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

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Liquidity Needs in Times of Stress: Should Latin America Go Beyond the IMF?

I. Introduction

Since the traumatic financial crises of the 1990s, emerging market economies have recognized the importance of counting with a large stock of internationally liquid assets as a means to mitigating the effects of capital market volatility and sudden stops in capital flows. Latin America has been no exception and most economies in the region have engaged in significant international reserves accumulation in this decade taking advantage of the largely favorable external conditions prevalent until the outbreak of the global financial crises as well as after the start of its resolution. By mid-2012 the stock of international reserves of the region had reached a level just exceeding USD 700 billion; Brazil accounted for USD 350 billion of this stock.

One clear lesson from the global financial crisis relates to the critical role that safe assets play in the credit process. At a very basic level, credit relies critically on collateral, and the availability of international collateral is directly linked to the global stock of safe assets. If safe assets suddenly evaporate, as it happened in 2009, a credit crunch is inevitable. The widespread use of liquidity requirements in the banking system in Latin America is a reflection of the recognition by central banks of the importance of this issue.

This statement focuses on the precautionary role of international reserves.[1] In this context, a central question is what are the adequate level and composition of international reserves and

[1] The large accumulation of international reserves in the region has prompted a discussion on the policy motivations behind this process; in particular, whether it is a precautionary policy or is simply the result of central bank intervention to prevent foreign exchange appreciation (mercantilism).

other sources of liquidity, since holding of liquidity entails significant opportunity costs especially when international interest rates are at near-zero levels.

Ideally, provision of liquidity at a global level calls for a global lender of last resort. However, the current financial architecture, composed by national central banks and multilateral institutions, performs such function only in a limited way and requires significant coordination efforts.

Thus, in the absence of a global lender of last resort, the Committee believes that it is central and timely to discuss the benefits of a regional multilateral institution aimed at strengthening and lowering the cost of liquidity management in Latin America and complementing the global role played by the IMF as well as by the ad-hoc bilateral swap arrangements implemented by the US Federal Reserve with some central banks.

II. A Latin American Liquidity Fund (LALF)

The Committee proposes the establishment of a LALF with two principal functions: 1) liquidity provision to the public sector and 2) lending to mitigate potential volatility in trade credit. As an additional function LALF could set-up and administer a regional stabilization fund to smooth out the effects of commodity price fluctuations on the real economy.

The main role to be played by a LALF is liquidity provision to central banks of member states in systemic liquidity crises. Systemic crises usually affect both the public and private sector and, especially, the financial system and the capital market.

In light of the region's past experience during systemic liquidity crises, **the Committee estimates that an effective LALF requires a minimum capital contribution of USD 25 billion (about 3.5 percent of the region's current holdings of international reserves) expandable over time to a desired capital objective of USD 50 billion.[2] Assuming a leverage ratio of two, such capitalization would provide LALF a minimum lending capacity of USD 50 billion, eventually expandable to USD 100 billion, equivalent to the net liquidity needs of the region during the crisis of 2008-2009.**

A lending capacity of USD 50 billion would be sufficient to satisfy the liquidity needs of all small and medium countries in the region. In the case of large countries, such as Brazil and Mexico, a lending capacity of USD 100 billion would provide a significant complement to the liquidity provision that could be obtained from global multilateral institutions such as the IMF.

[2] A capital contribution equivalent to 3.5 percent of total international reserves is in line with that of the Asian countries in the context of the Chiang-Mai initiative.

The Committee recognizes the importance of counting with unconditional liquidity in light of unstable capital market expectations. Thus, it envisages LALF's liquidity provision to central banks in two tranches. The first tranche, equivalent to a 100% of a member's capital contribution, would be disbursed unconditionally. Thus, the first tranche would count as part of members' international reserves. If additional liquidity needs arise, a second tranche of LALF's liquidity provision would be available. Depending on the size of the country, this second tranche would be equivalent to between 100% and 200% of a member's capital contribution and would be disbursed satisfying determined pre-qualifying criteria.

In the view of the Committee, pre-qualification should be mandatory for all member countries, and would be based on objective criteria that ensure that the member country has adopted policies to reduce its financial vulnerabilities. Examples of such criteria are the relative size of the public sector's borrowing requirement, the maturity profile and currency composition of the public debt, the extent of liability dollarization, and the ratio of the current account deficit to GDP. Pre-qualification should be based on objective criteria, and could be performed by a technical and independent office following criteria set by the LALF's board.

A central aspect of the LALF's operations is its own funding. In this respect, **the Committee believes that the LALF should focus on establishing credit lines with the US Federal Reserve, the IMF, and with economies that currently enjoy ample liquidity and display large current account surpluses, such as China and the main oil exporters in the Middle East. At the regional level, institutions such as the IDB and CAF could establish contingent credit lines to the LALF.**

The two main channels of transmission of the global financial crisis in 2009 to Latin America were the sudden stop in capital flows and the collapse of trade finance. The latter channel was deemed unprecedented at the time and was the direct consequence of a dysfunctional global financial system. Thus, trade credit, a usually safe form of financing, suddenly collapsed with direct deleterious consequences on the real economy.

In response to the collapse of trade credit in 2009, Brazil took the lead in utilizing public sector banks to step-in and substitute for the shrinking trade credit provided by private banks. Brazil funded such response by resorting to the swap line that had been established between the Brazilian central bank and the US Federal Reserve. At that time, the international community, particularly through the IFC, also adopted ad-hoc responses to mitigate what became a major component of the global crisis.

In view of this experience, **the Committee believes that a beneficial role can be played by a LALF along the lines of the 2009 Brazilian experience. In this respect, the LALF would establish a line to provide liquidity in the form of trade credit, channeled through designated public banks in the member countries.**

Additionally to the functions described above, the establishment and administration of a regional commodity-stabilization fund could be a useful role to be played by the LALF. In the past decade, the region has enjoyed a period of unprecedented improvement in terms of trade mostly reflecting a sharp increase in commodity prices in agriculture, energy, and mining sectors relative to the levels observed in previous decades.

As commodity prices tend to be highly volatile and sensitive to the conditions prevailing in the world economy, sharp increases in commodity prices raise the convenience of setting up stabilization funds that help insulate economies from the effects of such price changes on the real economy. However, it has been notably difficult for Latin American governments to set-up effective national stabilization funds as political pressures are likely to interfere with its efficient functioning. A notable exception is the case of Chile.

Therefore, **the Committee believes that the establishment of a regional commodity stabilization administered by the LALF brings a number of clear benefits. Firstly, the legal umbrella of a LALF provides a professional and credible administration and contributes to insulate the commodity stabilization fund from domestic political pressures. Secondly, a regional stabilization fund is able to take advantage of diversification to the extent that participating countries produce different types of commodities.**

III. Building on Existing Institutions: Advantages and Challenges

The establishment of a LALF with the objectives and functions described in the previous section might emerge from the strengthening of multilateral institutions already existing in Latin America. In particular, **the Committee believes that Fondo Latinoamericano de Reserva (FLAR) provides an institutional basis for meeting the functions of a LALF.**

There are a number of reasons why FLAR might evolve into an effective LALF. Firstly, together with CAF, FLAR is currently an example of a credible and well-functioning institution in Latin America, with a proven track record.[3] Secondly, compared to the IMF and other global multilaterals, it has a simpler governance structure, enjoys more regional ownership, and has the ability to respond promptly to the members' needs.

A major challenge for the transition of FLAR to a LALF is the ability to enlarge significantly its membership. In particular, no effective LALF could be built without the membership of Brazil and Mexico. By joining, these countries, like the other economies of the region, would benefit from a financially stable Latin America and a friendlier environment for intra-regional trade and investment. **The Committee believes that the strengthening of FLAR along the lines**

[3] Currently, FLAR has an A1 Moody's credit rating, which is significantly higher than those of its individual members.

discussed in this statement would be a major step towards fostering greater regional integration.

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