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

Statement No. 30

Is Latin America Ready for the End of the Bonanza?

I. Global and Regional Setting

In the past decade, Latin America experienced an extended period of economic bonanza characterized by low international interest rates, ample global liquidity, and high commodity prices and terms of trade. However, recent developments in the world economy as well as inside the region are changing the environment. The new environment will entail significant challenges and risks for policy in the region, notwithstanding a projected increase in world economic growth next year.

The May 22nd announcement by the US Federal Reserve that it was considering tapering bond purchases in the course of this year prompted a significant change in financial market perceptions about emerging markets. Following the announcement, risk indicators increased markedly in most emerging market economies, and liquid capital flows to emerging markets have declined. In Latin America, domestic interest rates on long-term public debt have increased by 150 to 200 basis points including Colombia, Mexico, and Peru. The increase in other measures of risk such as Credit Default Swaps has been moderate. In part, the reaction of domestic interest rates reflects the expectation of currency depreciation.

The reassessment of risk in international capital markets is affecting capital flows to the largest emerging market economies, such as Brazil, India, Indonesia, South Africa and Turkey. The entire emerging-markets asset class might become significantly more risky in the future. Such an event would likely translate into systemic capital outflows. In this context, the combination of depressed asset values with an incipient recovery in Europe and the US may contribute to an investors' retrenchment from emerging markets.

There is increasing concern that economic activity and investment may decelerate in the BRICS, particularly in China and India. Activity in Brazil has been slowing down significantly already for some time. The past boom in commodity prices has been attributed largely to the rapid demand growth coming from emerging markets and, particularly, from China and India. Thus, decelerating growth and a decline in investment in China may have significant real effects in the region.

Apart from the global environment, the frail economic and political situation in Argentina and Venezuela pose additional risks to the remainder of the region. Despite strict foreign exchange controls and widespread restrictions on imports and transfer of dividends, a severe loss of central bank reserves in Argentina increases the likelihood of a currency crisis. Because the conventional view is that the Argentinian economy will still manage to muddle through the remainder of the current administration, the occurrence of a currency crisis might have significant contagion effects in the region, notwithstanding its relative financial autarchy.

The boom in commodity prices can be viewed as a windfall gain. But without innovation and reforms that increase productivity (most importantly, improvements in education), the growth stimulus eventually vanishes. However, if the higher commodity price scenario is perceived as permanent, savings would fall as aggregate demand increases.

II. Risks Associated With the New Environment

The first important risk is associated with a marked current account deterioration in several Latin American economies. Many Latin American economies that recorded current account surpluses in the first part of the past decade are now showing deficits in the order of 4-6 percent of GDP (e.g., Brazil, Colombia, Chile and Peru). Large deficits are known to be among the best predictors of sudden stops and financial crises in general.

The deterioration in the current account balance in many countries has also been fueled by real exchange rate appreciation in the presence of a highly expansionary monetary stance in the advance economies in recent years. For instance, while Brazil's GDP measured in US dollars increased four-fold between 2003 and 2013, GDP at constant prices rose only by 43 percent in the same period. In addition, fiscal policy in most of Latin America has not stopped the deterioration in current account balances. According to IMF data, the fiscal position in Latin America deteriorated significantly between 2008 and 2013A second important risk is associated with a possibly substantial slowdown in economic growth that is likely to result in an increase in unemployment, lower fiscal revenues, social unrest, and institutional instability.

In several countries in the region, the bonanza period has been associated with rapidly rising real wages not warranted by increases in productivity, possibly connected to the absence of structural supply side reforms.

Higher real wages pose risks at various levels. There could be more unemployment than otherwise would be the case and, in many countries, higher unemployment implies more government expenditure due to social safety nets. Fiscal risks are compounded by falling tax revenues. Further, unemployment raises credit risk for banks and other lenders. In some countries household debt has increased in an important way, both with banks and with other agents, such as payroll lenders. In Colombia, this debt (in real terms) has increased by about 60 percent since 2007.

A third major source of risk is that an extended period of unusually low interest rates may produce a mispricing of risk in the banking system. Such mispricing of risk may in part be caused by the overvaluation of assets and, especially, bank collateral generated by unusually low interest rates. In fact, bank credit has grown rapidly in several Latin American economies. In Colombia, for instance, bank credit to households for consumption (i.e., excluding mortgages) increased by 60 percent between 2008 and 2013.

An additional effect of ample liquidity and extremely low world interest has been the rapid expansion of external private debts. Corporations in Latin America have stepped up their issuance of foreign currency denominated bonds since 2008. Corporations may have deposited the proceeds of these loans in the domestic banking system and helped fuel the credit expansion. Since the corporate borrower has foreign currency denominated debt and domestic currency bank deposit, the corporate has a currency mismatch that could adversely affect the banking sector. Therefore, many domestic banks may be holding higher levels of credit risk in their balance sheets than standard analysis would reveal.[1]

A fourth source of concern is that the policy response can further destabilize the situation. For example, in the presence of wage inflexibility and rising unemployment, policymakers may be tempted to rely on an excessively expansionary fiscal policy. While the reliance on fiscal stimulus has been part of the conventional policy wisdom during the recent global crisis in the advanced economies, such response may be risky in Latin American economies, as access to external financing may be drying up and fiscal revenues may be falling under a sudden stop scenario.

In addition, if the macroeconomic adjustment occurs suddenly, it may generate significant pressures on the exchange rate. In this situation, the Committee believes that it would be inappropriate for central banks in the region to indiscriminately resist such pressures. A weakening of domestic currencies may contribute significantly to mitigate the effects of the sudden stop, helping restore current account balance.

Another source of risk from inadequate policy choices relates to the regulatory response. The Committee believes that a relaxation of regulatory and supervisory standards in the midst of a worsening of the external economic environment may entail significant risks after

[1] For further discussion, see Caruana (2013) “Debt, global liquidity and the challenges of exit”, speech at 8th FLAR-CAF, Cartagena, Colombia, 8 July 2013. Available at: http://www.bis.org/speeches/sp130708.pdf

a period of credit boom and rapid expansion of various forms of shadow banking and the associated hidden liabilities.

A risk common to emerging markets in and outside the region is that the safety net provided by multilaterals and the international community is likely to be more limited than those provided to deal with past crises. Despite the fact that the IMF has established a Flexible Credit Line, the size of its funding may not be enough to cover the demand that would arise under a systemic event of turmoil in emerging markets. Unlike previous episodes, the Committee believes that political and economic conditions in the advanced economies are extremely unlikely to be supportive for substantial bilateral or multilateral financial assistance that could complement the potential role of multilaterals.

Moreover, if a systemic event would happen in emerging markets, the experience from the past global crisis suggests that private sector involvement, both of bondholders as well as bank stakeholders, is likely to be required as part of any international multilateral emergency financing in light of the recent European experience.

III. Policy Challenges

The Committee has identified four areas where policymakers need to take a proactive stance in anticipation of the changing economic conditions identified above. The first area relates to the need to identify the sources and assess the magnitude of hidden debts in the economy. Recent aforementioned research carried out at the Bank for International Settlements (BIS) suggests that the problem may be mounting.

The second area relates to the assessment of international reserve adequacy in the new environment. As is well known, international reserves are a powerful instrument that emerging market economies can use to reduce their vulnerability in the face of sudden interruptions in capital flows. Indeed, with the exception of Argentina and Venezuela, international reserves have increased significantly in most of Latin America. For instance, international reserves in Brazil and Mexico have increased from USD 193 billion and USD 94 billion in 2008 to USD 379 billion and USD 167 billion in 2013, respectively.

However, there is an ongoing discussion in academic and policy circles as to whether such reserve accumulation is excessive or too low, with views on both sides of the spectrum. Based on a careful empirical assessment, the Committee believes that, relative to the current stocks, the desirable level of international reserves has increased under recent developments. A key reason for this outcome lies in the above mentioned deterioration in the current account balances.

As regards the real effects of a sudden stop, the Committee believes that policymakers may face an important tradeoff between employment and income inequality when deciding on the monetary policy response. As the economy adjusts to a sudden stop, a crucial decision faced by the central bank is whether to allow for a significant depreciation of the domestic currency or not. This is especially true under the present circumstances, given that the sudden stop would come after a credit boom which appreciated emerging market currencies to levels that would be unsustainable after a credit crunch. Recent empirical analysis suggests that countries that choose higher exchange rate flexibility (and, thus, temporarily higher inflation) tend to experience lower real wages and unemployment with labor share falling. In contrast, countries adopting a more rigid exchange rate stance experience higher real wages and unemployment, with the labor share in total real income remaining stable. Those are the fundamental reasons that lie behind the trade-off between employment and inequality. [2]

Finally, the Committee believes that, when facing a reduction in aggregate demand in response to a sudden stop, policy should prioritize the stability of investment over consumption during the adjustment process. In previous crises, current account deficits were primarily corrected by investment collapses with adverse consequences for medium term growth.

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[2] See, Calvo, G., F. Coricelli and P. Ottonello (2013) “Jobless recoveries during financial crises: Is inflation the way out?” NBER Working Paper No. 19683, November