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# **LATIN AMERICA: THE MISSING FINANCIAL CRISIS**

by

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## **Abstract**

*This may well be the first time since Latin America gained its independence in the early 1800s that a major economic contraction and financial calamity in the industrialized world has not caused a wave of currency, sovereign debt or banking crises in the region. What explains Latin America's unprecedented resilience in contrast with, for example, Eastern Europe's now-evident financial vulnerability? Here we review the enormous progress made by many governments in Latin America in the past decade to reduce currency mismatches, allow for more flexible exchange-rate regimes, enhance the capitalization, funding and supervision of their banking systems, encourage the development of local capital markets, and implement sounder and more credible monetary and fiscal policies. Evidently, it is not necessary to wait for an improved international financial architecture in order for reform-minded, well-managed countries to reap the most benefits from, and minimize the deleterious impact of market cycles typical of, financial globalization.*

## Introduction

In recent decades, the conventional wisdom has come to hold that financial booms and busts are a frequent (and possibly inevitable) feature of capitalism, and that in an increasingly integrated world, so is the transmission of market cycles around the globe. In good times, international financial integration has particularly strong beneficial effects on the most open and thus more rapidly growing developing countries (the so-called emerging markets), but in bad times restrictive monetary policies, credit crunches, market downturns, and generalized risk aversion in the United States, Europe and Japan likewise reverberate most powerfully in those developing countries.

The financial vulnerability of Latin America to the vagaries of international capital markets has been on all-too-frequent and public display. This vulnerability first became evident in 1825, when Latin America experienced the fallout of a major financial crisis in Europe soon after many of the countries in the region gained their independence and their new governments began to borrow abroad. The crisis was the consequence of a tightening of liquidity on the part of the Bank of England starting in March 1825, which led to the failure of numerous banks in England and Wales – eventually, about 60 of them shuttered their doors. This wave of bank failures, in turn, generated a financial panic in December of that year that had worldwide repercussions (Bordo, 1998). The ensuing collapse in stocks and bonds, implosion in international trade, and shutdown of the London capital market prompted one after another of the fledgling governments in Latin America to stop servicing their foreign debt obligations. Peru suspended payments in April 1826, and by the middle of 1828, and with the single exception of Brazil, all the Latin American nations that had issued bonds abroad in the early 1820s –a dozen of them in total– had defaulted on their obligations (Marichal, 1989).

The repetition of currency, sovereign debt, and/or banking crises in Latin America, and their appearance also in Asia and in just about in every other region in the developing world at some point or another, has spawned a voluminous academic, policy-oriented and even journalistic literature, especially in the last decade (see for example Auernheimer, 2003; Blustein, 2003; Calvo, 2005; Claessens and Forbes, 2001; Dooley and Frankel, 2003; Edwards, 2000 and 2007; Edwards and Frankel, 2002; Edwards and Garcia, 2008; Eichengreen, 2003; Griffith-Jones, Gottschalk and Cailloux, 2003; Ocampo, Kregel and Griffith-Jones, 2007; and Reinhart, Vegh and Velasco, 2008).

As a leading economic historian has written in distilling the lessons of the past, “financial crises have always been part of the scene... The effects of crises are and were worse in emerging countries... because they are financially underdeveloped and have thinner markets, less diversified portfolios, less effective supervision and regulation, less well defined property rights and bankruptcy codes, and a greater proclivity to follow unstable macro[economic] policies. All of these features make them more prone to asymmetric information problems, lending booms and busts, and banking crises” (Bordo, 2003, p. 68).

In the aftermath of the international financial crises of the mid-1990s, the Office of the Executive Secretary of the Economic Commission for Latin America (at the time headed by José Antonio Ocampo) concluded as follows: “The recent crises have revealed the serious imperfections of the international capital market and the great vulnerability of developing economies to international financial shocks... In boom phases of capital flows, key macroeconomic variables (such as the exchange rate and the prices of assets) tend to move away from their long-term equilibria. The most serious threat is that, if flows reverse abruptly, this may set off banking and financial crises that cause great disruption to the countries directly affected and undermine the vitality of world development” (ECLAC, 1998, p. 41).

The phenomenon whereby capital inflows dry up and possibly exit from a country has come to be known as a “sudden stop,” a concept analyzed and popularized by Guillermo Calvo (e.g. Calvo, 1998). Interestingly, however, those who coined the term to help explain several currency crises (e.g., Chile’s in 1982 and Mexico’s in 1994) saw it as a phenomenon resulting from a combination of *both* domestic policy failures and events outside of a government’s own control (Dornbusch, Goldfajn and Valdés, 1995) – and not merely an exogenous development.

### **A. Transmission channels and policy implications**

Conceptually, there are several channels whereby a financial crisis in one or more industrialized countries can be transmitted to other industrialized and to emerging and developing countries. First there is *the credit channel*: a tightening of liquidity conditions in the United States, Europe or Japan, likely accompanied by a wave of risk aversion, will initially reduce the availability and increase the cost of funding for domestic borrowers and investors. In a financially integrated world, however, this credit slowdown will likely spill over across borders and, if sufficiently serious and prolonged, can lead to a “sudden stop” of capital to governments, banks and corporations in other industrialized and developing economies. In contemporary times, the importance of the credit channel was in clearest evidence during the early 1980s, when monetary policies were tightened to an extraordinary degree in the United States and then elsewhere, helping to trigger a major, worldwide credit contraction that helped usher in the debt crises of that decade in Latin America and beyond. Empirical research in the early 1990s confirmed that the most important identifiable factor behind swings in capital flows to Latin America were cycles in U.S. interest rates and in other exogenous macroeconomic, rather than domestic, variables (e.g. Calvo, Leiderman and Reinhart, 1993). More recent empirical research confirms that monetary disturbances in the United States have had large and significant impacts in Latin America, for instance by affecting capital flows and thus having destabilizing effects on exchange rates in the region (Canova, 2005). And by now globalization has proceeded to the point where there is evidence that external financial conditions are capable of affecting even the previously isolated countries in Sub-Saharan Africa (Drummond and Ramirez, 2009).

A second main transmission channel for financial crises is through *international trade*: a credit crunch in one or more of the leading industrialized countries, whether induced by monetary policy or not, will reduce the pace of domestic investment and consumption. In a commercially integrated world, however, this slowdown in domestic demand will likely generate a drop in merchandise import volumes, commodity prices, tourism spending overseas, and workers’ remittances normally sent abroad. Since many commodities are also financial assets held by investors with access to credit, and not just or mainly by end-consumers and producers, they are quite sensitive to developments in the credit channel, as well. And the credit and trade channels are interrelated in other ways: foreign trade is facilitated by the availability of lines of credit (e.g. import financing and pre-export credit), and credit crunches that disrupt selected productive activities (say, the automobile industry, which is highly integrated across borders) can obviously dislocate worldwide production processes and trade flows (Escaith and Gonguet, 2009).

A third transmission mechanism of financial crises is through *investor and lender herd behavior and contagion effects*: a tightening of liquidity conditions or surprise changes in economic, political or financial conditions will tend to trigger sudden portfolio adjustments, whereby investors and lenders will attempt to exit from certain asset classes, markets, industries and countries and turn to others perceived to be safer or more appropriate – regardless of longer-term economic fundamentals. Herding is presumed to be caused by problems of asymmetric information and by pressure on professional investors (like mutual fund managers) not to underperform their competitors, thereby encouraging them to follow each other in and out of asset classes or geographic or product markets. Contagion effects can occur when a shock in one asset class or country encourages lenders and investors to anticipate a similar event in

comparable asset classes or countries; or when a shock in one asset class or country forces lenders and investors –especially the most leveraged ones– to take offsetting measures elsewhere, regardless of different long-term fundamentals, for example when faced with deposit withdrawals or investor redemptions. A great deal of empirical research on this channel was undertaken in the wake of the financial crises of the 1990s (e.g. Claessens and Forbes, 2001), when financial crises in Mexico (1994) and Thailand (1997) caused a wave of investor and depositor retrenchment away from Argentina and much of East Asia, respectively; and also when a financial crisis in Russia (1998) had enormous impact in the world’s principal financial markets as well as in Brazil.

During the past decade, the identification of these transmission mechanisms has prompted a great deal of academic and policy-oriented writing on whether and how they could be broken or at least diminished. Some analysts took the understandable position that, given growing international trade and financial integration links, it is impossible to weaken the transmission mechanisms deemed undesirable during times of crises – because they are the same ones that are beneficial and welcome during the good times. Others advocated reforms in the international financial architecture, such as the multilateral imposition of a so-called Tobin tax on capital flows, the implementation of explicit countercyclical regulations that would dampen excessive cross-border lending or investment, and the meaningful expansion of IMF resources to help countries with good fundamentals defend themselves in turbulent times. A minority came out in favor of the unilateral establishment of quantitative controls on capital movements, to better administer capital inflows and/or outflows.

The most practical, constructive agenda recognized that there are structural reforms that could be implemented to encourage the necessary macroeconomic flexibility, fiscal solvency, financial soundness, investor education, and transparency to better cope with episodes of “sudden stops.” For example, casual observation and quantitative research identified that artificial exchange rate regimes tend to make countries more vulnerable to imported crises, because they encourage currency and maturity mismatches on the part of governments, banks and corporations, and because they encourage delay, and make it more costly, for economies to adjust to sudden surges or collapses in export earnings or capital inflows (Desroches, 2005; Dornbusch, 2002; Goldstein and Turner, 2004; Rosenberg and others, 2005).

Practical experience with financial crises also suggested that governments ought to manage their external assets and liabilities much better; should set aside savings from revenue bonanzas to create “rainy day” funds, to draw upon in times of revenue shortfalls and finance countercyclical fiscal policies; and ought to refocus and professionalize their central banks, to encourage greater trust in local currencies and gain the credibility necessary to run countercyclical monetary policies (Hemming, Kell and Schimmelpfennig, 2003; Inter-American Development Bank, 2006; Ugolini, Schaechter and Stone, 2003).

The promotion of domestic institutional investors, the development of local bond markets, the removal of obstacles to the arrival of strongly capitalized foreign commercial banks, and the enhancement of prudential supervision in domestic financial markets – these were likewise seen as part of a constructive reform agenda to be able to cope with future exogenous financial shocks (Hanson, Honohan and Majnoni, 2003; Inter-American Development Bank, 2004; Litan, Pomerleano and Sundararajan, 2003; Mishkin, 2006; World Bank, 1997).

As will become clear in the next section, it is because many governments in Latin America took these findings and policy recommendations to heart, and implemented them in recent years, that the region has been able to cope with the recessionary, sudden-stop global environment of 2008-09, managing to ward off the currency, sovereign debt, and banking crises –and thus deep recessions– typical of the past. This is not to deny the adverse consequences that the 2008-09 episode is having on regional exports, output, employment, incomes and wealth, particularly in Mexico, the Caribbean and Central America (ECLAC, 2009a, 2009b). These consequences have

been minimized primarily thanks to the absence of financial crises throughout Latin America, and secondarily thanks to the adoption of counter-cyclical macroeconomic policies in many countries – but they are meaningful, nonetheless. For example, the average open unemployment rate in nine countries rose from 7.9% in 1Q08 to 8.5% in 1Q09, and is expected to have kept rising to around 9% (ECLAC, 2009a, pp. 13-14).

## **The recession and sudden stop of 2008-09**

The economic contraction and financial crisis of 2008-09 has developed in four fairly distinct stages.

*Stage 1:* Between mid-2007 and mid-March 2008, there was turmoil confined mainly to the subprime mortgage market in the United States, but it exposed widespread vulnerabilities among global financial institutions –primarily major commercial and investment banks, but also at AIG, the world’s largest insurance company– that turned out to be significant holders of subprime securities or their derivatives. Valuation losses increased over time, causing damage to balance sheets and eventually triggering (in mid-March 2008) a liquidity crisis at Bear Stearns, a heavyweight in mortgage securities which had to be taken over (by JP Morgan Chase) with considerable U.S. government and Federal Reserve assistance.

*Stage 2:* The sense of relief that followed from the smooth takeover of Bear Stearns proved short-lived and, from April to mid-September 2008, interbank funding problems soon resurfaced aggravated by concerns about the solvency of leading financial institutions – including those that had provided insurance and other credit enhancements to bonds and structured instruments. The two major housing finance enterprises sponsored by the U.S. government, Fannie Mae and Freddie Mac, had to be rescued. Economic activity started to weaken and housing and commodity prices began to drop meaningfully; real GDP contracted in Europe and Japan already in the second and third quarters of 2008.

*Stage 3:* From mid-September 2008 to March 2009, market turmoil degenerated into a worldwide financial crisis and economic near-depression. The tipping point came after the U.S. investment banking firm Lehman Brothers was allowed to fail, imposing widespread losses on its debt holders including money-market mutual funds, and threatening to disrupt the CDS (Credit Default Swap) market in which Lehman was an anchor entity. The U.S. government minimized the potential damage to the CDS market by bailing out AIG, the other anchor of the credit default market, but investor nervousness nonetheless spread from money-market mutual funds to the CP (Commercial Paper) market, which experienced the largest outflows of all. Suddenly, every financial institution without a retail deposit base lost access to wholesale funding precisely when extra liquidity was needed to support affiliated money-market funds. The turmoil spread quickly throughout Europe, such that property lenders in the United Kingdom, Germany and Belgium had to be rescued by their governments, and the three main banks in Iceland collapsed. Back in the United States, Morgan Stanley and even Goldman Sachs, the most profitable and prestigious investment bank, had to turn to the authorities for financial support, and Merrill Lynch, the last remaining of the large, independent investment houses, found it necessary to sell itself over a weekend (to Bank of America, with considerable government assistance).

In the weeks to mid-October 2008, all kinds of monetary, fiscal and regulatory initiatives were taken by governments and central banks around the world, but it came too little, too late to prevent major damage to economic activity for months afterward. In the G7 economies, real GDP plunged at an annualized rate of about 8% in both 4Q08 and 1Q09, with the greatest contractions registered, ironically, not in the United States but in Japan, Germany and Italy. The

prices of virtually all financial assets –stocks, corporate bonds, commodities and housing– collapsed, the exceptions being AAA-rated government bonds and gold, the usual refuge of panicked investors. The resulting declines in household wealth accelerated cuts in consumption, investment and imports, with sharply adverse implications for world trade and cross-border capital flows.

*Stage 4:* Signs of financial and market stabilization emerged in March of this year, and since then stocks, bonds, and commodities have rallied and most economies seem to have found a bottom from which to start recovering during the second half of 2009. A key support was provided by a string of announcements made, and measures taken, by the leading governments and central banks to purchase assets and provide fiscal stimulus, guarantees, market liquidity, and lines of credit. China's economy was the first among the ten largest to announce GDP growth during 2Q09 after an earlier slowdown, and manufacturers from India to South Korea have been reporting improvements in industrial production, boosting optimism that the worst of the global economic slump is over. The economies of the euro area barely contracted in 2Q09 as Germany and France unexpectedly returned to growth, and now Europe is expected to recover during the second half of 2009, though at a slower pace than North America. Among emerging and developing economies, it would appear that the countries of Central and Eastern Europe, and the Commonwealth of Independent States, will be experiencing the deepest and longest recessions.

### **A. Impact on developing countries**

The deepening financial and economic crisis in the United States, Europe and Japan hit emerging and developing countries with full force starting in September 2008. The bankruptcy of Lehman Brothers and the near failure of other financial institutions in the United States and Europe triggered a sudden drop in consumption and investment spending that translated into significantly lower import demand. In addition, a wave of risk aversion led to herding and contagion selling in stock, bond, currency and commodity markets around the world, and to a *de facto* shutdown of the international capital markets, affecting the availability of international bank loans and cross-border portfolio investments. Transmission of recessionary forces via the international trade channel led, for instance, to a more than 45% year-on-year collapse in the export earnings of emerging and developing countries in 4Q08-1Q09 (see table 1).

**TABLE 1**  
**MERCHANDISE EXPORT GROWTH**

*(percentage change in US\$, seasonally adjusted annual rates)*

<b>Region/Country</b>	<b>1Q08</b>	<b>2Q08</b>	<b>3Q08</b>	<b>4Q08</b>	<b>1Q09</b>
<b>Developing countries</b>	<b>34.6</b>	<b>21.1</b>	<b>11.2</b>	<b>-44.3</b>	<b>-49.9</b>
East Asia and Pacific	8.9	17.2	16.6	-41.9	-55.6
China	8.5	16.3	17.2	-40.9	-56.2
Eastern Europe and Central Asia	63.3	19.7	9.1	-68.5	-59.9
Russia	65.2	14.0	20.2	-71.4	-81.0
Latin America	75.9	28.0	3.2	-42.4	-38.2
Brazil	12.0	91.9	13.9	-47.2	-64.4
Middle East and North Africa	127.6	42.7	23.0	N/A	N/A
Egypt	118.0	184.7	-27.7	-73.1	-11.1
South Asia	37.0	26.1	-10.2	-57.4	-37.4
India	32.8	26.2	-11.8	-60.2	-37.5
Sub-Saharan Africa	147.3	-9.8	41.7	N/A	N/A
South Africa	38.7	19.0	29.4	-61.6	-59.6

Source: Calculated by the author, on the basis of data from the World Bank.

Transmission of a sudden stop via the international credit channel resulted, for example, in a nearly US\$ 310 billion drop (on a constant-dollar basis) in cross-border bank loans outstanding to emerging and developing countries during the period October 2008-March 2009, more than reversing the nearly US\$ 270 billion increase in cross-border net bank lending that had taken place during January-June 2008.

**TABLE 2**  
**INTERNATIONAL BANK LOANS OUTSTANDING**

*(change in billions of US\$ adjusted for exchange rate changes)*

<b>Region/Country</b>	<b>1Q08</b>	<b>2Q08</b>	<b>3Q08</b>	<b>4Q08</b>	<b>1Q09</b>
<b>Developing countries</b>	<b>167.0</b>	<b>101.8</b>	<b>45.4</b>	<b>-202.9</b>	<b>-106.4</b>
Asia	77.8	22.5	-12.9	-134.5	-52.3
China	34.2	13.3	-16.9	-46.8	-11.4
India	14.9	7.9	2.9	-6.7	-3.1
Eastern and Central Europe	59.2	47.6	36.8	-26.9	-28.6
Russia	7.3	10.5	13.1	-21.3	-11.6
Latin America	12.0	26.4	11.6	-27.3	-15.9
Brazil	3.6	15.0	1.2	-12.7	-10.3
Africa and Middle East	18.0	5.3	9.9	-14.2	-9.7
Egypt	1.5	-0.7	0.5	-0.6	0.2
South Africa	-0.5	-1.8	1.0	0.6	-1.3

Source: Calculated by the author, on the basis of data from the Bank for International Settlements.



The observed six-month drop in net cross-border bank lending (see table 2) was the first such drop recorded since the late 1990s, in the wake of the Asian and Russian financial crises, and since 2001-02, in the wake of the September 11 terrorist attacks on the United States – and the one that took place during the “sudden stop” episode of September 2008-March 2009 was incomparably larger.

The disruption in capital flows to developing countries can also be measured by comparing the issuance of new international debt securities (money market instruments plus notes and bonds) to amortizations and redemptions of said securities falling due. During the period October 2008-March 2009, new issuance was so limited relative to repayments such that corporations and governments in developing countries paid out almost US\$ 24 billion, while during the first half of 2008 new issuance on their part had exceeded redemptions by nearly US\$ 22 billion (see table 3). No reversal like this had occurred since 4Q98, when the international debt markets virtually shut down in the aftermath of Russia’s devaluation and default.

**TABLE 3**  
**NET ISSUANCE OF INTERNATIONAL DEBT SECURITIES**  
*(billions of US\$)*

<b>Region/Country</b>	<b>1Q08</b>	<b>2Q08</b>	<b>3Q08</b>	<b>4Q08</b>	<b>1Q09</b>
<b>Developing countries</b>	<b>-1.33</b>	<b>23.23</b>	<b>5.59</b>	<b>-27.33</b>	<b>3.57</b>
Asia	4.50	3.05	0.42	-10.19	3.85
China	1.13	0.00	2.31	-1.53	-0.03
India	0.31	0.16	-0.10	0.62	-0.69
Eastern and Central Europe	-1.66	13.26	7.54	-2.00	0.05
Russia	-0.62	2.48	5.03	-0.22	-1.52
Latin America	-4.96	0.53	-3.47	-11.00	0.47
Brazil	1.63	-1.59	-2.00	-2.09	0.85
Africa and Middle East	0.80	6.40	1.09	-4.15	-0.79
Egypt	0.00	0.07	0.00	0.00	0.00
South Africa	-0.03	-0.57	-0.75	-0.04	-0.05

Source: Calculated by the author, on the basis of data from the Bank for International Settlements.

A recent attempt to quantify the intensity of the financial stress generated by this episode and its impact on emerging and developing economies, using a new index that captures a variety of financial market indicators, concludes that said financial stress was exceptionally high and surpassed the peaks seen during the 1997-98 Asian crisis (Balakrishnan and others, 2009). The crisis of late 2008-early 2009 affected all segments of the financial markets, in all major regions, and it showed unusual persistence. An indicator of banking stress reached levels previously seen only during the peak of U.S. banking woes in the early 1980s – but at that time the securities markets remained orderly, at least, whereas on this occasion they too suffered major dislocations. The presence of common factors in the transmission of financial stress is apparent from the co-movement of the indices for emerging and advanced economies, suggesting the presence of herding and contagion channels of transmission. However, individual country experiences were far from uniform, meaning that country-specific factors also influenced the transmission pattern. Differences among emerging economies in the degree of stress

transmission appear to be associated with the strength of financial linkages, generally measured by the stock of foreign liabilities. The extent of borrowing from foreign banks appears to have been an especially significant issue in the current crisis, illustrated by the fact that the most virulent responses to the crisis were initially experienced in Eastern and Central Europe, which has strong bank lending linkages to western European banks that were hit exceptionally hard by interbank funding problems and losses on securities.

## **B. Impact on Latin America**

The recessionary and sudden-stop forces unleashed in mid-September 2008 impacted Latin America in subsequent weeks and months via a collapse in foreign demand for the region's exports, a dive in regional export prices, a reduction in workers' remittances sent from the United States and elsewhere, a drop in foreign tourist arrivals, a disruption of external finance supporting foreign trade and domestic activities, and a wave of risk aversion that prompted panic selling of the region's stocks, bonds and currencies.

Relative to other regions, however, Latin America was not uniformly hit the hardest blows. For example, while Latin America's seasonally adjusted export earnings dropped a whopping 22% in 1Q09 relative to 2Q08, that was much less than the nearly 40% export collapse sustained by Eastern and Central Europe (see table 4). The observed drop in cross-border bank lending to Latin America during 4Q08-1Q09 was on the order of 13% (relative to loans outstanding as of mid-2008), yet developing countries in Asia endured a crippling loss of one-fourth of their external bank loan financing. However, Latin America was impacted very hard in terms of loss of access to the international capital markets. The placement of new equity issues by Latin American companies during October 2008-March 2009 (US\$ 1.2 billion) was a mere one-tenth of what they had successfully raised during January-June 2008 (US\$ 12.5 billion), while on average the placement rate for companies throughout the developing world was one-fourth of what they had obtained in the first six months of 2008. And the paucity of new international bond issuance on the part of Latin American borrowers during the sudden stop meant that US\$ 10.5 billion in net repayments had to be made abroad during 4Q08-1Q09, a figure equivalent to 3.3% of total international debt securities outstanding as of mid-2008. In contrast, net repayments by bond issuers from Asia, Africa and the Middle East, and Eastern and Central Europe totaled US\$ 6.4 billion, US\$ 4.9 billion and a mere US\$ 2 billion, respectively.

**TABLE 4**  
**REGIONAL IMPACT OF RECESSIONARY AND SUDDEN-STOP FORCES**  
*(Percent drop in)*

	Export earnings <sup>a</sup>	International bank loans outstanding <sup>b</sup>	Net issuance of international debt securities <sup>b</sup>
<b>Developing countries</b>	<b>-25.3</b>	<b>-14.0</b>	<b>-2.5</b>
Africa and Middle East	N/A	-5.3	-3.9
Developing Asia	-26.0	-25.9	-2.3
Eastern and Central Europe	-39.0	-7.8	-0.8
Latin America	-22.1	-13.3	-3.3

Source: Calculated by the author, on the basis of data from the World Bank and the Bank for International Settlements.

<sup>a</sup> Seasonally adjusted 1Q09 relative to 2Q08 export earnings. <sup>b</sup> Change during October 2008-March 2009 relative to mid-2008 stock of loans or securities.

The overall cost of the economic downturn and financial turmoil of 2008-09 cannot be calculated as of yet, of course, but one way of quantifying it is by the magnitude of the observed and anticipated deceleration in GDP growth during 2008-09. On the basis of the latest (July 2008) estimates and forecasts by the International Monetary Fund, the world economy is thought to be in the midst of a cumulative GDP growth deceleration worth about 6.5 percentage points, affecting industrialized and developing economies roughly to the same extent (see table 5). Within the developing world, however, there are significantly different impacts. Russia and the former members of the Soviet Union, and to a lesser extent the countries of Eastern and Central Europe, are estimated to be by far the most seriously affected, with a two-year GDP growth deceleration of 14.4 and 10.4 percentage points, respectively. The Baltic countries, in particular, have been ravaged. On the other hand, developing countries in Africa, the Middle East and throughout Asia (excluding Hong Kong, South Korea, Singapore and Taiwan) are estimated to be relatively least affected, with two-year GDP growth decelerations on the order of 4-5 percentage points.

**TABLE 5**  
**REGIONAL GDP GROWTH DECELERATION**  
(percentage)

	2007	2008	2009F	Cumulative deceleration <sup>a</sup>
<b>World</b>	<b>5.1</b>	<b>3.1</b>	<b>-1.4</b>	<b>-6.5</b>
Advanced economies <sup>b</sup>	2.7	0.8	-3.8	-6.5
<b>Developing economies</b>	<b>8.3</b>	<b>6.0</b>	<b>1.5</b>	<b>-6.8</b>
Commonwealth of Independent States	8.6	5.5	-5.8	-14.4
Central & Eastern Europe	5.4	3.0	-5.0	-10.4
Latin America	5.7	4.2	-2.6	-8.3
Developing Asia	10.6	7.6	5.5	-5.1
Africa	6.2	5.2	1.8	-4.4
Middle East	6.3	5.2	2.0	-4.3

Source: Calculated by the author, on the basis of data from the International Monetary Fund.

<sup>a</sup> Difference in the 2008/07 GDP growth rate plus difference between the 2009F/2008 GDP growth rate. <sup>b</sup> Includes newly industrialized Asian economies.

Latin America is estimated to fall somewhere in the middle, with real GDP growth slowing by around 8 percentage points, from positive growth of under 6% in 2007 to negative GDP growth of about 2.5% in 2009. Should the IMF's economic forecasts prove to be fairly accurate, 2008-09 will thus mark the first time in decades that a sharp economic slowdown and major financial disturbance emanating in the industrialized world, in fact, has not hit Latin America the hardest. In the early 1980s, for instance, when highly restrictive monetary policies slowed GDP growth down in the industrialized countries to a 1980-82 annual average of 1%, Latin America was the only region in the developing world that registered a major financial crisis and a severe economic contraction lasting two years (1982-83). In addition, when the industrialized countries decelerated from a pace of 4% GDP growth in 2000 to a mere 1.4% annual average growth rate in 2001-02, in the wake of the September 11 terrorist attacks, Latin America slowed down more than any other developing region, from real GDP growth in excess of 4% in 2000 to an anemic 0.6% yearly growth average in 2001-02. The countries of Eastern and Central Europe and the former Soviet Union, on the other hand, are being affected nowadays as severely as if they had acquired the economic and financial vulnerabilities that Latin America used to exhibit in decades past – a novel proposition which we explore in the next section.

Regional averages do not convey much information about the range of individual cases, of course, and thus it is worth highlighting the impact of the recession and sudden stop of 2008-09 in specific Latin American countries. On the basis of the latest (July 2008) estimates and forecasts by ECLAC, which differ slightly from the estimates and forecasts published by the International Monetary Fund, it is evident that Mexico and several of the countries in Central America are likely to be affected the most. These economies are projected to register a two-year growth deceleration of about 9-10%, largely because they are more inextricably linked to the United States than others – through trade (in Mexico's case, especially via the highly integrated but ailing North American automobile industry), workers' remittances (Mexico normally receives about 40% of the region's inward remittances), and earnings from U.S. and other tourists. On the

other hand, most of the countries in southern South America (e.g. Bolivia, Brazil, Chile and Uruguay) are thought to be affected the least, and are projected to record a two-year growth deceleration on the order of 2-6%. Brazil may well do better than anticipated by ECLAC, because the latest economic indicators published in that country have been coming out stronger than expected, such that private-sector forecasts have become rosier and the consensus view is now that the economy is more likely to register zero growth rather than a contraction in 2009.

**TABLE 6**  
**LATIN AMERICA'S GDP GROWTH DECELERATION**  
(percentage)

	2007	2008	2009F	Cumulative deceleration <sup>a</sup>
<b>Latin America</b>	<b>5.8</b>	<b>4.2</b>	<b>-1.9</b>	<b>-7.7</b>
Mexico	3.3	1.3	-7.0	-10.3
Costa Rica	6.8	2.9	-3.0	-9.8
Honduras	6.3	4.0	-2.5	-8.8
Panama	11.2	9.2	2.5	-8.7
Paraguay	5.5	5.8	-3.0	-8.5
Venezuela	8.4	4.8	0.3	-8.1
Dominican Republic	8.5	5.3	1.0	-7.5
Argentina	8.7	7.0	1.5	-7.2
Peru	9.0	9.8	2.0	-7.0
Colombia	7.5	2.6	0.6	-6.9
El Salvador	4.7	2.5	-2.0	-6.7
Guatemala	5.7	4.0	-1.0	-6.7
Uruguay	7.4	8.9	1.0	-6.4
Brazil	5.4	5.1	-0.8	-6.2
Chile	5.1	3.2	-1.0	-6.1
Cuba	7.0	4.3	1.0	-6.0
Nicaragua	3.0	3.2	-1.0	-4.0
Bolivia	4.6	6.1	2.5	-2.1
Ecuador	2.7	6.5	1.0	-1.7
Haiti	3.2	1.3	2.0	-1.2

Source: Calculated by the author, on the basis of data from ECLAC.

<sup>a</sup> Difference in the 2008/07 GDP growth rate plus difference between the 2009F/2008 GDP growth rate.

As concerns the incidence of adverse shocks due to export collapses and/or reversals in capital flows during the October 2008-March 2009 period, a recent analysis by ECLAC on the basis of deviations from detrended data on exports and capital flows concludes that the former type of shock has been more prevalent than the latter (ECLAC, 2009a, p. 7). Whereas seven out of 14 countries studied experienced an unusually heavy drop in export earnings between 4Q08 and 1Q09 (Argentina, Brazil, Chile, Ecuador, Mexico, Peru and Venezuela), three countries also

experienced heavy reversals in capital flows in 4Q08 (Brazil, Chile and Peru) and a fourth one did so in 1Q09 (Venezuela). Thus, since Brazil, Chile, Peru and Venezuela were hit by both types of exogenous shocks, it is truly noteworthy that none of them experienced a major financial crisis – or even a worse-than-average deceleration in economic growth, for that matter.

## II. The missing financial crisis

The main financial markets in Latin America have rallied very strongly since February, registering double-digit gains in many stocks, bonds, currencies and commodities. In Brazil, for example, by far the region's largest economy and the one with the deepest financial markets, the leading equity market index has jumped by more than 60% since March, recovering all of the ground that the Bovespa had previously given up. The Brazilian Real, which was worth US\$ 0.65 in early August of last year but had sunk to a mere US\$ 0.40 by the beginning of December 2008 –a nearly 40% depreciation versus the U.S. dollar in just four months– has since rebounded strongly and is worth US\$ 0.57 nowadays.<sup>1i</sup> And Brazil's benchmark sovereign bond due in 2040, Latin America's most actively traded international bond, which had turned over in the secondary market for an average price of US\$ 1.32 during August 2008, and had subsequently fallen 15% to trade at an average price of US\$ 1.12 in October, has been priced around US\$ 1.34 since mid-September.

As is the case throughout the leading financial centers in Asia, Europe and North America, domestic and foreign investors in the main Latin American financial markets have been bidding up asset prices because of renewed confidence in the future of corporate earnings, the liquidity and solvency of the largest banks, the fiscal viability of governments, the determination of central banks to be supportive, and the likely recovery of economic activity at home and abroad. In turn, rising asset prices have encouraged a reopening of domestic and international capital markets for new issues of stocks and bonds, as well as for large-scale transactions like mergers, acquisitions and restructurings.

The optimism that has been expressed in the financial markets strikes us as particularly justified, considering that for the first time Latin America has endured a major worldwide recession and reversal in capital flows without the usual collateral damage of home-made currency, sovereign debt or banking crises – although the experience has not been painless, given adverse consequences on regional exports, output, employment, incomes and wealth, as acknowledged previously.

What explains Latin America's unprecedented resilience –what we call “the missing financial crisis”– especially in light of Eastern and Central Europe's financial vulnerabilities now laid bare for all to see?

Here we review the enormous progress made by many governments in Latin America in the past decade to reduce currency mismatches, allow for more flexible exchange-rate regimes, enhance the capitalization, funding and supervision of their banking systems, encourage the development of local capital markets, and implement sounder and more credible monetary and fiscal policies. As we will illustrate, these are achievements that were not witnessed in the many countries in Eastern and Central Europe now reeling from deep recessions and domestic

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<sup>1</sup> As conventionally expressed in the currency market, the BRL/USD exchange rate went from 1.55 in early August 2008 to 2.50 in early December 2008. The currency was quoted at around 2.40 in early March 2009 and it has appreciated since then to about 1.74 BRL/USD.

financial instability. On the contrary, in recent years, countries in that part of the world allowed for a dangerous increase in their vulnerability to adverse external shocks – and are now paying the consequences.

## **A. Reduced currency mismatches**

The asset/liability structure of many emerging-market economies has been an important source of vulnerability to financial crises, and there is by now ample evidence that currency and maturity mismatches among banks, corporations and governments have been at the root of many financial crises (Goldstein and Turner, 2004). Currency mismatches, on which we focus here, are said to exist when a change in the exchange rate leads to major capital losses or gains among debtors because of a disparity in the currencies in which assets and liabilities are denominated – a highly problematic situation illustrated by the case of Argentina in 2001-02, when most liabilities were in dollars and most assets in pesos.<sup>2</sup>

There is no single or easy way to quantify the extent of currency mismatches in any one country at any point in time, but a first useful indicator is to estimate as comprehensively as possible the extent to which a country's public-sector and private-sector indebtedness is denominated in currencies other than its own.

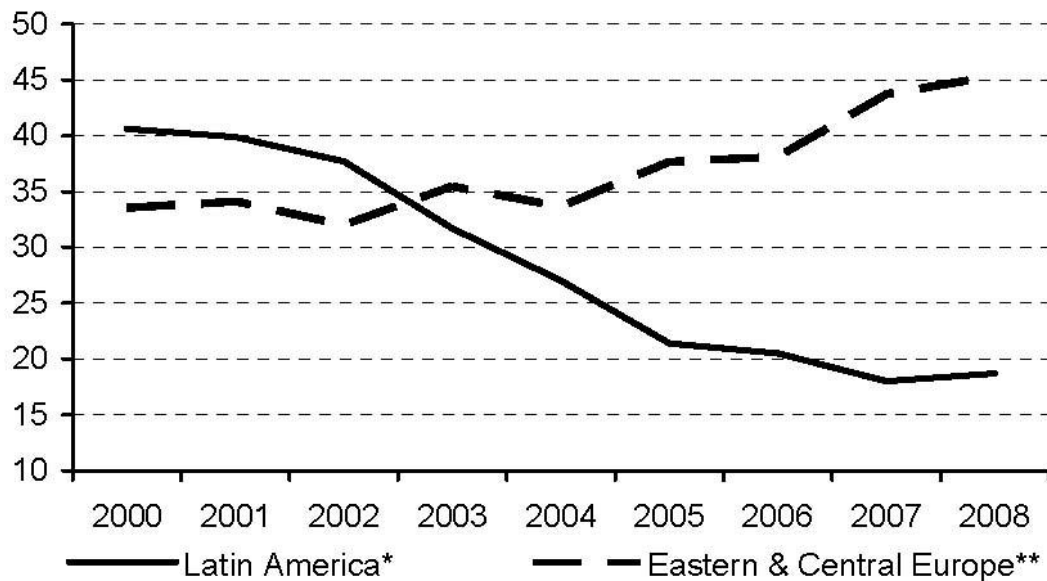
As can be seen in figure 1, a weighted average of what is known about the currency denomination of indebtedness in Latin America's seven largest countries experienced a steady improvement in the past half-dozen years, with the proportion of foreign-currency debt declining from about 40% of total at the beginning of the decade to less than 20% by 2007-08.<sup>3</sup> The reason is that most corporations, banks and governments in Latin America learned their painful lessons from the financial crises of the 1980s and 1990s, and decided to reduce their exposure to currency risks by taking on more debt in local currency, even if this was more costly in the short run, while paying down their liabilities in dollars, euros and yen. The switch in currency denomination was greatly facilitated by the development of local bond markets in many of the countries in Latin America, which was in turn made possible by the partial or complete privatization of pension regimes (Borensztein and others, 2008).

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<sup>2</sup> Maturity mismatches are said to exist when a gap between liabilities due in the short term and liquid assets leaves debtors unable to honor their contractual commitments whenever refinancing becomes very difficult or expensive, a conundrum exemplified by the case of Mexico in 1994-95.

<sup>3</sup> The figures shown are updates of the final column of Table 4.6 in Goldstein and Turner (2004, p. 50) and correspond to the methodology described therein, which involves comparing the value of any one country's international debt securities outstanding in foreign currencies plus non-bank foreign currency cross-border liabilities to BIS-reporting banks, plus foreign currency cross-border liabilities of banks to BIS-reporting banks, plus domestic debt denominated in foreign currencies, to the value of that same country's international debt securities outstanding plus non-bank cross-border liabilities to BIS-reporting banks, plus bank cross-border liabilities to BIS-reporting banks, plus domestic credit of the monetary authorities and deposit money banks. I am grateful to Philip Turner from the Bank for International Settlements for providing me with the requisite information for Latin America and various other regions and countries, out of which I calculated the regional aggregates for Eastern and Central Europe.

**FIGURE 1**  
**FOREIGN CURRENCY INDEBTEDNESS**  
*(percentage of total debt outstanding)*



Source: Calculated by the author, on the basis of data from the Bank for International Settlements.

\* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

\*\* Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania.

In sharp contrast, the weighted average of the currency denomination of indebtedness in eight countries in Eastern and Central Europe experienced a steady deterioration in the past half-dozen years, with the proportion of foreign-currency debt rising from about 34% of total at the beginning of the decade to 45% by 2008. The main reason for this trend was the widespread belief, on the part of individuals, banks, corporations, and governments in these countries, that it was increasingly safe to take on debt in euros (and even in Swiss francs!), at lower interest rates and longer maturities than were available in domestic currency, because sooner or later all of these countries would end up abolishing their own currencies and adopting the euro anyway.

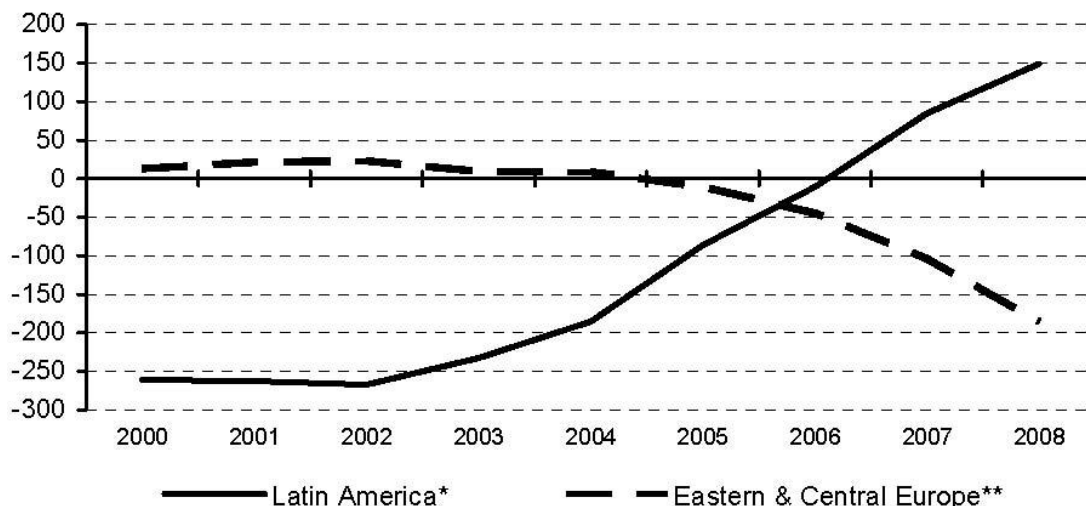
A second useful indicator of currency mismatches is to estimate as comprehensively as possible a country's net foreign-currency asset position (see figure 2).<sup>4</sup> This is important because at the same time that governments, banks and corporations in Latin America were switching away from liabilities denominated in foreign currencies, they were also building up a substantial stock of assets denominated in foreign currencies – for example, in the form of official international reserves. Therefore, whereas at the beginning of this decade Latin America had a

<sup>4</sup> The figures shown are updates of Table 4.3 in Goldstein and Turner (2004, p. 45) and correspond to the methodology described therein, which involves comparing the value of any one country's net foreign assets of the monetary authorities and deposit money banks plus non-bank foreign currency cross-border assets with BIS-reporting banks, minus non-bank foreign currency cross-border liabilities to BIS-reporting banks, and minus international debt securities outstanding in foreign currency. I am grateful to Philip Turner from the Bank for International Settlements for providing me with the requisite information for Latin America and various other regions and countries, out of which I calculated the regional aggregates for Eastern and Central Europe.



negative net foreign-currency asset position in the vicinity of US\$ 260 billion, the region's asset/liability mismatch was successfully eliminated by 2006, and by the end of last year, Latin America in fact had accumulated a positive net foreign asset position of about US\$ 150 billion. This meant that, when most of the region's currencies came under downward pressure in August-September 2008, in the aggregate, the public and private sectors in Latin America experienced a balance sheet windfall – quite a contrast with the enormous balance sheet losses that currency devaluations used to impose on many of the region's banks, corporations and governments in prior decades, helping to trigger widespread liquidity and solvency crises.

**FIGURE 2**  
**NET FOREIGN CURRENCY ASSET POSITION**  
*(billions of US\$)*



Source: Calculated by the author, on the basis of data from the Bank for International Settlements.

\* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. \*\* Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania.

Notwithstanding Latin America's aggregate balance sheet strength, there were about ten leading corporations in Brazil and Mexico that had heavy net foreign currency liability positions as of last August, often in the form of currency options and other derivative contracts that were not revealed in their published balance sheets (Kamil, Sutton and Walker, 2009). Thus, while it is true that during the past decade most publicly listed firms in the region did reduce their vulnerability to exchange rate fluctuations, corporations like Aracruz Celulose and Sadia in Brazil, and Comerci, Gruma and Vitro in Mexico, took large speculative positions in derivatives during 2007-08 with the aim of profiting from what had been a steady trend of local currency appreciation. When the Brazilian Real and the Mexican peso depreciated sharply in August-November of last year, these firms incurred big losses and the central banks in both countries found it necessary to intervene in their foreign exchange markets to supply dollars and help these flagship firms to unwind their currency positions. In recent months, the authorities in Brazil and Mexico have understandably taken steps to improve the transparency and disclosure of corporate exposures to currency options and other derivative instruments.

As concerns the net foreign-currency asset position of countries in Eastern and Central Europe, the best estimates show a steady deterioration in the past several years, from a slightly positive net asset position through 2004 to a negative US\$ 185 billion by the end the year. This

confirms the picture conveyed by the available data on foreign currency indebtedness –namely, that Eastern and Central Europe moved in the opposite direction to Latin America, such that its governments, banks and corporations became vulnerable to currency depreciation– and ever more dependent on uninterrupted financing from abroad.

A third and final indicator of currency mismatches combines the prior two measures of vulnerability –namely, a country’s net foreign currency asset position, which is negative whenever liabilities exceed assets, and the degree to which its cross-border debt is denominated in foreign currencies– and relates them to the country’s capacity to generate foreign currency via export earnings, while making an adjustment for the extent to which domestic bank lending and bond issuance is likewise denominated in foreign currencies and thus generates an additional degree of vulnerability. This calculation allows for time-series and cross-country comparisons because various country-specific amounts measured in billions of dollars are “normalized” (deflated) by export figures which are likewise measured in billions of dollars.<sup>5</sup>

The pattern that emerges is one where the seven main countries in Latin America are shown as diminishing their national currency mismatches and entering, or remaining, in positive territory during the past half-dozen years, while several countries in Eastern and Central Europe which have been hit very hard by recent events –Hungary, Romania and the Baltic nations of Estonia, Latvia and Lithuania– are shown as having increased their financial vulnerability (see table 7).

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<sup>5</sup> The figures shown are updates of Table 4.6 in Goldstein and Turner (2004, p. 50) and correspond to the methodology described therein. I am grateful to Philip Turner from the Bank for International Settlements for providing me with these calculations.

**TABLE 7**  
**NATIONAL CURRENCY MISMATCH**  
*(percentage of exports of goods and services)*

	2003	2004	2005	2006	2007	2008
<b>Latin America</b>						
Argentina	-169.9	-119.9	-33.9	-19.8	-10.0	1.2
Brazil	-29.8	-14.5	-5.9	-2.5	1.8	2.1
Chile	-10.1	-6.0	-3.1	-0.3	-1.3	-2.2
Colombia	-4.6	5.1	3.8	4.8	6.1	7.7
Mexico	-5.0	-2.9	-0.7	0.0	0.8	2.6
Peru	30.7	27.8	22.1	21.5	27.4	30.6
Venezuela	29.1	23.1	18.9	31.1	23.8	22.0
<b>Eastern and Central Europe</b>						
Bulgaria	5.8	6.8	16.5	19.2	14.5	-5.8
Czech Republic	7.4	6.5	7.3	5.6	4.8	3.1
Estonia	-20.6	-17.1	-14.6	-27.0	-40.6	-37.6
Hungary	-12.0	-13.5	-18.1	-21.4	-24.9	-31.6
Latvia	-6.9	-19.0	-36.5	-66.4	-104.6	-114.5
Lithuania	-4.1	-9.4	-17.2	-30.2	-48.1	-51.1
Poland	3.8	4.0	0.3	-2.2	-5.3	-9.8
Romania	-14.7	-12.2	-12.1	-15.6	-30.8	-30.9

Source: Calculated by the author, on the basis of data from the Bank of International Settlements.

Considering the extent of their national currency mismatches, it is probably no coincidence that Hungary, Latvia and Romania have all faced serious financial crises that have compelled them to obtain extraordinary financial support from the IMF, the European Union and other multilateral agencies; that Estonia and Lithuania are also having to overcome grave financial crises and are being supported by the Swedish government and central bank (via their bailouts of major Swedish banks operating in the Baltic countries); and that all of these countries have been experiencing severe recessions, with Latvia and Lithuania exhibiting the most extreme contractions, having recently reported real GDP collapses on the order of 20% in 2Q09 on a year-on-year basis.

In contrast, not a single one of the seven Latin American countries listed in figure 9 have faced a financial crisis or needed any balance-of-payments support from the IMF or other multilateral organizations. While Colombia and Mexico, together with Poland, have signed up for precautionary IMF support under the newly created Flexible Credit Line (FCL) facility, they have not needed to draw down any IMF funds.

## B. Exchange-rate flexibility

Economic theory has long recognized that external shocks, whether involving sudden increases or decreases in trade or capital flows, will result in a change in the equilibrium real exchange rate. If a country's nominal exchange rate is fixed by government fiat, then adjustment in the balance of payments and equilibrium in the foreign exchange market will have to take place through changes in domestic nominal prices (like wages, profits and rents) and in domestic demand (like consumption and investment spending). This adjustment process is likely to be slower and more costly (in terms of forgone output and employment), especially given rigidities in the labor, property and other markets, than when the exchange rate is allowed to fluctuate in reflection of the exogenous shock – because in this latter case consumers, producers, investors, and other economic agents will be encouraged by the rise or fall in the price of foreign exchange to change their behavior promptly in a manner consistent with the economic adjustment that circumstances warrant.<sup>6</sup>

Empirical research has been able to confirm this theoretical insight: exogenous shocks do get amplified in countries that have more rigid exchange rate regimes; the cost of a negative exogenous shock in terms of lost GDP is larger than the benefit of a positive exogenous shocks; and after controlling for other factors, countries with more flexible exchange rate regimes tend to grow faster than countries with fixed exchange rates (Edwards and Levy-Yeyati, 2005). Moreover, recent empirical research has also confirmed that the adoption of more flexible (and thus unpredictable) exchange-rate regimes has the added advantage that it tends to discourage corporations from running potentially damaging currency mismatches (Kamil, 2009).

In the past dozen years, starting with Mexico after its 1994-95 financial crisis, more and more countries in Latin America have shifted from rigid to flexible exchange rate regimes, and from monetary policies focused on exchange rate targets to monetary policies anchored on inflation targeting. Thus, by the time recessionary and sudden-stop forces hit the region with full force starting in mid-September of last year, most central banks were ready and willing to let their exchange rates depreciate and serve as natural shock absorbers. As conventionally measured, for example, the local currency price of U.S. dollars was allowed to increase by as much as 50% in Brazil, Chile, Colombia and Mexico during the year from March 2008 to March 2009, and by nearly 20% in Argentina and Peru. Among the region's major countries, Venezuela is the only one that did not allow its official exchange rate to move in reflection of the new market realities, and thus balance-of-payments adjustment there took place mostly through the massive loss of official international reserves –they dropped by nearly half from peak (September 2008) to trough (March 2009)– and via a parallel, virtually underground market for dollars where the price of hard currencies skyrocketed. In Ecuador, meanwhile, a country with no exchange rate flexibility because it is legally dollarized, official international reserves collapsed by 70% from peak (September 2008) to trough (May 2009).

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<sup>6</sup> For example, a sudden drop in export earnings or in capital inflows will lead to currency depreciation, encouraging consumers to import less and producers to export more, thereby hastening an adjustment in the balance of payments. When exchange rates are not allowed to move, this kind of exogenous shock will require the central bank to support the existing exchange rate by selling foreign currencies out of its international reserves in exchange for domestic currency, which leads to a contraction in the domestic money supply and thus to a drop in aggregate demand – which leads eventually to lower imports and higher exports.

**TABLE 8**  
**NATURE OF EXCHANGE-RATE REGIME**

	Flexible	Intermediate	Inflexible
<b>Latin America</b>	<b>5</b>	<b>1</b>	<b>1</b>
Argentina	X		
Brazil	X		
Chile	X		
Colombia	X		
Mexico	X		
Peru		X	
Venezuela			X
<b>Eastern and Central Europe</b>	<b>1</b>	<b>3</b>	<b>4</b>
Bulgaria			X
Czech Republic		X	
Estonia			X
Hungary		X	
Latvia			X
Lithuania			X
Poland	X		
Romania		X	

Source: Calculated by the author, on the basis of data from Levy-Yeyati and Sturzenegger, 2005.

In contrast, exchange rates for the most part played much less of an adjustment role in Eastern and Central Europe, where countries traditionally allow for little flexibility relative to the euro, which is their reference currency (see table 8). This reluctance also helps to explain why this region has been hit so much harder by recessionary and sudden-stop forces coming from Western Europe. From June 2008 through February 2009, a period during which the euro itself depreciated by about 25% against the dollar, Poland and Hungary allowed their currencies to depreciate by about 70% and 55% versus the U.S. dollar, respectively, and the Czech Republic and Romania by some 45%, but Bulgaria and the Baltic countries, formally pegged to the euro, did not permit their exchange rates to move (except indirectly against the dollar because of the euro's own depreciation). Their authorities have been understandably concerned about the destructive impact that a major currency devaluation versus the euro would have on their own banks, corporations and the government itself given the magnitude of currency mismatches – the same reluctance to devalue against the dollar that most Latin American governments used to exhibit in decades past.

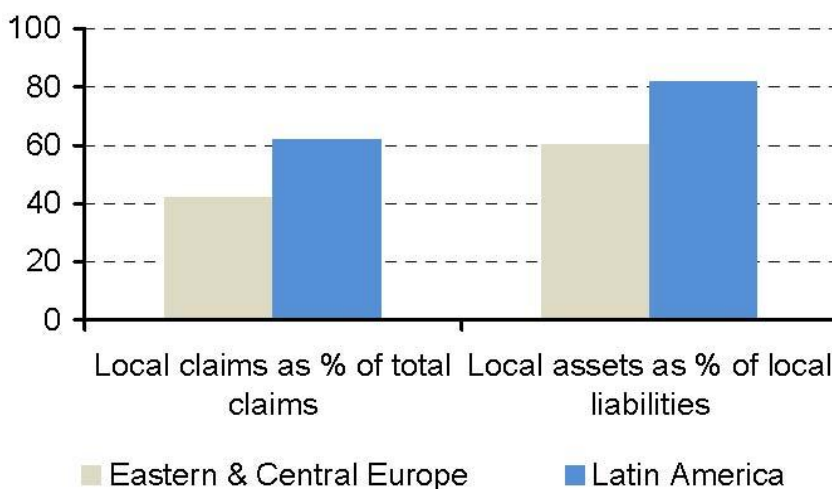
### **C. Resilience of the banking system**

The past decade has witnessed a strengthening of banking systems and a deepening of financial intermediation in nearly all emerging and developing countries. Mindful of the lessons from prior banking crises, most governments have taken steps to raise bank capital requirements, enhance regulatory standards, tighten controls over offshore operations, introduce

deposit-insurance schemes, improve accounting and disclosure norms, and open up the banking industry to foreign ownership. On the back of growing cross-border lending activity, in fact, international banks now play an increasingly important –in some countries, even dominant– role in the domestic financing structure. They provide the primary gateway through which corporations, local banks, and governments transfer funds abroad, borrow for the short and medium term, raise funds for companies through the equity and fixed-income markets, advise on transactions like mergers and acquisitions, and conduct foreign exchange and derivatives operations (World Bank, 2008, Chapter 3). Foreign-owned banks account for a particularly high proportion of local banking assets in Eastern and Central Europe as well as in Sub-Saharan Africa (50-60% of total domestic banking assets, on average), and for about 40% of total in Latin America, though the market share of international banks ranges from as high as 80% in Mexico to as low as 20% in Brazil and Colombia.

One important difference between Latin America and Eastern and Central Europe is that while in the former region foreign-owned banks have backed their local lending mostly with domestic retail funding, in the latter region local lending has been sourced mostly through cross-border, wholesale funding. In Latin America, in short, banking activities have been carried out for the most part by affiliates of multinational banks that operate much like their domestic counterparts – with the exception that they have deeper (and obviously foreign) capital pockets. In Eastern and Central Europe, on the other hand, many foreign-owned banks are largely vehicles through which international funds are loaned out domestically. This difference is of course consistent with the observations made earlier about the greater prevalence of currency mismatches in Eastern and Central Europe. Moreover, domestic lending that is underwritten by cross-border wholesale funding is much more prone to suffer from a “sudden stop” in capital flows than is domestic lending backed by relatively stable local deposits – thus the greater banking-system stability observed in Latin America.

**FIGURE 3**  
**DOMESTIC ROLE OF INTERNATIONAL BANKS**  
*(as of mid-2008)*



Source: Calculated by the author, on the basis of data from the Bank for International Settlements.

An illustration of the aforementioned regional differences is provided by two statistics: the extent to which the local claims of BIS-reporting international banks exceed (or not) their cross-border claims, and the degree to which the local assets (like loans) of said international banks are backed by local liabilities (like deposits). As can be seen in figure 3, as of mid-2008, the local claims of international banks in Latin America represented more than 60% of their total claims, and more than 80% of said claims were underwritten by local liabilities, whereas the comparable figures for international banks active in Eastern and Central Europe were closer to 40% and 60%, respectively.<sup>7</sup> Another related measure is the percentage of loans made by the local affiliates of foreign-owned banks that are backed by deposits: as of end-2007, the average for seven countries in Latin America was 105%, whereas the average for seven countries in Eastern Europe was only 75%. Yet another measure speaks to the degree of reliance on wholesale funding and parent-bank financing: in 2008, the size of inter-bank, cross-border lending to seven Latin American countries was equivalent to less than 10% of their GDP, while the equivalent figure for seven countries in Eastern Europe was around 30% (Kamil and Rai, 2009).

There are other good reasons why banks in Latin America have been able to withstand the recent external shocks without losing the confidence of their depositors, without reporting any major deterioration in their balance sheets, and without having to be rescued by their governments. Whether foreign- or domestically-owned, Latin American banks tend to meet high liquidity standards, with liquid assets exceeding 35% of total assets, and they usually maintain relatively deep capital cushions (e.g. BIS capital ratios averaging about 14%), which should allow them to keep managing with relative ease an increase in non-performing loans during the ongoing regional economic downturn (Moody's Investors Service, 2009). Moreover, the international commercial banks which loom large throughout Latin America, such as Britain's HSBC and Spain's BBVA and Santander, were relatively unscathed by losses in their securities and mortgage portfolios, and were not greatly exposed in Eastern and Central Europe – and have in fact reported healthy quarterly profits as of late. In short, they have helped to anchor confidence and to maintain financial stability in Latin America.

The credit rating agencies have also noted the difference between the quality of banks in Latin America and in Eastern and Central Europe. For example, Fitch Ratings recently tallied its credit-rating actions and opinions, and reported that while 18 banks in Eastern and Central Europe were downgraded during 2Q09, largely because of the underlying weakness of their European parent banks, no banks in Latin America had been downgraded during 2Q09. With regard to its credit opinions, as of end-June the majority of bank ratings in Emerging Europe (54% of total) had been assigned a Negative Outlook by Fitch, whereas the equivalent proportion in Latin America stood at 23% – with no Positive Outlooks awarded in Eastern Europe and a few assigned in Latin America. The Negative Outlooks apply mostly to banks in Russia and the Ukraine, and in Latin America mostly to banks in Mexico and Venezuela (Fitch Ratings, 2009a).

#### **D. Development of local capital markets**

Domestic bond markets were slow to sprout in Latin America, because of the decades-long track record of macroeconomic instability, the absence of a diversified investor base with a long planning horizon, the lack of transparency and accountability on the part of private and government issuers, a high degree of judicial uncertainty and, in many cases, a lamentable

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<sup>7</sup> These percentages were calculated from the consolidated cross-border claims of BIS-reporting banks in all currencies plus their local claims in non-local currencies, and from the local currency positions of reporting banks' foreign offices with local residents, namely, from Table 9A in the December 2008 edition of the BIS Quarterly Review.

history of payments arrears and outright defaults on the part of some governments.

In the past half-dozen years, however, domestic bond markets finally took off in the region's larger countries, since economic and political stability became the rule rather than the exception, and private pension and mutual funds began to manage substantial assets with a long-term investment mandate. These markets now constitute a growing source of financing for Latin American governments and first-tier local corporations, as well as a valid option for domestic and international investors. While there are currently no actively traded derivatives contracts on government bond benchmarks in the region, trading in short-term interest rate and swap contracts is developing rapidly in the major countries. In addition, asset-backed securities have arrived, particularly in Mexico and Brazil following new creditor-friendly legislation on collateral and improved bankruptcy procedures, offering a lower-cost source of long-term funding to banks and corporations while enhancing the liquidity of domestic residential mortgages and consumer loans.

The existence of a domestic source of nonbank financing has encouraged a shift in reliance from external to domestic debt, helping to reduce the risks resulting from earlier currency mismatches, because an increasing proportion of these local bonds are neither indexed to inflation nor to the exchange rate – never mind being denominated in U.S. dollars. Decreasing dependence on external markets is evidenced by the substantial increase in the stock of government domestic bonds, which almost tripled from the local-currency equivalent of US\$ 320 billion in 2002 to more than US\$ 800 billion by the end of last year. Domestic debt placements have contributed to lower balance-sheet vulnerability to exchange rate fluctuations as the share of foreign currency denominated government debt has declined in Brazil from 35% in 2002 to under 10% in 2008, from 40% to less than 20% in Mexico, from 50% in Colombia to less than 35%, and from more than 90% to under 70% in Peru (Moody's Investors Service, 2009). A less dramatic but nonetheless constructive switch has taken place among top-tier Latin American corporations, many of which have spread their wings and have become multinationals with access to several forms of funding abroad as well as in their home market.

There is little doubt that the fledgling domestic capital markets in Latin America have made a contribution to softening the blow delivered by the sudden stop in capital flows during 4Q08 and 1Q09, complementing the support provided to corporations and governments by the region's stable commercial banks. These local financial markets provided relief in the form of liquidity to meet short-term debt rollovers and current maturities nearly everywhere, but the success with which they were able to fill the cross-border financing void varied substantially throughout the region (Fitch Ratings, 2009c). Corporations in Chile and Colombia were largely able to meet their financing needs at home because borrower and investor confidence was supported by those governments' adequate response to the international crisis. Even multilateral agencies such as the Andean Finance Corporation (better known as CAF) and the Central American Bank for Economic Integration (BCIE) funded themselves in the Colombian capital market with great success.

Investors in Mexico and Brazil, on the other hand, experienced a loss in confidence and were reluctant to step forward and buy the obligations of many local firms, given the bankruptcy or near collapse of some of their large and respected companies which, as mentioned previously, shook investor confidence by disclosing huge losses related to currency bets gone wrong. As a result, many corporations in these countries had to seek and managed to obtain significant government support to stay afloat, e.g., through special lines of credit and priority access to foreign exchange. Companies in Argentina, for their part, faced serious financing constraints because of the government's decision of late 2008 to emasculate the local capital market by nationalizing the country's private pension regime.

As is usually the case in the midst of an uncertain world situation that prompts a "flight to quality" among lenders and investors, the weakest corporate credits have faced the most difficult



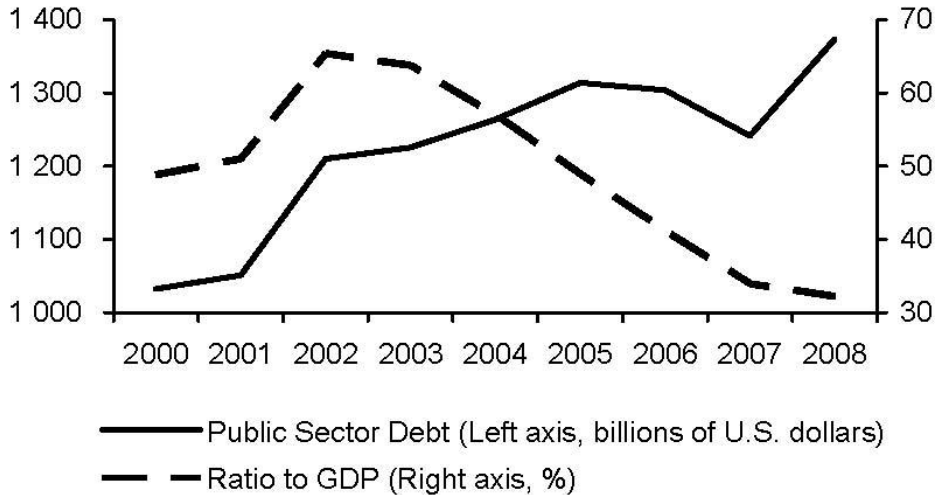
liquidity dilemmas. A recent report by Fitch Ratings of 42 Latin American corporations rated ‘B+’ or lower finds that 19 of them have liquidity positions classified as either “Below Average” or “Poor” – a sharp increase from one year ago, when only six companies were deemed to be in a similarly fragile situation. Of those companies, three defaulted during the second half of 2008. Similarly, Fitch has categorized the cash flow trend of 26 of the 42 companies to be either “Below Average” or “Poor,” an increase from the eight companies that shared this designation a year ago, four of which have now defaulted on their financial obligations (Fitch Ratings, 2009b).

In sum, the development of local capital markets in Latin America has helped governments and many top-tier companies to better endure the economic contraction and sudden stop of late 2008-early 2009, but it has not provided sufficient shelter to most private companies in most of the countries. In the absence of these local capital markets, however, the region’s financial vulnerabilities would have been greater and corporate financing woes would surely have been more critical, with adverse macroeconomic and macrofinancial repercussions of the type seen in decades past.

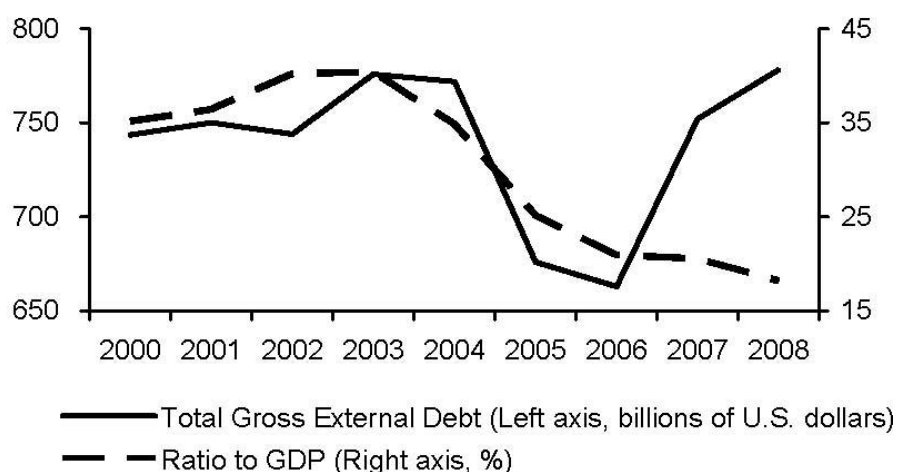
**E. Supportive fiscal and monetary policies**

In decades past, fiscal and monetary policies in Latin America tended to be strongly procyclical, namely, expansionary during economic booms and contractionary during economic downturns, thereby adding to the region’s damaging macroeconomic and macrofinancial volatility. During happy times, government revenues would swell and fiscal spending would expand accordingly, with bank credit flowing freely and currencies becoming overvalued. During times of economic stress, whether home-grown or imported (as during a drop in commodity prices or a sudden stop of capital inflows), governments did not have the requisite solvency and credibility to issue debt and run countercyclical budget deficits. Central banks, for their part, could not loosen monetary conditions during a downturn without undermining their exchange rate objectives or running out of foreign exchange reserves. Therefore, fiscal austerity measures and restrictive monetary policies were the norm during an economic bust – making matters worse, of course.

**FIGURE 4  
PUBLIC DEBT IN LATIN AMERICA & THE CARIBBEAN**



**FIGURE 5  
EXTERNAL DEBT IN LATIN AMERICA & THE CARIBBEAN**



Source: Calculated by the author, on the basis of data from ECLAC.

This time the policy stance has been very different in Latin America. The fact that many governments increased their indebtedness in recent years but not as fast as their revenues and GDP, and that as pointed out previously many were also able to switch from debts denominated in foreign currencies to obligations in their local currency, meant that they now had some degrees of freedom to engage in deficit spending (see figures 4 and 5).<sup>8</sup> Some 18 governments have put in place fiscal stimulus packages involving mainly additional housing and infrastructure outlays, cash transfers to the poor or unemployed, cuts in personal or corporate income taxes, and loans and guarantees as Brazil, for example, has done through its state-owned development bank (ECLAC, 2009a). And yet, the cost of the policy measures likely to be implemented appears relatively modest, in large measure because there has been no need to bail out bank depositors and other creditors – bailouts which in past financial crises have entailed huge commitments of public funds, as we are witnessing at present also in Europe and the United States. The spending involved is being comfortably financed by loans from multilateral agencies, draw-downs from accumulated fiscal savings, and from borrowing in the domestic or international capital markets.

Monetary policies in Latin America have also been uncharacteristically supportive this time around. All of the central banks formally committed to inflation targeting (Brazil, Chile, Colombia, Mexico and Peru), freed from the need to defend a particular exchange rate or currency band, have been able to loosen monetary conditions, announcing a series of cuts in overnight interest rates that have taken them to very low levels. Other central banks, including those like Venezuela's who are still wedded to a fixed exchange rate, and still others who pursue other kinds of exchange-rate targets, have also announced expansionary measures including

<sup>8</sup> It is thus not accurate to say that "the countries of Latin America generally paid down their debt over the last decade. This was especially true of the public sector and left the region in a better position than in previous crises, since there was less of a need to resort to the markets to roll over external obligations" (ECLAC, 2009a, p. 25). Since the region's public debt has increased in absolute terms from the equivalent of about US\$ 1 trillion in 2000 to US\$ 1.4 trillion by end-2008, and the external indebtedness of the public and private sectors has fluctuated but has also ended up higher than in 2005-06 at an estimated US\$ 775 billion as of end-2008, there is from this year on more rather than less of a need to refinance maturities coming due – especially domestically, but also abroad.

temporary lending facilities in local or foreign currency, even though that has meant having to draw down from their official international reserves. (These temporary facilities were also put in place by several of the inflation-targeting central banks.) Very few monetary authorities, such as Jamaica's, have had to adopt the restrictive monetary stance typical of the past, but that is because of a refusal to allow currencies to depreciate – despite lacking the necessary hoard of foreign exchange to defend their chosen parities or currency bands. And, as mentioned, the authorities in Brazil and Mexico took extraordinary steps to help certain flagship corporations that had gotten themselves in trouble from speculating in the foreign exchange market.

It is interesting to note that these countercyclical fiscal and monetary policies have not undermined the confidence of investors in the stocks, bonds or currencies of the many countries involved, and they have not led to downgrades of the governments on the part of the leading credit rating agencies. Moody's Investors Service, for example, actually upgraded the sovereign ratings of Belize, Chile and Uruguay earlier this year, and the company's only recent (and understandable) sovereign downgrade was that of Jamaica. It recently affirmed Mexico's sovereign ratings with a stable outlook, easing investor fears that the country's relatively severe recession and the weakening of its fiscal accounts would lead to a downgrade. Standard & Poor's has cut the ratings of Argentina, Ecuador, Jamaica and the Dominican Republic, and Fitch Ratings has also downgraded the first three plus El Salvador and Venezuela, but mainly because of their questionable macroeconomic and/or debt-servicing policies even ahead of the current world financial crisis, and not because of their countercyclical policies, if any.

The picture is a very different one in Eastern and Central Europe. Most of the countries there have had to adopt austere fiscal and monetary policies, often under the tutelage of the IMF, in order to protect their exchange rates, international reserves, and credit ratings. Only Russia and Kazakhstan, which had set aside "rainy day" funds now being drawn down, are able to implement some countercyclical fiscal measures and to support their banking systems. Most of the rest have been forced to implement austerity measures, which are exacerbating recessions and adding to social and political unrest. Governments in all three Baltic countries and in Hungary have fallen this year, in part because of the unpopularity of budget cuts and the difficult economic situation. Notwithstanding austerity measures and IMF, EU and other official financial assistance, all sovereigns in that part of the world have been downgraded by one or more of the major credit rating agencies. For example, since the bankruptcy of Lehman Brothers, Fitch has downgraded the ratings of 19 countries, 11 of which have been in Eastern, Central or Western Europe (Ireland and Iceland). Lithuania, Estonia, Latvia, Romania and Ukraine (as well as Iceland) have been subject to multiple downgrades. The majority of Fitch's ratings of sovereigns in Eastern and Central Europe remain on Negative Outlook, namely, potentially subject to further downgrades. Moody's and Standard & Poor's have reacted in a similar manner, although they have disagreed sometimes, like on Russia, downgraded by Fitch and S&P but not by Moody's, and on Latvia, lowered by S&P to BB, two notches below investment grade (from BBB+, or two notches above investment grade, a year ago) but not by Moody's. Romania was also cut to "junk" status by S&P earlier this year, though not so by Moody's.

## **F. Conclusion**

In sum, this may well be the first time since Latin America gained its independence in the early 1800s that a major economic contraction and financial calamity in the industrialized world has not caused a wave of currency, sovereign debt or banking crises in the region. Latin America's unprecedented resilience in contrast with, for example, Eastern Europe's now-evident financial vulnerability is explained by the enormous progress made by many governments in Latin America in the past decade to reduce currency mismatches, allow for more flexible exchange-rate regimes, enhance the capitalization, funding and supervision of their banking

systems, encourage the development of local capital markets, and implement sounder and more credible monetary and fiscal policies. It is not necessary to wait for an improved international financial architecture in order for reform-minded, well-managed countries to reap the most benefits from, and minimize the deleterious impact of market cycles typical of, financial globalization.

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