Office of Regional Chief Economist

THE GLOBAL FINANCIAL AND ECONOMIC STORM: HOW BAD IS THE WEATHER IN LATIN AMERICA AND THE CARIBBEAN?

April 24, 2009

Executive Summary

The current crisis, originated in the advanced financial markets of the center, has generated alarming ripple effects throughout the periphery. No emerging economy has remained immune to its destructive power, which intensified dramatically in the 4th quarter of 2008 after the failure of Lehman Brothers. The crisis is far from over and its rapid spread to the Latin America and the Caribbean (LAC) is occurring through mutually reinforcing channels (financial, remittances, terms of trade, export demand), leading to a sharp downturn in economic activity. Nevertheless, LAC is better prepared than in the past to withstand the global storm. Its traditional sources of vulnerability and magnification of external shocks—local currency, fiscal stance, financial system, external sector—are this time around, and by and large, not part of the problem. As a result, LAC may be able to avert a systemic financial crisis at home and a number of LAC countries enjoy some space for counter-cyclical policy, particularly in the monetary field. However, the magnitude of the shock is such that LAC will inevitably endure an economic recession so long as the global crisis lasts. Moreover, LAC remains vulnerable to a recession-induced reversal in social gains. Arguably, such a reversal would be a more difficult affair to manage in a period of electoral contests and considering that social indicators in the region, while having registered significant improvements in recent years, remain generally well below those of middle-income countries in other regions. This puts a premium on preventing an undue contraction in vital public spending in health, education, basic infrastructure, and social programs. The recovery path for LAC depends crucially on the ability of rich countries and key emerging economies to successfully contain and recover from the current crisis. It also hinges on the availability of substantial financial support from multilateral institutions and on the prudency and effectiveness of LAC's own policy responses.

The Big Storm that originated in the center…

The current crisis affecting the world economy is of historical dimensions and is re-shaping the international economic and financial landscape, including the traditional dividing lines between center and periphery. The eye of the storm is in the advanced economies, where the crisis has resulted in colossal failures of financial institutions, massive deleveraging, and a staggering collapse in asset values (some US$ 18 trillion in G-7 stock market capitalization has vanished relative to the admittedly overvalued pre-crisis peaks). The turmoil has also produced enormous job losses (total employment in the US and Euro area has shrunk by about 6.5 million jobs since the beginning of the recession) and a sharp contraction in economic activity (in the 4th quarter of 2008, GDP fell at an annualized quarterly rate of 6.3% in the U.S. and the Euro Area, and 12.1% in Japan). In an effort to restore confidence in financial markets and pull the economy out of the hole, governments in rich countries have resorted to large-scale financial rescue and fiscal stimulus packages—raising the degree of state intervention in private markets to levels not seen since the Great Depression.

… has reached deeply into the periphery

The ripple effects of the crisis on the periphery are in full swing and acting through multiple transmission channels. These include the sharply reduced availability of international market finance (debt and equity), the deterioration of terms of trade for net commodity exporters, the decline in remittances, and the pronounced contraction of external demand for emerging economies' goods and services. As a result, the periphery is being forced into painful adjustments and the entire world is in crisis. Global trade is declining for the first time in 25 years and world GDP is expected to fall by 1.7 percent in 2009. The International Labor Organization predicts that global unemployment could reach 38 million workers in 2009, up from 14 million in 2008.

Furthermore, the globalization of this crisis has accentuated the feedback loops between the mentioned transmission channels. For example, the world recession keeps commodity prices and exports down, causing loan quality to decay. In turn, this threatens employment, weakens profit expectations, and undermines credit flows, all of which further undercuts private investment and consumption, and so on.

Timely policy responses are called for, but constraints vary across emerging countries

The recessionary implications of the external shock call *in principle* for timely responses, including counter-cyclical macroeconomic policies, scaling up of social protection and basic infrastructure programs, and significant real exchange realignments to dampen the output and employment sacrifices involved in the adjustment. However, the capacity of emerging economies to respond *in practice* along these dimensions depends not just on the availability of financial resources from multilateral institutions but also on key policy and structural factors that determine the degree of vulnerability to the shocks *as well as* the scope for policy maneuver. These factors include:

a. The extent of pre-existing macroeconomic and financial policy weaknesses;
b. The extent of poverty and inequality, and the degree of social conflict;
c. Structural features, such as the diversification of trade, the degree of trade and financial openness, the extent of integration of the local economy to the global production chain, and the allocation of labor between tradable and non-tradable sectors.

LAC is better prepared in the macro-financial area, compared to its own past…

LAC's history has been marked by frequent and devastating financial crises. In previous episodes (such as the debt crisis in the early 80s, the Tequila crisis in 1995, and the Asian and Russian crises of the late 90s), LAC countries were usually caught with substantial, home-grown macroeconomic and financial vulnerabilities—reflected in high inflation, overvalued currencies, ample fiscal and current account deficits, and widespread maturity and currency mismatches (Figures 1 and 2). These conditions sapped LAC's ability to undertake counter-cyclical policies. LAC was instead compelled to raise interest rates or deeply cut fiscal spending in the midst of the crises in order to keep investors from fleeing, but exacerbating output and employment losses. In several past episodes, such desperate measures were unable to prevent financial meltdowns.

Fortunately, the pains from past crises have led to significant institutional and policy improvements in LAC's macroeconomic and financial areas. More specifically, LAC's vulnerability to shocks has

fallen in tandem with the emergence of: (i) sounder and more flexible currencies; (ii) more resilient financial systems; (iii) better fiscal and public debt management; and (iv) stronger external positions. These improvements are perhaps most noticeable in countries that have been able to build credible inflation targeting regimes.

Regarding local currencies, an increased number of countries in the region have moved to flexible exchange rate arrangements (Figure 3). The effectiveness of these regimes has risen in line with a reduction in the pass-through —implying that exchange rate movements now coexist with low and stable inflation—and the deepening of local currency debt markets—implying that exchange rate movements now generate much less adverse balance sheet effects. Similarly, the resiliency of LAC's financial systems has increased, reflecting significant reforms in financial legislation, regulation, and infrastructure that were introduced following the crises of the late-1990s. These reforms have led, among other things, to a virtuous combination of financial deepening and a rising share of loans funded by local currency deposits (Figure 4).

LAC's fiscal and external conditions have also registered improvements. To be sure, much of the good fiscal and external outcomes were driven by good luck. That is, LAC countries benefited from the benign external environment of the recent past, characterized by abundant liquidity, booming commodity prices, and vigorous global growth. Nevertheless, better policy frameworks are part of the story too. In the area of public finances, enhanced debt management systems and greater discipline in fiscal policy contributed to reductions in government debt burdens and improvements in the currency and term structure of such debts (Figures 5 and 6). The result was greater fiscal sustainability, even if, with the notable exception of Chile, LAC governments did not save sufficiently during the good times. Finally, in the external front, there was a substantial accumulation of international reserves across LAC countries, which was due not just to terms-of-trade windfall gains but also to efforts to self-insure against capital flow reversals (Figure 7).

In sum, improved policy frameworks in LAC have contributed to reducing the weaknesses that used to be incubated in the monetary, financial, fiscal, and external fronts. These vulnerabilities tended to greatly magnify the adverse effects of external shocks. In the current crisis, such vulnerabilities are tamed and are, thus, not an independent source of shock amplification. As a result, many LAC countries are likely to avert a systemic financial crisis at home. However, this reduced vulnerability is insufficient to prevent bad consequences—the storm spreading from the center to the periphery is of such a formidable magnitude that its recessionary impact is already being felt. Moreover, if the global crisis becomes more acute or extends beyond 2009, fiscal and financial conditions can weaken to a point where they could well become an increasing part of the problem. Finally, while vulnerabilities have decreased for the LAC region as a whole, there is considerable heterogeneity across LAC countries. A few countries are still saddled with significant fiscal and public debt complications which limit budgetary maneuvering room. Many others, particularly among the smaller countries in Central America and the Caribbean, have heavily-managed or pegged exchange rates and cannot therefore undertake counter-cyclical monetary policy.

… and perhaps also, at least in some respects, compared to other emerging regions

Unlike many past experiences, some evidence suggests that LAC was this time in a relative good position vis-à-vis other emerging regions when the crisis hit. For instance, countries in LAC had on average lower inflation rates and were equipped with more flexible exchange rate arrangements

compared to Eastern Europe and East Asia (Figures 8 and 9). Furthermore, in contrast with large current account deficits in Eastern Europe and South Asia, LAC was running current account surpluses before the crisis. Also, while significantly below South Asia, LAC's ratio of international reserves to short-term external debt compared favorably to those of East Asia and was above that of Eastern Europe (Figure 10). Moreover, financial systems in LAC, although smaller on average than in other emerging regions, had a larger share of loans backed by local deposits, a factor contributing to resiliency to reversals in capital inflows. East and South Asia had a lower loan to deposit ratio while in Eastern Europe a very high share of credit was funded by foreign inflows (Figure 11).

LAC will most likely endure a recession this year

The 4th quarter of 2008 marked a clear point of inflexion for LAC and the world economy. Prior to that, LAC (a net commodity-exporting region) had been enjoying a short-lived decoupling stage underpinned by an accelerated rise in commodity prices. During that stage, even as the subprime crisis and economic slowdown spread through the economies of the center, LAC currencies strengthened, foreign direct investment continued flowing in, and growth kept apace. The key policy concern for LAC then was inflation, which was being pushed by rising international prices of foods and fuels. That situation began turning around as commodity prices fell, and came to an abrupt end with the financial devastation unleashed by the failure of Lehman Brothers in September 2008. As a result, financial flows and economic activity throughout the world took a highly synchronized nose dive, and LAC fell into a sort of global economic whirlpool.

The overall deterioration of economic conditions that was registered in the 4th quarter of 2008 has been unprecedented. During that quarter, on average for LAC, the cost of international borrowing for firms doubled; corporate issues of debt and equity securities came to a virtual halt; the flow of credit by private banks stagnated; remittances began contracting sharply; exports and imports shrunk by about 30 and 25 percent, respectively, as trade surpluses vanished; and industrial production fell by about 12 percent (Figures 12 and 13).

As these developments were linked to tectonic shifts in the advanced economies, LAC countries that are closely linked to the U.S. economy (including Mexico and the small open economies of Central America and the Caribbean) have felt a more direct and stronger initial impact. For other countries in the region, the repercussions are being felt with a lag. But in all cases, growth prospects for 2009 have been downgraded dramatically as news on economic performance of advanced and developing countries were revealed on the 4th quarter. For instance, as of August 2008 the Consensus Forecasts put GDP growth for LAC in 2009 at around 3.7 percent; by contrast, Consensus Forecasts as of March 2009 already projected growth in negative territory, at -0.7 percent. April's Consensus Forecast, the latest one, is even grimmer, envisaging 2009 growth at -1.4 percent, which is fairly close to the recently released IMF's forecast of -1.5 percent.

While the range of growth forecasts is wide—reflecting the more general uncertainty about world growth—few doubt that 2009 would be, at a minimum, a year of economic stagnation for LAC as a whole and, perhaps more likely, a year of recession.

LAC is especially vulnerable to a recession-induced reversal of social gains

Poverty and inequality figures, as well as other social indicators, improved markedly in LAC during the last decade. For instance, infant mortality declined to 21.4 deaths per 1000 live births in 2006 from 36.1 in 1995, which is closely related to a larger access of the population to improved water and sanitation. Similarly, during the strong growth period of 2002-2008, almost 60 million people in LAC were lifted out of poverty (measured at PPP-adjusted US$4 a day) and 41 million left the ranks of extreme poverty (measured at US$2 a day). However, LAC still lags considerably other emerging regions in social dimensions. For instance, infant mortality is higher, educational achievement lower, basic infrastructure much less developed, and income distribution much more unequal in LAC compared to East Asia and Eastern Europe (Figures 14-16). Given LAC's unique combination of vibrant electoral processes with high income and wealth inequality, these deficits in social indicators suggest that a reversal in the recently achieved social gains might be a comparatively more complicated affair to handle for LAC. Hence, there is a premium on preventing an undue contraction in public spending in health, education, basic infrastructure, and other social programs.

The scope for counter-cyclical policy responses varies considerably across LAC countries

Perhaps the greatest scope for counter-cyclical policy is in the monetary arena. LAC countries with robust inflation targeting regimes (Brazil, Chile, Colombia, Mexico, and Peru) are clearly in a better position, with exchange rate flexibility and high international reserves affording them maneuvering margins. These countries have in fact entered into aggressive monetary policy easing, especially since January 2009 (Figure 17). Some of them have also used actively their public banks to offset the decline in private bank credit. Monetary easing has helped cushion the decline in economic activity through two main channels. First, by lowering policy interest rates, it dampens the fall in investment and consumption. Second, by allowing the currency to depreciate, it helps curb imports *while* redirecting demand towards locally produced goods and services. Unfortunately, as noted earlier, many countries in LAC—particularly the small open economies in Central America and the Caribbean—lack the ability to conduct counter-cyclical monetary policy.

The main challenge for fiscal policy in LAC is to manage the inevitable fall in tax collection (related to the economic downturn and fall in commodity prices) so as to protect expenditures in education, social security, and infrastructure. These expenditures are necessary to prevent a rise in poverty and inequality and lay the foundations for future growth. In practice, however, the maneuvering room for counter-cyclical fiscal policy varies considerably among LAC countries (Figure 18). It is greater in countries where: (i) savings were accumulated during good times (Chile is an indisputable leader in this regard); (ii) expenditures are not unduly rigid and can thus accommodate suitable changes in composition; (iii) the debt situation is such that there is scope for prudent borrowing; and (iv) local financial markets are relatively deep. However, given that the shortfall in fiscal revenues is likely to be substantial, a major achievement for LAC would already be to maintain fiscal spending at the initially planned level while protecting vital social and infrastructure programs.

Some countries in the region have already announced fiscal stimulus packages. Nevertheless, there is a great deal of heterogeneity across countries with respect the composition and size of these packages. For instance, some countries have focused predominantly on tax cuts (Brazil), while others have planned to raise infrastructure spending (Mexico, Chile, and Peru). Moreover, some countries are reinforcing their social protection networks (Argentina and Chile) whereas others are providing incentives to non-traditional exports (Peru). The size of these packages also varies

widely, ranging from 0.3 percent of GDP for Brazil to 2.2 percent for Chile. It is difficult however to ascertain the extent to which the announced fiscal stimulus adds to already existing plans or reallocates already budgeted spending. Furthermore, the effectiveness of some the fiscal measures announced (e.g., tax cuts) will depend on the private sector's willingness to spend.

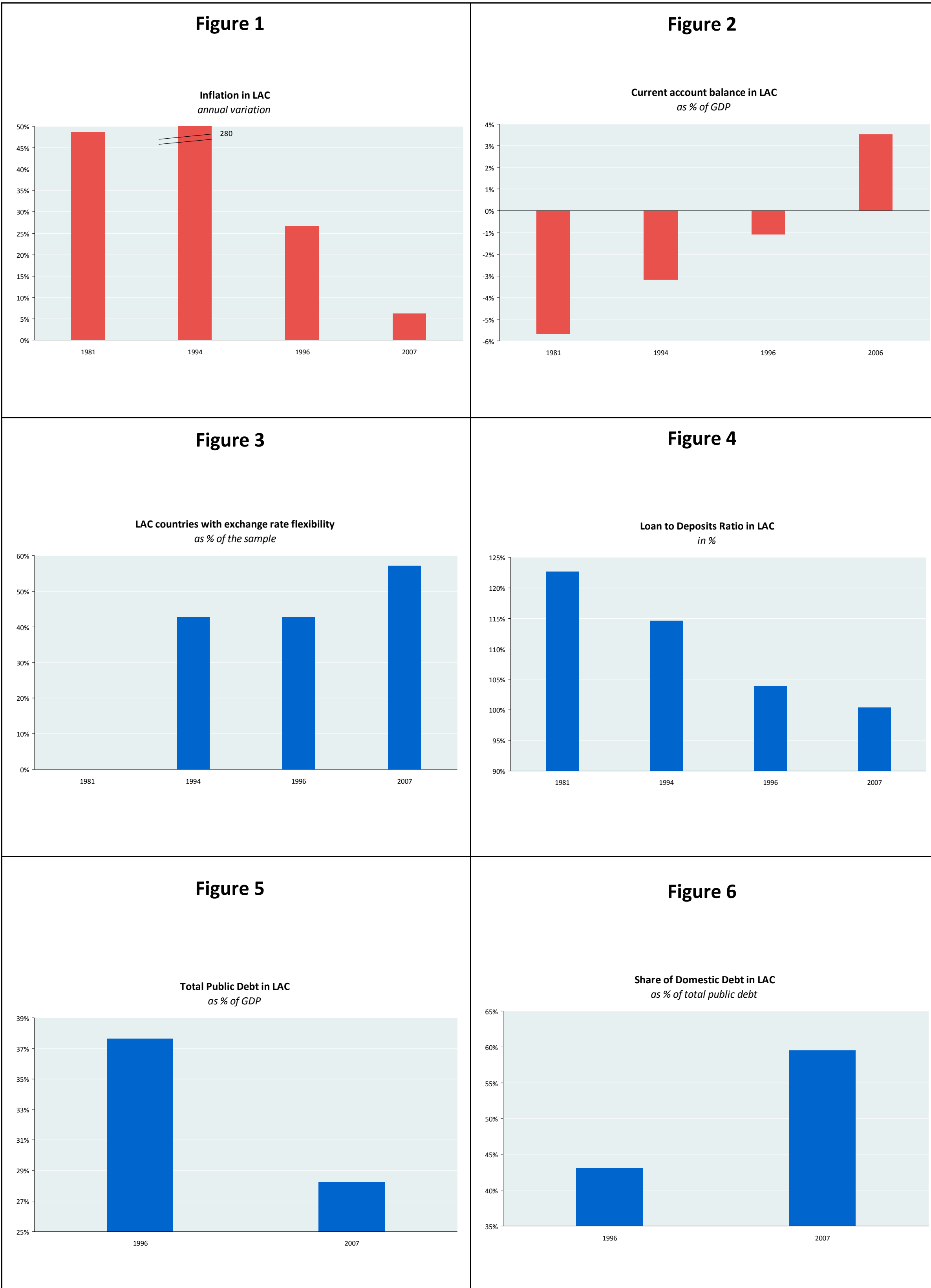
Closing thoughts

The world is gripped by the broadest, deepest, and most complex crisis since the Great Depression. As the current crisis was originated in the advanced world, its resolution mainly depends on the policies implemented there, particularly on the success of the fiscal stimulus and financial rescue packages. There is still no consensus on the effectiveness of such policies or on when things will bottom out. What is clear is that the crisis is far from over, although the rate of decline seems to be slowing down in some respects. In any case, the global nature of the crisis mutes two channels that have helped emerging markets rebound quickly from past crises—namely, the ability to export to the center and attract foreign direct investment from it. This time around, the real devaluations in LAC will not have those salutary effects on exports as long as the economies of the center and key emerging countries, particularly China, remain in crisis. In all, whether the large economies of the world rebound, remains stagnant, or further deteriorate will greatly determine the periphery's prospects in the medium term.

While all emerging regions are being hit hard, the impact of the crisis has been very heterogeneous. The crisis is creating havoc in the financial systems of emerging countries where pre-existing macro-financial weaknesses were substantial—the most notable case is that of several countries in Eastern Europe. Emerging countries, where such weaknesses were low or non-existent, are better able to avert a systemic financial crisis at home. LAC, fortunately, appears to be, by and large, in this latter category, thanks to significant institutional and policy improvements in macroeconomic and financial arenas achieved in recent years. These are now affording a number of LAC countries some room for counter-cyclical policy responses.

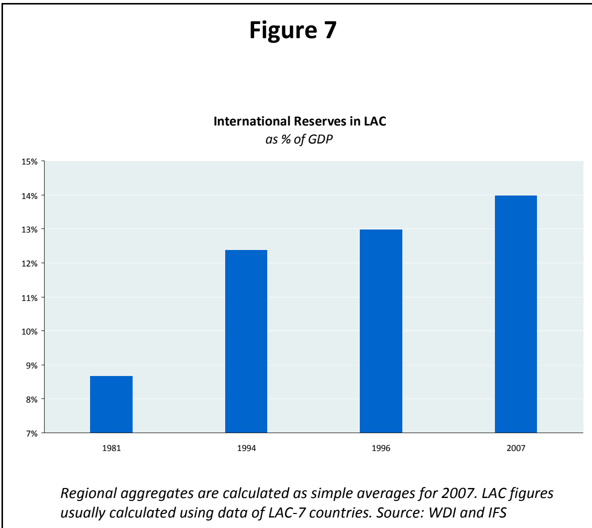
However no emerging country, regardless of how well-prepared or managed, is escaping the recessionary effects of the global crisis. The propagation of these effects is also marked by heterogeneity. For instance, countries that are tightly linked to world trade and highly integrated to the global production chain have experienced more severely the first-round effects of the crisis on manufacturing production and employment. In contrast, the impact is lagged in countries where growth was supported mainly by domestic demand. Unemployment effects have also tended to be initially smaller in countries with a higher share of labor in the non-traded sector.

Finally, while LAC seems well-positioned for a fast post-crisis growth rebound, the recessionary effects of the current crisis threaten to reverse important social gains achieved in recent years. Such a reversal can be highly problematic for democratic-but-unequal LAC. The availability of financial resources as well as technical and policy advice from multilateral institutions can be highly relevant in this regard. It can help LAC countries in maintaining their spending plans, or adequately recomposing them, to protect vital infrastructure and social protection programs in the face of falling revenues.



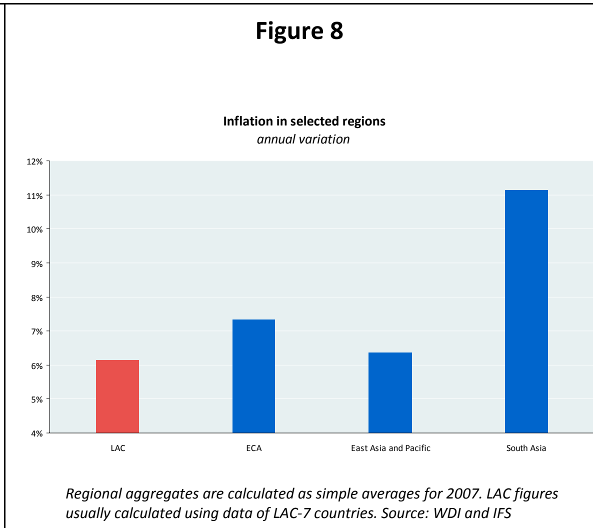
LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Figure 7



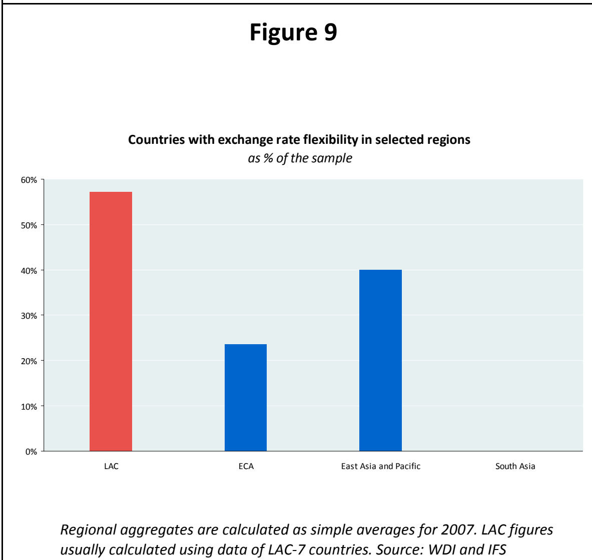
Regional aggregates are calculated as simple averages for 2007. LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Figure 8



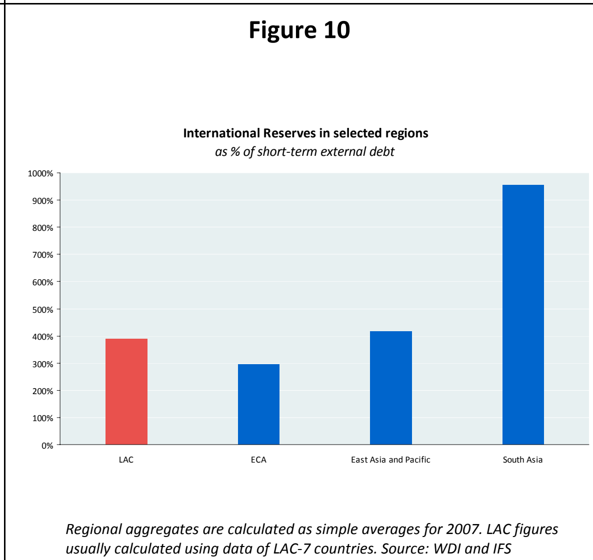
Regional aggregates are calculated as simple averages for 2007. LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Figure 9



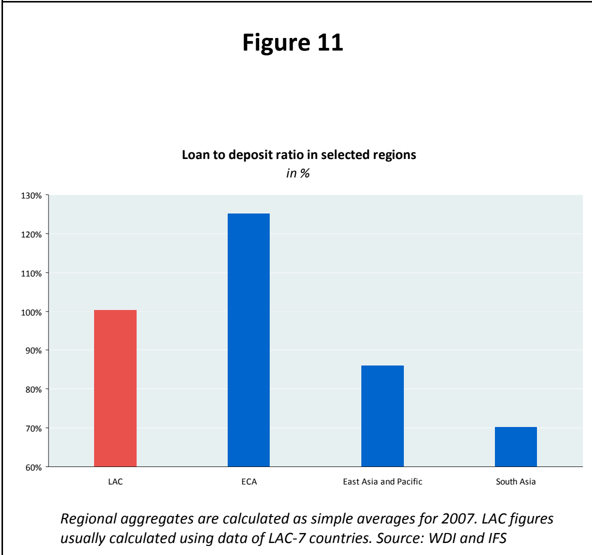
Regional aggregates are calculated as simple averages for 2007. LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Figure 10



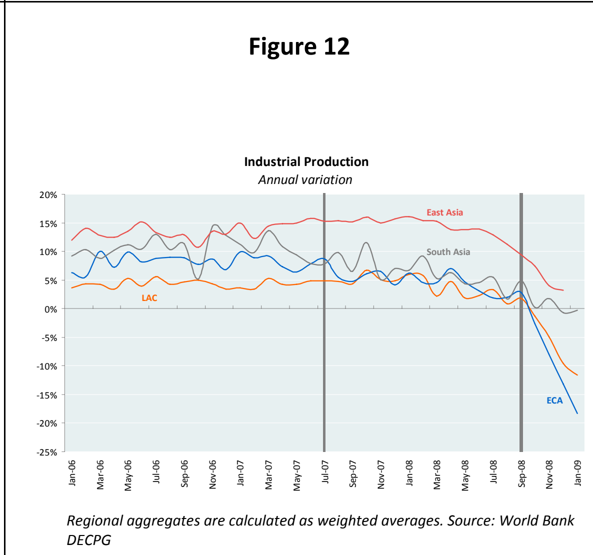
Regional aggregates are calculated as simple averages for 2007. LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Figure 11



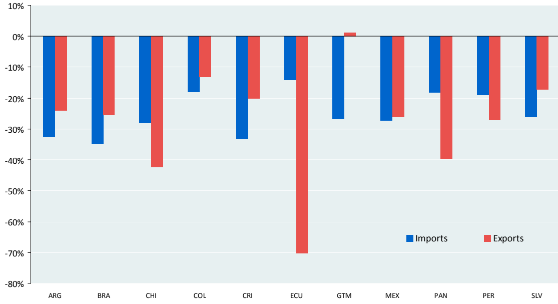
Regional aggregates are calculated as simple averages for 2007. LAC figures usually calculated using data of LAC-7 countries. Source: WDI and IFS

Figure 12



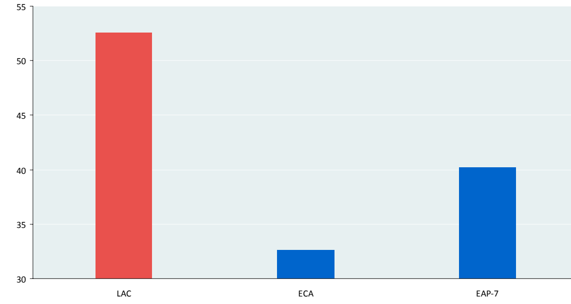
Regional aggregates are calculated as weighted averages. Source: World Bank DECPG

Figure 13



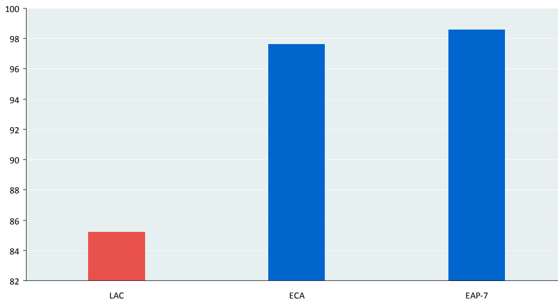
Source: Haver Analvtics and National Authorities

Figure 14



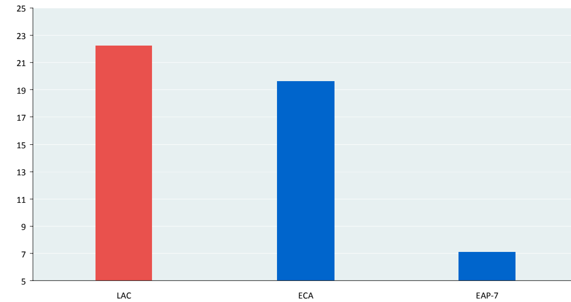
Regional aggregates are calculated as simple averages for 2005. LAC figures usually calculated using data of LAC-7 countries. Source: WDI.

Figure 15



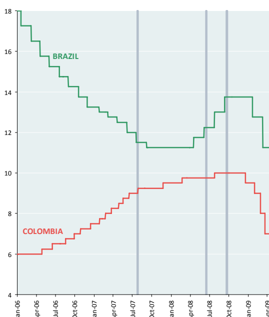
Regional aggregates are calculated as simple averages for 2005. LAC figures usually calculated using data of LAC-7 countries. Source: WDI.

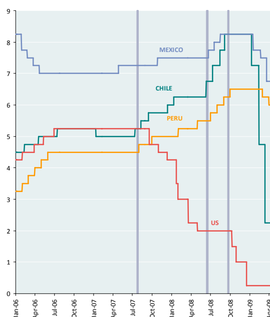
Figure 16



Regional aggregates are calculated as simple averages for 2005. LAC figures usually calculated using data of LAC-7 countries. Source: WDI.

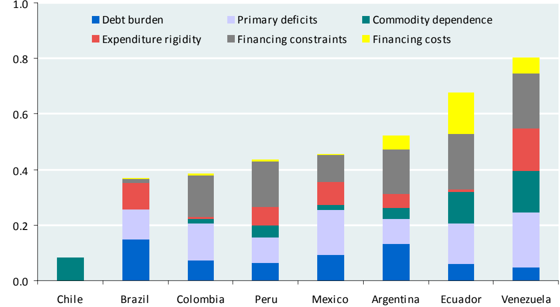
Figure 17





Source: Bloomberg – National Authorities

Figure 18



This index is the weighted average of the relative score of the six different categories. The index as well as each category take values between 0 and 1. Higher values indicate higher constraints on the scope for counter-cyclical fiscal police. Source: LCRCE Office calculations based on National Authorities data.