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De-leveraging

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On 2003, economists Carmen Reinhart, Ken Rogoff and Miguel Savastano published a paper entitled "Debt Intolerance". It presented an assessment of the level of external-debt-to-GDP ratios that was safe or tolerable. They linked the debt threshold to the current observable economic fundamentals as well as to the historical behavior of countries, arguing that a bad record increased the probability of defaulting significantly.

Their broad conclusion was that the level of debt economies could tolerate was quite low, and that many Latin American countries had external debt positions that were too weak, so default was around the corner.

I saw the presentation by Carmen Reinhart at the Latin American and Caribbean Economic Association meetings (LACEA) in Puebla, Mexico that year. During the discussion, the debate in the audience centered around how these countries would eventually get back to sustainable debt positions. As the paper puts it,

"For debt-intolerant countries, sustaining access to capital markets can be problematic unless debt ratios are quickly brought down to safer levels. To assess how such "deleveraging" might be accomplished, we examine how, historically, emerging market economies with substantial external debts have managed to work them down. To our knowledge, this is a phenomenon that has previously received very little, if any, attention. We analyze episodes of large debt reversals, where countries' external debt fell by more than 25 percentage points of GNP over a three-year period. Of twenty-two such reversals that we identify for a broad group of middle-income countries since 1970, almost two-thirds involved some form of default or restructuring. Only in one case—Swaziland in 1985—was a country able to bring down a high ratio of external debt to GNP solely as a result of rapid output growth."

To some extent, the mood in the early 2000s was that, unless something extraordinary happened, many Latin American countries faced a non trivial probability of defaulting, as the possibility of running persistently high current account surpluses in a relatively short period was limited.

The decade shows that no default happened—Argentina aside—, and that countries were able to lower their net debt positions without requiring difficult adjustment in expenditures.

What happened then? What explains this surprising outcome? I want to argue—as many others have—that this was a combination of good luck and good policies. Good luck simply because the region faced an extraordinary period of high commodity prices and high terms of trade.

But good policies too because many governments decided to save a significant part of the terms-of-trade gains, in contrast to many other previous booms. Also, the region developed prudential regulation of financial markets which, combined with more flexible exchange rate regimes prevented the private sector from running high deficits.

This relatively strong net asset position was very important during the crisis, as the market's search for highly indebted countries and banks was not very successful in Latin America. A recent Financial Times editorial commenting on Latin America's recession argues that the biggest financial danger now facing the region is complacency, as an important part of the recent good fortune of the region is luck. Scarred by past crises, banks did a prudent job and avoided sub-prime junk, while the region was blessed with the commodity boom.

Some data come in handy here. During the first decade of the twenty-first century, Latin American countries were able to lower their net foreign debt by about 20% of GDP. The current account balance, which had shown a perennial deficit during the 1980s and 1990s, posted an average surplus during the 2000s of around 2% of GDP. Similar figures arise when we analyze fiscal balances. Finally, while stable during the 1990s, the real exchange rate of Latin American countries vis-à-vis the rest of the world appreciated about 20% over the next decade.

Is this important? I believe it is very much so because the challenge that many countries around the world face today is de-leveraging. Either because their fiscal stance was already weak before the financial crisis hit, or because their fiscal policies following the crisis were extremely active, the fact of the matter is that many countries—mainly developed ones—are in a very complex fiscal situation, which requires de-leveraging. The same thing happens with households and financial intermediaries in other developed countries, which after the downward correction in asset prices face the challenge of de-leveraging.

This challenge is not so different from the one that Latin American countries were facing in the early 2000s, but I am afraid the conditions that allowed a smooth transition in the region may not be present in many countries today. This reality, that markets seem to be considering very relevant in the past few weeks, will put the region and the world to the test in the coming years. Let us take a deeper look at it.

<u>High Leverage</u>

The crisis revealed high leverage in several sectors in developed economies; in households, banks, or governments. This leverage was somehow hidden behind high asset prices. It is not that markets and investors were unaware of credit growth or high debt, but the perception was that over-indebtedness was not there. This is what market prices and risk spreads were reflecting at that time.

This is a very delicate debate. It is not obvious to what extent there might have been an asset bubble, or whether high asset prices indeed reflected expectations of high productivity growth and low risk spreads. The key issue is that the downward correction in asset prices unveiled a degree of indebtedness larger than expected, and the market reacted accordingly with the increase in the cost of financing liabilities, especially short term.

The fall in risky asset prices may take some time to reverse, not only because growth may take some time to regain momentum but also because of a more permanent correction in the price of risk. The consequence of the new reality is that there is an important need for a substantial de-leveraging.

Where is the need for de-leveraging more urgent? Market prices give us a hint. In the United States, the costs of households' debt, either for mortgages or consumer credit, reflects the market perception that de-leveraging in the household sector is needed. The financial sector too has been subject to similar pressures, but the actions of the Central Banks have helped smoothing this process.

In some European countries, meanwhile, the fiscal position is very weak, and the level of sovereign debt as a share of GDP is very high. The high volatility in financial markets in the last weeks and the run against sovereign bonds in Greece and other southern European countries reflects such market perception. In Greece, government debt as a share of GDP is 115%, similar to Italy's (116%), while these numbers are somewhat lower for Portugal (77%) and Spain (53%), although these countries have much higher levels of private debt. The net foreign asset position of Portugal is about -100% of GDP, and Spain's is -75%, similar to Greece's.

The sharp jump in credit spreads in public bonds in these countries reflects the market concerns not only about the sustainability of their fiscal positions but also regarding their ability to do this de-leveraging process without restructuring their debts. In other words, back to the "debt intolerance" debate, the market seems to be incorporating the idea that improving their net asset positions would require a significant adjustment in expenditures and activity—which is highly difficult—as well as a higher probability of haircuts. The rigidity of their monetary policies and the inability to generate a rapid depreciation of their real exchange rates in response to the capital outflows makes the adjustment much more costly.

Interestingly, the possibility for these countries to regain sustainable debt positions through a terms-of-trade boom—similar to the one faced by Latin American countries during the 2000s—, is very remote, not to say impossible, given their comparative advantages and their highly concentrated trade structures within Europe. This is definitely not the way highly-indebted developed countries will reduce their leverage, which means that de-leveraging in these countries is going to be painful.

This is troublesome, and potentially has several implications on Latin America. The first implication is related to the short-run consequences of the stress in financial markets we have been seeing in the last couple of weeks. The exposure of the European banking system to Greece and other southern European countries with problems is limited, so it is possible that the debt crisis remains centered in these economies without affecting the balance sheet of financial intermediaries in Europe.

However, the uncertainty regarding the exposure of European banks to southern Europe and doubts about the ability of these countries to make the necessary fiscal adjustments is raising concerns on banks perceived to be highly exposed, and this is affecting short-term money markets and inter-bank lending. This has the potential to have a major impact on banks' balance sheets, promoting an even sharper flight to quality and a further weakening of credit.

Central banks are actively providing liquidity to short-term markets and, as we speak, the European Central Bank has just announced its willingness to buy sovereign and private debt as liquidity in most sovereign markets has deteriorated, as well as it has extended their liquidity facilities at fixed rates for 3 and 6 months. Also, the Federal Reserve announced an extension of their dollar-swap programs.

These measures have been well received by the markets, but the fundamental qualm regarding the solvency of many governments and their capacity to adjust is still there. A further decrease in risk appetite across markets could generate a significant increase in the cost of funding of banks, pushing them toward further de-leveraging. These events should be monitored carefully.

A fast deterioration of financial conditions could affect world financial markets. In the current conditions Latin American countries do not have large current account deficits, so the dependence on foreign financing is smaller than in the past. A strong deterioration in financial conditions and a flight to quality that increases the spreads on corporate and sovereign debt of Latin American countries would deteriorate the access to global capital markets and weaken the currencies, but their overall effect could be limited.

This effect could be reinforced though if the financial stress generates a downward revision on global growth. At this stage, it is likely that growth prospects for Europe might be revised downward, but it is too early to make such an assessment for the rest of the world.

An alternative scenario for Latin America is one where, although financial markets remain under stress, the problems in Europe remain ring-fenced, so there is no major de-leveraging in the European banking industry and a sharp and further flight to quality does not take place. In this case, while risk spreads could remain high for some asset classes, there is a reallocation of portfolios toward developing countries with stronger positions.

This is the scenario that most analysts and the market seem to be favoring, if a non-crisis development of current European conditions. In the words of Mohamed El-Erian, CEO of Pimco, one of the largest fund managers in the world:

“The second transmission mechanism [of the Greek crisis] pertains to capital flows and is more nuanced. Several countries, led by the United States, stand to benefit from a reallocation of capital away from the eurozone as investors react to both the deterioration in sovereign risk and the surge in volatility. As for the capital that flows just within the eurozone, there will be an even greater differentiation in favor of the solid core countries, particularly Germany. These flows are already happening. They will become even more pronounced in the weeks and months ahead as institutional investors revise their investment guidelines to exclude highly volatile government exposures from their "interest rate" bucket. But there is an important qualifier here. Since Greece is part of a general phenomenon of bloated public finance and higher systemic risk, we should also expect a generalized and volatile step-increase in risk premium around the world. Capital will thus be more selective in terms of destination, as it opts for liquidity over returns and for safe government bonds over equities."

Put it differently, a debt crisis in some European countries, and a process of de-leveraging and higher savings in other developed countries might induce a search for opportunities that could promote capital inflows to some Latin American countries. This scenario of higher growth rates, high growth of domestic demand, inflation pressures, and an appreciation of the real exchange rate cannot be discarded, and in some sense, it is not too different from the one of the first half of the 1990s in most Latin American economies.

High Commodity Prices

A second feature of the post-crisis world scenario is the prevalence of high commodity prices. Even in the worst days of the financial crisis, and even in the context of the worst world recession in decades, the evolution of commodity prices has been surprising, meaning that we are probably moving towards a world where commodity prices are relatively high. And I think the most reasonable phenomenon supporting this hypothesis is China. This has several implications, and I want to emphasize two of them.

The first one is that the conditions that sustain the de-leveraging of Latin American countries in the last decade could prevail again. This reinforces the idea that the region could become an attractive destination for capital flows.

A second implication is that the need for discipline—or the danger of complacency as the Financial Times puts it—is starker than before. In such a context, the need for prudent banking regulation and flexible exchange rate regimes continues, and it is central for governments to continue treating the commodity boom as transitory, for three reasons. First, there is always uncertainty about this, and after the financial crisis prudence in this dimension is particularly necessary. Second, even with one or two decades of high commodity prices, from an intergenerational perspective high government savings is always adequate.

The tendency to treat these commodity booms as permanent phenomena is in part the experience of the 1970s. In that decade, governments treated the commodity boom as permanent, increased government expenditures significantly and launched ambitious government programs. When the boom receded, the difficulties in bringing expenditures down meant that debts increased significantly, and the fiscal policy – and monetary policy as well – ended up amplifying the business cycle.

There is a final reason for why in developing countries government should be careful in spending the commodity boom. The lack of fiscal reforms in many governments means that they do not have the ability to spend in profitable projects. This reveals the fundamental weakness and challenge of Latin America, which is the growth challenge.

Several studies—and a vast literature in economics—have shown that differences in factor endowments cannot explain such large differences in income per capita across countries. This literature—or part of it—concludes that productivity differences explain a larger part of income differences.

These productivity differences arise from "technology differences", that is, different ways firms combine inputs to produce, but also—and maybe more importantly—from a sub-optimal allocation of factors across firms and sectors. In economic jargon, price distortions put the economy within the production possibility frontier.

Why do I say all this? Because although Latin American countries have roughly done the macro homework well in the last decades to prevent excess spending, but they still carry a large liability in terms of enhancing productivity and factor allocation.

This has many explanations. I would argue in favor of two of them: globalization, and China. Globalization implies among other things integration of world factor markets, mainly financial and human capital. This process is very attractive, but it makes evident the productivity gap with the rest of the world. In a world without factor mobility, productivity differences are "shared" across all factors, which face the burden of distorted policies. With factor mobility, only the immobile factors confront the cost of low productivity. Conceptually, factor mobility makes the concept of comparative advantage less relevant and it emphasizes the role of absolute advantage. In these poorer countries, like Latin American ones, this implies a fall in wages of unskilled labor and a shift in production toward labor-intensive sectors and land-intensive sectors. At the same time, China's growth and the changes in relative prices following its development pushes Latin American economies toward natural-resource-intensive goods.

Rather than facing the fundamental challenge of escaping the low productivity trap and educating their population, many countries keep pouring resources into low productivity sectors, fighting against the reallocation of factors.

In this context, if a permanent increase in expenditures—either privately or publicly driven—following a permanent increase in the terms of trade is going to take place, important reforms must be implemented. Otherwise, the chances of wasting an important part of the funds is too costly to afford.

Thank you.