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Global Financial Crisis Takes Toll on Central America

by Louisa Reynolds

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In the past few months, the global economy has been increasingly sluggish, mainly as a result of the deep crisis that has hit the eurozone. The report "Central America and the crisis. Can we do more than just wait?" published in March by the Instituto Centroamericano de Estudios Fiscales (ICEFI) says the global economy will continue its downward spiral due to the European recession and slow economic growth in the US and in the BRIC countries (Brazil, Russia, India, and China).

In 2011, Central America’s regional economy grew by 4.7%, above the Latin American average of 4.4%. ICEFI says this dynamic growth has been led by an increase in exports, private-sector investment, and domestic consumption. In the Northern Triangle (Guatemala, El Salvador, and Honduras), remittances have contributed significantly to the increase in consumption.

ICEFI predicts that this year, Central America’s economy will grow by approximately 4%, mainly as a result of steady growth in Panama, Costa Rica, and Nicaragua. Even though Central America is expected to grow at a slower rate than last year, the anticipated growth is still above the Latin American average.

However, with the exception of Panama, economic growth in all isthmus countries will largely depend on the global financial climate. "If the world economy continues to slow down more than has been predicted so far, dark clouds will begin to appear on the region’s horizon, which will make it necessary to revise the latest estimates," warns ICEFI.

But to what extent is the notion that Central America can escape the effects of the global financial crisis deceptive? And how would the collapse of the euro affect the isthmus?

Juan Carlos Moreno, co-director of the Economic Commission for Latin America and the Caribbean (ECLAC), explains that, in 2008-2009, the effects of the crisis caused by the explosion of the US real estate bubble had an indirect impact on Central America because of the fall in exports and remittances, whereas in developed nations, the impact of the crisis had a deep impact on the financial system (NotiCen, Dec. 11, 2008, and Feb. 5, 2009).

Moreno says the impact of the crisis for Central America was short-lived thanks to the countercyclical economic policies implemented by the US government, which led Central American exports to the US to recover, as well as the domestic policies implemented by most countries in the region. "Although some governments thought that the isthmus economies wouldn’t be affected because they were decoupled from the global economy, they gradually began to realize that the global financial crisis could have a deep impact and they took urgent measures to face the situation. Unlike other crises in which governments across the region decided to implement austerity measures, most Latin American countries have now learned that at times like these the best option is to implement countercyclical policies.

**The currency war**

Countercyclical policies helped Central America to lessen the impact of the crisis, but the underlying structural problems were not resolved and are now resurfacing with the eurozone crisis,
explains Moreno. "This is the same crisis that began in 2008 and was never resolved; the only
difference is that now it’s worse," he said. "Whereas in 2008 we were talking about investment
banking, now we’re talking about countries’ sovereign debt."

One factor that makes this new phase of the crisis worse for the isthmus is the "currency
war" (guerra de divisas), which is making capital flows to the region increasingly volatile. "Many
banks have lowered their credit ratings, they are not lending, and that is affecting the region,"
said Moreno. "The policies that have been adopted in the US in terms of quantitative easing are
generating huge capital flows that are highly volatile and affect our exchange rates, making our
exports less competitive compared to those of the developed world. This is what Brazilian President
Dilma Rousseff has called ‘the currency war.’ With these volatile capital flows we’re bearing the
brunt of the policies adopted by the developed world."

Moreno says that, in 2008, Latin America was better prepared to bear the impact of the crisis, as the
region had been experiencing five years of sustained macroeconomic growth and had high interest
rates that could be lowered, whereas now "fiscal debt has risen, the region doesn’t have the same
amounts of savings as before, and the isthmus’ response margins in terms of monetary policy are a
lot smaller."

In response to the currency war caused by volatile capital flows and the depreciation of the dollar,
many countries have opted for accumulating international reserves. Mexico, for example, increased
its gold reserves tenfold in February and March this year, now ranking number 33 globally in the
level of gold reserves, according to the International Monetary Fund (IMF).

The World Gold Council predicts that this year the central banks of developing countries will be the
world’s main buyers of gold. Moreno explained that, like any other investor, the central banks of
developing countries are trying to diversify their risks, a strategy that seems rational but would work
better if these countries purchased gold as a regional block rather than individually.

"This reflects yet another failing of the international financial system because each country is
seeking to protect itself individually from a new shock by accumulating reserves rather than
having a global financial institution that can gather all the reserves and make them available to
the countries that may need them," says Moreno. He added that, by accumulating international
reserves, emerging economies "are helping more industrialized nations to rebuild their savings."

In June, Central America and the European Union (EU) signed an association agreement under
extremely unfavorable conditions for both regions. Moreno emphasized that the isthmus should
focus on increasing trade with South America and strengthening ties with emerging markets, such
as China, as well as strengthening internal demand, thus reducing inequality.

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