

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

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Latin America: Back to the 1980s or Heading for Rebound?

I. The International Environment Affecting Latin America

In past statements, the Committee warned about a number of risk factors that have been deteriorating the external environment faced by emerging markets and Latin America in particular. It is clear today that many of those risks are materializing and, for the first time since the 1990s, the region faces the potential of financial contagion. Contagion may arise from, for instance, external factors such as China and other emerging markets, or from within the region.

In comparison with the emerging market crises of the 1980 and 1990s where international interest rate hikes played a central role, the channels of contagion to the region may be quite different in the present context. Although the forthcoming normalization of monetary policy in the advanced economies, in particular in the US, may lead to some increase in international interest rates, **the Committee believes that such increase is likely to be small and gradual. However, even modest hikes in international interest rates may give rise to significant further raises in sovereign risk premiums across the region.**

Other factors impacting the sovereign risk premium include the marked decline in world commodity prices, the significant slowdown in economic growth in emerging markets and China in particular, the absence of recovery in global trade, and the opaqueness in public and private sectors' balance sheets. There is considerable uncertainty about the level of public and private leveraging as well as recent extent of reserve losses. Geopolitical risks, particularly in Turkey and the Middle East, further complicate the global environment.

Uncertainty about the extent of leverage in many emerging market countries, in particular foreign currency indebtedness, arises in the context of the expansion of shadow banking, as the Committee has discussed in previous statements. The external indebtedness of the private sector may be underestimated both for financial and non-financial corporates. Indebtedness to China, which increased markedly during the past commodity boom, remains poorly documented in

standard databases (i.e., the IMF, World Bank, and the BIS). More recently, the international-reserve position of many emerging market countries may overstate true resources as the use of derivatives, foreign-currency debt, and third-party intervention in the foreign exchange market have intensified. As an example, there is the comparatively novel concern that swap lines may lead to double counting of international reserves. In sum, there is considerable uncertainty about net reserve positions in many cases potentially contributing to worsening risk assessments. **The Committee recommends that creditor and debtor governments take steps to better quantify the level and composition, at the sectoral and national levels, of liabilities and contingencies. The Committee also recommends that central banks step up their transparency as regards their net international reserve positions and their balance sheets more generally.**

In varying degrees, emerging markets have met their funding needs from two global sources: traditional financial markets, largely anchored in the advanced economies (especially the US) and increasingly China. These two common lenders to emerging markets are in the process of retrenching. The US may be in the process of tapering for some time, while China's slowing growth has also been associated with less direct investment and financing abroad. Commodity producers are particularly hard hit by China's slowdown and ongoing rebalancing from investment to consumption, as commodity-related foreign direct investment has scaled down. Within Latin America, those countries with limited or non-existent market access (i.e., Argentina, Venezuela and Ecuador) rely heavily on Chinese financing.

On balance, there are both similarities and differences in the current external environment, as compared to the eighties. In both periods there have been deep and sustained declines in world commodity prices and changes in US monetary policy have been at center stage. However, in this occasion, changes in Chinese economic activity and financial flows have played a role as important as changes in US and other advanced economies activity and financial flows. Further, shadow banking, while having a long history in advanced economies, is a relatively new phenomenon in emerging markets.

II. The Regional Internal-External Cycle

As in past cycles, the capital inflows/commodity boom enabled significant increases in domestic credit (in varying degrees across the region). This time around, in some cases, a portion of the capital inflows that occurred during the boom were not intermediated through banking systems. Through various mechanisms, the increase in credit took place through the non-financial private sector. For instance, larger firms with international capital-market access became a source of unregulated domestic credit. Examples often arise in the context of real-estate developers and merchandise retailers. In connection with ample credit availability,

significant asset price booms materialized across the region, coupled with overvalued currencies (i.e., increases in the price of non-traded goods).

Following a multi-year slowdown in economic activity and sharp currency depreciation, these asset price booms have begun to unwind, although with considerable variation across countries in the region. In these situations, to the extent that some of the credit is effectively unregulated, bank risks may be ultimately underestimated. In Brazil, where consumer credit expanded markedly, non-performing loans have begun to increase steadily. However, not all risks associated with the aftermath of the lending boom are manifest at this time.

In several countries in the region, as in other emerging market economies, lending booms were associated with declining savings rates. As a result, current account balances, which were in historically strong positions until the global financial crisis, began to deteriorate. The fall in commodity prices significantly worsened current account deficits. Current accounts deficits are still significant in many countries in spite of the economic slowdown of recent years and sharply depreciated domestic currencies.

The large terms-of-trade shocks resulting from the fall in commodity prices are contributing to the slowdown in economic activity, as these shocks are an important driver of business cycles in many countries in the region. In addition, the commodity price boom of previous years generated changes in domestic relative prices that induced Dutch Disease effects resulting in sectoral reallocation of productive capacity and investment, particularly in favor of residential investment. This implies that the macroeconomic adjustment (as commodity prices fall and domestic relative prices change) will persist as the reallocation of capital takes time to reverse.

Short-term capital-flow volatility has increased, particularly for the interest-sensitive component, as uncertainty about the course and timing of US monetary policy continues to influence global financial markets. Increased capital-flow volatility has complicated risk management for banks. Full-fledged banking crises have not taken place. However, numerous credit-ratings downgrades of financial institutions have occurred. In the previous statement, the Committee highlighted the risk associated with the stronger US dollar in cases where dollar private and public debts are significant. Since then, sharp domestic currency depreciations in several countries have reinforced those concerns.

III. Implications for the Region

Since the last statement, the region has continued to deteriorate and output is expected to decline by 0.3 percent in 2015, according to the IMF. In fact, this year growth in Latin America will be the lowest among emerging market economies. Brazil, the largest economy in the region,

is experiencing a contraction of 3 percent in 2015. It is expected that the recession will continue in 2016. These developments were associated with sharp currency depreciations, relatively modest effects on inflation, and increases in country risk premiums. This reflects the fact that the region is relying more strongly than in the past on flexible exchange rates, which help to explain why in spite of the severity of external shocks the region has avoided speculative attacks on domestic currencies, a common phenomenon in the 80s and 90s.

The Committee believes that exchange rate flexibility has been an important shock absorber but there are caveats. There are risks associated with relying on the exchange rate to take the brunt of containing the impact of an adverse global environment. Significant cumulative exchange rate depreciations could jeopardize the credibility of policymakers, rekindle exchange rate pass-through, and fuel inflationary expectations. Successful flexible exchange rate systems require anchored low-inflation expectations. Otherwise, rising inflationary expectations may drive interest rates higher potentially giving rise to a vicious circle of debt unsustainability, a phenomenon the region was familiar with in the 1980s.

A case in point is Brazil. The credibility of its monetary policy simultaneously relied on the introduction of an inflation-targeting regime in 1999 and, more fundamentally, on a strong commitment to sustain a significant primary fiscal surplus, in excess of 3 percent of GDP. The fiscal anchor weakened since the Lehman crisis, and Brazil posted a primary fiscal deficit in 2014. The loss of its fiscal anchor, in the midst of more adverse external conditions, forced Brazil to rely importantly on the interest rate as a means to anchoring inflation and inflationary expectations. As a result, the fiscal deficit widened owing to significantly higher interest payments. Relying heavily on interest-rate hikes could be a counterproductive policy.

Achieving fiscal sustainability may require going beyond restoring a primary surplus. Lacking credibility, fiscal adjustment cum high interest rates could depress the economy and be self-defeating. Recovering the fiscal anchor and the credibility of monetary policy to lower interest rates might require the support of the international community. This is especially relevant at a time in which Brazil has a precarious credit rating and is already experiencing a significant reversal of capital flows.

The Committee recommends the international community, and particularly the IMF, to stand ready to support adjustment in Brazil. This is even more urgent, as the ramifications of a deepening of Brazil's current difficulties impact significantly on several countries in the region and other emerging markets. Potential effects may occur both through trade links (Mercosur countries) as well as through financial channels, given Brazil's weight within Latin American debt markets as an asset class, and its comparatively high degree of liquidity of its financial markets.

If the reverberations of the Brazilian situation can be contained, a meaningful group of countries in the region, such as the Central American and the Pacific Alliance Countries, (Chile, Colombia, Peru and Mexico) could recover without experiencing major disruptions.

There are important differences across countries. Mexico is benefitting from the US recovery. However, given its high budgetary dependence on oil revenues, it is undertaking a pro-cyclical fiscal adjustment. Central America as a whole is now enjoying a positive terms of trade shock (as they are net commodity importers) and benefitting from the recovery in the US, its main export market and source of worker remittances. Nevertheless, an adverse financial shock can have important effects on some of these countries.

In Chile, Colombia and Peru (as in other countries in South America) the sharp fall in commodity prices has led to a significant reduction in terms of trade, a widening of current account deficits (in spite of the mitigating effect of sharp currency devaluations), an increase in country risk, and a retrenchment of investment in primary sectors. All of this resulted in significant slowdowns. Colombia faces the need of a significant fiscal adjustment given its budgetary dependence on oil revenues and the fact that, unlike Chile and Peru, it did not produce fiscal surpluses during the boom. Central banks in these countries have been facing a dilemma. Inflationary pressures due to exchange-rate pass-through have required interest rates increases to anchor inflation expectations, at a time when growth has slowed to around 2 to 3 percent per year. In the absence of additional adverse external shocks, the Committee expects a recovery in the coming years.

Containing a potential sharp deterioration in the Brazilian situation may be particularly important for the prospects of the Argentine economy. Argentina is in the midst of a change in government and faces significant economic policy challenges. **The Committee believes that a large fiscal deficit, dwindling reserves, tight capital and exchange controls, high inflation, economic stagnation, and an unresolved legal external debt conflict with holdouts pose a formidable challenge to the incoming authorities and requires a comprehensive economic reform program.**

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