

## Carlos Massad: New economy, old cycle?

Remarks by Mr Carlos Massad, Governor of the Central Bank of Chile, in a panel discussion organised by the Bank for International Settlements, Basel, Switzerland, 10 June 2001.

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### 1. Introduction

The new economy involves changes: faster and cheaper communications, higher labor productivity, savings in the supply chain in the business to business sector, and improvements in inventory control. It also involves growing integration of world markets. As a counterpart, we are experiencing increased volatility in stock prices and terms of trade. Krugman has gone even further, to assert that "growing integration does predispose the world economy to more crisis"<sup>1</sup>. What are the consequences of these changes on emerging market economies? Furthermore, we Central Bankers have faced many changes, and must be prepared for changes, whatever their source. How should these economies respond to those changes? These are critical issues today for almost every emerging economy.

### 2. Any impact on the real economy?

Globalization of international financial markets over the last decade, a by-product of cheaper and faster communications, has led to an increase in asset return correlation around the world. Swings in the Dow Jones, NASDAQ and in fixed rate instruments lead to adjustments in portfolio decisions the world over that have implications for the real economy. The higher the correlation of returns, the lower, on this ground, the incentive for short-term capital movements.

However other, well-known transmission channels from portfolio adjustments to the real economy are wealth effects on consumption and Tobin's q on investment.

Evidence in industrial countries suggests that the semielasticity of consumption to a permanent increase in stock prices is of the order to 0.04 after two years<sup>2</sup>. In emerging economies, where only a limited number of households own stocks in asset markets, the effect of changes in stock prices on consumption is substantially lower than in the developed world. In addition, as asset prices become more volatile it becomes more difficult to differentiate between permanent and transitory components.

There is another channel through which the new economy may affect real activity levels, and that is *productivity*<sup>3</sup>. Several academic studies have examined the factors behind the spur in U.S. productivity during the last decade, assigning particular attention to the new economy and the effects of the computer revolution. This issue is still under debate<sup>4</sup>.

The fact is that the internet revolution has increased the speed of information transmission, making information cheaper and more widely available. This acceleration is quickly changing the business environment, leading to significant savings in the business-to-business supply chain. One of the implications of this increase in the availability of information is a great improvement in inventory management. The optimal level of inventories is becoming smaller, so that the real economy reacts faster to demand and/or supply shocks, reducing both the length and the width of the cycle. And shorter cycles make for a more effective monetary policy.

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<sup>1</sup> Krugman, P. "Crisis: the price of globalization?" Paper presented at Jackson Hole, Wyoming, 2000.

<sup>2</sup> *World Economic Outlook*, May 2001, Chapter III: "Three Current Policy Issues: Impact of the Global Technology Correction on the Real Economy", page. 57-66.

<sup>3</sup> Brookings Institution (2001): "The Economic Payoff from the Internet". [www.brook.edu/es/research/areas/it/ipi-bisummary.htm](http://www.brook.edu/es/research/areas/it/ipi-bisummary.htm). Blinder, Alan (2000): "The Internet and the New Economy", *Brookings Institution Policy Brief* N°60, June. Altig D. y Peter Rupert (1999): "Growth and the Internet: Surfing to Prosperity?", *Federal Reserve Bank of Cleveland Economic Commentary*, September.

<sup>4</sup> For instance, Robert Gordon (Does the "New Economy" Measure Up to the Great Inventions of the Past? *Journal of Economic Perspectives*, Fall 2000) mentioned "the new economy has meant little to the 88 percent of the economy outside of durable manufacturing; in part of the economy, trend growth in multifactor productivity has actually decelerated, despite a massive investment boom in computers and related equipment". Page 72.

Optimal inventory management in an increasingly open international economy will not only imply shorter, but also, most probably, more synchronic cycles. A by-product of this development is an expansion of the geographical limits of optimum currency areas à la Mundell.

### **3. Terms of trade shocks and emerging economies**

The synchronization of the cycle increases volatility in commodity markets, an important source of international transmission of the cycle to a good number of emerging economies. The synchronization and shortening of cycles will probably also increase the volatility of international interest rates. Economies with liquidity constraints and limited access to international financial markets will suffer the most. The policy prescription here is to strengthen fundamentals and open and deepen the integration of both product and capital markets with the rest of the world.

The effect of synchronization and shortening of the cycle on international interest rates will probably also be an increase in the volatility of those rates. Coverage against interest rate volatility is an additional argument in favor of integrating the emerging country economies with that of the world.

### **4. Monetary policy**

Another by-product of the new information technology is the blurring of the traditional definitions of money. It is now clearly possible for the non-banking private sector to create money substitutes on demand. This development will tend to render inefficient the regulation of limited definitions of money as a tool to influence economic activity and prices. If this is so, interest rates will reign unchallenged as a monetary policy tool, while inflation targeting will be in the forefront as a nominal anchor for the economy. By the way, under these conditions it will become extremely difficult to differentiate between financial and non-financial firms.

Until a greater synchronization of the cycle becomes evident, the need for an independent monetary policy will necessarily lead to floating exchange rates. As the cycle, or perhaps I should say if the cycle, becomes synchronized all over the world, the need for independent monetary policies may fade away. Gradually, the number of currencies in the world will decrease through time. This is not economic fiction: a tendency in this direction is already present among smaller countries in Latin America with large trade and investment relationships with the United States.

However, a world tendency to a significant decrease in the number of currencies is probably a very long run one, where Keynes' dictum on the long run comes to mind. In any case, I am convinced that, as Rogoff argues in a recent paper<sup>5</sup>, it may not be desirable to pursue currency consolidation all the way.

Meanwhile, in the short and medium run, the increase in productivity provides more room for monetary policy to maneuver. Productivity growth alleviates inflationary pressures providing more room for monetary policy to exert its short run influence on the real economy.

### **5. Flexibility**

The key word for an emerging economy in a changing world is flexibility: in exchange rates and interest rates, to accommodate shocks without concentrating their effects in one particular market; in factor markets, both labor and capital, to minimize the cost of transition from one state of the economy to another.

The task before us, in an emerging economy like Chile, is to increase flexibility in all markets. We have been working on that in recent years following a careful, gradual approach, to make sure that we put in place the necessary prerequisites to introduce additional flexibility with minimum costs. An example of this approach is the way in which we moved first from limited exchange rate flexibility to a wider band and then to a full, clean float, at a time of our own choosing, September 1999. This was done only after the Central Bank had put in place hedging instruments in the market, had stimulated banks to do likewise, and had established currency mismatch regulations in the financial sector. Also incentives were provided to the financial sector to take into consideration currency mismatches of their client when evaluating their risks. The Central Bank has not intervened at all in the forex market since

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<sup>5</sup> Rogoff, K "On Why not a global currency", paper presented to the American Economic Association, January 5, 2001.

floating, and interest rate policy has not been based on an exchange rate target consideration but rather on the achievement of the inflation target. The volatility of the peso-dollar exchange rate increased after floating, but it is the second most stable among floaters, after Canada<sup>6</sup>.

A clean float, once settled, makes removing exchange restrictions easier and less risky, and the remaining restrictions in Chile were eliminated last April.

We are convinced that flexibility is the key policy approach to face a rapidly changing world. However, flexibility can be made fully operational only on the basis of strong fundamentals. In fact, exchange rate flexibility implies taxing the capacity of the financial system to adapt, as well as that of private enterprise to adjust. Moving towards exchange rate flexibility implies a structural change, as the costs of exchange rate risk coverage fall upon the private sector, rather than the Central Bank or the government. To be successful, a change of this magnitude requires strong fundamentals.

The role of fiscal policy must be emphasized in this context. Predictability of public sector reactions to shocks is a must for the appropriate functioning of all markets. Chile has recently moved to a fiscal policy guided by rules. The budget is planned in such a way that, under conditions of a long-term rate of growth of the economy and long-term prices for copper, a surplus of 1% of GDP is achieved. The level of expenditures is maintained through the cycle while government reserve moves with it, generating larger surpluses during booms and smaller surpluses, or deficits, in a slowdown.

Today, Chilean macroeconomic policy is defined by a monetary policy based on inflation targeting, the free float of the Chilean peso and a fiscal policy guided by rules. We expect that this policy set-up, together with well-established strong institutions in all areas will help us ride the waves of a rapidly changing world. A particularity of the Chilean macroeconomic policy is the fact that the Central Bank uses a real interest rate as its policy instrument, but this is a subject that require more time for discussion than is available today.

Pending tasks: further flexibility in factor markets and further integration with the world economy.

My conclusion: the new economy will eventually bring with it a new cycle, more synchronic all over the world. Preparations for such an environment include additional flexibility in all markets.

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<sup>6</sup> Implied Currency Volatilities. Source: *Bloomberg, JPMorgan*.

Mexican Peso/US\$	10.6
Chilean Peso/US\$	9.0
Canada/US\$	5.6
Real/US\$	9.2
Yen/US\$	9.7
US\$/Euro	11.2