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The COVID-19 Attack on Latin America: Proposals for an Effective Response

Latin American Committee on Macroeconomic and Financial Issues Statement N. 43

EXECUTIVE SUMMARY

- Latin America needs to implement an effective policy response on the public health front and on income transfers. This will require a massive provision of liquidity.
- The COVID-19 pandemic will require, on average, the equivalent to 10% of the region's GDP, including spending measures such as income transfers, credit provision, government guarantees, and tax reductions.
- Governments in the region should share the burden of the effort with the private sector and strive to be austere with respect to non-essential expenditures.
- Subject to specific conditionality, the IMF should make available to the region resources in the range of USD 200-300 billion to finance a portion of the required response.
- When adequately designed, unconventional policies such as wage subsidies and government's guarantees on private sector borrowing can be effective at relaxing financial constraints, preserving jobs, protecting productivity and helping output to recover once lockdown measures are phased out. Some countries may use cautiously public or development banks to provide short-term credit.
- Governments should also consider establishing recapitalization funds to minimize the bankruptcy of fundamentally viable firms.
- Heavy reliance on public debt issuance may render the economy more vulnerable to future shocks and to capital market volatility. In this context, the increase in the precautionary demand for money opens a temporary window for non-inflationary seigniorage as an additional source of financing in countries with limited or no access to capital markets.
- When facing the tradeoff between unsustainable debt accumulation and moderate inflation, the balance of risks has now tilted in favor of a more active role for central banks.

- As the crisis extends over time, additional actions are required to sustain credit growth, reduce default rates, and expedite corporate restructuring. New legal instruments—such as corporate reorganization frameworks—will be necessary to facilitate burden-sharing among the different private stakeholders.
- The Committee endorses the creation of a Latin American Liquidity Fund (LALF) and the establishment of an Emerging Market Fund (EMF), the latter being a facility aimed at stabilizing an index of global (or regional) sovereign emerging-market bonds.

I. COVID-19: A HUGE SHOCK TO THE GLOBAL ECONOMY AND TO LATIN AMERICA

The COVID-19 pandemic represents a massive global shock that hit Latin America particularly hard. The nature of the virus and the need to impose tight and prolonged lockdowns has been the same as in advanced economies, but the impact of the collapse of trade, commodity prices, tourism and remittances, the weak health systems, and the large informal sector, complicate significantly the crisis and pose serious challenges for an adequate policy response. Prolonged lockdowns required to contain the spread of COVID-19 led to major aggregate demand and supply disruptions. At the same time, the lockdowns have been poorly managed in several countries, and have had limited success in containing the pandemic, raising the prospect of extended and/or tighter lockdowns.

Overall, Latin America's policy response has been insufficient in various dimensions: health, fiscal, monetary, financial… Mitigating the extent of the human tragedy and restoring conditions for economic recovery will require a substantial, coordinated national and international effort. With few exceptions, Latin America entered the crisis from a position of economic weakness (low growth, deteriorating fiscal accounts, increasing corporate and sovereign external debts). Moreover, the region's large informal sectors make it very difficult for the government to channel assistance to those that need it the most.

Therefore, **the Committee believes that Latin America requires the implementation of a massive policy response on the public health front, in formal as well as informal labor markets, and in income transfers to support basic consumption for an increasingly large number of families that are living day-to-day.** To be sure, the reaction across the region has been quite heterogeneous. For instance, countries such as Nicaragua and Mexico have been slow to respond adequately to the health-care challenge. **In addition to strengthening actions and programs that have been put in place, the Committee believes that the policy response in the region will require a massive provision of liquidity.**

The Committee estimates that adequately responding to the COVID-19 pandemic will require, on average, the equivalent of 10% of the region's GDP. The response to the pandemic includes spending measures—such as income transfers and support for labor—credit provision and government guarantees, and tax reductions.

The response to the COVID-19 crisis poses financing challenges largely exceeding those faced by reserve-currency countries, given the increasing demand for safe assets triggered by the crisis. For this reason, **the Committee believes that governments in the region should share the burden of the effort with the private sector and strive to be austere with respect to non-essential expenditures.**

The Committee also believes that the international official community must step up and play a

significant role in the response to the pandemic. In particular, the Committee believes that the IMF should make available to the region resources in the range of USD 200-300 billion in order to finance a portion of the required response. These resources should come with conditionality that ties them to the critical uses for liquidity provision and income support for households and firms affected by the lockdowns, and for healthcare costs associated with the COVID-19 crisis.

II. THE DOMESTIC RESPONSE

The COVID-19 crisis is unique. In varying degrees across the region, it prompted governments to force firms to suspend operations and command workers to stay at home. This amounts to a negative supply shock of unprecedented size. Even if the jobs and the firms were guaranteed to survive the lockdowns, households sent to live in lockdown need to be provided with liquidity to survive it, otherwise the effect of lockdowns is likely to weaken and fail to avoid the collapse of the healthcare system. In the advanced economies, liquidity has been provided either as direct payments (e.g. massive, temporary increases in unemployment benefits and lump-sum payments via the tax system) or indirectly (e.g. loans and guarantees to firms and subsidies to payroll obligations).

One of the hardest challenges is to achieve optimal social distancing while minimizing unemployment. A firm holds much of its productive capital in the relationships it has built and "matches" between different players it has secured, including with customers, suppliers, creditors and, most importantly, with the workers it has hired and trained. If the crisis forces managers to fire those workers, the firm´s—and, more generally, the economy's—future productivity and, hence, payment capacity will diminish.

The central issue at stake here is not preserving full employment per se but avoiding the permanent destruction of viable firms and capital. The health shock is arguably temporary in nature. But, without massive intervention, the (hopefully transitory) health shock can cause permanent economic damage. A cascade of adverse effects can unfold as employers are unable to keep paying wages and honor debts, with harmful repercussions for households' capacity to pay and the quality of banks' loan portfolio. Higher insolvency rates can result in a major credit crunch, with falling collateral values feeding a downward spiral.

This threat is particularly relevant in the case of smaller firms in the services sector that have little cash and neither have assets they can pledge as collateral nor receivables that can be used in structured finance transactions. But even in the case of larger firms the value of equity and enterprise value is severely depressed at a time of great uncertainty, limiting their use as collateral. The upshot is that many firms may be unable to borrow. And if credit does not flow, then millions of jobs will be lost, and massive amounts of entrepreneurial capital will be destroyed.

Therefore, decisive policy intervention to preserve firms' relationships is called for, to avoid excessive bankruptcies and undue destruction of formal jobs. But governments should also be prepared with policies to deal with a potential rise in insolvency and a likely need for capital to enable firm restructuring. Given these threats, it is not surprising that in many countries—for instance, Argentina, Brazil, Chile, and Peru—governments have already resorted to unconventional policies such as wage subsidies and government guarantees on private sector borrowing. **The Committee believes that, if sufficiently large, these policies can relax financial constraints and, hence, be effective in preserving jobs and protecting productivity and, thus, helping output to recover quickly once lockdown measures are phased out.**

However, policies geared at expanding credit may face significant implementation challenges. In order to encourage credit growth, some bank regulators have relaxed regulatory constraints, such as capital ratios and provisioning requirements. The dilemma here is that, if the government provides only partial guarantees, banks will not lend. But if guarantees are given in full, prudent credit risk evaluation may not occur. **In order to solve this dilemma, the Committee believes that some countries may use cautiously public or development banks to provide short-term credit. However, this may not be possible wherever governance is weak, as the risk of inadequate credit evaluation may eventually morph into sizable quasi-fiscal deficits.** Moreover, countries that plan to use public banks to increase credit provision may take this opportunity to strengthen their governance.

As the crisis deepens and extends over time, the Committee believes that additional actions will be required to sustain credit growth, reduce default rates, and change the legal framework to expedite corporate restructuring. Loan guarantees may not be enough to reestablish the flow of bank credit. In order to raise debt firms may have to strengthen their balance sheets. **In the view of the Committee, this may require adopting new legal instruments—such as corporate reorganization frameworks—to facilitate burden sharing among the various private stakeholders (shareholders, creditors, management, labor) in the context of the COVID-19 crisis.** The out-of-court framework recently adopted by Ecuador is an encouraging example of this type of crisis response.

The Committee believes that, along with the adoption of reforms that facilitate private burden sharing and corporate restructuring, governments should also consider establishing long-term loan and guarantee programs as well as recapitalization funds to minimize the bankruptcy of fundamentally viable firms. Capitalization programs could be set up to attract the participation of foreign private equity funds. The private-sector arms of multilaterals, such as the IFC and IDB Invest, may play a catalytic role in this respect and may foster improved corporate governance in the region.

The policy response to the pandemic on the public health front, in formal as well as informal labor markets, and in income transfers to support basic consumption requires government to spend upfront at a time of crisis when revenues are falling, thus raising fiscal deficits and public debt. However, only a few countries in Latin American have the balance sheets to safely sustain such high levels of financing. That is, few countries in the region can deploy substantial lender/borrower-of-last-resort and risk/loss-absorption-of-last-resort assistance without endangering fiscal sustainability and central bank credibility. It should be noted that the financing capabilities of governments is quite heterogeneous across the region.

Some countries—including Brazil, Chile, Colombia, Peru and Uruguay—have been able to issue both sovereign and corporate debt in the international capital market at very favorable terms, although it is still an open issue whether the private sector will face similar favorable credit conditions. Others—like Argentina Ecuador, Venezuela, and the poorer countries in Central America—do not have meaningful access to international market finance. There is indeed significant disparity across the region.

At one extreme are Chile and Peru who enjoy significant fiscal space and currency stability. But even though they are at the top of the pack, these countries' bailout capacity pales relative to that of the advanced economies that have deep fiscal pockets and, as pointed out above, are able to issue reserve currencies—mainly, the G7 and China.

In the middle are countries with a fair degree of monetary space but little fiscal space—such as Brazil, Colombia and Mexico—and countries that retain substantial access to financial markets even though their fiscal and monetary space is currently constrained—such as Uruguay—because of their strength in terms of the rule of law—i.e., contract rights, citizen security, and institutional checks and balances.

Finally, at the lower extreme we find countries where fiscal and monetary space is severely constrained or nonexistent. This includes countries with weak currencies and fiscal solvency problems, such as Argentina and Venezuela, and countries without their own currency (formally dollarized) and little or no fiscal maneuvering room, such as Ecuador and El Salvador.

Even if a government has significant fiscal leeway, the additional public debt incurred in responding to the crisis may render the economy more vulnerable to future shocks (such as second wave of infections) and to capital market volatility. **The Committee reiterates that a higher public-debt-to-GDP ratios in advanced economies can be sustainable, while ratios have to be much lower in developing and emerging-market economies to be considered sustainable.** Moreover, market sentiment can shift suddenly even without significant visible changes in economic fundamentals. Therefore, ample market access today is no guarantee of future access. The size of fiscal packages announced by several countries in the region—often around 10 percent of GDP—makes this discussion particularly relevant.

In this context, the question of what role central banks (and monetary policy) can or should play in financing of the response to the COVID-19 crisis has become relevant. On the one hand, the COVID-19 shock has brought about a major income-redistribution, which has to be met by transfers to the poor and the informal sector.

On the other hand, the crisis has raised the precautionary demand for money. In this context, **the Committee believes that the increase in the precautionary demand for money opens up a window for non-inflationary seigniorage as an additional source of financing in countries with limited or no access to capital markets.** Even in extreme cases, such as Argentina's, where monetary financing has been almost the only source of financing to the government, a significant increase in money creation has not accelerated so far the rate of inflation. This notwithstanding, reported consumer price indices may be underestimating actual inflation given that in the midst of the COVID-19 crisis desired consumption cannot materialize and consumption baskets are likely to have deviated significantly from their normal behavior in the past.

The Committee believes that, when facing the tradeoff between unsustainable debt accumulation and moderate inflation, the balance of risks has now tilted in favor of a more active role for central banks. In this respect, **the Committee believes that the space for quantitative easing has increased in Latin America, although it recognizes that monetary easing does not necessarily translates into greater credit. Central banks should keep a close eye on inflation and avoid monetary and foreign-exchange sterilization policies that may bring back unstoppable inflation (e.g., directly or indirectly paying interest on quasi-monies) or inducing capital flight.**

III. THE INTERNATIONAL RESPONSE

The needed response to the COVID-19 crisis in Latin America exceeds what countries in the region can do alone. The international community—in particular via the IMF—has activated old aid programs and created new ones in order to facilitate the flow of official credit. But is the size of the international response large enough? **The Committee believes that the IMF needs substantially more resources at its disposal to meet the COVID-19 challenge in the region than it currently has.** Announced response packages in countries with fiscal space—such as Brazil, Chile, and Peru—are in the order of 10% of GDP. If one assumes that between a third to a half of such response should be financed by IFIs without putting in peril future debt sustainability, then the size of IMF resources that could be potentially made available to the region would be in the USD 200-300 billion range.[1]

Alongside the issue of size, **the Committee believes that it is necessary to revise the criteria under which liquidity assistance is provided to member countries.** In particular, given that the COVID-19 crisis is a large and exogenous shock affecting all countries, access criteria should be uniform across recipient countries. **The Committee believes that conditionality should focus on ensuring that foreign assistance goes to targeted sectors, and that it does not feed capital flight.**

Advanced economies enjoy a much greater capacity to respond countercyclically to the shock than emerging economies. The availability of sufficient volumes of multilateral finance can facilitate a more even response to the pandemic shock across developed and developing countries. **The Committee believes that IFIs are uniquely placed and qualified to facilitate a more balanced response to the global shock.**

A number of ideas and programs have been suggested to strengthen the international response to the COVID-19 crisis. These ideas involve debt moratoria (see Reinhart and Rogoff (2020)[2], Bolton et al (2020)[3] and Soros and Canavan (2020)[4] or vehicles to channel new hard currency flows to emerging-market economies (see Cárdenas 2020)[5]. **The Committee believes that these ideas should be given serious consideration but that "the devil is in the details." If poorly implemented these valuable initiatives may be rendered innocuous or even counterproductive.**[6]

The Committee endorses in particular two proposals that is has supported in past statements: the creation of a Latin American Liquidity Fund (LALF) and the establishment of an Emerging Market Fund (EMF).[7] In Statement No. 27, of December 2012, the LALF was proposed to: 1) provide liquidity to public sectors, and 2) mitigate potential volatility in trade credit. The establishment of a LALF was envisaged to require a minimum capital that could be leveraged to increase its lending

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1 This calculation is based on the latest 2020 IMF World Economic Outlook estimates of World GDP at market prices—of USD 83 trillion—and a 7.2% participation of Latin America and the Caribbean in world output.

2 Reinhart, C. and K. Rogoff, 2020, "Suspend Emerging and Developing Economies' Debt Payments," Project Syndicate, April. 13.

3 Bolton, P., L. Buchheit, P. O. Gourinchas, M. Gulati, C. T Hsieh, U. Panizza, and B. Weder di Mauro, 2020, "Necessity is the mother of invention: How to implement a comprehensive debt standstill for COVID-19 in low- and middle-income countries" in Voxeu.org, April 21.

4 Soros, G. and C. Canavan, 2020 "Pandemic Requires Comprehensive Debt Standstills," Bloomberg Opinion, April 16.

5 Cárdenas, M., 2020, "Emerging Economies Need New Finance, Not Moratoriums," Project Syndicate, May 13.

6 To illustrate, suppose that government uses IFIs dollar transfers to subsidize domestic "peso" wages. In order to do that, it will sell those dollars for pesos at the domestic central bank. This increases domestic money supply. If the central bank is afraid of inflation, it may turn around and sell the dollars back for pesos (i.e., it sterilizes) and the dollars may end up becoming capital flight. In sum, government would have increased its dollar debt to finance capital flight!

7 The EMF proposal is discussed in Calvo, G., 2005, Emerging Capital Markets in Turmoil: Bad Luck or Bad Policy? Cambridge, MA: MIT Press, pp. 499-500, (Chapter 18, click here), and in CLAAF Statement 19 (December 2008). The LALF proposal is discussed in CLAAF Statement 27 (December 2012).

capacity. It was envisioned that the LALF could establish credit lines with the US Federal Reserve, the IMF, the IDB and CAF.

In order to strengthening existing regional institutions, Fondo Latinoamericano de Reserva (FLAR) was seen with the capacity to evolve into a LALF and perform its functions. **The Committee believes the LALF proposal remains valid in the current context and, moreover, that it can be complemented with the establishment of an EMF.**

The EMF is a facility aimed at stabilizing an index of global (or regional) sovereign emerging-market bonds (e.g., the JP Morgan's EMBI+ Index or some sub-component of it). This facility would be relatively free from the stigma that kept the IMF's Flexible Credit Line from being widely subscribed by emerging-market economies. In the COVID-19 crisis, existence of an EMF would have probably attenuated the wild fluctuations occurred in emerging capital markets and perhaps would have mitigated the effects of flight to quality. **In the view of the Committee, an EMF is worth pursuing because flight to quality has been at the center of most systemic sudden stops and financial crises**. The timing is right because, firstly, there is no better prod than a liquidity crisis to motivate the discussion of an international lender-of-last-resort proposals and, secondly, a new outbreak of COVID-19/flight-to-quality cannot be ruled out.

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