MONETARY POLICY MEETING

JULY 2023

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Monetary Policy Meeting No. 299, held on 27-28 July 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; Beltrán de Ramón, General Manager; 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 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, Business Strategy Administration Manager; Miguel Fuentes, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Juan Pablo Rioseco, acting Communications Manager; Andrés Sansone, Advisor to the Finance Minister; Erika Arraño, Senior Economist; Marlys Pabst, Secretary General.

1. Background

The international scenario

Internationally, inflation had declined further, with downward surprises in a broad group of economies, including the United States. In the latter, the decline in both inflation and core measures increased the likelihood that inflationary convergence process would take place with no significant drop in activity. Contributing to this was the behavior of consumption, the fact that investment had picked up somewhat and that the labor market remained resilient. In the Eurozone, inflation had continued to decline, although service inflation remain high. Overall, in Latin America, headline inflation had continued to subside and core measures had recently begun to decline as goods prices decelerated.

The fundamentals, however, continued to point to the need for a more contractionary monetary policy in developed economies. The main central banks had raised their benchmark rates again and continued to signal that their monetary policies would remain in restrictive territory for a prolonged period of time. In the United States, the FOMC had conveyed a more hawkish tone at its June meeting, a position that had been reinforced at its July meeting by resuming the hiking cycle and by its authorities' emphasizing that the rates would remain high for several more months. The European Central Bank had also continued to raise its benchmark rates and communicated that its future decisions would continue to be reviewed on a meeting by meeting basis.

In this scenario, the impulse that the Chilean economy would receive from abroad was expected to remain moderate, with weak world growth prospects for both this year and next. In the United States, despite the recent resilience, a slowdown in activity was expected in the coming quarters. In China, the recovery of activity had continued to lose traction, amid fundamentals that pointed to less dynamism going forward. In the Eurozone, the outlook remained negative, due largely to the impact of the energy crisis and the tightening of financial conditions.

With regard to commodities, food prices continued to fall. However, in the days leading up to the July Meeting, the prices of grains had soared following Russia's withdrawal from the Black Sea Grain Initiative. The copper price, with ups and downs, was close to its level of the previous Meeting. Its evolution had received opposite influences: on the one hand, from lower activity in China and, on the other hand, from inventory levels, which remained tight. The price of a barrel of oil had risen by nearly 10% since the last meeting, favored by a greater global appetite for risk, the depreciation of the dollar and the continuous recovery of its demand.

The domestic scenario

Both headline and core inflation had fallen faster than had been projected in the last Monetary Policy Report. In June, they had posted drops of 7.6% and 9.1% annually, respectively. The differences owing mainly in the goods component, affected by the appreciation of the exchange rate over the last year. Regarding two-year inflation expectations, both the Economic Expectations Survey (EES) and the Financial Traders Survey (FTS) placed it at 3%.

In general, activity and demand continued to evolve in line with expectations. Although in May the Imacec had fallen by 0.5% from the previous month in its seasonally adjusted series, this monthly contraction was especially related to supply-side elements that had affected mining and, to a lesser extent, some industrial lines and others linked to external demand. In fact, discounting seasonality, non-mining activity had seen no month-to-month variation. On the expenditure side, retail sales and imports of consumer goods, among other indicators, continued to show a less marked deterioration in household consumption, validating the hypothesis that the first quarter contraction, particularly in durables, was rather a preview of the expected adjustment. The outlook for investment confirmed its weakness.

The labor market showed no major changes from its previous trends, as the unemployment rate had remained at 8.5% in the moving quarter ending in June, and firms' hiring expectations were low according to several sources of information. Compensations continued to increase in real terms. In this context, consumer (IPEC) and business (IMCE) expectations were still on the pessimistic side, but with some improvement.

The movements in the local financial market remained aligned with expectations that monetary policy would become less contractionary, in a context where global markets had reflected a greater appetite for risk, with a global depreciation of the dollar, an increase in stock markets and a compression of risk premiums. Local short-term interest rates had continued to fall, affected by the markets' reaction to the most recent CPI and Imacec data. The exchange rate had depreciated and the IPSA accumulated significant gains. Meanwhile, long-term interest rates had undergone minor adjustments.

Bank credit remained tight, as could be seen in the performance of real loans in all portfolios. Interest rates were high in all of them. Meanwhile, the Bank Lending Survey for the second quarter reflected tight conditions on the supply side, while the demand for credit remained weak.

Both the EES and the FTS anticipated a reduction of 75 basis points (bp) in the monetary policy rate (MPR) for this Meeting. However, around a third of the analysts polled in the EES and almost half of the analysts polled in the FTS expected a cut of 100bp or more. Furthermore, in July, both surveys had lowered their expectations for the MPR towards the end of this year, placing it at 8.0% and 7.75%, respectively. At the same time, the outlook implicit in the prices of financial assets anticipated that the MPR would stand at 7.5% next December.

2. Background analysis and discussion

On the domestic front, it was noted that activity and demand had evolved broadly in line with what was expected in the June Monetary Policy Report. This implied that activity gap was materializing towards negative values, which was necessary to control core inflation and ensure the convergence of inflation to the 3% target. It was added that this also indicated that the economy's adjustment was progressing in line with expectations, although this was a matter that needed to continue to be carefully monitored.

On inflation side, in June CPI inflation had been negative, with a difference with respect to projections concentrated in the goods component, both volatile and non-volatile. Given that no major developments were observed on the demand side and services inflation was no different from the forecast, the main explanation for the lower actual inflation was a faster-than-expected exchange rate pass-through. If so, it was important to keep in mind that this did not alter the magnitude of the expected transmission, but only brought forward its timing. It was also noted that the normalization of firm margins, with heterogeneity across sectors, was probably also contributing to a smoother pass-through of lower cost pressures.

The impulse that the Chilean economy would receive from abroad would remain limited, matching the forecast in the June Monetary Policy Report. Inflation remained the dominant problem, despite some recent progress, given the dynamics of demand and labor markets which remained tight in some developed economies, particularly in the United States. This problem was still a challenge for the monetary authorities and anticipated tight financial conditions still for a significant period of time.

3. Analysis of monetary policy options

All the Board Members agreed that, as expected, the Chilean economy had made progress in resolving the macroeconomic imbalances accumulated in recent years. Monetary policy had played a crucial role in this, allowing a reduction of MPR based on progress in the convergence of inflation.

The Board recalled that the central scenario of the June Report assumed that by this Meeting it would be in a position to begin discussing the reduction of the benchmark rate. Activity and demand did not show big differences with respect to projections, but inflation was falling somewhat faster. For this reason, the Board considered that it was reasonable to think that the MPR would have somewhat little trajectory that the estimated in the June central scenario. By the end of the year, this new level could be consistent with what the surveys indicated at the time of the Meeting, which as of December placed the MPR between 7.75% and 8%. In any case, all the Board members agree that the magnitude and timing of the MPR cuts will take into account the evolution of the macroeconomic scenario and its implications for the trajectory of inflation.

Taking the aforementioned arrival point as a reference, the Board considered plausible options of lowering the MPR 75 or 100bp. It was indicated that, depending on the accumulated information, in the next Meetings there could be movements around these magnitudes, keeping in mind that a total adjustment of between 325 and 350bp was required until the end of the year. Furthermore, there was agreement that the magnitude of the first move did not impose any conditions on those of the subsequent moves, which could be smaller. The considerations in deciding between these options, therefore, had more to do with tactical elements and the relative balance of risks of inflationary convergence given the new background information.

Regarding the tactical issues, there was agreement that the 75bp option would be less surprising, as it reflected the median of market expectations. However, all the Board Members noted that a significant portion market agents expected a 100bp cut, which lessened its surprising status. Some Board Members expressed concern about the impact that a decision to lower the MPR by 100bp could have on market expectations. In particular, because if that it would be considered a dovish decision, there could be additional falls in short-term rates and a greater depreciation of the peso. All five Board members agreed that this risk could be mitigated by a communication that would clearly state that the MPR was still inside the corridor considered in June, with an arrival level consistent with what surveys foresaw for the end of the year.

Regarding inflation risks, the full Board agreed that, in general, the evolution of the macroeconomic scenario pointed to a rebalancing of them. Several Board members said that the information available suggested lower inflationary pressures, including the evolution of activity and inflation. In addition, market expectations showed downward adjustments in the short term, while remaining in the two-year 3% target. One Board Member pointed out that, although the most extreme scenarios of inflationary outbursts had become less likely, in his opinion, continued to be a significant risk the effects of a prolonged period of high inflation and two-year expectations above the target could have had on the dynamics of price formation and expectations.

All the Board Members noted that, despite the recent decline, inflation was still very high, and inflation expectations had only recently returned to the 3% target, after several months of being misaligned. Therefore, it was still premature to think that the inflationary problem had been solved, so the Bank should remain watchful for developments in the macroeconomic scenario.

4. Monetary policy decision

Governor Costa, Vice-Governor García and Board members Naudon, Céspedes and Novy voted for lowering the MPR by 100 basis points, to 10.25%.

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