Double trouble for LAC?

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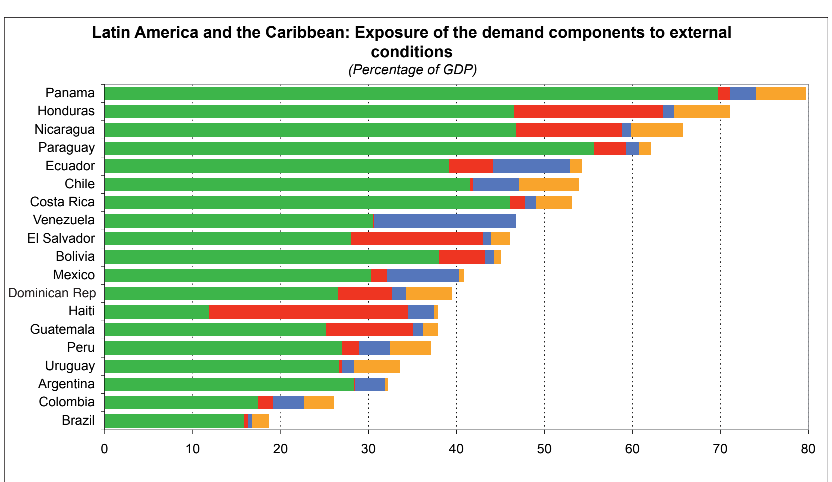
Following the collapse of the US subprime mortgage market and the meltdown in the financial system, global economic conditions have deteriorated sharply since mid-September 2008. The industrialised world is virtually in recession and the emerging economies are seemingly on the verge of a hard landing (growth well below potential).

In 2009, Latin American and Caribbean (LAC) countries will face a 'double trouble' with a significant slowdown in economic growth. The double trouble comes in the form of a combination of two negative external shocks (lower volumes of trade and deterioration of the terms of trade) which will slow down regional GDP to 1 to 2 per cent, well below recent performance trends. These estimates are optimistic and built on the premise of a soft landing. But a more pessimistic scenario of continuing and even deepening recession and tight credit conditions cannot be ruled out and the growth rate could even reach negative figures. Across the board, growth forecasts are being revised downwards for the entire region as well as for large economies such as Mexico, Brazil and Argentina which are expected to recover more slowly than the rest of the region.

From the viewpoint of LAC, these events signalled the start of the contagion of financial markets in emerging economies. The effect on corporate financing was also extremely negative, and this affected the equity position of large corporations, some of which have large subsidiaries in Latin America and the Caribbean while others are headquartered in the region itself. Although the LAC region is proving to be more resilient and better equipped to face this crisis than in the past, it is by no means immune to the financial contagion. The effects on the economies' real side remain uncertain and difficult to predict as the deflationary process is still unfolding and the severity of the credit crunch and the insolvency on the financial side are increasingly reinforcing to one another. The fiscal stimuli programmes undertaken across the region will do their part but the net effects are yet to be known.



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Figure 1

What we know

Three inter-related global shocks are hitting the world economy and are increasingly becoming mutually reinforcing: the financial crisis, the slowdown in growth, and changes in international relative prices. One incident marked a turning point in the development of the crisis: the collapse of Lehman Brothers. The repercussions of this event, far from being confined to the shareholders of that financial institution brought negative expectations which spread through the entire financial system and evolved into the current financial meltdown. Credit markets were virtually stalled, and demand for liquidity soared. This situation was clearly reflected in interbank markets, which further undermined the already fragile balances of some banks and threatened the very survival of large financial institutions, in addition to fuelling fears of a systemic failure of global financial markets.

Very often, the current financial crisis is explained in terms of the symptoms rather than fundamentals. At best, mainstream analyses reduce the assessment to the effectiveness of monetary policies (discount vs federal funds interest rates, money supply-open market operations, reserve requirement adjustments, lender of last resort actions) undertaken in reaction to the crisis. Their common assumption is that the crisis is a matter of insufficient liquidity that can be solved with additional injections of money supply by central banks, especially the US Federal Reserve (FRB), European Central Bank (ECB) and Bank of England (BoE). However, the current crisis is arguably less a liquidity crisis than a more serious solvency crisis, which has already begun to spread from the core investment and commercial banks of Europe and North America to other capital markets, and it has already affected non-financial corporate sectors in the wake of the inevitable defaults. Furthermore, with the unfolding of the US recession, the contagion has already migrated to the presumed immune emerging markets of China and elsewhere.

Therefore, following the famous financial fragility hypothesis developed by (US economist) Hyman Minsky, the ultimate causes of the global international financial crisis are arguably structural in nature. Firstly, the institutions and practices of the so-called New Financial Architecture which is comprised by a global system of giant investment banks, hedge funds and Special Investment Vehicles is poorly regulated or lacks any regulation at all. Secondly, the crisis unfolds under severe global imbalances (the imbalance between labour and capital mobility; the US trade deficit and the predominance of financial capital over productive capital). Thus the bubble in the subprime mortgage market and the subsequent debt deflation, the long period of abundant liquidity and low interest rates prior to the crisis led to a global quest for higher returns and a general underpricing of risk by investors; and the high levels of indebtedness of the private sector, particularly in US households, are rather a symptom and a reflection of financial and non-financial structural causes which lay at the heart of contemporary laissez-faire economies.

In the US, the crisis was shaped by perverse incentives and excessive risk-taking in the 'shadow financial system' including the poorly regulated financial intermediaries, as well as by complex and opaque securitisation structures and instruments (credit default swaps and collateralised debt obligations) which were not priced correctly, generating high leverage and widespread systemic risk which is now being spread out beyond US borders and it is showing strains on a scale and scope not witnessed in the past three quarters of a century. Two striking aspects are worth noting. One is that systemic risk built up progressively in the system. The second is that this buildup went unnoticed until it was too late. Financial innovation in a period of economic boom appears to have hidden it from view. In Minsky's words: "Stability breeds instability".

International economic conditions started to deteriorate in mid-2007, when the increase in the unemployment rate in the United States triggered the collapse of the subprime mortgage market. The failures in this market swiftly started to impact the balance sheets of established financial institutions which owned and sold derivative instruments with subprime mortgages as underlying assets. At the same time, the global economy was being hit by a sharp increase in food and energy prices. While some central banks increased interest rates in order to curb inflationary pressures, others kept the tight monetary conditions adopted during the boom phase.

What are the main transmission channels?

The global financial crisis is expected to impact the economies of LAC countries through three main channels: volumes of trade, relative prices (particularly commodity prices) and tourism; capital flows and remittances. Not all countries have the same exposure to the crisis (see Figure 1).

Firstly, the contraction in external demand will slow down the volumes of trade and this in turn will be the crisis' most fundamental transmission channel, particularly for countries whose export structure is concentrated on manufactured goods destined to the US market. On the other hand, in some of the region's countries part of the negative impact on growth will be the result of lower demand for services – particularly tourism, for which demand is highly income-elastic. Mexico, Central America and some Caribbean countries will be among the most likely affected.

The stance of imports by the United States from Latin America and the Caribbean has varied considerably from country to country. Non-oil imports from Mexico began to slow in mid-2007 and continued to fall to the point where they registered a year-on-year contraction of 2.4 per cent in the third quarter of 2008. Imports from the Central American countries have, on the other hand, behaved similarly to imports worldwide. This is because, although there is evidence of a slow down and even of a contraction in Central American manufactures destined for the United States market, this decline has been offset by the higher prices obtained for commodity exports. United States imports from the Andean countries and MERCOSUR,

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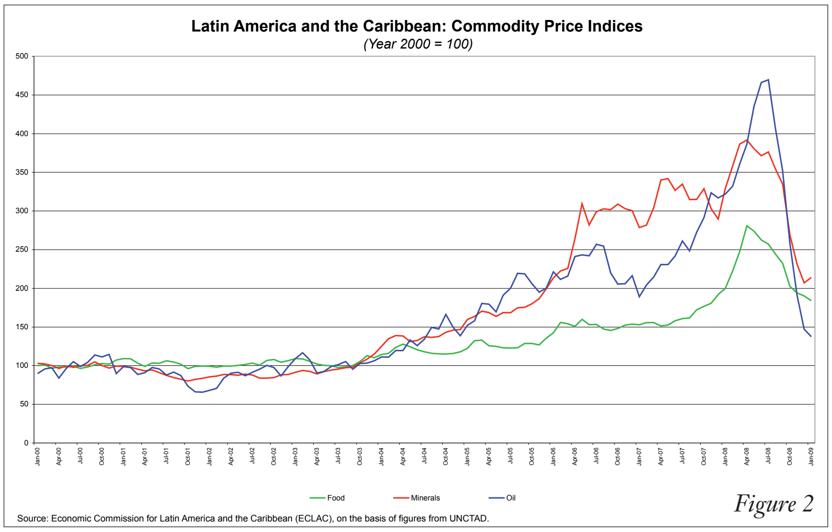
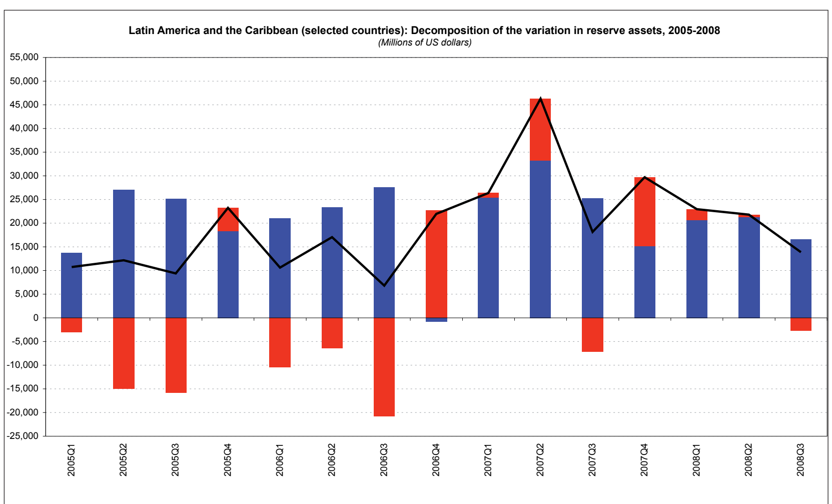


Figure 2

Decreasing or volatile commodity prices are expected to cause one of the recent engines of regional growth to come to a standstill

consisting mostly of commodities, rose in tandem with commodity prices from mid-2007 until the third quarter of 2008, when they began to level off. China's imports from Latin America and the Caribbean, which are most significant in the case of the Andean countries and MERCOSUR, followed a similar pattern. This Asian country is also facing a decreasing demand from the developed markets for its manufactured products, which will impact on its economic impetus and, therefore, in its demand for commodities exported by the region.

For many Latin American and the Caribbean countries, commodities make up a considerable proportion of the export basket and, in some of these countries; they are a significant source of public revenues. Thus, decreasing or volatile commodity prices are expected to cause one of the recent engines of regional growth to come to a standstill. For the region as a whole, terms of trade are forecasted to grow by 0.8 per cent in 2008 and fall by 7.8 per cent in 2009 (see Figure 2). For Chile and Peru, both metal exporters, the terms of trade are expected to deteriorate by around 8 per cent in 2008 and 30 per cent in 2009. For countries that export fuel, the terms of trade are expected to rise by 13 per cent in 2008, before falling by almost 20 per cent in 2009. As for MERCOSUR, where food comprises a major part of total exports, the rise in 2008 will be almost completely offset by the decline projected for 2009. In Mexico, the terms of trade are expected to improve very slightly in 2008 and then drop by over 2 per cent in 2009. In contrast, as Central America and the Caribbean are net importers of commodities, the fall in oil, metal and cereal prices alleviates and partially offsets the consequences of the world economic slow down and the fall in remittances mentioned below.



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
Note: The countries included are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico and Peru.

Figure 3

Secondly, as for the financial flows transmission channel and after the collapse of Lehman Brothers, the financial crisis had an increasing impact on the financial markets of Latin America and the Caribbean. In the final four months of 2008, the region has experienced a slow down in portfolio investment inflows, which afterwards started to decline (see Figure 3). Furthermore, vast falls in regional stock markets were registered and currencies depreciated drastically, which was in part due to previous speculative positions based on expectations of appreciation for Latin American currencies. However, companies with debt in foreign currency have seen their balances negatively impacted by the devaluations of several of the region's currencies. Unlike the situation in previous crises, the private sector seems to be the most exposed to exchange-rate volatility in many countries (see Figure 4). Additionally, the cost of international borrowing soared especially for firms, but also for sovereign debtors. The increase in sovereign risk premiums in the region has been nevertheless smaller than in previous crises, allowing for significant differences across countries.

Although the region's financial activity has not been exposed to toxic assets, the problems in the international inter-bank market and the impact of the tightening of external credit on local credit markets transferred part of the turmoil in the financial markets of developed countries to the region. However, the dimension of this impact is still to be fully known, as current available information is not sufficient to establish those results. Of particular concern are the credit access conditions for a series of large regional enterprises from several countries that usually find financing on international markets. Given the credit crunch and the higher price of credit in global financial markets, it is expected to become more difficult to meet borrowing requirements.

The reduced availability of external financing will force the larger private enterprises to turn to domestic markets, which are likely to suffer from liquidity squeezes. This, along with increased uncertainty, will probably make it more difficult for small and medium-sized enterprises to access financial resources. Inter-company borrowing along the productive chain has also decreased sharply in the region, bringing to a halt established practices and investment projects, seriously hurting the financial position of an increasing number of firms.

The tightening of international financial conditions will also have an adverse effect on inflows of foreign direct investment (FDI), which were an important source of resources for some countries in recent years. The inflows of FDI in Caribbean countries, mostly related to tourism, accounted in 2008 for 15 to 25 per cent of GDP; in the Dominican Republic, Costa Rica and Panama these flows accounted for 6.5 to 8 per cent of GDP, and in Chile and Peru they were around 5 per cent of GDP. The regional total FDI inflows were slightly below the amount registered in 2007, resulting from an estimated increase of 7 per cent in countries abundant in natural resources, essentially in South America, and an estimated decrease of 25 per cent in economies more dependent on exports, particularly manufactures and tourism, such as Mexico, Central America and the Caribbean. As the world economic growth loses its impetus, so will FDI inflows. The slow down in developed countries decreases the need for efficiency-seeking and resource-seeking FDI in the region, whereas the slow down of the economies of the region trims the incentives for market-seeking FDI. Furthermore, the liquidity crisis limits the ability of firms to finance merger and acquisition operations, the most important form of FDI in Latin America and the Caribbean. In sum, FDI inflows are expected to decline in 2009.

Finally, the weaker job market in developed economies will have an adverse effect on the remittances that emigrant workers send back to their families in their home country. Remittances have been an extremely important source of external revenues in Latin America and the Caribbean, where they have helped to increase the welfare of low-income families. In some countries in Central America and the Caribbean – in decreasing order, Haiti, Honduras, Jamaica, El Salvador, Nicaragua and Guatemala – workers' remittances represent between 15 and 40 per cent of GDP. In Belize, Bolivia, the Dominican Republic, Ecuador and Grenada these inflows represent between 5 per cent and 10 per cent of GDP. Therefore, any reduction in remittances will have a negative impact on the situation of low-income families in these countries. This is an important factor influencing the impact of the global economic and financial crisis on employment and poverty in the region.

What are LAC countries doing to face the crisis?

This time around, emerging markets were not the instigators of the crisis, but their aggregate demand is now more vulnerable to a global downturn because of their dependency on external demand and foreign investment. Financial institutions and hedge funds in developed economies rapidly pulled out massive amounts of money from emerging markets, creating problems for local markets and banks. International lines of credit, the lifeblood of international transactions, were also frozen, affecting trade and leading to reduced export earnings.

The governments' initial response to the crisis was in the central banks' domain, that is monetary policy by means of cutting interest rates and injecting liquidity into the their banking systems. Some countries have room for an additional fiscal stimulus, but this is not the case for the poorest countries, which do not have the fiscal space to implement counter-cyclical policy.

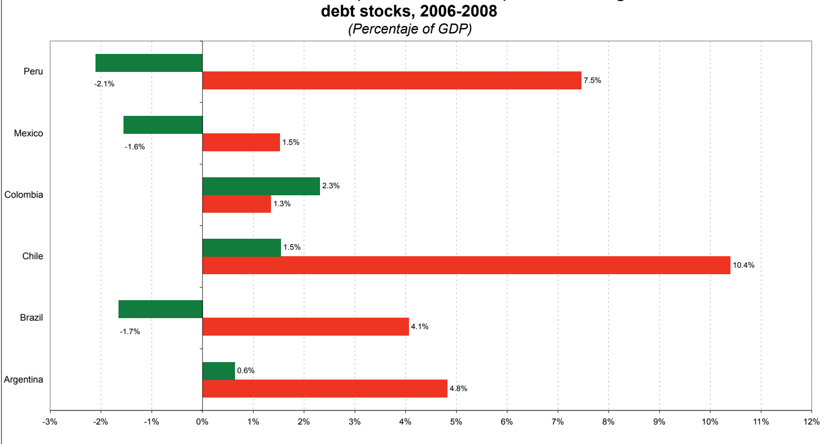
The LAC countries have adopted a variety of policy measures in response to the financial crisis (see Figure 5). Although the macro-economic foundations are significantly stronger than in the past, the region will not be immune to the impact of instability in world financial markets and to the anticipated recession in the developed economies.

The range of measures implemented is quite diverse as the effects differ from country to country and the instruments needed also vary due to differences in the countries' availability of resources and in their capabilities to implement such initiatives. That availability generally depends on the fiscal space available for financing the measures, when their implementation entails the use of public funds or when they involve foreign-currency transactions, and it also depends on the availability of external assets or the access to foreign-currency credit. In the current circumstances, the latter is limited to dealing with international financial institutions. It is worth noting that Keynesian-type fiscal stimulus (increasing government spending in infrastructure projects among others) can be a positive solution, but policymakers must be keen on how the stimulus package is timely implemented, ensuring enough credibility that avoids concerns on debt sustainability.

Beyond these considerations, taking into account the impact that these measures may have on the rest of the economy, a full analysis of the countries' capabilities should encompass other elements such as the degree of monetisation, the depth of the financial market and the balance-of-payments current account balance. It should

Inflows of FDI in Caribbean countries, mostly related to tourism, accounted in 2008 for 15 per cent to 25 per cent of GDP

Latin America and the Caribbean (selected countries): Rate of change in external debt stocks, 2006-2008
(Percentaje of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
Note: For 2008, data refer to September in the case of Argentina and Mexico and to November in the case of Colombia.

Figure 4

Keynesian-type fiscal stimulus can be a positive solution but policymakers must be keen on how the stimulus package is timely implemented

be remembered that a demand-led strategy based on increased public spending, aside from its fiscal impact, may widen the external deficit beyond a country's capacity to finance it. In this case, the availability of foreign-currency resources will be an issue even if there is plenty of fiscal room for manoeuvre.

In the short term, monetary and financial policies normally produce a swift reaction in the economy and their central objective is to avoid the contagion from external financial instability. Examples of these measures include the reduction of reserve requirements, provision of credit lines to domestic banks, intervention of troubled financial institutions, repurchase agreements of government bonds and shift from long-term to short-term bonds. Actions to grant liquidity can be designed for either domestic or foreign currency. They are often used as short-term instruments to avoid further confidence losses, provide liquidity and enable local credit markets to function normally, supply funding where markets cannot do so and work in conjunction with other measures. Even if the response to these measures is often very rapid, their effectiveness to foster real growth remains unclear. Furthermore, they can be constrained by the availability of external assets or foreign-currency credit, the degree of monetisation of the economy and the depth of the financial market.

Fiscal policy can act as a counter-cyclical instrument designed to drive the economy to its level of potential growth; its effect is normally observed over a longer period of time than monetary measures. They usually come in two modalities: tax cuts or subsidy increases. Other actions that also have a boosting effect on demand over the medium-term include trade policy (through changes in tariffs, import restrictions or export financing), sectoral policy (aimed at specific sectors, such as agriculture, Small- and Medium-sized Enterprises (SMEs), tourism, industry, construction, etc) and social/labour policy to assist those that are suffering more from the economic downturn. The implementation of these measures, however, may endanger the health of public accounts; if they are financed by new public debt, the already high liabilities of the economies of the region may increase; finally, they may put a pressure on external accounts, leading to the unsustainable situation of twin deficits. Even though their outcome is not observed instantaneously, they have a strong effect on domestic demand and serve as essential compensatory measures (see Figure 6).

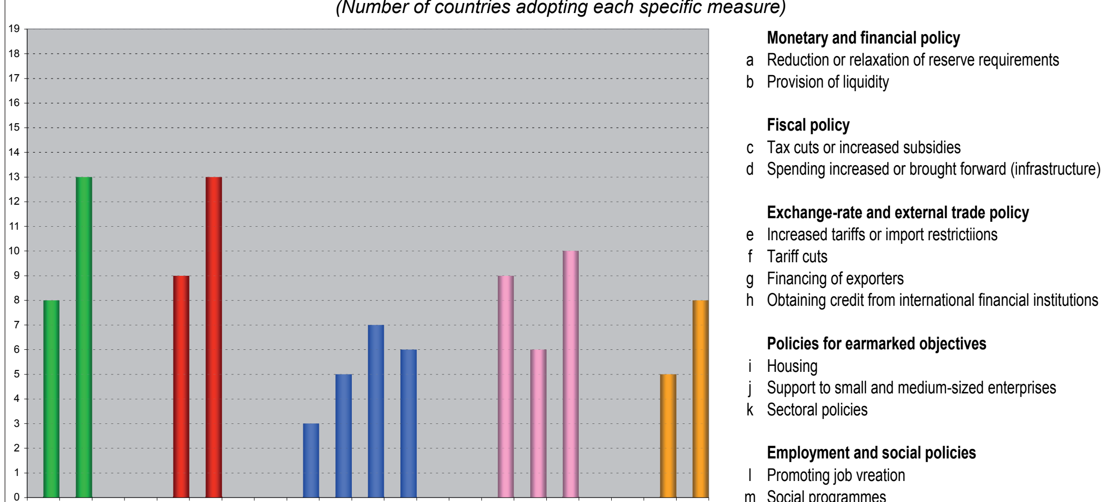
Finally, there are other actions that do not present many immediate benefits, but that instead contribute to the long-term growth of the economies. These comprise spending in infrastructure, development of education and health systems, explicit policies of capability-building directed both at education and training but also at nurturing and shaping specific corporate actors; essential structural reforms (electoral, labour, energy and others) and promotion of regional cooperation and integration.

What's next

The economies of the LAC region are expecting a

Latin America and the Caribbean: Adopted measures to respond to the international economic and financial crisis sorted by policy scope

(Number of countries adopting each specific measure)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
Note: The figure is based on available data up to February 2009.

Figure 5

significant slow down in economic growth in 2009 after six years of steady growth at an annual average rate of around 4.5 per cent. The deterioration of the external scenario will require a big effort from the governments of the region in order to mitigate the negative impacts expected on the economic and social situation. However, macro-economic space to counter-cyclical policies is quite restricted and not all countries are equally prepared to face this situation.

Besides these considerations, the situation worldwide calls for coordinated solutions to give maximum leverage to policies and strategies that are being implemented. It is now increasingly important that the role of the emerging economies in global economic growth has not only jumped in importance, but it is likely to increase further. They must therefore be included in forums to discuss strategies for coordinating policies to stimulate global growth and be provided, through international bodies, with the resources to finance the implementation of countercyclical policies.

Given the challenges above, Latin America and the Caribbean should take the opportunity to rethink the economic development model used so far and strengthen the links between economic development, social development and environmental sustainability. Designing coordinated responses to address the current economic conditions means actively seeking complementarities between growth and equity, between competitiveness and social cohesion, between the these two pairs and democratic development; lastly, between economic development and environmental sustainability. We are aware that these goals are often conflicting and that they generate multiple policy dilemmas. However, we must find creative ways to achieve them simultaneously in the medium-to-long term.

Therefore, the response adopted by any given country to the current global financial crisis must entail the ethical responsibility to recognise and strengthen the interrelationships between the economic, social and environmental policies, coupled with the equally important democratic progress in the region. This is crucial in the current context of uncertainty about the economic and social benefits of democracy, global economic integration and the uneven progress towards regional and sub-regional integration.

This discussion ultimately leads to the region's need to formulate a new development agenda, one that leaves the so-called Washington Consensus behind and that allows the removal of key standing obstacles to economic growth. The current challenge is enormous and will not be solved with minor adjustments in the current integration lines of the region into the world economy.

At the global level, the international community must revive multilateralism and the principles that underpinned the Monterrey Consensus so the Internationally Agreed Millennium Goals can be achieved in due time. The global community may then be proud of turning an appalling crisis into extraordinary global prosperity. F

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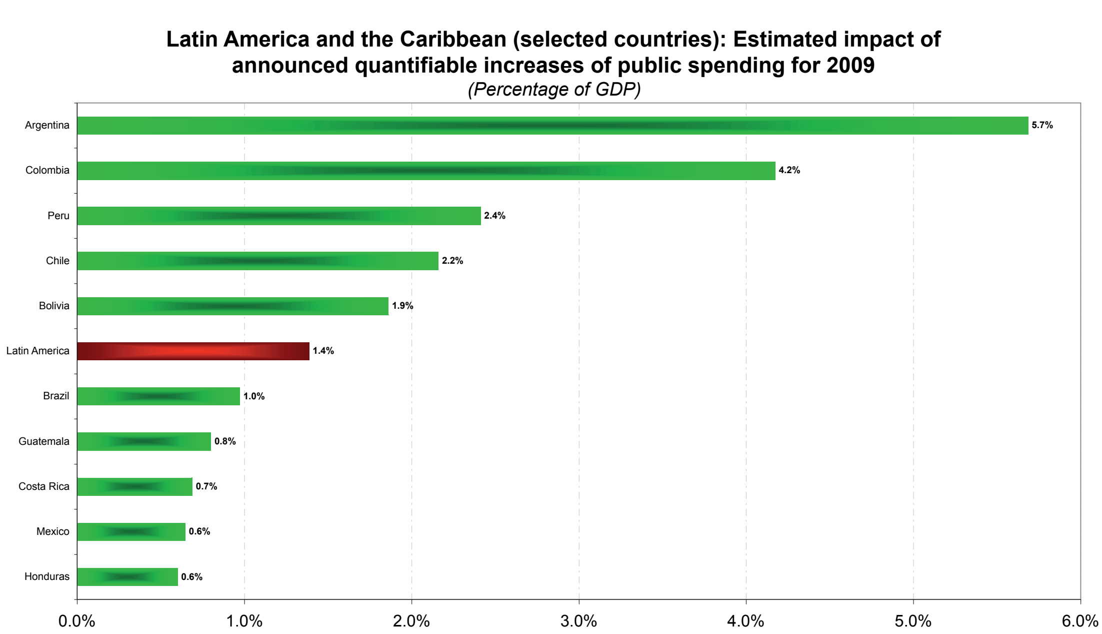

Figure 6

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.