Chile's Central Bank Injects Liquidity in Financial Markets

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Original post here.

In March, the central bank of Chile (CBC) cut interest rates twice from 1.75% to 0.5% and unveiled a series of liquidity measures to "ensure the normal functioning of credit markets and the effective transmission of the increased monetary stimulus." The CBC expanded its exceptional measures in June by an additional 10% of GDP. The current CBC liquidity injection represents 20% of GDP.

Chile's monetary policy rate has remained at 0.5%, its "technical minimum," and is expected to remain there over much of "the two-year monetary policy horizon." The CBC said it will also maintain the unconventional measures. The CBC has stated that "in case the evolution of the economy so requires, it will continue to assess other options to intensify such impulse and provide support to financial stability, using unconventional instruments" (July 15, October statement and minutes).

Chile, Latin America's fifth largest economy and the world's top copper producer, has been hit hard by COVID-19. It recently surpassed 15,000 deaths. Beginning in March, Chile experienced shortages in foreign exchange liquidity and a sharp fall in prices of copper and other export commodities, although prices have since improved. The country's monthly index of economic activity contracted 14.1% in April, 15.3% in May, and 12.4% in June compared to the same months in 2019. In its September Monetary Policy Report (IPoM), the CBC raised its expectations. It now estimates that GDP will fall between 4.5% and 5.5% (from the 5.5% to 7.5% estimates in June). The IMF expects a 6% contraction in 2020 (see YPFS blog posts on liquidity measures by the central banks of Brazil and Mexico).

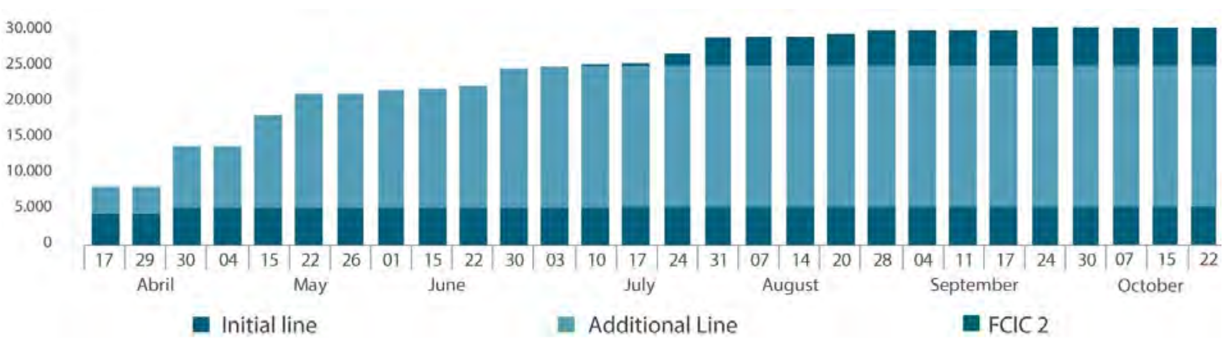
The CBC liquidity measures include the repo operations and the foreign exchange (FX) swap program, foreign currency sales, relaxation of liquidity regulations and reserve requirements, cash purchases and forward sale (CC-VP), and purchase of term deposits. The CBC also uses unconventional measures that include credit lines for banks to encourage lending to households and firms, bank bond-purchase programs, and the CBC bond-repurchase program (FSR 1, Exceptional Measures).

The CBC's Facility of Credit Conditional on Lending Increase (FCIC) and the Liquidity Credit Line (LCL) make resources available to commercial banks to "maintain financing and refinancing loans to households and companies, especially SMEs that do not have access to capital markets" (Exceptional Measures). Banks can access up to $24 billion through the FCIC, the LCL, or a combination of both. There are two lines available: a first line of $4.8 billion and an additional line of $19.2 billion. The FCIC is capped at 15% for each bank's baseline portfolio, which is the sum of commercial and consumer loans as of February 29, 2020. An initial 3% is available immediately to banks through the first line. The remaining 12% is offered through an additional line whose availability depends on the growth of the baseline portfolio and lending to SMEs. The LCL is limited by the average cash reserves in Chilean currency of each bank.

The FCIC and the LCL are similar to a repo with the difference that the FCIC has a term of 4 years and the LCL has a term of 2 years. Eligible collateral includes government bonds, bank and corporate bonds, and high-quality commercial loans. On May 6, 2020, eligible collateral for the FCIC was expanded to include highly-rated commercial loans (A1 to A3). The CBC has extended the facilities beyond the initial term of six months. They are priced at the monetary policy rate (0.5%). The first line started operations on March 30 and the additional line on April 16 (Exceptional Measures, FSR 1, Oct 15).

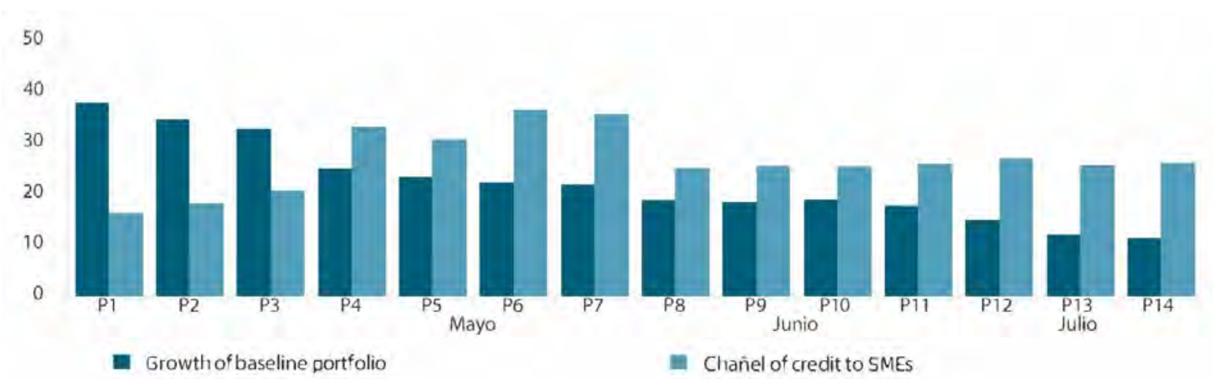
Since the announcement of the FCIC, loans in the baseline portfolio have increased significantly and come exclusively from commercial loans, in particular an expansion of credit lines (see Figure 2). By May, the majority of banks have accessed almost all of their allocated funds in the additional line (FSR 1, see Figure 1).

Figure 1: FCIC amounts (USD millions)



Source: Central Bank of Chile (Exceptional Measures)

Figure 2: Credit growth and SME ratio (percentage)



Source: Central Bank of Chile (Exceptional Measures)

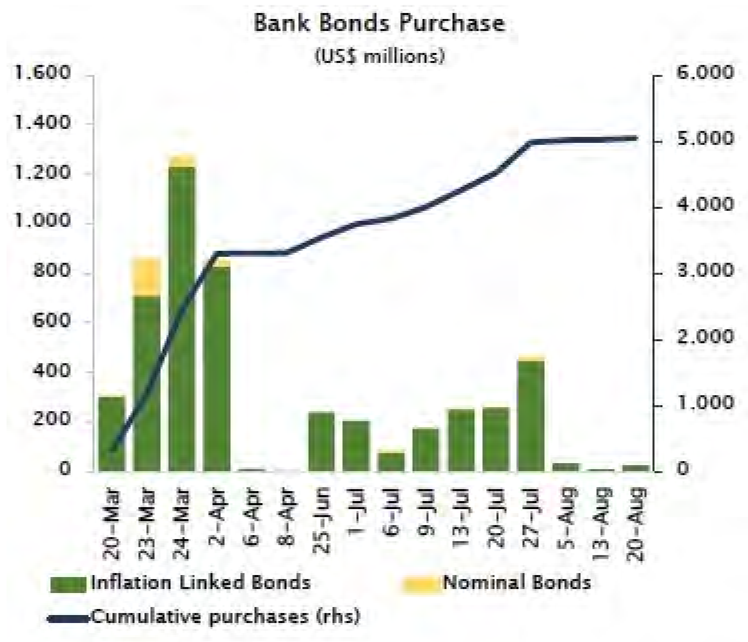
In June, the CBC expanded the use of non-conventional measures for an additional 10% of GDP to bring the total liquidity injection to 20% of GDP (Sep 16). These included phase 2 of the FCIC line (FCIC-2) and an $8 billion special asset purchase program over six months (June 16).

The FCIC-2 line included an additional $16 billion for eight months and strengthened incentives to lend to SMEs and non-bank credit providers (June 16). In the view of a CBC Board member, "implementing a new phase of the FCIC … would consider the role of non-bank credit intermediaries that depend themselves on bank financing. This can be complemented by a financial asset purchase program. This mechanism would allow, in principle, to reduce certain risk premiums in the capital market, facilitate portfolio rebalancing towards riskier assets, and directly provide liquidity to non-banking institutions, which nevertheless are important mobilizers of private savings" (June Minutes). As of November 5, the FCIC-2 line reached usage of $5.1 billion (Exceptional Measures).

The special asset purchase program allows the acquisition of bonds from eligible issuers to reactivate the bond market and reduce long-term borrowing costs (June Minutes). As of November 5, the program reached cumulative purchases of $3.1 billion (Exceptional Measures).

The CBC also established in March a program to purchase bank bonds to reduce the cost of long-term funding. The program is not limited to Open Market Operations System (SOMA) participants and can be used by other market agents such as pension fund managers, mutual funds, and life insurance companies (FSR 1). Initially, the CBC limited the program to $4 billion. It extended the program a couple of weeks later to $8 billion and eliminated the maturity constraints of the eligible instruments (March 31). As of November 5, the bank bond purchase program reached cumulative purchases of $3.8 billion (Exceptional Measures).

Figure 4: Bank Bond Purchase Program



Source: Central Bank of Chile (Exceptional Measures, Sep. 3 presentation)

On August 6, Chile's Congress approved a law to allow the CBC to buy bonds issued by Chile's Treasury in the secondary market. As of September 16, the measure had not been used. It was considered a source of additional liquidity if necessary (Sep 16).

To increase liquidity of local markets in domestic and foreign currency, the CBC reactivated foreign exchange interventions for up to $20 billion, split between repo operations (REPO) and the foreign exchange (FX) swap program (CBC March). Last year, the CBC had launched these programs and sold $7 billion in U.S. dollars between December 2019 and January 2020 to help boost the exchange rate (Sep 16). However, the currency fell in January and the CBC stopped the program. Due to the COVID-19 crisis, the CBC reactivated it in March until January 2021 (CBC FX). The CBC also extended a foreign currency sales program through January 2021. It includes longer maturities for Chilean peso and U.S. dollar liquidity programs (FSR 1).

The CBC has signed international financing lines with the IMF, the U.S. Federal Reserve (Fed), and the People's Bank of China to strengthen its liquidity position in foreign currency and to allow it to handle potential capital outflows in the event of a severe shock. In May, the IMF approved a $23.9 billion Flexible Credit Line (FCL) to Chile. The IMF stated that "Chile qualifies for the FCL by virtue of its very strong fundamentals, institutional policy frameworks, track record of economic performance and policy implementation and commitment to maintain such policies in the future" and that Chile intends "to treat the arrangement as precautionary financing" (May 29). In June, the CBC received access to the U.S. Fed's Temporary Foreign and International Monetary Authorities (FIMA) Repo Facility. The line allows the CBC to have flexibility in conducting currency swaps. In July, the CBC increased its bilateral renminbi/Chilean peso currency swap with the central bank of China from 22,000 million renminbi to 50,000 million renminbi ($7.1 billion). The agreement was originally signed in 2015 and renewed in 2018.

On July 8, Chile's Congress approved the withdrawal by individuals of 10% of their pension funds. The CBC later said that the resulting change in pension fund portfolios might increase market volatility. It said it would intensify its monitoring of local money and fixed-income markets and consider activating special operations if necessary (July 23).

The CBC implemented two additional measures on July 8. First, it introduced the cash purchase of bank bonds with joint and simultaneous sale (CC-VP) for up to $10 billion. Through the CC-VP, the CBC carries out direct cash purchase of bank bonds, and jointly and simultaneously, sells instruments of the same type at a term of one or three months to the same counterparty. Second, it introduced the direct purchase through the window of bank deposits for up to $8 billion. As of November 5, The CC-VP program held cumulative purchases of $5.5 billion and an outstanding amount of $1.8 billion. The purchase of bank deposits has been low at about $250 million (Exceptional Measures).

In September, the CBC indicated that it was achieving the intended objectives of these programs. The CC-VP and the purchase of bank bonds with a premium succeeded in keeping financial markets stable, despite enormous portfolio changes and large asset liquidations by pension funds. The CBC argued that low interest rates, combined with the exceptional measures to provide liquidity, have been a significant driver of credit growth (September Minutes). The CBC said it will continue with the asset-purchase program (October Minutes).

The CBC said in its Financial Stability Report released on November 11, that "notwithstanding the contribution of the policy measures mitigating the effects of the pandemic, the maneuvering margins have tightened." And "although an increase in lending has been essential to face the immediate impact of the pandemic, the higher leverage and lower capital margins make firms and lenders more vulnerable under more stressed scenarios" (FSR 2). CBC's President Mario Marcel stated that the measures have been effective and that the worst was avoided. However, the emergency is not over and there is still a long period of recovery in which there are significant risks to financial stability (Nov 13).

The following Figure 5 and 6 summarizes information on the CBC's extraordinary liquidity measures to date.

Figure 5: Usage of Central Bank of Chile Extraordinary Measures (USD millions)

Purpose	Program	Program Amount	Total amount since announcement

			(as of Nov 5, 2020)
FX Intervention	FX Spot	10,000	-
	NDF (Non-deliverable Forward)	10,000	36,090
	FX Swap	4,000	2,493
Foreign Exchange Liquidity	REPO		6,611
Domestic Currency Liquidity	CBC Debt Buyback	8,514	6,218
	Bank Bonds Purchases (Start date March 20, 2020)	8,000	3,863
	Special Assets Purchases (Start date June 22, 2020)	8,000	3,145
	CC-VP Cash purchase of bank bonds with joint and simultaneous sale (Aug 3, 200)	10,000	5,552
	Deposits Purchases (Aug 7, 2020)	8,000	250
Domestic Currency Liquidity with Credit Expansion Incentives	Facility of Credit Conditional on Lending Increase (FCIC 1) - Liquidity Credit Line (LCL) (Start date March 30th, 2020)	24,000	24,002
	Initial Line 3%	4,800	5,034
	FCIC usage		1,697
	LCL usage		3,337
	Additional Line 12%	19,200	18,968
	FCIC usage		15,368
	LCL usage		3,600

FCIC-2	16,000	5,115

Source: Central Bank of Chile (Exceptional Measures, Sep 16)

Figure 6: Timeline of Chile's central bank liquidity measures

Date	Action
Mar. 12	The central bank of Chile (CBC) foreign exchange interventions were reactivated until January 2021, for up to $20 billion split between the REPO and FX Swap program (CBC FX).
Mar. 16	The CBC in a special monetary policy meeting cut the monetary policy rate (MPR) from 1.75% to 1% (Mar 16). The CBC announced exceptional measures in the order of 10% of GDP: The Facility of Credit Conditional on Lending Increase (FCIC) and the Liquidity Credit Line (LCL) were established for commercial banks to encourage lending to households and SMEs. The FCIC and the LCL are similar to a repo, with terms of 4 years and 2 years, respectively. Banks can access up to $24 billion through the FCIC, the LCL or a combination of both. The FCIC is capped at 15% for each bank's baseline portfolio which is the sum of commercial and consumer loans. The LCL is limited by the average cash reserves in Chilean currency of each bank. The required provision of eligible collateral included government bonds, bank and corporate bonds, and high-quality commercial loans. The Bank bonds purchase program was established for Open Market Operations System (SOMA) participants for up to $4 billion.
Mar. 31	The CBC cut the MPR from 1% to 0.5%, its "technical minimum." The Bank bonds purchase program for Open Market Operations System (SOMA) participants of up to $4 billion was expanded to $8 billion and maturity constraints of eligible instruments were eliminated (Mar 31).
Apr. 28	The Small Business Guarantee Fund (FOGAPE) was expanded with additional contributions of up to $3 billion (1.2% of GDP) to enable the provision of credit guarantees of up to $24 billion (10% of GDP). This allows banks to lend to companies with annual sales of up to $33.5 million (Apr/28).
May 6	Eligible collaterals for the FCIC were expanded to include high-quality commercial loans—A1 to A3 buckets (Exceptional Measures).

May 29	The IMF approved a $23.9 billion Flexible Credit Line (FCL) to Chile, which Chile intends "to treat the arrangement as precautionary financing" (May 29).
	The CBC stated that "it will maintain a high monetary impulse for a prolonged period of time. It kept the MPR at 0.5% and said that "it will keep the MPR at its technical minimum over the entire projection horizon."
	The use of non-conventional instruments was expanded for an additional 10% of GDP to bring the total liquidity injection to 20% of GDP.
June 16	Phase 2 of the FCIC contemplates an additional $16 billion for 8 months. It strengthened incentives to lend to SMEs and to non-banking credit providers.
	The $8 billion special asset purchase program launched for a period of six months allows the acquisition of bonds from eligible issuers to reactivate the bond market and reduce long-term borrowing costs.
	The CBC stated that "if economic developments so require, it will continue to explore options to intensify the impulse and support financial stability, using unconventional instruments (June 16).
June 24	The CBC received access to the U.S. Federal Reserve's Temporary Foreign and International Monetary Authorities (FIMA) Repo Facility. This facility allows the CBC to have flexibility in conducting currency swaps.
July 24	The CBC increased its bilateral renminbi/Chilean peso currency swap with the central bank of China from 22,000 million renminbi to 50,000 million renminbi ($7.1 billion).
Aug. 8	Chile's Congress approved a law to allow the CBC to buy bonds issued by Chile's Treasury in the second market (Sep 16).
Sep. 1	The CBC maintained its MPR at 0.50% and specified that "it expects the MPR to remain at its minimum level over much of the two-year monetary policy horizon and will maintain the unconventional measures now in place" (Sep 1).
	The CBC's September Monetary Policy Report (IPoM) improved previous estimations and now expects GDP to fall between 4.5% and 5.5% in 2020.
Oct. 15	The CBC maintained its MPR at 0.50% and exceptional measures in place (Oct 15).