Chilean Experience in Financial and Trade Integration: Lessons for East Asia

Sergio Lehmann
Esteban Jadresic
Central Bank of Chile

September 2003

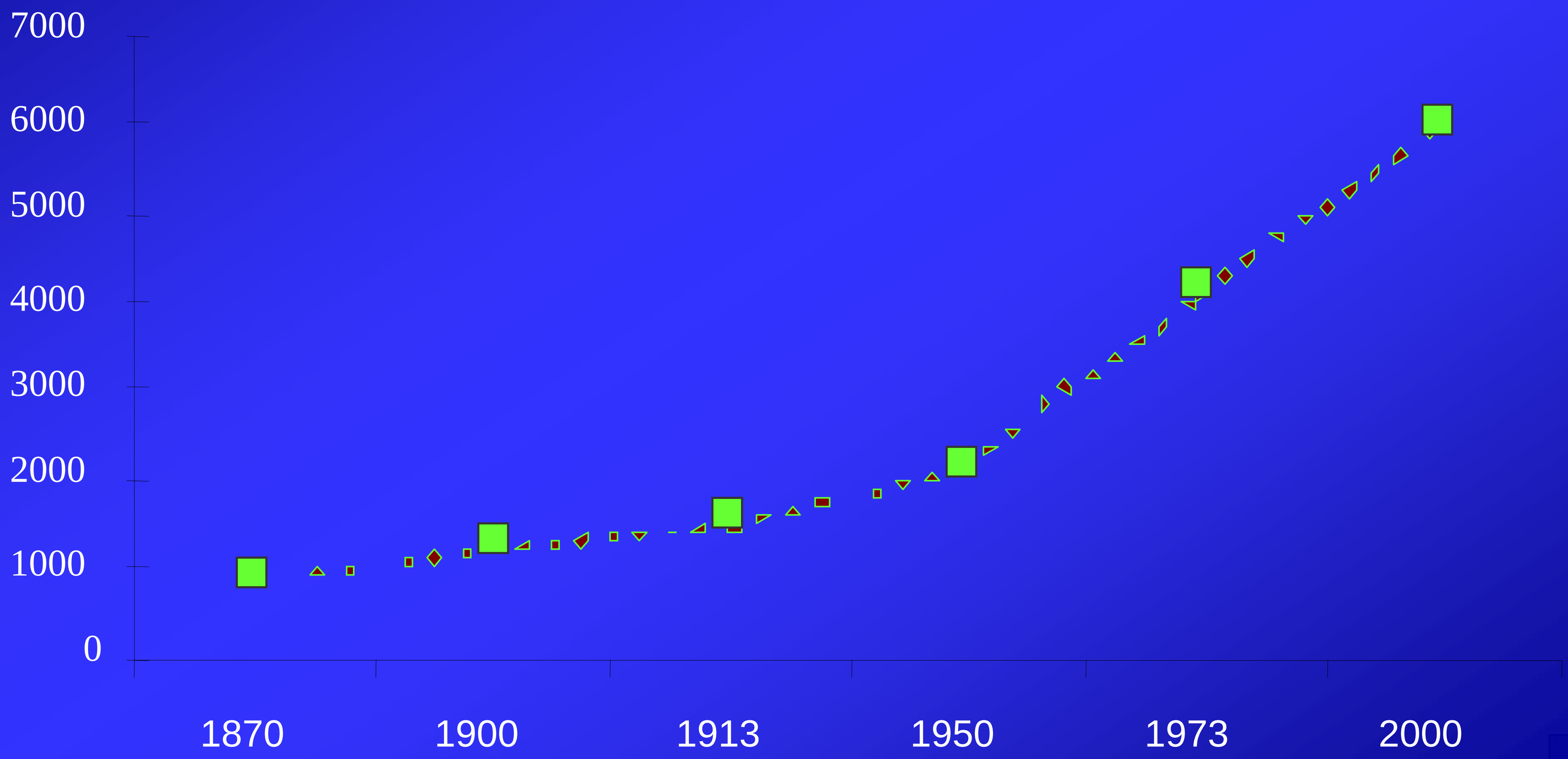
Motivation

- Increase in international trade negotiations
- Inclusion of financial topics: both capital movements and financial services
- However, globalization and integration has been controversial, particularly the financial integration

Benefits and Uncertainties Associated to Trade and Financial Integration

Globalization has Increased Life Standards

(World GDP per capita; real US$ PPP 1990; Based on Maddison)



Trade Integration

- Generates more opportunities for consumption, providing better prices.
- Improves allocation of productive resources.
- Promotes technological transference.
- Generates more competitive markets.

Benefits of Financial Integration

- Allows investment financing with foreign saving, reducing capital costs.
- Broadens opportunities to invest in external markets.
- Facilitates technological transference and market access.
- Develops and improves competitiveness in domestic financial markets.
- Reduces product and consumption volatility.

Literature and Empirical Evidence

- However, there is no empirical evidence that financial globalization has contributed to growth.
- Evidence shows that financial globalization has increased consumption volatility in countries that are not completely financially integrated.

Source: Prasad, Rogoff, Wei y Ayhan Kose, "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence" (March 2003)

Lessons from the Evidence

- We must to understand and derive lessons.
- Analyze problems behind the financial crises in economies that were in the middle of a financial integration process: Mexico (1994), Thailand, Korea, Malaysia and Indonesia (1997), Russia and Brazil (1998), Argentina and Turkey (2001).
- Evidence has shown that crises affect growth and increase volatility.

Role Played by Financial Integration

- Capital mobility amplifies the effects of domestic inconsistencies and distortions.
  - Unsustainable fixed exchange rates.
  - Excessive risks taking in financial sector.
  - Excessive indebtedness of public sector.
- Supply of international capital flows is volatile, and sensitive to contagion.

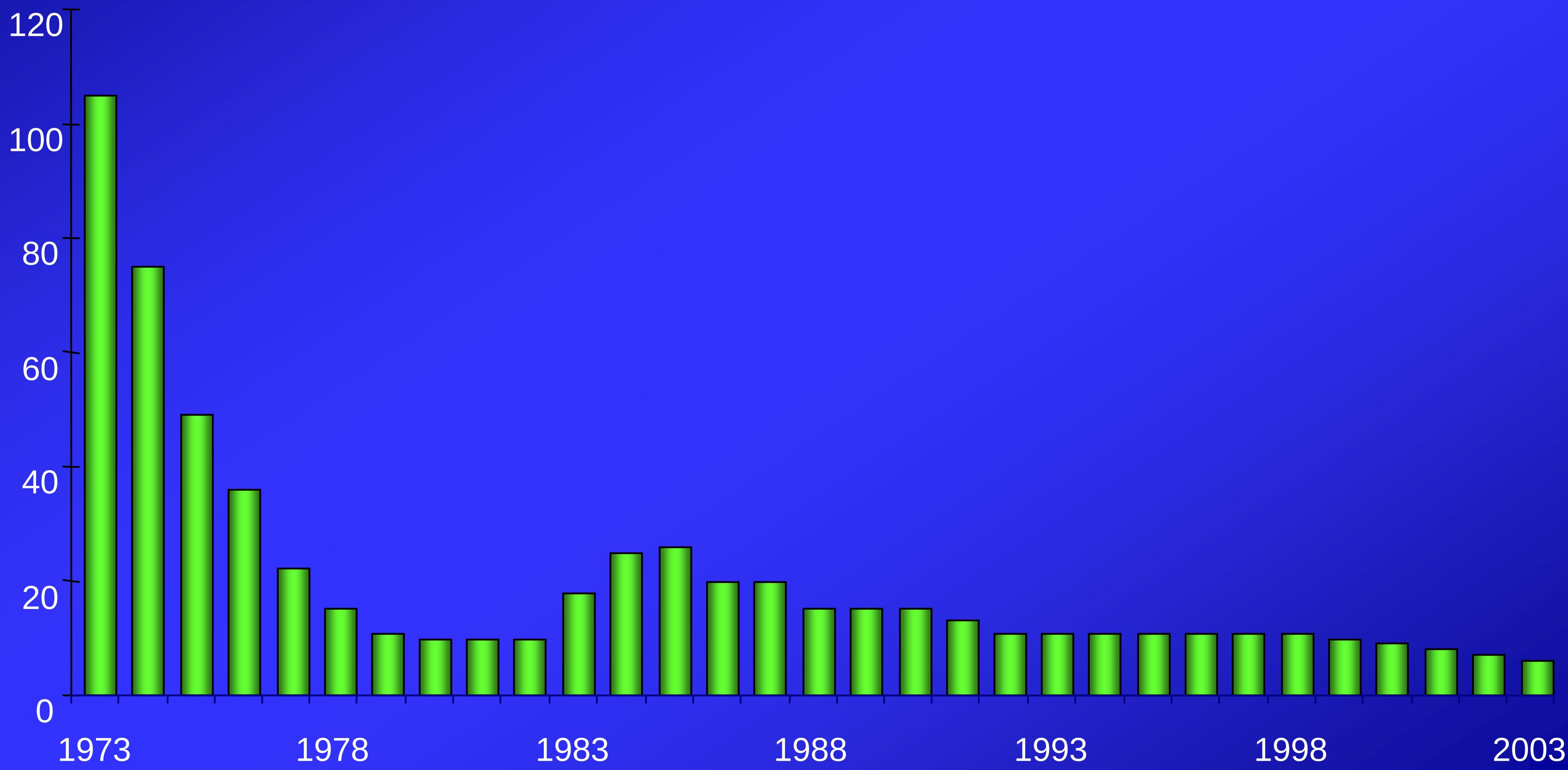
Implications

- Take advantage of the opportunities, but limit the associated risks.
- Adopt adequate economic policies, in order to eliminate inconsistencies and distortions:
  - Coherent exchange rate regime
  - Consistent and responsible credit policy
  - Adequate regulatory frame for the financial sector
  - Responsible fiscal policy
- Transparency, which diminishes contagion.

Chilean Trade and Financial Integration

Unilateral Trade Opening

(Tariff %; Source: Central Bank of Chile)

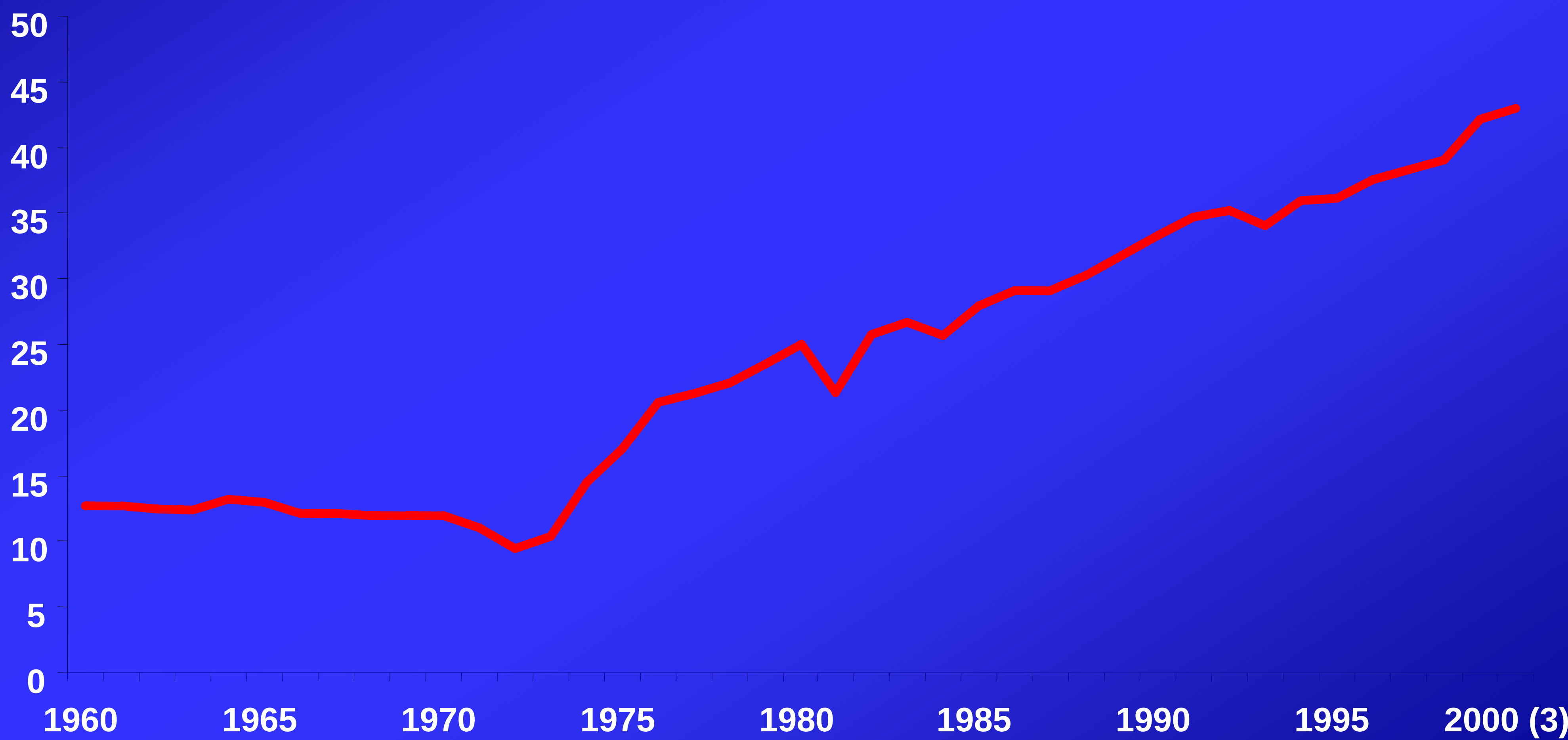


International Trade Agreements

- 1990s: Latin America and Canada
- 2000s: EU, Korea, USA, EFTA
- Consolidate and increase market access
- Provide confidence to investors
- Chile is open to new negotiations, in order to minimize trade deviation and to diversify trade (NZ and Singapore).

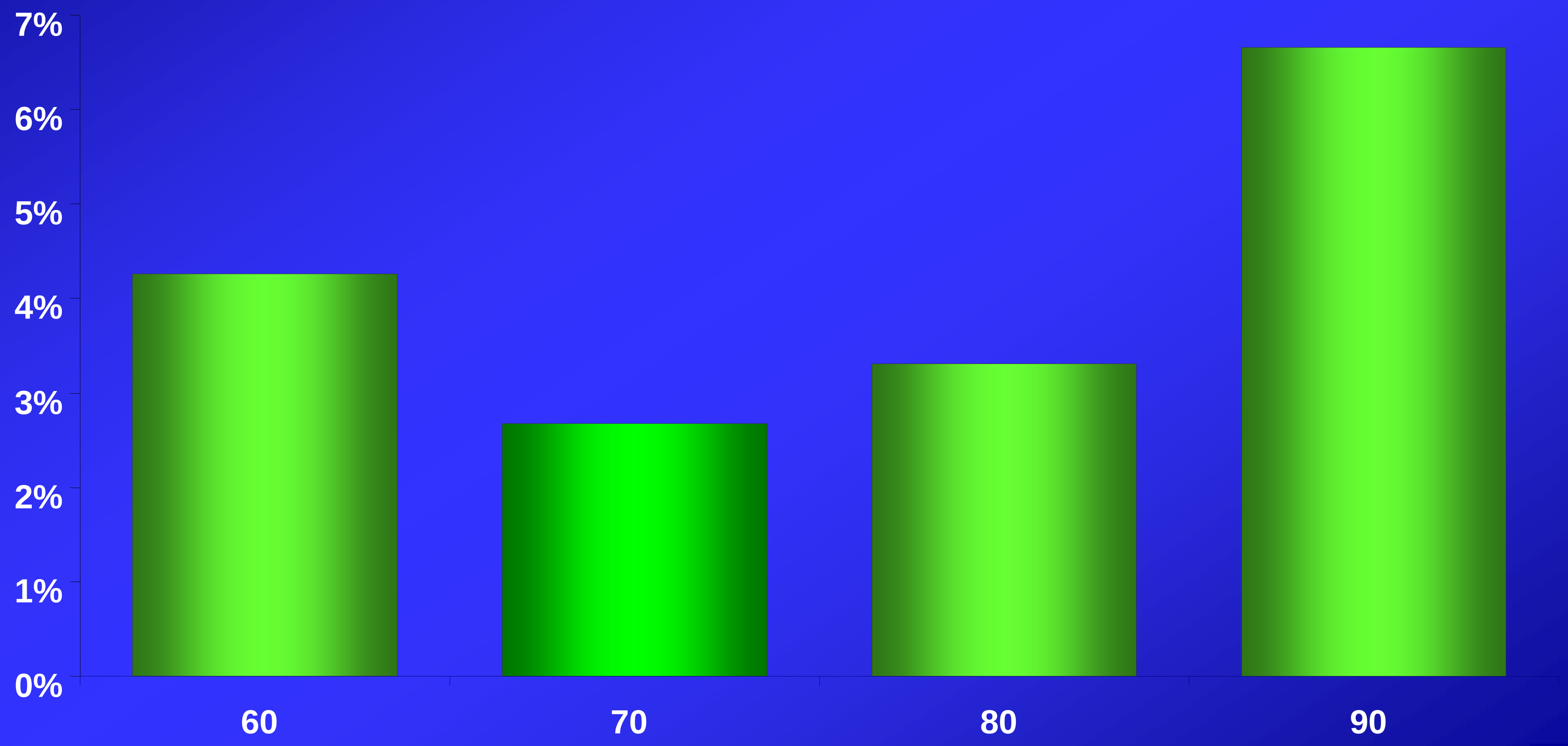
Importance of Foreign Trade

(Exports/GDP; Source: Central Bank of Chile)



Consensus in Contribution to Growth

(Decade average growth; Source: Central Bank of Chile)

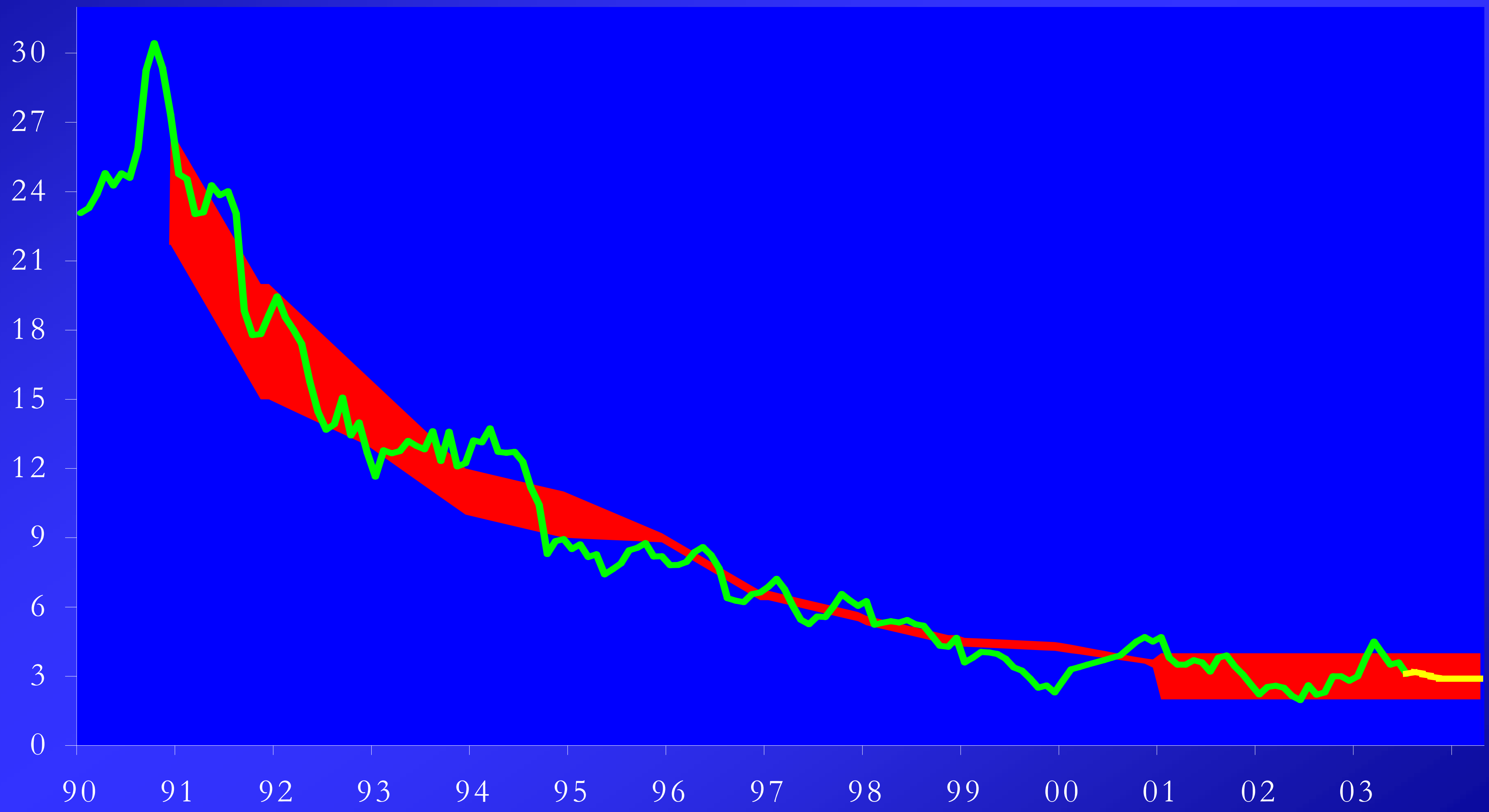


Financial Opening Completed in 2001

- During capital abundance, capital controls to outflows were eliminated.
- Gradually, controls to capital inflows were diminished
- In April, 2001 the remaining exchange restrictions were eliminated.
- Structural change, based on fulfillment of required preconditions.

Policies Behind the Chilean Financial Integration

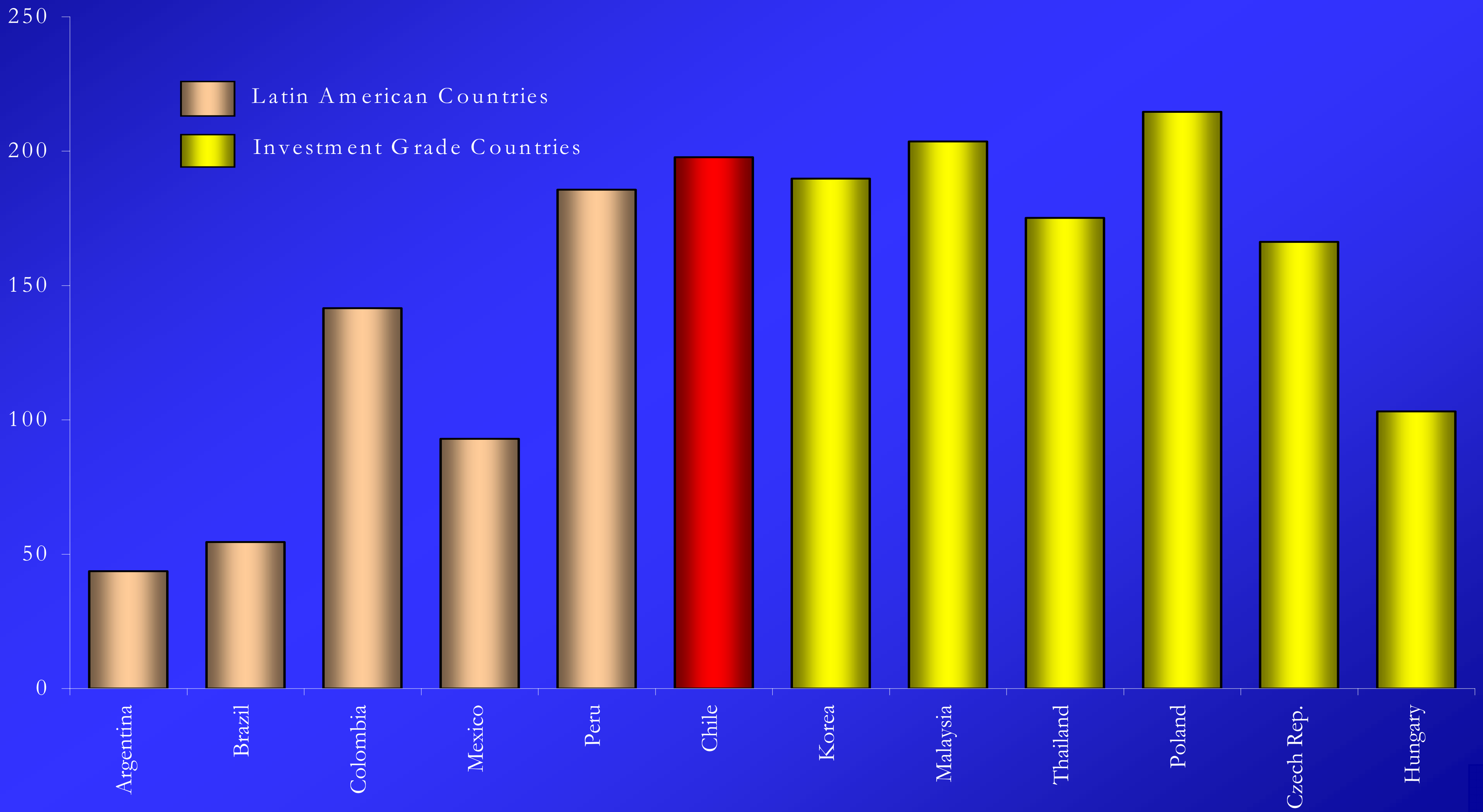
Inflation Targeting
(annual %)



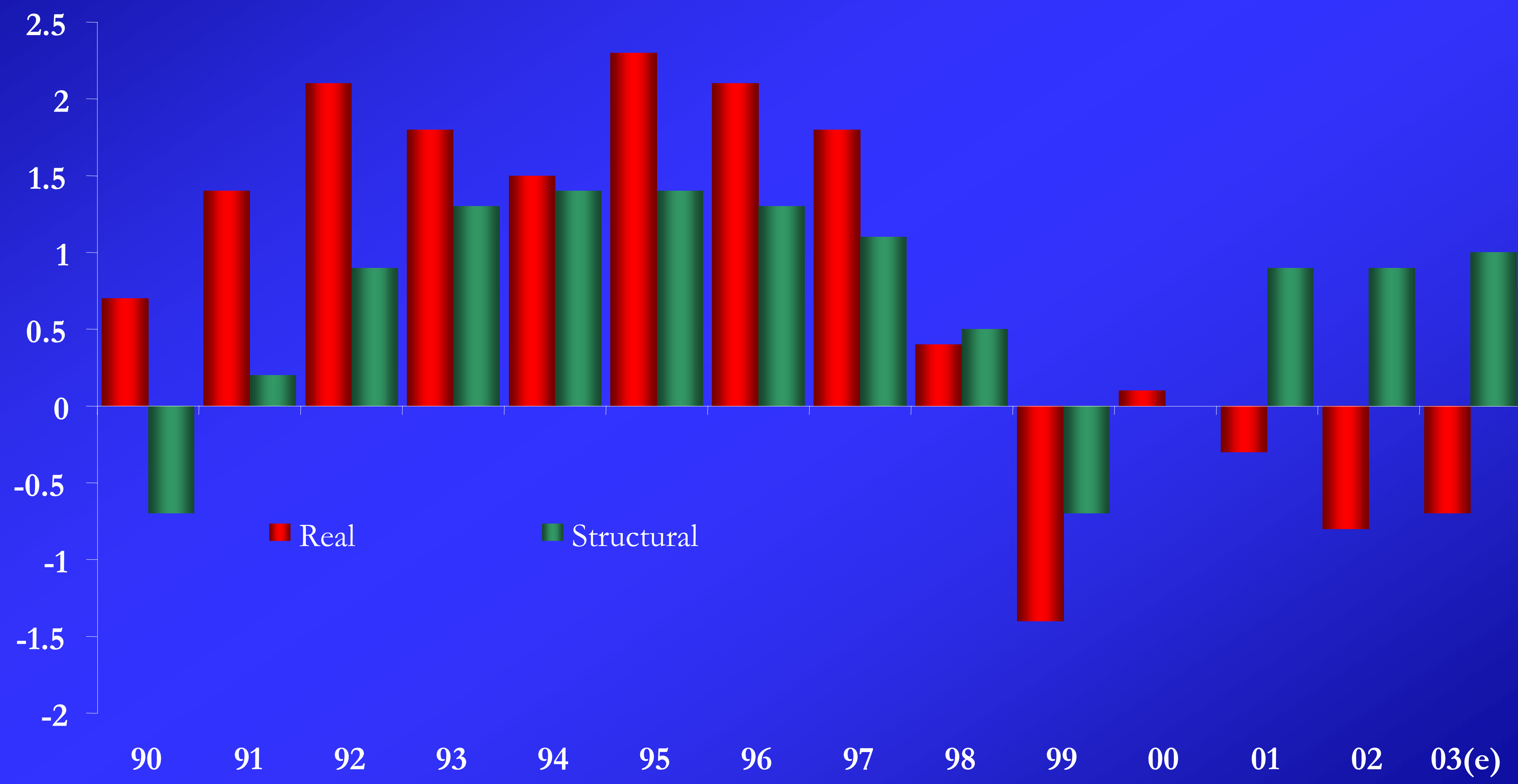
Floating Exchange Rate
(CLP/USD)

International Reserves

(As a% of short term debt+Amortization)(Source: JPMorganChase, 08.2003)

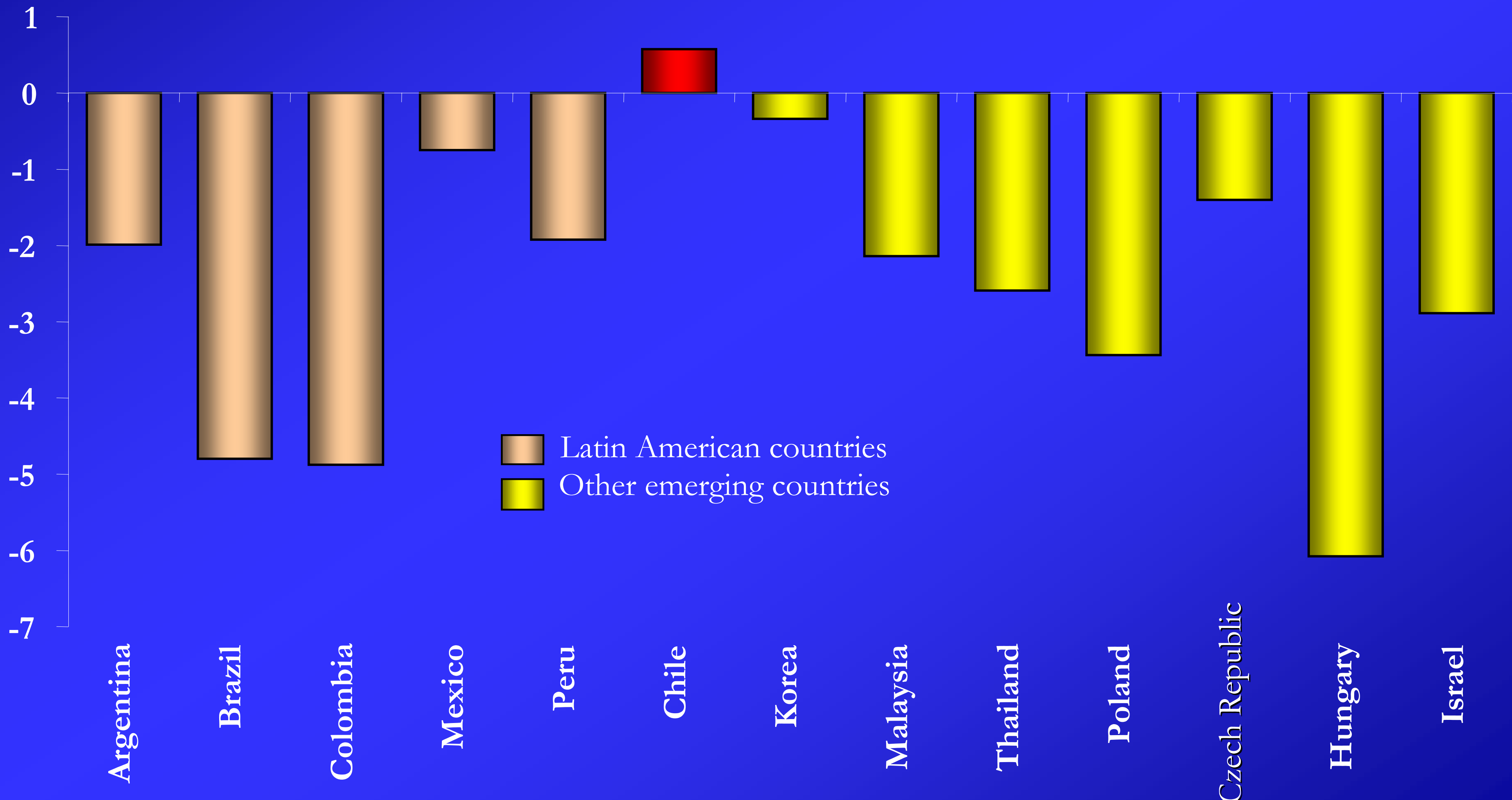


Fiscal Policy : Structural Surplus

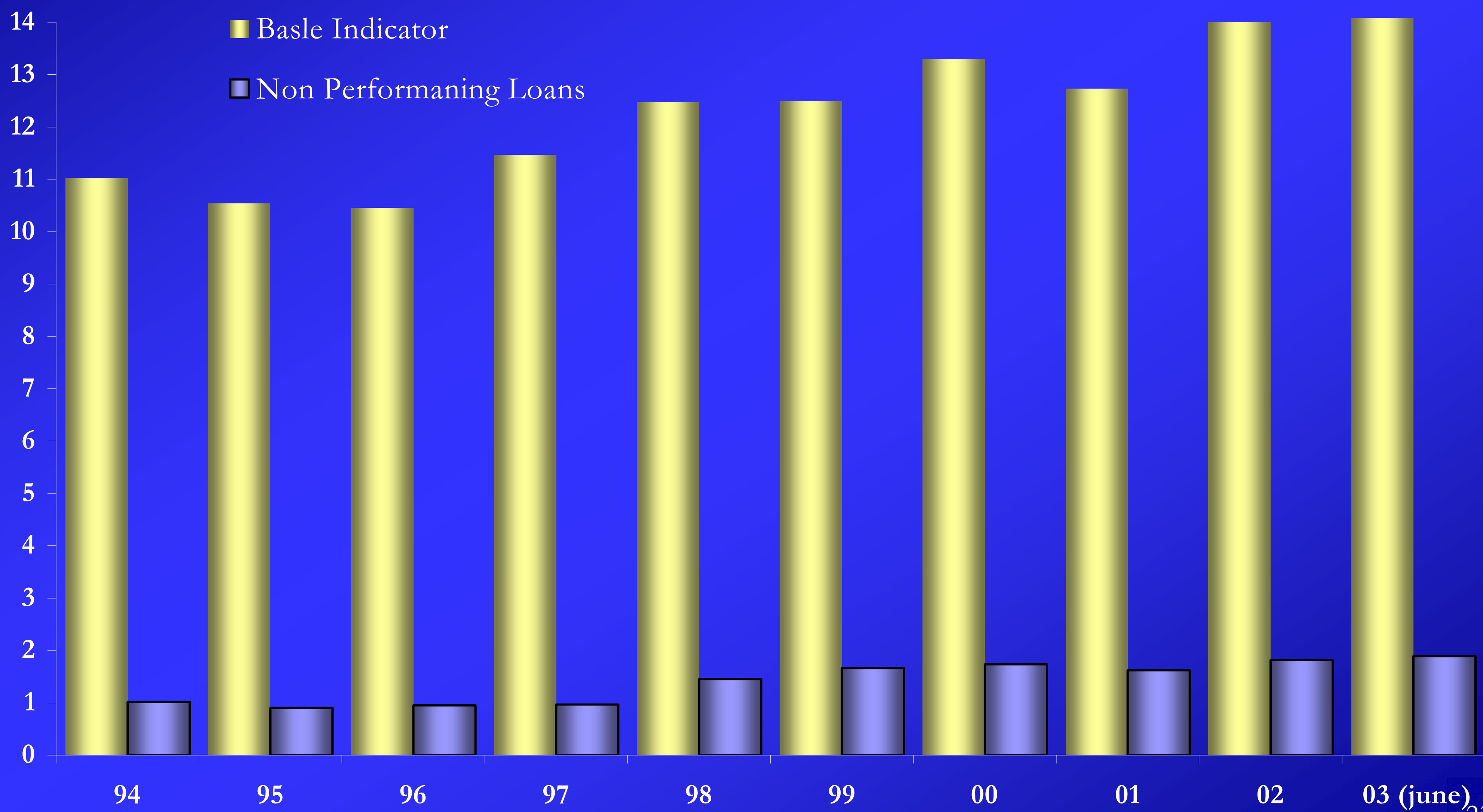


Fiscal Balance: Average 1995-2002

(GDP %) (Source: Moody's April 2003)

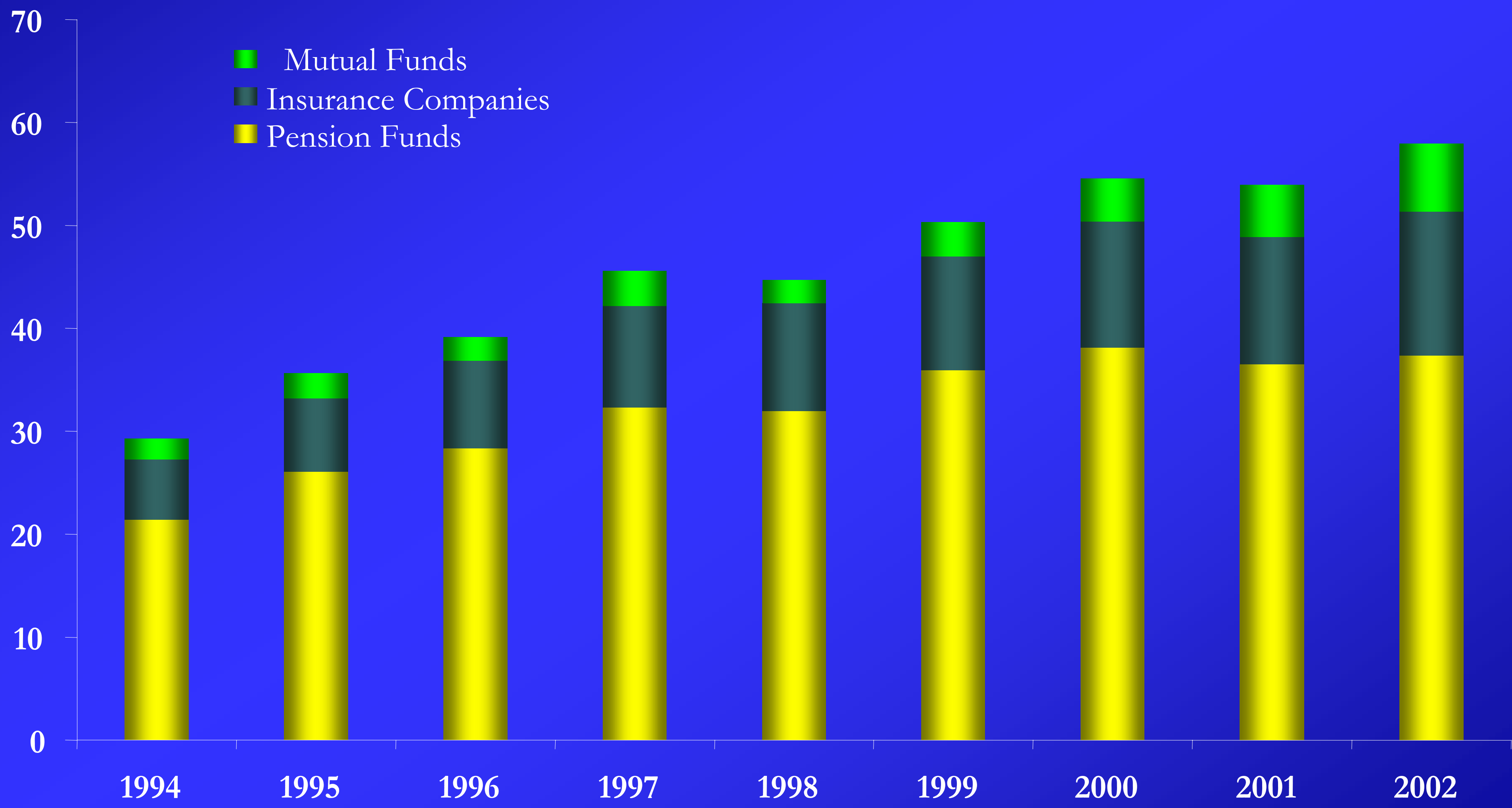


Solid Banking System



Institutional Investors

(US$, billions)



Reasons for Sustaining Financial Opening

- Eliminates inconsistencies between foreign exchange and monetary policy.
- Limits excessive risk taking.
- Provides more flexibility, under a frame of credibility about economic policies.
- Flexibility reduces the costs of adjustments.

Financial Topics in Trade Negotiations: The Chilean Experience

Financial Topics in International Negotiations

- Financial topics have gained importance.
- Trade negotiations has consolidated the current policy frame, limiting the possibilities to go backwards in integration.
- Increase in confidence on current regulations, benefiting investment and growth.

Capital Flows

- FTA between Chile and the US has been innovative in treating capital transfers.
- States the principle of free capital movements
- Leaves the possibility to impose controls, limiting the use of the dispute settlement mechanism.

Capital Controls FTA Chile-US

- Conditions for applying controls with no possibility to be sued:
  - Restrictions imposed for one year period or less.
  - Restrictions may not substantially impede transfers (dual exchange market would be allowed).
  - Restrictions may not be applied to FDI remittances or debt payments according to the pre-established schedule.
- In an exceptional event of applying restrictions over one year period, legal action may cover only direct damage.

Financial Services

- Reaffirms and assures the current financial frame: Stability of rules.
- Consolidates the establishment of foreign financial institutions in Chile.
- Assures non discriminatory treatment.
- Greater transparency in case of modifying or improving the regulatory frame.
- Prudential measures are not limited.

Conclusions

Conclusions

- Financial integration provides great opportunities, but also some risks may appear.
- We must move in financial integration, but limit risks.
- Adequate macroeconomic and financial sector policies.
- Inconsistencies and distortions must be eliminated.
- Flexibility may increase credibility.

Conclusions

- Within this frame, the inclusion of financial topics in international negotiations increases confidence in rules, benefiting investment and growth.
- The specific content of the agreements, should take into account the particular situation of each country .

Chilean Experience in Financial and Trade Integration: Lessons for East Asia

Sergio Lehmann
Esteban Jadresic
Central Bank of Chile

September 2003