Vice Presidency for Sectors and Knowledge
Research Department
Capital Markets and Financial Institutions Division

Structure and Composition of Firms' Balance Sheets

A Project of the Latin American and Caribbean Research Network

Given the exceptional monetary policies in advanced economies in the years following the Global Financial Crisis, Latin American and Caribbean (LAC) corporates have had unprecedented access to international capital markets at low interest rates. Persistent record-low yields and weak economic prospects in high-income countries have prompted international investors to increase their exposure to financial instruments issued by emerging market corporates. Taking advantage of these conditions, issuance of international debt securities by Latin American and Caribbean corporations reached record highs in 2013. However, the auspicious global financial conditions for EMs may be coming to an end, as normalization of monetary policy in the United States proceeds and, eventually, as short-term rates rise. Furthermore, recent projections suggest that growth in EMs will probably be relatively subdued in the next few years.

These developments raise a set of questions that may be critical for the economic and financial stability for the region. A challenge moving forward is that market finance is typically pro-cyclical and can evaporate in response to problems in the domestic economy or after a shift in paradigm of global investors. As U.S. interest rates normalize, investors' demand for the region's financial assets may fall. The asymmetry between U.S. and European monetary policy may also heighten currency volatility. Moreover, currencies may depreciate rapidly against the dollar because of increases in U.S. rates, and they may depreciate against both the dollar and the Euro if there is a retrenchment of international capital. Large depreciations in the face of slow-growth prospects may pose risks to corporations that increased their reliance on financing in foreign currency. The extent of the exposure of corporations to foreign liabilities may be difficult to gauge, as some firms issue debt through offshore subsidiaries, often off the radar screen of the authorities, and some firms may also hedge currency exposures using currency derivatives or exacerbate exposures using the same means. There may also be knock-on effects on domestic financial systems if larger firms lose access to international markets at competitive rates and borrow more through the domestic financial system, or if there are withdrawals of corporate deposits as international interest rates rise. In a context of subdued economic growth, banks may also become more conservative in their credit allocation decisions, and this may then squeeze smaller firms out of credit markets.

Against this background, this project will contribute to achieving a better understanding of the financial challenges that the Latin American and Caribbean region may face in coming years. The project aims to provide a solid empirical basis to underpin the policy dialogue with the IDB's borrowing member countries and to assist in formulating policy recommendations. The project objectives are a firm-level database on currency composition of balance sheets, a survey on hedging activities of international debt issuers, and an analytical paper studying a relevant topic and making use of these databases.

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