

## Macroeconomic and Financial Challenges Facing Latin America and the Caribbean after the Crisis RG-K1198

### 1. Background and Motivation

Following the turbulent 1990s, the decade leading up to the global financial crisis was generally very positive for developing and emerging economies. Most Latin American and Caribbean countries (LAC) took advantage of favorable global conditions by increasing growth, reducing poverty and inflation, lowering external debt, and improving fiscal balances. However, the crisis halted this progress, and the post-crisis period has been characterized by a rebalancing of the world economy and greater global economic uncertainty.

While there has been robust growth in most developing economies, the recovery in high-income economies has been more sluggish—accompanied by fiscal tightening and highly accommodative monetary policy. The IMF foresees output growth of just 2 percent in high-income countries but nearly 6 percent in developing economies, for the next few years. The expected fiscal consolidation in high-income countries in 2013–14 is estimated to be equivalent to a contraction in the structural fiscal balance of 1 percent of GDP, while interest rates in most advanced economies will remain close to zero for the near future. Central banks in high-income countries have significantly expanded their balance sheets in response to the crisis; most scenarios point to a tapering off of asset purchases in the relatively near future.

This global post-crisis scenario implies both macroeconomic and financial challenges for developing economies. Many countries responded to the crisis by implementing anti-cyclical monetary and fiscal policies. However, for some countries in Latin America, withdrawing this stimulus appears to have been more difficult, particularly on the fiscal side, and there is a danger that what was seen as highly successful, countercyclical macroeconomic management may simply translate into expansionary fiscal policy. Structural fiscal deficits have then deteriorated as output gaps have closed. If growth falls, there will be a temptation to maintain more expansionary fiscal stances, and debt positions may deteriorate.

The global economic environment has also implied easy conditions for enhanced access to international capital markets. Bond and syndicated loan issuance in emerging markets have been strong during the last few years, and are running well above pre-crisis levels (buttressed by persistent record-low yields on sovereign debt and the weaker economic prospects in high-income countries). Low dollar and euro interest rates have prompted corporations and some sovereigns in emerging economies to increase their issuance of foreign-currency denominated debt. In some developing economies, financial institutions have taken advantage of the relatively easy-financing conditions, leading to a strong expansion of credit. The current, strong debt issuance may therefore be provoking increased exposure to foreign-currency liabilities for banks, nonfinancial firms, and perhaps some sovereigns. In the current environment, relatively cheap, longer-term funding may be available for reducing potential issues regarding maturity mismatches; however, there is also concern that stronger liquidity regulations may push banks to lend in the short term, implying effective maturity mismatches on bank clients—rather than lengthening both sides of the balance sheet. A concern is that increased exposure of the private sector to foreign-currency debt, and relatively short-term bank balance sheets, may trigger deleterious balance sheet effects when

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advanced-economy central banks taper asset purchases, and global interest rates start climbing back to more normal levels.

Further macroeconomic challenges stem from the expansion in global liquidity and low yields in advanced economies, and the concomitant capital inflows to emerging economies in search of higher returns, together with high commodity prices and related earnings for commodity-rich countries. An intense debate has ensued regarding optimal monetary, fiscal, and regulatory policies in the face of this environment. One concern has been an excessive buildup of credit, upward pressures (and potential bubbles) on asset prices, and increased vulnerability to a sudden stop. A second concern has been the effects on the real economy reminiscent of the Dutch disease, associated with significant commodity booms. These effects include a booming commodity and non-tradable sector, including construction, but severe pressure on other tradables such as manufacturing. Assuming the boom is temporary (and there is now a greater expectation that the abundant liquidity in the global financial system may abate and some commodity prices have already fallen), then the large shifts in GDP composition in one direction and then another may imply significant adjustment costs. In particular, if capital is more like clay than putty, capital misallocations may result, and skills may be lost—or, at least, there may be a severe skills mismatch. Moreover, as the processes described are inherently uncertain, the uncertainty associated with the future composition of demand and relative prices may depress investment and growth.

At the same time, the nations of Central America and the Caribbean face somewhat different and, arguably, even more difficult challenges. In general, these countries are commodity importers and several have relatively high debts and have tended to have lower growth than some counterparts in South America. Many also have fixed exchange rate regimes and relatively high levels of dollarization. They have, therefore, not enjoyed the same boom in commodity revenues and, in some cases, have not attracted increases in capital inflows to the same extent as the rest of the region; capital inflows have been more tilted towards FDI rather than portfolio flows in some countries. A main challenge going forward is how best to manage debt and fiscal issues in a scenario of lower world and regional growth.

The motivation of this project is to sponsor a set of papers that individually may tackle specific aspects of the challenges across countries in LAC, or tackle a set of issues in one or more countries, thus comprising an interesting collection that represents the spectrum of current economic challenges for the region as a whole. Under a novel agreement, the IDB and the *Journal of International Money and Finance* (JIMF) will organize a conference in 2014 dedicated to this project, and publish a special issue including selected papers from the conference. Papers selected for both the conference and the special issue will undergo a standard review process. Selected papers are then likely to have a technical modeling or empirical component, and be crafted such that the analytical work proposed may shed light on a particular challenge and related policy conundrum or decision(s). Selected papers will both adhere to the relevant rigorous academic standards for publication, and support the IDB's continuous dialogue with policymakers in the region.

## 2. Objective, Content, and Methodology

The objective of this project is to produce a set of research papers examining the macroeconomic and financial challenges that LAC countries face in the post-crisis global economy. Proposals for papers may be made on a specific topic, in which case authors may wish to apply whatever theory

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or empirical aspects that are developed on more than one country or a set of countries in LAC. Or, they may focus on a particular country and analyze a specific set of topics or challenges using relevant theory or empirical tools.

As discussed above, it is expected that a general theme running through the project will be the challenges provoked by the post-crisis global economic conditions, including prolonged, low world interest rates, high capital inflows, relatively high commodity prices, exchange rate appreciation, credit booms, balance sheet risks in both the public and private sectors, mismatches including currency and maturity for sovereigns, financial institutions or firms and including mismatches between foreign-currency debt and non-tradable related revenues, Dutch disease-type issues in the real economy, including booming non-tradable sectors, commoditization of economies, and skill losses in manufacturing, or skill mismatches. There is also interest in including analyses that are particularly relevant for Central America and the Caribbean; topics might include fiscal and debt problems, appropriate monetary arrangements, determinants of low growth rates, and the barriers to enhancing growth. This list of topics is meant to be suggestive, and the topics are by no means exclusive. Authors are free to suggest alternative challenges and paper topics. Analyses comparing issues in Latin America and the Caribbean to other countries or regions may also be proposed, but all papers should have a main focus on LAC, and it is expected that each paper will carry implications for some aspect of policymaking in the region. The papers are expected to include a theoretical and/or empirical component and an analysis of relevant policy interventions or reforms that may address the challenge(s) being considered.

Core activities of the research may involve, but not be limited to:

1. Reviewing existing literature for the country(ies) being studied, comparing with regional or non-regional experiences, as relevant.
2. Collecting and analyzing historical data on debt issuance (bonds; loans) in domestic and international markets. Data may be at the transaction level or aggregated (monthly, quarterly).
3. Collecting and analyzing data on the relevant macroeconomic aggregates and/or financial indicators key to understanding macro-financial challenges.
4. Developing a theoretical model or performing an empirical analysis using state-of-the-art techniques, and with due consideration of standard robustness tests to consider a particular challenge or policy conundrum.
5. Writing a research paper according to the standard quality requirements for publication as an IDB working paper, to be considered for presentation in the joint IDB-JIMF conference and eventual publication in the JIMF Special Issue, being mindful of the relevant formatting and stylistic considerations.
6. Each research paper must contain either a theoretical model or an empirical analysis that sheds light on a macroeconomic challenge and policy decision(s). However, the proposal leaves open what type of model this may be or whether the empirical exercise takes the form of time-series, panel, or other econometric techniques. In the case of a theoretical model, it should be relevant for policy analysis or calibrated for a LAC country.
7. In all cases, the final dataset employed in the analysis will be delivered to the IDB along with the research paper (an exception may be made in the case of proprietary data, in which case some type of aggregation may be acceptable).

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While the proposal is quite open, we are particularly interested in proposals that might be thought of as fitting into a general theme of the challenges presented by the post-crisis global economic environment and, more specifically, the challenges presented by low world interest rates, high commodity prices, including what might be thought of as the financial and real aspects of Dutch Disease. In this vein, activities might include:

8. Gathering data and analyzing country balance sheets (assets and liabilities), disaggregating into the public and private sectors and detailing the extent of corporate and bank external borrowing by currency, and disaggregating by financial and non-financial firms.
9. Gathering data and analyzing capital inflows and their composition.
10. Gathering data and analyzing currency appreciation, financial asset prices, real estate and credit booms, and credit allocation between sectors, including tradable (commodity versus non-commodity) and non-tradable sectors.
11. Gathering data and analyzing shifts in GDP composition, commoditization of economies, deindustrialization, allocation of capital and labor to commodity, tradable (non-commodity) and non-tradable sectors, other aspects of the markets for capital and labor that may point to costs regarding shifts in GDP composition.
12. Policy measures that attempt to ameliorate the risks and costs related to financial and real aspects of these phenomena.

Having said this, we are also interested in papers that consider the particular situation of countries in Central America and the Caribbean.

We plan to commission 5-7 papers, depending on the proposals received and the available budget. Each project may either focus on one country, or compare countries, linked through the analysis of a particular topic or theme.

The papers produced as part of this research project should be submitted for publication as working papers of the IDB. They will be eligible to be selected for presentation in a conference sponsored by the *Journal of International Money and Finance* (JIMF) and the IDB. Subject to JIMF's usual peer-review standards, papers may then be published in a special conference issue by the JIMF.

### 3. Selection Criteria

**Research institutions only** may present proposals. The IDB will contribute **up to US\$30,000** for each study.

Proposals will be evaluated based on the following criteria:

- a) Quality of the proposal (50 percent) – this will include sufficient detail regarding any economic modeling proposed to judge its feasibility as well as sufficient detail regarding data sources and availability to judge the feasibility of any empirical analysis proposed. Creative and innovative proposals that are judged as feasible will be particularly welcome.
- b) Relevance to the policy challenges being faced by the region (30 percent) – the proposal should outline what challenge(s) the analysis refers to and why the results are expected to be relevant to policymakers that must deal with the challenge(s) under consideration.

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- c) Publication record and CV of the author(s) (20 percent).

The IDB will also judge a set of papers in terms of how they relate to one another, and may accept or reject papers for funding to ensure consistency and avoid repetition across the papers selected. In particular, the IDB seeks to create a balanced research project across different countries and topics.

To be considered for the project, the research proposal should include the following:

- a) A brief survey of previous studies on this topic, conducted on the country or countries (up to two pages).
- b) Data templates for the data being used and assessment of data availability. Proposals must additionally provide a description of strategy for collecting relevant data, including regulatory/proprietary data.
- c) A detailed description of the methodologies to be used in the quantitative exercise.

Final papers will be considered for dissemination as IDB working papers or technical notes, depending on quality. Papers will be eligible for presentation in a conference sponsored by the *Journal of International Money and Finance*, and may be published in a special conference volume—subject to the journal's usual peer-review process. Other forms of dissemination or publication should be explicitly approved by the coordinators. Proposals may include suggestions for further dissemination of the final version of the paper.

### 4. Proposal Submission

**Research institutions** interested should submit a proposal no later than **September 3, 2013** using the [Web Submission Form](http://www.iadb.org/en/research-and-data/research-projects-proposal-registration-form,3328.html?id=4734) (<http://www.iadb.org/en/research-and-data/research-projects-proposal-registration-form,3328.html?id=4734>). Please note that the submission form allows for two options: one for institutions and one for teams of individual researchers. Please be sure to choose the institutions option. If you are unable to submit the form electronically, please send an e-mail to [red@iadb.org](mailto:red@iadb.org).

The following information is required for submitting your proposal:

- The proposal describing all technical aspects involved in the development of the study, based on the Terms of Reference outlined in this Call for Proposals.
- A budget indicating the time and resources that will be used within the context of the research work plan. The budget is requested as a separate file and should not be included in the proposal. The proposed budget should disaggregate items financed by the IDB's contribution and those financed by the research institution. The budget should distinguish among amounts assigned to professional honoraria, "overhead", and other major categories of research expenditures. Moreover, the IDB will finance the travel of the leader of each research project to a kick-off workshop in Washington, D.C. and, assuming the paper is of appropriate quality, to the second, joint IDB-JIMF conference (location to be determined).
- The name and curricula vitae (two pages maximum) of the technical coordinator and other researchers involved. The research team should demonstrate its ability to meet the objectives of the project, including relevant experience. Please note that for proposals submitted by institutions, subsequent substitutions for researchers originally specified in the

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proposal may be made with prior approval from the project coordinators, but the technical coordinator should see the entire project through to completion.

If an institution submits a proposal and is subsequently selected to conduct the study, it must provide the name and contact information of the legal representative authorized to sign contracts with the IDB.

Proposing research institutions should register as Research Network members (contact Elton Mancilla at [red@iadb.org](mailto:red@iadb.org)) and be based in the Latin American and Caribbean region. U.S. and European institutions do not qualify as members of the Research Network. However, researchers from the United States and Europe can participate with research teams from proposing institutions from LAC. Such collaboration is encouraged.

**Note:** All proposals and research papers must be submitted in English.

### 5. Coordination and Schedule

The project will be administered by the Research Department (IDB/RES). The team consists of Julián Caballero (IDB/RES), Alejandro Izquierdo (IDB/RES), and Andrew Powell (IDB/RES). Carlos Végh (School of Advanced International Studies [SAIS], Johns Hopkins University and Associate Editor of the *Journal of International Money and Finance*), who will act as the managing editor of the special issue of the *Journal of International Money and Finance*, will be involved at each stage of the project. Other academics may also be asked to act as advisors or discussants.

The tentative schedule of activities is as follows:

- **September 3, 2013:** Due date for **receiving proposals**.
- **September 13, 2013:** Announcement of **selected research proposals**.
- **October 17–18, 2013: Kick-Off Discussion Workshop** in Washington, D.C., to discuss and refine the selected proposals.
- **December 16, 2013:** Due date for receiving a **first draft** of research papers, including the narrative, database, and preliminary results on the quantitative exercise.
- **March 10, 2014:** Due date for receiving a **second draft** of research papers. Supporting documents utilized in the study must also be received. The second draft will be considered for presentation in the IDB-JIMF conference.
- **March 14, 2014:** Announcement of papers selected for the IDB-JIMF conference.
- **April 28–29, 2014: IDB-JIMF Conference in Washington, D.C.**
- **June 30, 2014:** Deadline for receiving a **final version** of research papers (including a summary that discusses policy lessons), and datasets utilized in the study. This version will be considered for the JIMF Special Issue.
- **July 30, 2014:** Deadline for **editing the final version** of the research papers, in accordance with the **IDB Manual of Style**, for the IDB working paper series.

### 6. Financial Contribution and Payment Schedule

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The IDB will contribute up to **US\$30,000** for each study, depending on the scope of work proposed. The payment schedule is as follows:

- **30 percent** within 30 days of signing the formal agreement between the IDB and the respective research center;
- **35 percent** within 30 days of presenting and approving the first draft of the research paper;
- **15 percent** within 30 days of presenting and approving the second draft of the research paper;
- **20 percent** upon approval by the Bank of the final research paper and summary discussing policy lessons, and receipt of the databases utilized in the study.