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THE IMF'S OUTLOOK FOR LATIN AMERICA AND THE
CARIBBEAN: STRONGER FUNDAMENTAL PAYOFF

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PROCEEDINGS

MR. CÁRDENAS: Good afternoon, I am Mauricio Cárdenas, Director of the Latin America Initiative here at Brookings. I have the great pleasure of introducing and moderating today's panel, and as it is already becoming a tradition here at Brookings, we will be discussing today the latest regional economic outlook which, as you know, is a publication that the IMF puts together every six months right after the world economic outlook, to look at the Latin America economies in more detail.

The latest of these issues was published a few weeks ago. It has been already presented in some countries in Latin America, and now is being launched in Washington. For that purpose, we have Nicolás Eyzaguirre, who is the Director of the Western Hemisphere Department at the IMF. Nicolás was also Minister of Finance of Chile for six years between 2000 and 2006. Many of the things that we now praise Chile for doing in an exemplary way, as for example, the way in which the country has managed its fiscal policies, are the result of his work as Minister.

Next we have Steve Phillips, who is the Chief of the Regional Studies Division at the IMF. He is the person responsible for putting together this report, and as so, he will present its results.. Steve is a close friend, he's a colleague of mine from U.C. Berkeley, and has been at the

IMF since 1991 working in different capacities, but mostly related to countries in the Western Hemisphere.

As discussants for the panel we have two very dear friends and colleagues, Liliana Rojas-Suarez, who is a Senior Fellow at the Center for Global Development and is also the Chair of the Latin American Shadow Financial Regulatory Committee that basically holds permanent meetings and discussions, both in the U.S. and in Latin America, about regulatory financial issues. I should say that very soon she is going to be presenting a book on growth in Latin America that I know first hand is a remarkable work.

Last, we have Carlos Vegh, who is Professor of Economics at the University of Maryland. Prior to that, he was at the University of California in L.A. He is a very distinguished scholar on the issues that are treated in this report, particularly those related to the management of official policies. Many of his papers have been very influential in helping us understand what are the major constraints for running contra-cyclical policies in developing countries.

I think we will start with a brief introduction from Nicolás, followed by a representation from Steve that will take the first half an hour of the session. Afterwards, we are going to the panel.

So let me now turn to Nicolás and then to Steve.

Thank you again for coming and being here today.

MR. EYZAGUIRRE: Well, thank you very much, Mauricio. Thank you, everybody, for coming today. To be assigned to do a short introduction is sort of impossible. With that in mind, the purpose of this discussion is to share with you key ideas and findings of our new Regional Economic Outlook.

First of all, one of the key messages of our new Regional Economic Outlook is that a relatively hopeful outlook for growth will soon return to the Latin America region. More concretely, this means that we expect Latin America to do better than advanced economies. What is more important, we expect Latin America to recover earlier than advanced economies. And in relation to its own past record in relative terms to the rest of the world, we expect Latin America to do much better than it has in the past.

We do not believe its good luck. This has been an earned outcome and the payoff -- let's put it that way -- of policy steps taken prior to the crisis. Those preemptive measures in our view were decisive, and as I will elaborate, they helped countries to protect from external shocks and to prevent what has been the typical patten of the domestic amplification of shock. Moreover, preparedness has created some space for countries to actively fight the shock with contra-cyclical policies.

The second message is that Latin America is not immune to

external conditions. External development did matter very much for Latin American countries. Therefore any outlook of the region needs to consider conditions external to the region,, notably financial conditions, generally speaking, and in the U.S. in particular.

Overall, we are starting to have a more positive view of the very uncertain environment that Latin America will be facing. As you know, we have been marking down growth for the world and for Latin America for many months, and our recent world economic outlook released just one month ago has a baseline scenario with very gradual improvement of financial conditions worldwide, particularly the U.S. financial condition. We expect growth in the U.S. and advanced economies to begin early next year. So the baseline scenario was for the advanced economies to bottom out at the beginning of 2010.

But the balance of risks looks like it has shifted, and now the risks are outside of our baseline scenario. The good news is that on the financial side, with improvement at the U.S. epicenter, things have been going better than anticipated one or two months ago.

[This is] good news for Latin America Even though the high yield market spreads have narrowed, it has spilled over emerging markets and credited cold swaps very rapidly. Yet, it seems that those margins have been reduced substantially more recently. It will be fairly good news for

Latin America if it leads to better growth performance in the U.S. since we can, obviously, expect better conditions in terms of the real linkages of our economies to the more mature ones.

I am going to argue about the issue, of revising our baseline scenario for 2009. The IMF was way more pessimistic than consensus for 2009. We have not moved downwards, but consensus has moved downwards faster than we have, so the consensus is pretty much that the recovery is expected to begin in 2010.

Why are we so cautious in our language, considering that stock market spreads at every sort of financial bio you can look at are improving more recently? Because we believe that U.S. bank stress tests have provided information confirming the reduction of tail risks, [...] it is less likely that we will have negative surprises further down the road. We pretty much know how bad the situation is, so that puts a floor to another bout of instability and deleverage.

And as I was saying, the market seems to be discarding tail risks and there is more confidence that systemic risks faced are passing by. However, I have to be careful on this respect because there are three things you have to keep in mind to understand what was done in terms of the stress test.

One is the very good and amazing amount of information that

it provided in terms of how vulnerable bank balance sheets are to downside scenarios. Now, the stress tests were a bit below the baseline of the IMF, but were stressful enough. But that is one part, and from that you sort of do a lot of calculations about how much losses would be in the securities side and how much losses could ensue in the credit side of the bank balance sheets.

Second, there are two other parts of information that are crucial. The first one is where we have more doubts. and this relates to the profile of income that banks will have down the road to absorb those losses. We must confess that we were much less sanguine than the administration in terms of the profile of income that banks are likely to have, say, in four, five, or six quarters down the road. We believe the good numbers that have been released to the markets do have somewhat of a transitory effect on that, and as the real economy will continue to squeeze corporations and as defaults will continue to take a toll on bank balance sheets, we have some reservations in terms of whether that income profile is not a bit optimistic. To the ones that do not follow this closely, the capital needs for the major banks is the result of three-element equations: 1st, the stress test and therefore the losses are calculated; 2nd, the income that is going to cover those losses; and 3rd, what would be the required capital ratios after the capital index. As I was saying, though the stress tests were reliable, the income

flows down the road are still a bit optimistic in our view. Paul Krugman put it very nicely, it looks like the economy is going to get the banks out of the woods., This is contrary to our view that banks and the credit close would help the real economy. Notwithstanding, we still need to see whether those income figures are too optimistic.

And third, is whether the market's are going to be feeling confident enough with the ratios, the capital ratios, especially common equity to assets, that the administration is asking. So we are in a position where we cannot disregard absolutely that negative news down the road could still produced some skepticism in the market in terms of the capacity of banks to really resume lending. And if that is the situation, some part of the revival that we are seeing today could get sort of impaired.

To summarize of the main driving force, this economy we believe now is on the upside. National conditions have improved much faster than we thought, but we cannot rule out completely some setbacks because there are key assumptions that are not that robust.

The issues pending are: the public debt, what is going to be the potential growth of the U.S. economy after this crisis, and, of course, the open of the rebalancing of world demand.

To finish, I am going to say a couple of things about Latin America before Steve Phillips delves much more into that. As I was saying,

our forecast for the region is negative for the year, but recovering soon.. We see from data that the Latin America economy may be bottoming out as we speak. Clearly, that's the case of countries like Brazil, Chile, Peru, and some others. We expect Colombia in some months to bottom out as well.

This differs dramatically from the historical pattern. With any crisis you pick, the 80's crisis, the Asian crisis, the Dot.Com crisis, you will see that we fared worst than the world as a whole, and much more than the advanced countries. This time around it is not the case.

Why is that? Basically three points: First and most important the one is no banking crisis. Foreign banks in Latin America financed their portfolios with domestic deposits and not with cross-border lending. Foreign banks in Eastern Europe financed themselves, their credit allocation in those countries with cross-border lending as we used to in the '70s, in the '80s and in the '90s. This time around it was not that is the case.

What happened? What we economists that believe in contagion have been saying for centuries: The cross-border lending, although small, and that was the critical thing, reversed completely in Latin America in [inaudible], but the domestic, the directed deposit base, stayed in the country. So the stress on banks' funding was mild.

Second, no fiscal crises exist. Most countries and the more important ones did save somewhat during the windfall years, so they have

much more space.

Third, and very important, there is much more exchange rate flexibility. The inflation has decreased in sharp contrast with the Asian crisis, the dot.com crisis, or the '82 crisis, in which we do not see this awful pattern of interest rates going up trying to defend the pegs . Now we see quite the contrary. We see exchange rates going up, and interest rates going down, both helping the economy to recover.

Last but not least is the drop in commodity prices and that is a bit part of the good luck run and really good policies. Just remember that at the beginning of the 2000s when the dot.com crisis came, for instance, copper was in 60 cents and now it is in \$2-and something. Oil was in \$15 and now it is in \$60. Hence the industries that have taken the biggest hit are the ones that are more into manufacturing than into commodities.

So a bit of good luck, a bit of good preparedness. We really believe that if what we have seen in the financial markets in this country remains so, we are already bottoming out and the region should begin to grow on average next year. We see also that coinage prices may go up if the world economy goes up, and there will be sort of a tension between maybe better coinage prices that we believe the mature economies -- Japan, Europe, and the United States -- are most likely going to grow less in the outer years after this crisis.

Thank you very much.

MR. CÁRDENAS: Thank you, Nicolás.

(Applause)

So now we will have Steve.

MR. PHILLIPS: Thanks, Mauricio. ,I will go through some of the numbers on some of the key results from our Regional Economic Outlook publication that you have been able to pick up outside.

If I go too fast, or if the charts are too small, rest assured that everything I'm going to show you now is in your souvenir copy. So moving right along, this chart shows how important the manufacturing linkages were in the big drop during the fourth quarter of 2008.

So if you are like me, you might not have thought that countries for example, Brazil would be known as a big manufacturing country. If you could see clearly the little dots here, it shows that there is quite a striking relationship between a share of manufacturing in GDP in the fourth quarter output performance. And countries like Brazil and Mexico are about in the middle of that. So they are not in the same position as Singapore or various Asian countries, but they are certainly hit hard, and we think that is an important part of why their output was quite miserable in the fourth quarter.

But, as Nicolás mentioned, at least in Brazil we already see a

turning point, and that's sort of a natural cyclical rebound you'd expect to see. I think Nicolás covered some of these points: I just wanted to highlight one here about the terms of trade. We all know that the commodity prices fell dramatically, but just from a very brief peak in 2008, and what this chart is showing is for various groups of commodity exporters. Still the terms of trade have declined, but it is still no worse than it was, in 2005. So it is not the worst shock we have seen there.

Of course, it does hit a few countries -- Venezuela, Ecuador, the ones that are very intensive in oil productions -- extremely hard, and you can see that here. Much talk has been about the reduction of public debt in Latin America during this decade. This chart is to illustrate that, but maybe I will move on to the next one which shows a little bit of our analysis that compares how different countries in the Latin American region did, in terms of saving resources -- or governments, how did they do in terms of saving resources from the commodity boom years.

And here you see quite a bit of difference. As you can see in the chart, the countries below the line there, as Colombia, Chile, and Peru, in particular, showed a small sensitivity of their government expenditure to a given amount of shock to the government revenue income. And this is sort of the reward for countries that had the credibility to earn from saving. As we see here, the governments -- quite a few governments in the region --

were in a position to provide a strong fiscal stimulus. So not only to allow automatic stabilizers to work but to actually pick up government spending faster than the rate of trend output growth to try to give a demand boost to the economy.

We see countries that were able to have better saving records, including Costa Rica, Chile, Colombia, and Mexico at one end of the chart, but, unfortunately others have had, as we can see on the other end of the chart, to cut expenditures quite sharply this year, despite the demand impact in a downturn time, because they basically did not accumulate a large pool of liquidity to cushion them.

This is pointing out how the countries have been able to implement countercyclical monetary policies. So, as Nicolás mentioned, instead of hiking interest rates they are able to cut interest rates and taking advantage of the exchange rate and of greater exchange rate flexibility. The great thing about this is that their gamble has not been a gamble. It has paid off. The countries that thought they had the room to cut interest rates and let the exchange rate float are still keeping inflation under control, so it has been quite a success. Inflation is coming down and, in fact, inflation expectations never got as high as actual inflation last year.

The next chart is about the delinking of countries' external financing costs, how in the past the external bonds some of our stronger

countries in the region, moved closely with the U.S. high yield index, and so which went off the chart, and if you could see it on the right, after the laymen event. But, fortunately, by now these countries have been linked up with the U.S. investment grade index; in fact, they're actually outperforming it in the last six months.

This next chart highlights one of our econometric exercises where we attempted to see how the resilience of the Latin American economies had changed over time, and what it attempts to do is to look at a couple of different external shocks -- the world demand, external financing conditions and commodity prices -- and sort of measure the average effect of shock, negative shocks, to those factors on growth in the region. What we see here is that the negative effects are still there. You cannot escape them, but they have been much reduced. You see a kind of metric evidence of reduced sensitivity to external shocks of output.

Nicolás mentioned some of the key points about the banking systems in the region, their lack of exposure to toxic assets, one especially, the big difference with respect to Eastern Europe. I think six months ago many people knew that foreign banks were very big in Latin America, but I don't think everyone understood how different their role is in Latin America than it was in Eastern Europe, and so if you have a chance to look at chapter 4 of the Regional Economic Outlook, it goes into this in quite a bit

of detail. And what I have here is basically a number of charts illustrating some of the points that Nicolás mentioned.

The foreign-owned banks are basically funding themselves within the country and funding themselves in the local currency, therefore, extending credit in the local currency. What you see on the left of this chart is just very dramatic differences between the Latin American countries in terms of the current exposure of their borrowing from internationally active banks compared to other regions, especially Eastern Europe.

And here just another way of looking at it showing that, yes, there is cross-border lending, but it's a very small part of the Latin American financial scene. Latin America is on the left, and you see that this kind of lending, the sort of more dangerous or more sensitive kind, is a very small share of, in relation to GDP in Latin America, and no surprise it is very high on the right side when we look at Eastern Europe, and with Asia in between.

So that kind of lending is there, it is vulnerable, and it did get cut back sharply in the fourth quarter, but it was not that important in the first place. And this is the reward called the difference in action: it shows the two types of foreign banks' lending or extending credit to Latin America. The one in the red line is the one that's not so important, fortunately, because that is the one that crashed in the fourth quarter of 2008 as it did in Latin America and it did elsewhere in the world, but the more robust funding that comes

from the local affiliates and the local currency is moderated.. No crash, and that's what was important.

MR. PHILLIPS: Thank you.

MR. CÁRDENAS: Thank you.

(Applause)

So now we'll move to Liliana.

MS. ROJAS-SUAREZ: Thank you Mauricio for the invitation to Brookings and to the IMF, of course. I will make only two points.

The first one is that I want to congratulate the authors. The report got the key issues right. For example, the channels of transmission for the crisis are very well presented, and, as we know by now, there were two channels, one was financial, and the other one was commercial. From the financial side, we observe an increase in the cost of credit and the reduction of the availability of foreign trade. And from the commercial side, you have both a price and a quantity effect. We observe deterioration at the first rate and a decrease in the global demand for Latin American exports.

The only comment in this view, which I like and support, is that I do not fully and totally understand why there is a potential for still a farther decrease in global demands for Latin American exports coming from a possible farther deterioration of the world's economy. As Nicolás was explaining, how suddenly we go back and say, all right, but even if that

happens, Latin America is going to recover faster. That is the part that I get lost a bit. It is like going back to the decoupling theory.

The other comment, still within my point No. 1 on the issues the report got right is that clearly the relative resilience that we have observed in the region is related to policy choices made before the crisis. And I could say that if somebody tells me, okay, choose one, not being the strengthening in regulatory capacity of the banking sector, but something that the region did that has held immensely, I would choose the adoption of dirty floating exchange rate regime in the consummate politics of inflation parity.

Now, why is this so important? Because in this, for the first time in the presence of an aggressive external shock, the countries have been able to depreciate their currencies. This is unprecedented in a number of decades because in the past when an external shock happened, the countries were defending an overvalued exchange rate, and so they had to increase the rate to defend that exchange rate. This time around they did not have that constraint.

So why is it so important? For two reasons:

First, they were able, as the president of the IMF has said, they have allowed for contra-cyclical monetary policies. The interest rate has been coming down, allowing for the implementation of contracyclical

monetary policies.

But the other reason is that this time around Latin America did not use money and foreign exchange reserves to fight the stipulations against the currency. Latin America was really well known for being a one-side-bet region. This time around and in contrast to all the regions in the world the region basically was on the same grounds with Wall Street. You want to attack my currency? Go ahead and let's see if you are going to win this case. And people realized that the constraint of the exchange rate was not there.

Now, my second point related to the report is that it makes a very important effort to discuss the effects of the financial integration of financial banks, and I like that very much because it is true.

First of all, Latin America is the most financially open region in the developing world, and the table that I have here is a measure -- that after the industrial countries, the most liberalized capital account -- in other words, the jury opened financial markets -- the most financially open region in the world is Latin America. This is very important because Latin America chose to play within the constraints of the international capital market in contrast to many other regions.

This graph is a very interesting graph that shows the loans from international banks to Latin America. The blue line shows the loans

from international banks to the public sector, and the red line whether it is excluding loans to the public sector. The basic point here is how much went to the public sector during the 1990s. But if you look at the recent years, you can see that most of the loans from foreign banks go to the private sector. Therefore,, financial liberalization has been hand in hand with an increased participation of the private sector. That has broadened its opportunities, but, of course, it also entails risks and challenges. The report also says that financial liberalization have been accompanied with an increase in the maturity of loans. This is the proportion of loans coming from foreign banks that are of a duration of one year or less. If we look at the decline, we can see that Latin America has also been able to expand. It is not only improved taxes, but also the terms and conditions.

In the paper that I am currently working with the Inter-American Development Bank, we have studied precisely issues that are therewith in Chapter 4 or 5 of this report. We ask a number of questions, but I am going to focus on two questions here: How the financial integration has been affecting the behavior of domestic credit in Latin America? And how do foreign banks acting in Latin America behave differently than domestic banks? The paper, which will be available very soon, have many responses, but I amm going to focus only on the behavior on domestic credit.

Now, let me tell you some of the conclusions that I believe were interesting. One is that financial integration actually reduces the pro-cyclicality between domestic real credit growth and economic growth. So when you're facing a reduction in domestic activity, a more financial integrated banking system can actually get funding from abroad and substitute for lack of funding locally. However -- and this is what we find most interesting -- in the presence of an external financial shock like a change or an increase, let's say, in the spread of the U.S. high yield bonds, greater financial integration exacerbates the effect of the shock on the supply of domestic credit. So it is interesting. It has pro-cyclicality while at the same time it exacerbates a negative effect coming from abroad.

What about foreign banks? The foreign banks behave differently than local banks. The answer depends with respect to what. We found that with respect to pro-cyclicality, meaning if there is a change in economic activity, there is no difference: foreign banks and local banks in Latin America behave the same. However, in the presence of an external financial shock, again such as an increase in the U.S. high yield spread or a financial shock, the regression analysis confirms that foreign banks tend to adjust credit more than domestic banks, and this is quite compatible with a casual observation in both Mexico and Brazil.

So I didn't notice that the regressions that were done in that

chapter were for the late experience from 1998 to 2008 when there was no banking crisis. At the same time there was practically no economic contraction. But if there were going to be an economic contraction, then the behavior of foreign bank is different, so different that the analysis shows the foreign banks adjusted credit growth between 15 and 30 percent more than the adjustment by domestic banks.

So what to conclude from that; which way it goes? Well, the lesson is that we need to call for additional policies to minimize the amplifying effect of foreign banks, not to prevent foreign banks from acting, because as I just showed, it actually held many issues including pro-cyclicality, including improving terms, and many other things.

Then there is a number of new measures that some countries are applying but not all of them Among the ones that are applying the measures are Peru and Chile. Instruments such as ring fencing mechanisms that satisfy the assets of the [inaudible] its parent company, in cases of deep problems in the parent house. Again, casual evidence shows that both in Brazil and Mexico there has been movement of flows from the branches to the parent house. It's casual evidence, we don't have numbers.

Other mechanisms that we should be thinking are early warning mechanisms that prevent the transfer of resources from the foreign branch to its parent company. Imagine a credit card mechanism that

basically watch for irregular transactions. That is exactly what it will be doing, a mechanism that allows to see whether the movements from the branch to the parent house does not follow irregular behavior.

To conclude, I want to say a quick comment on the Letter of Agreement with foreign supervisors. You would think that this is very easy. No, it is not. One of the most difficult things is to get a letter of agreement between a supervisor in a Latin American country and a supervisor in an industrial countries. I think this is the issue that we should get deeper and,

So I learned a lot from the report and, you know, I congratulate the authors for as well.

MR. CÁRDENAS: Thank you, Liliana.

(Applause)

We now move to Charlie's presentation.

MR. VEGH: So I am very happy to be here, so thank you, Mauricio, for having me. This is actually a very nice report and I really enjoyed reading it.

Let me basically focus on two points, and both points have to do with fiscal policy. So the first point that I am going to take issue [with] here is this idea of new [inaudible] applied to the cyclical behavior of fiscal policy. I will argue that when it comes to the "pro-cyclicality" of fiscal policy,

the new luck is not really that much different from the old luck.

So my first comment when it comes to fiscal policy is how much it has really changed.

And then the second point that I am going to touch on here which I think is the issue that the report did not have a chance to go deeper into it, is the issue of the size of the fiscal commodity buyers. I mean, utterly, if we are discussing the pros and cons of fiscal expansion, we need to have an idea of how much bang for the buck. So that is going to be my first point.

Now let me give you a 60-second picture of what I call the old luck. So the old luck was highly pro-cyclical, right, so this is a chart that I love to show. This is later from 1962 to 2003. This is the correlation between the cyclical components of G. The output there in yellow bars denote the developing countries; the black bars denote all emerging countries. As you can see, by and large, all the developing countries have a pro-cyclical fiscal policy in terms of government spending, and, of course, all of Latin America is on the right side except for Colombia and then Jamaica. And to me this pro-cyclicality of fiscal policy that also applies to tax rates for the countries that we do have data for is one of the biggest macroeconomic mistakes that Latin America has made over the last 30-40 years because it is simply going to amplify and exacerbate an already very political [inaudible]. And further I believe that inability to save in good times has been at the root of bad times

becoming a crisis, because if you are actually not saving in good times, and then you have to save in bad times to sort of satisfy some inter-temporal fiscal constraint, there is a big chance that you are going to transform a simple recession into a big crisis.

So now let me show you the, presumably, new luck. As you can see, here where we are comparing the high-risk export of the pre-2000 with post-2000, you can see that, by and large, the countries that happened to be positioned like Argentina, Mexico, Peru, are, if anything, more pro-cyclical than the two bright stars in Latin America, typically Chile and Colombia. In some sense it becomes less contra-cyclical than before.

And this, of course, is nothing peculiar to Latin America or to the Luck- 7. As you can see in these figures, it is also true that if you compute the cyclical relations for developing countries or for emerging countries, all these countries have become more pro-cyclical in the last 10 years than before as opposed to the G-7 countries that if anything have become contra-cyclical.

So even though the report is careful in making the point that there is a lot of heterogeneity across the region, of course, my point will be that if you look at the (inaudible) in Latin American countries, there is not such new fiscal policy; it is basically what it used to be before.

I am moving to the second point. Here the big issue when you

try to estimate a fiscal multiplier is, simply to understand what is the response of output to a 10 percent increase in AG . And what I want you to focus is on the comparison between the G-7 countries and the Luck-7. And the picture for Luck-7 will be very similar if you do it for developing countries and all of Latin America.

And here notice that for the high-income countries the main thing is that not only there is some impact on output but that the impact is very persistent to the point that after six years there is still some fiscal expansion. If we compare this, we see a very drastic difference with the Luck-7. With the Luck-7 after basically four quarters, meaning almost a year, all the effect is gone, and after that, the output falls, it falls below its initial (inaudible).

And, of course, we conjectured that this has to do with the fiscal expansion in the U.S. For instance, people know that the U.S. Treasury is going to be able to sell all the T-bills that it wants, and that is okay, at least for the foreseeable future. If you do the same expansion in any Latin American country, they are going to be issues raised right away concerning their financing and sustainability. Therefore, if anything, even in the long run there is some crowding out of the private sector.

So you have already not too much bang for the buck, and even less if you are open and have a general flexibility. In here what we did

was to divide a sample of developing countries into regimes with some flexibility, and more fixed regimes. This include regimes with some sort of flexible rates and you can see that if you are a flexible country, your cumulative multiplier is below zero. So basically you have no benefit whatsoever. And then, if you're open, you can see that a cumulative multiplier is also negative, point 4, as opposed to if you're close to 1. The message here is that if you are an emerging country and you are open and have some rate flexibility, in the long run, fiscal expansion is completely ineffective.

Based on this, we would obviously conclude that we do not see much room for contra-cyclical fiscal policy, but still, we need to understand the fact that there has been a precarious financial position right now from most Latin American governments, in the sense that they have not been completely short of capital market, but have only been able to borrow at very high premiums. And a shorter maturity than before calls for the higher math, [which] is helping. I think that this recent flexible credit line that I understand both Mexico and Colombia have already begin to tap is, of course, a very good thing on the part of the Fund.

If you look a little bit more at what may be the lessons drawn when the crisis hits, the die has already been cast. There is nothing that you can do really in terms of policy because all casts already been done....

From a very long-run healthy macroeconomic policy, I think that the key question -- and this is my last point -- the real question is how can the IMF push for more fiscal saving in good times?

This I think, is a very crucial question because, obviously, when Latin American countries are in good times, they have no incentive whatsoever to even talk to the facts, right? It is very hard for the Fund to even get in important people on the phone because, obviously, they are having some very good times, so they have no incentive to talk to the Fund, so how can the Fund devise mechanisms that would tie the help in bad times to how you behave in good times.

I think that if one could establish a precondition for helping in bad times, the fact that you, for instance, on the fiscal front, follow a policy such that you are going to save in a sunny day for a rainy day, it could be one way of solving this incentive problem.

Thank you.

MR. CÁRDENAS: Thank you, "Charlie." Thank you very much.

(Applause)

MR. CÁRDENAS: We only have 10 minutes, and I would very much like to ask you for comments and questions. I think this is a very thought-provoking session. There are many, many issues, and I am very

appreciative of the fact that the two discussants have very complimentary remarks.

So let's open up for questions.

MR. (Inaudible): A question for Mr. Eyzaguirre. Which countries do you see pulling out quicker from the recession or from the crisis in Latin America? I mean what would you say are the hot spots and maybe the laggards? And I would like to hear your response to the question that Liliana made about this issue of why Latin America is going to pull out earlier than everybody else, if other countries do not want to buy their exports, at least in developed countries. I mean what is that strength that is pulling the region up? Thank you.

MR. CÁRDENAS: Let me collect a few before I give the floor to the panel again. Nora?

MS. NORA Lustig: Thank you very much. A question for Liliana and another for Carlos.

Latin America is very open, financially, as you showed, but something is different that protected it from getting involved in things that have hurt other regions. In the financial regulation, I was wondering whether you can identify which aspects of financial regulation have been keyed to help this protection.

And to Carlos, and I was surprised about your data on Mexico.

Mexico has this balanced budget law that was passed a few years ago, and so how can it be having such a pro-cyclical behavior.

MR. CÁRDENAS: All right. Then you had a question, too, sir.

MR. (Inaudible): I am (inaudible). A comment and a question on fiscal policy. We have to distinguish between specific and global fiscal expansion, so those multipliers are probably a mixture of a different kind of experiment, and in the limits when everybody expanded fiscal stance, there is no leakage in an open economic context, so that, I think, is an important thing to keep in mind.

And also, the kind of expansion that has been particularly useful is quasi-fiscal type of responses whereby reserved, but using all sort of supportive things like extending credit where credit was drying up or specific kind of credit – such as, microcredit .

Last, if one thinks forward as the Fund, we could think of putting in place a reserve accumulation. And my understanding is that this is one dimension in which the region has some experience. If we look at reserve accumulation and we look, like, huge in nominal deterrence, -- but, for example, normalized one, too, you see that it did not do that much of an improvement.

Perhaps, one lesson learned is that the monetary policy-framers should have built in bias toward increasing saving and

reserves for using in bad times to do the kind of things that Carlos has in mind.

MR. CÁRDENAS: All right. Any other comment? Question? If not, I'll make just a quick point.

I read this report with all of interest, as always, and found that much of the analyses is in the right direction. Let me just say that one point that is at the intersection between what both Carlos and Liliana said is the private sector. If you look at it from the fiscal perspective, it is the crowding out effect; if you look at it from the financial perspective, it is a sector that has received much of the external borrowing that could potentially be more affected by a reduction in lending.

And I think one aspect that we have not worried enough this time around is the private sector. There were some news in late 2008 resulting from the exposures to currency derivatives, especially in Mexico and Brazil, and the central banks were fast in responding to that. There were many losses in a few corporations, but the key issue now to me is that the corporate sector in Latin America is going to need this year at least \$150 billion to refinance its obligations. And \$150 billion is a lot of money, especially when the markets have been essentially closed for the corporate world. So this is posing some questions that we need to understand better.

I think we need to have better data-- on the one hand, in terms

of what is happening to the balance sheets of the private sector; but also we need to know more about what is going to happen if by the end of the year, or during the second semester, these corporations are not able to refinance their obligations, and they are going to go to the central banks and the ministries of finance to look for these resources. Moreover, this is the major risk that we have to assess, because you have to combine that with the fact that governments are introducing the stimulus packages and, if these two things result in fewer resources to the private sector domestically, then we could have very negative effects in terms of investment in the region.

So that is one area which I think it is very important to highlight because that's where I see the major risks.

And, finally, there is a whole section of this report which has not been talked about much. Liliana alluded to it, which is the issue of the compliance with [inaudible]. And I think that what you get out of reading that chapter is that many of the Latin America banks are not complying, at least when you compared them with the OECD countries. That is a way for the IMF to talk about the medium-term challenges and the agenda in terms of financial reform, essentially supervision and regulation.

But I think that is a difficult issue because it is somewhat based on this perception that the regulations and revision in the OECD countries are superior when the evidence that we have today is that, if

anything, most of the problems of these crises started from financial institutions in the developed world. So that is why I think that advancing that agenda before we have a better idea of what the financial reform will look like in the developed world is going to be difficult.

So these are two points that I wanted to raise, and now let me turn back to Nicolás for some responses, and then I will give the floor back again to the panelists.

MR. EYZAGUIRRE: Okay, thank you, Mauricio.

Liliana is right in the sense that it looks a bit odd to forecast what is going to happen with Latin America in the sense of rebounding sooner, so she asks what if the industrial countries do not rebound next year, how do you know that? So that it is like a variable in T depending on a variable in T-plus-1. Well, at that aggregation, it sounds like illogical, but what was behind the forecast of the advanced countries, is that given the type of financial conditions, especially in the U.S., the fiscal multipliers, plus monetary policy were going to come to rescue or to stop the free-fall but would not suffice to give positive growth before 2010. At the same time those financial conditions were going to ease through North American this summer.

So giving the monetary policy, the fiscal policy, and financial conditions getting better during this summer, that would spill over into Latin

America, given that Latin America has not a banking crisis and in turn, this will allow the Latin American region to start growing. Put it differently, if the U.S. stops the free-fall and prevents further deleverage and financial stress over Latin America, this coupled with better conditions in terms of coinage prices and flexible fiscal policy should be enough to get Latin America moving.

Now, of course, if financial conditions in this country do not get better during the summer, the region will not begin to grow during this year. But what we have seen is that those financial conditions have improved more, so we still believe that countries are going to rebound during this year.

What are the countries more favored? The ones probably having more clear rules-based macroeconomic policies that allow them to let the exchange rate go without consequences because they have inflation targeted in regimes and you have seen, –inflation is coming down, but interest rates are coming down as well. The countries that are better-equipped at least to do some contra-cyclical fiscal policies are probably Peru, Chile, Colombia, and Brazil, among others.

Mexico is more troubled because of its linkage to the United States, and as you saw today, the figures for [inaudible] were awful. Some others that did not save during good times will depend very much on whether

coinage prices go up sooner or not. If they don't, they will run into trouble

In response to Carlos Vegh's comments, it is very important to have the possibility to accommodate contra-cyclical fiscal policies that stimulate saving with time. To achieve this you can do two things. It is important to save, but it is also important to save in hard currency because most Latin American commodities -- currencies are sort of commodity currencies like [inaudible] and the Canadian dollar. So it is a very positive thing because when crises hit, you will have your savings in hard currency -- that is, the one that is going to become scarce at that time -- so on the one hand you have reserves, but at the same time you have softened the constraint on the fiscal side and the [inaudible] side. That is what Chile did and it has helped them to be extremely contra-cyclical this time around.

However, in this beautiful picture, the most vulnerable sector in some countries is the corporate sector. Banks were not terribly exposed to corporate lending, and, on average, given the BAS data, we do not have massive cross-border lending to countries, not therefore to corporations. But if [anything, it was concentrated on corporations. It is not terribly high when you compare the level of corporate indebtedness to corporate lending with the ones you see in East Europe, for instance. But is sometimes something to watch close, especially because, although at the macro level it is not a terribly different and difficult thing, some companies are very

over-indebted. And you were mentioning some companies in Brazil and in Mexico where short in foreign currency is speculating in the derivatives, and they took a big toll when the currency depreciated.

So there is some corporate vulnerability to cross-border lending, not very significant at the macro level but could be significant for some companies.

MR. CÁRDENAS: All right, thank you.

MR. CÁRDENAS: Unless -- well, then I want to thank first of all Steve and Nicolás for coming and sharing the report with us, and Liliana and Carlos for very great and thoughtful comments, and all of you for coming to Brookings this afternoon.

Thank you very much.

(Applause)

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