

LATIN AMERICA AND THE GLOBAL FINANCIAL CRISIS

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Abstract

The current world economic crisis has hit Latin America very hard. Although financial conditions deteriorated, particularly since September 2008, the financial shock has been less severe than during the two previous crises. Thanks to improvements in external balance sheets, there has been room for counter-cyclical credit and monetary policies. The decision to absorb large capital inflows during the boom as foreign exchange reserves is one of the major sources of the increased room to maneuver. However, these strengths have been insufficient in the face of a strong trade shock. The region's economies should therefore seriously think again in the domestic market, with regional integration and active production sector policies as engines of growth.

JEL Classification: O33 Fiscal and Monetary Policy in Development; O24 Trade Policy; Foreign Exchange Policy; O54 Latin America; F43 Economic Growth of Open Economies.

Keywords: Economic growth; Financial Crises; Financial shocks; Net external debt; Foreign exchange reserves; Trade shocks; Commodity prices; Counter-cyclical macroeconomic policies; Latin America.

Latin America has become a major and, in a sense, unexpected victim of the ongoing world financial and economic crisis. The end of the 2003-2007 boom was already visible since early 2008 in several countries, and particularly since the end of the commodity price boom in the middle of that year, but it became severe and widespread only after the collapse of Lehman Brothers in September 2008. The external channels of transmission are, however, different from past crises. Thanks to the significant improvement in external balance sheets during the preceding boom, the financial channels have been somewhat weaker and countries have enjoyed some space for counter-cyclical monetary policies –and, more generally, have avoided so far the need to

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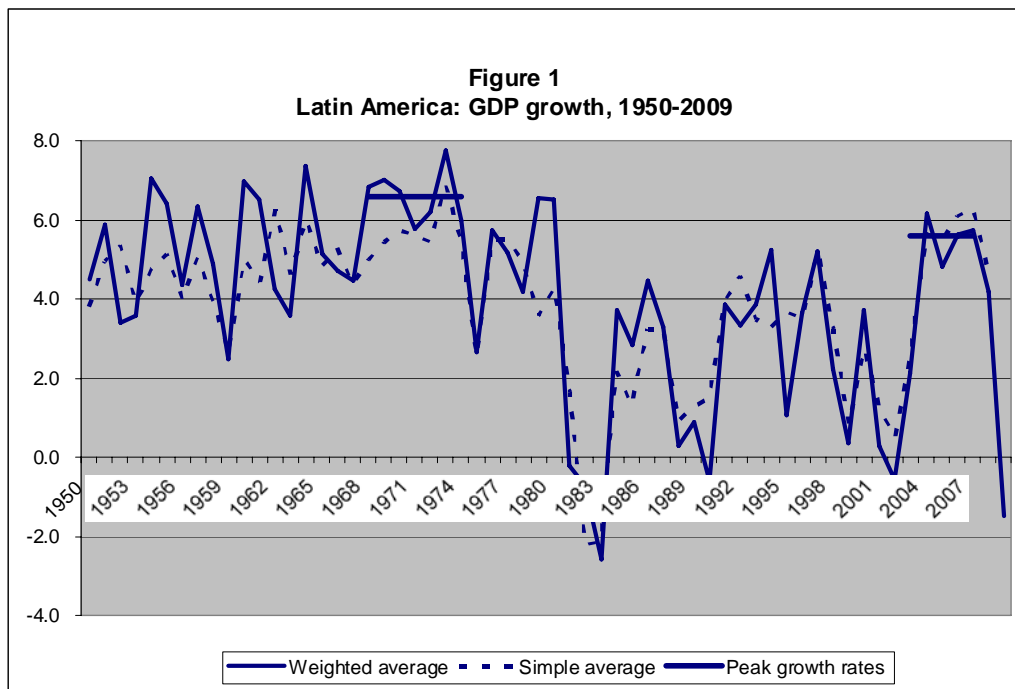
adopt pro-cyclical policies. In contrast, the trade channels have been very strong, and have affected manufacturing and service exporters through the reduction of world and particularly U.S. demand, and primary commodity exporting countries through the collapse of commodity prices. Contrary to popular perceptions, a third channel, the fall of remittances, is for the Latin American region as a whole the least important of all, but is still relevant in several of the smaller economies.

This paper takes a look at the impact of the world crisis on Latin America. It is divided in four sections. The first takes a brief look at the recent boom and growth prospects for 2009 (as of early May, when this paper goes to press). The second analyzes the channels of transmission of the crisis to Latin America. The third considers economic policy and the vulnerability of the region to the current turmoil. The fourth draws some conclusions and raises questions on the region's development strategy.

I. The end of the 2003-2007 boom

Although not necessarily spectacular by East Asian standards, Latin America experienced from 2003 to 2007 the most remarkable period of economic growth since the long post-Second World War boom that culminated in mid-1970s. This growth took place after almost a quarter century of unsatisfactory performance, marked by the "lost decade" of the 1980s, the "lost half-decade" from 1998 to 2002, and a period of weak performance between the two.

As Figure 1 indicates, growth rates during the recent boom were below the previous record set between 1967 and 1974 (5.6% vs. 6.6% per year). However, this is entirely explained by the slower growth in recent years of the two largest Latin American economies, Brazil and Mexico, relative to their rates in the 1960s and 1970s. If we estimate simple averages, recent rates of growth were actually higher (6.2% in 2003-2007 vs. 5.7% in 1967-1974) and indeed the highest in the post-war period. This is a reflection of the better performance of most of the small and medium-sized economies of the region.



Source: ECLAC.

The boom was based on the extraordinary combination of four factors: high commodity prices, booming international trade, exceptional financing conditions and high levels of remittances (Izquierdo *et al.*, 2008; Ocampo, 2007). The economic history of Latin America shows that the combination of high commodity prices and exceptional financing invariably leads to rapid economic growth. The last time these two positive factors coincided was in the 1970s. All four factors have never been seen together before. They had different weights in explaining rapid growth across the region and had features that were somewhat different from similar conjunctures in the past.

All of the aforementioned factors started to turn negative before the dramatic financial events of September 2008, but the rate of deterioration substantially accelerated as a result of the world financial meltdown. As we will see, remittances were the first to experience a weakening, but have also proven so far to be the most resilient to the recent collapse. Growth of international trade volumes also started to slow down in mid-2007 (United Nations, 2009a, Figure I.9), but financial conditions and commodity prices continued to be rather positive.

Favorable financial conditions were initially affected by the U.S. subprime crisis in the summer of 2007, but soon recovered vis-à-vis Latin America and the developing world in general (which in this study is meant to include emerging and developing countries alike), and were again very positive again during the first semester of 2008. Booming commodity prices through that semester seem to have been a crucial factor, as the turnaround of both variables took place in mid-2008, prior to the September meltdown. More broadly, it is now clear that the initial capacity of developing economies to partially “decouple” from the adverse events already taking place in the industrial world was closely associated with the acceleration of the commodity price boom. This factor, together with the high levels of foreign exchange reserves and the continuous boom of the dynamic Asian economies gave the impression that developing countries were a safe destination for capital. But decoupling proved at the end to be a mirage. After the mid-September 2008 meltdown, all these factors collapsed and the developing world became deeply engulfed in the global crisis.

Latin America has been severely impacted by the crisis. According to current projections, Latin America will be the region hardest hit in the developing world, with the exception of Central and Eastern Europe, both in terms of reductions in per capita GDP and slower growth vis-à-vis the boom years (United Nations, 2009b). The slowdown was already evident during the first semester of 2008 in several countries (Colombia, Mexico, Venezuela and several Central American countries). Those that continued to grow fast (Brazil and Peru, for example) hit the wall in September. The magnitude of the downturn was initially underestimated by international institutions and private agents alike,¹ and was not really visible until the data for the last quarter of 2008 was made public.

Recent growth projections for 2009 have therefore been significantly revised downward –around five percentage points relative to the projections in mid-2008.² As this paper goes to press, all projections indicate that Latin America will experience a recession in 2009 whose severity will be worse than in the previous two crises (1990 and

¹ Thus, the World Bank (2008) projected in October a rate of growth of 2.5-3.5%; the IMF (2008) in November a rate of 2.5%, and ECLAC (2008c) in December a rate of 1.9%. Private analysts predicted similar levels of growth. Thus, JPMorgan (2009a) still projected in early 2009 a growth of 0.9%.

² Similar estimates have been done by the World Bank (2009c) and the United Nations (2009b).

2002), and may be comparable to the worst year of the early 1980s (1983, when the regional GDP fell by 2.6%). This is reflected in Figure 1, which includes the April 2009 IMF estimate (-1.5%) but some private estimates are more pessimistic (see, for example, JPMorgan, 2009b, which projected -2.8% in early May). Indeed, according to some gloomy medium-term projections, the GDP of the seven largest Latin American economies would only return to pre-crisis levels by December 2013 if the global recession takes an “L” rather than a “V” shaped form—a likely scenario (IADB, 2009, chapter 4). In short, Latin America could face another half lost-decade of development!

II. The channels of transmission of the crisis

1. Remittances

Remittances experienced double digit growth rates in Latin America through most of the 2000s, peaking at 2% of the region’s GDP in 2004-2006 and much higher proportions of GDP in several of the smaller economies of Central America and the Caribbean. They experienced a significant slowdown in 2007 and then essentially stagnated in 2008. In the latter year, their share in the region’s GDP had fallen to 1.7%. The early slowdown is a reflection of the importance of employment of migrant workers to the U.S. in the construction sector, which has been experiencing a contraction since 2007 (JPMorgan, 2008). A similar story is true for Spain. Performance during 2008 was characterized by moderate growth during the first semester followed by a small reduction (around 2%) in the last quarter of the year (IADB-MIF, 2009).

The moderate reduction in the last quarter, relative to other indicators, reflects a certain resilience of remittances, a fact that is consistent with the views expressed by the World Bank for the developing world as a whole (Ratha *et al.*, 2008; World Bank, 2009b). Nonetheless, fragmentary evidence seems to indicate that the fall of remittances may have speeded up during the early months of 2009. The impact across the region will be uneven, not only due to the relative weight of remittance flows in different countries, but also due to exchange rate movements, both in the countries of origin and destination. In the Latin American countries where exchange rate depreciation took place during the recent crisis (Colombia and Mexico, in particular), recipient households benefited and

may have actually increased their purchasing power despite falling dollar flows, but this compensatory factor was absent in countries that did not experience a similar phenomenon (Central American countries and Ecuador). In turn, the dollar value of remittances from Europe (important for South American countries of emigration) was negatively affected by the depreciation of the euro (IADB-MIF, 2009).

2. The trade shock

International trade demonstrated a strong pro-cyclical pattern during the current decade. This trait has been visible both in the evolution of the volume of international trade as well as in commodity prices. Since the Latin American economies have had a strong export-led orientation over the past two decades, pro-cyclical trade shocks have therefore been strong. Furthermore, the severe negative trade shock may explain why the region has been so severely hit, despite the softer financial shock relative to previous crises.

The volume of international trade grew at 9.3% per year in 2003-2006, more than twice the rate of growth of world GDP at market prices (3.8%) (United Nations, 2009a, Table I.1). After slowing rapidly since mid-2007, it experienced a sharp contraction during the last quarter of 2008 and is expected to fall between 9 and 11% in 2009 (see WTO, 2009; and IMF, 2009, Table 1.1, respectively). This reduction is several times the expected reduction of world GDP at market prices, and several times the trade contraction that was expected early in the year (2 to 3%). Economies most open to trade have therefore received a dramatic shock, which explains the rapid reduction of GDP in the most trade-dependent economies, from Asia (Japan and the Asian Tigers) to Germany and Mexico.

The contraction in world trade volumes will be the main transmission channel of the crisis towards Latin American countries that specialize in manufactures and services, particularly in Mexico, Central America and the Dominican Republic. In turn, South America would be strongly affected by commodity price trends.

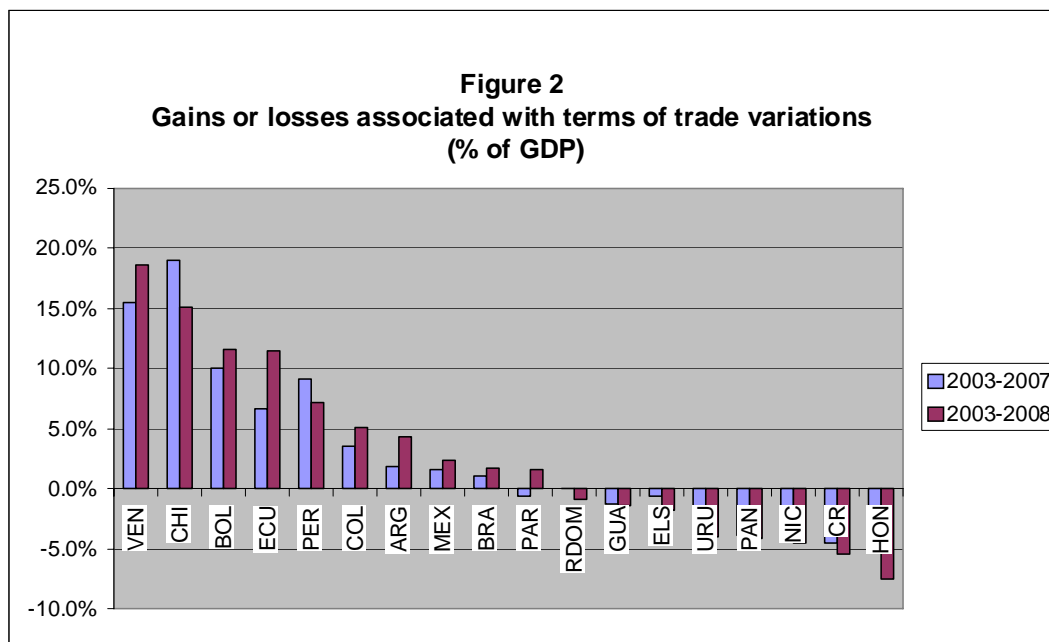
From 2004 to mid-2008, the world economy experienced the most spectacular commodity boom in over a century, both in terms of its duration (five years), intensity and product coverage (World Bank, 2009a, chapter 2; UNCTAD, 2009, chapter III). However, as Table 1 indicates, the boom was stronger for energy and mining products than for agricultural goods. This is reflected in the fact that, whereas at their peak, in the second quarter of 2008, real mineral prices exceeded by a substantial amount the levels of the 1970s (or the averages for 1945-1970, which is not unlike those for the 1970s in the case of non-oil commodity prices), and only returned, and briefly so, to those earlier levels. In other words, agricultural prices just reversed during the recent boom, and very temporarily so, the significant deterioration they had experienced during the 1980s and the Asian crisis,.

	Total non-oil	Total Agricultural	Tropical Agriculture	Other Agriculture	Metals	Oil
1945-70	101.8	103.7	108.6	98.8	93.1	33.6
1971-80	100.0	100.0	100.0	100.0	100.0	100.0
1981-90	78.3	73.6	65.7	81.6	100.4	128.2
1991-97	73.2	71.7	62.3	81.3	80.1	72.6
1998-03	67.6	65.2	55.0	75.5	78.3	100.9
2004	73.4	67.9	58.8	77.1	99.1	151.3
2005	78.2	70.4	64.8	76.0	114.7	213.8
2006	93.5	74.6	68.7	80.5	181.0	253.5
2007	101.9	82.0	77.6	86.5	193.7	270.0
2008-I	122.1	104.7	105.6	103.8	202.6	357.8
2008-II	124.5	106.2	111.4	100.9	208.9	448.1
2008-III	112.8	96.6	97.9	95.4	187.4	421.7
2008-IV	79.2	72.4	65.2	79.7	110.7	202.2
2009-I	76.4	72.9	68.1	77.8	92.5	157.3
Memo						
2008-Dec	72.7	68.5	60.5	76.6	92.1	149.7

Source: Ocampo and Parra (2003) and update with same sources.

A major implication of this is that, throughout the developing world, improvements in the terms of trade during the recent boom were strong for mineral exporters, they remained essentially flat for agricultural producers, and deteriorated for manufacturing and service exporting economies (United Nations, 2009a, Figure II.6).

This is also evident in Latin America. The countries that benefited the most from the commodities boom were all mineral (including again energy) exporters, essentially the Andean economies in a broad sense (from Venezuela to Chile).³ Major agricultural exporters (Argentina and Brazil) experienced only moderate and late improvements in their terms of trade. Energy importers, such as the Central American countries and Uruguay, had negative shocks, which were nonetheless moderated by the high prices of their own commodity exports (see Figure 2).



Source: Author estimates based on data from ECLAC (2008c).

The difference in performance between energy and minerals, on the one hand, and agricultural goods, on the others, indicates that the determinants of both commodity groups have been very different. In the case of energy and mineral goods, low prices led to low investment levels from the mid-1980s to the early 2000s. Low production capacity then met in recent years the high demand generated by rapid world economic growth and the unprecedented Chinese demand for metals. Investment responded to high prices but there is a significant lag between investment decisions and increased supplies, leading to a long and strong price boom. In the case of agriculture, and despite the alarms raised by

³ This may sound strange for Colombia, but two-fifths of its exports are also minerals (oil, coal, nickel and gold) and its manufacturing exports are largely destined for its two oil-producing neighbors.

the food crisis during the first semester of 2008, supply-demand imbalances were more moderate and were more rapidly corrected. An important channel of transmission of high energy prices to agricultural markets was, of course, the increasing demand for biofuels (von Braun, 2007). The sharp financialization of commodity futures trading since 2005 also helped to speed up the price boom –and the succeeding collapse (UNCTAD, 2009, chapter III). Dollar depreciation during the second semester of 2007 and the first semester of 2008 also fueled the boom in dollar terms.

Commodity prices started to fall since mid-2008. The price turnaround clearly preceded the September financial meltdown, but was transformed into a veritable price collapse after this event. By December real agricultural prices were back to levels only slightly above those experienced during the Asian crisis. Prices for energy and metals fell more strongly but in real terms tended to stabilize since December at levels that were still historically high in the first case and above previous troughs in the second. As with most economic variables, these reductions soon exceeded previous projections, which indicated that energy products would fall by 25% and non-energy by 23% (World Bank, 2009a, Table I.4).

The contraction of international trade may at the end be the most important channel for the transmission of the world financial crisis to Latin America. As mentioned earlier, Latin America will be the region hardest hit in the developing world, with the exception of Central and Eastern Europe. But, whereas the financial shock is severe in Central and Eastern Europe, its effects are much weaker in Latin American this time, as we will see in the following section. It is therefore difficult to explain the intensity of the crisis purely as a result of the financial shock (see also Griffith-Jones and Ocampo, 2009).

The strength of the trade shock was already reflected in the collapse of export revenues, which contracted at annual rates of about 30% during the last quarter of 2008, and faster rates during the first quarter of 2009 according to the fragmentary data available (World Bank, 2009c). The effects on GDP were severe, given the significant trade opening of Latin American economies today. A mitigating factor is the reduction of

energy prices for oil-importing countries, which, as we have seen, are generally small economies in the region. Historical experience also indicates that crises can also bring benefits in terms of economic diversification, particularly through the effect of more competitive exchange rates. However, to fully benefit from them, the region may need to rethink its production development strategy, an issue to which we will return in the concluding section of this paper.

3. The financial shock

One of the characteristic features of capital flow cycles to the developing world over the past four decades has been the persistent transformation of the source and destination of finance. In a sense, each of the three cycles that developing countries have experienced since the mid-1970s has been different from each other. In the case of Latin America, commercial bank lending played the leading role in the 1970s financing boom, bond financing to the public sector did so during the 1991-1997 period, and portfolio flows ran the show during the recent period of exuberance.

The nature of financial flows to the region during the recent boom can be better perceived by looking at the external balance sheet of the major Latin American economies (Table 2). Two major changes are noticeable. The first is significant asset accumulation, primarily foreign exchange reserves but also foreign direct and portfolio investments by nationals abroad, which in both cases exceeded the rapid growth of the region's nominal GDP growth (which essentially doubled between 2003 and 2007). The second is a significant change in the composition of external liabilities, with reductions in debt and increases in portfolio liabilities. The latter includes investment in local markets by institutional investors from industrial countries. Another aspect of the same process was, therefore, the boom in domestic bond and stock markets. Domestic bonds increased by 15 percentage points of GDP between 2001 and 2007. The stock market boom will be analyzed below.⁴

⁴ For a closer analysis of these trends, see Jara and Tovar (2008) and Ocampo and Tovar (2008).

Table 2							
External balance sheet of the seven largest Latin American economies							
(% of GDP at nominal prices)							
	2001	2002	2003	2004	2005	2006	2007
Assets							
Total 1/	26.5	29.7	31.9	31.5	31.4	32.4	37.5
Foreign direct investment	5.8	6.9	7.0	7.2	7.0	7.5	7.9
Portfolio assets	2.1	2.4	3.2	3.2	3.5	3.9	4.8
Derivatives	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Other investments	12.1	13.3	13.4	12.6	11.4	10.8	12.5
International reserves 1/	6.6	7.1	8.3	8.5	9.5	10.0	12.3
Liabilities							
Total 1/	62.4	65.4	70.4	66.4	61.5	60.3	65.6
Foreign direct investment	24.5	25.5	28.6	28.1	26.7	25.6	27.2
Portfolio liabilities	19.8	20.1	23.1	22.9	22.8	23.8	28.0
Stocks	5.5	4.9	7.2	8.4	10.4	13.0	16.9
Debt	14.3	15.2	15.9	14.5	12.3	10.9	11.1
Derivatives	0.0	0.0	0.0	0.1	0.1	0.2	0.3
Other investments 1/	18.0	19.8	18.6	15.4	11.9	10.7	10.2
Assets - Liabilities							
Foreign direct investment	-18.8	-18.6	-21.6	-20.9	-19.7	-18.0	-19.2
Financial	-17.1	-17.1	-16.8	-14.0	-10.4	-9.9	-8.9
Reserves as % of liabilities							
Reserves as % of portfolio liabilities	20.3	20.4	24.0	28.3	39.1	46.5	57.9
Reserves as % of portfolio liabilities							
Domestic capital market as % of GDP	33.1	35.5	35.9	37.0	41.6	42.1	44.0
Domestic capital market as % of GDP							
Assets - Financial liabilities	34.2	32.1	38.7	39.8	43.8	44.5	49.1
Assets - Financial liabilities							
Argentina	-0.3	19.8	20.1	22.0	29.5	26.2	29.0
Brazil	-34.9	-36.4	-35.2	-31.0	-24.1	-23.8	-28.9
Chile	-3.2	-1.5	3.9	13.5	17.3	27.6	42.7
Colombia	-13.8	-13.6	-14.5	-10.2	-5.2	-3.1	-0.9
Mexico	-17.6	-16.7	-18.6	-18.4	-19.3	-21.1	-16.7
Peru	-29.4	-27.9	-26.4	-21.3	-14.4	-7.6	-6.8
Venezuela	23.9	35.9	48.7	44.6	49.3	50.8	51.3
Reserves as % of portfolio liabilities							
Argentina	2.2	-14.2	1.7	19.6	67.6	72.8	93.4
Brazil	18.1	13.1	13.6	15.7	23.1	28.6	35.4
Chile	142.4	145.8	108.3	98.9	93.3	98.3	83.6
Colombia	78.8	88.1	84.2	91.8	102.7	96.8	114.6
Mexico	30.8	41.6	42.7	39.0	35.8	30.0	29.0
Peru	131.1	125.4	105.2	114.4	91.7	98.2	97.5
Venezuela	131.1	125.4	105.2	114.4	91.7	98.2	97.5

1/ Liabilities with the IMF have been subtracted from these accounts

Source: Author estimates based on IMF, International Financial Statistics. GDP at current prices according to ECLAC. Domestic capital market according to Bank of International Settlements.

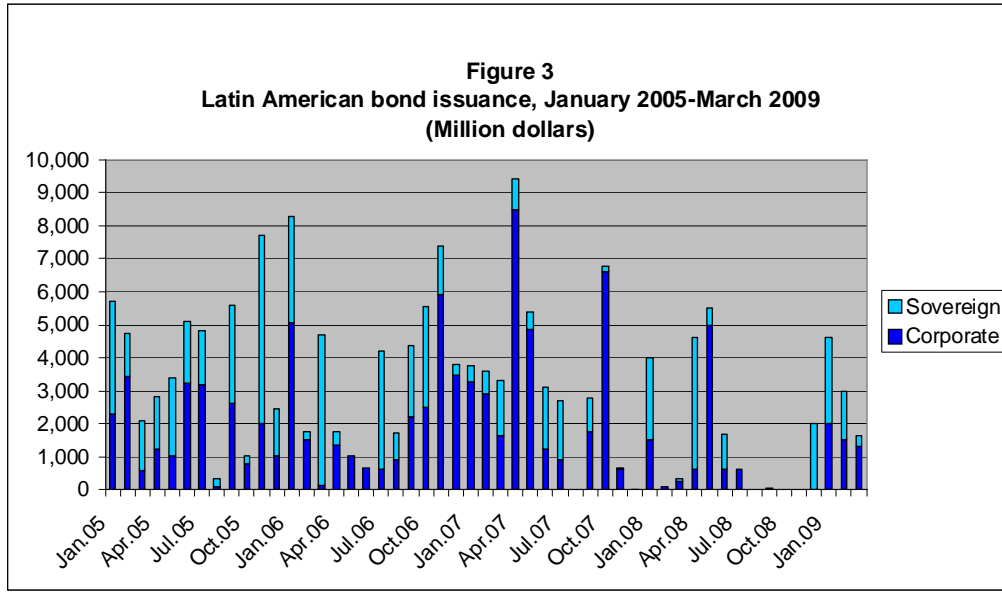
Data refers to the seven largest economies (Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela)

As a result of the accumulation of financial assets and the reduction in financial liabilities as a proportion of GDP, net financial liabilities fell by ten percentage points of GDP between 2003 and 2007. This trend was shared by all of the seven largest

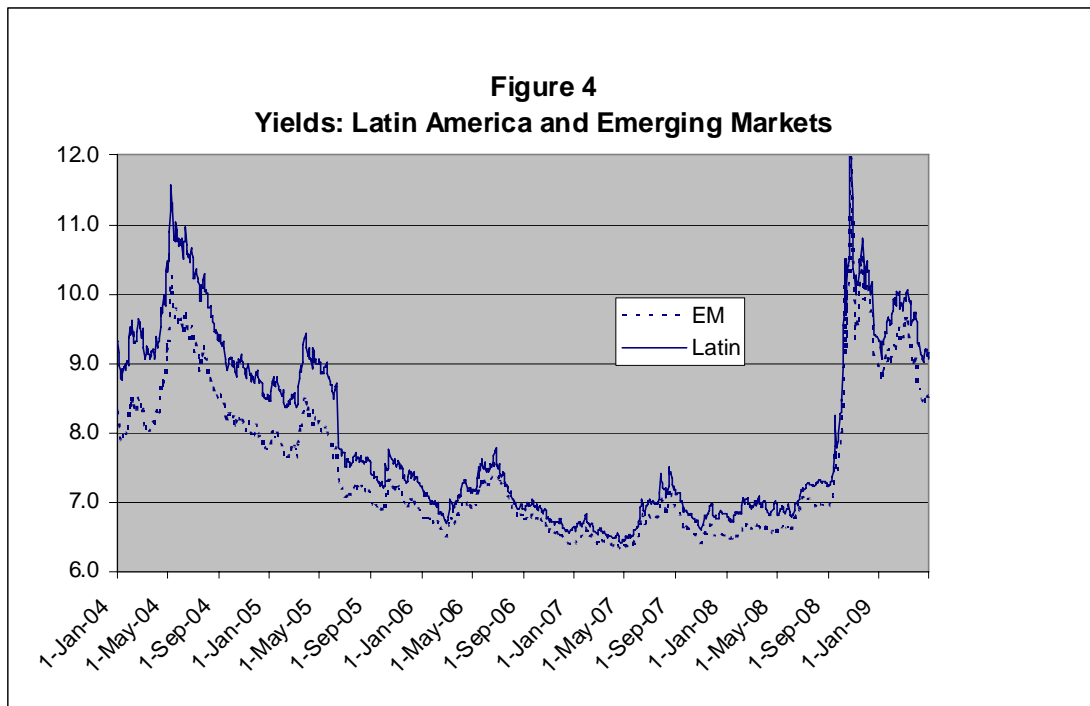
economies in the region. By 2007 three of them (Argentina, Chile and Venezuela) had positive net financial assets and the remaining two (Colombia and Peru) were close to balance. The ratio of foreign exchange reserves to external debt improved significantly, but the improvement was much less noticeable when we compare reserve accumulation with consolidated financial (i.e., including portfolio) liabilities. This reflects the fact that the accumulation of foreign exchange reserves was the counterpart of increased portfolio inflows, a fact that is consistent with the view that there were massive interventions in foreign exchange markets during periods of booming capital inflows (see below). For the two largest countries in the region, reserves only covered in 2007 a relatively low proportion of external financial liabilities, and in four of the seven largest countries (Mexico but also, from a stronger position, Chile, Peru and Venezuela), reserves fell as a proportion of such liabilities during the boom.

The improvement in external balance sheets is undoubtedly the major asset that the region has to manage the current world financial turmoil. Nonetheless, the extreme pro-cyclicality of capital flows continued to be a feature of the recent cycle. Net capital flows into the region had practically ceased between mid-2002 and mid-2004, but they recovered and started to exceed current account balances as the source of balance of payments surpluses since then. During the last quarter of 2006 and the first semester of 2007, net capital flows became a veritable flood. Such flows reached during these nine months close to \$100 billion dollars, which accounts for almost all of the reserve accumulation –by \$113 billion— of six of the seven largest economies (excluding Venezuela) (Ocampo, 2007).

Figure 3, which reproduces the monthly trajectory of bond issues by Latin American government and corporations, confirms that financing reached its peak in the last quarter of 2006 and the first semester of 2007. An important feature of such bond issues was the dominance of corporate bond issues, which represented about 70% of all issues during this peak. Corporate bond issues generally had a higher cost and lower maturity than sovereign issues. This change in the composition therefore resulted in a deterioration of debt structures. In particular, the risks associated with the need for debt rotation increased as a result of such changes in debt composition.

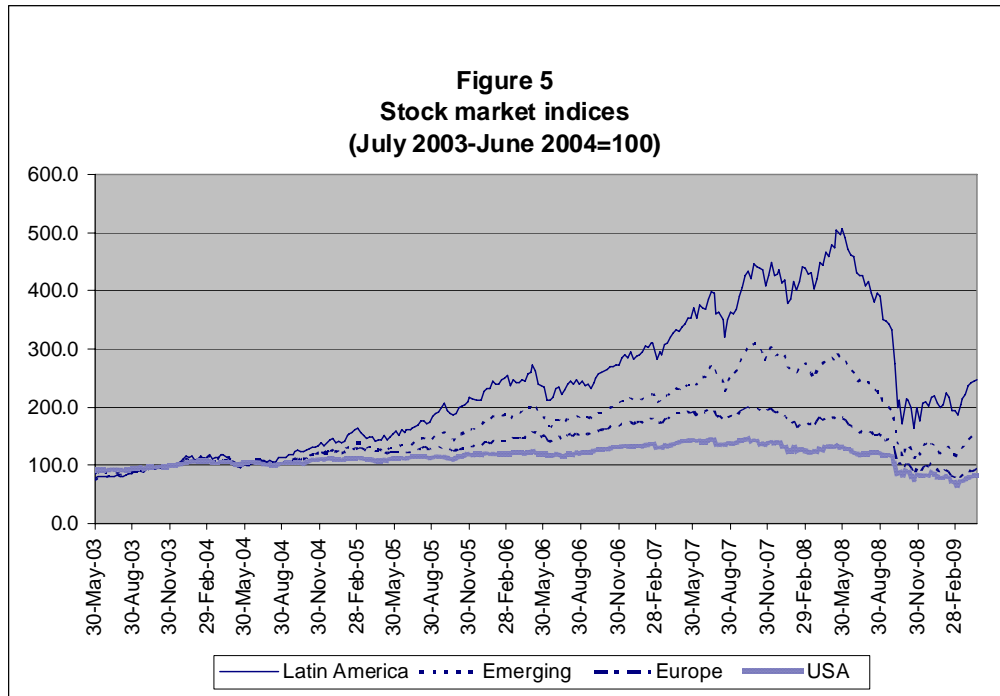


A further pro-cyclical feature of the boom was the tendency of risk spreads to fall, and therefore of the costs of external financing (yields) (Figure 4). Since mid-2004 risk spreads fell systematically below those levels that had prevailed before the Asian crisis. In the case of Latin America, spreads were above the emerging markets' average but fell more and had reached levels similar to that average by mid-2006. Furthermore, since long-term U.S. Treasury bonds (generally 10-year bonds), the benchmark upon which spreads are estimated, remained fairly constant during the period of rising Federal Reserve rates (since September 2004), yields for Latin American and emerging market bonds fell substantially from mid-2004 to early-2006 and then stabilized at fairly low historical levels: around 7% at their lowest level, in April-May 2007, vs. 10% during the first semester of 2004 for Latin America. The downward trend was disrupted twice, but only briefly: in March 2005 because of a broad based market disturbance that originated in the U.S., and in the second quarter of 2006 due to a disturbance in emerging markets that centered in Shanghai. It must be added that the reduction in spreads and yields benefited all Latin American countries, though it was more moderate for those countries that already had low risk premia at the beginning of the boom (Chile and Mexico).



Source: JPMorgan

Exuberance in financial markets was transmitted domestically through three channels. The first was the downward pressure on domestic interest rates. To the extent that central banks tried to raise domestic interest rates during the boom, this generated a risk spread that induced additional capital flows. For this reason, the second channel was strong appreciation pressures. The third was asset inflation. The launch of stock market boom coincided with the beginning of the capital account boom, in mid-2004. Average Latin American stock market prices quadrupled over the three following years, thus experiencing a boom that was stronger than those of emerging markets as a whole (Figure 5).



Source: Author estimates based on data from Morgan Stanley.

The world financial crisis spread throughout the region unevenly through time and across countries in the region. The initial impact, during the third quarter of 2007 was a strong but temporary reduction in capital flows (Figure 3), a temporary increase in yields (Figure 4) and a fall in stock market prices in dollar terms (Figure 5). Compared to the 2006 disturbance in emerging markets, spreads were more volatile during the third quarter of 2007. Following a pattern that became more pronounced later on, spreads increased significantly for Argentina and Venezuela, reflecting a certain element of “political risk”. As in the 2006 disturbance, exchange rates were more volatile in Brazil and Colombia, with a high correlation of exchange rates with variations in the costs of financing. The latter was also true of Mexico, though with lower levels of exchange rate volatility (Table 3).

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela	EMBI +
Average spread								
May 06-Jul 06	363	249	81	215	134	168	208	208
Jul 07-Sept 07	414	187	106	167	112	151	389	207
Oct 07-May 08	514	227	160	211	153	183	556	264
Jun 08-Sept 12/08	632	226	173	212	168	190	623	288
Sept 15/08 - Dec 08	1565	454	315	502	387	469	1457	632
Jan 09 - Apr 09	1719	418	343	471	367	413	1596	634
Spread volatility 1/								
May 06-Jul 06	26.2	19.6	3.6	27.7	14.7	10.1	20.9	16.4
Jul 07-Sept 07	60.6	21.9	14.5	31.6	15.0	23.5	64.6	25.0
Oct 07-May 08	102.7	31.7	18.9	33.9	24.9	27.1	85.9	34.2
Jun 08-Sept 12/08	58.5	24.2	7.0	24.3	22.1	24.0	48.0	24.5
Sept 15/08 - Dec 08	382.0	85.2	62.4	113.3	88.6	100.4	318.6	136.5
Jan 09 - Apr 09	131.3	27.6	39.3	39.9	34.8	43.4	159.5	46.2
Nominal exchange rate								
May 06-Jul 06	3.07	2.20	535	2494	11.16	3.26	2.59	
Jul 07-Sept 07	3.14	1.92	520	2041	10.96	3.15	2.15	
Oct 07-May 08	3.15	1.74	477	1920	10.74	2.90	2.15	
Jun 08-Sept 12/08	3.03	1.62	507	1818	10.26	2.89	2.15	
Sept 15/08 - Dec 08	3.30	2.22	628	2265	12.70	3.07	2.15	
Jan 09 - Apr 09	3.58	2.29	601	2404	14.13	3.16	2.15	
Exchange rate volatility 2/								
May 06-Jul 06	0.56%	3.24%	2.11%	3.12%	1.81%	0.57%	2.24%	
Jul 07-Sept 07	0.78%	2.95%	0.91%	4.51%	1.21%	0.57%		
Oct 07-May 08	0.48%	3.06%	4.98%	5.29%	1.62%	3.54%		
Jun 08-Sept 12/08	0.59%	3.16%	2.74%	5.99%	1.55%	2.17%		
Sept 15/08 - Dec 08	3.51%	8.77%	6.80%	3.89%	7.75%	1.83%		
Jan 09 - Apr 09	2.78%	2.92%	3.13%	5.02%	4.39%	1.95%		
Correlation exchange rate-EMBI +								
May 06-Jul 06	0.789	0.832	0.796	0.885	0.755	-0.388	0.477	
Jul 07-Sept 07	0.818	0.658	0.364	0.789	0.930	0.059		
Oct 07-May 08	0.206	-0.455	-0.787	-0.551	-0.232	-0.694		
Jun 08-Sept 12/08	-0.145	0.440	0.752	0.788	0.177	0.375		
Sept 15/08 - Dec 08	0.802	0.877	0.914	0.706	0.942	0.854		
Jan 09 - Apr 09	0.104	0.947	-0.217	0.830	0.938	0.643		

1/ Standard deviation

2/ Coefficient of variation

Source: Author estimates based on data from JP Morgan

This initial turbulence was followed by a partial normalization of external financing. Spreads did not fall to previous levels and remained more volatile, but were accompanied by a reduction in benchmark interest rates and, therefore, of yields. Financing returned, though in less irregular fashion, and stock markets boomed again, particularly in Brazil, and peaked in May 2008 –which was different from the average pattern for emerging markets, which peaked in mid-2007, prior to the subprime crisis.

The new market disturbance started in June 2008 and therefore clearly preceded the September financial meltdown. As discussed above, the disturbance may be associated with the negative turnaround of world commodity prices, a fact that is

consistent with the facts that Latin American countries are important commodity producers and that many of the rising Latin multinationals are commodity producers (including industrial commodities, such as cement and steel). Latin American bond issuance sharply fell in June and July and almost entirely disappeared by August. Yields increased by about 150 basis points before mid-September, impacting in particular Argentina and Venezuela. Stock markets substantially weakened but before mid-September they were at levels that were still three and a half times those of mid-2004. However, the measures of spread and exchange rate volatility did not substantially increase.

The mid-September 2008 meltdown accelerated all of these trends.⁵ Credit was frozen and there was an unexpected capital outflow through an expected channel, flight to quality (which meant U.S. Treasury bonds in particular), but also a rather unexpected one: the sale of assets throughout the world to finance the withdrawal of resources from mutual and hedge funds in the United States. The dismantling of carry trade with Japan, which had benefited Brazil in the latter case, was an additional factor. This generated a strong depreciation of most of the major Latin American currencies, as the dollar and yen appreciated at the global level. Exchange rate fluctuations generated massive losses in futures markets, particularly in Brazil and Mexico. Spreads and, therefore, yields increased sharply; spreads became volatile and their correlation with exchange rate movements peaked in all major countries; and stock markets collapsed. Brazil, Chile and Mexico now became countries with the highest exchange rate instability; in contrast, exchange rate volatility actually fell in Colombia, perhaps indicating that the reserve requirements on capital inflows that had been reestablished in 2006 had been effective in controlling the most volatile capital inflows. Argentine and Venezuelan spreads went up very sharply and now exceeded by ten percentage points or more those of the other major Latin American countries.

Following trends in U.S. financial instability, which indicate that the worst symptoms of illiquidity tended to be moderate since late October, Latin American yields peaked on October 23 at 12.35% and fell later on to a range between 9 and 10%, two to

⁵ See Bustillo and Velloso (2009) for a more extensive analysis of these effects.

three percentage points higher than prior to the U.S. financial crisis (Figure 4). The strongest pressure on foreign exchange markets was also concentrated from mid-September to late October, though they remained volatile in several countries.

Date	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela
12/31/2004	18,008	52,782	16,016	12,769	61,496	12,176	12,234
12/30/2005	22,742	53,800	16,963	14,206	67,081	13,599	17,136
6/30/2006	24,127	62,670	17,570	13,722	78,743	13,827	16,520
12/29/2006	30,421	85,839	19,429	14,673	67,680	16,732	19,956
6/29/2007	41,490	147,101	17,897	19,216	69,939	21,003	11,485
12/31/2007	44,175	180,334	16,910	20,096	77,894	26,853	15,713
6/30/2008	45,327	200,827	20,251	21,943	85,663	34,632	14,636
7/31/2008	45,367	203,562	21,847	22,453	78,135	33,978	15,237
8/29/2008	45,036	205,116	22,356	22,786	80,688	34,151	17,363
9/30/2008	45,017	206,486	24,204	22,850	83,553	33,778	18,848
10/31/2008	42,990	203,179	22,959	22,241	77,136	31,197	20,479
11/28/2008	44,063	206,377	21,921	22,411	83,396	30,098	20,026
12/31/2008	44,360	207,467	23,162	22,810	85,274	30,263	21,890
1/30/2009	44,986	200,813	23,454	22,404	83,631	29,117	
2/27/2009	44,977	199,412	22,896	22,106	80,061		
3/31/2009		202,460	23,947		79,004		
4/30/2009		201,941			77,491		

Source: Bloomberg

In many ways, however, the transmission of the financial crisis was more moderate than in the previous two episodes of its kind –the Latin American debt crisis of the 1980s, and the Asian-Russian financial crises of 1997-1998. This is reflected in many indicators: foreign exchange reserve losses were very moderate and reserves remained very high (Table 4); yields tended to fluctuate after the initial shock at levels that were much lower than the 12 to 17% range that had been typical between 1999 and 2003; and, although stock markets collapsed, they stabilized at a level that was about twice that of pre-boom years, showing therefore a much better performance than in the rest of the world –and shared in the March-April 2009 recovery. There was also renewed access to capital flows, particularly since the first quarter of 2009 (see Figure 3 in relation to bond financing). Furthermore, although exchange rates have depreciated in several countries, this can be considered a correction of the strong appreciation pressures that some of them had faced during the capital account boom. These favorable outcomes are, therefore, a reflection of the fact that improvements in external balance sheets during the boom did

provide an important protection during the downswing. There are also, we could add, no signs of domestic financial crises –again a significant difference with previous crises— though, of course, a long recession could reignite problems in this area (IADB, 2009).

Nonetheless, significant problems remain. All analysts concur that the most important risk is that associated with rotation of corporate debts. The shorter maturity of those debts vis-à-vis those of sovereigns and the strong dependence of several of the largest firms on commodity markets thus turned out to be the major weakness in the capital account. This has been reflected in the fact that spreads for corporate bonds have widened relative to sovereign debt (Bustillo and Velloso, 2009, Figure 10). Borrowing in the first month of 2009 has also been at higher costs and, particularly, at much shorter terms than before the crisis, particularly in the case of the private sector (IADB, 2009). Current account imbalances will also increase, reflecting in particular the dependence of the Latin American current account balance in recent years on exceptional terms of trade (see next section).

All of these factors indicate that, although the capital account shock has been more moderate than in previous occasions, the region is certainly not immune from the effects of a period of scarcity of external financing, particularly if that period turns out to be long. However, the swap lines provided by the U.S. Fed to Brazil and Mexico, by China to Argentina, as well as the new IMF credit facilities, particularly the Flexible Credit Line launched in March 2009, which by early May 2009 had already been tapped by Colombia and Mexico, and increased financing by multilateral development banks may serve as an additional line of defense, that was not available on a similar scale during previous crises (with the major exception of support to Mexico during its 1994-1995 crisis).

III. Economic policy and the vulnerability of the Latin American economies

The economic history of Latin America since the 1970s indicates that the region has been plagued not only by strong pro-cyclical capital flows but also by the predominance of pro-cyclical macroeconomic policies that tend to reinforce rather than smooth out the transmission of external shocks to the domestic economy. The

fundamental problem is the tendency to accumulate vulnerabilities during the boom. Such vulnerabilities include the deterioration in the current account of the balance of payments, fed by both booming domestic spending and exchange rate appreciation. The counterpart domestic public or private sector deficits are reflected, in turn, in increasing debts. The result is that when exceptional financing and trade conditions disappear, authorities must undertake a pro-cyclical adjustment, which has included in the past varying combinations of restrictive monetary and credit policies and strong exchange rate adjustments.

In the face of this historical pattern, many analysts have suggested in recent years that one of the fundamental advances of Latin America during the recent boom was the greater attention given to strong macroeconomic balances (see, among others, ECLAC, 2008c, and World Bank, 2009c). According to this view, proofs of improved “fundamentals” can be found in the healthy public sector balances as well as the current account surpluses of the balance of payments that tended to prevail during the recent boom.

This interpretation of recent economic history is subject to many caveats. The alternative interpretation indicates that the exceptional performance during the 2003-2007 boom was more a result of the intensity of favorable external factors rather than of improvements in economic policy, which overall remained pro-cyclical in most countries (see Ocampo, 2007; IADB, 2008; and Izquierdo *et al.*, 2008). Some changes in macroeconomic policy did matter, however, particularly the massive accumulation of foreign exchange reserves and reduced public sector external indebtedness. These changes in the external balance sheet provided the additional policy space for counter-cyclical macroeconomic policies during the current crisis.

Table 5 summarizes the evolution of fiscal indicators. In line with the “strong fundamentals” view, only three countries ran a central government deficit of over 2% of GDP in 2008: Brazil, Colombia and the Dominican Republic. Furthermore, the public sector debt, as a proportion of GDP, was lower in most countries in 2008 than in 1998, at the beginning of the previous crisis. The exceptions are again Brazil and Colombia, as well as Argentina and Uruguay. However, more in line with the “favorable external

shock” view, in most countries this was a reflection of exceptional public sector revenues rather than of moderate spending during the boom. Overall, primary public sector spending grew very fast, indeed faster than current GDP growth in most countries and, overall, continued to be pro-cyclical (IADB, 2008, chapter 3, and ECLAC, 2008b, chapter IV). This is reflected in Table 5 in the elasticity of real primary public sector spending to long-term GDP growth (estimated as the rate of growth for the 1990-2007 period as a whole). This ratio is lower than one (the clear sign of a counter-cyclical policy) only in three countries (Chile, El Salvador and Guatemala) and cycle-neutral in one (Costa Rica). In the rest, public sector spending was pro-cyclical and in some strongly pro-cyclical (in particular in Argentina, Brazil, Colombia, Ecuador, Uruguay and Venezuela, where it grew at a rate that was more than twice the long-term rate of GDP growth).

Table 5
Indicators of fiscal stance

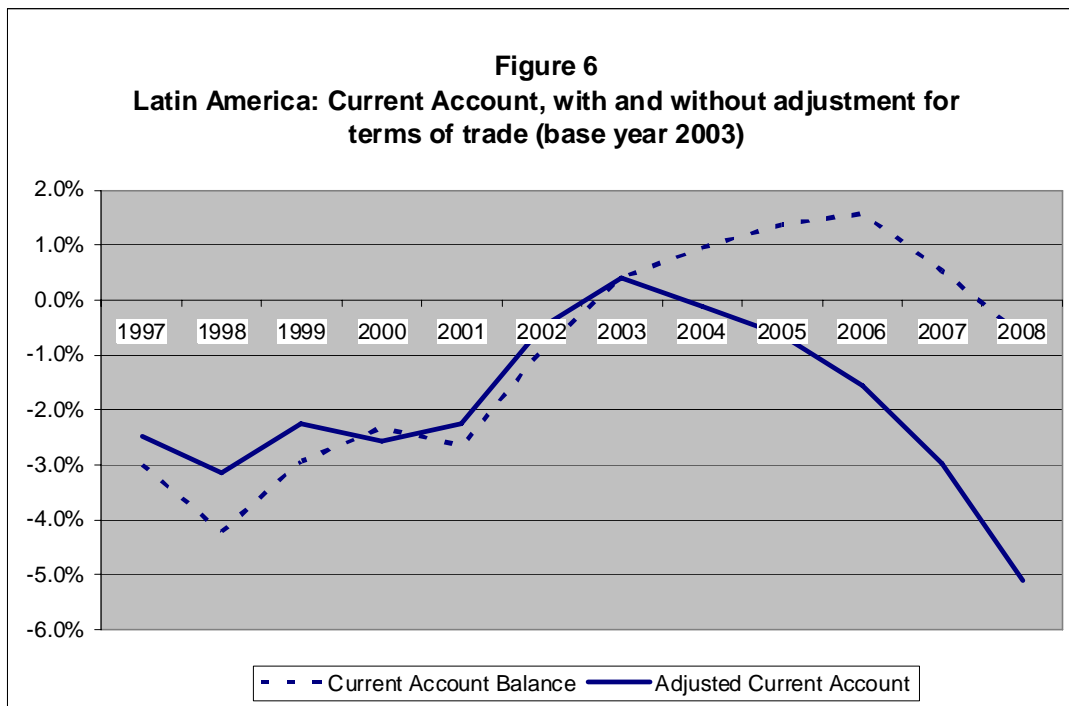
	Central government Surplus or deficit (% of GDP)		Central government debt (% of GDP)			Growth of real primary spending 2003-2007	Primary vs GDP Growth	
	2007	2008	2007	2008	Change 1998-2008		2003-2007	1990-2007
Argentina	0.6	1.0	55.7	48.0	10.4	11.9	1.34	2.97
Bolivia	2.3	3.0	37.1	30.7	-24.4	5.0	1.10	1.34
Brazil	-2.0	-2.6	32.7	30.1	5.9	9.0	2.03	3.11
Chile	8.8	6.9	4.1	3.5	-8.6	2.5	0.48	0.47
Colombia	-3.0	-2.7	35.2	33.2	11.1	7.9	1.24	2.25
Costa Rica	0.6	-0.5	27.7	23.5	-19.4	5.1	0.77	1.00
Ecuador	-0.1	-0.1	27.5	22.6	-34.4	10.3	2.01	3.34
El Salvador	-0.2	-0.6	34.5	31.2	-2.1	0.4	0.13	0.12
Guatemala	-1.5	-1.2	21.7	19.3	2.9	2.9	0.66	0.72
Honduras	-2.9	-1.9	17.4	17.4	-57.6	7.4	1.19	1.83
Mexico	0.0	0.0	21.1	20.4	-7.4	5.9	1.56	1.93
Nicaragua	0.6	0.8	42.2	34.6	-89.6	6.4	1.47	1.87
Panama	1.2	-1.0	53.2	46.6	-15.4	8.2	0.95	1.61
Paraguay	1.0	0.5	17.3	12.1	-8.4	4.4	0.96	1.91
Peru	1.8	2.3	27.2	22.8	-14.4	7.4	1.05	1.62
R. Dominicana	0.6	-3.2	19.0	16.7	-1.5	10.2	1.38	1.86
Uruguay	-1.7	-1.0	50.7	39.9	15.9	6.4	0.79	2.27
Venezuela	3.0	-1.8	19.3	14.0	-15.4	13.4	1.14	4.16

Source: Author estimates based on ECLAC data.

Chile’s accumulation of a sizable portion of the copper price boom in stabilization funds was the best example of a counter-cyclical fiscal policy. But it was the exception rather than the rule. In fact, although several fiscal responsibility laws had been approved during the previous crisis, rules for managing spending or the associated stabilization

funds were changed by many countries during the boom to facilitate additional spending (Jiménez and Tromben, 2006).

The evolution of external accounts also deviates substantially from the “strong fundamentals” view. Figure 6 shows the evolution of the current account of the balance of payments for the region as a whole, adjusted by terms of trade variations (using the year prior to the boom, 2003, as the benchmark). As can be inferred from the Figure, the current account surplus was essentially a reflection of improved terms of trade. In fact, adjusted for terms of trade, the current account experienced a sharp deterioration during the boom, reaching by 2008 a deficit equivalent to 5% of GDP, significantly larger than that which had prevailed in 1997-1998, prior to the previous crisis.



Source: Author estimates based on data from ECLAC (2008c).

Table 6 shows more detailed information at the country level. The only three economies that continued to run current account surpluses up to 2008 were three energy exporters (Bolivia, Ecuador and Venezuela) and Argentina. Two additional countries, with a mineral export base (Chile and Peru) also ran surpluses up to 2007 but they turned into deficits in 2008. However, adjusted for the terms of trade, the current account

deficits of these two (otherwise virtuous) countries were some of the largest in the region in both years. Brazil also experienced a late but sharp current account deterioration. And, adjusted for the terms of trade, only two countries ran small current account surpluses in 2008: Bolivia and Uruguay; in the latter case, this indicates that the deficit at current prices was just a reflection of high oil prices. An implication of this fact is that countries will face an adjustment due to the deterioration of the terms of trade in 2009, particularly the energy and mineral exporting economies.

Table 6
Indicators of the External Sector

	Current Account Balance (% of GDP)		Current account adjusted for terms of trade 1/ (% of GDP)		External debt (% of GDP)		External debt net of international reserves (% of GDP)		Terms of Trade Variation 2003-2008	Exchange Rate variation 3/ 2003-2008
	2007	2008	2007	2008	2007	2008	2007	2008		
Argentina	2.7%	3.5%	0.9%	-0.9%	47.2%	42.8%	29.6%	27.5%	21.9%	13.3%
Bolivia	13.4%	12.0%	3.5%	0.3%	41.3%	13.5%	0.7%	-30.9%	49.6%	5.3%
Brazil	0.1%	-1.9%	-1.0%	-3.6%	14.9%	14.2%	1.0%	-0.1%	13.7%	-42.3%
Chile	4.4%	-3.0%	-14.6%	-18.1%	34.1%	33.4%	14.3%	13.0%	72.2%	-14.2%
Colombia	-2.8%	-2.7%	-6.3%	-7.8%	21.7%	19.0%	11.5%	9.4%	47.8%	-32.8%
Costa Rica	-5.7%	-7.0%	-1.3%	-1.6%	32.0%	29.4%	16.3%	16.9%	-14.5%	-3.3%
Ecuador	3.6%	3.0%	-3.1%	-8.5%	38.1%	31.8%	30.4%	21.1%	45.4%	15.8%
El Salvador	-5.5%	-5.9%	-4.8%	-4.2%	44.5%	40.8%	33.7%	30.1%	-7.7%	4.5%
Guatemala	-5.1%	-4.6%	-3.8%	-3.2%	12.6%	12.0%	-0.3%	0.0%	-6.3%	-16.6%
Honduras	-9.9%	-14.9%	-6.4%	-7.4%	24.6%	22.5%	2.4%	4.9%	-9.8%	-4.9%
Mexico	-0.6%	-1.4%	-2.1%	-3.8%	12.2%	11.8%	3.7%	3.7%	9.2%	0.4%
Nicaragua	-18.3%	-25.8%	-15.5%	-21.4%	59.1%	51.2%	39.9%	34.7%	-9.9%	-2.0%
Panama	-7.3%	-7.3%	-3.5%	-3.2%	42.5%	36.4%	32.5%	28.9%	-8.4%	9.9%
Paraguay	0.4%	-2.1%	1.0%	-3.7%	25.8%	19.5%	5.2%	0.6%	3.3%	-26.1%
Peru	1.4%	-3.8%	-7.7%	-11.1%	30.4%	27.1%	4.5%	3.9%	42.6%	1.9%
R. Dominicana	-5.4%	-12.7%	-5.5%	-11.8%	18.4%	17.3%	11.3%	11.9%	-5.4%	-25.1%
Uruguay	-1.0%	-3.5%	2.1%	0.5%	52.9%	40.7%	35.1%	21.6%	-16.5%	-23.6%
Venezuela	8.8%	12.6%	-6.7%	-6.0%	23.2%	17.9%	8.5%	5.9%	163.8%	-30.3%

1/ 2003 as benchmark year

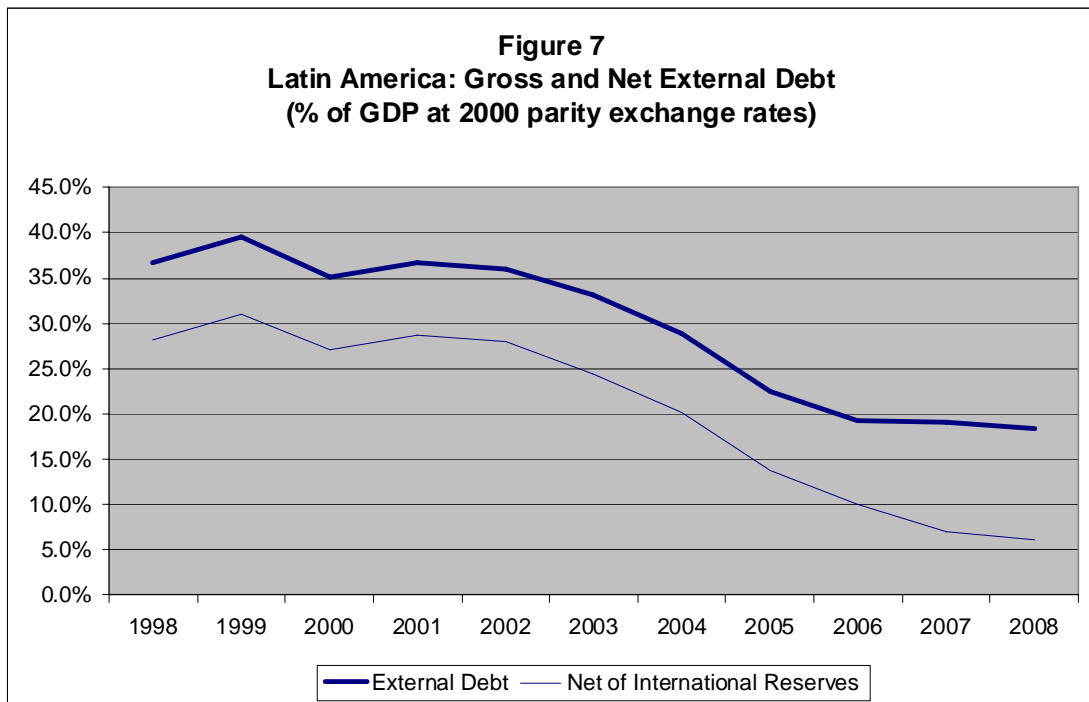
2/ In the case of Chile includes stabilization funds

3/ A positive sign indicates depreciation

Source: Author estimates based on ECLAC data.

As in the past, one of the reasons for the current account deterioration during the boom was exchange rate appreciation. As Table 6 indicates, this process was strong in Brazil, Colombia and Venezuela, and it was also present in several smaller economies (Guatemala, Dominican Republic and Uruguay). Chile also experienced an appreciation, though a more moderate one. The major exceptions to this trend were Bolivia and Peru. Argentina was also an exception up to 2006; the real depreciation that is shown in Table 6 is a reflection of the underestimation of domestic inflation, due to the official manipulation of the consumer price index. On the other hand, the depreciation of the U.S. dollar in international markets explains the real depreciation of the three dollarized economies (Ecuador, El Salvador and Panama).

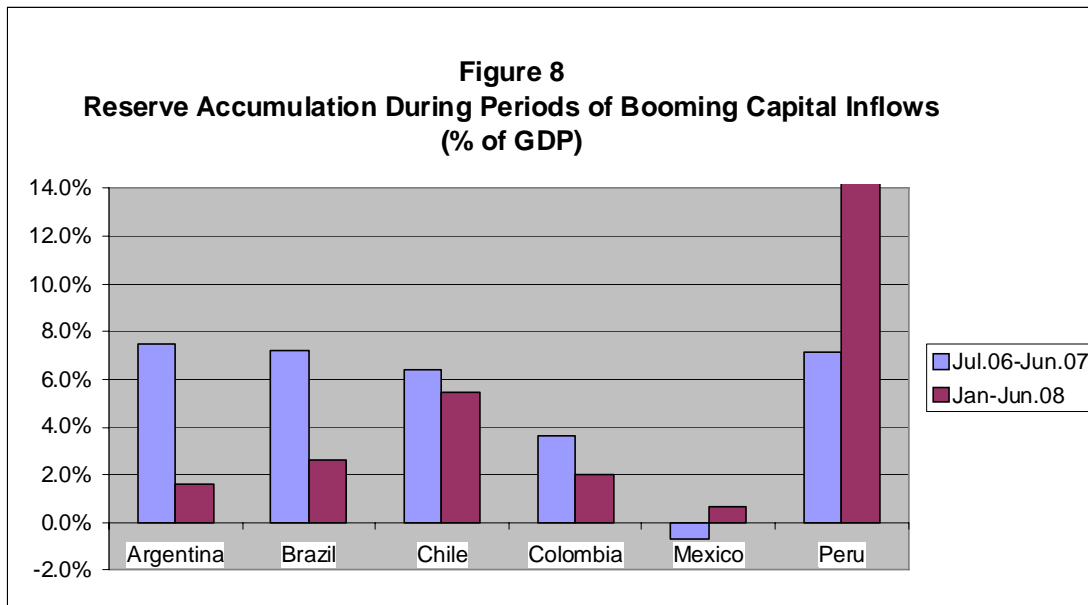
In contrast, Figure 7 shows the two dimensions in which there was a definite improvement during the boom years: reduced external indebtedness and foreign exchange reserve accumulation. To correct for the effects of the variations in exchange rates, coefficients in this Figure are estimated at 2000 parity exchange rates. As can be seen, the improvement in the net external debt (debt minus foreign exchange reserves) to GDP ratio was associated in 2003-2006 to the reduced dynamics of external indebtedness, and in 2007-2008 to the massive accumulation of foreign exchange reserves. The first of these phenomena was primarily due to the evolution of public sector external debts, as a reflection of low nominal deficits, growing reliance on domestic debt markets, and a few debt haircuts (Argentina and the Heavily Indebted Poor Countries of the region –Bolivia, Honduras and Nicaragua).



Source: Author estimates based on data from ECLAC (2008c).
 In the case of Chile, reserves include stabilization funds.

Foreign reserve increases were due, in turn, to the explicit decision to accumulate as additional reserves both part of the commodity price boom but also –and, we can say, in particular—, the flood of capital inflows. This is shown in Figure 8, which estimates reserve accumulation as a proportion of GDP in six of the largest Latin American

economies (all but Venezuela) during the two major episodes of massive external financing during the boom years: from mid-2006 to mid-2007, and during the first semester of 2008. As can be observed, interventions in foreign exchange markets were massive during the first episode in all countries but Mexico.⁶ This was also true of Chile and Peru during the first semester of 2008 and, to a lesser extent, of the other economies. This indicates that the description of foreign exchange rate regimes as “flexible exchange rates” is deceiving, with perhaps the exception of Mexico. Indeed, they were rather very dirty floats in the face of booming capital inflows –or “fear to float”. This strategy turned out to be a correct one, certainly much better than allowing the exchange rate to fully reflect the booming inflows, a strategy that would have led to disaster, as in the past. Nonetheless, in some countries, interventions were not strong enough to avoid exchange rate appreciation; Brazil and Colombia are the most important examples in this regard.



Source: Author estimates based on IMF International Financial Statistics
In the case of Chile, includes stabilization funds

As a result of both the trends in external debt ratios and reserve accumulation, net debt ratios were moderate in most economies of the region in 2008 (Table 6). The major exceptions were some Central American countries (El Salvador, Nicaragua and Panama)

⁶ In the case of Chile, estimates include resources transferred to the fiscal stabilization funds.

and South American countries which inherited a heavy external debt burden from the previous crisis (Argentina, Ecuador and Uruguay). Bolivia is the best example in this indicator, as reserves exceeded external debt in 2008 by a wide margin. Brazil was close to balance in this regard.

As a result of both strong external and public sector debt indicators, there was a broader room for maneuver of counter-cyclical macroeconomic policies than in the past. However, the room for counter-cyclical fiscal policies is modest, with a few exceptions (Chile being the most important and perhaps only one). The simple reason is that it would be impossible to maintain the high rates of growth of primary public sector spending that was typical of the boom years, notwithstanding the announcements of intentions to increase infrastructure and social spending (ECLAC, 2009).

In contrast, the room for counter-cyclical monetary and credit policies has been broader. High levels of foreign exchange reserves have allowed authorities to facilitate export financing and the rollover of some corporate debts (Brazil is noticeable in both regards). Development and public sector banks, still important in several countries, have also been used to maintain a healthy growth of domestic lending. And, with an initial lag, the strong external debt position has allowed several countries to reduce domestic interest rates since December 2008, sometimes quite rapidly –though, in general, spreads vis-à-vis Fed rediscount rates remain higher than was typical before the reduction of U.S. interest rates started in mid-2007.

IV. Conclusions and implications for the development strategy

The current world economic crisis has hit Latin America hard. The external factors that facilitated the 2003-2007 boom are now operating in the opposite direction. Overall, reduced remittances seem to have had the weakest effect, although it has been important for some small economies. This has been offset in some of the largest recipients by exchange rate depreciation. Although financial conditions have deteriorated, the financial shock per se is less severe than during the two previous regional crises – although, of course, this problem may become more severe if world financial conditions

remain poor for several years. So, the severity of the shock that Latin America has experienced can only be explained by the strength of the trade shock.

There has also been more room for maneuver for counter-cyclical macroeconomic policies. With some exceptions, this cannot be explained as a result of counter-cyclical policies during the previous boom leading to “strong fundamentals”. Improvements in the fiscal and external current account balances are explained rather by the very positive evolution of fiscal revenues and the terms of trade. Deterioration in favorable external conditions will lead to adjustment in both cases, which in the latter has been facilitated in some countries by strong exchange rate depreciation since September 2008. In particular, the growth of primary public sector spending is likely to be slower than that experienced by most countries during the boom years, and there will be a need for external adjustment in the face of worsening terms of trade in several countries.

It is only improvements in the external balance sheet and, particularly, the sharp reduction in external debt ratios and increases in foreign exchange reserves that provided significant space for counter-cyclical macroeconomic policies, particularly the reduction in domestic interest rates. The break with full exchange rate flexibility and, in particular, the decision to not allow the exchange rate to fully reflect booming capital inflows, but rather to accumulate the excess supply of capital flows as foreign exchange reserves, turned out to be one of the major sources of the current macroeconomic strength.

Thus, improved macroeconomic conditions were not simply the result of the application of inflation targeting-cum-exchange rate flexibility, as some interpretations suggest. They involved massive interventions in foreign exchange markets. Indeed, this break with orthodoxy may be one of the fundamental strengths of the Latin American economies, and has continued to be a characteristic of the management of foreign exchange markets during the crisis. Development and other public sector banks have also been used as a major mechanism to avoid the diffusion of the financial crisis. Pragmatism rather than orthodox management has therefore been one of the major sources of current macroeconomic strengths.

Despite such strengths, Latin America will experience one of its worst recessions and even another lost half-decade of development. This is reflected in the strong contraction in the volume of international trade and the collapse of commodity prices in economies that are today highly open. Export-led growth, the major strategy that was disseminated throughout the region during the period of economic liberalization now seems to have limited viability. Even more, the optimistic scenario of a return to commodity-led export growth, which had raised high expectations in several Latin American economies during the recent commodity price boom, now seems like an idea that has to be relegated to the past.

Were global trade conditions to remain weak, economies would be forced to rethink the relevance of domestic markets as well as regional integration as engines of growth, reviving strategies that were vilified during the reform period. This should not imply a return to the protectionist past, but it would mean rethinking the role of active production sector development strategies, including activity technology policies (see ECLAC, 2008a). It would also imply reviving the integration processes, now undergoing strains due to political confrontations among countries in the region. It would also be essential to counter the strong pro-cyclical trends that have characterized intra-regional trade in recent decades. Although some developments, particularly greater exchange rate competitiveness, may support production sector transformation, differences in exchange rate regimes that continue to be a major difficulty in integration processes will also have to be reexamined.

In short, stronger macroeconomic conditions have been of limited use in highly open economies in the face of the strongest adverse external shock since the Great Depression. Continuous macroeconomic pragmatism together with more active production sector policies is, therefore, the policy mix to pursue in the immediate future.

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