MONETARY POLICY MEETING

October 2023

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Minutes of monetary policy meeting No. 301, held on 25-26 October 2023.

Present: Rosanna Costa, Governor; Pablo García, Vice-Governor; Alberto Naudon, Board member; Luis Felipe Céspedes, Board member; Stepanka Novy, Board member.

Present the Finance Minister, Mario Marcel.

Also present: Juan Pablo Araya, Legal Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Ricardo Consiglio, Financial Markets Division Director; Rosario Celedón, Financial Policy Division Director; Gloria Peña, Statistics and Data Division Director; Michel Moure, Institutional Affairs Division Director; Diego Ballivián, Corporate Risk Division Director; Markus Kirchner, Macroeconomic Analysis Manager; Enrique Orellana, Monetary Policy Strategy and Communication Manager; Lucas Bertinatto, acting International Analysis Manager; Sofía Bauducco, Economic Research Manager; Felipe Musa, Market Operations Manager; Juan Carlos Piantini, Strategic Business Manager; Miguel Fuentes, Financial Stability Manager; Silvana Celedón, Communications Manager; Andrés Sansone, Advisor to the Finance Minister; Erika Arraño, Senior Economist; Marlys Pabst, Secretary General.

1. Background

The international scenario

On the external front, the main development had been the tightening and volatility of global financial conditions. This was associated with, among other factors, the dynamic performance of the U.S. economy. —with its implications for the future evolution of U.S. inflation— and a scenario of looming doubts about the country's fiscal performance. Another factor had to do with geopolitical conditions. This contrasted with the situation in the rest of the world, where an important group of economies remained weak in both their actual and expected performance, including China.

In this context, U.S. long-term interest rates had risen significantly, which had been transmitted to the rest of the economies. In fact, 10-year US Treasury rates had risen by nearly 70 basis points (bp) since the last meeting, to decade-long highs. This increase was largely explained by a decompression of term premia, associated partly with a market reassessment of the U.S. fiscal outlook.

In addition, the Federal Reserve (Fed) had strengthened its message of prolonged monetary tightening and did not rule out further hikes in the federal funds rate. The outlook for monetary policy in developed and emerging economies had also tightened. All these factors combined had led to a global appreciation of the dollar and a negative correction in stock markets.

Commodity prices had shown mixed movements. The recent escalation of global geopolitical risks, together with the announcements of OPEC+ production cuts, had increased the volatility of the oil price, which was trading at around US$87 per barrel in the days prior to the meeting (Brent-WTI average). Copper had fallen to US$3.6 per pound, in line with the global appreciation of the dollar. Food prices had continued their downward trend, although the rise in certain production costs and the effects of the El Niño phenomenon posed upside risks.

The domestic scenario

Inflation had continued to decline. Compared to expectations in the last Monetary Policy (MP) Report, a faster fall was observed in core inflation —which excludes volatiles—, particularly in its goods component. This was partially offset by volatile inflation, which had surprised slightly upwards since then. In September, total and core CPI had reached annual variations of 5.1% and 6.6%, respectively. As for two-year inflation expectations, in both the Economic Expectations Survey (EES) and the Financial Traders Survey (FTS) they remained at 3%.

Activity continued to evolve in line with forecasts in the central scenario of the September MP Report. In August, the seasonally-adjusted total and non-mining Imacec had fallen compared to previous month, due to one-off factors that had affected educational services. On the demand side, data on retail sales, imports of construction materials and capital goods, among others, again showed weak consumption and investment. In any case, some related indicators had performed somewhat better than expected.

The labor market had weakened further, mirroring the evolution of the business cycle. The unemployment rate had risen to 9% in the moving quarter ending in August. Real wage growth remained at around 2.5% per year. All this occurred within the context of still pessimistic household and business confidence.

The local financial market had reacted to the movements of its global peers. Long-term interest rates in the fixed-income segment had increased, while the IPSA accumulated losses. The peso had depreciated by around 9% from the previous meeting. Regarding credit, the third quarter Bank Lending Survey (BLS) reflected that credit demand continued to deteriorate in some segments, consistently with the deceleration of credit flows in several portfolios, especially toward firms. The BLS reported no significant change in supply conditions. Interest rates on commercial loans —more closely related to monetary policy decisions— showed decreases, while housing interest rates —linked to long-term rates— were on the rise.

For this meeting, the median of both the EES and the FTS showed an expected reduction in the monetary policy rate (MPR) of 75bp. MPR expectations for the end of this year stood at 8% in the case of the EES and at 8.25% according to the FTS. Financial asset prices also revealed an 8.25% inflation expectation.

2. Background analysis and discussion

Locally, it was noted that the information at hand showed that the macroeconomic scenario was evolving in line with expectations. About activity, there were occasional and transitory deviations, while the sectors most related to consumption continued to show signs of stabilization. At the same time, the CPI accumulated a somewhat smaller-than-expected increase, mainly in the non-volatile goods component. This difference could be linked to the exchange rate appreciation of previous quarters, whose effects still dominated over those of the most recent depreciation. However, these trends were expected to change in the months ahead.

There was agreement that the most relevant economic development was the tightening of international financial conditions. The discussion focused on how this situation would impact the Chilean economy. It was noted that, among other factors, this would depend on the persistence and possible intensification of these phenomena, which, in turn, would be related to their origin. With respect to the latter, some hypotheses were brought up. One of them was the possible effects of a more complex inflationary problem in the U.S., where monetary and fiscal policy issues could be intertwined. Whatever the case, higher real interest rates and inflation premiums were to be expected, both of which, to a greater or lesser extent, were being observed in the data. Other hypothesis to explain the rise in real rates was the decompression of term premia. There was ample evidence that a combination of regulatory, economic and financial factors had meant that, since the Global Financial Crisis, demand for government securities had increased. For this reason, investors were willing to pay a higher premium than usual to hold these instruments, which had caused rates to fall sharply in the U.S. The question was whether this phenomenon was slowing and thus pushing up long-term rates. A third hypothesis pointed to deeper factors, related to the global savings-investment balance, which could be affecting the neutral or more structural levels of long-term rates.

There was also consensus that each of these hypotheses would have different consequences for the global macroeconomic scenario and for Chile in particular, so their relevance and effects should be carefully analyzed. In any case, it seemed reasonable to think that long-term interest rates would remain high for quite some time. In this context, everything seemed to indicate that financial conditions for Chile would remain stressed for a prolonged period and that the risks of disruptions in global financial markets would also be higher than usual.

The impact that external phenomena were having on the local financial market was underscored. Among other things, the increase in the cost of medium and long-term financing for all types of agents, the fall of the stock market and the depreciation of the peso drew special attention. Regarding the latter, it was mentioned that the increase in the peso/dollar parity exceeded what was observed in other comparable economies, without there being a single hypothesis regarding the reasons for this sharper reaction of the Chilean peso. It was mentioned that there could be risk factors associated with the expected trajectories of monetary policy in Chile and the U.S. and the reduced presence of some important players in the forex market. Meanwhile, it was not obvious that the reserve replenishment program and the process of reducing the NDF position were affecting the level of the exchange rate in a relevant way, although, given the volatile external conditions, it was indicated that some effect on the functioning of the exchange rate market could not be ruled out. In this context, a precautionary attitude would be advisable. With respect to the financial considerations of the peso depreciation, it was noted that the available information showed that the exchange rate mismatches were being well managed by private agents.

3. Analysis of monetary policy options

All five Board members recalled that the monetary policy strategy defined at the previous meeting indicated that: (i) if the central scenario were to materialize, in the short term the MPR would be reduced further; (ii) the magnitude and timing of the MPR cut process would take into account the evolution of the macroeconomic scenario and its implications for the path of inflation; (iii) the Board would act with flexibility in case macroeconomic conditions so required. In this context, the Board evaluated lowering the MPR by either 50bp or 75bp.

They all coincided that the local activity and inflation scenario showed little change with respect to forecast, although the non-volatile component had fallen somewhat faster than projected. Regarding external developments, in the immediate future, an inflationary impact was to be expected due to the price rise of some commodities and the higher exchange rate. However, if the tightness of external financial conditions persists, the medium-term effects on activity and inflation would be negative.

There was agreement that the recent behavior of the exchange rate, marked by greater sensitivity to news and greater volatility, reflected several elements. On the one hand, Chile was further ahead than other economies in the inflationary convergence process and, consequently, the prospects were that the MPR reduction process would continue. It was added that the Fed had increased its hawkish tone. This change in the rate differential was generating uncertainty in a market where some medium and long-term investors were less present. All this was reflected in an increase in the exchange premium and the sensitivity of the exchange rate. In that context, an additional degree of prudence could help reduce the possibility of facing short-term financial stress.

In any case, the Board considered that was essential to have more clarity on the evolution of recent macro-financial developments, to deepen their understanding of the underlying factors of inflation and its persistence, as well as their possible contractionary impact. All the Board members agreed that at this point it was complex to assess the balance of these impacts, precisely because they were unfolding and were accompanied by higher-than-usual volatility.

In this context, and with inflation still not completing its convergence process, all the Board members agreed that it was necessary to continue with the cycle of MPR cuts, although this time around it was advisable to do so at a somewhat slower speed, which was well represented by a 50bp reduction. There was consensus that the December MP Report, where the complete macroeconomic scenario would be reviewed, would be the appropriate occasion to give guidelines on how the process of lowering the MPR would go on.

Finally, the Board emphasized that the objective of monetary policy was the inflation, and its instrument was the MPR. It was reiterated that this not mean that the exchange rate did not have an important role in the inflation targeting framework, since it was a relevant price in the economy, whose movements could have significant effects and which also provided valuable information on how things were going in the macroeconomic and financial scenario. It was added that, in no case would this imply that monetary policy or the reserve hoarding policy would target an exchange rate level. Although on some very special occasions massive exchange rate intervention measures had been implemented, this was not the case at this point.

4. Monetary policy decision

Governor Costa, Vice-Governor García and Board members Naudon, Céspedes and Novy voted for lowering the monetary policy interest rate by 50 basis points, to 9%.

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