THREAT OF A NEW ECONOMIC RECESSION?
Hopefully there will be a lesser impact on the agricultural sector

Some of the major world economies are facing the specter of a new economic crisis. If it develops, Latin America and the Caribbean (LAC) and the rest of the world will feel its impact. Can we expect a new episode or will this crisis be a recurring event that is a variation of the foregoing crisis that triggered the 2009 recession?

Although there are differences between the 2008 crisis and the current one, both were unleashed by the high debt and payment difficulties of the major debtor countries. The current crisis exhibits high levels of sovereign (government) debt, whereas in the 2008 crisis, the level of consumer indebtedness set off the alarm signals.

Growing concern has been warranted especially because of the exposure of European (and US) banks—through the contagion effect-- to the government debts of what are known as the PIGs (Portugal, Ireland and Greece), to which have been added France, Italy and Spain. Fears have escalated even further at this time because of the global character of the debt, compared with the 2008 crisis, which grew out of high-risk mortgage loans in the United States (the so-called sub-prime mortgage loans).

Markets have grown cautious due to recent indicators of a slowing down of economic growth and the increasing likelihood of a recession in the major economies which, traditionally, have been the engine driving the world economy.

While a recession in the United States has yet to be confirmed, there is reason for concern. The unemployment rate is more than nine per cent, in addition to which the economic growth rate is sluggish (0.4 per cent in the first quarter and 1.3 per cent in the second quarter). Historically, a growth rate of less than 1 per cent of the US economy in any quarter is generally a sign of a coming recession. However, consumers are now in a much weaker position than they were during the previous crisis, given high unemployment and more limited fiscal resources for social programs and fiscal incentives.

In Europe, on the other hand, the risk of a recession looms even larger. There is uncertainty about the adequacy of available liquidity in the system to face up to sovereign debt problems, and the countries of the European Union are unable to come to agreement on a rescue package for the PIGs. Bank funding needs are estimated to total 1.7 billion euros (US$2.5 billion) which the European Financial Stability Fund is unable to meet. Therefore, an approach would have to be made to obtain resources from other sources (e.g. Central European Bank, inter alia) and the necessary political channels would have to be involved, which would take time.

Signs of a recession have already manifested themselves in the Euro zone since the European Commission reported a decline in GDP growth in the first two quarters of the year (from 0.8 per cent to 0.2 per cent). Projected growth is expected to be barely 0.2 and 0.1 per cent for the third and last quarters.

In Japan, a 0.5 per cent decline in GDP is expected. This is 1.5 percentage points below estimates at the beginning of the year, largely due to the effects of the earthquake and tsunami. The OECD, for its part, is not discounting a recession in some of the larger economies.

As a result of the weakening of the global economy and the recent appreciation in the value of the US dollar vis-à-vis the euro, international commodity prices have fallen. The Reuters/Jefferies CRB index (which contains a basket[1] of products that are

[1] 19 industrial commodities and food products: aluminum, cocoa, coffee, copper, corn, cotton, crude oil, heating oil,

particularly sensitive to current conditions and future expectations in the world economy) peaked in April this year and, since then, has dropped by close to 22 per cent[2] as the world economy has cooled down (the agricultural subcomponent has behaved in a similar way). However, prices are still way above historic levels. According to IMF indices calculated through September this year, the prices of energy products are 89.8 per cent above the average for 2005; food prices are 75.8 per cent above the 2005 average; the prices of metals are 124.1 per cent above the average for 2005; and basic agricultural commodities are 49.6 per cent above average prices for that year.

With the contracting of demand, prices have tended to drop in the short term, but this is part of a cycle and greater volatility around a long-term trend where prices continue to climb.

LAC is in a good position to face the crisis

Whereas Europe, Japan and the United States have plunged into economic stagnation, Latin America has enjoyed a strong recovery over the last two years. This recovery has been driven by capital flows, record prices for basic commodity exports, sound policies and a staggering expansion of domestic credit. Last year, the region experienced a 6 per cent economic growth rate and, according to new IMF estimates, this year, the economy will grow by 4.5 per cent.

The region continues to be in a strong position to face the crisis, mainly because it has comfortable levels of currency reserves and relatively low debt to GDP ratios. As a result, the region is able to cushion the impact of external shocks. Most of the countries show fiscal equilibrium in their public finances, which enables them to build up an arsenal of stimulus policies and economic recovery measures, which the developed countries do not have. Besides, the engines that drive LAC growth have changed, with demand from China[3] and internal demand being the main engines driving growth.

Despite these strengths, the European crisis could have direct repercussions for the economies of LAC since the European banks are a major source of funding for the region. For example, the public-private sectors of LAC owe Portugal and Spain US$ 320 billion, that is to say, the equivalent of 8 per cent of regional GDP. The emerging economies of Europe owe LAC close to US$400 billion, in other words, 13 per cent of regional GDP. The Spanish banks hold more than 25 per cent of commercial bank capital in Mexico, Chile and Peru. On the other hand, Spain and Portugal are a source of foreign direct investment (nearly 12 per cent of FDI flows for Brazil in 2009).

The European debt crisis could also have an indirect impact on LAC if it hits the United States economy. US banks do not have too much exposure to Portugal's and Spain's debt problems and the likelihood of contagion would be lower. However, the situation changes with respect to Italy. According to recent estimates, Citigroup had US$12.7 billion in Italian funds, much of which was government-related, whereas JPMorgan Chase had US$12.2 billion in this country. However, given the complexity of relations in the global financial system, it is still difficult to predict what the likelihood and scope of the contagion might be.

Finally, it must be recognized that the region is not uniform in terms of its capacity to respond to a crisis, since some countries are more vulnerable than others because of their high dependence on food and energy imports, low currency reserves and high levels of indebtedness and fiscal deficit.

Countries of the region that are net importers of agricultural products (a total of 15[4]) include Haiti, the Bahamas, El Salvador, Dominica, Guatemala and Honduras, which show an import food quota of

lean hogs, live cattle, natural gas, nickel, orange juice, silver, soybeans, sugar, unleaded gas and wheat.

[2] Consulted for the last time on October 9, 2011.

[3] However, in Central America, only Panama and Costa Rica have relations with China.

[4] Haiti, the Bahamas, El Salvador, Dominica, Dominican Republic, Jamaica, Trinidad and Tobago, Mexico, Venezuela, Grenada, Saint Lucia, St. Vincent, St. Kitts and Nevis, Barbados, Antigua and Barbuda and Suriname.

over 20 percent as a percentage of total exports. This makes them particularly vulnerable to any increase in international agricultural prices. Some of these countries have little maneuvering room since they have a 50 percent debt to GDP ratio and their international reserves hardly surpass 30 percent of the total external debt[5] .

Another group of countries that comprise net agricultural exporters (and that are therefore vulnerable to a possible downturn in import demand from developed countries) show a food import quota of over 20 per cent in relation to total exports. This also makes them vulnerable, particularly in the event of a rise in international food prices. Nicaragua, Guatemala and Honduras are examples of this category of countries which, moreover, have relatively low levels of international reserves.

Panorama for the agricultural sector of LAC

Five possible channels of transmission are analyzed in order to visualize the possible impacts of the crisis on specific economic sectors, such as the agricultural sector: 1) changes in the supply of and demand for goods and services; 2) interest rates; 3) exchange rates; 4) metal and oil prices; and 5) global economic and financial uncertainty.

i. ***Imports from the developed countries could decline, but the effect will be lesser in LAC agriculture for export.*** The aggregate demand for goods and services declines in countries with a stagnating economy and that face a possible recession as a result of declines in real income and, consequently, household spending, which drives down the demand for imports. This will affect agricultural exports from LAC.

However, the hope is that a contraction in the demand for agricultural products and, especially, foods for basic consumption, will be far less significant, given the lack of elasticity in the demand[6] for these products. When faced with a decline in income, consumers first limit spending on items considered non-basic and, as a final resort, make adjustments in their consumption of products to meet their basic needs (such as foodstuff). Even so, and given recent experience, the possibility of a contraction of demand in terms of volume should be given due consideration, although, high international prices could offset the decline and sustain the value of LAC exports.

A possible fall in LAC exports to developed countries in a state of virtual stagnation could also be offset by a demand from emerging countries that continues to be strong and by an increase in intra-regional trade which has assumed more dynamic proportions in recent years. However, the panorama is more difficult for some countries in Central America and the Caribbean, which are highly dependent on agricultural trade with the United States and Europe.

ii. ***The combined effect of low interest rates and high risk levels is to push up the prices of agricultural products.*** This is positive for the countries that are net exporters of agricultural and industrial raw materials, but is negative for the net importers. Economic recovery policies have been based on lowering interest rates to almost 0 per cent in real terms. The main effect of this measure is to push up the international prices of basic commodities for three basic reasons[7]. Low interest is a disincentive to produce today instead of tomorrow and, as a result, supply drops and prices are pushed upwards. Secondly, low interest rates reduce the opportunity cost of companies in terms of maintaining inventories[8] because of the hope of increased future profits. The third reason is that investors stop investing their capital in Treasury bonds and bills because of lower average yields, investing rather in raw materials that may be expected to be more profitable.

[5] Includes El Salvador, Dominica, Jamaica and Grenada.

[6] Because they are basic commodity items for consumption, declines in the quantities demanded are less significant than they are with respect to consumer income.

[7] A topic to be addressed in future is why international interest rates fall whereas they remain high in the individual countries, especially in rural areas involved in agricultural production.

[8] Applies mainly to non-perishable primary products, such as grains.

In fact, the increase in non-commercial transactions in futures markets (financial speculation[9]) is explained in large measure by low interest rates and limited capital investment options in times of crisis. What is more, basic commodities and raw materials become a refuge in the face of high risk levels on the market.

Once growth in global demand resumes, international agricultural prices will continue their cycle and upward trend if interest rates remain low and uncertainty remains high.

iii. ***Recurring changes on the currency market produce short-term fluctuations in international prices.*** In the recent past, a weak dollar stimulated global import demand, pushing up international prices. More recently, the appreciation in the value of the dollar has brought down prices. Many countries focus their attention on exports as the key to surmounting the economic recession. Thus, the United States has used its exchange rate to drive growth, based on export and investment (and not increase further their public spending), whereas other countries with significant trade surpluses wish to lower them to stimulate domestic demand, as is the case with China.

The United States economy is the largest global economy and any weakening of the dollar can give rise to fluctuations in the prices of raw materials, given the fact that most raw materials are quoted in that currency.

In the last decade, price competitiveness with respect to US exports has increased by some 15 per cent. As a result, according to data as of July, that country hit historical export records and brought down its trade deficit by some 13.2 per cent. In fact, it has generated net agricultural exports not seen since the early eighties.

The appreciation in the value of local currency is a disincentive for LAC exports and domestic production. However, the net result for exports could be positive if the upturn in international prices is greater than the negative effect of the appreciation in the value of the currencies. Moreover, the devaluation of the dollar can bring down the value of the imported component of domestic agricultural production and also reduce the cost of food imports, which would be an advantage for countries that are net importers of food.

Short-term and speculative capital flows to the region could increase in the wake of the crisis, thereby giving rise to increased volatility in exchange rates and uncertainty in the local economies.

iv. ***The steady decline in oil prices will redound to the benefit of the net importing countries and contribute to lowering production and distribution costs with respect to agricultural products throughout the region.*** Oil prices and the prices of metals for some countries are a fourth channel of transmission of the crisis. There is a high correlation between the prices of oil and those of other basic products, especially those that are highly dependent on crude-oil-based inputs. What is more, oil prices are a major determinant in transportation costs throughout the input supply and distribution chain, which directly impacts the final price of agricultural products. High correlations can also be observed between oil prices and the prices of products such as corn and sugarcane, due to the fact that high prices of fossil fuels generate economic incentives for the production of biofuels, which benefits that sector.

Oil prices have had a favorable impact on the balance of trade of several net exporting countries in the region, but have negatively affected countries that are net importers of hydrocarbons. In the face of the threatening crisis, demand could fall and with this, prices as well. Oil prices fell by 13.3 per cent from April to September this year, following a continuous and significant increase of 140 per cent since December of 2008 when the average price per barrel stood at US$41.53 (average for three types of oil).

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[9] There is no consensus among academics as to whether financial speculation is or is not the cause of price hikes. There is, however, no doubt that non-commercial transactions have increased because of the attraction of better prices.

There is, however, no guarantee that even if oil prices continue to drop, so will the prices of agricultural products since there are market strictures and imperfections that prevent lower oil prices from transferring fully and quickly to local markets, as demonstrated during the foregoing crisis. What is more, the cost of fertilizers is usually a small proportion of the gross value of production.

v. ***A global scenario of high risk and uncertainty has negative effects on production and the agricultural profit margin.*** The fifth channel of transmission that we shall look into in this paper is the high level of risk and uncertainty on global markets. It is as important to recognize that high levels of risk and uncertainty have a negative impact on investment and production decisions in the sector as it is to look into how the variables we have analyzed generate uncertainty. Risk is perceived by companies as an additional cost and represents future expectations of a smaller profit margin. This gives rise to inefficient use of natural, human and capital resources.

In addition, incomplete information that is poorly managed, basically by the press, regarding the causes and consequences of the crisis, also contribute to uncertainty, translate into constantly changing speculation that run the gamut of optimism, enthusiasm and euphoria to anxiety, panic and depression. The main effect of this is increased volatility on the markets.

Future challenges and opportunities

In a globalized and increasingly interconnected world, what happens in the most developed economies will undoubtedly impact the LAC economies and agriculture.

On average, however, the region is in a favorable position to face the crisis, notwithstanding differences among countries. Nonetheless, it is to be expected that the region will have difficulty maintaining economic growth and that the growth rate might even fall to below 4 per cent in the face of a slowing world economy and likely recession.

It is therefore vital that we recognize the main challenges and opportunities in order to respond in due course with effective and comprehensive policies.

The first challenge is to resist the temptation to impose protectionist measures that distort agricultural markets. Especially noteworthy are those that have the immediate effect of increasing the level and volatility of international food prices (two examples are inventory accumulation and the closing of exports), which has the rebound effect of increasing domestic prices further and affecting food and nutritional security in the country.

A second challenge concerns the inflationary spiral that has posed a recent threat to several countries in the region, especially in light of the increase in food prices and its implications for food security.

A third challenge is how to respond to the possibility of a decline in demand for LAC exports. This is why new incentives that stimulate domestic and subregional markets must be maintained and encouraged so as to offset the decline in imports from developed countries

A fourth challenge, especially for the net oil-importing countries, is the need to tackle the rigidities and imperfections in the market that prevent the fall in crude prices from being transmitted to local markets and through the chain of inputs, transportation and agricultural production. The same applies in the case of net food importers, which would benefit from the decreases in the international prices of agricultural products and raw materials if they were transmitted rapidly to consumers and agri-food industries.

A fifth challenge is the need to provide a timely response should China, and the emerging countries in general, also be affected by the fall in private consumption in the U.S. and Europe, which would reduce the demand for agricultural products from LAC. Countries in the region could seize the opportunity to better explore the possibilities and advantages of interconnectivity (e.g., between Central America and the Caribbean and the Southern

Cone and Mexico), encouraging intraregional trade and investment, as the Asian Tigers did (those countries strengthened their ties with Japan and with each other).

A sixth challenge, particularly for net food-importing countries that also find themselves in a vulnerable macroeconomic position (low international reserves, high foreign debt and fiscal deficits), is the need to encourage domestic food production and, at the same time, improve the system used to supply and distribute agricultural products internally, linking small producers to local markets better and more efficiently.

Commodity prices will remain high in the long term. This will help the external balances and the agricultural production and profitability of the net exporting countries, but the benefits will not be as great as in the recent past, when price cycles were well above the long-term trend. The net exporting countries of products with greater elasticity of demand (fruits and vegetables, meats and dairy products) are likely to be affected by weakening global demand, but in general will depend on the evolution of the international terms of trade.

We must learn the lesson of recent years, when the region failed to take sufficient advantage of the boom it enjoyed. Saving and investment levels remained very low, workforce productivity barely grew over the last decade, and business innovation and public investment in education and transportation infrastructures were insufficient. The countries also failed to invest in technological innovation and in the training of more human capital.

It is time to take advantage of the region’s strengths by designing policies aimed at lowering transaction costs, making more sustainable and efficient use of natural resources, improving infrastructure, and investing in human capital and innovation. These are long-term measures that would promote quality employment in the countryside and growth in the agricultural sector, and thereby contribute to food security, the reduction of rural poverty, and social equity.