



Financial Turmoil, Illiquidity and the Policy Response The Case of Chile

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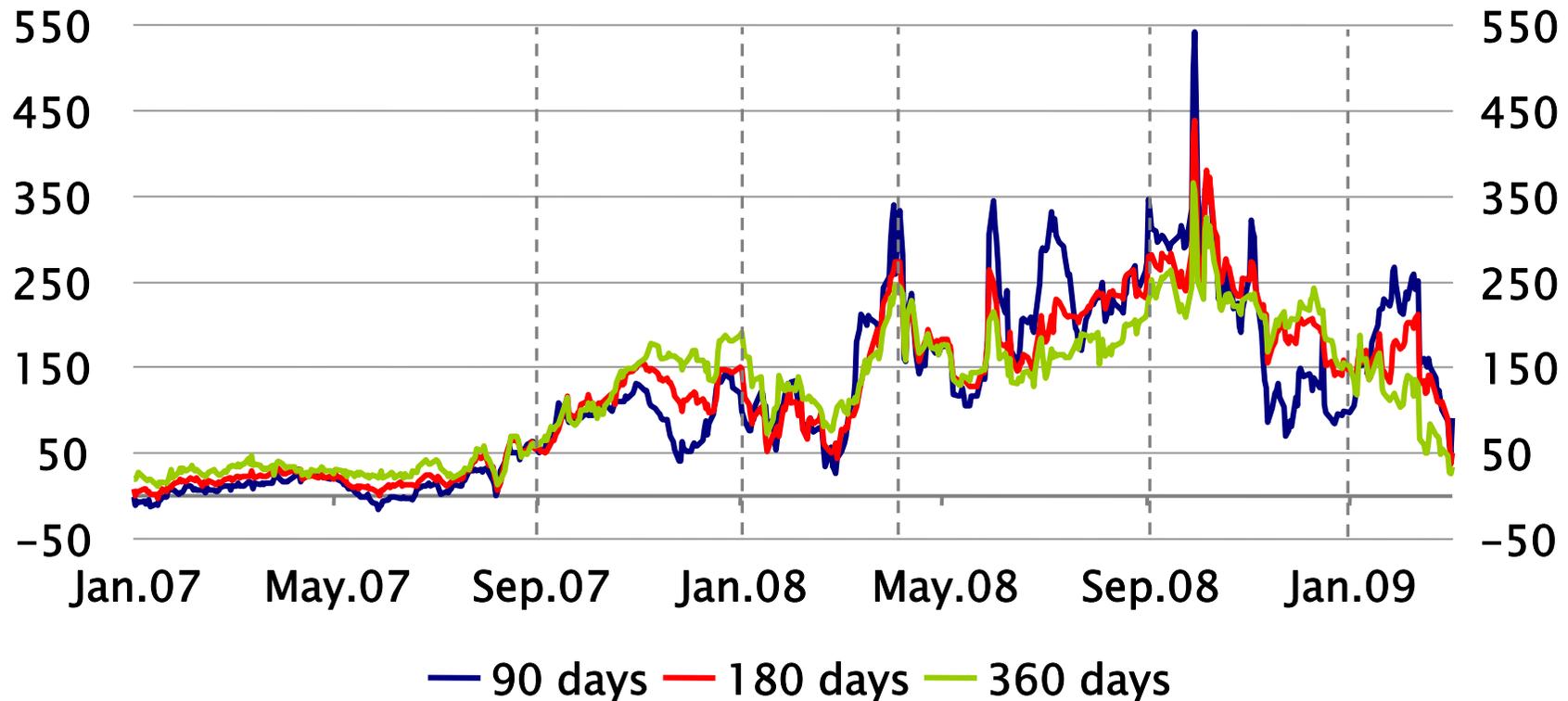
A crisis in stages

- August 2007 – December 2007: Financial stress contained within specific institutions and markets. Increase in external investments by pension funds.
- January 2008 – March 2008: Loosening of monetary policy, sharp USD depreciation, decoupling. Decision to intervene in the forex market.
- April 2008 – August 2008: High commodity prices and inflationary propagation. 200bp in MPR hikes over four months.
- September 2008 – December 2008: Global financial turmoil, focus on liquidity provision and normal functioning of financial markets.
- January 2009 onwards: Growth and trade implications, shift to countercyclical fiscal/monetary policy. 600pb in MPR cuts over three months, USD4 billion fiscal stimulus package.



Tight USD money markets

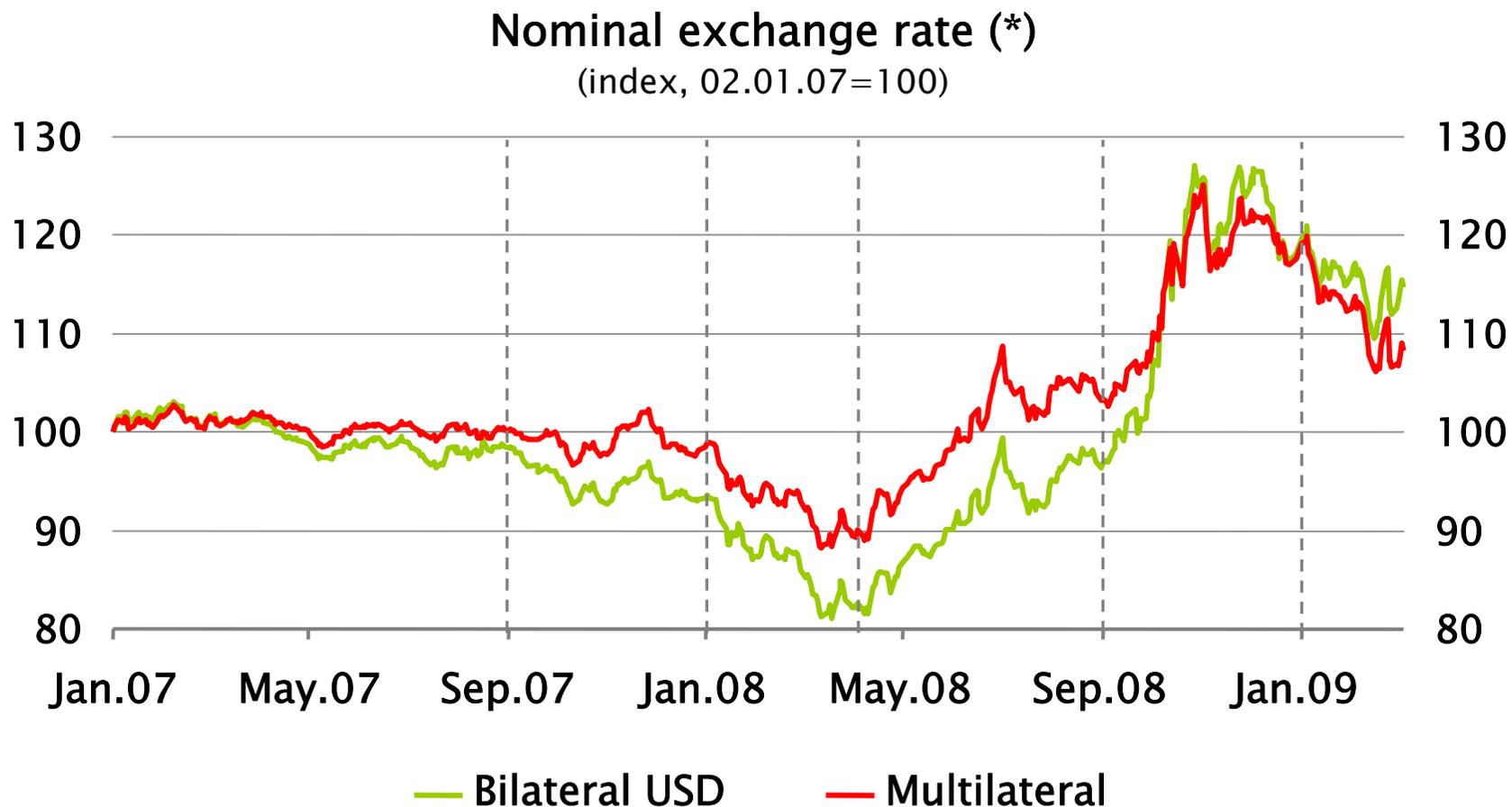
Spread between onshore USD rates and Libor (*)
(basis points)



(*) For calculation of onshore rates see text. Dotted line marks the highlighted periods in the text.



Exchange rate fluctuations

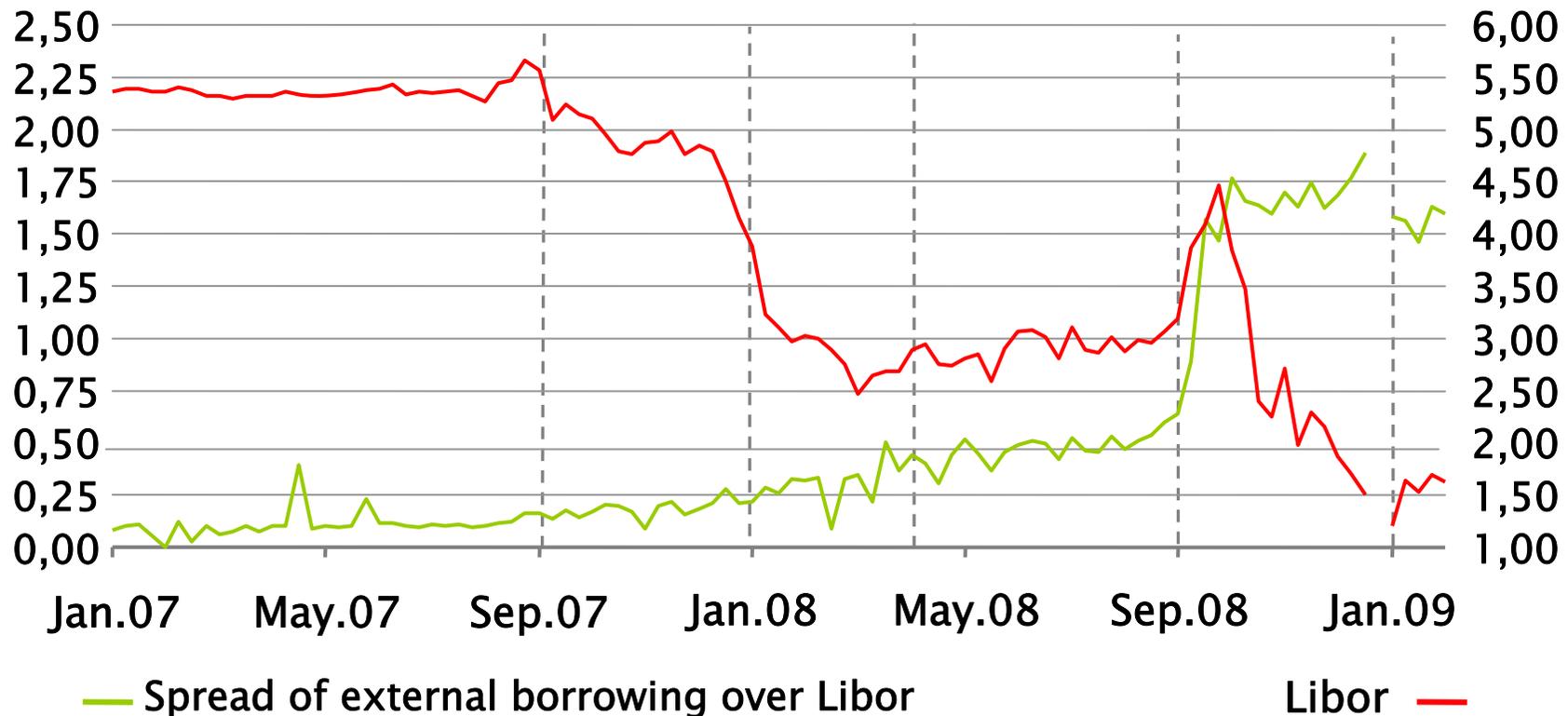


(*) Dotted line marks the highlighted periods in the text.



Increase in the external cost of borrowing

External borrowing cost for local banks (*)
(pct)

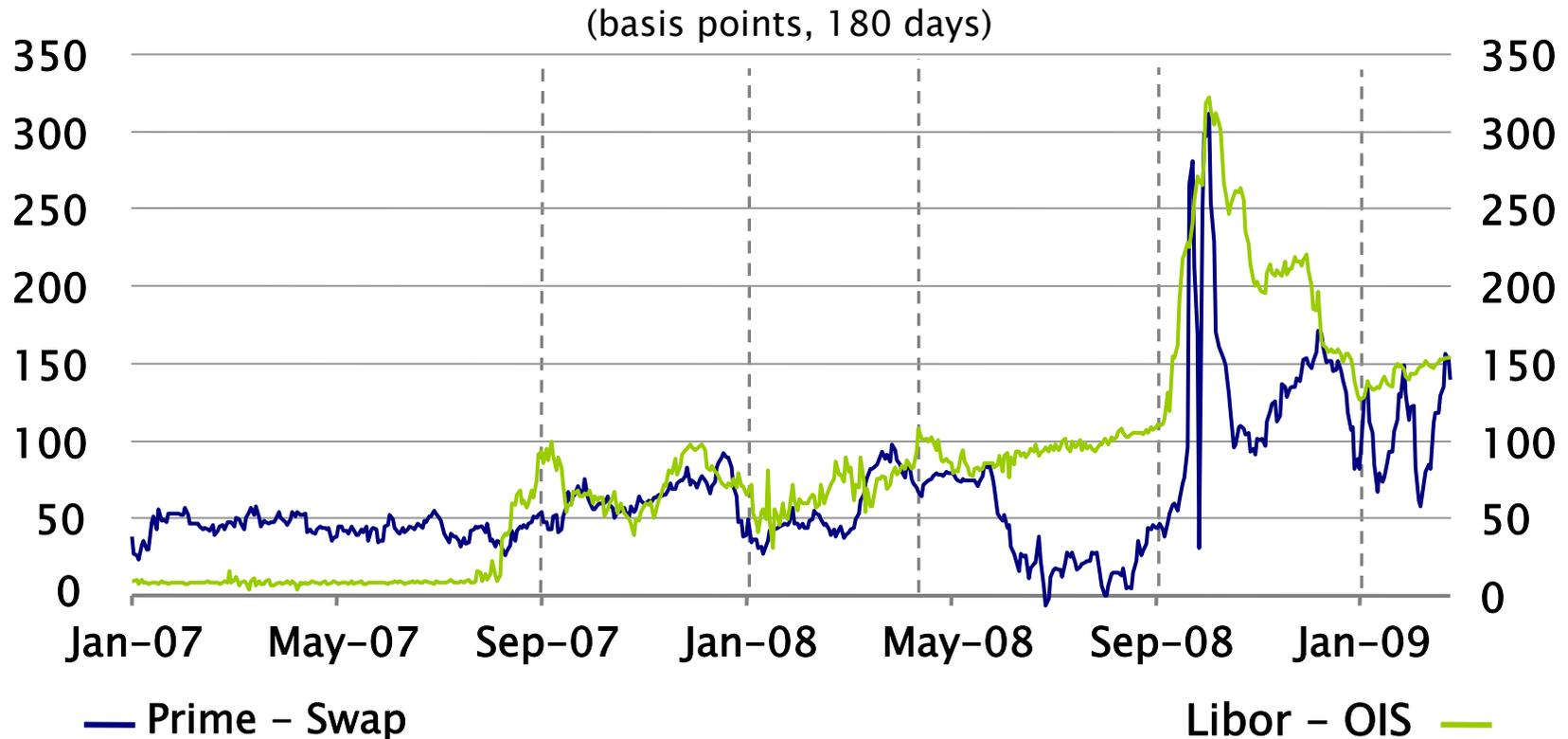


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Turmoil on local currency money markets

Libor-OIS spread and the spread between prime deposit rates and peso swap contracts (*)



(*) Dotted line marks the highlighted periods in the text.



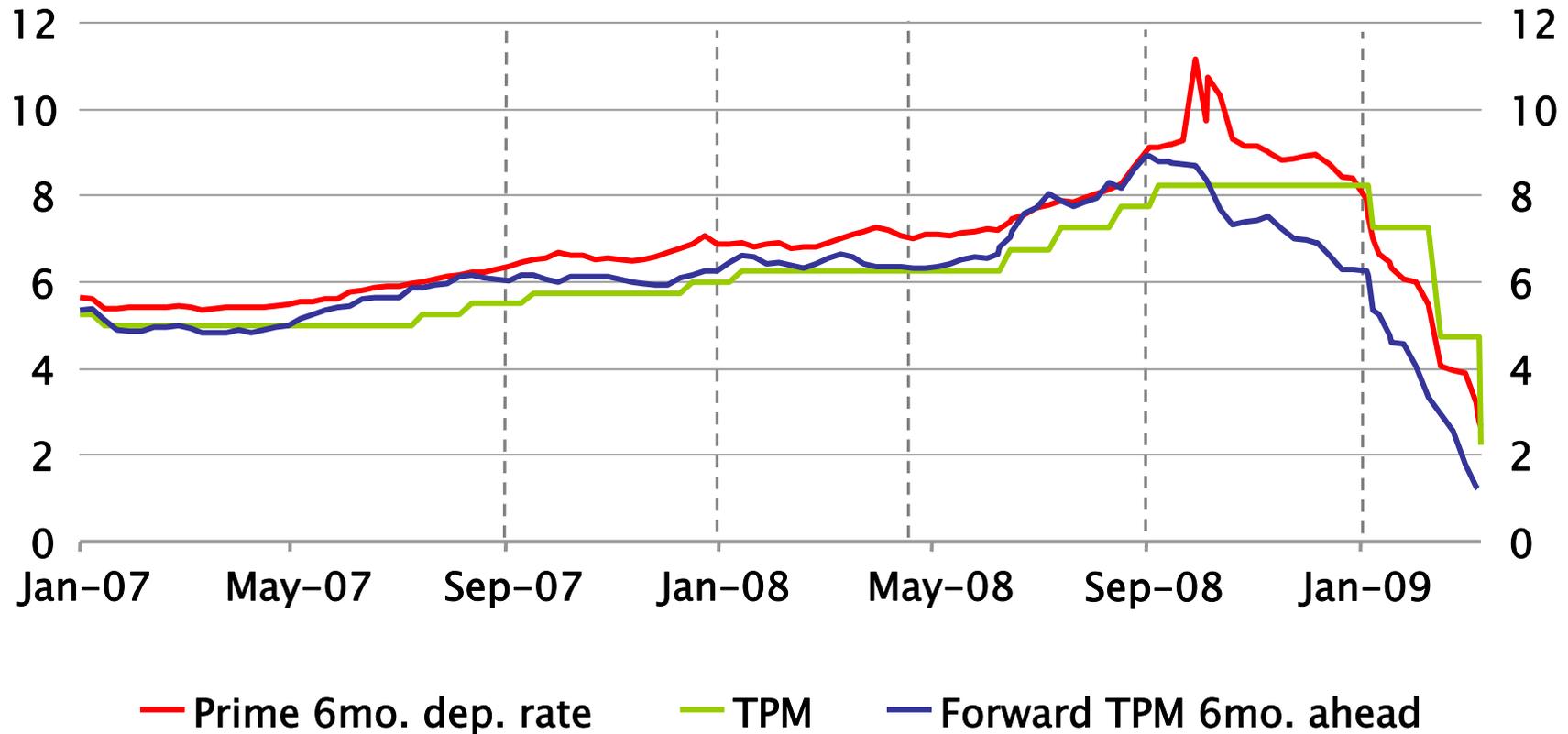
Main financial/liquidity measures

- April 10th 2008: Reserve accumulation program through daily USD50 purchases until Dec 2008 (USD8 billion target).
- September 29th: Suspension of reserve accumulation program. Implementation of weekly USD repo auctions.
- October 9th–10th: Changes in USD deposit reserve requirements. Broadening eligible collaterals for open market operations to include CDs.
- December 10th: Extension of special programs for all of 2009. Implementation of new liquidity facility to include government treasuries and longer term CDs.



Monetary Policy

Monetary Policy Rate and expectations of policy stance (*)
(pct)



(*) Dotted line marks the highlighted periods in the text.

Source: Banco Central de Chile.



Shift in macroeconomic policy stance

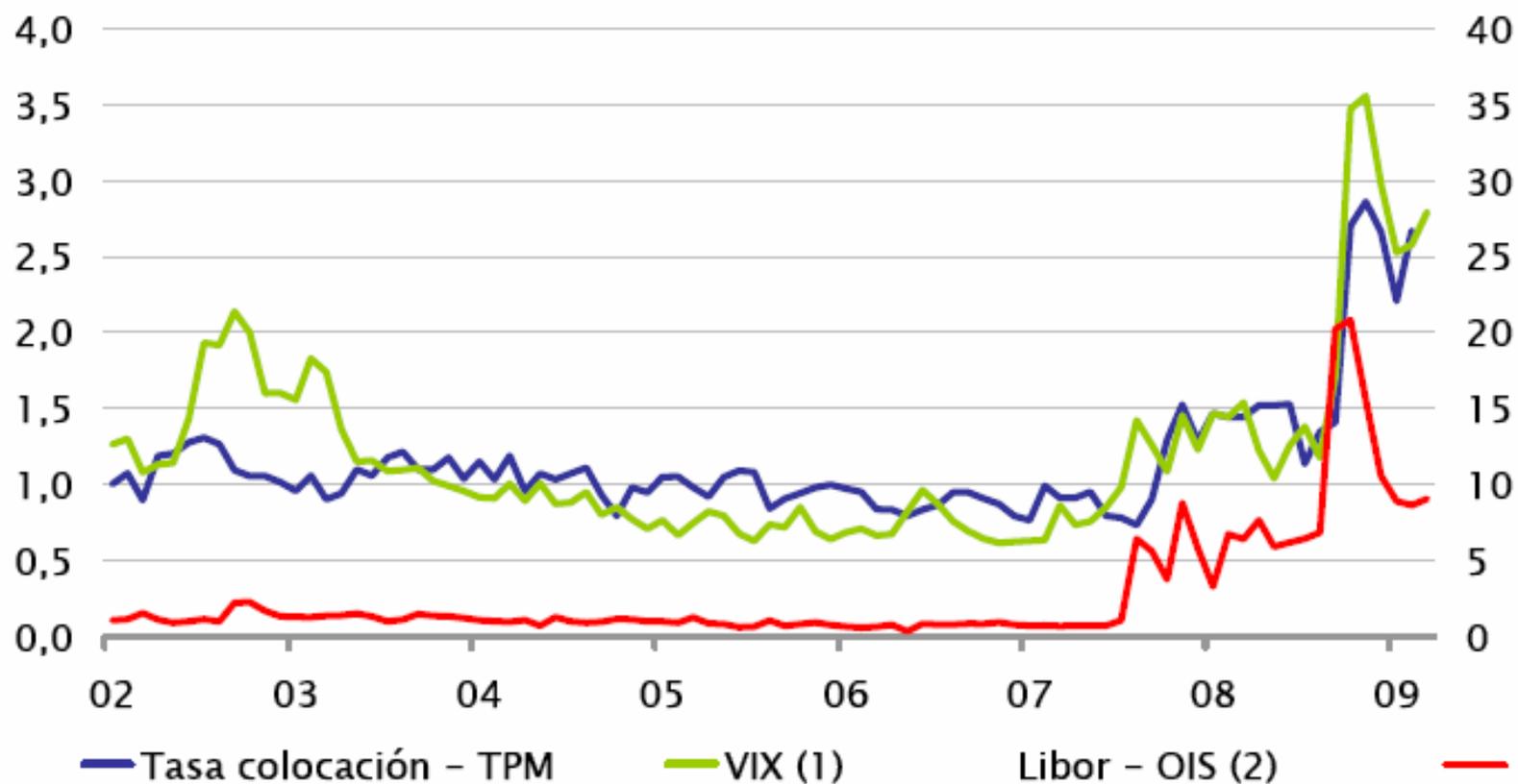
- September to December 2008: Easing bias replaces tightening bias in MP decisions.
- January 2009: MPR 100bp cut from 8,25% to 7,25% w/bias. Government unveils USD4bil stimulus package (USD3bil with macro impact):
 - USD1600mil in increased spending, direct transfers, job creation subsidies.
 - USD600mil in temporary tax cuts (stamp tax).
 - USD800mil tax credit.
 - Financing through repatriation of SWF and mechanic daily sales of USD50 million over three months.
- February 2009: MPR 250bp cut from 7,25% to 4,75% w/bias.
- March 2009: MPR cut 250bp from 4,75% to 2,25% w/ weaker bias.



Credit risk

Credit spreads and risk measures

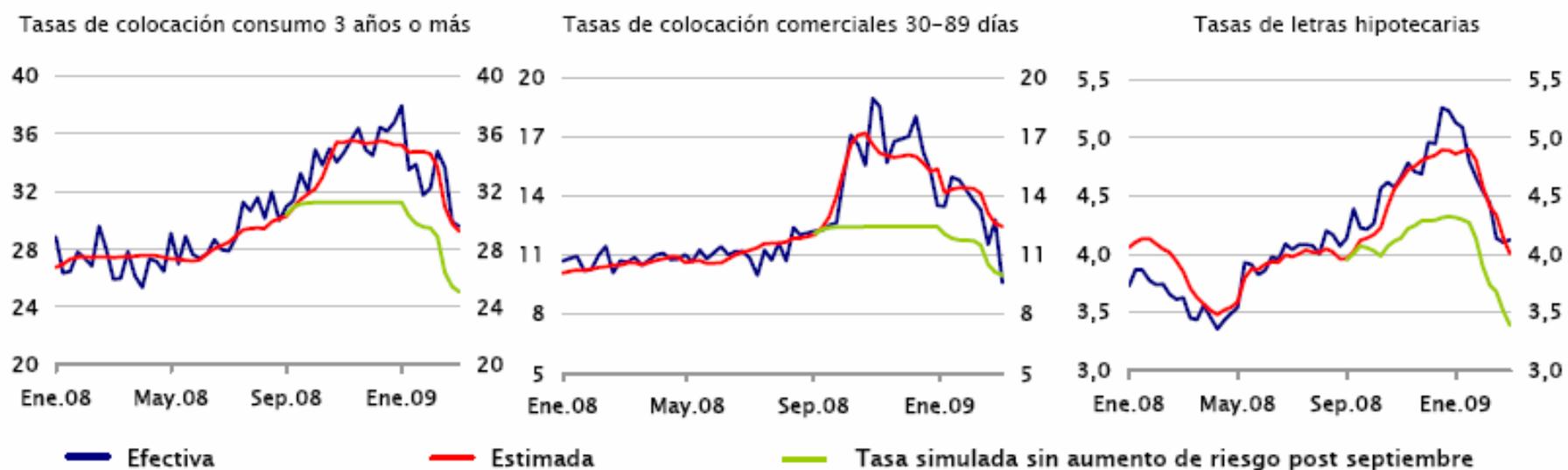
(index, 2002-2007 = 1)





Monetary policy passthrough to loan rates

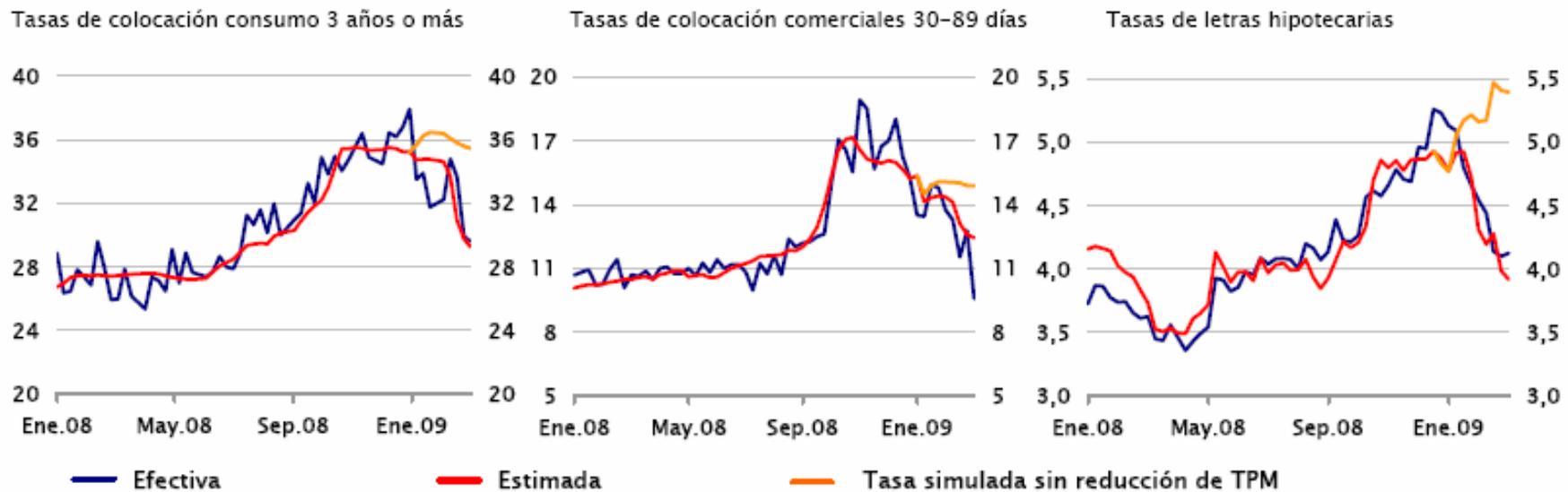
Loan rates and risk factors (pct)





Monetary policy passthrough to loan rates

Loan rates and monetary policy (pct)





Risks and challenges ahead

- Risks
 - Non-monotonic shifts in markets and financial asset prices (eg. commodity prices, exchange rates and financial conditions over 2008).
 - Medium term adjustment of main exchange rates and commodity prices.
- Challenges
 - Fiscal and monetary policy coordination in the macro sphere: limits to stabilization?
 - Fiscal and monetary policy coordination on the financial sphere: coherence between the financing of fiscal packages, forex intervention, debt issuance and liquidity measures.



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