Central Bank of Chile's Twentieth Annual Conference
"Monetary Policy and Global Spillovers: Mechanisms, Effects and Policy Measures"

Opening remarks by Governor Rodrigo Vergara

Good morning and welcome to the Twentieth Annual Conference of the Central Bank of Chile. It is a pleasure to host you here in this event that every year gives us an opportunity to reflect and discuss about issues that have direct implications on our work as central bankers from a broader perspective. I am looking forward to active discussions through the rest of the week on this year's conference theme: monetary policy and global spillovers.

Almost ten years have passed since the onset of the Global Financial Crisis and, despite the fact that the global economy has showed clear signs of gradual recovery, the notion that something has fundamentally changed this time around is prevalent in practically every major economic discussion. Of course, this perception is not necessarily at odds with the data. After all, the growth recovery in most Advanced Economies (AEs) has been remarkably slow. Meanwhile, inflation has since remained stubbornly below central bank inflation targets for several years despite unusually expansionary monetary policies.

This economic backdrop, which for many has become the "new normal," poses important questions about our understanding of the economy, and therefore potentially entails significant consequences for the appropriate policy response. Indeed, it has led professional economists, policy-makers, and practitioners in advanced economies to challenge well-established paradigms and reassess the current macroeconomic policy framework.

On the academic side, the research agenda of the past few years has focused on analyzing these problems. However, despite the significant progress that has been made in understanding various elements of the discussion, the impact and implications of the "new normal" in emerging market economies remains relatively unexplored. I'm sure this conference will help us bridge this gap.

Undoubtedly, the Global Financial Crisis was a pivotal moment for the field of economics. It was a once-in-a-generation event that forces us to go back to the drawing board and question our understanding of economic models and frameworks. Since then, we have made significant progress on learning about the origins of the crisis, its consequences, and policy responses. But recently, one element of the economic discussion has particularly aroused interest: it is the idea that certain trends that have been around for a while and to which we have paid little attention in the past, are critical for our understanding of current economic dynamics and to correctly design the policy response. This morning I would like to briefly refer to two of them that I find particularly relevant for emerging economies and that in one way or another will be present in our discussion during the next couple of days.

A first point is the rapid growth of financial markets and of global financial integration. The data is truly striking. As shown by Greenwood and Scharfstein (2013) the financial services sector contributed 8.3 percent to US GDP in 2006, considerably more than the 4.9 percent of 1980 and the 2.8 percent of 1950. This trend is not exclusive to the US. Indeed, several other developed countries have seen similar trajectories in their financial sectors./[1] The financial sector not only is big in size, but it also encompasses a complex network of global interconnections. Today international financial flows account for a much larger share of global GDP than some years ago. For instance, Lane (2012) shows that the sum of foreign assets and foreign liabilities relative to GDP in a group of Advanced countries, rose from 68 percent in 1980 to a peak of 438 percent in 2007/[2]. In parallel, we have witnessed an increase in the correlation of global asset prices, which is nowadays greater than has ever been. Interestingly, the increase in the correlation of asset prices has not been matched by a similar increase in the correlation of business cycles between economies, a phenomenon that demonstrates how intricate the connections have become across countries/[3]. Moreover, financial markets have become much more complex and data availability has not improved accordingly, making our assessment and understanding of the transmission channels of the global financial shocks much more difficult.

This reality has important implications for the management of monetary policy in small, open economies, and has led to the questioning of firmly established principles such as the "impossible trinity." Is monetary policy independence possible in the current environment? Is a free-floating exchange rate a reasonable shock absorber in this context, or does it introduce more volatility to the economy? Could the implementation of macro-prudential measures, including capital controls, ameliorate the problem? If so, are they complements or substitutes to monetary policy? The list of questions is long and we are far from reaching a consensus.

A second trend that I would like to point out is slower growth in Advanced Economies. According to some analysts, a mix of demographic changes and an increase in inequality, among other long-term factors, have generated a persistent lack of demand in advanced economies, which coupled with a decline in productivity growth suggests that it will be difficult for these economies to return to the higher growth rates of the past. What are the implications for Emerging Markets? This is obviously not good news. Advanced countries are important trading partners of most of them, so a reduction in their rate of growth will have an adverse effect. However, it is likely that some elements will help to mitigate this effect. To start with, the relative weight of AEs in world GDP has been falling, giving way to fast-growing EMs. Taking advantage of these changes will require redirecting exports towards new markets, a process that will surely take time, but the possibility is there. Additionally, in this scenario of low growth in AEs, it is very likely that monetary policy will remain particularly expansionary, something that should generate beneficial financial conditions for EMs.

The latter is not without costs. So far it is unclear what the side effects of maintaining unconventional monetary policies and low interest rates for a long period of time could be,

[1]/ See Philippon and Reshef (2013).
[2]/ See Lane (2012). The author also reports that in the case of EMEs the same ratio more than doubled between 1980 and 2007 (from 34.9 percent to 73.3 percent). However, this indicator was very flat during the most of the 2000s, indicating that EMEs did not participate to the same extent in the financial boom of that period. This indicator fell for both AEs and EMs during 2008 but returned to near its peak value by 2010.
[3]/ See Forbes (2016).

especially on financial markets' stability. There is compelling evidence that asset prices throughout the world have been affected by these policies; what is far from obvious is whether these movements are consistent with the fundamentals that must determine the prices of such assets. The increase in correlation between financial assets, but not between business cycles, that I already mentioned, raises some red flags here.

Finally, from a medium-term perspective, the relationship between the downward trend in growth in AEs and EMs potential growth, and for that matter with neutral interest rates, is not obvious. Does it imply a similar downside correction of potential growth in EMs? In principle, the slower growth of the AE should reflect lower productivity growth at the technological frontier, however EMs still have a long way to go in terms of catching up in terms of both efficiency gains and capital deepening, a process that should be facilitated by financial conditions that should remain favorable for a while.

These issues, evidently, lead us to rethink the way we conduct monetary policy and to evaluate our traditional toolkit. However, I believe that the crisis and the way in which EMs responded, should also lead us to recognize the benefits associated with the flexible inflation-targeting regime, a policy framework that is now common among EMs. After all, it is undeniable that despite the severity of the shocks experienced during the crisis and its aftermath, economic performance has been better than in comparable situations in the past.

Let me illustrate this point using the Chilean experience. In recent years, our economy has faced two major external shocks: the end of the commodity price boom and the significant changes in international financial conditions, which have fluctuated, to a large extent, according to the expectations that financial markets have regarding the evolution of monetary policy in AEs. The taper tantrum is a good example of the latter.

Clearly, these changes have required significant adjustment in the economy, which is reflected in the growth rate decline, the substantial reduction in the current account deficit and in the adjustment of relative prices. The relevant point, is that compared to other adjustment episodes, the recent process has been much less painful, owing largely to the important role played by the flexible inflation targeting policy framework.

First, exchange rate flexibility helped to generate a relatively quick change in relative prices, despite the fact that in Chile there is still a significant degree of indexation to past inflation in many prices and contracts. The floating exchange rate has also helped to absorb some of the volatility of global financial conditions while maintaining relatively stable interest rates. The cost was that inflation, driven in part by a depreciating currency, remained above the tolerance range for a prolonged period, a situation that has rapidly reversed in recent months. In this context, the Central Bank did not fight higher inflation by raising interest rates, rather it lowered them by 200 basis points to support the economy's adjustment process.

Why did we react in this way, letting inflation rise while pursuing an expansionary monetary policy? The answer is simple. In a flexible inflation-targeting scheme, what determines monetary policy is the evolution of the inflation forecast at the appropriate policy horizon (two years in our case). Therefore, one-off increases in the price level, typically associated with these types of relative price adjustments, should not be fought with a tighter monetary policy, since in principle they do not affect inflation expectations two years ahead.

There were, of course, some necessary conditions that allowed us to act in this way. Firstly, there were no big currency mismatches; otherwise significant exchange rate fluctuations could have jeopardized financial stability. Second, the central bank must have a high degree of credibility; if not, there is the risk that a prolonged period of inflation above target will affect long-term inflation expectations, a situation that typically leads to persistent deviations from inflation away from its target level. I would like to stress that during all this time inflation expectations at our policy horizon have remained well anchored at our target of 3%. Experience shows that to achieve this it is essential to have an autonomous central bank and a coherent fiscal policy, two characteristics of Chile's macroeconomic policy framework.

I will conclude with some remarks on how we see the role of macro-prudential policies in our general policy framework. As you all know, after the global financial crisis, the longstanding financial stability objective of central banks gained prominence, and a broad consensus has started to arise on the desirability of complementing the standard macroeconomic stabilization framework with macro-prudential policies. In this context, we at the Central Bank of Chile have repeatedly expressed that we should be "prudent" about macro-prudential. Why? Not because of a deep conceptual objection to the idea of having policies aimed at reducing systemic risk, we have actually implemented some, but because of a pragmatic concern about the breadth of the scope of macro-prudential policies implicit in early discussions, and on the still scarce evidence on the effectiveness and costs of the various types of tools considered under the macro-prudential umbrella. Broadly speaking, our financial system came out largely unscathed from the global financial crisis, and thus we can afford to be prudent and wait for more concrete evidence on the consequences of macro-prudential policies, both intended and unintended.

One of the most hotly debated aspects of the macro-prudential agenda has been whether central banks should use their standard monetary policy tools to lean against the wind and engage in capital account management measures to dampen potential excesses arising from large capital inflows. We are among those who think that, more often than not, systemic risk arises from specific sectors and markets, and as such it is best to deal with targeted prudential policies that tackle these problems and externalities without causing undue damage to the rest of the economy. Therefore, as a general rule, the policy rate should not be used for financial stability purposes, except under extreme circumstances. Now, with respect to capital account management, it is true that financial crises in EMs are frequently associated with sudden stops that take place after periods of large capital inflows and that there is a theoretical case for putting some "sand in the wheels" of capital flows. However, it is also the case that problems with these inflows tend to be of relevance when they are associated with maturity and currency mismatches that render borrowers vulnerable to refinancing and market risk. Again, it seems reasonable to use targeted prudential measures to limit mismatches as a first line of defense instead of restricting capital flows. Furthermore, at a more pragmatic level, having used capital controls in the distant past, we are aware of the difficulties of effectively implementing these measures, and of the potential damage they may cause on the incentives of borrowers to voluntarily reduce their exposure to such risks. For these reasons, we are also very reluctant to use these measures to deal with fluctuations in capital inflows and would only consider them as a last resort measure.

All in all, we strongly agree with the view that macro-prudential policies should not substitute for adequate macroeconomic and micro-prudential policies. Indeed, we see a strong micro-financial regulatory and supervisory system as a pillar of our macro framework. Furthermore, our existing regulation is relatively conservative and incorporates some measures that are nowadays considered as part of the macro-prudential toolkit aimed at reducing bank complexity, such as constraints on the composition of banks' trading book, restrictions to interconnections, and differentiated capital requirements for banks that grow too large as a result of mergers.

Nonetheless, we recognize the usefulness of targeted macro-prudential policies and the need to coordinate the eventual deployment of various tools across the different financial system authorities that are part of our institutional framework. Since Chile has a sectoral approach to supervision, coordination is key and it is currently achieved through the Financial Stability Council, where the Central Bank participates. We also recognize the need to have some additional time-varying tools to deal with the buildup of systemic risk throughout the cycle. In particular, we have supported the inclusion of a countercyclical capital buffer as part of the reform to our general banking law that is currently under discussion, and we expect to contribute with our broad systemic view of the economy in determining the credit cycle trigger and the deployment of the buffer.

In summary, our policy framework consisting of an inflation targeting scheme adopted by an independent central bank, exchange rate flexibility, a fiscal policy based on a rule and solid and sound regulation and supervision of the financial system, has allowed us to weather in an efficient manner the turbulences of the last many years.

Let me finish by thanking the distinguished group of economists that have joined us to present and discuss, in this day and a half, issues concerning monetary policy spillovers and policy responses. I would like to thank also Enrique Mendoza, Ernesto Pastén, Diego Saravia and Camila Figueroa for putting together an exciting program, and Carola Besa, Paloma Navarro and Alejandra Rozas for helping with the organization.

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