Vittorio Corbo: Recent trends and perspectives for the Chilean economy

Speech by Mr Vittorio Corbo, Governor of the Central Bank of Chile, at the Seminar "Business and Economic vision 2007-2008", organized by Sofofa and Universidad del Desarrollo, Santiago, 17 October 2007.

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The insertion of the Chilean economy into global markets has implied that its economic cycle has been determined by a mix of domestic macroeconomic policies, world economic events and by idiosyncratic conditions, such as recent energy supply shocks. In recent years, the prominent external environment for the Chilean economy has been favorable. On the one hand, a rising demand and high prices of our exports, and on the other hand, low import prices of consumption and capital goods. In addition, firms have also faced favorable financing conditions. In this presentation I will start by discussing the outlook for the World Economy. Next, I will discuss recent trends in the Chilean economy and, finally, some reflections on the conduct of monetary policy and the main risks we currently face.

Perspectives of the world economy

The last five years have been the best five-year period in growth, inflation and financial conditions that the World Economy has experienced in over 30 years. However, this scenario has been changing in the recent months. Although the turmoils in global financial markets that started in July have been reduced by the determined actions taken by the central banks of industrial countries, especially the Fed, risk aversion is still high, credit maturity has been reduced considerably and, except for prime firms, financial conditions have narrowed around the world.

It is foreseen that turbulences in global financial markets will have effects on the perspectives of the world economic growth. In any case, this adjustment comes at a time in which most firms and the banking sector around the world are on solid footing, perhaps with the sole exception of some economies in Eastern Europe.

The epicenter of this trembling is in the United States, which economy already was experiencing an important adjustment in its housing market, now expected to be more intense and extended as a result of the deterioration in the credit conditions that experiences its mortgage market. At the same time, the drop in US housing prices and the less favorable financial conditions faced by US consumers will affect the dynamism of private consumption. Although the deterioration of financial conditions has no direct effect on prime firms, their economic perspectives have been negatively affected by lower dynamism expected for consumption and by more restrictive financial conditions faced by their consumers and suppliers. Nevertheless, it is important to emphasize that the indicators of real activity of the third quarter have shown a surprising strength of the labor markets and consumption.

In the Euro Zone and Japan, partial indicators show that the third quarter GDP growth has strengthened after the contraction of the economic activity in Japan during the second quarter. However, consumption is still weak in both zones and, especially in the Euro Zone, financial conditions have also been deteriorated with potential effects on consumption and investment. In this sense, confidence indicators so much for consumers as for firms are showing less favorable perspectives.

Despite the still uncertain effects that the adjustment of global financial markets would have, projections of the world GDP growth have already been reduced (moderately). It is not a surprise that these reviews affect chiefly projected GDP growth of industrial economies. The *World Economic Outlook*, presented by the IMF today, reduces the forecast for World Economy growth for 2008, by half a percentage point, to 4.8%, with a forecast for the US

GDP growth of only 1.9%. In the same report, growth projections for the Euro Zone and Japan are also corrected downward for 2008. Corrections for emerging economies are marginal, particularly for China, India and Russia.

In spite of adjustments in global financial markets and of reductions in the GDP growth perspectives for advanced economies, the appreciation of stock markets in emerging countries is surprising. Apparently, markets have anticipated that the deceleration of industrial countries will have reduced the effects on these economies and their financial conditions will not deteriorate as much. The reason is the combination of a higher risk premia and lower interest rates in industrial countries, as a result of flight to quality and expectations of lower monetary policy rates than previously expected so much for the US as for the Euro Zone.

In this external setting, commodity prices have remained high and, particularly, crude oil prices are reaching record nominal levels in dollars. Besides, international prices of food are showing a rising trend. Accordingly, emerging economies have been more dynamic than previously expected, contributing to worldwide GDP growth. Thus, China, India and Russia as a group explain more than a half of the world GDP growth during the first semester of this year.

The Chilean economy

Chile's current framework of macroeconomic and financial policies and institutions has insulated the economy from the turbulences in international financial markets. In particular, the fiscal solvency and the conduction of an inflation-targeting monetary policy under a floating exchange rate regime have increased the economy's resilience to external shocks. Between July 19 and August 16 – the day before the Fed reduced its discounted rate in 50 basis points and authorized the use of bonds supported by mortgages and collaterals – the Chilean peso depreciated slightly, the 10-year bond rates decreased and the stock exchange experienced one of the lowest falls among industrial and emerging economies.

The Chilean economy started a period of above-trend-growth in the third quarter of 2006. This growth has been supported by expansive domestic macroeconomic policies and favorable external conditions. As a result, we estimate the GDP to reach its long-run trend level during the second quarter of this year. Partial indicators for the third quarter suggest that growth has slowed, and will be lower than expected in the September's Monetary Policy Report (MPR). This has been mainly the result of the weak behavior of the natural resources sectors (mining, fishing and electricity, gas and water) because of supply shocks due to technical problems in mining, and substitution of hydroelectric power with thermal generation based on oil. In addition, the manufacturing industry has slowed down surprisingly. We are yet uncertain as to the causes and persistency of this slow-down. On the demand side: private consumption is growing at close to 7% (yoy) while investment in fixed capital picked up after the slow-down of the second and third quarters of 2006. Partial indicators for the third quarter show a moderate growth in investment and a slight reduction in consumption growth. Capital good imports are still growing fast, while investment in building construction is growing at around an annual rate of 5%.

The expansion of private consumption is still supported by a solid labor market, with employment growing at an annual rate of 3% and a seasonally-adjusted unemployment rate under 7%, the lowest since 1998. Financial conditions are also still favorable. The 10-year bond interest rates are low and the annual growth of monetary and credit aggregates continue high, specially the growth of firm credit. At the same time, stock issuance up to the third quarter of 2007 is higher than that of 1996. Notice, however, that the persistent weakness of expectations indicators and the effect of the recent increases in inflation on families' purchasing power imply a risk for private consumption growth.

As a result of the above, the GDP and aggregate demand growth have been somewhat below the forecasts of the September 2007 MPR. There, the GDP growth forecast for this year was 5.75% to 6.25%, with a downward bias. The evidence accumulated so far, indicate that the GDP growth will be in the lower part of the range. The turbulences in international financial markets could be affecting expectations of consumers and entrepreneurs. In fact, consumer expectations have worsened and the forecast of the GDP growth in expectation surveys has fallen.

The most important development in recent months, however, has been inflation. Inflation has picked up, reaching annual rates of 5.8% in September, both for total CPI and core CPI (which excludes perishable foods, energy and regulated tariffs). This surprising rise of inflation has been influenced by unusual (and simultaneous) increases in the prices of food items, given rises in their foreign similes and harsh weather conditions in Chile. These high prices have not only persisted but also intensified in the last months. Additionally, electricity power rates have also increased, as a result of natural gas restrictions coming from Argentina, and the replacement of hydro by oil-based electrical generation.

Rising inflation due to a food price shock is a problem affecting many emerging economies such as Brazil, China, Mexico and South Africa. In turn, the impact of this food price shock on inflation in industrial countries has been smaller, because the share of food items in the CPI basket is lower in high-income economies.

As a result of these price shocks, now it is foreseen that projected annual inflation will be above those published in the last MPR. In line with inflation, short-term inflation forecasts have also risen. However, long-run inflation expectations are still anchored at 3%. This reflects the confidence of economic agents in the Central Bank’s commitment with the inflation target, and the transitory character of the recent hike in inflation.

The different measures of trend inflation have also been rising during the last months, following the rising perishables prices and the reduction of the output gap (effective minus potential GDP) as observed up to the second quarter of this year. At the same time, the growth rate of wages shows increases in recent months (except in August). In addition, the Chilean peso has appreciated in nominal and real terms during the last month.

These changes in the inflationary front have been the main concern of the Central Bank of Chile in the design of monetary policy, considering the purpose of keeping the inflation around 3% most of the time, with a tolerance range of +/-1 percentage points. Given this objective, the monetary policy has been adjusted to avoid persistent deviations from 3% due to the second-round effects of supply shocks or the widening output gap. This is why the Board increased the monetary policy rate in 25 basis points in July, August and September 2007, to a current level of 5.75%. In September, due to the turbulences in global financial markets and their possible consequences on the Chilean GDP growth, the Board decided to change the upward bias in the monetary policy rate to a neutral bias. This was then confirmed in the monetary policy meeting of October, when the Board decided to maintain the monetary policy rate and remarked that future trends would depend on new information and its implications on inflation forecasts. This time the Board added that the future of monetary policy would depend on developments of the World Economy, the eventual propagation of the inflationary shock to other prices, wage trends, medium and long-term expectations of inflation, and the evolution of the output gap.

The market has also adjusted its expectations on the future course of the monetary policy, given both the news on the internal inflationary front and the expected evolution of the worldwide GPD growth. As a result, financial prices have internalized the fact that the monetary policy rate will increase another 25 basis points during this year and another equal increase during 2008. In contrast, most of the market analysts who participate in the monthly survey of inflation expectations, expect an additional increase of 25 basis points for the whole period from now until the end of 2008.

The recent evolution of the exchange rate deserves to be specially mentioned. The Chilean peso has appreciated against the US dollar in the last few weeks, reflecting, in part, the depreciation of this last currency in international markets. This in turn has been the result of the monetary impulse to compensate for narrowing financial conditions in the developed markets and the necessary adjustment of the current account imbalances among the main economic areas. This phenomenon has stressed international financial markets and is a main concern among the economic authorities in industrial countries, especially in the Euro Zone. In Chile, the appreciation of the Chilean peso reduces profits in those tradable sectors that have not been able to adjust their prices in dollars. However, it is important to mention that, thanks to the combination of a fiscal policy, anchored to a structural fiscal surplus and that saves transitory income, and the inflation-targeting monetary policy framework with floating exchange rate regime, the appreciation of the Chilean peso with respect to the US dollar has been one of the lowest among countries all around the world, since the beginning of the US dollar depreciation in international money markets in February 2002.

By contrast, multilateral measures of the real exchange rate have shown a lower appreciation of the Chilean peso, both due to fundamentals (the important improvement of the terms of trade) and financial factors that are not easy to quantify. All in all, the effective real exchange rate is slightly lower than the average of the last 15 years, in spite of the important improvement in terms of trade. Again, the fiscal and monetary policies followed by the Chilean authorities have prevented a higher real appreciation of the Chilean peso and have minimized possible effects as the Dutch disease, i.e., a transitory overvalued currency associated to unsustainable expenditures.

Nevertheless, it must be emphasized that the Central Bank authorities are continuously monitoring the evolution of the real exchange rate considering changes in fundamentals. In particular, the Central Bank is always ready to use the available instruments to avoid negative effects on the Chilean economy derived from sudden and erratic movements in the real exchange rate.

Final remarks

In the last few months, the Chilean economy has faced different shocks, demanding special monetary policy attention so as to fulfil the obligation of ensuring price stability, as it was enacted in the Constitutional Law of the Central Bank of Chile. This objective is a necessary condition to achieve sustainable growth at a rate around its trend.

The main risks currently being considered by the Central Bank are: (1) an eventual propagation of food and energy price shocks to inflation dynamics, in the context of a closing output gap and transitory high inflation rates. This propagation could be materialized via rising wages, due to wage CPI indexation and a reduced unemployment rate; or via rising medium and long-run inflation expectations that significantly could diverge from the inflation target; (2) larger adjustments in global financial markets, with more severe consequences for world growth and commodity prices; (3) signs of more rapid moderation of internal GDP growth dynamism, beyond expected.

In particular taking into account these risks, the Central Bank continues conducting the course of monetary policy according to its constitutional mandate to safeguard price stability.

Yves Mersch: Recent financial market developments

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the 50th anniversary of ACI Luxembourg, Luxembourg, 12 October 2007.

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Since my first invitation to an ACI event as a speaker a few months after assuming my first mandate 9 years ago, the markets have undergone many turbulent sequences, although I could not detect a correlation between market upheavals and my regular appearance at ACI events. Let me therefore thank the Luxembourg chapter for inviting me again today. I feel honoured.

After a first ripple in the first quarter of this year and an increasing number of central banks pointing to the need to reprice certain risks (I gave a warning in that respect at a conference by the European Institute in Washington in April) the market reaction over the last couple of months witnessed what needs to be seen as a basically healthy reaction to mispricing. This reaction however was accompanied by the unpleasant effects of a crisis of confidence among the participants of the global credit markets prompting central bank intervention.

Since I agreed to speak about the turbulence in financial markets, many actions have been taken and a policy agenda for drawing the lessons is emerging.

Allow me therefore briefly to highlight the main events, before commenting on the experience we acquired inside the Eurosystem during these weeks and months with our elaborate toolbox of instruments and operations.

I will conclude with some tentative lessons to be drawn in terms of transparency, valuation, market functioning and supervisory framework adjustment.

At this stage of collecting evidence, I will not dwell on the macroeconomic consequences of this turbulence which took place against the background of a strong performance of the global economy. The momentum of past dynamics still outweighs potential downward risks to the baseline scenario.

I. What happened in the markets

If many expected turbulence, the specific features and the transmission mechanisms were less clearly anticipated.

Many were barking up the wrong tree: Hedge funds and private equity were not the main culprits but suffered.

Let me sum up the unfolding of events in 6 points:

1. **Credit spreads reach record lows in the first half of 2007.**

   The combination of relatively low interest rates for a long period of time, the trend to lay off credit risk out of balance sheets and to securitize and an increasing focus on short-term returns have led to a strong demand for credit risk, especially from non-bank investors. As a result credit spreads fell to all-time lows, leading to a mis-pricing of credit risks. Additionally, many investors relied greatly on credit rating agencies for the valuation of complex financial instruments and their use as collateral.

2. **Strong economies and higher commodity prices were fuelling expectations of tighter monetary policy before the crisis started.**

   In the first half of the year the economic situation proved to be very robust. Most major central banks were normalising interest rates. Strong demand for commodities put upward pressure on prices so that interest rates were rising in the first half of the year.

3. **Mortgage rate re-settings at higher interest rate levels caused delinquency rates to rise, most pronounced in the sub-prime mortgage market.**

This led to losses in the hedge fund sector and increasing difficulties in finding a fair value price for structured deals. Moreover, investment funds experienced difficulties in NAV pricing, resulting in the temporary closures of some funds. Asset-backed securities with high credit ratings have proved not to be as sound, nor as liquid as they appeared. Some of those structured investment vehicles or conduits were extensively leveraged and strongly dependent on short-term funding. In the absence of liquidity, sponsoring banks had to fund off-balance-sheet vehicles from their own balance sheet. This led to de-leveraging and forced asset sales.

4. Higher default rates caused the first bankruptcies in the US and credit spreads started to rise. Risk aversion spread to all asset classes.

Forced sales to cover margin requirements saw volatility rise sharply (VIX doubled from 15 to 30 %). The unwinding of riskier positions caused stock markets to fall (Stoxx50 -11 %) and carry trades were liquidated (EURJPY fell from 169 to 152, a 10 % appreciation). As markets fell, margin requirements rose further. The uncertainty about the pricing of some instruments added additional pressure.

5. As the credit crisis spread further short-term liquidity evaporated.

Short-term funding in the interbank market became unavailable, causing casualties amongst banks and funds. In Europe, IKB and Landesbank Sachsen were rescued from insolvency. Northern Rock followed later.

Funding in the primary market was impossible for banks. Trading in the secondary market stopped, with the exception of government issues.

6. The effective shut-down of the refinancing pipeline left banks to rely on short-term funding from central banks.

Neither primary issues nor short-term papers, such as ABS or ABCP, could be placed in the market. Banks hoarded liquidity in order to be safe from unexpected outflows or the unknown extent of write-downs. Because the usual market refinancing possibilities were blocked banks relied on highly rated collateral for their funding and the liquidity provided by the central bank.

The spread between EONIA and three-month Euribor rose to the highest level ever at 70 bps and has remained high. Unsecured trading in the money market beyond one week effectively ceased to exist.

II. Central bank reaction function

As liquidity retracted first from the credit markets, then money markets, intermediation vanishing, central banks had to move in: to restore orderly market conditions; ensure the integrity of monetary transmission channels, and to ensure financial stability or prevent a systemic crisis.

In view of the confidence crisis among market participants, due to uncertainty about financial individual exposures, the issues at stake were:

1) to have money market rates evolve close to the policy rates;

2) to address the term structure problem to the extent that it was threatening the first issue;

3) and thirdly to address the distributional problem of liquidity among market participants for reasons of financial stability.

The somewhat more complex and elaborate toolbox of the Eurosystem proved very valuable in this respect.

- this applies to the instruments used to provide liquidity: the MRO and LTRO

- this applies to minimum reserve features
- this applies to the number of counterparties with direct access to central bank money
- this applies finally to the range of eligible collateral

Let me say a word about each of these features of the Eurosystem operational framework:

1. At moments of term structure difficulties and shortening of the liquidity constraints, it is of advantage to have both: one-week and three-month liquidity providing tenders conducted weekly and monthly. Fine tuning operations and extraordinary additional tenders, according to standard procedures, allowed a commensurate response within a familiar context, rather than adding to prevailing uncertainty by introducing, in an emergency context, untested new facilities, instruments or procedures.

2. In monetary policy operations, the Eurosystem grants direct access to liquidity to a large number of credit institutions. All euro-area institutions subject to minimum reserve requirements and which fulfil the relevant contractual or regulatory arrangements applied by their respective NCB, may access the standing facilities and/or participate in open market operations based on standard tenders. At the end of August 07, 1 676 counterparties had access to the open market operations, 2 809 to the facility, and 2 141 to the marginal lending facility.

3. The combination of relatively high reserve requirements at 2% and the monthly averaging principle allowed banks to dip into their reserves to meet their liquidity needs.

   This averaging principle, which grants the banks more flexibility in meeting their reserve requirements, is conducive to more orderly market conditions.

   Since the start of EMU in January 1999 the ECB has been providing its (weekly) refinancing to the euro area banking system based on the concept of a benchmark allotment. This benchmark allotment is defined by the ECB as the allotment amount which allows counterparties to smoothly fulfil their reserve requirements until the end of the day before the settlement of the next MRO, when taking into account the aggregate liquidity need of the banking system.

4. The Eurosystem accepts a wide range of collateral to underlie its operations, including marketable and non-marketable assets.

   The Eurosystem has put in place a single framework for eligible collateral, which covers marketable and non-marketable assets that fulfil euro area-wide eligibility criteria.

   As far as marketable assets are concerned, there are four liquidity categories: The first and best category is made up by central government debt instruments, the second by jumbo covered bonds, agency, and local or regional government debt instruments, the third by covered and uncovered bank bonds and the fourth by asset backed securities.

   There are two types of non-marketable assets that are accepted as collateral: credit claims and non-marketable retail mortgage-backed debt instruments. Although different levels of haircuts are applied to the different categories, one might say that the Eurosystem also allows banks to use collateral easily where either the interbank Repo markets are less liquid (such as in category 3+4) or where there is even no interbank Repo market at all (such as for non-marketable assets).

   Banks have the choice to use more or less liquid assets as collateral, a facility which constitutes a big advantage in critical liquidity conditions such as those currently experienced by market participants.

Some recent figures:

The available eligible marketable collateral amounts to EUR 9 trillion.

While the amount submitted to the Eurosystem nearly reached 11% of all eligible collateral by 31 August 2007 (nearly EUR 1 trillion), around 6% is effectively used to collateralize outstanding credit operations with the Eurosystem.

By the end of 2006, uncovered bank bonds had become the largest single asset class put forward in Eurosystem operations (31%), surpassing government bonds for the first time (21%). ABS have also shown a steady growth, reaching 11.4 % of all collateral submitted by the end of 2006, and 19% by the end of August 2007 (+4% in August 2007).

The year 2007 has also shown a steady increase in the use of credit claims, which by end of July 2007 represented roughly 10% of all assets submitted as collateral to the Eurosystem. Even though handling procedures for credit claims are sometime more cumbersome, counterparties show an increasing interest for this asset class with very low opportunity cost.

The bottom line of these figures is that the increasing use of lower opportunity cost collateral shows that a growing number of counterparties are becoming more active and efficient in managing their collateral, and thus their liquidity.

Finally, the recent market turmoil provided tangible evidence that the collateral framework of the Eurosystem is broad enough to ensure that counterparties do not face collateral shortages, even in difficult situations.

Where do we stand today?

The degree of uncertainty concerning risk – where is it?, how much?, at what price? – is declining with every forthcoming disclosure. Some asset classes have already fully recovered their risk appetite.

Bank profits will be impacted, but their capacity to absorb adverse developments has also been strengthened by buoyant results over the last years.

However, we are not back to normal yet, especially in the unsecured interbank term money market. We are not fully safe from a low probability but potentially high impact negative event.

Before drawing some tentative lessons, let me add that there is no trade-off between liquidity provision and monetary policy, with its primary objective of maintaining price stability to which we are resolutely attached.

III. Key issues

At the international and at EU level a tentative agenda is emerging around 4 axes for further examination.

First: Transparency

Enhance transparency for investors, markets and regulators (including improvements at the level of data reporting). Credit risk transfer has facilitated the dispersion and sharing of risks across the financial markets, thus potentially enhancing their efficiency and stability. However, the recent market turbulence confirmed concerns about the risks stemming from the lack of transparency as to where the risks ultimately reside in the financial system, and in particular if those risks have been acquired by market participants that can properly manage them. The existing reporting requirements of the banking sector did not allow for a full assessment of banks' exposures to the structured products, leading to the absence of accurate and timely information.

Are Basel II requirements sufficient concerning the sponsoring by banks of SPV?

Is bank disclosure of securitization operations, and exposures to SIV adequate?

Questions also arise in relation to the functioning of markets for complex financial instruments.

How to inform the individual investor when there are difficulties in measuring risk in structured finance products and valuate them?

In this category of improved transparency, I shall also mention the need to implement ESCB-CESR standards for payment and settlement including ICSDs and large custodians in order obtain more information on intraday market liquidity.

Second: Valuation

More work is needed on standards to ensure reliable valuation of assets particularly of those assets where markets are potentially illiquid in time of stress. At the same time compatibility with international financial reporting standards must be assured.

Third: Market functioning

I have to mention first the assessment of the role of credit rating agencies, their small number, the transparency of their rating methodology, possible conflicts of interest in particular as regards structured finance instruments. Excessive exclusive reliance on credit ratings by investors without carrying out due diligence or conducting further own risk assessment is a problem as well.

The road map also includes a reflection on the consequences of the originate and distribute model of banks for credit markets. Does it induce wrong incentives?

A last item in this list relates to non-regulated debt markets and mortgage markets, which might deserve a hard look in the light of recent experience.

Finally: The regulatory framework

Above all, liquidity risk management relating to complex structured products needs to be investigated. We need a wider concept of concentration risk including wholesale and interbank markets as well as intragroup exposures. We have to look at warehousing and pipeline risk, deal with possible regulatory incentives to move risk off balance sheet into SPVs.

We have to assess the links between the regulated and the non-regulated part of the system, including the optimal perimeter of supervision. Special purpose investment vehicles and conduits were used as off-balance sheet investment vehicles. These were prone to liquidity mismatches between their assets and liabilities, causing contingent credit and liquidity lines to be drawn on banks, and resulting in an increased demand for money market liquidity.

Closer examination of procyclical effects of credit market developments and the treatment of risk embedded in structured products held for trading is also warranted.

The Deposit Guarantee Schemes, in the light of recent events, also need to be revisited. This is a piece of advice I would most urgently give to the authorities of this country with its unfunded DGS.

Last but not least

If there is one major lesson recent market developments have clearly shown, it is the shortcoming of a prudential framework which sidelines the central bank.

Cooperation at international level is only as good as cooperation at domestic level. Liquidity issues cannot be segmented between an FSA and a central bank with no contacts of an institutional nature.

With this personal remark for domestic consumption I thank you for your attention.