Central Bank of Chile's Twenty-first Annual Conference

"Monetary Policy and Financial Stability: Transmission Mechanisms and Policy Implications"

Opening remarks by Governor Mario Marcel

Good morning and welcome to the Twenty-first Annual Conference of the Central Bank of Chile. It is a pleasure to host this event that every year gives us an opportunity to reflect and discuss about issues that have direct implications on our work as central bankers from a broader perspective. I am looking forward to active discussions through the rest of the week on this year's conference theme: monetary policy and financial stability.

Ten years have passed since the onset of the Global Financial Crisis and we are still dealing with its economic consequences. But we have learnt a lot, and a decade of hindsight about the causes and long-lasting effects has led us to rethink the way we conduct monetary policy, how to ensure financial stability, and how these two elements are, or should be, interconnected.

One of the most important policy lessons from the crisis concerns the relevance of actively seeking financial stability in a context of ever-increasing financial complexity. And central banks worldwide have been increasingly involved in assuring this, since it has become clear that financial stability is a pre-condition for price stability. Although financial stability has long been a key concern for policymakers, particularly in emerging countries where financial vulnerabilities are, or were, more evident and where risks to stability often come from abroad, nowadays the key concern is how to act in a preemptive way with actions that are costly, to ensure financial stability into the future. How should macroeconomic policy pursue the goal of financial stability in normal times, when the benefits are uncertain but the costs are noticeable?

As many of you well know, this concern came with the observation that the buildup of risks in the United States before the crisis occurred during a period of stable prices and output, the so called "Great Moderation" period, where low nominal interest rates that were consistent with the Central Bank's commitment with CPI inflation stability may have led to excessive risk-taking by financial intermediaries, and to a rise in asset prices, while good economic conditions masked the developing of financial imbalances.

In the aftermath of the crisis, policy rates were drastically reduced and diverse policy measures were implemented as the zero-lower bound became an active constraint. But the increasing concern about financial conditions and the consequent reassessment of the macroeconomic policy framework was most evident with the adoption of macroprudential

policies. But the question remains about the role of monetary policy. Should monetary policy frameworks explicitly incorporate risks to financial stability? This, the so-called *Leaning Against the Wind* debate, has become one of the most hotly debated issues in macroeconomics, in policy as well as academic circles, and will be one of the main topics we will be discussing and learning about during these couple of days.

Let me contribute to this debate with the perspective of a policymaker in a small-open economy like Chile. In our case, financial vulnerabilities have been often related to large and volatile capital flows, with their consequent effects on asset prices and credit spreads. In this context, raising the interest rate in normal times due to financial stability concerns as the LAW strategy would prescribe, may be counterproductive as it would attract more capital flows, would tend to appreciate the domestic currency and would encourage foreign-currency borrowing. These mechanisms, of course, have been at the core of monetary policy in developing countries for many years. In the case of Chile, they were more evident during the 90s when capital controls were in place to try to give more autonomy to monetary policy in a context of persistent and large capital inflows. However, these mechanisms are relevant as well when debating about the role of monetary policy in actively pursuing an objective of financial stability.

A second issue I would like to point out is related to the credibility of the Central Bank, which is also a very important concern for emerging economies like Chile, where credibility was gained over several decades of responsible policymaking, and losing it would mean a costly institutional setback. A strong advantage of having monetary policy focusing exclusively on price stability is that it simplifies communication and enhances accountability, with the resulting positive effects on credibility. Adding a different objective would hinder transparency, endangering the anchoring of inflation expectations.

However, independently of the convenience of following a LAW strategy or keeping the pre-crisis consensus with monetary policy focusing primarily on price stability, I am convinced that the main lesson from the Crisis is that regulatory frameworks aimed at specific sectors and markets are a key element of a defense against financial disruptions. Macroprudential policies, and in particular monetary policy, are not substitutes for an efficient regulatory framework. Microeconomic policies can be targeted much closer to the source of market imperfections, mitigating their effects while at the same time avoiding the economy-wide costs of contractionary macroeconomic policies.

We cannot forget that inefficiencies in the regulatory framework were at the heart of the buildup of risks in the run-up to the crisis. The fact that fragilities in the financial system, namely inadequate levels of capitalization and liquidity, were not properly and timely identified, may primarily reflect inadequacies in regulation and supervision.

Our best response is to continue strengthening regulation and supervision regimes aimed at avoiding future crises. And central banks have a crucial role to play because there are clear complementarities between financial and monetary stability, which, as is the case of Chile, are often formally recognized in central banks' official mandates. Before referring to what we have done on this matter in Chile, let me briefly describe our experience with the Global Financial Crisis and our macroeconomic policy response to it.

While we were still enjoying the commodity boom of the 2000s, we were hit by the spillover effects of the crisis and its aftermath, namely the tightening of domestic lending conditions, capital outflows, a reduction of the external demand for our exports and a decrease in the price of copper, which is still the main source of external income for the Chilean economy, and in particular an important source of revenues for the Treasury. The price of this critical commodity fell more than 60 percent in just five months. Exports fell almost 20 percent in two years, a strong shock for an economy where exports accounted for more than 40 percent of GDP. A similar drop experienced public revenues, with those coming from copper production falling 23 percent in 2008 and 50 percent the following year.

Despite the severity of the shocks, economic performance and the resilience of the financial system have been better than in comparable situations in the past. Behind this favorable response of the Chilean economy lies a macroeconomic policy framework able to pursue an effective reaction, and a regulatory scheme supporting the high resilience of the domestic financial system.

In Chile the monetary policy framework consists of a flexible inflation-targeting regime with a floating exchange rate. This framework has allowed us to respond efficiently to external shocks keeping inflation expectations anchored. Before the Asian Crisis of 1998, we had a managed exchange rate and we had capital controls in place to allow monetary policy independence to manage inflation in a context of abundant capital inflows. Indeed, we experienced a costly adjustment to that episode, and this was fueled in part by financial stability concerns that called against an exchange rate adjustment. But once the harder times had passed, the exchange rate was allowed to float freely, facilitating not only the external adjustment against shocks but also improving the incentives for private agents to properly hedge their foreign currency operations.

The deep-rooted credibility of our Central Bank has also facilitated the conduct of monetary policy with a floating exchange rate system. The fact that the market understands that the Central Bank pursues a goal for inflation at a 24-month horizon means that the exchange rate pass-through to inflation is relatively low, indeed the lowest in the region. This can be illustrated with the reluctance of the Central Bank to tighten monetary policy in 2015 despite a 49 percent devaluation in 2014-2016, and without affecting 24-months-ahead inflation expectations, which remained anchored at the target level.

As the 2007 financial crisis unfolded and its effects spread-out, this framework helped us to avoid large costs and evade financial problems despite our strong ties with the global economy. In the aftermath of the crisis the local currency depreciated around 45 percent in seven months, while the monetary policy rate was reduced from a relatively high level of 8.25 percent in December 2008 to a point five percent in July 2009, remaining there for about a year. Together with lowering the interest rate, the Central Bank implemented a program of liquidity provision that significantly reduced the market interest rates to a level much closer to the monetary policy rate. Additionally, in the middle of 2009 it established a term liquidity facility for banking institutions, granting 90- and 180-day liquidity at the prevailing monetary policy rate, signaling a more expansionary path for the monetary policy rate than the market expected.

The active monetary policy response, together with an expansionary fiscal policy, favored by a healthy fiscal position that was achieved thanks to a fiscal rule where expenditures are determined as a function of long-run copper prices and economic growth, facilitated a rapid adjustment. After only one period of negative annual growth in 2009, the economy was able to sustain growth rates above 4 percent in the years that followed. The inflation rate fell well below the target range for about a year, but inflation expectations remained well anchored at our target of 3 percent in the two-year horizon.

Undoubtedly this is the strongest countercyclical macroeconomic policy response we have ever implemented to a shock of this magnitude, and it was possible thanks to a sound corporate sector, a well-capitalized and resilient financial sector, and a solid position in terms of international liquidity.

Importantly for the discussion ahead, this was the result of careful regulation and supervision of individual financial institutions. This scheme hails back to the banking crisis of the 1980s, and it has been constantly adapted and improved since then.

In Chile, financial services are regulated and supervised by different institutions according to the type of service; securities and insurance, the pension system and unemployment insurance, and banks. In the case of banks, the Superintendence of Banks and Financial Institutions and the Central Bank are in charge. Different schemes have been designed to facilitate coordination between institutions. This effort has led recently to the creation of the Financial Market Commission, which will be headed by an autonomous board of directors and will transform the financial supervision and regulation scheme to an integrated one, with a systemic view of the stability and risks facing the financial sector and more flexibility to deal with critical situations.

The Central Bank of Chile enjoys a special independent status under the Bank‘s Constitutional Organic Law. Besides specific regulatory tasks with regard to the banking sector, the Central Bank oversees the foreign exchange regulations and monitors closely and

constantly all the industries making up the financial sector. A central task performed by the Central Bank aimed at financial stability is the publication of the Financial Stability Report, twice a year.

The banking regulation has evolved gradually and steadily, adopting proven international standards and best practices. A new General Banking Law will provide for a gradual convergence to the Basel III framework, which will raise the quality, consistency and transparency of the capital base; strengthen risk hedging; introduce leverage limits; promote a countercyclical capital framework; and introduce a global liquidity standard. These requirements will be implemented gradually through 2019. They will provide higher stability and sustainability and contribute to Chile's reputation and access to international markets.

Chile largely complies with the Principles for Financial Market Infrastructure established by the BIS. An assessment made by the World Bank and the IMF last year identified a high level of compliance with the principles on the part of the entities assessed, as well as the authorities. The main conclusion was that Chile has sound and robust financial market infrastructures, in line with international standards and best practices on risk management, the finality and irrevocability of settlement, efficiency and transparency.

The Chilean financial market is, in general, deeper than those of other Latin American countries, with larger institutional investors and greater maturity. Banks' capital adequacy indicators are similar to those of other economies in the region, but lower than in OECD countries, while their exposure to credit risk is low relative to both OECD and emerging economies. The World Economic Forum Banking Strength index shows that the Chilean banking sector is very strong, as it ranks in the 11th place in the world.

Let me finish by pointing out the relevance that the exchange rate derivatives market has had in favoring both financial stability and the conduct of the flexible inflation targeting scheme in Chile.

This market is not as deep as it is in developed countries, but it has experienced significant growth of more than 10-fold since 1998, fueled in part, as I already mentioned, by the floating exchange rate regime. The role of pension funds has been significant as well, as they maintain a large positive foreign financial position, and keep hedging against exchange rate risk even above the regulatory requirements, especially in the aftermath of the last crisis.

Thanks to these factors and a favorable regulation, Chile shows a high level of penetration of financial derivatives compared to other emerging economies and countries in the region. All this has contributed to a limited exchange rate mismatch of corporations. Today the share of firms with a mismatch over 10 percent of their assets is below 10 percent, down from around 20 percent before the Crisis. Hence monetary policy can be conducted in a countercyclical manner, without the need to manage the exchange rate. However, as the recent experience in developed countries has revealed, the rapid development of derivatives

markets also poses challenges to regulators due to their complexity and potential concentration of risks in a few entities.

An additional strength of the Chilean economy in the context of emerging countries, which I think is very important for the topic to be discussed during these days, is the relevance of institutional investors, particularly pension funds. Their role in financial stability has gone well beyond the development of derivatives markets. They have contributed to the deepening of capital markets, portfolio diversification, and the development of new financial products, among other features. Moreover, with their peso-denominated liabilities and large foreign position, which is around 35 percent of GDP in the case of pension funds, they have facilitated the conduct of monetary policy being an important source of liquidity in foreign currency when needed. Acknowledging this, the financial regulation has gradually expanded the scope of possible investments for institutional investors, including raising the limits for investments abroad.

Let me finish by thanking the distinguished group of economists that have joined us to present and discuss issues concerning monetary policy and financial stability. I would like to thank also Alvaro Aguirre, Markus Brunnermeier, Diego Saravia and Catalina Larraín for putting together the program, and Paloma Navarro and Carola Besa for helping with the organization.