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Statement by Carlos Fernández
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On behalf of Argentina, Bolivia, Chile, Paraguay, Peru, Uruguay

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Minister of Economy and Production of Argentina
Speaking on behalf of the Southern Cone Countries of Latin America
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I. The Global Economy and Financial Markets – Outlook, Risks and Policy Responses

1. **Against the backdrop of unprecedented financial strains in mature markets, the global economy is facing its most difficult situation in years.** We have been witnessing a full-blown financial crisis, encompassing severe stress in banking, securities and foreign exchange markets all at the same time. This is indeed a period of exceptional uncertainty and profound changes in financial markets and further weakening of the global economy is expected in the coming months. Advanced countries are slowing markedly and many are close to recession while momentum in emerging economies is moderating although growth remains robust driven by domestic demand.

2. **Lenient monetary policies in advanced economies and excessive liquidity have interacted with market and regulatory weaknesses in complex ways, endangering global economic prospects.** On the one hand, credit flowed rapidly into different assets without any apparent consequence, absorbing large excess liquidity. Banks overextended their balance sheets on the back of higher asset values and lower perceived risks during booms, boosting asset values further, and fostering another round of lending and economic activity. The expansion was particularly fuelled by unbridled financial innovation and weakening lending standards. On the other hand, insufficient regulation and supervision allowed market stress and vulnerabilities to build up. Lending booms typically fed into the stock market and asset bubbles as regulatory flaws generated incentives to buy risky assets, with these bubbles now resulting in banking crises. The re-concentration of credit risk onto banks' balance sheets from off-balance sheet entities they had constructed is another distinctive characteristic of this crisis. Market self-regulation failed miserably in preventing this episode of irrational exuberance.

3. **Financial liberalization this time recycled excessive liquidity within advanced countries' own borders, affecting the sources of global growth and prompting a more severe economic downturn.** As developing countries are running current account surpluses, financial markets managed to lure investors in advanced countries to buy over-priced assets. This triggered a cycle of high indebtedness and mounting external imbalances. Global imbalances could prove to be more destabilizing now that bubble assets are bursting, as long as the U.S. deficit has financed private and public over-consumption rather than investment and it has been increasingly founded by short-term flows rather than direct investment.

4. **The bigger risk going forward is a mutually reinforcing deterioration in financial and economic conditions in industrial countries.** Financial institutions are in the midst of a

significant deleveraging process. An adverse feedback loop could accelerate the ongoing asset price deflation adjustment, making the banking system's deleveraging process, which is already underway, more difficult, and protracted. Selling assets in illiquid market conditions may induce losses that deplete capital. As weakening housing market spreads and economic slowdown are contributing to new loan deterioration, raising capital to bolster balance sheets could be more limited or expensive for both bank and other non-bank institutions. Tight credit conditions would weigh on domestic demand. Recent large financial institution failures and their sheer efforts to regain market confidence and rebuild capital buffers, despite public interventions, raise compound credit and liquidity risks. Thus, restoring normal credit conditions will take some time while involving fundamental changes in the banks' business models.

5. **Developing countries have not been at the forefront of the crisis and their growth has remained fairly robust.** Direct exposure to the U.S. subprime mortgage market has been limited. Structured credit and related derivative products are at a relatively low stage of development and prudential regulations have been instituted as a result of past financial crises. Profitable domestic activities have limited the "search for yield" elsewhere.

6. **Indeed, developing countries enter this period with a strong macroeconomic position.** Improvements in their external balances and their aggregate current account surplus have turned them into net exporters of capital to developed countries. This is a complete reversal of 20th century history, protecting our economies against external shocks. The reorientation of macroeconomic policies and greater focus on competitive exchange rates has promoted a broad-based growth, generating internal sources of financing. Thus, the slowdown in industrial countries would be partially offset by stronger domestic demand, intra-regional trade and active macroeconomic policies.

7. **Improvements in fundamentals are about stocks as much as flows**. In the first case, much higher international reserves, improvements in the structure of public balance sheets, significantly lower public debt and rollover requirements are remarkable in most developing countries. In terms of flows, high food commodity prices will presumably continue by historical standards as long as its key underlying forces will still be in place, notably increased biofuel production in advanced countries supported by subsidies, mandates and tariffs on imports, strong growth in large emerging market economies, the decline in the dollar, and increased production costs.

8. **However, developing countries cannot be immune to the global financial turmoil.** The continued deterioration of financial conditions is now testing developing countries' financial resilience. Many countries have felt the effects of the ongoing financial system stress, mainly through increased volatility or sell-off in their local equity markets, widening sovereign and corporate yield spreads and reduced international bond issuance. We are now witnessing a rapid unwinding of speculative and carry trade activities and a reversal in some capital inflows are exerting pressure on local markets. Risks are increasing for countries running high current account

deficits and pursuing a domestically driven foreign-funded boom. The key for the future is to ensure an orderly deleveraging process in mature markets.

9. **The balance of risks in many developing countries is shifting as inflation risks have begun to recede in a less benign external environment.** The past several years have proven that low real interest rates may lead to high real commodity prices. Growth in commodity index investments has indeed exploded as commodity indices provide a unique return profile being negatively correlated to equity performance. Footloose liquidity immediately began to crowd this asset class. The negative effect of interest rates on the desire to carry commodity inventories and the exhaustion of spare capacity has also led to strong increases in commodity prices. All in all, it is not a coincidence that the rush towards commodities reached a feverish pace with the onset of financial turmoil. Speculation was around the corner. The need to offset the contractionary effects of this crisis produced a new wave of excess liquidity in the global financial markets and exacerbated stress in the foreign exchange markets. The steep surge of commodity prices was unprecedented at the beginning of 2008, prompting exogenous inflationary pressures in developing countries. Both social and fiscal actions were warranted in response to rapidly rising prices, with the aim of protecting the most vulnerable sectors of the population and ensuring food security and food sovereignty. It goes without saying that the lack of liberalization for agricultural products in advanced economy markets also wrecked the agro economies of developing countries. Looking ahead, with energy and commodity prices down from their earlier all-time highs, inflation pressures should begin to recede.

10. **Internationally coherent and decisive policy measures are still urgently required to restore confidence in the global financial system**. We acknowledge the bold steps being taken by advanced countries so far. Concrete actions, however, are needed to tackle insufficient capital, falling asset valuations, and a dysfunctional funding market all at the same time. Thus, we call on developed countries to closely coordinate these efforts to prompt a return to stability in the international financial system.

11. **Stronger and fully concerted multilateral responses are needed to avoid a more severe feedback loop between the financial system and the global economy.** The crisis has long passed the stage when governments could leave the private sector to save itself. However, we now need to recognize that national economic policies cannot effectively mitigate the risks and costs of this crisis. Unparalleled public support or discretionary stimulus packages could further weaken the dollar, adding to the economic woes by aggravating instability in financial markets. A shift in indebtedness from households toward the government sector in the U.S. is not promoting the needed expansionary global rebalancing either. New liquidity injections, coupled with divergent monetary policy responses among advanced countries, may invite renewed speculation in foreign exchange markets.

12. **Thus, the world economy needs renewed multilateral policy consensuses built around coordinated policies supporting the needed financial system reforms.** A new growth impetus is necessary to offset the effects of the recovery of savings by U.S. households and bring their

debts to sustainable levels. In sustaining growth, concerted fiscal and monetary policy management must be in agreement, stimulating first demand growth in surplus countries – especially systemic economies –and allowing a gradual but coordinated adjustment of major currencies against the dollar to also stimulate exports from the deficit countries. We also need to prepare for more fundamental reforms in the creation of an officially backed multi-currency reserve system, as well as a more effective mechanism for providing liquidity, especially for developing countries. In addition, the credit crisis has revealed systemic regulatory and supervisory weaknesses. Greater public scrutiny, better prudential regulation, clearer accounting rules and transparency are warranted. This should include higher capital requirements for financial institutions and more effective surveillance of banks, intermediaries, and credit rating agencies.

13. **Forging a new political agreement toward concerted policy coordination will demand stronger leadership among systemic countries; however, proper consideration must be given to the principle of differentiated responsibilities among parties.** We need to shape multilateral solutions under a new multilateral network. A truly multilateral mechanism of surveillance and policy coordination must be instituted, broadening the participation of developing countries. In a less benign external environment, the IMF needs to revisit its excessive focus on inflationary risks and calls for more flexible exchange rates and full capital account liberalization in emerging market economies. Efforts to simply shield the credibility of existing monetary policy frameworks will only exacerbate the downside cycle, reducing the capacity of the developing world to counter-balance the envisaged slowdown in advanced countries. Special attention must be given to income distribution policies aimed at boosting consumption capacity of those low-income sectors in both developing and advanced economies to ensure sustainable growth. Without building a more inclusive globalization, the world will remain unstable. Overall, continuous growth in developing countries must be a priority.

II. The Role of the IMF – the Imperative for Change

14. **Clearer principles are still needed to help guide our thinking on the role of the Fund at this juncture.** Legitimacy is one of the principles on which we all virtually agree. At the outset, we claim that unless the Fund makes further efforts to have a legitimate basis, it will lack the authority and credibility to carry out its mission. Thus, the Fund needs to further reform its governance structure and introduce fundamental changes in its surveillance and lending functions. Stronger efforts are needed to ensure that the Fund will better serve the needs of its membership.

15. **Getting surveillance right is a priority**. Admittedly, the current macroeconomic and financial crisis is a clear reminder that the Fund is not giving the world what it needs. Surveillance failed to anticipate and provide policy recommendations to guard against the scale and ultimate impact of the crisis. There is a fundamental change in the nature of the Fund's surveillance mandate that still needs to permeate in the Institution. The IMF leverage to pressure members to adhere to "good" policies that came from its conditionality for access to IMF financing has vanished. By contrast, vulnerabilities now come from advanced countries, less compelled to

comply with its policy recommendations. Going forward, policy surveillance can only survive if its members voluntarily adhere to the mutually-developed rules and are in agreement on the smooth functioning of the global economy. We remain unconvinced that the approved triennial surveillance priorities will effectively facilitate this critical goal.

16. **Two fundamental steps must be taken to direct the Fund's surveillance in the right direction.** First, bilateral surveillance of advanced countries must be essentially strengthened and widened. The Fund should be prepared to speak loud and clear about its macroeconomic vulnerabilities and institutional weaknesses. Greater emphasis on macro-financial linkages, growing fragilities, cross-country and regional spill-over effects is needed. Likewise, the Fund's vulnerability exercises must be extended to advanced countries. Second, an early warning system aimed at preventing the recurrence of periodic financial crises must be introduced as a global public good. Targeted at medium-term risks, its main building blocks must soon be instituted by developing a set of tools for global appraisal focused on systemically important countries. Its overarching objective must be to provide clear, advanced warning of risks in the global economy. Work in this area must be fundamentally expedited.

17. **In addition, the Fund must decidedly initiate a new multilateral consultation process, including key players from the developing world**. The Fund's role as a credible mediator is key to this end. Existing arrangements seem to be unsuitable to achieve the necessary course of action. The response to these crises will have to be larger and global. Divergent views still persist among systemic countries but uncoordinated policy responses will not suffice in ensuring an orderly unwinding of global imbalances. The Fund's hesitant call restating the validity of the multilateral consultation process with flexible implementation is discouraging. Fully concerted multilateral responses need to be built around coordinated fiscal and monetary policies, supporting financial system reforms.

18. **Equally important, the rationale of Fund lending must be broadened toward a multilateral insurance scheme where members receive liquidity assistance contingent to shocks.** The sharp decline in demand for Fund lending proves that its financial assistance fails to provide the services members seek, as it continues to send immediate negative signals, comes with too many conditionalities and little financing relative to actual balance of payment problems. Overall, the Fund's lending facilities are indeed outdated and complex. Radical and innovative approaches deserve consideration. We fully endorse the Managing Director's view that the Fund needs to develop a new lending function founded on novel principles in order to secure global economic stability and growth.

19. **The goal should be to establish an integrated and consistent lending framework that meets members' needs and sets appropriate incentives**. In considering potential new facilities, two basic principles must be agreed upon. First, a lending facility must give confidence to members that resources will be temporarily available to them under adequate conditions. Second, it must meet members' needs and demands to cope with shocks, risks, and vulnerabilities. In short, new facilities must be demand-driven and solution-oriented. Unless we truly honor these

basic premises, the vast majority of the membership will continue to fail to perceive the "advantages" of a broad multilateral pooling.

20. **The challenge is tailoring lending instruments that provide relevant support to all members in a world where financial globalization and large scale capital movements are certainly blurring the distinction between endogenous and exogenous shocks.** This implies going beyond streamlining conditionality and revisiting whether a balance of payments needs, as presently defined, should remain the organizing principle for Fund lending. Under a new framework, we are open to discussing new signaling, crisis prevention, and short-term liquidity instruments. Indeed, the introduction of a liquidity facility is long overdue. Proposals that simply provide access to only prequalified countries that meet a raised qualifying bar will only be a cosmetic reform. We advocate a true insurance-like facility with wide coverage, setting different but confidential charges according to objective criteria. The crucially important features should be a fairly reliable, automatic and front-loaded access. A sudden change in market sentiment or self-fulfilling runs could trigger this facility for solvent but illiquid countries. We call on the IMF to expedite its work and put forward a concrete proposal on a liquidity instrument well before the 2009 Spring Meetings.

21. **We also reiterate our call for a comprehensive review of access limits and financing terms for using Fund resources.** We claim that if new quotas are not concomitant with members' potential need to borrow, then normal access should be brought to levels that are consistent with members' true need for Fund resources.

22. **Finally, we claim that the voice and representation of developing countries must be expanded beyond the modest steps taken in the recently approved quota increase.** A voting power still heavily skewed toward industrial countries, a constituency system that shelters the over-representation of advanced countries and the role of ad hoc intergovernmental fora as a focal point of countries' engagement in the multilateral system de-legitimizes this Institution. It is regrettable that the issue of voice and representation in the Fund was not amply addressed and that future realignments will be pursued only every five years, despite the increasing weight and responsibilities of developing countries in the world economy. We support further quota reforms and call on the IMF to promptly complete the necessary technical work to address major distortions in the measures of openness and variability in the quota formula that are in detriment of most developing countries.

23. **Concerns about legitimacy go beyond quota issues.** First, the size and composition of the Executive Board has received insufficient attention. The over-representation of advanced countries at the Board impedes a stronger and more effective voice for developing countries. Second, we claim that expanding the use of double majority voting in the Fund could be a powerful tool to balance the current competing demands of representation. The system could help strengthen the weakening consensus tradition in the Fund, providing a greater sense of ownership if properly implemented. Likewise, consideration must be given to reform the selection process of the Managing Director and his role as both chief operating officer as well as chairman of the

Executive Board. We reiterate the need to include these issues in the Fund's work program. Equally important for the legitimacy of the Fund is to put its finance on a sound footing as soon as possible, advancing the needed budget reforms.

III. Outlook for Countries in Our Constituency

24. **Argentina enters this period of financial turbulence with a strong macroeconomic position, accumulated over six years of sustained and inclusive growth, solid productivity gains and robust financial buffers.** GDP has expanded at an average annual rate of 8.8 percent since 2003 and current GDP per capita exceeds the previous peak in mid-1998 by 16.6 percent; investment has risen by an average 25.4 percent a year since 2003, accounting for record levels of GDP (23.4 percent); national public accounts continue to record an annual primary surplus of 3.3 percent of GDP for the last six years in contrast with an average -0.25 percent deficit between 1993-2001; trade balance sustains an average current account surplus of 3.3 percent of GDP; international reserves have increased by 33 billion dollars since 2003; the unemployment rate is now hovering around 7.7 percent after having reached 23.3 percent six years ago, while poverty levels and extreme poverty have been drastically reduced; national public debt fell from 166 percent of GDP in 2002 to 48.7 percent at the end of second quarter of 2008; and public investment has tripled from 0.45 percent of GDP in 2003 to 2.16 percent in 2007.

25. **Our economy is well-built to cope with a less benign external environment**. Our remarkable performance is the result of the macroeconomic policy framework instituted since 2003, which combines the maintenance of a competitive exchange rate with balance of payments and fiscal surpluses. This favors production, employment, and investment in both tradable and non-tradable sectors, promotes job creation, and establishes the proper conditions to generate public and private saving rates consistent with the pace of expansion. Indeed, unlike the past decade, in which expansion was entirely dependent on increasing flows of external financing, the current macroeconomic framework generates its own internal sources of financing. This protects the economy from a repeat of past boom-bust patterns and lays the foundations for a process of sustainable growth based on a continuing accumulation of capital. In fact, one of the most important features of today's strong macroeconomic performance relates to the macroeconomic financing of investment. Domestic saving (equivalent on average to 23.4 percent of GDP from 2003-2007) now exceeds capital investment (equivalent on average to 20.7 percent of GDP), producing a positive balance of almost three percentage points. Thus, the economic growth process now under way is generating a volume of savings sufficient not only to finance capital formation but also to reduce the economy's level of foreign borrowing for both the private and public sectors.

26. **Argentina is expected to record another year of vigorous growth in 2008 (around 7 percent).** Economic growth has been led by domestic absorption, especially investment spending, which consistently outpaced GDP growth from 2003-2007. Currently, gross domestic fixed investment (GDFI) stands 43.5 percent above the previous maximum. There is also a fundamental change in its composition, as long as there is a strong year-to-year growth in expenditure on

durable production goods which will bring about a significant improvement in investment quality. Capital goods are the fastest-growing component of imports and have been rising at more than 35 percent a year.

27. **Twin surpluses remain at high levels**. On the one hand, the trade surplus will be more than US$12 billion in 2008. We observe not only a sustained growth in export volumes of industrial manufactures (87.8 percent from 2003- Q2 2008) but also a process of diversification with a greater number of destinations, reducing the risk of slower trade growth going forward. Thus, the current account balance in 2008 should achieve its seventh consecutive year of positive results (US$6.6 billion; 2.1 percent of the GDP). On the other hand, the fiscal surplus remains robust and we expect to accomplish by the end of this year a primary surplus of at least 3.15 percent of GDP (as established in 2008 National Budget) and an overall surplus of around 1.0 of GDP. In the first eight months, total revenues grew at a faster rate than expenditures. The primary fiscal national balance recorded an accumulated surplus of $28.0 billion, posting an increase of 43 percent compared to last year. Part of the excess in revenues has been channeled to target social expenditures and public investment.

28. **Argentina has weathered the international storm fairly well through timely and targeted policy actions.** Two external shocks have been effectively confronted. First, in response to high international food commodity prices, the government has intervened in a responsible manner through active income policies aimed at protecting the welfare of the population with due attention to the most vulnerable sectors. Changes in export duties have been an indissoluble part of this strategy, aimed at uncoupling domestic prices and ensuring food sovereignty. The purpose has been to ensure an equitable distribution of benefits through sound public intervention. Second, in a volatile international financial environment, the Central Bank acted promptly through a well-targeted risk-management approach rooted on (1) a robust monetary policy that ensures the balance between supply and demand in the monetary market (2) a counter-cyclical scheme of liquidity accumulation together with a well-regulated financial system to mitigate vulnerabilities; and (3) a managed floating exchange rate regime. Indeed, maintenance of an appropriate level of liquidity, stabilization of the foreign exchange market, and introduction of regulatory changes have been essential to secure this goal. Today, Argentina’s banking system is healthy and well capitalized. Our monetary and financial system no longer creates nor spreads crises as in the past. On the contrary, it is a constraining factor in the face of unfavorable situations, providing financial stability and effective protection for the economy.

29. **Going forward, continued robust and inclusive growth is the government’s first priority.** Sustaining a competitive exchange rate and twin surpluses is a prerequisite. Cementing a sustainable growth process will require a high level of investment as in recent years and continual increases in productivity through technological advances that increase the economy's competitiveness. Many actions have already been taken in this direction. Among them, the zero-tariff policy for capital goods which has been successful; the Law on Investment Promotion and targeted tax incentives which will allow this dynamic investment performance to continue; the funding allocated to small and medium-sized enterprises (SMEs) has resulted in very low interest

rates; the government has deployed coordinated policy actions for training workers to ensure social mobility and lower unemployment; integration agreements have been negotiated to strengthen the balance between development of the domestic market and exports; and a highly coordinated program to promote investment is being pursued by the Ministry of Foreign Affairs with the support of the Investment Agency. These actions have already set a "virtuous change" in motion, aimed at increasing the levels of quality, innovation, added value and productivity of our production.

30. **Rebuilding and strengthening the social fabric reigns on the government agenda.** Income redistribution will remain a primary concern, as demonstrated by the decisions taken with respect to the Adjustable Minimum Living Wage and social insurance policy for retirees. The adjustable pension bill approved by the Congress will enhance our efforts to improve the welfare of our senior citizens. The 2009 National Budget is a clear sign that the government is fully committed to strengthening public infrastructure and social programs to sustain an inclusive growth process without impairing fiscal balance.

31. **Ensuring ample financing is one of our first strategies to further increase aggregate supply and fortify the success of the development process.** In the last four years, government savings have been used to reduce public debt and to increase public investment. The recent decision to regularize our debt with the Paris Club group of creditor nations is a renewed and clear sign of the strength of our economic model. The government is also considering proposals to pay back the foreign debt of those bondholders that did not participate in the 2005 restructuring. Likewise, the authorities are well placed to tackle the refinancing of guaranteed loans negotiated in 2001, substantially reducing financing needs in the future. These paramount actions will bring new investment and new credit lines to our country.

32. **Bolivia**'s main economic indicators show improvement. The real GDP growth for 2008 (5.9 percent) will be much higher than in 2007, despite severe climate conditions seen in February and March of this year. Higher growth comes as a result of strong commodity export growth, combined with increases in private consumption and fixed investment. Fixed investment growth will accelerate further in 2008, as well as sustained investments in infrastructure. Additional investments in oil and gas are also expected following conversations with private oil companies.

33. The balance of payments and international reserves have continued to evolve positively. The current account surplus has widened and there has been a recovery in foreign direct investment. Fiscal data for 2008 show that the non-financial public-sector accounts will reach a higher surplus (2.2 percent) owing to stronger revenue coming from higher import tax and modifications in taxes on the mining sector. Domestic prices, although higher in 2008 than 2007 (11.7 percent), are showing a slower pace since July and are expected to remain the same in the remainder of the year. Supply shocks are probably the main inflation drivers due to the floods and droughts caused by "El Nino", which particularly affected agriculture and, consequently, strong pressures on food prices emerged. Increasing international food prices also affected domestic inflation in this conjuncture. The surge in expectations played a major role in Bolivia's current

inflation rate and is a very sensitive issue given that Bolivia experienced hyperinflation in 1985. Expansion of the country's international reserve holdings, along with greater public investment, higher employment and increased remittances, boosted domestic demand. However, the upturn in inflation, which will probably be slightly higher by the end of year, does not threaten to derail the current economic expansion.

34. The Central Bank has sought to combat inflation by absorbing excess domestic liquidity arising from strong foreign exchange inflows through open-market operations and domestic currency appreciation. At the same time, it contained increases in commercial lending rates as banking credit to the private sector is slowly picking up.

35. Progress in reducing poverty has accelerated but much remains to be done. In this regard, revenue distribution is an issue of concern. Indeed, much of the economic growth has been in the hydrocarbons sector, which accounts only for about 2 percent of employment. In order for this increased revenue to have more of an impact on poverty, the government would have to use this revenue. As the increase in the fiscal surplus indicates, most of it has not been spent. One reason is that the federal government does not control a good part of these revenues, which under current law, belong to departmental and municipal authorities. The Bolivian economy has shown considerable progress on most indicators over the past two years. The government has introduced a number of initiatives to address the needs of the poor, but other structural changes (including land reform), faster growth, the reduction of regional disparities, and an accelerated diversification of the economy away from hydrocarbons and minerals are the medium-to-long-term development challenges facing the economy.

36. The economic deceleration in the U.S., which is stronger than previously anticipated, will have a small negative impact on Bolivia’s export performance. However, this will be partly offset by firm growth in Bolivia’s other trading partners, especially Brazil and some Asian countries.

37. In **Chile**, output grew 4.3 percent in the first half of 2008, below potential output. This result reflects the still favorable external environment, a more expansionary fiscal policy, an overall supportive monetary policy, and a less dynamic performance of the natural resource sectors. Growth was broadly based, with the communications, construction, and retail sectors exhibiting high growth, in contrast with the contraction of the electric, gas, and water sectors, given the lesser availability of hydrological resources, coupled with ongoing restrictions in the imports of natural gas and higher prices of oil. This last issue impacted industrial activity directly. Domestic demand grew 11 percent mostly due to a substantial dynamism of investment relative to previous years, as evidenced by the higher investment in machinery and equipment and construction. Consumption has exhibited a deceleration relative to the dynamic growth of recent years.

38. Going forward, output growth is expected to be between 4½ and 5 percent for 2008 and between 3½ and 4½ percent in 2009, with the balance of risks tilted to the downside. The latter is due to a less favorable external environment stemming from the slowdown in the world economy,

further complications from the ongoing financial crisis and the uncertainties associated with it, a slower domestic demand due to a less dynamic consumption in a context of lower real income, less favorable credit conditions, and potentially weaker conditions in labor markets. The main downside risks are related to how the credit crisis in financial markets would impact emerging economies, which include the possibility of a recession in the U.S., the persistence of the uncertainties in commodity prices, particularly oil, the possibility of a large correction in the price of copper, and less favorable global financial conditions overall. Prospects for output growth reveal that the downside risks have increased, although it is too soon to evaluate precisely if, and to what extent, global conditions might help in the disinflation process.

39. In the first half of 2008, annual CPI inflation continued to rise, reaching 9.5 percent in June. Such increase in inflation, which started in the second half of 2007, resulted from exogenous supply shocks, including a jump in global food prices and drought conditions affecting the prices of domestic food items, both of which have proved to be deeper and more persistent than initially anticipated, as well as increases in energy costs and disruptions in energy supply. Given these developments, inflation has propagated beyond what was initially envisaged, and core inflation measures and other inflation trend indicators have also remained above the 3 percent target level. However, the growth rate of wages has remained in line with inflation. Even though short-term inflation expectations have increased, medium- and long-term inflation expectations have remained anchored; this is coherent with the ongoing transitory increase in inflation.

40. CPI inflation is expected to remain above the upper limit of the target range during 2008 and most of 2009, because of still high oil prices and lagged adjustment in electric tariffs, since some indexed prices will have significant upward adjustments. However, the fiscal measures taken to reduce the impact of high oil prices on the domestic gasoline prices should mitigate the risk of excessive propagation of supply shocks to underlying price pressures. CPI inflation is now expected to gradually move down toward the target range by the end of 2009, converging to 3 percent in 2010. In line with these developments, and in order to ensure inflation convergence to 3 percent in the policy horizon, the Central Bank has raised the monetary policy interest rate by 325 basis points since mid-2007, bringing it to 8.25 percent in September. Further increases in the monetary policy rate might be needed to ensure the convergence of inflation to the target and the pace of such tightening will depend on incoming information and its implications for the inflation forecast.

41. In the implementation of the structural budget rule and due to continuing high copper prices, in the first half of 2008 the Chilean central government posted an overall surplus of 4.0 percent of GDP, with a real decrease of 3.4 percent in revenues, while public expenditure grew 10.5 percent in real terms in the same period. For 2008, the fiscal surplus is expected to reach 6.9 percent of GDP. In order to manage windfall revenues prudently and in consistence with the Fiscal Responsibility Law, the Chilean government has continued saving the surpluses into the Economic and Social Stabilization Fund, which as of June 2008 accumulated US$18.8 billion. Surpluses have also been saved into the Pension Reserve Fund, now totaling US$2.4 billion. At the same time, the Fiscal Responsibility Law allows the government to use up to 0.5 percent of

GDP of its surplus to recapitalize the Central Bank. The government announced that it will make use of this faculty this year. The 2009 budget was recently submitted to Congress, which provides for public expenditure growth of 5.7 percent in real terms, a slower pace relative to recent years that helps to contain demand pressures in the context of the current inflationary shock. However, the 2009 budget effectively increases social spending in health, education, innovation and social housing, and also incorporates a strong focus on the execution and quality of public expenditure. In the 2009 budget, an expected effective surplus of 3.7 percent of GDP for 2009 is considered.

42. In light of the increases in oil prices in international markets in 2008, the government has taken measures to alleviate its impact on inflation and the overall level of economic activity. Thus, in January 2008 the government submitted a bill to Congress destined to provide an additional injection of US$200 million to the Fuel Prices Stabilization Fund (FPSF), and in June an additional US$1 billion was injected into the FPSF. In March 2008, the government sent another bill to Congress to reduce the excise tax on gasoline by 25 percent for the next 2 years, until March 2010. In September 2008, an additional 22 percent temporary reduction in the excise tax on gasoline was approved by Congress. These measures should also help to facilitate the convergence of inflation to its target.

43. Moving to structural reforms, the government has continued working on initiatives aimed to boost competitiveness and investment, facilitating entrepreneurship, globalizing the domestic financial markets, further enhancing trade integration, improving government effectiveness, fostering innovation and human capital, and addressing the country's expanding energy needs. During the annual address to Congress on May 21, President Bachelet announced the establishment of a US$6 billion Fund – the Bicentennial Fund –. This fund will secure a permanent income flow from the investment returns in order to fund the provision of scholarships to study abroad for a total of 30,000 students of professional and technical careers over a 10-year period. This initiative constitutes a major investment in the improvement in human capital of the Chilean labor force with the purpose of significantly improving its productivity over the medium term. In August, the government announced a new reform agenda for the capital markets (Capital Markets III – MKIII). The reform agenda aims to improve the overall competitiveness of the Chilean financial system; to make Chile a financial services exporting country; and to promote market access for SMEs by improving the channels and financial instruments through which they can access capital markets. The agenda promotes foreign investor participation in domestic markets, the use of the CLP as a fully internationally traded currency, and increases the depth and liquidity of domestic financial markets by improving information and increasing the supply of securities available. To address the country's increasing energy needs responsibly with the environment, in September, the government announced the creation of a new fund called the New Energy Fund with US$400 million available for the development of small-scale hydroelectric plants and the development of renewable energy from solar, geothermal, biomass, and other renewable sources.

44. Last year, **Paraguay's** GDP growth was 6.8 percent, well above the average of the past 25 years, only comparable to the economy expansion of the seventies, when the Itaipú hydroelectric

dam was built. The expansion and high yield of commodities products was the engine of this strong outcome, benefited by high international prices and benign weather. The fiscal sector has been disciplined, a constant behavior that came into effect five years ago after the signing of the Stand-By Arrangement with the IMF. The central government accounts registered a surplus in 2007 – for the fourth consecutive year – equivalent to 0.5 percent of GDP. The external account continued to reveal positive outcomes, reflected by a current account surplus of 1 percent of GDP in 2007. This result has contributed to a large accumulation of international reserves, which cushioned the fast trend of the *guaraní* appreciation.

45. The new government is committed to continuing to implement sound fiscal and monetary policies to consolidate macroeconomic stability and to continue the needed structural reforms to improve the business climate, attain a high level of investments and sustained growth, with the ultimate goal to reduce poverty and inequalities. The positive trend continues this year, demonstrated by the 7.6 percent annualized GDP growth at the end of the first semester. An encouraging development is that the increase in demand is fueled by external demand rather than domestic factors, which implies a genuine and sustainable growth. Moreover, after a year of contraction, meat exports are expected to have a significant boost in 2008, thanks to the opening of the European markets for this commodity.

46. The adoption of counter-cyclical fiscal measures has prevented an overheating of the economy in the presence of high growth rates. However, the repercussions of high international food prices were felt in the domestic market, intensifying inflationary pressures and deteriorating expectations. In this scenario, the inflation rate began to rise until the second quarter of 2008, when it peaked at 13.4 percent. Since then, inflation has receded thanks to the tightening of monetary policy and the stabilization of international commodities prices. At end-September 2008, annualized inflation dropped to 9.1 percent and is expected to close at around 8 percent by the end of the year.

47. Looking forward, despite a challenging economic environment in 2008 and 2009, the Paraguayan outlook remains positive. The large size of its international reserves has reduced the country’s vulnerability to external shocks, which is an anchor to support counter-cyclical policies in a period of strong currency demand and dollar appreciation. In addition, the current strong macroeconomic framework and the sound and stable financial system will help banks and other financial institutions to weather the present global financial turmoil.

48. The **Peruvian** Economy continues to perform well, supported by sound macroeconomic policies, despite the international financial turmoil and the rise in fuel and food prices. Peru grew 8.9 percent in 2007 and the authorities foresee a solid 9 percent for 2008. Growth is expected to slow down in 2009 to 7 percent, consistent with the potential GDP growth. Peru’s strong external position, healthy public finances and diminishing debt burden provide adequate buffers against the current international financial turmoil. The government is committed to the economic program under the precautionary Stand-By Arrangement approved in January 2007, which aims at securing the macroeconomic gains achieved so far, implementing an effective poverty alleviation strategy,

moving ahead with growth enhancing reforms, and diminishing financial vulnerabilities. To protect the Peruvian economy against international developments, reduce inflationary pressures, and signal a strong commitment to fight inflation, the authorities have reacted strongly both on the monetary and fiscal side. The public-debt-to-GDP ratio has continued its declining path to 23.3 percent of GDP, one of the lowest in the region. The authorities have accelerated the structural reform agenda, e.g., a framework law was passed to improve the allocation of risks between private and public sectors in Public-Private Partnerships (PPPs), among other important measures. Furthermore, in line with the obligations under the Free Trade Agreement with the U.S., the government launched a number of decrees to improve competitiveness, including the reform of ports, improvements in markets oversees, and particularly the reform of the labor market reducing the labor cost for small enterprises in an effort to formalize this sector, among others.

49. In recent months, the authorities have faced significant inflationary pressures originated in soaring international fuel and food prices and weather-related shocks that affected Peru during the first quarter of the year. The annual inflation rate rose to approximately 6 ¼ percent in August. Consistent with its commitment to price stability, the authorities have rapidly responded to curtail second-round inflationary effects. The Central Bank (BCRP) has adopted an anti-inflationary stance, raising the reference rate by 200 points since 2007, to 6.5 percent, and increasing the reserve requirements. Furthermore, the fiscal authorities have raised their operational fiscal target by 0.7 percent of GDP to a surplus of 2.7 percent of GDP for 2008. Non-food prices have only risen by about 2.6 percent during the same period. The authorities expect inflation to gradually return to the target range of 1-3 percent by early 2010. Nevertheless, Peruvian inflation continues to be among the lowest in the region. In this context, interventions in the foreign exchange market have been oriented to smoothing volatility, without committing to any specific exchange rate, and to building reserves. As of August 2008, international reserves were more than 3 times the short-term debt. Finally, in recognition of strong growth, fiscal discipline, and a declining debt burden, Peru has been granted investment grade by two major credit rating agencies in 2008.

50. **Uruguay** continues to exhibit an impressive economic performance, with another year of outstanding growth which is projected to be about 9.5 percent this year. It is worth recalling that just a few years ago low growth rates were rightly underlined as one of the most significant vulnerabilities shown by the country. Nonetheless, sound macroeconomic policies and structural reforms, aimed at establishing better institutions and incentives, allowed Uruguay to take full advantage of the external environment. Thus, Uruguay has attracted a substantial amount of direct investment, which is key to attain high and sound economic growth, leaving behind the country's vulnerability currently on its way to be transformed into strength. This performance is fully compatible and synergetic with the government's objectives and achievements of reducing vulnerabilities. Of course, no country is immune to the current global financial turmoil, but the authorities firmly believe that the country's efforts and progress made during recent years have allowed Uruguay to be well prepared to face the international crisis and its effects. Among others, the overall fiscal balance is reaching the equilibrium; international reserves are around the level considered as optimal for the country; the debt-to-GDP ratio has continued to decrease; the financial needs have already been met for the next two years; there are continued and solid steps

towards de-dollarization; and the financial system is critically sounder. Although much remains to be done, poverty is significantly decreasing as result of an important reduction of unemployment rates – currently somewhat above 7 percent, being at the lowest level in more than a decade –, better quality of employment, a sound wage recovery, and social plans aimed at mitigating poverty conditions among the most vulnerable sectors of the population. The above-referred is fully coherent with the authorities' objectives of promoting stability in a broad sense, which includes economic, financial and social stability. As in many countries, inflation has been pressured by food and oil price increases. However, the authorities' monetary and fiscal policies, as well as other measures implemented with regard to further opening the economy and promoting sound incentives to increase current and future production, have allowed Uruguay to keep inflation under control (meanwhile, inflationary expectations for the next two years are about the upper limit but within the authorities' target range). Nonetheless, the authorities remain vigilant to deepen measures, if necessary. With satisfaction for the progress achieved so far, the Uruguayan authorities have stressed that these steps should just be seen as the first of further efforts and reforms towards a higher and sustainable economic and social development.