Latin American Shadow Financial Regulatory Committee
Comité Latino Americano de Asuntos Financieros
Comitê Latino Americano de Assuntos Financeiros

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Sailing in a Stormy Sea: Latin America's Response to Global Financial Turmoil and the Food Price Crisis

I. Introduction

Since mid-2007, a number of shocks have been hitting the global economy, thereby raising questions about the prospects for world-wide growth and stability. Up to recently, most Latin American economies appeared to be quite resilient to the effects of these shocks, especially to the impact of the international financial turmoil led by the US mortgage sub-prime crisis. This was due to a number of reasons.

Firstly, a direct contagion effect into Latin American financial markets has been extremely limited. For instance, sovereign bond prices have remained stable, local equity markets have reached a new peak in US dollar terms (by April 2008, the MSCI Latin American index increased by more than 40 percent relative to its value a year ago), and no signs of systemic banking weaknesses have appeared in the region. Banks remain well-capitalized and with ample liquidity. To a large extent, these developments reflect: (a) that domestic capital markets do not support the large-scale trading of sophisticated structured products; and (b) the strict regulatory framework in most countries in the region that limit investment activities of banks and pension funds. Moreover, macroeconomic policy frameworks have strengthened in most countries, reflected in improved fiscal balances and significant international reserve accumulation.

Secondly, most countries in the region have benefitted from improved terms of trade. In part, continued depreciation of the US dollar aggravated by the sub-prime crisis created investors' incentives to hedge against dollar weakness by investing in hard commodities (oil and gas, metals and minerals). Indeed, with the exception of Central American and Caribbean countries, most other countries in the region seemed to be net winners.

Thirdly, and related to the above, the concerted efforts by US authorities to prevent a systemic banking crisis have decreased the probability of a deep and prolonged recession in the US. Although the possibility of this extremely negative scenario cannot be ruled out at this time, the potential decrease in US demand for Latin American exports seems contained, and certainly not large enough as to induce a major slowdown in the region. Recent IMF forecasts support this scenario: while the US economy is predicted to grow at only 0.5 percent in 2008 (from 2.2 percent in 2007), economic growth in Latin America is forecast to reach 4.4 percent; an important, but not path breaking, decline from the 5.8 percent rate of growth achieved in 2007.

However, this positive outlook has been clouded since mid-2007 by rising inflationary pressures and, in particular, by the sharp increase in food prices. Food inflation has economic and social implications for the region. On the economic side, when combined with the even more dramatic increase in oil prices, it exerts pressure on domestic inflation and poses new challenges for monetary and exchange rate policies. On the social side, inflation is putting a heavy burden on those segments of the population for whom food accounts for a large share of their consumption basket: the urban poor and some segments of the rural sector.

These developments have exposed the *Achilles heel* of the Latin American economic performance: in many countries, economic growth has not been accompanied by the public's trust in democracy and market-based institutions and policies. Facing *social legitimacy* problems, dealing with food inflation becomes essential for the sustainability of the successes achieved so far.

In addition, over the medium term the outlook faced by the region may also be clouded by how the monetary overhang in the US will play out in the future; in particular, by the potential response of US monetary policy to rising inflation.

II. The recent acceleration in food and energy price inflation: how did it come about?

There are two very different but not mutually exclusive explanations for the current food and energy price crisis. One explanation is based on the increase in the demand for food and energy stemming from the remarkable growth in some developing and emerging market economies, such as China and India, and the diversion of land to the production of bio-fuel crops. By focusing on structural issues affecting demand and supply for food and energy, this explanation tends to view inflation essentially as the result of relative price changes, which are likely to be persistent.

A second explanation that has received relatively less attention is based on monetary causes and points to an increase in world inflation, prompted both by money demand and supply factors. From the demand side there is a concern that emerging market economies that have been accumulating international reserves at a very high rate may turn around and try to utilize those assets in order to acquire riskier assets through, for instance, the use of Sovereign Wealth Funds (SWFs). Thus, if this portfolio change is not accompanied by an increase in industrial countries' central-bank interest rates, it will generate an increase in monetary aggregates, leading to higher nominal prices. This inflationary effect is likely to be sharper in the US given that, originally, international reserves had a relatively high US dollar component. Incidentally, this could help rationalizing the devaluation of the US dollar *vis-à-vis* other reserve currencies. SWFs make this portfolio shift more likely, because some of their funding comes from holdings of international reserves. SWFs are currently equivalent to around USD 4 trillion, and they could easily double in size in the coming years.

Concerns about the money supply side relate to industrial-country central banks' responses to the financial turmoil associated with the sub-prime mortgage crisis. Such response resulted in the central bank's absorption of a broader range of assets in exchange for liquidity.

Although the Committee acknowledges the importance of structural factors in explaining the increase in commodity prices since 2002, it believes that the monetary explanation has the virtue of being able to account for the price rise acceleration that took place since the onset of the sub-prime crisis. Such acceleration has been exacerbated by some countries' reaction to commodity price increases through export bans and restrictions. **This Committee believes that it is the acceleration of food and energy inflation that poses the most significant challenges for policymakers in Latin America at the current juncture.**

While a monetary explanation focuses essentially on absolute price changes, it may also accommodate the possibility of a transitory increase in relative prices. More precisely, an increase in inflation, in its initial stages, tends to manifest itself as a non uniform process. In particular, commodity prices react faster than wages and prices of domestically produced services. Therefore, in the short run, a rise in the rate of inflation will bring about an increase in the relative price of commodities *vis-à-vis* less flexible prices. It is worth noting that the monetary explanation implies that, in the long run, there will be no major relative price change. Thus, the whole episode might resemble a price bubble.

Furthermore, the increase in commodity prices becomes a leading indicator of future generalized inflation. Thus, **the Committee believes a future scenario in which the US Federal Reserve is induced to implement a sharp monetary tightening cannot be ruled out.**

The structural and the monetary explanations require different policy responses, as will be discussed in the next section.

III. Impact on Latin America and policy response

The recent international price increases of food and energy have impacted on headline inflation rates in most Latin American countries. Some countries in the region are now overshooting their inflation-target levels. For instance, in Peru inflation is currently around 5% per year compared to a target of 2% while in Chile annual inflation exceeds

8% compared to a target of 2% - 4% and in Uruguay annual inflation approaches 10% compared to a target of 4%-6%. However, when removing the effects of energy and food prices, core inflation has remained relatively subdued in the region. Under the monetary interpretation, the latter may simply reflect the different adjustment velocities in the commodity prices compared to that of domestic prices and wages.

Moreover, the sharp increases in commodity prices have had a large impact in the region's terms of trade and thus on aggregate demand and on the equilibrium real exchange rate. For the set of countries that are net exporters of commodities (mainly South America and Mexico) the terms of trade shock has been positive, fuelling aggregate spending. Although mitigated by the nominal appreciation of domestic currencies, the increase in expenditure added to the inflationary pressures elicited by the energy and food price increases. For the countries that are net importers of commodities (mainly Central America and the Caribbean) the terms of trade shock has been negative, in a context of fragile current accounts and fiscal positions.

III.1 Monetary policy

Implicitly, several central banks in the region have operated under the assumption that the current acceleration in commodity prices is mainly explained by the above-mentioned structural changes rather than by monetary phenomena such as the recent large injection of liquidity by the US Federal Reserve or the shift away from US dollar financial assets into real assets by SWFs.

Although in most countries central banks are committed to price stability, the diagnosis that recent price increases mostly reflect world food and energy price supply and demand shocks, rather than monetary factors, explains why the monetary policy response has been relatively mild, allowing the price level to absorb the change in food and energy prices.

The Committee believes that, under the assumption that relative price shocks are dominant, such policy response is desirable in countries that possess credible monetary regimes and a long standing reputation at fighting inflation. In those cases, a monetary policy tightening would be unnecessarily costly because it would force a deflation in other goods' prices in order to prevent an increase in the general price level. In contrast, **where the commitment of monetary authorities to price stability lacks credibility, the Committee believes that such policy response could increase inflationary expectations, potentially triggering dangerous price dynamics**. **In the latter case, a monetary policy tightening is necessary in order to anchor expectations and preserve the hard-won price stability**.

If monetary factors are the driving force behind the sharp rise in food and energy prices, then **the Committee believes that the policy response should be a different one. In this case nominal food and energy price increases should be to a large extent neutralized by allowing a nominal appreciation of the domestic currency.** This policy should result in no major change in the long-term real exchange rate.

The possibility of a future sharp increase in US interest rates cannot be discounted and it is a source of concern for the Committee. For this purpose **the Committee recommends that central banks take precautionary measures by, for instance, developing contingent credit lines, and further accumulating international reserves** (ideally through fiscal surpluses and not through sterilized intervention).[1] In addition, central banks should go through "crisis drills" to discuss strategies for efficient utilization of international liquidity (including international reserves), ensuring that central bank liquidity is adequately provided through the financial system to critical sectors without creating unduly high moral hazard incentives. In addition, **the Committee recommends pursuing policies that take into account the eventual tightening of US monetary policy. Examples are counter-cyclical public expenditure policies and counter-cyclical prudential regulatory requirements**.

III.2 Poverty alleviation policies

The rise of food and oil prices is having a significant impact on the real income of the poor in Latin America, as well as of the middle classes in varying degrees. Differences also relate to whether countries are net exporters or importers, as exemplified in the matrix below.

NET EXPORTERS AND IMPORTERS OF FOOD AND ENERGY

		ENERGY	
		Importers	Exporters
FOOD	Importers	Central America	Bolivia, Venezuela, Ecuador, Mexico
	Exporters	Brazil, Uruguay, Colombia, Chile, Paraguay	Argentina, Peru

There are different situations among the countries in each cell; for instance, Venezuela and Mexico share the same cell, but price controls on food in the former case have exacerbated the crisis by curtailing supply, while in the latter case high prices had led to severe riots. In Central America, which is a net importer of both energy and food and export mainly to the United States, the impact of the crisis is magnified.

In countries that are net importers of food, the rise of international prices has reduced real income especially among the urban poor and, to a lesser degree, among the middle classes and non-food-producing rural dwellers. In the case of net oil importers, the crisis has increased the cost of the domestic consumption basket. The combined effect of higher

[1] CLAAF Statement No. 16 deals in detail with the Committee's recommendations regarding the development of international contingent credit lines.

international energy and food prices has deteriorated the terms of trade, unsettling social conditions and generating political stress. The wide array of conditions in different countries makes it impossible to develop a single and general policy response to fit them all. Moreover, in all cases the policy response is likely to involve actions on several different fronts, which cannot be expected to work overnight.

Indeed, countries have adopted different approaches to face up to the crisis, including: price controls, export taxes, export quotas and bans, and other measures that distort the working of the price system. **The Committee believes that price controls are self defeating because they retard the supply response and promote the development of parallel markets. Export taxes as well as quotas hurt domestic producers, exacerbate the hike in international prices and work against new investment. The Committee believes that poverty alleviation should be addressed through focalized programs explicitly accounted for in the government budget, and designed so as to maximize the impact of transfers on the sectors directly affected**

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