

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

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**Are Uncertainties in the North Seeding a New Crisis in the
South? Options for Latin America**

I. The global setting

Although the external environment for Latin America has improved significantly since the outbreak of the 2008-2009 global financial crisis the current dynamics in the advanced economies remain subject to significant uncertainty and pose potentially important risks for the region over the medium term. Risks for Latin America derive from three main (and interrelated) sources: 1) the evolution of US economy, 2) the unraveling of the European debt crisis, and 3) advanced economies' policies and regulatory changes affecting the international capital market.

As regards the US economy, the financial crisis has uncovered significant structural challenges. The impact of the crisis has been very different across sectors of the US economy. Households and financial institutions are in a protracted process of deleveraging while small businesses are faced with tight credit conditions. By contrast, large corporations and the US Federal Government are currently enjoying ample liquidity conditions. In this context, the major unresolved issues are the mortgage debt overhang and the burgeoning public debt.

The US economy has been facing for some time a strong downward pressure on real wages derived from the expansion of the Chinese economy (especially, the growth of its labor force at low wages) and the use of outsourcing practices by US corporations. These pressures had been compensated in the years previous to the financial crisis by the strong expansion displayed by the non-traded and labor-intensive sectors (such as, construction) fueled by the real estate bubble. As the financial crisis has directly impacted on these sectors, the downward pressure on real wages is now playing a significant role in explaining the softness of the US labor market despite the recovery in economic activity and household net worth.

Due to political gridlock on budgetary issues, US policy will most likely rely almost solely on monetary policy. In a context of persistent unemployment, slow growth and high levels of indebtedness in both the private and public sectors, US monetary policy is likely to remain accommodative barring significantly negative inflation surprises.

Therefore, under this baseline scenario, the Committee believes that the recovery of the US economy, and especially of employment, is likely to be modest by historical standards. Moreover, the likely low level of nominal and negative real interest rates in the US will continue to support conditions for further capital inflows toward emerging markets.

As regards potential developments in the European debt crisis, the Committee sees significant risks and uncertainties deriving from the current Eurozone strategy. Based on past experiences around the world, the Committee believes that the current strategy of providing financing assistance in exchange for fiscal adjustment in Greece is unlikely to restore growth in the medium term unless that country's fiscal situation becomes clearly sustainable in the eyes of the capital market. Although the current strategy is likely to postpone a resolution, the Committee believes that, in the end, Europe will face one of two possible scenarios: 1) a disruptive debt restructuring in Greece and possibly in other European economies, or 2) an outright bailout by the Eurozone governments to Greece and possibly other affected countries that results in a significant debt reduction and a relatively benign treatment of bondholders. However, a disorderly management of the European debt crisis may have severe contagion effects on Latin America, especially in light of the large presence of foreign-owned banks in the region.

The high debt situation in Europe has unveiled a long-standing challenge for that region: the need to raise productivity. However, the structural reforms required to generate a significant improvement in growth prospects face significant economic and political challenges. In view of these conditions, our baseline scenario assumes a slow growth recovery in the advanced economies as a whole.

The Committee views as unlikely the development of sustained inflationary pressures in the advanced economies in the near term. However, in terms of the international capital market, policy actions in response to the deteriorating public debt conditions may result in the adoption of regulations that may be reminiscent of measures associated historically with the concept of financial repression. An example of such actions is the rising share of public debt in the balance sheet of commercial banks and pension funds.¹

¹ For instance, in 2009 the UK increased the required holdings of government bonds held by banks. In 2010, France converted the pension reserve fund to a captive buyer of government debt. Basel III liquidity requirements require bank to invest in domestic government bonds.

II. Effects of the global setting on Latin America

Under the previously discussed external baseline scenario, Latin America is likely to face significant and continued capital inflows. Strong capital inflows have been, in varying degrees, associated with widening current account deficits, real exchange rate appreciation, and credit booms.²

Since the onset of the inflows, rapid increases in real estate and equity prices are raising the concern of the development of asset bubbles in several Latin American economies. Asset bubbles are reinforced by the perception of ample liquidity in domestic markets, although such perception may prove to be quite volatile. The surge in asset prices is also fueled by regulations that require pension funds to invest in domestic assets.

Of some concern is that saving rates in the region remain low and falling; current account balances are rapidly shifting into a deficit position in surplus countries or are deteriorating further in most deficit countries. The region is thus returning to its historical dependence on foreign savings. This deterioration is taking place against the backdrop of high world commodity prices.

The expansion of domestic demand is contributing to real exchange rate appreciation across the region and concerns about “Dutch disease” problems have resurfaced. To the extent central banks intervene in foreign exchange markets to mitigate the nominal appreciation, this is also fueling rapid credit growth and rising domestic inflation. There is considerable variation across countries in the region.

The surge in capital inflows has triggered a number of largely uncoordinated policy responses. Various central banks have resorted to widespread foreign-exchange intervention, to sterilization operations, to increases in reserve requirements, and to the adoption of capital controls. In some countries, regulators have implemented, or are considering the adoption of counter-cyclical capital requirements and/or other macro-prudential regulations.

Despite the widespread policy response, capital inflows have remained strong. Moreover, the adoption of capital controls in some countries may be displacing exchange-rate appreciation pressures to other neighboring economies. The absence or limited currency appreciation in China and other Asian economies exacerbate the above-mentioned pressures.

The rapid expansion of credit raises the question as to whether they are destined to capital formation and productive projects as opposed to simply fueling higher consumption and household indebtedness. Furthermore, the significant credit growth raises concern about the overall quality of new loans as well as inflationary pressures.

² For regional aggregates, see IMF’s World Economic Outlook, April 2011.

III. Policy Recommendations

In view of the region's challenges in coping with the current surge in capital inflows, the Committee has considered a number of additional policy options that could be useful in dealing with the risks associated with the above-mentioned surge as well as with the potential sudden stops in capital flows that may occur if external conditions worsen in the future.

The Committee's recommendations primarily focus on the risks posed by the ongoing credit boom in the context of a low domestic savings rate. Some of the recommendations have a predominantly structural nature to shape incentives to save, while other deal with counter-cyclical policies in response to the flows.

Cyclical: Credit booms

Given the relative importance played by the banking system in the development of credit booms, the Committee concluded that the macro prudential framework applying to the financial system needs to be strengthened in the following directions:

- **Central banks should consider adopting explicit credit growth caps (i.e., a maximum target applicable to the yearly increase in bank assets, implemented at the bank level).** Such instrument may be highly effective in preventing excessive credit growth, and aligning bank asset growth to macroeconomic objectives as well as to the capacity of banks to manage the risks associated with a fast expansion of their balance sheets.
- **In the current context it is appropriate to raise further minimum capital requirements (that in most countries stand in the range of 10-12% of risk-based assets), and introduce cyclically-adjusted capital and provisioning requirements, along the lines recommended by Basel III adapted and calibrated to Latin American financial institutions.**
- Non-deposit funding has proven to be very volatile. Hence, **maturity and currency mismatches associated with wholesale (especially external) funding should be limited.**
- Similarly, **central banks should consider the adoption of regulations designed to limiting the size of off-balance sheet activities of banks.** This is especially important for countries where the ability to adequately supervise its risks is insufficient.
- A source of concern is the potential negative effect on credit deriving from external banking problems on Latin America transmitted through the operations of foreign banks operating in the region. Bank supervisors in the region should evaluate closely the potential impact of external banking problems in their countries. In normal conditions branches and subsidiaries of foreign banks should

be subject to the same capital and liquidity requirements. However, **supervisors should be given the ability to impose supplemental liquidity requirements on branches and subsidiaries of foreign banks in the event that conditions affecting their home offices should be subject to a material adverse change.**³

Strengthened regulations in the banking system may shift capital inflows to non-bank financial and capital markets. Given the potential for the occurrence of asset bubbles, **the Committee recommends to raise margin requirements in capital market transactions on a counter-cyclical basis, as it may contribute to mitigate the effects of surges in capital flows outside the banking system.**

Additionally, **the Committee recommends relaxation of the requirements on pension funds to invest a significant portion of their assets in domestic assets may also contribute to reduce the pressure of capital inflows on domestic asset prices.**

Structural: Savings rates

The use of tax measures directed at changing the relative incentive between savings and consumption is recommended by the Committee as a means to increase the savings rate in Latin America. In some countries, such as Argentina, the current tax code provides an outright subsidy to borrowing by making interest income exempt from income tax while interest payments are tax deductible as expense. Also, as in the US, a common practice in Latin America is to treat interest payments on mortgages as deductible from the income tax. **Thus, existing tax codes should be revised to eliminate any pro-debt bias and encourage capital investment.**

Savings as well as efficiency in resource allocation will also be stimulated by the development of liquid and deep domestic capital markets. **The Committee recognizes that, while the objective of counter-cyclical policy is to prevent the risks associated with credit booms, it should be designed as to minimize its interference with capital market development.**

Are uncertainties in the North seeding a new crisis in the South? Low international interest rates offer a benign setting for Latin America, but sustained capital inflows have historically often ended badly. Credit booms and large current account deficits have been precursors of banking crises and debt difficulties and, as such, an active counter-cyclical policy stance is timely and appropriate.

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³ Similar regulations exist and have been applied by US regulatory authorities.