



Some Policy Lessons for Emerging Economies

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Financial integration

- **Financial integration is a mixed blessing for emerging economies. It has great benefits:**
 - Reduces cost of capital for domestic firms.
 - Increases opportunities for risk diversification and sharing.
 - Enhances competition in financial services.
 - Increases market discipline.

Financial integration

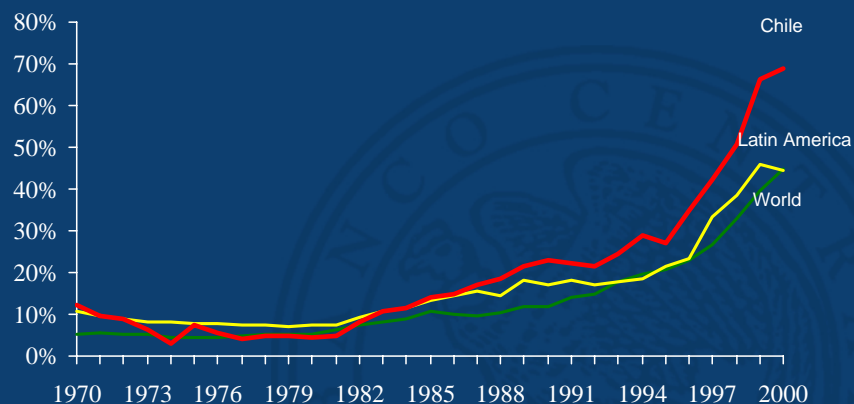
- However, it may also:
 - Amplify the costs of distortions and imperfections of domestic financial markets.
 - Exploit inconsistencies in macroeconomic policies.
 - Create an additional source of volatility:
 - ✓ irrational exuberance, bubbles and crashes in international capital markets.
 - ✓ contagion effects and sudden stop dynamics.

Coping with volatility

- Insulating the domestic financial system is no longer a viable alternative:
 - Openness.
 - Technology's impact on financial transaction costs.
- How can the potential costs of volatility be minimized?
 - Fiscal prudence.
 - Price stability and CB credibility.
 - Flexible exchange rate policy.
 - Sound financial system.

Financial Integration

(1970-2000, Stock of foreign liabilities over GDP)



Source: Calderón, Loayza and Schmidt-Hebbel (2005).

Coping with volatility

- Fiscal prudence:
 - Surplus rule to anchor long term credibility of fiscal policy.
 - Diminish procyclicality of fiscal policy.
 - Moderate level of public debt and public deficit in normal times.
 - Build up reserves for bad times and smooth cyclical adjustments.

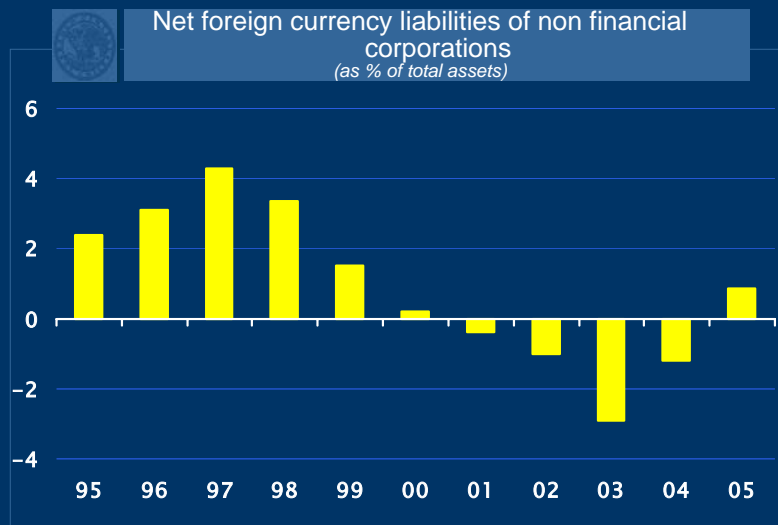
Coping with volatility

- Price stability and Central Bank credibility:
 - Build up nominal credibility.
 - Reduce currency and maturity mismatches in public finances and the financial system.
 - Allow room to implement stabilizing monetary policy in bad times and ease liquidity pressures under financial stress.

Coping with volatile conditions

- Flexible exchange rate policy. In Chile it has served to:
 - Help adjust to changing fundamentals.
 - Provide incentives for the development of the domestic market for bond and currency hedging.
 - Allow for early adjustments to international volatility (minimize abrupt ER corrections).
 - Provide room for more independent monetary policy: greater flexibility for interest rate policy.
 - Permit the use of international reserves to ease adjustment in extreme scenarios.

Corporate exposure to currency risk



Source: Banco Central de Chile.

Coping with volatility

- Sound financial system:
 - Well capitalized.
 - Effectively regulated and supervised, focused on risk management.
 - Market discipline.
 - Open to foreign participants.
 - Depth due in part to mature private pension system.

Coping with volatility

- There is room for further improvements in:
 - Corporate governance.
 - Financial infrastructure.
 - Integration to international financial markets.



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