Comité Latino Americano de Asuntos Financieros
Latin American Shadow Financial Regulatory Committee
Comitê Latino Americano de Assuntos Financeiros
www.claaf.org

Statement N° 32

Lima, October 28th, 2014

Emerging Markets Slowdown: Global and Domestic Economic Policy Challenges

I. Change in Growth Perspectives of the Global Economy

Towards the end of the 2008 economic crisis, the consensus was that developed economies would recover just as quickly as they did in past recessions. It was also expected that emerging market economies would continue acting as the world growth locomotive for a relatively long time. Until mid-2011, this perspective appeared to be in the process of materializing. By now, however, this scenario differs significantly from reality. For example, projections on economic growth published by the IMF at the October 2009 World Economic Outlook (WEO) forecasted a global economic growth rate of 4.5% for 2014, while the latest version of the estimate reduced the forecast to 3.3%. While the adjustment is minimal in the case of the United States, forecast revisions are important in some other regions. In Europe the projection was adjusted by -1.3%; in Japan by -0.9%; and in the emerging world by -2.2%.

Consensus among international economic analysts has, therefore, become increasingly pessimistic and projection adjustments reflect the fact that the observed recovery has actually been weaker than expected. In the case of developed economies, the slow recovery has even led some experts to suggest the possibility of getting into a secular stagnation process, increasingly emphasizing the need to implement structural reforms in order to foster innovation and productivity. Stagnation in Europe in particular has reached the entire continent.

Forecast revisions have been particularly strong in the case of Latin America. The WEO growth forecast has been revised downwards from 4% to 1.3% in the period between 2009 and 2014. The regions' largest economies have suffered the greatest revisions for 2014. Between 2009 and now, the revision for Argentina stands at -4.7%; in Brazil, Chile and Venezuela at -3.4%, in Mexico at -2.5% and in Peru at -1.9%.

In Latin America, most of these revisions are mainly explained by a reversion in growth rates towards potential rates similar to historical averages following a strong expansionary period. This would interrupt the catch-up process of the region's GDP –relative to the US GDP- that started in 2003.

Indeed, as discussed in CLAAF's Statement N° 26, the region benefitted from the aggressive response to the 2008 crisis by advanced economies' central banks (particularly the FED). The strong reductions in interest rates and the massive purchases of financial assets significantly changed the international capital market dynamics, and facilitated an increased demand for Latin American's assets. Between 2010 and 2013, the region increased its external funding in order to sustain increasing public and private expenditures; this translated into larger current account deficits.

At the same time, the region benefited from the strong anti-cyclical Chinese policy in the aftermath of the 2008 crisis. In China, economic policy was even more expansive than that in developed countries. This policy included substantial bank and non-bank credit expansions, and a boost for commodity demand.

Part of Latin America's slowdown is clearly cyclical. After the boom in commodity prices, there was a strong increase in investments related to these industries, which is now coming to an end. This has been particularly relevant in Chile and Peru. Also, in some economies, domestic policy difficulties and uncertainty towards reform implementation have curbed demand expansion.

The monetary stimuli in the United States and other parts of the developed world, as well as China's credit expansion, mitigated the effects the 2008 crisis had on expenditure and growth rates in the region. However, as the US FED has initiated announcement of measures to normalize its monetary policy position (suggesting a plausible increase in interest rates by mid-2015) the region's financial markets have been adversely affected. For example, the region's currencies have depreciated and country-risk premiums have risen.

II. Additional Risk Factors in the Global Scenario

Compared to the scenario described above, the Committee has identified two additional risk factors that have not been appropriately internalized by the current consensus. First, we are witnessing a global financial phenomenon without precedent in the post-war era. The mortgage crisis originated in developed countries and had strong repercussions in developing countries. These repercussions had an unexpected turn. Initially, the markets feared a severe recession in developing countries given the experience during the 1998 Russian crisis, when a relatively smaller shock related to the partial default of the Russian debt had a very strong generalized impact in emerging economies. In contrast, the mortgage crisis of 2008 was associated with a fast unexpected dynamic recovery until mid-2011, after having caused a drastic export contraction in developing countries. This is one of the most novel aspects in the crisis' post-Lehman phase.

The Lehman's crisis caused a massive and significant destruction of low-risk, highly- liquid assets, the so-called *Safe Assets*. These assets constitute an important source of credit collateral. Some estimates place the destruction of low-risk, highly- liquid assets at 25 percent of global GDP. This created an excess demand for safe assets, which in turn generated incentives to demand other assets with similar liquidity characteristics, although not at the same low-risk level.

Because emerging countries' assets suffered relatively less during the global financial crisis, they became a good alternative to the traditional low-risk, highly-liquid assets; thus improving their liquidity. In Latin America, during the pre-crisis period, a number of countries experienced improvements in their credit rating and some reached investment grade. This supported the increased demand for these countries' assets by institutional investors, such as pension funds and insurance companies.

A short-term interest rate close to zero in developed countries and the fact that the Lehman crisis led to greater banking regulations in developed countries (capital and liquidity requirements) fostered liquidity creation in emerging countries. This gave way to a strong expansion in the activities of institutions, such as investment and hedge funds, much less regulated and with lesser limitations for financial intermediation and for maintaining risk assets in their portfolios. This process, in turn, supported greater liquidity for emerging markets' bonds.

A main problem faced by emerging markets is that asset liquidity might fall significantly when the FED increase interest rates, a move the market has started to anticipate. The FED has already started tightening its monetary policy through the finalization of the Quantitative Easing (QE) program. However, the end of QE is much less dangerous for emerging markets' assets liquidity than increasing the policy interest rate in developed countries, given that high-liquidity assets (such as the US Treasury bonds) directly compete with the developing countries' liquid assets, especially those that expanded in response to the financial crisis. This factor raises deep concerns about a potential dry-up in the flow of capital towards emerging markets following an increase in international interest rates (that is, a *Sudden Stop*). These fears include risks of an important contraction in the level of activity and employment.

An additional problem is the FED's lack of clarity regarding its future decisions, due to the high complexity of the situation. The normalization of financial conditions in the US should be accompanied by an increase in interest rates to prevent inflation. However, interest rate increases can lead to important impacts in that country and in the global economy that are difficult to anticipate. This creates a dilemma for the FED; one that can generate uncertainty on the nature and *timing* of its decisions.

A second risk factor is that there are strong reasons indicating a deeper slowdown in China's economic growth than the forecasts by the current international consensus. On the one hand, investment quality has been uneven, since it gave way to excess capacity in the real estate industry and to an increase in spending by local governments in ambitious, but not very efficient infrastructure projects. In turn, the decreasing quality of projects, together with a significant indebtedness by companies and local governments, might lead to lower investment rates and growth prospects. In fact, investment in the real estate market has already started to fall and housing prices in several cities have started to go down.

On the other hand, the rapid increase of China's investment has been linked to an equally rapid increase of domestic credit. Total social funding reached almost 120 percent of GDP in 2008 and more than 200 percent of GDP in 2014.[1] Although a great deal of credit expansion has taken place through the regulated banking system, credit has been increasingly channeled through trust funds and other non-regulated instruments, usually known as "*shadow banking*". Assets in this category are currently estimated at 30 percent of assets in the traditional banking system. The combination of a credit boom with low-productivity investments has increased the fragility of the financial system in China.

III. Regional Risk Factors

A third risk factor which is particularly relevant for the region is the possibility that commodity prices might fall faster than what the current consensus considers. In fact, we have recently seen a significant reduction in the price of agricultural products, oil and metals from their highest peaks.

These additional risks that the Committee has identified find Latin America in more fragile initial conditions than in 2008. Firstly, excessive public and/or private expenditure and insufficient savings ratios led to a deterioration of current account balances even before the decline in commodities prices. Secondly, public sector deficits increased significantly in several countries, including those where counter-cyclical fiscal policies adopted in 2009 were not reverted during the subsequent recovery. Thirdly, domestic costs of production increased faster than productivity, reducing competitiveness in non-commodity tradable industries. Fourthly, indebtedness levels of firms and families are relatively high in several countries. Fifthly, efforts for increasing productivity in the region have clearly been insufficient.

Under these conditions, the likelihood of reductions in credit ratings of some countries has increased. This possibility may become generalized if, as a consequence of an increase in the US interest rates, there were a risk revision of the asset class formed by emerging markets bonds.

[1] Social funding is defined by the Popular Bank of China as an economic barometer that adds up total funding by non-public Chinese entities, including non-financial individuals and companies.

Likewise, the combination of the above mentioned factors might generate sudden currency depreciations which, in some countries that are still highly financially-dollarized, might generate adverse effects on the balance sheets of the public sector and of non-tradable private sectors. In other countries, where there still exists a significant *pass-through*, these factors might generate inflationary pressures.

IV. Policy Implications

The risks from the global scenario described above have a clearly systemic dimension. A sudden increase in international interest rates, together with a fall in the price of a wide range of assets, in the context of an economic slowdown, can generate a strong loss of investors' confidence on emerging economies. The Committee believes that if this scenario materializes, the current financial architecture, made up by local central banks and multilateral institutions will be inadequate to respond to the challenges entailed by such scenario. Therefore, restoring confidence will very likely require new liquidity support by the FED, this time towards emerging economies. However, it seems unlikely that such action will be supported by the US Congress to the extent that US recovery continues in its consolidation process, and that injecting liquidity is not clearly in the interest of the United States.

In this context, the Committee believes that it is desirable to strengthen the international financial architecture to improve its capability to respond to a sudden deterioration in global financial markets. The Committee particularly favors the creation of an Emerging Markets Fund (EMF) with the capacity to intervene in sovereign debt markets for the purpose of reducing volatility. Such a fund may intervene in debt markets in case of systemic financial turmoil and under predetermined rules; such actions could include transactions based in a bond basket (for example the EMBI basket). The fund may also establish swap lines with central banks of the same type that took place during the global financial crisis.

A potential problem with this kind of initiative is that it is subjected to usual criticisms regarding moral hazard. However, the Committee believes that this is not a major problem because the EMF is focused in establishing a bond basket price index that includes bonds from many countries and not for individual countries. Even if the moral hazard argument has some merit, and even if the EMF can experience losses in its interventions, the 2008-2009 crisis experience demonstrated that counting with powerful instruments, witch lender of last resort characteristics, in systemic situations of loss confidence derives in benefits that exceed the costs.

In previous CLAAF statements (see Statement No. 27), the Committee has already clearly expressed the need to complement the role of current multilateral organizations, particularly the IMF through the creation of regional institutions. In this regard, the Committee favors the creation of a Latin American Liquidity Fund mainly aiming at: 1) providing liquidity to the public sector, and 2) providing credit that can mitigate the possible volatility in trade credit lines. The Committee estimated that such institution should need a capitalization of US$ 50 billion and a lending capacity of US$ 100 billion, equivalent to the net liquidity needs by the region during the 2008-2009 crisis.

Facing the current scenario, the Committee recommends the countries in the region to run new *stress tests* so as to update possible financial needs for the public and private sectors that might arise if the FED increases interest rates suddenly in the context of the current economic slowdown and fall of commodity international prices.

In the preceding sections we have identified the growth of "*shadow banking"* –a response to greater regulatory constraints on the traditional banking system- as an important source of risk. To contain regulatory arbitrage, the Committee recommends that financial activities with similar characteristics should be treated coherently in the regions' regulatory frameworks; without distinguishing whether such activities are carried out by a bank or another entity if systemic risks -which require potential action from a lender of last resort, such as a central bank- derive from such activities. This implies a change in the traditional regulatory approach form "regulation by type of institution" to "regulation by function". In addition, it is advisable to exclude public sector liabilities from the definition of "highest-liquidity assets" recommended by Basel III in countries whose sovereign liabilities are subject to high volatility in the contexts of financial turmoil. This would prevent interconnectedness between sovereign risk and financial risk.

The above mentioned change of approach concerning regulatory frameworks suggests the convenience of consolidating regulatory and banking supervision with responsibilities for capital markets and insurance oversight. Some countries in the region, such as Colombia and Mexico, have already moved in this direction. However, in the US and the EU there is still separation between banking and capital market regulators.

The prospects for increasing volatility in capital markets causing the region to face sharp downturns in capital inflows also implies challenges to domestic economic policies. Turbulences in capital markets may generate a contraction in banking credit that may exacerbate the adverse effects on economic growth. It was demonstrated -during the 2008 and 2009 crisis- that in such case public banks may play a beneficial counter-cyclical role that could mitigates the contraction of private banks' credit. In countries where there are public banks, the Committee believes the counter-cyclical role of credit provided by those institutions should be strengthened. To do so, public banks should explicitly adopt said policy objective and develop specific strategies to appropriately exercise such role.

In terms of exchange policy, the Committee reminds the region about the importance of keeping appropriate exchange rate flexibility and avoiding "fear to float" behaviors. The countries that are most able to reduce currency mismatches in balance sheets and dollarization will be in better position to face the challenges of a greater financial volatility and lower economic growth.

This declaration was jointly drafted by:

Guillermo Calvo, Professor, Columbia University; former Chief Economist at the Inter-American Development Bank

Alberto Carrasquilla, Founder Partner, Konfigura Capital S.A.; former Minister of Finance in Colombia

Pedro Carvalho de Mello, Professor, Getulio Vargas Foundation; former Director, Commission on Movable Assets, Brazil

José De Gregorio, Professor, Universidad de Chile; former President at the Central Bank of Chile

Roque Benjamin Fernandez, Professor, CEMA University; former Minister of Economy Public Works and Services, Argentina

Pablo Guidotti, Professor, Torcuato di Tella University; former Secretary of Finance and Economy Vice-Minister, Argentina

Guillermo Perry, Professor, Los Andes University; former Finance Minister, Colombia and former Chief Economist for Latin America at the World Bank

Liliana Rojas-Suarez, President, CLAAF; Director, Latin American Initiative, Center for Global Development, and former Chief Economist for Latin America at Deutsche Bank

Ernesto Talvi, Director, CERES and Brookings Global Initiative -CERES for Latin America; former Chief Economist at Uruguay's Central Bank

The Latin American Shadow Financial Regulatory Committee (CLAAF) thanks Banco Central de Reserva del Perú for their support in preparing this declaration, and the Center for Global Developmnet (CGD), Banco Central de Chile, and Fondo Latinoamericano de Reservas (FLAR) for additional funding of its activities in 2014. The Committee is entirely independent and autonomous in issuing its statements.