

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

Statement No. 22

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**Latin America: Managing Capital Flows in the Wake of the
European Debt Crisis**

I. Latin America's Outlook in Light of the European Debt Crisis

In Statement No. 21, the Committee dealt with the risks to Latin America stemming from the international financial crisis. At that time, the Committee remarked the relative strength of the region's policy framework during the US sub-prime crisis. However, it also warned of the potential risks from a rapidly deteriorating fiscal situation in most advanced economies and the unprecedented amounts of debt issuance by those countries.

In the course of 2010, new pressures materialized in some European economies, requiring strong and swift policy responses from European Union (EU) governments and the European Central Bank (ECB). Notably, in April the EU and the IMF agreed on a €750 billion package to stem the uncertainty generated by the financial difficulties encountered by Greece and, to a lesser extent, by Portugal, Spain, and Ireland. The impact of the European debt crisis has been felt around various asset classes and regions.

Currently, most of Latin America continues to display a remarkable resilience to adverse external financial developments. In 2010 the region's GDP is expected to grow over 4 percent, inflation (although increasing) remains subdued and, most notably, capital flows have surged once again to near pre-Lehman crisis levels.

Such resilience partly reflects sound fundamentals and policy frameworks. External (public and private) debts to GDP ratios have been declining in recent years and are comparatively low vis-à-vis historic levels for the region and the current ones for advanced and emerging Europe. Fiscal prudence and economic growth for several years in the present decade have resulted in historically low overall public debt to GDP ratios. Current account surpluses, a high stock of international reserves and support by multilaterals provided effective protection against capital market volatility. Although current accounts have deteriorated, balances remain within a comfortable range to date.

For the first time in recent history, country-risk spreads of a number of Latin American economies stand below those of some advanced economies.

Although the European Debt Crisis is still unfolding and its full consequences remain still to be seen, **the Committee believes that the advanced economies' central banks and governments, and international financial institutions, have the means to avoid a new global financial panic along the lines of the post-Lehman collapse in 2008.** In such scenario, growth is likely to be sluggish in the advanced economies as fiscal consolidation and private deleveraging take place. Hence, international interest rates are likely to remain exceptionally low for the foreseeable future. In such an environment, Latin America may face a period of sustained and large capital inflows.

II. The Region's Policy Challenges and Opportunities

The prospect of an extended period of surging capital inflows poses significant risks and policy challenges but generates meaningful growth opportunities.

Reflecting a resurgence of economic growth, a number of countries in the region are already facing deterioration in their current account balances, and are starting to experience inflationary pressures. While central banks have stepped-up their foreign exchange intervention and sterilization efforts in response to the surge in capital inflows, currency appreciation pressures remain strong. In addition, central banks in the region are adopting a tighter monetary policy. In the presence of highly expansionary monetary policies in the advanced economies, relatively higher domestic interest rates in Latin America are likely to stimulate further inflows of short-term capital, reinforcing domestic currency appreciation pressures.

The Committee notes that massive capital inflows may heighten the risk of large current account deficits and real currency appreciation. The deterioration in current account balances that accompanies the surge in capital inflows may result in a renewed process of accelerated growth in external indebtedness. In such a context of ample liquidity in international financial markets, the private sector is likely to play the central role in taking on external debt. Debt surges of the private sector require close monitoring as it is often the case that they turn out to end up being assumed by the public sector at times of crisis. Moreover, even if fiscal policy appears to be sound, it may in fact turn out to be highly expansionary on a cyclically adjusted basis. Fiscal finances tend to appear deceptively solid during booms as revenues are boosted by strong economic growth.

The Committee believes that large capital inflows also induce a rapid expansion in bank credit and create the conditions for the emergence of asset price bubbles. There is ample international experience that credit booms, if left unchecked by regulators, are often accompanied by a significant underestimation of underlying credit risk. Because private decision making at financial institutions does not fully internalize their contribution to potential systemic risks, what at one time may appear profitable banking

business may turn into a major headache when macroeconomic conditions reverse. Credit booms have often ended in credit contractions and, possibly, in costly banking crises.

To be sure, the resurgence of capital flows is not a new phenomenon in the region. In fact, similar issues occupied the Committee's discussions in April 2004, when it issued its Statement No. 10. At that time, the principal concerns and recommendations highlighted by the Committee were to strengthen primary fiscal surpluses, to reduce public debt to GDP ratios, and to improve liquidity management by both accumulating international reserves and lengthening the maturity structure of public debts.

In the Committee's view, the difference at the present conjuncture is that initial macroeconomic conditions are significantly better than in previous episodes of capital inflows faced by the region. In particular, current account balances exhibit either a surplus or a relatively small deficit position. Public debt ratios (domestic and external) are at the lowest levels in decades, and most countries in the region have had in place for some time strong financial prudential regulation and supervisory frameworks as well as more flexible monetary policies in a moderate to low inflation environment.

Despite the central policy challenges highlighted above, the Committee believes that the prospect of a relatively long period of sustained and large capital inflows also generates significant opportunities. Sustained capital inflows provide the opportunity of consolidating an environment that is conducive to strong investment and economic growth. A period of ample international liquidity and low interest rates favors tapping long-term funding and attracting foreign direct investment flows.

However, **the Committee notes that capitalizing on these opportunities requires ensuring that capital inflows do not exacerbate major existing inefficiencies.** This means removing distortions in labor, goods, and financial markets in order to raise total factor productivity, improving infrastructure, and strengthening the budgetary decision-making process. More importantly, not undertaking the necessary reforms may mean more than simply missing opportunities. It may amplify the effects of existing distortions. Enabling Latin America to reap the benefits from sustained long-term capital inflows opens the region's prospects to consolidate a qualitative step forward in terms of growth and social progress.

III. Policy Recommendations

A surge in capital inflows requires a combined policy response aimed at moderating the pace of private sector borrowing as well as reinforcing the public sector's instruments to manage systemic liquidity risk.

Central banks have primarily focused on short-term interest rates and inflation targets. Financial stability considerations would suggest that more attention should be paid to credit aggregates and asset prices. Macro prudential regulations in the banking system are critical to manage private sector inflows. Broadly, this encompasses quantitative credit

measures or targets. Liquidity requirements on both domestic and foreign short-term banking sector liabilities help reduce the incentive to excessively expand bank credit funded with low-cost, short-term liabilities that increase the banking system's exposure to the systemic liquidity risk associated with credit boom-bust cycles. At the same time, in order to tackle the potential underestimation of credit risk that accompanies periods of easy credit conditions, **the Committee recommends that serious consideration be given to the adoption of counter-cyclical loan loss provisions and margin requirements on collateralized lending in the banking system.**

Combined with these regulatory actions, conventional macroeconomic fiscal and monetary policy actions should be adopted to ensure that the public sector maintains adequate capacity to respond to the effects of potential reversal of capital flows, and to ensure that fiscal policy does not reinforce the expansion of private sector demand. Hence, **the Committee believes that there is room for further accumulation of international reserves in response to a surge in capital inflows. At the same time, governments should adopt multi-period, cyclically-adjusted budgetary frameworks so as to preferably fund the accumulation of reserves with genuine fiscal revenues. Moreover, governments should maintain fiscal restraint so as to reduce or at least maintain public debt to GDP ratios at current levels, and should strive to lengthen the maturity profile of the domestic and external public debt.**

In the current international context, there has been a revival of the discussion on the potential effectiveness and desirability of capital controls as a complementary tool to deal with surges in external short-term capital inflows. The discussion is particularly difficult because the term "capital control" encompasses a large number of very diverse measures and span different experiences across the world, some of them successful and some other not. With all the appropriate caveats, specific permanent measures such as the adoption of minimum maturity requirements on foreign borrowing, the imposition of a tax on short-term capital inflows (along the lines of the Chilean variety) may contribute to lengthen the maturity composition of external inflows and in some cases reduce overall flows. However, **the Committee warns against widespread administrative measures that restrict outflows or inflows irrespective of whether they imply a change in net foreign assets, or emergency interventions that generate uncertainty regarding the foreign investment climate.**

The policy recommendations just discussed aim at reducing the systemic risks associated with a potential surge in capital inflows to the region. However, to ensure that capital inflows finance a sustainable expansion of investment requires decisive actions by governments aimed at fostering an increase in productivity and at reducing existing distortions in labor, goods, and financial markets. An important element is the establishment of a stable financial infrastructure conducive to the development of deep equity and long-term debt markets.

In order to improve the quality of public investment, governments can resort to the establishment of public-private partnerships (setting up an adequate legal framework), and should take decisive actions to upgrade their budgetary process by focusing on long-

term objectives that span across government administrations. **The Committee believes that multilateral financial institutions can play a key role as a vehicle to channeling international credit into socially profitable development projects.**

IV. A Caveat

This statement assumes that a financial panic of the kind experienced after the Lehman debacle will be successfully avoided by appropriate and timely policy actions in advanced economies and the international community. **However, the Committee strongly cautions against complacency. Given current global uncertainty, Latin American governments should be extremely prudent in their public policy management and recognize that, although a favorable period may lie ahead, such an outlook is also subject to considerable risks.**

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