

The Choice of Exchange Rate Regimes and the Experience of Chile

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Pros and Cons of Alternative Monetary / Exchange Regimes

More Flexible Regimes (Float)

Marks for Chile

- | | |
|--|----------|
| •Independent monetary/exchange rate policy for stabilization policy | high |
| •Relative price (RER) adjustment more quickly and less costly achieved through nominal devaluation | high |
| •Collection of seignorage | moderate |

More Inflexible Regime (Dollarization)

- Low credibility of monetary policy and Central Bank

- Mundell's conditions for common currency area

- Large de facto dollarization in domestic markets

- High nominal (and real) exchange rate volatility

- High international financial transaction costs

Marks for Chile

not a problem

not satisfied

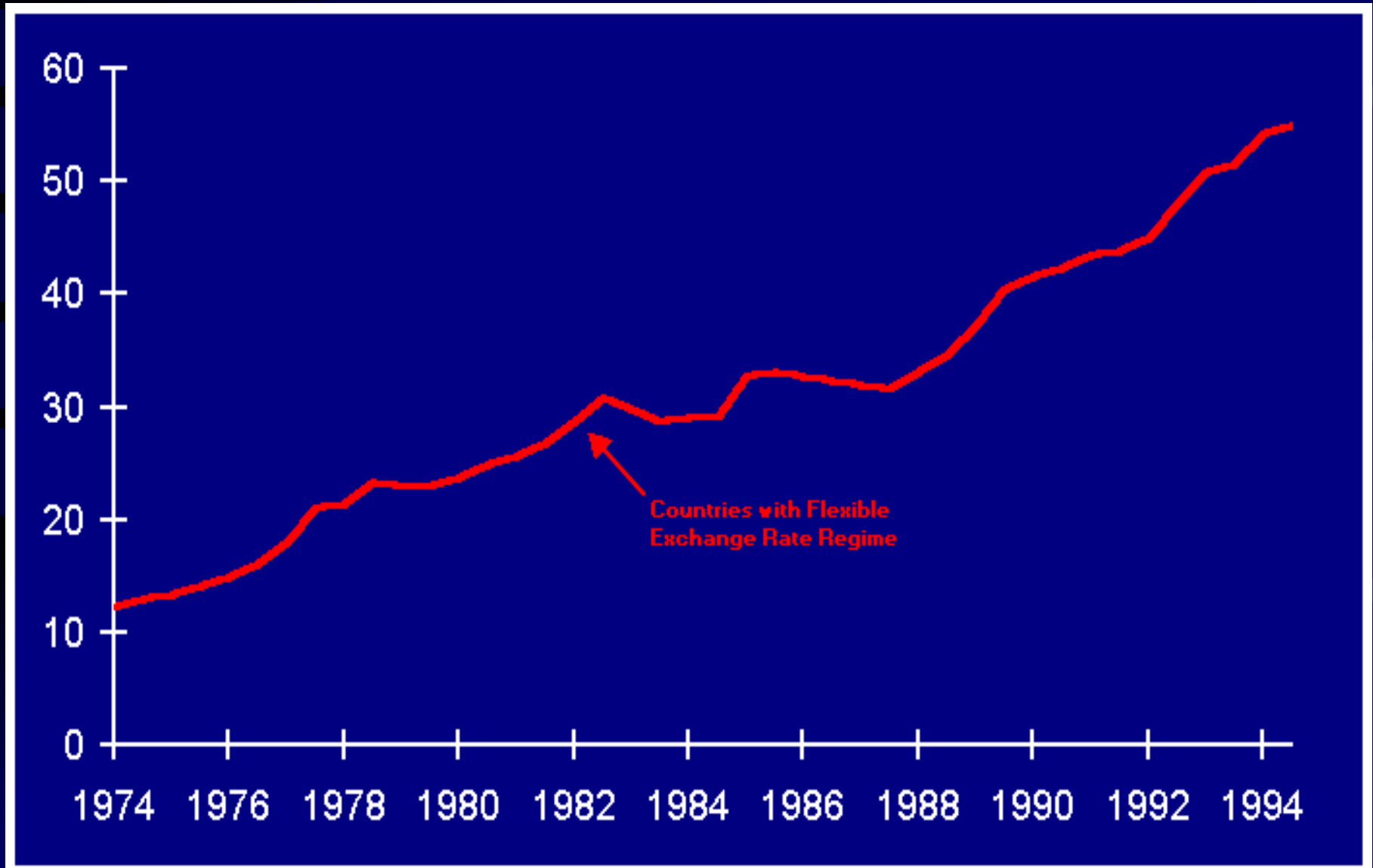
not satisfied

moderate

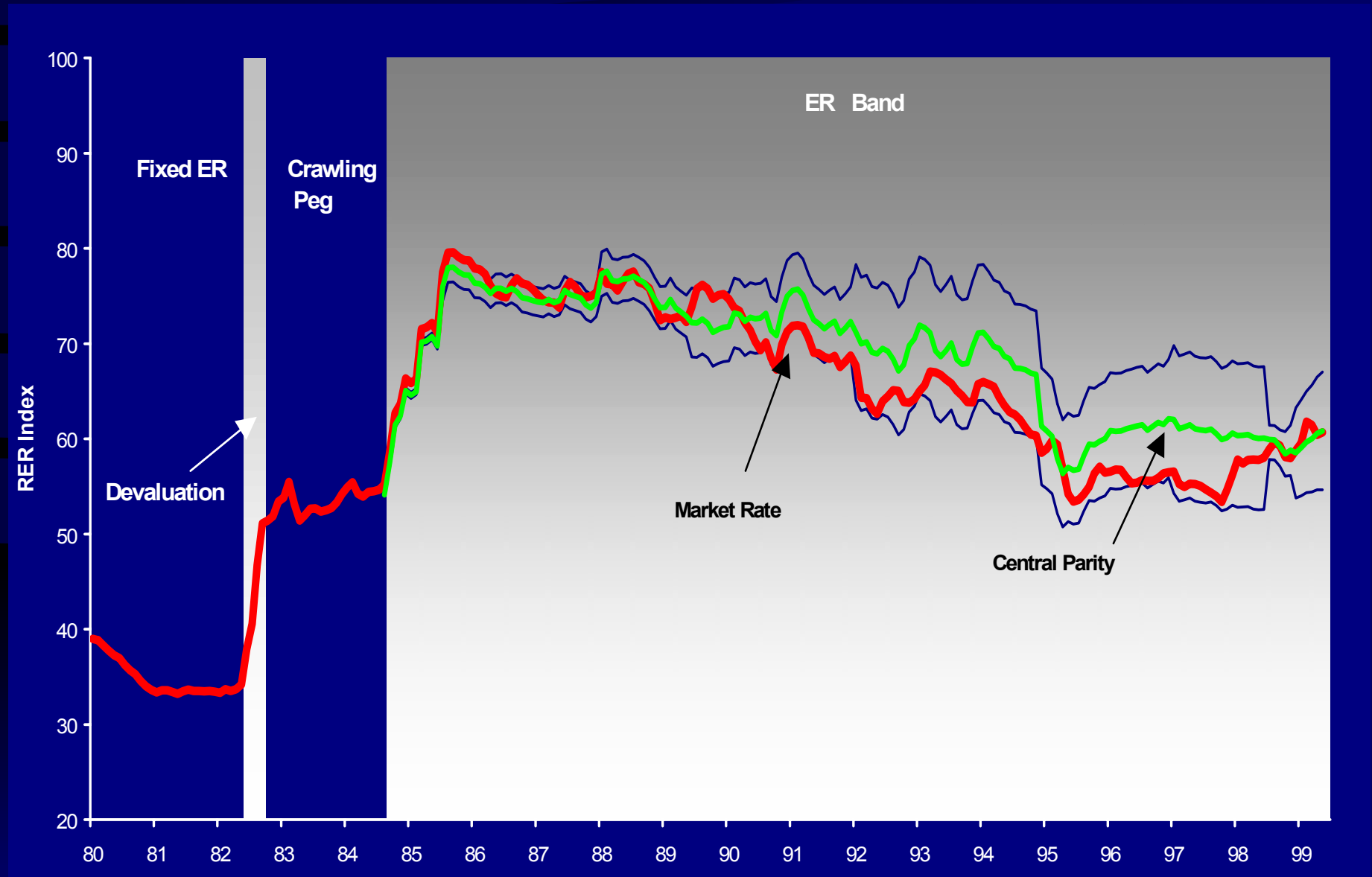
moderate

**“Economists of various political and economic views agree on adopting a flexible exchange rate system for Chile”
(F. Rosende, 07/20/99)**

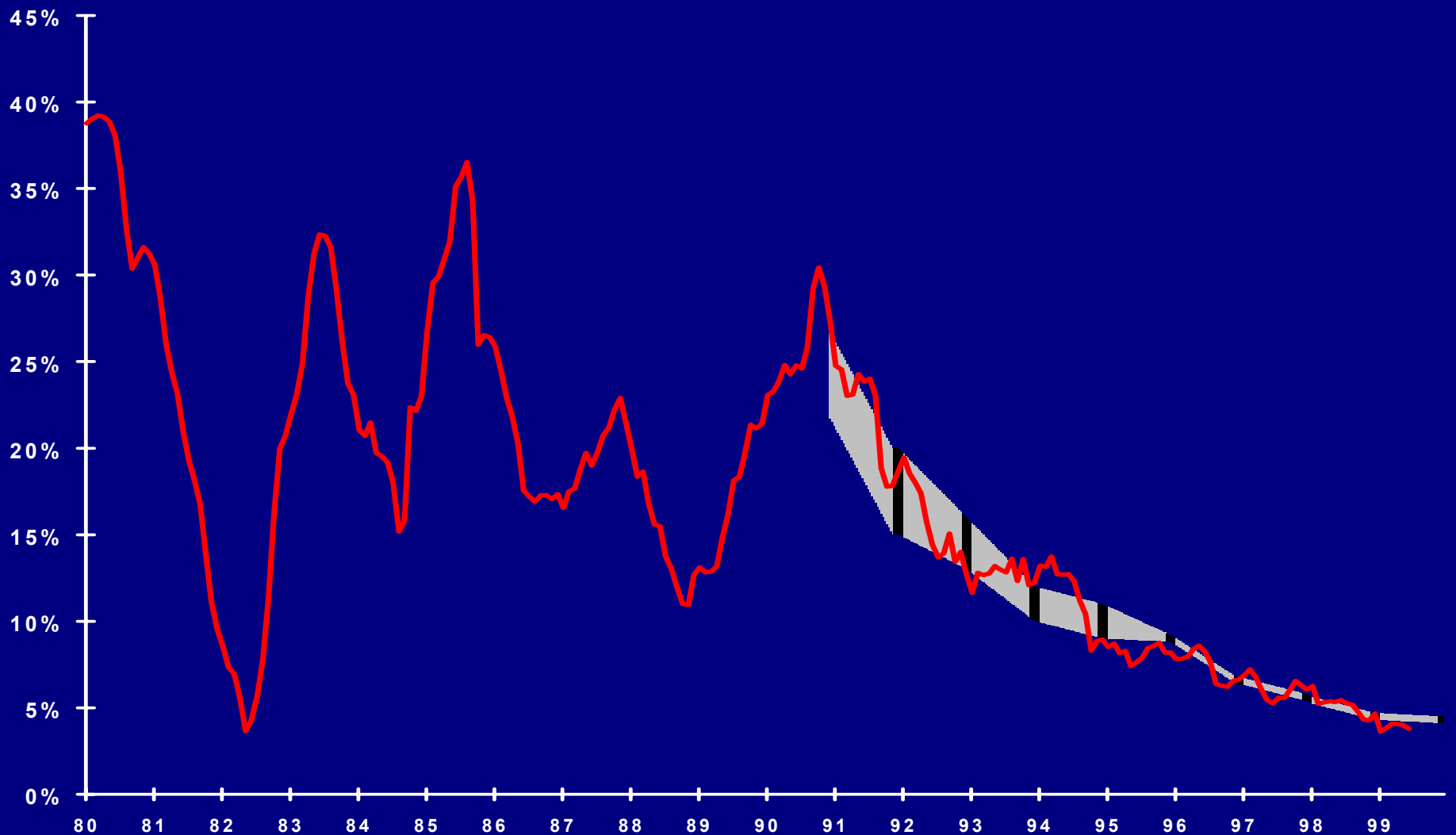
World Trend toward more Flexible Regimes



Toward more Exchange Rate Flexibility: Chile, 1980-99



Toward lower Inflation since Adoption of Inflation Targeting: Chile, 1989-99



From Asia 1997 to Brazil 1999: Effects of International Turmoil on Chile

Current Account Effects:

- 1997-1999 loss of terms of trade by 6.3%, equivalent to 3.5% income loss
- decline in export volume to East Asian market (initially 35% of Chilean exports)

Capital Accounts Effects:

- lower capital inflows (37.4% lower than 1995-97 average)
- higher cost of foreign borrowing
- significant but temporary increase in country risk spreads

Speculative Attacks:

- Three speculative attacks on the Peso during 1998
- In an initially overheated economy
- With growing current-account deficits

Policy Diagnose

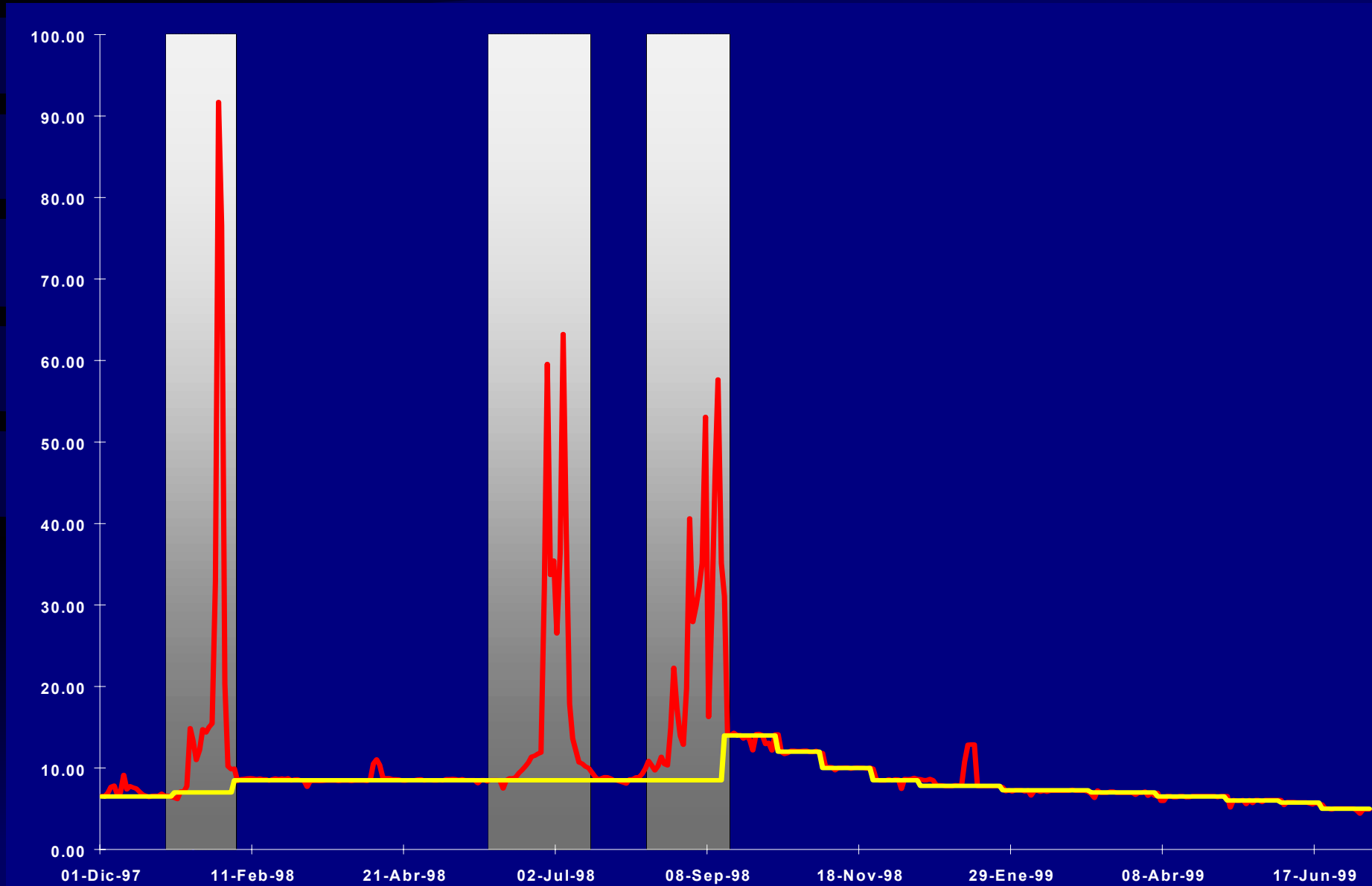
- Potentially unsustainable current account deficits and stubborn inflation require fiscal and monetary correction
- Speculative attacks on the peso jeopardize meeting the inflation target and maintaining domestic financial stability, if depreciation is too sudden and excessive
 - In a highly indexed and overheated economy, currency over-depreciation leads to higher inflation and a possible loss of the nominal anchor

- Overdepreciation leads to major capital losses of foreign-currency debtors and excessive relative price changes, causing excessive financial stress and output loss
- The terms-of-trade loss and the correction in domestic spending require a more depreciated real exchange rate, achieved by a combination of nominal depreciation and lower inflation
- To rule out an overdepreciation, the nominal exchange rate component of RER correction should be gradual, avoiding nominal (and real) overdepreciation

Central Bank Policy Response

- Adoption of a more restrictive monetary policy stance
- Substantial liberalization of capital inflows:
unremunerated reserve requirement set to zero
- Liberalization of domestic financial transactions
- Defense of the Peso:
 - Temporary but strong
 - In three stages: non-sterilized interventions, liquidity restriction (allowing spreads between market and policy rates), increase in policy rate (convergence of both rates)

Overnight Interbank Interest Rate and Monetary Policy Rate: Chile, 1997-99



Macroeconomic and Financial Performance: Chile, 1998-2000

	1998	1999	2000 ^(*)
GDP growth	3.4	0.5	4.5 - 5.5
Actual (Target) inflation	4.7	4.3	--
Unemployment rate	7.2	10.8 ⁽¹⁾	---
Current Account Deficit/GDP	6.2	3.6	4.0 - 4.5
Real exchange rate depreciation	3.0 ⁽²⁾	1.0 ⁽³⁾	---
Bad Bank Loans	1.5	1.8	---
90-day nominal interest rate	11.4 ⁽⁴⁾	7.7 ⁽⁵⁾	---

(*) Projected

(1) June 1999; (2) December to December; (3) Dec 98 - May 1999; (4) Average Nov-Dec 99 ; (5) July 99

Reaction of International Financial Markets: Spreads on L.A. and Chilean Sovereign Bonds



Chile: Future Policy Challenges

◆ For the Central Bank:

- More exchange rate flexibility
- Full integration into world financial markets
- At convergence to OECD inflation levels:
adoption of long-term inflation target range
- More flexible use of monetary policy rate
- Shift from CPI-indexed to nominal interest rate
as monetary policy rate
- Increase in Central Bank policy transparency (publication
of models, regular inflation report)

◆ For Fiscal Policy:

- Return to structural government surpluses

◆ For Economic Policies at large:

- Continuation and deepening of growth-enhancing structural reforms