

## **José De Gregorio: Adjustment in the global economy**

Keynote address by Mr José De Gregorio, Governor of the Central Bank of Chile, at the 2011 Institute of International Finance (IIF) Latin American Economic Forum, Calgary, 27 March 2011.

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Thank you very much for the invitation to speak at this 2011 IIF Latin American Economic Forum. The last few years have been the most challenging for economic policy around the world in many decades. From an unprecedented inflationary shock in 2007–08, the global economy went through a financial crisis and a recession in 2008–09, of a scale not seen since the Great Depression. Now, we are experiencing a process of recovery with strong inflationary pressures and tensions in the world economy as a result of asymmetries in this process. The purpose of my talk today will be the global adjustment, how it has been proceeding and what the current challenges for policymaking are, with special focus on the asymmetries and their implications for economic policy.

### **The uneven recovery**

The world economy is growing unevenly and subject to many tensions. Most advanced economies are recovering from the crisis, but they still have high rates of unemployment and excess capacity, and this is expected to last for some time. Although there are signs of improvements in the recovery, many economies are still in a weak financial position, and domestic demand is expected to grow at low rates for some time. After years of financial excesses, households in many countries, particularly in the U.S., have accumulated excessive debt.

Many advanced economies also have weak fiscal positions, due to fiscal expansions implemented to contain the recession, measures to support the banking sector, or simply the fiscal profligacy that took place prior to the crisis. In particular, the level of government debt in some European countries will require a significant and protracted fiscal consolidation to avoid insolvency. Therefore, the deleveraging process of households and governments implies that domestic demand is unlikely to be an engine of growth. As a consequence of this scenario, the inflationary pressures will be relatively contained. The rise in commodity prices is having effects on headline inflation, but the propagation to other prices will be limited because of a negative output gap. This is in sharp contrast with the situation in emerging market economies (EMEs). Accordingly, monetary policy in advanced economies will remain expansionary, and despite some tightening in the near future, they will still have lower interest rates than those in EMEs, and which will be well below what used to be considered a neutral stance.

In contrast, EMEs have been growing strongly, and after suffering moderately from the global crisis, many have already reached levels of full capacity, and some of them may even be overheating (Figure 1). At a global level, the buoyancy of EMEs has resulted in higher commodity prices, which coupled with some specific factors, such as weather problems impacting agricultural production and tensions in the Middle East and North Africa, have pushed food prices to record highs and oil prices to very high levels as well. This price shock, coupled with strong domestic activity, results in inflationary pressures that must be contained with tighter monetary policy. Contrary to the situation in advanced economies, international price (supply) shocks find fertile territory to propagate to wages or other prices when the economy is in a strong cyclical position.

This uneven recovery of the world economy is resulting in an uneven monetary policy landscape (Figure 2), which strengthens currencies in EMEs and induces capital inflows to these countries. Free trade and export-led growth have been a successful growth strategy in developing countries, which see the strengthening of their currencies as a threat to this strategy. Consequently, many countries have been trying to fight the appreciation via capital controls and exchange rate intervention.

China and the U.S. deserve special mention, as they are at the center of the tensions of the adjustment. China has been the growth engine of the world, and it would not be an exaggeration to call it the “grower of last resort” for the global economy. They have decided to appreciate gradually, much more slowly than most EMEs and commodity exporters. Since December 2009, the yuan has appreciated almost four percent, while this figure is much closer to ten percent for most EMEs. The comparison is even more dramatic when looking at a longer period of time. This has been achieved through massive reserve accumulation and limited financial integration. However, for measures in the foreign exchange market to have real effects – that is, on the real exchange rate, which is the relevant variable from the point of view of competitiveness – these measures need to have some support from the real side of the economy. In the case of China, this is a very high savings rate. China saves about half of its GDP and the resulting current account surplus sustains a depreciated real exchange rate. Otherwise, attempts to maintain a depreciated nominal exchange rate sooner or later lead to inflation, which is the way to achieve relative price adjustment when the nominal exchange rate is not allowed to adjust.

The U.S., in turn, is undertaking an extraordinary monetary expansion. Beyond having reached the zero lower bound for the federal funds rate, unconventional measures are adding additional monetary stimulus. In particular, the massive purchase of securities implemented in the so-called QE2 program. This explains why the dollar has reached its lowest level in several decades (Figure 3), but this is not only the result of expansionary monetary policy, but also of the lack of domestic demand and of the external imbalances.

Global rebalancing of the world economy needs countries in a strong cyclical position to direct domestic demand to imports, while countries with insufficient domestic demand to increase exports. Exchange rate adjustment should facilitate this process. Therefore, a faster appreciation of the yuan would relieve some appreciatory pressures in other EMEs, making the adjustment more balanced. But, for this to be achieved on a sustained basis, it is not enough to let the exchange rate adjust. Structural reforms will also be required to achieve a sustainable and efficient reduction of China's savings rate. On the other hand, a rise in advanced economies' interest rates, in particular in the U.S., would also alleviate currency tensions. However, the main responsibility for policymakers is to secure sustainable growth in their home economies that favors their citizens, and we all have to deal with the repercussions of those actions.

### **The response in emerging market economies**

Emerging market economies have been facing two challenges as a consequence of this global environment. First, exchange rate appreciation and a resumption of capital inflows, and second, inflationary pressures. Sometimes, these two challenges may lead to inconsistencies in macroeconomic management. However, it is important to highlight that in small open economies any attempt to persistently manage an exchange rate away from its fundamentals, in particular at an overvalued level, may end up leading to inflation. If the adjustment does not come from a change in the value of the currency, it will happen through inflation. This is the reason why it is an illusion to think that central banks can control both the exchange rate and the inflation rate. However, there are options available to temporarily reduce pressure on the exchange rate while monetary policy continues to focus on price stability.

In a flexible inflation targeting framework, a first implication regarding exchange rate fluctuations is that monetary policy would tend to lean against the wind. Indeed, a persistent exchange rate appreciation would have disinflationary effects and would induce a looser monetary policy than the one that would prevail with a more depreciated exchange rate (everything else constant). However, in the current juncture, this effect does not prevent the need to tighten monetary policy, given strong growth in EMEs and inflationary pressures coming from commodity prices.

A second option to mitigate currency appreciation is exchange rate intervention. In order to keep control on the interest rate, this intervention must be sterilized. Of course it has lower effects than when the monetary impact is not sterilized, but it is consistent with inflation stabilization. In Chile, since 2008 we have intervened twice, and we have implemented it in a pre-announced way, with a known schedule for intervention and sterilization, so it does not interfere with monetary policymaking. The rationale for the intervention was twofold. On the one hand, to accumulate reserves, strengthening our international liquidity position, and on the other hand, to provide some transitory relief to sectors that need to undergo an adjustment due to current international conditions.

A more debated tool is the use of capital controls. This is particularly important for countries that are going through a period of important net capital inflows, which is not the case of Chile. Capital controls are part of the central bank's toolkit in EMEs. However, their effectiveness is still a matter of discussion, and instead of discussing this evidence I would like to point to distortions that they may bring about. First, they may redirect capital inflows from controlled segments of the financial system to uncontrolled ones, fostering the shadow banking system. And second, they may generate discriminations in the corporate sector as some firms may have access to foreign financing free of controls, while other firms, especially small and medium sized enterprises, have to seek financing from more expensive domestic sources.

Capital controls are not only a macro tool, but have recently been considered "macroprudential" measures as well. Their purpose is to avoid the building up of financial vulnerabilities, in particular currency and maturity mismatches. But, this can also be achieved with regulation directly introduced to prevent these mismatches and through appropriate risk management. Finally, given some recent calls for the use of capital controls in EMEs, there is a collective action problem. As one country imposes capital controls, it pushes international financial flows elsewhere, inducing others to impose capital controls, and so on. Now assume that all countries are able to impose capital controls so that at the margin, there are no changes in net capital flows. Then the global adjustment would not take place, EMEs would grow beyond their potential, generating inflation, while weak economies would be trapped with low demand growth. EMEs can still try to temper capital inflows transitorily, but to completely avoid them would be unfeasible and inefficient.

## **Concluding remarks**

Despite all the current tensions, the global economy is adjusting. Exchange rates of EMEs and commodity exporters have been strengthening – albeit at different speeds as some economies try to smooth the adjustment – and the global recovery is taking place (Figure 4). Fortunately, trade restrictions, which represent the biggest threat to the global recovery, have not been implemented.

In recent weeks we have witnessed increased tensions in the world, such as the turmoil in the Middle East and North Africa and the natural and nuclear disasters in Japan. We need to pay close attention to these developments, but they should not change the perspectives of the dual-speed recovery in the world economy.

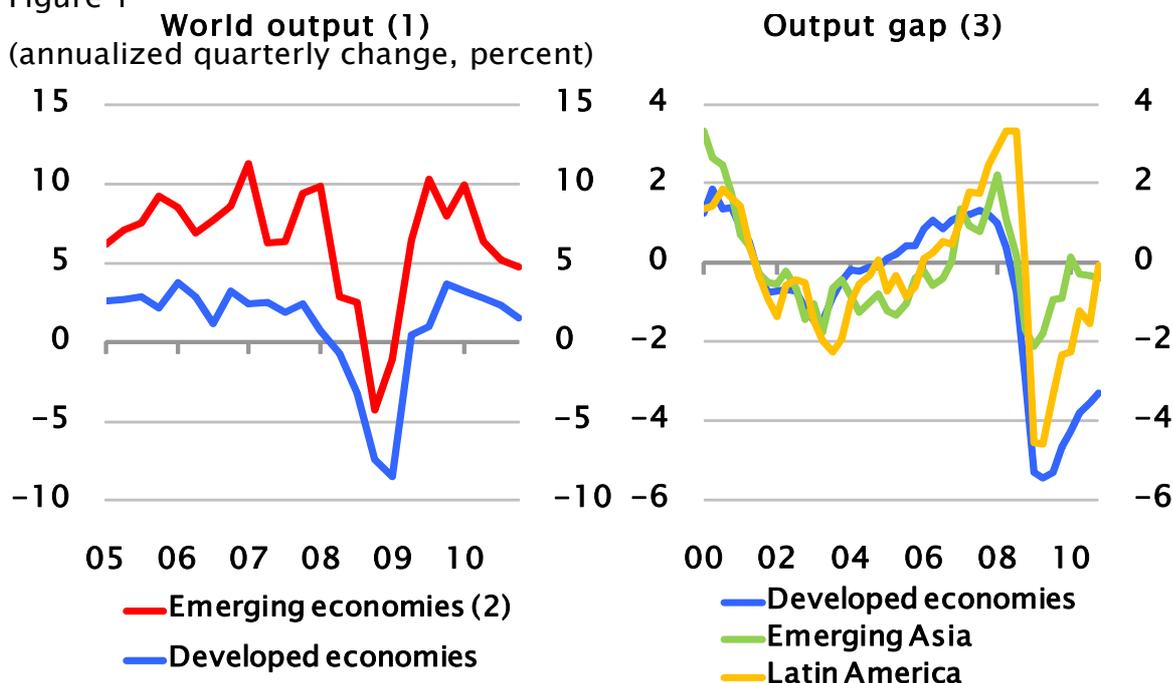
As discussed above, the policy decisions in large countries have repercussions on the rest of the world. However, the main role for policymakers is to secure recovery and to create the basis for sustainable growth, which requires macroeconomic and financial stability. Policy

measures in the U.S., such as QE2, are trying to do just that. Beyond our professional assessment, a successful recovery in the U.S. is good for the world economy. By the same token, Chinese authorities have decided on a gradual path of adjustment to secure enough growth for all the social and economic needs they face. From a macroeconomic standpoint, their policy of exchange rate management is something many EMEs have tried several times, and although I am a firm believer that exchange rate flexibility is crucial for small open economies, it is of course not the general rule and is not to be applied in all cases and under all circumstances, especially for large low-income economies. Overall, the world needs a sustained recovery in the U.S. and growth in China.

The same is valid for EMEs. We need to contribute to the global adjustment, but our main concern must be the welfare of our citizens. Containing the current inflationary pressures is essential to allow for sustainable growth. Delaying monetary policy adjustment may result in more severe adjustments in the future. Also, rebuilding fiscal buffers is important in order to have a more balanced recovery and to be better prepared to conduct macroeconomic policies. Some days ago, the Chilean government announced a timely and relevant fiscal tightening that should contribute to the moderation of aggregate demand.

The world is not going through a currency war; neither are EMEs being flooded by liquidity from advanced economies. But, in EMEs, there are many tensions and challenges that we must deal with appropriately in order to build more resilient economies and take full advantage of the great progress achieved during recent years in terms of macroeconomic and financial stability. These are the main contributions central banks can make to their countries.

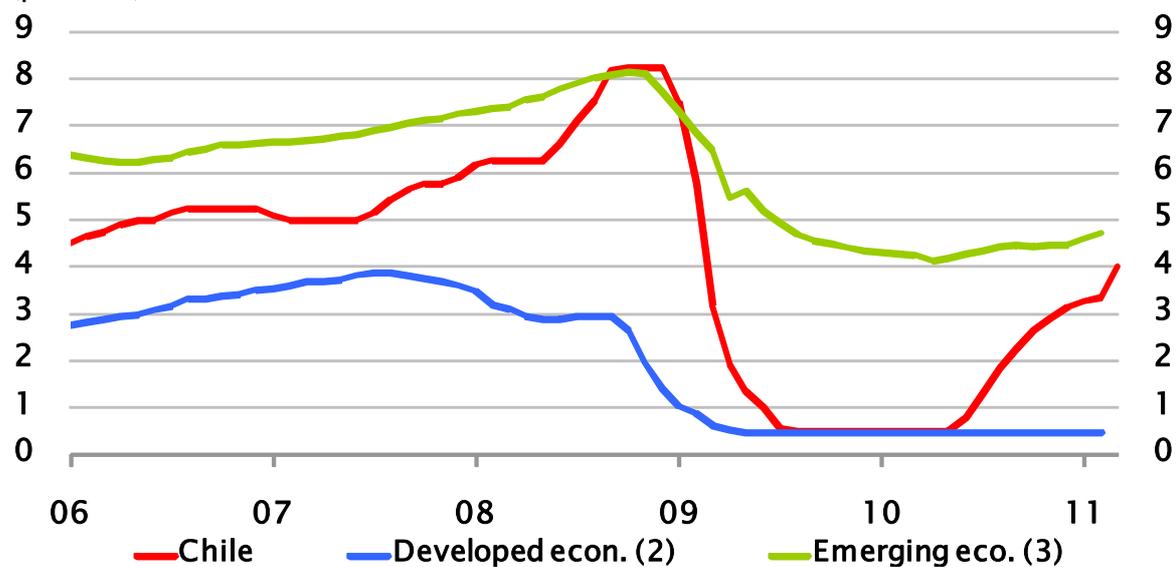
Figure 1



(1) PPP-weighted regions. (2) The fourth quarter is an estimate. (3) Gap obtained with the HP filter, except in advanced economies, where OECD estimates were used.

Sources: Central Bank of Chile based on data from Bloomberg, Consensus Forecasts, OECD, and the statistics offices of each country.

Figure 2  
**Monetary policy rates around the world (1)**  
 (percent)



(1) Corresponds to a simple average of the reference rates for each group of countries. (2) Includes Euro area, Japan, United Kingdom, and United States. (3) Includes Brazil, Czech Republic, China, Colombia, Hungary, South Korea, Mexico, Peru, Poland, and South Africa.

Sources: Central Bank of Chile and Bloomberg.

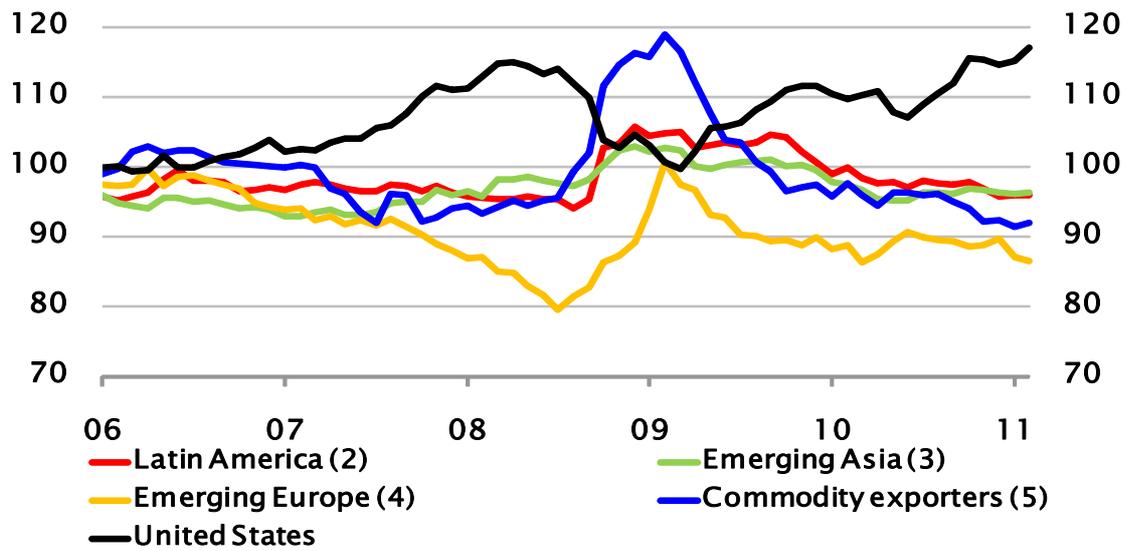
Figure 3  
**U.S. multilateral nominal exchange rate (\*)**  
 (index, March 1973=100)



(\*) An increase indicates a depreciation of the dollar against main trading partners.

Sources: Bloomberg and U.S. Federal Reserve.

Figure 4  
**Real exchange rate (1)**  
 (index; 2005=100)



(1) Correspond a simple average of the real exchange rate for each group of countries. An increase indicates depreciation. (2) Includes Argentina, Brazil, Chile and Mexico. (3) Includes China, Hong Kong, Indonesia, Malaysia, South Korea, and Thailand. (4) Includes Hungary, Poland, Czech Republic, and Russia. (5) Includes Australia, Canada and New Zealand.

Source: BIS.