José De Gregorio: Exchange rate and export development

Speech by Mr José De Gregorio, Governor of the Central Bank of Chile, at the Special Session on Exchange Rate at the Chamber of Deputies and the 23rd National Meeting of Fruit and Vegetable Producers, Santiago de Chile, 6 October 2010.

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Chile has prospered during recent decades thanks to globalization. Having tried various strategies, we can say we have reached consensus on this matter. For an economy of our size and characteristics, opening up to the rest of the world is essential for creating the competition and efficiency that will stimulate development. Four decades ago, this idea was a voice in the desert in developing economies, but today it is the accepted norm.

There is also consensus that monetary and exchange policy should be conducted by an autonomous central bank, and that fiscal policy should be governed by transparent, predictable and sustainable rules. After much trial and error, our country adopted an institutionality that has allowed us to walk through complex international situations with relative stability.

Today I would like to discuss how we at the Central Bank of Chile view the challenges facing export development, in particular with regard to monetary and exchange-rate policy.

Let me open by explaining the four principles guiding our decisions, so I can clarify some misconceptions with respect to the Central Bank and the exchange rate.

To begin with, the Central bank is not indifferent to the movements of the exchange rate, in the same way as we are not indifferent to the evolution of unemployment, credit or any other variables relevant to the country's economic performance. The Bank's constitutional act mandates that we safeguard price stability and the normal functioning of internal and external payments, but fulfilling this mandate requires us to adopt those measures which will drive the economy to making full use of its resources and maintaining a sustainable balance of payments. Price stability and financial stability are cornerstones of our economy's performance, growth potential and human well being.

I could make a lengthy discourse about how the Central Bank reconciles its mandate with welfare objectives but I think it is enough to observe our track record over the past two years to recognize that if output and employment are recovering so strongly today, it is largely thanks to the flexibility of our monetary policy in facing the worst global economic downturn in almost a century.

Our second principle is that we have to evaluate the effectiveness, costs and benefits, of our actions. We must also explain with maximum rigor and transparency our decisions and opinions regarding the main trends of our economy. Our reputation and credibility would suffer if we took any actions without being soundly convinced that they would be both convenient and effective towards achieving our objectives and at the same time inflict the smallest possible social cost.

The third principle is that the Central Bank does not use the exchange rate to target inflation. There are many examples of financial crises and economic disasters when the exchange rate has been used as an anti-inflationary tool, generating serious exchange setbacks that only brought on substantial, costly adjustments to the real sector and caused long-lasting harm to GDP potential.

However – and I must say this not to fail on the second principle I mentioned earlier – the exchange rate does affect inflation and, yes, it is affected by monetary policy in the short term. This is a channel for transmitting monetary policy in open economies that mitigates the cost in terms of increased unemployment of meeting the inflation target. Let me rephrase this. Inflation is controlled via the interest rate: if the outlook is inflation rising, then the

interest rate is raised. In a closed economy, interest rate hikes slow down demand, which means that they also slow down economic activity and employment, thereby controlling inflationary pressures. This allows medium- and long-term policy to be upheld but obviously inflicts short-term costs. That is what stability is all about. In an open economy, on the other hand, there is an additional channel and that is the temporary exchange rate appreciation that results from raising the interest rate and this diminishes the need to slow down economic activity. The effects of exchange rate fluctuations on activity are an important factor in our evaluation of the inflation outlook and in our monetary policy decisions. At the present time, interest rate differentials with developed economies are well below historic averages and the interest rate is still below normal levels.

The fourth principle I want to discuss is that stronger countries generally have stronger currencies. In other words, the purchasing power of their wage packets is comparatively greater as these economies outpace the rest of the world. We could discuss many more factors, such as ways to mitigate appreciation, what circumstantial factors spur it, etc. At the end of the day, what we need is to transform the cyclical strength of our economy into greater productivity which will increase our potential for growth. But it is important to note that this principle does not work the other way around. In the past we have been obnubilated equating a strong currency with a strong economy, but we soon had to realize that the strength of the currency was not due to a fundamentally sound economy but rather the outcome of policies inducing currency misalignment.

I would like to draw your attention to the fact that I have not included a flexible exchange rate as one of the principles, in order to avoid dogmatism. But in our country, experience overwhelmingly shows that exchange rate flexibility, managed pragmatically, is the most adequate system for us. This regime some times involves drastic exchange rate adjustments, which can be costly to many firms. The alternative is a more rigid exchange rate, where fluctuations in foreign currency supply are mirrored by fluctuations in domestic credit cost and availability, which can be very detrimental to the financial system's soundness and to firms. More rigid systems simply put off real-sector adjustments, but in the meantime capital flows, credit availability for firms and inflation are all affected and eventually the value of the currency is eroded and the higher nominal exchange rate does not lead to a higher real exchange rate.

On the other hand, a floating exchange rate allows more rapid adjustments and the next movements of the exchange rate are uncertain, preventing the market from betting on one direction. Thus we avoid repeating past mistakes and returning to the days where prospects of gradual appreciation artificially cheapened foreign borrowing and induced massive capital inflows.

Another important factor in determining the exchange rate are pressures from fiscal policy. For more than twenty years, Chile has benefited from a responsible fiscal policy, using it counter- cyclically when the situation warranted. Questions of budget go beyond macroeconomic considerations but the fact is that in the present circumstances our economy has started to take off and does not require an additional boost from fiscal policy. The Finance Minister's recent statement on the budget aims towards reducing the structural fiscal deficit and is fully coherent with assumptions in our latest Monetary Policy Report.

Now, from the standpoint of export development, several aspects are worth highlighting. Firstly, since the mid-1970s, Chile adopted an ambitious agenda of insertion into the world economy. This drive has accelerated and deepened over the years. Some sectors of the economy that were protected by international trade barriers had to adjust. Eliminating protection meant that each productive activity had to focus on its own comparative advantages and the export sector benefited from this structural change, as confirmed by the sustained growth of exports as a percentage of GDP. In the 1970s, goods and services exports accounted for about 10% of GDP (measured in pesos of 2003) while in the past five years they averaged 38%. Moreover, this increase has been based mainly on the growth of

non-copper shippings which went up from only 30% of total exports in the 1970s to 70% in the past five years. That is, more than 80% of Chile's exporting boom since the 1970s is due to non-copper exports.

Of course, this growth has not been free of reversals or accelerations due to external conditions and domestic circumstances. Among external factors we can point to the sharp global downturn caused by the debt crisis and the 2009 recession and, of course, the devastating earthquake and tsunami in February this year. Among domestic factors, we had the necessary sharp cutback to address high levels of foreign borrowing in the second half of the 1980s. Nevertheless, as I said, the long-term performance bears witness to Chile's vocation as an exporting economy.

What has been the role of the exchange rate in this process? This question can be looked at from two different angles. First, it is worth noting that Chile's export development has continued through good times and bad times in foreign accounts and with whatever exchange regime was in force and, over the past four decades, almost all possible regimes have been tried. However, on average, the real exchange rate has been significantly higher than it was in the period of economic development based on substitution of imports. This is no accident; practical evidence and economic theory both strongly indicate that more open economies tend to have weaker currencies in real terms.

Second, irrespective of the exchange rate regime, foreign currency supply and demand conditions fluctuate over time so, as in many other areas, relative currency prices must also fluctuate. Sometimes changes in supply and demand reflect speculation and thus are not associated with long-term fundamentals. At other times, they may reflect confusion as to the future evolution of monetary policy. In these situations, the Central Bank can intervene to affect the value of the currency and bring it back in line with fundamentals. The Central Bank does not consider exchange rate flotation as a dogma and constantly evaluates any possible over-reactions that could be harmful to the economy and call for an intervention.

In any case, we must mention some costs of interventions. Apart from the cost in net worth, intervention requires withdrawing money used to purchase foreign exchange by placing debt. This debt has an impact on market interest rates, affecting firms' financial costs and arbitrage conditions, which could end up undoing the direct effects. At the same time, repeated or frequent interventions lose effectiveness: it is essential for intervention to be an exceptional occurrence in order to transmit the relevant information to financial markets. Nevertheless, it is a valid tool, effective in changing the exchange rate and strengthening the international liquidity position. The board of the Central Bank of Chile constantly evaluates the timing and the size of any intervention and in the past few weeks it has certainly been present in our discussions, based on weighing the benefits, costs and the present context.

In the Central Bank of Chile we use a variety of methods for assessing the real exchange rate level with regard to its long-term fundamentals and thus we have an ample range of estimates. Our aim is not to determine which is the equilibrium – that is the task of the market –, but rather to detect any anomalous deviation. These discussions led us to the conclusion in our latest Monetary Policy Report that the real exchange rate is within the adequate range of levels, albeit in the lower part of it, and this is confirmed by the most recent appreciation.

The real exchange rate is currently slightly below its average over the past twenty years but, with respect to said period, terms of trade, even excluding copper, are today much better. Similarly, our economy is enjoying a much easier net external position – that is, how much we owe and how much is owed to us by the rest of the world – than in the 1980s and 1990s and the real exchange rate has only appreciated slightly over what it was then.

Since the floating exchange rate was adopted, there have been three occasions on which the board considered that intervention was warranted. In general, these interventions affected the exchange rate. Other episodes, that showed how difficult it is to apply an effective intervention, were experienced in the 1990s, when the real exchange rate was significantly

more appreciated that it is today, despite worse terms of trade, a weaker net external position, massive purchases of foreign currency reserves and restrictions on capital inflows.

In emerging and industrialized economies that have successfully weathered the crisis, export activity today faces considerable challenges. The financial crisis and the Great Recession have had profound consequences on the developed world because of their financial excesses. In this sense, they are facing a situation similar to what we lived through in the mid-1980s, only now the adjustments they make locally have global implications. Current account deficits in the advanced world will no longer be what they were five years ago, and this implies also adjustments in the economies that had strong current account surpluses. All this is resulting in a global reorganization of world currencies. However, not all countries are contributing to this exchange reorganization and this generates tension in the workings of international currency markets. I do not wish to enlarge on this point but what is happening in Chile is happening in many regions of the world irrespective of the macroeconomic policy measures they have adopted.

Four factors allow us to be optimistic about how Chile, as an exporting country, will be able to face these challenges successfully. In the first place, we have learned from our past and we have substantially reduced the harmful effects of copper price swings on the rest of productive activities. The danger of exacerbating commodity cycles is widely recognized so stabilizing macroeconomic policies are brought to bear. Secondly, a floating exchange rate discourages speculation and massive capital inflows; in fact, in Chile today there is no evidence of short-term capital inflows for this motive. Thirdly, exchange rate flexibility promotes the development of a hedging market (a mechanism practically unknown when there was a band-based exchange rate regime) and this is now a developing market. Access to this market is to be encouraged, especially for small firms, and any steps in this direction on the part of authorities are welcome. Fourthly, our financial system is solvent and well regulated, which limits the possibility of appreciation bubbles being created by the prospect of inexpensive financing from abroad and abundant credit.

We will continue to face important adjustments in the global economy, with exchange rate tensions in all the economies of the world because rigidity among the most important currencies persists. Recovery of the global economy will be gradual and will vary greatly from country to country. This situation presents a national task, which we must each take on board from our own perspective. In the Central Bank we are paying particular attention to the evolution of the exchange rate because we recognize that there has been rapid and substantial appreciation and we must be watchful that this does not hinder the vigorous growth of our economy. That growth will be long-lasting provided that we ensure stability.

Thank you.