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Latinwatch

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Exceptionally active demand-side policies have been unable to prevent the impact of the crisis

Fundamentals are increasingly important and Latin America will benefit from it

The growing economic links between Asia and Latin America represent an excellent opportunity for the region

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1. Editorial

As the recession takes hold and we look for signs of an upturn, it has been suggested that emerging countries could help pull the world towards global recovery and replace the indebted American consumer as the driving force for growth. Our impression is that this optimistic view is still premature, not so much because domestic demand in the emerging world is not significant (particularly in China), but because the elasticity of its imports is still limited, except in the case of some commodities (particularly those related to investment in infrastructure). In other words, Latin America, together with other commodity exporters, should benefit more than the developed world from the relatively strong performance of domestic demand in the emerging world, particularly in China and to a lesser extent India.

In more general terms, as explained in the chapter “Latin America and China: so far and yet so near”, there is a high level of complementarity between Asian economies and those in Latin America, and this will be key for an early recovery of Latin America. In terms of what is happening now, this link has been reflected in the unexpected recovery of commodity prices, which have provided a significant financial respite to Latin American economies, particularly those that have the biggest difficulties in accessing external credit.

In addition, the current crisis has shown that emerging economies in general, and those in Latin America in particular, are reducing their sensitivity to external factors. It can thus be seen that the fundamentals play an increasingly important role in the emerging world. For this reason, the region has a sounder basis for emerging from the crisis this time around.

Despite a possible greater boost from Asia, as explained in the chapter “The current situation and perspectives for Latin America”, the impact of the global crisis on consumer and corporate confidence in the region has been so big that it has led to a much greater contraction in domestic demand than we initially expected. Today nearly all the countries in Latin America are experiencing falls in their levels of activity compared with last year, together with a strong reduction in inflation. On a more positive note, however, we see a combination of greater exchange rate flexibility, swift reaction by monetary authorities and room for maneuver to preserve or expand public spending plans. This means we can be confident that the contraction will be limited, both in depth and length.

Our forecasts show that the region will start its recovery in the second half of the year, as anticipated by the improvements in asset prices and the recovery of confidence indicators. Thus Latin America should return to the path of growth in 2010. Although progress will be slow at first, it will gain force as the developed countries start their own recoveries.

2. The international background

Following a difficult start to the year, with extreme financial turbulence and sharp declines in activity, tensions have begun to ease in the second quarter.

Since the beginning of the year, the global environment has been characterized by high levels of tension in the financial markets, even though several indicators have shown considerable improvement over the last month. Thus in May, U.S. bank CDSs were at their lowest levels since the collapse of Lehman Brothers, while European CDSs, which have remained below their American equivalents, fell to their lowest point since November 2008. There have also been significant corrections on the interbank markets, with the 3-month OIS spread in the U.S. and the EMU reaching its lowest point since early 2008.

In the first months of the year, these high rates of risk aversion were basically caused by the contraction of the global economy. Data for 1Q09 show a sharp drop in activity in the U.S. (a quarterly fall of 1.6%), with a very similar rate of decline to that in 4Q08. In Europe, the indicators maintained an extraordinarily negative tone, with a quarterly GDP drop of 2.5% in 1Q09, even higher than the 1.6% fall in 4Q08. However, the general tone of the economic activity indicators in April and May is less negative. This means that the rate of contraction in activity may be slowing, but growth will still be negative in the short term. The markets reacted very positively to this likely turning point, but because of the uncertainty surrounding the duration of the crisis, the foundations for this change may be vulnerable.

New public measures to stabilize the situation

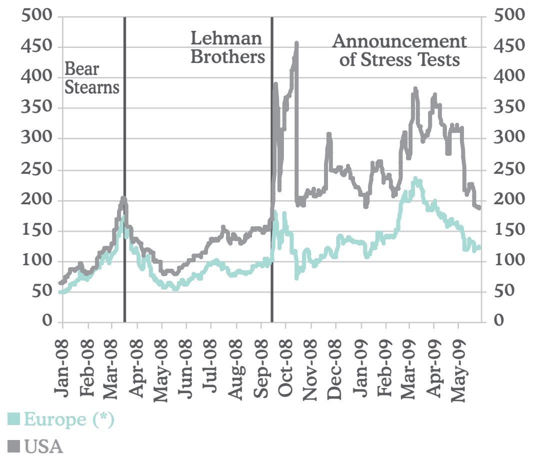
Against this background, governments have increased the range of measures used to tackle the global financial crisis. The U.S. remains the economy that has made most progress in adopting policies of this kind, with a new package of measures aimed at stabilizing the financial system. A key element of this program were the stress tests carried out on the balance sheets of the biggest banking institutions to reveal the system's capital requirements. As a result, 10 of the 19 largest American financial institutions have to raise $75 billion of additional capital within 6 months. These results were well received by the market and were largely responsible for the recent reduction in financial pressure. The second core element is the Public-Private Investment Program, which seeks to attract private investors to buy toxic assets from banks through funds whose capital will come jointly from the private and public sectors, with a highly significant level of leveraging. Finally, the Obama administration has implemented a plan to help access to housing. It makes refinancing mortgages easier and introduces subsidies for those financial institutions that change their mortgage terms for families facing default risk. Our assessment of the stabilization strategy for the banking sector is positive, even though the implementation of the approved plans appears extremely complex. Their impact could also be limited unless all the elements are properly coordinated.

The Federal Reserve has also played a crucial role in the financial stabilization process. It is now tackling deflationary risk, mainly through asset acquisition. This involves a program to purchase $1,250 billion in mortgage bonds, and up to $300 billion in public

Indicator of Financial Tension

Source: Economic Research Department BBVA
The first standardized principal component of OIS spread, implicit stock market volatility and bank, corporate and sovereign CDS (in the case of Europe).

Banks: Risk premium (5-year CDS)
(pb)



Source: Bloomberg
* Banks included: Barclays, RBS, Lloyds, HSBC, Alliance & Bingley, Standard Chartered, Allied Irish Bank, BNP, Deutsche Bank, ING, Unicredito, UBS, Credit Suisse, Crédit Agricole, Société Générale, Intesa, BBVA, Santander

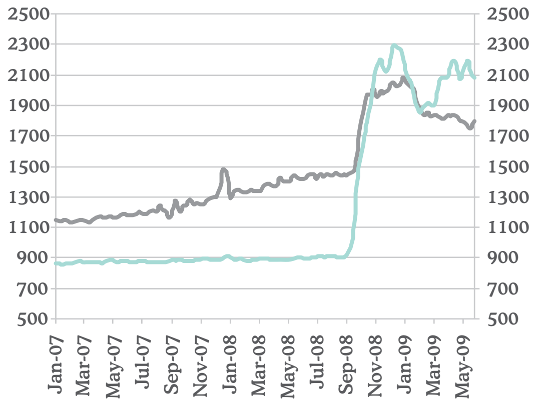
Interbank markets: 3-month OIS spread
(3M LIBOR - 3M OIS)

Source: Bloomberg

Interest rate for an average 30-year mortgage in the U.S.

Source: Bloomberg

Central Banks: Total Assets



■ Fed (Bn $)
■ ECB (Bn €)

Source: Datastream

debt. The Federal Reserve also plans to participate actively in funding the Public-Private Investment Program through the Term Asset-Backed Securities Loan Facility (TALF) program, which could reach around $1,000 billion.

In Europe, the financial stabilization efforts have mainly been implemented at a national level, with very different initiatives in each country. Germany and Ireland, for example, are putting the final touches to a “bad bank” that will buy other banks’ most toxic assets. Meanwhile, the European Central Bank (ECB) has continued to lower interest rates, which stood at 1% when this report was written. The ECB has decided to continue with its weekly liquidity auctions through the fixed-rate full-allotment system for as long as necessary, and certainly beyond 2009. The maturities on ECB loans have also been extended to 12 months. Apart from this, in May it announced the purchase of ¸60 billion of covered bank bonds, although details of this plan are not yet known.

These measures are justified, as in the short term the main risk is that the persistence of a very weak economic situation results in negative inflation rates being maintained for too long. In addition, although the balance sheets of the central banks continue expanding strongly, especially when it comes to the Federal Reserve, central banks should not have any difficulties in draining liquidity quickly when the time comes, as the Bank of Japan did at the end of its non-conventional monetary policy program.

Despite stabilization and the measures taken so far, recovery continues to be uncertain

Attention in coming months will be focused on two questions: first, the effectiveness of the policies aimed at restructuring the financial systems; and second, the fiscal policies designed to boost demand. Their success will depend to a great extent on the answers to three questions: When will the recovery begin? How fast will the recovery be? and Which economies will prove most dynamic?

Despite the fact that the measures taken are having a favorable impact on the economy, the foundations for a possible recovery in 2010 are still uncertain. Recent data seem to suggest that the recession has bottomed out, so falls in GDP can be expected to be less sharp in the next few quarters. However, our perception is that if the recession does end in 2010, growth rates will still be very moderate and below their potential. Besides, Europe will probably emerge from the crisis later, given the slow pace at which both financial stability and monetary policy measures have been adopted. These uncertainties will oblige central banks to keep official rates low for an extended period of time.

Emerging countries feel the effects of the global situation, but are also receiving significant support

Financial indicators were very favorable last month, following a sharp deterioration in the last quarter of last year and the first quarter of this. There has been a significant adjustment in sovereign risk spreads, depreciatory pressures on currencies have reversed, and even inflows in emerging countries have returned to positive territory, leading to significant upturns in stock exchange indices.

There is no doubt that one of the factors contributing to these changes has been moderation in global risk aversion. But at least two additional factors should also be mentioned. First, the support given by the G20 summit to emerging markets through the increase in resources made available to the IMF. This was complemented by the creation of a new IMF credit line that can be used by economies that have solid fundamentals, but that might be experiencing temporary funding problems. This instrument is designed to prevent, rather than bring to an end, a possible crisis in emerging markets. The success of this new formula has already been confirmed by applications from countries such as Mexico, Poland and Colombia, and by the positive reaction from the markets. Finally, but no less important, are the measures adopted on the domestic front to cushion the impact of the crisis. To a varying degree, we can see that a large number of emerging economies have adopted demand-side fiscal and monetary policies whose impact on activity will be felt during the second half of the year, and in some economies as early as 2Q09. China is clearly the most noteworthy example from within the emerging world, following the approval of a substantial fiscal stimulus package (16% of GDP over two years) and its exceptional relaxation of monetary conditions, which has encouraged a reactivation of credit to the private sector. Latin America is also noteworthy, since for the first time during this crisis it has found itself with the leeway needed to apply countercyclical policies.

Nevertheless, the impact of the crisis on activity in emerging economies has been significant. GDP adjustment in 4Q08 was extremely swift. This was basically a result of the collapse of international trade, which led to a downward adjustment of forecasts in the first months of the year. In this respect, it is important to emphasize the high degree of heterogeneity within the emerging world. The well-known vulnerabilities of emerging Europe – substantial fiscal and external imbalances, strong credit growth accompanied by high currency mismatch, and extreme dependence on external financing - will bring about very intense adjustments. Thus the region's GDP is expected to fall around 6%, with some economies falling up to twice this figure. This represents an element of risk for western European economies. Overall, it is expected that emerging markets, led by Asia and with very moderate GDP drops in Latin America, will grow at higher rates than the developed economies in coming years.

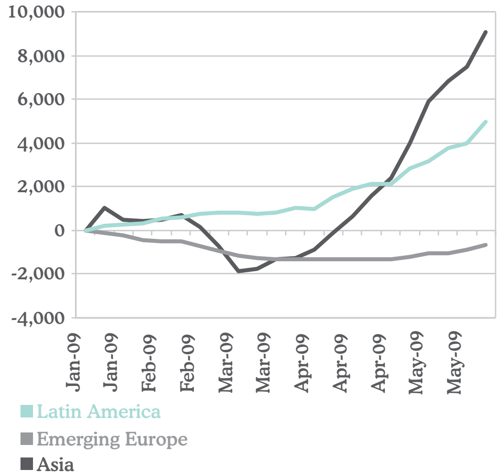
Despite weak global demand, commodity prices rose above their historical averages in the first quarter of 2009. More recently, commodity prices showed a considerable upturn due to significant cuts in output and the perception in the financial markets that the worst of the crisis may be behind us. Recent supply cuts and the prospects of an appreciation in the dollar should limit the current upward trend in commodities, but prices should continue to support Latin American countries.

EMBI spreads

Source: Datastream and JP Morgan

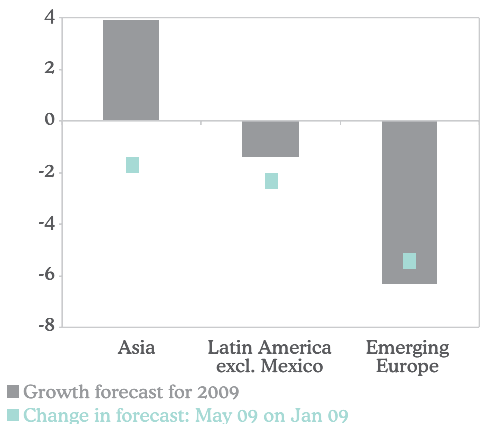
2009: Net equity inflows

(aggregate, $bn)



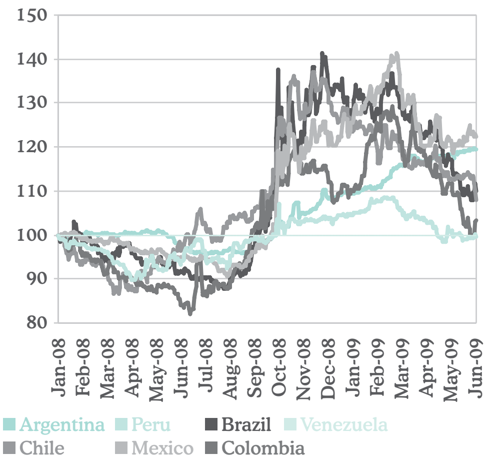
Sources: BBVA and EPFR

Emerging economies: growth forecast for 2009 and change in forecast since January



Source: EBRD and BBVA

Exchange rate against USD



Source: Bloomberg

3. The current situation and perspectives for Latin America

The global crisis is much deeper than anticipated

In our last Financial System Latin Watch (FSLW) published in March, we forecasted that the region would suffer less than has been the case in other similar situations, and that most of the countries in the region would weather the storm without falling into recession. In fact, only Argentina and Mexico have posted negative growth rates so far in 2009. Nevertheless, the crisis has struck harder than anticipated and all the countries will experience moderate GDP falls in 2009, with Peru the only exception with a positive growth rate this year. Despite this, we still believe that the current adjustment will be milder and less prolonged than in previous periods of external crises. This is particularly important given the extent of the slump in the world economy, and international trade in particular.

The external shockwave reached the region after the fall in commodity prices at the end of last year had affected both private and public sector income badly. Economies that were vulnerable because of their dependence on this income were plunged into severe financial trouble, as at the same time they faced restricted access to finance abroad.

At the end of last year there were also clear signs of the difficulty in finding finance abroad, including credit for foreign trade. But as we explained in the March FSLW, the combination of bigger and more solvent local financial markets, combined with decisive action by governments and central banks to provide liquidity, particularly in foreign currency, has allowed this problem to be overcome quickly. The situation has returned to normal, although with higher costs than those before the Lehman Brothers incident.

The surprise has been the extremely negative reaction of domestic demand

What is really surprising and worth highlighting in the current situation has been the extremely negative reaction of domestic demand to the events at the end of last year. As information emerged on what was happening, there was a marked fall in consumer and corporate confidence levels. They adopted defensive positions against a crisis whose size and duration was uncertain. Consumers reacted drastically to the new information. They adjusted their spending plans quickly and profoundly and limited their debt. This resulted in abrupt falls in car sales (of around 50% compared with the same period the previous year), as well as in other durables and even housing.

Companies for their part acted to preserve liquidity at times when access to short-term credit was much more difficult and no early return to normality could be seen. The reaction to this uncertainty was to reduce spending sharply to lessen financial vulnerability. Although inventory statistics are not very reliable, there is a great deal of isolated evidence, together with the aggregate estimates of national accounts in a number of countries (for example, Chile and Peru) showing that significant inventory reductions were initiated at the start of the crisis. These reflect precautionary adjustments in output, particularly manufacturing output, which were over and above the sharp falls in demand.

The evidence from credit markets reveals significant adjustments in these markets, both at corporate and consumer level. But it is difficult to identify how much of this is due to a preventive reduction in demand or to more restrictive credit supply conditions. Surveys of credit conditions carried out in many countries show that banks have adopted a more cautious attitude when granting loans, in response to expected increases in default rates because of the recession. However, this has coincided with a lower demand for credit, so it is difficult to assess whether the decision of companies to protect their liquidity was justified.

As a result of the collapse of expectations, we can see that falls in marginal GDP (on the previous quarter) for the region as a whole (Argentina, Brazil, Chile, Colombia, Peru and Venezuela) have been in line with those of domestic demand.

The unexpected shock to confidence and a globally more negative outlook at the end of last year have led us to revise our view of the impact of the crisis on the region. Today it is fairly clear that, with the possible exception of Peru, practically all the countries in the region will experience a fall in GDP in 2009. We also now calculate that the recovery will be slower than we anticipated, because foreign demand will continue to be unfavorable for a longer period.

If we examine the traditional determinants of domestic demand, it is clear that expectations had a strong impact on the adjustment noted at the start of the year. Although there was a fall in income as a result of lower export prices, those impacted most have been governments and foreign companies rather than local consumers, who were only slightly affected. Employment slowed first and in some cases even began to fall, but much less and later than consumption. In addition, the abrupt drop in inflation has increased the purchasing power of wages, which should compensate for the fall in employment.

Although interest rates have increased, this cannot explain a 50% fall on last year in sales of durable goods such as automobiles or homes.

In the case of corporate investment, what we see is a combination of falling confidence in the future, with strong falls in the prices of exportable goods, increases in the costs of imported supplies and capital goods, more expensive credit and falling sales of both goods for export and those on the domestic market. This particularly affects durable goods and supplies for the most affected activities (real estate, mining, etc.). All this has led to inventory adjustments, a fall in output and postponement or cancellation of investment. It is clear is that if expectations do not change favorably, private investment is unlikely to show an improvement.

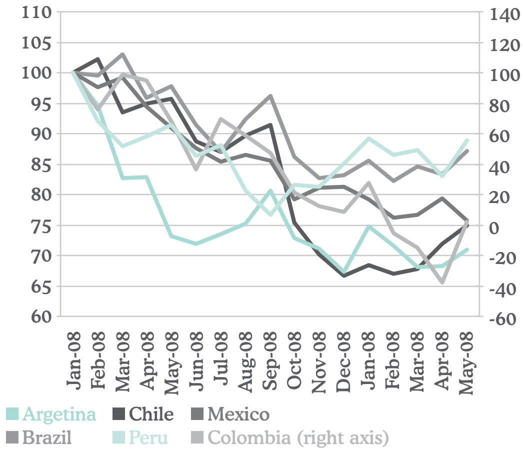
Inflation falls more rapidly than expected and central banks are able to lower interest rates aggressively

A side-effect of the steep fall in domestic demand has been the rapid reduction in inflation in all those countries with monetary policies based on inflation targets. All of them had applied policies to tighten liquidity. They had raised official interest rates in the first half of 2008 as a way of countering inflationary pressures derived from increases in oil and food prices, which had been boosted by the major expansion in consumption and investment that occurred throughout the region at the time.

The downturn in commodity prices, particularly oil, which fell to less than a third of its high point in the cycle in only a few weeks, together

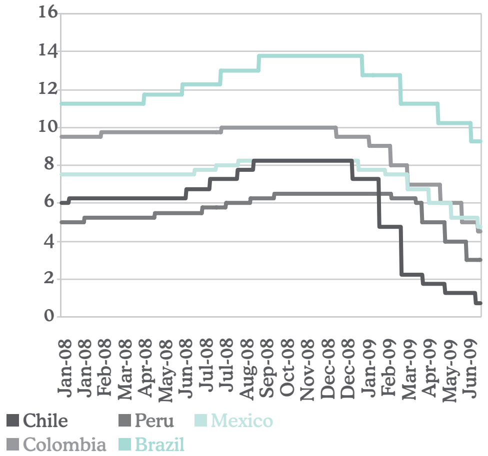
Consumer Confidence indicators

(January 2008=100)



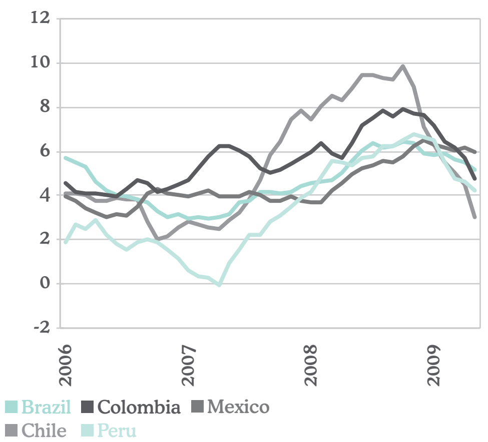
Source: Bloomberg

Interest rates (inflation targeters)



Source: Bloomberg

Annual inflation (%)



Source: Datastream

with changing expectations, rapidly altered the inflation scenario, as we anticipated in our report at the end of last year. This is despite the violent depreciation of Latin American currencies at the end of 2008.

Although core inflation has moderated less than headline inflation, largely because it is less affected by changes in international commodity prices, both are moving in the same direction. This is particularly true in Chile, where the adjustment has been much sharper, during both the upturn and downturn period. All this has led to expectations of future inflation approaching the central bank targets, or even moving below them.

This raises questions about the traditional pessimism with regard to inflation in South America. For decades in the region the predominant view has been that inflation has a great deal of inertia and that it is extremely difficult to lower it. This is why central banks have often resorted to setting exchange parities to anchor expectations, generally with only partial and fleeting results. Although this is a subject that is far beyond the scope of this report, it is important at least to raise one point. The rapid fall in inflation that we have seen over these months, which has also coincided with currency depreciation, at least in the initial phase, suggests that today inflationary inertia is much lower than it was in the past. Part of the explanation lies in the credibility earned by the economic authorities of the respective countries in their fight against inflation, but it is possible that there are other reasons. These countries have undertaken substantial economic reforms over recent decades, which have given a central role to market discipline in decision-making by consumers and producers, and this has possibly also had an influence. This is a subject that we will cover again in the future, once the data from the accumulated experience of this cycle has been properly processed.

The fall in inflation has had two important consequences for the future performance of these economies. First, the purchasing power of wages has increased, given that in practically all of these countries indexing wages to past inflation is very common. Second, the fall in inflation back to (or even below) central bank targets has allowed these banks to implement extremely aggressive cuts in interest rates.

The flexible reaction of monetary policy has been possible in part to two important achievements in recent years: one is that those central banks that have adopted inflation targets have won considerable prestige and credibility, thanks to the determination they have shown in meeting these targets, as well as the excellent results obtained. The other achievement is that since the Asian crisis central banks in the region have worked to create the conditions that can provide real flexibility for their exchange rates.

Exchange rate flexibility was translated into significant depreciations of the currencies in the region immediately after the Lehman Brothers episode, as a reaction to increased risk aversion and the consequent rises in risk premiums in all the countries involved. However, unlike similar episodes in the past, this did not lead to major turbulence through currency mismatch, either in the private or public sector, or in the financial system. In fact, one of the most significant changes that has taken place in the region in the last decade has been the gradual strengthening of public finances and the reduction of exposure of fiscal balance sheets to the risks of currency depreciation. Unlike what occurred historically in the Atlantic economies, today currency depreciation tends to improve the fiscal balance, thanks to the increase in international reserves and the significant reduction of government debt held in foreign currency.

The combination of clearly expansive monetary policies with increases in the purchasing power of wages should support a recovery in domestic demand in these countries. Given the normal time-lags in the region, the recovery should be in full swing towards the end of the year.

In addition, currency depreciation has given respite to exporters and others who compete with imported products, at a time when they were facing falls in international prices for their products.

At the time of writing this report, a number of central banks have suggested the end of the cycle of cuts in official interest rates (Chile, Colombia) or the start of a stage of more moderate adjustments (Brazil). This sets the stage for a relatively prolonged (about a year) period of very low official rates, both in nominal and real terms.

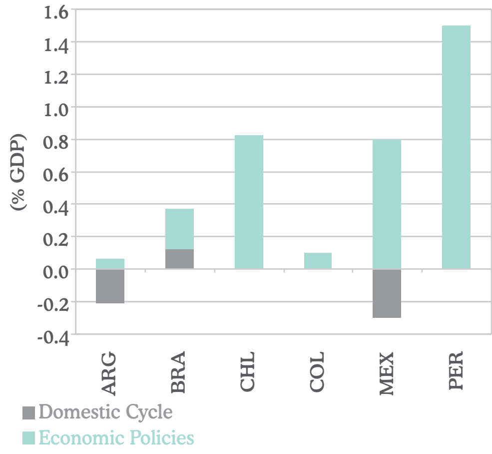
We have also seen most of the correction in exchange rates, after the collapse of the majority of the currencies towards the end of 2008. In fact, some countries such as Brazil have begun to accumulate international reserves through systematic interventions to limit the appreciation of their currencies. It would not be a surprise if Chile began to do something similar in the coming months to neutralize the effects of repatriating savings from sovereign funds to finance the fiscal deficit. In recent months a certain stability has returned, which we expect to continue in coming months. Exceptions to this are Argentina and Venezuela. In Argentina the authorities intervened forcefully to avoid a depreciation and then, after the initial nervousness had lapsed, they allowed a gradual depreciation of the peso to compensate for the loss of competitiveness with the country's regional partners. In the case of Venezuela we have seen more restricted access to the official foreign exchange market, where a fixed parity is maintained. There is also a greater inclination to tolerate an unofficial or parallel market that channels the transactions excluded from the official market.

Fiscal policy reacts with all its available force to counteract the fall in demand

The other important new aspect in public policies designed to tackle the crisis has been the reaction of fiscal policy. In our report we point out that this time the finances of most governments were in a condition to support the adverse shock caused by the fall in commodity prices and tax revenues, without having to cut back on spending plans. Subsequent events have not only proved our optimism correct, but we have also seen some countries introduce extraordinary fiscal packages, combining tax reductions with more spending on transfers and investment to stimulate domestic demand. This is nothing new in a region where automatic stabilizers of fiscal policy are practically non-existent, partly because of the acute financial restrictions traditionally faced by governments.

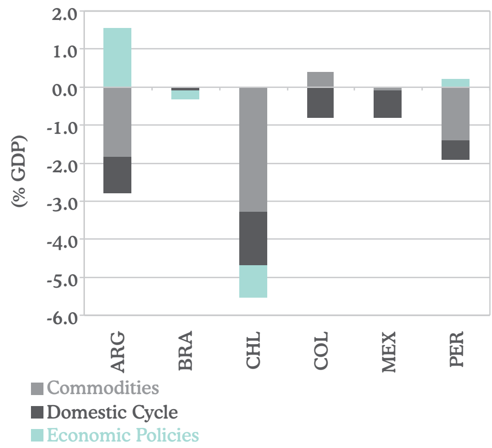
Initially, governments were concerned to guarantee the resources they needed to continue with spending plans already underway. This is why Brazil and Colombia took advantage of windows of opportunity during moments of market calm to place government bonds for $1 billion. Argentina did not have this option. It opted to transfer to the state all the resources of private pension funds to finance the servicing

Breakdown of variation in tax expenses in 2009



National sources, BBVA

Breakdown of variation in tax revenues in 2009



National sources, BBVA

Embi+ vs. Embi Latin America (pbs.)

Source: Datastream, BBVA

of the public debt and even announced a modest plan to increase public spending in 2009. Mexico took advantage of its capacity for indebtedness to boost extra spending in addition to that included in the original budget.

Chile and Peru had savings accumulated from the previous boom and a surplus in their public accounts. They announced extraordinary spending plans at the start of 2009. In Chile the plan included increases in public investment, transfers of one-off payments to the poorest families and some temporary reductions in taxes. The total amounted to nearly 2% of GDP, mainly in 2009. Peru announced a program of a similar size, based on investments in public infrastructure and development work at local level, mainly in 2009 and also in 2010. One of the doubts regarding these programs was the capacity to execute them, particularly in terms of the investments. However, the budget execution figures for the first months of the year indicate that spending, particularly investment, is growing at double-digit rates, thus dissipating these fears.

A consequence of all this is that the fiscal balances have deteriorated strongly in 2009. All the countries have budget deficits, but this does not threaten the solvency of their public finances, as is explained in the corresponding box.

Another important point in this crisis compared with previous ones is that the governments have been able to use local markets to finance part of their deficits. This has been possible thanks to the significant development of capital markets, particularly in those countries where the social security insurance system was privatized.

Various countries in the region have unconditional credit lines approved with the IMF, with other multilateral bodies and even with the Federal Reserve, either to support their reserves or to finance more public spending. But in practice they have not used these resources and are reserving them for a later date. In fact, in most cases we expect a reduction in external public debt in 2009.

The situation appears to be stabilizing

Although the situation varies between countries, there are a number of indications that economic activity in most of the economies of South America stopped falling at some point in the first half of the year and could begin to reactivate in coming months.

Some elements linked to the external environment have improved clearly in recent months, above all the recovery in commodity prices. Although prices are still far from the highest point of the cycle, they are sufficiently high for private companies to be reassessing their investment projects that were postponed at the end of last year. In addition, at current prices it is possible that the governments of Argentina and Venezuela could survive the situation without the problems of interrupting tax payments. This appeared unlikely at the end of last year when oil and soy prices were at their lowest point.

The improvement in commodity prices and the sharp fall in imports have produced an unexpected improvement in the trade and current account balances in nearly all the countries. This has also helped dissipate fears of a crisis in the current situation.

The other element in the external environment that has changed for the better in recent months is the fall in the risk premiums of countries in South America. In most of these countries the EMBI index has returned to levels prior to the collapse of Lehman Brothers, with only Argentina and Venezuela remaining higher. This trend has been confirmed by various countries seeing their risk rating improved by at last one specialized agency in recent months (Brazil, Chile and Peru). This makes it easier for governments to access finance and reduces the cost of funds for the private sector, thus helping the recovery of confidence and demand.

These factors have been reflected clearly in the currencies in the region, which have experienced a sustained appreciation in recent months, supported in part by the entry of foreign capital.

Another sign of the gradual return to normal has been the strong recovery of prices of shares traded on regional stock markets. All these different elements have coincided with an incipient recovery in the indicators of consumer confidence, which is a prerequisite for the reactivation of domestic demand.

Although there are still no clear symptoms of recovery, various short-term indicators ranging from the acquisition of durable goods, home sales and even imports of consumer goods in Brazil, Chile, Colombia and Peru, have given signs of stabilizing at significantly lower levels than those observed at this time last year – although still equal to or greater than those seen at the lowest point in the cycle. We expect that these positive signs will result in a stabilization, or even recovery, of GDP in the second quarter of the year.

Perspectives for the future

Our view is that the combination of higher commodity prices and somewhat lower country risk premiums, expansive economic policies and a gradual recovery in consumer confidence, will together allow a slow but sound recovery to start in most of the economies of South America.

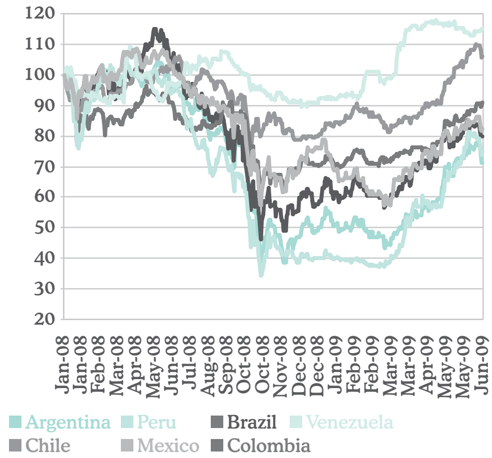
There is rather more uncertainty about those countries that are facing problems in accessing external finance, as this condition leaves them more vulnerable to a deterioration in commodity prices or possible capital flight. Such a situation cannot be ruled out given the political and economic uncertainty in these countries.

Despite the improvements for these countries, the process of returning to rates of growth close to their long-term trend will still take time, because of the low level of activity in the global economy and international trade that we expect to continue in coming years. This will particularly affect the more open economies in the region, such as Chile and Mexico, for example. They will have to redouble their efforts to improve competitiveness and earn greater acceptance in international markets that are not going to be growing at a satisfactory rate.

An underlying element in this forecast economic recovery is the idea that the ability of economic policies to respond correctly in most countries has given strong backing to structural reforms and macroeconomic policies in recent years. The strong support received by the finance ministers of Chile, Colombia and Peru, which is even being reflected in public opinion surveys, is very unusual in periods of crisis. Political leaders in these countries have taken note and this will surely leave an important legacy for the future. Just as the 1990s consolidated the idea that inflation was very bad business from the political point of view, we believe that the present decade will leave political leaders with the memory that prudent macroeconomic policies, particularly in boom periods, yield excellent political returns.

Latin American stock market indices

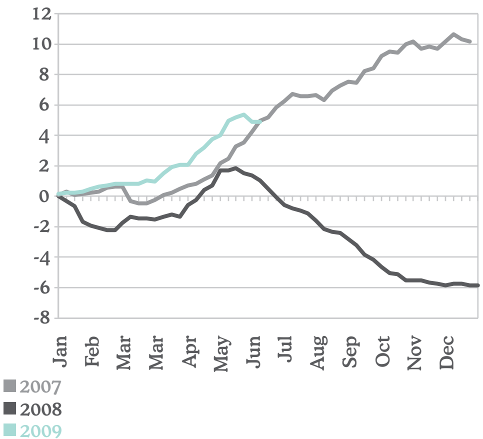
January 08=100



Source: Bloomberg

Latin America: Net equity inflows

(cumulative, US$ billions)



Source: BBVA-Capital Flows, EPFR

Box 1: Public accounts: has their deterioration been checked?

The slump in the world economy has hit emerging economies hard, and with them, their public finances.

In the case of Latin America, we can distinguish two direct impacts of the crisis, which have been common in episodes of this kind in the past. First, we have a strong negative impact on government revenues as a result of falling commodity prices such as oil, copper or cereals. The countries of Latin America are rich in natural resources, and the vast majority have created mechanisms for governments to capture part of the income from these resources. Some countries with a tradition in extractive activity, such as Mexico and Venezuela in oil, or Chile in copper production, have opted for the use of state-owned companies with a major - sometimes exclusive - role in the extraction and sale of these products. In these three cases the transfers from these state-owned companies into the public coffers are vital for the public finances. The most extreme case is Venezuela, where in some periods 80% of the public revenues have come from income from oil.

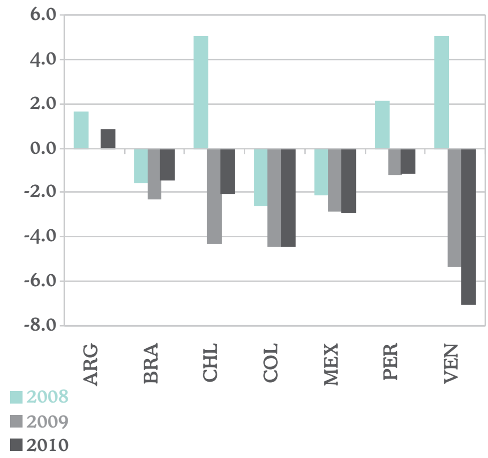
In other cases, when private activity dominates and is widely extended (mining in Peru and Chile, agriculture in Argentina), it has been the tax system that has collected this income, sometimes through special taxation, such as the special tax on soy exports in Argentina.

The initial impact of the price turbulence on public finances was extremely grave, with a maximum of nearly 3.5% of GDP in the case of Chile. This led many analysts to doubt whether public debt could be serviced (Argentina) or the government's spending plans continued (Venezuela). The situation has been eased recently as a result of adjustments in domestic policies and the (partial) recovery of commodity prices.

A second impact was the deterioration in tax revenues as a result of lower activity. In countries that depend on a high proportion of indirect taxes (VAT, import duties), a fall in domestic demand such as that registered since the end of last year can lead to a major deterioration in tax revenues. This is in fact what we have seen in the first half of this year.

Finally, we have a "non-traditional" component to the deterioration in the fiscal results for 2009: an increase in current spending and temporary investment to support the recovery of domestic demand. Historically, the rule has been that governments reined in spending in similar situations to the present, because they did not have the finance needed to maintain their spending programs (let alone increase them). However, this time the vast majority of the countries in Latin America are facing the crisis with public finances that have been strengthened by extraordinary revenues in previous years, profound reforms in the tax institutions and clear policies on savings and reducing public debt. At the same time, the intense development of capital markets in the region and the increasing presence of private pension funds have generated a mass of long-term savings. These have been available for financing of the continuity or even extension of public spending in almost all the countries in the region. Venezuela is the only country among the 7 biggest that has had to announce cuts in budgeted spending[1]

Chart 1.
Fiscal Balance
(% GDP)



National sources and BBVA

An important feature of the current deterioration in public finances is that it is temporary and does not have an adverse impact on the public debt profile. In the case of Chile, most of the debt is from savings deposited in sovereign funds, so there is minimum resource to debt. The case of Venezuela is somewhat similar, although here savings deposited in the financial system are also tapped on a large scale, taking advantage of the fact that the initial domestic public debt levels were relatively low. In the case of Colombia, which is turning to domestic and external debt markets, there has been a slight increase of the ratio of public debt to GDP, but without it endangering the sustainability of public finances.

If we look at the aggregate balance of public finances for the region, we see that the deficit reaches its highest point in 2009, when it is around 2.3% of regional GDP, and then falls in 2010. These figures contrast with those seen in the Asian crisis, when the level of aggregate deficit reached around 4% of GDP before stabilizing at around 2.5% for a number of years.

[1] We should point out that subsequently this measure was reversed as a result of the recovery in the oil price.

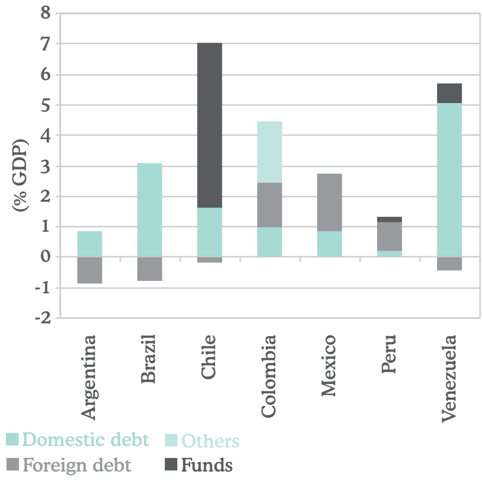
Chart 2.

LatAm 7 aggregate *: Fiscal Balance % GDP

Source: IIF and BBVA
*Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela

Chart 3.

Breakdown of fiscal financing in 2009



National sources and BBVA

In short, as could be expected in a situation such as the present, fiscal balances in Latin America have been deteriorating significantly, but we estimate that this is a temporary phenomenon. In practically all cases we see a greater capacity than in the past to finance the continuation of public spending plans, thanks to the systematic improvement in public finances over recent years and to the development of local credit markets. It is for all these reasons that we do not see a significant structural deterioration in public finances. On the contrary, we believe that the sovereign risk indicators for most countries in the region should emerge strengthened from the present crisis.

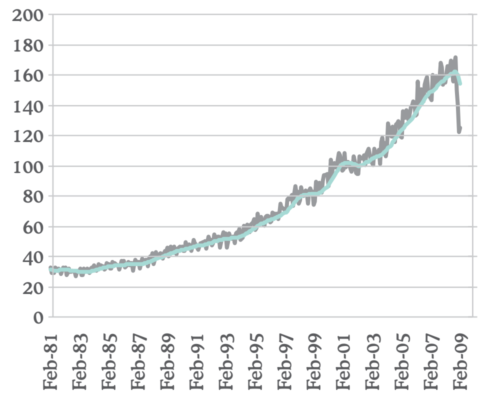
Box 2: The way Mexico adjusted to the cycle

The Mexican economy, dependent on developments in the U.S.

Intense adjustment of the Mexican economy in a global slump of international trade

Among the large economies of the American continent, the Mexican is registering the most intense adjustment to its growth, with three consecutive falls in GDP since the third quarter of 2008. This amounts to an accumulated fall of nearly 9% in output. Falls of this magnitude can be found around the world in economies that, like Mexico, have a high level of openness to the outside world, and are thus more exposed to changes in international trade flows[2]

Chart 1.
Global Trade in Goods
Volume; 2000=100



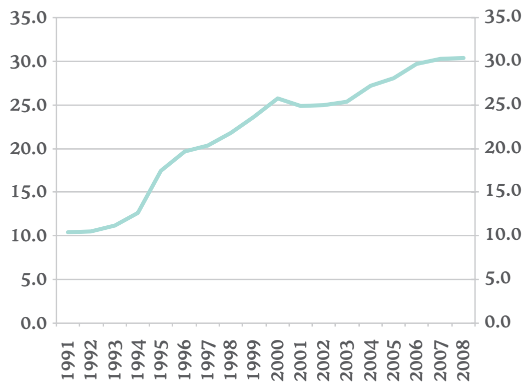
Source: FMI

The crisis that was already underway since the middle of 2007 became large-scale in the fourth quarter of 2008 with an intense contraction in world trade and the biggest falls ever in flows of both goods and services in these historical series. This was the result of a combination of an adjustment to reduced demand due to the lower level of economic activity and problems in the supply capacity of international trade transactions. To some extent, the difficulties for transactions were caused by financing restrictions in a global environment of scarce and expensive liquidity after the Lehman Brothers crisis in September 2008.

The U.S. is a determinant of Mexican foreign demand and relevant in domestic demand through remittances

Exports represented 30% of the real volume of Mexican GDP in 2008, practically twice the figure in 1995 after the entry into force of the Free Trade Agreement with the U.S. and Canada. In addition, practically 80% of Mexican exports of manufactures go to the United States, so any fall in demand there determines Mexican activity. U.S. imports of manufactures fell by nearly 40% in nominal terms between July 2008 (their all-time high) and March 2009.

Chart 2.
Mexico: exports of goods and services
Percentage of GDP



Source: BBVA ERD with INEGI data

Of particular importance for Mexican manufacturing exports is the deterioration in the automotive branch (80% of automotive production is for export). The loss in aggregate value between the end of 2006 and 1Q09 is equivalent to 30% (a fall of 38% with respect to the same period last year). In all, the biggest falls have been in the activities most closely linked to the U.S. cycle. In addition, although it is true that the weight in Mexican manufacturing output of the branches most exposed to the U.S. cycle is very similar to the weight of these branches in the U.S. (almost 25% of the total), total manufacturing output represents 18% of Mexican GDP, compared with 12% in the U.S. This intensifies the impact in Mexico of demand contractions in the U.S. In addition, the activities that are most dependent on the domestic market have also been registering an intense contraction recently, similar to those most exposed to foreign demand.

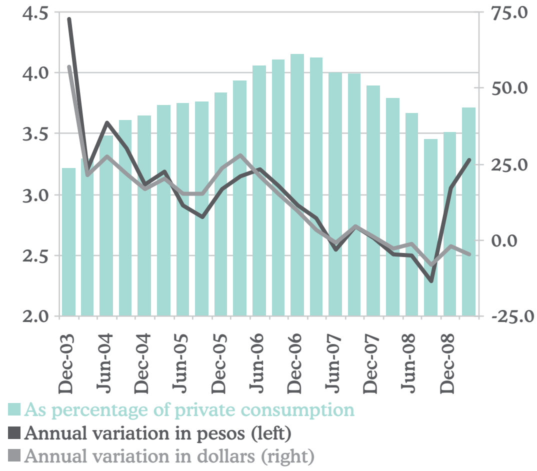
This local contagion of the external crisis is channeled through the fall in employment and disposable income, which in turn reduces the capacity for household and corporate spending. As well as this, there is the channel of remittances sent by Mexican emigrants living in the U.S. For the first time in 26 years, they registered a fall in 2008 of 3.6% in dollar terms.

Nevertheless, the depreciation of the peso exchange rate limits the impact of the fall in remittances in dollars on the capacity of household spending. So over recent years remittances have maintained a weight in terms of household consumption of between 3.5% and 4.0%[3]

[2] This is also the case, for example, of Germany and Japan, which in the last three quarters have accumulated falls of 6.5% and 8.3% respectively, although they had already registered GDP falls in the second quarter of last year.

Chart 3.

Mexico: income from remittances

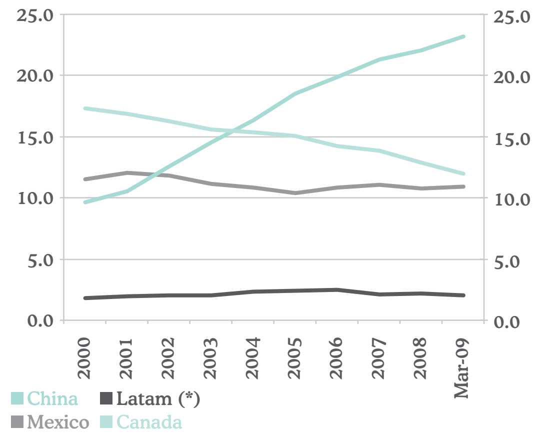


Source: INEGI and Banxico

Chart 4.

U.S. imports of manufactures

% by country of origin



Source: BBVA ERD, with data from the U.S. Department of Commerce
(*)Includes: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Peru and Venezuela

The impact of the influenza in the second quarter of 2009 is uncertain, but probably limited

In addition to Mexico's intense exposure to external shocks, as described above, there is the impact of a factor that ended up being global, but was domestic in origin: the AH1NI flu epidemic.

The fact that, as far as we know so far, the epidemic has been relatively benign, does not prevent it from having an economic impact derived from the combination of two factors: first, the direct impact of closing activities to mitigate the spread of the epidemic, together with the labor absenteeism caused either by the epidemic itself or by the need to care for family members; and second, the lower demand in affected areas because of fear of contagion. The lower demand for leisure affects services such as retail trade and above all tourist activities as a whole. The final quantitative impact of this kind of event is very uncertain, although given comparable experiences and the most recent information available, it will in any case be concentrated in the short term[4]

Prospects for recovery in the Mexican economy in the second half of 2009

Among all the economies in the American continent, the Mexican economy is most closely linked with the U.S. through the trade channel and the flow of remittances. Whereas Mexico has a share of between 10.5% and 11% of all U.S. imports of manufactures, the eight biggest countries in Latin America do not manage 2.5% between them.

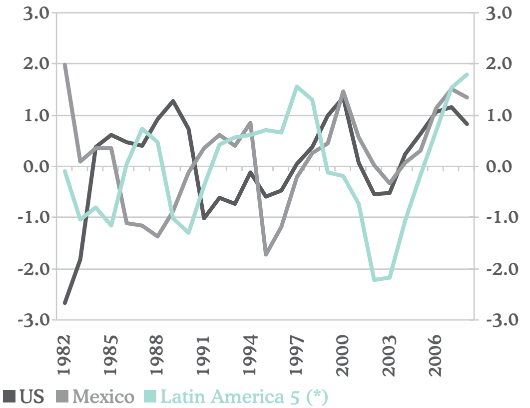
Both channels are passing on the intense contraction in demand in the U.S. for imported goods and services, and also for labor provided by immigrants. In this situation, given Mexico's geographical position, the trade agreements concluded and its specialization in production, the U.S. cycle will probably maintain a much closer correlation to the Mexican cycle than to that of other major Latin American economies. This has been the case since the mid-1990s, after the entry into force of the trade agreement between the U.S., Canada and Mexico.

Given all the above, it appears reasonable to think that although the adjustment has been intense and swift, the emergence from is likely to be so too in those economies that are most open to the external environment and have the closest relations with the U.S., which on current estimates is the country that will be the first to emerge from this crisis.

Chart 5.

Economic cycle

gap between registered and long-term GDP, as % of long-term GDP



Source: BBVA ERD. Standardized series
(*): Argentina, Chile, Colombia, Peru and Venezuela

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[3] For more information on the importance of remittances in the Mexican economy, see BBVA, Mexico Migration Watch, June 2009, available from: http://serviciodeestudios.bbva.com

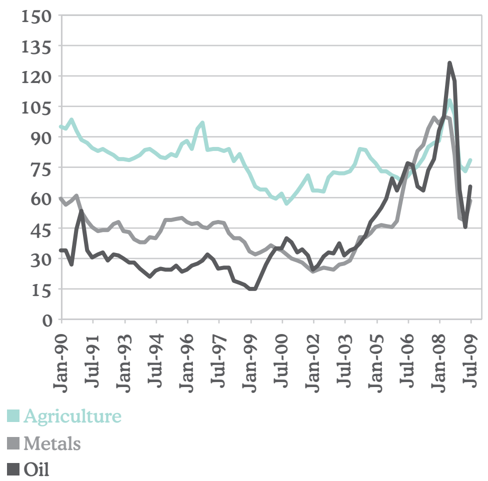
[4] For more information on developments in the health emergency, see BBVA, Mexico Watch, second quarter of 2009, available from: http://serviciodeestudios.bbva.com

Box 3: Commodity prices: recent developments and perspectives

After the boom in the first half of 2008, commodity prices fell sharply due to the deterioration of the world economy and the uncertain perspectives for consumption in coming years.

Despite the slump in commodity markets, the chart below shows that real prices in the first quarter of the year continued above the levels at the start of the decade, particularly in the case of metals and oil. Despite the world recession, prices continue to find some support in fundamentals due to growth in demand observed in emerging countries in recent years and some supply weaknesses.

Chart 1.
Commodities Real Prices
(Index 2008 IQ = 100)



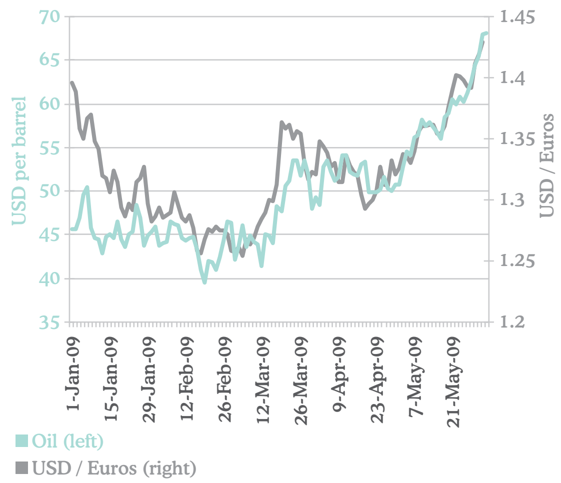
Source: CRB, Bloomberg

More recently, in the second quarter of this year, there was the start of an upturn in commodity prices. At the start of June the price of oil was 58% above the price in early March. In the same period copper and soy prices increased by 43% and 41% respectively.

This upturn is the result of a number of factors. First, the supply of commodities fell below the level initially expected. With regard to oil, OPEC has been coordinating a reduction in production quotas since the start of the crisis. As on previous occasions, global discipline has been possible thanks to the proactive attitude of Saudi Arabia. As a result, the cartel's production has been consistent with the announced cuts[5] . Another support for the oil market is the fall in production in Russia and other non-OPEC producers. With regard to metals, the reduction in supply has been much more severe than expected. In the agricultural markets, the climate problems in the Southern Cone of Latin America and other countries will result in a reduced harvest this season. As a result, the final inventory levels will remain low in historical terms[6].

Another factor is strong Chinese demand. According to our forecasts, China will be able to grow at least 8% this year and will thus continue to support demand for commodities. China has also been increasing its purchases of commodities such as copper and soy to accumulate strategic reserves.

Chart 2.
Oil Price and Dollar Correlation



Source: Bloomberg, BBVA

Finally, there are a number of elements in financial markets that have given additional support to the recovery in commodity prices. Among them are the low levels of interest rates, the depreciation of the dollar and fears that in the future inflation (particularly in dollar terms) will return as a result of the massive injections of liquidity over recent months. Commodities are a good refuge against this possibility. As a result, they have regained importance in the portfolios of hedge funds and other investors. For the last few months, there has been a significant increase in the proportion of long non-trade positions in the most traded commodity futures markets. This shows the appetite for of the financial markets for commodities.

[5] In April 2009, 82% of the cuts announced by OPEC were being applied by member countries.

[6] According to the FAO, cereal production will be 3.1% down on last season.

Chart 3.
Non-Trading Positions
Oil (%)

Source: CFTC, Bloomberg

Despite recent behavior, commodity prices should moderate over coming months, as nearly all of the factors mentioned above are strongly influenced by transitory elements. According to our estimates, prices will be above those observed at the start of the year, but they will have fallen from the highs reached in recent weeks.

Prices and BBVA Forecasts

	Jan 09	Current	Dec 09	Dec 10
Oil (USD/barrel)	45,6	71,1	56	67
Copper (USD/t)	3070	4960	3638	3373
Soybeans (USD/t)	343	425	370	320

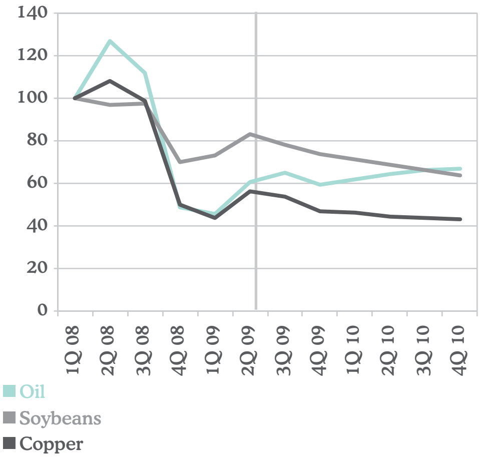
Source: BBVA, Bloomberg

In our core projection of a slow recovery in the world economy, the danger of inflation is low, at least in the coming years, and the expected differences between economic growth in the U.S. and the rest of the developed world should favor a recovery of the dollar in coming months. In other words, the "financial" supports should be less favorable to commodities in the second half of the year.

In addition to this, some of the falls in production, particularly in minerals, are associated with temporary production errors and postponement of investment projects. At current prices this investment is once more attractive. Our calculations suggest that metal markets are well stocked with increasing inventory levels. If to this we add that China's accumulation of reserves is by definition temporary, we should also reckon that these "real" factors would support a future fall in prices.

Finally, with regard to oil, it is obvious that OPEC discipline is balanced by increases in empty capacity. This should at least help reduce the risk premiums implicit in the oil price levels we experienced in previous years.

Chart 4.
Prices and BBVA Forecasts (Index: jan 08 = 100)



Source: Bloomberg, BBVA

Despite expecting prices to be contained for the rest of the year, we still expect a rise in the medium and long term, once the main economies of the world begin to grow more strongly. This is because the restrictions in supply that led commodity prices to all-time highs in the first quarter of 2008 continue in force. This last point is particularly important in the case of oil, which is facing a major decline in production in the oldest fields. The new discoveries made up to a couple of decades ago are not making up for the consumption of reserves. This means that oil prices have to be higher so that non-conventional energy reserves can be mobilized (such as the oil sands in Canada or the heavy oil in Venezuela, for example).

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4. Background

4.1. Financial tensions in emerging countries: contagion and fundamentals

The last months of 2008 confirmed the global character of the financial crisis that was unleashed in the U.S. a year earlier. What had originally been an extraordinary episode of financial instability limited to the U.S. and Western European markets was, after the Lehman Brothers bankruptcy, a crisis that has affected all the countries that have a certain degree of international financial integration. Emerging countries in general, and Latin America in particular, have since September become further victims of the financial crisis.

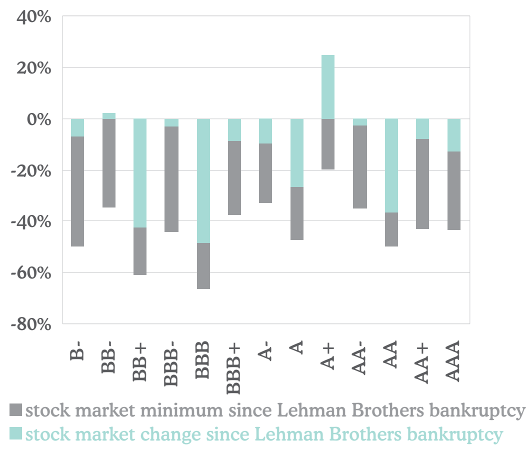
The extension of the financial crisis to the emerging world offers an opportunity to assess what factors determine the degree of contagion in emerging markets, and above all, to what extent we can say that fundamentals could be protecting these economies from a greater impact. An initial view is offered by the attached charts, which show how three financial variables (exchange rate, sovereign risk spread and stock market indices) have performed since the bankruptcy of Lehman Brothers, as well as the accumulated change from this point[7], in relation to the sovereign rating of Standard & Poor's (using this as a proxy of the country's macroeconomic strength).

First of all, it can be seen that the deterioration in the stock market indices has been general, and the pattern of adjustment is not related to rating levels. The biggest penalizations are in BBB and BB+ countries (around -60%), but emerging countries with better ratings are not far off this figure: the falls here are over 40%. Perhaps some difference can be seen in the recent rally, in which the stock markets in countries with a better credit quality have shown a significantly better recovery compared with the levels following the Lehman Brothers bankruptcy.

In addition, in the case of exchange rate movements, what is particularly notable is that countries with an A+ or higher rating showed smaller depreciations (all below 20%). Not only this, but in these cases the initial overreaction of the exchange rate was practically compensated by more recent appreciations, leaving current exchange rates at very similar levels to those before the crisis. The EMBI+ responds much more reliably to the rating with which the economy receives the impact of the crisis. This is not surprising, given that both are indicators of the quality of sovereign debt. In this case, countries with an investment grade are those that have reversed practically all the increase in the differential since the start of the crisis.

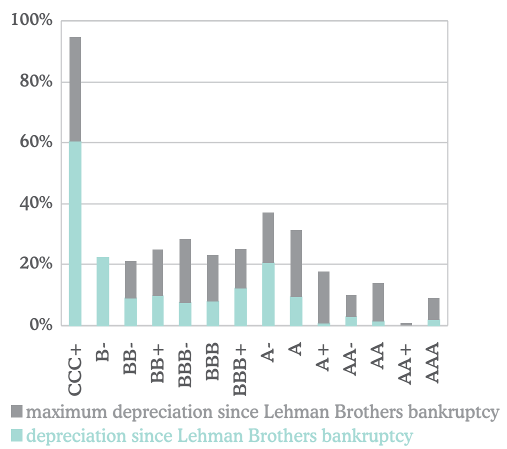
This initial view suggests that the behavior of exchange rates and EMBI+ spreads could have been affected by fundamental factors. In this case, the impact on these variables, both in terms of intensity and duration, would have been more limited in economies with better fundamentals. Next, we will present a more exhaustive exercise to check this possibility empirically. We have used the financial stress index designed in Box 5 of the current edition of LatinWatch, which synthesizes the behavior of the exchange rate, stock markets and EMBI+ in one indicator.

Stock market variation by rating (%)



Source: Bloomberg and BBVA
B-: Argentina; BB-: Indonesia, Philippines, Turkey and Venezuela; BB+: Latvia and Romania; BBB-: Brazil, Colombia, Hungary, India and Peru; BBB: Bulgaria, Lithuania and Russia; BBB+: Mexico and Thailand; A-: Malaysia and Poland; A: Czech Republic, Estonia and South Korea; A+: Chile and China; AA-: Taiwan; AA: Slovenia; AA+: Hong Kong; and AAA: Singapore

Exchange rate depreciation by rating (%)



Source: Bloomberg and BBVA
CCC+: Ukraine; B-: Argentina; BB-: Indonesia, Philippines, Turkey and Venezuela; BB+: Latvia and Romania; BBB-: Brazil, Colombia, Hungary, India and Peru; BBB: Bulgaria, Lithuania and Russia; BBB+: Mexico and Thailand; A-: Malaysia and Poland; A: Czech Republic, Estonia and South Korea; A+: Chile and China; AA-: Taiwan; AA: Slovenia; AA+: Hong Kong; and AAA: Singapore

[7] In this case, the period under consideration starts with the bankruptcy of Lehman Brothers and ends on mid June 2009. The countries are grouped together according to their rating. For each rating level a simple average is constructed of the changes in positions of the countries with this rating level.

Our aim with this index is to assess the stress sensitivity of emerging economies to a "global factor" that is estimated using indices from emerging and developed countries. Two complementary exercises reveal two interesting results. First, the financial stress of emerging economies, measured using the indicator constructed here, has for the first time in the crisis been below the financial stress level of developed economies. Emerging economies have suffered a moderate level of tightening compared with advanced economies (undershooting). This contrasts with other crisis periods in which emerging economies experienced overshooting. Second, and most important, the sensitivity of the emerging world to global factors has reduced steadily in recent years. In fact, we can see that there has been a structural change in this parameter since 2003. Empirical evidence suggests that domestic factors are increasingly important in determining financial stress in the emerging world. This conclusion clearly favors Latin America, given the progress made in terms of macroeconomic stability compared with the past, and above all in relation to other emerging regions.

Methodology

Our econometric strategy uses three steps: First, we extract the common component underlying the indices of financial tensions in developed economies[8] (FSIDE) and emerging economies (FSIEE) by analyzing their main components. The first resulting component (PC1) explains most of the movements shared between these indices, and is thus used as our indicator of global financial stress.

Chart illustrates changes over time in our financial stress indices for emerging and developed markets. The chart shows that each index behaves in a very similar way to the global stress indicator, with a correlation coefficient for the sample as a whole (fourth quarter of 1997 - first quarter of 2009) of 0.93 in both cases.

The first element that emerges from this analysis is that something has changed with this crisis for emerging economies. The FSIEE has performed more favorably than the FSIDE. The FSIEE remained at limited levels for nearly a year, while the FSIDE began to rise. As well as this, both at the moment of greatest tension and now, the FSIEE continued to be below the FSIDE. This represents a difference compared with previous crises, when the emerging economies experienced overshooting with regard to the tensions in global markets.

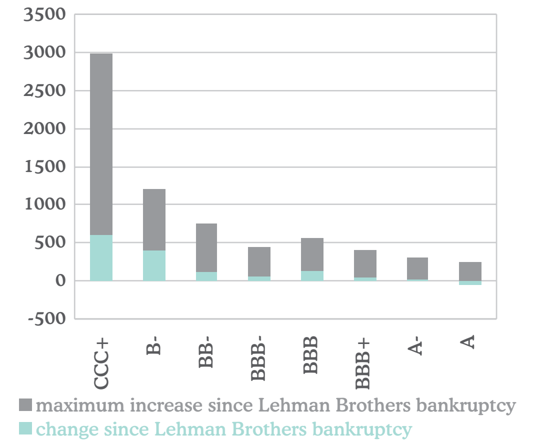
We have constructed a dynamic factor model in space-state format to evaluate the influence of global factors on our stress indices by region over time. Here, the dependent variables are the stress indices by region. We have included time-lags of these variables as explicative variables, together with the global stress indicator estimated earlier. The space-state model is shown below.

$$\begin{bmatrix} FSIDE_t \\ FSIEE_t \end{bmatrix} = \begin{bmatrix} 1.0 \\ \lambda_t \end{bmatrix} + \left[\beta_2 \beta_1\right] \times \begin{bmatrix} FSIDE_{t-1} \\ FSIEE_{t-1} \end{bmatrix} + \begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \end{bmatrix}$$

The inclusion of the principal component PC1 in this system of equations allows us to treat the coefficient measuring the response of the index of financial tensions of emerging countries to the global stress indicator as an unobserved component (or state) that is possibly variable (stochastically) in time. We shall call this λ_t.

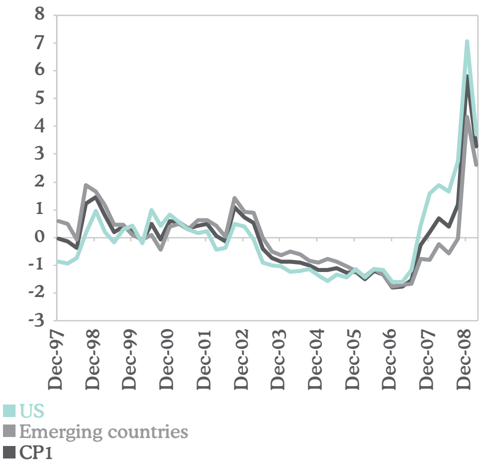
[8] In this case, we use the financial stress index of the U.S. as a proxy for developed economies.

Chart 5.3: EMBI+ change by rating (bps)



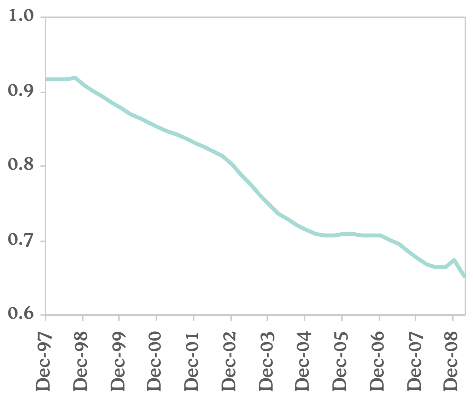
Source: Bloomberg and BBVA
CCC+: Ukraine; B-: Argentina; BB-: Indonesia, Philippines, Turkey and Venezuela; BBB-: Brazil, Colombia, Hungary and Peru; BBB: Bulgaria and Russia; BBB+: Mexico; A-: Malaysia and Poland; A+: Chile and China.

Financial Stress and Principal Component indices (PC1)



Source: BBVA

Emerging economies: Global Factors coefficient (λ)



Source: BBVA

Global Factors coefficient (λ) in emerging economies: Structural change test

	Coefficient	t-Student
λ1 (pre-2003)	1.01	4.46***
λ2 (post-2003)	0.81	11.1***

*** Significant at 99% confidence level
Source: BBVA

The estimated temporal trajectory of λ_t (using the Kalman filter) provides evidence of the temporal changes in the sensitivity of emerging markets to global financial tensions, and by extension, but in the opposite direction, of the role of idiosyncratic elements in these economies.

Shows that the coefficient λ_t maintains a downward trend that is unbroken exactly until the volatile episode triggered by the bankruptcy of Lehman Brothers. It is at this moment that the series experiences a slight and brief upturn, but quickly recovers its downward trend.

This result clearly supports the hypothesis that the financial systems of emerging countries have been experiencing a gradual process of decoupling from global financial factors, and thus their vulnerability has been reduced.

As an exercise of robustness, we have adopted a modified version of our space-state model, where the principal component PC1 is substituted by a common unobserved factor acting as an alternative proxy of global financial stress (estimated through the Kalman filter). In this case, the possible change in the sensitivity of financial economies to global financial factors is modeled as a unique structural change for 2003.

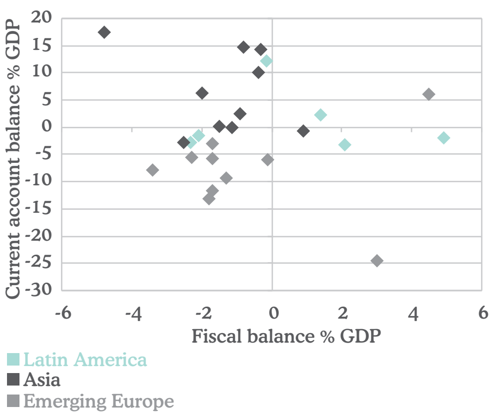
This exercise confirms that emerging economies experienced a turning point. Until 2003, the sensitivity to global factors of financial tensions in emerging economies was considerably greater, with a coefficient (λ1) of 1.01 (overshooting or overreaction to conditions in global markets). Subsequently, this coefficient fell to 0.8 (λ2). In other words, with a change in conditions on global markets, emerging markets responded with undershooting, or a lower level of change. Behind this could be the fact that emerging economies began a cycle of economic growth accompanied by a substantial improvement in macroeconomic aggregates.

Conclusions

Our analysis defines the influence of global and domestic factors on the development of the crisis in emerging economies. Compared with works that find great importance in external factors as determinants of the latest episodes of financial instability in emerging countries, these results show that it is the fundamentals that have gained increasing importance over time. Now more than ever these are the factors to consider when determining the degree of exposure of emerging economies to periods of financial instability. This greater explanatory power shows how there are substantial differences in the capacity of emerging economies to correct the initial deterioration of some financial variables, as we have seen.

If the fundamentals are increasingly important, it is clear that we would expect growing differences within the emerging world. An initial sign of this is the impact that the crisis is having in the real economy. Since the start of the year growth forecasts have been revised in all emerging economies, but particularly in many countries in emerging Europe. As can be seen in Chart 5.6, it is in this region where most fiscal and current account imbalances are concentrated. The greater difficulty experienced by these countries in accessing external finance as a result of the crisis may lead to an abrupt correction of these deficit balances, which obviously would have negative consequences on growth. Compared with this, Latin America has tackled this crisis with strengthened fundamentals, and with a low level of macroeconomic and financial vulnerability[9]. This should lay the foundations for a privileged position to recover from the current crisis.

Fiscal and current account balance % GDP (2008)



Source: WEO and BBVA

[9] See "Latin America vulnerability vs. other emerging regions" in LatinWatch, second semester 2008.

Box 4: BBVA financial stress index for emerging countries

After the events of recent months, there is a general consensus that we are in the midst of an unprecedented crisis. This is certainly clear for developed economies, given the comprehensive squeeze in all kinds of assets and markets. But it is worth reflecting whether this is also the case for emerging economies, which were affected by the crisis substantially later and on which the crisis has not initially caused the same level of collapse as in the developed economies.

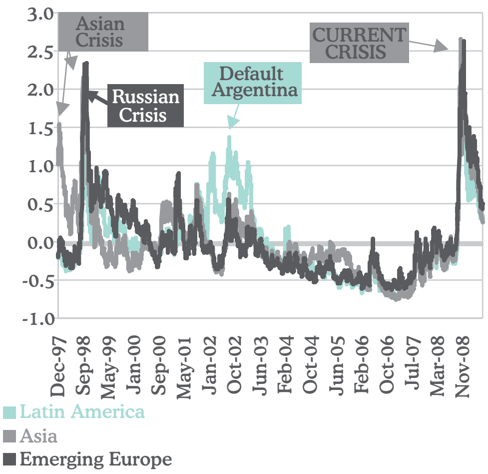
With the aim of quantifying and assessing the degree of financial contraction faced by emerging economies in general compared with developed ones, and Latin America in particular compared with other regions (Asia and Emerging Europe)[10] , we have constructed a Financial Stress Indicator for Emerging Economies (FSIEE). The first step has been to choose the variables in the index. In emerging economies, which are financially less sophisticated than developed economies, with little development in public and private debt markets, whether corporate or non-corporate, and lower exposure of households to stock-market fluctuation, it appears clear that the variables making up this indicator would be different from those for developed economies[11] . Given this fact, and taking into account the factors that have historically been associated with crises in emerging markets, the indicator has been composed of the following variables: country risk (approximate, based on EMBI spread), exchange rate volatility and global risk aversion (approximate with the VIX index, the S&P volatility index)[12]

The second step was to choose the methodology. Here we applied an Principal Component Analysis (PCA) of the variables mentioned so that, with 2,973 observations of 3 variables, we could analyze whether it is possible to represent this information adequately with a lower number of variables constructed as linear combinations of the originals. Principal component analysis is the first step in identifying the possible latent or unobserved variables generated by the data. This allows the original, in general correlated, variables to be transformed into new uncorrelated variables, thus making it easier to interpret the data. This reduction is achieved by assigning weights to each of the variables making up the model[13]

This methodology was applied to each of the three emerging regions: Latin America, Asia and Emerging Europe. An aggregate index was then constructed for emerging countries as a simple average of regional indices.

The first striking element that emerges when comparing the stress indicators for emerging countries (FSIEE) and developed economies, or the U.S., (FSIDE) is that the FSIEE has been systematically below the FSIDE throughout this crisis. In addition, the tensions in emerging countries have been somewhat more moderate and took place with a significant delay. In this channel, emerging economies remained uncoupled from the financial problems of developed economies for practically a year. Whereas the developed countries nearly doubled their stress level during the initial phase of the crisis, in emerging countries the tensions were limited within a very restricted range. The events of the last quarter of 2008 raised the FSIDE to maximum levels, nearly 7 times those before the crisis. Emerging countries also experienced a major upturn in the FSIEE, but its maximum levels were far below those in developed countries. Recent developments in both indicators show an abrupt correction starting in the first quarter of 2009. The latest data show that the index of financial tension has returned to pre-Lehman Brothers levels. Thus although we are still far from a return to normal financial conditions in both regions, recent developments have been extremely favorable, and emerging countries maintain a somewhat more favorable position than developed economies.

Chart 1.
Financial Stress Indicator in Emerging Economies (FSIEE)



Source: BBVA

[10] Asia includes China, Hong Kong, India, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan, Thailand and Vietnam. Latin America includes Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela) and Emerging Europe includes Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia, Turkey and the Ukraine.

[11] The variables composing the index for developed economies are as follows: 1) Credit risk indicator (TED spreads: the difference between interest rates on interbank loans and short-term U.S. government debt) and 10-year swap spread; 2) corporate risk indicator (BAA spreads: the difference between the interest rates of corporate BAA bonds and 10-year U.S. government bonds. These variables are considered valid individually as a way of gauging the degree of financial tension in developed markets such as America.

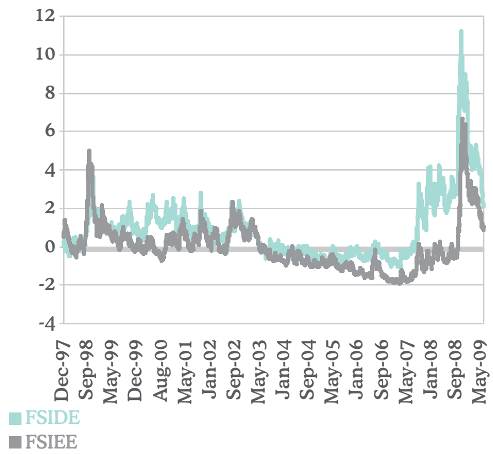
[12] Other approaches, such as those used recently by the IMF in its last "World Economic Outlook: Crisis and Recovery", incorporate other variables, similar to those used in the financial stress index for developed economies. They include stock market prices, or the beta of bank shares in emerging economies. But these variables are not in our opinion as relevant in the emerging world, and cannot have a similar weight to the variables mentioned, such as the exchange rate or spreads.

[13] In the weighting of the principal component, the variable with the biggest weight by far is the volatility of exchange rates, followed by the measure of global risk aversion and finally country risk. This pattern is common for the three emerging regions.

Focusing on emerging countries, we can see that the current financial turmoil has provoked a one-off upturn that is fully synchronized and extremely strong in the three emerging regions. As a result, in some cases the level of financial tension has exceptionally reached all-time highs.

Chart 2.

BBVA Financial Stress Indicators



Source: BBVA

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Latin America and China: Two complementary strangers

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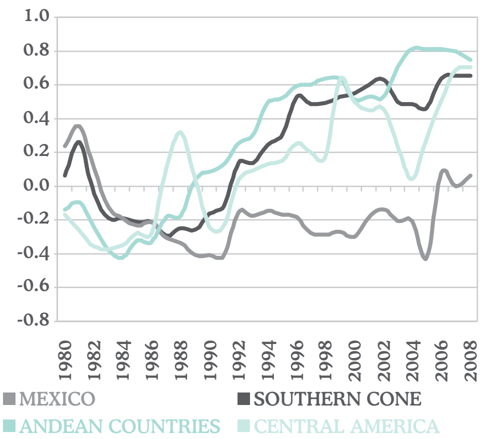
Over the last decade, economic globalization has linked economies like never before. Countries and regions in different parts of the world and at different stages of development have become more intertwined through trade and investment. This is starting to be the case for Latin America and China notwithstanding the geographical and cultural differences between them.

Although their economies are specialized in quite different sectors, both China and, to a lesser extent, Latin America depend on external demand and, as a result, both are vulnerable to the current crisis. In fact, such growing external dependence explains the higher correlation of their economic cycles over time as can be seen in the following chart:

Growth in Output Correlation between Latin America and China, 1980-2008
(10 year window rolling correlations)



Source: WDI, WEO and BBVA

Growing trade links and future opportunities

Trade between China and Latin America have to overcome huge geographical distance with high communication costs and long delivery times. To make matters worse, they are in very different time zones and they lack direct air links. Furthermore they have very few free trade agreements. Despite all these impediments, trade has flourished. The key reason for this is the striking difference in endowments between the two economic blocks. Latin America's agricultural land per capita is three times larger than China's and forest land and fresh water per capita is well over five times higher. The same is true for Latin America's natural resources as compared to those of China, in particular minerals and metal but also oil and food.

This difference in natural resource endowment explains growing trade between China and Central and South American countries.

Latin America has become the most important commodity supplier, producing just under half of the world's soybeans, over one fifth of global refined aluminium, 28% of the planet's zinc and just under a third of worldwide oilseeds.

On the other hand, China is one of the most relevant importers of natural resources and has become a major player in international copper, niquel, crude oil and zinc markets.

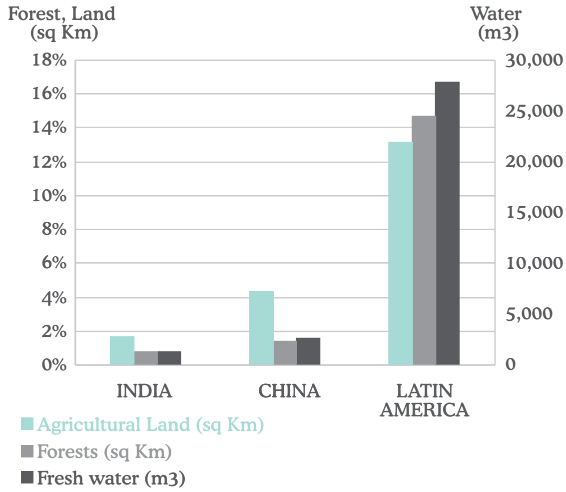
Thus, Latin America's supply of natural resources and China's hunger for them draws these two regions closer, overcoming all the geographical barriers.

China's economy is geared towards exporting mid and high-tech manufactures, a domain where its trade partner has yet to improve.

This relationship has been beneficial for both sides. China's high demand for natural resources has fuelled Latin America growth in recent years, becoming one of the top three foreign clients for Argentina, Brazil, Chile and Peru. In addition, China has also become the second most important supplier for many Latin America economies. Despite these impressive bilateral trade figures, however, Latin America cannot fulfill the booming Chinese demand and there is still room for more export growth, specifically in exports from Caribbean countries.

The recent trade agreements signed by China with Chile (2006) and Peru (2009) and the trade agreements that are being negotiated with Costa Rica and Colombia will undoubtedly increase trade flows in the near future.

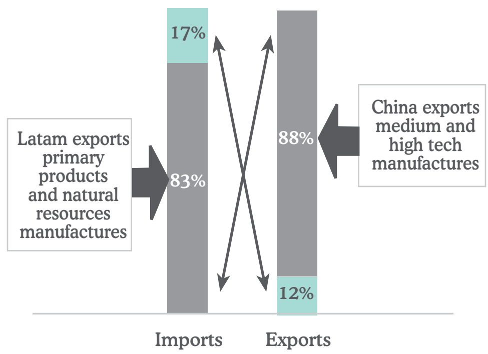
Selected natural resources per capita, 2005



Source: WDI

China: impot/export structure with Latin America, 2006

(% of imports/expots flows)

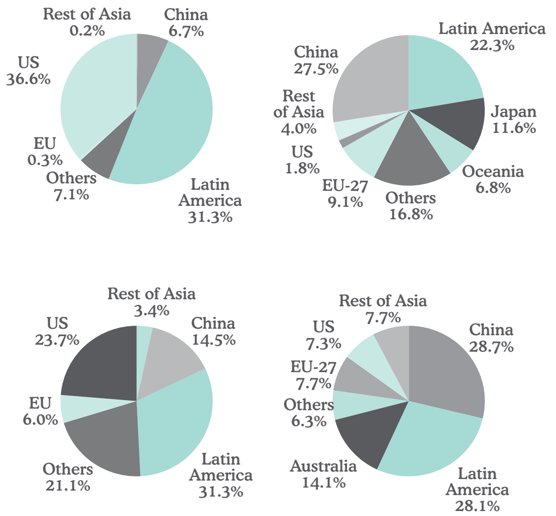


Primary products & natural resources manuf.
Low, mid and high tech manuf.

Source: ERB BBVA, ECLAC

Production share by region/country, 2006-2008

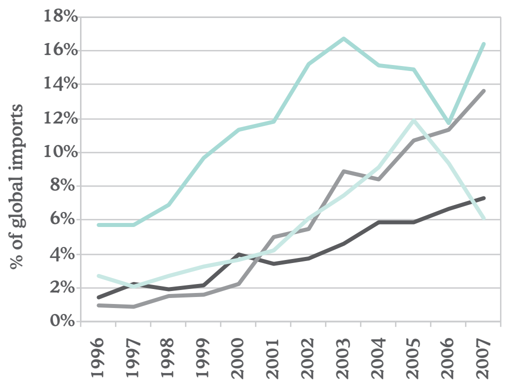
(as % of world, selected commodities)



Source: ECLAC (2008)

China: imports de materias primas

(% of total)



Copper Crude oil
Nickel Zinc

Source: ERB BBVA, UN Comtrade

Although the huge increase in trade relations between Asia and Latin America has undeniably benefited both regions, a further increase in commercial exchange could have certain downsides for certain industries and some countries could be hit hard. Regarding goods exports, Chinese competition in textiles, telecommunication equipment and electronic equipment will be strongly felt by local companies, in particular in Mexico and Central American nations. As for services exports, India's role will be much more important than China's, although only in certain sectors such as industrial engineering, legal services and R&D. Furthermore, LACs can compete in the service sector exporting their own know-how in the tourism industry and health sectors.

In spite of the above undesirable consequences of further trade for some sector and countries, an OECD[14] study shows that, with the notable exception of Mexico, export competition between Latin America countries and China is very low. The same study reveals as well that the exports of three big Latin America economies (Mexico, Argentina and Brazil) are complementary to Chinese exports.

Foreign Investment

As emerging economies, LAC and China would seem to be natural competitors for inward Foreign Direct Investment (FDI). However, empirical studies by Lederman, Perry and Olarreaga (2008)[15] and Garcia Herrero and Santabarbara (2007)[16] seem to indicate that this is not the case. China's effect on inward FDI flow in Andean and Southern Cone countries has been positive while Central American economies inward FDI flows have only been slightly affected.

Not only are FDI flows to LAC countries not affected by China, but the Asian country's large and growing reserves have been a source of financing and investment abroad. In relation to South Korea and Japan's investments abroad to GDP ratio, China has ample room to continue investing beyond its frontiers. Even though Chinese investments in LAC countries since 2003 have increased 80% year-on-year and in 2007 represent the second destination for Chinese capital flows outside the Asia region, there is still ample margin to increase China's share of FDI in view of the low starting base.

Chinese FDI in Latin America faces some challenges which need to be overcome. The most important is the cultural differences between Chinese investors and local partners followed by potential capital shortage.

However important Latin America is for Chinese investment, LAC countries should strengthen their institutions and improve their infrastructure to make their economies more attractive to FDI. Better infrastructures, specially in transport and communication, would lead to lower transportation costs and enable LAC countries to exploit their proximity to the US, is another important source of complementary.

In fact, Chinese companies could well use Mexico as a hub for their exports given Mexico's preferential access to the US and Canadian market through NAFTA. Asia's production chain, mainly fostered by Hong Kong and Taiwan's investors seem like a good model to replicate in Mexico. A recent study by Fung, Garcia-Herrero and Siu (2009)[17]

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[14] OECD Development Centre, 2008; based on WITS Databases, 2007

[15] *China's and India's Challenge to Latin America: Opportunity or Threat?* Edited by Daniel Lederman, Marcelo Olarreaga, Guillermo E. Perry, World Bank publication, October 2008

[16] *"Does China have an impact on foreign direct investment to Latin America?"*, in *China Economic Review*, vol 18. issue 3, pp 266-287.

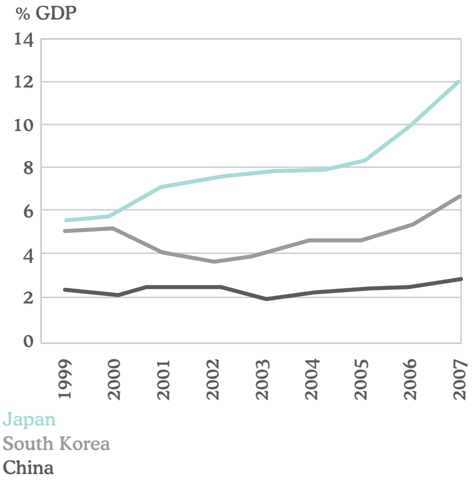
[17] *"Production Sharing in Latin America and East Asia" in "China and Latin America: Growing Economic Relations and Commonalities in Policy Issue Conference" held in Hong Kong in December 2008.*

reveals that the economies of Far East Asia gained comparative advantage over the production operations of parts and components from 1985 to 2006, while North and Latin America registered a modest increase. This puts forward the question of starting the supply chain in Far East Asia and ending it in Mexico, thus taking advantage of the free trade area to enter North America.

The final conclusions we can draw from the above analysis is that Asia offers many opportunities to Latin America. Intensifying Latin America's comparative advantage towards natural resources seems more warranted once China becomes a key member of the global economy. The way to foster theses processes is through permanent alliances in trade (FTA) to secure commodities to China and a gradual shift in LAC countries from the current inter-industry trade pattern to vertically integrated trade and reap the benefits of Mexico's favourable location.

Chinese FDI satock vs selected asian peers

(outward FDI stock as % of GDP)



Source: BBVA ERD, UNCTAD (2008)

5. Statistic and forecasts

International Context

Commodities (end of period)							
	2007	2008	2009		2007	2008	2009
Brent (USD/barrel)	93.9	45.6	48.9	**Soybean (USD/t.)**	423.2	343	336.0
Copper (USD/t)	6675.0	3070.0	3527.7	**Corn (USD/t.)**	161	144	147.0
Gold (USD/troyoz.)	833.9	882.1	875.0	**Weath (USD/t.)**	312	216	200.0

	Real GDP (%)				Official interest rate (%. end of period)*			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	2.0	1.1	-2.0	1.1	2.9	3.8	-0.3	1.5
EMU	2.6	0.6	-3.3	-0.1	2.1	3.3	0.3	1.0
Japan	2.0	-0.7	-3.0	0.6	0.5	1.0	0.3	0.6
China	13.0	9.0	8.1	8.4	6.5	2.0	0.0	2.0
Latin America								
Argentina	8.7	7.0	-1.8	0.7	8.5	7.2	7.5	10.0
Brazil	5.9	5.1	-2.1	3.0	4.5	5.9	4.2	4.4
Chile	4.7	3.2	-1.2	2.1	7.8	7.1	0.2	1.6
Colombia	7.5	2.5	-0.5	1.1	5.7	7.7	4.3	3.8
Mexico	3.3	1.4	-6.3	1.7	3.8	6.5	3.8	3.9
Peru	8.9	9.8	2.4	3.6	3.9	6.7	2.1	2.0
Venezuela	8.4	4.8	-0.5	-2.9	22.5	31.9	42.3	49.2
LATAM [1]	5.7	4.1	-2.9	1.9	6.0	8.1	6.6	7.5
LATAM Ex-Mexico	6.8	5.1	-1.4	1.8	7.1	8.7	7.5	8.7

* USA and EU Inflation: [1]Average of 7 mentioned countries

	Public Sector Balance (% GDP)				Current account balance (% GDP)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	-1.2	-4.6	-12.7	-8.4	-5.3	-4.8	-3.0	-2.9
EMU	-0.6	-1.9	-5.4	-6.0	0.5	-0.1	-0.3	-0.4
Japan	-5.4	-4.9	-4.8	-5.5	4.8	3.2	3.0	3.0
China	0.7	-0.4	-2.9	-1.4	11.0	6.8	9.5	10.0
Latin America								
Argentina [2]	3.2	1.4	0.1	0.8	2.7	2.3	1.9	2.0
Brazil	-2.3	-1.7	-2.3	-1.4	0.1	-1.8	-1.3	-1.4
Chile [2]	8.8	4.9	-4.2	-3.8	4.4	-2.0	-3.1	-4.6
Colombia	-2.7	-2.3	-4.2	-4.2	-2.8	-2.8	-4.0	-2.7
Mexico	0.0	-0.1	-1.8	-1.8	-0.8	-1.4	-1.9	-2.1
Peru	3.1	2.1	-1.2	-1.1	1.1	-3.3	-3.3	-3.2
Venezuela [2]	3.0	-0.2	-6.0	-6.6	8.7	13.1	0.7	2.4
LATAM [1]	0.1	-0.4	-2.3	-1.8	0.7	-0.4	-1.3	-1.3
LATAM Ex-Mexico	0.4	-0.4	-2.6	-1.9	1.3	-0.1	-1.2	-1.1

[1] Average of 7 mentioned countries; [2] Central Goberment

	Exchange rate (vs $. end of year)				Official Rate (%, end of period)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA					4.25	0.25	0.00	0.00
EMU ($/€)	1.5	1.3	1.2	1.1	4.00	2.50	0.75	0.50
Japan (yens/$)	113	96	96	93	0.77	0.10	0.20	0.70
China (cny/$)	7.3	6.8	6.8	6.6	7.47	5.31	4.50	3.96
Latin America								
Argentina	3.1	3.4	4.1	4.5	13.50	19.08	17.00	15.03
Brazil	1.8	2.3	2.1	2.1	11.25	13.75	8.50	8.50
Chile	499	649	560	566	6.00	8.25	0.75	2.00
Colombia	2015	2244	2343	2586	9.50	9.50	4.50	4.50
Mexico	10.9	13.7	13.0	12.4	7.50	8.25	4.50	4.50
Peru	3.0	3.1	3.15	3.20	5.00	6.50	2.00	2.00
Venezuela	2.2	2.2	2.2	2.2	11.70	17.00	16.00	14.50

Argentina / Brazil

	Argentina				Brazil			
	2007	2008	2009f	2010f	2007	2008f	2009f	2010f
GDP (%)	8.7	7.0	-1.8	0.7	5.9	5.1	-2.1	3.0
Consumer Prices (%. end of year)	8.5	7.2	7.5	10.0	4.5	5.9	4.2	4.4
Trade balance ($bn)	11.1	12.6	12.0	11.0	40.0	24.4	22.0	20.0
Current Account (m.M. $)	7.2	7.6	5.9	6.1	7.9	-28.2	-18.0	-21.0
% GDP	2.7	2.3	1.9	2.0	0.1	-1.8	-1.3	-1.4
Reserves ($bn. end of year)	46.2	46.4	44.2	s.d.	180.3	193.8	200.0	200.0
Exchange Rate (end of year vs US$)	3.1	3.4	4.1	4.47	1.8	2.3	2.1	2.10
Fiscal balance (% GDP) [1]	3.2	1.4	0.1	0.8	-2.3	-1.7	-2.3	-1.4
Interest Rate (end of year) [2]	13.50	19.08	17.00	15.03	11.25	13.75	8.50	8.50

[1] Argentina: Central Government. Excluding privatisation receipts.

[2] Argentina: 30-d deposits interest rate in pesos; Brazil: SELIC Rate

Chile / Colombia

	Chile				Colombia			
	2007	2008	2009f	2010f	2007	2008f	2009f	2010f
GDP (%)	4.7	3.2	-1.2	2.1	7.5	2.5	-0.5	1.1
Consumer Prices (%. end of year)	7.8	7.1	0.2	1.6	5.7	7.7	4.3	3.8
Trade balance ($bn)	23.6	8.8	0.9	-0.9	-0.7	0.8	-1.6	-1.3
Current Account (m.M. $)	7.2	-3.4	-4.6	-7.1	-5.8	-6.8	-8.0	-5.3
% GDP	4.4	-2.0	-3.1	-4.6	-2.8	-2.8	-4.0	-2.7
Reserves ($bn. end of year)	16.9	23.2	23.0	23.0	21.0	24.0	23.0	23.0
Exchange Rate (end of year vs US$)	499	649	560	566	2015	2244	2343	2586
Fiscal balance (% GDP) [1]	8.8	4.9	-4.2	-3.8	-2.7	-2.3	-4.2	-4.2
Interest Rate (end of year) [2]	6.00	8.25	0.75	2.00	9.50	9.50	4.50	4.50

[1] Chile, Colombia: Central Government

[2] Chile: Official Interest Rate (since August 2001 in nominal terms)

Mexico / Peru

	Mexico				Peru			
	2007	2008	2009f	2010f	2007	2008f	2009f	2010f
GDP (%)	3.3	1.4	-6.3	1.7	8.9	9.8	2.4	3.6
Consumer Prices (%. end of year)	3.8	6.5	3.8	3.9	3.9	6.7	2.1	2.0
Trade balance ($bn)	-10.1	-17.3	-16.2	-18.5	8.4	3.1	0.5	1.0
Current Account (m.M. $)	-8.3	-15.7	-16.3	-19.8	1.2	-4.2	-4.2	-4.2
% GDP	-0.8	-1.4	-1.9	-2.1	1.1	-3.3	-3.3	-3.2
Reserves ($bn. end of year)	71.8	83.0	78.4	81.4	27.7	31.1	31.2	31.7
Exchange Rate (end of year vs US$)	10.9	13.7	13.0	12.40	3.0	3.1	3.2	3.2
Fiscal balance (% GDP)	0.0	-0.1	-1.8	-1.8	3.1	2.1	-1.2	-1.1
Interest Rate (end of year) [1]	7.50	8.25	4.50	4.50	5.00	6.50	2.00	2.00

[1] Mexico: 28-d Cetes Interes Rate; Peru: Interbank Interest in soles

Uruguay / Venezuela

	Uruguay				Venezuela			
	2007	2008	2009f	2010f	2007	2008f	2009f	2010f
GDP (%)	7.6	8.9	-0.8	1.4	8.4	4.8	-0.5	-2.9
Consumer Prices (%. end of year)	8.5	9.2	6.8	7.0	22.5	31.9	42.3	49.2
Trade balance ($bn)	-1.1	-3.0	-1.8	-1.8	23.7	45.4	5.5	9.8
Current Account (m.M. $)	-0.1	-1.1	-0.1	-0.2	20.0	39.2	2.3	7.5
% PIB	-0.3	-3.4	-0.2	-0.7	8.7	13.1	0.7	2.4
Reserves ($bn. end of year)[3]	1.7	1.9	2.0	2.2	33.9	43.1	29.7	29.7
Exchange Rate (end of year vs US$)	21.6	24.1	24.4	26.65	2.2	2.2	2.2	2.15
Fiscal balance (% GDP) [1]	0.0	-1.3	-2.6	-2.5	3.0	-0.2	-6.0	-6.6
Interest Rate (end of year) [2]	7.25	7.75	7.00	7.50	11.70	17.00	16.00	14.50

[1] Venezuela: Central Government

[2] Uruguay: 30-d BCU Papers Interest Rate in pesos; Venezuela: 90-d *Certificado Participaciones* rate

[3] Venezuela: including FIEM

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