Erkki Liikanen: The changing financial environment in Latin America and global imbalances

Remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, at the III High-Level Seminar of the Eurosystem and Latin American Central Banks, Madrid, 4 December 2006.

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Latin American countries have successfully reduced their traditional sources of vulnerability in recent years. However, despite the stronger fundamentals, a possible disorderly adjustment of global imbalances would pose serious risks to the region. Against this background, some of the key questions are:

1) how well are the countries in the region prepared for possible future crises,

2) what can the authorities do to make the economies better withstand adverse economic conditions, and

3) what role can Latin America play in the adjustment of global imbalances?

To address these questions, I will focus my comments on three sets of issues. First, I will discuss briefly developments that have led to a significant reduction in external vulnerability in Latin American countries. Here I want to highlight the role that the strengthening of institutional frameworks has had in reducing economic vulnerability. Second, I will try to sketch out a possible disruptive adjustment scenario in order to examine what types of policies are needed to prepare the economies for more turbulent economic conditions. Finally, I will talk a bit about Latin America's role in the adjustment of global imbalances by highlighting some key differences between the region and those emerging market economies that are the main contributors to global imbalances.

1. Reducing vulnerabilities: importance of institutional frameworks

The background research paper prepared by the ECB staff ("Financial vulnerabilities in Latin American economies: a reappraisal") gives an excellent overview of the evolution of financial vulnerability in Latin American countries. The trend of narrowing spreads has been decomposed into three factors: reduced risk aversion, ample global liquidity and improved country specific factors. The paper also analyses the role that different country specific factors have played in this development. Such analysis is highly valuable for assessing the nature of risks ahead and appropriate policy responses to mitigate them.

The increased appetite for risk has been the main driver behind the narrowing of spreads in all EMEs, yet the effect has been particularly pronounced in Latin America. However, for most countries in the region, sensitivity to the global risk aversion has diminished in recent years. Similarly, the region seems to have become less sensitive to changes in the global liquidity conditions as approximated by the shape of the US yield curve.

The increased importance of country specific factors implies a greater degree of policy independence going forward. For a central banker it is comforting that research shows that monetary policy regime has a direct and significant impact on sovereign bond spreads and that legal independence of central banks has a significant impact on reducing external vulnerability.

These results fit well with other observed developments. It is clear that the exceptionally benign global environment has been a major factor. However, it is equally clear that many Latin American countries have reduced their traditional sources of vulnerability (i.e., a heavy reliance on external sources of finance, weak fiscal regimes and a volatile macroeconomic environment) through impressive improvements in economic policies and supporting institutional arrangements. Despite significant differences between countries, some general trends are clearly distinguishable:

- The quality of fiscal policies has improved considerably as many countries have used the favourable conditions for fiscal consolidation and have made fiscal policies more transparent.
- Monetary and exchange rate policy frameworks have become more sophisticated and the credibility of the policies has improved as inflation rates have declined. Flexible exchange

rate arrangements and inflation targeting have been underpinned by continued trend in strengthening the institutional independence of central banks.

- There has also been considerable progress in developing financial markets. Many countries have been able to satisfy an increasing share of their financing needs from domestic sources, partly because foreign investors have become more active in the domestic debt markets. Moreover, a few countries have successfully placed local currency issues in the international markets. In general, the dividing line between domestic and international capital markets has become less clear and the "original sin" has become less of a constraint.
- There has been significant progress in debt management practices. Many countries in the region, for example Brazil, have taken advantage of the changed environment and have systematically made their debt stock less vulnerable to exchange rate and interest rate movements (e.g. through changing the denomination and by issuing longer term fixed-rate debt).

Favourable market developments have contributed to strengthening of external positions. Helped by higher commodity prices and generally buoyant demand for exports, current accounts have swung into surplus in many countries in the region. Appreciation of domestic currencies vis-à-vis the US dollar has further supported reduction in external indebtedness.

However, despite these advances, some clear vulnerabilities remain. Public debt stocks have not declined significantly when measured as percent of GDP and indexation of debt remains significant in many cases. Consequently, public finances remain vulnerable to adverse economic shocks. A more recent concern in some countries is the build up of a potentially excessive exposure of the domestic financial system to domestic (non-indexed) government debt.

Before turning to discuss the policy implications of these remaining vulnerabilities, I would like to emphasize that advances in institutional development can never be taken for granted. Indeed, as we have seen in the past, populist policies can easily cause setbacks in this area. Therefore, it is crucial to maintain the political support to institutional reform that fosters financial development. In this regard, strong property rights and a legal system that enforces contracts quickly and fairly are of particular importance. As many of you may recall, we discussed the topic of globalization and financial stability last summer here in Banco de España and safeguarding these two factors were deemed as essential to avoiding pitfalls in financial liberalization.

2. Possible "anatomy" of the next crisis and the policies to increase resilience to shocks

The region weathered relatively well the May-June 2006 financial market correction, but this episode showed that it has not become immune to shocks emanating from the global financial system. While the "threshold of pain" has clearly improved, the resiliency of the system in the face of a more pronounced external shock remains untested. Against this background, there is no room for complacency. So, what might a more serious external shock look like and how can the authorities prepare the economies for such an eventuality? The region seems particularly vulnerable to the combination of a possible recession in the US and falling commodity prices. Let me elaborate on this a bit to examine the anatomy of a worst case scenario.

I want to emphasize that I am by no means implying that this type of outcome is likely and that there would inevitably be important differences between the countries in the region. Nevertheless, and at the risk of overgeneralising and oversimplifying, I think that it is useful to examine how a vicious circle might unfold in order to draw some policy conclusions.

- A recession in the US (triggered e.g. by wider decline in housing and other asset prices) would hit harder those Latin American countries that have the strongest trade links with the US, such as Mexico, Venezuela and Ecuador. A weaker US demand could well lead to a significant slowdown in China. Direct impact on the region might be relatively limited as the direct trade links between China and Latin America are relatively weak, despite some increases in recent years. However, indirect effects via lower global commodity prices could become quite pronounced.
- Increases in the US interest rates and investors' reduced appetite for risk could lead to significant widening of the emerging market spreads. Liquidity in some markets could dry up causing spreads to widen further as investors would try to reduce their exposures. And

currencies in the region could come under pressure to weaken as investors would try to exit certain markets.

- Contagion, which has been vanishing in recent years, could reappear as spreads would widen and investors try to beat others in their attempt to adjust their portfolios. Related to this, the original sin could also return as countries would have increasing borrowing needs in the face of a deteriorating economic outlook and weaker fiscal balances.
- One big question mark would be the role that credit derivatives might play in the propagation of the crisis. At the moment there is much uncertainty about the way credit risks have been distributed in the financial system and the issue who is their ultimate holder. Possible problems in the credit derivatives market could spell further trouble for emerging market borrowers. These issues are analyzed in great detail in the forthcoming issue of the ECB's Financial Stability Review that will be published any day now.
- Declines in stock prices and increases in bond yields could weaken domestic balance sheets. These factors, and a generally weaker economy, could put a strain on domestic financial institutions.
- Fiscal balances could be hit through many channels: weaker economy, higher debt service as a result of higher interest rates and possibly also weaker currencies. Possible problems in the domestic financial systems could also force governments to incur additional liabilities.

Countries with sound fiscal positions and well-anchored inflation expectations might have some scope for countercyclical policies. Such countries could also benefit from flexible exchange rates. However, in cases where the fiscal position is not sound enough, and if currency mismatches of debt would erode the potential benefits of exchange rate flexibility, there would be very little that the authorities could do after the onset of the vicious circle.

This analysis underscores the urgency to tackle the remaining vulnerabilities before a crisis. Specifically:

1) fiscal vulnerability needs to be reduced through more ambitious fiscal consolidation and further improvement in debt management practices. And

2) financial sector vulnerability can be reduced through enhanced supervision and by measures that support further development of deeper and more liquid markets. One challenge related to the financial sector is making domestic private sector balance sheets more resilient to potential interest rate shocks.

Unless these vulnerabilities are tackled decisively, monetary authorities could be faced with insurmountable tasks if a crisis materializes. Indeed, as a result of a possible severe crisis, there could be a backslash against central bank independence and other advances that have been made in institutional development in recent past.

3. Global imbalances: Latin American countries vs. East Asian EMEs and oil exporters

Latin America's role in the resolution of global imbalances is generally perceived to be minor relative to that of the East Asian economies and oil exporters. A number of factors help explain this difference. The most obvious difference is that many of the East Asian EMEs only relatively recently joined the global economy and are now experiencing a catch up phase characterized by particularly rapid growth (and oil exporters are benefiting from the high oil prices). Latin America's integration into the global economy has taken place more gradually over an extended period of time (and many times this process has been interrupted by economic crises.)

The East Asian economies' truly impressive growth masks underlying weaknesses, or at least it reflects the lack of development in certain areas, that have a bearing on global imbalances. To highlight such factors, it is instructive to compare and contrast Latin American countries with East Asian economies and other countries that are major generators of global imbalances.

East Asian economies and oil exporting EMEs are characterised by large current account surpluses, capital exports to the US (reflected in accumulation of reserves) thus contributing to the long-term interest rates in the US and also globally. Whereas Latin American countries are characterised by lack of major external imbalances. Setting aside the already mentioned differences in the growth rates and phase of the catch up process, what are the main factors that underlie these differences:

1) Level of financial market development. Many East Asian economies and oil exporters suffer from chronic shortage of high quality domestic investment assets relative to domestic demand. Moreover, their domestic financial systems have generally weak intermediation capacity. This phenomenon is contributing to lower interest rates in the US, thus fuelling further demand there and contributing to further build up of surpluses in the countries that satisfy this demand through their exports. As you know, e.g. Ricardo Caballero has written several interesting papers on this phenomenon of asset shortages and its role in global imbalances. Many Latin American countries have experienced rapid development of their domestic debt markets. Also, compared with the biggest surplus countries, their financial systems do a better job in financial intermediation.

2) These two groups of countries have also very different savings and consumption patterns. This reflects partly the already mentioned differences in financial systems but there are also other important differences. Many "surplus countries" have poorly developed social safety nets compared with the bulk of Latin American countries. The lack of safety nets forces people to save more and much of these savings are channelled abroad, given the lack of suitable instruments at home. In many of the surplus countries, most notably China, the markets for consumer goods are still underdeveloped, albeit they are developing quite rapidly.

3) There are also striking differences in monetary and exchange rate regimes. In the countries that are the main "culprits" for surpluses, the regimes tend to be based on external anchors and it seems that many of these countries have currently undervalued currencies pegged to the US dollar. In Latin America, the increased prevalence of flexible exchange rate regimes, often combined with inflation targeting, make significant exchange rate misalignment less likely. Furthermore, in these regimes policy stance is determined by domestic conditions not by an external anchor.

Deficiencies in institutional development in many of the surplus generating countries do not always receive sufficient attention in the discussion on global imbalances, which tend to focus excessively on the need for exchange rate adjustment. As for the Latin American countries, one could say that in many important respects these countries have already contributed to resolving global imbalances by implementing sound policies and building institutional infrastructures. In this regard, many of the surplus countries have a lot to learn from the experience of the Latin American countries.