THE EFFECTS OF THE INTERNATIONAL FINANCIAL CRISIS IN LATIN AMERICA AND THE CARIBBEAN

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Meeting of the Regional Coordination Mechanism
Santiago de Chile, 03 November 2008
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- Origin of the international financial crisis
- Bail-out and the response of central banks
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- Financial contagion and the effects on Latin America and the Caribbean
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THE HYPOTHESIS: THE COMPONENTS OF THE CRISIS ARE A MIX OF INCENTIVES AND POLICIES

- Excessive risk-taking and remuneration packages in the private banking system related to subprime mortgage market
- Expansionary monetary policy by the Federal Reserve Bank and industrialized countries (except Europe) for extended periods of time.
- Real interest rates are currently negative
- Persistent macroeconomic imbalances in industrialized economies
- Innovations in financial markets with complex instruments without transparency
- Inadequate prudential regulation
- Insufficient margins of safety
CENTRAL BANKS STARTED PROVIDING MASSIVE AMOUNTS OF LIQUIDITY TO THE INTER-BANK MARKETS AND, ONCE THAT PROVED NOT SUFFICIENT, BAIL-OUT PACKAGES WERE ADOPTED THROUGHOUT THE DEVELOPED WORLD

Total liquidity provision and bail-out packages, 14-Sep to 20-Oct 2008
(Trillions of USD)

<table>
<thead>
<tr>
<th>Country</th>
<th>Liquidity used</th>
<th>Total rescue packages</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>1.37</td>
<td>4.30</td>
</tr>
<tr>
<td>European Union</td>
<td>1.63</td>
<td>2.42</td>
</tr>
<tr>
<td>15 euro zone countries</td>
<td>1.16</td>
<td>1.56</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.46</td>
<td>0.87</td>
</tr>
<tr>
<td>Japan</td>
<td>0.12</td>
<td>...</td>
</tr>
<tr>
<td>Others</td>
<td>0.05</td>
<td>...</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3.17</strong></td>
<td><strong>6.72</strong></td>
</tr>
</tbody>
</table>

Source: ECLAC, on the basis of information of the IMF, World Bank and international press.

The bail-out packages in the Euro area include interbank lending guarantees by several countries (US$ 546 billion in Germany; US$ 435 billion in France; US$ 136 billion in Spain). Britain will guarantee credit up to US$ 340 billion.
THE TRANSMISSION CHANNELS

- Financial contagion
- Remittances
- External demand
- Changes in relative prices

Real economy

Long run productivity growth
Cycle of the financial crisis

- Housing market bubble
- Mortgage securitization + Developments in financial derivatives
- Balance-sheets of financial institutions
- Liquidity problems
- Real economy
- SMEs, Workers, Consumers, Investors
- Credit crunch
- Long run productivity growth
Projections for 2009…… recession

Source: ECLAC, on the basis of information of the IMF.
FINANCIAL CONTAGION REACHED EMERGING AND DEVELOPING ECONOMIES AND LAC

CHANGE OF PRICE INDICES OF SELECTED STOCK EXCHANGES
(Percentage change between December 2007 and average of first half of October 2008)

<table>
<thead>
<tr>
<th>Country</th>
<th>Index</th>
<th>Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA (Dow Jones)</td>
<td>(UKX)</td>
<td>-28.1%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Japan (NKY)</td>
<td>-34.9%</td>
</tr>
<tr>
<td>Argentina (MERVAL)</td>
<td>Brazil (IBOV)</td>
<td>-35.4%</td>
</tr>
<tr>
<td>Mexico (MEXBOL)</td>
<td></td>
<td>-25.7%</td>
</tr>
</tbody>
</table>

Source: ECLAC, on the basis of information from Bloomberg.
CONTAGION DOES NOT SEEM TO BE CORRELATED WITH FUNDAMENTALS

EMERGING MARKETS BOND INDEX EMBI+, January-October 2008
INCREASING RISK PERCEPTIONS TOWARDS EMERGING ECONOMIES DID NOT LEAVE OUT LATIN AMERICA

EMERGING MARKETS BOND INDEX EMBI+ AND SELECTED LATIN AMERICAN COUNTRIES’ EMBI+ INDICES, 2007-2008
IN MEXICO, CENTRAL AMERICA AND THE CARIBBEAN WORKERS’ REMITTANCES ARE A MAJOR SOURCE OF INCOME

(Millions of dollars and percentages of GDP)
DOWNWARD TREND OF REMITTANCES

LATIN AMERICA AND THE CARIBBEAN: REMITTANCES GROWTH RATE
(Quarter-on-quarter growth rate)

Source: ECLAC, on the basis of national official information.
Per capita GDP growth was over 3%

The unemployment rate went down from 11% to 7.7%

The quality of employment improved

The region had broad access to external financing due to low interest rates and low sovereign risk

The global demand of commodities increased sharply

The terms of trade increased 20% in the region: the growth rates between 2003 and 2007 were 6% in Mexico, -7% in Central America and 33% in South America

Current account balances shifted to surpluses or significantly lower deficits

Increased flexibility in exchange rates

Foreign exchange liquidity buffers have increased substantially

Net public sector borrowing requirements are lower
MACROECONOMIC BALANCES ARE IN BETTER SHAPE THAN BEFORE

Although the situation differs widely across countries …
... AND THE SAME IS TRUE FOR PUBLIC FINANCES
IN 2001-2007, THE INCREASE IN GOODS EXPORTS WAS DUE MAINLY TO PRICE RISES. THIS TREND HAS CONTINUED IN 2008, WITH VOLUME GROWING (2.0%) BELOW ITS HISTORIC LEVEL (5.5%).
SOME COUNTRIES THAT HAD ATTAINED LARGE TRADE SURPLUSES HAVE SEEN THEM DECREASE WHILE OTHERS HAVE SEEN THEIR DEFICITS RISE. THE TERMS OF TRADE IMPROVED IN 2008 AND WILL DETERIORATE IN 2009.

**LATIN AMERICA: TRADE BALANCE, 2007-2008**

(Millions of dollars)

**LATIN AMERICA: TERMS OF TRADE 2008**

(Annual percentage change)

Source: ECLAC, on the basis of national official information.
WHAT WILL THE EFFECTS BE IN LATIN AMERICA AND THE CARIBBEAN?

- The effects in the countries will be different according to their position in terms of:
  - Solvency of the financial system
  - Surplus or deficit in operations (current and financial) with the rest of the world
  - Fiscal sustainability and public debt level
  - Inflation rate and expectations
  - Relative importance of remittances
  - Degree of diversification of export markets
  - Net external trade position in terms of commodities (net exporter or net importer of food and energy)
  - Degree of diversification of productive structure
  - Technological capabilities
MEASURES TAKEN BY LAC TO ASSURE PAYMENTS AND LIQUIDITY

- Central banks have intervened directly to increase liquidity
- Concrete measures include:
  - Nationalization of the private pension system in Argentina,
  - Issue of credit lines in USD for exporters in Brazil,
  - Purchase of off-shore deposits and lending the resulting funds to domestic financial institutions in Chile,
  - Lifting capital controls in Colombia
  - Increasing public spending in infrastructure in Mexico.

- Financial institutions in LAC do not hold the kind of derivative instruments but there is lack of (mainly USD) liquidity that are causing problems in the external financing of big firms.

- The lesson —yet to be learned—is that capital markets complement not substitute the banking system.
WHAT WILL THE EFFECTS BE IN LATIN AMERICA AND THE CARIBBEAN?

- More resilient so far but sharper economic slowdown (3%)
- No decoupling from cyclical deceleration from global Stag-Deflation (stagnation/recession plus deflation)
- Weakening commodity prices
- Scarcity of external financing
- Higher interest rates and unemployment rate
- Volatility, uncertainty and higher capital costs will affect investment
- Microeconomic fundamentals are severely compromised
FINAL REMARKS

- Crises are opportunities to challenge conventional forms of thinking.
- Focus is needed in microeconomic consequences of volatility and instability in prices to ensure long run growth and productivity.
- Relevance of industrial policies and state interventions is needed and a new mix of gradualism and interventionism is required.
- Intrarregional trade can be an engine of growth.
- Social expenditure should be countercyclical both nationally and internationally.
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