Pain but no panic

A traditionally crisis-prone region is belying its reputation. But that has not spared it from the world recession.

Illustration by S. Kambayashi

Until recently many Latin Americans saw the financial crisis and the global recession as events happening somewhere else. But in the past six months the region's economies have swiftly slumped along with the rest of the world, showing double-digit falls in industrial output. Workers have been laid off in Mexican car factories, Brazilian aircraft plants and Peruvian building sites. For Latin Americans such woes are sadly familiar: income per person in the region has fallen on five separate occasions since 1980. What is different this time is that Latin Americans are faring no worse than the rest of the world. And there are reasons to believe that their recession may be relatively short and mild. That may not be cause for celebration but it is a crumb of comfort.

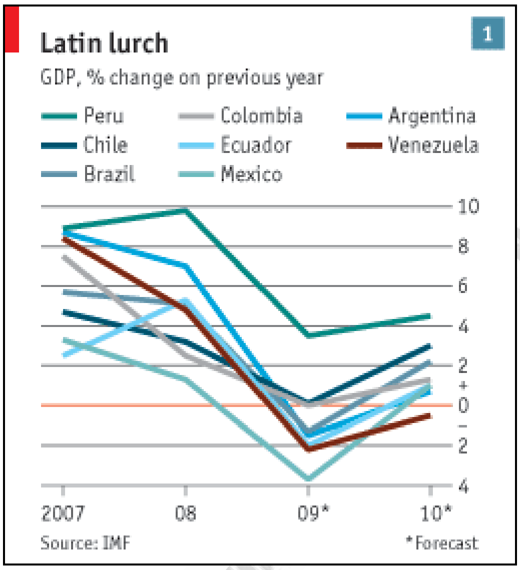
The bad news is, however, quite bad. Latin American countries have been hit by four different recessionary forces. As the financial crisis in the developed world transmuted into a collapse of manufacturing, trade plunged: total exports for five of the region's larger economies fell by a third between August and December, partly because fewer goods were sold and partly because the price of commodities fell.

The flow of capital to the region also dried up, leading to a steep rise in borrowing costs for governments and companies. The Institute of International Finance, a bankers' group, thinks that net private capital flows to Latin America will fall by more than half this year compared with last, to $43 billion (down from a record $184 billion in 2007). Foreign banks have trimmed credit lines, especially for trade. In addition, remittances from Latin Americans working abroad have begun to contract, and fewer tourists have come visiting.

Most forecasters think that GDP in Latin America and the Caribbean as a whole will contract slightly this year, but a moderate recovery will follow next year. The IMF, for example, predicts a contraction of 1.5% in 2009 and growth of 1.6% in 2010. With the population growing at 1.3% a year, income per person will shrink.

All this brings an abrupt end to five years in which economic growth averaged 5.5% amid generally low inflation. This golden demi-decade also saw social progress: according to household surveys, poverty fell from 44% in 2002 to 33% last year, when 182m people were classed as poor; the region's wide inequality of income narrowed; and tens of millions of Latin Americans joined an emerging lower-middle class.

Just how bad the recession will be varies markedly from country to country (see chart 1). Countries with close ties to the United States' economy—Mexico and much of Central America and the Caribbean—will fare worse than the regional average. In Mexico the fall in output was still accelerating in February, and the disruption caused by the outbreak of swine flu will make things worse (see article).



By contrast, countries such as Brazil whose exports are more diversified, spanning different markets as well as products, or those whose economies are relatively closed, will be hit less badly. In Brazil there are already signs that recession will be short. Guido Mantega, the finance minister, points out that more Brazilians were hired than fired in March. Many forecasters expect Peru's economy to buck the regional trend by growing this year and next, partly because it exports much gold, whose price has held up, and partly because it has a fat pipeline of foreign and public investment projects.

Lessons learnt

The good news is that things might be much worse, and in the past usually were. The three classic Latin American sources of weakness—financial systems, currencies and the public finances—have not been an independent source of woe this time, as Augusto de la Torre, the World Bank's chief economist for Latin America, points out. In the case of financial systems, that is partly because they are relatively small and undeveloped (paradoxically, this was often cited as a drag on growth). But it is also because most were tightly regulated, the result of lessons learnt the hard way over the past quarter-century. So the banking system is not acting as a magnifier of recession.

A decade ago governments in many of the larger countries in the region reacted to a previous bout of financial-market turmoil by switching from fixed to floating exchange rates. They backed these up with more responsible fiscal policies, and by requiring their central banks to target inflation. In contrast to the practice during previous booms, Latin America maintained a current-account surplus (and so accumulated reserves), and paid off public debt.

In this group of countries (Brazil, Mexico, Chile, Peru and Colombia among the larger ones), these policies are now proving their worth. The currencies of several of them depreciated by around 30% when money fled emerging markets in the weeks surrounding the collapse of Lehman Brothers last September. But devaluation, which will help exports, has not led to panic. In contrast to past recessions, when governments were forced to raise interest rates to defend the currency as well as to cut spending, this time they have been able to take steps to mitigate recession. Several of the larger economies have announced fiscal measures to stimulate demand, averaging around 1% of GDP. Some have done more: both Chile and Peru promise to raise public spending by around 10% this year, much of it on infrastructure such as roads and housing. It is not yet clear how much extra spending will happen in practice.

As important, central banks are cutting interest rates steadily (see chart 2). They have scope for further cuts. They have also taken other measures to provide credit. Brazil's Central Bank, for example, stepped in to provide dollars to help companies to repay foreign debt. It also allowed commercial banks to draw down some of the funds they are required to deposit at the Central Bank in normal times. As a result of these actions, credit is gradually returning, says Henrique Meirelles, the Central Bank's president. Peru's Central Bank has taken similar steps. State-owned development banks in Mexico, Chile and Brazil have all stepped up their lending.

The dissenters

Other countries have taken a radically different approach. Venezuela, Argentina and Ecuador have pursued expansionary fiscal policies in recent years, and their populist governments have harassed the private sector and foreign investors. All have fairly rigid exchange rates: Venezuela's bolívar is fixed, Argentina has long intervened to manage the peso and Ecuador uses the dollar as its currency. The growth of public spending in these countries was highly dependent on the commodity boom. To sustain spending, Argentina and Ecuador have raided pension funds while Venezuela's government has plucked reserves from the Central Bank. Venezuela's public debt is low and it can tap local banks for loans, but it is the only one among the region's bigger economies to have announced a cut in public spending this year.

The IMF reckons that these three will be among the worst-performing Latin American economies, along with Mexico's, though it thinks Mexico will recover more quickly. Many economists believe that the longer the world recession lasts, the greater the risk that Ecuador, Argentina and Venezuela (in that order) will run out of money. Supporters of these governments point out that the IMF's past growth forecasts for Venezuela and Argentina have been unduly pessimistic. All three countries are looking to China for support: Venezuela and Ecuador have signed investment agreements, and Argentina has a currency-swap line aimed at reducing its need for dollars. But such help may be inadequate.

Other governments are starting to queue up for support from the IMF. This month Mexico arranged a loan of $47 billion under the fund's new flexible credit line. Colombia has requested a similar loan of $10.4 billion. This credit is designed for countries with sound policies and carries no strings. Buttressing the balance of payments in this way gives more scope for interest-rate cuts without triggering currency weakness, says Nicolás Eyzaguirre, the IMF's top official for Latin America.

Even in the better-run countries, the scope for fiscal stimulus is limited. Only Chile, which saved the equivalent of 12% of GDP in a special fund during the boom, can repeat the dose for several years from its own resources. As recession bites, tax revenues are falling everywhere and public deficits rising. Mr de la Torre predicts that in the region as a whole fiscal revenues will fall as a proportion of GDP from 24.4% in 2008 to 21.2% this year. The multilateral banks are stepping into the breach. The World Bank will lend about $14 billion to the region in the year to June, and a similar amount in the following 12 months, up from a recent annual average of $5 billion, according to Pamela Cox, the bank's vice-president for the region. The Inter-American Development Bank (IDB) has also increased lending, to $15 billion a year. It is seeking to raise more capital.

The big fear in the region is that the longer the recession lasts, the more difficult it will be to sustain government spending without additional aid. That is because the vast stock of public debt to be issued by rich countries may crowd out Latin American borrowers. Researchers at the IDB argue that aid should be geared more to helping government refinance public debt than to providing further stimulus. Unlike rich countries, this argument goes, Latin America may gain more in the medium term by defending its hard-won fiscal stability and relying on the outside world for stimulus.

But there will be political pressure to do more. Already recession has halted some of the social progress of the past few years. Even if the recession is short and mild, the result will be 6m more Latin Americans in poverty than would otherwise be the case, estimates Marcelo Giugale, a poverty specialist at the World Bank. Of these, 4m are people whose incomes will sink below the poverty line, while 2m are people who would have risen above it had it not been for the recession. Mr Giugale notes that traditionally recessions in the region see an increase in child malnutrition and in teenagers dropping out of school to seek money in the informal economy. Public-health provision deteriorates both because budgets are cut and because demand rises as some middle-class Latin Americans can no longer afford private health insurance.

In social policy, too, the region is better placed than in the past. A dozen countries have cash-transfer schemes aimed at tackling extreme poverty in rural areas. In some countries, such as Mexico and El Salvador, governments have increased payments under these schemes. Many are looking at expanding their coverage. Peru is trying to extend the provision of free school meals to cover family members.

In the 1980s poverty rose steeply in Latin America, and public services and investment were slashed. There are reasons to hope that it can be different this time. Seven months after the financial crisis hit the region, pain is spreading but not turmoil, nor is economic stability being lost. "If the world economy rebounds, Latin America can rebound," says Mr Eyzaguirre. The question is when that will happen.

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