

The Case for Exchange Rate Flexibility: The Chilean Experience

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Outline

- I. The Chilean Experience
- II. Exchange Rate under Inflation Targeting
- III. Final Remarks

I. The Chilean Experience

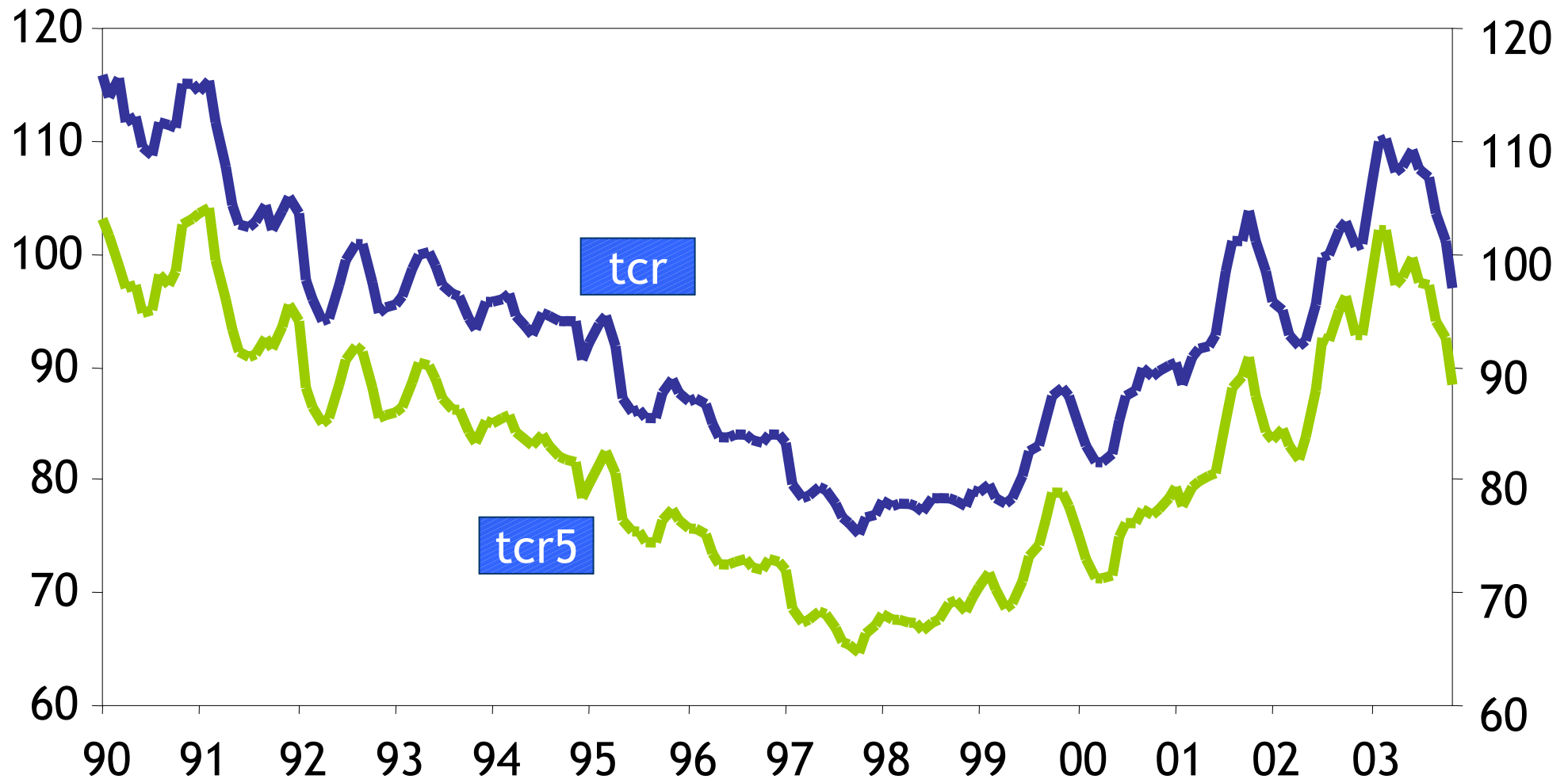
- Chile has always had some form of exchange rate management: crawling pegs, crawling bands, fixed-exchange rate, etc.
- Currency (liquidity) crisis associated to rigidities in the exchange rate regime: early 60s, early 80s and late 90s.
- Long term concern for competitiveness and potential misalignments, well grounded on bad past experiments.

I. The Chilean Experience

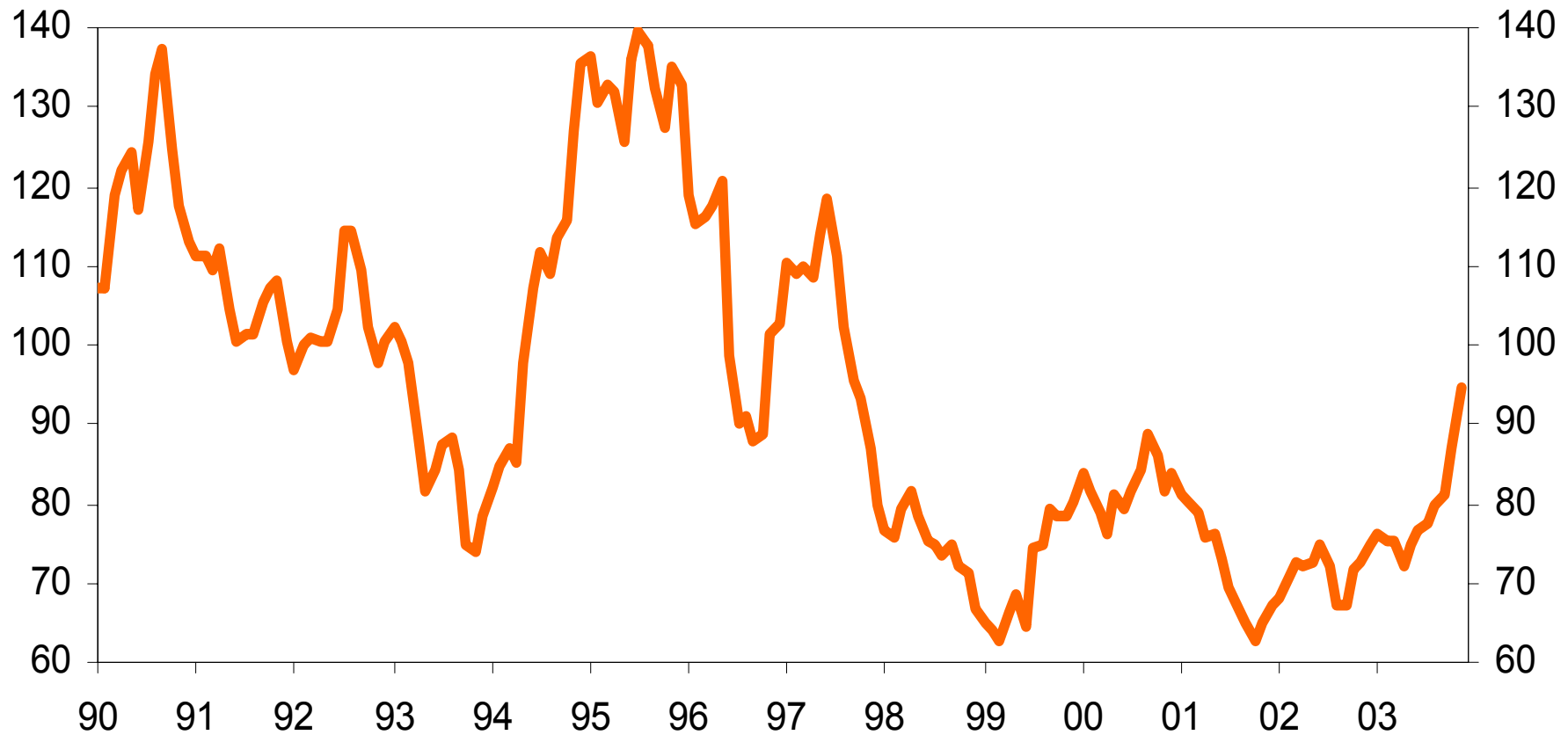
But:

- The real exchange rate has fluctuated according to international environment and domestic policies has not been able to change this trend.
- During the 90s the most appreciated real exchange rate occurred in the presence of a managed exchange rate and capital controls.

II. Real Exchange Rate in Chile



II. Copper Price (US\$c per lb LME)



I. The Chilean Experience

Some lessons from the Chilean experience:

- Credit and current account cycles are more pronounced under rigid exchange rate system. Incentives for speculation and arbitrage under a system of “managed--but with significant changes from time-to-time--exchange rate”. This serves support extremes: Fully-fixed or fully-flexible.
- Defense of competitiveness and commitment to stable exchange rate may also prevent significant depreciations, leading to fear of floating because of exchange rate mismatches.

II. Exchange Rate under Inflation Targeting

- Exchange rate flexibility to conduct independent monetary policy, and inflation is the primary objective.
- It is the inflation target not the exchange rate the anchor.
- Exchange rate adjusts to external and domestic conditions. The exchange rate could be more volatile, but the economy as a whole much less.
- Allowing early adjustment of the exchange rate is better than going into a costly defense.

II. Exchange Rate under Inflation Targeting

Is there scope for intervention in the foreign exchange market?

- Extremely limited to avoid “intervention addiction” and the drift to a managed exchange rate.
- Very limited period and size of the intervention.
- Transparent: time frame and magnitudes announced at the beginning, as well as the reasons for intervention. This helps to prevent interventionism lobby, in either direction.
- In my view is a first line of defense in case of extreme turbulences that could lead to inflation and monetary tightening.

II. Exchange Rate under Inflation Targeting

They help to eliminate fear of floating and allow to have a consistent macroeconomic framework of flexible exchange rate and inflation target.

- Independent Central Bank with control over monetary and exchange rate policies.
- Fiscal conservatism, which in addition loses power as a stabilization tool under floating rates.
- Sound financial system.
- Are they pre-requisites? To a large extent yes.

III. Final Remarks

- The depreciation of the dollar and the adjustment in the US current account will induce capital inflows to emerging markets (already good signals in spreads). Macroeconomic policies must be ready for the return of capital inflows.
- The current dilemma in Asia may be useful: How much can a currency be kept depreciated? Inflationary pressures, asset prices boom, etc.
- As capitals inflows resume, the chances for future sudden stops also increases, regardless the exchange rate regime. However, while a fixed or managed exchange rate allows only for five meters to stop, with flexible exchange rates you can go for five hundred.

III. Spreads (basis points)

