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# A Comparative Assessment of How Trade Liberalization and the Economic Crisis have impacted Mexico and Chile[1]

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In 2007, when the financial crisis exploded in the United States and spread to developed and the developing nations, multilateral organizations and national authorities repeated, once and again, that it will not affect Latin America with the severity other crises did. It was assumed that the region, thanks to the reforms and the instauration of the export lead model, was protected and in better shape to react to external shocks. The arguments that supported the Latin American resilience to external crises pointed out the relative higher growth coupled with low inflation that Latin America enjoyed during the four years preceding the crisis; the better macroeconomic foundations created with the reforms, especially the low fiscal deficit and the ideology of fiscal discipline that is embedded in policy makers; the reduction of direct taxes on income that were supposed to lead to higher savings and investments rates and the full liberalisation of capital accounts and foreign trade regimes leading to higher productivity and exports; the independence of the central banks leading to sound monetary policy; the expected high prices of export products: commodities; sound and efficient financial system; high international reserves, shielding the economies from speculative attacks to national currencies.

By mid 2008, the region, nevertheless, was contaminated by the financial crisis. As Puyana and Tokman illustrate in their respective contributions to this volume, open economies that are more integrated to world markets are highly vulnerable to crises that occur in other parts of the world. Latin American economic history is full of lessons regarding this fact. Besides the "Debt Crisis" of the early 1980's, the region was affected by recurrent crises that took place during the period after the acceleration of financial and trade liberalization and the redefining of the economic borders of the state. During the second half of the 1990's and early 2000's, countries were affected by crises that originated inside the region, such as the one in Mexico and Argentina, as well as by those registered in other parts of the world, like the Asian crisis in the late 90's. More recently the situation in countries like Greece, Spain, Portugal and Turkey, and the feeble and protracted recuperation of the United States' economy, may also affect the prospects of a sustained recuperation by Latin American economies.

The effects of the global financial crisis manifested in Chile and México during the third quarter of 2008. It increased unemployment and inflation, reduced incomes, and partially wiped away the meagre gains

1 This comparative analysis is based on two detailed background papers prepared by: Alicia Puyana, Trade Liberalization in Mexico: Impact of the Global Financial Crisis 2008-2009 on Productive Sectors, Employment and Incomes, ICTSD Programme on Competitiveness and Development, Issue Paper No. 15, (2010); Tokman, Viktor E. (2010), Globalization in Chile: A Positive sum of Winners and Losers, ICTSD Programme on Competitiveness and Development, Issue Paper No. 14.

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in poverty alleviation and income distribution obtained during 2002-2007. Additionally, the crisis hit the real sector and service sector of both nations' economies. Manufacturing and agriculture declined affecting GDP and employment, intensifying the evident Dutch Disease Symptoms that impacted both countries. Apparently, the financial sector was not affected and foreign owned banks were able to repatriate substantial earnings that helped to alleviate the crisis affecting their headquarters located in developed countries, mainly the USA, Spain and the United Kingdom.

There were several channels of transmission of the crisis to Latin America. Amongst the most important we can identify are: the reduction of demand for Latin American exports and declining terms of trade; the contraction of credit and the reduction on the inflows of FDI; the reduction of remittances and international migration outflows; and the decrease of external tourism. Latin American banks did not engage in mortgage activities but they swapped with banks in developed countries and Mexican and Chilean companies borrowed from abroad, causing them to become heavily indebted. All the above elevated the demand for foreign resources and induced devaluation. To support the national currency central banks decided to sacrifice reserves: From September 2008 to April 2009, Mexico spent some $26 billion US, making up 26% of the reserves supporting the exchange rate. Nevertheless, the peso devalued by 50% and the Chilean government also devaluated but only to a minor degree. This time devaluation will not help to expand or sustain exports since the world market is depressed.

The recent crisis started during the last trimester of 2008 interrupting five years of economic expansion stimulated by relatively high nominal commodity prices, which benefited Chile but not Mexico, a country that is a net importer of almost all the agricultural and other commodities its economy demands except for oil. This time the crisis affected all countries in Latin America with different intensities. On average, output decreased by 1.9 per cent in 2009 and around 3 per cent in per capita terms. The average unemployment rate increased 0.8 percentage points during 2009 and at its peak it increased by 1 percentage point.[2] Unemployment increased from 7.3 to 8.1 per cent in one year, adding approximately 2.2 million people to the pool of unemployed laborers. As a result of the economic contraction, the occupation rate also decreased on average by 0.5 per cent, while the participation rate remained constant. Wage workers in private enterprises were more affected, but their decreased level of employment was partly compensated by the increase in public employment and particularly, by special employment programs. Self employment and unremunerated family members increased by 4 per cent and the demand of labor from formal enterprises decreased. This resulted in increased informal employment affecting job quality.

As we mentioned above, the "Global Financial Crisis" affected Chile and Mexico with higher intensity than the rest of Latin America. But the Mexican economy suffered significantly more than that of Chile's. In 2009, total Mexican GDP contracted by 6.7 per cent while Chilean GDP declined by 1.8 per cent. That trajectory was reflected in a dramatic contraction of Mexican per capita GDP of 7.8 per cent and a relatively moderate, but important fall in Chilean per capita GDP of 2.8 per cent. Since Mexican GDP decreased more intensively than in Chile, the impact on employment and wages was more severe in the former than in the latter. In 2009, Mexican unemployment reached 6.8 per cent, the same rate registered in 1982 when the debt crisis more severely reduced the GDP. In Chile, the unemployment rate in 2009 was 9.8 per cent, larger than in Mexico, but lower than the record levels Chile suffered during the 1981-82 crisis. The impact on minimum wages has been dramatic in both countries. Neither Mexico nor Chile have been able to prevent the repetition of the deep economic downfall of the debt crisis and its deleterious effects on employment and salaries. Table 1.1 explores the channels of transmissions of the crisis to the two economies and illustrates why the effects vary so much from one country to another.

2 This refers to the weighted mean for the Region. The increase of the rate of unemployment reached 1.6 percentage points during the first three trimesters of 2009.

**Table 1.1. Effects of the Global Financial Crisis in México and Chile. Rates of Growth of GDP, Employment and Labour Incomes (RMW = Real Minimum Wages/MRS = Medium Real Salaries).**

| | Mexico | | | | | Chile | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Total GDP | GDP Capita | MRS | MRW | Unmplyt. | Total GDP | GDP Capita | MRS | MRW | Unmplyt. |
| 2000 | 6.6 | 5.1 | 6.0 | 0.7 | 3.4 | 4.5 | 3.2 | 1.4 | 7.1 | 9.7 |
| 2001 | -0.2 | -1.2 | 6.7 | 0.4 | 3.6 | 3.4 | 2.2 | 1.7 | 3.8 | 9.9 |
| 2002 | 0.8 | -0.2 | 1.9 | 0.7 | 3.9 | 2.2 | 1.0 | 2.0 | 2.9 | 9.8 |
| 2003 | 1.4 | 0.3 | 1.4 | -0.7 | 4.6 | 3.9 | 2.8 | 0.9 | 1.4 | 9.5 |
| 2004 | 4.0 | 3.0 | 0.3 | -1.3 | 5.3 | 6.0 | 4.9 | 1.8 | 2.8 | 10.0 |
| 2005 | 3.2 | 2.2 | -0.3 | -0.1 | 4.7 | 5.6 | 4.4 | 1.9 | 1.9 | 9.2 |
| 2006 | 4.8 | 3.7 | 0.4 | 0.0 | 4.6 | 4.6 | 3.7 | 1.9 | 2.5 | 7.8 |
| 2007 | 3.2 | 2.2 | 1.0 | -0.7 | 4.8 | 4.7 | 3.7 | 2.8 | 1.8 | 7.1 |
| 2008 | 1.3 | 0.7 | 2.2 | -2.1 | 4.9 | 3.2 | 2.2 | -0.2 | -0.1 | 7.8 |
| 2009 | -6.7 | -7.7 | 0.6 | -1.0 | 6.8 | -1.8 | -2.8 | 4.8 | -1.7 | 9.8 |

*Sources: own elaboration based on: CEPAL, 2009b; for MRW, Mexico: CNSM, 2009 and for Chile, for and CN*

In 2009, the index of Chilean real wages (2000 = 100) decreased by 2 per cent, while in Mexico it declined by 1.5 per cent. It is important to explain why these two countries, the most open medium sized Latin American economies, were the ones that suffered the most from the recent crisis. And why Mexico more harshly affected than Chile.

Chile and Mexico were early reformers and intensive economic liberalizers. Chile introduced the export lead model as early as 1974, just after the military coup against the democratically elected president Allende. Mexico so introduced the same model after the debt crisis broke out in 1982. In 2009 the external coefficient of their GDP was 72.3 and 60 per cent for Chile and Mexico respectively. Both countries privatized almost all public companies except for cooper and oil, and both signed trade agreements with the USA (Mexico in 1993 and Chile in 2001) and a myriad of other countries around the globe. As a result, the movement of goods and capital became practically free. Therefore, the differences in economic performance and resilience to external shocks have to be attributed to aspects other than protectionist policies and excessive state intervention.

The severity of the crisis is related to the nature of the external shocks that affected each economy and the particular characteristics of each country. As the International Monetary Fund (2009) indicated, Mexico was the "hardest-hit economy in the Western hemisphere ... because its economy has suffered a sharper drop in trade flows, because of its high trade integration, dependence on the United States, and reliance on manufacturing exports".[3] Mexico was hit by the contraction of exports, remittances and external financial flows. First, it was negatively affected by the diminished volume of manufacturing exports to the US, which receives 90 per cent of Mexico's labour intensive exports. Secondly, Mexico suffered from a fall in external prices and in the decreased volume of oil exported. Thirdly, the Mexican economy was harmed by the diminished level of remittances from Mexicans living in US. The recession of the US economy is the main factor behind the fall in Mexican GDP due to the decrease in exports and remittances.[4] On top of that, Mexico did not benefit by the expansion of the Chinese demand of raw materials as Chile, Brazil and other Latin American countries did. Additionally, tourism declined by 16.8 per cent in Mexico and 8 per cent in Chile. Chilean exports are heavily concentrated in agricultural products and other commodities and resource based manufacturing goods. Exports of these goods go to several countries demanding such products such as China. Mexican exports are concentrated (85 per cent) in manufacturing goods originated in subcontracting models and in only one market. The contrast is evident: In 2009, Mexican exports contracted by 14.8 per cent while Chilean exports did so by 5.6 per cent. Devaluation and financial constraints reduced imports in both countries: In Chile by 14.3 per cent and in Mexico by 18.2 per cent. These figures reveal a dramatic vulnerability of the external sector of both economies that puts both nations' growth prospects in peril. Mexico is, nevertheless, more vulnerable. Some additional figures help to understand this point: Since 1980, Chile has accumulated an annual average trade surplus of 6.7 per cent of GDP, while Mexico has a

3 International Monetary Fund (October 2009). World Economic Outlook. pp. 83-86.

4 The World Bank (2009). Commodities at the Crossroads. Global Economic Prospects.

deficit of 1.7 per cent of GDP, which was reduced in 2009 thanks to the intensive contraction of imports that more than compensated for the fall in exports. Current account deficit increased in both countries and will remain high up to 2014 according to the FMI, 2010 World Economic Outlook.

What is more worrisome is the long lasting loss of income. In 2012 it is expected that Mexican per capita GDP will be smaller than in 2008, but the Chileans may recover in 2011. All in all, Latin American GDP in 2014 would be 3 per cent lower than the projection from before the crisis (FMI 2009: 26). In any case, the level of economic activity will remain depressed and the recovery may be a jobless one. In addition, if employment and wages are not revived, domestic demand will remain feeble and effects of the recovery will not occur (ILO, 2009). The path to jobless growth is evident in Mexico and Chile: during the crisis unemployment and informal employment explode and during the growth spells the jobs recovery does not compensate the loses. It looks like natural unemployment rate tend to be larger as time passes by and economic cycles repeat.

The measures that governments put in motion to respond to the crisis are contrasting as well. Instead of achieving stabilization as the first goal of its macroeconomic policy, Mexico maintained a rather small fiscal deficit and planned to have an equilibrated budget by 2010 with minimal tax reductions and almost nil expenditure expansion. The reason for such an austere response to the crisis was the reduction of fiscal income due to the fall in the volume and prices of oil exports. Chile put in motion more intensive countercyclical policies thanks to the margin created by the establishment of the stability fund due to the boom in copper prices; which Mexico failed to do when oil prices were particularly high. Chile implemented a countercyclical fiscal policy more intensive by about 3 per cent of GDP, while Mexico affected by fiscal crisis, prioritized anti-inflation policy and controlled expenditure. A credit crunch affected internal demand in Chile and Mexico and the deceleration of foreign direct and portfolio investments aggravated the impact of the contraction of export revenue. Both countries devalued their currencies. The positive effect of devaluation on exports may not appear though, since external demand will remain weak for quite some time.

Chile instrumented complex programmes oriented to stimulate medium and small enterprises in manufacturing, tourism, and home construction. Mexico initiated similar programmes but were smaller in size and scope.

All in all, we can conclude that Chile suffered a relatively milder impact from the crisis because as a commodity exporter it had better terms of trade. Chile preserved some of the public financial institutions to promote development that Mexico managed to eliminate. Chile created a stabilization fund to maintain fiscal expenditure.

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