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

Statement No. 28

Let the Good Times Roll? Hidden Risks beneath Latin America's Current Prosperity"

I. Introduction

The sizable financial shock experienced by the international economy in 2008-2009 has been followed by an unprecedented policy response in advanced economies. This framework has had implications for Latin America in several fronts. On the one hand, growth in the region has benefited from the low interest rate environment prevalent in the international markets. On the other hand, substantial capital inflows and improved terms of trade, exacerbated by the effects of ample liquidity, pose challenges for policy makers.

This statement is composed of two main sections. The first section assesses the implications of the present state of the world economy for the future of Latin America. The Committee identifies three significant sources of hidden risks for the region: 1) the future behavior of world interest rates; 2) the slowdown of economic growth despite improved terms of trade; and 3) the role played by inadequate domestic policies.

In light of the above discussion, the second section discusses the main lessons for the region for the design of monetary policy and the role of the central bank.

II. Sources of risks for Latin America from the current state of the world economy

Is a sharp increase in world interest rates likely?

The incipient recovery of the US economy raises the question of whether the stance of Fed policy is likely to change in the short term and, if that occurs, whether there will be a sharp increase in short-term world interest rates. Such policy change could be triggered by a sudden surge in inflationary expectations, by concerns about excess liquidity, or doubts about the effectiveness of the current policy stance. This is a central issue because, as it is well known, a sharp increase in world interest rates is likely to be associated with a sudden stop of capital flows to the region.

The concern that world interest rates may rise rapidly once the recovery in the US economy consolidates relates to the possible unwinding of the Fed's monetary stimulus. The conventional view is that if credit resumes and banks reduce their deposits with the central bank, the latter would need to undertake open market operations to absorb excess liquidity. The sale of bonds or other assets in the Fed's balance sheet would, in turn, raise interest rates. Although other major central banks have also engaged in expansionary monetary policy, their more uncertain prospects for a recovery in economic activity makes an increase in interest rates in those countries less likely.

However, the conventional view may underestimate the crucial role of government bonds. In the current circumstances, government bonds are an integral component of liquidity. As the financial crisis destroyed a large portion of safe assets and financial markets remain vulnerable, collateral is scarce and particularly crucial for the provision of credit. As the US economy resumes growth and bank credit increases, the demand for government bonds for collateral also increases. Hence, the unwinding of the Fed balance sheet that would increase the supply of US treasuries will be accompanied by a corresponding increase in demand for collateral.

Thus, as a result, **the Committee believes that interest rates may not increase significantly over the short-term. However, in the medium term, as market segmentation disappears and new safe assets are created by the private sector, the demand for US treasuries will eventually fall and interest rate will increase.**[1]

Although the prospect of continued low world interest rates is favorable**,** the search for yield has also lowered yields in emerging markets to record levels, and risk may be mispriced. In this context, **the Committee believes that the upward response of emerging markets yields to an increase in world interest rates may be amplified**. **Moreover, continued low world interest rates may induce policymakers into complacency and delay the implementation of needed reforms.**

Is there a hangover from the improvement in the terms of trade?

In the years prior to the outbreak of the global financial crisis, improved terms of trade resulting from high commodity prices have fueled strong economic growth. In the present decade the unprecedented improvement in the terms of trade co-existed with an extended period of high

[1] The hypothesis that an increase in world interest rates may be delayed for some time may be contradicted if market expectations about debt sustainability in the US turn pessimistic. In this case, interest rates would increase sharply.

external liquidity. Current account surpluses allowed many economies to reduce their external debts and increase significantly their holdings of international reserves. As a result, the region has become more resilient to external shocks.

However, high external liquidity and strong economic growth also induced a significant real appreciation of domestic currencies, especially in those countries where central banks left their nominal exchange rate float. The economic expansion was associated with rising real wages and falling unemployment.

Nevertheless, despite the obvious gains from improved terms of trade, many Latin American economies are starting to experience a more difficult scenario. On the one hand, the improvement in the terms of trade may be reaching an end and further growth from that source appears unlikely in the years to come. On the other hand, the real currency appreciation and higher real wages is placing an increased competitive burden on the tradable sector, in particular the industrial sector, a case of “Dutch disease”. Therefore, **the Committee believes that the growth outlook of the region has deteriorated in several economies and, in particular, the prospects of the tradable sector look bleak.**

The overhang from the gains in the terms of trade is quite general and is also affecting countries that are less integrated to the international financial market. For instance, Argentina and Venezuela are also experiencing a significant growth deceleration. Despite reliance on capital controls and lesser exchange-rate flexibility, the real appreciation of their currency has been induced by high inflation.

Risky domestic policies

Especially in the past five years, the improved terms of trade may make fiscal policy and the current account look stronger than what they actually are, as revenues for commodities may be temporarily over estimated. Moreover, in some countries, the increased fiscal revenues associated with the commodity sector have been directed to additional government spending and entitlements which are hard to reduce if a reversal in the terms of trade occurs. Therefore, **the Committee believes that fiscal risks associated with a possible reversal in the terms of trade in the future have increased and may be magnified by the weaker growth prospects discussed earlier.**

In Chile, for instance, fiscal revenues from copper will amount in 2013 to half of what they were in 2012. Furthermore, the contribution of the copper sector to total fiscal revenues will amount to less than 10 percent in 2013 compared to 21 percent in 2010, and 14 percent in 2012. The decline in revenues from copper reflects not only price changes but also the effect of higher real wages due to the strengthening of the domestic currency.

The Committee also believes that the recent deterioration of the current account in several economies is worrisome because, in the event of a reversal of the terms of trade, the resulting current account deficits would be large. In turn, a large current account deficit exposes the economy to the risk of a significant real adjustment in the event of a sudden stop in capital inflows.

An additional source of risk comes directly from the expansion of the non-bank financial sector. Fueled by ample external liquidity and low interest rates, a recent trend in Latin American financial markets has been the expansion of non-bank credit, including debt issuance in domestic and foreign markets by corporations, the growth of credit by financial services companies and large retailers. In this context, traditional banks have increased the share of consumer credit and mortgages.

The expansion of different forms of credit outside the banking system may be seen as a positive event, as it reflects the development of domestic capital markets. However, **the Committee believes that as such development occurs under a lower degree of regulatory supervision, it may induce the build-up of hidden financial risks. This is especially true if the growth of non-bank credit responds to regulatory arbitrage and, hence, results in an excessively large leverage in the economy.**

III. Lessons from the global financial crisis for central banking in Latin America

The global financial crisis has shaken the conventional policy framework of major central banks and provides a rich experience to re-think central banking in Latin America. In every financial crisis, the response of central banks can be viewed as combination of the existing policy framework with actions that respond to new and unforeseen challenges. Hence, central bank policy in the midst of a financial crisis is unlikely to be optimal, although it provides valuable lessons for the design of future policymaking.

Initially, advanced-economy central banks relied on the interest rate as the central instrument of monetary policy: the policy interest rate was virtually reduced to zero. As the financial crisis deepened and resulted in an unprecedented loss of confidence and liquidity, the financial sector became segmented because of a sharp increase in counterparty risk.

When the financial market is segmented, the interest rate becomes less effective as a policy instrument. Hence, advanced-economy central banks resorted to a wide variety of unconventional actions, such as the various rounds of quantitative easing implemented in the US, the UK, and Japan. Also, terms, collateral requirements and maturity of central bank lending were significantly modified, access to the discount window widened and liquidity provision was extended, even to some non-financial corporations. In sum, central banks have acted far beyond their traditional boundaries, as the liquidity crunch spread in a much wider fashion than previously anticipated.

This experience has important implications for central banking in Latin America. Firstly, **the Committee believes that the policy interest rate should not be viewed as the single monetary policy instrument. The conduct of monetary policy should also rely on a wider variety of policy instruments, such as liquidity or reserve requirements and counter cyclical capital and provisioning requirements.** These are commonly referred to as macroprudential. Some countries, such as Brazil and Peru, already employ these instruments.

In addition, **the Committee believes that foreign exchange intervention may be desirable even when central banks operate under a flexible exchange rate regime. It is advisable that such policy be clearly announced in order to avoid unnecessary market uncertainty.** In addition to the important role of international reserves as an insurance mechanism against capital market volatility, foreign exchange intervention should be utilized when capital inflows put a strong pressure on the domestic currency. For instance, when a country faces large capital inflows the central bank may be tempted to increase the policy interest rate as a means of containing inflationary pressures. But, contrary to conventional thinking that associates the increase in interest rate to a restrictive monetary policy stance, the result may be the opposite. An increase in the interest rate may induce larger inflows that may turn out to be expansionary for the economy. In addition, the domestic currency may strengthen excessively. Therefore, what may be called for in the face of strong capital inflows is a reduction in the policy interest rate and the imposition of higher liquidity requirements or, alternatively, the adoption of controls on inflows.

The experience from the global financial crisis also shows that central banks need to carefully identify the relevant definition of liquidity in the economy in order to determine the extent to which the central bank liquidity may be provided if a crisis breaks up. **The Committee believes that identifying where central banks may need to act as lenders of last resort should then result in an extension of its regulatory and supervisory responsibility.** The growth of different forms of non-bank credit in recent years points out to the risks of having the central bank responsibility only limited to the traditional banking system.

The development of Latin American financial markets is also being accompanied by increasing financial integration. As a result, a number of international banks from Latin American origin have expanded their cross-border business. For instance, banks such as Brazil's Itau, Colombia's Bancolombia, and Peru's Banco de Credito currently operate in several countries in the region. Besides, the financial market of Central America and Colombia are becoming highly integrated through the expansion of Colombian banks in Central America. Although this should be viewed as a positive development, **the Committee believes that it should be accompanied by stronger formal cooperation between bank supervisors and regulatory frameworks should be**

harmonized to avoid regulatory arbitrage. At a minimum, such banks should be supervised effectively on a consolidated basis.

The recent experience shows that central banks need to act flexibly in the context of financial turmoil, as unprecedented challenges are prone to appear. The legal framework under which most Latin American central banks operate is typically quite inflexible. Of course, providing for more flexibility may conflict with the credibility of the central bank. But, **as many central banks in the region have effectively achieved a strong credibility, the Committee believes that in these cases the legal framework should be modified to allow central banks to adjust their response to the new challenges that are likely to appear during the management of financial crises.**

Lastly, the global crisis has raised the question of whether it makes sense to concentrate central banks only on the objective of maintaining price stability. For instance, based on the previous discussion, **the Committee believes that, by focusing only on a single objective, the central bank may induce an excessive currency appreciation that adversely affects the tradable sector.** In the case of economies with high dependence on commodities, real shocks may be very large and warrant an active monetary policy response.

The Latin American Shadow Financial Regulatory Committee (LASFRC) gratefully acknowledges financial support by the Center for Global Development, the Central Bank of Chile, and FLAR for funding its activities during 2013. The Committee thanks Maria Alejandra Amado for her support in the production of this statement. The Committee is fully independent and autonomous in drafting its statements.