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Opening Comments

Enrique V. Iglesias observed that the present moment is characterized by widespread frustration with Latin America's historically low growth rates, and that these circumstances suggested the need to examine the region's relationship with international conditions and with international financial institutions. He also noted the importance of current efforts toward regional trade integration and the necessity of looking beyond financial variables to consider the real economy. Guillermo Calvo stated that new solutions to the region's growth and labor market problems must be found, and that these solutions must be politically sustainable.

Session 1. Global Outlook

Introducing the session, Guillermo Perry stated that the region must address several issues arising from international and regional financial crises since 1998. First, it is unclear whether international investors have fully or permanently adjusted their portfolios in relation to the region, and the size and eventual composition of investors' Latin American holdings remain to be seen. Second, the effect of the G-7 business cycle on capital flows to the region must be determined. A third question that must be resolved is whether a shift in regional financing from international to domestic creditors represents a positive development. Finally, is the region's movement away from external debt complete?

Assessing the global and regional economic outlook, Carmen Reinhart observed that the world economic recovery remains anemic. While the United States is recording the best performance of the world's three primary economic regions, the country's growing current account deficit must be financed with increasing capital flows from abroad. The United States' net importation of capital is drying up sources of capital to emerging markets, including Latin America. Latin America is additionally affected by international investors' "debt intolerance" toward the region. Like Turkey and emerging market countries in East Asia, Latin American countries have recently increased their issuance of public debt, but this debt displays two unusual characteristics: i) sales increasingly to domestic rather than foreign investors and ii) an increasing share of domestic debt denominated in foreign currency.

While the results of these innovations are yet to be seen, the possibility remains that Latin America's financial crisis has not ended. The crises of the 1980s involved defaults staggered over time, and the same pattern may occur once more, as middle-income countries have more typically undergone debt reversals through default rather than through repayment agreements or growth. Moreover, in a period of crisis, conditions are complicated by the frequent conversion of private debt to public debt. These circumstances are particularly aggravated in Latin America, as the rapid growth of indebtedness in the early and mid 1990s has been followed by extensive deleveraging at a time when spreads have increased and public revenue through taxes and seigniorage have fallen.

Ernesto Talvi offered a more optimistic assessment. In addition to improvements in the global economy, Latin America is benefiting from improving terms of trade and a decline in lending spreads. The economic risks of the Iraq war have not materialized, and the conflict has

had relatively little impact on oil prices. Latin American countries appear to be at or near the final stage of a sharp macro adjustment, and some countries are restructuring their debt in spite of the absence of statutory approaches such as the Sovereign Debt Resolution Mechanism. Systemically important countries such as Argentina and Brazil are further improving the prospects of the region as a whole. Argentina appears to be engaged in a slow but genuine recovery, and Brazil seems to have averted a financial crisis.

Several difficulties remain within this largely positive outlook. Capital flows to the region remain well below their peak levels of the 1990s, a phenomenon accompanied by real exchange rate appreciation throughout the region, with the exception of Mexico. The region's adjustment to these conditions has included efforts to increase exports and a forced decrease in consumption. Argentina's situation remains complicated: in spite of many signs of recovery, and a stable inflation rate, the country has historically found it difficult to generate the high primary surpluses that will be necessary to successfully complete the debt restructuring process.

Nonetheless, investment and growth have increased since the first quarter of 2002, and unemployment, though still high, has decreased. Regional growth of 1.4 percent is expected in 2003, and 4.3 percent in 2004. Capital inflows are expected to be sufficient to support these growth rates.

Michael Gavin, while also taking an optimistic view, expressed concerns regarding both global and regional conditions. The sustainability of U.S. growth is uncertain, and slow world growth in 2003 has cast doubt on the vitality of the global economy. Asia's prospects are complicated by slowing growth in China and South Korea, as well as fears regarding the spread of Sudden Acute Respiratory Syndrome. The "Enron effect" on securities markets, initially understood as a decline in investor confidence related to corporate conduct, may further encompass fears of a double dip recession.

At the regional level, Latin America's deleveraging is essentially complete, and every country but Mexico is currently displaying a current account surplus. Led by the private sector, this adjustment has so far been dominated by a decline in investment rather than an increase in savings, and it is uncertain whether investors will possess the confidence needed to finance a return to higher growth. One of the key factors affecting investor confidence will be political developments in the region, and these are largely encouraging, as current left-populist leaders have so far exercised macroeconomic discipline. Future challenges include making Latin America's financial integration into world markets more stable than in the past and managing the region's debt exposure in ways that aid growth. A more specific policy question is whether countries in the region are willing and able to undertake corporate governance and bankruptcy reforms. A second specific question is how countries in the region will issue debt in the presence of erratic currency movements. If currency volatility continues, the likely result of flexible exchange rate regimes, countries must issue debt in domestic rather than foreign currency in order to avoid future crises.

Moisés Naím posited two scenarios for the region. The first, an "Atlantis" scenario, envisions Latin America as a lost continent that fails to reclaim the attention of a world distracted by other issues. This scenario is to some extent supported by the *Foreign Policy* Globalization Index, which shows the region's worldwide integration declining over the last two years. The results of a recent survey of chief executive officers also suggests low levels of business interest in the region. On the other hand, remittances from workers abroad to the region have increased significantly and may surpass Foreign Direct Investment in importance.

A second scenario allows for the possibility of positive developments in the region. These possibilities include the following:

1. Brazil may stabilize and grow;

2. Argentina may overcome its current difficulties in the manner of South Korea, Thailand and Russia following the debt crises of the late 1990s;
3. Mexico and Chile may continue on their current paths of growth and development; and
4. Venezuela may be poised for an investment boom, regardless of whether the Chávez government remains in power.

Overly certain predictions must be questioned, but additional possibilities include a democratic exit from power by the Chávez government, which would make Venezuela especially attractive to investors, and a United States-Brazil free trade agreement. In any scenario, the importance of the private real sector cannot be ignored. Factors that call for particular attention include competitiveness, which must be improved through advances in infrastructure and education, and the effects of debt restructuring and currency devaluation in Argentina.

In discussion following the presentations, José de Gregorio questioned optimistic assessments, as forecasts call for slow world growth, the United States current account deficit continues to divert capital, and declining spreads do not necessarily lead to an increase in capital flows. Guillermo Calvo noted that, as capital markets are not rational, sudden and irrational inflows as well as outflows of capital could occur in the region, particularly as debt levels decline; as such inflows may not be sustainable, international financial institutions may have to consider the implications of this possible development. Pablo Guidotti stated that the region still suffers from large debt overhangs, and that the region's inability to manage large debt inflows in the past may cause investors to be more cautious than in the past. Doubting the resurgence of Foreign Direct Investment and long-term debt, Guidotti observed that much future debt is likely to be of lower quality. In the case of Argentina, he noted that the government's management of the recent crisis demonstrated institutional deterioration and a lack of respect for the rule of law. Guillermo Perry observed that the contagion effects of Argentina's crisis have been limited, and Ernesto Talví stated that the region's outlook is enhanced by the extensive deleveraging of the private sector. Michael Gavin noted that institutions have been damaged only in some countries of the region; on the other hand, Brazil's institutions have strengthened, those of Mexico have maintained their quality, and those of Colombia have ceased to deteriorate.

In further discussion, Michael Gavin questioned the contention that the United States is crowding out capital flows to other countries, and that the insufficiency of global demand must be considered instead. Arturo Porzecanski questioned the degree of emphasis placed on the United States' role in the global economy and noted that, in any event, a gradual adjustment to the U.S. current account deficit was already underway, as reflected by the weakening dollar. He also noted that a local investor base is being created in the countries of the region through pension funds and multinational ownership of debt, and that increasing domestic demand for both corporate and public debt is likely to make the region less subject to sudden stops. Enrique V. Iglesias observed that the world's distraction from Latin America is a long-standing phenomenon, and that other developments call for greater attention. First, Brazil's current combination of macroeconomic balance and active social policy may represent a new approach in the region, with implications for Ecuador and Peru, among other countries. Second, trade policy deserves consideration, as in many countries of the region this is the only area of policy that is explicitly articulated. Third, interest in the region can be generated by paying attention to the private sector, and governments should concentrate on domestic rather than international conditions.

Luncheon Presentation

Jagdish Bhagwati observed that Latin America is presently reversing its globalization process as a result of both popular and elite views that the reforms of the 1990s have been tried and found wanting. In particular, a fallacy of aggregation leads some to believe that an excess or a failure of reform in one area invalidates the reform process as a whole. While many reforming countries in the region have proven vulnerable to crises in recent years, the greatest resiliency has been

displayed by Chile, which has carried out the most extensive reforms. In fact, Chile's experience indicates that countries that first stabilize their macroeconomic situations are those best poised to take advantage of increasing trade.

He noted that much of the debate on globalization is driven by individuals' immediate circumstances rather than the underlying soundness of policies and that some actors, particularly among non-governmental organizations, act on the assumption that globalization is a negative force that must be stopped or heavily constrained; non-governmental organizations further attempt to expand into areas beyond their core competencies, and these organizations' lack of political accountability must also be considered. Moreover, even well-intentioned policy interventions can produce unintended and negative consequences. These concerns notwithstanding, globalization has produced benefits in gender issues by exposing individuals to more equitable views of gender relations, and the growth benefits of increasing openness to trade have reduced poverty in China and India.

Assessing current and future policy, he questioned the value of focusing primarily on the world distribution of income, as accelerating growth appears to improve distribution. While many developing countries' institutions do not appear ready to accommodate the demands of globalization, the World Bank should assist countries through assisting institutional globalization rather than diffusing its largesse in all directions. He additionally questioned the notion that programs undertaken by international financial institutions, particularly the IMF, are "one size fits all" arrangements. Although the direction of country programs and conditions is consistent, specific details can vary greatly across countries.

In response to a question by Guillermo Calvo on the role of regional trade agreements, Bhagwati stated that such agreements can have positive results. Movement toward the establishment of the Free Trade Area of the Americas, for instance, has exerted pressure on Asian countries to move toward regional integration. Bilateral agreements, however, can clutter the international trading system with numerous rules, and stronger countries can use existing templates to divide and conquer weaker trading partners in developing countries, which lack the trade and non-trade lobbying groups found in countries such as the United States. Pablo Guidotti noted that unilateral lowering of tariffs can weaken countries' bargaining positions as they work toward free trade agreements, but Bhagwati stated that such remaining tariffs can be exploited by lobbying groups, and that the benefits of lowering tariffs unilaterally can outweigh the costs. Responding to one participant's concern that China's labor-intensive industries may be overwhelming competitors in Latin America, Bhagwati noted that over time the share of labor-intensive production in a given country's output tends to decline, and that other countries then take its place in labor-intensive activities.

Session 2. Recent Proposals for Bond Markets in Emerging Economies

Ricardo Caballero began his presentation by observing that Latin America is especially afflicted by the volatility of capital flows. The IMF and United States Treasury Department's focus on extreme situations such as bankruptcy, however, neglects opportunities to prevent the self-fulfilling prophecies that characterize investor behavior toward emerging markets. Even a macroeconomically stable country such as Chile experienced a larger-than-expected response to the financial crises of the late 1990s and a negative shock to the price of copper.

To reduce the impact of shocks on a country such as Chile, which is macroeconomically disciplined but highly dependent on a single commodity export, hedging and insurance mechanisms may provide a manageable and relatively low-cost alternative to previous proposals such as large reserve holdings and stabilization funds. Long-term bonds, for instance, might include put options linked to the price of copper, or to the occurrence of exogenous financial constraints such as sudden stops. While activity by specialists would be necessary to create a market for these bonds, initial success can lead to their mainstream acceptance by institutional investors. Widespread acceptance of these bonds would contribute to countercyclical policies.

Eduardo Borensztein proposed the creation of bonds indexed to GDP growth rates. These bonds would be designed to avoid defaults, dampen the procyclicality of fiscal policy, and promote risk-sharing at the international level. A basic example of such a bond would involve adjustable interest rates that pay out at lower levels during periods of slow and negative growth and higher levels during periods of more robust growth, with a premium paid out to investors during high-growth periods as a form of insurance.

Growth-indexed bonds possess a variety of advantageous features. First, GDP growth represents a well-understood concept that investors already follow. Second, sovereigns have little incentive to misreport growth, and their reporting can be monitored. Third, precedents for this type of debt instrument can be found in inflation-indexed bonds, tax revenue-indexed bonds, options on United States economic statistics, and Brady Value Recovery Rights.

Questions attending the creation of growth-indexed bonds include the possibilities of externalities and coordination problems, the potential role of international financial institutions, and the unpredictability of demand for a new instrument. Nonetheless, the financial crises of recent years suggest that it may be time to undertake innovations in debt restructuring.

Ashoka Mody discussed crisis resolution in relation to lessons that can be learned from bond markets. First, aggregation effects are significant. Investor behavior is sensitive to the quality of existing credit, especially in relation to countries with poor reputations or that issue low-quality debt. The law (United States or United Kingdom) under which debt is issued, however, does not appear to be significant in influencing investor behavior. As credit conditions improve for an issuer of debt, though, spreads decline faster for debt issued under United Kingdom law, which includes collective action clauses. Second, collective action clauses (CACs) have highly variable effects. Low-rated debt issues pay a premium for including CACs, while middle-rated debt pays a somewhat lower premium, and high-rated debt actually benefits from a discount. These costs nonetheless remain dependent on market conditions, as high volatility and Emerging Market Bond Index spreads lead to a high cost for including CACs. Third, a transition to debt including CACs features both costs and benefits. CACs tend to raise the cost of debt, but they may serve to reflect its true price.

In discussion following the presentation, participants raised the questions of how the speakers' proposals might address extreme changes in conditions, and whether an Emerging Markets Fund might provide a more feasible approach than the proposals presented. It was also suggested that the kind of frictions that lead to sudden stops may determine the kind of hedging mechanisms that countries employ. Liliana Rojas-Suárez observed that CACs could help to prevent overindebtedness and suggested that growth-linked bonds could collapse when output declines.

Session 3. Bond Markets in Latin America: Policy and Market Views

Surveying the state of bond markets in Latin America, Pablo Guidotti observed that governments face a tradeoff between flexibility and credibility. Under these circumstances proposals for contingent contracts are of interest, but they are attended by several difficulties. First, markets have difficulty in pricing these types of instruments. Second, short-sighted governments may not be able to issue bonds of this type. Third, governments can be more optimistic than markets.

Conditions are further complicated by the difficulty of defining fiscal sustainability. First, sustainability involves considering both levels and maturity of debt. Second, the dollarization of debt poses a variety of problems. Third, political considerations complicate definitions of sustainability, as governments' willingness to repay debt can be questioned; in fact, changes of government tend to elevate risk premia. Fourth, many governments in the region have low tax bases, which limits their ability to repay debt.

Countries in the region facing debt crises will have to emerge from restructuring before their sustainable levels of debt can be determined, and the current experience of Argentina illustrates several issues in the restructuring process. First, the lengthening of terms can serve merely to alleviate short-term problems while leaving a debt overhang in place. Second, it should be borne in mind that only 40 percent of the country's debt is in default, while 60 percent is in fact current. Third, over time reductions in principal cost less than interest rate reductions.

José de Gregorio stated that while many regional debt proposals are being discussed, these proposals have neither originated in nor met approval from financial markets, nor have they been adopted by governments. Alternative approaches remain unrealized for the following reasons:

1. Arguments in favor of innovative debt instruments assume very low risk premia and very low levels of risk—frequently an unsafe assumption.
2. CACs can alienate minority shareholders and, in the case of the private sector, allow a decline in the quality of corporate governance.
3. Risk-sharing will occur as investors regain an appetite for risk, rather than through compulsory means.
4. At the margin, a country issuing debt through growth-indexed bonds may be subject to perverse incentives in order to lower payments.
5. A country's history already determines whether it issues debt in domestic or foreign currency.
6. Transparency, accountability, and an independent financial surveillance process are more important than the details of the debt instrument that is issued.

Alfonso Prat-Gay returned to the question of defining sustainability, noting that it can be viewed as the ability to pay under a certain set of circumstances or in relation to all possible circumstances. Moreover, given the diversity of conditions among emerging markets, a single number or formula may not be apt for all cases. In regard to CACs, he stated that they suffer from an incomplete information problem, and that they present a signaling problem by suggesting the possibility of default.

GDP-linked bonds, while interesting in principle, may present a variety of problems at the technical level:

1. These bonds may be based on questionable assumptions regarding output levels and exchange rates.
2. A countercyclical fiscal policy is necessary to make these bonds attractive.
3. The dichotomy between normal conditions and crisis assumed in arguments for these instruments does not take into account the range of other possible conditions.
4. It is uncertain how GDP-linked debt can be priced.
5. It is uncertain whether this type of debt would represent an improvement in quality over existing instruments.
6. The question exists of who might be willing to buy GDP-linked debt. As emerging market access to financial markets is sporadic, there may be a role for International Financial Institutions in purchasing or otherwise supporting this debt, but this is also uncertain.

Alejandro Werner observed that discussions of financial instruments have focused on three objectives: i) reducing volatility, the rationale for indexation; ii) smoothing capital flows, the rationale for contingent contracts; and iii) dealing with default, the rationale for collective action clauses and sovereign debt restructuring mechanisms. Recent discussions, however, have focused primarily on restructuring while neglecting sudden stops and other shocks. Moreover,

any attempt to address debt issues must involve a policy response by governments and participation by IFIs, as well as consideration of the design of financial instruments. Indexed bonds, for instance, are subject to risk from fluctuations in exchange rates, growth rates, and fiscal conditions, all of which must be addressed through policy. In addition, the introduction of exotic elements into debt instruments can prove expensive for the issuing country. Surveying Mexico's situation, he noted that domestic demand for sovereign debt has risen, a development made possible by the growth of institutional investors.

Paul Denoon stated that emerging market capital flows are subject to periods of feast and famine, and that a feast is presently underway. The volatility and drying-up of capital flows that occurred in 1996 and 1997 may not have been rational, but the inflows that preceded this development may not have been rational either. An appropriate or rational level of capital inflows remains to be determined.

Current inflows, however, appear to have a rational basis, with demand primarily for long-term debt rather than hedging instruments. Mexico has encouraged investment through the adoption of CACs. Markets, for their part, have lowered their expectations of extremely high returns and seek mainly to surpass the yields available in G-7 countries; this perspective may help to prevent another investment bubble in Latin America.

The region still faces several sources of uncertainty, beginning with political uncertainty in Venezuela, Ecuador, Argentina and Colombia. The role and performance of international financial institutions in monitoring countries' performance and debt levels will also be important. Whether IFIs will allow Turkey to default on its debt may hold significant implications for vulnerable Latin American countries.

Assessing recent developments and proposals in debt instruments, he noted that the trend toward issuing emerging market debt in domestic currency represents an important and positive tendency. GDP-linked instruments, while an interesting concept, might be difficult to place in a bond fund; problems with pricing this debt correctly might also lead to an increase in short-term hedge fund trading. Contingent debt is also of interest, but it may be difficult to structure for countries with broad rather than narrow sources of risk. CACs, on the other hand, may prove feasible in the short term, especially as most investors do not pay close attention to the law under which debt is issued. In addition, Mexico's example of adopting CACs may help to end discussions of SDRMs. In regard to Argentina, the recovery value of its debt appears to be quite low, and the country's debt should be made sustainable going forward through a large haircut.

Arturo Porzecanski observed that the recent literature on capital flows resembles the discussion on terms of trade in recent decades in being characterized by complaint rather than action. While countries including Chile have taken active approaches to dealing with the external environment, and other approaches are a distraction. Surveying proposed financial instruments, he noted that any bond that must be supported by IFIs is presumably not one that is easily understood by investors. Likewise, contingent debt proposals seem complicated, and most portfolio managers are not very sophisticated or flexible.

GDP-indexed bonds present a variety of difficulties:

1. While domestic investors in emerging markets may be comfortable with indexed bonds, given the history of inflation-indexed debt, international investors may prove less receptive;
2. Governments have been known to alter statistics, and IFIs cannot guarantee the reliability of government statistical agencies.
3. Investors who want exposure to GDP growth will buy equities, while fixed-income investors do not seek this type of exposure.
4. Variations in GDP are already reflected in bond prices and debt ratings.

In the discussion that followed, it was noted that aggregation remains an important issue. While most sovereigns have only a few debt issues outstanding, Argentina has a large number of issues outstanding, which will pose considerable difficulties in the restructuring process. It was also noted that most of the negotiation models discussed were based on government and IFI models rather than those drawn from the private sector, which generally settles debts expeditiously. In addition, the question was raised of whether proposals for orderly defaults are viable because the adoption or implementation of such proposals could signal disorder. The observation was also made that GDP-indexed bonds are problematic because GDP growth is difficult to measure at high frequencies, and that it tends to be revised even months after the initial figure is published.

In further discussion, Guillermo Calvo stated that, in their present form, international financial institutions are too small to have a significant effect on bond markets. Moreover, IFIs do not have a high tolerance for risk in their own portfolios. In addition, while improved monitoring of loans and financial systems represents an admirable goal, the currently politicized state of IFIs prevents such actions from taking place. Ricardo Caballero observed that it is important for markets to distinguish between countries whose problems have internal origins and those whose problems have external origins. Eduardo Borensztein noted that an alternative to indexed instruments might be to reduce debt levels and keep them low.

Session 4. Sudden Stops and Economic Performance: Research and Policy Lessons

Introducing the session, Enrique Mendoza contrasted the theory of current account dynamics with the experience of emerging markets. Theoretically, intertemporal optimization results in smooth and countercyclical current account shifts, because investment-augmenting effects dominate consumption-smoothing effects. While this paradigm serves to explain business cycle and current account dynamics in industrial countries, in the 1990s emerging markets experienced sudden stops that significantly raised the current account-GDP ratio and significantly lowered equity prices, industrial production and private consumption.

These circumstances raise the following questions:

1. What causes Sudden Stops?
2. Why do Sudden Stops affect emerging markets?
3. What role do underlying real shocks play?
4. What role does financial globalization play?
5. How can Sudden Stops be avoided or mitigated?
6. How does fiscal policy contribute to causing or avoiding Sudden Stops?
7. How do Sudden Stops shape debates on exchange rate arrangements and IFI reform?

Discussing the empirics of Sudden Stops, Alejandro Izquierdo described the phenomenon's characteristics and possible causes. The characteristics of Sudden Stops include i) the ability to create major disruptions in trade and finance, particularly through real exchange rate effects, aggravated by high liability dollarization in emerging markets and ii) the ability to produce a "bad equilibrium" of low investment and growth. Theories on the causes of Sudden Stops included fiscal indiscipline, soft currency pegs, and self-fulfilling expectations, but none of these views explains the tendency of Sudden Stops to occur in clusters among emerging markets with very different conditions and policies. In macroeconomic terms, Sudden Stops are associated with substantial increases in real interest rates, large output contractions, and substantial reserve losses, all indicative of loss of access to credit.

Two policy approaches have the potential to prevent Sudden Stops or mitigate their impact. The first involves the use of contingent debt contracts based on a menu of possible indices according to country conditions. These indices include non-trade prices, inflation, growth,

and commodity prices. A second approach emphasizes policies to increase openness, decrease liability dollarization, and bring down debt levels. These policies may prove particularly important because closed and highly dollarized economies are particularly vulnerable to Sudden Stops.

Fabrizio Coricelli reviewed Emerging Markets in Europe, comparing their experience with that of Latin America. Unlike Latin American countries, European EMs faced relatively little disruption from the financial crises of the late 1990s, and only two Sudden Stop episodes occurred. These countries' relative success appears to be explained by i) open economies; ii) low volatility in terms of trade, due to a diversified export base; and iii) a relatively underdeveloped financial sector, which limits the transmission of extreme volatility. European EMs have additionally benefited from the parallel growth of trade and financial integration, a relatively large tax base, a high degree of trade integration with the European Union, and favorable expectations based on these countries' scheduled accession to the EU. Challenges for the near future include addressing the impact of additional financial liberalization, setting exchange rate policy, adopting appropriate fiscal rules, and managing entry into the Eurozone.

Addressing financial dedollarization, Eduardo Levy Yeyati observed that Sudden Stops may be largely a symptom of a currency problem. This occurs when the local currency is used as a means of payment and a unit of account, but not a store of value. Under these circumstances residents hold assets and liabilities, including short-term obligations, in dollars; this practice in turn amplifies real exchange rate fluctuations. Dollarization is further reinforced by portfolio hedging, time inconsistency between debts and the currency in which they are issued, and currency-blind regulations.

Dedollarizing economies calls for both incentives and disincentives. Disincentives to dollarization consist primarily of less favorable treatment of dollar than peso assets, particularly in deposit insurance and reserve requirements. Incentives to use domestic currency can include long-term indexed debt for domestic investors, the development of deep forward markets, and the introduction of specialized financial instruments and institutions. As rapid dedollarization may produce unintended consequences, it appears best to pursue the gradual and simultaneous introduction of incentives and disincentives. Several countries in the region are already undertaking measures along these lines, particularly differential treatment of assets in Uruguay, long-term peso deposits in Peru, and CPI-indexed debt in Argentina. It may also be possible for IFIs to lend in indexed pesos.

Surveying policy options to address Sudden Stops, Liliana Rojas-Suárez noted that these options are divided among those that emphasize international capital markets and those that emphasize domestic policy. Proposals that focus on international capital markets are in turn divided between those that consider public-sector involvement to be currently distortionary and those that view more public-sector involvement as necessary to address market imperfections. Market-centered approaches include the elimination of moral hazard, the use of CACs, improving the transparency of policies, and improving liquidity provision, especially in times of stress. Approaches that center public-sector involvement include additional regulation, including that of hedge funds, statutory rather than contractual approaches to debt restructuring, and capital controls at the national level.

Among the domestic options available, the most attractive are prudential regulation measures, particularly capital requirements that correctly weight risk and adequate loan-loss provisions to help mitigate the effects of volatile capital flows. These measures would encourage banks to diversify portfolios away from government debt and correctly price the risk of loans to the tradable and non-tradable sectors, respectively. These measures are easier to adopt than dedollarization, as dollarization is based on the historical concerns of both domestic and international investors. Policymakers may instead wish to encourage the holding of domestic currency assets while maintaining the option of holding stable dollar assets.

In the discussion that followed, Arturo Porzecanski stated that he found it difficult to understand why scholars were experiencing problems in modeling Sudden Stops. As there are cycles in risk aversion as well as in economies, Sudden Stops must also be viewed as part of wider patterns that also include Sudden Starts. Investors' behavior depends on their preferences and capabilities, and on the size of the adjustment made during a Sudden Stop. The payment or restructuring of large amounts of short-term debt during a Sudden Stop, for instance, creates opportunities for the purchase of long-term debt, as addition, investors respond to opportunities and risks in the moment. Additionally, in order to avoid future investment crises, countries in the region must move away from exchange rate fixing. Ricardo Caballero noted that prudential regulation must be geared toward preventing crises rather than reacting to them, and José Viñals observed that Sudden Stops may need to be addressed at the regional level. Guillermo Perry asserted that it is important to produce strong domestic currencies that can serve as a store of value and to determine the causes of large capital flows, along with the relative importance of endogenous and exogenous causes.

Session 5. What Does Latin America Need to Grow? New Policies for Growth

Discussing the role of property rights in economic development, William Armstrong observed that the gap in financial system depth between developed and developing countries is increasing, and that Latin American countries lag well behind developed countries in terms of both financial system depth and the related factor of effective creditor rights. Those indices are in turn undermined by the region's presently inadequate property rights. The improvement of property rights, however, can promote economic development through the following financial and non-financial transmission mechanisms:

1. Improved access to credit, through guaranteed access to assets offered as collateral.
2. Lower cost of capital under most circumstances, as uncertainty of asset ownership is diminished.
3. Greater solvency of the banking system, as secure property rights strengthen loan portfolios and attract capital.
4. Improved stewardship of assets, as owners are secure in their titles.
5. Increased tax revenues based on transparent and accurate data.
6. Increased mobility, as individuals with secure titles can buy and sell property.
7. Improved regional planning capabilities, as officials can review records to assess infrastructural and other needs.

Reviewing Research and Development and its relationship to growth, William Maloney noted that R and D tends to increase with a country's level of economic development, and that natural resource abundance does not necessarily discourage R and D. In fact, countries with abundant natural resources experience higher returns to R and D than other countries, and the returns to R and D are not lower in developing than developed countries. Nonetheless, the amount of R and D that takes place in Latin America and the Caribbean remains low.

In the regional context, R and D is discouraged by inadequate intellectual property rights protection, credit markets, and public expenditure. Countries in the region additionally tend to spend less than they might on R and D when natural resources are abundant. Moreover, the region is not efficient in converting R and D into patents. This failure stems from weak academic institutions, an emphasis on basic rather than applied research, and poor public/private collaboration.

The experience of other resource-rich countries with extensive R and D, most notably Finland, provides lessons that the region can follow. To establish effective national innovation systems, countries should engage in the following measures:

1. Increase tertiary education in science and engineering.
2. Encourage private-sector R and D through further openness and deregulation, as well as through competitive subsidies.
3. Reorient R and D toward applied sectors, particularly through reforming universities' incentives.
4. Create and extend R and D networks through university-firm links, sectoral innovation clusters, and international connections.
5. Facilitate R and D through improving conditions for start-up and venture capital and through undertaking labor market reform.

Surveying regional growth in the wake of Washington Consensus policies, Andrés Rodríguez Clare stated that Latin American growth remains fragile, and that the results of those policies have yet to meet expectations. Lessons have nonetheless emerged from the reforms of the 1990s. First, countries with better institutions realize greater benefit from reforms. Second, neutrality of policy toward private sector participants, as envisioned in the Washington Consensus, is not necessarily advisable and may in practice be impossible, as any policy change affects the relative positions of private sector actors. Given that there are failures of the state as well as of markets, it may be necessary to embark upon explicitly non-neutral activities. These activities can serve to encourage activities (e.g., exportation, FDI, innovation, and small and medium enterprises) or particular sectors (e.g., tradables, nontradables, and clusters).

No single policy prescription is immediately apparent or apt for all cases. The content and direction of policy can depend, for instance, on a country's initial level of human capital, or on the desirability of spillover effects in that area. A country's response to low levels of innovation may further depend on whether innovation can respond to specific initiatives or the lack of innovation represents a symptom of other problems, such as the mix of industries present in a country.

Non-neutrality, which in effect represents industrial policy, takes two main forms. The first is "hard" industrial policy, with specific outlays and/or fiscal incentives, and measures that in some cases may include protectionism. The success of such measures depends largely on local conditions, however, and lessons from one country or region may not transfer readily to another. "Soft" industrial policy, on the other hand, is more closely linked with creating an atmosphere conducive to certain activities; measures can take the form of export promotion or of initiatives to attract FDI and/or small and medium enterprises in certain sectors. Whatever approach is taken, it is necessary to assess whether industry-specific externalities exist, and whether it is appropriate to undertake policies that affect sectors in related sectors rather than in isolation. It is also necessary to select measures with a certain vision of development in mind, something many economists are not accustomed to doing.

In subsequent discussion, Alejandro Werner observed that priorities for industrial policies should be established *ex ante* rather than on an *ad hoc* basis. Otherwise there is the danger that policies will reflect the power of interest groups more than national goals. Ernesto Talvi noted that in some countries credit may be seen as a luxury good, available largely to the rich, and that determining the cause and effects of credit-related phenomena may thus prove difficult; he also noted that the state must gather information before it can set rules. Rodrigo Valdés questioned whether state-directed R and D can be performed equitably, and Eduardo Fernández-Arias asked how policy can help to facilitate the exit of inefficient firms. Arturo Porzecanski stated that countries may wish to consider establishing ministries of technology, provided those ministries serve to meet outward-looking objectives rather than spread favors, and Arturo Galindo observed that volatility in times of shock is greater in countries with less effective creditor protection. The question was also raised of whether R and D is likely to occur in small firms or elsewhere.

Responding to participants' questions, William Maloney noted that somewhat large firms are more likely to engage in R and D, and that both within-sector reallocation of resources and firm exit are important. In addition, while public-sector intervention in innovation is not necessarily advisable until R and D problems are better understood, governments can exchange in more

neutral activities such as reducing or eliminating support for traditionally underperforming functions such as ministerial-level think tanks. In regard to industrial policy, Andrés Rodríguez Clare stated that little political mobilization occurs in relation to programs that do not provide subsidies, and that regulation of new sectors must evolve along with the sectors themselves.

Session 6. Labor Markets in Latin America: What is Wrong?

Carmen Pagés noted that, as unemployment leads the concerns of Latin American citizens reported in surveys, increasing unemployment since the early 1990s has proven highly problematic. More specifically, rising unemployment has coexisted with rising growth rates, particularly in the Southern Cone and, to a lesser extent, in the Andean Region. Within this larger pattern, unemployment has increased more in rural than urban areas, while involuntary underemployment, informality, and self-employment have also increased.

While it is difficult to determine whether recent developments represent a long-term trend or merely a cyclical movement, it is necessary to consider possible causes of unemployment. Structural reforms do not so far appear responsible, as they have had little or no impact on employment demand and no effect on labor market reallocation. Technological change can also be ruled out, as no evidence of labor-saving changes has been found. Labor market regulations and institutions, however, may be at least partially responsible for the region's unemployment. High and increasing levels of job security regulation prevailed during the 1990s, for instance, although it remains uncertain whether regulation can be tied to both lower employment and higher unemployment. Social security and other payroll taxes also increased during the 1990s, and they are known to affect unemployment.

The most important explanation of Latin American unemployment, however, may be the shocks that affected the region. In contrast to the inflationary 1980s, where adjustment to shocks occurred through wages and prices, the 1990s, a period of low inflation and increasing regulation, required adjustment through changes in labor demand. This situation has been aggravated by low levels of access to capital and a decline in directed credit in the region, as well as lower rents in product markets. In spite of the importance of this issue for much of the population, researchers and policymakers have so far paid little attention to its causes and solutions.

Martín Rama presented the following series of ten propositions on labor market rigidity:

1. Labor market rigidity matters, at least in times of economic turbulence. Rigidity intensifies downturns and slows recovery.
2. Rigidity cannot necessarily be seen as a representation of the extent of a country's labor code.
3. Labor market problems can result from problems in regulation of labor and product markets, but they can also result from poor macroeconomic management. Labor market regulation is not a substitute for fiscal and monetary discipline.
4. Not all labor regulations are alike. Impacts vary among types of regulation and across countries.
5. Looking at labor costs alone is misleading. Researchers and policymakers need to consider the costs and benefits of labor regulations, as workers and managers already do.
6. Coverage is to a large extent endogenous, and endogeneity reduces the adverse effects of distortions.
7. There is no one-size-fits-all labor policy. For each labor market intervention, several alternatives can be considered. These options differ, however, in coverage and cost, and in their impacts on incentives and consumption smoothing.
8. Labor policies are not a powerful redistributive tool. Spending through social security policies, though, does appear to reduce inequality. Policy changes

that lead to lower levels of social security coverage must be viewed cautiously.

9. Reforms produce winners and losers. Although losers are usually not poor, they are often concentrated in the public sector and/or heavily regulated activities, and they are often unionized and vocal. Designing appropriate compensation mechanisms is crucial to the success of reforms in labor markets as well as product markets.
10. There is scope for a multi-tier system of labor regulation. Approaches can include labeling by independent organizations as well as traditional enforcement approaches.

Rodrigo Valdés assessed the relationship between labor markets and macroeconomic performance in Chile. In spite of the country's generally strong performance, the unemployment rate in Chile has remained high since the shocks of the late 1990s. Some explanations include a strong decline in job growth during the 1990s, and structural changes such as labor-saving technology and a mismatch between jobs and workers; inflation and wage dynamics have also been considered. These hypotheses, however, lack empirical support. There is little evidence for structural changes, and wage indexation is of minor importance after more than a decade of importance of successful inflation targeting. A more important explanation for the country's persistent unemployment is high levels of labor market rigidity, which led to high levels of unemployment as an adjustment to shocks and which have prevented unemployment from declining substantially afterward.

In subsequent discussion, José de Gregorio observed that it may be necessary to distinguish between skilled and unskilled labor in analyzing unemployment rates, as unemployment has persisted at higher levels among the unskilled. Eduardo Lora noted that the Rama propositions, in their present form, may not be entirely consistent; certification, for instance, may not comport with the proposition that there is no one-size-fits-all solution to labor market problems. Guillermo Calvo noted that as inflation declined in the region, unemployment rose; the importance of payroll taxes may need to be taken into account. Ernesto Talvi asked whether there was a relation between public and public sector labor market rigidity. Adrian Armas Rivas asked whether rigidities in labor markets and product markets were related in Latin America.