banco central Chile

MONETARY POLICY MEETING

OCTOBER 2021

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Monetary Policy Meeting No.285, held on 12-13 October 2021.

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

Present the Finance Minister, Rodrigo Cerda.

Also present: Beltrán de Ramón, General Manager; Juan Pablo Araya, Legal Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Paulina Yazigi, Financial Markets Division Director; Solange Berstein, 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; Miguel Fuentes, International Analysis Manager; Andrés Fernández, Economic Research Manager; Diego Gianelli, Market Operations Manager; Juan Carlos Piantini, Financial Markets Analysis Manager; Juan Francisco Martínez, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Felipe Lozano, Communications Manager; Tatiana Vargas, Senior Economist; Pilar Cruz, Senior Economist; Cristóbal Gamboni, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

The domestic scenario

Headline inflation had risen above forecasts in the last MP Report, standing at 5.3% annually at September. On the other hand, core inflation --CPI without volatiles-- had risen to 4.2% annually, in line with projections. The rise in recent months had affected all the different items that make up the CPI basket, reflecting domestic demand-side and cost-side inflationary pressures, as well as the significant idiosyncratic depreciation of the peso. In this sense, the low inventory levels perceived in trade and manufacturing continued to stand out, as did the prospects of higher costs and generalized wages across sectors (IMCE). The National Statistics Institute (INE), meanwhile, reported that the percentage of imputed prices during the pandemic had continued to decline. Increased prices of fuels and some foodstuffs had raised inflation of the volatile component to 7.5% annually. In this scenario, inflation expectations had shown increases at all terms, and in some cases exceeded 6% at December this year, surpassing the projections contained in the September Report. Two years ahead, for the second month in a row the median of the Economic Expectations Survey (EES) was above 3% annually, with 70% of the respondents pointing to a value above 3%. The median of the Financial Traders Survey (FTS) remained around 3.5% for the third month in a row, while 90% of the respondents expected inflation to be higher than 3%.

As for activity, the August Imacec had significantly surpassed its pre-pandemic level, growing by 19.1% annually and 1.1% monthly in seasonally adjusted terms. In a context of continued abundant liquidity derived from massive fiscal transfers and pension withdrawals, trade remained the most dynamic sector. In annual terms, it had continued to grow at high rates —25.5% in August—, but in seasonally-adjusted terms it had dropped 1.5% with respect to the previous month. Retail trade evidenced that private consumption of goods had remained dynamic. Accordingly, imports of consumer goods had continued to post record-high annual variations, especially in the durable segment. The recovery of several sectors that had been lagging behind —especially services activities—, was compounded with the high liquidity and eased sanitary restrictions. Goods production had maintained the high growth of previous months. Consumer expectations (IPEC) continued to be pessimistic, with a slight decline in their last figure, especially due to the increase in inflation. On the investment front, short-term indicators such as construction and business services had improved, while capital goods imports remained high. The business outlook (IMCE) was in optimistic territory, although it also revealed cost increases and inventory shortages. However, medium-term expectations for investment remained less favorable, as suggested by the evolution of the stock market and uncertainty indicators, the abrupt deterioration of local financial conditions, as well as cash management decisions made by big companies.

Preliminary information for the Business Perceptions Report (IPN) showed significant dynamism of activity, especially in private-consumption-related sectors. This continued to respond to the abundant household liquidity and advances in the reopening of the economy. Nonetheless, survey participants listed several causes for concern. To begin with, costs —especially of imports— remained historically high, which had led to narrowing margins or increased sale prices. Moreover, further price increases were expected in the short term. In addition, labor costs were rising due to difficulties in hiring labor, especially of lower-skilled workers. Finally, political/legislative uncertainty had intensified, as had concerns about the possible resurgence of violence, especially affecting investment decisions. Thus, the outlook for the coming year had become more pessimistic.

In this context, the growth outlook for this year according to the EES had seen another revision upward, to 11.0% in its October version (10.4% in September). In contrast, expected GDP for 2022 was down to 2.2% (2.5% in September), and remained at 2.0% for 2023.

In the labor market, employment (INE) had risen in every category and the unemployment rate had declined to 8.5% in the June-August quarter. Still, there was a significant lag in the recovery of categories with a high percentage of informality, especially informal salaried employment, while the lag in self-employment had been reduced. Moreover, despite a certain upturn in labor supply as seen in lower inactivity and more job postings on the Internet, there was still a big mismatch between the supply of and demand for jobs, especially for lower skilled persons. Accordingly, labor income showed a strong recovery from year-before levels. For the short term, business expectations (IMCE) predicted increases in hiring.

Local financial markets exhibited much sharper and more systematic deteriorations than their external peers, with corrections at the extremes of international movements. This was due to the influence of idiosyncratic factors, especially the change in the inflation outlook and uncertainty about political/legislative issues, particularly with respect to new pension savings withdrawals. In the fixed-income market, interest rates had risen along the curve, especially in the medium and long tranches, although with low amounts traded in those instruments. The 10-year nominal interest rate had exceeded 6.5%, a rate unseen in more than a decade. Thus, from early September to the time of the Meeting, the differential with its U.S. counterpart had moved from around 370 basis points (bp) to around 500bp. In the same period, the exchange rate had continued to rise, accumulating a depreciation of more than 5% against the dollar, drifting away from its fundamentals. The IPSA had fallen close to 8%, while country risk posted an increase of nearly 25bp, similar to the average of other Latin American economies. In the money market, the banking system's dollar liquidity remained near its all-time highs and kept the cost of dollar funding contained at the local level. In pesos, interest rates had risen, with trading centered on more immediate terms.

As to banking credit, commercial loans had reduced their real annual contraction rate (-1.9% in September) —reflecting a recent improvement in non-Fogape credit activity—, as had consumer loans (-9.3% in September), with smaller declines in all products of this portfolio. As of September, mortgage loan flows remained relatively stable (6.3% in real annual terms in September), largely supported by a higher number of transactions, in a context in which interest rates had risen again in the different categories. Non-performing loans in the overall system remained contained.

According with the Bank Lending Survey (BLS) for the third quarter, demand for credit had strengthened in most segments. The exception were mortgage loans, where the impact that the higher interest rates were having on credit applications stood out. For larger companies, the BLS reported an increase in credit demand for working capital. On the supply side, it generally reported fairly stable conditions for the various portfolios. In any case, preliminary information from the IPN revealed a drop in the number of transactions carried out in October, especially mortgages, with a tightening of lending standards, greater restrictions in terms and in the required down payment, among others.

Regarding the evolution of fiscal expenditure, the 2022 budget bill contemplated a convergence trajectory in accordance with the structural balance rule, with a nominal reduction of close to 20% in 2022 with respect to the expenditure that would be executed in 2021, according to the Public Finance Report for the third quarter.

In this scenario, expectations for the monetary policy rate (MPR) had risen. In particular, the FTS and the EES projected an adjustment of +75bp at the October Meeting, while the prices of financial assets pointed to +100bp. One year ahead, the outlook for the MPR contained in these measures fluctuated between 4% and 5.5%, while two years ahead they did between 4.25% and 6%.

The international scenario

On the external front, the outlook for global activity had moderated marginally as a result of constraints due to the resurgence of Covid-19 in some economies and the persistence of bottlenecks at the global level, which had limited growth in certain sectors. In developed countries, high vaccination coverage had allowed economies to continue to reopen despite increases in infections. However, in the U.S., although the outlook remained favorable, the outbreaks had affected the consumption of services and job creation. In Asia, on the other hand, the outbreaks had led to maintaining restrictions in place. In China, disruptions in supply chains, demands to meet Government environmental targets, higher energy prices and the tension generated by the Evergrande situation in the real estate sector were all factors that anticipated an economic slowdown.

These developments had taken place in a context where global inflation had continued to rise, most notably in the U.S. and Latin America. Bottlenecks continued to be reflected in high shipping costs, longer delivery times, shortages of inputs, and lower inventory levels, which together had continued to put pressure on costs. In addition, energy prices had risen sharply after the August meeting. In particular, the price of a barrel of oil had surpassed US$80 (+15% for the WTI-Brent average since the last meeting). This added to the significant rise in the price of gas (+45% since the last meeting), due to the strong world demand increase and supply disruptions in some of the world's main producers. Meanwhile, the copper price was stable at around US$4.2 per pound.

In this scenario, several central banks had adopted a less expansionary stance. Worth noting were the changes in both the Fed's communication —which had signaled that it would withdraw its unconventional monetary stimulus faster than had been foreseen— and of the Bank of England, which had signaled an upcoming increase in its policy rate. This had been compounded by the start of monetary normalization by the authorities in Norway, New Zealand, and various emerging economies. External financial markets had reduced their appetite for risk, considering, mainly, the aforementioned elements, doubts that had also triggered a higher degree of volatility in the markets recently. Interest rates had risen across the board, the bulk of global currencies had depreciated against the dollar, and sovereign spreads had risen in an important group of countries, while stock markets showed mixed movements. Capital inflows to emerging economies had tended to moderate, with marginal outflows from Latin America. The region was still underperforming with respect to other emerging economies.

2. Background analysis and discussion

On the external front, it was noted that there had been changes in recent months, with some deterioration in activity and a tightening of financial conditions, and that this responded to some increasing risks —such as the persistence and extension of supply disruptions— and to the beginning, or approaching, monetary normalization in several economies. The reaction of financial markets had increased volatility and long-term interest rates, although quite more moderately in developed countries than in emerging ones. These adjustments were also based on a certain fear about what was happening with the Chinese company Evergrande, which placed the focal point on the Chinese real-estate indebtedness, but that after Covid-19 appeared as a broader concern. This would likely have an impact on China's growth outlook, although for now its potential effects were contained, and the copper price was still high. While the local economy bore the impact of all these developments, it was clearly dominated by idiosyncratic factors. In fact, the deterioration of the different variables of the Chilean financial market had been much more marked and systematic and was at the extremes of the international movements.

Locally, indicators showed that since the last Report, both activity and core inflation had behaved in line with estimates. A somewhat lower-than-expected Imacec in July had been offset with a better-than-expected performance in August. Meanwhile, cumulative core inflation between August and September differed only marginally from the September Report's estimate. Short-term forecasts for domestic demand and activity were also within expectations. In contrast, total inflation posted somewhat bigger changes in projections that affected mainly the volatile component —not core— given the price hikes in fuels and some foods. The core part had smaller changes in its projections, although higher levels were expected in its goods component, mainly due mainly to the additional depreciation of the peso and the greater pass-through implied by its idiosyncratic nature.

It was mentioned that the biggest difference with respect to the central scenario of the September Report were seen in the financial conditions and inflation expectations. The former had experienced a significant decline, as evidenced by the significant depreciation of the peso, the decoupling of the local stock market with international markets, and the significant increase in long-term rates since the beginning of the year. Interest rates had risen much more than that of economies such as Australia, New Zealand, Norway, and even greater than that of other countries in Latin America. The analysis of structural models was added as a precedent, which confirmed that both the exchange rate depreciation and the rise in long-term rates were mainly explained by idiosyncratic elements. It was emphasized that this tightening of financial conditions would have an effect on activity.

As for inflation expectations, it was noted that they had risen for every source and every term, including the 24-month policy horizon. It was mentioned that the fundamental cause of the rise in these expectations seemed not to be linked to lack of credibility of the Bank's commitment with inflation control but to the uncertainty caused by the political/legislative context and its implications on the demand impulse measures.

Attention was drawn to the high complexity of the Chilean macroeconomic scenario. On one hand, high growth and demand-side pressures —which in normal circumstances would cause an appreciation of the exchange rate and a softening of inflationary pressures— were overwhelmed by elements of exchange rate risks whose depreciative effects would put pressure on prices. On the other hand, the higher interest rates and the higher exchange rate will negatively affect activity and investment in the medium term. Add to this the evolution of inflation expectations and preliminary background from the IPN that signaled the relevance of cost increases and indications of higher pass-through to prices.

3. Analysis of monetary policy options

The Board members agreed that a macroeconomic scenario where activity was above potential and inflation was speeding up, needed monetary policy to continue to go from an expansionary stance to a more neutral one. In this context, the Board examined four options of MPR increase at this Meeting: (i) a 75bp raise; (ii) a 100bp rase; (iii) a 125bp raise; and (iv) a 150bp raise.

They all agreed that, given the evolution of the macroeconomic scenario and considering its risks, it was necessary to approximate the MPR to its neutral level earlier than projected in the central scenario of the September Report. In the Board's opinion, the best option was to place the MPR around its neutral value in the next Meeting, leaving room for the December Report to calibrate the next steps, considering the revised outlook for activity and inflation for 2022 and 2023.

In this context, the Board members coincided that the options of raising the MPR by 100 or 125 bp seemed to be the most appropriate. On one hand, they were consistent with the need to accelerate the pace of the monetary stimulus withdrawal and, on the other hand, in both cases the MPR would be below the lower bound of the estimated neutral rate, so it should certainly be further increased in the coming meetings. In the opinion of one Board member, the option of raising the MPR by 100bp was consistent with the evolution of market expectations, and could suffice to signal the increased risk materialized, given its sources, particularly the dynamism of consumption and uncertainty in financial markets. In the opinion of another Board member opting for one option or the other entailed a relevant tactic element, namely the pertinence —or not— of surprising the market. In his view, what mattered most was to communicate that the MPR would sooner come close to its neutral level, and in that scenario a 125bp raise was a wise combination between a somewhat higher than what the market expected increase and the need to convey the earlier materialization of the MPR trajectory.

The options of raising the MPR by 75 or 150bp seemed less plausible to the Board, because they carried a surprise component that could be complex for the market to understand. On the one hand, the 75bp option could give a feeling of continuity of the Report's central scenario which was not consistent with the observed changes and which, in a context where inflation expectations had risen, could be counterproductive. On the other hand, the option of raising the MPR by 150bp seemed a good choice if the intention was to shock the market and try to affect inflation expectations. There were some caveats, however. In particular, that it could generate an even greater tightening in local financial conditions —and there were no forecasts to quantify this effect— or it could be associated with a response to inflationary surprises that had no relation with core inflation.

4. Monetary policy decision

Governor Marcel, Vice-Governor Vial, and Board members García, Naudon, and Costa voted for raising the MPR by 125 basis points, to hasta 2.75%.

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