

José De Gregorio: Recent monetary policy actions and their effects

Speech by Mr José De Gregorio, Governor of the Central Bank of Chile, before the Finance Commission of the Honorable Chamber of Representatives, Santiago, 27 July 2009.

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Thank you, Mr. President of the Honorable Chamber of Representatives, Representative Mr. Julio Dittborn for the invitation of the Chamber's Finance Commission to speak about the effects of the monetary policy decisions we have adopted over the course of this year.

Last March, at a special session of the Economic, Promotion and Development Commission of this Chamber, we presented our view on the pass-through we then observed in market interest rates of our monetary policy decisions. In following months, the Central Bank has taken additional measures that have significantly increased the monetary stimulus. The possibility of revisiting this subject, now before the Honorable Finance Commission is, therefore, very timely and very welcome, because it gives us the chance to present an analysis of the effects of our latest decisions.

I wish to remind you that monetary policy, especially under an inflation targeting regime with a floating exchange rate like the one we have in place in Chile since 1999, is an important stabilizer of the business cycle. Thanks to institutional developments and high degrees of solvency and liquidity of our economy, the monetary policy makers have been able to act with unusual vigor. This has allowed us to confront the negative effects of the global turmoil on our country's demand and output decisively. Let me begin by reviewing the monetary policy measures we have adopted since the beginnings of the global turmoil.

The monetary policy measures to address the global crisis

Since the early stages of the global crisis, monetary policy has acted aggressively to cushion the effects of the crisis on our economy. Our main policy instrument – the monetary policy rate (MPR) – influences the cost of interbank lending at one day term. Because the credits that banks provide to households and firms are at longer terms, what is central to determine the magnitude of the monetary impulse is the future path of the MPR expected by the market, rather than its current level. Thus, although the MPR was kept constant at 8.25% in the latter months of last year, the communication of the external scenario meltdown and its disinflationary consequences, together with the incorporation of an explicit bias, pulled down MPR expectations significantly between October and December, also affecting the market interest rates.

This process was substantially heightened between January and March of this year, when the Board cut the MPR by 600 basis points, above what the market and analysts were expecting. Between April and June, the MPR was cut further, by a combined 150 basis points. The Central Bank stated, repeatedly, even in our May Monetary Policy Report, that the monetary stimulus would be sustained for a prolonged period, even beyond what could be inferred from financial asset prices at the time. Finally, in our latest monetary policy meeting on the 9th of July, the Board cut the MPR to its minimum level (0.5%), indicating again that the MPR would be kept at expansionary levels for a prolonged period of time. In order to reinforce this decision and align financial asset prices and the money market interest rates with the monetary policy path, complementary measures were adopted for the provision of liquidity and the administration of our debt.

After this rapid process of monetary easing, that has no precedent in any emerging economy nor in our economic history, the expectations regarding the level of the MPR have shown a very significant adjustment (figure 1). Not only has the shortest segment of the yield curve shifted downward, close to the current MPR level and the new measures of liquidity

provision, but the longer-term segments as well. Private expectations and financial asset prices are showing that the expansionary monetary policy stance will remain in place for several more quarters, or even years. Our latest monetary policy decision was complemented, as I just said, with additional measures that enhanced its impact. Deposit rates dropped significantly at maturities of one year or more, while the rates on our instruments at terms of two or more years, also fell after the announcements.

One issue that has been on the table, not only in Chile but in the developed world and a number of emerging economies as well, is precisely the behavior of longer-term interest rates. Unlike those at very short term, which are largely arbitrated by the monetary policy stance, interest rates on long term government bonds are more influenced by, among other factors, the appetite for risk, the evolution of interest rates around the world and the widespread uncertainty prevailing in the economy. This last point is connected with expectations for long-term inflation and growth and fiscal solvency prospects, with particular strength in those economies that have had to embark in costly financial packages and bank bail-out programs, thereby multiplying their levels of public debt. In some emerging economies, and even in some developed ones, this increased debt has spurred doubts about the sustainability of their fiscal accounts and monetary arrangements, questioning their capacity to grow in the coming years.

Although luckily, and thanks to the efforts made, the Chilean economy is not in such a situation, the determination of the long-term interest rates does depend indisputably not only on the prospects for growth and inflation – and thus on monetary policy – but also on portfolio decisions of domestic agents and the appetite for risk. Developments early this year are very illustrative. At times where there was still high uncertainty, and there was a higher demand for safety and liquidity, the long-term interest rates of various public instruments in Chile went to record lows. As this uncertainty faded, the precautionary demand followed suit, pushing up long-term interest rates in pesos and in UF until the end of May. In the last couple of months, because of a string of episodes of higher and lower doubts about the true strength of the global recovery, long-term interest rates have fluctuated, but always above the levels of early this year. A similar pattern has been seen in long-term interest rates around the world (figure 2).

We are not indifferent to the evolution of long-term interest rates. This is evident from the facts that, to enhance our last monetary policy measure, we have not only begun providing liquidity at the current MPR level for up to six months, but we have also suspended issues of instruments at one to two years' terms. Furthermore, we permanently take into consideration bond issuance plans of the Treasury before defining our own programs.

Nonetheless, it is necessary to undertake a careful analysis of the long-term interest rate levels to properly assess their implications. After all, very low long-term rates are a symptom of depressed prospects for long-term growth and strong demand for safety. At the end of the day, what matters is the cost of borrowing for households and firms, which does not stem directly from risk-free interest rate structures, but goes through the filters of the capital market and the banking system.

Pass-through from monetary policy to market interest rates

As I indicated the latest monetary policy measures were clearly transmitted to the banking system's borrowing rates, thanks to the complementary measures adopted by the Board at its last meeting (figure 3).

Last March, we stated that the aggressive reductions to the MPR implemented by the Board in January and February had begun passing through to the cost of borrowing faced by households and firms, affirming that such transmission could be reasonably expected to continue. This diagnosis still holds, particularly after what we have seen since our last meeting and especially in consumer and commercial loans (figure 4). We estimate that,

without the 425 basis point's reduction of the MPR that began in March, consumer lending rates would be between 400 and 500 basis points above their current levels. Short-term commercial credit rates, at 30 to 89 days, would be between 350 and 450 basis points above their current figures. Long-term mortgage loans would be some 25 to 30 basis points higher. We believe that the reduced funding costs of financial institutions will continue to be passed on to the cost of credit with the usual lags. We expect the banking industry to actively cooperate in this process.

A full normalization of credit demand and supply conditions will have to wait until the dust settles in the international financial scenario, to allow more clarity about global and domestic growth prospects. These risk factors have a direct incidence on credit risk premiums implicit in banking operations. We can see that the monetary policy action has more than offset the increase in risk premiums, resulting in a significant drop in credit costs, thus mitigating the effects that the global crisis has had on our economy.

One important aspect of the access to credit, aside from its cost, draws from the effect of the environment of uncertainty and economic weakness on the credit approval conditions and credit demand. In these dimensions, we have recently seen signs of stabilization. Internationally, the various indicators of uncertainty and risk in global financial markets, while remain relatively high, have continued to fall. Domestically, the evidence at hand from the Banking Credit Survey for the second quarter of this year reveals that, on average, banking institutions have already stopped tightening their lending standards and perceive early signs of a recovery of the demand for credit. This is particularly evident in the mortgage segment, suggesting that the levels of the long-term interest rates on these loans are not necessarily holding back the demand for housing credit (figure 5). Also, early in the year we witnessed a substantial increase in issues of corporate bonds, which can be interpreted as the response to less favorable financing conditions in both the domestic and the external banking market, a situation that has lost momentum in recent months.

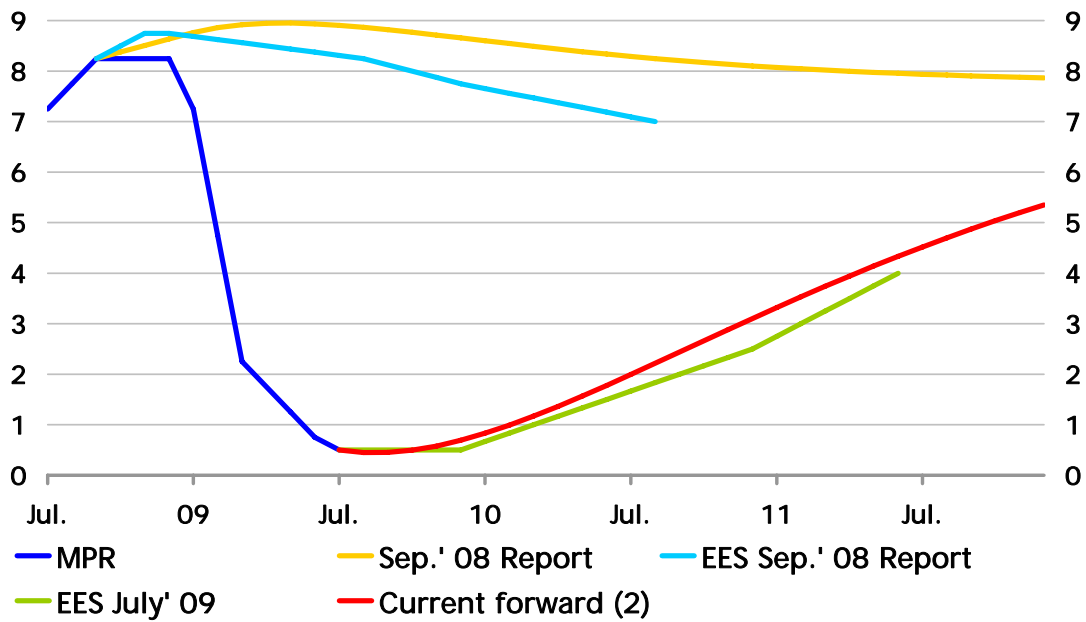
Conclusions

Monetary policy has acted aggressively to soften the impact of the global financial crisis. Although it is impossible to fully offset all the repercussions that such a severe crisis has on a small, open economy like Chile, especially with the lags that monetary policy operates, we have succeeded as a country in mitigating them substantially. We have preserved the macroeconomic stability framework, even providing room for an extraordinarily stimulating mix of macroeconomic policies. Therefore, we can now state without a doubt that, had we not adopted the stimulus actions you have seen in recent months, our country's economy would be in considerably weaker shape and we would not be able to envision any prospects of recovery for the second half of this year.

Conditions are ripe for the Chilean economy to experience a healthy recovery of output and expenditure during the second half of this year. For the economy to pick up, however, it will still require that the global uncertainty, regarding both the financial dimensions of the crisis and its effects on world activity, fades. We have seen promising signs allowing us to be hopeful, but it is premature to think that the bad news are over. For this reason, we believe that it will be necessary to maintain the monetary stimulus for a prolonged period of time, in order to ensure that inflation approaches its 3% target and prevent it from stabilizing undesirably below that target. The latest decision of the Central Bank Board and its recent effects are proof that the monetary policy has effective instruments to continue applying the monetary stimulus even with the MPR at its minimum.

Again, I am grateful to the Finance Commission of the Honorable Chamber of Representatives and its President, Representative Mr. Julio Dittborn, for letting me share with you our visions. The transparency with which we conduct our monetary policy is crucial in the uncertain global environment we are still enduring. Thank you very much.

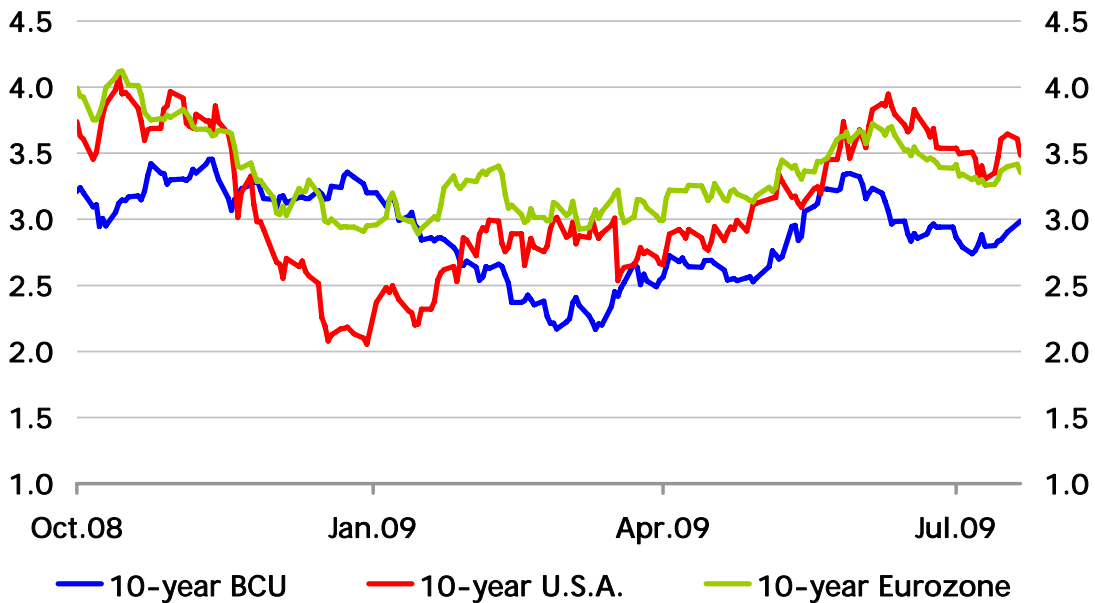
Figure 1
Expectations for the MPR (1)
 (percent)



(1) Weekly averages used for the forward curve.
 (2) Forward curve at 21 July 2009.

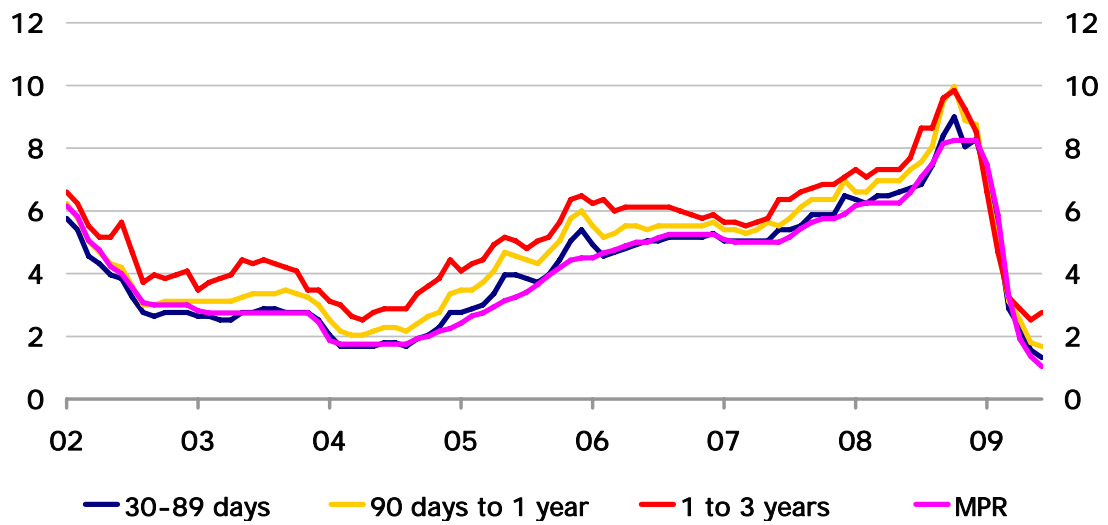
Source: Central Bank of Chile.

Figure 2
Long-term interest rates
 (percent)



Sources: Central Bank of Chile and Bloomberg.

Figure 3
Deposit rates
 (percent)



Source: Central Bank of Chile.

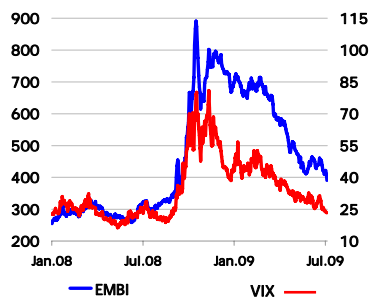
Figure 4
Lending rates
 (weekly data, percent)



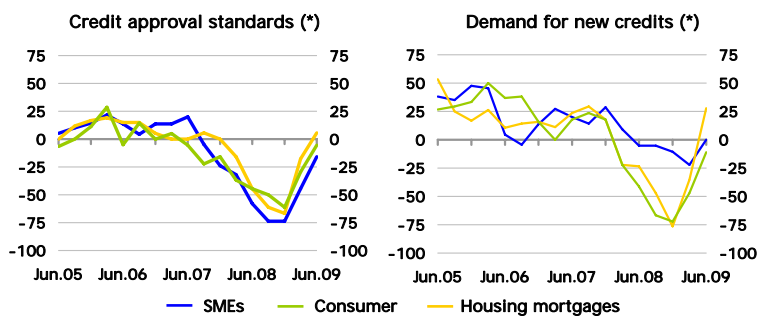
Source: Central Bank of Chile.

Figure 5

Volatility and risk premium
(basis points, percent)



Quarterly survey on banking credit
(balance of responses, percent)



(*) Average responses per quarter. Negative figures denote tighter conditions than in the previous quarter.

Fuentes: Central Bank of Chile, Bank Lending Survey; Bloomberg.