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Latin America
The Outlook After WTC

Walter T. Molano

A Review of Events

The events of September 11, 2001 changed the global and Latin American outlook. Although the situation is fresh, we can contemplate about the new trends in the global and Latin American economies. Let’s commence with the outlook for the U.S. and the global economies.

(i) The Global Economic Environment

The attack on the World Trade Center delivered a severe blow to U.S. consumer confidence. Airline travel plunged, leading to a collapse in the hotel and travel industries. Consumer spending, which accounts for two-thirds of U.S. economic output, dropped 1.8% on a seasonally adjusted basis in September. The largest companies across the U.S. were forced to slash employment rolls. In October, the U.S. economy lost more than 400,000 jobs, pushing the unemployment rate above 5.4%. This was the largest decline in employment for more than 20 years. The impact on the U.S. economy was immediately registered in the equity markets. The Dow Jones index lost 14% during the week after the attack. This was the largest weekly decline since 1933. The impact on economic activity was immediately reflected in the third quarter GDP data.

The pace of economic activity in the U.S. contracted 0.4%, reflecting the first decline in economic activity in almost 10 years. The impact of the U.S. slowdown had global ramifications, accelerating the global economic downturn that was already underway since the start of the year. For example, Singapore, one of the most open

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Each of the world's economies, reported a 9.9% decline in economic output during the third quarter. Similar results were registered in other parts of Asia and Europe.

While the effects of the September 11 attacks were evident, the longer-term outlook was more difficult to assess. The trajectory of the U.S. and global economies will surely change, but the environment will be dynamic.

It is apparent that the impending U.S. economic slowdown was caused by excessive investment during the 1990s. A combination of easy money and technological advancements fueled the investment boom. As a result, the supply and demand of goods and services moved out of alignment. There was too much aggregate supply for the level of demand. By the end of 2000, the U.S. was starting to adjust, but the realignment process was going to be lengthy. The U.S. government tried to stave off the decline, only prolonging the process. Furthermore, wide access to credit allowed questionable companies to survive, thus forestalling the needed rationalization of the marketplace. However, the process was accelerated after September 11, 2001. The decline in output and the stress on the U.S. economy may force the demand and supply curves to realign much quicker, providing an environment that will eventually attract investment. The recent decline in consumption produced a sharp increase in the savings rate. The savings rate in the U.S. rose to 4.5% in September, the highest rate in 3 years. The increase in savings will eventually provide the resources for a rapid recovery in the U.S. and global economy. Therefore, the timeline of the global business cycle may have changed in the aftermath of September 11.

(ii) Impact on Latin America:

The impact of September 11 will have a varied effect on Latin America. Geography and levels will register the variance. On a generalized level, the economic slowdown in the U.S. and core economies will ripple through the region. The reduction in global economic activity will reduce trade flows, commodity prices and capital flows. The World Bank reported that global trade was expected to grow only 1% year on year in 2001, after expanding 13% in 2000, with most of the adjustment registered in the second semester. Exports in many Latin American economies dropped in the aftermath of the World Trade Center attacks. The impact on the trade balances was not noticed, since imports often dropped further. The decline in global economic activity will be reflected throughout the region. The Latin American economic growth outlook for 2001 is 0.7%, in contrast to 4% at the half-year mark. The decline in global commodity prices will generate more problems for the region. Oil crude prices fell 31% in the two months following the attacks. Soybeans and Coffee dropped 9%, while copper declined 6%. Moreover, the World Bank said that gross capital flows to developing countries would drop by one third to $160 billion. Indeed, the capital markets were closed for most of the
countries, with some limited exceptions. Therefore, the generalized impact would be serious. However, the individual and geographical impact would be more varied.

(iii) **Mexico:**

The Mexican economy should witness the most dynamic impact from the new global environment. At first glance, the Mexican economy is suffering from the U.S. economic slowdown. The Mexican economic authorities announced that the level of activity declined between 1% and 1 ½% in the third quarter. We expect that the pace of economic activity will grow less than 1% in 2001, suggesting another powerful decline in the fourth quarter. Exports from Mexican companies have suffered in the aftermath of September 11. However, the indicators of country risk, such as the JP Morgan Emerging Markets Bond Index (EMBI) and the Mexican peso, did not show any deterioration. On the contrary, they improved. The Mexican EMBI gained 4.8% in the two months since the week of the attack. The Mexican peso was 2 ½% stronger at the end of October than the close of the day of the attack.

The reason was that the expected changes in global trade might bode well for Mexico. The decline of trans-Pacific trade is probably one of the residuals of the World Trade Center attack. Indonesia, for example, reported a 25% decline in exports during October. Taiwan and Singapore are reporting huge declines in embarkation. The concerns about security is forcing multinationals to look for new locations for their factories. Mexico is the most obvious winner in the contest. The new preference for security and proximity to the U.S. will override the concerns over price.

In 2001, the Mexican economy faced an onslaught of competitive pressures from Asian countries and companies. The over-valued Mexican peso reduced the competitiveness of Mexican producers in the domestic Mexican and U.S. markets. As a result, waves of Asian firms stole market share. However, the crisis increased shipping costs and trade barriers for Asian firms, erasing their competitive advantage. The result was an increase in foreign direct investment, as more global firms relocated operations in Mexico. The announcement by Asahi, a Japanese glassmaker, to manufacture flat glass in conjunction with Vitro in Mexico, only confirmed the trend. In the end, the Mexican economy will witness a sharp increase in foreign investment, at the same time that much of the flows to the rest of the region will decline. The expectations of higher capital flows helped explain the strength of the peso in the aftermath of the September 11 attacks. Hence, the Mexican economy should witness only a mild recession, followed by an investment-led recovery. This will provide a political respite for President Fox, who has been under pressure for not advancing on the economic reforms that were promised during the presidential campaigns.
Argentina:

Argentina lies at the opposite end from Mexico on the Latin American spectrum. The events following September 11 exacerbated the economic and financial crisis in Argentina. The Argentine recession deepened, leading to a 14% plunge in tax revenues in September and an 11.3% decline in October. At the same time, the mid-term congressional elections led to further political instability. The rating agencies sensed that the Argentine situation was untenable. Standard & Poor’s downgraded Argentina debt rating to CC at the end of October, lowering the country to three notches from default. Left with no other choice, the De la Rua government decided to take steps to restructure the foreign debt.

In early November, the Argentine government announced that it would introduce a voluntary debt restructuring that would allow investors to exchange their bonds for new instruments with an average interest rate of less than 7%. The instruments will have a grace period of two years. The average interest rate is 12%, and some of the bonds have rates in excess of 16%. In order to induce investors to participate in the transaction, the government will back the new instruments with tax receipts or pledges from the multilateral lending agencies. The swap operation is expected to take place in the beginning of the year. The local institutions are expected to fully participate in the transaction. They hold approximately $38 billion in the total stock of $93 billion in foreign debt. The Argentine government announced that it needs at least $15 billion of the foreign debt to be tendered in order for the operation to be a success. The government expects to reduce interest payments by $4 billion in 2002, thus providing enormous relief on the fiscal accounts.

The Argentine government hopes to take other measures to reactivate the economy, including tax rebates for individuals who pay with credit cards, a reduction in the payroll pension deductions, and an expansion of the money supply through the introduction of the Lecop. The latter is a non-convertible currency unit that will be used to pay government wages and suppliers. The Lecop is non-convertible, which means that it can trade at a discount, without creating implications for the peso parity. Indeed, the Lecop could be way to provide some monetary relief to the Argentine economy, without producing destabilizing the Convertibility Plan.

Looking ahead, the future of Argentina depends on three factors. The first is its ability to implement the voluntary bond swap, without undermining the stability of the banks. So far, Argentine depositors have not panicked. However, a run on the banks could force the transaction to fall apart. The second factor is the need to maintain political stability. The Argentine political factions are anxious to seize power from President De la Rua. Even though the political parties fared poorly during the midterm elections, there appears to be a power vacuum in Buenos Aires, and some of the more desperate politicians are anxious to grab power. Unfortunately, such an event would lead to a
collapse of the financial system, economy and the possibility of completing the
transaction.

The third factor is the cooperation from the U.S. Although the U.S. government,
or the IMF, is not expected to provide additional funds, it can invite Argentina into a
bilateral trade agreement. This would attract additional capital flows, in the form of
foreign direct investment. There are indications that the U.S. wants to support Argentina.
The Argentines have been loyal allies in the aftermath of September 11—something that
was mute in Brazil and Mexico. In the aftermath of the World Trade Center attack, the
Argentina government offered to deploy a field hospital in the Afghanistan conflict. The
U.S. government also requested that Argentine troops be deployed in the Balkans to free
U.S. troops for the upcoming land war in Afghanistan. The Argentine government
complied. Therefore, there is a lot of goodwill in Washington towards Argentina. In the
end, the shock of September 11 accelerated the meltdown of the Argentine economic and
financial situation. However, it could also have accelerated the recovery.

Currently, with two of the three components having taken place in Argentina, i.e.
the run on the banks and sweeping change of presidents, the hope is mostly on the third
component and it is up to the U.S. to take assertive steps to accelerate Argentinean
recovery.

(v) Chile:

Chile is a country that will suffer from the global economic slowdown. However,
its strong economic foundation will mitigate the damage. The Chilean economy has
suffered from very short economic cycles since the end of the 1990s. The Chilean
economy suffered a cyclical downturn from March 1998 to October 1999, and from
October 2000 to March 2001. Unfortunately, it is poised to go into another down cycle.
The previous cycles were due to a lack of coordination between fiscal and monetary
policies, or concerns about the presidential elections. Yet, this time the international crisis
is the reason behind the slowdown. Copper prices have been freefalling since May 2001,
surrendering 25% in 5 months. The Asian recession, and serious over-supply problems,
explained the plunge in copper prices. Unfortunately, the global shock following the
September 11 made matters worse.

The only way the Chilean economy can respond to the external problems is by
devaluing the exchange rate. The Chilean peso was already in a downward trajectory in
2001. The Chilean peso depreciated 18% prior to the attacks. The currency had stabilized
in August, but the World Trade Center attack allowed it to return to its downward spiral.
The peso lost another 6 ½% in the two months following the attacks, bringing the
devaluation to 28% for the first ten months of the year. The massive devaluation was
compared to an inflation rate of 4.1%, indicating a massive erosion of real wages and asset values. The devaluation allowed Chile to maintain a strong trade surplus of more than $1 billion for the first nine months of 2001, but there were concerns about its ability to sustain the surplus, given the collapse of copper prices and the economic slowdown in Asia. Chile sends about a third of its exports across the Pacific. The September trade balance showed a deficit of $238 million, suggesting that the depreciation was not enough to offset the decline in commodity prices. At the same time, the devaluation of the peso impoverished the Chilean population. The central bank has gone so far as to intervene in the current markets in order to stabilize the currency, but it was to no avail. Political unrest is growing, and the government is desperate to do something to revitalize the economy. Nevertheless, a history of prudent economic policies means that Chile will be able to weather the storm, without any serious disruptions. The financial sector remains well capitalized. The fiscal accounts are solid, and the national savings rate provides a domestic cushion to absorb much of the volatility in international capital flows. In sum, the Chilean economy will tossed about in the storm, but it should fare fine.

(vi) **Colombia:**

The fate of Colombia is one of wildcards in Latin America in the aftermath of September 11. The economic situation is straightforward. Like the rest of the region, the Colombian economy will suffer the global slowdown. The Colombian economy was already decelerating in the first semester, and the trend will only worsen. Colombia’s industrial production dropped 3.2% year on year in August, just prior to the World Trade Center attack. A closer look at the sectorial data showed that the deceleration increased velocity in September. Building permits dropped by 18% year-on-year in September, and Bavaria, the dominant brewery in the country, reported a 30% decline in beer sales since 1999. Colombian exports dropped 3.7% year on year in September, due to the decline in coffee prices and reduced oil production. To make matters worse, the government decided to shelf the privatization of ETB, the Bogotá telephone company. Fortunately, prudent macroeconomic management will avert most of the damage. The Colombian government had already pre-financed $2 billion of the $2.2 billion it would need in 2002. Furthermore, the truce between the Liberal and Conservative Parties has assured a peaceful presidential election and transition process. In the end, the Colombian economy will decelerate. The peso will depreciate, serving as a shock absorber. However, there will be no major economic or political disruptions.

The military situation, however, is the wildcard. The U.S. government intensified the war against terrorism in the aftermath of the World Trade Center attacks. The U.S. singled out Colombia when it said that it would target all terrorist movements. On the eve of the attack, the U.S. classified the FARC as a terrorist group, and after September 11 it expanded the classification to all three major terrorist movements. The discovery of IRA members in Colombia, and the death of an IRA soldier in one of the rural battles, will
only heighten the possibility that the U.S. could take a direct military involvement in Colombia. The jury is still out, but the indications are that U.S. troops could become involved in Colombia. Should that be the case, then the military action will most likely expand to the urban areas. This will lead to an escalation of the war, and a possible disruption of the Colombian economy. At the same time, it will lead to further economic assistance from the U.S. Colombia is in a position to weather the regional downturn, but an escalation of the military conflict could be disruptive.

(vii) **Brazil:**

Although Argentina felt the most direct impact from the events following September 11, the effects on Brazil will be delayed. However, they will be worse. Brazil enjoyed two years of calm following the maxi-devaluation of 1999. The Brazilian central bank successfully stabilized the Real and returned the country to a pattern of economic growth, but the economic authorities lost their magic in 2001. The central bank committed three major mistakes.

First, the Brazilian central bank abandoned its inflation targeting arrangement at the start of the year. In February 2001, the central bank raised interest rates 50bps, even though it had no justification under the inflation-targeting scheme. The devaluation of the BRL during the Argentine crisis was the only reason why the central bank raised the SELIC. Yet, under inflationary targeting, the central bank should have ignored the level of the exchange rate. Instead, it should have focused solely on the inflation rate. However, the trajectory of the inflation rate was well within the year-end target. Moreover, the Brazilian economy was decelerating in early 2001. Unfortunately, the increase in interest rates pushed the Brazilian economy closer to a recession. Hence, there was no reason to raise rates, unless the central bank was signaling that it was abandoning its monetary arrangement.

Second, the central bank signaled its pain threshold after the first series of speculative attacks. The central bank openly intervened in the market each time the BRL approached 2.50. Therefore, the central bank signaled that it was no longer following a true floating exchange regime.

Third, the central bank announced that it would spend $6 billion during the second half of the year to sustain the BRL, clearly tipping its hand to speculators. Not surprisingly, economic agents lost confidence in the exchange rate regime. Brazilian corporates and multinationals quickly hedged their fixed assets, putting additional pressure on the BRL. The BM&F reported a 50% increase in hedging operations during August, when contracts increased to $120 billion. Unfortunately, Brazil’s domestic debt dynamics could not sustain the volatility in the exchange rate and the rise in interest rates.
Brazil has a long history of indexation. The central bank used indexation since 1964 as a hedge against inflation and exchange rate volatility. Brazil’s indexation experience has been difficult. In the early 1990s, an over-reliance on indexation helped create an inflationary momentum that propelled the country into hyperinflation. At the start of the Real Plan, in 1994, indexed public sector debt represented 70% of Brazil’s total debt stock. The fixing of the exchange rate reduced the reliance on indexed instruments, allowing the government to reduce the percentage of indexed debt to 30%. The government was close to restructuring the domestic debt, when a draconian fiscal adjustment, low pass-through inflation, a bumper crop and a large IMF bailout package allowed the central bank to stabilize the situation. Brazil was able to walk a fine line in 2000 and 2001, maintaining a floating exchange rate regime and a potentially explosive domestic debt situation, through the use of its inflation targeting policy and a large primary fiscal surplus. However, a series of external shocks in 2001 proved too much for the country’s floating exchange rate regime, and forced a return to indexed instruments. The Brazilian central bank issued $5 billion in indexed instruments since the start of this year. Indexed instruments now represent half of the total stock of Brazilian debt. Furthermore, the central bank increased the SELIC by 375 bps since February, while the BRL lost more than 45%. The result was a sharp deterioration of the nominal fiscal balance, as well as Brazil’s creditworthiness. Brazil’s debt to GDP ratio was 48.5% at the start of 2001, but it deteriorated to 54% at the end of the third quarter. At the same time, the nominal fiscal deficit is almost 9% of GDP. To make matters worse, the Brazilian economy is decelerating, consumer prices are rising, Foreign Direct Investment in falling and the external obligations remain high. Brazil’s GDP growth in the second quarter was flat, and we are now forecasting a 0.8% growth rate for the year. The central bank raised its inflation expectations to 6.5%, from 6%. The $12 billion in FDI that we expect in 2002 will cover less than half of the current account deficit. This is not to speak of the $30 billion in debt amortizations programmed for 2002. At the same time, the central bank’s intervention in the marketplace is becoming irrelevant. The central bank intervened in the currency markets six times on Friday, to no avail. Yesterday, they intervened twice and drove the exchange rate down 9 centavos. However, the rally was mainly due to the better tone in the core international markets.

Brazil’s central bank is virtually rudderless. Inflation targeting was nothing more than a silly fad. Brazil’s monetary authorities must look for a new anchor. President Cardoso’s economic team met last night to discuss the situation, but nothing was announced. The government indicated that the country must export its way out of this crisis. Unfortunately, Brazil is one of the most insular economies in the world. Brazilian firms enjoy producing for their captive domestic market, and many do not want to compete globally. Furthermore, the global economy is decelerating at a very rapid pace, thus reducing export opportunities. In the end, Brazil may be forced to make some hard decisions about its internal debt situation. It should have restructured the domestic debt
after the 1999 maxi-devaluation. The Cardoso Administration was able to avert a restructuring in 1999, but it may not be so lucky this time.

To make matters worse, Brazil adopted a critical tone in the aftermath of the World Trade Center attacks. It refused to cooperate in the military campaign. It criticized the bombing of Afghanistan. The country will pay dearly for its statements. Brazil will need further assistance from the U.S. and multilateral lending agencies as it is forced to deal with its overwhelming internal and external debt burden, as well as the huge current account deficit.

(viii) Conclusion:

Latin America is in for a rough ride in the aftermath of September 11, but the impact will vary across countries in intensity and duration. All of the countries will see a decline in capital flows. All of the economies in Latin America will suffer from the slowdown in the global economy and the decline in commodity prices. However, their macroeconomic management leading up to the attacks determine their ability to weather the storm. Countries, such as Mexico, Chile and Colombia, which were pursuing prudent macroeconomic policies prior to the attack, will continue to do well. All of them will see a decline in the pace of economic activity. Two of the three responded with a weaker exchange rate, but all of them fared well. The countries that faced serious macroeconomic flaws prior to the attack, such as Argentina and Brazil, only aggravated their situations. Argentina was thrown into a debt restructuring, and Brazil will most likely follow. Therefore, there were not many surprises.

There is one last item that needs to be examined as we look beyond 2001. The recent moves by the G-7 to loosen monetary and fiscal policy will eventually lead to a renewed bout of global inflation. This could be a good thing for Latin America. An inflationary global environment is good for debtors. It also bodes well for commodity producers. Latin America fits both categories. The increase in inflation will erode the real value of Latin American debt. At the same time, commodity prices will rise, in line with inflation. As a result, Latin American governments will increase their capacity to finance a dwindling real stock of debt. Although these trends will manifest themselves over the medium and long term, it could be a ray of hope for the region.