First Encounter Of The Finance Ministers Of The Americas And The Caribbean

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The World and Regional Economic Outlook

Discussion Note

a. Global Economic Environment

The global expansion has been losing speed in the face of a major financial crisis. The slowdown has been greatest in the advanced economies, particularly in the United States, where the housing market correction continues to exacerbate financial stress. The emerging and developing economies have so far been less affected by financial market developments and have continued to grow at a rapid pace, although activity is beginning to slow in some countries.

At the same time, headline inflation has increased around the world, boosted by the continuing buoyancy of food and energy prices. In the advanced economies, core inflation has edged upward in recent months despite slowing growth. In the emerging markets, headline inflation has risen more markedly, reflecting both strong demand growth and the greater weight of energy and particularly food in consumption baskets. Commodity markets have continued to boom despite slowing global activity.

Strong demand from emerging economies, which has accounted for much of the increase in commodity consumption in recent years, has been a driving force in the price run-up, while biofuel-related demand has boosted prices of major food crops. At the same time, supply adjustments to higher prices have lagged, notably for oil, and inventory levels in many markets have declined to medium- to long-term lows. The recent run-up in commodity prices also seems to have been at least partly due to financial factors, as commodities have increasingly emerged as an alternative asset class.

The financial shock that erupted in August 2007, as the U.S. subprime mortgage market was derailed by the reversal of the housing boom, has spread quickly and unpredictably to inflict extensive damage on markets and institutions at the core of the financial system. The fallout has curtailed liquidity in the interbank market, weakened capital adequacy at major banks, and prompted the repricing of risk across a broad range of instruments.

These financial dislocations and associated deleveraging are affecting both bank and nonbank channels of credit in the advanced economies, and evidence is gathering of a broad credit squeeze—although not yet a full-blown credit crunch.

Recent financial market stress has also had an impact on foreign exchange markets. The real effective exchange rate for the U.S. dollar has declined sharply since mid-2007 as foreign investment in U.S. bonds and equities has been dampened by reduced confidence in both the liquidity of and the returns on such assets, as well as by the weakening of U.S. growth prospects and interest rate cuts. The decline in the value of the U.S. dollar has boosted net exports and helped bring the U.S. current account deficit down.

Direct spillovers to emerging and developing economies have been less pronounced than in previous periods of global financial market distress, although capital inflows have moderated in recent months and issuance activity has been subdued.

Underpinning the resilience of the emerging and developing economies are their increasing integration into the global economy and the broad-based nature of the current commodity price boom, which have boosted exports, foreign direct investment, and domestic investment in commodity-exporting countries to a greater degree than during earlier booms.

Commodity exporters have been able to make progress toward diversifying their export bases, including by increasing manufacturing exports, and the share of trade among the emerging and developing economies themselves has increased.

Strengthened macroeconomic frameworks and improved institutional environments have been important factors behind these favorable developments. As a result, the growth performance of emerging and developing economies has become less dependent on the advanced economy business cycle, although spillovers have clearly not been eliminated.

b. Latin American and Caribbean Region

The Latin American and Caribbean (LAC) region, in particular, has reaped the benefits of stronger macroeconomic positions and improved credibility of policy frameworks. Countries have also been buoyed by the exceptionally strong global economy of recent years, some especially by the boom in commodity prices, and rising foreign direct investment (FDI). However, the global expansion is losing momentum in the face of the recent financial disturbances.

Despite the global financial shock, LAC financial markets have held up well so far. The shock to housing markets and financial sectors in industrialized countries has thus far had less impact on LAC financial markets and external funding than in past episodes of global financial stress. Domestic money and bond markets remain generally stable. However, external funding conditions have tightened, especially for the LAC corporate sector, though less as compared with other emerging markets.

The commodity boom of recent years has boosted growth and strengthened fiscal and external positions across the region. Commodity prices are projected to decline somewhat, in line with indicators in futures markets, though levels will remain elevated by historical standards. Combined with strong import growth, external current account surpluses in the region are expected to shrink. Growth in the LAC region is nevertheless expected to slow given the weaker external conditions.

Inflation pressures remain a concern for monetary policymakers. Strong demand combined with exogenous external shocks, especially to food and fuel prices, have put upward pressure on inflation. This has posed risks for one of the region's most important macroeconomic accomplishments in the past decade—the sustained decline in inflation to the single-digit range. High food prices have also had a disproportionate impact on the poor—governments have sought to mitigate these effects.

Rising public spending has been eroding fiscal balances. A substantial strengthening of primary fiscal balances has been a key achievement for the region in the past few years. However, in many cases the strength of fiscal positions is dependent on the continued buoyancy of commodity prices. Moreover, spending has surged in recent years, lowering primary surpluses. The balance of risks for growth is tilted to the downside, reflecting the uncertainty over the global growth and commodity price outlook.

The financial shocks currently playing out in the United States and global economy introduce a particularly high degree of uncertainty for growth and financial stability prospects across the world. The outlook for commodities also remains a key unknown, and an unwinding of recent price increases would be an important downside risk for the LAC region.

At the same time, inflation risks remain a concern given the region's strong growth momentum, especially if growth turns out to be stronger than in the baseline. Navigating this period of financial turbulence and heightened uncertainty is the key near-term policy challenge. The region is facing the current situation from a far stronger position than in the past, especially given flexible exchange rate regimes.

However, balancing the expected growth slowdown against ongoing inflation pressures will require careful policy management:

- Monetary policy. This has been oriented toward containing continued pressures on headline inflation and inflation expectations. The moderation of domestic demand and tighter financial conditions seen in the baseline scenario should reduce overheating pressures and may ease the task for policymakers. Flexible exchange rates would be the first shock absorber in the event of a weaker external environment than envisaged in the baseline.

- Fiscal policy. Compared with the past, there is less need for countries to reduce spending in the face of a cyclical slowdown in revenues, and many have room to allow automatic stabilizers to operate. In the LAC region, increases in public spending could undermine policy credibility and ultimately have a negative impact on growth as risk premia rise and investment falls.

- Financial sector policies. Supervisory authorities are continuing their close monitoring of financial sector risks, as well as maintaining a close dialogue with regulators in other countries, given the international nature of the current shocks.

- Social policies. Addressing the impact of higher food prices on the poor is an important policy concern. Well-targeted cash transfers present an effective policy tool in this regard. However, administrative measures to reduce the pass-through of high food prices risk creating fiscal and quasi-fiscal costs and distorting economic incentives and efficiency.

Issues for Discussion

- What further adjustments are still needed in the U.S. mortgage and credit markets? What is the expected evolution for the rest of the current year and 2009?

- In case that a significant lower growth scenario takes place, how can we be sure that no restrictive trade measures will be put in place?

- What measures should be implemented in order to boost-up domestic demand and offset the drop of the external demand resulting from the U.S. economy's adjustments?

- Remittances to Latin America have been affected by several sectors' slowdown, but also by tighter migratory restrictions and controls against undocumented migrants. What can we expect in the future and how can we offset these flows' turn down?

- Once knowing that weather-related supply disruptions, low inventory levels, and legislation living incentives for bio-fuel production in the U.S. have created upward pressure on agricultural commodity prices. How can economies reduce their exposure to high and volatile food prices?

- What kind of measures could be implemented in order to prevent inflationary pressures and mitigate the impact of higher food prices?

- It is expected that energy and food prices remain high and volatile. In the hemisphere some countries have benefited from this situation while others have been negatively affected. What are the suitably robust macroeconomic policy frameworks in this context?

- In a context of international slowing growth, increasing energy and food prices and, for some countries, dropping remittances flows, what measures should be implemented to achieve the balance between price stability and the incentives to macroeconomic growth and development?

- In the current international context of greater uncertainty and volatility, what kinds of structural reforms and social policy measures could be suggested to continue reducing poverty and accelerating economic development?