



Chile's macroeconomic policy framework: Facing a changing world

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The Chilean economy: past and present

		1990	2013
Per capita GDP	PPP	5,851	22,534
	% of US	24	43
Poverty	% of population	39	14 (*)
Gini	index	57	54 (*)
External debt	public (% of total)	56	6
	private (% of total)	44	94
Trade (X+M)	% of GDP	65	66
FDI (gross)	% of GDP	2.1	7.3
Inflation	(annual average of y-o-y; %)	26	1.8
Public debt (gross)	% of GDP	44	12

(*) As of 2011, last available CASEN survey data.



Chile's export matrix

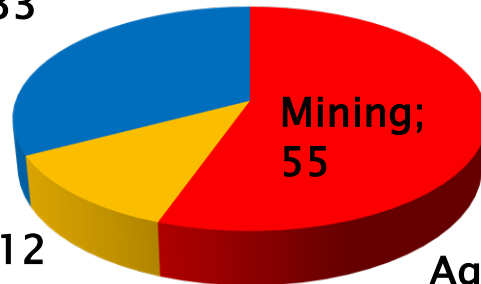
Total by sector

(%)

1990

Manufacturing; 33

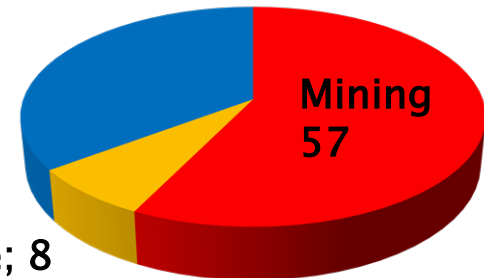
Agriculture; 12



2013

Manufacturing; 35

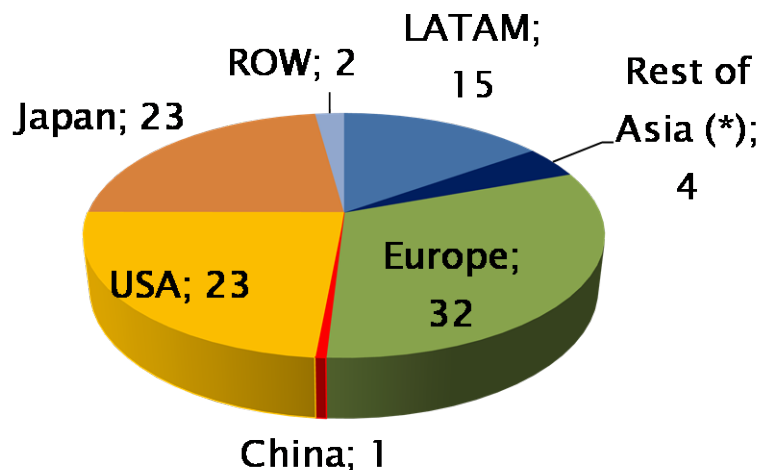
Agriculture; 8



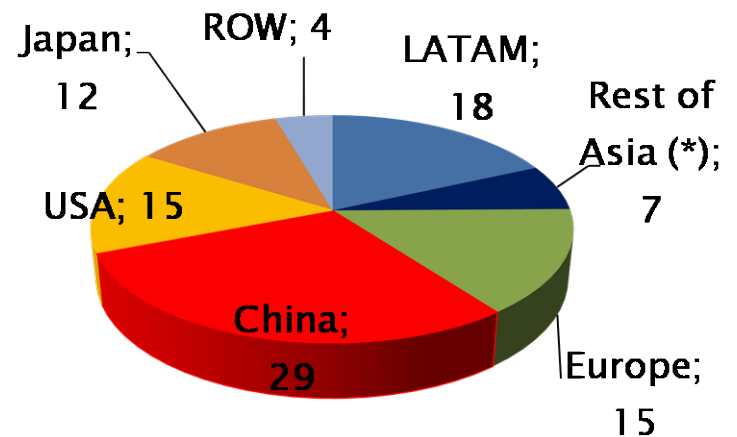
Total by destination

(%)

1990



2013



(*) Excluding China and Japan.
Source: Central Bank of Chile.



Chile's economic policy framework

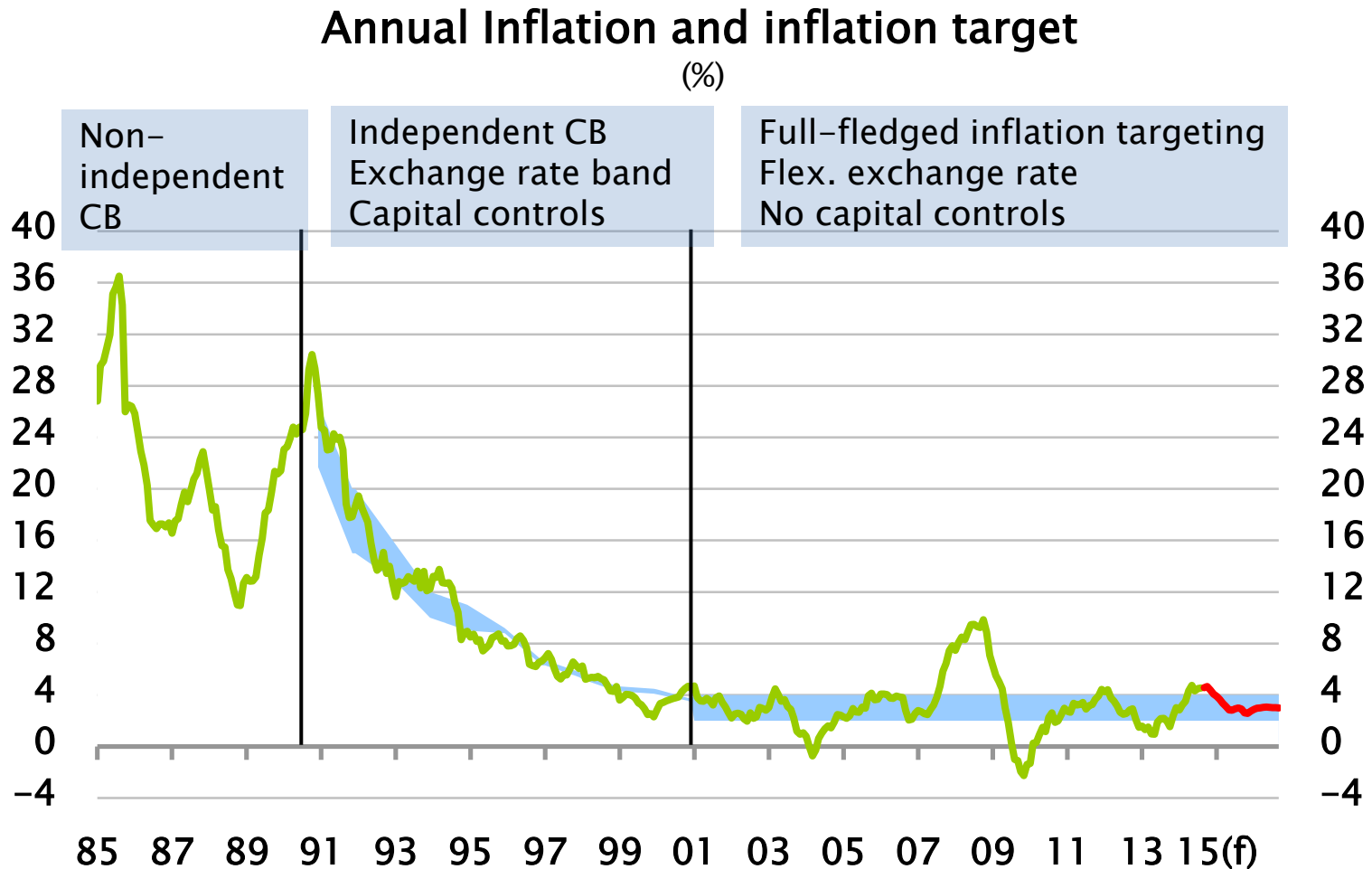


Four pillars of current economic policy framework

1. Inflation-targeting regime and a flexible exchange rate, administered by an autonomous Central Bank.
2. Responsible and predictable fiscal policy based on a rule that isolates expenditures from the business cycle.
3. A prudent regulatory and supervisory framework governing the financial system.
4. Integration into international markets.



..but it was not always the case



(f) Forecasts, Monetary Policy Report, September 2014.

Sources: Central Bank of Chile and National Statistics Institute (INE).



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

- Macroeconomic problems in EM 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).



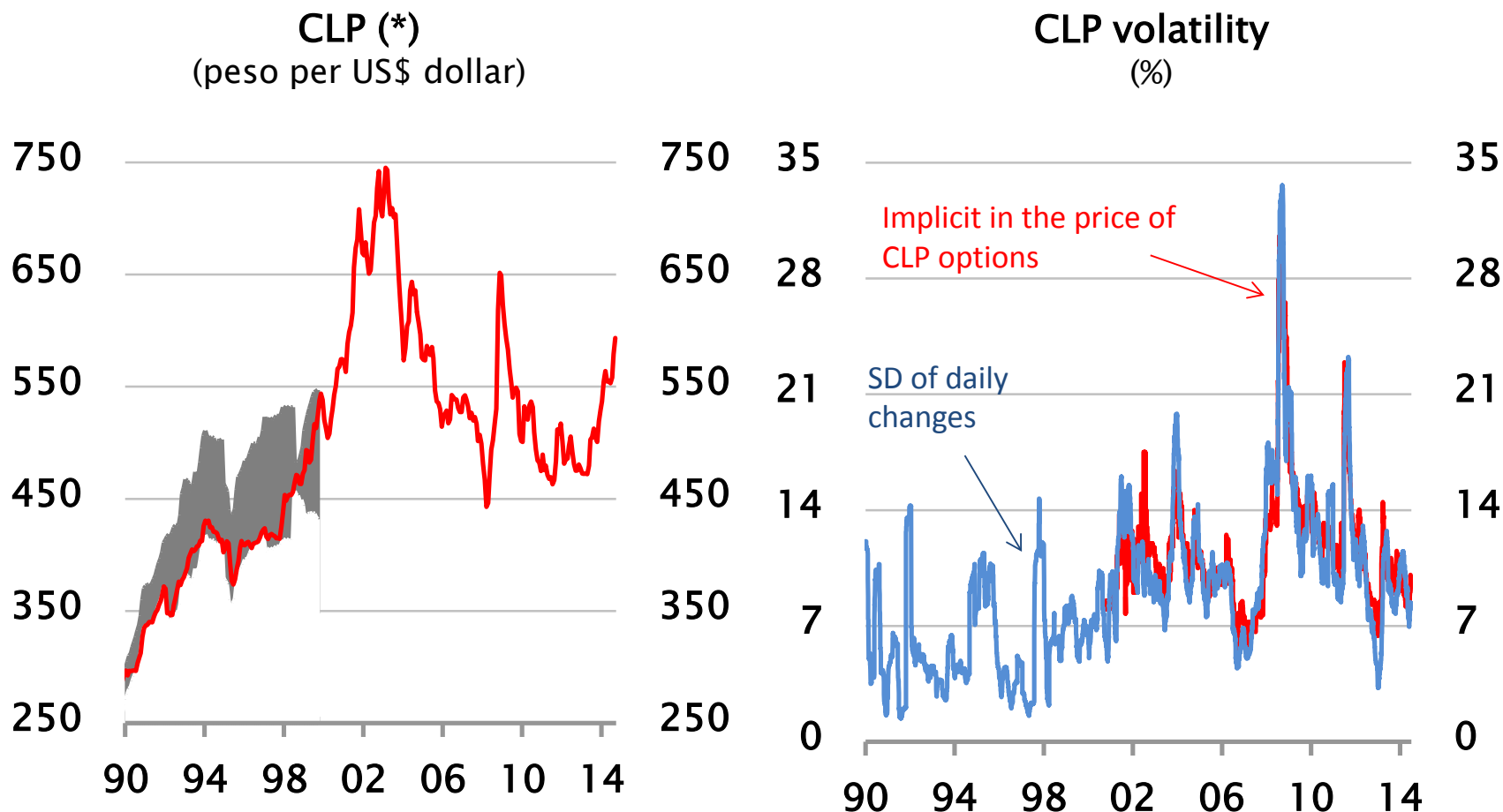
Why did we move to a flexible inflation– targeting regime?

- 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).
- 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 90's 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

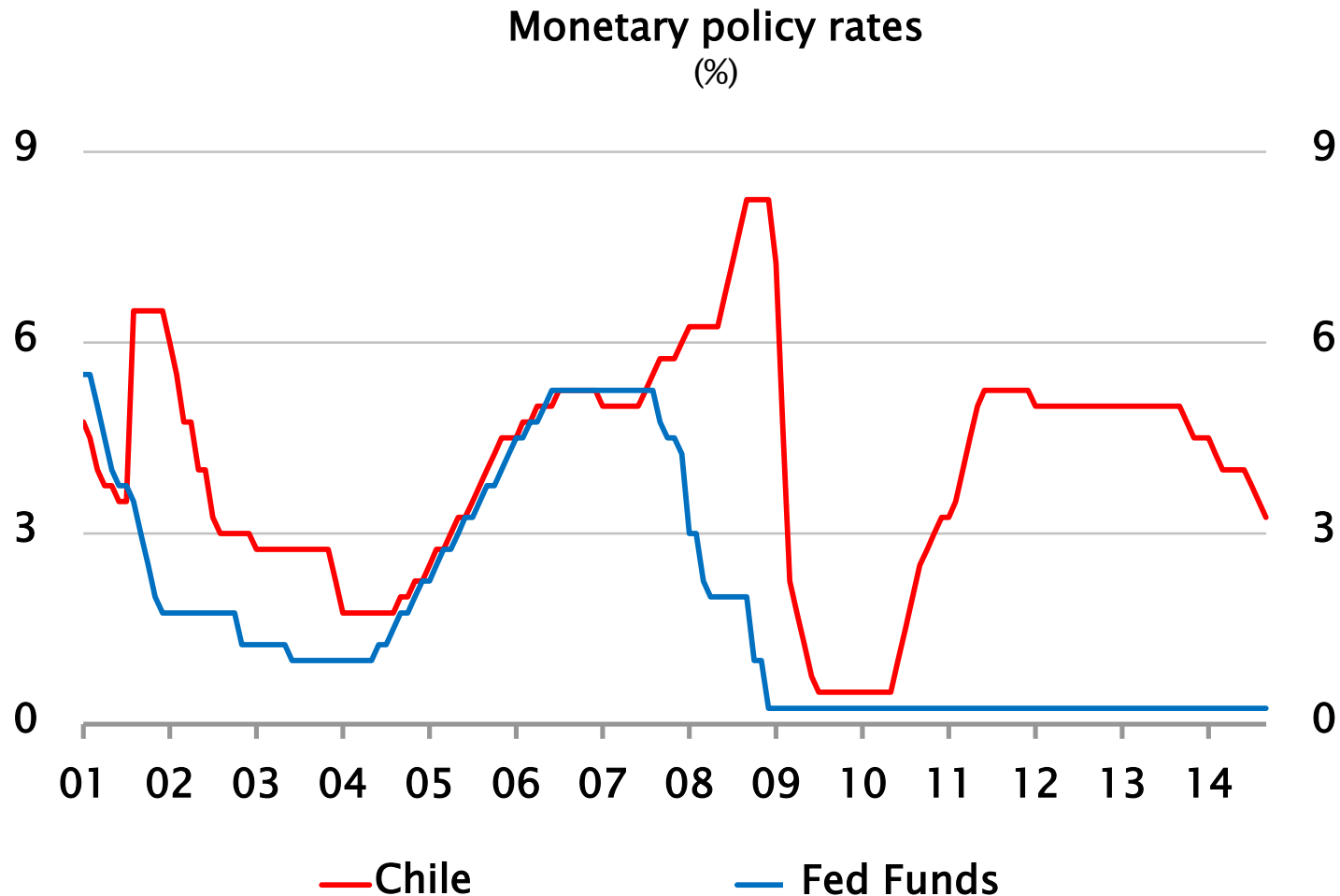


(*) An increase indicates a depreciation of the currency against the US\$. The exchange rate bands are the upper and lower limits of a range inside which the exchange rate is allowed to float. This system operated until September 1999.

Sources: Bloomberg and Central Bank of Chile.



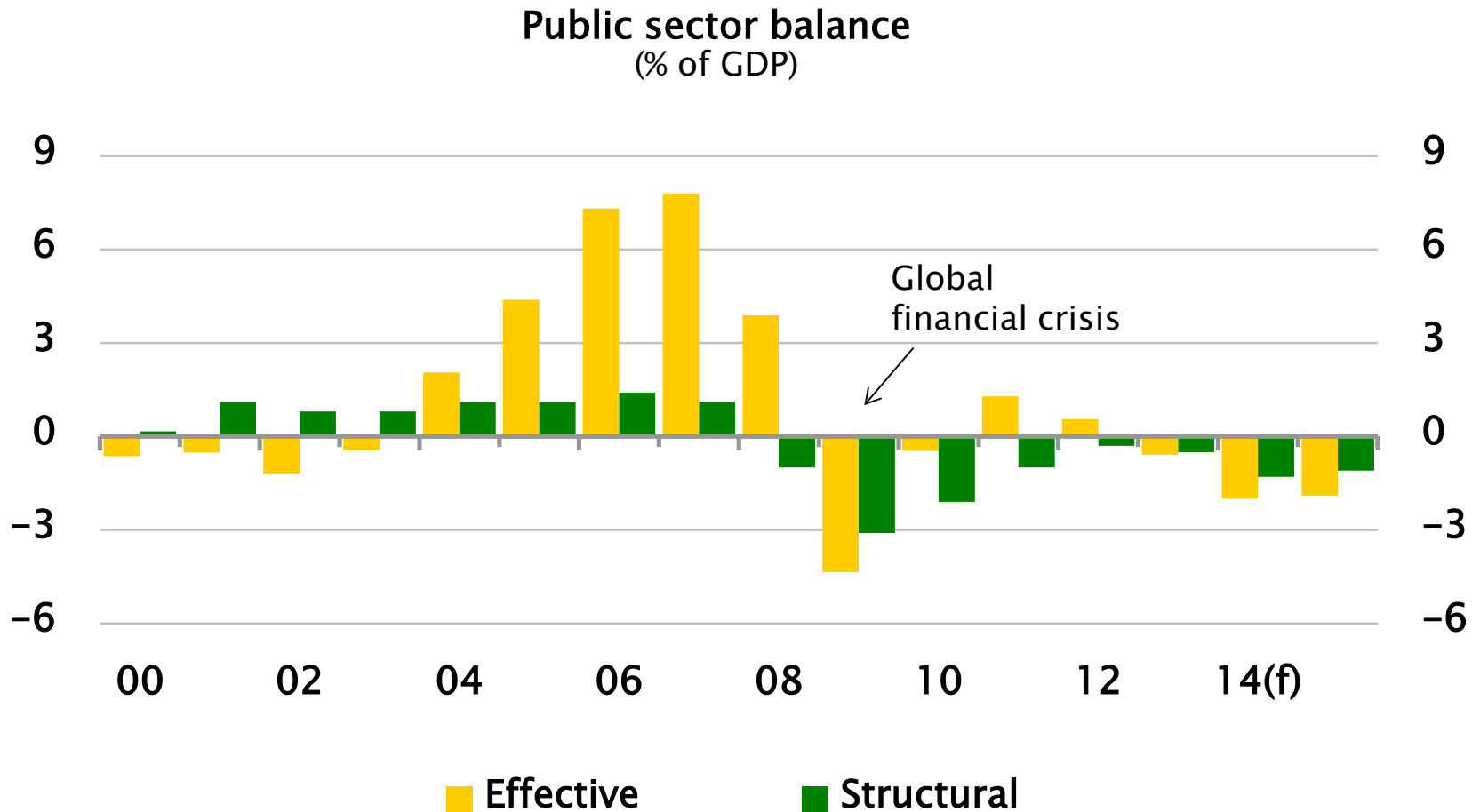
... allowing to carry out an independent monetary policy



Sources: Central Bank of Chile and Bloomberg.



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



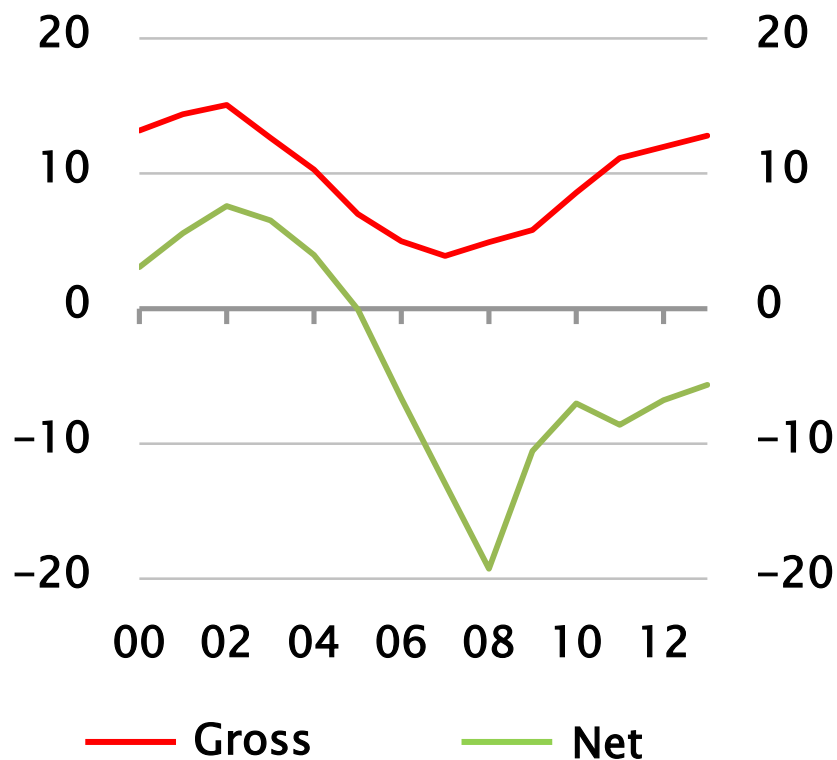
(f) Forecasts.

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

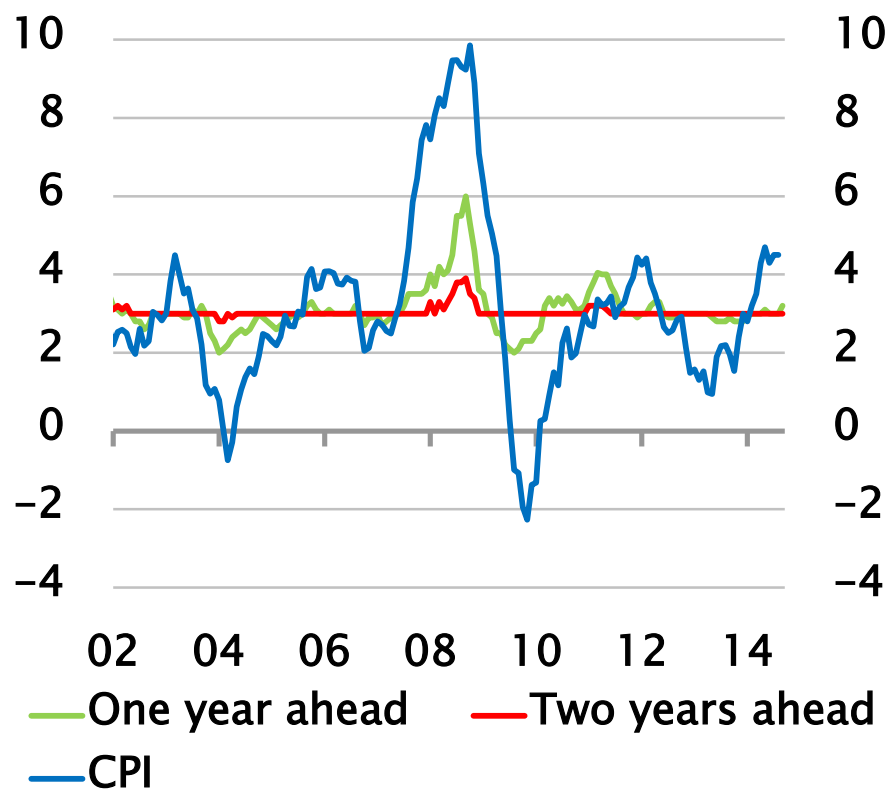


... while keeping fiscal accounts in order and inflation expectations anchored.

Central government debt
(% of GDP)



CPI inflation and expectations (*)
(annual change, %)



(*) Economic Expectation Survey.

Sources: Central Bank of Chile, National Statistics Institute (INE) and National Budget Department, Ministry of Finance of Chile.



Sound financial system

- In order 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 is converging to Basel III standards.
- The level of leverage is reasonable in both the household and the corporate sectors.
- Dollarization is low.

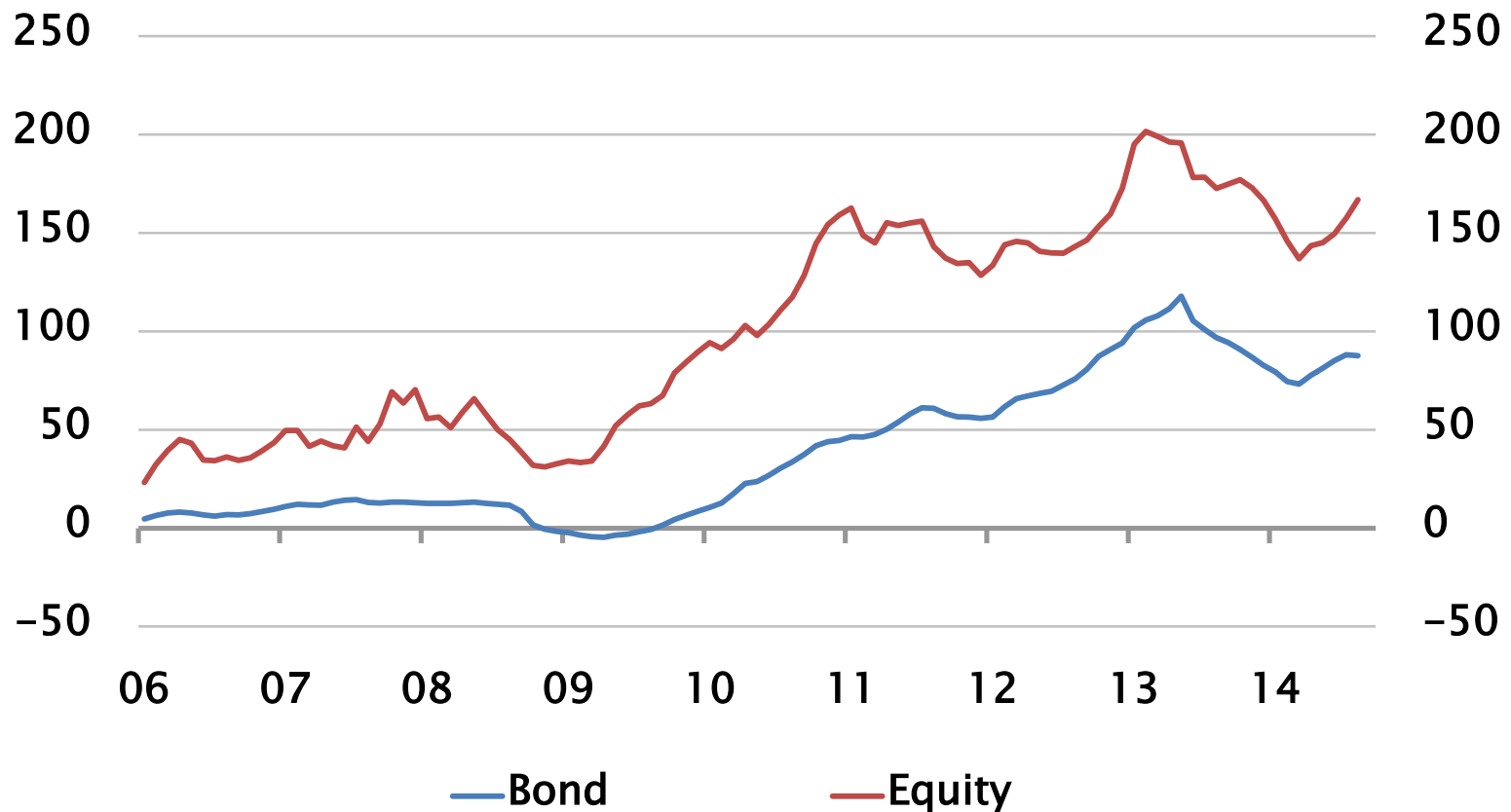


Chile's adjustment to the current international cycle



Global liquidity generated a massive increase in capital flows to emerging markets after the GFC.

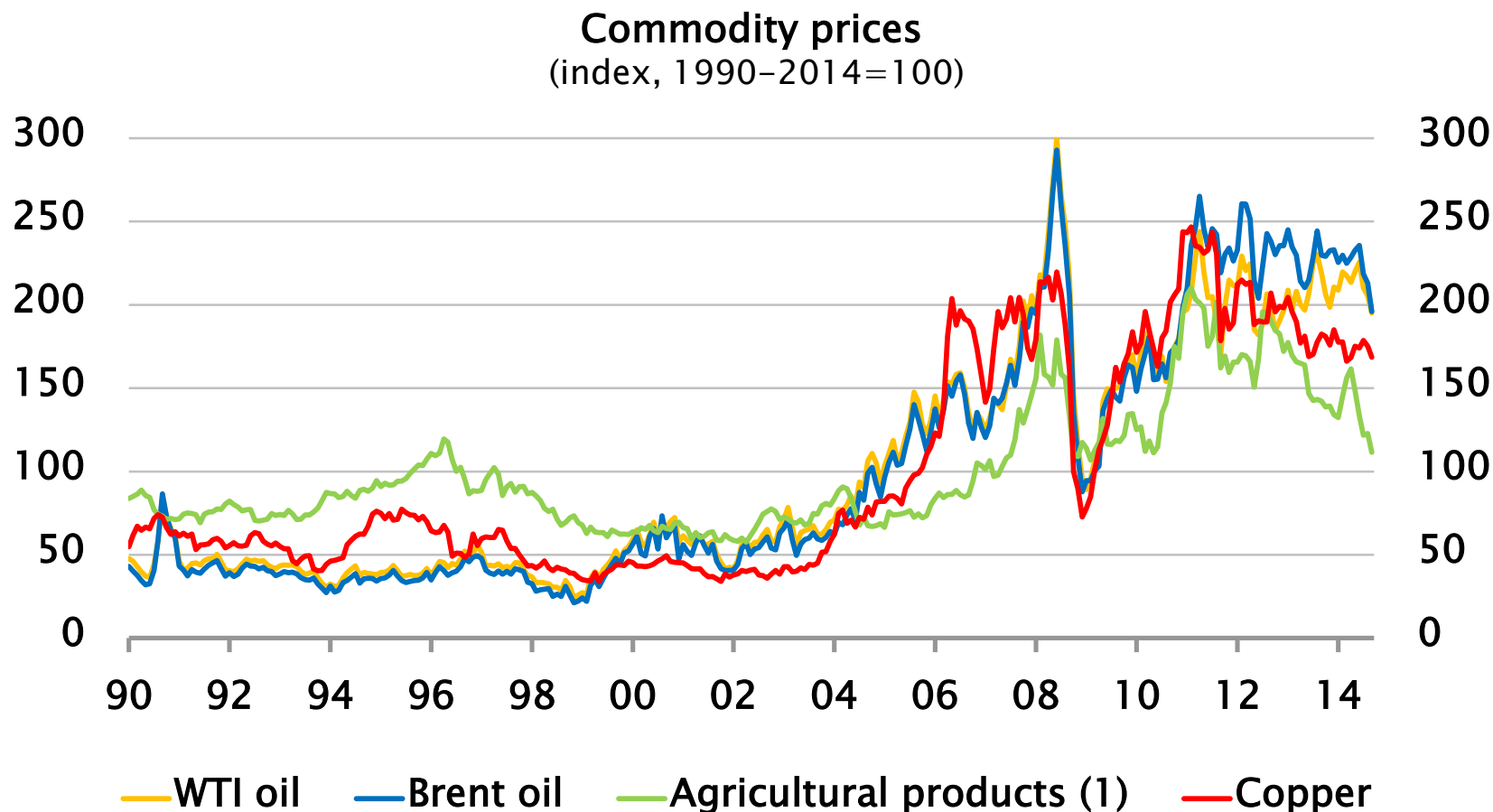
Capital flows to emerging markets
(US\$ billion, accumulated in 6 months)



Source: Emerging Portfolio Fund Research.



That was reinforced by commodity prices that were at their highest historical levels.

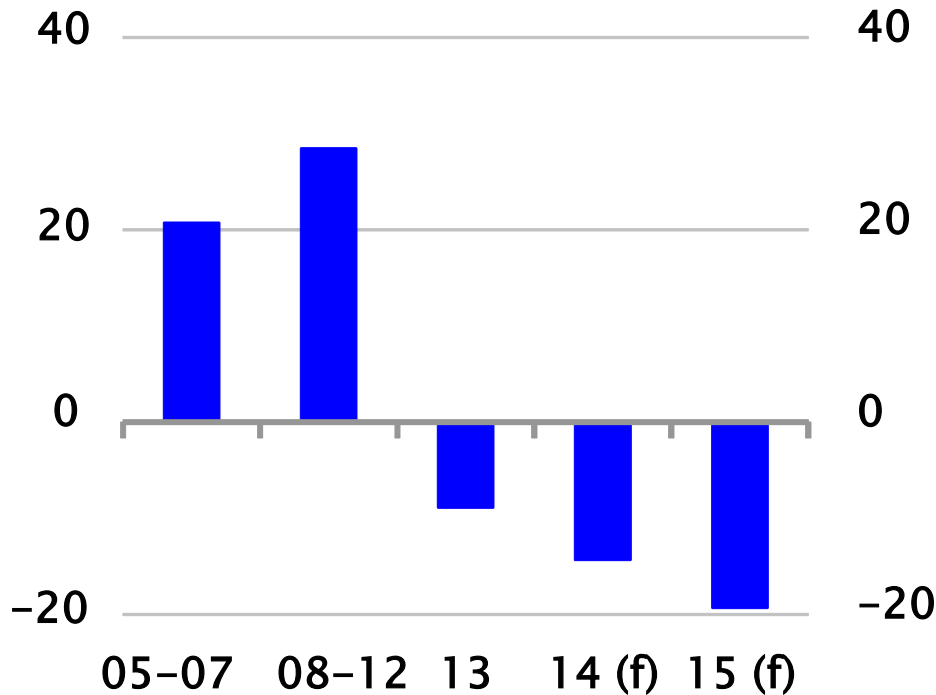


(1) Goldman Sachs aggregate index.
Source: Bloomberg.

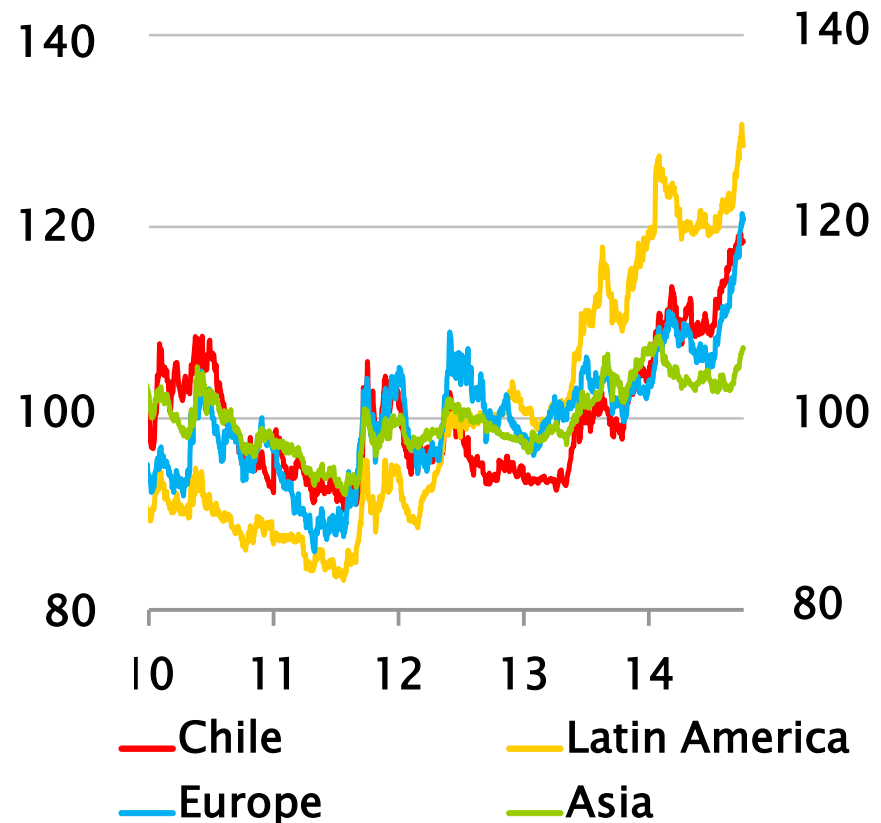


After the “tapering talk” and China’s economy slowdown the game changed

Copper: Capex
(annual change, %)



FX rates in emerging markets (*)
(index, average of period=100)

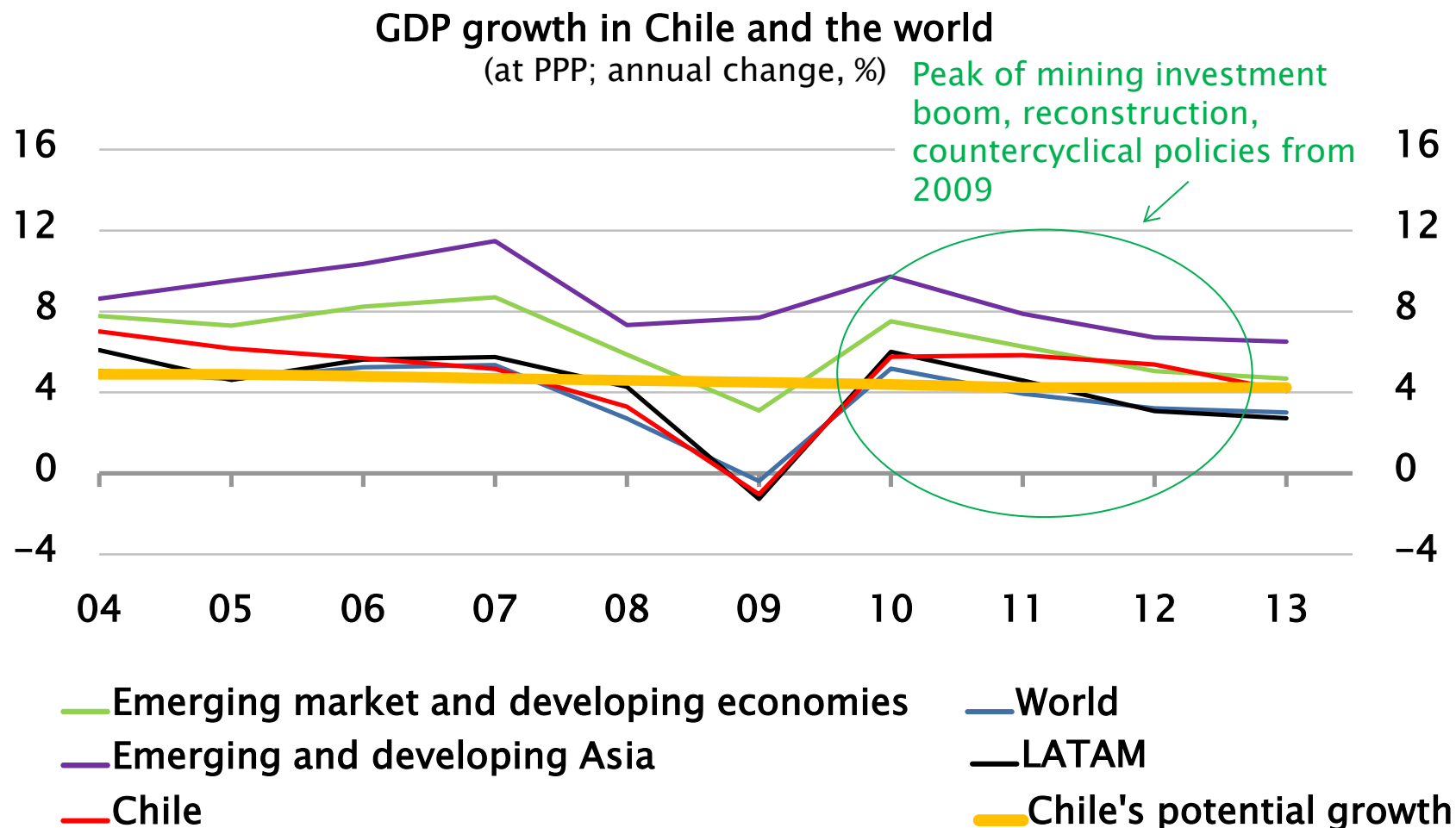


(f) Forecasts, financial information of producing companies. (*) PPP-weighted average for each region. An increase indicates a depreciation of the currency against the US\$.

Sources: Bloomberg and International Monetary Fund.



...triggering an economic adjustment, after several years of above-potential growth

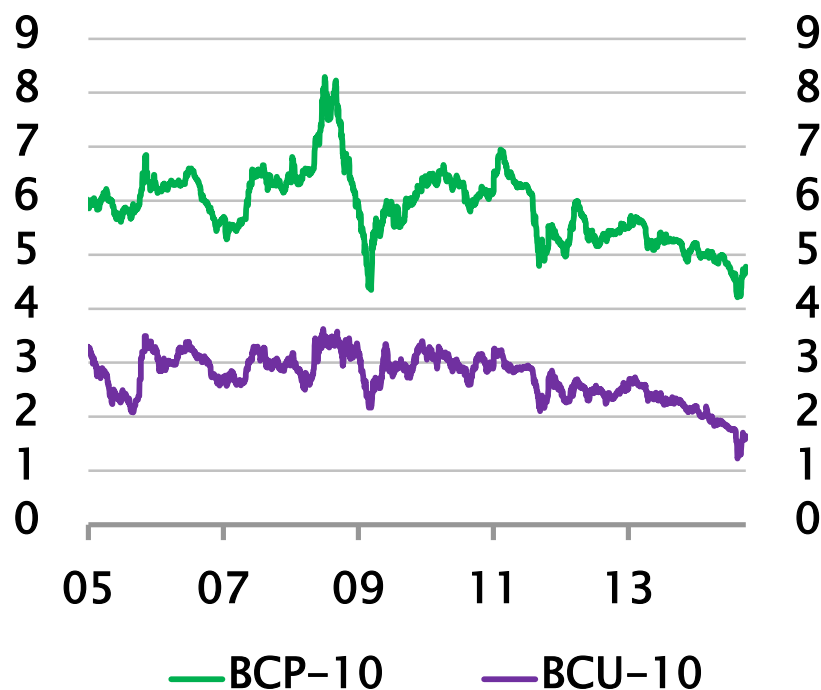


Sources: Central Bank of Chile and International Monetary Fund.

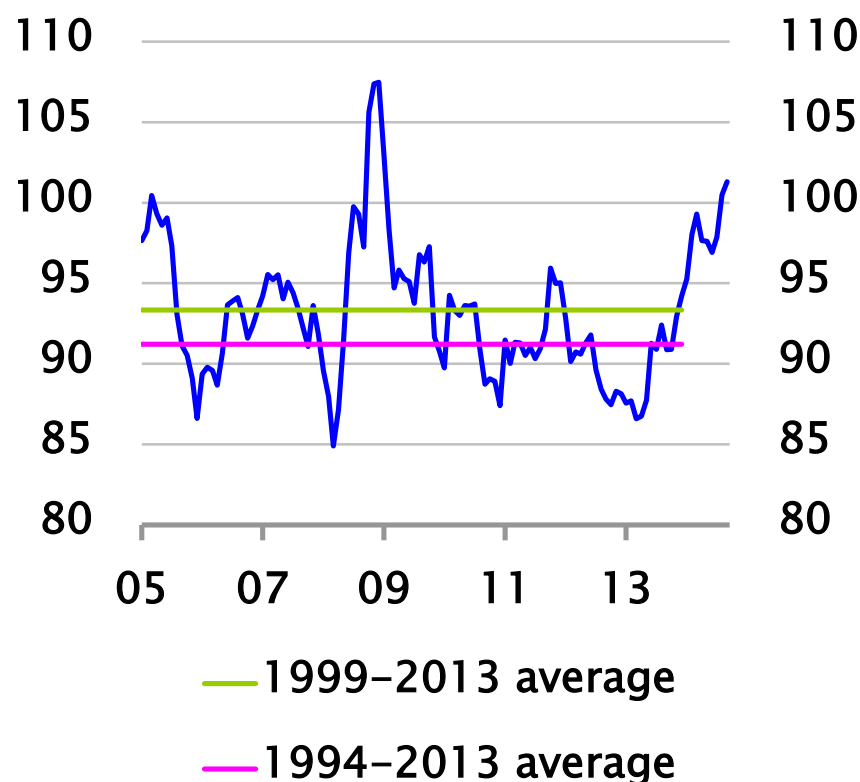


The monetary and fiscal policies are helping the economy to smooth this process.

Long-term interest rates
(%)



Real exchange rate (*)
(index, 1986=100)



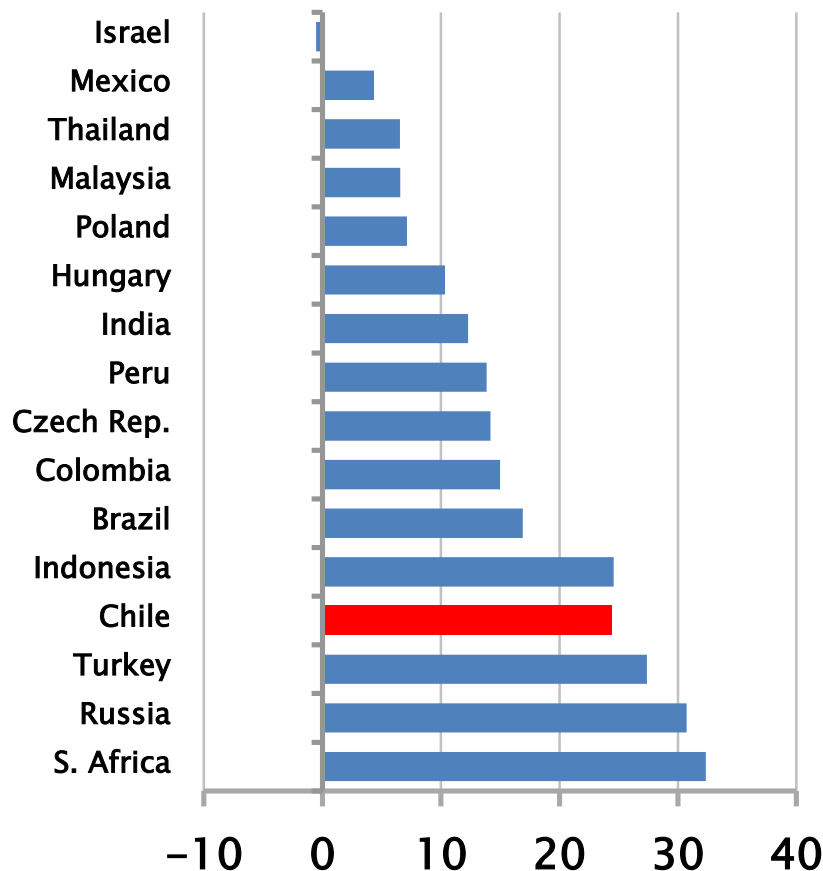
(*) An increase indicates a depreciation of the peso.
Source: Central Bank of Chile.



The FX has depreciated around 25% since last year and long-term interest rates have also declined.

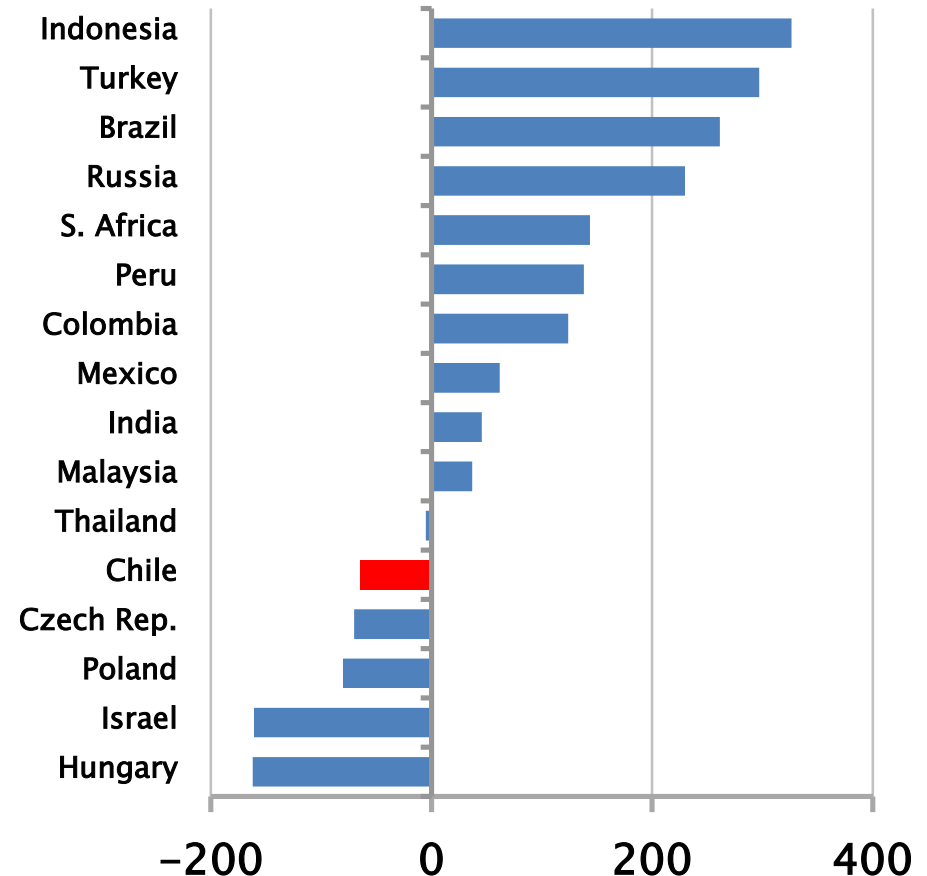
FX depreciation

(change since January 2, 2013, %)



Nominal interest rates on 10-year gov. bonds

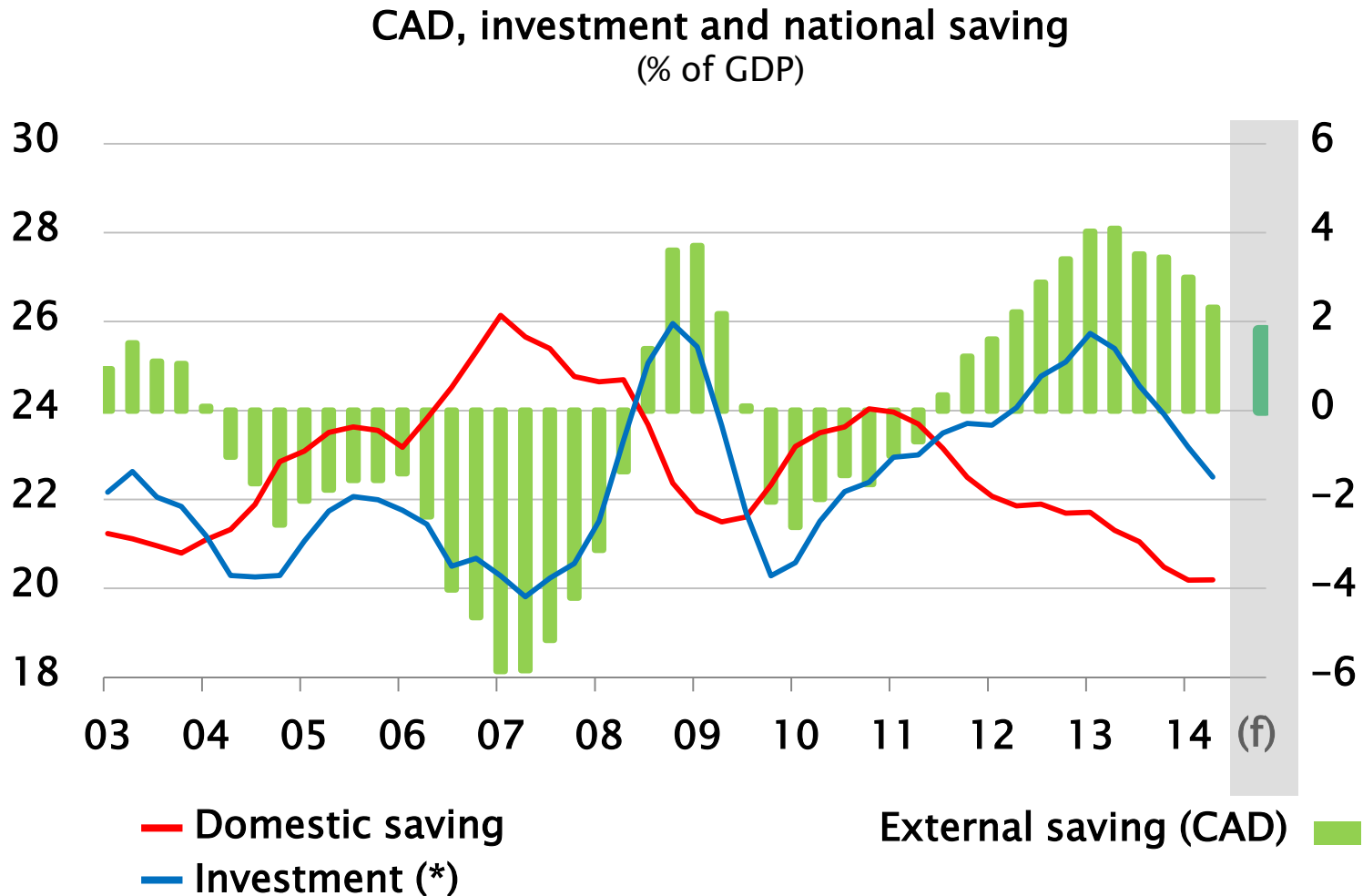
(change since January 2, 2013, basis points)



Sources: Bloomberg and Central Bank of Chile.



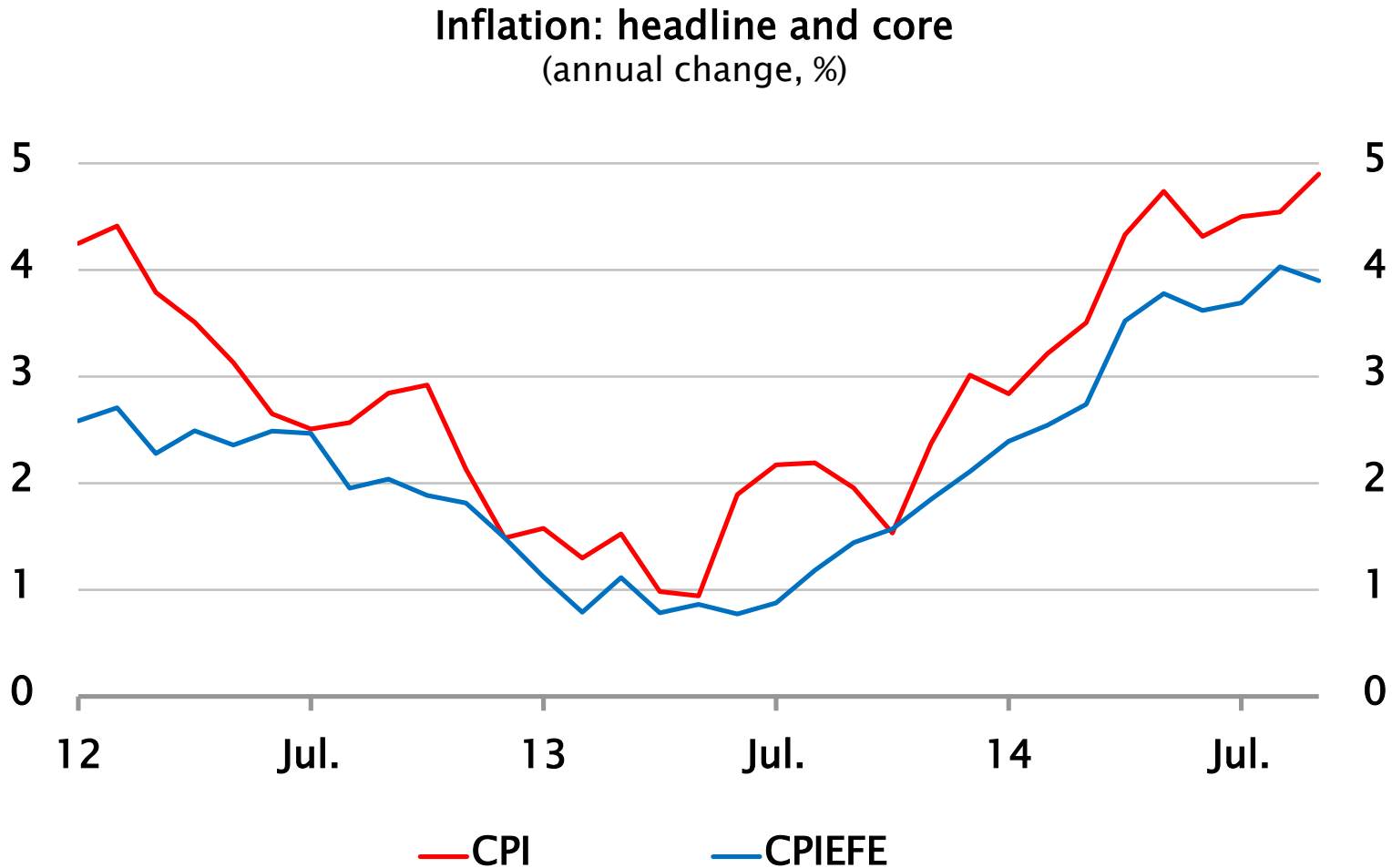
The current account has improved.



(f) Forecast, Monetary Policy Report, September 2014 (*) Considers gross fixed capital formation and inventory adjustments. Sources: Central Bank of Chile, National Statistics Institute (INE).



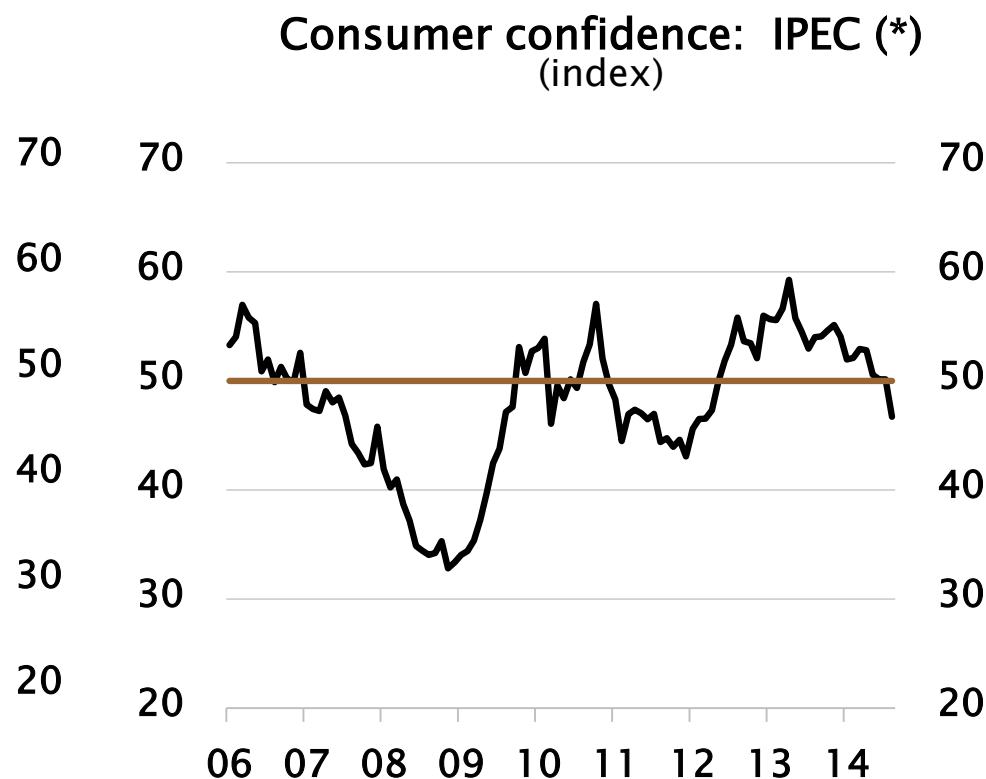
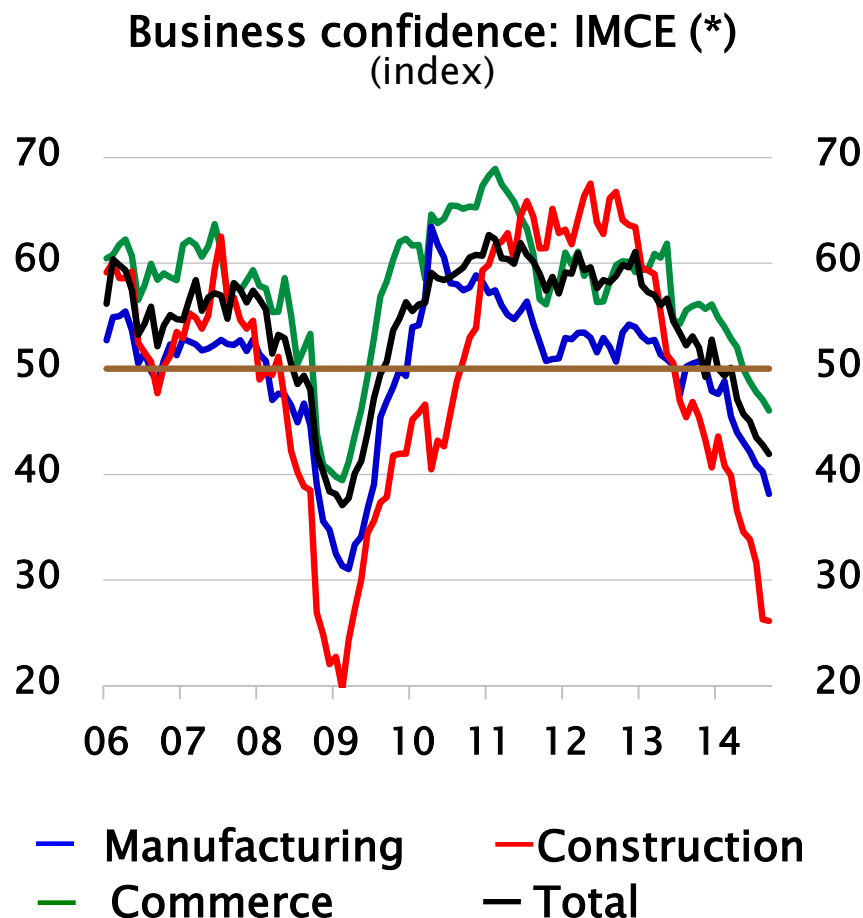
Inflation has increased, mostly because of peso depreciation.



Source: National Statistics Institute (INE).



There are other things going on that explain why the slowdown has been more profound.



(*) A figure above (below) 50 points indicates optimism (pessimism). Seasonally-adjusted series.
Sources: Adimark, Icare/Universidad Adolfo Ibáñez and Central Bank of Chile.



Forecasts

Economic outlook

(annual change, %)

	2012	2013	2014 (f)	2015 (f)
GDP	5.4	4.1	1.75–2.25	3.0–4.0
Domestic demand	6.9	3.4	0.1	3.4
Domestic demand (w/o inventory change)	7.1	4.2	1,0	3.2
Gross fixed capital formation	12.2	0.4	–4.1	1.8
Total consumption	5.6	5.4	2.6	3.6
Goods and services exports	1.1	4.3	2.4	3.8
Goods and services imports	5.0	2.2	–3.9	4.0
Current account (% of GDP)	–3.4	–3.4	–1.8	–2.2
Gross national saving (% of GDP)	21.7	20.5	19.8	19.7

(f) Forecasts, Monetary Policy Report, September 2014.

Source: Central Bank of Chile



As it is always the case, there are some risks

- Although growth in China and its outlook have stabilized most recently, its future performance is still a risk factor.
- The macro-financial situation remains an element of uncertainty in the Eurozone, a situation that is compounded with the geopolitical tensions.
- Global financial markets could suffer major episodes of stress when the Fed Funds rate begins to rise (or the markets to anticipate it).
- In the local economy, one risk is growth of domestic output and demand being less than projected, because expectations do not reverse gradually, as is assumed in our baseline scenario.
- It cannot be ruled out that, at least temporarily, the effects of the exchange rate on inflation could delay the convergence of this variable.



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