Pass-through, expectations, and risks: What affects Chilean Banks' Interest Rates?

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Seventh BIS CCA Research Conference
Central Bank of Peru Conference, Lima 19 May 2016

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Contribution and main results

- Revisiting Chile's Interest Rate pass-through **conditioning** on several risk factors as well as monetary policy expectations

- Conditioning on risk factors seems consequential for an accurate estimate of the pass-through from MPR to bank lending and deposit rates (especially credit risk)

- Conditioning on MP expectations less compelling

I like the topic and I think the paper is on to something

- Conditioning on risk is important
  - Espinosa-Rebucci (2003): macro risk area of future research
  - Cesa-Bianchi and Rebucci (2015): incomplete pass-through may generate tradeoff between macro and financial stability
  - Jimenez et al (2014): monetary policy can induce large risk shifts
- I have several clarifying questions and a few comments
- Some possibly redundant, so will focus on two big issues

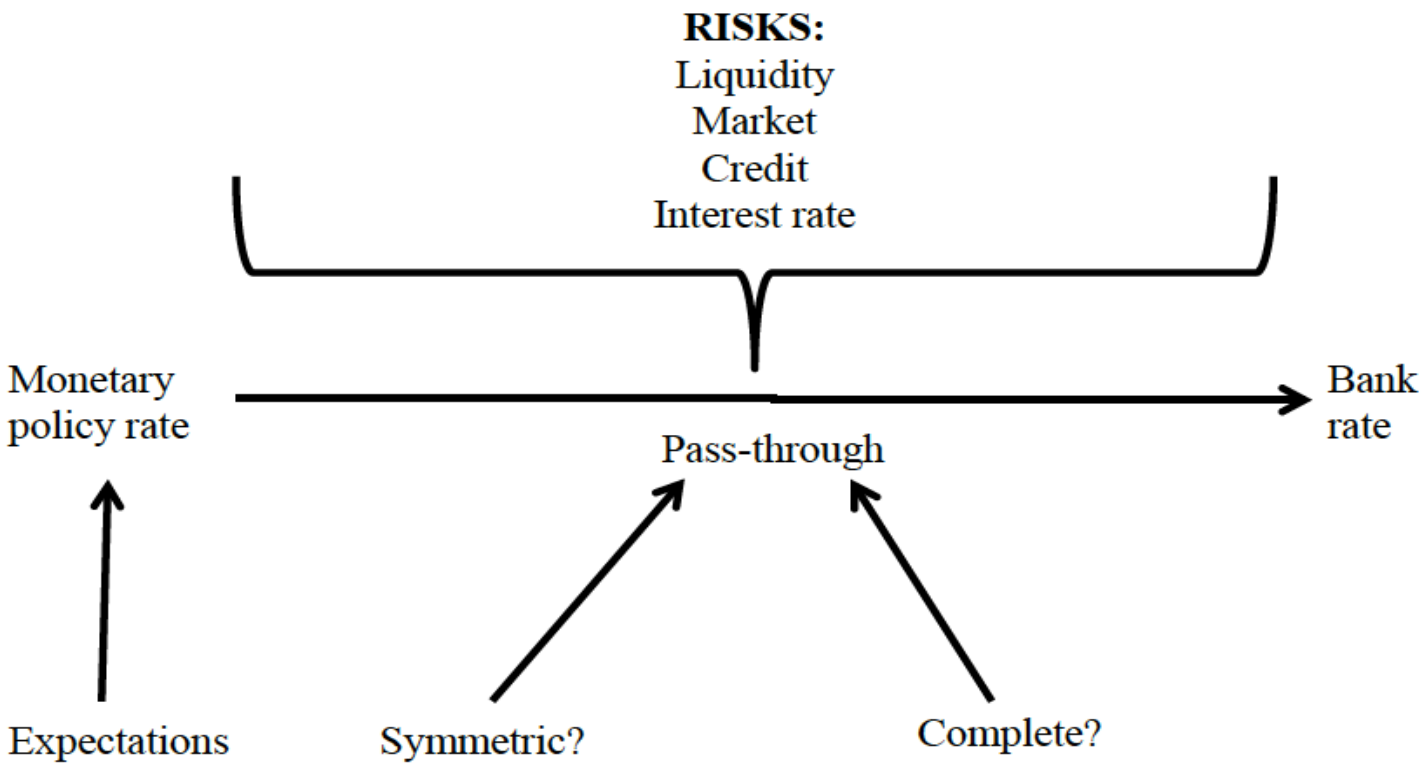
First main comment: clarify and focus … Focus, Focus, and Focus!

- Credit, interest, market, liquidity, and global risks
- Inflation (?) and policy expectations
- Real and nominal rates
- Loan and Deposit rates
- Consumer, Commercial, Mortgages
- Different maturities

Second main comment: can we ignore reverse causation?

- Do banks charge higher rates because borrowers are riskier?
- Or borrower become riskier because banks charge higher rates?
- Causation can run both ways.

Main question:
What is (Δr/Δmpr) | risk, monetary expectations?



A very simple framework

- Focus on credit risk, assume perfect competition, risk neutrality, and zero recovery rates, and no-arbitrage pricing
- Then pass-through is instantaneous and complete
- But in the data we might not see it if margins are adjusted to compensate for shifting credit risk in response to changes in policy rates as assumed in the paper

A simpe framework (cont.)

- Net return, k, on a one dollar loan: (1+k) =1+ (base rate + credit margin)
- $(1+k)(1-p) + 0p = 1 + E(r) = 1+rf \rightarrow 1+k=(1+rf)/(1-p) \rightarrow k \approx rf + p$
- Paper assumes that p=p(rf) with p'rf<0 (Jimenez et al, 2014)
  - If indeed p increases when rf falls, and we don't control for that, estimated pass-through might be smaller than 1 and/or not instantaneous
- But p also depends on m, p=p(rf,m)
  - Measures of risk shift in loan portfolio might be endogenous to rate setting decision

Way out?

- Can we model jointly credit risk and interest rate setting conditional on monetary policy changes?
- Reduced form estimation might is sufficient to quantify pass-through

Things become more complicated with:

- Risk aversion and positive recovery rates (loan specific collateral /LTV / and Leverage)
- Imperfect competition: for nominal rates mark up isstate contingent; for real rates is constant
- Link between rf and mpr and assumptions made on terms structure of interest rates
- Perhaps we need a simple model to guide the empirical specification
  - Hard to come up with model general enough to accommodate all that is being considered in the paper.
  - Pick and chose what matters. Use nice description of system features

Laundry list

- Place contribution in context of the literature:
  - Literature on Chile
    - Espinosa Vega-Rebucci on macro data (2003)
    - Cifuentes on micro data (2003)
    - Becerra et al (2010)
    - Pedersen et al (2015)
    - ---
  - Is the Chile case teaching a more general point?

Laundry list (cont.)

- Distinguish between MP cycle and business cycle—See Sarno, L. and D. Thornton (2002)
- Expectations: why do we look at inflation expectations? And why nominal factors should matter for real rates? The UF is supposed to hedge nominal factors
  - UF share of the market is quite small as of 2013. I would drop from analysis and focus on nominal rates.

Laundry list (finished)

- Many risk measures between and within risk category. Analyze in a first stage and focus on those that are most satisfactory. Correlation matrix in page 7 unclear what is for and what is the message
- Econometric model in first difference: long and short run pass-through are the same. You can/should specify ECM even if rates are I(0). ADL is the standard in the literature. Model is restricted arbitrarily. Vector ECM can have restricted cross dependence as you have for model in first differences.
- Better explanation of the variables, how are they constructed, relation to underlying data. In the end is a time series analysis.
- Sample period starts in 2003, why? Other countries?
- Paper layout as in slides. Data and variables presented twice in paper. See for instance section 3.2.2.

In conclusion

- A good stab at a very interesting and important question
- Simplify, clarify, focus, analysis and make explicit assumptions to nail a more compelling answer
- Clean up presentation

Thank you