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ILO NOTES ON THE CRISIS

International Labour Office

ARE DOMESTIC MARKETS THE ANSWER TO THE GLOBAL FINANCIAL CRISIS? COMMENTS BASED ON THE EXPERIENCE OF LATIN AMERICA[1]

During the recent economic crisis, the drop in exports and existence of abundant reserves created opportunities for recovering economic growth and employment through the promotion of domestic demand. Brazil was among the countries that faced the new international circumstances most successfully by implementing a series of policies designed to diversify domestic consumption and partially offset the fall in exports.
Several Central American countries showed some development of domestic markets, which has helped mitigate the impacts of economic shocks like the most recent one and serves to develop stable grounds for economic growth and job creation in the medium term. This suggests that it is crucial that a more balanced economic strategy between exports and the domestic market be implemented.

1. From expansion to crisis

Over the past few decades, every country in the region has made an effort to increase exports as part of a strategy that privileged the consolidation of international inclusion through financial and trade liberalization. While this goal has been achieved in most cases, it has not been sufficient to radically change growth patterns.

An analysis of aggregate demand trends[2] in Latin American countries in the years leading up to the crisis (2002-2007) can be grouped in two set of countries: those in which growth was based on external demand (Argentina, Bolivia, Brazil, Chile, Ecuador, Panama, Uruguay and Venezuela) and those that made their economies more dynamic by focusing on domestic demand (Colombia, Costa Rica, the Dominican Republic, Guatemala, Honduras, Mexico and Paraguay). The first group achieved economic expansion through a sustained increase in the price of raw materials -stemming from growth of the world economy- and development of their raw-exporting drive. For the second group, a relatively high propensity to import and low propensity to save, significantly reduced the impact of increased exports. The economic stability of these nations was sustained through continuous growth in remittances by emigrants and debt despite increasing consumption and trade deficits.

These results are reached by breaking down aggregate demand by "inflows" using exports (X), and investment (I), and "outflows" such a imports (M), and saving (S). This yields the direct domestic multiplier impact (I/s) and external impact (X/m), where s and m are propensities to save and import, respectively. This allows us to identify the main factor dynamizing aggregate demand (Y). This will be domestic demand when I/s >Y, and it will be external demand when X/m >Y.

Table 1 shows results obtained for Latin American countries for 2002-2009. Data given as multipliers are ratios between multiplier values with respect to aggregate demand such that a figure greater than 1 is evidence of dynamizing behaviour of aggregate demand, which in turn is conditioned by figures for propensities to save and import in each case.

1 This article was prepared by consultant Mario Velásquez. It is based on the paper by the same name by Diego Sánchez-Ancochea, Reader in Political Economy at Oxford University. Valuable comments were contributed by Janine Berg (ILO, Brazil), Andrés Marinakis (ILO for the Southern Cone of Latin America) and Raymond Torres, Director of the ILO International Institute for Labour Studies.

2 Based on the breakdown proposed by Berg and Taylor (2000) and Taylor and Vos (2002) in Sánchez–Ancochea (2010)

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Exports expanded significantly between 2002 and 2007, and the expansive impact of external demand prevailed in countries with a relatively high propensity to save (such as Argentina, Brazil, Chile, Peru and the Bolivarian Republic of Venezuela). This is supplemented by relatively low propensities to import as compared to the remaining countries studied. Similar results are obtained for Bolivia, Panama and Uruguay, although the dynamizing impact of external demand is dominant but less so than what was observed in the previous cases since the propensities reported are intermediary figures in the context of the total recorded.

Table 1
Domestic and external dynamizers of aggregate demand and propensities to save and import in Latin American countries, 2002-2009

Country	2002-2007				2008				2009			
	Direct Multipliers		Propensity[c]		Direct Multipliers		Propensity[c]		Direct Multipliers		Propensity[c]	
	Domestic[a]	External[b]	Savings	Imports	Domestic[a]	External[b]	Savings	Imports	Domestic[a]	External[b]	Savings	Imports
Argentina	0,69	1,51	0,24	0,17	0,86	1,19	0,24	0,17	0,80	1,33	0,23	0,14
Bolivia	0,91	1,09	0,17	0,26	0,72	1,18	0,18	0,28	nd	nd	Nd	nd
Brasil	0,86	1,23	0,18	0,11	0,99	1,01	0,18	0,12	1,00	0,99	0,15	0,10
Chile	0,72	1,28	0,26	0,25	0,87	1,10	0,21	0,29	0,71	1,26	0,21	0,23
Colombia	1,28	0,79	0,17	0,17	1,17	0,84	0,17	0,18	1,17	0,82	0,17	0,17
Costa Rica	1,23	0,91	0,13	0,35	1,55	0,84	0,11	0,36	0,99	1,00	0,10	0,30
Ecuador	1,08	0,95	0,19	0,25	1,00	1,00	0,21	0,27	nd	nd	nd	nd
El Salvador	-0,91	0,59	-0,04	0,32	-1,96	0,53	-0,05	0,32	-5,51	0,59	-0,02	0,27
Guatemala	4,28	0,63	0,03	0,30	9,77	0,63	0,01	0,28	12,33	0,74	0,01	0,25
Honduras	3,37	0,75	0,03	0,45	9,87	0,62	0,02	0,46	7,99	0,68	0,02	0,38
Mexico	1,07	0,95	0,19	0,23	1,09	0,93	0,19	0,23	1,07	0,95	0,16	0,23
Nicaragua	-3,08	0,49	-0,01	0,41	-6,56	0,48	-0,03	0,43	-9,01	0,57	-0,02	0,38
Panama	0,78	1,08	0,16	0,43	nd	nd	0,00	0,00	nd	nd	Nd	nd
Paraguay	1,28	0,92	0,09	0,35	1,40	0,91	0,08	0,36	1,48	0,90	0,07	0,34
Peru	0,85	1,20	0,24	0,18	1,01	1,02	0,21	0,21	0,85	1,17	0,20	0,17
Dominican Rep.	1,46	0,87	0,07	0,27	4,02	0,65	0,03	0,28	2,17	0,74	0,05	0,23
Uruguay	0,94	1,04	0,14	0,23	1,24	0,87	0,14	0,25	0,95	1,04	0,15	0,20
Venezuela	0,62	1,74	0,28	0,20	0,73	1,45	0,29	0,17	nd	nd	0,19	0,17

Source: Prepared by the author based on Sánchez–Ancochea (2010) data
a/ (I/s)/(Y) average ratio for 2002-2007
b/ (X/m)/(Y) average ratio for 2002-2007
c/ 2007 figures

On the other hand, in countries such as Costa Rica, Guatemala and Honduras, the main source of dynamism was domestic demand. This is explained by a combination of low propensities to save (or even negative propensities to save, as was observed in El Salvador and Nicaragua) with high propensities to import. These conditions offset the expansive impact of the increase in exports. These countries were able to maintain consumption and their trade deficit through continuous increases in remittances from emigrants and debt, both of which were seriously affected by the world crisis. The other countries that demonstrated greater relative dynamism of domestic demand present less extreme figures for their propensities to import and save.

The global economic crisis deeply impacted Latin America through the reduction of imports and inflows of capital and remittances. Portfolio investment in the region fell by US$76 billion in 2008, foreign direct investment (FDI) dropped in 2009 and exports fell by 30% p.a. during the last quarter 2008 (a trend that would continue over the next several months).[3] In view of this, some countries were expected to partially redirect growth drivers from external demand to domestic demand.

The results obtained show changes in the dynamizing components of aggregate demand in 2009 in comparison to the pre-crisis period in all countries. Hence, the importance of the domestic multiplier increased in Argentina, the Dominican Republic, Guatemala, Honduras, Paraguay and Uruguay and remained unchanged in Mexico. The situation reverted in Brazil in 2009, when the country moved from a situation in which dynamism stemmed from external demand, to one in which domestic demand played a key role. In El Salvador and Nicaragua, the impact of the crisis led to additional reductions in negative figures for the respective domestic multipliers. Finally, in the remaining economies, the dominant driver continued to be external demand, despite the existence of an array of measures designed to dynamize domestic markets. In any case, it is important to recognize that practically all governments responded to the fall in aggregate demand by introducing countercyclical fiscal policies.

3 Ocampo (2009) in Sánchez–Ancochea (2010).

2. Measures implemented to expand the domestic market: The case of Brazil

The measures adopted by Brazil were meant to increase consumption by reducing indirect taxation of the motor industry, raising minimum wages as well as conditional transfers. They also were designed to increase investment (or slow its fall) by expanding credit and augmenting public investment in infrastructure. This included boosting public spending by the central government by two percentage points of the GDP in 2009.

One of the high-impact measures introduced involved reducing indirect taxation on cars[4] and increasing the number of car loans available from public banks. Banks also lowered their interest rates. This led to an increase in car sales in the domestic market that managed to offset the 35% fall in exports, meaning that there was practically no decrease in total output in 2009. In addition, and in response to the abrupt fall in private loans during the second half of 2008, the Central Bank reduced reserve requirements for sight deposits as well as the interest rate, and worked with the main public banks to expand credit for the private sector.

Furthermore, the *Bolsa Familia* programme provided income to ten million poor families and extended coverage to 1.3 million additional families while increasing their benefits. This policy had a positive impact on domestic demand given the beneficiaries' propensity to consume locally produced goods.

Finally, it is important to bear in mind that Brazil has implemented a sustained increase in real minimum wages during more than a decade. When the crisis developed in 2008, the government did not back away from its promise to raise the nominal minimum wage in 2009 (12%) and again in 2010 (8.9%). This directly benefitted 16% of workers and represented an injection of R$21 billion in 2009 alone. It also resulted in social security benefit increases, which were adjusted to reflect the new minimum wage. This experience is proof of the importance of reducing duality in the labour market, which is expressed by the significance of informal employment, and highlights the positive dynamizing impact of domestic markets created by a policy that expands real wages in line with increases in productivity.

3. Can other countries follow suit?

In order to answer this question, we will analyze the situations of Central American nations, which present small, very open economies with external strategies that are less dependent on natural resources than other countries in the region. However, Central America does share a lack of countercyclical policies with the rest of Latin America. In Costa Rica, for example, the ratio between GDP and public consumption has been clearly procyclical since 1961. There is no relationship between the two variables in the remaining countries.

Although every country in the subregion increased public spending and adopted measures designed to expand private aggregate demand in response to the economic crisis, the initiatives were relatively limited and were not capable of influencing domestic demand. Implementation of the measures proved difficult in some nations, and restrictive policies were adopted before the economy had recovered its pre-crisis level of employment. In any case, our analysis suggests that there are three structural problems related to adopting systematic policies to promote domestic demand like those adopted in Brazil.

a) Structure of the economy

Due to its size, Central America has always been highly dependent on the external market, a condition that has become more pronounced over the past 20 years. Trade liberalization reduced the significance of domestic manufacturing output and has threatened the survival of traditional agriculture. In addition, export incentives have led to the creation of free trade zones and tourist services, which have become dynamic poles and have contributed a great deal to the creation of growth and employment. However, trade liberalization has increased the propensity to import significantly, thereby reducing the multiplier effect of public spending on GDP.

Tradable sectors producing for the domestic market (agriculture and manufacture) have increased the weight of imports, which has reduced the number of companies that can respond quickly to government incentives. Major manufacturing companies that still make agribusiness products have become commercial representatives and importers of transnational corporations. Meanwhile, small and medium size enterprises find it difficult to compete in the domestic market, or to react quickly to incentives in times of crisis. This reduces governments' ability to focus production on the domestic market. Finally, there is increasing duality in the productive structure.

4 Industrialized Product Tax fell from 7% to 0% for 1,000 c.c. or smaller cars, and from 13% to 6.5% for 2,000 c.c. or smaller cars between January and September 2009 (ECLAC, 2010). See Sánchez-Ancochea (2010), op. cit.

A significant share of the more dynamic and more productive sectors focuses exclusively on exporting, since there is no significant domestic demand and therefore no real opportunity to reallocate production.

b) External restrictions

Increasing dependence on imports has created greater deficits in the current account balance for Central American countries. These deficits are financed through external debt, development aid, remittances from emigrants and FDI. In 2007, prior to the crisis, remittances represented between 8% and 22% of the GDPs of all of the countries on the isthmus (with the exception of Costa Rica), and they contracted by 9% in 2009 as compared to the previous year.[5] The crisis in the United States impacted the flow of foreign currency almost immediately due to declines in exports and remittances.

Although all Latin American countries face significant external restrictions on the adoption of expansive policies in times of crisis, the situation of Central America is particularly difficult. On the one hand, an external shock like the one that took place in 2008 reduced foreign currency inflows substantially by impacting exports –in price and volume- as well as remittances and FDI. In addition, these economies must finance much higher and more permanent current account deficits than other countries, and must do so with insufficient reserves.

c) The capacity of the public sector

Over the past two decades, the public sector has experienced setbacks in its institutional capacity to support and promote traditional productive areas of agriculture and industry. In countries such as El Salvador, for example, there are few large public banks that could actively intervene in times of crisis and provide support for enterprises that produce goods for the domestic market. Meanwhile, the agencies that promote exports and lead trade negotiations have become stronger. Furthermore, it is difficult for these countries to increase tax revenues. In Central America and the Dominican Republic it is very difficult to subsidize domestic production in the short term and support consumption by the poorest members of society when tax revenues represent between 10% and 18% of GDP.

The restrictions described above appear simultaneously with significant duality in the labour market, which is in turn indicative of the nations' productive structure. There is thus a need to strengthen domestic markets in order to reduce this segmentation by improving the transition to productive employment. However, it is important to keep in mind that strengthening internal sources of growth depends on one key factor: the existence of strong corporate dynamics that are capable of responding to trends in demand. Neither wage growth nor public incentives are capable of promoting domestic demand on their own.

4. Conclusions and policy recommendations

In recent years, it has become increasingly evident that it is difficult to achieve broad-based development through in-bond manufacturing (maquilas), tourism, remittances and similar sectors. The economic crisis has shown us that there is a need for more balanced development and the maintenance of instruments for integration to the world. It has also become clear that this must be accompanied by tools that can be used to develop the domestic market. From this viewpoint, it may be more appropriate to encourage the use of a two-pillar strategy for promoting systemic development of economies based on expansion of domestic markets and competitive inclusion in external markets.

One pillar could be based on a policy of medium-term investment in infrastructure that includes identifying plans for benefitting the most disfavoured regions and that foster the greatest multiplier impacts on employment. This effort should also involve reducing the manifest duality of labour markets, which is expressed in formal/informal and export-market/domestic-market segmentations, promoting a shift towards formal and productive employment. This would help productive companies to prosper and respond to both domestic and foreign demand. Finally, raising real wages as productivity increases in the medium term will minimize over-indebtedness[6] and stimulate autonomous demand growth. The promotion of a regional Central American market may also increase the dynamism of domestic markets.

The second pillar would involve strengthening social security in order to create an effective protection network. This would mitigate the pernicious impact of new crises and make local economies more dynamic, while

5 Fomin, Inter-American Development Bank, http://www.iadb.org/mif/remesas_map.cfm?language=Spanish

6 See Torres, R. 2010. "Incomplete crisis responses: Socio– economic costs and policy implications" in International Labour Review, Vol. 149, No. 2. International Labour Organization