

Conference

“THE ROLE OF CENTRAL BANKS IN MODERN TIMES: TWENTY-FIVE YEARS INTO THE CENTRAL BANK OF CHILE’S INDEPENDENCE” (October 24, 2014)

PANEL

Comments by Carlos Massad

We should not be just commemorating independence: we should be celebrating success. Let me take a quick look into the past to illustrate this.

As a young undergraduate student of economics by mid 20th century, I participated in street demonstrations against inflation. In the past century, inflation averaged about 30% per year, with peaks of 80% in 1955, and over 800 % in 1973.

Demonstrations obviously did not contribute to stability, but stimulated my interest to study the problem. As a research assistant at the Instituto de Economía of the University of Chile I began to do some work into the causes and consequences of persistent price increases. My thesis on monetary inflation in Chile, a result of such work, was published as one of the chapters of the first book of the Instituto de Economía: El Desarrollo Económico de Chile 1940-1956.

In 1964, President Eduardo Frei Montalva was elected. One of the main issues of his campaign was to accelerate

the rate of growth of the economy achieving, at the same time, a gradual reduction in the rate of inflation. I was 32 years old when he put my name forward first as vice-president of the Central Bank and, three years later, as president of the Bank. So, I was a privileged witness and active participant in the successes and failures of the time.

Inflation targets were announced for the first three years and government policies were true to the targets, the first experience I know of inflation targets in the world. The targets were met for the first two years but then political difficulties made it impossible to continue. So inflation decreased and then increased again, going back to the stubborn 30%.

The capital and financial markets had been smashed by inflation, so that open market operations designed to help control the rate of expansion of money and credit were unfeasible. Maximum interest rates, determined by law, were set below the inflation rate so that real interest rates in the banking system were negative. Furthermore, it was mandatory for the Central Bank to finance fiscal deficits. Despite the introduction of measures designed to correct some of these deficiencies, the political and institutional environments were not conducive to appropriate monetary policies, to say the least.

We were, however, extremely successful in closing the external gap. A new exchange rate policy allowed for small and frequent changes in the exchange rate determined by the Central Bank. This was contrary to the prevailing view everywhere, including international institutions: fixed nominal exchange rates were defended until unemployment and recession raised political pressures that could not be resisted.

The new policy, later called “crawling peg”, was designed to defend the external sector from inflation. It allowed the drastic reduction of arbitrary foreign exchange and import and export controls and the reconstruction of net foreign reserves. Financial market institutions at the time were basically official, governmental or international, so that capital movements did not prevent the efficient working of the crawling peg.

Despite serious political difficulties, other important objectives of the government were attained, but not the rate of inflation.

I left the Bank in November 1970.

Inflation went on, and reached such highly destructive levels that it contributed to the rupture of democratic processes in 1973.

In 1996, President Eduardo Frei Ruiz Tagle presented my name to the Senate for the position of member of the

Board of the Central Bank. After some turmoil, the Senate approved my designation and the president appointed me as President of the Bank. Inflation was decreasing year after year since 1989, precisely the year when the Bank was made independent. It continued decreasing systematically, with the bank announcing in September every year the inflation target for the next calendar year. The exchange rate was moving within a band set by the Central Bank, so that the bank was offering implicit limited free exchange rate insurance to the market. This insurance was not at all events, as the Bank was forced to change once in a while the limits of the band, compelled by capital movements despite the existing regulations.

The Bank used, as its main policy instrument, an overnight interest rate set over and above the rate of change of the UF. The free exchange rate insurance, together with relatively high domestic interest rates as compared to foreign rates, stimulated external borrowing and currency imbalances all over the economy, including the domestic financial sector.

By 1997, it was clear that important policy adjustments were required. This was made evident by the Asian crisis, when capital inflows into the Chilean economy were reversed and the Chilean peso came under strong pressure. The obvious policy response should have been a mix of floating and increased interest rates, but the floating of the exchange rate was not a feasible options at

the time. So, initially, interest rates had to face most of the pressure.

The Bank had already started to gradually prepare for floating. Limits were set for currency, maturities and interest rate imbalances in the financial sector and, indirectly, in the nonfinancial sector; forward and derivative exchange operations in the banking sector were stimulated so that the private sector could itself provide coverage for exchange rate risks, and the band was widened gradually until it became completely irrelevant: the peso was floating. And the policy interest rate was set in nominal terms, breaking its relationship with the UF.

With a floating exchange rate, the Bank won degrees of freedom in monetary policy, and administrative controls on capital movements became irrelevant. As inflation had already reached acceptable long term levels, a new form of operation of the inflation target was put in place: a permanent target was set, within a range between 2 and 4%, centered in 3%.

Most of the new policy approach was in operation in 1999, with the support of President Frei Ruiz-Tagle. It was complemented in 2000 with a new form of fiscal management: the structural approach to fiscal equilibrium, a fundamental ingredient in macroeconomic policy introduced by Minister Nicolás Eyzaguirre with the

support of President Ricardo Lagos. This monetary, exchange rate and fiscal policy approach, with relatively minor adjustments, has been in operation in the last 15 years, the longest period of stable macroeconomic policies in Chilean history.

I have often asked myself if the policy changes at the turn of the millennium could have been implemented if the Central Bank authorities depended from some other political entity or person. And my answer is, and continues to be, negative. As a matter of fact, some of the changes in policy at the time were opposed by several distinguished economists, both domestic and foreign, both in the private and the public sector, which delayed but did not prevent the policy changes.

The results are well known: inflation has been contained; the country is number one in Latin America in terms of income per capita, quality of life, and poverty reduction. These results are not due to macroeconomic policies alone, but such policies have made a decisive contribution, recognized everywhere. **This is success**, which we should celebrate today.

Of course, there is yet a lot to be done, and monetary policy cannot do everything. But the Central Bank is now one of the most respected institutions in the country, and its credibility, gained at some cost, is asserted by the fact that, despite all the turmoil in world markets, long run

inflationary expectations are still anchored at 3% per year.

The comparison of these two events, in 1964-1970 and in 1998-2000, brings out another lesson. The most appropriate policies on each occasion are not always the same. The present policy set up is not the end of the story. Proper policies depend on many different circumstances. Existing policies do not solve all problems under all circumstances. Policy making is a never ending exercise, demanding permanent research and creativity based on research, which are enhanced by independence.

However, policy changes in themselves are always costly. They have to be carefully evaluated and implemented; they have to be explained to the community; they have to be defended from criticism from political, social and academic quarters. There is an adjustment cost to policy changes themselves. This has been made very clear recently, so that I do not have to dwell upon it.

But there is one particular characteristic of markets that helps reduce adjustment costs of all kinds. This is **flexibility**. A floating exchange rate provides an efficient means to adjust to changes of circumstances in the external sector. Flexibility in labor markets, dully compensated with increased benefits to the unemployed and their families helps to adjust more efficiently to changes in relative prices. Flexibility in market interest

rates helps to incorporate more people to the financial markets and to create new opportunities of entrepreneurship and employment; flexibility in relative prices allows for a better transmission of consumers' signals to producers, inducing productivity increases that benefit the economy as a whole.

But flexibility, to be efficient, requires competition. Flexibility abhors monopolistic behavior. So, flexibility needs to be accompanied by self control and strong anti collusion and anti monopoly action of the authorities. We are improving in that direction, but we still have a long way to go.

Let me close with a very personal note. I am sure that, for new generations, it will be difficult to appreciate the feelings of a central banker, and of a Central Bank, that have seen victory, in their watch, in a long, centennial battle against inflation. And for present generations, it will be very difficult to appreciate the feelings of frustration that a revival of inflation would throw upon those that fought the winning battle. After all, winning a battle, even a long battle, is not winning the war.