LATIN AMERICA: Between debt and the pandemic. Guarded prognosis.

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Red Latinoamericana por Justicia Económica y Social

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Contents

PRESENTATION

Debt has been part of the history of Latin America. The debt crisis of the 1980s left lessons and wounds that required a period of recovery in fact greater than the so-called “lost decade”.

After renegotiations with private creditors and initiatives of debt relief for the poorest borrowers, the subsequent trend of debt growth in the region took place in a context of high prices of commodities; implying that debt in the region – with most of its economies highly dependent on commodity exports – was to be considered “sustainable” despite its continuous increase. This situation contributed to the fact that the 2009 crisis did not significantly impact the region.

However, the debt outlook has been changing once more as it is no longer just about external debt. That is, domestic debt has been gaining relevance in many countries, in some cases even surpassing its external counterpart. This implies that a comprehensive and timely assessment of public debt and its derived fiscal risks has only become more challenging.

The Covid-19 crisis has accelerated a multiple crisis in what is the most unequal region in the world, with severe financing needs and very few options in terms of access to resources and aid programs, mainly because most countries in the region are classified as middle-income countries, thus implying that these must opt for programs with the IMF, sovereign bond issuance and increasing domestic debt.

This document analyzes the context of the crisis for Latin America and the Caribbean and identifies the new debt risks and the different challenges faced vis-à-vis the macroeconomic and fiscal situation of the countries in the region. It is, therefore, a warning about the necessity to take urgent measures, in the national and global scope, towards a sustainable recovery after one of the worst crises in history.

Patricia Miranda
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GLOBAL ASSESSMENT

The pandemic has affected the world economy in a very particular way. Both production and purchases halted, which simultaneously caused a clash between supply and demand. The confinement caused an unprecedented crisis, like no other in history. This was a supply and demand crisis that involved a drop in production and consumption, affecting tax collection and international trade in general. Global demand and supply collapsed between March and June 2020 and produced the worst figures in a quarter in economic history.

This event occurred in an already complicated context, with a poor global economic growth which was already slowing down since 2018, especially for developing economies. The trade war unleashed in January 2018 between the US and China limited the ability to expand international trade and affected all. While economic growth and trade slowed down since 2018 in the western world, China grew three times faster than developing countries, with an increasingly important leadership, especially in sectors such as energy, pharmaceuticals, automotive, technology and telecommunications.

Starting with the great recession of 2008, the economy changed its dynamics worldwide: the trend towards financial deepening was strengthen, financial players became increasingly relevant and a poor GDP growth rate was observed in the leading economies, known as the two-speed recovery. Since then, a severe contradiction is observed, between a boom in financial markets and a slowdown in the real economy. This was accentuated with the lockdown in 2020, when financial markets benefited from a capital injection from the US Federal Reserve (Fed) in March 2020, reversing the worst stock market crash in financial history, in six weeks between February 12 and March 23, 2020.

The 3.5 trillion-dollar injection helped to revive hedge fund investments, as well as investment banks in general, dragging up stocks and commodity prices, except for oil. Thus, a shift occurred from the traditional productive companies -those that generate employment- towards new high-tech companies that create few jobs (see Graph 1 below).

Graph 1 - Rankings of various companies according to the Standard & Poor's 500 index, by market capitalization

Diciembre 2000	Diciembre 2010	Septiembre 2020
1st General Electric	1st Exxon Movil	1st Apple
2nd Exxon Movil	2nd Apple	2nd Microsoft
3rd Pfizer	3rd Microsoft	3rd Amazon
4th Cisco	4th General Electric	4th Facebook
5th Citigroup	5th Chevron	5th Alphabet
	14th Pfizer	
	16th Citigroup	
	21th Cisco	
		25th Pfizer
		33th Cisco
		40th Exxon Movil
		46th Chevron
		67th Citigroup
		116 General Electric

Source: Debru, "S&P 500 or S&P 5? Is the current concentration sustainable long term?" in https://www.etfstream.com/features/sp-500-or-sp-5-is-the-current-concentration-sustainable-long-term/ Accessed on December 19, 2020.

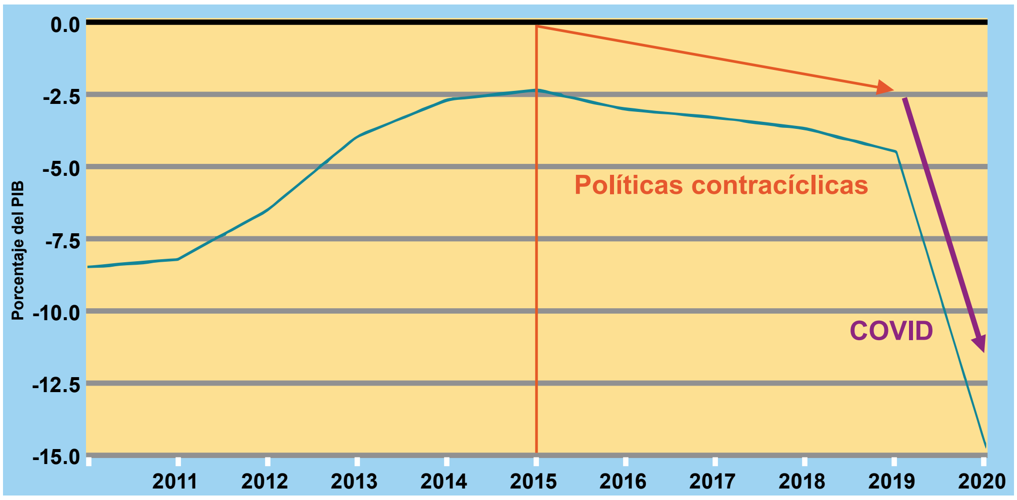
Due to the Covid crisis, the employed/total population ratio has dropped from 61% in November 2019 to 57.3% in November 2020. In absolute terms, in November 2000 there were 69.5 million working age people unemployed, in addition to retired people, children under 16 years old and housewives. That number increased to 82.6 million in November 2009 and to 100.6 million in November 2020. In twenty years, the number of unemployed people in the United States grew by 40%, including housewives, retirees and, particularly, people who leave the labor market and are unable to return.

Only between November 2019 and November 2020, according to the report "The labor situation- November 2020" from the *Bureau of Labor Statistics*, the number of long-term unemployed people (those who have been unemployed for over 27 weeks) increased by 385,000 to 3.9 million, representing 36.9% of the total unemployed, while the number of people who have been unemployed between 15 and 26 weeks fell by 760,000 to 1.9 million. The number of people who have been unemployed for 5 to 14 weeks and those unemployed for less than 5 weeks showed little change in November reaching 2.4 million and 2.5 million, respectively.

Paradoxically now, with fewer active people in the workforce and more companies out of business, the stock market indices of five companies rise while GDP falls. This is an abnormal situation. The leading economy is going through a critical period as reflected by the growing fiscal and external deficits financed from abroad or through the injection of money from the Fed.
The trade war with China that started in April 2018 and ended in January 2021 was not followed by an improvement in trade balance and, in fact, the end of war seems to have precipitated a very large pent-up demand. The latter does not have a dynamic productive side to explain it. It is essentially consumption with credit. The US public deficit recovered in 2015 (vertical bar) when it fell to 2.5% of GDP after the massive injection of resources to rescue financial and productive activities that struggled in 2008/09. The countercyclical policy came with the decline in GDP growth, leading to an increase in the deficit from 2.5% to 4.6% in 2019. In 2020, the deficit increased significantly to 14.9% of GDP, while GDP fell by 3.4%.

The 2009 crisis had led to a fiscal deficit of 9.7%. The current crisis is similar to the one during the final stage of the Second World War, when the deficit reached -26% of GDP in 1943 and decreased as the war came to an end. There is no certainty as to whether these deficits will be systematically reduced or not, or whether the world will continue financing them. Otherwise, the liquidity injections from the Fed -such as the one in March 2020- will keep the currencies of emerging economies overvalued.

Graph 2 – Federal deficit/surplus as % of GDP



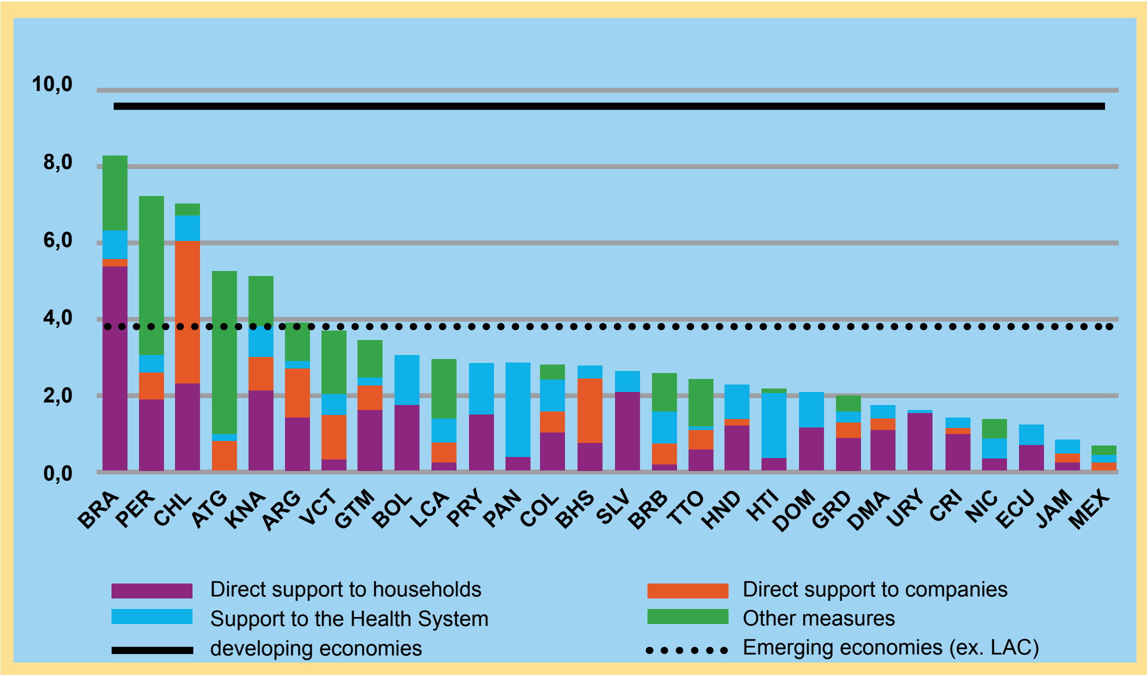
Source: FRED based on OMB, St. Louis Fed

LATIN AMERICAN ASSESSMENT

The domestic debt problem arises

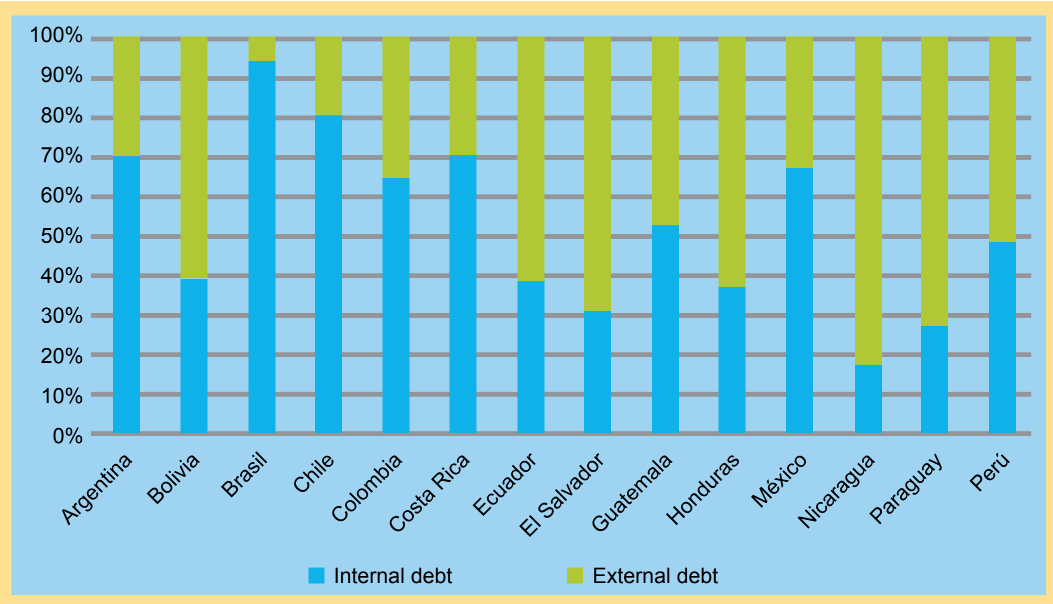
The actions countries have taken vary between regions. In Europe, government support is relatively more significant with regards to its economy, especially during the pandemic. An IMF regional report from October 2020 shows the official fiscal and monetary support by country. Extraordinary support in the form of expansionary fiscal or monetary policies (above the line) in emerging economies averaged 4% of GDP. In developed economies, these policies represent 9.5% of GDP.

Graph 3 – Discretionary tax measures



Source: Based on data from IMF REO WH, October 2020

Graph 4 – Central Government external and domestic Public Debt 2018, in percentage



Source: Based on ECLAC data

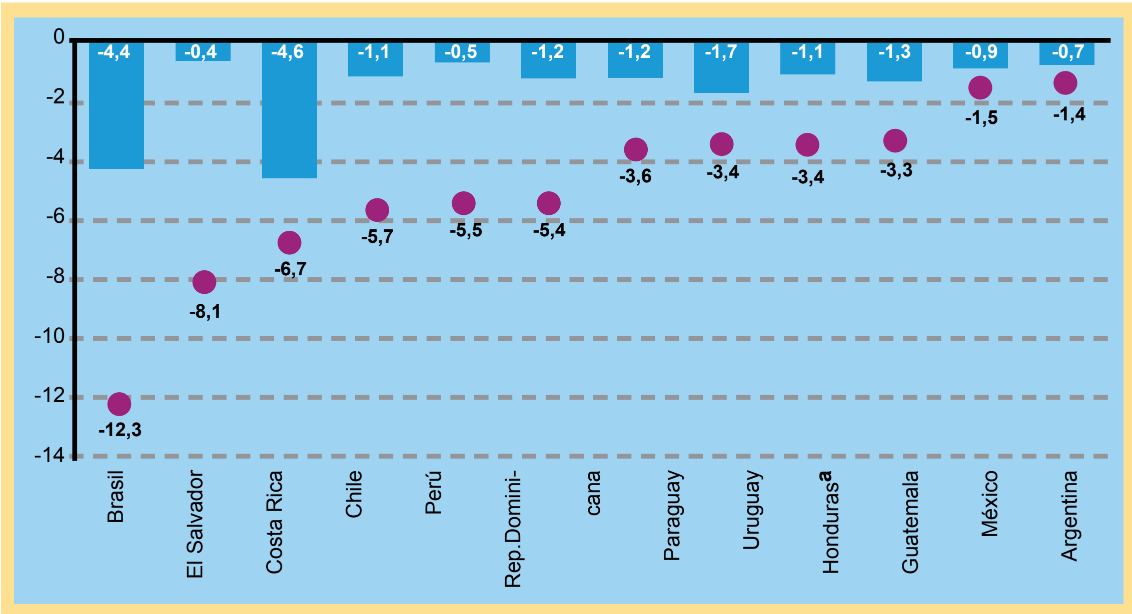
These policies occurred when aggregate demand fell dramatically and the world economies collapsed, with the loss of thousands of jobs and the bankruptcy of a large number of companies.

This would have generated a proportionally greater fiscal deficit compared to the fall in GDP if the previous public expenditure rhythm had been maintained.

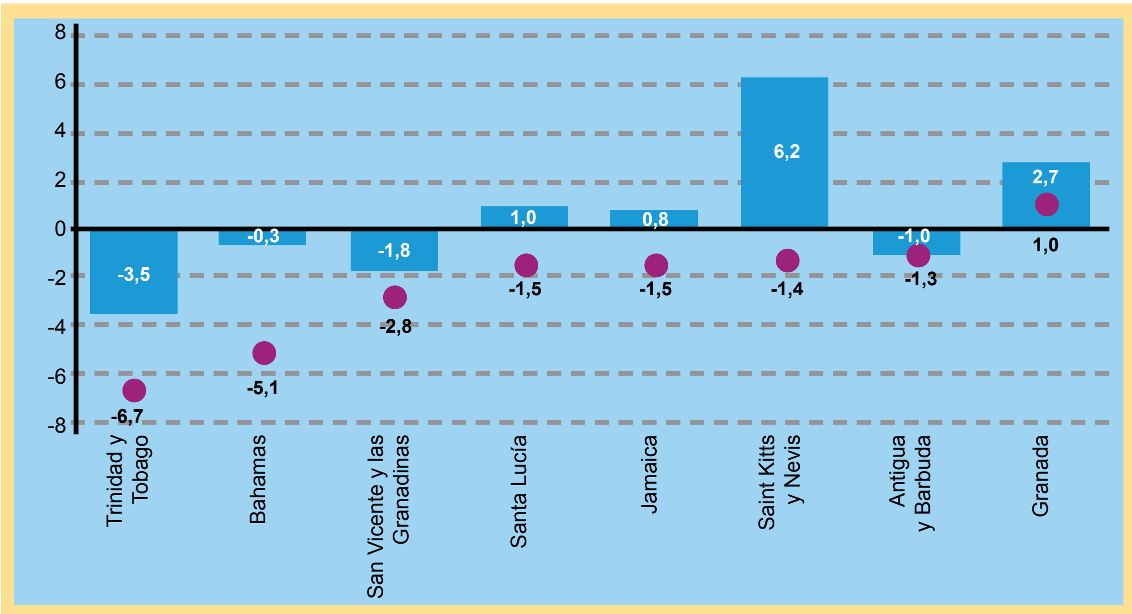
More seriously, the weight of the public debt service in local currency with respect to tax revenues increased. This is the indicator that has increased the most. Since it is denominated in local currency, it does not require external assistance but rather domestic relief.

Graph 5 – Global result of central governments of Latin America and the Caribbean 2019-2020

A. Latin America (accumulated between January and September)



B. The Caribbean (accumulated between January and June)



2019
2020

Note: In the case of Argentina and Mexico, figures correspond to the national public administration and the federal public sector, respectively.
a The Information refers to the period between January and August 2020

Source: ECLAC

When public debt securities in local currency are held by foreign investors, central banks must intervene, buying public and private debt securities, in order to inject liquidity into the system. Domestic public debt is very important for almost every country except for the three fully dollarized countries in the region, El Salvador, Panama and Ecuador; in addition to Honduras and Nicaragua. For the rest of the countries, domestic debt is at least half of total debt.

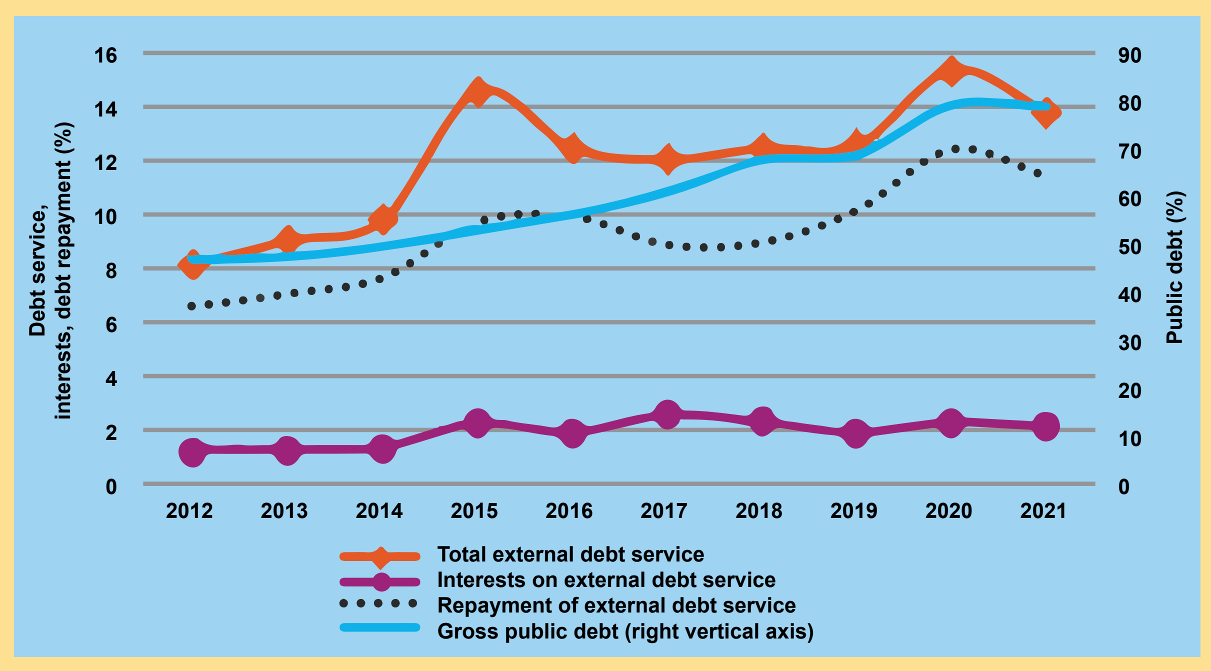
The governments that applied fiscal and monetary measures more intensively to stop the collapse and encourage economic recovery were Brazil, Peru, Chile, Antigua and Barbuda and Saint Kitts and Nevis. This is reflected in their stronger economic rebounds, with the exception of Chile. The interventions of all other countries yielded results below the average of 4% of GDP. Accordingly, governments showed difficulties to finance themselves through tax revenues. There seems to be a clear consensus on the need to strengthen government action.

Countries such as Brazil, El Salvador, Costa Rica, Chile, Peru and the Dominican Republic took specific fiscal measures that resulted in increasing fiscal deficits, of above 5% of GDP. Part of these deficits were financed with domestic debt and treasury bonds, avoiding problems related to the balance of payments or their net foreign asset position.

The increase in public debt in countries in the Caribbean does have a direct impact on the external sector and may effectively constitute a public debt problem. The exception is El Salvador as it does not have a local currency and -like Ecuador- transfers its public debt abroad, as a consequence of the lack of a monetary policy.

The increase in regional debt service in 2015 is similar to the IMF's predictions for Latin America for the period between 2020 and 2021 (Figure 4). The amount of debt service is currently higher, although at this time it does not represent a significant problem for most of the countries in the region.

Graph 6 – External debt service and total public debt in Latin America, as a percentage of GDP



Source: WEO FMI

International reserves

A critical symptom of economies facing challenging conditions is the fall of their international reserves, frequently caused by a drop in exports, either in price or in volume. Major crises throughout history (1872, 1930, 1982) have always shown this symptom. The crash of 2020 has seen some economies gaining reserves, but also many others facing significant losses. There is no universal pattern because commodity prices did not collapse, and some even increased.

The second element that impacts international reserves involves interest rates, which decreased throughout 2020. A country that was strongly impacted by the loss of reserves was Bolivia, given the cancellation of its gas export contract to Argentina and the reduced volume of gas exported to Brazil. Nonetheless, these impacts are in the process of being reversed, thanks to the discovery of new gas reserves.

With regards to Argentina, the country has a debt problem that must be addressed, but it bears no relation with the crisis of 2020. Chile is a unique case, with loss of reserves since 2017, as well as very large international credit operations related to the private sector and stock market operations throughout Latin America for significant amounts. In general terms, domestic debt is relatively more important than external debt, except for small economies.

Table 1a – International Reserves (in millions of dollars) - countries with more than 18 million inhabitants

	Argentina	Brasil	Chile	Colombia	México	Perú
Q4 2019	44848	3568849	63924	58267	183065	67718
Q1 2020	43561	343164	67170	58773	189817	67942
Q2 2020	43241	348780	65483	58750	197054	71672
Q3 2020	41378	356605	62034	57951	199815	72942
Q4 2020	39387	355619	59198	63763	199056	74784
var $	-5461	-1264	-4725	5495	15991	7066
var %	-12,2%	-0,4%	-7,4%	9,4%	8,7%	10,4%

Table 1b – International Reserves (in millions of dollars) - countries with less than 18 million inhabitants

	Bolivia	Costa Rica	Ecuador	El Salvador	Guatemala	Honduras	Nicaragua	Paraguay
Q4 2019	6468	8937	3237	4446	14784	5744	2397	7404
Q1 2020	6091	8059	1905	3998	15333	6021	2571	7971
Q2 2020	6272	8600	2958	3442	16987	7322	2738	8968
Q3 2020	6356	8238	3773	4015	17606	7509	2908	8675
Q4 2020	5276	7232	7534	3083	18464	8138	3212	9211
Var $	-1192	-1706	4297	-1363	3679	2394	814	1807
Var %	-18,4%	-19,1%	132,7%	-30,7%	24,9%	41,7%	34,0%	24,4%

Source: World Bank - Quarterly External Debt Statistics.

The most common problem in Latin America is not the external debt but the lack of fiscal resources to face its domestic debt. The reduction of tax collections could eventually result in extremely low fiscal revenues necessary to buy foreign currencies and repay the external debt. However, for countries with high levels of reserves, this is a domestic issue, rather than an international one.

Unlike the 1980s, there is no significant decrease in international reserves for most countries, due, on the one hand, to the fact that the services account in the current account has been positive -as there were no trips abroad- and that the domestic production linked to imports fell.

On the other hand, imports of final consumer goods also decreased due to the economic slowdown, deriving in many cases in trade surpluses despite the fall in exports, albeit supported too by lower oil imports in the region. This positive external outcome is the result of the economic downturn and contrasts with the fiscal collapse. The increase of the debt to GDP ratio in the region is effectively more related to the fall of GDP.

Illusions and the real problem

In general, Latin America has a low level of public debt, with some exceptions including Argentina, Ecuador, Bolivia and Honduras. The size of the debt is not similar to that of developing economies, where it has reached 100% of GDP for some years.

In Latin America, even considering 2020 estimates, the median debt level is of around 56% of GDP and is mostly denominated in local currency with the exception of Argentina, Ecuador and Central America, where most of their public debt is issued in US dollars.

If a simple average is used in the calculation, Brazil's debt causes the region´s average to reach almost 80% of GDP, which is misleading considering that this is the only country in the region that has a debt larger than 100% of GDP, similar to G7 economies. This is radically different from the 1980s, when public debt was mainly external and debt/GDP levels increased rapidly -in a staggered manner- due to the refinancing processes that began in 1982, triggered by historically high interest rates.

In 2020, the US reference interest rate fell to 0.25%, while in June 1981 the rate rose to 19.1%. The COVID crisis has nothing in common with the one that occurred in the 1980s and can hardly be referred to as a external debt crisis. Since 1825, all debt crises have taken the same form: a rise in the international interest rate, a simultaneous fall in commodity prices, a fall in GDP and tax revenues, and a default on payments. However, this is not the case in 2020.

The new variable of concern in 2020 is private debt, that is, from the private sector to the private sector. This variable has been increasing in Brazil, Chile, Colombia, Peru and Mexico according to BIS numbers, and did so even faster during the pandemic. Chile stands out, where external credits to the non-financial private sector are greater than 150% of its GDP.

What is unprecedented is that GDP contracted in all countries, giving the impression that the total debt/GDP ratio had grown suddenly for all of them. However, a debt expansion is not the same as an economic contraction, nor will the solutions to the debt issue be the same, since an economic contraction is accompanied by a reduction in tax collection. The average ratio increased sharply in 2020 but mainly due to the 8% drop in GDP. This, nevertheless, gave the misleading impression of a dramatic increase in debt. (Graph 7)

The elasticity of debt in relation to GDP is defined as:

$$\textbf{\textit{Elasticity}} = \frac{\Delta \textit{Debt} / \textit{Debt}}{\Delta \textit{GDP} / \textit{GDP}}$$

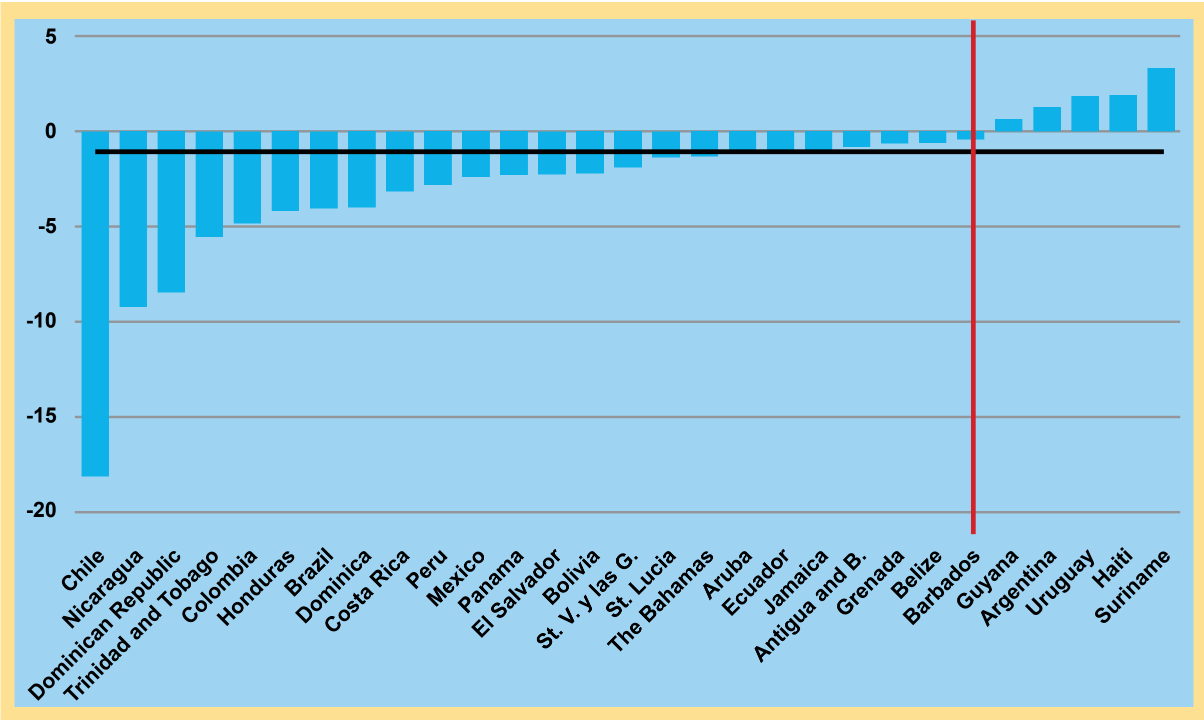
To see how much the debt/GDP ratio has changed, the effects of GDP contractions were observed in 17 countries, the most affected being Guatemala, Paraguay, Chile and Nicaragua. The latter by no means implies that these countries have real external debt problems, but rather that their ratio grew as a result of a GDP contraction.

In Guatemala, GDP contracted 2% and debt in dollars grew by 21%, as a result the elasticity of the index increased, giving a false illusion of debt problem. In this understanding, this country's debt/GDP ratio was 32%.

To prepare Graph 7, Guatemala and Paraguay -the two most severely affected countries in terms of the contraction of GDP affecting the ratio- were eliminated.

As shown in Graph 7, from Chile to Barbados, the contraction of GDP had an important impact on the ratio. From these countries and moving to the right in the Graph, some cases show no impact and – in those in the far right - an increase in the absolute level of debt is identified.

Graph 7 – Elasticity GDP – Debt 2019/2020



Source: prepared by authors, based on IMF data.

The increase of debt stock in these countries (in US dollars) had a median of 14.8%. If the four most indebted countries in that year are excluded, the median would be 13.6%. However, the debt/GDP ratio grew much more, as a consequence of the economic contraction in Guatemala -which does not have external public debt problems- as well as Paraguay and Chile.

The exports of some South American countries could eventually recover. However, the domestic markets will continue to be severely damaged given the fall in personal income. Additionally, some countries engaged in credits with the aim of applying active fiscal policies and offer positive net transfers of money to the population. (see Table 2)

Table 2 – Changes in the Debt Stock in relation to GDP, between 2019/2020

Antigua and Barbuda	35%	Guatemala	21%
Argentina	7%	Guyana	-7%
Aruba	56%	Haiti	14%
The Bahamas	17%	Honduras	14%
Barbados	10%	Jamaica	8%
Belize	28%	Mexico	22%
Bolivia	18%	Nicaragua	15%
Brazil	13%	Panama	34%
Chile	18%	Paraguay	36%
Colombia	30%	Peru	46%
Costa Rica	20%	St. Kitts and Nevis	23%
Dominica	6%	St. Lucia	39%
Dominican Republic	28%	St. Vincent and the Grenadines	17%
Ecuador	33%	Suriname	77%
El Salvador	28%	Trinidad and Tobago	27%
Grenada	21%	Uruguay	5%

Source: IMF WEO, October 2020

Public finance

The economic activity of these countries, as well as the collection capacity of their governments, contracted. According to the Inter-American Center of Tax Administration (CIAT), during April, May and June 2020, tax collection in Latin America fell on average by -30%, -28% and -22%, respectively.

It is important to emphasize that the selective consumption tax -important for both oil-exporting or non-oil exporting economies- was one of the most affected taxes, falling by 37.3% in April, 42.9% in May, and 30.1% in June, according to the latest available tax collection report from CIAT[1].

Additionally, VAT revenues fell from February to June by -24.41%, then by -29.59%; and later by -23.93%. In the same line, income tax revenues fell by -28.78%, -15.99%, and -19.89%, in the same period until June. The tax revenues that fell the least were those related to the income tax, and most of these reduced collections will be observed at the end of the fiscal year, as in most countries annual tax declarations take place in March 2021 and other related payments are partial.

A positive characteristic of emerging economies with fiscal problems is that interest rates are at their lowest historical levels (even in countries with historically high rates such as Brazil and Mexico). The Central Bank of Brazil lowered the SELIC tax rate from 6.5% in July 2019 to 2% in August 2020, where it has stabilized.

The interest rate of the Bank of Mexico remains the highest in Latin America, even though it fell from 8% in February 2020 to 4% in February 2021. Interest rates in the rest of the region are below 2%. This rates will remain low worldwide as long as inflation remains distant, which helps to reduce the burden of the domestic and external debt service. The underlying reason is a general bias towards fiscal surplus typical of orthodox policies.

1.- https://www.ciat.org/Biblioteca/DocumentosdeTrabajo/2020/DT_02_2020_RRC.pdf, Table 7. Accessed in December, 21th, 2020.

The strength of the region is reflected in its international reserves, which in most cases, remained stable compared to the beginning of 2020 or even increased in some cases, with the exception of Bolivia.

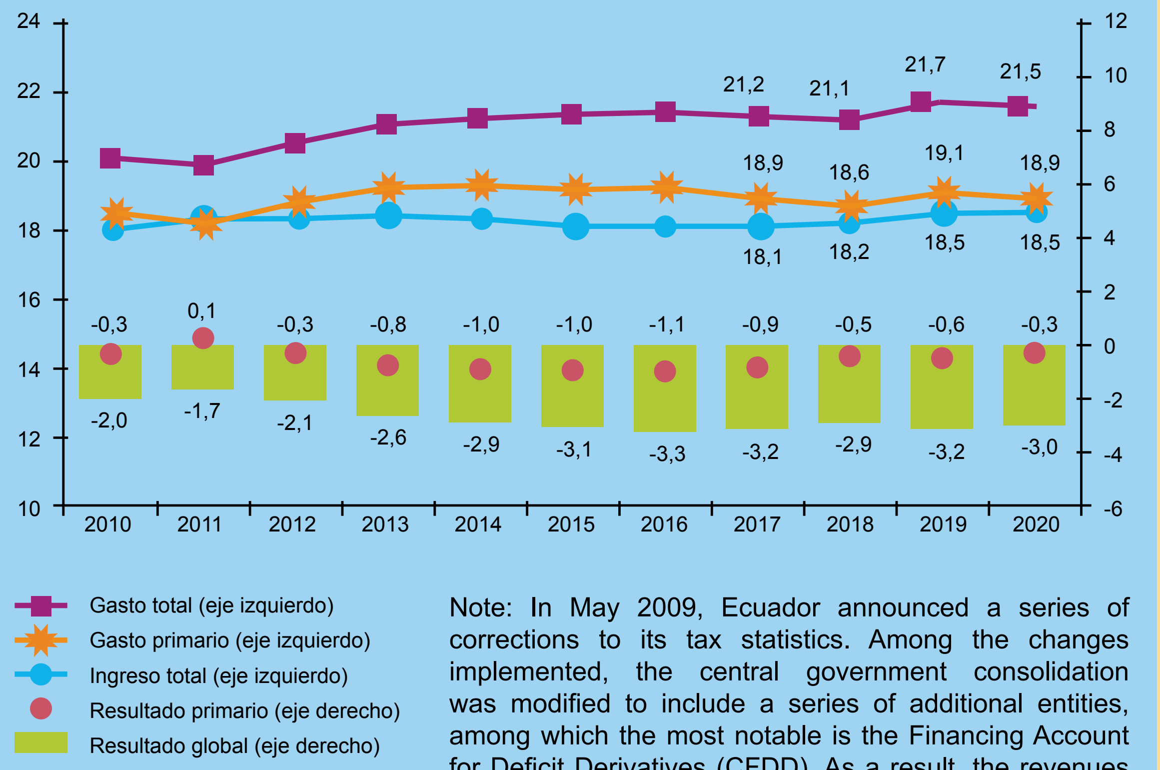
GDP contracted in 2020 and fiscal expenditure remained above 21.5% of GDP, which means that the amount in absolute values grew significantly.

This important increase was basically financed with domestic debt, except in the case of the island economies, the four oil-exporting countries (including Trinidad and Tobago) and the dollarized countries. Furthermore, the countries with the highest share of GDP within Latin America financed their expenditure mostly through domestic debt, except for Argentina.

The difficulties generated by the crisis are, therefore, on the fiscal and domestic debt side, but also on the real economy, on employment, and on the inability to transform the weak productive capacity, the latter identified even before the Covid-19 crisis.

It is imperative to strengthen the public administrations across the region. Also, the recovery strategy must include actions beyond fiscal and monetary policies, including those aimed at mitigating the immediate effects of the crisis caused by the pandemic.

Graph 8 – Latin America (16 countries)[a].
Main fiscal indicators of central governments, 2010 - 2020[bc]



Note: In May 2009, Ecuador announced a series of corrections to its tax statistics. Among the changes implemented, the central government consolidation was modified to include a series of additional entities, among which the most notable is the Financing Account for Deficit Derivatives (CFDD). As a result, the revenues and expenditures of the central government increased considerably. The resulting adjustment in the series affects the average of all fiscal indicators in Latin America as of 2019.

a.- Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Dominican Republic and Uruguay.

b.- Simple averages. In the cases of Argentina, Mexico and Peru, the figures correspond to the national public administration, the federal public sector and the general government, respectively.

c.- The figures for 2010 and 2019 correspond to observed values and those for 2020 reflect the projections included in the budgets approved at the end of 2019.

Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

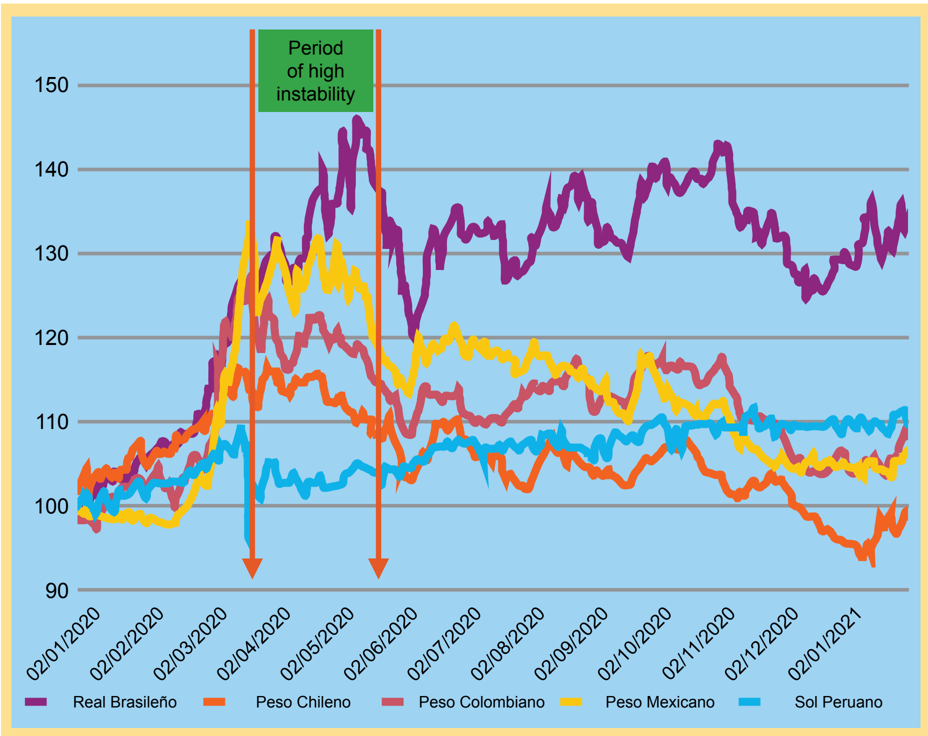
It will be impossible to think of an economic recovery while there is confinement. Furthermore, an effective "counter-cyclical" reactivation will be inconceivable if it is solely based on higher credits and fiscal support to companies.

Confinement must end first and citizens must be supported in order to reactivate the demand and alleviate to some extent the current simultaneous supply and demand shocks. The recovery will depend on the ability of governments to implement a strategy for delivering resources to citizens, combined with vaccination campaigns.

Exchange rates

A devaluation of the currencies of these countries would be anticipated given the high uncertainty and continuous growth of fiscal deficits. However, the latter is not observed in the largest economies, except for Brazil, which has a debt similar to its GDP.

Graph 9 - Fiscal indicators of central governments 2010/2020, as a percentage of GDP



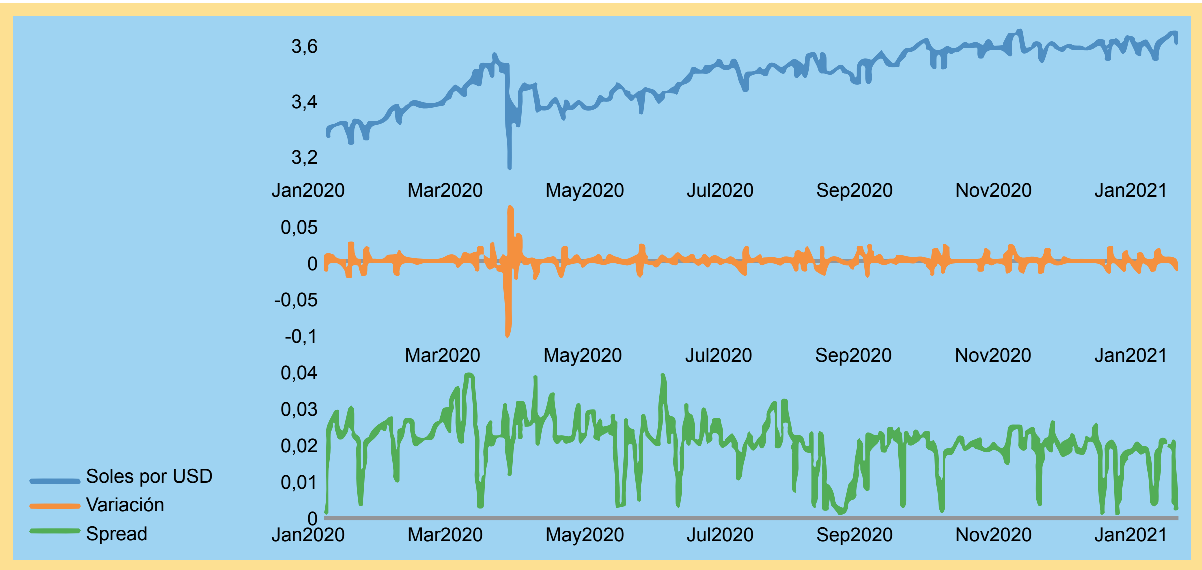
Source: Prepared based on data from ECLAC

Graph 9 begins in 2020 with the real exchange rate indices at 100, and twelve months later, in January 2021, they are approximately 10% higher, except for two countries: Chile that fully recovered the depreciation experienced from January to March, and Brazil that experienced a 38% devaluation of the real against the US dollar. The moment of greatest volatility occurred between the end of March and the end of May 2020, shown by the two vertical bars in Graph 9.

The instability of the exchange rate is not due to fiscal deficits but to uncertainty regarding economic reopening after the C-19 lockdowns. When it was said that it would reopen in June, most exchange rates stabilized, except in Brazil. Then, the exchange rates recovered with a slight depreciation at the end, which could also be interpreted as an adjustment on past inflation. However, there was no stampede in the face of growing inflationary fears, not even in economies that have remained under strict lockdown.

After analyzing each case, a slight depreciation was observed, with a stable variance except at the end of March. Additionally, the spread tends to disappear, suggesting stability at the new foreign exchange equilibria.

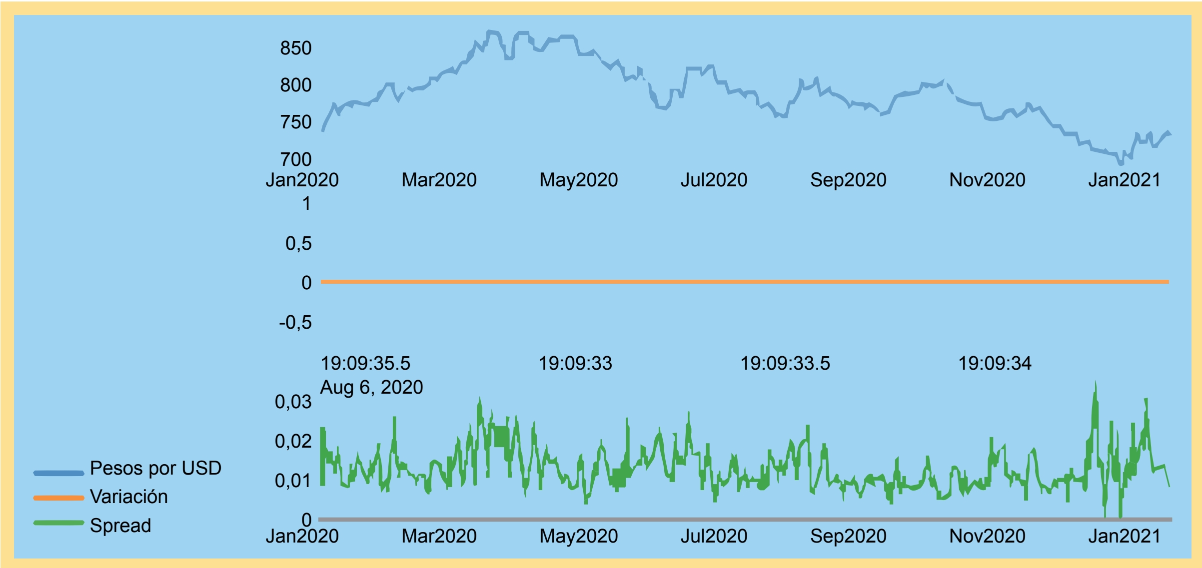
Graph 10 - Peruvian sol : Index, variation and spread



Source: Own elaboration from Quandl

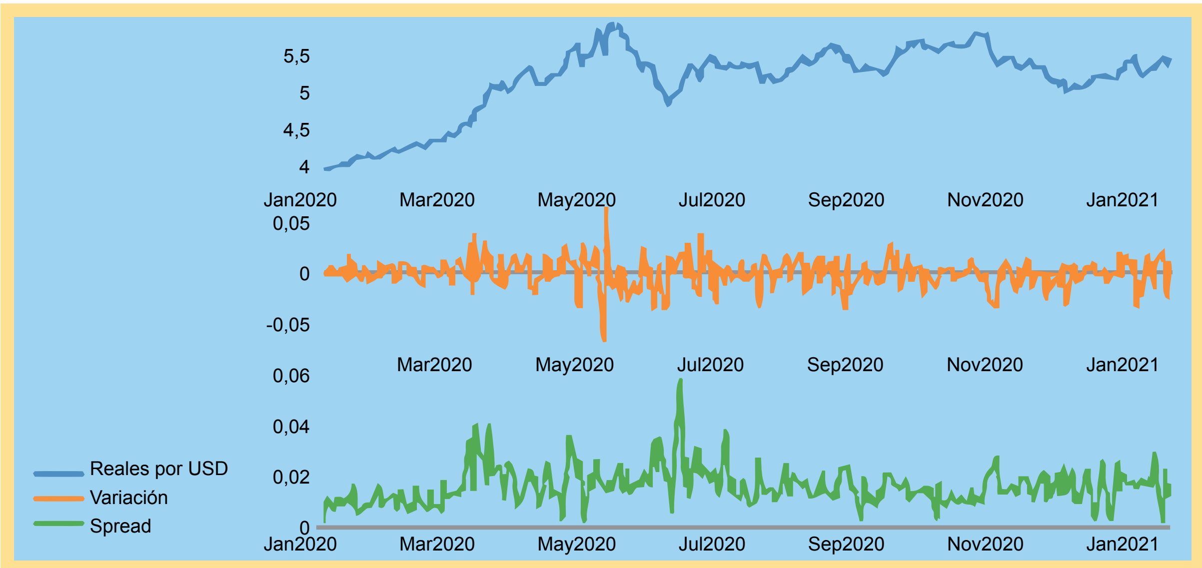
This was true for Peru and Chile, since the end of the period was more unstable. The rest presented a similar behavior. Brazil, on the other hand, showed a strong depreciation towards June and was not able to recover like the others. The spread remained high (green line), and the variation remained volatile (orange line).

Graph 11 - Chilean peso: Index, variation and spread



Source: Own elaboration from Quandl

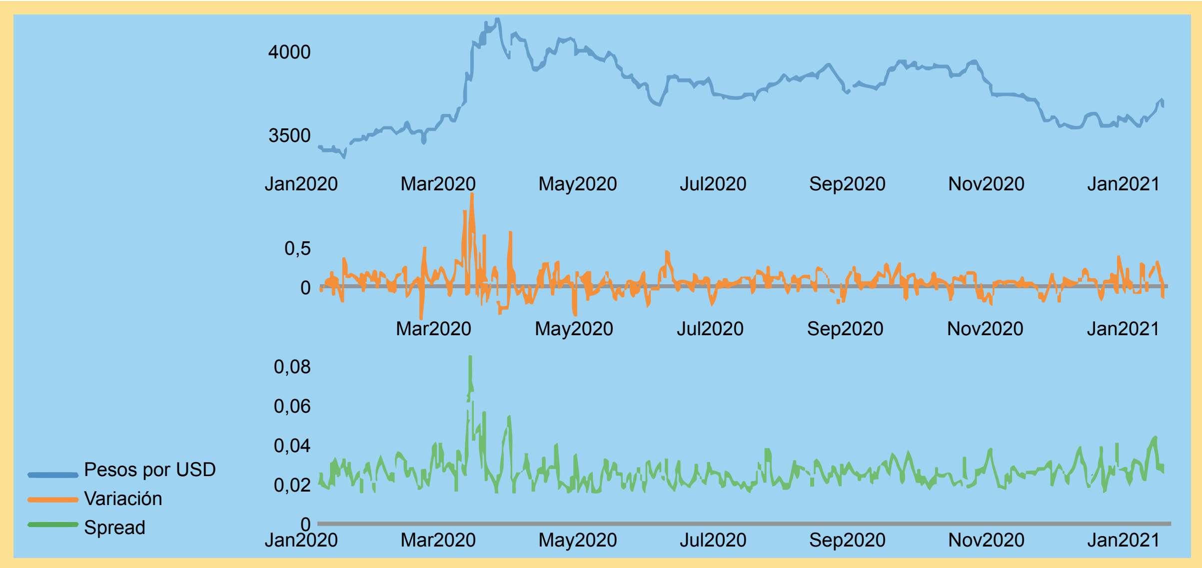
Graph 12 - Brazilian real: Index, variation and spread



Source: Own elaboration from Quandl

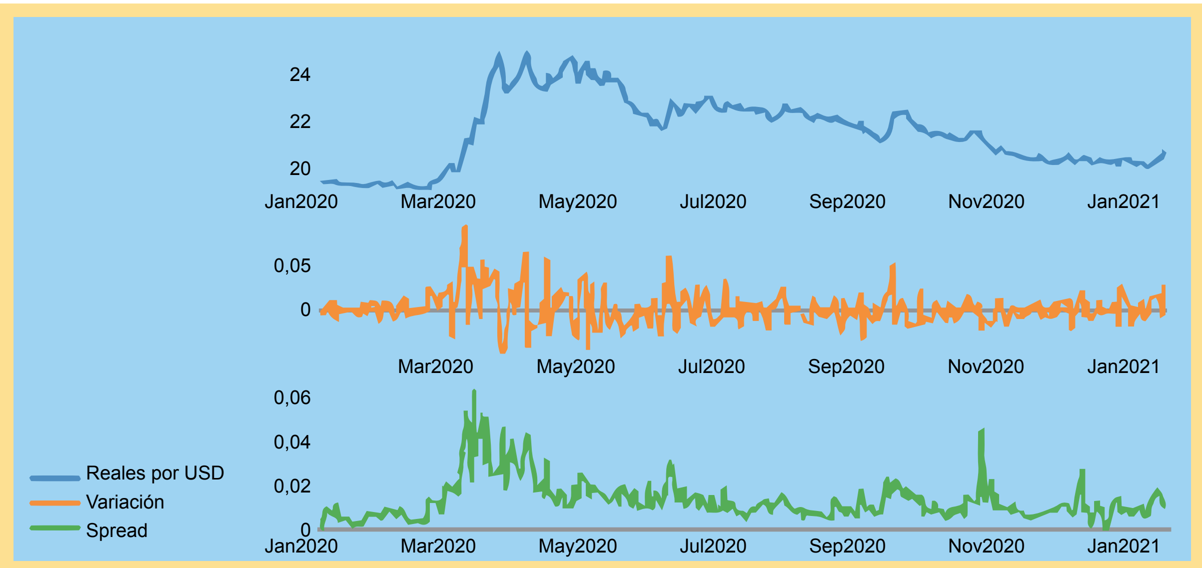
Colombia, just like Peru and Chile, had its critical moment in March and then stabilized, adjusting around 10% above the starting point. The uncertainty in these countries, unlike Brazil, does not have the same impact nor the same size of the fiscal deficit.

Graph 13 - Colombian peso: Index, variation and spread



Source: Own elaboration from Quandl

Graph 14 - Mexican peso: Index, variation and spread



Source: Own elaboration from Quandl

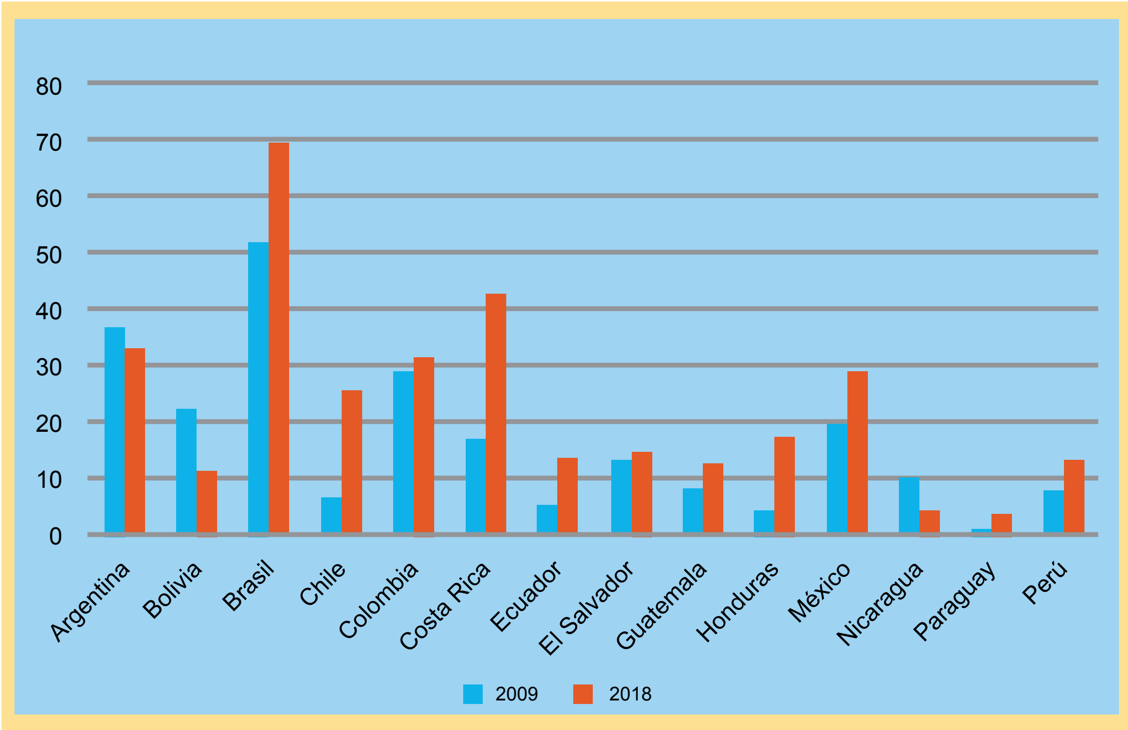
Mexico, in turn, suffered a strong impact in March, but recovered throughout the year, ending with a 7% depreciation versus twelve months earlier. Its variations remained high between March and September and the spread had a shock in November. Apparently, in Mexico the exchange game is different. This could be due to the size of foreign investments in debt securities in local currency, or even due to the departure of foreign portfolio investors from the country, as these are less important in other countries of the region in relative terms.

The relative stability of the exchange rate indicates that there is no concern about the economies stagnating for long. In other words, a long-term economic crisis is not anticipated, but rather a serious temporary problem is expected. The risk perception could change and exchange rates may suffer if reactivation measures are not applied as soon as possible.

At the beginning of 2021 there were two fundamental variables: the speed at which the population would be vaccinated in order to return to work and their economic routine; and how much effort the central governments would put into that task. Undoubtedly, countries where no resources are injected will see more exchange rate instability, and this should be understood as a sign of increasing economic risk.

The non-financial sector debt has grown since the 2008-09 crisis to levels close to 30% of GDP in Argentina, Brazil, Chile, Colombia, Costa Rica, and Mexico. This could have severe implications in the absence of a prompt economic recovery, forcing the implementation of monetary interventions in order to avoid financial crises.

Graph 15 – Domestic Debt of the Non-Financial Public Sector 2009-2018



Source: Latindadd elaboration based on ECLAC data

MODEL: DEBT DIAGNOSIS

The econometric model developed for the debt/GDP ratio, the level of international reserves and GDP growth, shows possible debt problems in six out of 16 countries, that is, in those with more internal than external problems, starting with Brazil.

Definition and treatment of variables

Variables

- Quarterly Gross Domestic Product [GDP] at constant prices, obtained from the corresponding statistical institutes and central banks.
- International reserves and liquidity in foreign currency [reserves] obtained from the IMF in monthly series.
- Debt / GDP ratio obtained from IMF WEO in annual series.

Variables treatment

- Starting with the quarterly GDP series, a SARIMA model was used in each series to forecast GDP growth until 2025. Later, data were annualized to standardize the frequency.
- Starting with the monthly series of international reserves, a SARIMA model was used to forecast them until 2025. Then, data were also annualized to standardize the frequency.
- Then, using GDP and debt/GDP ratio annualized data, it was possible to calculate the level of debt *[debt]*, as well as their growth rate *[dfdebt]*

Development of the model

Considering that GDP, debt and reserves are (mostly) variables with trend, it was decided to carry out a model in first differences.

The model carried out is a hierarchical model with a random intercept.

The final model is described below:

Level 1:

$$\Delta debt_{ij} = \pi_{0j} + \pi_{1j}\,\Delta PIB_{ij} + \pi_{2j}\,\Delta reserves_{ij} + \varepsilon_{ij}$$

Level 2:

$$\pi_{0j} = \beta_{0j} + \beta_{1j}\, country_{ij} + \tau_{ij}$$

Where:

i = subscript of time

j = subscript of the subject (j = country), where the change in the debt shares is equal to the changes in GDP plus the change in the level of reserves over time.

The detailed analysis of the estimated coefficients shows the average debt increase rate (during the study time) in the coefficient obtained for each country. However, some coefficients do not reach statistical significance due to their greater variability or due to strong fluctuations in the period. Meanwhile, the coefficient obtained through ΔGDP represents the inverse relationship between GDP growth and debt growth.

Given these two points, it is important to reflect on the cases of Costa Rica and Paraguay, which have higher GDP growth rates than the regional average, but also have rapidly growing debts.

Table 3 – Coefficients estimated by Maximum Likelihood

Fixed effects				
Variables	**Coef.**	**Std.**	**z**	**P>|z|**
Country				
Bolivia	0.091	0.056	1.64	0.100·
Brasil	0.034	0.033	1.02	0.308
Chile	0.081	0.033	2.42	0.016*
Colombia	0.067	0.033	2.00	0.045*
Costa Rica	0.118	0.040	2.95	0.003*
Ecuador	0.070	0.036	1.95	0.050*
El Salvador	0.055	0.033	1.65	0.099·
Guatemala	0.066	0.039	1.72	0.086·
México	0.029	0.033	0.89	0.372
Nicaragua	0.070	0.041	1.71	0.08·
Panamá	0.080	0.035	2.28	0.023*
Paraguay	0.059	0.058	1.02	0.305
Perú	0.027	0.034	0.80	0.421
Uruguay	0.033	0.035	0.93	0.352
Δ GDP	-0.836	0.176	-4.750	0.000**
Δ Reserves	-8E-07	0.000	-0.030	0.977
constant	0.019	0.024	0.780	0.434
Random effects				
sd(_cons)	2.3E-13	1.3E-12		
sd(Residual)	0.100	0.005		
AIC	-347.4504			

Model results

The lack of statistical significance of the variation in international reserves (ΔReserves) reflects the little relationship that these have with the debt, within the sample. In most cases, both variables tend to increase over time or maintain a relatively high level of reserves, except for the Bolivian case that shows a deterioration of international reserves together with a strong increase in indebtedness, thus suggesting a possible problem of balance of payments and debt in the near future.

In addition, the forecast of debt/GDP ratios for the coming years is included (please refer to Table 4). Argentina will continue in intensive care given its debt; Bolivia will run into trouble in 2023; Brazil shows a current domestic debt problem, greater than its GDP; Costa Rica and Ecuador will remain in trouble and El Salvador will get into trouble at the same time as Bolivia. The other ten countries show reasonable indicators. If economic growth were faster than that projected by the IMF -whose data were used for the study- the situation would improve. If it were lower, the situation would worsen.

Los demás pueden tener problemas fiscales más que probablemente, pero no problemas internacionales de inicio. No obstante, los problemas fiscales podrían convertirse en un problema novedoso de falta de recursos del tesoro para comprar las divisas a fin de pagar la deuda externa a lo largo de 2021.

The debt/GDP ratio strongly increased in 2020 for all countries, given the contraction of the denominator (GDP), even though there were some important increases in the amount of debt in Argentina, Haiti, Paraguay and Suriname. Improvements in this indicator will depend on the rate of indebtedness of these economies, as well as the speed at which they manage to recover their pre-pandemic production levels (GDP).

The six countries that are above 0.6 with an upward trend (marked in red) include: Argentina, Bolivia, Brazil, Ecuador, Costa Rica and El Salvador and they may suffer debt problems. The current problem in Brazil is related to its domestic debt, while Ecuador, Argentina and Costa Rica have been struggling for some years.

Table 4 – Debt/GDP ratio forecast 2021-2025

	2017	2018	2019	2020	2021	2022	2023	2024	2025
Argentina	0.570	0.864	0.904	0.967	0.901	0.899	0.898	0.898	0.898
Bolivia	0.513	0.539	0.590	0.694	0.674	0.712	0.821	0.897	0.981
Brasil	0.837	0.871	0.895	1.014	1.03	1.04	1.06	1.07	1.09
Chile	0.236	0.256	0.279	0.328	0.363	0.385	0.400	0.409	0.414
Colombia	0.494	0.537	0.523	0.682	0.617	0.603	0.588	0.577	0.569
Costa Rica	0.483	0.531	0.584	0.701	0.785	0.895	1.01	1.14	1.27
Ecuador	0.446	0.461	0.518	0.689	0.828	0.856	0.871	0.884	0.897
El_Salvador	0.672	0.680	0.694	0.890	0.983	1.01	1.03	1.06	1.08
Guatemala	0.251	0.265	0.266	0.322	0.290	0.312	0.330	0.350	0.371
México	0.540	0.536	0.537	0.655	0.654	0.663	0.674	0.685	0.697
Nicaragua	0.341	0.376	0.421	0.483	0.532	0.574	0.618	0.665	0.716
Panama	0.348	0.368	0.410	0.550	0.577	0.595	0.608	0.615	0.618
Paraguay	0.198	0.222	0.261	0.355	0.354	0.357	0.358	0.356	0.353
Perú	0.254	0.262	0.271	0.395	0.393	0.416	0.430	0.441	0.452
Uruguay	0.610	0.634	0.659	0.695	0.658	0.664	0.664	0.665	0.665

El Salvador and Bolivia are new in the list of countries with problems.

The other countries could eventually present fiscal problems, but not international problems in a first stage. However, fiscal problems could become a novel issue, given the Treasury's declining resources to buy foreign currencies and repay the external debt in 2021.

THE IMF'S RETURN TO LATIN AMERICA

Latin America has suffered severe effects of the financing conditions promoted by the IMF in previous years. Recent cases include Argentina and Ecuador, which serve as examples to emphasize the necessity for a sufficient and proactive public administration. The results of those policies have been insufficient and the IMF has lost credibility as a result of its intervention.

In this new stage of the pandemic, the IMF's pressures are concentrated on the fiscal side. Ecuador and Argentina made fiscal adjustments to reduce inflation, improved prospects for foreign investment and improved their balance of payments. In reality, austerity reduces spending capacity and slows down economies; production does not grow and tax revenues fall, which leads to a fall in GDP that makes it difficult to meet new expenditure commitments and new debt services.

Therefore, higher levels of debt followed by more austerity can be predictable and catastrophic. Austerity does not work to improve the internal or external conditions of an economy in times of fiscal crisis, and when the fiscal space is limited it can be counterproductive and dangerous. There is social unrest in various countries given the restrictions and the poor economic situation.

The problem with the pandemic and the closure of activities is the little fiscal space that remains to expand the output, given the massive decrease in revenues. The IMF is showing relative flexibility in the midst of this situation, given the health emergency. Support is underway and is mainly concentrated in Latin American countries, with 62% of this financial assistance allocated to the region as of 2020. The main recipients are Chile, Peru and Ecuador, which account for almost two thirds of funds allocated to the region.

The conditions for the recovery of countries are complicated given their limited fiscal space. The positive side is that this institution does not exert pressure for austerity at the moment, and the fall in GDP seems to have had an impact on the IMF's orthodox views.

The uncertainty for some governments is related to the continuity of this flexibility, especially if it is expected that future agreements and conditions will return to pre-Covid arrangements.

Between March and December 2020, the IMF has granted 63.809 million dollars in credits to a group of 22 countries that include many island economies in the Caribbean, highly affected by climate change and the downfall of tourism.

Among continental countries, Central American countries borrowed from the Rapid Finance Facility in the second quarter, when their balance of payments was severely affected. In South America, Colombia, Chile and Peru -members of the Pacific Alliance and the Lima Group- took most of the resources through flexible credit agreements. These three countries have managed to recover their exchange rates against the dollar and applied expansionary monetary policies to support their productive systems.

Table 5 - Financial assistance and debt service relief
IMF FINANCING FOR COVID-19 DURING 2020
(MARCH-DECEMBER)

Country	Type fo emergengy financing	Amount Approved in millions of Special Drawing Rights (SDR)	Amount Approved in millions of US dollars	Date of Approval
Bahamas	Rapid Financing Instrument (RFI)	182,4	250	jun-01
Barbados	Augmentation of Extended Fund Facility (EFF) Augmentation of Extended Fund Facility (EFF)	66,0 48,0	90,84 69,0	jun-03 dic-09
Bolivia	Rapid Financing Instrument (RFI)	240,1	327	abr-17
Chile	Flexible Credit Line (FCL)	17.443	23.930	may-29
Colombia	Flexible Credit Line (FCL) Augmentation of Flexible Credit Line (FCL)	7.849,6 4.417,4	10.748,30 6.200	may-01 sep-25
Costa Rica	Rapid Financing Instrument (RFI)	369,4 1.237,49	508 1.778	abr-29 mar-01
Dominica	Rapid Credit Facility (RCF)	10,28	14	abr-28
República Dominicana	Rapid Financing Instrument (RFI)	477,4	650	abr-29
Ecuador	Rapid Financing Instrument (RFI) Extended Fund Facility (EFF)	469,7 4.615,0	643 6.500	may-01 sep-30
El Salvador	Rapid Financing Instrument (RFI)	287,2	389	abr-14
Granada	Rapid Credit Facility (RCF)	16,4	22,4	abr-28
Guatemala	Rapid Financing Instrument (RFI)	428,6	594	jun-10
Haití	Rapid Credit Facility (RCF)	81,9	111,6	abr-17
Honduras	Augmentation of SBA and SCF	162,37	223	jun-01
Jamaica	Rapid Financing Instrument (RFI)	382,9	520	may-15
Nicaragua	Rapid Financing Instrument (RFI) Rapid Credit Facility (RCF)	86,67 43,33	123,55 61,77	nov-20
Panamá	Rapid Financing Instrument (RFI) Precautionary Line and Liquidity (PLL)	376,8 1.884	515 2.700	abr-15 ene-19
Paraguay	Rapid Financing Instrument (RFI)	201,4	274	abr-21
Perú	Flexible Credit Line (FCL)	8,007	11.000	may-28
Santa Lucía	Rapid Credit Facility (RCF)	21,4	29,2	abr-28
San Vicente y las Granadinas	Rapid Credit Facility (RCF)	11,7	16	may-20
Total Amount Approved		49.417,44	68.287,66	

Source: IMF, available at: https://www.imf.org/en/Topics/imf-and-covid19/COVID-Lending-Tracker

Financing from the IMF -beyond the austerity that may be promoted later- may be insufficient to support the region, since these countries need to modify their productive systems towards clean economies, improve their fiscal structure and their income distribution in order to revive their economy.

URGENT MEASURES FOR LATIN AMERICA

1. *Debt Cancellation/relief.* Latin America, as such, does not face balance of payments problems. It had liquidity problems in the second quarter of 2020, but in 2021 the central problem remains fiscal. Small Caribbean economies have high debt ratios. Additionally, dollarized countries such as Ecuador and El Salvador do not have a monetary policy and their only way to achieve economic reactivation is through a debt balance reduction.

2. The disadvantage of recommending the cancellation of debt in the presence of a fiscal problem is that the new debt becomes more expensive. The best examples are Ecuador and Argentina, which had deeply discounted buyback policies that resulted in a debt reduction of over 50%, in both cases. However, the cost of the new debt was higher than the previous one and the problems that originated the initial debt crisis were not addressed, causing both countries to return to the negotiating room with higher levels of more expensive new debt. Any debt cancellation initiative will cause an increase in the country risk assessment by risk rating agencies, and this will generate an additional and greater problem in the balance of payments which at the moment is not too relevant for many countries. The exchange rates of most continental countries have appreciated against the US dollar in 2020.

3. Since the current problem is fiscal rather than a balance of payments issue, debt restructuring initiatives could help to organize fiscal expenditures by reducing the debt service. Since countries need to spend more, perhaps one way to solve this would involve the implementation of expansionary monetary policies with the issuance of Treasury bonds denominated in local currency in coordination with Central Banks. This would allow a combination of external and domestic debt restructuring.

4. For some countries whose reserves were seriously affected, more liquidity in SDRs would be desirable. For most countries there has been no great variation in their reserves.

5. It should be noted that two countries that are fully dollarized have serious debt problems. Also, it is important to note that Bolivia is likely to enter into this high indebtedness path. Higher SDR allocations for El Salvador and Ecuador would not solve the fiscal problems these countries face. However, Bolivia could benefit from more SDRs, which would help to keep the exchange rate fixed at 6.80 Bolivianos per dollar, although this would not solve the fiscal problem or the balance of payments deficit.

6. The crisis that the six countries (Argentina, Bolivia, Brazil, Costa Rica, Ecuador and El Salvador) on the list are currently experiencing -or approaching- has to do with their inefficient productive system and not with the rise in interest rates or with the drop in the prices of commodities, as it has usually occurred in previous crises endured by these countries over the last two hundred years. The situation forces domestic production to be strengthened in all six cases in order to achieve higher tax collections.

The most important question is whether to do so with an expansionary monetary policy or with an expansionary fiscal policy, or with both.

The second question has to do with the possibility to reinstate former key economic activities: Intel left Costa Rica and the tourism industry is in trouble since 2020; the price of oil and the transition towards clean energy should force leaders in Ecuador, Colombia and Venezuela to think and decide where to redirect their economies, given the current importance of the oil and gas sector in their balance of payments and fiscal revenues. Bolivia maintains a fixed exchange rate and has just escaped a major problem by finding new gas fields and renegotiating gas sale contracts with Argentina -a measure that gave very good results during the government of Evo Morales. The contract renewal with Brazil for 20 million cubic feet of gas per day instead of 27 signed by the interim Government in 2020 forces the newly elected Government to renegotiate again aiming for higher volumes. The Salvadorian problem, in turn, must be managed at the balance of payments end where remittances from abroad are a key element, which is why it is not reflected in its decreasing tax revenues in 2020. Additionally, there is a problem at the production end, such as the “maquila” textile sector and other economic activities aiming to replace it as a key source of foreign exchange. Brazil is undergoing an energy transition led by investments from China, while Petrobras has invested large sums in oil production, similar to what is happening in the case of Pemex in Mexico. The Brazilian and Mexican automotive industries are focused on oil and, unfortunately, companies like Ford have closed their three plants in Brazil. The central question is whether the automotive industry will turn entirely to clean energy and under whose leadership and conditions, or whether parts of it will work on cleaner fossil fuels.

7. Dollarized countries cannot apply expansionary monetary policies hoping for a solution through the balance of payments or by higher issuances of SDRs, since these are beyond their control. The only solution for these countries is to opt for a debt restructuring, reducing their debt balances despite the adverse effects this measure may have on future capital costs. These countries will benefit more from new SDRs issuances than others.

8. Non-dollarized countries should find a way to convert the new allocations of SDRs into meaningful resources for fiscal support, through agreements between their Central Banks and Ministries of Finance. These resources should help solve current domestic debt problems for which no inflation-free solutions have been designed to date.

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