COVID-19 in Latin America: Liquidity Needs and the Role and Limits of Central Banks

Liliana Rojas-Suarez
Center for Global Development
and Columbia University
April 2020

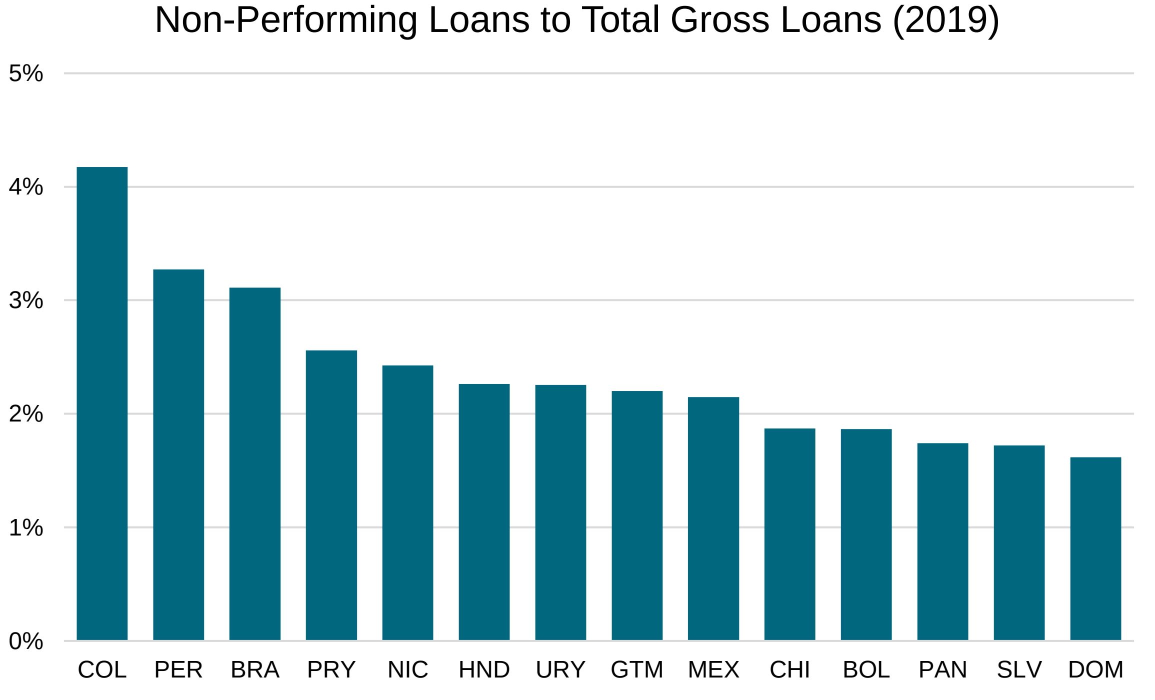
Provision of Liquidity: What Central Banks Can Do

- Provision of liquidity is absolutely needed now. But central banks will be able to reverse their expansionary monetary stance when the crisis is over if there are no major financial sector fragilities
- If existing vulnerabilities in the financial sector get intensified during the crisis, resolving banking difficulties might press central banks to keep interest rates at lower rates than desired for a significant period of time (to contain the increase of nonperforming loans)

Provision of Liquidity: What Central Banks Can Do

Indicators of banking soundness were strong in the region and satisfied Basel III requirements at the beginning of the crisis

1. Low Ratios of non-performing loans



Source: IMF

When 2019 not available using latest available data

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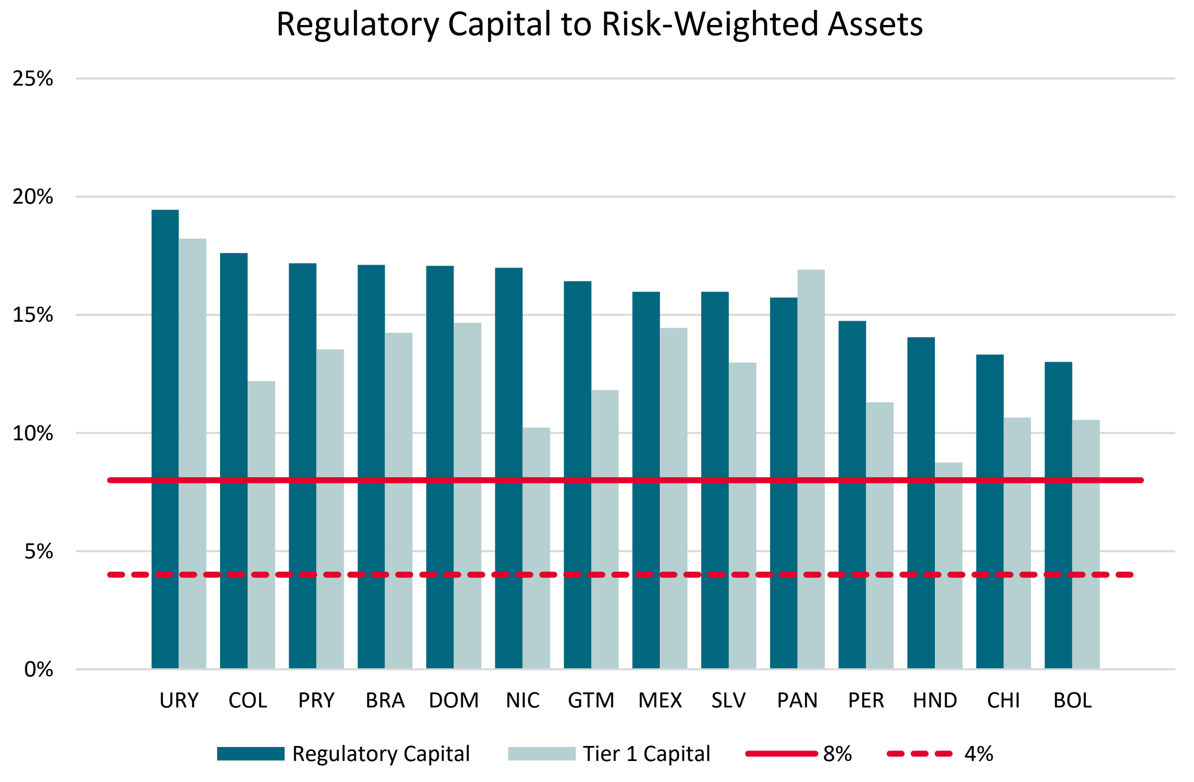
2. High-Quality Capital Requirements under Basel III are met



Source: IMF

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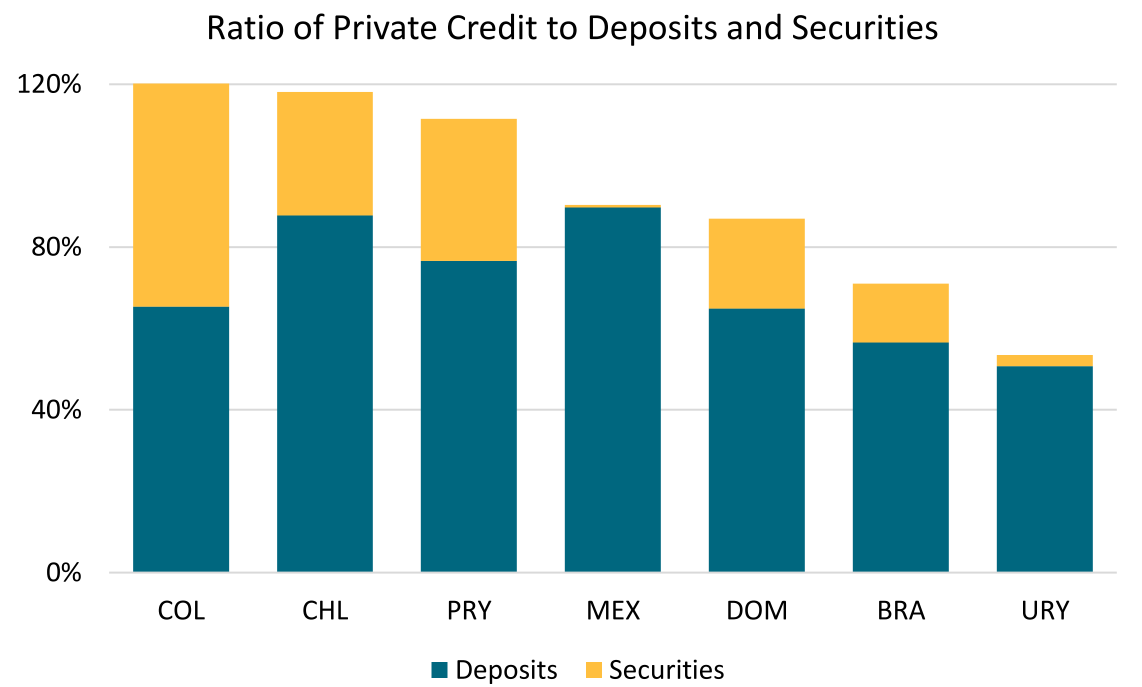
3.Liquidity ratios under Basel III are also met

Compliance with Basel III "Net Stable Funding Ratios" because credit is mainly funded with residents' deposits as opposed to securities



Source: IMF

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Provision of Liquidity: What Central Banks Can Do

In this context central banks have been active using their tools:

Interest Rate Reductions	Reduction of reserve requirements	QE Policies	Credit Provision or Liquidity Support	Countercyclical Capital/Provisioning Requirements
✓ Argentina ✓ Brazil ✓ Colombia ✓ Chile ✓ Costa Rica ✓ Dominican Republic ✓ Guatemala ✓ Honduras ✓ Mexico ✓ Paraguay ✓ Peru	✓ Argentina ✓ Brazil ✓ Colombia ✓ Dominican Republic ✓ El Salvador ✓ Mexico ✓ Paraguay ✓ Peru ✓ Uruguay	✓ Bolivia ✓ Colombia ✓ Chile	✓ Argentina ✓ Brazil ✓ Dominican Republic ✓ Paraguay ✓ Peru ✓ Uruguay	✓ Costa Rica ✓ Panama

But Not all Liquidity is Created Equal

- In spite of efforts by central banks to provide liquidity, Latin American (and other emerging markets) **governments and corporations have a need for US dollar liquidity, a currency that their central banks can’t issue**
- Previous to the COVID-19 crisis, net capital flows were large enough to finance current account deficits in many Latin American countries and still allow for accumulation of international reserves
    - ➢ With outcomes depending on exchange rate regimes

Provision of Liquidity: What Central Banks Can Do

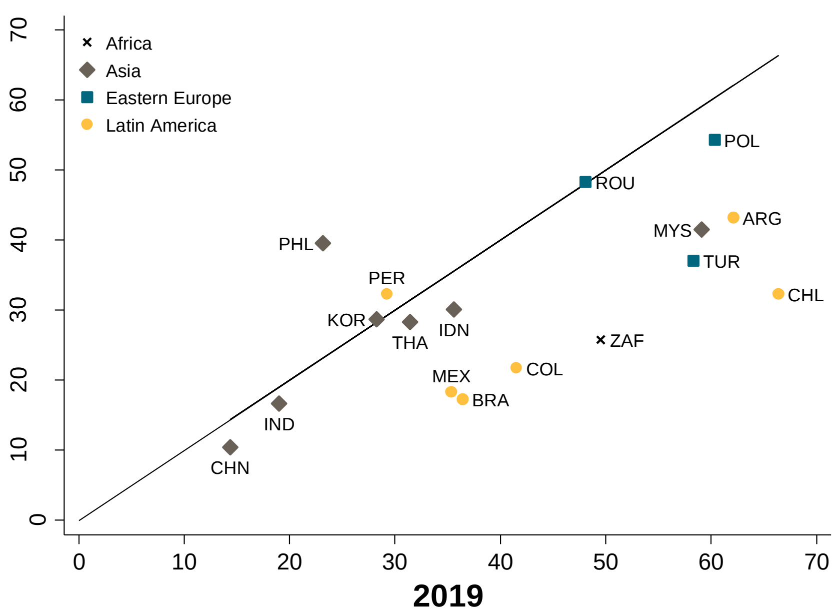
- Some central banks have been providing FX liquidity auctioning swaps in dollars through which international reserves are sold and bought back in 60 days or more. Among emerging markets, Colombia and India are recent examples
- A (very) few central banks have access to the temporary US Fed swap lines (Brazil, Mexico, South Korea and Singapore)
- Some additional dollar liquidity support through the Fed offering of overnight dollar loans (repos)

But this is far from enough

Large and Increasing External Debt as an Additional Constraint to Monetary Policy

- Increased external corporate debt has added to external government debt over the last decade. Thus, the ratios of total external debt to GDP have increased significantly in a number of countries

External Debt (in percent of GDP)



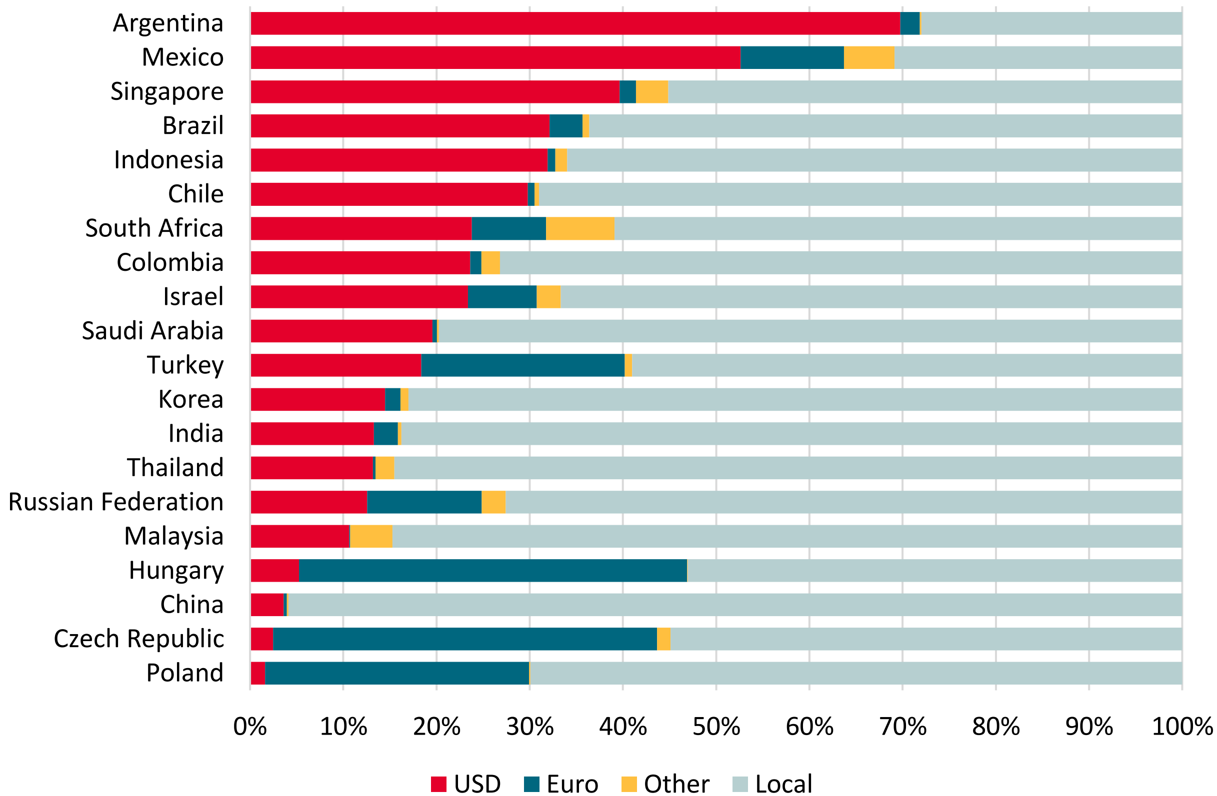
Source: World Bank/IMF

Particularly in a number of Latin American countries

Large and Increasing External Debt as an Additional Constraint to Monetary Policy

- Available data show that Latin American corporations, in general, are more vulnerable to dollar appreciation than other corporations in Emerging Market regions

Non-Financial Corporate Debt: Currency Composition (2019)



Source: IIF

The degree of vulnerability, however, depends on the extent of unhedged exposure by corporations, for which data are not fully available. Hard to assess currency mismatches

Large and Increasing External Debt as an Additional Constraint to Monetary Policy

- The large exchange rate depreciations that followed the unprecedent reversal of capital flows, has made more costly for firms to buy dollars
- Thus, in countries with large dollar-denominated net liabilities, central banks might try to prevent further depreciation of the local currency (fear of floating)

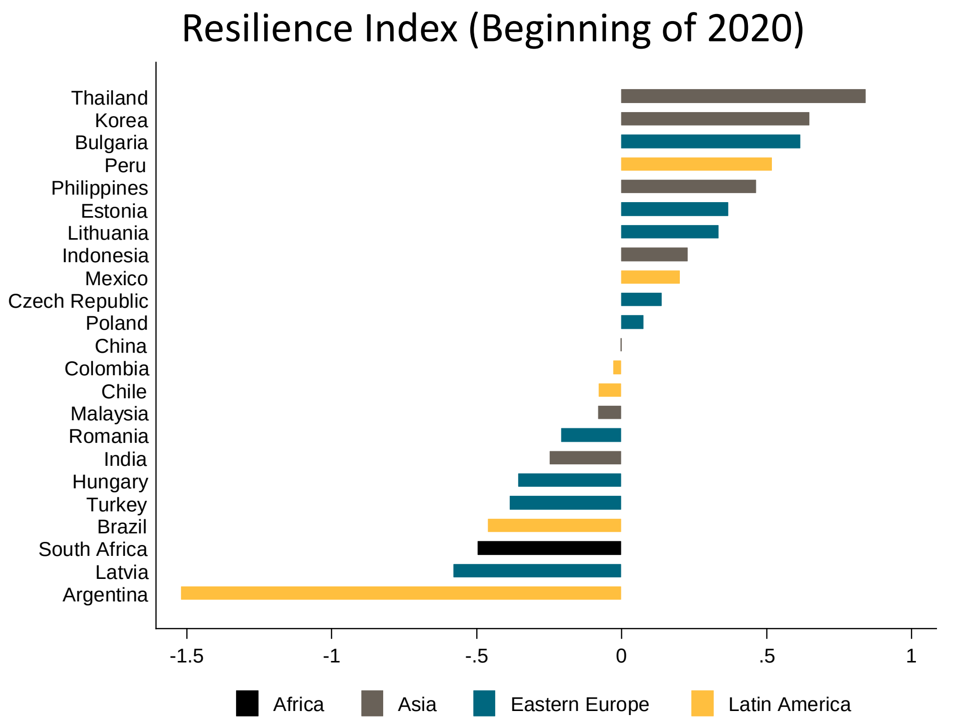
Large needs for dollar liquidity might pose a constraint on central banks for the provision of local-currency liquidity

Alleviating dollar liquidity constraints calls for much greater support from multilateral organizations, the IMF in particular

At the end of the day…Beyond Monetary Policy

Resilience goes back to overall financing needs (private and public) and absence of constraints to the implementation of monetary, fiscal and regulatory policies

Latin America is very diverse in terms of resilience



Source: IMF/WB

- Peru among the strongest
- Argentina the weakest (with Brazil also facing large challenges)