Global Economic Outlook:
Cold in the North, Overheated in the South?

Center for Global Development

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The Good, the Bad… and the Uncertain

GOOD

- Emerging markets (including Latin America) as motors of world's growth
- Asia and Latin America resilience to external shocks

BAD

- Europe sovereign debt crisis

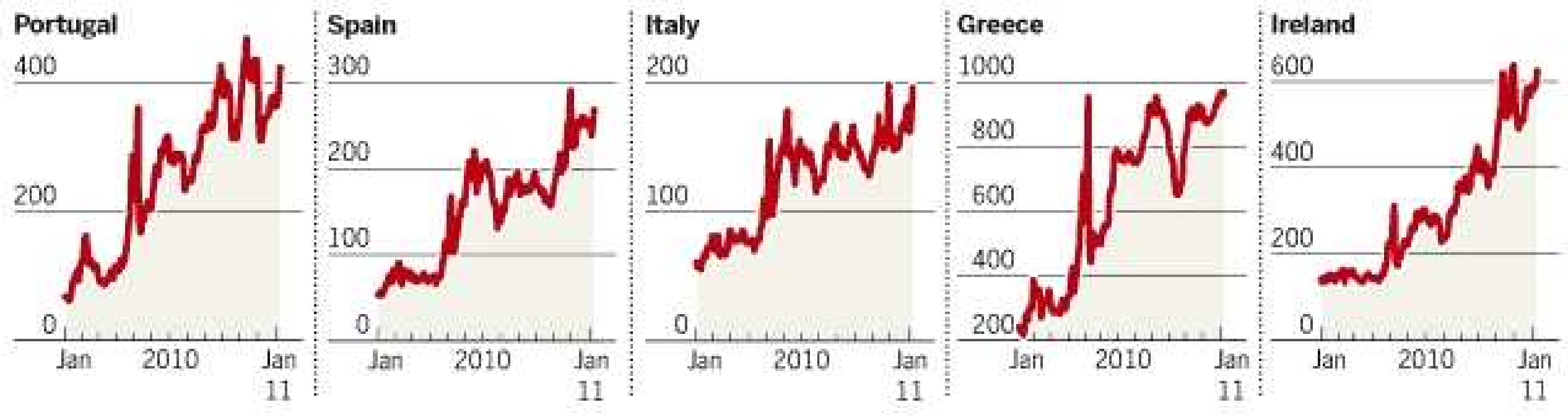
UNCERTAIN

- US recovery path
- Assets-bubble formation in emerging markets (including Latin America)

Europe Sovereign Debt Crisis

- The evidence shows that debt problems in Europe have significantly increased recently

10-year Government Bond Yields
(for Portugal, Spain, Italy, Greece and Ireland)



Source: Financial Times using Thomson Reuters Datastream

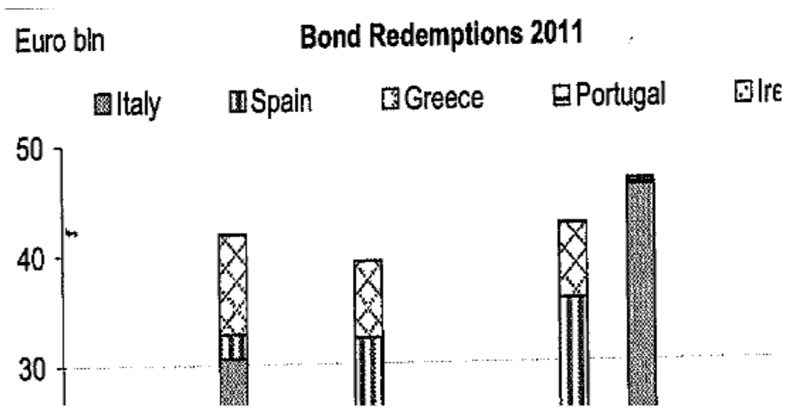
- Spreads are in an upward trend in Greece, Ireland, Portugal, Spain and Italy…

European Sovereign Debt Crisis

… In a context where governments need to roll over existing maturing debt <u>every month </u>of 2011

In the first quarter of 2011, Italy, Spain and Greece will have to refinance over € 65 billions of maturing debt. The estimated governmental refinancing needs of Greece, Ireland, Italy, Portugal and Spain combined reach more than € 270 billions in 2011

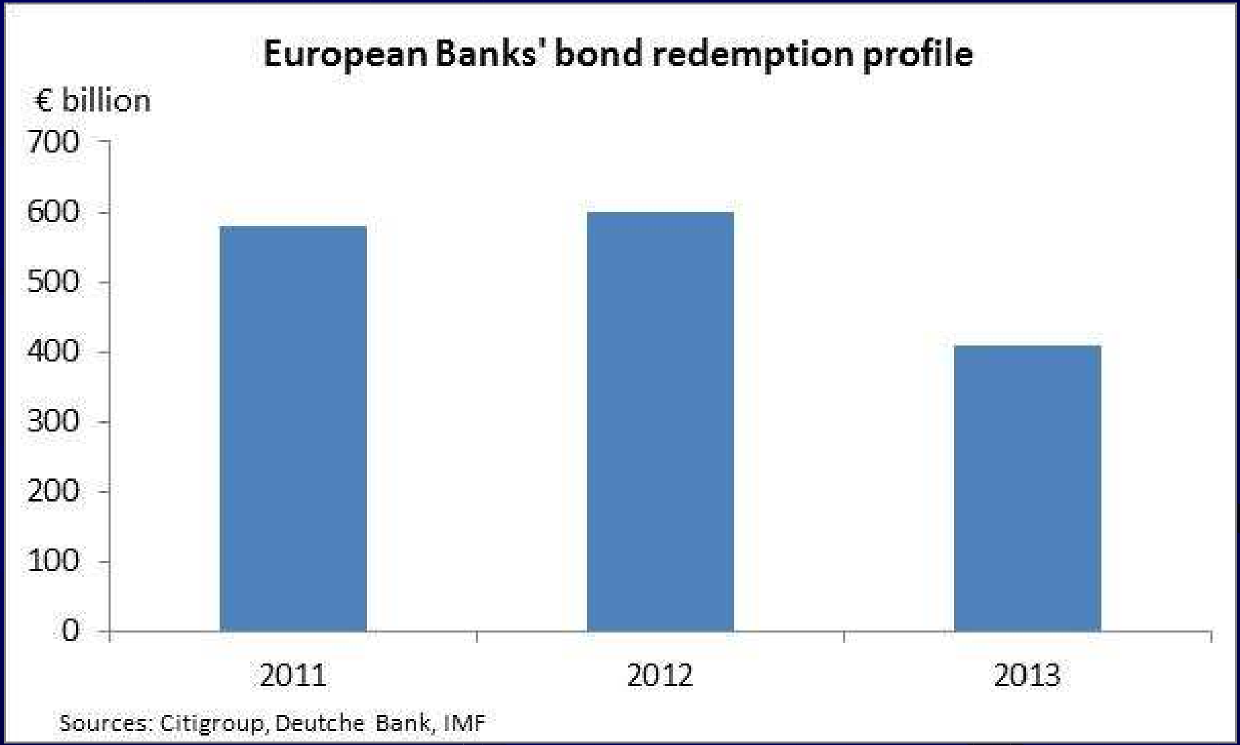
Government Bond Redemptions in Selected EMU Countries



Source: Deutsche Bank

European Sovereign Debt Crisis

… And companies and banks also have large refinancing needs in 2011 and 2012.



In 2011, more than 50% of the refinancing needs come from banks in Greece, Ireland, Portugal, Spain and Italy. Banks from Spain and Italy have the largest financing needs.

European Debt Crisis

WHY HAVE THE PROBLEMS SCALATED SO MUCH?

Four major reasons:

1. **Huge policy Mistakes**

- Policymakers in several peripheral countries have reacted too little and too late. Spain stands out as a case in point. Only in late January a pension reform (with positive impact on the fiscal stance) was approved. However, the plan to recapitalize the "Cajas" (saving banks) is insufficient (the authorities are underestimating the amount of capital needed and are not responding fast enough).

- At the EU level, leaders announced (early November) that Eurozone sovereign debt issued after June 2013 could be subject to restructuring (so that costs of future bail-outs would be shared by the private sector).

Since markets reflect announcements of future changes in today's prices, spreads of bonds from fragile Eurozone countries jumped (and have remained high)

European Debt Crisis

WHY HAVE THE PROBLEMS SCALATED SO MUCH?

2. Denial and Delays to Access Sources of Funding

- Not recognizing the dimension of the problem and delaying access to available funds in the European Financial Stability Fund (EFSF) (total € 750 billion)

- Greece: delayed acceptance of an IMF program. But months later (May 2010) had to accept it, together with a bail-out from the EFSF
- Ireland also delayed an EU/IMF agreement until late 2010
- Portugal is currently not recognizing that the country needs to access the EFSF

Denial is hurting European countries and increasing the cost of crisis resolution

European Debt Crisis

WHY HAVE THE PROBLEMS SCALATED SO MUCH?

3. "Fatigue" with Adjustments coupled with political tensions

- Riots in the streets of Greece over the austerity masures
- - Elections in Ireland (February 25th) when the most likely winner (a coalition between the Fine Gael and Labour parties) will seek renegotiation of the terms of the EU-IMF loan.

- Criticisms on the current government's handling of the crisis (especially of the large bail-out of Anglo Iris bank) have resulted in public discontent.

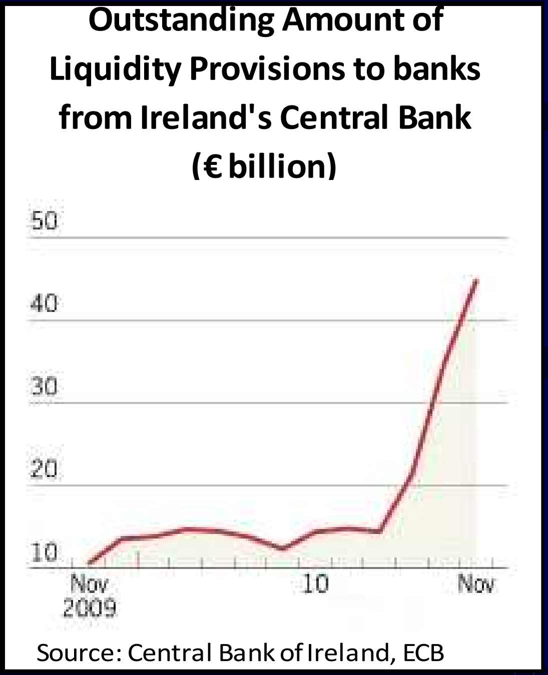
- In Spain, Prime Minister Zapatero has very low public support and polls forecast that his party will lose next year's elections.
- In Portugal, assurances of a NO to an EU/IMF rescue is a key point in major parties' political agendas
- Political divisions in Belgium (and a weak central government) have created serious obstacles to implement needed reforms

European Debt Crisis

WHY HAVE THE PROBLEMS SCALATED SO MUCH?

4. Uncertainty about Bank Soundness in European Countries

- New stress tests in Europe may reveal levels of undercapitalization much greater than currently estimated
- In Spain, the decline in house prices will continue. This further erodes the solvency of the Cajas.
- In July 2010, stress tests revealed a capital shortfall of only € 3.5 billion in Ireland. In December 2010, Irish banks needed more than € 30 billion for the rescue; and Ireland's central bank has been providing large amounts of liquidity into its banks.



- Exposure of large European banks to Eurozone peripheral countries is uncertain. What is known, however, is that European banks hold billions of European sovereign debt.

European Debt Crisis

WHY HAVE THE PROBLEMS SCALATED SO MUCH?

All the factors above imply that default in one or more European countries cannot be ruled out, as the following scenario is a clear possibility:

Fiscal adjustments → lower growth rates → lower tax collections and increased banking sector fragilities → higher costs of debt refinancing → international demand for further fiscal adjustments and structural reforms → increasing popular discontent (in the context of weak governments) → failure to meet fiscal targets → cesation of financial support from multilateral and/or EU fund → large difficulties to roll over external debt → default!!

European Debt Crisis

WHY HAVE THE PROBLEMS SCALATED SO MUCH?

- The problem is that if a European default materializes, contagion to the rest of peripheral countries in the Eurozone would be unavoidable. In that event EMU cannot continue in its current form.

- 2011 is the critical year for determining prospects for the Euro and the Eurozone

- What investors need to watch is the month-to-month evaluation of: (a) yield spreads; (b) any shortening in the maturity of debt issuance; (c) social and political unrest; and (e) political pressures in Germany for a reduction in the use of taxpayers’ money to rescue governments with excessively high debt ratios. Watch the evolution of the newly proposed European Stability Mechanism and its potential ability to buy back debt at market prices (i.e. a voluntary restructuring of debt)!!

European Debt Crisis

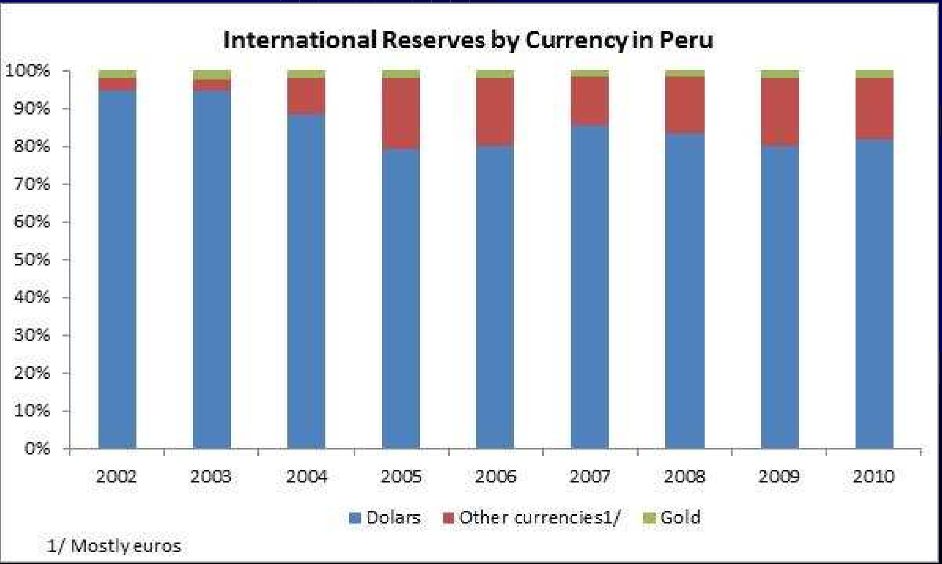
But what happens in Europe does not stay in Europe. Disorganized defaults would have severe effects on growth and stability prospects of emerging markets, including those in Latin America.

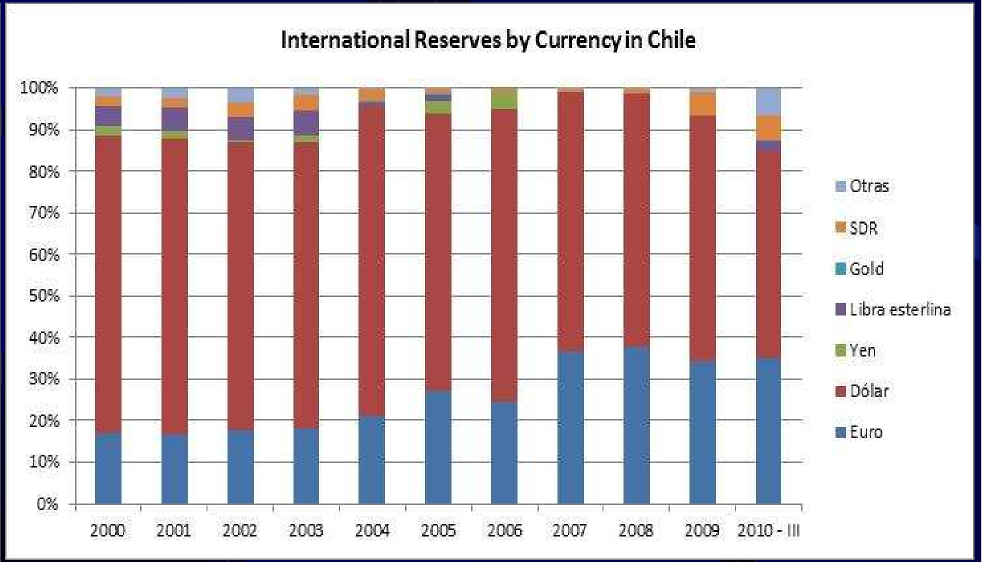
THERE ARE FOUR TRANSMISSION CHANNELS:

1.Interconnected financial markets

•A sharp decline in European sovereign bonds would affect balance sheets of private and public institutions around the world

•After the US-led financial crisis, many central banks diversified the currency composition of international reserves, increasing holdings of euro-denominated assets.





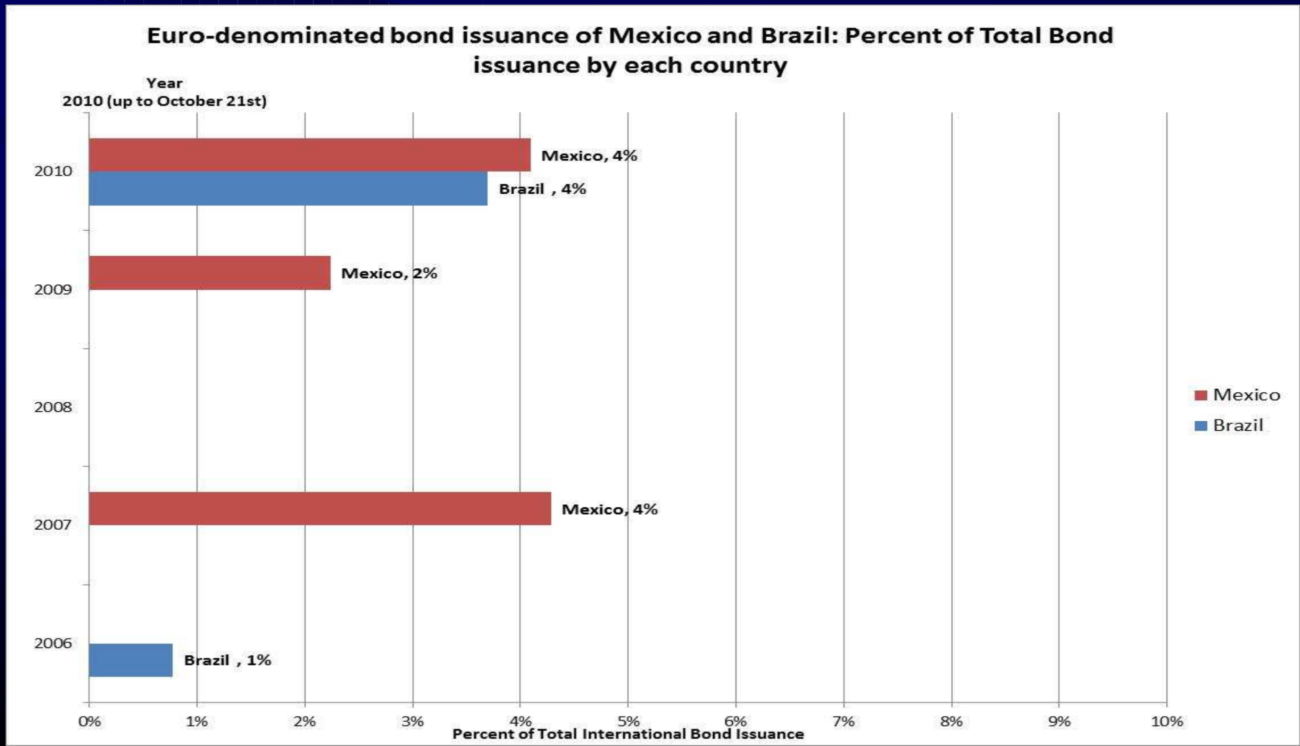
In some countries, like Chile, exposure to Euro denominated assets is significant

European Debt Crisis

FOUR TRANSMISSION CHANNELS:

2. Disruptions in global bond markets

- Particularly in the Eurobond market, where a number of emerging markets have increased their fund-raising activity
- In Latin America, Mexico and Brazil are the major issuers of Euro-denominated bonds, but this issuance (as percentage of total essuance) remains small

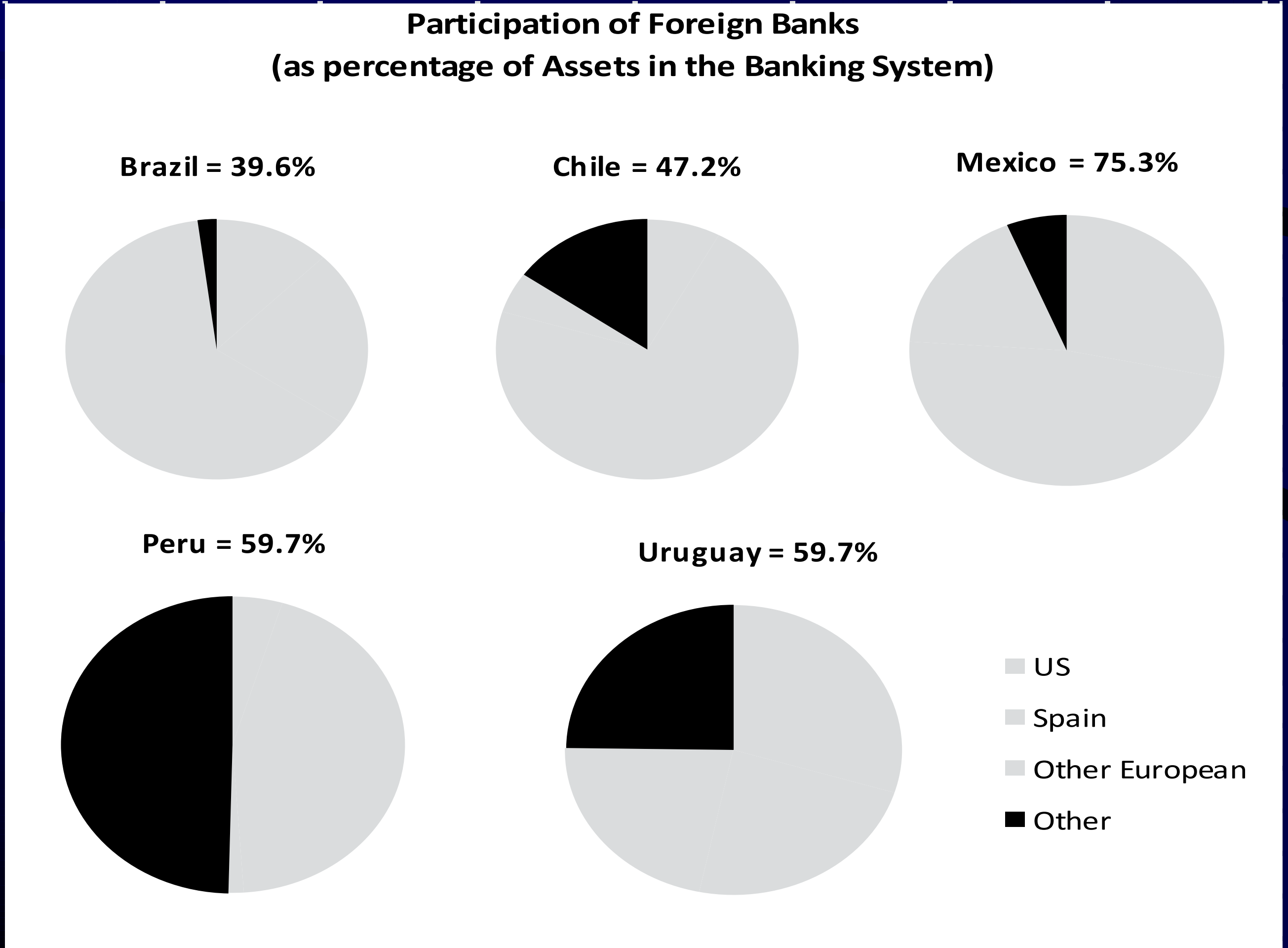


European Debt Crisis

FOUR TRANSMISSION CHANNELS:

3. European Banks' Activity in Latin America

Which is important in a number of countries, especially Brazil, Chile, Mexico, Peru and Uruguay



Source: Bankscope

European Debt Crisis

FOUR TRANSMISSION CHANNELS:

4. Trade

Export Direction by Commercial Partners
(in percentages)

	Latin America		United States		Europe		Asia (excluding China)		China		Resto del Mundo	
	1992	2009	1992	2009	1992	2009	1992	2009	1992	2009	1992	2009
Argentina	33.50	42.54	10.74	6.22	34.59	22.22	12.35	13.70	0.99	6.59	7.83	8.72
Bolivia[a]	39.88	64.96	16.02	6.93	41.10	8.51	1.67	15.52	0.001	1.89	1.33	2.19
Brasil	22.43	20.51	19.34	10.20	32.64	26.73	17.66	17.58	1.27	13.20	6.66	11.78
Chile	17.09	16.84	15.16	11.68	31.67	20.33	29.81	23.22	2.85	24.06	3.42	3.87
Colombia	26.93	29.86	35.83	39.20	28.58	18.89	4.69	7.22	0.05	2.89	3.92	1.94
Ecuador	19.00	42.43	45.65	33.21	17.09	20.31	15.86	1.45	0.03	0.89	2.37	1.71
México	5.00	6.38	80.60	80.52	7.81	5.33	2.96	2.33	0.10	0.96	3.52	4.48
Perú	19.02	15.72	20.70	16.99	34.34	30.96	15.10	10.57	5.40	15.25	5.45	10.51
Venezuela	17.30	37.06	50.34	21.57	10.82	16.10	3.69	2.23	0.01	16.55	17.84	6.49

a. The information for the year 2009 corresponds to the year 2008
Source: INTAL - IADB

Although Europe's participation in Latin America's exports has declined (favoring Asian countries), it is still the most important (or second most important) trading partner for Argentina, Brazil and Peru.

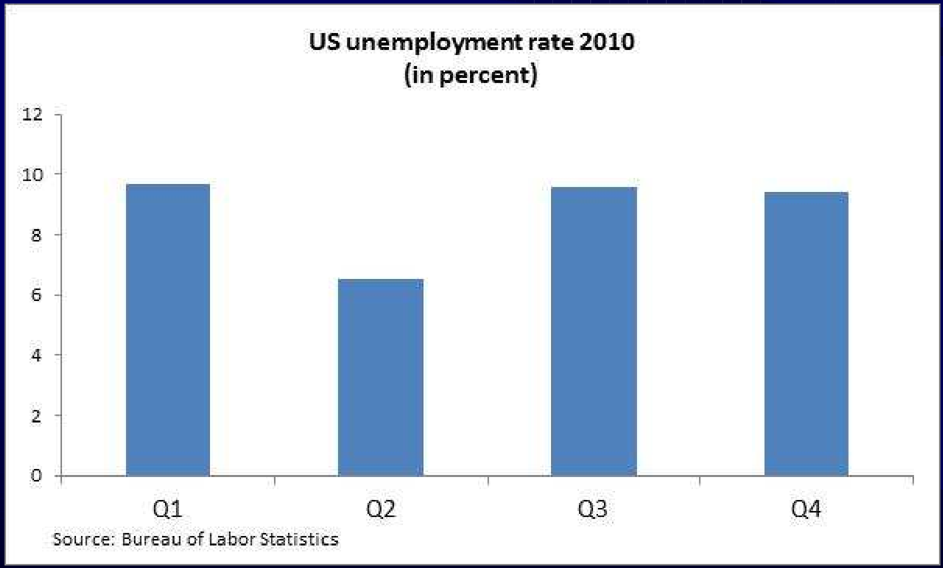
Continued Sluggish Growth in the US

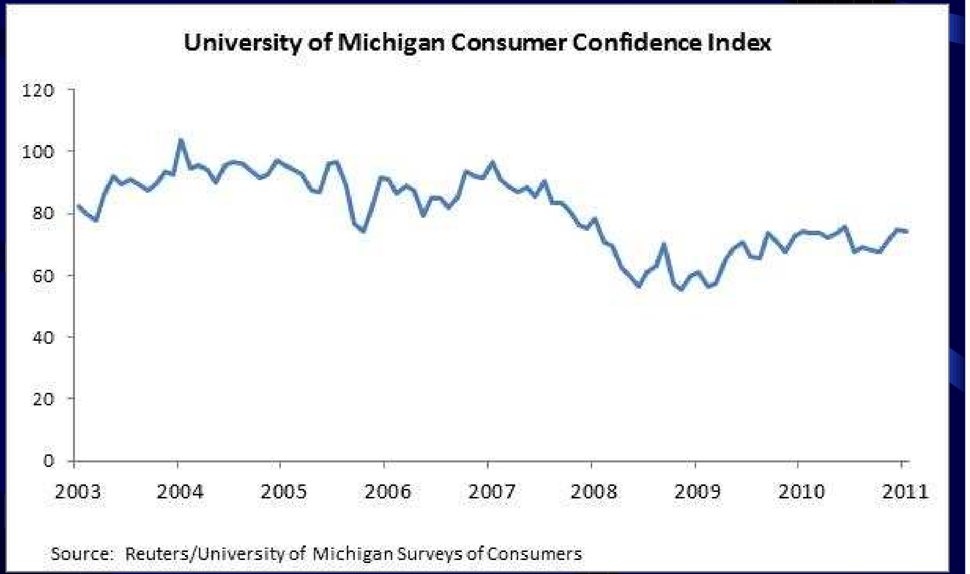
- In spite of improved growth in the last quarter of 2010, the US recovery is fragile

Sustainable recovery needs two components:

job growth + strong consumer confidence

This is not happening





Consumption is the lion's share (almost 70%) of GDP. Sustained growth needs increased consumption

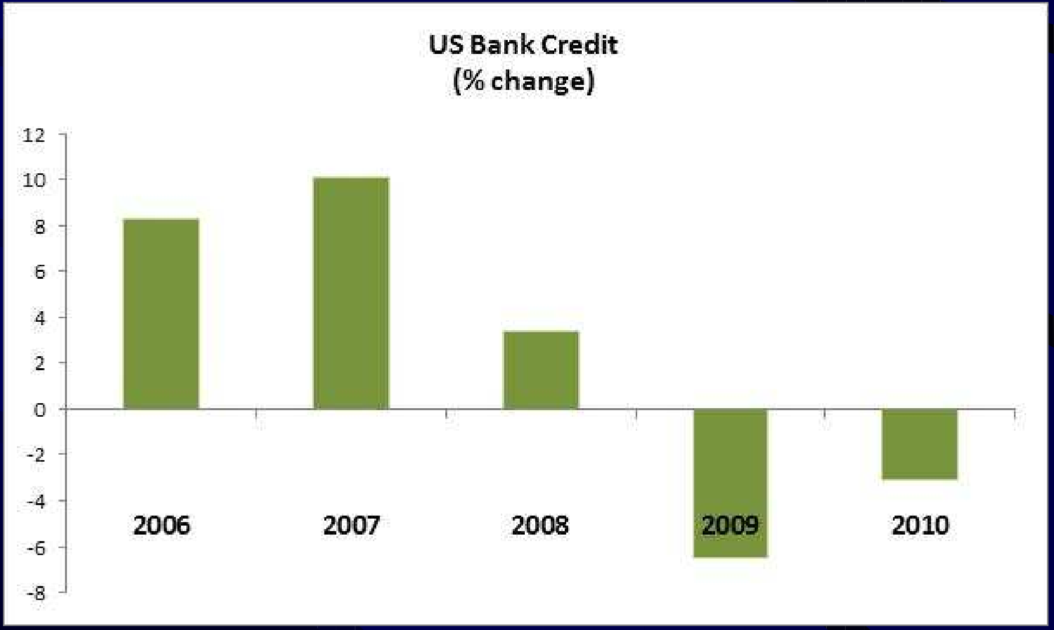
Continued Sluggish Growth in the US

A central problem facing the US is that its tools for enhacing growth (monetary and fiscal policies) are facing severe limitations.

1.Monetary Policy:

•QE2 (the second round of quantitative easing) has the intention of reducing long-term interest rates and create incentives for increased credit and consumption.

•But the policy misses a key point: as long as the problem of excessive bad debt in the mortgage market is unresolved (debt-overhang) consumers will not borrow and credit expansion will remain limited.

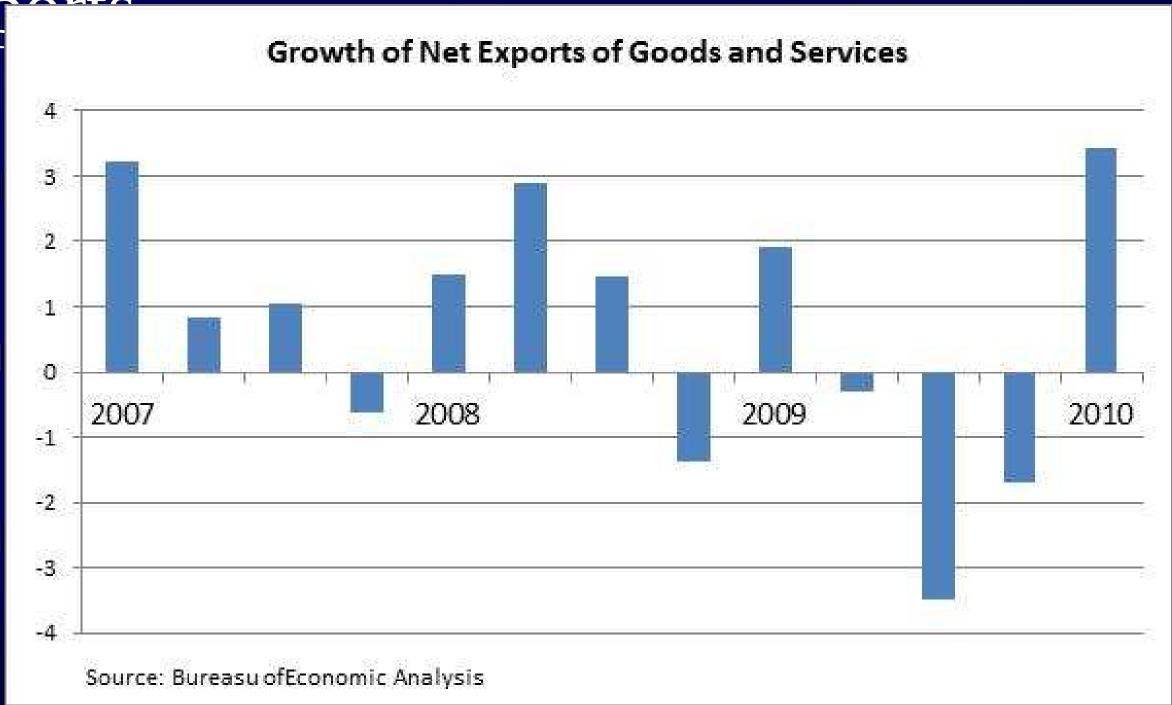


Under conditions of unresolved problems in mortgage markets, more liquidity cannot induce significant credit growth

Continued Sluggish Growth in the US

1. Monetary Policy:

What the announcement (and implementation) of QE2 can do (and have done) is to contribute to weaken the US dollar and promote exports.

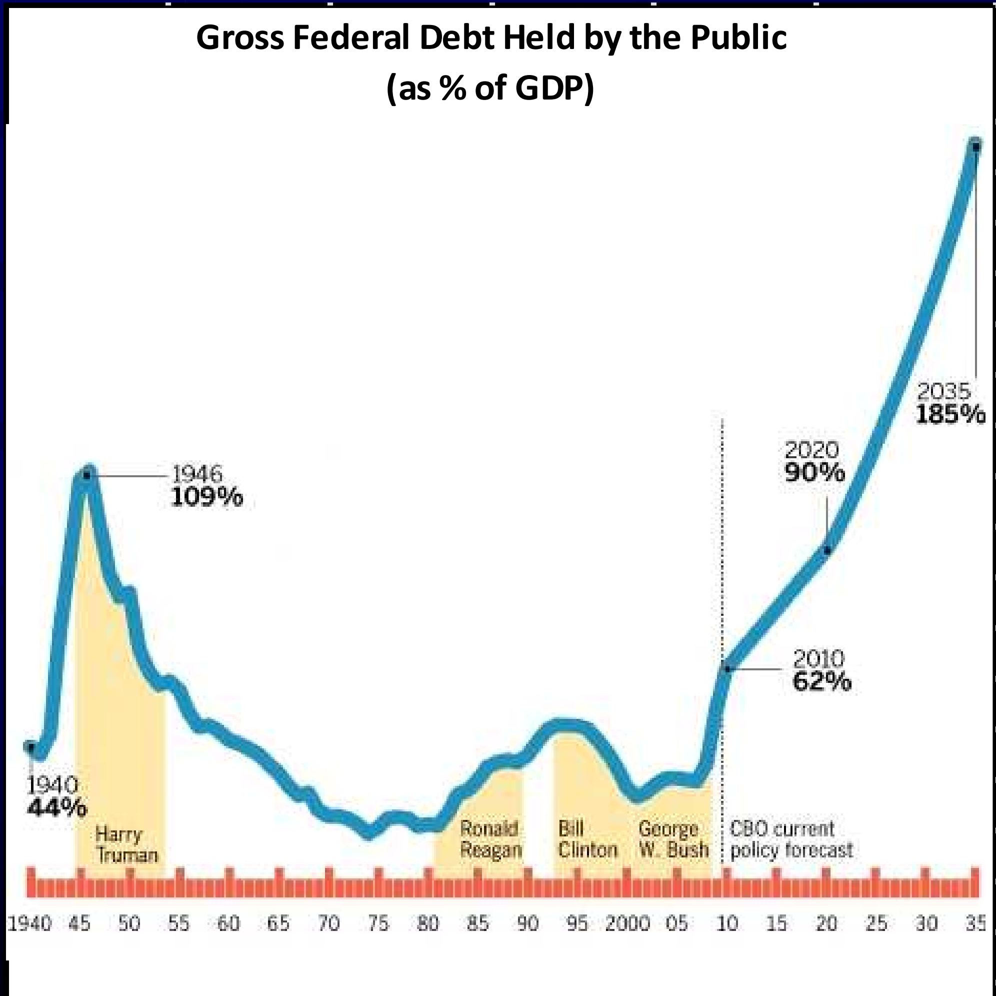


QE2 also sends a signal that the Fed will keep trying even of Government and Congress fails to reach necessary

Continued Sluggish Growth in the US

2. Fiscal Policy:

The dilemma is: fiscal stimulus for growth now will worsen the sovereign debt dynamics, which will lead to Europe-like problems



Source: Financial Times

Continued Sluggish Growth in the US

2. **Fiscal Policy:**

- The real problem (similar to Europe) is the lack of political will to implement <u>the right policy mix:</u>

More stimulus now + an agreed plan (enacted now) to reduce the deficit significantly in two to three years

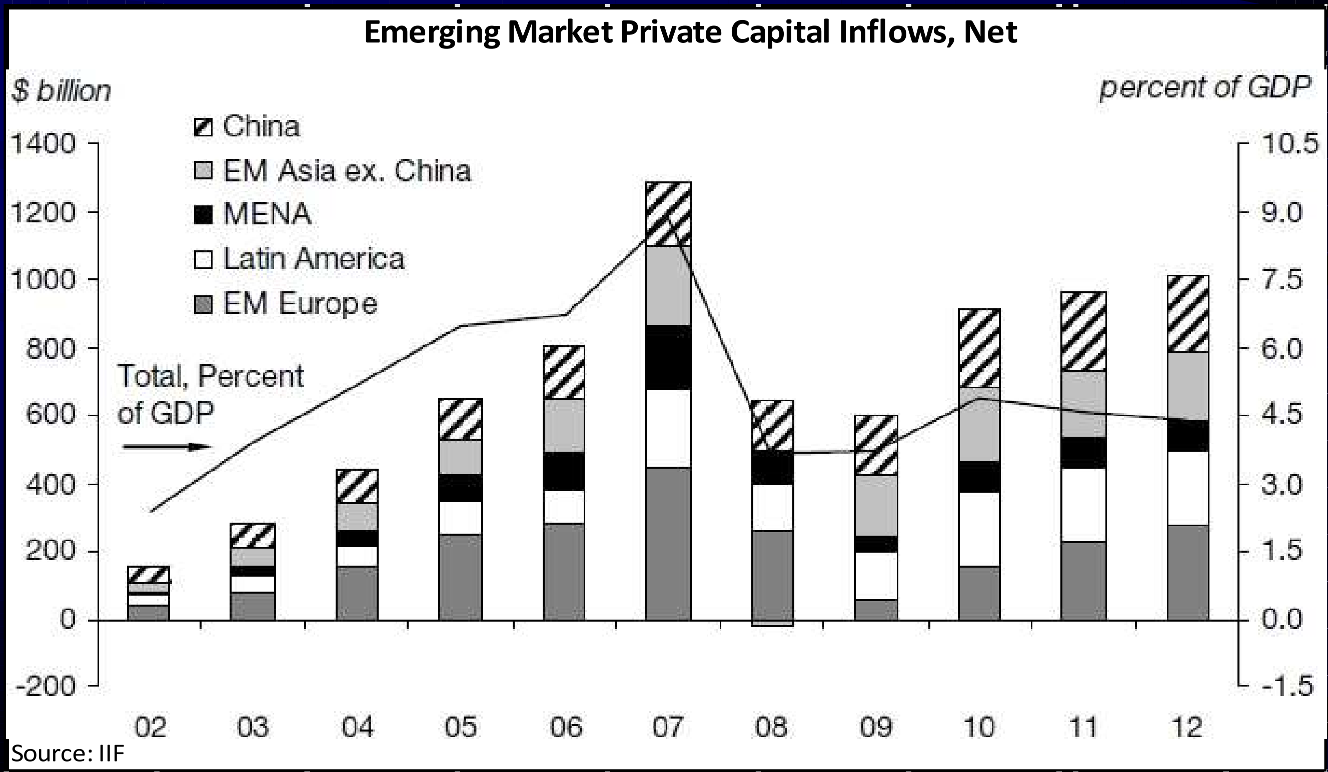
- The first part (stimulus) has been adopted (at least partially): extending the Bush-era tax cuts, unemployment insurance and, most importantly, the payroll tax holiday. NO word on using public funds to revive the mortgage markets though
- The second part (reducing the medium-term deficit) is totally uncertain. This will keep makets nervous about the sustainability of the US debt

Watch out for the government's request to increase the debt ceiling in Q2 of this year. If no agreed plan for debt reduction is in place, I expect increased market turmoil.

Continued Sluggish Growth in the US

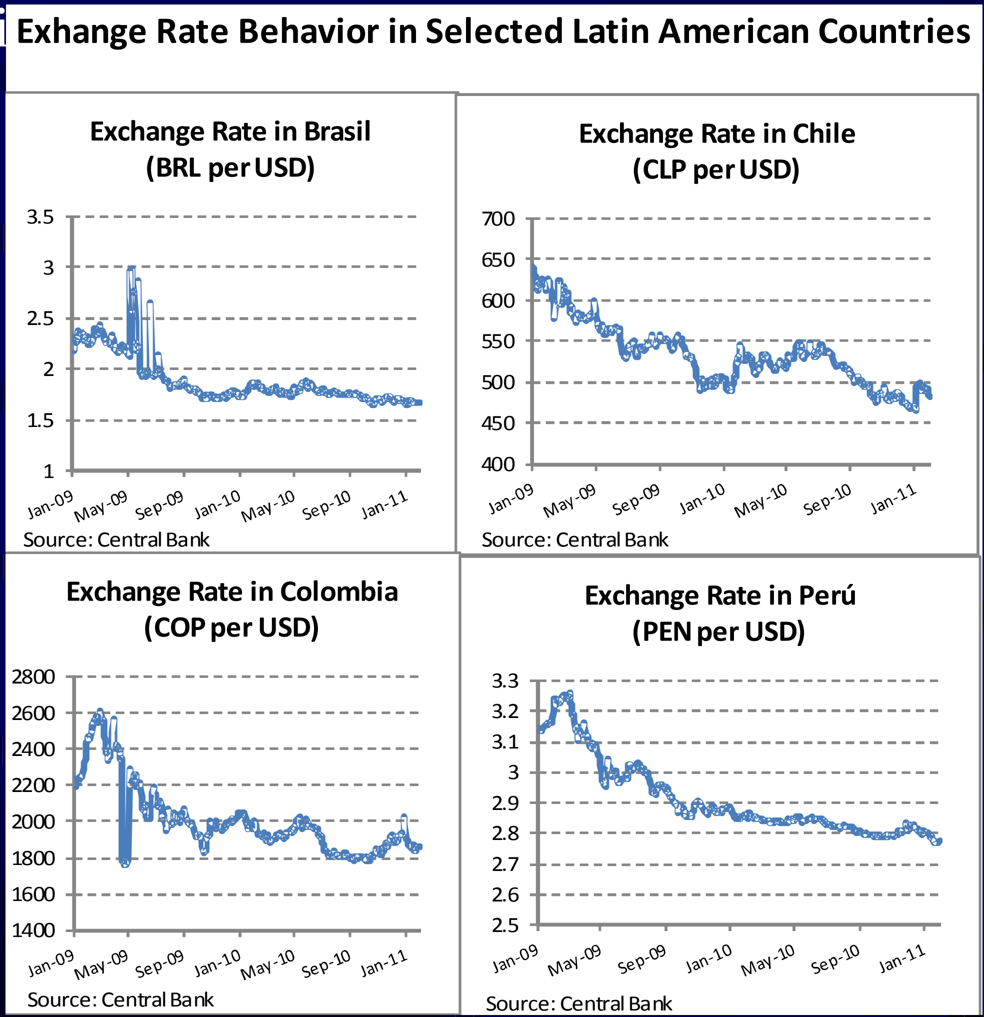
US policies are having deep impact on emerging markets, particularly in Latin America

•Expansionary monetary policy in the US, coupled with sluggish growth in the country, is resulting in huge capital inflows to emerging markets



US Policies Impact on Latin America

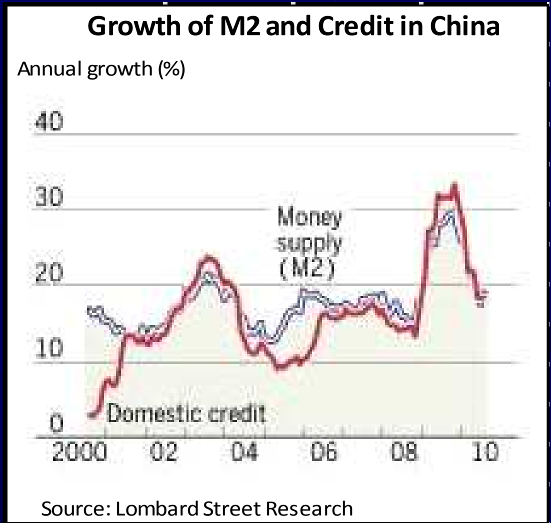
- This is creating strong pressures for exchange rate appreciation, especially in countries with greater exchange rate flexibility, such as those in Latin Ameri

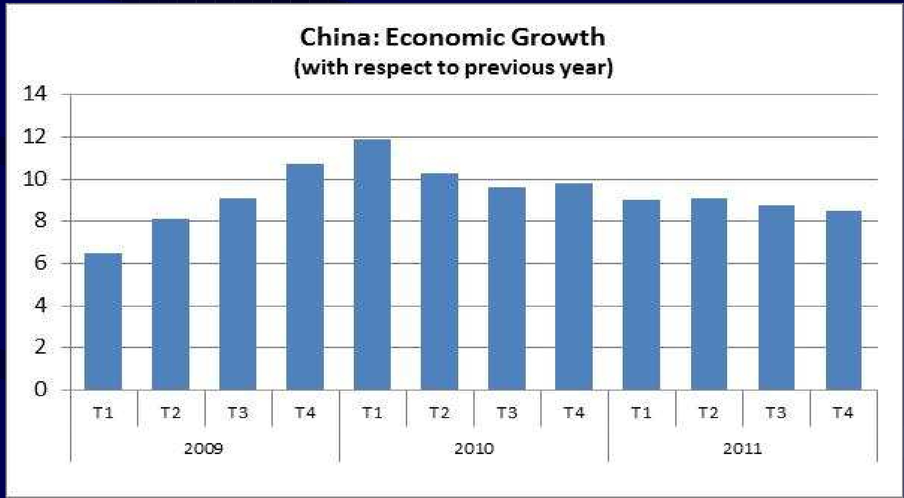


This in spite of interventions in foreign exchange markets and, in some cases, capital controls

China's Role

- Supporting global growth, China will continue expanding in 2011, albeit at a lower rate than in 2010.
- Increased inflation and rising real state prices have become growing concerns for the Chinese authorities
- This justifies a deceleration of money supply growth (which is already happening) and a slower pace of economic activity in 2011





- Achieving credit growth reduction and slower growth would be positive developments in China to contain bubbles in asset prices.

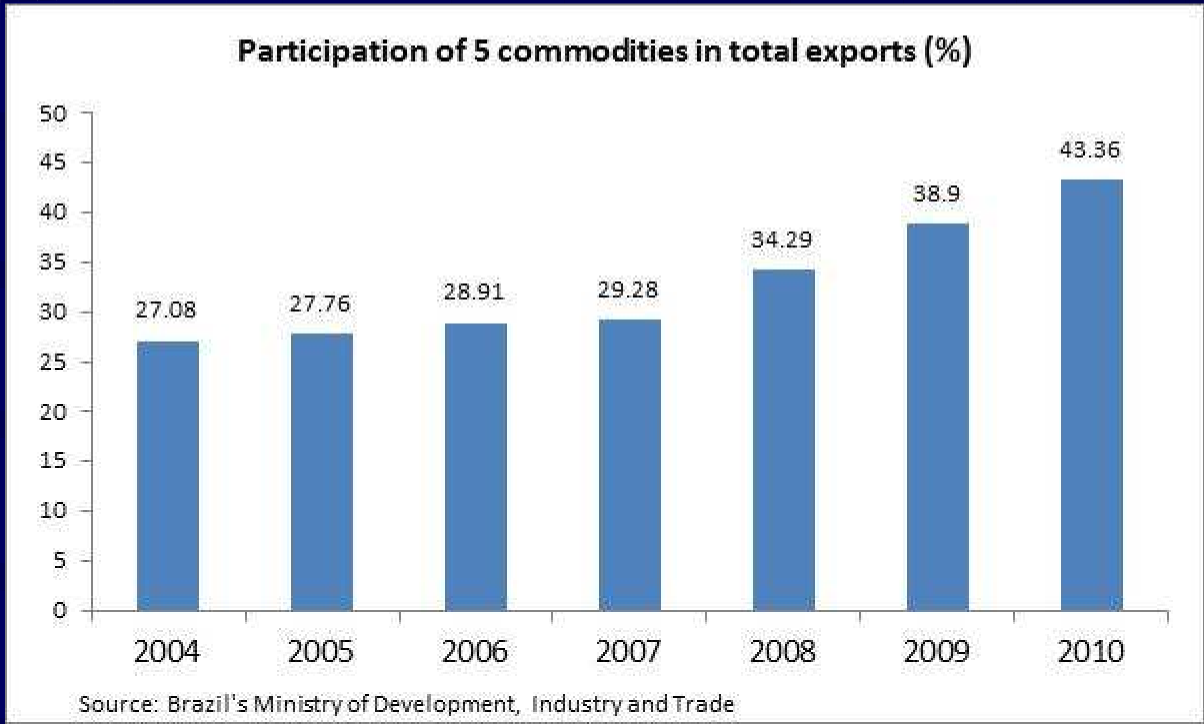
Indeed, a serious risk is that China does not continue reducing credit growth in 2011 and that the authorities be forced to implement drastic measures in 2012, including broadening price controls (which would result in supply shortage for companies)

China’s Role

- On a less positive note, China’s exchange rate behavior is hurting competitiveness in other EM economies, especially Latin America.
- While very low interests rates in the US (and other advanced economies) are at the root of the large capital inflows to Latin America, the reluctance of China to appreciate the yuan faster exacerbates the exchange rate pressures.
- The combination of high commodity prices (also supported by China) and exchange rate appreciation is hurting domestic manufacturing and reducing export diversity in a number of countries.

China's Role

Brazil is the best example of recent export concentration



Only five commodities: iron ore, crude oil, soy (beans, meal and oil), sugar and meat accounted for 44% of Brazilian exports in 2010. This compares with 27% in 2004.

The recent trade tensions between Brazil and China will persist as long as the yuan remains undervalued

And Commodity Prices will remain high in 2011

The world's economic conditions lend themselves for an increased demand for commodities, since investors can:

•Gain exposure to emerging market economies (especially given low interest rates in the US)

•Hedge against turbulence in financial markets (especially from Europe)

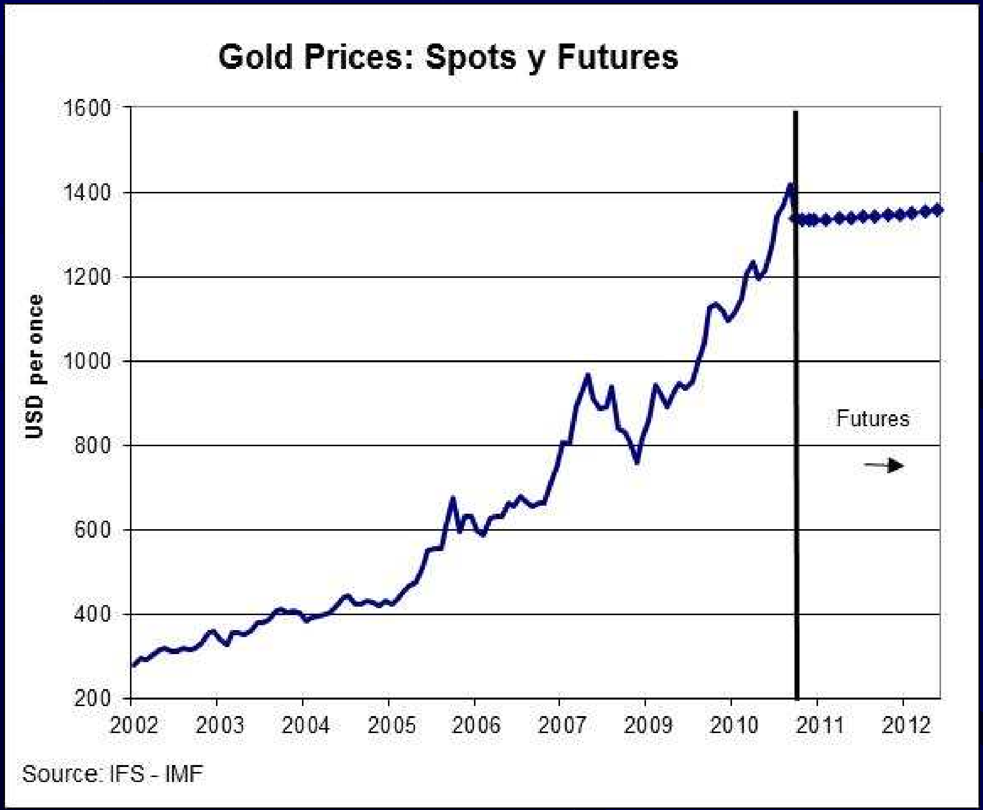
•Hedge against inflation's concerns.

The inverse relationship between the value of the US dollar and oil prices is a long-run one

If adverse events in Europe materialize it is possible that we would observe both an appreciation of the US dollar and an increase in the price of oil.

And Commodity Prices will remain high in 2011

The price of gold will also remain high supported by an increased demand for gold by central banks from emerging markets (especially Asia)



Concerns about a bubble in gold prices are a serious issue. If gold prices surpasses US$2,000/oz, it can be called a bubble.

And Commodity Prices will remain high in 2011

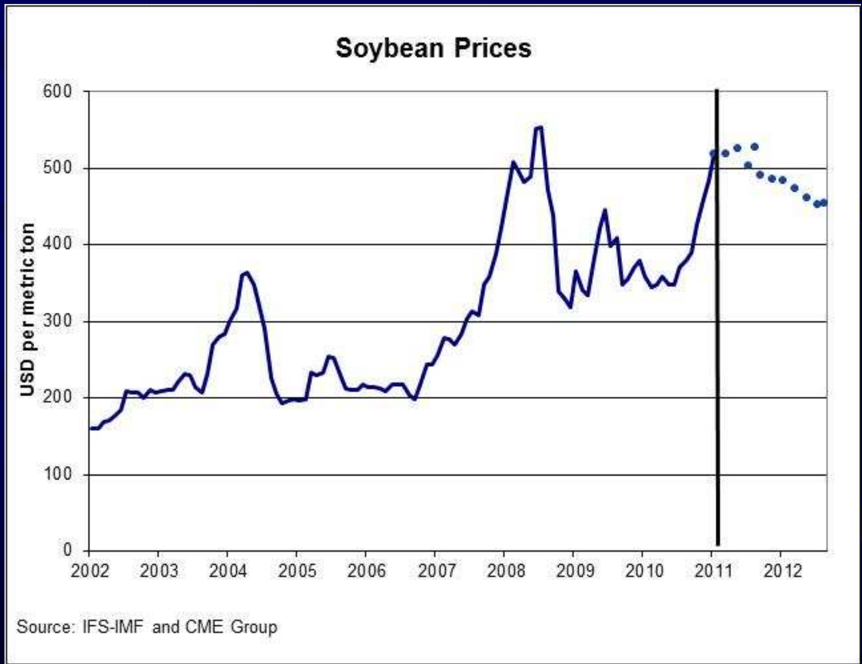
The potential behavior of agriculture commodities is mixed. While corn and soybean prices will remain high in 2011, albeit at lower levels, it's likely that wheat and cotton prices will decrease significantly.

•Corn: rising chinese shortages and increased use of corn by the US ethanol industry

•Soybeans: strong demand from China combined with Argentina's droughts

•Wheat: Decrease in supply problems in the EU, Canada and Australia

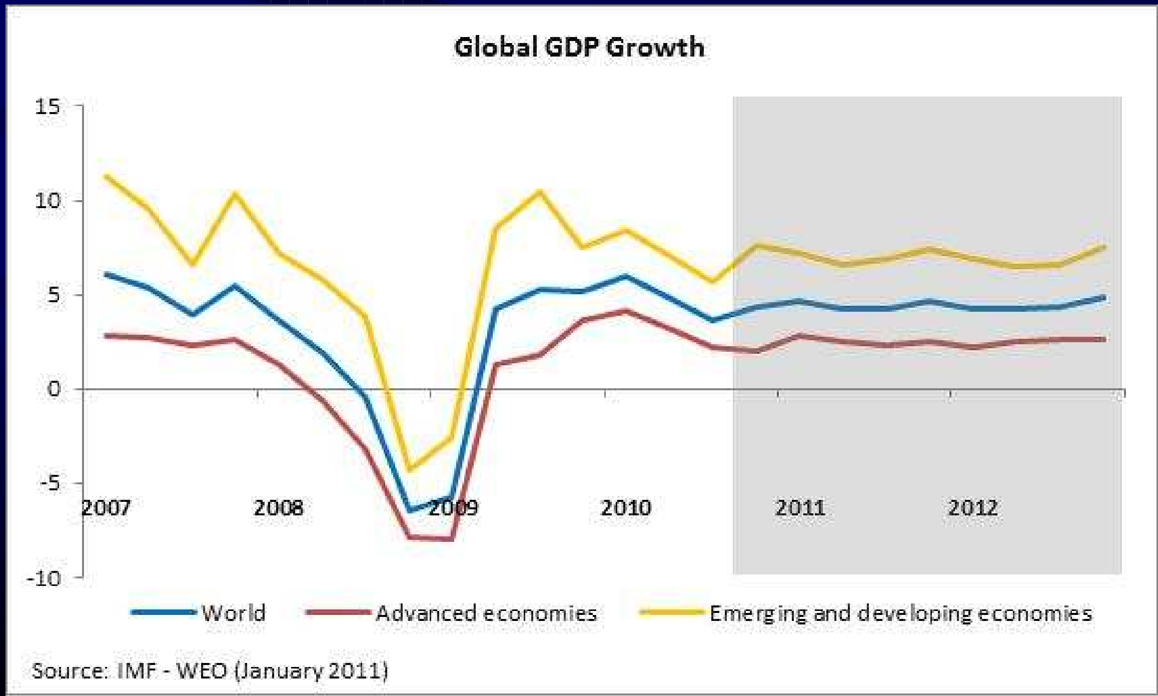
•Cotton: Possible increase in India's exports



On an overall basis, while metals and oil prices will remain high, the recent sharp increase in food prices will be temporary.

Asia and Latin America: Sustained Growth or Overheating

- In the context of : (a) problems and uncertainties in advanced economies and (b) good economic performance in emerging markets (Asia and Latin America), investors' increasing interest in these two regions is not surprising.
- Even more, as discussed before the major risks for the stability of emerging markets come from actions and policies in advanced economies!!



Asia and Latin America: Sustained Growth or Overheating

The fundamentals speak loud and clear: the fiscal deficits in industrialized countries are two or three times larger than those in emerging markets

Fiscal Balance (%GDP)								
Euroland	**2010 F**	**2011F**	**Emerging Asia**	**2010F**	**2011F**	**Latin America**	**2010F**	**2011F**
Germany	-3.7	-2.8	Indonesia	-0.6	-1.1	Argentina	-1.5	-1.5
France	-7.6	-6.2	China	-2.5	-2	Brazil	-2	-2.1
Italy	-5	-4.1	Phillipines	-3.9	-3.6	Chile	-4.3	-0.7
Spain	-9	-6.5	Singapore	4.1	4.3	Colombia	-3.9	-4
Greece	-9.9	-8	South Korea	-2.6	-2.3	Mexico	-2.6	-2.4
Portugal	-7.5	-6.4				Peru	-1.5	-0.9
Ireland	-11.8	-9.5						
UK	-9.5	-7.9	**US**	-8.8	-9.7	**Japan**	-8.8	-8.2

Asia and Latin America: Sustained Growth or Overheating

- But is it too much of a good thing?
- Are exchange rate appreciation and increase in inflation signals of overheating that compromise stability?

The answer varies by country and depends on the policymakers' capacity to contain overheating pressures.

The good news is that, in contrast to developed economies, many Asian and Latin American countries have plenty of tools to deal with their current macro challenges.

The Strength of Latin America to Deal with External Shocks

- Beyond an adequate use of monetary policy, most countries are very well equipped to deal with a reverse of fortunes and avoid a hard landing
- This is because:

A. External debt is low and foreign exchange reserves are large

Short-Term Debt / International Reserves (%)

Country	2007	2008	2009	2010	2011[F]
Brazil	21.57	23.01	20.90	17.11	15.39
Chile	66.04	64.34	68.76	67.94	50.83
Colombia	24.63	26.04	21.18	15.49	14.33
Mexico	45.08	49.41	39.91	33.80	30.98
Peru	20.97	19.71	9.01	7.22	7.35

Source: Deutsche Bank

With very low ratios of short-term debt to international reserves, the resilience to external shocks is even larger now than in 2007

And…

The Strength of Latin America to Deal with External Shocks

B. Banking Systems are highly capitalized

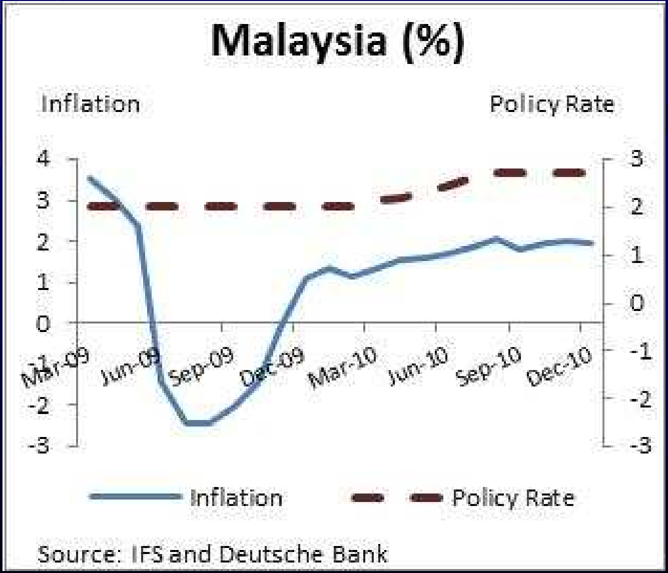
Capital Requirements in Latin America - 2010 (to Q2)					
(in percent, %)	Brazil	Chile	Colombia	Mexico	Peru
Minimum Regulatory Capital to Risk Weighted Assets	11	10 - 12	9	10	10
Actual Capital to Risk Weighted Assets	18	13.8	18.1	17	13.5
Actual Tier 1 Capital to Risk Weighted Assets	14.1	10.2	14.3	15	10.5

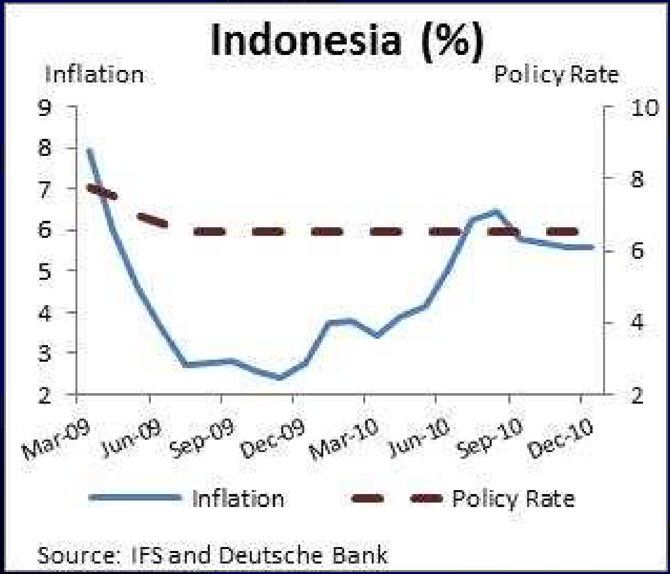
Well beyond the requirements of Basel III!

Asia and Latin America: Sustained Growth or Overheating

While food is the most important component in consumer price indices in emerging markets (50% in the Phillipines and 48% in Peru, but only 19% in Chile and 22% in Singapore), the acceleration of overall inflation also depends on: (a) the strenth of economic growth and (b) local policies pushing inflation up.

•In Asia, the acceleration of inflation is mostly the result of food inflation. Since this is expected to be temporary, interest rates will increase only moderatly in the first half of 2011. If inflation pressures accelerates due to domestic pressures, interest rates hikes will accelerate in the second half of 2011.



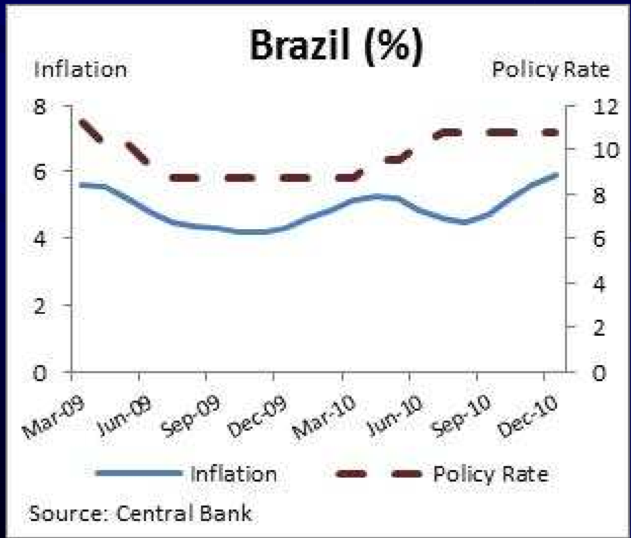


Latin America's Response to Inflation

Countries differ significantly in the causes and response to inflation

<u>In Brazil</u>, commodity prices are only one factor contributing to inflation. Domestic demand has been increasing rapidly and the money supply (broad money) rose by 19 percent in 2010.

- Thus, the policy response has been to increase the Selic rate and I expect increases to continue.
- However, the monetary stance, attracts capital inflows further. Therefore, Brazil will continue with its capital controls policy.

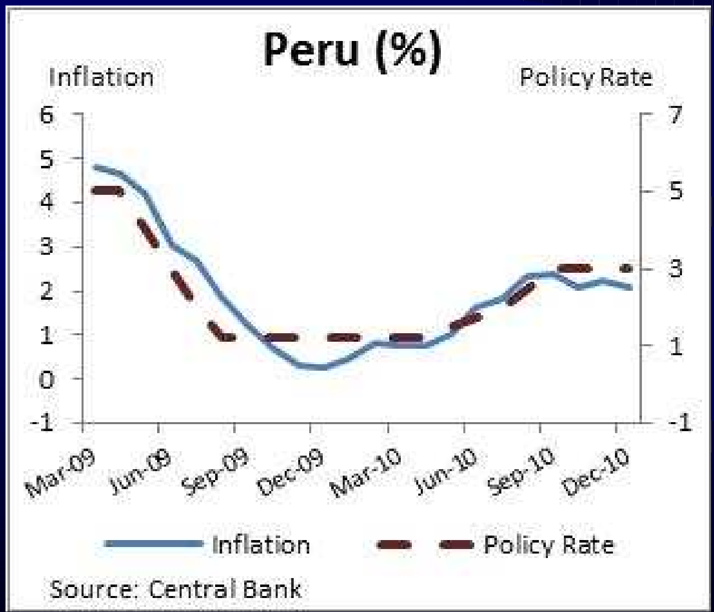


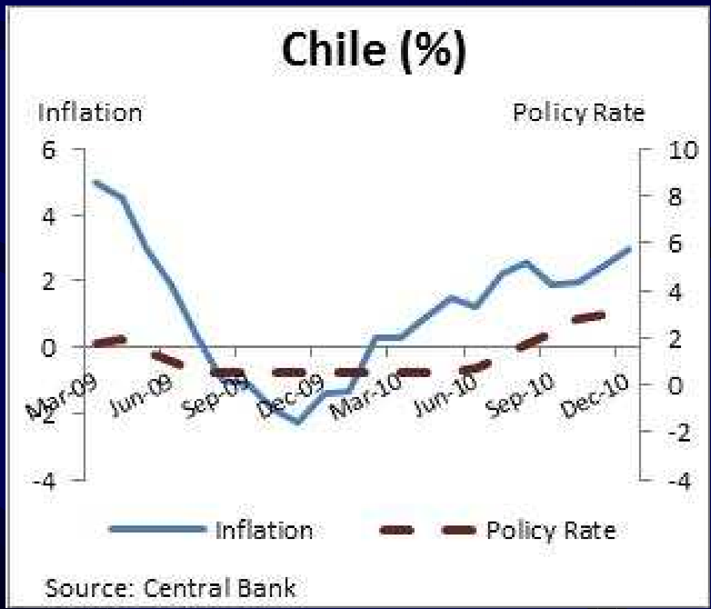
- Given current circumstances, Brazil needs to adjust fiscal policies.

Latin America's Response to Inflation

In **Chile and Peru**, the effect on food inflation is decreasing. Overall inflation mainly reflects rapid economic growth (domestic factors).

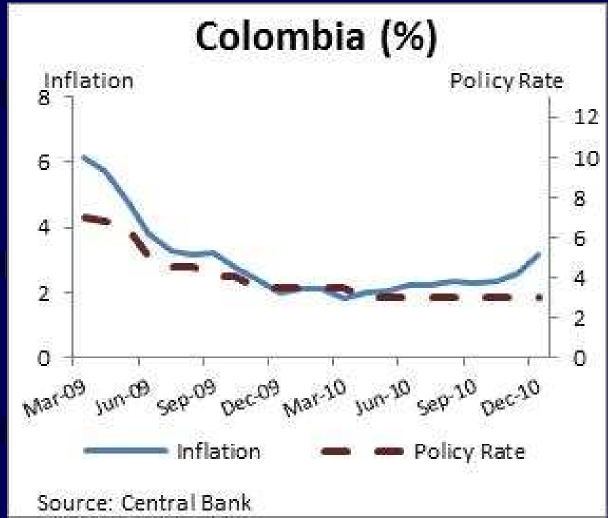
- Because of its sound fiscal performance, Peru and Chile have more room than Brazil to increase interest rates at a moderate pace. This helps to contain (to a certain extent) capital inflows.



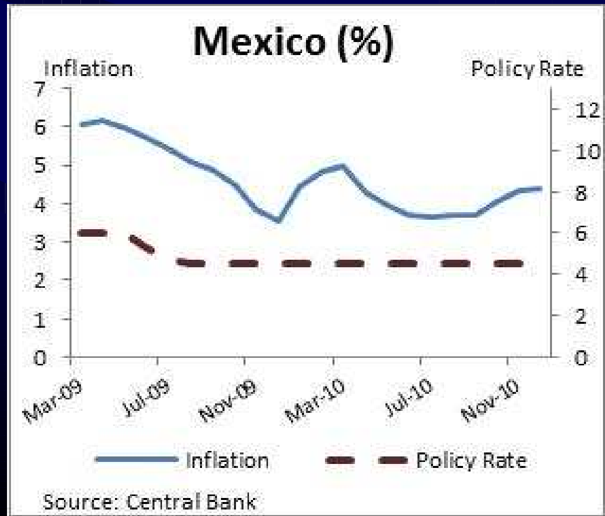


Latin America's Response to Inflation

In **Colombia**, the impact of food inflation has been large (compounded by La Niña). Because this effect is expected to be temporal, the Central Bank will not increase rates in the first half of 2011 (to contain capital inflows). If economic growth accelerates, interest rates will increase in the second half of 2011.



Mexico's inflation also increased as a result of food inflation. However, given the still fragile growth performance in Mexico (associated to US behavior), interest rates will remain unchaged through most of 2011.



In a Nutshell

- Major risks to emerging markets (including Latin America) comes from advances economies
- There are signs of overheating in Latin America, but the conduct of policies has been, so far, appropriate
- However, if the lack of sufficient economic growth in industrial countries keeps pushing capital inflows to Latin America, there will be a strong need for fiscal adjustment and further exchange rate appreciation to counteract overheating problems.
- At this point, I am positive about the ability to implement adequate policies in Peru and Chile. Some doubts remain in the cases of Brazil and Colombia.