

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

Statement No. 21

**Latin America in the Road to Global Recovery: Short-Term
Macroeconomic Challenges**

I. Introduction

Relative to past international financial crises, Latin America has fared well in the recent global turmoil. In part, the region's good performance reflected improved fundamentals, summarized in stronger fiscal and current account balances, and in ample external liquidity positions. In the run-up to crisis, a benign external environment characterized by low interest rates, low inflation, and subdued volatility contributed to consolidating more credible monetary and exchange rate policy frameworks, to developing domestic capital markets, and to strengthening banking systems.

Latin America remained relatively insulated from the process of financial innovation that led to the US sub-prime crisis. Relatively stringent regulatory and supervisory frameworks in the region impeded a rapid growth of securitized instruments, and generally prevented the creation of, and investment in, toxic assets.

This time, because of the region's stronger fundamentals, the flight-to-quality stemming from Lehman's collapse was not entirely directed to US treasuries. In several Latin American countries, a shift occurred from bank deposits at private financial institutions into deposits at public banks and into domestic government bonds. Additionally, in some cases, domestic capital markets, through pension funds, mitigated the effects of the international credit crunch on the financing of domestic companies. Furthermore, some central banks (e.g., in Brazil and in Mexico) effectively intervened to moderate the sharp reduction in trade finance that took place at the height of the crisis.

The region's outlook is likely to remain significantly dependent on the pace of recovery as well as the unfolding of still significant imbalances in the world economy.

II. Latin America's immediate challenge: Dealing with currency appreciation

In a number of countries, such as Brazil, Chile, Colombia and Peru, a significant strengthening of their currencies is rapidly weakening the external competitiveness of the tradable sector. Such currency appreciation is the price to pay for success, but is also in part the consequence of the exceptionally accommodative US monetary-policy stance and lower global aggregate demand. Loss of competitiveness *vis-a-vis* the Asian markets has been aggravated by the exchange rate policy followed by China and most Asian economies.

What should the region's policymakers do? In order to prevent further deterioration of external competitiveness, **the Committee believes that leaning against the wind remains the appropriate policy stance.** In this respect, central banks should continue intervening in the foreign exchange market and accumulating additional international reserves.

For further reasons that will be discussed below, **the Committee believes that an additional strengthening of the external liquidity position is desirable in several economies in the region.** Although some have argued that excessive international reserve accumulation may be an inefficient form of self-insurance, **the Committee believes that a future renewal in capital market volatility cannot be ruled out, even under the assumption that the current economic recovery in the advanced economies maintains its pace.** Even though the recent creation of the Flexible Credit Line (FCL) at the IMF constitutes a promising instrument to help dealing with capital market disruptions, **the Committee believes that countries in the region should continue to develop their own policies and instruments to manage the effects of sudden stops in international capital flows.**

An option to foreign exchange intervention is for Latin American central banks to adopt a more expansionary monetary-policy stance. The credibility of monetary policy frameworks (in particular, those in countries with established inflation-targeting regimes) has certainly been strengthened in recent years. In spite of this, some central banks may find that a more accommodative monetary stance could fuel unstable inflationary expectations. Currently, market indicators suggest that, despite some recent increase, inflation expectations remain subdued in most countries and within the announced central bank targets. Hence, **the Committee believes that consideration should be given to the adoption of a coordinated lowering of domestic interest rates or quantitative easing in Latin America, in consultation with the IMF.**

Additionally, Brazil has implemented a 2% tax on capital inflows. **The Committee believes that, as a policy of last resort and in spite of some undesired side effects, the imposition of temporary restrictions on short-term financial inflows may be warranted.**

The future strength of currency-appreciation pressures in the region will be highly dependent on how the adjustment to global imbalances unfolds. In this respect, there are two central issues to be considered.

Firstly, **the Committee believes that, to the extent China maintains its current exchange-rate policy unchanged (similarly followed by most of other eastern Asian countries), the adjustment of global imbalances will place higher appreciation pressures in the region.** In this respect, a strengthening of the Yuan would contribute to a more balanced adjustment among emerging market economies, particularly in Latin America. Notwithstanding, an excessive appreciation in China could be counterproductive to the extent it may contribute to slow down economic activity in that country via lower exports.

Secondly, **the Committee believes that reducing the US budget deficit is fundamental to achieving a sustainable reduction in global imbalances.** As a matter of fact, while the private sector component of the US current account has already adjusted sharply, the budget deficit remains as the principal driver of the US current account deficit. While relying on a real appreciation in emerging-market currencies as a means to rebalancing demand in the world economy is likely to place a higher burden on those economies, a US budget deficit reduction may imply accepting a more moderate pace of recovery in the world economy.

Not addressing the current global disequilibria runs the risk of greater protectionism around the world.

III. Renewed capital market risks: Consequences of mounting public indebtedness in advanced economies

Substantial budget deficits in advanced economies are likely to place significant pressure on mature, high grade, bond markets over the next few years. As flight-to-quality subsides or even reverses partially in response to the reduction in volatility in international capital markets, the substantial supply of government bonds by advanced economies' governments is likely to put upward pressure on interest rates. Although it is unclear by how much (real) interest rates on the public debt will increase, there is no precedent for a situation in which major advanced economies combined will need to place an estimated USD 2.8 - USD 3.5 trillion of public debt on a yearly basis over the next 2 to 3 years. Recent IMF projections estimate that public debts in the G-20 advanced economies will reach a level of 120% of GDP by year 2014. At the same time, although there has been a recovery in US private savings that is likely to provide added demand for government bonds, a significant excess debt supply may develop at current interest-rate levels, especially as the recent flight-to-quality continues to unwind.

The US Treasury is expected to be the largest issuer of government debt in this process. Moreover, around 60% of outstanding US Treasuries (excluding Treasuries held by US public institutions) are placed in foreign markets and especially at central banks.

Although it is unlikely that advanced economies will face roll-over difficulties, **the Committee believes that their large fiscal deficits generate risks for Latin America.** While mature markets are unlikely to suffer major disruptions despite this massive supply of government debt, less-liquid emerging (public and private) markets may face significant pressure from the resulting crowding out exercised by the advanced economies. Moreover, such pressure may even be amplified if China reduces its rate of foreign-exchange reserve accumulation, as a major source of demand for US Treasuries would be withdrawn at a time when there is a surge in their supply.

In addition, while US interest rates have remained low, a major risk for Latin America is that world interest rates increase sharply as a consequence of the above situation. There is ample empirical evidence that sharp increases in world interest rates are one of the main causes of sudden stops in capital flows to emerging markets.

Thanks to the active role played by the G-20, the international financial system is currently better prepared to deal with the effects of sudden stops on capital flows than in past crises. However, the size of the newly established FCL remains small in relation to the potential needs of both the private and public sector in emerging markets.

The Committee encourages policymakers in Latin America to remain cautious, maintain prudent fiscal policies, and place a high priority on maintaining a strong external liquidity position. Governments should consider unwinding fiscal expansions to the extent possible, recognizing that the evolution of economic activity across the region has been heterogeneous and thus calls for diverse policy responses.

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