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

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Rethinking Monetary, Regulatory, and Financial Policies in the Midst of the Global Crisis

I. Latin America's fundamentals, while strong, are weaker

Contrary to what happened prior to the collapse of Lehman Brothers in 2008, macroeconomic fundamentals in most of Latin America are considerably weaker. Current account surpluses have vanished in many countries and fiscal balances have noticeably deteriorated. According to IMF's most recent World Economic Outlook, the region's current account balance displayed a surplus of 1.6% of GDP in 2006, compared to a deficit of 1.2% of GDP in 2011. Fiscal deficit moved from 1.3% of GDP in 2006 to a deficit of 2.6% of GDP in 2011.

Notwithstanding weaker fundamentals, Latin America continues to receive capital inflows. Capital inflows by themselves may fuel asset price bubbles, much like a herding effect. However, a more fundamental argument than herding is that large capital inflows lead to the perception that assets are easily marketable and, thus, more liquid, representing an additional source of asset price appreciation. But liquidity is in the eye of the beholder. It may rapidly unravel, for instance, in the face of financial turmoil in the rest of the world.

The external environment continues to be in a state of flux. A repeat of a Lehman-type scenario, or an even worse outcome, cannot be ruled out. Issues such as systemic banking problems, unsustainability of public debts, weak growth prospects or even deeper recession in advanced economies are factors that may trigger significant instability in the international capital market.

But even if a new full-blown financial crisis does not materialize, the persistence of a long period of extremely low (risk-free) interest rates in the advanced economies may engender new risks or exacerbate existing ones. Firstly, sustained low risk-free interest rates may lead to significant underestimation of risks in relatively sound financial institutions. In particular, while low interest rates may be of help for undercapitalized banks or for those still holding large quantities of toxic assets in their balance sheets, they may induce excessive (but not necessarily irrational) risk taking in institutions that are in relatively good financial shape. **Therefore, the Committee believes that the problem of toxic assets should be dealt head on, since a general policy of promoting low interest rates for a sustained period may end up planting the seeds of future problems in the segment of the financial system that is currently sound.**

Secondly, the prospect of sustained low risk-free interest rates may distort significantly perceptions about public debt sustainability. At risk-free interest rates of, say, 1% a year for a 10-year maturity bond, even a very high risk spread of 500 bp may yield a funding cost (of 6% on an annual basis) that appears consistent with current public debt ratios in several advanced economies. But it is clear from this example that, even small increases in risk-free rates may rapidly lead into unsustainable debt positions. Concerns about sustainability may easily turn into a liquidity dry-up.

The Committee believes that liquidity is of the essence. Latin America needs to be alert to a possible deterioration of the external environment and build up its policy defenses.

II. Monetary policy in the midst of the crisis: what lessons have we learned?

The first lesson that may be drawn from the central banks' response to the global financial crisis is about the importance of the lender of last resort function. The major central banks in advanced economies rely on their ability to issue *hard currency* in order to credibly provide liquidity.

In contrast, Latin American governments do not issue hard currency assets and, therefore, cannot provide their financial systems with truly safe assets. Hence, alternative instruments need to be (and have been) developed. In particular, the recent experience in the region points to the importance of counting with a large stock of international reserves and imposing liquidity requirements on banks (expressed as a fraction of short-term liabilities) invested in foreign exchange high-quality assets. **The Committee recommends maintaining high levels of external liquidity in hard currencies both at central bank as well as at the financial system.**

Domestic policies to strengthen the capacity of central banks to act effectively as a lender of last resort should be complemented by the use of existing international instruments designed to enhance central bank liquidity. **The Committee recommends that countries in the region take advantage of the Flexible Credit Line (FCL) facility offered by the IMF, which allows countries that meet conditions regarding macro and financial stability to pre-qualify and have immediate access to this line at times of acute stress.**

At this time, only Mexico and Colombia have taken advantage of this facility. Other countries have expressed reluctance to request access to the FCL. Given that currently many countries in the region meet the criteria for qualification, **the Committee believes that countries that qualify should apply to this contingent source of liquidity.**

A second lesson is about the importance of central banks having a clear inflation target. Although central banks have engaged in foreign exchange intervention, these operations have not been imbedded into the announced monetary policy framework. To be sure, setting an inflation target per se does not rule out the occurrence of high exchange-rate and inflation volatility. **The Committee recommends that the inflation target be complemented *explicitly* by foreign exchange intervention as a means to anchor the system.**

A different issue relates to the growing popularity of the notion that central banks should adopt an objective function that includes the output gap. However, adding the output gap to the monetary policy objective assumes away the problems of discretionary policy. **The Committee believes that, in Latin America, a modification of the monetary policy framework along these lines may turn out to be dangerous and re-introduce an inflation bias given the historical record of the region.**

The third lesson is about the importance of trade finance as a channel of transmission. The region's experience after Lehman's collapse showed that the sudden stop of trade finance lines was a critical channel of transmission from the external financial crisis to domestic economic activity. While at the time there were a few ad-hoc initiatives to stabilize and reconstitute trade lines, no permanent mechanisms have been put in place to deal with potential future disruptions. Protecting trade finance amounts to protecting a central component of the international payment system. Therefore, **the Committee believes that the international community should put in place instruments for the private sector (possibly with prequalified and automatic access) to protect the stability of trade finance.**

III. Regulatory and financial policies

Before the global financial crisis of 2008-09, the Basel Committee on Banking Supervision (BCBS) was silent on the issue of liquidity risk (Basel I and II), precisely the central risk during the crisis. Recognition of this problem led the BCBS to advance recommendations on liquidity ratios that banks should hold.[1] Regardless of the details and computations of the recommended ratios, the key issue is the focus of the BCBS on what is defined as *high-quality* liquidity. According to the BCBS, assets with the highest quality of liquidity include: cash, central bank reserves that can be drawn at times of

[1] The BCBS recommends a continuous assessment of two ratios: (a) the liquidity coverage ratio defined as the stock of high-liquid assets as a proportion of net cash outflows over a 30-day period under an acute stress scenario; and (b) a net stable funding ratio defined as the available amount of stable funding as a proportion of the required amount of stable funding. The specific recommendation is that these two ratios should be greater than 100 percent.

stress, claims on (or guaranteed by) the local government and central bank, as well as claims on the IMF, BIS and multilateral development banks.

Banks' asset positions in Latin America appear to comply with BCBS recommendations because in several countries banks hold a large share of government and central bank paper in their balance sheets (this is particularly important in Brazil, Argentina and Venezuela). However, as was discussed earlier, the inclusion of government paper as a *high-quality asset* generates a false sense of security about financial stability. **The Committee recommends that the BCBS define liquidity for bank purposes as composed of truly safe assets. In many countries government bonds do not enter into this category.**

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