**Latin American Shadow Financial Regulatory Committee**
**Comité Latino Americano de Asuntos Financieros**
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# Does Latin America Need the International Monetary Fund?

## I. Is the IMF still relevant?

The IMF is currently perceived to have lost its relevance in Latin America: it's not needed at the macro level and it's not wanted at the micro (structural reforms) level.

At the macro level most countries in Latin America are doing better than they have done for many years. The region is experiencing a period of solid growth and low inflation. Considering that in 2007 GDP growth will be somewhat lower than in 2006, but still above 4%, the current expansion is the best in the region since the 1970s. Regional inflation has also declined during this period of growth, currently averaging slightly over 5%.

Latin America's economy has benefited from high exports, strong economic growth in its trading partners and good global financial conditions. But the region's success has also benefited from good domestic policies. Fiscal and external balances are much stronger than in earlier expansions; more countries have flexible exchange rates that should help them to better absorb shocks; banking regulation and supervision have improved; and central banks have become increasingly independent and have established credibility in combating inflation, allowing for lower real interest rates, which support growth.

Despite this good performance, poverty levels remain too high and income distribution remains too uneven in many countries. As a result, voters remain dissatisfied with economic outcomes and the policies that have produced them, which are associated with the Washington Consensus and especially the IMF.

Notwithstanding the reassuring picture provided by the unusual combination of high growth, current account surpluses, strong fiscal positions, and high international reserves, the Latin American Shadow Financial Regulatory Committee (LASFRC) considers that the region remains vulnerable to adverse changes in external conditions.

First, the improvement in most of the macroeconomic and financial regional indicators has benefited strongly from the expansionary phase of the current cycle, and especially from exceptionally benign external financial conditions and positive terms of trade. If these conditions were to change the region would be left in a vulnerable position. In particular, a disorderly unwinding of global imbalances would very probably hurt the region through lower exports as well as through capital outflows due to changes in international investors' portfolio composition in favor of lower risk assets.

Secondly, current very low international real interest rates and market measured levels of risk, including Latin American country-risk, have occurred concomitantly with the quick and significant growth of unregulated financial intermediaries, mainly hedge and equity funds, and with the development of complex financial instruments, which have not been tested under stress. Although these developments have probably contributed to distribute risk in a more efficient way, they may also have contributed to undervalue systemic risk. An eventual market correction could have a significant impact on Latin America.

The Committee is highly concerned that a re-pricing of risk could result in a liquidity crunch for Latin America. In fact, the last two big crises in the region in the early 1980s and late 1990s that resulted in a protracted period of economic contraction, financial crises an debt restructurings, were triggered by events in global capital markets: the large rise in US interest rates in the former, the Russian default and the rise in risk premia for emerging markets in the latter.

The huge rise in capital flows to emerging economies since the mid 1970s has been associated with equally large market volatility. Thus, shocks to the region have come mostly from the capital account. In contrast to trade-account shocks that have a flow dimension, capital-account shocks have a stock dimension: in periods of international capital market turbulence, emerging market economies may find it difficult to roll-over the existing stock of debt.

Shocks that result in a sudden interruption in the flow of international liquidity and/or hit the domestic banking sector have the potential to seriously disturb the credit chain and domestic payments system, and have major economic, social and political implications. Moreover, capital account shocks are rarely confined to one country at a time. Evidence shows a considerable degree of bunching. Thus, shocks could be large and in some cases involve in a critical way the domestic banking sector.

In this context, the IMF is perceived as losing relevance on two dimensions. First, good macroeconomic performance has meant that most countries of the region no longer have programs with the IMF and most governments do not seek out the Fund for meaningful policy advice. Secondly, the sheer magnitude of private capital markets and size of capital account shocks vis-à-vis IMF's resources have led many analysts to believe that the IMF will have a limited role to play in future crises resolution.

The Committee strongly disagrees with the view that the IMF has become irrelevant. First, in an increasingly financially integrated world there is a need for countries to cooperate in order to promote monetary and financial stability. With all their imperfections, multilateral institutions are the appropriate vehicles to organize such cooperation. Second, although the IMF lacks the mandate and the necessary financial capability to deal with a systemic liquidity crunch by acting as a lender of last resort in world capital markets, it can nonetheless play a key role in stabilizing individual countries affected by a shortage of international liquidity. Third, as has already occurred, when a global liquidity crunch financially destabilizes simultaneously a large number of emerging economies whose financial needs exceed available IMF resources, coordinated action by the industrial countries' governments is required. In that context, the IMF with its in-depth knowledge of the countries affected is the appropriate vehicle for channeling such assistance. Fourth, IMF resources can be complemented by self-insurance on the parts of individual countries.

From the perspective of Latin America, the importance of counting on a global institution such as the IMF, in charge of promoting monetary and financial stability, cannot be stressed enough. Latin America's relatively small domestic financial markets, pervasive liability dollarization and an open capital account make it very vulnerable to sudden changes in global liquidity for emerging market economies.

## II. A more focused IMF

The Committee believes that the IMF should become a more focused institution, concentrating on its primary responsibilities—i.e., monetary and exchange rate policy, fiscal sustainability, the level and structure of the public debt, strength of the domestic banking system. Getting involved in issues such as the level and composition of government expenditures, structural reforms not involving primary responsibilities and issues relating to poverty and income distribution directs IMF efforts and resources towards issues that may be more effectively dealt by other multilateral organizations or are better left to be decided through the political process in individual countries.

In this vein, the Committee endorses ongoing efforts to put financial issues at the heart of the IMF work, to integrate financial and macroeconomic issues in its analytical work. In particular, the Committee recommends that the IMF develop analysis to better understand and measure the risks of contagion derived from the high level of integration of Latin American economies to international capital markets.

Because of financial integration the region is affected by regulations and practices regarding the operation of the markets. One such practice is the so-called Value-at-Risk methodology. At the core of that methodology is an estimation of the potential maximum loss that can result from a given portfolio over a defined time period. Because risks are assessed on "net" terms, the methodology provides incentives to hedge risky positions (at least partially) in order to reduce the "expected maximum loss" from an investment. In those markets, even a small signal of problem can result in very large sales of the instrument often at fire-sale prices.

Facing these features (liquidity characteristics and regulatory/market practices), investors from industrial countries interested in a high-yield but relatively illiquid instrument issued by an emerging economy will often also invest in other instruments issued by countries with more liquid markets to hedge their investment in the illiquid instrument. If an adverse shock materializes that drastically reduces the liquidity of the instrument, the investor has the option to sell holdings of the more liquid instruments, therefore reducing the net loss from the portfolio. This will result in contagion from the illiquid instrument to the liquid ones. The best example in recent times arises from the Russian crisis.

These features of emerging markets in general and of Latin America in particular are not adequately taken into account when the IMF assesses countries' vulnerabilities. While the Fund is careful and thorough about identifying risks arising from some key "economic fundamentals," like fiscal, monetary and exchange rate policies, its assessments fall short of discussing liquidity risks generated from both the characteristics of the countries' instruments traded internationally and the potential impact of liquidity shortages in one emerging market economy over the price of debt of other (more liquid) emerging market economies. For example, debt sustainability exercises are conducted under the assumption that liquidity problems will not occur during the period under analysis and, hence, are not aligned with the search for liquidity embodied in private capital markets.

While this Committee places significant emphasis on enhancing the IMF's capability to act in capital market crises, it also recognizes the useful role played by traditional IMF programs when member countries face external or real shocks not related to the capital market (such as, for instance, deterioration in the terms of trade, natural disasters, etc.), or need to strengthen their policy framework and regain fiscal sustainability. Particularly relevant in today's environment is the need to develop an effective methodology for the appropriate management of fiscal and international reserves policies in times of boom.

The Committee calls on the Fund to review its practices with the goal of strengthening its ability to enforce conditionality by ensuring full consistency of IMF-supported economic programs with the highest democratic institutional standards. "Ownership" by the member country is an essential pre-requisite for the success of IMF programs. But ownership can vary significantly in depth, as programs may be owned by the Executive Power of a member country (typically the IMF's counterpart in the negotiation) but lack a much deeper support in Congress or society at large. The Committee believes that ensuring deep ownership of IMF-supported policies goes to the heart of what makes reforms sustainable over the years and ultimately legitimate, even at the (apparent) cost at times of slowing down a country's pace of reform. In turn, sustainability and deep ownership of reforms will help the IMF regain a meaningful rapport with societies and policymakers in many countries in Latin America and, hence, regain credibility in the region.

**III. Effective IMF instruments in crisis management**

The Committee believes that the IMF should expand its role and instruments to deal with prevention and resolution of crises stemming from the capital account. In this respect, the Committee believes that it is important that the IMF continues to perform and strengthen its traditional role of surveillance, i.e., developing a view of member countries' economies and policy frameworks, assessing the risk characteristics of emerging markets, and establishing an ongoing rapport with the countries' authorities. The information gathered through the surveillance process is key for designing the IMF's response when a crisis erupts and ensuring wide support by the IMF's member countries. When viewed from this angle, surveillance is a critical input in the IMF's decision-making process (which can also have some public-goods characteristics if the information is shared with the markets).

By its nature, surveillance is a permanent operation, independently of the number and size of existing Fund programs. In this respect, the Committee endorses the Committee to Study Sustainable Long Term Financing of the IMF's proposal to find stable sources for financing of such operations, separate from the income derived from lending operations.

In the view of the Committee, the most urgent task is to empower the IMF with adequate instruments to deal with capital market/financial crises through the creation of a "liquidity facility" that serves as an effective successor to the extinct Contingent Credit Line (CCL).

The Committee welcomes the fact that the IMFC has provided the Fund with the mandate to work on specific proposals and the initiation of discussion of a new liquidity facility. However, the Committee has received with disappointment recent remarks pointing to "a lack of sense of urgency in our membership" to advance faster on the creation of such a mechanism made by the IMF's Managing Director.

The creation of a new liquidity facility needs to take stock of past experience and avoid repeating some of the shortcomings that made the extinct CCL inoperable. In particular, three principal aspects—one of political dimension and two of technical nature—of the CCL signaled early-on its death. The political aspect is that the CCL was created in the midst of a crisis with potential users in mind while, at the same time, the instrument was being marketed as one designed to protect countries that were not affected by the ongoing crisis. The technical problems were related to the processes of "entry" and "exit" to the facility—i.e., the negative connotation of requesting access or losing eligibility. The CCL experience should serve the international community with a powerful reminder that instruments such as these, which are of a permanent nature, are best designed and politically agreed at times when there is no pressing need to respond to an ongoing crisis.

The Committee wants to contribute to the discussion of a new "liquidity facility" that avoids the "entry" and "exit" problems. One possibility is to provide ex-ante automatic qualification and access based on a limited set of measurable prior actions by the member country directed at reducing its vulnerability to liquidity crises. In this respect, the Committee believes that qualification should be based on self-insurance indicators expressed in terms of, for instance, achieving predetermined minimum standards relative to the reserve-to-short term debt ratio, to average maturity, size, and currency composition of a country's public debt. Given these measurable standards, qualification should be ex-ante, automatic and would not require a judgment by the IMF on a forward-looking economic program. By linking qualification to self-insurance policies, the new liquidity facility would provide countries with a strong incentive to adopt adequate and pro-active liquidity management strategies in good times to complement the implementation of prudent fiscal policies. In turn, incentives to maintain adequate self-insurance policies by a significant number of emerging market economies would reduce the potential for contagion in international capital markets.

The Committee also believes that consideration should be given to tying qualification to a country's recent record of transparency as well as of adherence to international debt contracts and internationally accepted standards for sovereign debt restructurings, so as to provide incentives, on the one hand, for adherence to international standards of data dissemination and, on the other hand, against rogue behavior or opportunistic defaults.

Access under the new facility should be large and the Committee finds the expected 300 to 500 percent of quota size appropriate. However, no specific pre-set upper limit should exist and, rather, it should be left to IMF management to decide as a function of the nature of the crisis and the potential aggregate demand on Fund resources.

The Committee recognizes that automaticity with respect to qualification and access, while helping significantly in mitigating the "entry" and "exit" problems, may raise questions about adequate safeguards on the use of Fund resources. In this respect, the Committee believes that this line should be collateralized explicitly with the drawing member's present and future international reserves. In this respect, member countries interested in qualifying for access under the new facility should ensure that appropriate legislation is in place to authorize attachment of collateral by the IMF in case it is needed.

Potential access to IMF resources may be significant especially if crises are characterized by significant contagion. Given the limited amount of IMF resources, the Committee recommends that new instruments be considered to provide the IMF with added flexibility in its funding. In particular, we encourage the IMF to set up appropriate procedures to raise funds in the capital markets, as well as to securitize loans of countries that have recovered and regained access to capital markets.

Regional arrangements have been seen in some cases as complementary instruments to enhance the effectiveness of the overall crisis resolution process. The usefulness of regional arrangements is predicated on the principle of risk pooling, assuming that countries' economic conditions are not positively correlated. Considering Latin America, the Committee believes that the scope to develop a significant role for regional arrangements for the purpose of emergency liquidity provision is limited, as past experience has shown a significant positive correlation between the economic conditions of the region's major economies.

Crisis management requires effective coordination and speed of response. The Committee believes that IMF should be the appropriate discussion forum for designing the policy response. Multilateral consultations among relevant groups of countries should be set-up within the IMF to discuss and coordinate the appropriate policy actions to respond to arising financial crises.

## IV. Concluding remarks

Lack of crises should not lead the IMF to look for new roles. There is still plenty that the IMF and the profession have to learn about the characteristics of the capital market for emerging market economies, the anatomy of crises triggered by capital market turbulence and effective prevention and crisis management policies. The IMF should play a key role in this endeavor in tranquil times when the IMF has a valuable opportunity to develop new insights and skills.

Moreover, the IMF should engage in Crisis Drills, much as a Fire Department engages in Fire Drills. This is an activity that we would rank as high if not higher than more fundamental research. Crisis Drills should be a primary responsibility of area departments. Some argue that because the next crisis will likely have new characteristics, Crisis Drills are of little value. However, experience has shown that even though the triggers have changed from crisis to crisis, phenomena like liquidity crunches, large real devaluations and output collapses, have been a constant through crises.

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