



**SPILLOVER EFFECTS OF THE ECONOMIC AND FINANCIAL
DEVELOPMENTS IN MATURE ECONOMIES: AN EMERGING
MARKET'S PERSPECTIVE***

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Thank you for inviting me to deliver the keynote speech at the Annual Meeting of the Group of Trustees of the Institute of International Finance. This time I have been asked to talk about the spillover effects on emerging markets of the economic and financial developments in advanced economies.

Since the onset of the Great Recession, growth rates in advanced economies have remained low while unemployment rates have remained high. The recession also uncovered and aggravated a number of financial and fiscal problems that through time have limited the ability of fiscal and monetary policy to provide additional stimulus in these economies. Meanwhile, several countries have been forced to engage in processes of consolidation to restore fiscal solvency. Uncertainty about the future path of fiscal and financial policies has triggered sudden changes in investor sentiment and market volatility. In this scenario, central banks have responded forcefully, keeping policy interest rates at historically low levels, and in some cases exhausting the standard policy tools and experimenting with unconventional alternatives.

While progress has been made in some fronts, problems in advanced economies are such that the main aspects of this scenario (i.e., low growth, expansionary monetary policy, fiscal consolidation and market volatility) are likely to continue for the coming years. In fact, according to the recently released World Economic Outlook (WEO), projections of growth in advanced economies for 2012 and 2013 are 1.3 and 1.5 percent respectively, a downward revision from previous projections, and interest rates are projected to remain low until 2015, according to the statements of monetary authorities.

In an increasingly integrated world, the developments in advanced economies have spilled over to emerging markets on several fronts. For the purposes of today's discussion, I will distinguish between spillovers operating through trade, financial, and policy channels, although, of course, this distinction is somewhat artificial as all types of spillovers interact and reinforce one another.

The trade channel

On the real side, the main impact of the economic slowdown in advanced economies on the rest of the world comes from the trade channel. Weak economic activity in these countries results in low global demand for all goods, including imports from the rest of the world. Since advanced economies still represent the core of global activity and demand, this channel has a direct impact on the exports of most countries.

However, the quantitative importance of spillovers through the trade channel is heterogeneous across countries. It depends on the direct and indirect importance of advanced economies for a country's exports, and it also relates to the relevance of manufactured and durable goods in its export basket.

Countries that usually direct a larger share of their exports to advanced economies are particularly affected. Everything else equal, they see their main export markets shrink, and their net exports and domestic activity decline. For instance, China, one of the main exporters to the US and Europe, has seen its exports' growth rate decline significantly.

On the other hand, countries that do not trade heavily with advanced economies but do with countries that are dependent on advanced economies are also indirectly affected. In an increasingly interconnected world, these indirect effects can be equally important.

China, again offers a nice example of this indirect propagation. China itself has become a relevant player in global markets, becoming a significant trading partner for many developed and emerging economies, particularly in Asia and Latin America. Thus, a slowdown in advanced economies may have an indirect effect on China's trading partners, to the extent that Chinese domestic demand cannot fully substitute for the decline in its exports.

For several structural reasons, manufacturing activity in advanced economies has declined and moved to developing countries in recent decades. So, nowadays, advanced economies tend to import a higher share of manufactured goods and a lower share of industrial commodities than in the past. At the same time, some emerging market economies, particularly China, have become large importers of industrial commodities for using in both manufacturing and investment.

Manufactures producing countries were, therefore, more directly vulnerable to a slowdown in advanced economies than commodity producing countries. The latter have benefited from the relatively good performance of commodity importers.

Finally, on top of the relatively more favorable state of global demand for commodity producing countries, global liquidity conditions may have also helped sustain commodity prices. The low global interest rates prevailing in advanced economies has contributed to push up the prices of commodities by reducing the cost of storage and by the effect of the depreciation of the dollar on the dollar price of commodities. This channel is at least partially financial, so allow me to use it as a starting point to turn now to the financial spillovers from events in advanced economies to emerging markets.

Financial spillovers

Emerging markets are today much more closely integrated to global capital markets than they were in the past. As a result, the financial transmission channels from advanced economies to emerging markets work with greater intensity. It is not my goal to be exhaustive in the description of these channels. Instead, I will highlight what I consider to be the main channels nowadays, as well as those that pose the largest policy challenges.

The uncertainty about the resolution of the structural problems of Europe and the US has resulted in a more cautious attitude of investors, and a corresponding decline in the prices of risky assets. For instance, global stock prices have not fully recovered their 2007 levels and EMBI Global spreads are also higher than in August 2007. Furthermore, this uncertainty has also resulted in episodic fluctuations in investors' risk appetite and the prices of risky assets around policy announcements—or lack thereof. During these episodes, corporate and sovereign spreads, as well as stock prices and exchange rates, have experienced sharp movements.

The danger with this form of financial transmission of events in advanced economies to emerging markets lies on its speed. We saw this in the days after the collapse of *Lehman Brothers*, where funding spreads skyrocketed worldwide in a matter of days. These sudden fluctuations may quickly put financial institutions under undue stress, and requires constant monitoring. While financial

markets have been more benign recently, we saw some worrying developments in the second half of 2011. As long as the uncertainty about the resolution of the sovereign crisis in the Eurozone and the fiscal cliff in the US remains, we cannot dismiss this channel of transmission.

Financial spillovers to emerging economies not only occur through the prices of financial assets, but also through quantities and the prices of real assets. In the aftermath of the Great Recession, advanced economies engaged in strongly expansionary monetary policies. Policy interest rates were driven down to or near their zero lower bound, and after that limit was reached, unconventional policies were deployed to push further down the yields of various types of long term assets. Unsurprisingly, recent years have seen a large expansion of global liquidity.

This expansion in global liquidity has coincided with an important increase in gross capital inflows to many emerging markets, especially those in Asia and Latin America. These surges in inflows have been associated in some cases with expansions in domestic credit, real exchange rate appreciations, and housing price increases.

Part of the increase in capital inflows to emerging markets is surely related to fundamentals. Emerging markets in general, and Latin America in particular, have exhibited relative strength compared to advanced economies in the aftermath of the crisis. For instance, while it used to be the case that “when the US sneezes Latin America catches a cold”, this time Latin American emerging economies recovered faster from the Great Recession than advanced countries.

Although the sluggish recovery of the advanced world has undoubtedly affected emerging markets’ growth prospects, many emerging markets are still expanding at good rates. For instance, our latest projection for the growth of GDP in Chile in 2012 is in the range of 4.75-5.25 percent. Similarly, our projection for GDP growth in 2013 is that it will be between 4 and 5 percent. In addition, the resilience of several emerging economies to the worst episodes of the Great Recession showed that the institutional and policy framework of these countries has exhibited significant improvements in the last decades. Another reason to believe that fundamentals are partly behind capital inflows to emerging economies is that not all emerging markets have experienced the same ease of access to international financing. Some emerging economies with weaker fundamentals are having trouble getting access to credit.

However, the coincidence between the expansion in global liquidity conditions and capital inflows suggests that they are related. The volume and composition of the inflows, more heavily tilted to volatile portfolio flows, has led policymakers in various emerging markets (and some developed countries too) to worry about them being “excessive” and voice various concerns about these developments.

The concerns come from two fronts. First, several emerging markets have experienced a persistent appreciation of their currencies. Under some conditions, a persistent appreciation of the currency may have long lasting impacts on the productive structure of a country with relevant welfare costs after the appreciation reverses. Second, a quick expansion of credit in an underdeveloped financial system that cannot properly allocate the new funds may result in mismatches and vulnerabilities in the financial system. In fact, one of the lessons of the subprime crisis is that even relatively sophisticated financial systems may have trouble dealing with a fast expansion in credit.

The worries of emerging markets about the capital flow spillovers of monetary policy in advanced countries also come from the historical experience of EMEs with past episodes of so called “sudden stops”. These sudden stops were frequently preceded by surges in capital inflows, exchange rate appreciations, and housing price increases like the ones recently observed. The possibility of a sudden reversal is not purely hypothetical. Even during the last couple of years, where differences in performance between emerging and advanced economies have persisted, episodes of extreme uncertainty and risk aversion in international financial markets have resulted in fast retrenchments of global investors from emerging markets toward some “safe haven” assets.

In reaction to the concerns about this form of financial spillovers, some emerging markets have implemented various types of policies. This has produced another type of spillover, a policy spillover.

Policy spillovers

As previously discussed, monetary authorities of advanced economies have reacted strongly to reduce the macroeconomic consequences of the recent developments in the US and the Eurozone. Short and long term interest rates have been slashed in an effort to stimulate domestic demand. These measures have also created pressures for the depreciation of the currencies of advanced economies against countries that are not taking such an aggressive monetary policy stance.

We understand that for advanced economies this is a healthy and necessary policy response. Facing a limited ability to stimulate domestic demand because of both fiscal constraints and a desire to reduce leverage by households and companies, a depreciation of the currencies of advanced economies is another way of boosting external demand for their goods. The flipside of these developments, of course, is an increase in capital inflows to emerging markets and an appreciation of their currencies, as previously described, which may interact with other distortions on their economies creating a policy problem.

The concerns of emerging markets about the increase in capital inflows, currency appreciation, and domestic credit expansions have led some of them to undertake policies aimed to tame these phenomena. Thus, policy actions in developed countries have induced policy responses in some emerging economies. On the one hand, there are the traditional adjustments to fiscal and monetary policies. For instance, a tighter fiscal policy leaves room for a more expansionary monetary policy reducing interest rate differentials with advanced economies. However, there are limits to the contribution of fiscal policy. If you already have a budget surplus and net public debt is negative, as it is the case of Chile, it is clear that fiscal policy is already making a significant contribution to achieve a better macroeconomic balance. More fiscal adjustment could help but there are other considerations that must be taken into account.

On the other hand, there are the less traditional policies. The range of these policies undertaken by emerging markets in recent years is broad. Overall, they fall into three groups. First, macroprudential measures aimed at reducing the imbalances and vulnerabilities that may arise in the domestic financial system as a result of the quick expansion of its intermediation of funds. Second, interventions in the foreign exchange market that attempt to reduce the volatility of exchange rates or contain its appreciation. Finally, capital controls trying to reduce the entry of some or all forms of capital owned by non-residents. The line between these different categories is

not always clear. Some countries consider capital controls or exchange rate interventions as macroprudential tools and some macroprudential tools can also be used to depreciate the currency or tame capital inflows.

The effectiveness of these various policies in achieving their stated goals is still under debate and probably depends on the specific circumstances faced by each country. On the other hand, it is clear that the implementation of these types of policies is not free of potential costs, such as those resulting from distorting allocations, creating confusion regarding the objective of monetary authorities, or deadweight losses from the efforts of private agents to comply with them or try to evade them. For these reasons, we, at the Central Bank of Chile, believe that they should be considered only under exceptional circumstances and with the goal of tackling specific short term misalignments rather than leaning against medium to long term trends.

Final thoughts

The current situation in developed economies is very complex, and teaches valuable lessons. Probably the most important one is that imbalances that are not addressed in time end up creating enormous costs for the population. For those of us in charge of economic policy in our countries, it is absolutely essential that we strive to address these imbalances if they exist, and at the same time that we do not create them through our decisions. One way Chile has tried to minimize the potential appearance of imbalances has been through a fiscal policy that is accountable and predictable thanks to a structural balance rule. The significant amount of savings accumulated during the run-up of copper prices has been a crucial factor in bolstering the resilience of the Chilean economy and provided room for a countercyclical fiscal boost during 2009. Another challenge of EMEs is to take measures to raise productivity. This is key from a long-term perspective.

The outlook for advanced economies suggests that the trade and financial spillovers to emerging markets we have seen in recent years are likely to remain large in the near future. The concerns of emerging economies about some of these spillovers, especially those related to capital inflows and exchange rate movements are also likely to remain in place.

In this scenario, one of the challenges we face as policymakers is to avoid a combination and escalation of beggar-thy-neighbor and bubble-thy-neighbor policies. This requires a mutual understanding of the needs and concerns of advanced and emerging economies. While the former may benefit from a boost in external demand coming from emerging markets, the latter may reasonably worry about the potential consequences of quickly losing access to international capital in the future. Finding a solution that is mutually beneficial is both crucial and possible.