RESEARCH INSIGHTS

External Crisis Vulnerability in Latin America and the Caribbean: Is the Glass Half-Empty or Half-Full?

- **Quantifying risk tradeoffs between different external balance sheet exposures, macroeconomic fundamentals, and global shocks is key to gauging the risk of external crises.**
- **This study highlights the need for the countries in the region to carefully manage their external portfolios and buffers.**
- **Despite progress, there is ample room for Latin America and the Caribbean to reduce their external crisis vulnerability through strategic risk management policies.**

CONTEXT

While the Latin America and the Caribbean has improved macroeconomic policy management since the 1980s, it remains vulnerable to external crises, like sudden stops in capital flows. Guiding prudential policy to increase countries' resilience to these crises requires assessing risk factors that can trigger them. This study sheds light on the driving factors behind external crises and on the policy levers that may be used to make those crises less likely. Specifically, the study explores the temporal evolution of risk factors for the region, both risk-creating and risk-mitigating, and the overall likelihood of crisis.

PROJECT

This project examines the evolution of external crisis vulnerability in Latin America and the Caribbean from 1970 to 2019. It develops a model to assess the region's risk exposure based on factors like the composition of external assets and liabilities (specifically, debt instruments, portfolio equity, and foreign direct investment), the level of international reserves, the prevalence of macroeconomic imbalances (fiscal and current account deficits and exchange rate misalignment), and global shocks or contagion. The analysis benchmarks the region against advanced and non-advanced economies to highlight remaining weaknesses and inform policies to further strengthen its resilience to external crises.

RESULTS

The average country in the region has made significant strides in reducing its external vulnerability over the past decades, reaching historic minimum levels by 2019. Changes in the composition of external assets, especially the rise in safer assets, in particular foreign direct investment, along with the accumulation of international reserves, have been key factors in lowering risks in the region. Changes in liability composition away from risky debt further contributed to improving the risk indicators. Moreover, macroeconomic imbalances have not been an additional substantial risk contributor on average, not even in the 1980s when the region faced a series of costly financial crises leading to the Lost Decade.

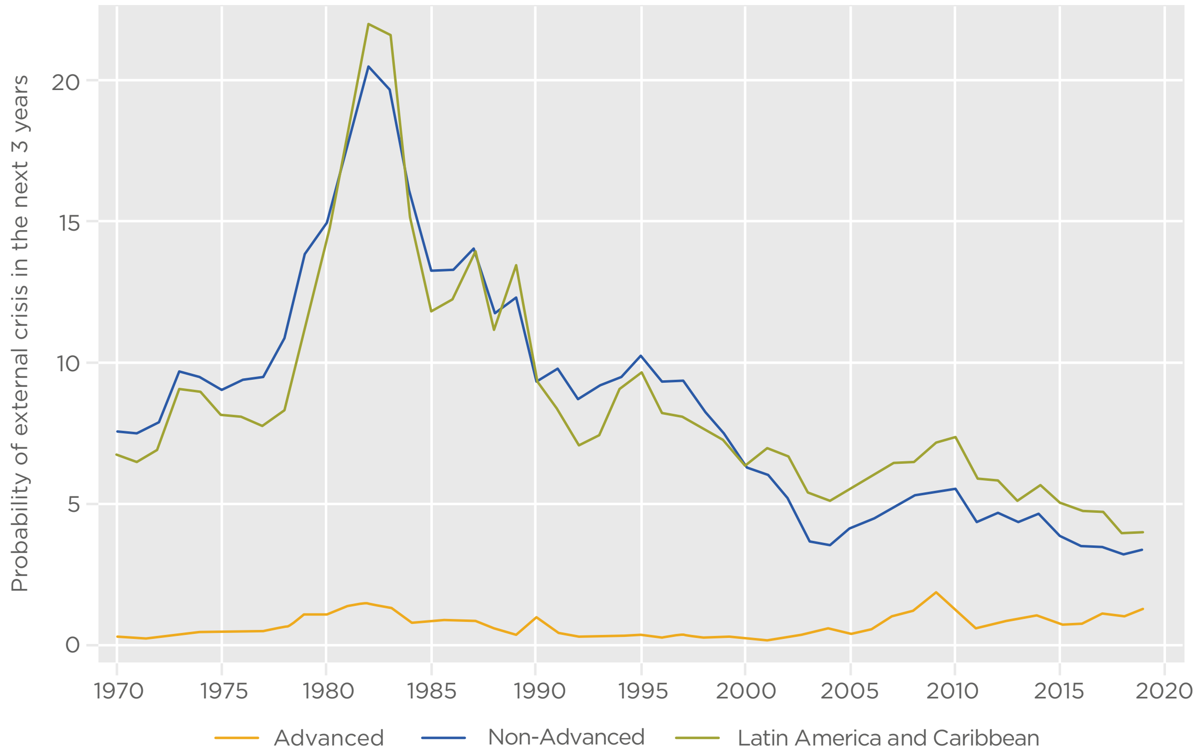
Nonetheless, countries in the region remain more susceptible to external crises in comparison to both advanced and other non-advanced economies. Since the late 1990s, non-advanced peer regions have seen more substantial improvements in asset composition and reserves accumulation than Latin America and the Caribbean has achieved, and as a result, the average probability of a crisis in the region over time was about 1.4 times larger than in other non-advanced economies (see Figure 1). Relative to advanced economies, Latin America and the Caribbean faces structural weaknesses that increase its exposure to external shocks and limit its resilience in preventing that exposure from resulting in crises. The probability of a crisis in the region was about 11 times greater than in advanced economies on average over fifty years.

POLICY IMPLICATIONS

There is considerable scope for countries in the region to further reduce their susceptibility to external crises through deliberate enhancements to their policy frameworks and improvements in the macroeconomic policy frameworks. Regarding a country's external balance sheet, the emphasis in academic and policy discussions has usually been on the level and composition of a country's external liabilities. The results in this paper show that considering external assets can be even more important in reducing crisis vulnerability. Continuing to improve the composition of external assets by increasing the amount of safer types such as foreign direct investment can reduce crisis risk. In fact, we found that advanced economies benefit from a considerably safer portfolio composition than Latin America and the Caribbean and other non-advanced economies due to the high presence of foreign direct investment in their external portfolios. This safety advantage is further amplified by substantial financial integration (openness) in advanced economies, which far surpasses that of the region and other non-advanced regions.

Accumulating more international reserves is another important way countries in Latin America and the Caribbean can strengthen their defenses against external volatility. Since the 2000s, the rest of the non-advanced economies have substantially outstripped the increase in international reserves in Latin America and the Caribbean. Increasing reserve accumulation, especially in countries with low stocks, would lower the region's crisis risk and align it more closely with non-advanced peer regions.

Figure 1. External Vulnerability Assessment (cross-country averages by group)



Note: The external vulnerability assessment (EVA) is a model-based estimate of the probability of a crisis three years forward. The EVA results from applying the probit (normal density) function to the overall external risk indicator (ERI) developed in the paper. The figure shows the average EVA across countries in each region or group.

IDB RESEARCH ON EXTERNAL CRISES

This paper is part of a research agenda at the Inter-American Development Bank (IDB) on identifying the drivers of external crises and assessing countries' vulnerability. A related study explores the empirical determinants of external crises using a similar model and dataset, finding that considering gross positions in external assets and liabilities, rather than just net positions, provides critical information.

FULL STUDY

Cavallo, Eduardo A., and Eduardo Fernández-Arias. 2023. "External Crisis Vulnerability in Latin America and the Caribbean." IDB Working Paper No. 1487. Washington, DC: Inter-American Development Bank.

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.

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