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Latin America and the Financial Crisis of 2008: Lessons and Challenges

Dr. Luisa Blanco[*]

ABSTRACT

In October of 2008 there were two main views of what the financial crisis would do to emerging countries in Latin America. The optimistic view predicted that they would do well overall and that the crisis would not have a significant impact on them because their economies were decoupled from the rest of the world. The pessimistic view saw these economies as vulnerable to the financial crisis, which meant they would become unstable and perform poorly. Over a year later, the outcome is something in between. This article will explain the current state of the financial crisis in Latin America and the policy responses of various Latin American countries. Brazil, Mexico, and Chile, will be highlighted because they present very interesting cases. These examples are important when discussing lessons and challenges in Latin America. The idea is to focus on what these Latin American countries have done that has allowed them to perform relatively well during the crisis, and discuss what challenges policy makers in the region are facing today and will face in the future.

I. THE IMPACT OF THE FINANCIAL CRISIS ON LATIN AMERICA

Four pieces of macroeconomic data illustrate the impact of the financial crisis in Latin America: levels of gross domestic product (GDP), foreign trade, foreign direct investment (FDI), and remittances. World Bank projections from September 2009 estimate a 2% GDP decrease on average for the region for the year of 2009.[1] Mexico, however, is a different case; its GDP is expected to decrease by about 7% in 2009.[2] The Latin American experience during the crisis is quite heterogeneous, because some countries did not experience contractions (Bolivia, Panama, Peru, and Uruguay), some experienced miniature contractions (Brazil, Colombia, and the Dominican

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Republic), and others saw large contractions (Mexico). It is very important economically for Latin America that the financial crisis did not originate there, as it did in previous financial crises. Compared to other regions, Latin America was certainly not the hardest hit. Projections estimate that Western Europe's GDP will contract by 4.1%, Eastern Europe's by 5.4%, and Japan's by 5.7%.[3] The projection for the U.S. is similar to the Latin American region, around 3%.[4]

There are three main factors, using current data from the Organisation for Co-operation and Development (OECD)[5], which affect the well being of Latin America. One is that there was a significant reduction in world trade in the first quarter of 2009, but in the second quarter world trade started to stabilize.[6] There was a significant decrease in exports from non-OECD countries in the first quarter of 2009. One should focus on non-OECD exports, since most Latin American countries are not members of the OECD. The second quarter however, saw an increase of 1%, indicating some stabilization[7]. Some project that the level of exports in Latin American countries reached bottom, so future growth may be approaching. The level of non-OECD imports from the fourth quarter of 2007 to the fourth quarter of 2009 indicates some stabilization, or even future growth. In 2008, exports in non-OECD countries decreased by about 2% in the third quarter and 4% in the fourth quarter.[8] It is not all bad news. Exports actually increased from the first quarter to the second in 2009.

Data from the United States is important for Latin America because Latin American countries export much of their products to the United States. In 2009, there was a significant reduction in imports from the rest of the world into the United States, and especially from Latin America. Monthly averages of United States imports from the world offer a grim picture. From 2008 to 2009, they fell by 28%.[9] Imports also fell in 2001 due to that recession, but only by about 6%. The monthly average of the available observations for Latin American countries shows a very similar picture. There was a drop during the recession of 2001 and a drop in the recession of 2008, and the magnitude is greater now than it was then.[10] Brazilian imports to the United States have increased significantly over time, but dropped precipitously during the current recession. On the upside, they started stabilizing in July of 2009. Chile shows a similar picture, as does Mexico. In fact, such drastic drops and the following stabilizations can also be seen for most of the other countries in the region.[11]

Data from the Economic Commission of Latin American countries show trade falling 31% from the first half of 2008 to the first half of 2009.[12] Commodity prices decreased by 29% in the same time period, which affects Latin America's export market.[13] That drop in exports is comparable to the drop back in the 1930s.[14] Projections of volume of trade reduction indicate a

decrease of 13% in 2009, which is comparable to the time period from 1937 to 1939.[15]

Another aspect related to the implications of the financial crisis in Latin America is FDI. FDI plays a key role in Latin America because it provides capital and technology to countries that otherwise would not have it. Projections for FDI are not good. FDI is expected to decrease significantly in 2009, but start to recover slowly in 2010. However, it is expected that FDI will recover to 2008 levels in 2011.

A recent United Nations Conference on Trade and Development's World Investment Report asked international corporations what their investment plans for 2009 were, and 58% answered that they are expecting to decrease their investment in all of their countries.[16] Therefore, the projections are not good. For Latin America a lot of FDI took place before the financial crisis. Now, however, the effects are starting to show. There was a drastic drop of 42% from the first quarter of 2008 to the first quarter of 2009.[17] Although the drop was drastic, the experience of Latin American countries with FDI during the crisis has been quite heterogeneous. For some countries there was an increase in FDI, but for other countries there was a decrease.

Remittances, money that immigrants send from abroad to their home regions, are another important indicator. Remittances have grown significantly for many years in the region, and Mexico is one of the countries that receives the most remittances. In 2009, however, there is expected to be a decline in remittances of about 11%.[18] This fall in remittances will bring them back to the level of remittances in 2006. This drop in remittances is expected because there is more unemployment in the United States, where Latin American immigrants have been hit harder and they are less able to send money back home. The average amount of money sent back was $241, but is now about $230.[19]

There is something called the reverse remittances phenomena that has not been around until now. Immigrants in the United States that used to support their families back home are now unemployed. Now, they need their relatives back home to help them. There is some data showing in some cities in Mexico that the net transfer is negative; more money going out than coming in, which is a new phenomenon in Latin America.[20]

II. LATIN AMERICAN RESPONSES TO THE FINANCIAL CRISIS

Latin American countries responded differently to the crisis than other developed countries did. The first difference is that the crisis did not

originate in Latin America. They are being affected by something external, not internal, so they are taking a different approach. Something important to note is that Latin American countries went through important reforms during the 1990s, which improved their ability to face a crisis. They are in much better shape than they were before the reforms.

Just like the United States, many Latin American countries used fiscal stimulus through greater government spending to address the crisis. Because of the reforms they implemented in the 1990s, which forced governments to be more fiscally responsible, many Latin American countries had more room to maneuver and to implement these fiscal policies. In previous crises, some Latin American countries did not have the luxury to do that. They actually had to decrease government spending during a recession.

Another important policy measure was the use of an expansionary monetary policy. In January of 2009, Mexico decreased its benchmark interest rate by half a point to 7.75 points.[21] That was actually its first cut in the interest rate since 2006. That is a substantial shift in policy, caused by the financial crisis. Many other countries in the region had to use an expansionary monetary policy as well.

Finally, Latin American governments have provided assistance to financial institutions, but their approach has been different than the approach taken by the United States because the banking sectors in Latin American countries did not have the toxic assets that banks in the United States did. There was, however, some decrease in credit, to which Latin American governments have responded. The development bank of Brazil started purchasing shares from banks, and the development bank of Mexico, Nacional Financiera, started giving credits to small and intermediate enterprises.[22]

There are some interesting cases worth noting when discussing lessons and challenges for the region. Brazil, for instance, is a leader in the region. It has been affected by the crisis, but is expecting to recover faster than any other country in the region. One of the reasons Brazil has been very successful is that it has a very diversified export sector in terms of products and regions. Another good thing about Brazil is that it has been able to achieve macroeconomic stability. Brazil faced some trouble during the 1980s and 1990s, but was able to implement some reforms that allow it to control inflation and be fiscally responsible. In 2000, Brazil passed the Fiscal Responsibility Law, which forces the government to set a fiscal target for government expenditures, revenue, and debts, and then stick to it.[23]

Mexico is a different story. There is a saying that when the U.S. sneezes, Mexico catches a cold. The current situation is a bit worse than a cold because the Mexican economy is very dependent on exports to the United States. Other factors affect Mexico's economy as well. There are still major problems with the drug cartels, and in May, the H1N1 flu had a

negative effect.[24] The recession in the United States, however, is definitely the major reason why Mexico caught not just a cold, but bronchitis.

Mexico is an interesting case because after it faced the Peso Crisis in 1994, Mexico implemented reforms that encourage more fiscal responsibility, including having a reliable and capable central bank.[25] Even though Mexico is in trouble, it has been able to use fiscal stimulus. It is surviving the crisis in much better shape than it would have without the reforms. In one sense, Mexico learned its lesson in the 1990s. Mexico has a relatively healthy banking system that was not exposed to toxic assets. Also, it has large reserves of foreign currency, which put it in a much better position than before.

Chile has also been implementing significant reforms. It has actually done an excellent job in macro-management. This is because Chile created stabilization funds.[26] During the 2000s there was a significant increase in the price of copper and Chile received a huge windfall. Instead of wasting that money, it put it away and saved it. When it needed to implement fiscal stimulus, it had the stabilization funds to draw from. Chile took the windfall profits from the state-owned copper company CODELCO, and put it away and saved it abroad in bonds. Chile is now considering buying foreign stock with its funds. Chile's finance minister offered the following financial philosophy: Chile will spend what is permanent and save what is transitory. In other words, Chile will spend what it needs to spend, but whatever is extra, Chile will save because Chile is going to need it later. This policy seems to be working very well for Chile.

III. LESSONS AND CHALLENGES FOR LATIN AMERICA

A commonality of these countries is that they have implemented effective policies in a timely manner. This is a plus when looking at the financial crisis. There are lessons from the Latin American experience that can be applied to the future. The first one is that Latin American countries realize that it pays to be fiscally cautious. Latin American countries went through significant reforms in the 1990s that allowed governments to spend money more wisely, and provided them with reserves that gave them some security during the financial crisis. For the region in general, government debt as a percentage of GDP has decreased significantly.[27] They are in a better position, because now that they need to increase government spending, they have room to borrow.

Another important fact for Latin American countries is that central banks and improvements to financial institutions played a key role in

allowing these countries to be resilient in the financial crisis. In general, central bank performance across Latin America has been solid; many of the countries have gone from having inflation rates in the triple digits to inflation rates in the single digits. Lower inflation gives them more room to work with monetary policy. They can use expansionary monetary policy without causing significant inflationary pressures. Also, the improvement of financial institutions has been important. There has been a significant increase of credit, as well as financial regulation and supervision. This has allowed the financial system to remain relatively healthy during the financial crisis.

The next lesson is very important. Latin American countries after their reforms of the 1990s were able to build up the credibility of their institutions. Countries did not panic when the financial crisis hit. Even when the economic situation was poor, Latin American countries could pursue stabilization policies. The governments have more control, and the central banks can monitor inflation carefully.

The last lesson is that countries should not be afraid to ask for international help. During the financial crisis, many Latin American central banks worked with the Federal Reserve to insure that they would have enough foreign currency reserves.[28] Cooperation is very important. Until recently, Latin American countries were very reluctant to get help from the International Monetary Fund (IMF). In the 1990s, the IMF gave them loans, but attached stringent conditions. The IMF eventually changed that approach. It created a flexible credit line in the midst of the financial crisis. There is no stigma or conditions attached to it. Therefore countries can tap into it and without worrying about damage to their reputations. Mexico took advantage of this credit line in May of 2009, which helped it stabilize its economy.[29] Therefore, more Latin American countries should look into tapping that resource. The World Bank and the Inter-American Bank are also increasing funds available to deal with the financial crisis.[30]

There are several challenges that Latin American countries are likely to face in the future. The first challenge for policy makers in the region is that Latin America's fate depends on the recovery of developed countries. Latin American countries can use fiscal stimulus, but that can only go so far. Their economies depend significantly on their export sector, primarily the export of commodities. Global demand needs to pick up so that commodity prices rise, which will support the export sector in Latin America. Each country can implement its own policies, but in reality global demand is going to play a key role in allowing them to recover. If global demand does not recover quickly, then governments will face some restrictions with their expansionary fiscal policies because they will have fewer revenues to tap into it. They will eventually run out of the extra room that they have now.

Next, policy makers in the region may find it difficult to be fiscally responsible in the midst of a financial crisis if unemployment continues to increase. Latin American policy makers should ensure fiscal sustainability and solvency. If policies in Latin American countries start being perceived as unsustainable, then there is going to be capital flight and less investment. This would be a shame because there have been significant improvements in macroeconomic stability during the 1990s and 2000s.

Another reason that it might be more difficult for Latin American countries to be fiscally responsible is that many Latin American countries have very small tax bases. In order to ensure that they remain fiscally responsible and fiscally solvent, they should implement tax reforms that improve their tax systems. It has been suggested by some that they create an independent agency to monitor government spending and the fiscal stimulus to make sure that solvency is maintained.[31] Other Latin American countries should consider something similar to the Brazilian Fiscal Responsibility Act, as well as stabilization funds similar to Chile's.

Finally, it is important for policy makers to keep in mind that they are dealing with Latin America. While small in comparison to previous crises, the current crisis is still a crisis. Latin America has a long history of instability, poverty, and inequality. According to the World Bank, poverty is around 33%.[32] The financial crisis may increase poverty by 15%. That could create some instability. There is some political instability rising up, so Latin American countries must make certain to maintain a stable environment by continuing the process of democratization and strengthening institutions that promote democracy. They need to be especially careful that social spending is targeted at the population at risk of falling into poverty. Latin American countries need to make sure that social spending is targeted in the right way.

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