Implications of Capital Flows to Macroeconomic and Financial Policies

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Agenda

1. Introduction

2. The facts

3. Macroeconomic Implications

4. Financial Stability Implications

5. Tools

1. Introduction

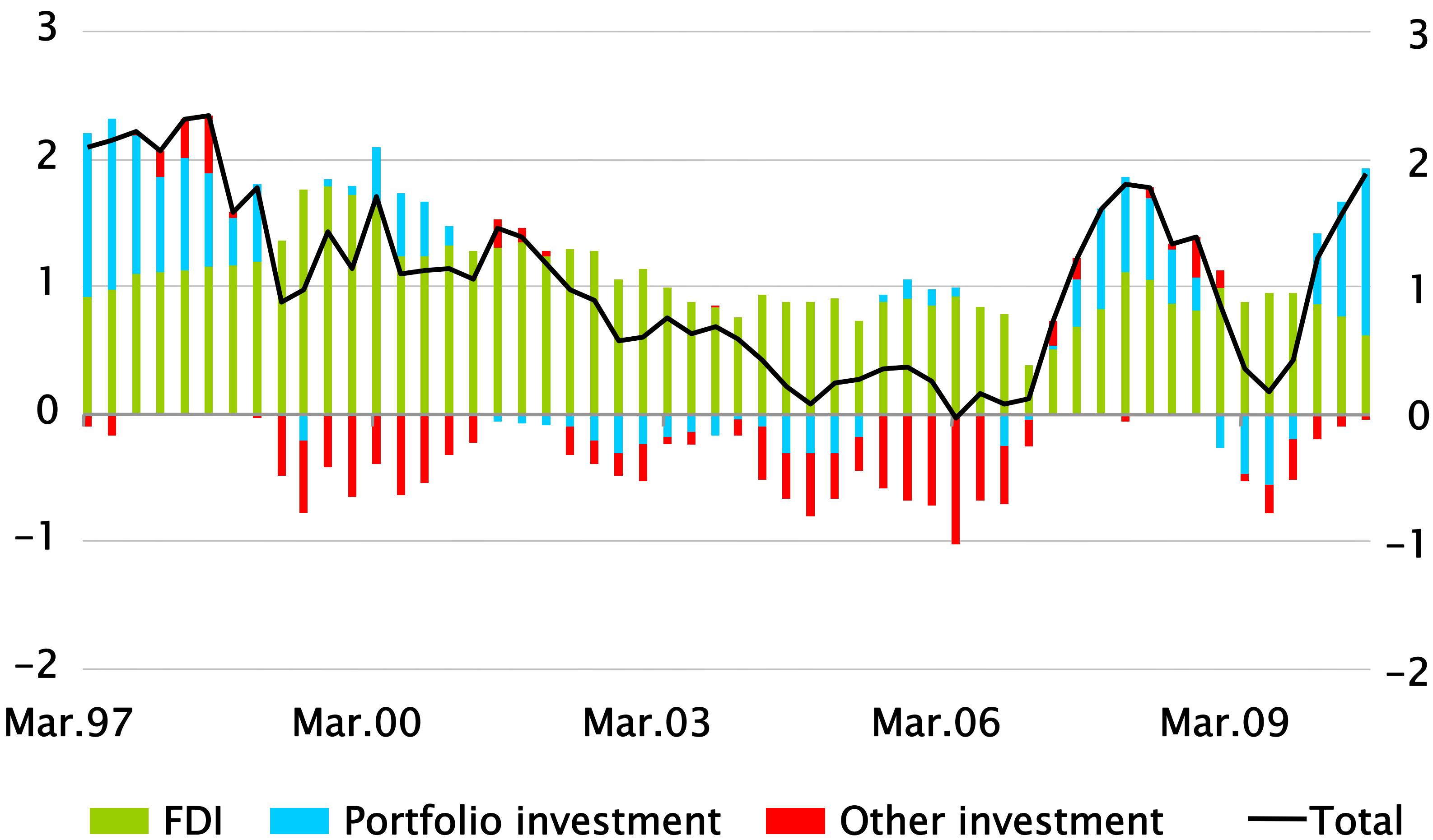
There are two issues regarding capital inflows. Although they are interrelated, they have different policy implications.

- Macroeconomic stability
- Financial stability

2. The facts

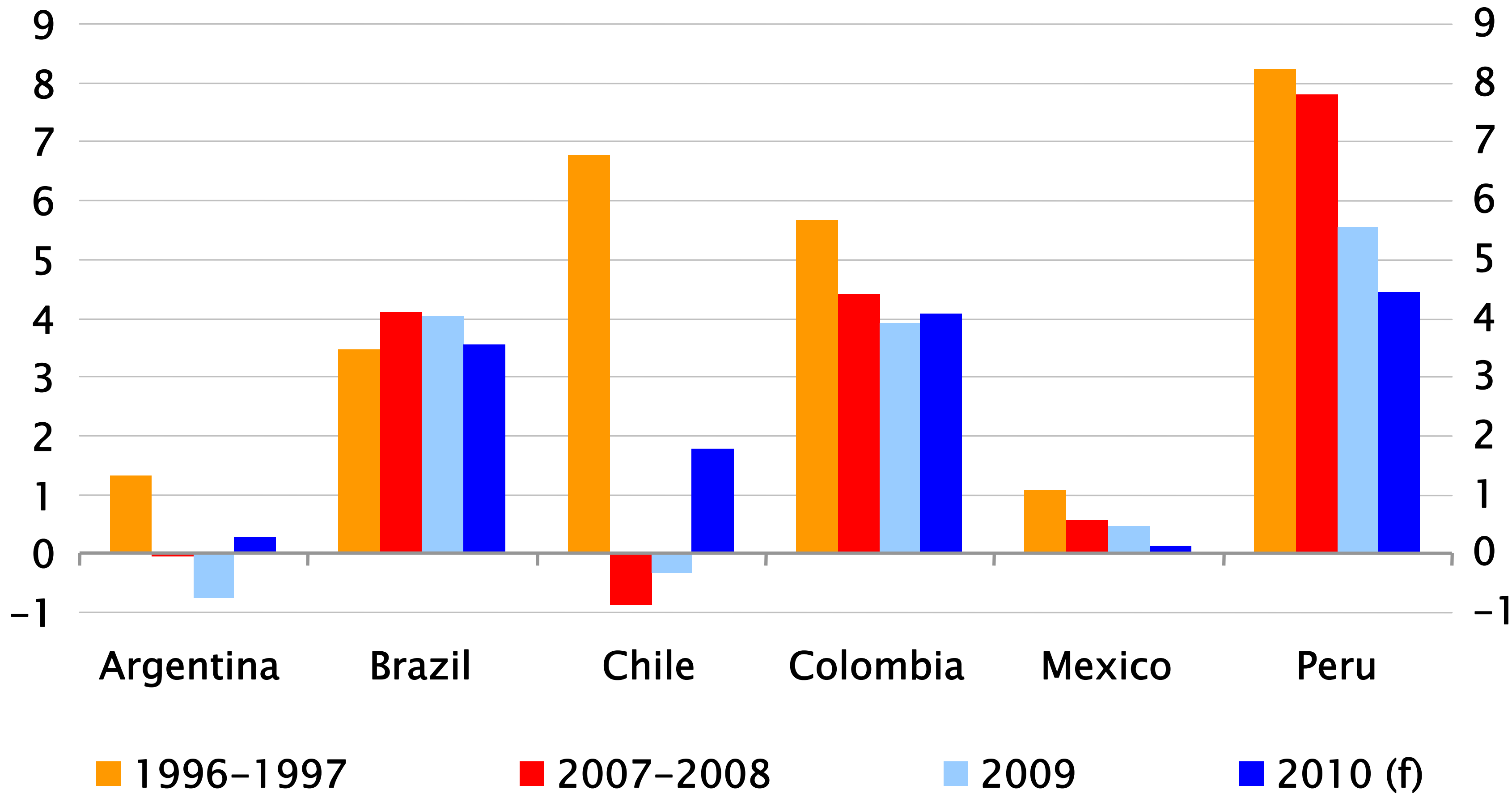
- Capital inflows to Latin America have resumed. In net terms the volume is similar to that observed before the subprime crisis.
- They are not financing unsustainable current account deficits, they are not financing unsustainable fiscal expansions.
- This occurs in a context of low interest rates in industrial countries, normalization of monetary policy and strong growth prospects in emerging markets.
- Capital inflows will continue, with important implications for macroeconomic policies.

Net capital flows into LA, by type (*)
(% of aggregate GDP, through Q2 2010, 4Q ma)



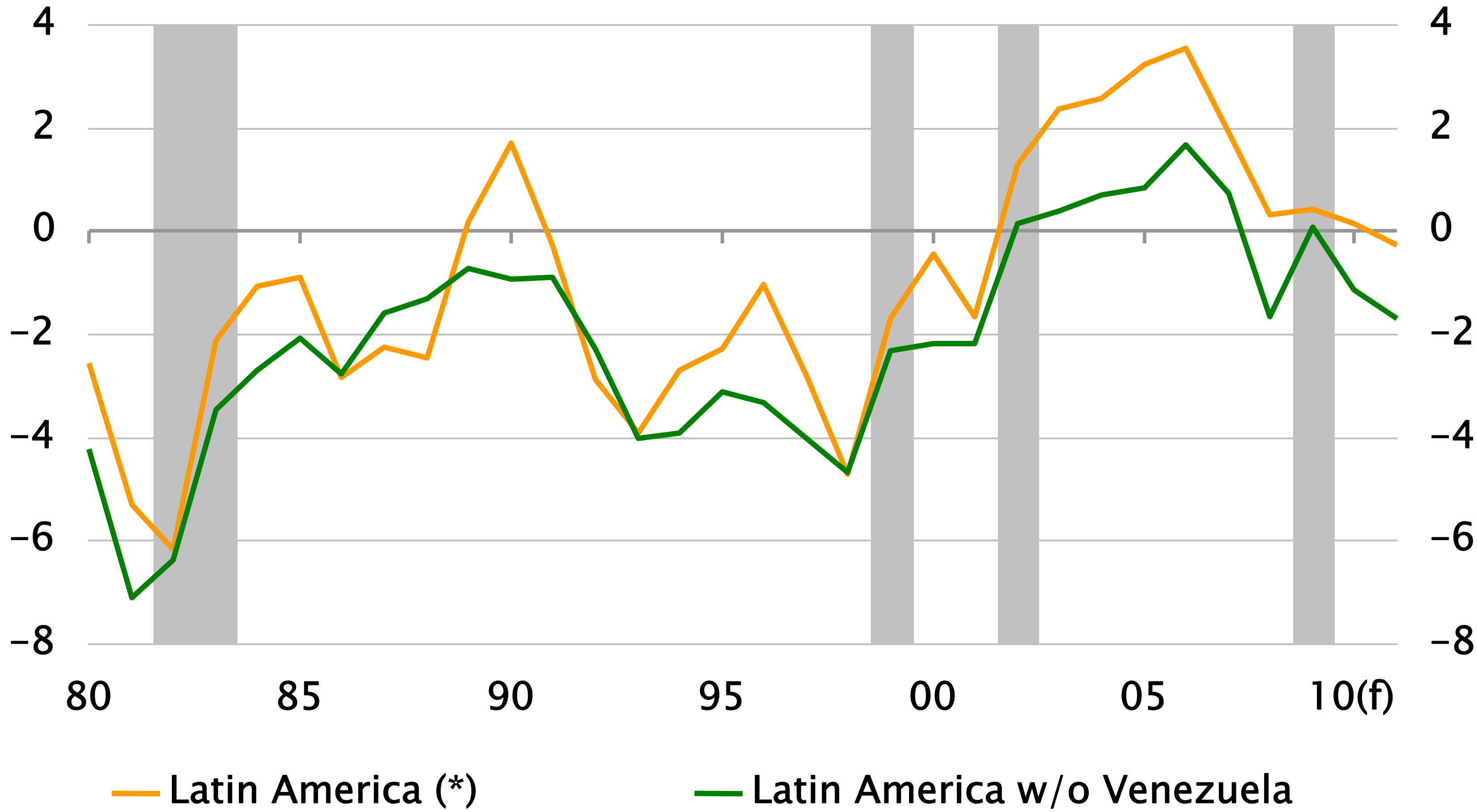
(*) Data as presented are not strictly comparable across time, due to change in composition. Showing Argentina, Brazil, Chile, Colombia (through Q4 2009), Mexico, Peru. Source: IMF.

Net capital flows by country
(percent of GDP; period average)



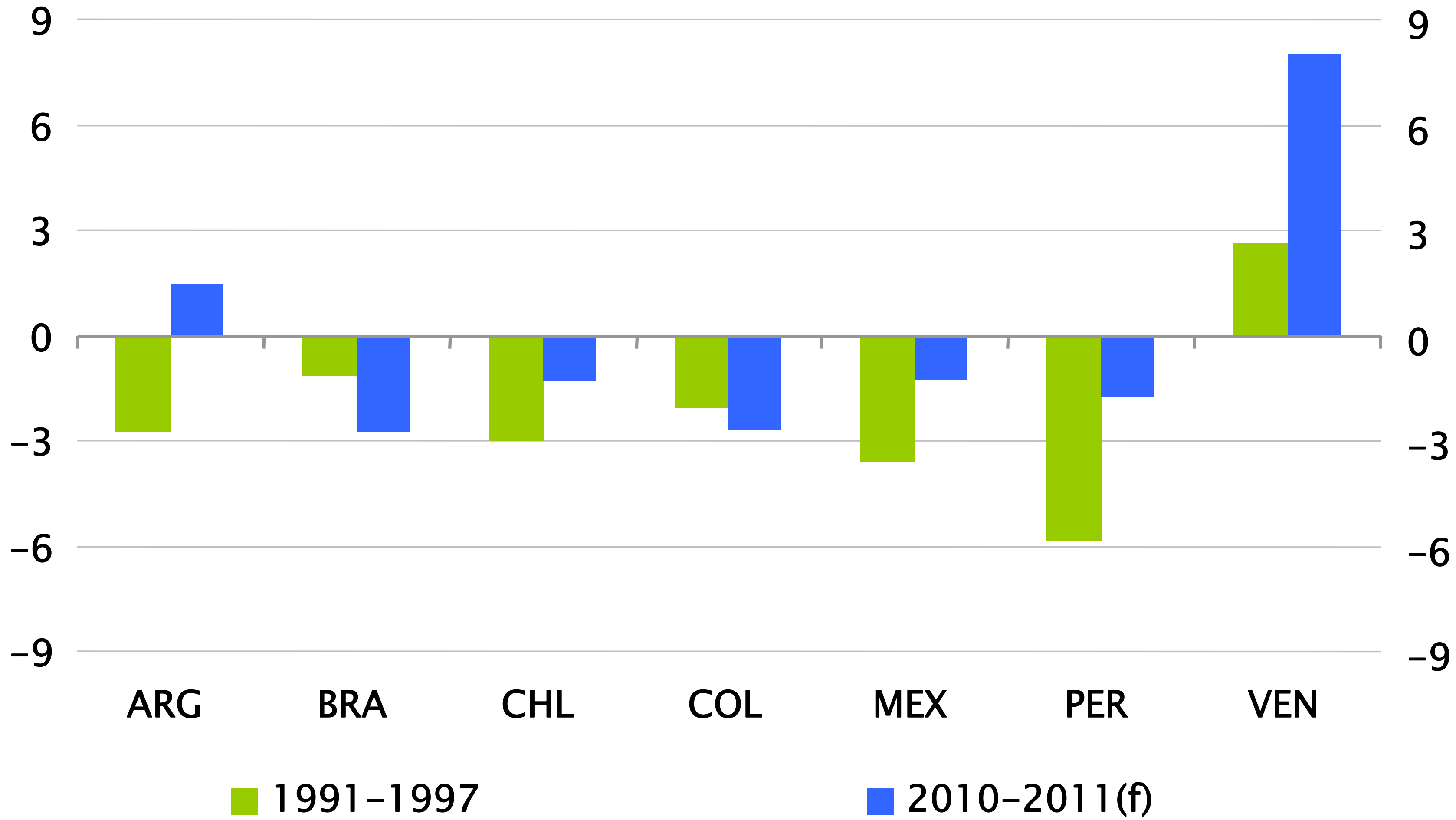
(f) Forecast. Considers effective data through 2Q2010 and an estimation for the 2H2010, based on countries' participation in net capital inflows to Latin America of 2009 and the forecast for 2010 of net capital inflows to Latin America made by WEO, October 2010. Source: Central Bank of Chile based on IMF.

Current account balance (*)
(percent of GDP)



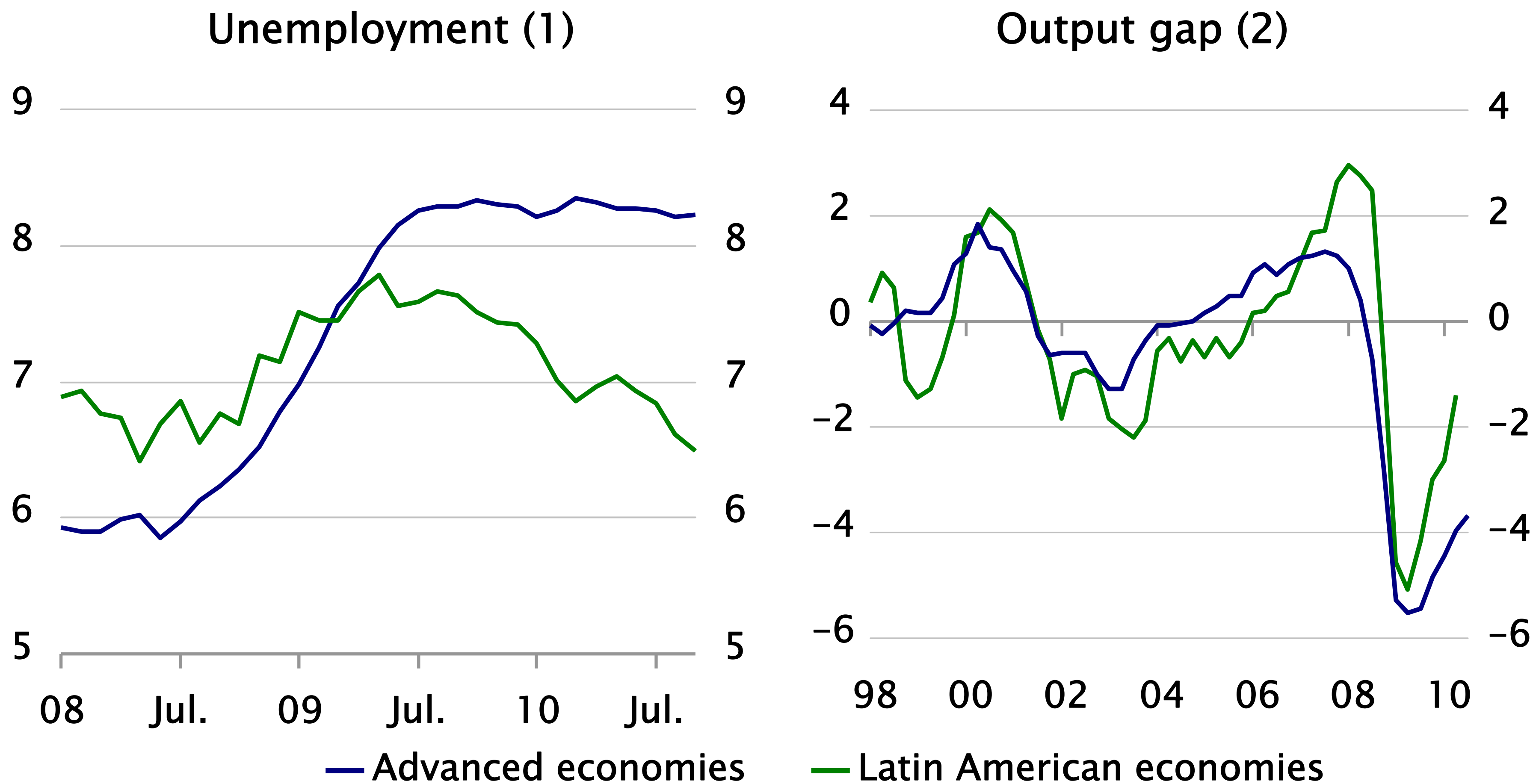
(*) Simple average of Argentina, Brazil, Colombia, Mexico, Peru and Venezuela.
(f) Forecast. Source: WEO October 2010.

Current account by country
(percent of GDP, average of period)



(f) Forecast.
Source: WEO October 2010.

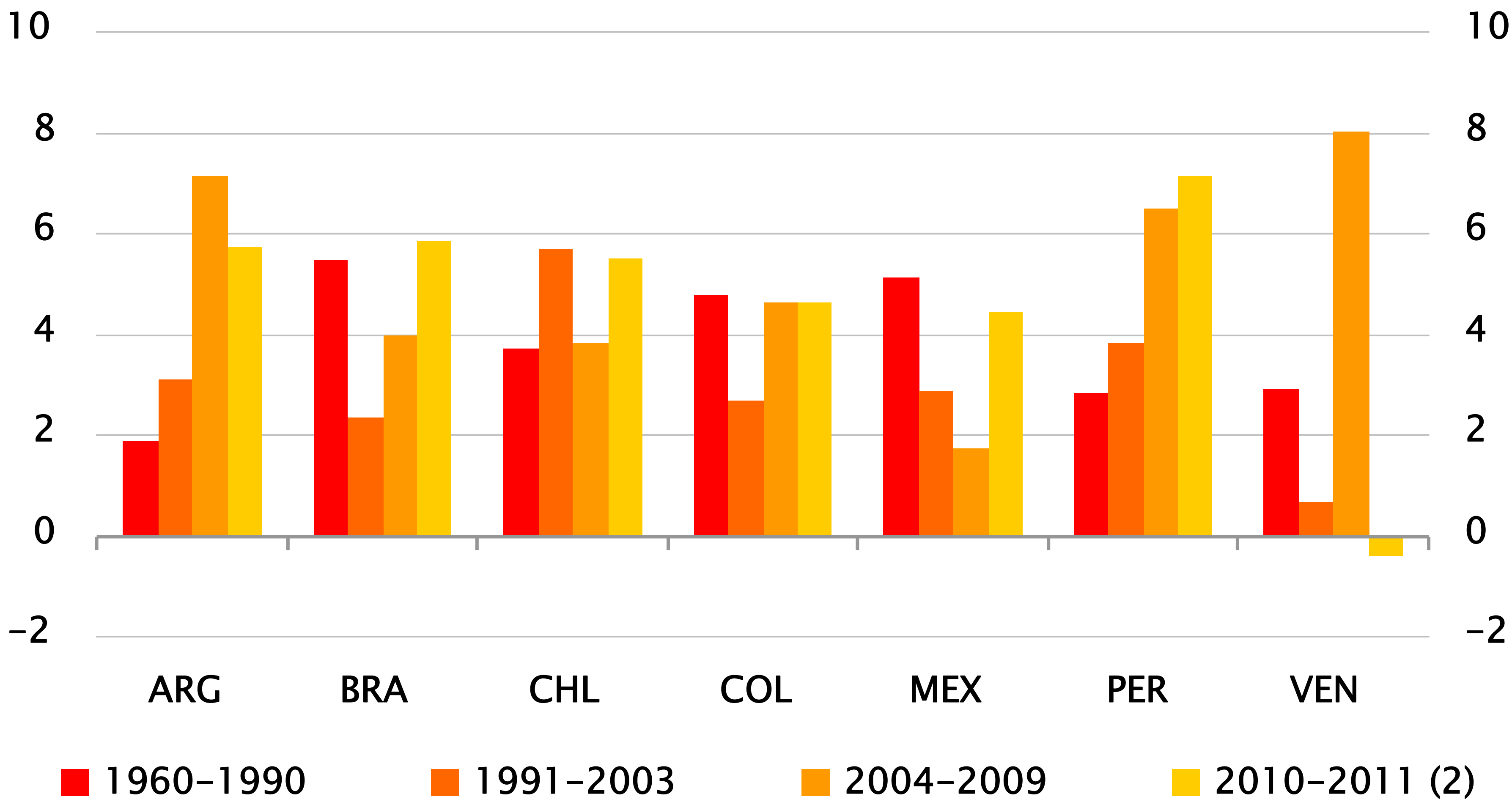
Unemployment rates and output gaps
(percent)



(1) PPP weighted regions. Advanced economies: Canada, Euro Zone, Japan and USA. Latin America: Brazil, Colombia, Mexico and Peru. (2) OECD estimates for advanced economies (Canada, Euro Zone, Japan, UK and USA). For Latin America, output gap calculated using an HP filter, using data for Argentina, Brazil, Chile, Colombia, Mexico and Peru.

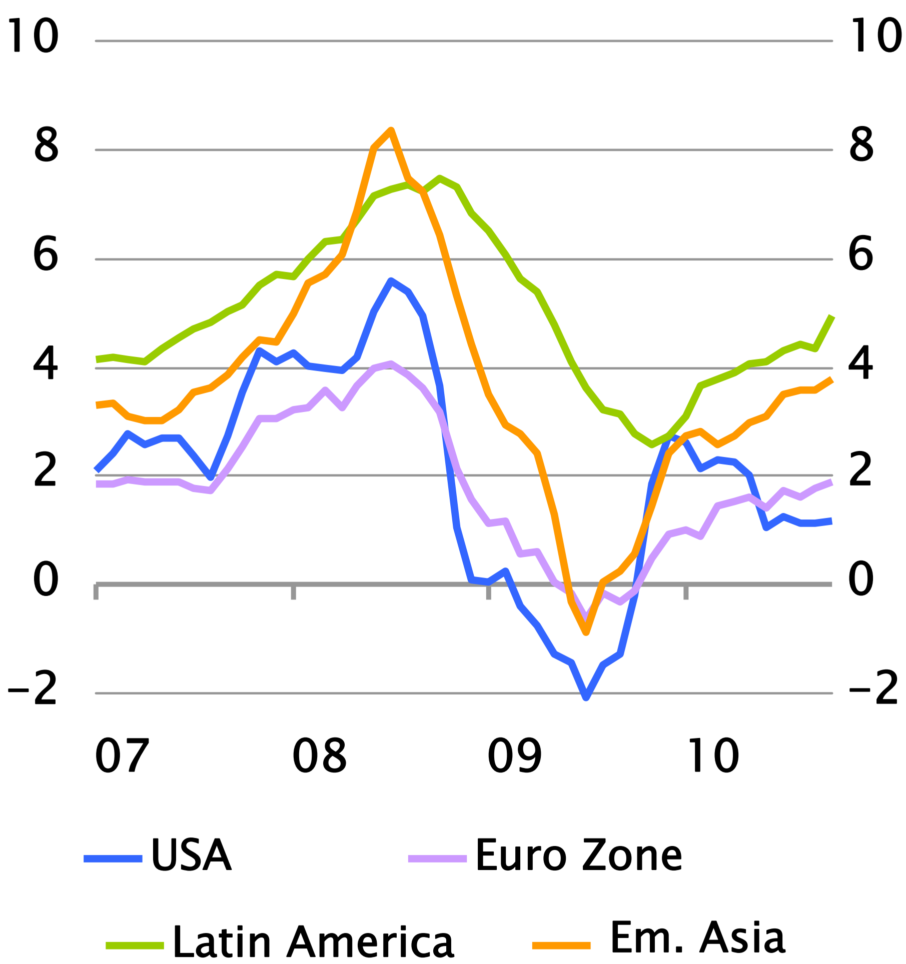
Source: Central Bank of Chile based on Bloomberg, OECD and statistical bureaus of each country.

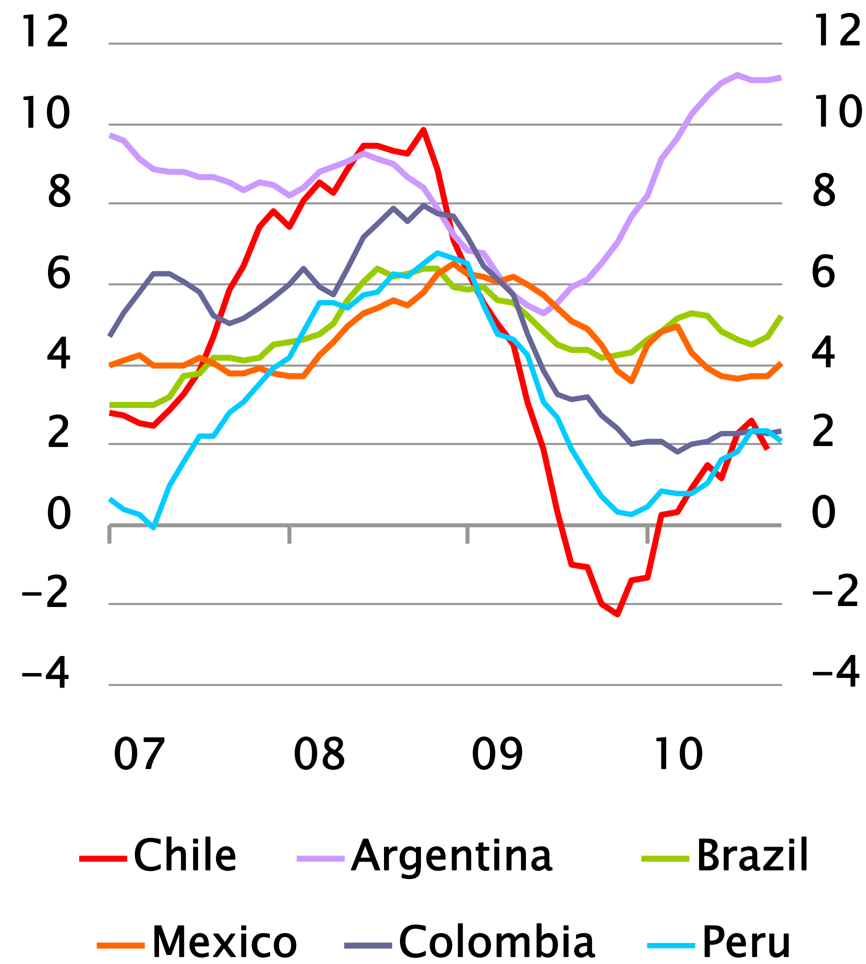
Annual GDP growth rate (1)
(percent)



(1) Average GDP growth rate in the corresponding period. (2) Considers forecast of WEO October 2010.
Sources: WEO October 2010 and World Development Indicators.

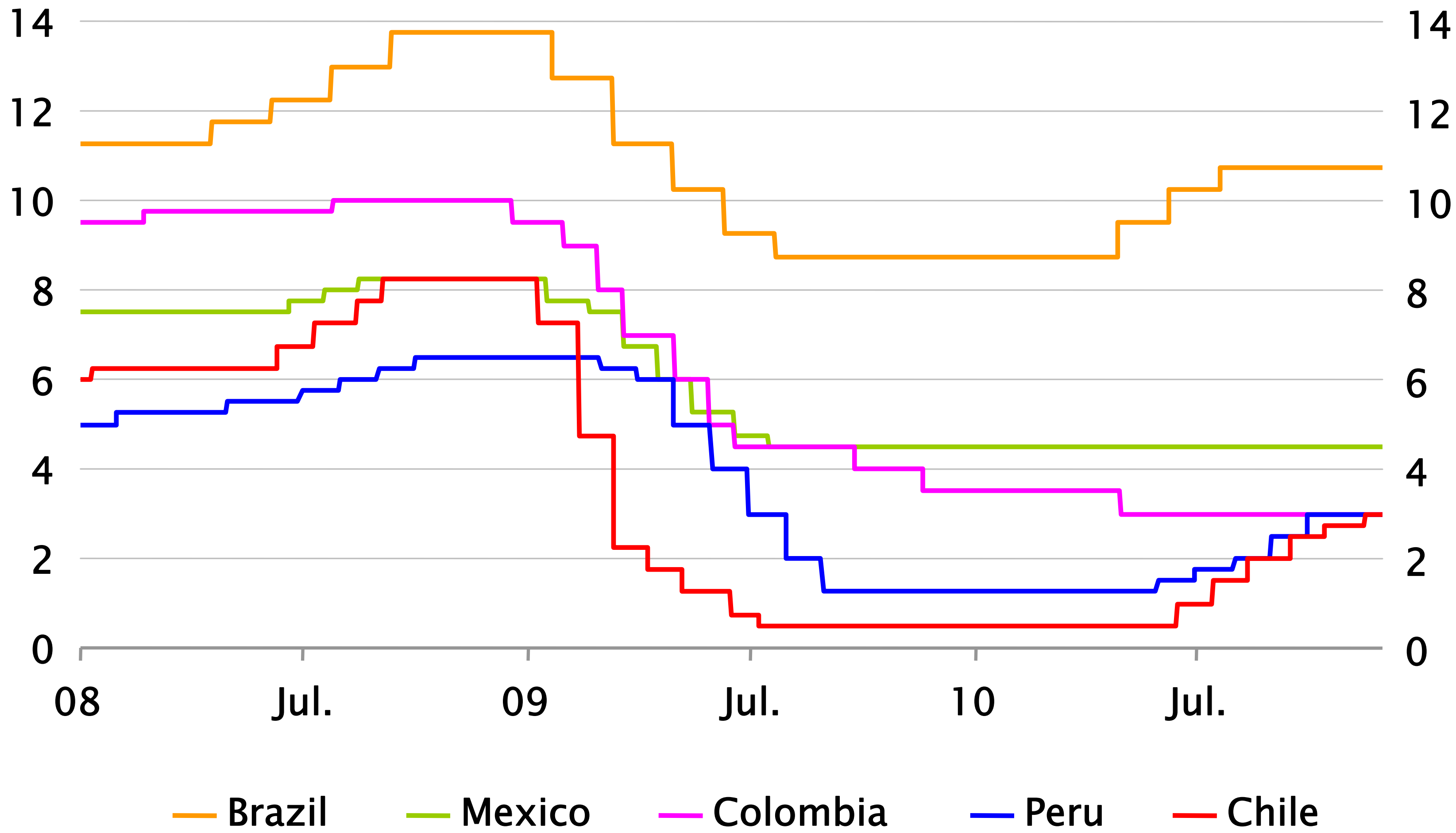
CPI inflation
(annual change, percent)





Sources: Bloomberg and statistical bureaus of each country.

Monetary Policy Rate
(annual percent)

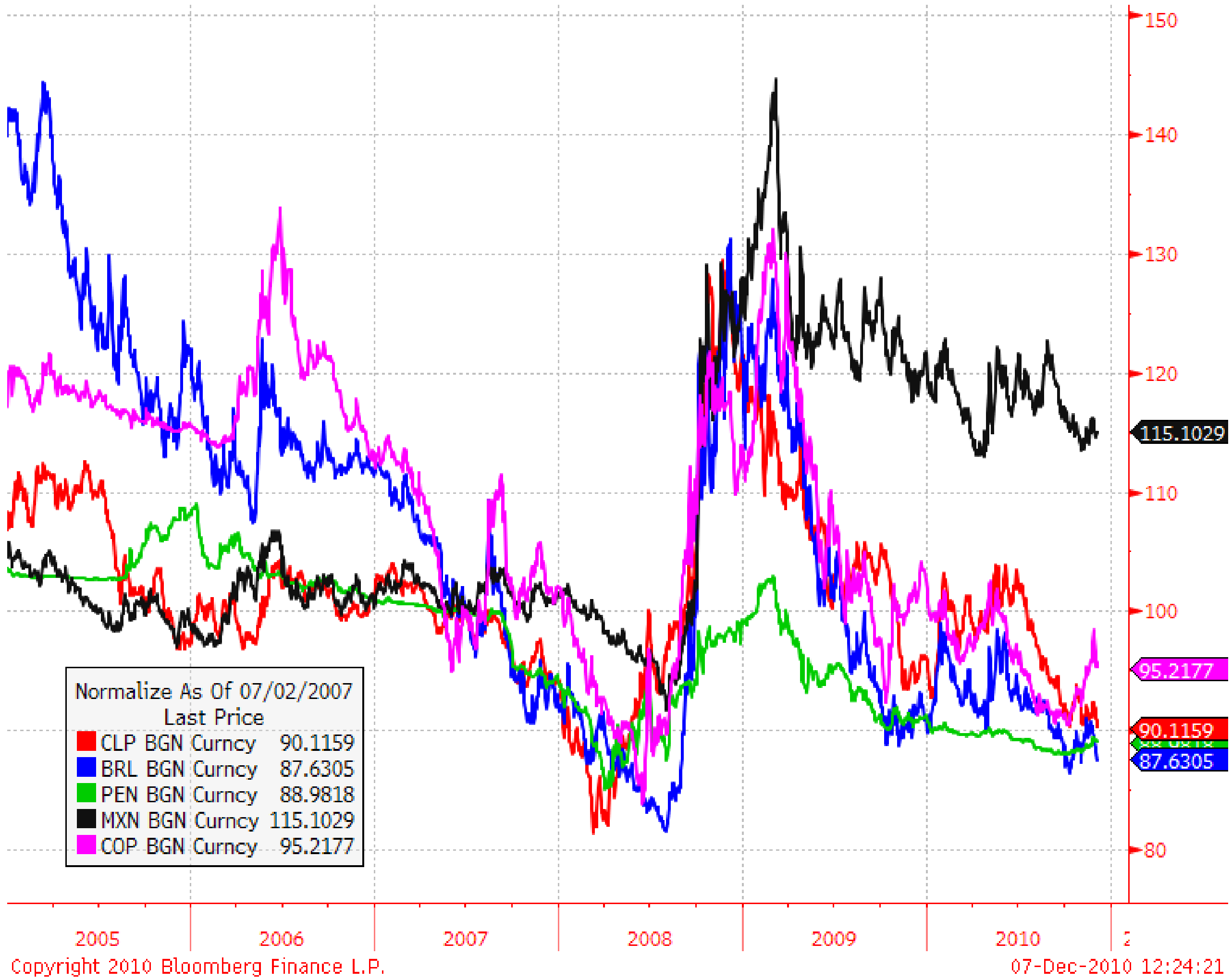


Source: Bloomberg.

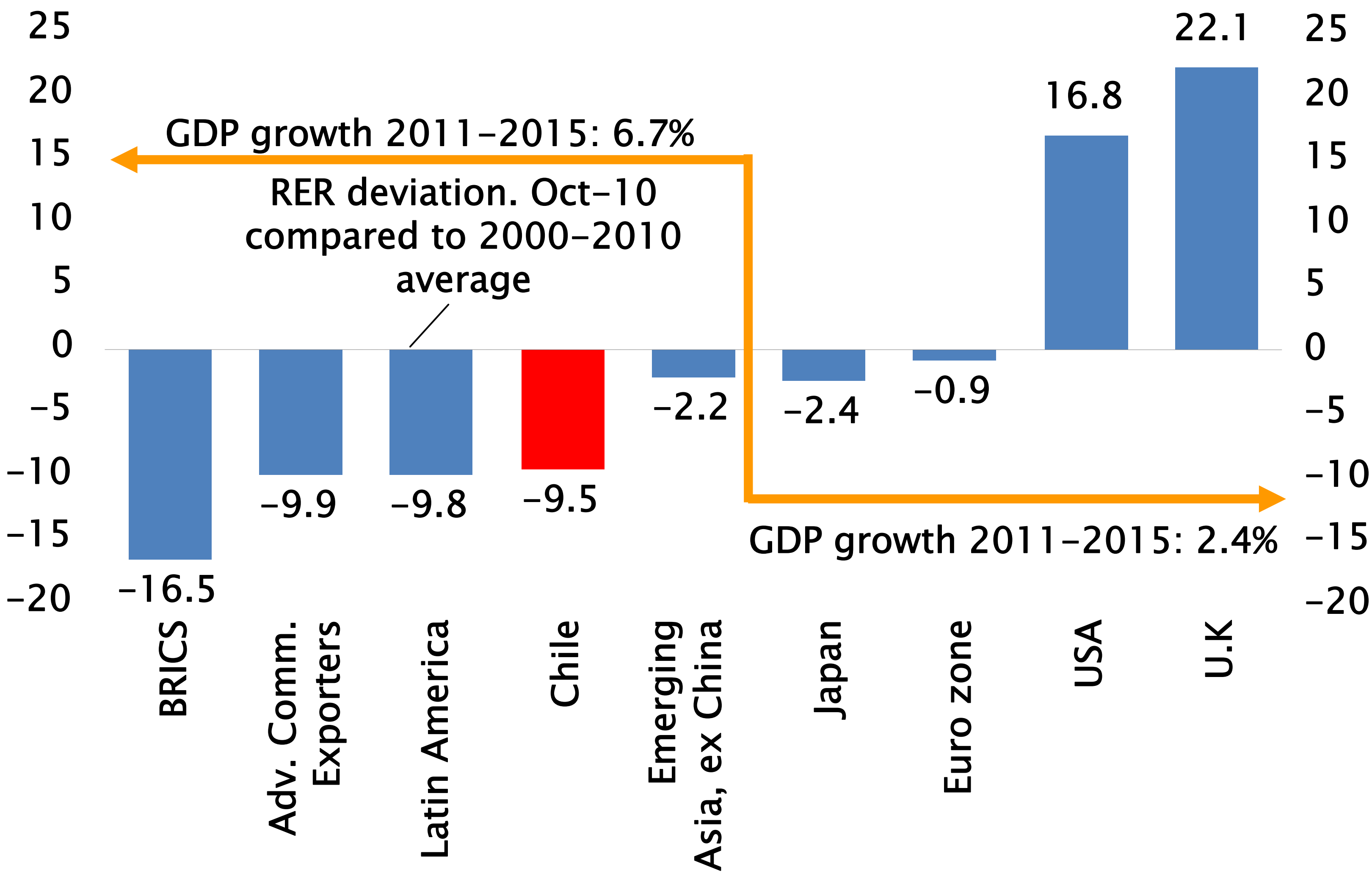
3. Macroeconomic Implications

- Exchange rates in Latin America have appreciated.
- This has occurred regardless of specific policies undertaken in different countries.
- This has implications on inflation and monetary policy. Appreciations have only temporary effects on inflation.
- Policies have to avoid overheating and inflation, but must also avoid contributing to the inflows.
- Capital inflows will likely continue.
- There is always a risk of sudden stops.

Nominal exchange rates
(July 2nd, 2008=100)

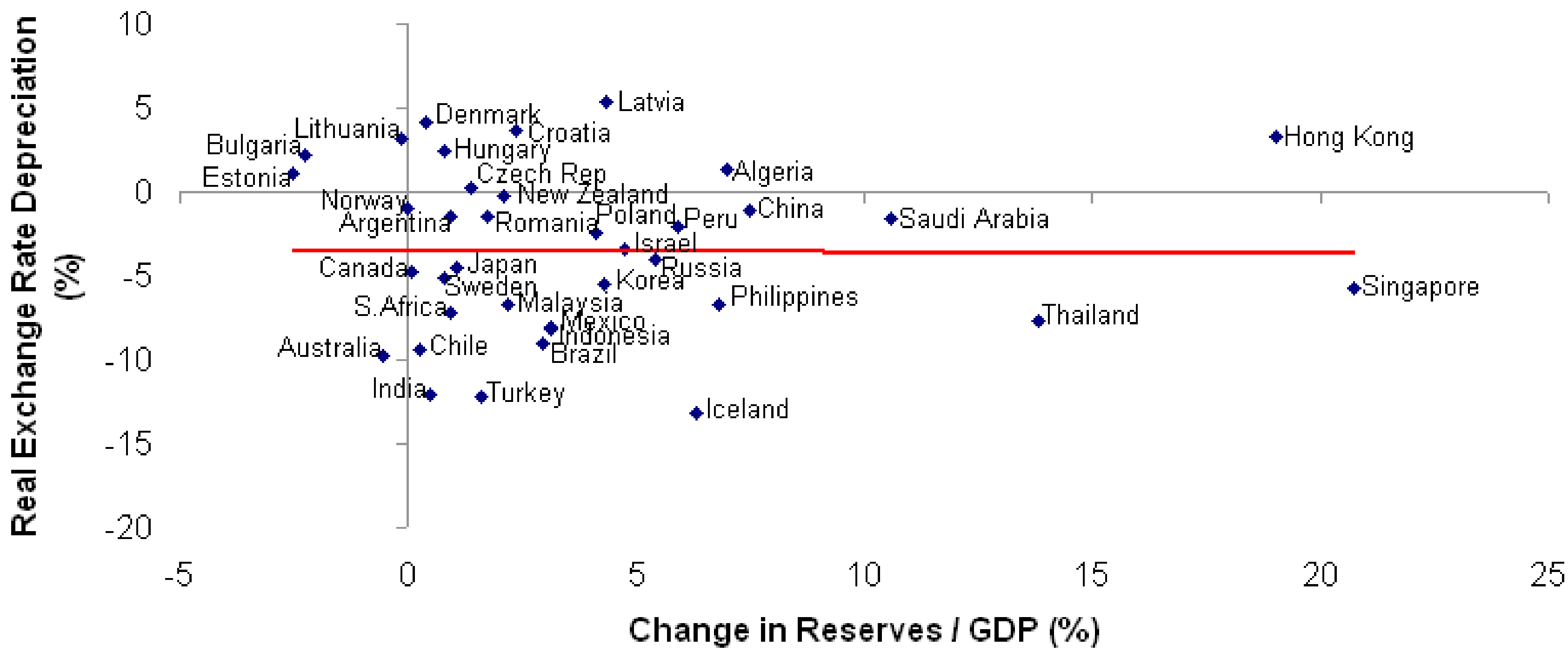


Real exchange rates (*)
(average 2000-2010)



(*) Regional aggregates correspond to simple averages.
Source: BIS.

Depreciation and reserve accumulation*
(September 2009 – September 2010)



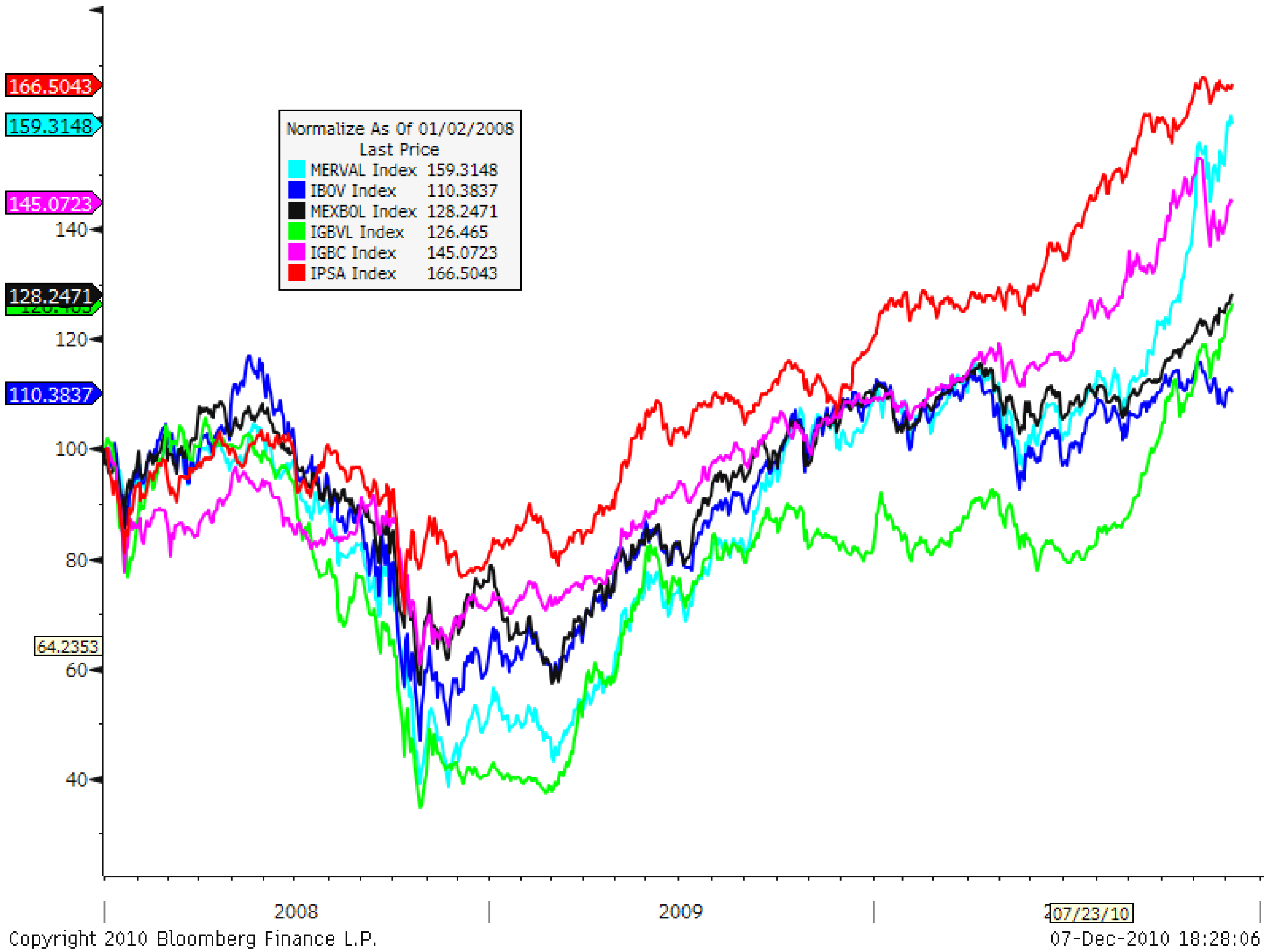
(*) A positive number is a real exchange rate depreciation.

Sources: BIS for real effective exchange rate and IMF and Bloomberg for reserves and GDP.

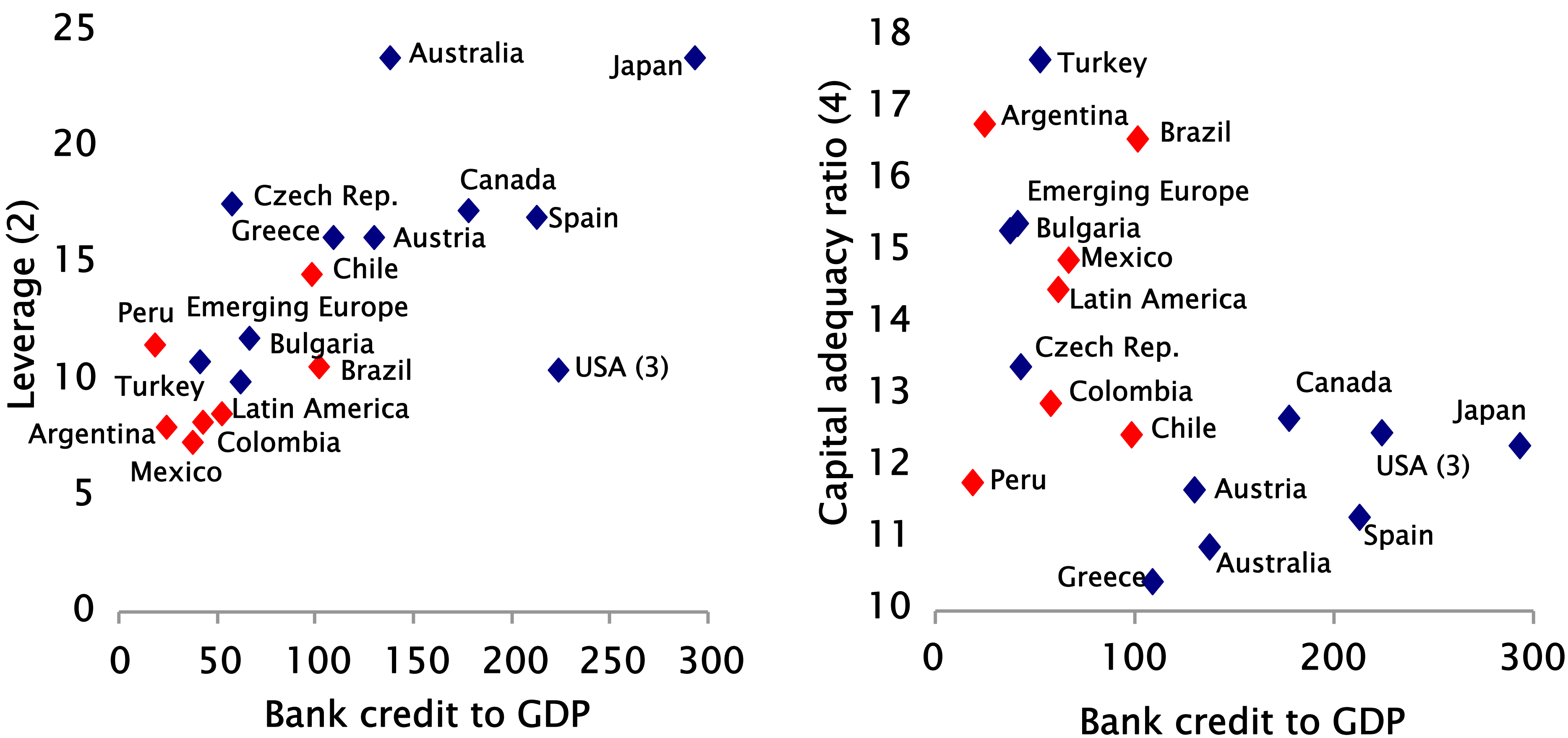
4. Financial Stability Implications

- Capital inflows may lead to increases in domestic asset prices, with the risk of misalignments.
- Sudden reversals of capital inflows have consequences on asset prices and potentially large balance sheet effects.
- There is also an expansion of cross border debt. Vulnerabilities may arise because of the risk of currency mismatches in the banking and corporate sectors.
- Capital inflows also bring increase in size and complexity of the financial system.

Stock prices
(domestic currency, initial date=100)



Banking System Indicators (1)
(times; percent)



(1) Data as of 2008. (2) Asset-to-capital ratio. (3) Considering the average of commercial banks. (4) Regulated capital-to-asset weighted by risk.
Sources: IMF and World Bank.

5. Tools

- Using monetary policy to correct asset price overvaluation may be ineffective, and insufficient.
- For financial stability prudential regulation must be strengthened.
- Using prudential regulation to address currency overvaluation may have negative impacts on risk management in regulated agents, and lead to “disintermediation”.
- Exchange rate flexibility is the first line of defense to discourage inflows. It also induces prudent exchange rate exposure in the private sector.
- Adequate levels of reserves are a cushion against shortfalls of foreign financing. Accumulation of reserves may also prevent the currency for becoming misaligned.
- The use of capital controls may be useful in countries with shallow domestic financial markets and low financial integration. However, it could potentially exacerbate capital inflows and lead to a search for loopholes – with potentially negative effects on supervision.

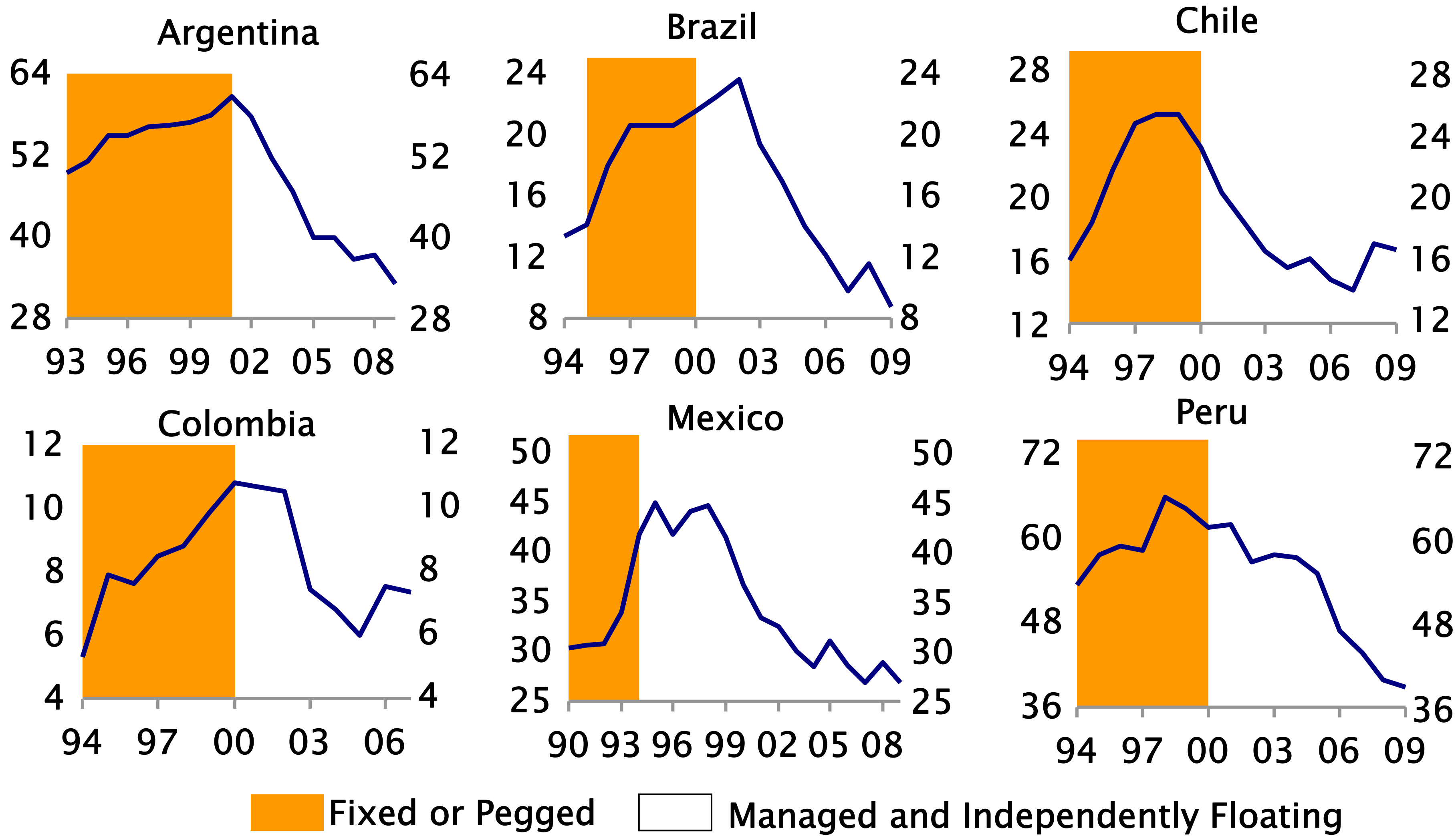
Monthly volatility of exchange rate (1)

	1980-1981	1997-1998	2007-2008	2009-2010(2)
Argentinean peso	7.1	0.0	2.0	0.9
Brazilian real	1.1	0.1	5.6	2.7
Chilean peso	0.0	1.3	4.3	2.6
Colombian peso	0.3	2.8	4.7	3.7
Mexican peso	0.5	2.8	4.0	2.9
Peruvian nuevo sol	1.0	0.9	1.8	1.2
Venezuelan bolívar	0.0	1.1	0.0	15.1
Average	1.4	1.3	3.2	4.2

(1) Standard deviation of the monthly change of the exchange rate during the period. Results multiplied by 100. (2) Considers data as of November 24th, 2010.
Sources: Bloomberg and IFS.

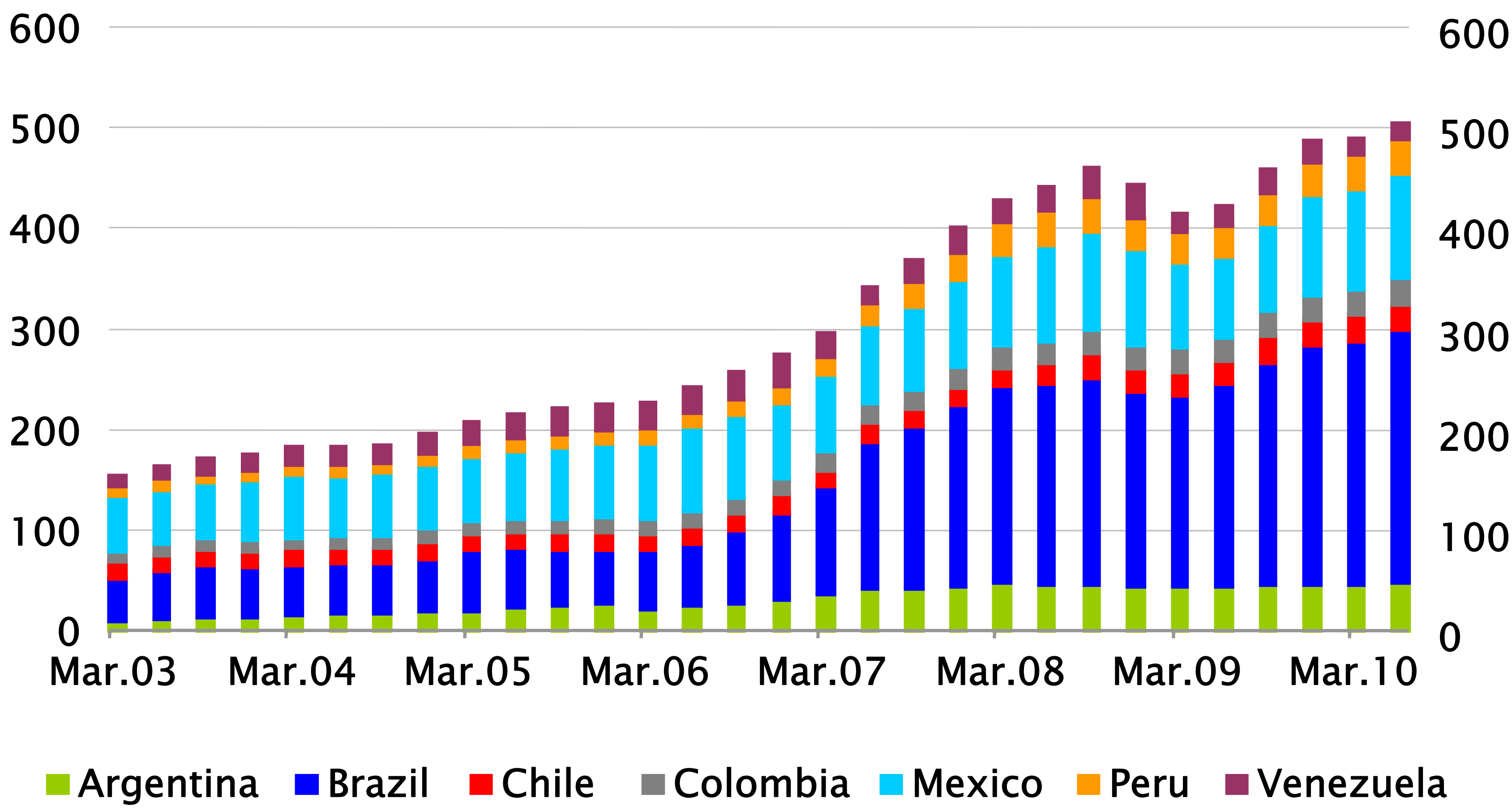
Dollarization of liabilities of the corporate sector in Latin America: 1992-2009

(percent, annual average across firms)



Source: IMF.

Latin America: International reserves
(US$ billion)



Source: IFS, International Monetary Fund.