Comité Latinoamericano de Asuntos Financieros
Comitê Latino-americano de Assuntos Financeiros
Latin-American Shadow Financial Regulatory Committee

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WHAT FINANCIAL POLICIES WOULD BE REQUIRED TO FACE THE RESURGENCE OF CAPITAL FLOWS TOWARDS LATIN AMERICA?

In some Latin American countries there is a growing concern regarding the incipient resurgence of financial and capital flows towards the region and the economic and financial consequences it might entail. The Latin American Shadow Financial Regulatory Committee [CLAAF] has proceeded to analyze the various aspects, causes and effects of this phenomenon. It is on the basis of the aforementioned analysis that the Committee presents the following recommendations:

- Primary surplus targets should be strengthened to levels consistent with a gradual and sustained process of debt- to-GDP ratio reduction.

- Governments must take advantage of the current favorable circumstances to improve the debt maturity profile and/or increase the availability of international liquid assets.

- Advantage should be taken of current favorable circumstances to neutralize future adverse shocks through measures for their protection against eventual and acute exchange depreciations. This may be achieved by issuing, for example, bonds indexed according to inflation instead of bonds denominated in dollars.

- In the case of public sectors exposed to excessive exchange risks, the Committee recommends that international organizations weigh the possibility of charging the implicit cost of non-acquired insurance to current fiscal results.

- Bank assets should be protected against the pernicious effects of fluctuations in real exchange rate, particular care being taken to ensure that the provisions incorporated within the current regulations adequately cover this type of risk.

- Existing regulations in financial and capital markets should in no way discriminate against viable financial instruments. Given the risks and characteristics of the region it is deemed desirable that the market have the broadest possible range of instruments so that it may evolve towards the completion of financial markets.

1. Recent Developments in Capital Flows towards the Region

Subsequent to the Russian crisis in August 1998, direct and portfolio investment flows towards Latin America collapsed from a level in the order of 100,000 million dollars a year to less than 10,000 million for the year ended in the third quarter of 2002. Ever since that period, there has been a significant reversion and according to projections it is expected that net capital inflows to the region exceed 35,000 million dollars during 2004.

This significant reversion was driven by an extraordinary improvement in financial conditions for high risk assets. The Fed Funds rate has recently reached its lowest level for the last 50 years and spreads paid by “high yield bonds” – or “junk bonds” as they are known in the USA, which are highly correlated with spreads in emergent markets – fell from almost 1100 points in October 2002 down to 350 points at the present moment, the lowest level in six years.

This significant improvement in financial conditions for the high-risk-asset class, combined with a vigorous surge in the price of main commodities which commenced in mid-2002, coupled with the fact that political uncertainty in Brazil was dispelled, rendered possible a highly sustentative reduction in spread for the countries of the region. The latter has recently reached the lowest levels since the outbreak of the Asian crisis in mid 1997. By way of example, suffice it to say that spread in Brazil dropped from 200 basic points in October 2002 to 600 points at the present time.

Effects of this reversion in capital and financial flows on financial variables did not take long in becoming apparent. Since October 2002 the real rate of exchange in some important economies within the region appreciated significantly and this appreciation would have been all the more considerable had it not been for the intervention of Central Banks which acquired substantial volumes of international reserves. Asset price has experienced a formidable boom: sovereign bonds of the main countries in the region have increased by an average 80% as from October 2002 and some stock exchanges have experienced increases which exceed 100%. Due partly to the significant upsurge in the price of assets and therefore to their collateral value, bank credit which had been significantly reduced as from the Russian crisis, recommenced an incipient reactivation as from the end of 2002. Hand-in-hand with bank credit, both investment and the rate of growth of economic activity have experienced reactivation. In point of fact it is expected that Latin America shall grow by 4% during 2004, the highest rate since 1997. And coupled with the upsurge in economic activity, revenues and fiscal results have improved as well.

Needless to say, this positive reversion of capital flows as well as its financial and economic effects, may well change sign without prior warning. A monetary restriction in the USA resulting in a significant raise of the rate of interest by the Fed, might bring about for emerging economies a substantial increase in spreads and an abrupt deceleration of capital inflows.

The Committee is fully aware of such risks. Nonetheless, fiscal and financial management in times of abundant supply of capital flows have, in the past, proven to be a major source of instability in times of adverse weather. Hence the Committee has believed it pertinent to analyze the opportunities and challenges which, seen from the perspective of fiscal and financial management, are available to the countries in the region under the current conditions of international financial markets.

These considerations are particularly important within a context wherein consolidation of low and stable inflation levels in various countries of the region renders possible a wide range of options in financial management which until not so long ago were unthinkable.

One example would be bond issue at fixed and relatively moderate nominal rates, [10 percent or less] over significant periods, oftentimes between five and ten years, which have extended in recent times over even longer terms. Furthermore, by virtue of causes other than inflationary reduction, bonds indexed to CPI [Consumer Price Index] have been issued over terms up to 30 years and at real rates which have been reduced to less than 5 percent.

The development of a certain type of institutional investor has played a significant role in this phenomena, such as pension funds based on the principle of capitalization and individual accounts in lieu of the "distributive" principle. In Mexico, for example, the amount of securities in circulation for terms exceeding one year, denominated in pesos or in UDIS [Investment Units the daily value whereof reflects the evolution of Consumer Price Index] had, at year-end 2003, reached the pesos equivalent of almost 100,000 million dollars. These bonds had been issued both by the Federal Government and public enterprises; the majority for an original term of over 5 years and in some cases as much as 30 years.

2. Financial Policies Vis-à-vis a Larger Supply of Capital Flows

In the current favorable external circumstances the Committee recommends:

2.1 Increase of primary surplus, reduction of public debt ratios and improvement of its temporal profile.

Within an expansive context, primary surplus targets should be strengthened so that they attain levels consistent with a gradual and sustained reduction of debt-to-GDP ratio. This strategy shall render possible consolidation of the achievements attained with regard to inflation reduction and shall supply the required cushioning for a counter-cyclical fiscal policy in times of adversity. The "structural surplus" rule used by Chile illustrates the application of this principle recommended by the Committee.

Furthermore, governments must take advantage of current favorable circumstances in order to improve debt maturing profiles and/or increase availability of international liquid assets. In this manner it shall be possible to give the countries time to adjust whenever access to capital markets be abruptly interrupted.

2.2 Setting forth clearly the fiscal cost of "insurance" against volatility of real exchange rate.

The experience gained within the last few years has taught us that favorable circumstances concerning international markets lead to financial policies that entail a high cost in the long term, regardless of how attractive they may seem in the short term,. For example, exceedingly favorable circumstances regarding rates and terms for placing dollar-denominated bonds during the '90s, led many Latin American countries to dollarize its debt. This meant that they not only incurred in new dollar-denominated debt, but that the existing debt in local currency was exchanged by dollar debt in order to take full advantage of *prevailing circumstances.*

This temptation of focusing policy decisions on short term developments was magnified due to its effect – also short term – on fiscal accounts. The lower interest rates of dollar-denominated debt rendered possible the presentation of better fiscal results in the immediate horizon When prevailing circumstances were reverted, so were fiscal results, leaving a negative net balance.

It was thus rendered evident how important it is that authorities take decisions on the basis of inter-temporal concepts. Were this concept to be taken into account it would draw attention to the fact that advantage should be taken of prevailing circumstances in order to neutralize future adverse shocks through the implementation of an "insurance" against such risks. This might be attained by issuing, for example, bonds indexed to inflation the reason being that, within the economic cycle, periods of capital inflow are associated to a real upturn of exchange rate which is typically temporal and winds up by reverting into another period of real downturn. Under these circumstances, prudence requires the issue of an indexed bond which is more expensive in the early stages during the period of exchange rate upturn, but whose benefits become evident during the period of exchange rate downturn. This is due to the fact that an abrupt devaluation at a time of capital flow reversion has no significant impact on real value of debt stock.

In the particular case of those countries whose public sectors opt for maintaining financial mismatches thus exposing them to excessive exchange risks, the Committee recommends that international bodies charge the implicit cost of the non-acquired sector to current fiscal results.

2.3 Ensuring current coverage of exchange mismatches of financial institutions

The Committee recommends that bank assets be protected against fluctuation of real rate of exchange through implementation of provisions that adequately cover these risks. The Committee considers that there is a wide range of mechanisms that may be employed in order to achieve this target. For example, while the majority of regulations in Latin America cover currency mismatches between bank assets and liabilities, provisions do not take into account the potential impact on bank asset risk derived from exchange mismatches among assets and liabilities of debtor. One recommendation to the point might consist of setting forth the requirement that banking provisions covering debtors in the tradable and those in the non-tradable sector be different .Nevertheless, it is an undeniable fact that this distinction among sectors is not only difficult to pinpoint, but moreover varies in time. Under these conditions an alternative recommendation would be that banking institutions evaluate the effect of movements of real rate of exchange on corporative assets. For this recommendation to be implemented in credible form, part of the surveillance should include a sensitivity analysis of financial statements of debtors whenever abrupt variation in exchange rate occur.

2.4 Promotion of a broad range of financial instruments and its derivatives

A recent debate concerning denomination of instruments according to currencies in Latin America focused on the extremes, either recommending full dollarization or recommending dedollarization. The Committee considers that given the risks and characteristics of region, holders of assets would benefit from a widespread range of instruments and therefore regulations should not discriminate against feasible financial instruments.

Among this extensive range of instruments there are those known as fixed rates, floating rates, indexation to the dollar, or indexation to GDP and its derivatives. Each has its advantages and

each has inconveniences and therefore have been conceived so as to appropriately cover a broad scope of risk coverage.
Dollar denominated assets undergo marked variations in their real value whenever there is strong volatility of the real rate of exchange. But these in turn may constitute an incentive to develop markets in local currency while the investor would concurrently have a ”safe” asset into which to move in case of growing expectancy of exchange rate depreciation, without abandoning the local financial system.

Within a context wherein the interest rate is subject to high volatility, floating rate bonds facilitate the placement of long-term bonds. However, a high nominal rate of interest derived from an unexpected increase in inflation, might signify the accelerated and unforeseen repayment of the real value of principal. This accelerated repayment of debt may result in serious problems to debtors, since it may decrease the capacity to proceed to the corresponding amortizations.

Another clear example of “trade-offs” is to be found in bonds indexed to GPD. It is possible thereby to issue for the long-term in contexts where inflation is high and variable, while concomitantly ensuring balances against volatility of the real rate of exchange. In Chile 89% of all domestic debt issued in the country towards the end of 2000, was indexed to inflation. Together with several structural reforms, indexation of financial system in Chile has helped to complete and develop its financial markets, thus permitting the existence of a bond market in the medium and long term, which would otherwise not have existed. Nonetheless, as in the case of the other instruments discussed, indexed bonds are no “panacea” since they have the drawback that real shocks [such as for example, abrupt upturns in oil price] which affect GDP have an adverse effect on the net worth situation of debtors and banks. Furthermore, financial indexation may lead to other generalized forms of indexation potentially detrimental to other sectors of the economy.

With respect to the derivatives market, the Committee is of the opinion that the use of these negotiated instruments renders possible risk coverage and financial engineering operations at low cost. Nevertheless, derivative instruments do not offer, even in the most developed markets within the region, the possibility of implementing coverage over relatively extensive periods so as to ensure correct risk management within a high volatility context.

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