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IMF's Regional Economic Outlook Says Latin America Prepared to Face Current Global Shocks, but Risks Persist

The ongoing global turmoil represents a confluence of negative shocks for Latin America and the Caribbean, but the region is expected to deal with the current global shocks better than in previous crises, according to the most recent *Regional Economic Outlook (REO)* from the International Monetary Fund (IMF). "The region's resilience reflects the progress many countries in the region have made in improving their macroeconomic fundamentals over the past decade," said David Robinson, Deputy Director of the IMF's Western Hemisphere Department, during a presentation in Santiago.

The confluence of shocks—freeze in global credit market, weaker external demand, and lower commodity prices—can have strong negative feedback loops, particularly for financing conditions, the report says, but adds that the region has not reached that point. The REO projects growth of around 3 percent next year, close to the average for emerging market countries, after 4.6 percent in 2008.

A number of downside risks for the region remain, including the outlook for commodity prices and the possibility of spillovers from the strains to global financial stability. The report says commodity prices remain elevated but could fall further, as the experience in previous global downturns shows. While lower food and fuel prices would bring welcome relief for some countries, in particular low-income commodity importers in Central America and many Caribbean countries, for the region as a whole, strong commodity prices have been a major factor in bolstering fiscal and external positions and driving growth in recent years. A further sharp fall would have considerable adverse implications, the report warns.

Against this uncertain background, the report says, the region should focus on a number of priorities. First, it is key to preserve the proper and efficient functioning of financial systems by acting proactively in addressing risks from liquidity and asset quality. Second, countries must preserve the hard-won gains on inflation. Central banks will need to maintain an active communication with markets on policy challenges and measures, especially on the future course of inflation, to keep inflation expectations well anchored. Third, the fiscal outlook in some countries will likely come under stress at a time when there will be increased need to maintain a robust safety net for those low-income households who would be affected by the slowdown. This will require a much more targeted strategy for fiscal spending to ensure that essential needs can be met while containing any additional financing needs.

The report's analytical chapters discuss the different models Latin American countries have adopted to handle the challenge of controlling inflation and the fiscal options to deal with high food and fuel prices while protecting the most vulnerable.

Chapter Three, *Keeping Inflation under control* argues that the recent inflationary episode in Latin America and the Caribbean has been the first real test of the region's commitment to low inflation, and that countries that have adopted inflation targeting frameworks were better prepared to cope with the challenge and have experienced the lowest inflation in the region, on average.

Chapter Four, *Elevated Food Prices and Vulnerable Households: Fiscal Policy Options* analyzes the different measures countries in the region have adopted to try to mitigate the impact of rising food prices on the poor (such as tax cuts, trade restrictions, targeted subsidies and price controls). It argues that targeted transfers are the most cost-effective policy to ease the burden on the most vulnerable, and that it is possible to compensate the extreme poor for much of their loss in real consumption at a relatively low fiscal cost.

Chapter Five, *Corporate Vulnerability: Have Firms reduced Their Exposure to Currency Risk?* looks at how firms in the region have managed currency movements in this new environment, which has a bearing on the vulnerabilities of the corporate sector arising under a flexible exchange rate regime. The analysis finds that despite the heightened exchange rate volatility and the sharp depreciation of currencies in the region in the past few months, the corporate sector has successfully reduced exposures to foreign exchange risks as a result of proactive efforts to decrease vulnerabilities as well as improved macroeconomic policies and institutional reforms that have increased financial depth and opportunities for risk diversification in these economies.

Chapter Six, *Boosting Private Investment in the Long Term*, studies the factors behind the performance of private investment in the region in recent years and presents a new cross-country analysis showing that firms in Latin America, especially smaller firms, continue to face important financing constraints that hold back investment, despite the recent gains on macroeconomic stability. The analysis concludes that to sustain long-term investment, it is crucial to preserve the region's disinflation gains and deepen financial systems, strengthen capital market development and credit institutions, and promote access to finance.