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Department of Economics
and Management

The Role of Financial Crises in Altering Wealth and Growth Patterns in South America

Economics and Management of Cooperation and Development

Andrea Češková & Javier Ávila
Università degli Studi di Pavia
Technische Universität Dresden

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Outline

I. Theoretical Background

Crises, Growth and Inequality

- Financial crises in Latin America are **recurrent**, with large output and employment losses and substantial social costs.
- Recent evidence shows crises are also **inequality events**, not only macro shocks.
- Bodea et al. (2021) find that financial crises tend to **increase income inequality** and that these effects can persist long after macro indicators recover.
- Latin America is a critical case:
  - Large informal sectors + volatile capital flows $\Rightarrow$ high vulnerability
  - High baseline inequality

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Conceptual Framework: Crisis Types

- Following Claessens & Kose (2013), four main crisis types are distinguished:
  - **Currency crises**: sharp depreciations or collapses of exchange-rate regimes.
  - **Banking crises**: systemic bank runs and failures requiring public intervention.
  - **Sovereign debt crises**: default or restructuring of government obligations.
  - **Sudden stops**: abrupt reversals or collapses in capital inflows.
- Sudden stops: often triggered by balance-of-payments crises with binding collateral constraints that deepen recessions and asset-price collapses (Mendoza, 2010).
- Nguyen et al. (2022) document frequent **twin/triple crises**, where currency, banking and debt crises occur simultaneously, magnifying output costs.

Transmission Mechanisms to Inequality

- **Three channels:** labor market, wealth (asset), and fiscal policy.
- **Labor market:** Crises hit informal and low-wage workers hardest; weak safety nets mean shocks persist.
- **Wealth channel:** Asset collapses hurt poor more; wealthy use hedging and foreign assets, widening wealth gaps.
- **Fiscal policy:** Austerity cuts social spending when needed most; COVID-19 showed transfers can dampen inequality rise.

Our Study

Growth, Inequality and permanent crises

- **Hypothesis:** Financial Crises in the LATAM region have negative effects on both GDP growth and income inequality.
- **Empirical Evidence:** Historical data back the idea that the permanent crises that LATAM has been experiencing since the 1970's have hurt their growth prospects.
- **Data and Sources:** We base our work on data from the World Bank and Nguyen et al. (2022) research on financial crises.

II. Case of Latin America

Why Latin America is "Special"

- **Twin & Triple Crises:** 40+ episodes of simultaneous currency, banking, and debt crises, not isolated shocks.
- **Asymmetric Inequality Impact:** Bottom 50% loses 0.4–0.5pp of income share per crisis; top 1% insulated. Effects persist 3+ years.
- **Sudden Stops & Collateral Constraints:** Commodity dependence and external debt trigger capital reversals with deeper recessions than advanced economies.
- **Lasting Effect:** Inequality spikes never fully revert. Each crisis locks in permanent distributional losses.

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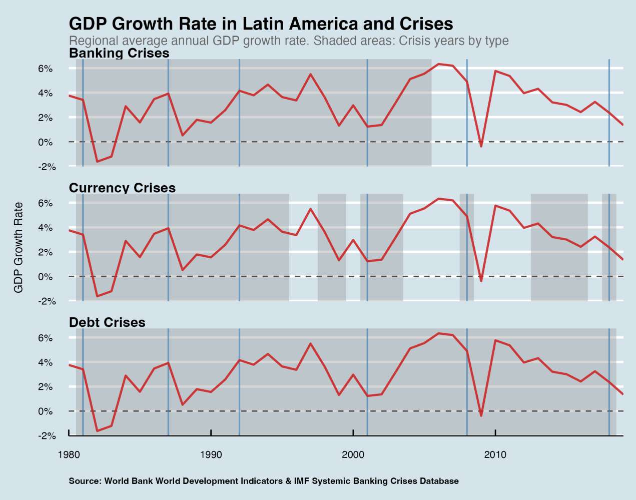
A Central Question: Why does Latin America experience so many financial crises? The answer lies not in external shocks or bad luck, but in a fundamental institutional problem.

When governments cannot commit to consistent economic policy, confidence erodes. Capital begins to flee before policymakers even recognize the danger.

The Scale of Failure: Between 1980 and 1999, the region experienced several episodes of severe economic collapse. This was not a handful of bad years. This was a pattern. This reflected institutional systems incapable of implementing preventive macroeconomic discipline.

Unstable institutions make crises both more likely *and* more severe. (Sawyer C. 2010)



- 1981: Latin American debt crisis
- 1987: Late phase of the debt crisis
- 1993: Tequila Crisis
- 2001: Argentine Crisis
- 2008: Global financial Crisis
- 2018: Argentine monetary Crisis
- 2019: COVID-19 Crisis

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Lasting Scars

The Multiplier Effect: Twin crises produce permanent output losses of **15%**—three times that of single crises. Credit systems stall, investment evaporates, import prices explode. Productive capacity is destroyed, not merely redistributed.

The Transmission Channels: Labor markets suffer disproportionate unemployment at the bottom; wealth channels erode savings while the rich hedge; fiscal austerity cuts education and infrastructure precisely when most needed. The poor bear the largest burden.

Scarring is Permanent: The 1980s debt crisis was not bad luck, for it was the consequence of institutional weakness.

For LATAM, financial crises are not an "if" but a "when."

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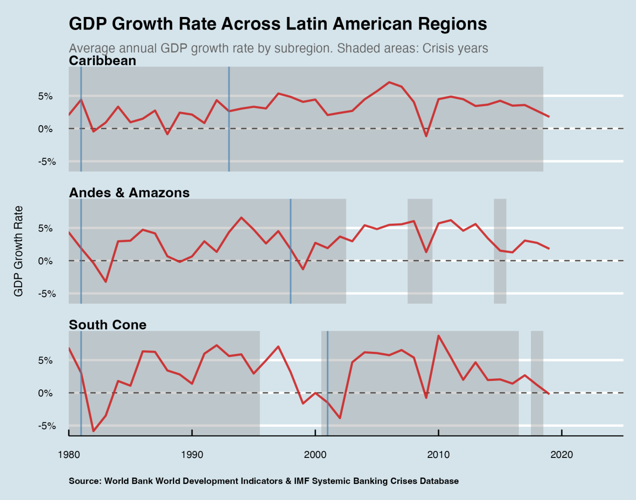

- **Caribbean**
  - 1981 - Mexico Defaults on its obligations.
  - 1993 - Mexico's Tequila Crisis
- **Andes & Amazons**
  - 1980 - Brasil's debt crisis.
  - 1998 - Ecuador's currency crisis.
- **South Cone**
  - 1990 - Chile's banking crisis.
  - 2001 - Argentina's first debt crisis.

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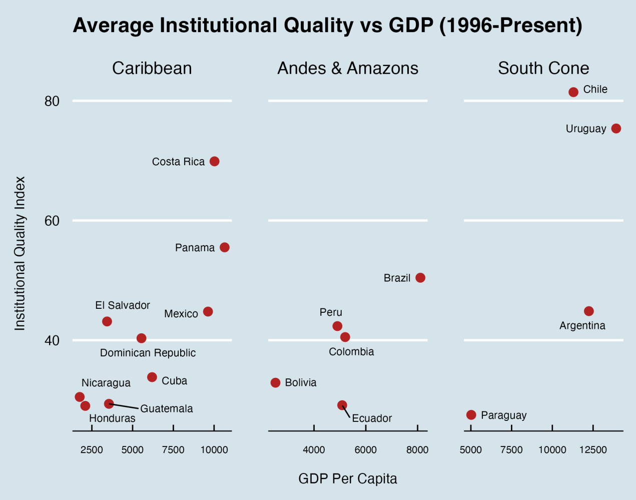

- There is a clear correlation between institutional quality and GDP.
- If this trend is compared with the shocks during and after crises, is clear that countries with more solid institutions are more well equipped to paddle these effects trough time.

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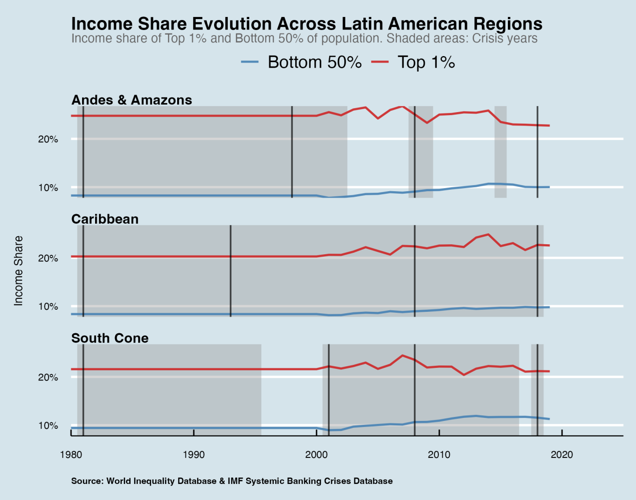

- Important observation for our hypothesis: Crisis are not *creating* inequality.
- Rather, in most cases the crisis are aggravating or maintaining structural inequality.

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III. Empirical Methods

Econometric Specification

Fixed Effects Model with Lagged Crisis Effects and Controls

Our baseline specification is:

$$Y_{it} = \beta_0 \text{Crisis}_{it} + \sum_{k=1}^{3} \beta_k \text{Crisis}_{it-k} + \gamma X_{it} + \alpha_i + \varepsilon_{it} \tag{1}$$

Key features:

- **Three dependent variables estimated separately**:
  - Annual GDP growth rate
  - Pre-tax income share of top 1% (adults 20+)
  - Pre-tax income share of bottom 50% (adults 20+)
- **Crisis indicators**: Separate regressions for banking, currency, debt, and twin crises
- **Lagged structure**: Captures dynamic effects up to 3 years post-crisis
- Controls: Trade Openness, Log GDP Percap and Secondary School Enrollment

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Summary of Empirical Results

1. **Effect on GDP Growth**
   - All crises types cause inmediate GDP Contractions. With Currency Crises being the most damaging: -4.4% on impact.
   - Crises leave everlasting scars on growth: There are significative negative effects even three years later.
   - Some recovery exisist starting from two years after the initial hit, but is largely incomplete and weak.
2. **Effect on Income Inequality**
   - Bottom 50% of income loses about 0.5% of income share due to financial crises.
   - Top 1% of income is essentially unaffected.
   - Scarring effect up to three years later suggest household income recovery is very slow.

For complete results, please refer to our GitHub repository.

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IV. Policy Implications

Institutionalize Crisis Response

Crises are structural, not emergencies. Over 40 episodes of 4%+ GDP collapse demands permanence, not improvisation.

Three institutional anchors:

- **Countercyclical social protection floor:**Automatic triggers during crises, funded by central bank or independent body.
- **Structural fiscal buffers:** Accumulation during booms, to enable spending during downturns.
- **State level crisis bodies:** Ready to deploy, independent statal entities. Not crisis response tied to political cycle.

Why it matters: Without protection, productive capabilities are destroyed, families sell productive assets. As shown by our study, these losses persist for **decades**, locking in permanent inequality.

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Differentiate by Crisis Type

Not all crises warrant identical responses.

- **Debt crises:** Largest inequality increase, longest duration. Require aggressive, prolonged response. Cannot assume short-term fixes suffice.
- **Twin crises:** More severe than single types. Demand coordinated banking + currency + fiscal intervention.
- **Currency crises:** Smaller distributional impact. Target exchange rate stabilization and capital controls.

Main Takeaway: Crises reveal *existing* inequality; they do not create it. Inequality reduction must be continuous structural work, not crisis-only intervention.

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IV. Closing Toughts

Adressing Structural Weaknesses

Inequality is structural, not cyclical. Our results show that crises aggravate what already exists; *yet they do not create it*.

- **45% informal workforce is a policy choice** — labor market overregulation, licensing requirements, tax burdens exclude the poor from formal participation.
- **Emergency transfers are palliatives** — they implicitly admit policy failure to create accessible formal economy.
- **Institutions Matter:** Countries with more solid institutional backbones (eg. Chile, Uruguay, Brazil) have shown better endurance to crises everlasting effects.

Our Solution: Deregulation, not redistribution — Reform formal sector to make it accessible. Remove barriers. Invest in solid legal and economic institutions.

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Depoliticize Poverty

Unlimited redistribution destabilizes growth. When inequality dominates politics, distributional conflict deincentivize investment and perpetuates poverty.

- **Embed anti-poverty in permanent fiscal rules:** Automatic countercyclical transfers, constitutional debt limits, non-discretionary policy.
- **Remove redistribution from political agenda:** Fighting inequality and low income share requires constant state level policies, outside of the political battleground.
- **LATAM's priority: Growth, growth and growth:** Non-discretionary safety nets can coexist with growth agenda. Continuous redistribution politics cannot.

Bottom line: Political stability is the prerequisite for growth. Growth is the prerequisite for ending poverty. Endless distributional conflict achieves neither.

Thank you!