Guillermo Ortiz: The global financial crisis – a Latin American perspective

Speech by Mr Guillermo Ortiz, Governor of the Bank of Mexico and Chairman of the Board of Directors of the Bank for International Settlements, at the conference "Financial globalization: culprit, survivor or casualty of the great crisis?", Yale University, New Haven, 13 November 2009.

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I would like to start by thanking our hosts for inviting me to participate in this important event. I would like to devote my presentation to the origins of the global financial crisis and its impact on emerging market economies, particularly Latin America. I would also like to share a few thoughts on some of the lessons that we have learned during this crisis with regard to the challenges that globalization represents to financial authorities.

1. The global financial crisis

In many aspects, the current crisis is not very different from the events we have seen in many emerging markets in the last decade. Macroeconomic disequilibrium derived from large current account deficits and fiscal imbalances; high growth rates of consumption financed with short-term capital inflows; lax monetary policies; financial deregulation; and excessive leverage coupled with inadequate regulation and supervision of financial institutions.

All of this sounds very familiar to many emerging market economies that have sustained financial crises in the last decade. However, what makes this crisis different are:

1. Its truly ***global nature***: while contagion resulting from the problems observed in emerging market economies in recent years was significant in countries believed to have similar characteristics, the crisis in the U.S. economy ended up substantially affecting all regions around the globe.
2. The second important difference is the ***magnitude*** of the crisis. The magnitude is not only explained by the fact that the crisis sprang from the largest economy in the world, but also by the high level of financial leverage that prevailed in many large financial institutions, as well as the disintermediation of resources from traditionally regulated financial agents in favor of less regulated ones – the expansion of the so-called parallel banking system.
3. The third aspect that characterizes the current crisis is the ***simultaneity*** of the events taking place in many different markets, as well as in economies as diverse as Germany, Korea and Mexico.

The trigger of the crisis may have been the bursting of the housing bubble in the U.S. However, the fundamental forces behind the current crisis are deeply related to large and increasing global imbalances among the most important world economies (an enormous U.S. deficit coupled with surpluses in Japan, China, Russia, and OPEC countries), abundant liquidity worldwide, and a prolonged period of very low real interest rates.

The deterioration of financial institutions' balance sheets led to a deleveraging process, which contributed to a sharp fall in asset prices and to tighter credit conditions. As a result, lending plummeted, and thus business investment and consumer spending in advanced economies fell. The problems in credit markets have had a strong negative impact on the real economy.

The international financial crisis began a second, much more dangerous phase after Lehman Brothers' collapse for a number of reasons.

- First, financial globalization and liberalization have increased cross-border investments and transactions. At the same time, financial innovation has facilitated segmentation and the distribution of financial risks, resulting in more interconnected economies, markets, and financial entities (regulated and non-regulated). This situation enabled the crisis to spread rapidly, first among developed and then emerging economies.
- Second, the widespread use of optimization models based on market prices and credit ratings has led to financial market participants acting similarly and simultaneously, resulting in illiquid markets. A necessary condition for liquidity in a market is precisely the existence of a variety of opinions about the prices of the goods or assets being traded. This is how individual cautionary measures, such as the selling of financial assets when associated risks increase, can become systemic problems.
- Third, authorities in some of the most developed countries failed to identify the origin and anticipate the spread of the crisis quickly enough. Initial responses were in some cases tardy and insufficient. There was neither sufficient clarity with respect to the strategies which needed to be followed nor sufficient coordination among the financial authorities involved.
- Fourth, serious liquidity problems and the collapse of credit in the financial markets of developed economies rapidly undermined growth prospects, bringing economic activity to a near standstill. The erosion of household wealth stifled consumption along with the production of goods and services, leading to a contagion effect on the real economy and international trade. The upshot was a severe slowdown in economic activity for both developed and emerging markets irrespective of the conditions individual financial systems faced.

2. The impact of the financial crisis on Latin America

The relatively good economic performance of emerging Asia and Latin America throughout 2007 led several analysts and policymakers to embrace the decoupling hypothesis. It was argued that emerging market economies had successfully been able to decouple themselves from the more developed markets. It also was considered that countries like China could become engines sustaining world growth, replacing the U.S. economy in that respect.

However, the international risk aversion brought about by Lehman’s demise and the global nature and magnitude of the crisis soon engulfed emerging market economies. The decoupling hypothesis did not stand up, and financial turbulence in industrial countries spread to developing countries mainly through two shocks of considerable magnitude, as follows.

1. An ***external demand shock***. The recession in global economic activity reduced the demand for emerging market exports, which led to two effects:

   i) ***A fall in export volumes:*** emerging economies’ exports have experienced a sharp decline. The drop in the volume of exports is due to the global slump and the adjustment in spending patterns to sustainable levels in advanced economies.

   ii) ***Deterioration in terms of trade:*** the global recession has not only reduced the volume of exports for emerging countries, but also led to a change in relative prices. In particular, commodity prices have declined significantly, although they have experienced some recovery recently.

2. ***An external financial shock.*** The rise in international investors' risk aversion and the losses incurred by many large cross-border banks have led to a substantial decrease in risk positions held in the majority of EMEs.

   i) ***Restricted access to external financing:*** Many EMEs faced a reduction in the amount of external financial funds available. This shock was related to both the increased risk aversion among institutional investors, as well as the deleveraging process taking place in advanced economies.

   ii) ***Decrease of liquidity*** in EME foreign exchange and domestic debt markets: The increase in risk aversion and capital losses have forced many global banks to reduce their risk positions in EME securities and currencies. As a consequence, liquidity conditions in these EME markets have substantially decreased, leading to increased volatility and wider bid - ask spreads. The loss of liquidity in EME financial markets left them highly vulnerable. The flight to quality away from EME domestic capital markets after the Lehman demise led to sharp depreciations of many EME currencies.

   iii) ***Tightening of lending conditions in domestic markets:*** Large global banks usually manage their risks, capital, and business lines on a global consolidated basis. The initial rise in risk aversion in mature markets and the capital losses incurred by many banks led some of them to reassess the allocation of their capital and business lines. The reallocation has hit countries with a large foreign bank presence particularly hard. Subsidiaries of foreign banks, especially those of parent banks in trouble in their home-countries, tightened their lending conditions. This has led to a decrease in bank lending, particularly in EMEs with a large foreign bank presence. Some of these countries also experience some pressure in their domestic interbank markets as a result of the channeling of liquidity by their subsidiaries to parent banks established abroad.

The adverse impact of these two shocks was not the same across all Latin American countries. The external demand shock has had a more profound impact on countries with a higher degree of openness, as the fall in exports had a larger impact on domestic economic activity. In contrast, Latin American countries with a relatively more robust internal market tended to be less affected. In the same vein, countries with a low level of export diversification, like Mexico, were particularly affected (Mexico has specialized in exporting manufactured goods to the U.S. economy).

However, in this respect there were significant differences between what happened in Latin American countries and what happened in several Eastern European and the Baltic countries. In Latin American, exchange rate risk has always been at the forefront in the minds of financial regulators. Past experiences have shown in multiple occasions that fixed exchange rates and currency pegs are doomed to fail sooner or later. Hence, domestic regulations prevented the large foreign currency mismatches that characterized lending in many Eastern European and Baltic countries.

Prior to the current crisis, several economies such as Hungary, Estonia, Latvia, and Lithuania experienced un-sustainable private credit booms, usually fueled by un-hedged external financing. These credit booms led to huge debt overhangs and foreign currency exposures on their domestic balance sheets, making them highly vulnerable to capital outflows. The adoption of exchange rate pegs in some of these countries also contributed to the buildup of these imbalances. The sudden reversals of capital flows and the depreciation of many exchange rates left debtors and banks in these European countries facing significant insolvency problems.

Nevertheless, financial system prudential regulation did not prevent the private sectors of many EMEs from incurring these currency mismatches. The risks inherent in the adoption of free-floating foreign exchange regimes in many emerging markets heralded the development of OTC derivatives markets in which participants could hedge unwanted currency exposure. However, OTC derivatives were also used in what turned out to be mere speculative trades by non-financial firms. The relative stability of the foreign exchange markets in the years leading up to September 2008 drew some firms to use derivative instruments in an apparent attempt to lower the cost of capital.

The abrupt depreciation of many EME currencies altered the value of the derivatives held by non-financial firms. Thus, a negative surprise bedeviled many EMEs when it became public that important large corporations, mainly in Mexico, Brazil, and South Korea, were being hit with large losses from derivative products. The lack of information about the identity of the firms involved, as well as the magnitude of the losses, increased risk aversion.

When fundamentals moved to justify sharp depreciations of exchange rates, the adjustments were exacerbated by these financial structures. The depreciations resulted in significant losses from the derivate positions for non-financial firms. In order to post collateral against these losses, firms had to demand more dollars. When firms could no longer meet collateral requirements, banks themselves had to buy the dollars, as they were forced to unwind their positions with the firms. However, their exposure to local currency depreciation losses remained a problem.

3. Regulatory policy responses to the global crisis

Since the onset of the crisis, financial authorities of different countries, as well as international organizations and standard-setting bodies have been working on a very ambitious agenda to strengthen financial regulations and to create a financial system better suited to support sustainable economic growth.

One of the outcomes of the current crisis has been the recognition that the G10 economies have lost some of their clout in favor of other countries and regions. This, together with the failure of some of these countries to regulate and supervise their own financial institutions, has raised the question of their ability to continue leading international policy coordination and to establish principles and standards for best practices and regulations. The result has been the acceptance of the idea that international efforts should be led and coordinated by a wider and more representative set of countries, the G20.

The ongoing crisis has also made it clear that the current international financial infrastructure and the cooperative efforts adopted in forums such as the IMF, the FSB and the Basel process, were insufficient to prevent the most severe crisis of the last six decades. However, it should be recognized that these organizations have lacked sufficient authority and tools to effectively carry out their assessments and enforce their recommendations in all countries, especially in developed ones.

Not surprisingly, one of the conclusions of the G20 is on the need to implement international financial standards and agree to undergo periodic peer reviews using IMF/World Bank Financial Sector Assessment Program reports, among other actions.

An important number of initiatives being discussed are aimed at preventing the financial system from leveraging itself to the extent that it did before the crisis. Capital adequacy and liquidity are at the center of the discussions. It is important to be aware that less leverage, although beneficial from a prudential perspective, probably implies less potential for economic growth.

Another important set of initiatives are aimed at modifying the regulatory and supervisory architecture. For example, in some countries discussions are taking place about moving banking supervision under the aegis of central banks. However, at the end of the day, what it is important about a building is not its size or particular style, but whether or not it serves the purpose for which it was built. Buildings should be designed according to the particular climate in which they will operate.

I would like to share a few thoughts about some of the lessons we have learned during this crisis with regard to the challenges that globalization represents to financial authorities:

1. ***Regulatory and supervisory arbitrage:*** For any financial regulation to be effective, it is of paramount importance to avoid the sort of regulatory arbitrage that has been taking place to date, such as financial intermediaries' practices of booking some of their operations in the places, entities or conduits where they face a more favorable regulatory or supervisory treatment. In this sense, it is crucial to advance in the international harmonization of domestic financial regulations – e.g. resolution regimens, accounting standards, provisioning rules, capital definitions.

2. ***Incentive structure:*** Regulations will not be effective if they do not alter incentive structures. Financial markets have some particularities. Within these particularities lie the incentives that make them vulnerable. And it seems that actions taken towards correcting some of these vulnerabilities uncover other weaknesses: limited liability and deposit insurance schemes create incentives for more risk taking. The problem is that the growing complexity of the financial system, as well as the availability of new instruments (the products of financial innovation), considerably complicate the task at hand for regulators. The challenge faced by authorities is to create the right incentives and to understand the motivation behind innovation.

3. ***Large cross-border banks:*** There is ample agreement that systemically important banks pose a complex challenge to financial stability. A vast stream of literature has always seen as positive the consolidation and expansion of large cross-border banks. However, this crisis has highlighted the moral hazard posed by institutions that are deemed too big to fail, either due to size or interconnectedness.

   There are no easy answers to deal with the problems represented by large and complex institutions. However, it is clear that we should differentiate among prudential measures and resolution tools. The first should be aimed at reducing the probability and impact of a large bank failure, and the second at making the financial system better able to deal with a large bank failure.

   a. ***Reducing the probability of a large bank failure.*** To reduce the probability of a large bank failure some policy makers argue in favor of imposing additional prudential requirements and oversight measures. Among them, there is a group supporting the idea of applying a capital surcharge to banks deemed too large or too interconnected.

      I have strong considerations regarding this measure. A capital surcharge will convey the wrong message to the financial market. The message will be that the authorities consider that particular bank as too big to fail. This certainly would not help to decrease the moral hazard posed by some institutions. Such a measure would also bring to bear particularly adverse effects on countries that have truly opened up their financial systems to foreign investment and maintain a large foreign bank presence, like Mexico and Poland. The imposition of proportionately higher capital requirements for large cross border banks would inevitably translate into higher intermediation costs. Foreign banks enjoy a large and dominant presence in many emerging market economies. Therefore, imposing higher capital requirements will also have potential negative impact on the achievement of a level playing field across countries. Furthermore, this measure would also represent a draw-back in terms of financial integration.

      Others are in favor of strong measures such as breaking up banks into utilities and casinos. However, to draw a line between utility and casino banking may prove too difficult to do. There might be other policies which could make more sense. The European Commission seems to be leaning towards the idea that whatever the benefits of size in banking, the public interest requires smaller banks.

Measures should also be tailored to the nature and structure of the institutions. Different responses may be more appropriate for large and very complex cross-border structures with centrally managed capital and liquidity than for institutions organized as simpler networks of national banking subsidiaries, each with their own separate capital and liquidity.

We consider that complex cross-border banks should be regulated at local levels. There are no global lenders of last resort, neither global bank resolution process. We do not have either a global pool of tax payers to fund the cost of rescue operations of cross border banks or an international court to deal with legal differences. Hence, the ultimate responsibility for banks' depositors, domestic payment systems and, in general, for the functioning of the domestic economies lies in the hands of the national authorities. Hence, liquidity and capital regulations should be subject to local regulations. Each subsidiary should be subject to the liquidity and capital requirements of its local jurisdiction.

b. Facilitating the orderly unwinding of large banks when they fail. The second issue deals with policies to improve the resolution capacity of authorities and those that make the financial infrastructure better able to deal with a large bank failure. These policies include the creation of conditions needed to facilitate a bank's unwinding if it becomes troubled. Different international groups are already working on finding ways to facilitate unwinding. Simpler corporate structures and more compatible national resolution regimens would make unwinding easier.

4. Final remarks

One lesson from the current global crisis is the importance of investing in building solid macroeconomic fundamentals in the aim of a more resilient economy and more maneuvering room to cope with external shocks. For instance, in this episode of financial turbulence, the most affected countries have been those with larger external imbalances, weaker fiscal positions, and banking systems characterized by currency mismatches and other flaws. On the other hand, those emerging economies with relatively better fundamentals have had more space to ease policy than they had in previous downturns. Although these economies are also feeling a sharp impact from the financial turbulence of the crisis, they have experienced a less disruptive adjustment process.

Another lesson from the current crisis is that international reserves help in episodes of financial stress. In principle, foreign investors interpret large holdings of foreign reserves as a signal that a country will be able to honor its external obligations. Thus, a capital flow reversal is less likely.

This means that we are likely to see strong demand for reserves in many countries over the next few years. Thus, under the current rules of the game in the international monetary system, we could face Triffin's dilemma once again. In other words, if everything else is unchanged, the only means to satisfy the demand for reserves would be through high U.S. current account deficits, which, paradoxically, are at the root of the current crisis. Conversely, in the absence of high external deficits in the U.S., a shortage of liquidity would emerge, which could lead to a new period of economic contraction.

Enhanced international monetary cooperation can provide a way out of this dilemma. Certainly, the SDR allocations of 283 billion dollars, which multiplied the existing stock tenfold, have helped to complement many countries' international reserves and boost confidence. But other avenues need to be explored to reduce the demand for reserves. I believe that bilateral swap agreements such as those negotiated between the U.S. Federal Reserve and a number of other central banks could play a useful role in this regard. Moreover, the IMF should build on the success of the Flexible Credit Line (FCL) and consider more instruments offering credible alternatives to self-insurance through reserve accumulation. Indeed, the Fund needs to design additional financial instruments to promote long - term global stability and the proper functioning of the international monetary system.