

THE BROOKINGS INSTITUTION

LATIN AMERICA'S MACROECONOMIC OUTLOOK
IN THE GLOBAL CONTEXT: BRIGHT FUTURE OR DÉJÀ VU ALL
OVER AGAIN?

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P R O C E E D I N G S

MR. DERVIŞ: Good morning, everybody. Thank you very much for being with us and it's a great, great pleasure to have our guests with us. We have four leaders, four economists who know the region extremely well, who are very active in it, and so I'm really grateful on behalf of Brookings that they agreed to join us here in a conversation this morning. We have Jose Juan Ruiz Gomez, who is the Chief Economist and the Manager of the Research Department at the Inter-American Development Bank. He was also in the private sector Director of Strategy and Chief Economist of the Latin America division of Banco Santander and held many positions in the Spanish government in economy, finance, and commerce, and '91 to '93, he was Undersecretary of International Economy and Competition and Chairman of the Economic Policy Committee of the European Union.

The topic today is Latin America, not Europe, still it tends -- there is some interaction. And he is a regular contributor to *El Pais*, which, as you know, is the major Spanish newspaper. I, unfortunately, don't speak Spanish, but once in a while I try to read *El Pais* and can understand about one-third of it.

We have Augusto de la Torre, who's the Chief Economist for Latin American and the Caribbean at the World Bank where he has had many senior positions. Before, he was head of the Central Bank of Ecuador and before that he was at the IMF in various positions, including resident representative in Venezuela. So, Augusto, you went from the IMF to the Central Bank to the World Bank.

And we have Alejandro Werner, Director, Western Hemisphere Department of the IMF since just January, so he's quite new in this position, distinguished career in public and private sectors as well as academia. He was Undersecretary of

Finance and Public Credit in Mexico. He was an economic professor at the Instituto de Empresa in Madrid and he was also head of corporate and investment banking at BBVA-Bancomer, which is another one of the big international banks.

And finally, we have our own Ernesto Talvi, who joined us some months ago, who is now the Director of the Brookings-CERES Economic and Social Policy Initiative in Latin America, which is a joint venture between CERES, the think tank where he has been chief economist and leading the economic work for many years, and the Brookings Global and Economy Program focusing on economic and social policy issues in Latin America. He was and is visiting professor at Columbia University, was a special advisor to the Inter-American Development Bank research department on global, regional, macroeconomic, and financial affairs, and he also held positions at the Central Bank of Uruguay and at the IMF.

So, this is a wonderful panel. Again, thank you very much for being with us. We were discussing with Ernesto the other day in terms of, you know, the size of Latin America in the world economy. It's about -- close to 8 percent of world GDP at market prices. Compare it to about 20 U.S., 12 China, and then the European Union, roughly 25. So, in a sense, when one looks at the big sets of economies, it is the fourth major group of countries, group of economies in terms of market price GDP.

It's a continent, as you know -- most of you, I'm sure, know the history of Latin America, has had some very good years some decades ago and some very tough years, particularly when Paul Volcker decided to kill American inflation, but at the same time, he raised interest rates so high that emerging countries that were borrowing at variable rates were hit very hard.

And it has been doing well overall with a lot of diversity, of course, it's a

very diverse group of countries, over the last decade, as have other emerging market economies, and I think one of the key issues is, you know, will this much better performance continue, what have been the causes, what are some of the obstacles, how does the world economy impact on Latin America and the Caribbean and vice versa. We're living in a very interdependent world but still with a lot of diverse performance.

So, without saying much more, I will turn to our first panelist to ask Ernesto to introduce the topic, tell us a little bit about his work, and then we will go to our three guests. Ernesto.

MR. TALVI: Thank you very much, Kemal.

MR. DERVIŞ: And I have to say, I'm going to intervene after nine minutes, so every one of us -- so that we can have more of a conversation.

MR. TALVI: Well, good morning. Thank you all for being here. When we were discussing with Kemal about organizing this event, we thought it could become a classic and we should name it after the dust settles. After the IDB annual meetings, after the IMF-World Bank spring meetings, after the three Washington institutions have produced their macroeconomic reports on Latin America backed by an impressive (inaudible), I might say, we thought it would be a good idea to organize a panel discussion taking advantage of this formidable knowledge being produced yearly while adding our own microeconomic report, this one coming from the academic think tank community and through the partnership between Brookings and CERES, with a view from the trenches, I mean, filmed on location, as they say in Hollywood.

So, in fact, what we will be presenting today are some of the key ideas that will be forthcoming in the Brookings-CERES Latin America macroeconomic outlook from a global perspective.

Just a few additional words to thank very specially the three outstanding economists and very good friends, Jose Juan, Augusto, Alejandro, for being here with us in this panel. This is the first official event of ESPLA, the Brookings-CERES Economic and Social Policy in Latin America Initiative. I would also like to thank very specially Kemal Dervis, a true gentleman and the director of the Global Economy and Development Program at Brookings, and the global Brookings team, for their unconditional support, for putting their best efforts into ensuring the success of this noble partnership, and last, but not least, I would like to thank the CERES support team in Montevideo.

So, let us start off, now the nine minutes, Kemal, start to kick.

First, Latin America's growth is cooling off and it's doing so sharply. If we contrast the rate of growth of the 6 percent the region displayed during what I like to call the golden years, 2004-2008, pre Lehman crisis years, and compare them with the projected growth for the 2012-2013, which is around 3.7 percent, then there is a 3 percentage points below the growth rates of the golden years. And moreover, with very few exceptions, every country in the region, and in some cases, very significantly, the growth rates are cooling off relative to the golden years, 2004-2008.

Now, the cooling off has occurred in spite of the fact that external conditions for the region are slightly more favorable today than they were during the golden years. And this assertion might come a little bit as a surprise, but if we take a close look at the key external drivers of Latin America's growth rates, that we identified in a model that we developed with my colleagues, Alejandro Izquierdo and Randall Romero at the IDB in 2006, a model that, by the way, does a very good job in tracking growth rates in Latin America, the picture that emerges is the following: first, although global

growth, G7 plus China has declined from an average of 3.8 percent in 2004-2008 to 3 percent currently. Nonetheless, commodity prices are still 40 percent above today than they were during the golden years, emerging market bond yields are around 5 percent, they are 2.5 percentage points below what they were on average during the golden years and below the minimums achieved during the golden years. And capital inflows at 217 billion a year, are higher than the maximum level achieved during the golden years and three times the average of that period.

So, in fact, if we use the model I just described to simulate future performance, under current external conditions and the conditions prevailing during the golden years, 2004-2008, the model yields consistently higher growth rates and output levels under current conditions. So, that means that the current combo of external conditions with lower growth, but with higher commodity prices and lower costs of capital and borrowing are, overall, more favorable than those prevailing during the golden years.

So, how can we explain the very substantive cooling off in economic activity in a context in which external conditions, at an average, even better than those prevailing in a period in which we grew 3 percentage points more than we are doing now? And the answer is, that during the golden years, external conditions improved significantly relative to the preceding period, '98 to 2003, but current conditions, although still very favorable, have ceased to improve.

Let me give you some numbers: global growth in 2004-2008, on average, was increased from -- relative to '98 to 2003 increased from 3 percent to 3.8 percent. Commodity prices rose by 75 percent, on average, and emerging market bond yields declined from 13.5 percent to 7.5 percent.

Now, as I said, current conditions are still very favorable, but they have

ceased to improve, and this is a very important observation. Since improvements in key external drivers have (inaudible) effects, not growth effects. The impact on growth of an improvement in external conditions will dissipate over time. Therefore, the cooling off that we are seeing today is the natural and predictable outcome of external conditions that remain very favorable for the region, even more favorable than those of the golden years, but that have ceased to improve and therefore the effect is fading away.

This is important when we (inaudible) and interpret current performance in Latin America, because it is not the case that the region is doing relatively well in a more hostile external environment, but rather the region is growing, again, at mediocre rates in spite of the fact that the external environment remains, overall, very favorable. In other words, unless we anticipate external conditions will improve significantly relative to current levels, the observed slow down in growth rates is not an oddity that will go away any time soon, but will be part of the landscape even if external conditions remain favorable.

Now, we want to ask the question whether idiosyncratic factors in Latin America are playing a role in mitigating or contributing to the cooling off set in motion by the dynamics of external factors. And after many years of very high growth, well above the regional historical average, it may well be the case -- and we have a lot of casual evidence of that that we can talk about -- that production possibilities are being exhausted in a region where there are symptoms that improvements in the physical and technological infrastructure in human capital and productivity have not kept up with the strong output growth performance of the last decade.

For this reason, among the multiple relevant idiosyncratic factors, we focus, in the forthcoming report, in identifying potential supply bottlenecks in the region,

and in order to identify these bottlenecks, we estimate for each country in the region, the production possibility frontier based on the current endowment of natural capital, physical and technological infrastructure, human capital, and total factor productivity, and assess which countries are above or below the production possibility frontier.

And very interestingly, the countries with supply bottlenecks, those that are above the production possibility frontier, according to our identification strategy, are the ones experiencing the greatest growth reversals. If we compare 2012-2013 growth rates with the golden years, 2004-2008, the slow down in countries with supply bottlenecks is 2 percentage points higher, on average, than in countries without supply bottlenecks.

Moreover, and this is very important, it is in countries with supply bottlenecks -- it is countries with supply bottlenecks that are experiencing the largest deterioration in the fiscal and external balances and the largest depreciation of the real exchange rate as the combination of still very favorable external conditions and very large inflows of foreign capital trigger increases in aggregate demand that cannot, because of these bottlenecks, translate into commensurate increases in output.

So, just to conclude, three thoughts -- three summary points and one final thought. Current growth rates, in our view, in Latin America today, are mediocre in spite of a still very favorable external environment as the impact of favorable external conditions on growth dissipates and supply bottlenecks kick in.

Two, even if external conditions remain very favorable, unless they start improving once again, the slow down in growth rates is here to stay as stimulus to growth coming from domestic sources will not be easily forthcoming. In spite of the visceral improvement in macroprudential policies and successful implementation of some social

programs, the region has lagged behind other emerging regions with notable exceptions, obviously, in improving its human capital, it's physical and technological infrastructure, and total (inaudible) productivity. It would be fair to say that in the region now, we grow what we are.

Third, Latin America's growth rates remain relatively vulnerable to a deterioration in the external environment that has not yet materialized and whose effects have not yet -- we have not yet seen. Moreover, it is countries with supply bottlenecks that are building the largest macro vulnerabilities.

And finally, to conclude, I cannot help but wonder, and this gives me a certain sense of uneasiness, that Latin America's spell of vigorous growth translated into higher incomes, lower poverty rates, and the rising middle class when the latter are measured by income, not by the ability to generate income. Higher incomes achieved because the goods we sell are now more expensive and the capital and financial resources we used to produce them are now cheaper, is not the same as improving our ability to generate income because, for example, of large improvements in the quality of education.

In a deep sense, part of the income gains the region made in the last decade are, in our view, highly dependent on the continuity of the still very favorable external conditions that in no minor part made these achievements possible. Thank you.

MR. DERVIŞ: Thank you very much, Ernesto. This was very stimulating, also cautious, and I just want to throw in a line, you know, that when you look at the period until 1990, the aggregate of all emerging economies and developing economies compared to the advanced country per capita growth rate, they were more or less the same for decades, actually the advanced country rate a little bit higher.

Since the 1990s when you take the whole group of developing countries until 2012 and compare the per capita growth rate, it's been three times as fast. So, there is an emerging market phenomenon, but within the emerging market, of course, there's Asia, there's the Middle East, there's Latin America, there's Eastern Europe, and so Ernesto has started us off with quite a bit of caution in terms of, you know, this new convergence between the industrial advanced world and the emerging markets.

So, maybe we will get somewhat more optimistic? I don't know. Jose Juan.

MR. RUIZ GOMEZ: Thank you, Kemal, thank you, Brookings, and thank you, Ernesto, for inviting us to be here and to be able to present our macro report.

Yes, I am going to give a more optimistic view as Ernesto, but this is not new. We have been doing the bad cop and the good cop for the last ten years, therefore, it's going to continue the tradition.

I am going to organize my comments around three numbers. The first number is 3.9 percent, the second number is zero, and the third number is 6.2 percent. Let me explain. The first number, 3.9 percent, is what is projected by the IMF as the growth rate of Latin America in the next six years. We are not talking about the short-term, we are talking about the medium-term growth of Latin America, and 3.9 percent, although, can be a mediocre rate of growth when you compare with emerging markets, it's very decent for historical (inaudible) of GDP growth for Latin America. And my first idea is that Latin America is not near to have a crisis, at least as a region. We are going to have a GDP growth, which is quite decent, and taking into account that the population rate of growth in Latin America it's round now 1.2 percent, will provide the space to have GDP per capita increase continue to have increase in the welfare standard of the citizen

of Latin America.

This is the first idea. But let me connect what Ernesto was saying. What we believe is that the world economy, it's going to enter a state of maybe suppressed growth -- this is the way we have put it -- which means that we believe that growth is not going to be as high as it was in the golden years of 2003-2007.

If you go to the World Economic Report, you will see that prospects are to have GDP growth on average for the next five years, which is going to be around 1.6 below the rate of growth we have in the past, although, I would say, Ernesto, I fully agree with him, when you put this number in our model what you get, it's Latin America could grow one full percentage point less, that will have been the case if the previous condition were -- had remained in place. That's to say, Latin America amplifies the (inaudible) in GDP growth, nearly double the GDP rate of growth that we have seen in the (inaudible).

This, I think, it's a quite interesting phenomenon because it puts on the table one thing, that maybe something has to be done, and I think Augusto is going to talk about headwinds and tailwinds, and therefore I give him the opportunity to enter and to comment more on these phenomenon. But my first idea, it's we are going to grow 3.9 percent, and according to our model, this deterioration in world prospect, in GDP growth prospect, are going to affect Latin America and Latin America could lose something around one full percentage point.

Maybe you are growing at rates of 9, 10 percent, to lose one full percentage point is not very costly. When you are -- you have a potential GDP rate of growth of 4 percent, to lose one full percentage point means that you are losing 25 percent of your potential growth, and maybe policymakers are going to ask themselves what can be done.

And this leads to my second number, zero. I am quite worried about the success that we have had making -- trying to fight the great recession of 2008. Latin America was quite successful -- Latin American countries used counter-cyclical policies and these counter-cyclical policies helped to reduce the impact of the world crisis in Latin American performance. We have had a very short crisis and for the first time in many, many years, Latin America did not have a financial crisis -- a systemic financial crisis, high devaluation, high (inaudible) process, default -- this has not been the case. Latin America has escaped from this world crisis in a good way.

And my worry now is that governments try to react to this deceleration in growth with the same tools they used in the years 2008 to 2011. Why? Because, in our view, the space to develop counter-cyclical policies are nearly zero. Latin America has been using all the fiscal margin or narrowly, all the fiscal margin, all the monetary margin they have, to use these counter-cyclical policies to face something that maybe is temporary, but maybe is permanent, and my second point, which I will make very strong, is that if Latin America tries to face this suppressed growth area using the traditional demand policies in Latin America, we are going to see problems, maybe not in the next 12 months, but we are going to have problems in the next years because -- in the medium-term -- because this is not the way to face a suppressed growth -- the suppressed growth we are believing we are in front of. This is my second point. There is not such a thing as space for developing counter-cyclical policies to increase the expenditure, to have a much more looser monetary policy to face this slow down in economic growth.

And then it comes, my third number, the 6.2 percent and my optimism I promised you, Kemal. How we can face -- we can escape from this suppressed growth

earlier if we are not able to be, in a wide sense, to use counter-cyclical policies? The word, I don't know it's the proper way, we are trying to find a better word for describing what we are proposing, is a structural reform, reforms which increase productivity in Latin America.

We have run -- and we have David Alejandro who was one of the men who was working on these issues -- we have run a quite long experiment about the sources of productivity growth and the track record of productivity growth in Latin America, and the numbers, really, are very somber. We hear -- we saw -- we tried to analyze what just happened to the gap between the GDP per capita in 26 Latin American countries as against the (inaudible) from 1960 to 2007, and from 1960 to 2007, out of 26 countries, which are a member of the IDB, just four countries were able to narrow this GDP per capita gap. These four countries were Chile, Peru, Republic of Dominicana, and Panama. And out of these success stories, just two countries, Panama and Chile, were able to narrow the productivity gap as against the assets.

The other two were able to narrow the gap because they invested more or they put more workers on the productive process. It was an accumulation of factors. Just two countries were able to increase the GDP per capita in a sustainable way due to the increase in productivity. And this is clearly related to a misallocation -- a massive misallocation of resources in Latin America.

What we are proposing, it's to retake -- to renew the structural reforms agenda, which is going to have some different futures of the structural reforms agenda of the '80s or of the '90s. First of all, we don't believe that there is such a thing as one-size-fits-all. Each country has to look at the way in which they are having the allocation of resources and has to discover where are the more important bottlenecks, and they also

have to look at their institution and to try to figure out which are the kind of reforms they can digest and keep and maintain through the period in which reforms last -- the reforms mature.

This is a very important thing. There is not such a thing as an agenda proposed by the IDB to increase productivity in Latin America. Each country, it's (inaudible) approach, and this is an important thing.

Our models say that if Latin America turns, in the next ten years, to reallocate resources just to near the misallocation of resources you have today in Latin America, that is to say, you try to reallocate resources among the sectors, and it's a very micro analysis what we have done, and tried to get the same labor, marginal product, and capital marginal product in each of these sectors as the allocation -- the marginal capital product and labor marginal product that you have in the states. In the next ten years, what you get, it's the typical, the average Latin American country can increase growth by one full percentage point, but this is still left us quite far away from our 6.2 percent, and the question is, why, if Latin America is growing at 4 percent and you add one more percentage point of growth as a result of this allocation, that makes five, you are talking about 6.2 percent? And the answer to this is very easy. What we are proposing in our macro report is that there is a spillover in the region that can help to enhance the regional growth if all the countries in the region makes the reforms that are proper, the reforms that their economies are asking for.

We have -- beginning to adjust to think what happened to Latin America if Mexico or Brazil makes the reforms, and we get that Mexico and Brazil grew more than in the baseline scenario, but the other countries in Latin America did not get substantial spillover effect from the reforms in Mexico or Brazil, which makes 60 percent or more of

Latin America GDP, which is quite surprising and shows you that the integration of the region is quite low, the commercial and financial integration of the region.

And then we rerun our model including in the reforms in all the other countries, and what we get is that these regional agenda reform, provides to the region an increase in GDP which was narrowly a full 1.2 percent more, which makes that Latin America would be able to grow at a rate of 6.2 percent.

These are my three numbers. First of all, 3.9 percent if nothing happens, this is a medium-term scenario, which is not as high as it could be. Latin America, it's (inaudible) on the table a lot of growth, which is not juice. The second point is that, against this slow down in the world economy, you cannot react just with monetary and fiscal policy. This is not the right tool, and that reforms are the right tools to do that, and the key word for Latin America in the coming years will have to be reforms to increase productivity. This is the key word. And if all follow this script, Latin America will be able to grow at 6.2 percent. That's, by the way, higher than the rate of growth that the -- we are now expecting from Asia. That is to say, that Latin America could grow faster than Asia because we don't have any constraint, which cannot be removed before the growth of our societies and our economies.

MR. DERVIŞ: Thank you very much, Jose Juan. That was very stimulating also. This is going to be a great discussion, I can feel it. Now, of course, Augusto, the World Bank is on the supply side of things more than the demand side, so maybe naturally you will support Jose Juan, I guess.

MR. DE LA TORRE: We're on both sides. You know, I find it very stimulating that my colleagues have made a lot of their comments on the issues of growth, which I think is an important factor to keep in mind, because a similar meeting, I

don't know, ten years ago, we would have been talking mostly about stability, and systemic stability, macroeconomic stability, and exchange rates and so forth. So, I'm -- I think there's some important fundamental change that we are now talking about growth and structural reforms and we are talking about productivity and innovation.

And unless Alejandro chooses to talk about stability, we may actually end up talking only about growth. So, even the IMF may --

MR. DERVIŞ: He is, after all, from the IMF. Yes.

MR. DE LA TORRE: So, we will see what he has to say, but I think that's crucial because it puts us before the question, which I think has been nicely framed by Ernesto, as to what type of economic engine do we have.

I have often used this parable that Latin America reminds me sometimes of these old Lada cars that the Russians used to produce, which Ecuador used to import a lot, and what's typical about the Lada engines is that once you try to accelerate it beyond 60 miles per hour, smokes starts coming out, and that's the contrast between a Lada engine and a BMW engine. A BMW engine is one where you accelerate and you got 100 miles, you cruise along and you feel that the engine can even give you more.

And I think what happens in Latin America is, in the absence of a lot of help from the world, these things that have now been called external -- global tailwinds or however you want to call them, these external exogenous factors, in the absence of that help, which, as Ernesto says, has to come not only by the fact that the conditions are good, but that they are improving. So, we're asking for the world not only to give us good conditions, but we're asking to give increasingly better conditions.

So, in the absence of that type of impulse, we tend to be more like a Lada engine. We start realizing that beyond 4 percent, we really cannot do it because at

rates of growth above 4 percent, we generate bottlenecks or the bottlenecks become very visible, and inflation pressures. And then when we talk to our colleagues in Southeast Asia, they say, well, you know, five is too little, six is okay, seven -- they talk about seven and eight rates of growth without concern about the inflation and bottlenecks. And that suggests to me that they have economies that are much more flexible that can accommodate -- that have the capacity to accommodate an accelerated pace of growth without major frictions.

So, that's what we have in Latin America. We have a region that reaches its speed limits relatively fast and we are in a juncture where, unless we do something about the engine, we are faced with a 3.5, maybe 4 percent growth on average over the next years, and that's not enough.

And it's not enough, I think, mainly because of the type of expectations that the last ten years have generated for our populations. You know, the last ten years were years where -- of a strong global factors we were able to transform them into a relatively strong pace of aggregate demand growth, consumption grew as the poor came out of poverty and as people joined the middle class and were able to express their new purchasing power in terms of consumption. Like the Brazilians said, we have thrown millions of people to the markets with a new purchasing power ability, and these are folks that have become accustomed to this pace of social progress and of economic conditions, and with a 3.5 percent, 4 percent growth without a head from the world, the pace of social progress will just come to a halt and growth will become, I think, central to the policy debate. And it's becoming, as you go to Brazil and to Mexico, Colombia, Peru, you find out that that policy debate revolves now around growth with equity, of course, but growth (inaudible).

So, one of the things we did in our recent report was to say, okay, we all agree that we need to get higher productivity and more accumulation through investment and so forth, but we need to become more specific about that because that's what we're going to be talking in the future, and we said, well, let's do one thing, which is to understand how we have grown, because there's some personality about the economies that don't change overnight.

So, we admired the Southeast Asian countries, but we are not Southeast Asia, and so what we tried to do is establish the contrast between the way in which Latin America grows and has grown, and Southeast Asia, and there are some very significant contrasts, which lead me to believe that we are going to have to find our own way.

Let me tell you some contrasts. Contrast number one: clearly, Southeast Asian countries are a growth model that is export-led. We look at the structure of GDP, you see that aggregate demand is relatively low fraction of total GDP, and that net exports are big -- in bigger items, as a result, they have a current account position that is much stronger, and that model is accompanied by currencies that in real terms are more competitive.

Latin America, what you see, is that despite all of this commodity bonanza in exports we have had, we -- the term we use is we find ways to metabolize external factors into domestic dynamics. So, Latin America is essentially a domestic, demand-driven, growth model. And that's how we do it. That is consistent with the type of social change we have had. I doubt that we could have had the type of growth in the middle class or reduction of poverty if we would have had a purely export-led growth model. I doubt -- I think that things are consistent -- there's a certain consistency there. So, we have that. We cannot have our cake and eat it too. That's what we are.

The result of being an aggregate demand driven growth is that we tend to generate current account deficits very early in the game. In fact, by 2008, we were already generating current account deficit in the region. There was an interruption in 2009, but we're back to current account deficits.

When you look at how we finance those deficits, there is a change. The last ten years have been mainly financed by FDI. We worry about portfolio flows. They are volatile. They move a lot. But the stability in the size of FDI has been very strong. And when you look at direct current account deficit, it's really a trade surplus that becomes a deficit because we pay a lot of factor payments abroad, and that's not a surprise. We use a lot of FDI. And when you look at Latin American economies and contrast them with the Southeast Asian economies, you see that they rely much less on foreign savings -- much less -- and their current account surplus is trade, and very little factor payments abroad.

So, that's what Latin America is.

The good thing, and I want to make a point here, because I tend to be a little more optimistic than Ernesto, which is good, because you want to have friends that are optimistic and pessimistic -- Ernesto is my pessimist friend. So, I tend to be a little more optimistic because when I saw the dynamics of domestic demand in Latin America, our surprise was to find out that much of it revolved around investment. I had, in my mind, that the last ten year story in Latin America was essentially a consumption story. Well, I was wrong, I was proven wrong. We kept looking at this. It is basically an investment story except for Brazil. People only look at Brazil, but you take Brazil out -- Colombia, Chile, Peru, they are essentially an investment story, investment as the component of aggregate demand that grew the fastest.

When you now look at the real shares of investment to GDP to eliminate the (inaudible) effect out of the shares, compare them to the Southeast Asian investment rates, we have closed the gap. We are not there yet -- Peru is, but not all of Latin American countries are there yet -- the rates of reversals have grown up.

So, there's the same capacity to accumulate that the region seems to be developing.

The second thing is that -- and then I want to finish with this -- the other side of being an aggregate-demand driven model for growth, is that our production side tends to be service oriented. So, service was, in the last ten years, the great employer in Latin America. Latin America is running historically low unemployment rates. Service is largely responsible for that. And, you know, there's a lot of economists, including people in the Bank, that think that that's not good. People like to bad mouth services. And there may be some a priori logic for that, you know, services don't look like computer chips and they don't look like iPads, so they look like people selling (inaudible) on the corner of the street. That's the image people have.

So, we thought, okay, we better start looking at services because it's an under-researched sector, it's the largest one in Latin America. It's the one that has employed most people, the one that's growing the fastest, so let's look at that. And then a lot of surprises come up. Surprise number one: service in Latin America is the sector that has the highest content of education in terms of the labor force. I didn't know that.

But there you have it. So, there must be a lot of services that are employing educated people. Maybe the story is that they are PhD economists driving taxis, but I doubt that that's the whole story. I think there's a lot of economists doing financial services and medical services and accounting services and outsourcing, and

things like that.

The second thing is services are a strange animal now. You know, in the past we used to have this manufacturing, services, agriculture, and we thought that the lines were easy to draw. Well, they're not longer easy to draw. As modularity becomes possible for enterprises, outsourcing is more of that, so things that used to be called manufacturing in the past now may be classified as services because there are these firms producing things for the larger firms.

And there is an interaction between services and manufacturing that's not trivial, you know, in order to have good medical services you have to have your MRI machine. So, that interaction cannot be forgotten.

So, we come with our report saying, listen, let us not be so negative on services. Let's first understand what's happening there. We find that there is a lot of heterogeneity, a lot of skill intensity, more than I thought, and tradability of services begins to grow up. Latin America actually is low when you look at how much of the services are traded internationally. With the exception of tourism, where we're big, in other services we're relatively low. So, there's a lot to grow there.

So, we have a huge -- by no means I want to minimize that -- we have a huge challenge in front of us. We need to learn how to produce productivity growth. In Latin America, we are not very good at that. We're good at reducing -- we're good at dealing with social inequity, we're good at dealing with macroeconomic stability, we can teach lessons to the world about that, but we need to learn from the world on how you put together innovation structures and skill systems and productivity oriented reforms. We are not very good at that. And we have a huge gap in infrastructure. Quality of education is a big problem. So, we have a huge agenda, but I'm not that pessimistic because I

think that we -- the last ten years were not just a matter of good luck. I think there were some decent policies, our macroeconomic frameworks are now, in my opinion, almost first world. Our progress in social policy is important, and I think the region has finally come to the view that now we have energy, we have time, we have almost like the social capital start thinking about growth, and we have been investing much more than before, and we're using FDI much more than before.

So, not all of the things are bad, while the challenges are humungous.

MR. DERVIŞ: Thank you very much, Augusto, again, a third perspective which complemented and added a lot to the first two ones, and I'm dying to get the discussion started. But first we'll have Alejandro give his fourth perspective, which I'm sure will be as, you know, complementing the others, but add a lot more also.

MR. WERNER: Thanks, Kemal. And thanks for the invitation and I guess the perspective is going to be -- I mean, relatively similar.

I think -- I mean, it's hard to get away from the fact that the last ten years have been a commodity-driven story, and I think what we have heard here is exactly that. I mean, in terms of trade shocks in Latin America in the last ten years have been the largest in history for Latin America -- has been slightly larger than the terms of trade that we saw in the 70s, however, the windfall effect in terms of income from the last -- from this terms of trade shock, has been much, much larger because it lasted longer and it covered a wider array of countries, and in some cases, countries were producing a large share of commodities in their economies and therefore in terms of windfall effect, in terms of income generated, it has been the largest we have seen in history, in Latin America or at least in recent history.

Obviously, that led to higher investment, as Augusto was saying,

however, the increase in investment that we have seen in Latin America is similar to the one we have seen in the past when windfall coming from terms of trade happened. The only thing is that we had a much larger windfall and therefore the increase in investment was larger. But it can be -- I mean, the magnitude can be explained by the sheer amount of windfall earnings we had. And in that sense, we haven't gotten deeper into the numbers, but Augusto can do it with his larger staff, in terms of looking at the sectors in which we have -- I mean, in this sectoral analysis, I mean, exactly if this is basically a lot in mining energy and then, I mean, feeding into construction, housing, et cetera, that is the typical aggregate demand expansion that follows a terms of trade windfall in Latin America.

And I think that's what we have seen is smaller countries where the visibilities of large mining projects make a huge impact on microeconomic numbers. We're seeing investment rates that are very close to Asian standards. In much more diversified economies and larger economies, the effect is not so visible, but still I think it's a main driving force.

I mean, just in terms of numbers, some countries in Latin America, on cumulative terms in the last ten years, have had a windfall effect of 300 percent of GDP, that's 30 percent of GDP per year. Other countries have 100, other countries have had 40 percent of GDP. I mean, obviously, the largest countries it's very similar to what has been experienced by Middle Eastern oil exporting countries and in those countries we're seeing current account surpluses of 15, 20 percent of GDP.

In Latin America, as Augusto was saying, we're not seeing current account surpluses, we're seeing deficits. So, in a sense, it is hard to think that we were able to spend this money wisely. I mean, no household, no corporation, and no country,

and I guess the way you end up spending the money, it's inversely related to that, households spend it better than corporations, and then countries. It's able to have the institutions to assign that windfall to profitable projects in such a short period of time, especially if we were not able to build those institutions beforehand.

And I think a little bit of what we have heard here explains that. I mean, from 2003 to 2008, what Ernesto called the golden years, I think we saved much more. We went into current account surpluses. We grew, et cetera, because we didn't think we were rich.

Then, especially, the crisis came. We enter in this counter-cyclical mode that Jose Juan mentioned. We spend a lot. Then the crisis didn't hit us as hard. We started to correct our counter-cyclical policies. We didn't fully correct them, and now we're in a situation in which terms of trade are not growing we think have reached -- counter-cyclical policies have not completely taken away, and we are in the situation in which we are not saving, we are not generating surpluses, and we are not growing as fast as before because terms of trade do not continue to increase. We have used all of our spare capacity that we had during the golden years, and now we are left with future growth that should be TFP led, and TFP in the region has not been that exciting.

And I think that's the consensus on this panel that basically now we want to grow, we are at the lowest level of unemployment rates in the region in almost every country, infrastructure is showing significant bottlenecks, capital utilization is relatively high and our investment grades are not that exciting, and therefore either we turn our growth agenda into a TFP-led growth agenda through structural reforms, as Jose Juan was saying, or we are going to suffer an important slowdown and aggregate demand policies need to recognize. If aggregate demand policies fight that, I think that's a true

risk that we will be facing in terms of fighting a slowdown in an environment of cheap finance that we'll be willing to finance this thing for a long while.

We're seeing, I mean, Latin American and Central American countries going to the markets for the first time in their histories. Corporations, I mean, around 20, 25 percent of total issuers in the last 12 months are new issuers, so the market is willing to finance names that they were not financing before. They now know that well, and basically they're taking more risks than they were taking before.

To close on, I'll maybe go quickly to the discussion that Kemal wants to have, and I think is the richest point of this panel, I think there's also an important thing to discuss in terms of growth for the region that is getting a little bit more to the idiosyncratic growth processes in the region that is most likely illustrated by just looking at Brazil and Mexico. I mean, they're the largest economies in the region, and also the terms of trade shock have worked -- or let's say the drivers of the terms of trade shock have worked in opposite directions in these two countries.

I mean, in the southern corner, illustrated, let's say, by Brazil, obviously, the rise of China and the increase in commodities prices have had a very stimulating effect during this 2003 to 2012 period and has (inaudible) a growth process led by this terms of trade boom. On Central America and Mexico, basically, the entrance of China to the WTO and world trade was a negative competitiveness shock basically through these countries exports to the U.S., and therefore growth in the 2003 to 2012 period has been relatively slow.

Now, the competitiveness effect in Central America and Mexico vis-à-vis China has kind of flipped -- was flipped on its head as real wages in China have significantly increased and as low energy costs in North America have kicked in, and

therefore, we are seeing a manufacturing revival in North America that is positively affecting Mexico and Central America, and therefore we are having, let's say, a relatively boost to growth coming from manufacturing in Mexico and Central America that is compensating this terms of trade story for the region as a whole and I think is going to play down importantly in the economic numbers we see in the next three to five years.

To close out, I think the biggest risk for macro stability -- and I mean, we have to talk about macro stability because we are not into so many things as other institutions, we're a little bit more stubborn and we focus on these issues -- I think it's basically what I said before, a situation in which there is a growth slow down by definition because these income effects will no longer be there. We are at full potential. The outputs gaps have been closed. However, there is a tendency for authorities, for financial institutions, et cetera, to misjudge this slowdown to think that maybe it's more cyclical than trend, and therefore to keep on pushing aggregate demand.

If this is the case and financial markets are willing, as they seem to finance this, basically we could be building some (inaudible) in the next, let's say, 24, 30 months that would lead to some mispricing, also, in asset markets and eventually -- I mean, hopefully it won't be like the Volcker effect that again increases in interest rates -- in the international economy can generate some pull back away from emerging markets and therefore trigger an adjustment that now we are not, I think, working to reduce the vulnerabilities to this eventual adjustment in interest rates.

Just to close out, the other important tailwind that Latin America has been significantly benefitted from is low interest rates in the world. If we look at Latin America's debt service in the last six years, it has been reduced by almost half, basically by the accumulation of net external assets and reduction in debt associated with good

behavior, but also through the reduction in interest rate that we were blessed with being a net external debtor throughout the region as a whole. And these two things, terms of trade and interest rate, eventually are going to change, let's say, in the next three to four years, and the region should start working now to reduce their vulnerabilities to that reversal and eventually think how we will turn on the engines of growth through total factor productivity growth. Thanks.

MR. DERVIŞ: Thank you very much, Alejandro. Thank you all very much. And let me just ask two questions to get the discussion going.

We talked about investment and the rise that was due to the windfall effects, particularly in many of the countries, but, you know, and of course the other side of the financing side, you didn't quite address it, is the savings rate, and when you contrast the region to Asia, you know, the savings performance is -- it varies of course, some countries have much better, Brazil has one of the worst, Mexico, also, I think is pretty low savings, right? And then there's another -- in East Asia you've had very high savings rates in the East Asian countries, but one country which is very kind of interesting in that sense, and that's India, which went up over the last two decades, 15 years or so, from a savings rate around 20, 21, 22 percent -- not as low as Brazil, but, you know, pretty low, to something close to 35 percent. And so I was wondering, any comments on the savings? Because you strongly emphasize TFP, and in a sense, TFP is the best growth one can have because in a sense, you know, you sacrifice less in the present, but I guess the two are linked because unless you have investment, you have trouble realizing the TFP.

So, any comments on the savings rate to complete the picture would be useful, including the differences among countries.

And the second question is this whole issue of leverage. I think we've learned, Spain being one major case, that you can have kind of low leverage in the public sector, low public sector debt-to-GDP, but very high household and corporate debt. My own country, Turkey, is quite interesting, also very low public debt-to-GDP because of major fiscal reforms and it started with very low household and corporate debt, but household and corporate debt is going up very fast. We're still far from some of the European country levels, but -- so, how is the household and corporate debt in Latin America behaving? Is it increasing rapidly, credit card debt, you know, mortgage debt and things like that? Or is it more moderate, I think, is a question maybe the answer would complement the picture we got -- the very rich picture we got.

MR. RUIZ GOMEZ: Talking about savings rates, the numbers really are very, very surprising. The country in Latin America, which has the highest domestic savings rate to GDP has a savings rate which is lower than the country in Asia which has the lowest savings ratio. In fact, Latin America has -- the median savings rate in Latin America, it's equal to the savings rate in Sub-Saharan Africa, we are talking about 18 percent, and these could be explained by the history of Latin America. In my view, what we are talking here, it's about a country -- a region in which a financial crisis has been very often, we remember from 1980 to the year 2005, if I remember well, (inaudible) counted something like 35 episodes of financial crisis, and this has meant that people who have trusted their savings to the domestic financial system has been, to some, to a large extent, liquefied their savings and they don't trust the financial system.

I think it's a historical reason, you have also question about property rights, enhancement of (inaudible), all these things, and this is, in my view, it's one of the reasons that keep domestic savings rates as low in Latin America. And it's a huge

problem because if you put together the very low savings rates with something that has appeared in the conversation, very weak infrastructure, capital, and you say, okay, let Latin America try to solve this problem of infrastructure, taking the opportunity of these various (inaudible) and very favorable condition in the external markets financing this infrastructure, which is going to increase productivity levels, and we double our effort in infrastructure and we go from something like 2.5 percent of GDP in infrastructure efforts to something like 5 percent, which will be what we need to close the gap, investing 5 percent for the next 15 years just to have the infrastructure we need to have the productivity increase.

Well, we have made this simulation and we have asked our self, what happens if Latin America tries to finance this infrastructure gap with foreign savings, and we have looked at the past, and just seven countries in Latin America has been able to keep -- to finance current account deficit of more than 5 percent of GDP for five years, which means that you cannot do that. If you tried to close the gap in infrastructure just trusting on foreign savings, you are taking a very high risk of repeating your history of financial crisis. You need to increase domestic savings. Domestic savings is going to be increased by a much better regulation of the financial system, the recovery and the confidence of people in their domestic institutions, but it's not a process that can be solved just in one jubilee.

MR. DERVIŞ: Any additions, Ernesto? Alejandro?

MR. WERNER: I mean, just to complement, during this period, savings rate increased, let's say, from 2003 to 2008, together with investment and it increased more than investment, therefore improving our external balance, but still, I mean, given the levels that Jose Juan basically said, extremely, extremely small.

And going forward, I think -- and at the IMF we will be saying that this is extremely risky to -- I mean, to widen these current account deficits, and it is. However, I think we have to recognize that if external rebalance is going to take place, I mean, we cannot have countries that used to have large current account deficit reducers without nobody increasing theirs at the same time, and I think some of these countries in Latin America will have to see why there are current account deficits, and I think we float and accentuate inflation targeting regimes and good banking sector regulation, I mean, we should be looking both at our own history, but also as how current account deficits have behaved in countries like Australia, New Zealand, Canada, in which they have had periods of larger current account deficit, some adjustments through the exchange rate that were not as painful, as catastrophic as the one we have had to the extent that we are able to, I mean, withstand the rising vulnerabilities in the financial sector.

And obviously -- and the last thing, I do think the market will have to significantly help in finance and infrastructure, because with Basel III, the banking system, I mean, just having funding there for 15-year or 20-year (inaudible), I mean, I don't see them as aggressively. I mean, the Spanish banks used to be, I mean, at the forefront of this and with the new regulation it will be very costly to do it through the banking system, so I think we will have to see -- I mean, pension funds throughout the world, et cetera, starting buying toll roads, et cetera, in Latin America, and I think those vehicles will have to be designed to have a significant inflow of foreign and local money, but coming through market instruments and not through the banking system.

MR. DE LA TORRE: Just a couple of thoughts, you know, we do have low savings in Latin America and it's never been clear to me whether we have low savings because we don't have a lot of income or we don't have a lot of income because

we have low savings, and I don't think that this particular problem has been clearly solved.

When you look at what happened in Southeast Asian countries what you see is that there were countries with low savings, but with a high elasticity of saving-to-income, and this is where Latin America struggles. I'm not sure also what's the cure for this. Jose Juan was saying, well, maybe when we have more reliable financial systems people will save more. They actually may borrow more. Who knows? It's not clear to me. In fact, there is some research shows that the deeper your financial system, the less people save because they use the financial system to (inaudible).

So, not clear to me how that goes. The only thing that's clear to me about savings is that you need a bigger effort in the public sector. This is what our colleagues in the IMF have said several times, and I agree with that. That's the only clear thing you can do, and then as growth picks up and people have better expectations of the future, they will be more willing to invest in human capital and to build assets and so forth, so maybe savings shall follow.

With respect to your question of leverage, I think that that's an important one precisely because of what Ernesto and my colleagues were saying, we may be going to a world where terms of trade are flat and growth in China slows down, Europe and the U.S. have sluggish growth. In that type of world we may not have these external factors in our help, but we may have a lot of finance. And that can create many headaches.

If it is just FDI, I worry less, but if it -- as it is, it's portfolio and people waiting to buy bonds from countries that wouldn't sell in other circumstance and so forth and so on. We may be up for a situation where we may think we could fix our productivity problems by just borrowing more, or we might think we can fix our social

equity problems by just expanding finance. And we may end up with weakening of financial systems, and in the process we may end up also with competitiveness problems that may be deeper than what we want.

So, I really think that this issue of leverage, private sector leverage, it's not only households, it's obvious that also corporations are borrowing quite a bit, and so that, I think, is going to be also part of the discussion over the next.

MR. DERVIŞ: Ernesto, anything you want to add?

MR. TALVI: Two or three very short comments. On the savings side, two results of academic work that we did with Ricardo Hausmann and Michael Gavin many years ago, but I still think that they are important, the discussion about savings was going on at the time, I mean, Latin America saves very little and therefore that's a big difference with Asia. And what we found in our empirical work is that it is growth that tends to precede savings rather than the other way around. It's not that you mobilize saving and suddenly you would get growth, it is the fact that the economy, for some reason, growth jumpstarts, and then as you have greater opportunities and a better future, I mean, people tend to save more, and that would be consistent with your --

MR. DERVIŞ: India.

MR. TALVI: -- telling about India, and it's consistent across the board.

About public saving, the result that we got is that if you are in a period in which credit is very easy and interest rates -- international credit is very easy and interest rates are very low, if you make a huge effort to increase private saving -- public saving, you would get enough said coefficient between .8 and .9, so the private sector would undo practically everything you will try to do if you have access to easy credit.

That offset coefficient declines to .2 when you are in a period in which

you have no credit and you are de facto in a financially closed economy.

So, all I'm saying with this mobilizing saving, it might make no sense as a policy to begin with, and rather than looking at the correct target and mobilizing public saving might be self-defeating if you are in an environment --

MR. DERVIŞ: Mobilizing public saving, you mean?

MR. TALVI: Mobilizing public saving might be self-defeating if you are that environment. You might want to increase public saving for other reasons that have to do --

MR. DERVIŞ: (Inaudible).

MR. TALVI: -- with stability, fiscal space, but not necessarily to increase total saving.

And on the leverage, I just want to put the attention -- because I agree fully with what Alejandro brought about. We didn't talk about stability because we think that tail risk has diminished substantially after (inaudible) all that it takes to save the Euro.

I tend to think, as many tend to think, Kemal tends to think, that we have not seen the last from the European story yet, and I tend to think that we have not even seen the worst, and we are still going to have some ugly surprises coming out from there.

So, we should be talking about stability. And if you look at the countries where we have now supply bottlenecks, and those are the countries that actually benefitted very substantially from the financial crisis, not the Mexicos or the Central Americas, the Brazils and the South Americas, the ones that got low commodity prices, very low interest rates, huge inflows of capital, huge increases in spending, now that those effects -- those favorable conditions are still there but the growth effects are waning away, what we are seeing is that, on average, those countries' public expenditures is

growing at 11.5 percent a year when revenues have reduced to 5.

So, fiscal gaps are opening, and if you compute them in structural levels, they are even higher than they actually are, so we might be -- and the same is happening at the corporate sector and at the household sector, and you can see directly in some countries through the huge growth in credit, 30, 40 percent a year, and in countries where credit has been clamped because of supervisory reasons you can see it through other means through the capital account.

So, I think, especially those countries that have had the great bonus of high commodity -- high terms of trade and low interest rates and now are facing supply bottlenecks, are still spending as if income could grow (inaudible) with spending when it cannot, and they are building serious macro vulnerabilities that will not come to haunt us if the world continues to be like the one we have, but might come to haunt us if we have adverse --

MR. DERVIŞ: Can I just ask, if anybody remembers, what is the corporate plus household debt to GDP ratio -- private debt, corporate plus household, let's say, in Mexico or Brazil, Colombia? Any figures?

SPEAKER: Very low.

MR. DERVIŞ: Very low.

SPEAKER: Something like 17 percent of GDP. Credit to GDP, internal credit to GDP --

SPEAKER: But that's banking credit.

SPEAKER: That's banking credit.

SPEAKER: That market data, all the housing thing, we put into 50 --

MR. DERVIŞ: Credit card.

SPEAKER: -- maybe 70, but I don't know the number.

MR. DERVIŞ: Okay, roughly.

SPEAKER: If you add the non-financial -- non-banking --

SPEAKER: Non-banking institution.

SPEAKER: -- that come into the capital account directly to finance --

MR. DERVIŞ: No, because I mean, I think these figures, you know, one always has focused on the public deficit, but the variance is huge. In Spain it's, what, 350 percent?

MR. WERNER: 370.

MR. DERVIŞ: 370 percent. You know, I mean, just as an order of magnitude, it kind of -- and let me just -- Ernesto's point about savings, I think, is very interesting in his research with Ricardo in the old days, let me just give you an example of my country, Turkey. Public savings rate vis-à-vis GDP over the last seven, eight years, increased by 5 to 6 percent of GDP, so the public primary surplus rate, big fiscal adjustment and big increase in public saving, completely offset by a decline in private savings.

So, very frustrating.

SPEAKER: To complement, Kemal, on the countries we -- I mean, we're discussing Latin America in the last six years, so, I mean, the same time as you mention, I mean, the southern (inaudible), let's say, financially integrated economies, Brazil, Uruguay, Peru, Chile, Colombia, I mean, both the private and the public sector deteriorated their savings investment balance.

In the non-financially integrated, the Argentina, Venezuela, Bolivia, (inaudible), basically the public -- and then you have Mexico -- I mean, not having a terms

of trade boom, basically the public sector significantly deteriorating its savings investment balance and the private sector improving it.

MR. DERVIŞ: Improving it, very good. Okay. All right, we're going to open to questions now and take two or three, four questions, and then go back. Yes. Please, do identify yourself so that everybody knows.

SPEAKER: (Inaudible) with American University. I was wondering if part of the Latin American story that you didn't get a chance to talk about is the diversity within the region, right. We have countries, especially in the Caribbean and Central America, that are not growing, have not had favorable terms of credit, the tourists aren't coming, the workers remittances aren't coming, they're defaulting on their debt, some of them twice in the past ten years, completely different story right from the commodity -- larger commodity, net exporting countries, different story.

But even within this latter group, tremendous diversity. There are, as you mentioned, some investment driven countries, they don't have an inflation country because they're expanding capacity with demand. Other countries where inflation is raging and others, which refuse to even acknowledge they have an inflation problem.

SO, I think the diversity within the region needs to be mentioned. The generalizations are nice, but some of the most interesting stuff is happening at the country-by-country level, like in other regions of the world, of course.

MR. ECHEVERRIA: Thank you, yes. My name is Carlos Echeverria from the Central American Integration System, General Secretariat. I'm here with my Secretary General on a visit.

Just a short question: how do you value, and perhaps Augusto can -- which it's good to see you, Augusto -- Augusto can answer the question probably -- how

do you value the role of the regional or the sub-regional integration -- trade integration or economic integration schemes? Keep in mind, for example, that in the year 2011, the Central American trade of goods, not services, which is growing, but goods, grew from the previous year almost 21 percent, when trade -- global trade was relatively flat in that sense.

So, how do you perceive or what can the role of the sub-regional integration schemes can be? Thank you.

MR. DERVIŞ: Thank you. Yes.

MR. NELSON: Thank you very much. David Nelson with GE. Thank you very much for the presentation, very interesting, and actually, if I might, I have two questions. First of all, on the issue of bottlenecks and the structural reforms that are needed, can you just highlight -- I realize you can't go through all 35 countries, but say for the biggest two, are the reforms in Mexico the right ones -- education, fiscal, energy, and telecoms? And in Brazil, what are the key reforms that are needed to get past the bottlenecks?

And the second question is you haven't addressed at all the energy issue, and there does seem to be potential -- the resource seems to be there in a lot of countries in Latin America. There may be some changes needed in the investment climate to get to it, but the potential for oil and shale gas is huge in the region and this would not be a terms of trade issue, it would be an actual output issue of they start producing. Could you just talk about how that -- what the outlook is for that affecting growth in the region? Thank you.

MR. DERVIŞ: Any other -- yes.

SPEAKER: -- formerly from the IMF. Very interesting presentations,

everybody. I would like to ask, how do you all view the risks from the political cycle, in particular, in Brazil? What we are seeing is really Brazil doing exactly the opposite of what you are recommending, that is to say, you know, giving -- providing fiscal and monetary stimulus to address what is essentially a supply-side problem. My view is that this is going to get worse in the next year because, you know, the electoral timetable, and this probably is the case also in other countries of the region that are facing, you know, the same electoral cycle. Thank you.

MR. DERVIŞ: Okay, we'll take one more.

MR. IZQUIERDO: Hi. Alejandro Izquierdo, from IDB. Thanks for great presentations. I'm going to repeat sort of a question I asked to Jose Juan when he presented at IDB the macro report, but I think it's important. With interest rates so low and the credit constraint gone, in a way, why don't we see investment pick up like crazy? Investment has been going up, but are we losing an incredible opportunity here? And what are the constraints you think may hide behind this? Is it country constraints or is it perhaps that we're not that interesting as an investment area?

MR. DERVIŞ: Let me add one question and then we'll go back to the panel. In terms of this whole fiscal stimulus debate and, you know, expenditure debate, and I guess it has a counterpart in the U.S., is it not true that it's one thing to stimulate by increasing wages in the public sector, by, you know, providing more subsidies and things of that sort, which create the demand and spillover without capacity versus given that infrastructure is such a bottleneck, and assuming that investments in infrastructure have a return, even a financial return of 5, 6 percent, and maybe an economic return that's higher, 8, 9 percent, and the fact that interest rates are so low and there is access to finance, isn't this also actually an opportunity to borrow, provided, of course, that the

returns on that borrowing are growth oriented and oriented towards relieving the bottlenecks? So, I think that distinction in how fiscal policy is conducted, to me, seems important.

What we'll do is we'll go the opposite order, so we'll start with Alejandro.

MR. WERNER: Okay, regarding Arturo's question, I think he's completely right. I mean, basically if you look at growth rates for the decade, I mean, Mexico, Central America, the Caribbean have not had a stellar decade and actually after the crisis are doing relatively poorly. In the Caribbean we have a significant high debt, low growth problem, debt overhang, and yeah, and it's a situation that should be dealt with with a very different framework and we should be thinking about it because it's also a good period of time to deal with these issues. Low interest rate, relatively low degree of risk aversions, these countries are willing to put in place things that are workable. The market could be there to help them, and also, I think, a growth strategy, and that's -- I mean, debt restructuring is hard, but I think a growth strategy for this region is even harder, and that's, I think, what is lacking.

But you're totally right, and I mean, you mentioned the case of Panama, the highest growth country in Latin America at 9, 10 percent, investment-led, very interesting story. I mean, regarding reforms, if they are the right ones, or not in the case of Mexico or Brazil, I think for the region as a whole, I mean, focusing on infrastructure and savings, education, et cetera, whatever comparison you do, we are at the bottom of the chart. And I think the key question there is the details of the reforms that you need experts on the metrics of country and sector, whatever is politically feasible, and the right reforms, I think, in education and infrastructure.

In the case of Mexico, energy, I mean, one of the closest energy sectors

in the world, I think that's the way to go. In Brazil, a significant improvement in business climate in terms of regulations, in terms of tax policies, et cetera, I think should be the key. Teresa is completely on the point, I mean it's, in many of these cases, a political calendar. At the end of the day we end up saying structural reforms, but the outcome of structural reforms is the outcome of a very complicated political economy equilibrium that might not change overnight and especially changes when big things happen, and we're not seeing big things, not yet, so it's hard to envision. In some countries it might be the case, but it's hard to envision a boost or a broad-based reform agenda in these countries, and I think it's our job to continue mentioning this until it actually happens.

In terms of Alejandro's question on investment, I totally agree. I think the big problem is, for example, in infrastructure, it's very hard to go from doing very low level of infrastructure to doing something large. The projects are not there, the environmental impact is not done. I mean, I think you get to the financing just designing the projects, having them ready to be financed and assigning it to a sponsor is very hard and countries have not built infrastructure -- the institutional infrastructure to be there, and I think also there was a transitional issue in terms of funding might be there, but capital was not there.

A lot of the firms that were involved in infrastructure got extremely extended in other parts of the world when the crisis came, they had severe problems, so you had funding but you didn't have capital and now that thing has been re-accommodated and now we might have both of them.

MR. DERVIŞ: Augusto?

MR. DE LA TORRE: Yes, let me take three points. One is -- let me pick up on what Alejandro was saying. I think that the issue of low interest rates -- low interest

rates are necessary but not sufficient condition to generate the type of investment that you would like and the sense I get is that you need a financial system that's able to transform the available funds at that cost into suitable financial contracts for the type of investments we need and financial systems have a hard time doing that.

Generating long-term finance for financial systems is a big challenge. We recently wrote our flagship study on financial development and one chapter was devoted to this very complicated thing, which is creating long-term financial contracts. This is a market where, you know, people want to have access to their money, they want to redeem it, they want it to be liquid, and the other side, the users want long-term and fixed interest rates, local currency.

So, I think we have a huge challenge in understanding how our financial systems can become useful for long-term finance. I don't think we have solved it, and there are not many solutions in the world. One is the U.S., and it has pitfalls, the other one is Chilean, where you have to have dedicated, long-term asset liability managers, but we need to tackle that.

So, for me, low interest rates are not the condition. In fact, sometimes you have periods of low international interest rates, a lot of capital inflows, and a lot of consumption. The translation of availability of funds into investment is a much more difficult matter than what most people believe.

Second point I want to make is on trade integration, you know, one of the Latin American features is that when we integrate to the world, we do not seem to also integrate among ourselves, and this is in contrast with what's known as the Asia Factor or the flying geese. You see the ability of the Southeast Asian economies to integrate to the world as they integrate among themselves and a lot of feedback loops between internal

division of labor and integration and international integration.

Latin American integration partners are uni-directional. We sell something to China, we sell something to the U.S., but what happens inside the region and the connections inside the region don't get developed, and this is a big challenge. It's not clear to me what is the appropriate policy package, but clearly some things must matter -- infrastructure, logistics, making sure that borders unite more than separate, et cetera, et cetera.

So, I think we have a huge agenda in integrating the region better so that the region can integrate better to the world. I think that the model of the past of just integrating among ourselves without integrating to the world is flawed, but the idea of the interaction between the two types of integration needs to be developed. And my sense, I'm pessimistic about that because I see some progress in Central America, but much less than what we would expect, and all of the other sub-regional or trade arrangements have not prospered as much as we would like, and it doesn't seem to be a lot of political momentum on that side.

Finally, on the last point about whether these are the right reforms, as we said before, I think, they have to be tailored to countries, but one thing that I just want to - - a thought I have there is that when you think about productivity oriented reforms, you can easily throw the towel, because all the things you need to be productive -- institutions, infrastructure, education, logistics -- these are not the only thing -- by the time you put the list, you may become discouraged. So, I think we need to figure out in the region something that I think came through in a nice paper that Ricardo Hausmann did with Lance Pritchard some time ago where he -- essentially, the point is that you need to get some growth additive for the juices to get moving to do all of the institutional and

other reforms that you need to accompany.

If you just do reforms and don't get the initial benefits, it's tough. So, we need to think very carefully, what are the packages, the policies that can get some early wins where people can get some excitement about things moving? And when you think that way, I think Mexico is starting to -- if I could give some suggestions to Mexico I would put a lot of effort, for instance, in the energy sector, because if you do that quickly, you would get a very quick win and people will see that investment is coming in and then there may be more political consensus to do the deeper reforms.

So, sometimes it's not a good idea to do what we can do because what may be important is not exactly what's politically feasible.

That said, I do think that the direction which some of the Mexican reforms are going is, in general, the right one, particularly the reforms on competition.

MR. DERVIŞ: Thank you very much. Jose Juan?

MR. RUIZ GOMEZ: I will take some points raised by Augusto. I think to answer to some way the question raised by Teresa. We need that success, a success reform that could be generate these -- this climate in favor that structural reforms pay off in terms of dividend.

We are -- when you talk about structural reforms in our policy dialogues with the economic authorities, all of them say, okay, that has a very high political cost, our political capital is low, elections are coming, and this is because in the mind of our policy makers, reforms are related to cost. Something is going to pay. It's a zero sum gain, at least in the short term, and I am not sure that this is the case.

Just for instance, think of a reform that could be applied in nearly all the Latin American countries, to fight against informality in the labor market. Informality in

the labor market is one of the reasons that our total factor productivity is growing as slow as it is, because informality in Latin America is pervasive, 56 percent of Latin Americans work in the informal economy, and you have countries such as Bolivia, Ecuador, you have 80 percent of the total labor force which are working in informality.

And you think about informality and you say, why this is happening? Of course, we have problems of human capital, we have problems of institution, but we have tax problems, we are taxing the people who are working in the formal market, and you are taxing companies, which are working in the formal economy. You can move these taxes and you need tax reforms from this taxing labor and formal companies and to move to a broad tax (inaudible) or whatever (inaudible) the taxation on formal employment. And this will give a boost to your productivity, will reduce this informality, and if you think in this way, what you get in reforms, it's a (inaudible) improving reforms, workers will be able to get more wages because productivity is going to be enhanced, companies are going to pay less taxes and they are going to be able to get more profits, and tax is going to increase because government is going to raise more taxes from this reform. It's a win-win reform. It's not necessarily a reform, which in the short-term, has costs, or at least could be designed in some way.

And now I take the opportunity to make a commercial, on June 24th, we are going to present here in Brookings, our fiscal flagship more than revenues, taxes as a tool of development, and this is the kind of message that we want to translate to people that we need tax reform, and as Alex was saying, the problem is not saying that we need tax reform, we need a kind of tax reform in which the details are as important as the whole concept of reform, and we need to have a success. And we can have a success. We can follow what is happening in Colombia, (inaudible) reform in which the target has

not been to raise revenues, but to try to reduce distortion, to try to reduce these taxes on the formal employment, and maybe there or in the competition reform in Mexico, we are going to get some flagship reforms in which we can convince policymakers of the society that this time it's not -- it's going to be different. This time it's not going (inaudible 1:37:25.) in the '90s.

MR. DERVIŞ: Thank you very much. Ernesto, some last words?

MR. TALVI: Yeah. Well, on the diversity that Arturo brought about -- I would emphasize not only the diversity in outcomes, also the diversity in policies, and this is, I think, very, very important because we've seen some very relevant setbacks in countries that have done very, very well previously. Argentina is an example where exchange controls, capital controls, licensing on imports, nationalizations, now price controls, doing away with the independent judiciary -- blah, blah, blah -- I mean, if you look at the big scheme of things, and this is the comment I'm going to make -- the closing comment in Latin America -- and this goes, in a sense, a long way to answer Alejandro's question and your question on why if we have available cheap financing we are not seeing the amount of the investment that we should be seeing -- if you remove away investment in construction and housing, things do not look -- and maybe the mega projects in mining, then the mom and pop kind of investment, essentially, does not exist. I mean, really. So, to me, we should call it the core investment still is very, very low in Latin America.

Why? Why? And when you look at the big scheme of things, we had this huge liberalization, policies that started in the mid 1970s because we thought that the import substitution, state intervention kind of model had failed. We have a different view with the report papers we wrote with (inaudible) and Alejandro that it had a lot to do with

the change in external factors, but -- and then we switched to a different model, completely different model. We opened up, we privatized, we removed controls on flows, on exchange rates, on prices, and then the Russian crisis came by, the Argentinean crisis, and then we said, this is all the fault of the neo-liberal opening up policies, and we switched back again, okay, in some cases, in a very big way, in some others trying to do it in a reasonable way.

But I think that the risk of policy change is always there. And therefore, that risk, if the environment changes, and what today is fine, tomorrow starts not to go so fine, and therefore, I think that the horizon is still for the domestic residence, for the mom and pop or core investment, it's still very short.

However, mega projects that come with financing through the World Bank, the IDB, with the protection of their own governments that cannot be touched by new legislation or new rules, those are going to come in. But beyond mega projects and construction, you are not seeing a lot, and I think that unfortunately it is because -- and we are seeing it in many countries in the region and we cannot think that the others are completely immune of circumstance in change -- of substantial changes in the rules of the game.

MR. DERVIŞ: Well, thank you very much. I really would like to thank our guests, and Ernesto, this was a very exciting panel. I hope, as Ernesto said, that we will make it a tradition, once a year, to kind of take a look. I will set up an infrastructure so that we keep track what people have said, and it's a dynamic process. There are many issues, which, I guess, we didn't have time to touch -- employment, technical progress, you know, that whole thing, and of course the social policies, safety issues, and on the other hand, you know, great potential, probably 30, 40 million Chinese tourists

may come to Latin America over the next decade, and so there are many issues.

But I think we really provided a very rich picture and I want to thank also the audience for sharing your time with us on this rainy day. Keep dry and come again next year when we will have a repeat with a retrospective and another look forward.

Thanks a lot.

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