American Enterprise Institute for Public Policy Research

No. 3 • May 2008

What if the United States Sneezed and Latin America Didn't Catch a Cold?

By Megan Davy and Roger F. Noriega

Latin American and Caribbean (LAC) economies, usually susceptible to international financial turmoil, are especially vulnerable to even minor tremors in U.S. markets. Regional policymakers and entrepreneurs, therefore, have been closely watching the current U.S. subprime credit crisis. Here is the good news: all signs point to relatively minor symptoms in LAC countries—despite a rocky financial history during the 1980s and 1990s—thanks in large part to reforms undertaken in response to previous financial crises, as well as continued high commodity prices that will likely buoy export markets. Although the economic downturn in the United States and other global markets will likely expose lingering weaknesses in the region's economy, this latest crisis can provide an impetus to complete the unfinished business of building more modern, resilient economies.

What began as a relatively localized credit crisis in the U.S. subprime mortgage market has now spread to other major financial markets. As U.S. financial institutions scramble to get their ledgers in order, credit to domestic and international recipients alike is shrinking. Investment and consumption patterns are beginning to shift, and many are predicting a U.S. recession this year.

Fifteen to twenty years ago, these conditions would have been enough to send Latin American economies into a tailspin, yet initial indicators from the major LAC countries suggest that the region's financial markets and economies will remain relatively calm. Why is this time different? One reason is that the current credit crisis is located in a sector of developed countries' financial markets that does not, for the most part, exist in developing economies—that is, securitized mortgage markets. Furthermore, with the notable exceptions of Argentina and Venezuela, almost all LAC countries continue to make strides to remedy many of those domestic vulnerabilities that exposed their economies to international financial turbulence and made adjusting to fluctuations difficult to impossible. But no less important is the fact that high commodity prices have allowed many LAC governments to build up foreign exchange reserves and pay down their external debt to better maneuver global financial volatility. High commodity prices will also buoy many LAC economies in spite of the global economic downturn.

In short, the relative health of the region should not be undermined by the U.S. crisis. Rather, what matters is whether policymakers are lulled into a false sense of security by burgeoning export income or whether they recognize the lingering vulnerabilities and summon the courage to do something about them. Have these countries learned the lessons from their troubled history with global financial markets?

Megan Davy (mdavy@aei.org) is a research assistant at AEI. Roger F. Noriega (rnoriega@aei.org) is a visiting fellow at AEI. His law and advocacy firm, Tew Cardenas, LLP, represents foreign governments and companies.

A Rocky Relationship with International Financial Markets

Latin America was plagued by a series of maladies, leading up to the external debt crisis in the early

1980s that made the region particularly susceptible to any weakening in the world economy. A bloated, inefficient, and costly government-directed banking sector combined with unsustainable levels of external debt and macroeconomic mismanagement meant that when foreign investors started to have doubts about the health of Latin American markets and began pulling their money out of the region, governments were ill-equipped to respond, and their economies took serious hits.

In short, markets demanded corrective action, and policymakers had no choice but to respond. The economic crises of the late 1980s exacted reforms, and the fortuitous global upturn that followed in the late 1990s and the early part of this decade made reform possible. Latin American governments found the political will to enact the costly but necessary reforms to strengthen the region's financial backbone.

> Within the last four years, Latin American governments have taken advantage of a very favorable global environment. As a result, Latin America is better equipped to respond to domestic and international economic fluctuations.

Some of these reforms were to the banking sector itself: in 1980, Latin American governments owned two-thirds of the assets of the ten largest banks in the region;[1] political objectives took precedence over sound financial practices, and the governments were left to absorb debt on nonperforming loans. In response, governments reduced their interventions in capital markets, especially with regard to pricing credit and controls on foreign exchange and capital transactions. Loosely regulated banks were encouraged by this new freedom to expand lending beyond reasonable capacity, resulting in the now famous banking crises in Argentina, Bolivia, Colombia, Ecuador, Mexico, Peru, and Venezuela in the 1990s. Burned twice, government regulators put in place stricter controls on lending, raised capital and loan reserve requirements, and instituted differentiated treatments for dollar deposits and loans to mitigate the currency mismatch risks endemic in many of the banking crises. Finally, in December 1999, all major Latin American states signed the World Trade Organization Convention on Banking, Insurance, and Financial Services, thereby agreeing to open financial markets to foreign banks and insurance firms.

Thanks to a more stable global macroeconomic environment and a push by Latin American governments to pursue further reforms—including allowing nonbank institutions to provide basic services such as deposits, withdrawals, and loans—the banking sector has expanded significantly throughout the region, both in terms of geography and liquidity. As a result, large and small borrowers are now less dependent upon international lenders and are supported by a growing network of domestic financial services and capital markets.

Perhaps even more important were reforms in other areas of the economy that paved the way for greater stability. LAC governments first set out to decrease their external debt, which had come to consume an increasing percentage of government budgets (upwards of 50 percent in Mexico in 1987).[2] Governments could not simply pay off debt by printing more money or finding new lenders—the effect of which would have been to rekindle inflation, with which the region has been all too familiar. The solution was appropriately a combination of austere fiscal policy (including selling state-owned enterprises to generate funds) paired with monetary policy directed by increasingly autonomous or newly independent central banks that made inflation targeting a priority.

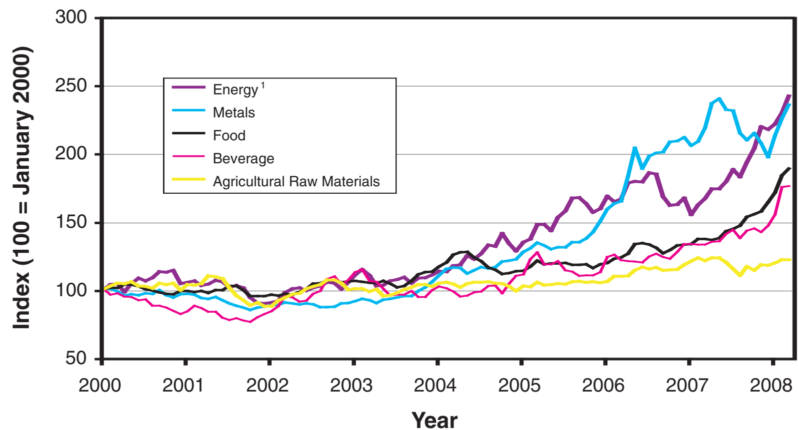
Owing to these reforms, many Latin American governments have reduced their external debt (Brazil and Chile have earned net creditor status), brought inflation levels down sharply to levels comparable with developed nations, and increased international reserves to serve as a buffer against international shocks. Within the last four years, Latin American governments have taken advantage of a very favorable global environment—including low interest and inflation rates, high levels of foreign direct investment in the region, and rising commodity prices—to address vulnerabilities, largely by achieving fiscal surpluses and padding international reserves. As a result, Latin America on the whole is better equipped than ever to respond to domestic and international economic fluctuations.

Lies, Damned Lies, and Statistics

Though the great majority of governments in the region have adopted essentially sound economic policies, some have not, and none has completed the task. For example, several countries' economic health is buoyed mostly by astronomical increases in commodity prices rather than by any real improvement in the "fundamentals" of their economies.

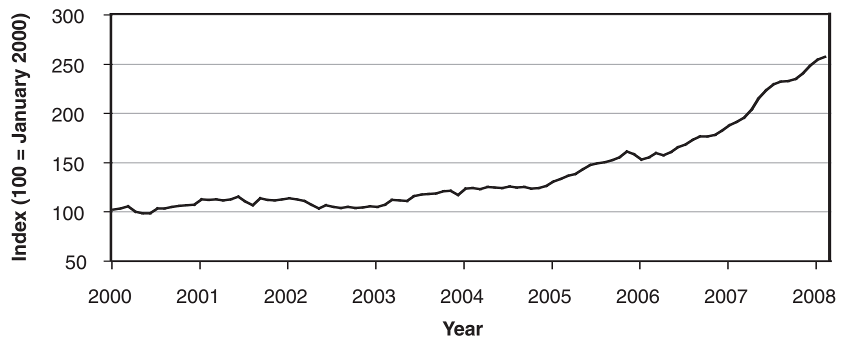
Venezuelan president Hugo Chávez is using his country's vast oil revenues to finance his very peculiar populist economic project while his country's economic foundation is crumbling. Mexico's oil profits are rising markedly, but sound reforms in its energy sector are stalled by polarized politics. Argentina is bouncing back from the 2001–2002 financial crisis, but the root causes of the meltdown there have not been addressed. The government is inviting an economic slowdown by taxing the life out of its mighty agriculture sector, and it is pretending to tame galloping inflation rates by tampering with official statistics. Brazil's government is credited with following "orthodox" macroeconomic policies, but recent evidence suggests that its fiscal health depends more on high export prices than on the government's economic decisions and that current spending levels are not sustainable in the long run. Finally, it is next to impossible to compare oil-rich nations with Central American and Caribbean neighbors who literally are struggling to keep the lights on and keep fuel oil flowing to their productive industries.

FIGURE 1
INDICES OF GLOBAL COMMODITY PRICES, JANUARY 2000–MARCH 2008



SOURCE: International Monetary Fund, International Financial Statistics Online.
[1]Includes crude oil, natural gas, and coal.

FIGURE 2
INTERNATIONAL RESERVES FOR LATIN AMERICA AND THE CARIBBEAN, JANUARY 2000–FEBRUARY 2008



SOURCE: International Monetary Fund, International Financial Statistics Online.

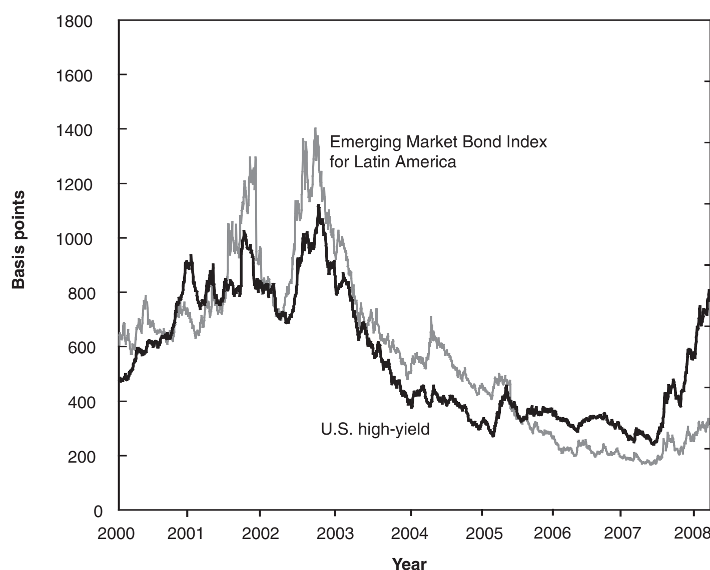
In short, the overall statistics showing that the economies of Latin America experienced near record growth last year do not begin to tell the whole story. A closer look at exports from the region shows that commodities are largely responsible for the upsurge. And that infusion of income, no matter how robust, cannot compensate entirely for the global economic downturn; every country will be affected in some way, depending on its own fundamentals.

When the United States Sneezes

The less-developed economies of Latin America and the Caribbean will fare better than most developed economies whose financial markets are more closely integrated with a slumping U.S. economy. Still, there is no escaping the fact that the expected U.S. slowdown will have some impact on the rest of the Americas. The International Monetary Fund predicts that annual GDP growth in Latin America will decelerate from 5.6 percent in 2007 to 4.4 percent in 2008 and 3.6 percent in 2009. This is compared with an estimated global slowdown from 4.9 percent GDP growth in 2007 to 3.7 percent in 2008.[3] The Institute of International Finance predicts a similar slowdown for the region, from 5.2 percent annual GDP growth in 2007 to 4.4 percent in 2008 and 4.2 percent in 2009.[4]

Economic crises spread to other countries through the negative impact on financial and trade flows. In the case

FIGURE 3
EMERGING MARKET SOVEREIGN AND U.S. HIGH-YIELD SPREADS



SOURCES: Bloomberg and Datastream. Data provided by the International Monetary Fund.

of downturns in the financial sector, decreased liquidity in U.S. markets may make it more difficult for Latin American governments and firms to access credit. As U.S. consumption drops, Latin American countries will also export less to the United States, which will affect their GDPs, exchange rates, and terms of trade.

U.S. credit woes have had a relatively limited impact on Latin America's financial markets thus far, thanks largely to the region's ability to rely on domestic sources of capital, particularly local bank lending, as opposed to capital market financing. Only 15 percent of LAC corporations' net funding in the formal financial sector is from external bond, loan, and equity sources,[5] and as U.S. banks look to adjust their balance sheets, they will likely shore up credit both at home and abroad. This move is liable to affect access to credit, as well as produce increases in interest rates and other costs—but not to the degree that it would have ten years ago. While U.S. financial market indicators show significant turbulence (high-yield interest rates, for example), LAC market indicators have remained relatively calm in recent months.

Firms and governments in Latin America and the Caribbean looking to renegotiate expiring U.S. or other external loans or take on new ones will likely look to domestic lenders. While the data suggest that the region's domestic banks can provide some of the capital, the financial sector in the region is much less developed and more shallow than that of developed nations. Less credit-worthy enterprises and individuals—mostly small and medium enterprises (SMEs)—may find themselves crowded out of the credit market as larger, more established firms move to domestic sources of credit, a trend exacerbated by any economic slowdown stemming from decreased trade or other factors.

In short, the region will be affected by the U.S. downturn, with some sectors hit harder than others. That said, the reforms and modernization demanded by past crises have strengthened domestic financial markets in Latin America in ways that will mitigate the impact.

But where will the impact be felt? Naturally, countries in the Americas should expect the greatest impact from a U.S. economic slowdown in export levels as a result of decreased consumption in the United States. This will be especially important for Mexico and Central American countries, whose economies are most interconnected with the United States. South American economies will be more immune to shifting trade patterns with the United States, thanks to high commodity prices that will bolster exports at least in the short run, as well as a more diverse set of buyers. Commodities represent 40 percent of export revenues across the LAC region, and these prices have been booming. Commodity prices are expected to hold steady in the near term, especially if the U.S. dollar continues to weaken. Any appreciable slowing in the economies of buyers such as China and India, however, could affect prices and cause fiscal and trade balances in the region to deteriorate sharply.[6]

With increased turbulence in global markets and higher costs of capital, capital inflows to the region are expected to slow in the coming months, but it is unlikely that investors will pull their funds out of the region. Over the long haul, however, the LAC region is likely to experience relatively strong capital flows, especially when compared with previous financial crises that led to capital flows out of the region when investors became nervous. Investment in the region in commodities has picked up in the past few years and will likely remain strong in the coming years as countries like China and India seek to consolidate their supply chains. Furthermore, as investors

become increasingly wary of the investment climate in the United States and Europe, many are looking to emerging markets, including Latin America, as a place to invest their funds.

Remittances to LAC countries will likely decrease as well. Remittances to the region as a whole showed the first single-digit growth rate in recent years (7 percent, bringing total remittances to $66.5 million in 2007), and numbers for January 2008 show that remittance receipts are down in Mexico compared with the same month last year.[7] Some of this reduction is attributed to the recent crackdown on illegal immigrant workers, and the generalized economic slowdown will only make matters worse.

The overall statistics showing that the economies of Latin America experienced near record growth last year do not begin to tell the whole story.

This combination of financial and trade spillovers will test Latin America's newly strengthened economic backbone. Perhaps most worrisome is inflation. In certain countries—especially Argentina—inflationary woes are the result of domestic monetary and fiscal mismanagement. All countries in the region, however, will find it increasingly difficult to keep inflation down because of rising international food prices, growing domestic demand, and calls to loosen monetary policy to alleviate liquidity problems. Balancing the growth effects of decreased credit availability against the inflationary effects of loose monetary policy will be tricky—a concern not lost on many LAC central banks.

A deteriorating trade situation—especially if commodity prices start to decrease and demand for imports remains strong—could have detrimental effects on current accounts and terms of trade, as well as fiscal policy. High commodity prices and relatively high levels of investment (heavily concentrated in natural resources) in commodity-rich countries have fostered currency appreciations and a buildup of international reserves. As a result, many of these countries are running fiscal surpluses (in some cases aided by profits from state-owned commodity enterprises) and have improved their fiscal and trade balances. While many governments have made great strides in decreasing their debt burdens and therefore generally improving their fiscal health, the threat of economic slowdown is expected to reverse trade balances and dry up surpluses.

This deteriorating trade balance will hit Central American countries and Mexico even harder, as they did not benefit very much from high commodity prices and did not create fiscal surpluses before the credit crunch. They will likely have to tighten their belts even more as oil and food prices continue to rise. More flexible exchange rates and greater international reserve holdings compared with the previous credit crises of the 1980s and 1990s will help these nations adjust to sharp fluctuations in international markets. Perhaps more worrisome are current trends in increased spending irrespective of fiscal health: regional policymakers would be wise to adopt strict measures to keep their fiscal houses in order while maintaining a progrowth environment. But some may compound the effects of the economic slowdown by raising taxes rather than controlling spending.

Impetus for Future Reforms?

To their credit, many LAC countries have poured the foundations for more responsible fiscal policies, made inflation targeting a policy priority, and established regulatory frameworks for more modern and competitive financial systems. They stand to reap the benefits of these sound policies in the turbulent months ahead. Some observers contend that governments did not take full advantage of the optimal economic environment at the start of this decade by enacting more robust, integral, and consequential reforms. Unfortunately, "reform fatigue" and the rise of populism have overshadowed the unexpectedly favorable conditions of the last few years and led many policymakers to lose their nerve in pressing forward with essential reforms. Now, the global financial turbulence and a more virulent strain of protectionism might erase many of these favorable factors that made some of the recent reforms possible, and governments will focus most of their efforts once again on treating the immediate symptoms rather than remedying the underlying vulnerabilities.

One can only hope that, as policymakers react to the short-term effects of this latest global downturn, they will recognize that past reforms have mitigated the impact of this crisis and that sound policies are *always* worth the trouble. Indeed, the current turbulence might just be the timely reminder that some governments need to complete the unfinished business of retooling their economies to be more open, competitive, resilient, and just.

The same windfalls from high commodity prices that will help a number of regional economies ride out

the current crisis might also lead otherwise intelligent policymakers to postpone reforms. But the inescapable fact is that much remains to be done to retool regional economies in order to sustain real growth over the long term. The essential ingredients to sustain growth are strengthening the rule of law and central institutions, improving transparency, and enhancing education—all of which are needed to attract capital and put it to effective use. While fiscal windfalls can support increased social spending or transfer payments to the very poor, such short-term activities are no substitute for systemic change that extends political power and economic opportunity to those on the margins of society so that they can work their way to the middle.

Institutional Environment Reform. Guaranteeing the rule of law means building the elements of a modern state that can apply the rules of the game without fear or favor. Fighting corruption, eliminating state-sponsored privilege, streamlining judiciaries, and bolstering police services to guarantee the physical security of all inhabitants are the essential responsibilities of any accountable government. As with any enterprise, the financial sector is affected profoundly by the institutional environment in which it operates. As such, improvements in the rule of law yield important dividends that affect diverse interests.

Regulatory reform that makes it easier for entrepreneurs—foreign and domestic—to start businesses is the low-hanging fruit for reformers. SMEs are the building blocks of any modern economy. They are able to identify demand, access credit, generate commerce, and create jobs. Outdated and unnecessary regulations stunt the growth of new businesses, driving them into the informal economy and thereby slowing growth in the developing world. Myriad checklists exist for how to streamline these processes. Any government that is serious about sustained, broad-based growth must treat such modernization as an urgent priority.

Though the financial sector has benefited from regulatory reform as described earlier in this *Outlook*, a few key reforms remain to be accomplished. Some countries tax financial transactions as a means for central governments to raise revenue quickly in hard fiscal times, but the taxes are often maintained after fiscal conditions improve. These taxes discourage SMEs and individuals from setting up and maintaining bank accounts or taking full advantage of banking services. Furthermore, LAC governments weight government debt as less risky than private sector debt. As a result, banks in the region now maintain a much higher proportion of government debt as a percentage of total bank assets than do banks in developed nations—a phenomenon that only increases in times of economic contraction, crowding out the private sector from the credit market. By adjusting the risk weightings assigned to government debt to treat it more like private sector debt, LAC governments can correct those incentives that favor public instead of private debt irrespective of the inherent risks of either.

Policies that secure capital and property rights will attract direct investment to sustain growth and allow financial institutions to provide credit and other services more effectively to SMEs and individuals in greater need of credit during economic downturns. Governments cannot micromanage an economy, but they can create favorable conditions for the right kind of growth. A first step in securing property rights would be to reform and update property registration to help SMEs and individuals better use property as a guarantee for loans and to help them move from the informal sector into the formal economy. And first-class intellectual property protections will encourage high-tech, direct investment and invite technology transfer that will enrich an economy in many ways.

State-Owned Enterprises and Fiscal Policy. Despite the existence of immense hydrocarbon deposits in the Americas, many countries have adopted policies that discourage investment and maximum profits in this key sector. Pricing and marketing regimens that prevent private companies from recovering their investments have strangled this sector and created inexplicable shortages and even blackouts in states rich with energy potential. For example, price controls in Argentina have sown the seeds of disaster in that country, just as its economy is seeking to consolidate its recovery. Bolivia's self-inflicted political woes have discouraged foreign investment, despite the desperate need for vast amounts of capital and specialized technology to exploit and market its impressive deposits of natural gas. In Venezuela, Chávez, who has replaced able technocrats with partisan loyalists and squandered billions of dollars in revenue in unaccountable and overtly corrupt spending at home and abroad, has wrecked the country's state-owned oil company. Mexico's polarized politics, populism, and nationalism have stalled even the tentative reforms proposed by President Felipe Calderón to open its underperforming sector to foreign investment and technology.

Mexico's national budget depends on petroleum revenue for 40 percent of its spending.[8] As in too many nations, as oil prices rise, politicians plow the windfall into discretionary, popular spending programs rather than reserve the funds for tougher days. Chile has a decades-old restraint mechanism that channels any excess revenue from burgeoning copper exports into a capital fund that cannot be accessed for short-term spending.

It is essential for countries to undertake fiscal reform in the relatively good times in the region. Of course, spending in sound, integral social or infrastructure programs should be part of any country's development plan. In the current context, fiscal restraint does not mean imposing austerity but, rather, managing prosperity. By simplifying tax codes and making them more transparent and by designing codes to prevent evasion, the private sector and investor class can make better decisions for growing their businesses—which in turn will produce jobs (always the best "social program") and generate tax revenue to support an effective modern state.

These second-generation reforms are indispensable for attracting foreign direct investment, not just speculative capital. Such direct capital investment—building modern, high-technology factories or training local labor forces—is a much more valuable source of capital to a developing economy than is revenue derived from the export of raw materials, farm products, or hydrocarbons.

Conclusion

It may be counterintuitive to expect economies in the Americas to ride out the current U.S. economic woes with relative ease. But the fact is that high commodity prices, enhanced diversity in the region's economies, and robust global trade should combine to minimize the impact of the global downturn on most major economies in the region.

Countries that may find themselves hardest hit are those that have been hijacked by irresponsible leaders who are trying to swim against the tide of market forces. Even nations rich in oil or other commodities are discovering that there is no substitute for responsible leadership. The others are benefiting from a little bit of luck and years of hard work—learning the essential economic lesson that the harder they work, the luckier they get.

The authors would like to thank AEI resident fellow Desmond Lachman for his invaluable contributions.

Notes

1. Jan Smith, Tricia Juhn, and Christopher Humphrey, "Consumer and Small Business Credit: Building Blocks of the Middle Class," in *Can Latin America Compete? Confronting the Challenges of Globalization*, ed. Jerry Haar and John Price (New York: Palgrave MacMillan, 2008).
2. Victor Bulmer-Thomas, *The Economic History of Latin America since Independence*, 2nd ed. (New York: Cambridge University Press, 2003).
3. International Monetary Fund (IMF), *Regional Economic Outlook: Western Hemisphere* (Washington, DC: IMF, April 2008), available at www.imf.org/external/pubs/ft/reo/2008/whd/ENG/wreo0408.pdf (accessed May 20, 2008).
4. Institute of International Finance, "Regional Overview: Latin America," March 21, 2008, available through www.iif.com/emr/article+248.php (accessed May 20, 2008).
5. IMF, *Regional Economic Outlook: Western Hemisphere*.
6. Anoop Singh, "The Financial Market Crisis and Risks for Latin America" (presentation, "The Euro: Global Implications and Relevance for Latin America," IMF, Sao Paulo, Brazil, March 17, 2008), available at www.imf.org/external/np/speeches/2008/031708a.htm (accessed April 23, 2008).
7. Inter-American Development Bank, "Remittances to Latin America and the Caribbean Slower, IDB Fund Says," news release, March 11, 2008, available at www.iadb.org/NEWS/articledetail.cfm?artid=4459&language=En (accessed April 28, 2008).
8. Thomas Black and Andres R. Martinez, "Pemex Missteps Pare Oil Revenues, Pave Way for Petrobras Entry," Bloomberg.com, March 31, 2008.