

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

### **Setting the Stage**

On the basis of IMF data, the global economic outlook is characterized by solid growth and declining inflation in most areas. The U.S. economy is likely to experience a soft landing with low inflation as housing demand falls and energy prices work through the system. In addition, the U.S. economy is benefiting from a flattening Phillips curve and reduced levels of pass-through from commodity prices to inflation.

The view was expressed that Latin America is currently benefiting from external factors such as rising world output, improving terms of trade for both oil and non-oil commodities, and favorable financial circumstances that include high levels of international liquidity and historically low emerging market spreads. When these “windfall” factors are extracted, however, the region’s growth is disappointing compared to global and emerging market averages. Risks for the region include the possibility of a U.S. recession, an oil supply shock and the unwinding of global imbalances, with the possibility of a sudden stop.

The global outlook is complicated by several factors. The first is the historical overvaluation of U.S. home values, combined with declining U.S. household savings and rising U.S. household debt service payments. The second is the simultaneous rise in the U.S. current account deficit and China’s current account surplus. A third factor is the divergence of unit labor costs in Europe, which since 2001 have risen in Italy and France but have declined in Germany.

### **Special Presentation: Commodity Markets: Christopher L. Gilbert**

The current commodity price boom is centered on energy and metals, prices of which can fluctuate widely during long cycles. Growing Chinese demand has been a leading factor, with only short-term effects from speculation. Although copper prices may have already peaked, with lower prices projected, a combination of countervailing forces is likely to result in oil prices of \$40 to \$50 per barrel by the end of the decade.

### **Defining the Structural Deficit and Fiscal Rules through the Cycle**

While there is no consensus on the desirability of fiscal rules, strong budget institutions and centralized fiscal procedures are likely to improve compliance with those rules. Transparency is also crucial, and policymakers must consider factors in addition to fiscal policy if they wish to contain debt. It was noted that although fiscal rules are second best policies, such rules should be countercyclical, consistent with tax smoothing principles, and transparent in their execution.

## **Unwinding Global Imbalances: How Much Will It Hurt?**

Nouriel Roubini surveyed a range of explanations for current imbalances and found most plausible among them a global investment drought, Chinese demand, and oil prices. While G-7 consensus exists on how to address these imbalances, little has been done to implement related policies. In the mean time, imbalances continue to grow and the chances of a disorderly unwinding increase. Taking a somewhat more optimistic approach, David Backus noted that imbalances should be viewed in terms of the ratio of capital flows to GDP rather than as isolated figures. It is too soon to determine how the current globalization of finance, which resembles the period prior to the First World War, will progress.

## **Fiscal Policy through the Cycle: What Has Been the Experience?**

Following its 2001-2002 crisis, Argentina is undergoing a macroeconomic transition based on a robust balance of payments and a combination of fiscal soundness and debt sustainability. Both subnational and national governments have improved revenue collection and overall fiscal position, and the country has experienced a historic increase in the national savings rate.

Chile's policy framework for managing shocks has reduced GDP volatility, and budgeting based on medium and long-term copper prices has increased fiscal stability. Under these circumstances, the Central Bank can be capitalized.

Colombia's fiscal management was reviewed in relation to recent decades' business cycles of brief high growth periods and lengthy periods of low growth, punctuated by crises. Government finances have generally been procyclical, although it is hoped that fiscal reforms in the last decade and growth in recent years will reduce deficits and lead to greater stability.

## **The Effect of Oil Prices: The Case of the Importers**

The future paints a mixed picture in which rising prices are in part offset by increasing user efficiency. Growth prospects are generally not affected, particularly for exporters of non-oil commodities, which display co-movement with oil. Pass-through to inflation remains an important concern, however, as it may affect public finances. Supply shock risks must also be considered, especially in tandem with a sudden stop or other shocks. It was noted that the current favorable picture consists of a combination of good policies and good luck, and that global risks are weighted to the downside. Latin America's challenges are to contain the effects of rising interest rates and to maintain long-term growth. In Jamaica, there have been inflationary impacts on gasoline, public transportation and electricity; at the same time, factors that stimulate global oil demand also stimulate demand for Jamaican bauxite and tourism. Lessons for Jamaica include the need to maintain a competitive exchange rate and a cushion of foreign reserves to manage shocks. At the same time, world oil prices should be passed through to consumers in order to encourage rational use of resources.

## **Living with Debt**

The 2007 IPES noted that total government debt must be considered rather than external debt alone. Debt structure, however, may matter more than debt level, and Latin America's sovereign debt structures remain vulnerable. Domestic bond markets, while still small, are growing and offer benefits such as local currency instruments and protection for the banking system. Debt can be made safer by domestic policies such as controlling debt flows by strengthening fiscal policies and institutions, and managing inherited debt stocks through improving debt structure, providing-self insurance, and developing local markets. Proposals for IFIs include the following: i) country insurance facilities and support for pooling of reserves; ii) creating an emerging market fund to reduce contagion risk; iii) strengthening crisis resolution mechanisms; and iv) assisting in the development of local currency and contingent debt instruments. The implications of the IPES for IFIs include helping to solve market failures in catastrophic risk insurance. Areas where additional research is needed include the relationship between debt and fiscal sustainability and that between debt and the procyclicality of fiscal policies.

## **Reserve Pooling and Seignorage Income**

Presenting an econometric model of reserves accumulation, Marcus Miller noted that complete financial markets entail relatively little loss aversion and only minor global imbalances. Incomplete markets, however, can lead to serious imbalances with low and even negative interest rates. If interest rates cannot become negative, there is global risk of a liquidity trap. While countries' present reserve accumulation is understandable, a more meaningful question is how to move to a more balanced scenario.

## **The Optimal Level of Reserves, Reserve Management, and the Efficacy of Pooling Reserves**

Pooling reserves entails several risks, most notably simultaneity in demand for resources. Peru's experience in accumulating reserves has proven successful, however, for its dollarized and vulnerable economy, along with inflation targeting and foreign exchange interventions. Chile has reduced its international reserves due to the relatively low level of need for them in a non-dollarized economy with a floating exchange rate regime. The value of pooling in the region was questioned, as total reserves remain relatively small and the region's countries experience correlated shocks. Mexico's accumulation of foreign reserves has resulted from oil sales rather than policy, and a floating regime with inflation targeting has reduced the need to hold reserves. It is presently more desirable to cut carry costs. The widespread accumulation of international reserves represents both a form of self-insurance and an instance of competitive imitation among emerging countries. Overall, reserve pooling presents problems of political economy and multilateral institutions seem unable to manage such a pool.

## **Monetary Policy Instruments in Emerging Economies**

Emerging markets are still learning how to use monetary policy to prevent and mitigate

financial crises. It is now generally accepted that inflation targeting must be consistent with a country's financial stance, which is in turn shaped by expected future conditions and contingent liabilities. Less well-known is that Sudden Stops have been closely associated with many recent EM crises and often coincide with bank crises. As spending international reserves is the best available option for addressing the contingent liabilities that arise with Sudden Stops, countries can reduce expected volatility by holding international reserves or having access to credit lines in normal times; given capital mobility, the amount of reserves to be held depends on the desired ratio of reserves to M2. Possibilities for spending reserves include foreign exchange intervention, which bears risks as well as potential benefits, and extending directed credit if the banking system's condition allows. Central Banks should additionally carry out periodic drills on responding to Sudden Stops, and they should be prepared to explain their actions to the public in times of crisis.