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P R O C E E D I N G S

MR. CÁRDENAS: Welcome to Brookings. My name is Mauricio Cárdenas and I'm a senior fellow here and the director of the Latin America Initiative. We're delighted to host today an event on the macroeconomic outlook for Latin America and the Caribbean. We are also very happy to have two of the leading reports on this topic to be discussed, one the report that is put together by the Inter-American Development Bank led by Ernesto Talvi and Alejandro Izquierdo; and the other, the report that is also biannual and put together by the IMF, the Regional Economic Outlook, led by Nicolás Eyzaguirre and Steve Phillips.

Today's event will be moderated by Carol Graham. Carol is a senior fellow here at The Brookings Institution, very well known to many of you, a leading scholar on the topic of the economics of happiness. So I really hope that the news that we're going to hear today are good news -- and they seem so anyway -- as Latin America is doing relatively well in the macroeconomic front. So without further ado, let me welcome Carol who is going to be moderating today's event. Thank you very much.

MS. GRAHAM: Thank you Mauricio, and indeed I have the happy pleasure of introducing both these reports and the speakers. And they are reports with good news where Latin America has better news than the United States so it's a nice changing of the tides. In fact, we had another wonderful presentation here on Monday by Nora Lustig and another group of scholars telling also a positive story about Latin America about inequality declining somewhat. And so let's keep the good news rolling here.

I have the unhappy task, though, of moderating a rather complicated panel with two reports and two sets of panelists. So I'm going to do my best to keep us

on time, and I have even an especially large watch to do so. I suppose I'm in charge here.

So first of all, I'd like to -- we're going to discuss the IDB report, "The Aftermath of the Crisis: Policy Lessons and Challenges Ahead for Latin America and the Caribbean," and that's going to be presented by Ernesto Talvi and Alejandro Izquierdo followed by a brief discussion. Then we'll switch over and do the IMF report.

Alejandro Izquierdo is currently a principal economist at the research department of the Inter-American Development Bank and previously worked in the World Bank, and he's taught in several Latin American universities. He has a PhD. in economics from the University of Maryland and undergraduate degrees and Master's degrees from the Institute (Spanish) in Argentina and the University (Spanish) in Buenos Aries.

Ernesto Talvi is currently the executive director of CERES, Center for the Study of Economic and Social Affairs in Uruguay. And he's also a permanent advisor to the chief economist of the Inter-American Development Bank and is well known to many of you here in Washington.

So with no further ado, I'll turn it over to Alejandro and Ernesto and then we'll start a discussion after their presentation.

MR. IZQUIERDO: Well, thank you, thanks a lot for the invitation. I want to thank Mauricio and Steven Magnuson for all their organization and their participation in this event. It's a pleasure to be here, so much so that Argentina is right now playing a game, and I decided to come here. And I'm from Argentina.

Alright, so I'll be presenting the macro report today together with Ernesto. This is joint work by the research department coordinated by us. And the presentation today is going to have two sections. The first section is going to be an outlook and some

macro policy challenges for the region, and the second section will be a part of the report that contributes to understanding the resilience of Latin America during the global crisis and how much the international financial architecture had again to play in this crisis.

So for a long time now at IDB we have been focusing based on the tradition that Guillermo Calvo, Carmen Reinhart, and Leonardo Leiderman in 1992 started with the impact of external factors in economic activity. We've built a framework that just by using a key set of variables -- basically industrial production in the G-7, the terms of trade, U.S. T-bond yields, and the high-yield spreads -- those variables, when you put them together in a formal economic model, account for about 60 percent of the various output. So that has been our key element workhorse for forecasting or for building up scenarios for the region.

So as you can see in this graph here just by fitting in the growth of industrial countries and China, commodity prices, and international financial conditions into this estimated model, we can account pretty well for the growth behavior of the region. So here you have the green line being the observed growth rates and the red line being our estimates based on external factors.

So with this framework we take a look now at what happened to these inputs for our growth scenarios in 2010 compared to 2009 to understand where we are. And what we see is that there has been a rebound in growth in industrial countries. China is now growing faster, and commodity prices have recovered at least to early 2007 levels.

If you look at financial variables, you see that silver and bond spreads have declined significantly after the crisis, and bond prices recovered to pre-crisis levels as well. So it should come as no surprise when we look at the behavior of economic activity on the forecasts, the growth forecast for the seven largest Latin American

economies, that there is a rebound of about 6 percentage points in growth, from like 1.7 percent contraction in 2009 to about 4.1 percent increase in GDP expected for 2010.

Now this is where we stand, and the report aims to build alternative scenarios in order to understand possible outcomes for the region. And we at this point and in the report specifically bar any catastrophic or panic scenarios. We do not assume that the European crisis is going to get messier than it has so far.

I will mention something at the end of my presentation, but basically the report bids two scenarios, one which is a positive scenario of global demand rebalancing. In this scenario the U.S. starts a deleveraging process which can be seen by the fact that the current account deficit has been narrowing. And this deleveraging process with a fall in demand in the U.S. is accompanied by an increase in demand in the rest of the world, basically the emerging world and China. And that leads to higher commodity prices because China is basically a strong consumer of commodities and the fact that still excess world savings remain. Then we expect in this case to have high capital inflows and declining spreads. So that's the first positive or rosy scenario if you want.

And then we constructed an alternative scenario where the U.S. again goes through the deleveraging process, but that's not accompanied by an increase in demand in the rest of the world so commodity prices do not keep on increasing as in the first scenario. And as part of the excess world savings, there's going to be lower growth in the rest of the world meaning that there will be declining capital inflows to emerging markets and maybe higher spreads.

So to summarize you have these two scenarios depicted here in terms of world growth, commodity prices, and international financial conditions. We see the diverging paths for growth in G-7 and China. This is the positive scenario. This is the alternative scenario. We see commodity prices increasing in the first scenario where

they stall in the second scenario. And again, bond spreads remaining at low levels in the first scenario and then increasing spreads in the second scenario.

How does that translate into our expected growth path for each of these scenarios? Well, in the first scenario the region returns to a growth rate of about 6 percent which is pretty much the same as their pre-crisis growth rates, whereas in the second scenario with the shrinking world savings and lower growth we would be reaching an average of about 3.4 percent growth in the period 2011 to 2014.

So what you see is these two possible scenarios that we constructed and we discuss in much more detail in the report. These two scenarios have different implications in terms of policy as you can imagine. In the first scenario would be a scenario of bonanza which I'm not going to discuss in detail here. Where I'm going to make the argument is that to the extent that risk aversion elements remain within policymakers and those elements are stronger than political economy elements, then the region should focus on managing a short-run bonanza, planning perhaps for a slowdown in growth ahead. So in that scenario the report recommends a rebuilding up to levels of international reserves throughout the bonanza, saving for a rainy day, and controlling inflation to avoid excessive re-exchange rate appreciation. And the policies in that case would be reserve accumulation, a re-profiling of dead maturities, and a fluid relationship with the IMF and the MDB Center -- Ernesto has a lot more to say on this later on -- avoid large expenditure growth, and work with a tighter fiscal and credit policy and perhaps sterilize intervention.

So these are the scenarios that we have in the report. Now we cannot ignore the fact that the European crisis is evolving every day and for now has been contained, but there is still many elements to be solved and it's not an easy issue

because it involves collective decisions which may be difficult and they have proved difficult to contain.

So in this other scenario which we -- it's not in the report but we did it out of curiosity -- we said okay, let's go back to the Liman crisis levels of external variables, basically returning to spreads about 900 basis points as they were at the time of the Liman crisis in the region, then also taking a fall in commodity prices of the same amount that took place -- a proportional amount that took place -- by the time of the Liman crisis, and also a slowdown in the economic activity in the industrialized world. When you feed those inputs to our model, what you see is that in this particular case, growth would be on average about .6 percent of GDP for the same period I was discussing before so there would be a substantial slowdown of growth in the region.

Now whether this scenario is going to materialize or not depends on several events. What we would suggest is that in this particular -- if we were to go into this mode, then the policies that should be addressed can be traced to our last year's report where we focused on the policies necessary for a crisis mode situation and that incorporates a lot of systemic elements, and this is why Ernesto is going to tackle it with the next section.

MR. TALVI: Mauricio, thank you so much for the invitation. Thank you, Stephen, for your organization. It's a pleasure to be here. I'm from Uruguay, so no crowding out. We won yesterday 3-0.

One of the most intriguing puzzles during the Liman crisis episode was the fact that in spite of the global nature of the crisis, MB spreads for emerging markets actually never reached the levels that it had reached during the Russian LTCM crisis that was a more localized and less widespread crisis. So this is the puzzle we wanted to address. What happened? I mean we should have expected that much larger impact

given the global nature of the crisis. In any measure of financial shocks or real shocks suggests that actually the shock was much larger this time around than it was during the Russian crisis.

So one possible explanation is that emerging countries -- and this is done for emerging countries as a whole and I'll go back to Latin America in a minute -- had much better fundamentals this time around than they had prior to the Russian LTCM crisis. So in order to test for that -- and we did a lot of tests -- and essentially we came up with the Cray's ratings as a very reasonable proxy of fundamentals including in the fundamentals the liquidity that countries do have on their own, their own buildup of liquidity or reserves. And, in fact, when we look at Cray's ratings, what we see is that the pre-Liman crisis Cray's ratings of fundamentals were better and closer to investment grade than they were prior to the Russian crisis.

So what we did is we created two groups of countries during the Liman crisis, a group with a BB+ rating which were the pre-Liman crisis fundamentals, and an alternative group or control group with the pre-Russian crisis fundamentals. And what we expected is that not only the countries with the worst fundamentals were to perform worse than they did during the, in this case, during the Liman crisis which in fact they did as you can see here. The red line is the BB+. The green line is the BB Cray rating countries during the Liman crisis. But since the shock this time around was larger, we were expecting these countries to perform worse than would the BB countries did during the Russian crisis. And, in fact, what we found is that still during the Russian crisis, even controlling for fundamentals, the shock was larger. So basically fundamentals, although important as we see, are not telling us the whole story.

So a second competing explanation has to do with the fact that this time around given the global nature of the crisis and the readiness of the international

community to provide liquidity support to emerging markets early on, in a timely, unconditional, preventive, and sizeable way because this was something of a novelty during this crisis. I mean during the Russian crisis, the aid from the international community was slow moving, conditional, curative rather than preventive, and much smaller in magnitude.

This predisposition of the international community to provide or to play the role of international lender-of-last-resort was seen early on. As early as April 2008 Japan arranged swap agreements with Indonesia, two months later with India; when the Liman crisis exploded, the fed immediately offered swap lines to Brazil, Korea, Mexico, and Singapore. The IMF announced, launched, the short-term liquidity facility. Many voices in academia and in the policy world were calling for a recycling of some of the flight capital back into emerging markets to prevent liquidity crises or financial distress in these countries. So the markets actually could have reasonably expected that through these actions at what eventually happened in April 2009 which was the decision by the G-20 to recapitalize in a very substantial way the international organizations, in particular the IMF, and with the launching of the flexible credit line which essentially created the means through which these resources could be channeled unconditionally and in a very timely way and in sizeable amounts to fundamentally sound emerging economies.

So what we did is say, well, let's see if there's something to this lender-of-last-resort aspect of the crisis that could have made the difference this time around. So what we did is we created a group of countries that could reasonably not have been expected to have access to these lender-of-last-resort facilities. How did we define objectively this group? Through any of these three conditions: No Article 4 confrontation with the IMF for at least two years which could be an indication that there's some problems in the relationship, a country that is in arrears with the IMF, or in default with

bond holders. Any of these conditions would indicate that probably these countries would not have obtained access to lender-of-last-resort facilities being launched during the crisis.

So once we identified these countries, we looked at the average credit rating of these countries and we constructed a control group that had the same credit rating as these now access to lender-of-last-resort facility countries, the same credit rating but with access to lender-of-last-resort facilities. And the results are really striking. When we looked at the access countries, spreads went up by approximately 800 points. That's -- these are very low credit rating countries, but the no-access countries, which is the orange line, the spreads went up by 1600 points. And, in fact and more importantly, they went up by more than the countries with the same credit ratings during the Russian crisis. So this is very interesting because once we control for both fundamentals, and they have access to international lender-of-last-resort facilities that were essentially absent during the Russian crisis, then the impact on spreads is larger in this crisis, the Liman crisis, than it was during the Russian LTCM crisis which was exactly what we were expecting and this crisis was a lot larger in magnitude. And, in fact, we did this formally, and you can find it in the report by regressing the change in spreads in the 60-day window, 15 days prior to the Liman crisis, and 40 days following the Liman crisis which was the apex of the U.S. high-yield spreads and a moment of more tension during the crisis. And what we find is that both, the fundamentals as proxied here by Cray's ratings and many alternative measures that you can see in the econometric work, and the access, the binary variable access, no access to liquidity facilities by the international community are both very, very relevant.

Now, quantitatively -- and this is very important -- the exercise we perform is that now that we have a model of the spread changes, what spread changes

should we had expected to occur had Latin American countries had the Cray's ratings that they had prior to the Russian crisis and no access to lender-of-last-resort facilities? It was essentially the environment during the Russian crisis and we would have predicted an increase in spreads of 1300 points, however, the observed increase was only 500 points. And when we split the difference between fundamentals, the role of stronger fundamentals, and access to international lender-of-last-resort facilities, the second aspect is quantitatively, during this action, is more important than actually the strength of fundamentals.

Now, let me -- this should come as no surprise to Guillermo Calvo, and I'm glad that he's here because after the Russian crisis, he immediately suggested that this was a systemic crisis that required systemic solutions and proposed the creation of an emerging market fund. This is conceptually what happened. It's very akin to that and essentially as Guillermo suggests that it worked, and it worked big time.

Now -- I'll be there Carol -- this is very important to make clear. When we present this, people react saying well, I mean, we've been doing all the homework putting our fundamentals right. And now you're telling us that fundamentals don't matter. It's important to understand the nature of the experiment, and I like to compare it with a very severe accident, car accident, you're being hit by a truck. Then if you smoke or if you don't smoke, if you exercise or you don't exercise, probably it's going to make a little bit of a difference whether you survive or you don't survive the accident because you're physically stronger. But in the instance of such an accident, the most important thing is how quickly the ambulance is going to come to the scene and take you back to the emergency room. No matter whether you smoke or you don't smoke, whether you -- now smoking, exercising, is very important for longevity. So it's very important for very meaningful things, but it's not necessarily the most relevant factor when you are in the

middle of a huge accident. Then the ambulance -- and the ambulance to us was the support by the international community.

MR. EYZAGUIRRE: You're saying it's irrelevant, the smoking?

MR. TALVI: Well, it's not irrelevant, Nicolás, it's not irrelevant --

MR. EYZAGUIRRE: Oh, I'm just kidding.

MR. TALVI: -- but it's quantitatively much less important than the ambulance.

Let me skip so I can go to the last two slides and comply with Carol's stringent rules. So to us in Latin America, and I think for emerging markets, the architecture that it's somehow in an ad hoc form and in response to a crisis was created which to us had this ingredient. I mean at the multilateral level, we had these example automatic, very timely, and sizeable assistance that actually worked. But it was only made available to countries with sound fundamentals and to us going forward, sound fundamentals should mean more redeemed-based rather than concrete and specific targets and redeemed-based can be the jury with fiscal rules, (inaudible), for example but they also could be de facto. I mean, many rules are there because they happen to be enacted or practiced for many, many years, and then they create a track record of performance even if it's not actually engrained in the law.

And these two ingredients together with the endowing the IMF and the MDB with the other researchers for tests constitute what we like to call a long-term stability pact between the international community and emerging countries that provide lender-of-last-resort facilities for these countries, and at the same time create the incentives to promote sound policies in order to be able to access these facilities.

So this is -- and just as close to me and Alejandro -- a very, very relevant and may have far reaching implications for emerging markets because they will reduce

the probability of the threat of the crisis of contagion; therefore, they may improve substantially the long-term prospects of our countries as disruptively created the crisis, diminish their incidence, and incentives for good policies are enacted. Now these insurance mechanisms will also create problems in the sense that the reallocation of more capital in favor of the EMs actually create our problems.

And just in closing one caveat that I think the international community -- or note of caution -- the international community should be prepared for. According to this evidence, the pool of liquidity that was made available to emerging economies was very important in preventing financial distress and allowing for countercyclical policies. Now if the European crisis gets worse and the IMF is going to start committing a lot of resources in that crisis, I mean, let us pay attention to the fact that that may crowd out resources that were initially thought for emerging economies. And that if we enter into panic mode at a certain point during the European crisis, I mean, hopefully the international community will realize that these resources for emerging markets have to be there. And eventually it may require at least transitorily increasing even more the resources that the IMF and the MDB have at their disposal. Thank you.

MS. GRAHAM: Okay, thank you Ernesto and Alejandro for a wonderful presentation and a really good report. We're going to turn now to the presentation of the IMF report and then bunch the questions for both. So we have Nicolás Eyzaguirre and Steve Phillips presenting the Western Hemisphere, "Taking Advantage of Tailwinds."

Nicolás Eyzaguirre is director of the Western Hemisphere department at the Fund and prior to that was Minister of Finance of Chile. He's also been professor of economics at the University of Chile and director of economic studies at the Central Bank there among other things.

Steve Phillips is chief of regional studies at the International Monetary Fund, and he's been there since 1991 when he received his PhD. in economics from the University of California at Berkeley. And he's written on issues pertaining to IMF support of economic programs, in particular with regard to moral hazard, the Asian crisis, and the accuracy of program forecasts.

So with no further ado, I'll turn it over to the two of you, and then after that we'll have all four presenters up here at the podium and we can have questions and answers.

MR. PHILLIPS: Thanks, Carol, and thanks Steven and everyone for organizing this and inviting us.

I think Nicolás and I will take 10 minutes each. The good news is, is I think we agree on most points with our IDB colleagues, so I'll just try to briefly go through a few of the key messages from our reports and maybe emphasize a few subtle differences. And Nicolás will close then with some bigger picture remarks on the region but also on the global context and the challenges going forward.

Before I forget, before the question thing, I'd say the one nuance to mention that I think we might differ on a bit is -- and it's just a nuance -- is that how important the fundamentals were relative to the improvement in the lender-of-last-resort facility. I mean, we certainly welcome their message. It's very clear that the improvement in the international community's attitude with more access that that was a key, key difference. I just have one concern that maybe the fundamentals improvement that occurred in our region might have been a little bit understated, in particular say if the credit agency is a perfectly fine thing to look at. But I wonder if the credit agencies were getting it right in 1997 or 1998, whether the improvement from BB to BB+ really reflects all the improvements. My own take is just an intuition and I'll pass over it quickly is that

the credit agencies weren't looking hard enough at things like floating exchange rates, currency mismatches, the Greenspan-Guidotti rule. The information wasn't even available well enough for rating agencies to say look at a country like Korea and know what its foreign exchange position was. So I think basically there might be a mis-measurement of the improvement that's happened in countries' fundamentals around the world, especially in regime changes in Latin America. But it's just a thought to go on with.

I brought with us just a few slides on how we -- I need to -- Steven, how do I move to our presentation? I like theirs but I need ours. Press this? Okay. Again? Sorry. Okay. Thanks a lot. -- The global recovery we see in 2010 is what we're calling multi-speed, that's multi-speed around the world with contractions still in some parts of Europe and also in Venezuela, so with our region as well. But basically, we've got a multi-speed recovery and unbalanced global recovery going on. And within Latin America we've got countries such as Brazil and Peru, Uruguay, growing very fast, in fact they were growing quite fast before the crisis. So there's quite a bit of divergence within our region.

One thing, although the global economy -- the global recovery has been mixed and not the strongest, not the full rebound that you like to see, a V-shaped recovery in say the U.S., it's been strong enough to push commodity prices back to what are very high levels still. And this still holds even with the developments in the last six weeks. That's I think going to be an important message, that we don't really see what's happening in Europe and in the global economy, the global financial markets, in the last six weeks-two months as really changing what's most important for our region. But still it's a very favorable, external environment for our region in two particular areas: Easy external financing conditions still, I'll make that case, and historically high commodity prices which are good for most of our -- well, for our bigger countries especially. This is

to basically make the case that easy external financing conditions are here and are continuing.

This chart basically compares bond spreads around the world -- that's the overall end date in our Latin American five countries, LA5. So these are sort of the financially integrated countries, the countries with good credit ratings. It's basically the LA7 that you were mentioning, minus Argentina and Venezuela. We could have Uruguay in there, but it happens not to be in this particular chart. The message here is that it wasn't that so long ago in mid 2007 that spreads were at historic lows. And what was driving that was partly fundamentals, but this was around the world. This was mainly global risk aversion which is proxied by this VIX measure, the one in the green bars. So that was at an historical low level around 10 or 12 in mid 2007, and spreads were very low. Our average LA5 spread was only 100. Of course, the crisis came. It could have been worse. But the point is is that as recently as mid April spreads were back to very low levels. Now the question is, does what happen since about the end of middle April, this last segment here, does that undermine the case? Well, obviously spreads have gone up. But they're still, for our more strong countries, they're still around this 200 level mark. And keep in mind that's just the spread. What about the overall borrowing cost? Where is the U.S. 10 year bond which is important in your output regressions we saw from our IDB colleagues? Well, here's the answer. What's happened since we used this as sort of a -- we used April 26 as sort of right before Europe, you know, the turbulence really picked up. The VIX went up. What happened you see is that the U.S. 10 year bond, this yield went down substantially and, therefore, even though our countries' spreads increased in the last six or seven weeks -- and this is our favorite LA5, our strongest group -- their borrowing cost is essentially stable. No loss at all from that point of view, and in fact if we had just the last few days, it's be down even more. So this is still

what we call easy external financing conditions and that poses some challenges. Good news, of course, but just like high commodity prices are good news for most of our countries, it poses a lot of management challenges.

Now I don't have much time. I'll just say if you have a chance to look at our report -- and I did bring a couple of copies in Spanish and English; it's also available on our Web site for free -- if you look at it, you'll see that we basically look at the region in four analytical groups that are defined mainly not geographically, but by their exposure to certain kinds of shocks. So the more financially integrated countries are one group -- actually that's a subdivision of the countries that are commodity exporters -- then within the group of countries that are net commodity importers, we have those that are tourism intensive, and those that aren't. Well those -- it turns out that those external conditions, consistent with the message from the IDB, turn out to explain a lot in our region about risks and recent output performance.

And I won't have time to go into it, but I'll just say that you can see the differences here in the growth picture across our four groups of countries. So here you see that the countries who are affected differently in terms of output -- this is output -- in 2009 with the tourism intensive countries doing the worst, but they also have quite a bit of difference for 2010. Here we have the commodity exporting, financially integrated countries -- the ones I was just emphasizing on the left on the blue bar -- doing the best. And I have to say that when the new IMF forecasts are released in the first week of July, those numbers will be higher than they were. So we'll have instead of nearly 5 percent, it will be over 5 percent for that group. And I think you know why, it's that the latest data going back to Q1 and also -- first quarter -- and also some monthly data since then for countries, especially such as Brazil, are coming in very strong. So the growth outlook varies widely. Within that group it's important to mention that Brazil and Mexico, I guess,

are at quite different cyclical positions. So where we have Brazil, Peru, and Uruguay sort of closer to overheating than anybody else, Mexico is quite a bit below potential.

Back to our group of -- this is the financially integrated groups highlighted in this map -- they're back to this challenge of managing good times. And what we pointed out or basically the theme of our REO and where I'll stop today, is just what are the policy challenges when you've got easy external financing conditions and high commodity prices? Well, to look at that we did quite a bit of analysis that I'll just show summarized on these two charts. There's not time to go into the detail, but the point is that we focus on how domestic demand in our countries responds to these situations. So it's a little different from the idea that well, capital flows come in. They change the exchange rate. That hurts exporters, et cetera. That story has some validity, but what we really want to emphasize is how in our countries, domestic demand seems to be very sensitive to external financing conditions. We split that into two parts, the VIX is again as a proxy essentially for their spreads for the borrowing cost that's attributable to their spreads, and into what we call the international REO interest rate. And what we're trying to do here is to show in both cases that our countries' domestic demand responds positively when either the VIX -- the borrowing cost -- goes down, the spread goes down, or the international real interest rate goes down. Since we define the shocks as things going down, you see positive numbers here. So the point is the blue bars are showing how our countries react in terms of domestic demand growth, faster than their output growth, faster than their trend growth, how they react to those conditions compared to a control group.

Now just to do something different here, we've got the control group being not a bunch of Eastern European emerging markets, but we've got Australia, Canada, New Zealand, and Norway. These countries share a couple of things. They

share being commodity exporters as an important part of their economies and their exchange rate determination. And they have inflation-targeting, very flexible, exchange rate regimes to go along with that. Well, so do our countries to a degree, to a degree that's varied over time. We have to estimate these responses using a long sample period that includes times when our countries were not as flexible in their exchange rate policy as they have been in recent years. And we think that's one of the key reasons why our countries seem to have their domestic demand be so sensitive to these easy external financing conditions. There are other reasons that probably have to do it, liquidity restraints, many structural reasons, also the fiscal policy response which we -- there's another variable that gets controlled for them among other factors we just won't go into today. So there's a number of reasons, but one of our key candidates is we're still -- key suspects -- is that we still don't see our countries taking a sort of symmetric approach to exchange rate flexibility when they have times of capital inflows or what we prefer to call easy external financing conditions.

The policies that we want to emphasize, I think, to respond to manage these conditions may sound kind of standard, but we have a few twists. They're similar to the ones that were outlined in your report, but the thing I'll close with is to say that we really feel that the ability of a floating exchange rate, of letting the exchange rate appreciate especially in the early stages of capital inflows when the exchange rate might be close to where people think is a sort of normal level, but really letting it flexibly appreciate without trying to lean against the wind or manage it. We think that there's a big value to that in preventing credit booms, overheating of demand, inflation, bubbles, all those bad things. We think there's a big value to that flexibility, and we think it's underestimated or underappreciated. It's often overlooked and the countries can kind of

shoot themselves in the foot by jumping in too early to things like sterilized foreign exchange market intervention.

Of course, we also see a role for the monetary policy -- monetary fiscal policy mix -- especially it's fairly easy right now to argue, as our colleagues at IDB did, that having just come off massive or very large stimulus policies in 2009, the very natural thing to start with for our countries is to reverse those stimulus policies on the fiscal side first. That's a -- that'll help a lot with the capital inflows problem, and it will also help credibility. If you announce the temporary fiscal stimulus, it's important to remind people that it really is temporary.

Then the other hot area is a macro prudential regulation, and I think Nicolás will be speaking about that and some other global issues, but really creatively looking at financial regulation and recognizing that a floating exchange rate, fiscal tightening, all the standard prescriptions, are not going to give you perfect results. They're not going to be satisfied with it, and it's going to be important -- even if they did, it's going to be important to look at the financial system as it always is.

The last area is well, what about capital controls? What about sterilized foreign exchange market intervention? Well, I mention both of those together because in a way they're sort of things you might try when everything else has already been tried to the limit that you can do it. So it's easy to say, "Tighten fiscal policy," but perhaps you can't go as far as you'd like. It's easy to say, "Be flexible with the exchange rate." Perhaps you've already allowed it to move, appreciate very flexibly, to a range that everyone thinks is overshot, and yet still some crazy carry traders are not scared off by the appreciation that's gone on so far.

Well, certainly there is -- the IMF has taken a view to be very open to the idea of capital controls, and basically the spirit I think is that it's worth a try. We all know

there are limitations. We're not sure they're going to work, but we're certainly not sure they're not going to work. On the other hand what everybody seems to want to go to first is sterilized foreign exchange market intervention to fight the appreciation. And even that we can't say we rule out, but we really caution countries against taking that as the very first approach, to sort of prematurely jumping into that area. Of course, it does have the advantage of accumulating some reserves, and reserves are good for sudden stops, for resilience, et cetera. But we really don't think that the best way to accumulate reserves, the best way to establish a good external liquidity position, is by leaning against the wind in an ad hoc way, responding to capital inflows. It may happen, but that's not the best way to do it. Nicolás?

MR. EYZAGUIRRE: Well, thank you very much Steve. Well, since everything that is sort of solid economics and solid economic reasoning has already been said, I'm going to enjoy the luxury of going to science fiction.

First of all, I couldn't agree more with the IDB report as stressing the importance of external conditions. Well, we have known that in the region through the stop-and-go for awhile. Actually it's very, very important, and the importance of the lender-of-last-resort is just music to my ears. It's not that I just care more, I mean, a lot of people -- I remember my old times as a director in the Fund together with Stan Fischer who tried to convince the fundamentalists of the moral hassle thing, to do the CCL without success at all. It took really a major, major crisis to move them out of their comfort zone seats. And now that some of them are receiving the hard treatment of political capital flows, they are even more inclined to understand that there are things like innocent bystanders. So I fully agree, and I very much appreciate what you did, guys, in terms of providing a solid and empirical basis to show that did make a difference.

Of course, we cannot -- being IMF -- forget domestic policies matter a lot. And when Ernesto was talking and I said that smoking was irrelevant was just a joke because I am a heavy smoker. They asked us -- Steve emphasized we really detect a lot of difference in terms of the resilience of the countries depending on how solid domestic policies are. I remember vividly being Minister of Finance of Chile when Argentina was falling apart and markets were getting crazy about Latin America because they feared Lula, and the spreads were 1600 basis points. And we in Chile did have sort of very solid fundamentals, and we never were really put under question so even without lender-of-last-resort at that time. Domestic policies matter a lot but are necessary conditions, not sufficient conditions. And we have dramatically come to that conclusion even for the more sort of advanced economies like the European one.

Now that's the good part. What I'm not so sure I would sort of pick the same alternative scenarios the IDB people did because I do not -- we do not -- particularly see that there is major probability of China decelerating. All of our information is that they have still a wall of money, an ample ability to relocate money from the tradable sector to the non-tradable sector, from private to public, so we don't think that they're going to hit the wall anytime soon. There's no evidence of that. So the deceleration of China is not really a risk that we see as something very probable.

Furthermore, you seem to believe that this can be a bit politically incorrect, that more of our sort of linkage, trade linkage, between what China is doing and the U.S. economy. We -- our research models do not suggest that. This is not to say that what happens in China and the level it is generating in China and the savings rate in China is irrelevant for the U.S. and the exports and all that, but it's not a first order of importance. What really matters is what consumers do in this country, and that's very much to what I'm going to go to, that is financial conditions.

What really drives this economy, the U.S. economy, is financial conditions. We have a compulsive for that, and that's what we have to look at very carefully. They have been improving systematically, but have imitated a bit after the European thing so that's the crucial variable to watch. In other words, what my alternative scenario would be rather than a China slowdown would be to what extent what's going on in Europe is going to be short lived or not short lived, but more important than that whether it's going to have spillovers to the rest of the world and to this economy in particular or not. That's sort of the -- or what they call -- we will have a decoupling like Europe living its own saga and the rest of the world living happily thereafter or we'll have more contagion.

And some remarks on this. Trade linkages between Europe and the U.S., and trade linkages between China and the U.S., are not that big, not that big. And given the improvement in the underlying financial conditions, we are looking to a solid growth in the U.S. of around 3 percent for this year and the next one. What remains to be seen is to what extent if the European thing really gets out of hand we can have financial contagion. And we can have financial contagion basically through two channels. One is that the degree of risk aversion goes up so the relaxation of the lending conditions here -- I'm talking corporate bonds, small and medium enterprises -- all the credit channels could be affected. And that's one important thing, but the other one is that the connections between the European financial system and the American financial system may be more important than we know. The Administration has put forward a number of reforms that are in Congress now, and we hope after those reforms are passed probably the next crisis we won't be in the situation we are now. But the fact of the matter is that we do not know for sure how important is in the credit process in this country, the presence of European banks. So if really we have a Hell in Europe and a lot of

deleveraging, we'll be looking a bit to what would happen if Spanish banks have a lot of funding problems and what would happen to Mexico and Brazil because of (inaudible). But there are also big European banks in this country, and the institution is not immediate.

But there's another aspect of this, that given the regulatory empowerment that we do not know for sure, that it's the exposure of the U.S. financial system to Europe. We know the bulk of it, but we do not know all of it especially the exposures through OTC because that was not within the regulatory frameworks. So I guess the key variable to watch is where is this financial thing going to stop?

Now a couple -- four closing but important remarks, sort of error type one kind of thing. We have seen clearly that as the situation of Europe has worsened, some other markets have benefited because to some extent this is a -- as the IDB people were saying -- this is a matter of distribution of liquidity. So if some agents get more liquidity squeezed, necessarily for the given level of liquidity, some others are going to get less liquidity squeezed so we'll have more space. So one error -- and I am IMF so you could say this guy's going bananas -- but an error would be everybody rushing to the exit door in terms of fiscal conciliation because it's just a fallacy of composition. Not everybody can get liquidity squeezed at the same time. I mean in an environment of VIX going up, people are not going to run to stocks. Are they going to run to gold? It's too tiny. It's a small market. To land? Transaction costs. So you have seen (inaudible) are going down 80 basis points so the ones that have fiscal space should not run to the exit door. That would be a mistake.

Moreover, because if everybody's too conservative in terms of fiscal policy, the wait over monetary policy to avoid a double dip would increase, and the more you use monetary policy in the countries that are sluggish to get out of the cycle, the

more you're going to flood the countries like Switzerland but also Brazil and also Peru and also Indonesia. And the premise that Steve was talking about the difficulties of absorbing too much liquidity when you have a sort of better fundamentals for the time being are sometimes insurmountable. So that's not a cooperative world.

Okay, that's one. I'm not saying by that -- two minutes -- I'm not saying by that that the ones that already received the wake-up call from the markets in terms of fiscal space should not begin to do it yesterday. Of course, of course, as fast as they can. But the ones that are not receiving that wake-up call and quite the contrary that have been benefited should not rush to the exit door. I guess I have no -- this Administration in the U.S. is pretty much on the same page so I have no further elaboration on that.

Okay, what else? We have basic problem solved let's say coordination. What's going on really in Europe these days that is dangerous? It's not just sovereign risk. The thing is that given the lack of a good sort of comprehensive regulatory perimeter and authority, markets do not know which banks really do have the toxic paper. So the sovereign constraints are transforming themselves into liquidity constraints for banks, and the credit process is getting impaired. So we barely -- we desperately need that Europe does a stress test like the one that was done in this country. Why it's not done yet because in this country the stress test we're doing, but public money was provided to ensure that if you would find a big hole in this or this or this bank, public money was going to replenish those holes because if not, you just create a panic. That's not going on in Europe because there's no such a thing as that pool of funds, but those things are in the making. So coordination, it's not just the lender-of-last-resort, it's sometimes the ability to have funds that could be sort of displaced from this country to this country to fill the holes and to avoid a contagion.

I guess given that I have two minutes, whatever -- are we making enough progress -- this will take me 10 minutes so I won't do -- I guess for us Latin Americans it would be very important to keep very close the discussion in this country and others about regulatory reform. There's no doubt that legislation in Congress is making diligent progress in terms of correcting blind spots, expanding the regulatory perimeter, and requiring skin in the game to align the originators' incentives in the right direction. But I guess the crucial test would be to answer -- to ask ourselves if those reforms were in place, would still we be conscionable in terms of being sure that a mess in Europe would not spill over into a financial problem in the U.S. We have to see. Even it's in the details here that as we are seeing in this new world that is before us, the speed, the unpredictability of financial contagion, given the sometimes unsurmountable problems of information asymmetry in the financial system, is really calling for another level of coordination at the world level -- including through the lender of last resort, but sometimes also having some more sort of fiscal funds that can be moved around to avoid sort of "corner" solutions, where the liquidity gets too much shifted away, say, from Spain or others, and too much into Switzerland or Mexico or Brazil.

Finally, if you want me to make sort of a guesstimate, I do not think that the alternative scenario is one where we will be -- we Latin Americans are going to be liquidity-squeezed, or China would sort of decelerate so commodity markets are not going to be that great. I think that the name of the game in the coming years is going to be how, for the first time in our lives, are we going to cope with better fundamentals, and with extraordinarily positive financial conditions and commodity prices, without developing a full-blown -- I mean, a complete bubble, and afterwards, a full-blown crisis.

And conventional policies, fiscal, monetary and exchange rate -- as Steve was highlighting -- are badly needed at the realm of prudential regulations is

something that we have to explore much more. New Zealanders, others, are doing a lot of things in that regard. And I guess the research agenda should be heavily concentrated in those issues going forward.

Thank you.

(Applause)

MS. GRAHAM: So, I'd like to ask the other presenters to come up. And we have just 10 minutes for questions before turning to the next panel.

So -- Ernesto, Alejandro, Steve, would you mind coming up here?

We have time for just a few questions. Maybe what we can do is collect a couple, and then let the respective speakers take the relevant question.

S -- the gentleman right there? If you wouldn't mind standing up, and also just identifying yourself.

MR. BLACKMAN: My name is Courtney Blackman, and I was the Governor of the Central Bank of Barbados from '72 to -- to '87. I forgot now. That's a long time ago.

Through most of the -- as a matter of fact, after the '80s, when we had the counterrevolution against Keynes, which was spearheaded by Reagan and Mrs. Thatcher, the IMF effectively pursued the market fundamentalism, that paradigm.

Since we have two members from the IMF here, senior members here, can I ask you now, has the IMF accepted that that paradigm has failed? And what steps are they taking to reconstruct it, or replace it? Or are we going to pretend that it's still working?

MS. GRAHAM: I'd like to collect a couple questions, if we could, and then we'll give the members of the panel a chance to respond.

MR. SALASMORA: Eduardo de Salasmora, Georgetown University. I have a question, maybe it's Mr. Alejandro.

You mentioned -- well, I read just a few days interview with ex-President, former President Bachelet. And she mentioned that one of the successes during her term was these funds of the copper that allowed Chile to move forward in the (inaudible).

I would like to have a more explanation. I didn't understand well if how effective, really, this kind of funds are, were, in the crisis. And also, if you're taking account in the methodology these kind of specific conditions of some countries.

Thank you.

MS. GRAHAM: Why don't we take one more? There's a lady right there.

MS. RAJ: Hi, my name is Raj. And I'm a Ph.D. student and currently an intern at the IMF. I have a question for IDB.

So, basically, as you said, liquidity management or reserve accumulation is something that the countries should consider going forward. But if I've read correctly, that during this crisis a lot of Latin American countries did not use the reserves? Instead, they actually let the exchange rate take care of itself. And there was not much utilization of the entire stock of reserves that accumulated over the last five years.

And secondly, the swap lines that were provided by the Federal Reserve were also not used as much as, maybe, by South Korea.

So, in that sense, how would that fit into the discussion? That would be my question.

Thank you.

MS. GRAHAM: A last question? There.

MR. LLOYD: Good morning. My name is Ernest Lloyd. I'm from the University of Maryland.

Do you have any investments, or any Latin American country have heavy investments in human resource development? Because, in times of crisis, when all things fail such as machinery, money, and everything, people would still matter the most.

So how much are you Latin American countries investing with human resource development?

Thank you.

MS. GRAHAM: Okay. I think what we'll do is just -- I'd like to give each of the presenters a chance to respond to any of the questions that are relevant, and also to each other others' reports.

But please remember, we really have to start the next panel in the next 10 minutes. So -- be brief.

Do we want to start with Ernesto?

MR. TALVI: (Off mike) Let me start by simply addressing two or three points (inaudible) --

SPEAKER: We can't hear you.

SPEAKER: Mike.

MR. TALVI: -- how to make consistent the fact that you may want to accumulate reserves, and at the same time promote a more flexible exchange -- although the promotion for the flexible exchange rate is more on the IMF side, though basically we share part of the --

Many times these reserves were not used for exchange rate purposes. I mean, they're -- but, in terms of, of extreme illiquidity, they were used as a mechanism to provide direct credit to, for example, exporters, when trade tried up.

So the simple answer is they might be put to uses that are non-orthodox, and not necessarily related to intervention in the foreign exchange markets.

Now, as international arrangements are perfected, and access to an international liquidity or lender of last resort is made available, then the need to accumulate reserves, in principle, should diminish, as long as you have a predictable access to those other resources.

I just want to make only one more comment, just to give my -- I totally agree with Nicolás, fully, that the greatest challenge for Latin America is today how to cope with initial conditions that are fundamentally sound, together with very high commodity prices -- and, more importantly, massive inflows of capital.

We live in a very strange world. This is the most likely outcome, if the European crisis at some point doesn't go astray. And if you look at Europe as a collective entity, there should be nothing that should prevent the ECB and the European Union from solving this crisis without entering into panic.

But the problem is that this is a looser federation of nation-states, not of states. And something can go wrong -- as you've said, Nicolás -- in the coordination.

So two comments. One, I don't think that the problem is very complex, from the banking point of view, in the sense that these are plain vanilla, sovereign bond holdings. These are not very sophisticated instruments, and easily measurable. And the impact on the balance sheet of the banks is pretty easy to estimate.

So I think we have a huge problem, fiscal problem, in some countries in Europe that is not going to be resolved without a bailout. That's the bottom line. And whether implicit or explicit -- implicit, through ECB purchases of bonds of the countries that have problems.

But -- so if everything goes right, and no coordination failure has put us into panic mode, then I think that the scenario of our capital flow abundance is going to be the one we will have to deal with.

And the only concern I would put forth on the table is that when we analyze the policies of individual countries -- and this may be relevant for smaller countries -- we analyze them from the country perspective, but we are not taking a global perspective on the matter.

Let's assume, just for the sake of argument, that capital controls work perfectly, and that you prevent capital from flowing into the country. Then, in a world where you have de-leveraging in the private sector of the industrialized world, fiscal consolidation, I mean, it would be natural for that excess liquidity to flow into emerging economies, and that they will be collaborating in the global adjustment by reallocating demand from the industrial world into the developing world.

Now, if we block the system by preventing this capital from, let's say, successfully entering into the countries, then we would be contributing to a world recession, or a world -- even a world depression.

So systemically relevant countries such as China should bear part of the brunt of reallocating world demand towards emerging economies.

MS. GRAHAM: Alejandro, please be brief --

MR. IZQUIERDO: Yes.

MS. GRAHAM: -- because we're really running out of time.

MR. IZQUIERDO: Okay. As brief as I can. So, I'll tackle three questions.

First, the one about the copper fund -- I mean, I couldn't agree more. A couple years ago we produced a report that we called "All that Glitters May Not Be Gold for Latin America." And we were making exactly the point that external factors were so good in the region -- we had very high commodity prices, very low interest rates, and growth in the industry, that the region was growing faster than its long-term growth rate. But pretty much due to such strong external factors.

And the Chileans took that seriously, and they made the savings that were necessary during the good times to fight the crisis that came later on, and let them even do expansionary, and quite expansionary fiscal policies with no credibility problems whatsoever.

Regarding the human resource development question, multilaterals are aware of that, and I can give you a precise example about the IDB. The IDB was lending $7 billion before the crisis, and it increased its envelope to about $11 billion, just to keep those long-term programs afloat, even at the height of the crisis.

And I had a quick response to Stephen's remark about the use of credit ratings.

(Laughter)

No, I mean, it's a very valid question. I just wanted to mention that there is -- even though I'm not going to defend credit-rating agencies here, let me just say that there's a strong correlation between those ratings and variables that we typically use as fundamentals, as current account deficits, fiscal positions, and so on.

Thank you.

MS. GRAHAM: Thank you very much.

Nicolás?

MR. EYZAGUIRRE: I agree that, to some extent, the countries with the better position do have to absorb part of the world savings as Ernesto was saying -- and China among them.

That's what Steve said what is our line, that do not begin to counteract exchange-rate appreciation too soon, on top, because it's counterproductive. Because that creates gallery trade and other things.

But what you cannot -- and I'm sure you agree with me -- ask is the emerging world to do all the work. Because we're just going to drama -- you know? And the realm of political official degrees of maneuvering within fiscal and monetary in an exchange rate may not suffice. And so you will have a non-cooperative world, with a lot of trade restrictions, capital restrictions.

So as we need a lender of last resort for emerging markets, to avoid too much liquidity squeeze, maybe we need some kind of fiscal class lender of last resort for advanced economies that cannot get out of the woods, and try to over-rely on easing monetary conditions to get out.

MS. GRAHAM: Thank you.

Steve?

MR. PHILLIPS: Really quickly.

On the IMF's market fundamentalism, and whether we've -- I'd like to focus on whether we've changed over the years. But just interesting, because what we're advising right now. Let's take Keynesian economics.

If you looked at the what the IMF was advising last year, for advanced economies and for many developing economies, it was basically a textbook from 1932 or 1933. I mean, very large fiscal stimulus.

Was the IMF always doing that? Not so much. But what was different was that many of the countries for whom we might have liked to have recommended it, it just wasn't realistic. They didn't have the financing possibilities. They had incredible fiscal policies, and serious fiscal solvency problems. It just -- the shot wasn't on the board.

Financial regulation -- I think over the years the IMF has very continuously realized even more the importance of that. If there was a time when the IMF's idea of financial regulation was just to liberalize interest rates and say "everything will be fine after there's only one market interest rate," that time has been long gone. And all the efforts that IMF is leading or participating in right now to basically tighten -- you can call it many different things, but it all ends up in "tightening" -- financial regulation, really shows that there's no market fundamentalism. Everybody agrees that the financial

markets are fundamentally imperfect -- for information asymmetry reasons, just for starters.

Capital controls is an area where, again, the IMF has an extremely open mind.

And, finally, the big area where the IMF's changed, we -- it was emphasized by the IDB, the recognition that providing -- that there's international coordination problems that deserve huge liquidity responses for countries that have good fundamentals. Maybe the IMF was slow to come up with that, but one thing that's different is that the number of countries with good fundamentals that can really benefit from this kind of thing has increased over the years, too.

So I'd say the IMF has changed, along with the world.

MS. GRAHAM: So -- a good-news panel.

First of all, I'd like to thank all of our presenters for wonderful presentations -- and I'd say fairly optimistic view of a possibly choppy future.

So thank you very much.

(Applause)

And then I'd like to ask Guillermo Calvo, Nancy Lee and Mauricio CÁRDENAS to come up. We're going to have a panel discussion in the last half hour.

(Pause)

MS. GRAHAM: So, I'll keep my introductions brief. I think we're going to start with you. About six minutes, something like that.

So, Guillermo Calvo is professor of economics and international and public affairs, and Director of the program in Economic Policy Management at Columbia University. He has a very distinguished trajectory beyond that, but I'm, for the sake of time, just going to keep these introductions brief.

Nancy Lee is Deputy Assistant Secretary for the Western Hemisphere at the Department of Treasury.

And Mauricio Cárdenas is Senior Fellow and Director of our Latin America Initiative here.

Again, all of them have much longer and much more distinguished backgrounds than I can speak to now, but I'd rather give them time to speak.

So, with that, we'll turn it over to Guillermo. And if you could keep your remarks to about six minutes each.

MR. CALVO: Well, thank you very much for the invitation. This has been a lot of fun. I've been making notes, and I'll probably be very confused trying to read them.

I guess we opened up many key issues here that go beyond the Latin American experience. And I think it's worth starting, reminding us that we are looking at the crisis, where the financial market has not been working properly. In fact, it's the source of the problem.

And economists have not been trained about thinking in those terms. Those that study macroeconomics, normally the financial sector is something that fundamentally works. It's not a source of big trouble. We always talked about the Great Depression, only to say that we don't know what happened here. (Laughs)

So we are very confused now, too. But I think it's very important to keep our eyes on the financial issues.

And I welcome very much the discussion that we just got from the presenters. And let me just say a few words about that.

I think obviously there are these two factors about Latin America. They have done their homework, number one. That's very clear. Also, they got Latin

American emerging markets new support from -- and very quickly, I was surprised, the G20, how quickly they reacted to this. Because when you don't have a good theory, it's very hard to react in such a way. But they did. And actually, they started the foundations of mechanisms that look very much like lenders of last resort at the global level. So that's something very striking, I would say.

Now, is that enough?

I think Lehman is a very interesting episode, because it shows to me, at least, that that was not enough. That the decoupling -- we discuss a lot about decoupling of emerging markets after Lehman, but Lehman changed everything overnight. Very quickly. And countries that you would not suspect that they were going to be hit so badly, they did. I mean, Chile is a stellar performer in Latin America from many angles, and however, if you look at the sudden stop in domestic credit, it was one of the largest in Latin America.

When you think a little bit about it, then you realize that being integrated sometimes may be dangerous. I'm not saying that you should not be financially integrated, but in a world where the financial sector fails, you are at the eye of the storm all of a sudden.

So I don't want to concentrate on, or open up a discussion about Chile or Brazil, which also suffered from this. But just to indicate that for me, at least, the Lehman hiccup was very important. And the fact that they went out so quickly, I think is because the lenders of last resort in the north came back to the fight. And they quickly -- not only they said that they were going to give a very strong signal by bailing out AIG, that was not even a bank.

So I think that's an indication that we live in a period where the financial sector is at the center, and that the other big issue -- given that we don't have a lot of time, and I'd rather leave time for the others, and questions and answers from the floor.

But the other big issue that came up in the presentations, especially by Nicolás, is the concern of what to do with this excess liquidity that we have in some sectors of the global economy.

And I think there is wide agreement that we want that excess liquidity to be re-channeled, and it's good news that it will be re-channeled to developing countries. We've always been talking about that. This is a chance -- and I agree that if well-administered in Latin America, it could give us a shot in the arm for several years.

And so the question is how to do it. And I'm just coming from a meeting at the Latin American Regulatory Committee. It's a shadow committee. And the concern, when you look at the details, is how you're going to implement it. Because if it's going to happen, then the current account is going to widen. And we know that the wide current account is very fertile ground for a sudden stop.

So our countries are aware of that. So there is a tendency to stop the capital flow.

So in that regard, I think an idea that we started floating is that maybe the multilateral institutions and the financial institutions have a role to play here, and maybe we should go a little further and follow countries in the sense of -- for example, the FCL, the flexible credit line, could be adjusted counter- or pro-cyclically, whatever you want to call it, by maybe giving support to countries so they facilitate the adjustment that will have to take place. If the adjustment is big, it is very risky for individual countries to take it by themselves. They will have to perhaps accumulate lots of international reserves, and make it very costly.

So I think that's an idea that maybe we want to discuss.

I'll finish on a couple of things, too.

On the fiscal front, for Latin American in particular, I think there's little room except for countries like Chile, as shown in the IDB several reports.

But maybe we should think more deeply, or go back to some of the issues that I remember we discussed when I was at IDB, with the Fund, on PPP -- private-public partnerships. It's very tricky, I know. But we seem to be moving to a regime now where the private sector is taking the backseat, and the public sector is borrowing and investing, perhaps -- taking a bigger role in that dimension.

And I think maybe that's a way to go. Some of us may not like it, but that's better than not using savings, otherwise you fall into a Keynesian trap.

So if that is going to be the case, then I see a role for institutions like the IDB and the World Bank to help out in countries, to recycle those funds by procedures that are stable, and hopefully free of corruption.

And maybe we should think -- another issue that I remember when I was here that we discussed a lot is how to measure fiscal deficit. Should we include investment or not, for example. So if it is done -- of course, we don't want -- it's a very tricky issue, because once you open the door, then everything becomes investment. We know that.

But that's precisely why a very close collaboration between multilaterals and the countries that make those investments, credible, bone fide investment, maybe that's something that we have to think more seriously now. Because the funds have to be re-channeled.

MS. GRAHAM: Thank you, Guillermo.

Nancy?

MS. LEE: Thanks very much. This has really been an incredibly interesting discussion.

I don't want to prolong it unduly, but -- so what I'll do is just focus on drawing out a little bit the question of what all this means for reform of the international financial institutions -- the IMF on the one hand, and the multilateral development banks.

And also, I just want to say a word about this question that is actually at the center of the G20 discussion right now, which is re-balancing global growth, which several have mentioned already.

I am actually deeply grateful to Ernesto and Alejandro for doing their very careful empirical analysis, because I have actually been asserting what their conclusion has been for about a year now -- that the role of the FCL and the other IMF reforms has been transformative in terms of the ability of this region to recover from the crisis.

I had a much less sophisticated empirical analysis. Basically, I just looked at spreads, emerging market spreads, particularly for this region, and noticed that if you look at April 2009, particularly April 1, 2009, you see, after Mexico announced its intention to seek an FCL, a steep drop in spreads, a very steep drop in spreads, after they had been sort of perking along at a fairly high level.

And I think that there's a real indication that markets thereafter viewed emerging market risk in a really, a fundamentally different way -- particularly emerging markets with sound policies. I think the combination of tripling the size of the financing capacity of the IMF, plus the FCL, plus its brother or sister facility called the HAPA -- the High Access Precautionary Arrangement -- basically created an insurance policy for countries with decent policies, so that they didn't have to rely solely on self-insurance in the context of reserves.

Let me just make two more points about this.

First, this is a tool -- these tools, these precautionary insurance tools, are particularly beneficial for this region. In fact, they have been taken up disproportionately by this region. Because this region went into this crisis with smaller macroeconomic imbalances, lower debt levels, particularly external debt levels, and were not -- and this is not true of all the economies in the region, but for the LAC-5 that we've been talking about, they didn't need gap-filling finance. What they needed, it was precautionary finance.

So I think these innovations have had a particular benefit for Latin America. Europe is really in a very difficult -- different -- difficult and different situation with respect to the need for IMF financing.

The second point I'll make is that there was another thing that happened in April 2009 which I think received a whole lot less attention. Which is part of the G20 announcement, or communiqué in April -- so let me just quote, in case you missed this particular sentence in the G20 communiqué. "In the context of the current crisis, consistent with the IMF's mandate, we back the case-by-case of IMF resources to support the fiscal needs of countries with solid, medium-term fiscal prospects."

So the additional innovation and flexible element that's quite important is the fact that there is less now of this, of a rigid line drawn between balance of payments and budget finance in cases where there is basic fiscal sustainability, and in cases where that line is pretty arbitrary.

So far, for this region there has not been a large budgetary element to the finance provided by the IMF, on either a precautionary or actual basis. But it certainly has -- there has been a big budget component to the finance provided to Europe. And over time, it may well prove useful to countries in the region, maybe the smaller countries of the region, to have the capacity to use the IMF as a budget-crisis response tool.

That brings us swiftly to the role of the multilateral development banks, which are generally viewed as the providers of budget support.

We very much supported a very aggressive and rapid ramping up of the financing from the World Bank and the IDB. By 2009, approvals had reached something like $14 or $15 billion for both institutions, up sharply from much lower levels prior to the crisis.

A lot of that finance was investment finance, and the actual emergency response tools weren't really taken up very substantially by the countries of the region. So I don't think we view those institutions as very good at being lenders of last resort. We, instead, very much agree with the points in Ernesto's and Alejandro's paper that these banks are much more suited to the question of the long-term growth potential, the poverty reduction performance, the inequality reduction performance.

And then that also brings us to another very important study the IDB just released, which is on productivity in the region. It's called "The Age of Productivity." I commend it to all of you.

And it has some very useful estimates about productivity performance. And they're pretty disturbing for the most part.

And in particular, the thing that I learned which I had not really realized is that productivity performance for Latin America in the services sector is lagging very substantially behind that of East Asia, for example. And in Latin America, as in other emerging markets, 60 percent of the labor force is employed in services. So this is a fundamental productivity issue.

We just go finished with a long and sometimes intense set of negotiations on a capital increase for the IDB. Of course, the United States, for the large share of that institution, will furnish 30 percent of that 70 percent increase in capital. And

I'm pleased that the reforms that we agreed on in that process -- and particularly the priorities that we set -- map pretty closely with the kinds of issues that are identified in the IDB productivity report as critical issues: the very high transport costs of the region, which are impeding trade very dramatically -- much more substantially than trade barriers at this point; the education and innovation issues; the lack of access to finance, particularly for small businesses.

So, we're very intent on seeing those reforms go forward.

One final point. This is actually a region which recovered, began recovering in 2009 in a fairly balanced way. The initial spur to recovery in the major countries of Latin America was domestic demand. It was actually not net exports. I think Mexico is an important exception to that. So it is, in fact, showing the growth in domestic demand that we need to see in the global economy in order to sustain recovery.

As you know, there is a conversation happening now in the G20 about this question of how to sustain recovery, how to strengthen it. And there is, of course, a strong view among a number of countries that the surplus countries have to have -- have to play their role -- and I think this was mentioned by Nicolás and, I think, Ernesto -- in terms of creating enough domestic demand to help sustain the recovery.

So I think this region has a very strong stake in that discussion, in this question of a kind of global collective action to ensure that there is enough domestic demand, and particularly from countries that are surplus countries. We cannot have the U.S. continue to be the consumer of last resort for the world. Although as Nicolás said, our economy is mostly led by consumption trends.

So this is something where I think the United States and other countries in the region share a strong interest with respect to the rest of the world.

Thanks.

MS. GRAHAM: Thank you.

Mauricio, you have the last word.

MR. CÁRDENAS: Thank you, Carol.

Well, it's been really great to read these two reports. As I was saying in introduction, the two reports are really complementary in a way. And also, you know, great input for our own discussion and debate on the economic outlook of Latin America. And we could go, you know, on and on for hours, and speak about them and all the details and the topics that they covered.

But let me focus on a few of them in these six minutes, and try to make some comments.

I think these two reports essentially deal with three types of questions. One is explaining what happened, like right before and after the Lehman crisis.

Two, explaining what's happening today.

And three, discussing how to prepare for the future.

I see the IDB report a little bit more focuses on the initial question -- why did some countries in the region respond better to the global crisis than others? -- with a very compelling response. Which is the difference is whether you have access or not to an international lender of last resort. I think that's a very interesting answer. It is a very important conclusion. It does give a lot of support to the idea of improving the facilities that we have today. It puts the center and the focus of attention here in Washington, and in the multilaterals.

But it is important also to discuss a little bit more how Ernesto and Alejandro reached that conclusion. Because I think that's not the only answer that has been given so far. It is a very good answer, it's a good approach, but there are other potential explanations.

One is what Steve mentioned in his comments, which is whether differences in the fundamentals went beyond differences in the credit ratings -- which is their control variable. Where there were other aspects. There was a question in the audience about destabilization funds, for example. And I think those issues are very important, and they were not necessarily captured by the credit ratings.

Another explanation -- which I actually heard here at Brookings the other day by Olivier Blanchard and co-authors -- is that, really, the countries that handled the crisis better were the countries that had less short-term external debt. That it was not a matter of how much your trading partners were growing. It was not much about how much reserves you had accumulated. It was basically the old type of explanation that it's how much you needed to rollover, in terms of your debt. And I think that's another competing explanation which is quite interesting.

So I think in the refining -- because I'm sure this is not going to be only paper by the co-authors, and by, you know, people in the profession about this topic. In refining this explanation, I think we have to in some way make sure that we put this hypothesis to compete with other potential explanations and make sure that, at the end of the day, we get the conclusion that it's the international lender of last resort -- once we also control for these other potential explanations.

Now, one interesting aspect about the international lender of last resort is that in the way they have it in their paper, it's a dummy variable on whether you had access or not. Think of a regression where the dependent variable is what happens with your spreads 60 days after the Lehman crisis, and the explanatory variables are your initial ratings, plus this dummy on whether you had a lender of last resort or not.

And that dummy takes a value of "1," not just in the case of the countries that were -- where resources were made by the IMF through the different lines, especially

the FCL, not just the countries that had access to the swap lines from the U.S. Federal Reserve. But also countries that had access to swap agreements with central banks, like the Central Bank of China.

So, for example, Argentina, which had access to a central bank line from the Bank of China, would have a value of “1" in that dummy variable.

So one, I guess, interesting extension of this work is to see whether it matters who is this lender of last resort. Whether there are differences in credibility, I think that will have an impact also, in terms of the way we design these things in the future, and whether the IMF plays a differentiated role, say, relative to other providers of resources and liquidity.

So that’s one question regarding the conclusion -- which I agree, it’s a very compelling explanation, and a very interesting one.

Now, on explaining what’s happening today, which was more like the focus of the presentation that Steve made, I’d say that these are confusing times. And I think it’s a difficult time for economic authorities in the countries, in the region. Because on the one hand, the key words are “we have overheating in Latin America.” Our economies or many of the economies in the region are growing above potential. There are some inflationary pressures. So, you know, it is, of course -- there is some pressure for responding to that overheating, and that’s what we’re seeing today with the central banks raising interest rates.

So now the game, in terms of the analysts that follow the region, is who’s predicting, by how much the central banks are going to increase interest rates, and how fast. And, you know, we’ve seen increase in interest rates in Brazil, in Mexico and Chile and Peru. There are other countries that will follow. And I think in the next meetings of the boards of the central banks we’ll see more of that.

But at the same time we have this overheating and inflationary pressures, we have a debate in the world about the possibility of a double-dip, and the possibility that the crisis in Europe creates another bump, and that at the end of the day, we go into a new recession.

And I think to add to the complexity of these -- of the current situation, there are risks in China. I tend to agree with what Nicolás said, which is basically a more optimistic view of China, that they still have a lot of fire power to respond in the event of a deceleration. But at the end of the day, China is not immune to lack of growth in the international market. China is -- we all hear about the possibility of a bubble, and they need to curb credit expansion. So, you know, it's not a certain thing that China will continue to grow at 10 percent.

So it's a complex and difficult situation.

Now, what to do in that context? I would say that there are two ways of going.

One is essentially what the governments in the region are doing, which is basically phasing out fiscal stimulus, and basically reversing monetary expansion so that their countries are ready for -- basically, in a position that if it's needed in the future, they can implement a new set of countercyclical policies.

But, also, it is true that there is a concrete and very direct expression of this environment, which is the pressure towards the appreciation of the currencies. And the response of the governments to that situation will -- it's something that will be very important from the point of view of future economic growth.

And I see, in that aspect, in that area, along with the point that was made by Nancy at the very end, the need in the region to -- as has already been done by the governor of the Central Bank of Brazil -- to join forces with the U.S., in terms of putting

pressure on China on exchange-rate issues. Because the problem with the appreciation of the currencies in Latin America, it's not that they're appreciating. I mean, when you have such an amount of capital inflows coming, it's only natural. But the problem is that the currencies of Latin America are appreciating, whereas the Chinese renminbi is not appreciating.

So that, to me, means that there is a need for more coordinated action. And, of course, the natural place to do that is the upcoming G20 meetings, where the countries of Latin America should take a stronger position in these, together with the U.S. Treasury.

And finally, let me just mention -- I was thinking of bringing today, but I guess the format is not the best to do that. We'll do it some other time -- we've been constructing here at Brookings some indexes of recoveries. Some of them were already published for the G20 countries in the *Financial Times*. But we're doing it for the LAC-7, the largest seven economies of Latin America.

Basically, the idea is to look at the principal components of the key, real sector, financial sector and confidence variables, to build an index of recovery for each one of these economies, and for the region as a whole. And based on the co-movements between these variable -- the variables include, basically, the usual suspects, like industrial production, exports, imports, GDP growth, the consumer and the business confidence surveys, the stock prices, the market capitalization, the MB spreads. All those variables that basically shape economic fluctuations.

And what we're getting from those principal components is that the economies in the region left, basically, the crisis behind. That's one thing that is already well known -- but that there is a lot of differentiation between the countries in the region.

And if you had questions a year ago on the usefulness of these classifications that the IMF has on countries in the region, between the primary exporters, the

ones that are financially integrated and the ones that are not financially integrated, the primary importers, the ones that depend on tourism -- those differentiations were not that clear about a year ago, when countries were in the middle of the recession.

Now it seems that there is a lot of differentiation. I mean, I wouldn't call them the primary -- the primary exporters are not financially integrated. Basically, Venezuela and Argentina, they are not doing well, and they're not doing well for reasons that perhaps not only have to do with the degree with financial integration, they have to do with, you know, issues related to the protection of property rights, governance issues. But we're seeing a lot of differentiation. That's one aspect.

And the other aspect is that within all these components of these real sector, financial sector, confidence measures, the one where the recovery has been the fastest, and where you're already back at the levels you were at the previous peak, it's in the financial sector variables. It's in the area of stock prices, market capitalization, MB spreads -- the variables that are in that area.

So that to me -- and with this, I'll conclude -- to me suggests that these current expansions and the overheating we're seeing is pretty much led by financial variables. And that is always a source of concern. That always should be a source of concern, because we know how fast these things can change, and how easy we have the reversals. Something worse happens in Europe, and therefore these countries have to be able to respond to a change in conditions very, very fast.

That's why I insist on the point of creating more fiscal space and, of course, monetary space as well, to be able to respond in the future to a change in conditions.

And let me just -- and I'll finish up. I promise I'll finish with this last remark.

Let me take a point that also was made by Nancy, which is, at the end of the day, what is remarkable about Latin America, it's not that Latin America is growing again, that it was able to respond well to this crisis, the recent crisis. But what I think is even more remarkable is how low the potential GDP growth is. That once you start growing at a rate with about 4 of 4-1/2 percent, you start seeing all these pressures, so you need to start, you know, stepping on the brakes to make sure that -- to cool down the economy.

So we have to worry more about potential GDP growth. We have to worry more about investment. We have to worry more about making sure that we capitalize this current economic context to basically move forward in terms of reducing some of these structural constraints on economic growth.

And that, to me, is very related to the question of increasing investment rates, and allowing these countries to run slightly higher current account deficits, and therefore accumulating a little bit less of international reserves in the next round of the world economy.

Yes -- I'll finish there. Thank you.

MS. GRAHAM: All right.

Okay, well thank you very much to our panelists. We're already over time.

So if we've got one, or possibly two, questions, then I'll give a last sentence to each of the panelists.

And, if not -- I think we may have tired everybody out.

Does anyone on the panel want to respond to anything else? Or -- Guillermo?

MR. CALVO: I don't know if it is a response, it's a plea.

Stop badgering China. China has increased -- the fiscal stimulus in China is the largest, by far. The exchange rate in China, what do you want to do with that? I mean, the competitiveness in certain sectors, in order to balance that, the exchange rate would have to take a big change.

And there are all kinds of problems. It's an economy with sticky wages. I think it's very dangerous. I don't think the exchange rate is the key to solve a financial -- or global imbalances.

The U.S. is already on its way to solve the balance, if they were to balance their fiscal accounts. The private sector has a current-account surplus of almost 4 percent, or around 4 percent of GDP. So if you stop the fiscal deficit, you can right away reverse the condition.

So I sympathize a lot with what you're saying, because from the point of view of Latin America, it's something that really hurts. But when you look at the big picture -- I mean, they've been doing their homework for us.

On policy, one issue that I think we touched, but I would emphasize, is that we have to think very seriously in Latin America now whether we want to pursue inflation targeting with one interest rate just looking at inflation. Should we also be concerned if monetary aggregates -- if credit is something that we have to put an eye on? Should we follow anti-cyclical credit policies?

Those issues, which was not for this panel to answer, but I think I will put that on the table.

And, finally, the issue of floating exchange rates that has become, here in Washington, something that you say, and everybody seems to agree -- it's like when you go to church, and these are the things that everybody sitting there does not question. And now we are not questioning floating exchange rates.

So how come the Fed is giving this enormous currency swap to the ECB? If the exchange rate does the work, why do you need to give dollars to the ECB? Lots of dollars. I understand that you give dollars to Brazil for the sudden stop problem. Was it because of the sudden stop? I doubt it.

So, floating exchange rate, I don't disagree with the idea. But obviously, I think, we are finding limitations to that. And there could be excessive floating where the financial issues that we have been discussing could get worse.

I mean, Latin America, they can't make the situation worse -- especially for countries that have liability realization. Now, we know that.

So, I'm not against it, but let's tone it down.

Thank you.

MS. GRAHAM: Mauricio, you have one -- 30 seconds.

MR. CÁRDENAS: Yes -- I couldn't agree more on the idea of the -- say, the general equilibrium consideration on the exchange rate of the renminbi. Yes, I think there are, you know, many ways -- many things you have to do, many things that have to happen to restore global finances, which are not just a change in the exchange rate.

So my comment was more on like the partial equilibrium, if you want, with regard to Latin America -- which is, when you look at the sectors that are growing in Latin America, interestingly are mining, or basically natural resources. And in some

countries there are construction. Manufacturing is not growing very fast, except for a couple of countries, particular Mexico.

And I was just reading one of the reports put by the banks in New York about Mexico, and about the region. An interesting thing is that Mexico's manufacturing output is growing very fast because of exports of manufactures. And exports of manufactures are growing because Mexico not only increased its exports to the U.S. and restored its market share in the U.S., but it's because Mexico is taking some of the market share that Germany had, Spain had, in the U.S. And I think this related to changes in the exchange rate.

So, in a way, the issue of the Chinese exchange rate is important in that limited context. That's why I think it's of interest for the region to join forces, not because I think that that would be a solution to global imbalances -- in which I agree with Guillermo.

MS. LEE: I have a sentence.

MS. GRAHAM: Yes? Take a sentence.

MS. LEE: I'm sorry. It's going to be three sentences.

Okay, I was focused -- with respect to global re-balancing; I was focused on domestic demand. I didn't use the word "exchange rate," actually. And the issue now is to prevent what happened prior to the crisis re-occurring. And there is a finite risk of that, which is -- it's surplus countries. If the balance of their growth is shifted too far to export-led growth, we would see the same kinds of patterns reemerge.

We know the globe has to adjust because the U.S. has to adjust. So there has to be more of a balance between domestic demand and export-led growth in surplus countries. And I am -- you know, I think China is moving in that direction. But I

think that's a good thing that they're moving in that direction, because it's really, it's really critical.

With respect to the swap with the ECB, I would just refer back to the points that Nicolás was making with respect to the European financial system. There is a need for access to dollar liquidity. And there are some risks there. And I think it's prudent for that swap facility to be in place.

Thanks.

MS. GRAHAM: So, we're concluding with a little more debate than we started. But that's, I think, the sign of a good session.

Thank you to all our panelists for both sessions -- and particularly now to this last panel.

And all to-be-continued, as we watch the next stages in the international economy unfold.

Thank you for coming.

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