Adam Posen: Economics, and our friends watching online live and via podcast. We are thrilled today to be presenting a new book by José de Gregorio of the Universidad de Chile, and now, as of today, officially as a non-resident senior fellow at the Peterson Institute. And we’re just thrilled that we’ve built this relationship with José over the last year or so. And in part, this is because José gave, thanks to Antoine van Agtmael and the Sunrise Foundation, the first in our series of annual lectures of emerging leaders in economics from emerging markets. José gave that lecture, the first Sunrise Foundation lecture here a little over a year ago, and that work has since expanded into the book that we are releasing today, “How Latin America Weathered the Global Financial Crisis.” And we’re very grateful to José, but also to Antoine for enabling us to entrepreneurially take José’s insights and build them out into what is a really terrific piece of work.

I will get back to the substance in a moment, but just to say, we continue in that vein. Many of you were here for the second Sunrise lecture, Sunrise Foundation lecture, which was given by Simeon Djankov in his, literally it turned out, last days as Finance Minister of Bulgaria, where he had taken a very brave and principled stand on Fiscal Policy, and there was a backlash. Simeon is now going to be working with our colleague, a long time senior fellow Anders Aslund. They’re going to be doing a joint project with many of the people such as [inaudible 00:01:46] and [inaudible 00:01:47], who actually led the transition in Eastern Europe on looking back at the post-Communist transition after 20 years. And we look forward to releasing that book in the fall. And again, so thank you to Antoine for giving us the jumping off point, and we look forward to announcing--I don’t know if anyone can quite compare to José or Simeon, but a comparable third Sunrise Foundation lecture in the next couple months.

Turning to the substance, the Peterson Institute, under Fred and particularly with John Williamson here through the years, but also with many of the colleagues still with us now, has always been concerned about Latin America, as well it should be. And concerned about Latin America, not just as what’s the direct impact on the US, what’s happening there,
but--and perhaps this comes across badly--but as a testing ground for many rules of policy. Many of you will remember the term “The Washington Consensus” was coined here some 20 years ago under John Williamson, with a group of distinguished Latin American scholars and economists. And we sit here now, and José is bringing us a message that is there in the title, that Latin America weathered, and inarguably a large part of the continent by both population and economic wealth, thrived in the aftermath of the global financial crisis.

And for all the talk about what’s happened since the taper, and concerns that our Barbara Kotschwar articulated a year ago almost at our forecast meeting with Brazil in particular, the record of how Latin America came through the crisis is really astonishing if you look back to Latin America’s vulnerability to external shocks in the ’70s, ’80s, and even the ’90s Asian crisis. And obviously, the official sector, including our many friends from the IMF and the Inter-American Development Bank and The World Bank, played a key role in this, but also it was people like José, as many of you are aware, he was governor of the Central Bank of Chile for 4 years--from 2007 to 2011. Prior to that, he was Vice-governor; he had been a member of the bank’s board from 2001. He and a number of people similar to him, who had trained in the US at MIT--Rudi Dornbusch and Stan Fischer’s legacy in many ways, but who came out and were broad-minded, and some people in Latin America would tar them with the term “neo-liberal,” which some of us would view as a badge of honor in a certain context, produced good results.

And I think, without wanting to take anything away from José’s work in terms of giving away the punch line, what matters is the argument, more than the punch line. But I think it’s important that we recognize, for all the well-deserved backlash against economists in the aftermath of the global financial crisis and the backlash against macro-economists and central bankers in particular, which again, I admit to being deserved, that there is still a mainstream consensus position on macro-economic policy. And it is one that has served a number of the countries, and thus a number of millions of people around the world quite well.

And part of the mission of the institute is not just to blindly parrot these things, part of what we feel we contribute beyond some academics, pure academics, is we do pay more attention to regional differences, to local institutions, to historical development, not just abstract. But in the end, we do believe that the vast bulk of mainstream economics is applicable, whether it is, as I’ve argued in the past to Japan, as numerous people in this building have been arguing with limited avail in Europe, and where José and a number of his colleagues, but certainly José foremost among them, have successfully helped Latin America weather the financial crisis.
So everyone out here gets a copy of the book. Everyone online, there’s a simple button to click on for your copy, and now I turn to José for a fantastic presentation. Thank you so much.

José de Gregorio: Well, thanks very much Adam for the kind introduction. It is really a pleasure to be launching this book at the Peterson. I think that I must thank first Fred Burks and Antoine, they invited me to give the inaugural Sunrise lecture here at the Institute, on emerging markets, and I talked about these issues. And of course, this was the first discussion to put all of this presentation and all of these in a book. So this was where the idea was born. Then I have came, and the Peterson has been a great place to work, to receive feedback, and to do all the necessary groundwork to produce this book. I’m very glad, I’m very grateful, I’m very glad now to continue in a more permanent basis as a non-resident senior fellow. So there are many colleagues also here that we had many discussions on the IMF and the ADB on the issue.

Now this book is about policies, and I like policies and talk about policies. And perhaps I said at the end, Latin America is kind of an excuse, but this is an excuse that’s very close to me because it’s the place that I know the most and where we have a lot of experience. And of course in this book, there is at some point, and I will have to recognize, a little bit of bias towards Chile, well I have to recognize it, just starting is my card, I don’t know.

Now when one writes a book about current issues like this one, and with all the publication lags and the production lags, you end up and at the end you say, “Well, I would have added this.” So I will try to convey to you some ideas, things that are not necessarily now in the book, but things that have been happening now, and I think that are quite important for the region, basically because the region weathered very well the global financial crisis, but that is not a guarantee that there will be more progress or everything has been done. Indeed, after you weather such a big storm, perhaps you shouldn’t be complacent and think that you can weather any kind of problems, and there are some problems in the region.

And especially, I think that Latin America now is slowing down. There are some financial tensions, and we have to take seriously the lessons from the crisis in order to grow and improve the living conditions of all people in Latin America. So I have to recognize that in my case, it’s not that dramatic the publication lag because I have to recognize the efficiency of the Peterson. We started this like a bit more than a year ago, and now we see the book and I think I’m quite impressed and grateful. So I will outline the main policy issues, and I will make some comments on current challenges. So let me start first--if you have been with me in some
presentations, this is a slide that is always with me. And this is what I want to explain and to tell you about Latin America.

What needs to be explained is that we see the first panel is--Latin America is the blue one--that was the debt crisis, the last decade for Latin America. So the debt crisis Latin America, 5 years after the crisis, was hardly 10% above what it was 2 years before the crisis. So basically there was no growth in per capita terms, there was not growth. Advanced economies, they had a recession. Okay, this was the ‘80s, but emerging Asia, they didn’t know that there was a crisis in Latin America, okay?

The book has discussed 7 countries, and I take the simple average. If we take average weighted by size in Latin America, we end up talking about Brazil, a little bit of Mexico and nothing else. Because Brazil and Mexico, they make two thirds. So a compromise, instead of taking the 32 countries, equal size in Latin America and the Caribbean, or weighting by size, I say well let’s take the 7 biggest countries that make more than 90% of Latin America GDP. I did the same, sort of arbitrary for Asia to China, India, Indonesia, Korea, Malaysia, Philippines and Thailand, which I made also the simple average.

And then the green line is advanced economies--G7, you can do it in many ways and it’s always the same. So this is the debt crisis. So then you say, well the debt crisis was a problem in Latin America, but then you come to the Asian crisis which is striking. The Asian crisis of course was in Asia, so the red line should be below all the other lines at the moment of the crisis, in ’98. But then Asia recovered quite fast, and Latin America stagnated. At the end, Latin America is almost at the same point as in the debt crisis. The difference of course is that we don’t have that output loss, but that was so huge, so there was no growth.

And this is now the recent crisis. Even if you take from the red line, but I don’t--China, you get very close; Asia, because China pushes a lot the Asian--but Latin America has done very well. So this is what we want to understand, and this is what I think that is, you set the stage at least for macro consolidation in Latin America. Nowadays, one has to recognize, and it was studied that was good luck. Latin America, we did in the early 2000s, in the mid-2000 with a very positive [inaudible 00:12:14] in terms of trade, and most Latin American economies have been very--being exporters of commodities; they have a [inaudible 00:12:23] gains.

This graph, I use a lot this graph, the bar is the maximum and the minimum in that long period--from 1980 to 2010. The red line is just at the beginning of the crisis--2008, I’m sorry the blue; and the red is the average of the first half of the 2000, just coming out of the Asian crisis that was very bad for commodities because it was Asia.
So what we see is that most countries, especially Chile, Venezuela, Peru, Argentina, have huge terms of trade gains. So that’s an important part in terms of helping the helping growth, investment, helping also public finance. The case of Mexico isn’t easy because Mexico has not such a big terms of trade gain because it’s not that important export in the world economy, but it’s quite important on the fiscal side because a lot of fiscal revenues are linked to oil price. So Mexico also enjoys, not overall the private sector, but the public sector benefit a lot from terms of trade.

Now, what the first thing--this is not [inaudible 00:13:39] it’s the order that I put it in the book, but the first thing that was achieved was inflation, consolidation, and a very strong monetary policy. Inflation, just to tell you the story very briefly, inflation until 1990, in all Latin America in the ‘70s and in the ‘80s, by the decades, inflation was 2 digits. Only in Columbia had no 3 digit inflation in the last 3 years, so it was a huge problem. Now, it came this period after the Asian crisis, especially only Chile had 7% in the ‘90s. So it was the first country to consolidate, but there was another low level, but it was 7% because the second half was with lower inflation or with a recession too.

But there was inflation consolidation except among the 7 countries, Argentina and Venezuela. Argentina is just at 10%, the official figure. So that’s it; and they make it at 10%. And then Venezuela which has been close to 30 most of the time, okay? But all the rest of the countries, all the countries that are here were able to consolidate low inflation, were able to implement inflation target that was key for the first time, having a strong monetary expansion that was key for the recovery, more than avoiding the recession, was central to the recovery. I discussed a lot in the book, inflation target worked quite well in emerging markets. Inflation target was a central piece of the equation to succeed during the crisis.

Now, rates are lower than pre-crisis still, and this wall, they are diverging path, and we see Brazil with more inflationary problems; they are raising rates. The other with the slowdown are cutting rates. But this is more discussion for the book and I don’t want to take too much time.

Now what’s happened with fiscal policy is interesting because for the first time, this is--I always said, there was sort of academic schizophrenia in Latin America, because we always told our students, whenever you have a recession, you have to do monetary expansion and fiscal expansion because that would, it was said in the books that we input to teach our students. But whenever there was a recession in Latin America, we tighten the monetary policy and we tighten the fiscal policy. So at the end, you have to--but this was not in the textbook, it was not in classes. So in this
time, there was also for the first time, based on fiscal expansions. This is cyclically adjusted 2 years before, the year of the crisis, 2 years after.

What is interesting I think this is a challenge for Latin America, is that the fiscal expansion has not been completely undone. And this is the blue line; this happened in all emerging markets. And if you look at more carefully a data on expenditure and revenues, what’s happened is that there was a very strong fiscal expansion on the expenditure side, and the contraction of expenditure was not at the initial level. So there was some stickiness in fiscal policy that I discussed further in the book, which is not traumatic, but is a couple of points of GDP that now countries are how to accommodate and have lost some fiscal space, okay?

Now, the question is why there was this completely against traditional standard macro policies; why there was this in Latin America? And this was the term that was coined more than 10 years ago; we had pro-cyclical fiscal policy. We have pro-cyclical, like in Greece I always say, just like in Greece. But it’s not because we knew all of these, what’s going on in these countries, but was not because we didn’t know, or we didn’t understand the book, is because in Latin America, we couldn’t finance a fiscal expansion when there was a recession because usually, a recession reduces greatly the worthiness of the government, the government depends a lot on borrowing, and in foreign borrowing in order to expand a fiscal policy. And all the problem now is financing.

So if you don’t have financing, you have to tighten, and that was the typical problem in Latin America that generated a lot of pro-cyclical fiscal policy. So whenever you have a terms of trade boom, you took advantage of spending more because you are constrained, without allowing for borrowing, you are constrained, was relaxed, so you took advantage of doing things that you were unable to do before. And that’s quite important. But also, monetary policy tighten’ because monetary policy was driven with fear of floating. And this is the big difference, and this is the second graph that is always with me, everywhere. This is, at the left side, these are exchange rates during the global financial crisis, and at the right hand side is the exchange rate in the Asian crisis.

You see that there was a--from peak to bottom, I have to clarify, high is depreciated, okay? So the depreciation in Latin America was about 60% during the crisis, for all these countries. Some [inaudible 00:19:17] but most of these countries were 60%. It’s the same scale 2-year window, exactly same. What we see in the Asian crisis is that countries struggle a lot to avoid the depreciation. There was fear of floating, at the end there was a crisis in Brazil, there was a first financial crisis in Columbia, there was a lot of currency pressures in Chile and Columbia. Well, Columbia had a crisis. Peru and Mexico, they had a serious problem.
So at the end, what we see here is that the fear of floating was at the center of all these contractionary policies during the previous crisis. And they end up generally with a crisis. And why was there a fear of floating? Two very simple reasons: Why, there was a belief that there was huge mismatch in the corporate sector and in the banking system, so any change in the exchange rate will cause huge balance shift effects.

So they even said that during the Asian crisis, there was no mismatch, and I reported in the book. There is some issues that flexibility itself brought a lot of hedging by corporations. And the other reason for fear of floating is that we depended on the exchange rate as a nominal anchor to control inflation. So whenever the exchange rate depreciated a lot, this went through inflation. Now, when we adopt flexible exchange rate, which I think that is a cornerstone of success in Latin America, the path through decline because monetary policy was credible, and the financial sector and the corporate sector, the banking, they hedge themselves without the need of compulsory hedging because it generates, were allowed to float.

And this is a monetary, this is not [inaudible 00:21:11] but this is, Brazil, Chile, Columbia and Mexico, interest rates, monetary policy rates, green Asian crisis, red during the global financial crisis. I don’t need to explain too much the difference. They were high, and they were even tightened during there is an inflation differential, but that doesn’t make that much a difference, and they were even tightened during the Asian crisis, contrary to what the textbook and what we learned that we should have done, okay?

So the other issue which is important, and I take a note of this which is interesting, is international reserves.

International reserves, countries have a lot of international reserves, and they are accumulated for 2 reasons, and this is a standard discussion in economics. They are accumulated because they are insurance, self-insurance; and they are accumulated because they help you to contain currency appreciation. And this is for competitiveness reason or mercantilism reason. What is interesting is that countries--a lot of countries. Countries accumulate a lot during the crisis, they use very little reserves and they keep accumulating after the crisis, which is a first indication that most of the accumulation of reserve had to do with competitiveness reason and countries trying to fight against appreciation.

And this is a table that is in the book, and I have the colors there, which another striking fact in Asia and in Latin America. The use of reserve during the crisis was much more during the Asian crisis than during the global financial crisis. That was much more dramatic, was the biggest crisis in the great depression, and on average, during the global financial
crisis, countries used between 10, 15 percent at the most, and was much closer to the 20% during the Asian crisis, which shows that countries allow to float, and they were accumulating most likely for competitive reasons. They had a lot of reserves, much more than in the Asian crisis, which also may be an indication that sitting in a big chunk of reserves, allows you to deter and to prevent speculation against your currency. So I have more discussion about this which is not clear, but it’s quite interesting how little was used all the reserves that countries have already accumulated.

And then we had monetary fiscal policy reserves, and then we have of course, a well-capitalized banking system, low leverage, high capital adequacy ratios, so compared to any other region is quite reasonable and quite low. Now why is this? This is not a surprise. I always say nothing of this because we had a very good thinking and we say, well no because we had a lot of crises, so we’re extremely prudent. We’re extremely prudent in terms of bank regulation, very prudent in terms of bankers who are relatively prudent, at least when compared to bankers in advanced economies. Because there was a [inaudible 00:24:32] of stories in the past about crisis.

The case of Chile is a [inaudible 00:24:38]. Chile in the 1980s had a huge crisis, a huge financial crisis which was kind of Greece, was fixed exchange rate, was financial realization, financing a huge current account deficit. Then came down the corporate price, the currency took a long time to adjust, and we had a 15% decline in output and a huge financial crisis. So we learned from that, the costs were paid by those that made the mistake. So at the end, I think that was quite important to have a very strong and well capitalized banking system.

The final point that I discuss in the book, which I think that’s quite important in Latin America, is capital inflows and capital controls, which is of course a quite debatable, and there are a lot of angles to discuss this issue. So I’ll start by asking one thing. Have the emerging markets been flooded by foreign capital? My point, discussed further in the book, is that if you compare the red and the black, the black is in the ‘90s, the red is in the 2000s. What we see is that if you take the surges of capital inflows – so if you take the countries that experience surge of capital inflows in the ‘90s and in the 2000s, what you see in Latin America and in Asia is that they have a surge. So there are issues with the figures because there are always several omissions that [inaudible 00:26:14] but they had, especially in Latin America, had net capital inflows similar in the 2000s and in the ‘90s, but not to finance a huge current account, but to finance most accumulation of reserves.
There is an issue of course, [inaudible 00:26:31], where its reserves that’s pushing capital inflows. I have long discussions with people here at the institute, but that is a very important issue whether reserves are driving capital inflows or capital inflows are being responded by reserves. But the fact here is that the current account was limited. In the case of Asia, they have a surplus, and they had net capital inflows because the accumulation of reserves was very large. And the emerging Europe was the only, that had huge capital inflows financing a huge current account.

So the first thing I think that’s quite important to understand to discuss, is that it doesn’t seem that we really have been flooded by capital--like it was perhaps in the ‘90s, when this term was coined in the early ‘90s, when especially when start with Calvo, later [inaudible 00:27:24], they had this capital inflows in the ‘90s because they were financing large current account deficits. So this is an [inaudible 00:27:32], then comes the issue of capital controls--a macro prudential, and I spend a lot of phases in that because it’s a very important issue. I just want to make one point, there is a very strong issue that where we talk about capital controls as a macro prudential tool, or as a macro policy tool. Because this is not true because macro prudential--all the discussion of macro prudential policies in the last 5 years have to do with how to avoid that the financial system creates excessive volatility, and may be very vulnerable.

So they did inquiry at some point, they put a tax on liabilities of our banks. You can do things because you see my objective is for the country not to have a very high leverage with foreigners. However, most of the time, capital controls are used when you say you claim that you are being flooded, but at the end, capital controls--and this is just my experience I’m talking a lot to people--is because the currency is too strong. So if the currency is too strong, how can I avoid it? I intervene and I put controls and I do all of that and that’s it.

So what I said is that we have to distinguish in order to have really and have a productive discussion on macro prudential tools, we should have very clear what are the objectives what we want to do, and try to separate even the same instrument that can be used for different purposes by what we want for financial stability, and those are the macro prudential tool.

On effectiveness, it’s very debatable. My take, I come from a country that use capital control is used as a poster child, and most of the [inaudible 00:29:22] said that, and I discussed it in the book, is not effective. And when countries have all these pressures of capital flows and exchange rate pressures, like in Chile in the ‘90s or Brazil in the late 2000s, is much more related to extremely high interest rates than to capital controls, but you can see it in the book.
So let me just close by saying, now there are 2 risks in the region. One is the declining commodity price, that we have seen already a declining commodity price. Oil is, it has a lot of geopolitical risks, but copper, food, that are quite important in the region, have been declining, and that’s a risk. And so that’s a problem, that’s a risk for public finance, so it’s necessary for economic activity for the current account. And the other risk is tapering, which is an irony, because at the beginning of this year, of last year – at the beginning, the [inaudible 00:30:35] was a currency war. Please US stop, your extremely expansionary monetary policy because you are killing us with the exchange rate. That was the talk in the early 2013.

Then the US may set, probably in a likely scenario, we may start gradually retiring the impulse, and currencies move widely and they depreciate. All that we were expecting for 10 years to depreciate than to gain competitiveness and say, “okay please, please don’t take it too strict, just taper the tapering. So don’t be so…” so it’s kind of an irony. But there is some truth about this, and this has to do with the issue of the fear of floating. Not all countries are the same; not all countries can resist and can absorb a 30% depreciation, so that’s a concern. Not because it will have a huge collapse, but this comes with a recession, a depreciation. Some countries may face some problems, and most of the countries that float in the region, I don’t think that they will have too serious problems, but outside the region, there may be countries that may face even once they were--perhaps Brazil, Mexico that are quite big, may face some bigger turmoil because they absorb a lot of capital inflows. And because, of course all this volatility and the tapering may shift capital flows in the direction of leaving emerging markets, and the issues, well if you can finance your current account deficit, there shouldn’t be, and with the depreciation, there shouldn’t be a big problem.

Now this is not the same for all countries. Now, at least countries have still a lot of reserves, so they can, most of them, Argentina is running out, so I’m not talking about Argentina but the rest of the countries, they have enough reserves in order to accommodate this. I discuss a lot in the book. You can intervene, you can use reserves, but try most of the time, do it on a rule base. Don’t be extremely discretionary because you become kind of addicted, or at the end you try to do every other week, some intervention, and it loses a lot of effectiveness. And also you get [inaudible 00:33:08] whether you want the level of the exchange rate [inaudible 00:33:10], you just say, if I want to provide liquidity, because liquidity may try, I will do it for the next year in this amount.

In Chile we did it on a daily basis rule base. We only, in the intervention where we accumulate reserves, we only have the discretion of doing it at any time between 10 and 11AM, because that was the degree of discretion
that was asked to us by the traders because they say, well if it is a strict
time, it could be a little bit expensive.

So what’s happened with the perspective in Latin America? Latin America
did relatively well during the crisis. Of course Mexico, because it had a
very bad neighbor, was the one that did worst. And then we have the Latin
America grew strong in 2010, and I like to put 2010 because countries that
did well in 2010 didn’t do exactly well. It’s not correlated in the next 3
years. And then the forecast, the IMF forecast for 2014.

The bottom-line is, countries are slowing down. Perhaps they are setting to
what should be their long-term growth. Long-term growth in Brazil
between two and three, they thought in 2010, growing at 7.5 that they
were like China. And you hear serious people say, “No, our long-term
growth is about 4%, four and a half percent.” I say, well… like Chile is
not a good [inaudible 00:34:43], you are better at soccer, but I don’t think
that our growth is--Chile may be between 4 and 5; there is a lot of
discussion with energy. Columbia to Peru, who was growing at six seven
before, and very strong, now is coming to more normal because Peru is
not a country that could grow at 7% forever; it should be also close to five
and six. There is a lot of catch-up effect on countries when they liberalize.

So countries are going--which is not a very good news in the way that
countries in Latin America have no very strong long-term growth,
especially the big ones. And when they said this deceleration, this brings
some additional risk to macro progress, because people were used to grow,
population were used to get jobs, to have increasing wages, and probably the
expenditure grew permanently a couple of percentage points, so it gave
more social expenditure. But now, with low growth, there would be
disappointment. And the region, and this is a, I also have the discussion, is
a region extremely unequal. An equality becomes extremely evident in the
slowdown knowing the boom.

So in the slowdown, after many years of reform--so here comes a lot of
risk for the region. I think that there is a risk of populism, and always our
region was the one that the example of populism. We have the [inaudible
00:36:15], basically doing things that are, perhaps may be positive for the
poor in the short-term, but are not sustainable, and also may be very
damaging from an incentives point of view. But also, we may face the
problem of not doing the things that we need to do because there are a lot
of vested interests, which is common in Latin America. And we need to do
progress in order, on the one hand, to increase productivity growth, but on
the other hand, to increase social inclusion, which I think that is the big,
more long-term challenge if the region wants to be developed. But all of
these, don’t forget macro. I think that that’s the most important.
There is no shortcut, and if you don’t have a strong financial system, strong macro policies, strong fiscal and independent central bank, you will always have the risk of not being able even to stabilize the business cycle, to provide the space for growth. So fear of floating is not a trivial thing in the region, and one has to be careful. Fiscal terms of trade, I think that there is still a [inaudible 00:37:25], especially we have a lot of reserves to absorb the financial turbulence. But also, you’ll never know also all the expansion of the economy and the financial system, the degrees of vulnerability across countries on the financial system that has been, in the case of Brazil, very strong policies in the development banks. And doing consumer trade in slow down, they may have problems. Nothing, I think, that is worse in the past and in the previous crisis, where we have even the macro very distorted. But there are challenges, and I think that is a--I have a moderate optimistic view, but with some bumpy roads. Thank you.

Adam Posen: Anyway, that was terrific, José. Right at the intersection of policy and analysis of specific to the countries, and general to the world, and really, just great to have you presenting this here for us. Before I open it up to our distinguished audience for some give and take, can I pose just a couple of questions, ask you to expand a bit on what you were talking about.

The first is, there’s always a question about macro policy--sort of like with central bank independence or many of these things. You know, it’s sort of, if it’s so good, why don’t you just do it? Why did you do the wrong thing in the first place? And you sort of hinted at that when you said that there’s this history of populism in Latin America, and the risk remains. What do you think was the key to getting this important group of countries to pursue broadly, sensible policies on average, both over time and across countries? Was it, you said that in terms of the banking system, it’s just we had a lot of crises. But you know, you had a lot of crises in the ‘70s and the ‘80s and the ‘90s, and that didn’t seem to be enough to prevent future crises. Was it just the intellectual case was made? Was it our Washington consensus really did have benefits? I mean, what do you think led to this sort of emerging set of good policies?

José de Gregorio: Yeah, that’s a very tough question because of its--I have some ideas of what may have--but there was the intellectual basis for this, and we work and we learn and we knew. There was, in a way, I think with the debt crisis, there was sort of a being tightened with too many crises, because it was not just one--the ‘80s were really, really bad.

Adam Posen: Yeah.

José de Gregorio: And in the ‘80s, for example you have the case of, in the case of Chile, I always say, fix exchange rate, which was kind of a very reasonable policy, until that time in Latin America to control inflation, exchange rate based
stabilizations, but we realized that was very bad, and that was also the financial system--a financial realization, I would say.

Now, so there was the entire--the experience, and I’m not sure how strong is this, because in my case it may not be very convincing. But I think that the Chilean experience was a little bit ahead of consolidation, of an independent central bank, and of a lot of growth.

Adam Posen: Yeah.

José de Gregorio: And in that regard, I think in the region, that may have helped also to provide empirical foundations for all of these kinds of [inaudible 00:41:31]. There was the Washington Consensus. I think that the Washington Consensus, when you take half of it, is do good macro and open your economy. And I think that that has been key to success.

Adam Posen: I know. Just a hint now that you’re one of us at PIE, you’re allowed to say it was your own personal brilliant leadership, creating the triumph in Chile that led the way in Latin America. But anyway--sorry, I’ve got a couple more from me then I’ll turn to the audience.

Turning from sort of [inaudible 00:42:01] economy to the more practical. Obviously, of the many things you argue, you make the case for exchange rate flexibility in time of crisis, for not getting too--while you understand the need for self insurance--not getting too caught up in fear of floating, that’s obviously a very controversial point of view, even though a number of us in this building, including Joe Gagnon, Ted Truman, Marcus Noland and I look at the Asian crisis, have argued that that seems to be the case as well. Why do you think there hasn’t been similar convergence on getting over fear of floating, as there were on some of these other macro policies?

José de Gregorio: Like…

Adam Posen: I mean, just the flexibility in the crisis.

José de Gregorio: Yeah.

Adam Posen: I mean, so we just happen for--it is our reason to be talking about Barbados the other day. And Barbados has gotten itself into a lot of trouble because it’s maintained a peg forever. I mean, they’re tiny so they don’t really have a choice.

José de Gregorio: But they don’t have, yeah I--this happen a lot with very small countries, that they don’t have market to have a currency. But I start from the Mundell-Fleming Dornbusch we have to call it the Mundell-Fleming idea that for a country that has a lot of terms of trade volatility, volatility of
international conditions, you better have a flexible exchange rate. It’s very difficult to find a case for not allowing in a small open economy to have a flexible exchange rate. Now, what’s happened I think that again is that we had a lot of crises in Latin America, and now we decided to float.

Now, float is not, we do not float as is done in Australia or Canada. No, then we intervene. I would say is a floating with an eye on competitiveness. So if things are too--if the currency is too strong, we did it in Chile, we accumulated reserves. How effective is reserves accommodation, we don’t know, but at least you are buying cheap foreign currency when your currency is very strong, so you can do it. And if you do it on a rule base, I think that’s quite important in order to have flexibility, and not to start with arbitrary intervention. That’s a big problem because countries, they’re saying, well--so this was the case of a country that said, well, 1.6 for the Riyal--I won’t say the name of the country--1.6 for the Riyal is too strong, but then they say, but 2.3 is too weak. So at the end, you have a ban. At the end, the market speculate, and at the end perhaps--so forget about they said anything, that it has worked; it worked quite well. There was a 60% depreciation and no financial crisis, and inflation was contained. So I think that’s…

Adam Posen: One of the—listen I promise this is my last one--but one of the many interesting things you point out in the book is you do this discussion of how it isn’t all just commodity prices, terms of trade. And you pointed out how Argentina and Venezuela, because they are not going as far along with good macro as some of the other countries, are vulnerable. Can you say a little more about what you think are some of the key differences among the 7 economies that you looked at? I mean, any other key, their institutional or forecast differences you think are important?

José de Gregorio: Yeah. Institutions are always different, but if I have a big, big difference, is the exchange rate. So in Argentina, I think that they lost--I discussed with official by that time too--they lost the opportunity to increase flexibility during the financial crisis. They should have let the exchange rate to float more, not completely because they say while still--okay, but to float more. Instead, they got in this, and they think about fixing the exchange rate because that was also the anchor.

So they said, well--and that they said publicly, we cannot let the exchange rate to move too much because that would affect a lot inflation. So they got like trapped instead of letting the exchange rate to float, they got trapped and they are now with 100% premium in the black market. And they just created a dollar committee with the government, the central bank, to try to fix it and the main important, and Venezuela’s the same, with the black market, they try to control inflation. Cheap import, or at least also doing industrial policy who has access to different exchange rate. And I
think that’s accumulate current account deficit, not still but they have a real over-valued currency. And I think that, on the macro front, is a big difference.

Now this may be because there are underlying weakness in the fiscal, weakness on inflation, so there may be other things, I wouldn’t say just let it float, because let it float maybe financial collapse. But I think that the dynamics have been this instead of going through flexibility, the dynamic was going through more rigidity, and I think that that’s really a problem.

Adam Posen: Great. Okay, let me open it up. As usual, we have a travelling mic upfront, we have a standing mic at back. I asked my colleagues in the Peterson Institute to let our guest ask the first couple of questions. Please identify yourself when you speak. We’re here to fill in on Antoine. Randy, if you want to go to the mic, you’re welcome to do so.

Phil Levy: Hi. Phil Levy with the Chicago Council on Global Affairs. Very interesting presentation. I was going to ask you to give some relative weights. You started and finished talking about the importance of macro policies. In the middle though, you had some enticing stuff about trade and trade orientation, where you had the data on what had happened with commodity prices, and then you made the remark about how Mexico’s performance lagged because of their unfortunate choice of neighbor. So how do you infer sort of the relative weights, because there didn’t seem to be anything particularly wrong unless I missed it, with Mexico’s macro policies?

Do we infer from this, therefore, that it was really more the fact that you were getting an emphasis on commodity exports, and you were trading with Asia and Asia was doing relatively well throughout this crisis, therefore you were less dependent on the developed countries that were lagging? Or how do you weigh that against the macro policies?

José de Gregorio: Yeah. It’s quite difficult and it depends on a country. When I say that Mexico did bad, but then Mexico recovered and may have done better with the '94 crisis, but have done relatively well. Now, how much is per country is quite difficult. Now I can tell you what I have gotten from more econometric things that I have been doing, and trying to look, I’ve always been very careful with econometrics because--but even with my own.

First, fiscal policy is not that clear. It’s always very difficult to get a monetary policy and exchange rate flexibility are important. Reserves do not appear that important, but when you have excess reserves, and the reserve excess is randomly distributed across your [inaudible 00:49:47], you may get nothing because you have excesses, not because reserves is no good. So this is the only claim. And terms of trade, and that should’ve
been sort of weak when you look at the big [inaudible 00:49:59]. To Adam’s question, I always mention one thing, which is the best example for me, and this is my Chilean bias—Chile, from 2000 to 2002 had the worst copper price since the great depression. If you take 3 years average, real terms, copper price the lowest 2000, 2002. Why I know that very well, because I was mining minister among other things, but I was not responsible for copper price.

So it was the lowest copper price, and the economy grew at 3.5%. And then we had the highest copper price in 2007 to 2010. Four times the one that we had at the beginning. And we didn’t grow 10, 15%; we just grew at 6%. So that shows you an example how policies dampen a lot the business cycle, which 20 years before, the same copper price would have been a complete disaster for the Chilean economy.

Adam Posen: It’s really interesting. And some of you may remember, I already mentioned Barbara’s presentation, you may remember at our last forecast where Arvind Subramanian did a very interesting presentation on the long-term for emerging markets, and had some cross-sectional results saying we shouldn’t over-estimate the effect of commodity prices on emerging market growth. Again, that’s not to over reduce Phil’s question, which was broader than that, but just a reminder. If we can have Antoine and then Randy, please.

Antoine: Antoine [inaudible 00:51:38]. José, you introduced, I thought, a really interesting idea that I hadn’t focused on very much until you spoke about it. I mean we all know about the importance of the macro economic framework; I think, most people are agreed that that’s important. But what you seem to say—and I just want to make sure I heard it right—is that an ounce of prevention goes a long way. In other words, that having policies well before a crisis that help you avoid bubbles, and particularly over-valued exchange rates, help a lot to kind of minimize crisis, and maybe—and I want to see if I heard that correctly—maybe nearly, or even as important as the tools during a crisis you have of monetary and fiscal policy, or did I hear that wrong?

José de Gregorio: No, you’re right. I think that it’s quite important to build them and to have them in place and working well. And in this discussion for example, the eye of countries on over-appreciation is precisely allows you to have some form of monitoring of risks. We have all the discussion on--most Latin American countries with inflation [inaudible 00:53:05], they have also a financial statistics report, doing very serious stress testing and for exchange rates, so yeah, you have to be prepared.

And this is, regarding also to the first question, how countries got here, countries got here, most of the macro framework was built after the Asian
crisis because of disappointment and because of the crisis in Brazil. And to a large extent, because in Brazil, they started very formally and very fast with inflation [inaudible 00:53:35]. And I think that that’s what created the—to have been, to have a policy framework that was already have some years of working and we knew how to do it.

Adam Posen: Yeah. To plug another one of our local heroes, Arminio Fraga on our board, of course was governor of the Central Bank of Brazil, overlapping somewhat with José’s tenure, and the region was very lucky to have those kinds of leaders at the central bank. We’ll come back to you in a second Wesley. Randy?

Randy Henning: Thanks Adam. I’m Randy Henning at American University. José, thank you for the presentation and for the book. I had a question about 2 of the instruments that were used in the crisis, and I wanted to ask you for your thoughts and reflections on them.

The first is the central bank swap lines that were extended by the Federal Reserve to central banks in Mexico and Brazil. As a central bank governor, I’m sure you’ve given some thought to the role of these swap facilities in stabilizing financial markets in the region, and I wanted to ask you how you assess them.

And the second instrument is the Flexible Credit Line at the International Monetary Fund. Of course, Mexico avails itself of the FCL, but the other countries in the rest of the region do not. And I’m curious to hear from you a little bit about the buzz within the region about the merits of applying for and receiving an FCL, and in particular, whether you in Chile had given thought to a Chilean application at the fund for an FCL. I think your thoughts about this might be useful as the fund approaches its assessment and review of the FCL over the next couple of months. Thank you.

José de Gregorio: Thank you. Regarding the FCL, I think that there are 4 countries—Mexico, Columbia, Poland—I have written a lot about the problems of FCL and the difficulties to be really massive because it has one fundamental flaw. It provides insurance, it maybe even cheap, but it reduces—it should rationally reduce—the incentives for countries to accumulate reserves. And you have to have the option of accumulating reserves. So when we accumulate reserves in Chile we say, “We accumulate reserves because it serves the insurance, it’s more expensive than the FCL, but we have the only exchange rate tool, which is to accumulate reserves from time to time. FCL said, I’ll give you something cheaper, and you don’t need to accumulate reserves. But I want to accumulate reserves, so I think that’s a…”
Adam Posen: Before you continue to answer Randy’s very important question, how much of that is, “I want to accumulate reserves because I don’t fully trust the FCL and I want my own insurance;” and how much of that is, “I want to accumulate reserves because I got a mercantilist export strategy.”

José de Gregorio: I think that most is mercantilist export. I’m doing also some research, but this is a lot and this is very experienced. Always people said, “No I will insure [inaudible 00:57:15] your currency’s very strong.” Well, [inaudible 00:57:19], but this is a lot of… So then you say, “I give you insurance but to not to accumulate reserves, but you want to accumulate reserves because of mercantilist, you cannot separate. So that makes it very complicated.

Then they say, “eligibility what you need is a…” And you see, even in this crisis, FCL was not relevant. Now the swap lines, I don’t know how important were they, but the swap lines were thought because of Brazil and Mexico. But very few countries had the swap line. So the swap line was for 4 countries. Now, you have to say that Brazil, Mexico, Singapore and…

Adam Posen: Poland. Was it Poland?

José de Gregorio: No, it was another Asian; I think it was Korea. You say, we have these 4 countries with a swap line, so they won’t have financing problems. So now, Latin America--Chile, Columbia--have not swap lines, and we perform relatively the same. So you have to tell a story that protecting these big 4, it’s spillover--I’m not so sure. I don’t think--they were--I called the Fed. I can tell you, now I can disclose. I called the Fed to get a swap line. They didn’t answer the phone because this was from Chile.

No, I had some discussions with some friends at the Fed. But we didn’t [inaudible 00:58:53] we’re too small to be taken seriously. But why we wanted a swap, why I picked up the phone? Because we’re talking about October, we were thinking that one possibility would be to survive, to do well and to write a book. But the other possibility, not a minor probability, was that the wall would disappear, so you need any kind of protection. And at that point, one kind of protection was to call our friends at the Fed and to say, “Well, we are so small, give us a swap line.” So it’s really for us would be more than enough for the next hundred years, and for you, it’s peanuts. But they didn’t answer the phone.

So I’m not sure how important were they because unless that you tell story of these 4 countries having swap, and it spill over to the rest. But other countries have a lot of reserves, so I’m not so sure. It would have been fun to have a swap line [inaudible 00:59:52], and to realize that good friends are really good friends.
Adam Posen: It’s great. This is how you can tell you’re in good, you get the swap line. Wesley, please if you could. And then we’ll go back to Ernie.

Wesley Layman: Wesley Layman from Ways and Means. Since I loved Mr. [inaudible 01:00:10] question about the ranking, the inflation targeting, exchange rate flexibility, financial system regulation, international reserves and terms of trade, and in particular, the case that you made that maybe the Mexico case shows terms of trade is actually pretty important among those 5. I’ll ask about, I’ll follow that same line up with focusing on the one of those 5 you didn’t mention in your answer to him, which is financial system regulation, and where that fits into the 5.

And in particular, use the Chile case, and then picking up Canada which is in your graph, pretty much the middle country like [inaudible 01:00:48] as far as sort of average capital adequacy ratio, average for the countries you’re looking at average leverage. Does that make out a case, looking at Chile also being sort of noticeably more leveraged and lower capital adequacy than most of the other Latin countries, and yet doing pretty well? Does that make out the case that financial regulation really isn’t very important once you sort of satisfy a floor, and then above that it’s not really going to help you?

José de Gregorio: I will [inaudible 01:01:23] the 5, but there is one thing that is more discussed in those--more stable countries than to have more leverage, and that would be the mean variance optimum. So why these countries are so stable, so they can have more leverage. And you see that relationship. So that explains, in some way, why Chile has more leverage than the rest of Latin America, and why Canada have a small leverage. So I think that’s quite important, and I would be very strict in terms of banking. I’m all for separation and [inaudible 01:02:01] rule, and all of those things; I’m quite in favor of that, because I think that is so devastating the cost of not having strong, well-capitalized banking system. And especially, because there is a--and I like the leverage ratio which is quite important because there is all these ways to use [inaudible 01:02:22] accounting, to increase leverage.

Now, this has to be with history, this has to be with the number of banks, degree of competition, and I don’t have a complete answer to this because many times, what you find in this Latin American countries, that you have concentrated financial system. So monopoly power gives you a [inaudible 01:02:50], but it’s bad for market functioning. So it’s not obvious. I did that idea at least, for example in Chile and in all Latin America, all the regulations on derivatives are quite strict. So you can have most some plain vanilla, in the book exchange rate derivatives, I’m very limited.
You have also a strong on—you cannot lend—something that I have never understood well in Europe—you cannot lend for a house in a different currency than your home currency, and this thing is quite simple. Then if you want to have a foreign bank in Latin America, it has to be [inaudible 01:03:35]. So have to be the board, like any domestic bank, there are some details, I won’t go in the details of the regulation, but all of those prudent regulations I think that have helped, at least to have financial system, that perhaps do not fulfill all the things that we would like for them to do, but at least that they are safe, especially recently.

Adam Posen: I just want to pick up on one little piece of what José was saying [inaudible 01:04:04] beyond Latin America. The trade-off of having—let’s not say monopoly; let’s say oligopoly—powering your banking system. I mean, at one point several years ago, I was sort of sympathetic to the view, and obviously [inaudible 01:04:20], that it’s the old saying, you know, you put all your eggs in one basket and you watch that basket.

I think that the terms of the trade-off we’ve seen over the last few years are even worse than the way José put it, because if you look at Switzerland, or you look at UK, where I was certainly dealing with this during the crisis, if you have 2 to 4 banks, even if it’s only 2 to 4 banks and you’re watching them very carefully, they can still drag you down.

Now part of that is of course that Switzerland or UK banking system, had a lot of external balance sheet. I mean, a lot beyond its system, which Chile or Brazil would not. But I would just, for what it’s worth, I would just pick up on what José was saying and all the structural things he said, and just not take too much comfort, even from the oligopolistic approach; I think it’s a false hope. Ernie, and then Jessica.

Ernie Preeg: Thank you. Am I on the mic? Ernie Preeg, Manufacturers Alliance. It should be no surprise my question has to do with the manufacturing sector. But the manufacturing sector trade is by far the largest; it’s almost two-thirds of merchandise exports, and it’s rising, in fact with the fracking revolution and share in energy is going down, and manufacturers could go up to 70% or higher in the next few years. But South America is just not in the game. It’s quite small and it’s losing market share. Between 2009 and 2013, the largest 11 exporters were over 80% of global exports, and Mexico was there, number 8, I believe. Whereas Brazil was way down 15 or 16, with Mexico 3 times larger in exports of manufacturers, Argentina was not even on the chart. So this raises a question for South America, in particular, it might be not Mexico. So my question is what should be the trade strategy for South America, for the investment and technology-intensive manufacturing sector?

Adam Posen: Or an option is none; no strategy.
Ernie Preeg: That’s the current strategy, sorry.

José de Gregorio: What’s happening is that the most open economies like Chile, which are very intensive in commodities. So you won’t force them to be in this, and they are very small players as industrial basis. I think that in Latin America, in terms of trade and being a player in the world, has to do with Brazil, which is quite a close economy. So I think that is where there’s much more potential to create trade within the region. In the region there is very little intra-country, across-countries trade, so I think that has to do a lot with that it’s a region that’s not very--especially because the country that’s almost half of the region, is not really open to trade. And I think that that’s a challenge for Brazil, and should have a big impact in the whole region.

Adam Posen: Thank you very much. Over there, I think Eduardo.

Eduardo Borensztein: I really enjoyed that first chart by the way, I’ve seen this several times. Each time I see it, I really say I—I’m sorry—I’m Eduardo Borensztein from the IDB. So I’m going to steal that chart, you know, when I remember. José, I wanted to ask you about exchange rate policies, and what seems to be an innovation that central banks are—notably in Brazil—intervening in the foreign market, with swaps, with other instruments rather than doing it in the spot market. And keeping their reserves there, but building up these other liabilities. And you might have done something of this sort back in 2009, but the question is, how do we see this? Do we see this as… is it just postponing the intervention by 3 months, or is it something different? What is your view?

José de Gregorio: I think that it’s the same. Whether you do it in the forward market or in the spot market, it should be the same unless that you are doing just a… if you are being a trader. But if you are taking a position in the forward market or in spot market, it should be exactly the same. The difference, I think, the difference is that the amount of reserves, because it’s not netting your forward position or your—because you appear to have a lot of reserves when you really don’t have it. And I don’t think that markets don’t understand that; they see it clearly. For that reason, in Chile we just did plain spot. I think that’s—there is an issue that the forward market are deeper, you can do it easier; it could be. Perhaps we should think more about how do we do the accounting of the real liquidity position, which it can be done. But more standard international liquidity position of countries, because I don’t think that there is a difference. And you think that you have the reserves, but you don’t have the reserves, you have a claim also.

Adam Posen: Very good. At back mic, another gentleman there.
Joe Gagnon: Thank you Adam. I’m Joe Gagnon, a senior fellow here at the Peterson Institute. José, I enjoyed this book; it’s very impressive and encouraging, I think. The story I take from it is that these countries in Latin America are becoming more developed and becoming more like the advanced economies, and having policies that work similarly to the way we think policies work in advanced economies; very encouraging.

My question focuses on, some people call it the original sin—the difficulty of being able to borrow in your own currency, which leads to the currency mismatches you talked about. It seems to me that still, one of the sharpest distinction that remain between advanced economies and non-advanced economies is this ability to borrow in your own currency, and the lack of currency mismatch that the advanced economies have. Do you see that this will continue to improve? Are there obstacles to this improving? I mean, at some point, will some of these or all of these economies become really identical to advanced economies in this sense, which there will be no mismatches at all? And if so, will that really change how you think about what adequate reserves should be?

José de Gregorio: Yeah. I have never been so much fond of the original sin story.

Adam Posen: That’s good of you.

José de Gregorio: Thank you. Because you said, [inaudible 01:11:45] just because they will buy pesos, I will be better off. So now, there is an issue about, and all this discussion about the transfer and [inaudible 01:11:59], and how you buy issue in your own currency, you can [inaudible 01:12:06] currency fluctuations, or terms of trade shocks. You can do it the [inaudible 01:12:11] other forms, so it’s not necessary that you go--because they will never--what’s happening is the following: they will never want in the world, to have peso exposure, to have an optimal portfolio. There’s no investor that will find that having--hey may say I want to have Chile risk, and I have to have copper, but to have peso.

So you want to have Chilean Electric Company; that’s what you want to have, or whatever, or telephone company. But in general, what you will do is to cover the currency risk because you don’t want to have the currency risk. And even when you do optimal portfolio, and this is a typical thinking on reserves, you end up with 3, 4 currencies. So what’s happened now in countries is that--what’s happened in many--Chile has done it. Chile issues has defeated the original sin. Chile has been able to place bonds in domestic currency index we don’t know, abroad; small bonds, but they have been bought by the Chilean pension funds abroad. They are the ones that want the--but it’s quite difficult for you if you say a big portfolio of currencies, you can cover, I would say, like finance people say...
the span—you could span everything with 10 currencies, 5 currencies, and peso won’t be there, so that’s a problem.

Adam Posen: Thank you. These 2 gentlemen here, if we could.

Manmohan Kumar: Thanks very much José. A really very rich, very thought-provoking presentation. I have a couple of [inaudible 01:13:53].

Adam Posen: Could you identify yourself please?

Manmohan Kumar: Manmohan Kumar from the IMF.

Adam Posen: Thank you.

Manmohan Kumar: Very rich, very nice presentation. Couple of points, one actually relates to the previous question on the original sin. I know you don’t like it, but we were talking earlier about the underlying factors that might have led to the changes in our policy framework, and the policy makers being wiser as it were. Now, we talked about a number of factors, but could it be that, let’s say with regard to exchange rate flexibility, the original sin, the sort of diminution in that, in the run up to the global crisis.

So if you take the period from say 2000 to 2007 or 2008, the share of countries that denominated in foreign currency was substantially falling. And we know now, for example, that relative to the beginning of the last decade, it’s half or even a third. So could that have been a factor? And the other point actually relates to the table you showed, and you touched on this, the performance since 2010. And it’s quite a remarkable decline in growth rates—2011, 2013 and going forward. Perhaps you could say a little bit more. The policy makers are still there. They, presumably, the wisdom hasn’t gone away. What is it that has led to this very worrying performance?

José de Gregorio: Yeah. Let me start from the second one. It’s not such a good international environment, and that you already spend your recovery bonus. So when you have a recession, you grow a lot because you have to go to potential output, and then you grow with potential [inaudible 01:15:51]. Now, Latin American economies are closer to their potential, and the world is not as good as it was before for emerging markets, and potential goes slow. So exactly, macro policy helps for potential, but you have many other things to do in order to have high productivity and growth. So Latin America is settling closer to potential which is kind of modest; it won’t be like Asia. So that’s a big difference.

Regarding the [inaudible 01:16:24], the big benefit of flexibility indeed [inaudible 01:16:28] you have a flexible exchange rate. It allows you first,
among other things, to be able to get more financial globalization with lower risk, in the sense that you don’t become a currency that’s subject to large fluctuation. They say, well okay it all depends on whether the central bank will decide to devalue. No, they just float, and I think that that helps a lot and I think that it helped a lot in the region.

Adam Posen: Very good.

Participant: Yes, [Inaudible 01:17:06] from [inaudible 01:17:07] Peterson Institute. José, one question following up a little bit on what Joe said. If emerging markets for Latin America have become more like developed world, imagine there is a shock and puts you as a central banker with rates at zero, do you think central banks and the political institutions in Latin America will be ready for a central bank to do quantitative easing? And if not, why not and what would be the alternatives?

José de Gregorio: Yeah. I think that it would be very easy to do quantitative easing. In Chile, we did forward guidance and a form of quantitative easing because we reached zero percent rate in 2009. We announced that the rates would remain at least 12 months at zero, at zero point five, and we open a liquidity line for 180 days at the monetary policy rate of that moment. So we did a commitment. Indeed, we said this is the best commitment because if we raise rates, it would increase our cost of funding and we are lending at very low rate. So now I can make a disclosure also--we’re thinking about quantitative easing, and there is a very easy way for emerging markets to do quantitative easing, and especially in order to jumpstart the economy which is like the Swiss, is to do quantitative easing buying foreign exchange.

Adam Posen: Most of us don’t call that quantitative easing. Most of us call that exchange rate manipulation.

José de Gregorio: No, no, no--I will tell you no, no, no because what’s the argument? The argument is quite simple. The argument is that we do not have, first a deep a long-term market, and the rate is not that important like the exchange rate, so we pick an asset price. So it’s just picking one asset price. You can pick the long rate, you can pick the exchange rate, you can pick anything that’s a rate at the end. And we picked the exchange rate and we said well, we will buy a lot of--I was thinking to do it in Chile, but we started recovering fast. But in the toolkit, I said well now we’ll come non-sterilized intervention, because basically you pump money, and instead of buying--now I understand your concern among big countries. But Chile’s too small. You didn’t give us a swap line, you won’t complain about doing quantitative easing and buy…
Adam Posen: The sentence might be, you didn’t give us a swap line, you shouldn’t complain. We might well not give you a swap line and still complain. Just before Ted, Ted’s next and then Bill Cline will get the last question. Just before we do that, I have to give a plug, something you may remember about 4 months ago, the governor of the Swiss National Bank, the excellent Thomas Jordan gave a talk here explaining his view and justification for the Swiss Monetary policy. And there were some very interesting exchanges with Bill, with Joe, with Fred Bergsten. It’s on our website for those of you who want to get into this, I’d recommend you go back and take a look. It’s quite a good discussion. Ted.

Ted Truman: Ted Truman from the Peterson Institute. José, a very nice presentation, very interesting discussion; nice and nuanced. I welcome you to the debates at the Peterson Institute on such issues of how we precisely define quantitative easing and currency manipulation to be continued. I do wonder, in terms of Joe’s question, whether you missed one punch line about the comparison of certain emerging market countries with advanced countries, and that is maybe we were better prepared than the advanced countries. You don’t have to answer that question, but I think that many people have argued that point, and maybe you want to comment on it.

The intriguing thing I found about your discussion at a policy level was your, that was the somewhat oxymoron advocacy of rules-based policy because it provides you with more flexibility. So I thought it might be worthwhile having you expand a little bit on how you see that oxymoron not being an oxymoron.

José de Gregorio: You got me Ted, that was a typo I think. I think if it is really what you say, but what I say is that you have to be--I like--I think that when you do discretion, do it on a rule-basis case, or say I will--it’s like an escape clause. The escape clause you want to have it with a rule-base because otherwise, it does not transmit that’s really an escape clause; it looks like [inaudible 01:22:08] well I will intervene tomorrow. In Chile we did it many times. They say, well--and in the night this was 20 years ago, is the Central Bank intervening? Yeah, according to some banks, they bought this amount. That has no real effect.

So you say, if I’m going to go all the way, I try to create within the escape clause, a rule. A rule makes it more effective; not more flexibility there. I would have liked to say, so it makes it more effective. And if it is not effective, I leave it there and I don’t keep trying to make it effective because that’s what I call intervention addiction, and at the end, the markets want you to intervene because, especially in forex market, because the easiest money to make is to bet against the Central Bank because they always make mistakes.
So I think that’s kind of the [inaudible 01:23:05], and I don’t know if it works or not; there is a long debate whether intervention, rule-based works or not. But at least it hasn’t created additional problems. And whenever--and I discuss [inaudible 01:23:19], they have to be also very big in magnitude when we do intervention. Because if you say, for example, a country that has, like Chile today, $40 billion in reserves, and they will say, “Yeah, we will accumulate 1 billion,” 1 billion has no impact on the forex market, it has no impact at all.

And then they say, “Well, do 1 billion today,” and then you will be pressured to say, “Well, do 5 billion this week.” Yeah, let’s start 15 billion the next 12 months. This is the way as we operate, and I think that that’s… because you also want to—especially in the forex market, you want to have truly flexibility. You can put some amount you will buy or sell, but you want the market to move and to function and to people to [inaudible 01:24:07] and to be serious in the forex market.

Adam Posen: Before I let Bill Cline ask the last question, I just need to pick up a second on Ted’s point and José’s response. Well, I think there is that issue, particularly in FX intervention as you said, I guess Ted, I just want to say for the record, there’s a decent body of literature out there that doesn’t find it oxymoronic. And in a sense, that’s the whole premise of flexible inflation targeting, and when I was writing with Ben Bernanke now, 17 years ago, I mean that was explicitly what we were saying. The more you have [inaudible 01:24:43] anchored during normal times, the more flexibility you have to deviate. And frankly, we saw that a lot in practice, both in Latin America and for example, at Bank of England. We were able to let certain inflation overshoots happen, in part because we had the rule say we’d go back.

Now, I mean Ted I’m not trying to dispute that there’s an issue here, and particularly it’s more complicated on the exchange rate side, but just I think it is useful for us to understand that in monetary policy, it isn’t directly contradictory to talk about having an anchor and being flexible if you could do it. Bill.

Bill Cline: Bill Cline from the Institute. I was glad that the discussion brought out the differences between Argentina, Venezuela on the one hand, and countries such as Chile, Columbia and Mexico on the other, because one of the emerging patterns in Latin America seems to be a bipolar approach--the swing back toward populism in part of the region, and a more sort of neoliberal approach in some of the other economies.

And Brazil is somewhere in between it would appear, with some apparent increase in tendencies for sort of interventionism. And in some of your earlier remarks, you sort of indicated that Brazil didn’t have the same
growth potential as some of the other economies in the region. So I’d be very interested to hear your diagnosis of what changes in the strategy Brazil needs to make in order to realize a greater growth potential?

José de Gregorio: Two comments, first I think that Argentina and Venezuela have taken another route. Now, there is one thing that is interesting in the case of Argentina. They had to say that they had low inflation because having high inflation in Latin America is not irrelevant as it was thought 20 years ago. Twenty years ago, you say 30% inflation is the cost they will have to pay for being I don’t know what. But now, there is a [inaudible 01:26:58].

My expectation is that, especially they won’t have a big crisis like the crisis in, one for Argentina, because they don’t have big financial [inaudible 01:27:10]. At some point they will have to move into the right direction, and that has to do a lot with fiscal and with macro policy. Now, the rest of the countries, they have settled with a sensible macro policy.

The problem of Brazil I would say, and to have more growth has to do, I would say, there are 2 or 3 things that are--is extremely, it’s a big country that has never needed, like all the rest of the countries, to be open because they have a huge market. And 2010, when the amount of foreign investment in Brazil, because you want to be in Brazil even if they have--but at the end, it’s a very close economy, and the region is also so heterogeneous that trade disputes tend to be very nasty.

And so I think that there is an issue with openness, there is an issue with a huge tax burden and very [inaudible 01:28:16]. And it’s a tax burden which is not a problem because this is the discussion being neo-liberal or not, and in the region is quite a hot topic today. But having had a large tax burden, if it is well-spent, you’re going to say, well--and if the tax burden is relatively efficient, but in their case, is quite inefficient and it’s returned back through development banks, in terms of subsidized grade; this is an example. So at the end you say, “Is this what you really need?” And they do a lot of industrial policies through development banks, which may play a role. But then they do even a consumer grade.

So it becomes--I think that they have problems with--those would be--at the problems that came first to my mind, that highly [inaudible 01:29:13] tax burden with no clear efficient expenditure. It’s not a very open economy, and a lot of development banks that, they are almost a third of the banking system which is also a problem. Now, those are things that need to be repaired in order to spur productivity growth.

Adam Posen: Great. We’re going to end it there. The book is “How Latin America Weathered the Global Financial Crisis.” The author is the incomparable
José de Gregorio, now proudly a full member of the PIIE family. And thank you so much for a terrific presentation.

José de Gregorio: Okay, thank you.