Protecting Latin America's Gains through the Current Financial Crisis

PAMELA COX

The problems we are confronting in the current economic crisis are unprecedented in recent history. The global economy is expected to shrink this year for the first time since World War II. Global industrial production, which dropped more than 10 percent early this year, has been picking up but at considerably lower levels than before the crisis. World trade is on track in 2009 to record its largest decline in 80 years.

The financial crisis will have long-term implications for developing countries. Debt issuance by high-income countries is projected to increase dramatically, possibly crowding out many developing country borrowers, both private and public. There are few lenders willing to finance enlarged deficit spending at a time of global crisis and many of the traditional intermediaries of Latin American debt (notably investment banks) are currently out of commission or out of business. Developing countries that can still access financial markets face higher borrowing costs and lower capital flows, leading to weaker investment and slower future growth.

It is not clear when and how we will emerge from the current crisis. Nor is it apparent how the global economy will be reshaped by the crisis. But one universally emerging trend is an increased reliance on the state in ways unthinkable only a few years ago.

Pamela Cox *is the World Bank's Vice President for Latin America and the Caribbean Region. From 2000 to 2004, Ms. Cox was Director of Strategy for the Africa Region. Previously, she served as Country Director for South Africa, Botswana, Lesotho, Namibia, and Swaziland and Chief of the Country Operations Division in East Asia. She also has served as Chief of the Agriculture and Environment Operations Division. Dr. Cox received a Masters of Arts in Law and Diplomacy and Ph.D. in Development Economics and Policy from the Fletcher School.*

COMMODITIES BOOM AND BUST: THE DECOUPLING THAT WAS NOT

The crisis brought a string of five years of strong economic growth in Latin America and the Caribbean—averaging five percent per year—to an abrupt end. This growth was fueled in part by the adoption of responsible macro and fiscal policies and in part by the boom in commodity prices.

Before this downturn, for the first time in 30 years, several Latin American countries were able to make significant progress in reducing poverty and inequality. For Brazil, Chile, Argentina, El Salvador, Colombia and others, poverty reduction was achieved in part due to the fiscal space provided by improved macroeconomic policy. This allowed for more intelligent social spending that focused on those who needed it most, produced budget surpluses and never-before-seen increases in international reserves, created a more attractive investment environment, and led to lower inflation rates. Indeed, it seemed as if the region had finally "taken off" on the growth path, following the model of the Asian tigers.

Those familiar with Latin America and the Caribbean know that the region is no stranger to financial shocks: it suffered severe financial crises in the 1970s, 80s, 90s and from 2001-02. People in the region know too well the pain of losing savings, banks collapsing, dramatic depreciation of the local currencies, and the resulting poverty, unemployment, and negative growth.

But this time around, Latin America did not experience the same declines in trade, stock markets, and currencies as other regions. From the eruption of the subprime crisis in August 2007 to the fall of commodity prices beginning in mid-2008, economic indicators suggested that the region would weather the global crisis relatively unscathed. While the subprime crisis roiled the economies of the industrialized world, the economic outlook for Latin America and the Caribbean was strong. Currencies were strengthening, the central banks continued to accumulate reserves, and levels of direct foreign investments were maintained while portfolio capital inflows rose. Growth prospects for 2008 were revised upwards, and Peru and Brazil joined the "investment grade" club of countries. Many interpreted this to indicate that Latin America had successfully de-coupled itself from the advanced economies.

However, the real explanation for this oasis in the midst of the crisis was the boom in commodity prices, which continued for a few more months as demand—particularly from Asia—remained strong. The link between Latin American growth cycles and commodity price cycles is powerful. According to World Bank's Latin America Chief Economic Office, more than 90 percent of the region's population depends one way or the other on commodity exports. This boom more than offsets the negative impacts to the region, such as a decline in trade and remittances, which resulted from the financial turmoil and the economic slowdown in many developed countries.

Yet, by mid-2008, commodity prices began collapsing and the de-coupling theory melted away. Commodity prices were now moving adversely for Latin America, reinforcing—rather than offsetting—the trend coming from the global slowdown and financial turmoil. After Lehman Brothers filed for Chapter 11 bankruptcy protection on September 15, 2008, a "perfect storm" took shape and the region was fully drawn into the global downward spiral. The clear impact of this change was reflected in the precipitous drop of many indicators, including industrial production (Figure 1).

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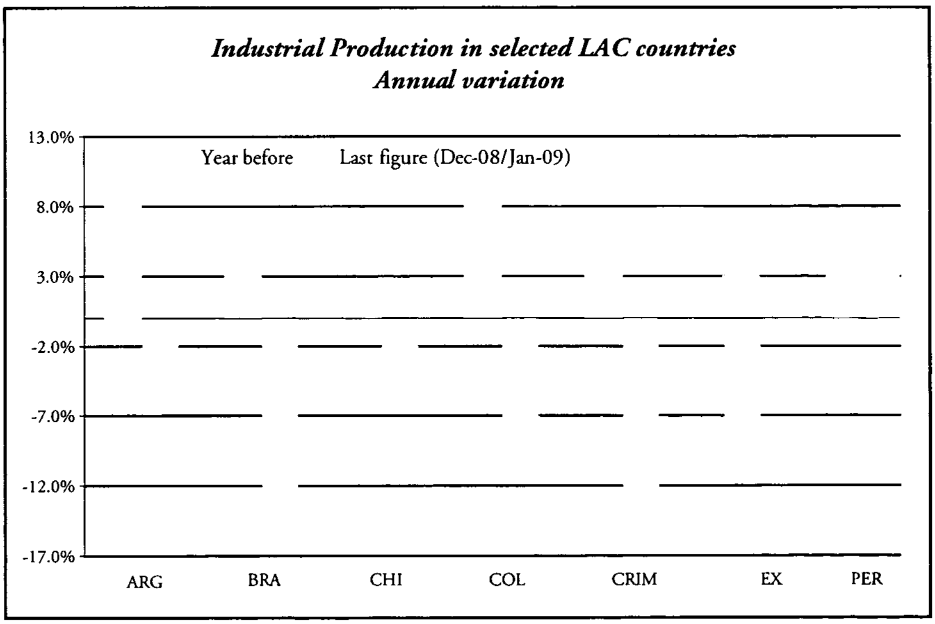
Figure 1:Industrial Production in Selected Countries[1]



The region's stock markets fell sharply as investors' risk thresholds receded. Brazil and Chile saw currency depreciations of 40 and 30 percent, respectively. Commodity prices plunged 50 percent to levels last seen in

January 2007. Remittance flows have contracted almost 15 percent, with particularly negative effects in Mexico, Central America, and the Caribbean.

Households, companies, and governments in nearly all countries in the region have started to feel the effects of the credit crunch, though in different ways. Mexico and other Central American countries risk suffering the most from a long recession in the United States as their economic and trade relations are closely tied to the U.S. economy. Mexico, for example, could contract as much as six percent this year. In South America, the collapse of commodity prices hit Brazil initially quite hard. Argentina, whose substantial agricultural sector was also affected, nationalized its pension system to help maintain fiscal balance. Oil exporting nations such as Venezuela and Ecuador will need to adjust spending in response to declining revenues resulting from the steep drop in international oil prices, (from US$147 per barrel in July 2008 to around US$52 per barrel in April 2009). The countries that will be less affected will be those that have managed to save during the boom times, and those with more diversified markets and stronger ties to Asian economies, such as Chile, Colombia, and Peru. Overall, countries with autonomous central banks, with inflation-targeting regimes, and solid fiscal processes are also better positioned.

In September 2008, the consensus forecast for Latin America, an average of multiple sources compiled by the World Bank, was 3.7 percent growth for 2009. In January 2009, by contrast, the consensus forecast envisioned only an anemic one percent growth. More recently, the consensus forecast dropped to minus 2 to 2.5 percent. During its strong growth period from 2002-2007, Latin America managed to lift 52 million people out of poverty. Today, this trend is in danger of being reversed. World Bank projections indicate that eight million people in the region could fall into poverty by the end of 2009 as a result of the impact of the global crisis (Figure 2).

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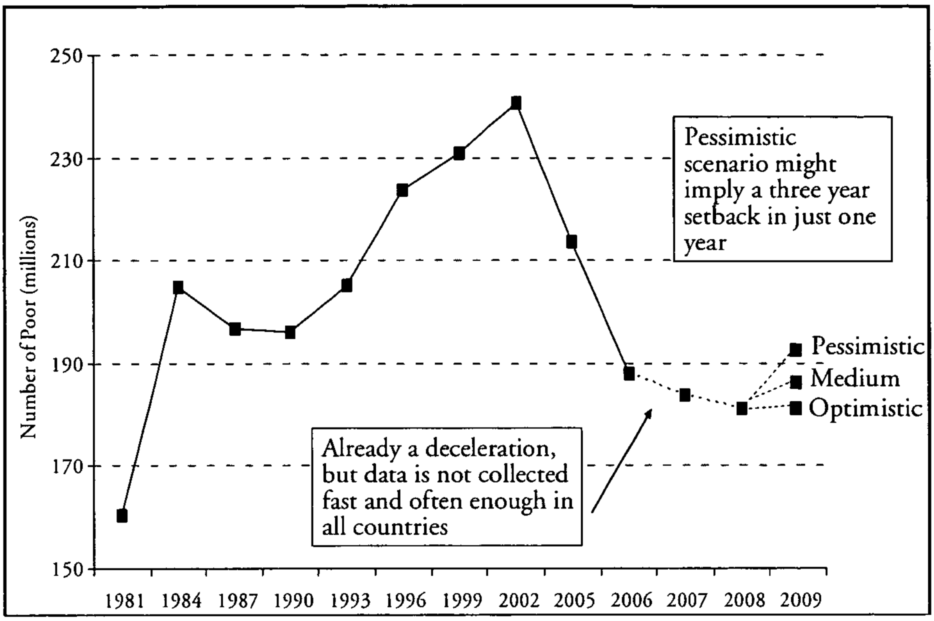
Figure 2: Number of Poor (in) Latin America (Using $4/day measurement)[2]



2009: PRIORITIES TO ACCELERATE A REGIONAL RECOVERY

Some countries in the region will be able to withstand this crisis better than they have in the past because for years they have been implementing prudent macroeconomic and financial policies, including stronger financial sector regulation. Nevertheless, policymakers will face significant challenges managing the short-term difficulties of the crisis while also maintaining conditions for long-term growth. We believe that human concerns should go hand in hand with economic ones. That is why World Bank President Robert Zoellick has insisted since the beginning of the crisis that the international community needs to act in support of the developing world to ensure that the global financial disaster does not become a human and social crisis. Timely and decisive actions are imperative to protect the social gains made in Latin America and the Caribbean during recent years. There are at least five key areas for action that governments, with the support of multilateral organizations, can consider under these extraordinary circumstances:

Support for the Most Vulnerable

The region already is moving ahead with well-targeted support to the most vulnerable by implementing social protection packages that ensure broad access to health insurance services, protection of public spending on key areas such as nutrition and vaccines, and additional targeted cash support. The recent years of fiscal discipline have allowed these countries the budgetary space necessary to fund these expenditures. Many countries in the region maintain social protection networks, such as Brazil's "Bolsa Familia," Mexico's "Oportunidades," and similar programs in Colombia, El Salvador, Jamaica and Nicaragua. These programs are now being expanded to mitigate some of the worst effects of the economic crisis.

Targeted Stimulus Spending

Second, for those countries that have the fiscal ability, temporary financing of emerging deficits is crucial to avoid cuts to spending on social protection, health, education, and vital infrastructure. Where savings or prudent borrowing from multilaterals permit, well-designed spending increases may help close the gaps in human and physical capital while boosting domestic demand. Multi-billion dollar stimulus packages have been set into motion in Argentina, Brazil, Mexico, and Chile to invest in infrastructure, protect jobs, provide credit, and promote consumer spending.

> *"Temporary financing of emerging deficits is crucial to avoid cuts to spending on social protection, health, education, and vital infrastructure."*

These programs can link short-term gains such as employment opportunities and increased consumption with long-term objectives such as greater participation in global trade through sustained investment in infrastructure, trade facilitation, education, and logistics.

Job Creation and Public Works Programs

Initiatives to create jobs through public works projects, programs boosting microcredit, self-employment initiatives, and small enterprise development, among others, are also critical. Together with retraining and training programs for the unemployed and wage and employment subsidies, these measures will not only have a direct human effect but will also contribute to the longer-term economic recovery.

Better Resource Allocation, Reforming Universal Subsidies

Countries in the region can take advantage of the present crisis to review policies on so-called "universal subsidies" that are going not only to the poor. The region spends between five and 10 percent of annual GDP on subsidies. Approximately one-third of this is captured by the top income-earning 20 percent of the population. If redirected to programs like Conditional Cash Transfers, such an amount could triple stipends to families to ensure that children and youth get regular health check-ups and attend school.

Restoring Global Trade

Countries in the Americas are still committed to open trade. This was reflected in the calls from several regional leaders to avoid falling into protectionist policies during the Summit of the Americas in April. Beyond such positive statements, the crisis should become an opportunity to put a premium on trade competitiveness—even if only to preserve a slice of a smaller global trade market. Many of the long delayed reforms that make integration worthy, from infrastructure and logistics to tertiary education and property rights, will now become even more urgent.

GLOBAL CRISES REQUIRE GLOBAL SOLUTIONS: EMERGING ECONOMIES AS PART OF THE SOLUTION

The time when global agreements could be negotiated among a few rich countries is over. As World Bank President Robert Zoellick has said: "A more flexible and broadly representative multilateral group is needed to coordinate the crisis response. Sustainable and inclusive globalization is key—without it, our world will remain unstable, despite financial rescue packages." Regional powerhouses such as Brazil and Mexico are prepared to respond as responsible global stakeholders in the design of a new global financial architecture. The global community will also benefit from the knowledge of financial regulators who have made strides in improving supervision and regulation in these countries, and have learned the lessons of past crises.

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Clearly, opportunities to advance a common hemispheric agenda will be affected by the current economic circumstances. This is the main concern of the regional leadership, and as Brazilian president Luiz Inácio da Silva has indicated, the best thing the United States can do for Latin America today is to put its own economic house in order. Success with fiscal stimulus in the United States may help the region recover from the current downturn as many countries in the region are heavily dependent on the U.S. for trade and remittances.

In this crisis, multilateral financial organizations—including the World Bank and regional banks—must play a coordinated counter-cyclical role to provide funding as other sources of financing dry up.

The World Bank is increasing financial support throughout the developing world, including lending to middle income countries through the International Bank for Reconstruction and Development (IBRD) ($100 billon total from 2009 to 2011), grants and concessional lending for low-income nations through the $42 billion International Development Association (IDA) Fund, and loans to the private sector through the International Finance Corporation (IFC).

One new financial product developed for middle-income countries is a committed credit line, the Deferred Drawdown Option (DDO). This provides an immediate source of liquidity with which several Latin American countries—Colombia, Mexico, El Salvador and Uruguay, among others—can respond to shocks. The DDO reflects one on the World Bank's efforts to assist governments in providing positive market signals by creating a reserve source of financing.

During the fiscal year that ended in June, the World Bank and the IFC almost tripled lending to the region. We have provided almost $17 billion, and this year we expect to do the same. These additional resources are critical to sustain jobs and social gains, boost ongoing public sector programs and inject liquidity into countries where needed.

Action is needed now and responsible leadership is crucial. This year may be remembered as the year that abruptly derailed Latin American growth; or as the year when recession inspired smarter and more widespread development. Which way it goes depends greatly on how policymakers respond, and whether they see opportunity behind the crisis and proactively take on issues that were holding Latin Americans back well before subprime became a household term.■

ENDNOTES

1 World Bank research data.
2 World Bank research data.
3 "Modernizing Multilateralism and Markets." Robert B. Zoellick, President, the World Bank Group. Speech to The Peterson Institute for International Economics, Washington, DC, October 6, 2008.
4 "From Gleeful to Fearful in Latin America." *The New York Times,* October 2, 2008.