

From Shock to Anxiety: Terrorism's Economic Fallout in Latin America

Economic Outlook

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As Americans emerge from their period of national grieving following unprecedented terrorist atrocities on their own soil, there is growing concern about the economic fallout: a weakened economy, further stock market losses, and rising unemployment. Bad news in the US is a chilling prospect for emerging markets. In particular, Latin American economies are increasingly tied to their northern neighbor. George Bush, who had shown great interest in Latin America, is now preoccupied with fighting international terrorism, an enormous and long-term task. Latin America, for the time being, has fallen off the US political map.

The economy was already in recession before the attack. But even after 10 consecutive months of negative industrial growth, US consumer confidence remained resiliently cheerful. The devastation of September 11th changed everything. The release by the Fed of their "beige" book on September 19th, two days after markets reopened, revealed the extent of the decline over the past year. Industrial production is down by 5% over 12 months with high tech output down by 7.2% over the same period. US exports slid 2.6% in July, even after seasonal adjustment. Consumer confidence slipped only slightly over the last year, in spite of the election crisis and sliding technology stocks. In the wake of the attacks, most observers are expecting to see much lower confidence levels when new indicators are released.

The attacks immediately undermine some sectors of the economy, such as air travel and tourism. Over the next three months, air traffic could drop by 25%, crippling airlines, which already were struggling under lower demand and higher fuel prices. Tourism spending by Americans, and others, will also drop, hurting the Sun Belt and other destinations.

Fundamental Weaknesses

As Americans begin to feel safe again over the next three to six months, travel will pick up once more. But the US economy has two fundamental weaknesses that will take much longer to remedy: a massive current account deficit and record levels of personal and business debt. The American current account deficit grew by 463% between 1990 and 2000, driven primarily by a widening trade deficit. As the only global superpower, US equities and bonds are viewed as safe havens by world investors. The dollar dominates all the world's foreign currency holdings. No other economy in history has attracted as much short-term investment as the US has since the end of the cold war. Defying all logic, the US dollar has appreciated against all other currencies while its trade deficit widens. This risky

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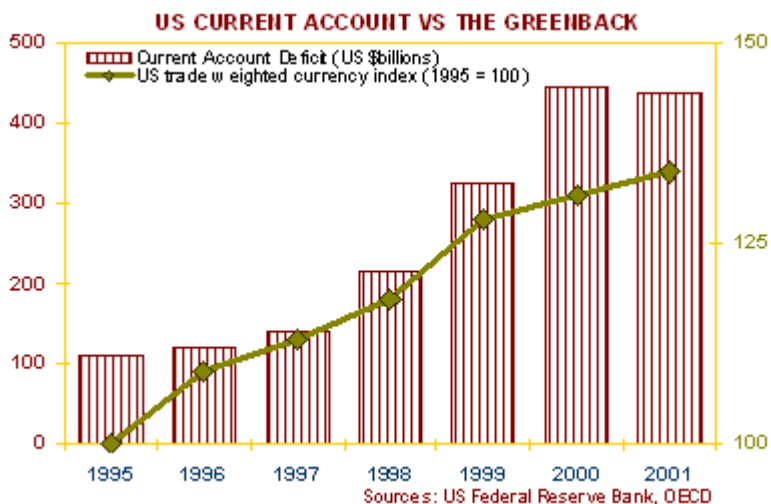
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formula works as long as the world continues to believe in an unshakeable US economy. If international investors pull out of US equity markets, cash in their T-bills, or trade their dollars for Euros or Yen, then the overvalued US dollar will begin to unravel.

The traditional means of supporting a threatened currency — higher interest rates — is not an option. Greenspan has dropped US rates an unprecedented eight times this year. In 2000, the US central bank foresaw problems ahead and began warning against rising debt levels. The strategy of carefully managed interest rate cuts was intended to maintain flat growth for 12-to-18 months, and avoid a recession. Consumer and business confidence is based to a large extent upon enormous respect for Alan Greenspan and the Fed. But the central bank's competence cannot alone counterbalance the lack of thrift

by Americans. The US savings rate dropped to negative levels in 2000. The incredible liquidity of the US economy, where the world has deposited its savings for ten years, has enabled consumers and business to borrow at record levels. There have already been more bankruptcies in 2001 than in any year in the great depression. The US is the only country in the world with a negative savings rate because of its borrowing habits, and because Americans invest in stocks more than others, equities that are shrinking in value in today's bear market. Although interest rates have dropped, lenders have tightened credit policies, making it tougher to get new loans. As negative news mounts, Americans will shift from a spending mode to a savings mode to pay down debt and hedge against diving stock prices. There is a good chance that the US economy, 65% driven by consumer spending, will be "saved" into a recession.



Uncertain Fiscal Responses

US government fiscal prudence over the last seven years may prove a valuable asset over the next 12 months. While consumers and business spent more than they earned, the federal government has run surpluses in recent years and has some fat to burn in the leaner times ahead. The terrorist attacks and anticipated retaliation have focused the government on military spending. Economically, this will provide some stimulus but is less effective than other forms of government spending and much less stimulating than tax breaks. It remains uncertain how much more will be spent to boost the economy, on top of the \$40 billion already appropriated from the surplus to fund a response to the disaster. Whether government spending can counterbalance reduced consumer spending and restore economic growth remains to be seen.

Tied to the US Economy

This growing uncertainty worries not only Americans but people around the world, and especially regions with strong trading relationships with the United States. Falling US spending means reduced export volumes for Latin America. Export values will fall even further as already-weak commodity prices continue to shrink. Oil will be the only exception, considering potential military threats to mid-east supply channels. Mexico, which sends 84% of its exports to the US, has already downgraded its growth predictions. The government now expects zero or negative growth in 2001, in spite of healthy oil revenues and 7% growth in 2000.

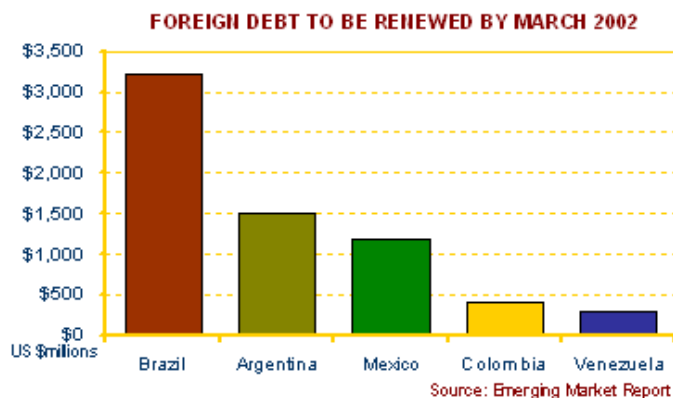
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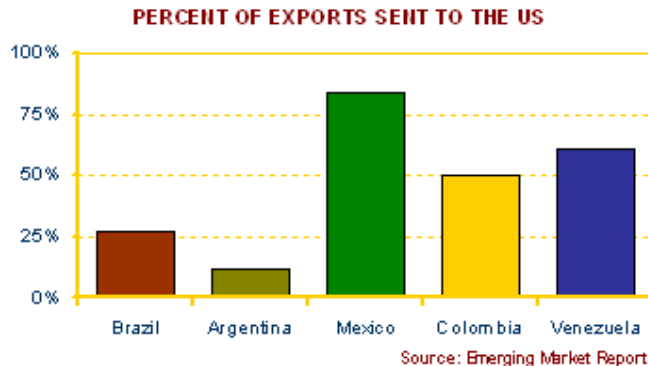


Aside from the general decline driven by reduced exports, a number of sectors that are closely tied to the US are vulnerable to specific harm as a result of the terrorist attack. Brazil may see its small trade surplus wiped out, as US airlines cancel orders for aircraft from Embraer. One estimate is for a 30% drop in orders, from 220 to 150 planes, reducing exports by some \$1 billion. Mexican and Caribbean tourism will suffer enormously this season, both out of fear of flying and reduced consumer spending. Since the attacks, 30% of pre-booked Mexican holidays have been cancelled by American tourists. Mexico's auto sector, which relies on exports to the US for about 40% of its revenue, could see a 15-to-20% decline over the next 12 months as the US

and Mexican economies slow down simultaneously. Declining metal prices will further strain export revenue and fiscal balances in Peru and Chile where mining is an important source of government financing.

Nervous Investors

Increasingly risk-averse institutional investors will be less willing to finance emerging market sovereign debt. Argentina and Brazil together must renew almost US\$ 5 billion in foreign debt over the next six months. The threat of Argentine default has further alienated nervous investors and pushed up the cost of financing in both countries. The Bush Administration, which showed only reluctant interest in the Argentina crisis in the first place, may have little time for the Mercosur in light of more pressing security issues. Argentina may be the first emerging market casualty of America's war on terrorism.



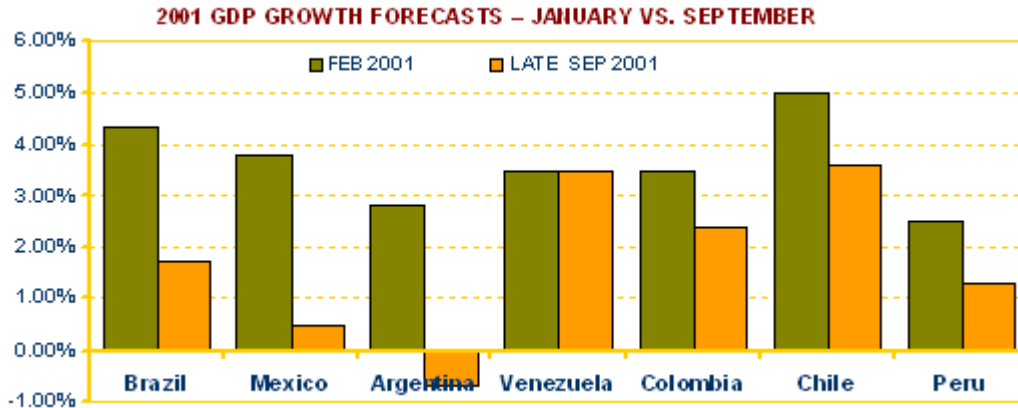
Foreign direct investment in Latin America will decline for the second straight year, even faster than anticipated (see related article in this issue). If the US remains distracted from its leadership role in hemispheric economics, the FTAA initiative will once again be stalled. Lobbyists are desperately trying to link the passage of TPA (Trade Promotion Authority) to a federal economic stimulus package. The Bush administration, however, is hesitant about leveraging its high approval ratings as a means of passing controversial legislation that is not credibly connected with a fight on terrorism. Without TPA however, Latin American leaders are not eager to hammer out a trade agreement. This prospect is bound to hurt long-term investment, which is desperately needed to boost competitiveness in Latin America.

Decreased investment flows into the region and lower US imports will put new pressures on the Latin American currencies. Mexico's Peso slipped 3% in the first week after the attacks. Mexico's currency had been one of the world's strongest over the last 18 months as global enthusiasm over the election of President Fox drew in investors. At the same time, high oil prices helped trade performance. But Mexico's mounting non-oil trade deficit will continue downward pressure on the floating Peso. Also threatened are the Brazilian and Chilean currencies, respectively the 2nd and 3rd weakest currencies in the world in 2001. Brazil's Real dropped by 4% in the week after the attacks. Chile's reliance on copper exports (45% of total) threatens its currency as long as copper prices remain at historic lows.

Tighter Border Controls

Increased security along the US border could dramatically alter Mexico's unique labor relationship with its wealthy neighbor. As many as 2 million Mexicans cross the border illegally each year to work in the US, with 1.7 million returning within 12 months to spend their dollars at home. The "leaky" border keeps wages and inflation down in the US and brings in dollars to Mexico. President Bush, to his credit, was the first US President to recognize this and promote a bold initiative to legalize up to 3 million Mexicans living in the US and create a migratory work visa. After the attacks, however, the US will examine its borders more closely and the immigration initiative will likely be shelved. Worse still, some speculate that the US may militarize its border, a worrisome prospect to Mexico's underclass.

Under Bush, the US began to re-establish leadership in the Americas, a role that was neglected by Clinton since the Peso crisis in late 1994. George W's unique relationship with President Fox of Mexico and his keen interest in the FTAA brought high levels of generally positive exposure to Latin America. The terrorist strikes illustrate how many global interests tug at the attention strings of the US President. Unless the executive branch makes the FTAA initiative a priority, it will stall. And without US media and Congressional attention, democracy could be threatened in parts of Latin America, as weak economies cry out for Caudillo responses. So much of Latin America's promise is tied to a strong and captive US, the same country whose economy is headed for a recession and whose leadership is focused elsewhere.



2001 FORECASTS PUBLISHED IN FEBRUARY							
Indicator	Brazil	Mexico	Arg	Ven	Col	Chile	Peru
Real GDP Growth	4.3%	3.8%	2.8%	3.5%	3.5%	5.0%	2.5%
Inflation	6.0%	8.4%	2.0%	17.0%	11.0%	3.7%	4.5%
Interest Rates (year avg)	14%	14%	9%	24%	13%	7%	13%
Trade Balance (USD Bn)	\$1.0	-\$11.0	\$0.5	\$7.0	\$0.7	\$0.5	-\$0.4

Current Acct (% of GDP)	-4.1%	-3.5%	-3.4%	2.5%	-1.9%	-3.8%	-2.9%
End-year Currency Forecast	2.40	9.40	1.00	740	2300	620	3.60
2001 FORECASTS PUBLISHED IN LATE SEPTEMBER							
Indicator	Brazil	Mexico	Arg	Ven	Col	Chile	Peru
Real GDP Growth	1.7%	0.5%	-0.7%	3.5%	2.4%	3.6%	1.3%
Inflation	7.0%	6.5%	-0.1%	15.5%	10.0%	5.4%	3.8%
Interest Rates	17.0%	12.7%	9.0%	22.0%	12.0%	8.0%	16.0%
Trade Balance (USD Bn)	\$1.0	-\$21.0	\$2.2	\$7.0	\$0.4	\$1.3	\$0.0
Current Acct (% of GDP)	-3.6%	-3.9%	-1.5%	1.0%	-2.0%	-2.1%	-1.7%
End-year Currency Forecast	2.75	9.80	1.00	790	2550	680	3.60
Sources - Economist, Business Monitor, America Economia, Latin Finance							

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