XXIV Annual Conference of the Central Bank of Chile
"Emerging Markets Credibility, Foreign Investor's Risk Perceptions, and Capital Flows"
Opening remarks by Mario Marcel, Governor of the Central Bank of Chile
November 22-23, 2021 – via *Zoom*

1. Welcome remarks

Dear colleagues and friends, distinguished guests: welcome to the XXIV Annual Conference of the Central Bank of Chile (CBC).

Since 1997, the CBC has been convening prominent scholars and policymakers to this Conference to discuss major issues in central banking and their implications for emerging economies. This version is no exception; fresh and thoughtful research will support discussion over the next two days, despite adapting to new standards of social interaction. We thank and welcome all participants to this online event, including 27 authors, 10 discussants, and two keynote speakers.

2. Capital flows to Emerging Markets

This year´s Conference is focused on Capital Flows to Emerging Markets and how they are shaped by Credibility and Risk Perceptions. This comes at a unique juncture, as countries all over the World have been struggling to recover from the deepest recession in many decades while financial markets have continued booming in 2021, fueled by unprecedented impulses from fiscal and monetary policy. In the course of the crisis, capital flows to emerging markets remained mostly positive, as investors searched for yields after many years of near-zero returns in low-risk instruments in advanced economies. However, we have also how easily these flows could turn around in response to unexpected developments and/or spikes of uncertainty.

In recent months, in fact, EMEs have suffered from currency depreciation, capital outflows, sharp falls in stock markets and rising risk indicators. In Latin America, the markets' more negative assessment of sanitary, political and exchange rate risks stand out, which has been reflected in higher interest rates, greater sovereign risk, falls in some stock markets and reduced capital flows.

This is then a time when understanding the forces that shape international financial markets and capital flows is particularly valuable.

To this end, I would like to underscore four major developments that have been shaping capital movements in the last decades or may do so in the near future:

a. In the last 30 years, there has been a significant change in the ***main actors*** of international capital flows. Banks and governments were predominant up to the 80s, giving way to hedge funds, and institutional investors during the 90s and early 2000s. The participation of institutional investors has promoted the development of a derivatives market that allows hedging of exchange risks, where their main counterparties are banks. In the case of large publicly listed companies, there is an active use of derivatives for hedging purposes. Also, the participation of institutional investors in the fixed income market, in addition to representing an additional source of financing, has contributed to reduce the volatility of long-term interest rates.

b. A global tendency towards ***exchange rate flexibility***, particularly evident among advanced economies, but involving a growing number of EMEs as well. Countries have turned to flexible exchange rate regimes to avoid tensions surrounding large depreciations in managed regimes and to significantly mitigate the transmission of external shocks, both to the real and financial sectors. In particular, floating regimes entail greater volatility in the value of the currency, but tend to lower volatility in local interest rates, smaller GDP variations and less volatile capital flows. For this mechanism to operate, it is necessary to draw on a well-developed local financial system, deep capital markets that can be a funding alternative to external sources, and a functioning exchange market that allows the various agents access to hedging instruments.

c. Since the global financial crisis, the development and implementation of ***macroprudential tools*** has become increasingly important for regulators and supervisors in different jurisdictions, constituting the main response to the need to strengthen the financial system and mitigate the real effects financial tension episodes. Macroprudential policy often requires coordination between the central bank and supervisory authorities, recognizing its interactions with monetary policy. In practice, monetary policy must consider the macroeconomic effects of changes in instruments of financial policy, and macroeconomic forecasts must take into account the evolution of financial variables, as well as potential financial risks. In turn, financial policy must incorporate the implications of the macroeconomic scenario for the financial sector, including the evolution of monetary policy.

d. Since the recession bottomed up in mid-2020, we are observing a very ***heterogeneous recovery process***, which contrasts with the largely homogenous shock initially caused by Covid-19, as well as the policy response to it. The strong recovery of demand in some regions, notably the US, combined with supply-side bottlenecks, has increased inflation and fostered expectations of monetary policy normalization. In turn, this has added pressure to emerging markets, many of whom are lagging behind in output recovery, and/or are challenged also by local factors resulting in further tightening of domestic financial conditions. Since this is taking place after a large accumulation of debt, the risks to the recovery in EMEs are growing. The adequate policy response in this scenario is challenging, as the loss of synchronization with AEs further reduces policy space and the likelihood of unwanted market responses.

These developments mean that capital flows may now behave quite differently from previous experiences and may have become more sensitive to uncertainty and risk perceptions.

3. Capital flows and risk perceptions in Chile

Such developments have also been noted in Chile, a small open economy, integrated to international financial markets for several decades. Since the early-1990s, the CBC developed a forward-looking inflation targeting framework to monetary policy that by 2000 was further strengthened with the endorsement of a floating exchange rate and an a-cyclical fiscal rule based on a structural balance measure. During the 40 years prior to the Covid-19 crisis, the domestic capital market deepened significantly through the growth of a funded pension scheme and the development of an annuity industry by insurance companies.

This framework has proved its relevance to the Chilean economy, allowing the CBC to manage monetary policy independently, with inflation averaging close to the 3% target, and two-year inflation expectations that have remained anchored to the target for most of the time over the last two decades. It has also allowed the country to mitigate the effects of significant external shocks, including the recent Covid-19 crisis. This framework allowed monetary policy to play a much more effective countercyclical role during crisis times, as well as in the episodes of terms of trade and capital flows volatility in the following years. Meanwhile, the local capital market provided a resilient basis of local currency, long-term financing for investment and helped develop an FX derivatives market that helped companies hedge financial and FX risks. A salient feature of the development of insurance, pensions and government savings was the development of large resident institutional investors.

The macro-financial scenario, however, began to change by end-2019. Since then the combined forces of a social crisis and the Covid-19 crisis did not only hit the real economy but the financial sector as well, given the sustained increase in uncertainty and political tensions surrounding fiscal decisions to counter the impact of the crisis on households. The latter, in particular, has resulted in three massive pension fund withdrawals amounting to some 18% of GDP in the last year. Combined with previous massive pension fund-switching by affiliates, this has limited the capacity of the capitals market and the exchange rate to cushion both external and domestic shocks, resulting in large idiosyncratic movements of the exchange rate, market long-term interest rates and stock prices.

More relevant to the subject of this Conference, however, is that over the last two years, we have observed disparate behavior of resident, institutional and non-resident investors, which have combined sometimes to confusing aggregate capital movements. To disentangle the puzzle, therefore, it is important to distinguish risk perceptions and reaction functions of the different groups of investors as well as changes in the international environment and forces operating in the FX market. Adequate policy responses, on the other hand, should integrate the international experience in managing macroprudential tools.

4. Conference contents

Thus, it is of paramount importance the role of academia to understand what the main drivers of capital flows are, particularly for EMEs, and what the consequences of their surges and retrenches on the economies of recipient countries are, especially when these are unanticipated by domestic economic agents.

The paper by **Bajraj**, **Fernández**, **Fuentes**, **García**, **Lorca**, **Paillacar** and **Wlasiuk** sheds light on these matters by looking at how global drivers of capital flows are related to business cycles in EMEs. Through state-of-the-art techniques and making use of the large-scale macroeconomic model used at the CBC for medium-term projections, they assess the salient role of global drivers in shaping business cycles in Chile. From here we learn that drivers linked to productivity and growth do not play a major role, in comparison with global financial cycle and shocks linked to global prices and commodities.

The work by **Fernández**, **Schmitt-Grohé**, and **Uribe** then tells us that stationary world shocks to commodity prices and the world interest rate explain about half of the world variance in output growth. Non-stationary shocks, that is, permanent shocks to the levels of these variables, are not playing a major role here. This goes back to a classical discussion of whether cycles in EMEs are driven by shocks to the trend. From this contribution we can say that no, at least not when it comes to trends in commodity prices.

Understanding the globalization of corporate control in EMEs, is the topic of the paper by **Papaioannou** and **Fonseka**. This is a very comprehensive, almost detective work that seeks to disentangle controlling shareholders from ownership structures. They find that there are large heterogeneities among countries, and that tax havens are used pervasively. Surprisingly, the tax system does not seem to be a main determinant of foreign control. Conversely, institutional arrangements such as legal origins and corruption are correlated with the use of tax havens in corporate control.

Large global shocks such as the Covid-19 crisis, and the policy responses engineered towards preventing massive bank and firm bankruptcies provide a valuable quasi-natural experiment to study the financing of firms in domestic versus international markets. The paper by **Acosta-Henao**, **Fernández**, **Gómez-González**, and **Kalemli-Özcan**. Does this by using a very rich dataset of firms in Chile. The authors find that support policies that reduced the cost of local currency domestic debt to firms caused them to switch from foreign debt to domestic debt. This type of analysis is crucial to learn from our success and our mistakes and, ultimately, improve the future design of economic policy.

If global financial and price shocks as well as institutional arrangements, country characteristics, and policy determine to a large extent the volatility of capital flows, is there an anchor, a natural level to which these flows revert to? **Burger**, **Warnock**, and **Warnock** propose a theory-based time varying supply-side measure of the natural level of capital flows. The natural level of capital flows they construct has impressive forecasting abilities, to the extent that it is a useful measure to predict highly damaging episodes such as sudden stops four to eight quarters ahead and flows during massive global shocks such as the Covid-19 shock.

Economic policy design is the focus point of three other extremely relevant papers, more so from the point of view of emerging economies' central banks. **Kalemli-Özcan** and **Gourinchas** discuss limits and design of monetary policy in emerging market economies when there are significant deviations from the uncovered interest rate parity (UIP) and the covered interest rate parity (CIP), respectively. **Kalemli-Özcan** shows that US monetary policy influences the risk sentiments of international investors and, through subsequent deviations from the UIP, the effectiveness of monetary policy in EMEs. In such cases, floating exchange rate regimes help revert this result.

Basu, **Boz**, **Gopinath**, **Roth**, and **Unsal** develop an integrated framework to evaluate monetary and financial policy in EMEs. In particular, they focus on prudential capital controls, exchange rate interventions, and monetary policy. The policy prescriptions that emerge from this analysis are varied, but it makes clear that the depth of exchange rate markets is key when considering the implementation of measures such as capital controls. For example, when exchange rate markets are shallow, capital controls may improve monetary autonomy.

Central banks have to choose policy given a set of instruments and a set of constraints. Decisions are made based on which shocks are affecting the economy at each point in time, the relevant gaps to be closed, and what frictions are operating. The exercise aims at "optimal" policies that would be chosen by a benevolent planner. The paper by **Itshoki** and **Mukhin** aims to characterize optimal monetary and exchange rate policies when there are segmented financial markets, with the choice between fixed or floating exchange rates depending on the constraints faced by monetary policy, such as the zero-lower bound, and non-negative requirements on central bank foreign reserves.

Switching to fiscal policy and sovereign bonds issuance, **Aguiar** and **Amador** explore the desirability of issuing long-term bonds with floating rates, and they find that such instruments encompass the desirable properties of both short- and long-term debt. The large stocks of sovereign debt that burden many economies in the aftermath of the Covid-19 crisis renders this analysis quite timely.

Finally, the keynote lectures of **Maurice Obstfeld** and **Carmen Reinhart** will put the focus on what has happened to capital flows in the recent past, what are the risks, especially for EMEs, in the near future, and what should be done to tackle those risks.

5. Acknowledgements

I would like to thank Sebnem Kalemli-Özcan for being the external organizer of this Conference, as well as to Alvaro Aguirre and Andrés Fernández for being our local counterparts. I also thank all presenters and contributors to our program and the Conference volume that will be published thereafter.

Let me finish by thanking María-José Reyes, Cristian Valencia, Francisco Rey, and both the Public Affairs Department and the Economic Research Department of the CBC for all their invaluable help managing the challenging logistics of organizing the first fully online Annual Conference.

Thank you and have a fruitful discussion over the next two days.

***