The Central Bank of Chile´s policy response to the Covid-19 crisis[1]

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Abstract

This paper describes the Central Bank of Chile's multifaceted policy approach to the economic and financial stability challenges posed by the Covid-19 crisis. It also highlights the response's interactions with regulatory and fiscal dimensions, as well as some considerations behind the design and implementation of policy.

JEL classification: E32, E44, E58.

Keywords: monetary policy, financial stability, pandemic effects, emerging market economies.

[1] This paper is an updated version of García (2021). Interested readers can find more detail in the Monetary Policy and Financial Stability Reports published by the Central Bank of Chile during 2020 and 2021, available online at www.bcentral.cl.

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1. Introduction

The Covid-19 pandemic created an unprecedented economic crisis. From a theoretical point of view, this crisis is very different from past recessions in both advanced or emerging market economies, which had at their root a large increase in leverage (a *boom*) that eventually became unsustainable (a *bust*). Policies aimed at managing this process tend to require a careful deleveraging of the economy, while providing support for aggregate demand. The Covid-19 crisis has differed from this process in several aspects that are worth examining.[3]

- The considerations for moral hazard were limited at the onset of the crisis. In contrast with earlier recessions, there was no need to tailor policies so as to avoid benefiting those sectors or agents that were deemed responsible for the boom. Thus, a broad-based design of policies was called for early on.
- In a typical financial crisis or recession, managing the deleveraging is a key issue. In the Covid-19 crisis, the policy response has instead aimed to up-lever and make it easy for firms to take on more debt. This was possible not only because the financial system was in good health when the recession hit, but also because the way to respond to a large (but transitory) income shock is by taking on more debt or using up savings.[4]
- The Covid-19 crisis is a strong negative supply shock to specific sectors of the economy (those that depend more on social and personal interaction, such as restaurants and hospitality). Aggregate demand support clearly cannot compensate the contraction in these sectors, but it can help stop negative spillovers to the rest of the economy. Over time, optimal policies should shift from broad liquidity support to the reallocation of resources away from those sectors that have suffered the most permanent damage.
- The speed at which this crisis has unravelled is also very unique. Response time has been measured in weeks and days instead of months or quarters. The actual outcomes have been heterogeneous. Due to legislative and political economy considerations, the response times in the health and economic areas have been diverse across jurisdictions. In contrast, independent central banks with a clear mandate and a credible framework have reacted remarkably fast. In the case of Chile and elsewhere, the recovery is proceeding fast but in a heterogeneous way. Other stimulative policies have responded forcefully and to a significant degree in a procyclical way.
- Finally, the world will emerge from this crisis poorer and more unequal. This is especially relevant for Latin America where structural factors such as labour market informality have not buffered the destruction of formal jobs.[5] In Latin America, SMEs represent a higher fraction of GDP than in the developed world. Since these firms have less access to financing, they will find the path to recovery more difficult. In order to weather this economic shock, the initial policy responses will need to be redesigned. Several new elements such as debt relief,

[3] For a detailed discussion on theoretical and policy challenges of the Covid-19 crisis, see the workshop held at the Central Bank of Chile, www.bcentral.cl/en/content/-/details/covid-19-economic-implications-and-policy-lessons-12th-13th-january.-2021-.

[4] See for example, Arellano et al (2020).

[5] Leyva and Urrutia (2021).

productive restructuring, more targeted support and research need to be enhanced.[6]

This paper will review the monetary and financial policy response to the Covid-19 crisis in Chile. It is organised as follows. The next section will highlight some metrics of the immediate impact of the crisis. Then, the main challenges for policy design will be presented. Section 4 will detail some of the specific policy measures implemented in Chile, and Section 5 will show the pandemic's impact on the balance sheet of the central bank as well as other macro-financial metrics.

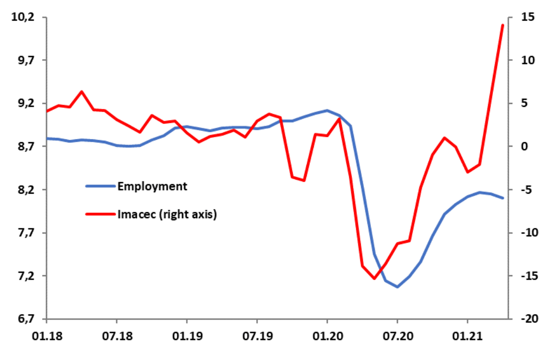
2. The economic and financial impact of the Covid-19 shock

The Covid-19 pandemic and the actions taken to contain it constitute a huge and unprecedented shock to the world economy. Most countries have experienced dramatic drops in economic activity, and Chile has been no exception. At a time when the economy had just started to recover from the effects of the social unrest of the end of 2019, the pandemic and the containment measures caused the largest economic contraction in 35 years, reaching its steepest fall in the second quarter of 2020 with a 14.1% year on year fall in GDP and almost 2 million jobs lost. The shock hit the service sector particularly hard, where activity and employment fell the most, and the recovery has been slower. However, in other sectors, most notably retail, the recovery has been swift and economic activity already is above pre-pandemic levels (Graph 1).

Graph 1

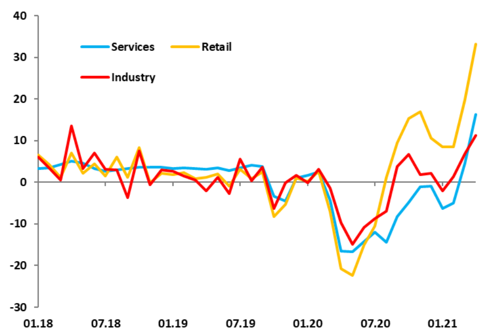
Employment and IMACEC

(quarterly moving average, millions of people; annual change, percentage)



IMACEC industry, commerce and services

(annual change, percentage)



Sources: Central Bank of Chile; National Statistics Institute.

Financial volatility has been a feature of the crisis, especially during the early months, as news about the spread of the virus, the lockdowns, and the first economic indicators that accounted for the effects of the pandemic became known. Since then, the volatility of emerging countries' sovereign rates has diminished and remains

6 Arellano et al (2020), Alfaro et al (2020).

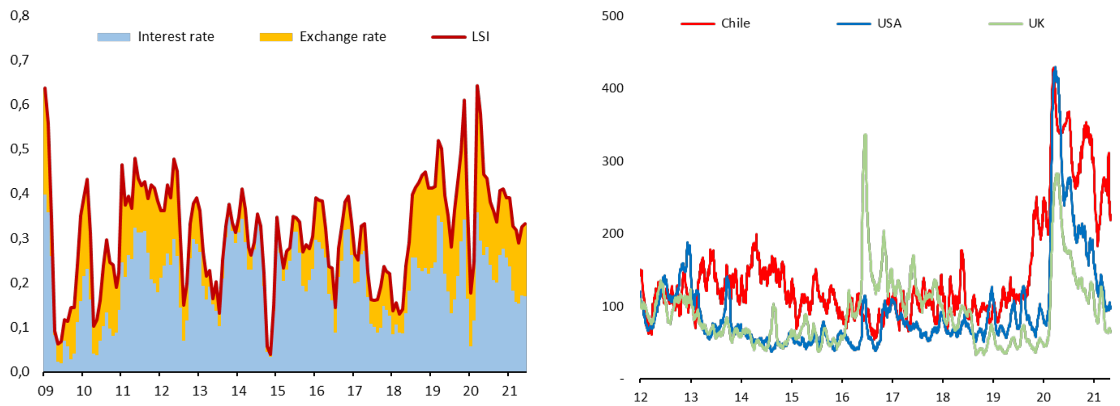
relatively low. While the Chilean economy has mirrored the reduction of its emerging peers, volatility remains near the median of the distribution, whereas in past years it was generally in the lower percentiles. This points to a reduction in the impact of some mitigators that have operated in past history, such as the behaviour of institutional investors. The increase in volatility could also reflect some structural and more permanent phenomena linked to institutional reforms that the country will undertake in the year ahead.

The effects of the Covid-19 crisis on Chile's financial system were almost immediate, and stress indicators reflected the uncertainty associated with both Covid-19 and the social protests of October 2019. According to the local stress index (LSI)[7] for the local currency market, tension increased substantially in this market during the events of late 2019 and the pandemic, as a result of increased exchange rate volatility. Similarly, the conditions in the local sovereign debt market tightened considerably in response to the sharp increase in sovereign rate volatility and the reduced participation of non-residents in this market (Graph 2).

Graph 2

Local stress index (1)
(Index: 2018 average = 0,1)

Daily economic policy uncertainty index (2)
(Index: Jan. 2012 = 100)



(1) Lower (higher) index values indicate looser (tighter) financial conditions in the respective markets.
(2) 30 – day moving average. Lower (higher) index values indicate a lower (higher) level of general uncertainty.

Source: Central Bank of Chile.

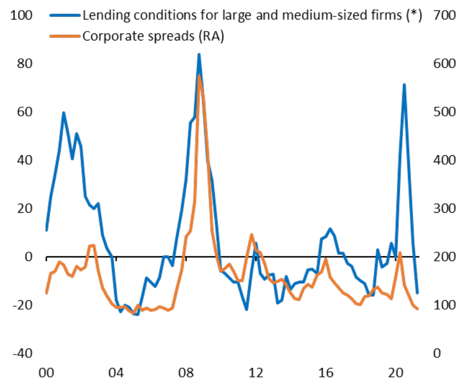
The effects of the crisis were also evident in the dislocation in the cost of funding by banks and corporations. Funding costs increased globally before aggressive measures were taken by central banks. In the United States lending conditions for small and medium-sized firms became tighter, and by the third quarter of 2020 reached the levels of the Great Financial Crisis at the end of 2008. In Chile, corporate spreads rose from below 100 bp in October 2019 to almost 350 bp in April 2020 (Graph 3).

[7] The local stress index (LSI) combines information from a set of variables that should capture the source of tension in both the FX and local secondary sovereign fixed income markets. See D Holló, M Kremer and M Lo Duca, "CISS-a composite indicator of systemic stress in the financial system", ECB, *Working Paper Series*, no 1426, March 2012.

Graph 3

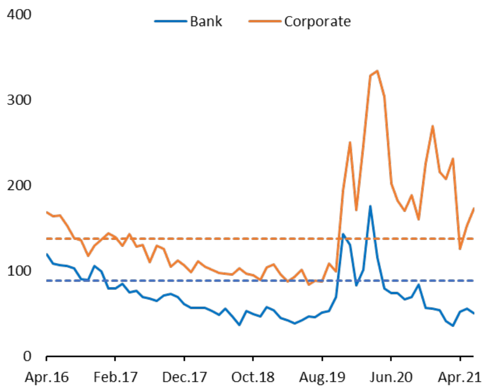
US lending standards and corporate spreads

(percent, basis points)



Bank and corporate bonds spreads (2)

(basis points)



(1) Positive (negative) values indicate tighter (looser) lending conditions.

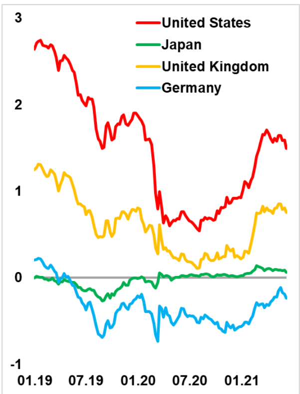
(2) Dashed lines indicate the 2015–18 average of the respective series.

Sources: Central Bank of Chile; Federal Reserve Bank of St. Louis; Santiago Stock Exchange.

Graph 4

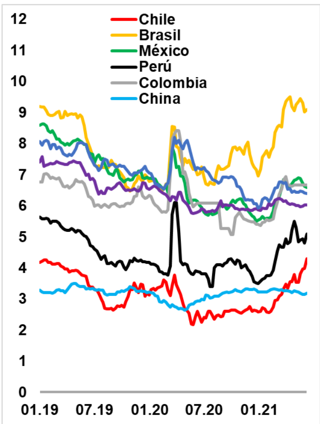
%.Ten-year sovereign bond interest rates: Developed economies (*)

(percent)



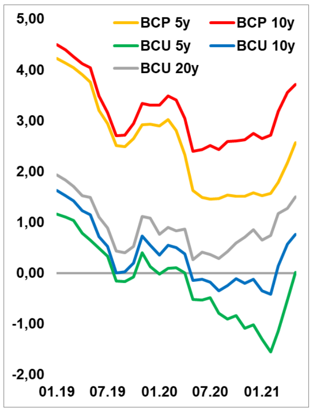
Ten-year sovereign bond interest rates: Emerging economies (*)

(percent)



Local sovereign interest rates (*)

(percent)



(*) Weekly data. BCU and BCP are inflation linked and nominal bonds, respectively.

Sources: Central Bank of Chile and Bloomberg.

Amid uncertainty, investors fled to safety into long-term sovereign bonds, compressing their yields to levels never seen before in most of the world. Thus, during the first five months of 2020, 10-year sovereign bond interest rates fell by more than 200 bp in the United States, by 100 bp in the United Kingdom and around 50 bp in Germany, where the rate remained in negative territory for most of the year. A similar trend was observed in several emerging market economies where, after a brief initial spike at the beginning of the crisis, 10-year sovereign yields continued their downward trend in 2020. In Chile, the rate fell by more than 100 bp between March and May 2020, to its record low of 2.4. Since then, as the vaccination process and large stimulus measures were deployed, government bond yields have recovered, reflecting both improved economic prospects but also relatively high local uncertainty (Graph 4).

3. Challenges in the implementation of unconventional monetary policies

The challenges faced by the Central Bank of Chile during the pandemic were not dissimilar to those faced in other jurisdictions. Both bank and non-bank intermediation is significant in Chile, and therefore to achieve the goals of both price and financial stability the policies need to be tailored so as to work effectively through both channels. This section highlights some of the key trade-offs involved.

The role of the banking system in the transmission of monetary policy through changes in lending capacity is not usually constrained in the case of idiosyncratic, or even business-cycle frequency shocks; but the fact that the Covid-19 shock has been large and spread over many sectors of the economy limited this ability. Therefore, many of the challenges for monetary policy that arose from the Covid-19 pandemic had to do with how to make sure that central bank liquidity injections would actually be transmitted to the real economy. To mention some: (i) **maturity mismatch** can be stressed as short-term central bank lending makes lending long term more difficult; (ii) **liquidity mismatch**, since the funding by the central bank needs to be rolled over frequently, whereas banks provide refinancing to their clients; (iii) **leverage**, as the increase in funding from the Central Bank of Chile if funnelled to credit would potentially squeeze the amount of equity available; (iv) **collateral**, as the liquidity provided by the Central Bank of Chile is backed by appropriate bank guarantees, but these are in essence limited in moments of high stress; and (v) **credit risk**, as banks increase their loans to firms that are affected by the pandemic and thus can potentially result in higher risk.

In order to tackle these risks, the Central Bank of Chile responded by injecting resources into the financial system, but with significant changes in the implementation methods. Specifically, the Central Bank of Chile and the Financial Markets Commission (CMV, bank regulator), (1) provided long-term financing in order to mitigate maturity mismatch; (2) regulatory liquidity requirements were relaxed, through a temporary suspension of maturity mismatch requirements, and of the Liquidity Coverage Ratio; (3) reduction of risk-weighted assets for loans guaranteed by the Treasury of Chile, CORFO,[8] and FOGAPE,[9] from 100% to 10%, moving them into line with sovereign risk; and (4) a significant broadening of collateral, including corporate bonds, commercial paper and commercial loans.

Apart from the banking system, non-bank intermediation in Chile is certainly significant. The institutional investor base is large, through mutual funds, pension funds and insurance companies, and these agents have also been susceptible to large portfolio shifts. Most notably, there has been a shortening of portfolios, a dollarisation of portfolios, and a liquidation of equity. Sudden portfolio adjustments, triggered by local or global events, could have a disruptive effect on domestic financial markets. If asset liquidation is concentrated in local market securities, in

8. Economic Development Agency.

9 Small Business Guarantee Fund, see below.

particular bank instruments, it could generate a significant increase in the banking system's funding costs by reducing the possibility of rolling over short-term liabilities. In this respect, the main challenges facing Chile were related to: (a) the massive legal changes allowing the withdrawal of pension funds, as well as other portfolio shifts; (b) the dollarisation of portfolios, in particular when derived from sudden and massive shifts between funds by pension fund affiliates, such as the ones that have increasingly taken place in Chile; and (c) the shortening of maturities for mutual funds and insurance companies.

In response to these challenges the Central Bank of Chile implemented a series of measures that included (a) the purchase of longer-date as well illiquid assets in stressed capital markets to accommodate private reshuffling of portfolios; (b) a special cash purchase/forward sale programme (CCVP) for bank instruments; (c) provision of dollar liquidity; and (d) the approval of a constitutional change to allow the purchase of treasuries by the central bank in secondary markets.

4. Main credit-easing policies and their implementation challenges

The Financial Market Commission (CMF), the Ministry of Finance, and the Central Bank of Chile implemented an unprecedented set of measures, as described below, with the aim of mitigating the economic impact of the health emergency, based on the above-mentioned considerations.

The central bank implements the Financing Facility Conditional on Increased Lending[10]

This is a four-year term lending facility charged the monetary policy rate at its effective lower bound (ELB, assessed at 0.5% annual). To incentivise its uptake, even if banks expect the ELB to be revised downward, a clause for automatic refinancing at a lower rate was included. Moreover, following up some examples from other jurisdictions the amount of liquidity provided to each bank was linked to their credit growth.

This link went through a number of stages. Early on, as cashflows were significantly stressed it was deemed important to allow the total stock of credit to absorb the immediate impact of the crisis. However, as time passed and firms became more concerned about their ability to refinance their debts, the amount of bank funding was linked to the flow of credit, which also includes refinancing operations. This recognises that, for aggregate demand support, which was key early on in the pandemic, the stock of credit was an important benchmark. From now on, however, the real sector's refinancing capability becomes of critical importance.

The significant increase in bank funding under the FCIC could not be accommodated through the standard set of collateral instruments. Hence, the Central Bank of Chile significantly expanded the eligible collateral under its money market operations, including so far soundly performing bank loans as well as commercial loans guaranteed by the State.

10 Facilidad de Crédito Conditional al Incremento de las Colocaciones (FCIC)

It is interesting to note that the amount of liquidity provided through the FCIC was linked to the overall growth of the bank's loan portfolio, but did not target any specific loan category. By the same token, the broadening of collateral did not aim at specifically boosting loan origination to an specific sector. Rather, the role of State credit guarantees (detailed later) played the key role for incentives to lending to different sectors. These guarantees also meant that leverage did not come under pressure, as the bank regulator allowed a reduction in risk weights on loans that benefited from such guarantees. The regulator also waived the need for higher provisions on refinancing existing loans.

The specific calibration of these measures was revisited every six months or so. The first tranche (FCIC1) was implemented in March 2020 and experienced an uptake in bank funding of close to 10% of GDP. The second tranche (FCIC2) was implemented in June 2020 but had a much more muted reception, probably due to the higher perceptions of risks outstanding. The third tranched (FCIC3) was implemented in January 2021 and aimed at funding refinancing operations of soundly performing or already-guaranteed loans. As the economy recovered, and the use of these lines had been fully taken up by the banking sector, no further extension of unconventional support measures has been contemplated.

A very important effect of this measure was that it reduced the demand for private borrowing from banks, both in time deposits and bonds. The stocks of both securities have diminished, because they have been replaced by the FCIC that has a four-year term maturity, which is equivalent to that of bond financing. The stock of bank deposits today is equivalent to that in 2012.

Government expands FOGAPE[11]

The FOGAPE is a well-known and targeted instrument for the funding of SMEs. The government decided in 2020 to use it as part of a massive guarantees programme to counter the economic impact of the Covid-19 crisis. Its size and scope were broadened significantly during the second quarter of 2020, with guarantees of USD 3 billion that could be increased to up to USD 24 billion in new credits. This represented a tenfold increase in the programme (reaching 10% of GDP in potential new credit), made available over a much shorter period of time (three months instead of several years). The cap-on-sales eligibility criteria for business increased from USD 1 million a year to USD 40 million a year.

Credit-loss coverage was capped at 15% of any loan – as a reference, the median credit loss during the Great Financial Crisis was 9% of outstanding loans – with a deductible of 1–2% of any credit loss. As mentioned, at first these guarantees were provided only for new loans, and banks initially agreed to automatically refinance other credit operations with a grace period of six months. The incentive for refinancing was internalised by banks early on in the Covid-19 crisis, and thus incentives needed to be provided to reduce credit risk on new loans instead. Lending terms were standardised (36-month loan with a six-month grace period) and during the legislative process a cap on the lending rate was established at 3.5%.

The programme features were tailored to the view that the immediate shock of the crisis would last a few quarters. Now, as the more long-lasting effects of the crisis are starting to be experienced, the programme has been adapted to this new stage,

[11] Small Business' Guarantee Fund (Fondo de Garantía para Pequeños Empresarios)

through FOGAPE reactiva (2.0), legislated in early 2021. It allowed for increased flexibility in refinancing Covid and pre-Covid loans, and also about the maximum lending interest rate banks could charge.

Other regulatory and prudential measures were adopted to complement the above two policies. In particular, the CMF and the Central Bank of Chile provided 90-day renewable waivers for regulatory limits such as the LCR and other liquidity regulations. This was important due to the large amount of voluntary refinancing in the different types of loan portfolio. The potential squeeze in equity from increased leverage by banks was managed thanks to voluntary lower dividend distributions, as well as the CMF allowance that FOGAPE credits could qualify for lower (sovereign) risk weights. The CMF also allowed the temporary freezing of provisioning for voluntary refinancing of soundly performing bank and non-bank loans to households.

Funding from capital markets was also promoted through the "CRECE" fund, which provides guarantees usable by non-bank providers of SME financing. Reforms to ensure a speedier issuance and registration of securities and convertible bonds were implemented, as well as rule changes for repos so that banks could link risk weights to underlying assets instead of the counterparty.

A constitutional amendment passed in mid-2020 with broad support in Congress allowed the Central Bank of Chile to purchase government treasury bonds in the secondary market, to face conditions of stress and financial instability. Note that government treasury bonds have been eligible guarantees for regular money market operations for several years already, but the outright purchase of those securities, or their use in repo operations, was not legally possible. So far, this new tool has not been used.

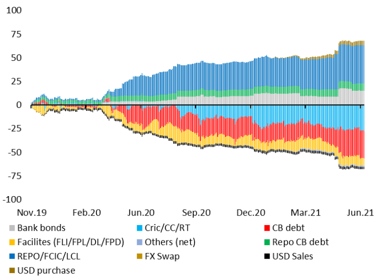
5. The implementation of unconventional monetary policies adopted by the Central Bank of Chile

The Central Bank of Chile's response to the crisis was rapid, decisive and unprecedented. Among the first measures was its lowering of the monetary policy rate (on March 20 by 75 bp, and on March 31 by 50 bp) to its technical minimum (0.5%). The effects of this monetary policy relaxation, as well as the credit easing measures described in the previous section, had a significant impact.

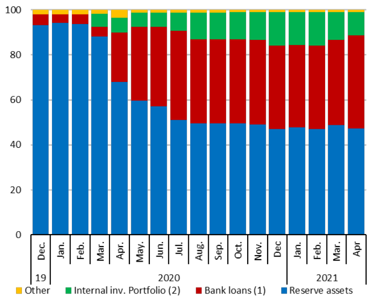
The balance sheet of the Central Bank of Chile expanded significantly and the range of collateral was broadened. The provision of liquidity via the purchase of both Central Bank of Chile and commercial bank bonds, as well as the FCIC and other facilities, entailed an extraordinary expansion of the Central Bank of Chile's balance sheet. Assets increased from 18.1% of GDP in March 2020 to over 30% by the end of 2020, mostly due to injections of liquidity to banks through the FCIC and bond purchases. The expansion of the range of instruments accepted as collateral was very effective. On 6 May 2020, eligible collateral for the FCIC was expanded to include commercial loans that were individually rated as high-quality loans, and more recently to the entire commercial portfolio with some form of state guarantee (Graph 5).

Graph 5

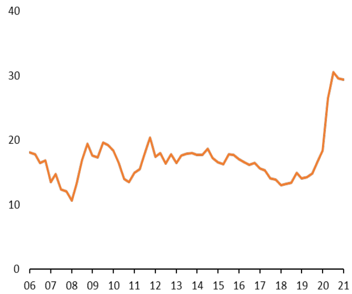
Sources of liquidity movements (*)
(USD billions)



CBCh's asset composition
(percent)



Assets on the CBCh's balance sheet
(percentage of GDP)

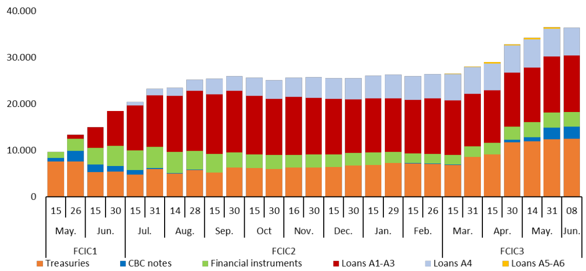


(*) FCIC: Conditional Financing for Increased Loans; LCL: Activation of liquidity facility; FPL: Standing liquidity facility; FPD: Standing deposit facility.

(1) Includes FCIC, repos and standing liquidity facility.

(2) Includes bank bonds, time deposit and CCVP purchases.

Collateral accepted by the Central Bank of Chile in loan operations (FCIC/repo)
(USD Billions)



A# is the risk classification for individual loans. The higher the # the higher the risk. FCIC3 will broaden to A5 – A6 with government guarantees.

Sources: Central Bank of Chile and FMC.

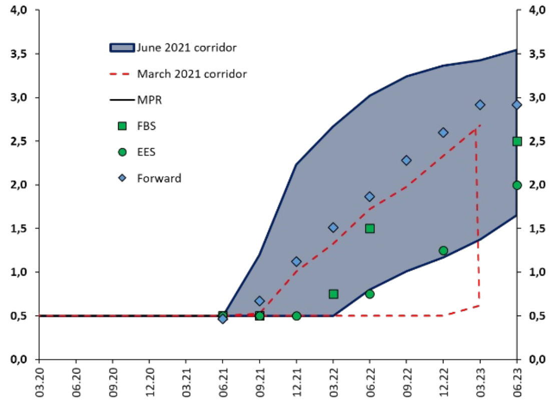
The Board communicated monetary policy would be stimulative with aggressive forward guidance. Since March 2020, the Monetary Policy Report has reported a corridor for monetary policy, which displays the implications for the monetary policy in the baseline as well as sensitivity scenarios for growth and inflation. In the December 2020 Monetary Policy Report, the Board stated that "it will maintain the high monetary stimulus for an extended period of time, in order to ensure the consolidation of the economy's recovery and compliance with the Bank's objectives. In particular, it foresees that the MPR will remain at its minimum level over much of the two-year monetary policy horizon. Unconventional measures will continue in place."[12] Moreover, the high demand for cash from households and firms required an aggressive logistical effort to ensure an adequate supply of notes and coins in the economy, as the pandemic slowed their circulation. More recently, as the need for stimulus has diminished thanks to the economic recovery, forward guidance shifted to expectations of a sooner but gradual lift-off in policy rates (Graph 6).

[12] Central Bank of Chile, Monetary Policy Report, December 2020, p 46.

Graph 6

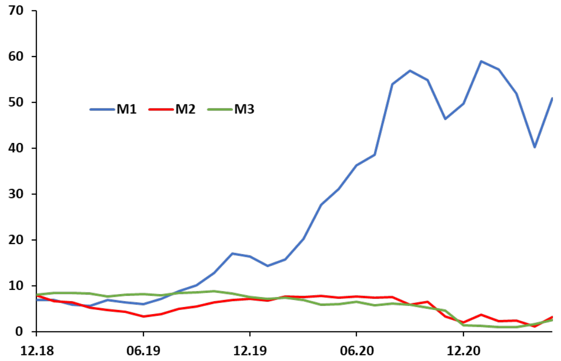
Monetary policy rate corridor (*)

(percent)



Monetary aggregates

(real annual change, percentage)



(*) The corridor follows the methodology of Box V.1 of the March 2020 Monetary Policy Report, Central Bank of Chile. It includes the Financial Brokers Survey (FBS) of 2 December, the Economic Expectations Survey (EES) of 9 November and the forward curve derived from a 10-day average of financial assets up to 2 December.

Source: Central Bank of Chile.

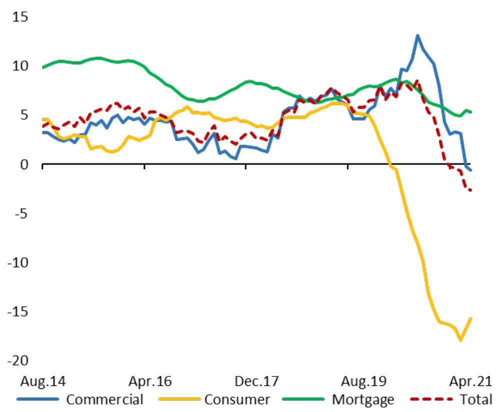
Assessing the effect of policies has always been a difficult task. In the context of an unprecedented crisis and after multiple regulatory changes, fiscal measures and unconventional monetary stimuli, such an endeavour becomes even more challenging. But even under the circumstances, some important conclusions can be drawn regarding the effectiveness of the adopted policies.

Credit provision accelerated to the corporate sector, helped by guarantees and liquidity provision. The first evidence comes from credit trends, which suggest a key role for the measures adopted by the Central Bank of Chile and the government. During the second quarter of 2020, the period with the strictest mobility restrictions, the commercial portfolio recorded strong growth despite the economic contraction, favoured by the support measures implemented by the authorities (Graph 7).

Graph 7

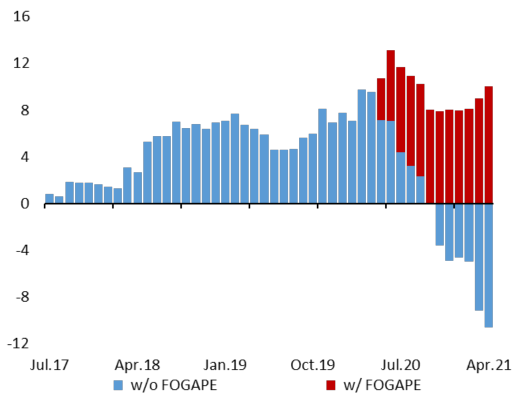
Growth of loans

(real annual change, percent)



Growth of commercial loans

(real annual change, percentage)



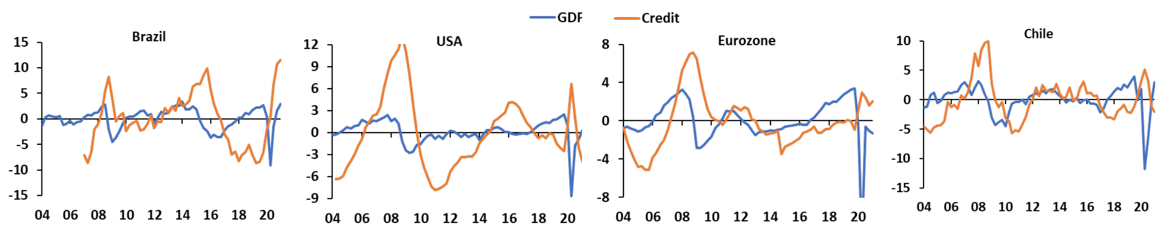
Sources: Central Bank of Chile and FMC.

The countercyclicality of commercial credit was a feature in several jurisdictions. It is noteworthy that this countercyclicality of credit during the current crisis breaks the traditional relationship observed in the past, not only in Chile but also in several other jurisdictions (Graph 8).

Graph 8

Economic activity and credit cycles (*)

(deviation from trend, percent)



(*) Calculated as the difference between the log of the GDP level and credit, relative to a trend calculated using a HP filter.

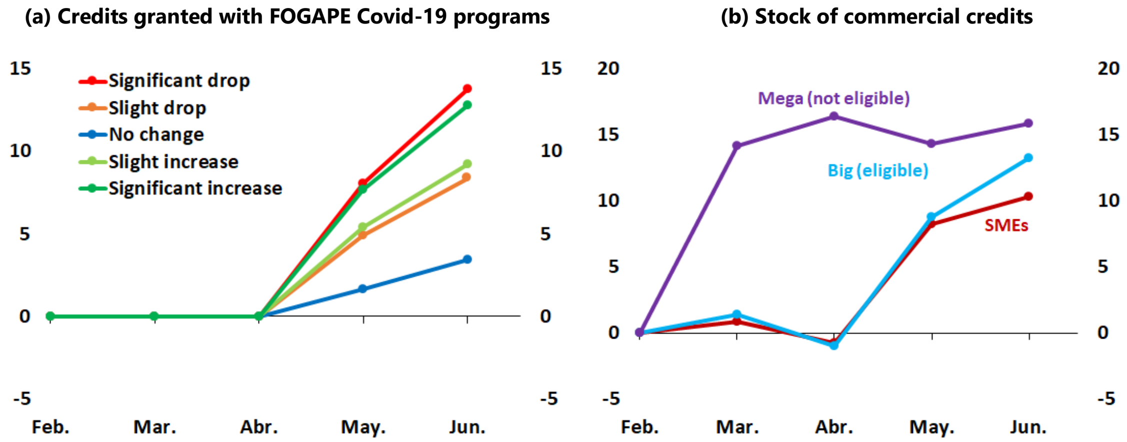
Source: Central Bank of Chile.

Loans granted through the FOGAPE-Covid-19 programmes targeted, to a greater extent, companies that had significant drops in their sales. Using matched tax and financial data at the firm level showed that the loans granted under the FOGAPE-Covid-19 programmes have gone mostly to businesses that recorded a major reduction in sales. Among companies that were ineligible for these programmes because of their sales level, there was a significant increase in credit to large firms. In terms of timing, credit to micro, small and medium-sized enterprises (MSMEs) and large firms only began to increase in May, when the FOGAPE-Covid-19 programmes were implemented. (Graph 9 and Huneeus et al (2021)). Moreover, the preliminary evidence also suggests that increased access to credit has been important in softening the real impact of the crisis, by mitigating the negative impact of the shock on firms´ investment and employment decisions (Albagli et al (2020)).

Graph 9

Stock of commercial credits by size and behaviour of sales

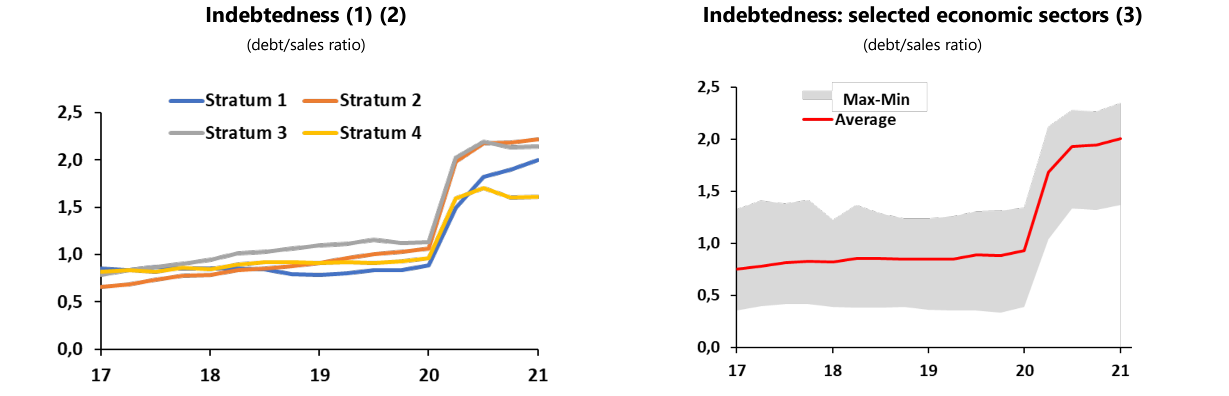
(change in annual variation compared to February 2020, percent)



Sources: Centra Bank of Chile and FMC.

Leverage increased, posing challenges going forward. The significant increase in business leverage – which was necessary to get through the most difficult months of the pandemic and prevent a large number of businesses from stopping operations – will present challenges going forward. Indebtedness has grown across the board, although most intensely in medium-sized firms and in the retail, business and personal services sectors (which are among the hardest hit by healthcare measures and households' precautionary behaviour). In the context of a partial recovery, the considerable fall in profits and increased indebtedness could hinder companies' ability to embark on new projects (Graph 10).

Graph 10



(1) The debt-to-sales ratio is calculated at the level of each firm for each period. The numerator is the stock of banking and foreign debt of each firm. The denominator is calculated as the average of the real sales of each firm (deflated by the UF) between the third quarter of 2018 and 2019. The indebtedness by sales stratum is calculated as the median among the firms of each stratum.

(2) Stratum 1 and 2: annual sales less than UF 25,000. Stratum 3: annual sales greater than UF 25,000 and less than UF 100,000. Stratum 4: annual sales greater than UF 100,000.

(3) The grey area indicates the maximum and minimum debt-to-sales ratio among the selected sectors for each period. The included sectors are: business services, housing services, financial services, personal services, commerce, restaurants and hotels, industry, construction and transport.

Sources: Central Bank of Chile, FMC and National Statistics Institute.

6. The role of other policies

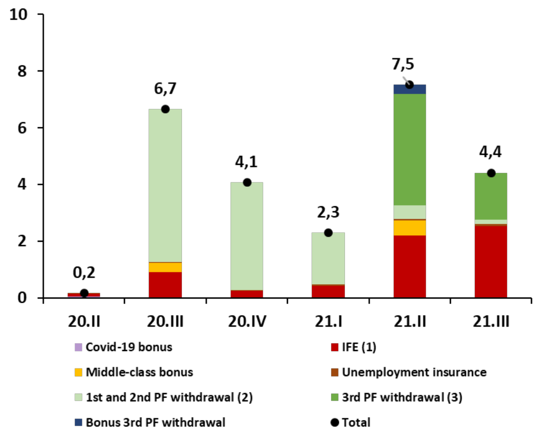
The Covid-19 pandemic had very significant adverse effects on households' income. Available data suggest that the autonomous income of households – income from work and other sources, not including transfers or other liquidity measures – fell by 5.7% in 2020, with the greatest contraction taking place during the second and third quarters, and a smaller reduction in the fourth. The fall in income was relatively larger for the lowest-income groups. Policymakers deployed various support measures to cushion these effects and improve household consumption possibilities. Among these measures were fiscal aid programmes and the early withdrawal of pension savings.

The effect of these measures was concentrated in the second half of 2020 and the first half of 2021, displaying a markedly procyclical tendency. Fiscal transfers, important from a historical perspective, only partially compensated for the drop in labour income early on, coming fully into line in the third quarter, and even increasing since then, and they have been targeted to lower-income households. Legislative changes were approved allowing for three withdrawals of pension savings, each up to 10% of assets in individual portfolios, with a maximum cap and a minimum. By their nature, these were not targeted and, as shown, were accessed mainly by higher-income households. The impact on consumption of durables has been significant, partly explaining the increased dynamism of the retail sector (Graph 11).

Graph 11

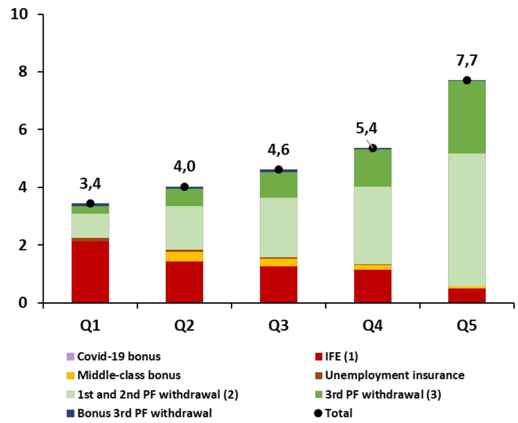
Effect of support measures on household income

(percent of 2020/21 average GDP)



Change in income and additional liquidity, 2020

(USD billions)



Source: Central Bank of Chile based on Barrero et al (2020).

Finally, a brief note about the possibility of intervening in the FX market as a complement to conventional and unconventional monetary policy. Should central banks have been more active in their foreign exchange interventions during the Covid-19 crisis? There are situations in which FX intervention or liquidity provision is necessary. However, the Covid-19 crisis seems to have created the need for local currency support due to the cash flow crunch for firms (in particular, SMEs) and households. Nevertheless, it is necessary to consider the extent of transaction-dollarisation for the role of forex in liquidity provision.

In general, under inflation targeting and flexible exchange rates, foreign exchange intervention can be rationalised in three ways: (i) monetary policy at the effective lower bound, plus significantly de-anchoring of inflation expectations below the target, could provide a basis for unsterilised foreign exchange accumulation as a QE policy akin to price-level targeting; (ii) periods of financial dislocation and high volatility can require sales or purchases of foreign exchange over limited periods of time; and (iii) regular assessment of the adequacy of reserves can lead to accumulation/decumulation of foreign exchange reserves.

Inflation expectations have remained well anchored, and the demand for liquidity has been focused on domestic currency. Therefore, the foreign exchange policy implemented by the Central Bank of Chile has responded to the second and third rationales over the recent period. Some sales of foreign exchange took place early on, to confront high volatility. During 2020, the Central Bank of Chile arranged for a two-year Flexible Credit Line for a 1,000% quota (around 9% of GDP) with the IMF to backstop its external liquidity position.[13] More recently, as a preparation for the exit

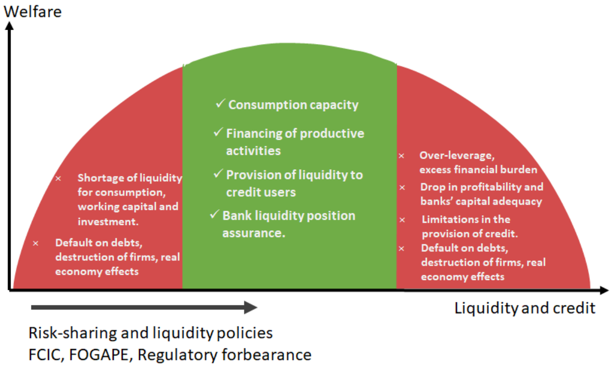
[13] In addition, an existing RMB/CLP swap line was expanded.

from this facility, the Central Bank of Chile implemented a 15-month programme of reserve accumulation for USD 12 billion, with small daily purchases, to avoid interfering in the operation of the foreign exchange markets.

7. Concluding remarks

An important challenge for the Central Bank of Chile has been to judge how extensive its support measures should be. Too little support and policies might not have been able to prevent severe liquidity crunches for firms and households, resulting in defaults and closures. Too much support and a situation with excessive leverage and risk-taking and future financial stability stresses could have resulted (Graph 12).

Central bank challenges — Graph 12



Source: Authors

The assessment of the cash flow needs from the real sector has benefited from work at the research and statistic levels. Evidence from individual firm-level data shows that the shock facing Chilean businesses was very large and heterogeneous across sectors, with plummeting sales and a significant increase in firms reporting zero sales. Electronic invoice data show that, over the first month of the Covid-19 crisis, there was a sharp reduction in sales. On average, sales fell by 13.6% in real annual terms between March and July of 2020. This compares with an increase of 10.5% between January 2014 – when electronic invoice data became available – and September 2019 – the month before the start of the social unrest.

These types of quantitative exercise require a close collaboration between institutions, statistical areas, and research teams. However, from a broader perspective of policymaking a conceptual framing of the limits of policies is needed. The Covid-19 crisis resulted in a very large increase in the need for liquid holdings and credit demand. Therefore, from a narrow monetary policy perspective, an obvious limit to policy accommodation is the credibility of the monetary and inflation targeting frameworks. Jurisdictions with credible inflation targets, anchored inflation expectations and less dollarised financial systems could afford more aggressive easing by central banks.

Beyond monetary policy, the Covid-19 crisis has posed significant political economy challenges in several economies, as it affected households and firms in many different ways. Tackling the risk-sharing and distributional implications of policy design has represented a political and legislative challenge everywhere, determining the speed, opportunity, breadth and magnitude of support policies across countries.

Against this backdrop, these tensions are likely to continue throughout the recovery process. For independent central banks, enhancing transparency in the communication of their policy rationale will continue to be paramount.

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