Central Banks and Global Imbalances

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Conference on Central Banks in the 21st Century

Agenda

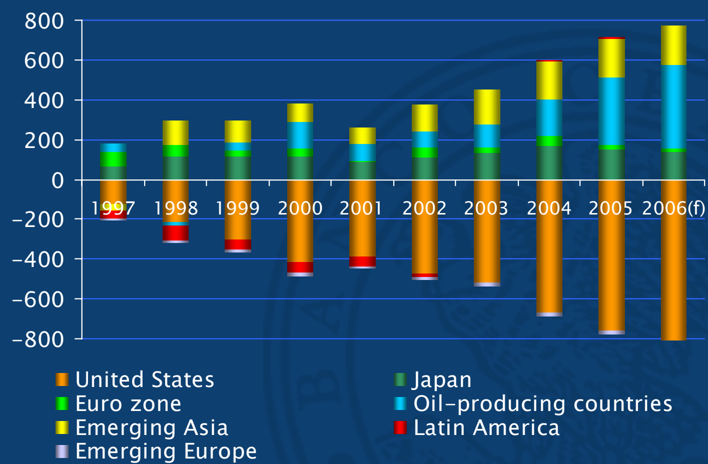
1. Global imbalances, a shared responsibility
2. Unwinding global imbalances: Is Latin America prepared?
3. Role of authorities
4. Concluding remarks

1. Global imbalances, a shared responsibility

Global imbalances, a shared responsibility

- Global imbalances have been widening:
  - Over the last thirteen years, US current account deficit has increased. In 2006 it is expected to be more than 6% of US GDP and more than 2% of world GDP.
  - Until now, the increasing CAD has been mainly financed by oil-producing countries, emerging Asia, especially China, and Japan.
- Latin America's contribution is negligible:
  - In 2005 the region ran a surplus equivalent to less than 1% of the US current account deficit;
  - However, it can still suffer the severe consequences of a sudden change in financial prices resulting from the global imbalances.

Current Account Balance
(billions of US dollars)



Source: IMF´s World Economic Outlook. September 2005.

2. Unwinding global imbalances: Is Latin America prepared?

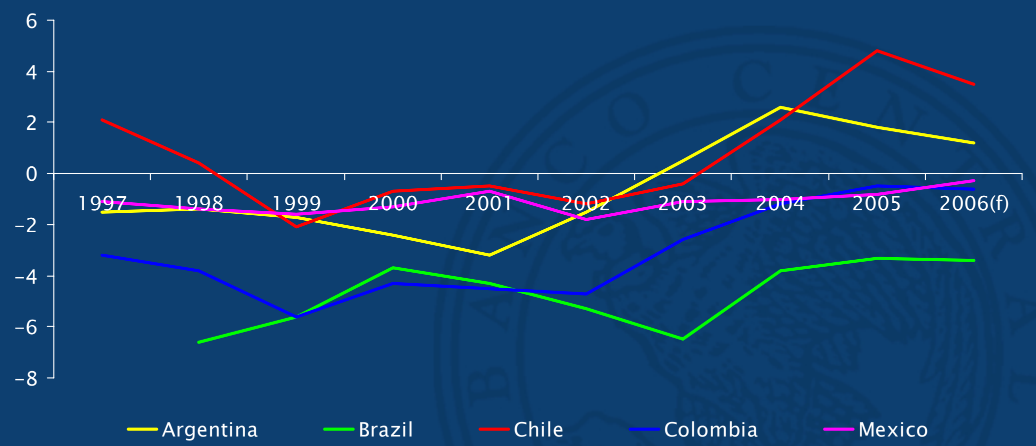
Is Latin America prepared?

- Over the past twenty years, and especially in the last five, Latin American countries have made significant advances in economic policy:
  - Prudent fiscal policies;
  - Improved monetary policy framework;
  - Progress in debt management;
  - Structural reforms.

Is Latin America prepared?

- and substantial improvements in economic conditions:
  - Smaller public sector deficits;
  - Lower inflation rates;
  - Improvement in the current accounts. The region had moderate surpluses in 2004 and 2005;
  - Reduced sovereign spreads: lower costs of external financing;
  - More solid financial systems.
- ***Strong and stable macroeconomic scenario reduces Latin America ´s vulnerability to disruptive adjustment of global imbalances.***

General Government Balance
(% of GDP)



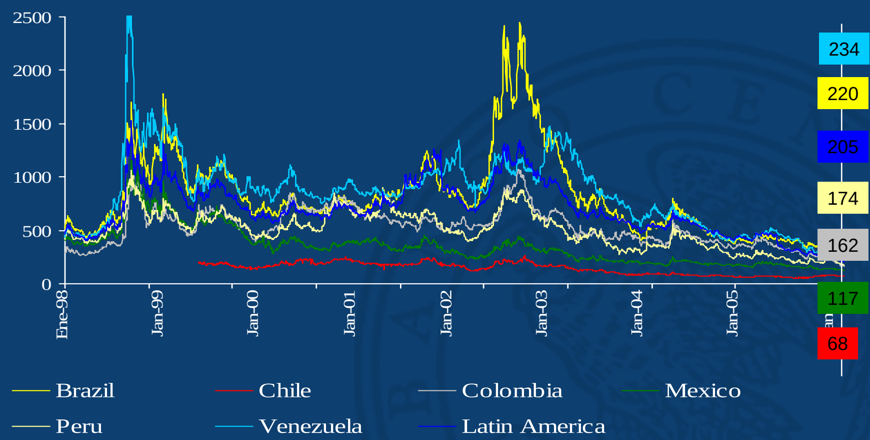
(1) Forecast for Argentina, Brazil, Colombia and Mexico.
Source: Moody's Financial Handbook. November 2005. Ministry of Finance of Chile.

Inflation Rates
(Annual average %)

	1980-89	1990-94	1995-99	2000-2004
Argentina	565.7	515.7	0.8	8.3
Bolivia	1383.1	13.4	7.4	3.0
Brazil	332.3	1690.2	19.4	8.7
Chile	21.4	17.5	6.0	2.8
Colombia	23.4	26.3	18.0	7.3
Mexico	69.1	16.3	24.5	6.0
Paraguay	20.5	23.3	9.7	9.2
Peru	481.3	1607.4	8.4	2.4
Uruguay	57.6	76.4	21.4	10.4
Venezuela	23.1	41.0	53.8	20.8
LA average	150.6	263.5	17.0	7.9

Source: IMF (2006).

Country Risk
(bips)



Source: JP Morgan (2006).

Is Latin America prepared?

- However, even if most Latin American countries have strong fundamentals, globalization makes the region's economies sensitive to how imbalances are solved.
- The international community agrees that an adjustment is required; "mid-air refueling" is not possible.
- The way global imbalances will unwind is not obvious.
- Impact on Latin America will depend critically on how the adjustment takes place. Country differences will arise according to their fiscal strenght and their monetary/exchange rate framework.

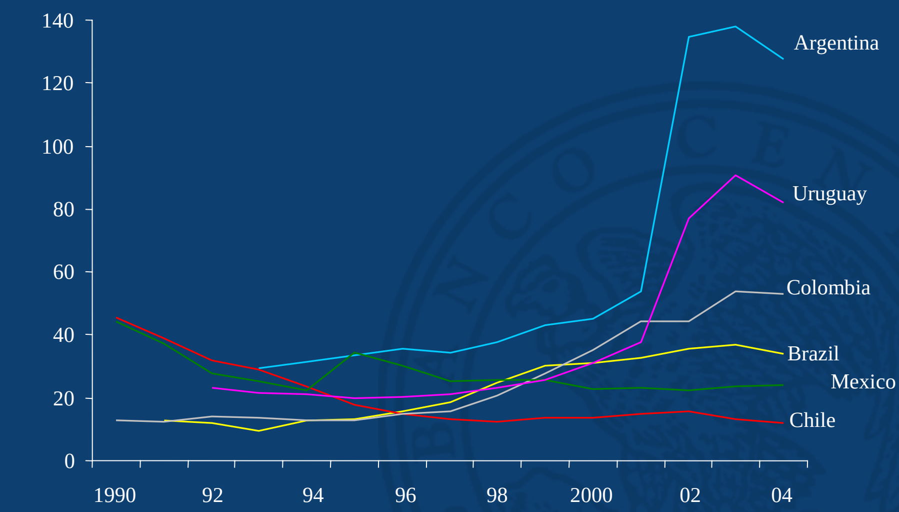
Is Latin America prepared?

- **“Hard Landing” or Disruptive Adjustment:**
  - Investors become unwilling to increase their holdings of US foreign assets:
    - Sudden stop in US, extended (Calvo) or not (Eichengreen) to other emerging economies;
  - Fiscal and monetary stimulus are abruptly withdrawn;
  - Proteccionism is installed as a means of controlling imports;
  - US interest rates increase and the US dollar overshoots.
- ***Consumption decelerates in the US without compensating increases in surplus countries. Significant slowdown of world output growth and US dollar depreciation.***

Is Latin America prepared?

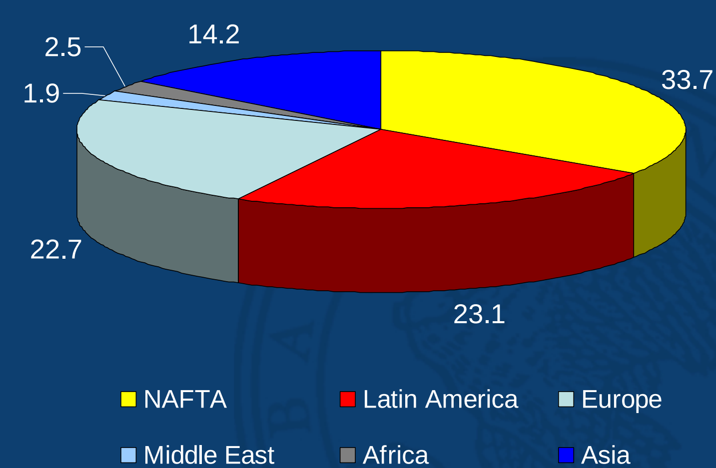
- **Latin America:**
  - Sovereign spreads expand;
  - Increasing interest rates affect countries with large public debt burden;
  - Reduction in US demand hurts more those countries with higher trade links with the US.
    - Mexico and Central America are more exposed under such definition.
    - However, despite increased diversification, NAFTA still buys 34% of total Latin American (excluding Mexico) exports.
- **A milder form of adjustment could come mostly through changes in financial prices.**

Public Debt* in Latin America
(selected countries, % GDP)



(*) Debt of central governments.
Source: ECLAC (2005).

Latin American Exports by Destination
(2004)



Source: WTO (2006).

Adjustment: Is Latin America prepared?

- **"Soft Landing" or Gradual Adjustment:**
  - Demand shifts gradually from deficit to surplus countries;
  - Consumption and asset prices smoothly converge to sustainable paths;
  - Debt valuation effect may reduce the need for abrupt exchange rate adjustment;
  - US savings increase, compensated by higher investment and/or consumption in the rest of the world, particularly emerging Asia and oil-producing countries.
  - Exchange rate flexibility in emerging Asia facilitates the adjustment.
- ***World output growth is not seriously affected: slowdown of US demand is partly offset by stronger demand elsewhere.***

Adjustment: Is Latin America prepared?

- Recent developments increase chances of gradual adjustment.
  - Positive signs of increasing demand in Japan and the European Union.
  - Signs of deceleration of US private consumption: recent indicators confirm slowdown of housing prices.
- Although less likely, the risk of a disruptive adjustment in still present.

3. Role of authorities

Role of authorities

- **Promote a gradual and cooperative adjustment:**
- Increase savings in the US
  - Fiscal effort;
  - Limit consumption growth and encourage private savings.
- Encourage private consumption in China
  - Financial sector reforms that improve households' access to credit;
  - Extension of social safety nets to reduce household´s precautionary savings.

Role of authorities

- Enhance investment in Emerging Asia:
  - Promote high-quality investment through structural reforms that raise expected rates of return:

    - Develop business environment;

    - Increase labor market flexibility:

    - Improve capital allocation by the financial sector.

- Use international forums to create awareness of the effects of re-balancing abruptly and promote cooperative solutions.
  - For example, IMFC April meeting agreed on giving a role to the IMF in analyzing and informing countries on the repercussions of global imbalances.

Role of authorities

- Ex-post reactions to minimize the costs of a sudden stop depends on monetary/exchange rate regime:
  - Countries with well anchored inflation expectations and low currency mismatches should allow exchange rate movements to "show" the way to new relative prices;
    - "Leaning against the wind" will only generate capital flight, financial instability, and credit crunch;
    - Countercyclical monetary and fiscal policies.
  - Other countries without well anchored inflation expectations have a more complex scenario: Real depreciation will be suppressed by higher inflation or depreciation will be contractionary when currency mismatches are high.
    - To avoid a major financial crisis, the only tool left is fiscal policy.

Role of authorities

- Uncertainty on how imbalances will unwind is at the core of policy making today. Monetary policy in emerging countries has very little impact, if any, on how they will be corrected. However, it certainly affects MP decision, implementation and effectiveness.
  - Greater uncertainty should be incorporated in forecasting output and prices.
  - Current global scenario also makes it harder to assess the impact of the present monetary stance on demand and inflation.
  - Credibility of inflation target must be retained to allow countercyclical policies when the adjustment takes place. However, Central Banks must be careful not to convey more certainty about what they know, than they actually have.

Role of Authorities

- Flexible exchange rate regime facilitates changes in relative prices.
- Sound domestic financial system serves as a precaution against international financial crisis when capital flows revert and lower the necessity of hoarding large foreign reserves.

4. Concluding remarks

Concluding remarks

- The way in which the global imbalances will unwind is one of the major uncertainties that central bankers face.
- Cooperative solution requires adjustment efforts from all key players: US, EU, Japan, oil exporters, and emerging Asia.
- In the meantime, other countries need to strengthen policies to prepare themselves for the uncertain world.

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