

# Central banks and global imbalances

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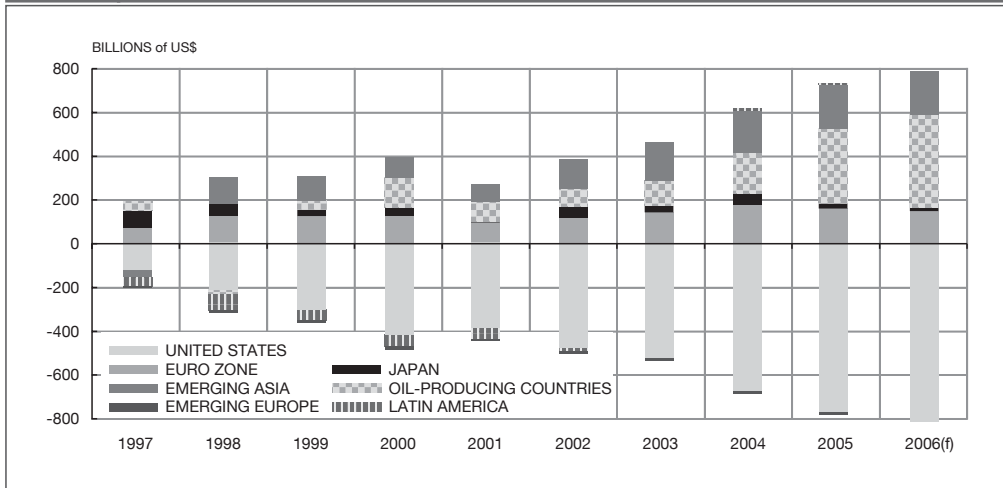
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**D**ESPITE SOME UPS AND DOWNS, world economic growth is soon to complete its best three years in the past three decades, with annual growth rates more than one third higher than the 1970-2000 average. Furthermore, for the first time in many years, this strong dynamism has been driven by a more balanced regional composition. World growth, induced by a single player – the US – in 2004-2005, today brings several other protagonists together. Worth underscoring are the Euro Zone definitely leaving behind its former lethargy, Japan's continued growth, and China and India, whose combined share in world GDP at PPP reaches that of the United States and whose economies are growing at amazing rates that are not expected to end any time soon, given their enormous unexploited potential. Thus, this stronger growth scenario is also more balanced, which speaks of increased sustainability.

This favorable global scenario faces short-term risks together with a rather structural and longer-term risk. In the near horizon, there is concern about the high oil prices persisting longer than previously forecasted and rising even higher. Accordingly, there is the associated risk of developed countries being unable to curb inflation or even to stop it from rising, putting an end to the days when second-round effects of oil hikes were not passed through to other prices, and beginning a cycle where the economies without idle capacity begin to lose their ability to absorb inflationary pressures from oil, which, with new price shocks would only make things worse. If this scenario unfolds, monetary policy interest rates will need to rise further with secondary effects on financial markets and in emerging markets.

Over a longer horizon, the main concern is how global imbalances will be accommodated and what will be their repercussions. In other words, how global imbalances will be resolved. The US has seen its current-account deficit increase considerably for the past thirteen years, and it is expected to account for 6.5% of the nation's GDP and 2% of world GDP this year. So far, this ever-expand-

FIGURE 1 CURRENT ACCOUNT BALANCE



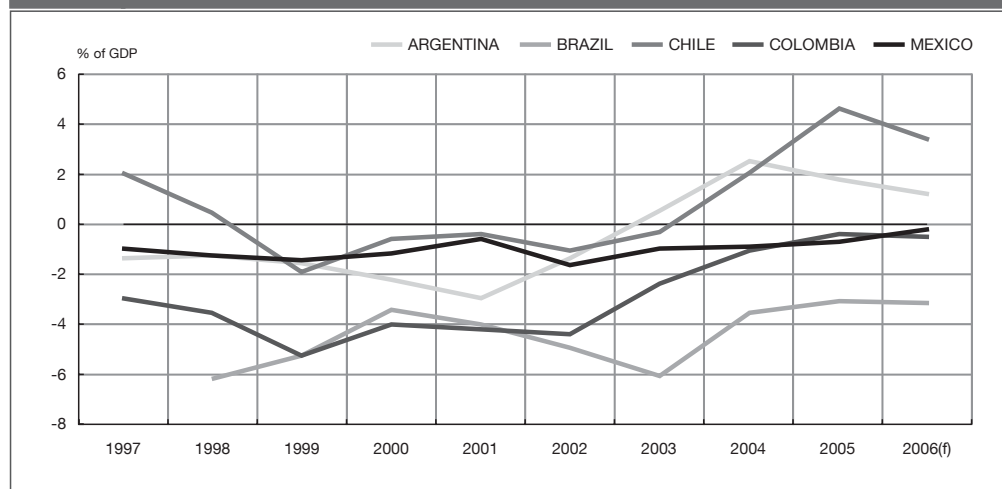
SOURCE: IMF's World Economic Outlook, September 2005.

ing deficit has been financed primarily by oil-producing economies, emerging Asia – especially China –, and Japan. Latin America's contribution has been negligible. In 2005, the region had a surplus equivalent to less than 1% of the US's current-account deficit. However, although the region is not helping to aggravate the imbalances, it can suffer the severe consequences of sudden changes in financial prices caused by this situation, which is believed by some to be unsustainable.

The earlier views on how the adjustment could occur were tainted by the Asian and Mexican crises, so the imbalance was expected to be solved abruptly when foreign investors lost interest in holding in their portfolios additional American assets at the existing interest rates and exchange rates. In such case a sudden stop would occur, thus causing a sharp breakdown to financing of the massive American consumption. US interest rates would rise and the dollar would overshoot. Consumption would slow down without compensating increases in surplus countries, causing major distress on world economic growth.

I believe this scenario, so popular until recently, is unlikely. The present flexibility and deepness of financial markets and portfolio choices in the rest of the world, suggest that the adjustment will be gradual and will take place through rather smooth changes in financial prices. In such case, demand can be expected to move steadily from deficit-ridden to surplus-running economies, while asset prices and consumption converge gradually to sustainable paths, as is already beginning to happen. Thus, larger savings in the US and increased consumption and/or investment in the rest of the world configure a more benign scenario for world growth, where the slowdown in US demand is partly offset by stronger demand elsewhere.

FIGURE 2 GENERAL GOVERNMENT BALANCE



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

This gradual pace would be favored if Asia, especially China, would make its exchange rates more flexible to produce the necessary reallocation of expenditures. More flexible exchange rates would also help countries to regain control over their monetary policies. Still, this benign adjustment, if materialized, would be coupled with a moderate deceleration of world growth.

An alternative to this gradual adjustment is a proposal under economist Ricardo Caballero's line of research, which claims that these imbalances are an equilibrium solution in a world where very dynamic emerging countries have not developed sufficiently their financial markets or any attractive investment securities, whereas the US has done so with remarkable efficiency. In this case, the adjustment would also be gradual and would occur to the extent that financial markets could be developed further in emerging economies and part of capital flows returned to their countries of origin where they would meet with profitable investment options.

Recent news of increased demand in Japan and the EU, and of a slowdown in private consumption and the real estate market in the US increase the probability of gradual adjustment. However, while unlikely, the risks of a sudden adjustment are still present and policymakers cannot sit and wait for global imbalances to resolve themselves. On the contrary, they must promote steady and cooperative adjustment and take actions to reduce the negative impact such adjustment might have in their countries.

To promote gradual, cooperative adjustment, saving must be encouraged in the US through fiscal efforts and incentives to private saving; stimulate private

TABLE 1 **INFLATION RATES**  
(ANNUAL AVERAGE PERCENTAGE)

	1980-1989	1990-1994	1995-1999	2000-2004
Argentina	565.7	515.8	0.8	8.3
Bolivia	1,383.1	13.4	7.4	3.0
Brazil	332.3	1,690.2	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	1,607.4	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

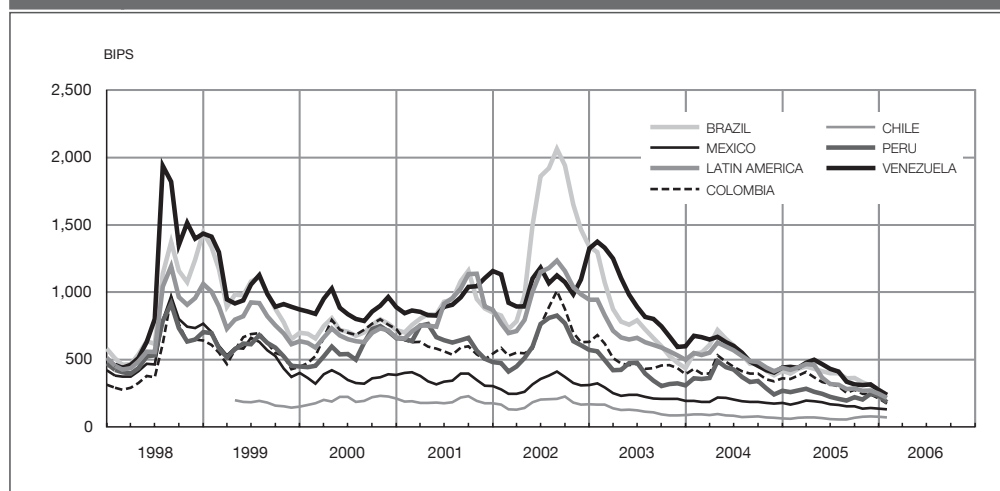
SOURCE: IMF (2006).

consumption in China – that saves over half its GDP – through financial reforms improving household access to credit and extending social protection networks in order to reduce precautionary saving, as the ones proposed in the latest Communist Party Committee. Also increase investment in emerging Asia – which collapsed in 1997 and has been unable to recover fully – through incentives to quality investment with structural reforms aimed at boosting expected returns, improving the ease to do business, increasing labor flexibility and promoting efficient resource allocation in financial markets.

Asian economies have addressed their crises through heavy hoarding of international reserves, that come quite inexpensive – or even profitable – to them at current interest rates and parities, in the hope that by so doing they will ward off a new crisis like that of 1997. The bad news is that they have let credit swell (especially China) and have neglected the reforms to the financial system that could protect them better from a shock. Finally, the adjustment could benefit from a reduction in the relative price of the US dollar in terms of other currencies, particularly the Chinese yuan/renbimbi.

Ex-post reactions intended to minimize the costs of an *abrupt adjustment* depend on the prevailing monetary and exchange policy framework. Countries with inflation expectations well-anchored in low levels and with limited currency mismatches should let the exchange rate adjust, thus driving the changes in relative prices. “Leaning against the wind” can only result in a capital flight, financial instability and a credit crunch. Countercyclical fiscal and monetary policies coupled

FIGURE 3 COUNTRY RISK



SOURCE: JP Morgan (2006).

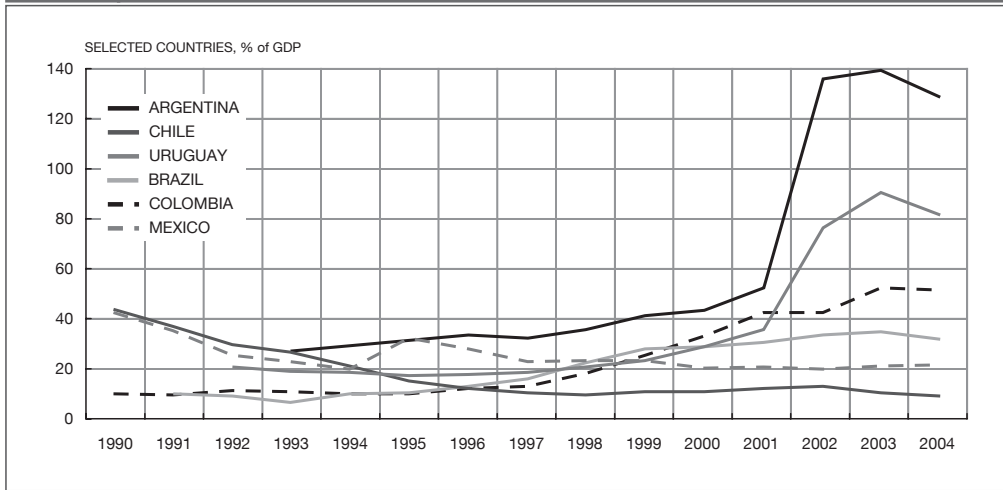
with a solid domestic financial system will help to address potential international financial crises with a reversal of capital flows, with a reduced need for international reserves accumulation.

Countries with de-anchored inflation expectations face a more complex scenario. Real depreciation will be shadowed by higher inflation or, if currency mismatches between assets and liabilities are large, depreciation will turn out to be contractionary because of important balance-sheet effects. To avoid a major financial crisis in these economies, the only tool they will have available will be fiscal policy, which would be recessionary.

Uncertainty regarding the way imbalances will be corrected has repercussions on economic policy decision-making. In emerging countries, monetary policy has limited or no impact on how adjustment happens. But regardless of its form, it undoubtedly affects monetary policy decisions, implementation and effectiveness. Increased uncertainty is something to take into account when projecting output and prices. The global scenario also makes it difficult to interpret the impact of monetary policy on demand and inflation.

The sound and stable macroeconomic environment that Latin-American countries have steadily built over the years has reduced their vulnerability to adjustments of global imbalances that might turn out to be more abrupt than expected. During the past two decades, and especially in the last five years, substantial advances have been achieved in economic policies and results. The fiscal discipline attained by these countries was unheard of before. Although Chile stands out, major improvements have been made in most countries. Annual inflation has been reduced from three-digit annual levels less than fifteen years back,

FIGURE 4 PUBLIC DEBT (a) IN LATIN AMERICA



SOURCE: ECLAC (2005).

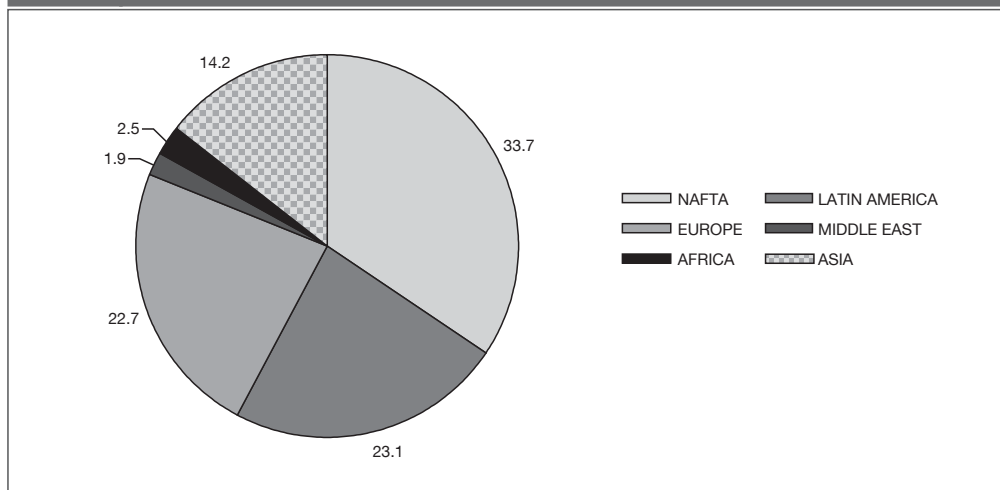
a. Debt of central governments.

to one-digit annual levels more recently. Current accounts have in most cases shifted to surplus positions, and sovereign spreads are down to historic lows, with the resulting reduction in the costs of foreign financing. This has boosted the countries' solvency, which in turn has permitted them to refinance their credits in much better terms. Finally, great advances in the development, supervision and regulation of the financial system have also helped to improve Latin America's resilience to shocks. But despite these advances, there is still a long way to go in terms of market liberalization, promoting competition and improving the efficiency of the state apparatus.

However, while Latin America is more resilient now than it was in the past, it is not fully protected and is sensitive to the way imbalances are ultimately corrected. An abrupt adjustment would increase sovereign spreads, enlarging the financial burden of the most indebted countries, such as Argentina and Uruguay, and might hurt the largest providers of goods to the US, whose demand would not be absorbed by others. Despite growing diversification, NAFTA members buy 34% of total Latin-American exports (excluding Mexico). Within the region, the most exposed are Mexico and Central America, because of their extensive commercial relations with the United States.

In conclusion, the world economy presents an exceptionally favorable scenario, where the big surprise has been the dynamism of China and India. However, this good environment is not free of risks. The most immediate threats are larger and longer-lasting rises in oil prices, and possible inflation increases in developed countries. Over a longer horizon, the biggest uncertainty lies in how global imbalanc-

FIGURE 5 **LATIN AMERICA EXPORTS BY DESTINATION**  
2004



SOURCE: WTO (2006).

es will finally unwind. This, however, looks less urgent now with some signs of gradual adjustments already beginning to occur. Furthermore, countries are recognizing that the solution will involve many players that will need coordination. In fact, as was discussed in the last IMFC meetings, demand is appearing for cooperative adjustment that can help correct the global imbalances at the lowest possible cost in terms of world economy deceleration. Last, but not least, countries have managed to implement sound macroeconomic policies that will help smooth the adjustment and cushion the impact. However, they must continue to strive to strengthen their policies to create more favorable conditions for long term growth and to face a world with growing uncertainty.