banco central Chile

FINANCIAL POLICY MEETING

MAY 2024

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Financial policy meeting No. 5, held on 3 May and 6 May 2024.

Present: Rosanna Costa, Governor; Stepanka Novy, Vice-Governor; Alberto Naudon, Board member; Luis Felipe Céspedes, Board member; Claudio Soto, Board member.

Also present: Luis Óscar Herrera, General Manager; Juan Pablo Araya, Legal Counsel and Attestor; Rosario Celedón, Financial Policy Division Director; Elías Albagli, Monetary Policy Division Director; Ricardo Consiglio, Financial Markets Division Director; Gloria Peña, Statistics and Data Division Director; Michel Moure, Institutional Affairs Division Director; Miguel Fuentes, Financial Stability Manager; Gabriel Aparici, Financial Infrastructure and Regulation Manager; Mauricio Calani, acting Financial Research Manager; Markus Kirchner, Macroeconomic Analysis Manager; Guillermo Carlomagno, International Analysis Manager; Enrique Orellana, Monetary Policy Strategy and Communication Manager; Sofía Bauducco, Economic Research Manager; Felipe Musa, Market Operations Manager; Solange Berstein, President of the Financial Market Commission (CMF); Nancy Silva, CMF General Research Director; Alejandro Puente, Advisor to the Finance Minister; Andrés Alegría, Head of the Financial Analysis Department; Marlys Pabst, Secretary General.

1. Background

a. The international scenario

Globally, uncertainty persisted about the starting date and velocity monetary regarding policy rate cuts in the United States, which had affected expectations regarding the duration and magnitude of the divergence of monetary policy between advanced and emerging economies putting pressure on emerging currencies. In the US, growth outlook was improving, and inflation records had surprised upwards, especially for services. In this context, expectations of cuts in the Fed funds rate for the year had been revised, with expected reductions somewhat below 50bp. In the Eurozone, the European Central Bank had maintained the benchmark rates for some months, and reductions were expected for the rest of the year. In turn, the prices of financial assets had been more sensitive to news related to monetary policy decisions. The latter was having a greater impact on long rates than had been observed in the past. However, at the margin, financial conditions had tightened, and long-term rates had risen.

The banking system continued to report tight lending standards in a large number of countries, with remaining concerns about the vulnerabilities of US regional banks, which were visible in the segment's stock prices. In turn, the non-residential property sector was under pressures globally, especially in US smaller institutions due to structural changes generated by the pandemic coupled with high interest rates.

Fiscal conditions in advanced economies had worsened because of high indebtedness and signals of increased fiscal deficits, especially in the United States. Ongoing geopolitical conflicts had affected oil prices and shipping costs, which were causing more inflationary pressures. The Chinese economy continued to draw attention, as its real-estate market and local governments' debt were still a source of latent risks.

b.The domestic scenario

At home, significant progress was being made in resolving the cumulative imbalances of recent years, which had allowed consolidating the reduction of inflation and apply cuts to the monetary policy rate (MPR).

Long-term funding costs had evolved in line with international macro-financial developments, with high interest rates on mortgage loans and longer-term commercial credit. This was in contrast with short-term rates, which were beginning to pass through the MPR cuts to the financial indicators of businesses and households.

The economy was taking early steps towards its long-term trend growth rates, although some sectors were lagging behind. This was causing increases in delinquency rates, which were on an upward trend and exceeded its historical levels. These higher delinquency rates were seen mainly in those groups of firms that received Fogape loans during the pandemic, especially in some specific sectors like commerce, construction, and real estate.

Lending activity remained in line with the evolution of the business cycle. By product, mortgage loans had maintained positive growth rates, although below their historical averages, while consumer loans were still in contraction. For their part, commercial loans continued to show negative growth rates, mainly due to demand-side factors. In this way, the Bank Lending Survey for the first quarter of 2024 indicated that the demand for credit had weakened with respect to the previous quarter, mainly because of lower investment. Supply conditions were perceived to be similar to those of the previous quarter.

The banks had already completed the payment of the first stage of the FCIC, and the expiration of the second and last phase of this facility was expected to have no major effects on the markets, given the high levels of liquidity of the banks and the many instruments available for managing the respective deadlines.

The banking system remained resilient with a good position in terms of solvency, liquidity, and provisions, which ensured that it could address severe stress tests. It was noted that as the Basel III implementation scheduled progressed, the banks would have to increase their capital requirements, so they should further strengthen their capital base. Finally, the outlook for the first quarter of 2024 showed that the credit to GDP ratio was below its trend, in line with the macroeconomic cycle. Meanwhile, the macro-financial models showed that commercial lending was closer to its recovery phase and would reach real annual growth rates close to their long-term level at the end of this year, after several quarters in negative territory.

2. Analysis of vulnerabilities, risks and mitigators

Since the previous financial policy meeting (FPM), the external scenario continued to be the main source of risks threatening domestic financial stability. Several external elements could trigger a tightening of financial conditions in emerging economies. On the one hand, long-term interest rates were estimated to remain high for a prolonged period. At the same time, uncertainty persisted regarding the direction that the US monetary policy would take. Riskier financial assets had also shown substantial price hikes and were reaching record highs. On the other hand, the world's geopolitical tensions were still severe. All these elements combined with the situation of US regional banking sector, non-bank credit intermediaries and the high global sovereign and private debt could cause abrupt changes in financial asset valuations and risk appetite. Therefore, spreads could rise and the amounts loaned to emerging economies could be significantly reduced.

Accordingly, the map of external risks continued to give warning signs. Vulnerabilities were seen in fixed-income variables, primarily in the US and Europe, as well as in China's real-estate sector. Volatility indicators were mixed. On one hand, the VIX was still low while, on the other, the implicit volatility of sovereign rates remained high, and in the US sovereign risk premiums had risen. By contrast, vulnerabilities seemed to have waned for the international liquidity variables.

Domestically, the significant macroeconomic imbalances of previous years had been resolved, although the capital market remained rather shallow. The fall in inflation and short-term interest rates had contributed to normalizing indebtedness and the financial burden of households and firms. Thus, the local risk maps showed no major changes since the previous FPM, highlighting the persistence of long-term rates at high levels and the deterioration of the banks' portfolios. The real-estate sector had not recovered its dynamism, as sales remained low, but showing incipient signs of a recovery.

Finally, stress tests indicated that the banking system maintained sufficient levels of solvency and liquidity to withstand the materialization of severe credit and market risks. It was emphasized that banks should continue to strengthen their capital bases to meet the increased requirements as the Basel III calendar unfolded. In addition, the resilience of local agents and the financial system also had to be further strengthened.

3. Analysis of policy options

Regarding the policy options, all the Board members supported the idea of maintaining the decision of the May 2023 FPM, the same as in the last meeting, that is, to maintain the counter-cyclical buffer (CCyB) at 0.5% of risk-weighted assets, enforceable as from the end of May of 2024.

The majority of the Board considered that the risk scenario did not differ significantly from that of the previous FPM and that risks originated mainly externally. One Board member, however, suggested that the risks had diminished somewhat. In line with the risk assessment of the Financial Stability Report of the first half of 2024, it was considered that global financial conditions were still tight, in a context where uncertainties persisted regarding when and how fast the developed economies would begin reducing their benchmark rates, especially in the US. The greater inflationary persistence translated into adjustments to expectations regarding the rate cuts. This was reflected in a significant change in lending conditions, with higher short-term rates that were themselves affecting long-term ones.

Several Board members mentioned that, given the high valuations of asset prices, constant or rising short-term rates could trigger an abrupt adjustment in the prices of financial assets, significantly widening credit spreads for emerging economies. Regarding vulnerabilities still present in regional banking in the US, it was considered that they had been managed by the authorities and that, despite still latent risks, they had not been explicitly manifested.

At the local level, the Board drew attention to the evolution of delinquency rates. Their increase was driven mainly by sectors whose recovery was lagging, which had caused defaults to increase across the board to record highs, except for the housing portfolio. This had resulted in the banks accumulating provisions to deal with the increase in credit risk.

It was noted that the Chilean economy had succeeded in resolving the significant macroeconomic imbalances of previous years, which was reflected in inflation being close to the target and the consequent reduction of the MPR, and in an important fiscal consolidation. This allowed lending rates to be reduced, which began to be seen in improvements in financial conditions. One Board member noted that it was not possible to rule out that the Chilean economy was now more sensitive than in the past to external shocks. In this context, it was mentioned that fiscal consolidation was a key element to ensure resources, as well as to create space to face shocks.

About local banking, it was noted that the system was well suited in terms of capital to deal with episodes of extreme stress, although the importance of maintaining robust capital level was emphasized. At the same time, it was pointed out the maintaining the CCyB constant was consistent with the need to preserve the resilience of the banks.

In line with the discussion of last year's FPM, one Board member stated that holding the CCyB at 0.5% would imply no significant costs for the economy, the banks, or the overall macro-economy, and it would help in the communication of the tool's objectives. Other Board member assessed that keeping it at 0.5% was consistent with the need to continue strengthening the resilience of the banking system. It was also noted that the activation of the CCyB at a limited level made available a complementary instrument to face a risk that, while unlikely, could not be ruled out. Accordingly, the Board members considered it relevant to stress that the CCyB is a macroprudential tool of financial policy conduct of a preventive nature that has the quality of being a buffer that can be released by the authority for the overall banking industry in the event of an episode of financial stress.

Lastly, the Board members reaffirmed the importance of further deepening the policy framework of the CCyB, by maintaining the program of refining the analytical framework, including the definition of a neutral level, announced for the current year, taking into account the evolution of this tool around the world, the idiosyncratic aspects of the Chilean economy and its financial system, and the progress status of Basel III.

4.Financial policy decision

Governor Costa, Vice-Governor Novy and Board members Naudon, Céspedes and Soto voted for maintaining the counter-cyclical buffer at a level of 0.5% of risk-weighted assets, which will be enforceable as from the end of May of 2024.

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