José De Gregorio: The international financial crisis and its impact on the Chilean economy

Speech by Mr José De Gregorio, Governor of the Central Bank of Chile, presented before the Honorable Senate of the Republic, Santiago de Chile, 8 October 2008.

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Mr. President of the Senate,

In response to your invitation to participate in this special session of the Honorable Senate, I would like to share with this audience our vision on the severe financial crisis the world economy is enduring, as well as its implications on our country.

The world financial crisis and international growth

The financial crisis being experienced by developed countries is the outcome of a period of stability, with abundant liquidity, fast economic growth and an asset price bubble. This combination of aggregate factors yields, as it frequently happens, to a cycle of high credit growth. The problem is that this occurred during an extremely accelerated process of financial innovation in market segments that were poorly or ambiguously regulated – mainly in the US.

Low interest rates prompted an intense search for higher returns. Individuals with little or no ability to repay were lent for housing and, to reduce risks, credits were securitized and often taken out of the banks' balance sheets (i.e. *Structured Investment Vehicles and conduits*). Money was lent on the assumption that housing prices would continue on the rise, so the mortgage was all that was needed to relax lending standards. Also, the real-estate bubble encouraged the demand for homes to be used as financial assets.

These credits were sold to agencies that did not do a diligent risk assessment, and that triggered contamination not only throughout the US financial system at large, but also to other developed economies. Risk-rating agencies were unable to give the proper ratings to complex instruments. In addition, there was a severe conflict of interests in the risk-rating system. The executive compensation structure also encouraged the search for returns with little attention to the risks involved.

That it is costly to lend to bad debtors that will not repay goes without question, but this can hardly spark off a crisis of the proportions we are seeing today. The problem worsened because of the way banks decided to get rid of these loans, the way they were rated, and the financial instruments that were devised to reduce risks and make it appear as they had vanished when they had only shifted. There are also doubts whether the operations of derivatives markets have been as transparent as they should have been or if they have been manipulated. The paradox here is that in the banking system, whose purposes must be credit intermediation and risk hedging, it seems that risks were covered up rather than covered against, in an intricate web of derivatives (and acronyms) favored by regulations that did not measure up to the challenges.

Chile suffered a major banking crisis in the early 1980s, part of which can be blamed on poor regulation, which cost the country, only in GDP terms, a drop of 16% between 1982 and 1983. The lessons learned the hard way have provided the basis for strict banking regulation, where banking business supervision and limits to risk exposure prevent episodes like the ones we are now seeing abroad from being replicated in our economy.

Regarding the external scenario we face, consensus projections and information at hand show that the international economy continues to grow and, surprisingly, there is a decoupling between developed economies and the rest of the world.

As can be expected in such a situation, and from the reactions we have seen at the global level, the world will see a deceleration, but from varied levels. While the developed world will probably go through a recession, emerging economies will moderate growth. This may be helped by the current-account surplus accumulation of emerging markets, favored by high commodity prices and more responsible economic policies than in the past. For example, the substantial hoarding of international reserves in many countries, Chile included, allows the financing of deficits for several years to weather the turbulences via domestic growth. Overall, more severe effects on emerging economies' growth from a prolonged period of weakness in developed countries cannot be ruled out.

The reserve accumulation program and liquidity provision

Confronted with the uncertain outcome of the financial crisis in developed countries, where difficulties in funding for emerging economies could not be ruled out, and at a time when the Chilean peso had appreciated significantly, the Central Bank of Chile deemed appropriate to strengthen its international liquidity position. To that end, in April it began an international reserve accumulation program.

In recent weeks, particularly after the downfall of Lehmann Brothers in September, signs of more severely constrained international financial markets and tight foreign currency liquidity conditions began to surface. Chile was no exception. Accordingly, on September 29, the Board of the Central Bank of Chile decided to terminate the reserve accumulation program. During its application, 5.75 billion dollars were acquired, amounting to 70% of the initially announced plan, which is the equivalent to an increase of 30% in international liquidity over the level of end of March 2008.

In addition, and to reduce tensions in foreign exchange market liquidity, the Bank has auctioned off one billion US dollars under the foreign currency swap modality where offers are made in terms of libor plus a premium. At first, this program considers two more auctions for a combined total amount of one billion US dollars. To sterilize the monetary effects of these operations and prevent effects on peso liquidity, Repo window operations are being offered at the monetary policy rate at 28 days.

In this aspect, it is necessary to contextualize the Chilean banking sector foreign indebtedness, especially the short-run component. Banking sector debt amounting to nearly 2.7 billion US dollars is maturing in the last quarter of this year, that is, less even than the reserves accumulated from April to date. Meanwhile, the total external debt of the banking sector overall amounts to some 13 billion dollars, the equivalent to 60% of total reserves. The level of Central Bank reserves is sufficient to back the normal operation of the financial system, in particular its needs for foreign funding. The Chilean financial system must be capable of securing funds in international markets, a feature it has displayed for several years already. However, should access to foreign funds and liquidity complicate further, the Central Bank is well prepared and equipped to take decisive action. Precisely the levels of international reserves can do the job.

International reserve management

To administer international reserves, the Central Bank has separate responsibilities at various hierarchical levels, complying with international recommendations on the matter, and which have been evaluated by the IMF. In addition, internal and independent auditors perform periodical audits to review the Bank's investment procedures. An internal middle office is in charge of monitoring compliance with the investment guidelines and parameters defined by the Board, on a daily basis.

This year, the investment policy for internally managed reserves has been revised on two occasions, which resulted in updating the benchmark comparison, credit risk, and portfolio duration, to better safeguard the Bank's assets and address international markets' volatility. The main changes consisted in reducing banking credit risk associated with deposits in commercial banks maturing in or before one year. The reference composition for banking risk was reduced from 37% to 20%, while for sovereign risk it was raised from 63% to 80%.

Furthermore, during this year the minimum risk rate for banks to be eligible was changed from A- to A, also restricting investments in banking institutions rated A and A+ to a maximum of 5% of the investment portfolio. In line with the new bank deposit policy, deposits maturing in the months of October and November will not be renewed, in order to comply with the newly defined ceilings before December.

Regarding asset breakdown by maturity, 60% of resources in the internally managed portfolio are invested in short-term instruments, with average maturity of three months, and the remaining 40% is invested in long-term securities (mainly sovereign bonds) with a duration of 30 months. Thus, average duration for the overall portfolio is 13.9 months. The reference currency composition remains 59% in US dollars and 41% in euros.

Despite turbulences in international financial markets, and considering that the biggest fraction of resources is invested in fixed-income sovereign instruments, the annualized return obtained from managing the Central Bank's international reserves in the first half of 2008 was 3.47% measured in foreign currency.[1] The differential return obtained with respect to the benchmark structure was 0.15%.

Implications of the ongoing crisis on the Chilean economy

It is premature to try to quantify the consequences of the crisis on the Chilean or the world economy. There is great uncertainty, but still there are two aspects worth noting which point at the core of the Bank's objectives. One is associated with the financial markets' operation and the other with inflationary prospects.

Regarding financial stability, our powers and capacities for liquidity provision permit us to mitigate the financial consequences of these developments occurring outside our borders. Certainly, borrowing costs will go up, because credit constraints are an increasingly global phenomenon from which there is no escaping. But the Central Bank must safeguard the normal functioning of the payments system, and that is what we were set out to do when we began hoarding reserves as an investment in stability.

Since the outset of the financial crisis, the Central Bank has been not only attentive to developments, but also analyzing much more stressful alternative scenarios and assessing the best policy responses to each of them. Although the reserve accumulation program was motivated by the possibility of having to face even worse scenarios than we have seen, we are well prepared to deal with bigger complications and shield our economy from their effects. It was in this context that we decided to offer the aforesaid foreign currency swap. In yesterday's tender offer, 30 of the 500 million dollars were awarded, which is evidence that the international liquidity problems are being properly managed by banks without having to resort to our credit lines. Notwithstanding, the Central Bank of Chile will continue to monitor the external financial conditions in order to mitigate the domestic impact of potentially bigger complications.

From the inflationary standpoint, our latest Monetary Policy Report assumed that the international scenario would not contribute in any significant manner to reduce inflation. However, our risk scenario also assumed that a further deterioration of the world economy could not be ruled out, and we are seeing it today. Most likely, in the near future world growth projections will be significantly adjusted downward, helping to reduce inflationary pressures

[1] As a function of the benchmark basket of the investment portfolio.

in the medium term. In addition, commodity prices have dropped recently, including a sharp reduction in the prices of oil and grains, especially wheat.

Our objective and commitment is that annual inflation gradually converge, over a two-year period, to its 3% target, so monetary policy will continue to be oriented to complying with said objective. The potential inflationary consequences of events occurring internationally will be duly pondered. We have in place a flexible monetary policy that allows for gradual adjustments to both changing international conditions and domestic developments, strongly committed with inflation control, because low inflation ensures the necessary stability for sustained economic growth. We do this while never neglecting our obligation with the stability of the payment system. Therefore, in the past several weeks we have also contributed to alleviate liquidity stress. Our commitment is to continue to walk this road to the extent that circumstances so dictate.

Our economy is not immune to episodes occurring elsewhere in the world and that is what we have been experiencing. However, we are on a good stand to deal with very adverse environments, and it is the commitment of the Central Bank Board to ensure the best possible performance of the Chilean economy in times of turmoil and uncertainty at their highest. With that in mind, we have established a monetary/foreign exchange policy scheme – as well as an international liquidity position – that will help us soften the potential repercussions of the current problems of the world economy.

Thank you.