

The Great Financial Crisis Aftermath, Unconventional Monetary Policy and Capital Inflows

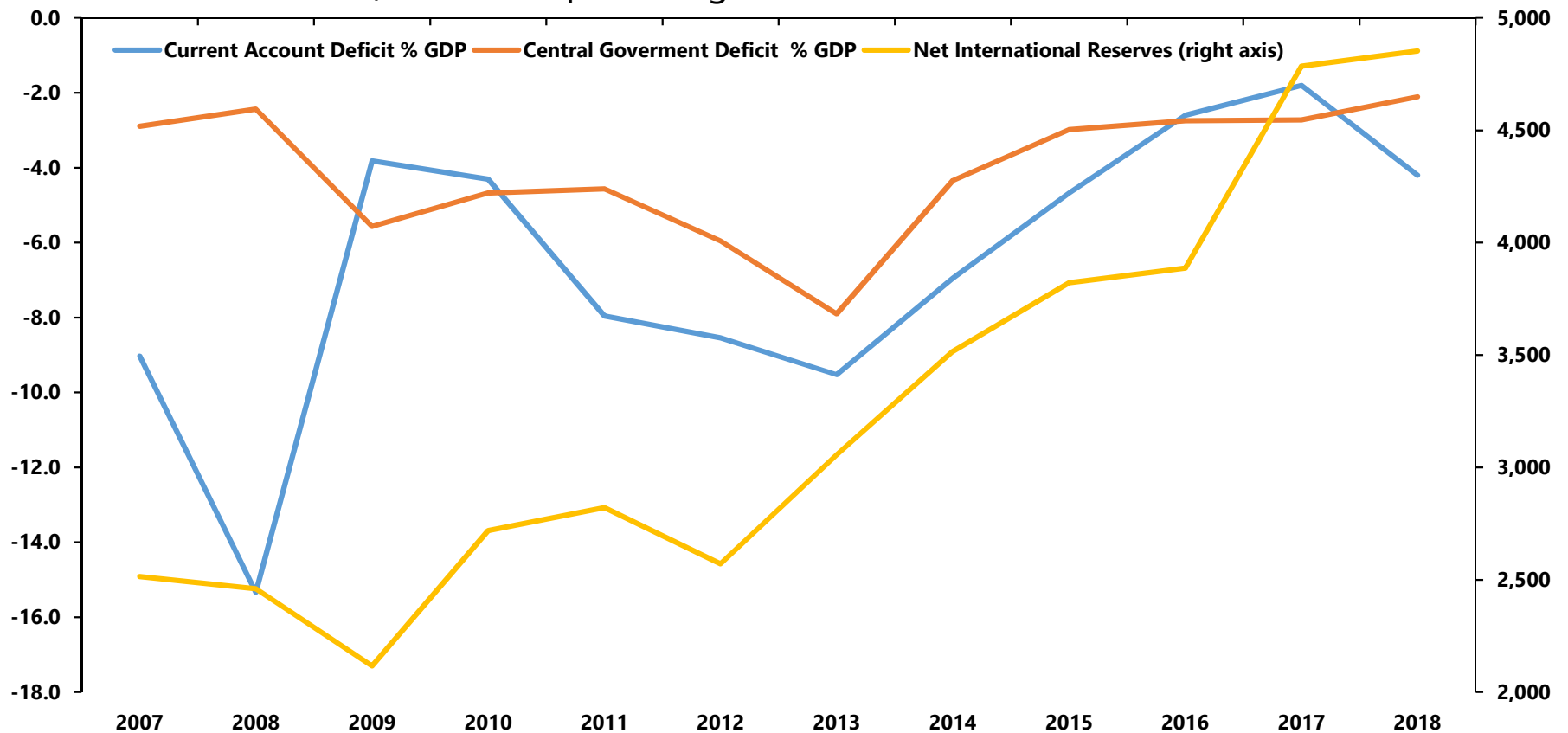
**XV Meeting of Monetary Policy Managers CEMLA-Banco
Central de República Dominicana**

Santo Domingo, Dominican Republic, September 26-27, 2019.

Background

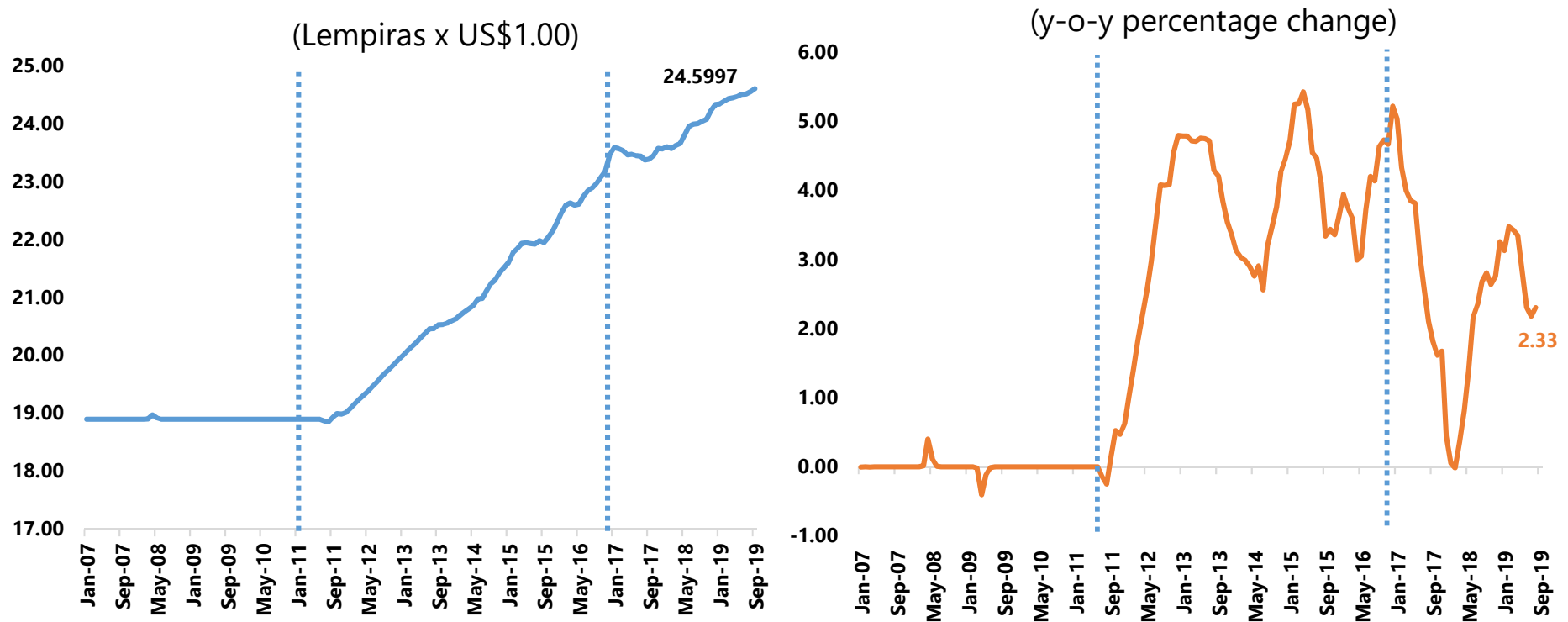
- ✓ The current policy framework is a “crawling peg”, in which the monetary authority purchase and sells currencies to keep the exchange rate in a defined range; however, it also includes elements corresponding to a framework of monetary aggregates.

Fiscal Deficit, Current Account and Net International Reserves (Deficit as a percentage of GDP and NIR millions of US\$)



How the exchange rate regime changed after the international financial crisis?

- ✓ Between May 2005 and July 2011 the exchange rate remained fixed. In August 2011, the BCH reactivated the exchange rate band ($\pm 7.0\%$), which is guided by the base price established by the monetary authority.
- ✓ Additionally, a mini roof was established through which the offer prices for currency purchases should not be greater than 1.0% of the average base price in force in the verified auctions in the previous 7 business days.
- ✓ Then in 2017 the BCH decided to progressively develop the interbank currency market.




Note: Data updated in september 19, 2019.
Source: BCH.


How the Base Price is determined?

- **The BCH determines a value for the base price or central value of the band, based on the following criteria:**

- **The differential between the internal inflation rate and the external inflation rates of the main trading partners of Honduras.**



- **The evolution of the nominal exchange rates of the main trading partners with respect to the United States dollar.**

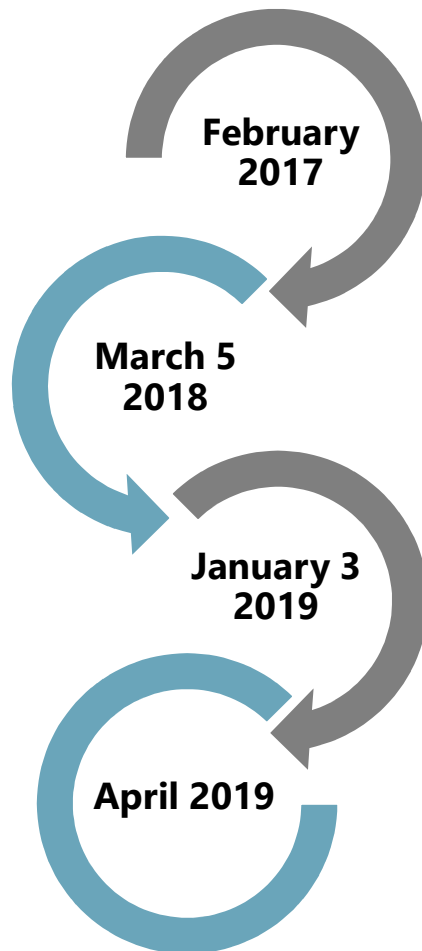


- **The behavior of the official reserve assets depending on the number of months of import covering the balance of the BCH Reserve Assets**

How the exchange rate regime changed after the international financial crisis?

HONDURAS

- The monetary policy efforts of the BCH focus on price stability and abandonment of the exchange rate as a nominal anchor, which will allow absorbing external shocks and strengthening the conduct and execution of monetary policy.
- In this regard, measures of gradual liberalization of the percentage of currency delivery to the BCH by foreign exchange agents have been adopted:



- The Regulation for the Negotiation in the Organized Foreign Exchange Market and its complementary regulations entered into force, in which the requirement of delivery of foreign currency by the exchange agents was established at 90%, and that the remaining 10% will be used for payments of own expenses and sales in the MID.
- The requirement of delivery of currencies is reduced from 90% to 80%, establishing that the remaining 20% can be negotiated in the MID for the payment of own expenses and for sales per client of the private sector for amounts less than US\$ 40,000 daily.
- According to the agreement No. 01/2019, the Reference Exchange Rate will be the weighted average of the prices resulting from the last event of the Currency Auction and the MID; Those modification came into effect on February 19, 2019.
- Negotiation in the MID within a band of $\pm 1.0\%$ with respect to the Base Exchange Rate.
- In April 1, 2019, the requirement for delivery of foreign exchange to the BCH is reduced, allowing exchange agents to negotiate 30.0%.

How the exchange rate regime changed after the international financial crisis?

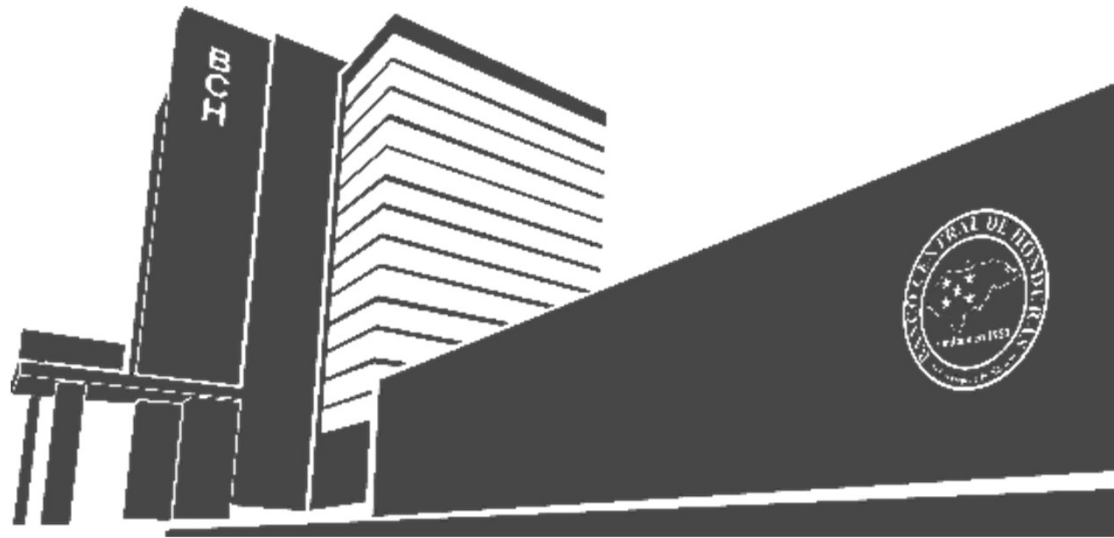
HONDURAS



- In July 1, 2019, the requirement for the delivery of foreign currency to the BCH is reduced, allowing exchange agents to negotiate 40.0%.
- Likewise, the Rules of Participation of the BCH in the purchase and sale of currencies in the MID are approved.

The progressive decrease in the requirement of currency deliveries by agents, continues to be a preliminary stage towards the flexibility that would generate the following benefits:

- ✓ **The flexibility of the exchange rate is a step towards migrating to a more robust monetary policy framework (Inflation Targeting).**
- ✓ **Honduras has high exposure to external shocks, particularly in terms of trade; A more flexible exchange rate will allow quick adjustments to relative prices, reducing product volatility and inflation.**
- ✓ **The exchange rate will strength the transmission mechanism of the monetary policy of the BCH.**
- ✓ **The transfer to domestic prices would be expected to decrease.**



The “Taper Tantrum” and Capital Outflows

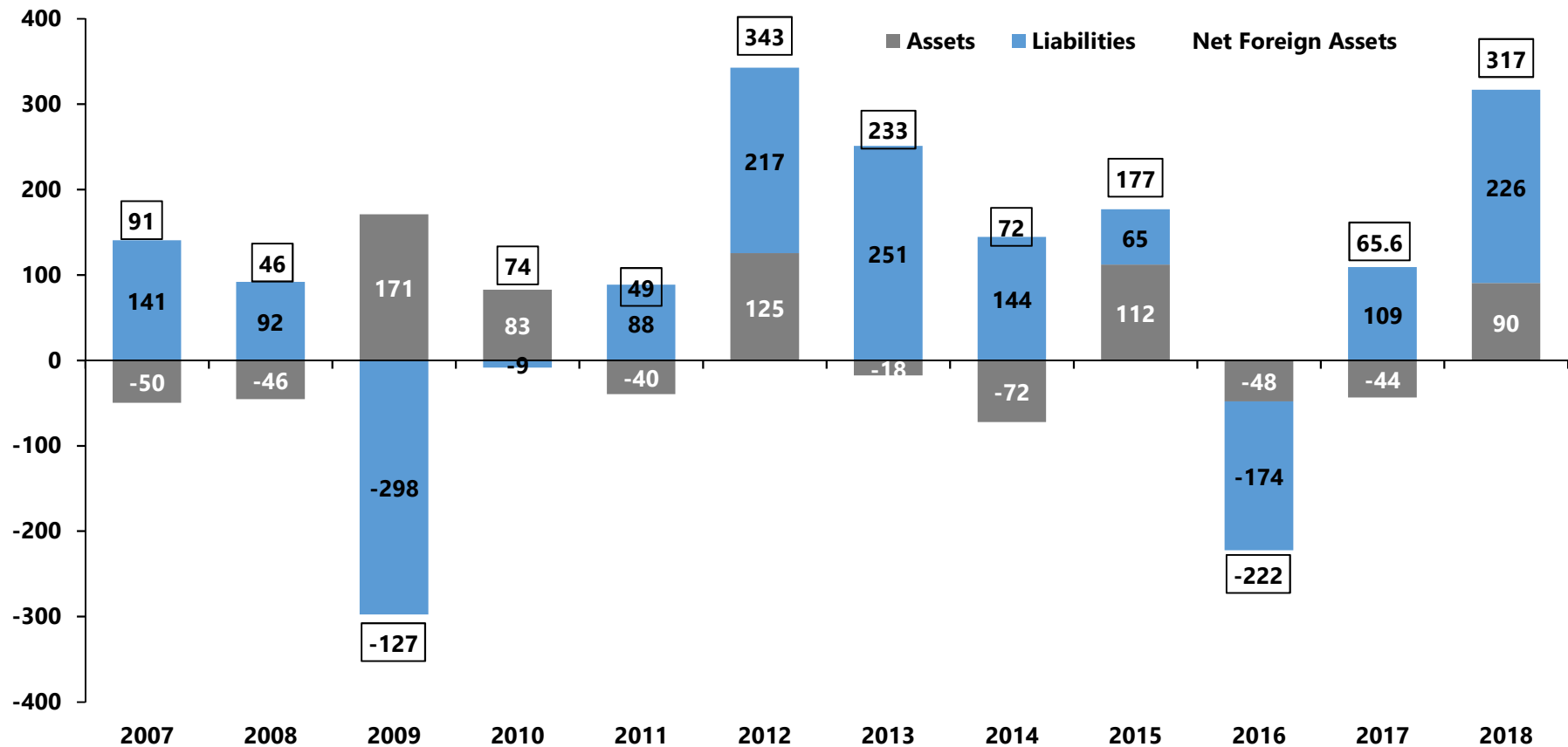
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Net Foreign Assets

- The exchange framework does not allow free capital mobility.
- The financial flows of the Honduran economy are financed mainly with Foreign Direct Investment and Government Loans
- After the Taper Tantrum there was no capital outflow.

Net Foreign Assets of the OSD
(accumulate flows in millions of US\$)

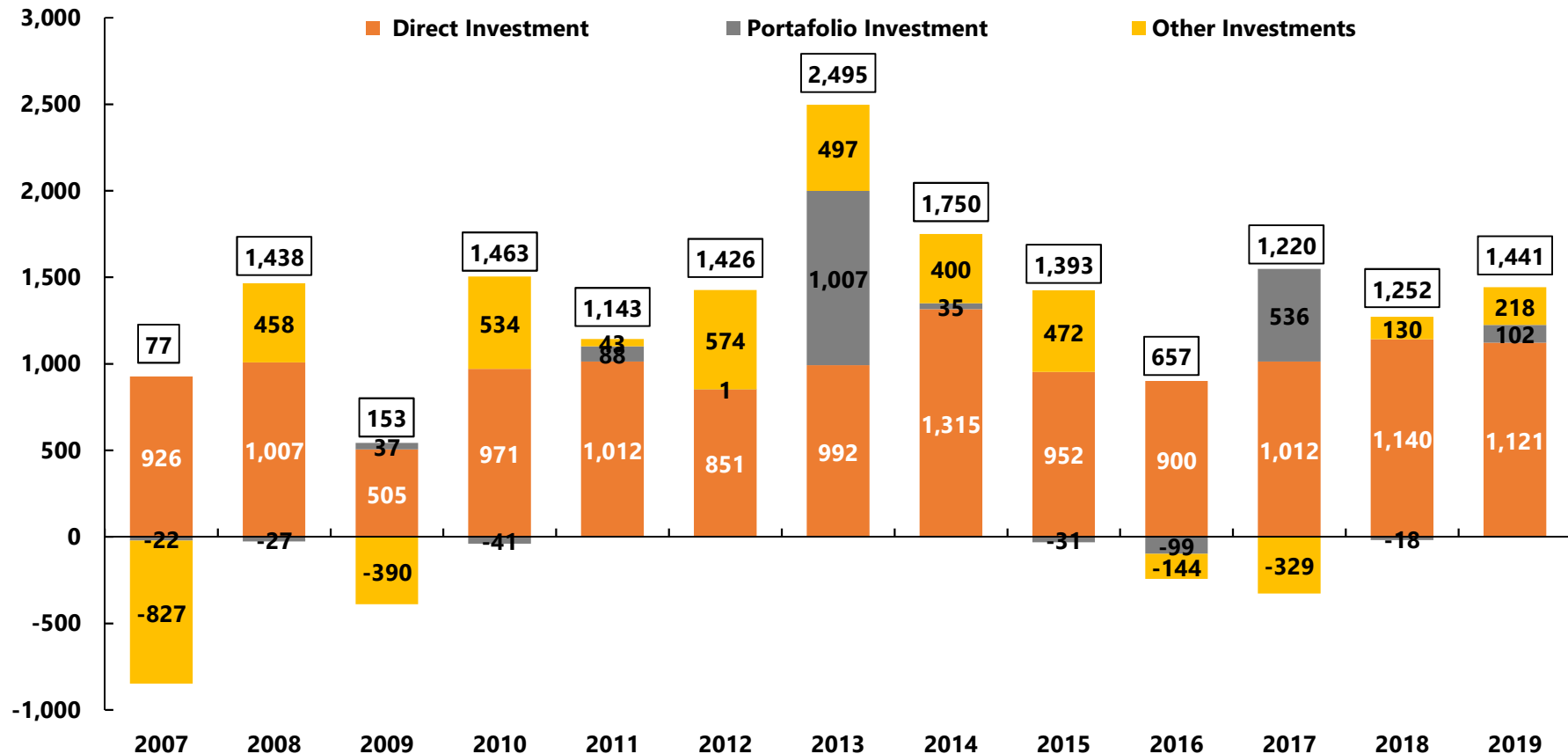


Source: BCH.

Financial Account

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Financial Account
(flows in millions of US\$)

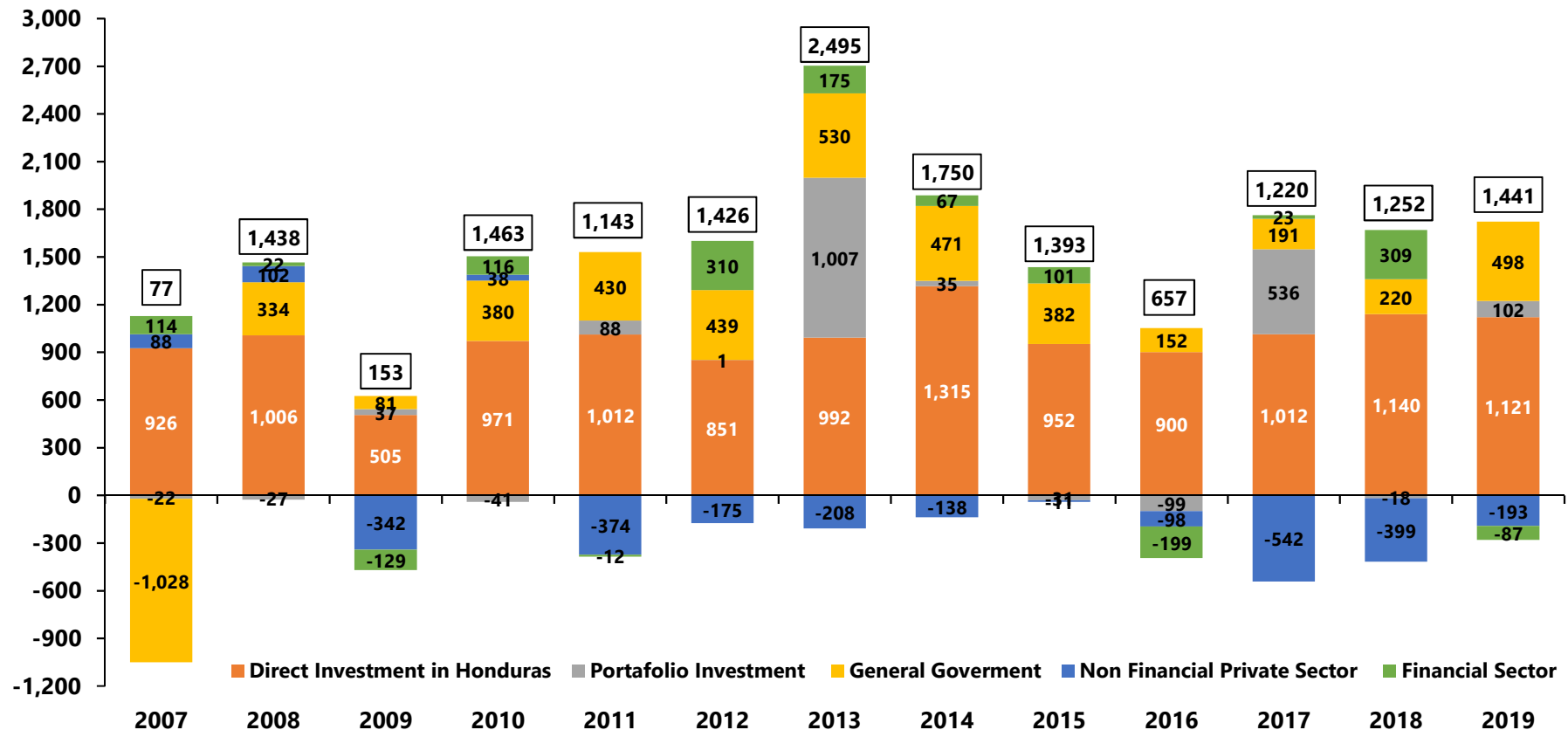


Source: BCH.

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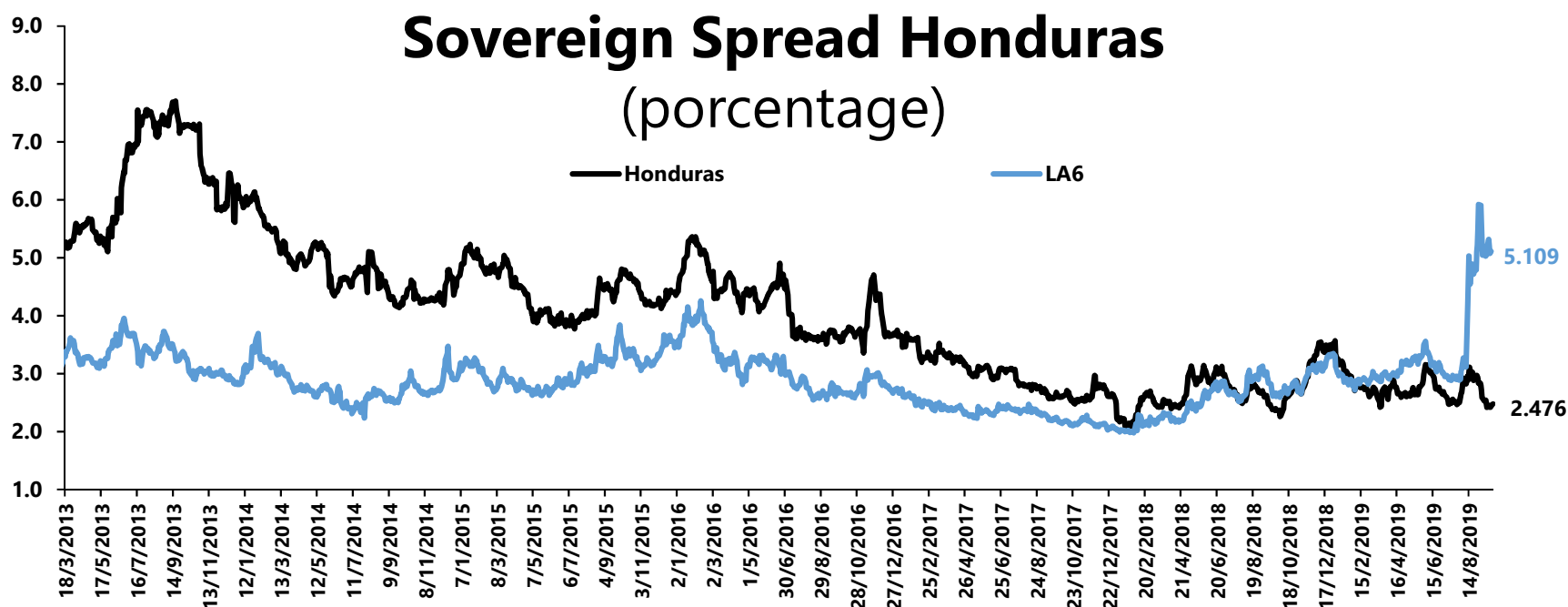
Financial Account
(flows in millions of US\$)



Source: BCH.

Sovereign Spread Honduras

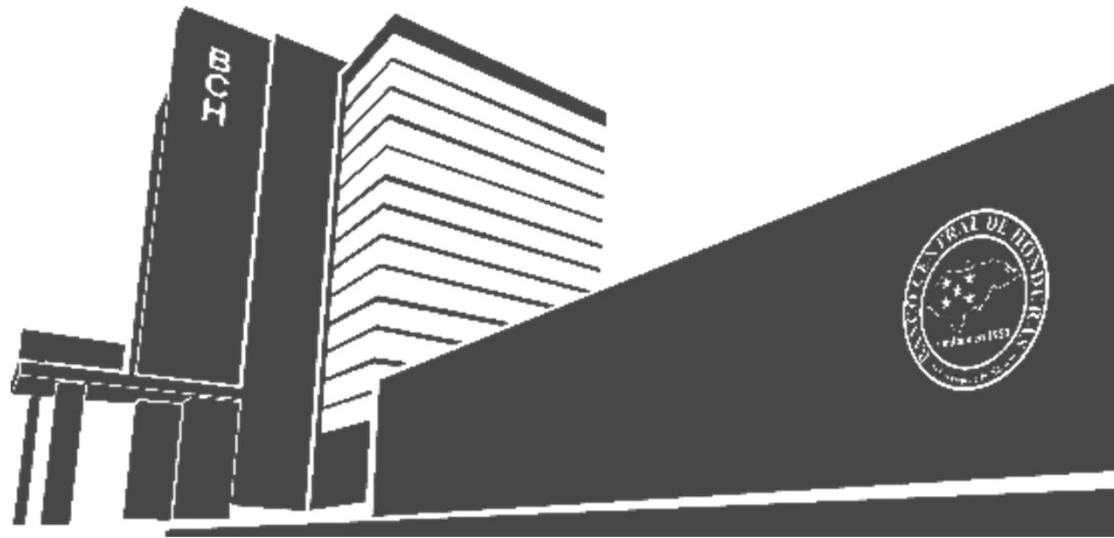
- In September 23, 2019, the sovereign spread of Honduras dropped 1.04 percentage points (pp) compared to the end of 2018; also, since the end of August of this year there has been a decrease in the spread respect to the upward trajectory registered at the end of July 2019.
- On the other hand, the increase observed since August in the risk premium of the largest economies in Latin America has begun to decline due to:
 - Relief in the financial market after the president of Argentina announced a series of exchange restrictions to curb the scolding of the dollar price.
 - Lower commercial tensions following the announcement of a meeting in October 2019 between US and China.
 - In the FED meeting of September 2019, the board decided to reduced the interest rate, placing it between a range of 1.75% -2.00%.
- On the other hand, volatility continues in the financial markets due to the projected slowdown in global economic growth for 2019-2020.



Source: Bloomberg y J.P. Morgan (Emerging Markets Bonds Index "EMBI").

Note: Honduras data corresponds to september 17,2019, while those from LA6 to 13 of the same month.

LA is the average of Argentina, Brasil, Chile, Colombia, México y Perú.



A low interest rates environment and EMEs policy outlook

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The main trade offs faced in your monetary policy

- The main economies have begun to lower their reference rates due to the slowdown in global economic growth, the uncertainty of trade policy and geopolitical risks.
- In accordance with the interest rate parity approach, estimates rates indicates that the monetary policy stance of the BCH is slightly restrictive.
- The most recent medium-term inflation forecasts indicate that inflation would be close to the midpoint of the tolerance range by the end of 2019; However, in the remainder of the forecast horizon it would be below 4.00%, mostly explained by lower inflationary pressures due to aggregate demand.
- However, some supply shocks experienced in the Honduran economy (increase in the cost of electricity) led that economic agents expectations located close to the maximum limit of the tolerance range, affecting a restrictive policy stance, even though the last forecasts for two quarters before indicates a downward trajectory of the TPM in the policy horizon.

The main trade offs faced in your monetary policy

Calculation of the Neutral Interest Rate (percentage)

		Past COMA	Actual	Differences
1	Real depreciation (July 2019)	-1.61	-1.91	0.30
2	Honduras Inflation Target	4.00	4.00	0.00
3	US Inflation (projection corresponds to the end of 2019, WEO FMI)	2.00	2.00	0.00
4= 1+2-3	Nominal depreciation in 2019	0.39	0.09	-0.30
5	US interest rate target (position of the Fed for the closing of 2019)	2.13	1.63	-0.50
6	Honduras Sovereign Spread (weighted average as of August 30, 2019)	2.60	2.83	0.23
7= 4+5+6	Domestic nominal neutral monetary policy rate	5.12	4.55	-0.57
8	Prize between the monetary policy rate and the interbank rate (August 2019)	0.36	0.31	-0.05
9=7-8	Domestic nominal neutral monetary policy rate (adjusted by interbank differential)	4.76	4.24	-0.52
10	Actual monetary policy rate	5.75	5.75	0.00
11=10-9	Interest rate gap	0.99	1.51	0.52

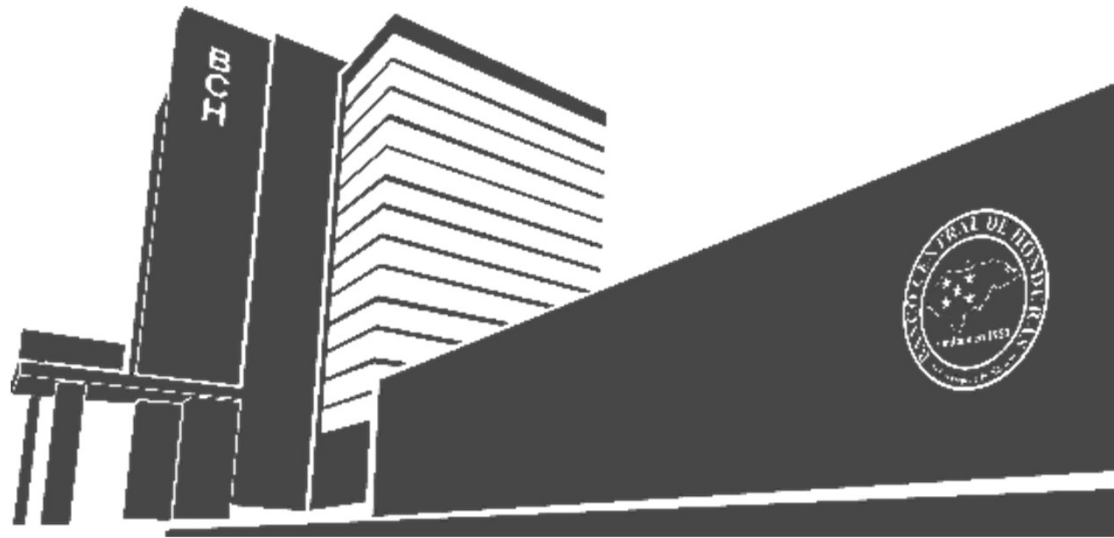
Note: Methodology based on the definition of real exchange rate and discovered interest rate parity.

$$\Delta s_t = \Delta z + \pi^T - \bar{\pi}^*$$

$$0.09 = -1.91 + 4.00 - 2.00$$

$$i_t = \Delta s_t + i_t^* + prem$$

$$4.55 = 0.09 + 1.63 + 2.83$$



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