TOWARD A FLAR WITH A REGIONAL OUTREACH

REPORT OF THE WORKING GROUP ON REGIONAL FINANCIAL STABILITY

October | 2019

Authors

Vittorio Corbo | Augusto de la Torre | Enrique García
Pablo Guidotti | Carlos Geraldo Langoni
Eduardo Levy-Yeyati | Guillermo Ortiz | Guillermo Perry
Liliana Rojas-Suárez | Andrés Velasco

Coordinator

Guillermo Perry | (R.I.P.)

REGIONAL FINANCIAL SAFETY NET WORKING GROUP MEMBERSL

Vittorio Corbo

President of Vittorio Corbo y Asociados. He served as President of the Central Bank of Chile, Professor of Economics in Canada, USA and Chile, World Bank executive, Consultant for the Inter-American Development Bank, the International Monetary Fund and the development agencies of several countries. In the private field, among other boards of directors, he was Director of Banco Santander S.A. in Madrid, Spain.

Augusto de la Torre

Professor at Columbia University in New York and Director of the Economic Research Center of the Universidad de las Américas in Quito, Ecuador. He served as Chief Economist for Latin America and the Caribbean at the World Bank. He was President of the Central Bank of Ecuador and Economist at the IMF.

Enrique García

International consultant and advisor, member of several Boards of Directors and visiting professor at the international level. He served as Executive President of CAF - Development Bank of Latin America for 25 years and as IDB officer for 17 years, where he was its Treasurer. In Bolivia, he was Minister of Planning and Coordination and Head of the Economic and Social Cabinet (1989-1991). Previously, he served as Under-Secretary for the Ministry of Planning and Coordination and as a member of the Board of Directors of the Central Bank of Bolivia.

Pablo Guidotti

He is Tenured Professor at the School of Government of the Universidad Torcuato Di Tella, founding member of the Latin American Committee on Macroeconomic and Financial Issues (CLAAF), and Regular Member of the National Academy of Economic Sciences of Argentina. He served as Vice Minister of Economy of Argentina, Second Vice President and Director at the Central Bank of the Republic of Argentina.

Carlos Geraldo Langoni

PhD in Economics from the University of Chicago. Former President of the Central Bank of Brazil (1980-1983). Currently, CEO and partner of the Economics Consultancy Project and Director of the World Economics Center of the Getulio Vargas Foundation.

Eduardo Levy-Yeyati

Dean of the School of Government of the Universidad Torcuato Di Tella and Visiting Professor at Harvard University. He served as Chief Researcher for Latin America and for Emerging Market Strategy at Barclays Capital, as Financial Advisor at the World Bank for Latin America, and as Chief Economist of the Central Bank of the Republic of Argentina.

Guillermo Ortiz

Currently a partner and advisor of BTG Pactual, President of the Per Jacobsson Foundation, member of the Grupo of Thirty and other international bodies. He served as Secretary of Finance and Public Credit in Mexico and as Governor of the Bank of Mexico. He was also President of the Board of Directors of the Bank for International Settlements.

Guillermo Perry (Coordinador)

He served as Minister of Finance and Public Credit, Minister of Mines and Energy and Director of Fedesarrollo, in Colombia. Distinguished Professor of the School of Economics of the Universidad de Los Andes and Non-Resident Fellow at the Centre for Global Development. Furthermore, he served as Chief Economist for Latin America and the Caribbean at the World Bank between 1996 and 2007, and was visiting professor at the universities of Oxford, Harvard (Kennedy School) and Firenze.

Liliana Rojas-Suárez

Liliana Rojas-Suárez is the Director of the Latin American Initiative and Senior Fellow at the Center for Global Development. She is also the Chair of the Latin American Committee on Macroeconomic and Financial Issues (CLAAF) and Professor at Columbia University. She served as Managing Director and Chief Economist for Latin America at Deutsche Bank and held senior positions at the International Monetary Fund and the Inter-American Development Bank.

Andrés Velasco

Dean of the School of Public Policy at the London School of Economics. He has been a Professor at the universities of Harvard, Columbia and New York. He served as Minister of Finance in Chile.

IN MEMORIAM
Guillermo Perry Rubio

As soon as the Latin American Reserve Fund (FLAR) decided to convene a Working Group of experts to discuss how to strengthen financial stability in Latin America, it was clear that the delicate duty of coordinating it should be assigned to an economist of exceptional academic and personal qualities. Luckily for us, Guillermo Perry accepted the challenge and devoted himself to carry out the project with the dedication and rigor that always characterized him.

Perry's successful career in various entities of the Colombian state, multilateral banking and academia led his peers, both at home as well as internationally, to recognize his vast knowledge, his skills as a policymaker, and his multiple intellectual and humane gifts. All this was confirmed, as fully expected, in his work as coordinator of the group brought together by FLAR.

The report now being published by FLAR was reviewed by Guillermo two days before his unexpected passing. Together with the members of the Working Group, I want to state the most heartfelt acknowledgment for this brilliant Latin American economist, and we want to underscore the professional excellence of his collaboration with us.

José Darío Uribe
Executive President
Latin American Reserve Fund

PREFACE

This report was prepared by a Working Group convened by the FLAR to review structural and circumstantial financial stability problems in Latin America and, in particular, to analyze to what extent a sound regional financing arrangement could contribute toward strengthening the region's Financial Safety Net.

The Working Group considered the issue by reviewing and using the academic and public policy documents available on this regard.[1] FLAR's technical team provided support for the discussions with information and documents on specific topics.[2]

We agreed with FLAR's management that the purpose would not just be to produce an expert report, but rather to promote a reflection process on the subject by the authorities and the public opinion in the region. For this purpose, the invitation extended by Alejandro Werner, Director of the Western Hemisphere Department of the International Monetary Fund, to the Executive President of FLAR to present a preview of the group's tentative conclusions at the official breakfast with the governors of South America and Mexico on April 13, 2019, was particularly useful. This presentation took place in the context of the spring meetings of that institution. The opportunity was also used to gather opinions and suggestions on the subject and, in particular, reactions to the group's initial proposals.

With those same purposes, FLAR Executive President and some group members conducted preliminary bilateral consultations with authorities in the region, especially those that are not currently FLAR members, during the spring meetings of the IMF and the World Bank and the meeting of the CEMLA Assembly in Cartagena, Colombia, in April 2019. Likewise, group members and FLAR Executive President held discussions on the matter with the presidents and other senior officers of the Development Bank of Latin America - CAF and the IDB.

The insights and suggestions of the regional authorities greatly enriched the group's discussions and the content of this report, which we hope will be useful in fostering collective decisions leading to Latin America's financial stability.

---

1 In particular, the G20 communiqués, the publications of the International Monetary Fund and of the existing Regional Financial Arrangements, the G20 Group of Eminent Persons Report (October 2018), the CLAAF statement (December 2012) and the collection of articles in the book Toward a Regional Monetary Fund, published on occasion of the 35th Anniversary of FLAR (December 2014).

2 We wish to expressly acknowledge the diligence and competence with which this team met our requests; without their help, it would have been impossible to successfully conclude the task entrusted to us.

I. Introduction

Over the past forty years, Latin American nations have experienced a great number of financial and exchange crises, which have slowed their economic development and caused considerable suffering to their citizens, particularly the poorest and most vulnerable. Similar situations have been seen in other parts of the world, but the frequency and economic and social impact of these events have been particularly high in our region.[3]

The high cost of the crises has led countries, both developed and developing, to adopt and strengthen institutions and policies to reduce and mitigate the macrofinancial vulnerabilities of their economies.[4] However, even countries that have significantly strengthened their institutions and their economy, and which showed reasonably sound solvency indexes, have been severely affected by disturbances in the financial markets or by the crises of their neighbors and trading partners. This evidence has led the international community to focus on the systemic and economic contagion risks that cause concurrent crises in several countries, to design and strengthen financial safety nets to reduce the likelihood, depth and persistence of these events and, therefore, their high economic and social costs.

Particularly, since the so called Global Financial Crisis (2007/2009), the international community has reached a consensus on the need to strengthen the main components of the financial safety net: the global net, focused on the International Monetary Fund; the regional nets, represented by financing arrangements such as FLAR; and at the national level, based on the accumulation of international reserves. Likewise, it has underscored the urgency of improving coordination among these three elements and the domestic macrofinancial policies (including the so called macroprudential), aimed at ensuring greater effectiveness in fulfilling the tasks of crisis prevention and mitigation.[5]

This report concludes that it is necessary, convenient and urgent to establish a sound financing arrangement with a regional outreach in Latin America. Specifically, a regional reserve fund that effectively complements both the countries' access to International Monetary Fund resources, as well as the individual policies of international reserves accumulation and use and, of course, the practical implementation of appropriate macrofinancial and prudential policies by each member country.

The report points out how such a fund would be of great use, both for small and medium-sized economies in the region as well as for the largest ones. In fact, a strengthened FLAR with a regional outreach, in becoming an additional source of liquidity and fast access for each of its members (which is particularly important in the early stages of a crisis), would

3 On the costs of crises, see, among others, Stiglitz (2000). What I learned at the world economic crisis; Cerra and Saxena (2008). Growth Dynamics: The Myth of Economic Recovery; Reinhart and Rogoff (2010). From Financial Crash to Debt Crisis; Reinhart and Kaminsky (1999) The Twin Crises: The Causes of Banking and Balance-of-Payments Problems.

4 Which may include countercyclical financial capital provisions or requirements and other measures to limit credit booms, the consideration of exchange rate imbalances discovered by borrowers in the credit risk ratings, limitations on the uncovered exchange rates of banks and other financial institutions, and the temporary adoption of capital controls on short-term capital inflows, among others.

5 See, for example, the report of the G20 Eminent Persons Group, which contains recommendations in this same vein. See https://www.globalfinancialgovernance.org

contribute to a greater financial stability throughout the region, with the ensuing benefit for the normal development of trade and migration flows among its members. In this manner, by complementing a financial architecture that has already achieved much withthe strengthening and growing relevance of two regional development banks (IDB and CAF), it would help in advancing the achievement of the goals of economic integration and cooperation that our countries have been pursuing for decades.

Latin America is way behind Europe and Asia on this important task. But, as the report points out, it has the capacity to move quickly because it has FLAR, an institution whose efficacy, even with a limited scope in the number of members and in terms of available resources, has already proven its usefulness for its members and enjoys a high risk rating and is widely respected in the financial markets and the international community.

For all these reasons, the Working Group's recommendation is that FLAR authorities should proceed to invite other countries in the region, in particular the largest and most advanced, to join this institution, hopefully simultaneously; likewise, supported on the positive experience of this institution, along with its current members and the entity's administration, to build a strengthened FLAR with a regional outreach which may contribute to more effectively and efficiently consolidate the regional financial stability.

II. Need and urgency of having a FLAR with a regional outreach

1. Need: main reasons of a structural nature

The authorities in the region are well aware of the importance of mitigating the impacts of the global or regional financial crises on their economies for the well-being of their citizens and the progress of their nations, and of preventing the occurrence of domestic crises or, at least, reducing the huge economic and social costs they have entailed in the past. For that reason, many countries in the region have implemented monetary, exchange rate, fiscal and financial policies that reduce the probability of crisis occurrence or allow its effects to be buffered, including the macroprudential policies we have referred to.

However, despite the progress made, there is still a long way to go. The Working Group believes that it is essential to make greater efforts to improve the quality of the macrofinancial institutions and policies, particularly in those countries with very high inflation levels, unsustainable fiscal or current account deficits, excessive public or external debt, or where a significant part of the financial sector is not subject to appropriate prudential regulation or supervision.

That said, and as evidenced in late 2008, the implementation of prudent macroeconomic and financial policies is a necessary but yet insufficient condition to overcome financial and external liquidity crises which, if unattended and left to their own fate, may lead to avoidable insolvency episodes.

This is because crises often arise (or are accelerated) by information or coordination failures, or by the presence of major externalities in international financial markets, generically called market failures. Such failures manifest themselves in the socially inefficient amplification of financial fluctuations, including excessive volatility and the procyclical behavior of capital flows, both gross and net; likewise, in "herd" behaviors and investor and lender "stampedes", particularly at times of sudden and massive changes in market sentiment (from exuberant optimism to panic and capital outflows). Hence the occurrence of "sudden stops" in capital inflows to a country, massive capital flights and financial contagion situations which may affect even solvent and properly managed economies.[6] (Charts 1 to 4, and Table 1).

For all this, a consensus has been reached among policy makers whereby, to reduce the risks of crises and to safeguard the macroeconomic and financial stability, there is the need to supplement the good domestic institutions and macrofinancial policies with an effective financial safety net, capable of offering adequate and timely crisis prevention and mitigation mechanisms.

To date, the FSN has relied mainly on access to International Monetary Fund (IMF) resources and on the international reserves accumulated by each country. (Chart 5)

However, resources and facilities available at the IMF are deemed insufficient in the event of some systemic crises, despite the insistent call from scholars and policymakers to turn it into a true lender of last resort who should play a role at the international level similar to that played in their economies by the central banks that enjoy credibility and maintain healthy currencies[7]. Additionally, the use of their resources may involve costly negotiations, except for those countries with access to contingent credit lines, as well as gradual disbursements. Furthermore, there are governments that, for ideological reasons, for stigma or negative signaling, refrain from resorting to IMF support in a timely manner.

In turn, the accumulation of large amounts of international reserves has a high financial cost and, while it is a protection mechanism that works as a deterrent, it can be less effective when liquidity crises unleash. In fact, there is a natural reluctance to use reserves in significant amounts amid adverse conditions, as this may lead to give a signal that may trigger or exacerbate a sudden reversal of net capital flows. Nevertheless, in view of the inadequacy of collective protective mechanisms of a global or regional nature, the authorities of many developing countries believe they have no other alternative than accumulating large amounts of international reserves to prevent or mitigate the impact of liquidity shocks originated internally or externally.

Simultaneously, other developing countries have not been able to accumulate significant amounts of reserves, or their authorities have chosen not to do so. As a result, in the current circumstances, international reserves are unequally distributed: they are abundant in some countries, but very insufficient in others. This is the case, particularly, in Latin America.

---

6 These phenomena have been extensively analyzed and documented by academia and multilateral and regional entities. See, among others, Velasco and Chang (1999). Liquidity Crises in Emerging Markets: Theory and Policy. NBER; Calvo, Reinhart and Leiderman, (1993), University Library of Munich: Capital Inflows and Real Exchange Rate Appreciation in Latin America: The Role of External Factors; Reinhardt and Rogoff (2010), NBER: From Financial Crash to Debt Crisis; Broner et al. (2011), University of Barcelona: Gross Capital Flows, Dynamics and Crises; Dornbusch, Goldfajn and Valdés (1995). Currency crises and Collapses. Brooking papers; Calvo, Izquierdo and Mejia (2008): Systemic Sudden Stops: The Relevance of Balance-Sheet Effects and Financial Integration; Calvo and Talvi (2005): Sudden Stop, Financial Factors and Economic Collapse in Latin America: Learning from Argentina and Chile; Pagliari and Hannan (2017), IMF: The Volatility of Capital Flows in Emerging Markets: Measures and Determinants; European Central Bank (2016): Dealing with large and volatile capital flows and the role of the IMF; Alberola, et al. (2015), BIS: International reserves and gross capital flow dynamics (on GFSN need and role of reserves); Ilhyock Shim and Kwanho Shin (2018), BIS: Financial stress in lender countries and capital outflows from emerging market economies; Izquierdo, Alejandro (2018), IDB: How vulnerable are the economies of Latin America and the Caribbean in the event of a sudden stop in capital flows? The Annex to this document reproduces evidence confirming the existence of these phenomena.

7 See Fischer, S. (1999): On the Need for an International Lender of Last Resort. The Journal of Economic Perspectives, 13(4), 85-104; Mishkin, F. (2000): The international lender of last resort: what are the issues? Prepared for the Conference: The World's New Financial Landscape: Challenges for Economic Policy. Kiel Institute of World Economics. International Financial; and Truman, E. (2010): The G-20 and International Financial Institution Governance. Peterson Institute for International Economics Working Paper 10-13.

In response to these limitations, as of the recent Global Financial Crisis, swap lines between central banks and Regional Financing Arrangements (RFAs) strongly grew. However, swap lines are limited to a few countries and their future availability is uncertain. RFAs, in turn, showed strong growth in the Eurozone[8] (European Stability Mechanism - ESM) and a more moderate growth in Asia (Chiang Mai's Initiative Multilateralization - CMIM) (Chart 6). In contrast, in Latin America (potentially exposed to a greater volatility because, unlike those regions, it does not have a reserve currency), the weaknesses of other elements of the financial safety net have not been mitigated by the growth of FLAR, which currently has a limited capital and covers only eight countries in the region.

As a result of the above, there is consensus over the fact that, despite the strengthening of the institutions and the macrofinancial policies in most of the region, Latin America is still quite exposed to external liquidity risks and relies excessively on the individual accumulation of international reserves to prevent or mitigate them. In other words, its financial safety net is particularly weak, which is especially worrying, considering that most countries in the region maintain open capital accounts and show a high degree of international financial integration.

The entry of a critical mass of new members to FLAR, particularly of the larger countries, would turn it into a financial arrangement with a regional outreach that would naturally and effectively complement the other elements of the financial safety net. We examine the contributions that a strong FLAR with a regional outreach could make to the Latin American financial safety net in greater detail in Section 3, and how it could take advantage of its potential complementarities with the IMF and the individual accumulation of international reserves.

2. Urgency: additional considerations

Besides being necessary and convenient, strengthening the financial safety net for Latin America is urgent because there are high and growing risks for the region today, arising from several external and internal factors. At the time of writing this report, such risks seem more likely to worsen than to diminish, and they may extend for a considerable period. Thus, the central message IMF's Managing Director Christine Lagarde at the end of the spring 2019 meeting is not surprising, regarding the enormous urgency of reinforcing the global financial safety net.

Those risks can be grouped into four categories, and they are strongly interrelated, as set out below:

- We are entering a period of low growth in the global economy (see Chart 7) amid a situation of excessive indebtedness in many industrialized and developing countries (Chart 8). In particular, the impact of expansionary policies in the U.S. is being moderated, the necessary process of China's deleveraging is ongoing but not yet completed, there are complex trade and technological leadership tensions between these two countries and, both the uncertainty over future relations between the European Union and the United Kingdom as well as political economy risks in various areas, overshadow the global growth outlook.

- The recent high volatility shown by international financial markets (Chart 9), which could easily increase in today's environment of lower global growth, high indebtedness levels and low fiscal and monetary response capacity in Latin America. Volatility could also worsen as a result of the risks associated to financial normalization in the U.S., the Eurozone and Japan, although these have decreased

[8] The European Stability Mechanism (ESM) established in 2012 in place of the European Financial Stability Facility - EFSF, which had been set up in 2010.

today to the extent that those associated to the greater slowdown of the global economy have increased.

Greater financial volatility, in turn, would reinforce the risks of slowing down the global economy through its effects on investment and private consumption. In this environment, the significant participation of foreign investors in the markets of some local assets may accelerate and aggravate an eventual abrupt restriction of financial flows.

- The greater vulnerability faced by the Latin American countries since the end of the super-cycle of high commodity prices (Charts 10 and 11). Latin America's economic history shows that most external, fiscal and financial crises have occurred during periods of low commodity prices, which have significant impact on the external and fiscal accounts of many countries in the region, in particular those of South America. It is precisely during these periods when the underlying macrofinancial vulnerabilities become more evident and more countries in the region have had to turn to the IMF and FLAR for liquidity support for their balances of payments. While there may be surprises on the rise, a sharp slowdown of the global economy would lead to additional decreases in commodity prices or, at the very least, to keep that current levels for an extended period.

  On this occasion, the vulnerabilities have been accentuated in those countries in the region that maintained expansionary policies for a longer period of time than was advisable after the Global Financial Crisis of 2008 and 2009, or as of 2013 - 2014, when there was a significant drop in the prices of the commodities they export (Chart 12). For this and other reasons, today, some countries in the region have high levels of fiscal or external deficits (current account), or of public and/or private indebtedness, which may be difficult to finance or refinance amid a situation of high volatility or sudden interest rate hikes in the international financial markets. In the cases of these economies, it is of the essence to introduce adjustments to the macroeconomic or financial policies as soon as possible.

- The weakening of multilateralism and the return to strictly unilateral or bilateral trade and other policies. This new situation makes it quite unlikely that, in the event of a global crisis, developed countries may act in the decisive way they did in 2009 to strengthen the International Monetary Fund and directly support emerging and developing economies of systemic importance. This circumstance is particularly serious for our region, whose financial safety has relied mostly on the accumulation of international reserves and on access to the IMF, and, in the case of countries of systemic importance, on credit lines from the FED or the U.S. Treasury.

  For all these reasons, it is not only convenient and necessary, but also urgent, to correct excesses and laxities in domestic macrofinancial policies, and to reinforce the region's financial safety net and, in particular, to overcome the limitations of its regional financing arrangements, which contrast with the greater strength of the RFAs available to Europe and Asia.

III. Benefits of a FLAR with a regional outreach

1. Liquidity provision

A strengthened FLAR with a regional outreach would be an important and agile source of external liquidity for the Latin American countries, particularly those of medium and small size, effectively complementing that offered by the other elements of the regional financial safety net, for the following reasons:

- Reserve contributions at FLAR can be significantly leveraged. Current members have access to resources in excess of their contributions: up to 2.5 times in the case of balance-of-payments support loans (2.6 times in the case of Bolivia and Ecuador). This multiple could rise to the extent that the shareholding base is diversified.

This possibility is due to the low likelihood of all of them needing external support resources at the same time, due to structural or circumstantial differences faced by the economies of the countries in the region, even during episodes of global or regional crises, as past evidence suggests (Charts 13 and 14 and Table 2).

- A country's available amount could be even higher to the extent that FLAR can leverage its capital in the capital markets and via credit lines, up to amounts that do not endanger its credit rating.

  In fact, today FLAR can leverage via bond issues more efficiently than any of its current members, because it has better risk ratings (Table 3)[9]. Perhaps even more importantly, FLAR could play an agglomeration role and gain access to contingent credit lines granted by multilateral entities or some central banks, with greater ease and better terms, cost and conditionalities than those available to most of its member countries. In both cases, Latin America could better take advantage of the genuine sources of sovereign financial cost reduction, by acting collectively through a strengthened FLAR with a regional outreach.

  In particular, it is convenient to explore the possibility of establishing contingent lines with the IDB and CAF. A FLAR with a regional outreach would not only complete the regional financial architecture, which already has two effective regional development banks, but it would allow to better specialize the roles of the entities that comprise it, improving the efficiency of its operations. Today, the IDB and CAF frequently take part in significant emergency liquidity operations with member countries in crisis, a role for which they are not well prepared or organized, thus causing inconvenient and unnecessary traumatisms to its fundamental task of promoting and supporting the economic, social and institutional development in the medium and the long term.

- A strengthened FLAR with a regional outreach could act faster and in a timelier manner than the International Monetary Fund to mitigate crises by providing external liquidity, for two reasons:

  On the one hand, because by serving a small number of countries, considerably homogeneous from the point of view of their economic structure, their institutions and their political culture, it could develop a deep knowledge of the specific economic and institutional characteristics of its members. These circumstances would also enable it to monitor the evolution of their vulnerabilities continuously and closely, and the changes in the financial markets' sentiment regarding the region or individual countries, which would make it easier for it to quickly respond upon the emergence of liquidity problems. These tasks would require strengthening FLAR's technical capacity, which would have to be approved by the expanded membership.

  On the other hand, because there are governments in the region which, for ideological reasons, stigma or signaling, refrain from resorting to the IMF in a timely manner. The same has not happened with FLAR.

[9] Currently, FLAR has a better rating than the member countries (AA/Aa2). In 2003 and 2006, the FLAR issued bonds for US$150 million and US$250 million, respectively. The 2003 bond was rated by Latinfinance as Latin America's best multilateral bond in Latin America that year.

- The Fund's faster response capacity would enable it, additionally, to serve countries as a "financing bridge" while they agree any obtain disbursements from a program with the International Monetary Fund, at a particularly critical time: at the beginning of the crises, when liquidity restrictions may be more severe. FLAR's experience attests to the materialization of this potential advantage in several instances, even for its current, larger economy members.

- Furthermore, granting partial loan guarantees by FLAR could become a particularly useful support for those members who have made advances in their adjustment processes to quickly return to the international financial market, after facing liquidity or solvency crises and applying corrective measures.

By becoming a supplemental source of external liquidity with the characteristics previously noted, a FLAR with a regional outreach would contribute both to mitigate crises of an idiosyncratic nature, as well as prevent episodes of financial contagion in region.

2. Prevention

The potential contribution of a FLAR with a regional outreach to crisis prevention deserves special emphasis, for three reasons:

- Access to another fast source of liquidity can help to prevent "sudden stops" of capital inflows, as well as massive capital outflows. In fact, technical literature has demonstrated that, in periods of market nervousness and greater risk aversion, investors and lenders are less likely to leave countries that have quick access to broader sources of external liquidity[10].

- The reasons why some countries are more promptly approaching a regional financing arrangement for de funding of liquidity, also valid for prevention actions.

  In fact, the deep knowledge that FLAR can develop about the economies and institutions of its members, the follow-up and ongoing dialogue with them on the evolution of their vulnerabilities and macrofinancial policies, as well as its ongoing follow-up and monitoring of the changes in the sentiment of the international markets that may affect them, could prove enormously useful to timely and effectively suggest preventive adjustments.

  At the same time, the fact that some governments are more willing to seek and listen to its advice, due to less mistrust or caution as compared to those they may have with respect to the IMF, could lead them to adopt the required preventive measures in a timely manner.

- A FLAR with a regional outreach could also contribute to this purpose by promoting coordination mechanisms and ongoing dialogues on prudent macroeconomic and financial policies among all members or member subgroups, along with the regional development banks. Mutual learning and group persuasion (peer pressure) often act effectively among countries that share similar problems, have close cultural traits and common historical ties.

3. Externalities on commercial and migratory flows

When a country faces liquidity problems, it often tends to cut imports from its trade partners, even in cases where there are bilateral or multilateral agreements, be it by using escape clauses permitted by the WTO and by those agreements, or openly in breach of its commitments. These

10 Scheubel, B, L Stracca and C Tille (2019). Taming the global financial cycle: What role for the global financial safety net?

behaviors have been generally seen in the region. Thus, to the extent that a strong FLAR with a regional outreach may effectively contribute to preserve the macroeconomic and financial stability of its members, it would facilitate and encourage a deeper and more stable development of the intra-regional trade flows.

Moreover, FLAR current rules demand a commitment from the country receiving a loan from the institution whereby it cannot affect imports coming from member countries. This condition should be maintained in a FLAR with an expanded membership. Evidence shows that it played a very important role in the first stages of FLAR to prevent these practices among the countries of the Andean Group (which used to be customary) and facilitated a constant and considerable growth of that group's intra-regional trade.

Likewise, when a country falls into deep crises, there can be a sudden intensification of migratory flows to neighboring countries, as is currently happening in Venezuela, creating difficulties in the labor market and imposing significant fiscal costs, at least in the short term, in the main receiving countries. Other less dramatic episodes, but which in any case are traumatic for the neighbors, have occurred in Central America and the Caribbean. This consideration is particularly important today in view of the new U.S. immigration policy. To the extent that a strong FLAR with a regional outreach effectively contributes to preserve the macroeconomic and financial stability of its members, it would help to prevent these sudden changes in migration flows, both intra-regional and to third countries.

For some countries in the region, particularly for those with larger-sized economies and for those who have achieved a greater financial stability, the benefits associated to these externalities may be even more important than the benefits resulting from their eventual use of the liquidity resources of the institution. In fact, the main interest of the most advanced countries in contributing to the International Monetary Fund, of Germany in contributing to the European financing arrangements, and of Japan, China and Korea in contributing to the Chiang Mai Initiative Multilateralization (CMIM), has been precisely to ensure greater global or regional financial stability to mitigate the consequences that an acute crisis in a country may have on their neighbors and, consequently, on themselves. Every country is stronger when it lives in a strong region.

These positive externalities of the effective support provided by a strengthened regional FLAR to individual countries, as well as the fact that the institution would be a privileged forum for the discussion and coordination of macroeconomic and financial policies, would be of great use for the broader objectives of integration and regional economic cooperation that Latin American countries have pursued during several moments of their history, with very variable luck.

IV. Current FLAR strengths

As previously noted, the region has a Regional Financing Arrangement, in FLAR, which today covers a limited number of countries (Bolivia, Colombia, Costa Rica, Ecuador, Paraguay, Peru, Uruguay and Venezuela) and has a relatively small capital, in contrast to the situation in Europe and Asia. That said, the Working Group believes that FLAR has developed the following strengths that could be exploited and boosted to turn it into a strong financial arrangement with a regional outreach:

- FLAR has a tradition of prudent financial management, recognized by the markets, which has led risk rating agencies to grant investment grade to its debt, with a higher rating than that of any of its member countries, CAF, and the other economies in the region (Table 3).

- Excepting Paraguay and Uruguay, all other members (i.e., Bolivia, Colombia, Costa Rica, Ecuador, Peru and Venezuela) have resorted to FLAR once or more in situations of tight liquidity and have obtained a fast response (Chart 15 and Table 2). This has been particularly useful during periods when the recipient is in the process of gaining access to resources from the IMF or other sources. Likewise, on many occasions, FLAR resources alone have sufficed to cope with temporary liquidity crises in the smallest economies of its current members.

- Contributions to FLAR have had, in the long term, a higher yield than that of its' members international reserves (Chart 16). Moreover, FLAR has developed a great competence in the management of treasury investment portfolios; because of this, several central banks, funds and public companies in the region come to FLAR asking for asset management services. Likewise, several central banks, from member and non-member countries, usually deposit part of their reserve assets at FLAR.

- FLAR has set up a technical team which, although small, is competent in supporting its loan decisions and in the investment of its reserves. This team organizes an annual, high level academic conference on macroeconomic and financial stability topics that has become a privileged forum for the monetary authorities of the region and the experts on these matters, which has contributed to improve the knowledge on international finance issues and regional vulnerabilities.

All these strengths could serve as the basis for an efficient expansion of its mandate, which would include the development of new leverage, prevention and liquidity provision instruments, as well as the strengthening of its technical and monitoring capabilities for following their members' economies and the international markets, as its membership expands to the entire region and its capital is increased.

V. The next steps

The transition between the current FLAR and one with a regional outreach managing more resources requires the influx of a critical mass of new members, and particularly of the largest economies of the region, ideally in a coordinated and simultaneous way. The task for both the current and the incoming members is to analyze, define and implement the process deemed most effective and expedited to finally establish a solid FLAR with a regional outreach.

Whichever process is adopted, the expanded membership will have to define the desired size of FLAR's capital, as well as whether a more differentiated structure of contributions is required according to member categories and some changes in the entity's governance. Likewise, it shall also determine whether all contributions shall be in the form of paid-in capital or whether a part of them could be made as secured capital, if they must be paid in full in hard currencies or a fraction could be drawn in national currencies, as well as the timetable for its gradual increase.

Likewise, it will have to agree on criteria, caps and modalities for the leverage of the new FLAR and authorize its Executive President to negotiate credit lines with the IDB, CAF, other multilateral agencies and central banks of the largest economies in the region and other regions. It will also have to establish the modalities, uses and conditions of the lines of credit and the guarantees that the broadened and strengthened FLAR would offer to its expanded membership, as well as the caps to which each membership category could have accessed, depending on their contributions.

On the other hand, decisions regarding the size and composition of the technical team needed for the follow-up and monitoring of the economies of its members and of the relevant international financial markets will be required, as well as to hold discussions with country authorities about the necessary preventive and corrective measures to receive FLAR support, and to provide assistance to FLAR's Board of Directors for the approval of specific operations, the evaluation of the credit lines, and the guarantees offered to the members.

Finally, the modalities of cooperation between the two entities should be agreed with the International Monetary Fund, as well as the technical assistance provided by the Fund and other matters such as the accounting of the contributions to FLAR in the balance sheets of the member countries' central banks. The Working Group examined some options on the matter with current FLAR staff. As a result, technical memorandums are available for the extended FLAR members, which may be updated and deepened at the appropriate juncture to serve as a basis for these decisions in the future.

VI. Conclusion and invitation to the authorities of the region

In view of the foregoing, the Working Group has no doubt about the need, convenience and urgency of building a strong financing arrangement with a regional outreach, based on the current FLAR.

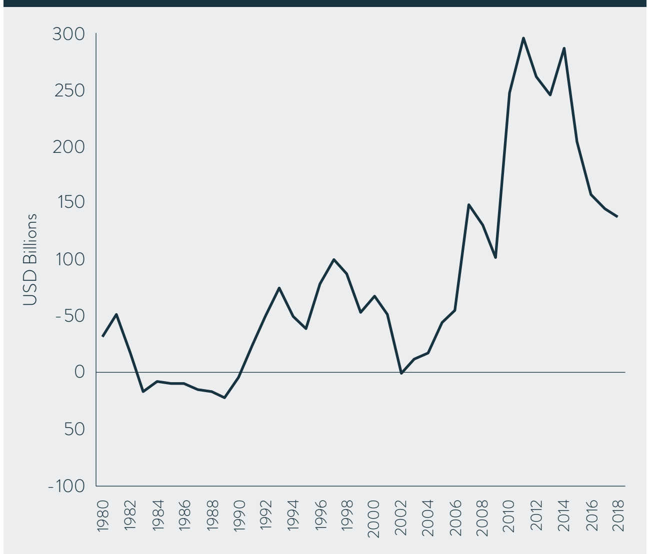
In our opinion, this task is essential to complete and strengthen the region's financial safety net and thus reinforce its macrofinancial stability in a world characterized by the structural volatility of international financial markets, sudden reversals of capital flows and financial contagion among countries. And tackling it immediately is urgent in light of the growing risks seen in the global economy today, the weakening of multilateralism and the region's increased vulnerability once the super-cycle of high prices of its export commodities ends.

Throughout this brief report we have stated the reasons that support this conclusion, outlined the desirable features of a strengthened FLAR with a regional outreach, and suggested some options to achieve it.

The final recommendation of the Working Group for FLAR's current authorities is to invite other countries in the region, particularly the largest and most advanced, to become part of this institution and, jointly, based on the positive experience of this institution, build a strengthened FLAR with a regional outreach, capable of more effectively and efficiently contributing to strengthen the macroeconomic and financial stability of this part of the world.

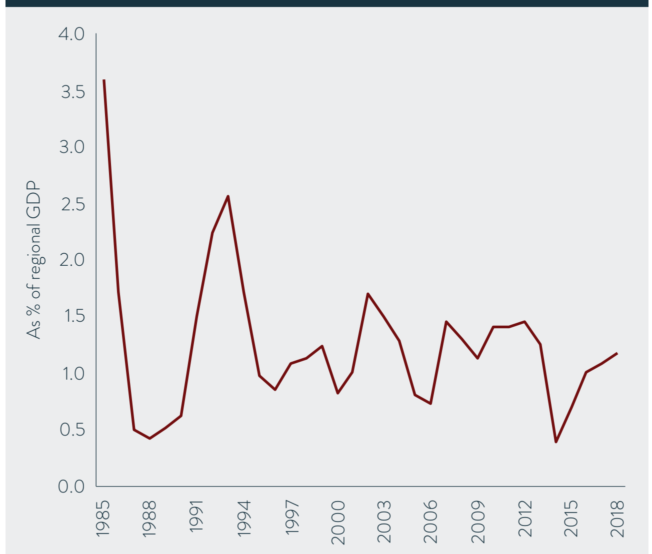
TABLES AND CHARTS

Chart 1. Latin America: Net capital flows[1]



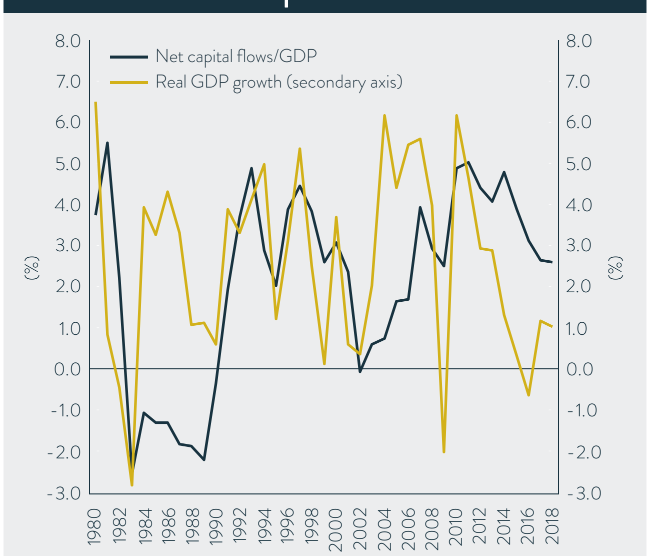
[1] Capital account + financial account (excluding reserves and related items) - direct investment.
Source: Own calculations based on International Monetary Fund.

Chart 2. Latin America: Net capital flows volatility[1]



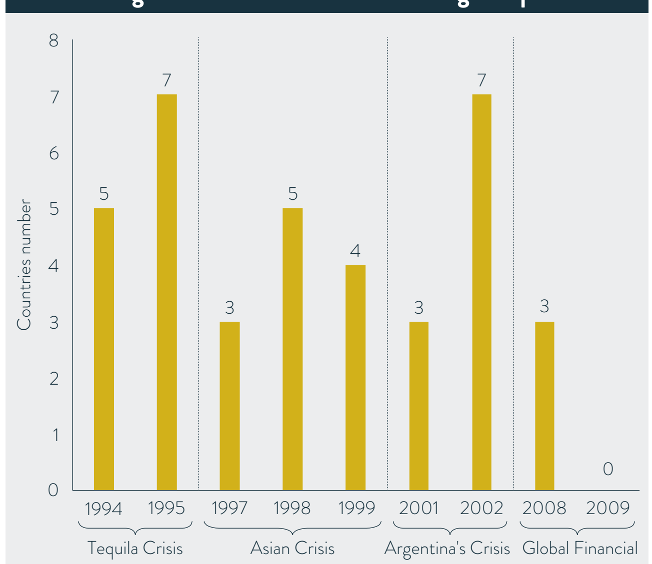
[1] 5-year moving standard deviation.
Source: Own calculations based on IMF figures.

Chart 3. Latin America: Procyclicality of capital flows



Source: Own calculations based on IMF figures.

Chart 4. Latin America: Number of countries with exchange rate stress in different contagion episodes



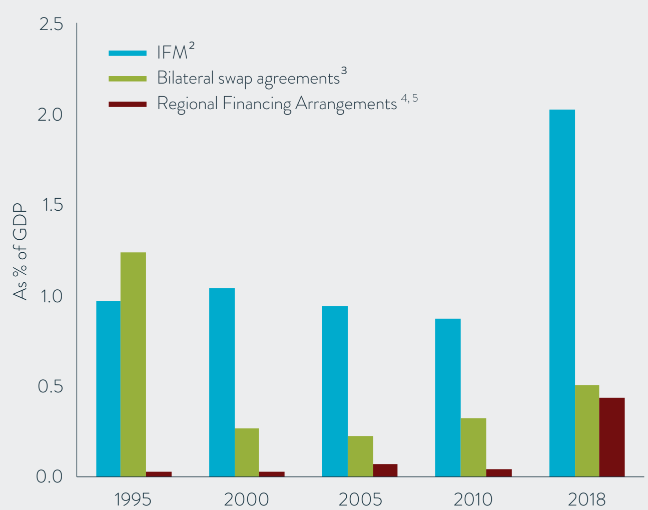
Source: NBER. (Reinhart and Rogoff, 2010), From Financial Crash to Debt Crisis.

Table 1. Latin America: Sudden stops episode[1]
(Maximum annual change in net flows per period)

	Tequila Crisis	Asian Crisis	Argentina's Crisis and LTCM[2]	Global Financal Crisis	Commodity Price Shock	Average (All episodes)
Period	1994-1995	1997-1999	2001-2002	2008-2009	2014-2015	1994-2015
USD billion	-36	-48	-68	-47	-83	-56
Como % del PIB	-2.0%	-2.3%	-3.5%	-1.1%	-1.6%	-2.1%
USD billion, calculations based 2019 GDP	-106	-122	-186	-60	-84	-111

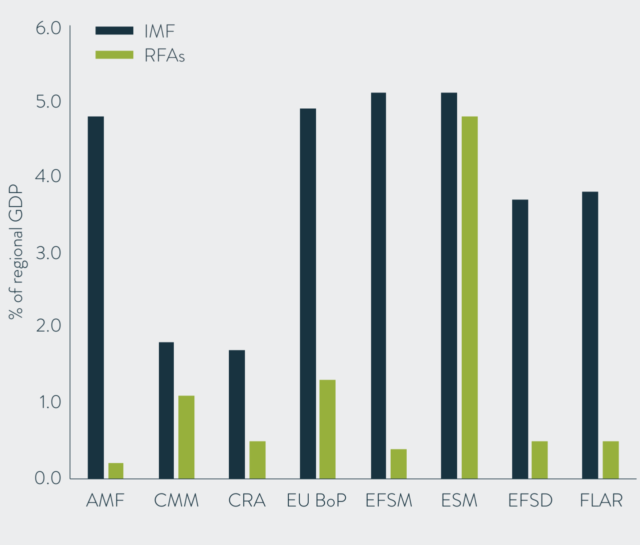
1 Annual changes in net capital flows.
2 Long Term Capital Management LP.
Source: Own calculations based on IMF figures.

Chart 5. Latin America: Evolution and composition of the Financial Safety Net



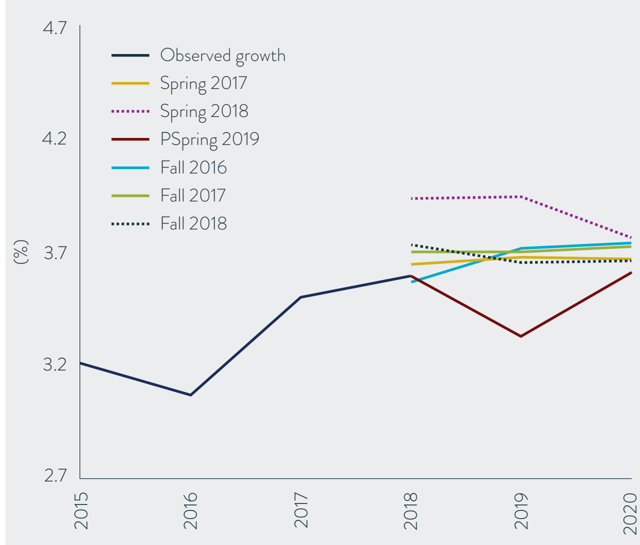
[1] FMI. [2] IMF access amount = (% participation of each country in total quotas) x (maximum amount of IMF resources available, including indebtedness). [3] Maximum amount approved for all types of swaps is used. [4] FLAR access amount = (% of participation of each country in total capital) x (maximum amount of available resources, including indebtedness). [5] BRICS-CRA includes the maximum access amount from Brazil.
Source: Own calculations based on IMF, Central Banks, FLAR and the Federal Reserve figures.

Chart 6. Regional access to the IMF and Regional Financing Arrangements (RFAs)



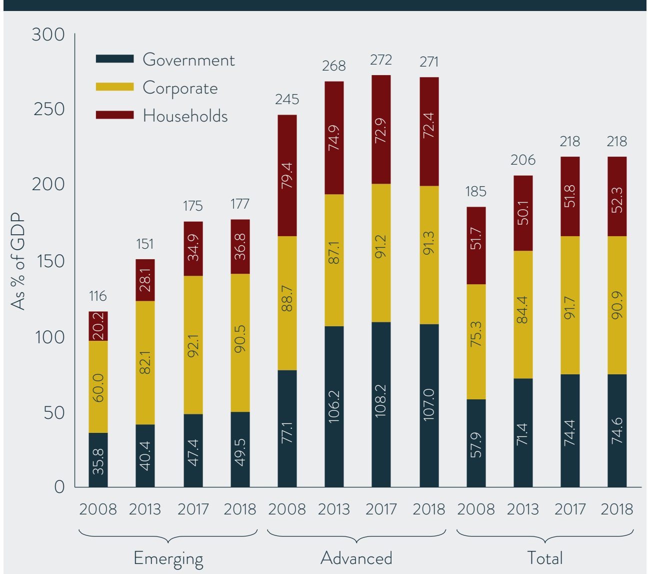
Fuente: Gallego, Sonsoles; L´Hotellerie-Fallois, Pilar; López, Fernando (2018). "The International Monetary Fund and its Role as a Guarantor of Global Financial Stability", Bank of Spain.

Chart 7. Forecasts of the global economy downward



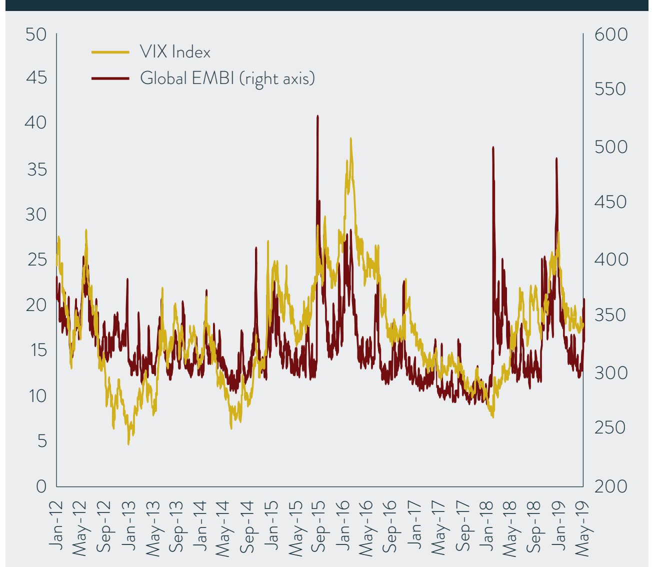
Source: IMF (World Economic Outlook).

Chart 8. Household, Corporations and Government debt



Source: BIS.

Chart 9. VIX and Global EMBI

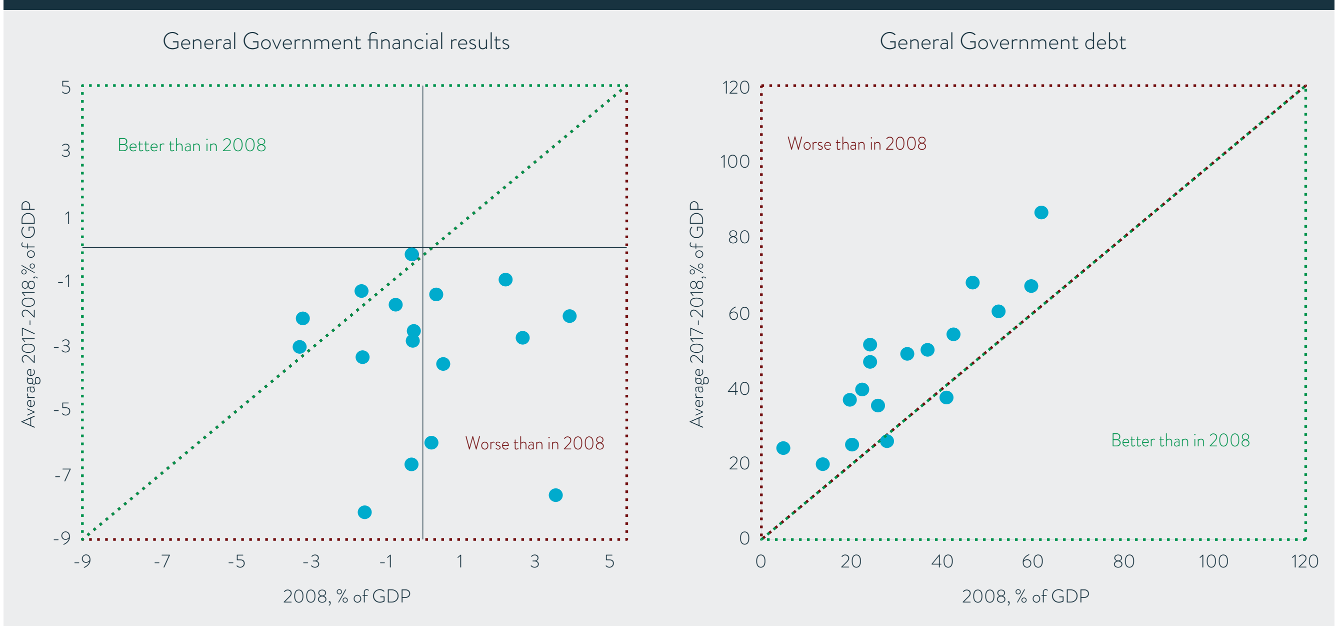


Source: Bloomberg.

Chart 10. Latin America: External vulnerabilities compared to 2008

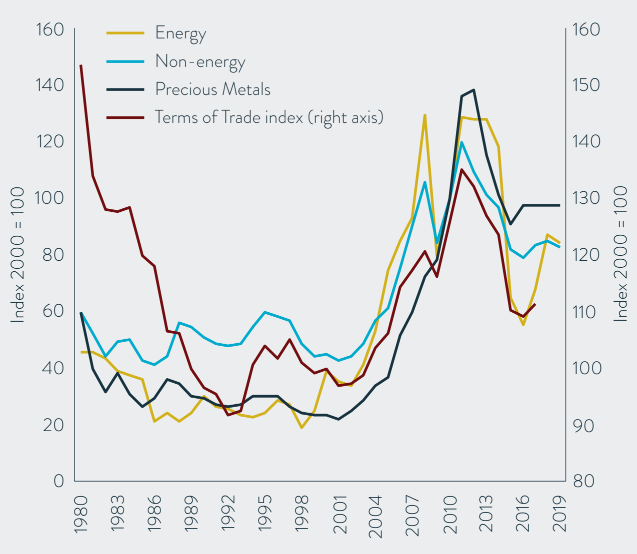
Source: Own calculations based on IMF figures.

Chart 11. Latin America: Fiscal vulnerabilities compared to 2008



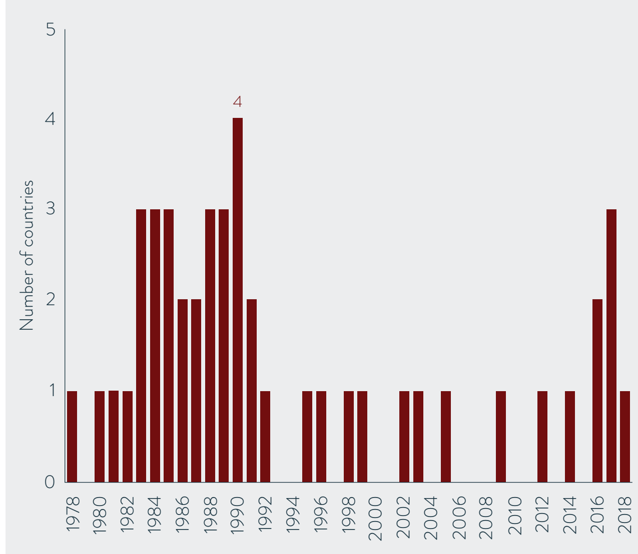
Source: Own calculations based on IMF figures.

Chart 12. Latin America1: Terms of trade and commodity prices



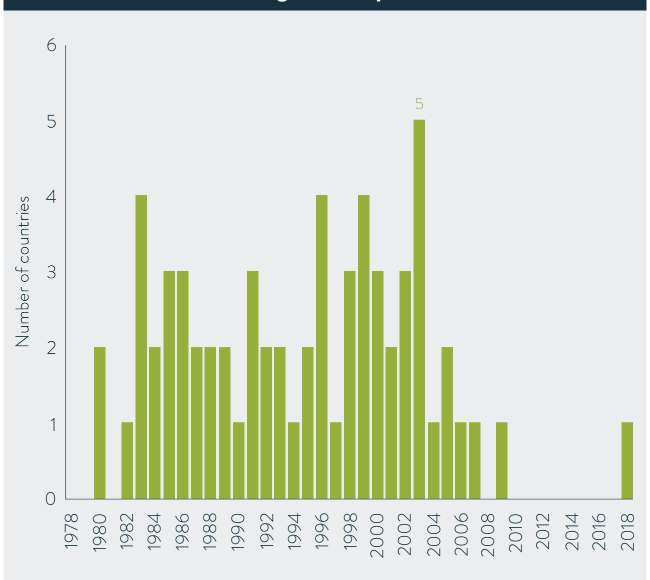
[1] Simple average.
Source: World Bank.

Chart 13. Loans granted by FLAR



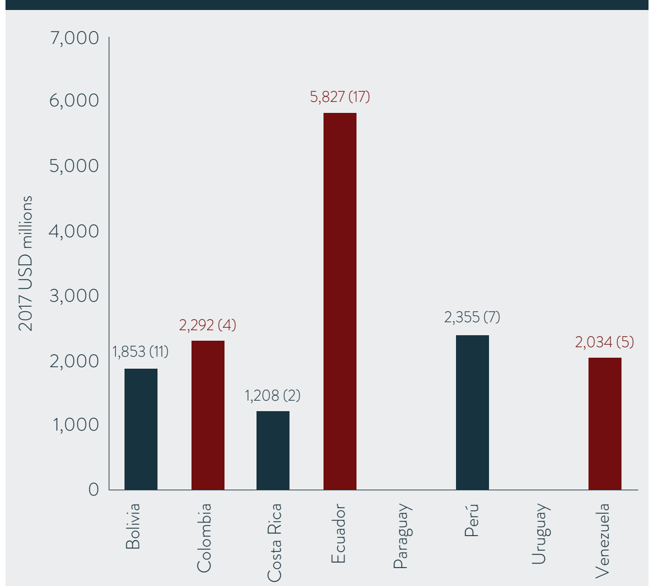
Source: FLAR.

Chart 14. Latin America: Loans granted by IMF



Source: Own calculations based on IMF figures.

Chart 15. Total amount of loans granted by FLAR, 1978-2018



Source: FLAR.

Table 2. Cases where FLAR lent and countries did not request to the IMF, and cases where FLAR lent and the countries request to the IMF

	Loan application			Approval year(s)			FLAR / IMF relative amount	
Country	FLAR only	FMI only	FLAR and FMI	FLAR only	FMI only	FLAR and FMI	Whole period	Simultaneous periods
Bolivia	9	3	2	1981, 1984, 1985, 1988, 1989, 1990, 1991, 1992, 2002	1994, 1998, 2003	1980, 1986[2]	1.4	1.8
Colombia	3	2	1	1983, 1984[2], 1985	2003, 2005	1999[2]	0.2	0.2
Costa Rica	2	8	0	2003, 2017	1980, 1982, 1985, 1987, 1991, 1993, 1995, 2009		0.9	0.0
Ecuador	13	3	4	1982, 1984, 1989, 1990, 1995[2], 1996, 1998[2], 2005, 2009, 2012, 2014, 2016, 2017	1991, 2000, 2003, 2009	1983[2], 1985, 1986[2], 1988	3.8	1.1
Paraguay	0	2	0		2003, 2006		0.0	0.0
Peru[1]	7	8	0	1978, 1983, 1987, 1988, 1989, 1990, 1991	1984, 1993, 1996, 1999, 2001, 2002, 2004, 2007		0.2	0.0
Uruguay	0	10	0		-1983, 1985, 1990, 1992 1996, 1997, 1999, 2000 2002, 2005		0.0	0.0
Venezuela, RB	5	1	0	1987, 1990, 2016, 2017, 2018	1996		1.2	0.0

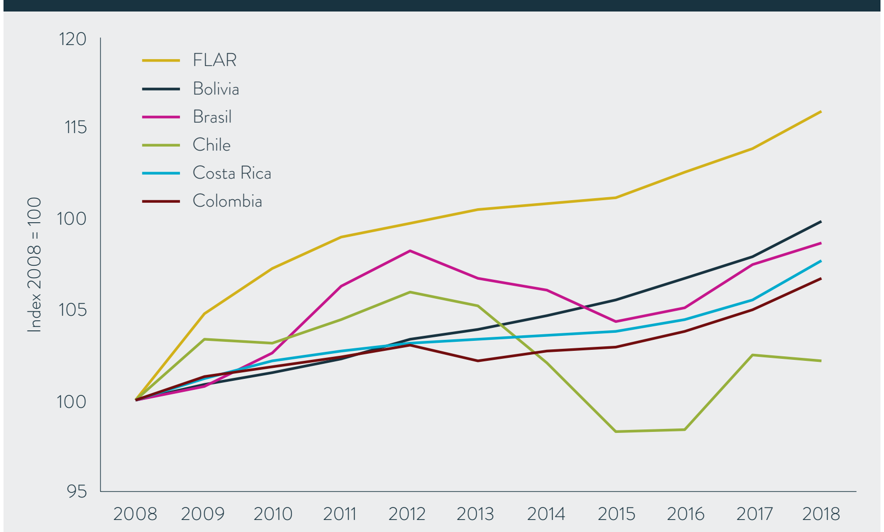
1 In the early 90s, financing granted by FLAR served as bridge loans for IMF assistance in later years. (FLAR, 1991, and IMF, 1993).
2 These countries applied for two FLAR lines of credit in the same year.
Source: FLAR and IMF.

Table 3: Credit Ratings

MOODY´S		S&P		FITCH	
Aaa		AAA		AAA	
Aa1		AA+		AA+	
Aa2	FLAR	AA	BCIE FLAR	AA	
Aa3	CAF	AA-		AA-	CAF
A1	BCIE[1] CHILE	A+	CAF CHILE	A+	BCIE
A2		A		A	CHILE
A3	MEXICO PERU	A-		A-	
Baa1		BBB+	MEXICO PERU	BBB+	PERU
Baa2	COLOMBIA URUGUAY	BBB	URUGUAY	BBB	COLOMBIA MEXICO
Baa3		BBB-	COLOMBIA	BBB-	URUGUAY

[1] Central American Bank for Economic Integration.
Source: Credit Rating Agencies. Data as of July 3, 2019.

Chart 16: Cumulative return for FLAR and its member countries[1]



[1] For countries, return of total reserves in USD, reported by the Central Banks. For FLAR, internal sub-portfolio.
Source: Own calculations based on Central Bank figures.

TOWARD A FLAR WITH A REGIONAL OUTREACH

REPORT OF THE WORKING GROUP ON REGIONAL FINANCIAL STABILITY

October | 2019