CENTRAL BANK OF CHILE

VI High Level Seminar of the Eurosystem and Latin American Central Banks on Macroeconomic Policies, Global Liquidity and Sovereign Risk[1]

OPENING REMARKS

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Good afternoon and welcome to this sixth High Level Seminar of the Eurosystem and Latin American Central Banks on Macroeconomic Policies, Global Liquidity and Sovereign Risk. The origins of this Seminar can be traced back to the regional seminars held regularly by the ECB with other regions of the world. Based on that experience and the long standing relationship between Spain and Latin America, the High Level Seminars between the Eurosystem and Latin American Central Banks were launched in 2002 to meet every two years, and have already been hosted by the Bank of Spain in Madrid three times, and by the Central Bank of Brazil in Rio de Janeiro in 2004 and the Bank of México in Mexico City in 2009. On this occasion, we have the honor of hosting the Seminar here in Santiago, as was proposed by my predecessor, José De Gregorio, in Madrid in 2010.

This Seminar provides an opportunity to continue the policy dialogue initiated in Madrid in 2002, and it marks the 10th anniversary of this initiative. In our view, it provides the chance to have candid policy discussions and to exchange views about how each of us is confronting macroeconomic challenges, global liquidity and sovereign risks. To this purpose, there was a workshop in Rome in late June which was organized jointly by the ECB, Banca D'Italia and Banco de España, where several papers on these issues were presented in preparation of the discussions we will be having today and tomorrow. Given the relevance of the three topics chosen for the Seminar, I would like to briefly introduce each topic as a way of motivation for our discussions in the next sessions.

The recent years have been challenging for policymakers across the world. The Global Financial Crisis of 2008-2009 produced an economic downturn that affected advanced and emerging economies alike. While most countries recovered quickly from the initial shock, the slowdown in advanced economies proved more persistent than in emerging markets. After going from minus 3.5 percent to 3 percent between 2009 and 2010, GDP growth in advanced economies halved to a rate of 1.5 percent in 2011. In Latin America, the initial recovery was faster, moving from a growth rate of minus 1.5 percent to a growth rate of about 6 percent between 2009 and 2010. The slowdown of 2011 in the region, with a growth rate of about 4.5 percent, was also milder.[2]

[2] All figures come from the IMF's World Economic Outlook of October 2012.

Through various mechanisms, the slowdown experienced by advanced economies led to episodes of financial and sovereign stress in several countries, including some members of the euro area. In this scenario, GDP growth rates in advanced countries in general, and the euro area in particular, are expected to remain at low levels in the near future.

At the same time, the relative strength of emerging economies, and the expansionary policies implemented by advanced countries to stimulate their economies have been associated with increased gross capital flows into emerging market countries. Latin America has not been an exception. While there is heterogeneity in the exact circumstances prevailing in different countries, the broad pattern has been that these flows have resulted in widening current account deficits, currency appreciations, expansions of domestic credit, and house price increases.

This global scenario, and in particular the need to deal with sovereign stress in some advanced economies and abundant capital inflows in several emerging markets has brought some old discussions back to the policy arena and raised new academic and policy questions.

On sovereign stress and sovereign crises, there is now renewed interest in better understanding some of the mechanisms behind sovereign problems. Topics such as fiscal federalism, the relation between banking and sovereign distress, the boundary between monetary and fiscal policy or between liquidity and solvency problems, and the potential for multiple equilibrium scenarios, are nowadays being revisited and discussed. The resolution of sovereign problems has also received increased attention, and thus so has the debate on the optimal implementation of fiscal adjustment programs and debt restructurings, the possibility and costs of debt overhangs, and the provision of liquidity to distressed sovereigns. There is also more global awareness of some of the challenges of dealing with sovereign distress, such as fending off the possibility of fiscal dominance and maintaining central bank independence.

Regrettably, Latin American countries are not new to these discussions. Most of our countries have experienced episodes of sovereign distress during the last three decades. Without going too far, with varying causes and degrees of intensity, most of the region suffered from the "sovereign debt crisis" of the early eighties. Before this crisis, the combination of relatively low global interest rates, abundant international credit, and fixed exchange rates in the second half of the 1970s, led many governments, banks, and private companies in the region to borrow heavily from international lenders in foreign currency and to the creation of important international and domestic imbalances that became apparent when nominal and real interest rates started to rise in the late 1970s and into the early 1980s.

The end of the story is well known to all of us. The 1980s are known in Latin America as "the lost decade": growth stagnated, inflation ran rampant, currencies depreciated and unemployment increased. In addition, in some countries we saw policies heading towards populism that, as is always the case, did not end well.

It is not my intention in this talk to get into the details of our region's history. We will have the opportunity to do so during our discussions. But I would like to highlight that the bright side of the painful experience of our region with sovereign crises is that we have a lot of experience to share with those countries that are dealing with similar situations nowadays.

Whether the easy or the hard way, most Latin American countries learned important lessons from these episodes that led them to implement institutional changes that have resulted in a much healthier financial and fiscal position than in the past, and allowed them to resist the strikes of the global financial crisis much better than during past episodes of global distress.

There are some common traits to the experience of different Latin American countries with sovereign problems that are relevant to the current debate. For instance, in most our countries the recovery from the debt crisis of the 1980s combined large nominal and real devaluations, the implementation of structural adjustment programs—usually under the supervision of international institutions such as the IMF and the World Bank—and the restructuring of debt payments and forgiveness of principal amounts associated with programs such as the Brady Plan. In other, more recent episodes, the timely provision of liquidity to the banking sector may have helped to prevent a contagion from the banking sector to the sovereign that is usually very hard to deal with.[3]

While some of these options are available to countries currently in distress, others are not. This raises interesting and important policy questions regarding whether this particular combination is necessary to exit sovereign distress or whether there are different or even better options to reduce the costs associated with the structural adjustment required by these episodes.

Looking ahead, there are also some solutions in place in the region that may be useful to prevent future fiscal problems, such as the structural fiscal rule implemented in Chile in the early 2000s that puts some constraints on the spending decisions of the sovereign, but at the same time permits an a-cyclical fiscal policy that allows expansions of the current deficit during bad times. The sovereign wealth funds also put in place by several countries inside and outside Latin America also offer a way to smooth cyclical fluctuations in government revenues.

Let me now turn back to the issue of capital flows to emerging countries. As I mentioned before, the combination of the different scenarios in emerging markets and advanced economies, and the expansionary monetary policies in advanced economies have been associated with increased capital inflows to emerging economies, including several Latin American countries.

Theory tells us that capital inflows are unlikely to be harmful if there are no frictions in the reallocation of resources or other externalities. It also indicates that, if there were such frictions, first-best policies should try to undo them. There are, however, two problems with this approach: first, there is no academic consensus on the precise nature of these frictions,

[3] See Cavallo and Fernandez-Arias (2012). Coping with Financial Crises: Latin American Answers to European Questions. Inter-American Development Bank, Policy Brief 176.

and second, correcting them may not be feasible within the timeframe required for policy action. This means that second-best policies may be the only choice at hand for policymakers.

So, while these inflows are not necessarily harmful, they still have raised several concerns and questions among policymakers in the region.

The concerns are partly related to past experiences with these types of phenomena. For instance, the debt crisis of the 1980s was preceded by capital inflows and credit expansions. As I said in my brief review of this episode, things ended up badly when capital flows quickly reversed after interest rates started rising in the developed world and the accumulated vulnerabilities and imbalances became apparent. Other episodes of capital inflows and sudden stops have followed similar patterns. These experiences suggest that there may be important frictions and market failures associated with the allocation of large volumes of capital inflows.

However, there are important differences between previous episodes of capital inflows and the current one that make the parallel incomplete. For instance, few Latin American countries have fixed exchange rate regimes in place. The macroeconomic and institutional environment has also improved significantly. These improvements have also been accompanied by a decline in liability dollarization, reducing the vulnerability of the financial sector to a sudden depreciation. Another difference is that while in the 1980s capital inflows took mostly the form of debt, this time around FDI accounts for an important part of these flows. Moreover, in many cases it is FDI directed toward the resources sector which is a tradable sector. Although a widening current account deficit may be a source of concern, it is clear that if it is financed through FDI in the tradable sector, the concern is mitigated.

All in all, the policy questions raised by this scenario are multiple and probably well known to all of you. For instance, to what extent are these capital inflows driven by push versus pull factors? Is the “global liquidity” expansion actually behind them? Are the inflows and the resulting credit expansion excessive? Have currencies become misaligned? Are the increases in real estate or house prices observed in some areas evidence of a bubble? All of these are important questions for policy making. At the same time, there are important questions regarding what are the most appropriate policies to deal with these situations if one has the conviction that a reaction is needed.

There are probably different answers to and views about these questions across the region. This heterogeneity has also resulted in different reactions. But Latin America has seen an increase in recent years in the implementation of policies motivated by the concerns about the potential costs of capital inflows and associated phenomena. The effectiveness of several of the policies being implemented is still to be determined and this meeting will provide a good opportunity to discuss them, as well as whether their benefits outweigh the costs that they entail.

There has also been some discussion about the nature of the different policies that have been implemented inside and outside the region. In particular, to what extent can different measures be considered as "macroprudential" and what is the role of central banks in dealing with financial stability concerns. Part of this discussion comes from a lack of clarity on what constitutes macroprudential regulation, what are its tools, and who should implement it. In its original, narrower view, the term macroprudential refers to an approach to financial regulation that takes into account the endogeneity of financial risk and the interactions between financial system participants. The tools are usually the same used for traditional micro-prudential regulation, but are applied based on systemic rather than individual criteria.[4] In a broader view, the term is applied to any policy aimed to curtail credit growth or other aggregate indicators considered to be of potential concern for financial stability. In this latter view, some of the policy instruments under the control of central banks could be used with a macroprudential goal. This discussion has extended beyond the pure definition of macroprudential policy into the nature of the optimal

[4] For a discussion, see Clement (2010), "The term 'macroprudential'; origins and evolution." BIS Quarterly Review, March.

institutional arrangement for its implementation. We will likely touch upon some of these issues during the next two days.

On the other side of the road, advanced economies that partly depend on external demand and currency depreciations to get out of their current situation, are worried that some of the policies being implemented in emerging countries may result in some form of isolationism or protectionism and call for policy cooperation to allow the global economy to recover. Again, forums like this one may help share views and reach common understandings on questions and concerns that will hopefully lead to better policies for all the countries we represent.

In closing, I would like to thank all those who worked in coordinating the preparation of the issues note and background material for our discussions, in particular Michael Sturm and Anna Ehrke from the ECB, Sonsoles Gallego and Enrique Alberola from Banco de España and Claudio Raddatz from the Central Bank of Chile, as well as all those involved in the drafting of the material. I would also like to thank Banca d'Italia for hosting in June the research workshop where much of the material included in the issues note was originally presented and discussed. Finally, I am also grateful to all those who have been in charge of the organization on the Seminar here in Santiago, again Anna Ehrke from the ECB and Sonsoles Gallego from Banco de España, and Alejandra Rozas and Alejandra Orrego from the Central Bank of Chile.

Thank you very much and I look forward to fruitful discussions today and tomorrow.