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The Monetary and Financial Policy Response to the CV19 Crisis: The Case of Chile

Pablo García

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Agustinas 1180, Santiago, Chile
Teléfono: +56 2 26702475 – Fax: +56 2 26702331

The Monetary and Financial Policy Response to the CV19 Crisis:

The Case of Chile[1]

Pablo García S.[2]

March 2021

1. Introduction

The Covid-19 (CV19) pandemic created an unprecedented economic crisis. From a theoretical point of view, this crisis is very different from past recessions in both advanced or emerging economies, which had at their root a large increase in leverage (a *boom*) that eventually became unsustainable (a *bust*). Policies aimed at managing this process tend to require a careful deleveraging of the economy, while providing support for aggregate demand. The CV19 crisis differs from this process in several aspects that are worth examining.[3]

- The considerations for moral hazard were limited at the onset of the crisis. In contrast with earlier recessions, there is no need now to tailor policies so as to prevent benefiting those sectors or agents that are deemed responsible for the unsustainable boom. Thus, a broad-based design of policies was called for early on.

- In a typical financial crisis or recession, managing the deleveraging is a key issue. In the CV19 crisis the policy response has instead aimed to up-lever and facilitate firms taking on more debt. This was possible not only because the financial system was in good health when it hit, but also because the way to respond to a large (but by nature transitory) income shock is by taking more debt or using up savings. [4]

[1] This paper is a summary and background of the main policies adopted by the Central Bank of Chile (CBCh) since the outbreak of the pandemic and as of February 2021. Interested readers can find significantly more detail in the Monetary Policy and Financial Stability Reports published by the CBCh during 2020, available online at www.bcentral.cl. Most figures and tables presented here are extracts from those documents.

[2] Member of the Board, Central Bank of Chile (pgarciasilva@bcentral.cl). I thank Miguel Fuentes and Juan Wlasiuk, as well as technical staff from the Monetary, Financial, Legal and Market Divisions of the CBCh, for their support. All errors should be attributed to the author.

[3] For a thorough discussion on theoretical and policy challenges from the COVID-19 crisis see the recent workshop held at the CBCh: www.bcentral.cl/en/content/-/details/covid-19-economic-implications-and-policy-lessons-12th-13th-january.-2021-

[4] See for example, Arellano *et.al.* (2020).

- The CV19 crisis is a strong, negative supply shock to specific sectors of the economy (those that depend more on social and personal interaction, such as restaurants and hospitality). Aggregate demand support clearly cannot compensate the contraction in these sectors, but it can help stop negative spillovers to the rest of the economy. Over time, optimal policies should shift from broad liquidity support to the reallocation of resources away from those sectors that have suffered the most permanent damage.

- The speed at which this crisis has unraveled is also very unique. Response time has been measured in weeks and days instead of months or quarters. The performance on this has been heterogeneous. Due to legislative and political economy considerations, the response times in the sanitary and economic areas have been diverse across jurisdictions. In contrast, autonomous central banks with a clear mandate and a credible framework have reacted remarkably fast.

- Finally, the world will emerge from this crisis poorer and more unequal. This is especially relevant for Latin America where structural factors such as labor market informality have not buffered the impact of the destruction of formal jobs.[5] In Latin America SMEs represent a higher fraction of GDP than in the developed world. Since these firms have less access to financing, they will have more difficulties recovering if they are able to survive at all. In order to weather this profound economic shock, the initial policy responses will need to be redesigned. Several new elements such as debt relief, productive restructuring, more targeted support and research need to be enhanced.[6]

This paper will review the monetary and financial policy response to the Coivd-19 crisis in Chile. It is organized as follows. The next section will highlight some metrics of the immediate impact of the crisis. Then, the main challenges for policy design will be presented. Section 4 will detail some of the specific policy measures implemented in Chile, and section 5 will show the pandemic's impact on the balance sheet of the Central Bank as well as other macro-financial metrics.

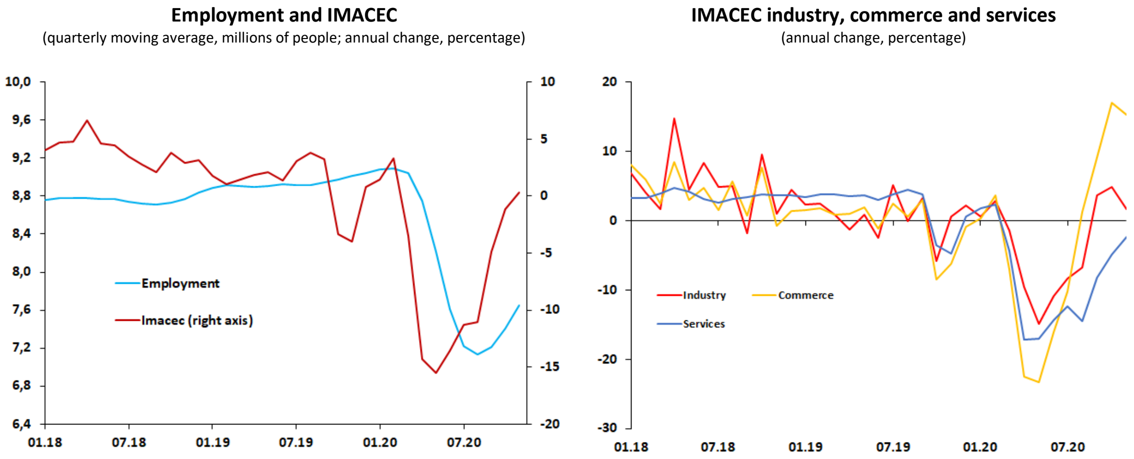
2. The Economic and Financial Impact of the Covid-19 shock

The Covid-19 pandemic and the actions taken to contain it constitute a huge and unprecedented shock to the world economy. Its immediate impact has been severe, its duration longer than expected and its long-term repercussions still uncertain. Most countries have experienced dramatic drops of economic activity, and Chile has been no exception. At a time when the economy just began to recover from the effects of the social unrest of the end of 2019, the pandemic and the adopted containment measures caused the largest economic contraction in 35 years, reaching its steepest fall in 2020Q2 with a 14.1% yoy GDP fall and almost 2 million employments lost. The shock hit particularly hard the service sector, where activity and employment fell the most, and the recovery has been slower. (Figure 1).

[5] Leyva and Urrutia (2021).

[6] Arellano *et.al.* (2020), Alfaro *et.al.* (2020).

Figure 1



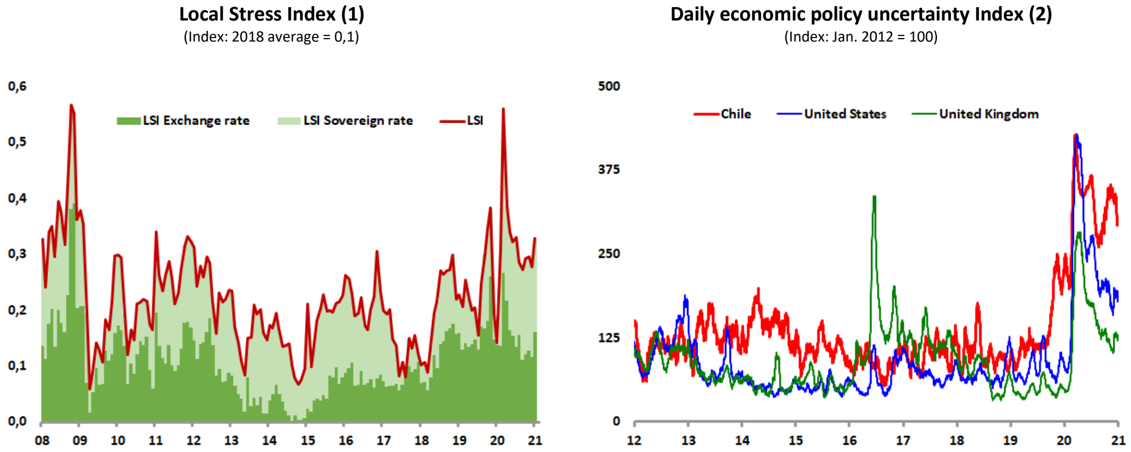
Source: Central Bank of Chile and National Statistics Institute.

Financial volatility has been a feature of the crisis, especially during the first months, as news about the spread of the virus, the lockdowns, and the first economic indicators that accounted for the effects of the pandemic became known. Since then, the volatility of emerging countries' sovereign rates, in particular, has diminished since the start of the pandemic and remains relatively low. While the Chilean economy has mirrored the reduction of its emerging peers, volatility remains near the median of the distribution, whereas in past years it was generally in the lower percentiles. This points to a reduction in the impact of some mitigators that have operated in past history, such as the behavior of institutional investors. The increase in volatility could also reflect some structural and more permanent phenomena linked to institutional reforms that the country will undertake in the year ahead.

The effects of the CV19 crisis on Chile's financial system were almost immediate, and stress indicators reflected the uncertainty associated with both Covid-19 and the social protests of October 2019. According to the local stress index (LSI)[7] for the local FX, tension increased substantially in this market during the events of late 2019 and the pandemic, as a result of increased exchange rate volatility. Similarly, the conditions in the local sovereign debt market tightened considerably in response to the sharp increase in sovereign rate volatility and the reduced participation of nonresidents in this market. (Figure 2)

[7] The local stress index (LSI) combines information from a set of variables that should capture the source of tension in both the FX and the local secondary sovereign fixed-income markets. See *"CISS-a composite indicator of systemic stress in the financial system" by Daniel Hollo, Manfred Kremer, and Marco Lo Duca (2012)*.

Figure 2

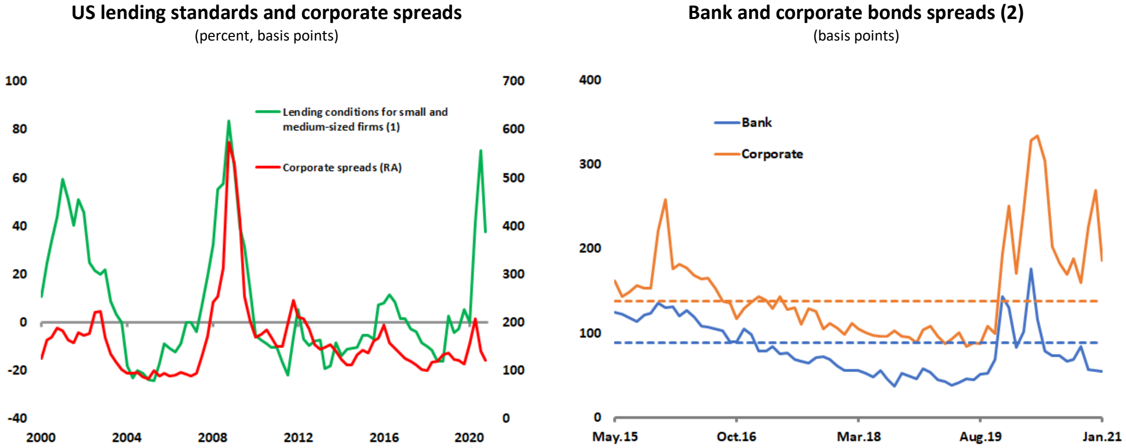

Local Stress Index (1)
(Index: 2018 average = 0,1)

Daily economic policy uncertainty Index (2)
(Index: Jan. 2012 = 100)

(1) Lower (higher) index values indicate looser (tighter) financial conditions in the respective markets.
(2) 30 – day moving average. Lower (higher) index values indicate a lower (higher) level of general uncertainty.
Source: Central Bank of Chile.

The effects of the crisis were also evident in the dislocation in the cost of funding by banks and corporations. Funding costs increased globally before aggressive measures were taken by central banks. The US lending conditions for small and medium-sized firms became tighter, and by 2020Q3 reached the levels of the GFC in 2008Q4. In Chile, corporate spreads rose from less than 100 bp in October 2019 to almost 350 bp in April 2020. Even sovereign bonds had significant rate hikes because of the short-term duration preference (Figure 3)

Figure 3

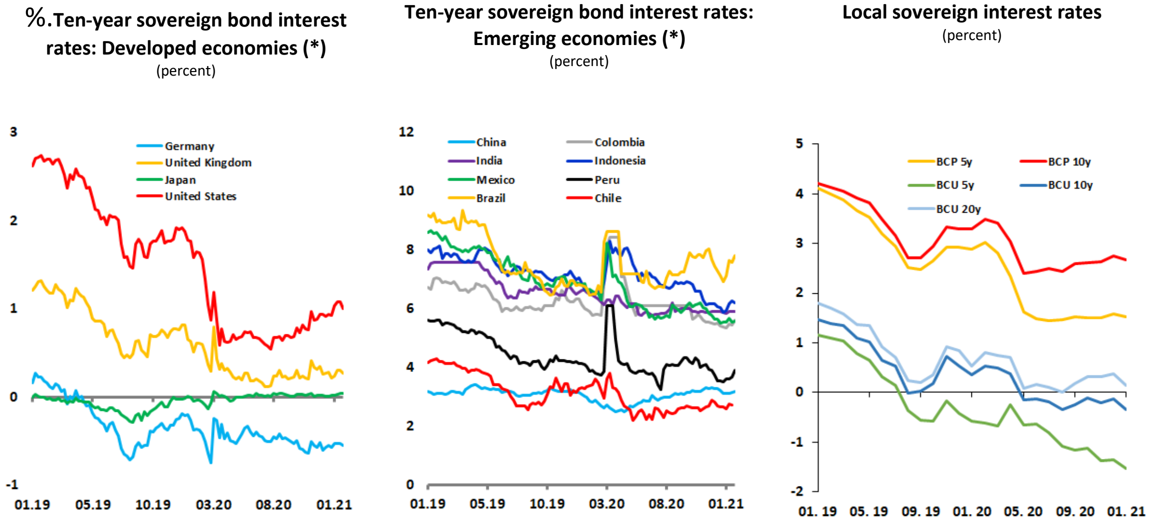

US lending standards and corporate spreads
(percent, basis points)

Bank and corporate bonds spreads (2)
(basis points)

(1) Positive (negative) values indicate tighter (looser) lending conditions.
(2) Dashed lines indicate the 2015-18 average of the respective series.
Source: Central Bank of Chile, Federal Reserve Bank of St. Louis, and Santiago Stock Exchange.

In this highly uncertain context, investors flew to safety towards long-term sovereign bonds, compressing their yields to levels never seen before in most of the world. Thus, during the first five months of 2020, 10-year sovereign bond interest rates fell by more than 200 bp in the US, 100 bp in the UK, and around 50 bp in Germany, where the rate remained in negative territory for most of the year. A similar trend was observed in several emerging economies where, after a brief initial spike at the beginning of the crisis, 10-year sovereign yields continued their downward trend in 2020. In Chile, the rate fell by more than 100 bp between March and May 2020, to its record low of 2.4.(Figure 4)

Figure 4



%.**Ten-year sovereign bond interest rates: Developed economies (*)**
(percent)

Ten-year sovereign bond interest rates: Emerging economies (*)
(percent)

Local sovereign interest rates
(percent)

(*) Weekly data.
Source: Central Bank of Chile and Bloomberg.

3. Challenges in the implementation of unconventional monetary policies

The challenges faced by the CBCh during the pandemic were not dissimilar to those faced in other jurisdictions. Both bank and non-bank intermediation is significant in Chile, and therefore to achieve the goals of both price and financial stability the policies need to be tailored so as to work effectively through both channels. This section highlights some of the key tradeoffs involved.[8]

The role of the banking system as a transmitter of monetary policy through lending capacity is not usually limited in the face of idiosyncratic, or even business-cycle frequency shocks, but the fact that the CV19 shock has been large and widespread stressed this ability. Therefore, many of the challenges for monetary policy that arose as a result of the CV19 pandemic had to do with how to make sure that central bank liquidity injections would actually be transmitted to the real economy: i) **maturity mismatch** can become problematic if the traditional pass-through of shorter-term central bank lending rates on longer maturities is weakened due to higher risk premia; ii) **liquidity mismatch**, since the funding by the central bank needs to be rolled over frequently, whereas banks are providing refinancing to their clients; iii) **leverage**, as the increase in funding from the CBCh, if funneled to credit, would potentially squeeze the amount of equity available; iv) **collaterals**, as the

[8] The Annex lists the main measures adopted in different areas.

liquidity provided by the CBCh is backed by appropriate guarantees by the banks, but are in essence limited in moments of high stress; and v) **credit risk**, as banks increase their loans to firms that are affected by the pandemic and thus can potentially result in higher risk.

In order to tackle these risks, the CBCh responded by injecting resources into the financial system, but with significant changes to the traditional implementation modalities. Specifically, (1) the CBCh provided long-term financing in order to mitigate maturity mismatch; (2) the CBCh, with the prior opinion of the CMF (bank regulator), relaxed regulatory liquidity requirements, through a temporary suspension of maturity mismatch requirements; (3) the CMF allowed a reduction of credit risk weights for loans guaranteed by the Treasury of Chile, CORFO[9], and *FOGAPE*[10], from 100% to 10% so as to mimic sovereign risk; (4) the CBCh significantly broadened collaterals, so as to include corporate bonds, commercial paper, and commercial loans.

Apart from the banking system, non-bank intermediation in Chile is certainly significant. The institutional investor base is large, through mutual funds, pension funds and insurance companies, and these agents have also been susceptible to large portfolio shifts. Most notably, a shortening of portfolios, a dollarization of portfolios, and liquidation of equity. Sudden portfolio adjustments, triggered by local or global events, could have a disruptive effect on domestic financial markets. If asset liquidation is concentrated in local market securities, in particular bank instruments, it could generate a significant increase in the banking system's funding costs by reducing the possibility of rolling over short term liabilities. In this respect, the main challenges facing Chile have been related to: (a) the massive legal changes allowing the withdrawal of pension funds, as well as other portfolio shifts; (b) the dollarization of portfolios, in particular when derived from sudden and massive shifts between funds by pension fund affiliates, as the ones that have increasingly taken place in Chile; and (c) the shortening of maturities for mutual funds and insurance companies.

In response to these challenges the CBCh implemented a series of measures that included (a) the purchase of longer-date as well illiquid assets in stressed capital markets to accommodate private reshuffling of portfolios; (b) a special cash purchase/forward sale program (CCVP) for bank instruments; (c) provision of dollar liquidity; and (d) the approval of a Constitutional change to allow the purchase of treasuries by the central bank in secondary markets.

4. Main credit-easing policies and their implementation challenges

As mentioned above, the Financial Market Commission (CMF), the Ministry of Finance, and the CBCh implemented an unprecedented set of measures with the objective of mitigating the economic impact of the sanitary emergency. The rapid adoption of such measures by the different market players was not without challenges. The main characteristics of these measures are described below.

[9] Economic Development Agency.

[10] Small Business Guarantee Fund, see below.

The Central Bank implements the Financing Facility Conditional on Increased Lending (FCIC, Facilidad de Crédito Conditional al Incremento de las Colocaciones)

This is a 4-year lending facility at the monetary policy rate in its effective lower bound (assessed at 0.5%). To incentivize uptake even if banks expect the ELB to be revised downward, a clause for automatic refinancing at a lower rate was included. Moreover, following up some examples from other jurisdictions, the amount of liquidity provided to each bank was linked to their credit performance.

This link went through a number of stages. Early on, as cash flows were significantly stressed, it was important to allow the total stock of credit to absorb the immediate impact of the crisis. To stimulate aggregate credit growth at this stage of the crisis, funding to banks was first linked to the growth of credit *stocks*. However, the longer duration of the crisis due to the resurgence of infections and sanitary restrictions has changed the focus towards facilitating debt refinancing at longer maturities. Thus, the new design of the facility links bank funding to the *flow* of credit --which includes refinancing operations.

The significant increase in bank funding from the FCIC could not be accommodated through the standard set of collateral instruments. Hence, the CBCh expanded significantly the scope of instruments eligible for collateral in money market operations, including so far loans guaranteed by the state and well performing loans.

It is interesting to note that the amount of liquidity provided through the FCIC was linked to the overall growth of the stock or flow of the loan portfolio by banks, but was not targeted at specific loans. By the same token, the broadening of collaterals was not aimed at specifically boosting loan origination to those sectors. Rather, the role of credit guarantees (detailed later) played the key role for incentives. These credit guarantees from the state also meant that leverage was not squeezed, as the bank regulator allowed a reduction in risk weights on those loans that benefited from credit guarantees. The regulator also waived the need for higher provisions on refinancing existing loans.

So far, the specific calibration of these measures has been revisited every six months or so. The first line (FCIC1) was implemented in March 2020, and experienced an uptake in bank funding of close to 10% of GDP. The second line (FCIC2), was implemented in June 2020 but had a much more muted reception, likely due to the higher perceptions of risks outstanding. The third line (FCIC3) was recently announced in January 2021 and aims at facilitating the funding of refinancing operations of well performing or already-guaranteed loans.

A very important effect of this measure was that it reduced the demand for private borrowing from banks, both in time deposits and bonds. The stocks of both securities have been diminished, because they have been replaced by the FCIC (its duration is 4 years), equivalent to the duration of bond financing. The stock of deposits today is equivalent to the one that existed in 2012.

Government expands FOGAPE: Small Business' Guarantee Fund (Fondo de Garantía para Pequeños Empresarios)

The *FOGAPE* has long been a popular and focused instrument for the funding of SMEs. The government decided to tailor it so as to use it as a vehicle for a massive guarantee program designed for the COVID-19 crisis. Its size and scope were broadened significantly during the second quarter of 2020, with guarantees of USD 3bill that could be levered up to USD24 bill in new credits. This represented a ten-fold increase in the program (reaching 10% of GDP in potential new credits), deployed over a much shorter period of time (three months instead of several years). The cap on sales for eligibility is increased from USD1mill a year to USD40mill a year.

The extent of credit-loss coverage was capped at 15% of individual credit (for reference, the median credit loss during the Global Financial Crisis was 9%), with a deductible of 1%-2% of credit loss. At first, these guarantees were provided only for new credits, and banks initially agreed to automatically refinance other credit operations with a grace period of six months. The thrust of this was that the incentive for refinancing was well internalized by banks early on the CV19 crisis, and thus incentives needed to be provided to reduce credit risk on new loans instead. Lending terms were standardized (36-month loan with a 6-month grace period) and during the legislative process a cap on the lending rate was established at 3.5%.

The features of this guarantee program were well tailored to the view early on that the immediate shock of the crisis would last a few quarters. Now as the more long-lasting effects are starting to be experienced the parameters of the program have been adapted to this new stage, through *FOGAPE reactiva* (2.0), legislated in early 2021, allowing for increased flexibility in re-refinancing of Covid and non-Covid loans, and also on the maximum lending rate allowed to banks.

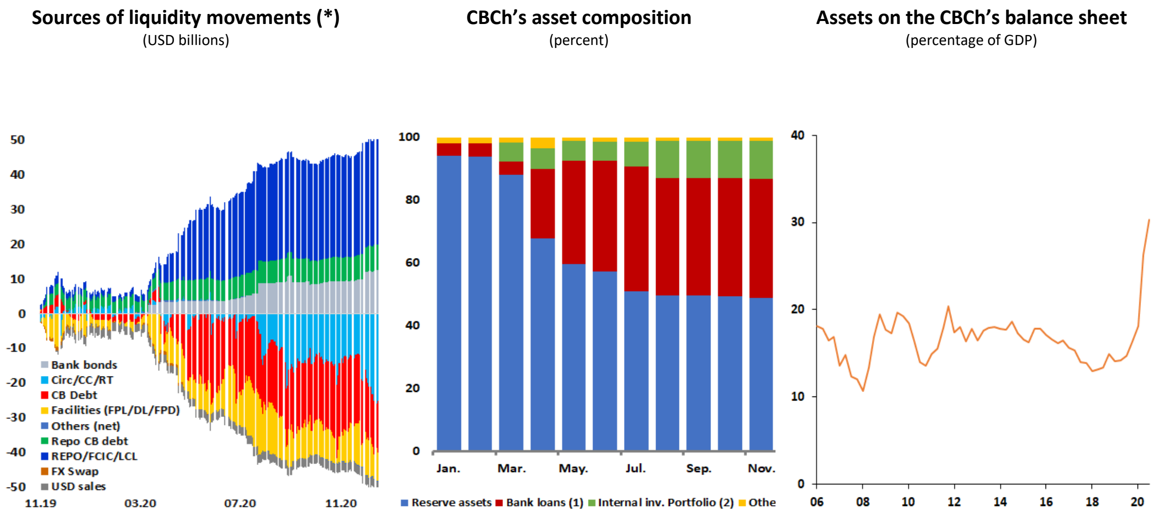
In addition to the waivers on liquidity regulation mentioned above, other regulatory and prudential measures were adopted. Banks voluntarily agreed to lower dividend distribution, the CMF allowed the transitory freezing of provisioning of voluntary refinancing of well-performing bank and non-bank loans to households, and the implementation start of Basel III was delayed for a year. Easing the funding from capital markets also was promoted through the "CRECE" fund, which provides guarantees usable by non-bank providers of SME financing. Reforms to ensure a speedier issuance and registration of securities and convertible bonds were implemented, as well as normative changes for REPOs for banks so as to link risk-weights to underlying asset and not counterparts.

A constitutional amended was passed in mid-2020 with broad support in Congress allowing the CBCh to purchase government treasuries in the secondary market, to face conditions of stress and financial instability. Note that government treasuries have been eligible guarantees for regular money market operations for several years already, but the outright purchase of those securities, or their use in REPO operations, was not legally possible. So far, this new tool has not been used

5. Impact and assessment of policies adopted by the CBCh

The CBCh's reaction to the crisis was rapid, decisive, and unprecedented. Among the first measures was the cut of the monetary policy rate (on March 20 --by 75bps-- and March 31 --by 50bps) to its technical minimum (0.5%). The effects of these monetary policy relaxation, as well as the credit easing measures described in the previous section, had significant impact.

Figure 5

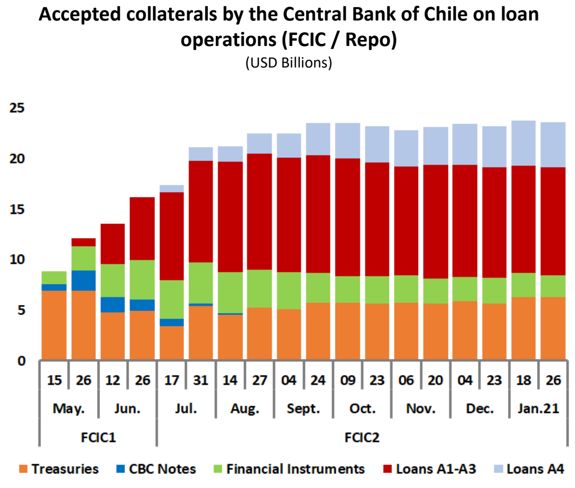


Sources of liquidity movements (*)
(USD billions)

CBCh's asset composition
(percent)

Assets on the CBCh's balance sheet
(percentage of GDP)

(*) FCIC: Conditional Financing for Increased Loans; LCL: Activation of liquidity facility; FPL: Standing liquidity facility; FPD: Standing deposit facility.
(1) Includes FCIC, repos, and standing liquidity facility.
(2) Includes bank bonds, time deposit, and CCVP purchases.
Source: Central Bank of Chile and FMC.



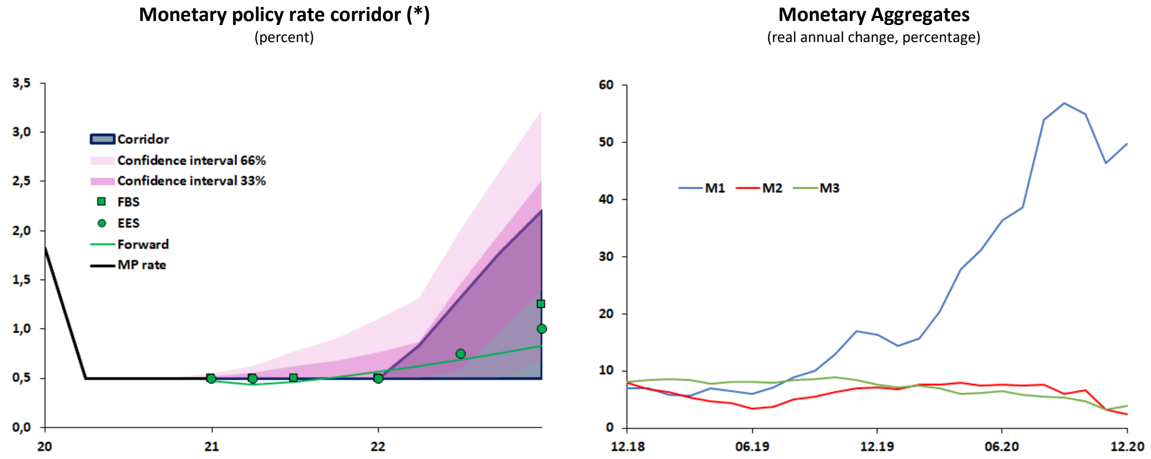
Accepted collaterals by the Central Bank of Chile on loan operations (FCIC / Repo)
(USD Billions)

Source: Central Bank of Chile. A# is the risk classification for individual loans. The higher the # the higher the risk. FCIC3 will broaden to A5 – A6 with government guarantees.

The balance sheet of the CBCh expanded significantly and collaterals were broadened. The provision of liquidity via the purchase of both CBCh and commercial bank bonds, as well as the FCIC and other facilities implied an extraordinary expansion of the CBCh's balance sheet. Assets increased from 18.1% in March 2020 to 30.3% in September 2020, mostly due to liquidity to banks through the FCIC and bond purchases. The expansion of the set instruments accepted as collaterals was very effective. On May 6, 2020, eligible collaterals for the FCIC were expanded, including commercial loans that were individually rated as high-quality loans, and more recently to the entire commercial portfolio with some form of state guarantee. (Figure 5)

Aggressive forward guidance. Since March 2020 the Monetary Policy Report has reported a corridor for monetary policy, which displays the implications for the monetary policy in the baseline and sensitivity scenarios for growth and inflation. More recently, in the December 2020 Monetary Policy Report, the Board stated that "it will maintain the high monetary stimulus for an extended period of time, in order to ensure the consolidation of the economy's recovery and compliance with the Bank's objectives. In particular, it foresees that the MPR will remain at its minimum level over much of the two-year monetary policy horizon. Unconventional measures will continue in place."[11] Moreover, the high demand for cash from households and firms has required an aggressive logistical effort to ensure appropriate supply of notes and coins in the economy, in a context that the pandemic has slowed their circulation. (Figure 6)

Figure 6



Monetary policy rate corridor (*)
(percent)

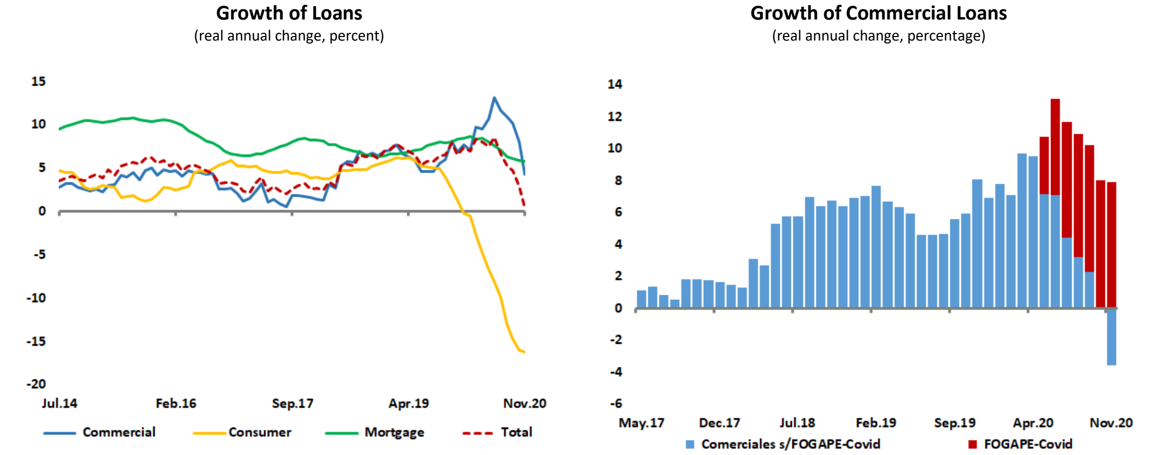
Monetary Aggregates
(real annual change, percentage)

(*) The corridor is built following the methodology of Box V.1 of the March 2020 Monetary Policy Report, Central Bank of Chile. It includes the Financial Brokers Survey (FBS) of December 2nd, the Economic Expectations Survey (EES) of Nov 9th and the forward curve derived from a 10-day average of financial assets until December 2nd.
Source: Central Bank of Chile.

Assessing the effect of policies has always been a difficult task. In the current context, in the midst of an unprecedented crisis and after the application of multiple regulatory changes, fiscal measures and unconventional monetary stimuli, such an endeavor becomes even more challenging. Nevertheless, some important conclusions can be drawn regarding the effectiveness of the adopted policies.

[11] Central Bank of Chile, Monetary Policy Report - Dec. 2020, pg. 46.

Figure 7


Growth of Loans
(real annual change, percent)

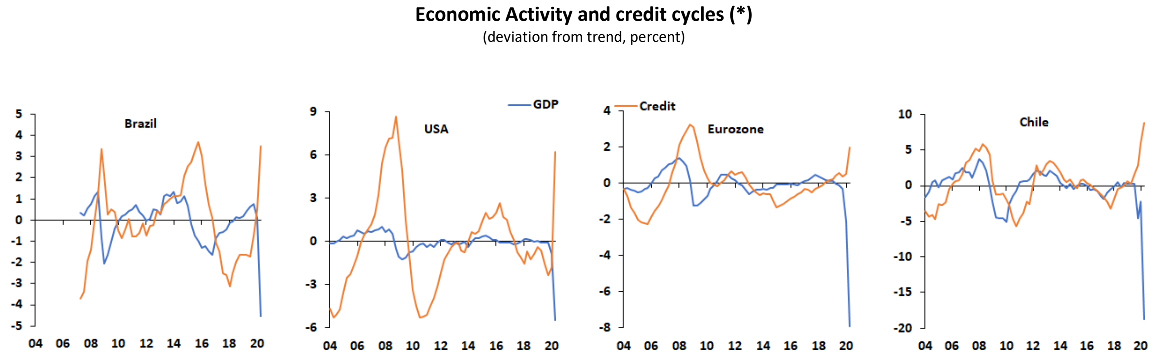
Growth of Commercial Loans
(real annual change, percentage)

Source: Central Bank of Chile and FMC.

Credit provision accelerated to the corporate sector, helped by guarantees and liquidity provision. The first evidence comes from the dynamics of credit, which suggests a key role for the measures adopted by the CBCh and the government. During the second quarter of 2020, the period with the strictest mobility restrictions, the commercial portfolio recorded strong growth despite the economic contraction, favored by the support measures implemented by the authorities. (Figure 7)

The countercyclicality of commercial credit has been a feature in several jurisdictions. It is noteworthy that this countercyclicality of credit during the current crisis breaks the traditional relationship observed in the past, not only in Chile but also in several jurisdictions. (Figure 8)

Figure 8


Economic Activity and credit cycles (*)
(deviation from trend, percent)

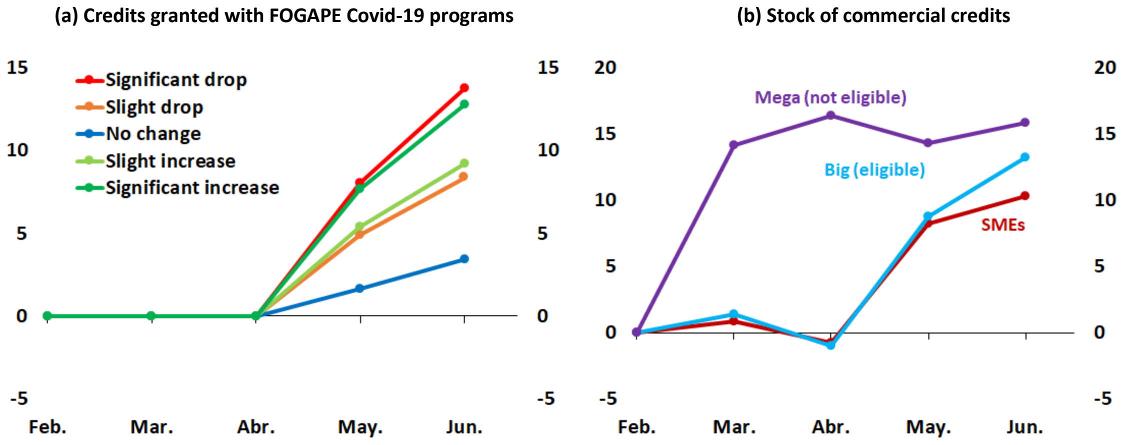
(*) Calculated as the difference between the log of the GDP level and credit, relative to a trend calculated using a HP filter.
Source: Central Bank of Chile.

Loans granted through the FOGAPE-Covid-19 programs targeted, to a greater extent, companies that had significant drops in their sales. Research using matched tax and financial data at the firm level shows that the loans granted under the FOGAPE-COVID-19 programs have mostly gone to businesses that recorded a major reduction in sales. Among companies that were not eligible for these programs because of their sales level, there was a significant increase in credit to mega-firms. In terms of timing, credit to micro, small, and medium-sized enterprises (MSMEs) and large firms only began to increase in May, when the FOGAPE-COVID-19 programs were implemented. (Figure 9, and Huneeus *et.al.* 2021)

Figure 9

Stock of commercial credits by size and behavior of sales

(change in annual variation compared to February 2020, percent)

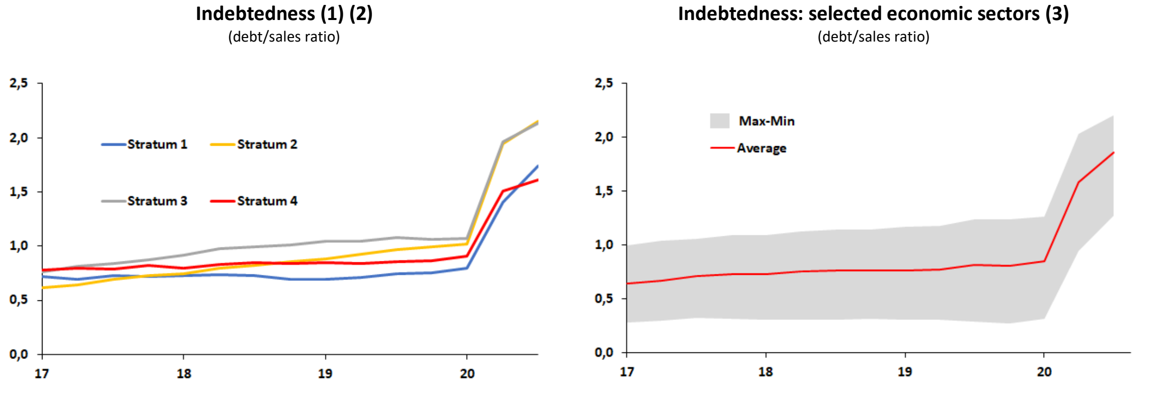


(a) Credits granted with FOGAPE Covid-19 programs

(b) Stock of commercial credits

Source: Central Bank of Chile and FMC.

Figure 10



Indebtedness (1) (2)

(debt/sales ratio)

Indebtedness: selected economic sectors (3)

(debt/sales ratio)

(1) The debt to sales ratio is calculated at the level of each firm for each period. The numerator is the stock of banking and foreign debt of each firm. The denominator is calculated as the average of the real sales of each firm (deflated by the UF) between the third quarter of 2018 and 2019. The indebtedness by sales stratum is calculated as the median among the firms of each stratum.

(2) Stratum 1 and 2: annual sales less than UF 25,000. Stratum 3: annual sales greater than UF 25,000 and less than UF 100,000. Stratum 4: annual sales greater than UF 100,000.

(3) The gray area indicates the maximum and minimum debt-to-sales ratio among the selected sectors for each period. The included sectors are: business services, housing services, financial services, personal services, commerce, restaurants and hotels, industry, construction and transport.

Sources: Central Bank of Chile, FMC and National Statistics Institute.

Moreover, the preliminary evidence also suggests that increased access to credit has been relevant to soften the real impact of the crisis, by mitigating the negative impact of the shock on firms´ investment and employment decisions (see Albagli *et al.*, 2020).

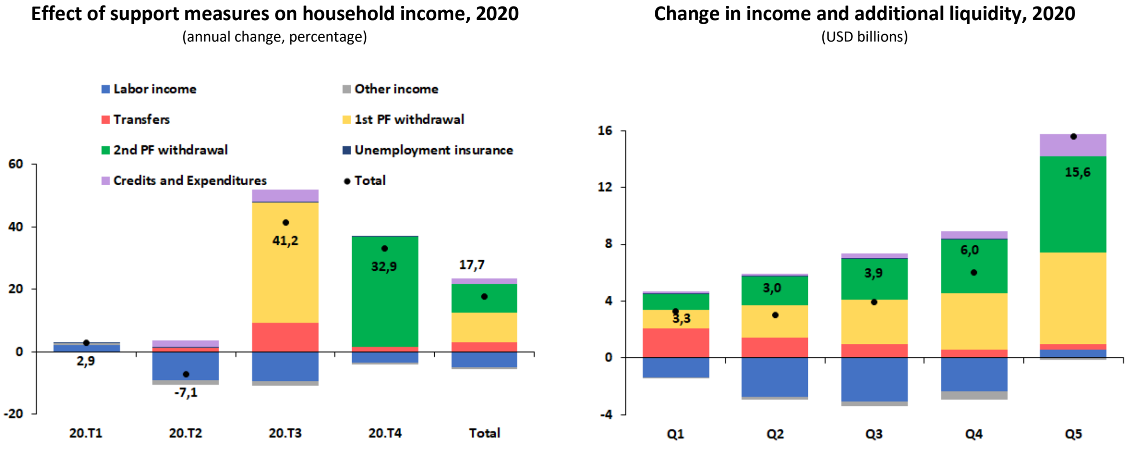
Leverage has increased, posing challenges going forward. The significant increase in business leverage—which was necessary to get through the most complex months of the pandemic and prevent a large number of businesses from stopping operations— will present challenges going forward. Indebtedness has grown across the board, though most intensely in medium-sized firms and in the retail, business and personal services sectors (which are among the hardest hit by sanitary measures and households' precautionary behavior). In a context of partial recovery of activity, the considerable fall in profits and the aforementioned increased indebtedness, could limit the capacity of companies to embark on new projects. (Figure 10)

6. The role of other policies

The Covid-19 pandemic had very significant adverse effects on households' income. Available data suggest that the autonomous income of households -income from work and other sources, not including transfers or other liquidity measures- fell by 5.7% in 2020, with the greatest contraction taking place during the second and third quarters, and a smaller reduction in the fourth. The fall in income was relatively larger for the lowest income groups. Policymakers deployed various support measures to cushion these effects and improve the households' consumption possibilities. Among them, fiscal aid programs and the early withdrawal of pension savings.

The evolution over time of the measures shows that their effect concentrated in the second half of 2020. Fiscal transfers, important from a historical perspective, only partially compensated for the drop in labor income early on, coming fully into line on the third quarter and were significantly targeted to lower income households. Legislative changes were approved and hotly debated allowing for two withdrawals of pension savings, each up to 10% of assets in individual portfolios, with a maximum cap and a minimum. These were not targeted and, as shown, were accessed mainly by higher income households. The impact on consumption of durables has been significant, but the effect on GDP more muted. (Figure 11)

Figure 11


Effect of support measures on household income, 2020

(annual change, percentage)

Change in income and additional liquidity, 2020

(USD billions)

Source: Central Bank of Chile based on Barrero *et al* (2020)[12].

Finally, a brief note about the possibility of intervening the FX market as a complement to conventional and unconventional monetary policy. Should central banks have been more active in their foreign exchange interventions during the COVID-19 crisis? There are situations in which FX intervention or liquidity provision is necessary. However, the COVID-19 crisis seems to create the need for local currency support due to the cash flow crunch of firms (in particular for SMEs) and households. Nevertheless, it is key to consider the extent of transaction-dollarization for the role of forex in liquidity provision.

In general, under inflation targeting and flexible exchange rates, foreign exchange intervention can be rationalized in three ways: (i) Monetary policy at the effective lower bound, plus significantly de-anchoring of inflation expectations below the target, could provide a basis for unsterilized foreign exchange accumulation as a QE policy akin to price-level targeting. (ii) Periods of financial dislocation and high volatility can require sales or purchases of foreign exchange over limited periods of time. (iii) Regular assessment of the adequacy of reserves can lead to processes of accumulation/decumulation of foreign exchange reserves.

Inflation expectations have remained well anchored, and the demand for liquidity has been focused on domestic currency. Therefore, foreign exchange policy implemented by the CBCh has responded to the second and third rationales over the recent period. Some sales of foreign exchange were performed early on, to confront high volatility. During 2020, the CBCh arranged for a two-year Flexible Credit Line for 1000% quota (around 9% of GDP) with the IMF so as to backstop its external liquidity position.[13] More recently, as a preparation for the exit from such facility the CBCh implemented a 15-month program of reserve accumulation for USD12 billion, with small daily purchases so as not to interfere in the operation of foreign exchange markets.

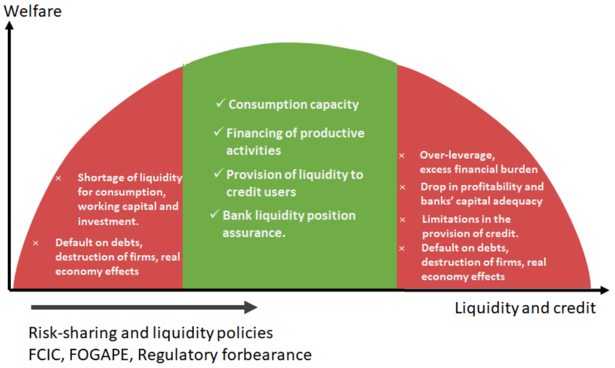
[12] *Estimación del impacto del Covid-19 en los ingresos de hogares, medidas de apoyo y efectos en el consumo*. Monetary Policy Report, Dec. 2020, Central Bank of Chile.

[13] In addition, an existing RMB/CLP swap line was expanded.

7. Concluding remarks

An important challenge for the CBCh has been to tailor the adequate magnitude of its support measures. Too little support and policies might not be able to avoid severe liquidity crunches for firms and households, generating inefficient defaults and closures. Too much support, on the other hand, could lead to unsustainable leverage, debt overhang, excessive risk-taking, and future financial vulnerabilities. (Figure 12)

Figure 12


Welfare
✓ Consumption capacity
✓ Financing of productive activities
✓ Provision of liquidity to credit users
✓ Bank liquidity position assurance.
× Shortage of liquidity for consumption, working capital and investment.
× Default on debts, destruction of firms, real economy effects
× Over-leverage, excess financial burden
× Drop in profitability and banks' capital adequacy
× Limitations in the provision of credit.
× Default on debts, destruction of firms, real economy effects
Liquidity and credit
Risk-sharing and liquidity policies
FCIC, FOGAPE, Regulatory forbearance

The assessment of the cash flow needs from the real sector has benefited from work at the research and statistic levels, which allowed merging firm-level data including performance measures (sales), firm decisions (employment, investment) and access to funding. This data shows that the shock facing Chilean businesses was very large and heterogeneous across sectors, with plummeting sales and a significant increase in firms reporting zero sales. Electronic invoice data show that over the first month of the Covid-19 crisis there was a sharp reduction in sales. On average, sales fell by 13.6% in real annual terms between March and July of 2020. This compares with an increase of 10.5% between January 2014—when electronic invoice data became available—and September 2019 — the month before the start of the social unrest. Access to rich, real-time, and broad-based data proved remarkably useful to inform policymakers about the magnitude of the shock early on, and has been key to inform the design and the timely evaluation of different measures.

These types of quantitative exercises require a close collaboration between institutions, statistical areas, and research teams. However, from a broader perspective of policy making a conceptual framing of the limits of policies is needed. The CV19 crisis materialized as a very large increase in the need for liquid holdings and credit demand. Therefore, from a narrow monetary policy perspective, an obvious limit to policy accommodation is the credibility of the monetary and inflation targeting frameworks. Jurisdictions with credible inflation targets, anchored inflation expectations, and less dollarized financial systems, have permitted more aggressive easing by central banks.

Beyond monetary policy, the CV19 crisis has posed significant political economy challenges in several economies, as it affected in disparate and heterogeneous ways households and firms, and had as well a sanitary and social distancing dimensions. Tackling the risk sharing and distributional implications of policy design has represented a political and legislative challenge everywhere, determining the speed, breadth and magnitude of support policies across countries.

Against these backdrops, the recovery process is likely to continue presenting these tensions. For autonomous central banks, enhancing transparency in the communications of the rationale, and limits, for policy design aimed at achieving statutory goals will continue to be paramount.

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Annex – Main measures adopted

Objective	Entity	Area	Measure	Potential impact	Date
Facilitate access to credit	CBCh	People and small businesses	Conditional Financing for Increased Loans (FCIC1). Program extension (FCIC2),	Increase credit and decrease the CAR.	March, 2020 June, 2020
	Finance Ministry	People and small businesses	Credit line for working capital with state guarantee (FOGAPE) up to 3 months of sales. Reduce deductible for FOGAPE guarantee and increase maximum financing for firms with sales under 1,000 UF.	Mitigate credit risk of firms.	April 28, 2020 June, 2020
	CMF		Use of mortgage collateral to back loans to SMEs.	Mitigate credit risk of firms.	May, 2020
			Adjustments in the treatments of good received.	Reduce provisions.	March, 2020
			For loan amounts guaranteed by the Treasury of Chile, CORFO, and FOGAPE, reduce de credit risk weight from 100% to 10% for the purpose of RWAs, replacing the legal provision that allowed a share of these guarantees to be considered as part of voluntary provisions that make up regulatory capital.	Reduce capital requirements.	August, 2020
			Relaxation of timeline for implementing Basel III.	Postpone start of new capital standards.	March, 2020
	Banco Estado	People and small businesses	Capital increase in order to increase lending.	Increase capital loans. Ambiguous effect on CAR.	March, 2020
Liquidity provision	CBCh	Commercial banks	Inclusion of corporate bonds as collateral.	Increase access to liquidity.	April, 2020
			Extension of foreign currency sale program. Longer maturities for peso and dollar liquidity programs.		March, 2020
			Extension of the temporary suspension (90 days) of maturity mismatch requirements. Extension of the relaxation of the LCR limit.	Reduce regulatory requirements.	April, 2020
			Activation of Liquidity Credit Line (LCL).	Reduce short-term funding costs.	March, 2020
			Special asset purchase program (BCP, BCU, bank bonds).	Reduce long-term funding costs.	June, 2020
			Check Clearing House regulations incorporated a special protocol to implement actions in contingency situations.	Mitigate liquidity risk.	July, 2020
			Special cash purchase/forward sale program (CCVP) for bank instruments. Effective only for rollovers.	Reduce long-term funding costs.	September, 2020
		SOMA participants	Purchase of time deposits. **Effective only through October**.	Reduce funding costs.	July, 2020
	Finance Ministry	People and businesses	Tax deferral or suspension.	Mitigate credit risk of firms.	September, 2020
			Microbusiness protection fund.		March, 2020
			Extension of the labor income protection program.	Mitigate household credit risk.	September, 2020

(*) Green: new measures; Black: ongoing measures.

Source: Central Bank of Chile, based on data from the CMF, and the Ministry of Finance.

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