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Financial and Monetary Cooperation: A Perspective from the Chilean Integration Progress

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1. Introduction

The purpose of this document is to present some views on monetary and financial cooperation among PECC economies, from the perspective of the last decade Chilean integration process. The analysis considers that a completely open capital and current accounts, and full integration with international markets in trade and finance, should be the final objective for all emerging market economies.

Economic integration and cooperation enhances efficiency in resource allocation. In addition, financial integration allows for the optimization of the intertemporal consumption path, to better diversify the financial risks by being able of taking positions in an array of net foreign assets, and to obtain a more complete provision of financial services under more competitive conditions.

In the case of Chile, the liberalization took place gradually over the 1990s, and it was important for its success that it was carried out after the Chilean economy had gained recognition for its macroeconomic and financial stability, and after the development of the local financial system. The indicators of external solvency and liquidity, of inflation, fiscal consolidation and domestic financial system strength were all among the best of emerging countries. The development of the domestic capital market, and of the banking system was also important, not only to create domestic sources for financing and financial services, but also to ensure that domestic financial institutions were in the position to compete with foreign providers. The opening up would not result in a stampede of local depositors and borrowers seeking foreign providers.

2. Liberalization Conditions

In the long run there are net advantages to be obtained from a free capital account. But, liberalization should advance cautiously, and only after certain conditions are being met, among which the most important are:

a) Establishment of a solid banking system. This condition is important, not only to create domestic sources for financing and financial services, but also to ensure that domestic financial institutions are in position to compete with foreign providers.
In order to reach this condition, following the financial crisis of 1982–83, the Chilean authorities embarked on an ambitious program to upgrade the prudential framework for the financial system. In 1986, the General Banking Law and the Organic Law of Superintendency of Banks and Financial Institutions were revised, to strengthen prudential regulations, minimize the need for state intervention in the financial system, and facilitate market self-regulation. In 1997, a new banking law was enacted that increased banks' capital requirements in line with the recommendations of the Basle Committee. Over the years,

Chile has developed a prudential framework for the financial sector that establishes high disclosure standards, stringent rules for loan classification and provisioning, strict limits on connected lending and on banks' exposure to foreign exchange risks, and clear procedures for the correction of liquidity or solvency problems. The soundness of the banking system today is reflected in the low level of non-performing loans, comfortable levels of provisions for bad loans and over compliance of all banks with the BIS capital adequacy ratio.

b) Development of hedging instruments, in order to facilitate the coverage against exchange rate fluctuations and interest rate risk. In order to do so, the Central Bank of Chile increased the scope of commercial bank operations with futures and options in order to include contracts on foreign currency and commodities. At the same time, regulation allowed residents who faced foreign risks, such as exchange rate risks, to hedge from those risks through the use of futures and options. All the regulation pertaining to the use of derivatives was further simplified, and financial operations involving hedging against interest rate risk were allowed.

c) Sound macroeconomic conditions. In this aspect, Chile has developed a solid position in terms of external liquidity and solvency, and has steadily reduced inflation within a context of a healthy financial system and balanced fiscal accounts.

d) Establishment of a solid and prudent fiscal position. In this regard, during the 1990's, fiscal policy was mainly characterized by fiscal consolidation, with an average surplus position of 2% of GDP from 1990 to 1997. Further steps have been taken to guarantee fiscal discipline, with the establishment of a fiscal rule that aims to achieve a 1% structural fiscal surplus balance.

3. The Chilean Integration Process

Only after securing the achievement of the conditions already mentioned was it possible to move on towards a different policy mix. This new policy framework involved the liberalization of the exchange rate with the abandonment of the crawling band system in September of 1999, and the adoption of a floating exchange rate regime for the Chilean peso.

In line with the adoption of the floating exchange rate regime, further steps have been taken to increase the degree of financial integration with the rest of the world. In terms of restrictions on capital outflows, the limits on foreign investments of domestic institutional investors have been further increased. In addition, the corporate sector has been authorized to issue securities other than ADRs, and on any stock exchange in the world. The minimum permanence requirement for capital inflows has been eliminated. Banks have been authorized to carry out a broader range of operations involving derivative securities with either domestic or foreign counterparts. In terms of capital inflows, the URR has been eliminated from the regulatory body pertaining to capital inflows, and several administrative requirements have been eased and expedited. The purpose of this most recent wave of measures is to lift all the restrictions to capital flows, either inflows or outflows, in the relevant regulatory bodies.

In terms of monetary policy, the main innovation to the already successful Inflation Targeting framework corresponds to a change in the way in which the inflation target is set. Since January 2001, the inflation target consists of a permanent band with a lower bound of 2 percent inflation and an upper bound of 4 percent. Given this inflation target band, the aim of monetary policy is to keep inflation at the mid-point of the band over a 1 to 2 year horizon, which is the estimated time lag for monetary policy to have its main effect on inflation in the Chilean case. The establishment of this new target responds to the fact that after a decade of inflation targeting, Chile has reached steady state inflation levels, and consequently the target had to be modified in order to take this fact into account.

The most recent change in monetary policy corresponds to a shift in the operational target of the Central Bank, from the overnight indexed interest rate, towards the use of nominal interest rates as the new operational target. The nominal rate is consistent with the existence of a floating exchange rate regime, the lifting of restrictions to capital flows, and the gradual issuance of nominal bills and bonds in financial markets. But, most importantly, is consistent with the credibility gained by the Central Bank with respect to its full commitment towards the achievement and maintenance of price stability. Furthermore, the shift from an indexed rate to a nominal rate is a strong signal and stimulus to further de-indexation in the Chilean economy.

So both tools were determinant in providing enough time to build-up the pre-conditions that were necessary to adequately move on to the next step, which is where Chile stands today, with a permanent inflation target range of between 2 and 4%, a floating exchange rate, completely free foreign exchange movements, continuing a path of further capital account liberalization and a higher degree of financial integration with the world.

In addition to the changing international environment, the evolution of the domestic exchange rate policy also favored the financial opening up. By granting additional exchange rate flexibility in every exchange rate policy adjustment from 1991 to 1997, monetary policy and the domestic interest rate had increased independence and required less support form capital account regulations. To a large extent the URR supported the defense of the floor of the band, the gradual reduction of the floor made the defense less demanding, until the reversal of capital flows completely eliminated its need. When the URR went to zero, and under the prevailing exchange rate expectations, the domestic interest rate appeared to be well aligned with the relevant international rate.

The exchange rate was able to fluctuate in response to the market pressures, and the resulting depreciation was not seen as a serious menace to domestic financial stability, while its effect on the inflation target can be compensated through monetary policy. A more flexible exchange rate required adapting the domestic economy to higher volatility. A continuous development of the local market for the coverage of exchange risk took place from 1995 on, with a continuous increase in the market deepness and a progressive extension of the contracts maturity. All this development increasingly allowed that foreign exchange risk could be shared and be transferred towards those parties better equipped to sustain it.

The banking system also deserved special attention, as with implicit and explicit deposit insurance risk control cannot be left to market discipline alone. Supervision and regulation becomes even more important with financial international integration, in particular to the extent that capital flows and exchange rate volatility can have significant impact on bank risks. With a floating exchange rate, exchange rate risk and market risk in general becomes a major concern for banks. Limits for the asset liability mismatches of banks in currencies as well as in maturity and liquidity were imposed, allowing direct exposure to market risk to be a function of the banks capital and reserves. Besides, the secondary foreign exchange risk derived from the exposure of bank clients should also be explicitly monitored by banks and supervisors, and considered in making lending decisions. New systems have been developed, but the problem continues to be significant.

The capital flow and exchange restrictions were introduced in Chile during a crisis period and under duress, and were backed by a well develop system of information and control and by solid institutions that could efficiently enforce them. The restrictions were gradually eliminated over almost decade, without trauma and at minimum costs.

4. Trade Agreements

In addition to the elimination of capital restrictions, Chile has also been focused its efforts in reaching free trade agreements (FTA) with its partners, as a fundamental way to increase the integration of the economy with the rest of the world[1]. In this perspective, export promotion and foreign investment attraction have been an important element of the Chilean growth and development strategy.

Recently, Chile has reached a free trade agreement with the European Union, which incorporates an investment chapter and financial services chapter. Under this kind of agreements, in addition to the elimination of trade barriers, the country provides the adequate conditions, stability and security for investors, generating strong incentives for integration and cooperation among the economies. Indeed, investment chapter covers protection the investment, in terms of law frame, as well as, capital movements. Financial services chapter, on the other hand, covers establishment of institutions and provision of financial services.

[1] To date, Chile has signed FTA with Mexico, Canada, Costa Rica, El Salvador and the European Union. In addition, Economic Complementation Agreements (less comprehensive than FTA) are in application with Bolivia, Colombia, Ecuador, Mercosur, Peru and Venezuela. Finally, Chile is negotiating FTA with US, EFTA (Switzerland, Norway, Iceland and Liechtenstein), Korea and Central American economies.

Trade agreements play an important role in development and, providing stability in economic rules, create economic and political conditions that are conducive to attracting and keeping foreign trade and investment.

The Chilean well-established track record on economic and trade reform make the economy, despite its relatively small size, ready, willing, and able to negotiate a mutually beneficial FTA with other economies.

5. The Role of Financial Cooperation Institutions

According to the Chilean experience, the role of financial cooperation institutions should be focused on creating the conditions for integration, monitoring and generating a discussion instance, in order to incentive financial integration.

In that direction, APEC Finance Ministers Forum is a well known and recognized instance for cooperation among the pacific economies. Chile has participated with enthusiasm in this forum, constituting, from the Chilean perspective, as the principal coordination frame. However, this has not been enough; we must move forward. It is necessary to strengthen PECC activities or create a specific institution under PECC-APEC coordination, to incentive a stronger economic and financial integration among pacific economies and provide a high level cooperation frame in these fields.

Specific Roles

a) The lack of prudential regulations and rules of financial transparency for financial institutions could affect investment performance and distort the decision process. In this context, financial institutions may be affected by moral hazard problems that distort their capability to adequately select investment projects. As a consequence, institutions as PECC, should motivate and create the incentives for deep structural reform in those financial systems.

b) Rules and operating procedures must be modified, when is required, in order to ensure transparency and limit excessive risk and hidden government intervention, so that these financial institutions can become good devices for the effective selection of investment projects. The elimination of the distortions that affect the investment decision process is the key for success.

c) Provide the incentives for financial system integration. Naturally, as a first step, economies must reach the liberalization conditions detailed in point 2. As a consequence, cooperation institutions should create the scenario for this objective. Note that these conditions are fundamental for building an adequate economic and financial system, able to confront external shocks.

6. Concluding Remarks

Economic integration and cooperation enhances efficiency in resource allocation and diversification of financial risks.

Then, under PECC coordination, our economies have the necessity to find the way of reaching a stronger financial integration. In this sense, we have not created all the required conditions.

We need a comprehensive institution, able to coordinate all the pacific economies, and provide technical support in each country. That would create the adequate atmosphere for moving in that direction.

In a globalization and internationalization context, it is crucial to strengthen PECC institutions, in order to reach a genuine and solid financial integration.