



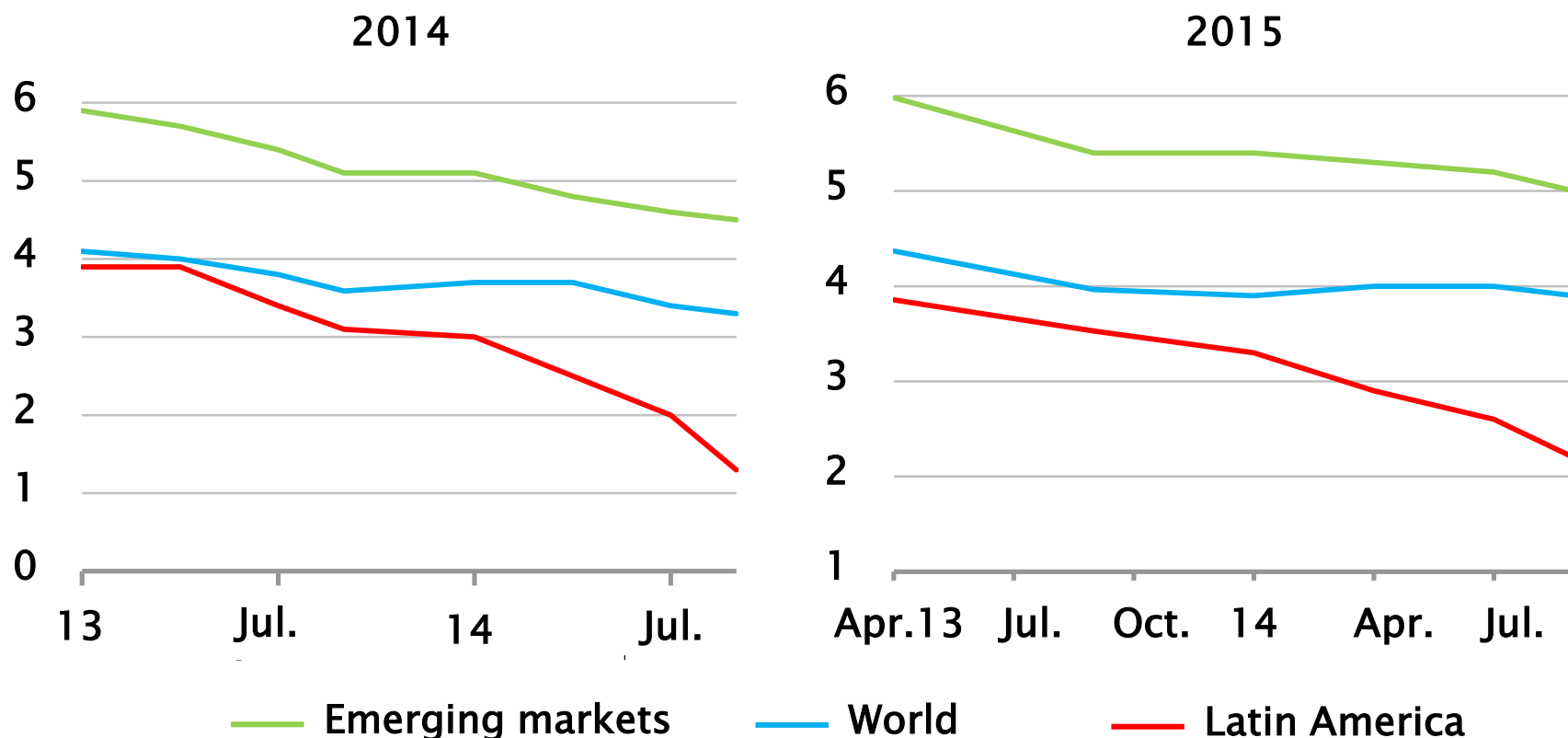
Latin America's adjustment to a changing economy. The case of Chile

Rodrigo Vergara
Governor
Central Bank of Chile



Latin American economies have underperformed the average of emerging markets. Revision of growth rates forecast this and next year have been among the biggest in the world.

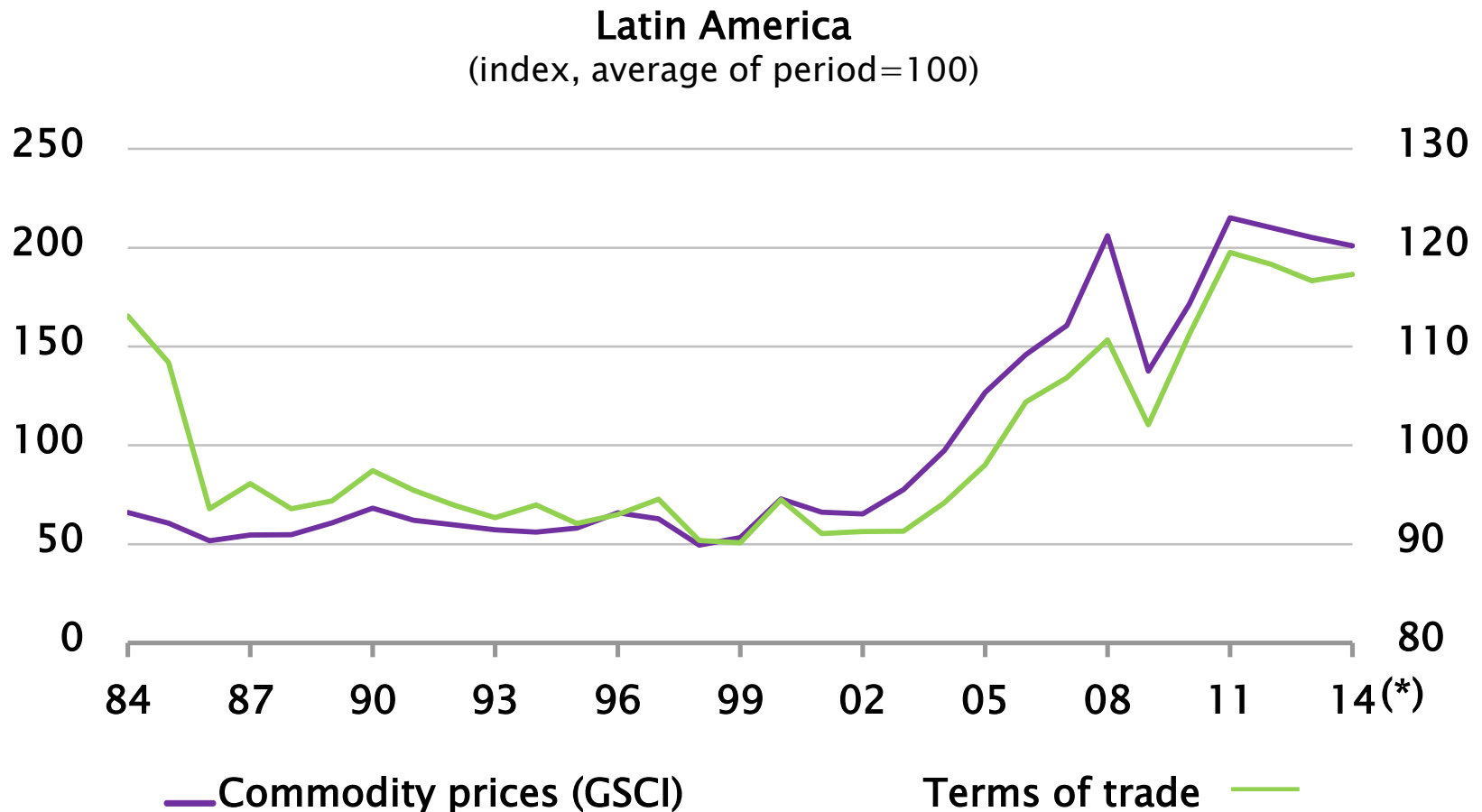
Forecast of GDP growth at PPP (*)
(annual change, percent)



(*) Considers WEO update of January and July and the publication of April and October.
Source: IMF.



Past high commodity prices had fostered growth of Latin American economies, a cycle that seems to have come to an end...

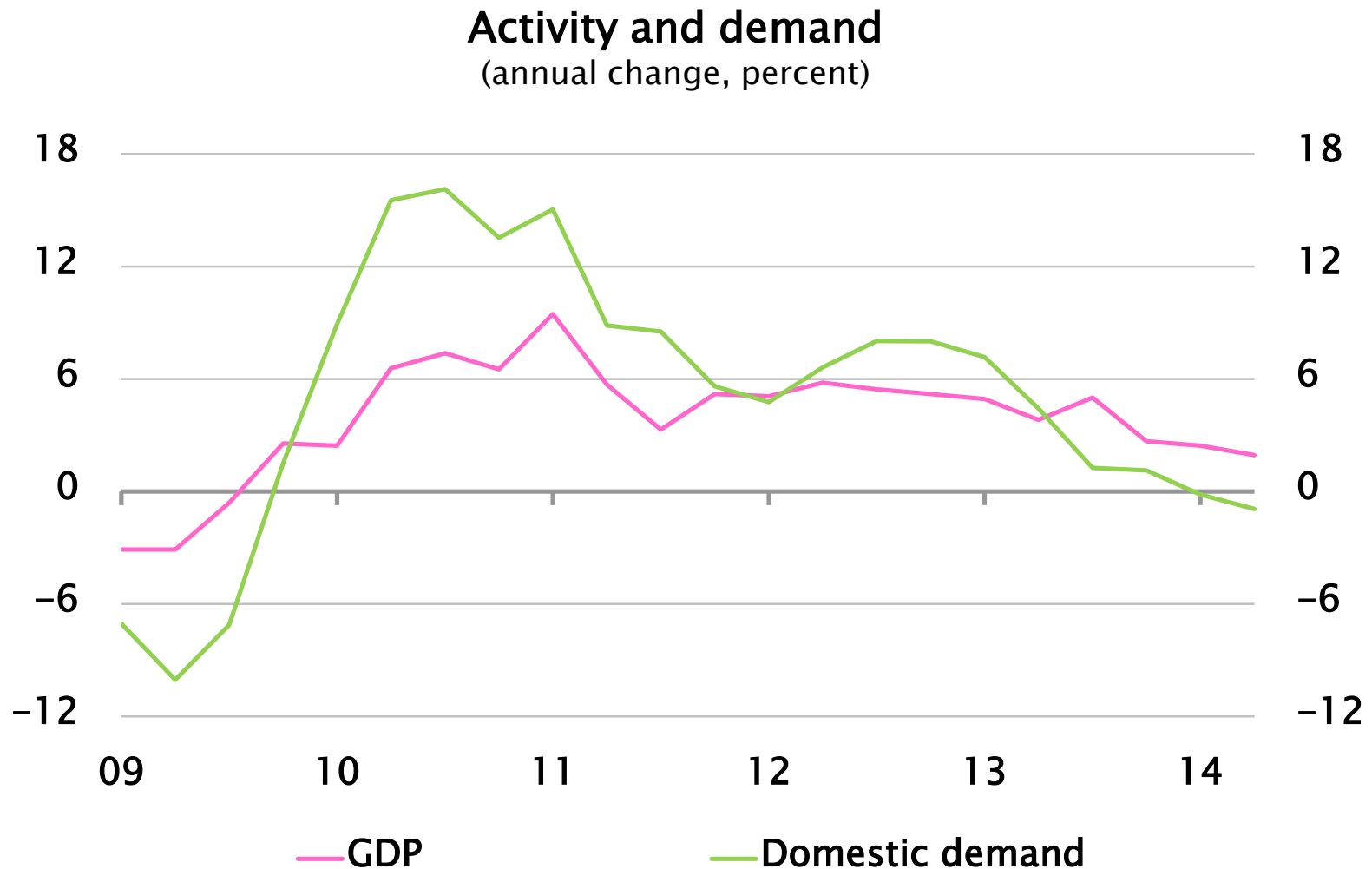


(*) Considers the annual average of GSCI up to October 2014, and IMF's terms of trade forecast for the year 2014.

Sources: Bloomberg and IMF.



The Chilean economy has also slowed down since September 2013, with successive growth revisions...



Source: Central Bank of Chile.

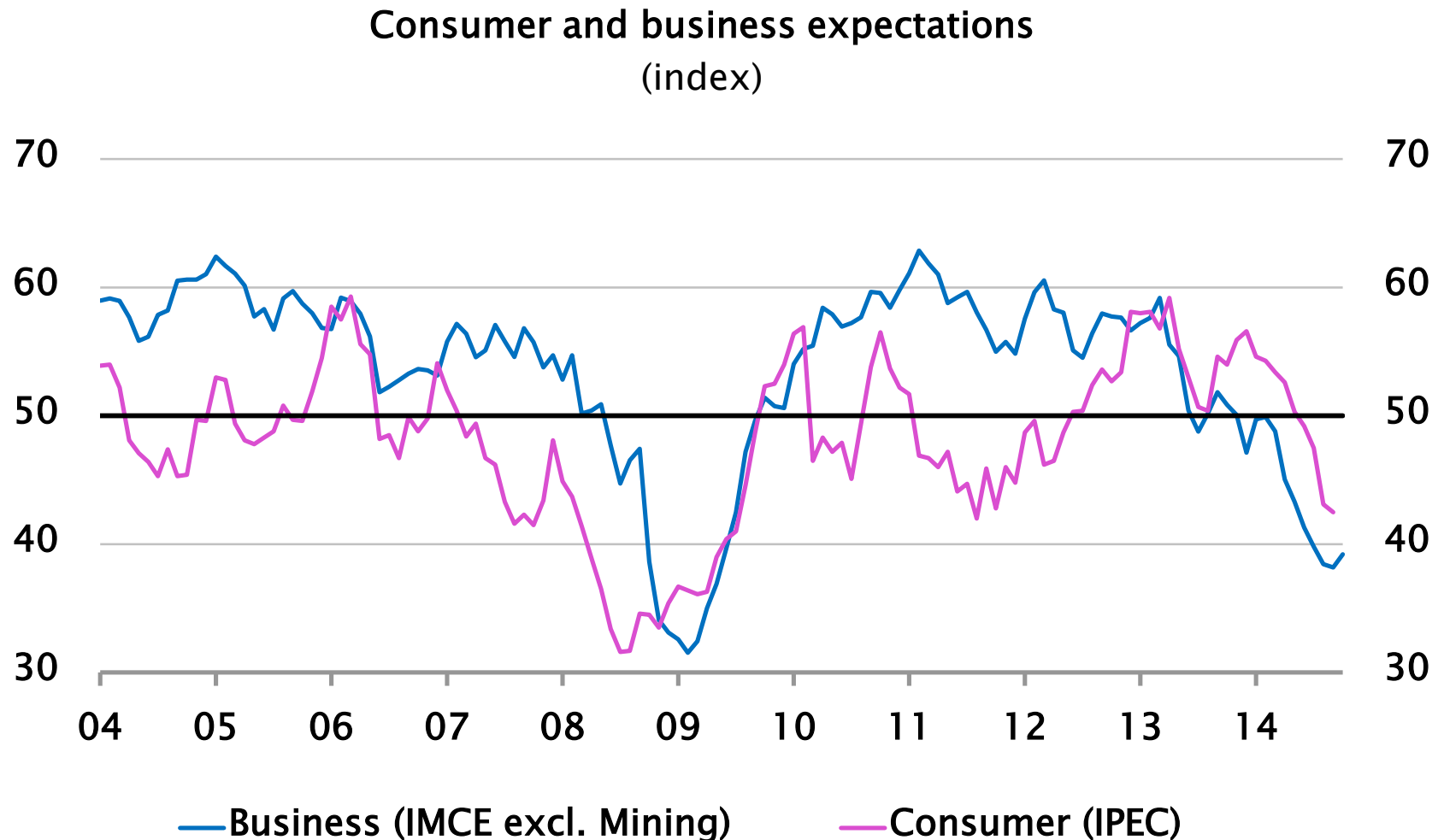


Factors behind Chile's economic slowdown

- To some extent, it was foreseen that the economy would slow down.
- The lower growth rates are a response to both external and domestic elements, among them:
 - The end of the cycle of high commodity prices.
 - The mining investment cycle is finishing.
 - International financial conditions have deteriorated, and further tightening is expected.
 - Slower growth of real labor income.



And there has also been a significant deterioration of consumer and business expectations...

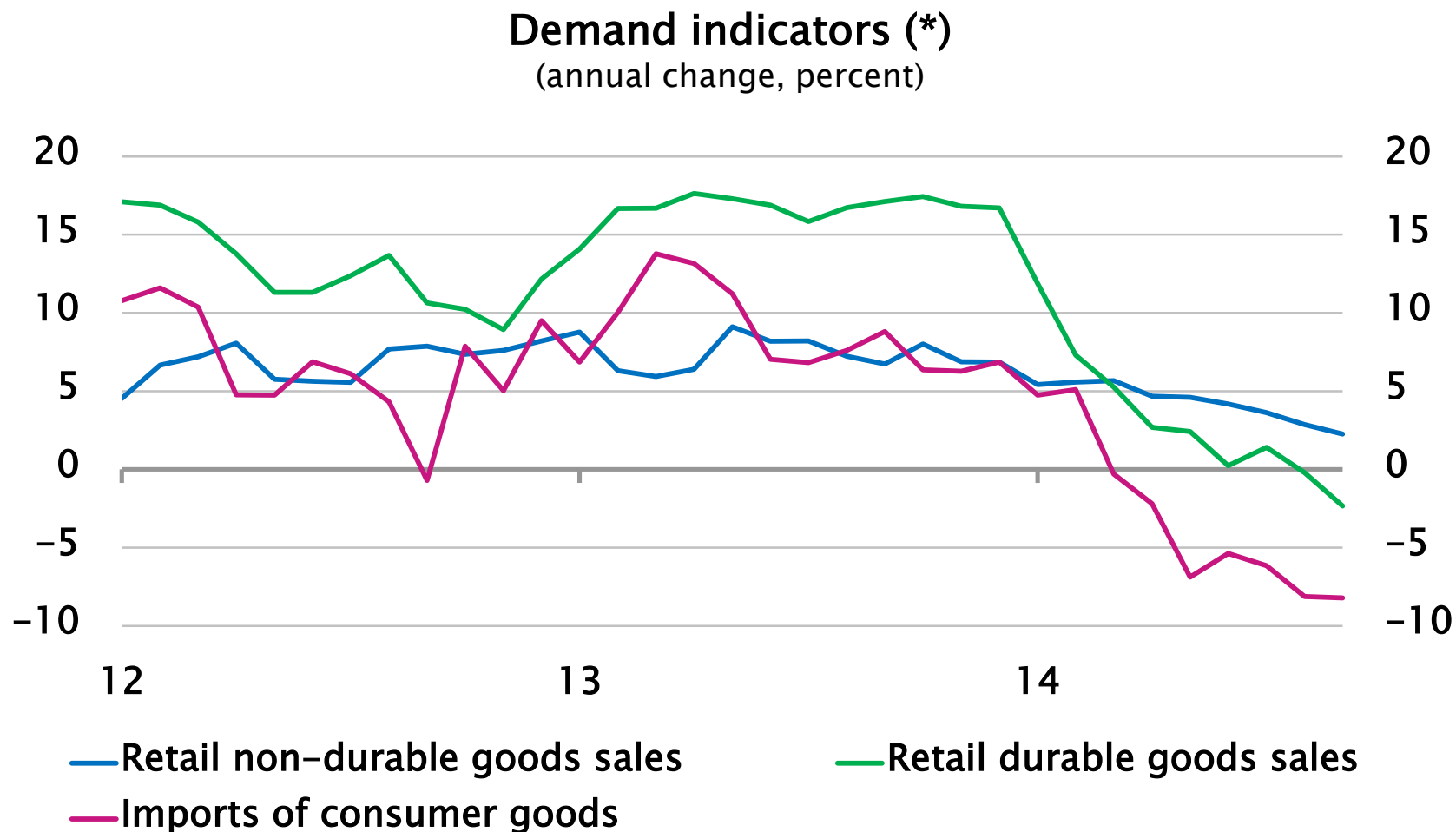


(*) A value over (under) 50 indicates optimism (pessimism).

Sources: Adimark and Icare/Universidad Adolfo Ibáñez.



In recent months, consumer and investment indicators show that weak performance continued during the third quarter, although there are signs of stabilization.

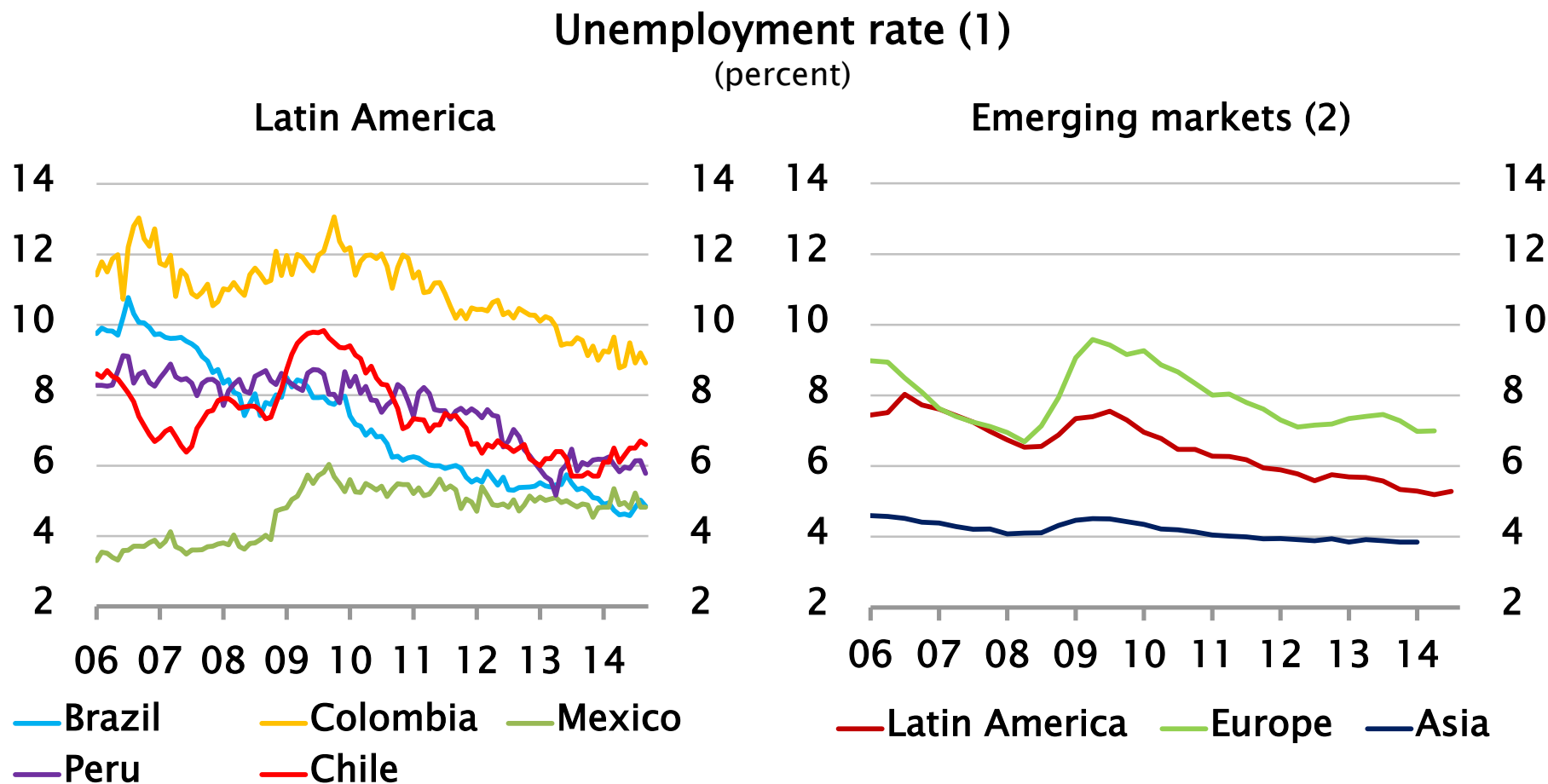


(*) Moving quarterly average. Data up to September 2014.

Sources: Central Bank of Chile and National Statistics Institute.



Chile's unemployment rate has increased moderately, however has remained at historically low levels. In other emerging economies, the labor market has shown few changes.



(1) Seasonally-adjusted series. (2) Measured at PPP. Data up to first quarter 2014 for Asia, second quarter 2014 for Europe and third quarter 2014 for Latin America.

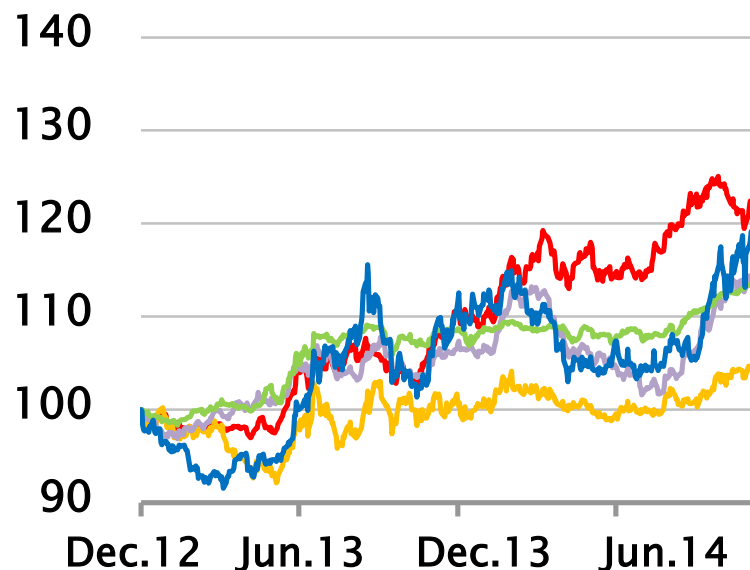
Sources: Chile's National Statistics Institute and Bloomberg.



The initial impact of the US tapering hit emerging economies hard, as reflected on the exchange rate depreciation. The recent geopolitical tensions in Europe boosted this movement. In Latin America, the depreciation of the Chilean peso was among the sharpest.

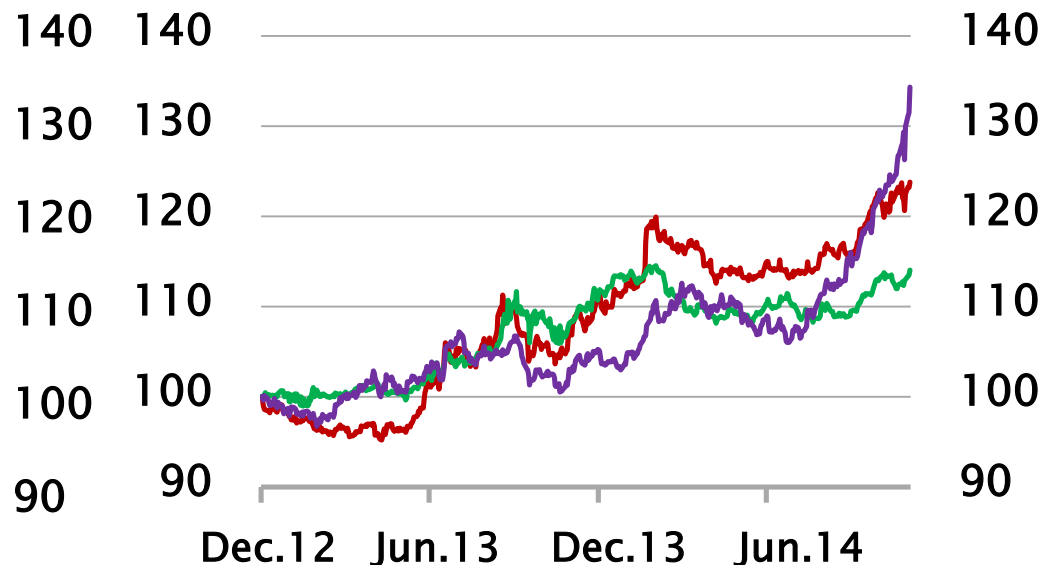
Exchange rates (1)
(index; 1 December 2012=100)

Latin America



— Chile
— Mexico
— Colombia
— Peru
— Brazil

Emerging markets (2)



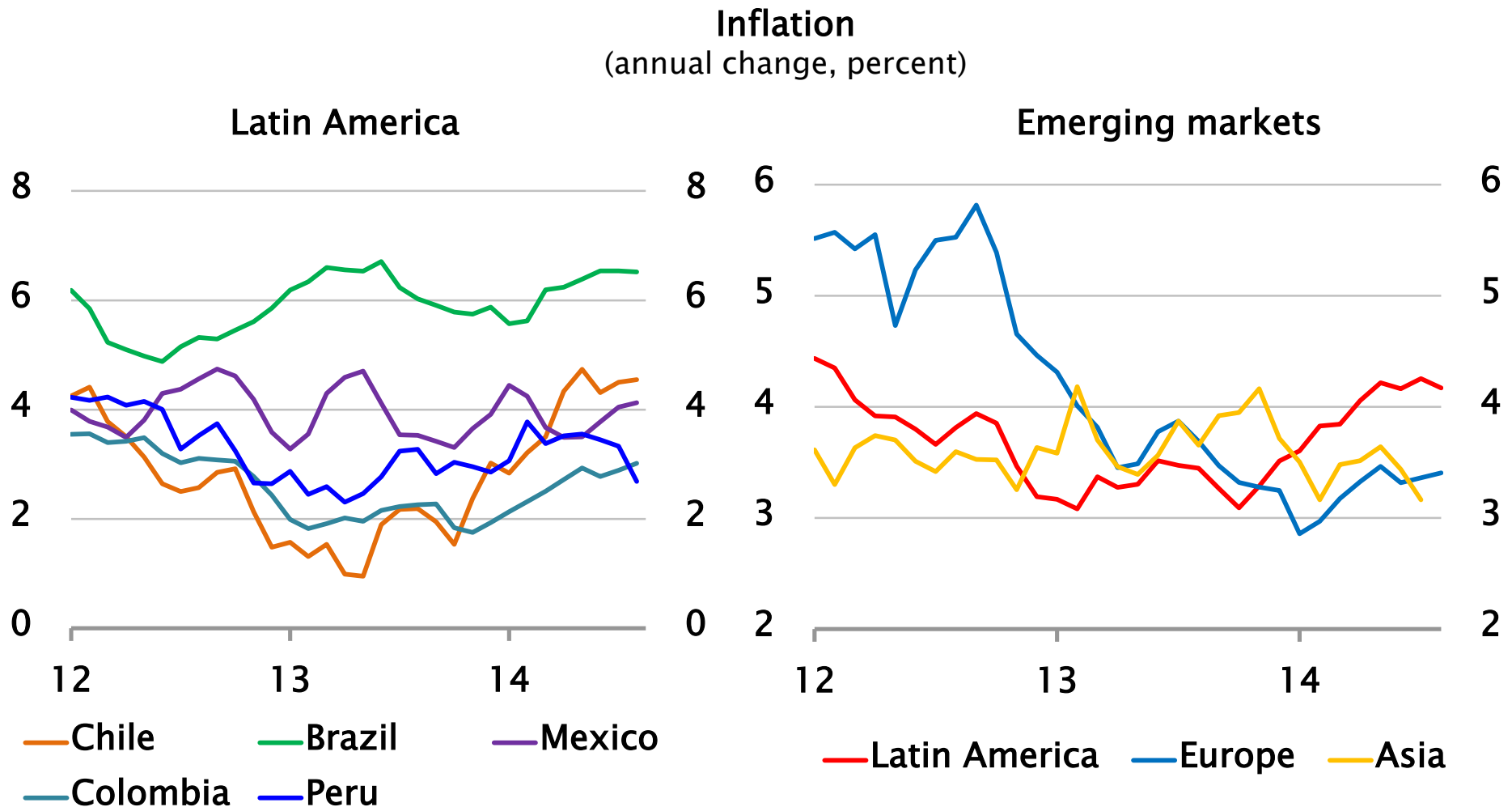
— Latin America — Asia — Europe

(1) An increase denotes a depreciation of the currency against the US dollar. (2) Measured at PPP.

Source: Bloomberg.



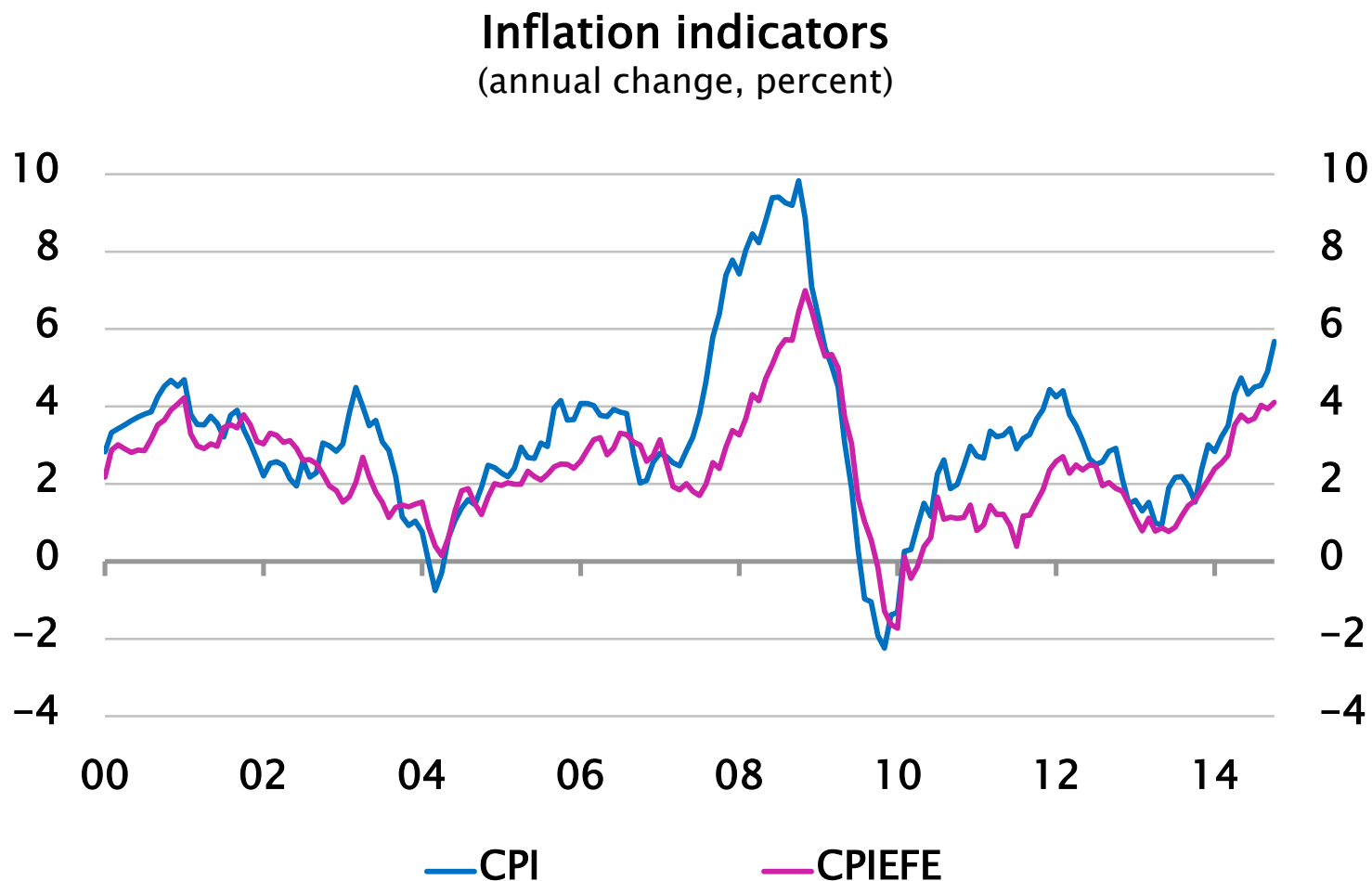
Inflation figures in Latin America have increased, reflecting the movement of the exchange rate, whereas in other emerging economies, inflation rates were lower...



Sources: Bloomberg and Central Bank of Chile.



The strong depreciation of the Chilean peso has had a significant impact on inflation, which has remained over 4% annually for several months.



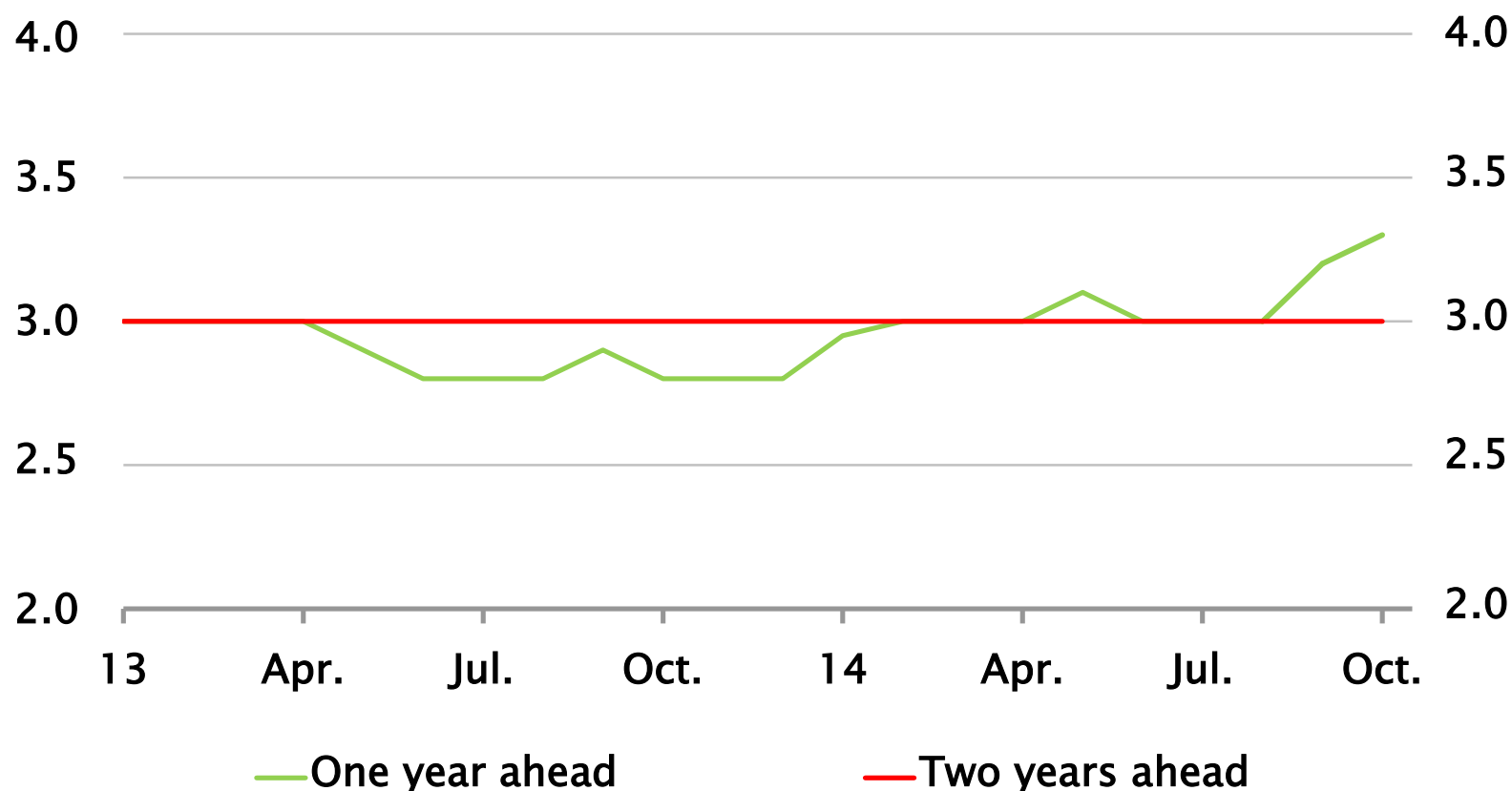
Sources: Central Bank of Chile and National Statistics Institute.



It is foreseen that the current high inflation rates will be transitory. Longer-term market expectations support that view.

Market inflation expectations

(annual change, percent)



Source: Economic Expectations Survey, Central Bank of Chile.



Policy options

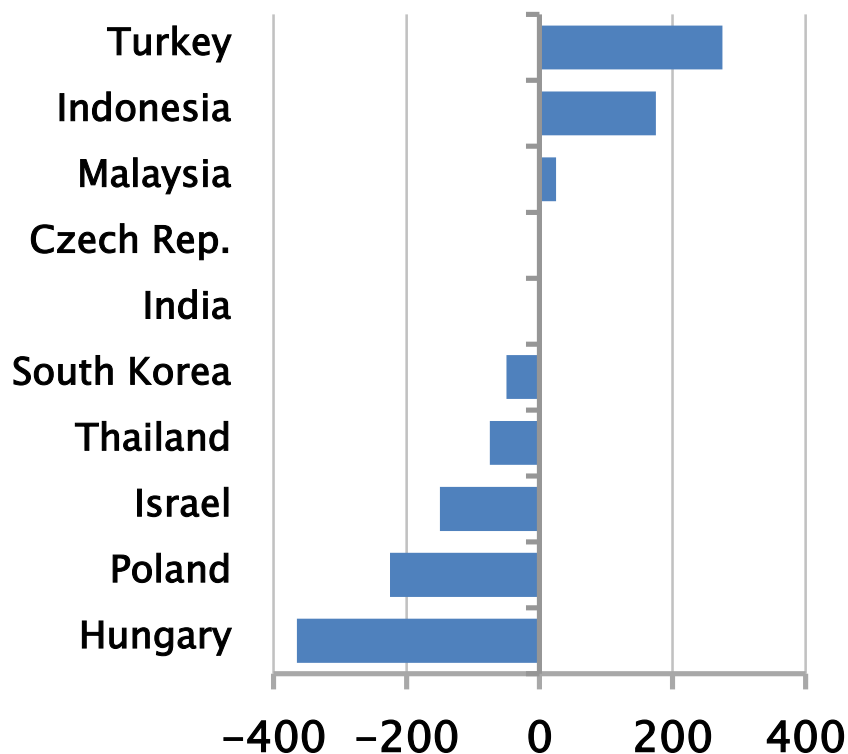
- Policy options in Latin America (more generally, in EMEs)
 - Currency depreciation
 - Even more depreciation if countercyclical monetary policy is in place
 - Policy interest rate increase to stop depreciation
 - FX intervention
 - Capital controls (outflows)
 - Fiscal policy (several options)
 - A mix of all of the above



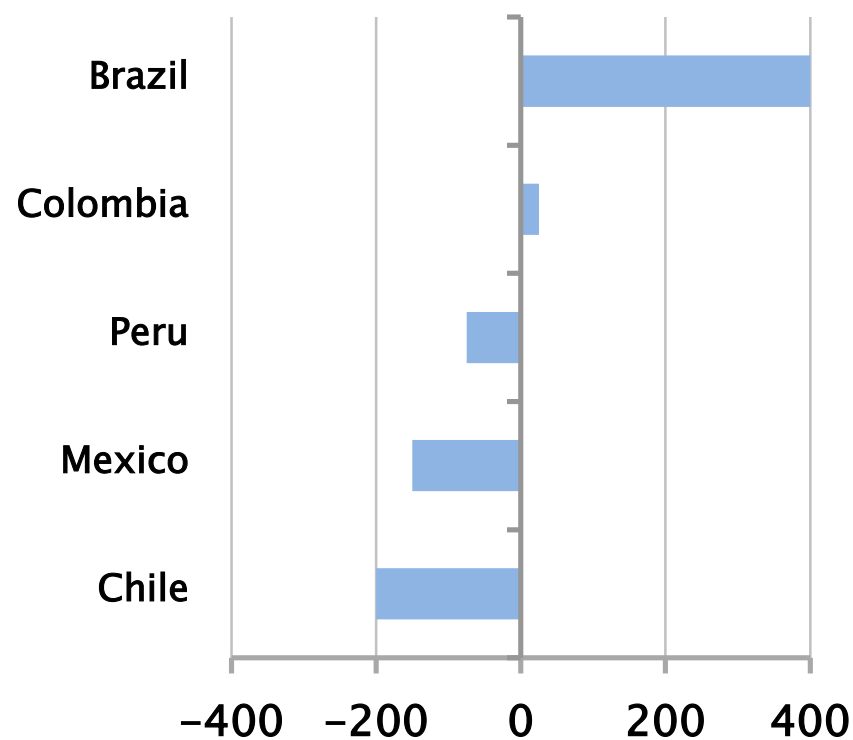
Facing an economic slowdown, currency depreciation and higher inflation rates, not all the emerging economies have been able to accommodate their monetary policy towards a more expansionary stance.

Change in monetary policy rate since 2 January, 2013
(basis points)

Other emerging economies



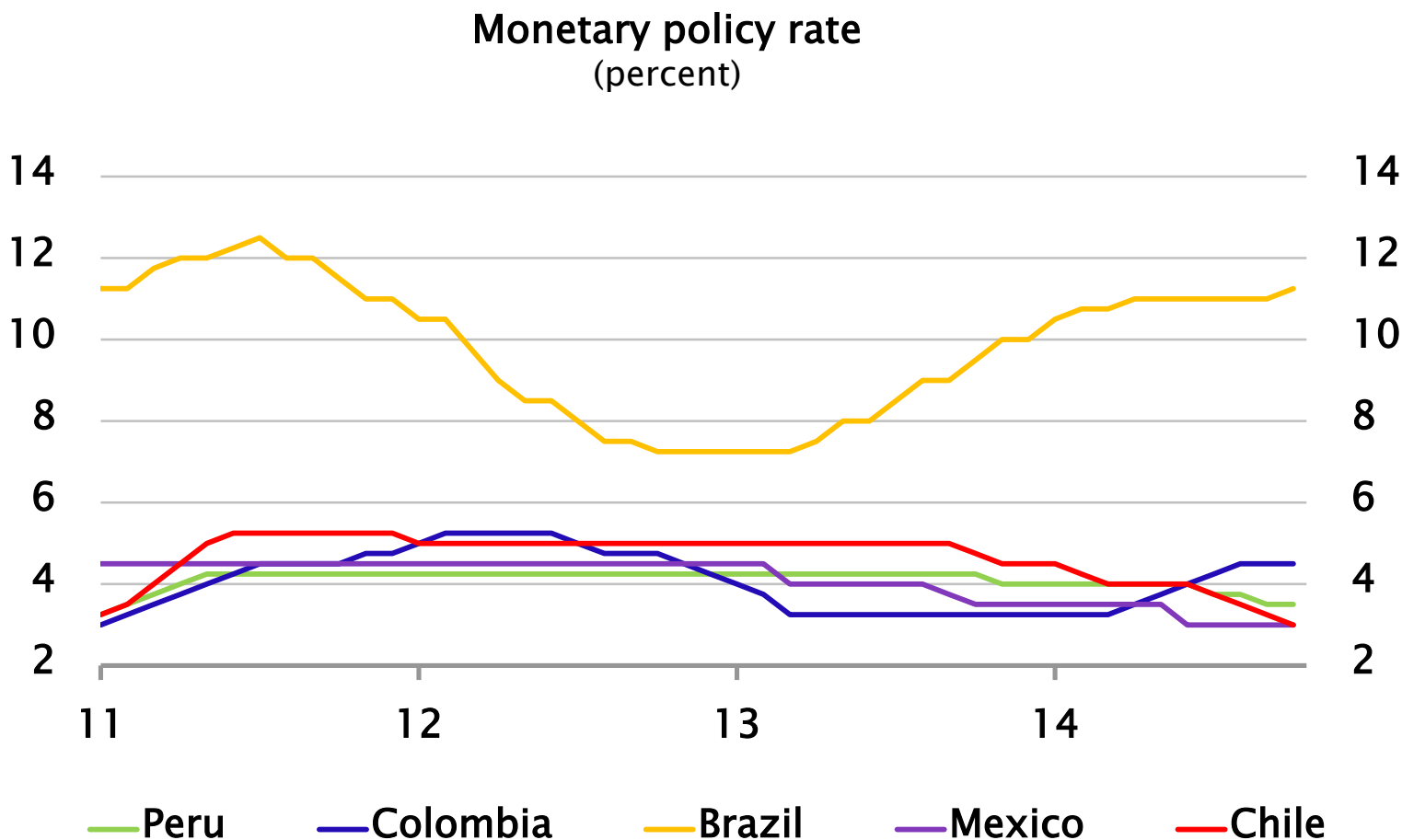
Latin America



Source: Bloomberg.



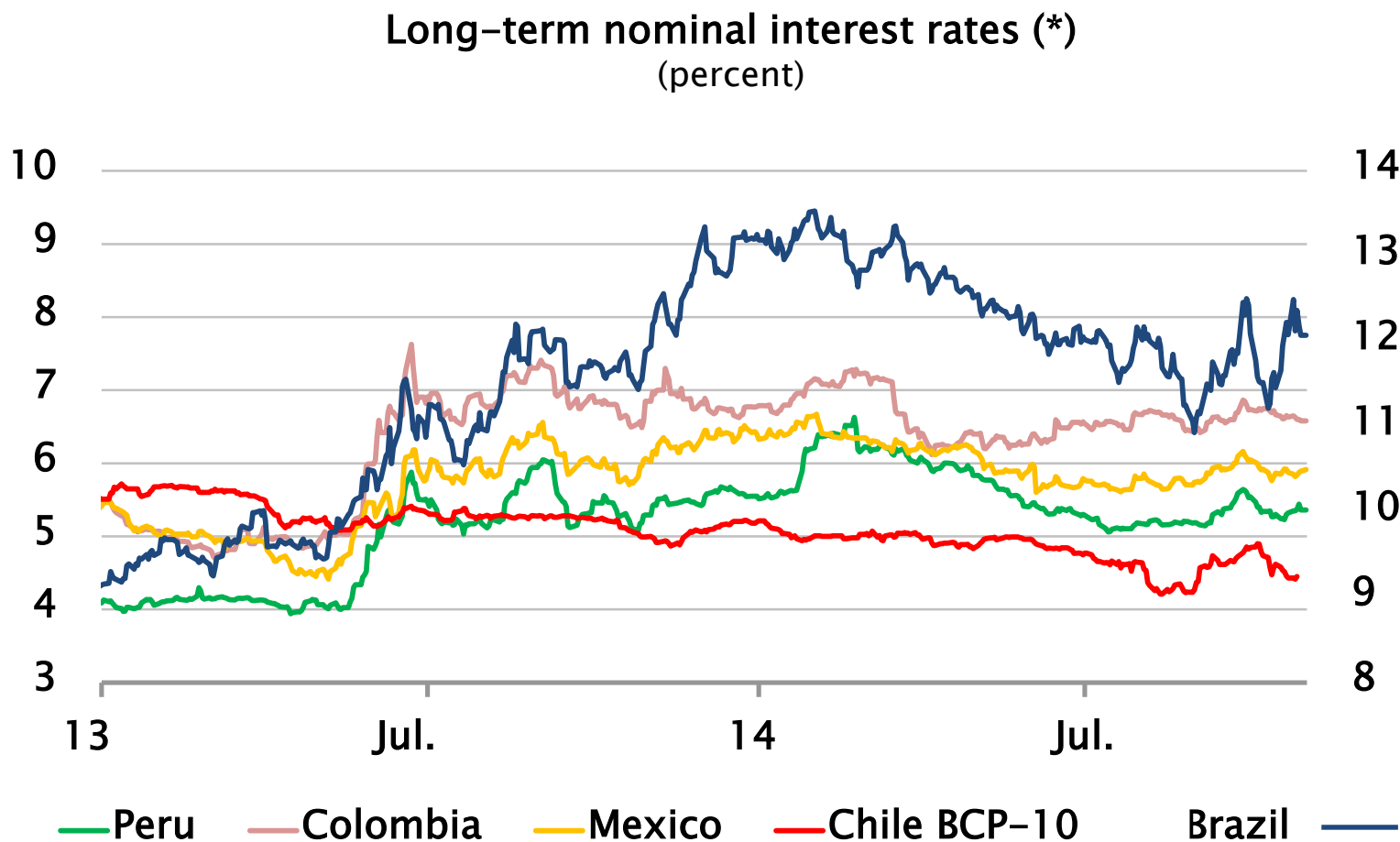
In Chile, the Board of the CBC has cut the rate by 200bp since October 2013, to 3%.



Sources: Central Bank of Chile and Bloomberg.



The lower MP rate in Chile has also been transmitted to long-term domestic financial market rates, to even historical minimums.



(*) Considers 10-year government bonds.

Sources: Bloomberg and Central Bank of Chile.

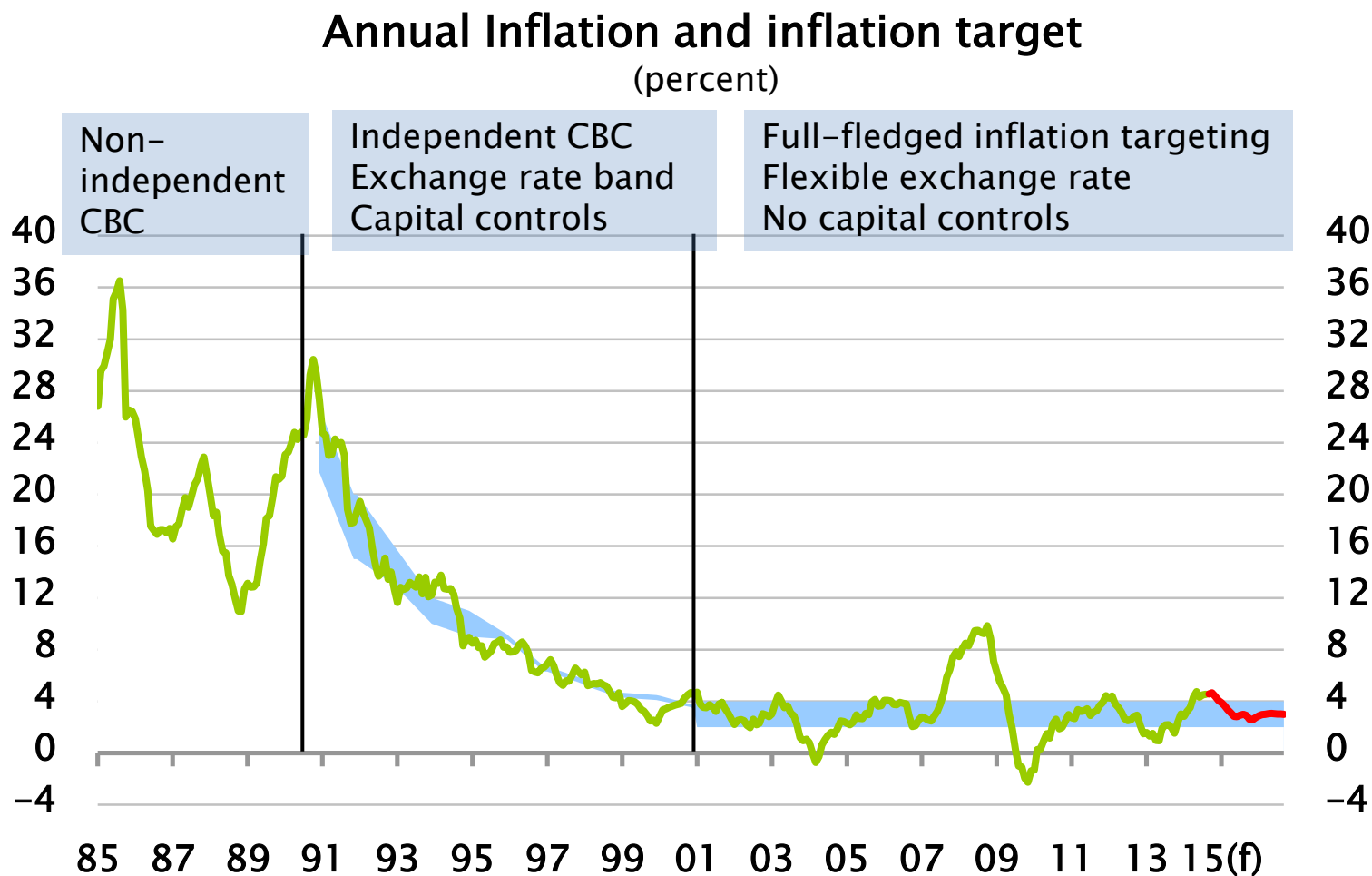


The Chilean Macroeconomic Pillars

- The option taken by Chile... for a decade and a half already.
 - Monetary policy based on an inflation target
 - Exchange rate float
 - Fiscal rule
- The other macroeconomic policy pillars:
 - Trade openness and capital mobility
 - Solid financial regulation/supervision



But, it was not always the case.



(f) Forecasts, Monetary Policy Report, September 2014.
Sources: Central Bank of Chile and National Statistics Institute.



Why did we move to a flexible inflation–targeting regime?

- Macroeconomic problems in EMEs have been often associated with:
 1. Credit booms
 2. Real exchange–rate overvaluation
 3. Large current–account deficits
- The literature shows that those phenomena are more frequent in rigid currency regimes than in floating regimes, particularly during episodes of large capital inflows.*
- In part because the extent of FX leverage, currency mismatches and foreign exchange loans in the banking and corporate sectors are significantly lower in floats than in less flexible regimes.[▲]
- And because the conduct of monetary and fiscal policies in rigid currency regimes during episodes of foreign capital bonanza tend to be pro–cyclical.

* See, for instance, Mendoza and Terrones (2010), Ghosh, Ostry and Qureshi (2013).

[▲] Ghosh and others (2014); Jeanneau and Micu (2002).



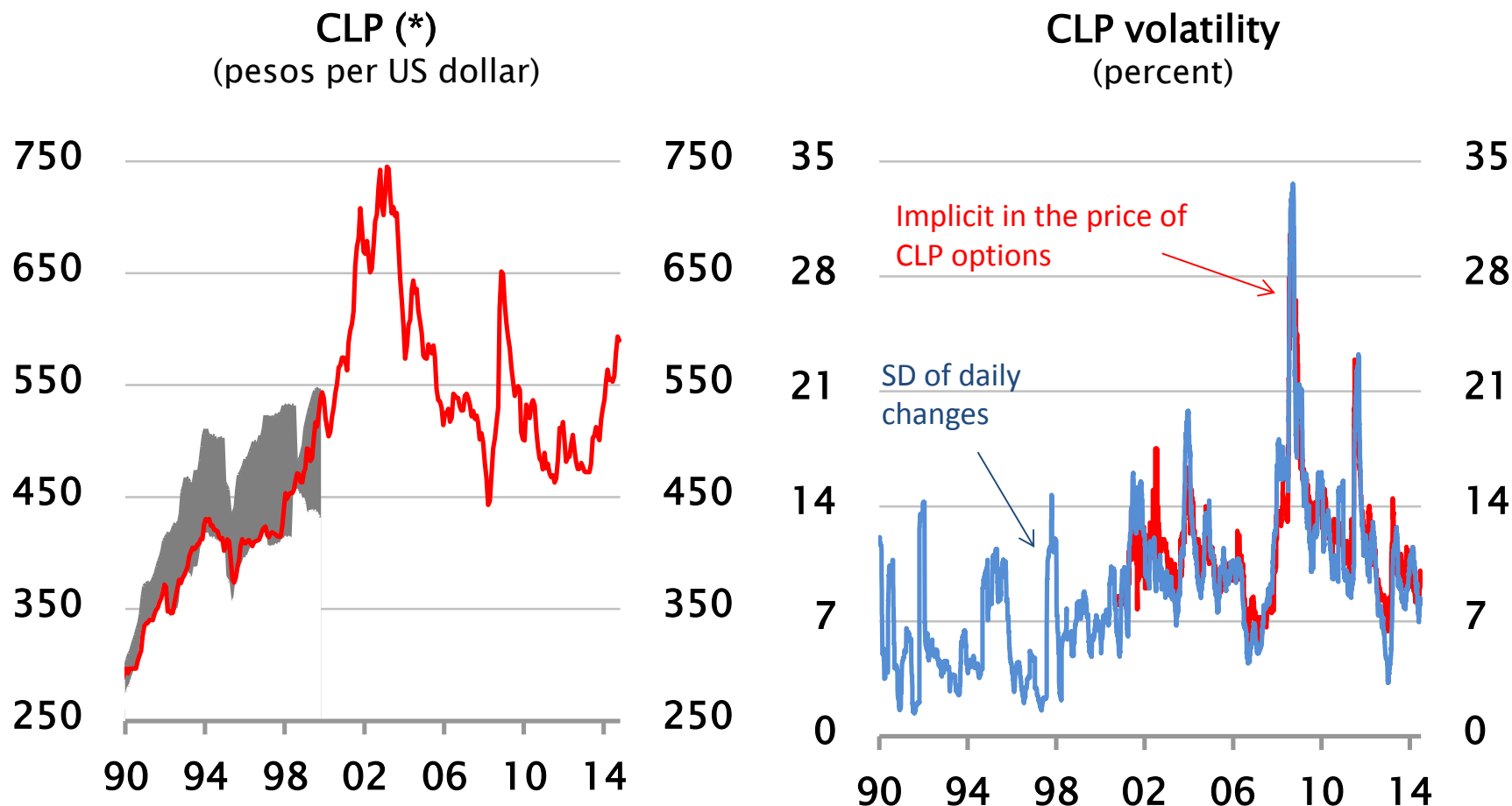
Why did we move to a flexible inflation–targeting regime?

- During the recent Global Financial Crisis (GFC), ITers were able to implement more aggressive countercyclical monetary policies that allowed the exchange rate to absorb more of the adverse external shock, without a deterioration in their risk assessment by markets (Carvalho Filho, 2011).
- Also, less currency mismatches allow for greater flexibility of the exchange rate and monetary policy during periods of market turmoil.
- Of course, in a financially integrated world it is not possible to insulate the economy from a the global financial cycle.
- The experience during the 1990s proved that capital controls did not have a big impact on the economy, that effects lasted mostly a short period and that with the exception of shifts in the composition from “short-term” debt inflows to “long-term” debt inflows, there were no other persistent effects. *

* See, for instance, Gallego and others (2000), De Gregorio and others (2000).



The flexible exchange rate has become the main shock absorber, allowing to carry out an independent monetary policy.

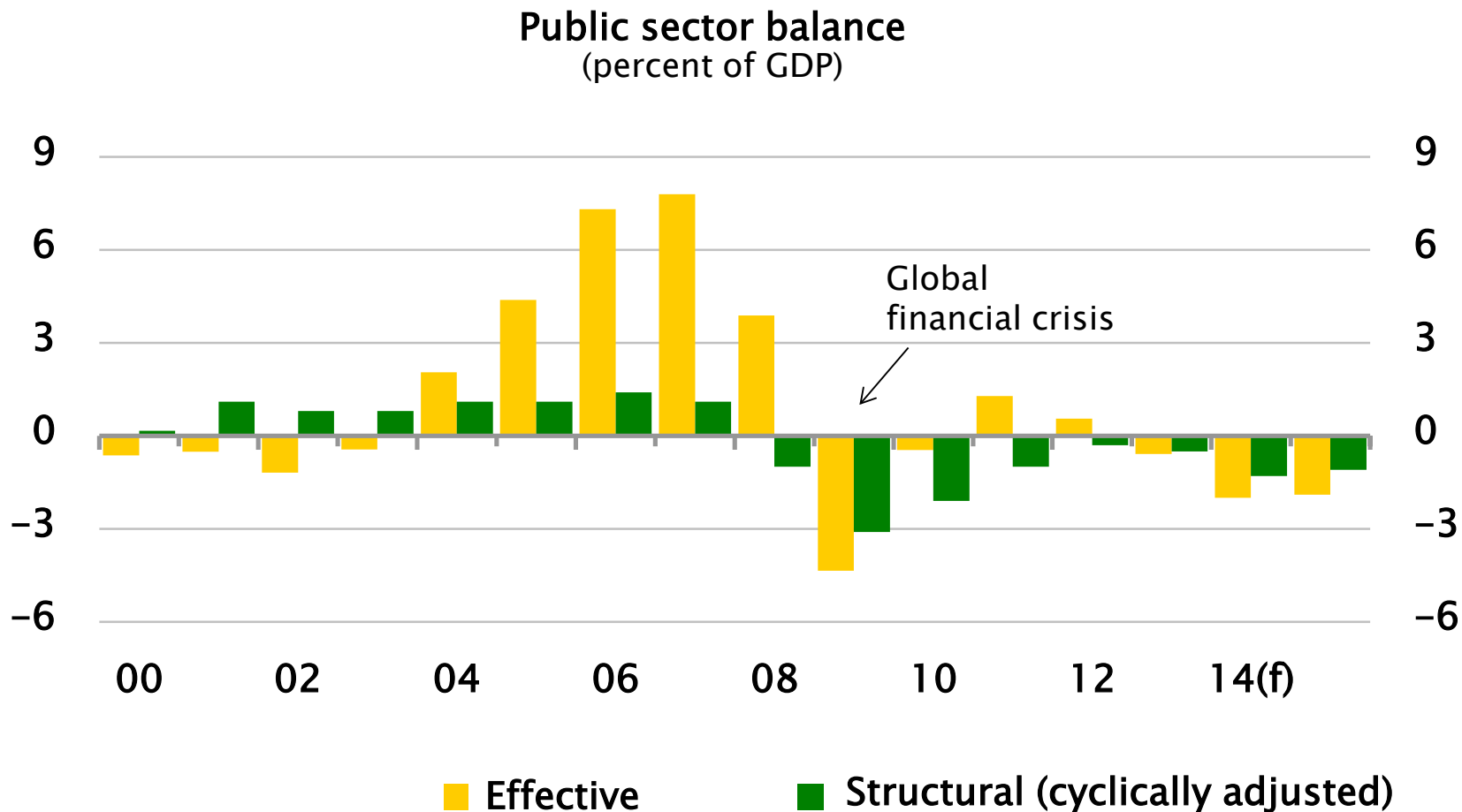


(*) An increase indicates a depreciation of the currency against the US dollar. The exchange rate bands are the upper and lower limits of a range inside which the exchange rate is allowed to float. This system operated until September 1999.

Sources: Bloomberg and Central Bank of Chile.



...coupled with a rule-based fiscal policy...

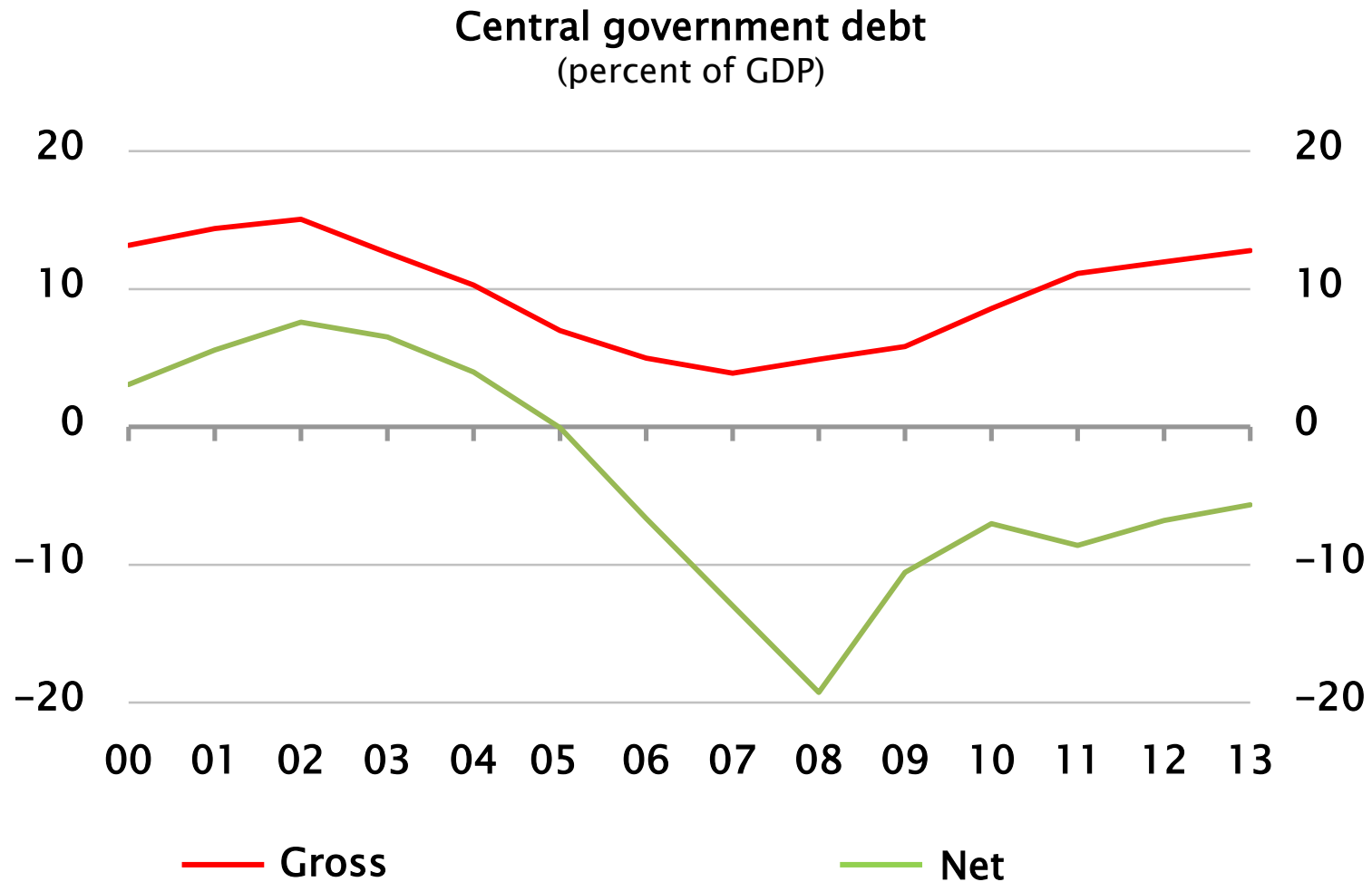


(f) Forecasts.

Source: National Budget Department, Ministry of Finance of Chile.



...while keeping fiscal accounts in order and inflation expectations anchored.



Source: National Budget Department, Ministry of Finance of Chile.



Sound financial system

- To work properly, this policy framework requires a sound financial system.
- In the case of Chile, the banking sector is characterized by good levels of capital and liquidity adequacy.
- Banking regulation will converge to Basel III standards.
- The level of leverage is reasonable in both the household sector and the corporate sector.
- Dollarization is low.



Final remarks

- The Chilean economy is undergoing a phase of low growth. Investment has remained weak for several quarters and consumption has slowed down.
- In the most likely scenario, we expect that the economy will resume higher growth rates towards 2015. Improved confidence of business and consumers is essential for this outcome.
- The macroeconomic adjustment has occurred so far via a more expansionary monetary policy and a depreciation of the Chilean peso.
- Inflation has increased above 4% annually because of the depreciation, but is expected to return to the 3% target during 2015.
- Chile's macroeconomic policy framework includes: an IT-scheme; flexible exchange rate regime; a fiscal rule; a sound financial supervision and regulation; and trade and financial openness.



Latin America's adjustment to a changing economy. The case of Chile

Rodrigo Vergara
Governor
Central Bank of Chile