



## **The Impact of the Global Economic Crisis on Latin America**

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From 2003 to 2007, Latin America experienced an exceptional economic boom thanks to an unusual combination of world financial prosperity, sustained growth of international trade, extraordinary raw material prices and high capital inflows from emigrant workers. This boom was the most significant in over thirty years, specifically since the region's economic growth between the 1960s and early 1970s. It was a widespread process and indeed benefited small and medium-sized economies more than the region's two largest ones. In contrast with the situation since the debt crisis (and earlier in some cases), its social impact was also highly positive. Unemployment and poverty were considerably reduced, employment grew dynamically and was of a better quality and inequality was diminished in a large number of countries.

The region was not significantly affected by the first part of the international financial crisis which started in August 2007 in the United States with the subprime mortgage fiasco. Foreign financing was reduced and became more irregular. Furthermore, capital inflow growth from migrants started to decelerate as a result of fewer employment opportunities abroad, especially in the US construction sector. Rising raw material prices, however, sustained the boom in several countries throughout the first half of 2008. When this trend changed halfway through the year, therefore, it signalled the end of positive growth. The world crisis, enhanced by the collapse of the Lehman Brothers investment bank in the US in mid-September dramatically increased this trend.

### **1. Economic impact**

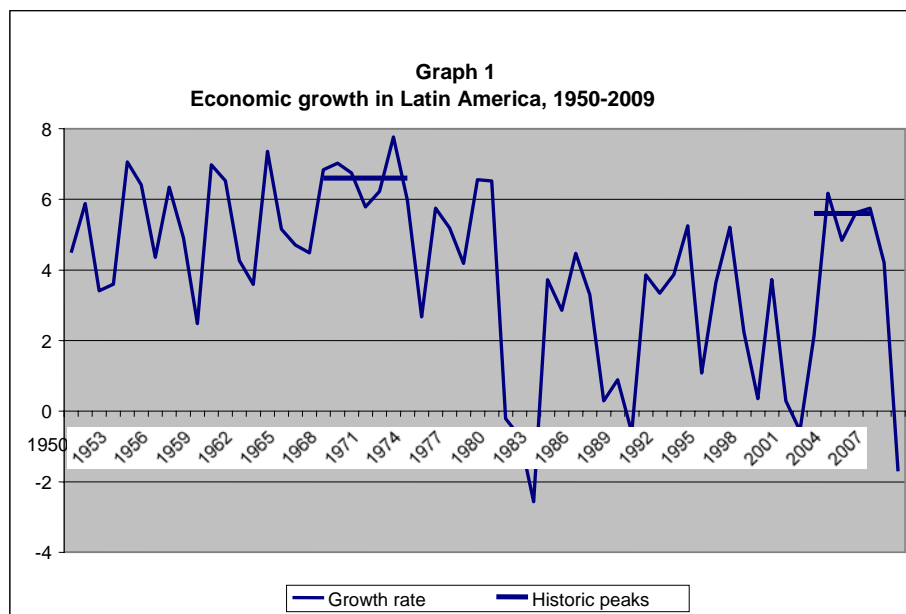
The economic impact of the world crisis, which took some time to be acknowledged, was enormous. The forecasts of all multilateral agencies (World Bank, ECLAC, IMF and UN) announce that the region's GDP will be falling by 1.5% (IMF) to 2.2% (the most recent estimate from the World Bank), with ECLAC and the UN predicting intermediate figures (falls of 1.7% and 1.9%, respectively). Some private organisations have made even more pessimistic forecasts. Furthermore, the crisis is widespread. Mexico is the most affected economy, but most of the region's countries will see their economic activity reduced.

From a historical perspective, this recession is worse than those of 1990 and 2002 and, according to the most pessimistic forecasts, could be worse than the post-war period in 1983, although possibly shorter in length (see Graph 1). The forecasts also show that what is lost in 2009 will only just be recovered in 2010, and the per capital GDP will not return to 2008 levels until 2012. In other words, this crisis will set development back by four

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years. It is not so bad as the “half a decade lost” in 1998-2003 and certainly better than the “wasted decade” of the 1980s. Some scenarios are, however, more pessimistic.



Source: ECLAC

The way this crisis has spread shows significant differences with the past, and some surprises. Notwithstanding some negative forecasts, the reduction in capital inflow from migrants has been relatively moderate (5.2% and 6.7% in the last quarter of 2008 and the first of 2009 relative to the same periods a year earlier).

The financial channels have also been weaker than was initially expected. In contrast with the three previous episodes (the debt crisis, the Mexican crisis of 1994-1995 and the financial crisis affecting emerging economies that first arose in Asia in 1997), none of the region's countries has now seen a collapse of its internal financial system. Risk margins, and consequently the cost of foreign financing, started to increase in mid-2008 and exploded with the world financial collapse in September, but peaked towards the end of October and has since been considerably reduced. In recent weeks, it was around 9%, some two percentage points higher than during the boom, but much lower than the typical rate found from mid-1998 to mid-2003, during the financial crisis affecting emerging economies. The availability of foreign financing fell drastically in mid-2008 and dried up altogether in September, but has been gradually improving since the beginning of 2009. In the critical weeks of the financial debacle, there were important losses on the derivative markets, especially in Brazil and Mexico, which brought pressure to bear on international reserves. However, they were only marginally reduced and remain at very high levels. Finally, although the stock markets collapsed in mid-2008, they remained at higher levels than in other regions and participated in the world stock market boom of April and May 2009.

From a historic perspective, although the financial sectors of industrialised countries were at the eye of the storm, in strictly financial terms, this has been a much worse crisis for Latin America than the debt crisis and the financial crisis affecting emerging economies. This is due to both external and internal factors. In external terms, the fact that the crisis arose in the industrialised world generated an active response from the economic authorities, which was not found in the past in crises arising in the developing world

(except for the Mexican crisis of 1994-1995). The internal reasons are associated to the fact that Latin American economies are macroeconomically stronger, as discussed in the following section.

In commercial terms, the current crisis is much more profound. The collapse in world trade is unprecedented since World War II and is even more severe than the situation at the start of the Great Depression in the 1930s. In the first quarter of 2009, the value of world trade was 31% less than in the same quarter of 2008, because of both the drop in raw material prices and the heavy drop in the world demand for manufactured goods. Although basic product prices partially recovered in the second quarter of 2009, a similar trend is not yet clear for manufactured goods, as shown in the 24% reduction in Chinese exports in April and May relative to the same months of 2008. Both the IMF and the UN are expecting a 11% reduction in world trade volumes in 2009, and no growth, or at best a very partial recovery, in 2010.

Latin America has formed part of this process. Its exports fell by 26% in the first quarter of the year, relative to the same period in 2008. As the magnitude of the current recession found in the region cannot be explained by the financial crisis, the present situation could better be described as a commercial crisis. In other words, although the region has reduced its financial vulnerability, its commercial vulnerability is much greater than in the past.

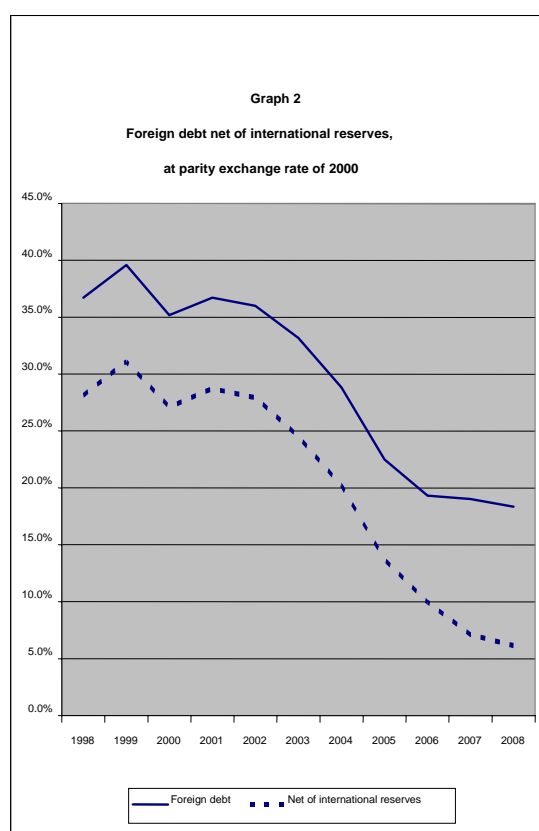
This means that, unlike the situation in Mexico after the 1994-1995 crisis or in Latin America as a whole after the 1998-2002 emerging economy crisis, the possibility of overcoming the recession thanks to export growth is limited. From a broader perspective, this presents policy-makers with important questions concerning the development strategy that, for a quarter of a century, has been emphasising the importance of economies forming part of world trade and investment trends. This issue is revisited in the last section of this document.

## **2. The response to the crisis**

It was generally agreed in the last few months that anti-cyclical macroeconomic policies were required in response to the crisis, on both a regional and global scale. It was also recognised that developing countries have more limited possibilities in this respect, basically because financial and trade flows have pro-cyclical effects on such economies. The different multilateral banks have therefore been active supporters of such policies, including the World Bank, the IADB, the ADC and the CABEI. The IMF has received unprecedented resources and substantially innovated its financing strategy, particularly with the creation of the Flexible Credit Line in March, which has already been used by Colombia and Mexico. The Federal Reserve also created lines of credit, through currency swaps, for the central banks of Brazil and Mexico, and China has provided Argentina with similar resources.

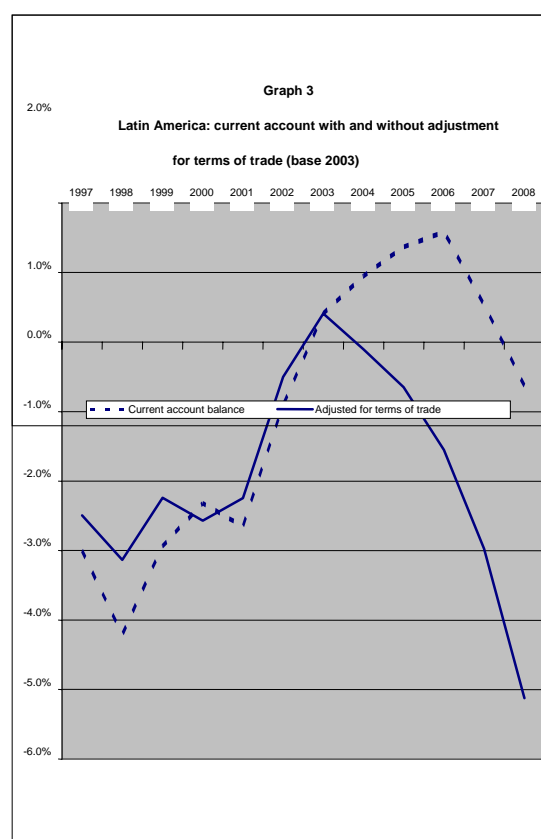
Furthermore, Latin America has wider margins than in the past for adopting anti-cyclical macroeconomic policies. The most important change can be found in the monetary and currency exchange field. The sudden interest rate increases characteristic of previous crises, often due to attempts to prevent depreciation of national currencies, have been avoided. On this occasion, central banks have been able to lower interest rates, provide the financial system with resources (reducing bank swaps, among others) and, in most large countries, they have let the exchange rate depreciate (with some intervention to prevent an uncontrolled adjustment process). The countries with development banks have also used them to support credit reactivation.

The basic reasons enabling this action to be taken were two factors which have hindered the transmission of the crisis through financial channels: the heavy reduction in governmental foreign debt and high levels of international reserves. As shown on Graph 2, in 2008, foreign debt net of international reserves, was equivalent to 6% of the GDP, compared to nearly 30% prior to the previous crisis. This was due to several factors. The first is the development of domestic bond markets, which have become a dynamic source of public financing in many countries. The second is the decision of most central banks to absorb excess foreign financing by accumulating international reserves, as shown by the fact that the two periods of abundant foreign financing (from mid-2006 to mid-2007 and the first half of 2008) also saw heavy accumulation of reserves. The third was the current account surplus. With a few exceptions (Argentina, Bolivia and Venezuela), however, this was not the most important source of accumulation of reserves. Indeed, the region's slight current account surplus during the recent boom is practically entirely explained by the improvement in terms of trade, as if the current account is estimated with the terms of trade prior to the boom, the decline was considerable during the period of prosperity (Graph 3).



Source: Author's calculations based on ECLAC statistics. For Chile, this includes.

resources from sovereign funds



Source: Author's estimated from ECLAC data.

In the tax field, there have been multiple announcements of anti-cyclical policies, but there is not much margin. The basic reason is that, although fiscal deficits remained at moderate levels and public debt levels are more favourable in nearly all countries than prior to the previous crisis (the most significant exceptions are Argentina, Colombia, Uruguay and, marginally, Brazil), these results are not due to spending austerity during the previous boom but to exceptional public income levels. Public expenditure grew faster than long-term economic growth and, in this respect, was pro-cyclical, with some exceptions, the

most important of which is Chile, but also El Salvador and Guatemala. It will not be easy, therefore, to maintain these rates of public expenditure growth during the crisis. However, with acceptable growth rates, expenditure could play a stabilising role and programmes could be launched to relieve part of the impact of this crisis on low income sectors. Indeed, such programmes have been instated in several countries.

### **3. The political implications**

The political implications of this crisis will first be found in a decline in social indicators. The information provided in the June report on employment published jointly by ECLAC and ILO, shows a fall in the employment rate, a considerable drop in the formal employment growth rate (social security contributors) and an increase in unemployment in the first quarter of 2009 relative to the same period in 2008. However, the impact is still modest and compatible with modest growth in employment, albeit with some important exceptions. The situation in Mexico is a cause for concern, as the country could be facing one of the most severe labour crises in the last few decades (among other things, due to the radical change in migratory conditions in the US), and the same applies to Colombia, where the unemployment rate has increased to one of the highest in the region. With regards to poverty, the UN has projected an increase of 3.6 million people living in extreme poverty in Latin America; this effect is also modest and susceptible to focalised policies. The impact on employment and poverty will increase, however, if the crisis lasts for long. Consistent with these as yet modest effects, there appear to have been no important political mobilisations associated to the crisis to date.

More significant is the switch to more active ideas of the role of the State, as part of a worldwide process. In Latin America, however, this was occurring before the crisis, as seen in several regimes clearly identified as leftist (with different variants), although there is also more pragmatism concerning the role of the State in central and right-wing governments. One interesting aspect is the renewed attention paid to the role of the domestic market and development banks. Brazil is a pioneer in both these issues. Anti-cyclical packages refer precisely to how to activate domestic demand in an unfavourable economic situation. Development banks would be the most important way in which to renew interest in industrial policy (or productive development policy in general), but so far this process is only showing strength in Brazil.

The most interesting question for the future refers to what will drive the region's economic growth. After more than a quarter of a century promoting a strategy based on insertion in international trade and investment currents, the collapse of world trade has generated major questions, which will become increasingly evident if international trade takes some time to recover, which is more than likely. If this happens, countries or regions with important domestic markets will be better off, as they were during the Great Depression in the 30s. Like then, this may be forced by the facts rather than by ideas, which in general continue to be open.

There are obviously other alternatives. It appears that China will be a driving force in Asia, something that the countries closer to the US and Europe, such as Latin American countries, do not have. It will be important to do more business with China, but it will depend on the ability to close the huge commercial divide with the Asian giant and diversify exports to that destination, as for Latin America they still depend on a series of basic products (soy, copper, oil and iron mineral).

The “domestic” market of Latin America is its regional market. This is particularly true for the smallest economies. Regional political differences, as shown in the Andean Community crisis and weakness in other processes, have become a major obstacle. But there are also economic factors at stake. As in the previous crises, the reduction in intra-regional trade is enhancing the crisis, and exchange rate policy differences continue to be an important drawback preventing further integration (due to dollarization, the only adjustment option for Ecuador is to limit trade, and this affects its regional partners).

Nonetheless, some initiatives appear to be progressing, especially those related to energy integration. There are also intra-regional payment proposals, including an initiative by Argentina and Brazil aimed at enabling payment in their own currencies (a mechanism which could spread to all ALADI Reciprocal Payment and Credit Agreement members) and the ALBA Sucre arrangement. But political differences are also in play here. For instance, the Sucre initiative could be adopted through ALADI (Latin American Integration Association), possibly with the collaboration of the Latin American Reserve Fund (FLAR), but the agents involved appear to prefer ALBA for political reasons. The region has the best regional financial cooperation mechanisms in the developing world (ADC, CAMEI, the Reserve Fund and the ALADI payment convention), which could be enormously strengthened by the crisis. In this respect, the most important incomplete task is to transform the FLAR into a true Latin American Reserve Fund, as its name implies.

Regional cooperation, therefore, needs an important political effort to make use of the opportunities provided by this situation to foster regional integration efforts. But this necessarily requires the region’s countries to overcome their political differences.

The relative absence of Latin America from major debates concerning international financial reform is also significant, as is that of the rest of the developing world in generation (with the possible exception of China). Regional members of the G20 are in an excellent position to construct an agenda which, while representing a consensus among themselves, is capable of mobilising a truly regional proposal.