José De Gregorio: Exchange rate, macroeconomic policies, and the global scenario

Speech by Mr José De Gregorio, Governor of the Central Bank of Chile, before the Senate at a special session on the exchange rate, Valparaíso, 14 December 2010.

* * *

I. Introduction

I am grateful for the Senate's invitation to analyze exchange rate issues, some of the most complex ones facing our country, as well as Latin American and most emerging market economies. We are thus obligated to carefully evaluate the current economic environment, its implications on the performance of our economy, and the measures that can be taken if deemed necessary. In addition, these instances for analysis are important opportunities to communicate in a very transparent fashion the vision of the Central Bank of Chile.

Along the last few decades, Chile has benefited enormously from being open and globally integrated. This has been one of the cornerstones of our economic growth. However, the international economy is at the same time a source of volatility for our economy. The prices of our exports, the economic activity of our trading partners, foreign interest rates and international investors' appetite for risk fluctuate substantially. These variables affect our national income, fiscal accounts, external demand for our products, and the availability and cost of external financing and, indirectly, expenditure, output, the interest rate and the exchange rate in Chile.

It is impossible to eliminate this volatility without sacrificing the benefits of our international openness. However, macroeconomic policies can help the economy to better accommodate this changing reality. During the last decade, Chile's policy mix has succeeded in significantly reducing output volatility and external vulnerability. This scenario of stability makes room for further economic growth.

I will begin my presentation by taking a look at the major changes occurred in both the world and the domestic economy in the past couple of years and which help explain the behavior of our currency. Then I will examine in some detail the role that macroeconomic policies play, with special emphasis on the monetary and exchange rate policies in this new external scenario.

II. Factors affecting the evolution of the real exchange rate

The past six months have seen the peso appreciate around 3% against the euro, and 12% against the dollar. The dollar, measured in multilateral terms compared to the main foreign currencies, has hit record lows for the past 40 years.

Today, the real exchange rate index estimated by the Central Bank is 5% below the average for the period 1990–2010 (October), and 6.5% below the average for 2000–2010 (figure 1). However, and as I will discuss in a moment, current conditions are very different from those prevailing over the past two decades. These factors warrant a somewhat more appreciated real exchange rate than the average for the past twenty years. Overall, we are aware of the volatilities affecting the international markets which can magnify the fluctuations of our real exchange rate way beyond its long-term fundamentals.

Unbalanced recovery of the world economy

We observe that the global recovery is very dissimilar between advanced and emerging economies. The US, Europe and Japan are growing slowly and have high levels of idle capacity and unemployment. The financial crisis has caused them lasting damage in the

balance sheets of consumers, banks and governments that will take years to heal. Most likely, their demands will continue to grow slowly. Recent financial turbulences in Europe confirm this scenario.

This situation contrasts with growth in Latin America and emerging Asia. In the past year, these economies have grown above trend, thanks to still expansionary macroeconomic policies, increased external funding available and, in our region, improved terms of trade. Output gaps are near exhaustion and policy-makers are withdrawing their stimulus to demand in order to avoid an inflationary resurgence and generate a sustainable growth path.

The main projections of the world economy foresee that this disparity between emerging and advanced economies will go on for the next two years. These aspects will be addressed in more detail next week when we present our December 2010 *Monetary Policy Report*.

The real issue here is that the recovery of the developed world will not hold if it happens at the expense of repeating the current account deficits of the pre-crisis years. A recomposition of global demand is necessary. The crisis has left an excess of savings in the world that drives down the international real interest rate. Meanwhile, the weakness of advanced economies leads us to believe that they will hold on to their low monetary policy rates for a very long time. These low real interest rates help boost domestic demand in surplus economies with sound financial systems, like ours. The consequence is a global re-accommodation of the currencies: deficit countries depreciate their real exchange rates, while the rest of the world appreciate theirs.

Within this context, the currencies of most emerging and/or commodity exporting economies are facing pressures for a real appreciation. The Chilean peso is part of this process of global parity re-accommodation. Our currency has appreciated significantly with respect to that of deficit-ridden economies: the US, the UK and, to a lesser extent, the Eurozone. However, it remains stable or has depreciated with respect to the currencies of other emerging or commodity exporting economies (figure 2).

One problem is that not every country is contributing to the foreign exchange adjustment at the same pace. Such a disparity creates tensions in the world economy. In the Eurozone, the rigidity imposed by the single currency slows down the real exchange rate adjustment between economies that are going through very different stages in the cycle. In China, high savings and foreign exchange market interventions hinder the adjustment. This can amplify the effects on other currencies in emerging and commodity exporting economies.

However, underlying pressures continue to manifest themselves in other ways. In the deficit economies of the Eurozone, the recession and its accompanying deflationary pressures depreciate the real exchange rate. In emerging Asia, the acceleration of spending and increased inflationary pressures appreciate the real exchange rate. Eventually, the foreign exchange regime affects the real exchange rate's behavior only temporarily, and the adjustment arrives sooner or later by other ways, some times at a greater cost.

Improved terms of trade

Another factor influencing the exchange rate's behavior has been the improvement of our terms of trade. Along the past ten years, the ratio between the price of our exports and imports, i.e., the terms of trade, has almost doubled. As of the third quarter of 2010, the terms of trade exceeded the average for the last two decades by more than 60%. Underlying this increment are the higher prices of copper, iron, wood pulp and other commodities relative to manufactured goods, partly attenuated by the oil price increases (figure 3).

Improved of trade lead to an increase in the real national income – the sum of wages, profits and taxes – faster than the expansion of our productive capacity. To the extent that this higher national income is perceived as permanent by policy-makers and private agents, it stimulates expenditure and puts pressure on the installed capacity, the domestic interest rate and, ultimately, the real exchange rate.

In the case of fiscal earnings, for over twenty years our country has implemented a responsible, prudential fiscal policy, generating fiscal surpluses for most of the period. Such a policy has sought to save the transitory income from copper, cushioning the impact of terms of trade cycles on fiscal expenditure, demand, and the real exchange rate. When confronted with the worst international recession since the Great Depression, this fiscal prudence allowed putting in place countercyclical measures that had no precedent in our economic history.

In the present circumstances where the economy has already gained momentum, it is adequate to withdraw part of the fiscal stimulus. The plan of gradual reduction of the structural fiscal deficit announced by the government will contribute to moderate demand and remove some pressure from the real exchange rate, although its effects will become apparent gradually over time.

Beyond the business cycle, it is also worth mentioning that the persistence of high copper prices in the world markets has been translating into better expectations for its long-term price. In the first five years of the fiscal rule of structural balance, the average reference price for copper was, in real terms as of today, US$1.14 per pound; now it is more than twice, at US$2.59 per pound. The higher earnings from copper have allowed financing an important increase in public spending as a percentage of GDP and greater transfers over the past few years. This situation has consequences also on the real exchange rate.

Reduced net debtor position

Throughout the years, the flip side of the structural fiscal surplus has been a significant reduction in public debt as a percentage of GDP, accumulated resources in foreign currency in sovereign funds, and an improvement of the net financial position of the Chilean economy relative to the rest of the world. This improvement also contributes to a more appreciated exchange rate via lower sovereign risk, access to external credit in more favorable conditions and a higher permanent income from interests paid on savings abroad (figure 4).

Sectoral heterogeneity

Because of heterogeneity in global recovery and currency evolution, the average path of the real exchange rate blurs the diversity of bilateral or regional parities. As I have pointed out before, the peso's real appreciation centers in the US and Europe, while it is more stable with respect to the currencies of other emerging economies or commodity exporters that compete with Chile in various markets (figure 5).

Such a disparity means that the effects of the appreciation of the peso have been heterogeneous across the different economic sectors. In some, the appreciation has been more than offset by higher export prices (mining), while in others the effects have been mitigated by appreciated currencies in some countries of destination. The agricultural industry, where nearly 70% of its sales go the United States and Europe, has seen a greater appreciation (figure 6).

III. Monetary policy and exchange rate intervention

Last October, when I was invited to the House of Representatives to analyze the exchange rate, I said there are three major principles in monetary policy conduct.

The first is that the Central Bank is not indifferent to exchange rate movements. Compliance with our constitutional mandate demands adopting measures to orient the economy toward full use of its resources and ensuring a balance of payments that is sustainable over time. The international price of our currency is a very important variable in the Chilean economy's performance, as it affects growth, inflation and the external accounts, and ultimately our monetary policy decisions. For example, in recent months the appreciation of the peso has

helped attenuate inflationary pressures stemming from narrowing output gaps. This has been an input in our decisions so, were it not for the strengthened exchange rate, our monetary policy interest rate would probably be higher than it actually is.

A second principle is careful assessment of our decisions' effectiveness, costs and benefits. We make no decision without being technically convinced that it will be effective and convenient for the economy as a whole. Acting otherwise would only erode our reputation and credibility, indispensable elements for achieving our objectives at the lowest social cost possible.

Finally, a third principle is that the Central Bank of Chile does not use the exchange rate to target inflation. Our history and that of the region is paved with stabilization measures based on the exchange rate, which generated severe setbacks, and ended in balance of payments crisis, financial turmoil and economic disasters. For this reason, we have evolved into a floating exchange rate regime, which permits to better reconcile the stability of the Chilean economy with the volatility of the external scenario.

This is not the time or the place for a lengthy discussion on the subject; suffice it to recall that every economic crisis in Chile over the past fifty years – except the recession of 2009 we are leaving behind with unprecedented vigor – have been associated to exchange rate misalignments and rigidities. Furthermore, a very significant element to explain why the emerging economies were spared the worst effects of the recent global crisis was that their currencies floated, which allowed them to absorb the shocks, eliminated the invitation to investors to wager against currency weakening and opened room to relax monetary policy and provide liquidity.

However, although a floating exchange rate has many advantages for economic and financial stability, it may happen that, at times of high uncertainty or excessive optimism, financial flows could persistently push the real exchange rate away from its medium- and long-term fundamentals, with negative effects on the economy. In such situations, the Central Bank may intervene in the foreign exchange market with the purpose of mitigating or eliminating these imbalances. If the exchange rate is actually misaligned from its fundamentals, the intervention will have a better chance to amend the situation, while it will also bring financial benefits. Conversely, if these are fundamental trends, the intervention will have transitory effects at best, at a substantial cost.

Since the implementation of the floating regime at the end of the last decade, we have intervened in the foreign exchange market on three occasions. In the current circumstances we have not ruled it out. It is an option we are permanently evaluating.

I want to go deeper into the elements that are weighed for this decision.

It is always possible to design an intervention of such magnitude that it can affect the evolution of the nominal exchange rate. But this has other consequences on the economy that need consideration.

One such consequence is the need to sterilize the monetary effects of the intervention. The money that is issued to buy the dollars must be taken out; otherwise monetary policy would be subordinated to the exchange rate objective, jeopardizing the stability of growth and inflation. This sterilization pressures long-term interest rates upward, which has an impact on activity, while inducing capital inflows that render the intervention ineffective. In turn, the intervention entails high financial costs, because financing the intervention via debt costs more than the returns on the international reserves, except, as I said before, when it is grounded on the expectation of an important correction of the exchange rate misalignment.

We must also consider the coherence of the intervention with the rest of the economy. A sufficiently bulky intervention could sustain a more depreciated nominal exchange rate, even if fundamental forces point to appreciation. However, these pressures to appreciate will take the form of higher inflation as they will drive demand for national goods to grow too fast. In the medium term, the real exchange rate is the same, but inflation is higher when the foreign

exchange rate adjustment mechanism is locked. Some emerging economies that have tried to avoid the nominal appreciation of their currencies are seeing a faster acceleration of inflation because the acceleration of expenditure squeezes internal production capacity.

As I said, currencies are appreciating around the world, even in Asian and Latin American countries that have intervened in the market and adopted other types of financial measures to contain this appreciation (figure 7). In fact, interventions may have attenuated somewhat the nominal exchange rate appreciation, but at the end what we are seeking is to affect the real exchange rate, and the evidence on the matter shows that, on average, there is no obvious connection between the level of the countries' interventions and the behavior of their real exchange rate (figure 8).

In Chile, the latest intervention occurred in April 2008, with visible effects on the exchange rate. At the time, the real exchange rate was more appreciated than today, and it was only a few weeks before the financial crisis took a turn for the worse after the collapse of Bear Stearns, which warranted strengthening our international reserves position in the face of a very volatile global economic and financial scenario. The exchange rate depreciated in the first weeks after we announced the intervention, but the subsequent depreciation in the following months coincided with a widespread weakening of emerging currencies, increased risk aversion in global financial markets, a strengthened dollar and a fall in Treasury bonds' interest rates.

But it is also helpful to learn from other episodes, and an interesting one happened in 1997, when the real exchange rate hit its lowest since the crisis of the peg in 1982. That intervention amounted to around 4% of GDP, there were capital controls, net capital inflows were at 8.1% of GDP, the copper price was at US$1.42 per pound in dollars of today, and the net international position was more to the debt side, at 50% of GDP. Certainly, the floating regime, a monetary policy more aligned with international interest rates, and reduced capital inflows have been key in limiting the amplitude of exchange rate fluctuations.

I want to highlight that net capital inflows to Chile are now less than the peaks we saw in the 1990s. Currently, capital inflows to the emerging world – particularly Latin America – have resumed pre-crisis levels but are still below those of the 1990s (figure 9). This is largely due to improved growth prospects in the emerging markets and to the fact that while in the advanced economies interest rates are and will continue to be low, in emerging countries monetary policy rates have been going up, to very high levels in some of them (figure 10).

In Chile, the current account balance for this year (i.e., our expenditures in excess of our income) will be not too different from zero, which means that there will not be a significant net capital inflow to finance excess spending (figure 11). It is thus important to note that I have not mentioned among the causes of the peso appreciation net capital inflows, which in some countries may be having some significant impact. In the 1990s we did receive substantial net capital inflows, but today they are not the main point. Certainly this calls for continual follow-up because the funds will always flow to the economies with the better prospects for growth, including Chile. As I said, sometimes these flows can trigger lasting misalignments in the real exchange rate with respect to its trend fundamentals.

IV. Final remarks

We are well aware of the challenges facing exporters under the present circumstances. In particular, we understand the difficulties exporters in the agricultural sector are enduring, whose primary destinations – Europe and the US – have not fully recovered yet from the financial crisis, and with which our currency has appreciated more. This situation is particularly complex in some regions. At the country level, however, it must be said that production, employment, wages and investment are growing strongly. Our economy is totally back on its feet after the global recession and the outlook is good.

I am convinced that our country must grow in a harmonious way and the benefits of progress must spread to all the country. Economic growth and global integration generate sectoral and regional adjustments; some economic activities expand and some contract, with all the associated tensions. This is what progress is all about. To mitigate the costs of sectoral adjustments – and, above all, the social costs involved – without hurting economic growth, public policies face a tremendous challenge, but the instruments with macroeconomic reach such as the exchange rate are ineffective when it comes to resolving sectoral difficulties.

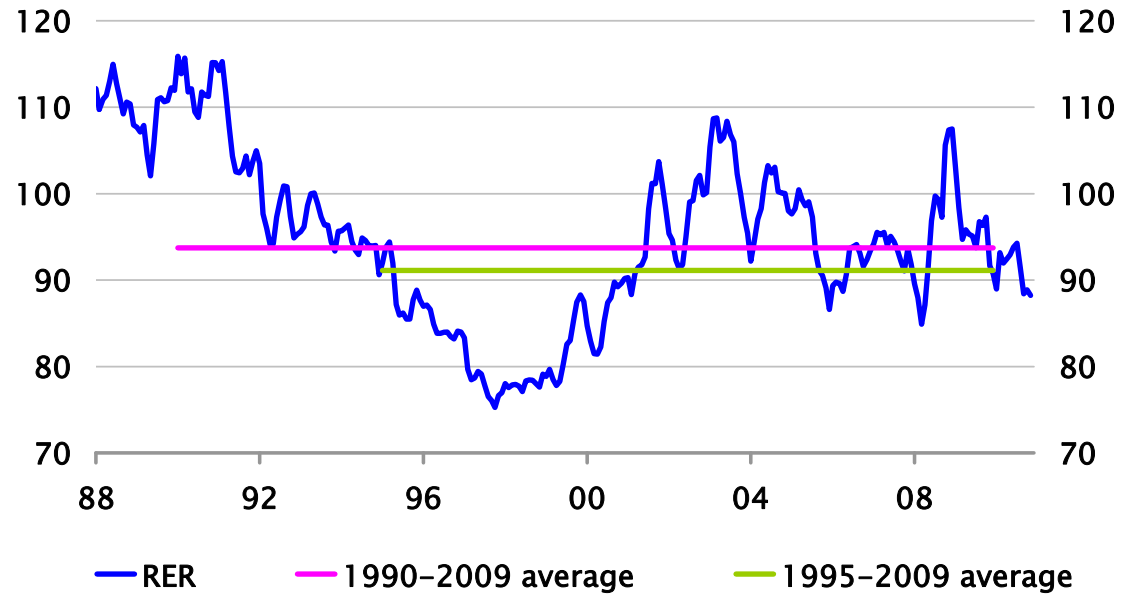
Next week we will be presenting our *Monetary Policy Report*. We hope that our economy will continue dynamic over the next 24 months, boosting higher income and employment for our people. Our role is to ensure that the process is sustainable in an environment of stable prices. We will watch over it taking every measure necessary.

In this presentation I have shown all the factors that may explain parity adjustments. However, many of the elements now pressuring the exchange rate may be reversed in the long term. As a matter of fact, today the real exchange rate is around the minimum levels believed to be consistent with its long-term fundamentals, hence the importance we assign to this issue.

So far we have not intervened in the foreign exchange market or taken any exceptional measures because we do not think they are justified considering what I have been presenting. We do not rule out these options, but it will depend on the evolution of our economy and its relevant external environment, in the current highly volatile scenario. The Central Bank of Chile will continue to orient its policies to safeguard the economy's stability and ensure propitious conditions for growth in our country.

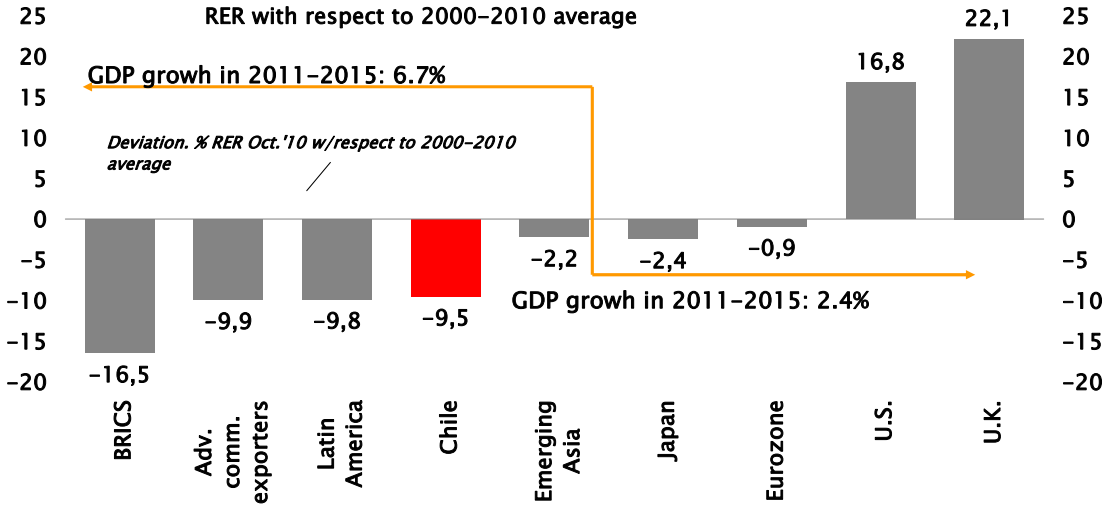
Thank you.

Figure 1
Real exchange rate
(index, 1986=100)



Source: Central Bank of Chile.

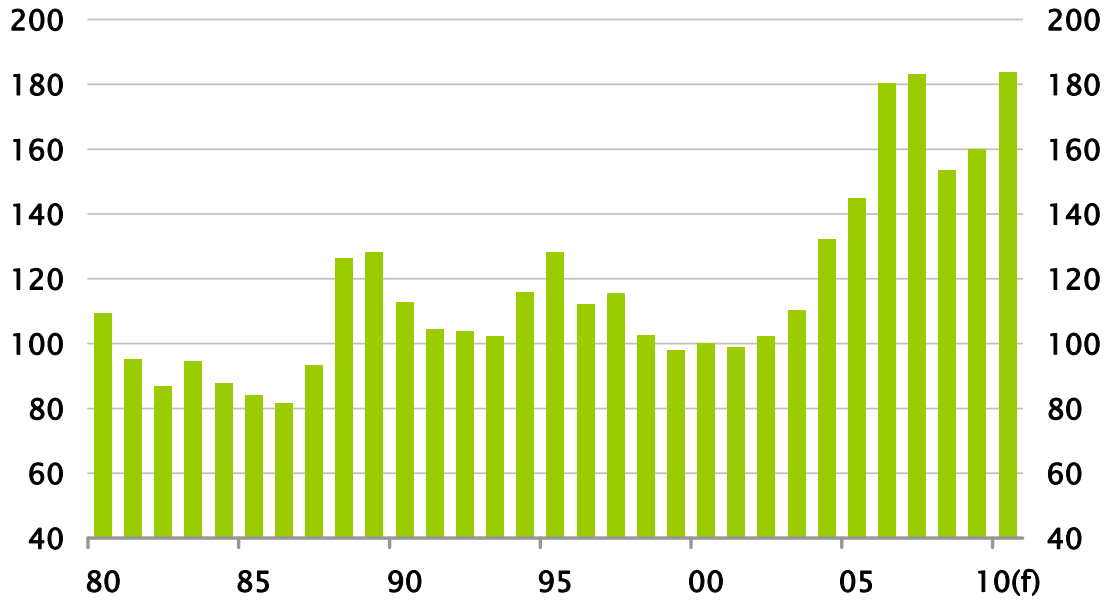
Figure 2
Real exchange rates: cross-regional diversityl (*)



(*) Regional aggregates reflect simple averages.

Sources: BIS and IMF.

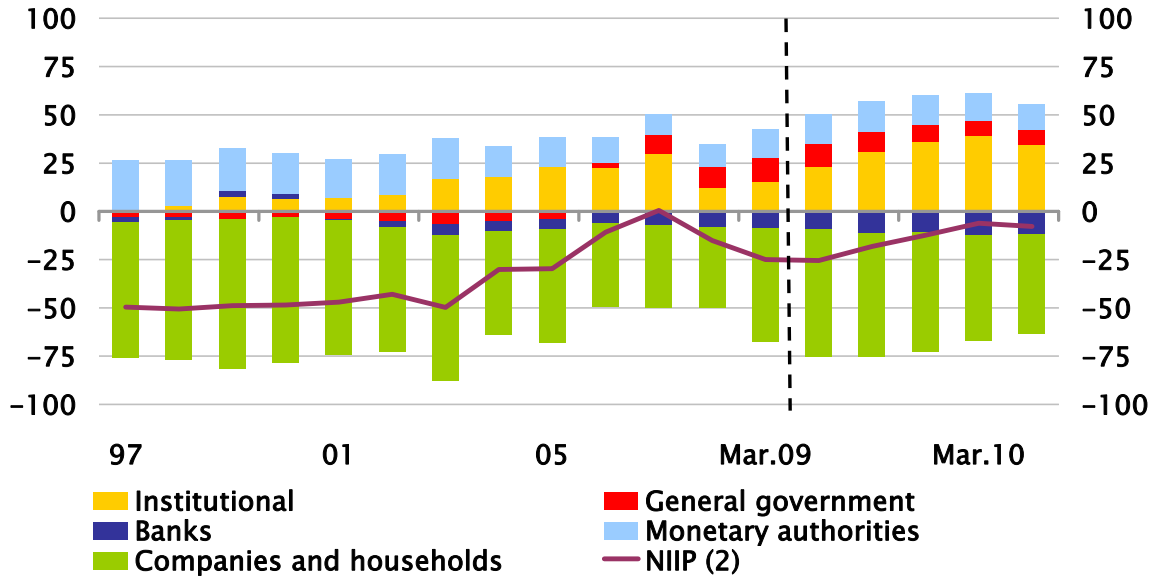
Figure 3
Terms of trade
(index, 2000=100)



(f) Forecast.

Source: Central Bank of Chile.

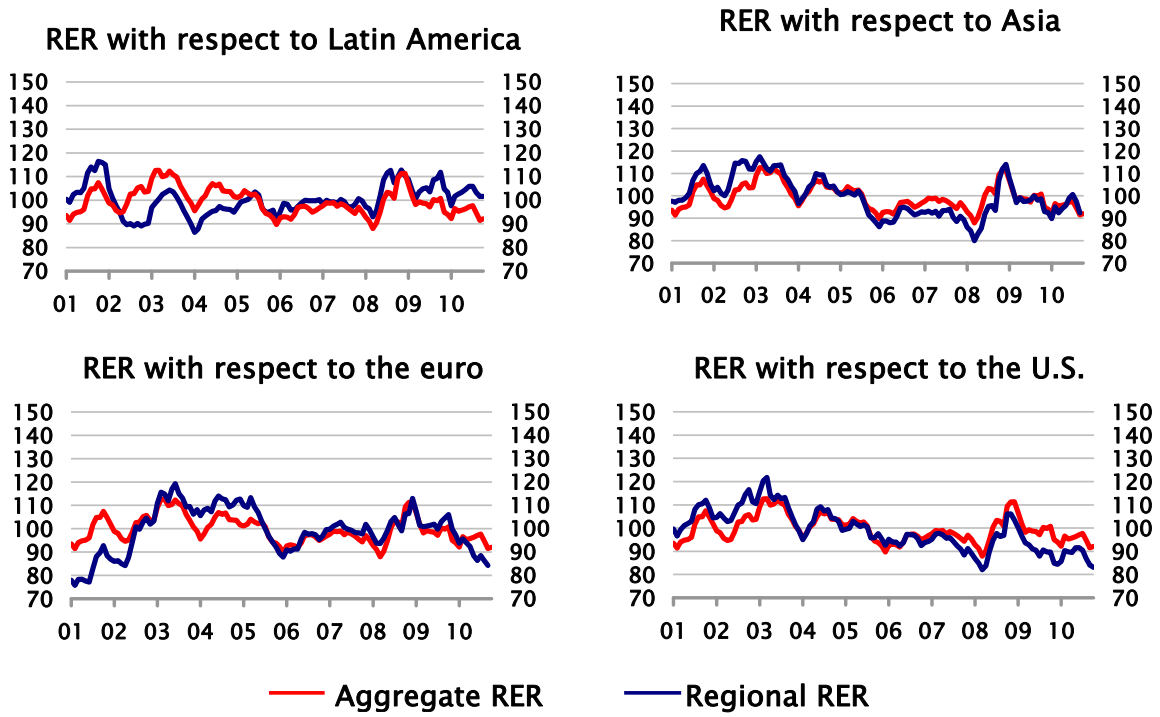
Figure 4
Net international investment position
(percentage of GDP) (1)



(1) GDP at constant exchange rate (index, September 2010 =100).
(2) Net international investment position.

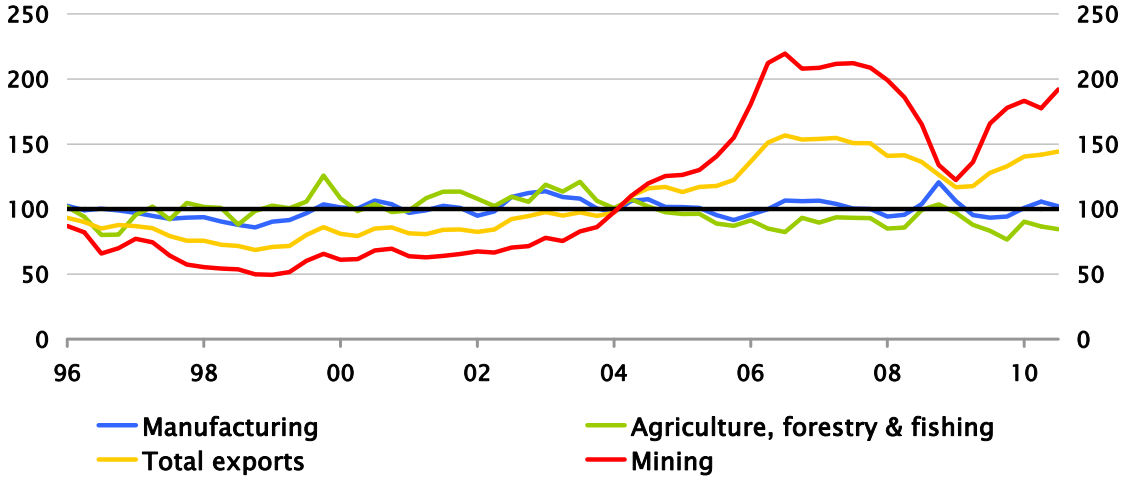
Source: Central Bank of Chile.

Figure 5
Real exchange rates by region
(monthly data; index, 2001-2009=100)



Source: Central Bank of Chile.

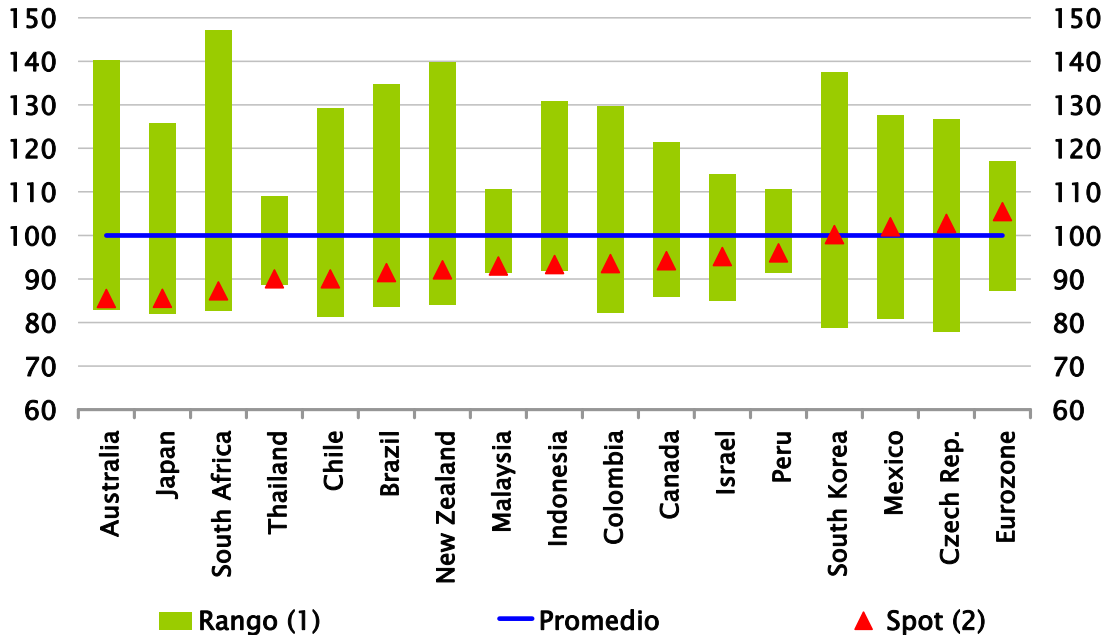
Figure 6
Real exchange rate by sector
(index, 96-07=100)



(*) RER estimated using unit-value indexes. Latest date corresponds to third quarter 2010.

Source: Central Bank of Chile.

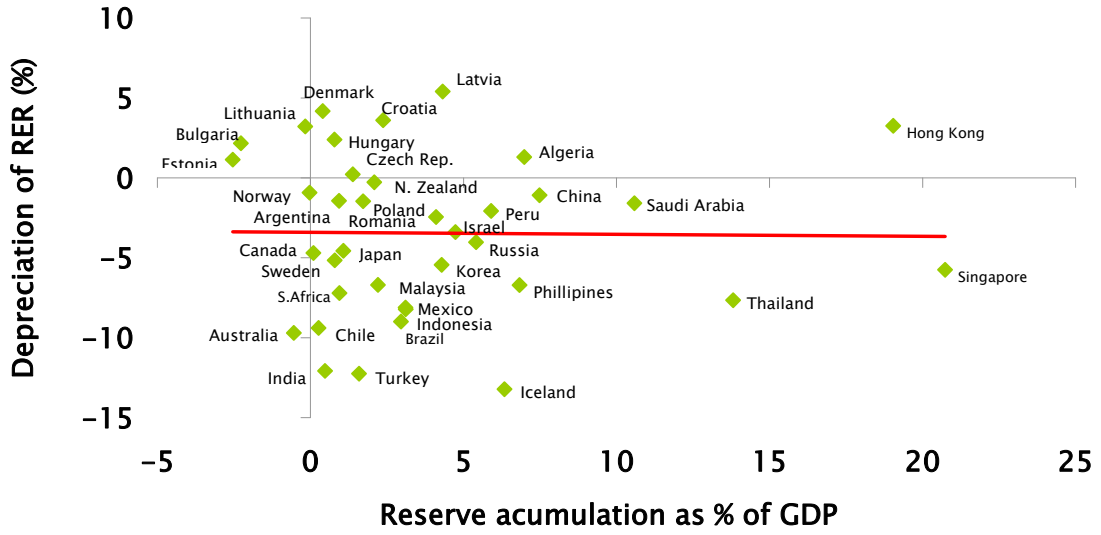
Figure 7
Nominal exchange rates
(averaged index, 1/Jul/2007-10/Dec/2010=100)



(1) Range indicates peaks and troughs of the local currency parities during the period.
(2) Spot value as of 10 December 2010.

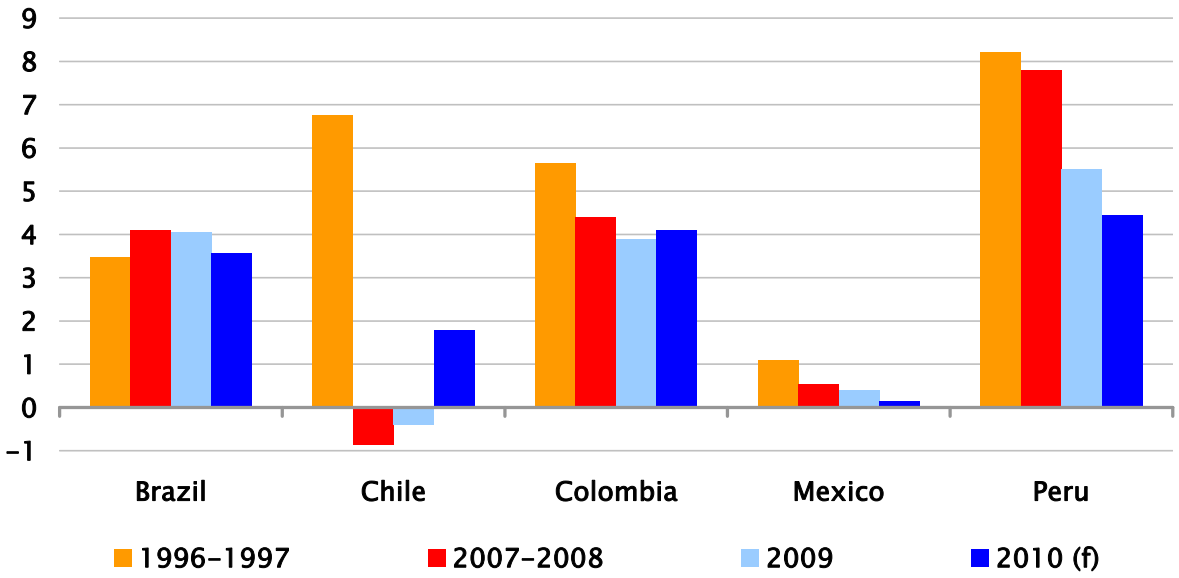
Sources: Central Bank of Chile and Bloomberg.

Figure 8
Real exchange rates and international reserves (*)
(percent)



(*) Considers variations between September 2009 and November 2010.
Source: Central Bank of Chile based on data from the BIS and Bloomberg.

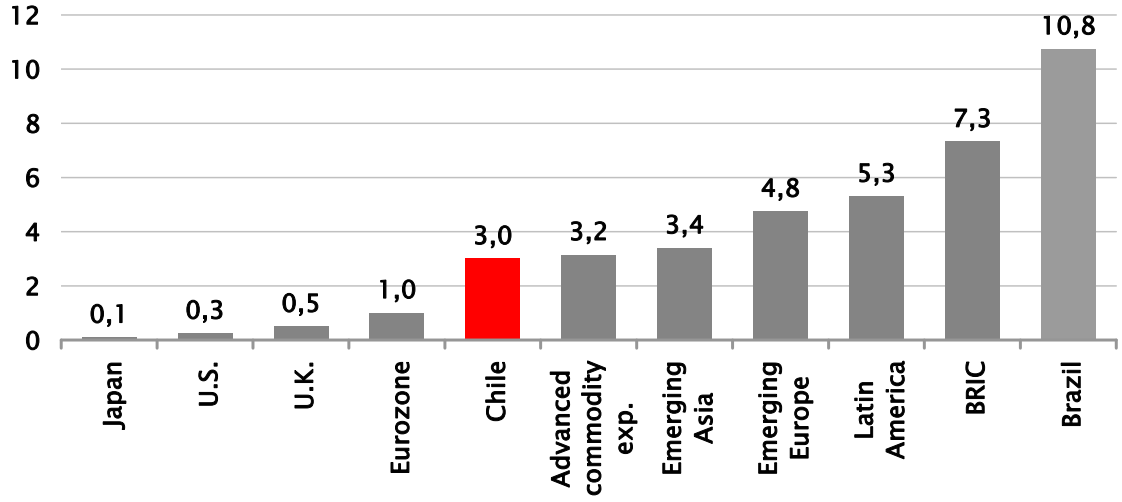
Figure 9
Net capital flows
(percentage of GDP, average for each period)



(f) Forecast. Considers actual data through second quarter 2010 and estimates for second half 2010, based on the share in net capital flows to Latin America in 2009 and forecast for 2010 from WEO, October 2010.

Source: Central Bank of Chile based on IMF figures.

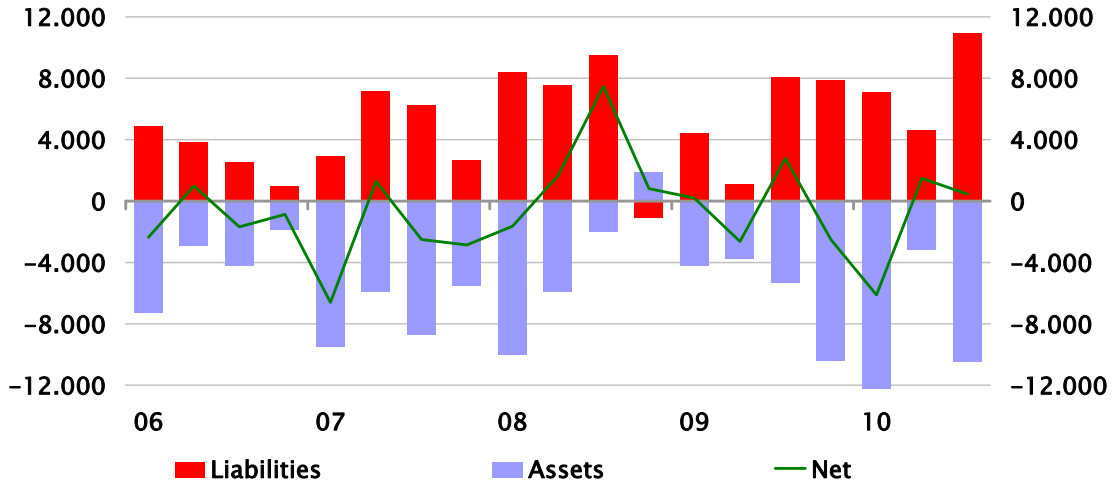
Figure 10
Monetary policy interest rate (*)
(percentage)



(*) Simple averages by region. Emerging Asia includes: China, the Philippines, Hong Kong, Indonesia, India, Malaysia, South Korea, Thailand and Taiwan. Emerging Europe includes: Hungary, Poland, the Czech Rep. Romania and Russia. Advanced – commodity exporters includes: Australia, Canada, Norway, New Zealand, and South Africa.

Source: Bloomberg.

Figure 11
Financial accounts' flows
(millions of dollars)



Source: Central Bank of Chile.