

Latin America in Today's Crisis



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Latin America couldn't escape the financial storm that has swept across the globe. As mortgage giants Fannie Mae and Freddie Mac teetered and Lehman Brothers fell, the crisis deepened and a sharp recession in the US, Europe and Japan became inevitable. Until then, Latin American countries had remained relatively unscathed and had kept their collective fingers crossed that the storm would pass them by. After all, many countries had kept their domestic houses in order and had benefited from the soaring prices of oil, metal, food and other commodities. But the specter of plummeting aggregate demand sent commodity prices into free fall and the terms of trade for Latin America's seven largest economies (LAC-7) slipped 25% between their peak of July 2008 and December 2008. To add insult to injury, corporate bond prices fell 21% between September 2008 and March 2009 and issuance levels collapsed, signaling that access to international credit markets had essentially shut down.

While corporates were shut off, the picture seems to be different for sovereigns. Latin American sovereign bond prices have fallen by close to 16%, and spreads stood at 650bps in March 2009. However, issuance data suggest that access to international capital markets remains open and continues to improve. Sovereigns were able to place \$57 billion in new debt during the first quarter of 2009, relative to \$70 billion during

A slow global recovery may pose challenges for Latin America that are far from trivial.

the second quarter of 2008. Nevertheless, even though markets remained open, market conditions have taken a significant turn for the worse in terms of maturity: short-term debt issuance as a share of total issuance for Latin American sovereigns jumped from 29% in second quarter 2007 to 63% at the end of 2008. This context in which access to capital markets is not closed, but available at substantially higher spreads and shorter maturities, has been dubbed financial precarization—or FP for short. The contrast between a Sudden Stop (SS) and FP is a key distinction that will have far-reaching implications for the macro dynamics and the risk perceptions of the region.

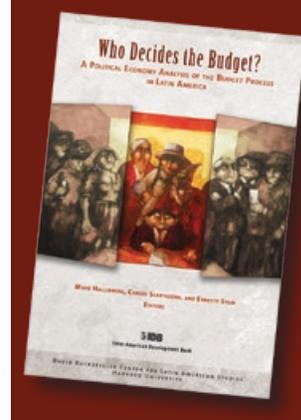
This context differs from that of the Russian crisis of 1998, when just one month into the crisis EM spreads reached almost 1700bps and EMs fell like dominoes one after another. Spread levels for sovereign borrowers at around 630 bps in March 2009 are well below those prevailing at the time of the Russian debacle.

What's different this time? For one, EMs were not part of the epicenter of the crisis but, instead, were innocent bystanders. Additionally, the sub-prime crisis found in the US Federal Reserve a strong lender of last resort that provided massive liquidity, indeed a function that was largely absent at the time of the Russian crisis. The fact that the current crisis has a global dimension provides

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incentives for industrial countries to come up with financial support for EMs.

Another difference is that Latin America appears stronger than it did in the late 1990s in some relevant dimensions. In particular, liability dollarization levels are currently much smaller on average and current account deficits are much less significant than at the time of the Russian crisis, implying potentially smaller changes in the real exchange rate were a SS to materialize. These two factors have been identified as key ingredients behind the probability of a SS in capital flows given their balance-sheet effect implications and may very well explain why Latin America has withstood the first wave of the global crisis so well. Its performance thus far is in stark contrast to other regions such as Emerging Europe, where dollarization is rampant and current account deficits are substantial.

However, while the door to market access for sovereigns has remained open so far, it is not wide open. Instead, access is in a context of FP, i.e., at higher rates and much shorter maturities. FP implies a different ballgame for the region relative to that of a SS. In a SS, since credit markets are closed, stock considerations pose an immediate threat to international liquidity as countries find it difficult to roll-over outstanding stocks of debt coming due, leaving little room for policy maneuver. However, under FP, access to markets is not closed but credit is obtained under more precarious terms, making liquidity issues a key element to keep an eye on.

The triple shock in external drivers—industrial country recession, a severe drop in commodity prices and terms of trade, and FP as described

above—has had stark implications for Latin America's growth forecasts. Market growth forecasts for LAC-7 in 2009 were revised downward from 2.5% as late as October 2008 to -0.9% as of March 2009 and -2% in July, consistent with a deterioration in global conditions. However, the region hopes to return to positive growth in 2010, assuming the US economy hits bottom in 2009.

Thus far, governments in the region have tilted toward expansionary monetary and fiscal policies to compensate for the deterioration in external conditions and been given the intellectual and financial nod by the international community. With greater exchange rate flexibility and a more independent monetary policy, the LAC-7 group had devalued its currency by almost 30% by March 2009 while at the same time gradually reducing interest rates. This policy reaction stands in stark contrast with the one enacted in the aftermath of the Russian crisis of 1998, when exchange rate intervention ruled and interest rates shot up in response to the crisis.

Fiscal policy has also leaned towards expansion. Several countries have announced additional expenditure programs and/or tax cuts in order to sustain growth that ranges from 1.5% of GDP in Mexico to 6.4% of GDP in Argentina. Again, these policy announcements contrast sharply with the policy reaction following the Russian crisis of 1998 when the LAC-7 countries displayed a negative fiscal impulse equivalent to 2% of GDP.

In sum, Latin America has been dragged into this new and uglier phase of the global crisis, but has survived the first shock wave of the global cri-

sis relatively intact. This has led many people to believe the following:

- Latin America starts with strong fundamentals for withstanding the worsening global conditions.
- The region is better equipped than it was a decade ago to pursue countercyclical monetary and fiscal policies to mitigate the impact of adverse external shocks.
- Multilaterals stand ready to support Latin America, and for that matter other EMs, given the global nature of the crisis.
- The recession in 2009 will be relatively deep but short-lived and the region should return to positive growth in 2010.
- As a result, the impact of the global crisis will be limited to the real sector, but liquidity crises and economic collapses, so prevalent in the past, will be largely prevented.

Unfortunately, this only explains the picture as of today. It is a static snapshot in time. But how about the movie? That will largely depend on future developments in industrialized countries.

What happens should the global recovery be more protracted than expected? Can Latin America beat the odds? This issue of *IDEA* looks at the most likely scenarios facing Latin America today, including the policy prescriptions and multilateral support programs available to confront the global crisis. It draws on research presented in *Policy Trade-offs for Unprecedented Times: Confronting the Global Crisis in Latin America and the Caribbean*, a document coordinated by Alejandro Izquierdo and

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Assessing the Potential Damage: How Vast is the Desert?

What does the global crisis mean for Latin America? It all depends. There are some signs of “green shoots” in the US economy, but there is still substantial doubt over whether the crisis has touched bottom and over the speed of recovery. Latin American policymakers are thus faced with very unsure global economic scenarios. Will recovery be quick or will it be more protracted? In other words, how vast is the desert that will have to be crossed? This question is key because its answer will largely determine the appropriate set of matching policies. Crossing a narrow desert strip may allow water in the canteen to be used lavishly. But what if the desert is more expansive and the caravan runs out of water before the end of the journey?

To assess the potential damage on the region, two scenarios are constructed to reflect uncertainty about future global developments. The first scenario envisions a relatively rapid recovery and is dubbed a V-shaped recovery. The second is a more prolonged recuperation termed an

L-shaped recovery. Neither scenario contemplates any catastrophic developments in the US or in the global economy that would certainly spell disaster for Latin American (LAC-7) fundamentals.

V-shaped Recovery Scenario. The assumptions behind a V-shaped recovery are that the US economy touched bottom in June 2009, its peak-to-trough contraction was 2.6% and it will rebound to pre-crisis levels of output by September 2010. From then onwards, the economy grows annually at about 3%, the pre-crisis average for the 1990s and up to 2006. Commodity prices too are expected to begin a gradual climb and reach pre-crisis (December 2006) levels precisely when US GDP recovers its pre-crisis levels. Thereafter, they grow at their historical rate (1990–2006) of 2.9%. LAC-7 terms of trade mimic the behavior of commodity prices based on historical correlations.

Finally, US T-bond yields are assumed to remain at slightly above 3% for the span of the analysis, while

EMBI spreads peak in the first half of 2009 at 660bps and continuously decline to 400bps when US GDP recovers to pre-crisis levels. The choice for the new EMBI floor reflects the expectation that spreads will remain higher than at the end of the recent boom period, a historical minimum but closer to levels prevailing before the Asian/Russian crises of 1997–98.

L-shaped Scenario. The so-called L-shaped scenario describes a more burdensome external environment. However, it is not a catastrophic scenario or a major departure from the V-shaped scenario: US GDP and G-7 industrial production reach their trough at the same time as in the V-shaped scenario, and the peak-to-trough contraction in US GDP and G-7 industrial production is identical in both scenarios, but in the L-shaped scenario US GDP and G-7 industrial production recover at half the historical average growth rate. This means that US GDP reaches pre-crisis levels by June 2011, three quarters after the V-shaped scenario, and that G-7 industrial production attains its pre-crisis levels by December 2013. This scenario is in fact more in line with the evidence of severe financial crises, which tend to be deeper and last longer than run-of-the-mill recessions. On average, during these episodes it takes about four years for output to return to pre-crisis levels.

In this scenario, commodity prices and terms of trade are not expected to recover to pre-crisis (December 2006) levels until G-7 industrial production returns to pre-crisis levels (December

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Ernesto Talvi for the Inter-American Development Bank's annual meetings. Latin America may be facing formidable odds if global recovery does not materialize in the way markets are expecting. This newsletter examines how global developments and policy

choices will influence final outcomes given the nature of a financial crisis in which liquidity issues are front and center and makes the case that a slow global recovery may pose challenges for the region that are far from trivial.

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2013). EMBI spreads decrease at a slower pace, reaching the 400bps floor when G7 industrial production recovers to pre-crisis levels.

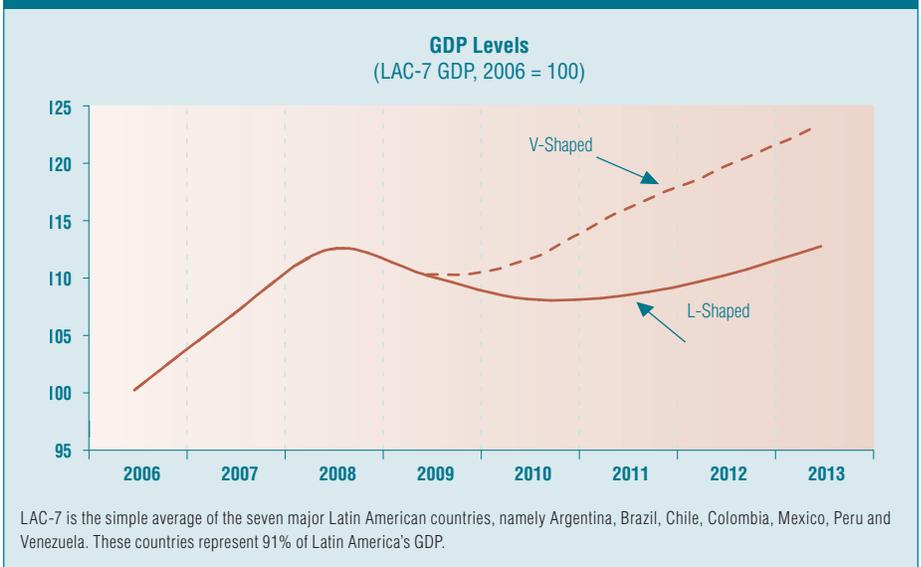
The Scenarios for Latin America

Given the two sets of assumptions for the global scenarios, the next task is to relate external performance to domestic economic activity. Results of this exercise for the Latin American regional average are summarized in Figure 1 for GDP levels and growth rates. Simulations in the V-shaped scenario yield a GDP reduction of 1.9% for LAC-7 in 2009, positive growth of 1.1% for 2010, and 3.9% for 2011. These dynamics imply a trough in September 2009, a peak-to-trough contraction of about 4%, and recovery to pre-crisis levels by March of 2011, which is squarely in line with market expectations.

Not surprisingly, a LAC-7 recession is more severe and prolonged under the L-shaped scenario. The region faces two years of declining GDP (–2.1% in 2009 and 1.8% in 2010), only to post a very weak recovery of 0.3% in 2011. These dynamics imply a trough in March 2010, a peak-to-trough contraction of about 5% and a slow recovery to pre-crisis levels by December of 2013. Slower world growth, a fainter recovery in terms of trade and lingering high EMBI spreads lie behind these results.

Differences between the V-shaped and L-shaped recoveries can be summarized as follows: whereas in the V-shaped scenario output growth returns to its historical average of 3% relatively quickly, the L-shaped

Figure 1. Latin American Economic Activity under Two Alternative Global Scenarios



scenario implies persistent under-performance relative to the historical average (see Figure 1). In any case, output performance for the next five years would be mediocre at best and substantially below the 6% average growth rates of recent years. Moreover, in the L-shaped scenario average growth will be close to zero over the next five years indicating that the collateral damage of the global crisis will be felt for years to come and that Latin America should be prepared to be in this for the long haul.

The fiscal position of the region will suffer on three fronts: declining revenues as GDP growth falters, relatively low commodity prices, and rising costs of financing. Under the V-shaped scenario, revenues are expected to fall on average by about 5.2% in real terms in 2009, and a further 2.2% in 2010. Contrasts with the L-shaped scenario are not impor-

tant in 2009, with revenues falling by 5.7% but they are stark for 2010, when revenues plunge 6.4%.

As far as the fiscal balance is concerned, the prospects are grim, even assuming that primary expenditures remain constant in real terms at 2008 levels—a politically difficult posture indeed. Even in the mildest V-shaped scenario with a passive fiscal policy, the fiscal balance quickly deteriorates to –1.5% of GDP in 2009, and –2.6% in 2010. Under the L-shaped scenario, the deterioration is more dramatic and peaks at –5% of GDP by 2011. These results lay bare the extreme vulnerability of fiscal accounts to adverse global conditions given the procyclical behavior of public expenditure in the recent boom years. Perhaps even more telling is the path of public debt. Figure 2 shows that under the V-shaped, passive policy scenario,

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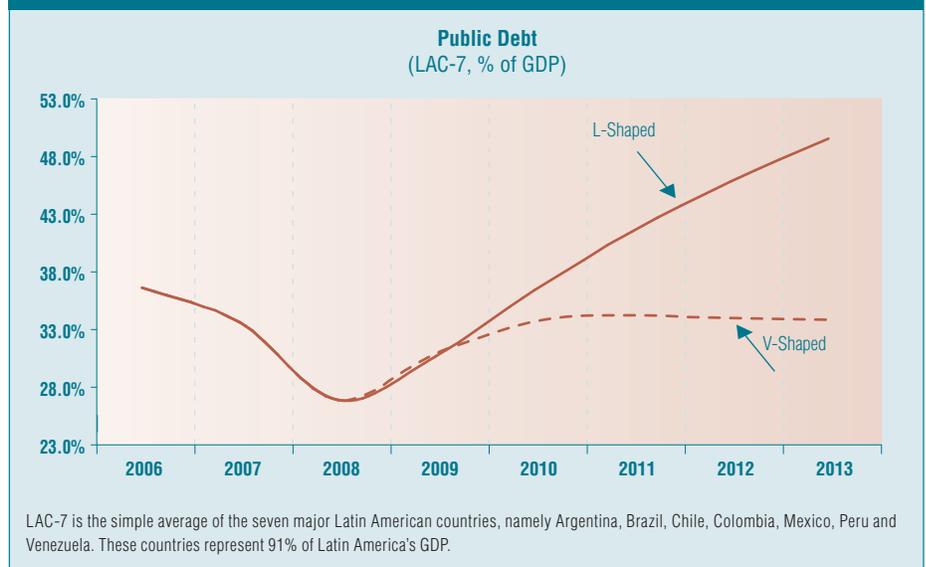
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public debt increases from 27% of GDP in 2008 to 34% of GDP in 2012 and stabilizes at that point. However, it nearly doubles to 49% of GDP under the L-shaped scenario.

Thus, although the region starts from a strong fiscal position (a surplus of 2% of GDP in 2007) the combination of declining economic activity, collapsing commodity prices and rising financial costs leads to a gradual, persistent and severe deterioration in the overall fiscal position of the region. This deterioration occurs in spite of the assumption that real primary expenditures remain constant. The fiscal crunch has dire consequences for public debt under the L-shaped scenario which, in turn, could quickly undermine credibility in the sustainability of fiscal policies. Given this potentially fragile fiscal scenario, proposals to pursue active countercyclical fiscal policies must be carefully evaluated. Most likely, a more measured approach than the one currently being sponsored by part of the international community is in order. Of course, the region is heterogeneous and countries like Chile, which have saved substantially in the past, will definitely have room for expansionary policies while countries that engaged in procyclical policies will have to adjust.

The banking sector of the LAC-7 region as a whole is currently in relatively good shape. In 2007, non-performing loans (NPL) were relatively low (less than 3% of total loans) and loan-loss provisions (LLPs) largely exceeded non-performing loans by a ratio of 2.4 to one. However, NPLs are expected to increase as the region slips into recession. Simulations show

Figure 2. Latin American Fiscal Position under Two Alternative Global Scenarios



that the share of NPLs in total loans could rise substantially in the coming years under the L-shaped scenario, ballooning as high as 8.8% of total loans by 2013, although their deterioration would be more subdued under the V-shaped scenario.

Even more relevant is a comparison of the difference between NPLs and LLPs as a share of bank capital. According to simulations, in the V-shaped scenario, NPLs would exceed LLPs by 2011 and the difference between NPLs and LLPs as a share of bank capital would be in the 6% range. However, under the L-shaped scenario, this difference could become a large share of bank capital, as high as 32%.

Therefore, although banks are currently sound, the decline in economic activity could lead to a gradual, persistent and relatively severe deterioration in banks' loan portfolios

resulting in equally large capital losses. Although capital losses remain manageable under both scenarios, if quick and decisive action to recapitalize institutions is not taken in a timely fashion, depositors may start to feel uneasy with their holdings in undercapitalized banks, increasing the likelihood of runs on deposits. Once again, it is against this backdrop of a potentially weakening banking situation that proposals to pursue active countercyclical fiscal policies must be evaluated; eventually, the public sector may be required to prop up the financial system too.

All told, the impulse to step up spending to compensate for the economic downturn must be considered in light of these various scenarios. The effects on fiscal situations could be dangerous and could compromise the government's ability to respond to a banking crisis.

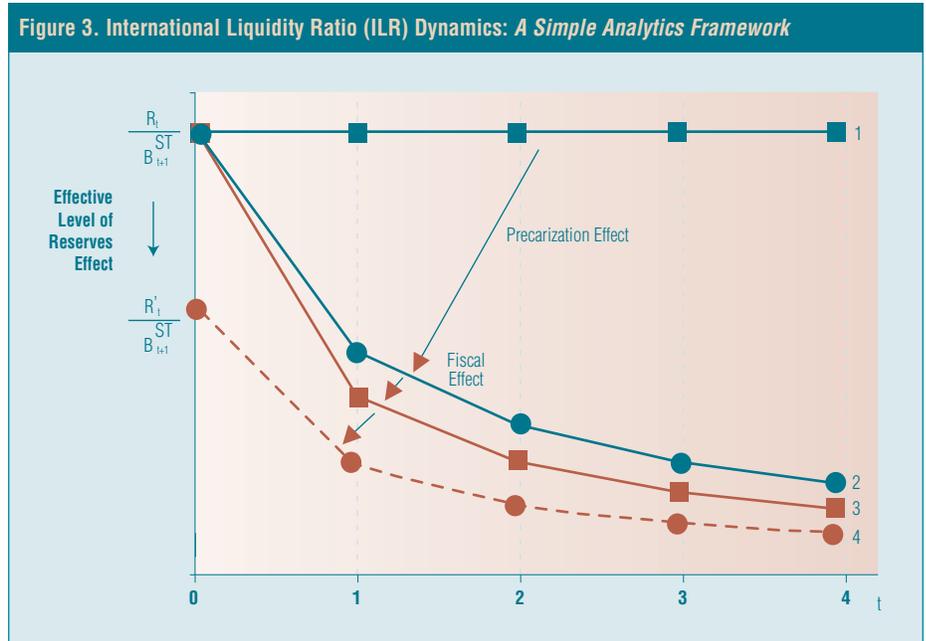
Liquidity Matters

Is a liquidity crisis in the offing in Latin America? Until recently, market access has been virtually closed for corporates in Latin America and has become much more precarious for sovereigns, meaning that although access is not closed, new issuance has taken place at higher costs and much shorter maturities. Given these tight credit conditions, the evolution of the liquidity position of a country is a primary concern as it affects the likelihood of a liquidity crisis.

How much liquidity do countries need? The Guidotti-Greenspan (GG) rule is that countries should hold at least enough international reserves to cover short-term (less than one year maturity) obligations coming due. This rule has gained wide acceptance in policy circles as a measure of financial vulnerability and the reserves-to-short-term-debt ratio has been found to be a robust predictor of financial crises. Reserve-to-short-term-debt ratios akin to the GG rule are used here as a “liquidity thermometer” summarizing the joint impact of global conditions and financial precarization (FP) as well as country and multilateral policy responses on the likelihood of a liquidity crisis.

International Liquidity Ratio (ILR) dynamics have four key determinants: 1) initial levels of public debt, 2) time profile of debt amortizations, 3) the dynamics of fiscal deficits and public debt, and 4) the “effective” level of reserves.

Access to markets in a context of FP can quickly affect ILRs by changing the profile of debt amortizations. For example, imagine if access to markets is suddenly limited to short-term debt issuance for a sufficiently long time. Total obligations coming



due every year could easily pile up, as any obligation maturing today would add fully to next year’s short-term obligations, thus affecting ILRs—the more frontloaded the amortization profile, the greater the effect. Figure 3 depicts two contrasting cases, one in which constant maturing debt can be refinanced on the same terms in which it was initially contracted, and another in which maturing debt can only be refinanced on a short-term basis. In the first case, ILR remains constant (line 1), while under FP it falls continuously in subsequent periods (line 2). This phenomenon is called the “FP effect” on ILRs. The opposite case would be that of a sudden stop (SS), when no access to capital markets implies that only reserves can be used to finance maturing obligations, causing ILRs to deteriorate more dramatically.

ILRs are also affected by fiscal deficit dynamics. Financing a deficit

on top of amortizations coming due adds to borrowing requirements and further weakens ILRs, over and above the impact of FP. This phenomenon is called the “fiscal deficit effect” on ILRs (see Figure 3, line 3).

Yet another factor to consider is the “effective” level of reserves available for liquidity provision that constitutes the numerator of ILRs. Countries with “fear of floating,” perhaps due to liability dollarization, may use reserves to intervene in exchange rate markets. Or, governments may have to tap international reserves to provide liquidity in support of corporates or in support of banks, which would also cut into initial reserve levels. Still another possibility is that markets could have priors about a country’s willingness to use reserves to honor debt repayments. Under the perception of less than full willingness to pay,

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this would be equivalent to a fall in “effective” reserves. Any of these policies and/or market perceptions would be equivalent to a downward shift in the ILR schedule, as shown in Figure 3 by line 4.

Each step down the liquidity line implies a higher probability of a liquidity crisis, i.e., a run against short-run liabilities. A simple way to rationalize this hazard would be to consider the existence of a liquidity threshold beyond which a country’s access to credit markets would be completely cut off.

The likelihood of a liquidity crisis as determined by ILRs will depend on the interaction between external factors (i.e., the duration of the global crisis) and idiosyncratic factors (such as initial conditions and policy responses). For example, ILRs will look much worse in countries that are heavily indebted, have a frontloaded schedule of debt amortizations and depart from a weak fiscal position, than in countries with a better profile. Low reserve levels can also pose a dangerous threat in a context of FP. Policies may also have a strong impact on delaying or hastening the moment of reckoning. In this respect, expansionary policies that at first glance may appear helpful could unintentionally backfire on ILR, thereby increasing the probability of a liquidity crisis.

Under FP, liquidity problems evolve gradually and may not be evident until it is too late. The fact that the likelihood of a liquidity crisis appears to be low today and that sovereigns in general have maintained access to credit markets does not necessarily mean that a country is strong enough to resist FP over time without entering a danger zone.

The moment of reckoning with FP, as opposed to a SS, may come only gradually instead of suddenly. Thus, FP could be quite different from the wrath of SS. As Roberta Flack’s song says, FP can “kill softly.”

Liquidity Indicators under Alternative Global Scenarios

The liquidity implications for each of the global scenarios—rapid US recovery (V-shaped) or gradual US recovery (L-shaped)—are analyzed by considering how the ratio of reserves to short-term debt obligations changes with international financial conditions.

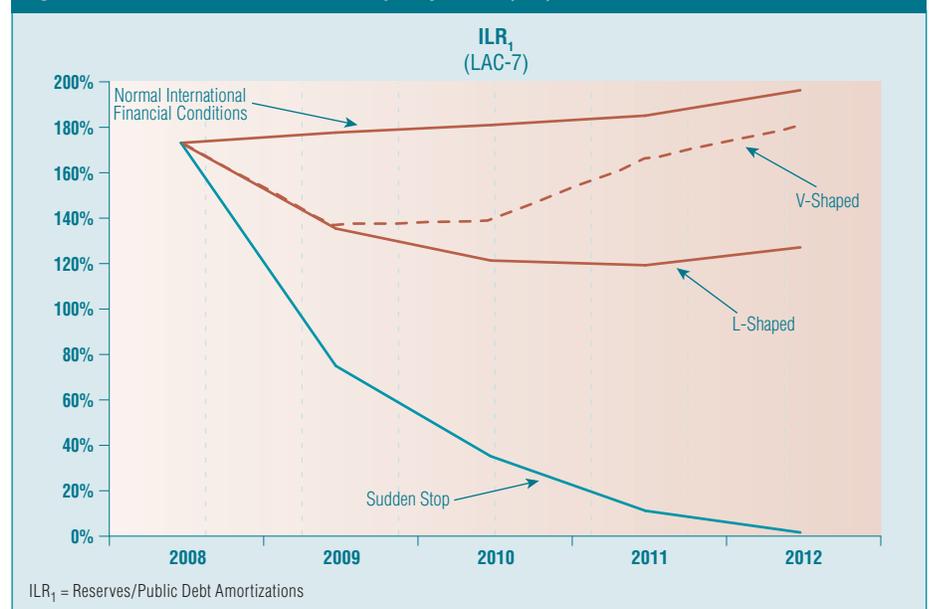
Two benchmark cases are constructed, one with no FP and one under SS. In the benchmark case with no FP, new debt is issued with the same maturity structure as that of previous period debt stocks. The LAC-7 average liquidity ratio (ILR_1)

would hover around initial levels of 171% by end-2008 (Figure 4). This path clearly indicates that passive fiscal policy in the context of a relatively mild crisis in the US, coupled with market access conditions that do not change the maturity profile of public debt, poses no threat for the region as a whole. In contrast, in the benchmark case under SS, when credit markets close down completely, ILR falls rapidly, exhausting the stock of international reserves. (Figure 4).

Once FP is introduced the dynamics of liquidity ratios fall in between these two benchmarks. Under the V-shaped hypothesis on the global economy, ILR falls to about 135% in 2009. However, it quickly bounces back, reaching 2008 levels by 2012. The difference between this scenario and the no-precarization scenario highlights the role played by

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Figure 4. Latin America International Liquidity Ratios (ILR) under Two Alternative Global Scenarios



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market access conditions. If debt could be renewed at pre-crisis maturities, there would be no deterioration in liquidity ratios.

A switch to the L-shaped global recovery scenario brings down the liquidity ratio further. ILR reaches a minimum of 118% by 2011. However, under this scenario, liquidity does not begin to recover until 2012 and lingers at lower, riskier levels.

If private sector financing needs are added into the equation, the picture looks even worse. It is not implausible that the public sector may end up using international liquidity to cover private sector maturing obligations. Indeed, some countries are already engaging in this type of policy. For simplicity, it is assumed that under the V-shaped scenario only private sector obligations maturing in 2009 are covered. However, under the L-shaped scenario, both 2009 and 2010 obligations are financed with international reserves. Liquidity indicators change drastically under this financing strategy. Under the V-shaped scenario, the liquidity ratio falls to riskier levels in 2009, but quickly recovers in 2010 and onwards (see Figure 5). Under the L-shaped scenario, it falls below the 100% threshold and does not recover above that threshold, entering and remaining in a danger zone in which systematically reserves would not be enough to fully cover maturing obligations (see Figure 6).

These scenarios imply that in the absence of policies, in some cases liquidity ratios could dangerously reach thresholds that could lead to a crisis. This is particularly so were the US economy to drag its feet for longer and produce an L-shaped scenario.

Figure 5. ILRs under V-Shaped Scenario

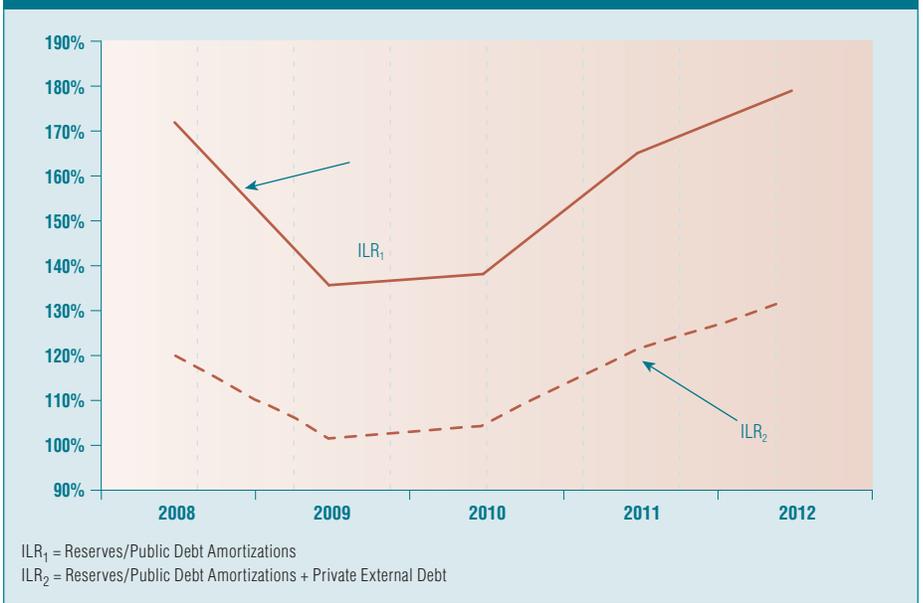
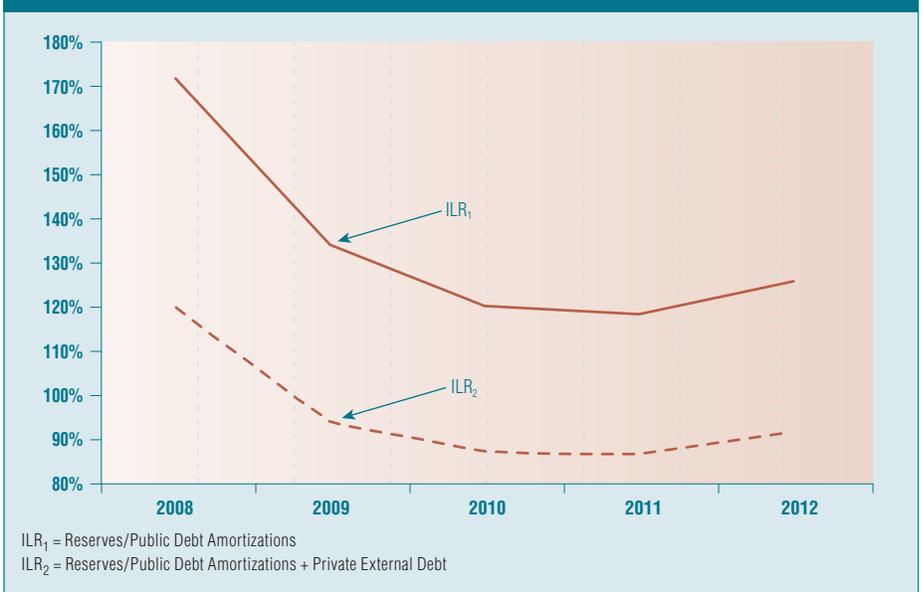


Figure 6. ILRs under L-Shaped Scenario



Needless to say, policy initiatives—whether domestic or multi-lateral—should weigh their impact on liquidity ratios to avoid putting

countries in a financially fragile position and exposing them to a liquidity crisis and an economic collapse.

Weighing the Pros and Cons: Policy Trade-offs for Unprecedented Times

With the world in recession, the temptation in the region is to compensate with greater spending. But how might this affect the liquidity position of a country? Countries will inevitably face trade-offs between the potential benefits of pursuing expansionary macro policies and the potential costs of these policies should they unleash a liquidity crisis.

Thus, the benefits of alternative policies should not be weighed solely against their costs based on inter-temporal considerations, but also against their immediate impact on the liquidity position of a country and their effect on its vulnerability to a liquidity crisis. Ultimately, the increased likelihood of liquidity risk could overshadow the expansionary effects of policies. As perceptions of liquidity risk and the probability of a liquidity crisis loom

larger, private investment and consumption may contract and more than counteract the expansionary impact of policies.

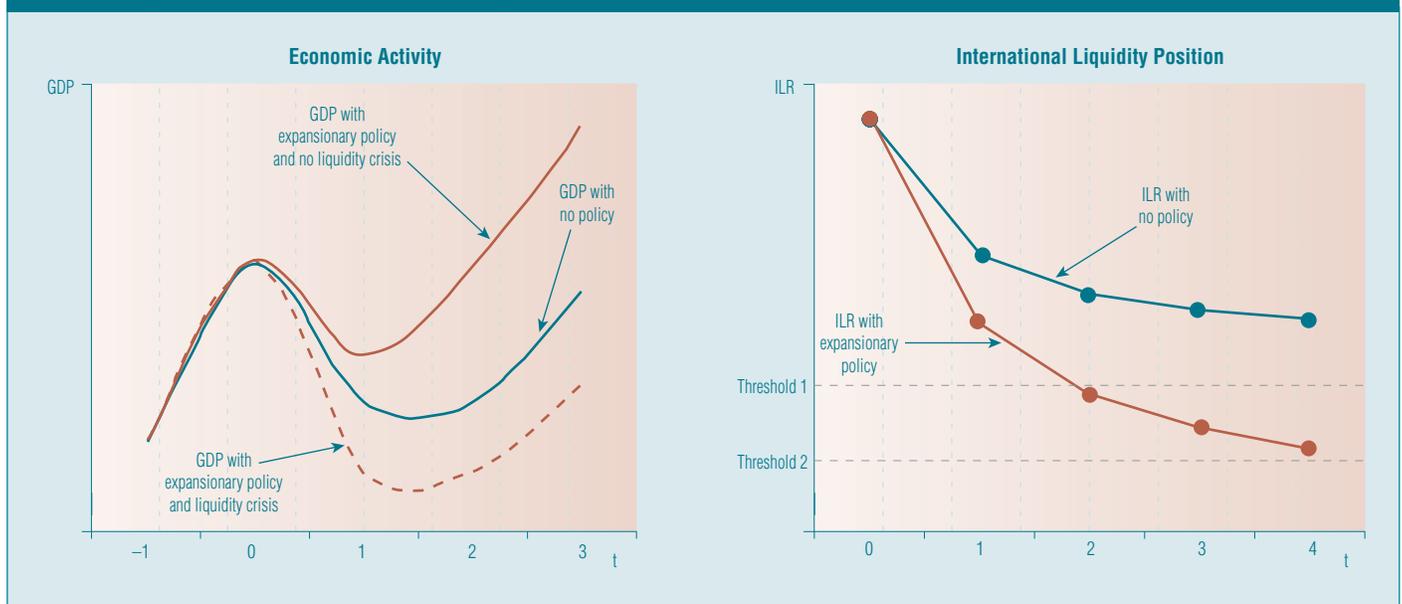
Consider the potential impact of two alternative fiscal policies: one offers no changes in either government expenditures or tax rates in response to recessionary pressures and, the other is countercyclical, implying a boost in government expenditures and/or a cut in tax rates. Since active fiscal policy will in principle expand the fiscal deficit, in the absence of explicit multilateral financing, this deficit will have to be financed under precarious credit market conditions, i.e., short term and at high rates. Therefore, a countercyclical fiscal policy will take a greater toll on the liquidity position of the country compared to the neutral fiscal policy stance. The trick is to

make sure that a liquidity crisis does not cut off access to credit markets and provoke a severe output contraction that more than counteracts the output gains achieved by a countercyclical fiscal policy (see Figure 7).

Some countries in the region may not have the luxury of considering these trade-offs, or may only do so at substantially higher downside risks. In fact, given the highly procyclical fiscal policies pursued by Latin American countries during the boom years of the 2000s (on average LAC-7 countries increased public expenditures by 80 cents out of every additional dollar of revenue between 2003 and 2007), pursuing a countercyclical policy during the downturn, which implies raising expenditures even further, may imply exponential

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Figure 7. Policy Trade-Offs: Expansionary Fiscal Policy



Why Multilaterals Stepped In

Argentina is not the United States; nor is Ecuador, Peru, or Honduras. While this may be obvious, the implications in today's world are important to understand. Even though the US has been at the epicenter of the financial crisis and credit markets among private sector agents have essentially ceased to function, the US government still enjoys preferential access to international credit markets and can be a “borrower of last resort” at very low cost, around 3% in nominal terms. This ability allows the US government to *de facto* act as an intermediary for private agents unwilling to lend to each other and to pursue expansionary fiscal policies. Latin American governments—and most EM governments worldwide, for that matter—do not have this luxury. Their ability to operate as borrowers of last resort without recourse to their international reserve stock is very limited and such intervention would increase the likelihood of a liquidity crisis.

Clearly, the precarious access to credit markets of many EM governments calls for multilaterals to step in and play for EMs the role that credible governments, such as the US government, play domestically. The question is not whether multilaterals should play a key role in the current crisis, but what is the most effective way to channel their intervention and at what financial cost.

With the guiding goal of preventing a liquidity crisis and economic collapse, the policy principles that emerge differ in many respects from current views. The principles are the following:

1. Multilateral support will be vital under FP, the more so the more pronounced is the global downturn and the more precarious the access to credit markets.
2. Multilaterals should avoid short-term emergency financing and provide long-term financing in order to partially “complete” markets in terms of maturities, ensuring that FP does not put countries on a liquidity collision course.
3. Multilaterals should not only provide for medium and long-term financing of fiscal deficits—when fiscal sustainability is not at stake—to support expansionary policies that contribute to sustaining global demand, but, more importantly, they should also provide for long-term refinancing of maturing obligations.
4. Multilateral assistance should be complemented by incentive-compatible conditionality ensuring a gradual convergence to sustainable structural fiscal positions.

Since the peak of the crisis, multilaterals have moved swiftly in this direction. In particular, the replacement of the IMF's short-term liquidity facility with a flexible credit line facility in March 2009 (with up to a five-year repayment period) has been crucial in ensuring access to liquidity, vastly improving effective or perceived liquidity stances of several countries in the region. The IDB has also contributed in this regard with its liquidity program for growth sustainability that was put in place in October 2008.

Still, a critical concern for the region is that the crisis may potentially exact a high toll in terms of employment and various social indicators, including poverty. Given an increasingly complex fiscal scenario, governments may need to engage in

Multinational institutions must assume lender-of-last-resort functions similar to those that governments perform in developed economies.

expenditure-switching policies to protect, and in some cases enhance, social programs.

Differently put, the challenge facing Latin America in this global crisis has two equally relevant and interrelated dimensions: protecting macroeconomic stability and protecting key social indicators; not one at the expense of the other, but both. And because two objectives need two instruments, a complementary two-pronged approach between the IMF and Multilateral Development Banks (MDBs) regarding financial support and incentive-compatible conditionality is required. While setting targets to achieve a consistent macroeconomic framework should be primarily the role of the IMF, MDBs should work on the design of optimal expenditure composition policies—or expenditure increasing policies when feasible—that maximize the impact on long-term development and poverty alleviation.

Following these general policy principles would be extremely ben-

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official for the region, allowing it to simultaneously pursue prudent countercyclical fiscal policies that may contribute to minimizing the impact on growth of the global crisis without risking a traumatic liquidity crisis (and thus avoiding large associated social costs and economic collapse), and at the same time insulating households, particularly low-income ones, from the negative effects of what may turn out to be a prolonged downturn. A strategy by the IMF and multilaterals that only pays attention to financing countercyclical fiscal policies is flawed, and ignoring the impact

of any fiscal expansion on liquidity ratios can be a costly mistake.

To conclude, if Latin America—and, arguably, other EMs—are to engage in stimulative fiscal policies to minimize the impact of the global crisis on domestic growth, it is necessary that lender-of-last-resort functions similar to those that governments perform in developed economies be recreated by multilateral institutions, so that liquidity concerns are kept at bay. This strategy will ensure that well-designed stimulus packages do not compromise financial stability. This strategy has three basic requirements:

(i) strengthening of the resources of multilateral institutions to allow them to act with a scale commensurate to the tasks at hand, (ii) appropriate division of labor between the IMF and MDBs, and (iii) careful country-by-country analysis that determines in each case fiscally sustainable combinations of expenditure-increasing and expenditure-switching policies. The joint work of countries and international financial institutions can hopefully help Latin America and the Caribbean transit successfully through these uncertain and unprecedented times.

Weighing the Pros and Cons: Policy Trade-offs for Unprecedented Times

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debt dynamics and seriously undermine credibility.

Another policy that some governments have pursued in response to the downturn in international financial conditions is to buy back outstanding public debt, especially long-term debt. The assumption is that yields on that type of paper are currently too high, and that gains can be made by purchasing them “cheaply.” Although this type of operation is supposed to send a positive signal towards investors and could in principle reduce financial costs and improve fiscal positions, the trade-off is that it directly deteriorates liquidity ratios, thus potentially undermining or even undoing the original intent of the debt buyback operation.

Regarding monetary policy, the region has been very effective in

absorbing the financial shock by permitting large currency depreciations while keeping interest rates low at least relative to those rates that would have prevailed had they intervened. This constitutes a major feat that was unthinkable for many countries at the time of the Russian crisis of 1998. However, further expansionary policy should be considered with care. To begin with, it is not obvious that while the banking system may be piling up cash reserves to reduce liquidity exposure, expansionary monetary policy, via lower interest rates or reserve requirements, will work as effectively through the credit channel. Moreover, lower interest rates or reserve requirements may result in international reserve losses, adversely impacting the liquidity

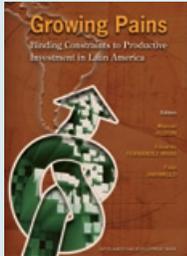
position and undermining the expansionary effect of looser monetary policy.

Many Central Banks in the region have also used their international reserve position to help corporates that could not easily roll-over their debts in current market conditions to refinance their foreign obligations. Although the intent of these policies is clear (i.e., to avoid costly restructurings that could depress output), the trade-off is that these policies directly weaken ILRs and increase the probability of a liquidity crisis. Again, a more vulnerable liquidity position can undermine any expansionary effect of the initial policy action, and only countries with sufficiently ample liquidity cushions will be able to afford those policies.

New Publications

Available in English only unless otherwise stated.

BOOKS



Growing Pains: Binding Constraints to Productive Investment in Latin America

Edited by Manuel R. Agosin, Eduardo Fernández-Arias and Fidel Jaramillo

Why are growth rates in Latin America so disappointing? This book reviews the results of an ambitious research project to determine the binding constraints to growth, that is, the barriers whose removal would yield the greatest benefit in terms of growth, in seven countries in the region.



Social and Labor Market Policies for Tumultuous Times: Confronting the Global Crisis in Latin America and the Caribbean

(Also available in Spanish)

Suzanne Duryea, Jacqueline Mazza and Ferdinando Regalia

This report examines the social impact of the current crisis and focuses on its effects on employment, nutrition, education, and poverty. It identifies the mechanisms by which the crisis can affect these critical social dimensions, and discusses possible policy responses given each country's circumstances, fiscal space and administrative capabilities. The social challenge generated by the crisis is not

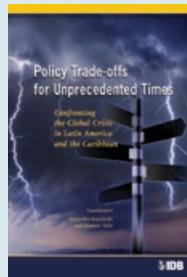
only to protect the vulnerable population, but to do so in a fiscally sustainable manner and with programs that contribute to, rather than retard, the resumption of growth.



Who Decides the Budget? A Political Economy Analysis of the Budget Process in Latin America

Edited by Mark Hallerberg, Carlos Scartascini and Ernesto H. Stein

This book goes a long way towards explaining how economies, institutions, and politics interact to produce budget outcomes in Latin America, a region in which informality dominates public governance.



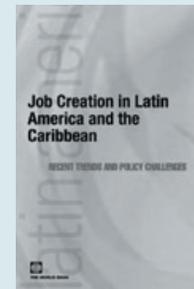
Policy Trade-offs for Unprecedented Times: Confronting the Global Crisis in Latin America and the Caribbean

(Also available in Spanish)

Alejandro Izquierdo and Ernesto Talvi

This report focuses on the region's macroeconomic performance in the context of an unusually sharp and rapid deterioration in external conditions. To assess policy options, the report develops a framework to identify the critical trade-offs faced by countries in the region, and evaluates these trade-

offs under alternative, plausible, global economic scenarios. It identifies some of the macroeconomic challenges and risks that policymakers face on the road ahead.



Job Creation in Latin America and the Caribbean: Recent Trends and the Policy Challenges

Edited by Carmen Pagés-Serra, Gaëlle Pierre and Stefano Scarpetta

Unemployment and job creation figure prominently in public policy agendas throughout Latin America and the Caribbean. This book examines the labor market trends of recent decades and assesses how labor supply and demand have shaped these outcomes.

RESEARCH DEPARTMENT WORKING PAPERS:

The Teaching of Economics in Mexico (WP-672)

Ivico Ahumada Lobo and Fernando Butler Silva

(In Spanish only)

This study examines the programs of study and the attributes and perceptions of *licenciatura*-level students in six of the principal economics departments of Mexico, as well as economists' labor market insertion in the period 2000–2005. Trends noted include a small reduction in matriculations in economics, an increase in the number of economists employed

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New Publications

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in the private sector, and a slow but undeniable increase in the use of the Internet and other computing tools. Also notable is the extent to which undertaking a degree program in economics changes students' opinions on economic issues.

Financial Development and TFP Growth: Cross-Country and Industry-Level Evidence (WP-682)

*Francisco Arizala,
Eduardo A. Cavallo and
Arturo Galindo*

This paper estimates the impact of financial development on industry-level total factor productivity (TFP) growth using a largely unexploited panel of 77 countries with data for 26 manufacturing industries for the years 1963 to 2003. A significant relationship is found between financial development and industry-level TFP growth. The relationship is stronger for sectors with high external financing requirements.

How Much Are We Willing To Pay to Send Poor Adolescents to School? Simulating Changes to Mexico's Oportunidades in Urban Areas (WP-680)

*Viviane Azevedo,
César Bouillon and
Patricia Yáñez-Pagans*

Although Mexico's Conditional Cash Transfer Program, Oportunidades, has increased overall school enrollment, many adolescents do not attend school, especially in urban areas. This paper simulates the effects of changes in program design and finds that eliminating or reducing school subsidies for primary education and increasing transfers for older students is a cost-effective way to boost overall school enrollment in urban areas. Increasing

school attendance of 16-year-olds to 80% or more, however, would require a quadrupling of scholarships. This suggests that complementary interventions are needed.

The Teaching of Economics in Argentina (WP-671)

*Gabriel Bezchinsky,
Marisol Rodríguez Chatruc and
Guillermo Rozenwurcel*
(In Spanish only)

This paper describes the principal characteristics of the Argentinean university system and surveys the teaching of economics in Argentina from its beginnings through today. The paper then directly analyzes the teaching of economics in three universities: Universidad de Buenos Aires, Universidad Nacional de Córdoba, and Universidad Torcuato Di Tella. The paper concludes that, although the state of teaching of economics in Argentina is generally good, in certain areas there nonetheless exists room for improvement.

Education and Democratic Preferences (WP-684)

Alberto Chong and Mark Gradstein

This paper examines the causal link between education and democracy. Motivated by a model whereby educated individuals can better assess the effects of public policies and hence favor democracy, where their opinions matter, the empirical analysis uses World Values Surveys to study the link between education and democratic attitudes. The paper finds that higher education levels tend to result in pro-democracy views. These results hold across countries with different levels of democracy, thus rejecting the hypothesis that indoctrination through education is an effective tool in non-democratic countries.

Taxonomy of Causes, Impacts and Policy Responses to the Food Price Crisis in the Andean Region (WP-674)

José Cuesta and Fidel Jaramillo

This paper analyzes the causes, effects and policy alternatives associated with the recent international food price crisis in the Andean region. Additionally, the document suggests policy options utilized to confront the crisis, discussing the mix of policies and their potential effectiveness. A final section underscores various messages common to the countries of the region. Specifically, the report concludes that this crisis offers a great opportunity for transforming its uncertainties and costs into a stimulus for developing an infrastructure of prevention and reduction of vulnerabilities in the Andean economies.

Crisis Response in Latin America: Is the "Rainy Day" at Hand? (WP-686)

*Eduardo Fernández-Arias and
Peter Montiel*

This paper examines the countercyclical policy options available to Latin American countries in the current global economic crisis, concluding that most of the major countries in the region have the fiscal space to run prudent countercyclical fiscal deficits. Those countries should undertake a constrained fiscal expansion focused on productive public spending and financed by "rainy day" funds—large stocks of foreign exchange reserves accumulated during recent years—rather than by market borrowing. The recent surge in multilateral financing strengthens the case for this policy prescription: with multilateral support, policy can be more expansionary, and its financing less reliant on market borrowing.

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New Publications

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The Multilateral Response to the Global Crisis: Rationale, Modalities, and Feasibility (WP-683)

*Eduardo Fernández-Arias,
Andrew Powell and
Alessandro Rebucci*

This paper reviews the case for a strong multilateral response to the global crisis in emerging markets (EMs). It discusses modalities and feasibility of intervention and its associated risks, depending on a country's fiscal space and liquidity needs. The specific role of Multilateral Development Banks (MDBs) in ensuring the development effectiveness of the fiscal response is also discussed. The paper concludes by highlighting the international financial architecture issues raised by the global crisis that will need to be dealt with once the current crisis has been tamed.

Ethnic and Gender Wage Gaps in Ecuador (WP-679)

*Lourdes Gallardo and
Hugo Ñopo*

Returns to labor for workers with similar endowments of productive characteristics in Ecuador are influenced by two characteristics that, arguably, should play no role in the determination of wages: gender and ethnicity. This paper analyzes wage gaps due to both characteristics in Ecuador for the period 2003–2007, applying a matching comparisons technique developed in Ñopo (2008). The results indicate ethnic wage gaps that are notably higher than gender wage gaps and higher among males than females. Differences in human capital characteristics explain almost one-half of the ethnic wage gaps but only a small fraction of the gender wage gaps. Both gender and ethnic wage gaps are more pronounced at the lower extremes of the earnings distribution.

Gender and Racial Wage Gaps in Brazil 1996–2006: Evidence Using a Matching Comparisons Approach (WP-681)

*Luana Márquez García, Hugo Ñopo
and Paola Salardi*

This paper explores the evolution of Brazilian wage gaps by gender and skin color over a decade (1996–2006). In Brazil, racial wage gaps are more pronounced than those found along the gender divide, although both noticeably decreased over the last decade. Differences in observable characteristics play a crucial role in explaining wage gaps. While in the case of racial wage gaps, observable human capital characteristics account for most of the observed wage gaps, the observed gender wage gaps have the opposite sign than what the differences in human capital characteristics would predict. In both cases the role of education is prominent.

The Gender Wage Gap in Peru 1986–2000: Evidence from a Matching Comparisons Approach (WP-675)

Hugo Ñopo

This paper analyzes the evolution of the gender wage gap in Peru from 1986 to 2000. For the period under analysis, males earn on average 45% more than females. This wage gap is composed of three additive elements: 11% differences in supports, 6% differences in distributions of individual characteristics and 28% unexplainable differences. About half of these unexplainable differences occur in the highest quintile of the wage distribution.

Political Institutions, Intertemporal Cooperation, and the Quality of Policies (WP-676)

*Carlos Scartascini,
Ernesto H. Stein and
Mariano Tommasi*

While economists have tended to focus on specific public policies when developing recommendations, the achievement of welfare objectives might depend more on the quality of policies than their content. This paper develops several measures of the qualities of policies across countries, arguing that the quality of public policies depends on each polity's ability to strike intertemporal transactions necessary to develop and sustain effective policies. This ability depends on several characteristics of political institutions including congressional capabilities, judicial independence, and bureaucratic independence and professionalism. The measures of policy quality developed here could be used for other purposes, including the determination of conditions under which more public spending in a given area is likely to generate the desired outcomes.

The Teaching of Economics in Bolivia and Chile (WP-672)

*Lourdes Espinoza, Carlos Gustavo Machicado S. and Katia Makhoulouf
(In Spanish only)*

This paper presents a statistical analysis of the teaching of economics at the undergraduate level on the basis of survey responses to questions on the following subjects: curriculum; teaching methods, students' perceptions of their universities, of economists and of their job prospects; their interest in undertaking post-graduate studies and other topics related to the teaching of economics in public and private universities. The paper further presents an exhaustive analysis of a series of topics that are compared among universities in each country as well as between countries.



New Publications

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RESEARCH NETWORK WORKING PAPERS

The Emergence of New Successful Export Activities in Latin America: The Case of Chile (R-552)

Manuel Agosin and
Claudio Bravo-Ortega

This paper surveys overall export growth in Chile and focuses on three case studies of successful export activities: wine, pork and blueberries. Each case study discusses how companies, associations, and governments at various levels have addressed market failures and facilitated the provision of public goods necessary for each activity. The case studies additionally profile first movers in each activity and describe the positive externalities they provide to imitators, particularly diffusion of export knowledge. Also included are counterfactual cases of a less successful firm or activity (an unsuccessful wine exporter, other types of berries, and commodity pork production rather than custom cuts, respectively) and a discussion of policy implications.

OUTSIDE PUBLICATIONS

Persistent Gaps and Default Traps

Luis Catão,
Ana Fostel and
Sandeep Kapur.

*Journal of Development
Economics* (2008), doi:10.1016/j.
jdevco.2008.06.013

This paper shows how vicious circles in countries' credit histories arise when output persistence is coupled with asymmetric information about output shocks. In such an environment, default signals the borrower's vulnera-

bility to adverse shocks and creates a pessimistic growth outlook. This translates into higher interest spreads and debt servicing costs relative to income, raising the cost of future repayments, thereby creating "default traps." A long and broad cross-country dataset reveals a history-dependent "default premium" and significant effects of output persistence on sovereign creditworthiness.

Corporate Governance in Mexico: Empirical Evidence

Alberto Chong, Jorge Guillén and
Florencio López-de-Silanes.

Journal of Economic Policy Reform
Volume 12, Issue 2 (Lead article)

This paper has two objectives. The first is an analysis of the recent evolution of capital markets and their effect on the availability of external financing in Mexico in the last two decades. The second objective, based on a newly assembled firm-level data set, assesses the relationship between corporate governance and firm performance. It is found that better firm-level corporate governance practices are linked to higher valuations, better performance and more dividends disbursed to investors. Overall, the evidence shows that the Mexican legal environment poses serious problems for access to capital.

Is the World Flat? Country- and Firm-Level Determinants of Law Compliance

Alberto Chong and
Mark Gradstein.

*Journal of Law, Economics and
Organization* Volume 25.

This paper revisits the effects of a country's institutional framework on individual firms' behavior, in particular focusing on their propensity to comply

with legal rules. The theoretical model presented suggests that these effects may be of paramount significance—contrary to the recently popularized paradigm arguing that differences across countries have ceased to matter greatly. The paper's empirical strategy consists of explaining the variation in measures of non-compliance with legal rules and employs a rich dataset based on thousands of firms from dozens of countries. It is found that most of the variation emanates from country-wide differences in institutional quality, although some firm characteristics play a role as well. The authors conclude that countries still matter in providing institutional infrastructure, which to a large extent determines the context within which firms operate.

The Mystery of Discrimination in Latin America

Alberto Chong and
Hugo Ñopo.

Economía Volume 8, Number 2, pages
79–107.

This paper surveys evidence on discrimination in Latin America and shows that there is a widespread perception of discrimination, especially against the poor, the uneducated and those who lack connections. The channels through which discrimination occurs may be built on the basis of economic factors. However, while perception surveys may be informative, they are less than ideal at helping pinpoint the extent and mechanisms related. Recent experimental evidence suggests little room for discriminatory practices in the region. This puzzle, where individuals perceive discrimination is in the air, but few act discriminatorily, is consistent with an explanation wherein stereotyping vanishes when information flows operate well.



Network News

Sixth Workshop of the Latin American Finance Network (LFN)

September 30, 2009
Buenos Aires, Argentina

This year's LFN workshop will focus on the Global Financial Crisis and the future of Financial Regulation, with a particular focus on Emerging Countries and Latin America.

The workshop will be structured around a small number of papers organized into thematic sessions. The list of selected papers:

- Giovanni Dell'Ariccia. "Lender Behavior During Credit Cycles"
- Anton Korinek. "Systemic Risk-Taking: Amplification Effects, Externalities, and Regulatory Responses"
- Mark Wright. "The Costs of Emerging Market Financial Crises:

- Output, Productivity and Welfare"
- Gustavo Suárez. "The Anatomy of a Financial Crisis: The Evolution of Runs in the Asset-Backed Commercial Paper Market"
- Enrique Mendoza. "Financial Globalization, Financial Crises and Contagion"
- Marcus Miller. "Leverage and Asset Bubbles: Averting Armageddon with Chapter 11?"
- Gabriela Mundaca-Elias. "Monitoring, Liquidity Provisions, and Financial Crises"

For additional information, please contact lfn@iadb.org.

14th LACEA - LAMES Annual Meetings 2009

October 1–3, 2009
9am–6pm
Universidad Torcuato di Tella
Buenos Aires, Argentina

www.iadb.org/res/researchnetwork

Welcome to RES

Paulo Rodrigues Bastos, a Portuguese citizen, joined RES as a Research Economist in August 2009. He holds a PhD in Economics from the University of Nottingham. Previously he worked at the Bank's Office of Evaluation and Oversight, the European Commission and the University of Nottingham. His research covers a wide range of topics in applied microeconomics, having recently appeared in the *Journal of International Economics*, *Canadian Journal of Economics*, *International Journal of Industrial Organization and Labour Economics*.

Fabiana Velasques de Paula Machado, a Brazilian national, joins the Research Department as a Research Economist. She is receiving her PhD in Political Science from the University of Rochester, NY. Prior to coming to the IDB she worked as an evaluation associate for Safe Horizon, a non-profit organization that helps victims of domestic violence in New York. Her research in RES focuses on issues of poverty and inequality and how they affect the political prospects of redistributive policies.

This issue of *IDEA* was prepared by Alejandro Izquierdo and Rita Funaro. It is based on research coordinated by Alejandro Izquierdo and Ernesto Talvi, with contributions from Luis Catão, Eduardo Cavallo, Eduardo Fernández-Arias, Arturo Galindo, Pablo Ottonello, Diego Pérez, and Alessandro Rebucci. The research was first presented in the book *Policy Trade-offs for Unprecedented Times: Confronting the Global Crisis in Latin America and the Caribbean*, which was presented at the IDB's annual meetings in March 2009.

Eduardo Lora
General Coordinator

Rita Funaro
Managing Editor

IDEA (Ideas for Development in the Americas) is an economic and social policy newsletter published three times a year by the Research Department, Inter-American Development Bank. Comments are welcome and should be directed to *IDEA*'s managing editor, Rita Funaro at Ritaf@iadb.org.

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