Rodrigo Vergara: Chile in the international scenario

Keynote address by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, at the 2014 IIF (Institute of International Finance) Latin America Economic Forum, Bahia, Brazil, 29 March 2014.

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Thank you for inviting me to this year's Latin America Economic Forum of the IIF, where I will share with you the Central Bank of Chile's views on where my country stands in the current global scene. I will also talk about the Chilean macroeconomic policy framework and how does it cope with the changing global economy.

International scenario

The external economic environment in which Latin America operates is changing, and it is necessary for the economies of the region to adjust to these changes.

First there is the rebalancing process the world economy is undergoing. The developed economies are beginning to show more evident signs of recovery. Consensus forecasts are that global growth will be stronger this year than it was in 2013, but virtually all the extra boost will come from said recovery in developed economies. Growth projections for emerging markets in 2014, on the contrary, have been revised down time and again throughout the past year. These revisions have been particularly sharp in Latin America, and the region probably will grow less this year compared with 2013. In addition, downside risks seem to have decreased for the advanced economies, and increased for emerging ones.

Secondly, the prices of industrial metals (i.e. copper, iron and others) have dropped. News of a slowdown in China and the bond defaults by some Chinese companies are cause for increased concern among investors, pulling prices down. And after several years of very high metal prices and a strong increase in mining investment, the supply has begun to react and new projects are now starting production. Metal prices are approaching their long-term costs, and the global impulse of mining investment has declined compared to the levels observed in the previous years. This is very important for Chile as copper is our main export. The prices of other commodities, including energy, should also face similar trends as new supply sources are developed.

A third point is that financial conditions facing emerging economies have tightened. After many years of abundant external liquidity, capital inflows to emerging economies, and especially to Latin America, have become scarcer in recent quarters. The Federal Reserve has begun to withdraw its massive monetary stimulus packages, and the focus has shifted to when and how fast will it begin raising the fed funds rate. Financial conditions began changing last May, when the talk about tampering of the asset purchasing program in the US began. Since then, the interest rate on 10-year US Treasury bonds has fluctuated within a range between 2.5% and 3%. While still low by historic standards, it is 100 basis points above its previous level. And we must add to this rise in the Treasury bond rate the increase in the foreign credit premiums facing the emerging economies. Emerging markets' currencies have depreciated substantially against the US dollar, and their market capitalization is lagging behind the advanced economies' stock markets. The external financial conditions facing our economies are entering a normalization stage, but they are still favorable from a historic perspective.

In short, after six years since the outbreak of the global financial crisis, international conditions are returning to normal. This scenario implies that most Latin American countries, including Chile, will be getting a weaker impulse from abroad at least in the short run, due to

the drop in the terms of trade and the more stringent external credit standards. Still, over the medium term, a recovery of developed economies' growth is certainly good news. And much more so, if we consider that a persistent "easy money" era may create economic and financial imbalances which, the longer they last the higher the price that has to be paid in terms of economic and balance sheet adjustments down the road.

The question is, where do the emerging economies stand to deal with this transition? There is no simple answer to this. Some have used the boom years to consolidate their fiscal accounts, balance sheets and macroeconomic policies. Others have vulnerabilities in some of these areas, which may have been magnified by access to inexpensive, abundant credit in international markets.

Chile's macroeconomic framework

Chile has gradually developed a scheme of macroeconomic policies that permits us to deal with the natural volatilities of the business cycle of any open, commodity-exporting economy. This scheme has evolved over time to address the new challenges, such as a growing degree of financial integration to the global economy. This scheme leans on several pillars.

One such pillar is our fiscal policy based on a structural balance rule. This rule dictates clear fiscal commitments that ensure that public finances are both sustainable and predictable. Our fiscal policy is no longer a factor amplifying the business cycle as it was in the past, but on the contrary, it is a buffer. More precisely, under our regime fiscal spending is neutral to the cycle. In turn, the resources accumulated in the sovereign wealth funds are an important source of external liquidity and financing to withstand periods of low fiscal income. Plus our public sector is a net creditor. Indeed, net public debt of the central government is negative, at around minus 6% of GDP.

Another pillar is the autonomy of our Central Bank and its commitment with its constitutional mandate to pursue price stability and its inflation targeting regime. Since the year 2001, Chile relies on an inflation target of 3% annually, with a tolerance range between 2 and 4%, which has been met over the years. Average inflation between 2001 and 2013 was 3.1% annually.

Pillar number three is our floating exchange rate regime. Exchange rate flexibility allows to rapidly and effectively accommodate big external shocks such as changes in the terms of trade via movements in the exchange rate. This flexibility gives more room to monetary policy to contribute to the smoothing of the domestic business cycle. Chile's long-term interest rates, unlike those of other economies, have decreased in recent months. And they are certainly lower than they were in the 1990s. By way of example, compare the 6.5% average rate of indexed 10-year bonds in the nineties with their 2% rate of today. The floating exchange rate provides the right incentives to the private sector to administer the currency and foreign liquidity risks in a much globally integrated economy like ours.

On the financial sector side, there is a sound regulatory and supervisory framework grounded on a set of prudential norms and standards. These are in line with international recommendations, and are under the supervision of specialized regulatory entities, aimed at the correct management of financial institutions. All this has helped to develop a mature, stable, solvent financial system. The Basel index, measured by the Capital Adequacy Ratio of the Chilean banking system is more than 13%.

The banking sector shows sound capital and funding structures, concentrated in long-term sources. Additionally, they carry no significant currency mismatches on their balance sheets, nor do their customers. Meanwhile, there has been a limited increase in the corporate´s sector leverage over the past few years and a slight decline in the case of households. Domestic credit growth, beyond the favorable financial conditions, has not increased substantially and has not changed much in recent years.

This combines with significant financial and trade integration, making it easier to search for new markets and opportunities for our businesses. In addition, Chile´s official and private

sectors have a fairly good liquidity position when its liquid foreign assets and the structure of its liabilities are properly assessed. In the past five years, the availability of net external financial liquidity has been around 70% of GDP, compared to its near 45% levels that the country had between 1998 and 2008. This includes the Central Bank's international reserves, sovereign wealth funds and liquid assets of the private sector. It has also been shown that in periods of financial stress the resources of the domestic pension funds operate counter-cyclically, as they return to the country during periods of increased volatility in world markets.

The credibility of this institutional framework has been reflected in the performance of macro-financial indicators. This framework successfully dodged a very challenging test during 2008–2009, struggling with the effects of the global financial crisis on our economy, and later with the consequences of the high terms of trade and over-abundance of international liquidity.

Chile's economic outlook for 2014

Nevertheless, the changes we have seen in the world macroeconomic scenario have had an impact that exceeded our forecasts of some months ago. Our new projections for 2014 will be released in our upcoming March *Monetary Policy Report*, but it should come as no surprise that our growth outlook for this year has been corrected downward from December. Private forecasts have already internalized this change.

What are the factors behind this? First and foremost, there has been a slowdown in domestic investment, caused by both the abatement of global mining investment cycle and other specific developments. The slowdown in consumption has been more gradual, in line with fundamentals that, although they ceased to improve, are still good. As I said, investment is the one component of expenditure that has endured the biggest adjustments in the past few quarters. One explanation is the deceleration of emerging economies, China mostly, and the impact it has had on commodity prices, particularly metals. The price of our main export – copper – is around US$3 dollars per pound, compared with a little over US$3.50 a year ago and nearly US$4.0 in early 2012. In addition, the outlook for future prices has also been revised downward, triggering a postponement of mining investments whose effects spread to other economic sectors. At any rate, what is happening in Chile has been mirrored in other metal exporters, but maybe with a different timing. In Australia, for example, this adjustment had already begun at the end of 2012 with the postponement of investment projects in iron or coal. Peru and Chile saw their adjustments in the second half of 2013. On the financial side, the normalization of international financial conditions has resulted in greater market volatility in emerging economies, together with higher risk premiums and capital outflows, plus a depreciation of their currencies against the U.S. dollar.

In Chile, unlike past episodes, the effects on domestic financial markets have been bounded. The long-term rates have fallen while the money market has operated smoothly, and the risk premium is close to or only marginally above its levels of a while back.

The exchange rate has absorbed the shock to terms of trade and the tightening of international financial conditions. Actually, the depreciation of the Chilean peso is among the highest in emerging economies. From a year ago, the currency has depreciated around 17% against the U.S. dollar, and the real exchange rate (RER) did by about 15%. This depreciation of the currency, in any case, is a desired effect, since it means an adjustment of relative prices and thus contributes to rebalance the sources of growth across economic sectors. In fact this is consistent with the macroeconomic framework that Chile has in place. Short- and long-term interest rates have declined while the currency has depreciated.

In this scenario, inflation in Chile has returned to near 3% and medium-term expectations are in line with the target. There has been a limited pass-through of the peso depreciation in to final prices, but no spillovers in medium-term inflation expectations or nominal wages. Given the recent slowdown of output, we expect some increase in the amount of slack in the

economy that should help to contain second round effects of this transitory inflation shock but we remain vigilant.

Monetary policy has turned toward a more expansionary instance. The monetary policy rate (MPR) has been lowered by 100 basis points in recent months to 4%, and the Bank has pointed out in its latest communication that it will assess the possibility of introducing additional cuts according to the evolution of domestic and external macroeconomic conditions and their implications for the inflation outlook.

This response of the Chilean economy to the changes in terms of trade and external financial conditions accurately reflects the operation of our policy regime. Over the years, the Central Bank has shown its commitment to take action to safeguard price stability. We have been consistent over time and we have built a credibility record that gives us room to use monetary policy in a counter-cyclical fashion when it is advisable. Our policy framework allows for timely adjustments of the real exchange rate and the interest rate, which provide the right signals to keep the domestic economy growing around potential, smooth the adjustment of the capital account, while inflation and inflationary expectations remains anchored.

This makes a difference with our economic history. Some time ago, when we had more rigid exchange rate systems, less adapted to cope with external shocks, when confronted with tighter external financial conditions, we needed to fight against the depreciation of currency to avoid destabilizing balance sheet and inflationary effects. We had to tighten monetary policy to reduce the speed of private capital outflows and sold massive amounts of foreign reserves to contain the depreciation of the currency. Most experiences ended badly.

Final remarks

The changes we are seeing in the world economy are part of the development that comes in the footsteps of the global financial crisis. The time has come for the recovery of developed economies, and therefore, the extraordinary monetary stimulus packages they brought about in the past must be withdrawn. By historical standards, the global financial conditions we faced in the past few years were very good, but we knew that sooner or later they would end. This is a healthy development.

What is important is where this new situation will find us, as economies that managed to keep strong fundamentals and prevented macroeconomic imbalances from building up, or on the opposite lane. How costly a moving toward a “more normal” world will be for each of our countries will depend on how wisely we have administered our economies during the good times.

In Chile, the policy framework that has been in place during the recent decades, has given us more tools to help the economy to accommodate the effects of changes in the external environment. However, we must always bear in mind that we are not immune to events abroad. For the moment, our economy has slowed and despite a sharp depreciation of our currency, inflation expectations have remained in line with the target, allowing us to steer monetary policy to a more expansionary instance.

Thank you very much.