Monetary Policies, Asset Prices and Policy Dilemmas for LATAM.
The Chilean Experience

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- The global context after the financial crisis
- The Chilean Experience
- Current Policy Challenges

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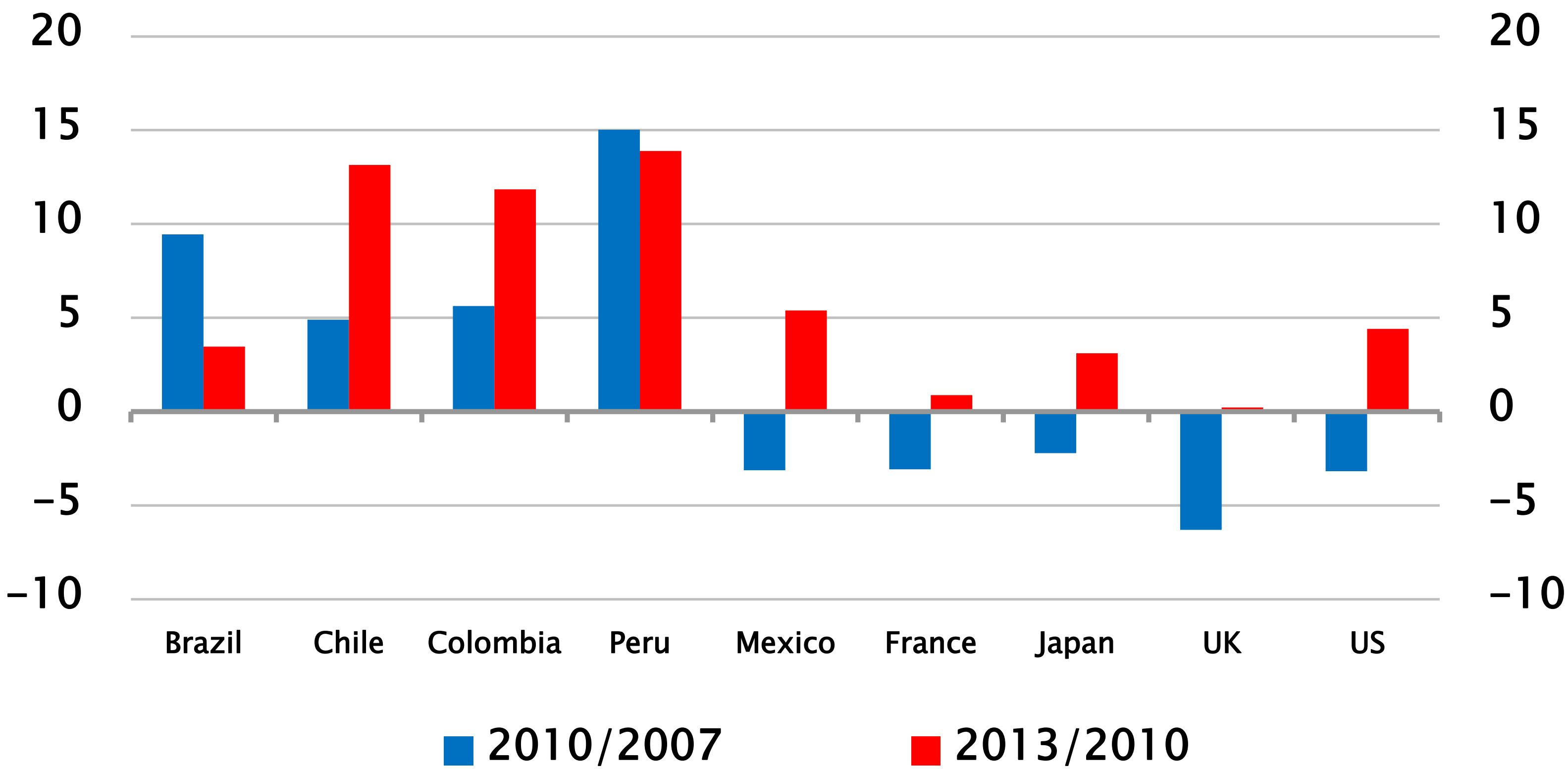
The global context after the financial crisis

- The role of commodity prices
- The real and the financial booms
- Policy responses and exchange rates
- Tapering and slowdown in China: End of the party?

Very unusual real cycle: while the Advanced Economies were very weak, Latin America surged after 2010

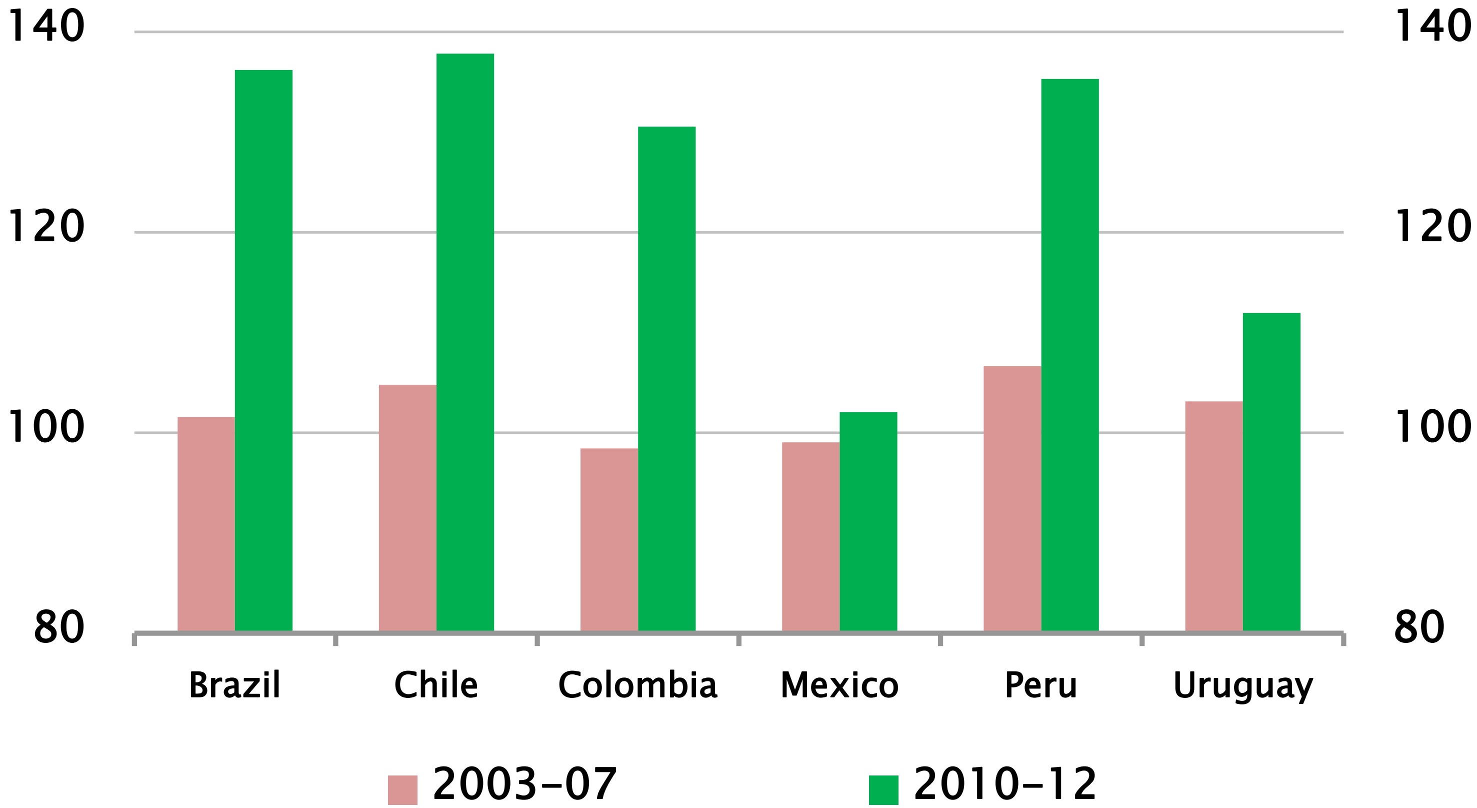
Accumulated changes in Per Capita GDP during the crisis and recovery phases (*)
(%)



(*) 2013 information is estimated .
Source: International Monetary Fund. World Economic Outlook Database, April 2014.

Terms of trade gains played a critical role. They were supported by rising demand from Asia, especially from China

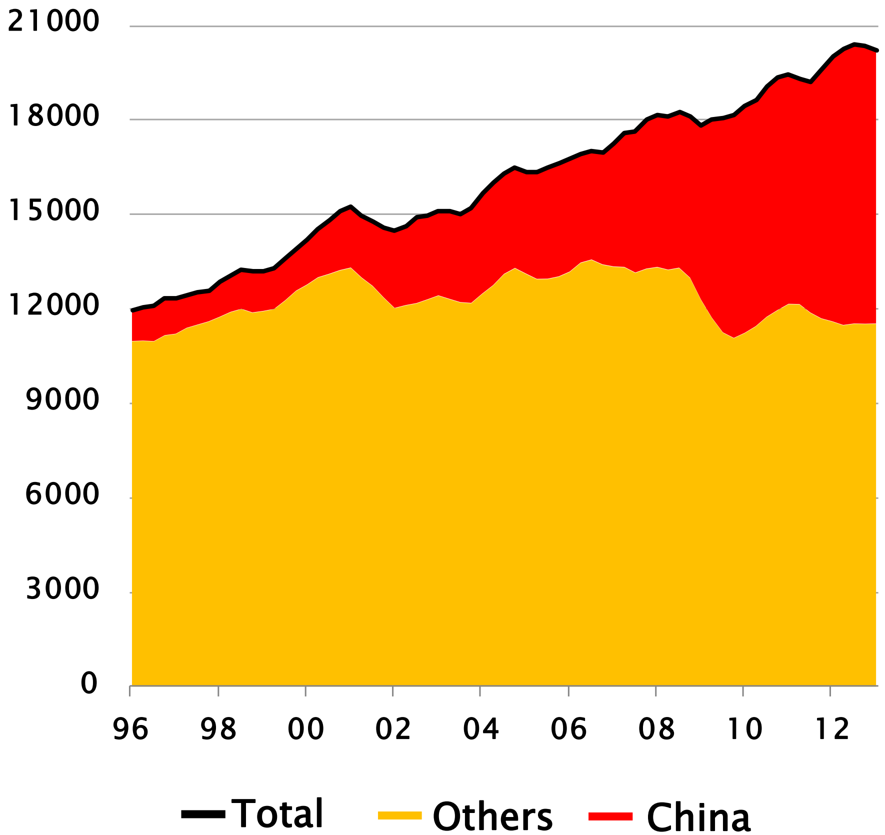
Terms of Trade for selected countries in LATAM
(Period averages, 2005 = 100)



Source: ECLAC Statistical Database.

The case of copper: global demand kept rising in spite of the Great Recession due to Chinese demand.

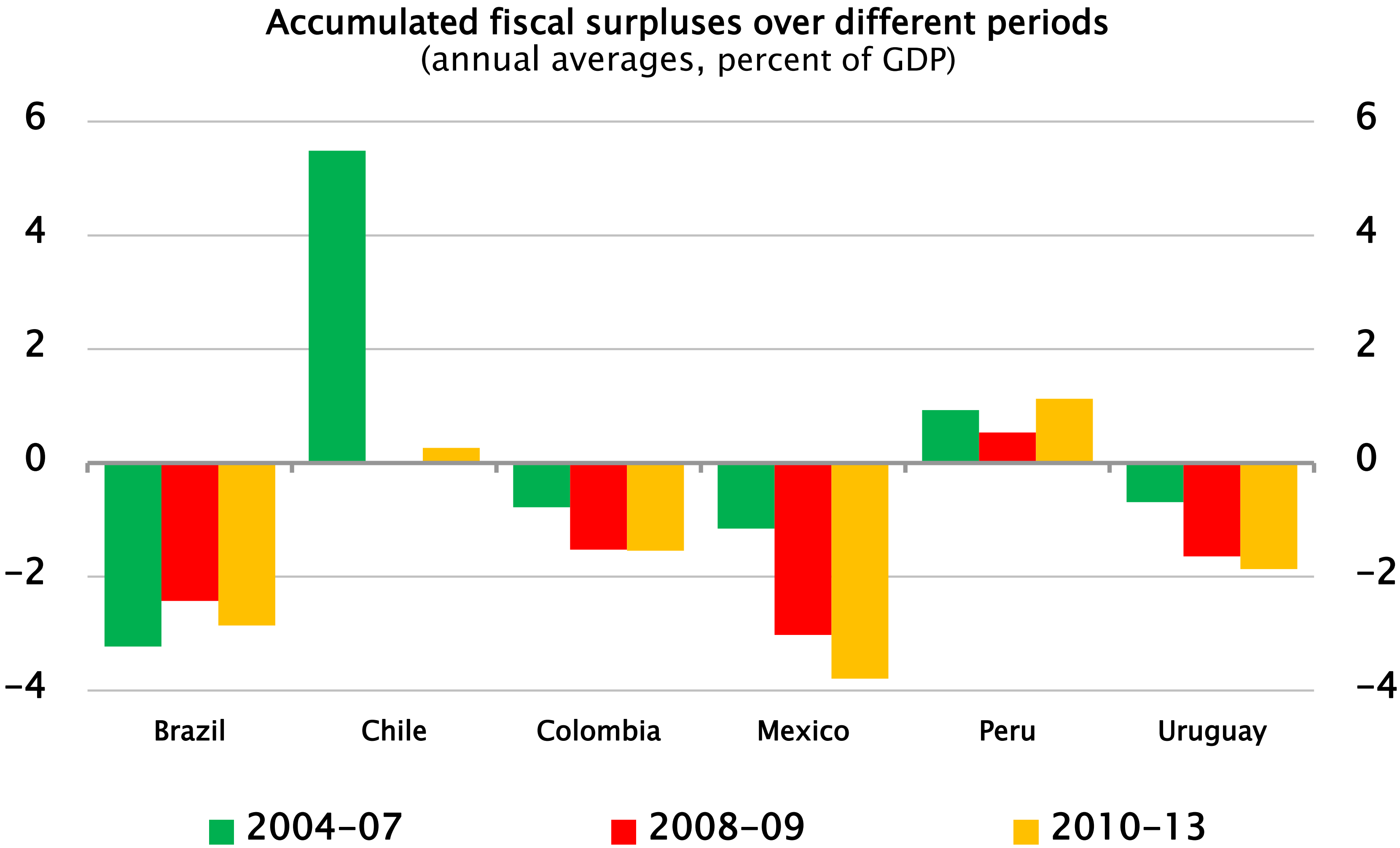
Apparent consumption of refined copper
(thousand metric tons)



Copper price
(USD cents per pound)

Sources: Bloomberg and Central Bank of Chile.

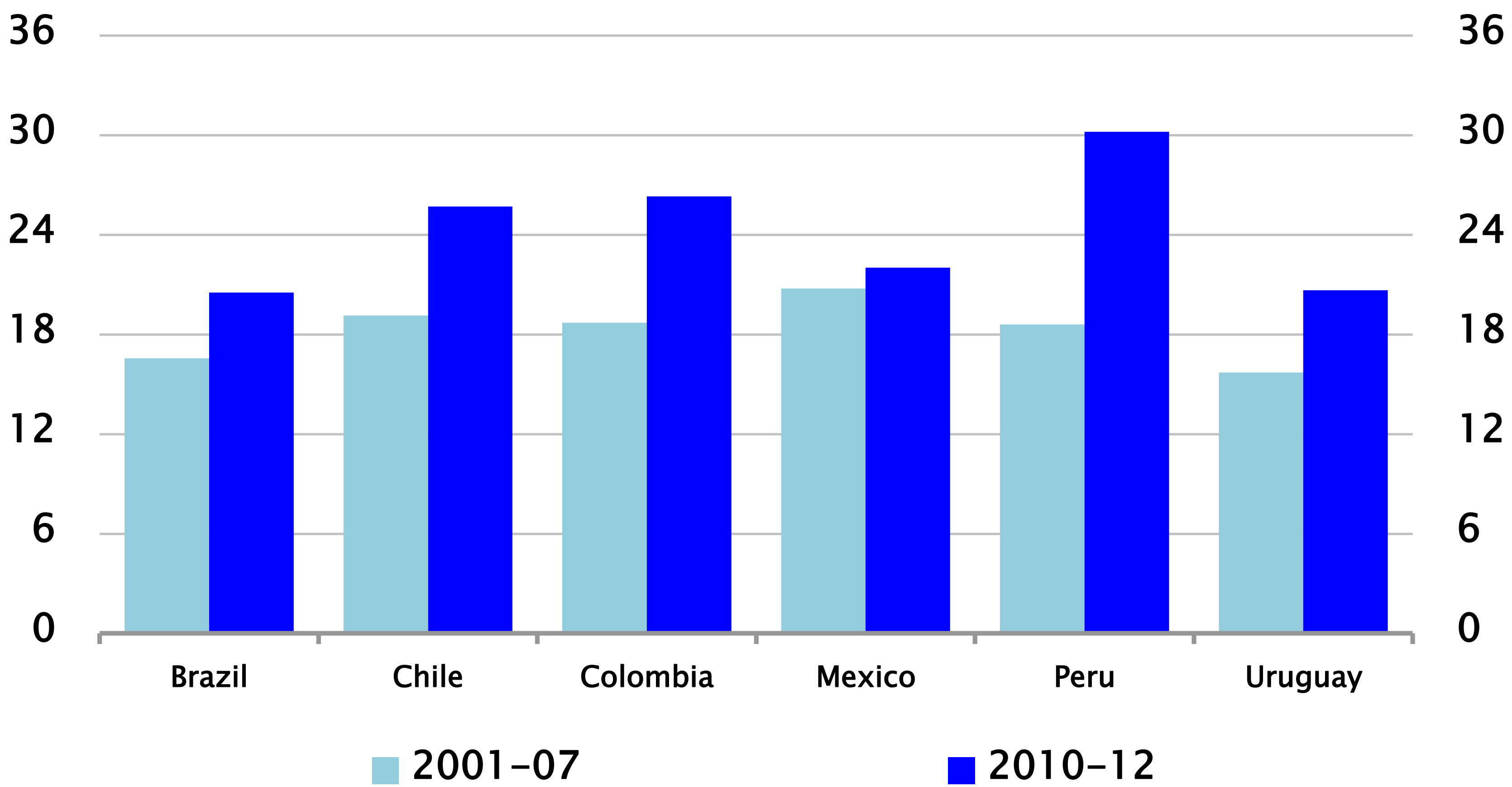
Most countries in the region, and especially Chile and Peru, saved a large fraction of the Cyclical Windfall from high commodity prices



Source: IMF, WEO April 2014 Database.

As a result of the ToT positive shock, there has also been a "Real Shock" in private, resource-led investment

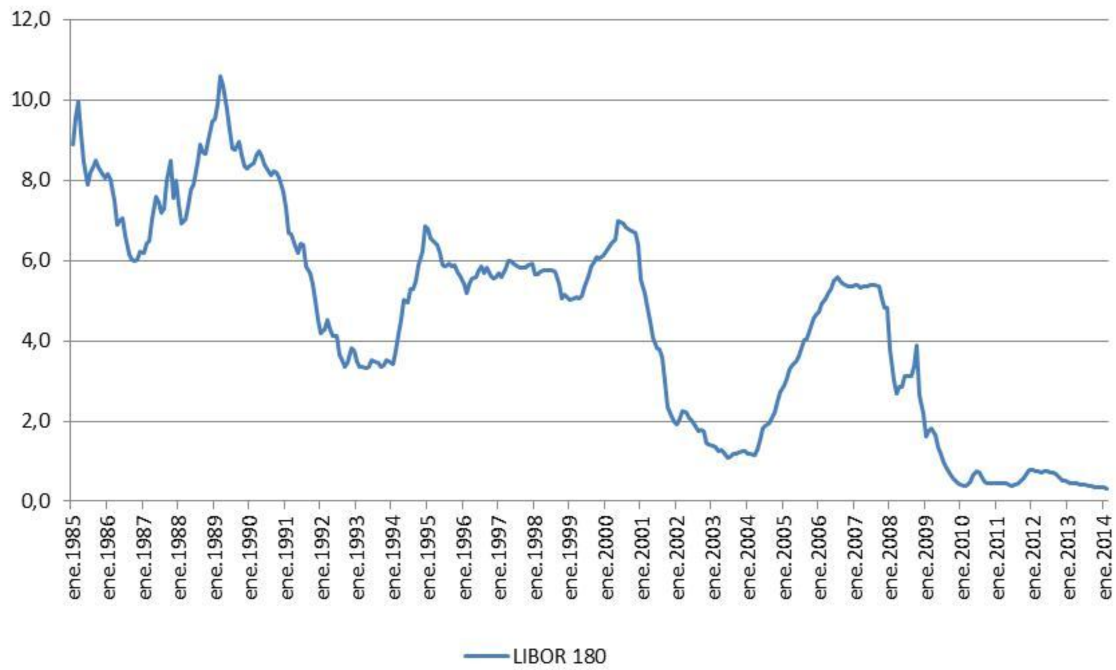
Gross Fixed Investment before and after the Big Recession
(Percent of GDP, constant USD 2005 based)



Source: World Bank, WDI database.

At the same, Advanced Countries have enacted extremely loose monetary policies

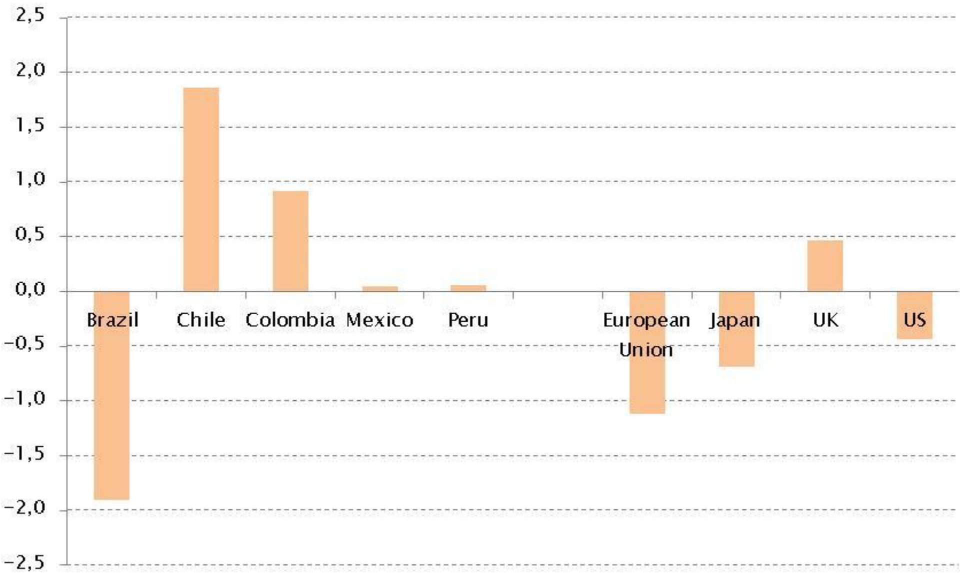
LIBOR 180
(%)



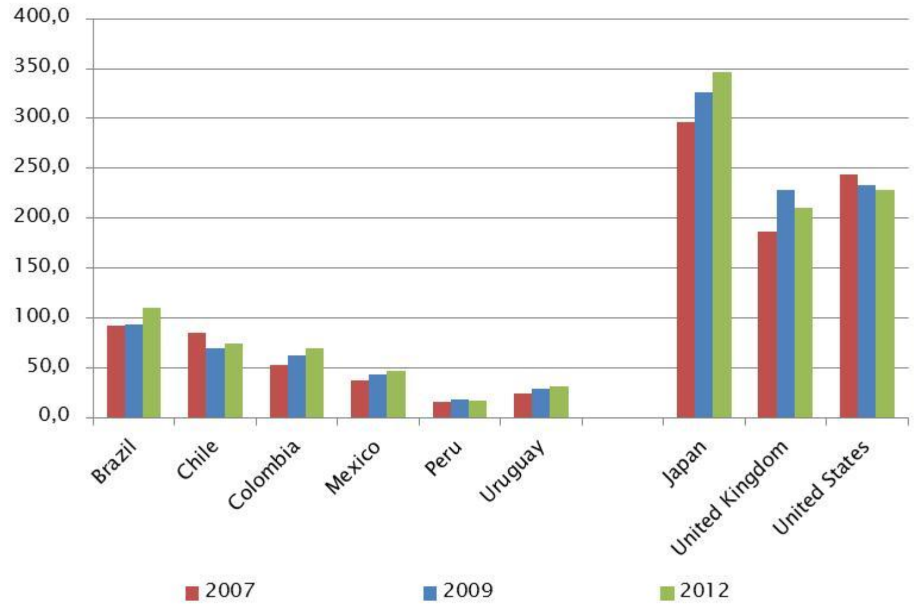
Martin Wolf: "central banks will be driven towards cheap money. Get used to it: this will endure". May 7, 2014

But during this period, most Latin American countries tightened their monetary policies, at least in real terms

Changes in Monetary Policy rates 2012-10
(Inflation adjusted, %)

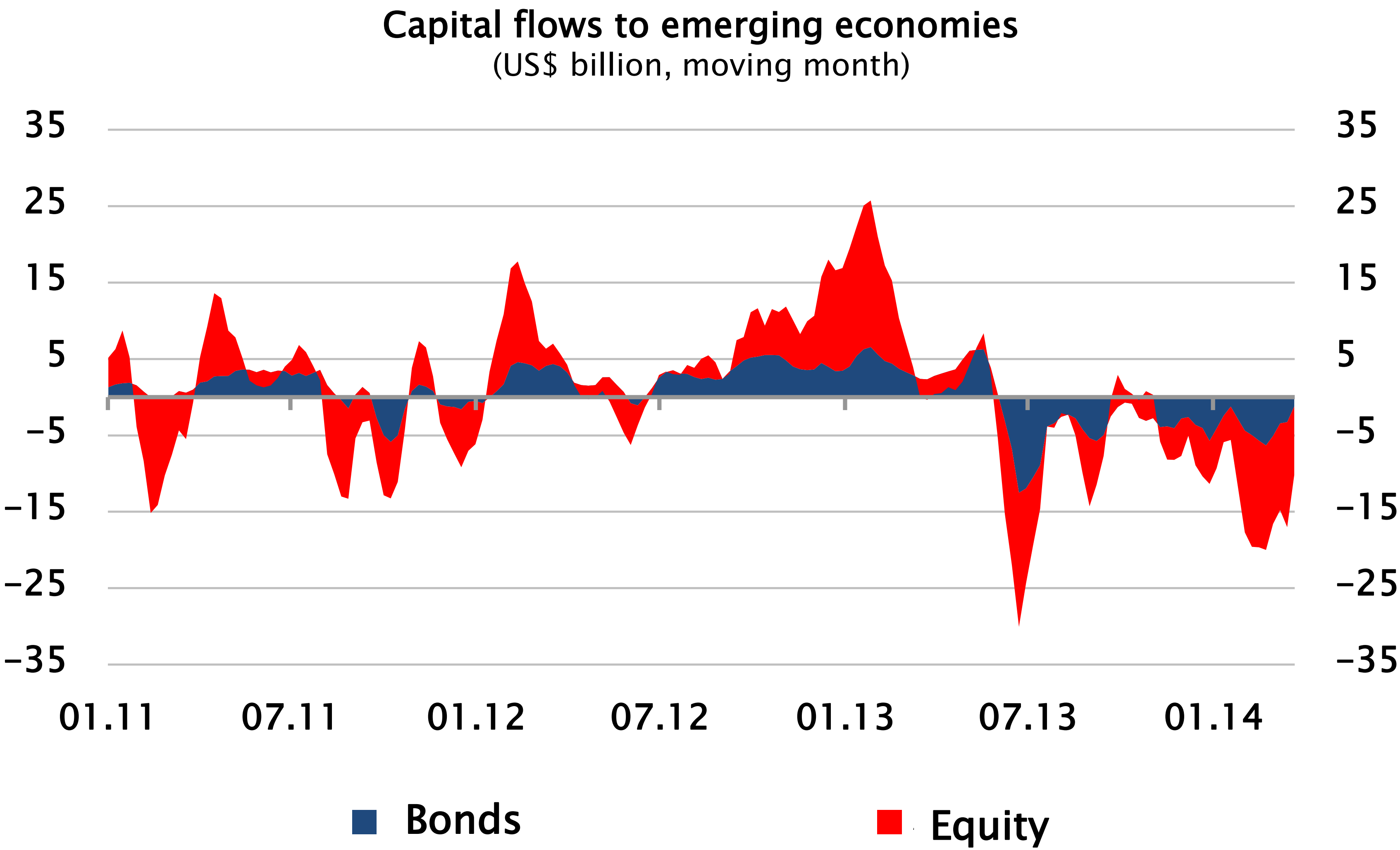


Bank Credit to private sector
(% GDP)



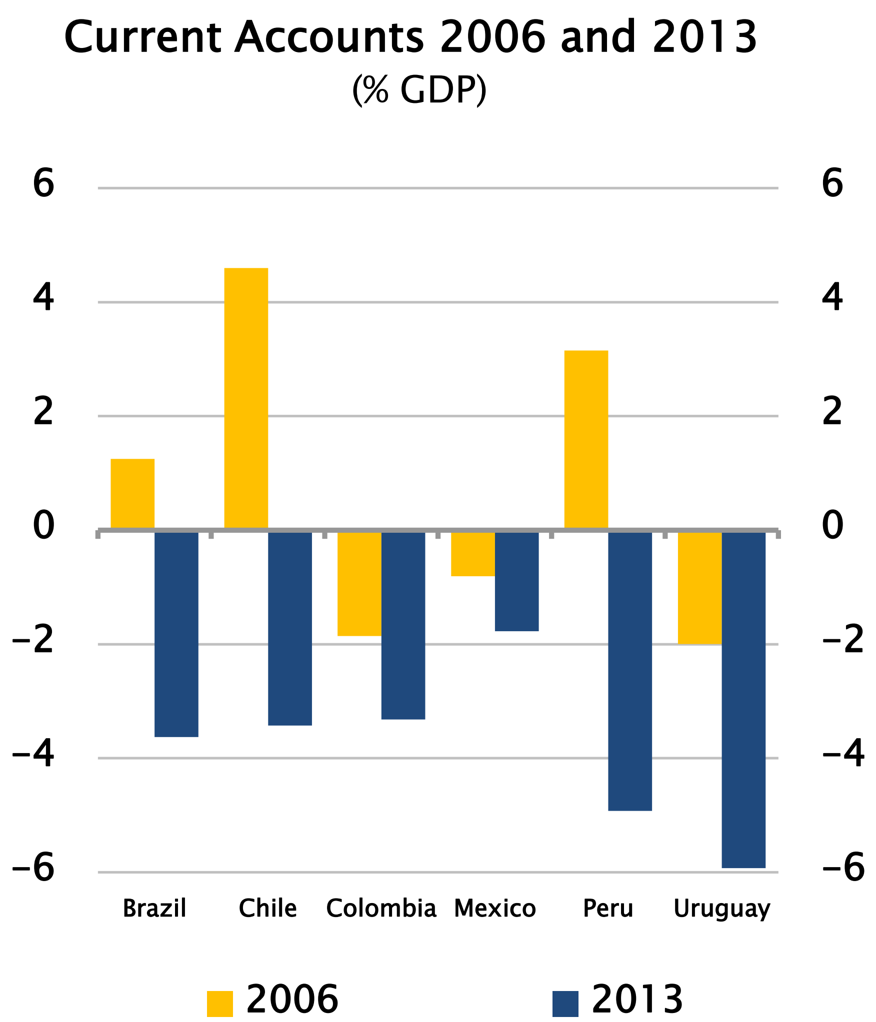
Source: International Monetary Fund. World Economic Outlook Database, April 2014.

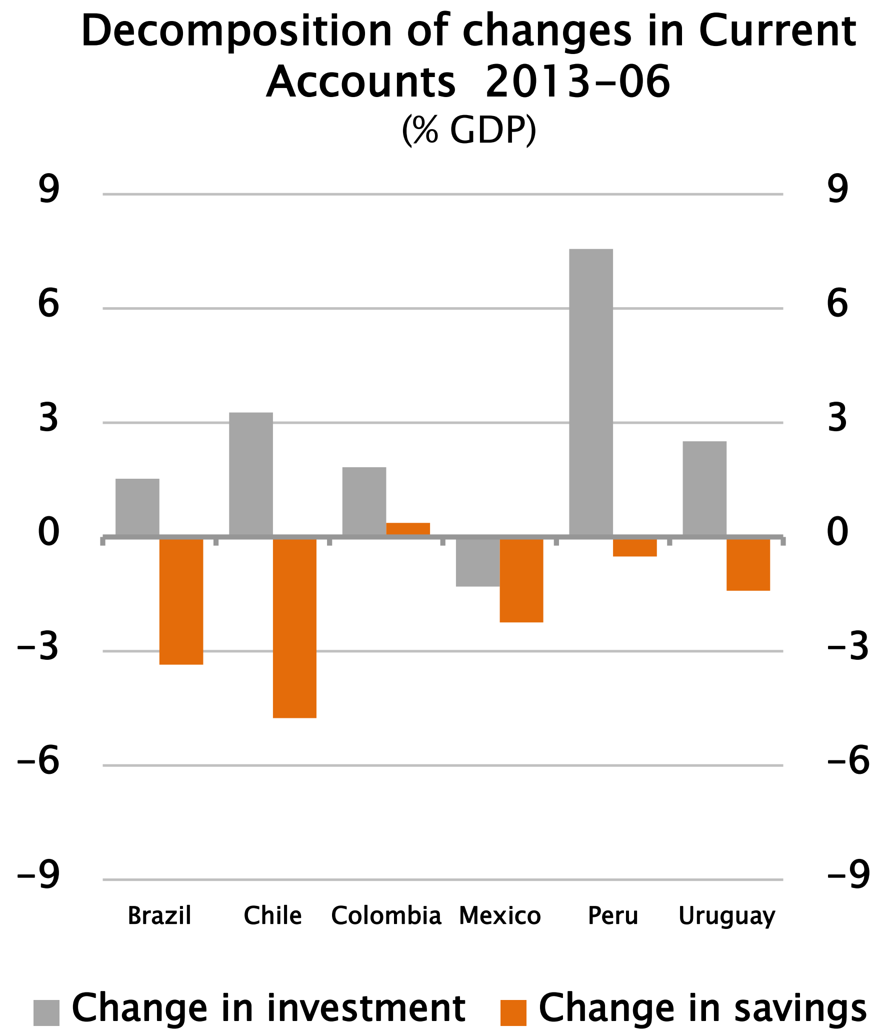
And financial capital flowed into emerging markets, in addition to FDI flows linked to the commodities. This changed drastically after the first signals of tapering



Source: Emerging Portfolio Fund Research.

Current accounts worsened, even before the correction in commodity prices, reflecting excess domestic demand growth over GDP

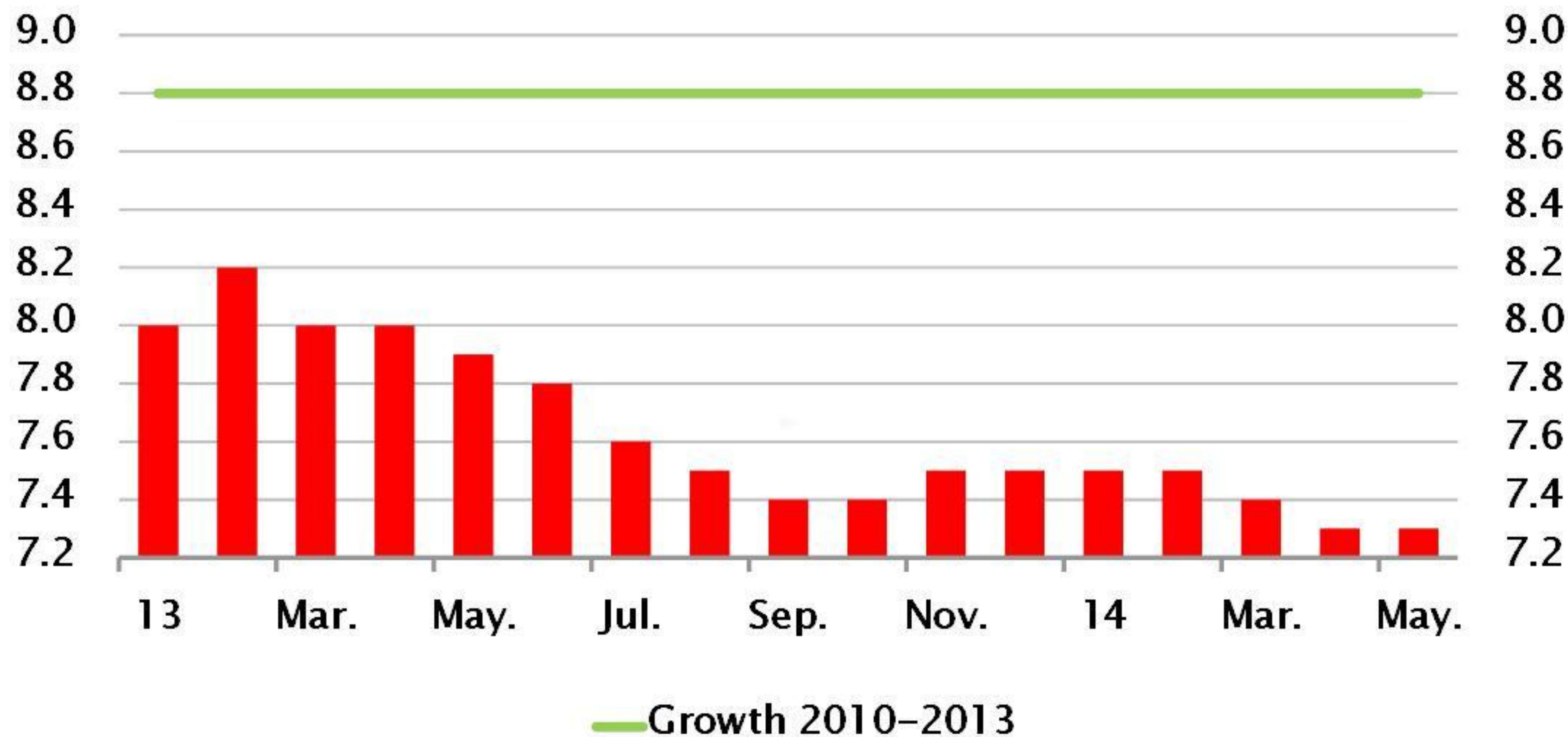




Source: International Monetary Fund. World Economic Outlook Database, April 2014.

Coincidentally (or not) China's economy has slowed down while trying to make structural reforms, and doubts about the health of the housing and financial markets emerge

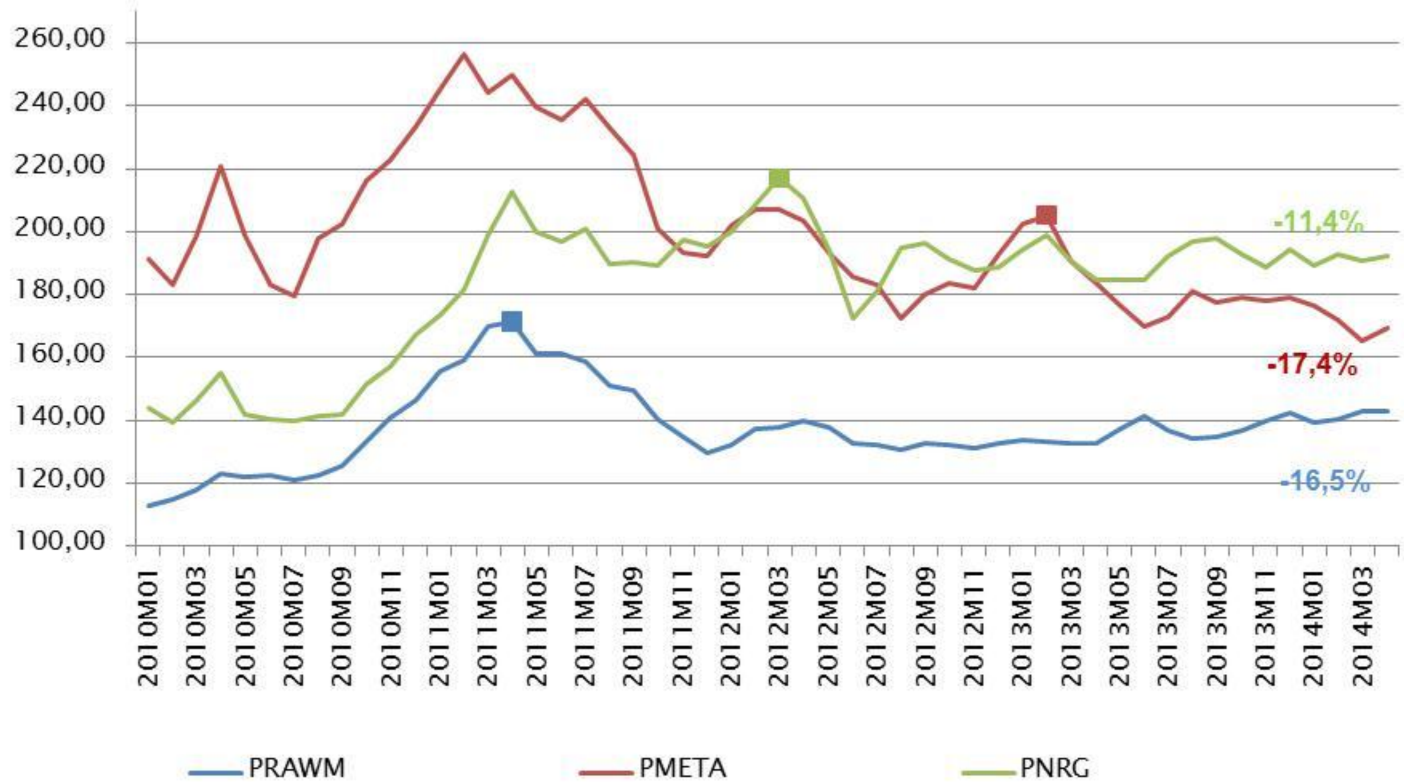
Evolution of China's 2014 growth forecast
(percent)



Sources: Consensus Forecasts and Bloomberg.

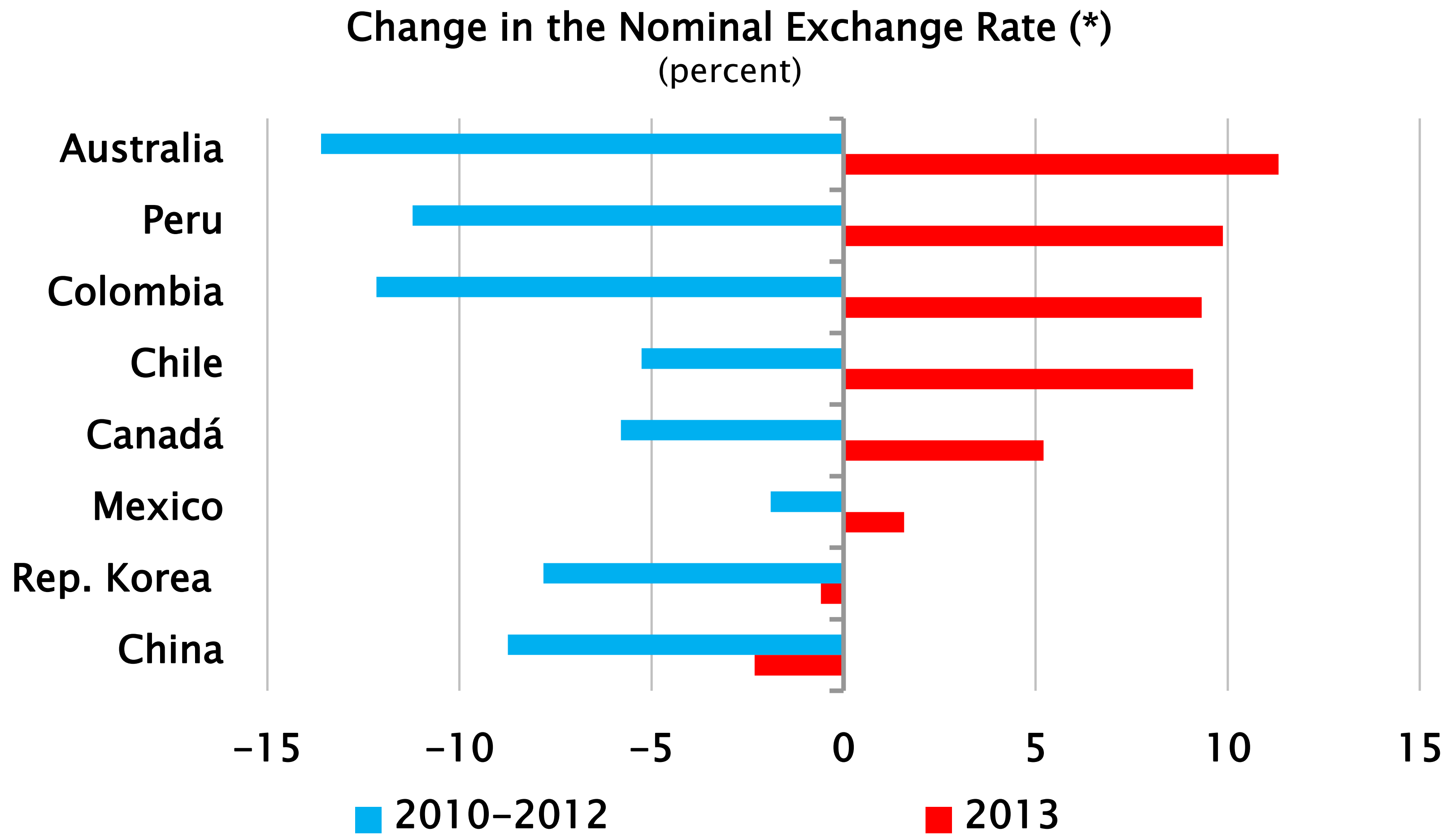
And commodity prices have come down from previous peaks

Commodity prices indexes, 2005 = 100



Sources: IMF

The fears of financial tightening in the US, the Chinese slowdown and a correction in commodity prices had an impact in EMEs currencies as well as in other NR based economies



(*) Increases (red) mean depreciation.
Source: Bloomberg.

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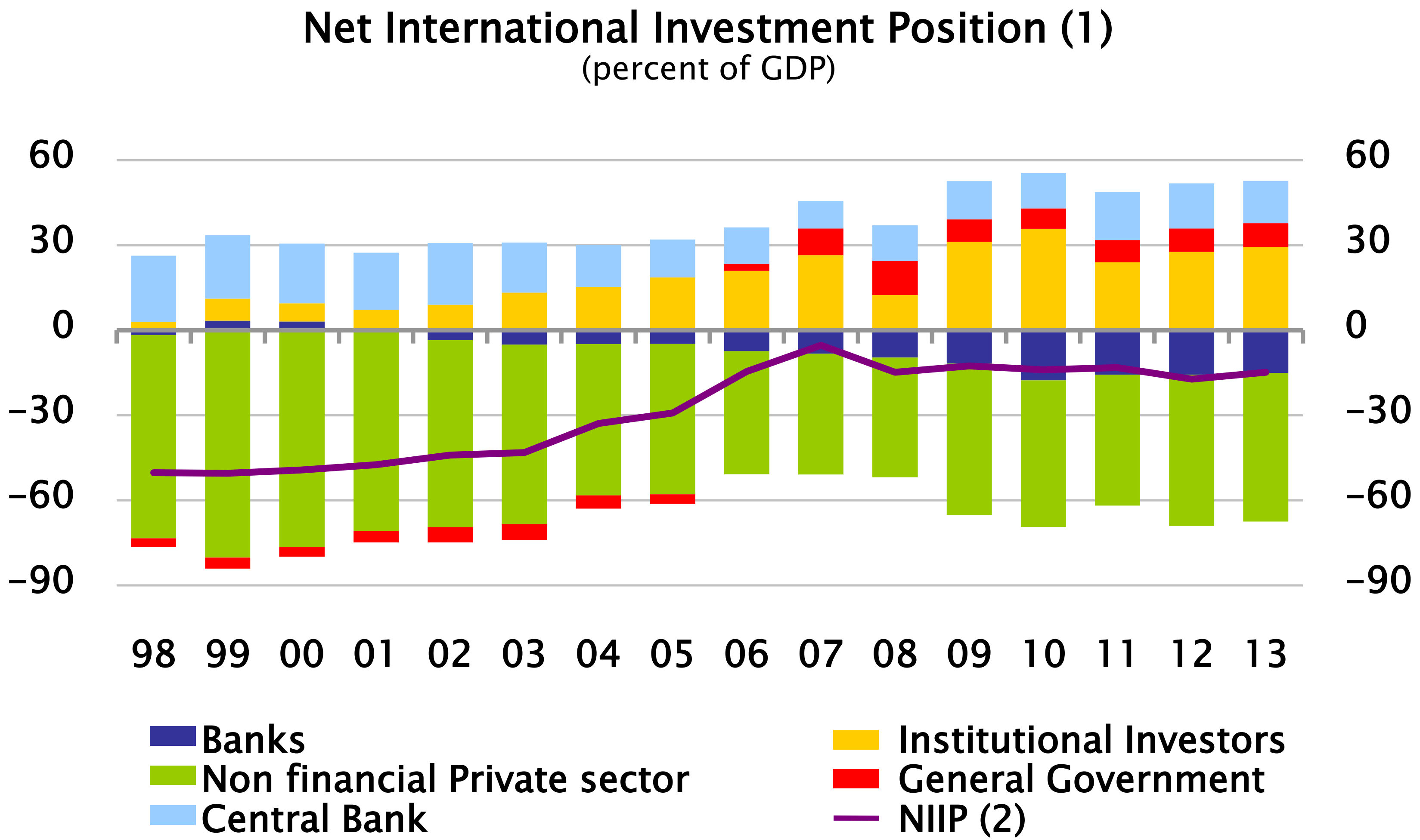
The Chilean Experience

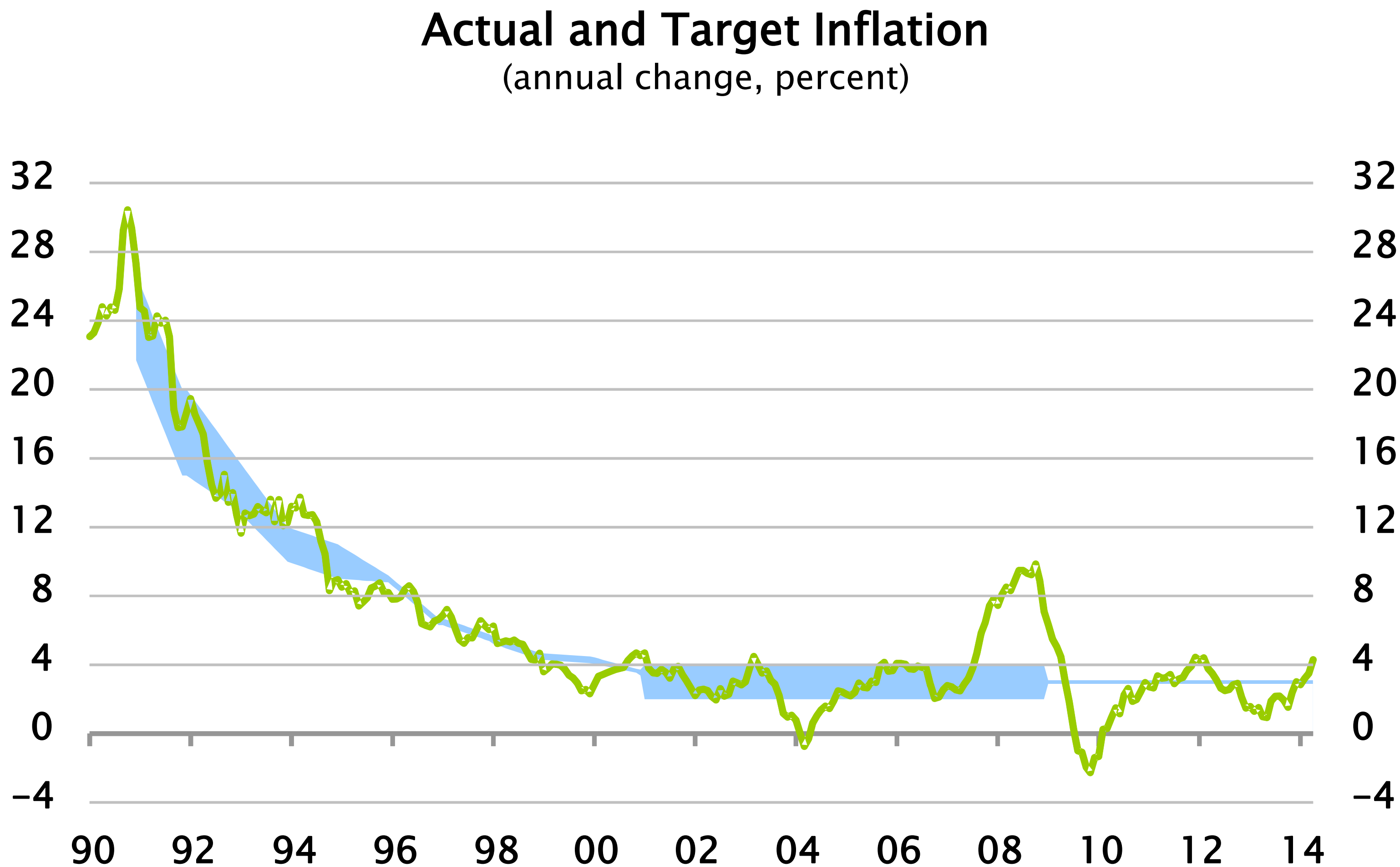
- Openness as a line of defense
- The importance of institutions
- FX flexibility vis a vis FX intervention
- The impacts of tapering

Chile has a very open economy, both in goods, services, including financial services, with a large role of domestic institutional investors



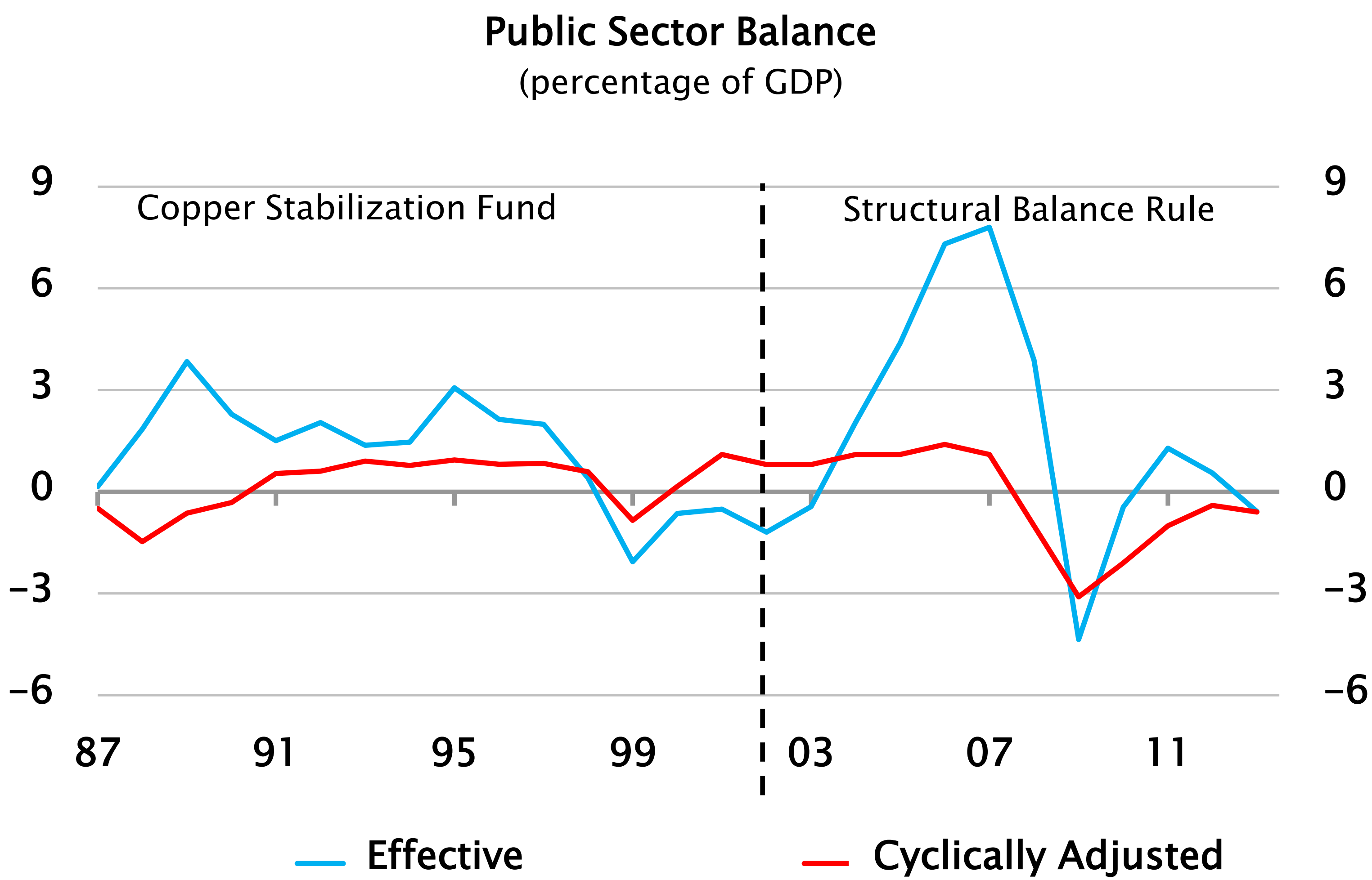
(1) GDP at constant real exchange rate (index in December 2013 = 100).
(2) NIIP: Net International Investment Position
Source: Central Bank of Chile.

Inflation targeting by an independent Central Bank: 3% (+/- 1% on 2 year horizon)



Sources: Central Bank of Chile and National Bureau of Statistics.

Rules-based Fiscal Policy, with preset targets on the Cyclically Adjusted Fiscal Balance, with strong fiscal institutions

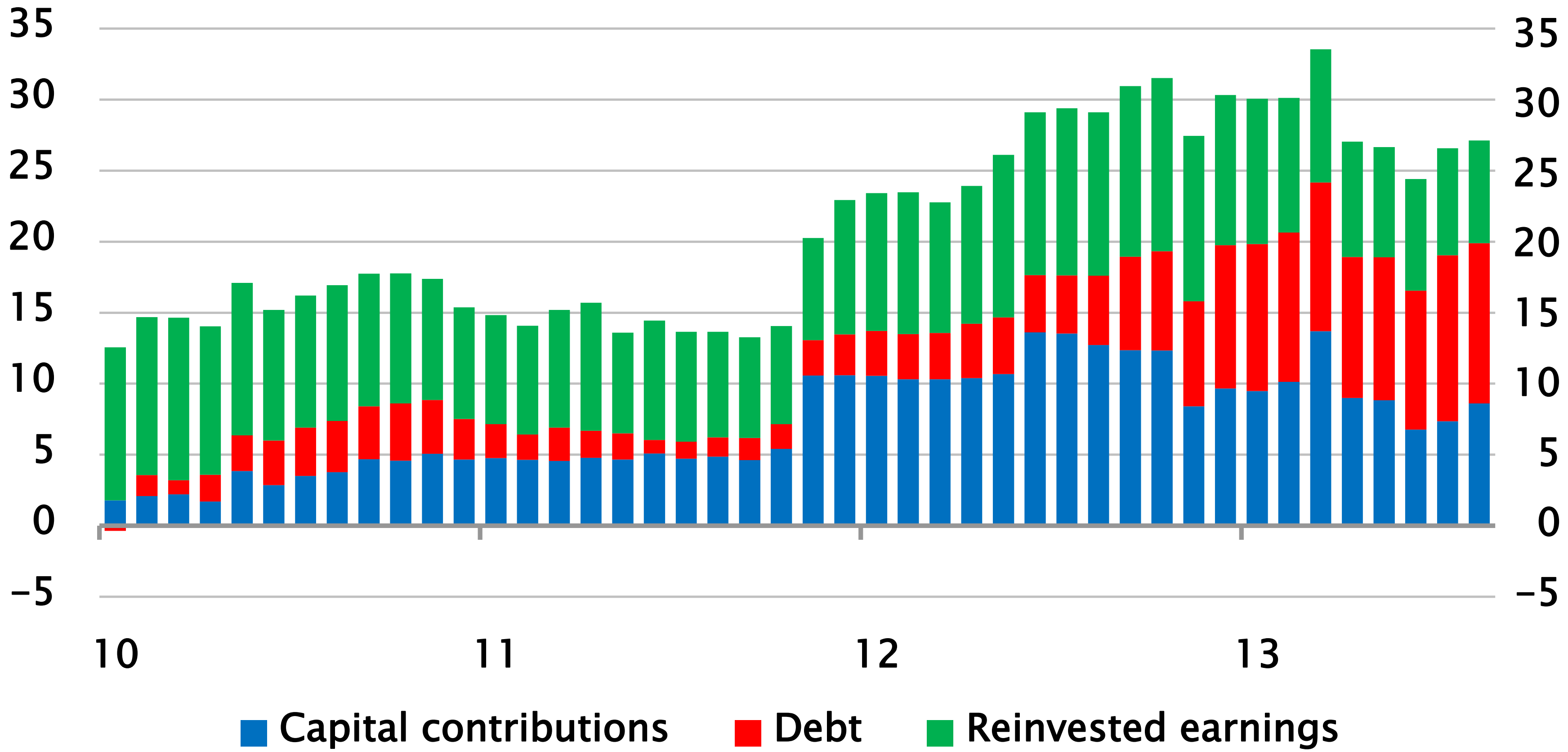


Source: Ministry of Finance of Chile.

During the boom phase Chile received large inflows of FDI, mostly directed to Mining and Energy. The correction in commodity prices coincides with a shift from Capital to Debt financed FDI

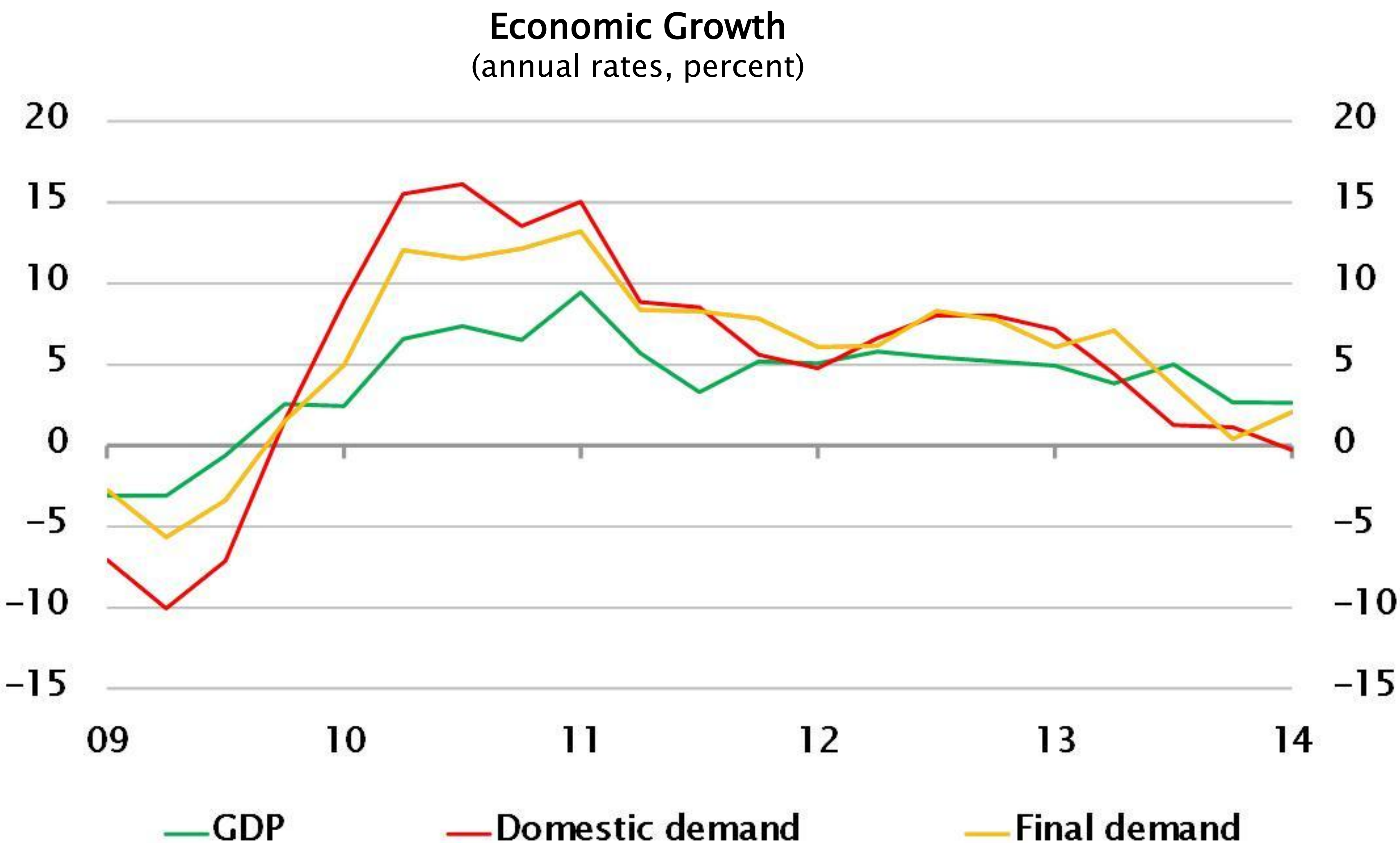
Composition of Foreign Direct Investment

(US$ billion accumulated in 12 months)



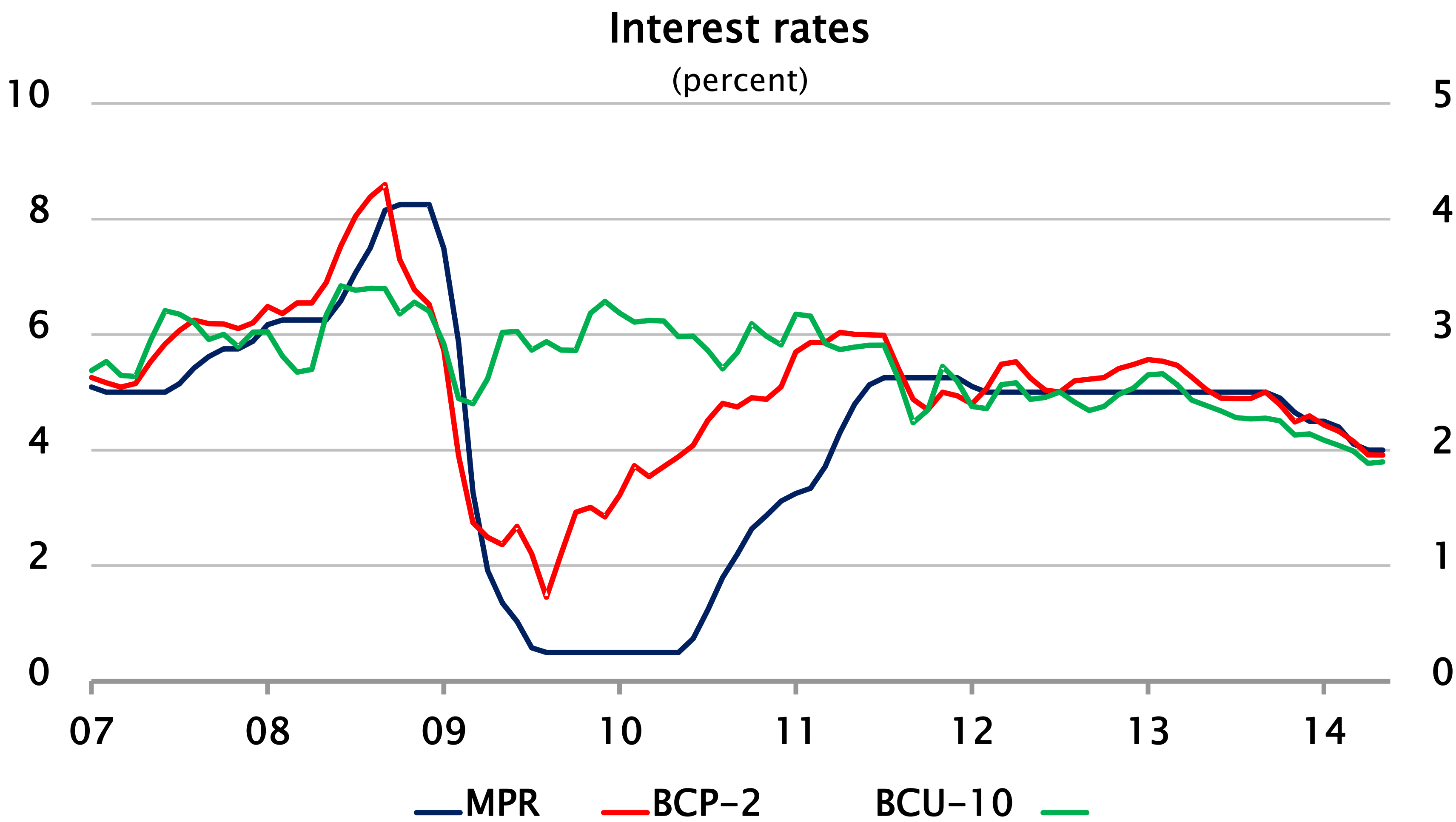
Source: Central Bank of Chile.

Investment-led Domestic demand was the main force behind growth. GDP grew above potential rates (4.5 – 5%) up to mid 2013



Source: Central Bank of Chile.

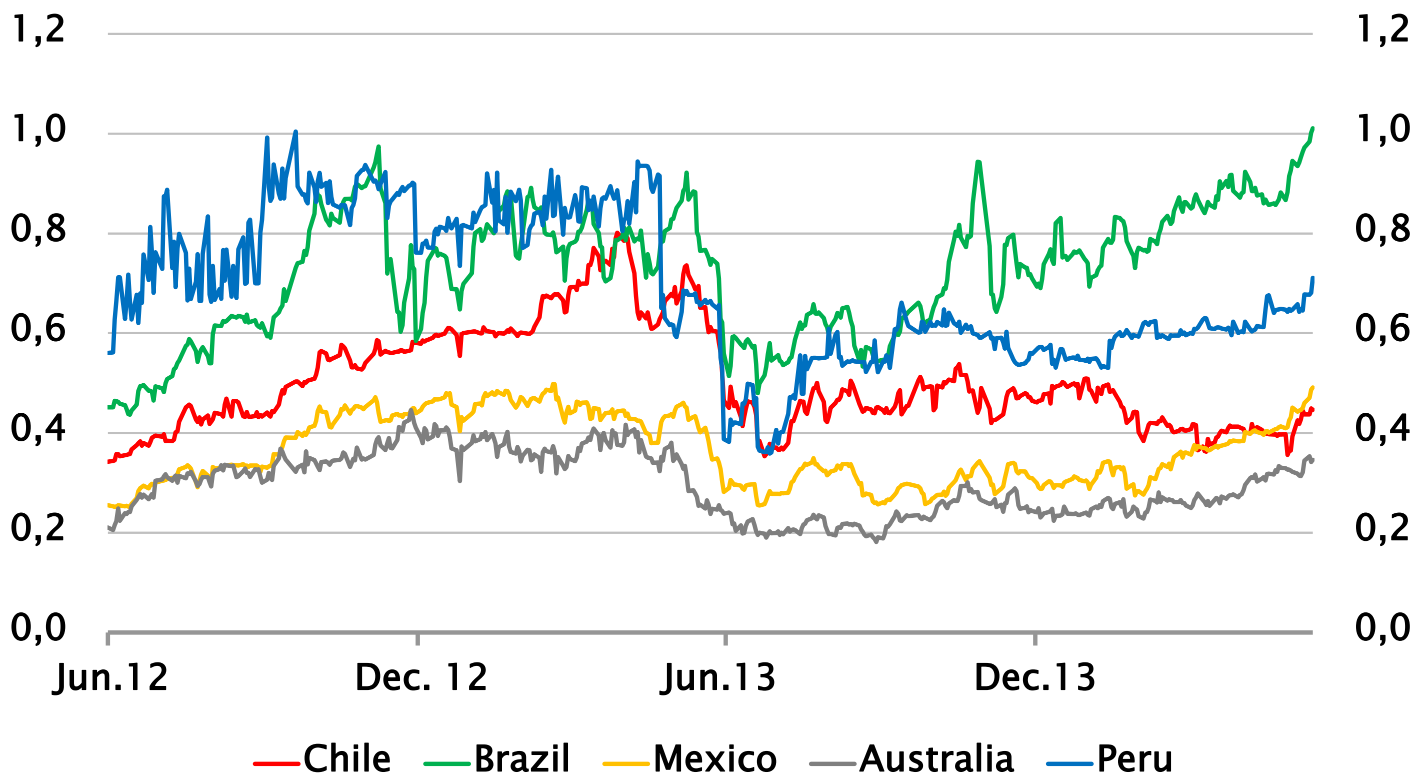
The Central Bank kept interest rates at 5% during the boom, despite large interest rates differentials, and began cutting them only after evidence of a slowdown in domestic demand emerged



Source: Central Bank of Chile.

Free floating and FX volatility has helped reduce incentives for arbitrage in Chile.

Carry to risk ratio for selected countries



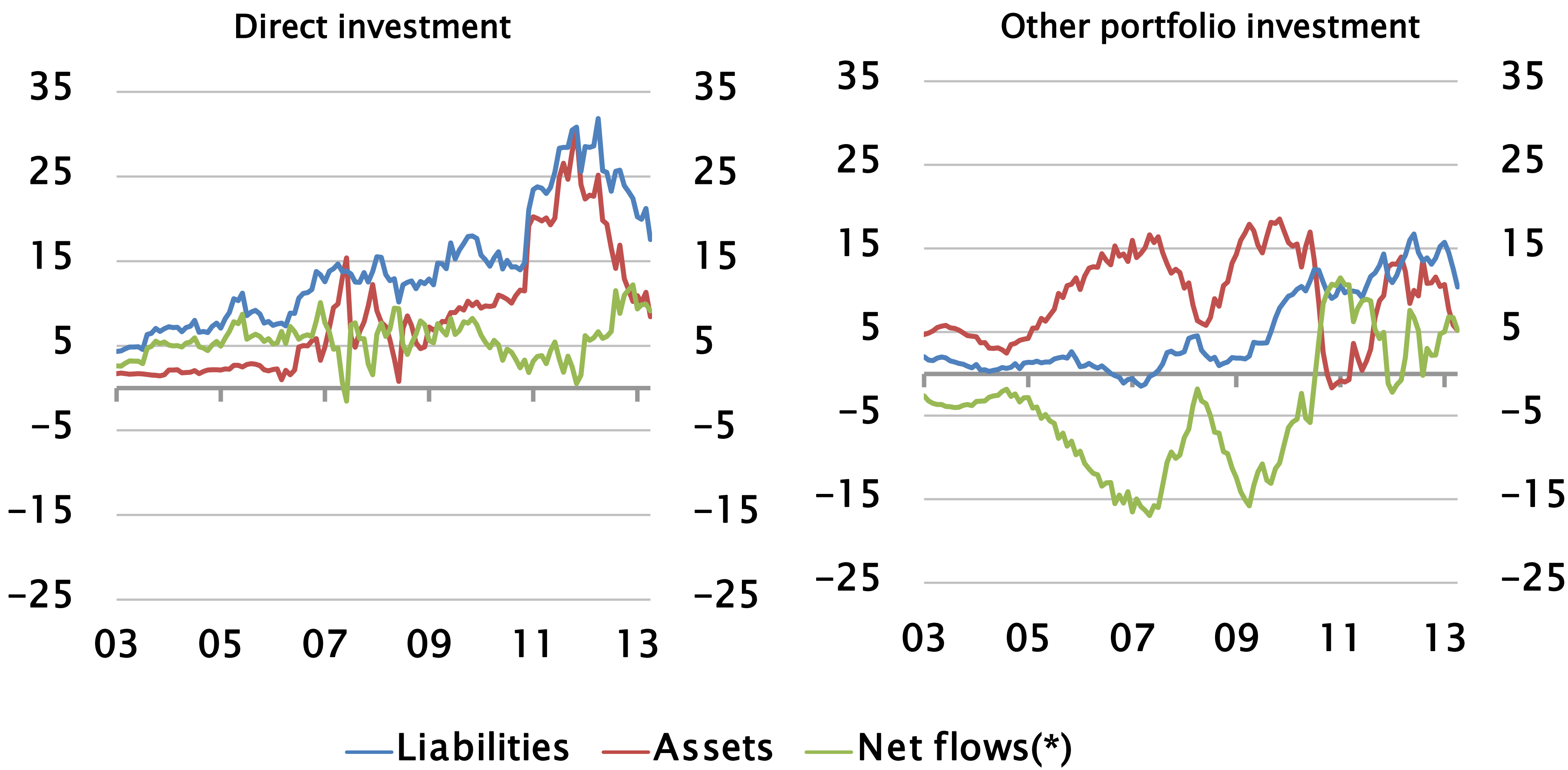
$$Carry\ to\ risk\ ratio = \frac{i_{3\ months}^{active} - i_{3\ months}^{passive}}{options\_implicit\_volatility\_3months\ active/passive}$$

i_{active}: 3 month deposit rate in local currency.
$i_{passive}$: 3 month deposit rate in USD.

Source: Bloomberg.

Financial inflows were partially compensated by outflows of FDI as well as portfolio outflows of Institutional Investors

Financial account flows
(billions US dollars, annual moving average)



(*) Liabilities minus assets.

Source: Central Bank of Chile.

Balance considerations play a role when deciding about FX intervention, but has not been a deterrent when needed

Central Bank Balance Sheet (% GDP)

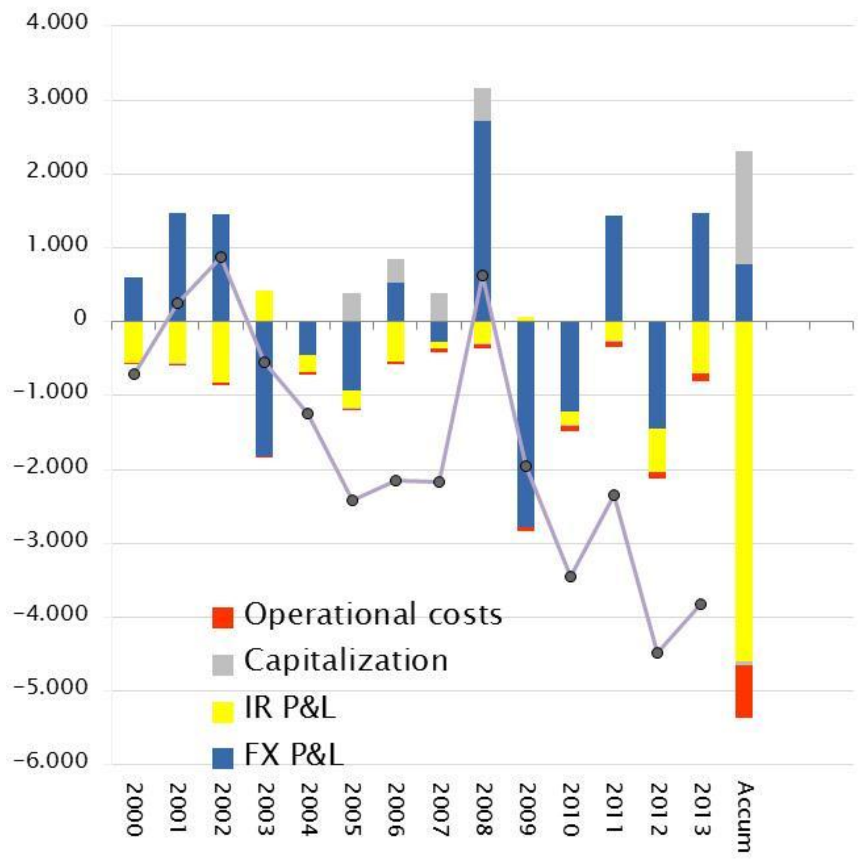
December 2007

Assets		Liabilities	
FX Reserves	9,3%	Money Base	4,1%
Credit to Banks	0,6%	Short Term Debt	0,9%
Govt. Debt	0,8%	Long Term Debt	7,6%
Other Assets	1,2%	Bank deposits	1,4%
		Other liabilities	0,3%
		Equity	-2,4%
Total Assets	11,9%	Total Liabilities	11,9%

December 2013

Assets		Liabilities	
FX Reserves	15,7%	Money Base	6,4%
Credit to Banks	0,1%	Short Term Debt	0,7%
Govt. Debt	0,5%	Long Term Debt	8,8%
Other Assets	0,6%	Bank deposits	3,2%
		Other liabilities	0,5%
		Equity	-2,8%
Total Assets	16,9%	Total Liabilities	16,9%

Annual changes in Central Bank Net Worth (USD million)



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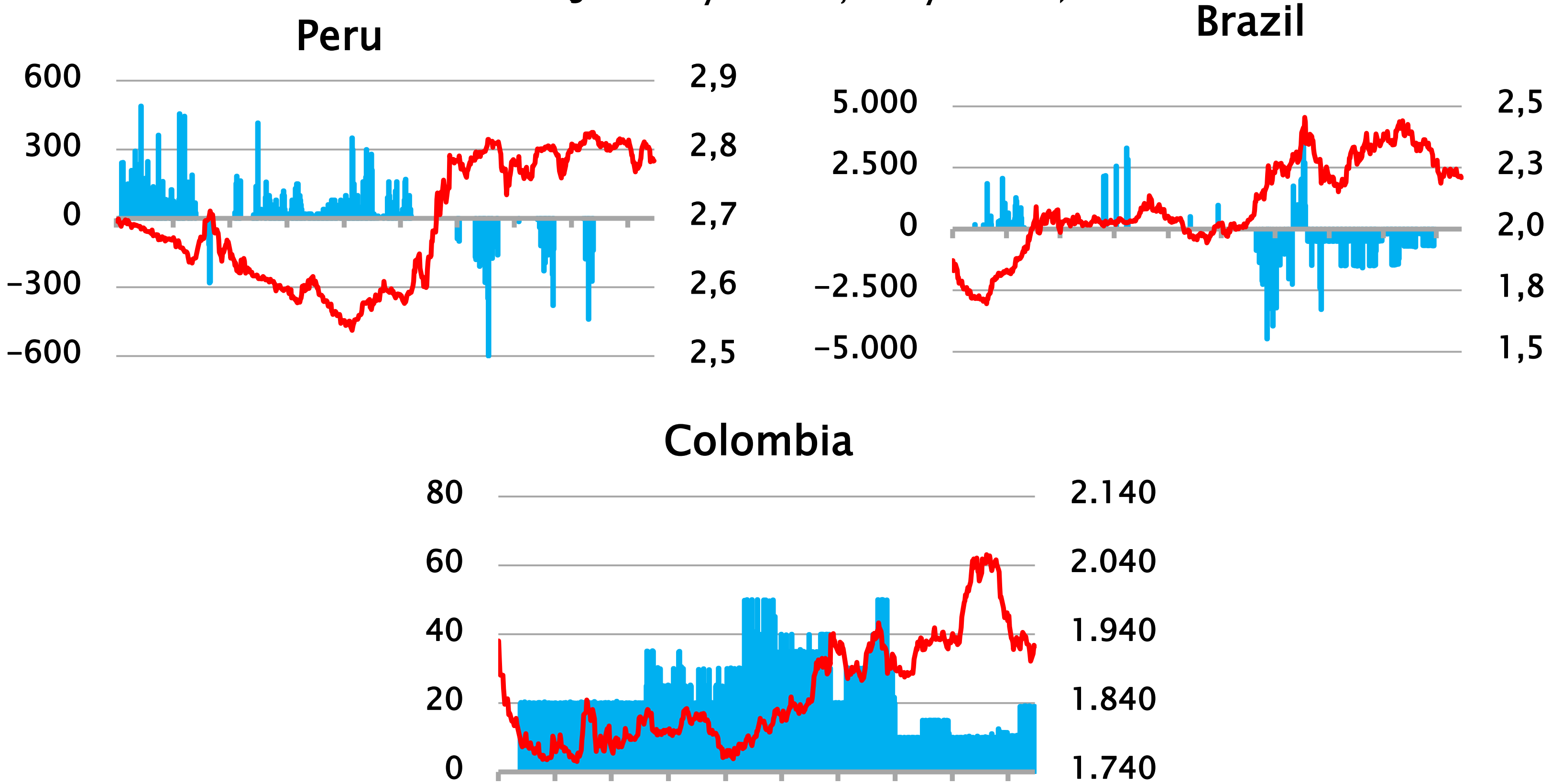
Other countries used FX interventions, first, to counteract appreciation, then depreciation.

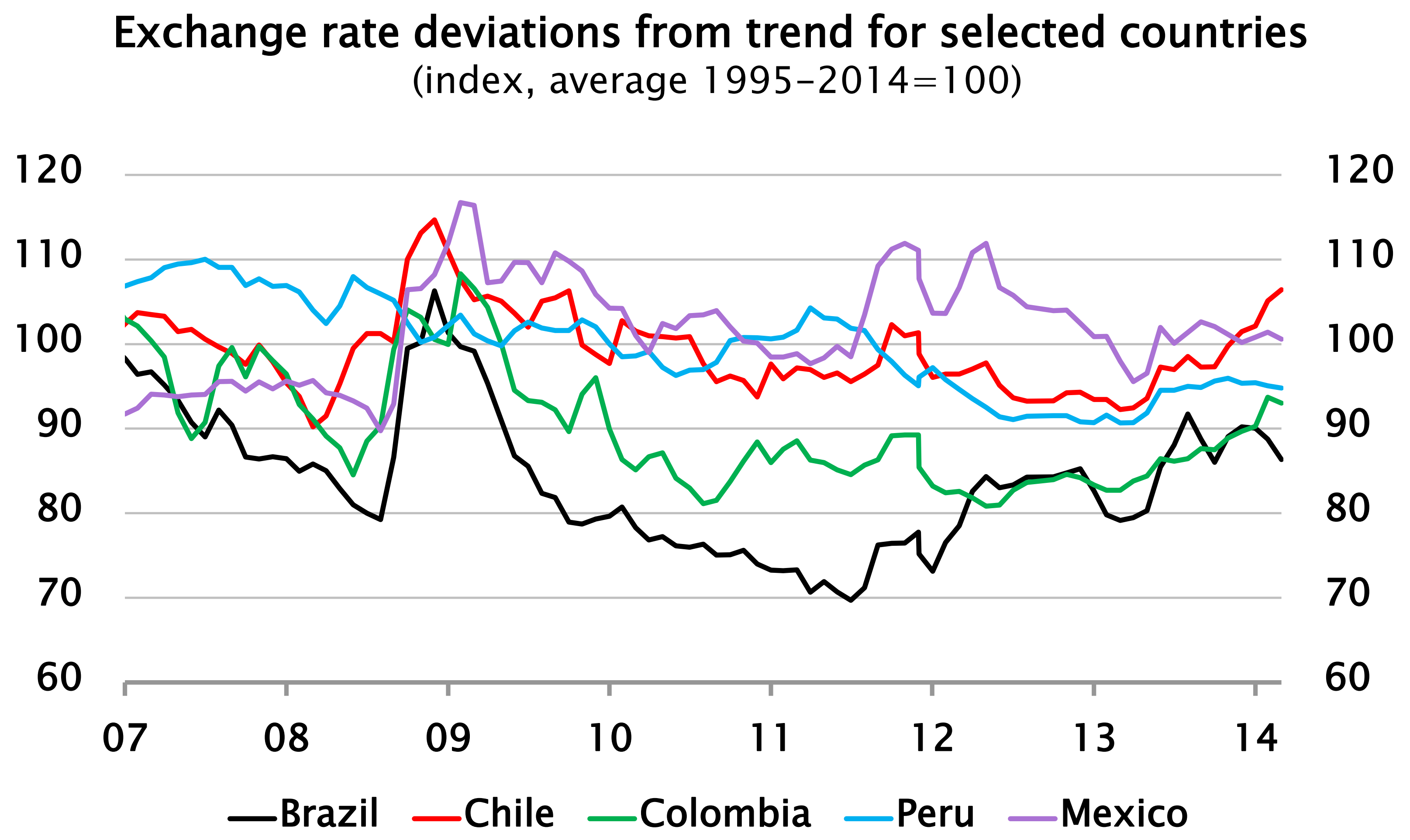
Interventions in FX markets and exchange rates (*)
(January 2012, May 2014)



(*) Left hand axis: size of interventions (millions of USD); Right-hand axis:, exchange rate (local currency/USD)

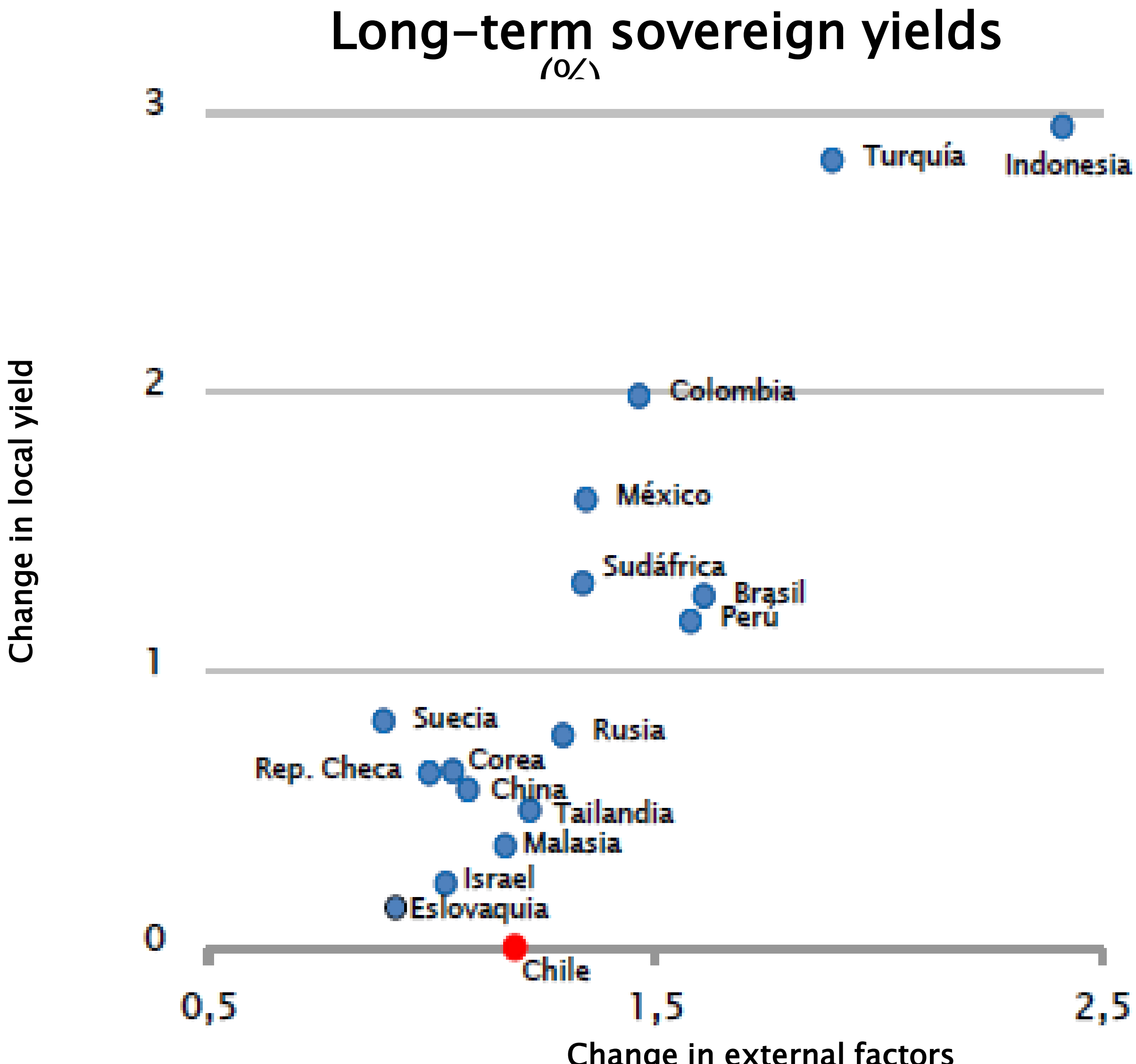
Sources: Central Bank of Chile, Peru, Colombia and Bloomberg.

However, deviations from trend for the Chilean peso have not been larger than those experienced by currencies of countries with more activist policies



Source: BIS.

Tapering had negligible effects on Chilean long term yields, in contrast with most Emerging Countries

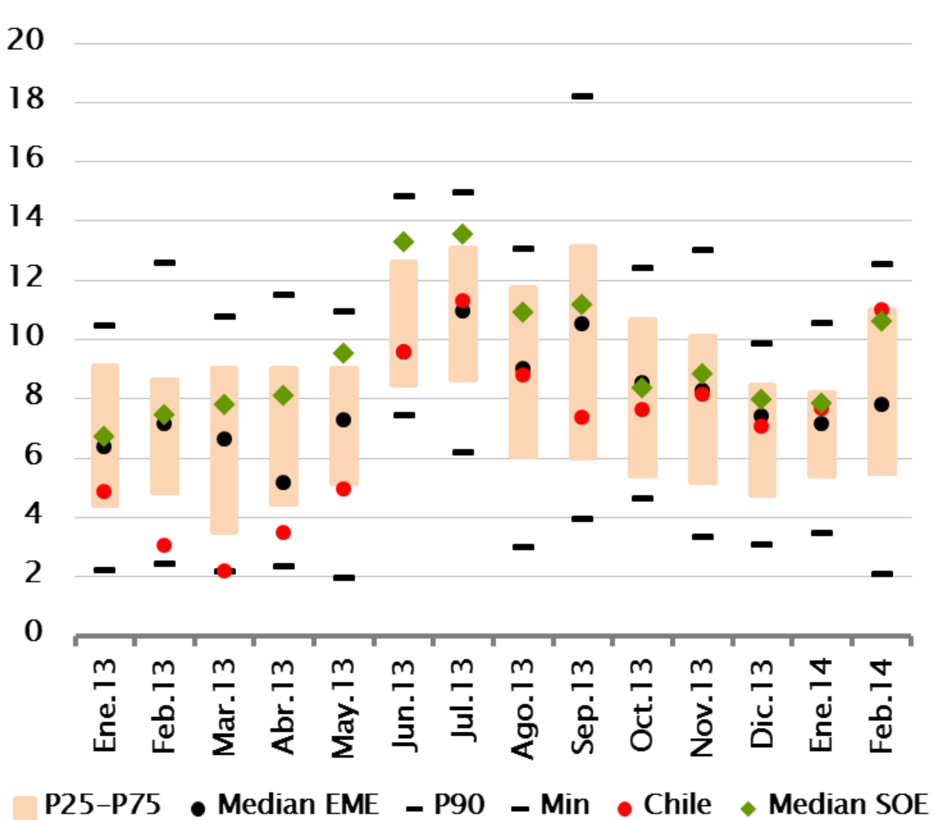


Source: Central Bank of Chile.

Although the impact in the exchange rate and asset prices has been significant …

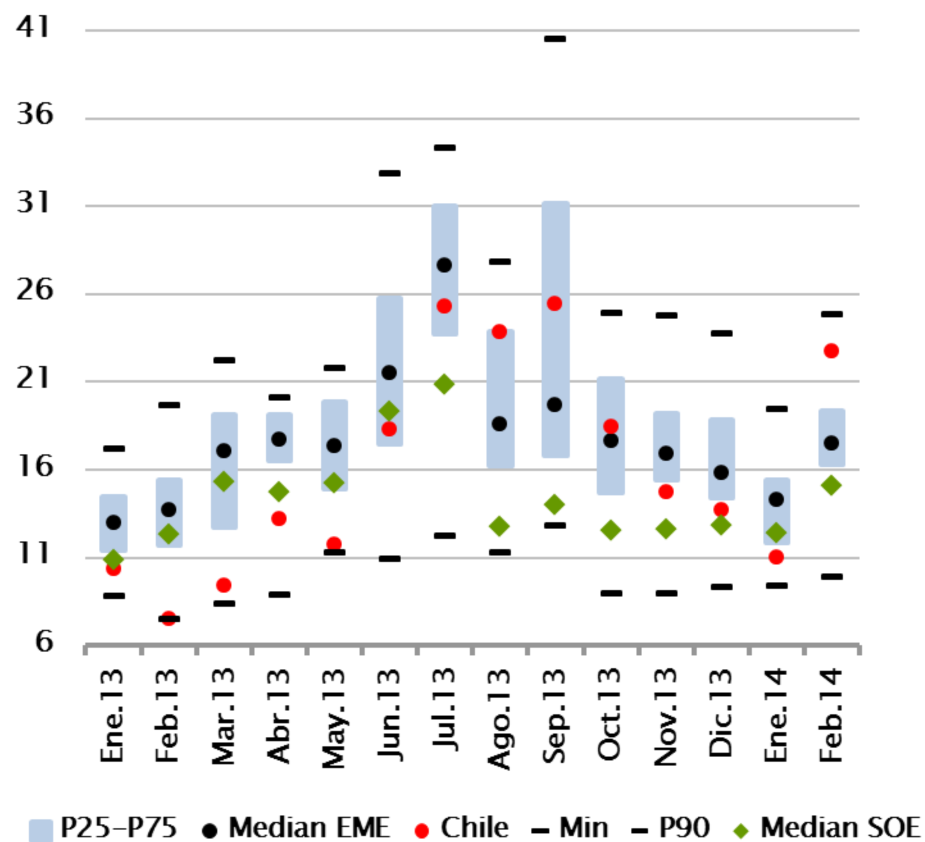
Exchange rate volatility

(percentage, local currency)



Equity volatility

(percentage, USD)



Source: Central Bank of Chile.

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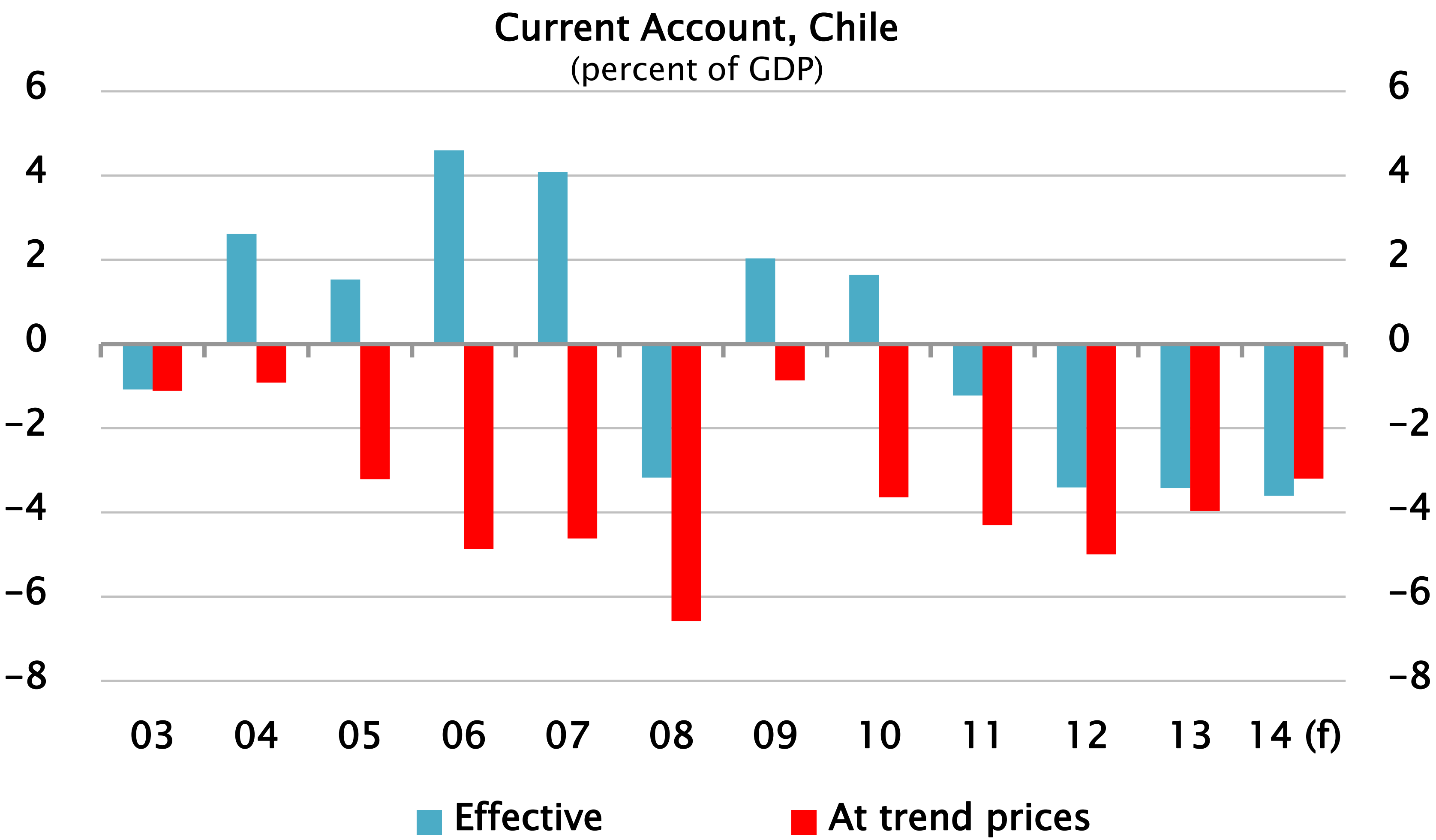
Current policy challenges

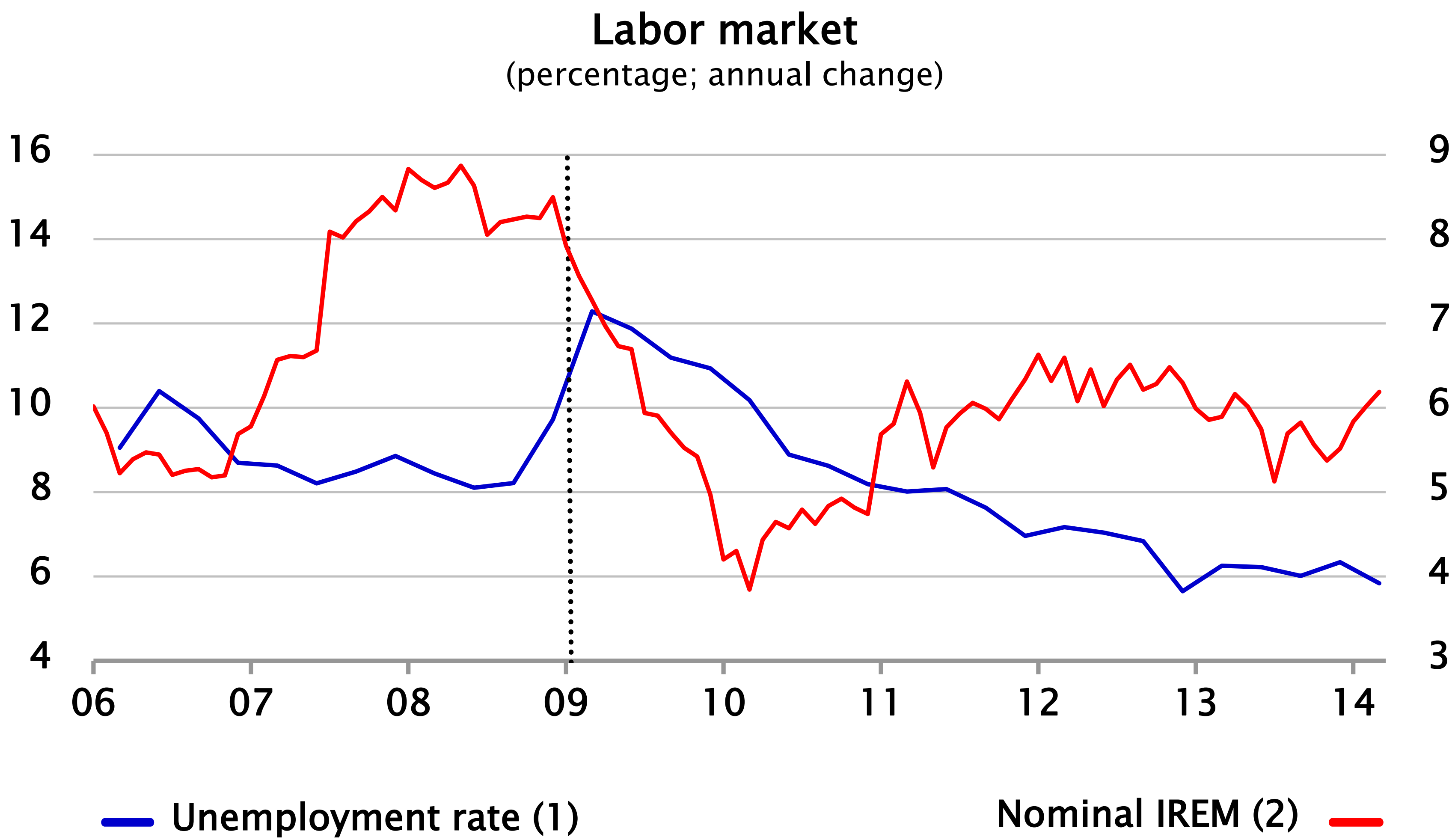
- Managing the slowdown
- Depreciation, inflation and capacity constraints

The current account deficit (at trend prices for copper and oil) is coming back to prudent levels



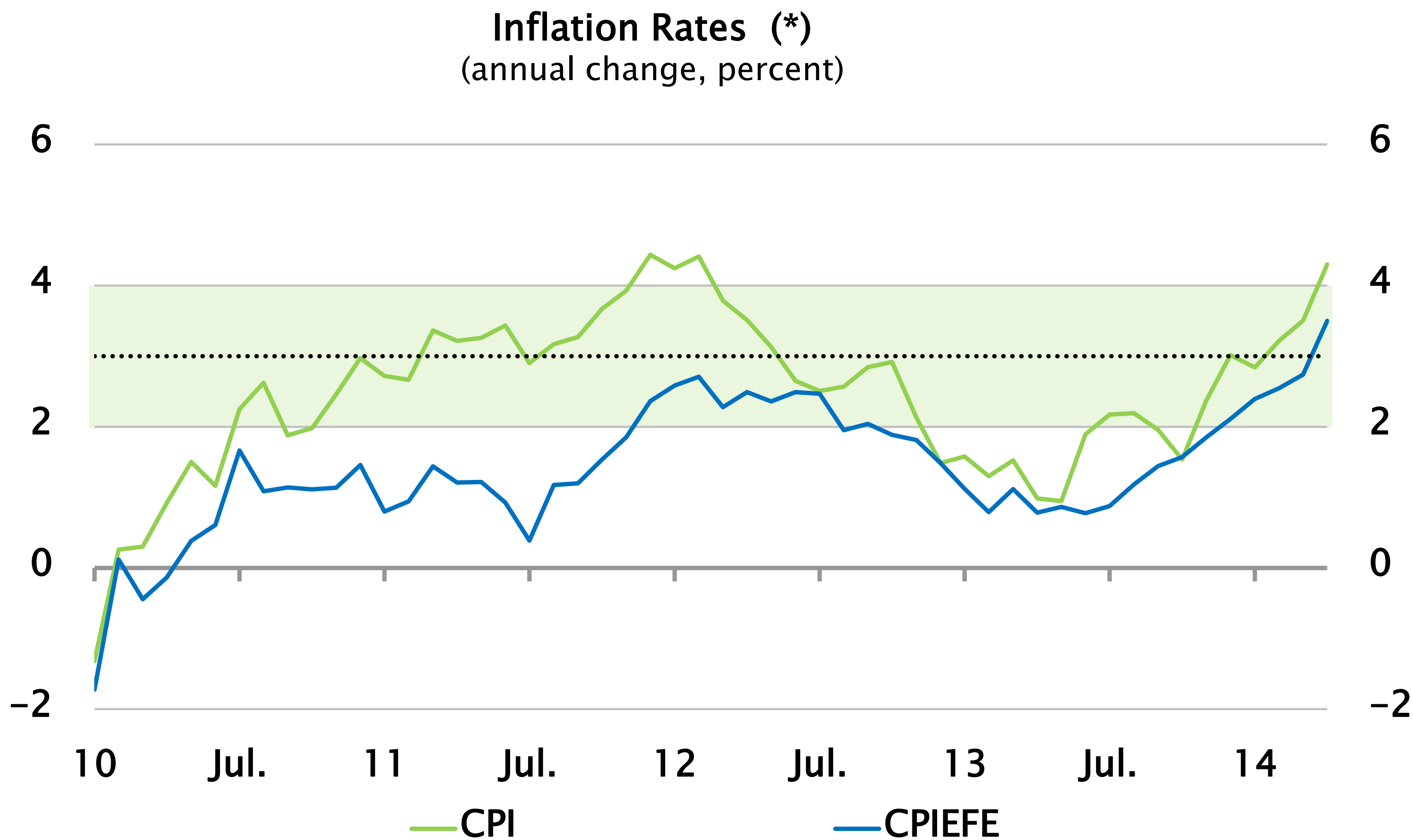
(f) Forecast Monetary Policy Report March 2014.
Source: Central Bank of Chile.

However the labor market remains strong. Unemployment rates are at very low levels and nominal wages are growing above 6%



(1) Considers Universidad de Chile Survey. Seasonally-adjusted series. (2) As from January 2010 (dotted vertical line) the new indexes with annual base 2009=100 are used, so they are not strictly comparable with earlier figures. Sources: Central Bank of Chile , National Bureau of Statistics and University of Chile.

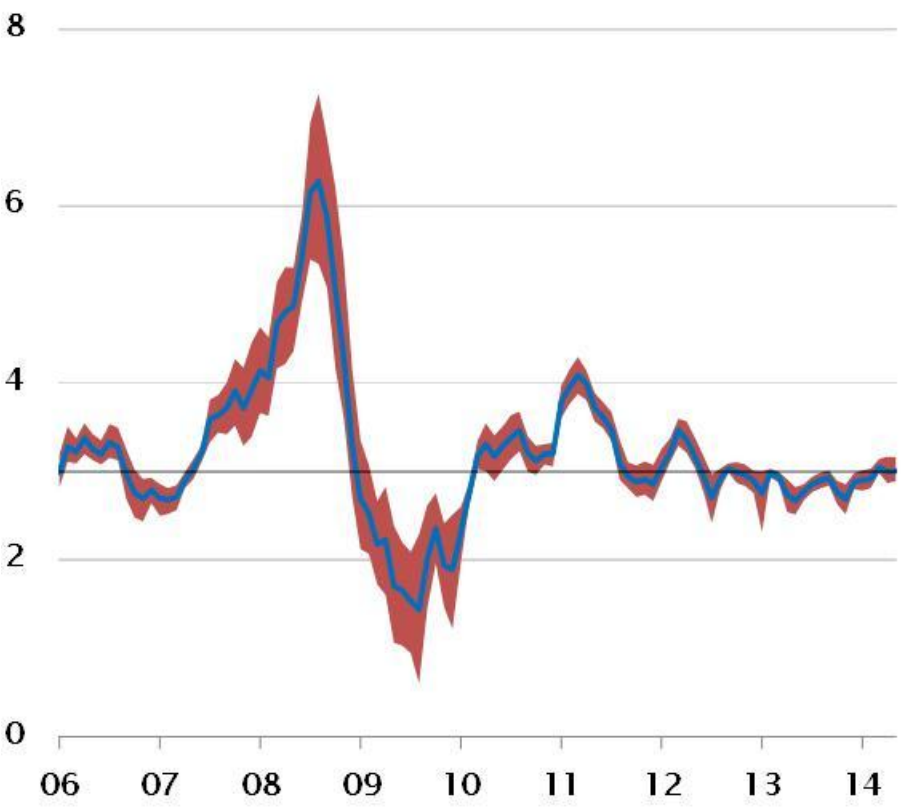
Inflation remained below the target zone for a long time, and began to pick up after The CB began to signal cuts in interest rates.



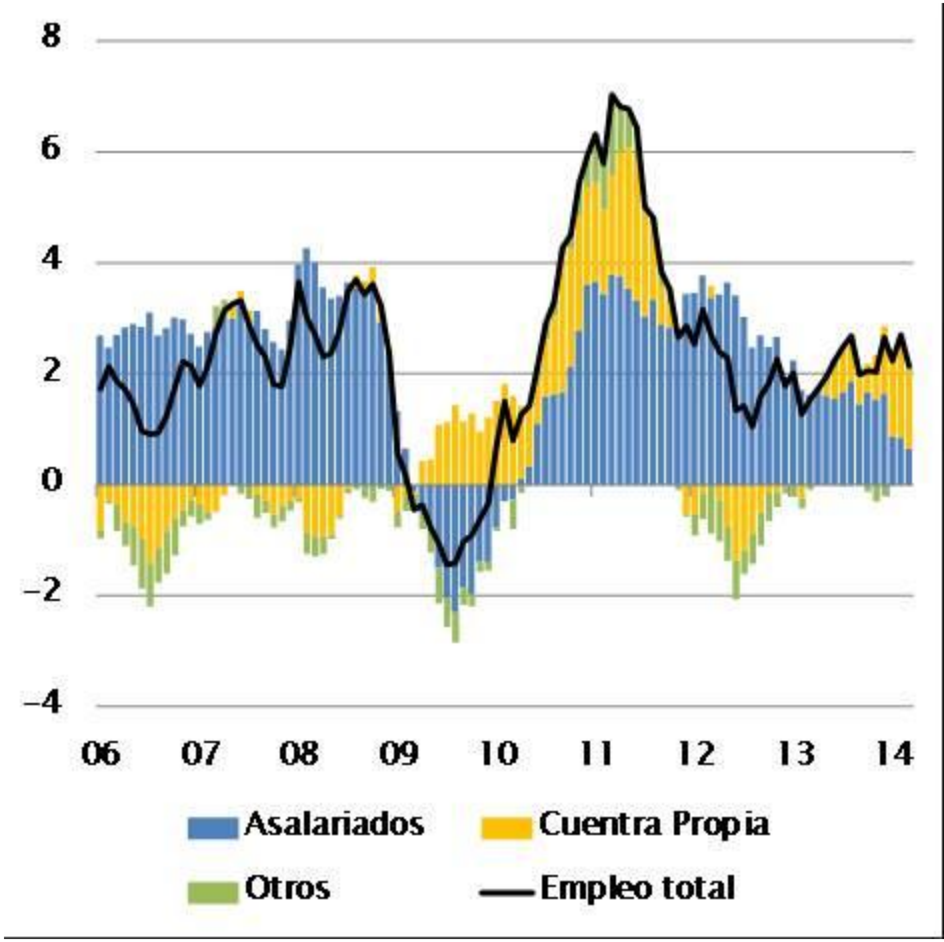
(*) Starting in January 2014, calculations are based on the new indices with base year 2013=100, so they may not be strictly comparable with earlier figures. Source: Central Bank of Chile and National Statistics Institute (INE).

Inflation expectations remain well anchored, in spite of recent surprises, while labor market conditions points to a gradual softening

Synthetic indicator of 2 years ahead Inflation Expectations
(annual change, percent)



Composition of Employment growth
(annual change, percent)



Final remarks

- Concerns about real exchange rates appreciation was an important one. Chile choose not to intervene in FX market, with good results.
- Openness and depth of financial markets and FDI helped by creating counter flows. Domestic markets were cushioned from volatility by the depth of the domestic currency financial market.
- Indexation has been critical for the development of deep long term financial markets denominated in local currency.
- Despite indexation, domestic prices seem quite flexible and responsive to the cycle.
- Nil impact of tapering seems to suggest that the market for long term government debt is supply-constrained. But we need responsible fiscal policies.

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