Ms. President of the Finance Commission, Senator Evelyn Matthei, senators of the Commission, senators. I am grateful for your invitation to present the recent macroeconomic and financial events that could have an effect on the financial stability of the Chilean economy, which are detailed in the Financial Stability Report (IEF, by its acronym in Spanish) of the first half of 2009.

The major crisis the world economy is undergoing presents great challenges, and the impact it is bearing on our country stresses the need for presenting to you our vision of the functioning of the Chilean financial system, as well as the actions taken by the Central Bank by virtue of our mandate to ensure the normal functioning of the internal and external payment systems.

Foreign Financial Situation and Threats to the Chilean Financial System

I would like to begin this presentation by discussing the international macrofinancial environment and the main threats it poses on the Chilean financial system. It is important to highlight that these threats are not a part of our baseline scenario; rather, they are risk scenarios which are the basis to perform several of the tests to assess the strength of the financial system, which are detailed in the Report.

Since the fourth quarter of last year, the world economy has experienced an output drop of a magnitude and with a synchronicity that have no precedent in the past sixty years. This decline has resulted from the uncertainty and pessimism which took over households and firms around the world, and from the severe tensions in the financial systems of several of its major economies (figure 1).

In this setting, the main advanced economies have implemented unprecedented monetary, fiscal and financial policy measures to both invigorate the economy and bail out troubled financial intermediaries. The monetary stimulus by way of interest rates cuts has reached its maximum in some countries, so quantitative expansionary monetary policies have been added. Meanwhile, exceptional mechanisms to support bank liquidity remain in place, government insurance plans backing bank liabilities have been granted in different ways and at different degrees, bank capitalization plans have been adopted, and steps have been taken to remove “toxic” securitized assets from the balance sheets of banks exposed to such assets.
These macrofinancial policy actions have significantly reduced the probability that the severe difficulties which took place in the financial system of some developed economies late last year (figure 2) will recur. Therefore, since we presented the latest Financial Stability Report in January, the global financial outlook has improved significantly. Proof of this improvement is that, since March, prices of many financial assets have risen, partially undoing the drops seen since September 2008. At the same time, risk premia—implicit in the prices of various assets—have declined gradually, and stock indexes at the main exchanges have experienced significant gains (figure 3).

The strong boost from economic policies has also contributed to stabilize growth forecasts. As we have thoroughly explained in our Monetary Policy Report last May, the most likely scenario is that the recovery of the global economic output will begin in 2010. Moreover, uncertainty regarding this scenario has decreased significantly in recent months. World recovery should move at a slow pace.

In spite of this recent improvement in financial conditions, the world financial situation has not returned to normal yet. Therefore, the two main threats for the financial stability of the Chilean economy identified by the Financial Stability Report are related to possible developments in the international financial system.

The main threat is an extension of the economic contraction that the world economy is going through, which would have a negative impact on local output. This threat is closely linked to the uncertainty currently prevailing on the capacity of financial systems of some advanced economies to fulfill their roles.

One primary factor underlying this uncertainty is the ability of the banking system to grant the loans needed for such recovery, due to the significant losses it has undergone since August 2007. Banks of the main financial centers have received both public and private capital contributions which only cover a third of the total estimated losses. Another factor is the reactivation of non-bank financial intermediation. An essential characteristic of the U.S. financial system is the importance of non-bank credit, particularly, asset securitization (figure 4). So far, this source of credit has not shown any signs of recovery, which is an additional challenge to the already weakened banking system.

The second threat coming from abroad is the health of the international financial system. Particular reasons for concern are the possible effects on banks and other financial intermediaries of a recession that is even deeper and more protracted than expected, in view of the already high delinquency levels in the largest advanced economies. Moreover, there are still doubts as to the solution to the toxic assets’ problem in the banking system. Thus, new episodes of uncertainty and/or credit tightening cannot be ruled out, which could in turn limit the supply of external funding to emerging markets, including the Chilean economy.

**Access to Foreign Credit by the Chilean Economy**

I will now discuss how the complex international financial situation has affected Chile’s access to foreign credit.
International financial strains have reduced the supply of credit to emerging economies. In this context, it is remarkable that, in Chile, different local users of credit have been able to access new foreign credit lines or to renew existing ones.

Generally, banks and firms have been able to obtain short-term loans abroad, albeit at shorter maturities and higher spreads than before the crisis. In fact, financing conditions have started to show a trend towards normal during the last few weeks (figure 5). This access has also been reflected in the lower dollar interest rates observed at the local market since the last Report. Firms have also been able to get foreign long-term credit, except for syndicated credits, which have closed down as in other emerging economies (figure 6).

The strong solvency and liquidity position of the national economy is the reason for this continued access to foreign credit at reasonable conditions. Solvency indicators are still at favorable levels, both compared to our historical standards and to other emerging economies. Something similar happens with the foreign liquidity position of the Chilean economy (figure 7). This relative strength can also be seen in the smaller increases in risk premiums of the Chilean external debt as compared to other emerging economies (figure 8).

The financial position of the Central Government and the liquidity position of the Central Bank have been determinant for this strength. The Central Government’s financial strength—among other factors—was a factor behind the upgrade of the Chilean sovereign debt by one of the leading rating agencies last March. This new rating is one of the highest among emerging economies.

**Functioning of Local Financial Markets**

Since the last Report, local short-term money markets in both pesos and dollars have operated more normally. Interbank markets have not shown any stress episodes similar to those of last October. The Central Bank has maintained the extraordinary liquidity facilities in both pesos and dollars for the local banking system, which were implemented in the fourth quarter of last year. As I have already said in the past, these liquidity facilities—since they reduce the banks’ uncertainty about their future access to liquidity—have played a major role in bringing the banks’ borrowing rates closer to the expected values of the monetary policy rate and, therefore, in ensuring effectiveness of monetary policy (figure 10). Other short-term money markets, such as the commercial paper market, have operated normally during the last few months, thereby supplying companies with an additional source of liquidity.

Likewise, the bond market has become a significant funding source, providing larger firms with an alternative to external borrowing. During the last six months, corporate bonds have been placed for around 3.2 billion dollars, an amount that exceeds the annual average for the period 2004-2007 (figure 11).

Such funding source is available within the domestic market thanks to the degree of development of the local bond market and to the presence of institutional investors with substantial foreign assets, which are able to and have adjusted their portfolios to supply
local banks and firms with funding resources in this current scenario. This behavior differs radically from the one seen in the late nineties, when a strong capital outflow by local investors occurred.

Long term interest rates have been affected by domestic events as well as by foreign financial factors. These interest rates at the local market reached their lowest level in January, when uncertainty and risk premiums were rising significantly. This modest impact of the global risk increase on domestic interest rates may be attributed to a better perception of government securities risk by local investors as compared to foreign investors (figure 12).

To sum up, the analysis contained in the Report suggests that local financial markets have operated adequately over the last few months, and performed their roles by allocating credit at interest rates which were essentially determined by their macroeconomic and financial fundamentals. In this sense, the greatest challenge to the Chilean financial system has been to manage the risks resulting from the major economic downturn that began in the fourth quarter of last year.

**Firms and Households**

The corporate sector has faced a complex scenario in the last few months due to the drop in both domestic and foreign demand. We have detailed information on the financial position of large firms, which disclose decreasing margins and deteriorated solvency and liquidity positions. Predictably enough, the economic downturn has increased the materialization of credit risk in this segment.

This sector as a whole has kept its access to various financing sources, although generally under more restrictive conditions. Total debt of Chilean firms grew by a real annual rate of 9.9% during the first quarter of 2009, in part due to the dynamism of the corporate bond market. Although bank credit has displayed substantial drops in interest rates, and the shortening of terms seen by late 2008 has reverted, access to credit is still tight for the vast majority of firms (figure 13).

One positive aspect of this sector—which has kept it sheltered from some of the financial problems suffered by other countries in the region—is that foreign exchange mismatches of publicly-listed companies are still significantly lower than those recorded early this decade (figure 14).

The recent evolution of household borrowing shows a cautious behavior of both lenders and borrowers, for every type of loan. This can be clearly seen in the last Bank Credit Survey (figure 15). Consumer debt increased slightly in twelve months in real terms, while monthly growth has been negative in the last months. For the first time in several years, mortgage loans showed a real annual growth rate below 10% at the first quarter of 2009 (table 1). These factors, together with an increase in disposable income and a drop in inflation, have led to a drop in the debt-to-income ratio and of the financial burden in the first quarter of this year (figure 16).
The Chilean Banking System

The current juncture has put pressure on the banking system, as expected. However, this sector has maintained its intermediation functions, thereby showing that no imbalances were accumulated in the past few years.

Consistent with the weak output scenario our economy is enduring, bank loans have slowed down their rate of growth. Bank consumer loans growth has continued the downward trend that started a couple of years ago, and real growth crossed into negative territory in the first months of this year. Commercial lending slowdown deepened as from the fourth quarter of 2008 (figure 17). This has happened for most of the segments, with the only exception being larger firms.

Risk indicators have reflected the deterioration of the credit quality of banks portfolios that has resulted from the drop in output and in employment levels. In the first quarter of 2009, non performing loans reached their highest level since 2005, yet still lower than the average of the past fifteen years (figure 18). Household loans, which are the most sensitive to the economic cycle due to the consequences that loss of employment bears on families' budgets, have shown the highest year-to-date increases of past-due portfolio. Increases in default levels have been seen at other institutions granting consumer loans.

At the Central Bank we have performed research to understand the impact that potential drops in employment would bear on families’ budgets, based on our Household Financial Survey. The estimates suggest that the increase in risky bank loans is still bounded at low levels, since there is a higher indebtedness in households where loss of family income is less probable.

In 2009, expenses related to setting up of provisions have increased at a faster pace than writeoffs and past-due portfolios, thus raising the provision-to-credit ratio (figure 19). This is an appropriate progress, since it is likely that credit risk materialization will continue over the coming months, and it is different from earlier episodes, when banks increased their provisions only when credit risk materialized.

Since our last Report, the banking industry has reduced its profitability as a result of the higher provisions and the temporary narrowing of intermediation margins, due to the recent negative inflation figures. Despite the drop in profitability, the banking industry at large shows reasonable levels of capitalization, with a significant endowment of basic capital.

Capital increases made by banks, in particular those aimed at raising basic or primary capital, are worth mentioning (figure 20). The capitalization index remains above 12%, with a slightly upward drift, while the system's basic capital is above 10% of its risk-weighted assets. Stress tests carried out as a part of the usual macro-prudential supervision scheme implemented by the Central Bank, suggest that this capital is adequate to face the drop in income from the operating margin and the increase in credit risk in the baseline macroeconomic scenario. In extreme risk scenarios, additional capital requirements would be marginal as a proportion of total capital of the system.
Soundness of the Chilean banking system has been evidenced by the evolution of stock price indexes and by the credit risk rating of its debt. Stock prices of local banks show very dissimilar behavior compared to the U.S. bank stock indexes. Furthermore, other qualitative indicators emphasize the strengths of the national banking system. Worth singling out are the quality of supervision and the positive perception by rating agencies.

I would like to take a moment now to emphasize some of the strengths of the Chilean banking system as compared to those of the largest advanced economies, particularly the U.S. banking system.

The global financial crisis was originated and amplified by the combination of two elements. The first element was the deterioration of credit practices as a result of the securitization process. In this process, credit originators sold credits to third parties who, in turn, packaged these credits and redistributed them. The fact that these credit originators did not reflect the loans on their balance sheets, partially accounts for the deterioration of the quality of such credits, due to their impact on incentives, at the time of both their granting and subsequent collection. The second element leading to the current crisis was the direct or indirect holding of substantial amounts of these risky financial assets by highly-leveraged financial institutions, which in turn depended on the very short-term wholesale financing.

Both elements have been absent in the Chilean financial system.

Firstly, the great majority of the credits granted in Chile remain on the balance sheets of the granting institution. Although Chile has a legal framework for debt securitization, it is still at an early stage of development. In addition, local regulatory provisions have created a single registry of securitized bonds, managed by the Superintendency of Securities and Insurance, which contains detailed information on such instruments and which reduces several of the distortions evident in the financial systems of advanced economies. In fact, the recent amendments proposed by the U.S. Treasury include the creation of an information system like ours.

Secondly, a traditional banking system model with an essentially commercial orientation has always prevailed in Chile. Most of its assets—70%—are credits, originated and managed within each pertinent balance sheet and, therefore, subject to supervision by the Superintendency of Banks and Financial Institutions. The financial portfolio represents a relatively low percentage of the banking system’s total assets, and it is composed mainly of high-liquidity and low-risk instruments, such as Central Bank notes. Leverage levels of the Chilean banks are lower than those of the advanced economies and, at the same time, they hold a wide base of retail deposits.

**Final Remarks**

I would like to end my presentation with some lessons learnt from this current economic situation, and their implications for financial stability.
The first lesson learned is that institutional investors have contributed to shield the national financial system from some of the volatility prevailing in foreign financial markets, becoming a source of significant financing and liquidity when foreign financial stress was at its peak. The degree of development of our markets for bonds and derivatives has been instrumental to the correct functioning of this financing mechanism. In fact, this demonstrates that financial disintermediation is not a source of vulnerability in itself. Bond markets are a sound source of financing for large firms. We should, in this regard, continue to make progress in improving and expanding these markets in Chile.

The second lesson learned is that the Chilean economy has profited from its solid international position of solvency and liquidity, thereby accessing foreign credit in better conditions than most emerging economies. Both the accumulation of fiscal surpluses in recent years and the forex reserve policy of the Central Bank have played an important role in this position. Responsible and stability-oriented macroeconomic policies boost resiliency of the financial system.

The third lesson learnt has to do with the importance of being prudent while making progress within the field of financial innovation. Although more often than not, financial innovations may bring considerable advantages, thereby generating productivity gains in firms or a greater wellbeing for households, some of them may also entail considerable costs, which are often incorrectly assimilated by the pertinent stakeholders. Frequently, innovations end up being detrimental to those they are supposed to help, such as the access to housing by low-income borrowers in the United States. This is the reason why, in Chile, progress in the authorization of derivatives contracts in local banks has been made on a cautious and gradual basis.

The fourth lesson learnt is the importance of continuing to make progress in the local implementation of some of the best international practices which have proven valid in the current global financial environment. A clear example is the securities settlement systems. In the year 2000, in pursuance of its Basic Constitutional Act, the Board of the Central Bank adopted a program oriented towards aligning the national payment systems with the international standards prevailing in this field, mainly aiming at increasing efficiency and safety of high-value payment systems. Therefore, and in coordination with the superintendencies of the financial area, vital changes have been made to the infrastructure and design of the regulatory framework for securities settlement. Furthermore, the agenda for upgrading the capital market includes the creation of institutions such as the Central Clearing Counterparty (CCP, by its Spanish acronym), whose purpose is to reduce the risks inherent to securities clearing and settlement processes, and to generate economies of scale reducing the processing timeframes and costs.

The fifth lesson learnt is the importance of keeping incentives correctly aligned throughout the credit origination process. Despite the strengths in the Chilean securitization regulatory framework, we must keep a close look on the international discussions on this issue. Our medium-term objective here should be the creation in Chile of a securitized market for expanding the scope of financial intermediation, without becoming a source of increased financial risk and fragility. It is important to take steps towards boosting financing
structures—such as mortgage backed bonds—to stimulate keeping credits within the balance sheet of their respective originators.

Finally, the recent crisis has revealed the importance of thoroughly monitoring the risks of the financial system, and of discussing the assessments resulting therefrom with relevant supervisory and regulatory authorities, as well as widely spreading our vision on financial stability, such as we are doing today with you.

Thank you very much.
FIGURES AND TABLES

Figure 1:
World growth at PPP (*)
(annual change, percentage)

(*), Purchasing Power Parity. Classification by region and related weights as defined by the IMF.
(f) Projection.
Source: Central Bank of Chile, based upon information from investment banks, Consensus Forecast and IMF.

Figure 2:
Valuation and premiums arising from bank default risk (1)
(indexes January 2007=100, basis points)

(1) As measured by the Credit Default Swap (CDS) 5-year spread.
(2) Europe includes the Eurozone plus United Kingdom and Switzerland.
Source: Bloomberg.
Figure 3:
Risk premiums from US corporate bonds and emerging sovereign bonds (1) (2)
(basis points)

(1) Generic 10-year corporate bonds, spread as per 10-year Treasury rate.
(2) Measured by EMBI premiums.
Source: Central Bank of Chile based on Bloomberg.

Figure 4:
Total flow of private net loans in the United States
(annualized flows, billion dollars)

Source: Cash flows, Federal Reserve Board.
Figure 5:
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(monthly average, percentage)

(*) Variable rate bank loans.
Sources: Bloomberg and Central Bank of Chile.

Figure 6:
Foreign loans to resident firms
(in millions of US dollars)

Source: Central Bank of Chile.
Figure 7:
Availability of net foreign financial liquidity (*)
(GDP percentage) (1)

(1) GDP at constant real exchange rate. External liquidity includes short-term loans, cash & deposits, and portfolio investment. It excludes derivatives positions.
(2) Official reserves less short-term commitments in foreign currency (BCX, BCD, swaps maturities).
(3) Outstanding short-term foreign debt.
Source: Central Bank of Chile.

Figure 8:
Variation of risk premiums (*)
(basis points)

(*) Difference of EMBI premium averages between two periods. The first period ranges from 15 September 2008 to 18 December 2008, and the second period ranges from 1 June 2007 to 15 September 2008. The value for each region shows the median variation of the country group.
Source: Bloomberg.
Figure 9:
Public sector debt (1) (2)
(GDP percentage)

(2) Data for emerging economies, except Chile, are Moody’s estimates for 2008.
(3) At December 2008, Central government net debt reached -20.4% of GDP.
Sources: Central Bank of Chile, based upon information from the IMF, JP Morgan Chase, Chile’s Ministry of Finance and Moody’s.

Figure 10:
Money market interest rates in pesos
(percentage)

Source: Central Bank of Chile.
**Figure 11:**
Corporate bond placements and registrations (*)
(in billion pesos of April 2009)

(*) Includes bonds issued by financial institutions registered with the SVS.
Source: Central Bank of Chile based on SVS information.

**Figure 12:**
Interest rates on Central Bank notes and monetary policy interest rate (percentage)

Source: Central Bank of Chile.
Figure 13:
Credit supply change index (1)
(net percentage of responses)

(1) Based on the Bank Credit Survey conducted by the Central Bank of Chile. Negative figures show more restrictive conditions.
(2) Firms with annual sales exceeding UF 100,000.
Source: Central Bank of Chile.

Figure 14:
Foreign exchange mismatch
(percentage of total assets)

(*) Liabilities in dollars, less assets in dollars and net derivative position.
Source: Central Bank of Chile based on SVS information.
Figure 15:
Perception of demand and flexibility in credit supply (*)
(net percentage of responses)

![Graph showing perception of demand and flexibility in credit supply](image)

(*) Based on the Bank Credit Survey conducted by the Central Bank of Chile. Negative figures show more restrictive conditions.
Source: Central Bank of Chile.

Table 1:
Household borrowing
(annual real variation, percentage)

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(1) Including securitized mortgage debt.
(2) Family allowance and clearing houses.
(3) Including automotive loans, university loans and insurance companies.
Source: Central Bank of Chile based on information from the SBIF, SVS and SuSeSo.
Figure 16: Long-term financial burden and indebtedness (*)
(available income percentage)

(*): The last long-term financial burden figure is an estimate.
Source: Central Bank of Chile based on information from the SBIF, SVS and SuSeSo.

Figure 17: Credit growth
(real annual change, percentage)

Source: Central Bank of Chile based on SBIF information.
Figure 18:
Past-due portfolio indexes by credit category
(percentage)

Figure 19:
Credit risk indicators
(percentage of total placements)

(*) Excluding foreign trade transactions.
Source: Central Bank of Chile based on SBIF information.

(*) Rolling years ending in each month.
Source: Central Bank of Chile based on SBIF information.
Figure 20:
Capital adequacy index by bank group (1)
(percentage)

(1) At March of each year.
(2) Including a fraction of subordinated bonds, plus general provisions, less non-consolidated investments and goodwill.
Source: Central Bank of Chile based on SBIF information.