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SET THE RIGHT AGENDA

LATIN AMERICA AND MULTILATERAL INSTITUTIONS

The Context

The predominant view on the region is that Latin America entered into the global financial crisis with very strong economic fundamentals (low inflation, twin surpluses, a sound banking system and large international liquidity) to be able to withstand a worsening of external conditions. Moreover, and in contrast to previous episodes of global financial turbulence, the region responded with countercyclical monetary and fiscal policies to mitigate the impact of adverse external shocks.

Under the assumption that the U.S. recession bottoms out in the first half of 2009 and the economy starts a relatively strong recovery thereafter–the so called V-shaped recovery--as the U.S. government and markets are currently expecting, this predominant view is essentially correct. A V-shaped recovery in the U.S. will improve the outlook for industrial country growth, commodity prices and global financial conditions, key external drivers of Latin America's economic fluctuations. Thus, the impact of the global crisis on Latin America is likely to be severe but short lived and limited to the real sector. Liquidity crises and economic collapses will be largely prevented. In such a scenario, Latin America will come out of the woods relatively unscathed.

So far events appear to validate this view. After all Latin America has withstood the crisis without major financial turbulences. Currencies have depreciated, stock prices have collapsed and growth forecasts have been revised substantially downward in the aftermath of the Lehman Brothers demise, but generally speaking the region has avoided (as of yet) currency crises, debt crises and bank runs so typical of previous episodes of global financial turbulence, such as those in 1982, 1998 and 2001.

The Challenge

The V-shaped recovery in the U.S. might well be the case. However, looking at the evidence of severe financial crises suggests that they tend to be deeper and last longer than run-of-the-mill recessions. On average, during these episodes it takes about four years for output to return to pre-crisis levels.

Therefore, Latin American policymakers and multilateral institutions should preemptively prepare for a less favorable scenario in the U.S.: a more protracted L-shaped recovery consistent with the evidence on financial crises. An L-shaped recovery would mean a peak-to-trough contraction that is identical to the V-shaped recovery scenario but results in: 1) a slower convergence to pre-crisis output levels for the U.S. and other industrial countries; 2) a slower recovery in commodity prices to pre-crisis levels and 3) a slower improvement in credit market conditions, as reflected in higher costs and shorter maturities for emerging markets (EM).

If this scenario—which is short of catastrophic—were to materialize, we would see a large deterioration in the region's outlook from the more rosy perspective initially outlined. Instead, the main predictions for Latin America under this alternative L-shaped recovery scenario in the U.S. are as follows:

First, Latin America would experience negative growth in 2009 and 2010 and average growth will be close to zero in the next five years, indicating that Latin American policymakers and multilateral institutions should prepare for tougher economic conditions in the years to come.

Second, although the region starts from a strong fiscal position—a surplus of 2 percent of GDP in 2007—the combination of declining economic activity, the collapse in commodity prices and the rise in financial costs, will lead to a gradual, persistent and large deterioration in the overall fiscal position that peaks at around 5 percent of GDP in 2011. Fiscal deterioration would result in an exponential dynamics of public debt, which almost doubles to 50 percent of GDP in 2013, even under very conservative assumptions on primary expenditures.

Third, although initial conditions of banks in the region are sound—low delinquency rates and high loan loss provisions-- the decline in economic activity will lead to a gradual, persistent and relatively large deterioration in bank's loan portfolio. Non-performing loans will rise to 10 percent in 2011 and loan loss provisions would be completely depleted, resulting in capital losses of around 35 percent.

Forth and more importantly, international liquidity ratios (ILRs) —defined as the ratio of international reserves to short-term public debt—will gradually evolve towards critical thresholds in 2010, and these thresholds have proven to be robust predictors of financial crises. Amortizations that coming due and growing fiscal deficits would need to be financed under very precarious credit market conditions, thus shortening the maturity of outstanding stocks of debt and deteriorating ILRs.

A key feature of this alternative scenario is that the deterioration in fundamentals, i.e., fiscal, banking and liquidity indicators, is gradual and therefore problems may not become evident until it is too late. Against this backdrop, proposals to pursue active countercyclical fiscal policies must be taken with a grain of salt. These policies could easily result in even larger fiscal deficits, ballooning public debts and a more rapid deterioration in ILRs, undermining credibility and increasing the likelihood of a liquidity crisis, even if fiscal deficits are fully financed by multilaterals. Should this be the case, the intended effects of expansionary fiscal policies will never materialize and could actually turn out to be counterproductive.

The challenge for Latin American policymakers and multilateral institutions is thus to anticipate gathering problems early on, to act in a timely fashion, and to design a set of policies that will prevent countries from entering into financially fragile territory that might expose them to a liquidity crisis and a major economic collapse.

Hemispheric Opportunity

In the worst crisis in almost 80 years, when credit markets essentially ceased to function among private agents, the U.S. government enjoyed preferential financial conditions. This phenomenon has allowed the U.S. government to *de facto* act as an intermediary between private agents unwilling to lend to each other and to pursue at very low financing costs expansionary fiscal policies.

In contrast, when EM corporations lost access to credit markets, financial conditions for EM governments deteriorated significantly. Thus, the ability of EM governments to act as intermediaries for private agents and to finance expansionary fiscal policies without recourse to their international reserve stock is very limited and such intervention would entail a deterioration of ILRs.

Precarious access to credit markets for many EM governments calls for multilaterals to step in and play a key role for EM, akin to the role that credible governments, such as the U.S. government, play domestically.

However, full support by multilateral institutions to ensure both the financing of expansionary fiscal programs and of stocks of public debt coming due, does not appear to be either politically or financially feasible. This kind of support for 2009 and 2010 will put the bill in excess of $600 billion for the seven major Latin American countries alone.

The natural question then is how to target limited resources to get more "bang for the buck." The likely evolution of the region's fundamentals under moderately less optimistic scenarios and the key role of liquidity considerations under precarious credit market conditions, points in the direction of switching the emphasis from traditional expansionary macro policies of uncertain and potentially counterproductive effects, to policies oriented towards reducing the likelihood of a liquidity crisis and a severe economic contraction. In our view, this should be the overriding goal of policy design.

This framework suggests a set of key policy principles that policymakers should focus on during the Summit of the Americas and beyond:

1. **Strengthen the role of multilateral institutions.** Multilateral support will be vital under financial precarious access to credit markets, the more so the more pronounced is the global downturn and the tighter international credit market conditions for emerging economies.

2. **Move away from short-term financing.** Multilaterals should avoid short-term emergency financing and only consider medium to long-term financing in order to partially "complete" markets in terms of maturities, ensuring that financial precarious access to credit markets does not put countries in a liquidity collision course.

3. **Redefine the emphasis of multilateral support.** Multilaterals should not only provide medium to long-term financing for fiscal stimulus –when fiscal sustainability is not at stake– but more importantly, they should provide for long-term refinancing of maturing debt obligations.

4. **Ensure that countries work towards sustainable fiscal policy.** Multilateral support that relaxes the constraints on liquidity ratios, may tempt governments to follow laxer fiscal policies that could eventually lead to sustainability problems. Thus, support should be complemented with incentive-compatible conditionality, ensuring a gradual convergence to sustainable structural fiscal positions.

Sustaining global economic activity through expansionary fiscal policies is more of a task left to developed countries and to a handful of emerging economies, where governments remain creditworthy to perform borrower-of-last-resort functions and liquidity issues are not at stake. Stimulus packages that compromise financial stability in the periphery and potentially lead to liquidity crisis and economic collapses would not be much of a contribution to sustaining global demand. Ironically, avoiding those extreme events could turn out to be the quintessential countercyclical policy in Latin America.

Want to Know More?

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