

# **XVII Meeting of the Latin American Network of Central Banks and Finance Ministries**

## **Minutes**

### **Opening Remarks**

In his introductory statement, Guillermo Calvo noted the particular relevance of this meeting. While previous sessions served as fire drills, the region's current crisis represents an actual fire that requires economists to apply their knowledge. Although the present debate on the region's direction is dominated by political concerns, the economic point of view remains necessary. Although economists may lack a public voice, they still can and must continue to play an advisory role.

In assessing the region's difficulties, it is necessary to take external as well as internal factors into account. The "Enron effect" of recent corporate governance scandals in the United States suggests that contagion, previously considered a phenomenon of emerging markets, may also emanate from financial centers. Consequently, not all of Latin America's economic problems can be considered as purely endemic to the region.

### **Session I. Global Outlook**

Carmen Reinhart began by observing that, after strong growth in the 1990s, the global economy experienced only slow growth at the beginning of the decade, which has remained stalled since 2001. There has been no return to sustained strong growth, and much depends on the state of the U.S. economy.

In both the United States and other developing countries, however, recovery is complicated by pro-cyclical capital flows. In the United States, for instance, the tightening of monetary policy coincided with factors including high oil prices and a strong dollar. The resulting recession of 2001, however, was kept short by the 2001 tax cut as well as the monetary response; low mortgage rates have stimulated spending in other areas such as fixed investment and durable goods. Ongoing downside risks include rising unemployment, declining consumer confidence, and lower equity prices, the latter possibly having a negative wealth effect and dampening consumer demand; investor uncertainty is also reflected in higher risk spreads. Oil prices, though expected to fall, remain elevated.

Other areas of the developed world provide even less reason for optimism. Effectively constrained at the zero bound, the Bank of Japan has little room to maneuver, and Japan's incipient recovery has lost momentum as industrial production has slowed. The European Central Bank's reluctance to ease monetary policy prevents the Euro zone from contributing to global recovery, and both confidence levels and equity prices remain depressed.

Recovery is only beginning in the emerging markets. The effects of the Argentine crisis on Uruguay and Brazil have raised concerns about other highly dollarized economies and led to

fears of other forced currency conversions in the banking system. Current difficulties in Mexico, Venezuela and Colombia, however, may represent homegrown problems rather than contagion effects. Latin American growth is vulnerable to changes in the U.S. business cycle, and Mexico and Central America, strongly linked to the U.S. real economy, are expected to display weak in coming quarters. Foreign direct investment (FDI) flows to Latin America are also expected to decline, as events in Argentina have made businesses wary of policy reversals. These fears are grounded in the region's history, which has featured liberalization in prosperous times and tightening of economic restraints during periods of adversity. There are concerns that the region's experiment with reform is ending and that varieties of financial repression may already be emerging.

Hung Tran began his presentation by noting that the external environment is not supportive of emerging market growth and that equity prices and earnings remain uncertain. Recent corporate scandals, expected to produce changes in accounting rules and pension plan provisions, have produced volatility in equities markets, with an increase in perceived risk and risk aversion. Under these circumstances spreads have widened and loans to top corporate borrowers are probably underpriced at present, and distinct tiers of perceived risk and quality are emerging. In this discouraging environment new bonds are confined largely to sovereign and high-quality corporate issues, and the issuance of emerging market debt is at a five-year low.

A process of tiering has also taken place in secondary markets, and distress spreads have entered uncharted territory. Perhaps strangely, volatility in emerging market indices such as the EMBI+ remains low even while risk premia remain high; the listed securities, especially those issued outside Latin America, are thus relatively attractive to institutional investors considering the low-yield alternative of developed country debt. Even though it is possible to diminish the risk associated with a given bond or class of bonds, increasing investors' appetite for risk will prove more difficult.

To make their debt more attractive, Latin American countries should consider a variety of measures. First, they should practice sound debt management, avoiding exchange-indexed short-term and floating-rate debt; investor interest may also be stimulated by linking bonds to an index of performance such as GDP or a key commodity price. Second, countries should deepen and develop their local securities markets so that sovereigns will be able to contract medium and long-term debt in their own currency. Third, countries should strive to cultivate a domestic base of dedicated investors in order to reduce volatility and reliance on crossovers from other investors; investor relations programs may be useful toward this end. Finally, countries must pursue stable and sustainable macroeconomic policies, particularly in regard to growth and debt.

In his teleconference presentation, Paul McCulley raised the question of why a mild global recession is accompanied by extreme risk aversion. He described this combination of circumstances as a corporate depression at the end of a 20-year bull market in capitalism; as such it differs from a traditional household sector-led recession, which in the United States at least has been staved off by monetary policy.

The current corporate depression has been preceded by approximately two decades of power being shifted from the public sector to the corporate sector, particularly in the United

States. In monetary policy, officials have responded to marketplace demands and brought about the disinflation of the last twenty years. In fiscal policy, which has been subordinated to monetary policy, a Keynesian emphasis on demand has been replaced by an emphasis on supply. Previous crowding-out effects have been replaced by a crowding-in of private creditors, with the effect of reducing public debt and increasing private debt. In regulatory policy, privatizations and deregulation have further shifted power to the corporate sector.

Current difficulties have ensued because of that period's excesses. Confusing the temporary journey to a more capitalistic place, with resulting efficiencies and benefits, with a destination in itself, markets displayed the hubris of capitalism, particularly in the United States. Three interrelated bubbles resulted in equity valuation, business investment, and corporate leverage. The bursting of those bubbles since 2000 has led to corporate sector deleveraging and risk aversion in banking. This procyclical movement has been accelerated because the deregulation and financial disintermediation of the bubble era allowed banks to become part of capital markets rather than serve in their traditional countercyclical role.

Given these factors, no current structural model is useful for predicting the years ahead, as this new type of recession is not merely a traditional inventory adjustment. Two scenarios, however, are possible. The first involves successful interest rate easing, which will sustain household sector demand through wealth effects in the property market, in effect shifting leverage from the corporate to the household sector. Risks attending this scenario include a bubble in the property and the possibility that household sector demand may diminish before corporate deleveraging is complete. A second scenario involves continued deleveraging which will dampen growth and maintain high levels of risk aversion, producing a downward spiral. Though the first scenario presently appears more likely, more aggressive aggregate demand policies based on fiscal stimulus are needed to prevent the second.

In the discussion following the presentations, Guillermo Calvo raised the question of whether risk aversion should also be assessed in terms of technical phenomena within capital markets, and Eduardo Fernández-Arias observed that the analysis of emerging markets made little reference to oil. Ernesto Talvi noted that the observations on the bursting of the interrelated bubbles did not include the impact of Enron and related scandals or geopolitical factors, and that a fourth bubble of accounting fraud may have existed. Carmen Reinhart asked whether the current U.S. situation is not necessarily unique, but perhaps like that of the United States in the 1970s or Japan in the 1990s, where weak domestic demand for loans eventually led to extensive lending and investment abroad.

### **Keynote Address**

Guillermo Calvo framed his remarks by stating that, although there is a currently a deep crisis in Argentina, some other countries in the region are only barely avoiding a similar condition. This situation has arisen because, while countries in the region have based their reforms on fiscal sustainability and credibility, they have remained vulnerable to external factors such as interest-rate fluctuations and Sudden Stops. Of particular importance is liability dollarization in relatively closed economies with large nontradable sectors, such as Argentina and Brazil; a sudden change in capital flows in turn changes the real exchange rate and disrupts financial activity. The

resulting policy question is how to make such economies more open in order to allow them to make adjustments through the tradable sector, as Chile and several Asian countries have done in the wake of shocks in the late 1990s.

A second question involves how highly dollarized economies can dedollarize, and why some countries appear so far to be more successful in this process than others. The range of viable options is, moreover, narrowed by the undesirability of pesoification, which entails a breach of contracts, invites lawsuits, and encourages similar behavior in other countries.

A third concern is increasing controls on capital mobility. These measures seem effective in avoiding Sudden Stops, as shown by Chile's experience. Still, their potential to dampen overall investment makes them desirable only as a last resort.

A fourth area of concern is achieving greater flexibility in labor markets. Financial vulnerability must be taken into account in this process because Sudden Stops can bring about sharp declines in real wages.

At the macroeconomic and policy level, fiscal adjustment alone is not useful, and can only be so when combined with accords with international financial institutions (IFIs). Otherwise, applying a stock solution to what is fundamentally a flow problem can only deepen the current recession. Nonetheless, IFIs seem reluctant to act, ostensibly for fear of creating moral hazard. The need for action in the region is nonetheless increasingly urgent, as Brazil's devaluation of the real is no longer working as it did in 1999 and popular discontent is evident in many countries' political systems. Possible policy approaches include tighter fiscal constraint, which could prove disastrous under current conditions, or a restructuring of debt, which IFIs seem ill-prepared to aid. In any event, only by addressing vulnerability can countries provide for sustainable growth.

In comments following the address, Pablo Guidotti asked why the regional economic debate has not previously addressed vulnerability and risk management and stated that in the past policymakers have relied on either ex post measures or piecemeal approaches to certain sectors such as banking rather than taking a systemic approach. Moreover, the debate has so far lacked a useful definition of sustainability. Pursuant to these concerns, governments may wish to establish a risk management ministry, as Ministries of Economy and Central Banks are neither equipped nor supplied with incentives in this area. Governments in the region presently delegate much of their planning in this area to multilateral lenders who lack information and can be simplistic in their analysis.

Carmen Reinhart stated that the region's countries must come to terms with the wider issue of debt intolerance, as levels of debt considered acceptable for OECD countries are not viewed as acceptable for Latin America. Not only is this a present-day concern, but it has also affected the region in the 1800s and in the 1980s. To address this reality, Latin American countries must close their current account deficits, or they will be forced to do so, as shown by the implosion of demand in Asia in the late 1990s.

In regard to the role of openness in reducing vulnerability, Eduardo Fernández-Arias noted that the market may not find the appropriate degree of openness for an economy and asked what policy instruments can be used for this purpose. Hung Tran noted that exports alone should not be seen as a panacea for vulnerable economies given the importance of China in global manufacturing, and Ernesto Stein stated that export-oriented policies must be conditioned on opening developed country markets to good where Latin American countries possess a comparative advantage.

## **Session II. Latin America against the Wall: Is There a Way Out?**

Ernesto Talvi observed that capital flows to LAC-7 countries stalled after the Russia crisis and have fallen in the wake of the effects of corporate scandals in the United States and a slowdown in the world economy in 2001. As a result of capital outflows and declines in FDI, capital flows have declined to those of the lost decade of the 1980s; at the same time, similar declines have occurred in Asia, with the exception of Korea, and the emerging markets of Europe. Latin America has consequently been affected by a generalized investment-led slowdown whose effects are exacerbated by the synchronization of business and financial cycles.

These shocks have led to major external adjustments. These have included a steep reduction in imports and a sharp rise in the cost of credit. Nominal and real exchange rates have also experienced substantial depreciation. These adjustments have proven particularly difficult for a country such as Argentina, which is burdened with a large public debt, financial mismatches in both the public and private sector, and significant bank sector exposure to public sector debt. Brazil's difficulties are roughly comparable to those of the region as a whole, but two difficulties stand out. The first is the country's public debt level. The second is vulnerability related to debt structure, either in terms of maturity or dollar-denomination or indexing. The large amount of public debt held in domestic banks represents a further source of vulnerability.

The conventional wisdom regarding the region holds that its economic difficulties can be traced to political uncertainty, but U.S. corporate bond spreads may be underlying increasing premia. For instance, there is co-movement of high-yield U.S. bond rates and Brazilian spreads. This may represent a coincidence, but it may also reflect the effects of corporate governance scandals and markets' resulting aversion to risk.

Assessing Brazil, César Costa Alves de Mattos observed that the country's outlook is one of general stagnation, a downward revision from forecasts earlier in the year. Although long-term forecasts call for more robust performance, with less concern for political uncertainty, Brazil presently faces weak durable goods sales, an increase in the basic interest rate, and an increase in unemployment over 2001. Even though the number of employed persons has increased, job creation remains insufficient to absorb all new entrants into the labor market.

In spite of these difficulties, Brazil is making a relatively successful current account adjustment. Imports have declined, and exports have increased unexpectedly, and apparently for reasons not entirely related to exchange rate fluctuations. Moreover, the country's \$30 billion standby agreement with the IMF has inspired confidence and stability, as has a pending \$7 billion accord with the World Bank and the IDB. Additional encouraging signs include a steep

decline in the government's share of external debt and the passage of a fiscal responsibility law designed to bring the country's states from deficit financing to fiscal surplus. Remaining vulnerabilities, however, include the possibility of an oil price shock, uncertainty regarding the level of the real, and low levels of FDI.

Surveying Ecuador, Alonso Pérez-Kakabadse stated that the country's experiment with dollarization has so far proven successful. The financial sector has experienced notable growth, as well as the economy as a whole, and the restructuring of the country's debt remains a stable process. The most recent estimates indicate that approximately 73 percent of households can afford a basic basket of goods, compared to only 35 percent when dollarization was first implemented.

Uncertainties nonetheless continue to attend the dollarization project. The Argentine default has raised questions regarding the viability of Ecuador's path. Although the monetary anchor has largely immunized Ecuador from contagion for the moment, and provided greater liquidity in the financial sector, the country's exports are less competitive, the current account has slipped from surplus into deficit, and the country's balance of payments is precarious. Moreover, dollarization effectively deprives the Central Bank of means to address a growth slowdown or recession.

Ecuador's prospects remain mixed. Oil revenues and three consecutive years of fiscal surpluses have improved the country's situation, as has the institution of a fiscal stabilization fund, but external problems remain regarding vulnerability to external shocks, volatility in financial markets, and inadequately responsive IFIs. In particular, the IMF's refusal to approve a \$130 million standby facility has undermined investor confidence, and the IMF's request that presidential candidates pledge to undertake Fund-endorsed policies has generated a political backlash. Perhaps the country's greatest vulnerability is that, whatever policies it undertakes, Ecuador is not considered "too big to fail."

Renzo Rossini's presentation focused on the question of how countries can be made stronger in the face of shocks. This question is particularly relevant for Peru, which in recent years has suffered the following shocks: a strong El Niño in 1997, declining terms of trade in relation to Asia, capital flight in the wake of the Russian crisis, the political crisis of 1999-2000, and adjustments to the recession beginning in 2001. All of these events have dampened investment.

Peru is currently rebounding from its most recent shocks. Exports of clothing and agricultural products have increased as a result of reductions in U.S. tariffs, and further improvement is expected as a result of a forthcoming natural gas project; traditional exports such as gold, other mining products, and fish are also expected to improve as external demand recovers. Ongoing challenges include attracting FDI and sustaining the dedollarization process.

In discussion following the presentations, Pablo Guidotti noted that the large decline in FDI in Latin America compared to other regions stems from Latin America's relatively insecure legal environment. He also noted that IFIs have not carefully evaluated previous "megapackages" in the region. Juan Luis Jemio stated that the relationship between FDI and

overall investment should be considered, and that domestic private investment should be examined. He additionally asked whether Ecuador's recovery represents a typical period of currency-based stabilization or another process is at work. It was also noted that political leaders in the region's countries are experiencing increasing difficulties in reaching consensus on domestic policies, and that this may affect both FDI and overall investment. Guillermo Calvo observed that Ecuador's financial system has to be flexible, and that the country's fiscal well-being requires letting public sector salaries fall to private sector levels.

### **Session III. Financial Systems in Latin America: What Lies in the Future?**

In his presentation on the prospects of the banking system in Latin America, Xavier Vives surveyed the functions of banks as providing a transactions and payments service, managing risk, and offering liquidity. In emerging markets, banking systems face serious challenges in carrying out these functions. These include currency crises, pronounced asymmetric information problems with borrowers, which require extensive monitoring on the part of banks, and weak supervisory structures that make the system prone to crises and incapable of inspiring confidence. As the regulatory structures of developed countries cannot necessarily be duplicated in emerging markets, other approaches to strengthening banking systems, such as changes in assets and asset restrictions, should be considered. Narrow banking (i.e., investment in safe assets) represents one such proposal, but in many emerging markets there are not enough safe assets in which to invest. Under these conditions, a narrow approach destroys the function of banks and may in fact worsen fragility problems. Dollarization represents another approach, but one that raises the question of which countries and conditions are suitable for its adoption; similar questions holding foreign short-term debt, which can represent partial dollarization. Rather than adopting one of these more esoteric solutions, emerging market banking systems should undertake a more conventional approach emphasizing property rights and the maintenance of customer confidence in order to achieve efficient payments and robust credit. The design of such a system involves traditional banks with regulatory supervision and a safety net that manages to contain moral hazard.

José Antonio González Anaya discussed the peso crash in Mexico, its implications for financial markets, and lessons from that experience. The ambitious liberalization of the 1980s and 1990s increased financial depth and fixed capital formation, but since 1995 the financial sector has undergone a notable contraction. Although investment has not declined, bank lending decreased dramatically from 1996 to 2000, particularly to the non-financial private sector. As there has been no private bond market in Mexico until quite recently, it is unclear where non-bank financing has originated. The possibility of a shift to other forms of financial intermediation in those years is ruled out by the simultaneous failure of financial markets and banks. As a consequence, the Mexican economy continues to lack financial depth.

Several measures need to be undertaken to encourage the banking sector's recovery. First, monetary policy should not provide moral hazard through a steady depreciation of the peso. Second, repossession laws must be improved and enforced. Third, banks should be allowed to sell previously untradable bonds in order to increase system-wide liquidity and incentives to make money by lending rather than merely holding bonds. Fourth, sound prudential regulation with limited deposit insurance must take place. Fifth, Mexico's small stock market needs to develop in order to finance firms that may not be large enough to offer equities in United States stock exchanges. Finally, reforms must be implemented carefully, and in some instances bailouts will be required.

Liliana Rojas-Suárez stated that Latin American financial systems remain bank-dominated, that participation by foreign banks is growing, and that foreign effective control of banks, particularly in Mexico, is also increasing; foreign participation in pension funds is already high. Financial intermediation nonetheless remains low in the region, at approximately 20 percent of GDP. The banking sector needs to be enlarged and strengthened in order to support other parts of the financial system with its unique functions of liquidity and credibility.

Banks' functions and franchise value in Latin America, however, are faced with two major threats. The first is incorrect pricing of risks, reflected in banks' excessively large holdings of government debt; while foreign banks hold less government debt than their domestic counterparts, public banks hold very large amounts. The second is inadequate provisioning that fails to reflect the expected probability of default. This is particularly evident in excessive lending and lending in foreign currency to non-tradable sectors, practices stimulated by fixed exchange rates. Narrow banking nonetheless does not represent a preferable alternative, as higher-risk lending would then be taken over by institutions that did not engage in the same monitoring as banks, thus increasing overall risk.

In discussions following the presentation, Eduardo Fernández-Arias suggested that measures to consider in bank reform include making deposits contingent contracts, making transactional deposits senior to time deposits, and differentiating deposits in ways that would resemble narrow banking. Pablo Guidotti raised the question of whether investors are concerned with where a stock market is located, and he noted that financial markets such as Mexico's can benefit from greater transparency in corporate governance and protection of minority shareholder rights. Guillermo Calvo observed that the issue of whether a bank is too big to fail should be considered differently in emerging markets than in developed countries, because the failure of relatively small but specialized or sector-based banks in emerging markets can lead to larger effects in the financial system. Arturo Galindo noted that the technological limitations of many banks in the regions prevent them from pricing risk appropriately and that a centralized system including a credit registry may help banks in this area.

Responding to participants' comments, Liliana Rojas-Suárez noted that government bonds in emerging markets should not be treated the same way as in developed countries, as they are in fact not the safest form of debt. Moreover, some banks hold large amounts of government debt to meet reserve requirements, but these holdings can prove misleading, as declines in value are not marked to market. In his response, José Antonio González Anaya stated that the value of having a larger stock market in Mexico lies in providing access to capital for smaller companies, and that exchange rate issues can arise when a company is listed in one country and traded in another. Xavier Vives observed that bank supervision in emerging markets should be carried out by Central Banks because of their credibility and independence.

#### **Session IV. How to Restart Financial Intermediation in Argentina**

Assessing the phases of Argentina's financial crisis, Augusto de la Torre said that a phase of contraction is continuing. In spite of the loosening of the *corralito* and the *corralón*, there are still capital controls, and the forced conversion of deposits from dollars to pesos has destroyed the contractual system by undermining property rights. A restructuring phase is likely to be complicated, as the banking system's infrastructure is now much smaller, and great uncertainty surrounds the rights and obligations of both banks and their customers. Depositors now perceive their accounts as ultimately claims on the government rather than the banks, and the expectation of state intervention has created perverse incentive structure that is likely to hamper the financial system's recovery. Rather than seeking to improve their institutions' balance sheets by investing, banks can be tempted to engage in asset stripping prior to liquidation. The repercussions of this situation include a challenge to fiscal policy in the long term and a short to medium-term delay in the sorting of banks into those that are non-viable, viable, or viable and capable of serving as anchors of a reformed system. Regeneration of the system will require a currency that serves as a store of value as well as a medium of transactions and financial intermediation. The experience of other countries in the region offers no immediately applicable lessons. Ecuador's dollarization, for instance, has improved credit but by definition limited nominal flexibility. Chile's use of an indexed medium of exchange has proven successful, and so has Colombia's currency policy, but the wider applicability of these approaches is uncertain, as neither country has a history of hyperinflation such as Argentina's.

Pablo Guidotti stated that Argentina's financial crisis must be properly understood in order to be resolved, and that any resolution of the crisis must involve appropriate measures in both the short and long term. The crisis, characterized by a steep decline in deposits, essentially represents a crisis of liquidity. Before the crisis Argentina's banks were well-capitalized and highly liquid, but their weaknesses lay in a failure to increase credit, largely unprofitable asset holdings, particularly in public-sector debt, and low profitability. The debt default and pesoification of late 2001 gravely disrupted the financial system, as debt collection was essentially suspended, multiple and frequently changing forms of indexation amounted to a loss of control for banks, and arbitrary Central Bank policies, with little transparency, amounted to de facto expropriation. At the same time, monetary policy has deteriorated, a situation both reflected and aggravated by governmental units' issuance of bonds that serve as quasi-currencies.

Argentina's current situation represents a leveling-off. Lower amounts of private capital are leaving the country, deposits are increasing, banks are regaining their liquidity, and the exchange rate has achieved a degree of stability; the latter, though, has depended on extensive Central Bank intervention. To further the recovery process, the following measures are necessary: i) the Central Bank must reestablish its regulatory and monetary policy framework; ii) uncertainty and instability must be reduced; iii) the government has to assess more realistically assets and debts; and iv) financial restrictions must eventually be lifted in order to reestablish the financial system's credibility.

Silvina Vatnick observed that at this point in the crisis restructuring of public banks is needed in order to lessen the danger of crowding-out. This is particularly important because public banks perform more poorly than their private counterparts, and public banks had been losing market share to other intermediaries even before the current crisis. This has contributed to the weakness of the system as a whole. Transactional deposits have fallen from 2001 to 2002, with only a slow recovery foreseen, and from 2000 to 2001 domestic banks yielded much of their share of savings stocks to offshore banks. The debate on how to revive the banking system must focus on how to organize available possibilities. Within this framework, some maintain that the financial system should move toward an emphasis on transactional banking, while others maintain that an emphasis on investment banking may be more appropriate. In practice, different types of risk may call for different types of intermediaries.

In discussions following the presentations, Guillermo Calvo noted that unilateral solutions such as that taken by Argentina can set a dangerous precedent for other countries and corporations. José Antonio González Anaya observed that it is important to distinguish between good and bad ways of assuming losses, and that it is necessary to preserve credit as well as the banking system. Pablo Guidotti said that, although the banking crisis was largely external in its origins, it is now necessary to reform the public sector and bank management, as a culture of non-payment is emerging in Argentina. Augusto de la Torre stated that a universal banking system such as that in developed countries may not be appropriate for Argentina, as there is no effective lender of last resort.

## **Session V. Tremors from the South: Will They Shake Chile, Mexico and Central America?**

Assessing the possible impact of South American economic troubles on Mexico, Alfredo Cuevas

observed that Mexico has experienced only limited contagion effects from other countries in the region. Although Mexico's country risk has increased recently, this development appears to be largely related to contagion from recent corporate scandals in the United States, a decline in the Dow Jones average, and only to a lesser extent related to uncertainty in Brazil. Some coincidence with Argentina existed before the 2001 crisis, but this link has since disappeared, and there is no apparent link with conditions in Venezuela. This situation derives largely from Mexico's links to the United States, particularly in the real economy but also in the financial economy. Mexico's economy is currently characterized by continuing disinflation and increasing international reserves. The government is in a strong cash flow situation, with solid long-term prospects.

Rodrigo Valdés explained Chile's relative resilience to shocks in recent years as the result of a strong macro framework and favorable initial conditions. Chile has nonetheless suffered from a terms-of-trade shock, an increase in spreads, and a decline in net capital inflows since 1997. The government's policy response to the external environment, however, has contained negative effects and allowed growth to continue. Fiscal policy has displayed discipline, with spending determined by revenues. Moreover, debt levels have been kept low, and there are no perverse dynamics at work in the structure of debt. Short-term debt denominated in foreign currency represents a low percentage of foreign reserves, and inflation has been held at target or near-target levels, in spite of a recent easing of monetary policy. Although Chile's growth has slowed recently, largely as a result of global conditions, rising export volumes have provided some stability.

Arturo Galindo discussed Central America's degree of vulnerability to capital markets disturbances, especially those originating in South America. Central America was largely unaffected by the shocks of the late 1990s. From 1997 the countries' currencies experienced little real exchange rate depreciation in relation to the dollar and lending interest rates remained relatively stable. In spite of a pronounced dip in private capital flows to the region in 2001, which has since reversed, both FDI and portfolio flows have generally avoided major fluctuations. In addition, the region's current account, while still negative, has remained within a relatively narrow range.

Central America has additionally shown resilience in the face of the recent global slowdown and volatility in South America, largely the result of links with the U.S. economy in exports and remittances; for most countries of the region, the latter represents a much larger contribution to the economy than FDI. Spreads have remained relatively low, and growth continued even in 2001, with higher growth levels projected for the next two years. The region nonetheless remains vulnerable to future capital market disturbances. Sources of vulnerability include low supply side openness in Nicaragua, and throughout the region problems of high indebtedness, high financial mismatches in both the public and private sector, and high financial exposure to the public sector.

Reviewing the impact of South America's financial crisis on Central America, William Calvo noted that so far there has been relatively little effect. Of primary importance is that the two regions have little trade and little financial integration with each other, as Central America's links are primarily with the United States, and South America's links are primarily with Europe and Asia. Financial markets have so far been able to distinguish between the regions, and Central American bond spreads remain well below those of Brazil. Several characteristics of the current situation nonetheless bear watching. First, South America's current difficulties coincide with a slowing of economic activity in the United States. Second, problems in South America's principal economies are continuing to intensify, with unpredictable consequences. Third, several countries in Central America continue to have imbalances in their macro policies that may render them vulnerable to future shocks. Fourth, Central American countries still face a credibility problem when placing their debt on international markets.

While a worsening situation in South America is unlikely to affect Central America's trade relations, financial system effects remain possible. These include a decline in value of

South America debt held by Central American investors, a decline in Central American debt ratings, the need to offer higher interest rates on future debt issues, and a reduction in FDI flows. Given these potential vulnerabilities, Central American countries to reduce their fiscal deficits in order to mitigate the effects of Sudden Stops. In addition, banks must lessen their exposure to public and dollar-denominated debt. Likewise, the region's increasingly important pension funds may become vulnerable to shocks if their assets include a large share of public debt.

In comments following the presentations, Manuel Agosin stated that the volume of capital flows as well as spreads should be considered. Moreover, Central America's recent success in placing debt on international markets may reflect purchases by investors seeking high-yield investment who have been diverted from Argentina, and it is uncertain whether demand for this type of debt will remain strong. Rodrigo Valdés noted that "selling" reform is politically difficult. Ernesto Talvi observed that private debt as well as public should be considered, and that private debt may also experience Sudden Stops.