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INTERNATIONAL DEVELOPMENT ASSOCIATION
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Statement by the Hon. **CARLOS A. MASSAD**,
Governor of the Fund for **CHILE**,
on behalf of the Latin American Governors of the Fund,
at the Joint Annual Discussion

STATEMENT BY MR. CARLOS MASSAD, GOVERNOR FOR CHILE,
REPRESENTING THE LATIN AMERICAN GOVERNORS OF THE INTERNATIONAL
MONETARY FUND AT THE ANNUAL MEETINGS OF THE WORLD BANK
AND THE INTERNATIONAL MONETARY FUND
Hong Kong, September 23, 1997

1. I am honored to address the International Monetary Fund at this year's annual meetings on behalf of Argentina, Bolivia, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Spain, Suriname, Trinidad and Tobago, Uruguay, Venezuela, and my own country, Chile.
2. The outlook for the growth of world output and trade this year and the next is quite good. Even more important are the trends in the factors contributing to the sustainability of global growth. Steady progress is being made in controlling inflation the world over and the fiscal position of most countries is improving.
3. In this favorable global context, the Latin American economy is also making definite progress. Having overcome the weak performance of 1995, the region is set to grow by more than 4 percent in 1997, a higher rate than the 3.4 percent recorded in 1996. Particularly noteworthy is the significant recovery of the Argentine and Mexican economies. We can also expect faster regional growth by 1998.
4. Together with this improved outlook for growth in the region, capital inflows that already in 1996 were at high level have continued to increase, a clear reversal of the temporary scarcity Latin America faced in 1995. Indeed, ECLAC estimates that capital inflows in 1997 will amount to approximately US\$70 billion, some US\$15 billion more than the projected current account deficit.
5. The progress with regard to inflation recorded over the last three years is continuing. The regional inflation rate for 1997 is expected to be one of the lowest this century.
6. However, much remains to be done. To accomplish these tasks, rates of domestic saving and investment in physical capital must be raised, and education and health services must be radically improved. In that regard, perhaps what is most needed is to avoid the cycles of excessive growth followed by recessive adjustment that have been the hallmark of the region for almost two decades. To this end, inflation control should be a priority and timely preventive action should be taken when signs of deterioration in inflation rates or the external position appear. Both conditions, namely domestic and external equilibria, can be met through a sound fiscal position, which ideally should also be flexible, so as to support monetary policy in achieving stabilization. Domestic macroeconomic policies must also be compatible with the exchange regimes adopted. Progress in this area is promising.

7. However, good fiscal management alone is not enough and is often hard to reconcile with far-reaching policies for improving equity and competitiveness, unless the proper instruments are in place for coping with private sector expenditure cycles. Development of a sound framework of prudential regulations and financial supervision, which our countries are working toward, is essential for ensuring the proper channeling of domestic and external financial saving into profitable ventures with a high probability of repayment. Too much private spending, financed by a poorly regulated and supervised financial system, may have been a determining factor in the recent financial and balance of payments crises in the emerging economies.

8. Equally as important as proper domestic policy management is a stable international environment. In that connection, although projections of world growth for this year and the next are positive, we should not underestimate a number of risks that are looming on the horizon.

9. The last two years have been characterized by ample international liquidity and the continued strengthening of the U.S. dollar. This abundance of liquidity has greatly benefited many economies. However, the pressure of this liquidity on the level of domestic spending in recipient emerging economies, has been a factor in the significant widening of balance of payments current account deficits. In some cases, these deficits have increased beyond sustainable levels. This has triggered crises in a number of places and the contagion has spread worldwide. Experience has shown that policy changes in the developed countries can have a major impact on the developing countries. Developed countries and also the Fund, must be mindful of the systemic effects that may arise from such changes.

10. In this context, continued stable conditions on international financial and exchange markets are of paramount importance, given countries' increasing openness to international capital movements—one of the key issues addressed at these meetings. Though progress on inflation and fiscal consolidation suggests that the moderate real interest rates on international markets of late should not significantly change in future, there are nevertheless some disturbing signs.

11. The U.S. economy seems to be operating at a sound and sustainable pace. Despite the absence of inflationary pressures in the goods and services markets, the sharp rise in asset prices, a phenomenon that has not yet been fully analyzed and which has spread to many emerging economies, is a cause for concern. As for continental Europe, the advent of the European Monetary Union will have major, and potentially positive, global repercussions. We are confident that the commitment of the European Central Bank to combating inflation will counteract any possible risks. In the case of Japan, the second quarter of this year was marked by sluggish performance and this is not an encouraging sign. There is considerable need for more vigorous growth both in Japan and in the economies that export to Japan, especially those in Asia that have recently been suffering financial and exchange problems.

12. Mr. Chairman, the points I have raised demonstrate the high level of interdependence in the world economy today and the growing importance of balanced development. Let me offer some thoughts on the proposed amendment of the Articles of Agreement of the International Monetary Fund, with regard to the broadening of its jurisdiction over international capital movements.

13. The representatives of the countries in the region have clearly expressed their willingness to extend the Fund's mandate to enable it to promote liberalization in the capital accounts of its member countries. The requirement that external saving should supplement domestic efforts to tap our vast investment opportunities will create an environment in which we can obtain additional sources of financing, with better maturities and prices. No less important is the opportunity to diversify our own financial assets to incorporate instruments from a wide variety of countries, so that the profitability and risks for large amounts of personal savings, such as those invested in pension funds, will no longer be so dependent on domestic economic cycles.

14. By broadening the Fund's jurisdiction, it will be possible to ensure that the natural process of deregulation that is spontaneously occurring will be more orderly, efficient, and balanced. To maximize this potential, however, it is necessary to ensure that the new wording of the Articles provides the flexibility and powers needed to properly guide the process.

15. The Fund's Executive Board discussed using a transition period to enable the countries regulating capital flows to phase out these restrictions. This period, its definitions and approval policies are of main importance. Precipitate liberalization would create new financial crises with a spillover to other countries resulting from the contagion effect.

16. A transition period is not sufficient. In our opinion, one of the most important aspects of the future regime is the treatment of prudential measures. Owing to the structural characteristics of the economies of our region—mostly small open economies requiring external resources and with insufficiently diversified exports—they are highly vulnerable to external shocks. Although this vulnerability can be lessened with proper macroeconomic management, the volatility of some key variables cannot be completely prevented. This volatility has a very considerable effect on the stability of the financial system. Thus, adoption of prudential regulations in the financial system is very important for preventing that any macroeconomic disturbance gets to be amplified into a full blown crisis.

17. It has been proposed that the guiding principle for prudential regulations should be to exclude any relating to balance of payments or macroeconomic management reasons. However, prudential regulations applicable to the financial system are specifically designed to prevent financial problems that are initially limited or microeconomic in scope from acquiring macroeconomic proportions. Thus, the decision to exclude a regulation based on its macroeconomic character could be arbitrary and even inappropriate. Take, for example, the case of a rapidly growing economy with sound fundamental balances. The high rate of return on capital in a booming economy attracts large inflows of external resources. These inflows

are further encouraged by the appreciation of the domestic currency, which is characteristic of economies experiencing rapid productivity growth. Capital inflows stimulate domestic demand and could push up domestic interest rates if the monetary authorities safeguard domestic equilibrium. This, in turn, could provide a further incentive for capital inflows. The probable outcome will be continued appreciation of the real value of the local currency, the resulting risk of widening the current account deficit, and the greater danger that these capital flows will be reversed, should some negative external shock occur. After implementing all the so called "first best" solutions, such as fiscal consolidation, incentives for capital outflows, and strengthening of bank supervision, the authorities may in addition have to take measures to discourage short-term foreign borrowing in order to minimize the impact, particularly on the financial system, of a possible reversal of capital flows. Wouldn't such measures be eminently prudent? Couldn't the same be said of a requirement that high levels of liquidity be maintained in the financial system of an economy that is sound but risks contagion from an unstable neighboring economy?

18. In our opinion, the appropriate criteria for admitting prudential regulations should be based on a review of the status of economic fundamentals and not on the assumed micro- or macroeconomic character of the regulations. If the fundamentals are in order, prudential regulations will in fact be preventive or prudential in nature. If, on the contrary, this is not the case and adjustments need to be made, countries must take action to correct these fundamental imbalances before resorting to regulations or restrictions which, quite probably, would be used as substitutes for the necessary adjustments, or which would have a very limited effect if markets are aware of the fundamental imbalances. Prudential regulations are complementary to, not substitutes for, the maintenance of sound fundamental balances.

19. In this new age of increasingly fluid capital markets, the role of international financial institutions is also affected. For the Fund, balance of payments crises will continue to emerge. Though such crises will probably be less frequent, they may well be more severe; thus, continually reviewing the modalities of the different available lending facilities will be an important future task of the Fund. We must also endeavor to provide the Fund with adequate resources and further facilitate drawings by member countries as the volume and scope of private capital movements increase.

20. In that connection, we welcome the agreement reached on the allocation of special drawing rights, an issue that was subject to lengthy discussions. The Fund's Executive Board has also reached a consensus, to be ratified by the Board of Governors, on the eleventh general review of quotas, requesting an overall increase of 45 percent. This consensus was not easy to attain, mainly because of the difficulties to reach an agreement on a criteria to distribute shares on a proper method for power-sharing among members. An in-depth and informed discussion on the calculation of quotas would be very desirable. In any event, we regret that, under the current review, the developing countries, which have for some time now been recording substantially higher growth rates than the other countries, stand to lose some of their relative weight. We hope that, as a result of reviewing the formulas, this situation will

be corrected in future. Meanwhile, we trust that the commitment reached to maintain the current representation will be honored.

21. Mr. Chairman, allow me to refer to my own country for a moment. The performance of the Chilean economy in recent years has meant that, in macroeconomic terms, the 1990s will undoubtedly be the best decade of the 20th century. In this decade, Chile has achieved a high and sustained economic growth rate averaging over 7 percent per year, while steadily reducing inflation gradually from almost 30 percent per annum in 1990 to an estimated 5.5 percent in 1997. The current account deficit has been maintained at perfectly sustainable levels, averaging less than 2 percent of GDP for the decade to date and peaking at just about 4 percent of GDP. At the same time, exports have continued to grow at a sustained rate that exceeds the GDP growth rate.

22. In the area of social development, in the last 10 years, the incidence of poverty has been virtually cut in half, thereby reducing the percentage of persons with incomes below the poverty line from almost 40 percent of the total population in 1987 to just over 20 percent in 1996. The results were even more favorable in the case of extreme poverty, which in 1996 was reduced to one third of the level of the mid-1980s.

23. We consider these favorable results to be the product of serious efforts reflecting the commitment by the Chilean authorities to maintain macroeconomic equilibrium and achieve sustainable performance in the medium term. This commitment is reflected not only in the policies followed by the government, but also by the central bank, whose autonomy and independence were established by law over 7 years ago.

24. The macroeconomic program for 1998 plans to maintain rapid economic growth, at a rate of 6.5-7 percent a year, and to continue to gradually reduce the inflation rate, aiming at a level close to 4.5 percent, 1 percentage point less than the target for this year. The fact that inflation targets for each of the past few years have been achieved and that the policies followed have been consistent has given credibility to the stabilization effort. Owing to careful regulation of capital flows, particularly the prevention of rapid increases in foreign borrowing, significant and sustainable advances have been made in Chile's integration into the external financial arena. As a result, the cost of foreign borrowing has significantly decreased and the composition of external financing has improved, with emphasis on foreign direct investment and long-term borrowing.

25. The success of these tasks is not only the result of the determination of the monetary and financial authorities; another key element is fiscal consolidation, which has resulted in repeated government finance surpluses, high levels of public saving, and moderate expenditure growth. This path of careful moderation must be pursued if success is to be achieved.

26. Policies to maintain macroeconomic stability will enhance the sustainability of the improvements in growth and development. This development will enable one fifth of all Chileans, who still live in conditions of poverty, to enjoy the increasingly abundant fruits of

progress. Sharing the fruits of progress is ultimately the foundation of social cohesion, institutional development, and democracy.

Thank you.