

## **José De Gregorio: The world economy, foreign exchange tensions, and recent monetary policy making in Chile**

Keynote address by Mr José De Gregorio, Governor of the Central Bank of Chile, at the Monetary Club of Universidad Finis Terrae, Santiago, 20 May 2011.

\* \* \*

### **Abstract**

*This presentation discusses risks and tensions that have emerged in the global economy due to the ongoing process of world economic recovery and its implications on the Chilean economy. It reviews the decoupling of emerging economies from developed ones in terms of growth, the difficulties endured by developed economies to boost their feeble recovery, Europe's public debt issues, the high commodity prices and symptoms of overheating in some emerging markets. This scenario has pushed emerging economies' exchange rates to their lowest levels of the past decade. It stands out that, although an important step to change the composition of world demand, it has created tensions and in some cases has prompted the adoption of policies to mitigate exchange rate adjustments. Capital inflows have added pressure to the exchange rate discussion in some emerging economies and might favor an unhealthy increase in lending and incubate financial fragilities. Chile's last forex intervention is mentioned. The differences in capital flows between Chile and other countries and episodes of substantial flows into emerging economies are described, emphasizing that large capital outflows from Chile have created a negative net balance. It is also suggested that the current level of the neutral MPR is probably lower than previous estimates, influenced by the low international interest rates.*

Thank you for inviting me to present at the Monetary Club of Universidad Finis Terrae. This is a good opportunity to review some recent developments in the Chilean economy, in particular the behavior of the exchange rate, the forex intervention under way, and our monetary policy decisions. But before diving into these issues, let me take a look at some important elements shaping the international scenario, which is where the main risks and tensions facing our economy originated.

### **The international economy**

The global economy is leaving the Great Recession behind. Its recovery, however, has been heterogeneous and is subject to risks. The developed world still hasn't fully overcome the negative effects of the crisis, while emerging markets are currently in a strong growth path. Despite they did not commit the excesses of their advanced counterparts; they suffered the effects of the crisis. Overall, the magnitude of the impact on growth in emerging economies was milder than it could have been expected based on recent history, and emerging economies were even able to recover quickly and strongly (figure 1).

The good performance of emerging economies is grounded on their macroeconomic policy schemes. These have evolved and improved over time, partly because lessons have been learned from numerous previous shocks, which originated in macroeconomic and financial imbalances. These schemes pursue low, stable inflation, healthy public finances, strong and well regulated financial systems and realistic exchange rates. Of course policies vary from one country to another, but their basic principles are shared. In Chile, a fiscal policy that saves during good times, an autonomous central bank that conducts monetary policy under an inflation targeting regime and a floating exchange rate, were key elements to successfully work its way out of the crisis. Furthermore, the country has a solid, well regulated financial system that does not allow for many of the operations that dragged some economies to their

troubled present-day situation. A traditional banking model dominates the banking industry, where a strong base of deposits, both personal and institutional, permits to finance mainly credits.

Before the crisis, a lot was said about the decoupling of emerging economies' growth path from that of developed countries. This idea, which gained momentum in 2007 and 2008, was seriously questioned during the disaster because, as I said, no one was spared its effects. In hindsight, however, we can say that there actually was a decoupling. It is true that in a globalized world commercial and financial intertwining does not allow the economies to isolate themselves from the global cycle, but the performance of emerging markets is living proof that mitigating the negative consequences from the external cycle can be done. In fact, it is hard to find another episode where the developed world suffered a severe recession that was not magnified in developing countries. This is especially relevant in Latin America (figure 2).

The developed economies face a different scenario. They are having important doubts about whether their fiscal situation will be sustainable. Large expansions of fiscal expenditure before the crisis and the implementation of unprecedented stimulus packages to cope with it threw their debt levels very high. Today they have no further room to continue increasing public spending and, even worse, they need to make substantial adjustments that are difficult to implement in such a weak economic situation. The cases of the United States and Japan are good examples. Add to this what is happening in peripheral European economies, the adjustments that are needed and the financial tensions this creates. What the founders of the euro had in mind early on was that the economies in Europe, particularly in the south, would adopt sound macroeconomic policies following in the steps of Germany. Nonetheless, it seems that some economies, such as Greece, only took advantage of the low risk premiums, over-borrowing and creating a deficit way bigger than set forth in the Stability and Growth Pact. The consequence was extreme financial vulnerability that is proving very difficult to resolve today.

For the time being, risks seem to be well contained, but the lack of credibility of the markets has resulted in some agents speculating with the possibility of some member country being discharged from the Eurozone. This seems implausible, as it would trigger a major financial crisis, a risk that policy makers in Europe are certainly aware of. It can be discussed at length if it was a good idea to let one or another country in, but once officially a member and in a situation as frail as it is today, the decision becomes irreversible.

At any rate, public debt troubles in Europe are quite complex and call for a global, permanent solution. According to the forecasts contained in the third review of Greece's stand-by agreement with the IMF, from now to 2020 Greece must generate a primary fiscal surplus of 6% of GDP per year. Thus it could take its public debt from its present-day levels of around 1.5 times its GDP to 1.3 times. This is a major adjustment if we consider that in 2008 the country posted a primary deficit of 4.5% of GDP, all this under the assumption that it will pay an interest rate between 6 and 7%, and the interest rate is today around 16%. Certainly, if the rates don't go down it will be hard for Greece to recover easy access to private credit markets, as hard as obtaining permanent funding by official agencies. From these cross-roads, Greece will have to find new permanent solutions that allow it to return to fiscal solvency and distribute the losses without jeopardizing financial stability.

Another complex aspect of the situation of developed economies is their weak recovery. Although their financial systems and economic activity have begun picking up, they have been unable to significantly reduce their high unemployment rates and their large output gaps (figure 3). In addition, growth prospects are poor and, as we have seen in recent weeks, each piece of information that is disclosed may put substantial volatility on the market's evaluation of the strength of the economic recovery.

Furthermore, their financial fragility hinders the possibility of a strong come back. The financial situation of households and governments is complex because of their high degree

of indebtedness. Therefore, it is unlikely that their domestic demands will become a source of output expansion. Thus, the basis for faster growth lies, for now, on the demand from the rest of the world. Their weak currencies are consistent with this. In this scenario, another paradox arises. Germany, the strongest economy in the European Union, whose example the peripheral countries should follow, has been one of the biggest winners in this conjuncture. Its fiscal rigor and productive strength as one of the world's greatest suppliers of capital goods have been boosted by a relatively weak euro. If Germany did not share the common currency, the Deutschmark would be without a doubt the strongest in the world, quite above the equivalent of 1.4 US dollars per euro. Belonging to a fragile monetary union has given it the benefits of a relatively weak currency, which has been an important factor of its fast expansion.

To blend more ingredients into the world economic cocktail, again we face a substantial increase in commodity prices. As usual, it can be attributed to various factors. One is the fast growth of emerging economies and the subsequent increase in demand. Add to this, among others, climate elements that have hindered the production of foods, and geopolitical risks that have pushed up the oil price. These high prices, combined with the fact that emerging economies are near their potential growth level, some with clear signs of overheating, both actual and expected inflation have risen all over the world. Several emerging economies, Chile among them, have withdrawn monetary stimulus as a response to this cycle. In contrast, developed economies, with a timid recovery, have not only sustained their ongoing monetary packages but are expected to keep them in place for a while. This mixture of monetary policy imbalances, high commodity prices, and good growth prospects in emerging economies have created tensions in exchange rates and capital flows, two issues I will refer to now.

### **The exchange rate and capital flows**

Before the financial crisis hit, some developed economies, particularly the United States, were accumulating big deficits in their current accounts. This excess spending was being financed by surpluses in emerging markets, primarily China with its high saving rates, and oil-exporting economies (figure 4).

Global imbalances were an important factor in the crisis. This was not uncommon for emerging economies: low saving rates, large current-account deficits and borrowing used to finance unsustainable consumption or fiscal expansions. This time around, the US strongly increased fiscal expenditure and borrowing, which was used to finance the purchase of overpriced housing. As we now know, and warned insistently before the crisis burst, this mix was bound to lead to severe adjustments, sooner or later.

High terms of trade, capital inflows and growth rates have resulted in exchange rate appreciations in most emerging and oil-exporting economies (figure 5). In real terms, the current level of the exchange rate is at its lowest in the past decade in most emerging economies (figure 6). Vigorous economic growth in these economies means also strong currencies, while the opposite is true in developed countries.

As I said before, the high indebtedness of developed economies holds back domestic demand growth. Meanwhile, in emerging economies domestic demand growth is thwarted by constraints in domestic supply, which require redirecting purchases towards imported goods. The adjustment of the global economy calls for a change in demand composition, and the exchange rate adjustments works in that direction. It is logical to expect that once the developed economies recover their strength, their currencies will follow suit. The transition may take some time, however. Although the adjustment is good for the world economy, it entails tensions that may require exceptional policies.

Thus, several emerging economies, Chile included, have taken action to moderate the exchange rate adjustment. However, due to the forces that underlie it, it is evident that this

trend can be mitigated but not reversed by just a unilateral measure. In January, the CBC launched a substantial process of reserve hoarding, by announcing the purchase of 12 billion dollars, the equivalent of around 5 points of GDP, the largest since the mid-1990s (figure 7). This intervention is sterilized, that is, the pesos issued to buy the dollars are withdrawn through debt issuance. Not doing this would mean that the increase in liquidity would be inconsistent with monetary policy, which would then be oriented to a forex objective and would divert away from its inflation target. I don't need to explain why this would be terribly damaging to our economy.

The purpose of the intervention is twofold. On the one hand, it allows having more reserves which, despite their costs, are a good hedge against sharp movements in capital flows. Although most economies did not significantly deplete their reserves during the crisis, their sole existence prevents destabilizing capital movements from occurring. On the other hand, the forex intervention mitigates exchange rate adjustments. As we have said before, without the intervention the peso would have appreciated further. Still, it is worth pointing out that the appreciation of the Chilean peso is not so different from that of the currencies of a large group of emerging or commodity-exporting economies, whether they have intervened their exchange rates or not.

Let me insist that the forex intervention has only transitory effects. It cannot permanently modify an economy's competitive position. This can only be made with policies that affect the real side of the economy. Monetary or forex measures can only have a temporary influence. The impact of a sterilized exchange rate intervention occurs via the currency portfolio composition. Because external and internal financial assets are not perfect substitutes, changes in their relative supply have an initial effect on prices, which then fades over time. The IMF's latest *Regional Economic Outlook* for the Western Hemisphere presents estimates showing that interventions reduce the rate of currency appreciation. Additionally, it indicates that the effects are milder in more financially open economies, and shows that rule-based or discretionary interventions have similar effects. Ours is rule-based, in order not to lose control over our monetary policy. As proven by this evidence, the effects would not be so different if our intervention had been arbitrary. This comes as no surprise, since the effects depend on both the amount of the intervention and the composition of the currency portfolios.

It has called the attention of many people that a measure similar to that of 2008 has caused a different behavior of the exchange rate. I don't need to say that the combination of events has also been different, especially abroad. Back then the world economy was headed to a severe crisis and risk aversion was growing. This eroded asset value in emerging economies and strengthened the dollar. Copper prices and terms of trade began to decline. Today the picture is quite different: the dollar is weaker than ever and the copper price has remained very high, and is forecast to stay near its present levels for some time (figure 8).

Another issue regarding exchange rate's discussion has to do with the effects of capital flows. Several emerging economies have seen their capital inflows increasing, which has added pressure on their currencies. It is worth noting, however, that this phenomenon is not generalized, because current-account deficits have remained fairly bounded. In the overall group of emerging economies, capital inflows are today close to where they were during mid-1990s, and certainly below the levels of 2006–2008. However, outflows from these economies largely exceed those of the 1990s, resulting in a near-zero net balance (figure 9).

Chile is not so different, with even negative net balances (figure 10). Besides, the structural conditions of our economy and the policy framework are not those of the 1990s. For instance, interest rates paid on indexed Central Bank instruments are now less than half (figure 11). The opportunity of high short-term returns, that are normally associated with massive flows of this kind of capital, is probably not so obvious anymore in our economy.

The possibility that increased capital flows may stimulate unhealthy growth in lending is another cause for concern. The data do not show for the moment that credit is growing fast. It is actually on a flatter slope than it was in the 1990s and that of other emerging economies

that have adopted measures to control capital inflows (figure 12). Still, it is important to be on the watch for excess flows that might incubate financial fragilities and exacerbate economic cycles, in which case it could be necessary to review financial regulations in place to avert any costly imbalances.

### **Recent monetary policy decisions**

The scenario outlined in the latest Monetary Policy Report assumes that in the coming quarters the Chilean economy will grow in line with its potential. This will allow trend inflation, today in bounded levels, to converge and remain around the 3% target in the coming quarters. To achieve this objective, we have withdrawn some monetary stimulus, bringing the monetary policy interest rate (MPR) closer to the neutral range.

Although this is the baseline scenario, the Report also indicated that inflation (and growth) risks were biased upward. For inflation, arguments were based on the combination of adverse supply shocks in energy and foodstuffs, the closing of output gaps and the strong dynamism of the domestic demand.

Some of the aforesaid risks have eased. Private inflation expectations have moderated, consistently with MPR adjustments and the recent decline in oil prices and other commodities (figure 13). Anyway, commodity markets remain volatile, so it is premature to evaluate at what level international prices will settle. Nor can we rule out that the pass-through of previous rises in world prices to domestic ones, especially for foodstuffs, may continue.

Other risks have not changed materially. Incoming news confirm a scenario of very dynamic domestic demand, particularly for consumption, and employment (figure 14). Also wage growth has speeded up and credit is recovering fast. The domestic economy is growing strongly and output gaps are closed. Nonetheless, it is still early to predict an overheating. Actually, the various core inflation measures are still below 3% (figure 15). Output is near full capacity and, mirroring the rest of emerging economies, excess domestic demand is being redirected to imports. The current account still shows a surplus, largely because of good export prices, but also because of steadily increasing volume sales abroad. Furthermore, monetary policy works with a lag, so it is likely that the full effects of the 450-basis-point increase in the MPR since June of last year will not be seen for some time. The information we will be getting in the coming months will give us a better sense of the magnitude of these effects.

Overall, the negative implications of these risks materializing led us to speed up the pace of monetary policy normalization in the past few months. Last week we actually raised the MPR by 50 basis points to 5%. Although the median of market expectations was foreseeing a somewhat smaller increase, we acted preventively to hold down the dynamism of domestic demand and the propagation of adverse supply shocks. Now that the MPR is at 5%, it is approaching the range that has historically been thought of as neutral. Still, a high degree of uncertainty surrounds the true neutral interest rate.

There are many definitions and methodologies to determine what would be the interest rate consistent with inflation being at the target and the economy operating at full capacity.

Although this is not the moment to get involved in a lengthy discussion over the level of the neutral rate, I think some observations are in order. On the one hand, the neutral rate is not a fixed number. It changes with the state of the economy and can even fluctuate in the short run. On the other hand, in an open economy the neutral interest rate depends not only on domestic factors such as the long-term growth rate, but also on external variables. The world is going through a period of low interest rates and in the short term the neutral interest rate is likely to be somewhat below previous estimates (figure 16).

I also want to point out that the objective of monetary policy conduct is not to attain a neutral rate, whatever its level is. The monetary policy interest rate (MPR) fluctuates around this neutral rate in order for the monetary impulse to be consistent with achieving the target. Accordingly, just as there are periods during which the MPR is below the neutral level, there are times when it is above. This is consistent with economic activity fluctuating around its full capacity level, going from periods of capacity under-utilization to periods of over-utilization. So the maximum level the MPR will ultimately reach and when this will happen in the current cycle is something the CBC Board will be analyzing as events unfold.

This year to date, a 200 basis point increase has already accumulated in the MPR and we believe further increases will be needed. The magnitude and timing of these increases will respond to incoming data, risks and their implications for inflationary prospects, taking into account the lags that are inherent to monetary policy. Thus, no scenario can be ruled out. It is likely that in the coming meetings the magnitude of the correction will be reduced and there may even be pauses. Likewise, although today it seems less likely, it can also happen that the recent pace is maintained if inflationary risks so recommend. In any case, there seems to be consensus in market expectations that smaller adjustments will be required going forward. Actually, most forecasts place the MPR around 6% at the end of this year (figure 17).

## Conclusions

The last several years have been very complex. Policy makers have faced probably the greatest challenges in decades. Swings in economic activity, inflation and expectations, among many other variables, have been marked in unprecedented ways.

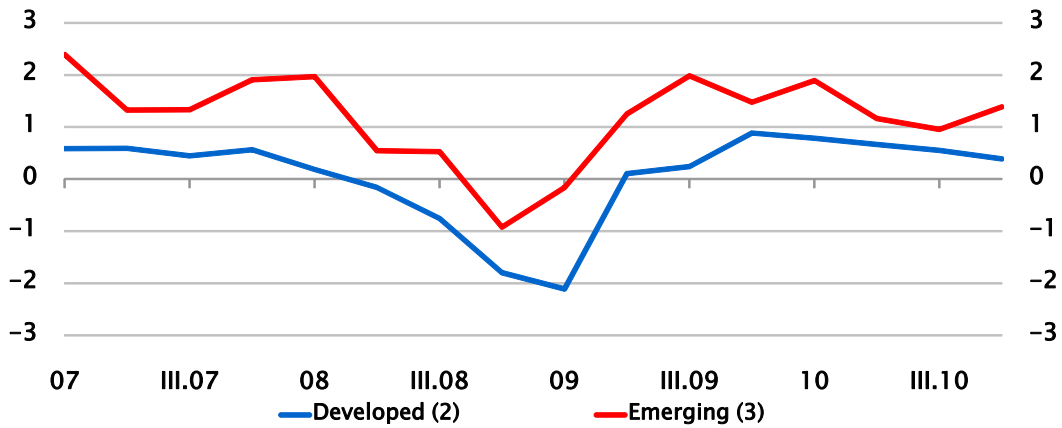
Chile's macroeconomic policy framework has given proof of its flexibility and effectiveness, succeeding in mitigating and overcoming the effects of the world crisis. Today we face new, significant challenges. The economy must continue on a growth path consistent with its capacity, while the inflation trend must be aligned with the target. Moreover, the asymmetric pace of growth between the developed and emerging economies brings along exchange rate tensions that subject us to new trials.

We face a complex scenario. Inflation has proceeded in line with the target, although, as we have been saying, it may cross over the upper bound of our tolerance range because of the strength of the world price hikes for oil and foodstuffs.

It is important to limit the unwanted propagation of these shocks to other prices. Accordingly, the Bank has quickly come to the scene, making sure that no inflationary pressures incubate that might compromise the fulfillment of the objective of low, stable inflation. We have withdrawn the strong impulse that monetary policy brought in 2009–2010. We estimate that the MPR will have to be raised further in the coming months, but by how much and exactly when will depend on the implications of incoming data, without ruling out any scenario *a priori*. As always, the Board will guide its decisions to ensure that inflation remains low and stable, which is the best contribution that the Central Bank of Chile can make to the country's development.

Thank you.

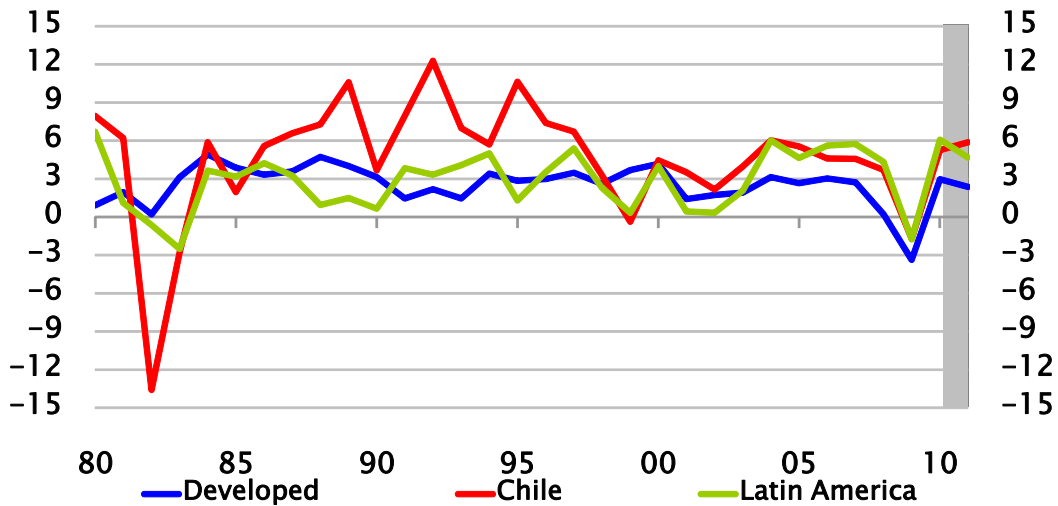
Figure 1  
**Quarterly economic growth (1)**  
 (q-o-q change, percent)



(1) Regions weighted at PPP. (2) Includes: Australia, Canada, Denmark, the Eurozone, Japan, New Zealand, the Sweden, Switzerland, the U.K., and the U.S. (3) Includes Argentina, Brazil, Bulgaria, Chile, China, Colombia, the Czech Republic, Hong Kong, India, Indonesia, Malaysia, Mexico, Peru, the Philippines, South Korea, Russia, Singapore, South Africa, Thailand, Taiwan, Turkey and Venezuela.

Sources: Central Bank of Chile based on each country's statistics institute and International Monetary Fund.

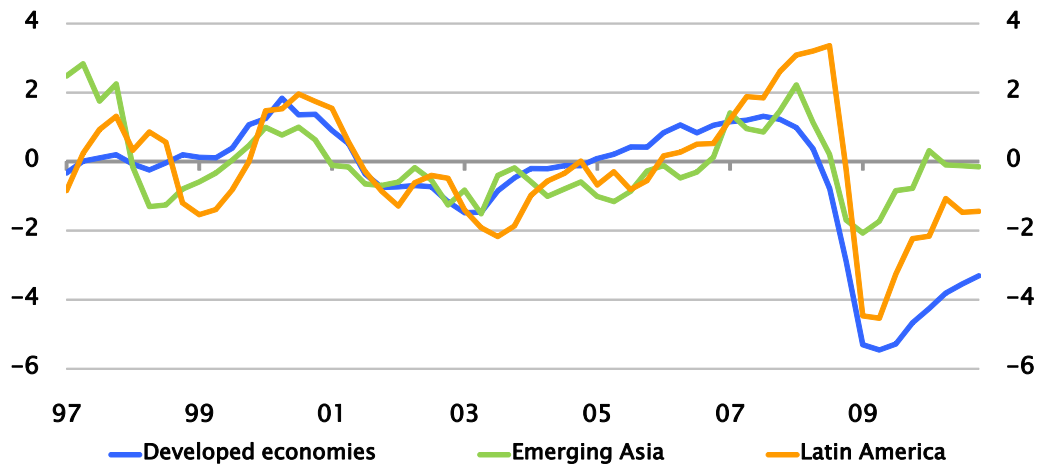
Figure 2  
**World growth (\*)**  
 (y-o-y change, percent)



(\*) Gray area shows April 2011's WEO forecasts.

Source: International Monetary Fund.

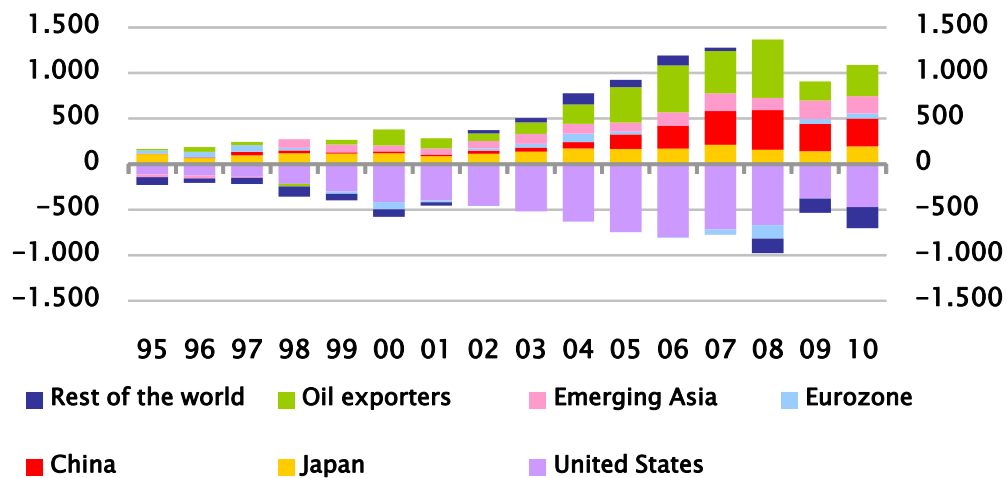
Figure 3  
**Output gaps (\*)**  
 (percent)



(\*) OECD estimates are used for output gaps in developed economies. For the other regions, output gaps are obtained using an HP filter.

Sources: Central Bank of Chile based on Bloomberg, Consensus Forecasts, OECD and the respective country's statistics institute.

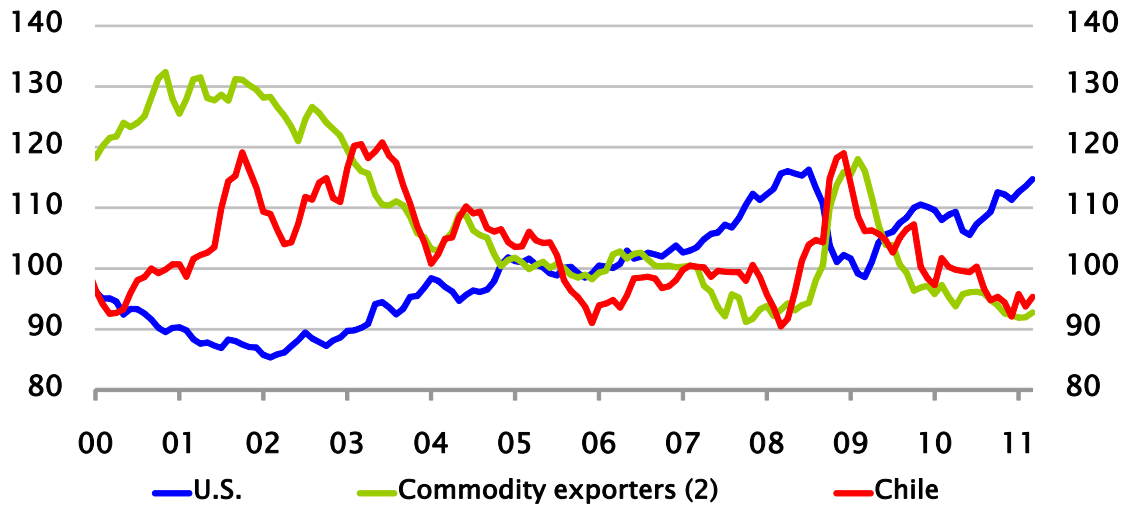
Figure 4  
**Current-account balance**  
 (billions of dollars)



Source: International Monetary Fund, April 2011's WEO.



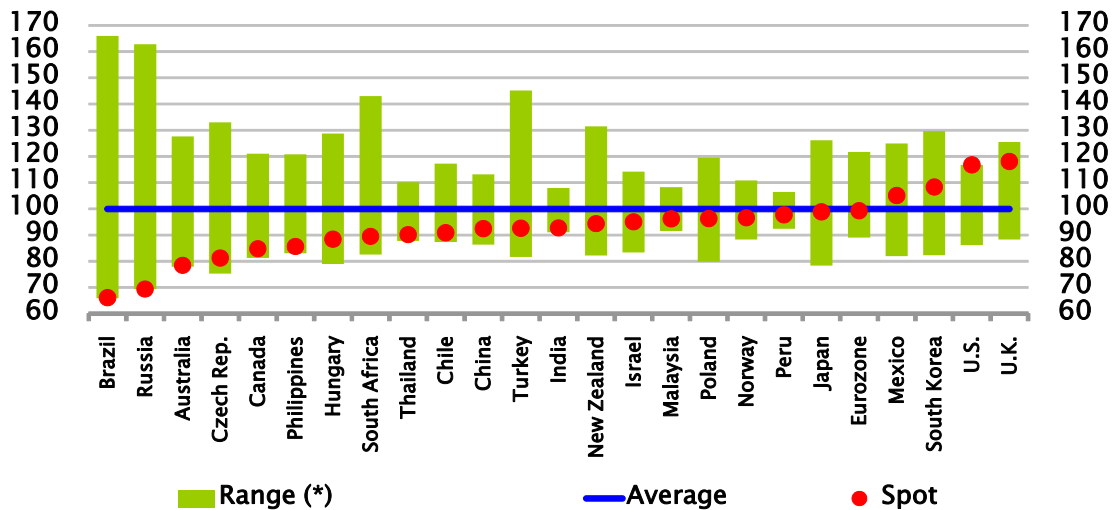
Figure 5  
**Multilateral nominal exchange rate (1)**  
(index, 2005=100)



(1) An increase indicates a depreciation of the local currency.  
(2) Simple average of Australia, New Zealand and Canada.

Source: Bank for International Settlements (BIS).

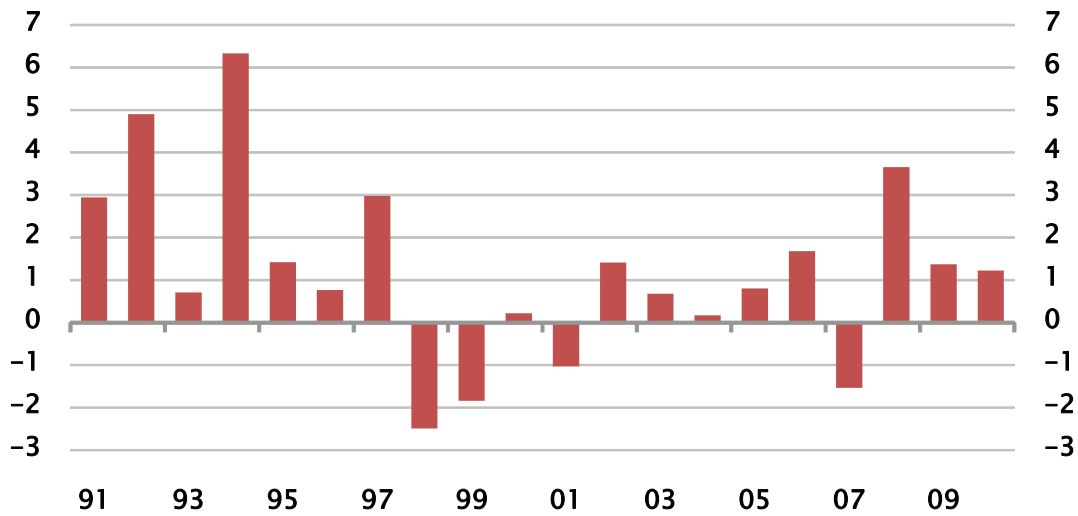
Figure 6  
**Real exchange rate**  
(index, Jan.00–Mar.11 average=100)



(\*) The range shows maximum and minimum values posted by the local currency during indicated period.

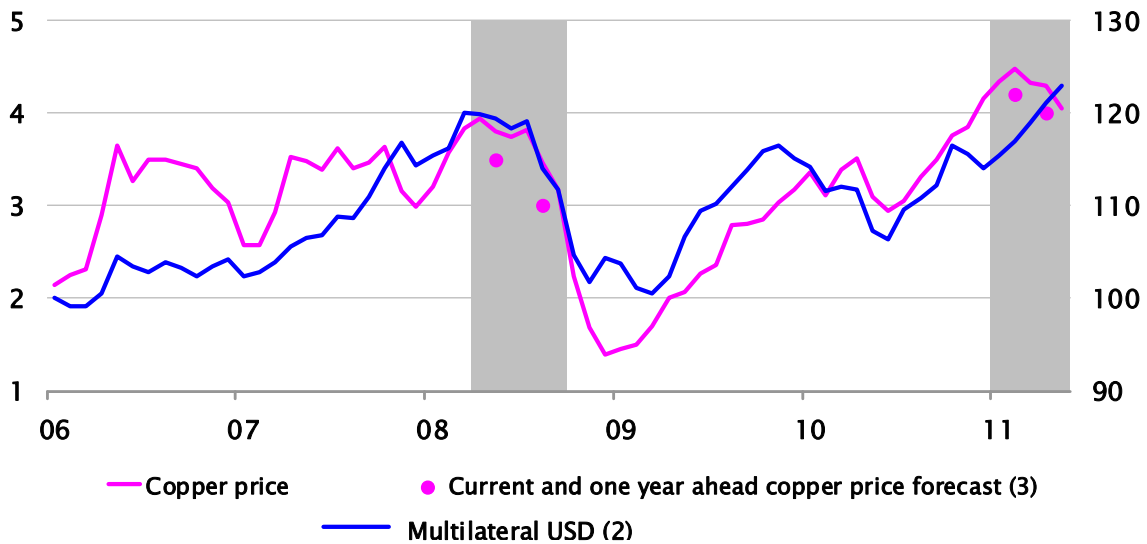
Source: Central Bank of Chile based on figures from the Bank for International Settlements (BIS).

Figure 7  
**Change in the Central Bank of Chile's international reserves**  
 (percentage of GDP)



(\*) Reserves consider purchase of US\$12.00 billion announced in January this year. For GDP, growth and inflation forecasts contained in March 2011's Monetary Policy Report are used.  
 Source: Central Bank of Chile.

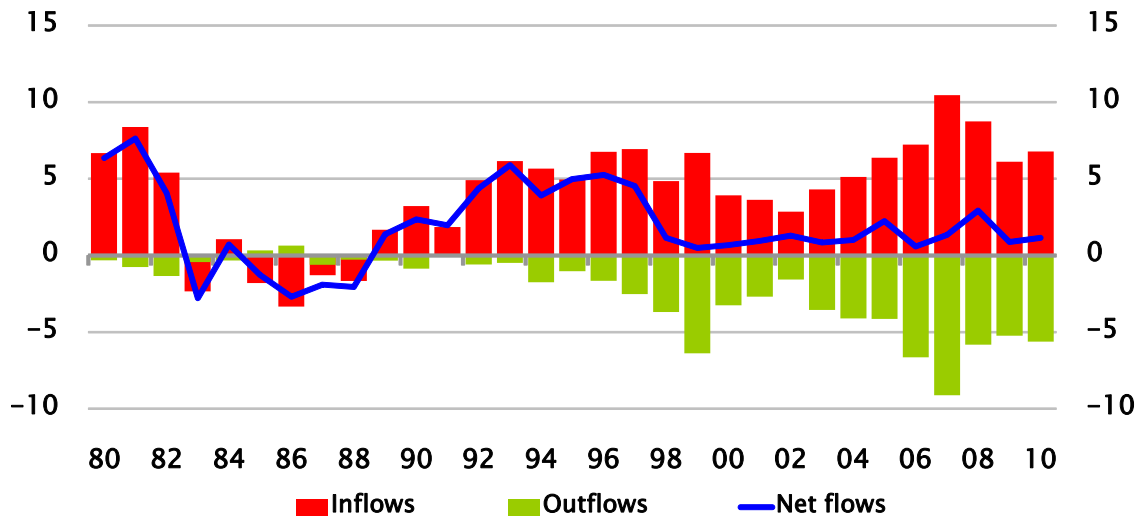
Figure 8  
**Copper price and multilateral dollar (1)**  
 (US\$/lb; index, January 2006=100)



(1) Gray bars depict forex intervention period. (2) Dollar against currency basket of the U.S.'s main trading partners. An increase shows an appreciation of the dollar. (3) In Monetary Policy Reports of May 2008 and March 2011, respectively.

Sources: Central Bank of Chile, Bloomberg and U.S. Federal Reserve.

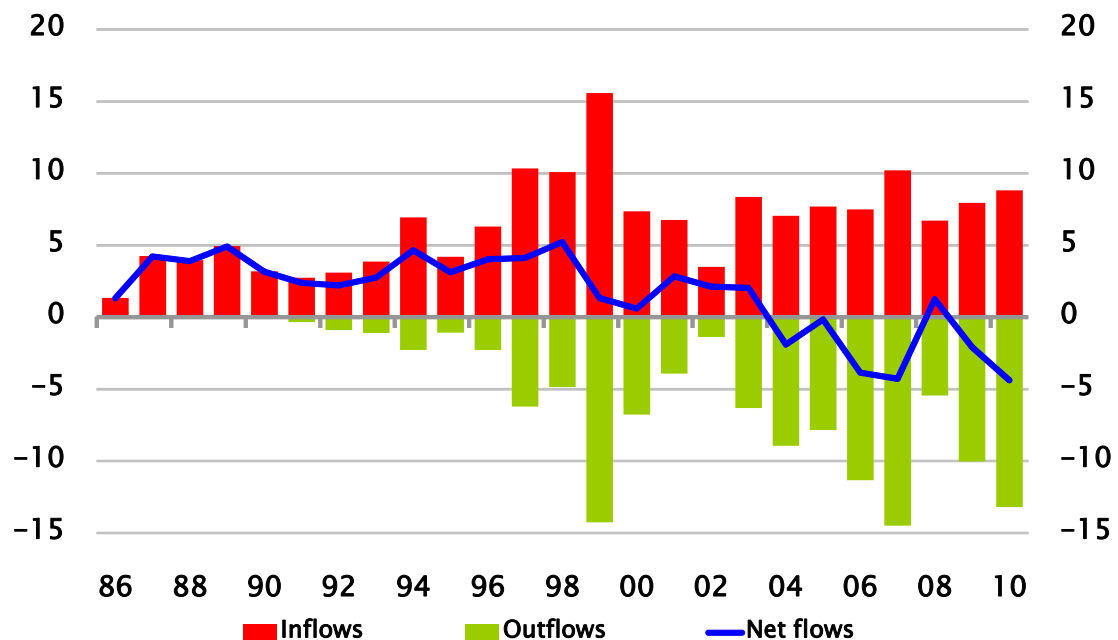
Figure 9  
**Average capital flows to and from emerging economies (\*)**  
 (percentage of GDP)



Source: Central Bank of Chile based on IMF data.

(\*) Includes Brazil, Chile, China, Colombia, Egypt, Hungary, India, Indonesia, Israel, Malaysia, Morocco, Mexico, Peru, the Philippines, Poland, Russia, South Africa, South Korea, Thailand, Taiwan and Turkey.

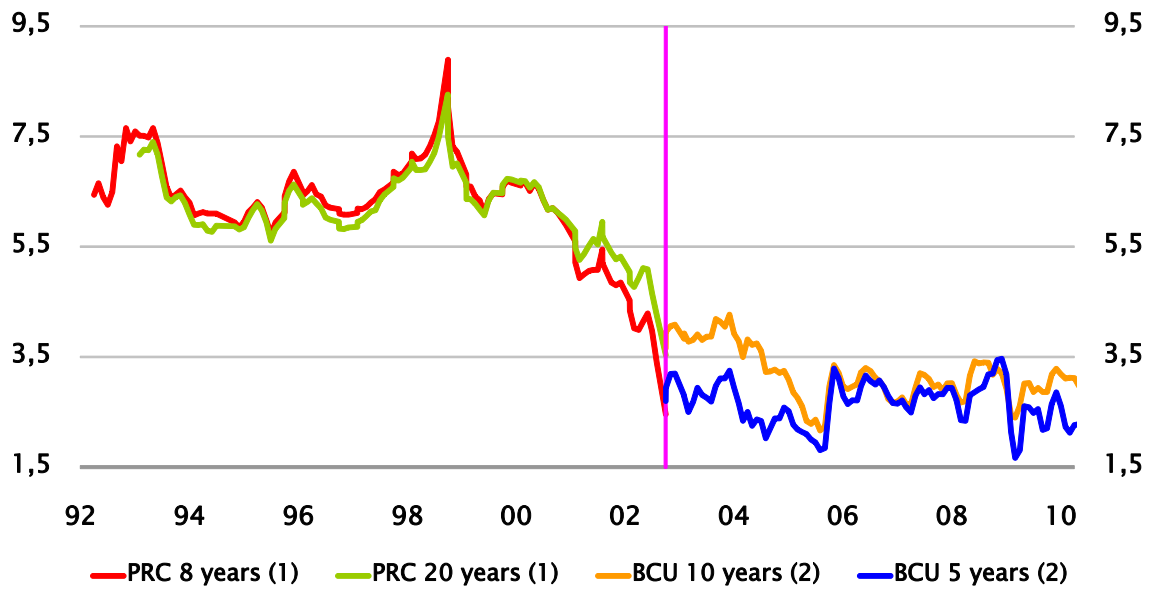
Figure 10  
**Capital flows to and from Chile (\*)**  
 (percentage of GDP)



(\*) Up until 1995, it shows foreign direct investment and portfolio investments from or in a foreign country, in the capital account (excluding reserves) of the balance of payments. From 1996 onwards, it shows assets and liabilities of the financial account flows (excluding reserve assets).

Source: Central Bank of Chile.

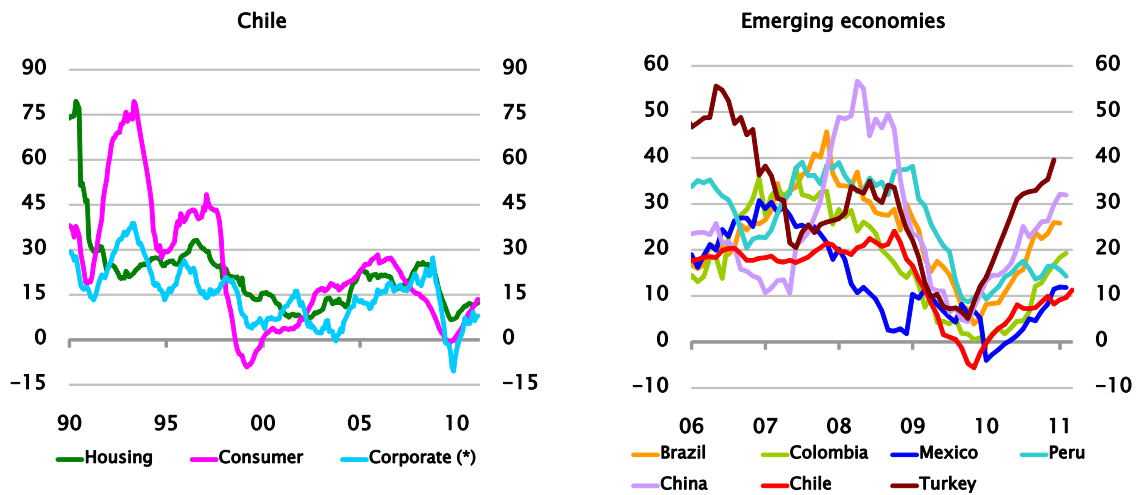
Figure 11  
**Long-term real interest rate**  
 (percent)



(1) PRCs are CBC bonds in UF with six-monthly equal installments (except for the last one), which can involve both interest and principal payments. (2) The BCU is a bond issued in UF, an inflation-indexed unit of account.

Source: Central Bank of Chile.

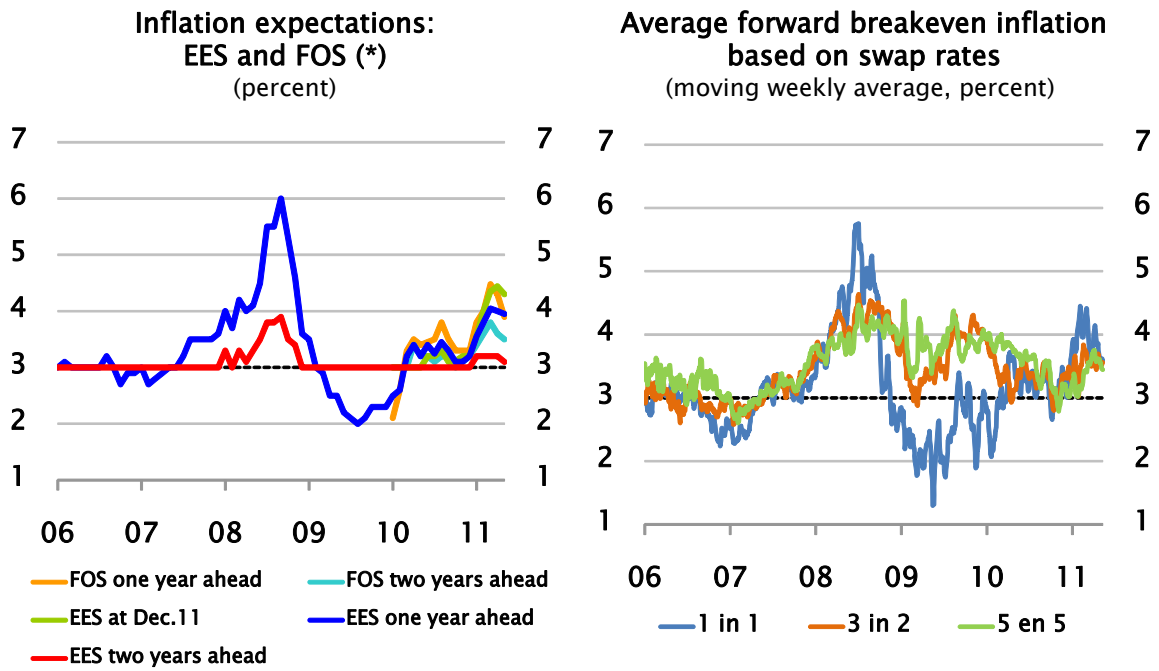
Figure 12  
**Banking loans to the private sector**  
 (y-o-y change, percent)



(\*) Sum of commercial and foreign trade credits.

Sources: central bank of respective country, International Monetary Fund and Superintendencia of Banks and Financial Institutions.

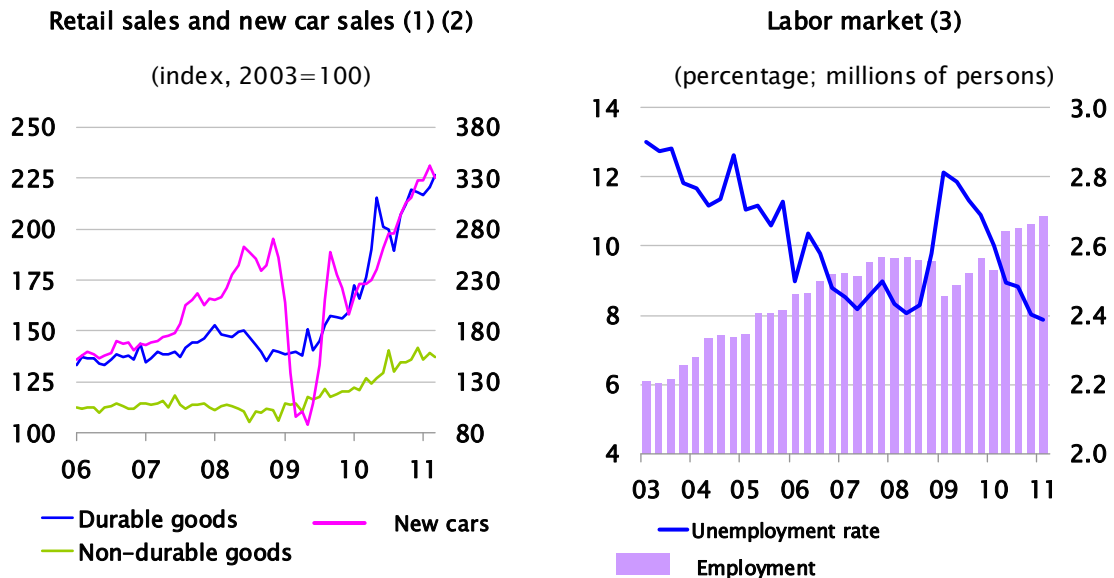
Figure 13



(\*) FOS uses survey of the first half of indicated month.

Source: Central Bank of Chile.

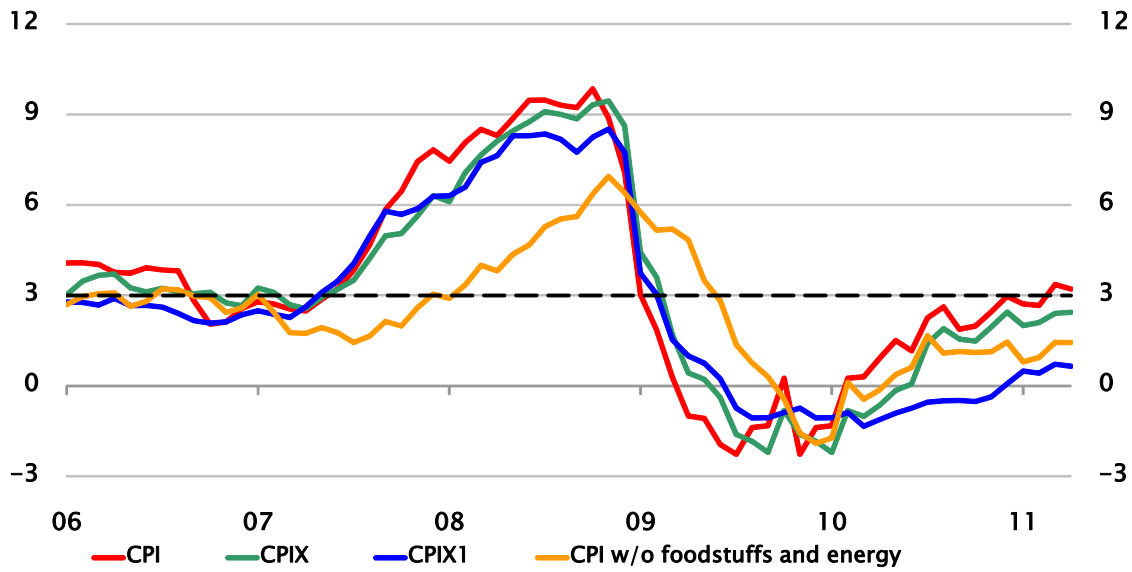
Figure 14



(1) Seasonally-adjusted series. (2) Sold during moving quarter. (3) Uses Universidad de Chile's Employment-Unemployment Survey for Greater Santiago. Seasonally-adjusted series.

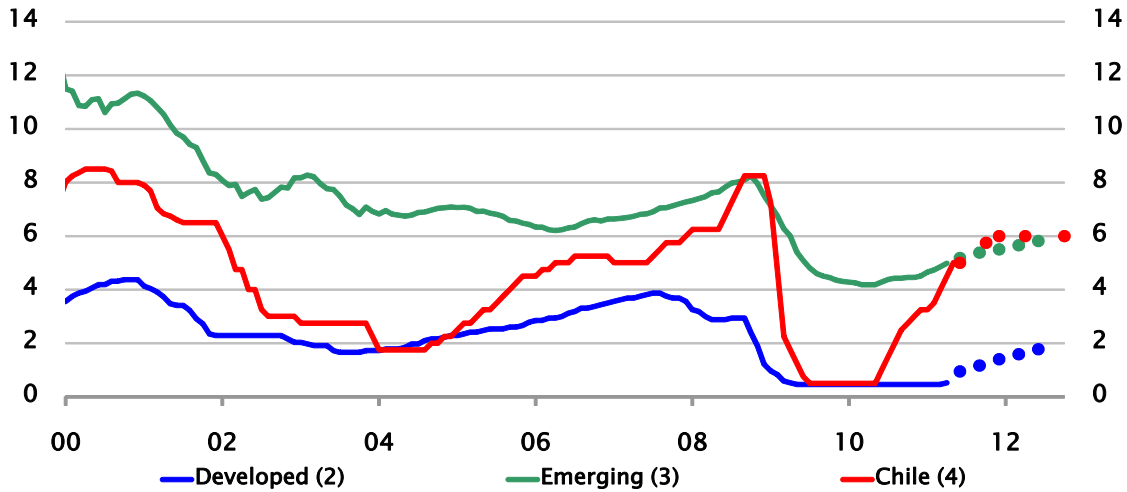
Sources: National Automobile Association of Chile, Central Bank of Chile, National Chamber of Commerce and Universidad de Chile.

Figure 15  
**Inflation indicators**  
 (y-o-y change, percent)



Sources: Central Bank of Chile and National Statistics Institute.

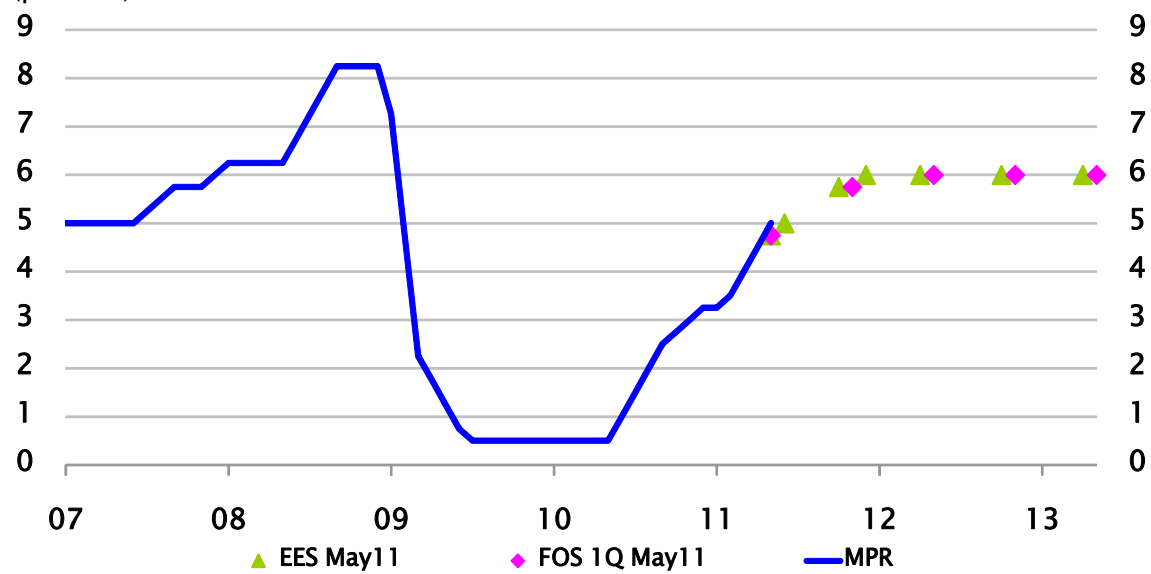
Figure 16  
**World: MPR and expectations (1)**  
 (percent)



(1) Solid lines show simple average of reference rates of each group of countries. Dots show Bloomberg median of analysts survey about expected MPR. EES is used for Chile. (2) Includes Canada, Eurozone, Japan, Norway, Sweden, Switzerland, the U.K. and the U.S.. (3) Includes Brazil, Colombia, China, the Czech Rep. Hungary, Mexico, Peru, Poland, South Africa and South Korea. (4) Data before the nominalization of reference rate (August 2001), consider overnight interbank rate in real terms plus CPI inflation.

Sources: Central Bank of Chile, the respective countries' central banks, Bloomberg, and International Monetary Fund.

Figure 17  
**MPR and expectations**  
 (percent)



Source: Central Bank of Chile.