# Some Policy Lessons for Emerging Economies

20 JUNE 2006

Vittorio Corbo
Governor
Banco Central de Chile

# Financial integration

- **Financial integration is a mixed blessing for emerging economies. It has great benefits:**
  - Reduces cost of capital for domestic firms.
  - Increases opportunities for risk diversification and sharing.
  - Enhances competition in financial services.
  - Increases market discipline.

# Financial integration

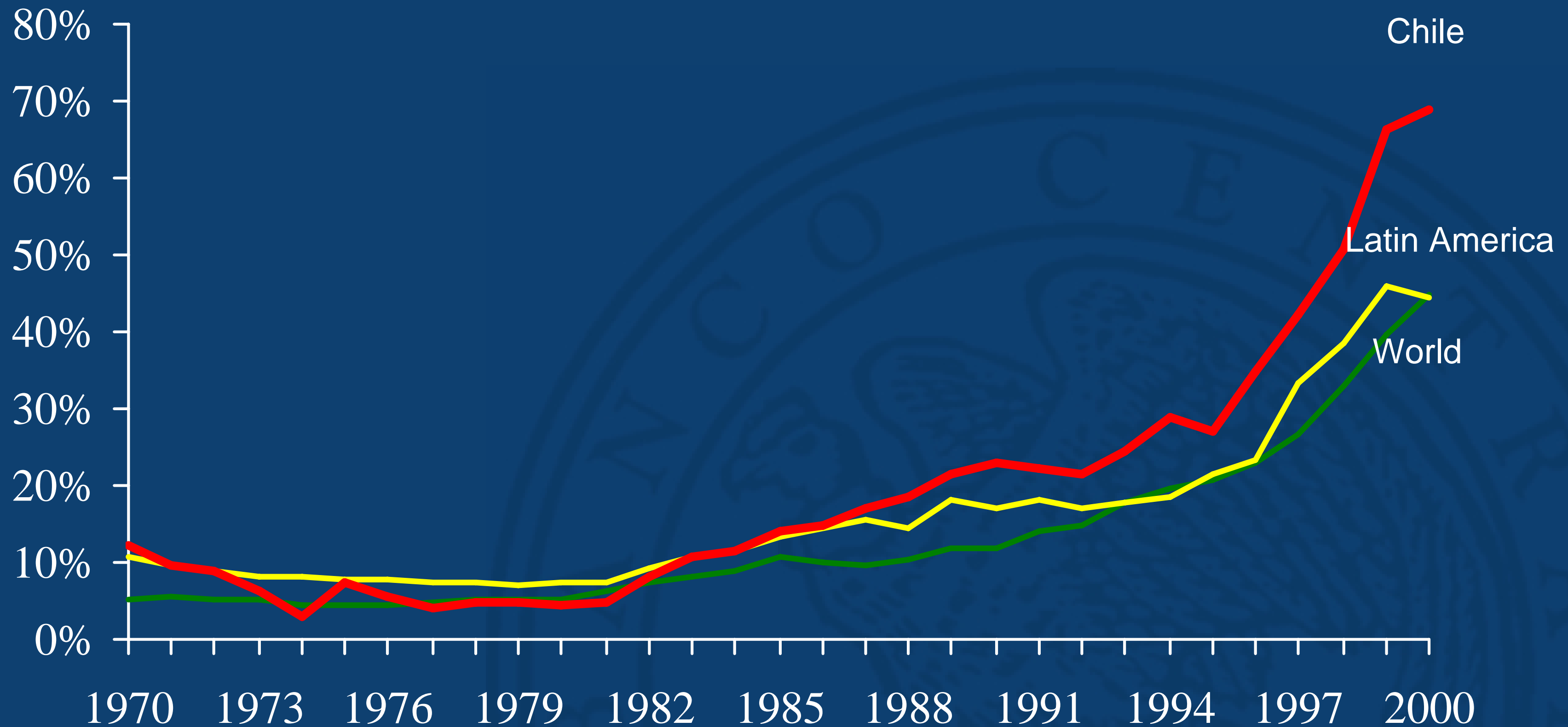
- However, it may also:
  - Amplify the costs of distortions and imperfections of domestic financial markets.
  - Exploit inconsistencies in macroeconomic policies.
  - Create an additional source of volatility:
    - ✓ irrational exuberance, bubbles and crashes in international capital markets.
    - ✓ contagion effects and sudden stop dynamics.

# Coping with volatility

- Insulating the domestic financial system is no longer a viable alternative:
  - Openness.
  - Technology´s impact on financial transaction costs.
- How can the potential costs of volatility be minimized?
  - Fiscal prudence.
  - Price stability and CB credibility.
  - Flexible exchange rate policy.
  - Sound financial system.

# Financial Integration

*(1970-2000, Stock of foreign liabilities over GDP)*




Source: Calderón, Loayza and Schmidt-Hebbel (2005).

# Coping with volatility

- Fiscal prudence:
  - Surplus rule to anchor long term credibility of fiscal policy.
  - Diminish procyclicality of fiscal policy.
  - Moderate level of public debt and public deficit in normal times.
  - Build up reserves for bad times and smooth cyclical adjustments.

# Coping with volatility

- Price stability and Central Bank credibility:
  - Build up nominal credibility.
  - Reduce currency and maturity mismatches in public finances and the financial system.
  - Allow room to implement stabilizing monetary policy in bad times and ease liquidity pressures under financial stress.

# Coping with volatile conditions

- Flexible exchange rate policy. In Chile it has served to:
  - Help adjust to changing fundamentals.
  - Provide incentives for the development of the domestic market for bond and currency hedging.
  - Allow for early adjustments to international volatility (minimize abrupt ER corrections).
  - Provide room for more independent monetary policy: greater flexibility for interest rate policy.
  - Permit the use of international reserves to ease adjustment in extreme scenarios.

# Corporate exposure to currency risk

Net foreign currency liabilities of non financial corporations
*(as % of total assets)*



Source: Banco Central de Chile.

# Coping with volatility

- Sound financial system:
  - Well capitalized.
  - Effectively regulated and supervised, focused on risk management.
  - Market discipline.
  - Open to foreign participants.
  - Depth due in part to mature private pension system.

# Coping with volatility

- There is room for further improvements in:
  - Corporate governance.
  - Financial infrastructure.
  - Integration to international financial markets.

# Some Policy Lessons for Emerging Economies

20 JUNE 2006

Vittorio Corbo
Governor
Banco Central de Chile