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The Economic Impact of the War in Ukraine on Latin America and the Caribbean

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Abstract

Despite a positive terms of trade windfall for commodity exporters, Latin America and the Caribbean (LAC) countries are likely to be negatively impacted by Russia's invasion of Ukraine. Greater global economic uncertainty is causing a flight to safe assets, changing the direction of capital flows and putting pressure on exchange rates. Higher inflation is forcing central banks to raise policy rates, while governments provide new subsidies to offset the effects of higher food and energy prices. A post-pandemic intelligent fiscal consolidation is necessary. Governments should gradually lift measures introduced during the pandemic to support consumption. Moderating the use of regressive energy subsidies –which have been significantly increased in response to high oil prices— is also advisable. Improving productivity and seizing "friendshoring" trade opportunities should be focal point of policymakers in the region.

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The Economic Impact of the War in Ukraine on Latin America and the Caribbean

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1. Introduction

The economic shockwaves of Russia's invasion of Ukraine have significantly impacted Latin America and the Caribbean (LAC). Supply chains in key commodity markets (especially food, fertilizers and energy) have been disrupted, affecting volumes and prices of products that are relevant for LAC's international trade. The effects can vary greatly from country to country depending on whether countries are net importers or net exporters of these products. Some countries with a positive net income effect can be considered winners in a narrowly defined trade dimension. In contrast, some energy and food importers are experiencing a negative net income effect as a result of the increase in commodity prices.

Net income effects—defined as net export positions as a share of GDP multiplied by the products' price variation—range from -2 percent of GDP (mostly in energy poor Central America and the Caribbean, with the exception of Trinidad and Tobago) to +2 percent of GDP (mostly in energy rich South America).

In contrast to the heterogeneity in the trade channel, countries in LAC are uniformly experiencing higher inflation. Although inflationary pressures predate the invasion of Ukraine, these have accelerated since February 2022, generating concerns in a region with significant social and political tensions. The higher unemployment and poverty rates resulting from the COVID-19 crisis are yet to be resolved, and can be exacerbated by the war in Ukraine. As the war contributes to food and energy inflationary pressures—which will be analyzed in the following sections—the vulnerability of lower income households has increased. As estimated by UNDP, food and energy inflation is set to increase the number of people living on less than US$ 1.90 per day by 51.6 million, increasing the global poverty rate from 8.3 to 9 percent.[1] The increase in poverty and the loss of wellbeing are caused not only by the decrease in disposable income due to inflationary pressures, but also by the overall negative effects of the war on LAC's economic growth.

Trade and inflation are not the only channels through which the war in Ukraine impacts LAC countries. Two other dimensions are worth underscoring. First, fiscal indicators were significantly weakened during the pandemic, and can worsen even further. Second, and relatedly, net capital flows into the region are being negatively impacted. This latter dimension is a source of concern, as a recent report indicates that 2022 has been marked by significant capital outflows from emerging and developing countries (JPMorgan, 2022). A flight to safe assets is unambiguously taking place as a result of the increase in interest rates in the U.S. and Europe, the likelihood of a global recession and the uncertainty related to the broader effects of the war in Ukraine.

As mobility restrictions eased and different economic sectors started to reactivate, most LAC counties experienced a sharp recovery in 2021. GDP in a number of countries, including Brazil, Chile, Colombia, and Peru, returned to pre-pandemic (2019) levels. However, increases in poverty rates have not been fully reversed in the majority of countries. This is particularly challenging as growth decelerates and inflation accelerates as a result of the invasion in Ukraine.

This document provides a preliminary overview of these challenges and offers some advice on the best strategies to confront them.

1 Molina et al. (2022).

2. Inflation

FAO's Food Price Index increased by 28.1 percent in 2021. Some specific products with large price increases include: vegetable oils (65.9 percent), sugar (37.5 percent), cereals (27.3 percent), dairy products (17.0 percent) and meat (12.8 percent).[2] The price of oil (Brent) increased by 68.4 percent in 2021. Increases in food and energy prices, together with increased consumer demand and wage indexation, explain why the average annual CPI increased 7.2 percent in LAC in 2021 (excluding the very high inflation countries).[3]

In April 2022, annual inflation rates in Brazil, Chile, Colombia, Mexico and Peru were higher than in December 2021. Led by food prices, inflation has been higher for the lowest income decile of the population, exceeding inflation for the median group by approximately 1 percentage point and inflation for the highest income decile by 2 percentage points.[4] According to World Bank preliminary estimates, such inflationary pressures will cause LAC's average poverty levels (measured at US$ 5.50 per day) to stay at 26 percent in 2022, rather than return to pre-pandemic levels (24 percent in 2019).[5]

This is likely to exacerbate social tensions. The number of reported social unrest events in LAC has nearly doubled since the first quarter of 2020.[6] The vulnerability of low-income households to price increases has forced governments to complement monetary policy tightening with measures to support consumption of key basic products. Tax and tariff reductions on certain goods that have a significant weight on the CPI basket, or explicit consumption subsides, are increasingly common. These measures have only been partially effective in reducing social tensions, albeit at a very significant fiscal cost.

3. Trade

Even though Russia and Ukraine represent only 2.5 percent of global GDP, they have a systemic role in key commodity markets, such as oil (12 percent of global exports), gas (9 percent) and wheat (25 percent). Together with Belarus they represent 37 percent of potassium, 17 percent nitrogen and 14 percent of phosphorus exports.[7] Russian imports between February and April 2022 fell 7.2 percent relative to the same period in 2021, while exports declined 3.7 percent.[8] Russian trade is expected to deteriorate even more in the coming months due to the effects of sanctions.

Trade disruptions in key commodity markets have had a cross-cutting impact on the external account balances of LAC countries. Current account deficits are expected to fall to around half of the pre-war estimates for the median LAC country in 2022 relative to 2021.[9] However, the scenario differs significantly between countries that are commodity exporters, those that mainly rely on tourism and the few cases that have diversified export baskets. High commodity prices are likely to turn the current accounts of commodity exporters to positive territory, while increasing the deficits of tourism-reliant commodity importers (their estimated deficit may be around 9 percent of GDP). The group of commodity exporters with a similar export basket as Russia and Ukraine can expect to benefit from commodity inflation and, in some cases, higher export volumes as they fill the gap generated by global supply restrictions. It

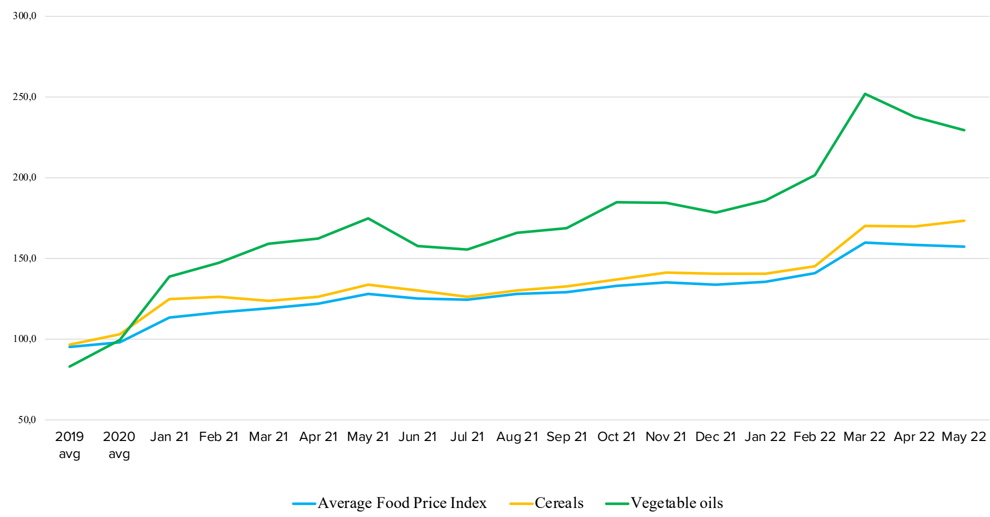
2 FAO (2022).
3 Argentina, Haiti, Venezuela, and Suriname.
4 Appendino, Goldfajn, and Pienknagura (2022).
5 Jaramillo and Taliercio (2022).
6 Barrett (2022).
7 Our World in Data (2022).
8 Kiel Institute (2022).
9 Inter-American Development Bank (2022).

is clear that the main recipients of Russian exports are currently looking for alternative energy sources, as the availability, reliability and political implications of buying Russian products come into question. In contrast, the commodity-importer group will face higher import prices and, potentially, lower demand for outbound tourism from European countries (especially Russia).

In addition to oil prices, natural gas prices have also hiked, from US$4.59 per million BTUs before the invasion in February to US$8.78 in early May, even though there has not been a widespread European import ban on Russian oil or natural gas. Generally speaking this is not good news for LAC, a region that imports most of its natural gas. The exceptions are Trinidad and Tobago, Bolivia and Peru, wich are natural gas exporters.

As illustrated in Figure 1, food prices have experienced significant increases over the past months. FAO's Food Price Index has risen 16.9 percent since January 2022. Increases in vegetable oil and cereal prices (27.8 percent and 20.6 percent, respectively) explain an important part of the index, which also comprises meat, dairy and sugar prices. According to the IMF, a 7 percent increase in food prices combined with a 30 percent increase in oil prices, would mean a 1.25-percentage point increase in inflation in Brazil, Chile, Colombia, Mexico and Peru, on average. The commodity terms of trade index increased for these five countries between January and April 2022, driven by price increases in oil, coal (mainly for Colombia) and food.[10]

Figure 1. Evolution of FAO Food Price Indices (2014-2016 avg = 100)



Source: FAO.[11]

The Caribbean is highly dependent on tourism-related services and—as Table 1 indicates—most countries are energy and food importers (exports of services represent 42.1 percent of total exports according to data for 2015-2019). Similarly, exports of services as a share of total exports average 40.8 percent in Central America, in contrast to only 13.3 percent in LAC countries that are fuel and energy exporters. Global inflation in food and energy prices and a slow post-pandemic recovery of tourism revenues pose a particularly dire scenario for Caribbean countries, especially Barbados, Belize, Grenada, Jamaica and St. Lucia.[12]

10 International Monetary Fund (2022).

11 FAO (2022).

12 World Tourism Organization (2020).

Table 1. Classification of Countries According to Net Exports of Energy and Agri-food Products

	Net exporter of agri-food products	Net importer of agri-food products
Net energy exporter	Bolivia (Plurinational State of) Colombia Ecuador Paraguay	Saint Vincent and the Grenadines Trinidad and Tobago Venezuela (Bolivarian Republic of)
Net energy importer	Argentina Belize Brazil Chile Costa Rica Guatemala Guyana Honduras Mexico Nicaragua Peru Uruguay	Antigua and Barbuda Bahamas Barbados Cuba Dominica Dominican Republic El Salvador Grenada Haiti Jamaica Panama Saint Kitts and Nevis Saint Lucia Suriname

Source: FAO.[13]

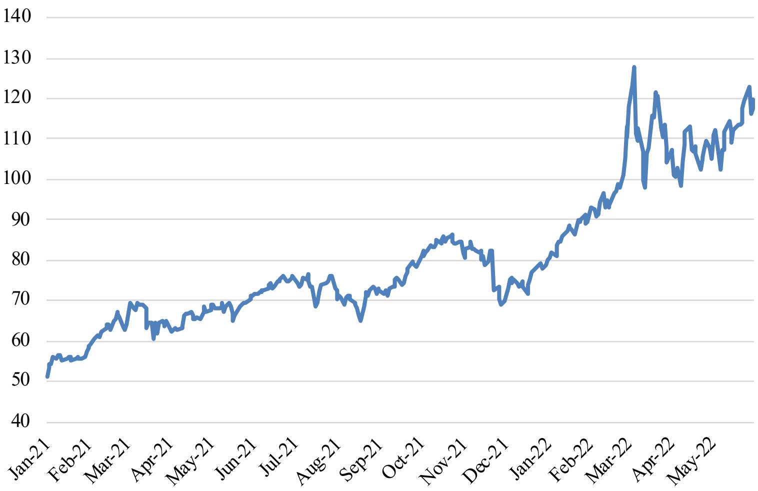
4. Fiscal impact

From a trade perspective, commodity-exporting countries are the apparent "net winners" of the current crisis. Adding the fiscal dimension makes this conclusion less clear cut. Although National Oil Companies (NOC) in countries such as Brazil, Colombia and Mexico benefit from high oil prices, there are other dimensions to consider: fuel subsidies have increased in tandem with higher international prices in order to prevent social unrest. The net fiscal effect depends on the profit of the NOC and the magnitude of the subsidy. Conceivably, if profits are low (because of very inefficient production and high costs) and subsidies are high (e.g., in Colombia the subsidy on a gallon of gasoline is close to 50 percent of the international price), the net fiscal effect can be negative. Another issue is who bears the fiscal cost. In some countries (e.g., Venezuela) it is the NOC, while in others, the cost is borne by the national government (e.g., Colombia). Some countries (e.g., Brazil) opt for a shared arrangement between the NOC and the national government.

As an example, according to Bloomberg, gasoline and diesel subsidies in Mexico are expected to total about US$2.39 billion in May amid a global fuel price rally, while the windfall from the state-owned oil company's crude exports is likely to be less than half of that: US$1.04 billion.[14] During the first quarter of 2022, Petrobras and Ecopetrol's net profits increased 3,700 percent and 110 percent year-over-year, respectively.[15] Likewise, crude oil export revenues from Pemex experienced a 60 percent increase during the first quarter of this year (year-over-year).[16] NOCs are expected to generate an average additional fiscal revenue of 2.2 percent of GDP in 2023, 1.4 percent in 2024 and 0.8 percent of GDP in 2025 for commodity exporting countries in the region.[17] However, these extra revenues will be offset by the higher cost of energy subsidies, which means that fiscal accounts can deteriorate even among oil producers.

13 FAO (2020).
14 Stillman and Cattan (2022).
15 Guerrero (2022), G1 (2022).
16 Solís (2022).
17 Arellano et al. (2022).

Figure 2. Evolution of Brent Crude Oil (US$ per barrel)



Source: Nasdaq

The positive effects of high commodity prices for energy and food exporters notwithstanding, assessing the fiscal effects of the crisis on these countries is not straightforward. Net commodity exporters are using the extra revenues to offset the effects of inflation on consumers. For countries that are not benefitting from commodity price increases, it is much harder to articulate an effective response, given their constrained fiscal space and the lack of increased export-derived incomes to counter it.

During 2020, the COVID crisis led Latin American governments to put in place unprecedented social protection measures in the context of a 10.9 percent decrease in tax collection combined with generalized decreases in GDP growth.[18] Inevitably, such conditions led to pronounced increases in fiscal deficits: the average Latin American deficit was 4.1 percent in 2019 and 8.8 percent in 2020.[19] In 2021, as the health emergency eased, cash transfers to vulnerable households and other social assistance programs were progressively reduced in some countries, but in most cases they were kept in place due to the severe socio-economic impact of the pandemic. Government spending in 2021 was still 1.3 pp of GDP higher than 2019 levels [20]. Therefore, even though fiscal deficits decreased in 2021 relative to 2020, averaging 4.5 percent of GDP, they were still a pressing issue before the war in Ukraine started.

Countries in LAC have implemented new spending and tax measures to counter energy and food price increases.[21] For the group, the largest six countries excepting Argentina, the measures thus far implemented have an overall estimated cost of 0.32 percent of GDP-PPP weighted average for 2022 (IMF, 2022). Most of the measures included in this estimate are tax-related, such as the reduction of consumption taxes and the exemption of certain import tariffs or custom duties. Nonetheless, energy and food subsidies have also been set and in some cases, they are expected to increase as part of social protection initiatives.

As shown in Table 2, as the crisis has endured, many countries have implemented a combination of policies aimed at mitigating the effects of food and energy inflation.

18 OECD et al. (2022).

19 IMF (2022).

20 Inter-American Development Bank (2022).

21 According to the IMF, measures are considered “new” if they were introduced between February 24 and March 23, 2022. See Acosta et al. (2022).

Table 2. Overview of New Measures in Response to Price Surges

	Tax Measures	Spending Measures
Brazil	• Tax cuts on fuel (max. consumption tax set at 18% for diesel, gasoline and natural gas)[22] • Tariff rate reduction (over 6,000 items)	• Increased cash transfers for vulnerable households (increased max. monthly transfer from R$400 to R$600 and included 1.6 million new beneficiaries – estimated cost US$4.7 billion)[23] • Cooking gas subsidies for low-income households (increased gas allowance from $R60 to $R120 in a bimonthly basis – estimated cost US$180 million)[24] • Fuel subsidies for truckers and taxi drivers (estimated cost US$1.3 billion)[25] • Credits for ethanol producers and distributers (estimated cost US$680 million)
Chile	• Custom duties reduction for wheat and sugar imports[26]	• Increased cash transfers for vulnerable households ("Bono de Invierno" for 7.5 million people up to September – estimated cost US$1 billion)[27] • Fuel subsidies (stabilization fund's capacity extended from US$750 million before the war to US$3 billion in June)
Colombia	• Tariff elimination on food and other commodities (total of 165 items)	• Fuel subsidies (the stabilization fund's accumulated deficit could reach US$7.7 billion by end of year)[28]
Ecuador		• Fuel subsidies (estimated annual cost US$3.35 billion)
Mexico	• Elimination of fuel taxes (can cost up to 1% of GDP)[29] • Tariff elimination of food and other commodities (total of 26 items)	• Fuel subsidies (estimated annual cost US$25.8 billion – approx. 1% GDP)[30]
Peru	• Elimination of fuel taxes on 80 and 90 octane fuels, and diesel (reversed after June 30)	• Fuel subsidies (stabilization fund's estimated cost for 2022 US$830 million)[31]

In countries like Chile, Colombia and Peru, price stabilization funds are in place in order to counter the increases in fuel prices, whereas in countries like Ecuador and Mexico, subsidies are not supported through the same stabilization mechanisms. The IDB estimates that fuel subsidies to offset price surges could lead to an increase in public spending in LAC of 0.42 percent of GDP in 2022.[32] This effect does not include measures to directly compensate for food and fertilizer price surges, which are increasingly concerning for countries like Brazil, Ecuador, Nicaragua, Peru and Suriname, which import over 30 percent of their fertilizers from Russia.

22 Agência Brasil (2022).

23 The estimated cost of the extension of the Auxílio Brasil program up to December 2022 is $R26 billion (US$4.68 billion). See Valor Investe (2022).

24 Ibid.

25 Kinast (2022).

26 Dirección Nacional de Aduanas (2022).

27 Toro (2022).

28 Assuming that oil prices are close to US$100 per barrel for the rest of 2022. See Comité Autónomo de la Regla Fiscal (2022).

29 De Haldevang and Gonzalez (2022).

30 BNamericas (2022).

31 Peru's Finance Ministry estimates the overall cost at 3.2 billion Peruvian soles. See Ministerio de Economía y Finanzas (2022).

32 Arellano et al. (2022).

The fiscal costs can be clearly illustrated by considering the case of Colombia. Before the invasion of Ukraine, its projected GDP growth for 2022 was 3.8 percent, but increases in oil and coal prices, continuity of COVID-related subsidies, and significant credit expansion have led to a much faster expansion, which will be close to 6 percent. However, to counter a 9.6 percent annual inflation rate (in June) and to prevent social unrest and eventual strikes in the transportation sector, fuel subsidies have increased to unprecedented levels. The government is providing a subsidy of approximately US$1.75 – $2.00 per gallon; this means that the price of every gallon of gasoline sold in Colombia is set at almost 50 percent of its international parity value (which is the price paid to refiners).[33] This will have a fiscal cost of about 2 percent of GDP in 2022.

Similarly, Chile's government modified its Fuel Price Stabilization Mechanism (MEPCO) in March by extending the fund's capacity from US$750 million to US$1.5 billion. However, due to the persistence of fuel price increases, the fund's capacity was expanded for a second time on June 8 to US$3 billion.[34] Considering Chile's role as a net energy importer, it does not have the cushion that the region's oil-producing countries do to buffer the effects of high fuel prices.

Finally, guaranteeing socio-political stability has become increasingly challenging in Ecuador. The initial (October 2021) budget to maintain a constant diesel and low octane gasoline price at US$1.90 per gallon in 2022 (and to keep the price of 85 octane gasoline at US$2.55) required US$1.9 billion in fuel subsidies.[35] However, inflationary pressures have accentuated existing social tensions, leading to a national strike that went on for 18 days, beginning on 13 June 2022. CONAIE (Confederación de Nacionalidades Indígenas del Ecuador), the confederation leading the strike, presented a series of demands to the government, which included reducing and freezing fuel prices.[36] On June 30, in order to stop the strike, the government issued a decree establishing maximum prices of US$2.40 and US$1.75 per gallon for gasoline and diesel, respectively.[37] Consequently, the cost of fuel subsidies for Ecuador in 2022 will no longer be US$1.9 billion, but rather an estimated US$3.35 billion.[38] This means that government spending on fuel subsidies will outpace government spending on "bonos sociales", which are transfers to vulnerable households; fuel subsidies will cost 1.6 percent of GDP, while spending on "bonos sociales" will be 1.2 percent.[39]

The cases of Colombia, Chile and Ecuador show that energy subsidies are regressive and compromise fiscal sustainability. These subsidies tend to have disproportionate leakage of benefits to high income groups that have more energy-intensive consumption baskets.[40] The regressive aspect of these type of subsidies also relates to their high opportunity cost; as indicated previously, financing such policies requires a significant amount of resources, which implies dismissing other policies with better targeting mechanisms and thus greater redistributive effects.[41] The case of Ecuador is also illustrative in this regard: the highest income quintile receives 53.2 percent of the benefit from gasoline subsidies and 34.1 percent of the benefit from diesel subsidies, while the benefit for the lowest income quintile is 5.1 percent and 10.6 percent, respectively.[42]

33 El Espectador (2022).
34 Diario Financiero (2022).
35 Grupo FARO (2022).
36 Romero (2022).
37 Decreto Ejecutivo no. 467, Gobierno del Ecuador.
38 Grupo FARO (2022).
39 Ibid.
40 Arze del Granado, Coadi and Gillingham (2010).
41 Coadi, Flamini and Sears (2015).
42 Jakob et al. (2019).

Regardless of whether they are commodity exporters, tourism-reliant or diversified exporters, most countries are expected to end up with lower fiscal consolidations in 2022 than were anticipated before the war. As estimated by the IDB, the combination of increased fiscal deficits, inflationary pressures and costly public financing could lead debt-to-GDP ratios to increase to 74 percent by 2024 for the average Latin American country, 68 percent for commodity exporters and 87 percent for tourism-intensive economies.[43] Estimates from the World Bank point in the same direction, as they forecast an average debt level of 69.8 percent of GDP for LAC in 2022.[44] This average comprises a wide range of debt-to-GDP ratios, depending on each country's characteristics; for LAC5, the estimate ranges from 38 percent in the case of Peru to 81 percent for Brazil.

Given the previous projections and the increased cost of financing, the key question becomes how to structure effective fiscal consolidation policies that are also consistent with the socio-economic vulnerabilities of low-income households. Governments should not shut down their spending on social programs that offset the effects of high food and energy prices, nor should they focus budget cuts on health and education where the scarring effects of the pandemic are still present and visible. However, initiatives for employment support are less necessary in cases where unemployment figures have returned to pre-pandemic levels. Smart adjustments should prioritize investment over consumption expenditures. According to the IDB (2022), "when public investment is penalized relative to public consumption a consolidation of 1 percent of GDP reduces output by 0.7 percent within three years."[45] This means that other measures must be put in place in order to reduce the deficit.

The political economy implications of fiscal reforms are central to structuring an efficient solution to the current fiscal conundrum in Latin America. It is not possible to safeguard public investment without compromising other areas and trying to increase tax revenues to decrease the deficit. Considering that energy and food prices are expected to remain at relatively high levels for the coming months, it is crucial for governments to reassess the viability and efficiency of the tax and spending measures that have been set to counterbalance commodity price surges. This is especially true of energy subsides for the regressive consequences outlined above.

Even if the political costs of reversing fuel and food subsidies in the region are significant, these measures are temporary by design, and should be phased-out. LAC governments should promptly structure well-balanced fiscal adjustment plans that include expediture cuts and additional revenues.

The state of public finances is heterogenous across different countries, as is the impact of the war in Ukraine. With few notable exceptions, fiscal deficits in Latin American and the Caribbean countries increased significantly in 2020 as a result of the policies adopted to respond to the COVID-19 pandemic (LAC average for 2020 was 6.9 percent of GDP). Deficits have yet to fully stabilize (LAC average for 2021 was 4.2 percent of GDP).[46] In 2021, countries like Chile, Colombia and Panama kept global deficit levels above 5 percent of GDP and for Caribbean countries like Bahamas and Trinidad and Tobago, deficits surpassed 10 percent of GDP.[47] The optimal fiscal consolidation plan will differ by country, depending on two main factors: the initial fiscal position and the overall effect of the war in Ukraine on public finances.

43 Inter-American Development Bank (2022).

44 World Bank (2022).

45 Inter-American Development Bank (2022).

46 OECD (2022) and Comisión Económica para América Latina y el Caribe – CEPAL (2022).

47 Ibid.

5. Financial channel

Geopolitical tensions, inflation and the risk of recession in advanced economies have unsettled global financial markets. Consequently, there is an exacerbated risk for LAC countries that have significant external gross financial needs and lack robust reserve cushions. The combination of higher interest rates and lower growth projections affects debt sustainability. The region would require a larger primary surplus relative to its needs before the invasion. But higher primary surpluses are much harder to achieve given the expenditure pressures associated with the subsidies introduced to cope with higher food and energy prices.

Despite LAC's low financial exposure to Russia and Ukraine's, most countries in LAC have experienced increases in bond spreads in the first weeks following the beginning of the invasion. These increases in country-risk premiums for LAC countries on average have been greater relative to the rest of emerging economies. The combination of upward inflation, local currency depreciation, failure to implement fiscal consolidation, increased risk aversion from investors and accelerated monetary policy normalization in the US create additional financial risks the region. Interestingly, this has been the case for commodity importers and exporters alike.[48]

In the US, the Federal Reserve first decided to increase interest rates to a range between 0.75 to 1 percent in May – the largest hike in 22 years –. As inflationary pressures have persisted, the federal funds rate has been aggressively increased in the past meetings of the FOMC to a level between 2.25 and 2.50 percent. Likewise, the Bank of England has set interest rates at 1.25 percent, a 13-year high, and the European Central Bank has led its rates out of negative territory for the first time in 11 years. Increased interest rates in advanced economies are expected to counter inflationary pressures by cooling down aggregate demand. This, of course, has global ramifications, as it will negatively impact imports from developing and emerging economies. Higher interest rates in advanced economies will also pull investors out of LAC towards hard currency denominated assets.[49]

Emerging Market (EM) net capital flows data, shown in Figure 3, confirm that outflows from emerging markets bonds have been significant in the midst of the war in Ukraine. As inflation increases worldwide, recession woes grow stronger, and interest rates rise in advanced economies, the outflow of emerging market bonds surpassed US$50 billion during the first semester of 2022, the largest since at least 2005. With regards to inflows into equities, emerging markets are currently facing the longest streak of quarterly declines since the crisis of 2008.[50] However, some expect it to recover in the second semester, outperforming developed market equities.[51]

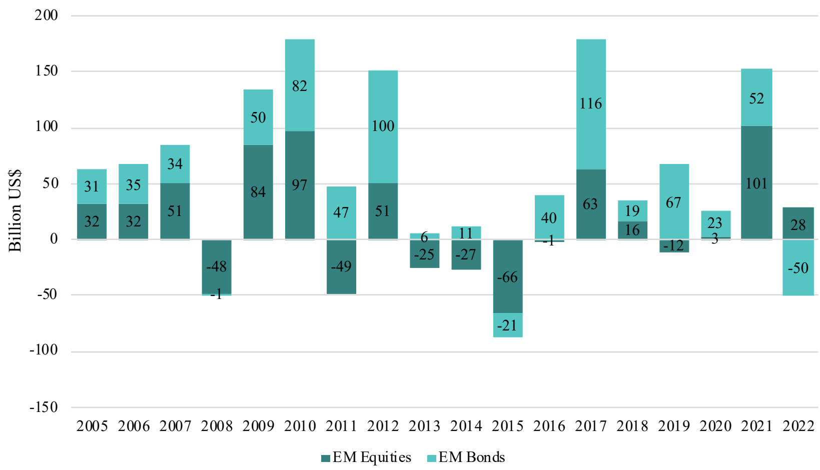
48 Fitch Ratings (2022).

49 World Economic Forum (2022).

50 Bloomberg News (2022).

51 Lazard Asset Management (2022).

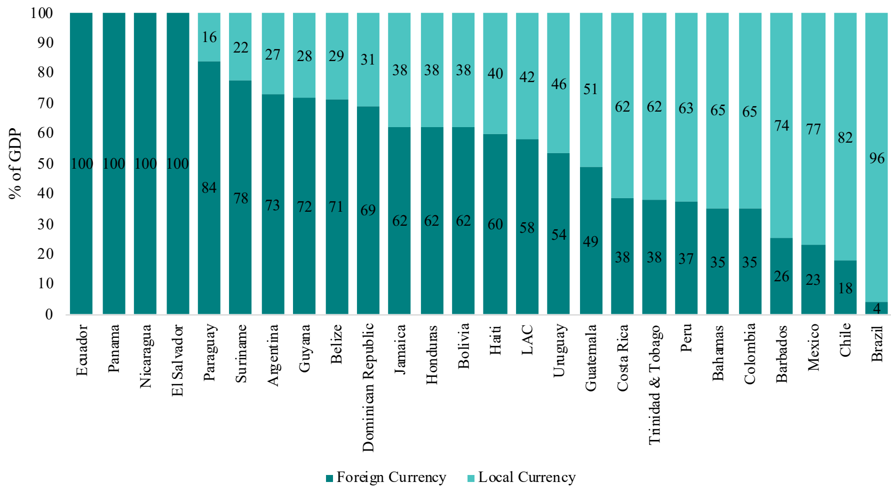
Figure 3. Annual EM bond and equity flows



Source: JP Morgan

Such capital outflows have the potential to offset possible windfalls in commodity exporting countries like Brazil while causing currency depreciations.[52] Depreciations could generate negative balance sheet effects in countries with significant debt exposure in foreign currencies, such as Argentina, the Dominican Republic, and Nicaragua (see Figure 4).

Figure 4. Currency Denomination of Total Government Debt (% of GDP), 2020

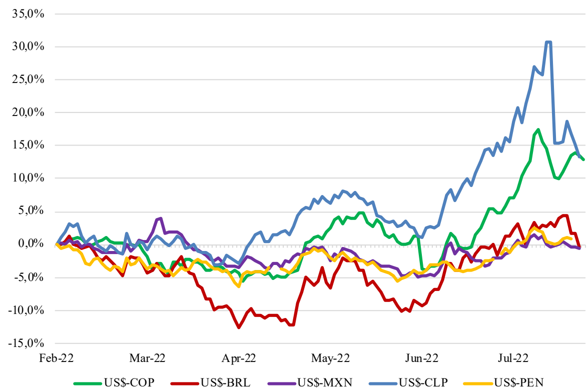


Source: IDB based on public credit directorates

52 Institute of International Finance (2022).

The generalized uncertainty regarding the global economic outlook has impacted exchange rates as investors seek less risky assets. However, not all currencies in LAC have equally impacted. In countries where as a result of previous social and political unrest there is considerable uncertainty about domestic policies, there has been a greater currency depreciation. In Chile, the upcoming referendum for constitutional reform has led to higher perceived risk and, thus, stronger current depreciation – reaching up to 30.9 percent with respect to February 2022 –. Similarly, the uncertainty surrounding the newly elected government in Colombia has proven to have negative effects on the value of the Colombian Peso – up to a 17.5 percent depreciation with respect to February 2022 –. These cases indicate that despite positive terms of trade effects, the financial channel is dominating the effects on currency value.

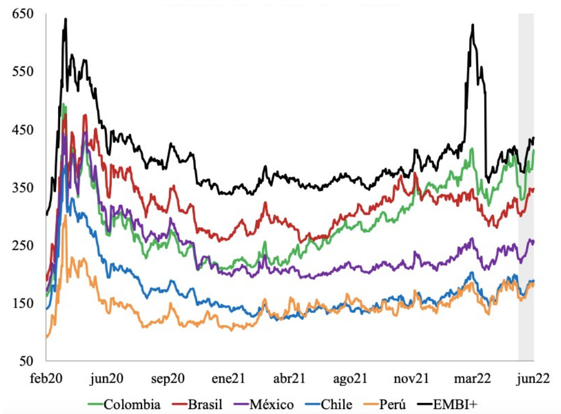
Figure 5. Effects of the War on LA Exchange Rates (Variation of US$ exchange rate with respect to February 1st, 2022)



Source: Wall Street Journal and Banco Central de Reserva del Perú

Therefore, stabilization of the emerging market bond index-global (EMBIG) spreads shown in Figure 6 should not be considered a sign of financial market stability in LAC. Even though the spreads decreased by the end of March in all LA5 countries, they have been increasing since.[53]

Figure 6. EMBIG Spreads in LA5



Source: Banco de la República de Colombia based on Bloomberg

53 Banco de la República (2022)

There is also a possibility that foreign investors will direct their capital towards countries that are more predictable and not directly impacted by the war in Ukraine. However, this will depend on governments taking the corresponding measures to stabilize inflation and reduce country risk premiums, especially by ensuring fiscal sustainability. Otherwise, rather than capital inflows, the region may experience significant outflows.

6. Medium-term growth

Latin America and the Caribbean must prepare for a prolonged war in Ukraine. The main reason is that a negotiated solution at this point is very unlikely. Even if Ukraine recognizes Crimea as Russian and the Donbas as independent (likely an unacceptable proposition), commits to a slimmed-down army and promises to never join NATO, Russia might not accept. The war is not about Crimea or the Donbas: Ukraine is only a hostage. In the eyes of Putin, the war will continue to escalate until the West changes its threatening attitude towards Russia, something that is highly unlikely to occur. At the same time, sanctions have failed to affect domestic support for Putin and the regime stands firm.[54]

A prolonged war will affect markets and economies around the globe, and the probability of a recession is growing. As estimated by the German Finance Ministry, a full embargo on Russian energy would decrease Germany's economic output by 2.2 percent in 2023, with a loss of over 400,000 jobs.[55] IMF GDP growth projections for 2022 in the Euro Area were 4.3 percent in October 2021, but are currently (July 2022) 2.6 percent, and for emerging European economies the projection shifted from 3.6 percent to -1.4 percent. Despite the fact that a full embargo on Russian energy is not in place at the moment, could happen sometime in the not-so-distant future and will worsen these numbers.

The likely recession in Europe could have a two-fold effect for LAC. On one hand, decreases in disposable incomes could affect demand for LAC exports. On the other hand, on a more positive note, it is also possible that disruptions in European energy and food supply chains could bolster further growth in commodity exporting countries in LAC as countries seek more reliable suppliers for energy and food products. However, the latter effect will take time to materialize, as it requires enhanced production capabilities. So far, only Venezuela—with an increased production of 50 thousand barrels per day in joint ventures with Repsol (Spain) and Eni (Italy) —will be able to respond fast.

Even though previous trade doctrines in the US have focused on nearshoring strategies, heightening the potential benefits of having trade partners in geographic proximity as opposed to distant ones, a new paradigm of "friend-shoring" may be arising.[56] Even though there are cost and efficiency benefits associated with having closely located trade partners, the war in Ukraine makes it evident that such proximity does not equate to high reliability. In the case of Europe, dependence on Russian energy has restricted the reaction to the invasion. Deciding on the political and economic costs of cutting ties with unstable and oppressive regimes becomes a balancing act.

Just as governments have come to recognize such costs, private multinational corporations have as well, for there are significant complications to operating in a such a politically convulsed environment that is currently subjected to unprecedent economic sanctions. In this line, the Chief Economists Survey (2022) indicates that multinational corporations are expected to restructure their supply chains by adopting strategies for diversification and localization in the coming years.[57] The most direct indicator of this tendency is the number of companies that have curtailed

54 Stanovaya (2022)

55 Arnold (2022).

56 Speech by US Treasury Secretary Janet Yellen on 13 April 2022 in the Atlantic Council, Washington, D.C.

57 World Economic Forum (2022).

operations in Russia since the beginning of the war, which has reached almost 1,000 according to a Yale School of Management publication (2022).[58]

The words of US Secretary of the Treasury Janet Yellen become increasingly relevant as the conflict endures. Those that are "sitting on the fence, perhaps seeing an opportunity to gain by preserving their relationship with Russia and backfilling the void left by others"[59] are led by short-sighted motivations that will not render them winners at the end of the day. Coming together through common values and principles will determine what the future international order looks like and it will allow countries that form part of a "trust-based and action-based cooperation"[60] system to extend their market access *securely*. However, there is no reason for excessive optimism on this front as some countries have taken a very cautious attitude towards Russia, in part because they depend on its energy supplies and want to avoid economic and social disruptions (e.g., Hungary), or because they see the opportunity to secure their sources of energy and minerals (e.g., India and China).

7. Conclusions

The once-in-a-century COVID-19 pandemic—and the risk that other dangerous new viruses may emerge at any time—is far from the only example of the new generation of global challenges. Extreme weather events resulting from climate change are having catastrophic consequences. The fallout from Russia's invasion of Ukraine is a reminder that we live in a permanent state of emergency.

The economic shockwaves of war and sanctions are highly relevant for Latin America and the Caribbean despite Russia and Ukraine's relatively small share of global GDP and their geographical distance from the region. This is a consequence of their role in commodity markets that are highly important for LAC, and the impact of the war for economies in Europe, which is a key export market for LAC's goods and services.

Crises are now much more frequent, multidimensional and interdependent. The ramifications of the war in Ukraine are plenty and LAC countries should be prepared. A simple classification between losers and winners from changes in commodity prices is not accurate. The region has to prepare for a number of negative consequences in terms of inflation, capital flows, trade and fiscal balances. Countries need to anticipate them and respond adequately to minimize their impact.

The region needs to rethink policy options. The war is occurring precisely when space for traditional monetary and fiscal policies is severely constrained. The COVID pandemic left the region with much higher levels of public debt. Inflation is running well above the targets set by central banks.

The increase in food and energy prices has exacerbated preexisting inflationary pressures in LAC. Central banks have responded by increasing interest rates, which ultimately has decelerated aggregate demand, especially private consumption. This has meant a moderation in the growth outlook for 2022 and beyond. This also means that for countries that have a negative terms of trade shock—food and energy importers—monetary policy will play a procyclical role, amplifying the negative effects of the war.

For countries that are food and energy exporters and could be considered net trade winners, such as oil-dependent economies (e.g., Colombia, Ecuador and Trinidad and Tobago), stronger external accounts will not

58 Chief Executive Leadership Institute, Yale School of Management (2022).

59 Speech by US Treasury Secretary Janet Yellen (2022).

60 World Economic Forum, Remarks by Klaus Schwab at annual meeting 2022 necessarily translate into faster economic growth. Higher interest rates and lower growth of private consumption will offset part of the trade gains. Capital outflows could play their part too.

Fiscal accounts will tend to deteriorate in most countries given the effects of additional price subsidies for a number of products, notably gasoline. It is hard to expect any type of fiscal consolidation and public debt is likely to increase even more. This, of course, has a cost in terms of credit-risk premiums and access to international financing.

The measures that governments implement in the short-run as a response to the initial shocks of the invasion could have long-lasting negative effects on fiscal stability and financial markets. This will undermine economic growth and with it the ability of governments to reduce high unemployment and poverty rates—which are yet to return to pre-pandemic levels. This poses a serious risk: governments may be tempted to adopt expansionary fiscal policies at a time when debt levels are already high, interest rates are increasing and flight to quality in international capital flows is a taking place. An adequate response has to give enough weight to risks such as a global recession and the retrenchment of capital flows. This calls for prudence and caution. Countries should not increase fiscal imbalances. Cutting unnecesary expeditures and raising tax revenues is an unpleasant but indispensable recommendation.

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