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

Statement No. 23
November 16, 2010
Lima, Peru

The Currency War: Risks for Latin America and the Role of Central Banks

I. The Problem

Latin America faces an external scenario characterized by strong capital inflows, a weakening dollar and, according to many observers, an undervalued yuan.

Since the financial crisis unfolded in 2008, the international economy has experienced deep changes on several fronts. First, firms and households in advanced economies, especially in the U.S., and the governments of the European Union, are initiating a deleveraging process. Second, the implementation of an active fiscal policy is encountering both financial and political constraints and is therefore coming to an end. In order to offset shrinking demand in advanced economies, several voices advocate a rebalancing of aggregate demand, especially in China, but also in emerging market economies.

In the five years prior to the crisis, the U.S. dollar had dropped significantly in value measured in effective terms. As this trend strengthened in the recent months, several export-oriented countries adopted various forms of foreign exchange market intervention. Foreign exchange interventions in China, Japan, South Korea, and Switzerland, among other countries, as well as the Federal Reserve's announcement of the so-called QE2 (Quantitative Easing 2), have created the risk of a currency war aimed at inducing a rebalancing of aggregate demand through exchange rate policy.

However, economic history shows that competitive depreciations may result in a sequence of protectionist measures with huge costs for the global economy and for the world's population.

The assumption that global imbalances and the international rebalancing of demand may be achieved through foreign exchange policy overlooks the fact that the main issue in the U.S. and other advanced economies is the persistence of financial sector problems. As a result of failure to address financial weaknesses explicitly, and to recognize the overvaluation of a significant portion of bank assets, a large part of the private sector does not have access to credit and cannot finance new investments.

In this context, QE2 is not deemed an effective measure, as liquidity injections end up as deposits with the Federal Reserve —which, additionally, remunerates excess reserves since 2008 to support the cleaning-up of banks' balance sheets— or in sectors that are already highly liquid.

Moreover, since QE2 is implemented through open market operations whereby the Federal Reserve purchases U.S. Treasury debt instruments with a yield close to zero, it is not clear whether it creates an economically significant monetary expansion. In the Committee's opinion, it is possible that markets could be overestimating the effectiveness of QE2, and therefore the recent weakening of the dollar in response to its announcement could be a transitory event.

Nevertheless, there is a remarkable aspect associated with the announcement of QE2. QE2 may be interpreted as a commitment to the markets that the Federal Reserve will guarantee the stability of the financial system. In this regard, its impact is to decompress the increased demand for liquidity. However, given that vast sectors in the U.S. and other advanced economies are not considered attractive due to the presence of unresolved banking problems, this decompression induces a significant increase in capital flows to emerging economies.

In the case of Latin America, the Committee's previous declaration anticipated that the region would face important challenges from the higher pace of capital inflows induced by interest rate differentials associated, among other factors, with dollar depreciation expectations. Different economies in the region currently face incipient overheating and experience current account deficits, both of which would seem to justify a currency appreciation.

As a result, some central banks have initiated monetary tightening, raising interest rates (e.g., Chile, Brazil, and Peru), while others have signaled their concern. However, the fact that China is reluctant to allow a strengthening of the yuan creates the risk of further deterioration of the region's competitiveness. In this regard, while aggregate demand should increase in countries with strong current account surpluses (China and emerging Asia), Latin American countries (with the exception of Argentina, Bolivia, and Venezuela) must face the risk of rapidly deteriorating current account balances.

II. Policy Recommendations

What are the main actions that the authorities can adopt in a context of strong capital inflows? What should the international community do to reduce the current imbalances?

In fact, the countries in the region have already been implementing a series of policies to address the impact of high capital inflows. First, several countries have addressed appreciatory pressures by stepping up central banks' interventions in the foreign exchange market. Given that the economies in the region have been experiencing overheating, it would be desirable to allow a moderate appreciation of their currencies. However, as long as China contains appreciation of the yuan, the strengthening of the region's currencies may generate a substantial competitiveness loss.

Therefore, **the Committee believes that the first policy scenario that should be explicitly explored is an agreement with China to establish some degree of exchange rate policy coordination between China and the region.** Since the Chinese economy is also undergoing a rapid expansion of aggregate demand, it would be desirable to allow a greater appreciation of the yuan and that the region's currencies adopt a coordinated movement in the same direction. Possible negotiation forums with China include the G-20, the BRIC meetings, and APEC.

If exchange rate policy coordination with China is not feasible, **the Committee considers that a reasonable response from the region's central banks would be to adopt exchange rate intervention to curb the risk of an abrupt appreciation of the region's currencies.** Two essential questions arise here: should the dollar be the benchmark currency for this policy; and should intervention be sterilized or unsterilized?

Regarding the first question, **the Committee recommends that the central banks of the region consider the possibility that the yuan take on a greater role as benchmark currency for exchange rate policy.** This reflects China's increasing importance in the region's international trade flows.

Regarding the second question, **the Committee believes that unsterilized intervention is preferable to sterilized intervention. If sterilization is chosen to contain inflationary pressures, it should not be used systematically, as it leads to interest rate increases that induce higher capital inflows and swells the central bank's quasi-fiscal deficit. However, unsterilized intervention must be complemented by an additional fiscal effort**. Especially in cases where the economy benefits from improvements in the terms of exchange derived from increases in commodity prices, it is recommendable to adopt an automatic fiscal countercyclical mechanism to save extraordinary revenues for difficult times. An example is a fiscal rule like the one adopted in Chile, which targets a structural primary surplus of 1% of GDP. However, even though the Committee acknowledges that it has an important complementary role, fiscal policy alone should not be expected to be fully effective in preventing appreciation pressures derived from higher capital inflows. In order to enhance the effectiveness of fiscal policy, **the Committee also recommends redirecting public expenditure from consumption to investment**.

At the same time, it is necessary to recognize that, in the presence of rigid nominal wages, currency appreciation threatens jobs in tradable sectors. **The Committee recommends introducing greater flexibility in wage contracts or, alternatively, establishing a fiscal compensatory mechanism to address higher payroll costs associated with real exchange rate movements**.

A second line of action that can complement and limit the need for exchange rate intervention is the use of macro-prudential policies. In this field, **the Committee recommends central banks to strengthen capital and liquidity requirements in the financial system and to adopt counter-cyclical financial regulation criteria**. An important example in this direction is the implementation of dynamic provisioning in Bolivia, Colombia, Peru, and Uruguay.

It is essential to strengthen prudential regulatory frameworks in a context where low international interest rates and the existence of unresolved banking problems in advanced economies are driving international capital into an indiscriminate search for yield in emerging markets. In these circumstances, the creation of speculative bubbles in these markets is a real risk that monetary and regulatory authorities must strive to identify and prevent.

Some countries in the region have complemented exchange rate intervention with the adoption of capital controls. Moreover, recently the IMF has explicitly recognized a potential role for these kinds of policies in the current context. This recognition is quite surprising, considering that one the IMF's main role is to prevent the proliferation of unilateral actions that can hamper the functioning of international capital markets. **Even though the Committee recognizes that capital controls can attenuate exchange rate pressures in some countries, it also emphasizes the considerable risks from the use of these instruments in the region and in other parts of the world**. The central problem is that it could lead to widespread protectionism and to a reversal of the financial and commercial progress achieved in the region.

The problems arising from capital inflows into emerging economies can hardly be handled only by implementing policies at the individual country level. The Committee believes that ensuring positive opportunities from this process and containing potential risks require determined action by the international community.

In particular, it is central to ensure the quality of investment supported by capital inflows. As suggested above, a situation in which international capital flows are mobilizing in a context of close-to-zero international interest rates considerably increases the risk of speculative bubbles in emerging markets. Therefore, it is a priority to establish mechanisms that can help to channel capital inflows towards productive long-term investment, thus preventing them from contributing to the creation of speculative bubbles. In this regard, **the Committee recommends the international community to**

further strengthen multilateral development institutions such as the World Bank, the Inter-American Development Bank, the Andean Development Corporation (CAF), and the Central American Bank for Economic Integration (BCIE). These institutions should actively support the establishment of Public-Private Partnerships that can channel resources towards priority infrastructure projects.

The current international situation reflects insufficient action from U.S. and other advanced economies' authorities in addressing underlying banking problems. This situation creates the prospect of a protracted period of close-to-zero international interest rates with uncertain recovery prospects. More effective and focused action on banking problems is critical to improve this outlook. **The Committee believes that QE2, as it is being implemented, is not effective and does not address or resolve banking problems. The Committee believes that it is urgent that U.S. authorities focus very actively in establishing a realistic valuation of banking assets and promoting the normalization and alleviation of the situation of mortgage debtors**.

The Latin American Shadow Financial Regulatory Committee thanks the support of the Central Reserve Bank of Peru. The Committee was completely independent and autonomous in drafting this declaration.