XXIII Meeting of Central Banks and Finance Ministries

Regional Overview

Macroeconomic Developments in LAC-7

The current bonanza stems largely from high commodity prices, a weak dollar, favorable terms of trade, and favorable financial conditions. These factors have led to notable growth, high asset prices and increases in both investment and domestic bank credit, as well as declining unemployment. The region is additionally experiencing an upward trend in international reserves. The dependence of regional outcomes on external factors nonetheless means that Latin American countries may be seriously affected by the unwinding of global imbalances.

Macroeconomic Developments in Central America

Capital flows have increased since the 2003 Dominican crisis, and Central America has additionally benefited from steady growth and stable real exchange rates, as well as remittances. Central America's growth continues to track that of the United States. Challenges include increasing inflation and high oil prices while remittances and fiscal deficit financing have exerted upward pressure on real exchange rates. Also noteworthy is that Central American countries eligible for participation in the Millennium Debt Reduction Initiative hold a large share of their multilateral debt with the IDB.

Participants: Ernesto Talvi, Alejandro Izquierdo

Real Exchange Rate Appreciation: Causes and Consequences

Uruguay

Though exports to Argentina and Brazil as a share of GDP have decreased, vulnerabilities remain. The banking system raises RER procyclicality by making domestic loans in dollars, and the government contributes to it by issuing foreign-currency debt to both foreign and domestic creditors. RER appreciation additionally complicates monetary policy and inflation targeting. Useful policy instruments include countercyclical provisions, modifying capital and reserve requirements, and fiscal flexibility.

Guatemala

Increases in the prices of oil and other commodities appear to be playing a part in RER appreciation, as do increasing remittances and proximity to dollarized El Salvador. The current policy mix consists of a unique combination of elements. First, transactions may be made in any agreed-upon currency. Second, since 2005, inflation targeting has been made an explicit goal of Central Bank policy. Third, the Central Bank monitors the exchange rate and maintains the option of intervening.

Chile

In spite of recent appreciation, the peso remains close to its 10-year average, and current RER appreciation is based on fundamentals such as recent favorable terms of trade and regional financial conditions. Public concerns regarding the RER are based on the different and sometimes conflicting roles of the exchange rate in a small open economy, and policy responses have mitigated the peso's appreciation.

Discussion

RER appreciation may need to be contained to sustain exports, and a longer-term worry is heading off a steep depreciation at the end of the current boom. Most available policy instruments can do little to contain RER appreciation, but exchange rate interventions and controlling inflation appear to have some impact. Central Banks should maintain their focus on controlling inflation.

Participants: Umberto Della Mea, Lizardo Sosa, Rodrigo Valdés, Caroline Atkinson

Laurence Whitehead Luncheon Speech, 20 April

The cluster of 13 national elections in Latin America from December 2005 to December 2006 holds major implications for the region's financial stability and sustained growth. Of particular importance are elections in Brazil and Mexico. The favored candidates in both Brazil and Mexico both represent center-left positions, and the next president of each country is expected to lack reliable legislative majorities. This will necessitate building coalitions, in spite of intra-party competition and strong opposition parties.

The region's electoral democracies display "overlapping regimes" with varying levels of institutionalization. Sometimes highly developed Central Banks coexist with weak regulatory and taxation systems, and modern sociopolitical systems at the national level may coexist with primitive forms of local government. A further challenge is "partidocracia," in which politicians serve themselves rather than the public. Countries in the region are building and integrating institutions at different rates, a process complicated by public dissatisfaction with structural reform.

Managing Capital Flows

High levels of foreign reserves can reduce vulnerability to crises, but their potential costs include liquidity management, RER appreciation, and domestic political distortions through the use of off-budget funds. Given the costs of sterilization and the vulnerabilities that can stem from exposure to foreign exchange risk, foreign reserves could be invested abroad through closed-end mutual funds, with shares sold in domestic currency at set times and in controlled quantities. In addition to maintaining Central Banks' domestic currency reserves, this proposal could stimulate financial market development and ensure international portfolio diversification, which may create space for macroeconomic reforms. This approach may additionally dampen further speculative inflows and securitize overall inflows.

Two caveats must be considered. First, this approach may delay more fundamental reforms that can be stimulated by capital inflows. Second, high demand for shares could allow rents to accrue to funds and their managers; this could be addressed by auctioning licenses for fund sales and management. In any event, a closed-end mutual fund of this type does not represent a substitute for reforms in exchange rates or other areas.

Discussion

The proposal's advantages include maintaining government control, transferring risk and reward to the private sector, and possibly reducing global financial imbalances; it may nonetheless lack relevance for Latin America, where capital account liberalization is predominant. The time profile of offerings may not fit demand, exchange rate effects may be smaller than hoped for, and countries may still face the problem of being unable to borrow domestically in their own currency. In the short term, sterilization represents a viable approach; though ultimately inefficient, it can be undertaken at relatively low cost when interest rates and spreads are low. For China the paradox remains that, though an expected appreciation reduces the costs of sterilization, the effects of sterilization can stimulate further inflows.

Participants: Eswar Prasad, Ricardo Hausmann, Claudio Irigoyen

Inflation Targeting in Emerging Economies

Countries that have adopted IT have witnessed declines in inflation levels and volatility, as well as interest rates. Moreover, output volatility has improved or at least not worsened, and exchange rate pass-through appears to be attenuated. Nonetheless, these outcomes represent part of a worldwide trend in the 1990s. More important than IT per se may be a strong nominal anchor, or the presence of a Central Bank "maestro" such as Alan Greenspan. IT appears to helps countries in lowering long-run inflation, reducing responses to oil and exchange rate shocks, strengthening monetary independence, and improving monetary policy efficiency;

these benefits increase once inflation targets become stationary. In addition, IT helps developing countries to converge to the same inflation level as industrial IT countries.

Discussion

Questions to consider are the following: the responses of IT regimes to different shocks, how such responses vary across countries, why countries choose IT regimes, and how to manage IT and floating exchange rates in the presence of domestic liability dollarization. Nonetheless, IT regimes can provide transparency and accountability when independent institutions are in place.

Participants: Frederic Mishkin, Laurence Ball, Andrew Powell

Credit Growth: Enhanced Credit Access or Problems for the Future

Chile

Caution is warranted in regard to the expansion of consumer credit, as financial growth is not necessarily linked with financial deepening or GDP growth. A boom followed by a collapse is possible, rather than stable growth and financial deepening, as credit is displaying excessive procyclicality and growing faster than GDP. Current dangers include poor regulation and the transfer of risk to households through variable-rate loans.

Ecuador

The financial system is highly concentrated in private banking, and credit is concentrated in short-term loans. Further concerns include insufficient deepening of the financial system, low international bank participation, and how to manage high levels of liquidity. That liquidity must be maintained to avoid future crises. Banks presently hold much of their reserves abroad, and stricter prudential regulations may be required to increase domestic reserves. Other measures being undertaken are the issuance of instruments by the Central Bank to support liquidity, reserves equivalent to 4 percent of lending by international financial institutions, and the establishment of a government-subsidized Liquidity Fund. Proposals under study include setting a daily minimum level for liquid reserves at the Central Bank, and making bank regulations more or less stringent depending on the share of reserves held abroad.

Peru

Peru faces several challenges in managing credit flows: continuing the process of dedollarization, managing the credit risk that accompanies present levels of domestic liability dollarization, guaranteeing transparency in the terms of loans, and mitigating credit risk in rural sectors and in small and medium enterprises.

Discussion

Although consumer credit has grown more or less uniformly in the region, housing finance as a share of GDP varies considerably, and commercial credit as a share of GDP has declined. Though there appears to be room for further growth, income inequality may represent a constraint, and rapid growth in the supply of new credit products can generate new risks. During good times analysts and policymakers should search for potential fragilities in financial systems and strengthen prudential regulation. These are complicated tasks, as some commonly used indicators of financial vulnerability appear positive during good times and may mask underlying weaknesses. Among country-specific issues, Peru faces a declining ratio of financial system credit to GDP, the rapid expansion of credit through *cajas municipales*, and extensive dollar mortgage lending. In Ecuador, macro fundamentals do not support the consolidation of a strong banking system, and deposits remain largely short-term. Brazil's potential vulnerabilities include investment based on high deposit interest rates, speculative positions in the Colombia-Brazil carry trade, short-term maturity of public debt, and the large share of public debt in bank portfolios.

Participants: José de Gregorio, Fernando Uzcátegui, Daniel Schydlowsky, Giovanni Majnoni, Liliana Rojas-Suárez

Mechanisms and Costs of Inflation Control in Latin America

Argentina

Economic collapse kept inflation low in 2002 and 2003, but it was deferred to the recovery. Demand rose in 2005, and inflation is expected to increase. A continued recovery without excessive inflation depends on a stable peso and the Central Bank's ability to accumulate reserves. Given Argentina's twin fiscal and trade surpluses, policymakers must strive to avoid a rapid exchange rate appreciation.

Brazil

A disinflation process has occurred from 2003 to the present, accompanied by changes in the underlying inflation process. These include an increase in inflation persistence compared to the beginning of inflation targeting in 1999, a permanent increase in the pass-through coefficient since mid-2002, and a flattening of the Phillips curve, leading to a 20-percent increase in disinflation costs from July 2002 to December 2005.

Colombia

Monetary policy is based on inflation targeting and foreign exchange intervention. Inflation is decreasing along the targeted path, and the negative output gap may be closing. Since September 2004, the Central Bank has engaged in discretionary foreign exchange intervention and defended short-run interest rates through sterilization measures, and the government has reduced its foreign exchange exposure. Nonetheless, increased reliance on domestic peso debt and the expectation of limited demand for peso-denominated foreign debt have raised market risk in the financial system. Another concern is that conflicts may arise between foreign exchange intervention and inflation targeting if the peso continues to appreciate.

Discussion

Concentrating on inflation, the region's Central Banks have largely resisted the temptation to intervene in exchange rate policy. Argentina, however, has subordinated inflation control to the reduction of unemployment, and there appears to be momentum for double-digit inflation, complicated by other distortions such as subsidized prices. Although Colombia has engaged in exchange rate intervention, the peso is being defended at sustainable levels. Along with possible inflation, some distortion of asset prices may also appear in the near future.

It is too soon to declare victory over inflation. Debt build-up in commercial banks and overreliance on surveys of inflationary expectations must be monitored. Argentina's negative real interest rate may prove inflationary, and other distortions may be introduced.

Participants: Jaime Héctor Saiegh, Alexandre Tombini, Hernando Vargas, Michael Gavin, Edwin Truman

Guillermo Ortiz Luncheon Speech, 21 April

In the period 1994-2004 the foreign share of bank assets in Latin America grew from 10 percent to 54 percent. This occurred because international banks opened subsidiaries in order to mitigate currency mismatch risks and to avoid unfriendly takeovers through growth. Moreover, advances in communications and computing technology have increased the velocity of information flows and created new financial products. Different regions and countries, however, have embraced foreign banking operations for different reasons, such as expertise and recapitalization.

Participation by foreign banks offers challenges as well as benefits. First, the stricter regulations and practices of home countries are not always applied in host countries. Second, the operations of global banks are not matched by a correspondingly robust legal framework. Third, there is limited scope for market discipline. A final challenge involves crisis management. Host countries are reluctant to assist failing or failed subsidiaries, and home country institutions are often willing to cut their losses rather than support subsidiaries in crisis. Crisis management and/or prevention may be facilitated by requiring full and equal access to information on home country institutions as well as subsidiaries. Alternatively, home-country banks should not be allowed to withhold information unless they are willing to take greater responsibility in crisis resolution.

On the Stability of Policymaking in Latin America

Public policies should be considered on the basis of their features, such as stability, adaptability, coordination and coherence, quality of implementation and enforcement, orientation of policy to public interest, and efficiency; these features may be more naturally linked to a country's institutional environment and policymaking process than to the content of policies. The features of public policies depend on the ability of political actors to strike and enforce inter-temporal deals and thus achieve cooperative outcomes.

Discussion

The quality of a country's bureaucracy is crucial to the stability of policies. From a financial perspective, this is particularly true of Treasury Ministries and Central Banks, which can enhance resilience to crises. In Bolivia, the instability of policies has stemmed from problems in the financing of political parties, accompanied by a personalistic rather than programmatic orientation and clientelistic policies.

In Peru there is significant convergence among actors on the direction of public policy. The transparency of the privatization process has increased, particularly as the lessons of the country's failed electricity privatization have been applied to the water sector. Concerns in the region include the tradeoff between efficiency and effectiveness, as well as the implications of high turnover in bureaucracies and legislatures.

It is difficult to reform political systems that meet the needs of current political actors, and societies may in some instances desire the very multi-party fragmentation that analysts consider a systemic problem. Public preferences further inform two other concerns. First, a better-informed population may eventually press for greater efficiency in government, but such a development depends on several years of sustained growth. Second, changes in policymaking processes may not work if reformed processes lead to unpopular policies and outcomes.

The experience of Mexico raises the question of whether reform should be gradual or undertaken quickly in a window of opportunity. Mexico's policymaking process, moreover, remains fluid, and a strong president may fill a power vacuum. Gridlock is also possible. While explicitly changing the PMP takes time, there remains the more immediate problem of designing or "packaging" policy proposals in a way that appeals to existing institutional structures. A question for further study is determining which experiences have been successful in generating support for reforms.

Participants: Ernesto Stein, Juan Antonio Morales Anaya, Alberto Pascó-Font, Walter Spurrier, Alejandro Werner