How Will Latin America Fare after the Current Crisis?

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Before the world economic crisis began in mid-2008, each country in Latin America had achieved five consecutive years of economic growth. For a region best known for being economically and financially volatile, this was an achievement not seen since the 1970s. However, the expansion of the financial crisis from industrial countries to emerging markets diminished optimistic expectations of sustained growth for the region.

Unquestionably, the crisis is having a negative impact on Latin America. Opinions vary regarding Latin America's ability to deal with this crisis, as the region still has a long way to go in implementing reforms and policies to ensure sustainable and equitable economic growth. Notwithstanding differences in views, at the time of this writing Latin America's performance in terms of maintaining economic stability during the international crisis has been far superior relative to the performance of some other regions in the developing world, especially Eastern Europe, and to its own performance during previous crisis episodes.

In my view, how Latin America fares after the crisis will depends on policymakers' ability to (a) identify, understand, and act upon the unique characteristics that distinguish Latin America from other emerging markets and (b) extract lessons from the current global economic crisis. This paper addresses these two points and is organized as follows. First, the paper discusses the characteristics that distinguish Latin America as a region. Second, it outlines the lessons learned from the global economic crisis. Finally, it briefly references gaps in the economic policy agenda that should be filled to strengthen the region's current marked-based growth model.

What distinguishes Latin America from the rest of the emerging markets?

Similarities with other regions (and differences among individual countries) notwithstanding, three characteristics distinguish Latin America from others in the developing world: Latin America is the most financially open, is the most democratic, and has the most unequal per-capita income distribution. These three characteristics are explored below. (The interested reader may find a further discussion of these in my book *Growing Pains in Latin America: An*

Economic Growth Framework as Applied to Brazil, Colombia, Costa Rica, Mexico and Peru, [Washington, D.C.: Center for Global Development, 2009]).

1. It is the most financially open region

Since the early 1990s, the countries in Latin America have increased their capital account openness to the point that by the mid-2000s, the region may have been the most financially open region in the developing world. Only the developed countries are more financially open than Latin America. This high degree of financial openness, which started in the late 1980s with the introduction of the Brady Plan, has led to an increase in both Latin America's financing capacity through international capital markets and its vulnerability to changes in foreign investors' perception of the financial and economic risks.

This increased vulnerability associated with major capital account liberalization has implied a need to maintain macroeconomic stability *on a continued basis* in order to achieve sustainable economic growth. Any deterioration of macroeconomic indicators may quickly increase investors' perception of risk, which will lead to diminished capital inflow and higher local interest rates, which ultimately reduce investment and growth.

Latin America's interest rates are highly sensitive to fluctuations in foreign investors' perception of risk, mainly because local financial markets are underdeveloped and national savings rates are low. Thus, sharp decreases in external financing cannot be offset by internal sources.

The current global financial crisis is testing Latin America's decision to undertake the market-based discipline that financial openness requires. Yet despite the capital outflows and lower growth in 2009, there is no evidence of a reversal in the capital account liberalization trend of the last two decades. All of the indicators seem to point toward continued financial openness in the region. In most Latin American countries, economic authorities evaluated financial openness and found that the benefits justified the risks involved.

2. It is the most democratic region

The degree of democratization in Latin America has increased dramatically in the past three decades, mainly because the military regimes were overthrown in the 1970s[1]. The growth of democracy has played a significant role in the reform process of the market-based economies, because the reforms would be unsustainable if their benefits were not shared by a large share of the population. If voters do not feel they are represented and do not benefit from reforms, they could use their voting power to prevent, stop or rescind reforms necessary for economic growth.

This fact is particularly relevant in the current financial crisis, since negative growth and higher unemployment could deepen the discontent that existed even before the crisis started toward market-based reforms and policies.

3. It is the most unequal region

Since the 1960s, Latin America has become one of the most unequal regions with respect to income distribution. The motivation to narrow this gap is not only social, but also economic. Evidence suggests income inequality, above some level, may hinder growth in a country. There

[1] The recent events in Honduras are an exception in the region.

is also evidence of a negative relationship between inequality and the reform process in Latin America.

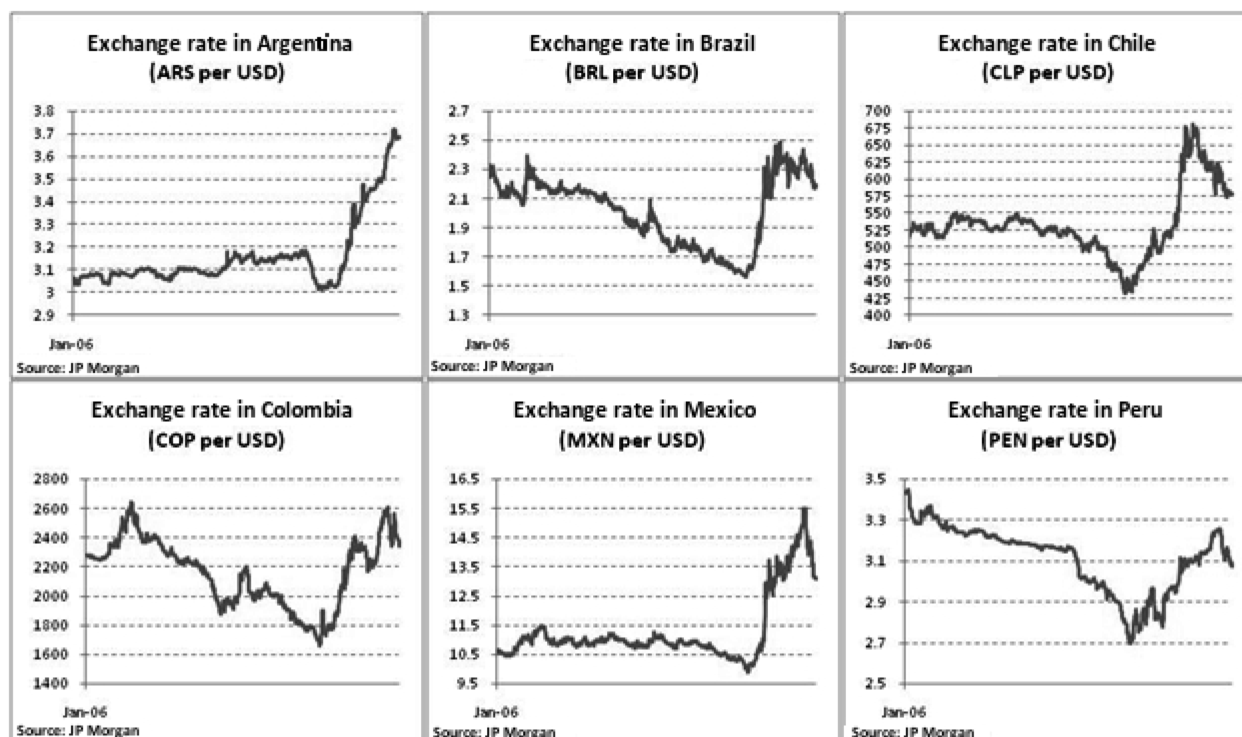
High inequality in income distribution, given democratic improvements, reinforces the earlier conclusion that economic growth is only sustainable if it is shared by a larger segment of the population. This requires implementing social policies concurrently with promarket reforms. Given the international financial crisis and its effects in the region, the reinforcements of social protection mechanisms are essential.

The combination of these three unique characteristics of Latin America implies big challenges. It is thus important to implement policies, reforms and regulations that account for these three characteristics. Later I will discuss examples of needed policies.

What Latin America has learned from the crisis.

While Latin America has felt the impact of the crisis, with the exception of a few countries the effects have not been as devastating as were the effects of previous crises. [3] Among the many lessons we can take from the crisis, two deserve emphasis.

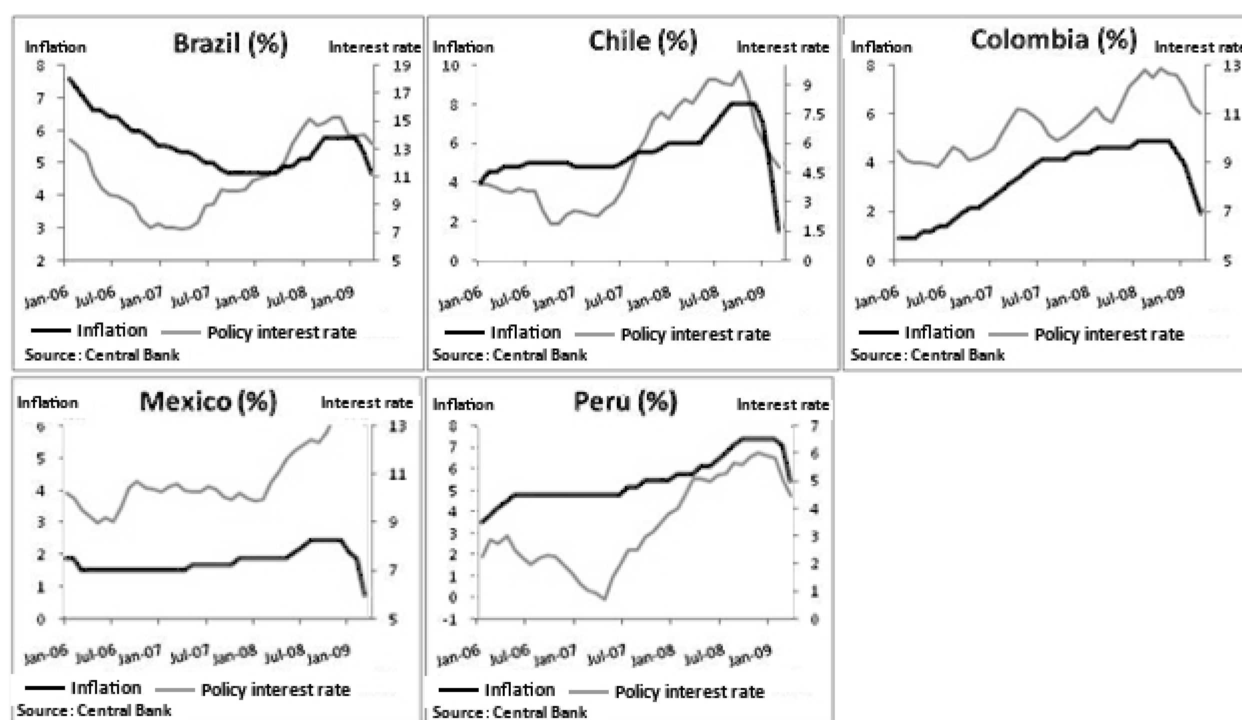
The first lesson is that the capacity to deal with a crisis depends on economic policies undertaken *before* the crisis. One crucial policy decision that allowed the region to minimize the impact of the crisis was the adoption of flexible exchange regimes within the framework of inflation targeting.



[3] The effects of the crisis are particularly adverse in Mexico and Central America.

This has allowed exchange rates to depreciate in response to the adverse international shock. Unlike past episodes, the monetary authorities have not needed to increase interest rates to defend overvalued exchange rates. In the past, countries in the region with fixed exchange-rate regimes have experienced severe exchange rate crises when investors perceived deep macroeconomic imbalances exposed by an adverse shock. Investors realized quickly that the increased interest rates and the huge international reserve losses necessary to defend exchange parity were not sustainable. Under these conditions, investors “bet” against the exchange rate parity in what is known as a “one-side bet.” The speculative attacks that occurred forced enormous devaluations of the currencies and ultimately resulted in deep financial crises.

This time around, most of the countries in the region did not need to defend their exchange rates following the adverse external shock. On the contrary, authorities allowed their currencies to depreciate while reducing interest rates to provide liquidity to the local financial systems. In stark contrast to past crises, many Latin American countries have been able to implement countercyclical monetary policies.



The second lesson is the need to maintain a stable banking system in the presence of an adverse external shock. Regulatory improvements in the financial system, a lower level of dollarization in the banking system, and very limited possession of “toxic” assets (generated by industrial countries) all helped prevent a Latin American banking crisis in the current period.

Achievements notwithstanding, risks in some banking systems in the region still exist. For example, some market indicators show significant increases in the probability of default of liabilities in Argentina and Venezuela. Still, for many Latin American countries, the increase in risk of default is less than in the industrial countries.

What still must be done to strengthen the market model?

As discussed, many countries in Latin America have maintained a market-based growth model even though the current international financial crisis has significantly decreased the growth experienced from 2003 to 2007. To allow the market-based model to achieve the desired objectives of sustainable growth, policymakers must act quickly and account for unique country and regional characteristics (mentioned in the first part of this speech). Three policy objectives stand out.

First, despite relatively healthy fiscal indicators throughout the region, only Chile has mechanisms in place to ensure *structural surpluses*—that is, a mechanism that allows for fiscal saving in "good times" and fiscal spending in "bad times." To strengthen the market model, countries must be able to implement **countercyclical fiscal policies** in conjunction with countercyclical monetary policies (which countries generally have the capacity to implement already).

Second, authorities should promote **deeper financial systems and more developed local capital markets**, as they can help improve internal savings. As discussed, Latin America's vulnerability to international financial shocks is accentuated, to a large extent, by low levels of savings. The current crisis has demonstrated this vulnerability, as corporations from large countries, specifically from Mexico and Brazil, have been hurt by lack of external financing and have not been able to fill the gap with internal private sources of finance.

Third, the current crisis shows that poorly used financial innovations can cause problems, not that financial innovations are inherently bad. Thus, it is important to **develop systems that protect against the financial risks** that the region faces. Accumulating international reserves is an affective but expensive self-insurance mechanism, and the liquidity facilities of the IMF are helpful but not sufficient. Latin American countries must create, with the help of the private sector and multilaterals, financial instruments to insure themselves against a variety of financial risks. Proposals like the issuance of bonds indexed to economic growth or the terms of trade already exist, but they have not been sufficiently evaluated and analyzed.

Regarding financial regulation, Latin America's delayed implementation of Pillar I from Basel II has been appropriate because this international regulation is subject to significant modifications and has shown important shortcomings in design and implementation. To avoid financial crises, the priorities for regulation/supervision in the region must be (a) implement the Basel Core Principles such as improvements in transparency, accountability, and governance of financial institutions; (b) eliminate distortionary regulations such as the financial transaction tax or interest rates controls; (c) improve institutional quality that promotes sound access to financial services, such as property rights, honoring contracts, respect for creditors' rights, and independence of the judicial system; and (d) improve coordination between supervisors of different types of financial institutions.

Finally, the unique characteristics of Latin America underscore the importance of social issues. The effective provision of basic services like health, education, and infrastructure are necessary so that the majority of the population can benefit from economic growth and effectively

participate in the market economy. Without proper social considerations, the sustainability of the market-based growth model is uncertain.