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How well has Latin America fared during the global financial crisis?

José Antonio Ocampo [1]
Septiembre de 2010.

Has Latin America broken new ground with its performance during the recent global financial crisis and, furthermore, during the recent business cycle? Some level of macroeconomic prudence was certainly present during the recent boom and the region responded to the recent crisis without the dramatic balance of payments adjustments and banking collapses that were typical in the past. But there seems is a significant level of complacency building up among governments, international organizations and some analysts. This paper argues that there are indeed good news, but that there is certainly no ground for euphoria. Neither has Latin America performance been so outstanding or generalized, nor is its fair performance associated only with the region's own efforts.

Although not spectacular by East Asian standards, Latin America did experience between 2003 and 2007 the period of fastest economic growth since that at the end of the long-post war boom that ended in the mid-1970s. The boom was fairly broad based and, indeed, stronger in the smaller and medium-sized than the two largest economies (Brazil and Mexico). Also, in contrast with the post-market reform period that started in the mid-1980s (before in some Southern Cone countries), its social effects were also favorable. Formal employment grew, unemployment fell, and poverty experienced a rapid decline, which was also enhanced by improved income distribution in several countries. This mix of good economic performance and positive social outcomes is seen as a distinguishing feature of recent Latin American performance (see, for example, Cornia, 2010). However, although this reflects policy improvements, the expansion was based on a usual combination of favorable external conditions:

[1] Professor, Columbia University. Former Under-Secretary General of the United Nations for Economic and Social Affairs, Executive Secretary of the Economic Commission for Latin America and the Caribbean, and Minister of Finance of Colombia. This is a revised version of a previous paper prepared by the author as part of his activities as Will Clayton Fellow in International Economics at the Baker Institute, Rice University, and presented at a conference on the impact of the recent financial crisis on Latin America organized by the Observatory on Latin America of the New School University in New York on November 2, 2009. It will be published in 2011 as a chapter in a book of conference papers.

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booming word trade and world commodity prices, ample access to international financing at historically low costs, and high level of remittances of migrant workers.[2]

The region also escaped the first phase of the global financial crisis, the collapse of US subprime assets in August 2007. Since then, however, external financing became more irregular and risk premia increased. The growth of remittances slowed down, due to reduced employment opportunities in recipient countries, particularly the construction sector in the US.[3] However, the persistence of the world commodity price boom until mid-2008, as well as expansionary policies in some cases (notably Brazil) allowed several countries to continue growing fast through the first semester of 2008. Changes in commodity price trends in mid-2008 may be seen, therefore, as an important turning point. However, the rapid spread of the crisis to Latin America was unleashed, as elsewhere in the world, by the bankruptcy of Lehman Brothers in mid-September 2008, and the financial meltdown, global recession and collapse of international trade that followed.

Contrary to optimistic perceptions, Latin America then experienced a strong recession, indeed one of the strongest in the developing world (including emerging economies). The external channels of transmission were, however, different from past crises. Thanks to significant improvements in external balance sheets during the preceding boom, but also to the series of stimulus and bailout packages in industrial countries, the financial channels were weaker and, particularly, shorter in duration than during past crises, and countries enjoyed some space for countercyclical macroeconomic policies. Aggressive expansionary policies in China and the return of the Asian giant to rapid growth rates also resulted in a rapid recovery of commodity prices to historically high levels, particularly in the case of energy and mineral products. In contrast, the collapse of trade volumes has strongly affected manufacturing and service exporters through the reduction of world and particularly U.S. demand. Remittances also had a strong effect on most small countries. The net effect of this mix of external shocks was very uneven. Several South American countries experienced a rapid recovery, amply

[2] See an extensive analysis of the boom in IDB (2008), Izquierdo, Romero and Talvi (2008) and Ocampo (2007).
[3] See an analysis of this issue in relation to Mexico in JPMorgan (2008).

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compensating for the 2009 recession or slowdown, but Mexico and several Central American countries have done less well, and Venezuela continued mired in recession as of mid-2010.

This paper looks at the effects of external events and domestic policies on Latin America during the recent global financial crisis and its policy implications. The first section analyzes the channels of transmission and its effects on the region. The second takes a look at policy responses. The third, concluding section, considers the major policy lessons.

I. The Impact of the Crisis

In contrast with the optimistic views, the impact of the crisis on Latin America was a strong recession in the last quarter of 2008 and the first quarter of 2009. Indeed, the initial GDP shock was stronger than that of the OECD, both in absolute terms and, particularly, in relation to rates of growth that prevailed during the boom years (ECLAC, 2010b, Box I.1). Furthermore, for the year 2009 as a whole, Latin America was second to the transition economies of Central and Eastern Europe and Central Asia in terms of the intensity of the shock (Ocampo *et al.*, 2010; United Nations, 2010). Figure 1 also indicates that this was the worst regional recession since the debt crisis of the 1980s, and the first one since then in which the simple average of the GDP growth rates of the region's economies turned negative, indicating that it was widespread. There was, in particular, a sharp slowdown with respect to the rapid growth rates that have prevailed in most countries during the 2003-07 boom (seven percentage points).

The magnitude of the initial slowdown or recession and, particularly, of the recovery, was quite diverse across the region.[4] This is reflected in Figure 2, which compares the annual GDP per capita growth of countries in region for 2009 and 2010 (expected growth rates according to the most recent ECLAC, 2010b, projections, which are more optimistic that those of the IMF, 2010b). Overall, a clear north-south pattern emerges, with South America fairing better than Mexico and Central America. Interestingly, this pattern is in sharp contrast to the previous and longer 1998-2003 shock, where South America was more strongly affected. But there are also sharp differences within the two sub-regions: Venezuela, a

[4] See a detailed analysis in ECLAC (2010b) and IMF (2010a).

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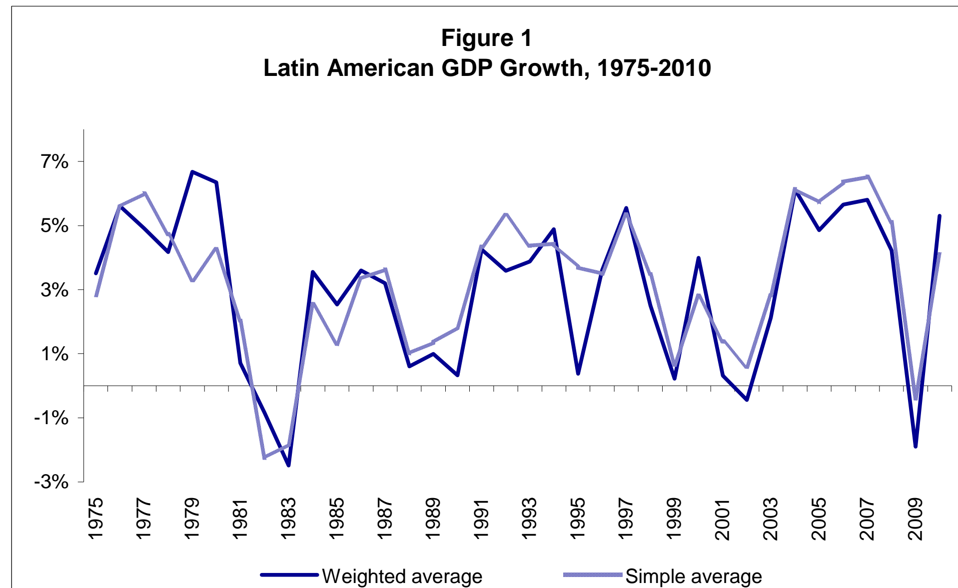
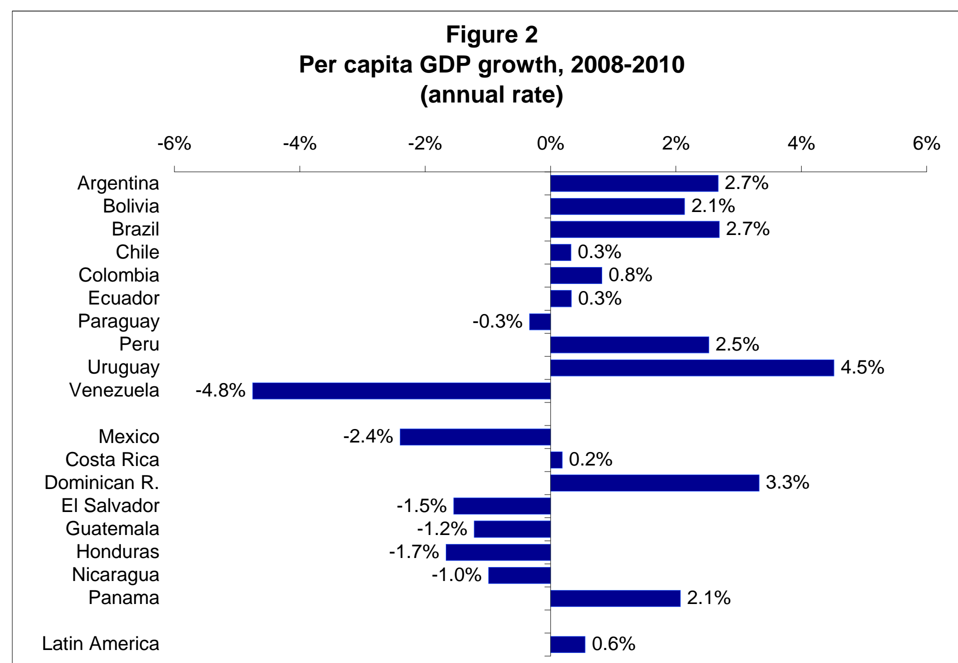
South American nation, is the worst performer, whereas two countries in the north of the region (Dominican Republic and Panama) have done relatively well.



Source: Estimated on the basis of ECLAC data



Source: Estimated on the basis of ECLAC data

Diverse performance reflects in part domestic policies. For instance, the sharp divergence between Brazil and Venezuela can only be explained by domestic

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factors: an active countercyclical policy in the former case and procyclical policies and a traditional crisis in the latter. In broader terms, improvements in external balance sheets, stronger prudential regulation and, to a lesser extent, better fiscal accounts during the boom years were responsible for the room to maneuver for countercyclical macroeconomic policies that several countries enjoyed during the recent crisis (see section II). But external factors also played a fundamental role. This includes, first of all, specialization patterns, particularly the stronger dependence of South America on commodities, in an international context in which commodity prices remained at relatively high levels and recovered rapidly after the initial downswing thanks to Chinese demand. In financial terms, international factors also played a fundamental role, particularly the strong recovery in international capital markets –though not, it could be added, of bank financing— thanks to the massive countercyclical monetary policy and financial bailouts in industrial countries. In this sense, a basic difference of the current crisis with the debt crisis of the 1980s and that of the emerging economies since 1997 was that there was a massive international reaction to contain its effects; the only precedent of which had been the response to the December 1994 Mexican crisis.

The nature of the transmission channels had, therefore, many novelties. A first, new, though negative factor was the sharp contraction of remittances. This shock came with lags. The initial contraction was not severe, but by the second and third quarters of 2009, remittances fell at a rate of 17% over a year earlier, and 15% for the year as a whole (IDB/MIF, 2010). Its overall regional impact was moderate, but it had substantial effects on smaller countries in Central America which are heavily dependent on remittances, as well as on services (tourism and transportation) which are provided to their citizens residing in the U.S.

The financial shock was initially severe: capital inflows were interrupted and risk premia went up sharply. However, the intensity of this initial turmoil was weaker, and, particularly, its length was significantly shorter than during previous crises. This is reflected in Figure 3, which shows the evolution of the yields of Latin American bonds during recent years. Spreads increased in mid-2007 as a result of the subprime crises, but the reduction of reference interest rates (10 year U.S. Treasury Bonds) brought yields back to previous levels by the year's end. Yields increased sharply in mid-September 2008, during the strongest phase of the global financial meltdown, as was typical of most securities worldwide. There were

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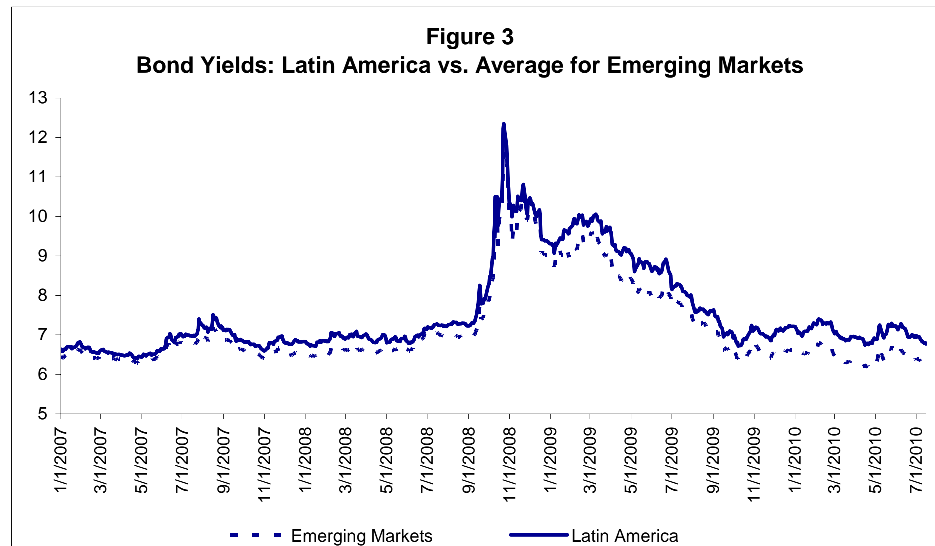
also massive losses in derivative markets by some Brazilian and Mexican firms. However, yields started to moderate late in 2008 and, particularly, since the second quarter of 2009, and were back to pre-crisis levels about a year after the Lehman collapse. Strictly speaking, this was the result of higher spreads (about 150 to 200 basis points relative to the situation before the subprime crisis of August 2007) that were compensated by lower reference rates. For the seven largest Latin American countries, yields are now *below* pre-crisis levels, with the exception of the two nations where spreads reflect an element of "political risk" (Argentina and Venezuela). Spillovers of the Dubai events of late 2009 and of European turmoil during the first semester of 2010 were negligible.



Source: JPMorgan

There are many other reflections of the early financial recovery.[5] There was a period of very irregular bond issuance after the August 2007 subprime crisis and several months of no issuance since mid-2008, which started somewhat before the Lehman collapse and may be thus reflect the reversal of commodity price trends. However, bond issuance returned in December 2008 and actually boomed since mid-2009, particularly for corporate issuers. The behavior of Latin America stock exchanges was of the most (if not the most) favorable one in the world during the turmoil: at the worst point in the post-Lehman days, stock prices remained about double (in dollar terms) the levels prior to mid-2004, when the

[5] For a closer analysis of these trends, see Ocampo (2009), and recent analysis of capital flows by ECLAC (2010c).

world stock exchange boom took off, and they also recovered, together with other stock markets, since the second quarter of 2009. The foreign exchange reserves of the seven largest economies fell only minimally during the worst of the crisis (from US$435 billion in September 2008 to US$411 billion in February 2009) before starting to increase again rather dynamically, with only one exception (Venezuela). Equally important, and again in sharp contrast with previous crises, there was no single domestic financial meltdown in the region. This cycle of short interruption in flows followed by a strong recovery of external financing was reflected in exchange rate patterns for those economies with more flexible exchange rates.

This allows us to state that, although the eye of the hurricane was the industrial countries' financial sector, in strict financial terms this is the least severe crisis that Latin America has endured. This is true not only relative to the debt crisis of the 1980s and the global emerging market crisis of the late twentieth century, but also to the 1930s, where the crisis led to broad based default.

In terms of international trade, the crisis had, in turn, two peculiar features. First, and again in sharp contrast with the three previous crises (the 1980s, the 1994-95 Mexican crisis and 1997-2002), where world trade continued to grow and facilitated recovery through export expansion, the trade collapse was dramatic and worldwide in reach. Second, and in contrast to most (or even all) trade crisis in history, commodities faired relatively well. As previously indicated, Chinese demand was crucial for this outcome. The early recovery of Latin American trade was also due in part to the capacity of Latin America to ride on the Chinese-led recovery of Asian trade and commodity prices.

These patterns are clearly visible in Figures 4 and 5. The first shows the dramatic collapse of world exports, by about a third relative to peak levels during the first semester of 2008. Latin America's exports followed the trend, falling just slightly less than the world average. More detailed analysis indicates that Central America did better than Mexico and South America, with Mexico having a stronger contraction in volume and South America in prices (ECLAC, 2010a). They also indicate that intraregional trade experienced a sharp downturn, again with the partial exception of Central America, and that exports to China from South America were the brightest spot, contracting only slightly during the worst phase

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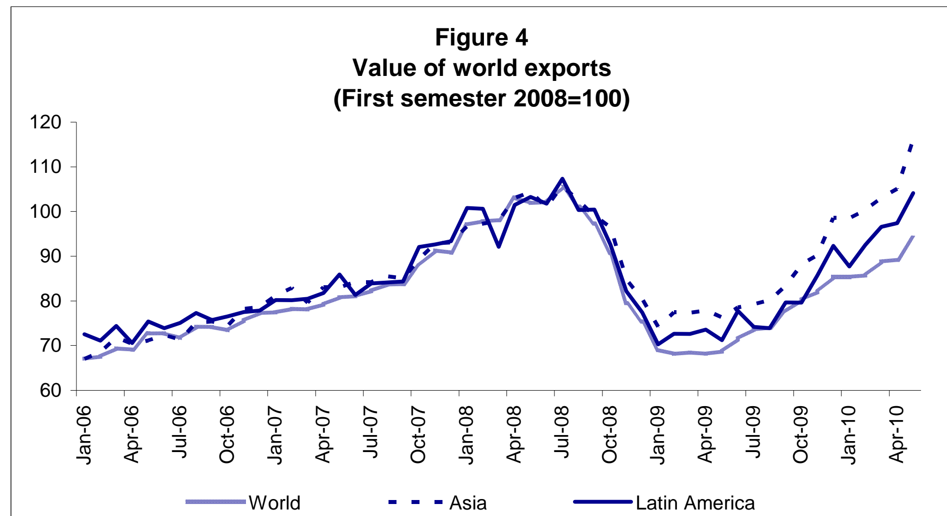
of the crisis and facilitating the recovery of Latin American exports thereafter. World exports have recovered since the second semester, with Asia leading the way and Latin America as the second best performer in the world.



Source: Estimated on the basis of data from the CPB Netherlands Bureau for Economic Policy Analysis

Commodity prices have done particularly well. As indicated at the beginning of this paper, this had been an essential feature of the 2004-07 boom, which continued through the first semester of 2008. Figure 5 shows the evolution of real non-oil commodity prices since the 1970s. As it indicates, there is also a significant difference between agricultural and mineral prices (with oil, not reproduced here, following a pattern similar to that of metals). For agricultural goods, the 2006-08 boom was only a recovery from the very depressed real prices that had prevailed since the 1980s. In the case of metals, prices had not been equally depressed and they reached historical peaks in real terms in 2006-08. One of the reflections of this is that terms of trade gains during the boom were concentrated in mineral (including oil) exporting economies: Venezuela and Chile, followed by Bolivia, Ecuador, Peru and Colombia, with a mainly agricultural exporter (Argentina) coming only seventh in the list, and relatively late in the process (Ocampo, 2009, Figure 2) In both cases, after the initial collapse, commodity prices recovered fast and the average real level continued to be very favorable in 2009, particularly again in the case of metals.

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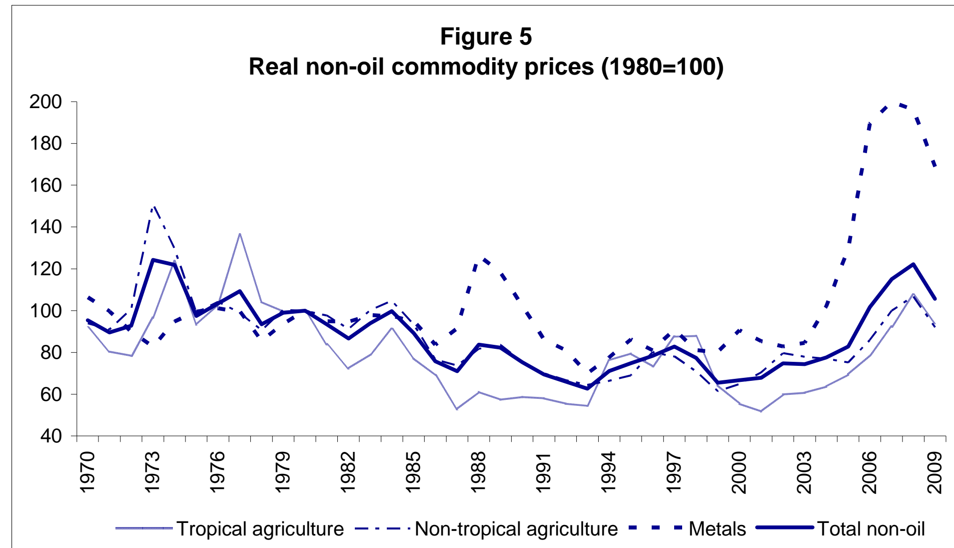

Source: Ocampo and Parra (2010) and update on the basis of same methodology. Commodity prices are deflated by the Manufacturing Unit Value estimated by the World Bank.

The external shocks had thus very diverse effects. Commodity exporters were placed in a relatively favorable situation relative to manufacturing exporters and those countries dependent on remittances. This explains large part of the diverse effects of the crisis throughout Latin America, particularly its "north-south" pattern. Financial events explain, in turn, the chronology: a strong initial shock followed by fairly rapid recovery. But domestic factors also played an important role. We turn to them next.

II. Domestic resilience and policy responses

The need to adopt countercyclical macroeconomic policies in response to adverse shocks crisis has been one of the major worldwide consensus during the recent crisis, subject more recently to an increasing divergence of views of how to mix it with fiscal sustainability. This is reflected in the fact that the word "countercyclical", which had been eradicated or at least marginalized from the lexicon of mainstream economics in recent decades, came back with force. It served also to frame the global macroeconomic response by the Group of 20 as well as multilateral financial institutions –both the IMF as well as the multilateral development banks. In the case of the IMF, it led to the doubling of all credit lines, the creation of the flexible credit line as a crisis prevention tool and the capacity to use other credit lines for that purpose. The multilateral development banks were capitalized and also responded boosting their lending, and explicitly recognized

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that they play a countercyclical role. The U.S. Federal Reserve extended swaps to some emerging markets, particularly Brazil and Mexico in Latin America, and China did the same with Argentina.

Several Latin American countries also enjoyed greater room of maneuver to undertake countercyclical macroeconomic policies than in the past. The reasons why countries enjoyed this "policy space" remains, however, subject to debate, particularly on whether it reflects "stronger policy frameworks", understood by the IMF (2009, ch. III), among others, as the mix of inflation targeting, flexible exchange rates, fiscal sustainability, adequate public sector debt profiles, and sustainable current account deficits. We will refer to this paradigm as the new orthodox policy framework. Major disagreements reflect diverse interpretations of what was achieved during the boom years in these areas. Alternative strategies emphasize the design of explicit *countercyclical* frameworks, the main purpose of which is to smooth out business cycles –i.e., *real* economic activity and employment—in the face of the procyclical capital flows that developing countries face (see, for example, Ocampo, Rada and Taylor, 2009, ch. 7). In some cases, the new orthodox framework can help achieve countercyclical objectives, but in others it may not. Broader consensus exists on financial resilience associated with prudential regulation and supervision of domestic financial institutions.

The most important change took place during the recent crisis in the monetary area, where countries were able to avoid the initial spike in interest rates that were characteristic of previous crises (Garcia and Marfán, 2010). This came with a lag after the September 2008 global meltdown, due to the initial persistence of adverse trends in food prices that had led to an acceleration of inflation in most countries during the first semester of 2008. Among the economies that use central bank interest rates as a major policy instrument, Colombia started this process in December 2008 but the most aggressive steps were taken by Chile during the first semester of 2009, followed by Colombia and Peru, with Brazil and, particularly, Mexico being more reluctant to ease policy rates (see Figure 6). Note, however, that this does *not* reflect a consistent countercyclical policy by central banks through the recent business cycle as, with the exception of Colombia, they did not take steps to cool the economy during the boom years, with interest rate hikes coming rather late in the process (only when the food price shock hit). One major issue is in fact associated with the biases

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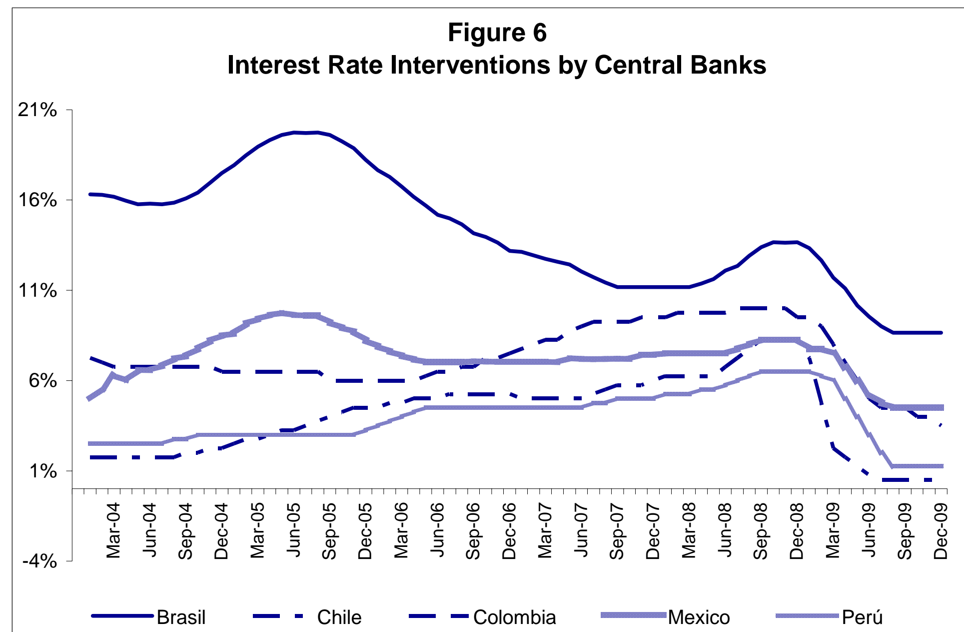
introduced by focusing exclusively (or primarily) on inflation targets, as exchange rate appreciation during booms helps achieve low inflation rates despite booming domestic demand, with the current account of the balance of payments deteriorating to absorb excess domestic demand.



Source: ECLAC

There were other expansionary monetary and credit policies adopted during the crisis. They included the reduction in reserve requirements, reversing increases that had taken place during the period of acceleration of inflation, and the creation of some central bank credit lines. It also included, quite contrary to the new orthodox framework, the use of public sector banks as an active instrument to increase domestic lending. This policy, which was at the core of Chinese and Indian countercyclical policies, was used by several Latin American countries, but only in Brazil did it have a major impact, given the still important share of public sector banks in that country. Brazil aside, credit did not experience an early recovery, indicating that the effects of expansionary monetary policies were rather muted.

Equally important, Latin America was able to avoid domestic financial crises, an essential feature of previous events of this sort. Strong prudential regulations were part of the story, though they did not include countercyclical prudential regulations, a topic that had been in the agenda for several years,

thanks in particular to their adoption by Spain. They did include, however, attempts to reduce dollarization in countries with a large share of domestic assets and liabilities in foreign currency, or to manage the additional risks that they generate. Peru and Uruguay were important examples in this regard, and Bolivia was also able to reduce dollarization of domestic public sector debt. Low dependence of bank financing on external funds was also important, with Chile as a somewhat less successful story in this regard (ECLAC, 2009).

In terms of foreign exchange, there have been diverse strategies, but none belongs to the orthodox standard of clean exchange rate flexibility. Among the large economies, Brazil, Chile, Colombia, Peru and Mexico were successful to absorb part of the initial shock through exchange rate flexibility; they all experienced, in turn, appreciation since the second quarter of 2009, when international capital markets started to normalize. However, none of these economies followed a clean flexible exchange rate policy, but rather a pragmatic mix of exchange rate flexibility *and* active foreign exchange interventions and, more generally, reserve management (in the case of Chile, also fiscal stabilization funds). Peru is the country that intervened more heavily in the foreign exchange market and was successful in smoothing exchange rate volatility, whereas Brazil and Colombia have experienced particularly volatile exchange rates. This pattern also prevailed in these two countries during the boom years (Ocampo, 2007). One exception from large interventions in foreign exchange markets during the boom years was Mexico, but it joined the club during the crisis. Aside from these cases, there a diverse set of experiences, which include dollarization (Ecuador, El Salvador and Panama), crawling pegs of different sort (Argentina, Bolivia and Costa Rica) and other "intermediate" regimes. The only country that has faced significant problems in exchange rate management has been Venezuela, which has used exchange rate policies which are reminiscent of past Latin American policies, now largely abandoned: multiple exchange rates, with significant overvaluation of a basic fixed rate, which was insufficiently devalued in January 2010.

In any case, orthodox exchange rate flexibility is no panacea, as it can generate significant instability in real exchange rates, and thus in the basic relative price indicator that tradable sectors face. It may, therefore, discourage investment in those sectors, with negative effects on growth (see Frenkel and

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Rapetti, 2010). Furthermore, in the face of procyclical capital flows, it is very rational, as a prudential policy, to absorb floods of foreign capital during booms as additional foreign exchange reserves. It is also now widely recognized that this self-insurance against crises can have a stabilizing effect even in economies that manage relatively flexible exchange rate regimes, and improves the room of maneuver for countercyclical monetary and fiscal policies. This is indeed what most central banks in the developing world, including those from Latin America, have done during the peak periods of booming capital flows: the second half of 2006 and the first of 2007, the first half of 2008 and since mid-2009. In this sense, intermediate foreign exchange regimes are friendlier with countercyclical policies than orthodox exchange rate flexibility.

Interventions in foreign exchange markets can be mixed with some capital account regulations. The IMF itself has recognized their virtue as a prudential tool during periods of booming inflows (Ostry *et al.*, 2010), a policy long recommended by the defenders of countercyclical macroeconomic policies (Ocampo, 2003; Marfán, 2005; Ffrench-Davis, 2008). Colombia applied some during the boom years, and Brazil introduced a tax on some inflows in 2009, but both were too moderate to have a significant effect in the face of large incentives for carry trade and other capital inflows generated by strong appreciation pressures in both countries.

Two factors also helped improved the room of maneuver for countercyclical policies, on which there is consensus. The first was the broader use of domestic bond markets to finance governments and increasingly, though less so, the corporate sectors. This significantly reduces public sector foreign exchange risks, which lead to significant increases in public sector debt ratios during crises as exchange rates depreciate. The second factor was the reduction in external debts, which had continued to be high up to the early 2000s. This, together with foreign exchange reserve accumulation led to the improvement in external balance sheets, which should be signaled as the major advance during the boom years (Ocampo, 2007). The Heavily Indebted Poor Countries (HIPC) Initiative supported debt reduction for the lower income countries in the region, as did the Argentina-led renegotiation of its debt after its 2001-02 crisis. As Figure 7 indicates, the external debt, both in gross terms and net of foreign exchange reserves, were still

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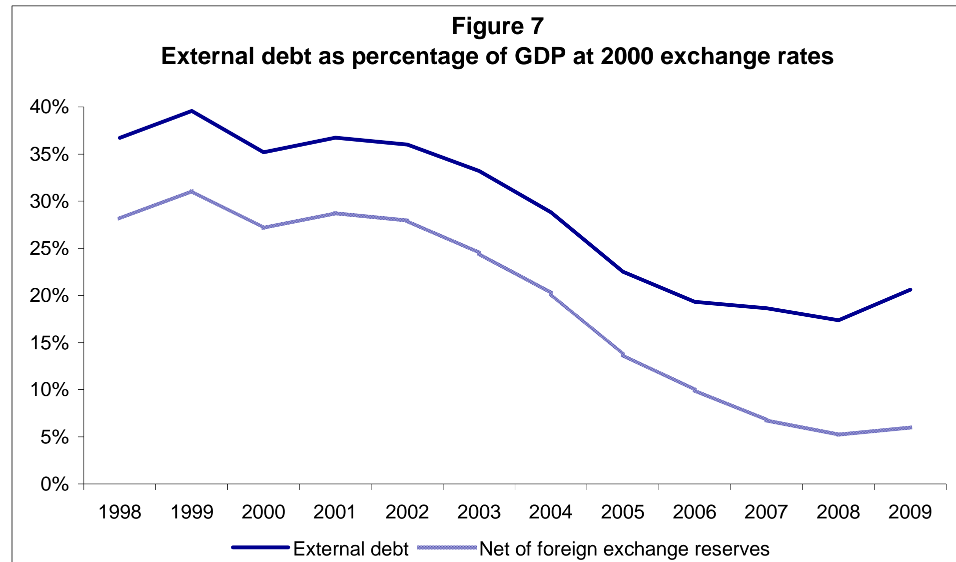
high in 2003, but then fell sharply. The net debt was only 5% of GDP in the latter case in 2008, and only increased moderately in 2009.



Source: Author estimates on the basis of ECLAC data

To what extent was this outcome a reflection of prudent aggregate demand management, as reflected in the current account surpluses that characterized the boom years? For most countries, the answer is clearly negative. Improvements in current accounts were essentially the result of booming terms of trade. As Figure 8 indicates, when the effect of terms of trade are netted out, there was a sharp deterioration of the current account to levels that by 2008 were significantly higher than prior to the previous crisis. Furthermore, as indicates, this was the pattern in most countries, with only a few exceptions –Argentina, Bolivia and Uruguay (Ocampo, 2009, Table 6). Thus, the unusual current account surpluses during the boom years were *not* the result of prudent balance of payments or aggregate demand policies. Rather, Latin America essentially spent –and, indeed, by 2008 started to overspend— its booming commodity foreign exchange revenues. In this regard, an important adjustment took place in 2009, equivalent to about two percentage points of GDP.

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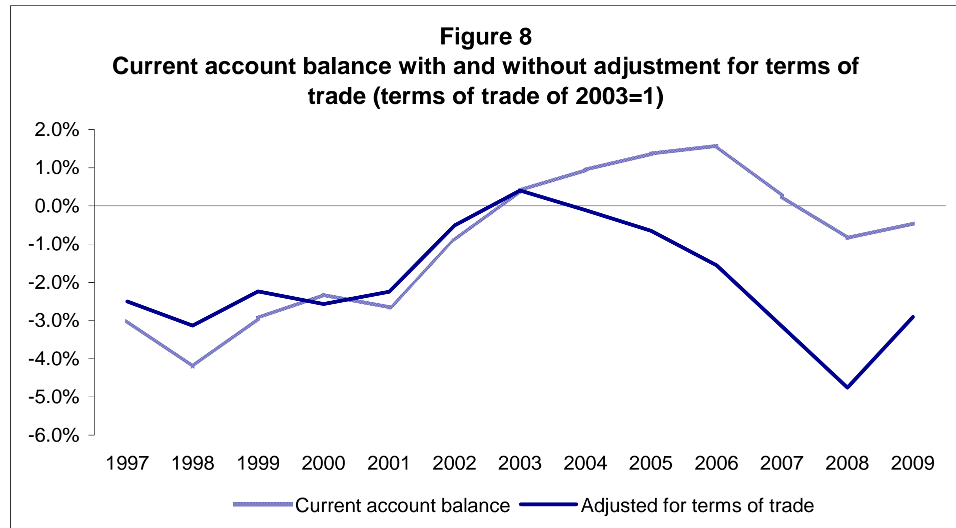

Source: Author estimates on the basis of ECLAC data

The fiscal story is overall a similar one. To start, fiscal prudence has been a feature of Latin America since the 1990s (or even the late 1980s), *not* the 2004-08 boom, and in this sense it is really a legacy of the debt crisis. As Figure 9 indicates, average fiscal imbalances have been moderate for the past two decades, with a cyclical pattern that may be described as essentially procyclical with some lags. During booms, spending responds with a lag to rising revenues, thus generating highly procyclical policies at the end of the boom. This had been the pattern at the end of the expansion of the 1990s, and was even more so in 2007-08, when real primary spending growth was running at an (unweighted) average of over 10% in real terms. Rapidly rising revenues included, in countries whose public sector revenues heavily depend directly or indirectly on natural resources, the fiscal side effect of booming commodity prices. During the first year after the crisis, spending dynamics maintains the boom pattern (with some moderation) generating, together with falling revenues, an increase in the public sector deficit that has countercyclical effects. If the crisis continues, as it did in the late 1990s, rising deficits and debts soon leads to a procyclical policy aimed at correcting fiscal imbalances.

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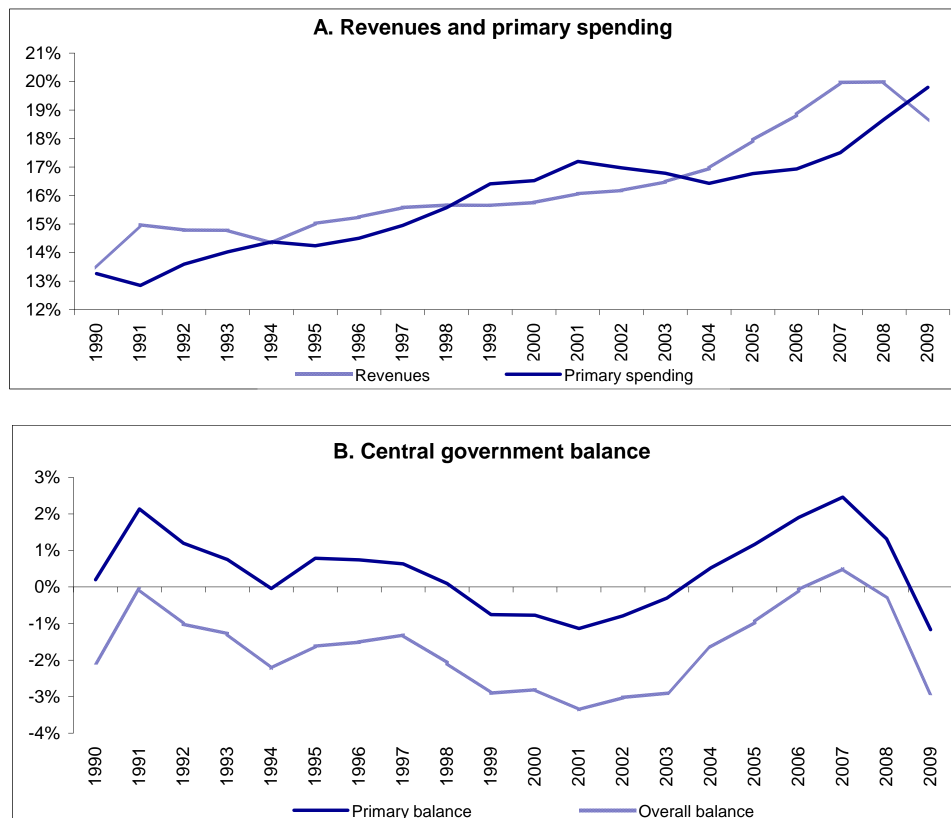
Figure 9
Central government finances (% of GDP, simple averages)



Source: Author estimates on the basis of ECLAC data

This initial countercyclical fiscal effect of fiscal policy was a feature of 2009, but also of 1998, as Figure 9 indicates. The effect was stronger in 2009 due to the sharper recession, which severely affected fiscal revenues, including those from natural resources, and through the steep rise in primary spending as a proportion of GDP, which reflected continued growth in spending but also the reduction of GDP. Real primary public sector spending actually fell to 6.6% from an average of 8.1% during the boom and, as already noticed, over 10% in 2007-08. There were also a few countercyclical tax cuts adopted in particular by Argentina, Brazil and Chile (all under 1% of GDP) (ECLAC, 2010b, Figure I.28).

The perception that fiscal policy continued to be procyclical during the 2004-08 boom for most countries coincides with the evaluations of IDB (2008), IMF (2009, ch. IV) and Ocampo (2009). This reflects a diverse set of country experiences. Table 1 presents a possible typology of the performance of different Latin American countries during the recent cycle (boom and crisis). It classifies as

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countercyclical the fiscal policies of those countries that meet two criteria: (i) the elasticity of primary spending to GDP was less than one during the boom years (either in relation to GDP growth during those years or GDP growth since 1990), and (ii) real primary spending in 2009 was faster than during the boom years (or faster than the Latin American average in one case). According to these criteria, only one third of the countries had countercyclical fiscal policies. Half of the countries can be characterized as having a procyclical policy: rapid growth of spending during the boom, followed by a slowdown –generally a sharp one— during the crisis. Finally, three countries had a procyclical fiscal policy during the boom and continued with rapid growth of spending during the crisis; these countries are characterized as having a persistent rapid growth of spending. According to some national evaluations (see, for example, Barbosa, 2010), Brazil should probably be placed in this category rather than that of a procyclical policy, which is where it is classified according to the data sources used to estimate Table 1. On average, according to this methodology, Latin America ran a moderately procyclical fiscal policy.

Wage policy, generally left aside from these analyses, should probably be added as a factor that had countercyclical effects during the recent crisis. The slowdown of food inflation had, by itself, a positive effect on real wages. But this was mixed with an active minimum wage policy in several countries. The join effect of these two factors was an important increase in minimum wage policies in most countries (ECLAC, 2010b, Table A-26).

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Table 1
Characterization of Fiscal Spending

	Annual real growth primary spending		Growth of spending 2004-08 vs. GDP growth in:	
	2004-08	2009	2004-08	1990-2008 1/
Countercyclical				
Chile	5.3%	14.8%	1.10	0.98
El Salvador	1.8%	9.1%	0.54	0.46
Guatemala	1.8%	6.4%	0.41	0.46
Paraguay	1.9%	28.7%	0.39	0.71
Peru	7.3%	12.7%	0.95	1.50
Uruguay	7.8%	7.4%	0.85	2.27
Persistent rapid growth of spending				
Argentina	12.1%	19.7%	1.44	2.92
Colombia	7.7%	10.9%	1.41	2.17
Costa Rica	7.4%	12.8%	1.27	1.46
Procyclical				
Bolivia	10.2%	-0.8%	2.11	2.66
Brasil	7.7%	3.0%	1.63	2.56
Dominican R.	11.6%	-13.3%	1.67	3.44
Ecuador	18.2%	5.6%	3.39	5.66
Honduras	7.8%	3.5%	1.33	1.92
Mexico	6.7%	-4.7%	1.97	2.25
Nicaragua	6.8%	-1.1%	1.71	2.05
Panama	11.2%	4.2%	1.21	1.95
Venezuela	12.0%	-1.0%	1.18	3.85
Average for LA	8.1%	6.6%	1.34	2.18

1/ 1997-2008 for Brazil and Dominican Republic
Source: Author estimates on the basis of ECLAC data

III. Policy implications

A basic implication of the previous analysis is that the recent strength of the region is not entirely due to "stronger policy frameworks" and it is clearly not due to a broad based shift of the region towards countercyclical macroeconomic policies. First, some of these outcomes were determined by favorable external factors, not only during the boom years but also during the crisis. Two factors stand out during the crisis: the rapid stabilization of international financial markets, thanks to massive action by industrial countries, and volatile but relatively high commodity prices, thanks to Chinese demand.

In terms of domestic macroeconomic policies, the evolution of the current account adjusted by terms of trade during the boom years reflects a macroeconomic policy that can be characterized as essentially procyclical, and this

is also true of fiscal policy in most countries. So, the strength of the balance of payments and the public sector account during the boom was more a result of high revenues rather than of macroeconomic moderation. Monetary policy was indeed countercyclical during the crisis but not so, in most countries, during the boom. So, rather than a commitment to countercyclical macroeconomic policies, the strength of the region as the global financial crisis hit was associated with *improved external balance sheets facilitated by an exceptional external boom*, which was reflected in moderate external indebtedness by the public sector and increased foreign exchange reserves. Domestic financial policies also had positive effects, particularly strong prudential regulation –though with the countercyclical focus still absent—, promotion of domestic bond markets, limited dependence of most banking systems on external funding, and reduced dollarization in some countries.

The internalization of inflation as a major objective is also a major step forward in a region that lived through several hyperinflations and a period of generalized moderate or high inflation, particularly in the 1980s. Whether inflation targeting is the clue to this outcome is more debatable. Indeed, the experience during the boom years indicates that inflation targeting may actually limit central banks action if a rapid expansion in domestic demand is not reflected in rising inflation, essentially because it is accompanied by exchange rate appreciation and a deterioration of the current account of the balance of payments. The crisis has also made clear that concentrating the focus of central banks on inflation is suboptimal. In industrial countries, central banks have been more concerned in recent years with economic recovery and domestic financial stability, which have thus been recognized implicitly and sometimes explicitly as central policy objectives of these institutions.

In developing countries, central banks should also focus on guaranteeing relatively stable and competitive exchange rates. As we have seen, few central banks follow orthodox flexible exchange rate regimes. This deviation from orthodox is actually fortunate, as it helps to absorb excess capital inflows during boom years as a precautionary policy that enhances the room of maneuver for countercyclical monetary and fiscal policies during the downswing (the self-insurance function), and helps avoid the adverse effects on growth of volatile and uncompetitive exchange rates. In this regard, if anything, central bank

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interventions in foreign exchange markets have been less than optimal in several countries of the region. Capital account regulations can also play a useful role as a way of moderating the macroeconomic effects of booming capital inflows, but have been used in a rather limited way. They could be more broadly used.

The experience of Latin America, as other parts of the world, during recent decades implies, in short, that central bank should have multiple objectives. The complexity that multiple objectives generate certainly makes central bank management more difficult, but this may be, after all, what a "stronger policy framework" means, not the new orthodox focus on inflation targeting and flexible exchange rates. This should be mixed with countercyclical fiscal rules, a fortunate emphasis in current policy debates, on which Chile has been so far the only example before the current crisis (Ffrench-Davis, 2010). And it should continued to be mixed with the positive domestic financial policies, including countercyclical prudential regulation. Overall, this policy mix leans much more to the countercyclical rather than to the orthodox policy paradigm. The latter should continue to be subject to significant revisions.

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