The Crisis: Opportunity for Reform

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A severe financial and economic global crisis is hitting all economies hard, particularly, those of developing countries. They are the first victims when exports decline and demand from industrialised and emerging economies contracts. Although this time Latin America and the Caribbean are not the centre of the crisis, the region is, unfortunately, being severely affected by it.

No De-Coupling

Let me first focus on what many experts characterised as the Latin American de-coupling. Until mid-2008, there was a sense that the region would weather the global crisis relatively unaffected. While the effects of the subprime crisis spread through the industrialised world, things in Latin America and the Caribbean didn't look so bad.

Currencies were strong, the central banks accumulated reserves, levels of direct foreign investments were maintained, growth prospects for 2008 were revised upwards, and Peru and Brazil joined the "investment grade" group of countries. Some central banks, such as Brazil's, equipped with solid monetary policy, addressed inflation by keeping interest rates high.

But, by mid-2008, as the financial crisis went global, the de-coupling theory melted like an iceberg reaching the Florida coast.

- Commodity prices started plunging.
- The region's stock markets fell.
- Currencies depreciated.
- The fall in remittance flows severely affected Mexico, Central America and the Caribbean.
- Households, companies and governments have all started to feel the effects of the credit crunch.

And as a result, regional growth for 2009 is projected at only 2-2.5%, down from an average of close to 5% during the last five years.

2009: Recovery Work

In 2009, Latin America and the Caribbean will be leaving behind a period of growth to begin one of adjustment.

The poor are extremely vulnerable to the potential impacts of this crisis, and it is critical to maintain the social gains of the last few years. In several countries, from Colombia to Chile, poverty went down and in some others, such as Brazil, even inequality trends started to reverse.

But, when a European or Asian importer is unable to purchase the region's raw materials because of the credit crunch, and at the same time the price of exported goods is falling, the result is increased unemployment affecting the most vulnerable groups of society. Moreover, sharply tighter credit conditions and weaker growth are likely to cut into government revenues and governments' ability to invest to meet education, health and other goals.

Significant Challenges

Finance ministries will face significant challenges managing the short-run difficulties of the crisis while also maintaining conditions for long-term growth. With regards to monetary policy, the challenge will be when and how much to ease.

Exchange rate flexibility coupled with deeper local currency debt markets open, at first, space for a counter-cyclical monetary policy. In practice, the room for manoeuvring will not only depend on inflation but also on how much stress the domestic currencies and financial systems are facing. Overall, countries with autonomous central banks and solid fiscal processes are better positioned to face this challenge.

On fiscal policy, the challenge will be to manage the inevitable fall in tax collection (related with the economic downturn and the fall in commodity prices), and to protect key expenditures – education, security and infrastructure – that can prevent an unwanted rise in poverty levels and hinder future growth.

Better Prepared

Countries that entered this crisis in better macroeconomic condition – that is, with low debt burdens, surpluses in their fiscal and external accounts, and large foreign exchange reserves – will obviously have greater room to manoeuvre in terms of flexible spending and prudent borrowing. On this front, Chile is an indisputable leader, with its special fund for commodities.

Along these lines, this is also an opportunity for revisiting the role and size of government and for taking measures to increase economic freedom.

Other areas for action are addressing:

- The decline in trade financing;
- Concerns with short-term corporate debt rollover; and
- Potential banking problems due to declining stock market valuations and loss of credit lines as major banks conserve liquidity.

So what should prudent governments do under these unique circumstances?

First, the region needs to temporarily increase well targeted support to the poor. Once households are pushed below the poverty line or pushed further into poverty, their chances of escape are dramatically reduced. Many countries in the region have well targeted social protection networks, such as Brazil with the *Bolsa Familia*, Mexico with *Oportunidades*, and also other similar programmes in El Salvador, Panama, Jamaica, and Colombia.

These programmes can now be expanded to mitigate some of the worst effects of the economic slowdown that are yet to come. Targeted safety net program can be very efficient and typically cost less than 1% of GDP. The World Bank has actively supported targeted social programmes and today provides over US$2 billion to implement Conditional Cash Transfers initiatives in the region.

Trade Facilitation

Second, the region needs to prepare for the turnaround. Countries that are better able to manage the dangers posed by the crisis, while seizing its opportunities, will be better positioned to resume rapid growth and gain a larger presence in world markets. This means, for example, continued investments in trade facilitation and logistics, as well as, the investment climate for business, including for SMEs.

Third, and for those countries that have the fiscal space, *temporary responsible* increases in expenditures, including infrastructure, can boost domestic demand particularly through public private partnerships. These increases, *however*, must be consistent with sound macro management to avoid inflationary pressures.

Along these lines, Chile's government has announced a US$4 billion stimulus package to increase public spending on infrastructure and tax rebates to sustain GDP growth of 2-3% this year.

Improve Environment

Finally, the effectiveness of governments and institutions will play a crucial role in weathering the storm. Governments can redouble efforts to remove obstacles to growth and create a better business environment by increasing transparency, respecting and strengthening property rights, putting in place a well functioning judiciary, and reducing crime and violence. This is crucial as the private sector is the engine of innovation and productivity – and best placed to create jobs.

Many governments could also take advantage of the present crisis to review their policies on "universal subsidies," which are subsidies that are going not only to the poor, but to others that can do without. Why should the state subsidise water and sanitation, education services, gasoline or electricity for those who can afford it?

With political will, leadership and the crisis, this is the opportunity to overhaul 'free for all' subsidies to a more targeted, temporary system. This could result in substantial savings that could then be used for targeted safety net programmes and economic stimulus. The region annually spends between 5-10% of GDP on subsidies. Approximately 1/3 of this is captured by the top income earning 20% of the population. This would be enough to triple (or more) direct transfer programmes for the poor.

Test of Resilience

To move this agenda forward, the leaders of the region will be tested. 2009 will show how resilient the region's economies are.

Some Latin American and Caribbean governments have adopted and implemented sound macro-economic and fiscal policies which resulted in budget surpluses, increased international reserves and monetary policies that maintained inflation at relatively low levels.

It is precisely during this crisis that the benefits of this sound economic management will surface – cushioning the external shocks and facilitating the resumption of growth once the storm has passed.

The current short-term demands on government will put this resolve to the test. Officials will have to decide among many fiscal priorities and must wisely choose those that both help shelter the most vulnerable and also underpin the recovery. And most importantly, these choices must be consistent with longer term growth strategies.

Private Sector Role

The private sector and its leaders also have an important role in shaping current responses to the crisis, particularly through their policy dialogue with governments.

Their role is also essential to push forward for more market-friendly business regulation, including support enterprise and job creation, as well as other measures to enhance market flexibility and facilitate the reallocation of assets and workers from sectors and firms facing problems to more promising ones.

I am confident that the same strong leadership that made possible the robust growth of the last five years will continue to develop in this critical time.

Crisis: An Opportunity

Turning to the global stage, we must recognise that there will be no solution to this worldwide economic crisis if the point of view and concerns of developing countries are not taken into account.

The G20 leaders meeting in Washington, DC last November agreed that emerging and developing country economies such as Mexico and Brazil, should have a seat at the table together with developed countries, as all are part of the solution. We welcome this initial step toward a new multilateralism.

But your question might be: What is the World Bank Group doing to support developing countries during this unprecedented crisis?

The answer is unambiguous. We are increasing financial support, including lending for middle income countries, grants and concessional lending for low income nations and loans for the private sector through our private sector arm, the International Finance Corporation (IFC).

Lessons from Success

We are also supporting south-south exchanges between developing countries to offer first-hand lessons from countries that have successfully managed similar crisis in the past.

The International Bank for Reconstruction and Development (IBRD) could make new commitments of up to US$100 billion over the next three years. This year, lending could be almost US$35 billon, triple that of last year.

This is especially relevant to Latin America and the Caribbean as the region has usually accounted for 35-40% of total IBRD lending. This fiscal year we are expecting about US$11 billion in new lending programmes for Latin America.

Critical Resources

These additional resources are critical to sustain jobs and social gains, boost ongoing public sector programmes and inject liquidity into countries where needed.

The International Development Association (IDA), the part of the World Bank that helps the world's poorest countries, has a facility in place to speed US$2 billion to the poorest countries to help deal with effects of the crisis. The IFC is committing US$30 billion for private sector support, especially for infrastructure and the financial sector with new facilities that will:

1. Ensure trade flows by doubling the existing IFC Global Trade Finance Program to US$3 billion over a 3-year period and mobilise funds from private sources in the financial markets.

2. IFC will bolster distressed banking systems by launching a global equity fund to recapitalise distressed banks with an investment of US$1 billion over three years, with an additional US$2 billion planned to be provided by Japan.

3. IFC will keep infrastructure projects on track by investing at least US$300 million over three years and mobilising at least US$1.5 billion to provide rollover financing and recapitalise viable private infrastructure projects. For instance, IFC has launched a Public-Private Partnership facility in Brazil to help finance major highway projects.

And finally, IFC is refocusing its advisory services programs to help clients, especially those in financial services, cope with the crisis.

Timing Essential

Timing is essential. The current global financial crisis must not become a human and social crisis. It is therefore imperative to protect the progress made in many Latin America and the Caribbean countries during the last five years.

These difficult times can lead to ad-hoc and counterproductive decisions – particularly in the face of rising pressures for protectionism. On the other hand, this can be a time of opportunity for leaders to change populist practices where they exist and allow citizens to take destiny into their own hands.

The private sector through its leaderships should play a key role in helping create and sustain the conditions in which businesses in the world can compete and prosper for the benefit of all.

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