Economic policy in LatAm in the age of Covid

Remarks by Alexandre Tombini[1], Chief Representative for the Americas, Bank for International Settlements (BIS), at the UBS Virtual Group Meeting.

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Thank you very much for the invitation. It's a pleasure and an honour to participate in this virtual call at UBS with Rafael de la Fuente.

My remarks today will touch on the recent economic and financial developments in Latin America and the difficult challenges facing policymakers in the coming months and years. I will limit my remarks to general trends without commenting on the specifics of individual countries' policies.

2020 was a tough year for many people and businesses. One year ago, I would have never imagined that I would be here talking to you today about an event that simultaneously brought the economies of most countries to a screeching halt. And yet, here we are.

The lesson is clear: no matter how good conditions may be, it is prudent to be prepared for unwelcome, unexpected events – however unlikely they may appear. This underlines the need for individuals, businesses and governments to build in safety margins. For households and firms, this means keeping vulnerabilities low. For governments, it means reinforcing institutions, building safety buffers in good times, and avoiding complacency.

From this point of view, the far-sighted decision made by many countries in the region over past decades to strengthen their macro-financial frameworks has paid off. Granted, the aggressive stimulus put in place by central banks and fiscal authorities in the United States and other major advanced economies has been instrumental in containing the Covid-19-related damage to the global economy. But stronger domestic policy frameworks in Latin American economies were important too. They made it possible to ease policy promptly and rapidly, unlike in previous crises.

As a result of this strong policy response, we're in a better position today than we would otherwise be. Of course, the current crisis is not over yet. And as new infections rise rapidly again, governments are being forced to reinstate containment measures. But, and this is important to note, the stronger macro-financial frameworks will continue to pay dividends.

I'll return to this point later. Right now, I'd like to give you my take on recent developments.

Strong recovery in the second half of 2020

At the end of November, the rebound in economic activity surprised on the upside in most countries in the region, although the good news remained largely confined to the manufacturing sector. Third quarter data turned out to be stronger than expected. And indications are that the slowdown in the fourth quarter was not as strong as anticipated.

What explains the better-than-expected outcomes? There are several factors.

[1] Any views expressed are that of the author and do not necessarily represent those of the BIS.

First, the massive policy response by major central banks has meant very favourable international financial conditions. The dollar, in particular, has continued to weaken against a broad set of currencies.

Second, the measures by the Federal Reserve and other major central banks – such as FX swaps as well as the emergency and contingency credit lines offered by the IMF and others – have provided important backstops, easing tensions in funding markets.

Third, a remarkable V-shaped recovery in China is underway, helping to boost commodity prices and Latin American exports. Likewise, the faster than expected rebound of the US economy also helped, particularly in boosting Mexico's exports.

Finally, the remarkable countercyclical domestic policy response has been critical, especially on the part of monetary and prudential authorities. This time, emerging market central banks responded in this way even when facing huge depreciation and capital outflows pressures. Indeed, major central banks in the region cut policy rates to historical lows. A number of them introduced forward guidance for the first time. Some engaged in outright asset purchases, although in small amounts. And all conducted large-scale refinancing operations for their financial institutions, initially to restore market functioning, and subsequently to support the flow of credit.

Importantly, financial authorities adopted supervisory flexibility and, in coordination with the Basel Committee on Banking Supervision, eased rules to allow banks to draw on buffers to support the extension of credit. Banks in Latin America, well capitalised and liquid at the outset of the pandemic, were in a good position to respond to these policy measures. Unlike in the Great Financial Crisis, banks were not the problem, but rather part of the solution worldwide thanks to forceful post-GFC regulatory reforms. This is another example of the importance of building buffers for the unexpected. Indeed, credit responded strongly in most countries.

Fiscal policy was less important as a stimulus tool in Latin America than in advanced economies and other emerging markets. With the exception of Brazil and a few other economies, the fiscal response was generally smaller. This reflected, in particular, more limited safety margins and hence fiscal space, as proxied for example by higher sovereign bond yields or CDS spreads.

An uncertain 2021 amid buoyant financial markets

Unfortunately, we are not yet out of the woods. A new pandemic wave has clouded the outlook since December. Growth forecasts for the first quarter of 2021 have been downgraded for most countries.

Key to near-term prospects is the evolution of the pandemic, the introduction of new restrictions to mobility and activity, and the uncertain prospect for large-scale immunisation. The availability of policy headroom will also be crucial. In particular, extending existing policy measures or putting in place new ones may be needed to bridge the gap between now and when widespread vaccination is achieved.

That said, despite the resurgent virus and the associated high uncertainty, global financial conditions continue to be favourable. Indeed, sentiment towards emerging markets generally improved further in the last couple of months. In line with the recovery in global trade and commodity prices, currencies in the region strengthened somewhat, sovereign and corporate yields narrowed further, and by now capital inflows have offset the massive outflows of the first half of 2020.

Key risks and challenges ahead

An open question is whether this market optimism is fully justified, especially in the face of the considerable challenges and risks facing the region. What are the potential downside risks?

The main challenge is to achieve widespread immunisation in a relatively short time. Financial market optimism seems to be predicated on this prospect. But this is far from certain. If the current

rebound gives way to a new contraction and the recovery is postponed and slower than anticipated, other risks would gain prominence. Let me mention the main ones.

First, the effects of a protracted downturn on firms' insolvencies and associated losses in the banking system may turn out to be worse than expected. Everyone expects non-performing loans to increase in the future. The question is how far and how fast. Data today are less informative as current measures to support credit are still in place. And historically, there's a significant lag between declining output and rising bankruptcies and unemployment.[2] While cliff effects may arise as support measures are removed, financial institutions seem to be more optimistic today than a few months ago.

Second, public debt has increased and reached relatively high levels in several countries. So far, markets have been quite tolerant. But, there is no certainty that they will continue to be, especially if credit rating downgrades take place. To minimise this risk, credible fiscal consolidation plans are needed. This does not mean immediate consolidation, but rather credible plans that would reassure financial markets.

Third, inflation may pick up more strongly than expected. True, inflation pressures are likely to be contained given the large economic slack, a slow recovery in employment, and favourable global financial conditions that should limit currency depreciation. Moreover, central banks' credibility should reduce the risk of a sustained increase. That said, some factors pose upside risks. Depreciation pressure and inflation expectations may increase if fiscal sustainability is called into question and/or investors come to believe that central banks have become more tolerant of above-target inflation. Additionally, potential supply disruptions and/or pandemic-related structural changes may overstate estimates of output gaps.

Finally, interest rates are at historical lows in many of the region's economies. One concern is that such low rates may increase the risks of large capital outflows, currency depreciation and steeper yield curves, even in the absence of strong inflationary pressures. Easy global financial conditions make the risk small today. But other factors may increase perceived country risk, including the ones I've just cited – that is, more fragile fiscal positions and the possibility of a wave of insolvencies once support is withdrawn.

Differences in longer-term growth prospects, in particular, may become an important discriminant for foreign investors. In this regard, the drivers of growth in Latin America once the pandemic is over are very uncertain. Growth had already been weak before the outbreak, due to lack of investment and various structural impediments. Following the current crisis, the economies may also bear the scars of an increase in bankruptcies and long-term unemployment. Higher public and private debt post-pandemic could further limit much needed investment.

Another challenge for the region is that, although China's strong rebound from the pandemic is currently helping, China may not have the same traction on Latin America's growth in the future as it did in the past, due to its diminishing reliance on commodity-heavy industries. A further complexity may be the likely continued increase in capital flows to China, which could make foreign investment in other emerging markets less attractive.

There are, however, some rays of hope. The pandemic may bring about productivity improvements as businesses and individuals learn to make better use of digital technology. Several technological companies in Latin America had already made their mark before the outbreak. And, in some countries, digitalisation within public administration has already been a successful reality. The pandemic may accelerate the adoption of digital technology and lead to the discovery of new services and new ways to conduct business.

In conclusion, Latin American economies face important challenges and risks, both during and after the pandemic. How do we tackle them?

2 See eg Agustin Carstens, "The Great Reallocation", Op-ed, *Project Syndicate*, 12 October 2020.

Going back to my initial remarks, the stronger macro-financial stability frameworks, including the hard-earned credibility of central banks and sound fiscal policy, will continue to play a fundamental role. Given the limited policy space available in several countries, it is essential that both monetary and fiscal policies reinforce each other. By reducing country risk premia, sound fiscal policy, including credible fiscal consolidation plans, will help increase space for monetary policy accommodation. Greater monetary accommodation, in turn, will contribute to increase fiscal space.

That said, macroeconomic stimulus is not sufficient to boost economic growth in a sustainable way. Structural reforms are needed to create a business friendly environment that makes much needed business investment attractive. Greater public investment, which normally takes a hit in a crisis, should also be maintained or strengthened post-pandemic. Ultimately, all policies are needed to achieve the common objective of raising long-term economic growth. This is the main antidote to rising inequality and poverty in Latin America.