Sebastián Claro: Chinese challenges facing Chile and Latin America

Speech by Mr Sebastián Claro, Board Member of the Central Bank of Chile, at the 2012 Latin American Cities Conferences "Chile on the path to development", organized by the Americas Society/Council of the Americas, Santiago, 30 August 2012.

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I would like to thank Consuelo Edwards and Yan Carrière-Swallow for their help in translating this speech from the original Spanish.

Thank you for inviting me to this event that for several years now has been gradually positioning itself – both in Chile and in the rest of Latin America – as a seminar dealing with key issues for the region's economic development. On this occasion, and at the organizers' suggestion, I would like to share with you some thoughts on the economic development of China and its implications for Latin America. Rather than focusing on aspects of the Chinese economy – which I will come back to at the end of the presentation –, I would like to focus on those dimensions in which China's spectacular growth affects the region directly.

Let me begin by recalling a widespread debate in the region in the early 2000s. While Europe was boastfully launching its new single currency, Latin America was struggling to leave behind the havoc of successive crises that had hit the region, starting with Mexico in 1994. The meager growth of the late 1990s and early 2000s, plus the accumulation of large current account deficits during the 1990s, caused the region to begin the new century with relatively high levels of debt-to-GDP.

For example, at the end of 2002 Brazil's government debt reached 80% of GDP while its external debt was close to 55% of GDP. In every other country in Latin America – with the exception of Chile –, the debt of the general government exceeded 40% of GDP. Moreover, large current account deficits persisted throughout the region. Take the year 2002, when Mexico and Peru – as well as Bolivia and Costa Rica – had accumulated 5 years of current account deficits of over 2% of GDP.[1]

Doubts about the sustainability of national debts across the region fueled an academic debate as to identifying the highest level of debt that could be tolerated. In a 2003 paper by Carmen Reinhart, Miguel Savastano and Kenneth Rogoff – which has been part of a successful research program on the history of debt crises –, the authors examined the history of defaults around the world, and concluded that relatively low levels of debt-to-GDP were enough to trigger credit restructuring events.[2] In particular, the paper found that several countries in the region had debt levels above the limits of what could be deemed "tolerable".

The authors also provided evidence of how countries – in Latin America and elsewhere – have historically used deleveraging to regain a sustainable path for their external debt. Their conclusion is clear: "For debt-intolerant countries, sustaining access to capital markets can be problematic unless debt ratios are quickly brought down to safer levels. To assess how such 'deleveraging' might be accomplished, we examine how, historically, emerging market economies with substantial external debts have managed to work them down. To our knowledge, this is a phenomenon that has previously received very little, if any, attention. We analyze episodes of large debt reversals, where countries' external debt fell by more than 25 percentage points of GNP over a three-year period. Of the twenty-two such reversals that we identify for a broad group of middle-income countries since 1970, two-thirds involved some form of default or restructuring. Only in one case – Swaziland in 1985 – was a country

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[1] Sources: World Bank, Moody's and IMF (WEO, April 2012).

[2] Reinhart, C., M. Savastano and K. Rogoff, (2003), "Debt Intolerance", Brookings Papers on Economic Activity 1.

able to bring down a high ratio of external debt to GNP solely as a result of rapid output growth." Thus, in the early 2000s, there were widespread expectations that a default would occur.

Overall, the history of Latin America in the 2000s did not go as expected. During the first decade of the twenty-first century, Latin American countries succeeded in lowering their levels of external debt by nearly 20 percent of GDP. The current-account balance, which had exhibited a secular deficit during the 1980s and 1990s, posted a surplus of nearly 2% of GDP during the 2000s. A review of the fiscal ledgers yields similar numbers.

What happened? What was the miracle? In a word: China. China's strong growth began to permeate international commodity markets early in the decade, leading to an enormous increase in the region's terms of trade beginning around 2004. This major increase in income enabled the economies to deleverage without having to make large adjustments to expenditure or output. Also, the real exchange rate appreciated by almost 20% with respect to trading partners during the 2000s, which contrasts with the greater stability of the 1990s.

Of course, better macroeconomic policies contributed markedly to this success. Whereas previous income booms had been accompanied by strongly pro-cyclical economic policies that incubated problems, this time greater efforts at fiscal saving, more exchange rate flexibility and better banking supervision helped the countries take advantage of the high commodity prices. But for a large part of the region, the seed of the success of the 2000s was sown by China.

Today our objective is to look ahead, not to dwell on thoughts about the region during the past decade. The strength of the Chinese economy leads one to think that this phenomenon of high terms of trade will go on for some time, posing a number of challenges to economic development in the region.

At the risk of oversimplifying these challenges, let me group them into three categories: (i) challenges to macroeconomic management, (ii) structural challenges, and (iii) cyclical challenges. The first two depend essentially on us, while the third refers to the short-term trajectory of the Chinese economy and its possible impact on developing countries.

Macroeconomic challenges

A first issue worth noting is that commodity prices have experienced successive cycles throughout history, and there is a permanent risk of mistaking a temporary phenomenon for a permanent one. This time is no different. There is a valid argument that the Chinese economy can sustain its recent dynamism for many years to come. While there are reasons to believe that the Chinese economy should converge to growth rates around 7% within the next few years, and that 9% growth rates are very difficult to sustain, this does not imply a substantial deterioration in Chinese demand for commodities.[3] In the case of Chile, the experts surveyed by the Ministry of Finance have raised their estimates for the long-term copper price on repeated occasions on the grounds of both supply- and demand-side considerations.[4]

However, economic cycles do exist and the response of supply – which has not been fully perceived so far – will tend to drive prices to their trend values, which are below current levels. Clarity on this point is not only fundamental to determine a fiscal policy consistent with medium-term income, but also to guide private spending and investment decisions on the basis of sustainable future earnings. For macroeconomic policies, there is an important

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3 Claro, Sebastián. Presented at the V Chile-China Entrepreneurial Meeting, Centro Cultural de Carabineros, Santiago, 10 June 2011. For transcript, see Central Bank of Chile website: www.bcentral.cl.

4 See Ministry of Finance of Chile website: www.hacienda.gov.cl.

challenge in facing a period of temporarily high terms of trade, and the improved external financing conditions that become available as a result. The experience of many countries shows that the best policy mix is sound fiscal discipline, prudent financial regulation, and a monetary policy framework that combines price stability and flexible exchange rates.

A sound fiscal policy not only smoothes the business cycle and helps minimize foreign exchange fluctuations, but also avoids commitments to spending on outlays that depend on uncertain future income. Fiscal policy in Chile has been moving in that direction for decades, the importance of which cannot be overemphasized. Sound banking supervision is key for several reasons, among others because the intermediation of large capital inflows – in a context of upward pressures on asset prices – may lead to excessive risk taking. The reversal of these conditions has hit particularly hard in previous financial crises, where risk-taking by financial institutions prompted aggressive deleveraging, with strong implications for credit and output. For this reason, in circumstances like these it is extremely important to closely monitor the prices of key assets and risk-taking patterns in the financial system.

Finally, regarding monetary policy two issues are worth noting. On one hand, a monetary policy that favors sound domestic price stability is consistent with macro stability in the medium term. This is a much sought-after objective in many economies of the region and must be protected.

On the other hand, a flexible exchange rate policy is the best framework for dealing the situation we face. The reasons are twofold: first, in a context of high commodity prices and good external financing conditions, a floating exchange rate helps prevent the incubation of macroeconomic imbalances,[5] as Chile can attest from past experience. There are many examples of countries facing favorable external conditions, in which foreign exchange rigidity resulted not only in higher inflation but also in large current account deficits, causing major imbalances in the external accounts.

Second, foreign exchange adjustments allow the economy to adjust to fluctuations in external conditions, such as those that have been so prevalent in the past several years. Volatility of the terms of trade and external credit conditions generates a constant need to adjust relative prices, which is more easily accomplished through flexible exchange rates.[6] Current developments in Europe are providing further evidence for this view.

The benefits of flexible exchange rates are accompanied by costs, primarily due to the possibility of an increase in exchange rate volatility. This introduces further difficulties for making business and investment decisions. The trade-off has been present in the academic and economic policy debate for many decades and, although opinions differ in terms of acknowledging the difficulties caused by exchange rate volatility, the benefits of a floating exchange rate to safeguard macroeconomic stability are perceived to trump these difficulties. For one thing, over the past decade the credible Chilean policy of flexible exchange rates has brought about a nearly total elimination of currency mismatches in the corporate sector that had hindered monetary policy making for so many years.

Structural challenges

In a context of good commodity prices and favorable access to credit, the phenomenon of real exchange rate appreciation poses structural challenges to economies in the region. I would like to focus on three issues that have been widely discussed in business, political, and academic circles.

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[5] Dornbusch, R., (1983), "Real Interest Rates, Home Goods, and Optimal External Borrowing", Journal of Political Economy 91(1).

[6] Calvo, G., A. Izquierdo and E. Talvi, (2003), "Sudden Stops, the Real Exchange Rate and Fiscal Sustainability: Argentina's Lessons," NBER Working Paper 9828.

First, it is worth emphasizing that part of the appreciation of the real exchange rate reflects the proceeds from the higher prices of our main exports. The resulting increases in expenditure and investment push up the price of services and wages, which is the counterpart of exchange rate appreciation.

The impulse to demand from these conditions does not depend essentially on monetary policy, which can primarily affect the trade-off between fluctuations in the nominal exchange rate and domestic inflation. Although monetary policy does have a toolkit to smooth short-term exchange rate fluctuations without jeopardizing price stability – which under some circumstances could justify intervening the foreign exchange market –, the underlying trends of the real exchange rate cannot be dealt with using monetary policy.

The second issue has to do with recognizing that this phenomenon has an impact on the competitiveness of certain export-oriented industries whose prices do not increase in dollars and whose domestic costs rise due to pressure on wages. Here we need to distinguish a couple of elements.

For one thing, essentially the same phenomenon that is holding the copper price above its long-term level is causing high prices of other commodities, such as foodstuffs. This is why Chinese growth offers such enormous opportunities to countries with agricultural and agribusiness potential, such as Chile.

In turn, Chile's capacity to diversify its exports and avoid specializing in a handful of raw materials requires a substantial effort to promote competitiveness, which is the most critical tool to foster growth and diversification. Support for and training of human capital, increased market competition and flexible labor markets all stand out as important measures to improve competitiveness.

All these dimensions point to the fundamental source of productivity gains, which is the creation and development of new enterprises. International experience shows that countries' export growth is driven mainly by new firms – in existing product categories and to existing destinations – with a stronger capacity for growth than existing exporters.[7] As some authors have pointed out, taking advantage of this growth potential requires fostering factor mobility across firms of different productivity levels. This process generates a major portion of the gains from economic openness, such that policies that hinder workers crossing over to other firms or that raise the cost of adjusting the scale of production weaken capacity for innovation.[8]

Finally, and in the same token, it is clear that the opportunities that China's strong growth generates for the region must be well used. For this to take place, not only will greater saving be required, but also more productive investment. In other words, one significant challenge facing the economies of the region – and Chile in particular – is to take advantage of this momentary boom in the terms of trade by promoting saving and investment, thus making sure that it does not simply translate into an unsustainable spending spree.

To that end, fiscal policy plays a key role by setting up well evaluated investment programs, while maintaining the incentives that promote the accumulation of scarce physical and human capital among private agents. Policies that distort these incentives inevitable end up lowering the rate of saving and investment.

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[7] See Eaton, J., M. Eslava, M. Kugler and J. Tybout (2008), "The Margins of Entry into Export Markets: Evidence from Colombia," in E. Helpman, D. Marin, and T. Verdier, eds., The Organization of Firms in a Global Economy, Cambridge, MA: Harvard University Press; and Blum, B., S. Claro and I. Horstmann (2012), "New Exporter Dynamics and Capital Adjustment Costs," Mimeo, University of Toronto, Central Bank of Chile and Pontificia Universidad Católica de Chile.

[8] Melitz, M., and D. Trefler (2012), "Gains From Trade When Firms Matter", Journal of Economic Perspectives 26(2).

Challenges facing China

I would like to end by referring to China's challenges in the short run, and the impact that current developments may have on the economies of the region. Already in the mid-2000s the Chinese economy was in a transition to becoming less dependent on the external sector and investment demand, and thus trying to promote domestic consumption. There were obvious signs of investment exhaustion in some sectors, together with doubts about the capacity to sustain such high rates of export growth.

The reforms adopted in the middle of the past decade to enhance the operation of the financial system and thus attain a more efficient allocation of credit – to offset the natural fall in the savings rate – came to a halt during the crisis of 2008–2009 due to the great boost in government expenditure and public credit.

This boost, which allowed the Chinese economy to deal quite successfully with the global financial crisis, brought about significant indebtedness of local governments, high exposure of the financial system to projects of dubious quality, and substantial over-investment.

The need to put a stop to this impulse in order to safeguard macroeconomic stability has defined China's economic policy decisions since 2010. Accordingly, the contractions in investment projects and credit availability have been the main stabilization tools used in China.

However, this process coincided with the aggravation of problems in Europe, which resulted in a very sharp reduction of external demand for the Chinese economy, among other things. The fall in exports, together with the need to withdraw the stimulus that had been given to investment over the past few years, has put significant pressure on China's growth. Its capacity to offset the drop in demand with increased domestic consumption is limited in the short run, especially since the necessary conditions to promote lower savings rates, such as changes to social security and health-care plans, a deepening of the household credit market, and changes in relative prices – such as a real exchange rate appreciation –, are often slow to implement.

Until now the Chinese economy has continued to decelerate, and somewhat more rapidly than was foreseen a few quarters ago. In my view, China has the necessary tools to deal with this deceleration, and to deal with a possible worsening of problems in Europe. But at the same time, the programs implemented in 2008–2009 have lost their efficacy, and the authorities are taking a more cautionary stance.

Today, China needs to rearrange its economy, and although events in Europe have caught China flatfooted with respect to its economic reforms, part of the adjustment to slower short-term growth is necessary and partly inevitable. A significant impulse to public expenditure and investment will only be observed if there is a significant deterioration of external conditions.

Overall, the Chinese economy faces important challenges in the short run. These could introduce fluctuations in commodity prices that threaten to expose the weaknesses of countries in the region whose recent growth has come almost exclusively from increased expenditure financed by the Chinese boom. In particular, it is especially important at this point that the region work hard to maintain the health of its fiscal and external accounts.

Thank you.