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Smoothing Booms and Busts

High financial and economic volatility—together with low growth and high inequality—is a Latin American trademark. The region's volatility, including the frequency of devastating financial crises, has been among the highest in the world.[1] It has reflected a wide range of external and homegrown factors: major swings in foreign capital flows (partly reflecting imperfections in the international financial architecture), sharp fluctuations in commodity prices (on which many economies are still unusually dependent), lack of credible domestic monetary policies, weaknesses in domestic financial sectors, and stop-go patterns of fiscal spending. Economic volatility in Latin America stands out regardless of the indicator chosen to measure it, whether it is the real exchange rate, the real interest rate, the budget deficit, banking system credit, or the growth rates of consumption, income, and employment. And while after the 1980s, as countries left hyperinflation behind, volatility did not increase in some dimensions (and even declined somewhat), it arguably rose along other dimensions, especially with respect to international capital flows.[2]

Hopes have been raised in recent years that volatility may be on a downward trend, given the region's stronger fiscal and external positions, improved financial regulation and supervision, and more flexible

1. See De la Torre, Levy-Yeyati, and Schmukler (2002); De Ferranti and others (2000); Hausmann and Gavin (1998); Singh (2006); and IDB (1995).

2. For instance, the variance in growth of real income and consumption did not increase in the 1990s above the level in the 1980s.

exchange rate regimes. However, the recent calm may be mainly a reflection of currently benign international financial conditions, such as abundant investable funds in major financial centers seeking yields throughout the world in the face of low interest rates in OECD countries, as well as buoyant export markets due to the strong demand in China for mining and agricultural products. These conditions cannot be expected to last indefinitely.

Volatility is bad for growth.[3] The uncertainty of returns on investment in human and physical capital undercuts total investment and biases the direction of investment toward shorter-term and riskier projects. Volatility is especially costly in Latin America because the region's underdeveloped financial markets fail to enable smaller firms to invest in technological adaptations and innovations and low-income households to invest in education, skill building, and health.

Equally worrying but less remarked, volatility in the form of financial crises involves inequitable wealth transfers that create major and enduring adverse distributional effects, including for those who do not directly participate in the financial system.[4] Volatility is particularly costly to poor and near-poor households. To be sure, the income of the rich fluctuates more, but a smaller fluctuation for a poor household can be much more costly. The poor benefit less during booms (when individuals with real and financial assets tend to gain most), and they are the first to lose jobs during busts.[5] For the poor, even short-term losses can have long-term implications. Evidence from Mexico and elsewhere suggests that many children who drop out of school to work in bad times never return.[6]

So, policies aimed at explicitly and systematically reducing volatility can exploit a vast terrain for win-win solutions to simultaneously advance the goals of growth, equity, and poverty reduction.

3. For more on Latin America's history of macroeconomic volatility and financial crisis and its impact on growth, see Singh (2006). On volatility and its relationship to growth, see Sahay and Goyal (2006); Hnatkovska and Loayza (2004); Ramey and Ramey (1995); and Easterly and others (1993).

4. See, for instance, Halac and Schmukler (2004). Dervis and Birdsall (2006) discusses the mechanisms by which high public debt in emerging markets generates inequality.

5. See Birdsall (2007, figure 7).

6. See Székely (1999); Lustig (2000); Duryea, Lam, and Levison (2007); Skoufias and Parker (2006); Blanco and Valdivia (2006); Guarcello, Mealli, and Rosati (2003); and Rucci (2004).

Policies to manage macrofinancial volatility and thus reduce the probability of crises cannot themselves be unpredictable or subject to constant improvisation. Instead, policies must be designed ex ante to lock in politically sustainable actions and responses. At the same time, rigid precommitments such as currency pegs can increase volatility over the longer horizon. Generally speaking, fiscal targeting and other institutional arrangements that put the emphasis on rules over discretion are a superior way to go. In particular, a framework should be established at the outset to constrain opportunities for political manipulation, thereby ensuring that a cushion of adequate savings is accumulated—not squandered—in good times and guaranteeing that mechanisms for compensatory spending (for example, on the social safety net discussed below) are triggered automatically in bad times.

In short, smoothing booms and busts requires fiscal, monetary, banking, and other policy tools that not only are well designed but also are underpinned by sound institutional fundamentals.[7]

Fiscal Tools

- *Rules to lock in additional fiscal effort during booms.* Such rules help avoid sharp fiscal contractions, thereby stabilizing spending on social programs in bad times, preventing spending binges when a country is enjoying a bonanza, and keeping public investment plans on track throughout the business cycle.[8] They also can help protect

7. A country could conceivably mitigate the consequences of volatility through market-supplied insurance, but it is at best thinly supplied in international capital markets. Hence, the emphasis unavoidably has to be placed on self-insurance (private and public savings accumulated in good times for use in bad) and self-protection (policy actions to reduce the likelihood that adverse shocks and sharp fluctuations will occur).

8. Governments in developed countries enjoy the benefits of countercyclical fiscal policy. During recessions they are still able to borrow at low cost in local and international financial markets; as a result, they can engage in deficit spending to stimulate their economy and provide a social safety net for their citizens. In Latin America, however, governments have been compelled to tighten fiscal policy (and even generate surpluses) in bad times—thereby exacerbating the economic downturn—because they tend to lose access to financial markets precisely when they need access most. Few countries, with the possible exception of Chile, command sufficient confidence in external markets to borrow in bad times. Building the capacity to undertake countercyclical fiscal policy therefore is a key priority for Latin American countries, and it begins with saving in good times.

access to financial markets in bad times. Specific standards for adopting a primary budget position—the fiscal position net of interest costs—that can be sustained over a long horizon need to be defined in each country (see chapter 1). In all cases, however, year-to-year fiscal policy targets should be defined, taking into account not just the country's long-run solvency but also its business cycle (cyclical deviations from actual and potential output). The "structural budget rule" used in Chile to determine year-to-year fiscal targets is a good example of how countercyclicality can be built into the budgetary process.[9]

- *Stabilization funds to smooth government spending during good times and bad.* Such contingency funds ideally operate under rules set by the national congress, stipulating that excess revenues earned during good times will be saved or used to pay down the public debt. If funds are saved, the government can draw down the funds in times of revenue shortfalls to help maintain critical spending. The Chilean copper stabilization fund is a good example.

Monetary Tools

- *A framework for countercyclical monetary policy that emphasizes building a credible record of low and stable inflation in the context of exchange rate flexibility.*[10] Monetary policy should enhance the role of the local currency as a store of value for savings, thereby providing a reliable currency of denomination for credit contracts. A reliable currency is essential to minimizing currency mismatches

9. The Chilean "structural budget balance" is a measure of the fiscal position adjusted for the output cycle (the difference between potential and actual GDP) and the "excess" or "shortfall" in copper-related revenues relative to trend. For a detailed discussion of the main issues and experience with the Chilean structural budget rule, see LeFort (2006); Rodríguez, Tokman, and Vega (2006); and Velasco and others (2007). For further discussion of structural balance, see Dos Reis, Manasse, and Panizza (2007) and Balassone and Kumar (2007, forthcoming).

10. The feasibility of introducing a monetary policy framework that allows a government to maintain low and stable inflation while maintaining a flexible exchange rate depends on sound fiscal and debt fundamentals, in particular controlling deficits and borrowing so that monetary authorities are not unduly constrained in raising interest rates by fear of increasing the government's debt burden.

and ensuring that currency depreciations do not have adverse balance sheet effects; it also makes exchange rate flexibility more feasible. Given Latin America's openness to capital flows, exchange rate flexibility is necessary to allow for the countercyclical monetary policy that has eluded Latin American countries for decades.[11]

Banking Tools

- *Prudential standards (for capital, provisions, liquidity) that follow best international practices yet are appropriately adapted to country circumstances.* Latin America must strive to converge toward the worldwide trend of enhancing the sensitivity to risk of bank regulation and supervision. Such efforts need to match the increasing sophistication of risk management systems among leading financial entities, take into account the implications of financial globalization, and reflect the growing complexity of financial products and markets. International accords and standards can help Latin American countries with that task. However, such standards must be adapted to better address specific features of the banking systems in individual countries—including higher volatility, illiquidity of securities markets, financial dollarization, and high exposure to government debt paper, among others.
- *Countercyclical loan-loss provisioning requirements to dampen the amplitude of the credit cycle and protect banks' solvency during downturns.* Banks would then have to build countercyclical provisions in times of high credit growth to use during the downswing of the credit cycle to absorb the losses from downward loan reclassifications and asset write-downs.[12]
- *Countercyclical liquidity or reserve requirements.* Such requirements would be higher in good times (with buoyant deposit growth) and

11. Monetary policy in Latin America has tended to be procyclical, with interest rates typically increasing sharply at the worse of times and thus magnifying the recessionary effects of adverse shocks. See, for instance, Calvo and Reinhart (2002) and Hausmann, Panizza, and Stein (2000).

12. The system of "statistical" provisions introduced in Spain is an interesting and useful example of countercyclical provisions.

lower in times of systemic liquidity crunches.[13] Such requirements do not exist in industrialized countries, but they can help in Latin America at least until creditor rights are much more consolidated in law and enforced in the region.

Other Policy Steps

- *Encouraging the entry of first-rate foreign banks, which in countries like Mexico, Chile, Peru, and Colombia have enhanced the stability and resiliency of the domestic banking system.* Foreign banks bring sounder banking practices and access, through the parent bank, to external capital and liquidity. They typically operate under the stricter regulatory and supervisory procedures of their home country, setting a high standard in the local market.
- *Promoting the development of local currency–denominated debt markets and reducing the exposure of government debt to rollover, interest, and exchange rate risks.* Mexico has made substantial progress on this front. Reducing the exposure of governments to risks associated with their debt entails generating a debt profile that takes into account risks, not just costs. CPI-indexed instruments can complement local debt market development in a way that is consistent with reducing currency mismatches.[14] To lengthen the term of private sector debt while limiting instability in capital inflows, Chilean-style reserve requirements discouraging excessive short-term indebtedness may be considered.[15]

13. These requirements should be complemented by management of adequate international reserves and, if possible, by arrangements for automatic access to international lines of credit in the event of a liquidity squeeze. The idea of Argentina's international repo facility, which was negotiated in the second half of the 1990s, was to lock in automatic access to hard-currency liquidity in good times for use in bad times. However, the repo contract gave Argentina the option of using government bonds, valued at market prices, as collateral to obtain liquidity from international banks. The price of those bonds declined steeply as fears of default rose and financial conditions in Argentina deteriorated in 2000 and 2001, precisely when the bonds were needed most.

14. See Goldstein and Turner (2004) on controlling currency mismatches. See also De la Torre and Schmukler (2004).

15. See Williamson (2005, 2000) for a brief discussion of Chile's uncompensated reserve requirement.

Multilateral financial institutions, such as the World Bank and the Inter-American Development Bank, can buttress such efforts by issuing or guaranteeing growth-linked bonds[16] and by exploiting their own balance sheet (obligations and income in a country's currency) to lend in borrowing countries' local currency, while hedging such positions in international markets—for example, by issuing bonds denominated in individual local currencies or in a suitable basket thereof.[17]

- *Continuing efforts to diversify trade and increase foreign direct investment, including by negotiating multilateral, regional, and bilateral agreements*. In the face of the entry of exports from the Asian giants (China and India) into the world markets, it is even more critical for Latin America to build broader markets for nontraditional export products, reducing its excessive dependence on a few commodity exports whose prices are subject to large fluctuations. Openness to foreign direct investment makes sense in this context because it is more stable and permanent than other forms of capital inflows, such as portfolio investment and short-term debt.
- *Diversifying catastrophic risk*. Many countries in the region are disproportionately exposed to natural disasters (earthquakes in Central America, hurricanes in the Caribbean). These disasters are particularly damaging for the poor, whose homes and livelihoods they destroy. Global financial markets offer little help in managing catastrophic risk in developing countries. But there is room for domestic authorities to cooperate regionally and internationally, with multilateral financial institutions and private firms, to create special catastrophe insurance programs. Such programs would tap the international capital markets to insure the domestic economy and victims of natural disasters against at least part of their losses.

16. See Borenzstein and Mauro (2004); Council of Economic Advisers (2004); and Chamon and Mauro (2006).

17. Eichengreen, Hausmann, and Panizza (2005) and Levy-Yeyati (2004) offer interesting proposals in this regard. In 2001 the World Bank began offering some of its emerging market borrowers financial products denominated in their domestic currencies, but at modest volumes. In 2005 the Inter-American Development Bank approved on a pilot basis a local currency option for disbursement of a US$300 million loan to Mexico. See also CGD (2006, 2005).