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Dealing with the crisis: Lessons from Latin America

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This column examines the lessons of Latin America's experience with sudden stops in capital inflows during the 1990s and applies them to the current crisis. While it is most important to be well prepared, today's policy reactions will determine how well countries handle the crisis.

Dealing with an international credit crunch is no easy task, as any policymaker in the world would tell you today! But if you're not a government like the US, which is a safe haven for global savings that can provide billions of dollars to pump into a stimulus package, what's a country to do?

This short note looks at this question from the Latin American point of view. Drawing from research on the region's experience with sudden stops of capital inflows during the 1990s, it reviews lessons learned that may be of use in the present. First, countries must realise that it's not necessarily their fault. A defining characteristic of systemic sudden stops is that they originate in shortcomings in international capital markets rather than in domestic policy failings (see Calvo 1998). However, while the cause may come from abroad, the solutions must often be homegrown. If sudden stops are not handled adequately, the output collapse can be severe and recovery more painful.

In designing a strategy to confront sudden stops and avoid output collapse, several questions come to mind:

- Can emerging countries afford expansive monetary and fiscal policies in times of crisis as proposed by Stiglitz (2002)? Should they instead restore credibility by tightening monetary and fiscal policy, or will these policies only make matters worse as argued by Fischer (1998)?
- To what extent are weak initial macroeconomic conditions an important constraint leading to disaster? Do they put a country on an irreversible path? Are they destiny, or can their impact be mitigated during a crisis?
- Should financial shocks be viewed as temporary or persistent, and what policy options are available?
- And further down the road, what implications does the latent risk of sudden stops have for economic policies during periods of bonanza?

This column draws from a new Inter-American Development Bank book that addresses these questions from different angles, considering lessons from both country studies and cross-country analysis. The book, made in collaboration with an excellent team of researchers, documents policy responses to sudden stop episodes of the late 1990s for eight Latin American countries.[1] It also takes a more systematic approach by analysing the impact of policies on output behaviour for a wider range of emerging markets. Using both sets of information, it provides policy recommendations for countries that might face a sudden stop in the future. As the world teeters on the brink of a major global financial crisis with potentially severe consequences for emerging economies, the issues addressed in this volume are at the forefront of the policy debate.

Be prepared

Expansionary fiscal and monetary policy that does not affect credibility or solvency can reduce the output collapse in the aftermath of a sudden stop. Countries that were able to adopt more flexible fiscal and monetary policies in the aftermath of a financial crisis experienced output losses of less than 5%, while nations with much less flexibility suffered output contractions exceeding 10%. However – crucially – countries need to be able to *afford* these policies

Initial conditions matter – being caught unprepared may seriously limit a country's viable policy responses to a shock. Countercyclical policies succeed during financial crises when governments can boost spending in a sustainable way and conduct looser monetary policy that does not fuel inflation or lead to balance-sheet problems for dollar-denominated debts (in the public or private sectors). There are no good substitutes for being well prepared.

But initial conditions are not destiny – even if they haven't done all their homework, countries still have means at their disposal to weather the storm. A targeted use of international reserves during an international credit crunch – for example, supporting export credit lines – might be a more effective use of available resources than exchange rate market interventions.

Perhaps the clearest lesson from the research is that countries that were able to conduct countercyclical policies were able to withstand crisis better. In turn, the lucky ones that earned the chance of conducting countercyclical policies were those that had previously resisted the temptation of taking comfort in favourable tailwinds and had prepared for a rainy day. Those that did not use the boom years to lay the groundwork for countercyclical policies had much less scope for independent policy actions during the credit crunch.

External assistance

While initial conditions primarily determine the availability of countercyclical policy options in the current crisis, policy reactions remain crucial, especially in countries where there is some room for manoeuvre. The multilateral system can help these governments by boosting their foreign currency reserves and providing financing for governments with a sustainable fiscal position. In other countries, seeking external financial assistance sooner rather than later might prove to be the least costly option.

The persistence of the shock is important in determining whether liquidity issues become solvency problems. The short-lived capital shortage experienced by Latin America in the aftermath of the Mexican peso crisis was much less dangerous than the long capital drought that followed the Russian crisis of 1998. The latter resulted in substantial real exchange rate corrections (needed to abruptly close current account gaps) that put solvency in shambles. Early recognition of the nature of the crisis proved to be very important.

External financial packages are essential when initial conditions don't help. This explains, for example, why Mexico recovered fairly quickly in the aftermath of the Tequila Crisis in 1994, while Argentina's economy collapsed when the IMF withdrew support in November 2001. Argentina's vulnerability made it clear that a protracted sudden stop requiring substantial real exchange rate depreciation almost inevitably called for debt restructuring, given Argentina's substantial dollarized liabilities. However, there is reason to believe that with international support, the restructuring process could have been much more orderly.

Current conditions

Economic conditions in Latin America and the Caribbean have improved since the Russian crisis, giving those countries some leeway, particularly in monetary policy, to implement measures to fight the crisis. Countries have built up $400 billion in international reserves, and they have substantially reduced their dollar-denominated debt, particularly within the banking system. Lower levels of debt dollarisation allowed Brazil, for example, to loosen monetary policy amid the credit crunch in ways that other countries were not able to do in the aftermath of Russian crisis. This time around, several Latin American countries swiftly depreciated their currencies without entering major financial turmoil.

Loose monetary policy typically leads to currency depreciation and an increase in exports that helps ease the economic slowdown. While emerging markets have successfully pursued this strategy in the past, the present downturn in rich nations mean that exports may not be the answer to the current crisis.

On the fiscal front, the picture is less clear. Most of the region's nations built up very little savings during the five-year commodity boom that ended last year, according to Inter-American Development Bank (2008). A simple average of the region's seven biggest economies – Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela – shows that they spent 77% of the extra revenue from the commodity bonanza since 2002. In contrast, Chile spent only 34%, setting aside a considerable part of the increased tax collection into a special fund. Some nations in Latin America will be forced to cut spending in the face of the current crisis because of insufficient savings; for others, the most feasible policy will be to maintain the current level of government spending. Only a few such as Chile are in a position to increase spending.

For multilaterals, the current crisis offers an opportunity to take a different approach than the Russian crisis policies. The prevailing view in 1998 was that emerging nations needed to reassure creditors about the solvency of their economies. As a result, emerging countries around the globe were asked to cut spending and raise interest rates, which deepened the recession. The Inter-American Development Bank study of successful policy responses during past crises suggests multilaterals should follow a selective approach that takes into account each country's initial conditions in order to design tailor-made policies. Countries that have their macroeconomic house in order need not enact strong adjustment policies to signal credibility. However, countries need to be particularly cautious regarding the duration of the current crisis, because large and/or sustained downturns in global economic trends could make fiscal caution a necessary element of any policy-response package.

Footnotes

1 This team includes Paul Castillo Bardález, Márcio G. P. Garcia, Federico Sturzenegger, Ernesto Talvi, and Rodrigo O. Valdés.

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