The Resilience of Latin America to the Crisis

The relevance of savings for economic growth and stability

Growth Based on the Fundamentals

Latin American economies have flourished in the very favourable external environment - strong world growth, high commodity prices and benign financial conditions - prevailing in recent years. In fact, 2008 marked the sixth consecutive year of growth and the end of a period which has very few precedents in the economic history of the region. Real GDP growth averaged nearly 5% per year, with regional per capita output increasing by over 3% on a yearly basis. This growth dynamic induced a sustained expansion in labour demand, social spending and a significant reduction in poverty in the region.

Nevertheless, this strong performance is largely attributed to a substantial improvement in the fundamentals. One of the most remarkable achievements has been the priority granted by policy-makers to keeping macroeconomic balances, and the high degree of social consensus built around this policy. This has helped generate important fiscal savings and current account surpluses. With those savings, several countries reduced their external debt and at the same time central banks increased their reserves and set up special funds both at home and abroad. Some of these countries have even become net creditors.

In addition, the gross investment rate on fixed capital increased continuously from 17% to 22% between 2002 and 2008, financed by an equivalent expansion in gross national savings, as percentage of GDP, mostly generated by domestic corporations. This development confirmed once again the extensive evidence on the positive association between savings, investment and growth.

Economic Crisis is Slowing Growth

These remarkable performances will not be repeated this year, however. The annual growth rate for Latin America and the Caribbean has been recently revised downwards and projected to be around 1.0%. What is surprising is that, in spite of the sharp recession in the U.S. and the decline in commodity prices (nearly 50% since mid-2008), these economies are going to be able to grow at all. Growth in Latin America will come from internal sources, notably consumption, investment and public expenditures.

Although the improvements in fundamentals allow the region to be less vulnerable to adverse external shocks and financial crises, the effects of the present crisis will be transmitted to Latin economies through seven channels:

- Export volumes are naturally falling as a result of reduced world demand;
- Prices of commodities have fallen dramatically and a decline of about 8% in the terms of trade has been predicted for this year by the Economic Commission for Latin America and the Caribbean (ECLAC);
- Remittance flows from migrant workers to the region are also falling;
- Reduced revenues from tourism;
- Expected contraction in foreign direct investment flows (FDI);
- Higher costs of external loans; and
- Reduced availability of international financing.

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Getting Through the Downturn

Yet even as nations await the full impact of the evolving global crisis, Latin America is better placed today to weather the downturn than at any other time in the past half century. These countries have also implemented a wide variety of countercyclical policies to stabilize aggregated internal demand and keep trust in financial markets. In particular, the larger the savings a country has accumulated, the more aggressive it can be on the implementation of its stabilization policies. Countries that have had the capacity and flexibility to implement such policies are the ones that resisted the temptation of taking comfort in times of bonanza and designed policies that accounted for cycles in the international economy, commodity prices and world financial markets. At the same time, however, some nations in Latin America are being forced to cut spending in the face of the current crisis because of their insufficient savings.

Another relative strength has been these countries´ financial systems. Their regulatory structure and oversight have been substantially improved. In addition, the latest available financial indicators continue to point to the overall robustness of banks across the region. Capital remains adequate, in part still reflecting relatively low levels of impaired assets. Meanwhile coverage against potential losses on identified nonperforming loans is sufficient, while banks´ income and profits remain at sound levels. However, some risks are increasing over financial stability prospects in the region given the recent deterioration on asset quality, especially in weaker banks, and because lending by global banks in the region has slowed more than credit from local banks.

Looking ahead

Looking ahead, regional financial institutions face important challenges in the short- and long-run. **To minimize the immediate consequences stemming from the ongoing global crisis, it is critical to improve the banking transmission of monetary policy; allocate available financial savings to those activities and projects with the highest economic and social returns** – preserving, at the same time, an adequate level of credit and market risk in their portfolios; and keep the real value and safety of the resources deposited and trusted to the banks over time. Public institutions have already played an important role in reinforcing the public confidence during the process of "flight to security" and the typical expansion of "precautionary savings" carried out by different economic agents, particularly occurring in turbulent and uncertain times.

At the same time, the regional banks´ actions for the medium- and long-term should be focused on mobilizing domestic savings efficiently to finance development and reduce their countries´ dependence on foreign savings; deepening internal markets via financial inclusion, continuous innovation and the widespread use of electronic means; setting countercyclical loan provisions along the lines adopted in Spain; and, last but not least, by promoting a "savings culture", especially among households and young people.

Finally, it is relevant to underscore that a strong commitment to these strategic objectives and actions will result in more socially-efficient financial systems that progressively contribute to moving Latin American economies towards a faster, more stable and equitable growth path.

José Luis Mardones
Chairman of the WSBI Latin America & Caribbean
Regional Group and President of BancoEstado, Chile