OECD's Working Party 3

"On Policies for the Promotion of Better International Payments Equilibrium"

Luncheon speech by the Governor of the Central Bank of Chile Mario Marcel

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First of all, I would like to thank you for the opportunity of kicking off this lunch discussion. I would like to contribute to the WP meeting with some brief remarks on the current global economic environment from the perspective of an emerging open and financially integrated economy.

The global economy seems to have finally made significant progress towards a more balanced and sustained growth. Looking ahead, the global outlook appears brighter than at any point after the Great Financial Crisis (GFC). This is, without doubt, a positive development, even if the speed and depth of recovery is not as strong as in previous episodes.

A stronger involvement of emerging market economies (EMEs) of different sizes in the current phase of the cycle is important to support momentum and to further strengthen consistency in international economic developments. Integrating EMEs into the analysis may also help in balancing views from some advanced economies (AEs) on globalization and inequality.

Global economic activity, especially in AEs, is expected to provide positive tailwinds to EMEs. Separately, major central banks have persistently reiterated that their tightening paths are expected to be very gradual. Yet many EMEs, after weathering well the GFC and helping contain its spillovers have failed to rebuild strengths and continue the reform agenda. The transmission of the effects of the *taper tantrum* of 2013 was an important reminder of the vulnerability of EMEs to financial turbulence, and the speed with which these may take place.

In order to deal with external shocks, EMEs have strengthened their positions in some areas. Most of them have improved their reserve holdings. Other external vulnerability metrics for EMEs, such as gross financing needs and non-resident holding of general government debt have also improved somewhat. Policy frameworks have become more

flexible in a number of countries by granting exchange rates a larger role as a shock absorber, thereby reducing the impact of idiosyncratic shocks on the real sector.

On the other hand, EMEs have not improved significantly on their fiscal standing. In a number of countries, structural balances have worsened and both government and corporate debts have climbed. This constrains the capacity of fiscal policy to contribute to a response to worsening financial conditions and increases the exposure of the economy to interest rate increases. In the case of monetary policy, this may be restricted in some countries (Southeast Asian) by exceedingly low rates, while others (Latin American and Caribbean) have not brought inflation entirely under control. Both issues limit the ability to respond to external shocks.

One especially important theme for EMEs is related to commodities. Commodities tend to play an important role in EMEs along several dimensions, supporting the real sector via investment and trade and providing fiscal revenues. To a large extent, the capacity of some prominent EMEs to run countercyclical policies during the GFC stemmed from the favorable commodity super cycle, which was barely interrupted by the crisis to continue for a number of years, until its decline by 2012-2014.

Commodity prices have recovered significantly with manufacturing, global trade and risk appetite. In this context, one important issue to consider is how commodity exporting emerging economies may manage the current windfall after four years in the dark.

While greater commodity prices should provide a positive impulse to EMEs, they may also push policy-makers to delay much-needed structural adjustments that may sustain higher growth rates in the long-run. Rather, policy-makers should grab the opportunity to improve their buffers and further enhance their policy frameworks. Sure, policy buffers have improved in some economies, however, the question remains on whether or not our policy frameworks are ready to sustain sufficiently large shocks while avoiding a severe economic downturn.

Commodities are an important watch-point for EMEs, especially at a time of gradually tighter monetary policy in AEs. Commodity price movements also tend to play an important role in exchange rate fluctuations in commodity exporting EMEs. If a sudden risk reversal were to occur in global financial markets, in the context of gradual tightening

of monetary policy in AEs, financial markets are likely to witness an appreciation of the dollar, widening credit spreads, downward adjustments in risk assets, and important losses in commodity markets. The latter is compounded by the size of non-commercial, speculative positions for some commodities, which could unwind in the face of a sudden change in market expectations.

Although policy frameworks across EMEs are generally more flexible today than in the past, this kind of shock would be particularly relevant for commodity exporting EMEs since monetary tightening to support the currency would dampen activity while loosening monetary policy could further exacerbate negative feedback loops. Close monitoring of financial markets and greater understanding of the transmission of policy should facilitate swift policy action.

Looking ahead, it seems that an important part of the agenda for EMEs should point at getting better prepared for an adverse scenario, either in the shorter or medium run. The positive performance during the GFC should not cloud the fact that past crises have led to "lost decades" in economic development, welfare, and equity. At the same time, it is important to recall that the strength to withstand crises are built in good times, not when emergency strikes.

There are a number of features that can make EMEs better prepared for a negative scenario.

First, EMEs with a high level of government or corporate indebtedness should take the opportunity given by low interest rates, investor appetite and relatively flat yield curves to refinance their debt, saving on debt servicing costs and reducing exchange rate and refinancing risks. While future changes in the yield curve may offset the immediate financial benefits of lengthening maturities, the latter provide a valuable insurance against the transmission of external financial shocks.

Second, EMEs should not miss the opportunity to rebuild economic buffers as the business cycle enters an expansionary phase. This is quite evident for the fiscal side, but it also has implications for corporations, labor markets, and the financial sector. In the latter case, this should be a great opportunity to catch up in the implementation of Basel III solvency standards for banks. Buffer rebuilding is equally—and perhaps more—important to

countries that weathered well past shocks, as they may have run down such buffers in pursuing countercyclical policies.

Third, floating exchange rates can be extremely helpful in cushioning shocks, as long as monetary policy inspires enough credibility to allow inflation to fluctuate in the short run without rushing monetary constraints. Monetary policy credibility is gained through a good track record, transparency and constant monitoring. The development of exchange rate risk hedging through insurance or derivative vehicles may also make floating regimes more palatable to exporters and help corporations to reduce currency exposures in their balance sheets.

Finally, in times of capital volatility, robust domestic institutional investors are a key asset. This helps gain more consistency on capital movements, reduces currency mismatches across the economy, and protects long-term capital markets from volatility abroad. The development of institutional investors is indeed a lengthy process, but some policy actions in fostering the insurance and pension industry would help speed it up.

If the economy is reasonably protected against external shocks, fiscal and political space may open for more forward-looking reforms.

Three dimensions of this agenda have been especially underscored by the OECD: (a) globalization; (b) competition in key markets, and (c) inclusiveness.

Economic openness and globalization has contributed to a remarkable increase in living standards in most EMEs. Yet certain factors are likely to influence the effect of financial globalization on economic volatility and growth: countries with well-developed financial systems, strong institutions, sound macroeconomic policies, and substantial trade openness are more likely to gain from financial liberalization and less likely to risk increased macroeconomic volatility and experience financial crises.

Chile offers a success story of integration in the world economy. Since the trade and financial liberalization, economic growth in Chile has been sustained. Per capita GDP increased 3.8 times since the beginning of trade opening (1975-2016), compared to a factor of 1.6 and 2.0 registered for Latin America and OECD members, respectively.

Strengthening competition is a key requirement to increase productivity and long-term growth. Aggregate productivity growth is the result not only of firm turnover but of the productivity gains of ongoing firms. Lack of competition, concentrated markets and barriers of entry may prevent firms from growing, investing and gaining from economies of scale. A recent study by the Central Bank of Chile provides supporting evidence in this direction for Chile from an analysis of a large panel of microdata.

Finally, financial inclusion (FI) provides the ability for different agents to adapt to cyclical ups and downs. Generally, central banks do not have an explicit role in FI. However, its traditional functions are related to it. Regarding the conduct of monetary policy, the FI improves smoothing of consumption, directly affecting policy decisions. Also, the interest rate becomes more effective as an instrument as a greater proportion of the population is financially included. There is a correlation between FI and lower relative volatility of GDP with respect to inflation; and in some economies, FI is associated with expansive credit cycles. As a result, the FI—hand in hand with financial education—provides a greater variety of financial products to resolve liquidity, financing and risk-hedging needs.

Good times are as challenging as bad times. The GFC demonstrated that this is true both for EMEs and AEs. The favorable overlap of the commodity super cycle and the financial cycle in the mid-2000s may have led some to believe that EMEs could live through global crises. Ensuing developments point instead to the need to build in good times to ensure continuity in the reform agenda for development.

Thank you.