José De Gregorio: Monetary policy and pass-through to interest rates

Speech by Mr José De Gregorio, Governor of the Central Bank of Chile, before the Honorable Chamber of Representative's Economic, Promotion and Development Commission, Santiago, 16 March 2009.

The Spanish original prevails.

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Mr. President. I wish to thank you and the Economic, Promotion and Development Commission of the Honorable Chamber of Representatives for inviting me to speak about how our monetary policy decisions affect the country's financial and lending conditions.

The global economy is enduring terribly uncertain times, which have implications on our country's prospects for growth and inflation. Thus, we share your preoccupation for evaluating how monetary policy actions – one of the main stabilizing tools we have available as a country – ultimately affect the cost of borrowing faced by households and firms.

Monetary policy, in the context of an inflation target and a floating exchange rate like the one operating in Chile since 1999, is an important mechanism for smoothing out the business cycle. Periods of weak output and demand performance, which reduce the medium-term inflation outlook, lend themselves to countercyclical monetary policy actions that cushion the negative effects on consumption, investment and employment. This is what the Central Bank of Chile is presently doing, acting resolutely to moderate the effects that the global crisis – the worst we have seen in decades – is having in Chile.

The transmission of monetary policy

The Central Bank of Chile's monetary policy operates largely through its effects on the cost of lending, as it influences the cost of bank financing. The Bank's main instrument is the monetary policy interest rate, or MPR. It is worth noting that the level which the Board chooses every month for the MPR represents an objective for the cost of overnight lending between banks. In other words, the Central Bank operates in the interbank market, seeing that the interest rate at which banks lend to and borrow from each other overnight approaches the MPR. Therefore, it is important to understand how this interest rate, which operates in a very specific and well defined market (among banks and for a term of one day only), affects the spending and investing decisions made by households and firms even over several years.

The explanation for this phenomenon is that, in normal circumstances, what matters is not only today's level of the MPR, but the whole future path expected by the market for such interest rate. This is what ultimately affects the entire yield structure. In other words, for a five-year loan, for instance, it is more important for the potential borrower to have an idea of how the MPR will be behaving in the next five years that to know its current level.

The above has first-order implications on the conduct, implementation and communication of monetary policy. In fact, while obviously important, the decisions that we adopt as the Central Bank Board at the monetary policy meetings are not the only element shaping the credit conditions within the economy. Also of first order is the market's perception of how the monetary policy will be managed in future months and years. This leads us to be extremely cautious in our communication, in order for the decisions we make to be perceived with the adequate persistence.

The monetary policy that the Board has been implementing in the past few months clearly illustrates this phenomenon. Despite the fact that the MPR was held constant at 8.25% in the last months of the past year, thanks to the way we communicate our decisions and to the

incorporation of an explicit bias the MPR level expected by the market six months ahead dropped significantly, pulling down the deposit rate at longer terms. Subsequent reductions to the MPR that have been applied this year have gone beyond market expectations, reducing financing costs (figure 1).

To succeed in communicating properly, transparently and credibly is then key for monetary policy decisions to cause the impact that is needed. This is what makes monetary policy effective, and it is why the Central Bank has maintained a systematic policy of communication and transparency, through the presentations we make as Board members, with our Monetary Policy Reports, and with the transparency mechanisms we have for our policy decisions. In the latter area we actually have made major innovations since our Monetary Policy Meeting last Thursday. We now upload to our public website the background information based on publicly available data before holding the meetings where we decide on monetary policy.

Today's scenario: uncertainty and risks

Monetary policy is one of many factors influencing the cost of borrowing faced by households and firms. Another factor that has gained significant importance is the perception of risk and volatility that has swept over every financial market. This increased with the worsening of the global financial crisis last September. In general, and despite efforts made by economic policy makers in the main economies around the world, we are still dwelling in an extremely uncertain scenario. This has a number of implications that ultimately affect the conditions and costs of credit to firms and households not only in Chile but everywhere.

To begin with, external lending standards for domestic banks have become more stringent. We see it in that, although our banks have been able to access foreign credit sources, these have been at shorter maturities and with larger spreads over external reference interest rates. This is a reflection of the difficulties that continue to haunt the main global financial institutions and their reluctance to embark in new businesses. This has not altered the liquidity available in the local money market, which has remained stable, aside from some transitory turbulence in early October that was addressed by the Central Bank through the implementation of new modalities in the provision of liquidity.

Secondly, the meltdown of world output and trade is increasing credit risk globally. In turn, firms and households with a better financial situation tend naturally to postpone their spending and borrowing decisions, awaiting the normalization of the financial environment, thus shrinking the demand for credit. All of this results in increased average financing cost and tougher lending standards for those agents actually engaging in borrowing operations. We can see that the various risk and volatility indicators are substantially above their pre-September figures (figure 2). As we wrote in our latest *Monetary Policy Report*,[1] the extra financial burden for the clients of Chilean banks has tended to reflect precisely the higher levels of global uncertainty and their impact on the Chilean economy.

I must stress that these phenomena are occurring today in every economy in the world, sometimes with catastrophic implications on their levels of output and the solvency of their financial institutions. Because we prepared as a country for a long while to confront severe deteriorations of the international economic environment, Chile and our financial market have suffered limited effects, with no sudden stops but, on the contrary, with increases in credit supply and without a generalized process of insolvency. These same precautions have permitted macroeconomic policies – both fiscal and monetary – to be clearly countercyclical, helping to cushion the effects of the world crisis on our economy.

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[1] Central Bank of Chile (2009).

The transmission of MPR reductions to lending interest rates

One important element in the diagnosis of how this countercyclical effort is actually working is the evaluation we perform on a permanent basis to the way our decisions are affecting the borrowing conditions facing households and firms. This issue is not new, and was the subject of analysis several years back when the Central Bank's monetary policy was on a sustained expansionary path.[2] The evidence we gathered then can be summed up in that the Central Bank's monetary policy decisions are reflected in the banks' financial cost very quickly, but in the overall cost of credit only after a few months. This response pattern was similar to that in other economies. Lately, we have reviewed that information,[3] and we have found that, even in moments of great uncertainty as we experienced in recent months, reductions to the MPR are translating into reduced borrowing costs for both businesses and consumers.

One good example is the trend of the interest rate on commercial loans at 30 to 89 days, which can be linked to the funding of working capital. This rate was very high in October last year, but this year so far it has fallen substantially. We estimate that if we had not cut the MPR by a combined 350 basis points (bp) between January and February, this rate would be some 250 bp above where it is today. A similar situation can be seen in the case of consumer loans. The cost of mortgage financing, meanwhile, has been less sensitive to the changes in the MPR precisely because those are long-term borrowing decisions. However, without the drop in long-term rates – which has partly originated in the monetary easing – mortgage rates would have stayed largely above their current levels (figure 3). We estimate, then, that the monetary policy decisions recently adopted have begun to pass through to the credit conditions faced by households and firms. This pass-through should continue in the near future, especially after the reduction in the MPR that the Board determined last week. We will keep monitoring these effects permanently, because for us it is essential that the MPR propagates to market rates smoothly. We certainly expect the latest MPR reduction last Thursday to result in additional decreases in the banking system's lending rates.

This type of exercises also permits to evaluate the impact of the higher degrees of uncertainty, volatility and risk we have been observing since last September. If we do the exercise of asking ourselves where would the lending rate be in a hypothetical scenario without the global financial crisis, we find that it would be between 50 bp and 350 bp below its present level, with the larger effect on the interest rates on commercial and consumer loans. In the specific case of mortgage loans, the increase in the interest rate occurred between September and December 2008 can be largely linked to the implications of the external conditions on the local perception of risk (figure 4). All the above is a clear illustration of how the severe uncertainty and high risks that were unleashed last September are affecting the domestic economy.

Non-bank financing sources

Notwithstanding the key role played by domestic banks in funding households and firms, especially smaller ones, for the bigger companies there are other equally important credit sources. Thus, around 45% of total corporate borrowing is non-bank, with external debt and domestic bonds at the top of the list. Therefore, it is important to understand the behavior of the interest rates on these credits before offering a global outlook of financial conditions.

The Central Bank of Chile has no direct effect on external financial conditions. Like banks, Chilean firms have seen their borrowing conditions tighten under the changed state of affairs. Still, our banks and firms continue to enjoy normal access to world financial markets, owing

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[2] Berstein and Fuentes (2003).

[3] Becerra et al. (2009).

to a great extent to our policy framework that ensures the solvency of our economy and to our sound financial system.

As for the local bonds market, January stood out for its large corporate bond issuances. Meanwhile, the interest rate demanded from corporate bonds in the secondary market has been falling through all of this year, and is currently approaching its levels of last September. This drop owes exclusively to the decline in the interest rates on Central Bank documents, because the spread between public and corporate securities has increased significantly since September, reflecting the same global risk factors already mentioned (figure 5).

Conclusions

The global financial crisis has hit hard credit markets around the world. In some unfortunate cases, economies that faced this debacle from a fragile initial position, with high indebtedness or with fast credit growth, have faced drastic adjustments in local asset prices, output, and employment, with dire consequences on their living standards. Thanks to the fact that we prepared for years as a country to confront deteriorations of the external environment, our monetary policy has been able to adopt a clear countercyclical stance to lessen the effect on our economy of the global financial meltdown.

We have seen that the aggressive reductions in the MPR implemented by the Board since January have begun to reflect on the borrowing conditions faced by households and firms. It is reasonable to expect this to continue in the coming weeks, especially after the MPR cut of last week. However, a full normalization of credit demand and supply will depend on the appeasing of the global financial environment, on more clarity about the definitive structure of the global financial system, and on economic growth prospects settling down in the larger economies of the world.

Overall, it is important to note that this analysis has focused on the cost of credit for operations already materialized. The other central dimension of the financial system operation is clients' access to credit. Lately loans have slowed down. It is difficult to figure out how much of this to blame on lower demand and how much on the financial institutions' reluctance to lend. In any case, we believe it is important that financial institutions, provided good risk management, continue to lend to firms and households. We agree with the Superintendent of Banks and share the principle that through tough times the banks must stand by their clients and cooperate in the solution of their financial problems.

I would like to inform you that, as part of our process of increasing transparency, particularly regarding public dissemination of information about interest rates charged on credit operations, we have decided to extend the available data on credit conditions by maturity, indexation, and type of loan. Thus, starting today our website has increased the level of detail of interest rate information made available to the public.[4] Part of said information was used in producing the results reported in this presentation.

Just as we did a year ago, when we discussed the exchange rate conjuncture at the Honorable Chamber of Representatives, I want to state that we act with the conviction that we are making the best decisions to provide stability to our economy and widen its growth opportunities. We permanently and carefully monitor the situation and we incorporate it consistently in our monetary policy decisions.

To finish, I thank again the Economic, Promotion and Development Commission of the Honorable Chamber of Representatives and its President, representative Mr. Antonio Leal for letting me present our visions here. The serious management of monetary policy and its formulation on a solid technical basis is essential to ensure economic stability in such volatile

4 Matus et al. (2009).

and blurred global conditions as we are now going through. I appreciate this opportunity to come and expose our vision of the relationship between market interest rates and the conduct of our monetary policy.

Thank you.

References

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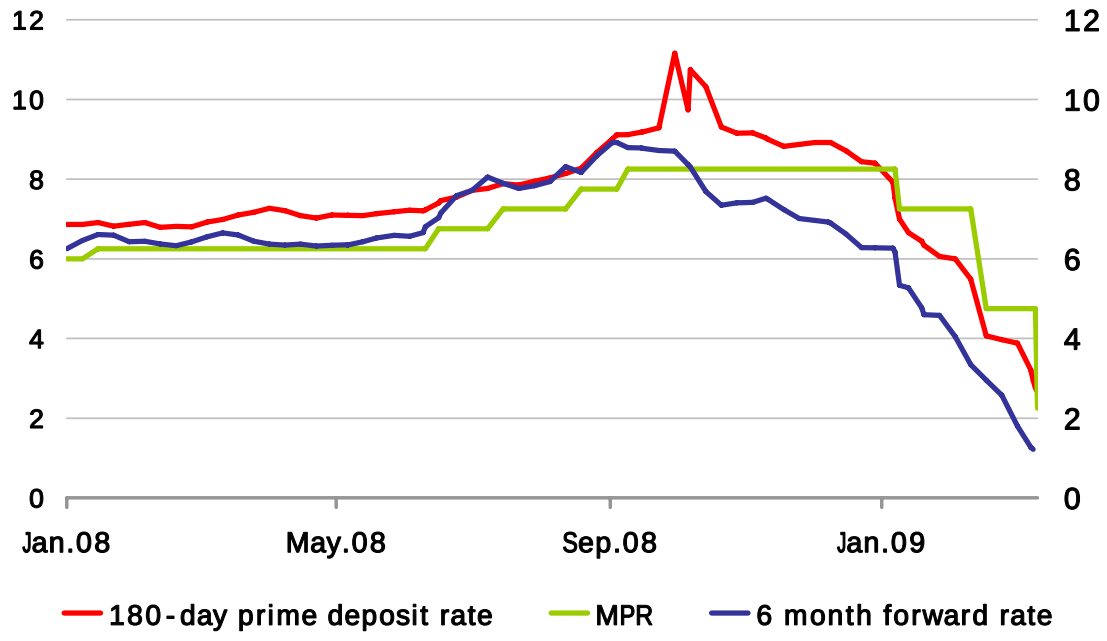
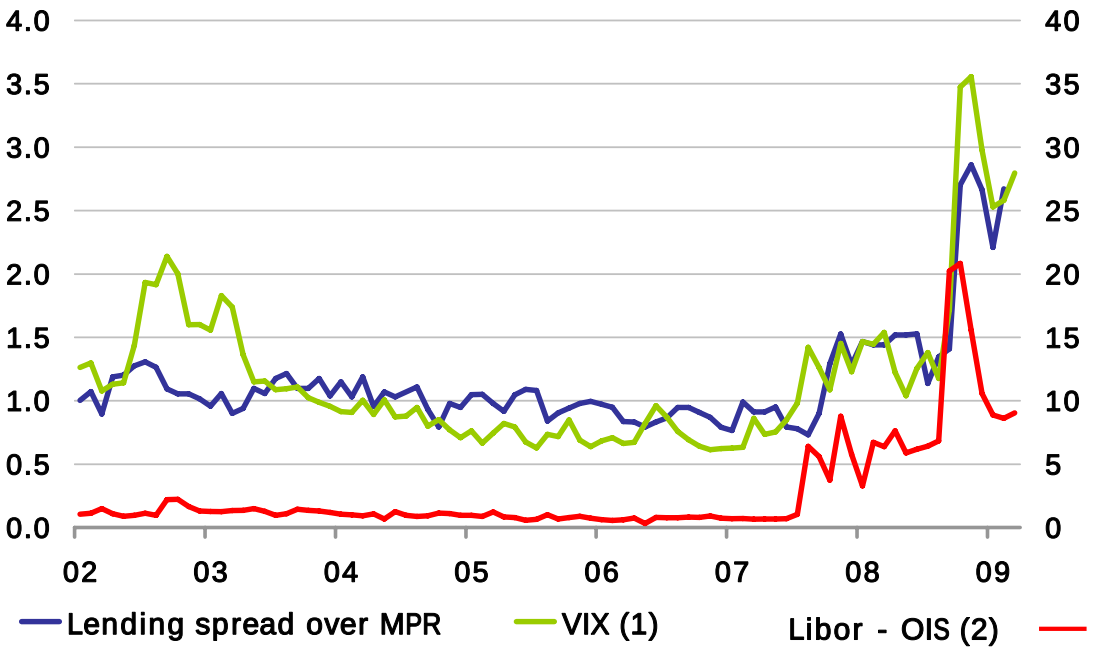
Figure 1
Monetary Policy Interest Rate, Deposit Rate, and Forward Curve
(percent)



Source: Central Bank of Chile

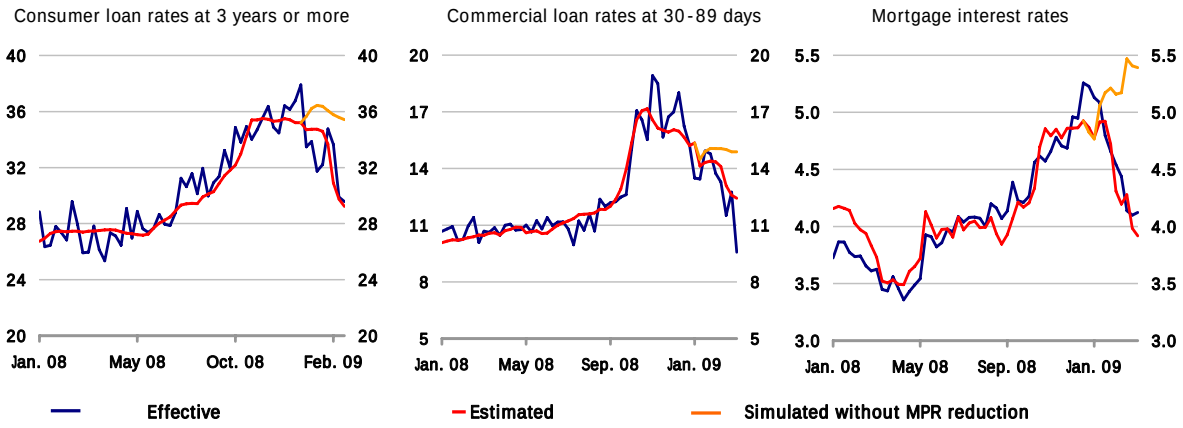
Figure 2
Lending Rate Spread over MPR and Other Financial Indicators
(index, average Jan. 2002-Jul. 2007=1)



(1) The VIX index measures implied volatility in the U.S. stock market
(2) Libor-OIS spread measures the difference between dollar financing cost for banks around the world and a measure of the expectation of the monetary policy rate in the U.S.

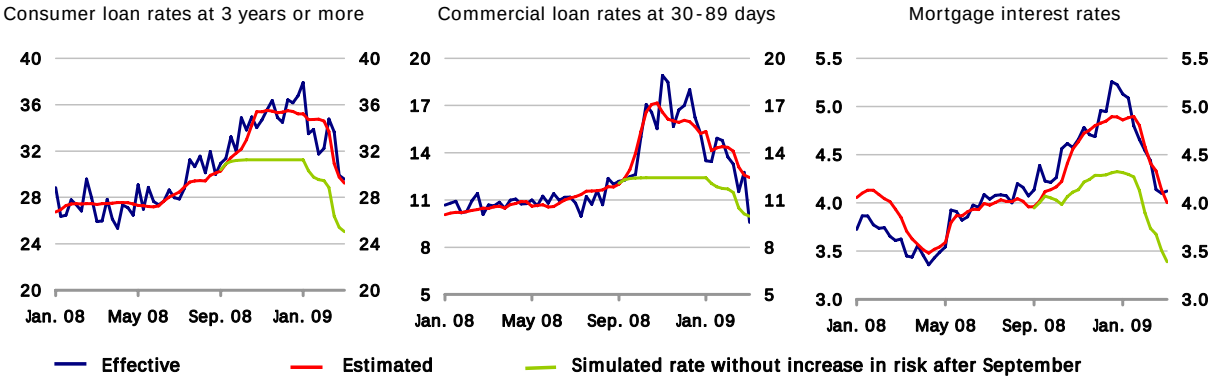
Sources: Central Bank of Chile; Bloomberg.

Figure 3
Lending interest rates without reduction in the MPR
(percent)



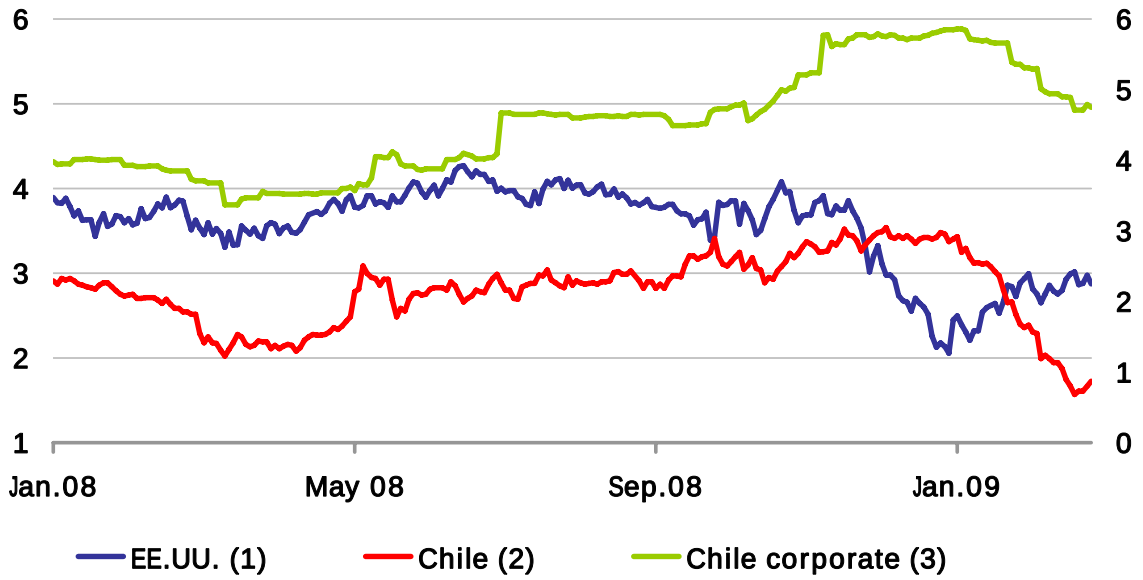
Source: Central Bank of Chile.

Figure 4
Lending interest rates without increase in risks after September
(percent)



Source: Central Bank of Chile.

Figure 5
Corporate Bond and Long-Term Interest Rates
(percent)



(1) Nominal 10-year interest rates in the U.S.
(2) Interest rate on Central Bank's BCU-5.
(3) Interest on domestic 5-year corporate bond.

Sources: Central Bank of Chile and LVA indices.