

LATIN AMERICA AND THE CARIBBEAN IN THE NEW INTERNATIONAL ECONOMIC ENVIRONMENT



This document was prepared by José Luis Machinea, Executive Secretary of the Economic Commission for Latin America and the Caribbean (ECLAC) and Osvaldo Kacef, Director of the Economic Development Division.

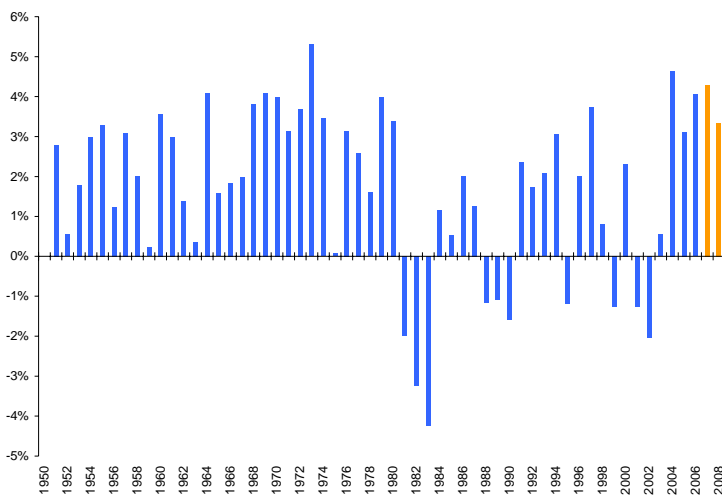
Contents

Introduction.....	5
The influence of the external context on the growth of the region.....	9
Changes in the international situation.....	13
Financing volatility and the slowdown in world growth.....	13
The global surge in inflation.....	16
Latin America and the Caribbean and the global economic slowdown.....	19
Latin America and the Caribbean is less vulnerable to external shocks than before.....	19
External conditions pose risks, however.....	21
Steeper inflation also poses risks.....	27
The distributive impact of rising food prices.....	31
Summary and conclusions.....	33

Introduction

According to ECLAC estimates, the economies of Latin America and the Caribbean as a whole will grow by around 4.7% in 2008. Although this rate is lower than the estimated growth of 5.7% for 2007, it nonetheless marks the region's sixth consecutive year of growth, and the fifth year in a row for per capita GDP growth of over 3%. The region's economy has not experienced a situation like this for 40 years, when similar rates of continuous expansion were recorded over a period of seven years at the end of the 1960s (see figure 1).

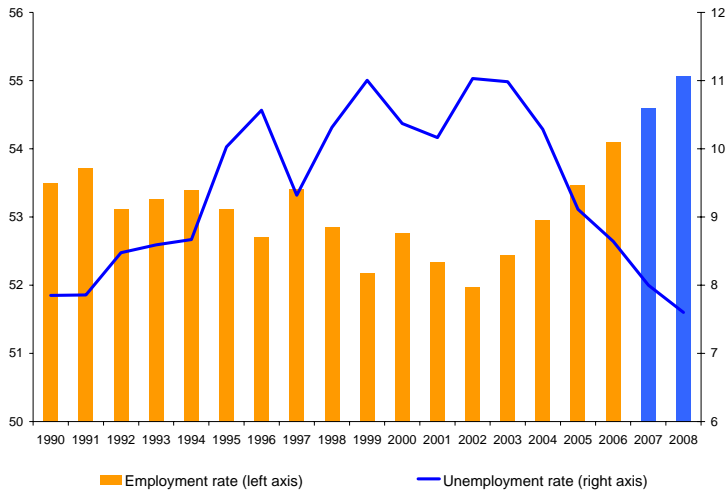
Figure 1
**LATIN AMERICA AND THE CARIBBEAN: PER CAPITA
 GDP GROWTH RATES**
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

One of the most striking features of this expansion is that it has been accompanied by a significant improvement in labour-market indicators. Indeed, the increase in employment has brought down the unemployment rate to an estimated 7.7% in 2008, which is over three percentage points lower than the rate observed at the beginning of the decade. Furthermore, the rise in employment is driven by the increase in wage labour, which is more usually associated with formal jobs and could therefore be a sign of improved employment quality.

Figure 2
LATIN AMERICA AND THE CARIBBEAN: EMPLOYMENT AND UNEMPLOYMENT
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

The combined effect of economic growth, falling employment, improved job quality and the rise in non-wage income (from remittances and conditional transfer programmes) has brought down poverty levels, although they remain very high. Although the percentage of poor in the population dropped by over nine percentage points between 2002 and 2007, poverty still affects more than 35% of the population, or 190

million people, which is higher than the figure recorded at the beginning of the 1980s.¹

Given the importance of external events in ushering in the almost unprecedented period of growth now under way in the region's economies, it is worth considering the scope of the changes afoot in the world economy and how they might affect the situation in Latin America and the Caribbean.

In the context of the current international situation, the aim of this document is to analyse possible scenarios and effects of the increased volatility and uncertainty that have characterized financial markets since mid-2007, as well as the continuous rise in commodity prices (especially oil and food) and its impact on inflation in Latin America and the Caribbean. The second section examines the role of the external environment as a trigger for the growth observed in Latin America and the Caribbean. The third section describes how the global situation has been affected by the crisis in the subprime mortgage market, combined with rising international prices for commodities and the resulting increased inflationary pressure. The following two sections analyse the risks that the new external situation poses for the future of the region's economies. The sixth section identifies the possible impact of the recent increase in food prices on distribution and consumption patterns. The final section offers a summary of the most salient aspects of the current regional and global situation.

¹ See Economic Commission for Latin America and the Caribbean (ECLAC), *Social Panorama of Latin America, 2007* (LC/G.2351-P/E), Santiago, Chile. United Nations publication, Sales No. E.07.II.G.124.

The influence of the external context on the growth of the region

The region's recent growth has been based on an extremely favourable external situation resulting from the sustained expansion of the world economy and abundant liquidity in international capital markets. Another factor is the rapid process of industrialization in developing Asia, particularly China and India, which has changed the structure of world demand. This has swelled the Latin American and Caribbean region's export volumes and improved the terms of trade, and these factors have, in turn, contributed to the accumulation of large trade surpluses.

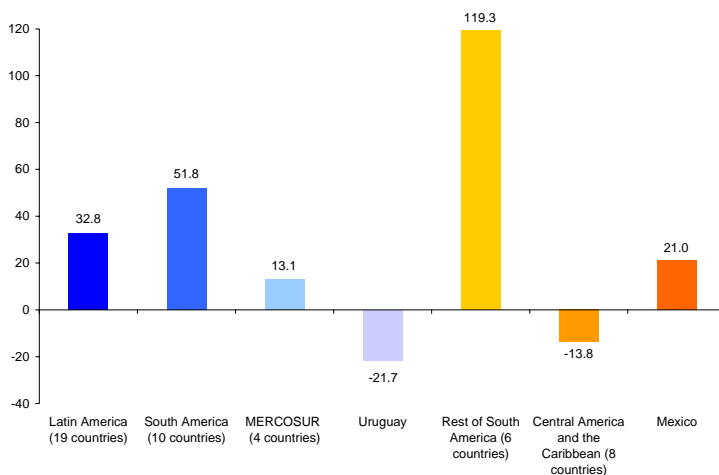
Terms of trade are estimated to have improved by around 33%, when 2007 is compared with the average for the 1990s. But this improvement in the regional average conceals different realities among and within the various subregions. In South America, for instance, the terms of trade increased by about 52%, while in Mexico the improvement was only 21%, and Central America, by contrast, posted a deterioration of almost 14% (see figure 3).

The trends in international goods markets have affected the terms of trade of the region's countries in different ways according to their patterns of integration into the world economy. South America exports raw materials and commodities, for which demand has soared in recent years thanks to the growing importance of China and other Asian countries in the world economy. South America also imports manufactures whose supply has increased for the same reason.² Central American countries, on the other hand, have suffered from Asian competition in the United States

² Within South America, there are also profound differences between MERCOSUR countries (whose terms of trade have improved by around 13%) and the rest of the subregion (including the Andean countries and Chile), where terms of trade for hydrocarbons and metal exporters have improved by almost 120%.

market (their main export destination) and are also net oil importers. Mexico is in an intermediate situation, as it also faces Asian competition in the North American market (like Central America) but at the same time is a net exporter of petroleum.

Figure 3
**LATIN AMERICA AND THE CARIBBEAN: VARIATION IN TERMS OF TRADE
 IN 2007 COMPARED WITH THE AVERAGE FOR THE 1990s**
(Percentages)

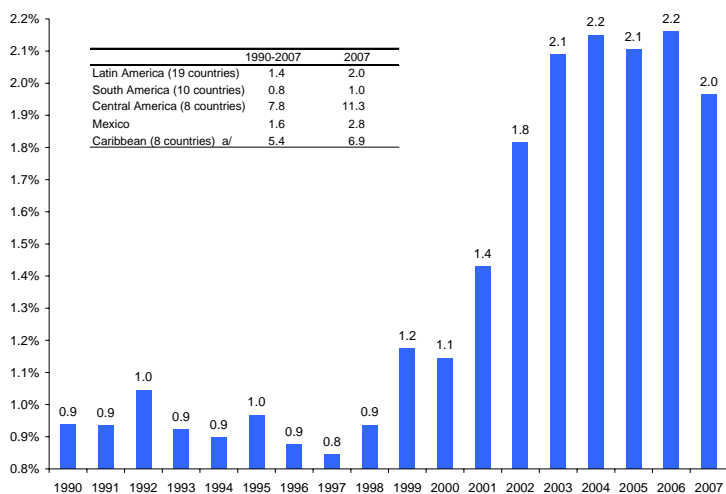


Source: Economic Commission for Latin America and the Caribbean (ECLAC).

Another feature of the current international situation, which will be explored further below, has been the growing influx of remittances from emigrant workers, especially in Central America, Mexico, some Caribbean countries and Ecuador and Bolivia in South America (see figure 4).

Domestic demand factors have become increasingly influential as the expansionary phase of the cycle has progressed. In recent years, investment has become the most dynamic element of demand, although it has not yet regained the level recorded prior to the crisis of the 1980s. Private consumption, meanwhile, is picking up momentum, on the back of strong credit growth and the upturn in employment (see figure 5).

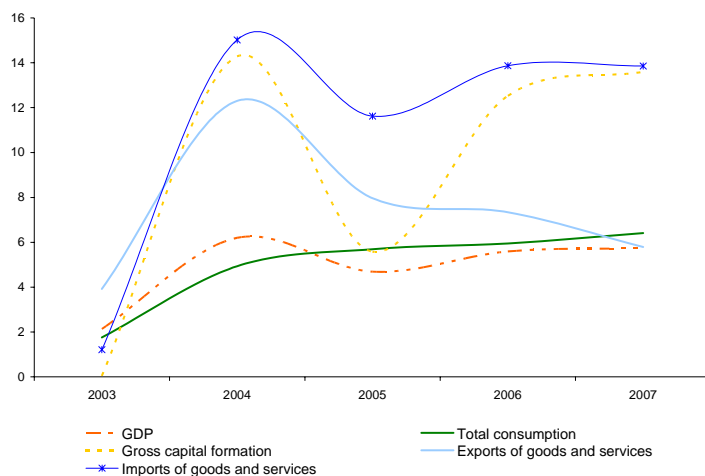
Figure 4
LATIN AMERICA AND THE CARIBBEAN: CURRENT TRANSFERS
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

^a 1990-2006 and 2006.

Figure 5
LATIN AMERICA AND THE CARIBBEAN: COMPONENTS OF SUPPLY AND DEMAND OF REAL GOODS AND SERVICES, RATES OF VARIATION
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

Changes in the international situation

Starting in 2007, certain significant changes began to occur on the international economic scene. First, strong growth in world demand has been followed by a slowdown owing to the financial crisis in the United States. Second, the worldwide rise in inflation over recent months, as well as having an impact on poverty levels, represents an additional factor of uncertainty.

Financial volatility and the slowdown in world growth

Unlike other episodes of financial instability that have affected emerging economies in recent decades, this crisis has been generated in the financial markets of the developed world (the United States in particular) and will have consequences for the growth rate of those economies.

This financial instability originated in the subprime mortgage market in the United States and then rapidly spread through the entire real estate market there and in other developed countries. The construction sector has also been affected and, more importantly, there is a serious threat to the value of the collateral behind many of the loans granted in those countries.

Before assessing the current situation, it is worth pointing out the serious shortcomings in regulation and oversight underlying this problem. One example has been that supervisors of the financial system in the United States have allowed financial institutions to securitize subprime mortgages. It is fairly questionable that banks that have granted bad mortgage loans have then been allowed to offload them in this way. The property-market bubble (which made mortgages more attractive), classification errors by the risk agencies and misinformed private buyers all contributed to the spread of such operations. It is to be hoped that the

need to avoid such mistakes in the future will result in far-reaching reforms to regulation and oversight during the months to come.³

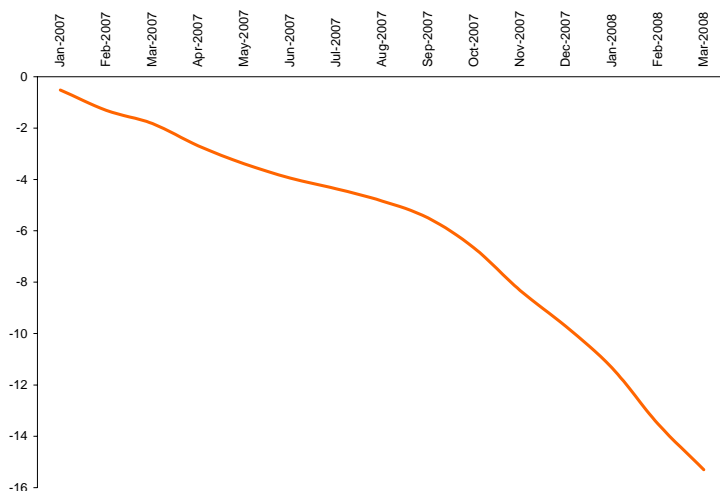
Uncertainty surrounding the solvency of financial institutions (and investment banks in particular) caused a run on their liabilities and serious liquidity problems. As tends to be the case, the liquidity problems began to give rise to additional solvency problems as banks attempted to liquidate assets in the face of deposit withdrawals. The timely intervention of central banks (especially the Federal Reserve) to inject liquidity into the markets, and the bailout of the investment bank Bear Stearns (although not of its shareholders) served to halt the run on institutions and the sense of crisis that had taken hold of banks and investors alike.

However, reducing the risk of a liquidity crisis does not mean that the problems of the financial system have disappeared, as the root of such problems lies in the quality of the loan portfolio. The scale of the losses involved is not yet clear, although estimates by the International Monetary Fund (IMF) suggest they may amount to between 4% and 5% of GDP in the United States (with global losses that could be double that amount in dollars). In the coming months, the possibility that the results of financial institutions will bring bad news cannot be ruled out. Such ill tidings could become additional factors of uncertainty, although this should not reach the levels observed in the days prior to the Bear Stearns bailout.

In this context, one key indicator to watch (due to the implications for the solvency of financial institutions) is that of property prices, which have been falling continuously since mid-2006, but dropped even more sharply from mid-2007 (although the decline could be beginning to slow down). In the United States, property prices have dropped by 15% in 15 months, although the situation differs significantly from state to state (see figure 6).

³ A first step in this regard is the United States Federal Reserve oversight in relation to investment banks, although what needs to be changed is, inter alia, the procyclical behaviour of the financial system, through regulations that serve to increase reserves during boom periods.

Figure 6
UNITED STATES: S&P/CASE-SHILLER HOME-PRICE INDEX
(Rates of variation on the year-earlier period)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from S&P/Case-Shiller home-price index.

Even though 2008 is well under way, there is still no consensus on the scale of the slowdown in growth, as the risk of recession has not been ruled out (although there are signs of a slow recovery starting in the second half of the year thanks to a package of fiscal measures announced a few months ago that should help to lift consumption somewhat). What is clear is that expectations around what happens on the financial market are key to assessing the impact of the crisis on levels of GDP in the United States. Property prices and the resulting reduction in wealth could increase the squeeze by affecting household consumption.⁴

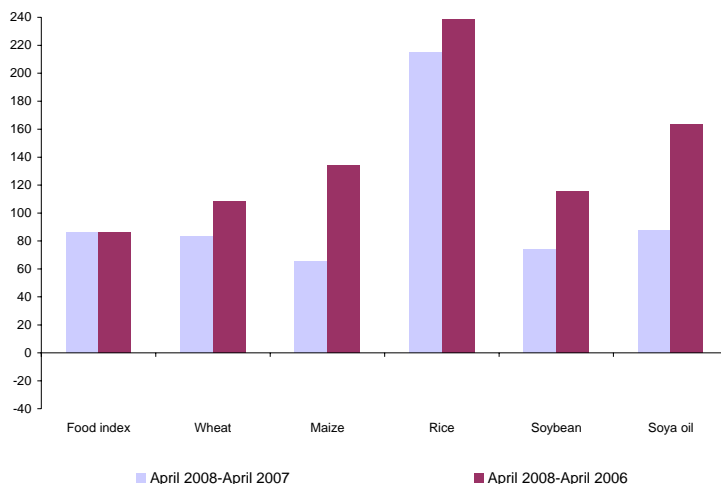
In any event, in terms of the impact on the world economy, the difference between a sharp slowdown and a slight recession (the two most likely results of GDP trends in the United States) is less important than the certainty of even weaker export demand from the United States. What is more, the economic performance expected in Europe and Japan suggests that the slowdown will spread throughout the developed world.

⁴ Notably, consumer confidence in the United States is at a 20-year low, owing to a fall in real-estate values and rising oil and food prices.

The global surge in inflation

Over the past year, the deterioration in financial-market conditions has gone hand in hand with faster rises in the price of some commodities (especially oil and food) (see figure 7).

Figure 7
FOOD PRICE INCREASES
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of United Nations Conference on Trade and Development (UNCTAD).

The increase in prices is due to various factors. First, there is the structural issue of increased world demand for food, due the emergence of a large consumer market in developing Asian countries, combined with simultaneous demand for biofuels and the effect of across-the-board subsidies for such products in the United States and Europe. Second, the rise in petroleum prices generated increases of over 100% in fertilizers.⁵ The situation then worsened as prices rocketed when several countries stopped exporting.⁶ Added to this was the rise in speculative purchases

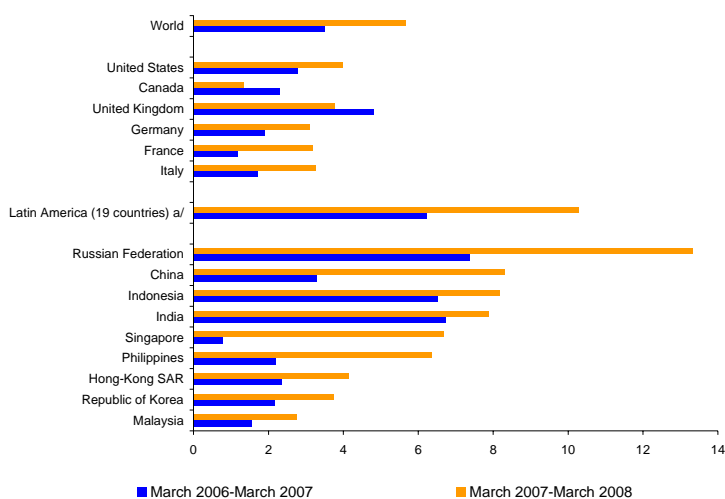
⁵ Adrián Rodríguez Vargas, “Análisis exploratorio de la evolución de los mercados mundiales de commodities agrícolas y del precio de los alimentos”, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), April 2008, unpublished.

⁶ This has happened mainly in the case of products in which world trade represents a relatively small share of production. Rice is the clearest example of this, as world trade

on futures markets that seems to be behind much of the increases in recent months.⁷

These increases are pushing up inflation virtually worldwide, although the impact appears to be greater in emerging economies (see figure 8) than in developed nations. In emerging countries, the lower average income means that food makes up a higher proportion of the basket of consumption and therefore the consumer price index. In developed economies, the slowdown is easing inflationary pressure.

Figure 8
ACCELERATION OF INFLATION IN SELECTED COUNTRIES
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC) and International Monetary Fund (IMF).

^a Simple average for 19 countries.

The surge in inflation, and especially the rise in food and energy prices, is having a direct and negative impact on world demand and has implications for income distribution and poverty (see below). This direct impact is combined with the indirect effect of inflation on the interest rate.

in this product represents only 6% of production, compared with 13% for maize and 18% for wheat (see Rodríguez Vargas, *op. cit.*). However, the international price of rice does not necessarily reflect its price in the domestic market of several countries.

⁷ See Rodríguez Vargas, *op. cit.*

To date, central banks have chosen to react with caution (as dictated by the circumstances), given that in most cases accelerated inflation is due to a supply shock rather than an imbalance resulting from an excessive increase in the demand for goods. So far, the result has been a fall in the real interest rate, which has often become negative. However, the higher the likelihood of price increases spreading to the rest of the economy (depending on the stage of the cycle and/or wage bargaining procedures), the greater the pressure will be on central banks to change their stance. Thus, in a context where inflation is heading towards double figures, it will be no surprise if the monetary authorities begin to raise interest rates or implement other measures to tighten demand.

Latin America and the Caribbean and the global economic slowdown

In terms of how the new context of slower world growth and increased volatility and uncertainty in the financial markets will affect Latin America and the Caribbean, what can be said is that the region is better prepared than before to face a situation of this kind. However, this does not imply that there are no risks in the real or financial sectors, as discussed in more detail below.

Latin America and the Caribbean is less vulnerable to external shocks than before

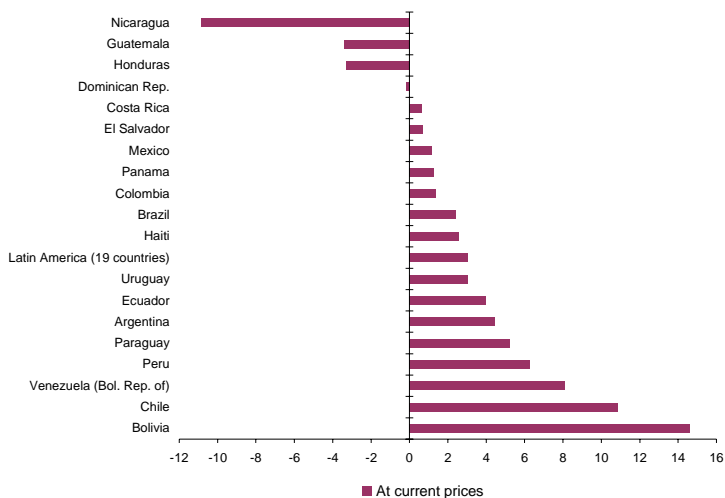
As ECLAC has discussed in other documents,⁸ the region is better placed to handle a deterioration in the international environment than it was in the past, for a number of reasons:

- *The current-account surplus.* Unlike other growth periods, this one has been accompanied by a current-account surplus on the balance of payments, thanks to the combination of trade surpluses, resulting from the growth in volumes exported and, especially, as noted earlier, from the performance of terms of trade and voluminous unilateral transfers in the form of remittances from migrant workers. Although this surplus is not equally large in all the region's countries and has been diminishing in the last few years

⁸ See, for example, José Luis Machinea and Osvaldo Kacef, "La coyuntura económica de América Latina: ¿se justifica el optimismo?", *Hacia un nuevo pacto social: políticas económicas para un desarrollo integral de América Latina* (LC/L.2855), José Luis Machinea and Narcís Serra (eds.), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC)/Fundación CIDOB, 2008; and José Luis Machinea, Osvaldo Kacef y Jürgen Weller, "Situación económica y del mercado de trabajo en América Latina", document presented at the seminar on social cohesion and reform in Latin America, Fundación CIDOB, Barcelona, 26 October 2007, in press.

(and could even turn into a slight deficit in 2008), it is still enough to allow the countries to cover their hard currency requirements, especially when added to resources from FDI (see figure 9).

Figure 9
LATIN AMERICA: CURRENT-ACCOUNT BALANCE, 2007
 (Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

- *Sounder public finances.* In the last few years the countries of the region have gained a sounder fiscal footing. They have been able to boost their fiscal revenues, thanks to faster economic growth and the upturn in the terms of trade. Simultaneously, and in contrast to previous expansionary periods, public spending has been kept relatively in check. These two factors have translated into large primary surpluses.
- *Lower levels and better profile of public debt.* The primary surpluses have enabled the countries to pay off large portions of public debt, and the higher liquidity in the financial markets has enabled them to improve the terms, rates and currency composition of debt portfolios.

- *Larger international reserves and lower external debt.* The room for manoeuvre allowed by the external accounts enabled most of the countries to lower their external debt (with the exception of a number of Caribbean countries) while building up their international reserves, in an unprecedented manner.⁹

External conditions pose risks, however

Slowdown in world growth

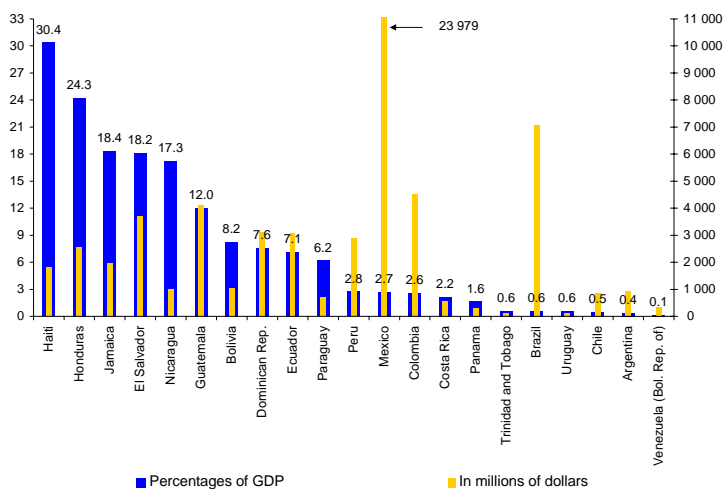
Remittances of emigrant workers. One of the possible impacts of the slowdown in the United States economy is that Latin American and Caribbean workers employed in that country will send fewer remittances, which are an important source of external finance for many Central American and Caribbean countries. In the five countries that receive the largest remittances (in relation to GDP) —Haiti, Honduras, Jamaica, El Salvador and Nicaragua— these inflows represent between 17.3% and 30.4% of GDP. These are not the only countries that depend heavily on remittances, however. The largest recipient in absolute terms is Mexico, which received almost US\$ 24 billion in 2007, or the equivalent of 2.7% of GDP. Although this percentage was small in comparison with other, smaller economies, these flows exceeded the amount Mexico received in FDI that year (see figure 10).

Remittances continued to climb in 2007, but at a markedly lower rate than in the recent past, largely owing to the standstill in those going to Mexico. A recent study presented by the Inter-American Development Bank,¹⁰ however, warned that the percentage of Latin American and Caribbean workers remitting began to decline at the start of 2008, for the first time since the series began in 2001. The study also suggested that this year remittances may begin to drop in real terms, partly because of the downturn in activity levels in sectors that employ large numbers of immigrants, such as construction.

⁹ The ratio of short-term external debt to international reserves, which captures the combination of debt reduction, improvements in the profile of terms and the increase in reserves, moved from over 1 in the early 1990s to 0.2 in 2007 (Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Overview of the Economies of Latin America and the Caribbean, 2007* (LC/G.2355-P), Santiago, Chile. United Nations publication, Sales No.S.07.II.G.161).

¹⁰ See Inter-American Development Bank (IDB), *The Changing Pattern of Remittances, 2008 Survey on Remittances from the United States to Latin America*, Washington, D.C., April 2008.

Figure 10
LATIN AMERICA AND THE CARIBBEAN: REMITTANCES, 2007
(Millions of dollars and percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from Inter-American Development Bank.

Export volumes. A decline in activity levels in the developed countries will reduce the demand for goods, which may hurt the region’s exports.¹¹ If the growth rate of the emerging economies slows less than that of the developed world, then the impact on Latin American and Caribbean exports will depend basically on how much is exported to developed markets, especially to the United States, and on the possibility of redirecting at least some of those exports to other markets in which demand holds steady. This, in turn, depends on the type of goods exported, since it is easier to redirect a standardized commodity than a manufacture produced to the specifications and technical requirements of a particular destination market.

A first look at the structure of Latin American exports by destination market and type of goods shows that manufactures represent around 45% of exports and that over 70% of these go to markets in developed countries. However, those percentages mask very different realities, which show up when the region’s largest manufacture exporter, Mexico, is

¹¹ Up to the first quarter of 2008, there was no major slowdown in United States imports.

separated from the rest of the region. In fact, 74% of Mexico's exports are manufactures and over 90% of these are shipped to developed country markets, mainly the United States.¹² In the rest of Latin America, however, manufactures represent little more than 25% of total exports and just over 35% of these go to developed countries. These percentages are even lower for South America.

Table 1
**LATIN AMERICA: EXPORT BASKET AND
 GEOGRAPHICAL DISTRIBUTION, 2006**
(Percentages of total exports)

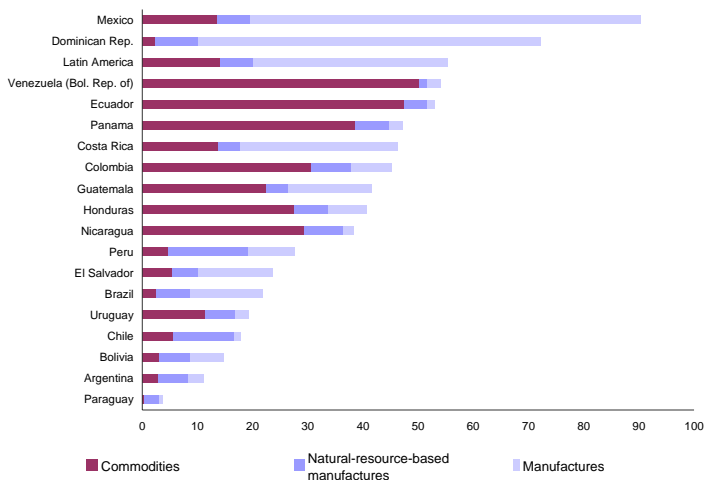
	Composition of exports	Geographical distribution	
		Developed countries	Emerging economies
Latin America (19 countries)			
Commodities	54.2	57.9	42.1
Manufactures	44.6	71.5	28.5
Total	98.9	63.6	36.4
Latin America not including Mexico (18 countries)			
Commodities	72.9	51.4	48.9
Manufactures	25.7	35.8	64.2
Total	98.6	46.5	53.5
Mexico			
Commodities	25.7	87.6	12.4
Manufactures	73.7	90.5	9.5
Total	99.4	89.8	10.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of United Nations Commodity Trade Database (COMTRADE).

Slower growth in the United States economy, in particular, and the developed countries, in general, may thus be expected to have a stronger impact on Mexico and Central America than on South America. This is because, South America's exports are more biased towards commodities, are easier to redirect and have more diversified destination markets, with a larger proportion going to Asian markets, which are projected to continue growing strongly.

¹² Although Mexico has made great efforts to diversify its export destinations, its exports continue to be highly concentrated in the United States market.

Figure 11
LATIN AMERICA: EXPORTS TO THE UNITED STATES AS A PERCENTAGE OF TOTAL EXPORTS, BY PRODUCT CATEGORY, AVERAGE, 2003-2006
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of United Nations Commodity Trade Database (COMTRADE).

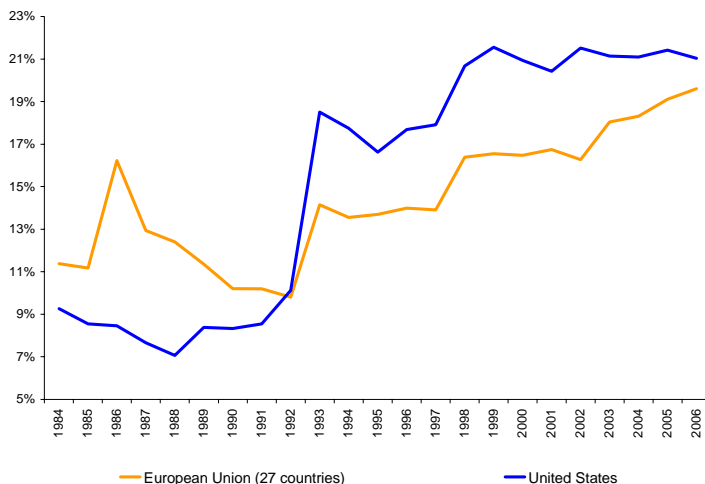
Commodity prices. Another probable effect of the slowdown in global growth is a drop in the prices of commodities, which would affect mainly South America. It is important to consider how other elements that can affect demand for commodities are likely to behave, including the performance of emerging markets, especially China, on the one hand, and the importance of demand for commodities as a financial asset, on the other.

Regarding the first of these two elements, around 40% of Chinese exports go to the United States and the European Union (and around 50% to these two plus Japan). A slackening of growth in those economies may thus be expected to impact heavily on China's export volumes and, hence, on its rate of growth.¹³ The potential size of China's domestic market (and other large Asian markets) could, however, at least soften the contractionary effect of a possible decline in exports. It may reasonably be supposed, therefore, that while a slowdown may occur, it is unlikely to

¹³ The appreciation of the euro may partially offset this effect.

amount to more than two or three percentage points (the Chinese economy grew 11.7% in 2007).

Figure 12
CHINA: TOTAL EXPORTS TO THE UNITED STATES AND THE EUROPEAN UNION (27 COUNTRIES)
(Percentages of total exports)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of United Nations Commodity Trade Database (COMTRADE).

As was noted earlier, however, commodity prices have recently been linked more to what is happening in financial markets than to equilibria in goods markets. In particular, commodities come into strong demand for their reserve value, especially at times when the prices of financial assets are highly volatile, as they are at present. It is therefore difficult to predict prices for these goods in international markets in the short term, although speculative buying may be expected to have a relatively short-lived effect on the behaviour of those markets. It is likely that the price trends seen over the last year will undergo significant changes in the next few months. This phenomenon spills over increasingly into issues of distribution and the impact on poverty, as will be discussed later on.

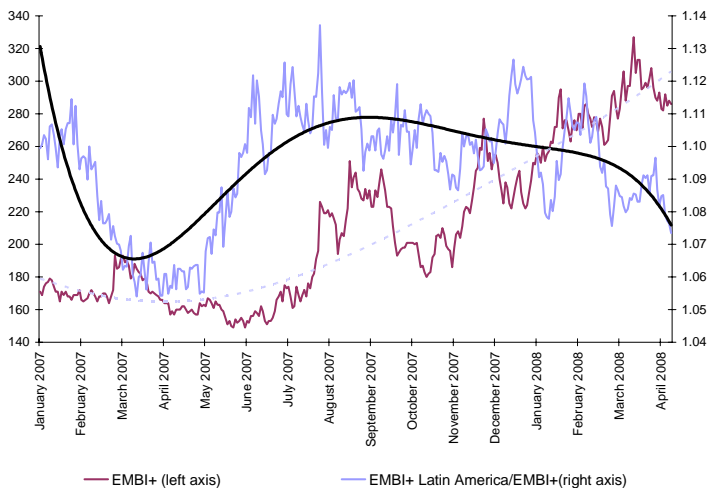
Falling demand for higher-risk financial assets

Increased volatility in financial markets is usually accompanied by a process known as “flight to quality”, as international investors take refuge

in lower-risk assets. This is already happening to some extent, as reflected in the evolution of the emerging markets bond index (EMBI+), which measures the risk attached to emerging country debt. A higher risk premium could affect the region by making financing more expensive, although this does not appear to be a problem in the short term.

Risk premiums have been increasing since mid-2007, but international interest rates have decreased sharply over the last year, thus even though the yield curve has steepened, total financial cost has not increased proportionally with risk spread. The Latin American and Caribbean countries have relatively small borrowing requirements, at least for the rest of 2008, so the higher country risk should have no major immediate consequences as regards liquidity or solvency, although some of the countries may begin to feel these effects next year.

Figure 13
EMBI+ FOR LATIN AMERICA AND RATIO WITH OVERALL EMBI+
(Daily series in basis points)

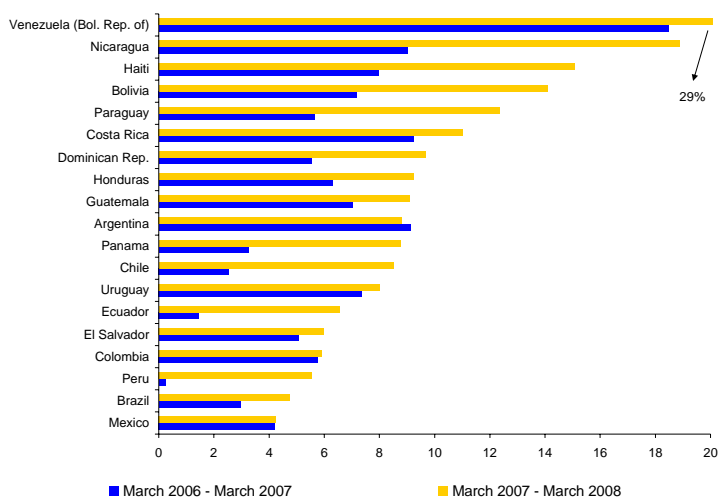


Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from JP Morgan.

Steeper inflation also poses risks

Inflation has risen across the board in the region, largely because of pressure from the supply shocks generated by the steady increase of oil and food prices, as noted earlier, compounded in some cases by demand-side pressures. After falling steadily for several years to around 6% at the end of 2006, the region's average rate of inflation approached 10% in the first half of 2008.

Figure 14
RISING INFLATION IN LATIN AMERICA
(Consumer prices, 12-month rates of variation)

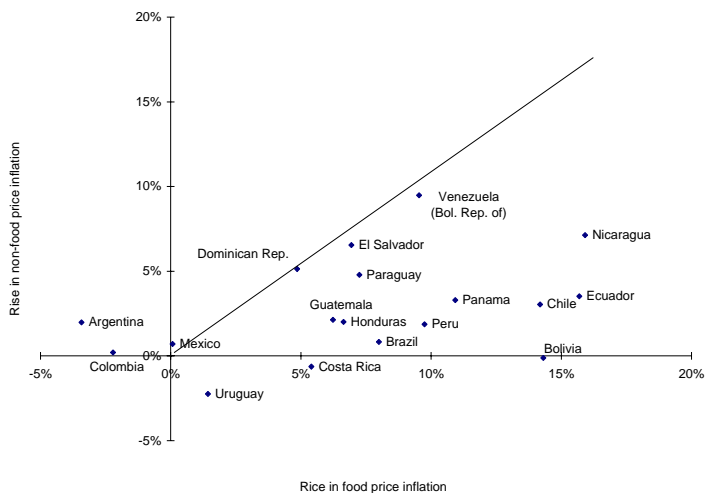


Source: Economic Commission for Latin America and the Caribbean (ECLAC).

Higher inflation worsens the dilemmas central banks already face in shaping monetary and exchange-rate policies in a context of free floating currency and free capital movement, as they have to use monetary policy to offset mounting inflationary pressure at a time when the United States Federal Reserve has sharply cut interest rates.

If central banks decide to raise interest rates to rein in demand, in a context of lower international rates, capital inflows may increase and put additional upward pressure on the currency. If they maintain a passive stance, however, current price rises may spread to other key prices and generate more widespread inflation. Figure 15 shows the increase in food prices in the last 12 months, compared to price rises for other goods and services. As the figure shows, the sharper rises in food prices matches the increase in inflation in some countries (the Bolivarian Republic of Venezuela, the Dominican Republic and El Salvador), but not in most countries of the region, although some effects are already noticeable.¹⁴

Figure 15
LATIN AMERICA: INCREASE IN FOOD PRICE INFLATION AND IN THE REST OF THE CONSUMER PRICE INDEX
(Inflation in the last 12 months compared to the 12 previous months)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

¹⁴ In figure 15, other goods and services include energy prices, so core inflation may be somewhat lower.

In the context of the economic expansion in most countries in the region, the best way to deal with rising inflation seems to be through fiscal policy, in order to avoid undesired effects on the real exchange rate. Public spending has exhibited a procyclical bias recently, however, and this, in combination with its relative short-term inflexibility, makes it likely that interest rates will now tend to rise in most countries, either because it is the right thing to do to slow demand in the absence of timely fiscal policy measures, or because the central banks will face mounting pressure to raise interest rates, whether this is the right course or not. Monetary policy may negatively affect economic activity in the near future, as a result of both the direct effect of rising interest rates and the steeper exchange-rate appreciation that is likely to occur in some cases.

The distributive impact of rising food prices

As discussed earlier, several factors pushed up food prices sharply last year. This, together with the rise in oil prices, explains the widespread increase in inflation. Estimates by ECLAC show that since early 2006, and especially since 2007, consumer food prices have been rising faster in most of the region's economies, posting an annual rate of between 7% and 30% in the different countries, with an average of somewhere around 16%.

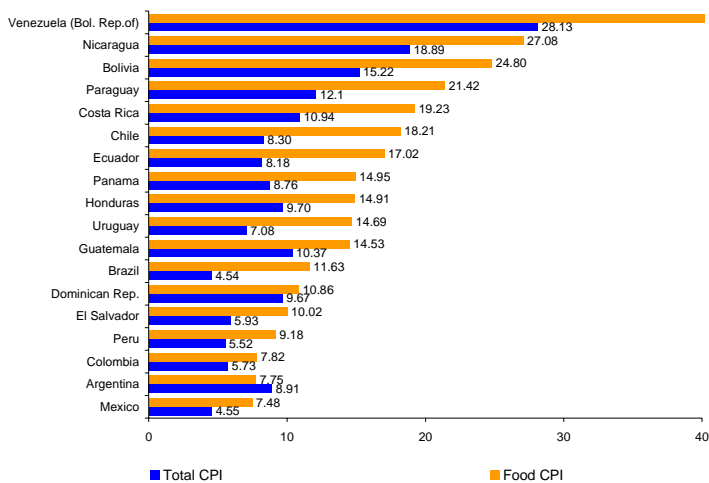
This combination of factors has a clearly regressive impact on income distribution. Those who spend the largest proportion of their income on food are the worst affected by rising food prices. The lower a family's income, the larger the share of that income is used to purchase basic foodstuffs to meet their nutritional requirements. This means that if basic food prices rise more than the prices of other goods, the poorest segments of the population suffer a worse deterioration relative to their real income.

As a result, the situation not only biases the income distribution, but it is also worsening the percentage of indigent (extremely poor) and poor in the region. Based on ECLAC projections for 2007, an increase of 16% in the price of food raises the indigence rate by more than three points, from 12.7% to 15.9%. In other words, 15.7 million more Latin Americans will be driven into extreme poverty.

These estimates do not take into account possible changes in the income of individuals and households, however, nor changes in the prices of non-food goods and services. But even considering that nominal wages have risen, food price variations continue to have negative effects on indigence and poverty. Factoring in a rise of 6% in household income, which is similar to the average income in the general consumer price indices, some 10 million people may slip into extreme poverty as a result of price rises. Moreover, the social conditions of those

who were already poor and indigent before the price rises occurred will also deteriorate further.¹⁵

Figure 16
CONSUMER PRICE INDEX, 12-MONTH VARIATION, APRIL 2008
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

Rising food prices will have a contractionary effect on consumption, since the segments whose consumer baskets are dominated by food are also those who spend most of their current disposable income, given their small or non-existent savings capacity. This adds another contractionary element whose effects may begin to be felt relatively soon. It is therefore all the more important for governments to adopt policies to soften these impacts, either through direct subsidies for lower-income groups or by reducing taxes or subsidizing the production of certain foods.

¹⁵ The outlook is even worse if the effects of increases in fuel prices, which impact on transport fares and utility rates, are factored in.

Summary and conclusions

The current international context is dogged by great uncertainty, which is manifested in extreme volatility in financial markets. The United States economy is expected to experience a sharp slowdown (or perhaps even a slight recession) and this will have a worldwide impact. The slowdown will most likely spread to developed countries, and this will have real and financial consequences in emerging economies in general, including Latin America and the Caribbean. The region may be less affected than in previous crises because it has reduced its external vulnerability in recent years. Nevertheless, the situation clearly poses risks for the economies of the region.

First, exports of manufactures to the United States and to other developed nations are expected to slacken, with Central America and Mexico being the most affected. Second, migrants working in the United States market may send fewer remittances, which may sharply reduce disposable income in several Central American and Caribbean countries. Lastly, future commodity prices, though difficult to predict, should tend to decrease as a result of the slowdown in demand and this, in turn, could affect exports, the current-account balance and growth in South America, although these effects may not be felt in the short term.

Similarly, the distributive impact of rising food prices will have a contractionary effect on consumption and on economic activity, since it affects the poorer sectors of the population most. It is also likely —though not always desirable— that central banks will raise monetary policy interest rates in order to contain the rising inflation, which will have further contractionary effects on regional GDP, although this will happen gradually.

Despite these possible impacts, ECLAC estimates that the region will grow at around 4.7% in 2008, one percentage point less than in 2007. As has occurred in the last few years, South America will post higher growth

rates than Mexico, Central America and the Caribbean. However, although the effects of some of the contractionary factors described will not be fully felt this year, and hence the impact will not be that significant in 2008, the slowdown in the region's growth is very likely to sharpen next year.

It cannot be overstated that, given its magnitude, the increase in food prices requires public policy measures to reduce the impact on lower-income segments. Failure to take appropriate measures will set the region back in the effort to reduce poverty. In this regard, it is worth recalling that undernutrition in childhood has irreversible effects in the medium and long terms. Lastly, it must be borne in mind that many of the region's poorest countries lack the fiscal capacity to take significant measures in this area. Support is therefore needed from the international community, without delay.