

ECLAC's CONTRIBUTION TO ANALYSIS ON THE ECONOMIC AND FINANCIAL CRISIS¹

24 February 2009

I. Background:

Evidence shows up to now that the international financial system has not worked to the benefit of developing countries. In the case of Latin America and the Caribbean countries, integration with international financial markets has been a process marked with lights and shadows. Deeper integration has provided benefits to Latin American economies in the form of greater access to external savings. However, this greater access to savings has not materialized into a higher growth plateau and has been accompanied by increased volatility.

Latin American and the Caribbean long run economic growth performance have been rather disappointing. Low and volatile growth rates, significant loss of relative per capita GDP over time when compared with that of industrial economies and of other economies that in 1950s had similar development levels, are some of the characteristics of the region's growth performance. Notwithstanding, since 2003 a conjunction of factors, especially related to positive external shocks, allowed Latin America to register the best economic performance in three decades with per capita GDP growth rates towering above 3% annually.

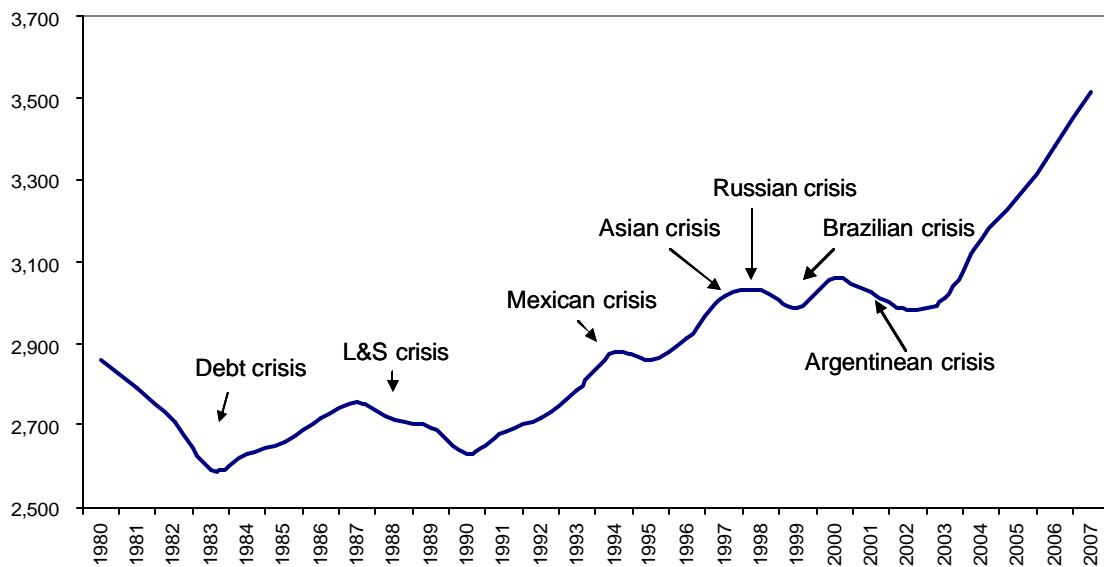
If Latin American's economic growth history can be characterized as "problematic", the history of the nexus of the region with international financial markets can be epitomized as one that is "continuously fragile and extremely vulnerable". Several documents prepared by ECLAC have argued that the functioning of the financial system can be one of the main sources of the instability for Latin American and Caribbean economies. In fact, the region's economic growth history is closely related to international financial crises. The Debt (1980s), Mexican (1994), Asian (1997), Russian (1998) and Argentinean (2001) crisis

¹ Document prepared by ECLAC coordinated by Alicia Bárcena and Daniel Titelman.

episodes, are emblematic examples of episodes in which crises in the international financial system have affected growth performance for emerging market economies and for the region in particular. See Figure 1.

Figure 1
**Latin American and the Caribbean: per capita GDP and
 some major international financial crises.**
 (1980 – 2007)

US\$ of 1990



Source: UN statistic division.

The current international financial and economics crisis is a new, and important, episode bearing to mind that favorable conditions are not immutable and can be rapidly reversed and that the region is still very much vulnerable to the functioning of international financial markets. The recent economic performance has been affected by the current turmoil in all major financial centers. Forecasts for 2009 still foresee positive growth for the region but at much smaller rates, close to 1%, and per capita rates in negative territory.

As in the case of past episodes, the current crisis underscores the need for a deep reform of the international financial architecture and for the design of a more stable and equitable international financial system. This time, however, the demands for reform are the expression of a wider specter of agents and with a new and renewed intensity. This is not only because the current crisis has been considered as the most severe one since the Great Depression, but also because this episode has shown, in a more explicit manner than earlier ones, that financial crises are a global and systemic phenomenon, generating large disturbances from small impulses, and that no country is isolated from contagion. In this sense the present context, despite its difficulty, provides a unique opportunity to introduce the necessary changes into the international financial system so that the latter is able to fulfill its fundamental role including the mobilization of savings and the smoothing business cycles across countries.

The needed reforms

The current crisis has once more shown the weaknesses of the international financial system in mobilizing and allocating savings to their most productive uses and to play a countercyclical role by smoothing out consumption fluctuations over the business cycle underscoring the need for deep reform. The financial system has been unable to fulfill these functions due to legitimacy and governance issues, its procyclical behavior, and the existence of inadequate financial regulation at the micro and macro level; and in the case of the latter particularly regarding the volume and direction of financial flows.

Legitimacy and Governance

The current financial system exhibits a weak legitimacy base. Its design does not adequately represent the participating countries (legitimacy) and does not provide proper operating rules (governance).

The financial system does not reflect the current global economic equilibrium including the importance of emerging economies some of which are fundamental to ensure sound growth and is also characterized by strong asymmetries, prominent in the role played by developed and developing countries.

For instance, the actual distribution of votes in the IMF gives to a small group of developed economies the capacity to block several initiatives, including those that could improve the actual balance of power in the executive board of the Fund. Furthermore, the countries with the blocking-capacity usually solve their monetary and financial issues in other national or international fora. Traditionally, the large shareholders are considered as the suppliers of resources and advices, while the developing economies are considered the consumers of resources and the ones that need advices. Additionally, instances as the G's groups, (G-7, G-8, G-20 or G-24), self-selected groups that include mainly developed economies, have a prominent role in deciding the IMF agenda and operation procedures through informal channels.

Moreover, the benefits and costs of international financial intermediation are unevenly distributed across countries and within nations.

In order to regain broad and solid legitimacy, the new financial architecture must take into account the needs of all countries by providing an adequate developing country representation and guaranteeing their right to a voice and a vote in the decision-making process including in the decision-making instances at the IMF and other global institutions as the BIS. It must also impose a more balanced distribution of power in the setting of the agenda and voting process between developed and developing economies, higher accountability on the IMF in its different activities, and improve the coordination of these global institutions, especially the IMF, with other multilateral institutions and specialized agencies as the Economic and Social Commission (ECOSOC) and the regional commissions of the UN system as well as subregional financial arrangements.

Recently, the accumulation of international reserves in the developing world, particularly in China, India and other Asian economies and oil exporters, especially in the Middle-East, has induced some discussions on the need to increase the quota participation of these countries given their capacity to capitalize the Fund. On the other hand, the current crisis has shown that the G's groups could play an important role but a broader support of the international community is needed in order to coordinate their actions to manage the crisis and to adopt the reforms that the financial architecture requires to reduce the systemic risk and minimize contagion effects.

Improving the legitimacy of the international financial system requires the strengthening the system of governance of the existing institutions responsible for the well-functioning and monitoring of the system (possibly the creation of others institutions). Improved governance mechanisms are required to ensure the reduction of systemic risk, improve financial intermediation and coordinate the regulatory, supervisory and decision making process and ensure an adequate degree of accountability.

The reduction of systemic risk involves the design of a global system to pre-empt financial instability and crises. It also involves the homogenization and ensured adequacy of the standards of supervision and regulation. The improvement of financial intermediation implies the creation of instances of cross-border supervision of global financial institutions. Finally, the coordination of the regulatory, supervisory and decision making processes require a clearly specified role for the different international institutions involved in the design of the new financial architecture as well as an agreement on the different forms of cooperation, not only in times of crises.

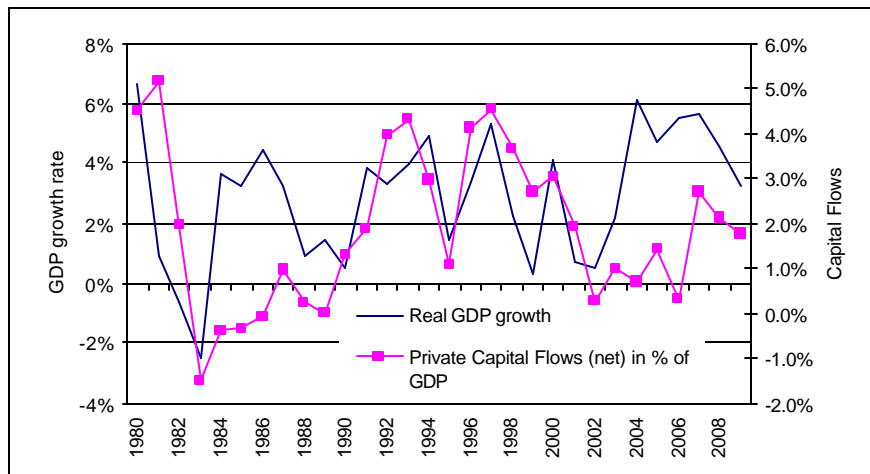
Making governance mechanisms operational requires a higher degree of accountability. And in fact greater accountability has become a common demand of both developed and developing economies. The formers demand that procedures and norms regarding the use of the IMF resources should be managed to protect the interests of their constituency. For the developing economies, the IMF should be accountable for the results of the policies that it recommends and for its actions to prevent and manage systemic crisis. The current structure of the IMF provides two main channels for accountability, the board of directors and the board of governors. In the former, a large number of member states, mainly the “consumers” have an indirect representation. In the case of the board of governors, some authors have argued that it seems unlikely that Governors have adequate knowledge to understand the specific of IMF operations. As result, in spite of the existence of channels, they are not well fitted to allow for the adequate level of accountability.

The countercyclical role of the financial system

Traditionally the financial system has behaved in a pro-cyclical manner contributing to accentuate rather than to dampen economic fluctuations. In the case of Latin America private capital flows have been a source of economic instability given their highly pro-cyclical nature (see Figure A.2.1).

Figure 1

Capital Flows and the Business Cycle in the Latin American and the Caribbean Region, LAC (32) Net Private Capital Flows in % of GDP and GDP growth rate



Source: Own elaboration using WEO database, IMF

Developing countries, and Latin American and the Caribbean economies in particular, have historically argued in favor of counter-cyclical instruments and policies to preempt the negative effects of financial and real crises. However, they have had very limited access to the use of counter-cyclical instruments as well as limited facilities to tap on additional financial resources.

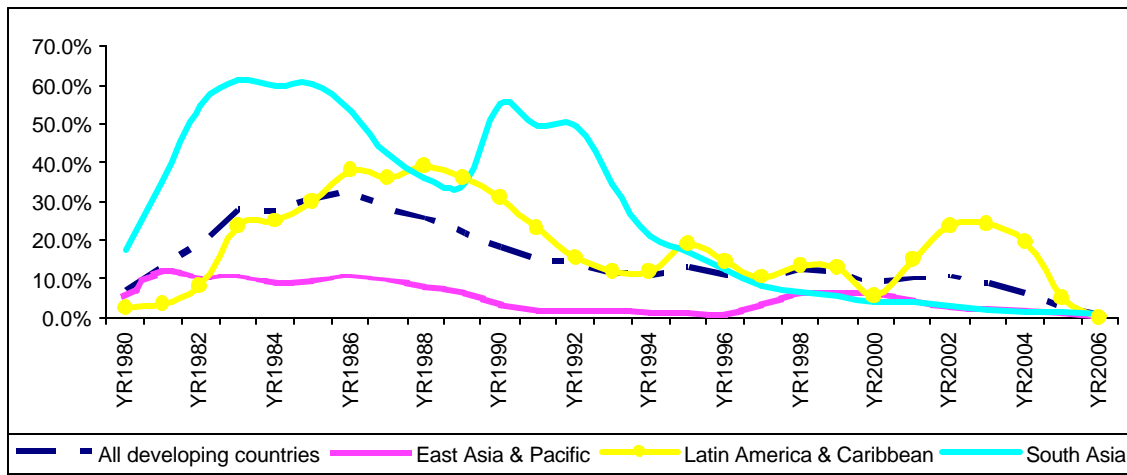
A global institution such as the IMF should have the financial and technical capacity to provide financial resources to those countries in need in order to avoid that a local crisis, through contagion, becomes global. It also should ensure that administrative procedures

and conditionality does not affect the timing of the assistance. We should note that during the current financial crisis, the IMF has created new credit facilities for emerging markets affected by the crisis without any attached conditionality. We see this as a step in the right direction and we highlight the importance of a facility that is readily available and of easy access to countries in need of it.

Given this failure of the international financial system and of the IMF in particular, several emerging market economies have increased their stock of international reserves. This situation has been interpreted by some authors as a sign of the loss in confidence in the capacity of the IMF to assist countries when facing critical times (Figure 2).

Figure 2

Use of IMF credits with respect to the holdings of international reserves



Source: Own elaboration using Global Development Finance (GDF) database, IMF.

The accumulation of international reserves for precautionary purposes can provide a buffer stock against unexpected and undesirable economic shocks. However rather than promote the growth and development of developing countries the flow of reserves accumulated by developing economies finds its way back to the markets of developed economies. The absence of developed capital markets in developing countries and risk considerations have encouraged developing countries to invest their excess reserves in the capital market of

developed countries. This has coincided with a negative net transfer of resources from the developing to the developed world reaching a record level of US\$ 933 billion in 2008. In the case of Latin America, the net transfer of resources turned negative in 2002 and has averaged US\$ billion 72 dollars annually for the period 2002-2008.²

Moreover, since developing countries accumulate reserves for precautionary motives, they need to have rapid access to their reserves. As a result, developing countries reserves are generally invested in highly liquid instruments in developed countries. This in turn can lead to situations of excess liquidity in the financial markets of developed countries.³

Besides increasing their holdings of international reserves, Latin American countries have also used other strategies to protect their economies against external shocks. In the favorable context that prevailed in the commodities markets until the first semester of 2008, some countries have created fiscal funds to reduce the instability of commodity export revenue and others have used the higher incomes to reduce the burden of external debt. Additionally, countries in the region have tended to increase the use of resources from alternative institutions such as sub-regional development banks and regional reserve institutions; instead of using the facilities provided by the IMF.

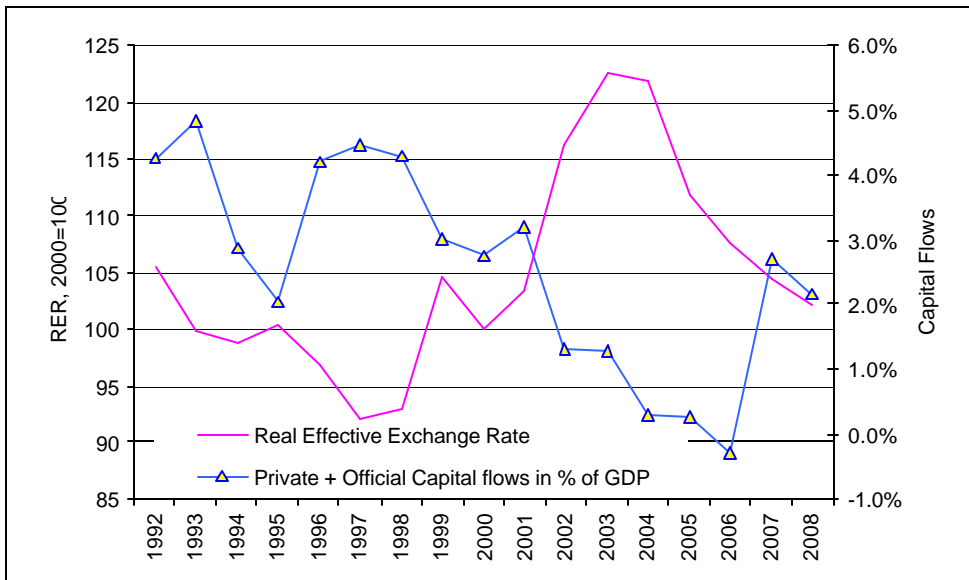
A.2 Regulation to face volatility of international financial markets

The design and implementation of regulatory mechanisms to face volatility of international financial markets is related to macro regulation. The existence of mechanisms for the attenuation of pro-cyclicality, are desirable since they would reduce the vulnerability of the domestic economies to sudden changes in the international financial environment.

² The net resource transfer is defined as net capital inflows less net interest and other investment income payments abroad. Developing countries began to record negative net resource transfer since 1997. See, United Nations (2009) World Economic Situation and Prospects. United Nations: New York.

³ Obviously increased liquidity can merely result from the transfer of liquid resources from the developing to the developed world. In the case of the United States the impact of the purchase of bonds by foreigners on long-term interest rates range from one to one and half percentage points. See, Warnock, F.E. (2006) The Impact of East Asian Reserves Accumulation of U.S. Interest Rates.

Figure 3
**Capital Flows and Real Exchange Rate in the
 Latin American and the Caribbean Region, LAC (32)**
Net Private + Official capital Flows in % of GDP and Real Effective Exchange Rate



Source: Own elaboration using WEO database, IMF and ECLAC

Capital account regulations is one the mechanisms that enable economic policy to act in a counter-cyclical fashion. In the upward phase of the cycle they enable monetary authorities to contract monetary while avoiding exchange rate appreciation. In the downward phase of the cycle capital controls allow monetary authorities to pursue an expansionary policy.

In terms of what type of capital account regulations the countries could implement, we believe that controls on inflows, with an emphasis in reducing the share of short-term liabilities in total capital flows are the most desirable type (*capital account regulations as a liability policy instrument*). On the one hand, this type of regulation helps prevent “capital flight” and therefore helps neutralize one of the most destabilizing forms of capital flows. On the other hand, the reshaping of the debt term structure towards a larger share of long-term finance goes in the line of promoting productive investment since the general tendency is for short-term capital to be tilted towards the financing of consumption. The experience with this type of capital controls of two of the region’s countries, Chile and Colombia in the 1990’s, is considered by us to have been positive in this regard and serves as an example of how these mechanisms can be useful to achieve –in part- the objectives mentioned above. Below we briefly discussed their experiences.

Besides capital regulation, prudential regulation provides a fertile area for the development of countercyclical instruments. While thus far as highlighted by the Spanish experience, countercyclical prudential regulation has been applied to developed countries, it can with the support of other measures be applied in developing countries such as those of Latin America.

Capital account regulations in Chile and Colombia in the 1990’s⁴

The mechanism of capital account regulation used in Chile and Colombia during the 1990’s can be described as a non-remunerated reserve requirement on capital inflows.⁵ In spite of its evolution over time and their different designs, both experiments with capital account regulations share three important characteristics *a) controls were imposed on capital inflows but not on capital outflows b) there were no quantitative controls, and c) they were designed to have more impact on short-term than on long-term capital flows.*

⁴ This section is based on ECLAC (2006, “Seeking Growth under Financial Volatility”) and ECLAC (2003, ECLAC Review # 81, article by Ocampo and Tovar)

⁵ The system of non-remunerated reserve requirements is equivalent to a tax on capital inflows where the rate of the tax depends inversely on the length of time the funds stay in the country and positively on the opportunity cost of these funds.

In terms of the results obtained in the pursuit of the objectives mentioned at the beginning of this section we can mention the following:

- i) There is still not a general consensus on whether reserve requirements reduced or not the volume of total net capital inflows thereby alleviating the pressures on the exchange rate and enhancing the capacity of exchange rate and interest rate policy to behave counter-cyclically. Some econometric studies for both countries fail to find effects of the reserve requirements on the volume of total capital inflows while other more recent studies show that there is such effect if properly controlling for some relevant factors in the econometric equations.
- ii) Most empirical studies in both Chile and Colombia coincide in showing that the reserve requirement on capital inflows did work successfully in reducing the share of the short term component of capital flows in the 1990's.⁶ From this point of view, they were an effective tool as a *liability policy*; with a longer term maturity of foreign debt stock, a sudden stop in the supply of capital flows has a smaller impact since the refinancing needs are lower.

Nevertheless some caveats to these positive experiences should be mentioned and they come from the fact destabilizing capital flight can take place even with a very low percentage of short-term debt in total external debt.⁷ If there is no prudential regulation that prevents currency mismatches in the balance sheets of relevant domestic agents, then these agents become very vulnerable to a crisis and will react defensively to expectations of devaluation and/or prospects of weak economic activity. They will wish to pre-pay their long-term foreign currency liabilities before maturity (as actually happened in Colombia) automatically turning them into “short term capital” that leaves the economy. They will also want to buy dollar-denominated assets in an attempt to hedge their positions again reinforcing capital outflows.

This is not a reason to suggest capital controls on capital outflows, but to stress the need of complementary regulatory measures -working in a parallel manner to the capital account regulations- in order to reduce the vulnerability to capital outflows by domestic residents.

⁶ For references see ECLAC (2006).

⁷ This indeed was the case in Chile and Colombia during the Asian and Russian crisis of 1997 and 1998 in which both countries were heavily affected.

In particular, some of these regulations should be addressed to control the currency mismatches of the financial intermediaries, of the main institutional investors and of households and firms.

Prudential counter cyclical regulation

Current prudential regulation is pro-cyclical. One example is provided by the pro-cyclical pattern of credit rating found in Basle II. Another useful example is the use of mark-to-market accounting, prevalent in the private financial sector of the United States, which assigns values to a position held in a financial instrument based on spot prices and which tends to exacerbate economic fluctuations and shocks as mark-to-market requires adjusting the value of marketable securities to their market value. Indeed, mark-to-market accounting is related to the current economic crisis as it guided the financial and economic decision making process of financial institutions including investment banks.

There are different proposals for counter-cyclical prudential regulation including the lean-against-the wind policy of capital and provisions. Indeed, capital requirements and loan loss provisions are considered two important prudential instruments to minimize the probability of insolvency and contribute to the stability of the financial system.

Among the most cited proposal for prudential counter-cyclical regulation are the Statistical Provision for Insolvency applied since 2000 in Spain aimed at counteracting the strong procyclicality in bank lending by ensuring adequate capitalization of banks and introducing dynamic provisioning in addition to traditional provisioning. The key logic behind dynamic provisions is that apart from being an increasing function of portfolio risk they are *inversely* related to the specific loan loss provisions made. Hence, when the latter decrease (there is a tendency to loose bank credit in an upturn) the statistical provisions increase.”⁸

⁸ See, Fernández de Lis, S. Pagés, J.M and Saurina, J. (2000) Credit growth, Problem Loans and Credit Risk Provisioning in Spain. Banco De España. Servicio de Estudios. Documento de Trabajo No.0018. For more recent proposals along these lines, see, Brunnermeier, M., Crockett, A.; Goodhart, Ch, Persaud, A.D. and Shin, H. (2009) The Fundamental Principles of Financial Regulation. International Center for Monetary and Banking Studies

This type of countercyclical prudential regulation should be supplemented, in the case of developing economies and in particular in Latin America by taking into account the specificities of their financial systems.

Surveillance

The current financial institutions do not provide the required level of surveillance to enhance the stability of the global system and the avoidance of undue economic imbalances.

In part as a consequence of limited surveillance powers the global institutions as the IMF have no leverage on the macroeconomic and financial policies of some countries that are considered as systemically important, given that those countries usually do not require the assistance of the IMF to solve their financial and macro-imbalances. However, the distortions that sustained disequilibria in those countries could introduce to the international financial system, demand that the IMF take on functions similar to those of a global regulator, ruling for all the participants of the system, and not only for the developing countries that require its financial assistance. The magnitude and persistence of the global imbalances that could be closely related to the genesis of the current financial crisis have shown that the stability of the system is deeply affected by crisis in financial centers that are outside the scope of surveillance of international financial institutions.

The surveillance of international financial system should be considered a public good and all economies regardless of their development level should be subject to the surveillance of the institutions that guard the stability of the international financial system. To this end the scope and aims of surveillance must be broadened to ensure improved risk assessments; the design of an early warning system; the application of homogenous criteria for all countries independently of their size and level of development; and the improvement in disclosure and transparency practices. In other words all international actors should be submitted to stricter surveillance and reporting requirements

B. Regional financial architecture

Regional and Sub-regional financial institutions should be viewed as complements rather than substitutes for global arrangement.

Regional financial institutions (RFI's) are playing an increasingly important role in the new international financial architecture by complementing global financial institutions. Among these, sub-regional development banks and reserve pooling institutions have helped the countries in the region to mobilize financial resources onto productive activities, as providers of counter-cyclical financing, as instances for reserve pooling, and also as instances for surveillance and macroeconomic policy coordination.

Regional financial institutions have specific characteristics which make them particularly valuable. They provide a sense of ownership of resources and of their destination, given the governance of those institutions. The RFI's also have the knowledge of the region's specificity and this fact eases the contact with local authorities. RFI have been able, conditional on their lending capacity, to act and provide a response in a timely manner. These features have allowed sub-regional institutions to project an image of trust and confidence. Despite these virtues, we stress the fact that RFI should be contemplated as complements rather than substitutes for global arrangements.

Regional and Sub-regional development banks

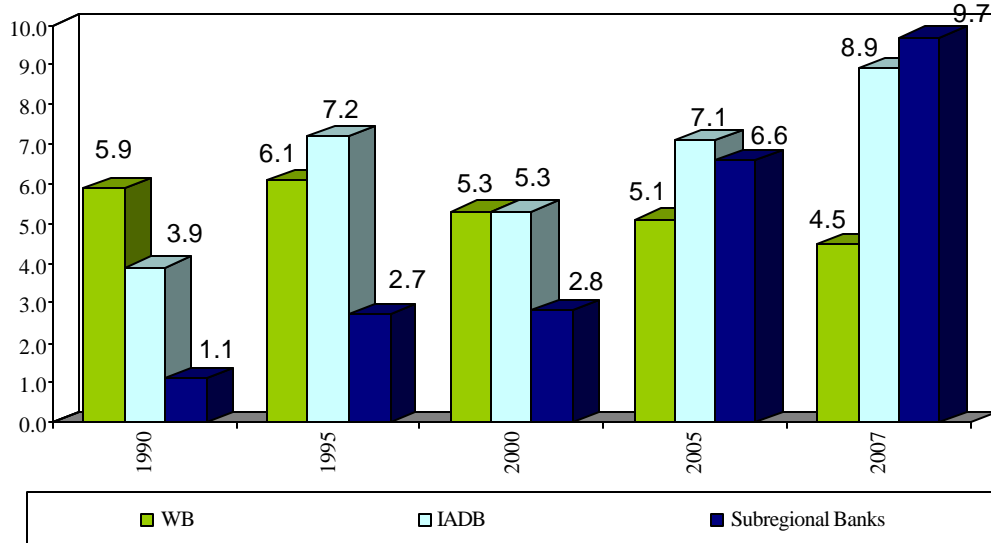
These institutions have allowed the region to increase its degree of integration to international capital markets and to develop their own domestic capital markets, by means of improving financial conditions of funding and issuing bonds in Latin American currencies. As a complementary effort jointly with IFI's, regional and subregional banks have helped countries in the current crisis, by providing liquidity.

Regional and sub-regional development banks grant loans and extend lines of credit to corporations, and banks financing foreign trade and working capital operations, provide credits to the financial sectors for channeling resources to a variety of productive sectors.

They also offer governments and government bodies special financing for physical infrastructure and integration projects, and for projects regarding the promotion of human development and integration of marginalized groups.

The credit rating of these institutions has enabled them to intermediate funds from international markets into the countries of the region in more favorable financial conditions. This, partially, explains why the sub-regional development banks have increased their relative importance as suppliers of resources to the region, when compared with other institutions as the World Bank or the IADB. See Figure 4.

Figure 4
Loans by global, regional and sub-regional
development banks in the region.
(US\$ Bn)



Source: World Bank, IADB, CAF and CDB annual reports.

Note: Subregional Banks include Central American Bank of Economic Integration (CABEI), Corporación Andina de Fomento (CAF) and the Caribbean Development Bank (CDB).

As a part of the efforts to reduce the negative effects of the current financial crisis on the region, sub-regional development banks have established contingency lines to

provide liquidity to Latin American and the Caribbean countries complementing the efforts of the global financial institutions.

Some years ago regional and sub-regional development banks have started to issue, both in domestic and international markets, bonds denominated in Latin American currencies. These bonds add value to international capital markets by providing better risk-rated assets denominated in local currency to international investors, who can then allocate currency risk separately from credit risk.⁹ But besides helping Latin American countries develop their capital markets, this tendency posts other advantages. On the one hand, it allows development banks to diversify their sources of financing and take advantage of favorable market opportunities in the region. On the other hand, the issues in domestic currencies provide development banks with funding that can be then used for local currency loans to its member countries helping them reduce their exposure to exchange rate risk in projects whose revenues are not at all related to the exchange rate. This market is still very incipient but it could also help the countries in the region to borrow abroad in domestic currency, avoiding the “original sin”, and therefore reducing the external vulnerability that external financial usually imply.

Reserve funds¹⁰

The regional experience with a pool of reserves, such as FLAR, has been successful in providing member countries with countercyclical financing when facing balance-of-payments problems. During severe crises this system has given countries access to a faster and larger financing than the IMF’s one. This gives a strong argument for the pool of reserves to expand to new members, enlarging its resource base and helping to avoid contagion.

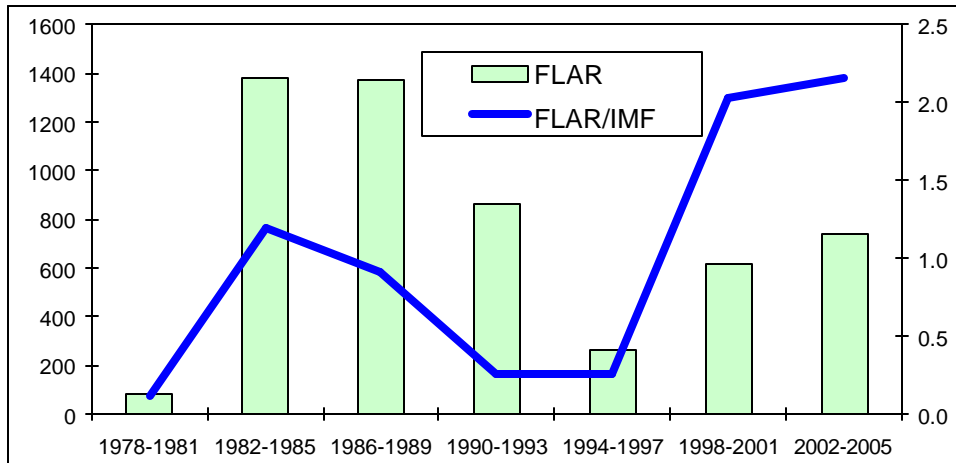
⁹ To take an example, since it was issued, the Yield to Maturity (YTM) of an IADB bond in Brazilian Reais has been on average 2.4 percentage points lower than the YTM of an equivalent bond in Reais issued by the Brazilian Government. This yield spread shows the difference between “Brazil risk” and “IADB risk” having isolated the currency risk of BRL

¹⁰ ECLAC (2007): “Less volatile growth? The role of regional financial institutions”, José Luis Machinea and Daniel Titelman. CEPAL Review 91, April.

Other instruments that the region has used to mitigate its external vulnerability are the reserve funds. The Latin American Reserve Fund, FLAR, has played an important role in stabilizing access to financial flows. Until the present time, it covers Bolivia, Colombia, Ecuador, Costa Rica, Peru and Venezuela. The main function of the FLAR is to provide financial support for its member countries' balances of payments complementing IMF financing. For this task, the FLAR operates as a credit cooperation in which the member countries' central banks are able to take loans in proportion to their capital contributions.

A remarkable characteristic of FLAR is its ability to assist member countries quickly and in a timely manner. The total disbursements of FLAR amounted US\$5,300 millions between 1978 and 2005, and 90% of this amount was used in same parts to provide both balance-of-payments support and liquidity. A large share of those credits was disbursed during the 1982-1984 crisis, and 1998-1999 crisis (see Figure 5). Indeed, during those crisis episodes, financing by the FLAR has been significantly larger than that of the IMF.

Graph 5
Total disbursements of FLAR.
1978-2005
(millions of dollars and proportion of IMF facilities)



Source: Own calculation based on data provided by FLAR.

To deepen regional financial integration RFI should continue to provide countercyclical financing, expand their functions to include supporting and facilitating the countries' access to international financial markets, and actively support national and regional financial development. Additionally, RFI should stimulate more coordination of the macroeconomic and monetary policies of the countries in the region, and could play a role regulating and supervising the financial system in the region. To perform these tasks, RFI must expand their coverage to improve their resource base helping to reduce contagion between countries. In this context, new initiatives such as that of the Bank of the South can complement the objectives and functions of the existing regional financial institutions, and therefore, complement the global financial architecture.