

Executive Summary

The global economy has fallen into recession, and faces a difficult outlook. Problems that originated in financial sectors of the United States and other advanced economies erupted into a full-blown crisis in the latter part of 2008. Almost immediately this triggered a steep drop in demand and a tightening of financial conditions worldwide. Policies have responded, but can only contain the damage, and the world economy is projected to contract by more than 1 percent in 2009, with the advanced economies performing the worst. Especially key to world recovery will be action to repair broken balance sheets of the financial system. (See the *World Economic Outlook* and *Global Financial Stability Report*).

In that context, this Regional Economic Outlook highlights a contest now playing out in the LAC region, as a constellation of adverse external shocks tests the region's progress in developing resilience.

The external shocks hitting the region are wide-ranging and severe—but differ in strength across LAC countries. All have sustained a loss of external demand, and many also have suffered terms of trade losses, as commodity export prices plunged. Countries with relatively larger manufacturing sectors have been especially hard hit. Income from remittances and tourism sources is also sinking. And external financing has become more costly for all, with some borrowers cut off from financing.

Against all this, the region has accumulated many sources of strength and resilience during this decade—though again in varying degrees. As analyzed previously in the *Regional Economic Outlook*, countries have made strides in strengthening fiscal positions and public debt structures, solidifying financial systems and their regulation, anchoring inflation expectations, and building more credible policy frameworks. And many more countries can count on flexible exchange rates as part of their adjustment process.

As a consequence of these preparations—and for the first time—many countries of the region have been able to respond to the external crisis with active policies to boost output and employment. This is in marked contrast to the past when home-grown vulnerabilities often forced policies to react defensively, to avoid a spiral into crisis.

Such preparations point to a better outlook for the LAC region: while spillovers of the global crisis have caused activity to contract, a return to growth is expected within the course of 2009, ahead of the recovery in advanced economies. Growth performance also will be favorable relative to past global downturn episodes, when the region typically performed substantially below the world average.

The message emerging from the LAC region is that policy preparations pay important dividends when external conditions deteriorate. Such preparations serve to dampen shocks, but also largely determine the room for near-term policy Responses to support output and employment.

Given the severity of the global financial crisis, this *Regional Economic Outlook* analyzes the condition facing the region's financial system and the role played by global banks. After discussing the global economic outlook, including for the United States and Canada, we analyze the economic outlook for the LAC region, putting special emphasis on the transmission channels from the global crisis and the policy options available. In Chapter 3, we discuss the potential impact from the crisis on the region's banking system, and identify potential stress in the loan portfolio as the main risk going forward. In Chapter 4, we analyze whether the global banks operating in the region could

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exacerbate, in the domestic market, the credit crunch observed worldwide. We document the role played by worsening global financial conditions in the contraction of credit from parent banks. Credit from local subsidiaries, which is more important in terms of size, has also been affected, but to a lesser extent.