Growth, Stability, and Prosperity in Latin America

Alexandre Tombini
Rodrigo Vergara
Julio Velarde
About the Authors

Alexandre Tombini is Governor of the Banco Central do Brasil
Rodrigo Vergara is Governor of the Banco Central de Chile
Julio Velarde is Governor of the Banco Central de Reserva del Perú

The views expressed in this paper are those of the authors and do not necessarily represent the views of the Group of Thirty.

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The Group of Thirty
1726 M Street, N.W., Suite 200
Washington, D.C.20036
Tel.: (202) 331-2472
E-mail: info@group30.org, www.group30.org
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Introduction

The three speeches presented here were delivered at the 73rd plenary session of the Group of Thirty, held June 11–13, 2015, in Rio de Janeiro, Brazil.

The Group of Thirty is grateful to the authors, Alexandre Tombini, Governor of the Banco Central do Brasil; Rodrigo Vergara, Governor of the Banco Central de Chile; and Julio Velarde, Governor of the Banco Central de Reserva del Perú; for allowing their presentations to be published as a Group of Thirty Occasional Paper. We are sure their remarks on economic growth in Latin America will be of interest to the central banking community, financial institutions, and those interested in the region.
In the spirit of the topic of this panel, I would like to present a Brazilian perspective on the challenges to growth and stability first, and afterward look at a longer-term perspective. Growth and stability are necessary, of course, but in and of themselves are not sufficient conditions for long-term prosperity. Prosperity is a broader, multifaceted concept that, inter alia, through economic progress, social inclusiveness, and institutional stability, enhances social welfare and produces a feeling of confidence about the well-being of the next generation and the future of the country.

It’s also interesting to note that, in a sort of feedback loop, confidence is the sine qua non condition for steady economic growth under sound and stable macroeconomic conditions, among which low and stable inflation are essential.

In order to understand where we are and to talk about our future, let me step back a few years.

Recent Economic and Social Progress

Like many emerging market economies, Brazil, learning from our experience during the typical emerging market crises of the 1990s, progressively developed a pragmatic policy framework throughout the following two decades.
From 1999 to 2001, Brazil established a macroeconomic “tripod” that set a stable framework enabling sustainable long-lasting growth—a tripod composed of a standard inflation targeting regime, a sound fiscal responsibility law aiming at generating adequate primary surpluses to control public debt, and a floating exchange rate regime that constitutes the first line of defense against external shocks.

This new policy framework, together with sizable benefits from favorable terms of trade due to a global commodity supercycle (figure 1.1), largely China-driven, allowed Brazil to achieve macroeconomic stability and build self-insurance in the form of international reserves. In the process, we became a net creditor and significantly reduced our risk premia in various asset markets.

The Bloomberg Commodity Index slid to a 12-year low in March 2015 with crude, hogs, and copper leading.

This period was a window of opportunity for Brazil to reduce its vulnerability to external shocks and to improve its fiscal sustainability. We seized it. The stronger current account and the surge of capital inflows allowed a large accumulation of foreign reserves. The composition of capital flows also improved, with foreign direct investment accounting for the largest share of inflows. On the fiscal front, currency composition
and maturity structure of public and external debt strengthened significantly due to sizable primary surpluses, which also allowed a significant reduction in the net public debt (figures 1.2–1.5).

**FIGURE 1.2 INTERNATIONAL RESERVES X NET EXTERNAL DEBT**

*Reserves on June 3rd; debt on April 2015.

**FIGURE 1.3 EXTERNAL DEBT RATIOS**

*Estimate.
Consequently, the widespread strengthening of our macroeconomic fundamentals was recognized by markets, and our credit ratings were upgraded over the decade. Brazil got its investment grade in April 2008.

But other remarkable achievements in the 2000s are noteworthy: much progress happened in our social agenda. The combination of the already alluded external tailwinds with improvements in our
institutional and policy frameworks produced an inclusive growth process that reduced unemployment, income inequality and poverty incidence.

It is worth briefly highlighting some indicators that began ringing the bell of prosperity in Brazil in the last decade:

1. The incorporation of more than 40 million people into the middle class (figure 1.6).

![Figure 1.6 Social Mobility](image)

*FGV forecast.

2. The steady decrease of our Gini coefficient (figure 1.7).

![Figure 1.7 Gini Index—Income Inequality](image)
3. The reduction by approximately 50 percent of the unemployment rate, especially from 2007 to 2014, together with an increase in formal jobs and a significant decline in informality (figure 1.8).

**FIGURE 1.8 FORMAL EMPLOYMENT AND UNEMPLOYMENT RATE**

4. Universal access to banking services, from 80 percent to 100 percent of municipalities (figure 1.9).

**FIGURE 1.9 GEOGRAPHIC COVERAGE INCREASED**

82% of municipalities had less than 5 points’ per 10,000 adults in 2000.

In 2010, 94% were above this level.

Bank branches, bank advanced outposts, credit cooperatives (headquarters and outposts), and correspondents.
5. The continuous, sound and well-supervised increase of credit-to-GDP ratio, from about 25 percent in 2004 to over 54 percent at present (figure 1.10).

**FIGURE 1.10 CREDIT/GDP**

- **2005–2008: 25.4%**  
  (average growth of nominal credit)  
- **2009–2014: 16.1%**  
  (average growth of nominal credit)

For a region that was under “adjustment” and experienced an array of crises in the 1980s and 1990s, these are impressive turnarounds. In many ways, Brazil is emblematic of the economic and social progress that we have seen in Latin American countries in the last two decades.

With these stronger fundamentals, Latin America in general, but especially Brazil, could conduct countercyclical macroeconomic policies during the 2008–2009 phase of the global financial crisis. Furthermore, our policy framework has been tested through its various subsequent phases. We passed and rebounded well. The most visible face of the resilience of our policies is the accumulated GDP growth path of the Brazilian economy during 2008–2015 when compared to mature economies and to some selected emerging markets (figure 1.11).
Although our framework has proved its resilience, more recently it has faced new challenges.

Response to the Global Financial Crisis

After our successful response during the first phase of the global financial crisis, Brazil and other countries in the region have faced rising challenges in recent years. Some of these challenges come from a weakening of fundamentals partly due to the countercyclical responses to the global financial crisis. Others are coming from the fading of the commodity supercycle.

In Brazil, for example, concerns rose in mid-2011, with the unpredictable negative effects of the second acute phase of the global financial crisis—the US credit downgrade and Europe’s debt crisis in August 2011. A strong countercyclical response was rapidly implemented, based on a combination of a classical accommodative monetary policy and significant fiscal and parafiscal stimuli that were unleashed to support activity even before the full effect of monetary accommodation materialized since, as we know, monetary policy operates with lags.

To be fair, and with the benefit of hindsight, part of this rush in simultaneously undertaking all these measures reflected the same fear of another Great Recession that prompted the adoption of unconventional monetary policies and other unprecedented countercyclical measures in advanced economies.
In any event, as a result, our domestic absorption grew much beyond supply, triggering inflationary pressures, especially in the service sector, resulting in a loss of competitiveness and a deterioration of external balance.

Therefore, after a first period of quick rebound out of the global financial crisis, like what many advanced economies experienced, rising public debt resulting from significant countercyclical measures started weakening fundamentals in Brazil and led to a progressive but steady decline in business confidence. These developments happened alongside a reversal of terms of trade and decreasing growth returns from the previous successful growth cycle that combined social inclusion with financial deepening.

The decline in business confidence compounded an economic deceleration in 2013–2014. That highlighted macroeconomic imbalances in both external and fiscal accounts (figure 1.12), further deteriorated the perception of loss of sustainability, and brought Brazil into the spotlight of rating agencies and commentators for possible downgrading of its sovereign debt. Furthermore, idiosyncratic noneconomic events created a sense of a perfect storm for a country that had been among the primary destinations of the international investor community.

So, in a nutshell, Brazil had exhausted its policy buffers accumulated during the good times and was facing strong headwinds.

**FIGURE 1.12 PUBLIC DEBT (EXCLUDING INTERNATIONAL RESERVES)**
Resetting Economic Policies

By the end of 2014, the logical conclusion was that it was prudent and necessary to reduce macroeconomic imbalances. The government, thus, decided that policy buffers needed to be rebuilt and that economic fundamentals needed to be strengthened, especially in preparation for the volatility that might stem from foreseeable normalization of US monetary conditions.

Therefore, in order to overcome this complex global and domestic outlook, the Brazilian economy is going through an important and necessary adjustment process. This makes 2015 a transition year, a time to restore strong fundamentals that will foster a new cycle of sustainable economic growth.

The adjustment is under way. The government is committed to a set of standard policies intended to strengthen fiscal accounts, cut spending, and eliminate subsidies and distortions.

While contractionary in the short run, the adjustment is key to sustainable growth in the coming years. Brazil will increase its primary surplus, with positive impacts on domestic risk spreads and on the public sector balance. These developments will contribute to the recovery of confidence, thereby increasing savings and investment.

As I said before, low and stable inflation is paramount for confidence and for sustainable economic growth.

Two important price adjustments have been challenging monetary policy in the short term: the realignment of domestic prices relative to international prices, and of regulated prices relative to market prices. A large part of the realignment of regulated prices was done in the first quarter of 2015, and we expect this process to be over this year. The realignment of domestic prices relative to international prices is under way. The Brazilian Real nominal effective exchange rate has depreciated about 10 percent in 2015, and 36 percent since its last peak in July 2011.

The Central Bank is looking at the direct impacts of relative price shocks, and monetary policy is mitigating their second-order effects. Our focus is to confine the effects of these shocks to this year, so that they do not influence inflation expectations in 2016 and onward.

We see some progress. Despite a current high headline accumulated inflation, markets have scaled down their inflation expectation for 2016 in response to monetary policy actions combined with the recent achievements of fiscal policy. Since the beginning of 2015, inflation expectations have consistently fallen for 2016, 2017, 2018, and 2019.
(figures 1.13 and 1.14), despite the rise of 2015 expected inflation due to the once-and-for-all price realignments already mentioned.

FIGURE 1.13 CPI EXPECTATIONS FOR 2015

FIGURE 1.14 CPI EXPECTATIONS FOR 2016–2019

Note: b.p. = basis points.
Monetary policy in Brazil, thus, is and remains vigilant to ensure the convergence of inflation to the center of the target by the end of 2016. The results so far show that we are on the right path.

Economic Reforms

Looking now to the future, our pragmatic policy framework has played a major role in bolstering the credibility and resilience of the Brazilian economy.

However, securing macroeconomic and financial stability is a necessary but not sufficient condition for long-term sustainable economic growth. Prosperity in the future requires thinking about our growth model, the perils of middle-income growth traps, and possibly finding a balanced and inclusive growth strategy that combines our obvious advantages in commodity sectors on production, size, location, and political stability, while improving on our weaknesses such as the cost of doing business and lack of progress in productivity.

The good news is that many of these structural challenges are well-known: longstanding supply-side bottlenecks, related to deficiencies in infrastructure and the absence of a more business-friendly environment, constrain economic growth. These constraints compound others related to Brazil’s labor costs and market rigidities.

Thus, it is critical to carry out supply-side structural reforms in order to boost productivity and to reduce infrastructure and human capital bottlenecks, such as: a program of concessions focused on infrastructure enhancement; efforts to boost the importance of local capital markets in infrastructure; and microeconomic reforms aimed at improving the business environment, such as simplifying the tax system.

These reforms will allow a more efficient allocation of production factors in our economy and will increase investment and productivity, while creating more room for noninflationary increases of domestic absorption.

Conclusion

All told, Brazil, as other countries in Latin America, is aware of the importance of strengthening economic fundamentals to reduce domestic and external vulnerabilities, in preparation for the normalization of monetary conditions in the United States.
Brazil is carrying out standard, relevant, and necessary adjustments in order to strengthen its fundamentals and prepare itself.

For Brazil and for some other countries, these are times of adversity, and hard choices have to be made. It is the price to be paid in the near term in order to both maintain the social advances achieved thus far, and to build a better foundation for macroeconomic stability. With some of the structural reforms mentioned above, and a successful adjustment in 2015, we can foresee solid economic growth in the coming years and hence, the road to prosperity.

Thank you.
Thank you very much, Mr. Chairman. And thanks to the Central Bank of Brazil and to the Group of Thirty for the invitation to participate in this meeting. I will start with some brief remarks on Latin America, and then I will also make some brief remarks on my own country, Chile.

**Latin American Growth and Challenges**

In terms of growth, Latin America does not look good these days. After years of strong expansion, came a couple of years of significant deceleration. If you take 2004 to 2011, the good years of high commodity prices and capital inflows to the region, Latin America’s growth, at an average of 4.5 percent a year, was only slightly lower than growth in, say, the ASEAN-5 countries (Indonesia, Malaysia, the Philippines, Thailand, and Vietnam) (figure 2.1).
Nonetheless, since 2012 the region has decelerated quite significantly. And for 2015, Latin America is expected to grow below 1%, very much influenced by Brazil, the largest economy in the region. A year ago, Consensus Forecast was projecting that our region would grow by 3% in 2015 (figure 2.2).
So the main challenge for the region is to resume growth and to acknowledge that in order to do that it is necessary to undertake structural reforms. It’s not that we didn’t implement or we didn’t introduce structural reforms beforehand. But I have the impression that during the years of high commodity prices, we took the bonanza for granted and thought that further reforms were not necessary.

Meanwhile, this has become a region of middle-income countries. And, as the Governor of the Central Bank of Brazil mentioned, we face higher demands from the population. Some of them are reasonable demands, and some are not. Hence, it is important to deal with these demands in a responsible way. There are groups that oppose and want to change almost everything, so there is the risk of populism, which by the way is a phenomenon that we see not only in this region. It is also present in many other regions of the world, including Europe. It is clear, however, that we face challenges, and some reforms are needed to foster growth and reduce income inequality. Importantly, income inequality is quite significant in the region. In order to reduce it, it is necessary to take measures such as improving the quality of education and fostering an increase in female labor force participation.

In terms of macro challenges, I would say that many of them come from abroad. The normalization of US monetary policy implies a challenge for the region. It is supposed to be gradual and smooth. But we know that it may produce some volatility, and we will have to deal with it. The decline in the prices of commodities is also a challenge our economies are facing, and in some cases, with significant adjustments.

Finally, there’s China. China has become a very important trading partner for the region. In many countries in Latin America, including my own, China is the main trading partner (figure 2.3).
The good news in this environment is that most of the countries in our region are better prepared to face this changing external environment. Countries now have lower inflation rates, more sound public finances, more solid financial systems and external accounts and, in general terms, better macro policies than in the past. Many countries have flexible exchange rate regimes, and their currencies have already made the adjustments to accommodate this new reality.

The Situation in Chile

Let me move now to the situation in my own country, Chile. In many ways, Chile has been a success story over the last 30 years. Average growth in the country since 1985 has been 5.3 percent per year (figure 2.4). That has meant that there has been convergence with the advanced world. While in 1990, per capita GDP at purchasing power parity in Chile was 24 percent of the US per capita GDP, in 2014 it reached 42 percent (figure 2.5). Of course, we have a long way to go, but we can say we have been gradually bridging the gap.
FIGURE 2.4 CHILEAN GDP (ANNUAL CHANGE, %)

Source: Central Bank of Chile.

FIGURE 2.5 GDP BASED ON PURCHASING POWER PARITY PER CAPITA: CHILE/UNITED STATES

Source: IMF.
The percentage of the population below the poverty line was reduced from over 30 percent in 1990 to less than 10 percent today (figure 2.6). And the Gini coefficient, although still high, as is the case in most Latin American countries, was also reduced. Meanwhile, inflation in Chile used to be around 20 percent in the 1980s, and it gradually declined over the 1990s. Since 2001, we have in place an inflation targeting regime with an inflation target of 3 percent annually. The average annual inflation since we implemented this regime has been 3.2 percent (figure 2.7); public debt is only 15 percent of GDP while net debt is negative, since Chile has sovereign wealth funds (figure 2.8).

**FIGURE 2.6 NATIONAL POVERTY RATE** (% OF POPULATION)

![Figure 2.6](image)

*Average of indicated period, according to data availability.
Source: United Nations Economic Commission for Latin America and the Caribbean (ECLAC).

**FIGURE 2.7 INFLATION (ANNUAL CHANGE, %)**

![Figure 2.7](image)

We learned the hard way that macro stability is a very important matter. It is a necessary condition for growth. And I say the hard way because in the past, most of our crises were related to macro instability, which of course was the result of misguided macroeconomic policies. So we know that macroeconomic stability is a necessary condition, but definitely not a sufficient condition. To achieve high growth, it is also necessary to improve productivity. During previous decades, we went through all sorts of structural reforms that increased the efficiency of the economy and translated into high growth. Indeed, we implemented trade reform, financial reform, pension reform, labor reform, fiscal reform, central bank reform, educational reform, deregulation, privatizations, and much more. But of course, this is an ongoing process.

Regarding more recent developments, Chile, like most Latin American economies, suffered a mild recession in 2009, which was related to the global financial crisis. The economy rebounded very strongly in the following years, but last year, 2014, it grew only 2 percent. For this year, 2015, we expect growth to be between 2 and 2.5 percent, which is not good enough.

The Macroeconomic Policy Framework in Chile

Let me now turn to the macroeconomic policy framework in Chile. Basically, we see it as based on four pillars. The first pillar is the inflation targeting regime, with a flexible exchange rate administered by
an independent central bank. The second pillar is a responsible and predictable fiscal policy based on a rule that isolates expenditures from the business cycle. The third pillar is a solid regulatory and supervisory framework governing the financial system. And finally, the fourth pillar is integration with international markets. In this framework, the shock absorber is the exchange rate. And this has enabled us to have a quite autonomous monetary policy. The cost is more volatility of the exchange rate. It is also worth mentioning that we don’t have capital controls. The last time we implemented some controls was back in the 1990s. Regarding FX [foreign exchange] interventions, we use them only under extraordinary circumstances. In fact, the last time we intervened was in 2011.

The reason we have this flexible exchange rate in place is because it allows a more rapid adjustment of the economy to changing conditions. Chile is a small, open economy that faces changing conditions over time, and in our view the exchange rate has to reflect these conditions. For instance, for a commodity-producing country such as Chile, if the prices of the commodities it produces are lower, it is reasonable to have a more depreciated currency. This is why many Latin American countries, including Chile, have experienced a depreciation of their currencies in the last couple of years. In our case, one of the costs of this depreciation has been inflation above target for some time. However, given the one-off nature of the depreciation and an output gap that has expanded, we see this as a transitory phenomenon. The market sees it the same way, as shown in inflation expectations, which remain very well anchored at 3 percent.

Of course, this is not to say that a flexible exchange rate regime is optimal for any economy. It depends on each case in particular. If you have, for instance, significant currency mismatches, I would not necessarily advise having a flexible exchange rate, given the balance sheet effects that might occur after a depreciation.

Our experience in Chile, however, suggests that currency mismatches are rather endogenous. Indeed, when we introduced a flexible exchange rate system in 2000, we saw that currency mismatches were reduced very significantly in the corporate sector as the currency risk became clearer.

On the fiscal side, we have a rule based on a cyclically adjusted balance. In my view, the key to the success of the fiscal rule in Chile is that the two key parameters, that is, the output gap and the long-term price
of copper, are not determined by the government but by independent committees. This is very important since it avoids the usual government temptation of being overly optimistic. During the good years of the high prices of commodities, we had significant budget surpluses. That is one of the reasons why now our public debt is so low.

Conclusion

As I said before, I think that the main challenge at this juncture is to resume growth. It is a challenge for Latin America at large, including my country. In Chile, we are facing a deceleration in activity. Although this year growth is expected to outperform last year, it is still projected to be well below potential. The good news is that the adjustment has already occurred. The currency has depreciated; we have low interest rates; and the current account deficit—which at some point reached 4 percent of GDP and the projections were that it would go up to 5 percent of GDP—is projected to be around zero this year (figures 2.9 and 2.10). In addition, public debt is low. So, from a macroeconomic perspective, there are no imbalances that might be hampering growth.

**FIGURE 2.9 MPR AND INTEREST RATES ON CENTRAL BANK OF CHILE BONDS**

![Figure 2.9](image)

*Note: BCP = Central bank bonds denominated in pesos; BCU = Central bank bonds denominated in Unidad de Fomento, a CPI-indexed unit of account; MPR = Monetary policy rate.*

*Monthly averages.*

*Source: Central Bank of Chile.*
FIGURE 2.10 CAD, INVESTMENT, AND NATIONAL SAVING

1 Accrued in a moving year.
2 Considers gross fixed capital formation and inventory adjustments.

Note: CAD = Current Account Deficit. (f) = forecast.
Source: Central Bank of Chile.

Thank you very much, Mr. Chairman.
Thank you very much. I would like to begin by thanking the organizers for the invitation and, particularly, the Central Bank of Brazil.

In the last 20 to 25 years, as a result of sound macroeconomic policies, fundamentals in many Latin American countries have improved considerably. In what follows I will argue that macroeconomic stability is an essential asset for sustaining economic growth in the region.

The Importance of Macroeconomic Stability

Figure 3.1 shows per capita GDP in Latin America since the 1980s, and illustrates the significant change in long-term growth that the region has experienced since the 2000s: in the 1960s, Latin America was growing at a faster pace than Asia. An outstanding case in that period was, of course, the Brazilian miracle. However, in the 1970s, and particularly in the 1980s, macro fundamentals became weaker, probably because too many social benefits were introduced at an early stage, while the income level was still low. During the 2000s, the region’s macroeconomic performance improved significantly as a result of structural reforms and the ability of independent central banks to deliver monetary and price stability.
In the case of Peru, average growth was close to 6 percent, more than 2 percent above the average for the whole region. Higher growth brought about a substantial reduction in poverty levels, as Governors Vergara and Tombini mentioned, and the middle class expanded. The middle class, which represented 20 percent of the population at the beginning of the century, has now reached 40 to 50 percent in some countries in the region. In addition, as stated yesterday by the Brazilian Minister of Finance, Joaquim Levy, a solid middle class is key to stability. Middle-class people are worried about securing a better livelihood for themselves and their children, and demand coherent macroeconomic policies from the government.

It is true that during the last decade we had a favorable external environment, with high commodity prices; but it is also true that the prudent macroeconomic policies applied in most countries in the region contributed to better macro fundamentals. Macroeconomic stability has therefore become a key factor in securing growth—not just monetary policy, but also fiscal policy. Some governments in the region have presidents who used to be Marxist. In Brazil, for example, President Dilma Rousseff was a political prisoner in the 1960s. In Uruguay, former President Mujica used to be a guerilla leader. In Chile, former President Lagos worked with Socialist President Allende in the 1970s. Now they have all embraced macro stability, and that is something remarkable.

Today, Minister of Finance Levy and Governor Tombini mentioned that, despite the low popularity of the government in Brazil, the country
is returning to a better fiscal situation. People are demanding macro
stability again. In particular, in many Latin American countries there
is a shift toward more credible monetary policies with low and stable
inflation. In this context, we can now implement larger countercyclical
policies than would have been possible 20 or even 15 years ago.

Inflation control has taken primary importance since the 1990s,
and many of the larger countries in Latin America have since adopted
inflation targeting (IT). Most of them adopted it at the end of the 1990s
and the beginning of the 2000s. In Mexico, it was adopted after the
Tequila crisis in 1994; in Chile, Colombia, and Brazil, at the beginning
of 1999; and in Peru at the beginning of the 2000s. Peru was relatively
late in adopting IT, although it was the first highly dollarized economy
to do so. By the time Peru implemented IT, the economy was in reces-
sion and facing mild deflation. In sharp contrast to other emerging
economies that adopted IT, Peru needed to put in place an expansion-
ary monetary policy to move inflation to a credible target. IT was not
intended for inflation convergence from above, but to anchor a cred-
ible rate of inflation from below. Peru has the lowest inflation target,
2 percent ±1. It should be noted that Japan also adopted IT recently,
with a negative inflation rate.

In addition, fundamental for implementing an inflation-targeting
regime in Peru were the reforms enacted during the early 1990s, which
introduced central bank independence, assigned monetary stability
as the sole objective, and established a floating exchange rate regime.

Since 2001, average annual inflation in Peru has been 2.6 percent;
and average annual growth has been 5.8 percent. In the group of the
five largest Latin American IT countries, which share somewhat simi-
lar economic structures and are subject to the same kinds of external
shocks, Peru achieved the lowest inflation and the highest growth.

In addition, government debt has declined strongly in many coun-
tries. In the case of Chile, for example, in 1990 public debt was 77 per-
cent of GDP; and this year, 2015, it is expected to be around 16 percent
of GDP. In the case of Peru, it was 56 percent in 1990, but it dropped
dramatically to an expected 21 percent this year.

During this period, we also built a substantial buffer of international
reserves. For example, in Brazil, international reserves are almost
12 times their 2000 level. In Mexico and Peru they are, respectively,
around six and seven times their 2000 level. High international reserves
and exchange rate flexibility reinforce confidence in macro policy and
contribute to anchoring inflation expectations. I believe this has led to lower financial volatility in the region and, through this channel, probably even to higher investment.

During the last crisis, we were able to use countercyclical fiscal and monetary policies which, according to the IMF, reduced the negative impact of the crisis on growth. Actually, some countries even managed to grow in 1999 (Colombia and Peru, for example). Other IT countries in the region experienced only a small contraction in that year.

Because of this improvement in macro fundamentals, there are now some Latin American countries that have achieved investment grade. In 2000, Chile and Uruguay had it, but now there are many more, including Peru and Mexico, with credit ratings of A3 and Aa3, respectively. In the 1960s, the only country in Latin America with investment grade was Venezuela. Unfortunately, that is not the case now for Venezuela.

The “original sin,” a concept introduced by Ricardo Hausmann to describe a country’s inability to issue debt in its own currency, was true until 1999–2000 for the region, but has become less relevant during the last 15 years, since the issuance of debt in domestic currency by Latin American governments has increased considerably. Peru began in 2002, and by 2005–2006, it was issuing debt with maturities close to 40 years, and the participation of foreigners in domestic currency treasury bonds has increased considerably in many Latin American countries. In our case, it reached 58 percent at its peak, and currently is somewhat below 40. In the case of Mexico, recently it reached almost 59 percent. Of course, the appetite for paper in domestic currency is somewhat lower today than two years ago, but market appetite for this kind of debt is still high.

I am convinced that international markets will remain open for the economies of the region with strong fundamentals even when the Fed starts raising its interest rate. Recently, we have seen a lot of interest in Peru from many countries around the world, despite the high financial volatility in anticipation of the first Fed interest rate hike. One month ago [in May 2015], the Peruvian government issued international bonds in domestic currency and dollars. The demand for bonds denominated in domestic currency was more than what we were offering, but small compared to the demand for dollar-denominated bonds. Actually, the demand for bonds in dollars was almost eight times larger than the initial amount auctioned. This is an indication that maintaining access to international markets should not be a problem, particularly for those
economies with strong macroeconomic fundamentals. Interest rates are also lower compared with those at the beginning of the 2000s.

Potential output has been declining, in part because of the performance of commodity prices. Commodity sectors are extremely productive. Thus, if investment in those sectors declines, potential output decreases. Because of chain effects, some of the sectors with high productivity have also been growing at a slower pace in response to lower commodity prices. Thus, productivity has not increased very fast in the last year. In our case, we estimate that potential growth was around 6.6 percent in 2010. This year we believe it is closer to 4.6 percent. We need to consider this when introducing countercyclical policy to make sure that the resulting expansion does not exceed potential growth.

What is Needed Going Forward

Going forward, one of the main challenges we have in comparison with Asia is to increase domestic savings. We are still probably too dependent on foreign financing, a condition that is not easy to change in the short run unless, of course, we adopt policies to coerce more savings—which may not be sustainable. Instead, we need to promote further capital market development and financial inclusion.

Another area of reform that should be a priority for the region is better institutions. Institutions are still weak in Latin America despite the progress achieved in recent years. At the same time, the good news is that the middle classes are pressing for reform. I mentioned before the importance of institutional reforms in securing price stability. However, to make these reforms sustainable, public support for low inflation policies is key. We changed our inflation control policies after a disastrous hyperinflation episode. After that experience, people of course demand macro stability. Now, as soon as inflation begins to creep up, the popularity of the government begins to drop.

A similar situation happened with the move to nationalize banks. Thousands of middle-class people protested against it, not because they liked bankers, of course, but because they were convinced that this kind of government intervention does not contribute to improving their living standards. Their experience in the 1970s taught them that nothing improved for them with government-owned banks. This is an interesting case of how people learn to value good public polices and express rejection of excessive state intervention, and I believe that has been a dramatic change in our society.
To be sure, much remains to be done. As I mentioned before, the pace of institutional reform must increase, but I am not pessimistic about the future. Even though the outlook is for a more challenging external environment, as Governors Tombini and Vergara underscored previously, I think we need to secure the necessary tools to sustain economic growth. In the case of price stability, a considerable challenge for our central banks is the impact of the depreciation of the region’s currencies on inflation. Since the end of 2012, depreciation has been almost 50 percent in Brazil and 20 percent in Mexico; Peru is in the middle (25 percent); and Chile and Colombia are close to 29 and 40 percent, respectively. At the same time, our economies are slowing down because investment in the commodity sectors is falling.

Of course, these adjustments have a common cause in global factors, but I believe the situation is much better than many would think. In our case, we still expect commodity export volumes to increase in the next three years. We anticipate that the production of copper, our main export, will grow by 74 percent during this period due to projects that have already started. This will not only contribute to growth recovery over the next couple of years, but will also reduce the current account deficit to levels close to 2 percent.

**Conclusion**

To conclude, I believe that we need to continue providing assurances to the population that we have the necessary policy tools to maintain and secure macro stability, which is fundamental for long-term growth. Looking at the low performance in many Latin American countries, especially during the 1970s and 1980s, or at the problems some of our neighbors are facing, it is clear that macro stability is one of the main factors for sustained growth.

We need to increase savings and invest in human capital and infrastructure. Going forward, it is important to recognize that some of our weaknesses have probably been hidden by the large increase in commodity prices until not long ago. In our case, for example, if in 2004 we had foreseen that commodity prices would increase by 40 percent and exports by almost 200 percent, we would have certainly pressed for saving a greater share of those windfall revenues.

Thank you very much.
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