Monetary Policy Meeting[1]

MAY 2020

CENTRAL BANK OF CHILE

[1] This is a translation of a document originally written in Spanish. In case of any discrepancy or difference in interpretation, the Spanish original prevails. Both versions are available at www.bcentral.cl

MINUTES OF THE MONETARY POLICY MEETING

Monetary policy meeting No. 273, held on 5 and 6 May 2020.

Present: Mario Marcel, Governor; Joaquín Vial, Vice-Governor; Pablo García, Board member; Alberto Naudon, Board member; Rosanna Costa, Board member.

Present the Finance Minister, Ignacio Briones.

Also present: Alejandro Zurbuchen, General Manager; Juan Pablo Araya, General Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Beltrán de Ramón, Financial Markets Division Director; Solange Berstein, Financial Policy Division Director; Gloria Peña, Statistics Division Manager; Michel Moure, Institutional Affairs Division Director; Markus Kirchner, Macroeconomic Analysis Manager; Enrique Orellana, Monetary Policy Strategy and Communication Manager; Miguel Fuentes, International Analysis Manager; Andrés Fernández, Economic Research Manager; Diego Gianelli, Market Operations Manager; Rodrigo Alfaro, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Bernardita Piedrabuena, Corporate Risk Manager; Felipe Lozano, Communications Manager; Luis Óscar Herrera, advisor to the Finance Minister; Tatiana Vargas, Senior Economist; Pilar Cruz, Senior Economist; Marlys Pabst, Secretary General.

1. Analysis of the technical teams

The international scenario

The external scenario continued to evolve driven by the spread of the Covid-19 pandemic and the sanitary control measures adopted by governments around the world. The first release of first-quarter GDP growth figures confirmed across-the-board contractions in the major economies, with downward surprises in several of them. By components, private consumption led these falls, consistently with the deterioration of the labor market that was emerging in most countries. Partial second quarter data, such as indicators of consumer and business expectations —in services and manufacturing—, among others, suggested still weak prospects, amidst perspectives that pointed to prolonged sanitary containment practices. In this context, the set of projections by public and private organizations anticipated a global recession for this year, with downturns in activity exceeding estimates in the March Monetary Policy Report.

In the developed world, the poor performance of the US in the first quarter (-4.8% q/q annualized) stood out, as it had been far below the markets' expectations. This denoted the initial effects of the containment measures imposed since mid-March. The main Eurozone members had reported their worst results ever. Others, such as Japan and the UK, had not yet published their quarterly figures at the time of the Meeting, but data such as retail sales and manufacturing output suggested that GDP would fall sharply at the start of the year. In the emerging bloc, activity in China had fallen by 6.8% annually in the first quarter, a result that showed its first quarterly decline in recorded history, most notably the deterioration of the secondary sector (construction and manufacturing). In Latin America, the picture was very complex, amidst doubts about the management of the sanitary emergency in some countries and the prevalence of a series of socio-political hot spots.

The monetary and fiscal authorities had continued to strengthen their stimulus plans to deal with this scenario, efforts which in the aggregate would go beyond their responses to the 2008-2009 financial crisis. The aim was to limit the negative impact on the situation of firms, households and financial institutions and to underpin the recovery in the second half of the year. From the monetary standpoint, several central banks had made further cuts in their benchmark rates and incorporated/extended non-conventional measures, which included different provisions for credit support to firms, asset purchase programs, among others. Governments, meanwhile, continued to implement substantial spending packages, often focusing on protecting the workers and sectors most affected by the current contingency. Nevertheless, concerns had been raised about the effectiveness of the macroeconomic policies in place, in particular about the insufficient flow of credit to smaller firms or to the consumer credit segment, which had led to new announcements by entities such as the Federal Reserve (United States) or the Bank of England.

All these measures had helped to contain the worsening of global financial conditions during March —although a high degree uncertainty remained around health and economic matters. Thus, the world markets were reporting better stock markets, falling risk premiums, some currency appreciations against the dollar and declines in long-term interest rates in a significant group of economies. Commodity prices also showed some upturn, especially for metals. In the case of copper, its value was being supported by, among other factors, production cuts, accumulating a rise in the order of 7% with respect to the March Meeting. By contrast, the price of oil, although with major ups and downs, had fallen in the last month, severely affected by falling global demand and storage difficulties.

The domestic scenario

Locally, the fall in the March Imacec had confirmed the onset of the economic contraction caused by the health emergency, ratifying the scenario set out in the last MP Report. A negative impact was observed in many economic sectors, particularly retail, education, transportation, restaurants and hotels. The fall in capacity utilization reported in the Industrial sector stood out. Nominal exports of goods also continued to be affected, mainly industrial shipments. On the domestic spending side, different indicators showed significant deterioration. Consumer expectations (IPEC) had declined sharply, consumption of non-essential goods (INE, ANAC) and imports of consumer goods —both durable and non-durable— had contracted dramatically. As for investment, the data at hand also pointed to a significant drop. Regarding the construction and other works component, business expectations (IMCE) had deteriorated, especially in construction. The CBC's investment project census for the first quarter of 2020 reported a rescheduling of projects towards the next few years. In the machinery and equipment component, capital goods imports continued to show a steep, widespread decline. In this context, expected annual growth for this year from the April Economic Expectations Survey (EES) pointed to a contraction of 2.2%, and an important rebound in 2021 (3%).

About the labor market, various sources of information saw significant deterioration. The employment survey of the moving quarter ended in March (INE) reported an increase in the national unemployment rate and other expanded indicators[2]/. In addition, annual employment growth continued to be almost entirely accounted for by informal wage earners. Administrative data showed a significant increase in termination notices and unemployment insurance claims, which was being partially cushioned by the measures announced by the Government. This was compounded with a sharp drop in the demand for labor in April and low hiring prospects (IMCE).

In terms of qualitative information, the May Business Perceptions Report (IPN) ratified many of the above-mentioned trends. In particular, the respondents reported a transversal deterioration of their business results, as well as high uncertainty about their future performance. The sectors most affected were those related to service activities (i.e. hotels, restaurants and tourism) and retail. Construction and real estate were also among the worst hit. This had paralyzed most investments and led to adjustments in the labor market —for example, by invoking the Employment Protection Law, agreeing to reductions in wages and/or working hours with their workers, or by terminating some of their staff.

[2]/ Labor potential and pressure rate. For definition, see chapter III in the March 2020 Monetary Policy Report.

Since the last meeting, domestic financial markets had replicated the positive trends in international markets, although several indicators continued to worsen compared to conditions prior to the escalating health emergency in Chile. Thus, the stock market had risen, rates for long-term instruments had fallen, money markets —especially in pesos— had become more liquid, bank spreads had fallen and the peso had appreciated against the dollar.

In the credit market, there was a significant acceleration in commercial lending during March and —according to partial data— April. Meanwhile, the annual change in the stock of consumer loans continued to shrink in March, while mortgage loans continued to grow at around 8%. Consumer and commercial interest rates had fallen, while housing rates continued to rise. As for the measures adopted by the Central Bank, commercial banks had requested around US$12 billion —close to 50% of the available funds— under the Conditional Credit Facility for Increasing Placements (FCIC), supported by the expansion of collateral. In turn, the bank bond purchase program had accumulated $3.3 billion of the up to $8 billion available, while the Central Bank's debt repurchase had reached just over $5.6 billion.

Qualitative information showed a more restrictive credit market. On one hand, the May IPN indicated an increase in the financing needs of companies. While respondents saw no major obstacles in refinancing or deferring existing loans, access to new loans was more difficult, particularly due to risk policies. On the other hand, the Bank Lending Survey (ECB) for the first quarter showed tighter credit supply conditions for firms and individuals and a perceived weaker credit demand, except for the large company segment. In any case, both large companies and SMEs perceived an increase in their need for working capital. In personal banking, weaker demand was linked to deteriorating customers' income and/or employment conditions.

Since the previous Meeting, annual inflation had fallen to 3.7% and the core measure had remained at around 2.5%. This figure had been somewhat lower than the March estimate, while the weakening of the lines most closely linked to services, stood out, which was linked to the demand that was being affected by Covid-19 containment measures. Looking ahead, medium-term inflationary pressures were still expected to be contained, in line with a greater widening of activity gaps as a result of the sanitary emergency, in addition to the fall in oil prices observed since the beginning of the year. According to some of the interviewees for the May IPN, although cost pressures linked to the pandemic and the exchange rate depreciation had increased, the transmission to prices had generally not occurred, with some exceptions. As for inflation expectations, the various indicators one-year-ahead had been adjusted downwards, most markedly

those reflected in the prices of financial assets (inflation insurance and the FBS), while at two-year horizons they remained at around 3.0%.

In this context, expectations for the monetary policy rate (MPR) implicit in financial asset prices and contained in the surveys to specialists available at the Meeting (i.e. the Financial Brokers Survey, FBS, and the Economic Expectations Survey, EES) anticipated that it would stay at 0.5% for an extended period. Both the FBS and the EES estimated that the MPR would not be raised any sooner than May 2021, while asset prices saw it rising by December that year. Two years ahead, asset prices predicted an MPR at 0.75%, while the FBS and the EES saw it at 1.25%.

2. Background analysis and discussion

In discussing the evolution of the macroeconomic scenario, the conclusion was that a deterioration was perceived with respect to forecasts in the March MP Report. On one hand, beyond the effective evolution of activity and its possible differences with projections, there were growing doubts as to how fast the economy would recover in the second half of the year, both locally and externally. In this area, not only was the evolution of the pandemic becoming a particularly relevant factor, but also the fact that in various sectors the return to previous levels of activity was complex, due to both voluntary actions of the population and behaviors induced by the authority, which would undoubtedly hold back the recovery of activity beyond earlier estimates. On the other hand, news about inflation was not encouraging either. While both short-term projections and expectations were being significantly revised downwards, largely influenced by the oil price, the foreseen weaker performance of the economy posed significant challenges to inflation convergence to the target.

The reversal of financial stress that had been observed globally in the second half of March was pointed out. The response of the economic authorities in various countries had been of great importance in this regard, underscoring an unprecedented opportunity and magnitude. The Chilean market also showed a more favorable performance than in March, with rising stock prices, lower long rates, increased liquidity in money markets —especially in pesos—, reduced bank spreads and an appreciation of the peso.

It was recalled that, beyond the evolution of financial markets overall, the assessment made in the March Report placed the increase in credit to businesses as a key factor in averting permanent damage to the economy. The data available at the moment were not conclusive. On one hand, the increase in commercial credit from mid-March to date was worth noting. On the other, doubts remained as to whether this increase was consistent with the significant rise in the cash needs of the corporate sector in the face of falling sales, especially for smaller companies, where preliminary information on loans showed a lower growth rate than for large-scale companies.

The complexity of assessing the extent of demand for credit was stressed, as the information available was inconclusive. On one hand, the Bank Lending Survey —which interviewed bank credit supply agents— suggested that, in several segments, there was no big difference between the evolution of credit demand and supply. On the other hand, the respondents to both the Business Perceptions Report and the special survey pointed to a much greater problem of resource availability. Finally, the use of the FCIC showed encouraging figures that went hand in hand with the increase in commercial credit; however, it was difficult to draw conclusions about its effectiveness without being clear whether it was providing access to liquidity to all sectors and whether there were disruptions that impeded an adequate fluency to all segments. In particular, it was striking that external and domestic bond issues had eased off considerably since March, considering they had experienced high dynamism in the first few months of the year. Thus, it was mentioned that reactivating this market was vital not only to provide resources to large companies, but also to make room for smaller companies in the bank credit market.

It was noted that for the expected credit increase to materialize, it was not only necessary to provide more liquidity to the financial system —which was being achieved according to all the available information— but it was also necessary to encourage credit providers to assume greater risks. In this regard, it would be particularly relevant to review the impact that the Covid-related credit lines with State guarantees would have, which at the time of the Meeting -—-early May— had just begun operations, so information was yet to come to light. In any case, it was recalled that the comparative experience of other economies showed the difficulties in successfully implementing these measures, which raised an alert because good timing in the operation of these mechanisms was especially valuable.

3. Analysis of monetary policy options

All the Board members agreed that given the macroeconomic context caused by the pandemic, and with the MPR at its technical minimum of 0.5%, there was no other option but to keep it there and reinforce the message that it would remain there for an extended period of time.

All the Board members reiterated that in the current circumstances, monetary policy and financial stability decisions were closely linked, and that a significant increase in credit was still essential to mitigate the costs from the massive bankruptcy of companies which, although solvent, could not face this shock because of the great need for cash that had been generated in many of them. If this increase in credit were to occur, it would limit the destruction of jobs, resulting in a smoother reactivation of the economy that would allow inflationary convergence and would prevent some adverse effects on the financial system that could aggravate the costs of the pandemic.

All the Board members agreed that, compared to the March Report assessment, they saw a worsening global economic outlook, as there was greater uncertainty about the form, speed and outcome of the withdrawal of the sanitary control measures in Chile and abroad. At the same time, there was downward pressure on inflation in the short term, a sharp deterioration in business and consumer expectations, and a significant expansion in commercial credit since the announcement of the stimulus measures. However, it was also apparent that there were areas of the economy that had not yet been reached by credit or economic stimuli that matched the scale of their needs.

In the Board's opinion, all of the above could be summarized in that some risks had been materializing and others had become more likely, which would impose additional challenges on public policies and the institutions responsible for their implementation. In particular, only considering a more negative external scenario could anticipate a further widening of the activity gap which could jeopardize the convergence of inflation to the target.

In this context, all the Board members agreed that it was necessary to review the effectiveness of the measures adopted, and its possible changes, that could enhance the conditions to improve. Thus, despite the credit increase since mid-March to date and how much the FCIC had been utilized, it was necessary to look closely at whether resources were reaching all sectors, especially smaller businesses. One Board member recalled that the objective of the FCIC was to provide a liquidity facility to banks on the condition that they would in turn grant such loans, but that under high risk conditions, the evaluation of credits was easier for bigger operations and/or with known companies. For this reason, the operation of the Covid lines would compensate with guarantees part of the risk, helping the credit to flow to the smaller firms. For the same reason, several Board members agreed that it was necessary to wait to see the results of these operations in order to have clarity as to whether further action was needed.

One Board member drew attention to the fact that the ceiling of the FCIC line was being reached much faster than originally thought. In his view, this was not only the response to the increase in the overall flow of credit, but also to the fact that credit had increasingly focused on smaller companies —which was still a small fraction of total credit— since the beginning of April. Some Board members noted that given the success of the FCIC, that its limit was being reached much faster than expected, and that it was likely that the demand for credit would continue to be high, it was possible to revise upwards the overall limit of the FCIC, weighing, as at present, the overall growth and the composition of banking credit. Some Board members noted that, while the conditions for credit growth allowed banks access the maximum amount of the FCIC, which they had done rapidly, the use of the facility was lagging significantly behind which, coupled with data showing that there was a high degree of liquidity in the money market, suggested that no immediate changes to the Facility were necessary. They also noted that the information at hand did not guarantee that an increase in the facility would be available to those who needed it, in particular SMEs. Thus, any decision to expand the FCIC required a prior assessment of its functioning in conjunction with the Covid-related guarantee line, something that was not possible as yet.

One Board member stressed that despite the FCIC being a good instrument, it should be used with caution because, by setting the interest rate at its minimum for four years for a significant fraction of the banks' loan portfolios, it had major implications for future monetary policy decisions. Therefore, first it was necessary to investigate whether the increased liquidity delivered via the FCIC was reaching the desired targets, in order to maximize its economic impact. For this, it was important to analyze the credit markets separately, to figure out how the liquidity injected in one place ended up flowing to another. In that sense, he expressed his concern about the corporate bond market, because although interest rates on risk-free bonds had fallen, there was some evidence that it was not being so easy for companies to borrow funds in that market. Thus, he believed it was necessary to see what kind of actions could be undertaken to enable the functioning of that market, which would also help to free up credit for smaller firms.

All the Board members agreed that, given the changed economic outlook, it might be necessary to boost the monetary impulse going forward, paying special attention to its impact on the flow of credit into the economy.

4. Monetary policy decision

Governor Marcel, Vice-Governor Vial and Board members García, Naudon and Costa voted for holding the MPR at 0.5%. All the Board members agreed that the macroeconomic scenario could require further monetary stimulus. With the MPR at its technical minimum and the commitment to keep it there for an extended period, the additional efforts should focus on a broader and more systematic use of non-conventional policies. Therefore, intensive work needed to be undertaken to identify non-traditional measures to enhance the monetary impulse and support for financial stability. All the Board members agreed that beyond the necessary evaluations, the urgency of the actions was vital for their success and if changes were deemed urgent they would have to be made as quickly as possible.