ECON 4311 – Economy of Latin America

Lecture 9A: Financing Current-Account Deficits

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Outline

Introduction

Recap:

- The current account and the financial account should be of equal magnitude and opposite sign. That is,

$$\text{Balance in current account} = -\text{Balance in financial account.}$$

- This implies that if a country has a current-account deficit, then it must have a financial-account surplus.
  - Conversely, financial-account deficit $\Longrightarrow$ current-account surplus.

- Simplest way to think of these two balances is in terms of accounting: $\text{BoP} = \text{CAB} + \text{FAC} = 0$.

Introduction

- **In modern Latin America, the norm has been to observe current-account deficits and financial-account surpluses.**
  - Overvalued exchange rate $\Longrightarrow$ exports expensive, imports cheaper.
  - Exports expensive, imports cheaper $\Longrightarrow$ current-account deficit.
  - Current-account deficit $\Longrightarrow$ need for inflows into the financial account.
- How to deal w/ current-account deficits/financial-account surpluses?
  - Foreign reserves. (previous lectures)
  - Exchange controls. (previous lectures)
  - FDI.
  - Portfolio capital.
  - Official development assistance (ODA).
  - Remittances.
  - Sovereign debt.

Debt vs. Equity

- **Important to distinguish between debt and equity:**
  - **Debt**.

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    - Examples. Mortgages, auto loans, T-bills, ...
  - **Equity**.

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    - Examples. Shareholders equity (e.g., stock).
    - Simple example. You own a car worth \$50k, but still need to pay \$10k on loans, then your car gives you \$40k equity.

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Conditions	**Debt**	**Equity**
Management influence	None	Voting rights
Repayment	Maturity	No maturity
Yearly obligations	Interest payments	Not liable to pay dividends
Tax benefits	Deductible	No deductible

Debt Financing

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Debt Financing

- **In international capital markets, debt occurs in three forms:**

  1. Bond issuance. Government (or firm) sells a bond, making a promise to pay periodic interests and the value of the bond at maturity date.
     - Most common form of debt-financing for governments throughout.
  2. Borrowing from commercial banks in developed countries. Large-scale loans typically contracted in foreign currency.
     - One of the most ancient forms of lending.
  3. Borrowing from other governments or multilateral institutions. (e.g., the IMF, the World Bank,...)

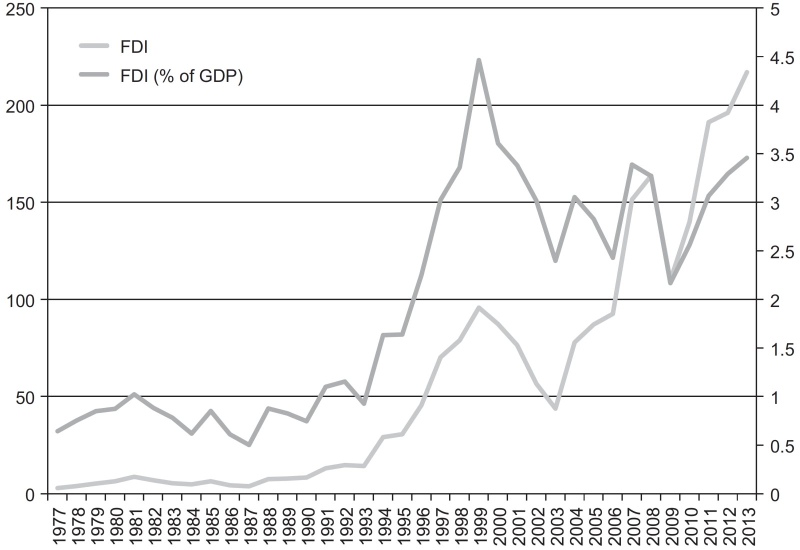
Equity Financing

- Capital may also flow into a country in the form of equity: the lender may also be an owner of the company/project that is being financed.
- **FDI flows are a form of equity.**
  - Foreign company provides (partial or full) funding for a project in domestic country. Example: Amazon builds a facility in Mexico.
- **Portfolio capital is another form of equity**.
  - Example: Acquiring stocks in *Cemex* (Mexican, materials company).
- **Back to the distinction debt vs. equity**: Owners of equity do not have a right to receive fixed payments in the form of a stream of income but rather a claim on (all or part of the) assets.
  - The role of institutions: treatment of domestic and foreign investors.

Capital Flows into Latin America

- Historically, capital has flown into the region mostly in form of debt.
- A characteristic of debt is that, regardless of market conditions, the timing and the amounts to be repaid are fixed.
- Hence, if economic conditions turn out to be worse than expected, governments can find themselves in trouble.
  - This was the case for Mexico in 1982.
- When debts cannot be repaid, governments end up (partially or fully) defaulting. This has happened way too often in the region.
- Breaking this pattern of (fairly common) default episodes is crucial for the economic development of the region.

FDI in Latin America (in USD millions)



FDI in Latin America

Historical context.

- Late 1970s to early 1990s:
  - Exceptionally low levels for middle-income countries ($< 1\%$ of GDP).
  - Reasons:
    - Oil shocks (late 1970s and early 1980s)
    - Lost decade (1980s and early 1990s)
    - Political turmoil (1980s): from authoritatian to democratic regimes.
- 1990s:
  - Return of foreign investors to the region due to:
    - Stronger economic performance.
    - Increased confidence in political landscape.
  - FDI peaked at approx. 4.5% of GDP.

FDI in Latin America

Historical context.

- Late 1990s and early 2000s:
  - Drops in FDI in Latin America (and most of the world) due to the world economy:
    - Financial turmoil in Asia.
    - The dot-com bubble.
- Late 2000s:
  - Drops in FDI in Latin America (and most of the world) due to the world economy:
    - Great Recession.

FDI in Latin America

Historical context.

- If current account deficits were matched with a similar amount of FDI, then there would be no problem.
- This is not what happened in Latin America in the 1970s and 1980s.
- Little to none FDI investment (as % of GDP) to compensate for the current-account deficits. Why?

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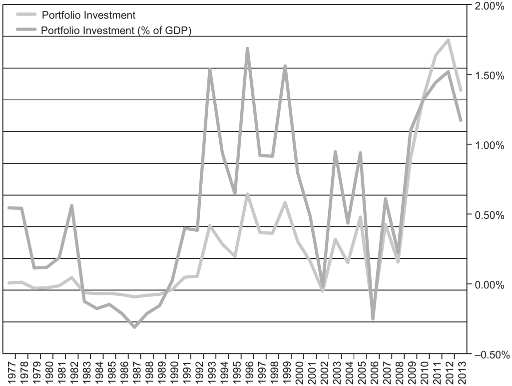
  - Typically, MPK(middle income) $>$ MPK(high income).
  - Scarce FDI must be understood by taking into account:
    - ISI policies.
    - Political instability.

Portfolio Capital

- Portfolio capital is, together with FDI, an important part of the financial account.
- **Portfolio capital** refers to money flows used to purchase financial assets such as stocks and bonds.



Portfolio Capital in Latin America

Overall.

- Positive trend.
- Highly volatile.
  - Not very surprising, inherent characteristic of this type of asset.

Historical context.

- Capital "flying away" during the Lost Decade.
- Solid return following the Brady Plan.
- Tequila crisis in Mexico in 1994.
- Dot-com bubble in late 1990s and early 2000s.
- Great Recession.

Portfolio Capital in Latin America

- **Portfolio capital flows are essential for economic development**, especially for the development of financial markets.
  - Bring capital to credit-constrained firms or governments.
  - This capital allows to carry out profitable (sometimes essential) investments.

- **However, large inflows and outflows of portfolio capital can be destabilizing** (in terms of exchange rates and economy as a whole).
  - Controls on these flows can insure against short-term shocks.
    - Remember the Chilean policies of the 1990s we talked about?

    ... but reduces long-term investments (it just messes with the market!)
  - Uncontrolled flows are best for attracting investments, but have the potential to produce exchange-rate shocks.

Official Development Assistance (ODA)

- Another form in which capital can flow into a region is ODA.
- **ODA's main purpose**: assist in the long-run economic development of a country.
  - Typically used to develop/rebuild infrastructure that is essential for economic development.
    - Example. World Bank partially partially financed infrastructure for the Itaipu dam in Brazil in the 1980s.
  - Sometimes used to support current-account deficits, national defense.
- **ODA flows take two forms** (depending on the origin of assistance):
  - Government-to-government. Either grants/gifts or loans.
    - Loans sometimes converted into gifts.
  - Multilateral institutions. Loans for particular projects.

Official Development Assistance (ODA)

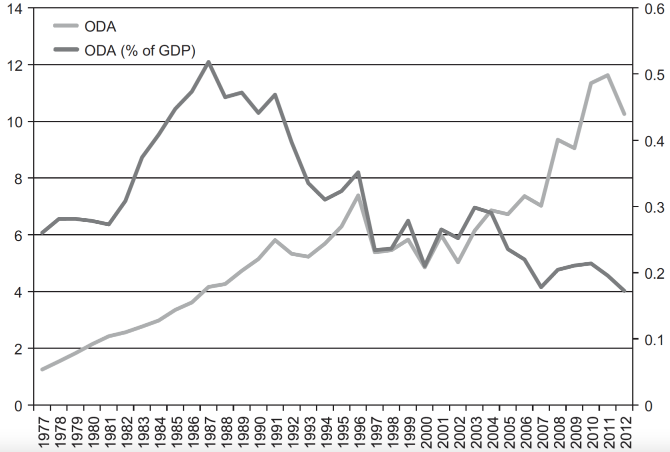
- **ODA from multilateral institutions**. (IMF, World Bank, IDB).
  - Loans and grants for specific development projects.
    - Money flows in as the project is being developed.
    - This is to ensure accountability.
- **ODA from multilateral institutions in Latin America**.
  - Little use of these funds by most countries in the region.
    - ODA from these institutions typically targets low-income countries.
  - LatAm countries most often have received these funds in the presence of very exceptional circumstances.
    - Natural disasters.
    - Debt relief for heavily-indebted poor countries (HIPC).

Official Development Assistance (ODA)

- **ODA from government-to-government**.
  - Not as generous as it might seem.
  - Typically apply restrictions on loans and grants.
    - Example: recipient country has to spend money on goods and services of donor country.
- **ODA from government-to-government in Latin America**.
  - Mostly from the US.
  - Most argue it responds to general foreign-policy objectives.

ODA flows in Latin America

left scale: USD billions   right scale: % of GDP



ODA flows in Latin America

Inter-American Development Bank (IADB).

- **Goal**.
  - Provide loans, grants, and technical assistance for the economic development of Latin America.
- **Composition**. 48 countries.
  - 22 non-borrowing countries: (16 European, US, Canada, Japan, South Korea, China, Israel).
  - 26 borrowing countries: Latin America geographic region.
- **Risk**.
  - Preferred creditor status.
  - Only 1 country has ever defaulted on them. Can you guess?

Remittances

- **Remittances**. Flows of money back to the home country of workers who are employed in a foreign country.
  - Example. Argentinian economist working at the Minneapolis Fed sends money home to help family members.
- Recall that these **show up as "unilateral transfers" in the current account** (not the financial account).
  - Help reduce the need for financial surpluses.
- **Long history of remittances in the region.**
  - Colonial Latin America $\longrightarrow$ Spain and Portugal.
  - Modern Latin America: US $\longrightarrow$ Mexico, Argentina, Brazil,...

Remittances

- **Rapid increase in absolute size of remittances, and larger relative importance in the region.**
  - 1990.
    - World economy: \$40 billions.
    - Latin America: \$2 billions. (5% of world total)
  - 2014.
    - World economy: \$584 billions.
    - Latin America: \$55 billions. ($\approx$ 9.5% of world total)
- **Still a small fraction of GDP.**
  - Exception. Lower income countries in Central America.

Remittances in Latin America in 2015: World Bank Data

	Remittances (US$ millions)	*% of GDP*
Argentina	540	0.1
Bolivia	1,201	3.9
Brazil	2,427	0.1
Chile	–	–
Colombia	4,233	1.1
Costa Rica	612	1.2
Ecuador	2,524	2.6
El Salvador	4,236	16.4
Guatemala	5,845	10.0
Honduras	3,329	16.9
Mexico	24,866	1.8
Nicaragua	1,140	9.6
Panama	760	1.1
Paraguay	591	2.0
Peru	2,639	1.3
Uruguay	124	0.2
Venezuela	121	0.0
Latin America	55,128	4.0

Sovereign Debt

- Recall that in the 1960 and 1970s, many Latin American countries borrowed money to finance ISI policies.
- All countries affected by the oil crises (1970s) and the decline in world prices of primary commodities.
  - Some did even borrow against future oil revenues.
- When oil prices went up:
  - Oil-importing countries increased their demand for foreign exchange.
  - Countries registered current-account deficits.
- **Alternatives to finance current-account deficits**:
  - Devaluate domestic currency.
  - Sell foreign reserves.
  - Borrow foreign exchange.

Sovereign Debt

Alternatives to finance current-account deficits.

1. Major currency devaluation.
    - Typically associated with mix of high inflation, low economic growth, and high unemployment rates.
    - Make ISI policies harder to sustain.
        - Example. Imports of intermediate goods become too expensive $\longrightarrow$ harsh resource reallocation.
2. Reserve management. In LatAm, many foreign reserves already depleted in the 1970s, so selling foreign reserves was in many cases not a viable option to deal with the oil crises.
3. Borrowing from international capital markets.
    - Feasible alternative: petrodollars loaned to LatAm countries in 1970s.

Sovereign Debt

Latin America in the 1970s.

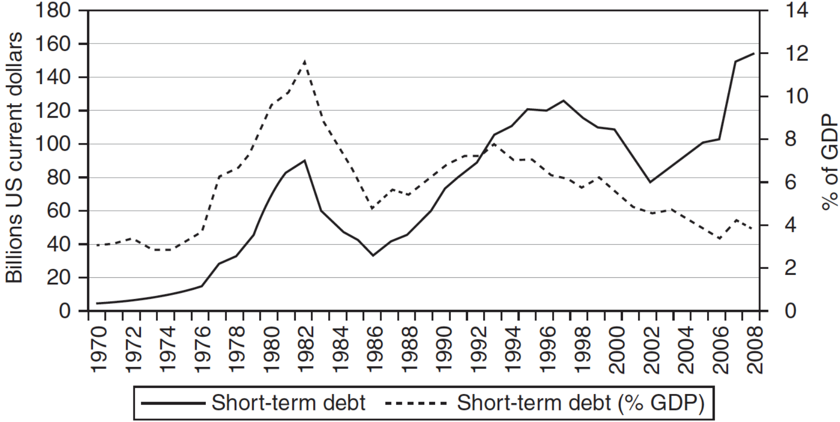
- Slow to adopt floating exchange rates.
  - Government decisions not uniform.
    - Some kept a fixed exchange-rate system.
    - Some others did not but still pursued complicated ways of depreciating their currencies.
- **Flows of FDI, portfolio capital, and stored reserves were not enough to cover current-account deficits**.
- Accumulated large amounts of debts in foreign exchange.

Sovereign Debt

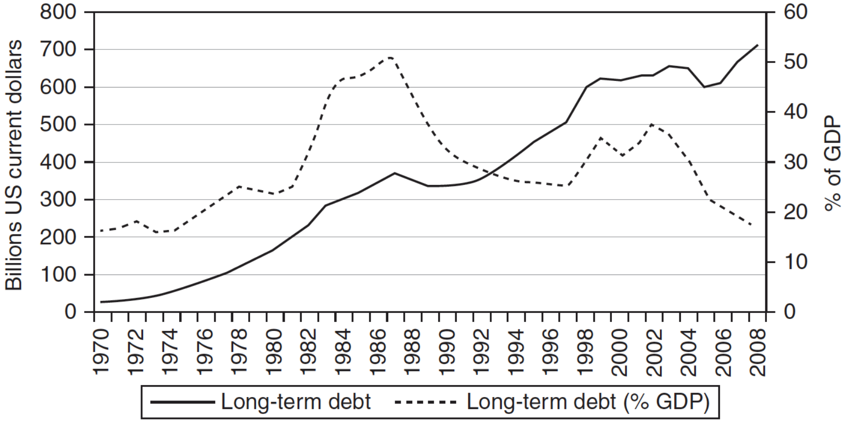
Latin America in the 1980s.

- Debt service became unsustainable.
- Countries were forced into major depreciation of their exchange rates.
- Many countries ended up defaulting.

Latin American Debt



Latin American Debt



Debt

Common-sense use of debt.

- Borrow to finance productive investments: $r_{\text{investment}} \geq r_{\text{debt}}$.
- Great!

Non common-sense use of debt.

- Borrow for "non-productive" activity. $r_{\text{investment}} < r_{\text{debt}}$.
    - Intervene in foreign-exchange market.
    - Support/sustain ISI policies.

The International Monetary Fund (IMF)

- Mexico defaulted in 1982.
  - Other Latin American countries followed the same path.
- Capital flights after default episodes:
  - Most lending from financial institutions withdrawn.
- **The IMF as a lender of last resort.**

The International Monetary Fund (IMF)

- **The IMF's role during the default crises of the 1980s:**
  - Correct current-account deficits.
- Provide borrowing under some conditions:
  - None if borrowing sufficiently low.
  - Austerity measures (tax increases, spending cuts) for high levels of borrowing.
- The IMF had a controversial role for many:
  - Not only in Latin America, also in emerging Asian countries, Africa,. . .
  - Necessary cushion vs. painful austerity programs.
  - Neoliberal policies.

Taking Stock

- Current-account deficits have been the norm in modern Latin America
- Many ways to deal with current-account deficits.
    - Foreign reserves and exchange controls (Lecture 8).
    - FDI, portfolio capital, ODA, remittances, sovereign debt (today).
- Debt- vs. equity financing.
- FDI, portfolio capital, ODA, remittances, and sovereign debt.
    - Concepts.
    - Historical context and trends.
    - Multilateral institutions (IMF, IDB).

Thank You!