Executive Summary

IDB

The World of Forking Paths

Latin America and the Caribbean Facing Global Economic Risks

Coordinated by

Andrew Powell

2012 Latin American and Caribbean Macroeconomic Report

THE WORLD OF FORKING PATHS

Latin America and the Caribbean Facing Global Economic Risks

Executive Summary and Conclusions

Andrew Powell
Coordinator

Inter-American Development Bank

March 2012

Executive Summary

The recent economic performance of Latin America and the Caribbean is cause for optimism. Growth has averaged 5.4% over the last two years, contributing some 14% of total global growth each year and helping the world to escape the Great Recession. Moreover, the Region survived that experience relatively unscathed, with all the larger economies avoiding a financial crisis. However, as noted in the previous Latin American and Caribbean Macroeconomic Report, *One Region, Two Speeds*, challenges remain. The Region's recovery was characterized by strong growth among commodity exporters in the South, but slower growth in many countries of Central America and the Caribbean.

The pattern of global demand and associated risks has once again changed. Uncertainty is high and the risk of another crisis, this time emanating from Europe, has risen. China, seen as critical for the commodity prices so important for many countries in the Region, is also slowing, and there are risks as to how deep that deceleration will be. While risks appear to be weighted towards the downside for Europe and China, they appear more balanced for the United States. Given recent figures there is some upside risk but with considerable uncertainty, particularly regarding fiscal policy.

The outlook thus implies divergent scenarios; it is indeed a world of forking paths. If Europe avoids a crisis, China's growth slows only mildly, and there are no significant unanticipated developments in the United States; forecasts for the Region are optimistic, with 2012 growth expected to be 3.6%. Interestingly, Brazil and Mexico should both grow at close to the regional average, although there remains heterogeneity across other countries in the Region. But if Europe's troubles deepen and Chinese growth slows more rapidly than expected, the United States may then be dragged into a new recession, and the Region will be affected. Scenarios developed in Chapter 2 illustrate that a shock of comparable magnitude to Lehman but originating in Europe, plus an autonomous negative shock to growth in China, would provoke a relatively mild recession for Latin America and the Caribbean. Moreover, in contrast to the previous crisis, the effects would be relatively homogeneous; the Region would slow at one speed. South America would be affected the most, but starting from a stronger position, while Mexico and Central America would be affected less, but starting from weaker initial conditions. However, the recession in the US post-Lehman was less persistent than the average. If Europe suffers a recession through 2012 and a crisis in 2013, the effects on Latin America and the Caribbean would be both deeper and more persistent, and they would have more serious impacts on fiscal positions and on banking sectors.

The analysis in the next chapter raises a set of important issues that are considered in subsequent chapters. A first relates to commodity prices. The detailed consideration of scenarios for China's growth in Chapter 3 reveals differences among commodities. If China's growth falters, prices for metals such as copper, particularly important for Chile and Peru, may fall by more than a commodity aggregate, while grains prices, important for Argentina and Brazil, would fall by less. That said, the analysis also details great uncertainty regarding future commodity prices and hence the need for Latin American producers to manage their increased commodity dependency very carefully indeed.

A second issue is raised by strong capital inflows into Latin America and the Caribbean both before the Great Recession and in the years afterward. While those flows have now abated, experience indicates that about 50% of inflow surges in emerging economies end in either a banking crisis or a recession. Moreover, the recent inflow episode displayed potentially dangerous characteristics such as a relatively high proportion of portfolio and banking flows. The statistical analysis in Chapter 4 suggests a significant probability of those flows provoking a banking crisis. That said, it should be noted that the Region has improved banking supervision and implemented a set of macro prudential measures to reduce the likelihood of a crisis. The analysis indicates both the need to consolidate such measures and the continued vigilance required to ensure macroeconomic and financial stability in the face of high levels of capital inflows.

A third issue relates to fiscal policy. One reason the Region survived the global economic crisis relatively well was that, in contrast to previous crisis episodes, countries were able to implement effective countercyclical fiscal policy. Chapter 5 provides a review of the size of the fiscal stimulus and detail regarding the measures adopted. A truly countercyclical policy requires that those measures be withdrawn once the downturn has passed. While the Region did indeed reduce or eliminate some stimulus measures, others appeared to become more permanent. As a result, the structural fiscal deficits of the typical country in the Region are now higher than they were before the global economic crisis and countries may have sacrificed a degree of fiscal credibility. In several countries, fiscal space to respond to any new downturn is such that countries should only consider stimulus measures that can be easily reversed and are truly temporary in nature.

Monetary policy has also been an active area of policy action and debate. Countries in the Region have very different regimes, including three fully dollarized economies, three with fixed exchange rates, nine inflation targeters or countries transitioning to that regime, and nine with intermediate regimes. Across these different arrangements, the countries analyzed in Chapter 6 have exhibited stable money growth and limited inflation despite serious shocks. Still, intermediate regimes had some of the highest pass-through from international commodities to domestic prices, while some fixed rate countries experienced sharp falls in growth but rebounded quickly. Inflation targeters allowed their nominal exchange rates to depreciate during the crisis but then experienced significant real appreciations. Interestingly, there was a tendency to increase policy interest rates at the onset of the crisis, given continued high commodity prices, and use direct monetary policy tools such as lowering liquidity requirements on banks to inject liquidity into financial systems. In this instance, direct tools and the interest rate were used as **substitutes**. However, as the crisis progressed, both direct tools and interest rates were used as **complements** to loosen monetary policy further. Subsequently, as the crisis passed and capital inflows resumed, both types of policy tools were again used as complements to implement tighter monetary policy. Inflation targeters may wish to consider new methods of communicating objectives and of using instruments in different ways in order to ensure full comprehension and hence appropriate reactions by the private sector.

One feature of monetary policy in several countries has been the build-up of international reserves. Nonetheless, considering Latin America and the Caribbean's balance sheet as a whole, while reserves increased, gross external liabilities fell prior to the Lehman crisis, further enhancing resilience, particularly among a group of commodity exporters that significantly reduced net liabilities. After the Great Recession, the Region as a whole resumed a process of financial integration with rising assets and liabilities. While foreign direct investment continued to increase as a share of liabilities for commodity importers, this was not the case for commodity exporters, for whom the share of potentially more dangerous portfolio liabilities has risen as a counterpart of higher portfolio inflows. At the same time, there has been a reduction in public sector liabilities, a corresponding fall in the share of external public debt, and an increase in local currency debt in total debt. The structure of private sector balance sheets suggests a rise in vulnerability since the Lehman crisis but coupled with an increase in the resilience of the public sector.

One of Latin America and the Caribbean's potential vulnerabilities is the major role that has been granted to foreign and particularly European banks in the Region. A detailed analysis of the links between Latin America and the Caribbean and the global banking network in Chapter 8 reveals direct links to European periphery banks, particularly Spanish banks, but also indirect exposures through links to banks in countries that are themselves exposed to Europe's periphery. In some cases these indirect exposures may be more important than the direct ones. The fact that European banks in Latin America are generally funded locally provides some measure of comfort. Nonetheless, European banks are deleveraging, and capital is considered by home supervisors on a consolidated basis, suggesting that adjustments in capital levels may yet imply lending restrictions. Deleveraging has also provoked European banks to go from net purchasers of Latin American assets (including equity stakes and entire financial institutions) to net sellers. If there are unlimited funds to purchase these assets, or assets are sold in ways that do not affect lender-borrower relationships, then this may have limited impact on the Region. However, if relationships are severed or funds are limited, then there may be significant effects, particularly if the European crisis worsens.

Latin America and the Caribbean has made substantial economic progress both in terms of growth and in the ability to respond to external shocks. Chapter 9 reviews the Region's strengths and vulnerabilities in the current global context. There is evidence that many of the Region's economies have a greater proportion of public sector debt issued locally in local currency, have been able to use effective countercyclical fiscal policy, have greater possibilities of employing the exchange rate as a shock absorber while maintaining stable prices, and have deployed several macro-prudential tools. Vulnerabilities nonetheless remain, particularly due to commodity dependence, the significant capital inflow and credit boom, countries' relatively weaker fiscal position and the major role of European banks. While the world is one of forking paths and it is impossible to know which alternative will become reality, the Region has good reason to be optimistic thanks to the new set of tools it has developed and the experience it has gained deploying them effectively.

Conclusions and Recommendations

This report details the divergent paths that the world economy may take and the potential effects on Latin America and the Caribbean. Scenarios are constructed employing a modeling exercise that captures trade, financial and other linkages between the Region and the rest of the world. While vulnerabilities remain and external shocks have been and remain critical, the Region has a distinct set of strengths and has developed a growing array of policy tools. A balance of the vulnerabilities and strengths is detailed below, followed by a series of recommendations addressing either the vulnerabilities identified or ways to improve existing policy tools.

Vulnerabilities

Due to high prices and positive supply responses, the Region has become increasingly commodity-dependent of late. While this development has increased producers' export earnings, it also raises risks. As noted in Chapter 5, assumptions regarding the structural prices for commodities imply significant changes in structural deficit calculations. Metals prices in particular are vulnerable to a slowdown in China and to a fall in China's rate of investment. Grain prices may also decline, although risks here appear more contained given more permanent changes in the Chinese economy.

The Region is additionally vulnerable for having been the recipient of a large influx of capital. Emerging economies have suffered either a banking crisis or a recession in about 50% of cases of such capital inflow surges. Given the nature of the latest inflow surge, particularly the proportion of portfolio and banking flows, there may yet be latent risks. If a negative shock hits the Region, then growth and credit growth will surely abate, and it is only when banks' balance sheets cease to expand rapidly that the full extent of the capital inflow and credit boom's after-effects will be known.

Although fiscal policy was used effectively during the recent global economic crisis, for perhaps the first time in the Region's recent history with such downturns, some fiscal stimulus measures remain in place. Structural fiscal deficits have therefore grown, and fiscal credibility may have been somewhat eroded. Although structural debt fell in recent decades, it has since stabilized at around 42% of GDP for the last few years. The Region is consequently less prepared to respond to a negative shock with countercyclical fiscal policy than it was before the Great Recession.

The vast majority of countries in the Region (across quite different monetary and exchange rate regimes), have maintained stable money growth and have been able to contain inflation despite strong exogenous shocks. The Region as a whole continues to transition towards inflation targeting, and countries with inflation targeting regimes used interest rates and direct (or non-conventional) policies in a variety of ways during the crisis. In the event of a large negative shock, however, inflation targeters may have only limited space to employ interest rate policies.

The Region maintains strong links to international banks and especially to European institutions. If the European crisis deepens this may be a source of vulnerability as a result of direct or indirect channels. Direct channels include pure cross-border lending and the presence of European banks in the Region. While most such banks are fully funded domestically, the process of deleveraging in Europe may still have significant impacts, potentially restricting capital and hence lending. Deleveraging has additionally promoted asset sales, and—if funds to buy assets are limited or sales imply the break-up of relationships—may lead to deleterious effects. Moreover, if the European crisis deepens, tensions may rise within the corporate governance of international banks and between home and host supervisors. In some cases however, indirect exposures may be even more important than those through direct links. The network of international banking is complex, and exposures may result not only from direct lending relationships but also through relations to banks that have lent to affected countries or institutions.

Strengths

While large capital inflows have increased potential risks, financial supervision in the Region has improved, and countries have employed a set of macro-prudential tools that have surely reduced the risk of a crisis. The use of those tools, moreover, has been a learning experience, and the lessons learned will be useful to the Region going forward.

The same can be said for fiscal policy. While structural deficits have increased, implementing countercyclical fiscal stimulus has been a process of trial and error for the Region, and the remaining fiscal space for countercyclical actions varies across countries. The experience of the previous downturn, however, will assist the Region in selecting the most effective policies given the more limited space.

Balance sheets in Latin America and the Caribbean overall have improved. Net liabilities fell, in particular those of commodity exporters, including the larger economies of the Region, although more recently the stock of portfolio debt and equity liabilities have risen. International reserves have grown. Moreover, the composition of public sector debt has changed. In general there is a greater share of domestic debt issued in local currency; the public sector balance sheet has improved.

Finally, many countries in the Region have displayed greater exchange rate flexibility, perhaps in part as monetary credibility has increased and dollarization declined. Moreover, countries in the Region have greater reserves and an array of direct or non-conventional monetary policies as part of their tool kit to respond to negative shocks.

Policy Recommendations

- Commodity dependency has risen in the Region, and commodity-dependent countries should actively manage this dependency. Commodity prices are likely to fall as China and the world slow, although metals may fall by a much greater amount than grains. However, there remains significant uncertainty regarding future outcomes. Countries should be considering how best to insure against these risks in the short term, perhaps employing financial hedging instruments, and how to adjust to lower prices in the medium term.
- A number of commodity importers, most located in Central America and the Caribbean, will benefit from any falls in commodity prices. While many will be affected less by the negative scenarios outlined in this report, if the epicenter of a future crisis is Europe and not the United States, they start from weaker positions. Moreover, several countries in this category have limited or no exchange rate flexibility and have limited fiscal space to respond with countercyclical policy. In the face of a negative shock, countries in this position may wish to consider fiscal stimulus as space allows while at the same time committing to future fiscal reform and adjustment, enhancing the credibility of such a plan through an agreement with the IMF. Some may also wish to consider an ex ante agreement along these lines as insurance in case such a downturn occurs.
- More generally, several countries in the Region implemented effective fiscal policy during the Great Recession, although in some cases policies have not been fully reversed during the recovery. In the event of a new downturn, countries should consider carefully designing fiscal stimulus packages to ensure that the measures implemented can readily be reversed in the event of a temporary negative shock.
- The Region now includes nine countries with inflation targeting, including two countries transitioning to that regime. Inflation targeters have used both

interest rates and more direct monetary policy tools. At times these policies have been used as substitutes, responding in different ways to different types of shocks, and at times they have been used as complements; direct tools may speed up transmission mechanisms of monetary policy or may make monetary policy more effective. Inflation targeting is in part based on effective communication with the private sector so that actors incorporate likely policy actions into their expectations, thus increasing the credibility of the nominal anchor adopted. However, this only works if objectives and instruments and the links between them are well understood. More work may be required to communicate the respective circumstances under which direct tools and interest rates will be employed and how their use relates to the objectives of the monetary authority.

- Although a number of countries in the Region have experienced large capital inflows and strong credit growth, at the same time prudential measures have been strengthened, decreasing the likelihood that latent risks in financial systems will develop into more serious problems. This experience underlines the importance of taking strong measures to lean against the wind in boom times. Now, as credit growth abates, authorities may wish to monitor the quality of banks' and other financial institutions' lending portfolios to be able to take prompt action if any problems do emerge.
- The Region is host to a set of international banks including European institutions that are currently undergoing a process of deleveraging. While such institutions are largely run as independent subsidiaries in the Region, it is advisable to develop rules that highlight appropriate corporate governance of domestic banks irrespective of their ownership structures. Authorities may wish to monitor liquidity to ensure there is no disruption to local markets if the situation deteriorates. While current capital levels appear healthy, as deleveraging continues there may be lending restrictions and further asset sales. Such sales require identifying potential eligible purchasers, and many regulatory approvals, and it will be important to ensure that that these transactions produce only minimal disruption to lender-borrower relations. Authorities in the Region may wish to take preemptive action to identify potential purchasers. They may additionally wish to smooth processes for regulatory approvals and influence the nature of those transactions to minimize information destruction.
- Apart from Spain, countries in Europe's periphery provide little direct lending to the Region. However, indirect exposures through the global banking network may be important. This calls for a high level of international cooperation to understand the nature of these risks and be in a position to take cooperative action to address them. European banks are also important in particular markets

including trade finance. Latin American and Caribbean authorities may wish to consider specific actions in those areas where European banks' activities are focused in order to ensure that those markets continue to operate smoothly in the event of a negative shock.

www.iadb.org