Crisis in Latin America vulnerability and immunity

Raimundo Soto
Universidad Católica de Chile

The impact of the current crisis in Latin America

Pre-crisis

- Solid economic growth in the last 5 years (5.5% annual)
- Very high terms of trade (50%+ in largest countries)
- Inflation upsurge (12%) and then moderate deflation

The impact of the current crisis in Latin America

Pre-crisis

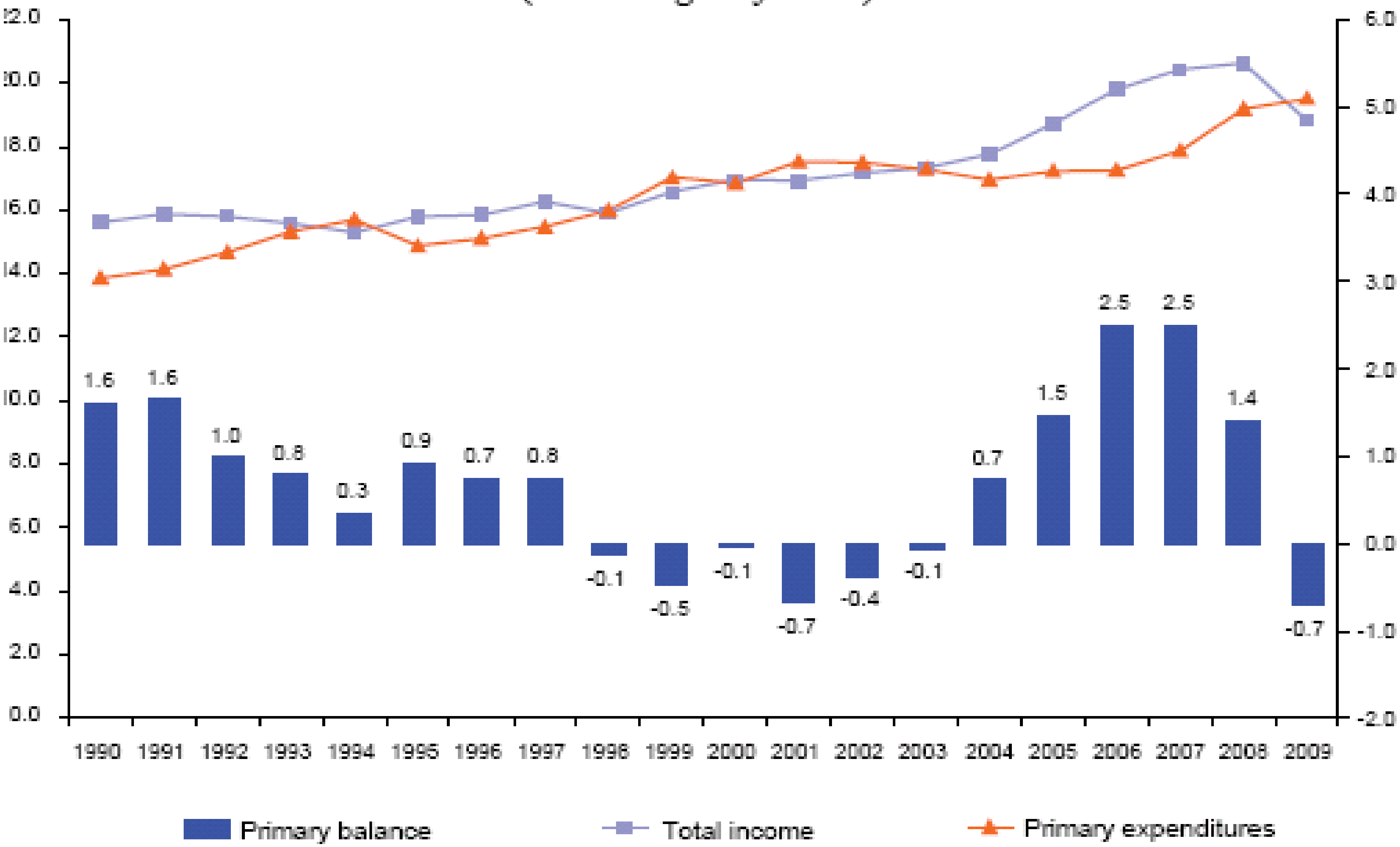
- Solid economic growth in the last 5 years (5.5% annual)
- Very high terms of trade (50%+ in largest countries)
- Inflation upsurge (12%) and then moderate deflation

Crisis Novelties

- Imported crisis (except in Ecuador & Venezuela)
- Solid external accounts (flow and stock)
- Solid fiscal accounts
- No toxic assets and reasonable financial regulation

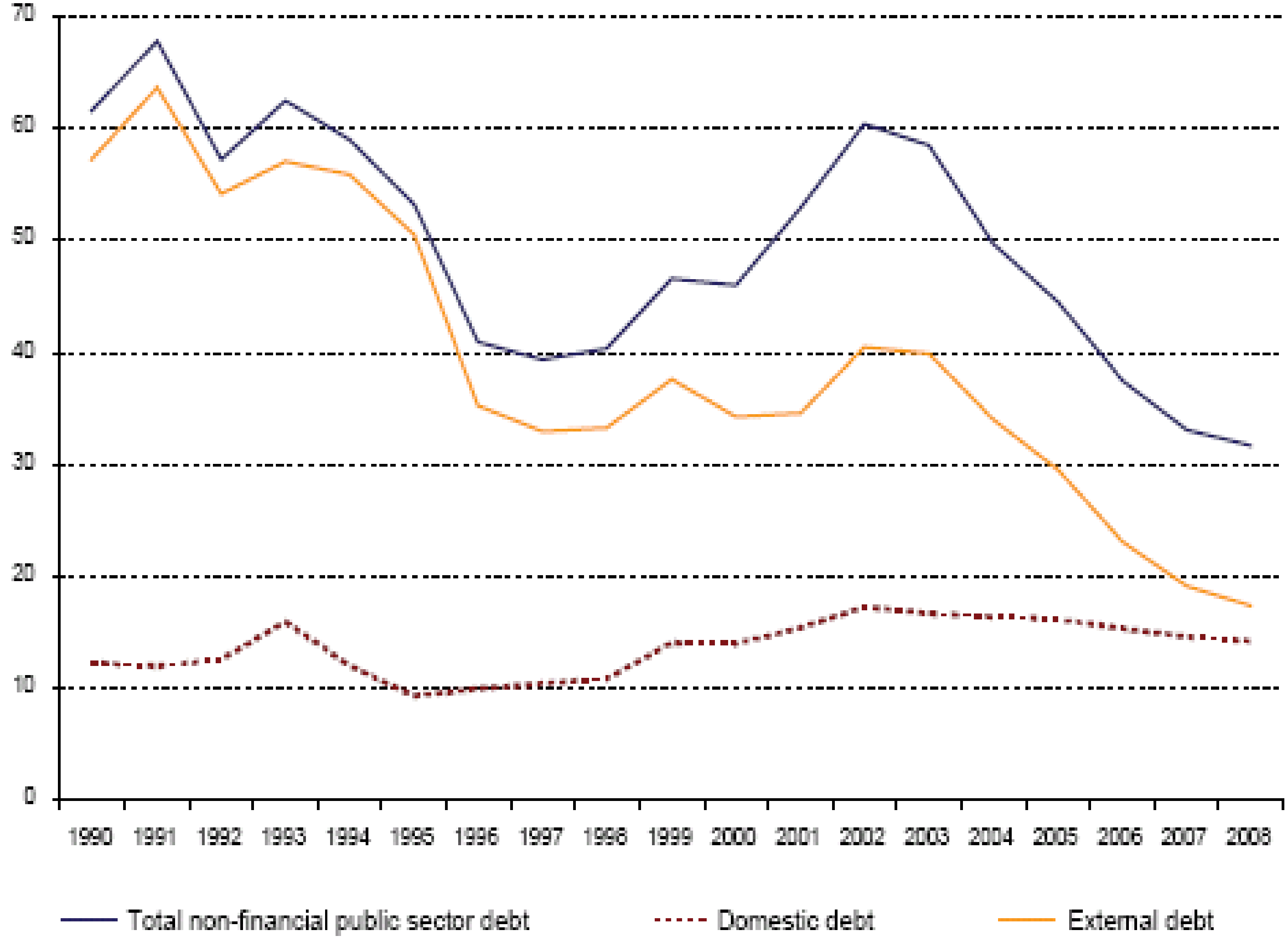
LATIN AMERICA: INCOME, EXPENDITURES AND PRIMARY BALANCE OF CENTRAL GOVERNMENT

(Percentages of GDP)



LATIN AMERICA AND THE CARIBBEAN: NON-FINANCIAL PUBLIC SECTOR DEBT

(Percentages of GDP)



Impacts of the downturn

- External accounts
  - exports (values, not volumes)
  - capital flows dried up (until 2009.1q)
  - no balance of payment crisis or currency collapses

Impacts of the downturn

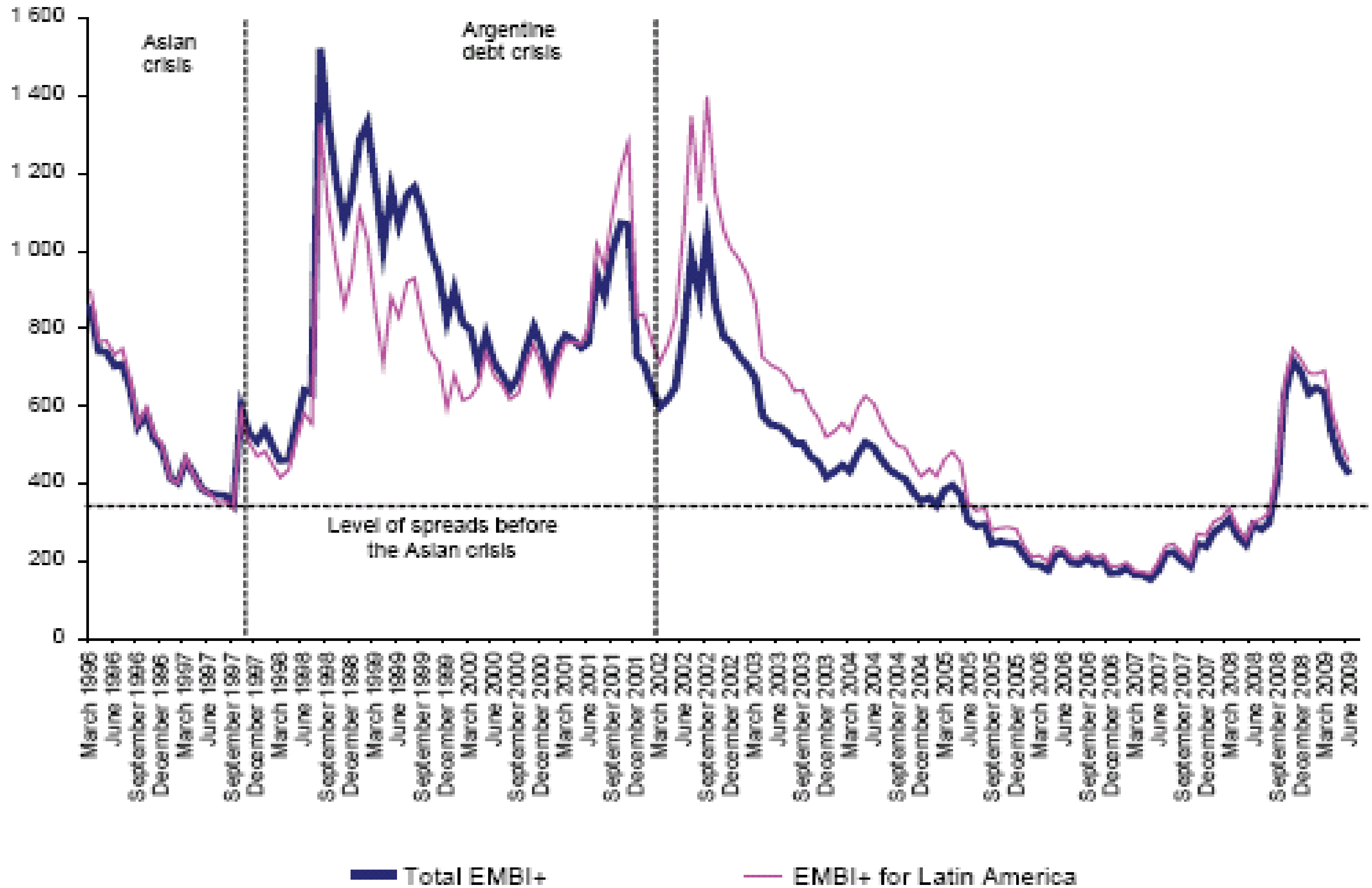
- External accounts
  - exports (values, not volumes)
  - capital flows dried up (until 2009.1q)
  - no balance of payment crisis or currency collapses

- Fiscal accounts
  - lower tax collection and commodity returns
  - low public debt and access to IFO money
  - enough space to unveil recovery plans

- Asset prices declined, no collapses.
  - Recovery started 2009.1q
  - Mutual and pension funds already recovered

EMERGING MARKET BOND INDEX: EMBI+ AND EMBI+ LATIN AMERICA

(Basis points)

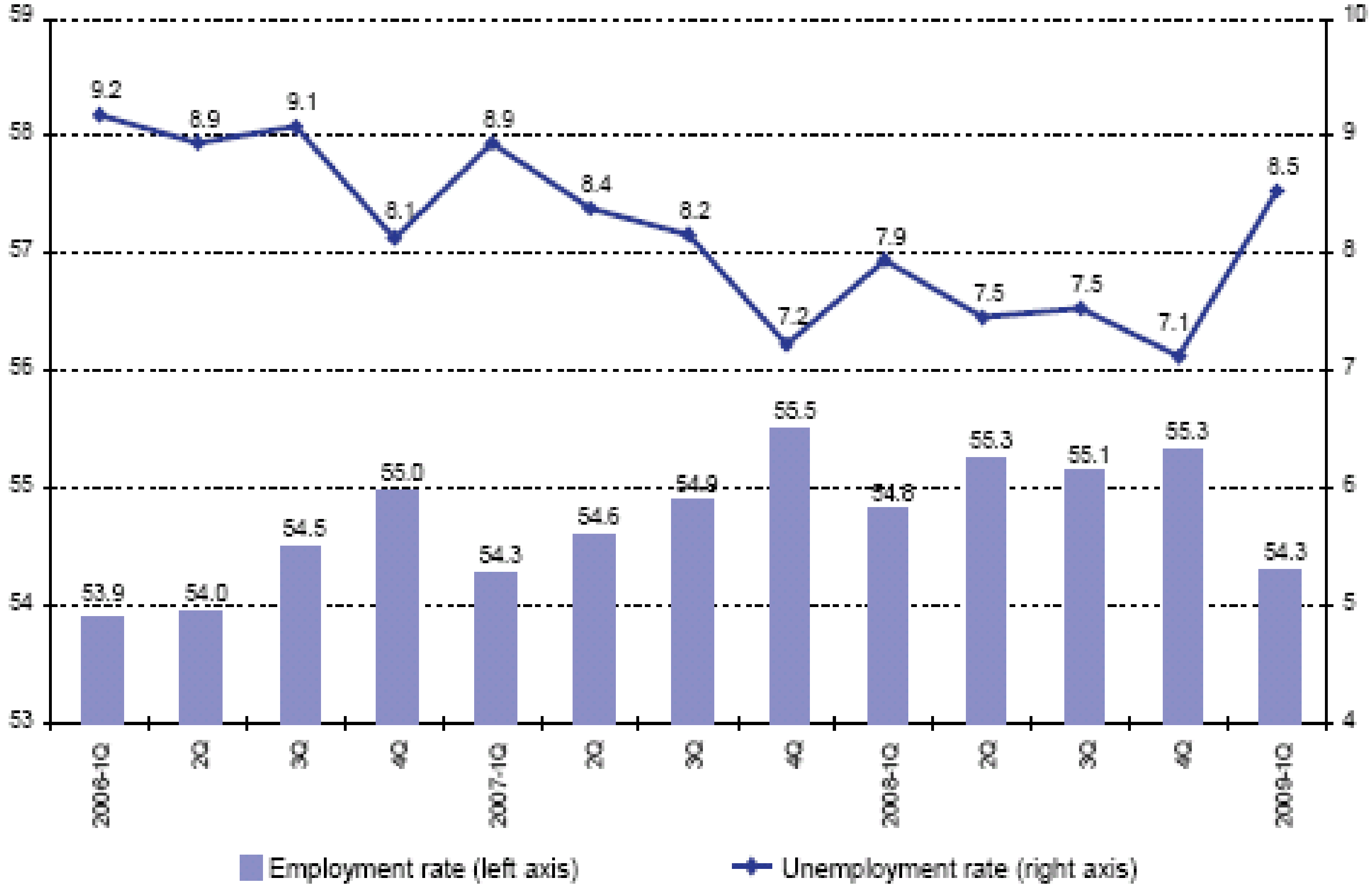


- Asset prices declined, no collapses.
  - Recovery 2009.1q
  - Mutual and pension funds already recovered

- Rising unemployment
  - but to one-digit levels

LATIN AMERICA (9 COUNTRIES): EMPLOYMENT AND UNEMPLOYMENT RATES, FIRST QUARTER 2006-FIRST QUARTER 2009

(Percentages)



So far its a mild crisis

So far its a mild crisis

for Latin American standards

Policy Responses to the Crisis

Standard policies (almost all countries)

Monetary Policy:	Reserve requirements Liquidity provision
Fiscal Policies:	Lowering taxes, increasing subsidies Increased expenditures
External Policies:	Tariff changes Subsidies to exporters Exchange rate policies

Standard wrong policies (some countries)

- Increase interest rates (Argentina, Venezuela)
- Administrative capital controls (Argentina, Ecuador)
- Exchange rate administrative management (Argentina)
- Impose taxes on investments abroad (Ecuador)
- External debt default (Ecuador and, before, Argentina)
- Nationalize pension funds (Argentina, Ecuador de facto)
- Increase domestic taxes such as VAT (Venezuela)
- Creation of ministries to "coordinate and guide" production (Argentina, Ecuador)
- Substantial increase public sector wages (Argentina, Ecuador, Venezuela) and minimum wages (Brazil, Chile)

Massive sector distortions (almost all economies)

- Subsidies for new/old cars
- Subsidies to agriculture
- Subsidies to SMEs
- Subsidies to housing
- Subsidies to exporters
- Subsidies to labor intensive industries
- Subsidies to public sector officials (of course)

Who pays for these distorting policies?

Were they really necessary?

Will transitory policies be removed?

Do these policies reduce vulnerability to crisis?

A naïve perspective on vulnerability

Two forms of vulnerability

- Consider my son (Lucas), 5, footballer, friendly, open, integrated to school community, park.
  - Infected and sick several times last year
  - Recovered very quickly
  - Build up defenses

- Consider my father, 85, retired, not-friendly, scarf and hat, no close contact with friends.
  - Seldom infected
  - Recovers very slowly (if at all)
  - Poor defenses

Recipe

Open the economy to achieve

financial integration
trade diversification
property diversification
increase opportunities to interact with other economies

and **benefit from growth** and welfare

AND …

Build up defenses.

Successful examples in Latin America:

Implement stabilization funds (Chile, Mexico)
Enact structural fiscal balance rules (Peru, Chile)
Modernize financial regulation (Chile, Colombia, Peru)
Exchange rate flexibility (all LA countries except a few)
Labor market flexibility (lot´s to do)
Diversify trade relations (free-trade agreements)
Modernize bankruptcy laws (Chile, Mexico)
Isolate technical policy decisions from politicians (Chile, Peru)

Will this isolate the country from the crisis?

No, but it will make it less painful for the future generations

How you come out of the crisis matters for the long run

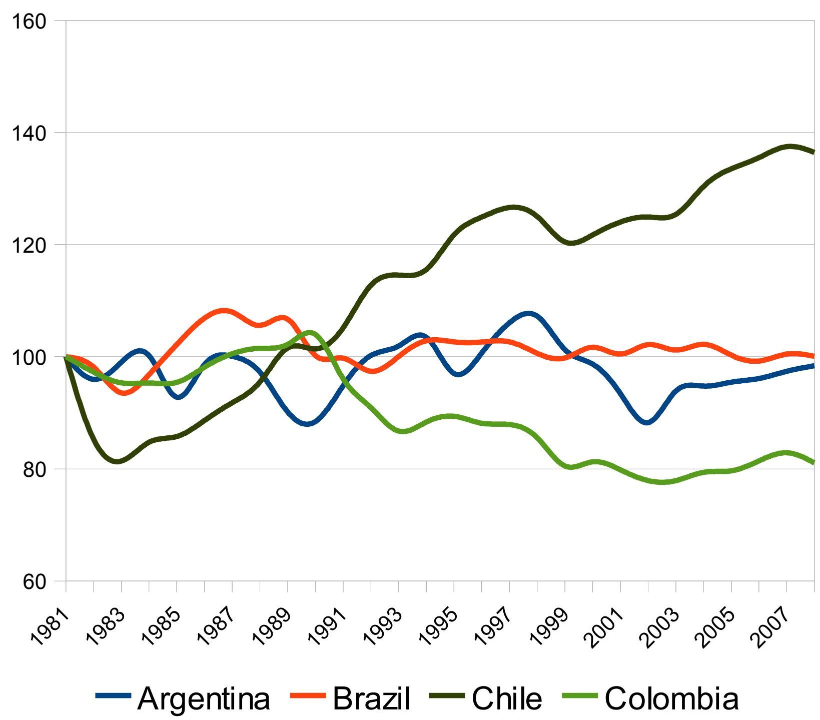
- Revisit 1982 crisis

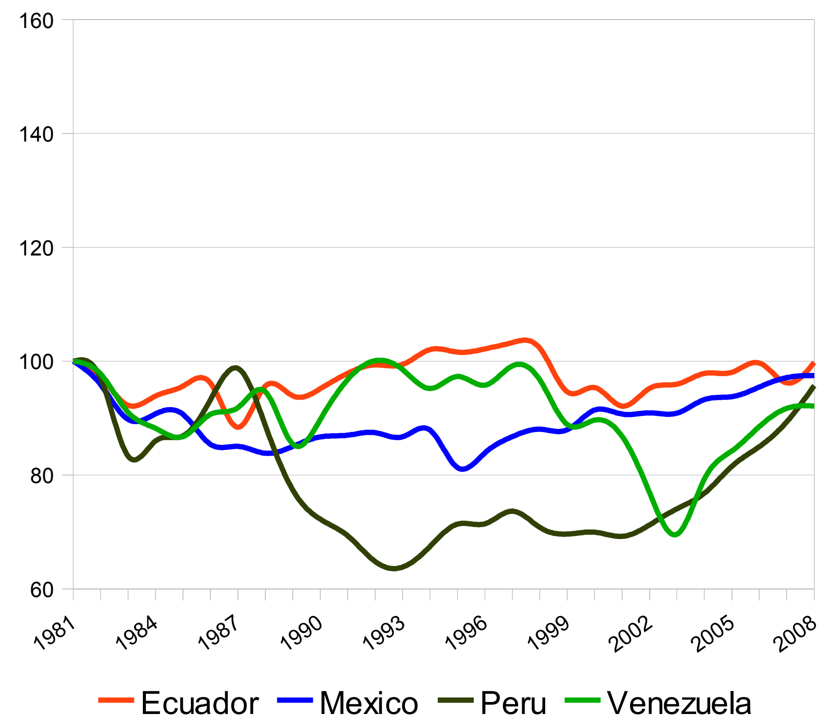
- Most countries in LA bailed out financial sector, renegotiated debts, granted substantial government subsidies, raised trade protection, protected investors...

- Chile paid the cost of the bailout up-front and explicitly, invested heavily in regulation, opened trade and markets and persevered. Others did it later (after 1994 crisis).

- Productivity –income and welfare— responses.

Total Factor Productivity
1981 = 100





Decades lost

Manufacturing and labor market regulations (min wage)