CENTRAL BANK OF CHILE

GLOBAL LIQUIDITY, SPILLOVERS TO EMERGING MARKETS AND POLICY RESPONSES [1]

XVII ANNUAL CONFERENCE ON CENTRAL BANKING, ANALYSIS AND ECONOMIC POLICIES

OPENING REMARKS

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November 2013

[1] Opening remarks delivered at the Seventeenth Annual Conference of the Central Bank of Chile, held on November 14-15, 2013, Santiago, Chile. I thank Claudio Raddatz, Luis Oscar Herrera, and Consuelo Edwards for helpful comments.

Good morning. Welcome to the Central Bank of Chile's Seventeenth Annual Conference on Central Banking, Analysis and Economic Policies. This year, our conference focuses on "Global Liquidity, Spillovers to Emerging Markets and Policy Responses". You will probably agree with me that this is a very timely topic.

The global financial crisis that started in 2008 prompted a quick and decisive reaction of monetary authorities around the world. The central banks of most countries soon slashed interest rates to boost their economies, and implemented various types of facilities to inject liquidity into troubled financial markets. However, while most emerging markets reversed some of these policies as their economies recovered, advanced economies have maintained historically low interest rates and engaged in unconventional policies that last to these days.

I will discuss today some of the policy issues around these developments and share some thoughts about the pending research questions along the way.

These years of global liquidity expansion have coincided with a surge in gross capital inflows into emerging markets, a real appreciation of their currencies, and an increase in the prices of their main commodities, stocks, and houses.

These trends have been particularly visible in Latin America. During 2012, annual gross capital inflows to the seven largest Latin American countries—as classified by the IMF—amounted to more than 250 billion dollars. Sovereign EMBI spreads shrank to around 150 basis points, and, with a few exceptions, stock market prices recovered or surpassed their pre-crisis levels.[2] After the large depreciation suffered at the peak of the crisis, the real exchange rates of these countries persistently appreciated, continuing with a trend coming from the mid-2000s. House prices in the region also experienced high annual growth rates, in many cases reaching two-digit figures.

Chile was no exception to these patterns, although they were a bit less pronounced than in the average emerging or Latin American country. Our real exchange rate appreciated by about 15 percent between the peak of the crisis and the end of 2012, real house prices grew about 20 percent between 2009 and 2012, and our current account moved from a surplus of 2 percent of GDP in the last quarter of 2009, to a deficit of 3.5 percent of GDP by the end of 2012.

Sure enough, these patterns could be explained by pull factors. The faster recovery of growth rates in emerging markets, the quick rebound of their commodity prices after the crisis, and the sounder policies being implemented by several of them during the last decade could give reason to allocate more capital to this group of countries. But even if we believe these factors

[2] IMF, Regional Economic Outlook, May 2013.

to be important some key questions remain open. For instance, why did this time emerging markets recover relatively quickly from the global shock, while advanced economies stagnated? Was it due to better policies, or to the new relevance of China for their external demand, or to another factor? We need to know more of the ultimate causes of this two-speed recovery, and more research on this front would be helpful.

Despite the likely role of pull factors, the fact that these phenomena coincided with the timing of the monetary expansion in advanced countries suggests there is a link between them. In fact, many believe that this "push factor" played a major role, and recent research lends some support to this view.[3] This afternoon we will be discussing one avenue through which low interest rates in advanced countries may channel capital toward emerging markets: carry trade flows, whose relevance will be addressed in a presentation by Craig Burnside.

The likely role of push factors is not a total surprise, since the recovery of advanced economies in the context of a deleveraging process requires a rebalancing of global demand toward emerging economies. This rebalancing needs the right price signals and quantity responses. Two presentations this morning by Philippe Bacchetta and Gian Maria Milesi-Ferretti will touch on the topic of global rebalancing and external adjustment to the crisis. Nonetheless, identifying the role of pull versus push factors poses problems akin to those of separating supply and demand. There is still room for research that finds clever identification strategies to settle this question.

Under most conditions, a situation of abundant capital inflows and low global interest rates is good for developing countries. Theory tells us that, in the absence of frictions, international capital flows not only contribute to expand a country's productive capacity, but also allow their citizens to share risk with the rest of the world. However, the presence of pecuniary externalities, of inefficient fluctuations in credit standards, or of other types of financial frictions may lead to perverse situations where these inflows result in excessive credit growth, risk taking, or misallocation of capital.

An important amount of recent research has been devoted to understanding how an economy may borrow in excess and miss-allocate credit.[4] Of course, if we believe that these frictions are present and strong, first-best policy actions should aim to undo them. But this may not be feasible, either because we are unsure about the presence, type, or magnitude of the frictions involved, or because first best policies cannot be implemented in the timeframe required. In such a situation, policymakers may have to resort to second best policies. We will address

[3] For example, Forbes and Warnock (2012) indicate that global factors were the most important drivers of capital flows to emerging markets, especially debt flows. Fratzscher (2012) uses an event study methodology to show that QE announcements had an effect on equity and debt flows to emerging economies.

[4] See Bianchi (2011), Korinek (2011), Dell'Ariccia et al. (2013), among others.

some of the roles of financial frictions in the transmission of foreign shocks in the presentation by Javier García-Cicco this afternoon.

On top of the difficulties with implementing first best policies, policymakers may feel compelled to act fast because past experience has led them to be wary of surges in capital inflows. History has taught us that these inflows have a tendency to end in sudden stops and sharp currency depreciations that for some countries may result in recessions and crises. In the session of tomorrow morning, the presentations by Jaume Ventura and Sebnem Kalemli-Ozcan will address some of the potential consequences of the capital inflows to financially-integrated emerging economies: the appearance of asset price bubbles and the transmission of foreign shocks.

These concerns have led several countries inside and outside Latin America to implement interventions in the forex market, capital-account-management and macroprudential policies to reduce the financial vulnerabilities that may arise from real exchange rate misalignments, fast credit growth, maturity or currency mismatches, and housing price increases. These types of policies have been more prevalent among emerging markets. But they have also been implemented by developed countries. For instance, Switzerland has actively intervened to maintain the value of the Swiss franc relative to the Euro, and South Korea has implemented various restrictions to the use of wholesale funding and foreign exchange derivatives.

Despite their prevalence, it must be said that the effectiveness of many of these policies, as well as their unintended costs, are still to be determined. Further research is needed here to eventually establish best practices in their conduct.[5] Today we will see two examples of such research. The first is a paper by Guido Lorenzoni that looks at capital controls from a different perspective and studies the role they have in the dynamic manipulation of terms of trade. The second is a paper by Marcos Chamon that studies the desirability of sterilized interventions under inflation targeting.

The worries about potential reversals in capital flows have been partially borne out by the events of this year. After the Federal Reserve hinted earlier this year the possibility of starting tapering the purchases of long-term bonds and MBS, financial markets quickly reacted with declines in the prices of US government bonds and increases in mortgage interest rates. At the same time, the spreads of emerging market debt increased importantly, their currencies depreciated against the dollar, and capital flows into these countries declined, albeit with some heterogeneity across countries that seems related to fundamentals. While more moderate than in previous occasions, this pattern is still reminiscent of the sudden stop episodes I previously mentioned. The simultaneous increase in the yields of sovereign bonds of many countries, issued in different currencies, has captured the attention of researchers

[5] A few papers trying to quantify the impact of various macroprudential policies include Lim et al. (2011) and Tovar et al. (2012).

and policymakers alike. Our understanding of the transmission channels behind this synchronized increase is still limited.[6]

These recent events have elicited mixed feelings in the international community. On the one hand, there is the view that the longer the global liquidity persists, the more likely that vulnerabilities will build up in capital-receiving countries. In this view, a gradual normalization of international liquidity conditions would be a welcome event for those countries where fundamentals are still strong. Furthermore, to the extent that the normalization comes with better prospects for advanced economies, the somewhat tighter access to international borrowing would be accompanied by an increase in external demand. On the other hand, there is the view that a fast reversal of expansionary monetary policies in advanced countries would yield a sudden and important tightening of financial conditions and a surge in financial volatility. Recent years have taught us all too well that a situation like this may have unforeseen consequences.

All in all, the final impact of the tapering of QE policies on the rest of the world will depend on when it takes place, how it is done, and what countries do in the meantime.

Let me first address the issue of when it will take place. After some speculation earlier this year that tapering would start in September, subsequent developments indicated that the recovery of the US labor market had been more sluggish than initially expected. This, together with the difficulties of the latest round of budget and debt-limit negotiations, shifted the consensus to postpone the expected date of the beginning of tapering. Recent figures indicating a recovery of employment in October stronger than expected have led some to bring forward again their forecasted date of tapering. Developments in coming weeks will be crucial to assess whether recent data mark a change in tendency or a temporary phenomenon.

The question of how the reversal will occur is the hardest to answer. If everything goes as planned, the withdrawal of the monetary stimulus would be gradual and related to improved economic conditions in the US. But, the significant reaction of markets to the announcement of the possibility of reducing the speed of purchases, gives us some reason to worry about the ability of authorities to guarantee a smooth transition to a scenario of normal monetary conditions. Financial markets are large, and even the Federal Reserve may have some transitory trouble taming them. For instance, it is estimated that about two-thirds of the outstanding stock of 10-year treasuries is in private hands.[7] It would not be surprising that those private bondholders would become wary of the possible price impact of a reduced demand for these assets by the Fed, and decide to anticipate this move. Dealing with such a situation would be challenging for any authority.

[6] See for instance the article by Rey (2013) and the presentation by Smets (2013) at Jackson Hole.
[7] Krishnamurthy and Vissing-Jorgenson (2013)

In sum, the baseline scenario is one of a gradual reversal with some temporary financial turbulence taking place as markets take notice of the new policy stance. However, a tail event of heightened and persistent financial volatility cannot be written off. Although there is some research estimating the impact of the implementation of QE on key interest rates in the US, it is likely that the impact of the removal of QE will not be the flipside image of its implementation.

Let me turn now to the last determinant of the impact of a reversal: what countries do in the meantime. Recent events have shown us that even a gradual normalization of global monetary conditions may not be welcome news for all countries. For various reasons, these conditions have bred more vulnerability in some countries than in others. Those countries that have been running large current-account deficits, where these deficits have been financed mainly with debt, where fiscal positions are weak, and where capital inflows have bred large expansions in credit, may have already become too dependent on abundant and cheap international funding. Thus, we have ended up in a somewhat strange situation where countries that not long ago were complaining about receiving too much capital inflows are now complaining about a potential shortage of funding.

Countries in this situation should consider the temporary postponement of tapering as a welcome opportunity to reduce their vulnerability by strengthening their fiscal position and addressing potential risks in their financial systems. There is still time, but the clock is ticking. Let me be clear: tapering will take place, global monetary conditions will and should eventually normalize, and the times of extremely cheap and abundant international financing will end.

In Chile, we are currently in a situation where we do not consider tapering as bad news. After declining for some quarters, our trade balance has gradually improved. Gross inflows are still concentrated in FDI, and an important part of foreign expenditure goes to investment goods. Furthermore, Chilean residents, mainly through pension funds, have large gross foreign asset positions, which have lately acted as a buffer against fluctuations in gross inflows by non-residents, as mentioned in the latest World Economic Outlook. Our fiscal position is solid. The on-shore peso rates have not moved in tandem with the latest global increase in long term rates, but instead they have actually fallen. And we have maintained a regime of fully flexible exchange rate that has helped us deal with external shocks in an economy with small degrees of dollarization.

Regarding financial markets, credit growth in Chile has been robust, although it has decelerated recently, and house prices have increased at a steady rate, but we see no reason to be especially worried about these developments in the short term. Nonetheless, as we have repeatedly mentioned in our Financial Stability Reports, we closely monitor developments in financial markets to act in coordination with the other members of the Financial Stability Council if needed.

Under these conditions, we think a normalization of the global monetary stance is a welcome and necessary development and we believe we are in a good position to face it.

Nonetheless, these are not times to be complacent. There are various issues and risks to be aware of. First, a prolonged persistence of the global liquidity conditions could result in sustained capital inflows to emerging economies. This may fuel vulnerabilities to a point where they become dangerous, especially now that the reduced growth prospects in emerging economies may channel new capital inflows towards consumption rather than to investment. Second, as I mentioned before, a volatile exit from quantitative easing is a relevant risk scenario. Market reactions to the announcements of future tapering have been relatively moderate so far. But the actual tapering has not yet begun, and there is considerable uncertainty about its exact timing and consequences. On this front we are still in unchartered territory. Finally, I am concerned about a potential interaction between the financial uncertainty associated with the tapering program and the political uncertainty about fiscal negotiations in the US in the coming months.

To close our conference, tomorrow we will have a policy panel where three distinguished economists: Guillermo Calvo, Vittorio Corbo, and Maurice Obstfeld, will share their thoughts on the end of QE and its consequences for emerging markets.

We have navigated through challenging times in recent years. The decisive action of policymakers worldwide has spared the global economy from further trouble. In many cases policy has had to go ahead of research. But we should take time to think hard about these events; their causes; their mechanisms; and the benefits and costs of the policies being implemented. This will allow us to finish the course and to derive important lessons for the future. I am confident that the discussion of the next two days will help us advance toward this goal.

I would like to finish this presentation by thanking Claudio Raddatz, Diego Saravia, and Jaume Ventura for putting together an exciting program and all of you for coming to participate and share in the discussion.

Thank you

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