Institutional Summary

August 2, 2018.

The 13th annual FLAR-CAF conference of economic studies, held on July 9-10 this year, focused on the challenges and priorities for economic policy a decade after the global financial crisis of 2008. Special emphasis was given to discussion of issues relevant to the Latin American region.

At the conference, there were professional presentations and discussions of the foregoing issues by leading policymakers from the region, high-level economists from multilateral organizations, and researchers from universities and other institutions.

Presentations and discussions at the conference focused on three main questions:

- What is the global and regional outlook for the near term?
- What are the main vulnerabilities and risk factors for this outlook?
- Are monetary and fiscal policies, as well as exchange rate regimes, well prepared to deal with adverse shocks such as a sharp drop in world commodity prices?

A first theme discussed at the conference was the global and regional economic outlook. Participants generally agreed that global growth has strengthened and widened across countries and unemployment rates have commonly continued to decline. Moreover, growth has become more balanced across expenditure categories, with a strong pick up in investment. Inflation remains subdued in most regions of the world. Overall, current favourable conditions can be viewed as the peak of the current business cycle and it would be well for the Latin American region to be prepared for slightly lower global growth rates in the next few years.

Keeping in mind that macroeconomic conditions were also relatively strong before the global financial crisis of a decade ago, our second main task at the conference was to explore the vulnerability of the current favourable outlook against various risk factors. Examples of the latter would be: a sudden rise in inflation coupled with a perception in financial markets that central banks are behind curve; a reversal in capital inflows or in financial markets' risk apetite, due to an unexpected slowdown in growth (e.g. in China); and an escalation of protectionist measures and geopolitical tensions. An additional risk factor for selected emerging market economies is a major drop in the price of commodities.

Another important dimension of vulnerability received significant attention at the conference, namely the gradual build up of financial risks. No doubt, current financial conditions in developed and emerging market economies remain quite easy from a long term perspective and financial volatilities are low. Yet there are good reasons to be cautious beyond the short term. In some countries, the abundance of monetary liquidity and very low interest rates contributed to a build up of debt and of financial imbalances, with strong private credit expansion and large property price increases. In a number of emerging market economies, we have seen rapid growth of credit denominated in foreign currencies, mainly from non-bank sources, which raises vulnerability given the implied currency mismatch in the balance sheets of the borrowers.

Is monetary policy well prepared to manage adverse shocks should some of the foregoing risk factors materialize? For advanced economies, the discussions at the conference stressed that given the extremely low current interest rates and the expansion of central banks' balance sheets, there is limited room for manoeuvre of monetary policy. Furthermore, the sharp rise in public and private debt ratios limits also the extent of policy rates normalization that could be effected without triggering a debt crisis.

Things look a bit better for monetary policy in emerging market economies, and in particular for central banks in the region. After many years of debates on the proper scheme for monetary and exchange rate policies, some countries in the region have adopted inflation targeting regimes coupled with a relatively flexible exchange rate regime, maintaining a high degree of autonomy of their central banks. Resolving the traditional monetary policy trilemma this way resulted broadly in increased central bank credibility which, in turn, enabled central banks to conduct countercyclical monetary policy for the first time in decades. Under that scheme, typical responses to an adverse external shock have been to use nominal and real exchange rate depreciation as a shock absorber, coupled with some foreign exchange market intervention when necessary, and, if possible, depending on the credibility and the magnitude of the shocks, to rely on countercyclical monetary policy to attenuate the negative impact of the shock on domestic growth and employment.

As far as fiscal policy is concerned, the room for manoeuvre in the case of adverse shocks is also quite limited. Although most economists agree that relatively good times are when fiscal buffers should be enhanced in order to be prepared to deal with relatively bad times, when they come, reality seems to deviate from this principle. In spite of strong growth in recent years, most advanced economies exhibit high and rising ratios of public debt to GDP. Although recent corporate tax reform in the US may have contributed to growth and investment there, the reform will not pay for itself and will have spill over effects to other countries. This may call for the need of a multilateral approach to this subject.

Fiscal consolidation remains to be achieved also in most countries in the region, though a positive development in some countries has been the shift away from procyclical to countercyclical fiscal policy in recent years. Having said this, in most countries there is a need to effect fiscal reforms including the broadening of the tax base and deepening tax collections. As usual, the extent to which fiscal consolidation should be achieved via a cut in public sector spending or a rise in taxes remains a controversial issue.

Overall, conference participants agreed that Canada provides a very good example of how a highly open economy, whose performance partially depends on commodity exports, can manage to deal with large swings in world commodity prices. The combination of a widely diversified economy, flexible labour market and exchange rate regimes, a credible inflation targeting scheme, strong institutions, and a solid fiscal framework with automatic stabilizers has played a major role in absorbing exogenous adverse shocks while implementing countercyclical macro policies. The latter attempted to attenuate as much as possible any negative impacts on domestic economic activity and markets.

Last, but not least, conference participants discussed the need to put together a fresh and new structural growth agenda for the Latin American region, one that puts emphasis on structural issues, such as having the proper set of institutions and policies, as well as on the need for a stronger outward growth strategy. As evidenced by the foregoing Canadian experience, strong institutions and credible policies are prerequisites for reducing vulnerability to shocks and for having countercyclical policies. Unfortunately, most countries in the region have not met these prerequisites, and the whole process of implementing structural reform has been extremely weak. Consequently, the region has exhibited lower growth rates than Asia and other regions. These will certainly be a central issue to be discussed in future conferences and meetings.