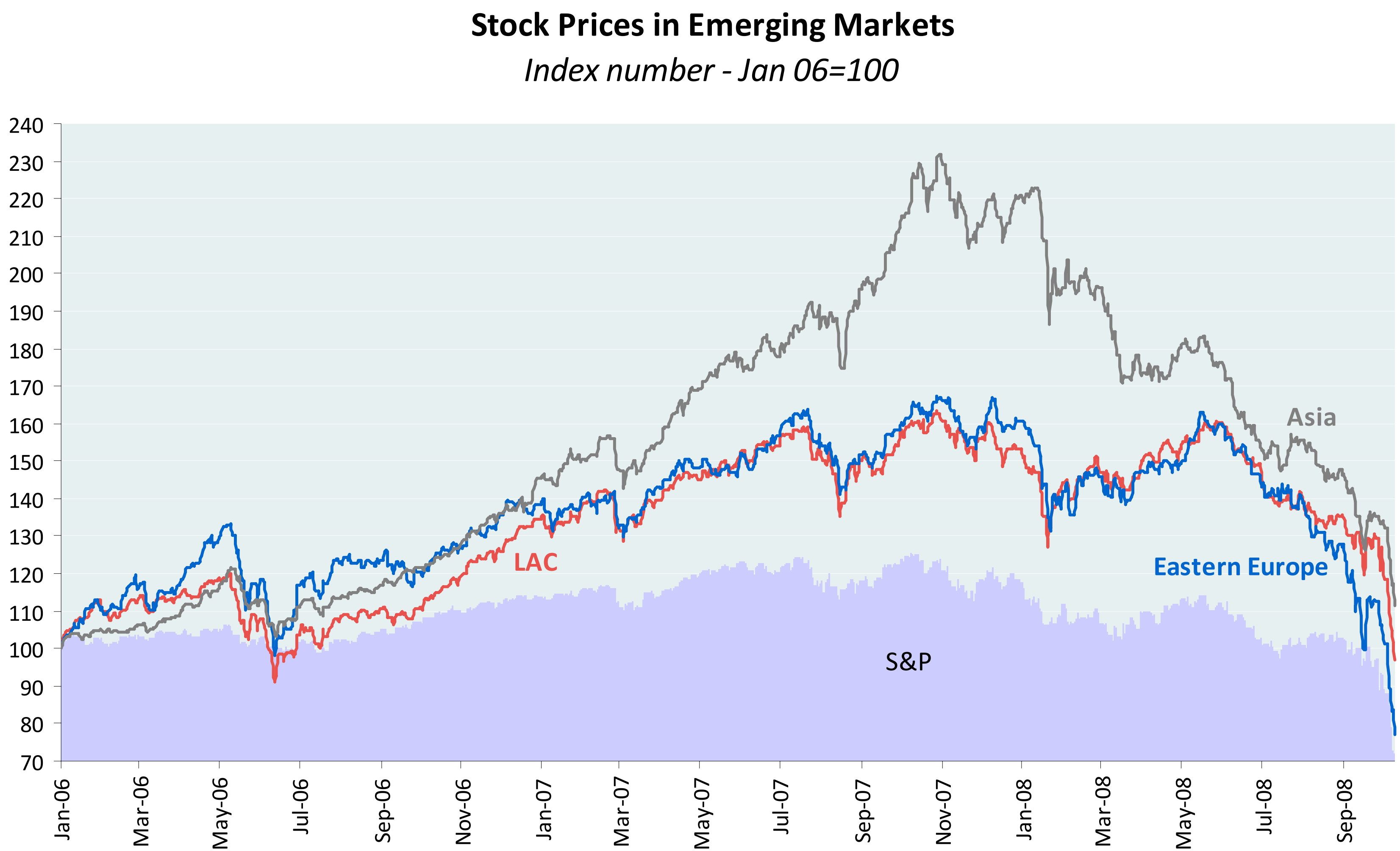
Commodity prices are moving now in the same direction as finance and growth, downward



Source: Bloomberg

Financial contagion effects

LAC has been caught in the global selloff of stocks

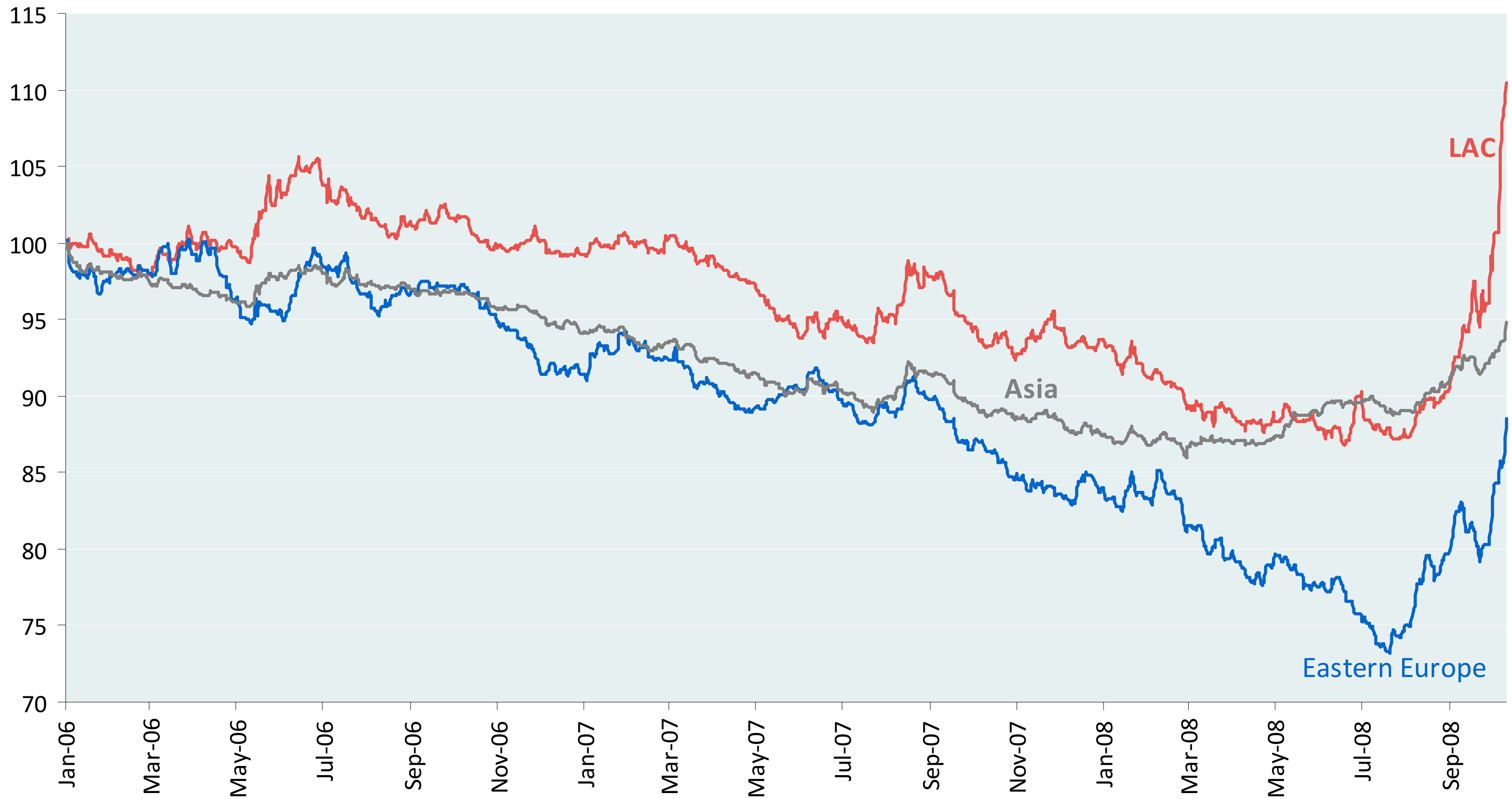


LAC: Argentina, Brazil, Colombia, Chile, Mexico. Eastern Europe: Czech Republic, Hungary, Poland and Russia. Asia: China, Hong Kong, India, Indonesia, Malaysia, Philippines and Thailand.
Source: Bloomberg

Latin currencies are adjusting sharply, more than in other regions, following a prolonged period of appreciation

Currencies in Emerging Markets

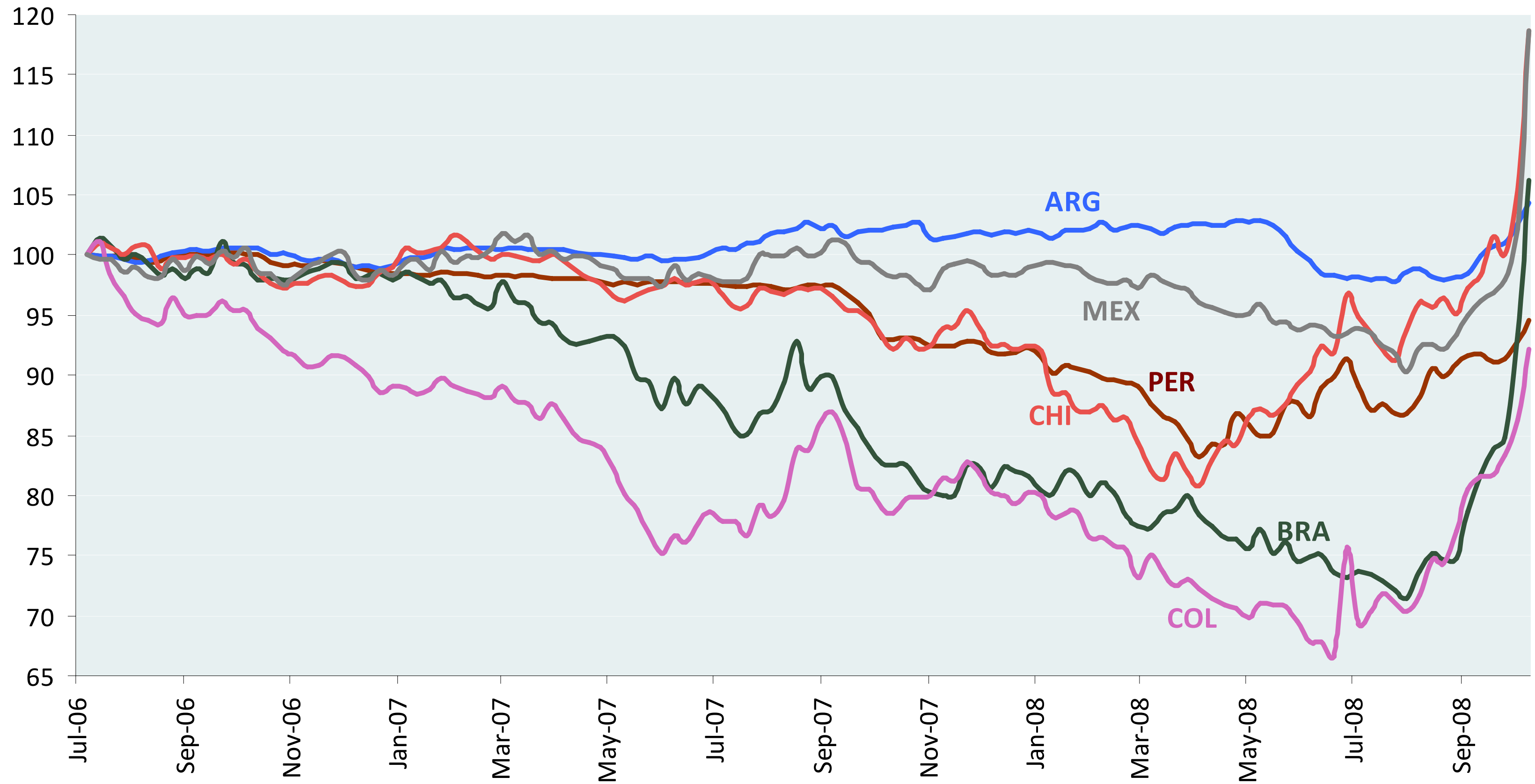
Index number - Jan 06=100



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

Depreciation has been fairly generalized across countries, but most recently Brazil and Mexico stand out

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

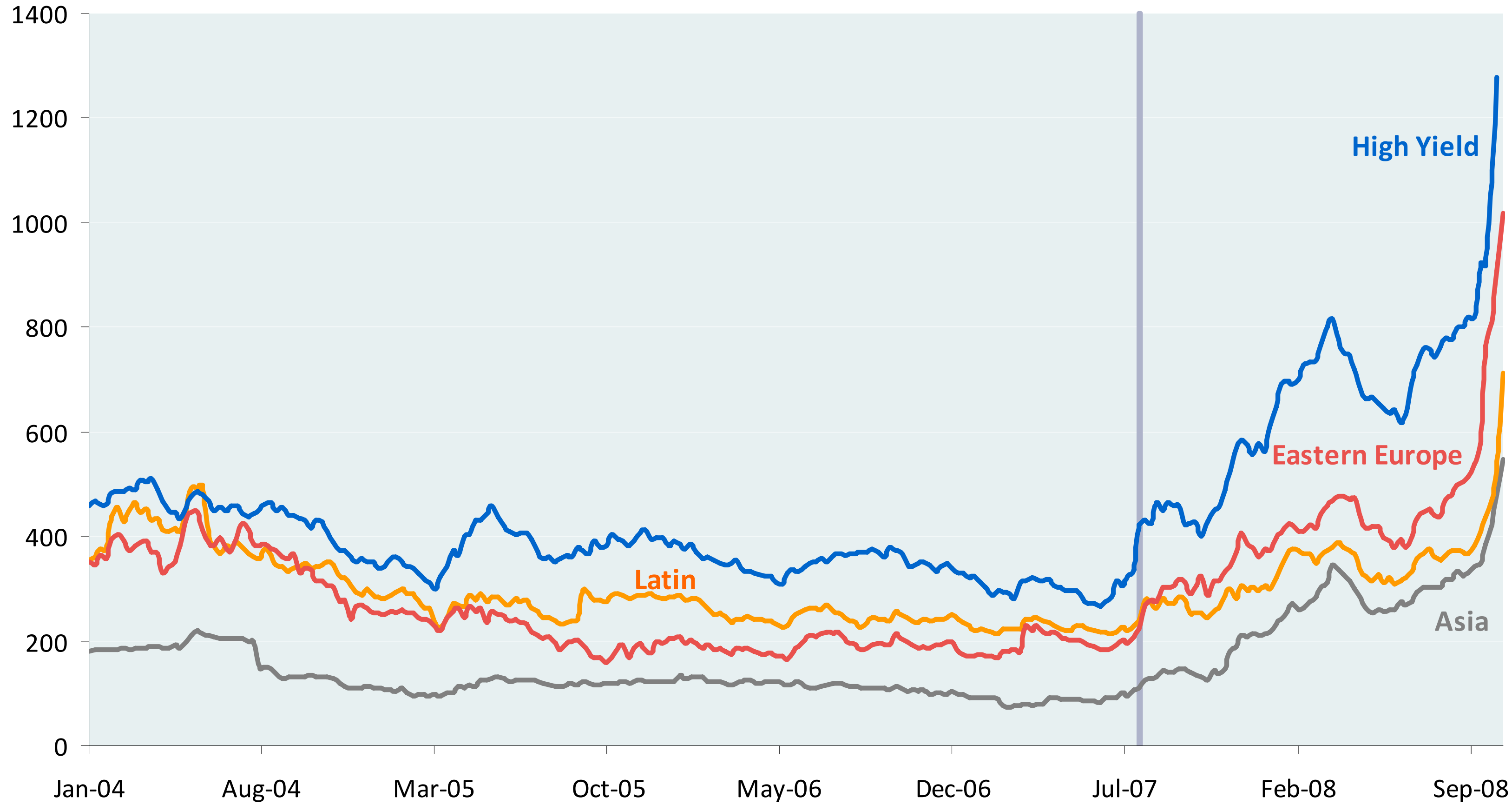


Source: Bloomberg

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

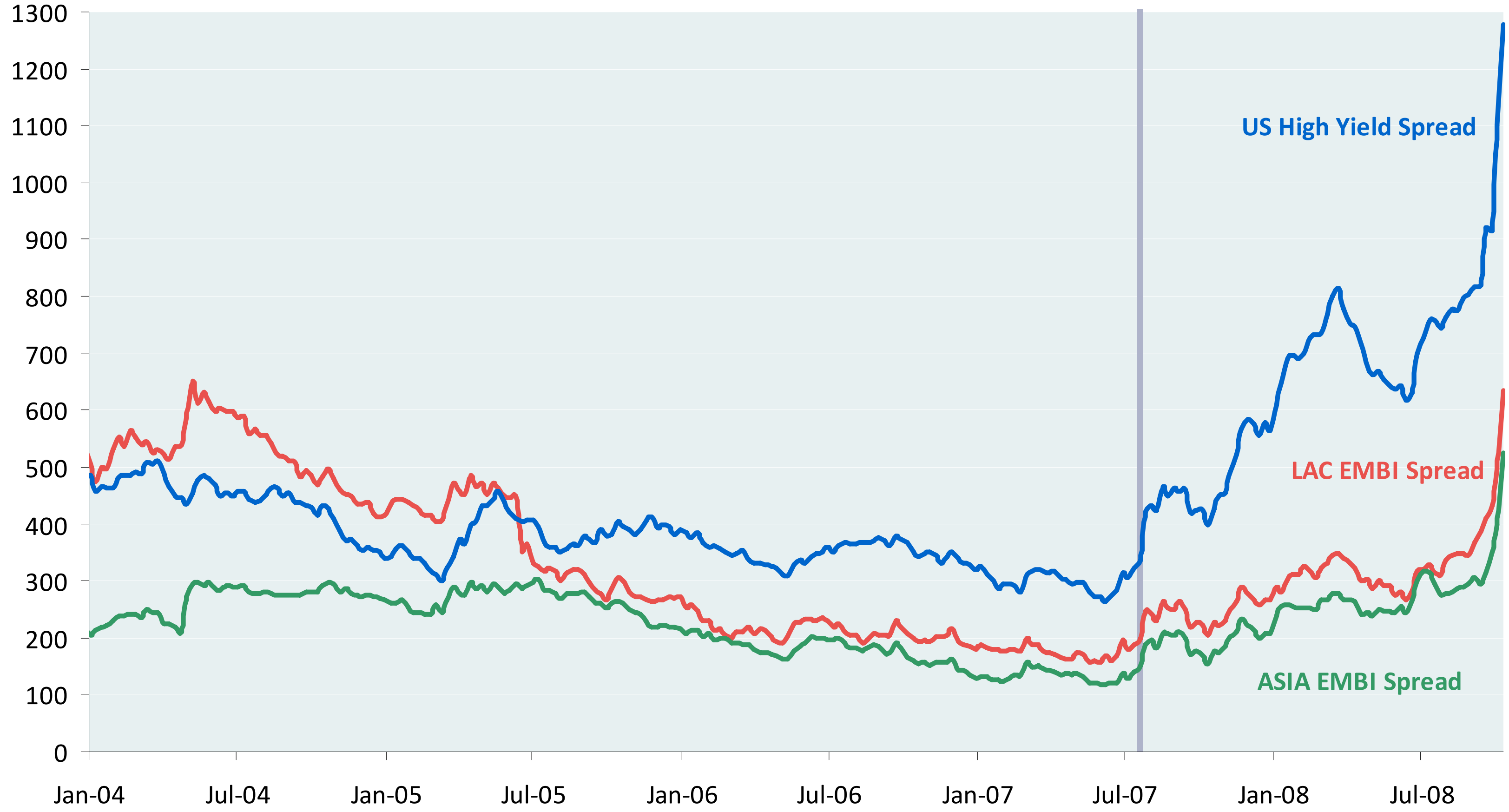


Source: Bloomberg – US Credit Suisse High Yield Spread, JP Morgan CEMBI Global: Corporate Emerging Markets Bond Index.

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

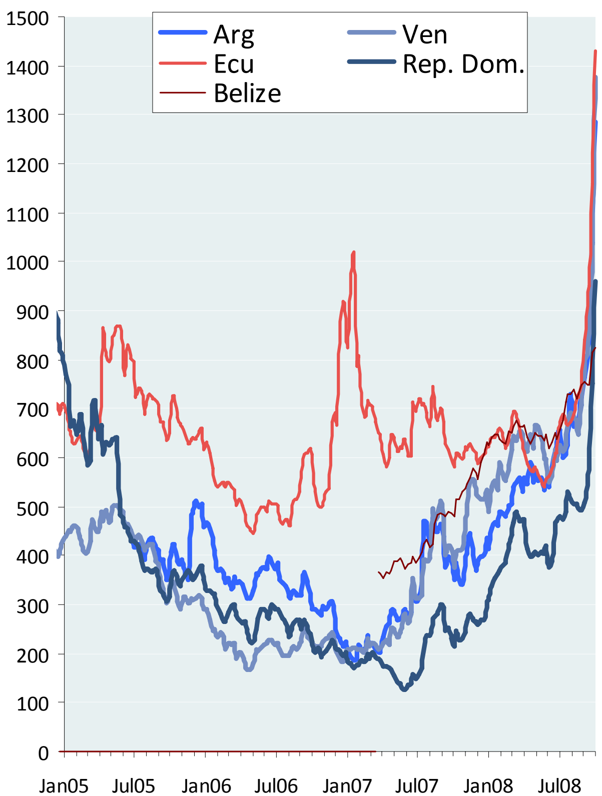
in basis points



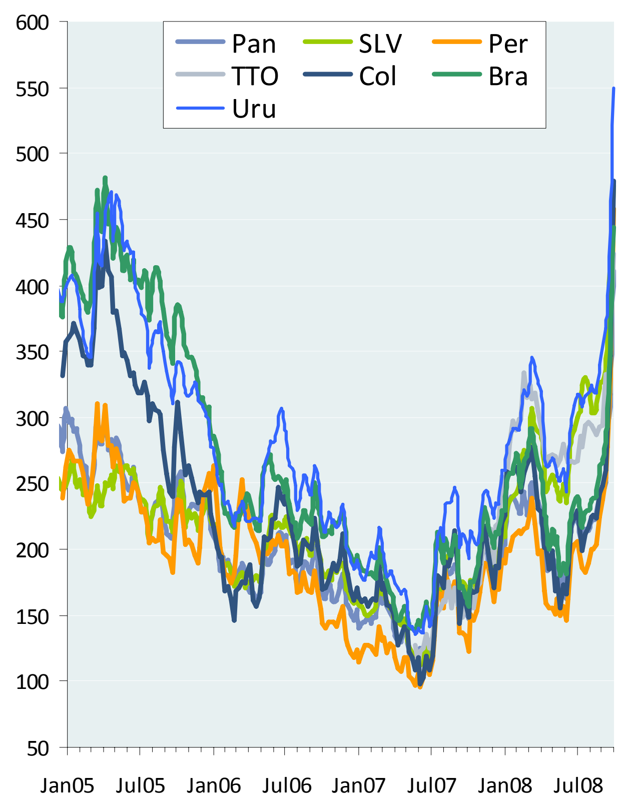
Source: Bloomberg – US Credit Suisse High Yield Spread, Latin America JP Morgan EMBI Global.

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

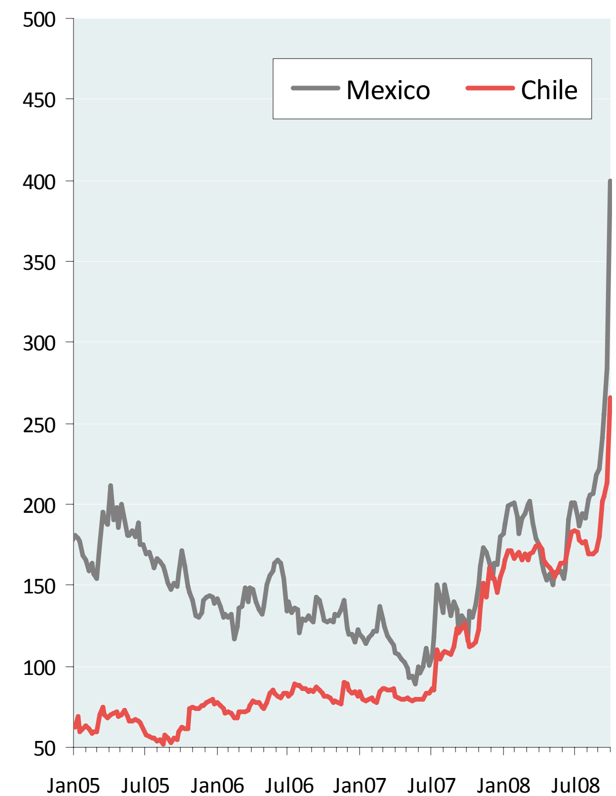
High EMBI Spread LAC countries
in basis points



Medium EMBI Spread LAC countries
in basis points



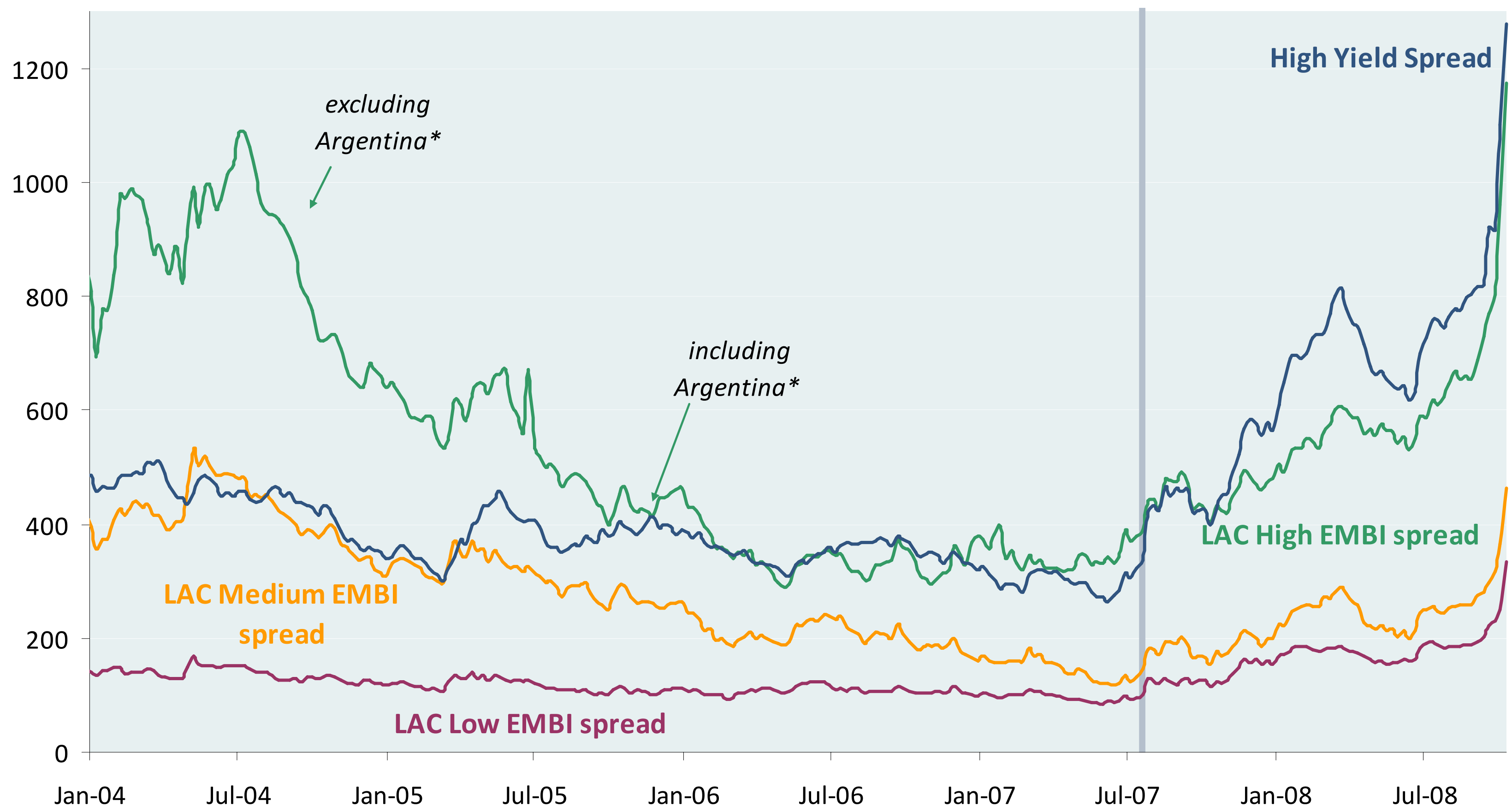
Low EMBI Spread LAC countries
in basis points



Source: Bloomberg – Latin America JP Morgan EMBI Global

… 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

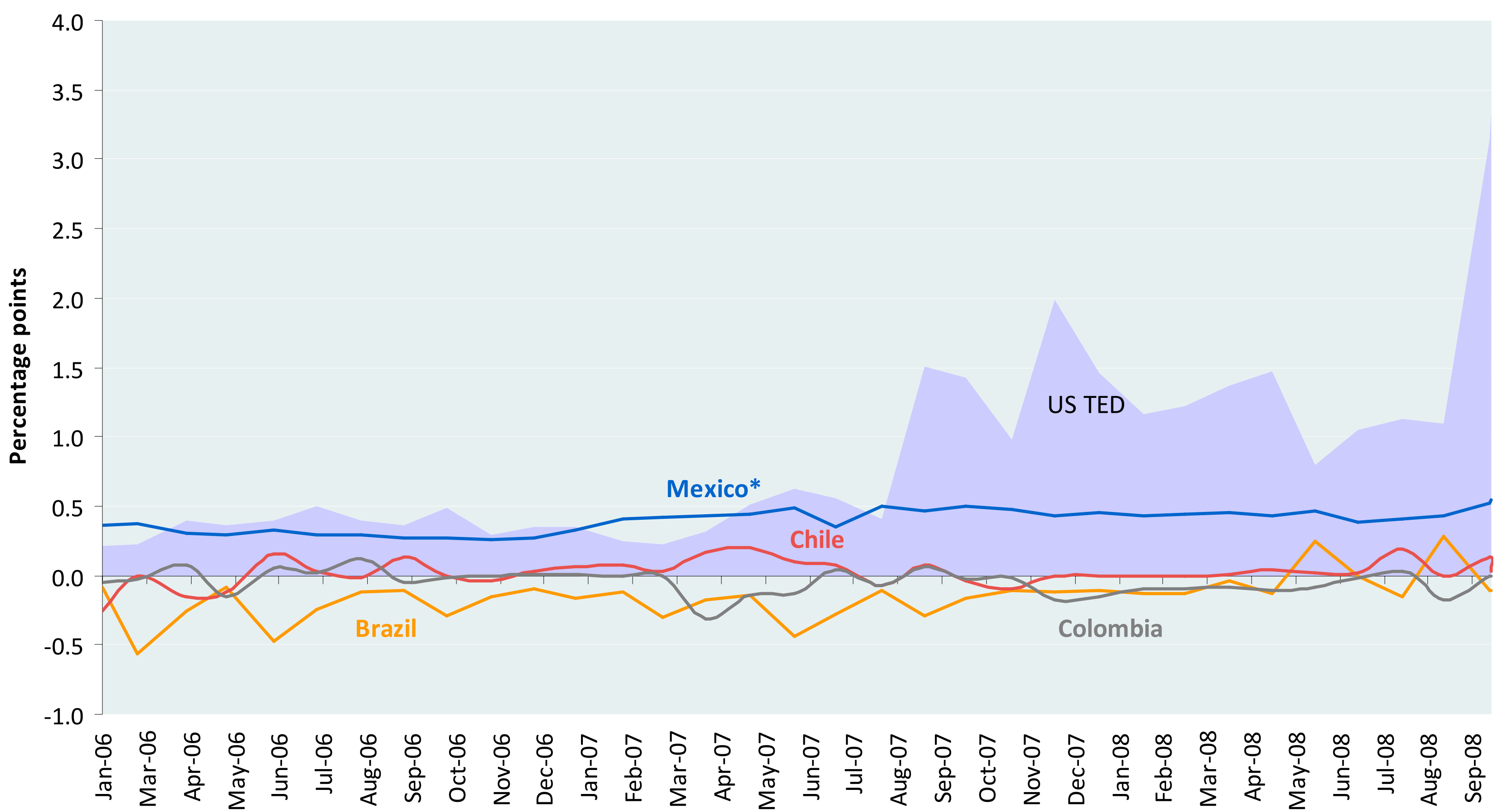


Source: Bloomberg – US Credit Suisse High Yield Spread, Latin America JP Morgan EMBI Global.

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



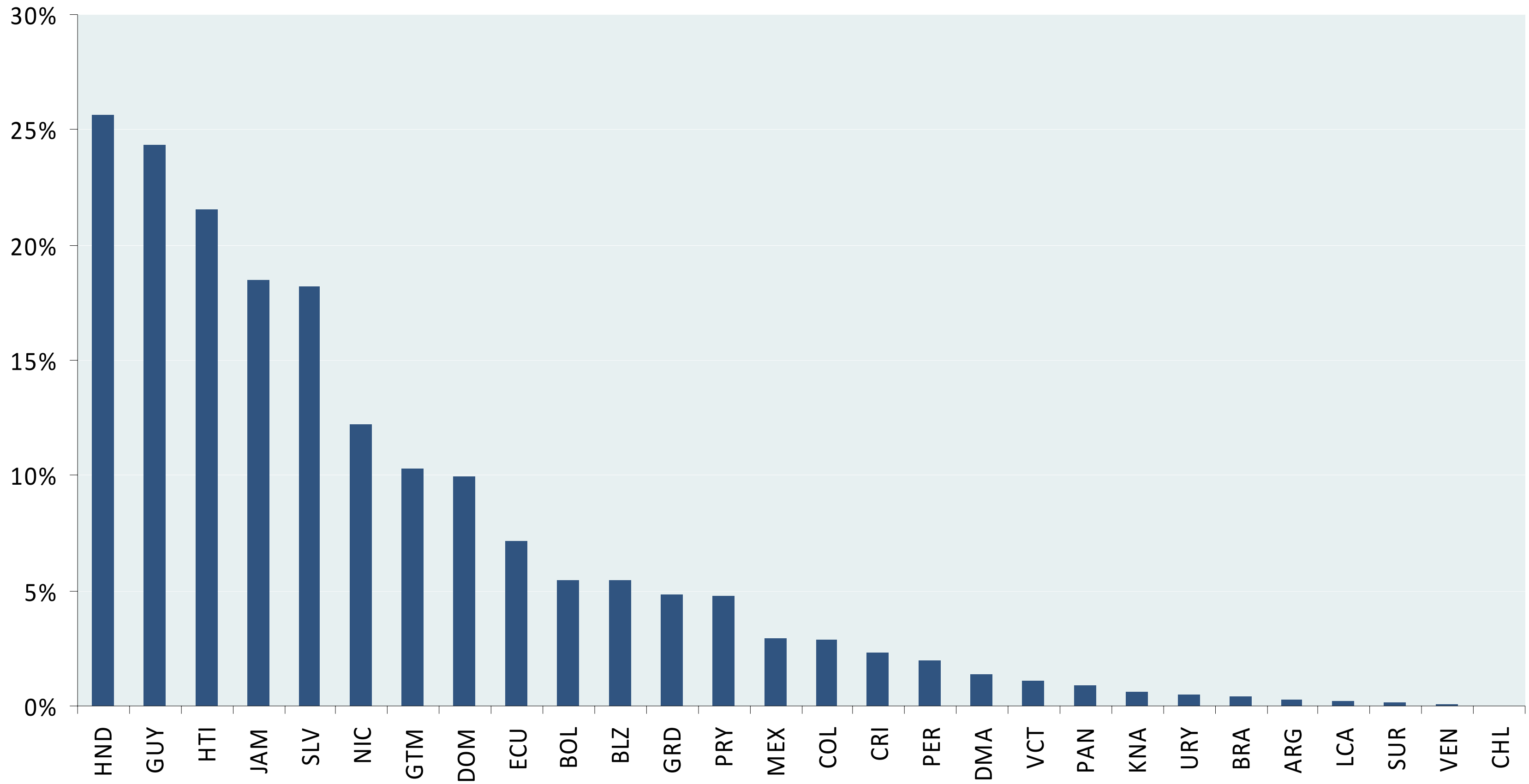
Source: Bloomberg

Remittances

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

Remittances to LAC in 2006

(Remittances inflows as % GDP)

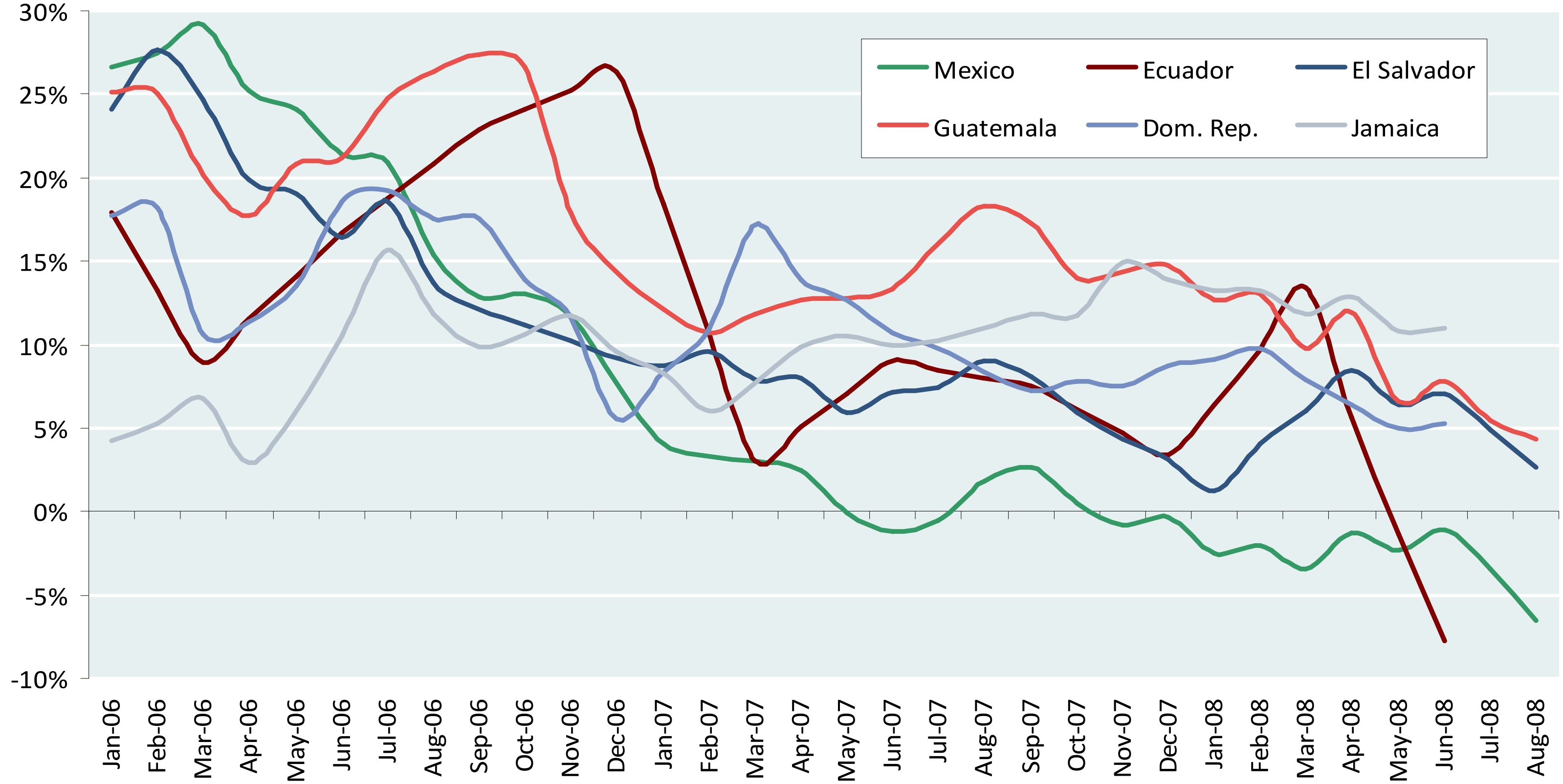


LCRCE calculations. Source: Migration and Remittances. Factbook 2008 – World Bank

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



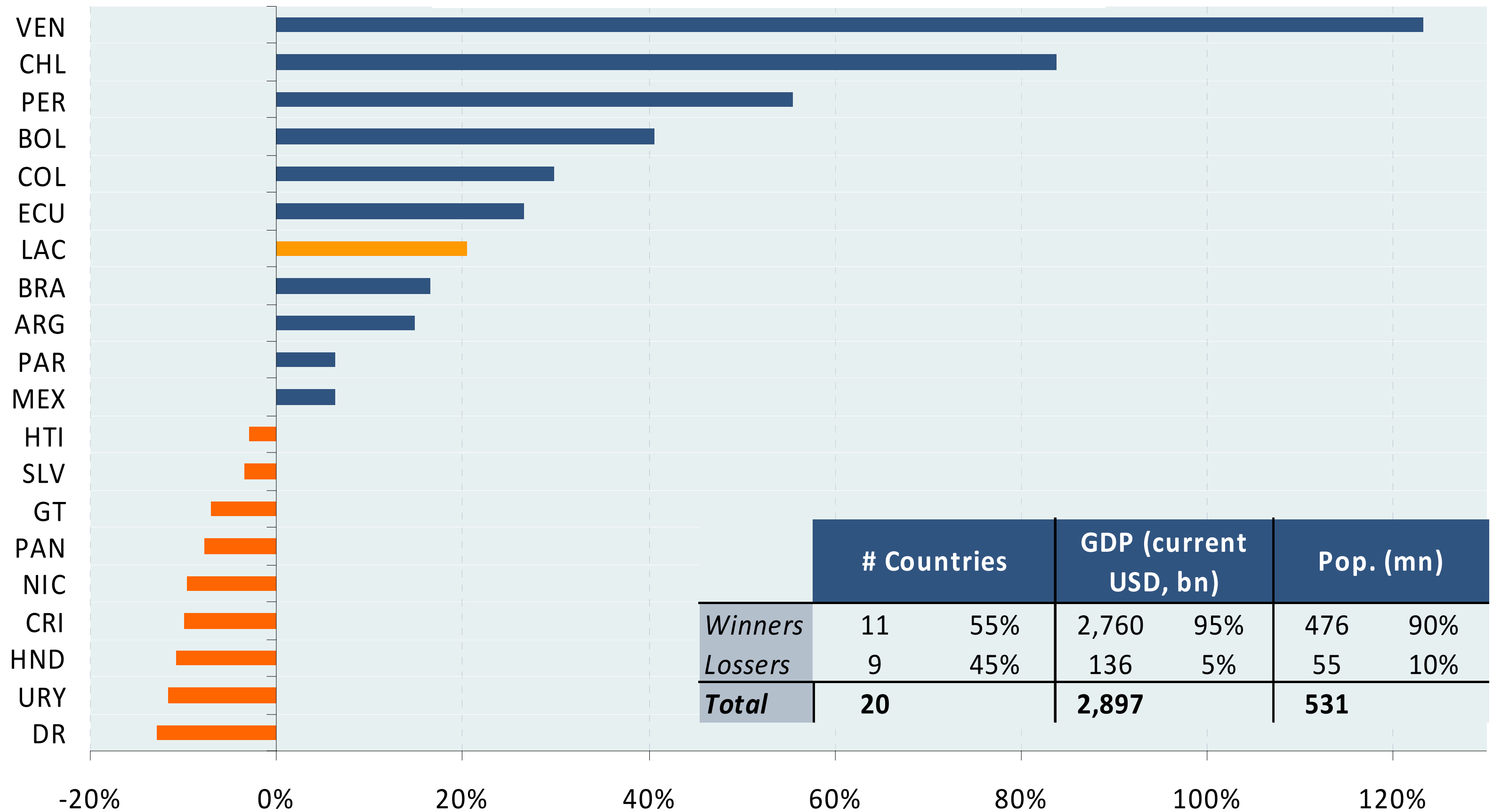
Source: Central Banks of corresponding countries

Commodity prices and inflation

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

Terms of Trade for Selected LAC countries

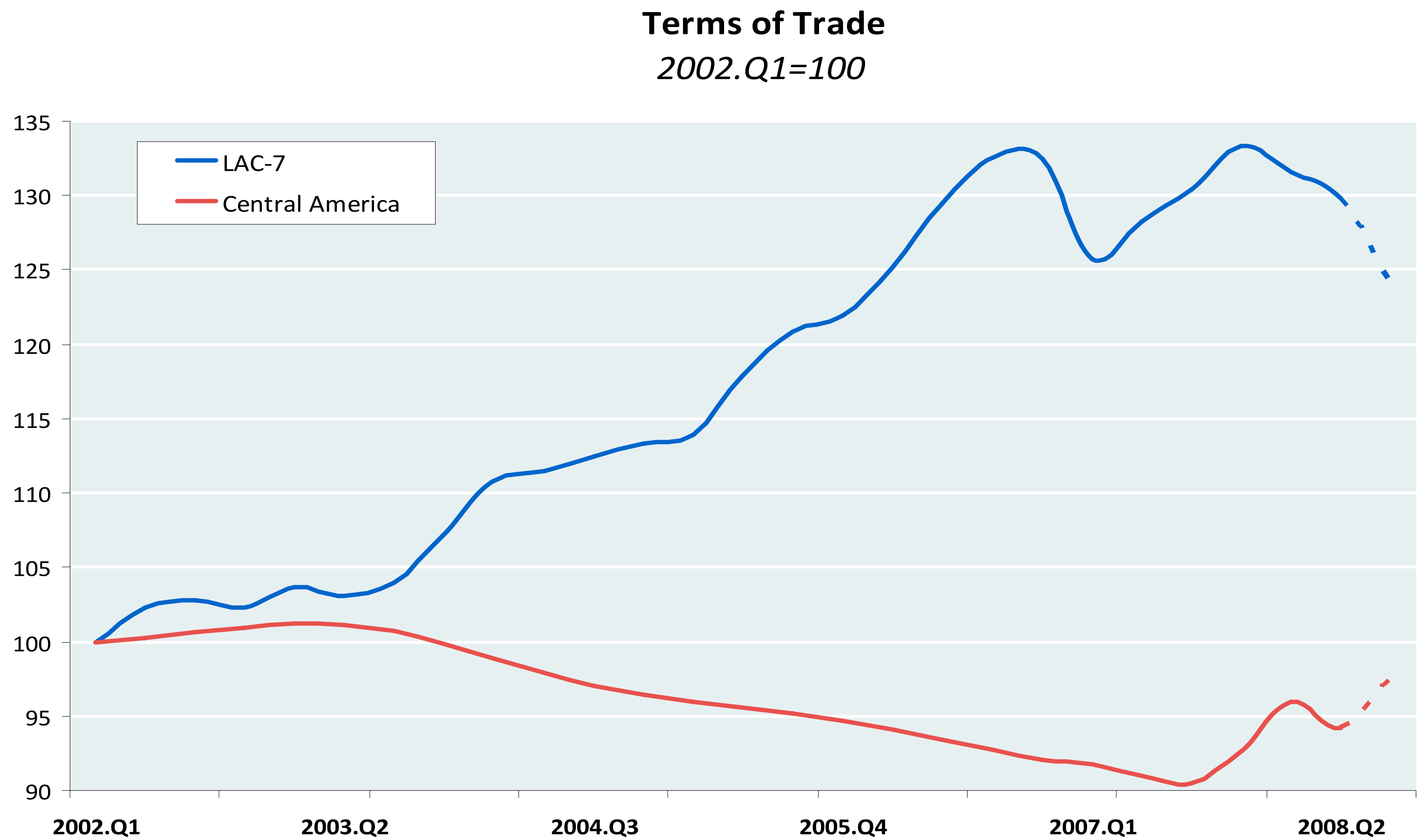
change between 2002-2007 - in %



	# 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.

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

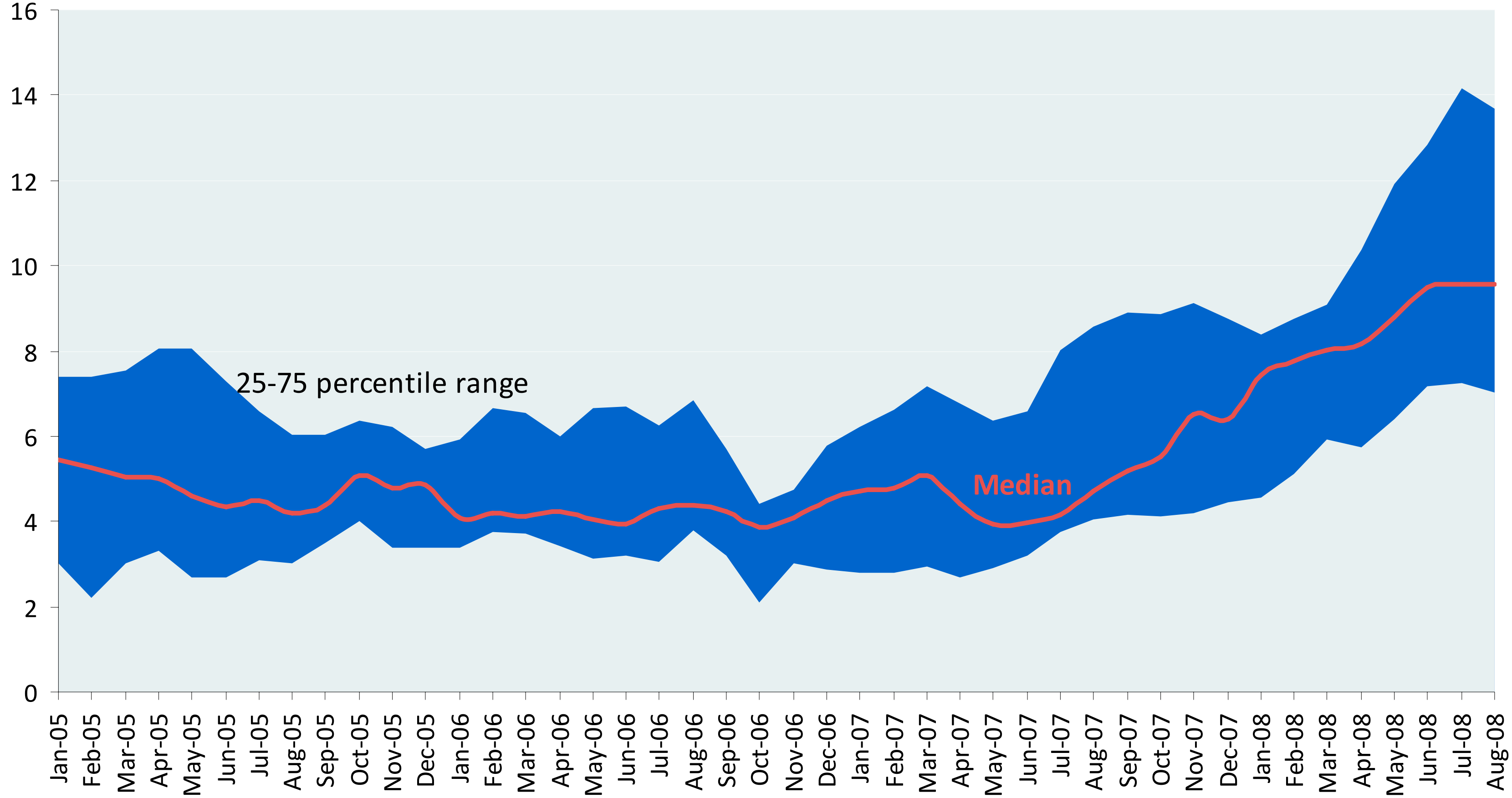


Source: WDI

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

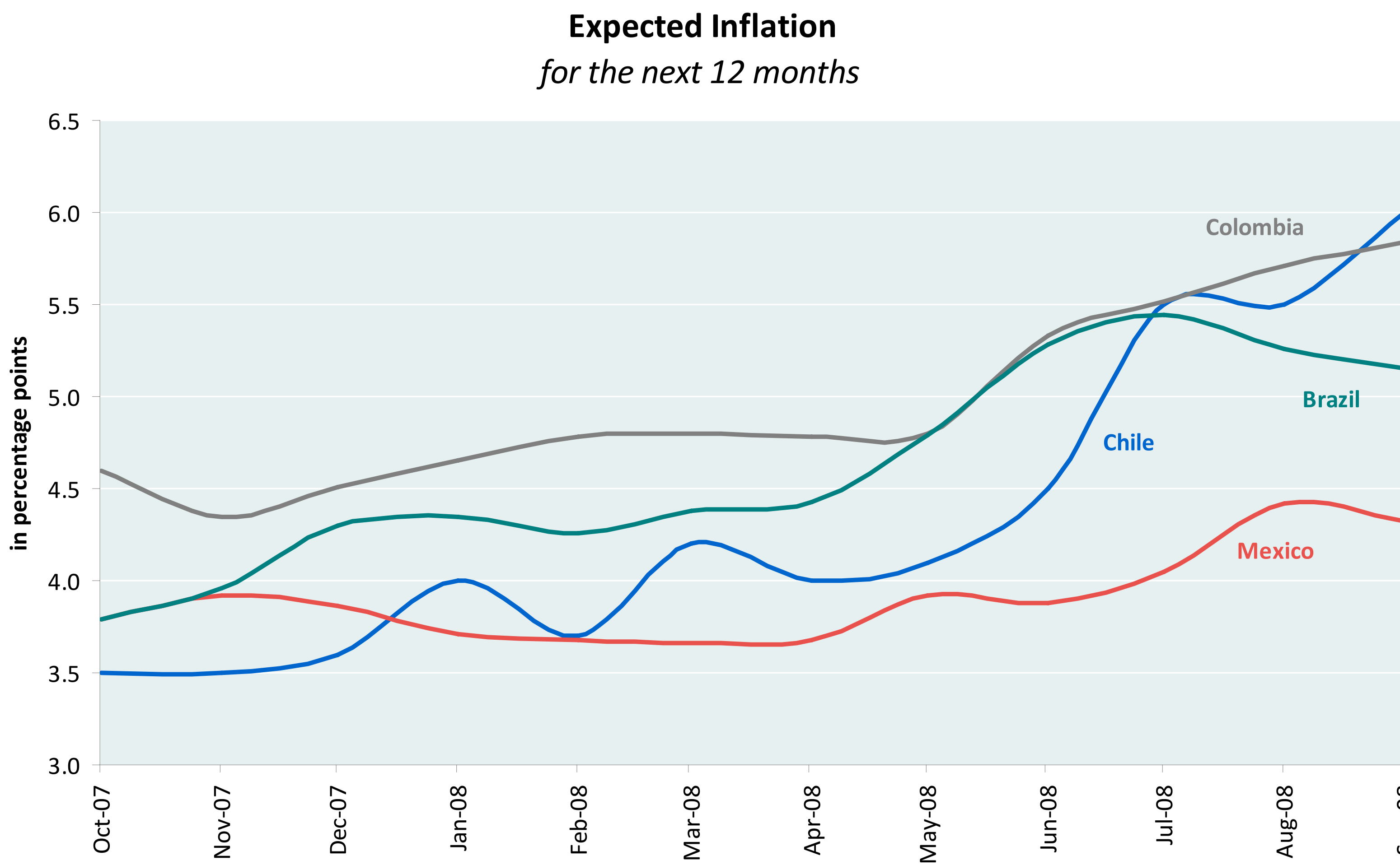
Consumer Price Inflation in LAC

annual variations, in %



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.

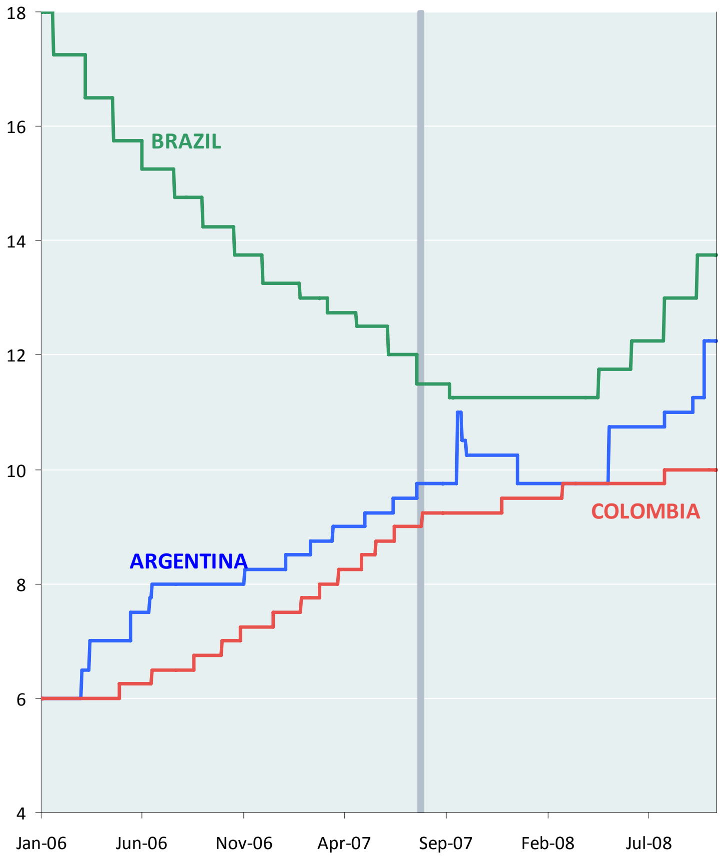
The good news is that inflation expectations have begun to yield in several countries…



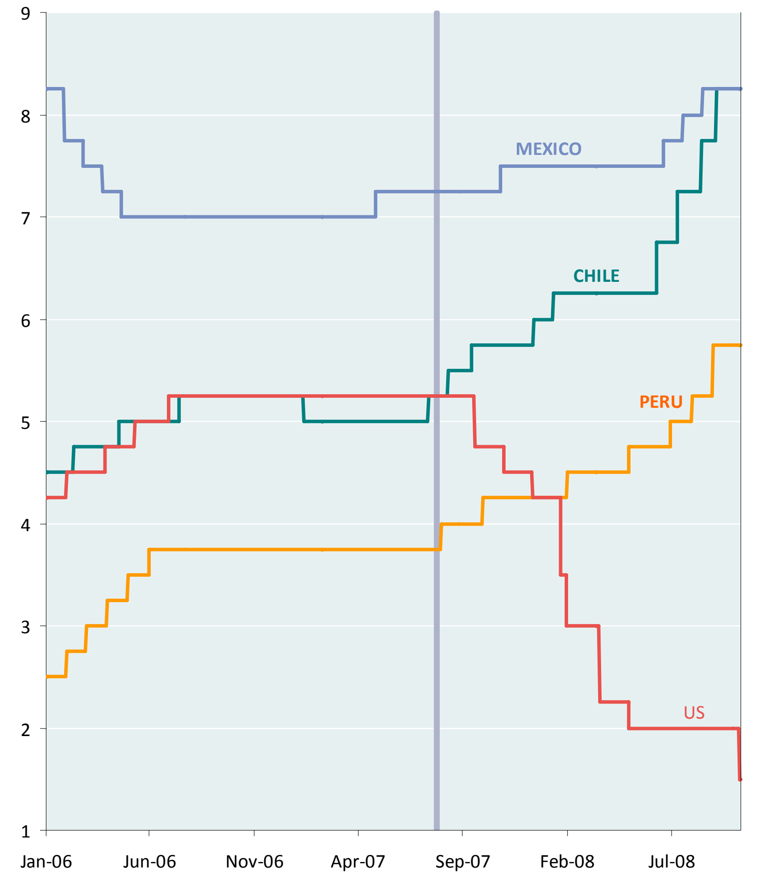
Expected Inflation as reported by central banks surveys. Source: Bloomberg – National Authorities

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

Monetary Policy Rates
in %

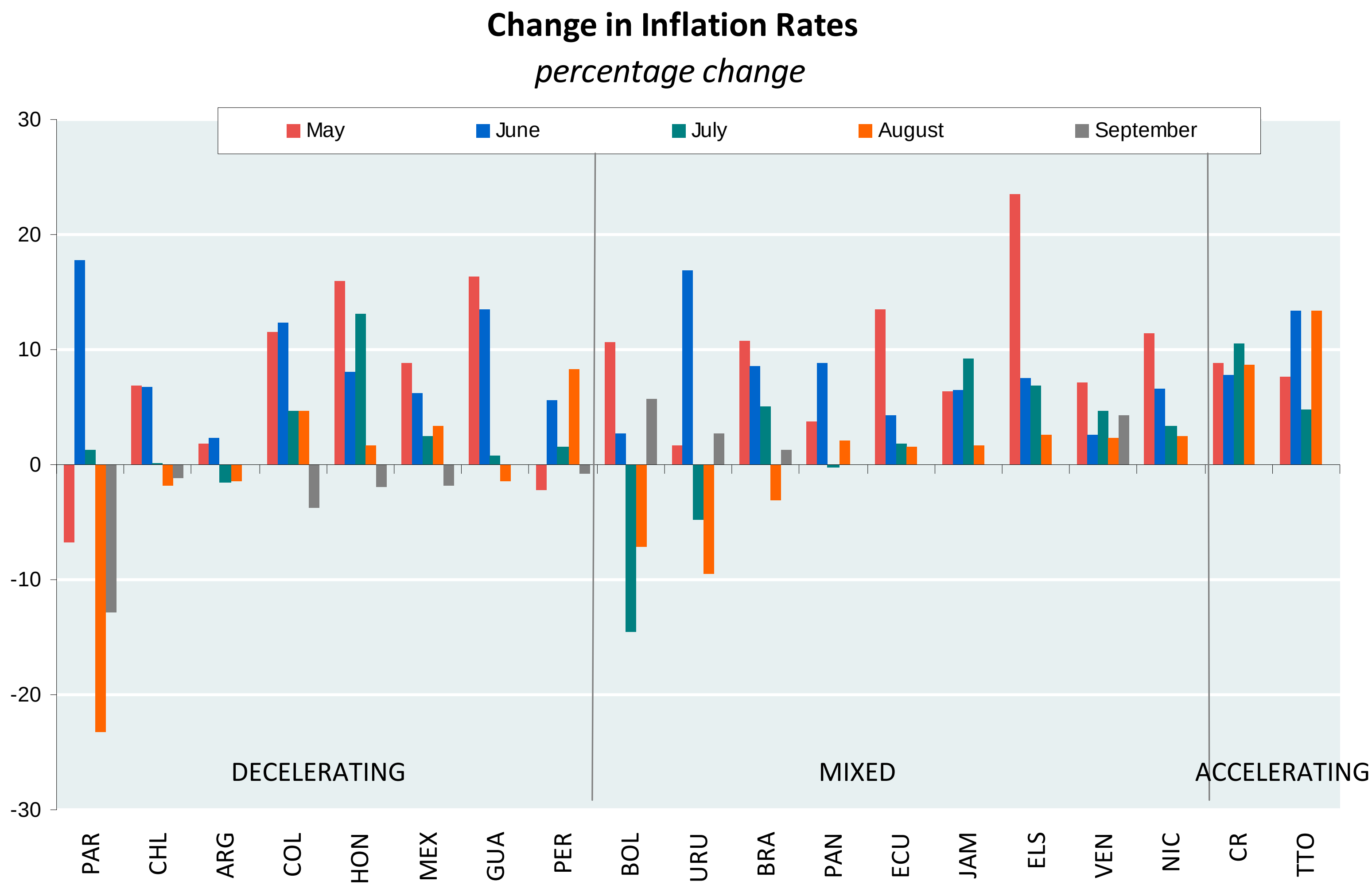


Monetary Policy Rates
in %



Source: Bloomberg – National Authorities

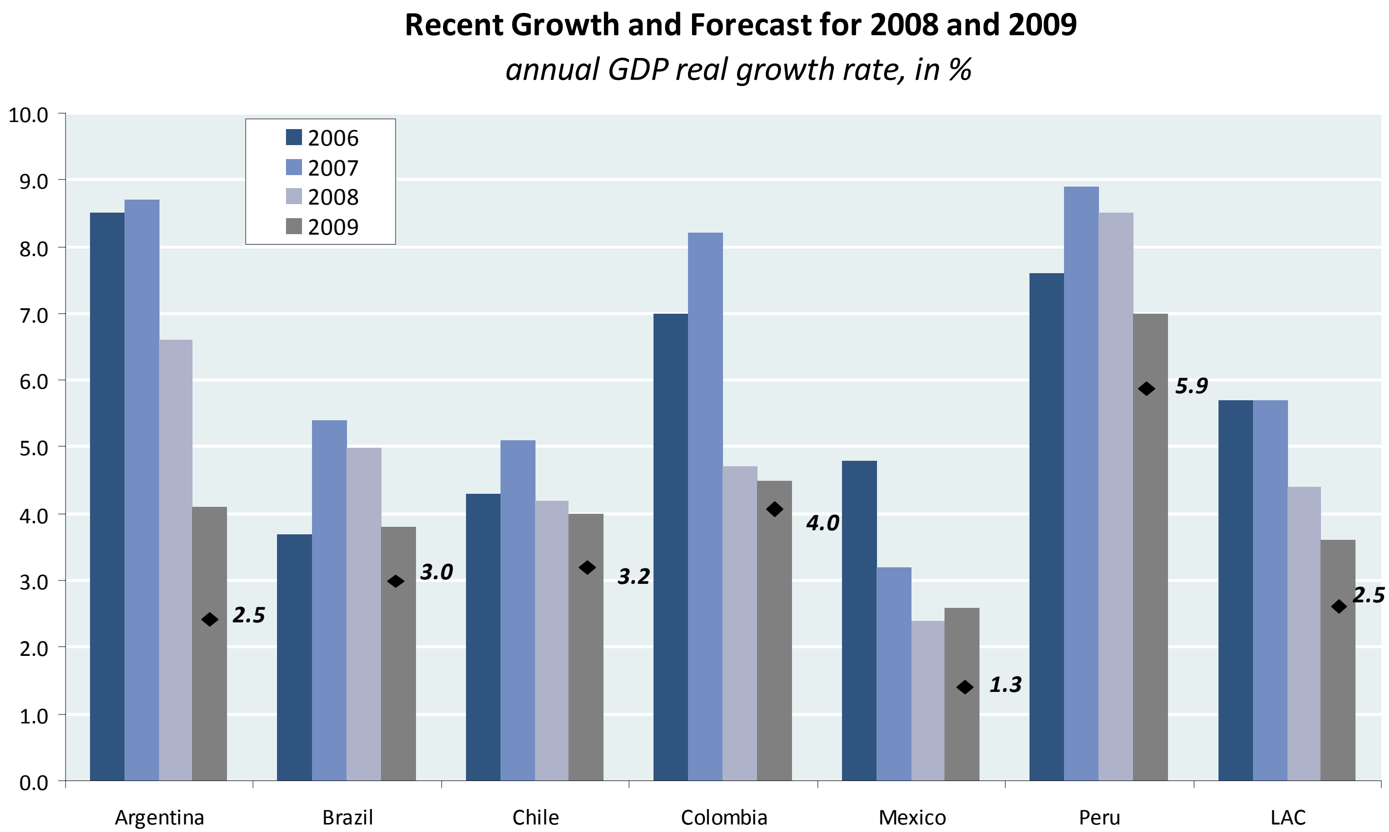
However, the taming of inflation is proceeding unevenly across Latin countries



LCRCE Staff calculations based on Bloomberg and National Authorities

External demand effects

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



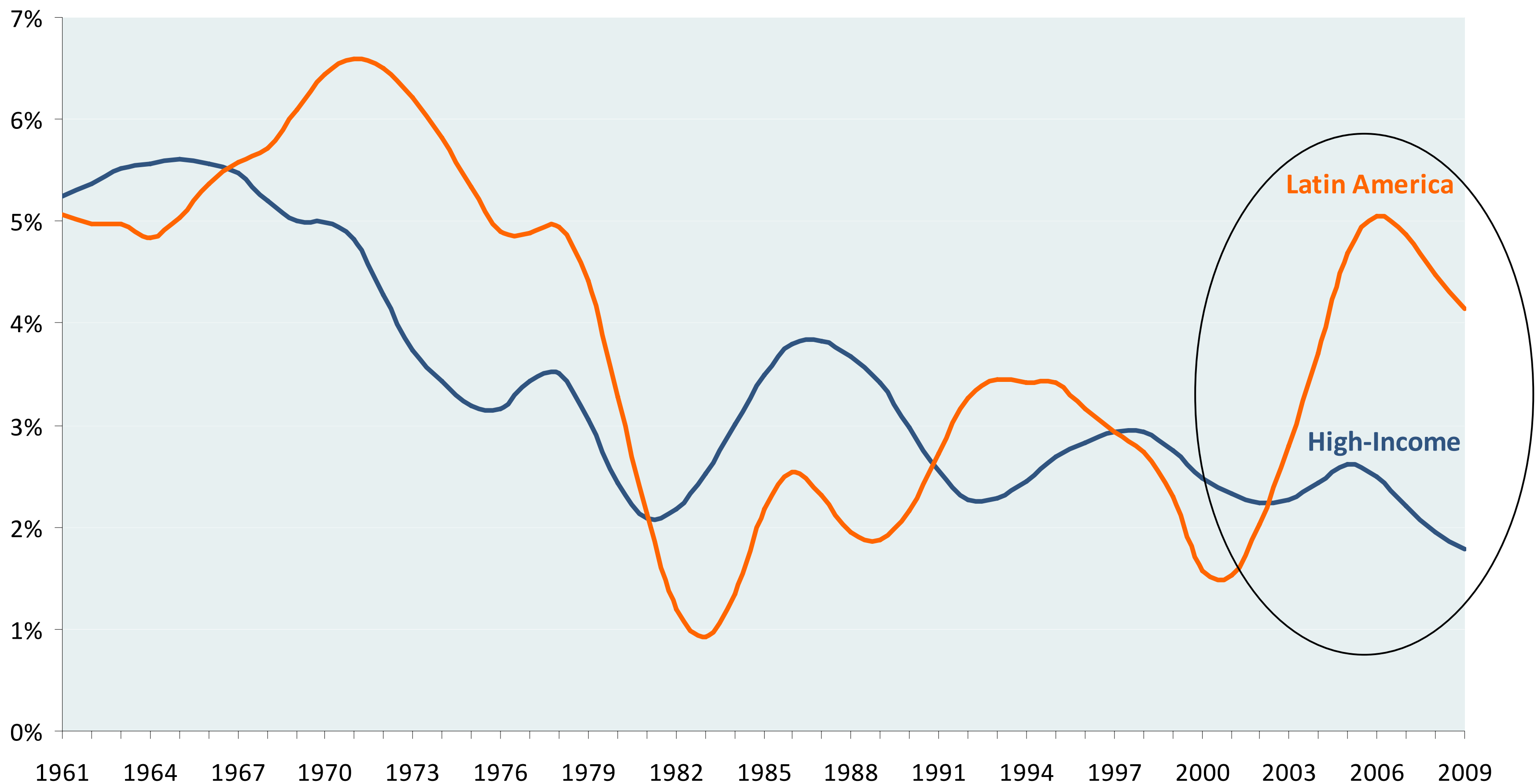
The global slowdown, higher costs of finance, weaker commodity prices, and the lagged effect of monetary tightening – all point to a sharper deceleration

Lowest forecasts for 2009 (in black dots) are taken from Consensus Forecasts, World Bank and Citibank. Sources: Consensus Forecasts, ECLAC and World Bank

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

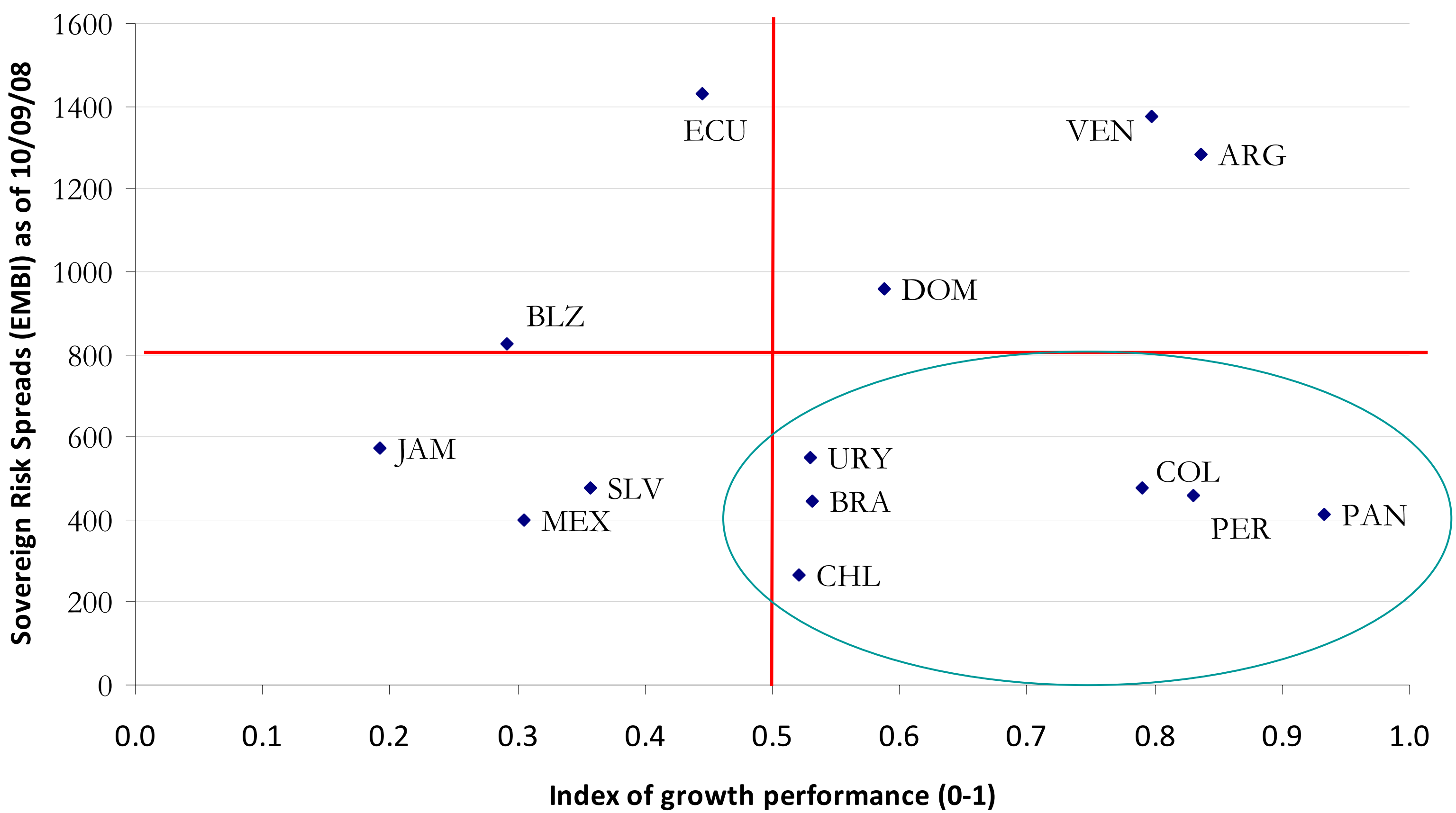
Cyclical-adjusted Growth in Latin America and High-Income Countries

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



The index of growth prospects combines information on annual variation of the investment to GDP ratio, annual average growth in GDP and TFP over the period 2003-7. The median of the growth prospects index for the entire LAC sample is 0.5. LCRCE Staff calculations based on Bloomberg, WDI and ECLAC

LAC perspective and policy challenges

LAC: a better-built boat facing a nastier storm

- LAC increasingly buffeted by rich-countries financial 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 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

Thank you