

## Macroeconomic Adjustment in the Andean Countries to the End of the Commodity Super Cycle<sup>1</sup>

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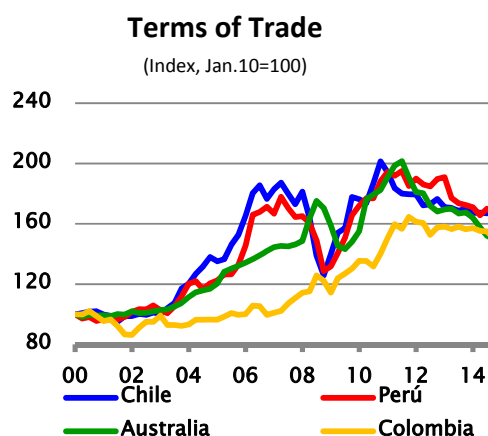
28 March 2015

It is a tremendous opportunity to be here, and I want to thank the IIF for inviting me to share our views about the impact of Asia's macroeconomic developments in Latin America. This is a very broad topic, so my plan is to briefly describe what has been, in my opinion, the main impact of Asia's growth on some commodity exporting countries in Latin America, and then focus on the macroeconomic responses that these countries are facing now-a-days given the so-called end of the commodity super cycle. Naturally, my comments will be mainly focused on Chile's experience, but I will touch upon parallel developments in Peru and Colombia. In some dimensions, I will also refer to the experience of Australia, which is a major commodity exporter.

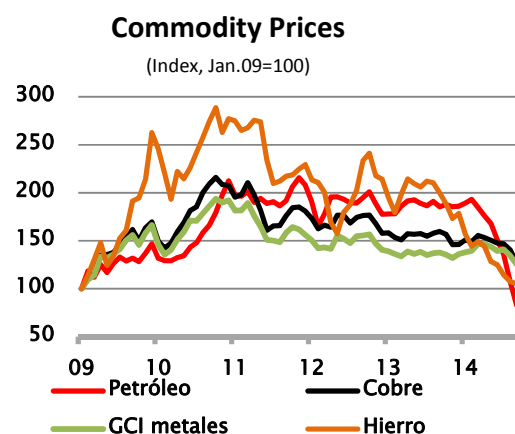
1. The very significant increase in commodity prices that started around 2004 generated a very significant terms of trade (TOT) boom for commodity exporting countries. In Chile, for example, TOT more than doubled from 2002 to their peak around 2010. Since then, we have observed a moderation in the terms of trade. Although they are still high by historical standards, the significant drop in commodity prices in the last few quarters – especially for oil– have put an end to the so-called commodity super cycle. After peaking in February 2011, copper prices have fallen more than 40% while oil prices have fallen more than 50% since March 2012.

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Source: Bloomberg and Central Bank of Chile, Colombia and Peru.



Source: Bloomberg

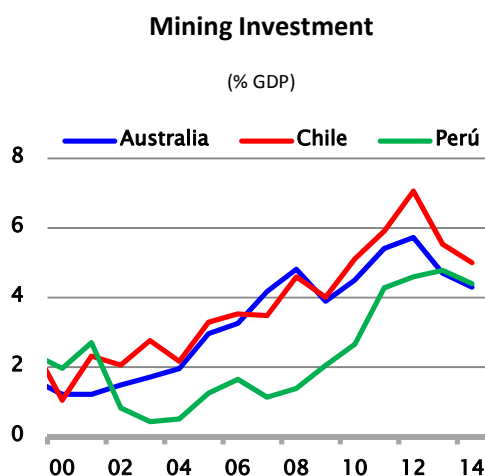
2. The boom in commodity prices had very important macroeconomic effects in exporting countries. Among many dimensions, two are worth singling out. First, GDP growth received an important impulse since 2004 – with the exception of the 2009 financial crisis – making the 2004-2013 decade a very successful one for these countries relative the performance of the United States and the rest of the world. Indeed, the growth rates between Peru and Colombia in this decade outperforms world growth rates by a sizeable amount relative to the performance between 1990 and 2003. The exception is Chile, where the 1990-1998 period was very dynamic. Anyway, the performance of Chile after 2004 was successful, too. Indeed, the strong reaction of commodity prices after the crisis – in large part due to China's strong macroeconomic impulse – helped these countries to weather the world financial crisis fairly well.

<b>GDP Growth</b> (Annual change, percentage)						
	Chile	Perú	Australia	Colombia	EE.UU.	Mundo (Bloomberg) (*)
<b>2014</b>	1,8	2,4	2,4	4,6	2,4	2,5
<b>Average 90-03</b>	5,7	3,2	3,3	3,0	3,0	2,8
<b>Average 04 -13</b>	4,8	6,4	3,0	4,8	1,7	2,5

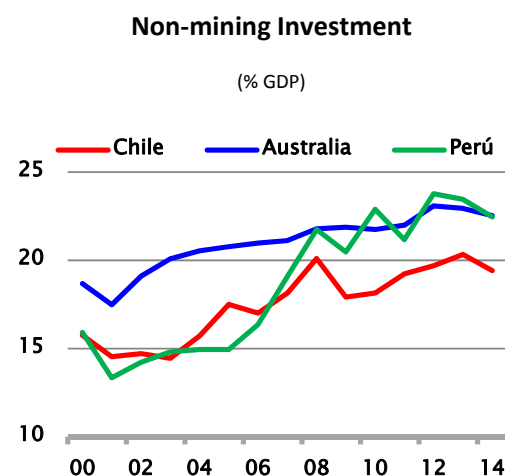
(\*)Bloomberg only provides world growth record since 1996.

Source: Bloomberg.

3. Second, investment rates, especially in mining, were significantly enhanced during the commodities boom. Mining investment grew from approximately 2 percentage points of GDP in 2002 to more than 5pp in 2012. Chile's performance in this dimension is notorious, with mining investment reaching almost 7% of GDP in 2012. The boom in mining investment also had a multiplying effect over other sectors, as we also observe an upward trend in non-mining investment in this period.



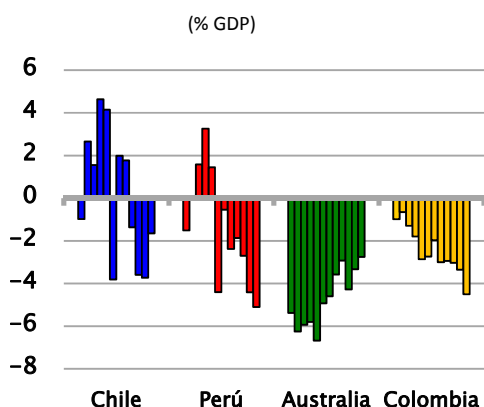
Source: Central Banks of each country



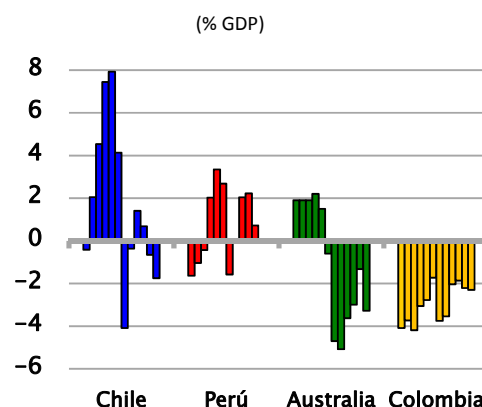
Source: Bloomberg and Central Banks of each country.

4. The investment boom led to a progressive deterioration in the current account since 2004. Interestingly, in the early part of the boom, Chile – and, to some extent, Peru – had current account surpluses, revealing the fiscal effort to save a substantial part of the windfall. In the case of Chile, the fiscal surplus grew from 2% in 2004 to over 7% of GDP in 2007. This allowed the country to save as much as USD 22 billion, more than 10% of GDP in sovereign wealth funds between 2004 and 2008. In the second half of the period, the increase in production costs and the internalization of higher long-term commodity prices significantly reduced the amount that high commodity prices contributed to fiscal surpluses, and hence current account deficits increased in the three Andean countries. Also, there is evidence that the strong investment boom after the 2008-2009 financial crisis – which contributed to the current account deficit – responded to the persistence of high commodity prices, enhancing the incentives for longer term investments.<sup>2</sup> By 2013, Chile, Peru and Colombia registered deficits of 3.7%, 4.4% and 3.2% of GDP, respectively.

<sup>2</sup> Fornero, J., and M. Kirchner (2014): “Learning About Commodity Cycles and Saving- Investment Dynamics in a Commodity-Exporting Economy” Working Papers Central Bank of Chile 727.

**Current Account Balance 2013-2014**

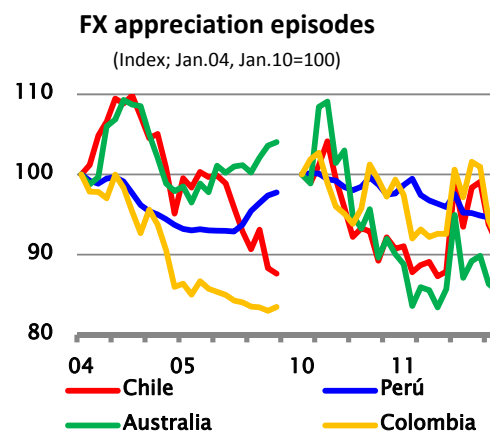
Source: Bloomberg

**Fiscal Balance 2003-2014**

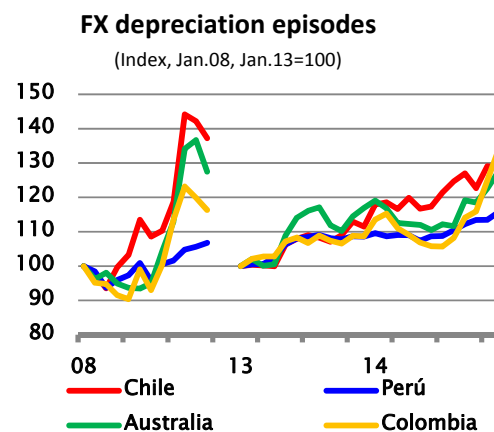
Source: Bloomberg

5. Since 2011, a significant fall in commodity prices has taken place. Starting with a decline in food prices since early 2011 (-45% to date), industrial metal prices have fallen 22% since the beginning of 2012, and energy prices, particularly in crude, have fallen more than 50% since their peak in early 2012. The perception that some drivers of this slowdown – expansion in commodity supply coinciding with weakness in global growth – have a structural dimension has affected significantly the Capex plans of mining companies. In essence, after several years of strong growth that peaked in 2012, we have observed a very relevant fall in the growth rate of mining investment. The latest figures show an annual contraction of mining investment in the range of 23% to a 7% for the main industrial metal exporters around the globe, including Chile, Peru and Australia. In this regard, Chile is one of the countries most affected, with a cumulative decline in mining investment estimated around 33% between 2012 and 2014. Besides, the fall in commodity prices could have affected non-mining investment plans and domestic demand overall, that have also adjusted downwards since late 2013. This is reflected in a 5.9%, 1.5% and 2% reduction in overall investment in Chile, Australia and Peru for 2014. The need for a fiscal adjustment to accommodate lower medium- to longer-term commodity prices, and the wealth effect on households, might explain the correction of domestic demand to the terms-of-trade adjustment.
6. Overall, the adjustment in domestic demand has led to an important adjustment in the current account as well as a sharp depreciation of the real exchange rate. This is very clear in the case of Chile: the current account deficit in 2014 was almost 2 percentage points of GDP lower than in 2013, with a real depreciation of the CLP of around 15% since early 2013. Colombia's peso has sharply depreciated as well, but this has been mainly a development of the last two quarters. It has yet to reflect the adjustment in the current account deficit, which was more than 4% of GDP in 2014. Finally, Peru's currency has experienced a minor real and nominal depreciation, not so much due to a more benign terms-of-trade adjustment but possibly in response to an aggressive strategy of the Central Bank of Peru to discourage a sharp adjustment in its currency. By 2014, Chile, Peru

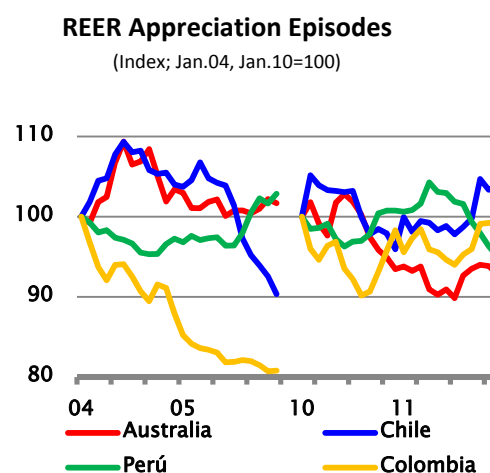
and Colombia registered current account deficits of 1.2%, 4.1% and 5.2% of GDP, respectively.



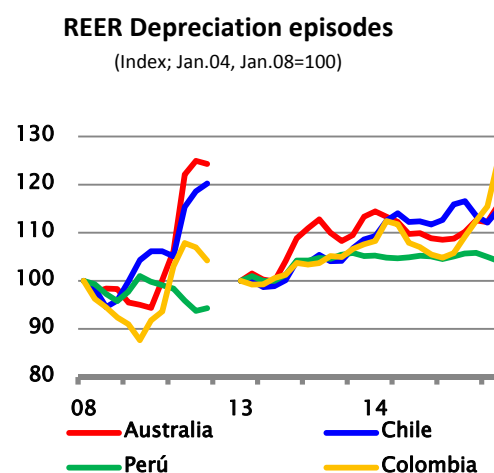
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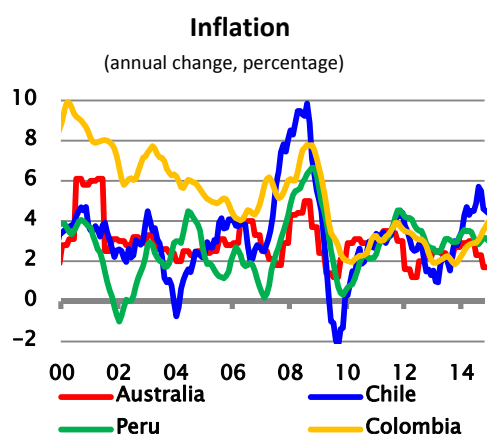


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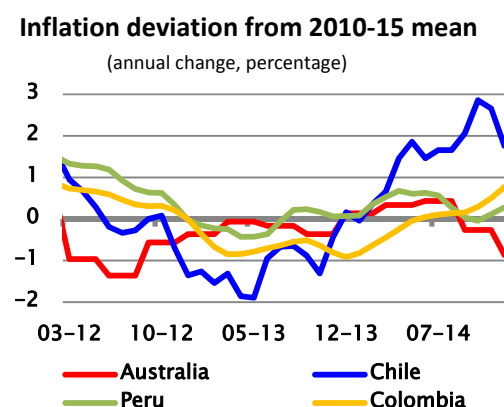
7. The exchange rate and current account adjustments are, in my opinion, a centerpiece of the macroeconomic adjustment process to the terms-of-trade fall. Allowing the exchange rate to depreciate has shown for many years to be the most effective mechanism to smooth out the necessary adjustment in domestic demand in response to external conditions. Of course, a significant part of the FX adjustment has also been related to the discussion regarding monetary policy adjustments in the United States, but it is also evident that if foreign financial conditions are to become more restrictive, the adjustment in exchange rate and current accounts are crucial. In this sense, the size of the adjustment that has taken place supports the expectation of a reasonable macroeconomic scenario

hereafter in Chile. In other countries, because the adjustment in the real exchange rate has been either muted or late, some challenges might arise.

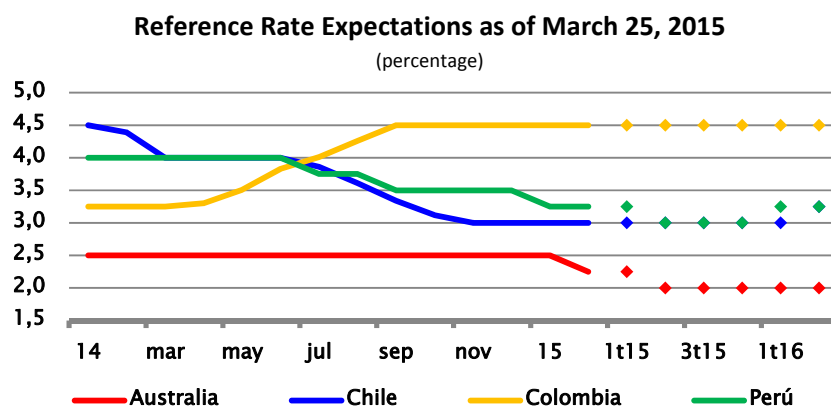
8. The macroeconomic adjustment that I am referring to has influenced the dynamics of inflation and growth significantly. On the inflation front, the depreciation of domestic currencies vis-à-vis the US dollar and in multilateral terms has affected inflation. FX depreciation is today the main threat to price stability in the Latin American countries, where the pass-through has ultimately been larger than previously expected. This reduces significantly the scope for monetary stimulus in the region. For instance, there are no expected reductions in the reference rates in 2015, even in countries where inflation is closer to the target. Interestingly, it is in Chile – the country with earliest depreciation – that inflation has deviated most from target. In contrast, in Colombia, where the depreciation of the peso has been very dramatic but only in the last few months, the inflation rate has started to pick up recently. In Peru, where the peso has been more stable, inflation is closest to the target.



Source: Bloomberg

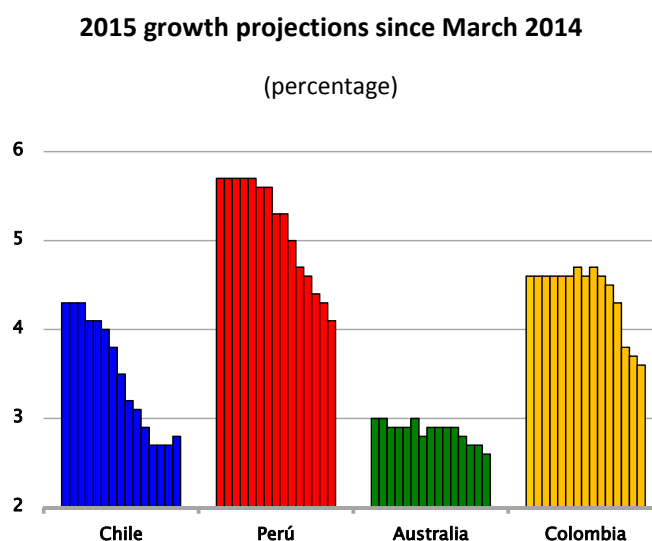


Source: Bloomberg



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9. The dynamics of the exchange rate in countries that were growing steadily in the last few years explains the apparent contradiction between a world where an incipient deflation debate takes place and a region where inflation concerns are on the rise. Arguably, a significant adjustment of the real depreciation has already occurred, meaning that expectations of a slowdown in inflation records – in a context of macroeconomic slowdown – do make sense.
10. A second question that should be carefully analyzed is about growth. Chile and Peru managed to grow only 1.8% and 2.4% in 2014; while Colombia remained somewhat more dynamic, growing 4.6%. Moreover, Consensus Forecasts growth expectations for 2015 have been revised downward in 1.5; 1.0 and 1.6 percentage points for Chile, Colombia and Peru relative to the forecasts in March 2014. After 10 years of good growth in a context of exceptional terms-of-trade and financial conditions, the current slowdown in growth raises the question of to what extent this is a cyclical phenomenon – driven by the adjustment in domestic demand, mining investment and the current account –, or whether there are more fundamental forces driving down growth rates, forces that were hidden during a decade of extraordinary external conditions. Although in terms of macroeconomic management the region has definitely improved relative to the standards of the 1990s, and there are good reasons to believe that a significant part of the region's deceleration has a cyclical component, it is not clear that fundamental reforms promoting competitiveness in product and labor markets have been enough to sustain rapid growth rates beyond some demand driven forces.



Source: consensus forecast