Rodrigo Vergara: The Central Bank of Chile and the external crisis

Presentation by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, at a special session held by the Honorable Senate to "analyze and evaluate the economic policy measures that have become indispensable to confront the severe symptoms of international recession and with the purpose of becoming familiar with the Contingency Plan announced by the Supreme Government", Santiago de Chile, 31 January 2012.

*   *   *

Mr. President of the Senate, Senator Guido Girardi, Honorable senators.

Thank you for your invitation to discuss the international economic situation and the measures that can be adopted in our country to address an external crisis. These instances are important for communicating the vision of the Central Bank of Chile (CBC) on these issues.

In the past several years, the advanced economies have gone through a severe crisis. The causes and consequences of the Great Recession of 2008–2009 have not yet been resolved and we are again enduring periods of external stress that put to the test the strength of our economy and its fundamentals. This forces us to carefully evaluate the current environment, its implications on the performance of our economy, and the measures we can implement if deemed necessary.

During the past year, the biggest tensions have originated in the frail fiscal and financial conditions of some economies in the Eurozone. This situation has persisted for a long time and no definitive solution is foreseen in the near term. Progress has been made in several areas, but the problems' complexities and the political difficulties to deal with them are huge. This, coupled with the delicate position of consumers and firms, has translated in deteriorating economic expectations in the region, anticipating a recession during this year. The situation in the United States, while less severe than that in Europe, is also complex, especially because of the slow recovery and little room for fiscal and monetary policies to stimulate the economy. The emerging world, Chile included, will undergo a period of slower growth than in the past few years. Market consensus forecasts, last week's IMF projections, and also those in our December 2011's *Monetary Policy Report* point in the same direction (table 1).

Most recently, the information coming from the U.S. shows a somewhat better performance than was forecast some weeks back, but does not modify medium-term problems and risks affecting its economy. In fact, last week the Federal Reserve extended from mid-2013 to end-2014 the period during which it would hold the fed funds rate at the minimum level where it is today, which reflects the magnitude of the problem. Meanwhile, information from China reveals its economy is growing strongly. It also shows a relief of inflationary pressures in that country, providing more space for policy-making. The prices of commodities, especially copper, have recovered significantly in the past few weeks. Actually, today's price of this metal is substantially higher than we had forecast for the year.

The baseline scenario in our December *Monetary Policy Report* is still totally valid. Our aforementioned report and the market expect a moderate deceleration of Chile's growth. Our economy is forecast to grow in the range of 3.75% to 4.75% in 2012, with y-o-y rates for every expenditure component below those of 2011. This would be the response both to a normal, sound convergence of the economy to trend-consistent growth rates, and to the effects of a less favorable external environment.

The latest data show our economy gradually adjusting to lower growth rates, at the same time that expenditure indicators are still showing substantial growth. Sure enough, there are differences across sectors. In some branches of manufacturing, especially export-oriented ones, dynamism is milder. In other sectors, such as retail, there is some degree of higher caution in inventory management. By contrast, the consumption of durable and capital goods, which are normally the first to react to a change in the agents' expectations, remains strong, the same as the construction sector. Meanwhile, various indicators signal a tight labor market. It has been recently reported that in December, the unemployment rate as measured by the Universidad de Chile survey for Greater Santiago dropped to a 15-year low, and that the creation of new jobs has, for the most part, been accounted for by salaried employment.

Turning to the debt burden of households and firms, as we noted in our *Financial Stability Report* of the second half of last year, the financial indicators of the corporate sector look favorable, with a stable and limited currency mismatch. The household average shows no financial deterioration because the increase in private consumption has been accompanied by an increase in labor income. However, households as well as firms must keep a watchful attitude facing possible risk scenarios. As for banks, the sector has adequate capital levels to absorb the materialization of a severe risk scenario. As shown in our last *Financial Stability Report,* stress tests indicate that the banking system's current levels of capitalization would permit it to absorb an episode of sharp GDP slowdown, an increase in the cost of credit in pesos and an exchange rate depreciation. Meanwhile, the State keeps a net creditor position, contributing to the access to external loans at low spreads.

Our terms of trade, although lower than some months ago, are high by historic standards, and our external credit access conditions are good, also by historic standards as well as compared with other emerging economies. Annual inflation is somewhat above 4%. The latest monthly CPI figure was unexpected, but given its characteristics it does not change our evaluation of the medium-term inflation trend, which remains centered on 3%, just as we stated in our *Monetary Policy Report*. Private inflation expectations are also stable around 3% y-o-y. This body of information leads us to establish that our baseline scenario remains in full force.

But still in this conjuncture, which looks fairly favorable for the Chilean economy and the Chileans' financial situation, it is necessary to warn about the high risks that persist and that is why the CBC keeps risks for growth biased towards more negative scenarios. In particular, among these risks there is the possibility of new episodes of international financial volatility ultimately affecting the agents' expectations, global demand and international credit. The possibility is still there of a deeper than forecast recession in the Eurozone, as well as of a disorderly evolution of the continent's problems or even of a fragmentation. And one must also consider the possibility of a sharper adjustment of growth in China. Neither should geopolitical tensions in the Middle East be overlooked, with its potential implications on the oil price. All these external contingencies are part of the preoccupations we monitor closely at the CBC in cooperation with the Finance Ministry and superintendences of the financial sector, within the framework of our coordination meetings and those of the Financial Stability Committee.

The preoccupation motivating this session is which measures we could take to confront a further worsening of the global situation that could wash over our domestic economy. The Central Bank of Chile has the necessary tools and policy space to act to mitigate the effects of adverse external scenarios over the Chilean economy. The capacity of the Bank to react to a global worsening has been already proven during the episode of 2008–2009. The Board, as has been said time and again, has the flexibility and disposition to use these tools as needed.

In this scenario, our latest *Monetary Policy Report* assumed that a somewhat more expansionary monetary policy would be necessary in order to accommodate and reduce the negative effects of the forecast external developments. The 25 basis point reduction in the monetary policy rate we applied in our last monetary policy meeting goes in this direction. At present our policy rate is at normal levels, and projected inflation and expectations two years ahead are aligned with the target for this variable. This situation grants us the flexibility we need to conduct monetary policy in the eventuality of a sharper deterioration of the external scenario with significant consequences to the Chilean economy.

The financial markets have exhibited an increase in external credit premiums paid by Chilean banks and firms abroad, offset to some extent by base rates in record lows. In the local money market we have seen some frictions. As a response, the Bank has applied more active management of liquidity in domestic currency, in order to make sure that the money market operates in consistency with the orientation of our monetary policy. In fact, with the measures adopted last year and specific factors cleared out, the money market's interest rates have shifted toward levels in line with the current and forecast levels of the policy rate (figure 1).

Beyond the recent measures, the Bank has at its disposal a toolkit it can use when the need arises. On one hand, in the years 2008 and 2009 we devised new ways to provide domestic and foreign currency liquidity which can be activated quickly but which in the present conjuncture have not been thought necessary. In case of a worsening of external financial conditions, the Central Bank has to possibility of alleviating its effects by using a number of guaranteed financing instruments, such as swaps, long-term REPOs and collateral extension, among others. Moreover, there are reserves available of close to 40 billion dollars, augmented with the reserve hoarding plan we carried out in 2011 and which has helped to strengthen the liquidity position of the Chilean economy.

It is worth noting that these measures are an alternative for providing subsidiary support, whose adoption is warranted only in the presence of major distortions in monetary and financial markets. In this complex environment, agents, banks, financial intermediaries and firms need to carefully evaluate the associated risks and take prudent action to properly manage their liquidity and financial risks. Any hasty behavior of the authority may mistakenly signal bad conditions to a market that is operating normally.

Similarly, keeping a floating exchange rate policy points in the same direction, as it provides the proper incentives for prudent management of external liquidity and borrowing. It also helps in the economy's process of real adjustment when facing a deterioration in the external scenario. In terms of both the exchange rate and access to credit, it is of high importance not to distort the incentives of financial institutions and firms to prudently administer their risks in a complex environment.

To sum up, I would like to point out once again that the Board of the Central Bank of Chile strongly believes that as a country, and particularly as a Bank, we are well prepared to confront periods of stress. We are certainly not immune to the events outside our borders, and risks are very high today. We have at our disposal the necessary tools to mitigate the effects of more adverse external conditions but, most importantly, we can and will use them whenever the situation calls for it. Solid proofs of this are the measures we have taken in the last weeks.

Thank you.

Table 1

World growth

(annual change, percent)

	Average 00–07	2010 (e)	2011 (f) Dec.11 MP Report	Jan.12 WEO	2012 (f) Dec.11 MP Report	Jan.12 WEO	2013 (f) Dec.11 MP Report	Jan.12 WEO
World at PPP (1)	4.2	5.0	3.8	3.8	3.5	3.3	4.1	3.9
World at market exchange rate (2)	3.2	3.9	2.8	2.8	2.7	2.5	3.2	3.2
United States	2.6	3.0	1.7	1.8	1.8	1.8	2.2	2.2
Eurozone	2.2	1.9	1.6	1.6	-0.1	-0.5	1.0	0.8
Japan	1.7	4.4	-0.7	-0.9	2.0	1.7	1.6	1.6
China	10.5	10.4	9.1	9.2	8.2	8.2	8.5	8.8
Rest of Asia	5.1	7.8	4.5	4.9	4.4	5.0	4.8	5.0
Latin America (excl. Chile)	3.5	6.3	4.2	4.2	3.6	3.6	4.0	3.9
Commodity exporters	3.1	2.9	2.0	2.1	2.5	2.4	2.8	2.6
Trading partners	3.6	6.1	4.2	4.2	3.8	3.8	4.2	4.3
Terms of trade	8.1	23.8	-2.9	–	-6.7	–	-3.5	–
					(levels)			
LME copper price BML (US$cent/lb)	–	342	401	–	350	–	340	–
Gasoline price (US$/m3)	–	598	804	–	784	–	748	–

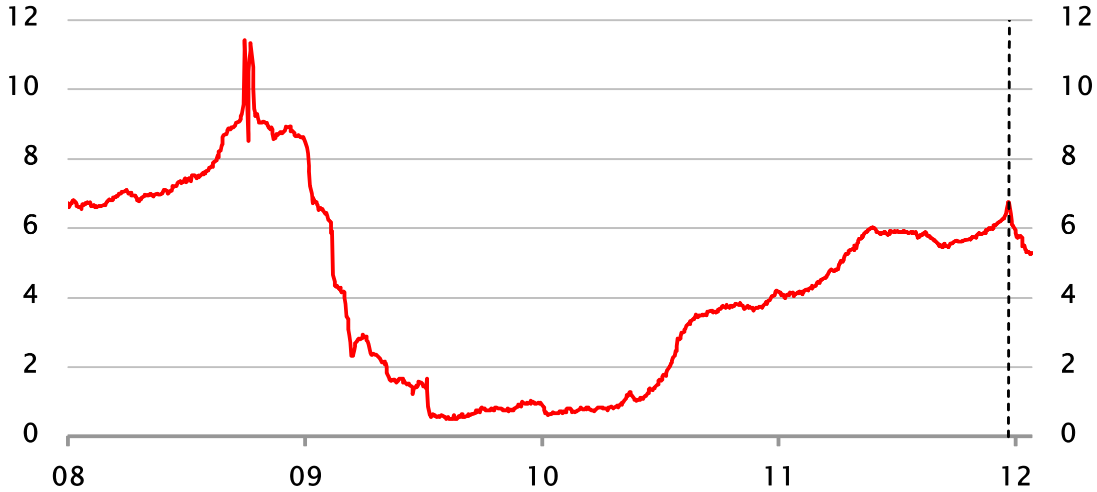
(e) Estimate. (f) Forecast.
(1) Assuming average economic growth for the rest of the world of 3.2% in the three-year period 2011–2013.
(2) Assuming average economic growth for the rest of the world of 1.7% in the three-year period 2011–2013.

Sources: Central Bank of Chile based on a sample of investment banks, Consensus Forecasts, the IMF and statistics bureaus of respective countries.

Figure 1

Conditions of 90-day rates in CLP market[(1) (2)]

(percent)



(1) Prime deposit rate.
(2) Dotted vertical line marks date of CBC's REPOS purchase announcement.

Source: Central Bank of Chile.