



**FOSTERING BALANCED GROWTH**  
**IN THE CURRENT EXTERNAL**  
**ENVIRONMENT**

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## **Two Dimensions of Balanced Growth:**

- i. Over Time (GDP vs. Potential GDP).
- ii. Across Sectors (commodities, other tradables and non-tradables)

## **Objective of Macroeconomic Policy:**

To Sustain (balanced) Growth Over Time.



## And what about balanced Growth Across Sectors?

Not necessarily a macroeconomic policy objective (It belongs more in the realm of trade and microeconomic policy).

UNLESS...

There are macroeconomic shocks that may affect both the sustainability and the composition of growth over time.



## Two Examples

- i. "Dutch Disease": Quantities or prices (or both) of an exported commodity reach levels that are unsustainable, but last long enough to distort resource allocation.
- ii. Unsustainably Large Capital Flows enter an economy.



Long term growth is compromised as costly resource reallocation is needed after the commodity boom and the unsustainable large capital inflows occur.



- In these cases, an appropriate macroeconomic policy response may be in order.
- The problem is to distinguish permanent from temporary movements in
  - i. Capital Flows and*
  - ii. The Prices and Quantities of Commodities Exported*

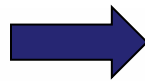
This is troublesome because policy responses depend crucially on the persistence (permanent vs. transitory) and the nature (i.e. Terms of trade vs. capital inflows associated to low external interest rate) of the shocks.



# CASE 1

## Permanent Shocks (Examples):

- A country that fixes a structural fiscal imbalance or that improves internal security.
- A country that discovers large amounts of natural resources.



- Permanently acquires a lower risk premium → Larger capital inflows.
- Large Amounts of FDI Flows and export revenue for a long time.



## IN THESE SITUATIONS:

- Attempts to counter the real appreciation of the currency are hardly justified and may involve risks. (i.e. inflation and financial stability).
- Generating a large permanent fiscal surplus may lead to inefficiently low levels of domestic consumption.
- In these cases, policies aimed at increasing the flexibility of market factors (esp. labor) help.



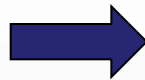
No macro policy fight against a permanent change in relative prices.



## CASE 2

**Temporary (“Medium Term”) periods of high external revenues related to (for example):**

- i. High commodity prices for several years due to strong world demand.
- ii. New oil/mineral reserve findings.



- Overheating
- Real exchange rate appreciation



The policy response primarily involves an effort to generate savings that:

- ✓ Help smooth the additional consumption that is made possible by the additional income flows over time.
- ✓ Prevent an excessive real appreciation of the currency that may accompany the undesirable effects of «Dutch Disease».



Fiscal Policy is the key instrument in this case to:

- ✓ Keep total output on a sustainable path
- ✓ Prevent a misallocation of resources among sectors
- ✓ Preserve a desirable composition of output

Fiscal rules that are linked to both the prices and quantities of commodities exported are essential to generate the required savings.



The use of other instruments in these cases is problematic.

- ✓ FX intervention is likely to be ineffective (as there are «fundamental reasons» for the real appreciation in a horizon of years).
- ✓ FX intervention may imply costs in terms of inflation, excessive credit growth or quasi-fiscal costs of sterilization

**AND...**

The moderation of such costs may need capital controls or financial repression (e.g. reserve requirements) that may be harmful for long term growth and may become ineffective if held for long periods of time.



## CASE 3

**Temporary waves of capital flows that could last months or even years (i.e. Due to low external interest rate)**

### POLICY RESPONSE:

- ✓ Exchange Rate Flexibility (avoid overheating).
- ✓ Ceteris Paribus, capital inflows will prompt a reduction of interest rates as a result of the decline in inflation and (tradeable) output that the currency appreciation produces.
- ✓ No fiscal policy response.



Low interest rates and strong capital inflows may put financial stability at risk (i.e. excessive credit growth and asset price bubbles).



- ✓ Monitoring and control of financial imbalances becomes crucial.
- ✓ Transitory macroprudential actions are justified, including capital controls and measures to contain credit liquidity and currency mismatch risks.



## MISALIGNMENTS

Over shorter horizons (months), it is possible that the exchange rate trends that result from the abovementioned permanent or temporary shocks could drive markets to overshoot. In this case:

- ✓ Sterilized FX intervention
- ✓ Short term capital controls

May be adequate responses to restore fundamental-based equilibrium.



## FINAL QUESTION :

Should Central Banks and Financial Authorities react to a changing external environment with macro-prudential measures?

### Answer:

Sometimes, under the following (connected) conditions (Vargas, 2011).

1. Inflation and sustainable output growth objectives are privileged.
2. Exchange rate flexibility (No target for the exchange rate level)
3. The effects of the shocks are the outcome of cyclical factors (not part of a long term trend).

These conditions determine whether the **benefits** of “macro-prudential” policies outweigh their **costs**.



- A macro-prudential policy reaction must be established so that the probability of making a policy mistake is minimized.
- To that end:
  - ✓ The *speed* of events is key to decide on a macro-prudential policy reaction (e.g. the speed of an appreciation or of credit growth)
  - ✓ The «burden of proof» must fall on the case for using macro-prudential policy (not the other way around)

**This helps to discipline the decision making process and avoids loss of credibility for Central Bank policy**

