Monetary Policy, Risk-Taking, and Pricing: Evidence from a Quasi-Natural Experiment

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Presented at the 9th Jacques Polak Annual Research Conference
Hosted by the International Monetary Fund
Washington, DC—November 13-14, 2008

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Comments

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November 13, 2008
This paper examines the relationship between the risk-taking behavior of banks and monetary policy.

It concludes that banks’ risk-taking increases during periods of monetary expansion, but fail to adjust loan terms to fully account for the additional risk.

But risk-taking is an important component in economic activity and a natural outcome of declining interest rates.

Risk-taking becomes a major policy concern when it is excessive because macroeconomic stability is at stake.
The real challenge lies then in identifying excessive ex-ante risk-taking and defining an adequate policy response to deal with it.

But risk is fully appreciated only in hindsight, and there is always a risk of interpreting ex-post outcomes as known ex-ante information.

The paper assesses ex-ante banks’ risk attitude from examining ex-post loan performance.

Ex-post performance may be severely affected by simultaneity problems, even after controlling for borrowers’ past performance at origination.
In 2000 and 2001 the Bolivian government introduced two programs: ("Programa de Reactivacion Economica" and "Fondo Especial de Reactivacion Economica").

Both programs provided financing to banks that restructured their loans to troubled debtors.

The restructuring would entail lengthening maturity, reducing the interest rate, and introducing grace periods for capital repayments.

By early 2003, 36 percent of total banks’ credit portfolio had been restructured, and 20 percent of the restructured amount was already non-performing.
Excessive risk-taking may manifests itself through asset price bubbles and lending booms.

But between 1999 and 2003 bank credit was shrinking in Bolivia.
1. Conclusion regarding risk-pricing may be affected because of loan restructuring programs.

2. Other variables (most notably collateral) that can be adjusted to mitigate risk do not play a role in the authors’ analysis of risk-pricing.
Interest rates

Fed Funds Rate and Bolivian US-dollar Interbank Rate

Fed Funds Rate

Bolivia US$ interbank rate

The paper has found a link between monetary policy and banks’ risk-taking attitude.

This link seems to be in line with intuition and not necessarily harmful from a macroeconomic stability point of view.

From a policy perspective, more research is needed to know when this becomes a problem, and how we should react to it.