Dealing with an International Credit Crunch: Lessons from Latin America

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Dealing with an international credit crunch is no easy task, as any policymaker in the world would tell you today! Credit flows are the blood of the world's economic system. When a human artery becomes clogged and the blood flow is interrupted, the consequences can be dire unless the flow is restored promptly. Similarly, a sudden stop in capital flows that blocks the normal supply of international credit to countries can inflict serious damage on the affected economies unless decisive action is taken. But if you're not a government like the United States, 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 that explored the region's experience with the sudden stops in capital flows of the 1990s, it reviews lessons learned that may be of use in the present. To begin with, countries must realize that it's not necessarily their fault. A defining characteristic of systemic sudden stops is that they originate in shortcomings in international capital markets –i.e. international capital supply shocks– rather than in domestic policy failings. However, while the cause may come from abroad, the solutions must often be home grown and if sudden stops are not handled adequately, then 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? Should they instead restore credibility by tightening monetary and fiscal policy, or will these policies only make matters worse? 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,

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and what policy options are available? What is the role of international financial institutions? And further down the road, what implications does the latent risk of sudden stops have for economic policies during periods of bonanza?

This note draws from a recent IDB book, "Dealing with an International Credit Crunch: Policy Responses to Sudden Stops in Latin America,"[2] which addresses these questions from different angles, bringing in both lessons from country studies as well as 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.[3] But it also takes a more systematic approach by analyzing the impact of policies on output behavior for a wider range of emerging markets. Using both sets of information, and distinguishing between successful and unsuccessful cases, it extracts policy recommendations for countries that might face a sudden stop in the future. As the world endures a major global financial crisis with potentially severe consequences for emerging economies, the issues addressed in this volume come back to the forefront of the policy debate.

The Relevance of a Common Framework for Cross-country Analysis

In the aftermath of the Asian and Russian financial crises of 1997-1998, two contrasting views emerged in academic and policy circles regarding appropriate policy responses for crisis resolution. One school of thought was that monetary and fiscal policies should become tighter in order to restore credibility in the prevailing policy stance and avoid potentially unstable dynamics. The rationale behind this policy prescription was that creditors had to be re-assured about the creditworthiness of the affected economies, and that credit would flow back promptly soon thereafter. This is exactly what had happened in much of Latin America in the aftermath of the Mexican Tequila crisis in 1995. The view was that countries faced short term liquidity problems

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[2] The book is available online through the link: http://www.iadb.org/res/pub_desc.cfm?pub_id=B-633
[3] This team includes Paul Castillo Bardález, Márcio G. P. Garcia, Federico Sturzenegger, Ernesto Talvi, and Rodrigo O. Valdés,

rather than solvency issues, and that crisis resolution entailed a strengthening of policymakers' commitment to sound monetary and fiscal polices.[4]

Others instead argued that a sudden stop, that would inevitably precipitate a contraction due to the ensuing credit crunch, was precisely the time in which both monetary and fiscal policies were called to be expansionary.[5] The rationale for this policy prescription is that the external credit crunch had to be compensated by a domestic stimulus package. The problem that arises is how to finance a stimulus package precisely at a time when credit dries up and there is a generalized run on domestic assets that curtails the effectiveness of monetary policy. One possibility is through the use of resources coming from multilateral financial institutions such as the IMF. But the use of public money for crisis resolution entails moral hazard issues that are hard to resolve. And back then, the IMF was the main proponent of the alternative view, so this was not really an option.[6]

Such a set of contrasting views fueled a heated debate which, a decade after the large sudden stops of the 1990's, remains unresolved. This issue is now back in the policy table, as countries consider the possibility of expansionary policies amidst the financial turmoil originated in the US sub-prime crisis of 2007-2008. In order to shed some light on this question, a common strategy is needed to assess policy responses, quantify them using an homogenous set of indicators, and use these for cross-country comparisons in order to extract general policy conclusions.

Setting up such common strategy was a major challenge of the book. This was the task undertaken by Federico Sturzenegger and Ernesto Talvi together with Alberto Ortiz and Pablo Ottonello in Chapter 2. However, as they acknowledge, even this unwieldy job is not enough because identifying policy responses and their effectiveness in terms of reducing output collapse is not sufficient to pass judgment on the adequacy of policy responses followed by different countries in the aftermath of a sudden stop. A

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[4] See Fischer (1998)
[5] See Stiglitz (2002, 2003).
[6] See IMF (1999)

second challenge was to understand the constraints that many countries faced in implementing policies given their initial conditions at the time of the crisis.

The cross-country study presented in Chapter 2 focuses on monetary and fiscal policies. While this might seem restrictive, upon closer inspection it is not: they are useful summary statistics for an array of other policies. Monetary policy encompasses also exchange rate policy, foreign exchange reserve management, and the use of capital controls, while fiscal policy includes an array of policies such a banking crisis resolution and debt restructuring that may require the use of public money. Fiscal and monetary policies are studied during sudden stop episodes that coincide with periods of global capital market turbulence for emerging markets, a phenomenon called "systemic sudden stop."[7] This encompasses the sudden stops of the late 1990's in many emerging market economies around the world.

How were policy responses identified? In the case of fiscal policy, it was necessary to remove the cycle from observed fiscal data. Since sudden stops are associated with relatively large contractions in output and therefore fiscal revenues, the fact that the observed fiscal deficit increases is not an indication by any means of an expansionary expenditure policy, but mostly an endogenous response of revenues to the decline in output. The strategy pursued, given that the analysis focused on emerging markets, was to "implicitly adopt" Chile's fiscal rule–using a suitable statistical equivalent–to smooth out fiscal revenues and thus compute the structural fiscal balance. Fiscal policy for every country was characterized by analyzing *changes* in the structural fiscal balance (i.e., the change in fiscal policy in a given period once the effect of cyclical fluctuations in commodity prices and output was removed from revenues).

In the case of monetary policy, in order to capture the discretional components of policy in times of financial turmoil, monetary policy was measured in the spirit of the

[7] For a characterization of systemic sudden stops, see Calvo, Izquierdo and Talvi (2006), and Calvo, Izquierdo and Mejia (2008).

new Keynesian models in international finance.[8] This involves directly estimating an expanded "Taylor rule" capturing the Central Bank's reaction function to changes in inflation, output and the exchange rate (fear of floating) immediately prior to the sudden stop episode. By assuming that the Central Bank will react according to this rule, the monetary policy stance can be characterized in a transparent way. When confronting a sudden stop, the Central Bank is faced with a trade-off: inflation and fear of floating motives will lead to monetary policy tightening, while the output motive will lead to monetary policy loosening. Estimated coefficients in the expanded Taylor rule provide an indication of the weight the monetary authority puts on each motive. In order to capture these relevant trade-offs, a set of monetary policy indices was constructed in such a way that a country with a higher value of these indexes tends to react during a sudden stop by tightening policy more than a country with a lower value of these indices.

The key finding is that measures of tighter fiscal and monetary policies during sudden stops encompassing the Tequila, Asian, and Russian crises are associated with larger output contraction. Does this evidence provide an endorsement for looser policies during an external financial crisis? Even if the results were to be taken as conclusive evidence—which they should not—a cautionary note is in order. Countries that were able to loosen monetary and fiscal policy during the crisis fared better than those that did not. But it does not follow from this statement that countries that followed tighter policies would have done better had they followed a more expansionary path, the main reason being that initial pre existing conditions in each country worked as a binding constraint at that time.

For example, countries with high levels of liability dollarization might resist nominal exchange rate depreciation in the aftermath of a sudden stop through higher interest rates, thus precipitating a more severe contraction relative to a country with no liability dollarization which can afford to let the exchange rate depreciate. However, it is unclear that a country in such a situation would have done any better by loosening

[8] See Lubik and Schorfheide (2007).

monetary policy and letting the exchange depreciate. With a large degree of liability dollarization it could conceivably have done worse.

The aforementioned example suggests that initial conditions matter probably as much as policy responses. The authors recognize that stringent preconditions need to be met in order to afford policy flexibility. In the case of fiscal policy it means following sound intertemporal fiscal behavior and having low debt levels; for monetary policy itself it means counting on high levels of credibility that keep inflation expectations at bay in the face of an expansionary move, and for exchange rate policy it means having low levels of financial dollarization as well as a large supply of tradable goods that will call for lower depreciation in the face of a stop in the financing of the current account deficit.

In summary, efforts should be aimed at removing the fundamental obstacles that preclude countries from using countercyclical monetary and fiscal policy in times of external financial crisis. Having the flexibility to implement expansionary policies during a sudden stop pays handsomely in terms of smaller recessions and lower output volatility. In this respect, it sheds light on the policy debate that emerged in the aftermath of the Asian and Russian financial crisis: while it does not vindicate entirely the expansionary policy view because it acknowledges the importance of initial conditions, it does show that the emphasis on tighter monetary and fiscal policies put at the time as pre-conditions for access to IMF and other multilateral funds should have been dealt with differently, factoring in initial conditions when deciding on policy tightness in the context of a protracted credit crunch.[9]

Learning from Successful Cases

Chapters 3 through 5 focus on detailed country narratives and analysis for three economies that, faced with the same external financial shock in the aftermath of the Asian and Russian financial crisis, were able to handle the ensuing adjustment avoiding a

[9] For example, Korea's public debt-to-GDP ratio was only about 10 percent on the eve of the crisis, indicating potential for expansionary fiscal policy. Yet, Korea followed a pro-cyclical fiscal policy.

full blown meltdown: Chile, Brazil and Peru. Why were these countries different? Was it the role of initial conditions? Or its policy responses? Or both? Below we summarize the findings of each case study.

Chile: Banking on Policy Credibility

Being prepared pays off. That is one of the big lessons of the Chilean experience with the sudden stop in capital flows in 1998. Hit by the retrenchment of capital flows following the Asian crisis and a decline in its terms of trade due to a drop in copper prices, Chile's net capital inflows plummeted from the equivalent of 7% of GDP in 1998 to less than 1% of GDP in 1999 while capital outflows reached $1.5 billion. But instead of an economic collapse, Chile suffered a small recession thanks to a strong financial system, healthy public finances and a flexible policy apparatus.

Throughout the 1990s, Chile laid the groundwork for strong monetary and fiscal policies. With the objective of maintaining price stability, the Central Bank of Chile used annual inflation targets as the predominant nominal anchor of the economy. Annual announcements aimed at ever lower inflation. An exchange rate band system sought to maintain the current account deficit within sustainable levels and the Central Bank intervened in the foreign exchange market not only at the edges of the band, but also actively within it. From a rather rough management of interest rates on instruments of different tenors in 1990, the Central Bank advanced to managing liquidity in order to achieve a particular overnight interest rate in the interbank market (the target being the monetary policy interest rate). Throughout the decade, fiscal policy too was well-managed, allowing the central government's net public debt to decline from 37.6% of GDP in 1989 to 5% in 1997. Strong growth certainly facilitated this result but institutional factors also weighed heavily. Chile had (and continues to have) strong fiscal institutions ranging from a centralized state and a strong Ministry of Finance to arrangements such as a copper price stabilization fund that allows the authority to set aside abnormally high copper revenues in a transparent way.

In addition to strong monetary and fiscal policies, the Chilean economy also enjoyed strong financial institutions. Following the collapse of the banking system in the fallout to the debt crisis of the 1980s, Chile worked hard to improve financial regulation and supervision. These changes allowed for the development of a healthy and resilient financial system.

When the crisis hit, Chilean authorities were in the midst of trying to tame an overheated economy. As the external shocks hit, the current account deficit widened, the exchange rate came under pressure and fiscal revenues declined; the need to control galloping domestic demand and regulate the depreciation of the exchange rate became of paramount importance. Contractionary monetary and fiscal policies were the government's initial policy response.

In a way, the policies were almost too successful. The combined effect of the external shocks and policies was an unexpectedly large and quick adjustment. Imports of goods and services transited from growing 16% year-over-year in second quarter 1998 to sliding 14% in the final quarter of the year. Behind this adjustment was a sudden decline in domestic demand of almost 8%.

This overcorrection highlights another important lesson. When in the eye of the storm, it is often difficult to assess the true nature and duration of a crisis. Chilean authorities initially misjudged the type of shock at hand. However, policymakers were able to bank on previously earned credibility to shift gears and accommodate the shock with expansionary policies before it was too late. By changing course, they were able to keep the economy from slipping into a deeper recession.

The macroeconomic framework and conditions that Chile had built over a decade served it well in the face of the sudden stop. Having capitalized, well regulated and supervised banks made it possible to follow a very contractionary monetary policy during the first phase of the crisis without overly jeopardizing the health of the financial system.

And avoiding liquidity risks in government financing let authorities boost interest rates substantially and pump prime the economy later to prevent a collapse.

Peru: Where Reserves Saved the Day

Nobody's perfect. Peru did a lot of things right during the 1990s but it had at least one critical flaw that made it highly vulnerable in the context of the 1998 sudden stop in capital flows: a high degree of financial dollarization. Still, the Peruvian experience teaches that bad initial conditions do not necessarily determine a country's destiny. In spite of its dollarization, Peru emerged relatively unscathed from the sharp decline in its terms of trade and the repercussions of the Asian crisis thanks in large part to savvy management of its extensive foreign reserves.

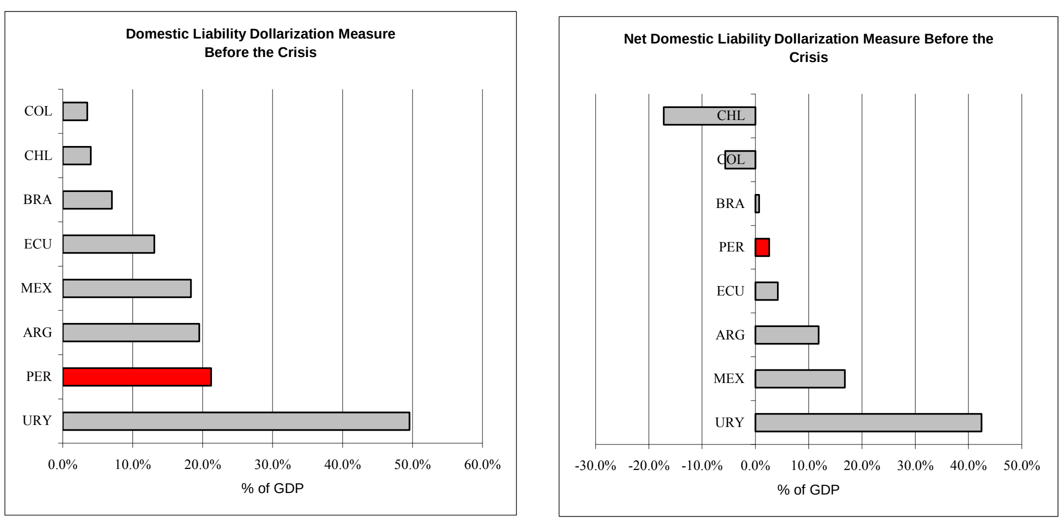
Throughout the boom years of the early 1990s, Peruvian authorities prepared to meet unexpected foreign currency outflows by building up a protective shield of international reserves. How did it amass one of the largest levels of international reserves in Latin America? To begin with, it established a high marginal reserve requirement ratio that allowed the banking system to accumulate some $3.7 billion in reserve deposits by 1997. Secondly, by reducing inflation from over 7,000% to just 6.5%, the government restored credibility in the domestic currency and progressively absorbed the reduced demand for foreign currency. Finally, the Central Bank added substantially to its international reserves with public sector deposits, mainly from the proceeds of an extensive privatization program. The result was that by the end of 1997, Peru's international reserves represented 78% of the total banking sector's liquidity and almost 18% of GDP.

As important as the quantity of international reserves stashed away in government coffers was the Peruvian government's willingness to use them to provide dollar liquidity during the credit crunch. In spite of its high degree of financial dollarization, Peru avoided a financial crisis with a combination of lender-of-last-resort policy in foreign currency and exchange rate policy that limited volatility in the exchange rate. By pumping foreign currency reserves into the banking system, the monetary authorities staved off the failure of those banks that were more indebted and in this way prevented domestic banking credit from drying up entirely.

Figure 1 plots the level of gross domestic liability dollarization (DLD)—basically dollar loans in the domestic financial system—as a share of GDP for eight countries in Latin America on the eve of the Asian crisis. The left hand side panel, showing the gross DLD position of each country, indicates that Peru fared worse than Argentina in this dimension. The right-hand side panel shows instead the net DLD position—DLD minus foreign exchange reserves as a share of GDP. Clearly, Peru's large stock of international reserves accumulated during the preceding period of economic expansion was an important element in diminishing the country's vulnerability to the dollarization specter.

<u>Figure 1</u>

Domestic Liability Dollarization: Selected Latin American Countries



Source: Calvo, Izquierdo and Mejia (2008). Systemic Sudden Stops: The Relevance of Balance-Sheet Effects and Financial Integration

However, effectiveness in the use of international reserves may depend on the particular instrument chosen. The Peruvian experience shows that direct and permanent injections of foreign liquidity—in this case, through a continuous reduction of the average and marginal reserve requirement ratios—were more effective to offset the negative effects of the sudden stop on the banking system than the direct sale of foreign currency on the exchange market. This is so because direct injections of foreign liquidity allow banks to boost liquidity in foreign currency without reducing their liquidity in domestic currency.

Although the role of its international reserves was crucial to its success, there are other aspects of Peru's preparedness that contributed to the resilience of the economy to the crisis. The fiscal reforms of the early1990s successfully pared down the large fiscal deficits that had plagued the country during the 1980s. In turn, the improvement in Peru's fiscal position had far-reaching effects on its macroeconomic stability. Initially, it contributed to the accumulation of the Central Bank's international reserves and government liquidity in the financial system. Later, those funds were fundamental to finance a countercyclical fiscal policy that prevented negative GDP growth rates and helped avoid a larger depreciation of the real exchange rate. Being able to spend during the sudden stop episode kept the Peruvian economy moving while the economies of many of its neighbors came to a screeching halt.

The 1990s was also a period of massive investment in Peru, particularly in the tradable sector. One of the main objectives of the structural reforms of the 1990s was to provide a macroeconomic environment that promoted investment. Policies favoring private investment were complemented by reforms guaranteeing judicial stability and equal treatment for foreign investment. The privatization process took off in 1991 and investment poured in, mainly in the tradable sector. Investment and projects in the mining sector, for instance, propelled average growth rates to 10.1% annually from 1993 to 1997. And they enabled the sector to continue growing at a similar pace (9.9% per year) during the sudden stop of 1998-99. Overall, previous investments in the tradable sector acted as a buffer for the slide in other economic activity in 1997-99.

Peru did not have all its macroeconomic pieces in place when the Asian crisis hit but it managed to survive the shock well. Certainly, the credibility built earlier in the decade by a series of monetary and fiscal reforms paid off. However, the life jacket that really kept the Peruvian economy afloat was its cushion of international reserves.

Brazil: A Two-Pronged Strategy for Solvency

The 2002 Brazilian sudden stop was a clear crisis of confidence that mixed political aspects with low liquidity in international financial markets. The leading presidential candidate—now President Lula—was perceived to be non-market friendly and the prospect of his election sent shivers through the investment community. Capital flows fell by some US$24 billion, around 6% of GDP, and there was a large turnaround in the current account. However, political stroking plus targeted economic intervention from a government that had done its financial homework allowed it to maintain solvency and avoid a meltdown. In fact, the Brazilian economy grew more than 4% over the 2001-2002 period, making it a clear case of a successful response to a sudden stop.

Not surprisingly, at least part of the response to this largely political crisis was political in nature. The fear that Lula would stray from Brazil's sensible macroeconomic policies and perhaps even default on its debt had to be assuaged. Brazilian Central Bank Governor, Arminio Fraga, negotiated a deal between all the presidential candidates, foreign investors and the IMF. In a program designed to provide good incentives to the candidates, the presidential wannabes agreed to sensible policies in return for large disbursements from the IMF. Although the entire loan was US$30 billion, only US$6 billion would be disbursed in 2002. The remainder would be disbursed when the next president was in office, provided he fulfilled the IMF program conditions. After Lula won the election and it became clear that he would uphold the three basic tenets of Brazilian macroeconomic policy—the large primary fiscal surplus, inflation targeting, and a floating exchange rate—and that he would not default on the debt, the markets regained confidence and the crisis was averted.

Despite this agreement, creditors tightened their purse strings in the 2001-2002 period. During this sudden stop, the resilience of the banking sector was achieved thanks to several factors. After the end of hyperinflation in 1994, several banks became insolvent. During the second half of the 1990s, two programs were put in place to deal with the private and local government-owned problematic banks. Consequently, in 2001-2002, there were no large banks with weak balance sheets that could pose systemic risk.

The second factor that explained the resilience of the banking sector is that there were no large currency mismatches in their balance sheets. Since the turbulent flotation of the real in 1999, banks were aware of the risks involved in large depreciations and were required, by prudential regulation, to control the exchange rate risk, among other risks. Even so, the sudden stop could have caused disruptions. However, the public sector played an important role during the crisis by providing insurance to banks against exchange rate depreciation through the issuance of dollar-indexed debts or via derivatives. Importantly, the Brazilian public sector had maintained a low level of dollarization prior to the crisis enabling it to assume the exchange rate risk in its own balance sheet, without compromising its own sustainability.

A second strategy that helped tide Brazil through the credit crunch was aimed at exporters and was made possible thanks to the country's accumulated international reserves. Although the exchange rate suffered enormous depreciation during the sudden stop, exporters could not fully profit from this because trade credit lines had dried up. Therefore, the Central Bank intervened to provide trade finance to exporters. Legally, the Central Bank could not sell its foreign reserves directly to exporters. However, an ingenious program was put in place to guarantee that at least some of the reserves sold by the Central Bank were channeled to exporters. Banks were only allowed to purchase reserves if they showed that those reserves were going to be used for export financing. Supporting the export sector helped bring dollars into the country and mitigated the shortage of currency stemming from the reduction in foreign capital inflows.

Throughout this period, monetary policy was conducted through Inflation Targeting (IT). Another important lesson of the Brazilian case is that while IT might be a useful tool for the conduct of monetary policy during normal times, during sudden stops the target becomes elusive as the monetary authority loses control of market interest rates and the exchange rate. Twice during this period the Brazilian Central Bank missed its annual inflation targets, forcing authorities to implement corrections along the way. Thus, IT frameworks should build in contingent mechanisms in order to successfully accommodate external shocks without undermining the credibility of the framework.

Together, the Brazilian Central Bank's interventions to shore up the banking sector and to provide credit to exporters helped the country weather the political and financial storms.

Policy Lessons

Systematic cross-country analysis, as well as the wide array of country experiences analyzed in this volume regarding policy responses to sudden stops—i.e., Chile, Peru, and Brazil (the "successful" cases), and Mexico, Argentina, Colombia, Uruguay, and Ecuador (the "unsuccessful" cases, not covered in this note)—distill five main conclusions:

- Expansionary fiscal and monetary policy that does not affect credibility or solvency can reduce 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 had a loss in output of less than 5%, while nations with much less flexibility had output contractions above 10%. However–and this is really crucial–countries need to be able to *afford* these policies.
- Initial conditions matter: the same shock can have different consequences in countries with different levels of preparedness and may seriously limit policy options. There are no good substitutes for reducing vulnerabilities during good times to confront the possibility of bad times in the future. For example, successful anti-cyclical policies during financial crises work when governments are prepared to boost spending in a sustainable way –for which you need to have saved before— and conduct looser monetary policy that does not fuel inflation or lead to balance-sheet problems in either the public or private sectors —for which you need to avoid the dollarization specter during the boom years—.

- 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.
- The persistence of the shock is important in determining whether liquidity issues become solvency problems. A short-lived crisis, such as the capital shortage experienced by Latin America in the aftermath of the Mexican 1995 crisis was much less dangerous than the long capital drought that followed the Russian crisis of 1998, where substantial real exchange rate corrections (needed to abruptly close current account gaps) put solvency in shambles. Early recognition of the nature of the crisis being faced 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 liability dollarization. However, there is reason to believe that with international support, the restructuring process could have been much more orderly.

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 favorable tailwinds and had prepared for a rainy day. While some basked in the sun of high global growth rates and soaring commodity prices, others remained wary of cycles in the international economy, commodity prices and world financial conditions. 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. Any attempt to boost spending dramatically, for example, could erode confidence in the country's ability to repay its debts in the future.

Thus, the biggest lesson is that there is no substitute for taking advantage of periods of external bonanza to improve macroeconomic fundamentals at home.

This lesson will most likely be at work in the prevailing financial crisis, meaning that the availability of counter-cyclical policy options, as well as final outcomes, will to a large extent be determined by initial conditions. However, policy reactions will remain key especially in countries where initial conditions have not predetermined their destiny and there is some margin of maneuver. 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.

Latin America and the Caribbean have improved their economic conditions since the Russian crisis, giving them some leeway, particularly regarding monetary policy, to implement measures to fight the crisis. Countries have built up US$ 400 billion in international reserves, and they have substantially reduced the level of dollar-denominated debts, particularly within the banking system. Lower levels of debt dollarization allowed Brazil, for example, to loosen monetary policy amid the credit crunch in ways that other countries were not able to do during the aftermath of Russian crisis. This time around, several Latin American countries swiftly depreciated their currencies and *lowered their domestic interest rates* without entering major financial turmoil, in stark contrast with monetary policies in most Latin American countries during the Sudden Stops of the 1990s, when interest rates shot up and currency depreciation was fiercely fought. This is a first for Latin America, and it can be read as the consequence of better initial conditions in the financial front.

Loose monetary policy typically leads to currency depreciation and an increase in exports that helps ease the economic slowdown. However, currency depreciation, which boosted exports as a way out of the crisis for several emerging markets in the past, may not fully work this time because of the ongoing global recession, particularly in rich nations.

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 IDB (2008), a simple average of the region's seven biggest economies – Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela – shows that they spent 77 percent of the extra revenue from the commodity bonanza since 2002. Chile, in comparison, which set aside a considerable part of the increased tax collection into a special fund, spent only 34 percent. Some nations in Latin America may 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 but only a few such as Chile are in a position to increase spending. Expansionary policies in countries that did not engage in countercyclical policies in the past may lead to substantial debt buildup, particularly to the extent that the global recovery takes time.

Multilaterals in the Current Crisis

For Multilaterals, the current crisis offers an opportunity for a different approach when compared with the policy options taken during the Russian crisis. 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 IDB 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 with 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 deem fiscal caution a necessary element of any policy-response package.

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 and at what financial cost. Our view, developed thoroughly in IDB (2009b) is that if Latin America—and, arguably, other Emerging Markets—are to engage in stimulative fiscal policies to minimize the impact of the global crisis on domestic growth, it is necessary that borrow-of-last-resort functions similar to those that governments perform in developed economies be recreated by multilateral institutions, so that liquidity concerns are kept at bay. This strategy will ensure that well-designed stimulus packages do not compromise financial stability. This strategy has three basic requirements: (i) a strengthening of the resources of Multilateral institutions to allow them to act with a scale commensurate to the tasks at hand, (ii) an appropriate division of labor between the IMF and MDBs, and (iii) a careful country-by-country analysis that determines in each case fiscally sustainable combinations of expenditure increasing and expenditure switching policies.

The good news is that since the peak of the crisis, Multilaterals have moved swiftly in this direction. In particular, the replacement of the IMF's short-term liquidity facility with a flexible credit line facility in March 2009 (with up to a five-year repayment period) has been crucial to ensure access to liquidity, vastly improving effective or perceived liquidity stances of several countries in the region. The IDB has also contributed in this regard with its liquidity program for growth sustainability that was put in place in October 2008. Since then, external financial conditions have been relaxed, making international liquidity concerns more subdued. However, concerns still remain about the speed of recovery in industrialized countries, a factor that must be taken into account when deciding policies and lending strategies. The joint work of countries and international financial institutions can hopefully help Latin America and the Caribbean transit successfully through these uncertain and unprecedented times.

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