

XXV Meeting of the Network of Central Banks and Finance Ministries

Setting the Stage

(Eduardo Lora, Moderator)

Beyond Perceptions: Macroeconomics in LAC

The region appears to be enjoying a period of sustained growth due to favorable external factors and improved macroeconomic policy, but a close examination of data reveals a troubling scenario for several reasons. First, Latin America's current growth is unsatisfactory compared to both its own long-run average and to the performance of other regions. Second, the region's fundamentals are not as strong as they seem. Current account surpluses, for instance, are concentrated in certain sectors and do not consider large outstanding debt stocks; the region thus remains vulnerable to external shocks. In addition, the region's international reserve position remains weak even after significant accumulation, and most countries in the region exhibit structural budget deficits in spite of high public debt levels. A deterioration of external conditions is also expected to lead to a return to high levels of debt dollarization and short debt maturities.

On Spreads, Ratings and Liquidity

Emerging Economy (EE) Ratings are explained fairly well by economic fundamentals. But according to these models ratings agencies appear are unduly harsh in their assessments of Argentina and Chile and unduly lenient in their assessment of Mexico. The compression of spreads for Emerging Economy (EM) debt in recent years represents a significant and welcome development. Ratings improvements explain part of this compression, but they do not tell the whole story. Global financial variables (lower US high yield and VIX indices) are required to explain the full extent of the fall in EM spreads.

Discussion of Presentations

Countries can apply increasing revenues from the present period of expansion to any of four uses: i) debt reduction, ii) increases in spending, iii) increases in investment, or iv) tax reductions. Most countries are choosing to increase current expenditures rather than invest in infrastructure, acting as if the current positive shock were permanent. This leaves unresolved the question of how to address social tensions if growth slows. In addition, countries may not be prepared for the consequences of stable or lower commodity prices once supply meets recent increases in demand.

Theories of Growth, Exchange Rates and Competitiveness

(Eduardo Fernández-Arias, Moderator)

Growth and Reforms in Latin America: Where Do We Stand?

The market reforms of the 1980s and 1990s are widely seen as failing to live up to their process. Critics cite low growth in comparison to other regions, only slow improvements in poverty, worsening inequality, and a sense that positive outcomes following reforms are largely attributable to other factors such as high commodity prices, easy financing, and debt relief.

Three explanations have been offered for why reforms did not deliver higher growth. The first maintains that market-based reforms did not go far enough and must therefore be deepened and broadened. Studies on the growth effects of reform, however, have found only small growth effects even when other factors are controlled for, and even these small effects are regional averages that do not assess differences across countries.

A second argument is that the reforms went too far. Some advocates of this view note that the region achieved much higher growth in the 1960s and 1970s before reforms were enacted, and the slow growth resulting from reforms makes them suspect. A milder version of this critique states that, although the policies of the 1960s and 1970s were unsustainable, reforms produced unintended consequences and/or excessively reduced the role of the state; in this view the state must therefore be carefully reintroduced into the economy to provide public goods, guarantee social safety, and set strategic priorities for the economy. Critiques of this view cite the underlying weaknesses of pre-reform economies and the proven value of reform in certain areas, as well as the value of macro stability and the lack of knowledge on how to formulate industrial policy.

A third approach maintains that reforms “missed the point.” One school of thought within this approach suggests that the original Washington Consensus reforms failed to consider certain growth constraints (e.g., institutions, inequality and social cohesion) and that those reforms may have even worsened factors such as social cohesion. A second school of thought holds that, rather than seeking a “holy grail” such as liberalization, policymakers should identify and remove country-specific growth constraints rather than seek reform in all areas. Objections to this approach note the slow-moving nature of constraints such as institutions and inequality, as well as the difficulty of reforming them, and the practical difficulty of identifying and removing growth bottlenecks in practice.

All of these explanations are broadly encompassed by advocacy of either facilitating the actions of the private sector or encouraging intelligent government activism. An assessment of both camps and of the region’s experience leads to the following conclusions:

1. “Letting the private sector do its job” may require reform rather than merely shrinking of the state.
2. Reforming institutions remains difficult.

3. Institutional reform must either identify specific changes that affect actors' incentives or identify policies that strengthen pro-reform constituencies.
4. Strengthening pro-reform constituencies may entail heterodox policies such as redistributive reforms and modifications of exchange rate policy.

Exchange Rates, Foreign Capital, and Development

Development ultimately involves engaging in different and increasingly sophisticated activities, and countries generally diversify before specializing. Moreover, countries that engage in a variety of productive activities can therefore increase growth and enter a virtuous circle of development by developing a culture of learning and flexibility.

Several patterns of escape from underdevelopment have been identified. Perhaps the best known is manufacturing and exports, but tradable services are becoming important as well. In addition, commodity-led development can prove successful in nations with either high endowments per capita or reasonable institutions, even in the presence of only moderate endowments. Development by one or more of these routes can be facilitated by maintaining an undervalued currency, but this approach is likely to succeed only in the presence of capital controls. In Latin America, where capital flows have been liberalized, policy must aim to finance development through increasing both government and private savings.

Structural Transformation

Structural Transformation

Development and sustained growth entail not only increasing production, but also increasing the diversity and sophistication of production. Making the transition to such diversity and sophistication requires a trial and error process of self-discovery that may be underfunded by markets. Additionally, countries can more readily engage in transformation if they are engaged in activities whose factors of production can be adapted to related uses. Filling the productive space in a group of related activities (e.g., electronics or textiles) can thus be compared to monkeys jumping to nearby trees.

Unfortunately, Latin American countries have so far largely developed in areas of "open forest" with limited opportunities for increasing the range and sophistication of production, particularly exports. The extent of this open forest effect, more than shocks, appears to explain the duration of countries' growth collapses. How to provide public goods to facilitate diversification, and possibly other incentives, represents a major question for policymakers.

Discussion of Theories of Growth, Exchange Rates and Competitiveness

The presentations raise several issues. First, economists must admit that they still cannot account for approximately half of economic growth. Second, the role of services must be considered in assessing countries' structural transformation. Third, it is important to

remember that changes in exchange rates can have nonlinear effects; assuming it is possible to engage in successful exchange rate management, such management must find ways to control for boom and bust cycles. Moreover, exchange rate policies that may be successful when applied by relatively few countries may prove far less successful when widely adopted. Fourth, the factors underlying successful currency undervaluations remain unknown. Fifth, intervention in exchange rates can produce perverse incentives for arbitrage.

Beyond these concerns, much research remains to be done on assessing reforms in the region. Particularly important is determining how governments can improve education and infrastructure, as well as offer incentives for behavior that leads to growth, such as increasing private savings.

Stimulating Growth: What Should Be Done?

(Fidel Jaramillo, Moderator)

The Case of Colombia

Colombia's recent high growth rates have resulted from increased investment and productivity, based on the confidence resulting from positive macroeconomic performance, and from household consumption and external demand. Sustaining investment and productivity requires policymakers to address the following issues: i) institutions and security, ii) competitiveness policy, iii) capital market development, iv) education, v) infrastructure, and vi) maintaining a stable macroeconomic environment.

Within these larger areas, the following concerns call for particular attention: i) reducing violence, ii) increasing innovation, iii) reducing informality, iv) deepening capital markets through means including improved corporate governance, v) increasing investment in post-secondary education, and vi) extending, modernizing and consolidating the country's transportation infrastructure.

The Case of Brazil

Improved macroeconomic management, particularly in inflation and net public sector debt, have laid the foundations for high and sustained growth; extensive development of the country's capital markets also appears likely to encourage growth. While limits to the economy's potential output growth remain uncertain, inflation and external accounts may represent sources of concern over time.

Brazil is undertaking a variety of measures to promote growth. In the area of investment and savings, the government is undertaking a large-scale infrastructure investment from 2007 to 2010, financed by a reduction of the public sector's primary surplus targets rather than by deficit spending. Although Brazil's fiscal structure makes it difficult to control current expenditures, economic stability and growing formal employment have increased tax collections, and other fiscal measures likely to have long-term impacts include a cap on growth in civil service payrolls and plans to change the social security system. Other

actions are designed to increase the Brazilian economy's efficiency through improving the quality of education and through reducing distortionary incentives in the tax system; inefficiencies in labor markets and other areas have yet to be addressed.

A long-term challenge involves Brazil's role in the global economy. Like other countries in the region, Brazil must find a way to encourage innovation and reduce dependency on volatile commodity exports. At the same time, inappropriate industrial policies may reduce economic efficiency and deepen economic inequality.

Banking Problems in LAC: Current Events and What Might Be on the Horizon

(Jonathan Davis, Moderator)

Credit Fluctuations in Latin America: Stylized Facts and Policy Issues

Credit in the region is gradually developing, though from a low base and in the presence of notable obstacles. Credit is low as a percentage of regional GDP and lower than expected given countries' institutional and economic fundamentals; on the other hand, the region is more integrated internationally than would be expected. Bond offerings are growing if limited in size and number of issuing countries, and bank credit displays volatile growth. Regional generalizations are nonetheless complicated by the presence of different bottlenecks across countries, as well as differences in credit composition.

Variations in credit notwithstanding, Latin American banking systems are increasingly sound, moving toward more robust macro and prudential frameworks, the latter including exit procedures in the event of bank failures. Other trends include enhanced risk management practices, especially in more internationalized banking systems, and notable improvements in some countries' contractual and informational environments. A recent strengthening of bank financial statements is encouraging but must be interpreted with caution in light of the current growth cycle.

Latin American banks are making additional progress in filling access gaps, in part because of improvements in technology and flows of information from credit bureaus, as well as in response to competition from other credit providers. Department stores, for instance, increasingly compete for consumer credit, and bank financing of corporate debt is rising to meet the challenges posed by local and international capital markets. Banks have additionally increased their coverage through consolidation of the microfinance market. Housing finance, aided largely by a more favorable contractual environment, has increased less dramatically.

Currently positive conditions, however, should not lead to complacency. Although the risk of Sudden Stops is presently low in most countries, other risks exist. High levels of liquidity are feeding asset price bubbles, and the credit scoring methods in use are based on only limited data series. Finally, while Currency mismatches appear to be contained, the extent of duration mismatches remains unknown.

The region's banking sector additionally faces several prudential policy challenges in the longer term. The first of these is a sensible transition to Basel II provisions that takes into account differential impacts and the implementation issues faced by individual countries. A second challenge is increasing compatibility with modern business models and risk management practices; desirable goals in this regard include arriving at a consistent definition of small and medium enterprises and improving links between screening tools and capital and provisions policies. Third, the banking sector must adopt forward-looking, cycle-sensitive provisioning and capital rules, particularly in the form of countercyclical provisions.

Exchange Rate Policy and Economic Performance

(Eugenio Díaz-Bonilla, Moderator)

Fear of Floating in Reverse: Exchange Rate Policy in the 2000s

In contrast to previous periods characterized by "fear of floating," in which emerging markets managed their exchange rates to prevent excessive depreciation, at present some emerging markets display "fear of flying" and are managing their exchange rates to avoid excessive appreciation. Mercantilist interventions in the exchange rate may thus substitute for export subsidies, though their less explicitly targeted nature makes them less prone to mismanagement and corruption. The results of this approach are so far mixed. While containing appreciation appears to have positive implications for long-run growth and productivity growth, its effect on exports remains small. Moreover, holding down appreciation remains vulnerable to the critique that is merely a form of maintaining low real wages.

Exchange Rate Policy and Growth: Remarks from the Argentine Perspective

Countries have a variety of reasons for accumulating reserves and for intervening in exchange rates. In the case of Argentina, reserves accumulation is serving as an insurance policy and as a potential instrument for countercyclical policy. Argentina's real exchange rate policy is also directed toward crisis avoidance and macroeconomic consistency in order to avoid a "purchasing power illusion" that benefits the middle class and makes modifying policies politically impossible until an unsustainable exchange rate regime collapses. Across countries, any analysis of exchange rate interventions must include the reason or reasons for which those interventions are undertaken and evaluate results in relation to intentions.

18 May Luncheon Speech, Ricardo Hausmann

Growth in the region remains limited and unevenly distributed in spite of greatly improved macroeconomic management and conditions. Alternatively, growth and development may result from countries' discovery of new activities and/or new ways to perform ongoing activities; interestingly, the extent of a country's development is correlated with the number of stock-keeping units (SKUs) it produces. The process of self-discovery and diversification, however, depends on non-market forms of cooperation that are largely provided by institutions such as governments and trade associations. The success of these complementary activities in turn depends on a society whose productive processes involve the largest possible number of persons.

This approach contrasts and competes with two other visions of development in the region. The first, the "neoliberal" vision fails to take into account the complexity of social relations and non-market processes in aiding development. A second vision, populism, sees development as a conflict between good and bad actors, the latter of which must be eliminated or restrained. The view of society adopted by citizens, particularly the young who are still choosing careers, holds major implications for social relations and countries' development paths.

Monetary Policy in the United States: Effects and Response in LAC

(John Hauge, Moderator)

Outlook for U.S. Economy and the Fed

The Federal Reserve Board appears to expect that the U.S. economic performance will not be greatly disrupted by a range of current risks. Nonetheless, downside risks to growth have risen, particularly declining housing construction and the anticipated effects of numerous defaults and foreclosures in subprime home mortgages. Upside inflation risks, though softening, remain in place. These include a tight labor market, high energy prices, inflationary expectations, and rental real estate inflation as former residents of foreclosed homes seek rental housing. Slow growth and receding inflation risks in the short term are expected to lead to a Fed rate cut by late 2007, but longer-term inflation risks remain.

Exchange Rate Policies: Leaning against the Wind in Good Times?

Although the real effective exchange rate (REER) in the region did not appreciate greatly during the notable decline of the dollar in recent years, that appreciation did not stop once the dollar's depreciation stalled. This does not represent a massive appreciation problem on average, but it does pose a challenge to regional competitiveness given the lesser appreciation of Asian currencies in recent years.

Maintaining a depreciated real effective exchange rate, or "leaning against the wind," has notable benefits. First, episodes of real depreciation boost export volumes. Second, real depreciations reduce export concentration and correspondingly increase diversity in

sources of growth; exactly how this occurs requires further study. Third, leaning against the wind may encourage investment in credit-constrained economies. Central Banks' already-limited ability to manage real exchange rates, however, is compromised by the fiscally problematic behavior of national governments; the latter could maintain depreciated real exchange rates through countercyclical fiscal policies but generally fail to do so. In any event, policy initiatives must be tempered by an awareness that excessively limiting REER volatility may reinforce financial dollarization, thus weakening domestic financial market development and increasing countries' vulnerability to Sudden Stops.

Monetary Policy in the U.S. and Exchange Rate Management: The Chilean Experience and More

Since inflation targeting countries base monetary policy on inflation perspectives rather than international monetary policy developments, the high correlation between emerging and developed market monetary policies stems from a correlation in inflation developments rather than an attempt to follow the lead of developed countries' Central Banks. Chile's policy rate, for example, is currently below that of the United States.

Chile's experience additionally offers several lessons for countries in the region. First, Latin American economies should try to move to floating in order to adjust to variable conditions in the world at large. Second, growth accompanied by foreign exchange interventions is not necessarily sustainable or desirable, and a policy of interventions can inhibit the development of foreign exchange markets. Third, Chile's experience suggests that case studies should be undertaken to determine the conditions under which countries have moved from a managed exchange rate to floating.

U.S. Monetary Policy and its Implications for Latin American Economies

Slowing U.S. growth and the prospect of a Fed rate hike hold less danger for Latin America at present than in previous economic cycles. In the financial sector, improved communication of U.S. monetary allows for gradual adjustment in markets, and investors have begun to differentiate among emerging markets; additionally, strengthened fundamentals have reduced the region's vulnerability to external shocks. In the real sector, the U.S. growth slowdown remains moderate and involves U.S. rather than global factors; moreover, growth in emerging markets has offset the U.S. slowdown.