

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

## **MINUTES**

### **Setting the Stage**

#### *All that Glitters May Not be Gold*

Improvements in policy management notwithstanding, the region's recent macroeconomic success may stem primarily from external factors such as international commodity demand and high levels of global liquidity. Moreover, growth in Latin America's seven largest economies has lagged behind both the world average and growth in any emerging region, and that growth is linked more to investment than to increases in total factor productivity. The region's situation is further complicated by many governments' failure to use the current boom either to improve their long-term fiscal situations, including debt composition, or to engage in sufficient levels of infrastructural and other investment. Countries have instead used increased revenues largely to fund increases in current (non-capital) expenditures. In addition, increases in foreign reserves, while large in absolute terms, do not match the relative level of the 1990s boom. Finally, the region's limited vulnerability to the U.S. subprime crisis may prove only temporary should the Federal Reserve Board sharply increase interest rates.

#### *First Response*

Using a regional average represents only a starting point for analysis, as it may obscure important national variations, such as different reasons for current account surpluses. A second concern is determining the appropriate level of fiscal adjustment to undertake for long-term stability. Any policy adjustment implies trade-offs, and the structure of public debt is difficult to change, especially in the short term. Third, it may be illuminating to ask whether the external environment can be considered without reference to commodities, particularly oil.

#### *Second Response*

Policymakers in the region must examine to what extent recent economic good times have resulted from good policies or good luck. Countries must prepare for the virtually inevitable times when external conditions are less favorable. An approach such as Chile's fiscal rule, for instance, favors fiscal sustainability and competitiveness, smoothing both revenues and expenditures and reducing the volatility of GDP growth.

### **The U.S. Credit Crunch and its Implications for Global Markets**

The sell-off in U.S. markets in recent months has gone beyond what would be called for only by changes in fundamentals, and a substantial deleveraging has occurred. The state of financial markets has eased since the Bear Stearns rescue, but there remain a variety of sources of financial stress. While U.S. credit problems have had little effect on emerging

markets, this does not necessarily testify to the skills of EM financiers and policymakers. Instead, timing represents a more important factor. EM financial markets are not yet deep enough to be affected by recent U.S. and U.K. problems, and they are not yet sufficiently developed to make the same mistakes involving sophisticated financial instruments.

## **Monetary Policy and Inflation in LAC**

### *Unveiling Monetary Policy in Latin America*

Although de facto monetary policy regimes in the region do not necessarily match their de jure descriptions, it is nonetheless possible to describe monetary regimes in the region as in practice moving toward inflation targeting and away from exchange rate management. Moreover, with the exceptions of Argentina and dollarized Ecuador, monetary policy management throughout the region is stable. Whether the new configuration of monetary policy has better prepared Latin America for a crisis than the previous approach remains an open question.

### *Monetary Policy in Latin America: Is the Inflation Regime Transition Really Over?*

The adoption of inflation-targeting regimes is meeting with mixed success as targets are in some instances missed and as countries face challenges that are not amenable to the instruments of monetary policy. Particularly relevant at the moment is the increase in headline inflation, driven by increasing food and fuel prices. Possible effects of headline inflation on core inflation, or the possibility of growing divergence between the two measures, offer an ongoing challenge for policymakers, as do dilemmas of balancing inflation and exchange rates. Under these conditions it is possible for inflationary expectations to become unanchored, and it may be necessary to choose between defining price stability according to either headline or core definitions.

## **Creeping Inflation: How Much of a Concern? What Should the Response Be?**

### *Peru*

Inflation in Peru, like much of the region and the world as a whole, is largely being driven by food prices, reflecting a permanent price realignment based on Chinese and other demand for commodities. While theory suggests that central banks should not intervene in non-sticky prices such as those of food, short-term inaction may lead to higher inflationary expectations and ultimately require a drastic response. On the other hand, a strong immediate response may entail a costly output reduction. Given these concerns, and faced by a combination of imported inflation and strong domestic demand, the Central Bank of Peru is engaged in moderate interest rate increases. Vulnerabilities such as financial system dollarization remain, but they are being reduced, and Peru currently displays one of the region's lowest inflation rates.

## *Mexico*

Increases in the real prices of food and fuel in the present macroeconomic environment call for a response that is preemptive, significant and transparent. The degree of strength and preemptiveness, however, must be appropriate for national circumstances, which vary according to the following: i) inflationary history, ii) weight of food and energy in the consumer price index, iii) the degree of persistence of inflation in response to price shocks, iv) the phase of the business cycle in which a country is located, and v) the impact of the current environment on a country's terms of trade. The impact of recent shocks has varied across countries, which calls not only for country-specific responses under the current policy framework but also a possible redefinition of monetary policy objectives. At present, creeping inflation may suggest a restrictive bias in monetary policy, even at a low phase of the business cycle. It may therefore be appropriate to ask what other policy instruments are available and to determine the optimal mix of policy responses so that negative welfare effects can be avoided.

## *Colombia*

Creeping inflation represents a legitimate concern in the face of large and persistent shocks and strong demand. The current situation recalls the 1970s, when central banks maintained low real interest rates yet inflation failed to decline even after food and energy prices did. Inflation is especially a concern in Latin America, where central bank credibility has yet to be consolidated and disinflation is still underway. In Colombia, for instance, several indexation measures remain in place and others may be introduced if high levels of inflation return. The official response to rising inflation has involved a restrictive approach, as recent shocks have increased demand pressures and inflationary expectations and led to nominal wage increases. Going forward, Latin American countries must control creeping inflation in order to pursue countercyclical monetary policy and permit exchange rate flexibility as needed. In addition, indexation mechanisms should be minimized if not eliminated as inflation reaches low and stable levels.

## **Rating Agencies: On their Role and their Value-Added**

### *Do Credit Rating Agencies Add Value?*

An analysis of sovereign credit rating changes shows that ratings do in fact provide information, with different information provided by each agency's changes. Rating upgrades reduce future interest rate spreads, increase stock market valuation and appreciate exchange rates. Downgrades also appear to reduce spreads but have no effect on either stock market valuation or exchange rates.

### *Latin America: Golden or Leaden Casket?*

Sovereign ratings in the region are in many instances failing to improve because of the narrowness of ratings themselves, which measure only ability or willingness to pay. Ratings do not measure other factors of potential interest such as pricing, liquidity, or appropriateness of investment. With this caveat in mind, the region's ratings are

constrained by the following factors: i) a lack of structural reform in fiscal management; ii) unexceptional growth rates in most countries; iii) low per capita productivity; iv) fragility of financial systems; v) poor management of public enterprises; vi) precarious composition of public debt according to source and currency denomination; and vii) suspect monetary policies.

## **The Commodity Price Boom and the Caribbean**

### ***Regional Presentation***

The Caribbean has proven vulnerable to high prices of both fuel and non-fuel commodities, particularly foodstuffs. All countries in the region have trade deficits, and some are highly indebted. At the same time, the region faces a dip in U.S. tourism. Policy responses have included both interventionist and market-based approaches, but policy is constrained by both limited fiscal space and political pressure. Working within these constraints, governments have addressed fuel prices by measures that include i) emphasizing conservation and public transportation, ii) participating in Venezuela's Petrocaribe program, and iii) developing alternative energy sources. Responses to high food prices have involved: i) emphasizing local production, ii) creating new linkages and business relationships in food sourcing, and iii) seeking less expensive sources of food imports. Long-term policies will require widespread changes in behavior and attitudes.

### ***Barbados***

While an erosion of price stability is disruptive to the social contract, the government's options are constrained by the conflicting needs to provide an acceptable level of services and to prevent the tax burden from growing onerous. Many potential short-term options are therefore of limited value for reasons of cost, distributional impact, or maintenance of existing patterns of consumption. A variety of longer-term approaches are needed, such as i) greater regional integration; ii) prudent fiscal and monetary policies; iii) improving food security through changing the culture to favor local and regional foods, and through linking tourism with local agroindustry; iv) improving distribution services, particularly port operations; and v) promoting energy conservation and alternative energy sources.

### ***Jamaica***

Jamaica has been greatly affected by increasing commodity prices, even as its own leading exports of aluminum and bauxite have not shared in the current boom. Petrocaribe, remittances, foreign direct investment and the use of foreign reserves have provided some relief, and monetary policy that is moving toward inflation targeting may contain demand pressures; structural reform is nonetheless needed. Other policy responses consist of the following: i) welfare support via initial subsidization of basic foods; ii) targeted income support of the most vulnerable citizens; iii) supporting expansion of the domestic food supply; iv) energy conservation and diversification; and v) expanding earnings from tourism.

## **Prospects for Latin America**

Regional prospects have so far not been greatly affected by reduced world growth, including U.S. conditions that are not expected to recover until 2009. Latin America is growing above the global average and has proved largely resilient to recent shocks, in part as a result of low exposure to problematic financial instruments and improved fiscal management, accompanied by lower spreads. High commodity prices have additionally helped in the short term, but potential price volatility and possible increased dependency on commodities raise concerns. Short-term concerns include rising inflation, rapid credit growth and high public spending that leaves little room for counter-cyclical action. Long-term concerns include lagging investment, infrastructure and productivity and uneven distribution of economic gains among the region's countries.

## **The U.S. Banking Crisis and Emerging Economies**

### *The U.S. Crisis in Historical Perspective*

Although the recent crisis has featured new markets and actors, it displays the same underlying dynamics as its predecessors: real estate and equity price bubbles and large investment inflows prior to a crisis. The Federal Reserve Board's unprecedented creation of liquidity and extensive accumulation of reserves in many countries have fueled those bubbles. A large financial crisis may prove both recessionary and protracted, and addressing its consequences will require fiscal rather than merely monetary measures.

### *The Credit Crisis and its Impact on Emerging Markets*

While the current crisis was caused by a combination of market, policy and regulatory factors, it has particularly reflected the presence of incentives for excessive risk-taking and the inability of capital markets to substitute for banking systems. Factors that might weaken the performance include a severe U.S. recession and/or systemic banking crisis, high inflation and interest rates in industrial countries, and threats to the sustainability of high commodity prices, particularly if Chinese demand softens.

### *The Brazilian Economy's Response*

The banking reforms of the 1990s and improved macroeconomic management have minimized the impact of the U.S. crisis. Brazilian assets depreciated only modestly and quickly returned to their former values, and the banking sector's current cycle of credit expansion was not significantly. In contrast to historical vulnerability to the external environment, "this time is different."

### *Impact on Mexico*

The impact of the U.S. crisis on the Mexican economy has been limited by strengthening of the latter's real and financial sectors. Improvements in the real economy include strengthening of internal demand and the non-tradable sector, as well as improved competitiveness and export diversification and the adoption of counter-cyclical fiscal policies. Financial sector improvements include structural reforms in the financial and

pension systems, along with greater macroeconomic and financial stability and greater availability of credit. Low levels of mortgage and consumer debt have further limited contagion effects. Remaining challenges in the real sector include additional structural reform, reinforcement of property rights and anti-monopoly measures, and increased trade liberalization and foreign direct investment. Pending improvements in the financial sector are increasing the size and depth of the financial system, as well as competition within the system, strengthening equities markets, reinforcing the security of the system and strengthening consumer protection.

## **Decoupling and the China Connection**

### ***China: Channel of Contagion or Line of Defense***

Although Latin America has generally benefited from high commodity prices and largely avoided the effects of the U.S. recession, it has been suggested that this situation may not last because of the end of a wave of commodities speculation and the eventual transmission of a U.S. slowdown to China; the latter may be expected to reduce commodities demand and prices. The assumptions underlying this suggestion, however, may be erroneous for a variety of reasons. First, China has been the principal driver of increasing commodities demand only in metals. Second, the world supply of both agricultural and non-agricultural commodities has been limited by factors such as droughts, crop failures and limits in port capacity, accompanied by inadequate policy responses. Third, as the United States accounts for only 19 percent of Chinese exports, a U.S. recession and fall in demand is likely to have only minimal effects on the Chinese economy. Fourth, Chinese internal demand and investment both continue to grow rapidly, and growth rates are likely to remain high. Under these circumstances further currency appreciation may be needed to contain inflation, which will in turn diminish the competitiveness of Chinese exports in relation to those of Latin America.

### ***Argentina***

A successful decoupling from current U.S. difficulties depends on a combination of two factors: i) Fed action to avoid financial system crisis and recession and ii) inward growth in China and, to a lesser extent, Europe. In the absence of a U.S.-style buyer of last resort, emerging market exports and growth will suffer, and countries may suppress their exchange rates and seek to restrict trade. Commodities demand is also likely to suffer. At the systemic level, coordination is needed among central banks. At the national level, Argentina's decoupling process is in part due to diversification of export destinations.

### ***Chile***

Decoupling and an increase in global inflation, which may require monetary tightening, apparently result from slowing U.S. productivity. Although short-term decoupling may have relatively minor inflationary effects, it could dampen growth, particularly in Asia. On the other hand, further integration of Asia into the world economy, particularly through enhancing the global labor supply, may limit inflation and ensure demand for commodities such as oil and copper.

## *Uruguay*

In a particularly significant sign of decoupling, emerging market debt has failed to track high-yield commercial debt in recent months and maintained relatively low spreads. In the case of Uruguay, improvements in policy have reduced vulnerability in times of stress.

## *China's Economy: Entering Troubled Waters?*

China's much-vaunted economic success faces a series of obstacles. Concerns with overheating have caused a tightening of monetary policy, while slowing U.S. demand is reducing exports. Addressing both of these situations at once presents a policy dilemma. In the absence of inflationary risk Chinese authorities may loosen monetary policy to lessen the impact of sliding exports, but the inflation rate may significantly constrain policymakers' room for action.