The resilience of Latin America to the current financial crisis
BRETTON WOODS II UNDER STRESS?
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Context

In the last five years Latin American economies have flourished in a very favourable international economic climate. The rest of the world has been hungry for our primary commodity exports. At the same time they have lent to us at very low interest rates and also given us ample foreign direct investment. In addition, inflation had been subdued until 2006 in part because the sold us cheaper manufactured imports.

My talk is about what would happen to us if this now changes. Coming up ahead is a slowdown in world growth, especially in the United States. We can also expect more turbulence and adjustment in international financial markets which will most likely mean higher rates on our borrowing. And then at this very moment we are facing a sharp rise in consumer price inflation.

Can we resist this combination of events?

Slowdown in world growth

Let us begin with a slowdown in world growth and start off with its effect on Colombia. In our last Inflation Report we estimated that the effect of slower world growth combined with past tightening in monetary policy could be to reduce growth in Colombia to somewhere in between 3.7% and 5.7% in 2008 with numbers above 5 being more likely. As part of that scenario we imagined a restriction in exports to Venezuela and we allowed for US growth to have come done to about 0.5-1% in 2008.

5% is certainly less than the 7.5% registered for 2007, but it is still a very good rate of growth in historical terms: it is at about the 60 percentile of Colombian growth rates in per capita terms since 1970. 5% is a sustainable growth rate for Colombia and a good starting point for more years of solid economic performance.

Most other Latin American countries are in a similar situation. There are some common factors which we can expect to support growth in the region.

First we expect primary commodity prices to remain high for the next year. Commodities continue to be an important part of Latin American exports. Past slowdowns in world growth bought down commodity prices with them, punching holes in government finances and trade balances[1]. But this time, the slowdown is not expected to be as generalized. In particular, we can expect the strong demand from world manufacturers for primary commodity inputs to persist. Therefore the most likely scenario is for these prices to fall back a bit from the very high levels they have reached as a result of slower growth, but not by enough to unsettle Latin American growth. For example Mexico, Ecuador, Venezuela and Colombia should benefit from what will still be a very high oil price.

A second factor that we expect to support our growth is continued strong foreign direct investment inflows to the region. The two factors are related: much of these FDI inflows are directed at improving our production of these commodity exports. Higher primary commodity prices and strong capital inflows have always been important impulses to growth in Latin countries, and need not depend on growth in the US.

In addition, many of us will receive strong remittance flows from our emigrants. Although these flows will naturally fall back with a slowdown in world growth, they are still likely to be large in terms of our national incomes[2].

Last but not least, we still expect internal domestic demand in Latin America to still keep growing at a strong pace. That will also be mostly likely the case in other parts of

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[1] See "The Financial Market Crisis and Risks for Latin America", Anoop Singh, Director Western Hemisphere Department, IMF, Sao Paolo, 17 March 2008 or IMF world Economic Outlook, April 2008.
[2] See "Remittances to Latin America and the Caribbean slower", IADB , March 11, 2008.

the developing world such as China and India. Growth in Japan and Europe will probably slow down but not by enough to push us into a major recession. Our exports are much more diversified across countries and not just in the US and Europe, so that it would need a more generalized world recession to damage our growth through exports.

In summary the most likely scenario is that the Latin American economies will keep on growing at very respectable rates for the rest of the year, even if the United States grows at about 0.5 % in 2008, and world growth slows to less than 4%.

Of course there is a risk that things will get worse. And what happens beyond 2008 depends on how domestic policies in the world's big nations can deal with the current financial crisis without setting off inflation. I turn to that financial turbulence now.

Adjustment in International Financial Markets

It is difficult to anticipate how exactly the ongoing turbulence in financial markets will impact on Latin America. But a sensible assumption is that it will make our borrowing more costly. The current crisis began in the US subprime lending market then spilled over onto the interbank market. As international financial markets seek to recover liquidity and reduce exposure, there will now most likely be a tightening of lending conditions generally.

But that rise in lending rates has to be seen in context. Chart 1 shows the spreads on select Latin American bonds in the year before and after the last three world financial market crises, and compares them to the current ongoing turmoil. One can see that the impact of the Russian Crisis raised the borrowing costs sharply, and on all of us. The bursting of the dotcom bubble bursting in 2000 has a smaller and more delayed effect. September 11th seems to have had an effect mostly only on Argentina, although that may have been a coincidence or a trigger, as the crisis in Argentine took place in December 2001. This current crisis began more than six years later. During those six crisis free years, the spreads on Latin American bonds had been crushed to very low levels. For the moment just less than six months after the defaults in the US subprime

market, what we have seen is a slow but persistent rise in Latin American spreads from these levels which is more pronounced in the case of Argentina and Venezuela.

Chart 1a. LTCM Russian Crisis (1998)

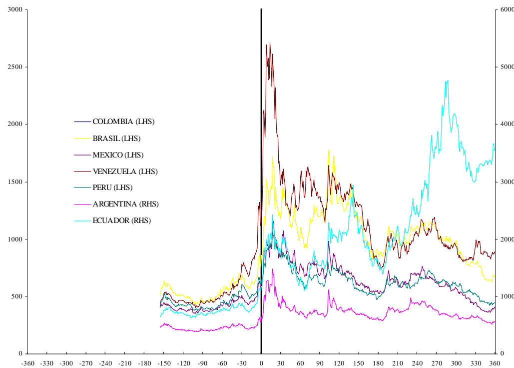


Chart 1b. Dotcom IT Crisis (2000)

Chart 1c. September 11th (2001)

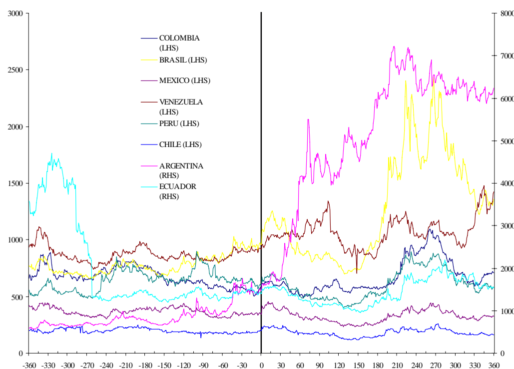
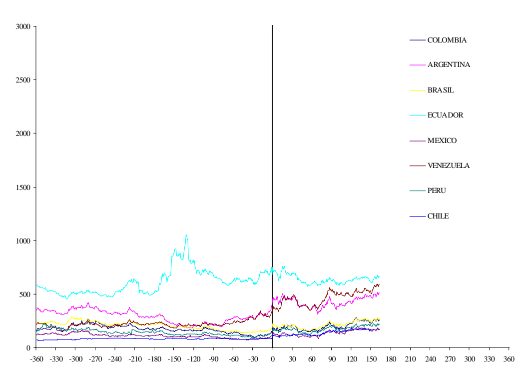


Chart 1d. Current Subprime Crisis (2007)



Source: JP Morgan EMBI+ spreads. Crisis dates as in the IMF WEO October 2007: 17.08.98 , 13.03.02, 11.09.01 and 27.07.07. Data for Chile not available for first crisis.

Let us assume then that tighter lending conditions raises rates on Latin American borrowing dominate any cuts in central bank rates. One scenario is that the spreads on our borrowing rise by about 300 basis points, recovering to approximately the average for 2003. How would be resilient to this?

These higher rates should not come as a complete surprise to us. Many of us been puzzled by how low rates have been in that last five years and a correction must have

been at the back of our minds. And although no borrower likes higher rates, higher rates might reflect a better pricing of risk and so should encourage banks to cut down on risk lending and improve the quality of our productive capital. And even a 300 basis point rise will leave our lending costs historically low. In sum, this should be good for us then in the long run. Our concern need then only be if our financial structure can cope with the transition to slightly higher rates.

Certainly our financial markets should be better prepared than the past. First we have improved our regulatory structure substantially. The evidence in Colombia for example is that we have low share of risky debt in our banks' balance sheet, historically speaking. Our financial sector is also less dependent on opaque instruments. Many of us have speedy insolvency and lender of last resort regimes in place, which might have helped for example in the case of Northern Rock, the UK bank that ran into a liquidity crisis. Then central banks in the region have accumulated a large amount of foreign exchange reserves that could be used to smooth any sharp depreciation.

It is also heartening that we face this crisis with less macroeconomic vulnerabilities. In general our governments have reduced their fiscal deficits and kept sovereign debt at a lower share of GDP than in the past. A smaller share of that debt is in foreign currency. Also significant is that a greater share of our borrowing is in the form of foreign direct investment. Although foreign direct investment is certainly not fixed, it is less likely to stop suddenly or reverse than short-term flows. Finally in general we place less emphasis on a particular value for our nominal exchange rates. This gives monetary policy much more flexibility to deal with any crisis, if and when that comes.

Of course one could argue that we could have done more, given just how favourable these past few years have been to us. Some recent calculations by Izquierdo, Talvi and Romero for example show that once we condition on cyclical movements in the terms of trade and borrowing costs, the improvements in Latin American fiscal balances and current account deficits do not look so good[3]. My interpretation is that it underlines the importance of building counter cyclical policy institutions in Latin America. I think we have to take this as work in progress. Some of us have begun

[3] Izquierdo A., E. Talvi, and R. Romero (2008), Booms and Busts in Latin America: The Role of External Factors, IABD working paper no 631.

working with legislated fiscal rules. Another interesting initiative of this type that could be imported into Latin America is that of countercyclical loan provisions along the lines adopted here in Spain.

The very fact that interest rates have been low for so long means that we cannot be complacent about the risks. Credit risk would materialize if some domestic borrowers pay back at higher interest rates. Market risk through currency changes is likely to be limited because of our strong reserve positions but is still there in terms of shifts in government bond prices for example. Liquidity risk could compound the other two. We have all been working at minimizing any possible disruption that could be caused by a rise in market premia acting through these channels.

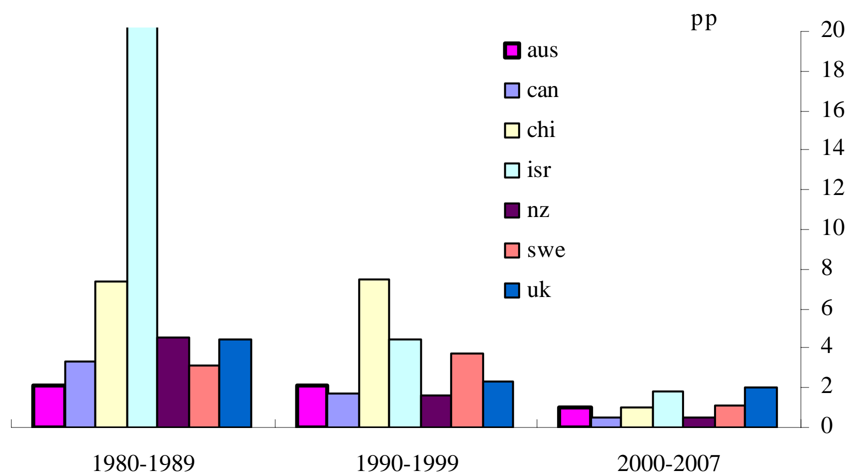
It is also worth remembering that while our financial systems are in much better shape than in the past, in general they are still immature. One symptom is that although the spreads between retail lending and short term-rates in the region have fallen, they remain relatively high.

It seems plausible that these persistently high spreads reflect a lack of stable investment opportunities within national borders and are not just because of a lack of competition or inefficiency per se. One important reason why investment within our national borders remains risky is because of the lingering macroeconomic volatility which comes with our higher and more volatile inflation. Macroeconomic risk matters more because individuals within the same economy cannot pool it. If this is true, then in order to improve the ability of our financial sector to absorb ups and downs of international financial markets, we need to do more to stabilize long-run nominal interest rates and thus inflation.

Our Unfinished Nominal Stabilization

To try and benchmark how much progress we have made in this respect, Chart 2 shows the nominal stabilization performance of the 7 countries which began inflation targeting in the 1990s. Those countries are Australia, Canada, Chile, Israel, New Zealand, Sweden and the UK. The message is that it took these countries over 15 years to reduce the volatility of inflation, but they eventually succeeded.

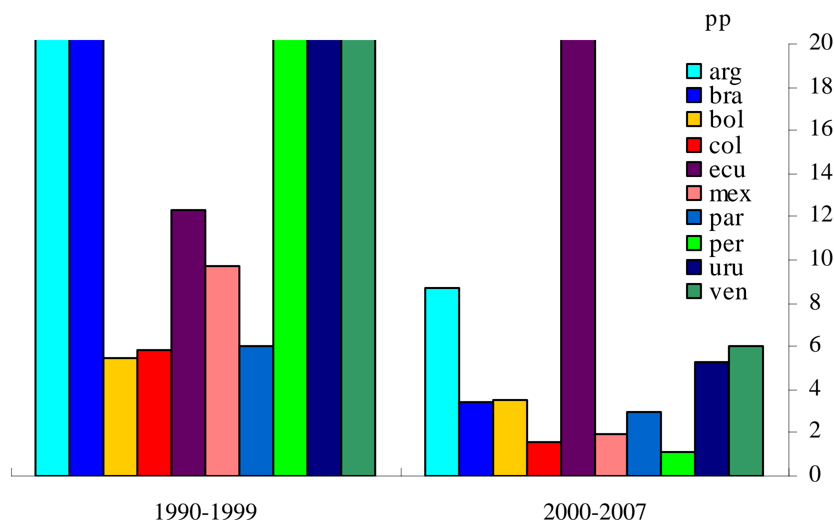
Chart 2. Inflation Volatility in Early Inflation Targeting Countries



Source: IFS and National Data Agencies. Volatility measured by unconditional standard deviation. **Israel 120%

When we compare the performance of some Latin American countries (except for Chile, which is one of the seven) in Chart 3, we can see that our inflation volatility though less than it used to be during hyperinflation is still high, granted with some exceptions. Some part of our higher volatility could be irreducible, being due to having a greater share of food in consumption or substitution bias in our CPI index. But most would surely agree that much of it is due to an unfinished nominal stabilisation. The point that I want to make here is that our monetary authorities will still have some work to do once this crisis has passed.

Chart 3. Inflation Volatility in Latin America since 1990



Source: IFS and National Data Agencies. 1990-99 sds: Argentina 56%, Brasil 850%, Perú 131%, Uruguay 31% and Venezuela 24%. The volatility of Ecuadorian inflation has fallen to very low levels since 2004.

Having explained the context, I turn to recent developments in inflation in the region.

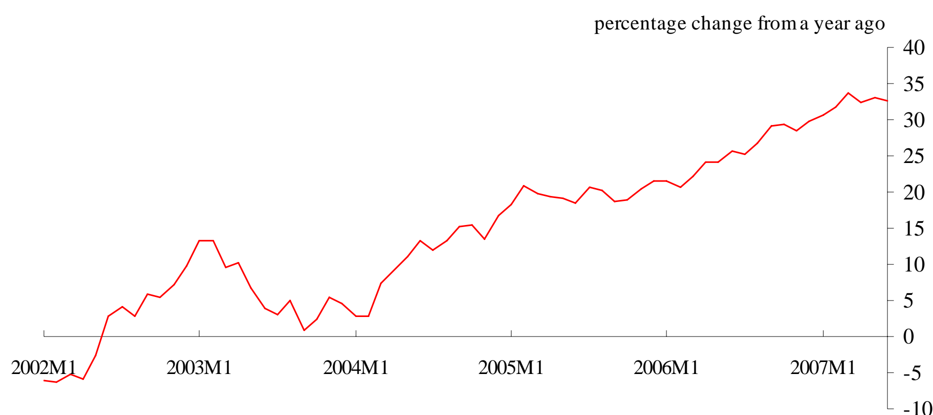
The Recent Pickup in Inflation

Inflation has picked up suddenly in the region last year. Chile, Colombia and Peru breached their inflation targets in 2007. When we mechanically decompose this acceleration in inflation that caught us unawares, the largest contribution is in food items. One might then think that means it would all disappear by itself with a good harvest. But the experience of the early 1970s shows that food inflation can persist and

pass on to other prices when there is a significant build up of domestic inflation pressure. And many countries in the region are exhibiting symptoms of excess demand.

Chart 4 shows that easier bank credit has been an important factor promoting high rates of domestic demand growth. In total, private credit has been growing at over 20% since 2006 in nominal terms.

Chart 4. Private Nominal Credit Growth in Latin America



Source: IFS. See IMF World Economic Outlook, October 2007

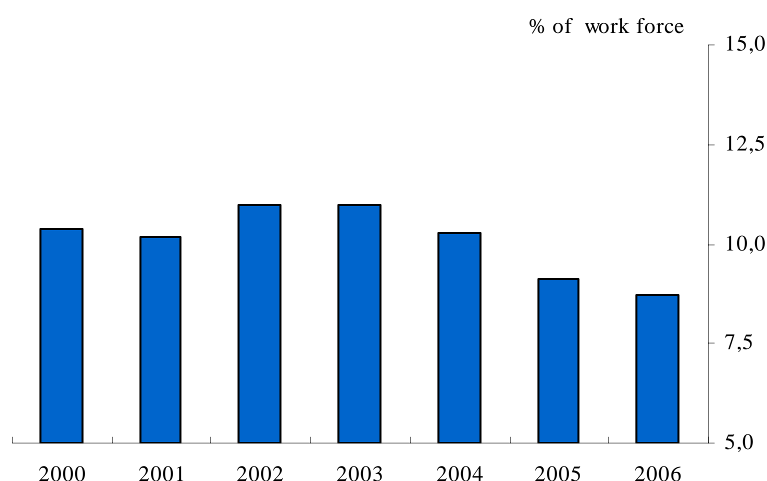
Another familiar sign of excess demand that some of us have seen is a widening in our current account deficits. And although much of the current inflation is still concentrated in food, it is seems to have become more generalized. Putting these signs together, this current bout of inflation represents a serious threat.

The threat is tangible. If we let inflation escape now, this will leave our economies vulnerable. In particular it will raise the probability that in a year or two year's time we have to deal with high inflation and lower growth. We should worry about that possibility, even if it seems unlikely now, because the combination of high inflation and low growth is always the most difficult scenario for Latin American monetary policy. One cannot cut rates for fear of setting off a devaluation that raises external debt costs. But one cannot allow real rates to rise too sharply either as that can lead to financial

crisis. There are no easy options and so it is better to avoid getting into this position in the first place.

And then a second problem with allowing this inflation to persist is its possible impact on our labour markets. To put this in context, we can begin by noting that Latin American labour markets have made a lot of progress over since the mid 2000s. Unemployment has fallen in most of our countries without triggering excess wage inflation. At least until now.

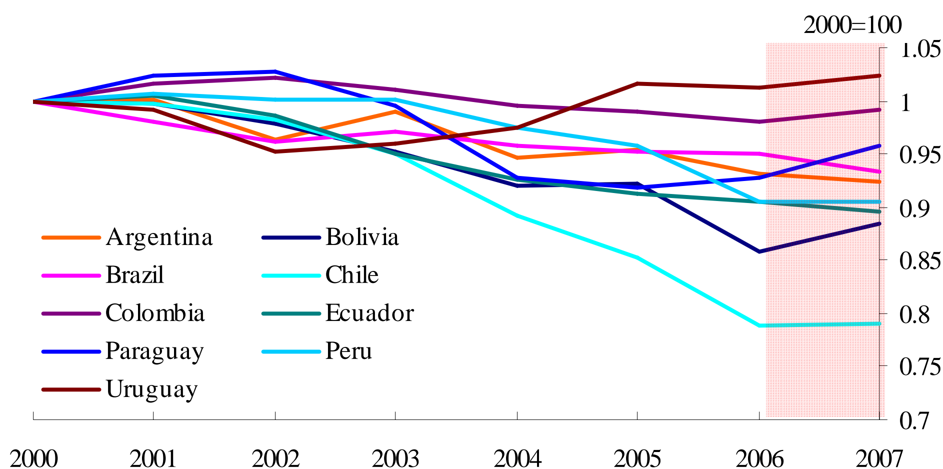
Chart 5. Unemployment Rate of the Latin America and the Caribbean



Source: CEPAL. Weighted by workforce

But in part this improvement may be due to the favourable consumer terms of trade that we have been enjoying. Chart 6 shows that the consumption prices fell relative to the GDP deflator for most Latin countries from 2000 to 2006. We can describe this as the honeymoon of globalization. We received cheaper finished manufactured goods in exchange for more expensive energy and other commodities. In terms of relative consumer prices, the first effect offset the second so that in net, workers' real consumer wages rose relative to the real product wages (paid by employers). This meant that workers felt less need to ask for compensation from their employers.

Chart 6. Relative Price of Consumption to GDP in Latin American countries (2000-2007)



Source: IMF and National Authorities. Note: Consumer Prices are measured by CPI, GDP deflator at market prices

But Chart 6 also shows that in 2007 the trend in general reversed or halted. Higher consumer prices may now be starting to outstrip even the large rises in producer prices. It seems that globalization is entering a new phase. One symptom is that even China now has high inflation. Another is that the continued pressure on commodity prices has burst through onto food prices. A further development may be that retail energy prices rise if our governments cannot keep shielding consumers.

If consumer price inflation continues to rise, and if our workers can successfully obtain compensation for this rise in living costs, and if that compensation is above productivity, then employers will have to respond by reducing its workforce. The impact of this real wage resistance on lowering growth and raising inflation could be significant, as the experience of the 1970s again shows. In Latin American we still have many institutionalized wage compensation schemes, which perhaps have until now been dormant. The key to whether these mechanisms will or will not be activated is again credibility. If we lose control of the nominal anchor this could herald a damaging

scramble for inflationary compensation, which would push up unemployment and disadvantage those who have less bargaining power.

Conclusion

In conclusion I expect that Latin America will be resilient to the combination of lower world growth and higher interest rates that we are most likely to see in 2008. But inflation is also a serious threat which had to be dealt while growth is still strong. Losing credibility has real costs for us.

In this speech, I have outlined what I think is the most likely scenario. Of course there is a risk that world growth could slow down further if the international financial crisis gets worse. That is something we are all aware of and are preparing for. But for the moment, one expects that the combination of government and central bank actions and access to the large amount of accumulated past savings globally will cushion the impact of financial firms' losses, and so eventually push world growth back towards its recent average. The key for countries like Colombia is to use the extra time that we have been given to keep our growth sustainable and our fundamentals strong.