Narrowing Monetary Policy space for Emerging Countries: The case of Chile

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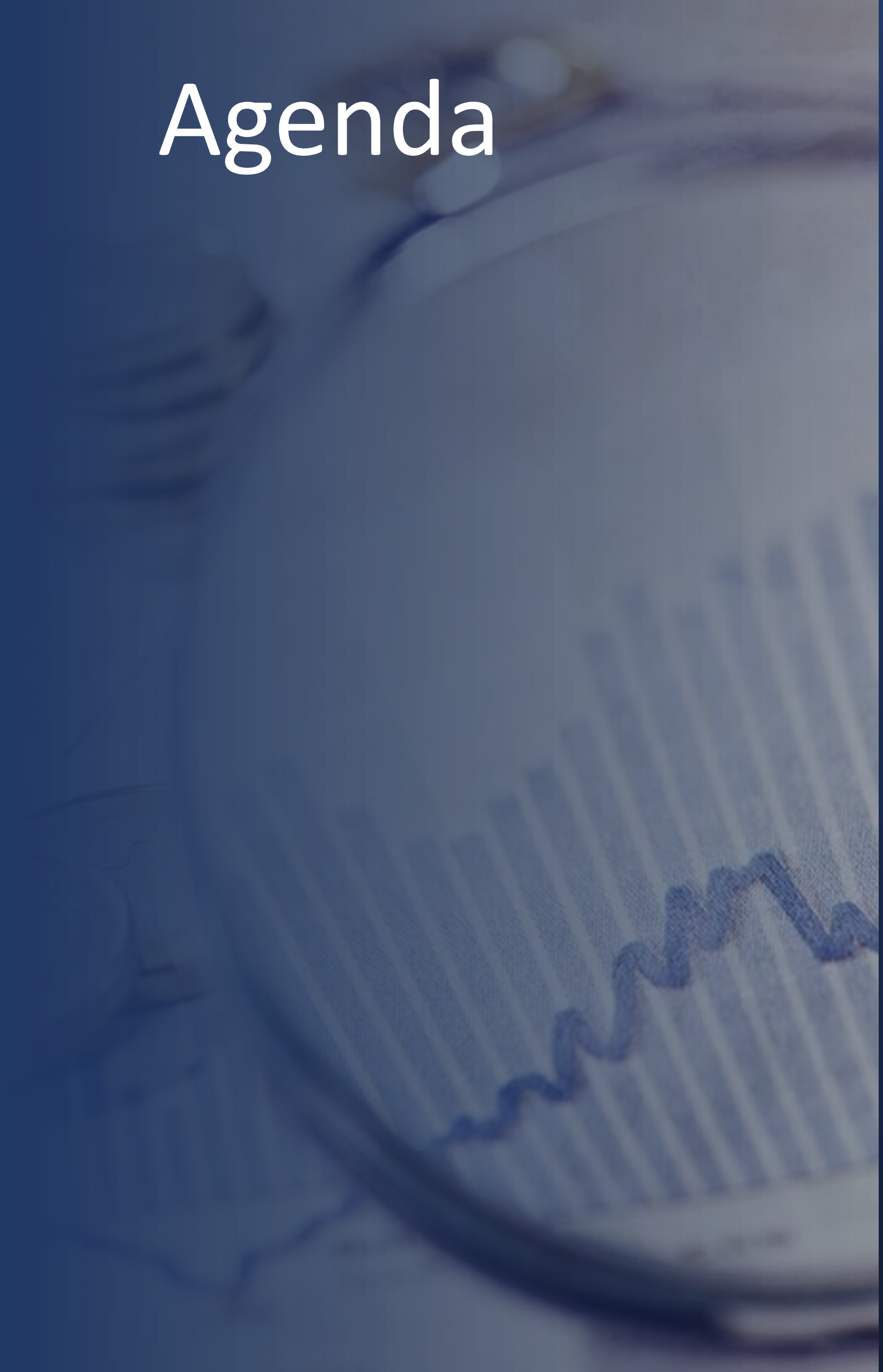
Agenda

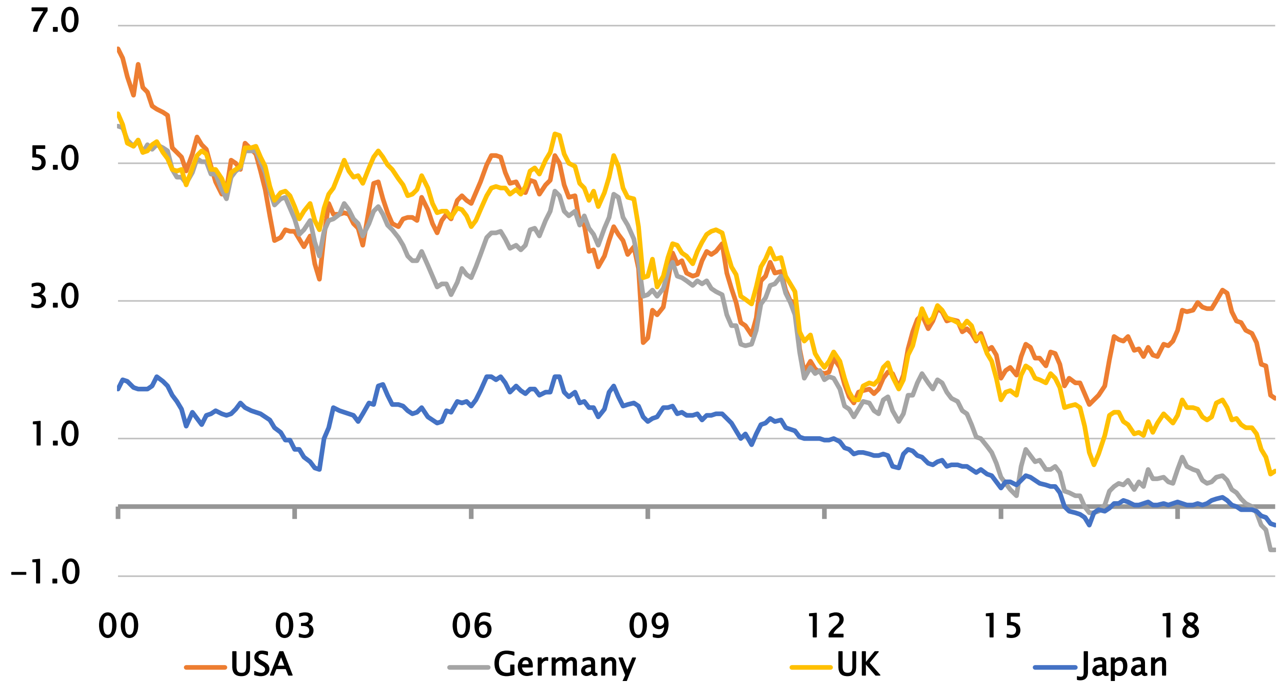


- Global context
  - Low interest rates escenario
  - Lower global economic growth and inflation
  - Trade War: supply side shock magnified by disruptions in global value chains
- Chilean context
  - Lower growth and inflation below target for almost years
  - Free floating exchange rate has given ample room for monetary policy
  - This was possible by two key contributing factors:
    - Fiscal policy rule
    - Well functioning domestic financial system with a significant presence of local institutional investors
- Current Challenges

1 Global context

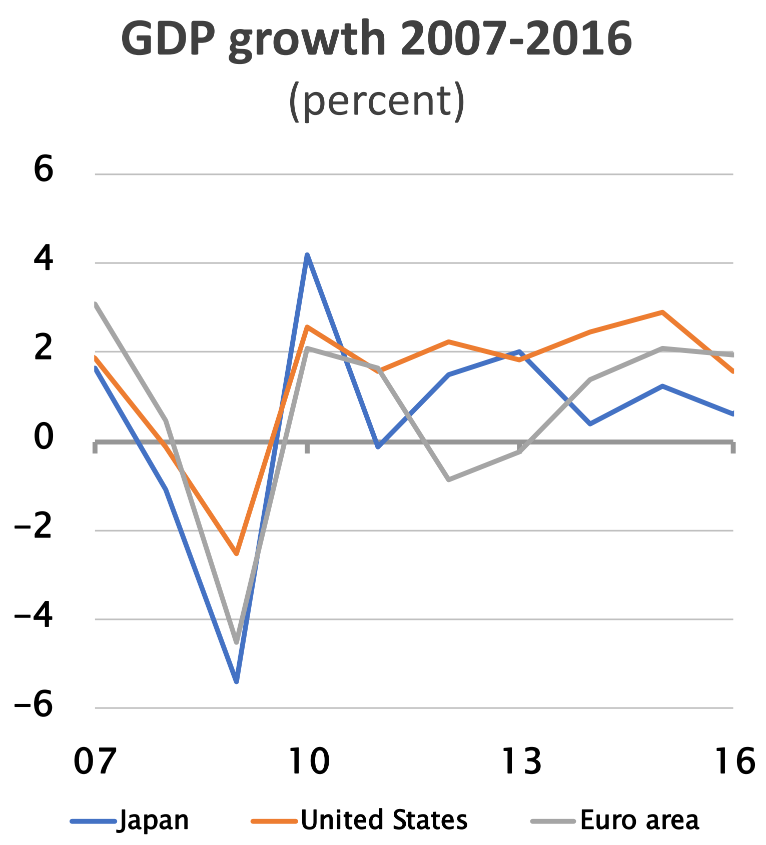
Long – term interest rates in Advanced Countries have been coming down steadily over time, in response – at least partially – to monetary expansion

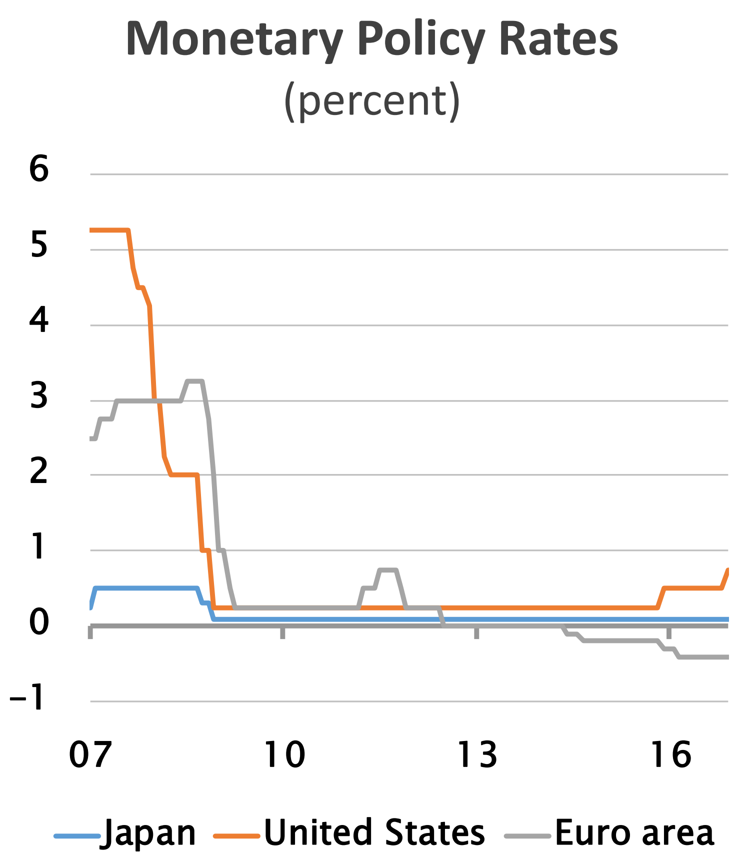
Sovereign 10y interest rates
(percent)



Source: Bloomberg

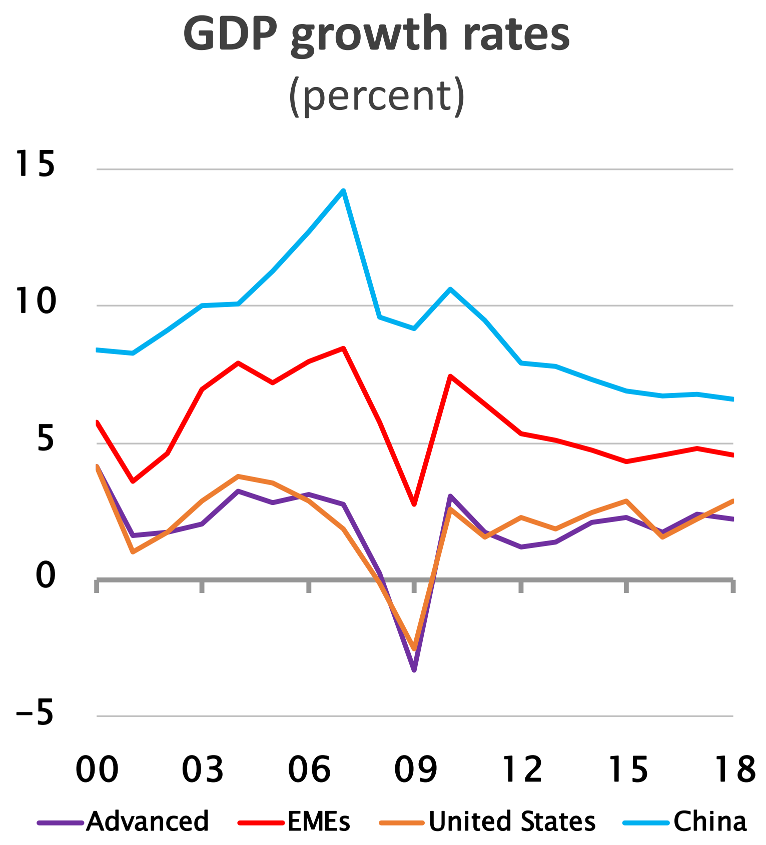
Monetary policy was effective to overcome the Global recession

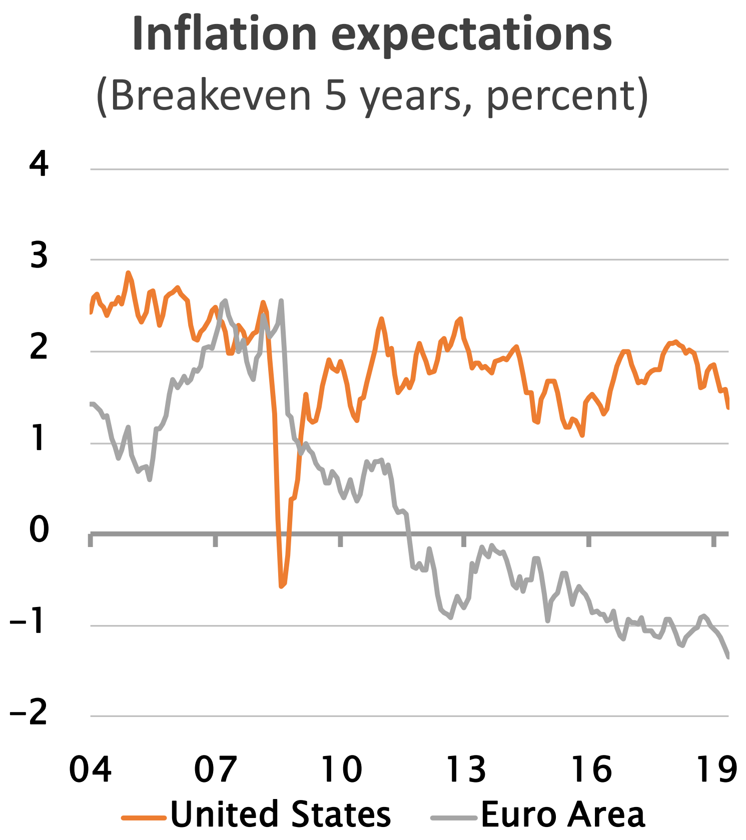




Source: IMF, World Economic Outlook April 2019. Bloomberg

Lower economic growth and inflation rates across the globe. Inflation expectations remain subdued almost everywhere.

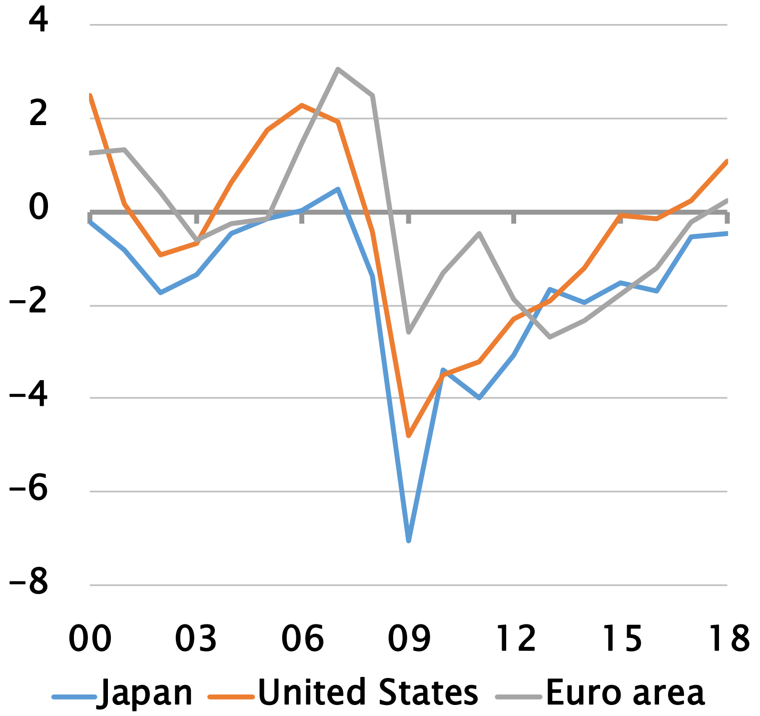




Source: IMF, World Economic Outlook April 2019. Bloomberg

We are facing a new Policy Challenge: While Advanced Countries are reaching Potential Output, the Trade War is causing a global slowdown

Output Gap
(percent of potential GDP)



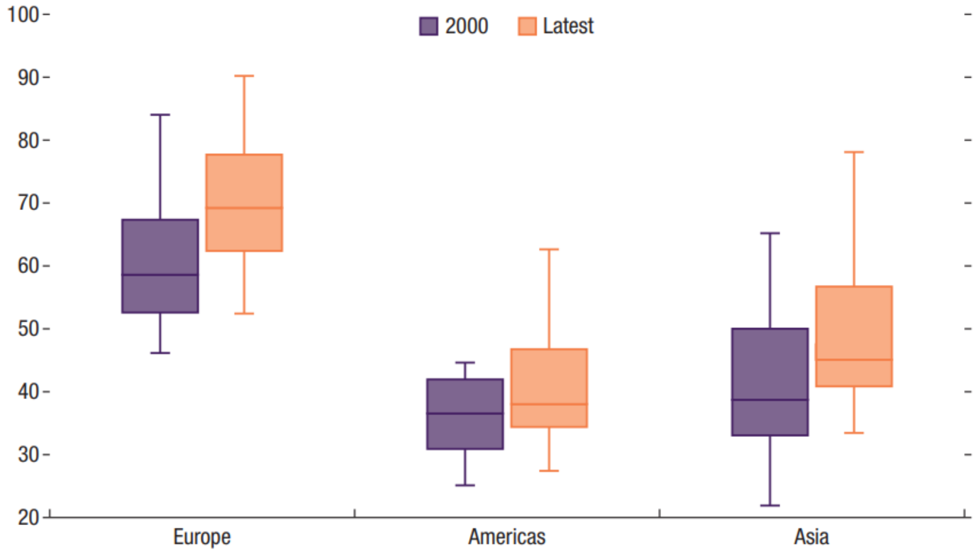
Economic growth forecast
(ann. Percent)

	June 2018		December 2018		September 2019	
	2019	2020	2019	2020	2019	2020
United States	2.3	1.9	2.3	1.7	1.6	1.7
Eurozone	1.9	1.7	1.8	1.7	1.3	1.4
Japan	0.8	0.5	0.8	0.5	0.5	0.7
China	6.3	6.2	6.1	6	5.5	5.7
Rest of Asia	4.3	4.2	4	4.1	3	3.2
Latin America (excl. Chile)	2.5	2.6	1.8	2.5	1.4	1.8

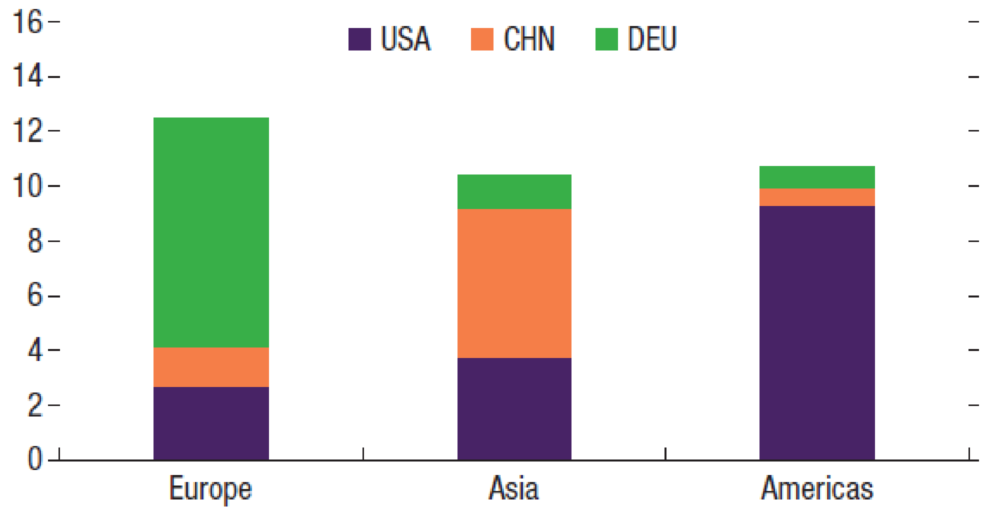
Source: IMF, World Economic Outlook April 2019. Monetary Policy Report, Central Bank of Chile

At first, the effects of the trade war were expected to be low. However, the relevance of global value chains has transmitted them to many more economies.

GVC Participation (*)
(percent of exports)



Exposure to Trade Hub countries (**)
(percent of gdp)



(*) Line refers to the median, the box to the 25-75 percentile range. Latest data available:2013. (**) Exports from European economies, Asian economies and American economies to: United States, China and Germany

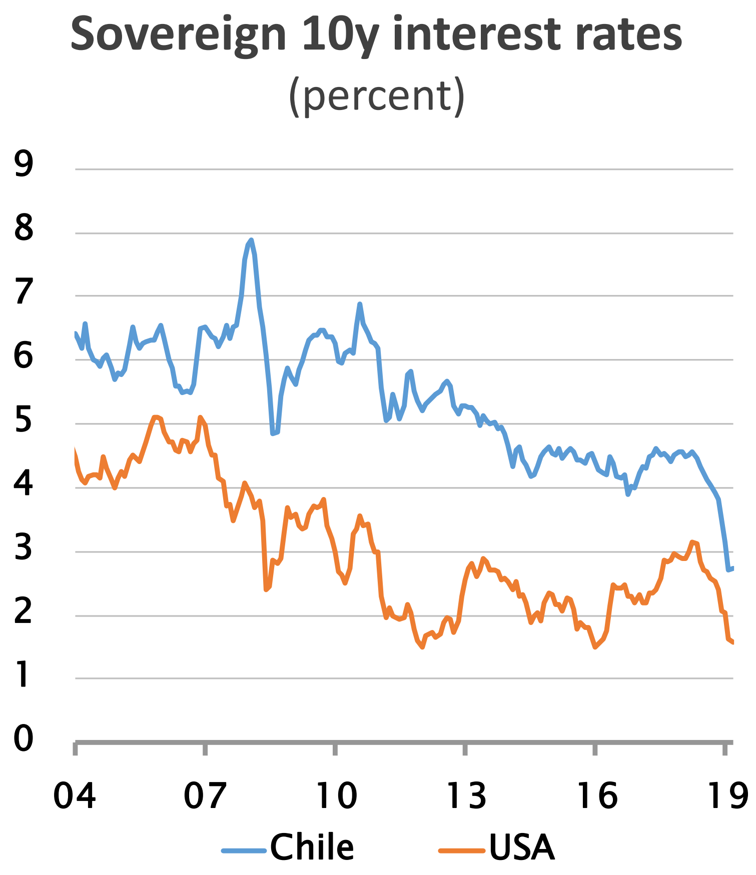
Source: Trade Tensions, Global Value Chains, and spillovers, IMF, June 2019

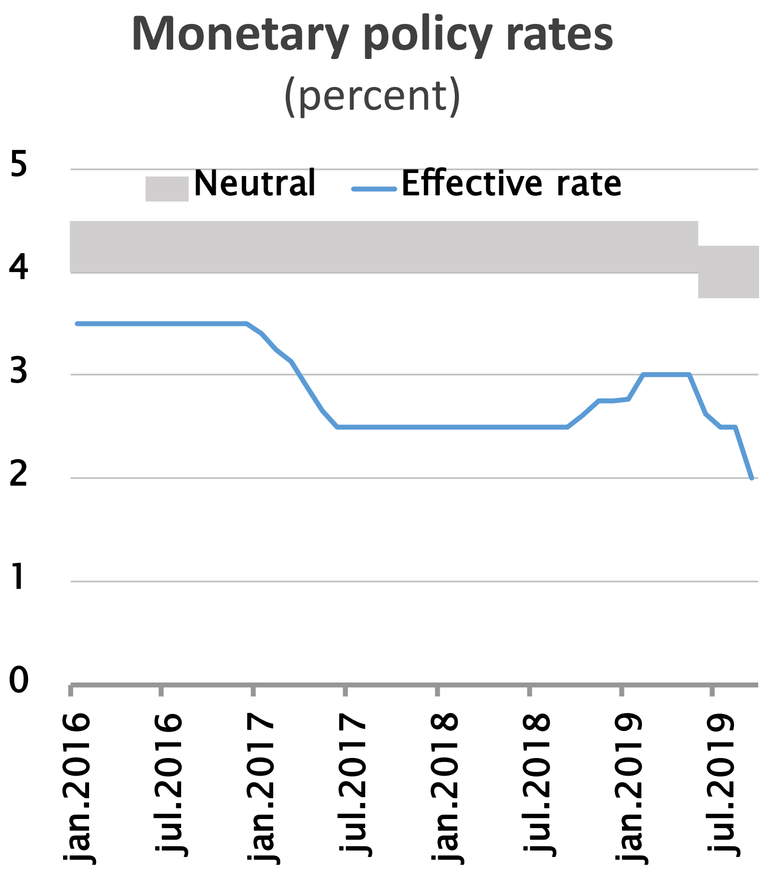
Trade war: supply side shock

- Increases cost pressures
- Reduces global productivity and potential output
- With direct impact on the two most dynamic growth centers in the World: China and the US
- Monetary Policy cannot compensate for this type of shocks
- It can help to soften the pain of the adjustment in the short-term
- Over reliance on monetary policy can feed long-term inflationary pressures

2 Chilean context

Lower long-term and neutral MPR due to lower global interest rates

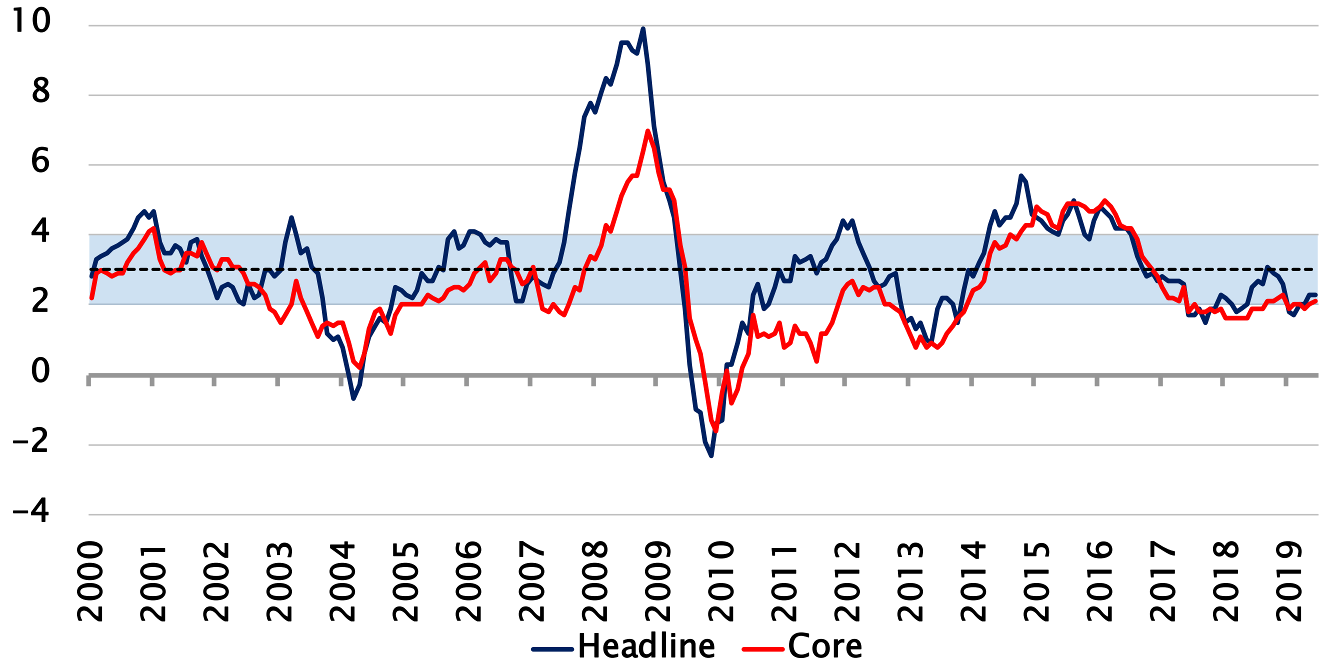




Source: Bloomberg, Central Bank of Chile

Inflation rate has been below the 3% target for almost 4 years

Inflation rate
(percent)



Source: Central Bank of Chile

Global uncertainty has affected business and households expectations. Short term projections for growth have been revised down

Economic growth forecast
(annual change. Percent)

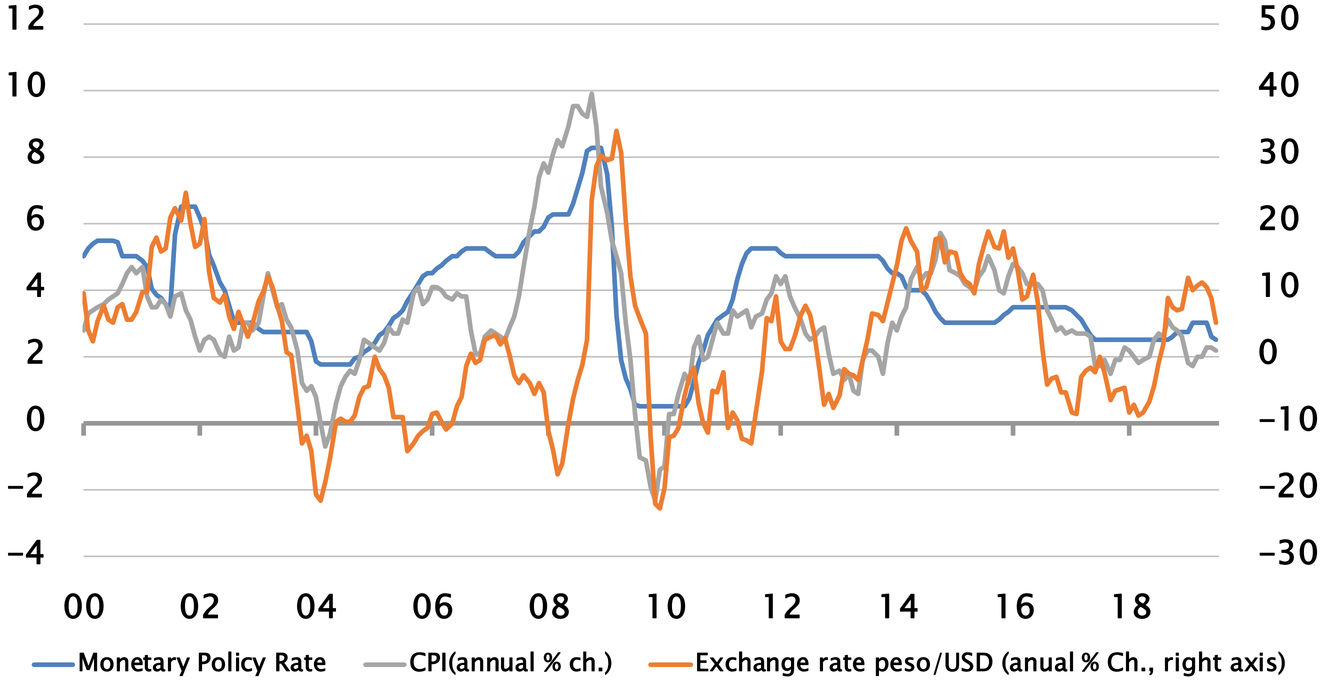
		December 2018		September 2019	
	2018	2019 (f)	2020 (f)	2019 (f)	2020 (f)
GDP	4.0	3.25-4.25	2.75-3.75	2.25-2.75	2.75-3.75
Domestic demand	4.7	3.8	3.3	2.4	3.5
Domestic demand (w/o inventory change)	3.9	3.9	3.6	3.0	3.3
Gross fixed capital formation	4.7	6.0	3.9	4.0	4.0
Total consumption	3.7	3.3	3.5	2.7	3.1
Goods and services exports	5.0	4.1	2.8	-1.3	1.6
Goods and services imports	7.6	5.0	3.0	-1.9	2.3

Source: Central Bank of Chile

However, free flotation of the Exchange Rate has given significant room for maneuver to monetary policy.

Inflation, Monetary Policy Rates and the changes in the Exchange Rate

(percent)

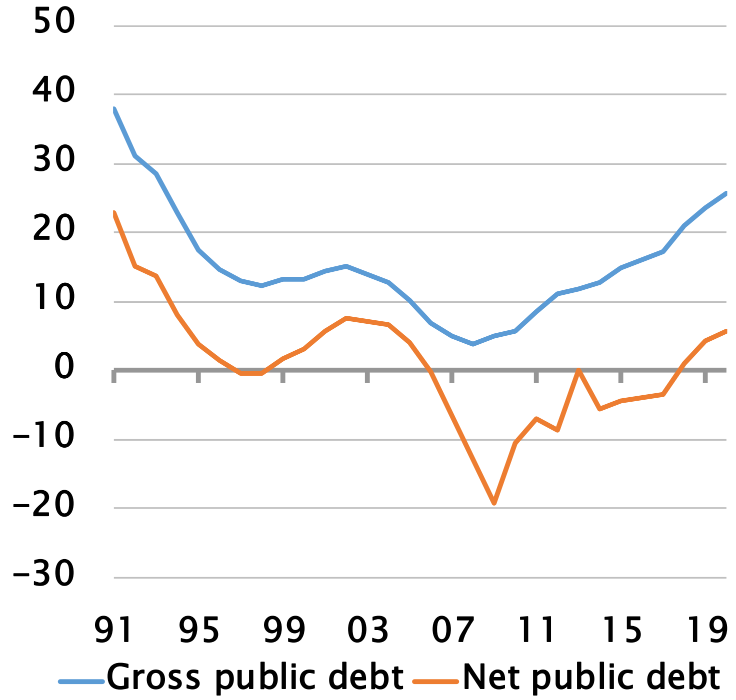


Source: Central Bank of Chile

A Fiscal Policy Rule and solid public finances have played a key role in the Macroeconomic Policy Framework in Chile

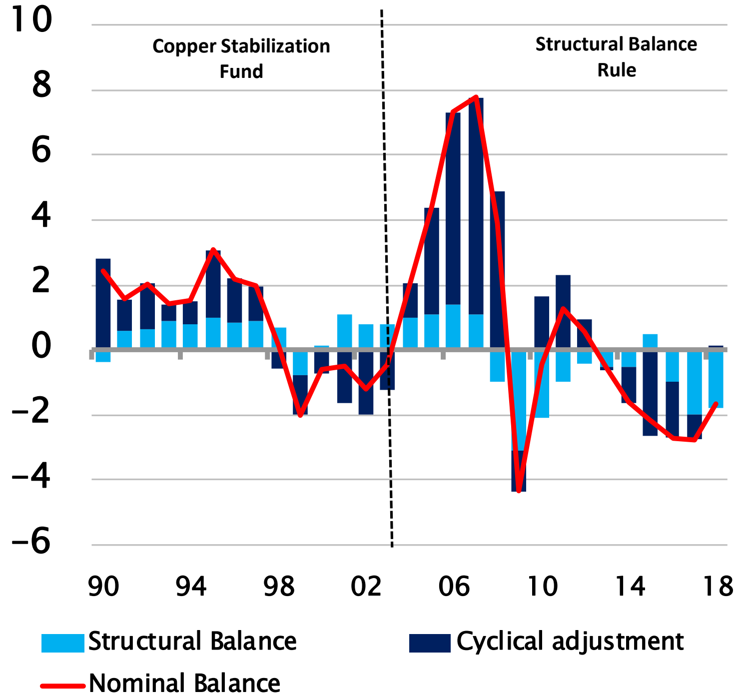
Gross and Net Public Debt of Chile

(percent of GDP)



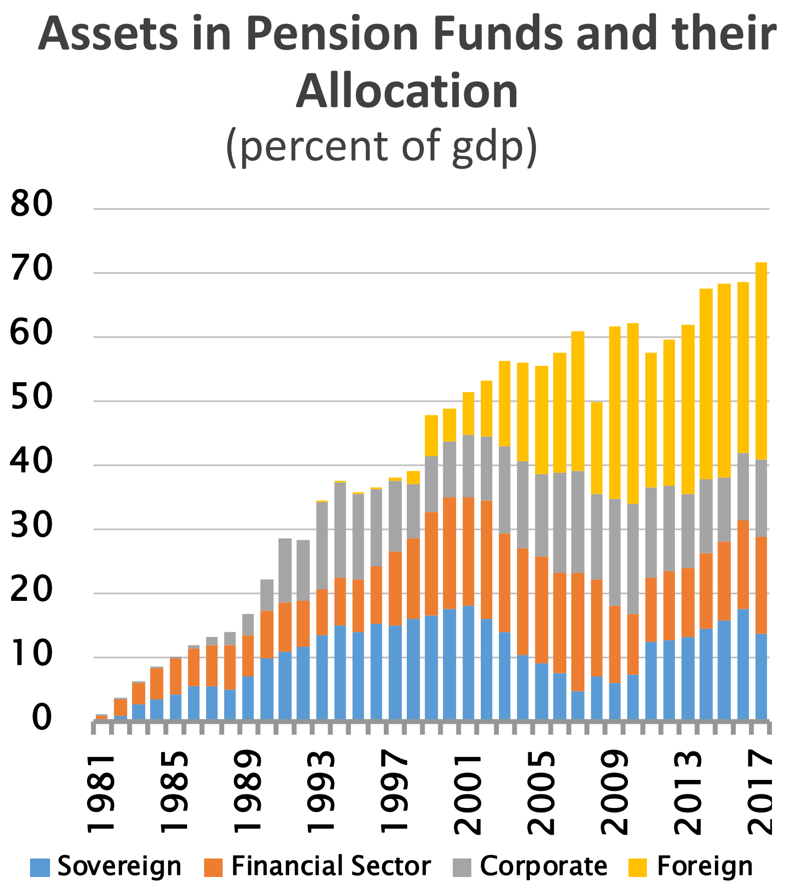
Fiscal Balance over the cycle; nominal and cyclically adjusted

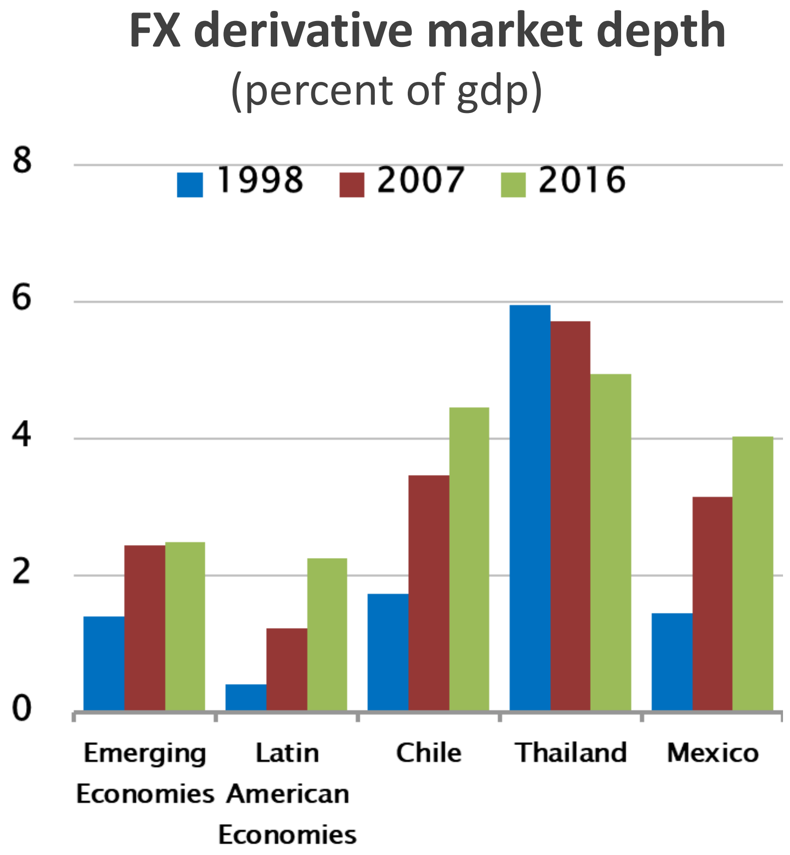
(percent of GDP)



Source: Budget Office, Chile

The Domestic Financial Market has developed significantly on the back of financial assets accumulation in the Chilean Pension Funds. They also helped the development of derivatives to cover FX risks



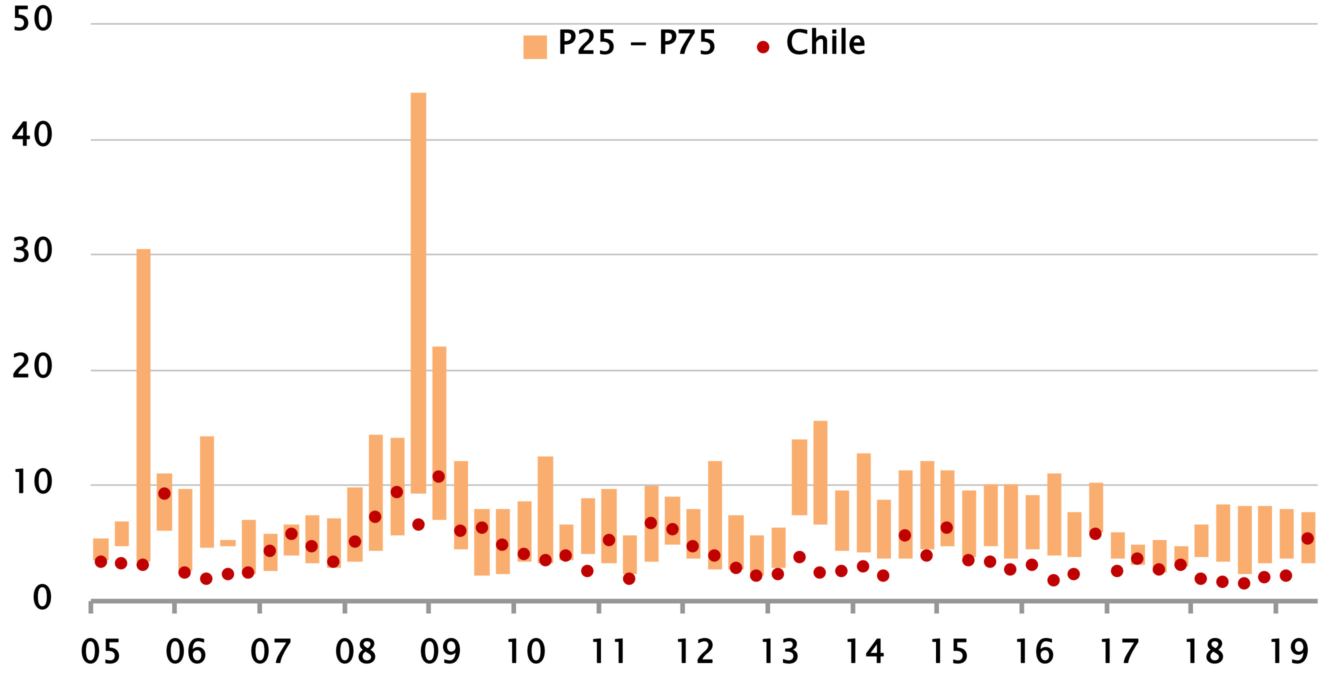


Source: Chilean Pensions Supervisor and Central Bank of Chile, OECD. BIS and IMF

The main "shock absorber" for external disturbances has been the Exchange Rate. Long-term rates have been amongst the least volatile in Emerging Countries

Long-term interest rate volatility in Emerging Countries

(basis points)



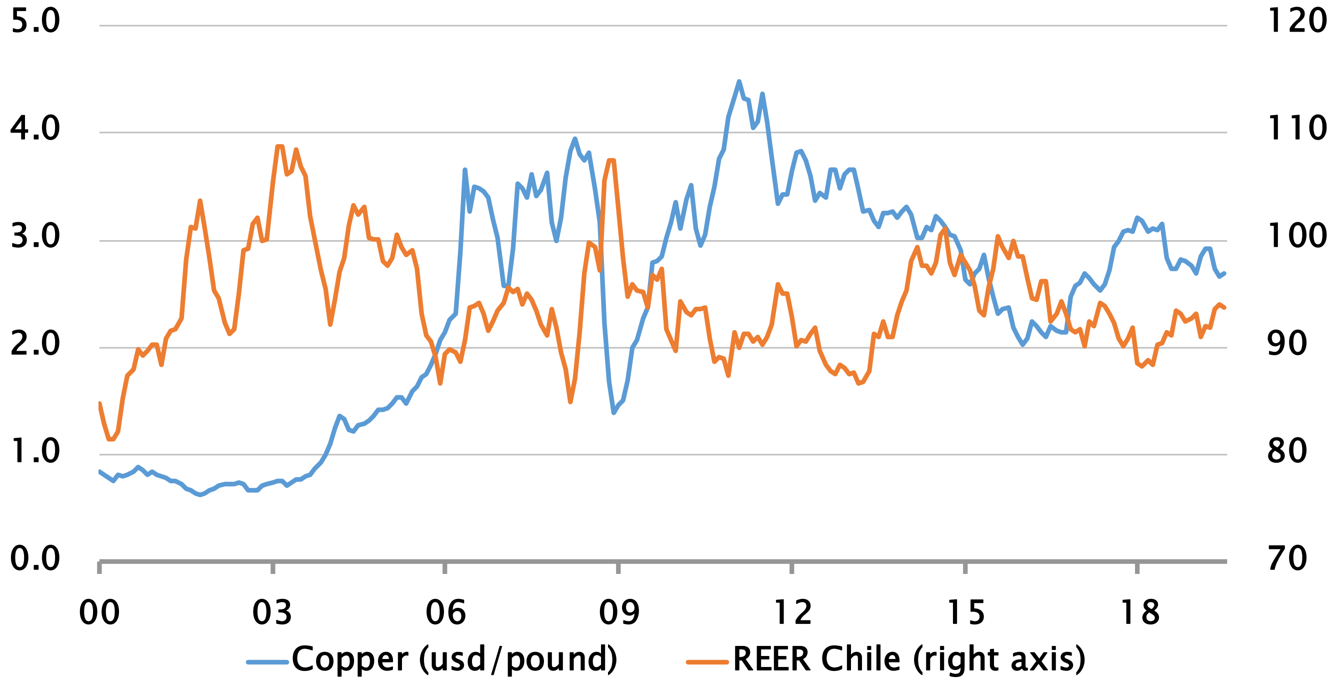
(*) Computed as the standard deviation within a quarter of the daily changes in both interest rates and exchange rates. EMEs include Chile, Brazil, China, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Poland, Russia and Turkey. Commodity exporters include Australia, Canada, Norway and N. Zealand. Source: Central Bank of Chile

3 Current Challenges

A worsening global scenario usually means lower copper prices, depreciation of the currency and weaker domestic demand and growth

Copper Price and Real Efective Exchange rate in Chile

(usd/pound, index)



Source: Bloomberg and Central Bank of Chile

Short-term challenges for monetary policy

- Should inflation become a concern, we have a lot of room to increase interest rates. Government finances are not a restriction. The private sector does not have significant FX imbalances.
- In the event of a significant slowdown of the economy there is room for monetary policy easing. We have already cut the MPR from 3% to 2% in the last three months and signaled our willingness to provide additional stimulus, if needed.
- The fiscal rule, based on a target for the structural deficit (correcting for cyclical deviations in GDP and copper prices) provides automatic stabilizers.
- We do not face a significant FX constraint. We hold Reserves in the range of 14% of GDP, there are about 5% of GDP in a sovereign fund designed to be used to finance cyclical fiscal deficits and about 43% of the assets under management by pension funds are invested abroad.
- However, the Trade War is a real shock that makes Chile poorer than before, we have to produce a real depreciation of the currency, and this is not painless.

4 Concluding Remarks

Summarizing . . .

- Monetary policy has been effective in bringing the World Economy back from recession

- The World now faces a real – stagflationary – shock that will result in lower potential GDP (global) and adjustments in relative prices

- There is a risk that over-reliance in monetary stimulus to cushion this shock might affect inflation and expectations at the global level

- In Chile we have room for manouver in Monetary Policy, thanks to a well-balanced macroeconomic framework, based on inflation targeting by an autonomus and credible Central Bank, a free floating Exchange Rate, a solvent Public Sector and a well-developed Financial System.

- We can soften the impact of the global shock, but the real trade shock will have a negative efect in local growth in the coming years.

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