Growth and Exchange Rates in Developing Countries

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Outline

1. Promoting Growth
2. The Role of Exchange Rates
3. The World Economy
Promoting Growth

• It is urgent to resume growth to consolidate reforms and to avoid costly shortcuts.
• What to do? There are many factors, but from the macro-policy point of view:
  • Institutions.
  • Openness.
  • Macroeconomic Stability: inflation - currency crisis.
Promoting Growth

- Currency crisis are costly: in a five-year period reduce output by 9%, if in addition comes with banking crisis the cost is doubled.
- Business Cycle: fluctuations are larger and more persistent, and exacerbated by pro-cyclical policies (fiscal, exchange rates, current account).
- Strong institutions pre-requisite for successful stabilization.
The Role of Exchange Rates

- Must promote stability. Acting timely as shock absorber.
- Need for flexibility: small open economies subject to a variety of shocks that need to be accommodated.
- Attempts to lean against the wind via aggressive reserve accumulation may encourage speculation and increase capital inflows.
- Capital controls: effectiveness it is not clear, specially when domestic financial markets are well-developed. Could be advisable for countries without strong macro institutions, but not as substitute for building them.
Real Exchange Rate
(average 1986=100)
### World Output Growth

<table>
<thead>
<tr>
<th>Region</th>
<th>2003</th>
<th>2004f</th>
<th>2005f</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>3.5</td>
<td>4.7</td>
<td>4.2</td>
</tr>
<tr>
<td>USA</td>
<td>3.1</td>
<td>4.8</td>
<td>3.9</td>
</tr>
<tr>
<td>Europe</td>
<td>0.9</td>
<td>2.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Japan</td>
<td>2.4</td>
<td>2.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Rest of Asia</td>
<td>7.0</td>
<td>7.6</td>
<td>7.1</td>
</tr>
<tr>
<td>Latin America</td>
<td>1.0</td>
<td>4.0</td>
<td>3.3</td>
</tr>
<tr>
<td>Chile’s trade partners</td>
<td>2.6</td>
<td>4.2</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Source: Consensus Forecast and Investment Banks.
World Growth (%)
Main issues and risks in the global economy. Consequences for emerging markets

- Twin deficit in the US: Fiscal imbalances and current account deficit.
- Exchange and interest rates pressures.
US: Current Account and GDP Growth
US Current Account Deficit and Capital Inflows to Emerging Markets (billion $)
Consequences of the Adjustment

- Increase in the availability of capital flows to emerging markets.
- Weakening of the US dollar and pressures in emerging markets competitiveness.
- Slowdown of growth in the USA.
- Interest rate risk, very bad news for highly indebted countries, serious risks on fiscal side.
- When? By 2005 and beyond. Its timing and intensity are uncertain.
Implications of the depreciation of the dollar

- Pressures on developing countries currencies, and appreciation may undermine resumption of growth.
- Higher international inflation in US dollars, although low domestic impact due to low pass-through.
- Increase in the price of commodities, good news for developing countries.
- Overall: the adjustment in the US is necessary, and if smooth is good news for the world economy. The main risk is on interest rates and slowdown.