DOCUMENTOS DE POLÍTICA ECONÓMICA

Latin America´s Challenges in an Era of Secular Stagnation

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N.º 60 Octubre 2016

BANCO CENTRAL DE CHILE

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Documentos de Política Económica del Banco Central de Chile
Economic Policy Papers of the Central Bank of Chile
ISSN 0717-7151

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Desafíos para América Latina en una Era de Estancamiento Secular*

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Resumen

Este documento describe algunos de los desafíos que un entorno de estancamiento secular plantea a América Latina. Crecimiento bajo e inversión deprimida en las economías avanzadas, y en China, limitan el crecimiento potencial de la región, resaltando las brechas que ha mostrado en décadas pasadas asociadas al débil proceso de acumulación de capital físico y humano. Sin embargo, la transmisión de la política monetaria en el mundo se ha vuelto desequilibrada. Mientras la transmisión habitual de tasas bajas en el mundo opera vía apreciación cambiaria y flujos de capitales que son expansivos, las peculiaridades de las circunstancias actuales implican que el canal cambiario es más potente. Por lo tanto, luego de experimentar alta inflación y altas tasas de interés en años recientes, las economías Latinoamericanas enfrentan ahora perspectivas de apreciación cambiaria y menor inflación. Esto da espacio para que la política monetaria se torne más acomodaticia, lo que es un contrapeso al entorno de estancamiento secular en el mundo y los límites al espacio fiscal en la región.

Latin America's Challenges in an Era of Secular Stagnation

Summary

This document outlines some of the challenges an environment of secular stagnation poses for Latin America. Low growth and tepid investment in advanced economies, as well as China, limits growth potential in the region, highlighting the gaps it has experienced in past decades regarding human and physical capital accumulation. However, the transmission of monetary policy elsewhere in the world to Latin American economies has become lopsided. Whereas the traditional spillovers of low interest rates in the world operates through both appreciating exchange rates and expansionary cross-border credit flows, the peculiarities of the current circumstances imply that the exchange rate channel is more potent. Thus, after enduring high inflation and high interest rates in the past few years, Latin American economies face now the prospects of appreciating currencies and disinflationary pressures. This provides room for monetary policy easing, which is a silver lining to the environment of secular stagnation in the world and limited fiscal space in the region.

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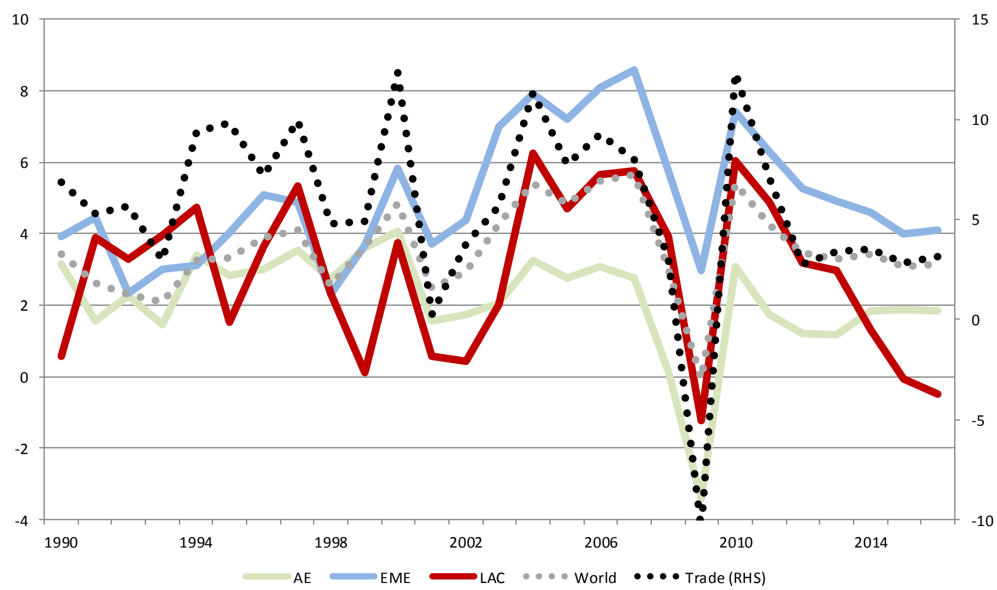
* Lecture presented at the Peterson Institute for International Finance, October 7th 2016.

Latin America faces today significant growth and adjustment challenges. Indeed, the pace of economic growth in Latin America has been below disappointing in recent years. Not since the episodes of the severe sovereign, financial and exchange rate crisis of early in this century we have witnessed such an underperforming of growth, compared to the world as a whole, and compared to both to advanced and emerging economies.

Figure 1 – Comparative growth performance



Source: World Economic Outlook, April 2016

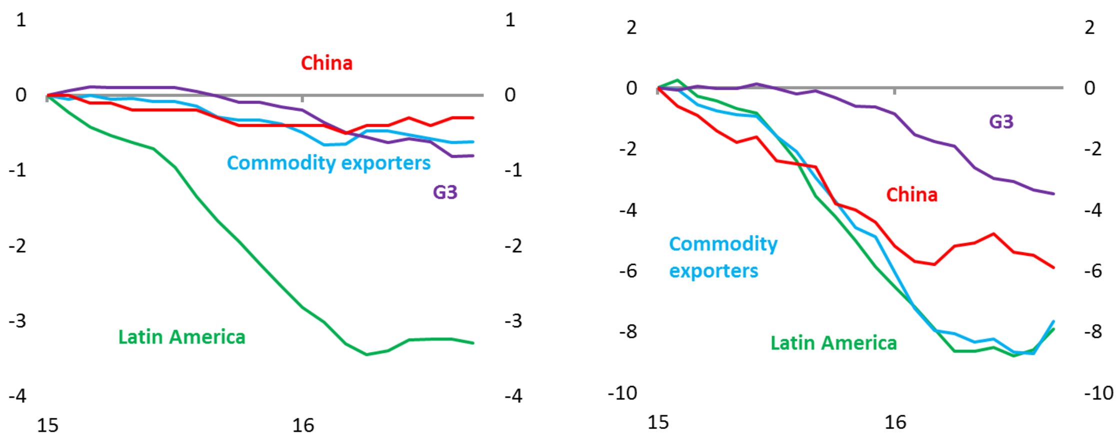
It could be argued that the openness of LAC economies has determined its growth performance over time. Given that international trade has remained muted, then maybe there lies the explanation for the weak growth in LAC? The answer is no. Admittedly global trade shows now a marked deceleration compared with the nineties, but it has remained stable following up overall global economic growth since the beginning of the decade. Thus, underperformance by LAC is still apparent once contrasted with the ups and downs of global trade.

Forming up a view regarding the short term vs long term nature of this growth slump is particularly challenging is the current characteristics of the global growth process, usually dubbed secular stagnation, where "[economies] suffer from an imbalance resulting from an increasing propensity to save and a decreasing propensity to invest. The result is that excessive saving acts as a drag on demand, reducing growth and inflation, and the imbalance between savings and investment pulls down real interest rates".[1]

[1] Summers, L. (2016), "The Age of Secular Stagnation: What It Is and What to Do About It", Foreign Affairs, February.

It is hard to argue that some of these aspects might be at play once one looks at the revisions in expected growth and investment across different regions. Across the globe we have seen material downgrades in both variables since early last year, a pattern that can actually be traced to even earlier. It is noteworthy that although the contraction in expected investment growth is widely shared across economies, Latin America boasts the largest cumulative decline in expected GDP growth for 2016. (Figure 2)

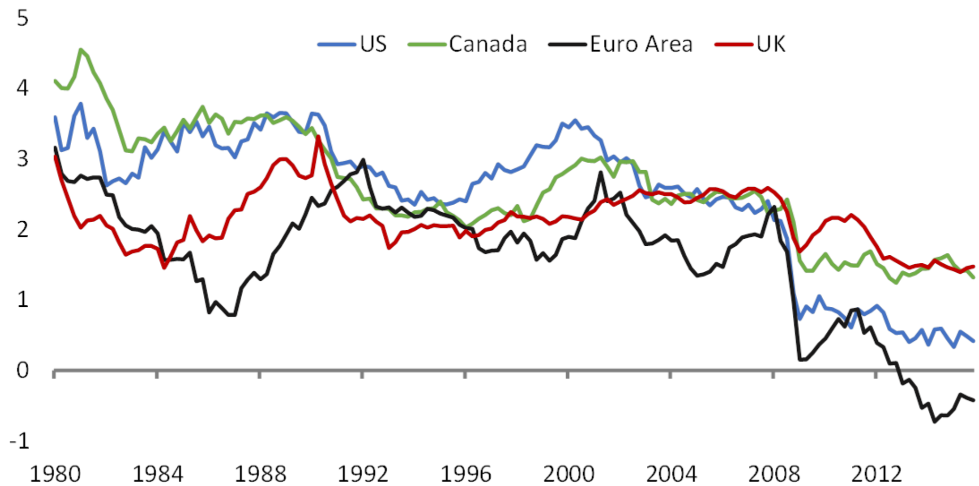
Figure 2 – Expected 2016 Growth and Investment revisions since January 2015



Source: Consensus Forecast. Commodity exporters include Australia, Canada and New Zealand.

As a response to low trend and actual growth, low growth of real incomes, high savings relative to investment, and low or even negative inflation, neutral interest rates have been estimated to have declined. Recent studies show that the level of the neutral real interest rate has actually fallen systematically around the world, and may even indicate real neutral monetary policy rates that are negative. This has been one of the reasons used to justify the need for ultra loose monetary policy stances in mayor advanced economies. (Figure 3)

Figure 3 – Real neutral interest rate in advanced economies



Source: K. Holston, T. Laubach and J.C Williams (2016), "Measuring the Natural Rate of Interest: International Trends and Determinants," August.

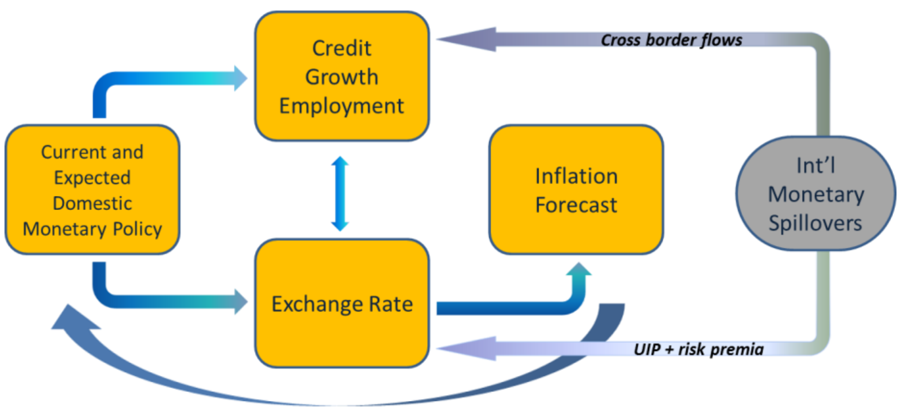
The implications of a persistent secular stagnation, with the resulting ultra-loose monetary stimulus in the advanced economies, needs to be seriously taken into account for Latin America's prospects. This is either is a risk scenario with a high likelihood of occurrence, or it is actually the current reasonable baseline. Either way, we need to ponder what the implications of secular stagnation can be for growth in Latin America going forward.

From this vantage I will elaborate three main themes in my presentation. Firstly, I will discuss how the ultra loose monetary policies in Advanced Economies have changed or distorted the standard international monetary transmission mechanism, and will contrast the current situation with the immediate aftermath of the Great Financial Crisis. I believe this change has bearings on the nature of the cross border spillovers from monetary policies to Latin America. Secondly, secular stagnation has implications for medium term growth. It will be useful to recap what the views are regarding the drivers of growth for Latin America, and how secular stagnation can affect them. Thirdly, I will conclude by discussing to what extent we have the appropriate policy levers and policy space in Latin America to manage the implications of these policies in the short term, as well as what challenges we face in the medium run to achieve higher and sustainable rates of economic growth.

The implications of extraordinary monetary measures in advanced economies

A useful starting point is a simplified version of the mechanism of monetary policy transmissions and international spillovers.[2] A common approach is to visualize domestic the monetary policy stance (current and expected) affects expected inflation by way of two main channels: the credit and expenditure channel and the exchange rate channel. A monetary expansion results in increased inflation through both channels, as it encourages credit generation, provides incentives to anticipate consumption and investment decisions, boosts employment, while at the same time depreciating on impact the value of the currency, as shown in the diagram below.

Figure 4 – Mechanisms of monetary policy transmission



It is straightforward to add an international dimension to this view, driven by the spillovers of monetary policy in the rest of the world. International monetary conditions will affect cross border portfolio and direct investment flows, through bank and non-bank intermediaries, and will as well have an impact in currency valuations (amongst other asset prices). In a simplified way, his will impact domestic inflation through similar channels as domestic monetary policy: on the one hand cross-border flows change local borrowing and lending conditions, which have an effect on the aggregate real economy, whilst exchange rate movements impact the domestic prices of imported goods.

How does this play out in terms of the implications for domestic monetary policy? Let's take as an example a monetary easing in the United States to deal with a debilitated US economy. This will encourage lending and risk taking, will depreciate the dollar against other currencies in the world and will push up commodity prices.

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[2] A more detailed version of the transmission mechanisms as seen at the Central Bank of Chile can be found in "Central Bank of Chile: Monetary Policy in an Inflation Targeting Framework" (2007), box No. 5.

Across the world economies see their currencies strengthen and experience capital flowing in. Since the domestic dynamics are not necessarily those of the US, it may be expected that monetary policy will become tighter to avoid an inflationary surge. Such a tighter policy is in turn consistent with the appreciating currencies vis-à-vis the US Dollar.

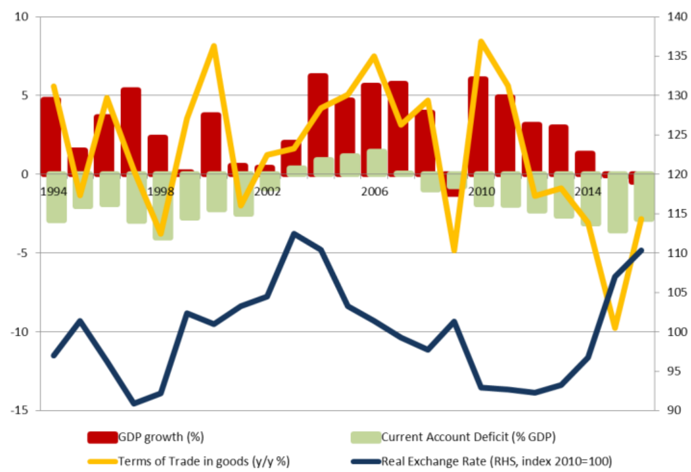
Over time, to the extent that lax monetary policy in the US succeeds in boosting growth and raising expected inflation, interest rate increases, strengthening the dollar in the world and reversing the previous process. Thus, as the US economy strengthens, the other economies are confronted with depreciating exchange rates pressures and capital outflows, pushing them into a weakening cycle that is addressed with a looser monetary policy. Thus, some degree of monetary policy autonomy is achieved from this exchange rate flexibility, easing the process of adjustment insofar it smooths the ebbs and flows of global financial conditions and limits the extent of boom-bust credit swings and foreign exchange accumulation/deccumulation cycles.

The way the international adjustment mechanism works in principle helps channel fluctuations in price pressures through current account and exchange rate movements. In periods of high growth, cost-push pressures from reduced slack in the economy are partially offset by a strengthened currency, and the significant vigor of domestic demand shifts to the imported components of expenditure. Conversely, in periods of slowdown the current account deficit narrows, the exchange rate weakens, and inflationary pressures over the medium term ease up. If monetary policy is credible, it can actually engage in countercyclical monetary policy, accommodating the real and monetary adjustment to changing global circumstances.

The past few decades in Latin America provide a good case study of this standard model of international macroeconomic adjustment. Periods of looser monetary policy in advanced economies (particularly the US), coincided with an upswing in economic growth, increased capital inflows and current account deficits. (Figure 5) Reversal of these circumstances then led to economic slowdowns if not outright recessions.

The average Latin American story from this prism hides significant heterogeneity. It is painfully clear that these swings not always, if ever, allowed a smoothing through countercyclical monetary policy reaction. Chile is a good example in which this was the case.

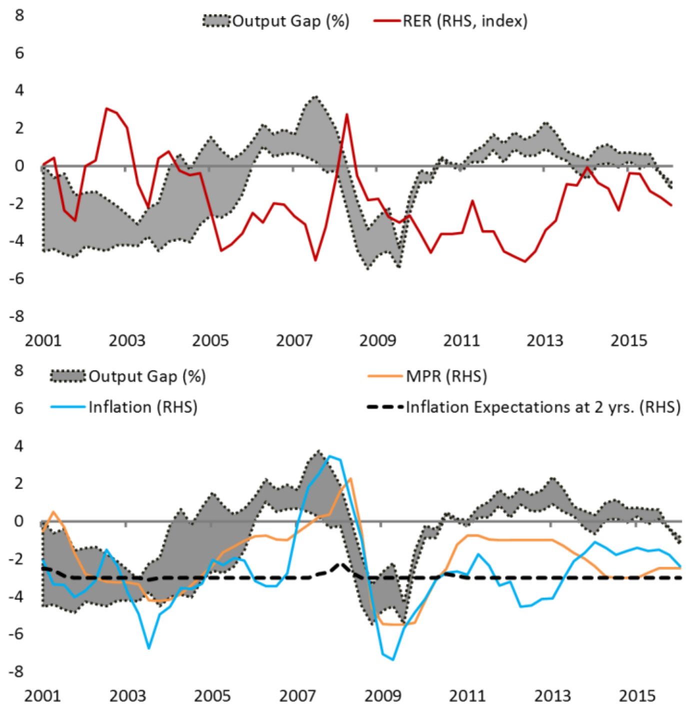
Figure 5 – Macroeconomic cycle in Latin America, 1994 - 2016



Sources: World Economic Outlook and Bank for International Settlements.
Real Exchange Rate (RER) index the simple average of Brazil, Colombia, Chile, Mexico and Perú. An increase denotes a depreciation.
2016 considers IMF forecasts and information as of August for the RER.

The broad contours of the process mentioned above transpired in Chile in a context of sustained price and financial stability. The immediate post GFC period saw a sharp increase in growth, a strengthening currency, and very low inflation, in spite of which monetary policy quickly tightened. Conversely, over the post Taper Tantrum period, growth stalled, the currency weakened, inflation increased, and monetary policy shifted to a stimulative stance. Throughout these ups and downs in the cycle, expected inflation remained strongly aligned with the 3% target. (Figure 6)

Figure 6 – Macroeconomic cycle in Chile, 2001 - 2016



Source: Central Bank of Chile. The output gap bands reflects the range of different estimates.

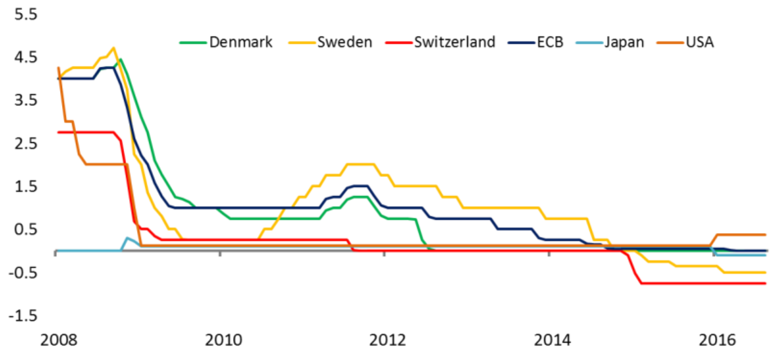
The prevalence of ultra-expansionary monetary policies in the developed world hinders the direct application of this vision of the international monetary adjustment. I don't think we can blame it on a failure of the model, rather it is a challenge to ponder what are the innovative elements we must input and how they affect the international transmission.

It may be odd to bring up this subject as original, since "we were there" in the period 2010-2013. But today's circumstance is qualitatively and quantitatively different. Not only have monetary policy rates pierced their theoretical zero lower bound (in the Eurozone, Sweden, Switzerland and Denmark), but huge quantitative expansions (QE) have been added to the short-term interest rate policy by the European Central Bank and the Bank of Japan. This has resulted in the yields on sovereign bonds from several advanced economies plummeting.

Although the US Federal Reserve is in a different situation, the maintenance for quite longer of a looser monetary policy also is part and parcel of this extraordinary monetary stimulus across the globe. (Figure 7)

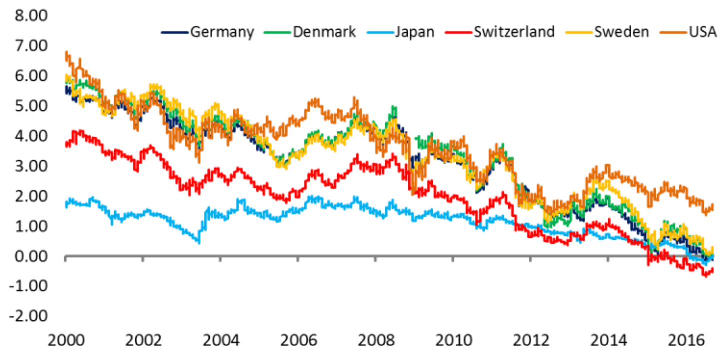
Figure 7 – Monetary policy across advanced economies

Short-term interest rates



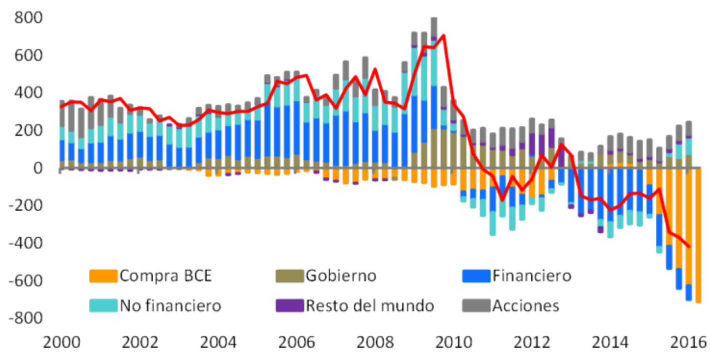
(*) Solid line shows monetary policy rates; dotted lines show overnight deposit rates.

Long-term interest rates



Source: Bloomberg.

Net supply of securities in the Eurozone

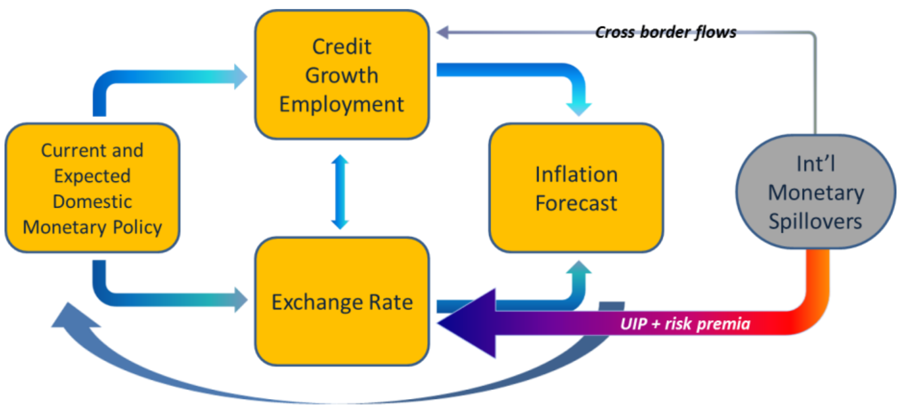


(*) Includes purchases under the ECB's QE program and longer-term refinancing operations (LTROs). Moving sum of 4 quarters.
Source: Citi Research.

The transmission of this type of monetary easing differs materially from the standard case. Due to market structure, competitive practices, and in some cases regulatory constraints, negative short-term interest rates have not been transmitted fully into equally negative deposit rates for retail bank clients in these economies. Since central banks have also used quantitative easing in a whole set of assets, market interest rates and credit risk premiums have contracted. This mix of policies has implied that the typical positive effect of an expansionary monetary policy on bank's interest spreads, consistent with a steepening of the yield curve, has not materialized as strongly in the current juncture. Some even argue that it might be operating inversely.[3]

On the contrary, the effect of this monetary policy via the exchange rate channel operates with no impediment, or even more powerfully, thanks to the specifics of the quantitative easing process of the central banks. These prevent the yield curve from a steepening that would constrain to some extent the exchange rate pass-through. This has been coupled in some cases by massive forex interventions. The combination of secular stagnation, quantitative easing, and low or negative short terms interest rates, makes the spillover effects from global monetary policy has become lopsided towards disinflation in emerging economies. (Figure 8)

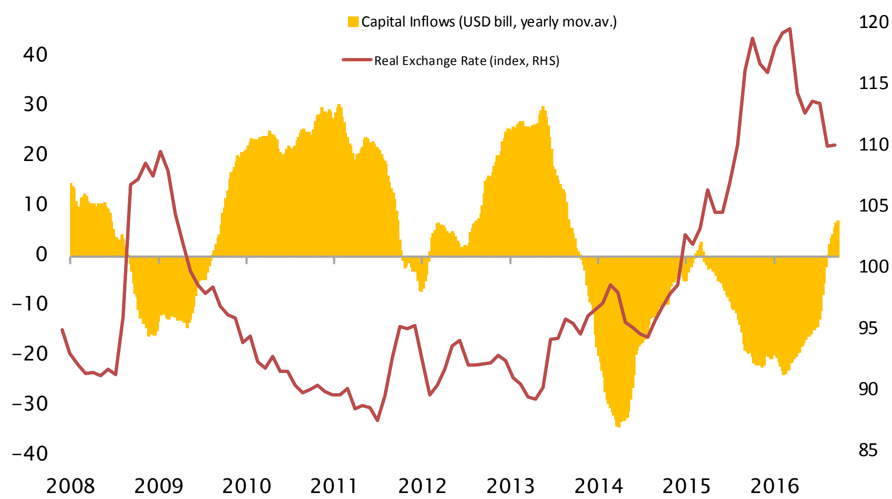
Figure 8 – Mechanisms of monetary policy transmission under secular stagnation, QE and NIRP



I believe this kind of phenomenon is behind the developments of the past year: more expansionary monetary policies in the advanced economies buttress appreciating currencies, but with only a very tepid reaction from capital flows, credit, spending and activity. The disconnect between global interest rates that remain at historic lows, similar to those we experienced in 2010-2012, a real exchange rate that has been appreciating, and lack of capital inflows is telling. The lack of sustained recovery in commodity prices is another reflection of this lopsided international transmission of monetary policy. (Figure 9)

[3] M. Brunnermeier and Y. Koby (2016)

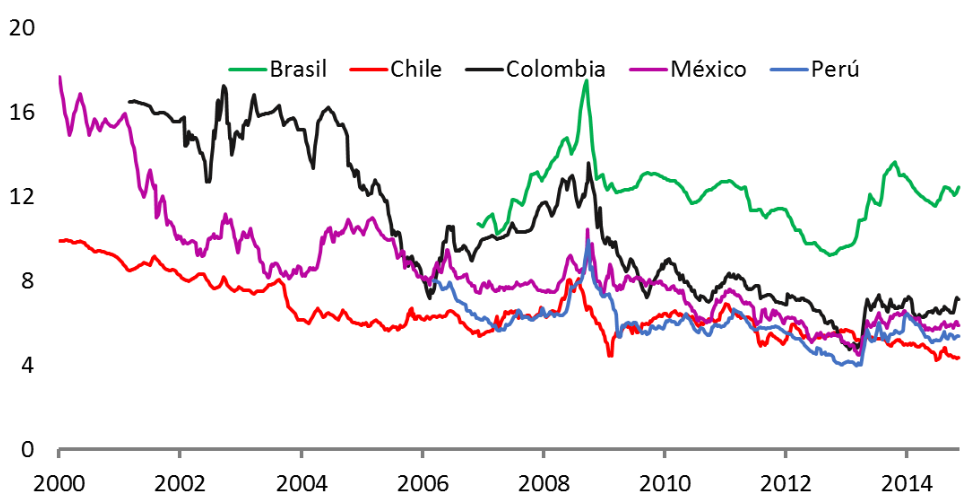
Figure 9 – Capital flows and the real exchange rate in Latin America



Sources: BIS, EPFR

One can note that Latin American economies are small and quite integrated. Therefore these financial factors have effects on our domestic financial markets. Specifically, the equilibrium with low real long-term interest rates in the world has also shifted towards our own financial markets, which in several cases display a clear downward trend. (Figure 10)

Figure 10 – Long term interest rates in Latin America



Source: Bloomberg

This may signify that stabilizing inflation also requires a lower neutral interest rate. At the Central Bank of Chile we have taken that into consideration into our own forecasting and policy analysis.[4] [5]

The anemic growth in investment around the world also takes a toll on the country's capital accumulation and economic growth. To the extent that the saving and investment equilibrium in the advanced world tends to generate smaller current account deficits—or greater surpluses—, pressures will push the opposite way in emerging economies, encouraging further exchange rate appreciation but with no commensurate increase in economic activity.

Medium term growth challenges for Latin America

Looking over the medium term, what kind of effects, beyond the obvious ones, could be expected from secular stagnation on growth in Latin America? To answer that question we need to look at the drivers of growth: trade linkages, capital accumulation, educational attainment.

To start, a clear link appears in that the swings in economic growth follow quite closely the swings in the terms of trade in LAC economies. Almost to a hilt, since 1990 years of increasing terms of trade are years of accelerating growth. There are a few exceptions, again in the early nineties, and more recently when the economy has kept on contracting even though the terms of trade recovered somewhat.

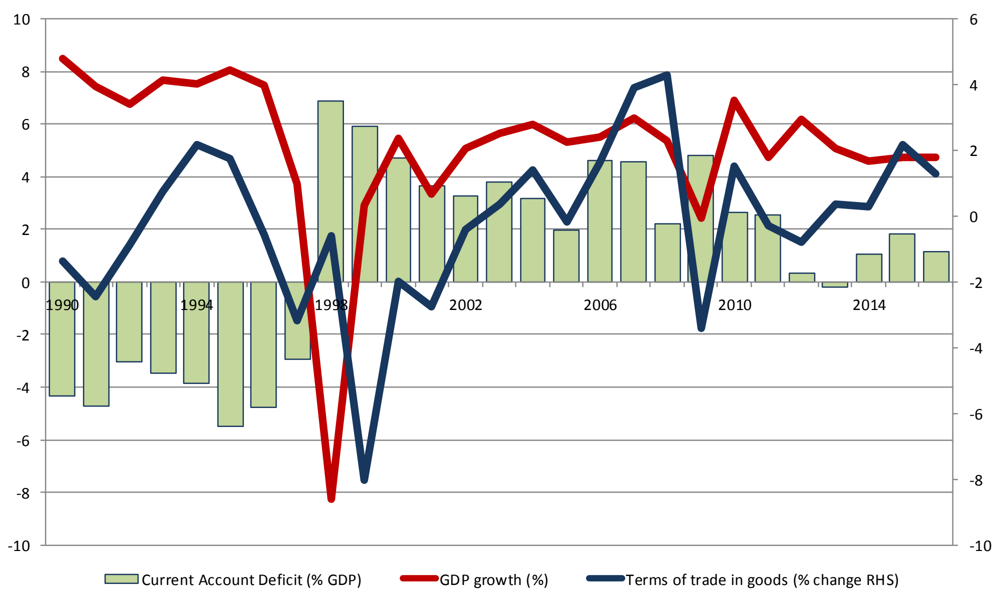
Moreover, apart from a few years right before the GFC, LAC economies have seen a systematic deficit in the current account. The relationship between capital flows, the current account deficit and growth is not obvious due precisely to the terms of trade. During periods of expansion, capital inflows finance domestic credit flows to investment and consumption, over and above the boost provided by terms of trade gains, whereas in periods of contraction, the plummeting terms of trade imply also the need for increased external finance to limit the extent of contraction in domestic demand.

These patterns of growth and the terms of trade are distinct from what can be seen in other regions. A fair comparison is with ASEAN-5 economies. They are at a similar stage of development, they have transited from a periods of authoritarian rule to a higher degree of democratization, and they boast abundant natural resources. They have also shown a

[4] L.O. Herrera and R. Caputo (2013).
[5] L. Ceballos, J. Fornero and A. Gatty (2016).

markedly fast development of their manufacturing sector. The patterns of growth, terms of trade and the current account are significantly different that in LAC. (Figure 10)

Figure 10 – Growth, terms of trade and the current account in ASEAN-5



Source: World Economic Outlook, April 2016.

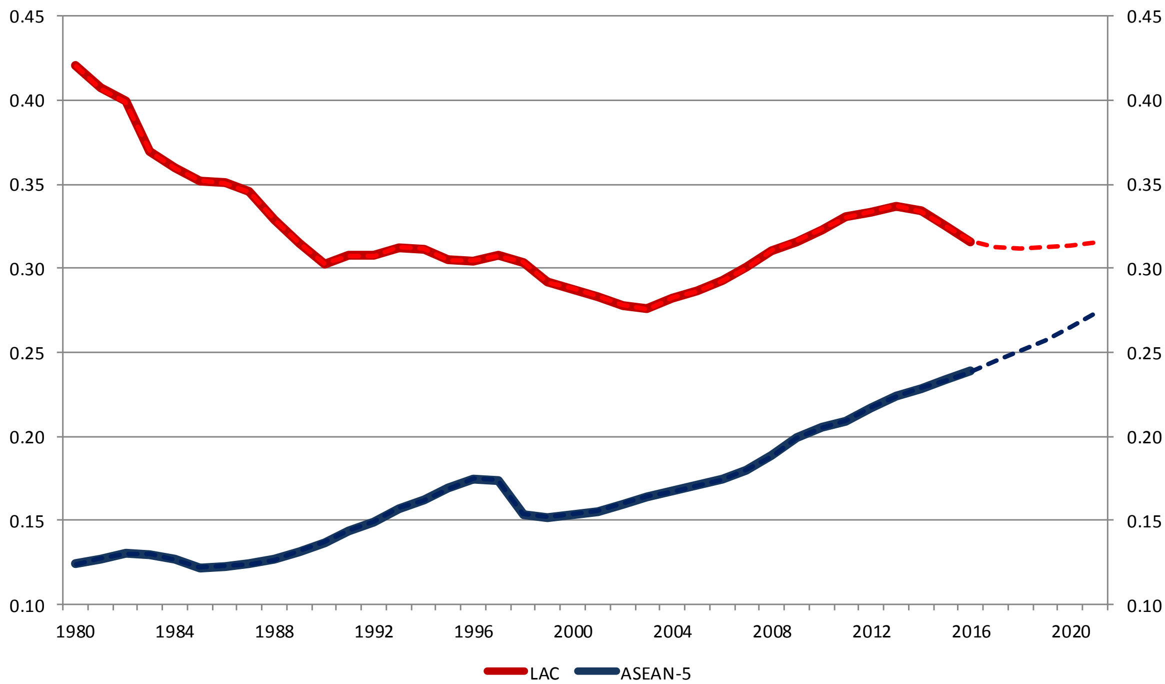
Economic growth has been significantly less volatile than in LAC. After a very quick recovery in the aftermath of the Asian crisis, growth has remained stable within a relatively narrow range of 4 to 6% per year. The GFC did have an impact but it was exceedingly minor. More importantly, the link to terms of trade fluctuations is materially weaker than in the case of LAC. Note that the economic recovery proceeded apace after the Asian crisis even through the terms of trade continued to contract. The follow-up increase in the terms of trade in the years previous to the GFC did not appear to be associated with significant growth acceleration, and as mentioned the impact of the GFC to the terms of trade was significantly larger than to growth. More recently, even though the terms of trade have remained quite stable, economic growth has resumed and is stable.

Another striking difference with the patterns in LAC was the turnaround in the current account balances after the Asian Crisis. Whereas in the nineties this grouping of economies experienced current account deficits of around 5% of GDP, after the Asian crisis surpluses have been the norm. Unlike LAC, the current account reversal of the late nineties has been persistent in ASEAN-5.

Regarding the underlying determinants of growth, Latin America and the ASEAN-5 economies also display significant differences. In spite of currently having similar levels of

GDP per capita, the trend since the early eighties cannot have been different. Whereas the ASEAN economies seem to display the usual convergence story, steadily closing the gap, LAC countries showed divergence, during the lost decade of the eighties, and then a stabilization around a third of the G7 per capita GDP.   Note how recent years have erased a sizeable fraction of the relative increase since the start of this century.

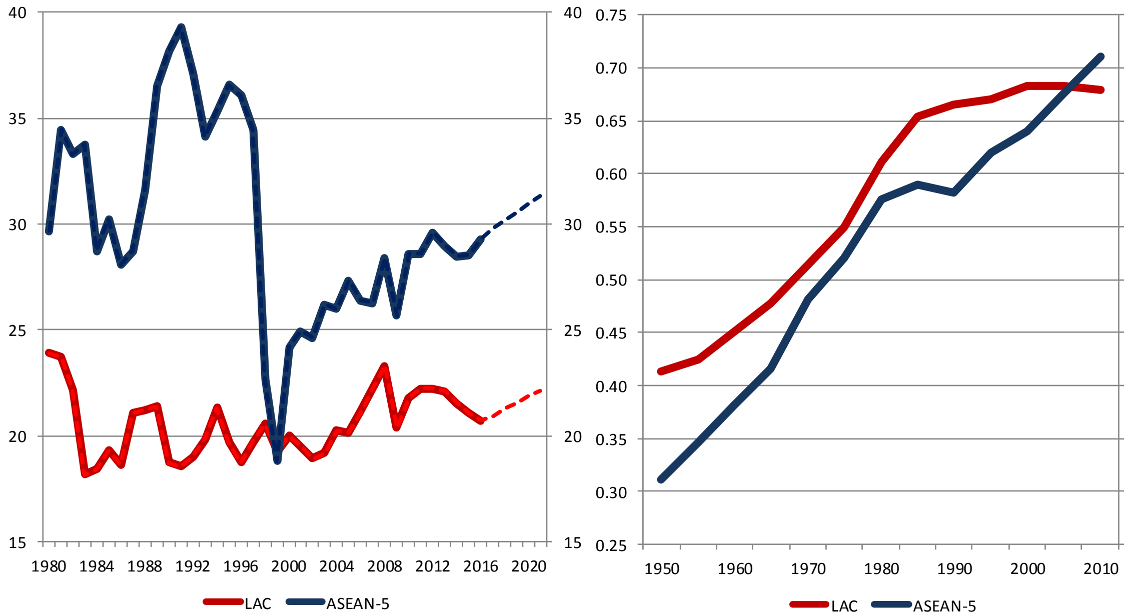
Figure 11 – Per-capita GDP, as % of G7



Source: From World Economic Outlook

The underlying factors behind this lackluster average of Latin America can be found both in capital accumulation and in educational attainment. Figure 12 shows that Latin America lags on both counts. The investment rate, as % of GDP, as remained stuck in the low 20's, whereas educational attainment has also stagnated since the eighties, at a level around 2/3s of the average years of schooling of G7 economies. ASEAN economies, in contrast, have not only catch up in educational attainment but also have surpassed Latin America as of 2010.

Figure 12 – Investment and educational attainment*



Sources: World Economic Outlook; Barro and Lee (2016)
Investment as % of GDP. Educational attainment measured as average years of schooling compared to G7 economies.

Concluding remarks and some policy implications for Latin America

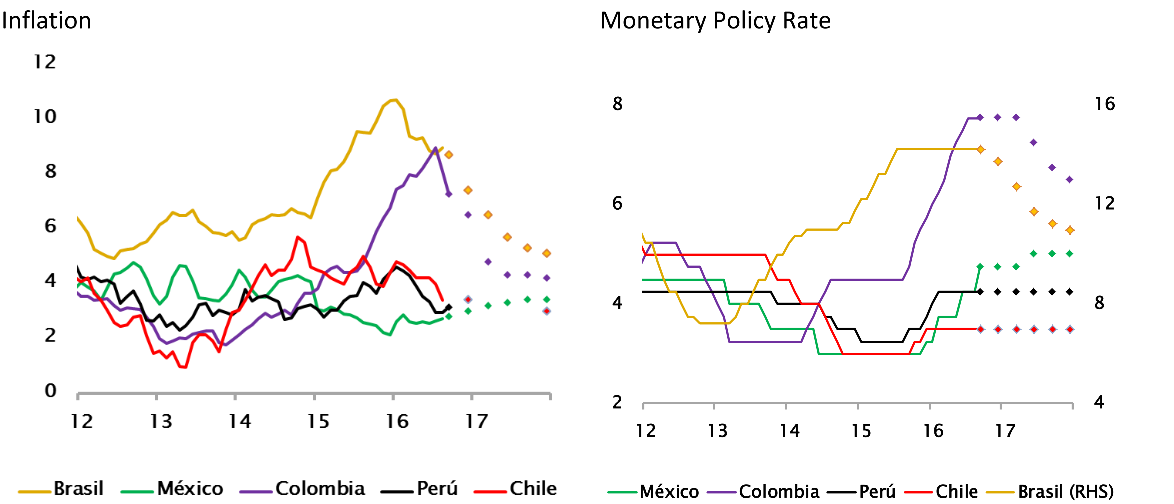
The arguments I have outlined present the challenges Latin America faces in an era of secular stagnation in Advanced Economies. On the one hand, it is undoubtedly the case that the prevalence of a low growth scenario, driven by lackluster investment, poses significant challenges to capital accumulation as a driver of growth in Latin America. Moreover, the implementation of ultra loose monetary policy, as argued here, appears to have limited cyclical upsides for economic growth in the short term, given the lopsided nature of the international monetary transmission mechanism today.

Within these dark clouds lie however a few silver linings, in the extent of the adjustment in the macro economy and in society's expectations, and in the validation of the macroeconomic frameworks. In the three and a half years since the Taper Tantrum episode put a sharp end to the idea that emerging economies could decouple from the international monetary transmissions, Latin America has undergone a painful process of adjustment to lower commodity prices, weaker currencies, decelerating growth and contracting investment. Painful as it has been, thanks to the sustained global monetary stimulus, the dreaded "sudden stop" and current account deficit reversal did not materialize.

The transition from the heady days of high commodity prices and high growth right after the GFC to the current state of lowered expectations is what lies behind most of the social and political tensions we have seen in Latin America. What is noteworthy is that, with only a few exceptions, the required downshift of societal expectations about what the economy can deliver, in terms of fiscal efforts for redistribution and income support, has occurred within a functioning democratic framework. In my view this is thanks to the overall environment of macroeconomic and financial stability we have witnessed.

The inflation targeting and flexible exchange rate frameworks, key to maintain a modicum of monetary policy independence, have mostly proven resilient, whereas rigid exchange rate arrangements have not. Although the weakening exchange rates over 2014-2015 did generate inflation pressures upward, these have mostly reflected the one-off nature of the impact from relative price changes. In the case of Chile, long term inflation expectations remained firmly at the 3% target in spite of a significant jump in inflation from the exchange rate weakening.

Figure 13 – Inflation and Monetary Policy Stance in Latin America



Sources: Bloomberg, Central Bank of Chile's Survey of Economic Expectations, Central Bank of Perú.
Dotted lines are forecasts.

The validation of this monetary framework, in the presence of low interest rates globally and low growth, points towards a gradual dissipation of inflationary pressures. The degree to which this creates some policy space for the easing of monetary policy will vary depending on each economy's circumstances. (Figure 13) Note that within the framework of inflation targeting an easing of policy in this environment is not because of exchange rate or short-term growth concerns—however legitimate—but simply because in a scenario such as this inflation would tend to position itself below the target.

Finally, the prevalence of a risk scenario of slow growth, disinflationary pressures and an appreciated exchange rate could generate an important policy dilemma in case that the monetary toolkit was near exhaustion. Of course, this is what we see in various advanced economies, even financially stable ones. Because of the high inflation we have endured across Latin America, the possibility of deflation and reaching the zero lower bound seems quite remote. For the same reason, the level of monetary policy interest rates is also far from the theoretical limits that can be conceived.[6] Therefore, as long as credibility on medium term inflation objectives is preserved, monetary policy in Latin America will have room to take action if necessary. Alternatively, a scenario of asset price inflation, and excessive froth in the credit market, is so far distant thanks to the tepid overall economic tone and the stability of commodity prices.

As we have known for a while, achieving macroeconomic and financial stability is not sufficient to successfully tackle the significant long term growth challenges Latin America faces, some of which I have briefly touched upon here. But by avoiding the mayor social dislocations that result financial instability appears to be necessary for such a task. So far, a global environment of secular stagnation, although not positive for growth or investment, does have some supportive elements that keep helping Latin America, at least in the short run.

[6] For these reasons the "beggar-thy-neighbor" cross-border spillover effects from monetary expansion in the zero lower bound found in Eggertsson, Mehrotra and Summers (2016) are not directly applicable, yet, to Latin America.

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