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From Steady Growth to Sudden Crisis: How Latin America and the Caribbean are Coping with the Global Recession

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Summary Points

- Latin America and the Caribbean are currently seeing severe collateral damage to their economies owing to the impact of the global downturn. Although this comes after the longest period of sustained growth since the 1970s, one which has left previously crisis-prone countries with stronger economic credentials than before, forecasts by the major international institutions (IMF, World Bank, ECLAC) are likely underestimating the scale of the local crisis in 2009.

- The region has primarily suffered as a result of the slump in demand in the industrialized economies, and the subsequent weakening in trade and commodity prices. This has been compounded by the losses in capital and income flows and the tightening of international credit. Regional currencies also witnessed severe devaluations last year although many have recovered some of the lost ground.

- The impact of the crisis will be particularly severe for the most vulnerable sectors of the population, many of which might be pushed deeper into poverty or unemployment, reversing the gains made during the growth period.

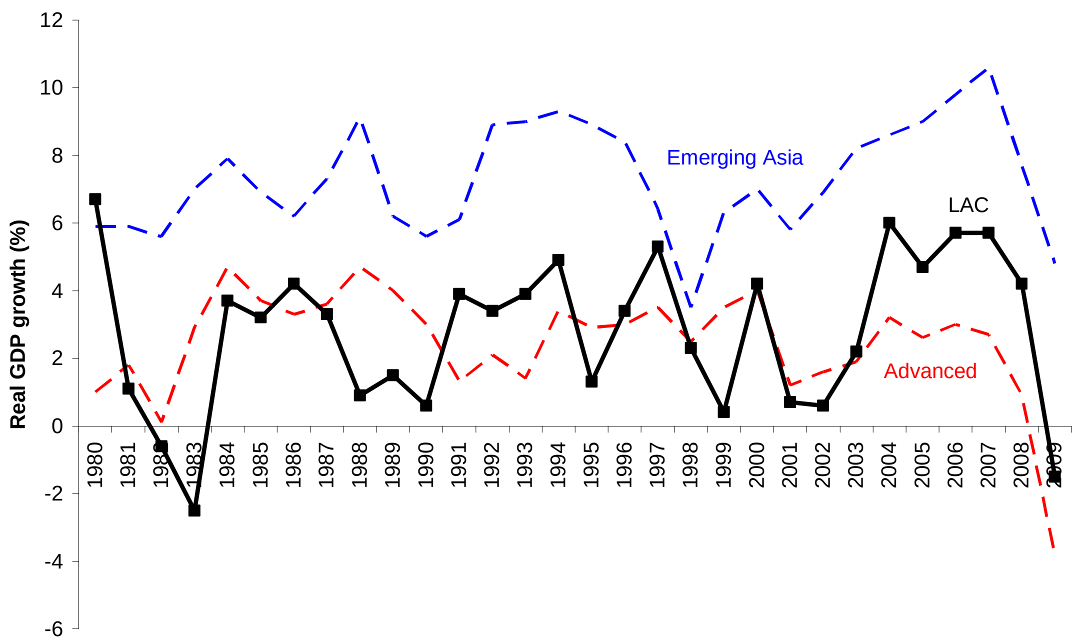
- However, the macroeconomic lessons gained as a result of previous crises have secured unprecedented fiscal discipline and monetary credibility, leading to the accumulation of foreign reserves and a reduction in the debt burden. This, in turn, has been reflected in upgrading by credit rating agencies and lower country risk premia, which have increased only slightly over the last year, comparing favourably with previous bouts of instability.

- These factors should help the region to cope with global turbulence and local recession, making it likely to emerge ready for a robust recovery once growth picks up in the industrialized economies. Nevertheless, while medium term prospects appear bright, fundamental concerns remain regarding the region's long-run economic performance, specifically the need for more balanced growth and the alleviation of poverty and social inequalities.

1. Background

The period of steady growth in Latin America and the Caribbean during 2003-08 was a remarkable achievement considering the numerous domestic crises (Mexico 1995, Brazil 1999, Argentina and Venezuela 2001-02) which had regularly plagued the region, persistently undermining economic performance even after a decade of macroeconomic reforms aimed at improving stability. With the Argentinian and Venezuelan recoveries in full swing, GDP growth averaged nearly 5% between 2003 and 2008, and some of the larger countries (Argentina, Peru and Venezuela) even recorded growth rates above 8% for multiple-year periods. The region in general also enjoyed a surplus on its current and fiscal accounts, thus reversing historical deficit trends and boosting financial robustness through a near-halving of foreign debt (from 43% of GDP in 2002 to 23% in 2007) as well as a nearly threefold increase in foreign exchange reserves (from \$160 to \$450 billion during the same period). Sustained growth was largely accomplished through the emergence of a dynamic export sector, which saw the volume of exports rise alongside an improvement in terms of trade, thus simultaneously benefiting those countries focused on manufactures as well as commodity exporters. As a result, exports more than doubled from around \$400 billion to nearly \$900 billion during the 2003-08 period, reaching roughly 28% of regional GDP.

Figure 1: Real GDP growth, 1980-2009



Source: IMF

Table 1: Real GDP growth and forecasts, 1990-2009

	1990-2002	2003-08	2008	IMF *2009*	World Bank *2009*	ECLAC *2009*
LAC	**2.7**	**4.8**	**4.6**	***-1.5***	***-0.6***	***-0.3***
Argentina	2.1	8.5	6.8	*-1.5*	*-1.8*	*1.5*
Brazil	2.0	4.1	5.9	*-1.3*	*0.5*	*-1.0*
Mexico	3.2	3.2	1.8	*-3.7*	*-2.0*	*-2.0*
Advanced	**2.6**	**2.5**	**1.0**	***-3.8***	***-2.9***	
United States	2.9	2.6	1.1	*-2.8*	*-2.4*	
Euro area	2.0	1.9	1.0	*-4.2*	*-2.7*	
Emerging Asia	**7.1**	**9.0**	**7.8**	***4.8***	***5.3***	

Forecasts: 22/04/09 (IMF), 30/03/09 (World Bank), 01/04/09 (ECLAC)

Note: own estimates suggest a worsening outlook for 2009 and the forecasts quoted above are likely to be revised down

Source: IMF, World Bank, ECLAC

Despite initial optimism about the resilience of emerging markets to what was effectively a financial crisis in the advanced economies, Latin America and the Caribbean have not been immune to the effects of the global recession, although the degree of exposure in each country has varied. The scale of the crisis has also proved remarkably difficult to predict, as the full extent of linkages across industries and regions was not immediately identifiable. This has led to overly optimistic forecasts despite emerging evidence that the severity of the recession is in many ways comparable to previous crises. It would not be unreasonable to suggest that regional GDP in 2009 will contract *at least* 2%, but perhaps as much as 4.5% if recent hints of recovery turn out to be premature and global markets continue to suffer throughout the year.[1] Further shocks may also emerge without notice, such as the recent outbreak of swine flu in Mexico which is expected to cost the country from 0.3% to as much as 1% of GDP.[2]

In broad terms, the main impacts of the global crisis can be categorized as follows:

[1] Some private sector forecasts are less optimistic as well: for example, Morgan Stanley estimated a decline of 4.3% in the regional economy with Argentina, Brazil and Mexico all expecting drops in GDP of over 4%. Morgan Stanley, 17 March 2009, 'Lengthening the Downturn', Available at: http://www.morganstanley.com/views/gef/archive/2009/20090317-Tue.html

[2] The Finance Ministry has stated in a 5 May 2009 press release that the epidemic will cost Mexico approximately 0.3-0.5% of GDP. But private estimates push the figure to as much as 1% of GDP, noting that Mexico City alone suffered losses of over $1 billion between 24 April and 5 May. El Universal, 6 May 2009, 'De 30 a 100 mil mdp, costo de la epidemia', Available at: http://www.eluniversal.com.mx/primera/32933.html (in Spanish)

- *External shocks*. The primary transmission mechanism has been the slump in demand in the industrialized economies, particularly the US and Europe, which has weakened exports (both in manufacturing and in services such as tourism) and caused commodity prices to collapse, adversely affecting the region's previously favourable terms of trade. Additionally, global financial turmoil has precipitated a collapse in capital and income inflows. This has also led to stock market volatility and the devaluation of regional currencies.

- *Internal finances*. Although local institutions and banking sectors have not been directly involved in the financial crisis in a significant way, risks remain as a result of the tightening of credit owing to the difficulties in accessing international capital markets. However, public finances are remarkably sound despite the external strains, and have been strengthened by the accumulation of foreign exchange reserves as well as the reduction and restructuring of external debt. As a result, country risk premia have held relatively steady in comparison with the spikes seen in previous crises, pointing to a significant improvement in investor perceptions of the region's fundamentals.

- *Social impacts*. An alarming characteristic of previous regional crises is that the social repercussions are often more severe and protracted than the slowdown in economic growth. Although it is too early to fully assess the impacts of the crisis on indicators such as poverty, inequality and employment, the global recession is expected to reverse many of the social gains realized during the growth period. But the degree to which this happens will largely depend on how quickly external conditions stabilize and domestic policies take effect in alleviating vulnerabilities.

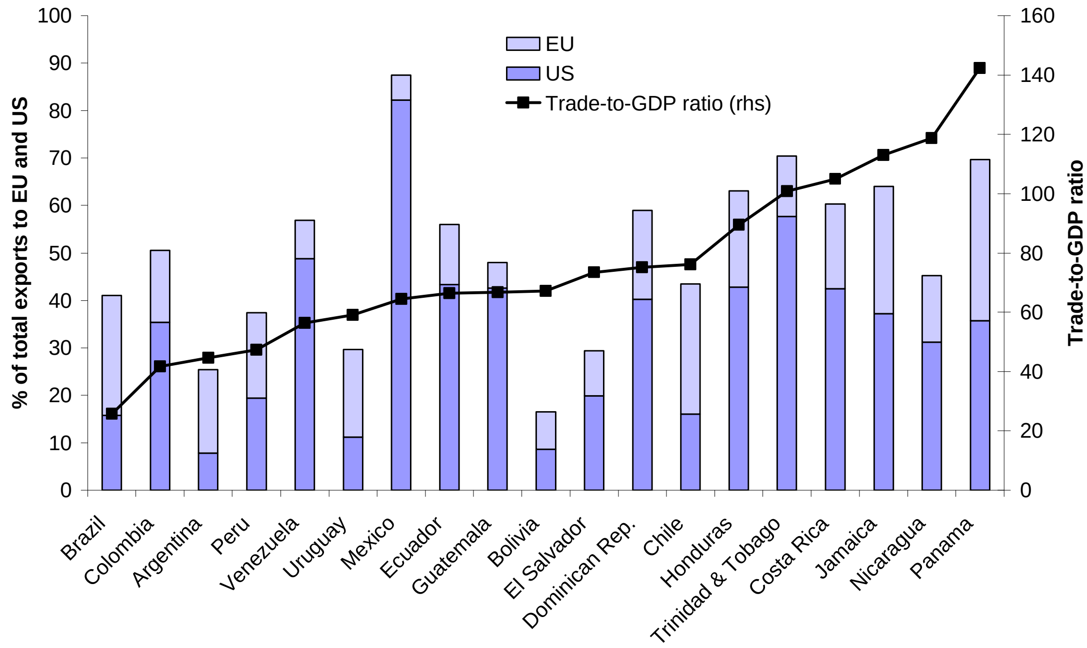
The following sections detail the way in which the crisis has affected Latin America and the Caribbean across these three categories, as well as showing how economic performance during the growth period may either mitigate shocks or contribute to the turmoil. The paper provides an overview of domestic and international responses to the crisis is provided, as governments and international institutions continue to search for ways of containing further deterioration of the economic environment. In conclusion, some observations are offered regarding the legacy of the growth period and the potential for similar sustained growth in the post-crisis period.

2. External shocks and financial turbulence

Trade is hit by slump in world demand

Like the rest of the developing world, Latin America benefited greatly from the unprecedented rise in exports during the growth period, fuelled by consumer demand in the two markets which dominate its trade: the US and the European Union (which together account for roughly 65% of the region's exports). With the OECD area currently in recession, demand for exports has fallen sharply, affecting countries through their degree of openness to trade, particularly with the US and Europe. The larger and more diversified countries in the region have the advantage of lower trade dependency although this figure is still high: apart from Brazil which has a trade-to-GDP ratio of 26%, all other countries have corresponding ratios of over 40% with some Central American and Caribbean countries exceeding 100%. On the other hand, export destinations tend to vary: geographical proximity to the US, more than any other factor, seems to be the primary determinant of whether a country's exports gravitate to the US rather than the European market. The case of Mexico stands out due to its overwhelming reliance (82%) on the US, while Southern Cone countries tend to have closer links to the EU.

Figure 2: Trade dependency, 2007



Source: WTO

For the larger economies in the region, the slump in exports to around two-thirds of their 2008 levels has had a devastating effect on industrial activity, particularly manufacturing given its predominant share of total trade. Figures for early 2009 reveal sharp contractions of the order of 13% or more for Brazil and Mexico, while Argentina is less badly hit. The auto industry (which accounts for the largest share of exports in Brazil, and second largest in Mexico)[3] has been particularly affected by the global consumer slump, but most export-oriented industries have felt the sting. Equally worrying is that non-manufacturing industries (notably construction) as well as services have also suffered, showing just how far the crisis has spread across nearly every type of economic activity. While there have been some signs that the fall in activity may be petering out, it remains unclear whether this suggests that the recession has finally bottomed out, or if it is merely a temporary respite from a more prolonged downturn. Certainly there is little conclusive evidence yet of a true upturn as annualized monthly figures may be misleading if previous year tendencies are not accounted for.[4]

Table 2: Slump in exports and industry, September 2008-March 2009

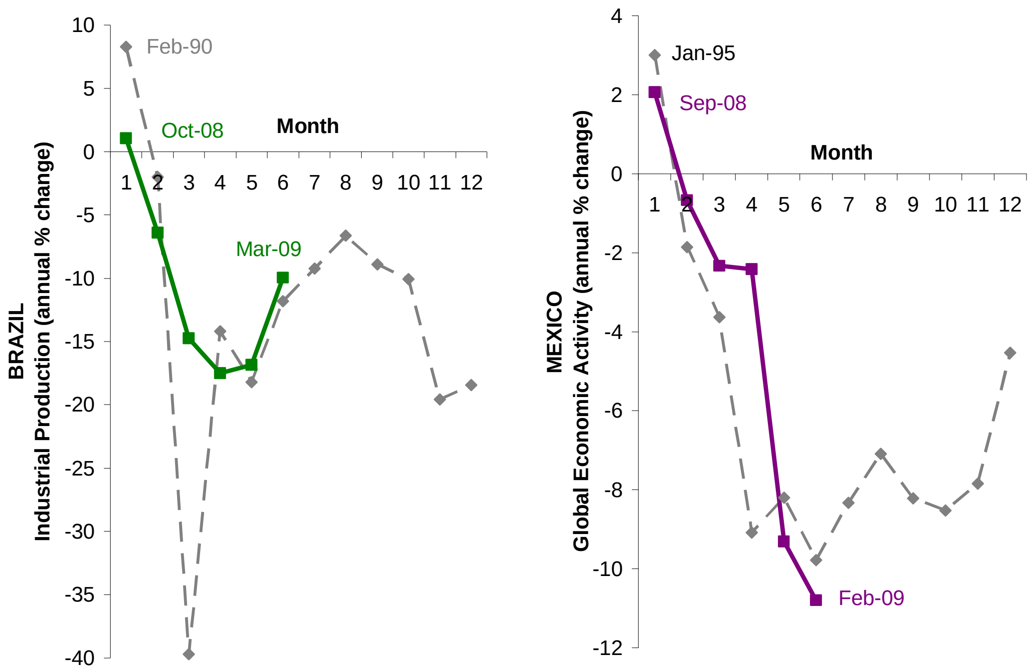
	Exports (annual % change)				Industrial production (annual % change)	
	Argentina	**Brazil**	**Chile**	**Mexico**	**Brazil**	**Mexico**
Sep-08	42.7	41.3	-13.4	8.5	9.6	-1.7
Oct-08	9.9	17.4	-23.1	-6.2	1.1	-2.1
Nov-08	-9.9	5.0	-27.9	-16.1	-6.4	-4.7
Dec-08	-28.0	-2.9	-27.2	-19.7	-14.7	-5.9
Jan-09	-35.7	-26.3	-41.8	-31.5	-17.5	-10.4
Feb-09	-26.7	-25.1	-42.7	-29.6	-16.8	-12.7
Mar-09	-15.9	-6.4	-45.1	-25.5	-10.0	-6.7
Apr-09	n.a.	-12.4	n.a.	n.a.	n.a.	n.a.

Source: INDEC, BCB, BCC, INEGI

[3] Brazil's annualized vehicle production (units) in April stood at -15.8% (from a low of -56.3% in December) while vehicle sales were -21.8% in the same month (from a low of -33.3% in November). Both had recorded significant upturns in March before falling again in April. Vehicle exports (in dollars) were down to -34.7% in April (from a low of -60.6% in January) according to official sources (BCB).

[4] Brazil's export figures are a clear example of how year-on-year comparisons can prove deceptive. March 2008 was a particularly poor month, making the improvement for March 2009 far more pronounced than it really was. Not surprisingly, the corresponding figure for April worsened. Furthermore, exports after May 2008 skyrocketed which means that current year figures will suffer unless any improvement is similar in magnitude, something which is highly unlikely. Lastly, Q4 figures for most countries will appear better than would be the case since they will be compared against the slump which began in Q4 2008. A more accurate comparison would be against Q3 2008 when economies were still performing well. This last effect may result in annual 2009 figures which will under-represent the scale of the downturn.

Figure 3: Comparisons with previous crises



Note: Annual GDP change was -4.2% in Brazil (1990) and -6.2% in Mexico (1995)

Sources: IBGE, INEGI

For many countries with less developed manufacturing sectors and commodity production, service exports account for a predominant share of trade, often well in excess of merchandise exports. The main component is tourism, which is a key source of income for many smaller regional economies (particularly in the Caribbean and to a lesser extent, Central America). Its effects are not that dissimilar to those of FDI and remittances: generating positive externalities for growth and employment, improving the balance of payments, and raising foreign exchange receipts. Given the high percentage of tourists from developed countries, the steep OECD recession will result in less tourism, although the competitive advantage afforded by weakened currencies may partially offset this. As Table 3 shows, growth rates in the tourism industry had already dropped in 2008, the English-speaking Caribbean being the hardest hit because it is the preferred destination for US and European tourists (75% of visitors). A further potential shock to tourism-dependent countries could be the spread of swine flu from Mexico. Should the current localized outbreak turn into a pandemic, Central America and the Caribbean could see a significant decline in tourist arrivals, aggravating their prospects for a quick recovery. Indeed, tourism could be hit in the short run simply by the threat of a pandemic, as seen in the case of SARS in Asia where the entire region suffered massive losses over several months even in countries with no cases.

Table 3: Tourism, 2008

	% of GDP	% of exports	Arrivals (% annual change) Jan-Aug 2008	Sep-Dec 2008
Mexico	1.4	5.0	-	-
Central America	6.1	17.8	9.7	4.6
Caribbean	19.7	41.3	3.6	-4.0
South America	1.6	5.2	6.8	3.1
LAC	7.2	17.3	-	-

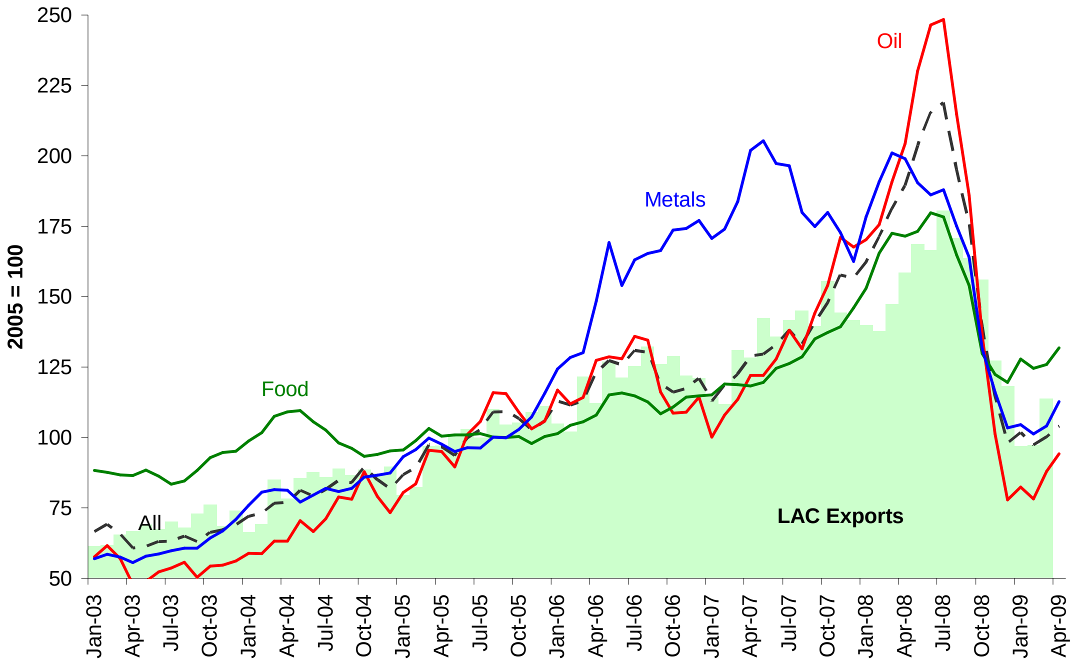
Source: ECLAC, UNWTO

Falling commodity prices exacerbate trade woes but ease inflation concerns

The unprecedented increase in commodity prices during the pre-crisis years was a mixed blessing for countries in the region. On the one hand, commodity exporters have seen a major boost in their fiscal revenues and external balances which supported the high and sustained growth rates that characterized this period. However, high prices also led to inflationary pressures, causing negative impacts on the region's poor, many of whom depend on these commodities as part of their basic consumption basket, Thus, compared with the national, average, the poor have faced higher effective inflation rates (up to 3% higher according to the World Bank)[5] than the national average. The global food crisis led to widespread protests and riots during 2007-2008 which, in turn, prompted many governments to resort to price freezes, subsidies and tax cuts on basic goods (among other measures) to quell burgeoning unrest.

[5] IMF (2008), pg. 40

Figure 4: Commodity prices and exports, 2003-2009



LAC7 = Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela

Source: IMF, National statistical offices

The current slump in world commodity prices, which began roughly in July of 2008, has actually reversed this phenomenon: it partially relieved the pressure on poor households who were at risk of sliding deeper into poverty, but has added a significant shock to commodity-exporting countries which may see macroeconomic gains reversed due to reduced export and fiscal earnings. To note the scale of these effects, a World Bank study shows that a 10% food price increase raises the poverty rate by 0.4% while the IMF estimates that a 10% drop in commodity prices reduces regional growth by 0.8%.[6]

The effect of commodity dependency is either magnified or offset by a country's net commodity position. Countries such as Venezuela and Chile, which have enjoyed large current account surpluses during the growth period primarily on the basis of single-commodity exports, will stand to lose most from the current price plunge, especially since their particular commodities are among the hardest hit (for example, both oil and copper prices are less than 40% of their 2007-2008 peaks). However, most Central American and Caribbean countries are net commodity importers, which means that the

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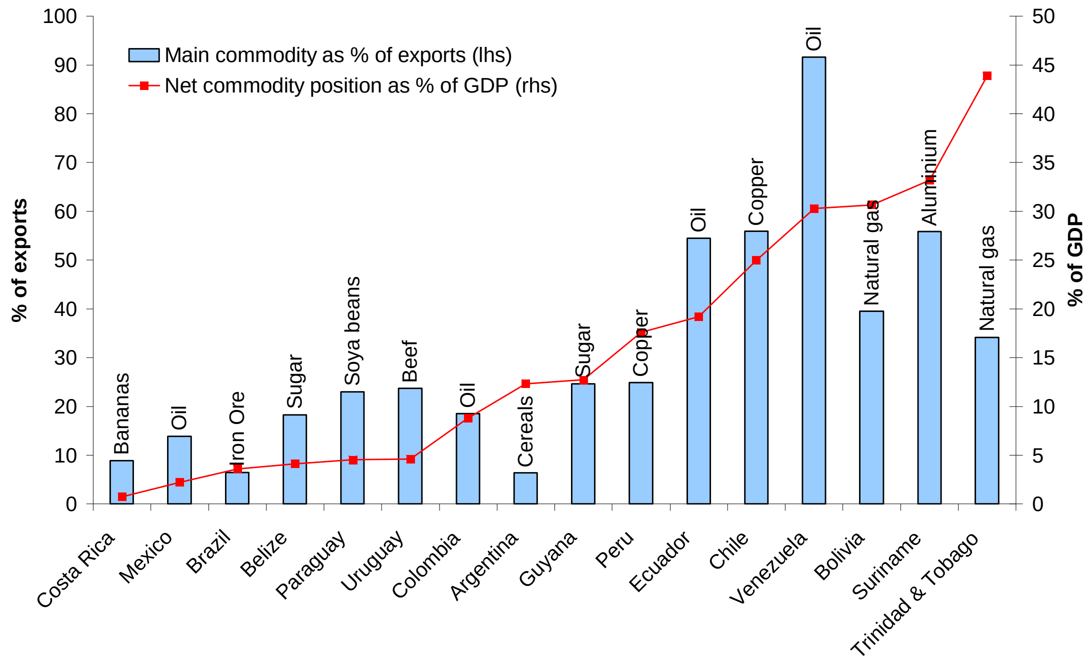
[6] IMF (2008), pg. 20

effect of lower commodity prices will provide welcome relief to their current account balances and result in improved terms of trade.

Figure 5: Net commodity exporters, 2006



Sources: Own calculations from ITC, IMF data

Table 4: Expected terms of trade

	2008	2009
Mexico	0.3	-2.2
Central America	-3.4	7.8
Bolivia, Colombia, Ecuador, Venezuela	13.0	-19.5
Chile and Peru	-7.9	-30.4
MERCOSUR	2.7	-2.6
South America	1.8	-12.7
Latin America	**0.9**	**-7.8**

Source: ECLAC

Capital and income flows in jeopardy

Capital flows, in the form of portfolio and foreign direct investment, have contracted sharply as a result of the crisis - a particular concern in a region which still has a limited capacity to undertake capital formation on its own. After the record flows achieved in 2007, private capital into the region fell by more than half during 2008 and are set to halve yet again during 2009. Portfolio investment was the first to retreat: following the post-Lehman

Brothers chaos in September 2008, many foreign investors fled en masse from local markets, thereby putting added strain on international reserves. Compounding the financial stress was the liquidation of equity holdings by foreign firms owing to pressures in home markets, and the tightening of bank lending which has resulted in a net outflow of capital as private borrowers are forced to repay debt.

Table 5: Net private capital flows

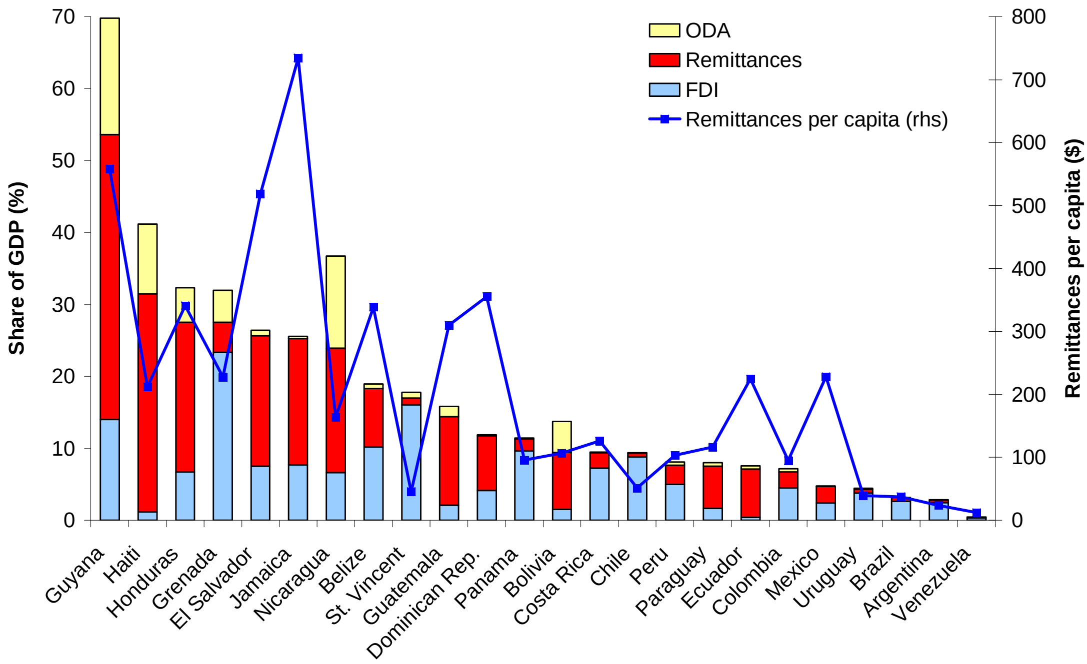
($ bn)	**2006**	**2007**	**2008**	***2009***
Private capital flows	51.5	183.6	89.0	*43.1*
Direct investment	26.2	65.7	58.9	*43.7*
Portfolio investment	2.7	15.7	-10.6	*-1.7*
Bank financing	9.0	30.8	8.6	*-11.7*
Non-bank financing	13.5	71.3	32.1	*12.8*

Source: IIF

Arguably, the most important component of capital flows is foreign direct investment (FDI) due to its impact on domestic and export business, technology transfers and employment, as well as its significant multiplier effects on GDP. FDI is generally preferred to portfolio investment because of its greater stability and long-term nature, as well as its resilience during turbulent periods. Although FDI in Latin America has fallen relative to the rest of the world as a result of the increased attractiveness of Asia, it still represents a significant inflow for many countries and, on a regional level, had shown sustained increases during the recent boom in world growth. None of the large countries have FDI levels which exceed the 5-6% of GDP rate but the same cannot be said of the Caribbean, where numerous economies depend on FDI for as much as 15-25% of their GDP (Central America is well below this figure). It is worth mentioning that a low level of FDI by no means represents a safe-haven from the crisis as it may be reflective of the general unattractiveness of a country to long-term investment opportunities. This is this usually the result of other institutional risks (violence, corruption, political instability) which may aggravate a country's vulnerability in periods of economic uncertainty.

Remittances represent the single largest source of foreign income for many countries in Latin America and the Caribbean which have large segments of their working population living abroad, mostly in the United States (and to a lesser extent, Spain). The total volume of remittances to the region is approximately equal to FDI, and over six times the amount of official development assistance (ODA). The recession affecting the industrialized countries is expected to curtail these remittances and put Caribbean and Central American countries more at risk. For example, whereas the enormous volume (over $26 billion) of remittances to Mexico accounts for less than 3% of its GDP, the share for Guyana is nearly 40% while Central American countries are somewhere in between, at 10-20%. Unlike FDI, whose benefits in terms of poverty-alleviation are mainly derived from the spill-over effects of expanded employment opportunities, the social impacts of remittances are direct: such payments typically go to lower-income households, improving income distribution as well as general economic performance.[7] Remittances are also remarkably stable when conditions in host countries are favourable, limiting local cyclical shocks.

Figure 6: Dependency on ODA, remittances and FDI, 2007



Source: own calculations from World Bank, IMF and IDB data

With the recession hitting the advanced economies where most migrants work, remittances to Latin America are set to fall for the first time in a decade: the total volume of $69.2 billion in 2008 was only 0.9% higher than in the previous year, and the $17 billion fourth quarter flow represented a 2% annualized drop.[8] Other projections put the growth in remittances for 2008 at

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[7] Exceptions are Peru and Nicaragua where remittances are distributed regressively. World Bank (2007), pp. 6-9

[8] IDB News Releases, 16 March 2009, 'IDB sees remittances to Latin America and the Caribbean declining in 2009', Available at: http://wwwt.iadb.org/news/detail.cfm?id=5160

barely 0.2% while predicting a 4.4% decline for 2009.[9] However, in local terms, this deterioration has been partially offset by the sharp devaluation of regional currencies, increasing the local purchasing power of dollar-denominated transfers. Additionally, countries which depend heavily on remittances tend to have lower shares of FDI and are therefore not as exposed to the much larger fall in FDI flows. However, this argument has to be tempered by the fact that low levels of FDI may simply reflect underdeveloped financial systems and low attractiveness for investment.

Overall, the high dependency of the smaller countries in the region on foreign capital and incomes makes them more vulnerable than larger countries with a greater capacity to self-finance consumption and investment. Recovery across the small economies, therefore, will be highly correlated with an improvement in external financial conditions, permitting a return of these inflows to stable levels. In contrast, the responsible fiscal management during the growth period has made the large regional economies far more resilient to episodes of capital flight than during previous crises. On the other hand, evidence suggests that the decline in capital flows, especially across the global banking sector will be protracted, whereas remittances are likely to pick up momentum once the global recession subsides.

Stock markets and currencies plunge

Equity markets have suffered from massive contagion effects and major regional stock markets lost nearly half their value in 2008 from their previous-year highs. The scale of index losses during the 2008 slump (which began in May but worsened in October) has varied, with the Santiago and Mexican exchanges were the least affected (20% and 24% losses for the year respectively) while Brazil's Bovespa index was down 41%, and the Buenos Aires composite fell to 49% below it's 2007 level. The biggest loser was the Lima stock exchange which registered a 60% collapse, the most severe in the western hemisphere. At its peak in May 2008, the market capitalization of the six major regional exchanges stood at over $2.5 trillion, of which over half ($1.4 trillion) was wiped out in the course of seven months - this represented the bulk of regional financial losses due to the crisis.

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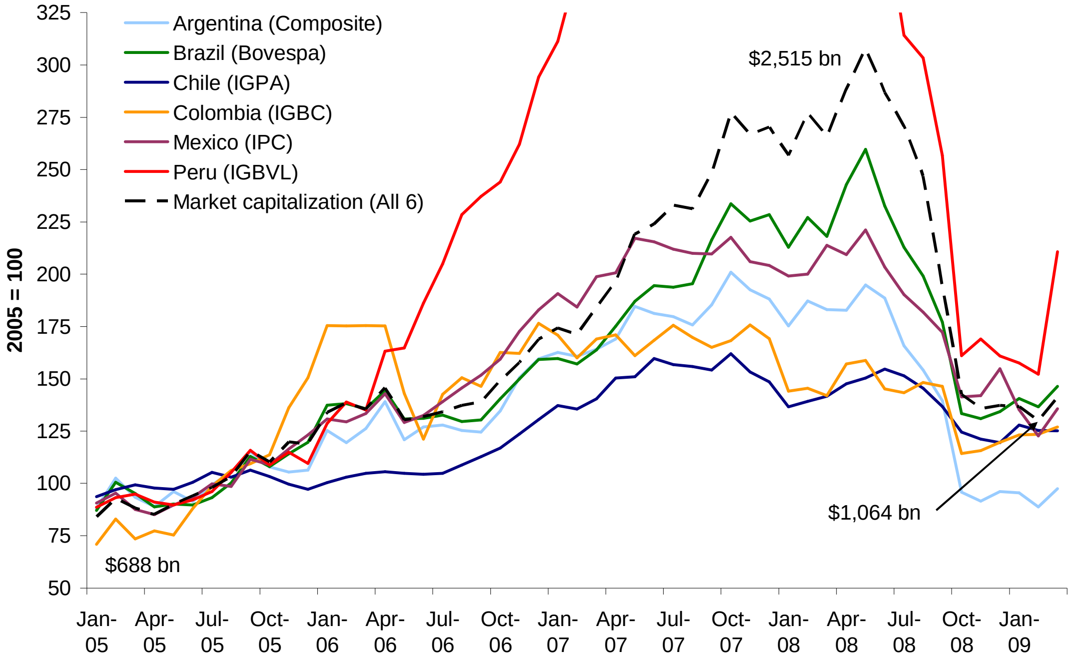
[9] World Bank (2009a), pg. 2

Figure 7: Stock market indices and market capitalization, 2005-2009

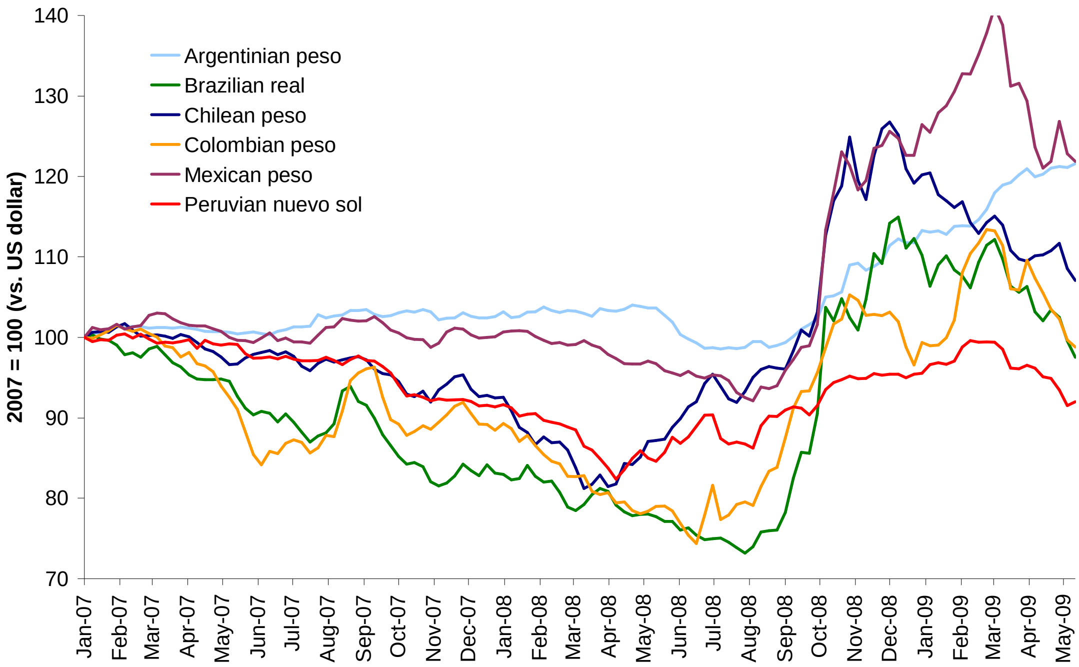


Source: WFE

Weak markets imply that companies will find it hard to raise capital for some time to come, although it should be noted that local corporates rely more on non-equity forms of financing than in other parts of the world, thereby reducing the impact of stock market weakness. It is also the case that wealth effects from equity market fluctuations are typically very low in developing countries compared with their significance in the US. It can thus be assumed that the overall impact of market losses on consumer spending will be low and even the investment impact could be quite modest – the key losses here being due to factors such as fear of a prolonged global recession as well as concern over lack of access to liquidity for corporate operations, which has encouraged hoarding of cash.

Adding to the financial contagion was the sudden devaluation of many regional currencies during the last quarter of 2008 which had particularly adverse effects on dollar-denominated debts and import costs. The immediate cause of these devaluations was a sudden reflux of money into Western banks, and a worldwide flight by investors to the perceived safe-haven of the US dollar, which accounts for the largest share of international reserves and foreign exchange turnover. Although flexible exchange rates can serve to absorb certain external shocks, large and sudden devaluations often require significant central bank intervention curb downward momentum and thus prevent investor panic. Mexico, for example, sold off over 10% of its foreign reserves in a matter of days in October to avoid the peso sliding out of control, a situation which was amplified by currency derivative losses from local corporates.[10] In that same month, Brazil arranged a $30 billion currency swap line with the US Federal Reserve to shore up confidence and provide the foreign exchange market with access to dollars.

Figure 8: Currency movements, 2007-2009



Source: Oanda

[10] Speculative losses from currency options in Mexico and Brazil prompted intervention by monetary authorities and increased regulation of over-the-counter derivatives markets. Some companies including Comercial Mexicana in Mexico, as well as Sadia, Aracruz Celulose and Grupo Votontarim in Brazil incurred losses of $1 billion or more, representing over 40% of their total assets. IMF (2009a) pp. 20-21

3. Internal finances and risk profiles

Financial sectors vulnerable to credit crunch

Although regional banks have largely been spared the exposure to the toxic assets which has brought down many of the most important financial institutions in the US and Europe, the global nature of corporate financing has meant that the private sector has not escaped unscathed from the credit crunch. The negative impact has been mainly through the difficulty and cost of accessing international credit and a 'liquidity squeeze' in local markets. Unsurprisingly, it has been estimated that the reductions in bank lending have been more severe in foreign-owned rather than local banks. As a result, larger firms may end up crowding-out small and medium-sized enterprises from whatever limited financial resources remain within domestic markets. The effect of this regional credit crunch will not be dissimilar to that seen elsewhere: companies will be forced to slow or scale down expansion as the increased cost or lack of credit and reduced sales force them to streamline their expenses, in many cases though layoffs as well as cancellation of investment projects. Nevertheless, financial indicators in the region suggest that banks were in generally good shape ahead of the crisis, with adequate capital margins, manageable levels of non-performing loans (NPLs), and high returns on assets.

Table 6: Financial soundness indicators, 2008

	Capital adequacy	NPL ratio	Provision/NPLs	Return on assets
Argentina	16.8	2.8	122.3	1.7
Brazil	18.1	2.9	181.7	2.8
Mexico	16.0	2.1	184.0	2.9
LAC	14.4	2.5	132.8	2.1
United States	12.8	1.7	189.4	0.6

Source: IMF

A further source of volatility is the degree to which a country's banking sector is foreign-owned. Since the 1990s, liberalization policies have dramatically increased the share of foreign participation in the region's banking system; this share amounts to approximately 45% today. Consequently, many of the most heavily hit foreign banks have significant operations in Latin America and account for a large percentage of total banking assets in some countries (notably, Mexico where over 80% of the banking sector is foreign). Transmission effects through foreign-ownership are therefore likely to impact on credit conditions as long as repatriation of capital from local to home markets and restrictions in credit persist. Illustrative of the impact of foreign banks, private credit growth in Mexico has effectively been on a standstill since late 2007, yet remained high in Brazil where the banking sector has the least foreign involvement.[11] Fortunately, the dominant foreign banks in the region have been among the least affected by the crisis, Citigroup being the major exception. The other major players – HSBC and the Spanish banks Santander and BBVA – appear to have survived the crisis relatively well. This suggests that credit growth in the region could be restored quite quickly once the global system starts to stabilize and emerge from shock.

Table 7: Share of foreign banking assets

	1990	2004	% of GDP
Argentina	10	48	20
Brazil	6	27	18
Chile	19	42	37
Mexico	2	82	51
Peru	4	46	14
Venezuela	1	34	9

Source: BIS

Overall, local institutions and banking sectors have had no significant direct involvement in the financial crisis, yet there has been a dramatic wipe-out of regional wealth. Most of this has been concentrated in equity losses from global stock market turbulence, although bank assets have also suffered to a lesser extent. This, however, should not be seen as a significant long-term risk considering that stock markets are likely to recover quickly once confidence in the economy is restored. Furthermore, the damage to wealth has been considerably less than in other emerging markets: for example, losses in emerging Asian economies may amount to nearly $10 trillion,[12] representing over 100% of its regional GDP (and roughly 20-25% of estimated global losses). Arguably, they may be more broadly distributed across the population as well.

[11] According to IMF-IFS data, claims on the private sector by banking institutions showed an increase of 30.7% in Brazil, 20.1% in Argentina but only 1.9% in Mexico between December 2007 and December 2008.

[12] ADB (2009), pg. 19

Table 8: Financial losses in Latin America, 2007-2008

	Value 2007 ($ bn)	% loss from 2007	Estimated losses 2008 $ bn	Estimated losses 2008 % of GDP
Stock market capitalization	2,292	55.0	1,261	34.1
Public and private debt	1,456	20.0	291	7.9
Bank assets	1,989	28.5	567	15.3
Total assets	5,737	36.9	2,119	57.3

Source: Asian Development Bank

Public finances

Fiscal developments in Latin America have largely reflected the buoyant growth achieved during the 2003-08 period and have led to the achievement of fiscal surpluses, debt reduction, accumulation of international reserves, and the upgrading of sovereign debt ratings. Compared with previous crises, these factors should bolster the region's resilience to the present global economic downturn and enable a smoother recovery than was typically the case in the past. In broad terms, government revenue has seen a pronounced increase as a result of the commodity price boom and this has been coupled with low levels of government spending. This combination has transformed what had been historically high fiscal deficits into surpluses during 2006-07. On the other hand, critics argue that *structural* fiscal balances (assuming that output was at its potential rather than observed level and that commodity prices maintained their long-run trends) have actually been much worse, with countries running deficits which have deteriorated significantly during the growth period.[13]

Table 9: Fiscal developments, 1995-2007

% of GDP	1995-01	2003	2005	2007
Public revenue	24.6	25.5	27.1	28.9
Public expenditures	27.6	28.7	27.9	28.7
Public expenditures (non-interest)	24.2	25.2	24.9	26.2
Public overall balance	-2.6	-4.6	-0.7	0.2
Public primary balance	0.8	-0.3	2.2	2.7

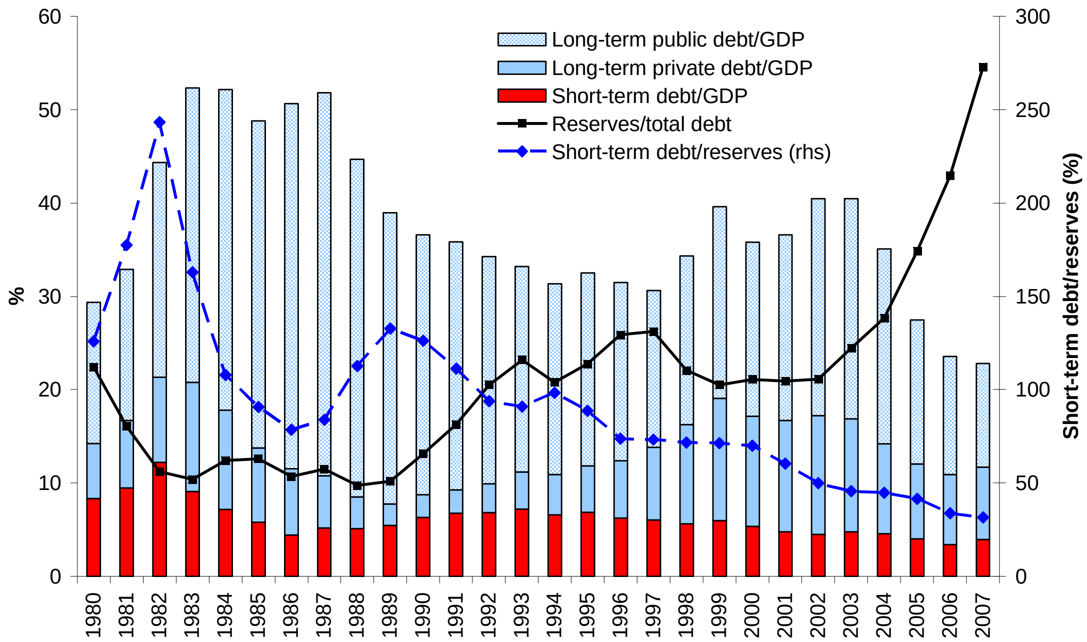
Source: IMF

In spite of the arguments over fiscal deficits, the reduction and restructuring of the region's external debt was without a doubt one of the most important

[13] IDB (2008), pp. 12-14

achievements during the growth period, especially considering the massive debt crises which had hit many of the larger economies since the 1980s. This reduction in the debt burden was largely accomplished though the surpluses in current and fiscal accounts but also through restructuring which became possible as a result of the overabundance of liquidity in global capital markets. Debt was renegotiated at more beneficial terms: lower rates, longer maturities and also into local currencies, reducing vulnerability to currency depreciations. One of the main mitigating factors of debt vulnerability was the spectacular accumulation of international reserves which stood at over three times the amount of short-term debt by 2007 (and comfortably over the 1:1 minimum recommended by the IMF). Nevertheless, some countries still have significant financing needs, with high levels of short-term debt driving borrowing requirements above those in other emerging economies. This puts added strain on deteriorating public sector deficits, particularly in those countries affected by decreasing commodity revenues. Although most countries should be in a position to cover their obligations, private short-term debt (affected by currency depreciation and derivatives trading in some cases) may place added strains on public finances if governments are required to step in to strengthen private balance sheets.

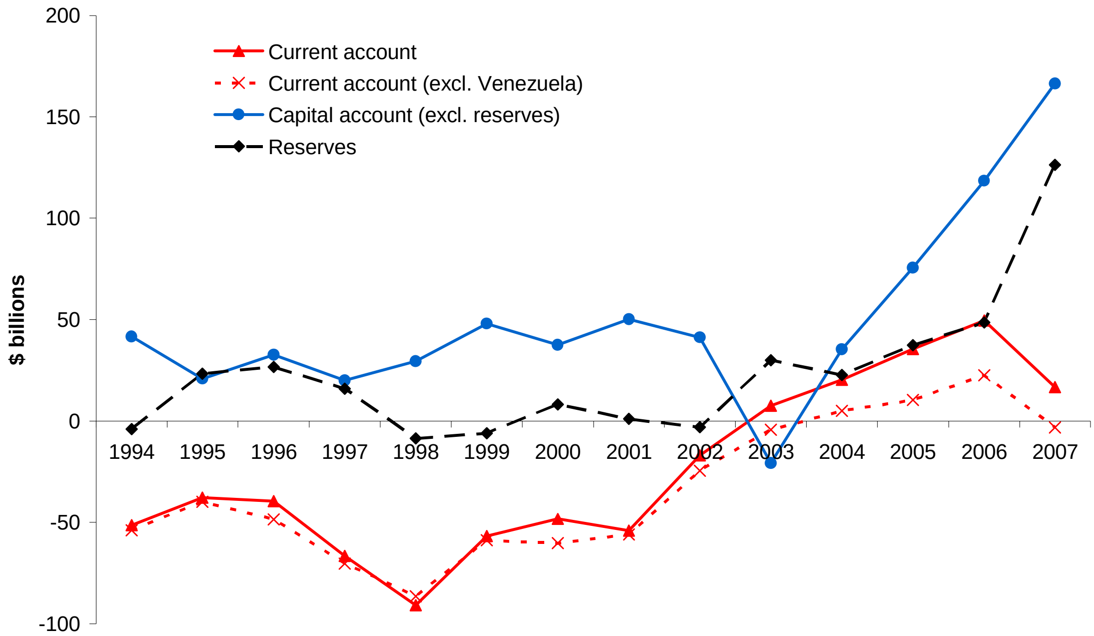
Figure 9: Size and structure of regional external debt, 1980-2007



Source: World Bank

Reinforcing the apparent soundness of the region's fiscal position is the high level of international reserves accumulated during the growth period: these reserves have nearly doubled their ratio relative to the total debt stock during the current decade, thus providing a welcome cushion against shocks. It is important to note, however, that a large part of these reserves have originated from capital account rather than current account surpluses (over half of which are attributed to Venezuela alone). This phenomenon also shows a clear deviation from historical trends in which current account deficits were financed through the capital account. Unlike other emerging economies, particularly those of East Asia, the accumulation of reserves in Latin America is therefore less a result of high savings rates than of credit, and could potentially be less resilient in the case of sudden capital outflows. So far, however, the crisis has not produced a significant weakening of reserve assets apart from Venezuela which burned over a quarter of its central bank reserves in January to finance development projects in the absence of other sources of income. Mexico has also tapped extensively into its reserves to shore up the peso (about $18 billion since October), while Brazil plans to use part of its reserves to guarantee private dollar loans of which $36 billion are due by the end of the year. It is also worth mentioning that much of the deterioration in the current account from 2006 onwards was linked to rising FDI profit transfers to home countries, rather than diminishing trade balances (trade, after all, performed well up to late 2008).

Figure 10: Balance of payments, 1994-2007

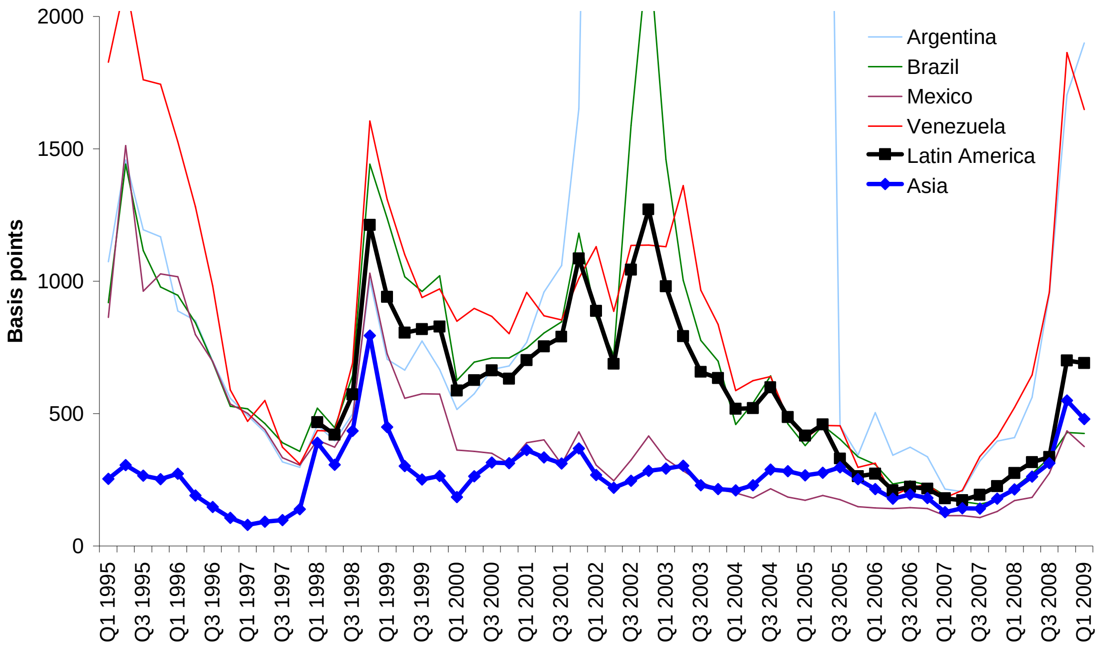


Source: IMF

Risk profiles improved

There are few more telling signs of the strengthened fundamentals of the region than the smooth reduction in sovereign risk premia during recent years. Despite the fact that many economic indicators have fallen equally or even more spectacularly than in previous crises, risk premia (as measured here by JPMorgan EMBI spreads) have seen a less dramatic upsurge compared with the massive jumps of 1000 basis points or more which were experienced at the height of the 1995 'tequila', 1999 'samba', and 2001 'tango' crises (which were themselves magnified by other global events such as the Russian and East-Asian crises and the collapse of Long-Term Capital Management). Although reduced financial and economic risk explains much of this performance, the importance of political stability has been paramount: there has been no violent or forced transfer of power in any of the major regional economies since 2002.[14]

Figure 11: EMBI spreads, 1995-2009



Source: OECD, IMF

[14] Venezuela's Hugo Chavez was briefly ousted during a failed coup attempt in April 2002. A few months earlier, in December 2001, Argentina's Fernando de la Rúa resigned after mounting protests due to the deteriorating economic situation.

The result of all of these factors combined has been a regional EMBI spread which has converged not only with the global composite but also with Asia, in addition to being considerably lower than US high-yield spreads. Individual country spreads have not been uniform, however, and three countries show particular risk which has locked them out of international capital markets: Argentina has been affected by farmer strikes and opposition to certain policies such as the nationalization of pensions, Ecuador has recently defaulted on its debt, and Venezuela faces growing uncertainty over its fiscal (and one could also argue, political) dependency on collapsed oil prices. These three countries have spreads which are well over 1,000 basis points above those of the more stable economies such as Brazil, Mexico and Chile (which has actually increased its credit rating), all of which have successfully tapped international debt markets in recent months.

4. Social impacts of the crisis

Poverty exacerbated by food crisis and recession

At first glance, the growth period proved to be exceptionally favourable for the reduction of poverty and inequality: approximately 38 million people were raised out of poverty between 2002 and 2007, of which the bulk (29 million) were those mired in extreme poverty. Much of this was achieved through the effects of growth on average incomes, mainly through labour income although government and private transfers also made an important contribution in various countries. However, these figures must be treated with some caution, as the 2001-02 crisis had thrust a considerable number of people into temporary poverty, thus making the subsequent accomplishments during the growth period rather less spectacular when compared to pre-2001 levels.

Moreover, it was apparent that falling poverty rates had come to a standstill even before the current turmoil began as a result of the upsurge in food and fuel prices: it was estimated that the number of extreme poor in the region swelled by at least 3 million (0.3%) between 2007 and 2008 owing to the food crisis alone.[15] As for the current global downturn, estimates point to many as 2.8 million people being pushed back into poverty as a result of to the crisis (assuming the IMF's earlier estimate of -0.14% growth for 2009) although this

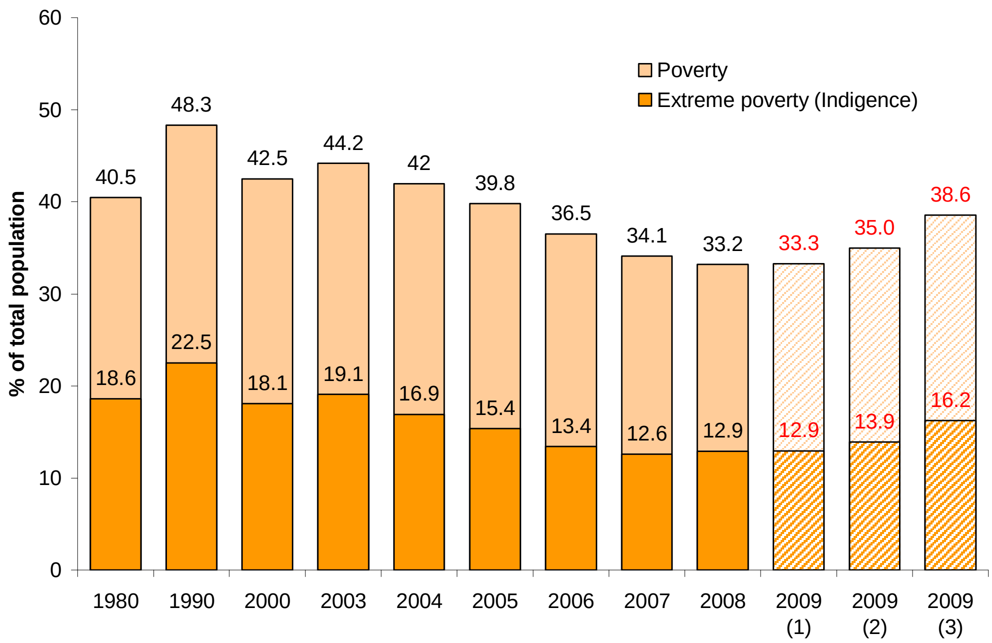
[15] The figures are even more alarming when comparing alternative scenarios: an ECLAC simulation showed that 4 million people could have escaped poverty in 2007 and 11 million in 2008 had food prices not risen so drastically. ECLAC (2008b), pp. 13-14

outlook may well worsen if the duration of the crisis is more prolonged and the contraction in output more pronounced as more recent forecasts seem to suggest.[16] Another scenario by the UNDP puts poverty as potentially rising by 10–15% if insufficient action is taken by governments to mitigate the effects of the shock, particularly in Central America and the Caribbean.[17]

[16] IDB (2009)

[17] BBC News, 7 February 2009, 'Latin America poverty 'may soar'', Available at: http://news.bbc.co.uk/2/hi/americas/7876169.stm

Figure 12: Poverty, 1980-2009



(1) Assuming previous IMF forecast of -0.14% growth (2) Assuming average contraction of previous regional crises (3) Assuming similar contraction to early 80s recession

Source: ECLAC, own calculations from IDB forecasts

Unemployment and labour informality set to increase

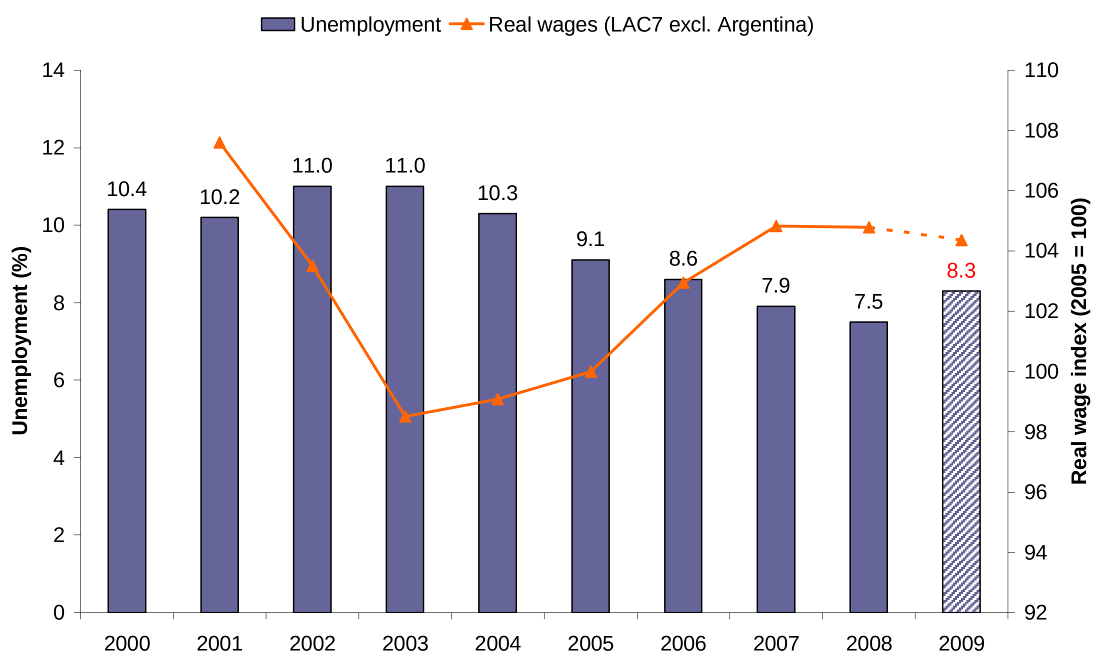
A further positive effect of the growth period was the simultaneous reduction of formal unemployment alongside a steady increase in real wages, although in most cases conditions have yet to return to their pre-2001 peaks. Unemployment in the formal sector fell by a quarter between 2003 and 2008 but real wages in most of the LAC7 economies began falling from 2007 onwards, likely because of increased inflationary pressures. Most of the major economies have since reported hundreds of thousands of layoffs as local firms were hit by plunging export earnings; compounding the problem is the return of thousands of immigrants who have also been left unemployed. ILO estimates put the regional unemployment figure for 2009 at up to 8.3%, which would represent a net total of 3 million formal job losses during the year. Evidence from past recessions also points to the fact that the recovery in jobs may come 2-3 years after the recovery in output, and that prolonged spells of high unemployment have serious social impacts, including increases in crime.[18] Even if positive growth in GDP resumes by 2010, coping with the

[18] ECLAC data shows unemployment rates took approximately 3-4 years to recover in Mexico from both the 1983 and 1995 recessions. Recovery in other countries such as Argentina, Brazil

aftershocks of increased unemployment will be a major policy concern throughout 2010-12.

Additionally, an enduring problem is the region's high level of informal employment, which accounts for over half the labour force in many countries. The growth period managed to reduce the size of the informal sector in most countries although the gains were quite marginal compared to improvements in other indicators: according to the latest available figures, only three countries in the region – Chile, Costa Rica and Panama – have levels of urban informality below 40% of the total employed workforce. For a few others such as Bolivia, Paraguay and Peru, this figure exceeds 60%. Although numbers are not yet available, the informal sector is likely to absorb a sizeable proportion of the formal unemployed given the general unavailability of public unemployment insurance schemes.

Figure 13: Employment and wages, 2000-2009



Note for real wages: Unweighted averages. Argentina excluded to show a more representative effect across the LAC7 countries since real wages increased considerably between 2003-08.

Source: ECLAC, ILO and own calculations from EIU data

and Venezuela was quicker (usually around 2 years) although it should be noted that but most began with already high levels of unemployment when their crises hit.

5. Coping with the crisis

National government policies

As the threat of a regional recession has become a reality, countries have adopted numerous measures to mitigate the fallout from the global turbulence. These have included domestic responses such as counter-cyclical spending, expansionist fiscal policies, and tapping of international reserves but also coordinated actions with foreign governments (mainly the US) and international financial institutions. As far as domestic measures are concerned, fiscal and monetary policies are undoubtedly the principal tools by which regional governments are seeking to counter the effects of the crisis. Foremost among fiscal policies are stimulus packages with the objective of increasing public spending (usually on infrastructure) to jump-start the economy and generate employment. Some proposals, such as Argentina's plan to nationalize the pension system, have been quite controversial. On the other hand, monetary policies are mostly geared towards the revitalization of financial sectors, and may include injection of liquidity (in both domestic and foreign currency), interest rate cuts, and the reduction of reserve requirements for banks. Additionally, many countries have adopted trade-related measures and have provided direct support to specific sectors such as agriculture, tourism and manufacturing. Policies vary throughout the region in accordance with individual country needs but a sample of fiscal and monetary actions taken by four of the most representative governments is outlined in Table 10:

Table 10: Sample of crisis relief measures

Argentina	Brazil	Chile	Mexico
• Tripling of central bank's credit line for local banks • Tax cuts for job-creating firms and certain exports • Tighter controls on certain imports, ban on maize and wheat exports lifted • Nationalization of pension system • $33.2 billion public works program	• Broad powers to intervene in financial institutions, including acquisition of portfolios of small and medium-sized banks • Reduction of primary surplus target for 2009 to 3.8% • Increase in public investment capacity including $45.2 to maintain consumption • Support for foreign trade financing and refinancing of private external debt ($20 billion of reserves) • Creation of a sovereign fund with initial amount of 0.5% of GDP • Lowering of interest rates by 350 bp (currently 10.25%)	• Countercyclical policy for 5.7% increase in total spending (incl. social spending). • Public investment spending of $7 billion including increase of 14.6% in public works and 10% in housing • Economic incentive plan of $4 billion to stimulate growth and employment • Lowering of interest rates by 700 bp (currently 1.25%)	• Fiscal stimulus of $6.9 billion, plus $43.6 billion for National Infrastructure Program • Hedging of oil price to $70 per barrel and freezing of petrol prices for 2009 • Gasoline prices frozen for 2009, gas cut by 10%, price of electric power lowered • Additional direct and indirect financing for businesses of $13.5 billion, plus SME and rural support • Lowering of interest rates by 250 bp (currently 5.25%)
Possible further policies…			
• Ensuring political stability and improving the country's risk profile for better access to capital markets	• Measures to relieve public and private sector financing due to high levels of short-term debt due in 2009	• Comfortable fiscal position and well-rounded policies probably subject to changes only if external conditions severely deteriorate	• More aggressive use of monetary policy particularly towards interest rate cuts • Use of IMF credit facility

Sources: ECLAC, own analysis

International responses

On the international scene, no country in Latin America and the Caribbean has yet required assistance on a similar scale to the bailouts which have kept various Eastern European economies afloat. Still, numerous regional governments have established precautionary agreements in the event that the crisis generates additional uncertainty. As already mentioned, Brazil and Mexico have arranged $30 billion currency swaps lines with the US Federal Reserve to ease currency pressures; Argentina has arranged a similar deal with the Central Bank of China worth $10 billion. With the IMF, El Salvador obtained an $800 million Stand-By Arrangement during January and, more recently, Mexico became the first country to express interest in the IMF's new Flexible Credit Line, seeking $47 billion of precautionary credit although there is no plan to actually use it yet (Colombia has since followed with $10.4 billion under the same facility). The Inter-American Development Bank (IDB) and the World Bank have also strengthened their support for crisis-hit countries with a total of $90 billion pledged between them and other regional development institutions.[19] Although most World Bank and IDB loans and grants are geared towards development projects, this support nevertheless provides an indirect boost by easing fiscal pressure, possibly freeing funds which can then be used for crisis management purposes. It may also be destined for social safety nets such as conditional cash transfers which help to alleviate the burden of the crisis on the poorest households.

Table 11: International crisis relief agreements since October 2008

Date	Recipient	Type	Institution	($ m)
23 Apr 09	**Guatemala**	Precautionary loan	IMF	935
22 Apr 09	**LAC**	Development/crisis relief	IDB/IIF	29,500
22 Apr 09	**LAC**	Development/crisis relief	World Bank	35,600
22 Apr 09	**Andean Region**	Development/crisis relief	CAF	20,000
22 Apr 09	**Central America**	Development/crisis relief	CABEI	4,200
22 Apr 09	**Caribbean**	Development/crisis relief	CDB	500
20 Apr 09	**Colombia**	Precautionary credit line	IMF	10,400
13 Apr 09	**Costa Rica**	Precautionary loan	IMF	745
30 March	**Argentina**	Currency swap line	CB of China	10,000
01 Apr 09	**Mexico**	Precautionary credit line	IMF	47,000
12 Feb 09	**Costa Rica**	Precautionary loan	World Bank	500
03 Feb 09	**Uruguay**	Economic protection	World Bank	400
16 Jan 09	**El Salvador**	Economic protection	World Bank	450
16 Jan 09	**El Salvador**	Precautionary loan	IMF	800
16 Jan 09	**Jamaica**	Economic protection	IDB	300
15 Jan 09	**Jamaica**	Economic protection	World Bank	100
29 Oct 08	**Brazil**	Currency swap line	US Fed	30,000
29 Oct 08	**Mexico**	Currency swap line	US Fed	30,000
13 Oct 08	**Andean Region**	Liquidity facility	CAF	1,500
13 Oct 08	**LAC**	Liquidity facility	FLAR	1,800
13 Oct 08	**LAC**	Liquidity facility	IDB	6,000

Sources: IDB, IMF, World Bank

[19] These $90 billion are expected to be shared roughly equally between the IDB and IIC (Inter-American Investment Corporation), the World Bank Group, and various regional development institutions. IDB, 22 April 2009, 'Development banks join efforts to provide $90 billion for Latin America and the Caribbean', Available at: http://www.iadb.org/news/detail.cfm?language=English&id=5360

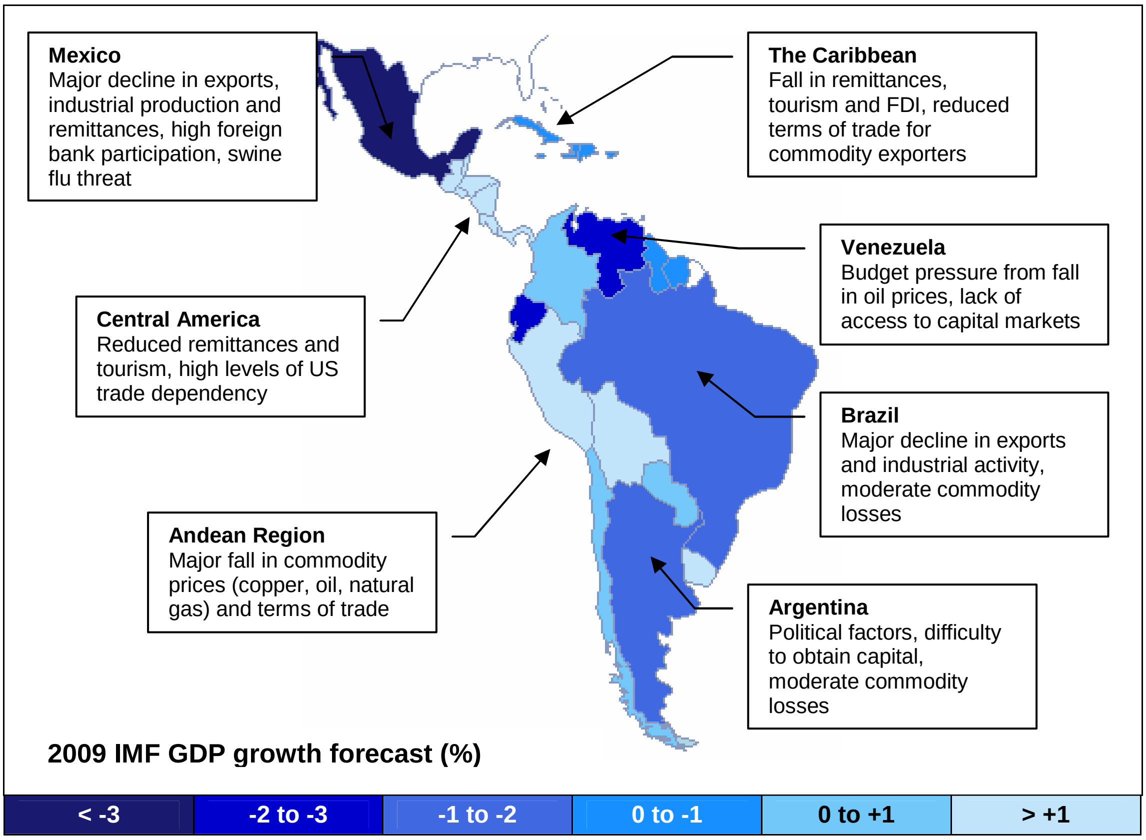
6. Conclusions

Summary of risks

The effects of the global financial crisis on Latin America and the Caribbean will undoubtedly be severe and protracted, yet there is little reason to believe that any country will suffer the sort of systemic collapse which characterized the region's previous economic catastrophes in 1995 and 2001, or the prolonged slowdown of the 'lost decade' in the 1980s. Still, growth forecasts by the major international financial institutions seem to significantly understate the severity of the downturn: Brazil and Mexico alone – which together represent approximately two thirds of the regional economy – show declines in their economic activity on a scale similar to those experienced during their respective 1990 and 1995 crises, while the impact on trade and capital flows on some of the other large economies is unprecedented. Although it is certainly true that fiscal and financial stability has played a major role in averting an even greater collapse (and should serve to reduce the risk of extended turbulence), this advantage is countered by the fact that the current crisis must be managed in the context of an extremely unfavourable external environment, worse than in previous periods of volatility.

As a result, the recovery of the region as a whole will be highly dependent on the success of industrialized economies in climbing out of their own recession (the most optimistic scenarios suggesting late 2009 as the turning point) and thus restoring growth in trade and capital flows which have deteriorated so dramatically. The importance of external factors cannot be understated, but this does not diminish the role of individual governments in adopting an appropriate macroeconomic policy mix to address the transmission mechanisms which affect them the most. For those countries still facing difficulties in their fiscal positions and balance of payments, swift action by international financial institutions will be decisive in ensuring that no country suffers a major meltdown. Overall, the regional distribution of risks can be summarized as shown in Figure 13.

Figure 14: Risks and vulnerability



Note: Central America and the Caribbean taken as aggregates

Source: IMF, own analysis

Looking ahead: can sustained growth be resumed?

The global crisis has also shed some light on the fundamental questions regarding both the short term resilience of the regional economy (which is currently being tested, with reasonably encouraging results so far) and its long-term prospects. Although the achievements of the 2003-2008 growth period are undoubtedly praiseworthy (and quite remarkable considering the volatility of the region in the previous quarter-century), it is doubtful that regional growth rates on such a scale could have been sustained over the long-term insofar as they remained highly reliant on a particularly favourable external environment rather than domestic factors such as increases in private investment or productivity. Responsible macroeconomic management has certainly left a valuable legacy of improved stability (in stark contrast with the disastrously irresponsible policies of the past), yet unfortunately this has not been translated into significant industrial restructuring and productivity gains, nor have there been significant strides towards reducing social inequalities and unacceptably high levels of corruption[20]. An important post-crisis objective, therefore, will be to address structural weaknesses which were largely masked by this promising yet ultimately short-lived bonanza.

The more immediate task, however, is to put the region back on track for growth and avoid the prolonged spells of volatility that characterized previous crises. The 1982 debt crisis comes to mind not because it led not only to a decade of stagnation but also led to pronounced instability – to the extent that a few of the larger South American economies (Argentina, Brazil and Peru) subsequently experienced bouts of hyperinflation during 1989-90 and required painful adjustment policies in the aftermath. Previous periods of financial turbulence are also a troubling reminder of how perceptions of the region tend to unduly influence reactions (particularly among investors) to events in individual countries (a case in point being the fallout in Argentina following the 1995 Mexican and 1999 Brazilian crises). In this regard, the current behaviour of risk premia indicates that Latin America as a whole enjoys a far higher level of confidence than it did just a few years ago – a testament to the region's improved macroeconomic fundamentals and political stability.

Provided there is no unexpected worsening of the recession in the industrial countries and the key Asian economies, the region therefore seems to be poised to weather the storm in much better shape than in the past – and in better shape than other emerging markets especially Eastern Europe. If governments in the region also act appropriately (which for the most part they have), by 2010 Latin America and the Caribbean should see a rebound, quickly recovering lost ground and setting the stage for further sustained growth.

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[20] Indicators for competitiveness and corruption among the three major regional economies show no substantial improvement during 2003-2008, and in relative terms, most have fallen in the rankings although this may be partly due to a broader sample of countries. According to the World Economic Forum's *Global Competitiveness Index*, Brazil had a slight increase from 3.95 (54th) to 4.13 (64th), Mexico from 4.12 (47th) to 4.23 (60th) and Argentina from to 3.35 (78th) to 3.87 (88th). Meanwhile, Transparency International's *Corruption Perceptions Index* showed Brazil dropping from 3.9 (54th) to 3.5 (70th), Mexico with no improvement at 3.6 (but falling from 64th to 72nd in ranking), and Argentina increasing from 2.5 (92nd) to a still troubling 2.9 (109th).

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