VIRTUAL SEMINAR **ON COVID-19** RELATED MEASURES: **EFFECTIVENESS AND EXIT STRATEGIES**

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Good morning. It is a pleasure to welcome you to the Seminar on Covid-19 related measures that CEMLA co-organizes with the Financial Stability Institute. This seminar provides a platform to foster the dialogue among central banks and other institutions aimed at improving our understanding of relevant challenges for financial stability, particularly in these special times.

We are honored with the participation of more than 60 representatives from 28 institutions associated to CEMLA. Let me begin by thanking Patrizia Baudino and her team from the FSI for their collaboration in organizing this seminar. I would also like to kindly thank Carola Müller from CEMLA's Financial Stability Department, who did an excellent job in designing this seminar's program.

Given the excellence of today and tomorrow's speakers, I am confident that we will have a fruitful exchange of ideas and knowledge. We at CEMLA are indebted to the time and effort our invited speakers invest on this event. I would therefore like to thank our colleagues Fabiana Amaral Carvalho from Banco do Brasil, Alejandro Peña from Banco Central del Uruguay, and Juan Francisco Martínez from the Banco Central de Chile for their support. We are also pleased with the participation of our external guests, Karin Lundberg, Emily Beau, and Tomas Edlund.

Latin American and Caribbean countries' vulnerabilities

Let me spend a few minutes to reflect on the state of the current Covid-19 crisis and economic outlook in Latin American and Caribbean countries to set the stage for the discussion of the next two days. I will give an overview of fiscal policy responses in the region with the aim of complementing our program, where we will hear more about macro-financial policies. Clearly, fiscal and financial policies, as well as monetary and other policies, are co-dependent in fighting this crisis and in sustaining the recovery path ahead of us.

I have to start with a painful truth. Covid-19 hit Latin America and the Caribbean much harder than other Emerging Economies. The population in this region suffered the highest death rates and the largest economic downturn in 2020, worldwide.[1] Caribbean Islands depend strongly on tourism, which almost came to a halt. And although most economies in the region started to recover in 2021, more than half have not been able

[1] According to data from the WHO Coronavirus (COVID-19) Dashboard (as of Feb 03 2022), Latin America and the Caribbean accounted for 28 percent of worldwide recorded deaths due to Covid-19 despite being home to just 8.4 percent of the global population.

to return to pre-crisis GDP levels yet. In contrast to Advanced Economies, where pre-pandemic levels may be reached this year, the IMF expects that it will take at least 2 to 3 more years until the output losses caused by Covid-19 will be recovered in Latin America and the Caribbean (IMF, 2021).

The crisis put a spotlight on some long-standing structural problems in the region that not only aggravated its negative impact, but that may also slow down the recovery. For example, weak health care policies and systems, social imbalances, and a high share of informal labor worsened the hardships that came with the crisis, and put governments in a difficult position to implement targeted policy measures (Goldfajn and Levy Yeyati, 2021). In particular, the unequal access and availability of vaccines and therapeutics around the world have dampened the prospects of a speedier economic recovery and might even spur further social unrest for those countries of the region with low vaccination rates.

Governments' scope for action was further reduced due to the economic situation. At the time the crisis hit, Latin America had experienced a period of low growth with most governments running fiscal deficits that implied a high debt burden and limited fiscal space (ECLAC, 2020). As the crisis evolved, the conditions for fiscal spending aggravated even more. Foreign investors withdrew capital rapidly, local currencies depreciated against the dollar, risk premia rose, and in some cases rating agencies revised their outlooks for sovereign debt downward. These factors have contributed to make refinancing of the existing debt, as well as the issuance of new one, costlier.

A recent paper by Prof. Marti Subrahmanyam and co-authors published in the Journal of Financial Economics (Augustin et al., 2021) highlights the trap that many Emerging Markets initially stepped into. Focussing on the first months of the pandemic, that is until May 2020, they find that sovereign risk premia were more sensitive to the intensity of the pandemic, the more fiscally constrained the sovereign was. Hence, it was hardest to provide fiscal stimulus where it was most needed. First, since the fiscal space was slim to begin with in Latin America and the Caribbean and, second, given that financial markets paid more attention to their spending.

However, the ability to react immediately to a crisis is only one part of resilience. Fiscal policies must also prove sustainable in the medium-term. In this sense, ironically, countries that spent more generously in immediate response to the crisis can face higher premia now, whereas countries that held back on spending before, might be currently viewed more favourably by markets and rating agencies.

Uptake and effectiveness of fiscal policies

Using data collected by the IMF on fiscal measures since the start of the pandemic, we observe that countries in Latin America and the Caribbean spent on average 4.7 percent of GDP on public support, whereas Emerging Economies in Asia or Europe spent on average 7.1 percent. Advanced Economies on the other hand launched fiscal policies that on average accounted for 11.7 percent of GDP. In the United States alone the fiscal stimulus amounted to 25 percent of GDP.[2] However, public spending and guarantees in Latin America and the Caribbean still added up to 404 bil. USD, considerably more than, for example, what the region spent during the Great Financial Crisis. Nevertheless, the trend shows that those countries with greater fiscal stimuli, have a stronger and faster recovery.

First evidence suggests that fiscal policies prevented a significant share of bankruptcies, employment losses and, ultimately, an even deeper recession (Gourinchas et al., 2021; Elenev et al., 2021; Chudik et al., 2021). For example, Pierre-Olivier Gourinchas and co-authors (2021) estimate that the increase in bankruptcies, which they compute at 4.5 percent on average for 27 countries, would have been twice as severe without the massive fiscal support. Overall, they estimate that the recession would have been 8 percent deeper.

They point out that in Emerging Economies these "un-cushioned" effects would have probably been even worse without any fiscal support. This does not, however, account for the role of monetary and financial policies in alleviating the economic impact of the crisis. Contrary to some Advanced Economies, Emerging Economies had, in relative terms, substantial monetary policy space to lower interest rates. In addition, central banks and supervisory authorities implemented loan guarantee schemes and facilitated bank lending, which contributed to avoid a deeper recession.

The need for fiscal spending continues, as the long-term consequences of the crisis start to show. The World Bank estimates that in Latin America and the Caribbean about 4.7 mil people have fallen into poverty or lost formal employment.[3] Unemployment hysteresis is one factor that can dampen the long-term recovery path from Covid-19, which can leave the region lagging behind others.

Interaction of fiscal and financial policies in the recovery phase

While addressing these developments is beyond the scope of central banks and financial supervisory authorities, they will nevertheless shape the macroeconomic environment in which financial policies have to be implemented during the recovery. These trends imply the following take-aways for financial policies:

- First, the reduced growth prospects make it necessary to continuously monitor credit risks and non-performing loan ratios in corporate and consumer lending.
- Second, growing global imbalances and structural differences lead to different paced recoveries. In this seminar, we will discuss, for example, the implications of these disparities for the setting of the Countercyclical Capital Buffer. It also means that volatile international capital

[2] Own calculations based on Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic from the IMF. Numbers calculate "Additional Spending and Forgone Revenue" accumulated until 27 September 2021 relative to GDP based on October 2021 World Economic Outlook.
[3] The World Bank "Pandemic Crisis Fuels Decline of Middle Class in Latin America and the Caribbean", Press Release, June 24, 2021, available online.

flows could cause liquidity shortages in local financial markets and funding markets of banks and sovereigns.

- Third and last, fiscal budgets had to expand during the crisis while demand for public spending will remain high. Since the bank-sovereign nexus keeps being tight as both commercial and central banks hold large amounts of sovereign debt, a close monitoring is warranted to avoid a "doom loop" (Farhi and Tirole, 2018).

A combined view on fiscal and financial policies is needed to account for the strong role of government interventions in and out of this particular crisis. Not only do fiscal policies influence the macroprudential policy space, but also macroprudential policies themselves can have a "fiscal footprint" (Reis, 2020), especially considering that the latter can affect the demand for sovereign bonds. For example, the liquidity coverage ratio incentivizes banks to hold more safe liquid assets, which in most cases means sovereign bonds. Furthermore, the intended macroeconomic effects, e.g., of the CCyB, have repercussions on tax income.

Last, but not least, macroprudential policies (e.g., some regulatory forbearance) and unconventional monetary policy can have an impact on bond risk premia, and thus on interest rates, with direct repercussions on governmental budgeting. Ultimately, financial stability relies on sound public budgets, while also contributing to them.

Finally, one should also bear in mind that the comprehensive fiscal and macroprudential support might also have repercussions on inflation. Thus, the picture is incomplete without considering the interaction of macroprudential and monetary policy as well. As inflation is picking up, a loose macroprudential stance cannot uphold for long when monetary policy is tightening without sending mixed signals to the markets.

In summary, fiscal and macroprudential authorities have a difficult time ahead. They have to navigate between subdued growth at a time of growing inflationary pressures, an increased demand for social policies, difficult refinancing conditions for sovereigns, and imbalances emerging from a multispeed recovery.

Closing remarks

However, I do not want to end my talk without also mentioning some positive news. Overall, banking sectors in Latin America and the Caribbean were well equipped when the crisis emerged. Banks were strongly capitalized after undergoing several regulatory reforms in the past decade, including the implementation of Basel III standards in many countries of the region. Central banks were able to lower interest rates in a timely fashion, which allowed for an immediate and effective impulse in response to the crisis.

Monetary and supervisory authorities in the region further swiftly issued measures that helped to restore liquidity quickly where needed and supported bank lending through the crisis. Banks' capital ratios meanwhile stayed above the regulatory requirements. [4]

[4] Summary based on the recent financial stability reports and COVID-19 stress tests from Chile, Colombia, Mexico, Brazil, and Uruguay.

In tomorrow's session, we will hear about the policy mix implemented in Chile and Brazil. I expect the discussion in this seminar will contribute to our understanding of how policies can help mitigating crises. This is, after all, the common goal of policy making institutions.

I will conclude here by wishing you a constructive and interactive seminar. Thank you very much.

Thank you very much.

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