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Panel on Outlook for the World Economy (I)

World Regions and United States

IMF Chief Economist Raghuran Rajan characterized the world economy as making a strong recovery in early 2004, followed by slower growth later in the year due to downside, oil and geopolitical risk. While the 2004 forecast of 5 percent growth is likely to be met, growth of 4.3 percent is so far predicted for 2005, a figure that may be revised downward in light of continued oil uncertainty.

The United States economy, which appears to be alternating between stronger and weaker growth in each quarter of 2004, faces mixed prospects. Positive elements include quiet inflation, robust investment, and a strong housing market. Negative elements largely involve uncertainty in second quarter figures, particularly a decline in consumption possibly due to the waning of fiscal stimulus from 2003. Other negative factors include weak consumer confidence, possibly due to oil prices, as well as mixed job numbers, and the effects of an unusually strong hurricane season.

In contrast to mixed United States results, the Euro zone has displayed the weakest performance among major economic regions. Although France has enjoyed export-led growth, Germany is constrained by high levels of corporate debt and ongoing uncertainty regarding structural reforms. Given continuing concerns regarding oil prices, the Euro zone's performance may continue to weaken.

Like the United States, Japan presents mixed results. Strong performance in early 2004 has faltered, and both investment and consumption remain weak. At the same time, the corporate sector appears increasingly healthy, bank restructuring is underway, and exports to China are growing. Nonetheless, technological-sector inventories have risen, and oil prices represent a continuing source of uncertainty.

Amid these conditions, the global economy faces a variety of risks and challenges. First, it is uncertain whether export-led growth will be sufficient to boost the overall performance of sluggish economies. Second, additional uncertainty attends recent oil price increases. Temporary sectoral imbalances in production and refining, as well as geopolitical risk, may continue to extend high prices, and it remains to be seen how demand will respond. Third, U.S. interest rates, subject to recent tightening by the Federal Reserve Board, may dampen growth. Additionally, the U.S. current account deficit seems to be worsening, and the dollar remains somewhat weak. Finally, in spite of the U.S. economy's underlying strength, private sector investors have shown a recent lack of interest in U.S. securities. Whether this represents only a temporary decline is unclear.

China

Steven Dunaway observed that China's GDP growth, though slowing in the third quarter of 2004, remains strong. A notable problem, however, is fixed investment; too much expansion could strain the financial system, which remains largely bank-based and subject to political influence. Although the country's two largest banks were recapitalized earlier in 2004, financial system reform takes years to accomplish, even as the growth and integration of the Chinese economy make reform increasingly urgent. Although land-use and environmental measures have slowed fixed investment recently, excess cash reserves may lead to an increase in credit; the appropriate level of credit is currently under debate in Beijing.

In addition to the factors above, China's macroeconomic policy is being made in a unique international and domestic context. While the Central Bank has attempted to sterilize international capital inflows in order to mitigate their inflationary effects, the institution has only a limited range of action; faced with a bank-based financial system with low interest on deposits, investment flows increasingly into real estate, an inefficient vehicle, and inflationary expectations are expressed in purchases of goods. In this atmosphere of many risks and few policy options, the Central Bank may need to tighten monetary conditions in order to avoid a "hard landing" from current high growth rates.

In spite of China's growing importance as an exporter and its overall integration into the world economy, foreign direct investment does not play a highly influential role in the country's economy. Instead, FDI figures are inflated by the practice of "round-tripping." As returns on foreign investments are taxed at a lower rate than their domestic counterparts, Chinese citizens respond to this incentive by investing in firms in nearby countries; those firms' nominal FDI constitutes the largest share of FDI in China. The more important effects of FDI occur indirectly through technology transfer and management practices.

The potential international impact of China's economic evolution is difficult to assess. Although China has increased its purchases of United States Treasury securities, it is highly unlikely to use U.S. debt holdings as a means of political blackmail or otherwise use them in ways that would affect the U.S. economy. China is more likely to increase oil prices through increasing pressure on global demand. China's will most likely impact the world economy in the near future through adjusting its presently undervalued currency as part of its trade and financial liberalization process.

Discussing the presentations in relation to emerging markets, Rodrigo Valdés noted that EMs, particularly in Latin America, are particularly affected by changes in U.S. interest and exchange rates. Given the global imbalances of the U.S. economy, an adjustment in the value of the dollar is likely in the absence of major policy changes; a further depreciation is possible. On the other hand, the Chinese economy is expected to have less direct impact on Latin America, as trade between that country and the region is limited.

In general discussion, Ernesto Talvi asked whether low U.S. interest rates caused what is considered to be the current housing bubble, and what might be the effects of a decline in U.S. housing prices. Assessing the impact of oil prices on the global economy, Linda Goldberg noted

that energy-intensive production has largely moved from developed to developing countries. She also raised the question of how consumption might respond to changes in oil prices. Guillermo Perry questioned whether China would continue to accumulate high levels of foreign reserves, as well as whether those reserves will remain in China. Further addressing China, Guillermo Calvo questioned the basis on which the country's high savings rates are calculated; given the low wages of most Chinese workers, it is unclear who is saving.

Responding to comments, Raghuram Rajan expressed uncertainty as to whether interest rates have created a U.S. housing bubble, as Federal Reserve Board actions do not necessarily have a great impact on U.S. fixed-rate mortgages; the effects of interest rate changes are cushioned by the outside market for mortgages. Rajan also noted that overall sensitivity to oil prices remains an open question because of technological changes. In further reference to the U.S. economy, he observed that the country's ongoing current account deficits may have impact on long-term interest rates, and that there is reason to be skeptical of the economic plans of both major presidential candidates. In particular, Bush Administration spending estimates appear overly optimistic, and U.S. budget deficits are not yet seen as an urgent concern. Discussing China, he observed that an appreciation of the yuan may lead to a consumption boom and increased imports, as well as a decrease in the size of reserves. Reforms including bank restructuring and exchange rate flexibility are expected to lead to additional reforms and increase the transparency of policymaking. China's high savings rate results from firms' and individuals' response to a poor social safety net and the need to self-finance investments rather than rely on an underdeveloped financial system. In reference to Latin America, he noted that improvements in the structure of public and external debt have enhanced the region's prospects, but public debt remains high in some countries. In his responses, Steven Dunaway noted that consumption is more energy-intensive in developing countries, such as China, and that the path of the yuan would be difficult to predict after exchange rate flexible.

Panel on Outlook for the World Economy (II)

Latin America

Ernesto Talvi suggested that, following the growth and investment boom of the 1990s and the subsequent collapse, Latin America may be in the early stages of another growth and investment boom. This development is based on the external deleveraging that occurred during the collapse period, which forced the private sector to utilize installed capacity, and a positive external environment. The external environment is composed of several factors, however, and these have varying impacts on different countries. Of particular note is the increase in commodity prices, which has increased both real exchange rates and international reserves in the region. Increasing oil prices, moreover, have not had major effects in the region's oil-importing nations, as oil prices are denominated in the weakening U.S. dollar. The region has additionally benefited from tightening spreads between emerging market debt and U.S. Treasury bonds; investors' pursuit of higher yields has persisted, while the Enron effect and the Lula effect have dissipated. Additionally, in spite of recent tightening by the Federal Reserve Board, most emerging markets have continued to enjoy ready access to financial markets. In the larger countries of the region, these conditions have led to circumstances resembling those of the early 1990s. In particular, the larger economies are experiencing growth in current account surpluses, in spite of rising

domestic demand, as well as improved fiscal balances and low interest rates and inflation; currency appreciation, in light of high levels of debt dollarization, also represents an encouraging development.

Among the region's larger economies, Brazil displays largely encouraging prospects. In addition to enjoying narrow spreads on borrowing, Brazil is experiencing an increase in industrial production, stable real interest rates, and increasing growth rates. The size and structure of Brazil's public debt are additionally promising. The public debt to GDP ratio has been declining in recent years, and the largest share of public debt is indexed to the interest rate, a relatively flexible modality. Only 27 percent of Brazil's public debt, on the other hand, is indexed to foreign currencies or exchange rates.

Argentina is experiencing a more complex situation. Like other countries that have suffered collapses in the wake of a Sudden Stop, Argentina has undergone a V-shaped recovery, with collapse and recovery phases of roughly equal duration before GDP returned to pre-collapse levels. Further progress, however, depends on resolving the country's outstanding debt issues; this will entail major writedowns and successful negotiations with several classes of bond holders. Over the longer term, a successful resolution of Argentina's debt crisis may accelerate economic progress throughout the region.

The Impact of China on Latin America

Andrés Rodríguez-Clare observed that China's growth represents meaningful opportunities as well as a source of competition for Latin American and Caribbean countries. While Chinese exports have grown much faster than world trade as a whole since 1970, Chinese imports have grown dramatically as well; this is particularly true as China has lowered tariffs in the procession of accession to the World Trade Organization. In fact, meeting Chinese demand for natural resource and agricultural commodities has aided the recovery of several Latin American countries, particularly Argentina, Brazil and Chile.

China nonetheless remains a formidable competitor of Latin America in global markets, and in a relatively short time the technological content of China's exports has overtaken that of Latin American exports. This stems in part from differences in factor endowments, particularly the relative abundance of labor in some of China's provinces, compared to Latin America's endowments of national resources. At the same time, the higher development level of other provinces has enabled China to export more and increasingly more complex manufactured goods. In terms of the U.S. market, China's exports have thus become increasingly similar to those of Mexico and, to a lesser extent, Brazil; on the other hand, in the last decade Chinese exports to the United have become less similar to the exports of Costa Rica, Argentina and Brazil.

Another area of concern is the recent rise in foreign direct investment in China. Potential FDI diversion from Latin America to China, however, is estimated at no more than 4 percent, with differential impact among countries according to source countries and sectors where FDI is prominent. Additionally, the source countries of FDI in China are primarily Asian, and other

countries in Asia are more likely than Latin American countries to be in competition with China for FDI.

China's growth bears a variety of practical and policy implications for Latin America. Countries most likely to be affected by Chinese competition are those whose exports depend on cheap labor, such as Mexico, the Dominican Republic, and the countries of Central America, and sectors such as textiles and apparel. Given that transport costs provide only a small advantage for Latin America, countries exporting to the United States should specialize in product lines where they have an advantage in speed to market. Additional policy measures, which may entail sub-regional cooperation, include customs facilitation, infrastructure improvement, and promotion of export diversification. At the same time, China's increasing prominence offers a variety of opportunities for policymakers. These include stimulus for the global economy, growing demand for goods and services provided by Latin America, partnership in multilateralism and exchange of knowledge, and possibilities for serving as both a source and host of FDI.

Responding to China consequently provides an opportunity for countries in the region to rethink their development policies. An effective policy framework in this new environment must include the following elements: i) public-private alliances that enhance competitiveness and address market failures; ii) a strategic national social process, fairly and transparently arbitrated by the State, which allows for competition among private-sector interests, capabilities and visions; and iii) horizontal and vertical policies that improve the overall environment for private-sector actors while providing public support for sectors seen as likely to provide social benefits. Several areas call for specific action. One is dealing with "Dutch disease," the movement from knowledge-based activities to primary goods when commodity prices rise. A second area of concern is the provision of public goods, especially that complement private-sector activities. Third, investment in and access to secondary and post-secondary education must be increased in order to create a more skilled workforce. Fourth, targeted export development and investment initiatives are needed, such as specialized agencies and programs, maintenance of competitive real exchange rates, providing predictable rules of the game for investors, and improving transport systems and other infrastructure. Fifth, innovation must be supported through clusters, research centers and public-private collaborations such as those between firms and universities. Finally, countries must make use of economic integration to benefit from the effects of scale and to level the playing field in competition with China.

Addressing the effects of China's effects on Mexican exports, Alejandro Werner noted that the post-NAFTA increase in Mexican exports slowed after 2001. At the same time, exports from China to the United States increased quickly, and China displaced Mexico as the second-largest exporter to the United States in 2002. Possible explanations for this change included the U.S. recession at that time, increased Chinese competition in the U.S. market, and deterioration in Mexico's competitiveness. The latter two explanations contributed to the impression that Mexico-United States trade linkages may have weakened, as Mexican exports did not promptly rise as the U.S. economy recovered.

A sector-level examination of Mexican exports, however, shows that Chinese exports have not had a significant negative effect on Mexican manufactured goods. Chinese exports did, however, appear to have a small negative effect on Mexican exports of machinery and transport equipment

beginning in 2002. Chinese exports additionally exerted a negative effect on Mexican exports in the miscellaneous manufactures sector, although this effect was at least to some extent offset by positive effects that were not controlled for in the estimations. In the 1998-2003 period, then, the expansion of U.S. imports led to a rapid increase from 1998 to 2000, while declining U.S. import demand explained most of the decline in Mexican exports from 2000 to 2003. Although some negative effects of Chinese exports have continued in 2004, the overall increase in U.S. import demand has boosted Mexican exports.

Further analysis shows that Chinese exports had the largest negative impact in dollar terms in the following subsectors: textiles, office and data processing machines, telecommunications and audio equipment, furniture, and apparel, clothing and footwear. The U.S. import slowdown had the greatest effect in dollar terms on iron and steel, office and data processing machines, telecommunications and audio equipment, and road vehicles.

The data and analysis thus indicate that Chinese exports had only a second-order effect on Mexican exports to the United States. Nonetheless, increased competition from China is now a permanent feature of Mexico's commercial landscape.

In discussion following the presentations, Katherine Hennings noted that Brazil's favorable economic situation has stemmed primarily from domestic measures rather than external conditions. José de Gregorio raised the questions of why Brazil is accumulating foreign reserves and how the country's economy can grow in the presence of high interest rates. Rodrigo Valdés suggested that including inputs other than capital and labor could provide additional insights in comparisons between China and Latin America; he also noted that price as well as volume effects of Chinese growth should be considered.

In further discussion, Guillermo Calvo raised the question of how V-shaped crises originate. Respondents offered several suggestions. In the case of Argentina, the crisis may have originated in self-fulfilling prophecies and overreactions, such as banking restrictions, at the end of the Convertibility period that addressed fears of hyperinflation. These processes may also have been aggravated by insufficient trust in the ability of market processes to provide for the adjustment to the new exchange rate regime. It was also suggested, however, that overtightening of the financial system may be necessary until credibility in a challenged system is restored. Crises may further originate in the psychology of policymakers, as success can breed closedmindedness until a crisis forces a change of personnel.

Other participants made additional points regarding V-shaped crises. José de Gregorio stated that Argentina's pre-crisis economy may not represent a satisfactory baseline for analysis given the high levels of unemployment prevailing at the time. Liliana Rojas-Suárez asked whether the shape of a country's recovery might be linked to its default status, and Alejandro Izquierdo stated that it may be useful to examine investment behavior and growth following V-shaped recoveries.

The Role of Foreign Banks

Linda Goldberg stated that the entry of foreign banks in Latin America is a largely positive development. Foreign banks enhance local banking sector efficiency through competition, reduce the magnitude of local credit cycles, and promote institutional changes in the local banking sector. Although foreign banks transmit shocks from their home countries to host countries, they do not accentuate those shocks. Foreign entry into Latin American banking markets is generally associated with other changes in the operating environment. Since 1990 foreign banks, particularly those based in Spain and the United States, have made extensive acquisitions in the region; in recent years this has been followed by a mix of acquisitions and divestitures.

Foreign banks' activity in the region can be viewed as analogous to FDI in manufacturing, and their impact differs from that of locally based banks. While domestic bank lending is largely procyclical due to domestic business cycles and asset sources, foreign banks dampen business cycles through intertemporal smoothing and risk management; in fact, the behavior of healthier domestic banks is comparable to that of foreign banks. Foreign-owned banks additionally display better allocative and technical efficiency than their domestic counterparts, and by making domestic counterparts compete on that basis they improve the efficiency of the sector as a whole. Foreign banks provide the further benefit of innovation in financial products and expansion of the financial system.

Another way to examine the impact of foreign banks is to ask whether host economies are worse off than they would otherwise be in the wake of divestiture by those banks. Two corollary questions may also be asked. First, do institutional and efficiency changes persist after foreign banks divest from a country? Second, is a country's financial system healthier than it would otherwise be for experiencing an injection of foreign capital at a time when it was needed?

In the following presentation, Arturo Galindo stated that the presence of foreign banks involves a trade-off between costs and benefits for host countries, and that foreign banks are more likely to provide some benefits than others. Efficiency is a benefit clearly provided by the entry of foreign banks, as discussed in Chapter 10 of the IDB's 2004 Report on Economic and Social Progress in Latin America. The evidence is more ambiguous, however, on foreign banks' impact on stability and volatility. In the presence of liquidity shocks, foreign banks display more stable behavior than domestic banks. At the same time, foreign banks behave with greater volatility in the presence of opportunity shocks. Foreign banks' effects on small and medium enterprises remain inconclusive, including the question of whether those banks lead to market segmentation.

Discussing the presentations and the issues they raised, Claudio Irigoyen summarized the advantages of foreign banks as the following: new capital, a willingness to defend their reputation through continuing operations during times of adversity, management expertise and the diffusion of best practices, and access to funds abroad. Disadvantages of foreign banks include their potential to decrease stability through capital flight, the risk of exposing host countries to financial contagion, and the possibility that foreign banks will engage in "cherry-picking," lending to the best borrowers and leaving domestic banks with worse credit risks. All other things being equal, though, the lending behavior of domestic and foreign banks is similar.

Comparisons between domestic and foreign bank behavior are nonetheless complicated by a variety of circumstances. Foreign banks' response to crises, for instance, depends on their nature.

During Mexico's Tequila crisis foreign bank headquarters provided extensive capital flows to their subsidiaries in order to address a temporary liquidity problem, but foreign headquarters did not provide such capital flows during the Argentine crisis, which involved fundamental macroeconomic and financial issues. In addition, while a higher presence of domestic banks may lead to higher SME lending, some loans for SME operations are issued as personal loans.

These circumstances hold several policy implications. First, clarification and transparency are needed in the legal distinction between branches and subsidiaries of foreign banks so that their operations may be monitored and regulated more effectively. Second, mergers and concentration must be monitored in order to avoid a "too big to fail" problem. Third, as foreign banks may transmit home-country shocks, diversification among banks is needed.

In general discussion, José de Gregorio observed that in Chile concentration and competition in banking have coexisted. Rodrigo Valdés observed that foreign banks may differ in behavior depending on their host countries, Enrique Alberola raised the question of how public sector demand affects the behavior of foreign banks, and Ernesto Talvi asked what the role of foreign banks might be under conditions of liability dollarization. Linda Goldberg suggested that, in practice, foreign bank branches and foreign bank subsidiaries do not differ greatly in their behavior.

The Role of Public Banks

Augusto de la Torre began by noting that any discussion of public bank reform in the region must take into account the political and economic realities in which public financial institutions operate. At one extreme, subsidized lending through public banks has already been tried and found wanting; at the other extreme, the elimination of public banks is politically impossible and may lack technical economic validity as well.

Three realistic propositions must consequently be considered. First, public banking is unlikely to disappear, even in developed countries. Second, the role of public banks in a country and the type of reform that they need depends on a country's degree of financial development and international integration; given these conditions, reforms cannot necessarily be transplanted mechanically across countries or applied at different stages in a country's development. Third, durable public banking reforms tend to find adequate solutions for the "Sisyphus Syndrome," a process in which public banks eliminate financial losses by imitating the lending behavior of private sector banks, only to be returned by policymakers to unprofitable social lending.

Among approaches to reform that have been proposed, privatization does not address the social policy mandate of public banking, and administrative suggestions (e.g., governance and supervision improvements, and a shift toward second-tier banking) do not completely address the Sisyphus Syndrome. Moreover, any reform initiative must be independent of corruption, politicization and capture by special interests.

Given the practical impossibility of sweeping reforms, several more feasible approaches are available. One such approach entails public policy to improve the enabling environment of the

financial system, with particular attention to fiscal and monetary institutions, contractual institutions, regulatory and supervisory frameworks, and financial market infrastructure. A second option is to restructure public banks to emphasize their “development agency” functions in ways that will promote the development of financial markets. Such restructuring is likely to involve restricting operations to activities such as non-subsidized second-tier public banking, exiting first-tier banking on the asset or liability side, and phasing out lending and other banking activities as financial markets develop. Several institutions in the region, particularly in Mexico, have modified their activities to emphasize social objectives, and they provide ongoing experiments.

Presenting the findings of three recent IDB papers, Ugo Panizza contrasted two prevailing views of public banks. In development and social views, public banks are seen as able to address market failures and achieve development goals. The political view, on the other hand, suggests that politicians create and maintain state-owned banks as a political tool to maximize their personal objectives. There is empirical evidence consistent with both theories, as state-owned banks are prevalent in developing countries, countries with low financial development, and countries with poor institutions. The political view has received little testing, however, and there is supporting empirical evidence for only two countries to date.

Two key policy questions surround public banking. The first is whether the state should intervene at all in the banking sector. If the answer is “yes,” the following question is whether the state should intervene through direct ownership or indirect means such as regulation, subsidy and contracting. Arguments in favor of state intervention include maintaining the safety and soundness of the banking system, mitigating market failures due to the presence of costly and asymmetric information, financing socially valuable but financially unprofitable projects, and promoting financial development and providing access to financial services in isolated areas. The appropriate form of state intervention depends on whether banking services possess primarily contractible qualities that can be measured or primarily non-contractible qualities that underlie the provision of services.

The answers to these questions hold several implications for policy. In developing countries with low institutional quality, the establishment of public trust is an important and largely non-contractible quality; in such a setting, direct state ownership has the potential to increase public trust in the banking system and lead to deeper financial markets. Public involvement in development banking is additionally useful in areas where results cannot be measured in the short run; such an approach is preferable to grants and subsidies because of development banks’ feedback between lending and research. Public banks can also help to realize the benefits of countercyclical lending, although empirical evidence in this area is mixed so far.

Other rationales for public banking call for different policy responses and encompass different problems. Providing access to competitive banking services in isolated areas appears to be amenable to indirect approaches such as contracting, regulation and subsidies. Direct ownership, on the other hand, can provide the state with an additional policy tool to address political economy problems and undertake difficult tasks such as the resolution of bank failures. These uses of public banking, however, can bear significant costs in terms of transparency and accountability.

The empirical evidence on public banking offers several regularities. At the micro level, public banks in developing countries are characterized by low profitability, particularly in Latin America, and low interest margins. In industrial countries, however, public banks and private-sector banks are not significantly different. The relatively poor performance of public banks in developing countries is explained by their high levels of both employment and non-performing loans.

At the macro level, state-owned banks appear to have largely negative or neutral development effects. While public-sector banks seem to limit lending procyclicality, they do not increase the allocation of credit to small firms or increase allocative efficiency. In addition, the relationship between state ownership of banks and financial development is weak, particularly in developing countries. Simply put, this means that state-owned banks appear particularly ineffective in the countries where they are needed the most.

Given the limited evidence so far available, it cannot necessarily be concluded that public-sector banks should be eliminated; even if those banks are found to be detrimental, they are likely to remain popular with politicians. A particularly relevant pragmatic question is then whether public-sector banks are so detrimental that international policy advisors should spend their limited political capital on this issue. An alternative approach is to consider how the performance of public-sector banks might be improved. Clarification of public banks' objections and improved measurement of the subsidy they receive would permit genuine cost-benefit analyses and make managers accountable for their institutions' performance. In addition, the governance of public banks may be improved by applying lessons from the literature on Central Bank independence. In discussion following the presentations, José de Gregorio questioned the role of second-tier banks, as they lack transparency and their interest rates are not necessarily transparent to the public. In addition, public banks risk being politicized; financial depth, moreover, depends primarily on the quality of institutions. Alejandro Werner noted that international financial institutions should not be too enthusiastic about public banks; in addition, there is a risk that development banks are not correctly priced or measured in fiscal accounts. Ernesto Stein noted that the administration and financing of public banks and development agencies should take place in an ex ante and transparent manner rather than through an ex post attempt to address deficiencies. In addition, transparent subsidies are crucial, and governance issues such as how to members of institutions' boards of directors must be addressed. It was also noted that, as public banks represent second-best solutions, they should remain limited in mandate and should not be revived as a large-scale policy solution. Another participant observed that some publicly supported institutions, such as Fannie Mae in the United States, are able to behave like private institutions over long periods of time as a result of their lobbying efforts.

Responding to comments, Augusto de la Torre observed that a total separation of banking and social policy activities would be ideal, and that public banks are able to obscure their losses through clientelism. A necessary first step in reforming many public banks is to remove from their mandates either first-tier depositing or lending.

