“Monetary and Fiscal Policy Challenges in Latin America”
Comments

Liliana Rojas-Suarez

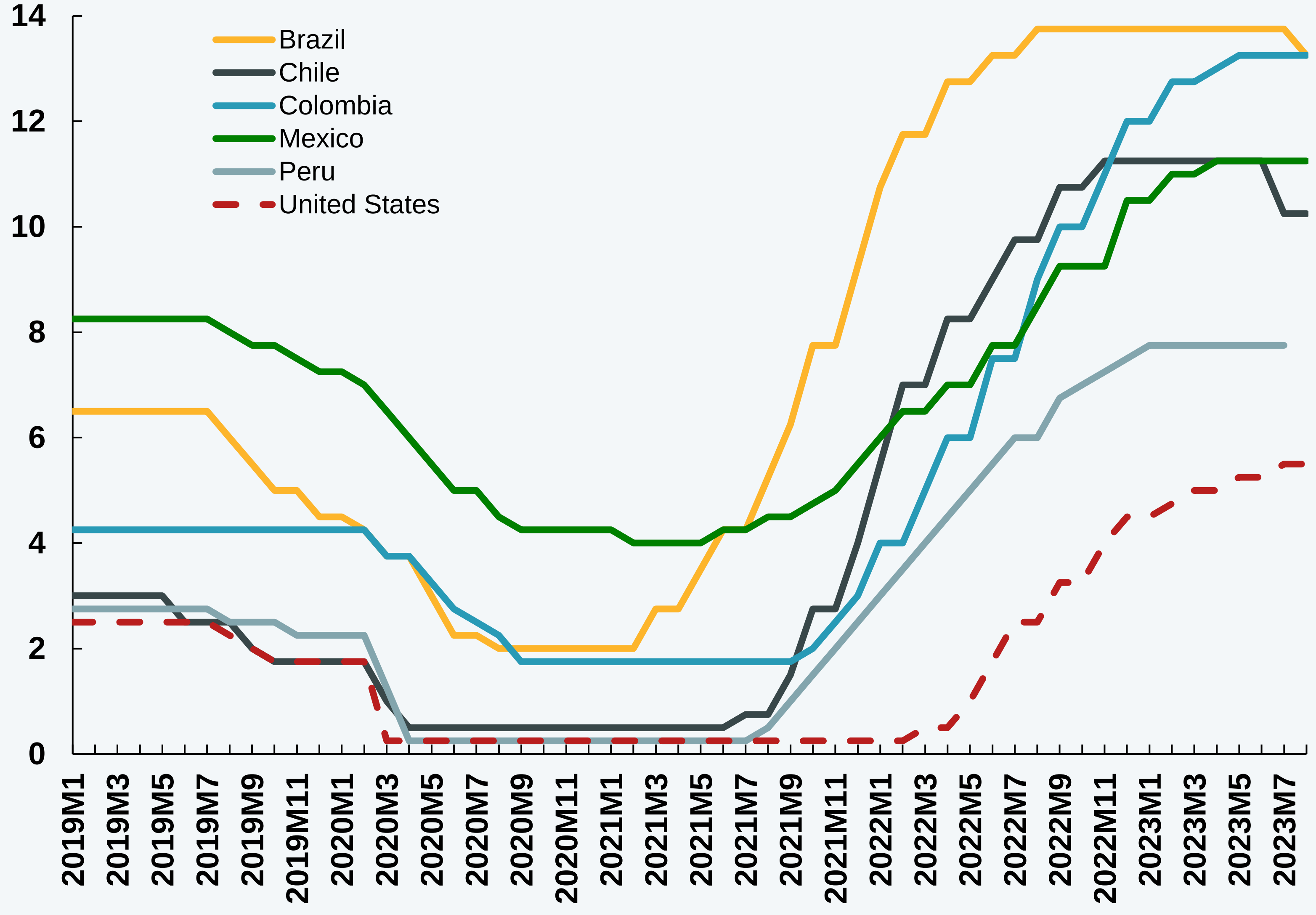
In assessing Macroeconomic Challenges

- Large country heterogeneity
- Significant differences in soundness between Monetary Policy and Fiscal Policy
- But an important similarity in many countries: Disappointing medium and long-term economic growth

Appropriate Monetary Policy

- **In contrast to advanced economies**, based on their inflation-targeting regimes, many central banks quickly reacted by increasing interest rates in 2021 (way before the war in Ukraine) in an effort to revert their expansionary monetary policies at the beginning of the pandemic.

- These countries held large stocks of reserves and their **central banks remained independent.**



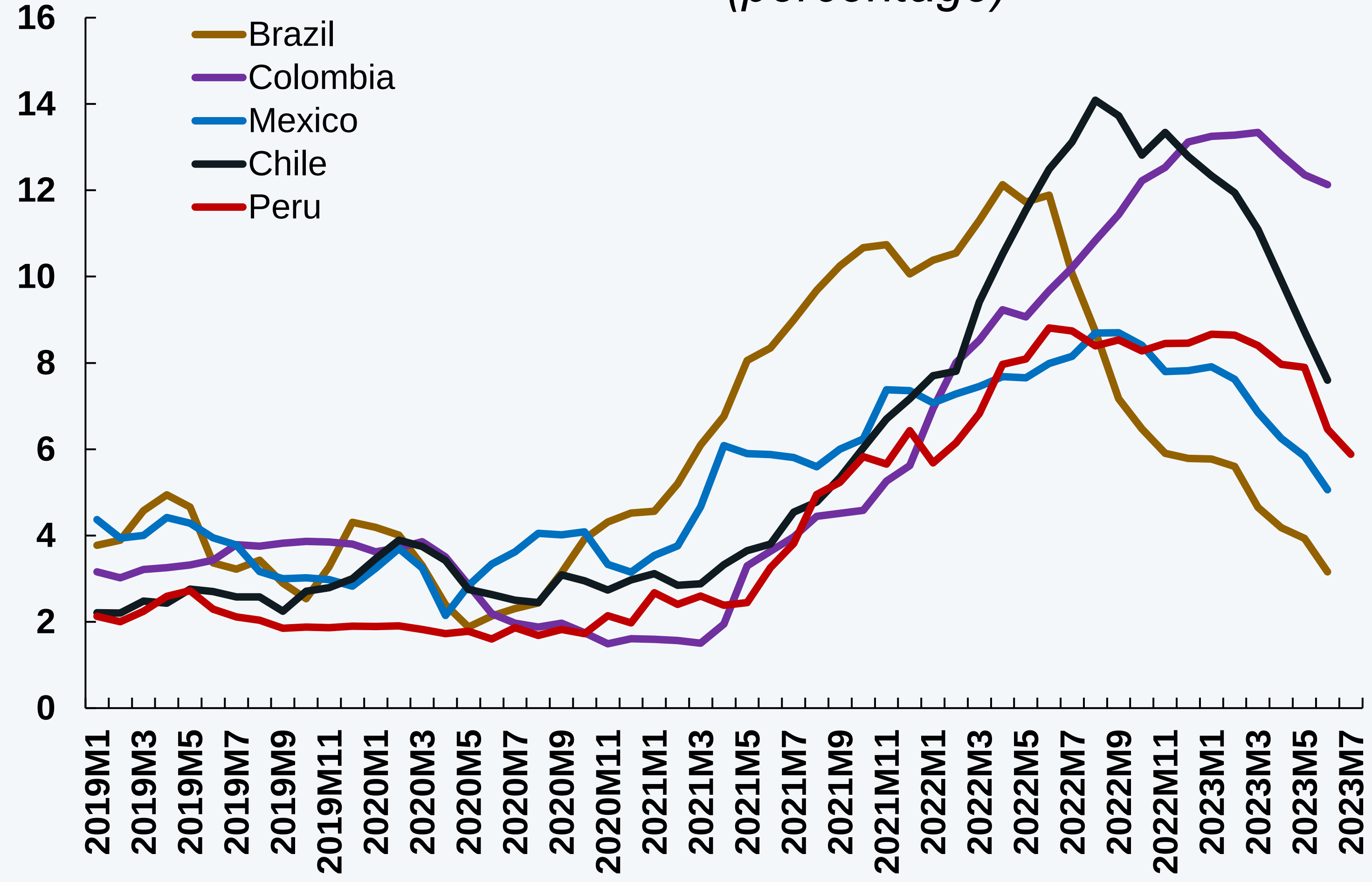
Source: Central banks

Appropriate Monetary Policy

Inflation is declining (although at different pace between countries).

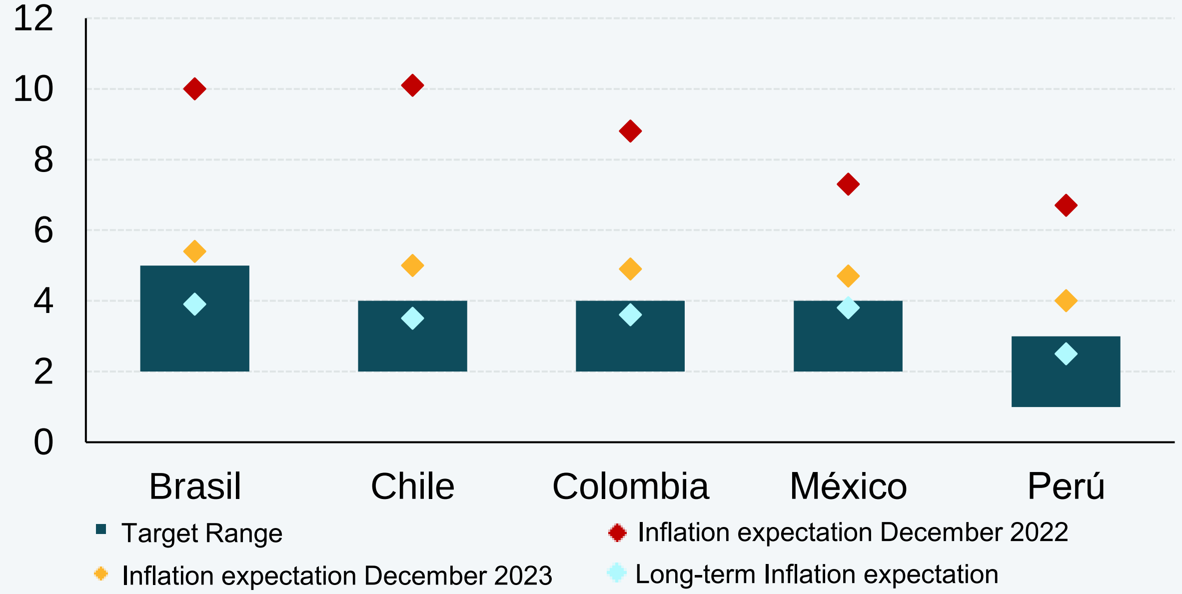
Most importantly, **expectations never de-anchored** during this episode confirming central bank independence.

Inflation in Latin America
(percentage)

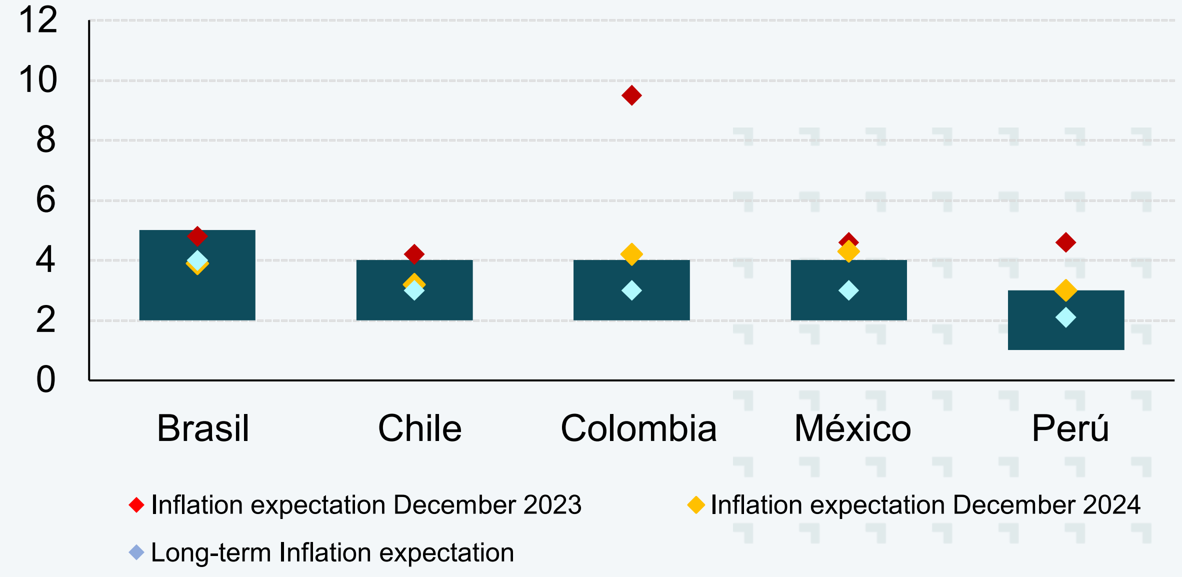


Source: IFS-IMF

Inflation Expectations (July 2022, percentages)



Inflation Expectations (July 2023, percentage)

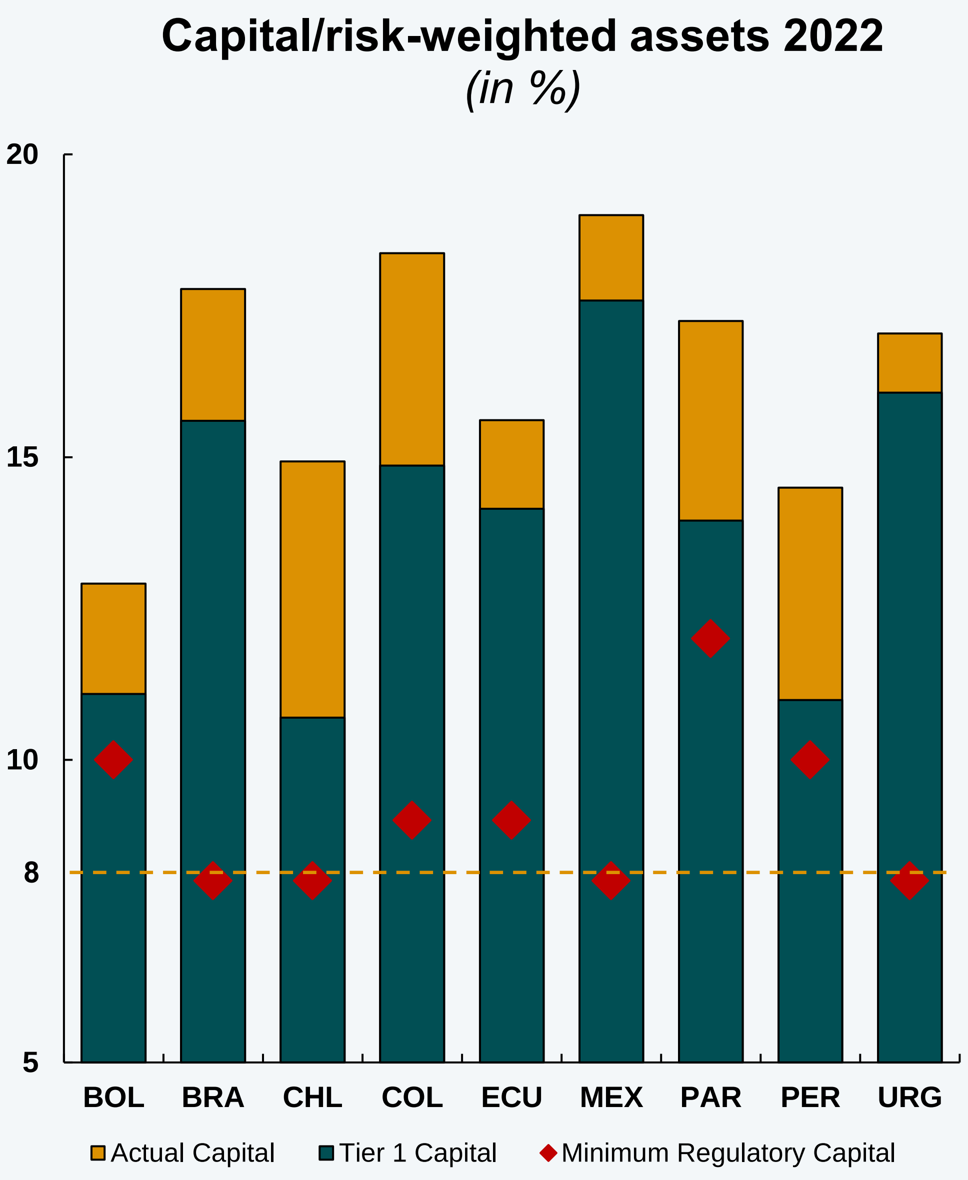


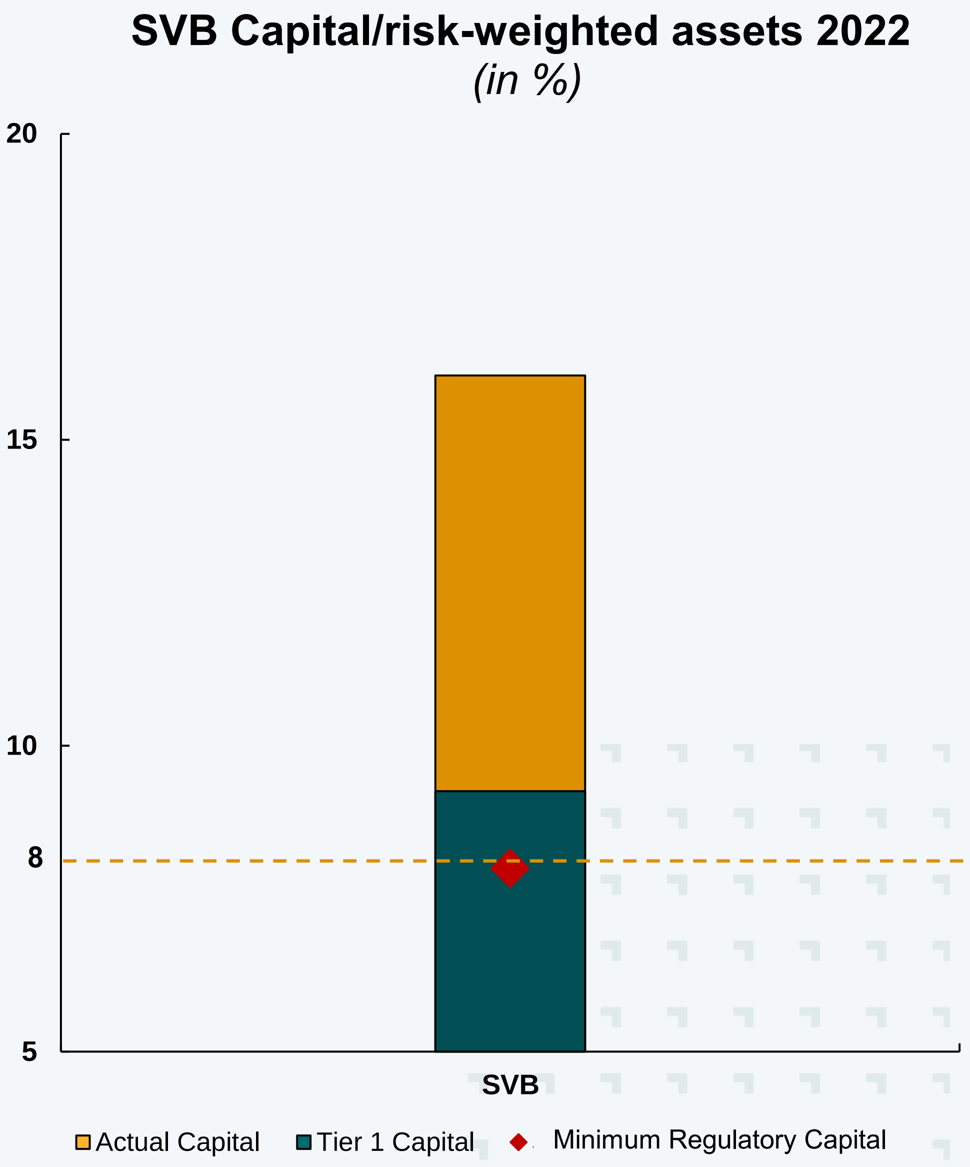
Source: Central Bank of Spain and Consensus Forecast

Financial System Fragilities?

- The fall of Silicon Valley Bank is a reminder of how fragilities in the financial system can hinder the successful implementation of monetary policy
  - ➢ As evidenced by the deceleration of the Fed's interest rate hikes following the emergence of problems in the banking sector last March.
- How strong are financial systems in Latin America?
  - ➢ Traditional ratios show strong capitalization that did not weaken during the pandemic…
  - ➢ …But so did Silicon Valley Bank

Sources: IMF, FSI and SVB



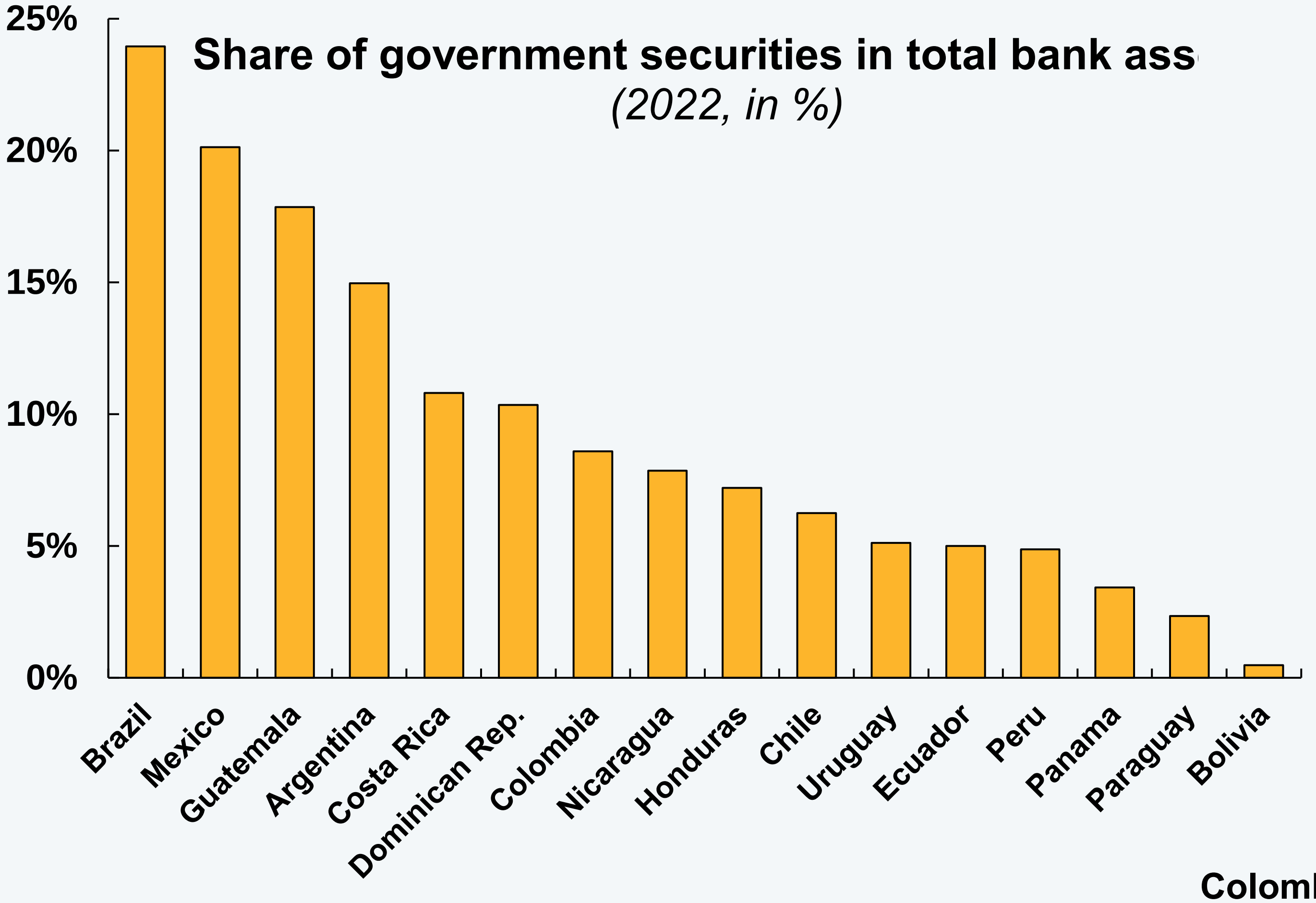


Financial System Fragilities?

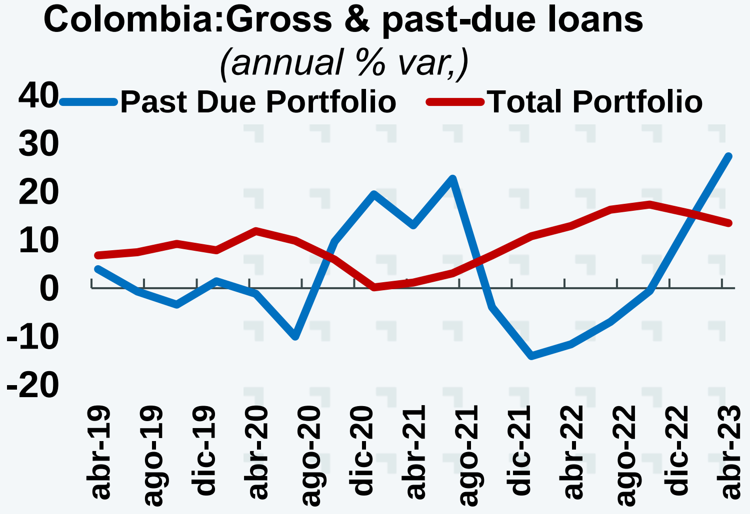
- Regulatory deficiencies (assets qualifying as capital), weak supervision and bad management are at the core of banking problems.
- In the context of:
  - ➢ Several banking systems with large holdings of government paper
  - ➢ uncertainties about interest rates (global and local)

Key questions:

- Are banks adequately covering for risks, including hedging market risks?
- Are banking supervisors conducting stress tests needed to assess whether banks can withstand large and unanticipated deposit withdrawals?



Source: IMF-IFS



Financial Superintendence of Colombia
Calculations of Grupo Bacolombia

The good news is that in some countries recent stress tests show strong banking systems (e.g. Brazil, Peru). In others, however, some indicators of financial strength have weakened.

Financial System Fragilities?

Since financial crises may occur/start in non-bank segments of the financial system

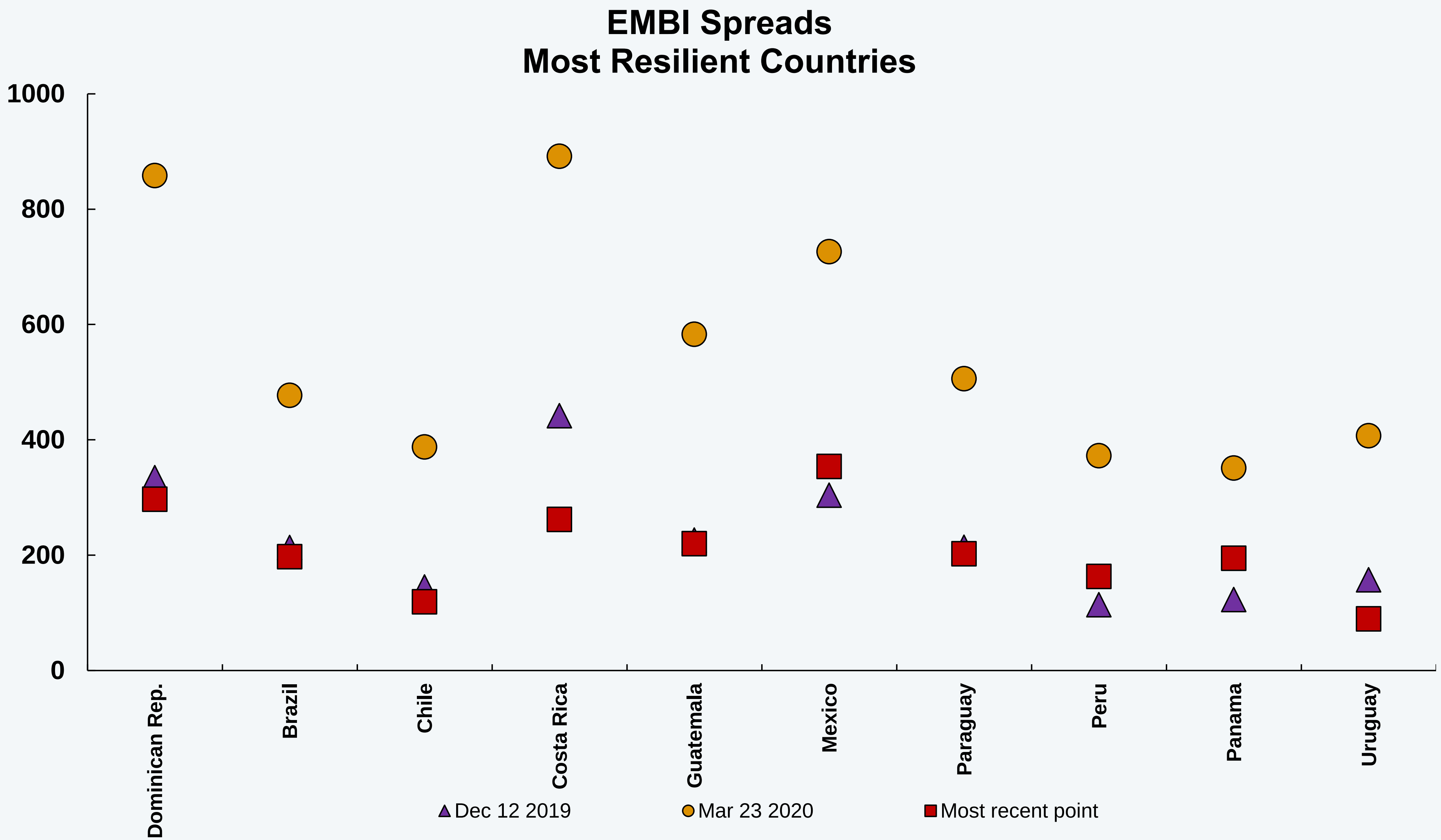
A red flag to look out for: Segments in the financial system that are:

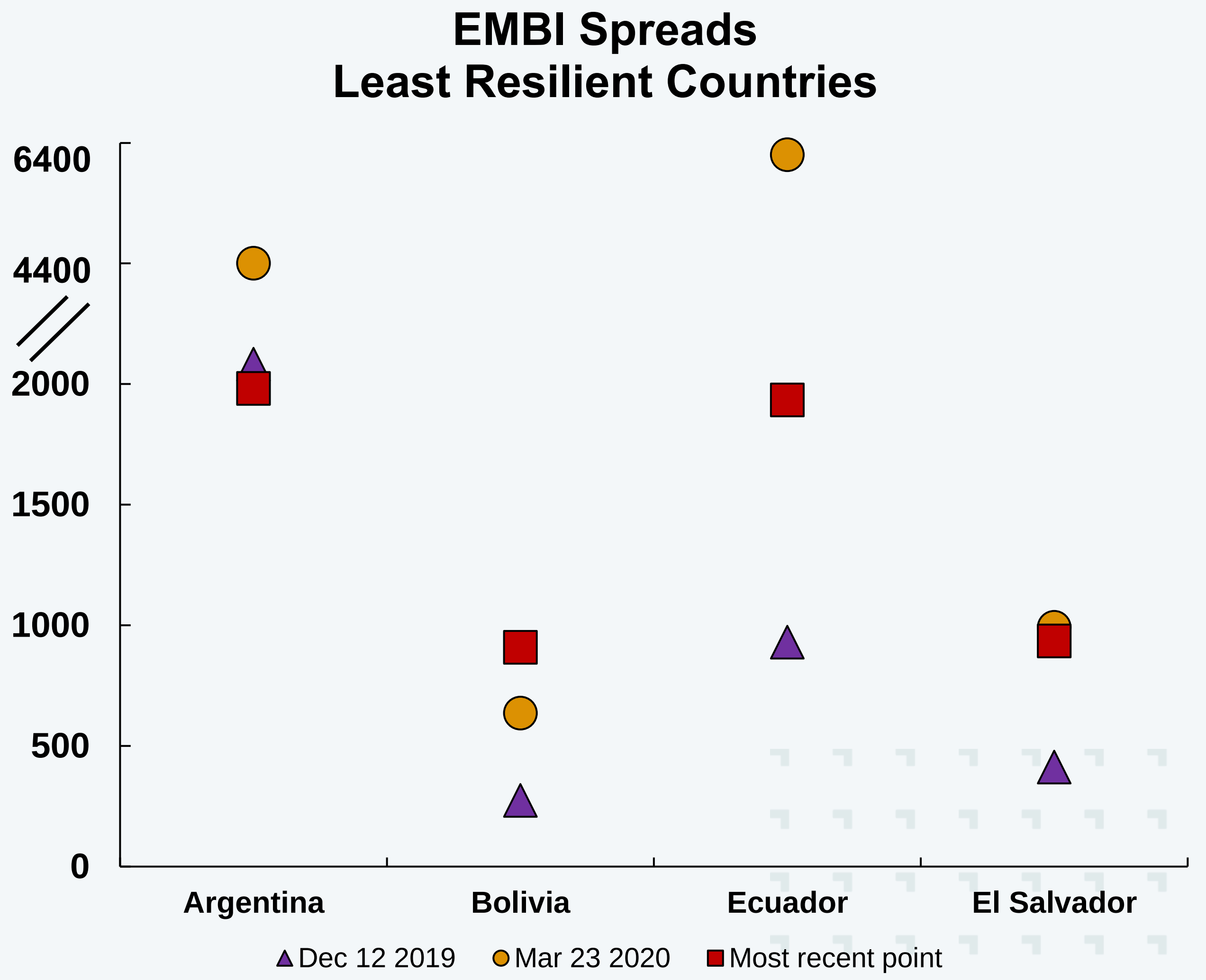
- Subject to lower regulatory requirements than banks
- Experiencing fast asset growth
  - ➢Reflecting regulatory arbitrage

In some Latin American countries, non-bank financial institutions (such as credit unions in Ecuador) can be the Achilles tendon of financial stability.

Vulnerabilities to capital market differ between countries

- All countries experienced significant increases in their external financing costs following the global shocks that started with Covid-19, but some were more resilient than others.

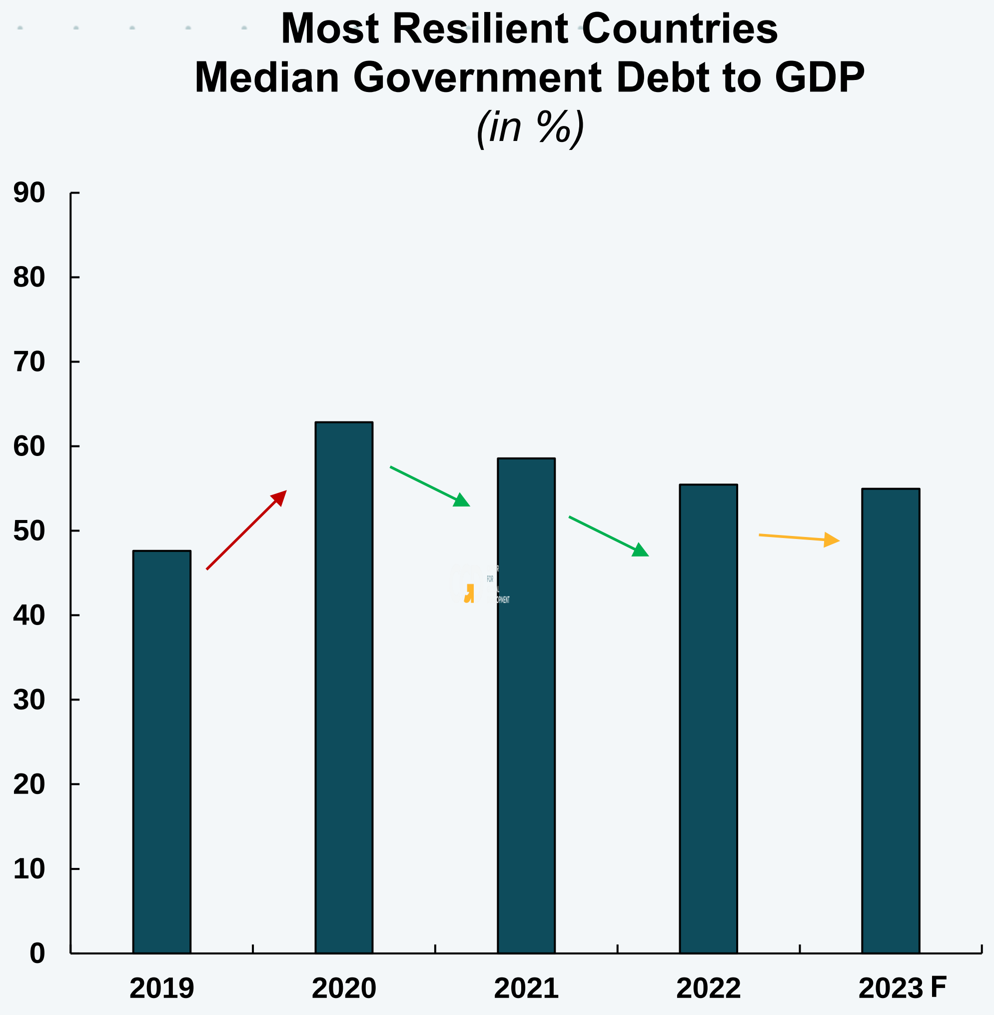


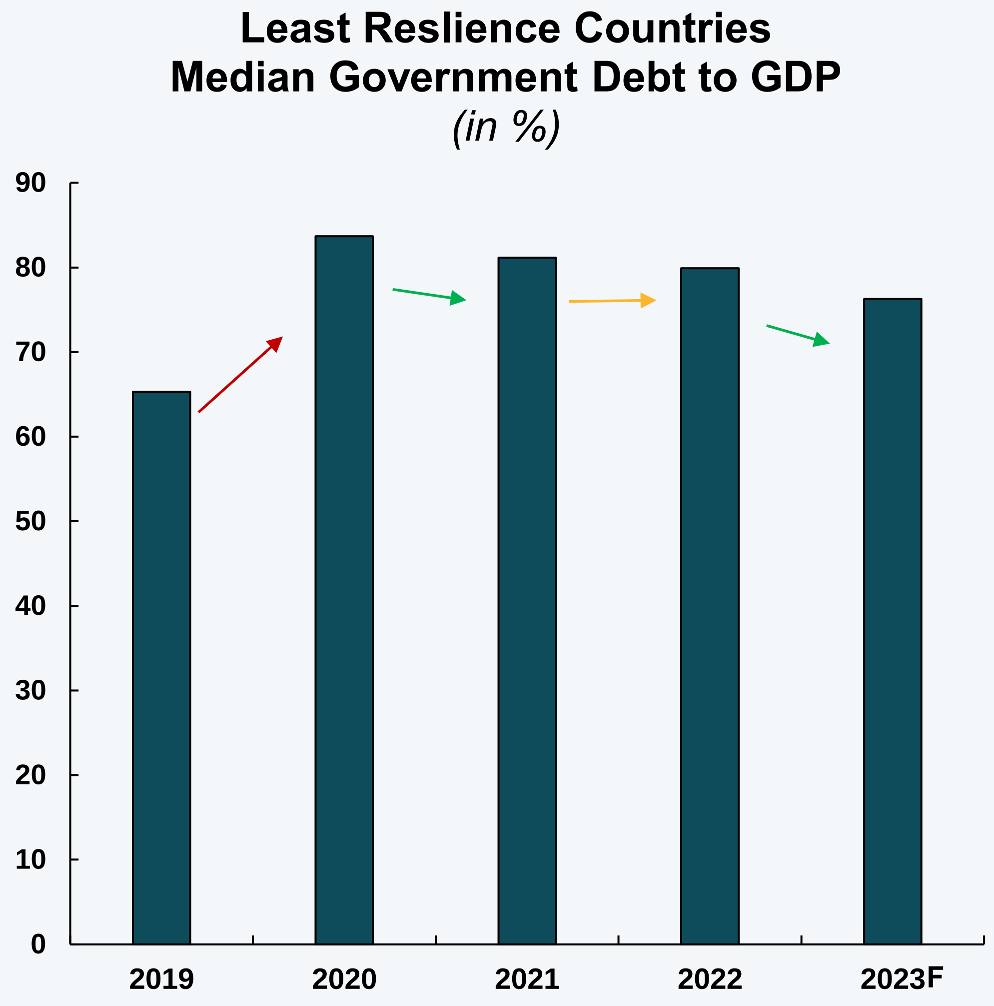


Sovereign bond spreads are back to pre-pandemic levels in some countries, but remain quite elevated in others

Vulnerabilities to capital market volatility reflect fiscal imbalances

A common characteristic of the least resilient group of countries is their high and persistent ratios of government debt





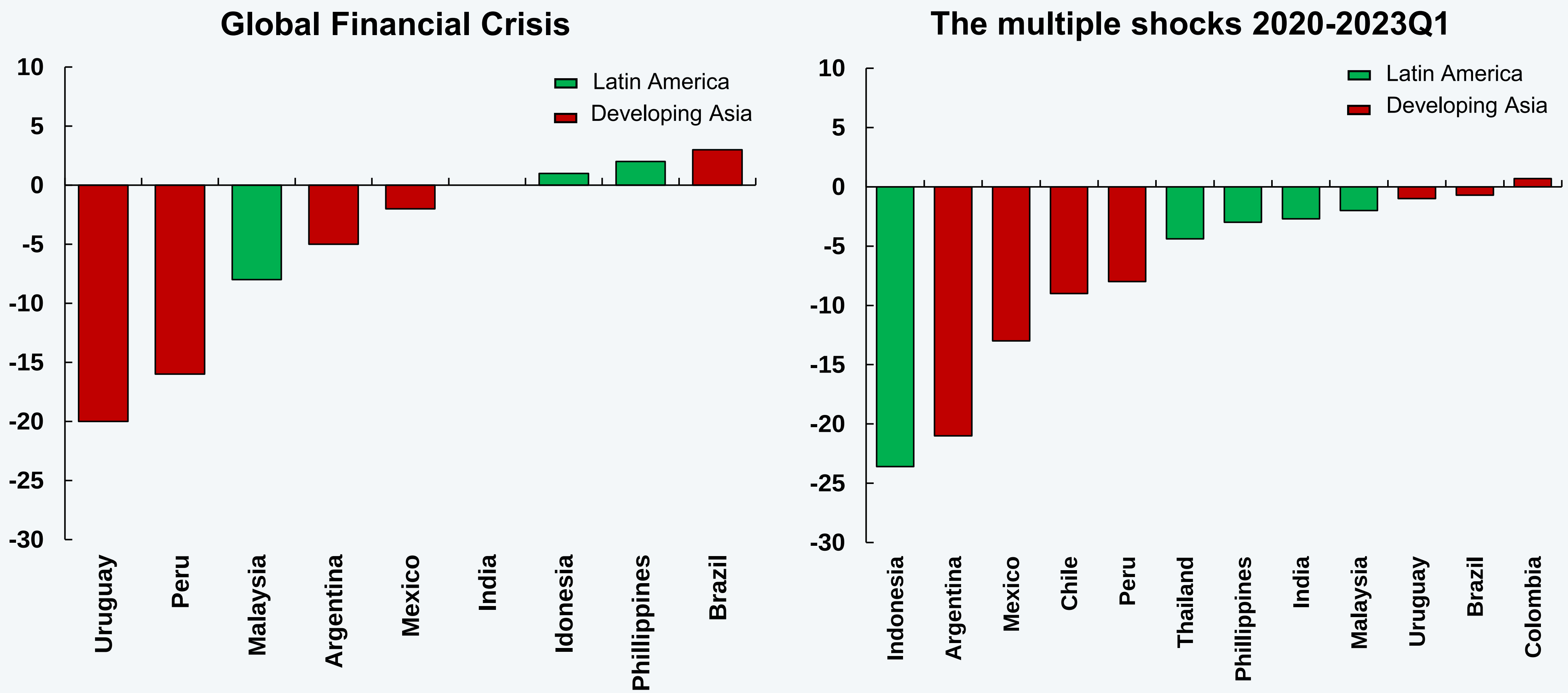
- Debt ratios in the pre-Covid period were larger in the least resilient countries.
- The ratios increased in all countries during the pandemic but have been declining since 2021 in the most resilient countries. They .remains quite elevated in the least resilient countries.

Vulnerabilities to capital market volatility: Structural problems

1. Local-currency government bonds are not panacea

Despite the advantages of significant participation of foreigners in local-currency government debt markets (by increasing liquidity, contributes to lower interest rates), foreign investors tend to reduce their holdings of these bonds in times of crises (original-sin redux)

Change in Foreign Participation in Local-Currency Sovereign Bonds during crises (percentage points)



Source: IIF and updates of Arslanalp and Tsuda (2014)

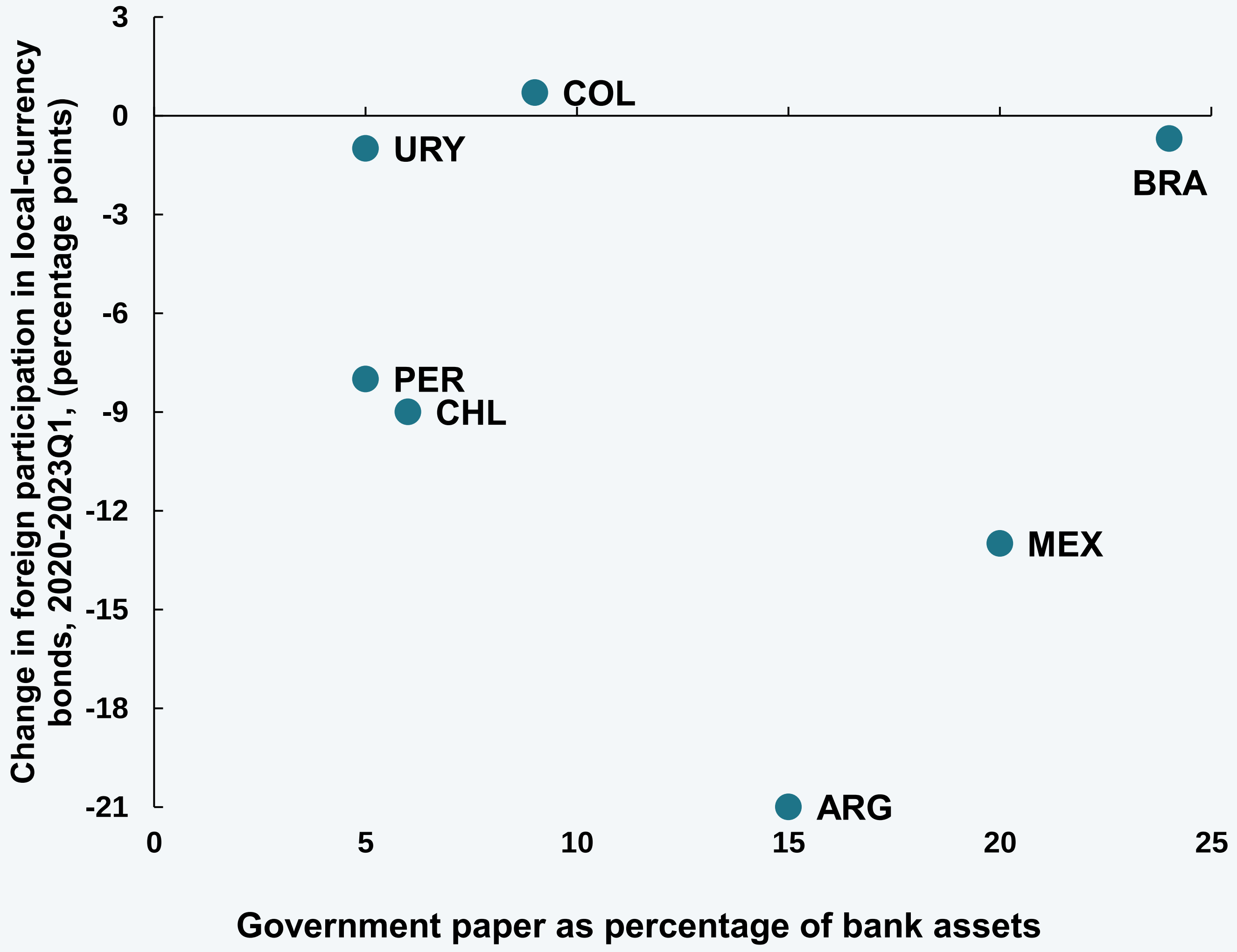
- Generally, this is more pronounced in Latin America than in Asia.

Vulnerabilities to capital market volatility: Structural problems

1. Local-currency government bonds are not panacea

A source of banking system fragility may arise in countries where:

- Government bonds represent a substantial amount of their assets and
- Foreigners significantly decrease their participation in local-currency bonds in times of financial stress

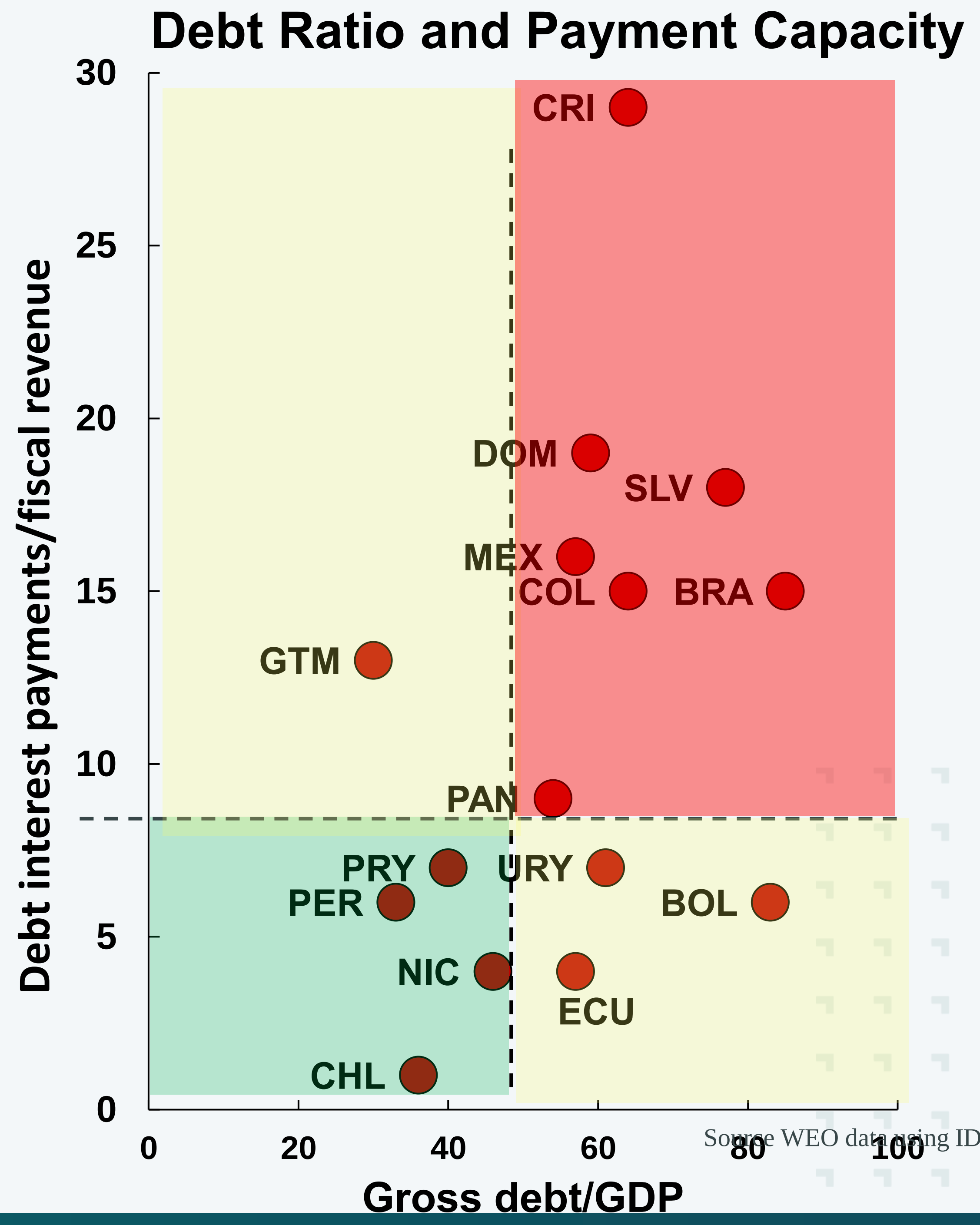


Vulnerabilities to capital market volatility: Structural problems

2. Low ratios of fiscal revenue constrain the levels of "safe" debt

- Several countries are in a high-risk position

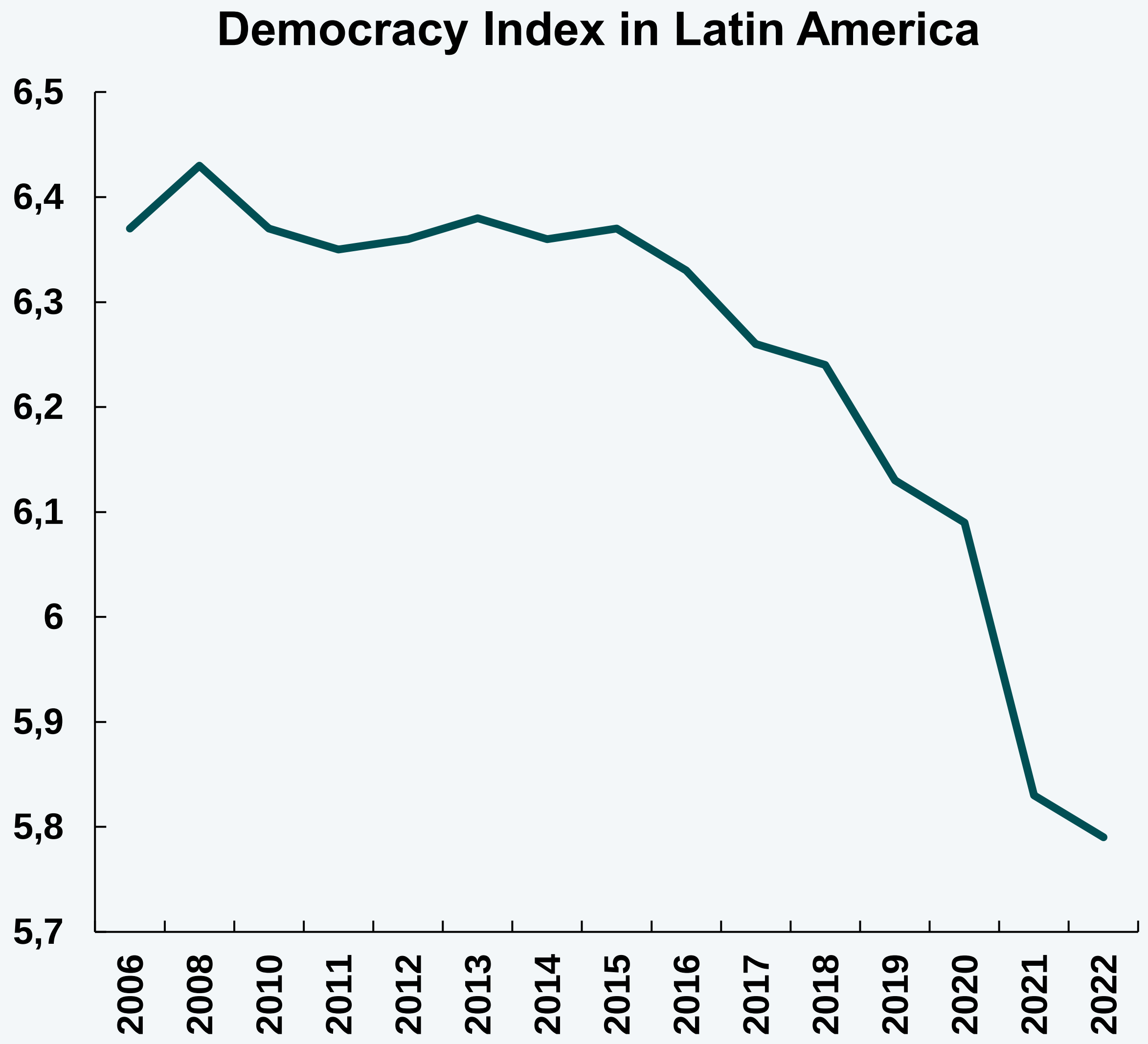
- Greater efforts to increase fiscal revenues would allow countries to carry larger stock of debt without compromising sustainability.



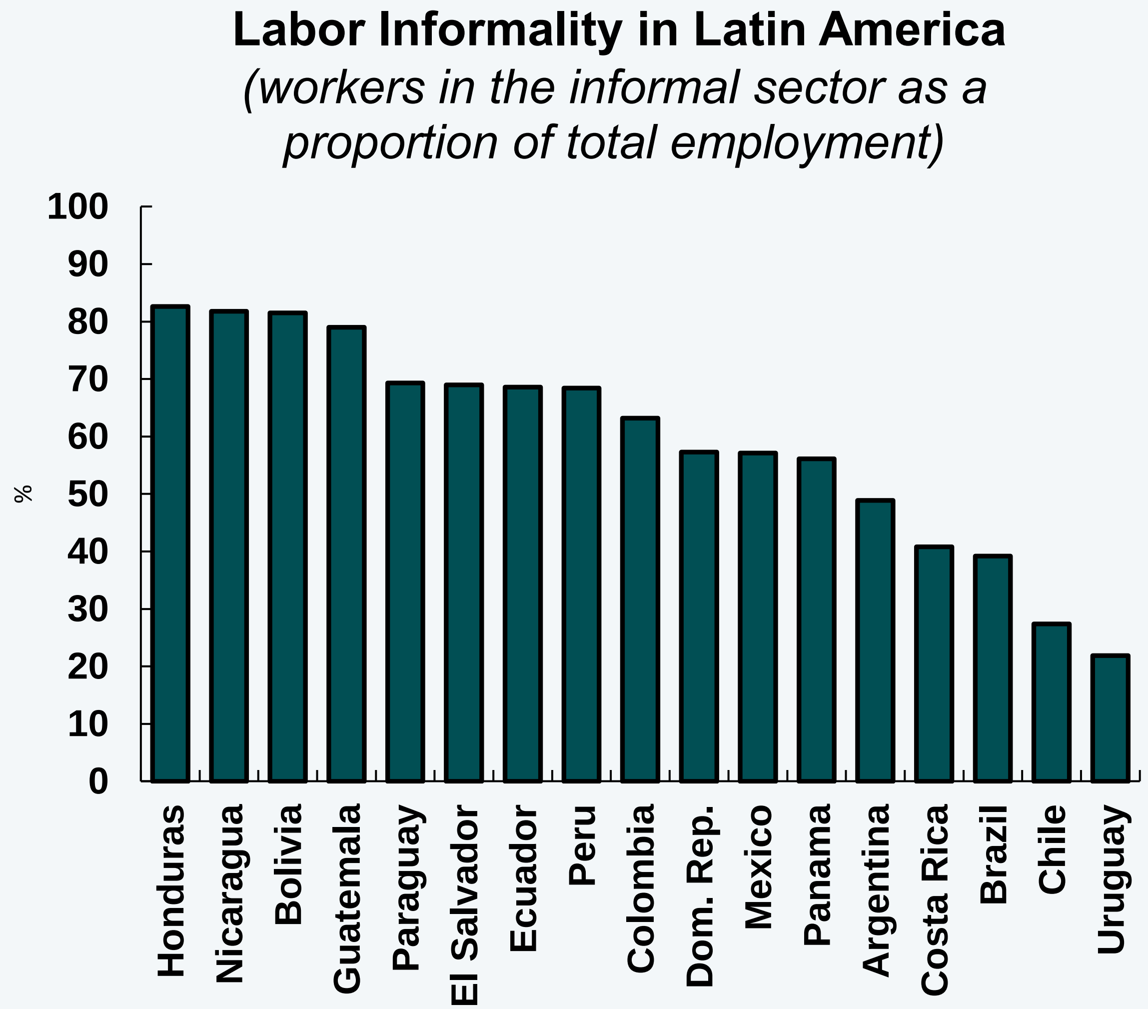
Source WEO data using IDB methodology (2023)

Beyond Macroeconomics Policies

And here we have come a full circle since it's hard to see improved ratios of fiscal revenue with stagnant rates of growth, which is structurally affected by low and decreasing institutional quality and high levels of informality



Source: Latinobarometro and The Economist



Source: ILOSTAT