Financial Stability Board's Analytical Group on Vulnerabilities Meeting in Santiago

Opening Remarks by Solange Berstein, Head of Financial Policy Division*
Hotel Intercontinental, 6 June 2018, Santiago, Chile

Good morning and welcome to the Analytical Group on Vulnerabilities Meeting. It is a pleasure to host this event which gives us the opportunity to compare and discuss our analyses and experiences, and attempt to answer open questions that are central to our work as a Central Bank. I am looking forward to two days of active discussion in dissecting the sources of vulnerabilities and potential transmission mechanisms of shocks and risks, which affect all countries represented in this table.

Perhaps nine out of ten opening remarks to conferences and workshops dealing with the topics we will examine these two days, start by mentioning the severity of the Global Financial Crisis that broke out in 2008. And that is to be expected. Ten years have passed, but we are still dealing with its economic consequences, and only beginning to understand what exactly went wrong. This, by all means, does not mean we have learned nothing in this last decade. It only means that we are still learning, and while we have made enormous advances, we major challenges still lie ahead. I will refer to some of the challenges I consider of particular importance at the end of these remarks.

Financial crises are costly and protracted affairs. We knew this in 2008, and the last ten years have confirmed so. Financial and real mechanisms interact with each other, amplifying shocks and delaying recovery.[1] While the Global Financial Crisis is a perfectly good example, the Chilean Crisis of 1982 is just as good. In 1981 macroeconomic variables did not point toward risk buildup or a crisis scenario. However, private expenditure grew rapidly coupled with large current-account deficits, in a fixed exchange rate setting.

Credit grew rapidly too. If by 1975 the annual growth rate of banking credit was basically zero, in 1977 it soared to a record of 70% annual growth, and a little below 20% in 1981. Banking credit went from 21% of GDP in 1977 to 90% of GDP in five years. Notably, credit risk indicators remained subdued. Expenditure in loan loss provisions, and nonfinancial operational expenditure were at record lows in 1981, and nonperforming loans were only 2% of the total loan portfolio. In 1984—after the financial crisis unfolded—, nonperforming loans were estimated to be 19% of the total portfolio value.

The causes of the crisis were, most notably: unfit regulation and supervision, lax oversight, and lack of attention to excessive credit growth boosted by a fixed exchange rate regime. By 1983, 22 financial institutions had been intervened, representing 60% of total credit. Many of them were later liquidated. The policy response by this Central Bank in 1982 was bold.

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* I thank the comments and suggestions in preparing these remarks to Mauricio Calani. The views expressed in these remarks are not necessarily represent those of the Central Bank of Chile or its remaining authorities.
[1] A large body of literature documents these facts. Among many others, see Claessens, Kose, and Terrones (2009), Reinhart and Rogoff (2009), and Jordà, Schularick, and Taylor (2016), and Fischer (2017).

In general terms, in order to inject liquidity to the system, the Central Bank bought nonperforming loans—and later even performing but risky loans—from troubled banks at par value with a buy-back clause. In 1989, virtually all the banks that had sold their risky portfolios to the Central Bank, took advantage of a new agreement, and the repurchase obligation was replaced by a "subordinate obligation".

In 1995 five banks had not yet paid their subordinate obligations, and the Central Bank assessed that four of them were in no position to pay back in the foreseeable future. A new mechanism for the elimination of the subordinate debt was put in place. It is expected that the last bank, which to this day has not repaid its subordinate debt, will do so in 2019; more than 35 years later.

The total cost of this intervention was huge. The Central Bank has maintained negative net worth since this crisis, and it is estimated that the cost of foreclosure of insolvent institutions, and operations related to subordinate debt, amounted to around 17% of total GDP.[2] Remarkably, throughout all this period, public confidence has remained solid.

The Global Financial Crisis was not bred locally. And while it was not as costly as the 1982 banking crisis for Chile, the policy response was just as bold. The lessons learnt in the aftermath of the 1982 crisis and the 1998 Asian Crisis, resulted in radical changes and modernization of our financial architecture and policy framework, with which we navigated through the 2008 Crisis. With a flexible exchange rate regime in place, the Chilean peso depreciated nearly 35 percent in the three months following the Lehman Brothers' filing for bankruptcy, and the policy rate set by this Central Bank was swiftly lowered from 8.25% to 1.5% within a seven-month window.

In addition, a liquidity provision program was put together, both in national currency and in US dollars. A term liquidity facility for banks was set in place, together with new credit lines for banks, and the broadening of acceptable collateral to access liquidity facility in pesos. Foreign currency liquidity was supported with currency swap auctions and relaxation of reserve requirement denomination for US dollar liabilities.[3] Also, monetary policy actions were in close coordination with expansionary fiscal policy, which operates under a structural balance rule. All this countercyclical policy response was possible to implement because a number of necessary conditions were met. Namely, a healthy corporate sector, well-capitalized banks and financial institutions, contained household leverage, and a solid position in international liquidity.[4]

Meeting these pre-conditions is hardly a coincidence. It is the result of constant monitoring of every sector involved in the financial system, and the understanding that monetary policy and financial stability set the pre-conditions for one another to function efficiently. In the same way, and in a far more intricate international financial system, the analysis distilled from the work of the group gathered here today, is the stepping stone for local country-specific risk assessment.

Our local monitoring work is condensed twice a year in our Financial Stability Report (FSR). The FSR aims at assessing the vulnerabilities and risks in local and international financial markets,

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[2] For a chronology of these events see Marshall (1991) and Sanhueza (1999).
[3] A detailed timeline of extraordinary policy responses by the Central Bank of Chile and their effect on local interest rates can be found in Calani, Cowan, and García-Silva. (2011).
[4] The Central Bank of Chile increased its foreign reserves by USD 8 billion between April and December 2008, through competitive, and sterilized, auctions of USD 50 million per day.

households, firms and financial institutions. We are cautiously proud that our FSR has improved in time.

Last year, the International Monetary Fund reviewed and ranked 19 FSRs in Latin America and the Caribbean. Chile's FSR was ranked top of the list in the region. Readers of the Report praise its strong content, useful trends in international and domestic markets, broad coverage, and useful data on financial indicators, credit users, debt trends, and housing sector developments, among others. Nevertheless, there are several dimensions in which we can further improve our FSR. We are currently embarked in the implementation of a strategic plan that will set the path for such improvements.

Our regulatory architecture has been recently revised and strengthened as well. First, only a few months ago the Financial Market Commission (FMC) was created. This body is led by an autonomous board of directors whose main task is to supervise and regulate—among others—insurance companies, corporations, stock exchanges, and mutual funds and their administrators. Notably, the Commission's regulation and oversight of these financial agents is done in a systemic and integrated way.

Second, our banking regulation has been recently revised and moved into the best international practices. In the next few months a new General Banking Law should be approved by Congress. This new framework provides gradual convergence to Basel III guidelines, raising the quality and transparency of the capital base; strengthening risk hedging; limiting leverage; and promoting a countercyclical capital framework.

After this new law is passed, the FMC will also become the new banking regulator, taking over the work of our current Superintendence of Banks and Financial Institutions. This last merge aligns incentives, reduces coordination costs, and fosters the systemic and integrated view that the new regulator should maintain.

Before ending these remarks, I would like to point to a few challenges ahead for our analysis of financial vulnerabilities, and risks. Our monitoring still needs to go deeper, and farther.

By now, it is hard to disagree with the view that the financial system is constantly and swiftly evolving. After the Global Financial Crisis, we have updated our toolkit as policy makers, and delved into understanding the pros and cons of pursuing macro and micro prudential policies. However, we need to go deeper, and reach consensus on the quantitative effectiveness of our current, or new, prudential instruments in reducing systemic risk, and the tradeoffs they pose with different policy options. Even if we agree on the specific policies, we have yet to be fully convinced that we have the right calibration. For all these issues, your insights, experience and the research carried out in your institutions is paramount.

A particular dimension that can make our analysis more robust, is the use of micro data; either from large longitudinal surveys or from administrative records. Research based on these resources must be encouraged. Many answers to the effectiveness of prudential policies can be found only looking beyond averages and aggregates. Also, these types of analysis complement and provide input for state-of-the-art structural heterogeneous agent models, which can provide a laboratory for the evaluation of policies.

We need to go farther too. We have concerns we need to address, that we did not have ten years ago. The obvious example is financial innovation and the potential risks it poses. Most of the countries represented at this table are developed economies, but those of us who work and live in emerging economies need to balance the challenges of financial innovation with financial development. While technologically-supported financial products can potentially foster financial inclusion; improve the quality of financial services; lower transactions costs; and make financial services more democratic, a central bank needs to assess how these developments change the risk borne by the financial agents involved, as well as the overall systemic risk. One size does not fit all. To this end, our last FSR has included a special chapter titled "*Financial Innovation and Financial Stability*" in which we elaborate our view and balance of risks regarding financial inclusion, block-chain technology, crypto-currencies, and cyber-security.

Lastly, let me finish by thanking Robert Patalano from the FSB for organizing the agenda and bringing together this remarkable group of representatives. I look forward to two days of fruitful and enlightening discussion, on issues that affect us all.

Thank you

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