Rodrigo Vergara: Macroeconomic and financial stability – challenges for monetary policy

Opening remarks by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, at the XVI Annual Conference on "Central banking, analysis and economic policies" of the Central Bank of Chile, Santiago de Chile, 15 November 2012.

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Good morning. Welcome to the Central Bank of Chile's sixteenth annual conference on Central Banking, Analysis and Economic Policies. This year's version is about "*Macroeconomic and Financial Stability: Challenges for monetary policy.*"

We are expecting two exciting days of learning and discussion on topics at the forefront of academic and policy research on macroeconomic and financial stability. The interaction between academics and policy makers fostered by this conference provides an important opportunity to learn from each other and share views and experiences that will help us improve our policy decisions and hopefully go home with new ideas for research.

Today and tomorrow we will reflect on the role of central banks in preventing and reacting to financial exuberance and financial crises. The discussion will focus on two important policy questions: first, did the conduct of conventional monetary policy before the crisis contribute to shaping it? And second, how should monetary policy react to a crisis? In particular, we will discuss the efficacy of conventional monetary and macro-prudential policy action in ameliorating the effects of financial crises. With these two questions in mind, we will also explore the consequences of financial crises on unemployment, household credit, and the real economy, and will try to understand how markets operate in environments with multidimensional private information. Our last session will be devoted to analyzing the effects of unconventional policies in dealing with the impact of the recent financial crisis in Chile. I am confident that valuable lessons will come out of these two days of discussion.

To begin, I would like to share my views and Chile's experience in four issues that are currently in the policy debate and that will underlie the discussion we will be having over the next two days. The first issue relates to the debate on financial stability as a macro policy goal and which institutions should be responsible for it. I will then turn to the availability and usefulness of policy instruments to pursue financial stability. I will also refer to two aspects of our experience in conducting monetary policy during financial crises: our experience with unconventional policies during the recent global financial crisis and our experience with financial rescues in our own financial disaster in the early 1980s. In the latter case, I will also touch briefly on the impact of rescues on the Central Bank´s balance sheet.

1. Financial stability as a policy goal. The role of the central bank

The recent financial crisis challenged the paradigm that the stability of the financial system could be preserved through a combination of micro regulation and macroeconomic stability. Before the crisis, many countries focused financial regulation on the risks faced by individual financial institutions (as indicated by Basel II), and macroeconomic policy on the preservation of price stability. This approach may have worked well during calmed times, but it also may have allowed hidden financial risks to build up unchecked. As a result, there is growing consensus that the pursuance of macro financial stability has to be considered in its own right, in a way that combines micro regulation with a systemic view of the financial system.

However, while there is consensus in the approach, there is still debate on what institutions should be in charge of ensuring financial stability, and in particular, what should be the role of central banks.

There are advantages in having central banks involved in preserving financial stability, but these advantages do not necessarily mean that they have to be the sole institutions in charge. Central banks have a systemic vision of the economy that allows them to visualize links between different players of financial systems and their potential consequences for the real economy. Also, as lenders of last resort, the preservation of financial stability is of natural interest for central banks. Thus, even if not formally in charge, central banks should and do care about financial stability.

But at the same time, there are important risks in having central banks in charge of financial stability. First is the risk of diluting the mandate of the central bank and damaging its credibility. Central banks have fought hard to establish credibility by focusing on measurable goals, maintaining clear communications with the public, and being transparent and accountable in achieving these goals. The focus on inflation, a simple observable variable has helped. Having a central bank with multiple mandates creates risks of policy dilution and conflicting goals. In contrast with inflation, or even employment, financial stability is a fuzzy concept with many dimensions that are hard to encompass in a single indicator. Attempting to do so risks ending with a narrow view of financial stability, but having a broader, less precise definition of financial stability makes it hard to establish credibility and accountability for achieving it. On a more pragmatic front, there are good reasons to have banking supervision conducted outside the central bank (which I will not address now), and many countries follow this institutional arrangement. This should be considered when thinking about the involvement of the central bank in financial stability because it is desirable that micro and macro aspects of financial regulation be well coordinated to avoid sending conflicting messages to regulated entities.

For these reasons, the institutional setting for monitoring and preserving financial stability will likely vary across countries. But the natural interest of central banks in financial stability and their advantages in providing a systemic view of the financial sector and the economy suggest that they should be involved at some level. Whatever the institutional setting for pursuing financial stability, it is important that it guarantees that the systemic aspects of financial decisions are properly taken into consideration, that the institutions involved have the necessary tools to prevent the formation of excessive risks in the financial system and quickly act when they materialize, and that it ensures that these tools are used with a unified view of the micro and macro aspects of financial regulation. Whether this is achieved by having a single entity in charge of regulation or by having instances that facilitate the coordination between the different entities in charge of it may be of second order importance if such coordination works well.

In Chile, the Central Bank is expected to act as a lender of last resort to commercial banks facing liquidity problems. We are also in charge of some aspects of financial regulation such as retail payments; bank liquidity and market risk regulation, aggregate limits for pension funds, and others.[1] Furthermore, preserving an appropriate functioning of the payment system is a goal established in our charter that is clearly related to the stability of the financial sector.

So, we naturally care about financial stability, and accordingly we monitor systemic aspects of the functioning of all participants in the financial sector, conduct regular surveys of market participants, run an annual survey of the financial position of households, and produce a twice-yearly financial stability report that is widely read by other regulators and market participants, among other activities.

[1] Source: Central Bank of Chile, Compendio de Normas Financieras.

However, in Chile the supervision of different groups of financial institutions, and the legal power and tools to enforce regulation are spread across several entities. For instance, the banking sector is under the supervision of the Superintendence of Banks and Financial Institutions (SBIF), mutual funds and insurance companies are regulated by the Superintendence of Securities and Insurance (SVS), and pension funds, which are large players in our financial system, are regulated by the Superintendence of Pensions (SP). In this setting, the preservation of financial stability crucially relies on the capacity and ability of all players involved, including us, to share our views and coordinate our actions. This is currently done through routine interaction between us, and more formally through periodic meetings in the Financial Stability Council, an entity created precisely to guarantee such coordination.

2. Financial stability tools

Let me now turn to the discussion of what are the most appropriate tools to pursue financial stability. Of course, this discussion draws from the previous one on whether the central bank should be in charge of it. But let's forget about that for a second to tackle one of the main aspects of this debate, which is whether a central bank that cares about financial stability should use the policy rate as a tool. There are different views on this regard, both in academic and policy circles that you probably know well. I am among the ones who think that the interest rate is often too blunt a tool to deal with financial stability issues, especially when they have clear sources that can be addressed more directly, since the policy rate affects every sector of the economy.

Furthermore, under some circumstances the required movement in the policy rate for financial stability purposes may be in conflict with the price stability mandate. Assuming that such tradeoff is absent, that reasonable movements in the policy rate are expected to be useful to deal with financial stability concerns, and that there are no better tools at hand, it may be reasonable to rely on it as a tool for financial stability.

However, in many situations at least one of these conditions would not hold and other options would prove more efficient. For instance, more often than not financial stability concerns are related to specific segments of financial intermediation. Concerns about rapid growth in credit to the housing sector can be tamed by changes in loan-to-value or debt-to-income ratios, for example. Dynamic provisions related to general or specific forms of credit may also help banks maintain a solid position through the financial cycle, and discretional changes to reserve requirements may also help rein in rapid bank credit expansion. Of course, all these measures are not cost free and their use must properly consider these costs against specific financial stability concerns. For instance, increases in reserve requirements affect only the banking sector, which may lead to disintermediation and increased cost of credit for those with limited access to other sources.

In Chile many of these tools are under the control of the Superintendence of Banking and Financial Institutions (SBIF). This makes the Financial Stability Council I just mentioned a crucial instance for coordinating and implementing financial regulation with a systemic view.

3. Monetary policy in an environment of financial crisis

When using policy tools to prevent financial crisis is not enough and the financial system becomes unstable, standard monetary policy tools might be impaired. Many central banks target the overnight interbank rate, so the transmission of monetary policy relies on a working financial system and its effectiveness may be significantly weakened in conditions of financial distress. Furthermore, under extreme conditions, such as those experienced during the recent financial crisis, standard monetary policy may reach its natural limit that is the zero-lower bound. Under these conditions, unconventional monetary policies may be the only ones at hand for a central bank.

The experience of the United States and Europe with unconventional tools during recent years is well known to all of you, so let me briefly describe our experience with them. It is important to mention that the scale of our interventions was substantially smaller, since we had to quickly undo many of our policy actions because of the fast recovery of the Chilean economy after the recession of 2009. I hope our history will shed some light on those that view the undoing of large interventions as a cause for concern.

Shortly after the collapse of Lehman Brothers, the Central Bank of Chile began reducing the policy rate from an initial level of 7.25 percent until it reached the effective lower bound of 50 basis points in July 2009. The rate remained at that level for one year until June 2010. During that period, the Central Bank also took unconventional measures aimed at providing liquidity to the financial markets. For instance, we offered financial institutions access to a term liquidity program (FLAP) at the monetary policy rate of 0.5 percent. During January 2010 we reached a peak of 6.5 billion dollars on the liquidity program, equivalent to 40% of the banking system's capital and reserves.[2] Our exit strategy from this expansionary policy was free from major difficulties. We started unwinding these special facilities in November 2009 by gradually shortening their term. As we finished dismantling our special programs we slowly began increasing the monetary policy rate to a neutral range. The withdrawal of the monetary stimulus at an appropriate pace allowed us to maintain inflation expectations at a two year horizon close to our target of 3 percent.

Before moving on to the next topic, let me close this discussion by stressing that, while central banks have been and will continue to be creative in using all available tools to achieve their mandate, we must recognize the limits of conventional monetary policy in circumstances of extreme financial distress. Conventional monetary policy alone is unlikely to be able to put back the economy on the right track and its combination with other policies certainly increases the chances of success.

4. Financial rescues and their Impact on a central bank's balance sheet

Please allow me now to finish with another topic where Chile's experience can contribute to the international debate: the implementation of a financial bailout and the risks it imposes on the operation of a central bank. In normal times, central banks conduct their operations maintaining only the safest assets on their balance sheets, typically government bonds or other low-risk assets. But in times of distress, acting as lender of last resort, central banks may also accept lower quality, more risky assets, as collateral for liquidity provision or in outright purchases aimed at rescuing banks, with the consequent risk to their balance sheets. This has been indeed the case in several countries during the recent financial crisis.

The possibility that risk-taking by central banks may result in losses that affect their reputation and operations has recently preoccupied policymakers, especially when pondering about the possibility of a large rescue operation of troubled European banks by the ECB. The concerns are both financial and operational. The financial soundness of a central bank, the usual lender of last resort in a country, is an important firewall for trouble in the financial system. While a central bank may count with the help of the sovereign, this channel may be a source of concern when sovereign themselves are facing problems, and it also raises some worries about the ability of the central bank to maintain its independence. There are also those who argue that, since the liabilities of central banks can be arbitrarily created, the financial position of a central bank shouldn't matter. But this argument forgets that doing so may endanger the achievement of the inflation targets that many central banks have taken as their operational goals, affecting their reputation and independence.

[2] Céspedes et al. 2012.

In 1982, as the debt crisis spread through Latin America, the Chilean financial system, which had channeled substantial foreign-currency-denominated syndicated loans, became largely insolvent. Under these conditions, the government engineered a massive rescue operation through the central bank where several of the most important banks became nationalized and others disappeared, after their assets were absorbed by other institutions. This intervention prevented an even larger collapse of activity than the one we ended up experiencing. The manner in which it was implemented, where shareholder equity was fully diluted and institutions assumed a subordinated debt to the central bank that took a long time to repay, helped maintain the rescue's moral hazard concerns at bay. This, together with new regulation, resulted in a healthier financial system. However, an important cost of this intervention is that the balance sheet of the Central Bank of Chile was severely stressed, leading us to operate with negative capital until today. This negative capital is also a consequence of the Central Bank's balance sheet composition, with international reserves in foreign currency earning a much lower return than the interest we pay on our domestic currency liabilities. In addition, an appreciation of our currency makes our capital more negative, as we mark to market our international reserves.

The lesson from our country's experience in this regard is that we have been quite able to operate with negative capital for the last several years, maintaining inflation under control and preserving the working of the financial system. Thus, while operating with negative capital is far from ideal, at the levels at which we have been operating, it is not cause for undue alarm. It is possible to conduct monetary policy under these conditions, especially when accompanied by an environment of good institutions and fiscal strength. Other well respected central banks have been operating under similar conditions.

I cannot finish this presentation without thanking Sofia Bauducco, Lawrence Christiano, and Claudio Raddatz for putting together the program of what promises to be an exciting conference, and all of you for coming to participate and share in the discussion.

Thank you.

References

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