Rodrigo Vergara: The global economic scenario and monetary policy management

Speech by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, at the 2012 Latin American Forum of the Institute of International Finance (IIF), Montevideo, Uruguay, 17 March 1012.

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I thank Luis Oscar Herrera, Enrique Orellana and Tatiana Vargas for helpful comments.

Thank you for inviting me to speak at the 2012 meeting of the IIF Latin American Economic Forum. This is my first time here as governor of the Central Bank of Chile. I have been asked to share with you some thoughts on the impact on our region of the crisis that is affecting the developed world, especially of how we can confront it using policy instruments, and the challenges that lie ahead of us.

These last years have been very challenging in terms of the evolution of macroeconomic conditions in our region and worldwide. After the crises in Argentina and Brazil of the late 1990s and early 2000s, for the most part Latin American economies experienced a period of sustained growth, lower unemployment and a drop or relative stability of inflation rates.

Nonetheless, towards the end of the past decade this state was abruptly interrupted by the international financial crisis. The worst came with the fall of *Lehman Brothers* in September of 2008. The abrupt and significant collapse of global demand caused serious problems in all our economies. Terms of trade plummeted and soon we were facing a completely different picture.

Economic policy reaction came promptly. In Chile, and other Latin American countries, we implemented a combination of fiscal and monetary policies to stimulate the economy. More important was the fact that probably for the first time, a crisis of the magnitude that affected – and still affects – developed countries, did not cause Latin American economies to enter into a balance of payments crisis or a profound recession. Suffice it to remember what happened in the early 1980s, when our own weaknesses and the shortcomings of economic policies, coupled with a significant rise in interest rates worldwide, dragged us into a deep recession. This is of utmost importance as it shows that we have matured in economic policy framework and that we face the challenge not only of maintaining but also of improving it.

After some quarters, the world economy began to recover gradually. This process took place at two speeds. Emerging economies recovered at a fast pace, while developed countries experienced a slower rebound. The causes and consequences of the Great Recession continue to affect economic performance of the developed world. This is so because the fundamental problem, high indebtedness of households, companies and governments, is still present. The fact that the higher the level of debt the more costly the solutions and greater the side-effects, poses a problem.

We have been seeing this clearly during recent quarters. You may recall that just a year ago the main problem faced by emerging economies was how to deal with inflationary pressures, given the narrowing of domestic capacity gaps and the rise in prices of commodities in international markets. This happened at the same time as the two-speed recovery process I just mentioned was accompanied by an interest rate differential that redirected capital flows towards emerging markets, exerting strong pressures to appreciate our currencies. Our concern then was the pace at which we would lower impulse to our economies, taking care that it did not intensify pressures on the exchange rate and cause new imbalances.

Only six months later our major concern had changed dramatically. The intensification of financial tensions in the developed economies drastically changed our perception of the future of the global economy. Financial markets drastically picked up this change of mood and very quickly we saw, among other developments, drops in stock prices, hikes in risk premiums, and reductions in the prices of commodities. The tough discussions held in the United States on fiscal issues, together with the weakness of its economic data towards mid-year, fueled these negative perceptions.

Overall, emerging economies dramatically changed their perceptions and communication as to the future of monetary policy. Between August and October, probably on the peak moments of the last financial turbulences in the developed world, many central banks stopped the process of interest rate raises, and many also changed the direction of changes in their monetary policies to more expansive ones. In Chile, after raising MPR by 200 basis points during the first half of 2011 and stating that there were still some increases to be made, in August we moved towards a neutral stance. In October, considering the envisaged consequences of the deterioration of the international scenario, we announced that we would increase monetary impulse if we foresaw that this situation could have a negative impact on our economy. Thus, in January of this year we lowered the MPR by 25 basis points. Now we have announced that new monetary policy actions will depend both on our assessment of the effects of the international scenario on the domestic economy as well as on the evolution of the domestic economy itself.

Allow me to present you our vision of what is going on in the world and how it will affect us. Particularly, to do so from a monetary policy perspective.

The current international scenario

The onset of 2012 has surprised us with a considerably calmer state of affairs than we expected a few months ago. The Eurozone situation is far from being solved. There are many challenges ahead, among them increasing productivity in many peripheral economies. Nonetheless, significant progress has been made. The European Central Bank (ECB) has provided long-term liquidity to the financial sector, European leaders have placed conditions on this financing, governments have agreed on adjustment plans that seem to go in the right direction, and it seems as time has been bought to address the more structural problems that are still present in the Eurozone. Financial markets have understood this, and risk indicators and monetary conditions have improved.

Consensus forecasts on world growth point to a performance of the global economy below that of 2011. Nonetheless, the degree of downward correction has diminished noticeably in the latest data. Does this mean that circumstances in developed countries have reached a point beyond which we must not expect other significant setbacks? This is not so in my opinion.

Allow me to give you some background. As mentioned, the solution to the Eurozone's problems is still far ahead. Its economy is in recession and the necessary adjustments are expensive and highly unpopular among the population. Some economies have very high unemployment and a very fragile fiscal situation. If anything, measures adopted up to now have put a firewall to isolate systemically relevant economies from greater disaster. Also, financial conditions have improved these last weeks, mainly due to the ECB's LTRO initiative. With it, the concern over the region's banking sector financing needs has been dealt with.

However, serious fiscal and financial problems and macroeconomic imbalances continue to exist in the Eurozone. In response to high unemployment and low growth, banks' portfolios deteriorated. On the other hand, the European Banking Authority (EBA) has demanded a capital increase of the system's major banks. Finally, US dollar financing pressure persists in some major banks. This has resulted in more stringent credit conditions, which may continue and have a profound impact particularly on small and medium-sized businesses and, eventually, on some countries' foreign trade.

The situation of the Eurozone is complex and we cannot rule out as a possible risk scenario a disorderly default of peripheral economies, due to the challenging debt maturity profile they face. This high risk scenario is, however, less likely that at the end of last year.

The US economic data of the last months have been a pleasant surprise. The labor market and households' expenditure seem to have behaved better than forecast. Although, the difficulties that persist in the labor market and the fiscal adjustments that are needed explain the continuing doubts as to how true and sustainable the recovery we are currently witnessing is. In spite of the more positive indicators, the Fed authorities extended from 2013 to 2014 the period in which it expects to keep interest rate at minimum levels. Certainly, the problem of fiscal indebtedness continues.

In emerging countries the data are diverse. Over the course of the second half of 2011 we witnessed a generalized deterioration of consumer and business expectations. Neither case can be compared to what happened between late 2008 and the beginning of 2009. Generally, the data show a deceleration of activity. Nonetheless, it is difficult to identify how much of this decline is due to a lower external stimulus, how much is accounted for by a natural slowdown in each economy, and what part is explained by particular events.

All these elements add up to a situation in which, although the external scenario is not worsening, the belief that risks have disappeared is far off. It is possible to think that the likelihood of extreme scenarios is low, but, in my opinion, it is still there.

More challenges for monetary policy

As already mentioned, the change in how the global panorama was perceived led many emerging economies to change their views on their future economic policies. This made them halt their processes of lowering expansiveness and/or made them resume impulse. However, the new change of mood brought about by the greater calm of the beginning of the year, coupled with geopolitical factors, has again put us in a dilemma.

On one hand, probably as a result of the recent memory of the late 2008 and early 2009 global confidence crisis, most economic authorities quickly set up a close monitoring system and prepared a batch of instruments to implement a quick offsetting of the adverse effects of a global crisis. However, time has shown that the effects of the crisis of the Eurozone area have been fairly limited so far.

Financial markets have suffered the biggest impacts, but trade, output and employment have not been greatly affected. In Chile, activity and domestic demand, specially consumption, have not worsened significantly. This does not mean that our vision of the effects that the crisis in the developed world will have on our economy or the rest of the world has changed. However, it is a fact that activity at the beginning of the year is at a higher level than we envisaged a few months ago.

On the other hand, this has been compounded by an increase in the oil price. Political tensions in the Middle East have again put pressure on this price, thus affecting domestic prices.

The effects of a higher oil price can be interpreted at least twofold, with opposing implications for monetary policy. On one hand, in a situation of tight output gaps – as is the case of many emerging economies, Chile among them – an increase in the price of energy may exacerbate domestic inflationary pressure, making the dynamics of inflation more complex and demanding great care when assessing the evolution of the inflation trend. On the other hand, in the face of existing risk scenarios, an increase in the oil price also has a negative effect on world activity. If we take into account the fragile state of households, businesses and governments in the developed world, a higher price of energy may further weaken their position and lead to a more lasting and deeper economic fragility.

A third factor that has added difficulty to monetary policy management is a renewed concern over capital flows towards the emerging world. The change in investors' mood has made them look for other markets in which to invest, and has led to a widespread appreciation of emerging countries' currencies. As usual, this has rekindled a debate that was present in our discussions a year back, as to the convenience of implementing measures to avoid currencies from appreciating. Last year several emerging economies, among them Chile, intervened their exchange markets using different mechanisms. This year some emerging economies have continued to do so.

Clearly, the discussion as to the convenience or not of performing such actions remains unresolved. The first thing to bear in mind is that in small open economies, all efforts to persistently keep the exchange rate at levels beyond margins aligned with the fundamentals, particularly at overvalued levels, are not sustainable and may eventually generate higher inflation.

We are convinced that a floating exchange rate regime is the most appropriate one for the Chilean economy, as it facilitates macroeconomic and external accounts adjustments. Nonetheless, certain circumstances may lead the Central Bank to intervene in the forex market, either to maintain an adequate international reserve position or to respond to overreactions of the exchange parity beyond its long-term fundamentals. However, there are costs associated to this type of intervention. A first cost is that it may create confusion as to the objective of the monetary authorities: inflation or the exchange rate. In our case, we have dealt with this through transparent mechanisms whereby we anticipate the amounts and terms of interventions, and by maintaining a flexible exchange rate. In addition it has always been clear that the exchange rate is not an objective and the main goal of the Central Bank is price stability. A second cost is of a financial nature. Foreign reserves are invested in highly liquid and secure instruments of developed countries, whose interest rates are lower than those of domestic instruments used to finance their acquisition. Conversely, the benefits of having these reserves are the enhanced security they provide in case of an abrupt cut of external financing. These benefits are hard to measure, but it is reasonable to expect that they will decline as the availability of reserves increases, as has been occurring in Chile since 2008.

Allow me to express some final thoughts.

Final thoughts

News during these last weeks have led us to a scenario in which the effects of the deteriorating external situation that we forecast some time back are not evident and in which inflationary pressures stemming from a higher cost of energy have resurfaced. Hence, if a few months ago it was clear that the most likely scenario for monetary policy in emerging economies was a further loosening, today it is much less clear so. Compounded to it is the renewed influx of capital flows towards emerging economies and the resulting appreciation of our currencies. Against this backdrop, managing monetary policy has become more complex.

Today, our assessment continues to be that the crisis in the developed world will sooner or later affect the performance of our economies. It is possible that the impact will be less than what we thought some time ago, but to assume that nothing will happen does not seem sensible. Nonetheless, the difficulties involved in measuring the actual impact makes me very cautious in measuring the impulse required by each economy to offset the effects of the external scenario.

Today, prudent monetary policy management has to be prepared for all kinds of scenarios and to adapt the amount of stimulus applied according to needs established on a case by case basis. As I said a moment ago, activity we see today is at a level above what we forecast a few months back. In fact, in our latest Monetary Policy Meeting we decided to maintain the Monetary Policy Rate at 5% for a second month in a row.

The current situation in developed economies is very complex, and teaches valuable lessons. On one hand, as to how imbalances that are not addressed on time end up creating enormous costs for the population. For those of us in charge of economic policy in our countries, it is absolutely essential that we strive to address these imbalances if they exist, and at the same time that we do not create them through our decisions. Over-stimulating the economy when output gaps are narrow and inflationary pressures have risen could lead to imbalances. I trust that they are not as sizeable as those of the developed world, but in any case solving them is always costly. On the other hand, it has taught us the relevance of maintaining and improving a good macroeconomic framework. In Chile, this framework rests on four pillars. First, monetary policy management is based on a flexible inflation-targeting regime, conducted by an autonomous central bank and supported by a floating exchange rate system. Second, a fiscal policy that is accountable and predictable thanks to a structural balance rule. The significant amount of savings accumulated during the run-up of copper prices has been a crucial factor in bolstering the resilience of the Chilean economy and in providing a countercyclical fiscal boost. Third, a high degree of commercial and financial integration with the rest of the world. Finally, a sound financial system, with globally integrated, well capitalized, and adequately-regulated banks. Our countries have suffered decades as a result of mistaken economic policies. The Great Recession showed that our current state of preparation to confront and mitigate the impact of an adverse scenario is much better than in the past, and that it is the path that we must continue. Undoubtedly, there are still many things to improve. Attaining a level of development such that prosperity reaches the whole population is still far away, but at least we are on the right track.

Thank you.