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Managing Abundance to Avoid a Bust in Latin America

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EXECUTIVE SUMMARY

Exceptional global circumstances have produced a double bonanza of easy foreign financing and high terms of trade for Latin America (LA), particularly for commodity exporters—favorable conditions that will not last forever. Managing this abundance will be critical to avoiding a boom-bust cycle. This note explores the sources of these double tailwinds, the problems and vulnerabilities they can engender in LA, and how to build an appropriate policy response.

Persistent double tailwinds, with risks of an abrupt end. *A Global Liquidity Flood:* Building on capital flow "pull" factors associated with improved fundamentals in emerging markets (EMs) and a likely sustained shift in investors' portfolios, the combination of low interest rates in advanced economies (AEs) and investors' higher risk tolerance is a strong "push" factor that will continue for some time, but could revert hastily once AEs' recovery gains footing. Economic and political constraints in AEs have led them to lean strongly on easy monetary policy. At the same time, some key EMs are limiting the adjustment of their current account balances—by maintaining broad capital account restrictions and heavy exchange rate intervention—leaving others to receive higher capital inflows and contribute more to the restoration and rebalancing of global demand. *A Terms of Trade Bonanza:* As demand by systemic EMs has pushed up commodity prices, LA is enjoying strong terms of trade, raising issues in many ways similar to easy foreign financing. A key risk for the region is a sharp reversal of these two favorable external conditions following, e.g., a large oil price shock, rapid monetary tightening in AEs, or a global slowdown coupled with heightened risk aversion.

Concerns for Latin America. The unusual intensity of these favorable external conditions is conducive to a buildup of vulnerabilities and heightened risks of reversals. These conditions can mask underlying fragilities in external, financial, and fiscal accounts, and bring complacency and exuberance. Risks of demand booms, large current account deficits, and excess financial intermediation are concerns of first order, compared to Dutch disease concerns. Current accounts in LA, already in deficit, can rapidly move to vulnerable positions as domestic demand tends to react exuberantly to easy external financing conditions and strong terms of trade. The financial sector is susceptible to playing an amplifying role in credit and asset bubbles and excess absorption, and can seriously exacerbate problems when capital inflows reverse or terms of trade decline. The risks from financial vulnerabilities and excess current account deficits interact and reinforce each other, compounding the difficulties countries may face when tailwinds turn to headwinds.

Building the policy response. A set of policies is needed to contain the risk of boom-bust cycles. The region's flexible exchange rates should play a key role in dampening incentives for capital inflows and currency mismatches while also facilitating warranted equilibrium appreciations; foreign exchange intervention should avoid playing an early role and resisting fundamental shifts. Fiscal policy needs at least to be acyclical, undoing recent stimuli and saving temporary revenue gains. Always-desirable macroprudential policies should continue being developed and intensified, with the focus on segments prone to bubbles, to contain financial vulnerabilities and reduce credit procyclicality. But even with sound macroprudential policies, private sector exuberance and excess current account deficits can happen as corporates bypass domestic financial institutions. In the current exceptional global setting, to avoid excessive risk from large current account deficits, the temporary use of capital account restrictions on macroeconomic stability grounds could be considered, but adjustments in macroeconomic policies are a key first priority. As long as such restrictions are not used to substitute for such adjustments, their temporary use in financially-open LA can be viewed as a prudent move to prevent boom-busts, thereby contributing to global financial stability.

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I. INTRODUCTION

Latin American economies today are at a challenging juncture as key global conditions have aligned in very exceptional ways, representing a double tailwind for many countries of the region. These countries must figure out how to best respond to a sustained period of unusually easy foreign financing conditions and large capital inflows. At the same time, they face high world prices for their commodity exports—another source of abundance that is likely to be persistent but not permanent. Such conditions are, of course, in many ways favorable, creating opportunities with important upsides. But such conditions can also lead to an accumulation of important vulnerabilities for the future. There are challenges both while these conditions persist and during the transition after they end because severe dislocations and crises may arise if the good times are improperly managed. Indeed, some of Latin America's own past experiences with the "problems of plenty" have illustrated that good times can be followed by bad endings.

Indeed, one key concern in Latin America (LA) should be that the double tailwinds of easy money and high commodity prices may lead to financial exuberance and external vulnerabilities, heightening the risks of costly sudden reversals. Past experience has showcased how both market and regulatory failures can lead to excess absorption and accumulation of risks in private balance sheets. Moreover, the external current accounts in Latin America have shown in the past a significant propensity to overshoot under similar conditions.

Relative to the past, many LA countries today have better policy frameworks, a development that reduces the chances of excesses and risks and thereby makes them more attractive to foreign capital. Improved fundamentals in the region likely have brought a permanent shift in investors' portfolio allocations. At the same time, they reduce the vulnerabilities associated with larger capital inflows. Especially relevant is the greater degree of exchange rate flexibility accompanied by relatively successful inflation targeting frameworks as an alternative nominal anchor. Bank supervision has progressed greatly in controlling currency mismatches, at least on banks' balance sheets. In some cases, the degree of fiscal policy procyclicality has been reduced. Moreover, the level of public debt has been brought down considerably, reducing vulnerabilities in general.

The problem that Latin America now faces from external factors is on a scale of uncharted dimensions. First, the global setting implies that the region has unusually ample access to cheap foreign financing—a combination of persistently very low interest rates in advanced countries and higher risk tolerance from international investors—while at the same time some countries outside the region have policies in place that represent strong barriers to capital inflows and wider current account deficits. Second, strong growth in Asia, coupled with supply constraints, has sustained high commodity prices, bringing terms of trade for LA commodity exporters that are unusually favorable but unlikely to be fully sustained. (These global conditions are discussed more fully in the following section.)

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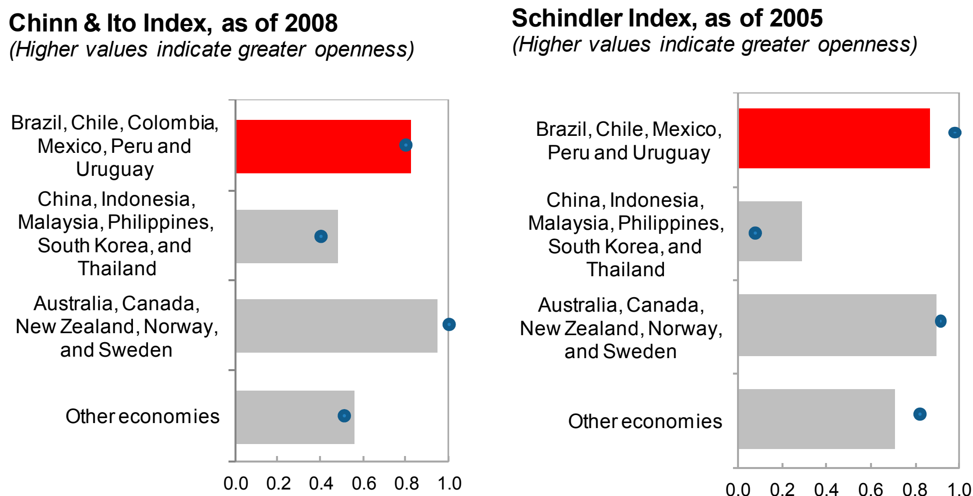
It is essential to recognize that key characteristics of LA countries today make the challenges and policy discussions different from many EM countries of other regions. This note emphasizes especially the larger economies of LA, those which in general are characterized by a high degree of financial integration with the global market and by having important commodity exporting sectors. These LA countries have open capital accounts (see Figure 1 for a comparison with other regions) and most have highly flexible exchange rate regimes. Many of them have fiscal policy rules to ensure debt sustainability. Crucially, these countries normally have external current accounts that are in deficit (and in fact already have deteriorated, notwithstanding the boost from commodity revenues). Much of this stands in sharp contrast with the situation of a number of Asian economies today, with their current account surpluses, less flexible exchange rates and more aggressive foreign exchange market intervention policies, and less open capital accounts.

While there is increasing agreement about the broad contours of policy responses to episodes of surging capital inflows to emerging economies (see IMF, 2011, Ostry et al, 2010, and Ostry et al, 2011), this note differs in being focused on the particular situation of LA today, incorporating also the commodity boom challenge and LA's structural characteristics. It seeks to address for LA in particular the rationale, nature, and sequencing of the policy response. What is known as the "capital inflows problem" in fact encompasses a variety of problems and issues, including drivers, distortions, and associated vulnerabilities, which have important tradeoffs. To help with the policy judgments that are required, this note seeks to organize the main issues and challenges that LA faces at this juncture and to discuss the effects of alternative responses.

Figure 1. Capital Account Openness of Latin America and Other Regions

Capital accounts tend to be relatively open in Latin America.



Note: Bars correspond to means and dots to medians of each country group.
Source: Chinn & Ito, 2009; and Schindler, 2009. Indices have been rescaled to facilitate comparison.

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