GOVERNMENT BORROWERS FORUM

May 5-8, 2014, Cartagena, Colombia

Introduction

I want to take a moment to thank the organizers of this Government Borrowers Forum for their kind invitation to address a few words to such a distinguished audience. I trust that during these three days of discussion there will be a fruitful exchange of ideas on issues relating to the general proper functioning of our economies and, in particular, of public debt markets.

This morning my focus will be on the challenges and risks that our economies may face in the coming years. The story has three parts: Where did we come from? Where are we now? And what are the challenges and future risks? I will rely primarily on the experience of Colombia and some other countries in the region that share similar macroeconomic frameworks. It's possible that some of the risks and challenges this region faces may also apply to other economies.

Where are we coming from?

The macroeconomic performance of many of the South American economies between 2003 and 2012 was satisfactory. Their GDP per capita compares favorably with growth in earlier decades, as does inflation. At the same time, countries in the region successfully avoided the ups and downs of the world economy, especially those resulting from the worst global financial crisis in the last eighty years and the ensuing unusually strong response of economic policy in advanced countries.

There are two main causes behind the remarkable recent behavior of South American economies. First, external conditions favored the demand and relative prices of basic goods that the region exports. As a result, it experienced a substantial improvement in terms of trade and large inflows of foreign direct investment, which have significantly boosted the growth of national income and output. Furthermore, access of the private and public sectors to external financing was ample given the abundance of international liquidity before and after the global crisis.

Second, macroeconomic policy frameworks have been strengthened. Public debt as a share of GDP has declined this century in countries like Peru and Colombia and economies like Brazil and Colombia have developed a deep and liquid domestic market for government debt. This has reduced sovereign risk premiums as well as the general cost of financing. It has also been essential in absorbing adverse external shocks since the payment capacity of governments has not been directly compromised despite episodes of sharp currency depreciations, increases in foreign interest rates, and global risk aversion.

Likewise, the increase in fiscal strength has allowed countercyclical fiscal policy responses to exogenous shocks. It may have even increased its multiplier effect on output by reducing the likelihood of contractionary reactions to a fiscal expansion, which might occur due to higher risk premiums and expected tax hikes (see, Vargas, et al. 2012, for the Colombian case). In some countries, the possibility of using fiscal policy as a countercyclical tool prevented an excessive reliance on monetary policy in its role of adjusting the economy to various shocks.

The strength of financial systems has also been crucial to keep them from becoming a source or a channel of negative shocks on economic activity. So far, capital and liquidity levels of financial intermediaries have shielded the credit channel from the recent blows that our economies have suffered. Progress in financial regulation and supervision, timely and often careful use of "macro-prudential" measures, and maintaining adequate levels of international liquidity have been essential in achieving this result. These elements have minimized the impact of macroeconomic shocks on solvency of financial intermediaries, payment systems, and credit supply.

Finally, in addition to achieving low inflation rates, the inflation targeting strategy with a flexible exchange rate adopted in some countries in the region has allowed these economies to absorb external shocks with only moderate and temporary fluctuations in output and employment. The exchange rate has served as an important variable of adjustment to such shocks. Additionally, an increase in credibility of the inflation target and a diminished exchange rate pass-through have allowed monetary policy to react countercyclically to adverse shocks. The role of the exchange rate as an adjustment variable and the countercyclical response of monetary policy have been key to the stability of economic growth in the last decade.

In summary, progress in the macroeconomic framework for certain countries in the region have brought enormous benefits to their economies. Achieving low inflation has reduced the uncertainty about (ex-ante) real interest rates and, possibly, relative prices. This has contributed to increases in the investment rate. The sustainability of public finances has brought about a permanent reduction in the cost of financing, along with a decrease in the sovereign risk premium. High capital and liquidity levels of intermediaries have allowed the credit channel to remain relatively unaffected by the blows suffered by the economy. Currency flexibility has allowed the exchange rate to function as an adjustment variable that cushions external shocks; this discourages dollarization or currency mismatches in the private sector by inducing the internalization of currency risk in its decisions.

Where are we now?

With good economic performance and a macroeconomic framework that incorporates the lessons learned from past crises, the economies of the region are looking at a change in external conditions that involve new challenges.

In particular, it is reasonable to expect that in this and the coming years, we will see a strengthening of the expansion of the industrialized economies most affected by the international financial crisis. Indeed, three of the factors that have restricted growth during the past few years have been losing strength. The process of fiscal consolidation is now less strict than in the past in many advanced economies. The private deleveraging has advanced, especially in economies like the United States. And uncertainty about future demand has also declined while monetary policy in the U.S., Europe, and Japan is strongly expansionary. Overall, global financial conditions support growth despite the gradual tapering of assets purchased by the U.S. Federal Reserve.

Nevertheless, three other forces can negatively affect global growth. International trade growth has fallen, perhaps due to low investment in industrialized economies, trade restrictions, or unknown reasons for me. In Europe, inflation and inflation expectations have fallen, thus creating the risk of deflation, which could compromise their recovery process if consumption and investment decisions are postponed and the real value of debts increase. And in China, there is considerable uncertainty about the transition from an economy based on investment to one that relies more heavily on consumption while they attempt to control credit growth. If a strong contraction of credit or a collapse in confidence occurs, there could be a sharp correction in the real estate market in China with negative consequences for economic activity and the stability of the financial system.

In this context, some of the issues that attract the most attention today are the behavior of the terms of trade and the adjustment of our economies to the gradual tapering of assets purchased by the U.S. Federal Reserve. The region's terms of trade have remained stable or declined slightly over the past two years as a result of the behavior of international commodity prices. Reflecting a lower expected growth of the Chinese economy, the prices of metals have fallen, especially copper. Coal prices have dropped sharply since the end of 2011 partly as a result of developments with respect to shale gas. The price of energy and agricultural commodities remain high as a consequence of several supply factors. Accordingly, due to the recent stability, or even decline, in terms of trade, the strong impulse that they gave to commodity producing economies in the past, including most South American countries, seems to have begun to fade.

Moreover, with the gradual dismantling of the quantitative easing policy in the United States, international financial conditions of abundant liquidity and low interest rates - which for so long have stimulated the growth of emerging economies- are beginning to change. Local medium and long term interest rates in some Latin American economies have increased substantially. This may intensify in the future as the Fed continues tapering, especially in economies with large external imbalances and high participation of foreign investors in the local bond market. Additionally, the exchange rates of the region's currencies against the U.S. dollar have been highly volatile and prone to depreciate. If a sharp devaluation should occur, the financial health of agents with greater exposure to currency risk could be compromised.

Therefore, with stagnant or deteriorating terms of trade, lower international liquidity, and increasing local and external interest rates as well as some vulnerabilities, it is likely that growth in the major South American economies will be lower in this and the coming years than in the recent past. It is highly likely that this pattern will also be observed in other emerging economies beyond South America.

What are the risks and challenges?

Given these risks and challenges, we must ask ourselves what the appropriate policy response is. The obvious answer is to preserve macroeconomic and financial stability and deepen the structural reform agenda to facilitate sustained and more equitable economic growth.

Macroeconomic and financial stability is the responsibility of central banks, governments, and the financial system. Central banks must achieve and maintain price stability and smooth out the business cycles. This requires countercyclical monetary policy management for which exchange rate flexibility is crucial. Governments must ensure the sustainability of public finances by generating tax revenues that cover medium term expenditures and by correctly managing the sovereign debt market. At the same time, central banks and governments must ensure an adequate supply of liquidity, including emergency liquidity, and maintain a system of micro and macroprudential regulation and supervision to help maintain the health of the financial system as a whole.

Regarding the financial system, its potential role for enhancing economic growth and improving income distribution is hardly questionable. However, in order to achieve this, the financial system must carry out its role appropriately (for example, by transferring resources from savers to investors, and effectively managing risk). Governments must impose liquidity and capital regulations by learning from past experiences, and remove the many barriers to the proper functioning of credit, savings, and insurance markets. The financial system should have a long-term view of regulatory initiatives and structural reforms, and abolish microeconomic incentives that in some cases were clearly perverse. Global banks (and others) must protect their core functions from potential losses in their investment banking and securities market activities. Additionally, in emerging markets, we must be prepared to identify the impact of these policy actions on local financial markets, including government bonds.

Evidently, the decrease in economic growth that arises from changes in the external conditions described above cannot be offset by abnormally low interest rates, fiscal activism, or by relaxing the financial system's standards for risk measurement. On the contrary, such actions create macroeconomic and financial imbalances that eventually lead to deep economic and financial crises. Neither macroeconomic nor financial stability are sufficient to grow at high rates and reverse the inequitable distribution of income and wealth. Other factors are necessary for these purposes.

To be precise and conclude, we must focus on the long-term determinants of economic growth and equity. In many of our economies, the room for improvement in productivity is large: to catch up, we need to create or maintain a competitive environment that is conducive to investment and innovation. For example, we need true trade openness without the proliferation of non-tariff barriers and measures that in many of our countries maintain high levels of protection. We also need institutional frameworks that follow best practices in the structuring of infrastructure projects, and help in identifying appropriate funding instruments during different phases of the projects. We must prioritize investment in human capital, in education, child nutrition, and the overall health of the population. And moreover, we need to eliminate the many obstacles that prevent the proper functioning of production factor markets.