Latin America and the Financial Crisis

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1. The International Financial Crisis

The Crisis has gotten worse

- ✓ In recent months, the financial crisis has gotten deeper and more encompassing as a result of:
  - ✓ Further reduction in the value of underlying asset used in collateral instruments (specially house prices);
  - ✓ A sharp reduction in world economic growth and worsening economic prospects;
  - ✓ Greater uncertainty on the solvency of financial institutions.
- ✓ Lehman's bankruptcy was a turning point.

New Dimension of the Crisis Called for a new approach

- The deepening and globalization of the crisis required a quick and global response to stabilize the financial system and to contain its effect in the real economy.
- But although central banks were doing their homework, the response of the fiscal authorities was not in accordance to the circumstances.
  - In EE.UU. the Treasury put forward a flawed and cumbersome program, the TARP.
  - In Europe individual initiatives were introduced that many times were competitive among them.

In search of a proper program

- Given the magnitude of the crisis and drawing on the historical experience what was required was a program that would act in four fronts:
  - (1) Provide liquidity to financial system;
  - (2 Capitalize weak financial institutions with systemic effects;
  - (3) Purchase low liquidity assets of financial institutions;
  - (4) Provide time limited guaranties to deposit and other liabilities of financial institutions.
- At the end it was the initiative of Gordon Brown (8/10), that opened the door to broader programs to try to control the crisis.

Recent measures improve the situation

- Thus, after much vacillation, in the last month all industrial countries have been introducing initiatives to capitalize banks and to insure banks liabilities.
- The deepening of the financial crisis encountered a global economy that was already close to a recession, making the situation worse.

The world economy is on dire straits

- ✓ In the second quarter, four of the five largest countries experienced a fall in GDP; the exception was the US.
- ✓ In third quarter the US, the Euro Zone and Japan experienced a reduction of GDP.

Economic Prospects in Industrial Countries

- A number of factors are bound to maintain a weak world economy for several quarters:
  - The deepening of the financial crisis and the associated worsening of the credit crunch;
  - The employment reduction;
  - The wealth reduction;
  - The low confidence levels and the great uncertainty with respect to the evolution of the financial crisis and of the overall economic activity.

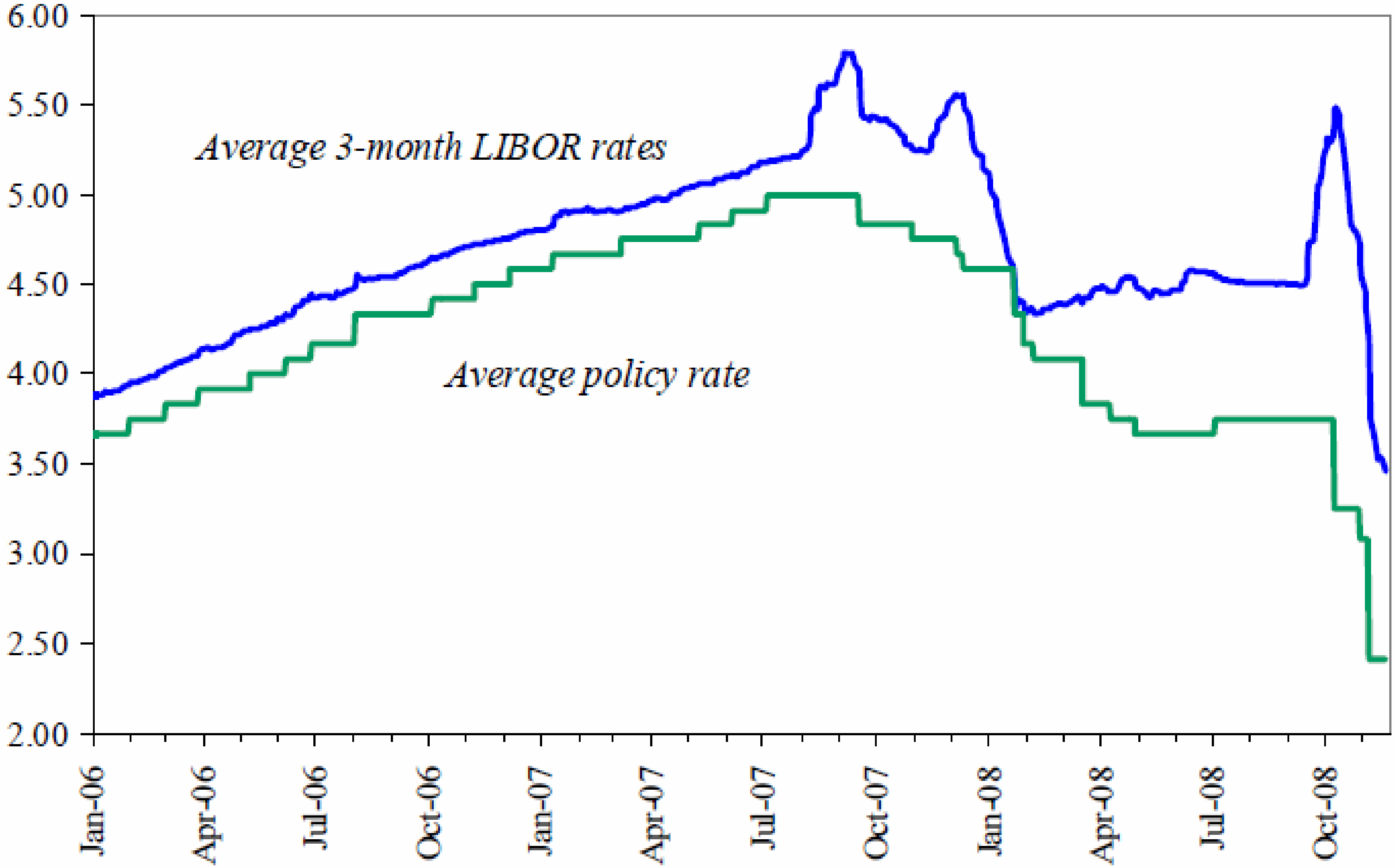
World Economic Outlook

- ✓ The world economy should start to recover in late 2009 or early 2010 assisted by:
  - ✓ Expansionary fiscal and monetary policies;
  - ✓ The progress in the reconstruction of the financial system;
  - ✓ The end of the adjustment of the housing market;
  - ✓ Lower commodity prices;
  - ✓ Lower inflation;
  - ✓ The resilience of emerging and developing countries.
- ✓ But the risks of a deeper and more protracted recession are higher that at anytime in the last 70 years.

World Economic Outlook

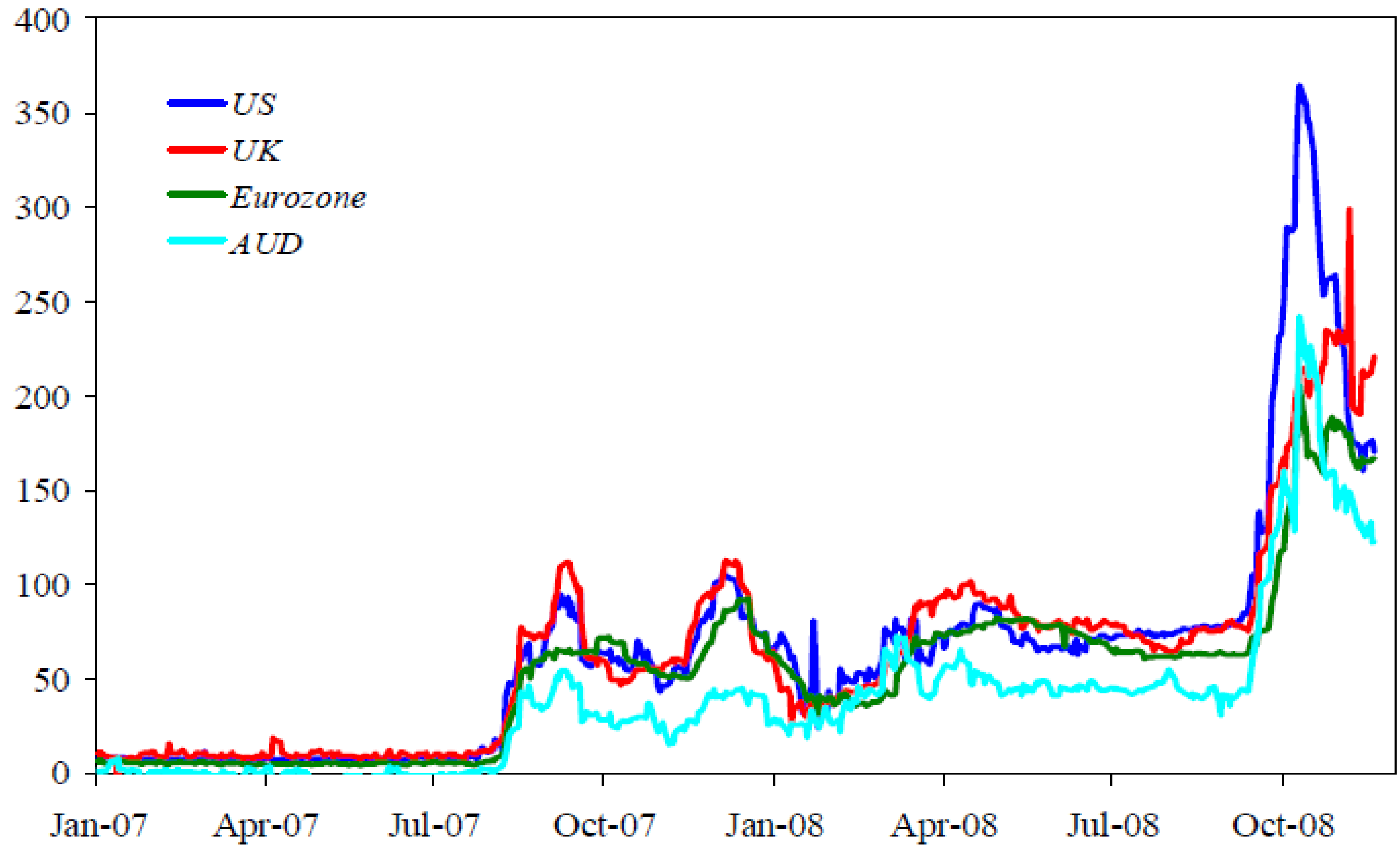
- ✓ But thanks to the recent initiatives of the monetary and fiscal authorities money markets are slowly recovering, however credit markets remain severely impaired.

3 Months Libor and Policy Rates



Source: Bloomberg,November 18th, 2008

LIBOR-OIS Spreads



Source: Bloomberg, November 18th, 2008

The Crisis is affecting Emerging Markets

- ✓ Until the first half of the year emerging markets were experiencing high growth and rising inflation. There was much talk about decoupling.
- ✓ But now as a result of the flight to quality, higher risk aversion and the credit crunch, the cost of credit has risen and the access have been reduced.
  - ✓ Capital is leaving, credit conditions have become tighter, local currencies are depreciating, sovereign and corporate debt spreads are rising and stock prices are dropping.
  - ✓ Even trade credit and credit lines are becoming more difficult to obtain.

The impact in Emerging Countries

- To control the contagious to emerging markets, financial support programs are beginning to be put in place with the collaboration of the IMF, the FED and the EU:
  - Among others, currency swaps of the FED with Brazil, Mexico, South Korea and Singapore;
  - IMF programs with Ukraine and Hungary that are also being supported by the EU,
  - The IMF also set ups a contingency credit program;

2. How well prepared is Latin America to face this crisis?

Latin America is in a better position his time

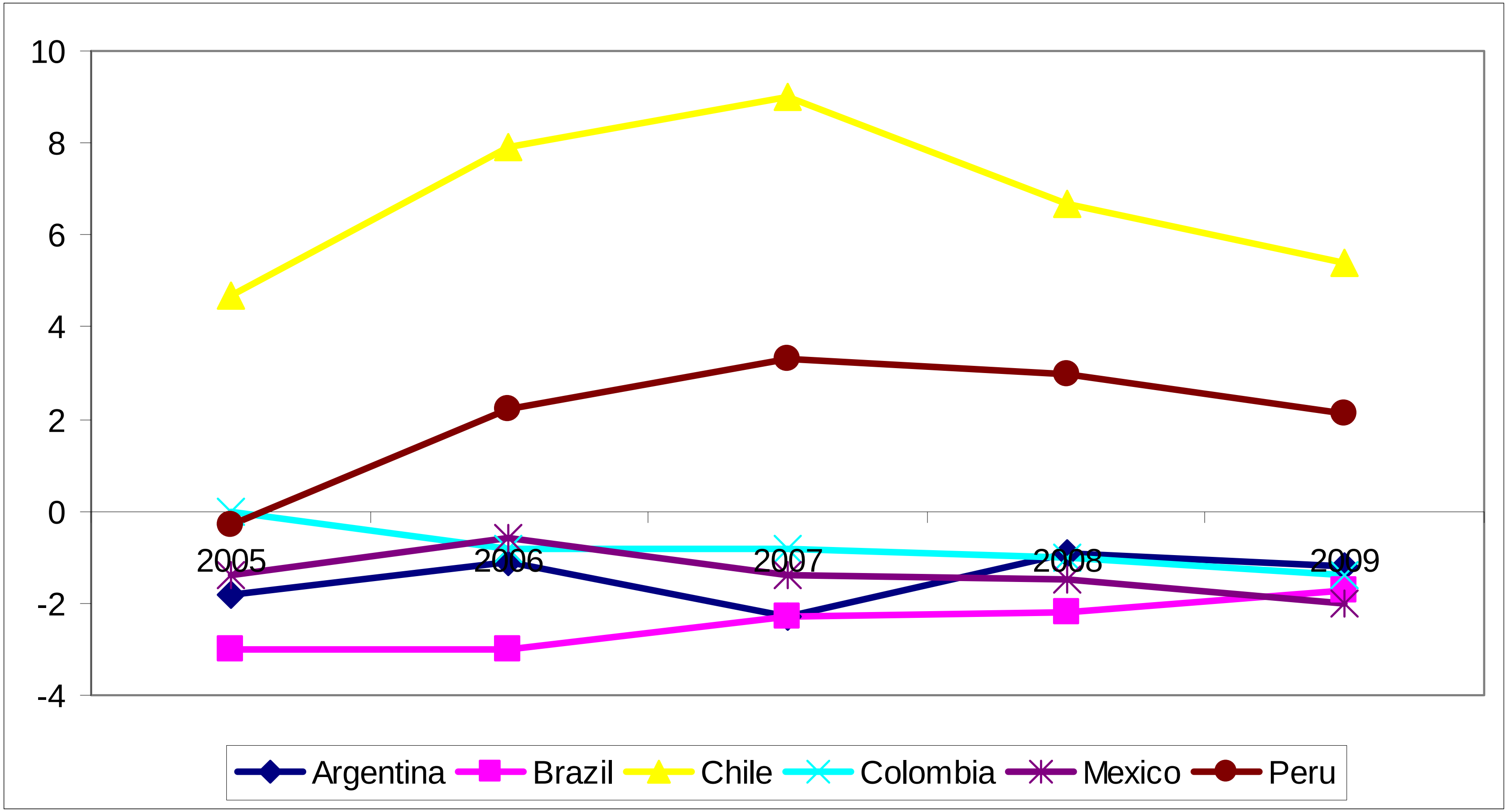
- This time Latin America is much better prepared to face the crisis that in previous cases:
  - It has stronger policies and institutions that have contributed to: lower inflation, stronger fiscal balances, lower current account deficits and more robust financial systems.
  - More flexible exchange rate regimes.
  - Major reduction of currency rollover risks in governments' debt portfolios.
  - More developed local debt markets in local currency.
  - Large accumulation of foreign reserves.

Inflation
(%, annual rate)

	1980-1984	1985-1989	1990-1994	1995-1999	2000-2004	2005-2007
Argentina	268.2	863.2	505.2	0.8	8.2	10.0
Brazil	132.5	532.2	1667.4	19.4	8.8	5.0
Chile	22.4	20.4	17.4	5.8	2.8	3.3
Colombia	23.0	24.0	26.6	17.8	7.2	4.7
Ecuador	24.8	43.0	44.8	33.2	31.4	2.3
Peru	83.8	878.6	1607.8	8.4	2.4	2.0
Latin America	76.3	357.8	289.0	12.5	8.7	5.4
Emerging Asia	9.7	6.0	8.0	7.8	2.4	4.4
Eastern Europe	31.1	44.6	308.0	51.1	16.5	6.5

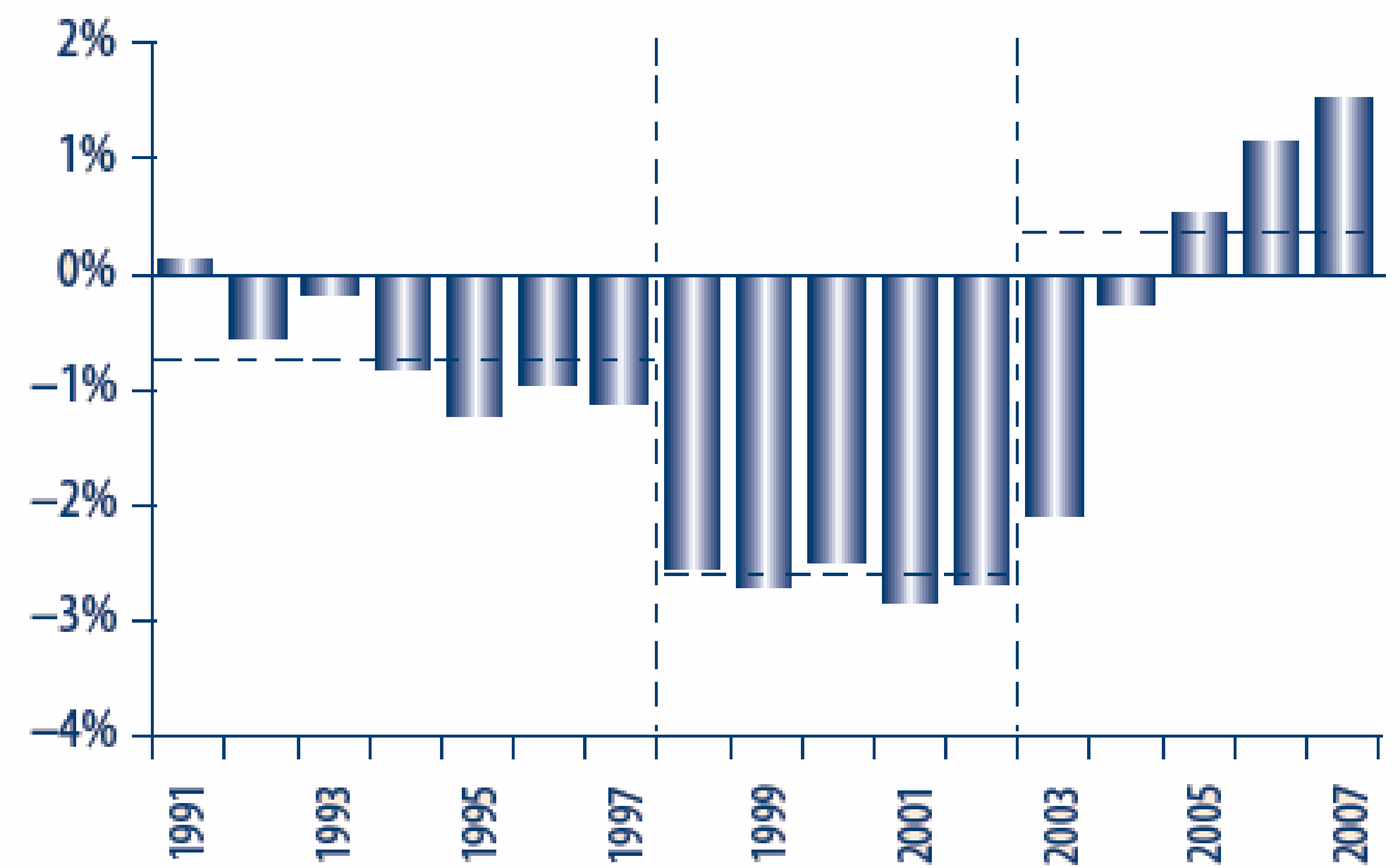
Source: World Development Indicators, World Bank (2008).

Fiscal Balances
(% of GDP)



Source: IMF (2008). Regional Economic Outlook: Western Hemisphere -- October, 2008.

Fiscal Balance in Latin America
(% of GDP)



Note: Latin America is the simple average of the seven Latin American countries, namely Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

Source: IADB (2008). "All That Glitters May Not Be Gold: Assessing Latin America's Recent Macroeconomic Performance".

Current Account Balances
(% of GDP)

	1980-1984	1985-1989	1990-1994	1995-1999	2000-2004	2005-2007
Argentina	-4.0	-2.2	-1.2	-3.4	2.6	3.3
Brazil	-3.6	-0.2	0.2	-3.2	-1.4	1.0
Chile	-9.4	-4.6	-2.4	-3.0	-0.6	3.3
Colombia	-5.2	-1.0	0.2	-3.8	-0.8	-2.3
Mexico	-1.6	-0.4	-5.6	-2.2	-2.0	-0.5
Peru	-3.8	-6.8	-5.4	-6.2	-1.8	2.0

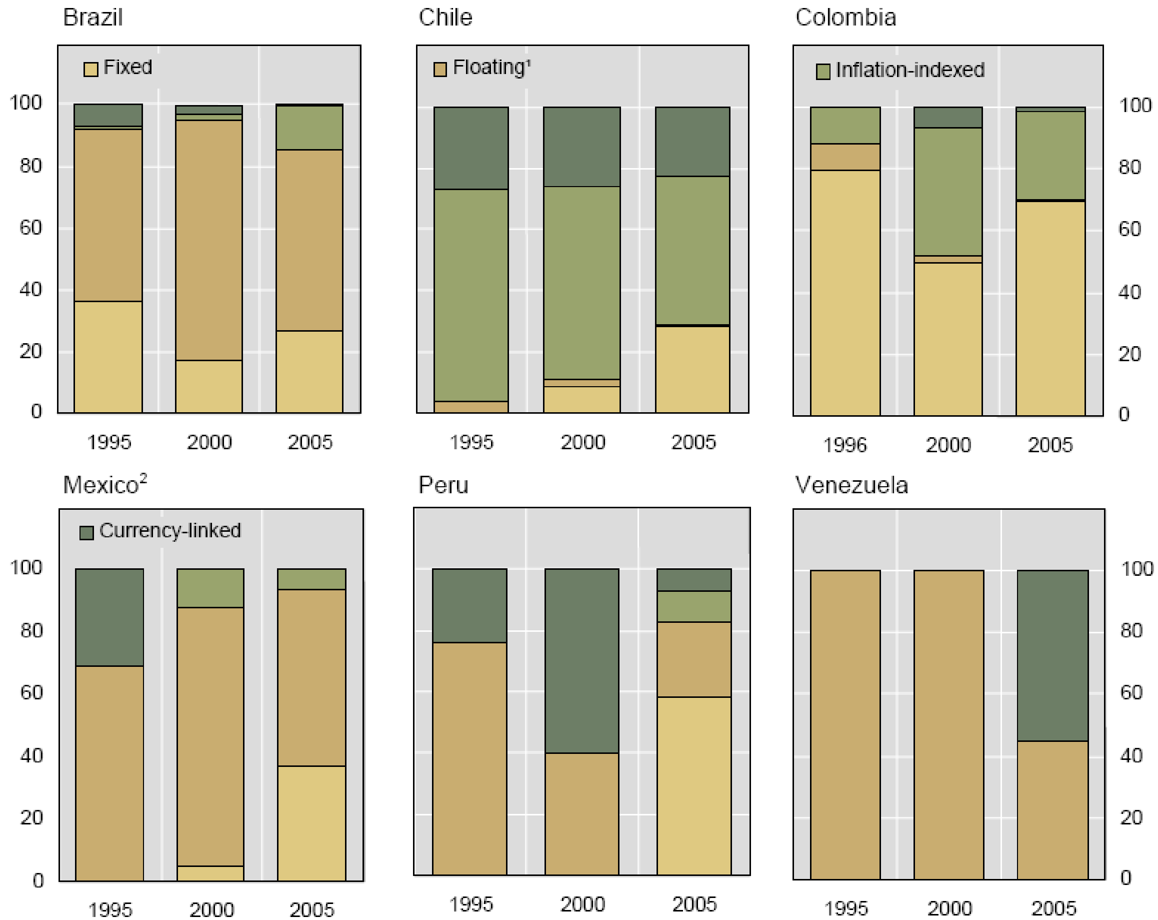
Source: World Development Indicators, World Bank (2008).

Exchange Rate Arrangements

Country	In the Beginning of 1980s	Today
Argentina	Pre–announced crawling peg to US dollar	De facto crawling band around US dollar
Brazil	Managed floating	Managed floating
Chile	Peg to US dollar	Managed floating with rare interventions
Colombia	De facto band around US dollar/Multiple rates	Managed floating
Mexico	De facto peg to US dollar	De facto crawling band around US dollar
Peru	Freely floating/Parallel market	De facto crawling band around US dollar

Source: Ilzetzki, Reinhart y Rogoff (2008).“The Country Chronologies and Background Material to Exchange Rate Arrangements in the 21st Century: Which Anchor Will Hold?” for the beginning of the 1980s, own classification for Today.

Composition of Central Government Debt (%)

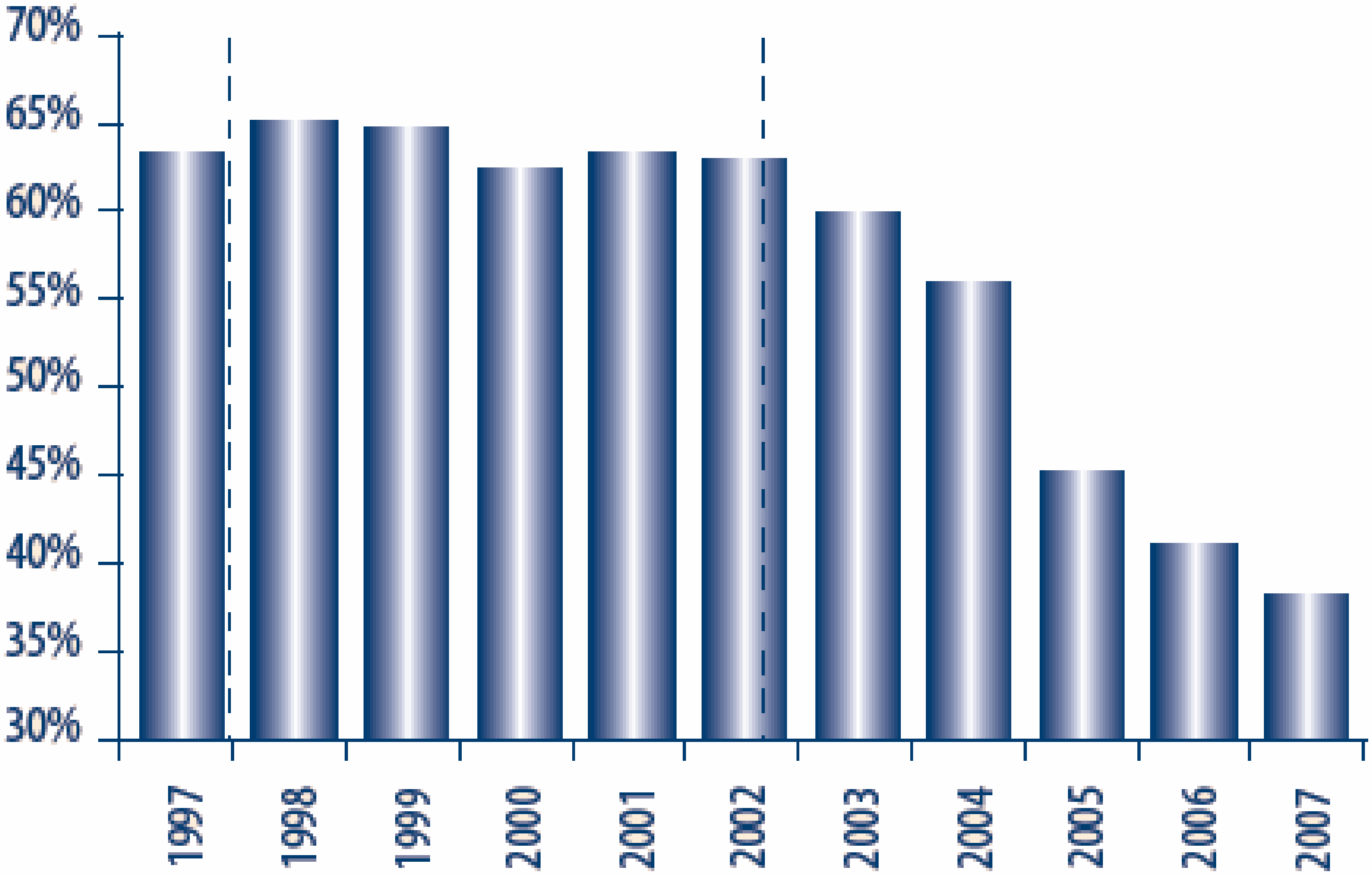


Note: 1 The floating rate grouping includes instruments with mixed characteristics. 2 Brems and Cetes are included as floating rate instruments.

Source: Jeanneau, S. and C. E. Tovar (2008). Latin America's local currency bond markets: an overview. BIS Working Paper.

Foreign Currency Debt in Latin America

(% of Total Debt)



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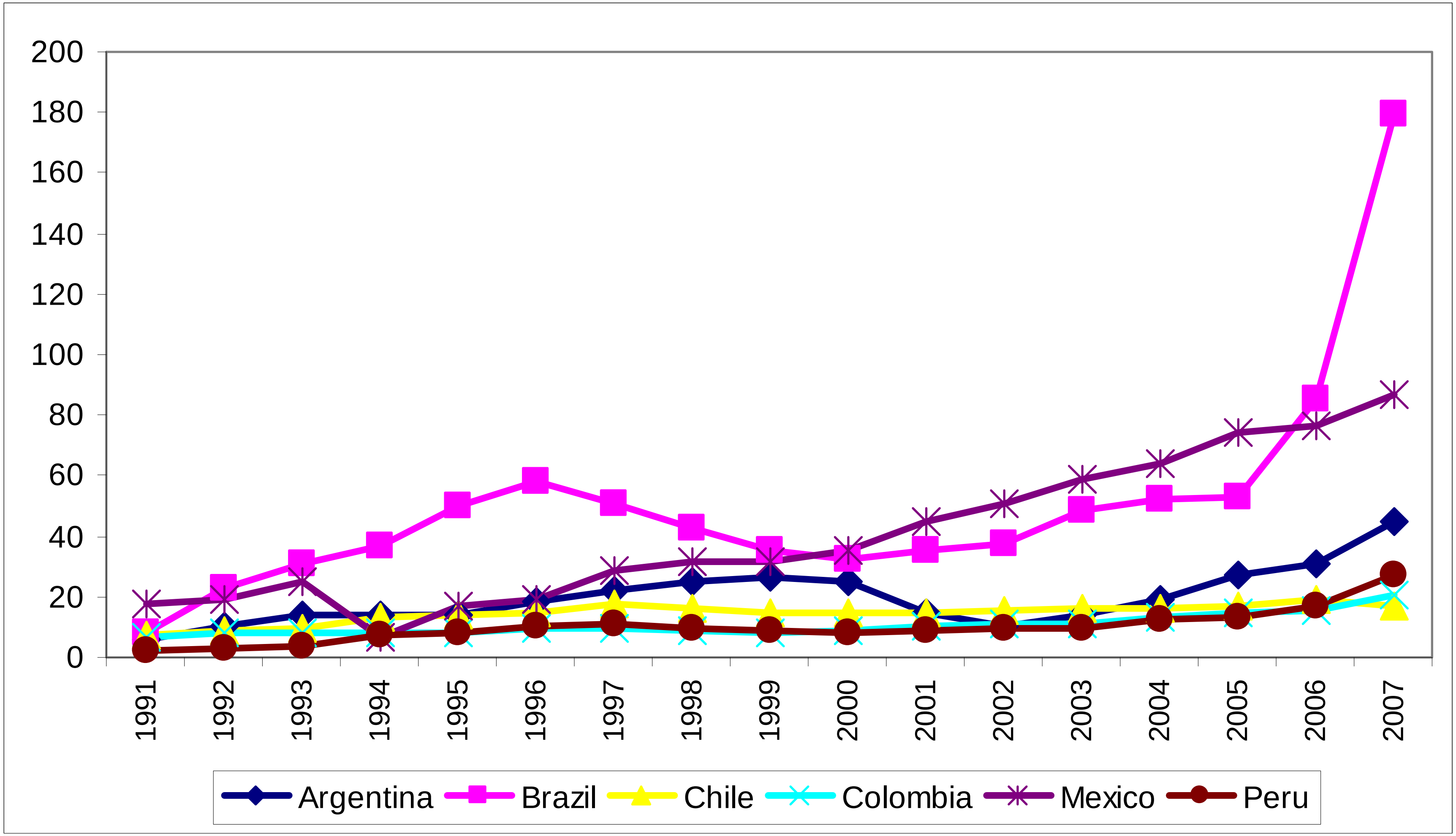
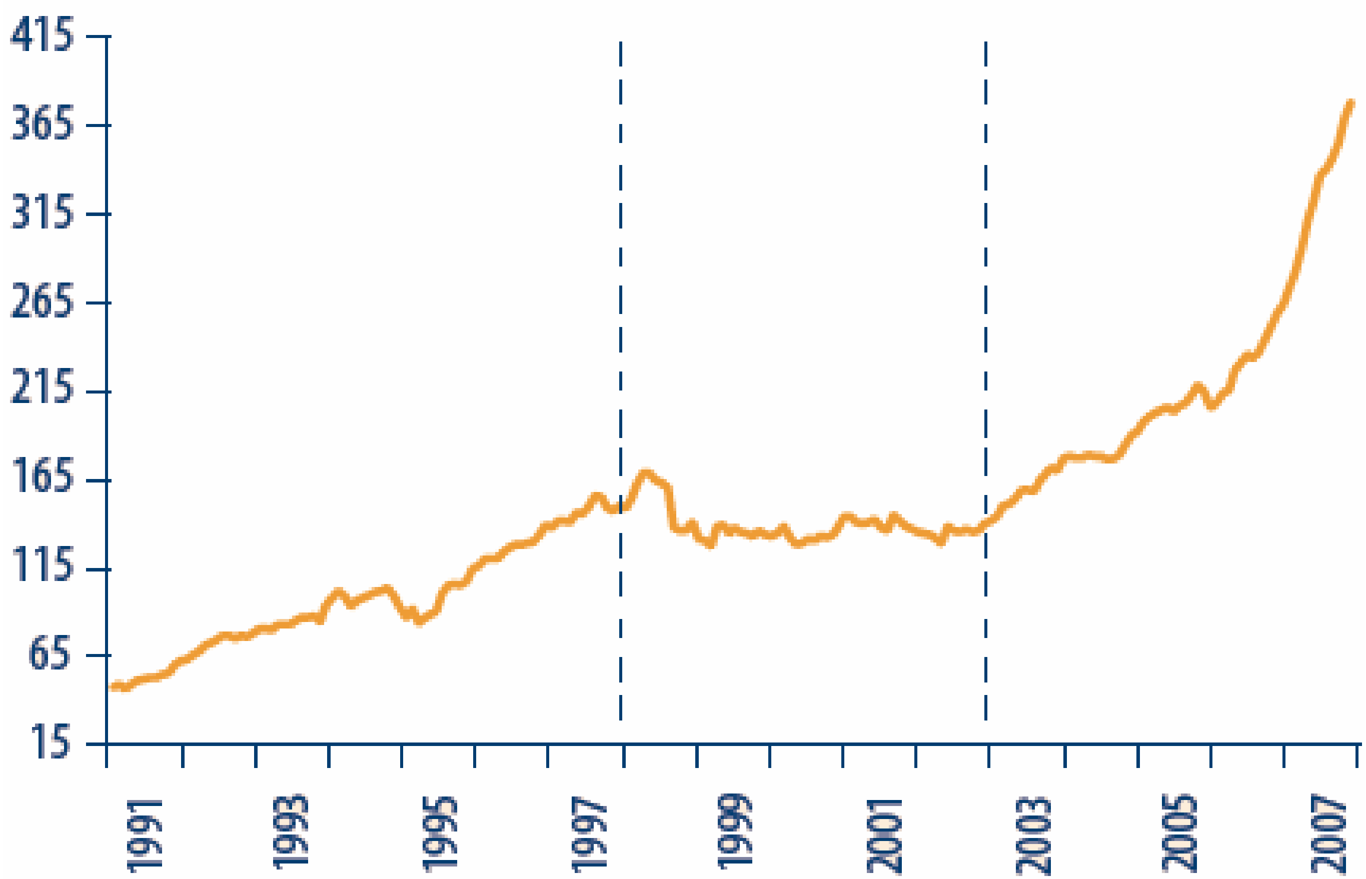
International Reserves
(Billions of US Dollars)



Source: World Development Indicators, World Bank (2008).

International Reserves in Latin America
(Billions of US Dollars)



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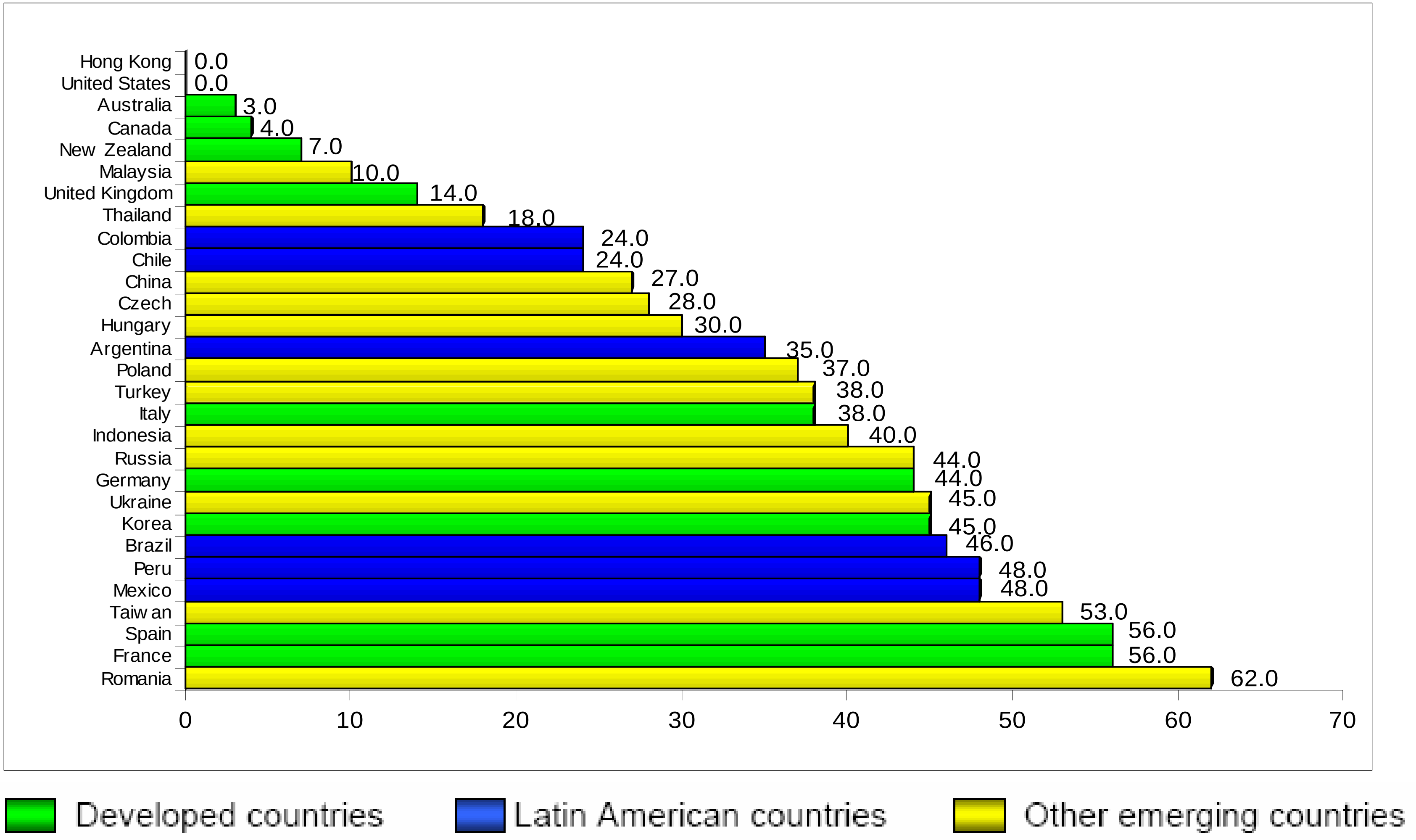
Source: IADB (2008). "All That Glitters May Not Be Gold: Assessing Latin America's Recent Macroeconomic Performance".

But there are also some weak points.

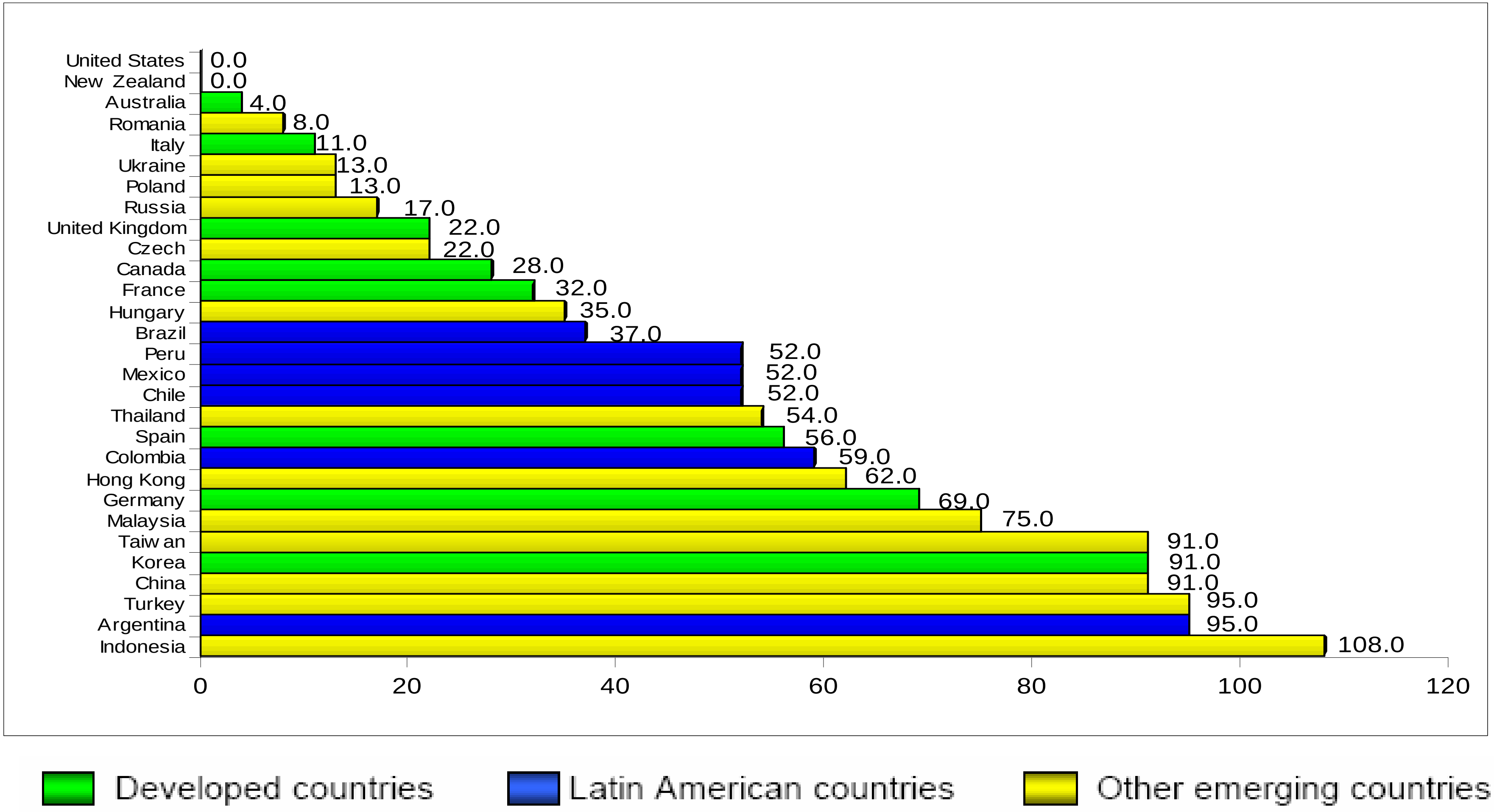
- With the exception of Chile, the improvements in the fiscal balances and the current accounts are not as great when adjusted for the cycle (IDB, 2008).
- Low flexibility of labor markets.
- Bankruptcy procedures are slow and costly.
- Exports are heavily concentrated on primary commodities.

Employment Rigidiy index
(0-100)



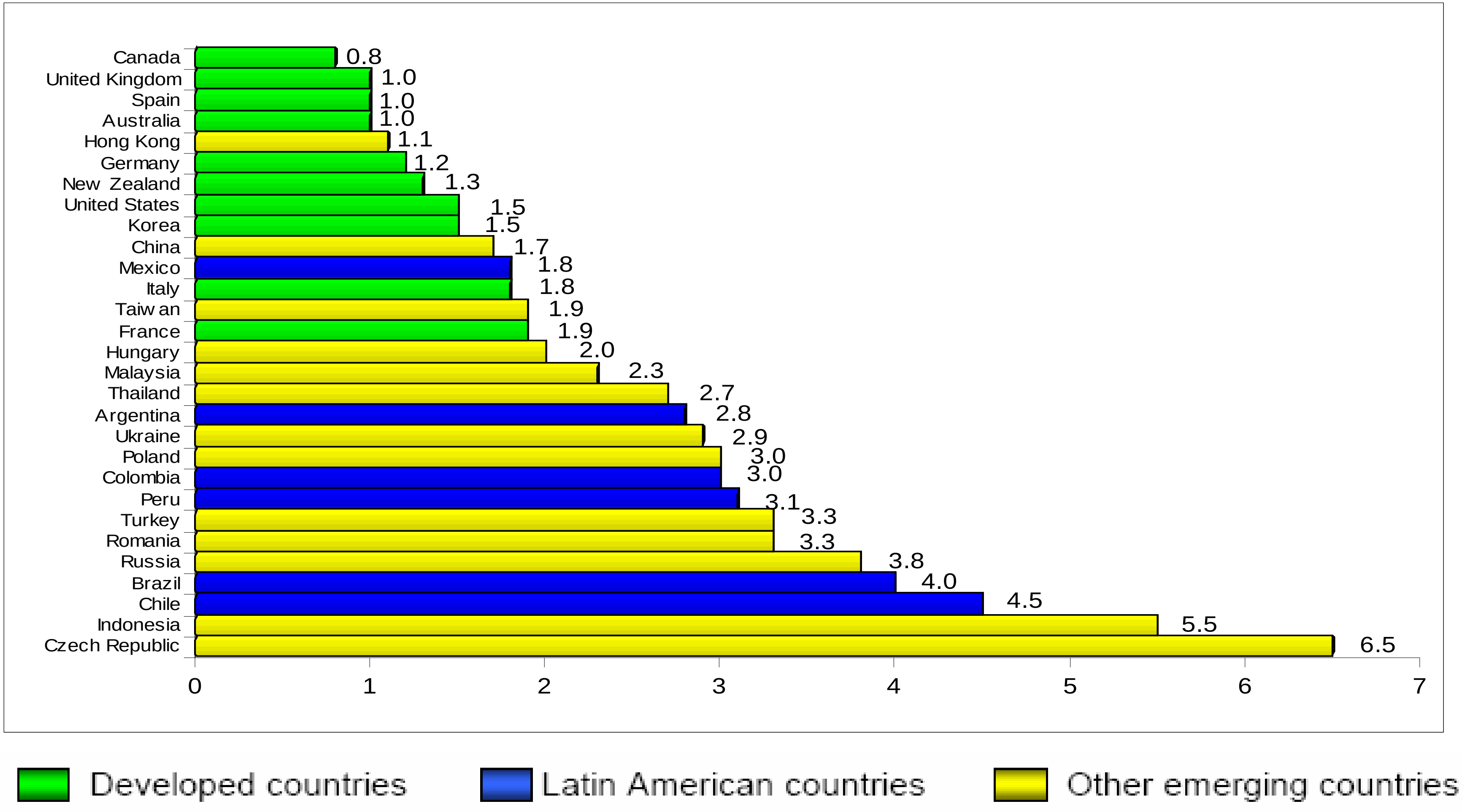
Source: Doing Business 2009.

Firing cost
(weeks of salary)



Source: Doing Business 2009, World Bank (2008).

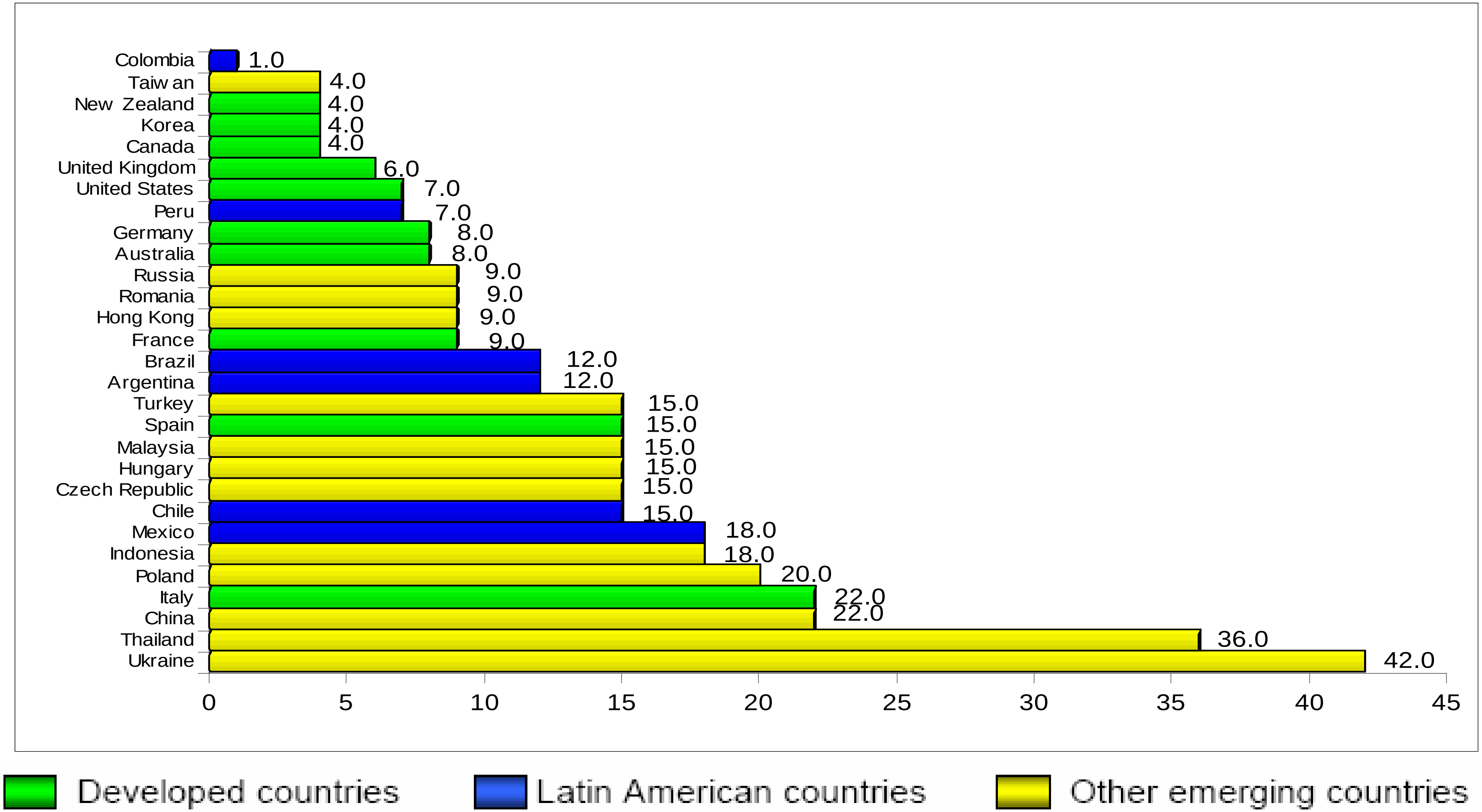
Time to go through insolvency
(years)



Source: Doing Business 2008, World Bank (2008).

Cost of insolvency

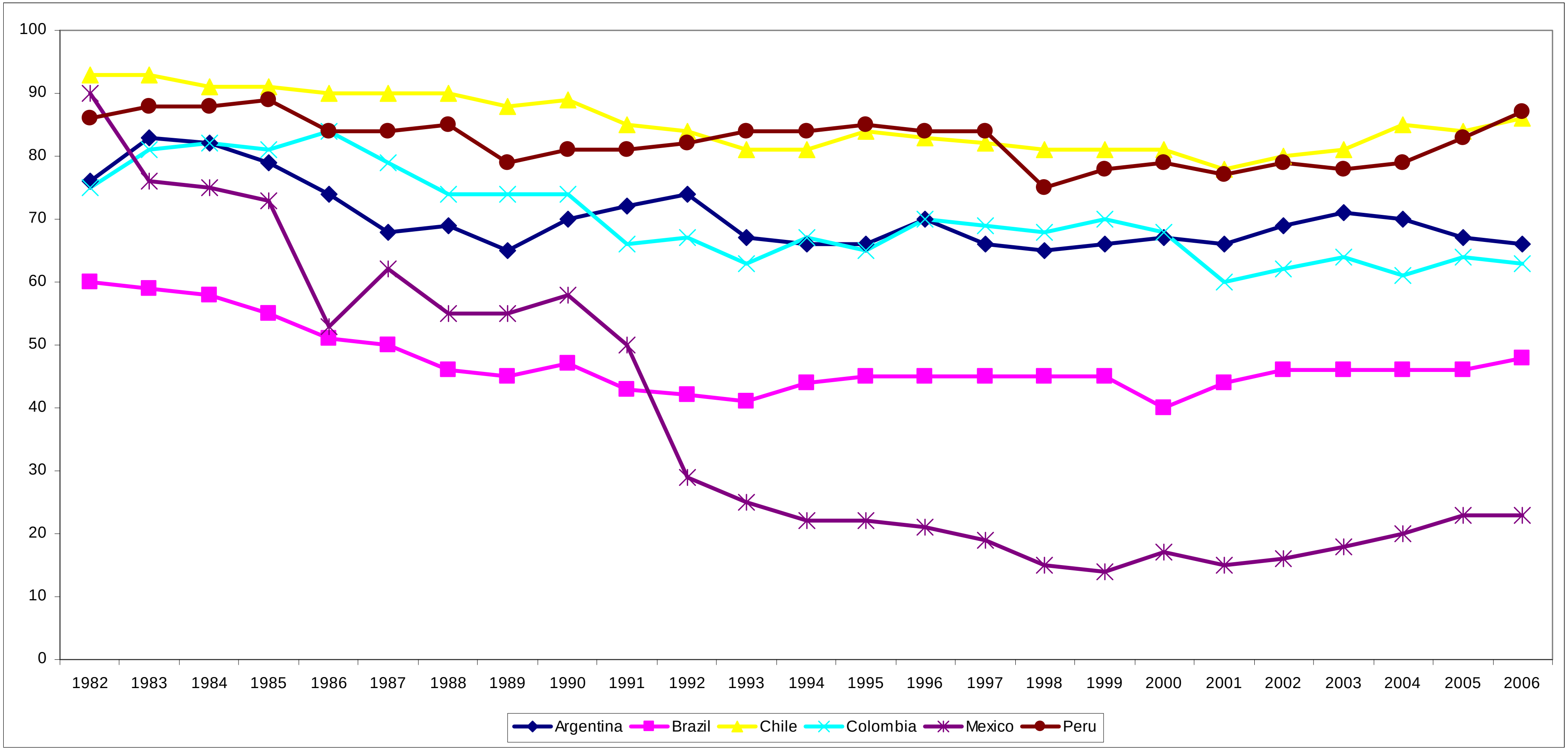
(% of estate)



Source: Doing Business 2008, World Bank (2008).

Primary Commodity Exports

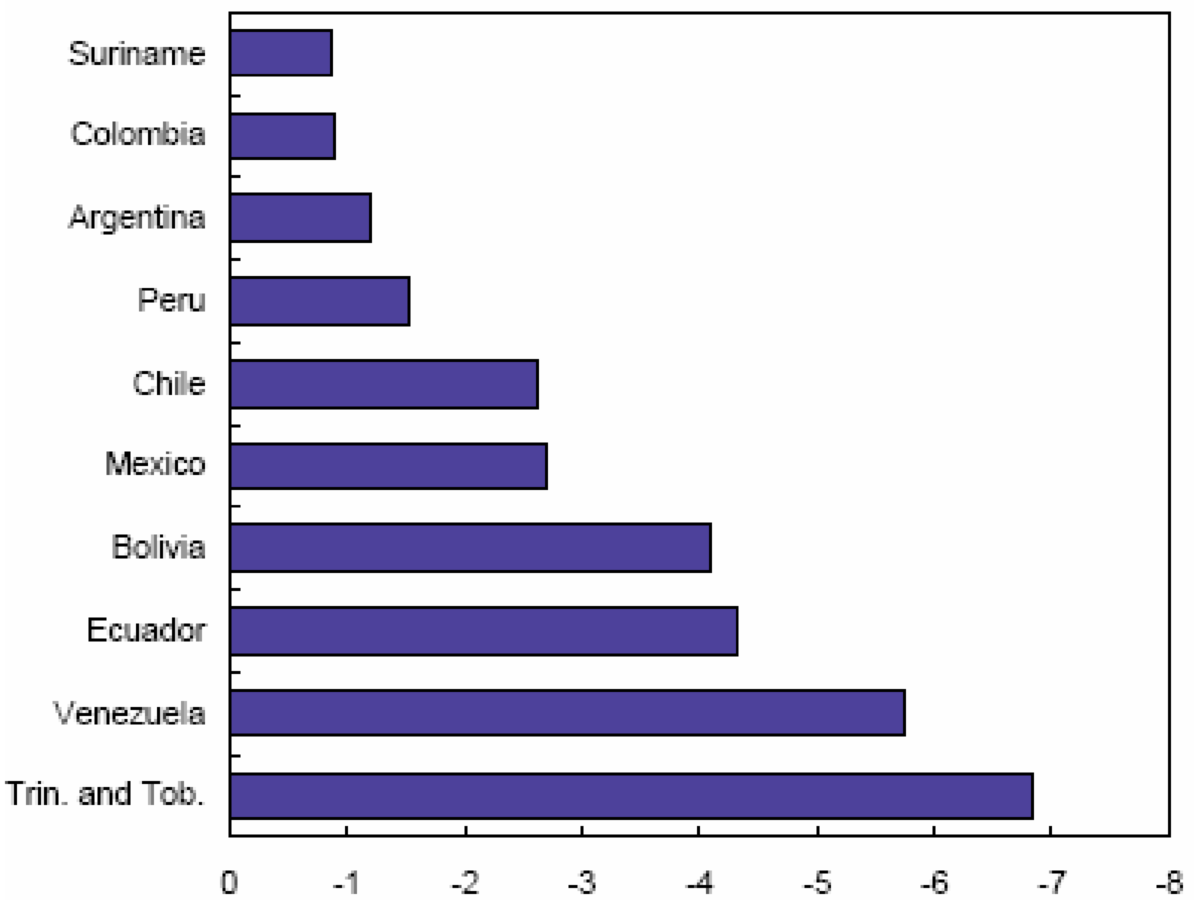
(% of total exports)



Note: Primary commodities exports are agricultural raw materials, food, fuel, ores and metals exports.

Source: World Development Indicators, World Bank (2008).

But Fiscal Revenues are very sensitive to Commodity Prices (% of 2008 GDP)



Note: Impact on fiscal revenue of a 35 percent decline in commodity prices. Results for the 9 countries with public commodity revenue above 2 percent of GDP.

Source: IMF (2008). Regional Economic Outlook: Western Hemisphere -- October, 2008.

But the region is not immune

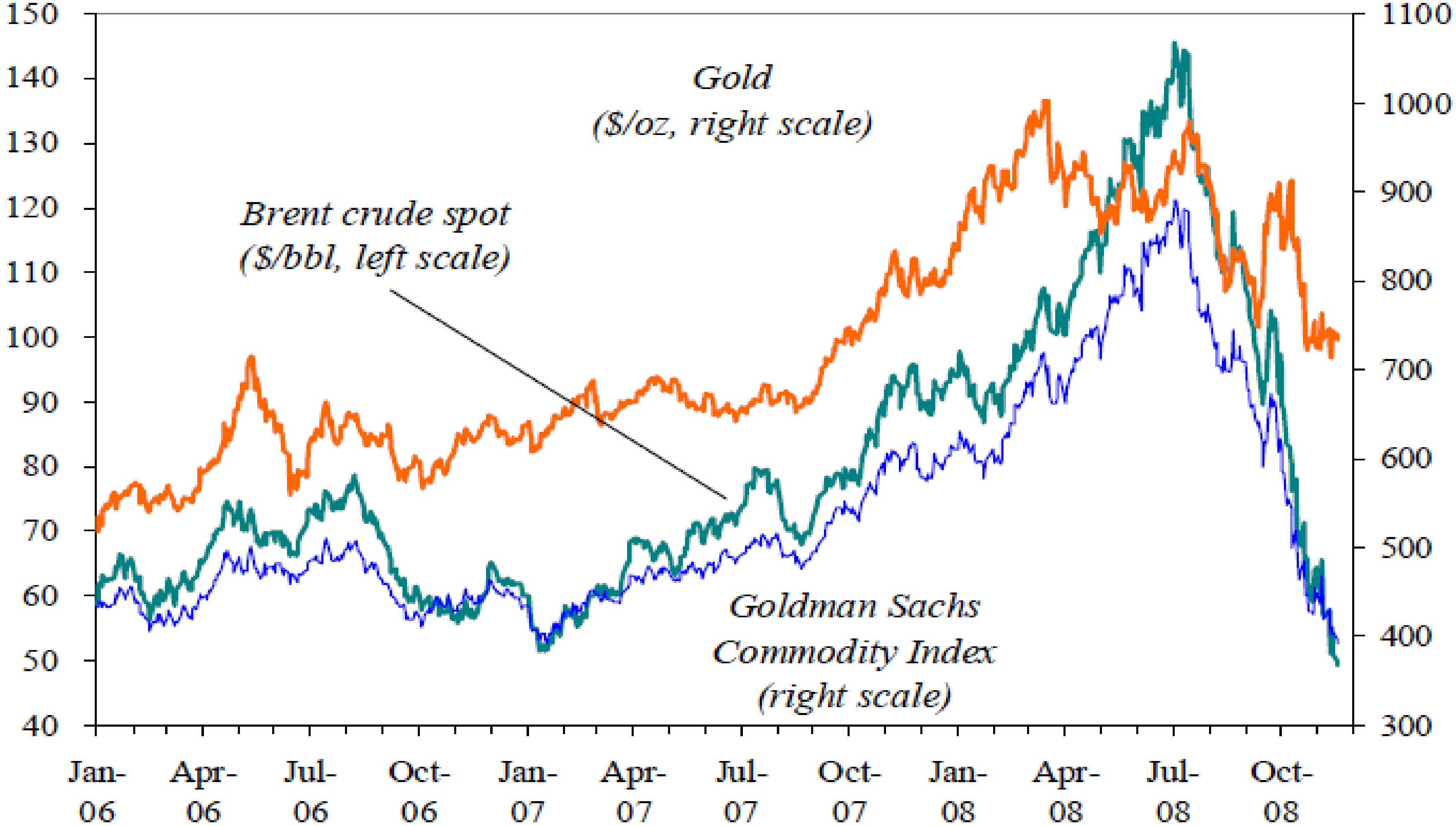
- ✓ But although the region is better prepared to deal with the consequences of the crisis than in previous occasions, still is not immune.
- ✓ Furthermore, some countries are much better prepared than others.
- ✓ As a result, it is not surprising that the effects of the crisis have been different across countries.

3. The Actual Impact of the Financial Crisis

Financial Crisis

- ✓ The international financial crisis is affecting all Emerging and Developing countries through several channels:
  - ✓ A sharp reduction in the price of primary commodities;
  - ✓ Large declines in their equity markets;
  - ✓ Plunges of local currencies against the dollar, along with higher levels of currency volatility;
  - ✓ Higher external borrowing costs for both governments and corporations;
  - ✓ Raising local borrowing costs.
- ✓ Latin America has been affected also, especially Argentina.

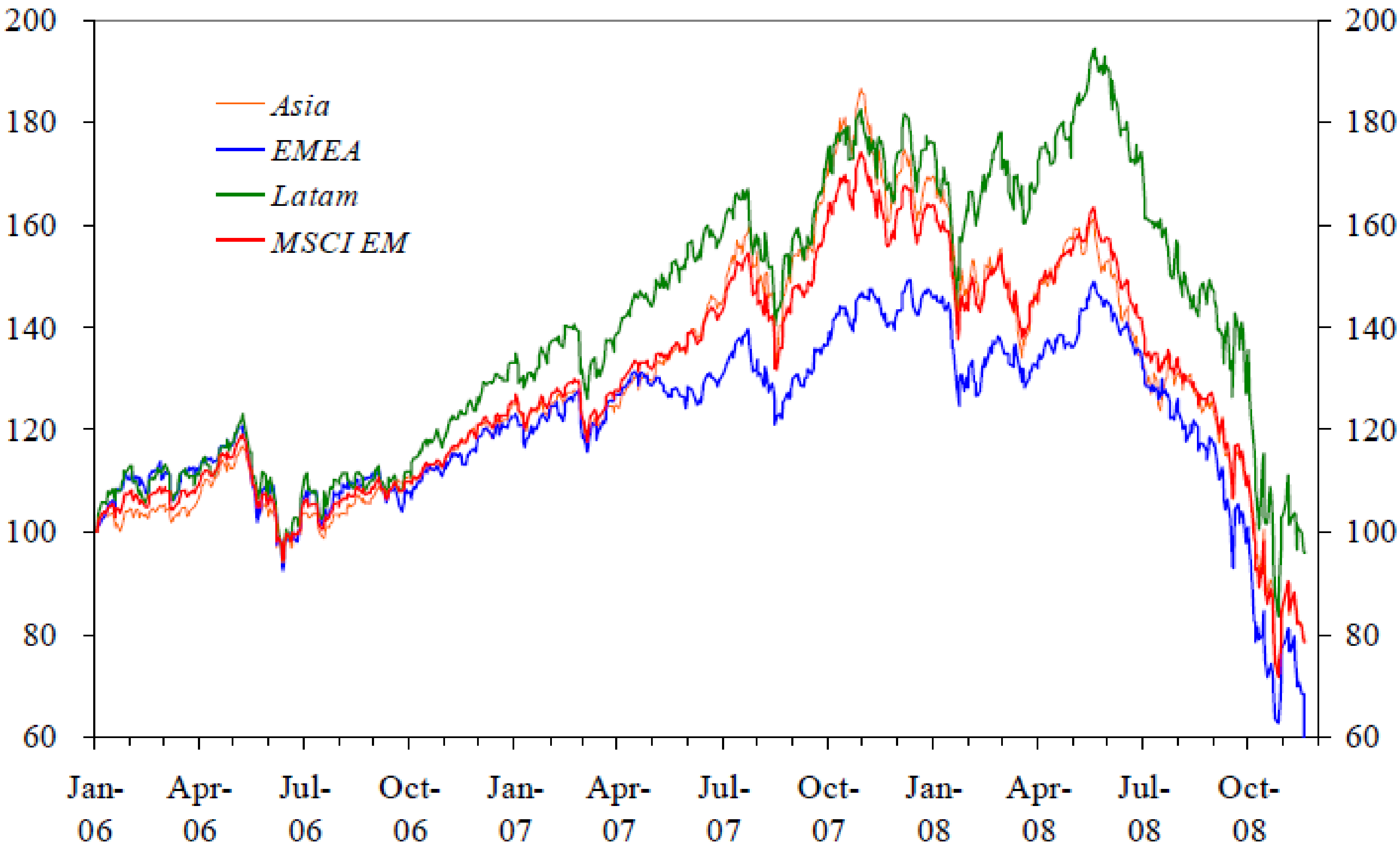
Commodity Prices



Source: Bloomberg, Nov 18, 2008

Equity Markets

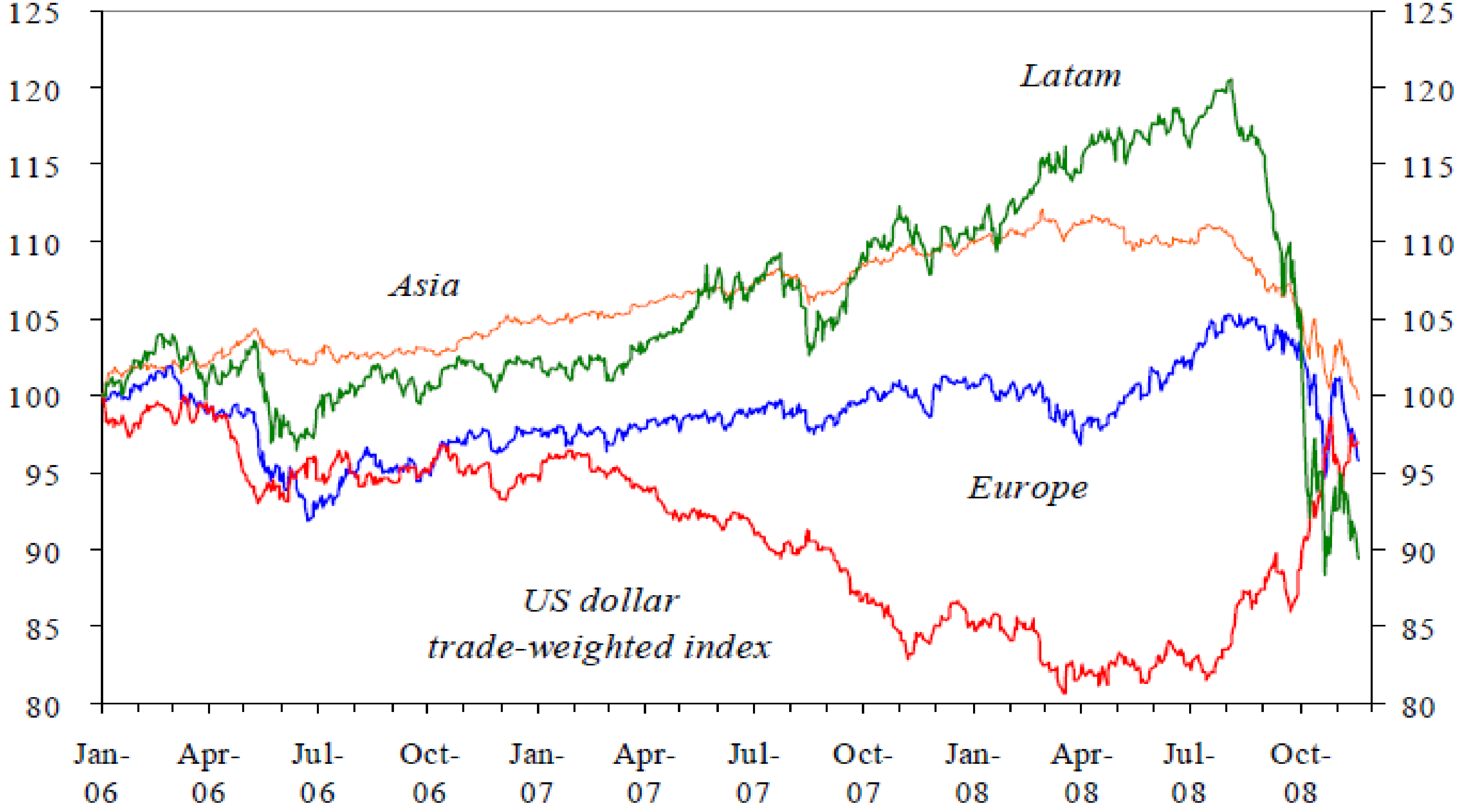
(US dollar values, index January 2006=100)



Source: Bloomberg, Nov 18, 2008

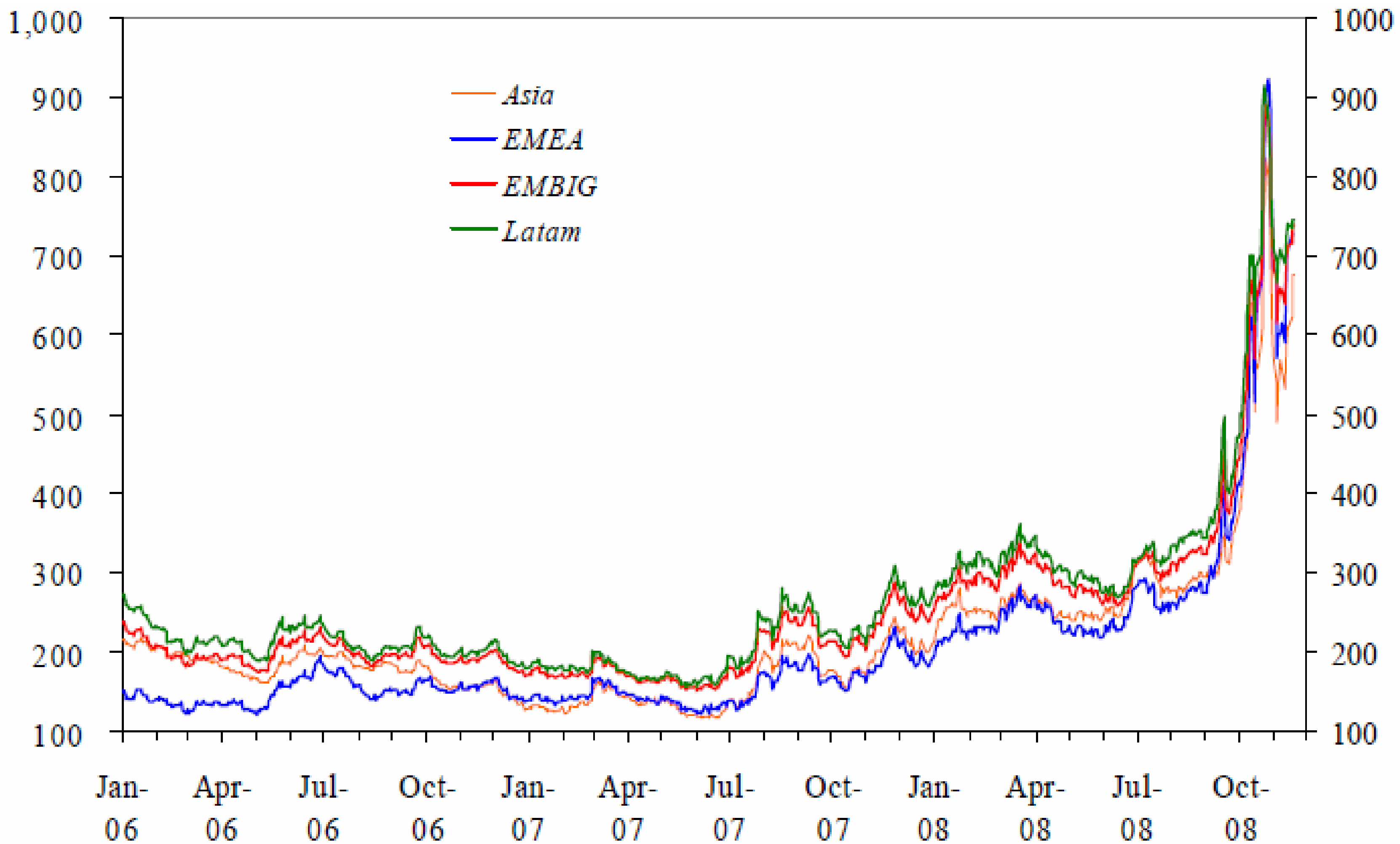
Currency Markets

(Dollar per unit of local currency, index January 2006=100)



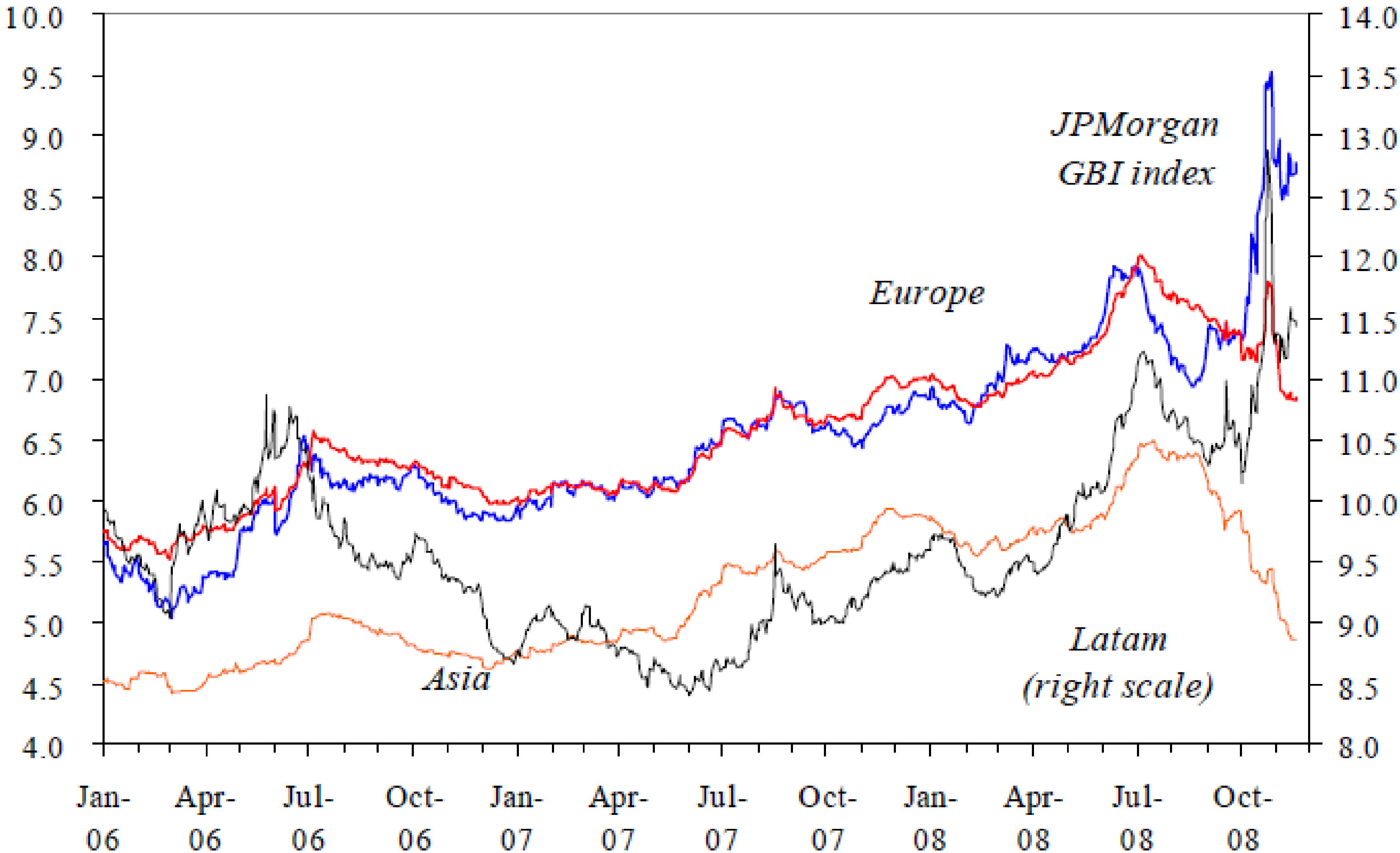
Source: Bloomberg, Nov 18, 2008

External Public Debt Spreads
(basis points over treasuries)



Source: Bloomberg, Nov 18, 2008

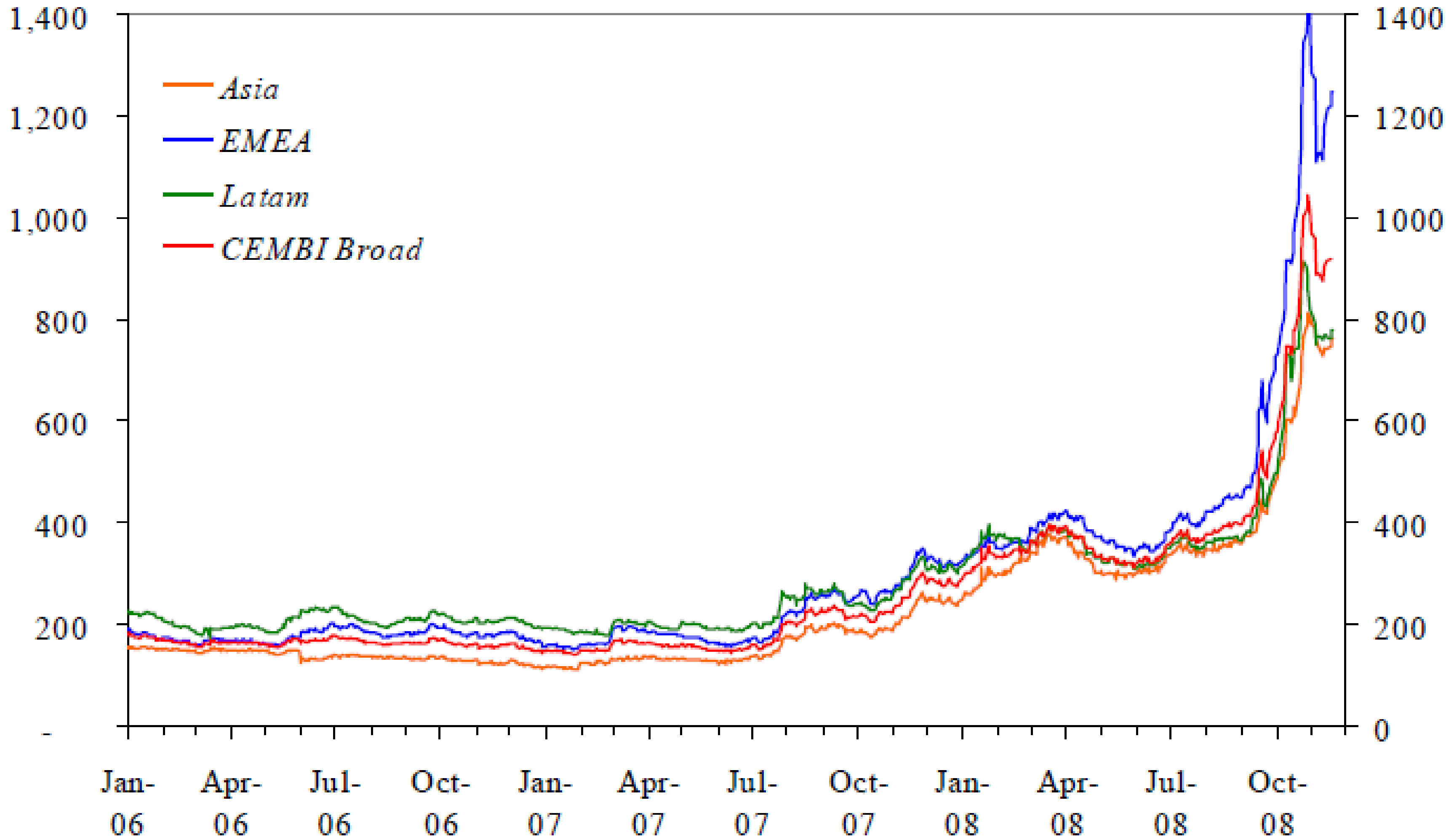
Local Debt Market Yields
(%)



Source: Bloomberg, Nov 18, 2008

Corporate Bond Spreads

(basis points over treasuries)



Source: Bloomberg, Nov 18, 2008

Financial Indicators

Changes since 9/12/2008 - Other Emerging Markets

	Currency (% change)	CDS (bps)	Equity index (% change in local curr.)
China	0.23	125	-8.52
Czech Republic	-20.42	119	-39.80
Estonia	-12.71	323	-43.27
Hungary	-28.54	284	-40.59
Korea	-30.59	262	-29.89
Latvia	-13.51	557	-32.34
Malaysia	-4.34	147	-15.42
Poland	-29.67	164	-34.50
South Africa	-28.14	313	-28.32
Turkey	-33.86	257	-36.56

Source: Bloomberg, Nov 18, 2008

Financial Indicators

Changes since 9/12/2008 - Latin America

	Currency (% change)	CDS (bps)	Equity Index (% change in local curr.)
Argentina	-7.76	2989	-42.66
Brazil	-30.66	215	-34.92
Chile	-22.31	163	-11.67
Colombia	-13.48	183	-27.90
Mexico	-24.04	227	-25.61
Peru	-4.32	210	-40.22

Source: Bloomberg, Nov 18, 2008.

Is there room for a Policy Response?

- In countries with a more flexible exchange rate regime part of the response is automatic, a substantial depreciation of the local currency.
  - Commodity exporters have had a large depreciation.
  - Some countries have limited the depreciation of their currency selling foreign reserves.
- Countries that have a more consolidated monetary framework and robust public finance adjusted for the cycle will have room too for countercyclical macro policies.

4. Concluding Remarks.

Concluding remarks

- ✓ The global economy is in the middle of a severe slowdown at the same time that the world is experiencing the worst financial crisis since the Great Depression.
- ✓ Every region of the world will be affected.
- ✓ This time around Latin America is much better prepared to deal with this type of shock.
- ✓ However, its growth is going to be reduced substantially in 2009 and part of 2010.

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