



CHALLENGES FOR MONETARY POLICY

Rodrigo Vergara
Governor
Central Bank of Chile
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Thank you for inviting me to speak at the 2013 Annual Meeting of Latin American Executives organized by the IIF and Banco de Chile.

Developed economies continue to pose major risks, challenges and opportunities for emerging countries, including those in Latin America. Although the specifics of each country may vary, and thus their optimal policy mix to deal with the external situation, we have many issues and questions in common. A forum like this one, where policy makers and the financial community have the opportunity to interact, allows us to improve our understanding of the current juncture and its different aspects so as to enhance the effectiveness of our policies.

Today, I will share with you my views on the interactions between monetary policy and financial stability issues in emerging market economies. I will also refer to some of the challenges facing emerging countries in the current context of long-lasting expansionary monetary policies in the developed world. Finally, I will refer to recent developments in the Chilean economy.

Monetary policy in a world where financial stability issues attract increasing attention

Before the 2008 Lehman Brothers' collapse, a common view was that stability of the financial system could be preserved through a combination of microeconomic regulation and macroeconomic stability. Hence before the crisis, many countries focused financial regulation on the risks faced by individual institutions, and macroeconomic policies on the preservation of price stability. The conduct of monetary policy centered mainly on price stability, while in many cases financial stability played a secondary role.

The international financial crisis and its dramatic consequences have taught us that this approach might have actually helped to foster financial risks as they built up without proper surveillance. The common view nowadays is that micro regulation has to be combined with a systemic perspective of the financial system.

Latin American countries had already made progress in that direction, since after many decades going in and out of currency and banking crises, financial stability had already become a key concern for policy makers. Many institutional changes were made in our region in the last couple of decades that have resulted in much healthier financial and fiscal positions than in the past. This is one of the reasons why the effects of the recent global financial crisis were limited and no financial breakdown occurred in this part of the world.

One debate currently in place is whether central banks should be the sole institutions in charge of safeguarding financial stability, or whether this responsibility should be shared with others. A cost-benefit analysis and our past experience suggest that central banks have a unique macro-systemic vision of the economy, linking different economic agents, real and

financial markets. In addition, our role as lenders of last resort places us in a key position in periods of financial stress.

However, undergraduate economics students learn that there should be as many instruments as policy targets. And thus, for central banks, having a second policy objective besides our price stability mandate can create confusion and damage hard earned credibility. Indeed, having a price stability goal is easy to understand as inflation is an easily observable variable. On the contrary, financial stability is a fuzzy concept with many dimensions and hard to express in a single indicator. Therefore, earning credibility and being accountable for this objective is a major task. This leads to the question as to what the appropriate tools to deal with a financial stability objective should be. This is an issue I will return to later.

Considering these aspects, countries have chosen different institutional frameworks. In some, banking supervision is conducted outside the central bank, such as in Chile, whereas in others it is conducted inside the central bank or there is shared responsibility. In some supervision is based on sectors – in others it is objective based. Whatever the institutional setting, however, there is consensus on the importance of having a well coordinated framework in which to analyze and discuss risks to the financial system, and possible actions to address these risks. This discussion must be sufficiently broad to include all relevant regulatory and supervisory agencies, in addition to the Central Bank.

In Chile financial stability is part of our mandate. The Central Bank is expected to act as a lender of last resort and we are also in charge of several aspects of financial regulation, such as bank liquidity and market risk regulation, aggregate limits for pension funds, amongst others. Having this objective in mind, we monitor systemic aspects of financial sector, as well as the overall financial position of firms and households. The two Financial Stability Reports we publish every year are widely read by other regulators and market players

But we are not the sole responsible entity. The supervision of different groups of financial institutions and the legal power and tools to enforce regulation are spread across several agencies. We have a Superintendence of Banks and Financial Institutions, a Superintendence of Securities and Insurance, and a Superintendence of Pensions; keep in mind that pension funds are large players in our financial system.

For this framework to be effective, the capability to coordinate actions and constantly share our views is crucial. The Financial Stability Council (CEF for its Spanish initials) was created in Chile in 2011 and brings the previously mentioned institutions together. The CEF meets once a month and has two main objectives. First, to provide a forum for the analysis of events that could become a source of financial instability. And second, to discuss and propose supervisory or regulatory actions by members that could address these risks.

As I mentioned before, another key question relates to the instruments available when dealing with financial stability. The natural question is whether the monetary policy rate should be used as a tool. In my opinion, the interest rate is usually too blunt an instrument to deal with financial stability issues. On the one hand the required policy changes for financial stability purposes may be very large indeed. In addition, risks to financial stability usually arise from specific sectors and are not economy wide –so monetary policy will impact sectors that are not playing a role in the buildup of risks. Moreover, when there are clear sources that could be creating risks to financial stability, there are often instruments that can address them directly without affecting the other sectors of the economy. Finally – in certain cases-- the optimal monetary policy rate decision from a financial stability perspective may conflict with the optimal rate from a price stability perspective leading to a potential loss of credibility.

Hence – so called “macro prudential” policies make a lot of sense, but in turn raise a different set of questions. What are they, precisely? What measures can be considered macroprudential? Who should implement them? Should they replace instruments in use, or should they complement the current policy setting? And of course, another pressing doubt is about their effectiveness and macroeconomic consequences over a longer period of time, since we do not as of yet have a broad experience using them.

As opposed to microprudential regulation, used to ensure the health of specific financial institutions, macroprudential measures are tools used to safeguard the stability of the financial system as a whole. In general, policies aimed to curtail credit growth or other aggregate indicators that could be potentially harmful for financial stability are considered macroprudential measures. More specifically macroprudential regulation takes into account the time varying dimension of financial risk and the interactions between financial system participants. As such, macroprudential tools aim to avoid the buildup of financial vulnerabilities and provide a cushion for the downturn.

It is safe to say that in several aspects this is an old instrument with a new name. Indeed, in the past many countries have used instruments that can clearly be defined as macroprudential. On the other hand, it is important not to label too many policy decisions as “macro prudential”. One example of this would be to label changes in bank reserve requirements as macroprudential, when in most cases their objective is to rein in demand for inflationary purposes. This distinction is not merely academic. As transparency is an important component of central bank policy making, communication on macroprudential regulation should clearly specify the risks being addressed.

Hence, macroprudential measures can be used to complement current policy settings, when specific concerns to financial stability arise. For example, concerns about the risks to financial stability arising from rapid growth in credit to finance housing could be addressed by changes in loan-to-value or debt-to-income ratios. Dynamic provisions related to

general or specific forms of credit may also help banks maintain a solid position through the financial cycle

Of course, all these measures are not cost-free and their use must weigh these costs against specific financial stability concerns. In Chile, the regulatory instruments that could be used are under the control of different agencies, which makes the Financial Stability Council I just mentioned a crucial instance for discussing and proposing financial regulation with a systemic view.

Monetary policy in a world with large interest rate differentials

A different challenge for central banks, particularly relevant at the current juncture, has to do with the fact that the most likely scenario for developed economies in the next couple of years is one of low growth rates and, accordingly, very low “risk free” interest rates. At the same time, the emerging world is growing at a faster pace and higher interest rates prevail. Experience teaches us that this could lead to rapid and sometimes destabilizing capital inflows to emerging countries, including Latin American. This is a potential risk that we have been flagging since 2010 in our Financial Stability Report. The discussion of how to cope with these capital flows has been mixed with the rhetoric of currency wars and the use of competitive devaluations in the developed world to boost their meager growth perspectives.

Emerging market economies are wary of rapid capital inflows, especially due to our past experiences and their huge consequences in terms of lost growth that sudden stops have had in our economies. The debt crisis of the 1980s was preceded by capital inflows and rapid credit expansions. But, when interest rates started rising in the developed world and imbalances became evident, capital flows reversed quickly. During that time in Chile, the economy contracted dramatically and unemployment reached record levels. The story in other Latin American countries is not too different and all of us have previous experience with episodes that are similar in many aspects to the current situation in some economies of the periphery of Europe.

However, capital inflows need not be considered dangerous. They are unlikely to be harmful if there are no frictions in the reallocation of resources or other externalities. If such frictions existed, theory prescribes that first-best policies should try to undo them. But, there is no academic consensus on the precise nature of these frictions, and also, correcting them may not be feasible within the timeframe required for policy action. This means that second-best policies may be the only choice at hand for policymakers.

Besides, much of the traditional frictions and market failures produced when allocating these capitals have been reduced. Today’s economic policy framework is more advanced in terms of financial regulation and supervision to prevent the incubation of excessive risk. The macroeconomic and institutional environment has improved significantly in most Latin

American countries. In Chile, for instance, it includes a rule that governs fiscal policy and cushions the impact on public expenditure of both copper price fluctuations around its long-term trend and the ups and downs of the business cycle.

Another difference is that while in the 1980s capital inflows took mostly the form of debt, this time around foreign direct investment (FDI) accounts for an important portion of these flows. Moreover, in many cases, such as in Chile, this FDI is directed toward natural resources, which is a tradable sector. Although a widening current account deficit may be a source of concern, it is clear that if it is financed through FDI to the tradable sector, the concern is mitigated.

However, at the Central Bank of Chile we feel that considering our past experience with capital flows and the widening current account deficit that we have seen recently, it is paramount to closely monitor the factors that are behind the current account deficit, as well as capital movements, in order to avoid the incubation of imbalances that may affect the future performance of the economy.

Some emerging markets, including some Latin American economies, have actually taken action to try to curb capital inflows or to avoid excessive appreciations of their currencies. Both administrative measures and outright interventions in the foreign exchange market have been used. The effectiveness of several of the policies being implemented is still to be seen. In any case, whenever these kinds of appreciations occur, increasing pressures to take action appear.

We are convinced that a floating exchange rate regime is the most appropriate for Chile, as it facilitates macroeconomic and external account adjustments. Nonetheless, there are circumstances that may lead to Central Bank intervention in the foreign exchange market, either to sustain an adequate level of foreign reserve assets, or to respond to overreactions in the exchange rate that are not aligned with medium-and long-term fundamentals. Associated to this type of intervention, there are costs. One is that it may create confusion as to the monetary authorities' objective: inflation or the exchange rate. In Chile in recent years, a specified exchange rate level has never been a Central Bank goal. It has always been made clear that the Central Bank of Chile pursues a price stability target. Another cost is of financial nature. Foreign reserves are invested in highly liquid and secure instruments of developed countries, whose interest rates are lower than those of the domestic instruments used to finance their acquisition. This originates a significant cost that deteriorates the Central Bank's net worth. The benefit of having these reserves is the enhanced security in case of an abrupt cut of external financing. These benefits are hard to quantify, but it is reasonable to expect that they will diminish as the availability of reserves increases.

I cannot finish this talk without referring briefly to the recent developments of the Chilean economy.

Monetary policy decisions over the last year have been guided by two opposing forces. On one hand, the international situation is fragile and its unfolding is still unclear. Major economies are expected to register meager growth rates for some time and keep their historically expansionary monetary policies in place. Even though the risks of extreme scenarios have diminished in recent months, the situation in Europe is delicate and in particular some political risks could put pressure on financial markets. This was the main risk identified over several quarters. Now, extreme scenarios seem to be less probable, but are still possible and their consequences could be very serious. By now, a resurgence of financial tensions in the Eurozone cannot be ruled out, particularly related to recent political developments.

On the other hand, domestic risks have gained importance, at least in the short term. Output and demand indicators exceeded forecasts over the last year. GDP is estimated to have grown 5.6% in 2012, after expanding 6% in 2010 and 2011. In January 2012, market expectations for the year were at 4% and had to be gradually adjusted in line with higher actual figures. In this cycle, growth has been driven by domestic demand, which, in turn, has been boosted especially by investment projects related to the mining industry. Indeed, investment in the mining sector has been growing steadily during the last decade, and from representing less than 15% of total investment in 2003, its importance has increased to an average of about 25% in the last three years. Dynamic consumer spending has also been a feature of the current cycle fostered by favorable consumer expectations and stable financial conditions. A key element in the evolution of consumer spending has been the tight labor market: the unemployment rate is at 6%, near its minimum from a historic perspective, and real wages are growing at 4 to 5% annually. One important feature of the current juncture has been that high growth and low unemployment have not translated into higher inflationary pressures. Both headline and core inflation have followed a downward trend during the last year and are currently below 2% y-o-y. At the same time, inflationary expectations in the policy horizon remain aligned with the target. In this context, we have held the policy rate at 5% since January 2012. It is important to note that in these days this level for the policy rate is quite high by international standards.

Undoubtedly, the effects on our country of the external situation have been milder than we had feared. Part of that has to do to the fact that during this cycle we have benefited from high terms of trade and in particular from the high price of our main export, copper. This in turn is related to the dynamism of the Chinese economy. But also much of that limited effect on the domestic economy of the external situation has to do with the economic policy setting that we have built over the years, that has increased our resilience to external shocks. Besides the independent central bank with a floating exchange rate regime, our policy framework includes the already mentioned fiscal rule. Our effective fiscal balance

last year yielded a surplus of 0.6% of GDP. Gross public debt is about 11% of GDP while net debt, that is, discounting financial assets, is negative, which means that the public sector is a net creditor.

Another pillar of the Chilean economy is the proper financial regulation and supervision that I talked about previously. Our financial system has a capital adequacy ratio of more than 13%. Stress tests that we regularly perform show that the banking system is in an appropriate financial position to operate normally and has the capacity to absorb the materialization of a severe risk scenario.

To conclude

Recent developments have raised several questions and dilemmas for central bankers. But that is what policy making is all about, dealing constantly with different situations where there is no particular recipe and we have to be creative having always in mind that our ultimate goal is attaining welfare for our population.

We at the Central Bank of Chile are clear about our mandate. Our policy decisions are made so as to maintain inflation under control and to safeguard the stability and efficiency of the financial system. Those are the best contributions we can make to our economies.

Thank you.