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

Statement No. 19

Latin America in the Midst of the Global Financial Meltdown: A Systemic Proposal

I. Introduction

Since our May 2008 statement, the evolution of the financial crisis has significantly worsened economic prospects in emerging markets in general and in Latin America in particular. **The Committee urges authorities in the region and the official community more generally, to take preventive measures to address the risks of a potential significant deterioration in economic conditions.**

The Committee identifies three main risks emerging from the new international context. First, a number of countries in the region will face recessionary pressures in 2009 as a result of the sharp slowdown in world economic activity and falling export prices. Second, the rollover of corporate and public sector debt has been disrupted by the freezing up of the international capital markets. Even the domestic debt markets, which have developed significantly in recent years in many of the region's economies, are suffering from the sudden pull-out of foreign investors. Third, in the absence of credit, countries may be forced to choose between painful pro-cyclical fiscal adjustment and highly distortive measures to avoid it.

The region's initial conditions are relatively strong, anchored on a period of rapid growth and prudent macroeconomic policies. However, as we discuss below, given the complexity and depth of the challenges ahead, complacency on the part of national authorities and the international community may result in a significant drop in economic activity, loss of jobs, rising poverty, bankruptcies in the private sector, problems in the banking sector and, perhaps, payment difficulties in some sovereigns of the region.

II. Proposed actions

The risks described above merit a systemic approach and innovative solutions.

Recent financial developments have reinforced the process of flight-to-quality towards US Treasuries. While the US authorities might find it reasonable to use these funds stemming from the flight-to-quality to stimulate the US economy through expansionary fiscal policy, an approach which places an undue burden on the US Treasury may not be the most desirable one to deal with a global slowdown, and could end up being counterproductive for the global system and for the US. A more balanced stimulus around the world will contribute to mitigate the US recession through export growth, while reducing the growth of the US federal debt.

The Committee supports the US Treasury's calls for surplus countries such as China to contribute to an orderly global adjustment by taking measures to stimulate aggregate demand, but cautions that flight to quality might crowd out emerging market economies in need of external financing. This is critical for Latin America as the region is moving from current account surpluses to deficits under present circumstances.

The Committee believes that the central challenge to be addressed by the international community is the simultaneous combination of flight to quality with the freezing up of international credit. Powerful and innovative mechanisms are needed to recycle funds that are fleeing to US Treasuries back towards the private and public sectors in Latin America and emerging markets more generally. In this respect, the required recycling of funds demands strong leadership and a global perspective by governments in the US and other advanced economies. The Committee is encouraged by the G-20 decision "to help emerging markets and developing economies gain access to finance in current difficult financial conditions."

The Committee identified a number of mechanisms that will facilitate the recycling of funds and resolve the region's private and public sectors debt financing needs.

A crucial issue is to determine the size of funding that is required to effectively deal with the problems at hand. **The Committee believes that the seriousness of the international situation calls for the commitment of an unprecedented amount of resources.** Business as usual is not enough. Our estimates suggest that an amount in the order of USD 250 billion may be required to address the potential rollover needs and budget support of Latin America's public sectors in 2009.

Given that the amounts involved exceed what can reasonably be handled by multilaterals under current capabilities, **the Committee believes that the role of multilateral institutions should be enhanced through additional resources and new facilities.** One possibility is to resort to capital replenishments and such actions should be pursued. However, in order to avoid protracted negotiations and for the sake of expediency, **the Committee recommends establishing a specific Emerging Markets Fund (EMF). The EMF would channel resources through multilaterals by purchasing assets (loans and bonds) arising from the facilities described below.**

The Committee recommends two facilities for the private sector. **In the case of companies which have already gained access to the international capital markets, and thus demonstrated adequate governance, the Committee recommends that multilaterals such as IFC, IIC, and CAF, channel EMF resources to provide funding or guarantees directly to these companies. For companies with rollover difficulties**

not active in the international capital markets, and in particular for the replenishment of trade credit lines, the Committee recommends swap lines with central banks to be channeled through the local public and private banking system.

In order to address public sector rollover requirements and budget support, the Committee recommends establishing credit lines through the IMF, IDB, and the World Bank. At a minimum, the objective of these lines is to provide the financing to ensure an acyclical (neutral) fiscal policy response. However, the Committee recognizes the need to go further and facilitate funding for moderately counter-cyclical fiscal policies to be channeled through, for instance, temporary investment tax credits, accelerated depreciation regimes, and lower labor taxes, rather than new public spending programs. Given the importance of maintaining fiscal solvency, such a stance should be consistent with a sustainable public debt position.

To make these new facilities effective, it will be important to overcome the stigma associated with emergency financing support. To this end, **the Committee recommends that the new facilities be made available to all qualifying countries, whether they require them or nor.**

III. Risks of inadequate action for the global economy

The Committee strongly believes that lack of timely and decisive action may have serious detrimental effects for emerging markets and the global economy. Unless the recycling of funds to emerging markets is effectively implemented, countries may be forced to adopt import restrictions and capital controls in an attempt to reduce external financing needs and impose a cost on capital flight to force domestic residents to direct their savings to domestic assets.

In the absence of adequate international actions, beggar-thy-neighbor policy responses may be politically inevitable, seriously undermining the basis of the global cooperative system that emerged in the aftermath of World War II and allowed for unprecedented rates of growth of trade and incomes and a reduction in global poverty.

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