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THE IMPACT OF THE FINANCIAL CRISIS ON EMERGING MARKET REGIONS –THE CASE OF LATIN AMERICA

Jose Maria Serena (+Sonsoles Gallego, Luis Molina)
Economist

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OUTLINE

1. **Introduction. The impact of the financial crisis on Latin America**

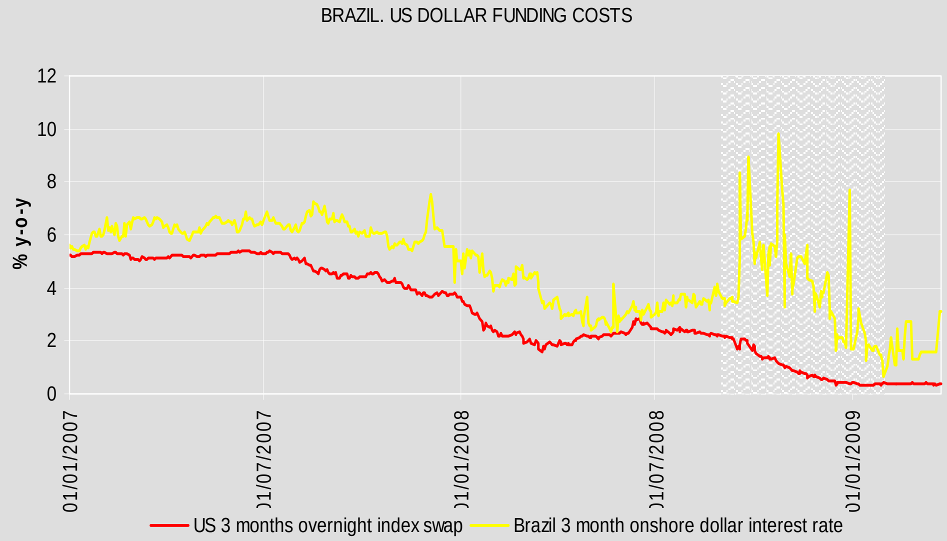
2. **Strengths and vulnerabilities before the crisis**

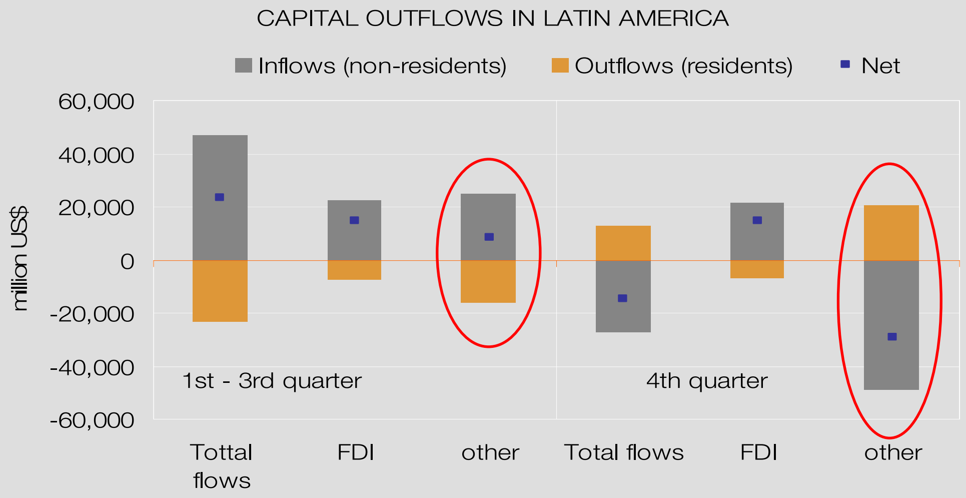
3. **The role of macroprudential policies in the last years**

4. **Conclusions**

INTRODUCTION. THE IMPACT OF THE CRISIS ON LATIN AMERICA

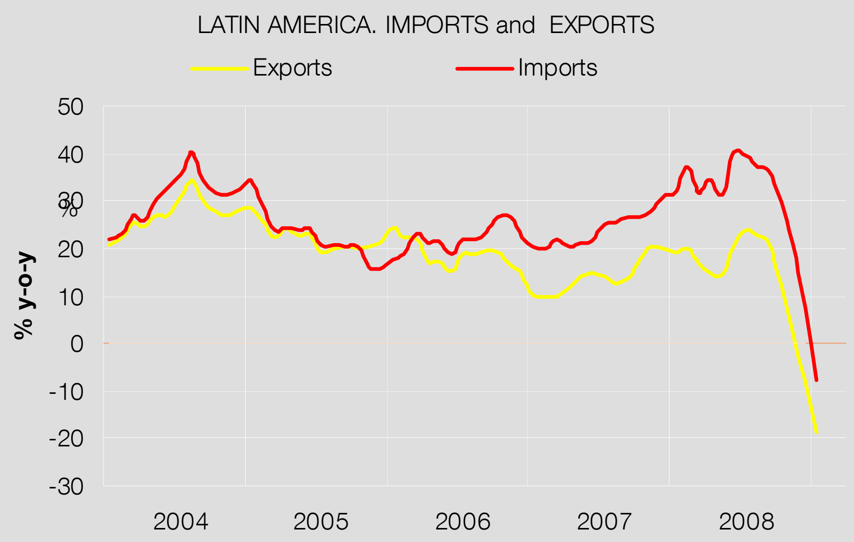
- The global financial and economic crisis impacts on Latin America in sep08 through different channels…
  - Huge financial shock
  - Real shocks: commodity prices & contraction in external demand
- Financial tensions (4Q08):
  - US dollar funding pressures
  - Large capital outflows
  - Sharp exchange rate depreciations
  - Increase in domestic financing costs
- Financial systems withstood relatively well, in part due to central bank responses…

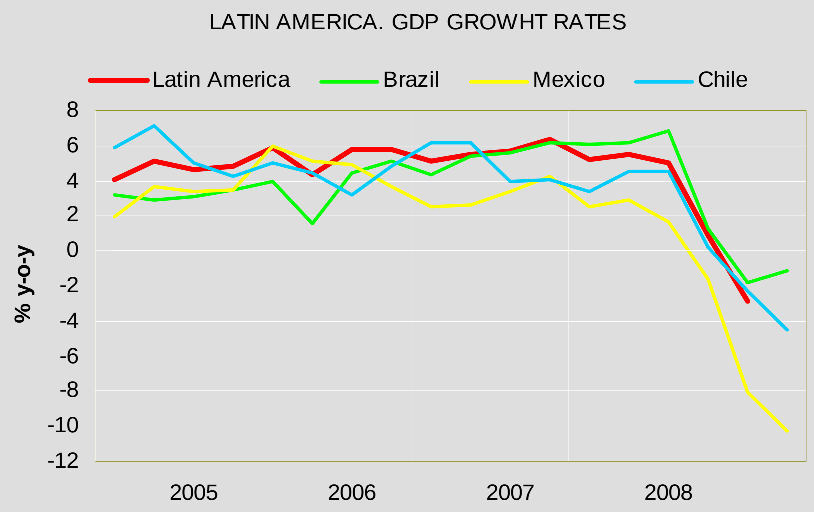




INTRODUCTION. THE IMPACT OF THE CRISIS ON LATIN AMERICA

- But the real economy was severly impaired (4Q08-2Q09?:
  - Sharp drop in trade flows
  - Large contraction in GDP
  - Drivers: credit crunch and real shocks
- Gradual recovery (but which is the place of LA countries in the "new world"?)





STRENGTHS AND VULNERABILITIES OF LATIN AMERICA

- Latin American countries have been prone to credit booms and busts (1982, 1995, 1998, 1999, 2001, 2002….)
- The anatomy of a "boom-bust" cycle:

Good external conditions

& easy financing

→

1. Credit boom
2. Financial dollarization
3. Large short-term capital flows

Interrelated problems

- The end (bust) can be endogenous, or driven by an external shock

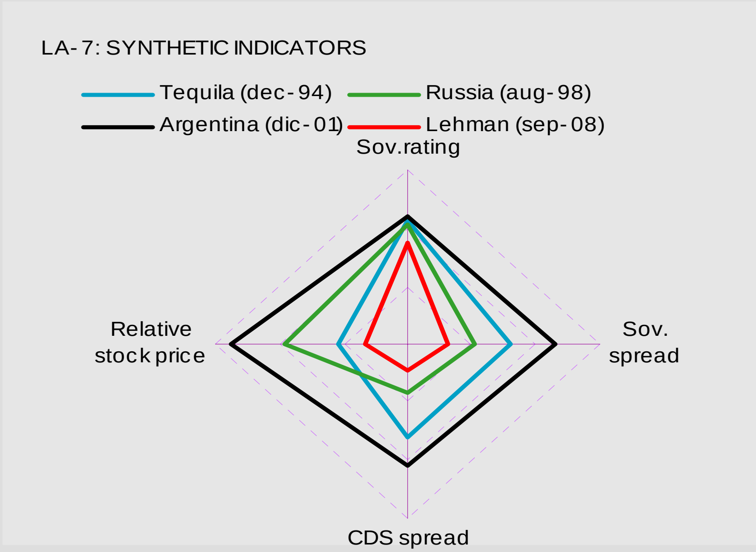
- Vulnerability indicators can be used to assess the position of Latin American countries before the 2007-2008 crisis

STRENGTHS AND VULNERABILITIES OF LATIN AMERICA

1. Market perceptions:

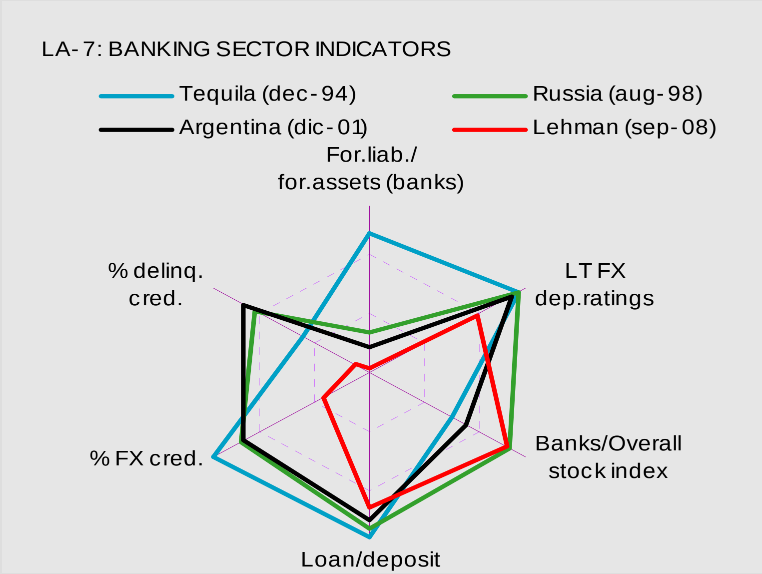
- Best valuation ever…remember the “decoupling”/”resilience”

But what about fundamentals?



2. Banking sector indicators:

- Low deliquency
- Low dollarization of credit
- Low loan to deposit ratio
- No toxic assets



STRENGTHS AND VULNERABILITIES OF LATIN AMERICA

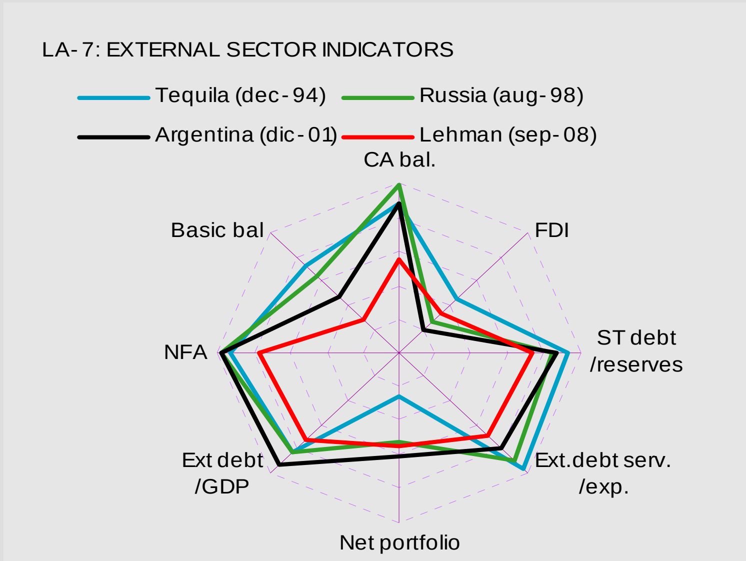
3. External imbalances indicators:

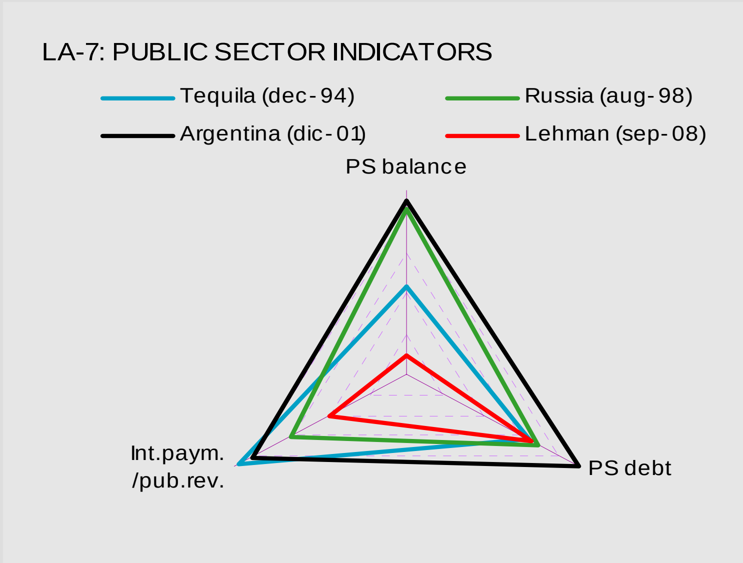
- Better current account balance, financed by long term flows
- Lower external debt

4. Public sector indicators:

- Stronger position, sustainable debt
- But, is there room for countercyclical responses?

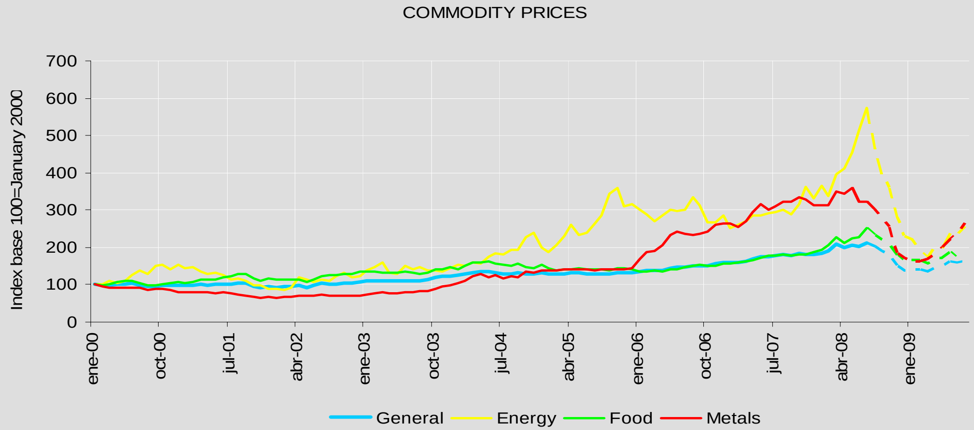
Why vulnerabilities decreased in the last years?

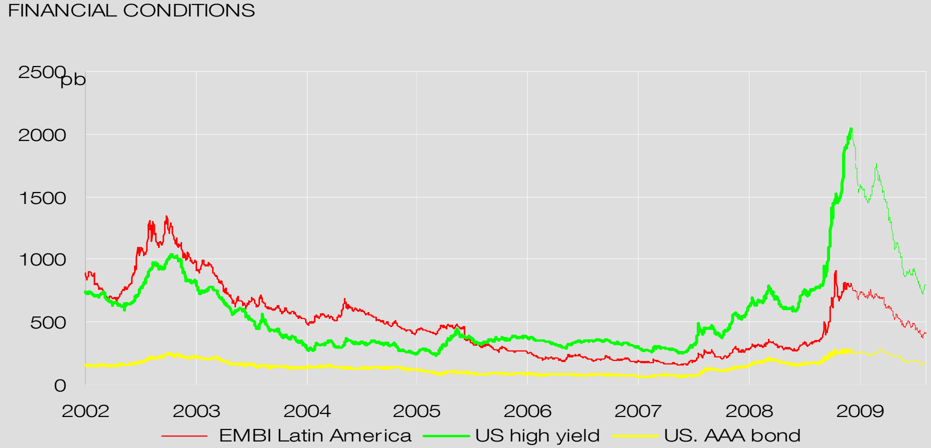




THE ROLE OF MACROPRUDENTIAL POLICIES

- During 2002-2007, Latin America enjoyed the longest and most dynamic growth spell since the 70s.
  - High commodity prices
  - Easy access to financial resources
- Hence, just inertia? Not only... this environment is plenty of opportunities, but also of risks





Financial vulnerabilities build up in the upswing…and the room for countercyclical policies can increase or decrease

THE ROLE OF MACROPRUDENTIAL POLICIES

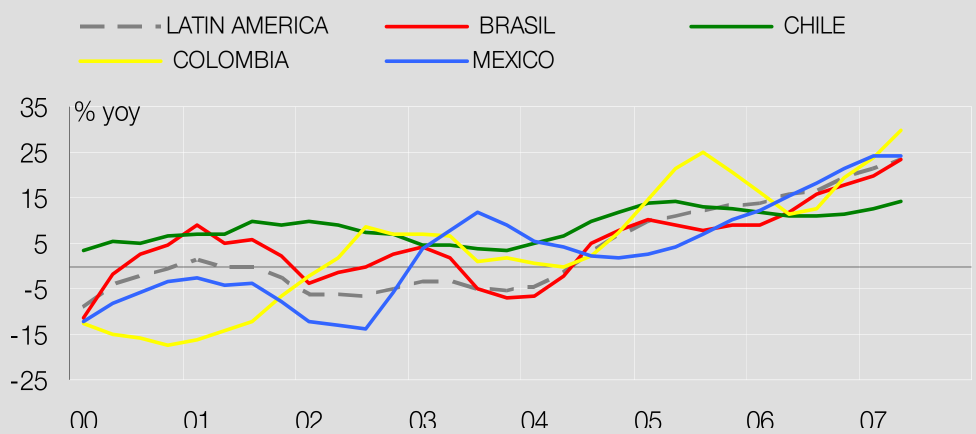
1. The increase in financial vulnerabilities might be consequence of inadequate standard macroecononomic policies…
   - Fixed exchange rates
   - Laxed monetary policy (according to standard Taylor-rules)
   - Inadequate forex intervention -low exchange rate volatility
   - Fiscal procyclicallity
2. However, even when policies are "conventionally orthodox", some problems migth arise…
   - Financial markets exhuberance (i.e., complacency, underestimation of risk, procyclicallity of financial markets)
   - Difficulties in pursuing policies in the short-run

- CBs can complemente them with "less conventional"/macroprudential policies

THE ROLE OF MACROPRUDENTIAL POLICIES. CREDIT GROWHT

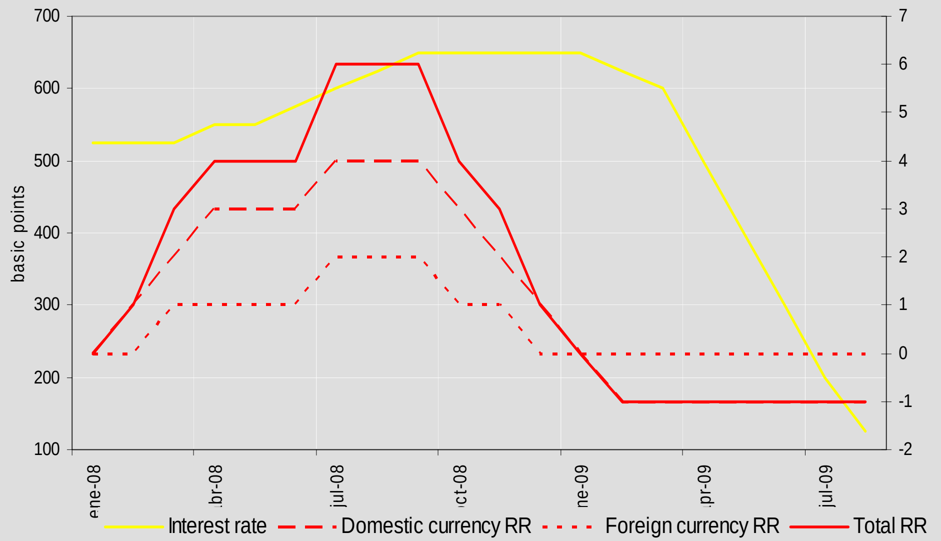
- Rapid credit growht in the region: “financial deepening” or “credit boom”?
- Policy responses:
  - Monetary policy/ short-term interest rates:
    - *Might be ineffective to curb credit*
    - *Can induce short-term capital inflows*
  - Complementary mesaures: tightening reserve requirements (RR).
- Assessment:
  - Pragmatism: short-term interest rates & reserve requirements
  - Asymetric loss function: minimize the risk of experiencing a credit boom, even if precludes financial deepening…

REAL CREDIT GROWTH: CLAIMS ON PRIVATE SECTOR



PERU: MONETARY POLICY

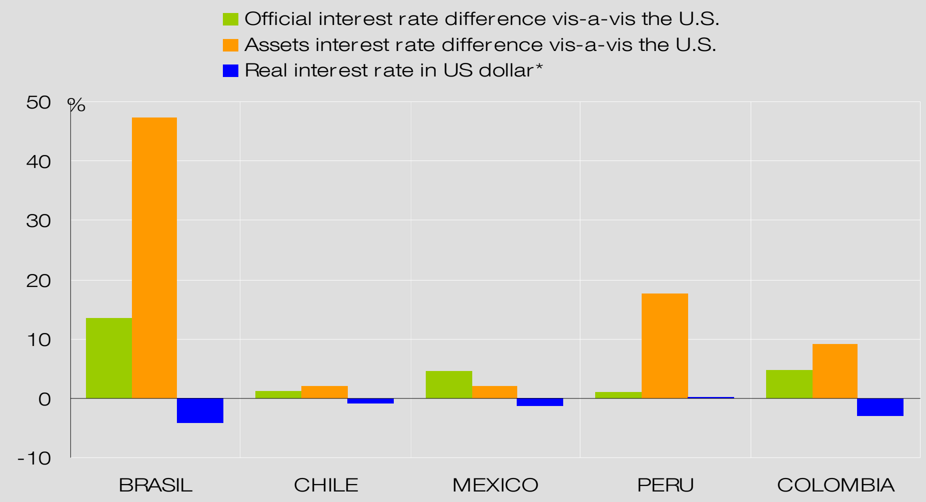
Index: increase=tightening



THE ROLE OF MACROPRUDENTIAL POLICIES. FINANCIAL DOLLARIZATION

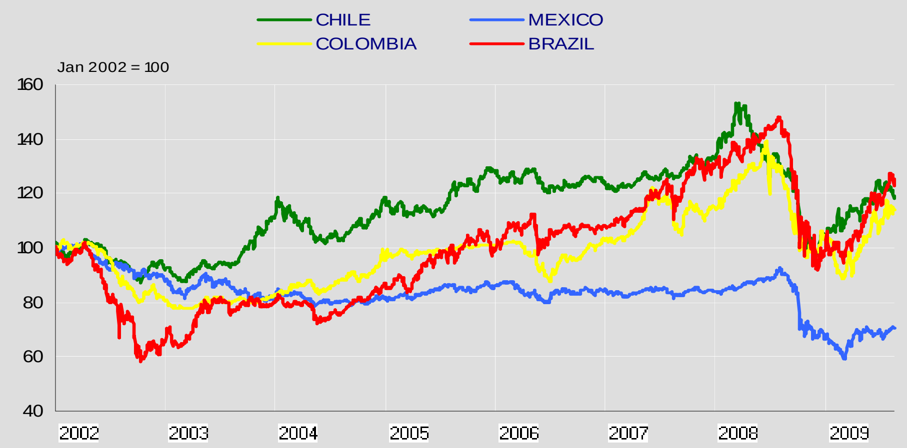
- Risks of experiencing financial dollarization:
    - Large interest rate differentials vis-a-vis the dollar
    - Exchange rate appreciation trends…or just stability
- However, financial dollarization has not increased too much (but bets in Mexico & Brazil 1H08)…
- Role of policies to mitigate financial dollarization…

L.A.: INTEREST RATE DIFFERENTIALS (average 2003-2008)



*Official Fed interest rate deflacted by domestic currency (CPI) inflation

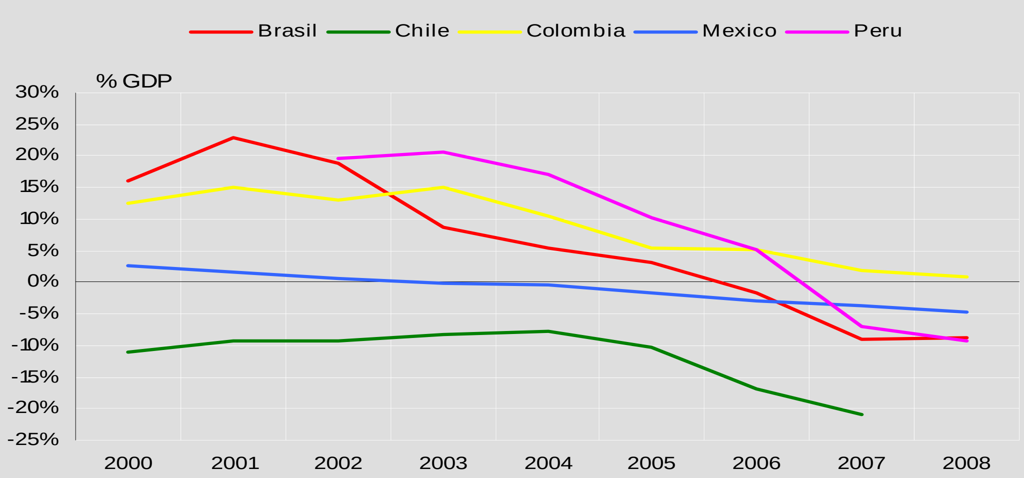
NOMINAL EXCHANGE RATE VS DOLLAR



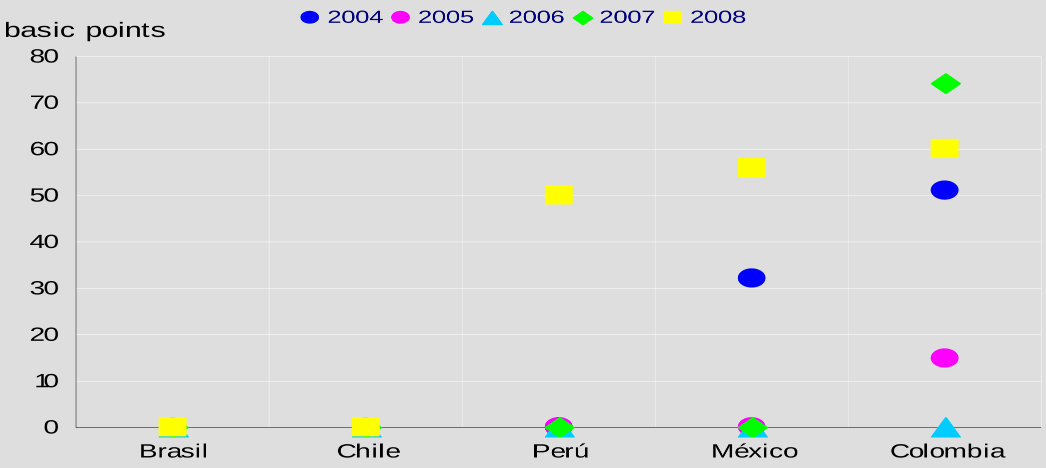
THE ROLE OF MACROPRUDENTIAL POLICIES. FINANCIAL DOLLARIZATION

- <u>Macroeconomic policies</u> intended to discourage financial dollarization…
    - De-dollarization of the public sector: many countries are net creditors in foreign currency
    - Credibility of monetary policy
    - Exchange rate policy?
- <u>Regulation</u> on financial dollarization has been strong:
    - Regulation of balance sheet currency mismatches
    - Stronger liquidity requirements in foreign currency

NET PUBLIC FOREIGN CURRENCY DEBT



INFLATION TARGET CREDIBILITY IN L.A.



* DIFFERENCE 12-MONTHS INFLATION EXPECTATIONES VIS-A-VIS INFLATION TARGET (UPPER LIMIT)

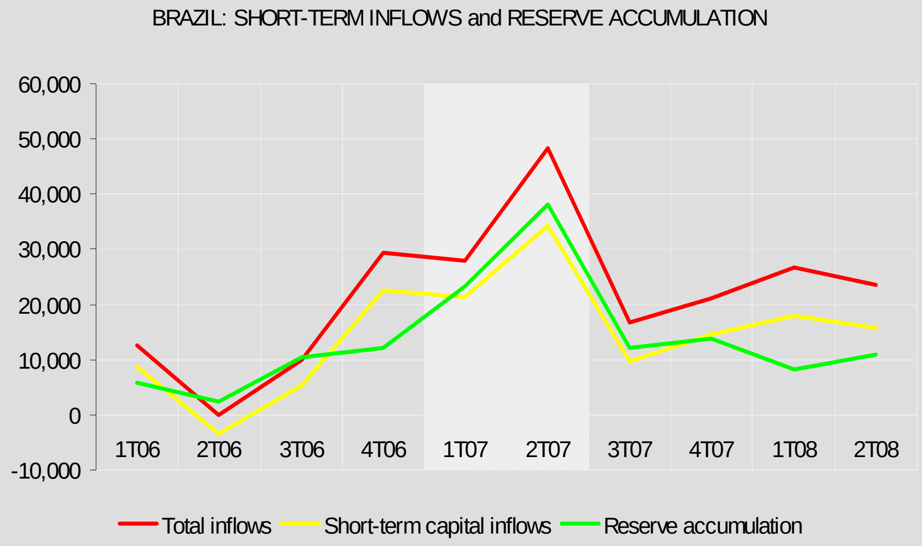
THE ROLE OF MACROPRUDENTIAL POLICIES. SHORT TERM CAPITAL FLOWS

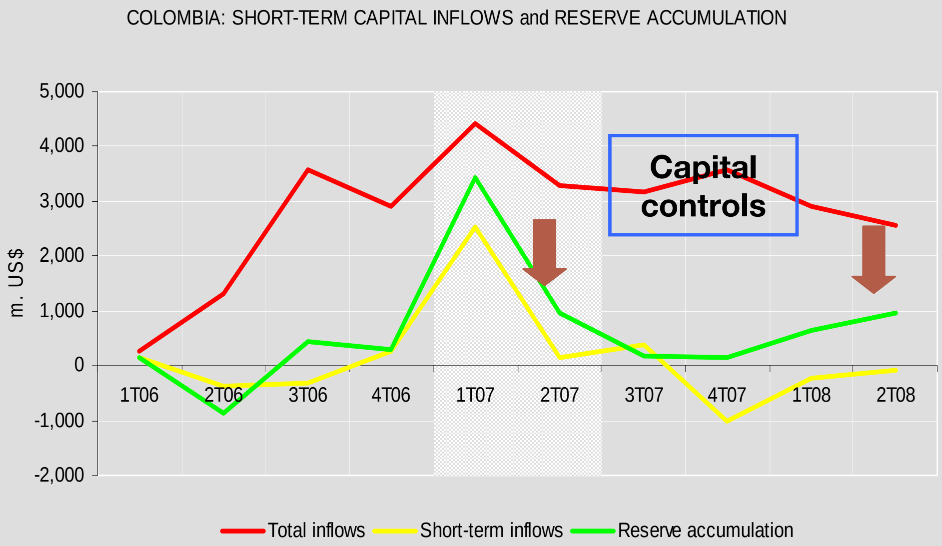
- Large FDI inflows, with punctual episodes of large short-term capital flows (Brazil and Colombia, 1H2007; Peru, 1H2008)

- Which are the risks posed by short-term capital flows?
  - Exchange rate misaligment, fuelling credit booms or financial dollarization
  - The magnitude of the risks depends on the development of financial markets, economic structure
- The "orthodox response":
  1. Discourage inflows through macro policies: floating exchange rates, fiscal policies…
  2. Implemente reforms: development of financial derivative markets, de-dollarization of public debt…
- Some shortcomings of the "orthodox response"…
  1. What if short-term capital flows are inelastic to standard macro-policies?
  2. Reforms take some time: what to do in the meantime?

THE ROLE OF MACROPRUDENTIAL POLICIES. SHORT TERM CAPITAL FLOWS

- “Less orthodox” responses:
  - Forex intervention
  - Price-based capital controls (URR) in Colombia and Peru…
- Difficult assessment:
  - Were short-term capital flows endogenous to economic policies?
    - *Garcia (2008): Brazilian forex intervention was self-defeating…*
  - Were they driven by exogenous reasons (carry trades: global liquidity, foreign banks, interest rate differentials)?
    - *It could be the case, Plantin and Shin (2008); Williamson (2005)*





CONCLUSIONS

- The global economic and financial crisis had a relatively moderate impact on Latin America and central banks had room for countercyclical responses.

- To some extent, this is due to policies to mitigate the build-up of financial vulnerabilities in the years prior to the crisis (2003-2007).

- Some central banks resorted to “non-conventional” macroprudential policies to mitigate the build-up of macrofinancial risks and vulnerabilities. Assessment:
    - Probably these policies could be improved, but all in all they were useful

- Issues for further analysis:
    - Is reserve accumulation self-defeating?
    - Which other measures are useful to avoid exchange rate misaligment?
    - Capital controls: last bullet” or a “short-cut”?
    - Fiscal policy?

THANK YOU VERY MUCH

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SOME REFERENCES

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