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

Statement No. 33

Montevideo, March 17th, 2015

The End of a Cycle in Latin America and its Associated Risks

I. The Region at the End of the Bonanza

Latin America is no exception regarding the changes in emerging market conditions that have occurred since May 2013. The first wave of bad news for emerging markets, which put an end to the bonanza of 2004-2013, has entangled a number of factors, both foreign and domestic, which have been discussed by this Committee in previous statements.

First, the Fed's announcement in May 2013, stating the reduction of its asset purchase program, changed risk perceptions about emerging economies. Since then, the likelihood of a US interest rate hike has haunted international investors and created a substantial though gradual decrease in capital flows to emerging economies.

Second, the Committee emphasized the risk of a deep slowdown in China's economic growth to the region. The Committee warned about the consequences of the end of the commodity super cycle. Specifically, the Committee warned that the plunge in commodity prices which started in 2011 could be aggravated by China's economic slowdown.

Third, the shortfall in Chinese economic growth derives from the exhaustion of strong investment in low productivity sectors, which was part of the Chinese response to the global financial crisis. The Committee placed great emphasis on the large credit expansion, which was channeled mostly through institutions outside the traditional financial system (known as *shadow banking*). Given this factor, risks coming from China may simply exceed those associated with an economic slowdown, to the extent that such development occurs together with a financial crisis.

Taking the abovementioned factors into consideration, the Committee focused on its last statement about financial consequences deriving from the external environment. The lack of

clarity about the future evolution of US monetary policy and the revaluation of risks associated with investments in emerging economies have increased the likelihood of a sudden slowdown in capital flows to the region (*sudden stop*).

Last but not least, domestic policies have exacerbated the risks derived from the external environment. Weaker fiscal positions and higher current account deficits in several Latin American economies, the presence of hidden risks associated to high indebtedness in foreign currency by both public and private sectors, and the lack of policies to boost productivity have contributed to increase the region's vulnerability.

All of these factors have had an impact on the region's economy. Latin America and the Caribbean have suffered a sharp slowdown. Estimated growth dropped from a regional average of 4.5% in 2011 to merely 1.2% in 2014. In contrast, according to IMF estimations, the average growth of emerging economies decreased from 6.3% to 4.4% during the same period.

In most Latin American countries, the drop in commodity prices has been the major cause of the observed slowdown. The reduction in commodity prices was much greater than initial forecasts. For example, since 2012, metal prices (copper, gold, silver, iron) decreased by more than 30% on average while agricultural commodity prices suffered a 20% drop on average; also, oil prices have plunged by 50% since the end of 2014. While the drop in metal and agricultural commodity prices was mostly due to slower growth in international demand, largely resulting from the Chinese economic slowdown and from sluggish growth in other commodity-importing developing countries, supply factors added to demand factors to explain the sharp drop in oil prices. In particular, the strong supply expansion associated with greater production from unconventional sources, especially in the US and Canada, was a major contributor.

Moreover, some of the transmission channels for the drop in commodity prices on the economy were initially underestimated. Investment in commodity sectors (minerals) has collapsed[1] and impacted directly related sectors which served as providers or processors. Moreover, both total portfolio and foreign direct investment flows have fallen due to lowered economic growth expectations.[2] Capital inflows peaked at more than US$ 300 billion in 2012 and dropped to approximately US$ 270 billion in 2014. The Institute of International Finance forecasts an additional decline to approximately US$ 246 billion in 2015. As on other occasions, capital flows have amplified the effect of the sharp deterioration in the terms of trade.

---

[1] Specifically, exploration expenses have suffered a sharp decline since this type of high-risk investment is rarely financed using external funds, and profits from mining and oil companies, which have traditionally funded this activity, were dramatically cut due to the drop in prices of the respective commodities.

[2] It should be pointed out that the stability of foreign direct investment has been traditionally overestimated since it may also suffer a *sudden stop* (drop in foreign flows) when investment is cut as a consequence of an actual shock (fall in the terms of trade).

This means that we are facing decreased capital inflows due to a decline in export prices. This drop led initially to a weaker current account position. However, as a consequence of lower capital inflows, countries are being forced to adjust the current account deficit through dramatic currency depreciations and lower growth rates. Over the last 6 months, currency depreciations have been particularly significant in countries that previously experienced the largest currency appreciations (Brazil and Colombia) and as a consequence, had larger current account deficits.

Additionally, the drop in commodity prices has had a significant direct and indirect impact on the fiscal accounts of most countries within the region. Facing increased certainty about the persistence of the shock, several authorities are making fiscal adjustments, including lowering government expenditure and raising taxes (such is the case of Mexico, Colombia and the announcement of tax reforms in Brazil).

In this setting, there has also been credit rating downgrades.[3] This factor has exacerbated the above mentioned reduction in capital inflows in some countries.

II. New Challenges in the International Scenario

There are new risks that may generate a second wave of adverse effects for the region and for emerging markets in general. Even though a reversal of capital flows may be sudden, it may also occur in stages or waves.

The first stage clearly began in May 2013 when the Fed announced the tapering of its Quantitative Easing policy (QE). After the initial harsh impact on markets, the unequivocal Fed statements, stating that the increase in interest rates would not materialize soon, had a reassuring effect on markets and partially reversed the initial 'taper tantrum' effects. However, this financial episode left significant and persistent consequences which, added to the above mentioned sudden decline in commodity prices, resulted in a reduction of capital inflows to Latin America and emerging economies in general.

During the last decade's bonanza, financial contagion risks from other emerging countries were strikingly absent, when compared with the Tequila Crisis in Mexico, the Asian crisis in 1997 and the Russian crisis in 1998. Only the 2008 global crisis temporarily hit the region.

---

[3] Standard and Poor's lowered Brazil's credit rating to BBB in March, 2014 (based on weaknesses in fiscal accounts), while, in September 2014, Moody's changed the outlook on Brazil's Baa2 rating to negative from stable. (Baa2 is the second lowest rating in the investment grade category).

Due to the impairment of economic conditions in several systemically important developing countries (Such as the “Fragile Five” of Brazil, Indonesia, South Africa, Turkey and India; and most recently Russia), contagion risk has reemerged as an underlying threat.

Historically, there are two types of international contagion: the first is fast and virulent, where access to international capital markets is abruptly cut off and financial asset liquidity dries up.[4] These episodes generally occur when three conditions converge: a trigger that takes financial markets by surprise, high leverage ratios undertaken by (high levels of debt compared to the collateral value) both creditors and debtors, and a common type of creditor (being it banks or investment funds etc.) forced to rebalance its portfolio and cut credit to countries that are not necessarily at the crisis epicenter.

The second evolves more gradually in the absence of these three conditions. This type of financial contagion, which may also have significant adverse consequences, tend to have more gradual transmission channels that are generally more related to the real sector rather than the financial sector. For example, Brazil’s currency depreciation in January 1999 had a strong cumulative impact on its major commercial partners within Mercosur, although financial contagion was very limited.

Given that Latin America is passing through its second year since the end of the economic bonanza, international investors’ exposure to the region has decreased and credit rating agencies have started to reappraise the creditworthiness of many important emerging countries, the current episode is developing in stages or waves associated with a gradual decrease in capital inflows. The gradual decrease in international investors’ exposure tends to fragment debt holdings and reduce concentration on a common type of creditor, reducing liquidity of such instruments.

The view of the Committee is that there is a possibility of entering a second phase or wave of decreased international investors’ exposure and capital flows to emerging markets. These new risks are based on developments and that might raise volatility and uncertainty to another level and hit emerging markets individually and collectively.

The list of most relevant risks includes:

i) **Tighter US monetary policy.** The Fed’s monetary policy framework is moving towards the abandonment of non-conventional expansive monetary policies (QE). As a result, there is a possibility that investors change their expectations on the speed and magnitude of US monetary policy normalization, increasing volatility and uncertainty in international financial markets. Having said this, the Committee forecasts that

[4] See, Kaminsky G., Reinhart, C. and C. Végh, “The Unholy Trinity of Financial Contagion,” *The Journal of Economic Perspectives*, Vol. 17, No. 4 (Autumn 2003), pp. 51-74.

international interest rates will slowly increase due to the high indebtedness in advanced economies which make them intolerant to an increase in financing costs.

ii) **Abrupt appreciation of the US Dollar.** The asymmetric QE policies by main central banks (particularly, the Fed, the European Central Bank, and the Bank of Japan) has ushered in a significant appreciation of the US Dollar against the Euro and the Yen, and practically all currencies. The speed and magnitude of this appreciation had a strong surprise element. The fast strengthening of the dollar has highlighted once again the risks associated with accumulating public and private debt in dollars during the years of the bonanza. This vulnerability is complicated by the fact that a large portion of Latin American debt has been issued by the private sector and therefore, the identification of risks has become more opaque, which in turn reduces the capacity for direct interventions by the public sector. Recent events in Spain and Ireland remind us that private debt tends to be a contingent government liability. On the flip side of the coin, it should be noted that the appreciation of the dollar (partly associated with higher US economic growth) may mean good news for some countries.

iii) **Financial Contagion in Emerging Markets.** New sources of emerging market contagion risks have appeared. The most visible possibility is Russia, which has the potential of entering into a default episode such as in 1998. A possible Greek exit from the Eurozone is another example. Turkey is yet another example. At the regional level, the Brazilian political crisis and subsequently, a likely credit rating downgrade to below investment grade, is another potential source. Venezuela might also represent a potential source of instability, although it is not systemically important.

III. Economic Policy Responses to the New External Scenario

The high expected volatility and higher levels of debt weaken the effect of monetary and fiscal policy, with more unpredictable results. This gets more complicated for economies with high domestic liability dollarization. In addition, as mentioned above, current shocks in international markets seem to be highly persistent which, as mentioned below, further complicate the overall external environment.

Under these circumstances, the Committee believes that, unless complemented with other policies, a monetary policy based on movements of the short-term interest rate to temper the initial effects of a financial shock may rapidly lose effectiveness. Two economic policy tools need to be prioritized in this respect: (1) fiscal policy and (2) measures to mitigate the effects of illiquidity and loss of access to international capital markets.

A permanent negative shock should be addressed through fiscal adjustment. However, this adjustment should be carried out gradually and credibly. Gradualism is important to smooth

the adjustment's social costs. On the other hand, credibility is essential to fund the financial imbalances involved in fiscal gradualism. Therefore, these adjustments should be supported by multilateral institutions such as the IMF, the World Bank and the IDB.

Although these policies help mitigate funding issues, in the presence of adverse news from the global economy, special attention needs to be given to the region's disequilibria on pre-existent debt, such as currency or maturity mismatches. To address this, the Committee believes international reserves could play a significant role, especially in economies with a high proportion of foreign-currency denominated debt. This policy must not be confused with using reserves to smooth exchange rate fluctuations. Even though the latter plays an important role, focusing exclusively on containing fluctuations may be counterproductive as it promotes capital flight.

Reserves, even if abundant, can be rapidly absorbed by capital flight, especially if initial capital inflows were highly speculative to begin with. Therefore, the Committee recommends that reserves should be used mainly to facilitate foreign currency funding in critical sectors. A successful case of this unorthodox policy is Brazil in 2002, when towards the end of the Cardoso Administration, the Central Bank facilitated export sector access to credit lines in dollars.

A significant risk to be prevented is that of poor quality adjustment policies. For example, the adjustment process might result in inadequate investment reductions, introduction of distortionary taxes, or an increase of regulatory uncertainty, which can all damage productive sectors and further expand the *informal* economy. This is a period in which economies depend relatively more on the *domestic* market and growth requires sustained increases in productivity. Therefore, the Committee believes that *public policies* with a high degree of credibility and sustainability should be emphasized.

Considerations about Recent Changes in the International Financial Architecture

Having a framework of policies designed to reduce external vulnerability is even more important now in the light of the recent evolution of international financial architecture. In particular, multilateral organizations' framework of financial support, such as that of the IMF, has changed radically in comparison with the one that prevailed during financial crises in emerging markets during the 90s.

At present, the IMF and the governments of advanced economies will probably grant financial support bearing in mind the recent experiences of Ireland, Greece and Ukraine. In these cases, the international community has favored financial support contingent on aggressive debt restructuring, both of bank liabilities (in the case of Ireland) and public debt (Greece and Ukraine).

This standpoint, in the view of the Committee, possibly increases the risks of financial contagion if new crises were to occur in emerging economies. The model of *financial assistance combined with restructuring*, whose contagion effects have been relatively contained in Europe due to actions by the European Central Bank and the Eurozone's institutional strength, could have much more unpredictable results in emerging markets.

This significant change in the international financial architecture can be particularly dangerous in economies where the national policy framework contains populist connotations. Argentina and Venezuela are evidently most vulnerable as a result of not receiving significant support from the IMF.

This statement was jointly written by:

Laura Alfaro, Professor, Harvard Business School; former Minister of Planning and Economic Policy, Costa Rica

Guillermo Calvo, Professor, Columbia University, former Chief Economist, Inter-American Development Bank

Pedro Carvalho de Mello, Professor, University of Sao Paulo; former Commissioner, Brazilian Securities Commission, Brazil

Pablo Guidotti, Professor, Torcuato di Tella University; former Vice-Minister of Finance, Argentina

Guillermo Perry, Non-resident Fellow, Center for Global Development; professor, University of the Andes; former Minister of Finance, Colombia

Carmen Reinhart, Professor, John F. Kennedy School of Government, Harvard University

Liliana Rojas-Suarez, President, CLAAF; Main Researcher and Director, Latin American Initiative, Center for Global Development

Ernesto Talvi, Director, CERES; former Chief Economist, Central Bank of Uruguay

The Latin-American Shadow Regulatory Financial Committee (CLAAF) is grateful for the financial support of the Center for Global Development (CGD), the Central Bank of Chile, the Latin American Reserve Fund (FLAR); and the Bank of the City of Buenos Aires for funding its activities. The Committee is grateful for the logistical support provided by the CERES team, with special thanks to Mariana Rodríguez. The Committee is fully independent and autonomous in the drafting of its Statements.