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Abstract

A year ago, the prospects for Emerging Economies (EE) looked very promising. There were concerns about the effect of a shallow recession in the US, but the general perception was that Asia and, to a large extent, Latin

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America and other regions were doing well. Most thought they had 'decoupled' from the advanced economies, and the emerging markets would grow with few restrictions.

Since then, the financial crisis has become the worst in the last fifty years. The complex and wide-ranging interaction between the financial world and the real economy already has begun to have serious consequences for the emerging economies. Whereas the conditions in the financial markets have tended to stabilise from the unsustainable position of September–October of 2008, the real economy is weakening and the prospects for an early recovery are remote. Commodity prices have declined by about one half from their peak; demand for manufactured goods is declining sharply all over the world; stock market valuations have declined by about one half or more; and currencies in many emerging countries have depreciated, as capital flows reversed seeking to find a safe heaven. The loss of financial wealth is enormous. The authorities and economic agents were initially taken by surprise by the collapse. Now they are responding to the challenges caused by the rapidly deteriorating external environment. However, there are serious economic and political stumbling blocks that may well cause the recovery to be costly and slow to consolidate.

This article reviews the origins of the current crisis in emerging market economies, mainly in Asia and Latin America in the context of the global crisis. It reviews the recent developments on a worldwide basis and how they affected them, even after the process of consolidation observed over the last 10 years or so, including the integration with the rest of the world. The article also discusses what can be realistically expected as financial volatility and recessionary forces may continue to prevail for a while.

I. Introduction

A year ago, the prospects for Emerging Economies (EE) looked very promising. There were concerns about the effect of a shallow recession in the US, but the general perception was that Asia and, to a large extent Latin America and other regions were doing well. In a wishful way, most thought that they had 'decoupled' from the advanced economies and wealth would grow with few restrictions.

Surely, policies had been conducive to significant improvements in fiscal and external balances, with a few exceptions, and international reserves were at record levels. Policymakers felt comfortable. Commodity prices were expected to continue to rise, foreign demand, including among EE, was strong and there was no serious worry about financing as creditworthiness was solid. Problems were hitting only the US and a few other developed countries.

Since then, the financial crisis from which the world is suffering has probably become the worst in the last 50 years. Some analysts consider that its intensity is equivalent to that of the Great Depression of 1929–33. That crisis was the worst of modern times, and reflected previous excesses and subsequent incompetence. Although the comparison with the Great Depression is an exaggeration unjustified by the facts, the damage caused to the world economy is enormous. The complex and wide-ranging interaction between the financial world and the real economy as a result of the present turbulence has already begun to have serious consequences for the EE and the prospects for a fast recovery appear more remote by the day.

Whereas the conditions in the financial markets have tended to stabilise from the unsustainable position of September–October of 2008, the real economy is weakening and the prospects for a recovery can only be envisaged for late 2009 or early 2010. In different ways, Asian and Latin American countries were initially able to absorb the initial impact of the crisis on account of their considerable progress in recent years in consolidating economic performance. Nevertheless, these countries are now facing mounting difficulties. The difficulties seem even greater in Eastern Europe and Russia, as they were even more dependent on credit and high export prices respectively.

The previous sense of strength and invulnerability is now gone. Commodity prices have declined by about one half from their peak; demand for manufactured goods is declining sharply all over the world; stock market valuations have declined by about one half or more; and currencies in many emerging countries have depreciated, as capital flows reversed, seeking to find a safe haven. Governments were reasonably careful with their policies, but private enterprises held 'toxic' assets to an unexpectedly large extent, with serious effects for their own financial health as well as that of their countries. The loss of financial wealth is enormous and the consequences for the economies of the world will unfortunately be commensurate.

The authorities and economic agents were initially taken by surprise by the collapse. Now they are responding to the challenges caused by the rapidly deteriorating external environment. However, there are serious economic and political stumbling blocks that may well cause the recovery to be costly and slow to consolidate.

This article reviews the origins of the current crisis in emerging market economies, mainly in Asia and Latin America in the context of the global crisis. For this purpose it reviews the recent developments on a worldwide basis and how they affected the economies, even after the process of consolidation observed over the last 10 years or so, including the integration of the region with the rest of the world. The article also discusses what can be realistically expected as financial volatility and recessionary forces may continue to prevail for a while.

II. Recent Evolution of the World Economic Environment

Over the last decade, Asian countries were able to emerge from the serious crisis that had brought many of them down in the late 90s. Helped by the consistent growth of China, and to an increasing extent India, the Asian region witnessed a stellar performance. Concurrently, after a period of low economic growth, persistent crises and high volatility that extended through the 1990s, Latin America made a very strong recovery. Inflation declined, the fiscal accounts and monetary policy showed great strength, international trade boomed, poverty declined and the external accounts were much sounder than they had been in decades.

Within this overall positive picture, not all countries acted in a similarly prudent fashion. The limited initial impact of the financial crisis gave rise to a false sense of security that has now disappeared. The crisis is now in the open, as the impact on the balance of payments and on domestic activity becomes very serious. The adverse terms of trade effect will aggravate the situation, compounded by a massive loss in financial wealth.

Economic growth in 2009 may decline by half among developing and emerging economies (Table 1). It is likely to be negative in Latin America, with a sharp recession among the newly industrialised countries of Asia (NICs) and much lower growth rates, even though still in the order of 4–5 per cent in Emerging Asia, mainly on account of the resiliency of China, and to a lesser extent India. Of course, this is shocking for all the regions that had experienced very strong growth from 2002 onward. Under these conditions, policy makers will need to find a balance between the needs of economic stimulus and of financial stability.

In order to understand fully the current situation for developing countries, it is useful to review the major developments at the international global level. As appropriately described by the World Economic Outlook (WEO) of October 2008, and updated in November and January 2009 (IMF 2008a, 2008b, 2009), the

Table 1: Selected Countries: GDP growth and Inflation: 2002–09

	GDP(%, Annual)			*Inflation (%, Annual)*		
	2002–07	*Est. 2008*	*Proj. 2009*	*2002–07*	*Est. 2008*	*Proj. 2009*
Argentina	5.6	6.6	–2.5	11.9	25.0	25.0
Brazil	3.2	5.1	–.5	7.3	6.3	4.5
Chile	4.5	4	1.0	3.3	8.5	5.0
Colombia	5.0	4	–1.0	5.7	8.0	5.0
Dominican Rep.	5.7	4.7	–1.0	16.7	14.0	8.0
Ecuador	4.2	2.5	–3.0	4.3	9.0	4.0
México	2.9	1.6	–2.0	4.4	5.7	3.0
Perú	6.0	9.2	2.0	2.3	5.5	3.5
Uruguay	4.0	6	–1.0	10.5	7.0	6.5
Venezuela	4.7	5.5	–3.0	22.0	32.0	35.0
Latin America	3.8	3.8	–1.0	7.1	8.5	6.5
NICs	5.1	2.1	–3.9	5.1	4.0	3.2
China	10.5	9.0	6.7	2.5	4.5	5.5
India	7.9	7.3	5.1	4.8	9.2	5.1
Asean 5	5.7	5.4	2.7	5.7	9.6	7.2
Developing Asia (ex. NICs)	8.8	7.8	5.5	4.0	7.4	6.2
Emerging and Dev. Economies	6.9	6.3	3.3	6.2	9.3	6.2

Sources: IMF and Author's estimates.
Note: NICs: Hong-Kong, China, Prov. of Taiwan, Singapore, Rep. of Korea.

world economy has decelerated rapidly, as it confronts the most violent shock experienced by the financial markets since the Great Depression of the 1930s. Global growth slowed substantially in 2008, and a recession is already in place in the US, Europe and Japan while, as noted above, growth in the EE has come down sharply as well.

As discussed in more detail below, recovery is expected at best for late 2009 or early 2010. Inflation, which was very high in the earlier part of last year, driven by a surge in commodity prices, has moderated. However, the sharp depreciation of currencies like the Euro, and to a greater extent the Pound Sterling as well as many in Asia and Latin America, have offset this effect. The WEO notes that the situation is exceptionally uncertain and subject to considerable downside risks. Prospects for global growth have deteriorated, as financial sectors are shrinking and producer and consumer confidence have fallen, with a direct impact on economic activity.

Genesis of the Present Financial and Economic Crisis

The reasons for the current crisis are complex and are linked to the financial market deterioration of the last 20 months or so, after a period of extraordinary growth fraught with dangers that were not anticipated by most even a few months ago. As noted in the WEO, for four years through the summer of 2007, the global economy boomed. Global GDP rose at an average of about 5 per cent a year, its highest sustained rate since the early 1970s. About three–fourths of this growth was attributable to a broad-based surge in the emerging and developing economies. Inflation remained generally contained, even if with some upward pressures.

These developments led to the perception that the world economy was entering a new and prosperous stage, which, using an abused phrase, entailed a new economic paradigm. The value of financial and real assets was growing without a perceptible limit and commodities had reached new and sustainable heights. Concurrently, the value of financial assets rose sharply, as described in further detail later in the article. The most important factor behind the increasing imbalances was the emergence of growing imbalances among the main economies of the world. The US, with low rates of savings, embarked on a consumption binge and faced a growing fiscal deficit, as well as growing external current account deficits. These were financed by the surpluses of oil producing countries, China, Japan, and to a lesser extent Europe and Latin America. These imbalances grew rapidly, but markets did not respond significantly before 2007. However, the US Dollar started to weaken in international markets and there were growing signs of impending problems. As stated very precisely by Jack Boorman (2009), these trends were further complicated by an increasingly integrated global trading and financial system which magnified and accelerated the transmission process; inadequate regulation and supervision of national financial systems and fragmentation of global regulation; weak surveillance by the IMF and other multilateral organisations; and aggravated by weak and uncoordinated policy responses to the initial signs of trouble in the financial system—responses that, as noted subsequently, in many instances did more to shake confidence than to instill a sense that policy was up to the task of dealing with the banking system crisis and the impact on the real economy (Boorman 2009).

Global Transmission of the Crisis

The financial crisis that erupted in August 2007 after the collapse of the US subprime mortgage market entered a tumultuous new phase in September 2008. These developments badly shook confidence in global financial institutions and markets. Most dramatically, intensifying solvency concerns triggered a cascading series of bankruptcies, forced mergers and public interventions in the US and Western Europe, which eventually resulted in a drastic reshaping of the financial landscape.

When the real estate bubble burst in the US and Europe (the UK and Spain come to mind), investors moved to commodities, where experts expected a continuous increase in prices. The commodity bubble peaked in mid 2008, with a subsequent collapse that only decelerated by the end of the year. In the second half of the year commodity prices declined by some 45 per cent; losses were particularly large in the case of metals and oil (Figure 1).

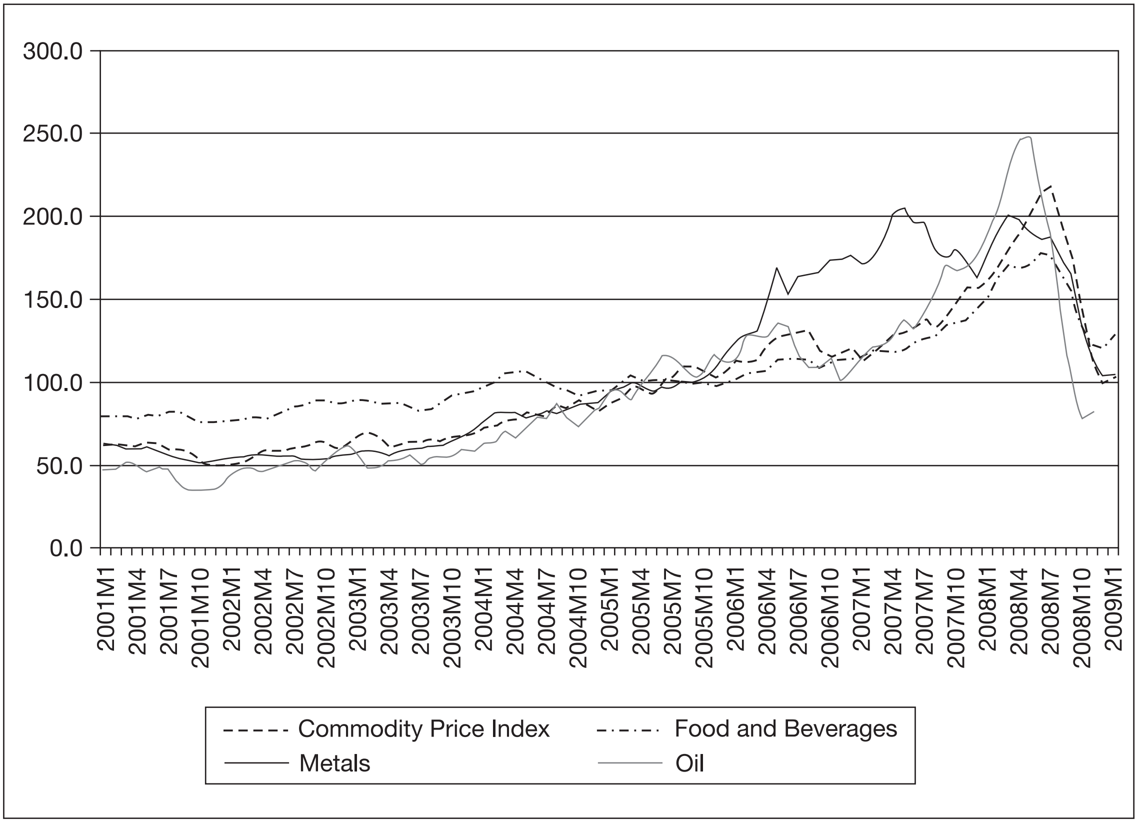
Dramatic Loss of Global Wealth

The loss of capital valuation of financial assets worldwide may have reached well over USD 50 trillion. This loss in the capital stock has been very significant, as it amounts to the equivalent of about one year of world GDP. The decline reflects the reduced capitalisation of stock markets, loss in the value of bonds supported by mortgages and other assets and the depreciation of many currencies with respect to the US Dollar, on account of a surprising run toward the US currency, and its perception as a safe-haven currency. Table 6 provides an estimate of the losses in capital stock valuation for Latin America and Developing Asia in 2008.

Consequent Liquidity Crisis

Interbank markets virtually locked up in the fourth quarter of 2008, as trust in contractual counterparties evaporated. In September, the disintermediation process that had been observed for at least a year led to the worst liquidity crisis of the last 30 years, or perhaps since the great depression of 1929. The closing of the venerable Lehman Brothers, which did not get official support, aggravated the panic in the financial

Figure 1: Evolution of Commodity Prices (2005 = 100)



Source: IMF (Commodity Prices) and Author's Estimates.

markets, as doubts increased about the stability of the domestic and international payments system.[1] The cost of intermediation rose rapidly between financial organisations, together with the fall, or more precisely, a generalised paralysis, in the transactions between them.[2]

In order to respond to this situation, the authorities of many countries, particularly the European Union and the US, adopted extraordinary measures to stabilise the markets, by providing liquidity and other financial support on a massive scale, extending deposit guarantees and adopting legislations whereby public funds are used to support problematic assets of banks. In the case of the US it was done through the TARP (Troubled Asset Relief Program), with further actions taken in February 2009 by the new US administration regarding a stimulus to the US economy, but with only general statements about the financial system at the time of writing this article.

Similar actions have been announced in other major countries, including programmes of bank acquisitions in the UK and (initially poorly coordinated) actions within the Euro zone and in other European Union member nations and elsewhere. As described below in more detail, actions were also taken in Latin America and Asia.

International Response

The national rescue operations have been followed by major swap transactions between the Federal Reserve of the US and a number of other Central Banks of industrialised economies, in order to provide sufficient liquidity in response to a steady demand for US Dollars. More recently, this was extended to the Central Banks of Brazil, Korea, Mexico and Singapore, again to support the currencies of those countries in the face of continued pressures in foreign exchange markets at least through end–2008.

With high financing requirements, access to the International Financial Institutions (IFIs) has also become imperative. The IMF has already indicated that it will show greater lending flexibility and it can mobilise significant resources. In the past, any borrowing had to be based on what was seen as burdensome conditions. The IMF will now provide assistance on the basis of fewer conditions for countries seen as generally good performers. The conditions would be fewer and more targeted than in the past.[3]

The creation of the G-20 Summits is another noteworthy development. It follows a group formed in the 1990s to discuss international financial issues, at the ministerial level. Up to now, many decisions had been taken at the level of the G-7/G-8, the important group formed by the largest advanced economies and Russia. The G-20 includes the G-8 and the largest emerging, newly industrialised economies, including China, India, Korea, South Africa and in Latin America, Brazil, Mexico and Argentina. This forum reflects better the growing importance of the emerging world and may also open the door to a more representative governance system at the IFIs. However, over-represented Europe and others will need to accept the realities of the new world and shift their voting power to the 'new' countries and make IFIs more relevant.

Inflationary Pressures

By now, inflation, a major concern less than a year ago, has subsided. A combination of the surge in food and fuel prices and tightening capacity constraints had propelled inflation to rates not seen in a decade. Consumer price rises were particularly strong in emerging and developing economies. This acceleration reflected the high weight of food in consumption baskets, still-quite-rapid growth and strong inflationary expectations. Notably, countries that adopted inflation-targeting regimes generally fared better. In the advanced economies, oil price increases had pushed up headline inflation, but underlying inflation pressures were contained. In fact, concerns about inflation have now changed towards a greater preoccupation with creeping deflation, in response to the decline in commodity prices and sharply declining world aggregate demand.

Medium Term Prospects

While dramatic and painful, the recent deterioration of the global economic performance follows a sustained expansion built on the increasing integration of emerging and developing economies into the global economy that is unlikely to unwind. Over the last quarter century, trade in goods and services, remittances and capital flows to and among emerging regions have risen significantly. Without question, their economic and trade growth have constituted the most dynamic aspect of globalisation in recent years. The current crisis may slow down this process but it is unlikely that a recovery will take more than two to three years.

- *Developments in Trade of Goods and Services*

As part of the significant slowdown/decline in world activity, trade volumes are expected to decline for the first time in many years—as a minimum by 3 per cent according to IMF estimates. The impact will be very different in various areas of the world. Over the last quarter century the volume of world trade had grown at an average rate of 6 per cent, or about double the rate of world output. Asian exports have grown at a rate of 10 per cent and those of Latin America and the Caribbean by some 7 per cent, with a marked transformational impact.

The NICs, which have become highly integrated with the rest of the world, recorded an average ratio of exports to GDP of 71 per cent for the period 2002–07. Developing Asia recorded a ratio of 55 per cent, tempered by the much lower but growing ratios for China (31 per cent) and India (12 per cent), which were clearly dominated by domestic developments. In Asia the ratio of exports to GDP reflected increased volumes of trade, but to some extent also showed some real depreciation of their currencies. Latin America which had become much more open in the 1990s, registered a stable ratio of exports to GDP of 21 per cent notwithstanding the impact of a strong real appreciation, as export volumes increased significantly over the period.

Under these conditions, it would be easy to suggest that the countries that have been most open to international trade may be subject to the greatest shock on account of reduced world demand, thus justifying protectionism. However this should be viewed in a broader light. Countries that opened more vigorously to trade grew the fastest and benefited more from global prosperity. It may be the case that they will experience a significant short term loss, as is being observed in the Taiwan Province and in Korea. But this is taking place from the vantage point of much higher gains in the past, and with the understanding that the losses, even if large, will be temporary. More significantly, the more open traders may benefit from a more flexible productive structure that allows them to adjust more efficiently. More closed economies, adjusted for their size,[4] may be much more dependent on a few commodities and thus will have more difficulty in correcting possible imbalances as their domestic economies may find a lower productive base to provide for their imports.

- *Remittances and Tourism*

Two other areas that can be expected to show the impact of the slowdown are remittances and services, like tourism. Remittances over the last fifteen years have become a major channel of prosperity. The merits of increased mobility of large numbers of workers to well-paying jobs in prosperous destinations may be subject to debate. However, the impact of the consequent remittances to their home countries has helped increase prosperity and reduce poverty, particularly in Asia and Latin America—India, Mexico and the Philippines being the largest recipients of workers' remittances. Remittances amounted to some USD 280 billion in 2008 (some 2 per cent of GDP of the receiving countries), with near USD 110 billion to Asia and USD 70 billion to Latin America. These flows have been very stable and have acted as a countercyclical force in the receiving countries (Loser 2006). However, they are highly sensitive to economic conditions in the countries of employment. With many emigrants working in the US, Europe and the Middle East, remittances started to fall in 2008, for the first time in a quarter century. The prospects for 2009 are equally dire, with adverse consequences for the well being of many millions of households among developing countries.

Tourism is another area of concern. Receipts from tourists are also a significant source of income, particularly for Thailand, Maldives, India and some other countries in South and South East Asia and Mexico, Central America and the Caribbean and some countries in South America. Even though transportation costs are declining, tourism from the richer countries has fallen and will continue to do so. With emerging economies, arguably the most dynamic segment of international tourism, also entering into recession, the prospects for this segment of economic activity look particularly grim for the near future.

- *Foreign Direct Investment*

Foreign Direct Investment (FDI) will also suffer in the short run. FDI stocks and flows grew at a very fast rate in recent years, reflecting both the emergence of new countries as origin and destination of capital flows, and the rapidly evolving capital markets. This allowed for a sharp increase in available capital within the private sector, resulting in a decline in lending by IFIs. Most interesting was the change in the composition of these flows. While FDI directed to developed countries retained the lion's share of the total inflows (70 pre cent of the total), both Asia and Latin America became increasingly important, even with some volatility in the case of Latin America (Table 2). Also, the countries of the Commonwealth of Socialist Independent States (CSIS) and of Eastern and Central Europe began to receive increasing flows (UNCTAD 2006, 2007; Loser 2008a). As an illustration of the size of inflows and outflows, Table 2 presents the cumulative inflows and outflows of FDI and portfolio investments

Table 2: Foreign Direct Investment: Recipient Regions Stocks (USD Billions)

	1980	*1990*	*2000*	*2006*
	551	1779	5810	11999
Developed economies	411	1414	4031	8454
Share in total	75	80	69	71
Developing economies	140	365	1708	3156
Share in total of which:	26	21	29	26
Latin America and the Caribbean	35	105	481	909
Share in total	6	6	8	8
South, East and South-East Asia	50	152	1000	1684
Share in total	9	9	17	14
World FDI stock (real terms) 1/	859	2388	7948	11999
Capital Flows (US$ billion; 1998–07) 2/	Dev Asia	LATAM		
FDI Inflows	841	728		
FDI Outflows	–151	–142		
Portfolio Inflows	127	170		
Portfolio Outflows	–102	–103		

Source: UNCTAD, 2007; Centennial Database and Author's estimates.
Note: 1/ Adjusted by world export prices .
2/2007 values for Asia are estimates.

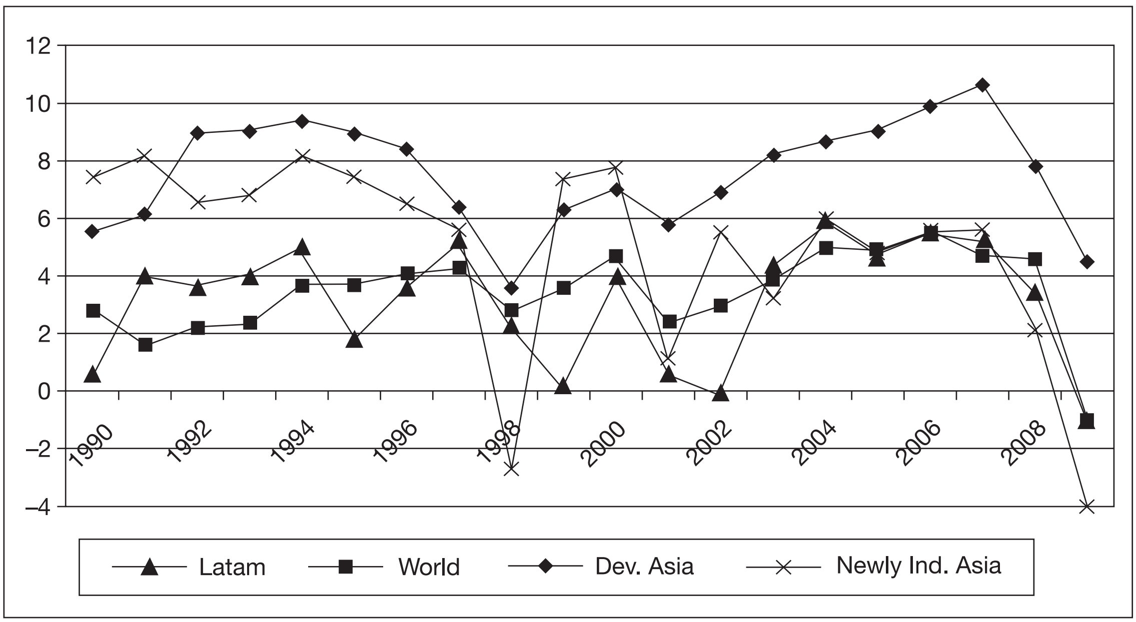
for Developing Asia and Latin America for the period 1998–2007. The information is particularly interesting as it shows the large sums of capital outflows from EE, as they became increasingly important investors, as opposed to the previous experience when these outflows reflected capital flight.

By early 2008 capital flows to developing countries had started to slow down and these flows fell sharply in the second half of the year reflecting the financial crisis. In the end, cumulative flows for the year were only about one half of those registered in 2007, with sharp declines both in Asia and Latin America. The Institute of International Finance estimates that net private flows to emerging economies declined from a record USD 930 billion in 2007, to below USD 470 billion in 2008 and to projected flows of only USD 165 billion in 2009. Net flows are projected to decline by 80 per cent from their 2007 peak for Emerging Asia, and by 75 per cent for Latin America. This will complicate economic management, as countries deal with weakening external accounts (IIF 2009).

III. The Conditions in Asia and Latin America Prior to the Crisis

As noted, to a different degree and until very recently, Emerging Asia and Latin America had not reacted in response to the international turbulence. The authorities viewed their continued growth as a clear signal of a new resiliency (Figure 2). Without seeking to over-generalise, these were the broad developments that may explain the perceived resiliency (Loser 2008 b):

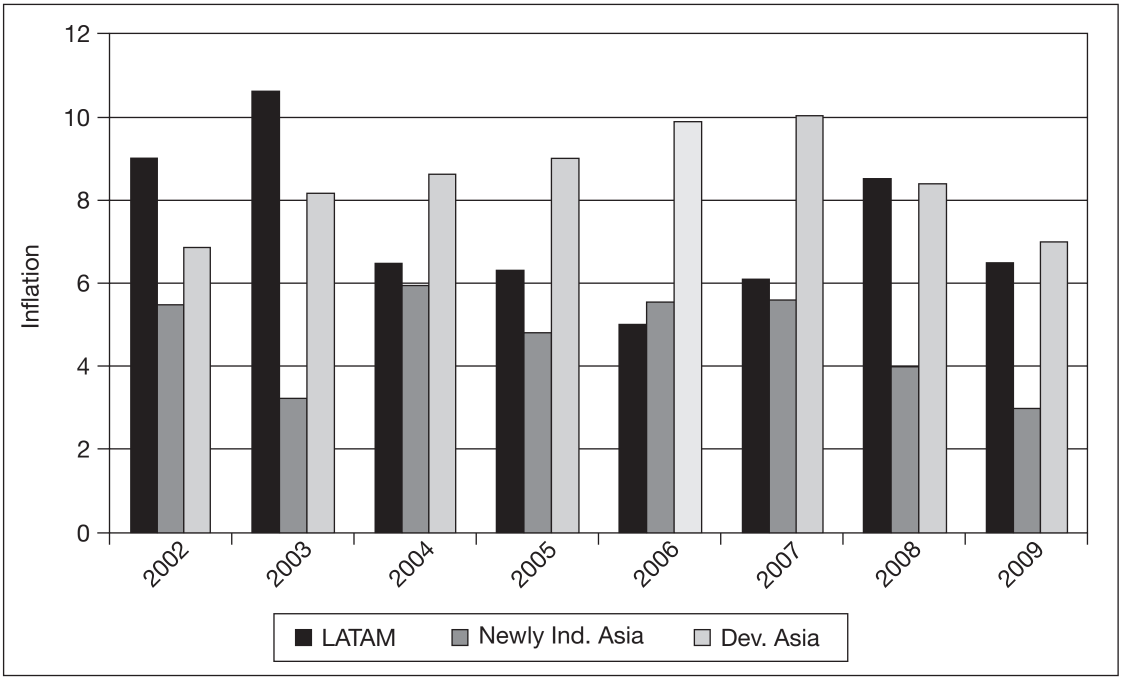
Figure 2: Growth of GDP in Developing Asia, Latin America and the World (Annual Per cent)



Source: IMF; ECLAC and Author's estimates.

- Latin America was characterised until very recently by high volatility and about the lowest overall growth rate of any emerging region, but in the last five years there has been an acceleration of growth, helped by the favourable conditions in the world, with sharp reductions in poverty. Growth in Asia has persisted for more than two decades, with the exception of the traumatic 'Asian Crisis' period, but with a high and steady performance subsequently. Strides in terms of alleviation of poverty and in quality of life have been impressive.
- Before the 1990s, Latin America had been the worst performer with regards to inflation, but now they have converged, although not fully, with world inflation, helped by their efforts to control both monetary and fiscal policy (Figure 3). Developing Asia has been less successful in reducing inflation, but in most cases has not experienced hyperinflation. Monetary policy was generally prudent, particularly after the Asian Crisis, and fiscal policies helped reduce public debt. The NICs had low inflation and generally good fiscal policies as well.
- Both regions have seen an increasing role of international trade and FDI. Latin America has reduced its trade barriers, which had been very high in the past. However, to a large extent, trade and investment has focused on natural resources and commodities (Loser 2008a). In Asia, with considerably more differences, there was also an emphasis on natural resources in South and South East Asia. However, a major process of incorporation of an excluded workforce in China and India, a complex process of

Figure 3: Inflation (in per cent)



Source: WEO, IMF, ECLAC, and Author's estimates.

industrialisation and a rapid integration in the productive process helped create a sophisticated and highly integrated production process.

- There was a sharp reduction in the previously high dependence on private capital flows, while international reserves rose to record levels throughout the emerging world and the debt burden was reduced. These trends have been strengthened by growing workers' remittances to Asia and Latin America.
- To a large extent, many of the changes described above were the result of the efforts in the 1990s by many countries engaged in market-friendly reforms, including on taxation, public finances, financial sector, trade, privatisation and the labour market. The favourable impact of these policies was dramatic, even though certain countries went through major crises on account of individual or regional circumstances (The 'Asian Crisis', Argentina, Brazil and Mexico come to mind).[5]

Under these circumstances, with improved productivity, and in the case of Asia ample markets and large supplies of unskilled and increasingly skilled labour, both Asia and Latin America became attractive destinations for FDI, as investors saw an opportunity to share in the new regional prosperity.[6] Moreover, countries like Brazil, China, India and Mexico have become key players in the international cooperation dialogue.

IV. The Impact of the Crisis on Emerging Economies

As described earlier, the beginning of 2008 augured a period of robust growth for emerging economies. Even though a deceleration was expected in growth for most emerging economies for 2008, the expectations by the end of 2007 were that the GDP would grow by some 7.5 per cent, and 9 per cent for Developing Asia and 4.5 per cent for Latin America. Inflation was expected not to exceed 5.5 per cent.

After the onset of the present international crisis, circumstances have changed compared with the previous projections and perceptions that emerging markets economies had become delinked from events in the developed world. Although output growth was helped by the favourable conditions at the beginning of the year, growth is estimated to have been below 6.5 per cent, one percentage point under the average for the previous six years. Growth in Asia was 7.8 per cent, also one percent below the previous six years, while growth in Latin America, was 3.8 per cent, in line with period 2003–07 but well below the previous five years.

After reaching significant lows, particularly in Latin America, inflation rose in 2007 in line with commodity prices and almost reached 10 per cent, with higher levels of inflation in Asia than in Latin America. Eventually, inflation decelerated in 2008 as price pressures receded towards the end of the year, but still remained high at 9 per cent—reaching over 7 per cent in Asia and more than 8 per cent in Latin America. During the first part of 2008, high inflation reflected the increase in world demand. In the second half, as these trends reversed, many countries experienced major currency devaluations, thus precluding a decline in local prices, on account of lower commodity prices in international markets.

Medium Term Prospects for Asia and Latin American Economies

According to most recent projections, GDP growth in 2009 can fall by some five percentage points, to –1 per cent in 2009 in Latin America, and by 3–3.5 percentage points in Asia, and there only because of the resiliency of China and India. NICs are very likely to experience a serious recession as their exports are being hit markedly by the world crisis. A decline is expected in the rate of inflation from the peak observed in 2007–08. Overall price increases may average 2–3 percentage points lower than the previous year at about 6.5 to 7 per cent, but as usual with wide country dispersion. (See Table 1)

The fall of activity in the advanced economies will be aggravated by the expected volatility in financial markets, with a direct effect on the demand for goods and services. The fall in commodity prices has resulted in a sharp decline in export receipts for Latin America and parts of Asia, as these regions continue to be highly dependent on exports of raw materials, even as some Asian countries are expected to benefit from lower prices. However, the decline in international demand will hit them hard.

These events could have serious adverse effects on the balance of payments. Specifically, the terms of trade loss for Latin America could amount to 2–3 per cent of GDP in 2009. (Table 3 provides an estimate of the terms of trade effect for Latin America and for Asia).[7]

Table 3: Asia and Latin America: Terms of Trade Effects (US$ Billion, Unless Otherwise Specified)

	2007	*2008 Est.*	*2009 Proj.*
Latin America			
Commodity trade balance 1/	210.52	237.4	149.2
Terms of Trade Effect 2/		26.8	–88.2
as percent of GDP		0.7	–2.4
Dev. Asia and NICs			
Commodity trade balance 1/	46.38	96.9	60.9
Terms of Trade Effect 2/		50.5	–36.0
as percent of GDP		0.6	–0.4
Terms of Trade Index (2005 = 100) 3/	135	175	110

Source: IMF, Directions of Trade, and Commodity Prices, UNCTAD, and Author's estimates.

Notes: 1/Balance of exports and imports of raw materials and commodities. Based on UNCTAD data base (2006) for commodity composition, and IMF, Directions of Trade for overall trends.

2/ Terms of trade effect is calculated on the basis of 2006 composition and movements in overall trade data for 2008, and on the basis of projected terms of trade effect for 2009.

3/ Estimated on the basis of a weight of 50% for energy and 50% for other raw material.

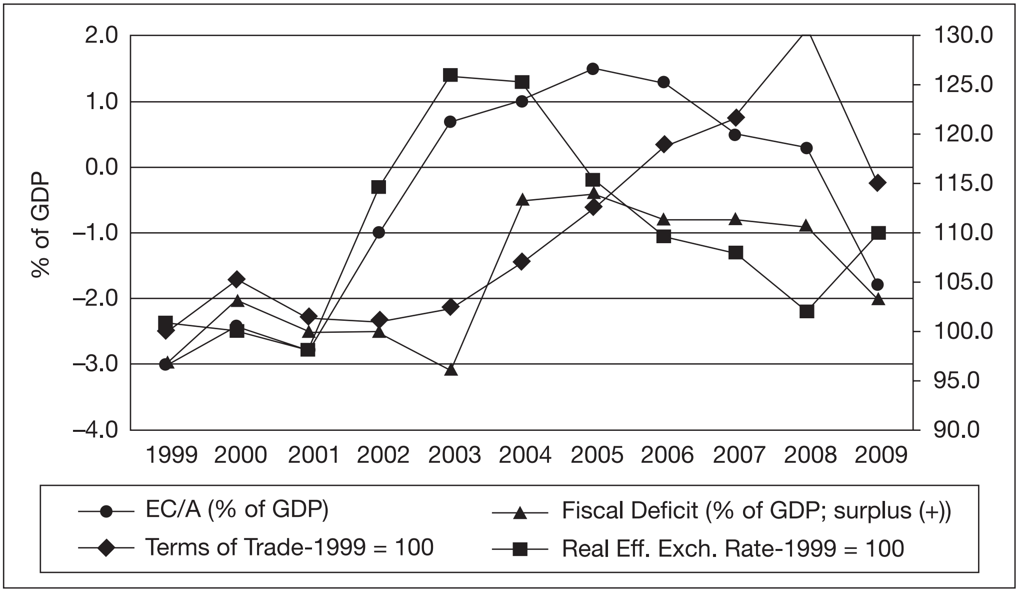
The external current account of Latin America can deteriorate by 2 per cent of GDP between 2008 and 2009, and record a deficit for the first time since 2002 (Figure 4(a)). The current account had moved to a surplus that year, thanks to fiscal adjustment and a strong devaluation, but had weakened subsequently. The impact on tax revenue will decline on this account, with adverse effects on the fiscal outcome.

In the case of Asia, developments are somewhat more complex. Because of the trade composition of developing and emerging Asia, the impact of lower export prices is minimal, although there is a significant divergence among countries. However, the expected impact of the recession on exports can also be estimated to be the equivalent of 2 per cent of GDP. This will be translated into a significant decline in imports, thus reducing the impact on the external current account, which may only weaken by 1 per cent of GDP. The fiscal accounts may also weaken, but from a position of strength achieved through hard work over recent years (Figure 4(b)). The effect of the recession on the NICs will be worse, as it is expected that current account balance could deteriorate by 3 per cent, again starting from a very strong initial position, as is the case with the fiscal accounts (Figure 4(c)).

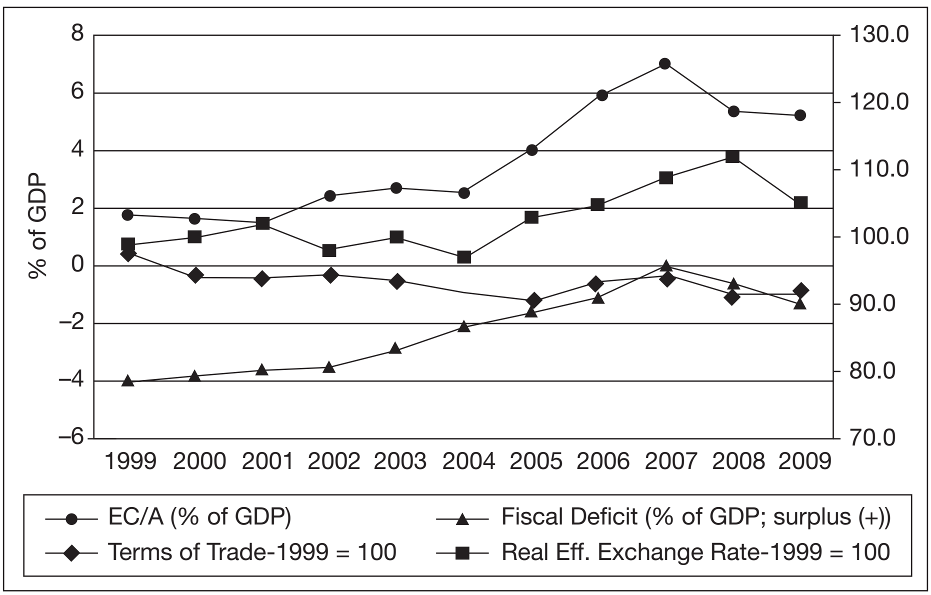
To some extent, the adverse effect on the balance of payments and the public accounts will be mitigated by the strong devaluation that has been observed since mid 2008, particularly in Latin America. After an appreciation of many currencies of approximately 20 per cent in real effective terms,[8] there was a subsequent

Figure 4 (a): External Current Account, Fiscal Balance, Exchange Rates and Terms of Trade

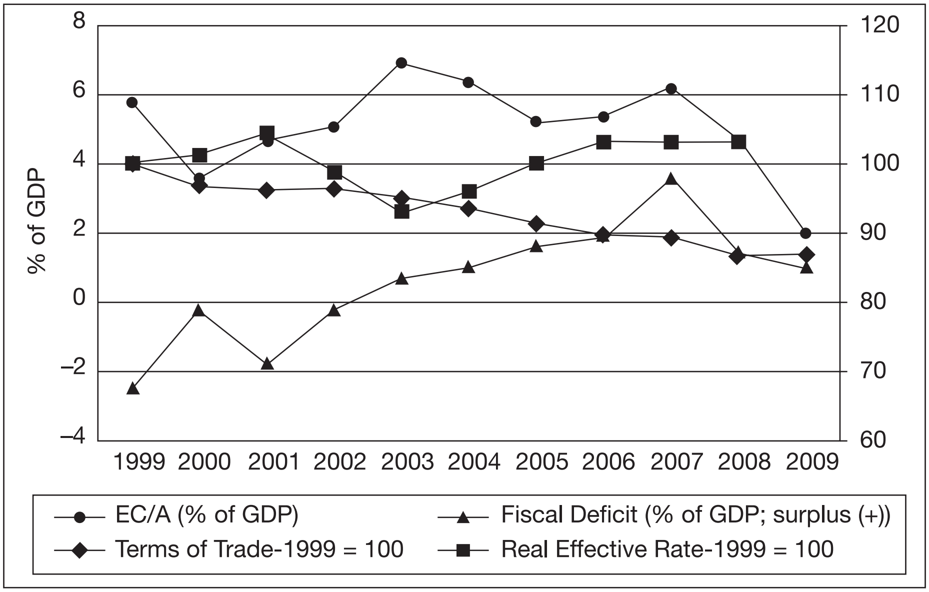
Latin America



(b) Developing and Emerging



(c) Newly Industrialised Asian Countries



devaluation. In relation to the US Dollar, the devaluation in the six months to end-2008 was of the order of 45 per cent in Brazil, 35 per cent in Mexico and 14 per cent in Argentina (Table 4). In Asia, where the real exchange rate had appreciated less during the period of the boom (15 per cent for Developing Asia, and about 10 per cent for the NICs), the depreciation has been much smaller, ranging from virtually no change in China, 12 per cent in India and 20 per cent in Korea. The devaluations were in part the consequence of the strengthening of the US currency with respect to the most important currencies of the world, but also of a decline in the worldwide demand for Asian and Latin American exports, and strong negative pressures in the financial markets of the region.

Impact on Financial Systems

The impact that the crisis has had in the local financial markets can be viewed from different points of view, but fundamentally in terms of the valuation of companies, particularly those being quoted in stock markets, the investments by some economic agents in toxic assets, the general conditions of the banking system in the region and problems of external financing.

The stock markets have experienced a sharp fall that has exceeded that of the stock markets in the advanced countries. The fall was particularly strong from midyear, in contrast with what happened in the US and Europe, where the reduction began in the middle of 2007. For example, the S&P 500 index of the US fell by 36 per cent from June to end–2008 and the Japan Nikkei index fell by 36 per cent. The stock market index in Brazil fell by 49 per cent, and in Mexico, the other key Latin stock market, the valuation fell by

Table 4: Selected Countries—Stock Market and Exchange Rate Changes

	Stock Market Changes June–December 2008 (%)		*Exchange Rate Changes June–December 2008 (Appreciation (+); %)*	
Argentina	–51	A.	B.	14
Brazil	–49	C.	D.	45
Chile	–23	E.	F.	27
Colombia	–25	G.	H.	28
Mexico	–29	I.	J.	35
China	–48	K.	L.	1
Hong-Kong	–40	M.	N.	1
India	–41	O.	P.	–13
South Korea	–36	Q.	R.	–20
Japan	–36	S.	T.	18
Euro Area	–37	U.	V.	–11
USA(S&P 500)	–36	W.	X.	—

Sources: Bloomberg, market data, and Author's estimates.

29 per cent. Among Asian countries, the stock market valuation declined by 36 per cent in Korea, 41 per cent in India, and 48 per cent in China (Table 4), reflecting the wide-ranging effect of the world financial crisis.

Initially, it was thought that because of the characteristics of the developing financial markets, there would be no significant presence of 'toxic' financial assets. Nevertheless, in many of the markets, including in Korea, India and China in Asia and Brazil and Mexico in Latin America, companies had invested in derivatives, particularly regarding foreign exchange risk, and to a lesser extent, commodities. The fall in international prices and the devaluation of local currencies had an important impact on the finances of these companies and therefore their share values suffered, generating strong pressures on the exchange market.

There has been some improvement from the trough in the fourth quarter of 2008 and conditions may improve because of the fiscal and monetary actions of the authorities (See section VI). Nevertheless, the financial markets remain volatile, generating considerable uncertainty about the capacity of Latin America and to a lesser extent Asia, to renew their debt, even though this is far less problematic than in the past. However, the perceived risk of investments has resulted in a sharp increase in risk premiums, with particularly marked increases for Argentina, Ecuador and Venezuela. In the case of these countries, the risks caused by the fall of international prices have been accompanied by macroeconomic and structural policies that are considered weak or deficient. Only a greater access to official and multilateral financing will offset this situation.

Commercial banks in Latin America did not invest to any significant degree in 'toxic' financial instruments, but they are being hit by the sharp contraction in external credit. These institutions, not being strongly exposed to external risks and focusing mainly on domestic markets, are not incurring risks similar to financial institutions in the advanced countries and in Asia. The banking system there is much larger and banks have tended to be more invested in the troubled assets, with the possible exception of India, among the larger countries. Latin America has been helped by the relatively small size of the national financial systems and the strong supervision and prudential regulations, an inheritance of the crises of last the 10 to 15 years (Kohli 2008).[9] Thus, the risks have tended to be concentrated in possible disruptions in the traditional flows related to international trade and foreign investment and the contraction in international economic activity. Nevertheless, as is also the case in Asia, additional problems in the financial system may arise due to the combination of lower exports and share values, if this were combined with the maintenance of poor policies, or if some countries experienced a further deterioration in the next months.

With significant levels of assets abroad, either in the form of investments by companies or in the hands of individuals that have taken money out in response to uncertainties with regard to domestic policies, the international crisis will have an additional impact due to the reductions in returns for those investments abroad, and financing difficulties in connection with these investments. This problem did not exist when the main emerging economies were fundamentally on the receiving end and were not capital exporters, as is the case at present.[10]

V. The Massive Loss in Financial Wealth

Between 2003 and 2007, the value of financial assets grew much more rapidly than GDP, entailing an increase in the ratio of financial assets to GDP of 45 per cent, which stood at 490 per cent by end–2007. These assets include collateralised financial instruments (mortgage backed securities or MBS and Collateralised debt obligations or CDOs). They do not include the complex set of financial derivatives like CDS (Credit Default Swaps) that further multiplied the size of the financial market. Clearly these operations deepened the capital markets, but simultaneously they constituted the base of the speculative bubble that was building up. During the period under review, financial assets in Emerging Asia rose from 250 per cent of GDP in 2003 to 370 per cent in 2007, an increase in the ratio of 48 per cent. The rise in the ratio of Financial Assets to GDP in Latin America was more modest, from 135 per cent to 176 per cent, representing an increase of 30 per cent.[11] As noted earlier, the loss of wealth at a worldwide level may amount to an astounding USD 50 trillion, or one year's worth of GDP.

Table 5 provides a stylised calculation of the possible losses arising from the crisis in Asia and Latin America, through the end of 2008. The numbers are based on data on the size of world financial markets for end–2007 included in the Global Financial Stability Report (IMF, October 2008). The table estimates

Table 5: Asia and Latin America: Losses Arising from the Financial Crisis

		Estimated Loss 2008			
	Value End–2007 (in US$ Bill)	*Percentage Loss from End 2007*	*US$ Billion*	*% of GDP*	*Notes*
Latin America					
Stock market Capitalisation	2292	55%	1261	34.1	1/
Public and private debt	1456	20%	291	7.9	2/
Bank Assets	1989	29%	567	15.3	3/
Total Assets	5737		2119	57.3	
Developing Asia and NICs 6/					
Stock Market Capitalisation	13782	52%	7167	81.0	4/
Public and private debt	4504	15%	676	7.6	5/
Bank Assets	9382	19%	1783	20.2	2/
Total Assets	27670		9625	108.8	

Source: IMF, 2008e; Bloomberg news and Author's estimates.
Notes: 1/Assumes an average loss of 40% in value and 25% depreciation.
2/Assumes an average loss of 20% in value (increase in spreads).
3/Assumes 5% loss in local currency value and 25% average depreciation.
4/Assumes an average loss of 50% in value and 10% depreciation.
5/Assumes an average loss of 15% in value (increase in spreads).
6/NICs include Rep. of Korea, Hon-Kong, Taiwan, and Singapore.

the impact of currency depreciations, the decline in stock prices, the loss of value of private and public debt and the effect of depreciation on deposits. The estimate does not include the loss in the value of assets held by local investors abroad. Even so, the estimated losses are very large—more than USD 2 trillion (57 per cent of GDP) since end–2007 for Latin America, and more than USD 9 trillion (109 per cent of GDP) for Emerging Asia and the NICs.[12]

Such losses will have an enormous impact on domestic expenditure. The terms of trade/export decline effect will aggravate the situation, as it will reduce incomes by 2–2.5 per cent of GDP. Thus, EEs' economic growth in 2009 will decline by at least 3 percentage points, with an unavoidable setback in the fight against poverty. Policy makers will thus need to find a balance between economic stimulus and financial stability. In the end, there is no room for denial or for populist policies; otherwise the crisis will become even deeper and harder to reverse.

VI. Stimulus Packages: How Much Can Emerging Economies Afford?

John Maynard Keynes, long relegated to history books describing his fundamental contributions to macro-economics, has returned with a vengeance, but now mixes with Friedman. In times of crisis, large countries can both have recourse to government spending stimuli (as Keynes proposed) and an ample supply of money in times of financial implosion (as Friedman discovered). Latin America and to some extent Asia, have been a fertile ground for Keynesian demand–enhancing measures, even if they were frequently misunderstood. At a time of widespread economic crisis, authorities have been announcing fiscal and credit packages aimed at softening the impact of lower commodity prices and reduced external demand. These measures are being taken on top of the currency devaluations in many larger countries.

Several issues arise in this regard: Are the packages large enough to shore up demand? How do they compare with the efforts of advanced countries? Can EE afford to do this? Table 6 helps elucidate these questions. The table lists the recently announced stimulus packages in some Latin American and Asian countries, as well as those in the US, Germany, Japan and the UK. The numbers are adjusted to reflect what could be expected to be spent in 2009. For example, in the case of China, the programme will extend for two years, and in the US, the numbers include the unspent portion of the package of October. The table includes numbers for public debt, both total and net of international reserves, to reflect the ability of the countries to finance the increased spending. It does not include, however, the requirements arising from reduced government revenues on account of a lower GDP and export earnings.

With the exception of those announced by China and Singapore, the packages among EE are considerably smaller than those to be implemented in the US and Japan (6 per cent of GDP) and Germany (3 per cent). In these countries, even with high levels of debt to GDP, their size and the depth of capital markets allows them to increase spending. In China and Singapore, a very low level of net debt and high reserves allow for the proposed effort. In Latin America, the two countries that have announced larger packages are Chile and Peru. Both countries have a very low level of net debt and in the case of Chile, the authorities have been building a successful stabilisation fund. All other countries have announced packages amounting to about one per cent of GDP, about the maximum they can afford, either because of the level of their debt (Argentina, Brazil and Mexico in Latin America, and India and Korea in Asia), or the size of their financial markets (Indonesia).

Table 6: Stimulus Packages: Selected Countries

Country	*Announced Amount of Stimulus* *US$ Billion, Annual*		*Gross Public Debt*	*Public Debt, Net of International Reserves*
		(% of GDP, 2008)		
Peru	3.2	2.5	31	1
Chile	4.0	2.2	19	6
Argentina	3.8	1.2	59	46
Mexico	10.8	1.1	22	14
Brazil	16.0	1.0	57	46
China	300 (586) 1/	7.1	18	–30
Singapore	6.2	3.2	92	2
Indonesia	6.3	1.3	17	5
South Korea	10.8	1.1	32	11
India	8.3	0.7	58	37
USA	800 (1150) 1/	5.6	38	38
Japan	250	5.2	153	128
Germany	102	2.7	67	64
Great Britain	30	1.1	44	41

Sources: National data; Press Releases; IMF; Eurostat, and Author's estimates.
Notes: 1/Estimated expenditure in 2009. Number in parenthesis reflects announced total package.

In the end, emerging market economies only have limited room for expansion and many countries have already used it. Thus, they unfortunately will need to rely on the effect of the external stimulus packages and of their devalued currencies, more than on their own actions, with the possible exception of monetary policy, where margins may be greater.

VII. Concluding Remarks

Most emerging market economies, including those in developing Asia and Latin America are at crossroads, and the next 12 to 18 months will be very difficult. The perception that they had broken the links with the larger economies has been painfully refuted by the hard facts of the last 18 months. Financial markets of the world are closely interconnected and the impact of the world financial collapse on EE is a witness to this fact.

Even as Asia and Latin America have diversified their investment and trading partners, the effect of the slowdown on exports, finance and investment is earthshaking. As a minimum, growth will fall sharply and a decline in GDP is a likely outcome. The external accounts are reflecting the consequences of the fall in prices, economic activity and in wealth, while capital flows are falling drastically.

In hindsight, poor macroeconomic and regulatory policies allowed the global economy to exceed its capacity to grow and contributed to a build-up in imbalances across asset and commodity markets. Policy and market shortcomings have prevented equilibrating mechanisms from operating effectively and hence, market stresses arose. These errors occurred both in advanced and emerging economies, so that the blame cannot be easily shifted to others. However, there has been no destruction of physical and human capital, boding well for a strong recovery, possibly more cautious and sustainable, after the adjustments in the financial markets are worked through over the next year or so.

The situation is extremely serious nonetheless, and the effect on output, wealth and still more, on poverty is critical. National authorities see the situation with a greater degree of realism. The main countries of the world have reacted positively, which is helping restore international stability. EE are better prepared than at any time in the last quarter century or so. Unfortunately the shock is far greater than in the past and the defenses may not be enough to protect the two regions. Each country will have to follow a difficult path and populist and protectionist temptations will remain a major threat. These tendencies carry a high cost. Even with better defenses, the world faces the most serious economic challenge in several generations. Countries will need to find a balance between economic stimulus and the fight against poverty on the one hand, and financial stability on the other. Such a task is far from simple, and will require effort and clarity of vision.

On this basis, three general topics for discussion emerge with respect to the future performance of EE:

- While the strength of the national economies depended on domestic policies, it is now clear beyond doubt that the new prosperity was highly dependent on the sustained growth of the advanced economies and the new key Asian players. Under these conditions, and while the stimulus packages of those economies will help, what should the appropriate policy path be? Are there any specific actions beyond the announced fiscal and monetary packages to avoid aggravating the impact of the crisis? Is there a role for further coordination at a regional level with respect to demand policies, as well as financial supervision and prudential regulations?
- How important is it to preserve the attempts at structural reforms to enhance investment prospects and productivity in the region? Should the countries in the region review and revise their approach towards further integration into the world economy, particularly with other emerging regions of the world, or should they focus on regional strategy? To what extent should the stimulus packages seek to consolidate the process of infrastructural integration that has been at the core of the regional cooperation process?
- After a period when the governments and business community thought they would not depend on IFI financing, is there a need to revise this approach? In particular, should efforts be focused on regional institutions, or should Asia and Latin America seek a change in lending rules and governance of the key IFIs, namely the IMF and the World Bank, to better represent the realities of the world economy, while streamlining conditionality?

Notes

1. Although subject to debate, part of the financial collapse may have occurred because of actions, or lack of them, on the part of the authorities. A possible example is the demise of Lehman Brothers, without looking carefully at the consequences, and that many actions were seen as haphazard measures, without a systematic approach.
2. During this period an obscure concept became instantly fashionable, the *TED spread*. The Ted rate is the differential between US treasury rate and LIBOR (London Interbank Offer Rate), which measures the lending costs among financial intermediaries. The TED differential, which had been below 1 per cent for most of the last quarter century, showed significant volatility in mid-2007 and rose to a peak of 5 per cent in October. It has fallen since then and now is back to historical levels, helped by key Central Banks.

3. There have already been several loans with such conditions, including to Bulgaria, Iceland, Hungary, Ukraine and under a more doubtful eligibility, Pakistan. No Asian or Latin American country had drawn from the IMF as of February 2009.
4. Countries like the US, China, India and Brazil, for example, tend to show a relatively low ratio of exports to GDP, reflecting the more significant importance of domestic activity in GDP.
5. The market-friendly reforms of the 1990s have been subject to considerable controversy in political and economic circles in developing countries. For example, some poorly implemented privatisations, and the creation of protected private monopolies instead of public companies gave privatisation a bad reputation, well beyond what was warranted. Most privatisations had worked well, but those few that did not were described as emblematic of what the critics considered the wrong way.
6. Corporacion Andina de Fomento: RED 2004; Corporacion Andina de *Fomento; RED 2005; Corporación Andina de Fomento;* RED 2006; Corporacion Andina de Fomento: RED 2007–08.
7. Table 4 seeks to estimate the terms of trade effect on the basis of the trade composition for the various regions, where the latest information available is for 2006. On this basis, the estimates incorporate the effect of both the increase in trade and changes in prices for 2007, and 2008. The estimates for 2009 only cover the change in export and import prices, without including changes in volumes.
8. The real effective exchange rate presented here is based on IMF information, although many alternative estimates exist. It is calculated as the weighted nominal exchange rate relative to a country's main trading partners and competitors, and corrected by price movements in the countries represented in the sample.
9. The index of Financial Development and Stability, developed by the Centennial Group, and presented in Emerging markets in October of 2008 show that the countries in Latin America have developed considerable institutional strength, with index levels that exceed what could be expected in light of their levels of income. In turn the development indices (reflecting the depth and structure) are below what is expected in light of the region's per capita income. This is the opposite of what was observed in the case of Asian countries, where the development indicators tend to run ahead of their relative institutional strength, with the exception of the NICs.
10. Table 2 provides an illustration of the importance of these flows, during the period 2002–07 (the most recent period with full data), with large outflows in the form of FDI and portfolio investments.
11. These ratios are far from stable. Since the publication of the series by the IMF in the Global Financial Stability Report in 2001, the ratios of financial assets to GDP declined through 2003, reflecting the effect of the bursting of the technology bubble at the beginning of the decade, and rose subsequently.
12. See Loser, By the Numbers, Latin American Advisor, Inter-American Dialogue, November 2008.

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