

**Speech by Rodrigo de Rato, Managing Director of the International Monetary Fund, at the Ibero-American Association of Chambers of Commerce
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As Prepared for Delivery

1. I would like to thank Juan Mato for that generous introduction and the members of the Ibero-American Association of Chambers of Commerce and the members of the Inter-American Commercial Arbitration Commission for inviting me to be with you today. Over the last several years, we have seen a striking improvement in the economic policies and the economic performance of many countries in Latin America. I would like to talk today about the economic prospects for Latin America, especially in the wake of the recent turbulence in global financial markets, and also about some of the policies that Latin American countries can follow to guard against risks and to improve their economic position further.

2. One of the trends that has supported growth and stability in Latin America during the past decade has been the increased integration of Latin American countries in the global economy. Of course, the price of increased integration is a potential increase in vulnerability to events beyond the region, especially changes in trading partners' demand for imports and changing conditions in financial markets. Therefore, it makes sense to begin with an analysis of what is going on in the global economy, before looking at the implications of this for the Latin American region.

3. Obviously, the event that is dominating the headlines and the minds of policy makers is the turmoil in credit markets. We in the International Monetary Fund believe that this turmoil is still some way from being resolved. The steps taken by major central banks to relieve liquidity shortages in overnight markets are certainly helpful. But events in the financial markets are still unfolding, and it will be some months before the extent of banks' and investors' losses become clear. The great question now is what impact the financial market disruptions will have on the real economy. It is concern about this that has led the Fed to lower interest rates in the United States and the European Central Bank and the Bank of Japan to hold off on interest rate increases. We believe that these decisions are sensible and that they will help to limit the wider economic impact of the recent turbulence.

4. Nevertheless, we expect that recent developments will have some economic impact. The extent of this will remain uncertain so long as the situation in financial markets remains fluid. On the basis of current information, it seems that the turbulence is unlikely to have much effect on the growth figures for 2007: most of the production, investment, and consumption decisions that will affect global GDP had already been taken before the turbulence began. We see a larger effect in 2008, but at the moment we believe that the effects will still be modest. We expect global growth to be slightly lower than in 2006 or 2007, but still high by historical standards. This is based on our view that solid fundamentals in both advanced and developing countries should provide resilience to the global economic expansion. But I should stress that if the financial market turbulence turns out to be prolonged, the impact on the global economy could be more substantial. It is clear that the risks to the global economy are now tilted to the downside. We will have more to say on this next week, when we present our World Economic Outlook—a detailed assessment of global economic prospects.

5. What does the global outlook imply for Latin America? Under the projection of a modest fall in global growth in 2008, the picture for Latin America remains basically good. In 2008, the crisis could knock off about one half of one percent of growth in some countries in the region, although it is too early to assess specific effects on the real economy. If this is correct, then it will be a notable departure from past episodes of disruption. In the past, Latin America has been quite vulnerable, both to reductions in growth outside the region and especially to worsening of conditions in advanced country financial markets. Let me explain why we think things will be different this time around, by describing some of the ways in which Latin American countries could be adversely affected by global developments, and some reasons why we think that these effects will only be limited.

6. Reduced demand for Latin American exports could certainly affect growth in the region. However, Latin American countries are offered some protection by changes in the pattern of trade over the past decade. Specifically, the share of the exports going to the United States—the country likely to be most affected by the turbulence—fell from 57 percent of total exports in 2000 to 47 percent in 2006. This reflects a broad global trend in which emerging economies, including those in Latin America, are becoming more important sources of global demand and potential engines of global growth themselves.

7. Many Latin American countries have benefited from very large gains in their terms of trade in the last five years, and especially from rising commodity prices. This suggests that those Latin American countries which are major exporters of commodities could lose out if lower global growth reduced demand—and hence prices—for these commodities. This is a source of concern, but so far commodity prices have remained high, in part again

sustained by increased demand from emerging economies, and a large decline is likely only if there is a sharp downturn in global growth.

8. In the past, the region has been particularly susceptible to worsening conditions in financial markets. But so far credit markets in Latin America have been relatively unaffected by the turbulence. Financial institutions in some countries depend heavily on external financing, and this finance could be affected by the turmoil in the credit markets. But more generally, it appears that the vulnerability of the region to such developments is much lower today than it has been in the past. Most countries in the region are much less dependent on rolling over short-term debt than in the past. Currency mismatches have also been greatly reduced, external and fiscal positions are stronger, and public sector financing requirements are generally low. In this sense, Latin America is now reaping the benefits of good macroeconomic management in recent years.

9. This points to another respect in which things are different now. In past crises, governments have often been constrained in their policy response by inflexible exchange rate regimes and by being forced by the burden of debt payments to cut government spending at times when growth was slowing. Today, many more countries in the region have flexible exchange rate regimes which give them more options in responding. Some also have more flexibility in fiscal policy, though this is an area where more improvements are needed. Few countries are yet sufficiently strong to be able to pursue counter-cyclical fiscal policies, and debt ratios across the region are still uncomfortably high.

10. Finally, some countries in the region may be concerned about loss of remittances, especially from the United States. On this, research by the Fund offers some reassurance. A recent study by Fund staff, which will be summarized in our forthcoming Regional Economic Outlook for the Western Hemisphere, suggests that there is very little direct relationship between the amount of remittances and economic conditions in the United States. This situation bears watching, especially for countries like Mexico and El Salvador, where remittances from the United States are large in absolute terms or relative to GDP. And there have been some suggestions recently that falls in real estate prices and declines in construction in parts of the United States where many migrants live could produce sharp falls in remittances. But we have not seen this effect in the past.

11. All of this said, governments in Latin America cannot afford to be complacent. First, as I have already indicated, there is a risk that the financial market turmoil may continue and get worse. For example, a recession in the United States would hit Latin America both directly, through exports to the U.S., and also indirectly, if it had a sufficient effect on economic growth in other advanced economies or on major emerging markets that export to the United States to reduce growth in those countries, too. Also, if the credit crisis were to spread to a major emerging market country—and I should stress that this does not seem to be happening at the moment—this could lead to a reassessment of risks for all emerging markets. Moreover, while the economic fundamentals in Latin America are stronger on average than in the past, there are also variations between countries, some of which have already been noticed by the markets. This of course, has implications for the policies that governments should follow. Let me know turn to these policies.

12. Fiscal policy, of course, will remain particularly important. Many countries have seen improvements in their structural fiscal positions over the past few years, reflecting improvements in tax policy and administration as well as the effects of higher commodity prices. However, we have seen significant increases in current expenditure in recent years in many countries, and revenues could fall if commodity prices decline or tax collection efforts falter. We would therefore advise finance ministries to avoid further sharp increases in government spending and to keep a careful eye on public debt ratios.

13. In the area of monetary policy, many countries in the region are doing the right things. In Latin America, as in other countries around the world, governments have recognized the virtues of central bank independence and central banks have moved towards inflation targeting. Their reward has been increased credibility and—as the inflation risk premium has been stripped away—lower real interest rates, which have supported higher growth. Nevertheless, central banks and regulators may see some testing times ahead. Certainly they will need to remain focused on inflation risks, including those coming from rising food prices. Given the uncertainties in global credit markets, they will need to make sure that they have good information about the risk profile of major domestic financial institutions. Policy makers will also need to make decisions on how to develop and regulate financial markets. Further financial market development is important for Latin America's growth, and recent developments in advanced economy financial markets hold important lessons for the region, on both how to develop financial markets and regulatory infrastructure and some things to avoid.

14. Financial market development is an area of structural reform that is crucial for Latin America's development. But it is not the only one. For example, I am concerned that Latin America is falling behind in investment. Capital spending has fallen as a proportion of total government spending in Latin American countries, while increases in private sector investment that were expected to offset this fall have mostly not materialized. This must lead one to

ask whether the combination of tax laws and public expenditure policies in key sectors are sufficiently encouraging to investment. It is important to create an environment that offers a competitive return to both domestic and foreign investors under stable market conditions, and provides for stability of contracts and well-defined dispute resolution processes. Public investment must also be strengthened. The new fiscal parameters require improved efficiency in the programming of public investment, and there is also a need to develop further countries' capacity to plan public investment well and to spend it wisely.

15. It will also be important that Latin American governments continue to make strong efforts to reduce poverty and inequality. We have seen some important progress in this in recent years. Recent studies both by national governments and by multilateral agencies show that in the period since 2000 growth has been significantly more effective in reducing poverty than it was during the 1990s. This trend towards more pro-poor growth has been reflected in declines in poverty in Argentina, Bolivia, Brazil, Chile, Colombia, Peru, and Uruguay. One of the reasons for this success has been improvements in the targeting of social spending, including through conditional cash transfer programs. But even with this progress, income inequality and poverty remain serious problems: about 38 percent of Latin American citizens still lived in poverty in 2006.

16. There is more that governments can do. They can use fiscal policy to reduce inequality, and indeed many governments are already taking initiatives that will help. For example, on the revenue side, a number of countries have recently introduced taxes that will be paid mostly by those with the greatest capacity to pay—especially taxes on vehicles, other property, and financial income. Governments could also reduce exemptions which normally benefit high earners and relatively wealthy consumers. Simpler taxes and broader tax bases will make it possible to set lower rates. Expenditure policy can also be used to promote equity and increase equality of opportunity. The most effective way to do this would be to pursue direct social policies that reallocate spending toward programs designed for the poor—including the cash transfer programs that I have already referred to—and away from the subsidies that heavily benefit middle- and upper-income groups. For example, subsidies for petroleum products and electricity could be replaced with direct social assistance. The quality of expenditure between sectors can also be improved. For example, we know that education is crucial for equality of opportunity, particularly in a globalized world. But a recent study by the Economic Commission for Latin America and the Caribbean estimated that over half the benefits of spending on tertiary education go to the richest quintile of the population, while the poorest quintile get just 2 percent of the benefits. Equity could be improved if cost recovery was increased at the tertiary level, and if the proceeds were then used to strengthen the quality of primary and secondary education, where spending is of much more benefit to poorer people.

17. Progress can also be made in other areas. For example, governments could adopt policies aimed at increasing access by the poor to finance, including by encouraging microfinance institutions. Microfinance institutions can play a central role in providing credit to businesses in low-income areas and help people lift themselves out of poverty. They can also help to channel remittances toward productive investment and greater credit for households and more broadly encourage use of banking services by individuals. Simplifying procedures for setting up new businesses and removing barriers to private investment can increase employment, especially if the liberalization is in labor-intensive sectors, such as agriculture. Measures to liberalize employment laws can bring more workers into the formal sector and so promote equality and help to reduce poverty. And greater efforts can be made to reach the poor in rural areas, through improvements in service delivery and infrastructure and attempts to address land inequality.

18. Let me now conclude. I have emphasized today the tasks that remain undone, and the actions that governments can take to improve things. This is because strategies for the future are generally more interesting than congratulations on what has already been achieved. But this emphasis should not obscure just how profound are the changes that have already taken place in Latin America. While I have been Managing Director of the Fund I have seen great progress in many countries, much of it owing to the seriousness and sophistication of leaders and officials in those countries. Over the past years, the Fund has worked very closely with Latin American countries. We have given support to Latin American governments and societies during difficult times of economic crisis and instability. Sometimes we have been these countries' only supporter. We know how challenging certain kinds of decisions can be. And we will continue to do our part in such areas as macroeconomic surveillance, institution-building, and crisis prevention. The goals are clear: a more complete integration of Latin America into the global economy, more rapid and sustainable growth, and significant and durable poverty reduction. With good policies and some good luck in external economic developments, these goals are achievable. And the progress that Latin America has already made should give us hope that they will be achieved.

19. Thank you very much.