Escola de Economia de São Paulo

STRATEGIES OF GROWTH AFTER THE CRISIS

FINANCIAL INSTABILITY IN EMERGING LATIN AMERICA

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The "Old" Unstable Latin America

- External constraint
- External debt burden
- Capital Flight (residents) /Capital Reversal(foreign)
- Devaluation – Pass Through (Inflation)
- Banking Crisis--Bankruptcies
- (Hyper) Inflation
  - (Fiscal Policy, Structural Adjustment Inertia)
- Remedies: (IMF) Structural Adjustment Program
- Result: Recession/Lost Decade/ Rising Unemployment

Today: Where is the difference?

- Role of Banking/Financial System:
- Two Masters:
  - First Master (take NO risk)
    - Liabilities: Transactions System/ store of value
  - Second Master (TAKE RISKS)
    - Assets: Financing of Productive Investment
    - Inherently Risky
- How are Financial Institutions Serving the Second Master in the New Latin America?

A "New" Stable Latin America?

- External Surplus
- Capital Inflows
- Reserve Accumulation (Bullet proofing)
- Exchange Appreciation (Dutch Disease)
- Deindustrialisation (Decline in manufacturing in GDP)
- Inflation (Food, Administered Prices)
- Inflation Targetting – (anchoring price expectations)
- Self-imposed SAP: Tight monetary/fiscal policy
- ?Recession/Unemployment?

Stylised Facts of New LatAm Financial System

- Financing of government debt
- Financing of external trade
  - Derivative/structured finance
    - In response to overvaluation of exchange rate, high domestic interest rates
- "Americanisation" of the Financial System
  - Financing of consumption
    - Credit card, installment debt
    - Financing of household mortgage debt
- Financial Arbitrage/Hedging – Proprietary Trading
- Products for Foreign Investors/FDI
- **Little Financing of Domestic Non-Business Sector**
  - Especially of PyMEs
  - Large firms' get international/external funding
- Impact on Production/Export Structure

Can Emerging Latin America Support Global Growth?

- Is it more stable?
  - Is it Serving Second Master (taking the Asset Risks)
  - Government insures First Master
- Supports Tendency ~~to the decline in the Terms of trade~~
- Tendency to Appreciaciation
- Tendency to Deindustrialisation

Risks of an Improvement in the Terms of Trade

- Impact on Commodity Prices
  - Commodities as as Asset Class
  - Brazil as a “Derivative” of China
- Improved Terms of Trade
  - Increase in Domestic Income
  - Loosen External Constraint
- BUT
  - Like a Asset Bubble
  - Like a Capital Gain
- Fisher: Capital Gains are not income
  - Capital Gains are supporting rising middle class incomes that must validate increased bank lending to households/ export firms

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