

Policy Trade-Offs for Unprecedented Times

**Confronting the Global Crisis in Latin America
and the Caribbean**

March 29, 2009

Prepared for the XLX Annual Meeting of the Board of Governors of the IADB,
Medellín, Colombia

FOREWORD

This presentation is based on work carried out at the IDB's Research Department and CERES under the leadership of Alejandro Izquierdo and Ernesto Talvi.

The views expressed here do not necessarily coincide with those of the management of the IDB, its Board of Directors, or its Board of Governors.

The analysis does not refer to any individual country in the Region, nor do the numbers constitute forecasts by the IDB; rather, they are simulations of potential scenarios with the purpose of contributing to the assessment of policy alternatives. No country-specific suggestions are offered.

OUTLINE

- I. The Good Times (2003-2008.II)**
- II. End of the Good Times (2008.II-Present)**
- III. Macro Dynamics in LAC under Two Hypotheses on the Global Economy**
- IV. Confronting the Global Crisis in LAC: Policy Trade-Offs**
- V. The Role of the IDB**

SUMMARY

- **Between 2003-2008.II LAC enjoyed an exceptional economic and financial period, and a notable improvement in macroeconomic fundamentals**
- **Moreover, the first phase of the US financial crisis (2007.II-2008.II) exacerbated rather than attenuated the expansionary cycle**

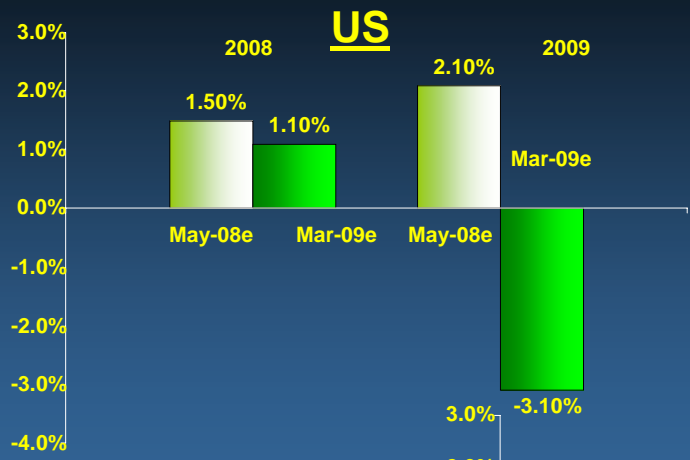
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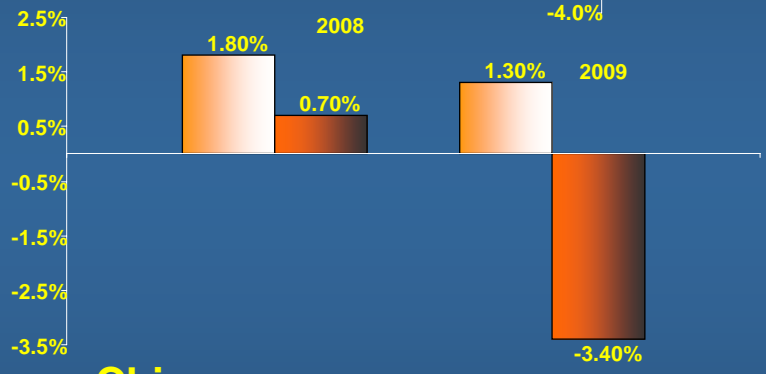
End of the Good Times: *World Growth*

(Real GDP growth, yoy)

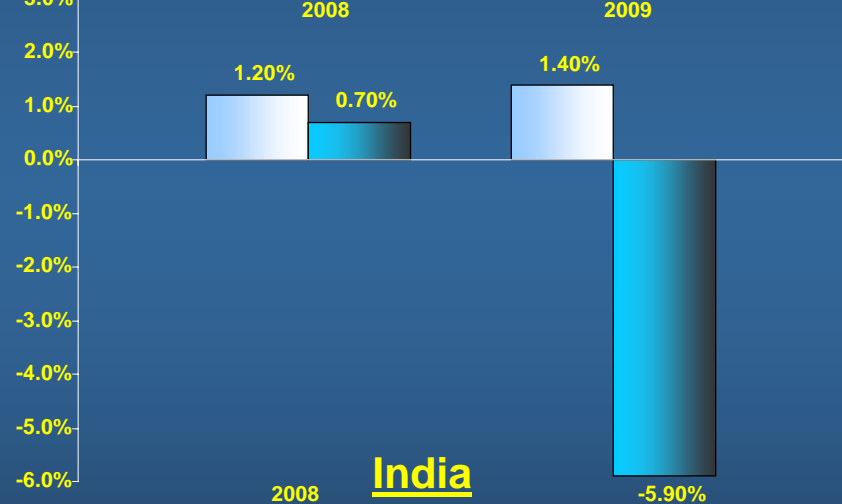
(Light) forecasts in May-08
(Darker) forecasts in Mar-09



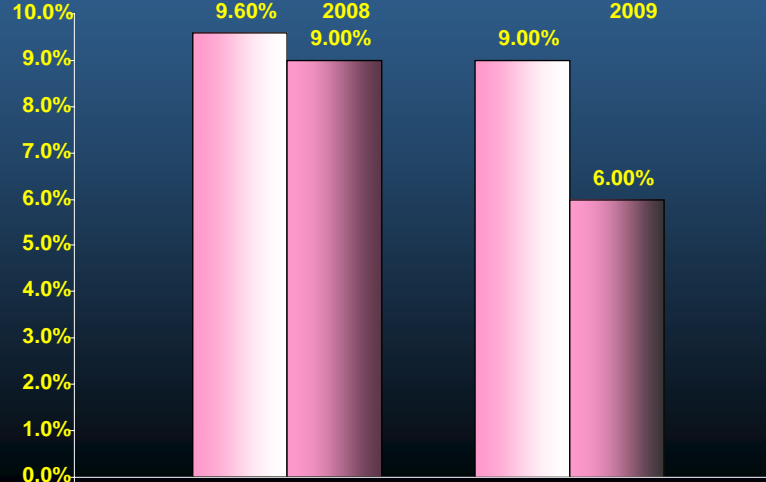
Euro Area



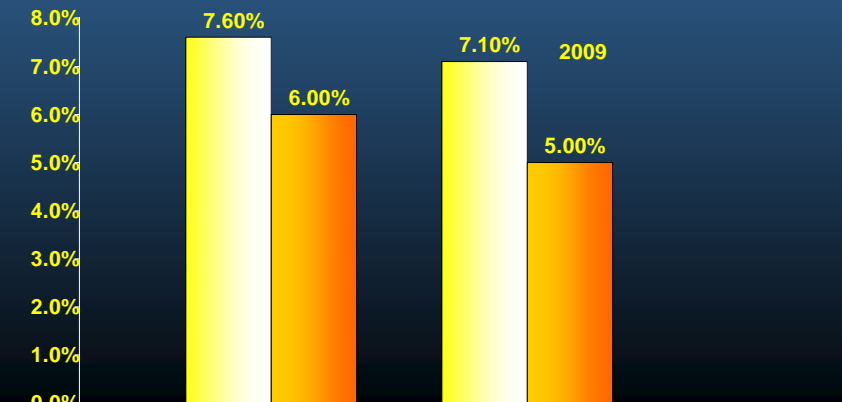
Japan



China



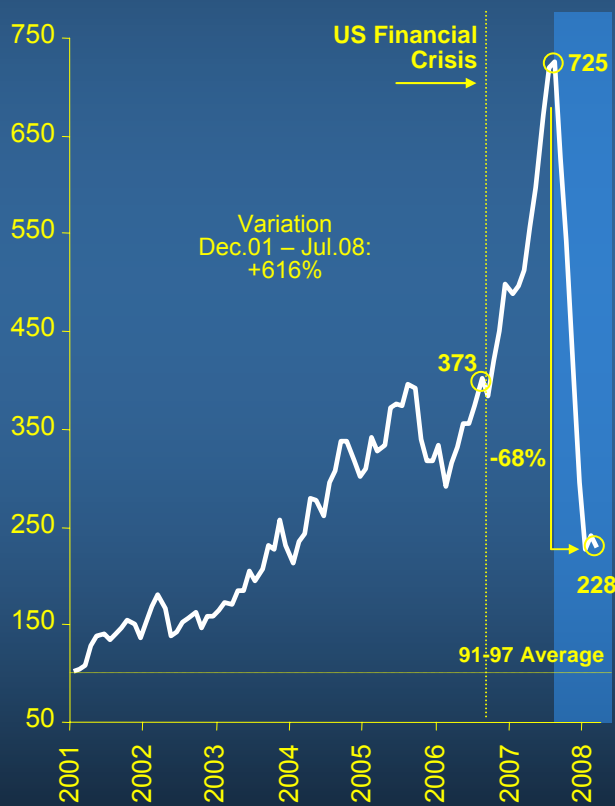
India



End of the Good Times: *Commodity Prices*

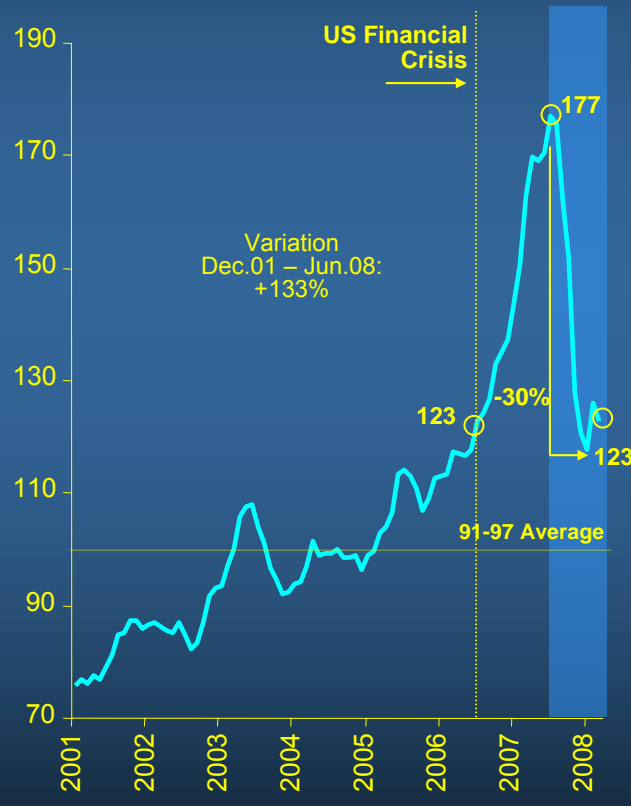
Oil

(1991-1997 Average = 100)



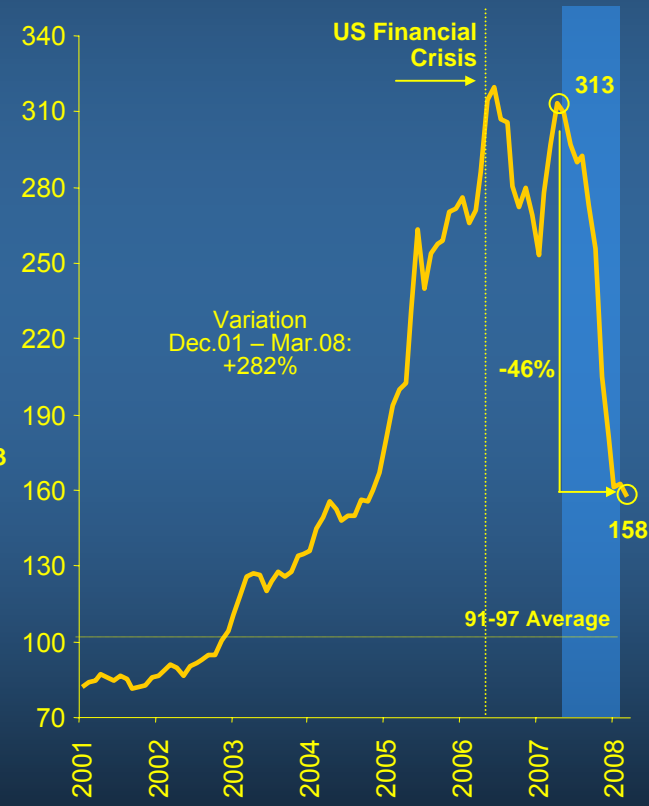
Food

(1991-1997 Average = 100)



Metals

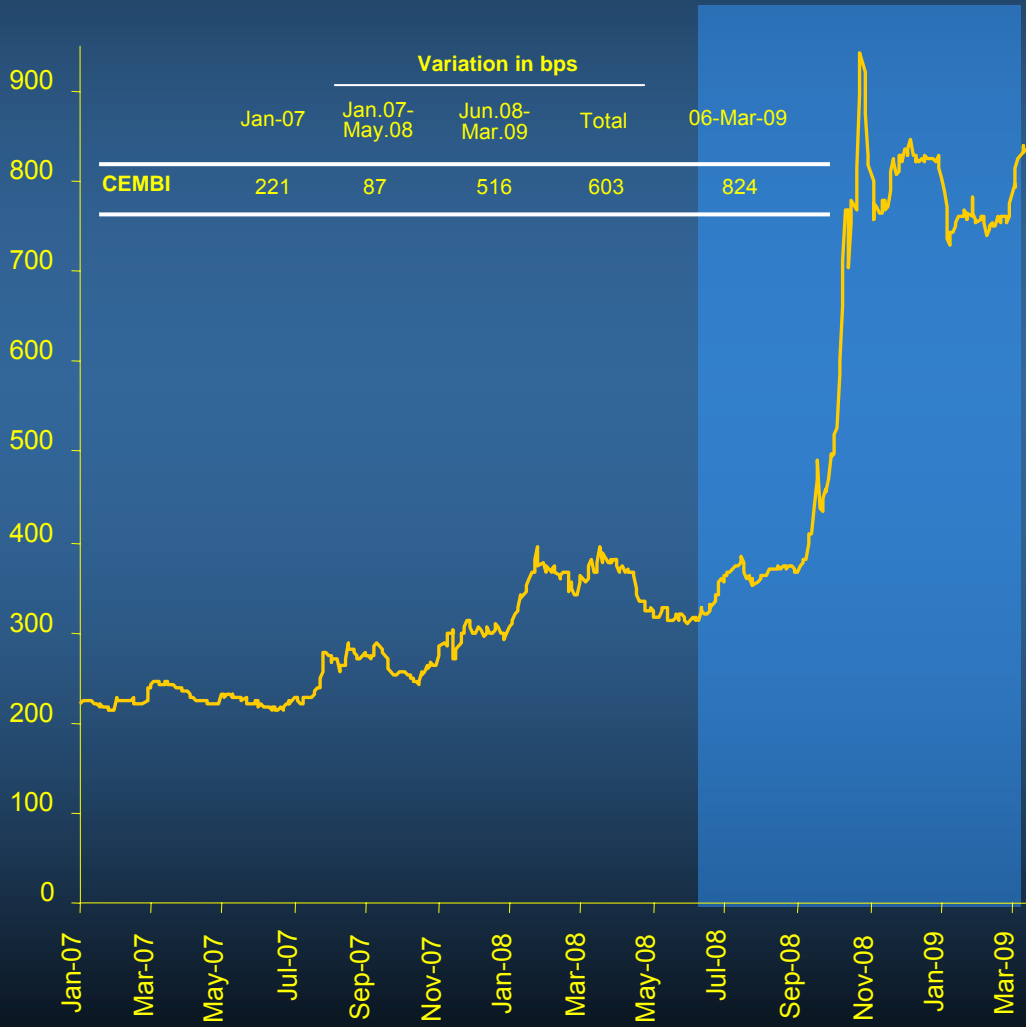
(1991-1997 Average = 100)



End of the Good Times: *International Financial Conditions*

Corporate Bond Spreads

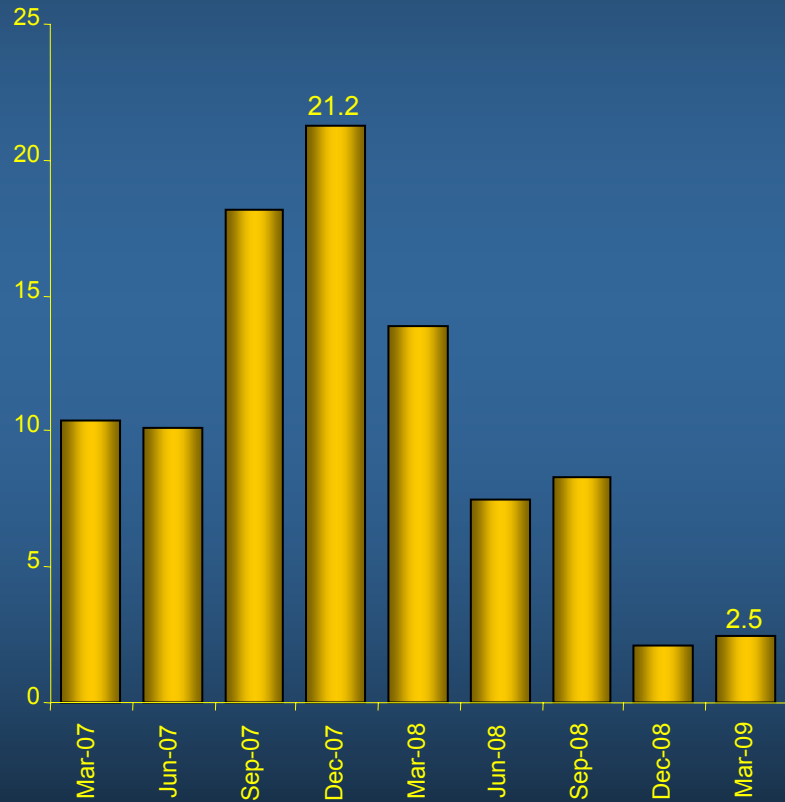
(Latin CEMBI; 01-Jan-07 = 100)



End of the Good Times: *International Financial Conditions*

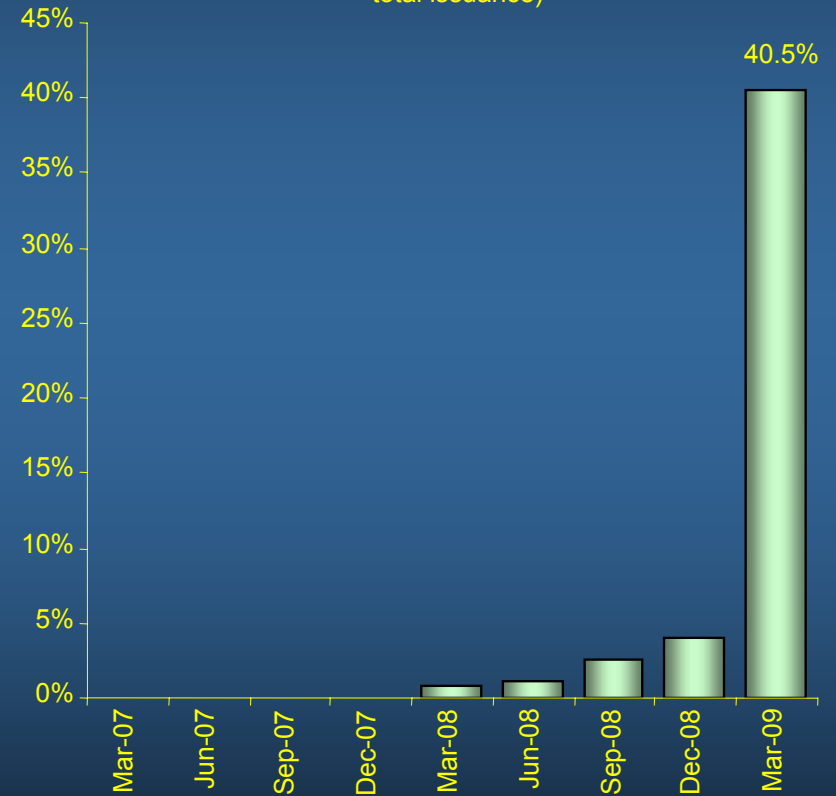
Corporate Bonds: Issuance

(LAC-7, billions of USD)



Corporate Bonds: Maturity

(LAC-7, issuances with maturity less than 1 year, % of total issuance)



End of the Good Times: *International Financial Conditions*

Sovereign Bond Spreads

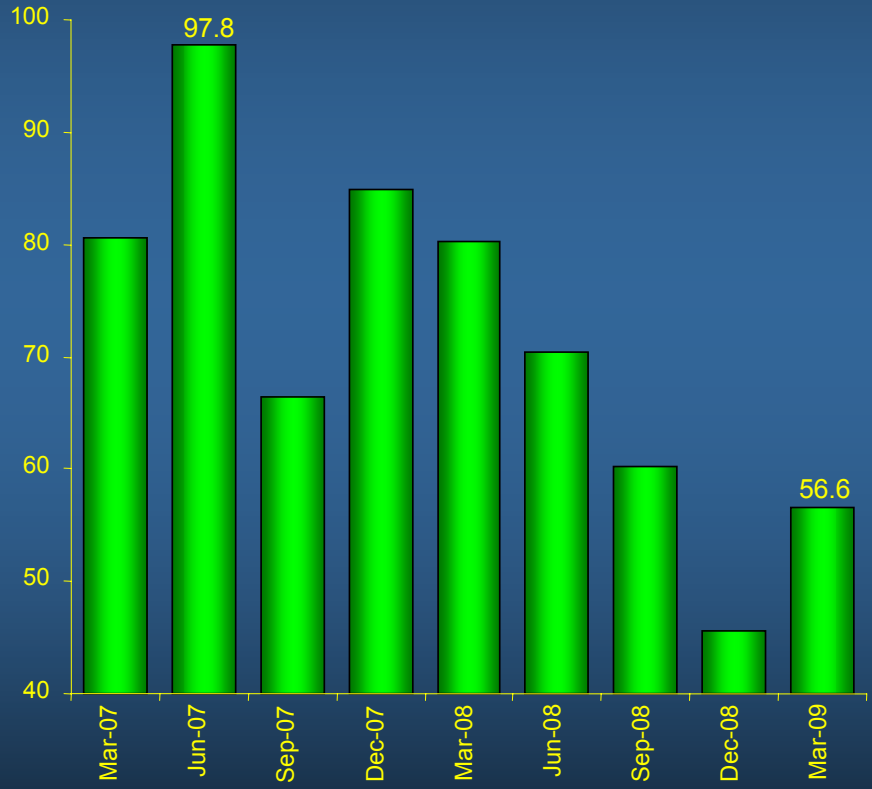
(EMBI+ and Latin EMBI; Spreads, Basis Points)



End of the Good Times: *International Financial Conditions*

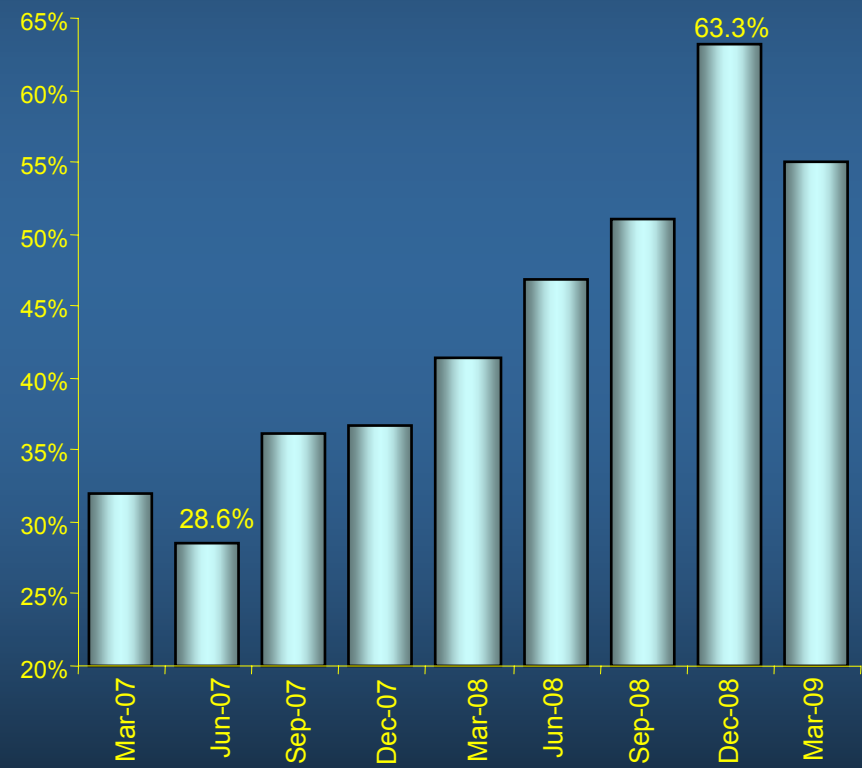
Sovereign Bonds: Issuance

(LAC-7, billions of USD)



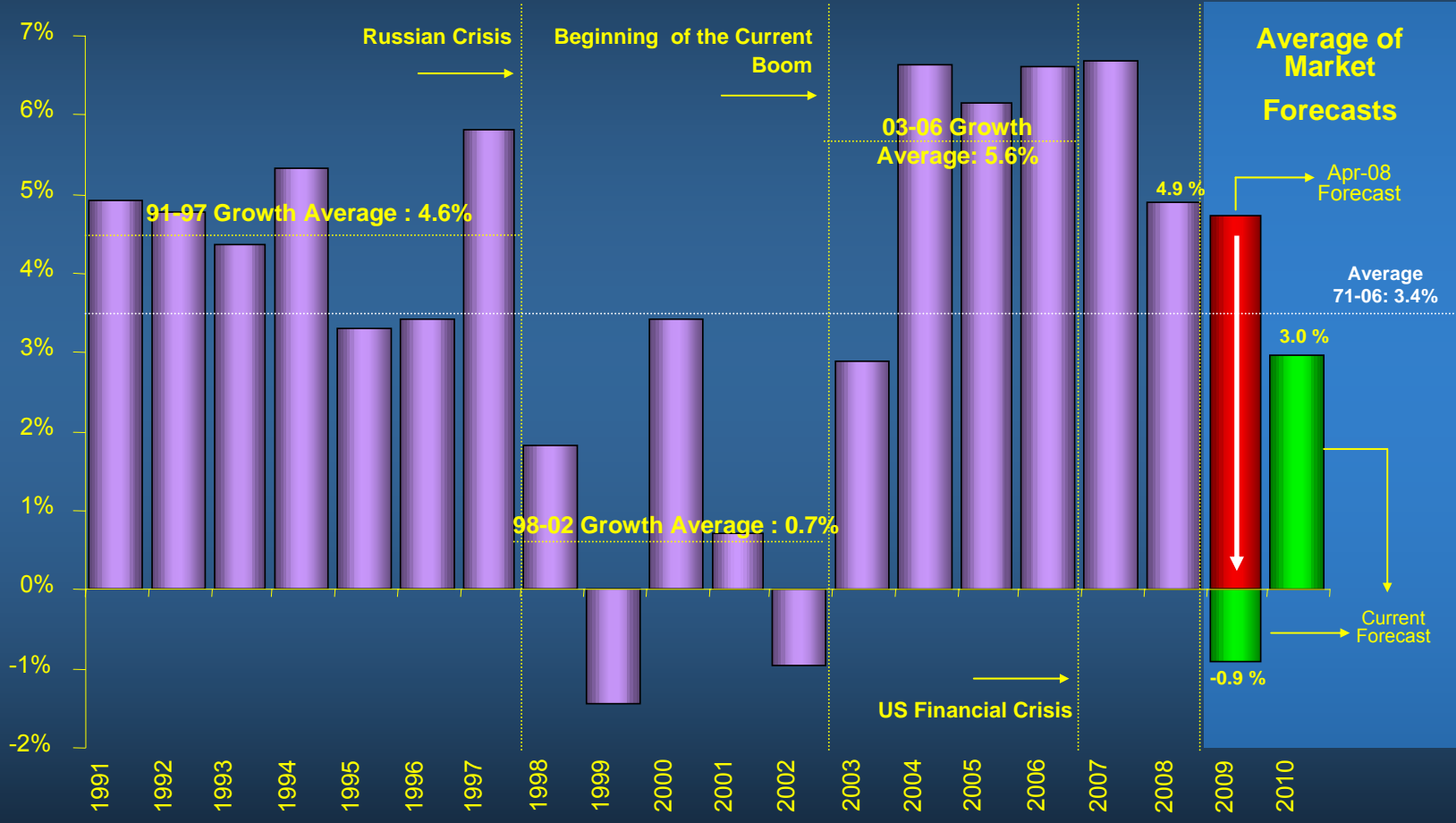
Sovereign Bonds: Maturity

(LAC-7, issuances with maturity less than 1 year, % of total issuance)



End of the Good Times: *Economic Performance*

(LAC-7; real GDP, annual variation)



End of the Good Times (2008.II-Present)

EXTERNAL FACTORS

- Drastic downward revision of growth forecasts in industrial countries
- Drastic collapse in commodity prices and terms of trade
- Severe deterioration of international financial conditions
 - Sudden Stop (SS) for EM corporates
 - Financial Precarization (FP) for EM sovereigns

ECONOMIC PERFORMANCE IN LATIN AMERICA

- Drastic downward revision for 2009 growth forecasts, with a rebound expected for 2010

MACROECONOMIC POLICIES

- Countercyclical fiscal and monetary policies

THE END OF THE GOOD TIMES (2008.II-PRESENT):

SUMMARY

- **Drastic deterioration of the external environment**
- **Sharp downward revision in Latin America's growth forecasts, with a recession expected in 2009 and a rebound in 2010**
- **A countercyclical monetary and fiscal policy response, generally with support from the international community**

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MOTIVATION

- **To assess perspectives for the Region in the face of the global crisis, we proceed as follows:**
 - i. Trace the macro-dynamics of a key set of variables under alternative hypotheses on how the global crisis unfolds, to go beyond a snapshot of the region and see the motion picture right to the end**
 - ii. Develop a simple framework emphasizing liquidity issues as a key element in evaluating the region's risks and policy trade-offs**

Hypotheses on the Global Economy

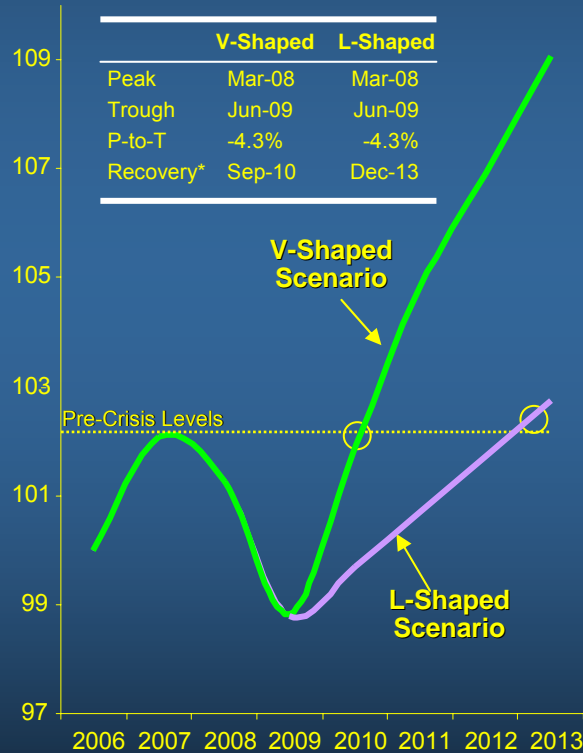
Hypotheses on the Global Economy

EXTERNAL FACTORS

Industrial Countries Growth

G7 Industrial Production

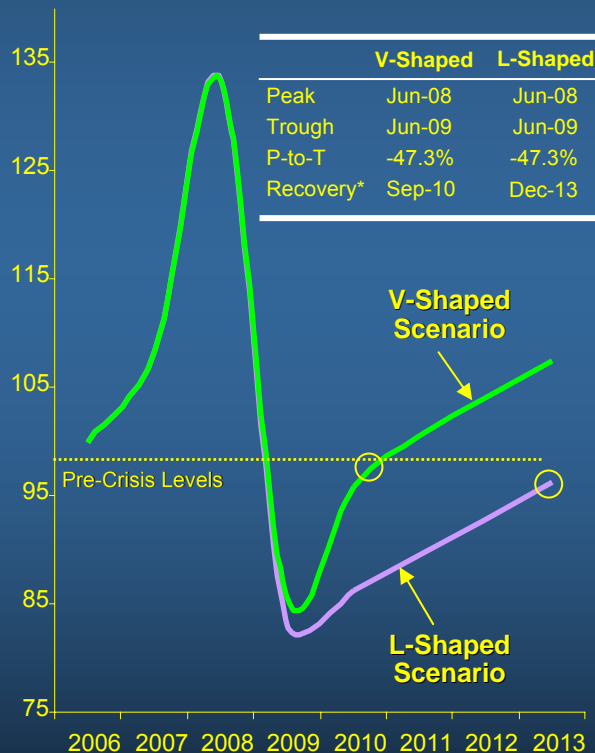
(2006 = 100)



Commodity Prices

Global Commodity Price Index

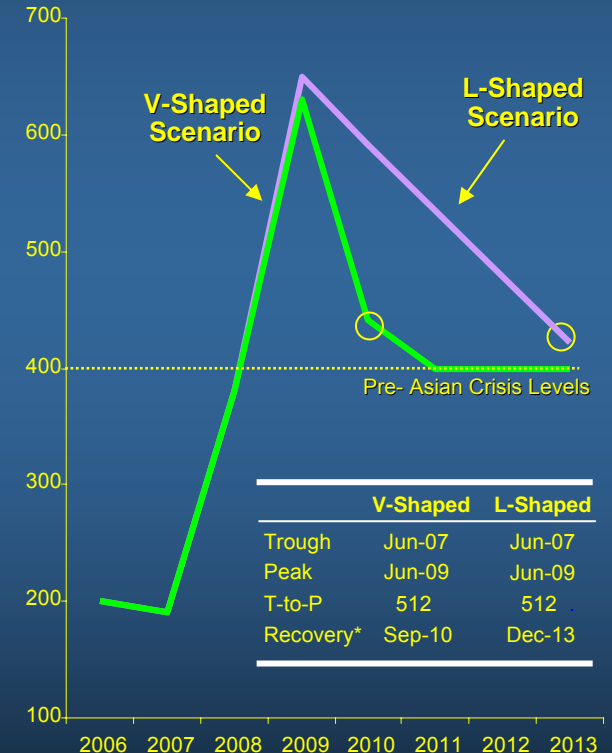
(2006 = 100)



International Financial Conditions

Sovereign Bond Spread

(EMBI +, bps)



Source: Own calculations based on WEO and JPMorgan*, Oct-08.

Source: IMF and Bloomberg*

Source: JPMorgan for Bond Spreads

G7 is the PPP-weighted average of the Canada, France, Germany, Italy, Japan, United States, UK

*Recovery to Dec-06 levels

*Recovery to Pre-Asian crisis levels

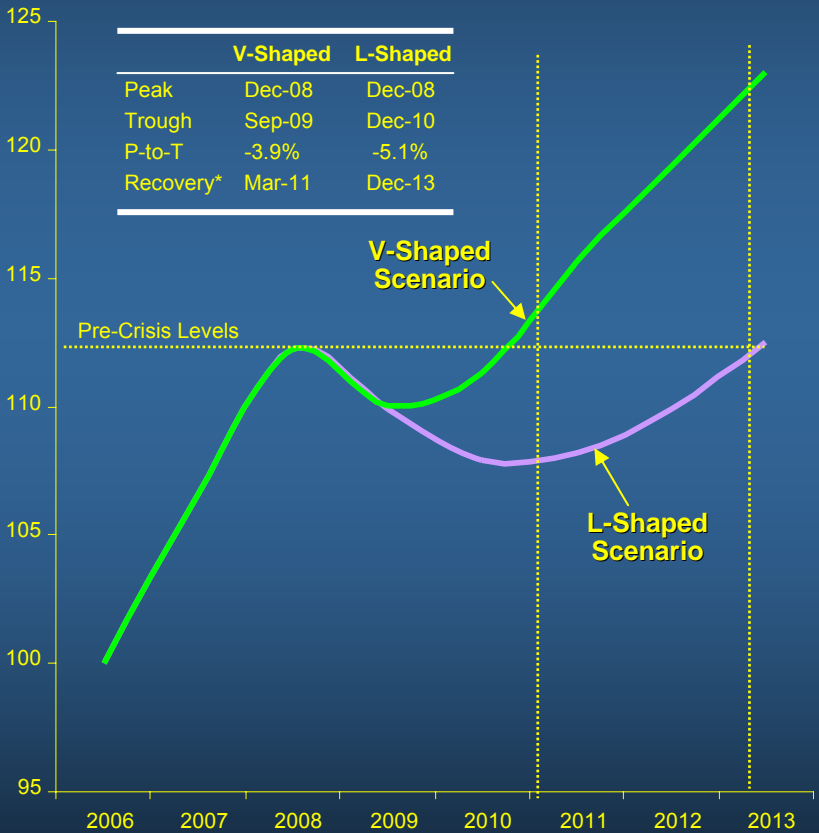
*Recovery to pre-crisis levels of output

Economic Performance

Economic Activity under Two Hypotheses on the Global Economy

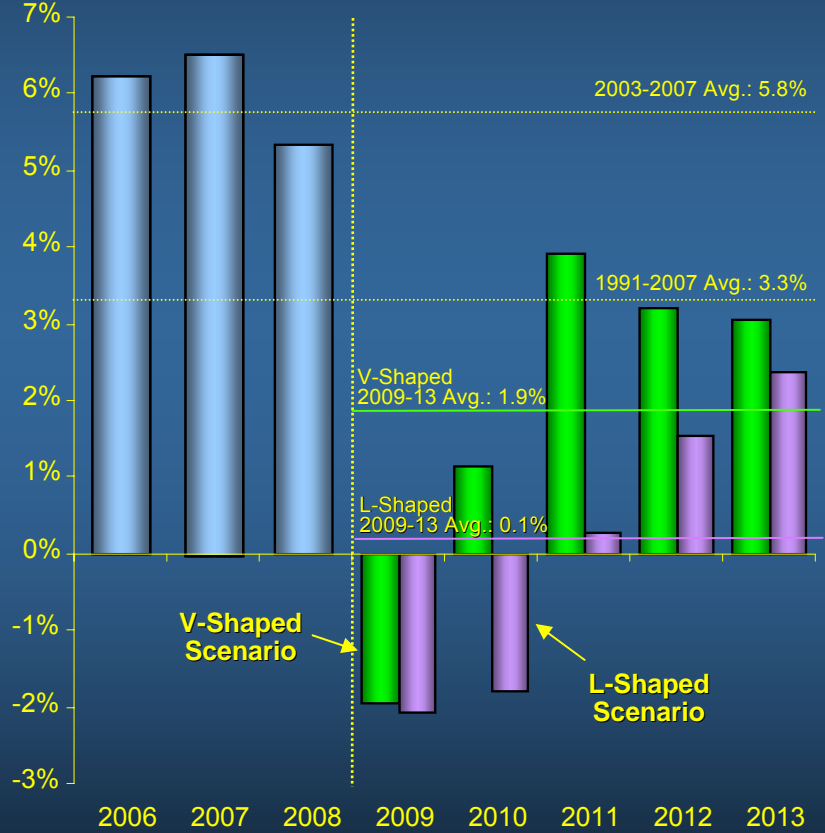
Economic Activity

(LAC-7 GDP, 2006 = 100)



GDP Growth

(LAC-7, annual growth rate)



*Recovery to pre-crisis levels of output

ECONOMIC ACTIVITY UNDER TWO HYPOTHESES ON THE GLOBAL ECONOMY

CONCLUSIONS

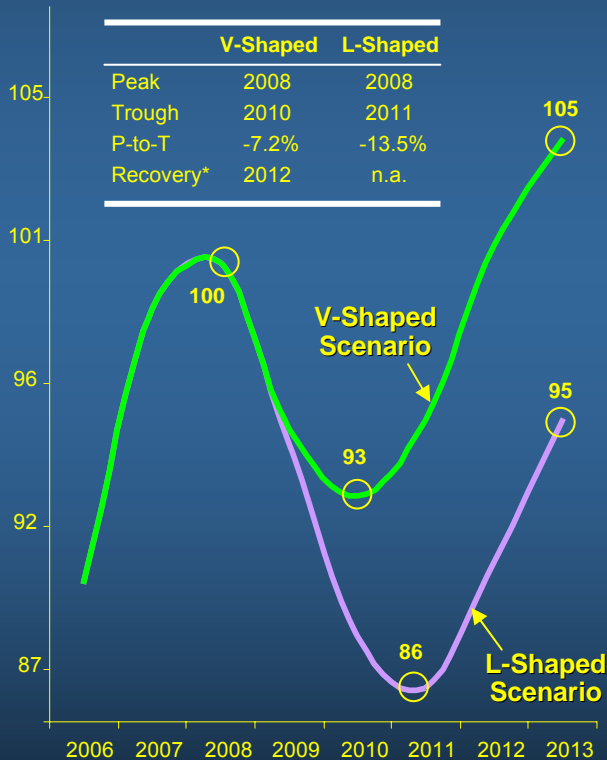
- Under both hypotheses, output performance for the next five years will be substantially below the 5.5 percent average growth rates of the 2003-2008 period
- Moreover, in the L-shaped scenario average growth will be close to zero in the next five years (and maybe negative in per capita terms), indicating that collateral damage of the global crisis could be felt for years to come

Fiscal Position

Fiscal Position under Two Hypotheses on the Global Economy

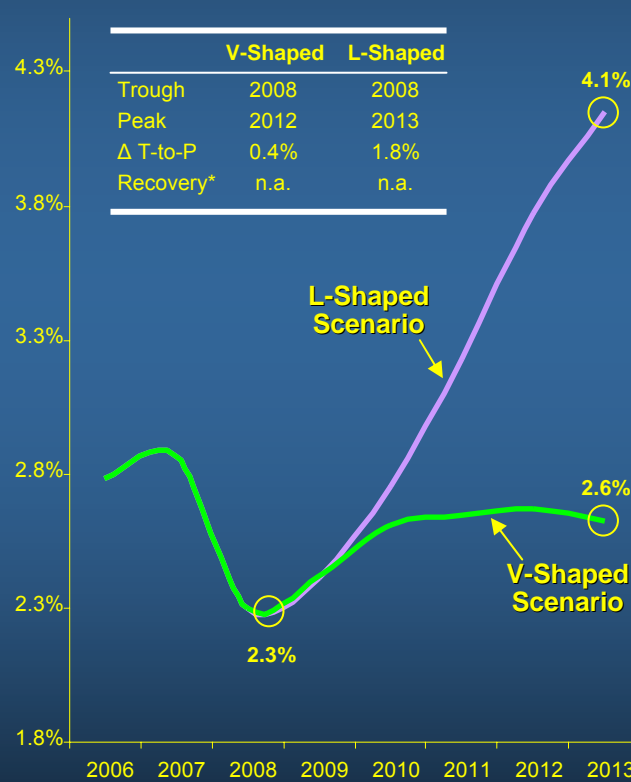
Fiscal Revenues

(LAC-7, 2008 = 100)



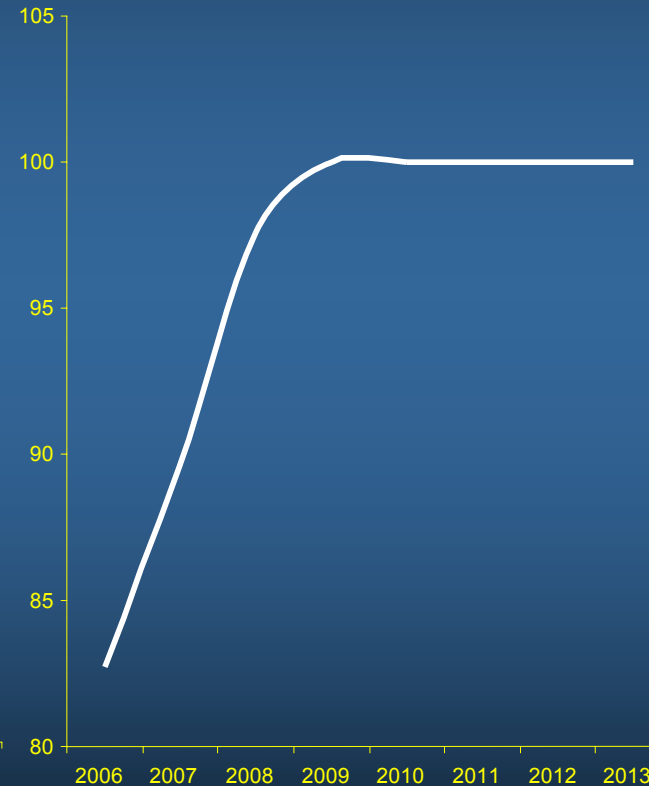
Interest Payments

(LAC-7, % of GDP)



Primary Expenditure

(LAC-7, 2008 = 100)

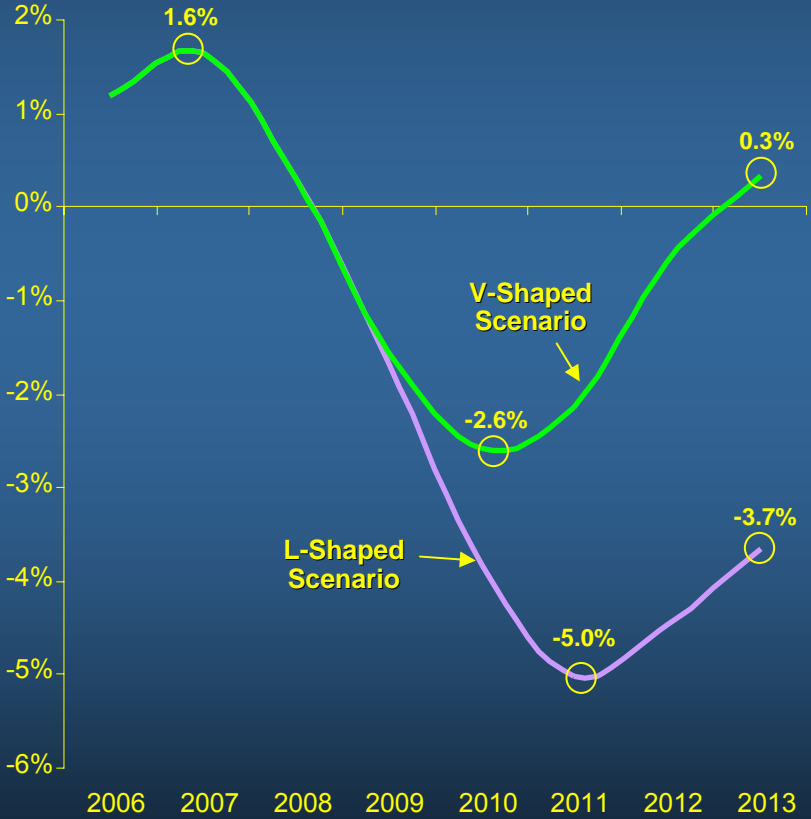


*Recovery to pre-crisis levels of output

Fiscal Position under Two Hypotheses on the Global Economy

Fiscal Balance

(LAC-7, % of GDP)



Public Debt

(LAC-7, % of GDP)



FISCAL POSITION UNDER TWO HYPOTHESES ON THE GLOBAL ECONOMY

CONCLUSIONS

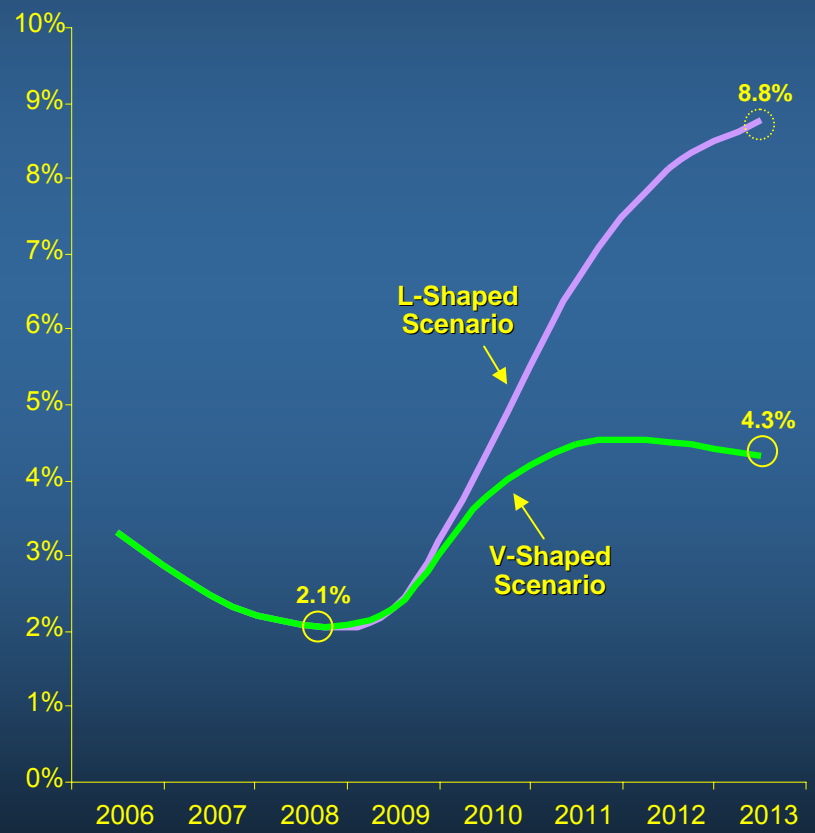
- Although the region starts from a strong fiscal position, the combination of declining economic activity, the fall in commodity prices and the rise in financial costs, could lead to a gradual and possibly large deterioration (even if primary expenditures remain constant)
- Fiscal deterioration could result in potentially exponential dynamics of public debt under the L-shaped scenario

Banking Indicators

Banking Indicators under Two Hypotheses on the Global Economy

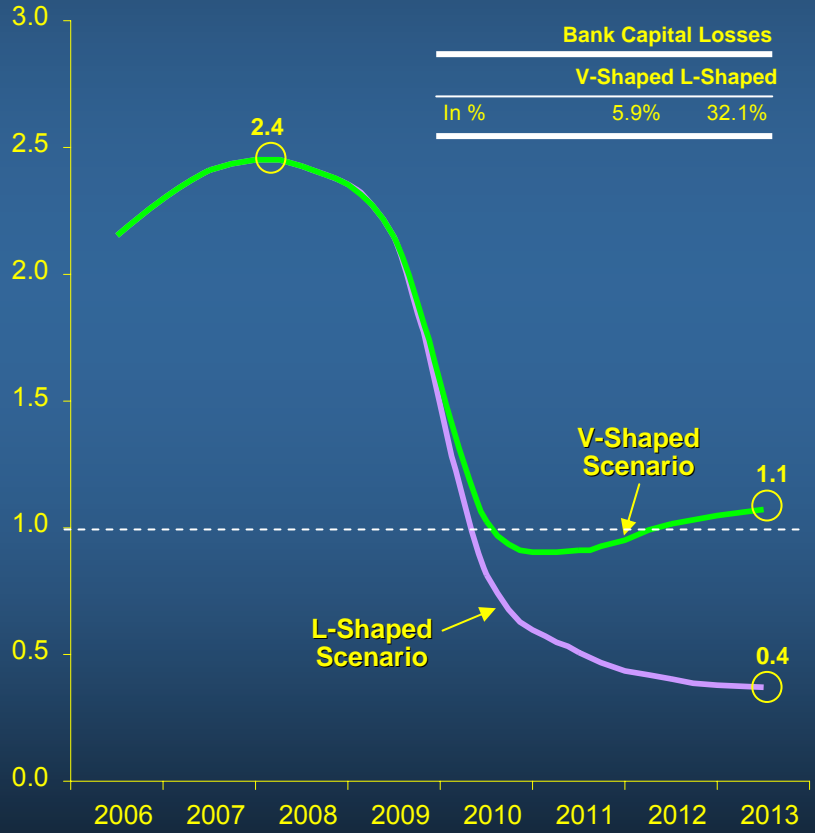
Non Performing Loans

(LAC-7, in % of Total Loans)



Loan Loss Provisions

(LAC-7, Loan Loss Provisions to Non Performing Loans)



BANKING INDICATORS UNDER TWO HYPOTHESES ON THE GLOBAL ECONOMY

CONCLUSION

- Although initial conditions of banks in LAC-7 are sound, the decline in economic activity leads to a gradual deterioration in banks' loan portfolios, resulting in relevant capital losses in the L-Shaped scenario

Liquidity Indicators

Liquidity Indicators: Simple Analytics

Liquidity Indicators

Definition

$$ILR_t = \frac{R_t}{B_{t+1}^{ST}}$$

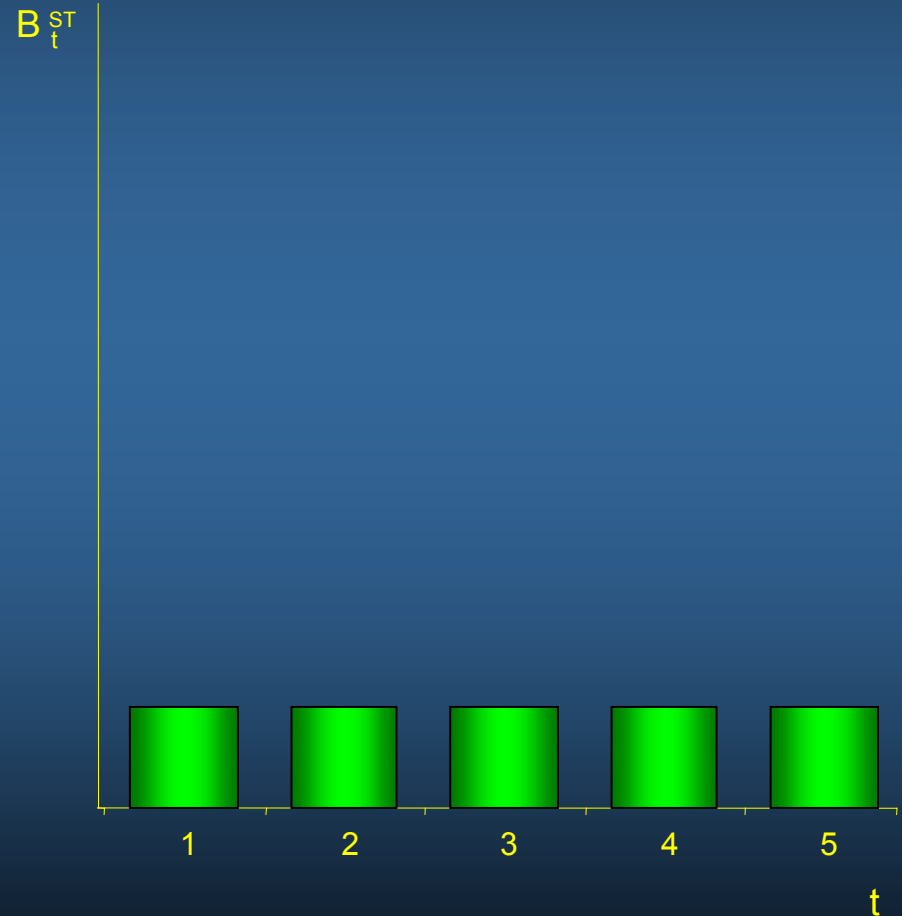
where

ILR_t = International Liquidity Ratio in t

R_t = International Reserves in t

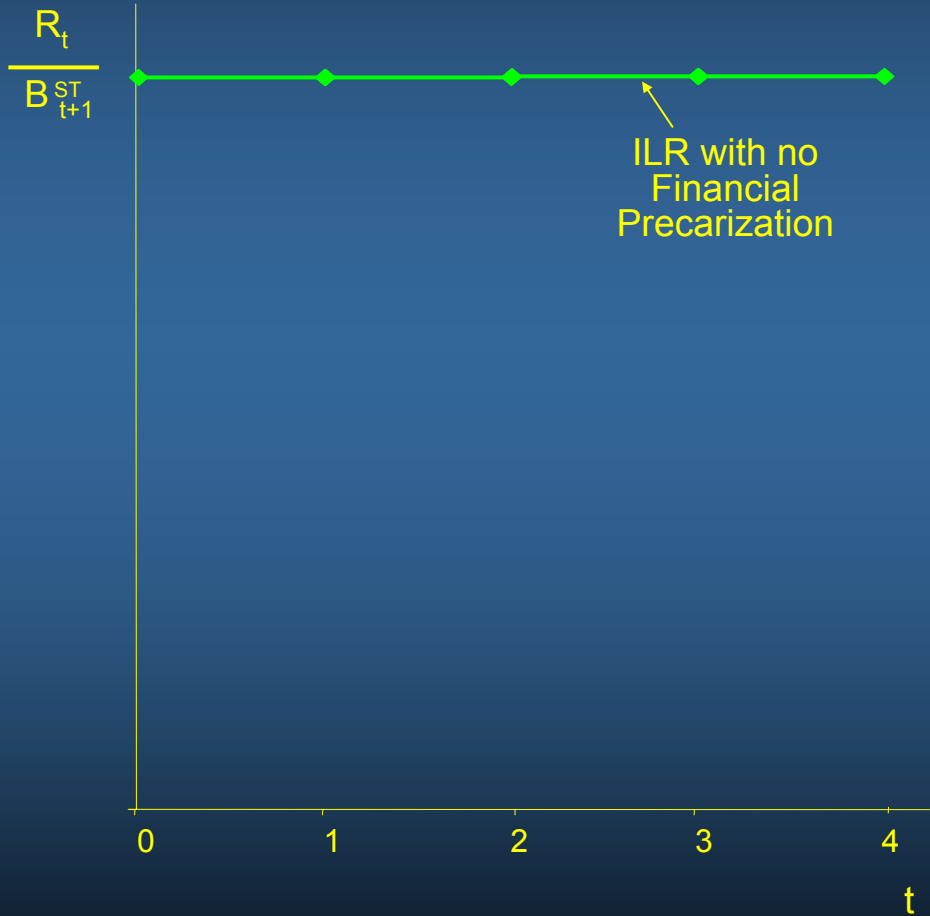
B_{t+1}^{ST} = Public Debt Amortizations in t+1

Debt Amortization Profile

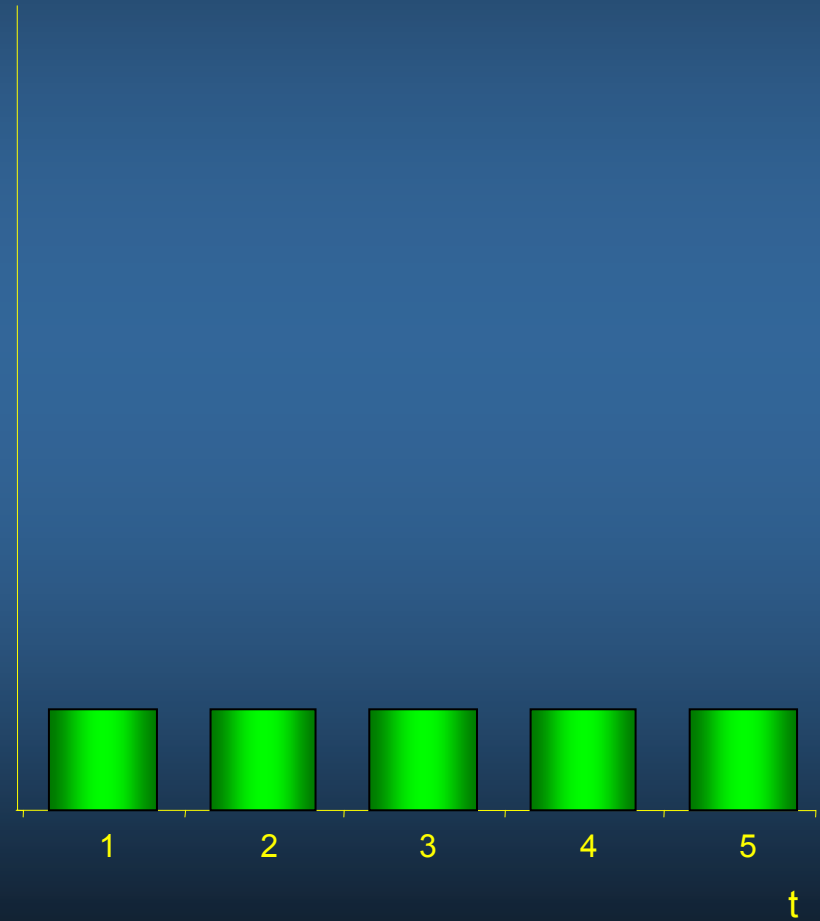


Liquidity Indicators: Simple Analytics

ILR Dynamics

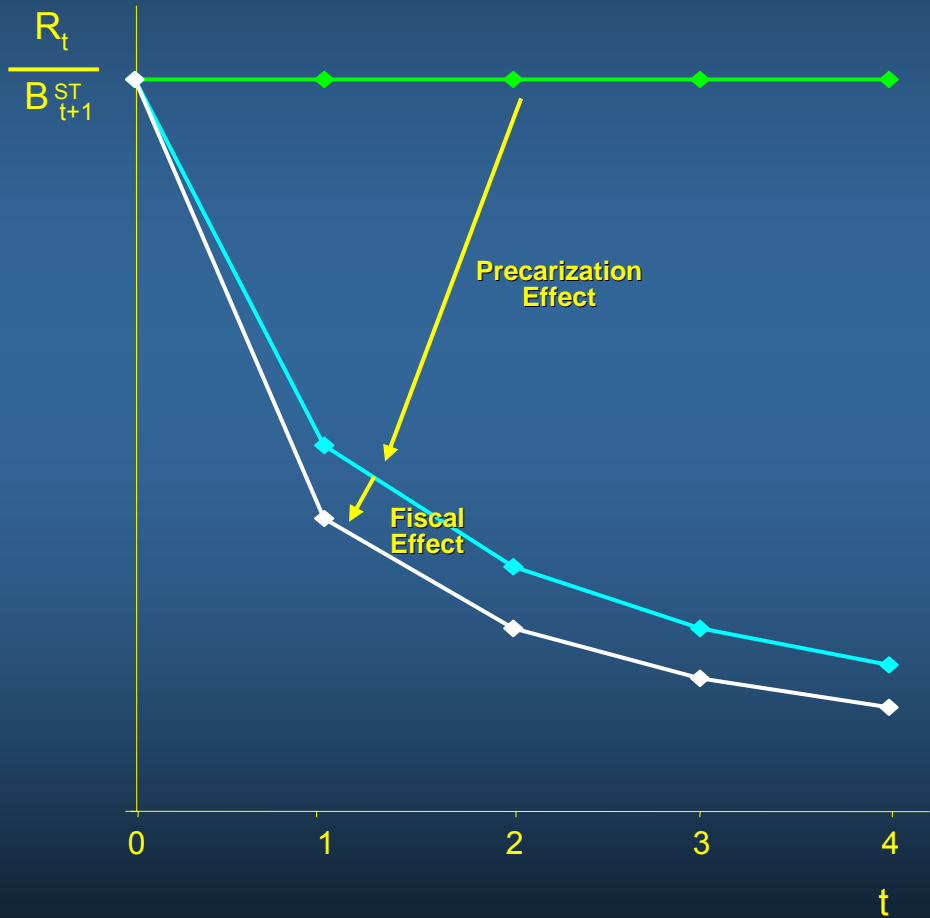


Debt Amortization Profile

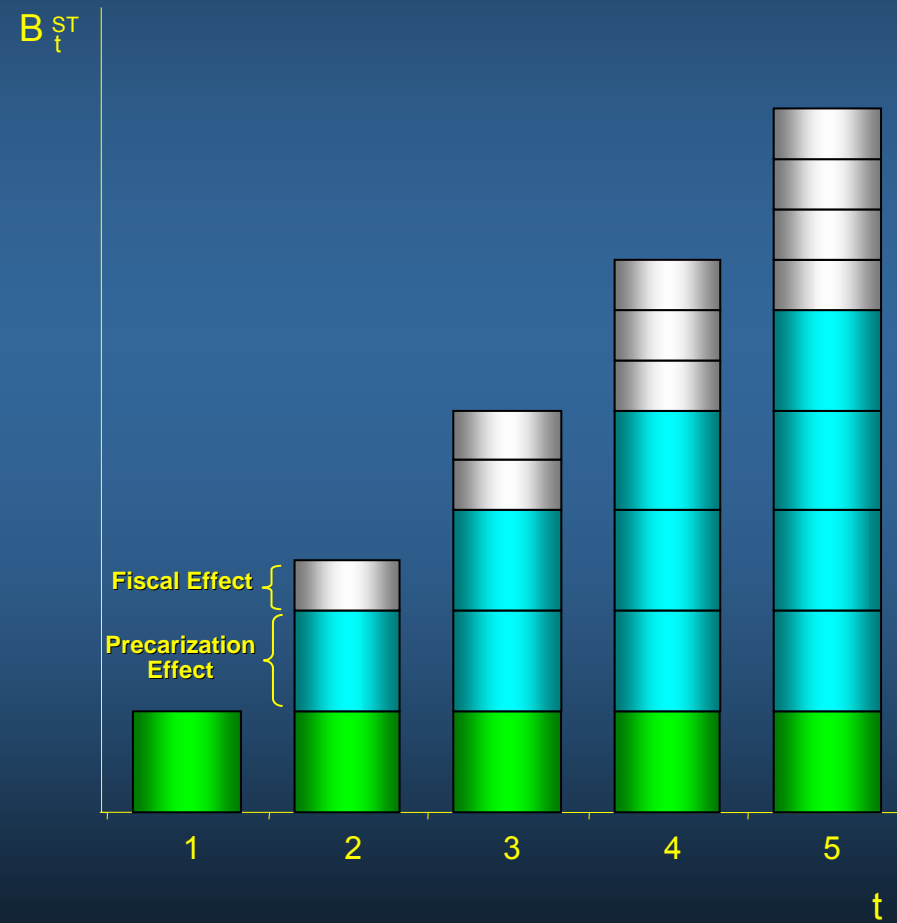


Liquidity Indicators: Simple Analytics

ILR Dynamics

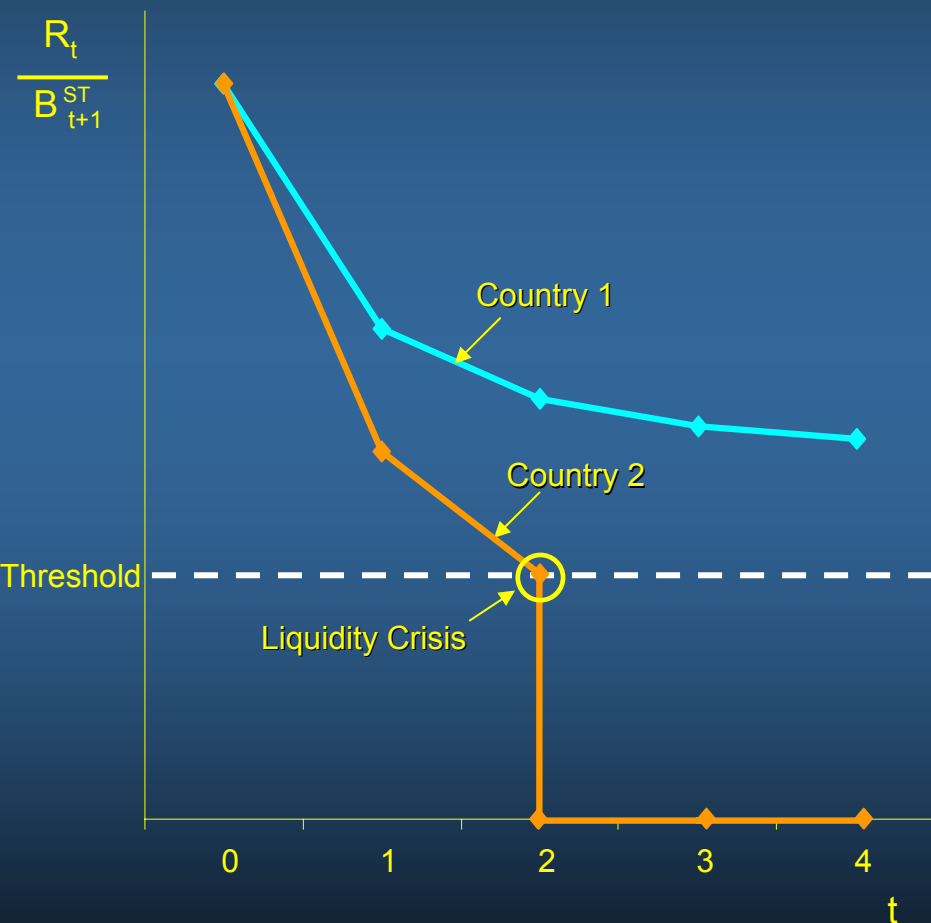


Debt Amortization Profile



Liquidity Indicators: Simple Analytics

ILR Dynamics

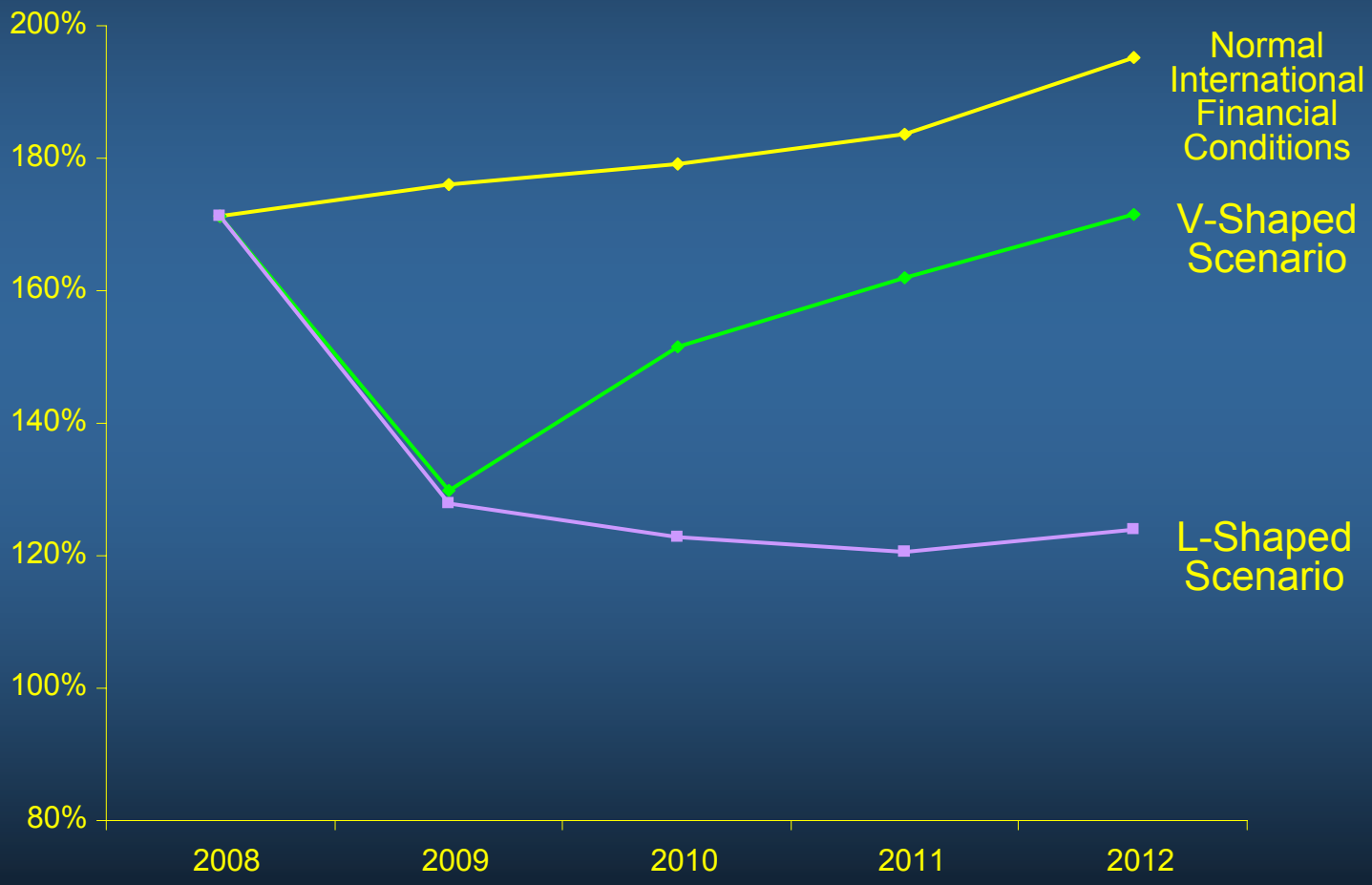


Conclusions

- The likelihood of a liquidity crisis as determined by ILRs will depend on external factors (i.e. duration of the global crisis) and idiosyncratic factors (i.e. determinants of ILRs dynamics).
- Not every country may hit a critical threshold in the relevant period of the global crisis and for those that do, they may not do so at the same time.
- Liquidity problems may evolve gradually but materialize suddenly when a critical threshold is hit. Therefore, problems may not be immediately evident.

Liquidity Indicators under Two Hypotheses on the Global Economy

Simulated ILR Dynamics
(LAC-7)



LIQUIDITY INDICATORS UNDER TWO HYPOTHESES ON THE GLOBAL ECONOMY: CONCLUSIONS

Under a V-shaped global recovery, the dynamics of liquidity indicators suggest that the region will suffer a recession in 2009, but no major financial turbulence

Under an L-shaped recovery, liquidity ratios could gradually evolve towards critical thresholds, increasing the likelihood of financial turbulence and larger output losses

A key feature of the L-shaped scenario is that the deterioration of fundamentals is gradual, and therefore problems may not become immediately evident

Against this backdrop it is crucial to anticipate gathering problems early on to act in a timely fashion, and to design policies that prevent countries from entering into financially fragile territory

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CONFRONTING THE GLOBAL CRISIS IN LATIN AMERICA: POLICY TRADE-OFFS

MOTIVATION

- Under precarious access to credit markets, liquidity considerations become paramount. In particular, the benefits of alternative policies should be balanced against their cost in terms of the liquidity position of a country and how they affect the vulnerability to a liquidity crisis

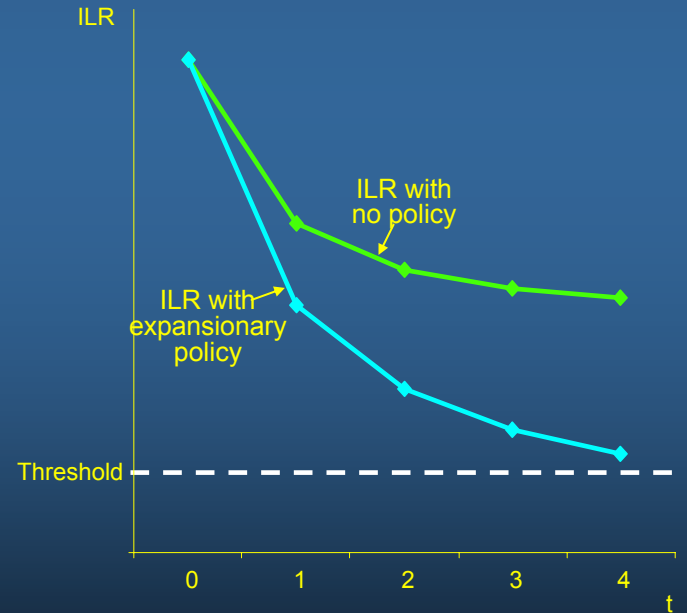
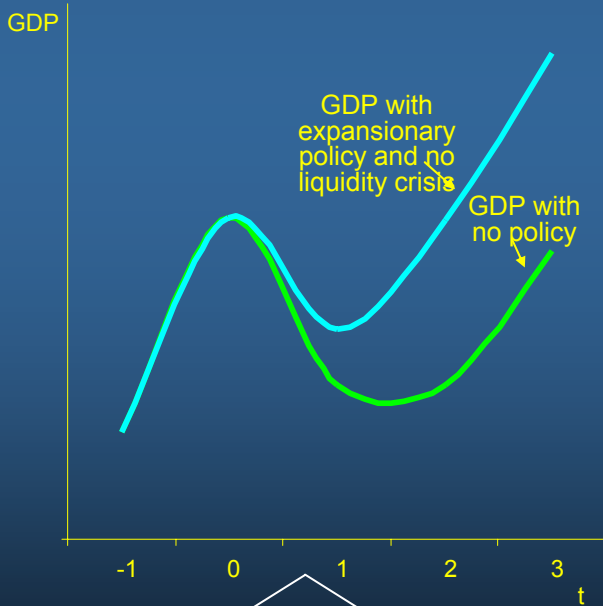
Confronting the Global Crisis in LAC: Policy Trade-Offs

EXPANSIONARY FISCAL POLICY

Mitigate
Recessionary
Pressures

Trade - Off

Weaken Liquidity
Position



A similar analysis follows for monetary and other policies.

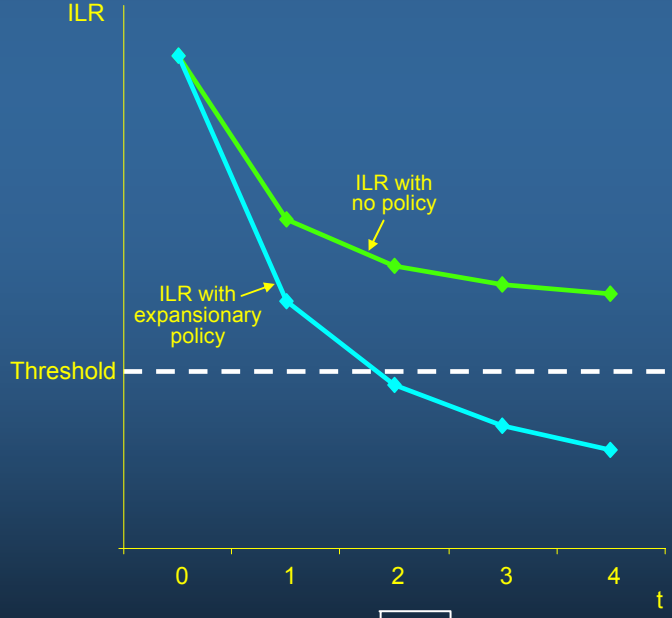
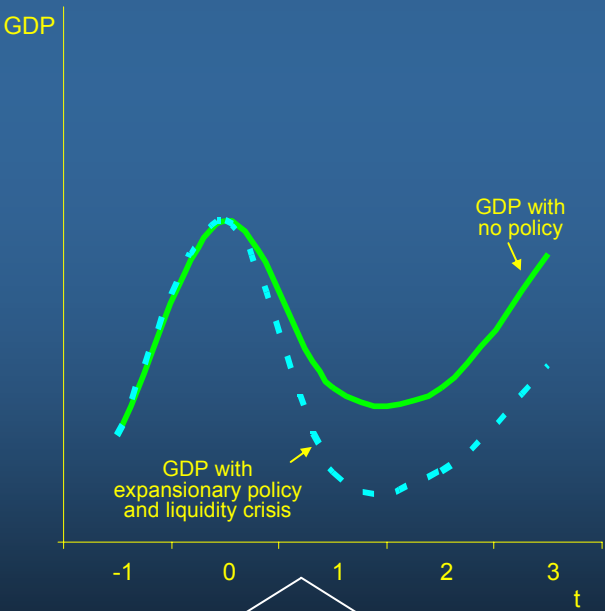
Confronting the Global Crisis in LAC: Policy Trade-Offs

EXPANSIONARY FISCAL POLICY

Mitigate
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Weaken
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Policy Suggestions

POLICY SUGGESTIONS

- **Precarious access to credit markets for many emerging market countries calls for multilaterals to step in and play for these countries the role that governments with better access to credit, such as the US government, play domestically**
- **Thus the question is not whether multilaterals should play a key role in the current crisis, but which is the most effective way to channel their intervention**

POLICY SUGGESTIONS FOR LAC

- With current resources, MDB's cannot provide full support to refinance stocks of public debt coming due and large counter-cyclical fiscal programs in LAC. In consequence, the question is how to target limited resources to get more "bang for the buck"
- The analysis of the relevant policy trade-offs, particularly under the L-shaped scenario, points in the direction of switching from financing additional expansionary policies, to financing policies oriented to minimize the risk of a liquidity crisis, typically associated with more severe output contractions
- This suggests the following set of policy principles...

POLICY PRINCIPLES

Multilateral support is vital to avoid financial precarization, more so if one believes that the global downturn will be long-lasting

In this context, multilaterals should shift from short-term emergency financing to long-term financing in order to partially “complete” markets in terms of maturities, ensuring that financial precarization does not put countries in a liquidity collision course

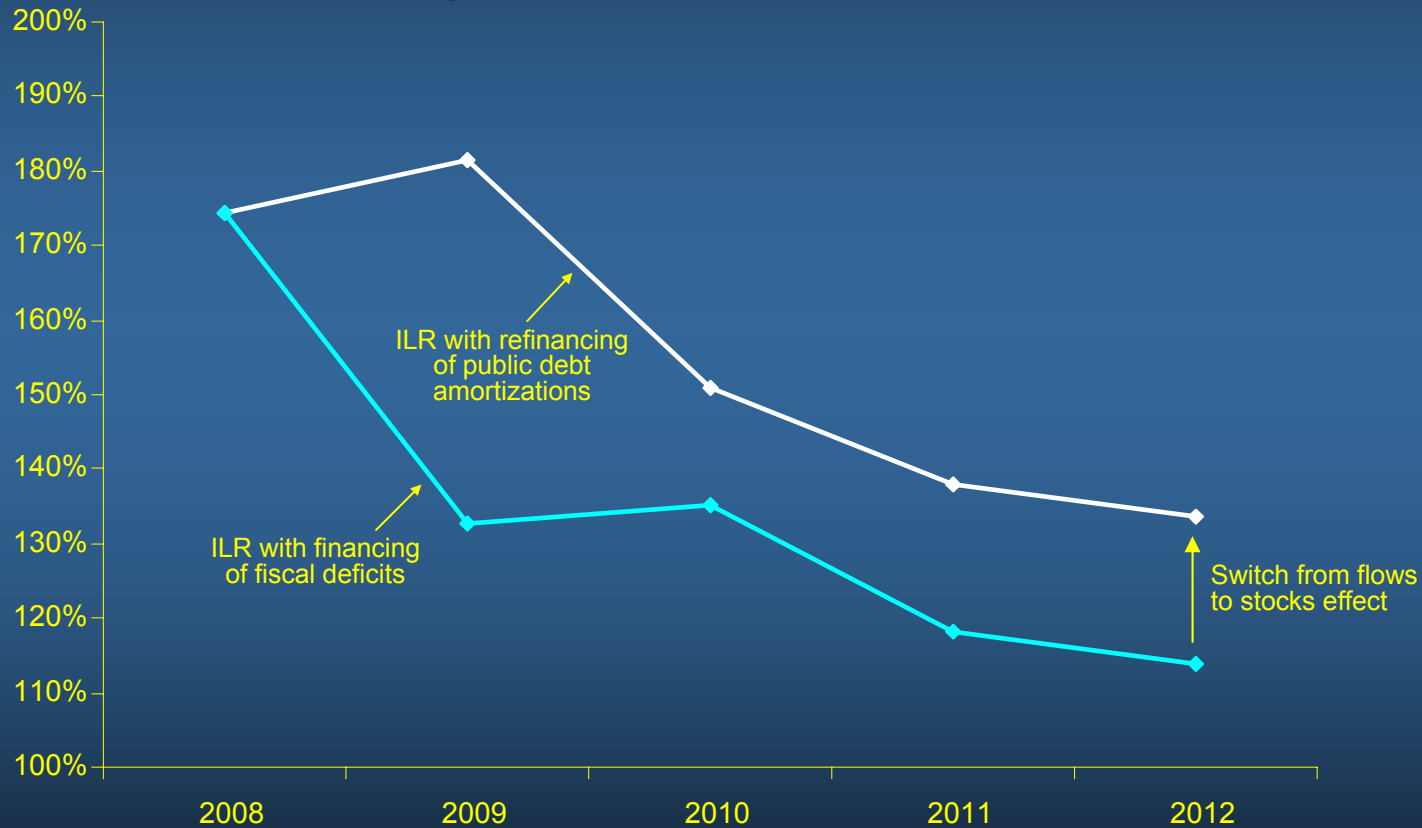
(In this light perhaps we could see the new Flexible Credit Line announced by the IMF on March 26)

In parallel, multilateral assistance should contribute to a gradual convergence to sustainable structural fiscal positions while protecting social programs and enhancing productivity

These principles need to be considered on a country-by-country basis, as conditions vary importantly between them

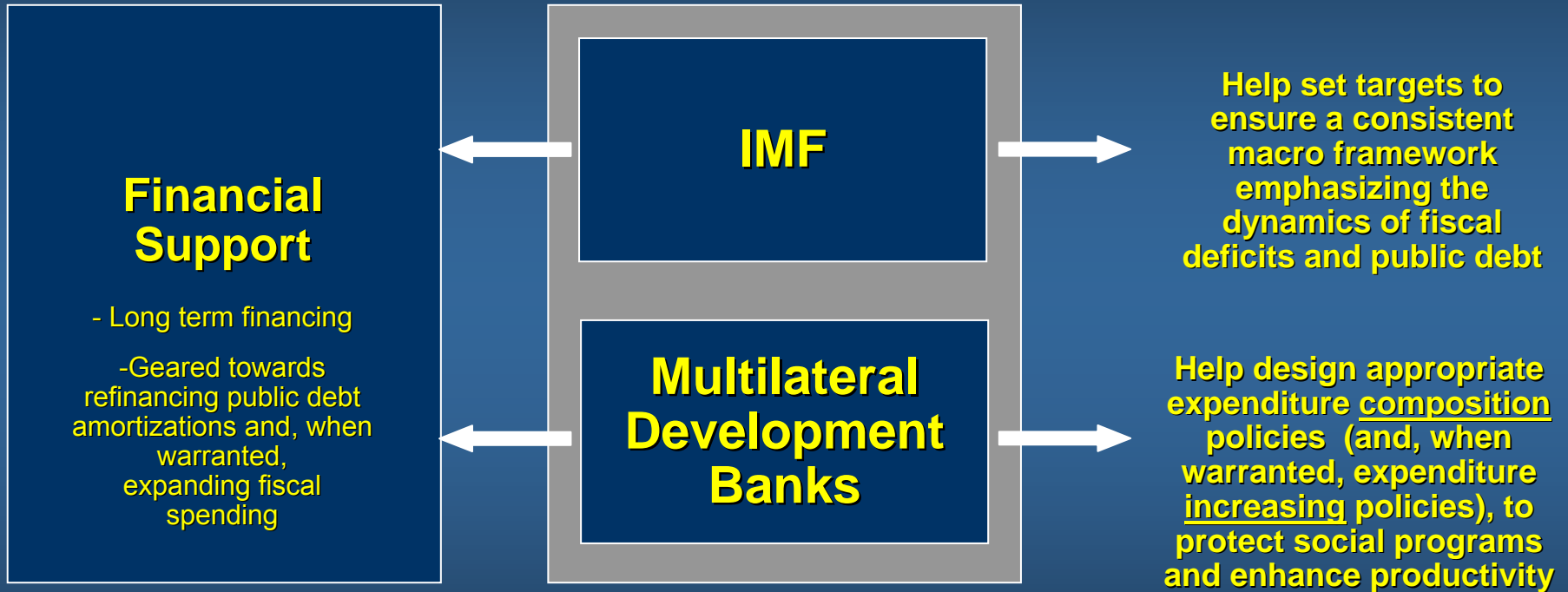
Confronting the Global Crisis in LAC: A *Stocks Financing Policy Suggestion*

Simulated ILR Dynamics: Refinancing Public Debt Stocks vs. Financing Fiscal Deficits in the L-shaped Scenario



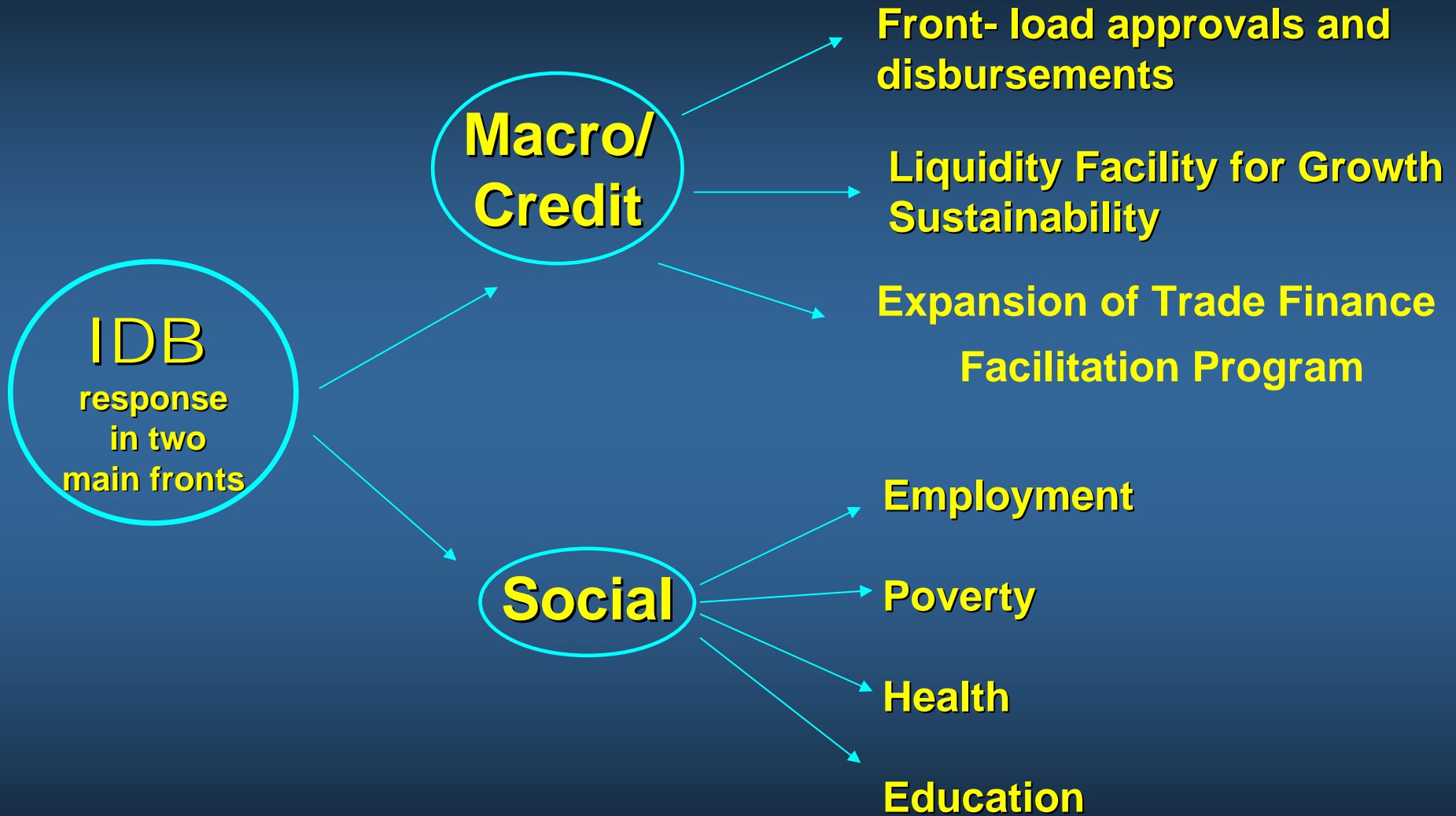
Both policies assume a 250 bn financial assistance package for the region in 2009 and 2010.

Confronting the Global Crisis in LAC: *The Role of Multilaterals*



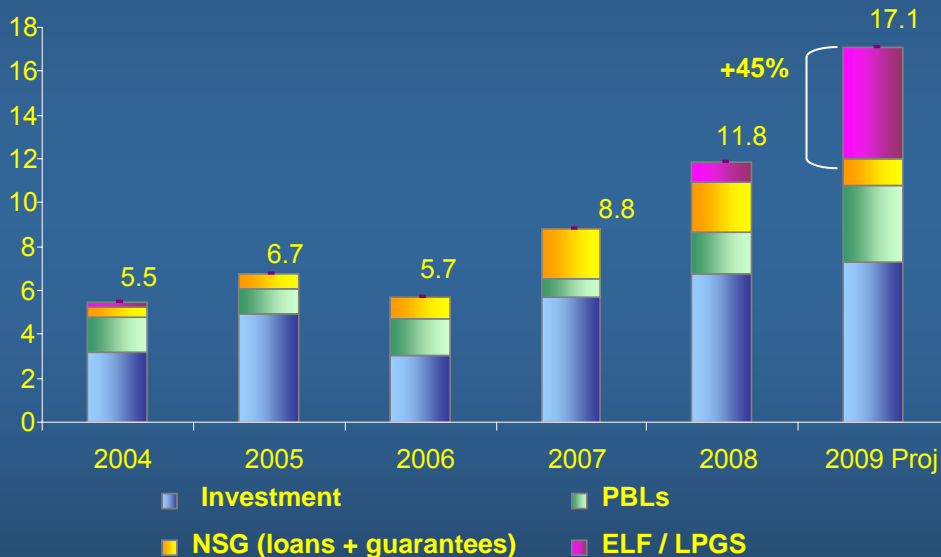
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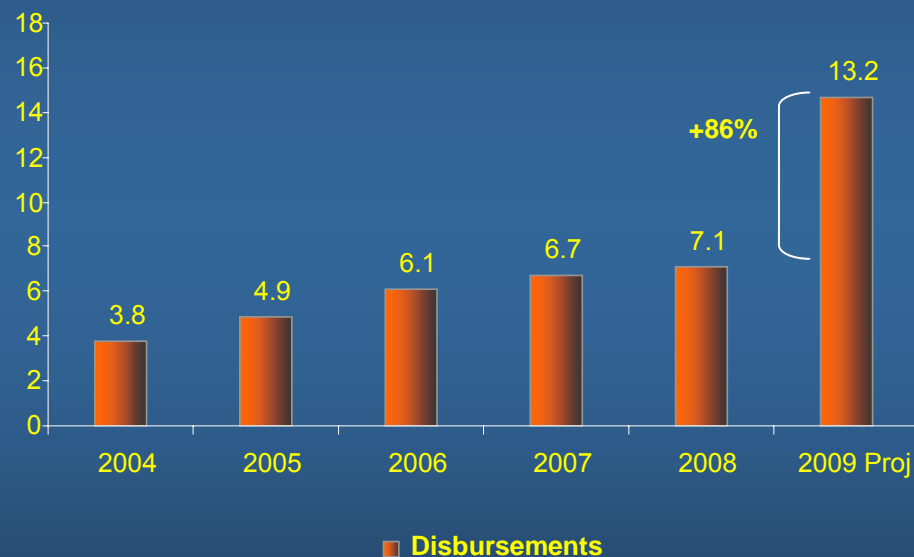


Approvals and Disbursements

OC Approvals 2004-2009*
(billions of US\$)



OC Disbursements 2004-2009*
(billions of US\$)



The Bank is realizing an unprecedented effort in 2009 which, nonetheless:

- is insufficient given the magnitude of the problem, and
- cannot be sustained in 2010 with its current resources.

Liquidity Facility for Growth Sustainability

Approved by IDB Governors in October of 2008 with up to US\$ 6 billion from Emergency Lending Resources, and implemented in close consultation with the IMF.

Objectives:

- ❑ to partially and transitorily substitute for the reduction in the flow of foreign commercial credit to LAC
- ❑ to support domestic production, foreign trade and protect employment
- ❑ rapid response : Costa Rica (500 m); El Salvador (400m); Jamaica (300m); Dominican Republic (300m); others under study.

However, amount of assistance (up to US\$ 500 million per country) can be useful for small and some medium size countries, but not large ones.

IDB Response in Social Sector

Overall strategy:

Strengthen or redirect existing loans and prepare new ones in the social sector in the space given by IDB's overall lending limits and country's fiscal space, and in the context of country dialogue.

Policy instruments:

- Employment Retention Programs (training) in formal sector.
- Temporary Employment Programs, with emphasis on poor.
- Intermediation Services for unemployed.
- Strengthen and expand Conditional Cash Transfer Programs.
- Provide budgetary support to protect public spending in key health and educational intermediate inputs.
- Distribution of micronutrients.
- Temporary suspension of user fees.
- Careful monitoring of school attendance, health and employment outcomes.
- Overall expenditures in the context of fiscal constraints.
- Tailor-made to individual country administrative capabilities.

However.....

Social policies to protect the poor and other vulnerable groups must learn from previous experiences to:

- ↓ Ensure that “transitory” measures are credibly transitory, and
- ↓ Avoid perverse incentives, particularly in the labor market, that may increase informality, with negative implications for productivity and medium term growth.



Social and Labor Market Policies for Tumultuous Times



**Confronting the Global Crisis
in Latin America**

In sum, the policy challenge for LAC is very complex:

Social policy needs to be strengthened in a context of fiscal scarcity to protect the vulnerable and, in parallel, to help make prudent economic policies politically sustainable, until the overall world environment becomes less adverse.

In turn, economic policy needs to be facilitated providing LAC countries with sufficient access to international credit to avoid more precarious debt profiles and minimize the risks of liquidity crisis, and support expenditure switching policies (and, when warranted, expenditure increasing policies).

Two critical and urgent tasks:

Find immediate sources of funds to bolster the possibilities of the IDB to act counter-cyclically, with a focus on the social front. This becomes all the more important as the front-loading of disbursements in 2009 may imply an absolute reduction in IDB flows to LAC in 2010, and

Provide the IDB with a capital base commensurate with the medium term development objectives for the Region. This task is equally urgent given the large uncertainty that characterizes the world economy at present, and the possibility that this crisis may persist for some time.

THANK YOU