

II. Latin American and Caribbean Outlook

The regional outlook is being increasingly clouded by the deepening global financial turmoil. Growth is expected to slow markedly as the global slowdown and tightening financial conditions take hold, while external current accounts are set to weaken. Downside risks to growth have also increased, given the uncertain outlook for world commodity prices and the possibility of further spillovers from the strains to global financial stability. Flexible exchange rates should ease the adjustment for some. Policymakers face a delicate balance in mitigating the expected slowdown while maintaining orderly funding conditions, and seeking to anchor stability over the medium term.

Context

The commodity boom has benefited many in the region . . .

The region is coming off a remarkable growth spell over the past five years, which has been achieved in tandem with strengthened balance sheets in all sectors and, until last year, generally falling inflation. Real growth has averaged about 5 percent since 2003, compared to the region's long-run average over 1970–2000 of about 3½ percent. Inflation meanwhile fell to a 37-year low of just over 5 percent by end-2006.

Important gains in the credibility of fiscal and monetary frameworks have supported these achievements. The increase in commodity prices over this period, with the especially sharp run-up since 2005, has also been a key part of the story.

. . . but global shocks are tightening financing conditions and weakening commodity prices

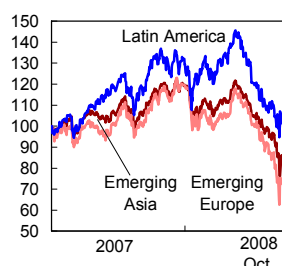
The worsening global financial conditions are increasingly clouding the regional outlook. The

impact so far has been contained by the limited direct exposure of regional banks to troubled U.S. housing related assets. However, overall financing conditions for the LAC region have been tightening, especially since the sharp increase in global counterparty risk this past September.

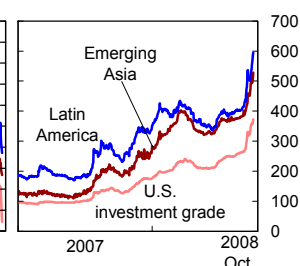
- Equity markets have sold off dramatically in recent months raising the cost of capital. Spreads on external corporate bonds have also risen sharply, including since September. Meanwhile overall corporate bond issuance has slowed, which will have adverse effects on investment and growth in the coming period.
- Exchange rates have been more volatile over the past year, and have weakened sharply in many cases since September. This depreciation reflects in part, the loss of access

Financial Market Developments

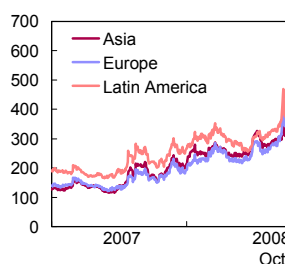
Stock Prices
(Index: January 2, 2007=100)



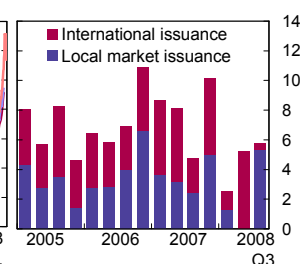
Corporate Spreads
(All asset classes, basis points)



EMBI Spreads
(Basis points)



Private Bond Issuance 1/
(Billions of U.S. dollars)

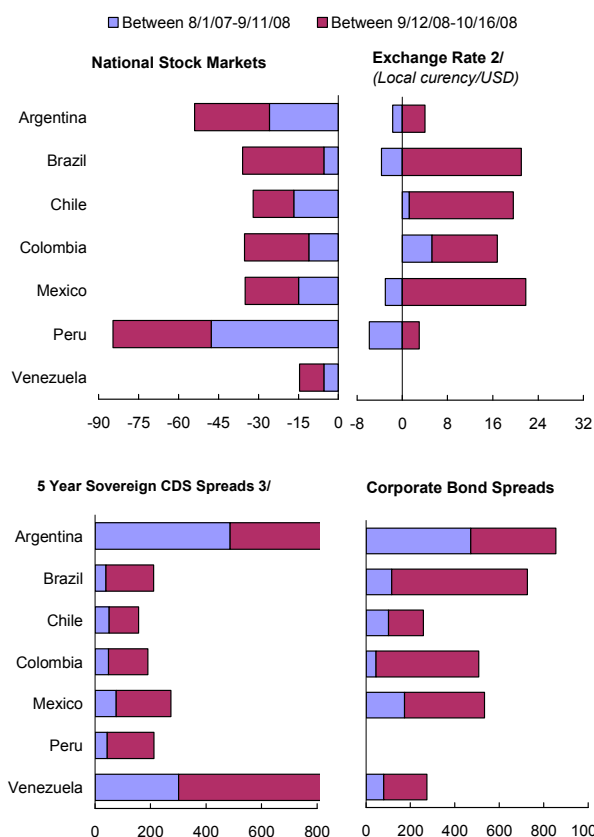


Sources: Bloomberg; Datastream; Credit-Suisse; DealLogic, Inc.; and IMF staff calculations.

1/ Third quarter of 2008 comprises information available through August 2008.

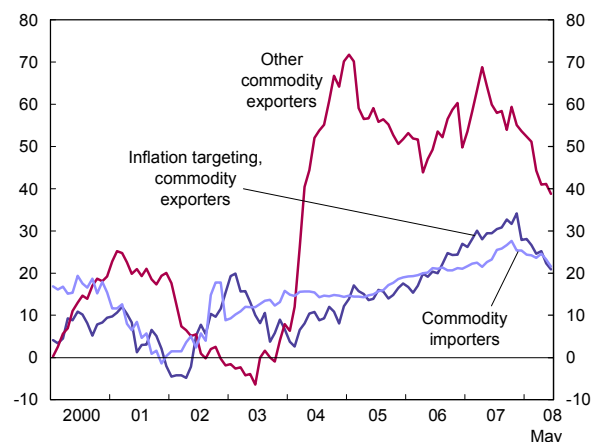
Note: This chapter was prepared by Vikram Haksar, Robert Rennhack, Jingqing Chai, Ana Corbacho, Roberto Garcia-Saltos, Herman Kamil, Carolina Saizar, and Bennett Sutton.

Selected Financial Indicators – Recent Shocks 1/



Sources: Bloomberg, LLP; Credit Suisse; Deutsche Bank; and IMF staff calculations
 1/ September 12 refers to market close prior to Lehman Brothers bankruptcy.
 2/ Increase indicates depreciation.
 3/ Bars truncated for Argentina and Venezuela. Increase in spreads since September 11, 2008 are 1670 and 954 respectively.

Credit to the Private Sector 1/
 (12-month percent change)



Source: IMF, International Financial Statistics.
 1/ PPP-GDP weighted average.

to foreign credit lines, some capital repatriation, and the impact of lower commodity prices for the region’s major commodity exporters.

- Domestic financial markets in many countries are beginning to come under pressure. There have been signs of stress for dollar and local currency funding in a number of important markets. Also, interbank funding costs for small and mid-sized banks have increased in some cases.
- Sovereign spreads have also risen, albeit less than in previous episodes of international financial stress, reflecting mainly the region’s substantially strengthened fundamentals (Box 2.1). However, there has been substantial variation with some countries seeing sharp increases in risk premia.

This has been accompanied by a slowdown in credit growth in many countries. While timely from a financial stability perspective, this will also tend to weigh on growth. The credit deceleration reflects a variety of factors including some natural pulling back by banks that have rapidly expanded balance sheets. Moreover, banks’ own funding costs have risen with the increased global risk aversion (Box 2.2). There has also been some reduction in credit extension by global financial institutions that are important players in the region, but are experiencing strains on their balance sheets in home markets.

Weaker global growth prospects, along with resolution of some supply constraints, have led to a sharp fall in commodity prices since peaks in July, though prices are still well above end-2006 closes. Nonetheless, commodity price volatility has increased sharply, highlighting risks ahead. Oil products have experienced the sharpest declines and are down about 30 percent, at the time of writing, from their average levels in the first semester of this year. Likewise, prices have also dropped for many of the region’s food exports, including soy products, corn, and coffee that are

Box 2.1. Determinants of Sovereign Bond Spreads in Latin America

Sovereign spreads in most Latin American countries have increased less than in previous bouts of international financial turbulence. Following the collapse of Long-Term Capital Management in 1998, for example, the average sovereign spread in Latin America surged by more than 1000 basis points, to as high as 1600 basis points. This time around, while spreads on sovereign external debt for Latin America have risen since the onset of the credit crisis in mid-2007 (to 550 basis points, on average, by mid-October 2008), they remain well below their historical averages. Indeed, LAC sovereign and U.S. high-yield bond spreads have historically moved closely together during periods of financial stress. Since August 2007, however, U.S. high-yield spreads have increased almost 850 basis points, but LAC sovereign spreads have risen by about 350 basis points.

What explains the more subdued response of the region's sovereign spreads in the face of the ongoing financial turmoil? This is an important question given

past research showing that external financial conditions and sovereign risk premia have historically been important determinants of fluctuations in Latin American growth (see Österholm and Zettelmeyer, 2007). To shed light on this issue, we review recent trends in Latin American sovereign debt spreads using a version of the panel data model developed by Hartelius, Kashiwase, and Kodres (2008). This model explains sovereign spreads in terms of two sets of factors: country fundamentals (proxied by economic, financial, and political risk ratings) and external financial factors (capturing global liquidity and investors' perception of global financial risk).¹

The region has entered the recent period of global financial turbulence from a position of reduced vulnerabilities. The substantial buildup of international reserves, stronger fiscal positions, more credible monetary policy frameworks and improved structure of public debt have made Latin America more robust to external shocks. This is reflected in market perceptions of the region's economic and financial strength, as measured by a set of economic, financial, and political risk ratings (whereby higher ratings indicate better fundamentals and lower risk).² Many of these gains reflect the boost to the region from the recent commodity price boom.

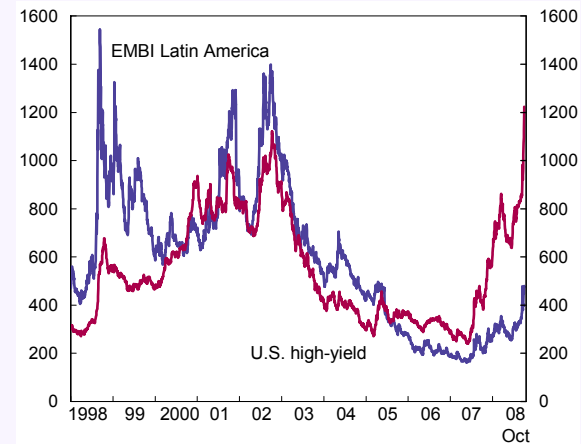
Note: This box was prepared by Kristian Hartelius and Herman Kamil.

¹ As a proxy to capture investors' attitudes toward risk, we use the implied volatility of the U.S. stock market (VIX). The VIX has increased steadily in the last year as the global financial crisis has deepened. The model also includes both the yield on the three-month ahead federal funds futures and its volatility, to capture the extent to which the expected direction and uncertainty about U.S. monetary policy affects Latin American sovereign spreads. While the Fed has eased considerably since mid-2007, the volatility of the federal funds rate has increased systematically since the beginning of 2008.

² The *International Country Risk Guide*, published by the PRS Group, releases monthly ratings covering three types of risks: economic, financial, and political.

Emerging Market Sovereign and U.S. High-Yield Spreads

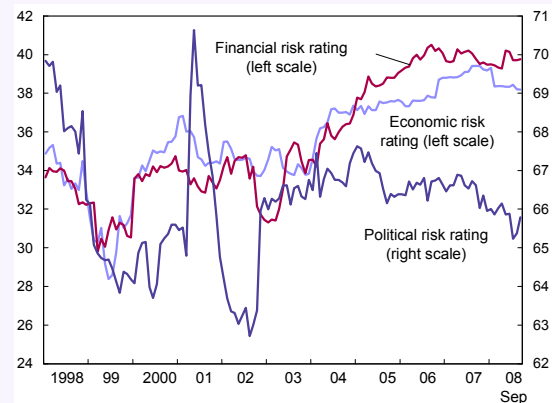
(In basis points)



Sources: Bloomberg; and Datastream.

Fundamental Determinants of Sovereign Risks Have Improved

(Average using EMBI weights)



Sources: PRS Group, *International Country Risk Guide*; and IMF staff calculations.

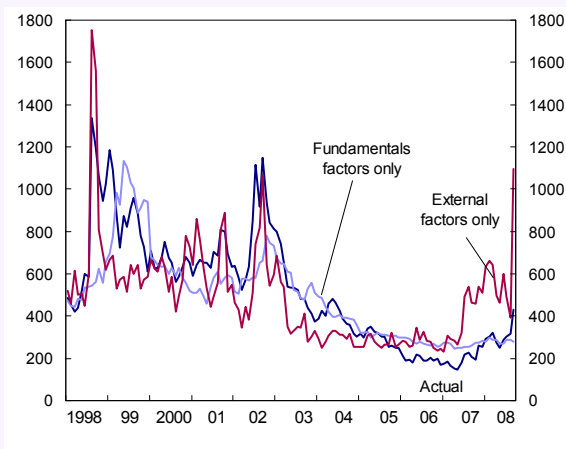
Box 2.1 (concluded)

The model explains fairly well the trends in sovereign spreads. It captures most of the bouts of volatility in Latin American spreads during the 1990s and the Brazilian crisis in 2002, and mirrors closely the compression in EMBI spreads that started in 2003 during the period of expanded global liquidity (see Box 1.5 in the April 2006 GFSR). However, since mid-2007, the model's fitted values have overestimated actual spreads, which have been about 100 basis points lower than predicted by the model. This divergence could be explained by structural shifts in the parameters, or a faster decline in issuance of external debt than in previous periods, which are not controlled for in the model. It could also be reflecting an additional "search for yield" that is not captured by the VIX index.

Importantly, the results also suggest that recent movements in Latin American EMBI spreads appear well anchored in country fundamentals. A separate regression using only the three risk ratings as independent variables (rather than the aggregate model), reveals that improved financial and economic risk ratings explain much more closely the recent dynamics of sovereign risk premia. This suggests that strengthened macroeconomic policy frameworks and robust fundamentals in the region can explain the observed resiliency of EMBI spreads in the face of global financial market volatility. At the same time, external financial factors alone appear to have over-predicted sovereign bond spreads over the past year. This may further suggest that the transmission of external financial shocks to sovereign financing conditions in Latin America have become more muted.

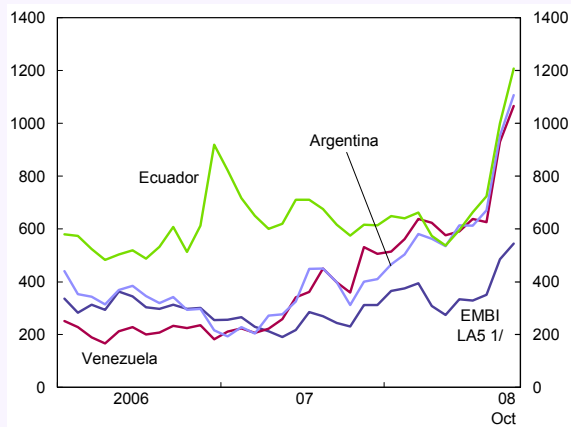
However, with the sharp worsening in the global outlook since September, the influence of external conditions has increased. The global slowdown and softening in commodity prices could have important effects on the fiscal stance of commodity producing countries. This may already be having an impact on aggregate EMBI spreads, which have risen substantially in recent weeks. Moreover, the aggregate regional EMBI masks increased differentiation across countries. Spreads have risen sharply in Argentina, Ecuador, and Venezuela. In other countries, by contrast, increases in spreads have been more modest. At the same time, spreads on external bonds issued by Latin American corporations have widened substantially since August 2007, rising on average by 530 points. This could point to an increasing role for private credit spreads as a mechanism for transmitting global financial shocks to the real sector in the region.

EMBI Spread: Actual and Predicted Values by Separate Regressions
(Basis points)



Sources: Bloomberg; and IMF staff calculations.

Increased Differentiation in EMBI Spreads Across the Region
(In basis points)



Sources: Bloomberg; and Datastream.

1/ LA5 is a weighted average that includes Brazil, Chile, Colombia, Mexico and Peru.

Box 2.2. Financial System Stability Developments

Latest available financial soundness indicators (FSIs) continue to point to the overall robustness of banks across the region through earlier this year.

Capital remains adequate, in part reflecting relatively low levels of impaired assets. Meanwhile coverage against potential losses on identified nonperforming loans (NPLs) is high, while bank income remains buoyant. However, FSIs are backward looking and slow-moving indicators of financial system risk. Looking ahead, some risks are rising over financial stability prospects in the region:

Concerns are rising over asset quality, especially for weaker banks. Slowing output growth and increasingly volatile commodity prices could adversely affect corporate and household cashflows in many countries. This would undermine credit quality and create risks for bank capital. These concerns are highlighted in bond and equity market measures of financial institution risk.

- Bond-market-based indicators suggest that risks facing emerging market financial institutions have increased sharply, including in Latin America, and especially among lower-rated banks in the region. Risk premia on bonds issued by high-grade financial institutions have also not been immune from the global shock, moving up in tandem with spreads for high-grade U.S. financials.
- Equity-market-based estimates of default risk (measured as the probability of default) show a widening dispersion in the risk among regional banks. The distribution of risk has shifted upwards with a fatter tail. This implies that default risks for smaller banks have increased substantially.

Lending by global banks in the region has slowed more than credit from local banks. The emerging signs of slowing aggregate credit growth offer a timely pause from the recent years' rapid credit expansion, which has lowered credit quality in some institutions. However, there is evidence that lending by global banks active in the region has slowed sharply, in part reflecting their efforts to reduce leverage and shrink balance sheets globally. A disruptive slowdown here could add further pressures on already tightening financing conditions for the corporate sector in some countries.

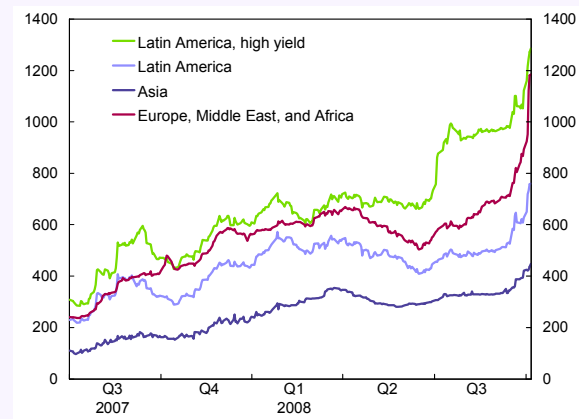
Note: This box was prepared by Jingqing Chai.

LAC: Selected Financial Soundness Indicators, 2008

	Capital Adequacy		NPL Ratio		Provision/NPLs		Return on Assets	
	2007	2008	2007	2008	2007	2008	2007	2008
LAC	14.4	14.4	2.5	2.5	134.4	132.8	2.1	2.1
Argentina	16.8	16.8	2.7	2.8	129.6	122.3	1.5	1.7
Brazil	18.7	18.1	3.0	2.9	181.8	181.7	2.9	2.8
Chile	12.2	12.4	0.8	0.9	210.4	187.5	1.1	1.1
Colombia	12.8	13.3	3.2	3.9	134.5	120.2	2.3	2.7
Mexico	16.0	16.0	2.5	2.1	169.2	184.0	2.8	2.9
Peru	11.7	12.2	1.3	1.3	131.6	139.4	2.5	2.6
United States	12.8	12.8	1.4	1.7	156.5	189.4	0.8	0.6

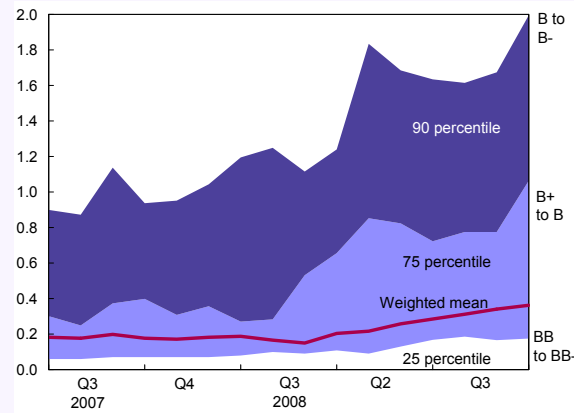
Sources: National authorities; and IMF staff calculations.

External Spreads for Emerging Market Financial Firms
(In basis points, all asset classes)



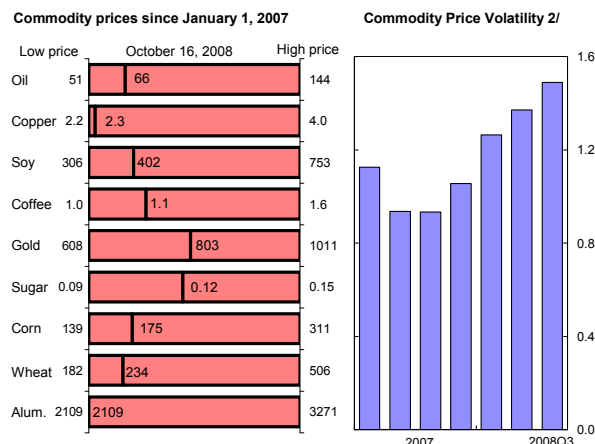
Source: Credit Suisse EMCI.

Estimates of Default Risk of Latin American Banks 1/



Sources: Moody's KMV and IMF staff calculations.
1/ One-year ahead EDF. Right axis shows correlations with S&P rating categories.

Regionally Important Commodity Prices Have Retreated 1/



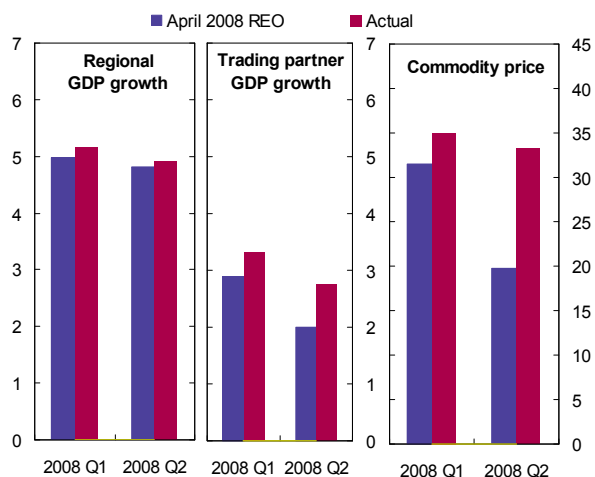
Sources: Bloomberg; Wall Street Journal; and IMF staff calculations.
 1/ Black line and adjacent number indicate closing price as of October 8, 2008; prices in dollars per metric ton except crude oil (per barrel), coffee, copper, sugar (a pound), and gold (an ounce).
 2/ Conditional standard deviation of daily percent changes in aggregate commodity export price index for Latin America.

Box 2.3. Differential Impact of Commodity Boom

To analyze the impact of the commodity price boom and its interaction with monetary policy regimes, we consider three groups of countries across the region in discussing the outlook.

- Inflation-targeting (IT) economies (Brazil, Chile, Colombia, Mexico, Peru, and Uruguay), many of which are net commodity exporters that have experienced sizable terms of trade gains. These countries have grown rapidly, though inflation pressures have in part been offset by appreciating currencies and monetary policy actions.
- Other net commodity exporters, which have less flexible exchange rate regimes (mainly Argentina, Bolivia, Ecuador, Trinidad and Tobago, and Venezuela). These countries have mostly experienced very large terms of trade gains, which combined with procyclical policies have boosted growth, but also pushed up inflation significantly.
- Net-commodity-importing countries, in Central America and the Caribbean, which have been especially hard hit by rising food and fuel prices, pushing up inflation and underlying current account deficits. With many of these countries having exchange regimes pegged to the dollar, the weaker dollar has allowed for some nominal depreciation to smooth the effects of the terms of trade shock.

Developments in the First Half of 2008
(Percent change)



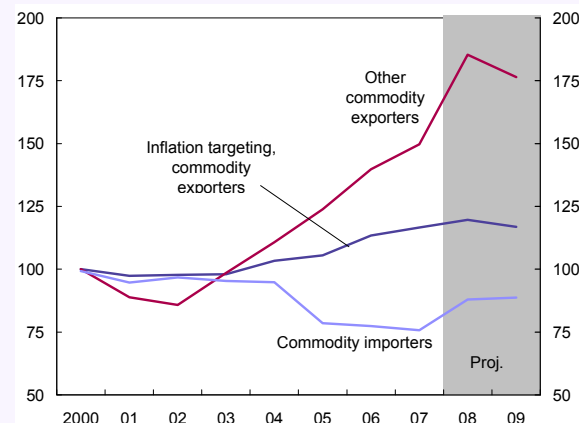
Source: IMF staff calculations.

important in countries such as Argentina, Brazil, and Colombia.

In the first half of 2008, growth and inflation exceeded expectations . . .

The outlook in the April 2008 REO was also dominated by uncertainty from the burgeoning global financial turmoil, and how and when this would affect the region. Given the April WEO projections for slower global growth and slowing

Terms of Trade 1/
(Index 2000=100)



Source: IMF staff calculations.
 1/ PPP-GDP weighted average.

Note: This box was prepared by Vikram Haksar.

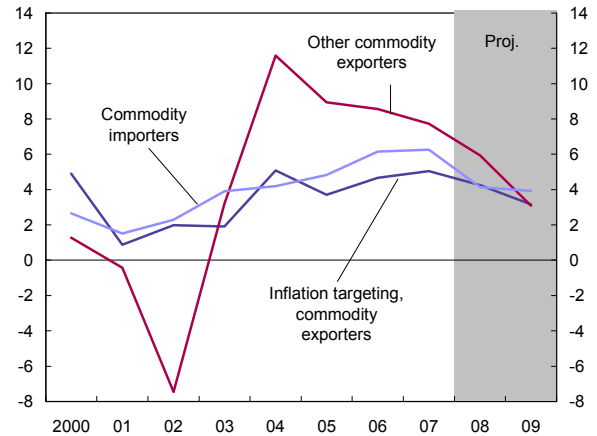
world commodity price increases, the April REO forecast a gradual slowdown in GDP growth in the LAC region to 4.4 percent in 2008 and 3.6 percent in 2009. Inflation was simultaneously projected to fall from 6.3 percent in 2008 to 6.1 percent in 2009.

In the event, both the growth momentum and inflation pressures in the first half of this year proved higher than expected. Growth in the first half of 2008 averaged 5¼ percent, reflecting a more gradual than projected slowdown in external demand and stronger than expected commodity prices.

This strong growth reflected a continuation of the trend whereby the region’s net commodity exporters have been supported by the commodity price boom. Commodity strength boosted household incomes and consumption; and created internal funding for new investment, including attracting substantial foreign direct investment (FDI). Separately, growth in many of the commodity importers was supported by factors such as the effects of regional trade initiatives (such as CAFTA-DR), and increased tourist arrivals (especially important in the Caribbean). Additional impetus to growth came from the rapid public spending growth in commodity exporting countries. As a result, output gaps in the region’s main economies have largely closed, with several economies, including, for example, Argentina and Colombia, above potential.¹

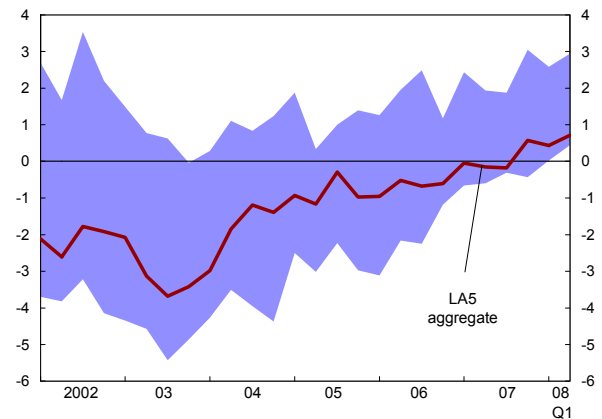
By the first half of this year, overheating was a significant concern as strong domestic demand, combined with supply shocks—including from commodity prices—pushed up inflation across the region (as examined more closely in Chapter 3). Since the end of 2007, headline inflation in the LAC region has risen by over 1½ percentage points, reaching 8¾ percent year-on-year in August. Inflation has risen well into the double digits in the non-IT¹ commodity exporters, including Venezuela and Bolivia, and analysts

Real GDP Growth 1/
(Annual percent change)



Source: IMF staff calculations.
1/ PPP-GDP weighted average.

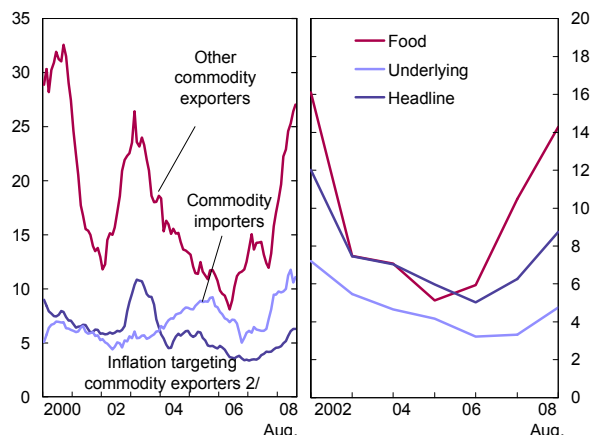
Output Gap in Selected Latin American Countries 1/
(Percent of potential GDP)



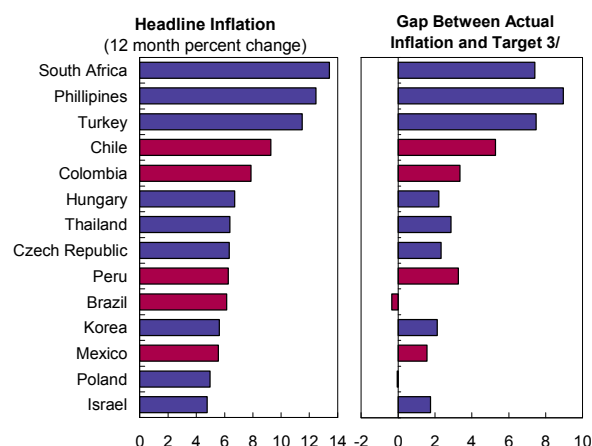
Source: IMF staff calculations.
1/ Shaded area corresponds to the maximum and minimum of the output gap estimates from individual countries' GPMs. LA5 includes Brazil, Chile, Colombia, Mexico, and Peru.

¹ The output gap estimates presented in the figure are derived from a regional model recently developed by IMF staff: the Global Projection Model–Latin America (GPM–LA).

**Inflation in Latin America 1/
(12-month percent change)**

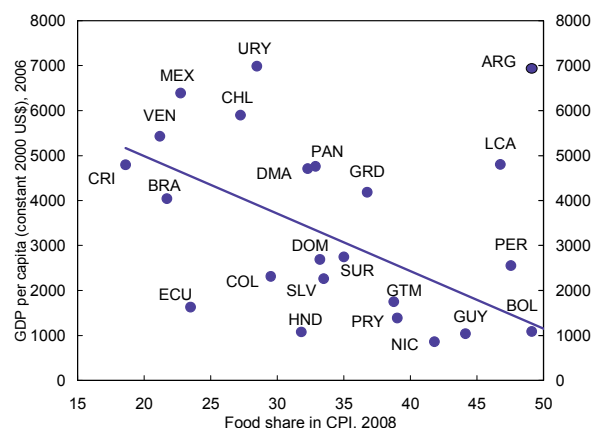


Performance of Emerging Market Inflation Targeters



Sources: Haver Analytics; national authorities; and IMF staff calculations.
 1/ PPP-GDP weighted average.
 2/ Commodity exporters that are inflation targeters.
 3/ Gap defined as the difference between headline CPI inflation over the 12 month period to August 2008 and the upper bound of inflation target band.

GDP per Capita and Food Share in CPI



Sources: World Bank, *World Development Indicators*; national authorities; and Haver Analytics.

believe that actual inflation in Argentina is considerably higher than the official rate of 9 percent in August.² Inflation also moved up sharply in commodity importers, including several in Central America and the Caribbean, many of whom have been hard hit by the global food price shock. The region’s inflation targeters have fared better, also in comparison with many emerging market inflation targeters from other regions. Nonetheless, outside Brazil, inflation is currently above target ranges, in some cases by a wide margin.

Underlying inflation also increased in most countries across the region reflecting second round effects of recent supply shocks. Inflation expectations for 2009 have also shifted up. Indeed, both core and end-2009 expected inflation have risen in most countries by ½–2 percentage points since end-2007.

The pick-up especially in food inflation has prompted significant social concerns and puts at risk the gains on poverty reduction from the sustained reduction of inflation across the region through 2006 (see Box 2.4). Food price shocks tend to have a bigger impact on consumption levels in low-income countries, which have higher shares of food in their consumption baskets. Within countries, food price hikes also impact poor households the most. As discussed in Chapter 4, the increase in food prices since end-2006 has likely implied a sizable reduction in real consumption levels for the poor, particularly in urban areas, as well as net food consumers in rural areas. For instance, analysis by IMF staff suggests that the rise in food prices since end-2006 may have lowered real consumption of poor urban households, all else equal, by 16 percent in Nicaragua and 3 percent in Mexico in this period.

² Data for CPI inflation for several provincial capitals for August 2008 are generally well above this rate, although it should be noted that provincial data do not reflect price changes on the same basket of goods.

Box 2.4. Inflation and Poverty

The sustained growth with low inflation of recent years has helped substantially reduce poverty levels in the LAC region. Poverty rates have declined from 44 percent in 2002 to 35 percent of the population in 2007, implying an absolute reduction in the poverty headcount of more than 30 million people. In many countries, the reduction in poverty has also been accompanied by some improvement in the distribution of income. Past REOs have discussed the links between growth and poverty reduction. It has been argued that sustained aggregate growth has contributed to rising employment and wages. The resulting boost to household income has helped lower poverty. But lower inflation itself has likely boosted growth in the region. Numerous studies (including Sarel, 1995, and Ghosh and Phillips, 1998) have documented the presence of a nonlinear relationship between growth and inflation. Reducing inflation to even moderate levels can have important growth effects. Moreover, strengthened fiscal frameworks have created fiscal room to expand targeted anti-poverty schemes in countries ranging from Brazil, to Chile and Mexico that have also contributed to these gains.

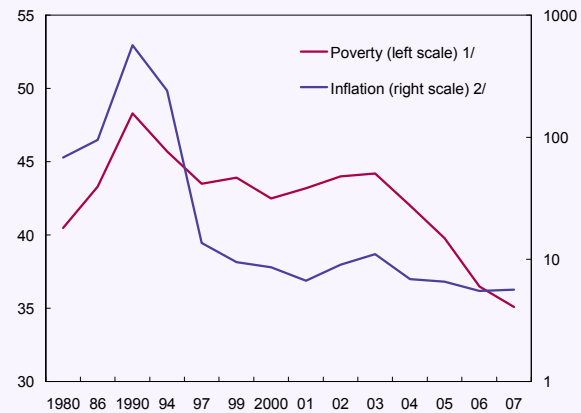
However, there is a risk that the recent acceleration in inflation may reverse some of the achieved social gains. First, higher inflation could indirectly affect poverty by putting growth and employment prospects at risk because of its negative impact on the efficiency of investment. But inflation could also increase poverty by reducing the purchasing power of wages, incomes from self-employment, and government transfers. Disposable incomes could suffer further through the erosion of nominal assets, including cash, by the so-called inflation tax. Finally, inequality could rise, for example if low-income households or the middle class have less access to instruments that protect against the negative consequences of inflation than high-income households.

Most available empirical studies show that inflation is harmful for the poor and for the distribution of income. Cross-country studies by Romer and Romer (1999), Agénor (2004), Bùlir and Gulde (1995), Bùlir (2001), and Easterly and Fischer (2001) found significant positive relationships between the level of inflation and poverty and income inequality. For specific LAC countries, studies by Cardoso, Paes de Barros, and Urani (1995); Amadeo and Neri (1997); Corseuil and others (2000); and Ferreira, Leite, and Litchfield (2006) for Brazil and Székely (2005) for Mexico have found similar relationships.

The fact that higher inflation has been driven by rising food prices is of added concern. Poor households are likely to experience sharper declines in real income than more affluent households, because food products make up a higher share of their consumption. This is confirmed by the World Bank's poor persons price index, which shows that during 2007 in 10 out of 12 LAC countries the poor faced effective inflation rates that exceeded significantly the general rate (World Bank, 2008a). Additional discussion of this issue is presented in Chapter 4.

Note: This box was prepared by Andreas Bauer.

Latin America: Poverty and Inflation, 1980–2007
(In percent)



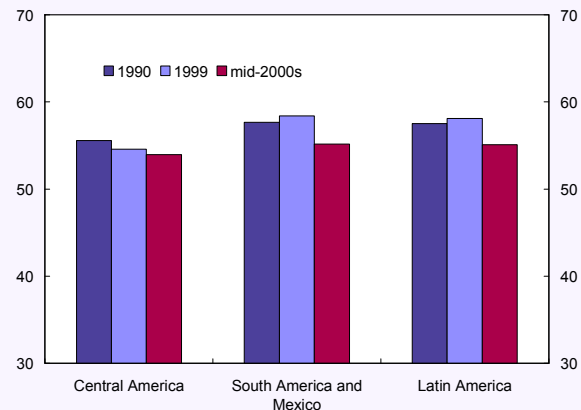
Sources: ECLAC (2008); and IMF staff calculations.

1/ Population-weighted average for 19 countries.

2/ Period average. PPP-GDP weighted average for 19 countries. Logarithmic scale.

Latin American Income Inequality

(Gini coefficient; larger figures indicate greater income inequality) 1/



Source: ECLAC (2007).

1/ Population-weighted averages. 1990 indicates available observation closest to 1990; 1999 indicates available observation closest to 1999; mid-2000s indicates most recent available observation.

... and current accounts have weakened

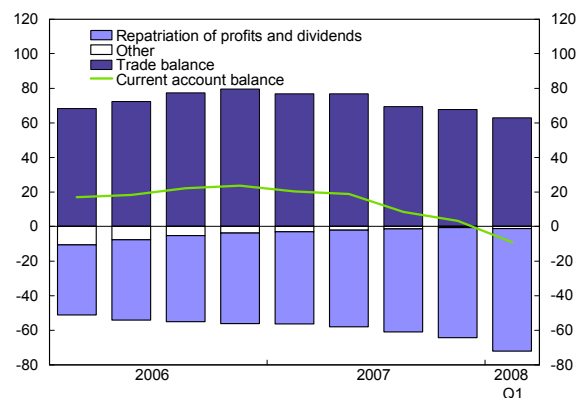
External current account positions across the region are weakening. Deficits are already large in the smaller commodity importers in Central America and the Caribbean. But current accounts also moved into deficit in several of the largest regional economies in the first quarter of 2008, for the first time in the last five years. Indeed, the aggregate trade balance for the IT commodity exporters through March 2008 had shrunk 50 percent from its peak 18 months earlier. Surpluses are also falling in the non-IT commodity exporters.

Another new development in the region is that a large part of the deterioration in the current account for many commodity exporters has come from rising profit and dividend repatriation of foreign firms, likely linked to FDI in resource-intensive industries and the financial sectors. Indeed, over half of the deterioration in the aggregate current account of Argentina, Brazil, Chile, Colombia, Mexico, and Peru between September 2006 and the first quarter of 2008 is explained by higher profit and dividend remittances, though part of this may re-enter as FDI in the capital account. This is in contrast to developments in other emerging market regions discussed in the WEO, where the deterioration of current accounts mostly reflects a marked weakening of already negative trade balances.

Nonetheless, while current account surpluses have shrunk, international reserves in all the major regional economies have increased this year. This reflects continued positive overall capital inflows. However, the pace of portfolio flows and external issuance has slowed. Meanwhile, FDI flows have decelerated in some cases. Recent reports also suggest that carry-trades have been unwinding on the back of global difficulties in obtaining funding.

Decomposition of Aggregate Current Account Developments 1/

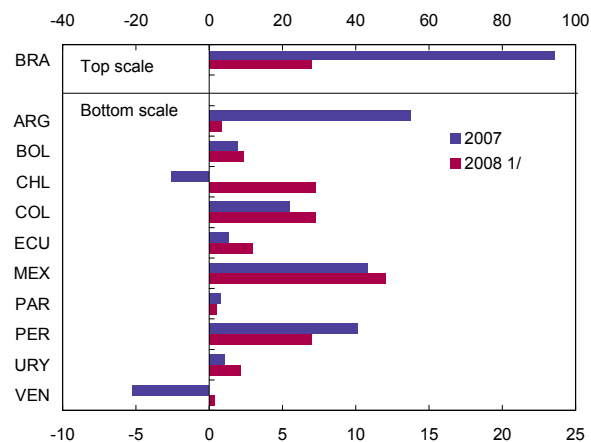
(4-quarter rolling sums, billions of U.S. dollars)



Source: IMF staff calculations.
1/ Countries included are Argentina, Brazil, Chile, Colombia, Mexico, and Peru.

Reserve Accumulation in Selected Latin American Economies

(Billions of U.S. dollars)



Sources: IMF, *International Financial Statistics*; and IMF staff calculations.
1/ Change in the stock of reserves from end 2007 to September 2008 (or latest month available).

A Varying Policy Mix

Public expenditures have grown rapidly. . .

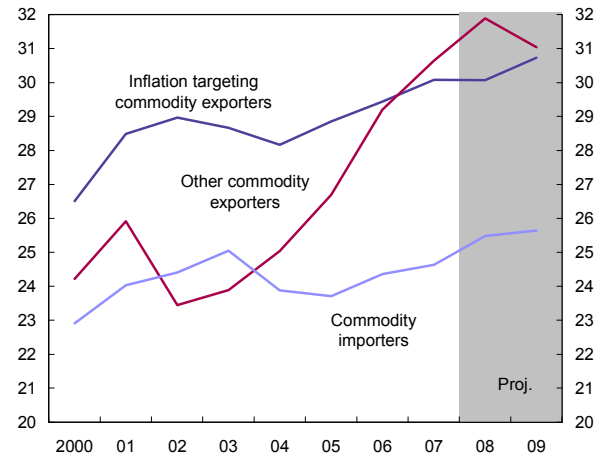
Real public spending has grown at a fast clip through this year, which has tended to add a procyclical fiscal impulse across much of the region, including in many of the inflation-targeting (IT) countries. Primary public spending has risen especially sharply in the energy exporting countries, which were already growing extremely rapidly. While capital spending has increased in some countries, growth in current spending has been even faster in most cases.

The fiscal impulse discussed above reflects the fact that a large part of the spending increases have been financed by taxes on buoyant commodity exports. Increased tax revenues, on the back of higher commodity prices and strong economic activity, have supported a strengthening in aggregate primary and overall balances across much of the region. However, surpluses have stabilized for the region as a whole in recent years and indeed have contracted in the non-IT commodity exporters, where revenue gains have begun to moderate while spending has continued to rise quickly.

. . . while monetary policy was tightened in several cases

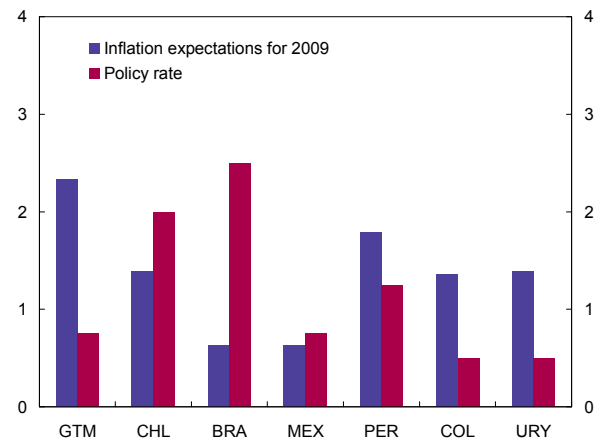
Responding to the rise in headline inflation and pick-up in expectations, monetary authorities in many inflation targeting countries raised policy rates this year. On average rates rose by about 125 basis points through mid-October, with larger increases including in Brazil, Chile, Colombia, Mexico, and Peru. Interest rates have also been increased in a number of other countries, including Argentina, the Dominican Republic, Guatemala, and Jamaica, and reserve requirements were increased earlier this year to tighten credit conditions in some cases.

Primary Expenditure 1/
(Percent of GDP)



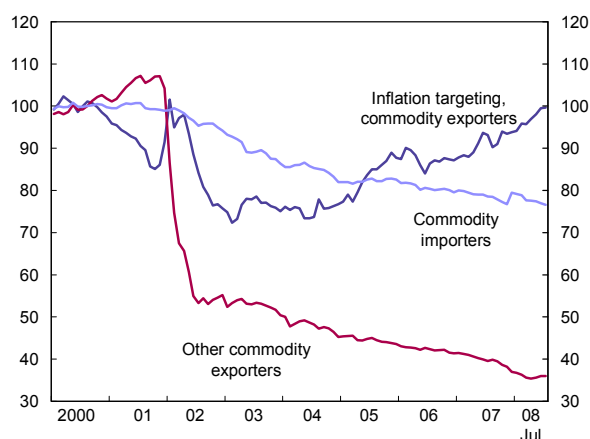
Source: IMF staff calculations.
1/ PPP-GDP weighted average.

Inflation Expectations and Policy Responses
(In percent; change in values between Jan. and Sept. 2008)



Sources: Consensus Economics, *Consensus Forecasts*; Inter-American Development Bank, Revela Database; and IMF staff calculations.

Nominal Effective Exchange Rates 1/
(Index 2000=100)



Source: IMF staff calculations.
1/ PPP-GDP weighted average.

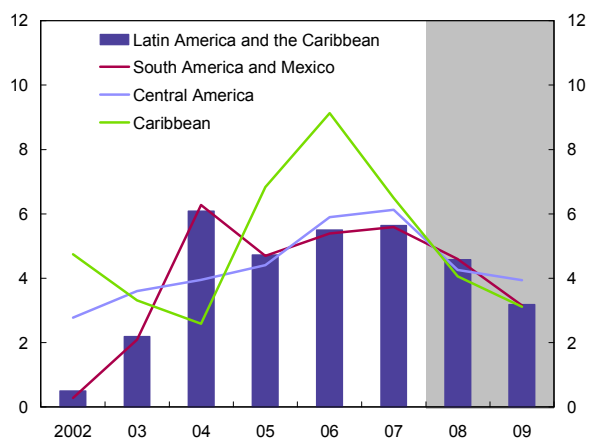
Macro Outlook for LAC Region 1/

	2005	2006	2007	2008 Proj.	2009 Proj.
Real GDP growth, percent	4.7	5.5	5.6	4.6	3.2
End of period inflation, percent	5.9	5.0	6.3	8.5	6.6
Overall public sector balance, percent of GDP	-1.2	-1.0	-1.1	-0.7	-1.1
Overall primary balance, percent of GDP	3.4	3.3	2.9	3.0	2.4
Current account balance, percent of GDP 2/	1.3	1.5	0.4	-0.8	-1.6

Source: IMF staff estimates.

1/ PPP GDP weighted averages.
2/ Weighted by GDP at market exchange rates.

Real GDP Growth
(Annual percent change)



Source: IMF staff calculations.

Several currencies in Latin America appreciated significantly through mid-2008, against the dollar and in effective terms, in tandem with strong reserve accumulation in many cases. This reflected high commodity prices, strong macroeconomic fundamentals, and significant foreign investor appetite for domestic assets. The nominal effective appreciation was an important counter to inflation pressures in IT countries. By contrast, monetary conditions tended to ease in countries with exchange rates pegged to the dollar, as these effectively imported the looser policy stance from the United States. This is apparent, for example, in the Caribbean countries with long-standing dollar pegs. The resulting depreciation in effective exchange rates in these countries helped them adjust to some extent to the large negative terms of trade shock they have experienced, but also contributed to inflationary pressures.

More recently, in response to growing pressures in domestic financial markets as the global turmoil spread, some central banks have taken steps to inject liquidity. Measures have included lowering reserve requirements, and arranging dollar funding lines for banks and trade credits for exporters. Moreover, a number of authorities have intervened in foreign exchange markets at times in recent weeks to smooth volatility in their currencies.

Economic Outlook and Risks

Growth is now set to slow . . .

During the second half of the year, the region's strong growth momentum will increasingly be offset by the sharply weaker outlook for global financial conditions, external demand, and commodity prices. Given the strong first half, growth for 2008 as a whole is projected at 4.6 percent—still at, or above, trend in most countries—before falling back sharply to 3.2 percent in 2009 (Box 2.5 discusses prospects for the Caribbean region).

Box 2.5. The Caribbean: Weathering the Global Storm

The Caribbean has been buffeted by slower global growth and the sharp rise in international commodity prices since 2005. Real GDP is projected to grow by 3¼ percent this year—well below the 4 percent average annual growth in 2003–07. Inflation is projected to reach 8 percent by end-2008—the highest rate since the mid-1990s.

The slowdown in advanced economies is dampening demand for tourism—one of the region’s key exports.¹ Tourism has been hit by more stringent travel requirements for U.S. citizens, the reopening of the Cancun market, as well as weaker economic conditions in the United States. The weak U.S. dollar propped up demand by Canadian and European tourists, but looking ahead, slower growth in these countries will dampen tourism demand. Moreover, high fuel costs are forcing major airlines cut back their routes.

Headline inflation has escalated on the back of higher world food and fuel prices. Food accounts for a large share of consumer baskets in most countries, reaching 54 percent in St. Vincent and the Grenadines. Hurricane-related damages drove food price inflation up to 35 percent in Jamaica. Many countries generally allowed full pass-through of higher international fuel prices to domestic prices. In several countries the depreciating U.S. dollar and strong domestic demand have pushed up inflation.

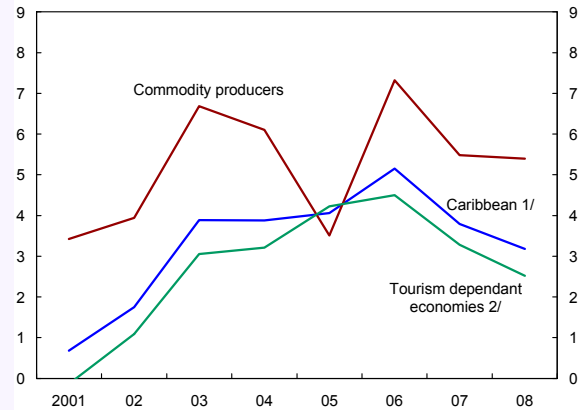
With more costly imports, the external current account deficit has soared in most countries. Food and fuel imports are expected to rise substantially, pushing current account deficits to as high as 35 percent of GDP in the ECCU. Financing for current account deficits is expected to continue to come mainly from foreign direct investment and external assistance (most notably via Petrocaribe).

The key near-term policy challenge is to weather the difficult period ahead. Thus far, the region has been relatively unaffected by the global financial crisis. Looking ahead, it will be important to ensure adequate liquidity for the financial system and foreign exchange reserves to support external payments. Policymakers should seek ways to establish precautionary credit lines. In most of the region, fiscal discipline and a restrained credit policy would help safeguard net international reserves and signal continued commitment to ease high public debt burdens both of which would be key to support confidence among market participants. In fact, a number of countries (including Barbados, Belize, Jamaica, and St. Lucia) are targeting lower fiscal deficits. At the same time, many countries have also sought to soften the negative consequences of the rising cost of food on the poor through measures ranging from cuts to domestic tax rates and import tariffs to targeted subsidies. The possible benefits and cost of such efforts are explored more fully in Chapter 4 of this REO.

Note: This box was prepared by Trevor Alleyne.

¹ The net-commodity-exporting countries in the region are exceptions to these trends. Trinidad and Tobago (oil and gas) and Suriname (metals) are projected to grow by 5½ percent this year. Both countries will continue to run current account surpluses.

Real GDP Growth in the Caribbean
(Percent change)

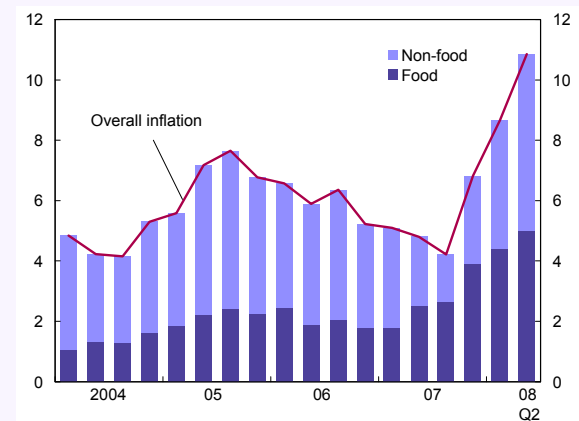


Sources: National authorities; and IMF staff calculations.

1/ Simple average.

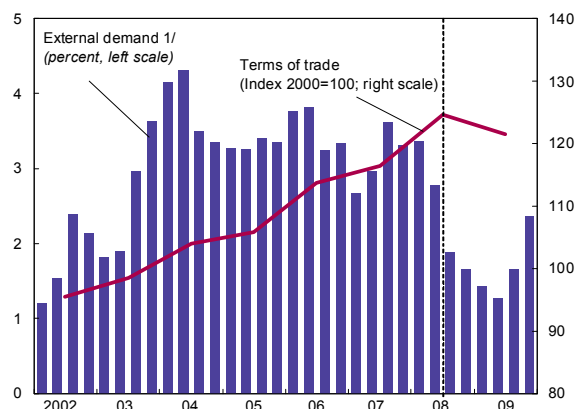
2/ Includes ECCU, Bahamas, Jamaica, Barbados, and Belize.

Contribution to Overall Inflation in the Caribbean 1/
(Annual percent change)



Sources: National authorities; and IMF staff calculations.

1/ Unweighted inflation across The Bahamas, Barbados, Belize, ECCU, Guyana, Jamaica, Suriname, and Trinidad and Tobago.

External Demand Growth and Terms of Trade

Sources: WEO; and IMF, *Direction of Trade Statistics*.

1/ Growth in real GDP, weighted by trade shares with respect to LA6.

Box 2.6. Do Migrant Remittances to the LAC Region Fall During U.S. Slowdowns?

It has previously been difficult to find a relationship between economic slowdowns in the United States and reductions in remittance flows to the LAC region at the aggregate level (Roache, 2007). However, ongoing research at the IMF (Magnusson, 2008) suggests that remittance flows to countries in the region are more connected to economic conditions in the specific region of the United States where their migrants live, as well as the sectors especially important for migrants' employment opportunities. Immigrants from the region cluster in a limited number of U.S. states while there is substantial heterogeneity in business cycles between states. As such, the ongoing housing related slump that has hit states such as California particularly hard, may have especially adverse effects for countries such as Mexico. This reflects the high concentration of Mexican migrants living in California and working in the construction sector. Remittances to El Salvador have also slowed markedly, but by less than in Mexico reflecting that they are less exposed to regions in the United States comparatively hard hit by the housing and construction downturn.

Note: This box was prepared by Kristin Magnusson.

Underlying this forecast are three key factors. First, the tightening in global financial conditions and increase in risk aversion now underway is likely to prove persistent as the seismic shifts taking place in the global financial system are expected to take some time to play out (Box 2.7 examines the impact on the region of the tightening in U.S. financial conditions). This will continue to dampen external financing and further tighten domestic financing conditions. Combined with the deceleration in credit growth, these factors should add substantial drag to growth.

Second, growth in partner country demand for the region is now expected to fall markedly. The United States, Europe, and Japan—which together account for about 70 percent of the region's exports—are set to slow sharply over the next couple of years. This will affect all economies in the region, but especially those that have close economic linkages with advanced economy partners, such as Mexico, Central America, and the Caribbean. Further, many countries, including especially in the Caribbean, are being affected by a reduced demand for tourism services from both the United States and Europe. Additional downdrafts are set to arise from already weakening remittances from the United States, and especially so for Mexico and some in Central America and the Caribbean. This reflects the slowdown in the United States, especially in the construction sector, which employs many migrants from Mexico (Box 2.6).

Third, as commodity prices fall back, the terms of trade facing the LAC region are projected to worsen by about 3 percent through 2009 in the current WEO baseline. This will shift into reverse another key growth impulse of recent years for the region's commodity exporters—a 10 percent drop in commodity prices reduces regional growth by about 0.8 percentage point. However, the projected falloff in oil prices would reduce the drag facing the region's net commodity importers.

Box 2.7. Spillovers from the United States to Latin America

A key question is how much financial conditions in the United States affect growth in Latin America. This box assesses the effect of different shocks in the United States on the region, drawing on the Global Projection Model (GPM) for Brazil, Chile, Colombia, Mexico, and Peru (LA5).

The results suggest that shocks in the United States account for about 12 percent of the variation in LA5 growth. About half of this variation is explained by changes in U.S. financial conditions, which are a forward looking indicator on the availability of financing and a leading indicator for output.¹ Within this, there is also substantial variation across countries. The effects of shocks in the United States, unsurprisingly, are strongest in those countries with the closest trade linkages to the United States, although in some countries, financial linkages are relatively more important.

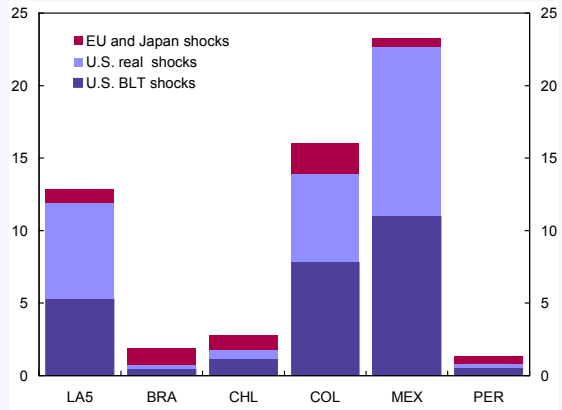
Output shocks in the United States tend to affect Latin America more than Europe or Japan, in terms of size, speed, and duration of impact. A shock of 0.4 percent to the negative output gap in the United States generates a negative output gap in the LA5 of 0.1 percent on impact and a 0.4 percent cumulative effect after a year. Also, a shock to output in the United States transmits more quickly to Latin American output than shocks to financial conditions in the United States.

Shocks to U.S. financial conditions affect Latin America with a lag—a peak effect occurs after 1½ years—but are more persistent than U.S. output gap shocks. A 6 percentage point increase in bank lending tightening conditions in the United States—which grows to 35 percentage points after a year because of negative feedback effects—generates a negative output gap in the LA5 of 0.1 percent on impact and 0.6 percent after 2½ years. This is a particularly important finding to keep in mind in the current context, where the financial condition variable used in the GPM has increased 53 percentage points since September last year. This suggests that, with the large shock to U.S. financial conditions still playing out, the effects of the financial tightening in the United States on growth in the region could still be in the pipeline.

Note: This box was prepared by Jorge Canales-Kriljenko and Roberto Garcia-Saltos.

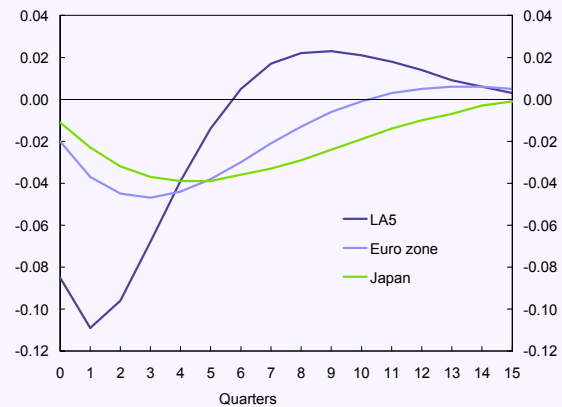
¹Measured by the Bank Lending Tightening (BLT) variable as described in Appendix 3.1.

Contribution of G3 Shocks to the Variance in the 4th-Quarter GDP Growth
(In percent)



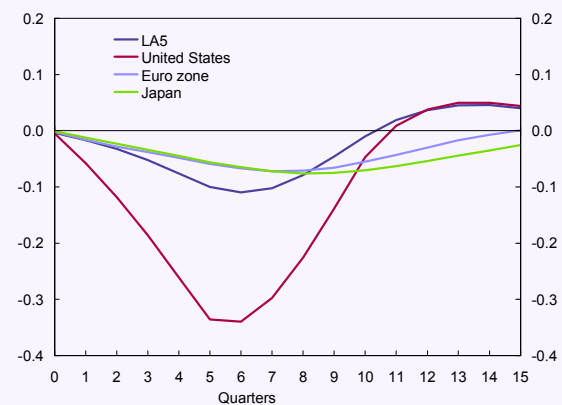
Source: IMF staff calculations.

Output Gap Response to a 0.4 Percent Negative U.S. Output Gap Shock 1/
(In percent)



Sources: IMF staff calculations.
1/ Size of the shock is one standard deviation.

Output Gap Response to a 6 Percentage Points Shock in U.S. Bank Lending Tightening 1/
(In percent)

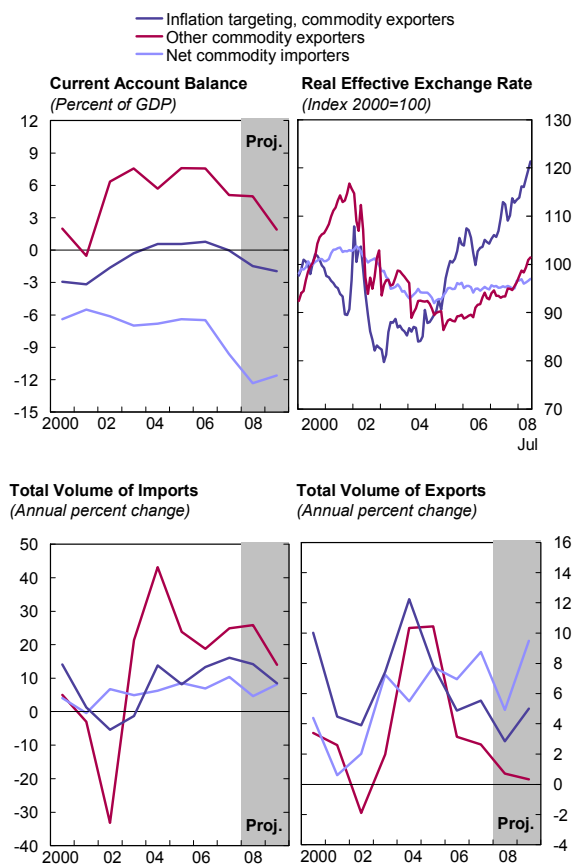


Sources: IMF staff calculations.
1/ Size of the shock is one standard deviation.

... current accounts to weaken ...

The worsening in the current account in recent years reflects a combination of strong domestic demand, exacerbated by contracting oil export volumes in some of the energy exporters, especially Venezuela, and rising profit transfers. Meanwhile, the net commodity importers in Central America and the Caribbean have seen substantial increases in their oil import bills in recent years, which in some countries have been partially financed through Venezuela’s Petrocaribe initiative (see Box 2.8). Looking ahead, external current account positions are expected to continue to weaken—especially in Bolivia, Chile, the Dominican Republic, Panama, Trinidad and Tobago, and Venezuela—as external demand, remittance flows, and the terms of trade weaken, offsetting the impact of weaker domestic demand. Indeed, the LAC region as a whole is expected to run a current account deficit this year for the first time since 2002.

External Sector Developments 1/



Sources: World Economic Outlook database and IMF staff calculations.
1/ PPP-GDP weighted average.

... and inflation to fall ...

The sharp slowdown in the global and regional economies, falling commodity prices, and the lagged effects of past policy tightening should bring inflation down. Inflation in the baseline scenario is projected to fall from 8.5 percent in 2008, to 6.6 percent in 2009. Inflation in the region as a whole should gradually return toward levels consistent with countries’ inflation objectives over 2009–10, though in some cases, pressures may persist. Some authorities in the region (including notably Brazil and Peru) have tightened fiscal policy in 2008 to better support the overall policy mix in containing inflation pressures.

... with growth risks to the downside

This is a time of unparalleled uncertainty for the global and regional economies. The shocks currently working their way through the global financial system are beyond any seen in the last 70 years in terms of their size and scope.

Box 2.8. Absorbing the Oil Shock in Central America and the Caribbean: The Role of Petrocaribe

Rising world fuel and food prices have had a significant impact on external balances in Central America and the Caribbean (CAC).¹ External current account balances have deteriorated markedly since 2006. This

reflects primarily the increase in the oil bill, as CAC countries are net oil importers, while some countries (the Dominican Republic, El Salvador, Grenada, Haiti, Jamaica, and Panama) are also net food importers. Recent work by IMF staff suggests that the impact on the current account of any further increase in oil prices would likely be larger than a similar additional increase in food prices. If a combined shock were to materialize, the most affected countries within the CAC would be Dominica, the Dominican Republic, El Salvador, Grenada, Haiti, Honduras, and Jamaica (IMF, 2008a).

The Petrocaribe initiative has helped cushion the shock. Petrocaribe provides concessional financing on petroleum imports from Venezuela, and in many countries, also a framework for coordinating energy policy. The terms of this financing are common across countries (25-year maturity, with a 2-year grace period, at an interest rate of 2 percent), while the amount of available financing varies, being governed by an import quota negotiated bilaterally with Venezuela in thousands of barrels per day. In addition, the share of imports that can be financed, as well as the grant element of the loan, fluctuate with the world price of oil. Venezuela has also provided financing under the *Alternativa Bolivariana para las Américas* (ALBA), including for energy infrastructure projects. Among the CAC countries, Nicaragua has been the largest beneficiary of ALBA financing during 2007, a trend that is expected to continue in 2008.

Financing from Petrocaribe is expected to be substantial for the CAC. So far, members have not received their full quota,² including due to rigidities in changing oil supply sources,³ and technical considerations linked to the use of the Venezuelan crude oil mix in local refineries. Financing is still expected to be substantial for some countries in 2008, reaching about 5–6 percent of GDP in Guyana, Jamaica, and Nicaragua, and about 1–2 percent of GDP in the Dominican Republic, Grenada, Haiti, and Honduras. Many other CAC countries are seeking similar arrangements with Venezuela (which need to be implemented in El Salvador and Guatemala, and are under negotiation in Costa Rica).

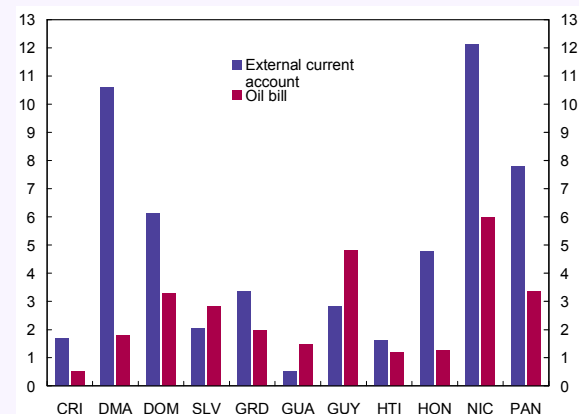
Note: This box was prepared by Gabriel Di Bella.

¹ CAC countries analyzed in this box include Costa Rica, Dominica, the Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, and Panama.

² According to IMF staff projections for 2008, Honduras will import crude and derivatives from Venezuela equivalent to about 55 percent of its quota, Nicaragua about 60 percent of its quota, and the Dominican Republic about 70 percent.

³ The counterparty must be a state-owned oil company, but a significant part of oil imports are still managed by private companies.

Increase in Current Account Deficit, 2007-08
(Percent of GDP)



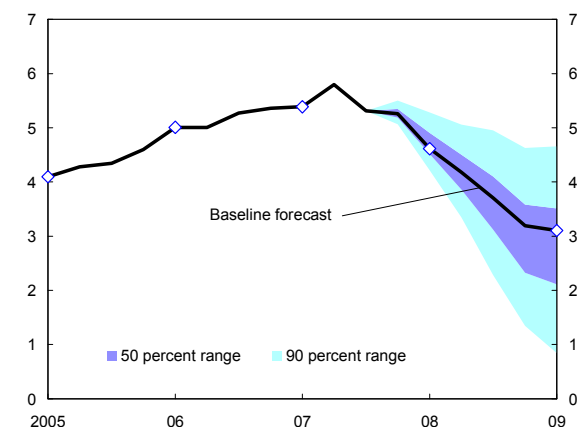
Source: IMF staff calculations.

Oil Bill and Expected Financing Under Petrocaribe, 2008

Country	Oil bill (% of GDP)	Financing	
		US\$ bn	(% of GDP)
Costa Rica	6.1	0.0	0.0
Dominica	9.9	0.0	0.0
Dominican Republic	11.2	0.8	2.0
El Salvador	8.6	0.0	0.2
Guatemala	7.7	0.0	0.0
Grenada	10.5	0.0	1.2
Guyana	30.9	0.1	6.2
Haiti	9.4	0.1	1.4
Honduras	11.0	0.1	0.8
Jamaica	15.5	0.8	6.2
Nicaragua	18.7	0.3	5.1
Panama	6.4	0.0	0.0

Memo item:
Total financing in billion dollars: 2.2

Source: IMF staff calculations.

LA6 Growth Forecast: Balance of Risks*(Annual average growth rates; in percent)*

Source: IMF Western Hemisphere Department Regional Economic model.

Moreover, their short- and long-term implications are very difficult to judge, with much depending on how quickly the ongoing steps being taken by the U.S. and European authorities can stabilize financial markets. Also, in contrast to the outlook in April, global financial and commodity risks are now moving together, adding to potential volatilities for many commodity producers (although falling oil prices are an upside factor for growth and external sustainability in a number of countries, especially in Central America and the Caribbean).

Reflecting on these uncertainties, IMF staff have undertaken new risk scenario analysis for the growth outlook using the regional economic model for Latin America that has been developed earlier.³ The model is focused on analyzing the impact on regional growth of shocks to external demand, international financial conditions, and commodity prices.

With the global economy projected to reach the threshold of recession in 2009 (which in the WEO is considered to be global growth of 3 percent or lower), our analysis focuses on commodity price

³ The model used is the Bayesian VAR growth model (see November 2007 *Regional Economic Outlook: Western Hemisphere*, Chapter 3), for the LA6 countries (Argentina, Brazil, Chile, Colombia, Mexico, and Peru) which together account for about 80 percent of regional output.

risks as well as the impact of further tightening in financial conditions. We model the impact on regional growth of a 35 percent drop in average commodity prices in 2009 from their mid-2008 level. Such a drop in commodity prices is broadly in line with the experience of past global recessions. Tight financial conditions are modeled in two ways. First, a proxy for U.S. financial conditions (high-yield corporate spreads) is assumed to stay unchanged at currently high levels through end-2009. Second, the region's EMBI spreads are assumed to remain at current elevated levels of over 600 basis points reflecting the dependence of fiscal positions in many countries on commodity related revenues. In this scenario, regional growth would slow sharply, dropping to -0.3 percent annual growth in the last quarter of 2009. Full year growth in 2009 would average 0.7 percent, compared with 3.2 percent in the current baseline scenario.

Downside growth risks for the region as a whole have risen since April, in line with the increased downside global risks discussed in the October 2008 *World Economic Outlook*. These reflect especially uncertainties over the evolution of global financial conditions and external demand that have increased since the April 2008 *World Economic Outlook*. While there are some upside possibilities, for example if commodity prices were to rise sharply again, all told, risks to the growth outlook continue to be tilted to the downside around the baseline scenario discussed previously. The balance of risks is encapsulated in the fan chart for the regional growth outlook derived from the BVAR model. This fan chart merges together the baseline scenario, as well as the weaker growth scenario conditional on lower commodity prices and tighter financial conditions.

Vulnerabilities Have Been Reduced, But Risks Still Present

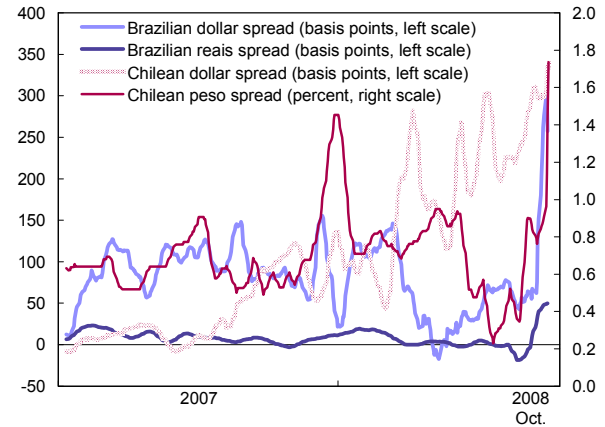
As documented in past REOs, the LAC region's resilience to shocks has increased in recent years. Public debt levels and financing requirements have been reduced, and external

current accounts have been strengthened. Moreover, the credibility of macro policy frameworks in many countries has been strengthened, while flexible exchange rates have provided an important shock absorber for several countries. Financial sectors too are more robust, with higher levels of capitalization and profitability.

Nonetheless, a number of concerns arise in the current global environment. First, developments since the failure of Lehman Brothers in mid-September have shown that money markets in some of the largest and most liquid regional financial systems are not immune to the ongoing global funding stresses. The cost of both dollar and domestic funding has shot up in a number of countries' interbank markets in recent weeks; and anecdotal evidence suggests that in some countries, access to external credit lines and trade credit has begun to tighten. Moreover, global banks account for a significant share of deposits in a number of countries in the region. Pressures on these banks in home markets could create risks of liquidity pressures in some countries in the LAC region.

Second, funding concerns also arise in the context of the still significant public sector borrowing requirements in a number of countries. While public external financing requirements are much reduced relative to the start of the decade, a number of countries still face large domestic rollover requirements on public debt. Overall financing needs in some countries in the region are also well above those in other emerging market comparators. While many countries have a diversified domestic funding base, in some cases heightened risk aversion in domestic financial markets could pose risks, including upward pressures on yield curves. Additional risks arise in

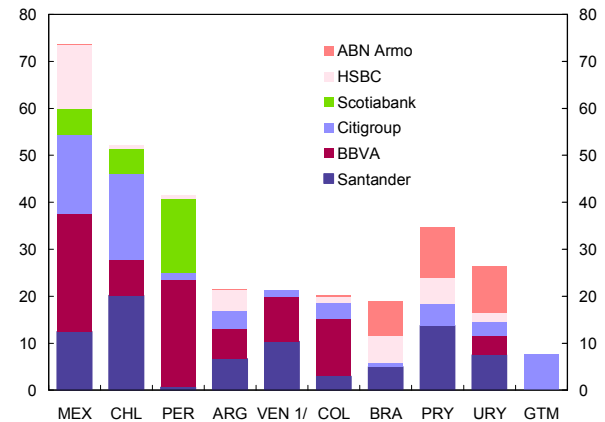
Money Market Pressures 1/
(Two week moving averages)



Sources: Barclays Capital; and IMF staff calculations.
1/ Local currency interest rate spreads: one-month deposit to Pre-DI swap spread (20-day m.a.) for Brazil; 30-day deposit rate to monetary policy rate spread in percent for Chile. Dollar interest rate spreads: 90-day USD/DI swap to 3-month Libor spread for Brazil; on- to off-shore 3 month Libor spread for Chile.

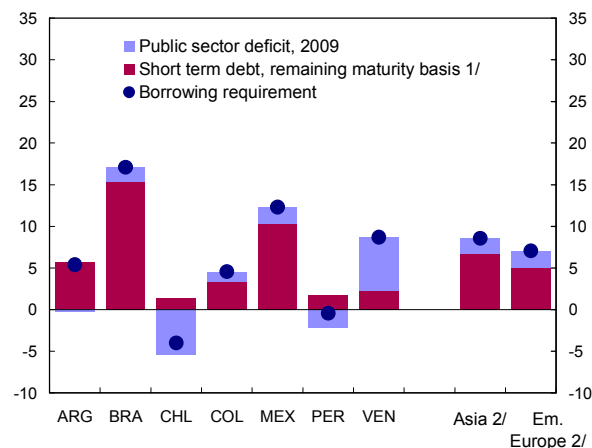
Share of Deposits Held by Subsidiaries of International Banking Groups

(Percent of total banking system deposits, latest available)



Sources: National authorities; and IMF staff calculations.
1/ Foreign banks' liabilities in percent of total banking system liabilities.

Public Sector Financing Requirement
(Percent of GDP)

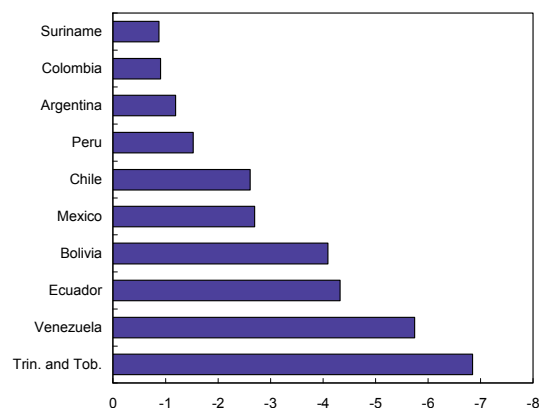


Source: IMF staff calculations.
1/ Stock of short term debt including amortization projected for 2009.
2/ Public sector deficit measured by general government deficit.

this context from the dependence of several countries on commodity revenues. Were commodity prices to fall by amounts consistent with past global recessions (the 35 percent drop discussed in the downside scenario above), fiscal revenues could drop sharply, putting pressure on borrowing requirements in some countries.

Third, rising current account deficits and tighter external financing conditions need to be carefully monitored. At the current juncture, aggregate external financing requirements appear manageable. Even with the projected increase in current account deficits in 2009, the level of external reserves in most of the major countries in the region is sufficient to cover external deficits as well as debt falling due. Nonetheless, coverage ratios are low in some countries, while the region as a whole is less well insulated on this metric than emerging market comparators in Asia, though in a stronger position than those in Eastern Europe. Moreover, while corporate foreign currency debt levels have fallen substantially (Chapter 5), risks have arisen in some cases from currency derivative exposures. Corporates in a number of countries have recently been exposed to large losses from weakening currencies on account of off-balance sheet derivative positions. Risks could arise here given uncertainty over the aggregate size and nature of these positions.

Sensitivity of Fiscal Revenue to Commodity Prices 1/
(In percent of 2008 GDP)



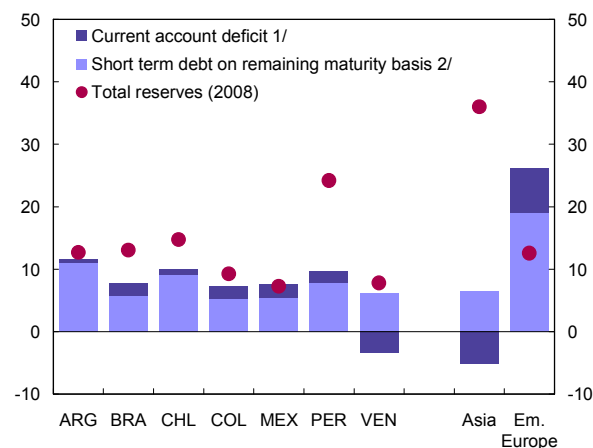
Sources: National authorities; and IMF staff calculations.
1/ Impact on fiscal revenue of a 35 percent decline in commodity prices. Results for the 9 countries with public commodity revenue above 2 percent of GDP.

Policies: Maintaining Confidence and Stability

The shocks buffeting the global economy present the first major test for the region's strengthened policy frameworks. The key policy challenge at this juncture is maintaining confidence and financial stability, while mitigating the expected slowdown. With significant downside risks to the outlook for the region, and the global situation evolving rapidly, policymakers will need to adapt quickly to changing circumstances.

Coverage of Aggregate External Financing Requirements

(Percent of GDP)



Source: IMF staff calculations.

1/ Projected 2009 current account deficit (positive values indicate deficit).
2/ Stock of short term debt including amortization projected to come due in 2009.

Monetary and Exchange Rate Policy

With growth expected to slow, and commodity prices falling sharply, overheating and inflation concerns have become considerably less pressing. In light of the rapidly evolving global situation, authorities will have to carefully balance the impact of both internal and external developments, including on the exchange rate. Some countries—in which underlying inflation pressures are strongest—may need to tighten monetary policy. Others—particularly those where domestic demand is expected to weaken markedly and external pressures are not a concern—may have increasing room to ease.

Nonetheless, policymakers will need to keep a close eye on preserving the credibility of the monetary policy framework. Many countries will miss their inflation objectives this year, with the fast-growing non-IT commodity exporters facing the most significant challenge in reining in inflation. Moreover, inflation may not come back within target ranges in many countries till past 2009. In all cases, it will be important to clearly communicate authorities' expectations with regards to the inflation outlook. It will also be crucial to moderate wage demands to avoid

destabilizing inflation expectations, especially in countries with fixed exchange rate regimes.

In the current global environment, flexible exchange rates in many countries will continue to act as a natural cushion in the event of such shocks. Countries faced with a temporary and sudden shortfall in capital flows will need to respond quickly and effectively, including by using reserves where such buffers exist. The purpose of intervention should not be to defend a particular exchange rate, but to mitigate adverse effects from the global crisis on banks and firms.

Fiscal Policy

Fiscal positions are currently projected to weaken through 2009 in many countries in the baseline scenario, reflecting lower projected revenues, but also continued spending growth especially in those countries most dependent on commodity revenues. As such, fiscal policy in the region will need to be mindful of constraints that could arise from tightening financial conditions in some markets, and the desirability of taking steps to solidify further structural fiscal balances.

In the baseline scenario, fiscal policy across the region needs to be rebalanced towards containing spending growth to maintain fiscal stances broadly unchanged, allowing monetary policy to play the main countercyclical role. Also, in many countries, the ongoing global shock is beginning to create some pressure on government financing. This adds to the need for caution on spending, but also for vigilant treasury management, especially in countries with large financing requirements. Moderating spending would also facilitate needed adjustment in the face of large external imbalances in the commodity-importing countries.

In the event that downside risks to growth materialize, there is scope for countries that have built up credibility to allow revenue to fall without cutting spending. However, if a slowdown in growth is coupled with heightened global risk aversion, tighter financing conditions may impede a loosening of fiscal conditions, particularly in

countries with high debt levels and large financing requirements.

Additional spending stimulus would not be advisable in most countries in the region in the event of a sharper than expected downturn. The rapid spending growth in the region over recent years is probably perceived as permanent. As such, further discretionary spending increases risk undermining the credibility of the fiscal framework (as discussed in the April REO) and raising risk premia even further with adverse implications for medium term growth. These concerns are especially pointed in the case of the non-IT commodity exporters, whose particularly procyclical fiscal stances in recent years have left little room for maneuver on fiscal policy. Options are also constrained for the commodity importers with fixed exchange rate regimes. A looser fiscal stance could result in a loss of international reserves and weakening of the underpinnings of exchange rate frameworks.

Looking ahead, countries would benefit from moving towards adopting long-term budgetary planning, which in the current conditions of heightened uncertainty would ensure authorities' commitment to a sound and sustainable fiscal policy for the future.

Financial Stability Policies

Deeper domestic financial markets, reduced public sector financing requirements, together with lower exposure to exchange rate risks, have helped improve the resilience of regional financial markets to external shocks. Nonetheless, the ongoing turmoil roiling international financial markets is beginning to have an impact on some domestic financial markets in the region. Responding to these emerging stresses, authorities in several countries have taken appropriate measures to maintain stable conditions, including providing liquidity as needed, and seeking to safeguard the flow of trade credit.

The financial sector pressures in advanced economies have highlighted the need for vigilant

oversight over domestic liquidity conditions, and authorities in some countries have already taken steps to ensure orderly market conditions. In this context, it will be important to continue work on contingency planning and improving financial safety nets (such as the clarification of the lender-of-last-resort functions and the role of various authorities in managing financial stability) and bank resolution frameworks. Further, the significant foreign participation in several regional financial systems highlights the need for continuing to strengthen consolidated and cross-border supervision, as well as coordination with foreign supervisory authorities.

While now decelerating, credit has grown rapidly in recent years and risks from deterioration in credit quality may still be in the pipeline. As much international experience has shown, including the recent developments in the United States, episodes of rapid credit growth are often accompanied by a relaxation in lending standards, which subsequently tends to compromise the quality of bank portfolios and erode financial institutions' capital. While credit-to-GDP ratios in the region are low by international standards, the rapid catch up process in recent years raises prudential risks that regional authorities are already responding to with steps to strengthen oversight.

Social Policies

Higher inflation, especially food inflation, has created substantial stress on the income of the poorest. International experience has shown that targeted social assistance is the most cost effective means to mitigate the impact on the poor of higher food and fuel prices. Indeed, the fiscal cost of protecting the most vulnerable households is moderate when using targeted instruments.

A key challenge is that many countries still lack effective social safety nets that adequately reach vulnerable households. Second best options, such as subsidies or tariff reductions, may be needed in the near term, but should be periodically

reassessed and removed as better instruments can be put in place. More fundamentally, a strong anti-inflation policy is also a strong pro-poor policy. This increases the imperatives for authorities in the region to deal firmly with inflation pressures.

Policies to Boost Growth Potential

IMF staff analysis highlights the unfinished agenda on boosting investment and growth. From a medium term perspective, staff analyses have shown investment growth to be affected by the size and persistence of financing constraints (see Chapter 6). These constraints are found to be more severe for smaller firms in the region, which gives additional impetus to the need to strengthen capital markets and credit institutions, and promote access to finance. Key aspects here

include developing financial infrastructure (e.g., ratings agencies, transparent and better accounting standards) and sound legal frameworks (property rights, foreclosure process and bankruptcy reform), to increase intermediation and lower obstacles to increased bank and capital market funding for mid-sized and smaller firms.

Constraints implied by the low rates of public capital formation in the region have also been well documented. Many analyses point to continued deficiencies in public services provision in the region, whether on infrastructure but also on education. As such, giving increased priority to increasing the level and quality of public investment as opposed to consumption remains a key challenge for the region.