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Presents

Sailing Calm in a Stormy Sea? Latin America's Response to Global Financial Turmoil and the Food Price Crisis

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Liliana Rojas-Suarez: …That get together and produce statements on issues that are of central relevance for Latin America in the monetary-financial systems areas. The committees are larger than the people sitting at this table right now. You can find the full name of everybody at our web page. Let me just give it to you because the other 17 statements are also there. The webpage is www.claaf because in Spanish we are called Comite Latinoamericano de Asuntos Financieros.

We have with us today, well you can read the names, like Roque Fernandez, former Minister of Finance of Argentina as well as former president of Central Bank of Argentina; Guillermo Calvo, which among his many activities, now professor at Columbia, but former Chief Economist of the IADB; Roberto Zalher, who was a former president of the Central Bank of Chile; Ernesto Talvi who heads the most important think tank in Uruguay, CERES, and also as the Chief Economist of the Central Bank of Uruguay; Pablo Guidotti, who was the Deputy Minister of Finance in Argentina; Guillermo Chapman, former Minister of Finance of Panama; and our special guest, Harald Benink who is the chair of the European Shadow Financial International Regulatory Committee.

Just to let you know, the Latin American Committee is part of a consortium of committees that have representations in the U.S., there is the U.S. Shadow Regulatory Committee, Europe, Japan, emerging Asia, and Australia-New Zealand.

Having said that, let's move to the matter of today's discussion, which of course, had to do with the international turmoil in different aspects, and how Latin America is coping, or from the perspective of the committee, should be coping with it.

I will try to present the statement, that I hope all of you have a copy of, and then we'll open for questions and a very candid discussion with all the members of the committee, which in addition of having written the statement where they also are experts in a number of countries.

So, just to start the set-up, we all know that since the middle of last year, there has been a number of shocks hitting the global economy, especially with the eruption of the sub-prime crisis in the United States.

Now, as of recently, Latin America seemed to have been quite resilient to these shocks. This is manifested in a number of data, and in a number of outcomes.

First, when you look what's been happening in the sovereign bond crisis for Latin America, they have remained stable and the prices in local equity markets have continued to increase in U.S. dollar terms.

Now, these particular factor, we believe, is the result especially of a strict regulatory framework in most Latin American countries that, basically, limit the kind of investments that banks and the other intermediaries can undertake.

But, very importantly, too, we believe that the monetary-fiscal policy frameworks – the macro framework – has been strengthened, and this is reflected in better fiscal balances, and international reserves accumulation. That's the first reason why we see resilience.

The second reason, is, of course, what we well know has been happening, is that the region as a whole has benefited from improved terms of trade. In part, the continuation depreciation of the U.S. dollar which was aggravated by the U.S. sub-prime crisis created an incentive for investors to hedge against dollar weakness and invest in commodities.

With the exception of Central America and the Caribbean countries, most other countries seem to be net winners in terms of terms of trade shocks.

Third, another reason for this resilience, and of course related to the above, is that because of the concerted intervention of both the Fed and the U.S. Treasury, it seems that the probability of a huge and prolonged, severe depression in the U.S. doesn't have an extremely high probability. We cannot rule it out at this stage, but because of the actions being taken by policymakers in the U.S., we don’t think this is not the baseline scenario. And so, when we look at data for the region, we see that if the U.S. is not going to get into a huge and prolonged recession – a sharp and prolonged recession – then the effect on the demand for export from Latin America is contained.

As a result of that, the forecast that you see coming from the multi-lateral organizations, as well as from the market estimates do not predict a sharp decrease in growth in Latin America. Just as one example of forecast, growth in Latin America is forecast to reach 4.4%. In 2008 it was growing as a region as region – as a whole, of course – it was growing at 5.8. Of course, this is a decline, but it's not a sharp decline.

All right. That has been until relatively recently. But since the few months was difficult to point – exact point – but when the sharp increase in the food and oil prices started taking place, especially food, because food combined with an ongoing trend for the oil prices, then we, the committee, identified some problems – some cloudiness – in the region, both on the economic and on the social side.

On the economic side, the problem is that the increases in food, when combined with oil inflation, poses new challenges for the region in terms of monetary and exchange rate policies.

And on the social side, when we are talking about food, well, food inflation is putting a heavy burden in the segments of the population where the consumption basket is formed, has a large proportion of food component, and we believe that the urban poor and some segments of the rural sector.

The problem with this development is that they have exposed a weakness in Latin America economic performance, and is that that economic performance has not been accompanied by the public trust in democracy and market-based institutions and policies in many countries.

In other words, there are a number of countries, actually, a large number of countries, there is discontent with democracy and the way the market is operating. So given that the regions face a social and legitimacy problems, dealing with food inflation becomes essential for the sustainability of what's being achieved on the economic route. That's why we are so concerned about food inflation.

In addition to that, another potential cloud – you will see that as I expand further – is that in resolving or in dealing with the U.S. sub-prime crisis, there has been monetary actions by the industrial countries, including especially by the United States, that eventually – 2009 possibly – will imply that the U.S. will have to absorb the liquidity that has been injected for at that time, integrated with the U.S. will need to go up, and that will have a negative impact on the region.

So, very briefly, we ask the following question. How does the recent acceleration in food – food, but we deal also with energy – inflation came about. And when you read what the institutions put about the countries, the press, basically, we believe that there are, not exclusive, but different explanation of the recent current food and energy price crisis.

One explanation is, basically, an structural explanation, is that the increasing demand for food and energy comes from the growth of some developing countries, emerging market economies, such as China and India, and the diversion of land from food production to bio-fuel crops.

Well, if you focus and you think that this is the most important explanation, then immediately you see what has happened is a change in relative prices – change in the relative prices of food, relative to the rest of the goods in the economy. These relative prices will tend to be persistent.

A second explanation and one that the committee has been focused on, that, basically, does not explain the trend – that, actually, if you observe the trend in the price of food – the trend has had a positive flow, the increase in price has been increasing continuously for a long time. But if you focus on the acceleration – on the increase in the price of food – the recent acceleration – then we would like to focus on a monetary phenomenon in the industrial world that has two components.

One component is a reduction in the demand for money, especially the U.S. dollar, and the other, the increase in the supply for money, especially the U.S. dollar.

The decrease in the demand for money, especially the U.S. dollar, is very much related to the fact that emerging markets have accumulated an enormous amount of foreign exchange reserves, and seeing low interest rates in the industrial world, have created, among other things, sovereign wealth funds that are now are investing in other riskier assets.

So there's a shift in the composition of the portfolio of the reserve that has been shifted toward sovereign wealth funds that in turn been invested in other assets.

And on the supply side, well, they basically, as you know, not only the United States, but other countries, particularly the U.K. and many other countries too, have given almost a blank access to the liquidity provision of the Central Banks.

So, if you focus on those events, then you have the monetary phenomenon that we believe heavily contributes to explain the sharp increase, not the trend, but the sharp increase that we have been observing in the food prices.

So, the committee believes that it is the acceleration of food and energy inflation that poses the most significant challenges for policymakers in Latin America at the current juncture – not so much the trend – but the jump.

Now, the way inflation transmits is not a once-and-for-all phenomenon. First, go through, in this particular case, if you have a huge amount of increase in the net supply of money, then it goes first to affect those prices that are more flexible, and those are commodity prices, including food.

But then, it could transfer to other prices more slowly. When you have a monetary phenomenon, then you don’t have a relative price effect. What you have is an absolute price effect. But in the short run could look as a relative price effect because it's affecting first those prices that are more flexible, and usually those are commodity prices.

So, there's a difference in the way you perceive the impact coming from a trend, which implies a relative price shock, or a monetary phenomenon that tends to explain the acceleration of prices, but is an inflationary phenomenon that has no permanent relative price effect.

Now, does it work? Now let's go to Latin America. We observed that in a number of countries in the region are missing the targets – this is the observation – they are missing the targets in terms of what they want to have in terms of inflation. Chile, for example, I think, is the most dramatic. Chile has a target of between two and four percent and currently inflation is eight percent. Peru is also missing the target, and so is Colombia.

We focus on two issues that are related to what we think Latin American countries should do in light of these developments in the world economy. One is the focus on monetary policy, and the second, the focus on poverty alleviation.

On monetary focus, what we observe is that implicitly, many Central Banks in the region are operating under the assumption of a relative price shock – under the assumption that is there an increase demand in the food and oil, more than if it were a monetary supply phenomenon.

Now, of course, the prescription that you give for what a country should do when it's observing this imported inflation, is going to be different according to the origin of that imported inflation. The recommendations are going to be different if we, the committee believe it’s due to a monetary phenomenon than if we believe is a relative price.

However, we cannot – we are not in a position to fully differentiate exactly which one is the most dominant. As the committee, we tend to believe that the dominance for the acceleration is the monetary phenomenon.

However, under the assumption that relative price shocks are dominant, say that the relative price shocks are dominant – assume that's the scenario – the policy response that many Central Banks are taking, which is very mild, is basically doing very little. Right now, there's not a sharp increase in interest rates or letting the exchange rate appreciate significantly.

In that situation, well, such response is desirable in countries that have credible monetary regimes and a strong reputation for fighting inflation. The reason is that if you know that is a relative price shock and you respond by tightening monetary policy, well, you're unduly going to really create this acceleration or depression in other prices. And that's unnecessary and it's not really welcome in countries that have strong credibility in their conduct of monetary policy.

However, we have the issue – we're in Latin America now, right? So we have the issue that a number of countries yet have not developed a strong credibility about how to conduct monetary policy and as to whether inflation is going to be contained. In those circumstances, the committee believes that the committee response if it's too mild – if it says, "Well, it's a relative price shock, so the Central Bank should keep their hands basically out of the problem," that policy response could actually increase inflationary expectations, potentially triggering a dangerous price dynamics. In such a case, the monetary policy tightening is necessary to anchor expectations.

If instead, in the situation of a relative price shocks – if instead, monetary factors are the driving force behind the sharp increase in food and energy prices, then the committee believes that the response should be a different one.

Since it's not a relative price phenomenon, I mean the acceleration – then we believe that the nominal and food energy price increase should be neutralized by nominal appreciation of the domestic currency.

Basically, what we are doing by giving this advice is that since we know that it's not a relative price shock but it's a monetary shock, the real exchange rate is not going be affected by letting the exchange rate appreciate, we're basically allowing the real exchange rate to remain constant and allowing the exchange rate to absorb all the shock of the increase in the price of food and energy.

But what has been, during our discussions over and over came has been the potential problems that the region might face, especially since the beginning of 2009, when the U.S. would need, in one way or another, to absorb the liquidity that has been injecting for dealing with the U.S. sub-prime crisis.

Because we believe that has the possibility of happening, what we don’t know is how sharp the increase is going to be. Guillermo Calvo has a term that he terms it a Volcker jump. Volcker jump refers to – if you recall – during the time of the Volcker administration, inflation was very high and has been increasing the rate sharply.

So a Volcker jump is a sharp increase in the interest rates. But we don't know whether the increase in interest rate is going to be sharp, or is going to be mild. But in any case, actions – the committee believes – that actions should be taken now – that Central Banks should be taking precautionary measures by developing contingent lines of credit and further accumulation of international reserves, preferably through fiscal account surpluses, to get prepared for the potential negative impact that in half a year from now, Latin American regions could experience if the United States sharply increase – sharply and suddenly – increase interest rates.

In addition to that, the committee also recommends pursuing policies that are countercyclical in nature. Again, to prepare for a likelihood of an increase in interest rates in the United States. We do not want to have a long list here, but we definitely encourage the countercyclical public expenditure policies, as well as countercyclical potential regulatory policies like countercyclical provision, for example.

Finally, this committee, although we focus on financial and the monetary issues, cannot stop or finalize a statement without talking about poverty alleviation problems. Why? Because if we motivated these statements, the social unrest created by the increase in the food of prices, may actually derail the success achieved in the macro economic area.

Now, in the statement we present a little matrix that shows what countries are more or less affected by the food and energy price crisis. And as you can see, in net terms, the most affected are Central American countries. But the situation in every country for these particular issues is incredibly different. An example is that you have Venezuela, Mexico in the same cell in the matrix.

But, however, price controls in Venezuela are exacerbating the crisis by curtailing supply. While in Mexico, high prices have led to severe riots.

They are different – the situation in every country cannot be generalized. We cannot, in this statement, have, as we've been doing it for the early parts of the statement, have more general conclusions for the regions. We only know that we want to stress the need to undertake, in every country, policies that control the adverse impact on the poor. As such, we want to emphasize that there are some, perhaps with good intentions, but with very bad results, are the policy that relates to price controls.

Price controls are self-defeating and hurt the poor. Why? Because they retard the supply response and promote the development of parallel markets. Right? Export taxes, as well as quotas also hurt domestic producers and exacerbate the hike in international prices and works against new investments.

Therefore, the committee believes that the way to deal with poverty alleviation needs to be addressed through focalized programs that are explicitly recognized in the budget – policies that do not distort relative prices and do not interfere in the working of the market economy. Instead, they are well recognized in the market and designed so as to maximize the impact of the transfers of the sectors directly affected.

With this, I conclude the general presentation of the statement. I have not gone into a number of details, but my colleagues will do that. I'm sure they'll be taking notes and she didn't say that, and she didn't say the other...

So, what I would like to do now is to invite all of you to start raising questions and we have an open and candid discussion based on the statement.

We can start collecting questions – we can go into several rounds, so you know, please, Sara.

Sara: Thank you very much.

Liliana Rojas-Suarez: And please identify yourself so that people know…

Sara: Sara **** from **** University. I want to refer to the last sentence of the statement. In order to implement focalized programs accounted for in the government budget, space in the budget will have to be met. In that case, then they could pressure to use the international reserves to finance the programs. The question is how to handle that situation. One proposition that I heard recently at a conference, instead of cutting expenditures in other particular and sensitive areas, to increase taxes and since this a prestigious committee made of also finance ministers, I would like to hear from you.

Liliana Rojas-Suarez: Great. There's another question in the back, if you can…

Sherry Stephenson: Thank you very much. Sherry Stephenson from the Organization of American States. Yesterday I was in New York at a meeting of ECOSOC on food prices and it was remarkable how many governments and international actors were there to discuss the problem. Given the gravity of the situation **** including we could negatively affect Latin America in the near future, could you say a little bit when this becomes a community program there is injustice that something is developed? Yesterday there was a lot of mention of coordinated response. Do you think for Latin America that any kind of coordinated response is useful or does it have to be nationally, country by country, and then does the response depend upon the explicit fiscal situation in which the country finds itself and as the earlier question referred to the amount is based in the budget and so forth?

Male: I am **** from Al-Jazeera. You made reference to a (inaudible). And another question, you continue to have the US as a central role, and my understanding also is that there is diversity in Latin America in relationship to US and the effect on the US (inaudible).

Scott Thomas: I'm Scott Thomas from CNFA. These two scenarios have radically different implications for policy. You've mentioned that of course the appreciation will allow some pass through or some insulation from the monetary – increase in monetary aggregates if that's at the base of these increases in commodity prices. Now some of the – a number of currencies in the region have in fact appreciated, while others have not – some countries are dollar based. Has anyone gone through the numbers to try and tease out these different effects to see which scenario tends to be supported by the numbers?

Liliana Rojas-Suarez: Okay I'm going to take one more question in this round, please. And we'll go through some answers – maybe we'll take that question too and then please.

Gloria Ospina: Thank you my name is Gloria Ospina I am an ex-IADB person. My question is more related to the last part of your advice for Latin America. I do understand that CLAAF committee is more in the financial and banking kind of sector; however your recommendation is to do something for poverty alleviation.

Last week I attended a meeting at the Brookings Institution for the launching of a book of Mexico by the current IDB economics chief and the issue was also, you know that, I wouldn't say the failure, but the problem that for such a long time I have to say, 30, 40 years Latin America has had with either poverty alleviation or grow with equity. Now my question is very simple. Why again after so many years are there so many committees, so many institutions, IDB, all of what we have been doing for the last 30 to 40 years, poverty alleviation, equity in Latin America. Despite the minor successes of the macroeconomic policies of the last ten years, or even in favor of the anti democratic thing that we have now in the region, it's still poverty alleviation. Equity is the biggest problem in all of our Latin American countries. Thank you.

Liliana Rojas-Suarez : Okay, one more question for this round. For – Let me – This – We are going to go around and then we'll bring it again if we have time.

Male 2: Thank you **** University of Maryland.

Liliana Rojas-Suarez: From what University?

Male 2: Maryland University.

Liliana Rojas-Suarez: Thank you.

Male 2: And my question is 2009 is going to be a pre electoral year, like for instance in Colombia where I come from, some programs like conditional cash transfers are now showing – so many countries are using those and there some studies showing that those programs are effective, are also good vehicles for populism. And so my question is if you have to think about how this is going to play – the pre electoral thing is going to play and interact with the programs that your kind of suggesting, because that could raise leftist parties and things like that.

Liliana Rojas-Suarez: Okay who wants to start? Or maybe should I go through all of the members right now? Guillermo do you want to start?

Guillermo: Yeah, I'll refer to Sara's question. This was definitely an issue we discussed at length. There is no easy answer to that question. One of the possibilities that we dismissed is raising the VAT, because it would affect the poor and a segment of the middle classes which have been affected by the increase in prices of commodities. Basically the answer we came up with and it's something that has to be taken with a grain of salt and identified on a case by case basis, is raising the income tax in those countries where the income tax is still relatively low. There are several cases that we know also in general that would be approached with and yes part of the answer is that we feel the way to finance it is by increasing taxes and increasing central government revenues.

Liliana Rojas-Suarez: Pablo.

Pablo Guidotti: Thank you. I want to – I want to respond to these issues but I want to maybe point out in more general message okay. In a certain sense, part of the objective – or an important objective of our statement is sort of try to change the focus of what has been until recently, sort of the convention explanation of how Latin America was facing this international developments versus maybe new significant challenges. This is where we make this difference between the explanation based on the structural reasons that have generated the slow moving, increasing relative prices of food and energy versus something that has been relatively new in which we have a sharper acceleration. Now and this is what we call the monetary based explanation. This explanation process changes very much the picture of how the region is going to be affected because first of all we are setting that the traditional direct contagion of financial of the sub prime crisis is not there okay. However, this does not mean that we will not face another sort of financial contagion which would actually come in the future if we anticipate that the US Federal Reserve may be required to actually increase sharply interest rates.

And in this basically what we have in mind is if we are seeing sort of an over shooting effect and in fact the sharp increase in commodity prices is actually an anticipation of future generalized inflation. This poses two main issues. First of all that is in the short term, the relative price change is magnified and this generates immediate social tensions because increases in prices are sharp. And we are particularly worried that some of the reactions that some of the countries have had in terms of banning the exports, in terms of imposing export taxes to try to lower domestic prices of these goods in fact have added to a problem internationally. And in fact a significant portion may be up to 30 percent of increase in prices recently have been motivated through these sanctions okay.

So – but this – the fact that we have a bigger problem in the short term in terms of the relative price change in place, countries have to focus on the social effects much more than what they have been doing in terms of just talking about redistribution and poverty reduction in general. Now we may have something that may be transitory but maybe important maybe sharper. And the second is that they have to anticipate that maybe the good times, I wouldn't say are over, but maybe significant further challenges lie ahead if we – if the region is going to face the effects of an increase in interest rates by the US Federal Reserve sometime in the future. And in this we also need planning and for instance one of the aspects that we have been discussing and it is in the statement is the role of the international community.

We are worried and we have said in previous statements that for instance the issues like building again, a contingent credit line, or aliqiudity line at international organizations like the IMF, have sort of essentially passed away to be a less important issue. And maybe these are instruments that are going to be needed in the future. And this is the time, in fact, in which both domestically countries have to actually prepare and also the international community has to prepare for something that may happen and may have – many times in the past may have important implication for the region.

Liliana Rojas-Suarez: Ernesto?

Ernesto Talvi: I would like to address – expand a little bit on the question Sara made and the person from the OAS on either the financing or the coordinated response. There is an important aspect that we should not miss here. Since the current expansion started at the end of 2002 in Latin America, we've had a very, very dramatic increase in revenues – in government revenues. And for the region as an average, 75 cents out of every dollar of extra revenues were basically spent they were not saved. With the notable exception of Chile that essentially only spent 30 cents on every dollar and increased in a very important way the fiscal surplus and amassed a huge stabilization fund that can be precisely used in times of adversity. So in countries such as Chile maybe this type of programs could be financed out of previously accumulated savings during the boom and in the rest of the countries maybe we could attenuate a little bit our pro-cyclical response to the increase in revenues and reallocate some of the expenditures. The planned increase in expenditures which are very important into these more focalized programs that could allocate poverty.

Now in cases such as Central America where fiscal precisions are fragile and therefore there's not a lot of room to increase taxes or reduce other kind of spending then maybe the international community could play a role and the IMF could in that sense come back into the region with the kind of traditional programs that could be useful in this sense. Although for the moment, and perhaps that is a concern for the future, there is so ample liquidity there that these countries are being able to place debt in the markets and essentially finance these programs by issuing debt which might pose a problem if eventually you get over indebted and there is a substantial change in international financial conditions you do a future and abrupt rise in US interest rates.

On the question of the diversity of the impact of the US on Latin America, that's a very important question and in fact it is very relevant to asses what the net impact of everything that's happening will be. On the one hand, there is a real channel through trade and through investment that clearly, to the extent that the US enters into a recession, is going to hit adversely every country in the region and it's going to hit the most those countries which are very connected to the US both in trade and investment relations. On the other hand, the response of the US Federal Reserve to the crisis has put us in a situation of ample liquidity negative real interest rates. So periods of negative real interest rates have always been favorable for the region. So this financial channel is going to have an expansionary effect. So in the net it might be even expansionary for some of the countries that do not have very strong real ties with the US such as Brazil, Argentina, and some countries in the southern part of Latin America. So this is quite an important distinction and there is a big difference between countries such as Mexico and Central America and countries in the south and therefore we might be going through a period of what we call sweet money coming in through the south and promoting an important expansion in our economies.

And finally and very shortly how to disentangle these two interpretations. It's not easy. The only evidence that we know of, and have been working at CERES to try to see what kind of result have you had in terms of inflation performance of those countries that do peg to the dollar versus the countries that have allowed some kind of appreciation and in fact what we find is overwhelmingly that the countries that peg to the dollars have had much worse acceleration – a much sharper acceleration in inflation than countries that have allowed their currencies to appreciate. So this gives us the suspicion that there is something nominal. An important nominal component, a monetary component, down there that fundamentally is affecting differential behavior in terms of inflation.

Liliana Rojas-Suarez: Roberto.

Roberto Zahler: Yes to add to, many of the questions have already been answered. Regarding Sara's question of fiscal space to increase finance -- focus social spending. Besides the issue of raising income taxes, which is quite complicated, I think that most of the region at this moment are in a favorable position because of their fiscal and especially because of the international reserves accumulation. And there is space in some countries to use this accumulation of reserves in a sense to finance the increased spending. However, the challenge there that most countries are seeing regarding this social financing is the fact that most of the currencies have appreciated recently and have let us say big discussion in the region regarding the export reciprocation, export promotion, and that exports could end up being hampered by appreciation. So, there is a big challenge there also. Though you have the resources, the issue of how to put them into local money which is what you need. Again, creates a problem and it's a big challenge. But I will say in terms of practicality that would be, in some countries like Brazil, Chile for sure. But I will say most countries have increased very dramatically their reserves much above what one would consider normal or a reasonable level. You could use them but you have to see how you deal with the exchange rate issue.

The other thing I wanted to mention was that I tend to agree very much with the point of our statement being in the sense biased with what's happening to the US. In the sense that in the last five years, or six years, it's very dramatic with the exception and only to a certain extent of Mexico. How countries in the region have diversified their trade towards Asia, basically towards Asia. And in that sense if the thesis of the **** is correct in the sense that big emerging market economies today have a sort of endogenous sort of rate of growth, little bit, more independent from the US and from industrial countries than in the last 20 or 30 years, then clearly, in addition to the sweet money sort of element that Ernesto Talvi just mentioned, I think there's a more structural benefit of most Latin American countries today because of their exposure to Asia and even to some of the old exporting countries in terms of exporting to them commodities is today much bigger than before. And there is a, I would say, some rationality or some groundings for being optimistic or less pessimistic regarding this change, this diversification.

Regarding, I think the question of equity and income distribution. I think there have been many attempts in the region to face this. I will tend to agree that according to a latest data that most of them have not been successful. Although I will say there is more success regarding how we have faced, in recent years, extreme poverty as compared to income distribution. I think that, that is very important because I think in many countries extreme poverty has been reduced quite significant. However income distribution I think still is a major problem and precisely increasing the price of food and in oil are affecting very much not only the poor classes, but also the middle class. And that is why this is one of our motivations of our statement.

Liliana Rojas-Suarez: Guillermo?

Guillermo: Why thank you very much. Certainly we have covered a lot of ground and I have been striking out points that I was going to make as my colleagues addressed them. So let me be brief and to the point. In the first place I think we are here concerned about the price of food because it went up so sharply. Not so much because it is high because it was higher in 1975 when you deflate by CPI, much higher than now. So I think it's the fact that there's been a turn around, a very sharp turn around, those prices and obviously minerals, oils etc., even more. So that's what lead us to think that besides this growth factors to give you the names structural, long term, which we all welcome in principal because it reflects the process very big and critical areas in the world like China and India. There must be something else. There's a big discussion out there whether something else is just pure speculation or there's a fundamental at play. And our sense is that – well maybe there is speculation and we are now ready to think about bubbles. That's what happens when there is a bubble. We all get predisposed to think about bubbles, but bubbles don't take place after a bubble. Like people don't have an accident the next day after they have an accident. They are very careful. So I think we are going through a period now where everybody's very risk averse. So it would be very strange that in the midst of that there's a birth of the new bubble. So let's be careful because we have that tendency to extrapolate very quickly. So that's why we thought that just to discipline ourselves we should at least try to think of other components and that's what lead us to think that there is something going on there that has not been focused in this – from this perspective. And that's SWF, sovereign wealth funds.

Everybody's talking about their governor's and transparency and so on. But there is something monetary going on there, what these guys have done is to take very liquid assets from the central bank, for example in China 300 billion dollars, and put them in a fund that is – it's main objective will be to invest in real goods out there. So it's like all of the sudden someone who has a lot of money in his pocket dips into his pockets and goes on a buying spree. So that naturally will lead to an increase in global prices, dollar, euro, whatever. Maybe more dollar than euro, that's what we say here. And therefore if that were to happen, and I think that's been happening already, then you will see a big depreciation of the dollar, a big increase in oil prices that can move very fast. So that's what led us to think that maybe what we call speculation and so on is just a result of the fact that Asian countries in particular are fed up with holding those treasury bills that yield nothing and is yielding even less now and spending it to something which is more attractive from their point of view. That causes inflation and that – but as I said before first we'll go commodities, commodities will go up and that will mean that a relative price change in favor of food etc. Now that's important to keep in mind because if that – if you challenge yourselves to say well yeah you had to explain not only the rising in those commodities and relevant prices, but also, as was pointed out in the presentation, the acceleration, that's a big thing.

I mean how can you explain the acceleration because nothing accelerated in Asia recently. If anything, we are talking about slowing down in Asia and we are concerned about slowing down in China following the slowing down in the US right. So how come in the midst of that you have an acceleration in the price of some commodities. That is what has to be explained. So if you accept that there is something monetary down there, then an implication, which is very important to keep in mind, is that most likely we're talking about the transitory relative price increase. So the food is very expensive now but it's going to be much less expensive maybe in a year time.

If you look back to 1975 that's exactly what you see. You see prices going up very sharply and then coming down in a year or so, the relative price. So it could – this could be a harbinger of future inflation. When we look at this in a year from now, then all prices in dollars may have increased to such an extent that yes there is still food has become more expensive than a year ago, but not as sharply as now. So, bringing that down to Latin America. If you face that then you ask yourself what am I facing. There is a very temporary component here and of course I have some segments of the economy which are very liable or sensitive to this increases the poor, and I want to do something about it. How should I do that?

Well this is a typical case of a transitory shock. When you have a transitory shock you respond to that by increasing debt, which I think is a little bit in line that you hinted at. And that is in line with the fact that if you have reserves you can increase debt, along with your reserves. Which is in principle the same thing leaving aside the liquidity aspect of reserve. So it makes sense I suppose. Not so much to increase tax, in the first place increasing taxes is hard. If you do it, Argentina now well you can have a tax revolt. So and if you really want to play the democratic game, taxes is something that moves and should move slowly and with a lot of consensus. So unless people understand very well what you are doing, be careful with taxes.

So in the short run it seems to me that it's perfectly natural for countries to fall into debt, increase debt, maybe get credit lines from international institutions that was mentioned before and so on. So that would mean in response to Sara's point which I – is very basic to all of this, it makes sense. But let's be careful not to confuse that with the fact that oh well look now we know how to spend it. Really we made a big mistake by having such a stock of international reserves. That's an issue I don't want to touch now because that's a different issue all together and I think it would be a mistake myself. But I don't have time to address that issue and let me just finish with a comment on the decoupling.

The decoupling – Latin America its relationship commercial links to the United States are very different. If you look at Mexico, 80 percent of Mexico exports go to the US and they have NAFTA and so on. They are extremely close to the US from that point of view. If you go down to the south much less and as Roberto has pointed out, through time there's been a bigger, a wider decoupling from that point of view.

But where it's not clear that there is a decoupling is in respect to the interest rate. We have had – in the 70's an experience that doesn't look that different from the one we are going through now. Remember that in the 70's interest rates in the US were very, very low, negative. They were going through a recession. There was the recycling of petrodollars and one day Mr. Volcker got fed up with inflation and raised interest rates above 20 percent. That's what I call a Volcker jump instead of a quantum jump in interest rate, so instead of three words you have two. That's always welcome for policy circles. So that is something that may happen in the future, and why? Once again you go back to this explanation that maybe what we are seeing is a harbinger of future inflation. Well when that future inflation materializes into the CPI of the US the Fed will have to do something and the question is whether a slight 50 basis points increase will do the job or a much bigger increase will do the job. My fear, and I think it's some what shared by some members of this committee, is that there could be – there may be a need for a much, of a sharper increase in interest rates and that I think may still be bad news. The decoupling there I'm not sure it's been so deep as the other one I mentioned. Thanks.

Liliana Rojas-Suarez: Roque?

Roque Fernandez: Okay I just took all the items from the list, except one. I think that Mr. Stevenson asked for a coordinated response and so it's the only one that other members have not addressed, no? And if we understand his coordinated response from the point of view of the Latin American countries, I would say that this is very difficult because we had crisis in the past and we never could, ourselves, be coordinated. Because we are all having the same problems, so we are all having capital outflow, we are all having a decreasing economic activities. So the idea of a coordinated response I think it would have to be more related to the behavior of multi-lateral organizations or discussing some sort of insurance with other countries in the world that are not all having positive coordination among themselves. So for example we think about Eastern European countries or other emerging countries where they are not having the capital flight maybe they are having a capital inflow. But just to think about the coordination of how the ones that are having capital inflows would help the ones who are having the capital outflows is really a really difficult issue. So we thought about what could be done but we always end up in this sort of reserve accumulation, prudential regulation and that kind of individual actions in each country. And perhaps some sort of contingent line from mutli-lateral organization. But this is very much – or very difficult to go behind this sort of general response.

Liliana Rojas-Suarez: Great, we have time for just a few more questions if some people want to raise them.

Eduardo Cepeda: Eduardo Cepeda, Carnegie Endowment for International Peace. I have one question on the last item, the poverty. Increasing food prices is very difficult to track how increasing food prices is going to affect the poor. There are three major channels the direct impact of the crisis itself depending on if they are net buyers or net sellers, there is employment effect and there is the local economy effect. If we say that we are going to confront any effect of these price increases the problems that are already in the budget, we are not really making room to accommodate a situation that we didn't have before. So thinking in terms of the cash transfer programs, which are probably the ones we are thinking about, does it mean that we are going to increase the transfer for those sectors that we think are going to be most affected? Does it mean that we are going to change the membership of the program to accommodate that? Does it mean that we are going to change the frame work or the design to accept temporary deviations from conditionalities in order to make sure that they get the money to confront the increases in prices? That is my question, what do you have to say about it?

Liliana Rojas-Suarez: Any other questions?

Male 3: Yes just a follow up on the data question, the commodity price adjustments, has there been any evidence that there has been a past through to other sectors and other prices other than commodities?

Miguel Robles: Miguel Robles from IFPRI. I just want to ask, I mean I'm getting the flavor that – Maybe I'm – Correct me if I'm wrong that the committee some how thinks that this increasing prices is mainly a monetary issue.

Liliana Rojas-Suarez: Acceleration?

Miguel Robles: Yeah the acceleration so then we're clear that still we have a structural change?

Liliana Rojas-Suarez: Yes.

Miguel Robles: So – and if we go back to that, what can be done, because if this is a relative price problem basically what we are observing as a whole world is that food and energy is becoming a more scarce resource so basically we are – If there is no supply response we are left basically with a distribution problem. So I mean to make it an extreme case, if the supply of food and energy is fixed so basically we are saying the world as a whole we cannot keep the consumption pace that we have seen over time. So basically someone has to consume less. So from that point of view what can Latin America do? I mean as a region that is relatively poor – We are relatively poor against rich economies. I mean probably Africa is in a worse situation. So this is a real – if we are facing a real problem other than a nominal problem. So is there any room for policies from the consumption side or on the consumption side or can you imagine just substitution. Policies help us to substitute our consumption. I don't know who is going to tell Mexicans to eat less tortillas, it's hard. And from the production side basically, supply a response. What can we do from a supply response? And from that point of view I want to just point it out. Isn't this just a great opportunity for rural Latin America given that price are high?

Liliana Rojas-Suarez: Any more questions? Okay I'm going to take just a little bit of some and then I'll ask anyone who wants to jump on. First of all I'm going to start with the last question. Yes, the committee does not, as you have clearly said, does not ignore – does not put aside the fact that it is a trained increase. Is because the committee and the specialization of the committee, that we have been focusing more on the acceleration and the acceleration of prices. Now it happens to be that I am a member of the board of trustees of IFPRI and I believe that you guys are the ones who are well equipped to give the answers to the questions you have posed. And in the last meetings that you had with the European Union in Belgium last week there was a number of proposals related to the supply of food on a more long term basis related to technology. There has been so many, so many proposals and the committee really does not take on those issues, it's not our comparative advantage. But yes we do not ignore the trend it's just that's not what we're dealing with when were talking about monetary policy response.

On the same line of answer, yes I don't think that the committee is well equipped to answer questions related what are the most effective cash transfer programs for each individual country. They – I'm going to let other members say more on their countries as they come along, but when we had the discussions within the committee yesterday and we focused on this, the feeling was in each country, members from different countries, was at first the situations are very different, second that there were more space in the budget in some countries than in other countries, third somebody was saying too some countries, the rural sector was actually benefitting more while in others it was not depending on what crops we were talking about and what kind of land. So we cannot focus on making specific statements about that. And finally a comment on the path through, there has been recent estimates by the market, I'm talking Wall Street. The estimate have been on what would be the path through the general price level and vague estimates range from 20 to 40 percent depending on what country they are. But nothing really systematically or specifically focused on the different price recent increase. That's what we know of. But now I'm going to let Pablo.

Pablo Guidotti: Yes just to compliment a little bit about what was the last question because I think it's very important. I think we although we cannot enter into a lot of details and the type of programs, certainly there are some basic issues that we have clear. And first of all, it is obvious that the response to such a situation can not be an interference with the price mechanism, with the price system. Because eventually if you have the structural changes you need to reallocate some of the demand and you need to increase your supply? And so in this the price system is a crucial element in terms of providing the incentives to do that. Then you have the problem of interrogating the segments of the populations that are more hardly hit. And I – and what we are a sort of trying to raise is the awareness that if this is a sharp change, which maybe well a transitory phenomenon, it needs to be addressed specifically not through the programs that are already in the budget. But authorities and policy makers have to focus on these as a new issue and therefore try to either reallocate some of the expenditures in a different manner or maybe use part of international reserves to actually provide a temporary relief but without interfering with the price system.

Therefore for instance attempting to use export taxes or export bans to solve the issue to try to lower domestic prices, it's a bad idea okay. First because you are distorting with the price system and in addition I think that this is a situation, like other crisis and other situations, in which we always see Latin America as part of the – as a region that's been hit by some thing but has essentially not a relevant responsibility in the world economy. I think this is a situation which the region also has responsibility **vis**-à-**vis** the world economy. And some of our countries are large producers of food and therefore it is a very egoistic way to just react and say I'm going to ban exports to solve my internal problem and there by contributing to a bigger problem in other regions of the world. And the types of estimates that we have seen in terms of the impact of these types of actions have had on price is very significant okay. So in terms of supply, again I think that it's very important to keep the supply system moving and clearly here we want to shift supply and therefore part of the answer will have to do with technology and investment. And for that – for instance it is something that we have discussed although it has not – I think in the end – in the final drafting of the statement is actually the role of the real exchanger. And in some countries have actually made an emphasis in having a weak real exchange rates in order to promote economic activity but we know that strategy actually tends to be a hazard bias against technology okay. So again we should try to focus on – which is the way which policy and policy reactions are actually impacting on the supply.

Liliana Rojas-Suarez: Harald.

Harald Benink: Just to add something from the International European perspective to the question raised by the gentlemen from the International Food Research Institute IFPRI. We were looking at your publication over the weekend and it's very spectacular. When we look at the graphs which have been produced in terms of in particularly the acceleration of some of the food prices including, raised here in the past year, but of course the structural part and in terms of Asia, China, and India is very important. And I would like to mention that anybody who is visiting Asia on a regular basis has to be impressed by the rapid wealth, and this is something which is going to stay. These types of structural effects that Asia is the need for food for energy is not something which is going to reduce substantially even if Asia will be slowing down a bit. From the European perspective it's interesting to note that you may be aware that we have the famous common agricultural policy kept in Europe. And it's not so long ago that the farmers were producing far too much which they couldn't sell in Europe and which had to be dumped on world markets, again it's very low prices so the farmers got income support that in return for that they had to accept certain restrictions in the contingency of supply. Now this is changing in Europe and Europe the cap will be reformed and as far as there are still restrictions going on existing, they will be dropped. So Europe is also in the way on the track of increasing supply and of course Pablo was saying it would be good if other parts of the world including Latin America could do that as well. Thank you.

Liliana Rojas-Suarez: Ernesto?

Ernesto Talvi: I want to address one of the questions that came up again in terms of if there is any evidence that – Unfortunately there is preliminary evidence that this is going beyond the commodities and metals. And that is very difficult to see very quickly in the CPI's of the countries, once you remove food and energy, although they are creeping up slowly because they do have a very strong untradeable component. But if you look at import prices and you divide them by category, then you will see – you are starting to see that both consumption and capital goods industries are starting to accelerate very, very significantly. And this is sharp contrast to the immediate past in which this goods were actually either rising very slowly or even declining in price when we were experiencing a rise in commodity and other prices.

So there is evidence in these more wholesale type industries that commodity price inflation is somehow transpiring into other kinds of goods and that means that eventually they will creep into our indices soon and then that's what is one of the major sources of concern for us. That if that's the way the story unfolds then the

US might be forced into a very abrupt reaction to try to cut down on inflationary pressures and then we might be in a little bit of trouble.

Liliana Rojas-Suarez: Okay if there’s no further response from the members, I want to thank all of you for coming, accompanying us this morning and for being faithful company to the Latin America Shadow Financial Regulatory Committee. So until next time thank you very much.

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