Some Policy Lessons for Emerging Economies

Vittorio Corbo
Governor
Banco Central de Chile

20 JUNE 2006
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.
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

Vittorio Corbo
Governor
Banco Central de Chile

20 JUNE 2006