



Fear of Floating and Exchange Rate: The Chilean Experience

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Agenda

1. ER policies: the road to flexible ER regime
 - 1998: Fear of Floating
2. Low and decreasing reasons to *Fear Floating*
 - Price instability: passthrough
 - Financial Instability: corporate sector exposure, liability dollarization, derivatives market development
3. The ER and the framework at work: Policy response to ER shocks
4. Concluding remarks



1. ER policies: The road to a flexible ER regime in Chile

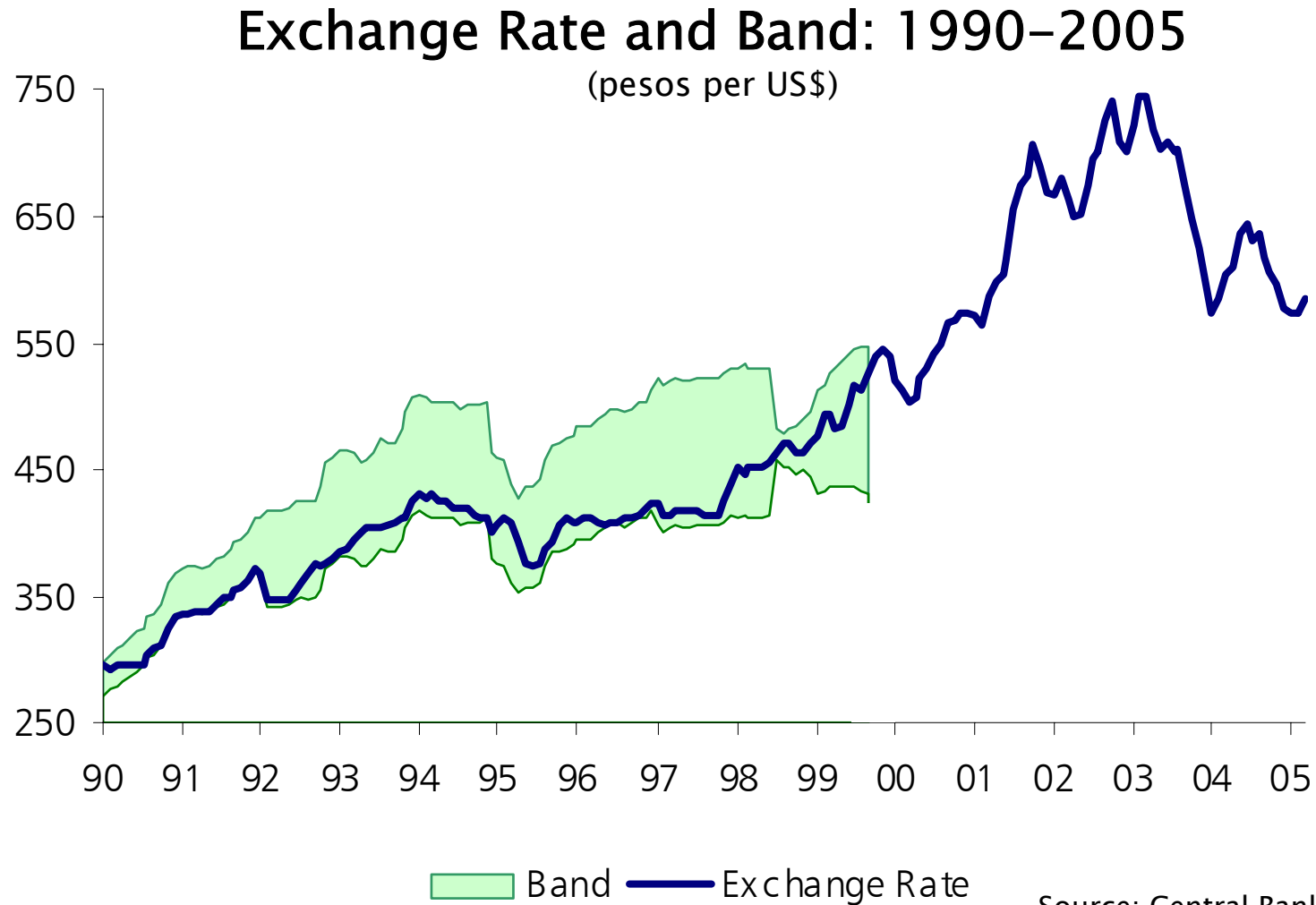


Road to a flexible ER regime

- Problems with ER inflexibility. Crises in 1962 and 1982 with fixed ER. Recession after Asian crisis and ER band
- ER band suffered multiple adjustments affecting its credibility; ER usually near low limit in the 90s
- Capital controls during the 90s
 - Useful? Not central; ER regime more problematic
 - Dismantled after the crisis



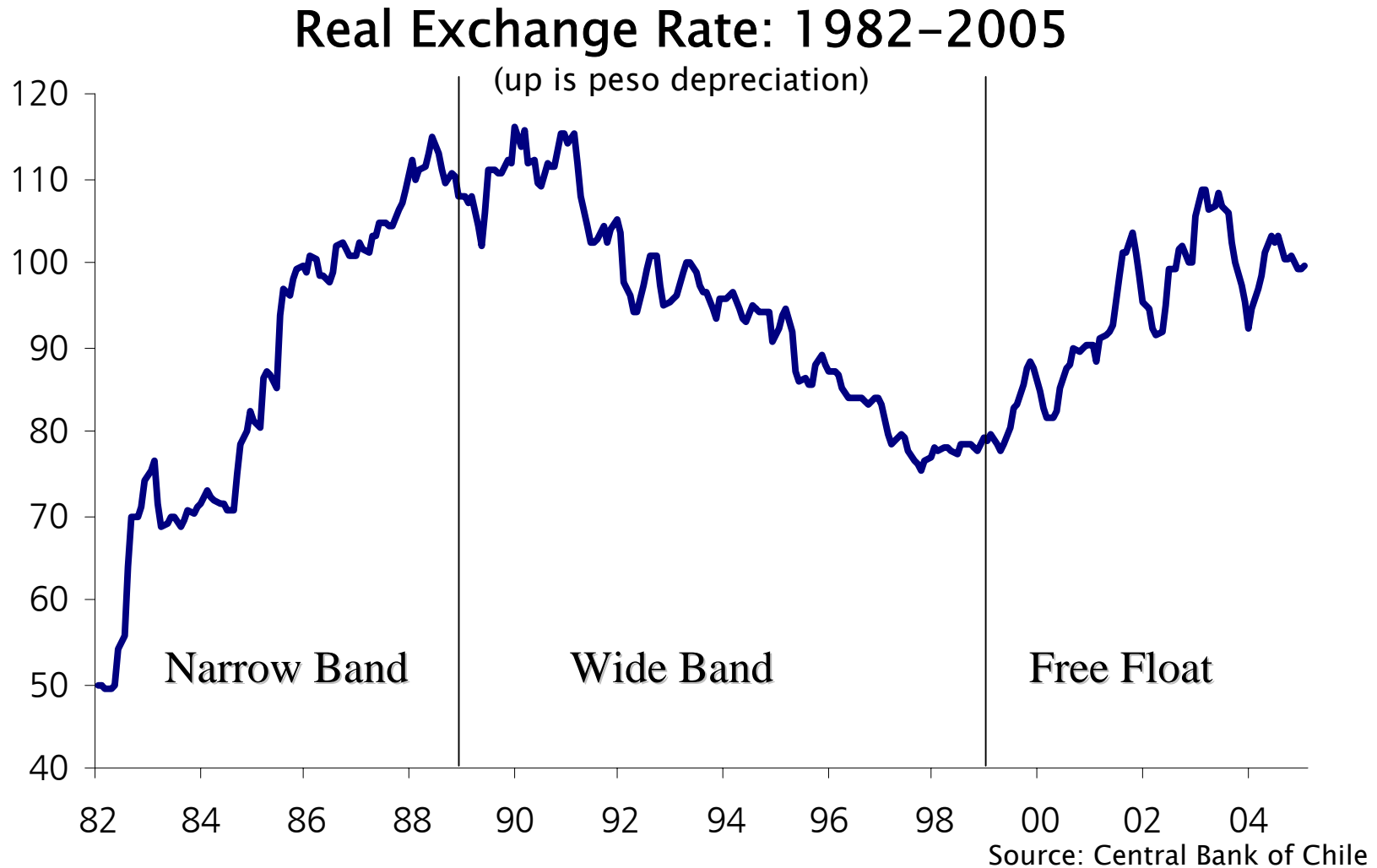
The Road to Flex



Source: Central Bank of Chile



The Road to Flex





2. Fear of floating



Fear of Floating

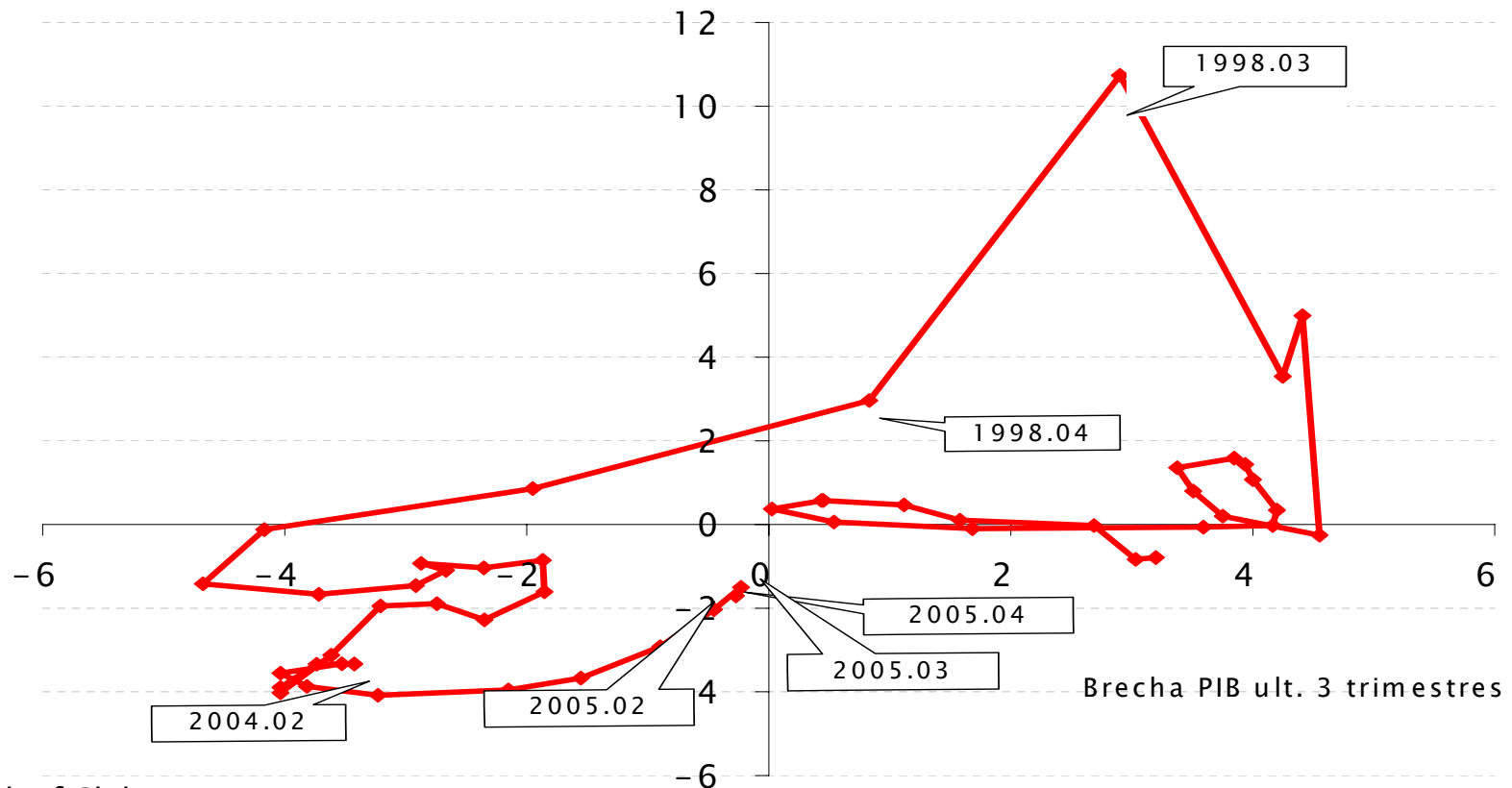
- Fear of floating in 1998. Belief of unrealistically high
 - Passthrough into domestic prices
 - Vulnerable corporate sector
- Response to the trend change in ER: narrowing of the band ($\pm 12.5\%$ to $+2\%$ and -3.5%) + restrictive MP.
- Russian crisis
- 1998-1999: gradual process to flotation
 - gradual widening of band,
 - elimination of KC and
 - restrictive MP.



Fear of Floating

Countercyclical MP under IT

Real Interest Rate – Neutral Interest Rate



Source: Central Bank of Chile



Fear of Floating

Costs were low and decreasing

- Volatility did increase
 - but not excessively, and not exclusively due to flexibilization of the ER regime.
- Passthrough, liability dollarization, and ER exposure were and are **LOW**
- Financial sector is well developed and provides hedging opportunities
- ***Costs are decreasing endogenously***



Fear of Floating

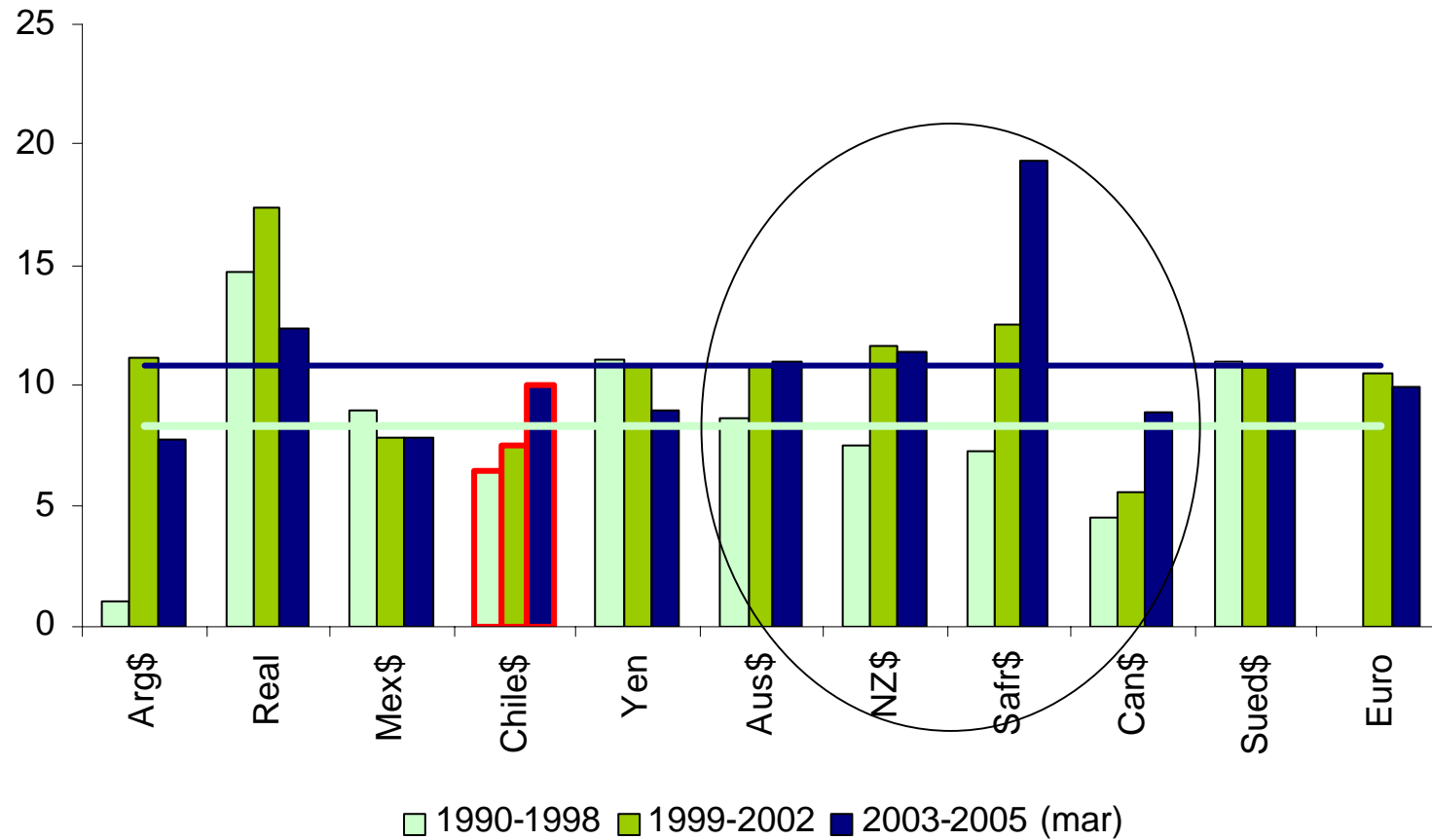
Benefits Outweigh Cost of Floating

- Small open economy, better adjustment to real shocks
 - RER adjustment to negative shocks in 2001 and 2002
- IT Powerful anchor for medium term expected inflation
- Allows countercyclical MP



Volatility

Exchange Rate Volatility: 1990-2005



Source: Riskmetrics

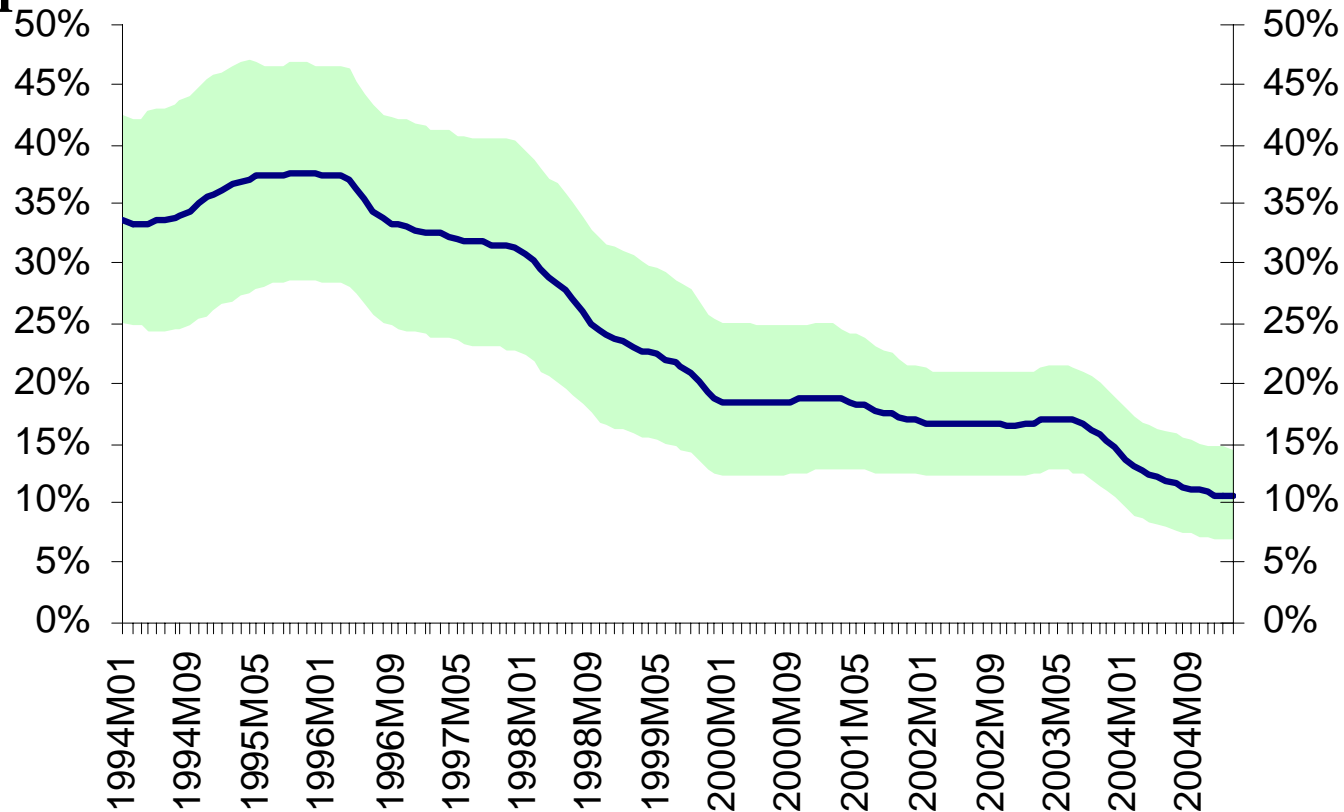


Passthrough: Low and Decreasing

One-year Passthrough Coefficient

15-25% in 1 year

1998 belief: 50%
and 70% in
overheated
economy 1997.

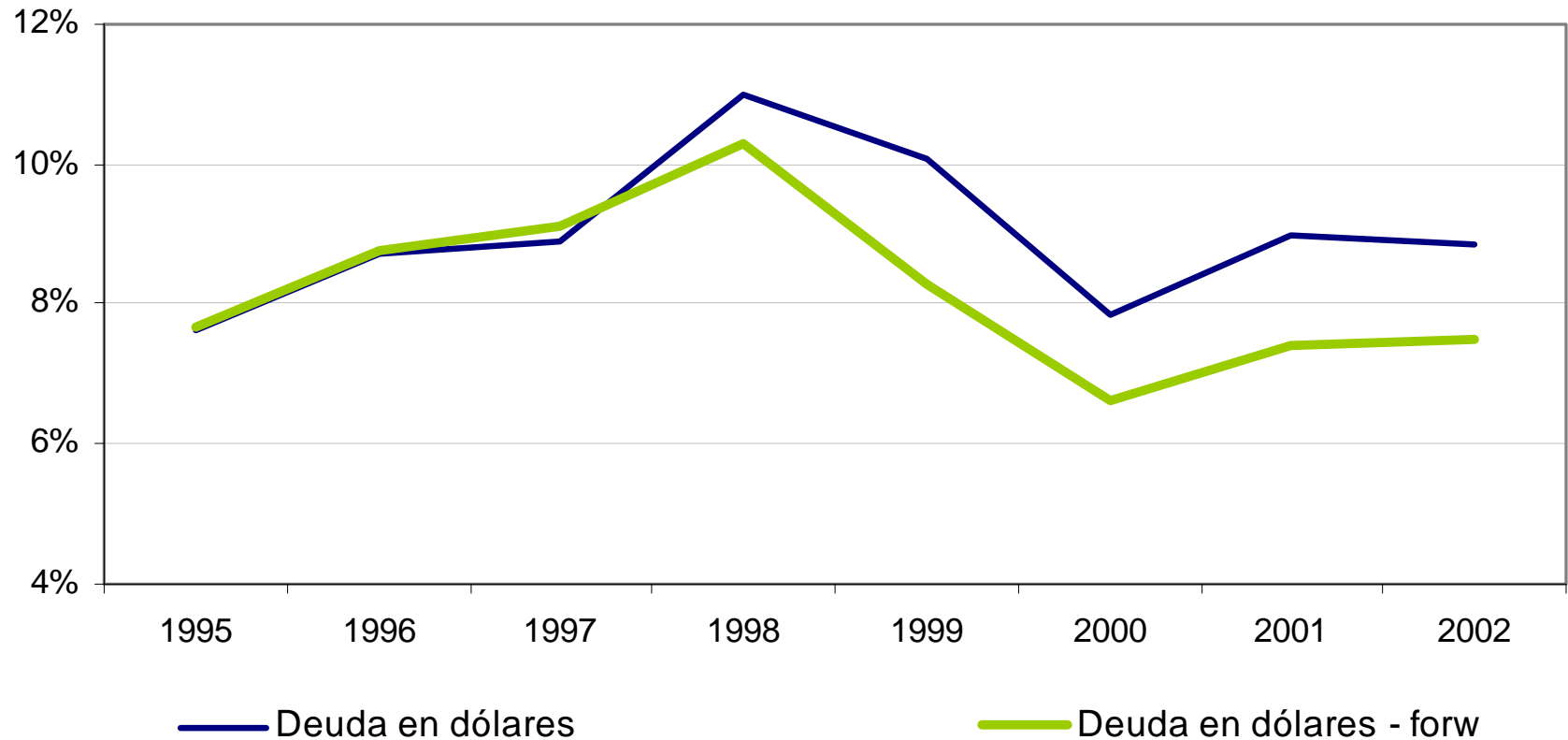


Source: Author's calculations



Financial Instability: Low FX Exposure

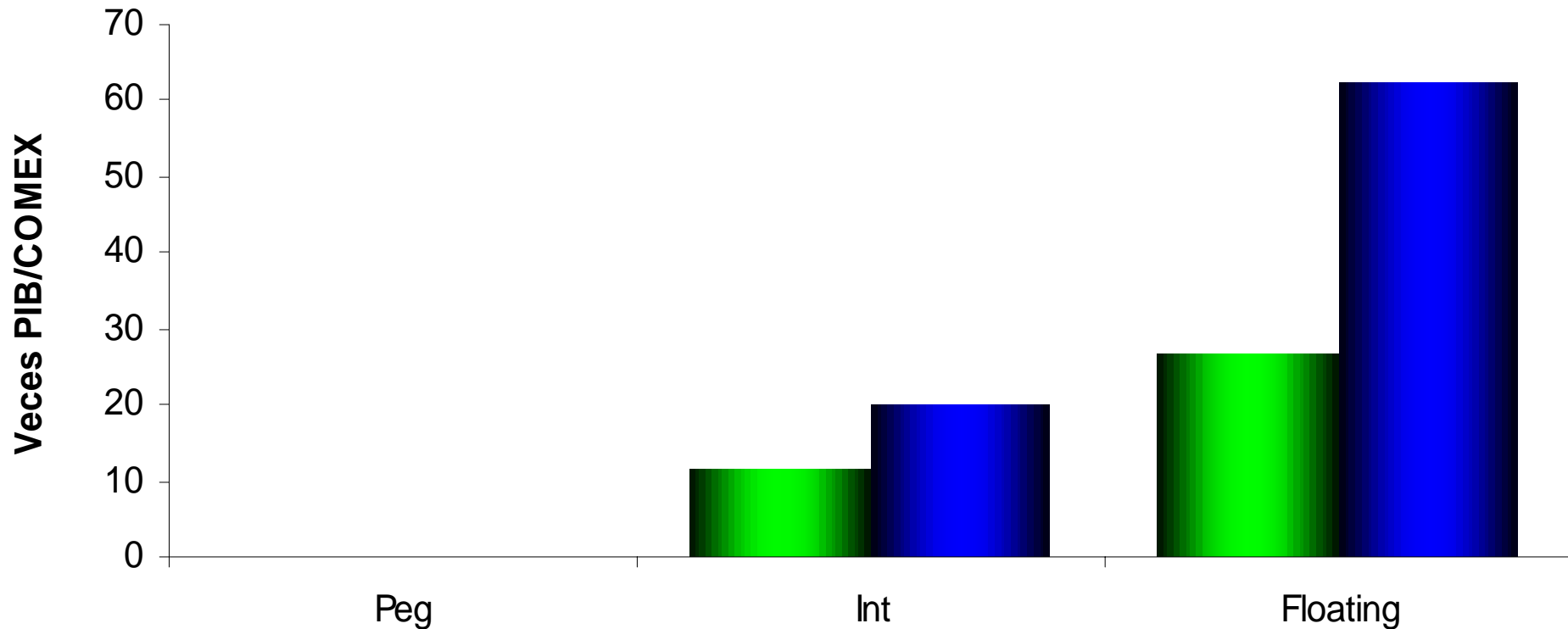
Dollar Debt Adjusted for FW Position
(% of total assets)





Financial Instability: *Endogenous* Deepness of Derivatives Market

ER Regime and Deepness of Derivatives Market 1998



Source: Central Bank of Chile



3. The ER and the Framework at Work: Policy Response



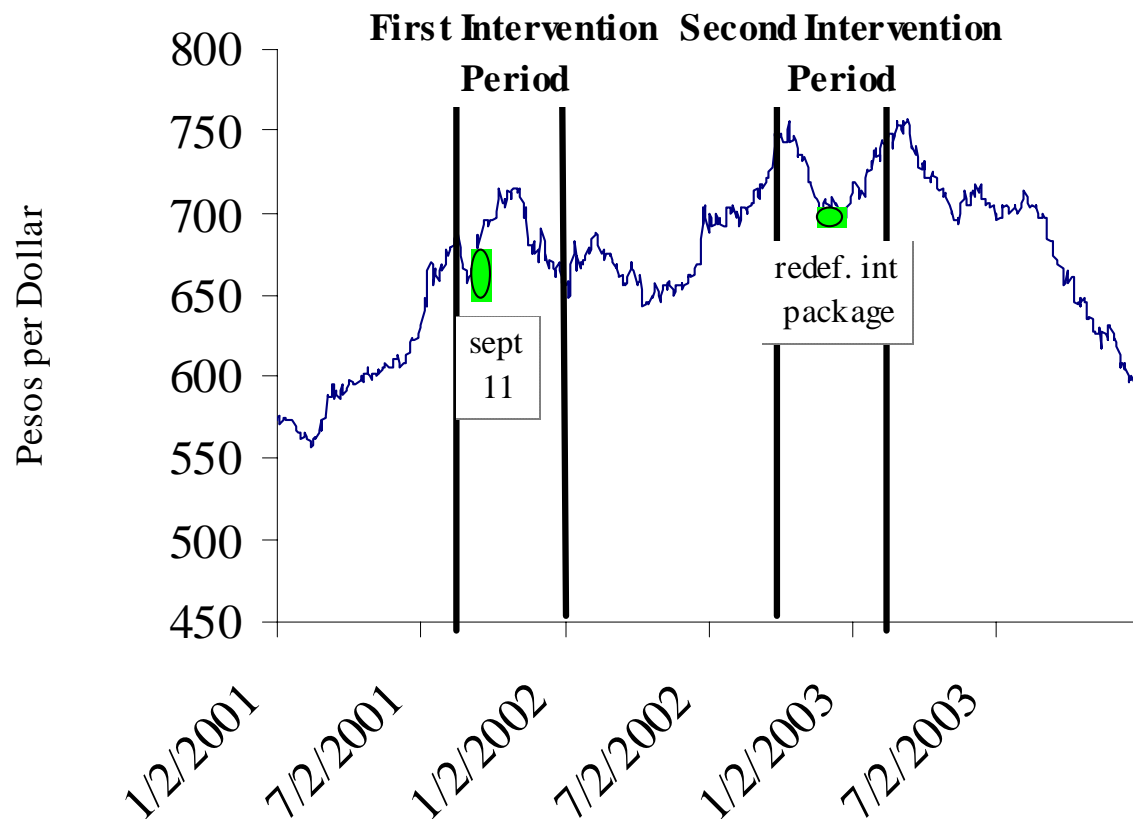
ER and the Framework at Work

- Since sept. 1999 floating ER regime, but CB reserves the right to intervene in exceptional circumstances
 - Overreaction with negative consequences
 - Transparency
- Two intervention episodes (2001 and 2002)
- Why?
 - *Probable* overreaction with inflation (and MP) consequences
 - Informed call by CB board
- Fixed period (4 months), maximum amounts (US\$ 4 bn)



ER and the Framework at Work

Exchange Rate Interventions



Source: Central Bank of Chile



4. Concluding Remarks



Concluding Remarks

- The ER regime + IT framework has worked well...
 - Inflation under control and countercyclical MP
 - RER has adjusted substantially and there is more stability (with other developments, e.g. fiscal policy)
- Volatility has increased (as elsewhere?)
 - There is more hedging in deeper markets
 - Extreme valuations seem less likely
- The country has favorable conditions to face ER shocks: low fear of floating.
- The flex ER regime reinforces the IT regime, provides credibility in the framework and reinforces the commitment to make interventions a very rare event.



References

- De Gregorio, J. and A. Tokman (2005), “El Miedo a Flotar y la Política Cambiaria en Chile”, *Economía Chilena*, vol 8 – N°3: 29–54, December.
- De Gregorio, J. and A. Tokman (2005), “Flexible Exchange Rate Regime and Forex Interventions: The Chilean Case”, BIS Papers series N° 24 Foreign exchange market intervention in emerging markets: motives, techniques and implications, May. <http://www.bis.org/publ/bppdf/bispap24j.pdf>
- De Gregorio, J., A. Tokman and R. Valdés (2005), “Tipo de Cambio Flexible con Metas de Inflación en Chile: Experiencia y Temas de Interés”, Economic Policy Paper N° 14, Central Bank of Chile, August.



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