BOX:

Annual Conference of the Central Bank of Chile

The XXIV Annual Conference of the Central Bank of Chile was held on November 22-23 online and focused on the credibility of emerging markets, foreign investors' risk perceptions and capital flows. The conference was prepared over the last two years in collaboration with leading University of Maryland economist Sebnem Kalemli-Özcan. Leading international experts on these topics participated in the conference and presented a series of research papers prepared for the event. In addition, Maurice Obstfeld and Carmen Reinhart participated as plenary presenters. Each paper was examined by a specialized discussant and will be published in a forthcoming book in the Central Banking series[1]/. The opening speech, given by the Governor of the Central Bank of Chile, Mario Marcel, discussed the recent evolution of capital flows to and from emerging economies, with a special focus on the Chilean case.

Research papers presented

The Conference's central theme is of particular relevance for Latin American economies that in recent months have faced exchange rate depreciations, capital outflows, declines in local stock markets and increases in risk perception. Phenomena such as these were analyzed in the work of Bajraj and others (2021), who showed that the global financial cycle and international prices, such as commodity prices, are the primary determinants of capital flows, which in turn have an impact on the economic cycle of emerging economies. Related to this, Fernández and others (2021) reported that transitory commodity price shocks and changes in the international interest rate explain around 50% of the variance in the growth of small, open economies.

Although an important part of capital flows to emerging economies can be explained by global factors beyond their control, their structural characteristics continue to play a preponderant role. In fact, the development of the capital market, the strength and credibility of its institutions and the policy instruments (monetary, fiscal and macro-prudential) available make it possible to attenuate the economic cycle in the face of local and international shocks[2]/. The inflation-targeting scheme with floating exchange rate adopted by the Central Bank, combined with a fiscal rule and a deep capital market, allowed the country to conduct an independent monetary policy, keeping inflation expectations anchored to the 3% target, while allowing for an expansionary fiscal policy when the economic situation so required, as during the global financial crisis and the Covid-19 crisis. The work of

[1]/ The speakers' presentations are available [on the Bank's website].

[2]/ Fonseca and Papaioannou (2021) investigate in detail corporate ownership structures in a broad sample of countries, a relevant topic to understand how globalization has led to an internationalization of corporate ownership with the consequent effect on the shocks' pass-through across different economies. They find that there is wide heterogeneity among countries, related to characteristics such as the tax and legal system, their size and the degree of corruption.

Kalemli-Özcan (2021) shows that, even though in emerging economies the effectiveness of monetary policy is strongly tied to investors' risk perception and influenced by U.S. monetary policy, in Chile this has been less prevalent. This has avoided having to use policy tools such as capital controls, which can be very effective in economies with underdeveloped capital markets, but are less necessary when they are deep[3]/.

Since the end of 2019, however, the political, social and institutional configuration of the country has changed. The scenario of social and political tension, coupled with the high uncertainty stemming from the Covid-19 pandemic, have resulted in disparate behaviors of resident, non-resident, and institutional investors. For some segments of businesses, it has been more difficult to access international capital markets, which is reflected in the decrease in capital inflows and the higher risk premiums demanded by foreign investors[4]/. Policies such as Fogape loans, backed by the FCIC, have mitigated these effects, expanding credit volume and making it cheaper, particularly for small and medium-sized companies. The work of Acosta-Henao and others (2021) shows how the complementarity between these policies also affected larger companies, encouraging foreign debt to be replaced by local debt, and cushioning the real effects of the reduced inflow of capital when the pandemic struck.

In view of the worsening of investors' risk perception, with the resulting increase in exchange rate volatility and lower capital inflows, the ability to predict capital movements needs to be improved in order to design mechanisms to mitigate possible sudden stops of capital flows. Equally important is to design instruments that facilitate the funding of companies and the government in an environment of high interest rates. The former was the reason for the work of Burger and others (2021), who proposed a measure of the "natural level of capital flows" with high predictive power and which could be added to the projection tools currently available for this variable. The latter was explored by the work of Aguiar and others (2021), who proposed that long-term government bonds with variable interest rates are instruments that allow combining the lower rates of short-term bonds with the greater safety provided by long-term instruments. Although this type of instrument is very little used at present, it may become relevant because the high debt levels of emerging countries will require rethinking the forms of financing for the Treasury.

Plenary presentations and general messages

Both Maurice Obstfeld and Carmen Reinhart, in their plenary presentations, emphasized the future risks that may impact the global economy. Obstfeld spoke of the vulnerability of emerging economies to the way that central banks of developed countries may respond to inflationary pressures. This could put an end to the current expansionary phase of the global financial cycle and create abrupt reversals of capital flows, putting emerging economies in a precarious situation. Reinhart places the current scenario in a wider context, arguing that since

3/ The works by Gourinchas (2021) and Basu et al. (2021) explore the optimality of capital controls in weaker financial markets.

4/ As described in the *Financial Stability Report* of the second half of 2021, this has been accompanied by capital outflows, mainly from firms and households.

2015 there has been a reversal of the benign tendencies of convergence between rich and poor countries and less crises in the emerging world. Said reversal would be characterized mainly by plummeting commodity prices and would have accelerated with the recent sanitary crisis.

The present global situation makes emerging countries especially vulnerable to shocks, more so because of their recent fiscal deterioration and inflationary pressures. Therefore, it is particularly important to have sound financial markets; an inflation-targeting monetary and macro-prudential policy, a flexible exchange rate and, in countries with shallow financial markets, capital controls[5]/; plus disciplined fiscal policy and a restructuring of sovereign debt if dangerously high. These tools should enable a fast and effective reaction to potential shocks. In the case of monetary policy, moreover, it is crucial that the central banks of emerging countries act promptly so as to maintain the credibility of its inflation targets.

More generally, rebuilding the strengths of many emerging countries depends on restoring the leeway that permitted them to confront the latest crisis. For that, fiscal rules must be established that are consistent with sustainable debt trajectories, while strengthening the capital markets, and restore the confidence in local institutions, ensuring that the policies implemented are credible and predictable. In this sense, it is key that said institution are able to transmit clearly and for a wide-ranging public the scope of their functions, decisions, and fundamentals behind them, as will as the mechanisms for checks and balances[6]/.

[5]/ Implementing capital controls must follow a cost-benefit analysis. The costs include the possible loss of confidence of foreign investors to reinvest in the country.

[6]/ This was one of the points discussed by the economist Charles Engel on the work by Itskhoki and Mukhin (2021), who explore what is the optimal combination of monetary policy and foreign exchange intervention in emerging economies.