Vittorio Corbo: The Fund's medium-term strategy – a view from Latin America and a dialogue with high-level officials

Keynote speech by Mr Vittorio Corbo, Governor of the Central Bank of Chile, at the High-level Seminar "The Fund's Medium-Term Strategy: Considerations for a New Liquidity Instrument for Crisis Prevention and Effective Surveillance. Dialogue with High-Level Officials", organized by the International Monetary Fund and the Central Bank of Chile, Santiago, 11 December 2006.

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Latin America has benefited substantially from the fast growth experienced by the global economy during the last four years and from domestic policies that have contributed to enhanced macroeconomic stability. External current accounts and primary fiscal balances are in surplus, exchange rates are more flexible, and inflation is no longer a major issue as it was for several years and after surpassing the average of 400 percent per year during the 1990s. Likewise, the structure of public debt has become less vulnerable, characterized by lower shares of short-term and foreign-currency debt in most countries as compared with the early 2000s. At the same time, there is renewed appreciation in the region that a solid commitment to maintaining macroeconomic stability is a necessary condition to achieve high and sustainable growth rates in the medium term.

A distinguished feature of the region is that fiscal revenues are highly dependent on natural resources. In the current favorable context for commodity prices, primary fiscal surpluses have clearly shown positive numbers, averaging around 4 percent of GDP of the region. It is therefore imperative that policymakers in the region consider the risks of a possible turnaround of this positive cycle, and carefully monitor fiscal spending. Expenditures should be established in coherence with the permanent levels of fiscal revenues so as to ensure that, once the current boom is over, public finances are not depleted, and public spending is shielded from commodity price fluctuations.

Although the region's economies have made significant progress regarding integration to the global markets, they are still vulnerable to international financial volatilities. A yellow light was turned on by the episodes of May-June of this year, when the market correction hit hard on some currency and stock exchanges of emerging economies.

The main challenge for our region at this point is to take advantage of the opportunities provided by the actual international situation by making progress in the design of policy framework and institutions so as to consolidate macroeconomic stability, and strengthen the conditions necessary to achieve high and sustainable growth rates. This is the best strategy to prevent future crises.

Main opportunities are in continuing advancing in:

- Macroeconomic policies oriented toward making the economy more resilient to external shocks. This requires a credible and flexible policy framework, with prudent and consistent monetary, exchange rate, and fiscal policies. In this direction, progress in fiscal accountability, and the adoption of inflation-targeting monetary frameworks alongside more exchange rate flexibility have left the economies of the region better equipped to participate in the global economy.
- Modern regulation and supervision of the financial sector, so as to ensure efficient financial intermediation and manageable risk levels.
- Openness to foreign trade in goods and services and to financial flows, in order to improve domestic efficiency and to reap the benefits of globalization.
- Quality and transparency of macroeconomic and financial information by adopting international standards and codes of best practices. This improves the effectiveness of policies by allowing markets to internalize changes in a more orderly and gradual way. At the same time, it establishes a framework for a greater responsibility and creates incentives for a better design of policies.

Achieving macroeconomic stability together with trade and financial integration pose important challenges for the countries' institutional and policy frameworks, at both the domestic and the global level. Therefore, progress in these fronts must be simultaneous, and at a pace that countries feel comfortable with, because otherwise, economic integration may increase exposure to external shocks and local vulnerabilities, while macroeconomic instability, in turn, could hinder integration.

The long-lasting weakness and volatility of growth rates of the region have made it difficult for governments to reduce poverty significantly and the endemic inequality in income distribution. In the current positive cycle of booming commodity prices, governments face the difficult tradeoff between continuing to bring down public debt vis-à-vis facing social pressures for increased spending. All this maintaining macroeconomic stability. Balancing these objectives requires having in place very flexible budget processes, and tax and spending structures. In addition, governments of the region should also take a careful look at existing social policies so that they are aimed at reducing poverty and improving the access of the poorest groups of the population to quality education and health services.

In his concise and well-focused document, launched before the 2005 Annual Meetings, Mr de Rato addressed the fundamental strategic question for the Fund: Given the purpose of the Fund, as set out in Article I of Articles of Agreement, what is the relevance of the Fund in today's global economy and financial markets? In our opinion, the Fund has a privileged position to contribute to more effective management of global macroeconomic and financial risks around the world. This process involves taking several steps simultaneously:

- **Identify threats** to global macroeconomic and financial stability and to member countries;
- **Quantify its effects on key variables** such as exchange rates, relative prices, and real outputs, etc.;
- **Identify economic and financial vulnerabilities** at global, regional and country level;
- **Manage implied risks** by making better analyses and developing better understanding of institutional and market mechanisms so as to absorb, cushion, transfer, hedge, strengthen the resilience to such risks, and ultimately, minimize their potential impact;
- **Continue surveillance of risks and vulnerabilities**.

  In our opinion, continued surveillance of macroeconomic and financial stability is a shared responsibility of the Fund, member countries, and private sector institutions of the international financial system, especially those participants of systemic relevance. In this vein, the Fund's work should focus mainly on economies, developed or emerging, that have played an increasing role in the global economy developments.

On multilateral surveillance, the Fund should deepen its analysis, while improving its communication capability and persuading the countries involved to adopt its recommendations. In this context, we are particularly interested, and strongly support the high priority given by the Fund's management to the first multilateral consultations involving several systemically important members or groups of members such as China, the Euro Area, Japan, Saudi Arabia and the United States. This exercise constitutes an important collaborative effort among major countries that could provide an important forum for debate on issues of systemic or regional importance with a special focus on how to address global imbalances while maintaining robust global growth. The success of this exercise in making an effective contribution to orderly adjustment, thus reducing the burden of disorderly adjustments on the global economy, will depend crucially on the commitment of countries participating in the consultation.

On the bilateral surveillance front, it is essential that the Fund's staff make a clear contribution to strengthening macroeconomic and financial resilience of member countries. This could be achieved by promptly recognizing, and taking into account, cross-country differences, and also by upgrading the Fund's capacity to perform stress-testing analysis. In particular, we are of the view that the Article IV consultations should focus more on core macroeconomic issues against the backdrop of the challenges posed by globalization. Also, although we believe that the Fund should be more explicit about the reasons why its recommendations may not deliver the expected outcomes, we note that this should not be interpreted as, nor convey the message that, the Fund's recommendations are always correct or that member countries' authorities always take a defensive attitude. We believe deeply in a policy dialogue process that could be beneficial to both parts. At the end, successful policies are those implemented by economic authorities that feel them their own and are capable to create the political framework for their execution.

We also support a more systematic focus of the Fund's surveillance on regional developments by detecting regional trends and fostering dialogue with region-wide institutions such as ECLAC. Along these lines, we appreciate the Fund's regional outlook report, whose last issue was simultaneously launched in Mexico City and Santiago in early November.

As a Central Bank fully committed to an inflation-targeting framework, we place substantial weight on making continuous efforts in strengthening transparency. In this direction, we think that the Fund's communication strategy would be more effective if analysis goes beyond the mere publication of reports, making it an integral part of the public debate on policies and economic reforms. Considering the importance of communications, we believe that enhancing the Fund's outreach activities both at global and regional level will strengthen the effectiveness of the Fund's monitoring and surveillance.

The risks the world economy faces in the medium term - associated to an abrupt resolution of global imbalances, a commodity price downturn, a slowdown of global growth, or an abrupt shift in risk perception and valuation by global investors - require that the agenda on international financial architecture be focused more on preventing, rather than resolving crises *ex post*. As countries are progressively more integrated into a more global financial system, new challenges emerge for economic authorities. The increased mobility of international capital flows - beyond their potential benefits - entails the risks of sudden and unexpected reversal of capital flows that could be further worsened by the contagion associated to the financial market reaction. Also, in the current market-driven international environment, characterized by increasing access of emerging economies to private funding, and by a more complex international financial system, externalities, market failures and perverse incentive effects are still in place and impede private financial flows to become a permanent and stable source of financing.

Therefore, strengthening countries' resilience is not only about developing and improving appropriate and consistent policies and institutions, but also about providing countries with access to emergency liquidity and the possibility to obtain short-term liquidity by private financial instruments. The Fund should therefore play a leading role in facilitating the development of more complete global financial markets, which will ultimately help emerging economies to protect themselves against external reversals while complementing authorities' efforts in building up a sound policy framework.

It is our view that there is a need for further improvement of the current precautionary facilities to make them more suitable in providing countries with preventive financial assistance to face capital account crises. In this context, the discussion of this morning gave the Fund's staff useful elements to consider on the design of more effective financial instruments to limit contagion from shocks in the global financial market.

But not only the Fund's financing instruments should be explored. The Fund should have a dialogue and a permanent association with private financial markets around the world to promote and eventually participate in the creation of new financial instruments that provide liquidity support at times of stress. This is an integral part of the process of managing systemic risks to macroeconomic and financial stability, which we referred to previously. From this standpoint, the Fund could contribute to alleviating the impact of existing externalities in global financial markets by creating new knowledge relating to the design of new market instruments, valuation methodologies, benchmarks and indices, for instance. This is especially important for countries that have made lots of progress in addressing their main weaknesses both on policies and the development of their intuitional framework.

After almost twenty years since the debt crisis of the eighties, a good part of the Latin-American countries have repaid their obligations with the Fund. Also, the global financial system currently provides ample liquidity, and since global markets have increasing access to more information on the productive and financial structure and the functioning of the economies of the region, they are more willing to provide tailored financing at good rates of return. Against this backdrop, we believe that the economies of the region have a good opportunity for building a new relationship with the Fund, which should be based rather on a collaborative dialogue about how global financial development could contribute to the final objective of achieving high and sustainable growth rates in the medium-term, than on meeting a certain set of stringent conditions associated to the lending programs as has been so far.

Should the weight of emerging economies in the decision-making process of the Fund be increased, all these necessary efforts to which I have referred to above would produce better outcomes. Chile, as the rest of South America, did not support the proposed resolution on the quota reform in September, although it did fully support the search for an integral solution. The reasons for our vote are well known and it is not is my intention to reiterate our arguments in this occasion. We still believe that an increase in emerging country quotas would lead to more active and committed involvement of emerging economies in the Fund's decisions that definitely would increase the Fund's legitimacy in the region.

Our commitment for the future is to continue working constructively in the improvement of the quota system, the strengthening of the governability, credibility and effectiveness of the Fund.