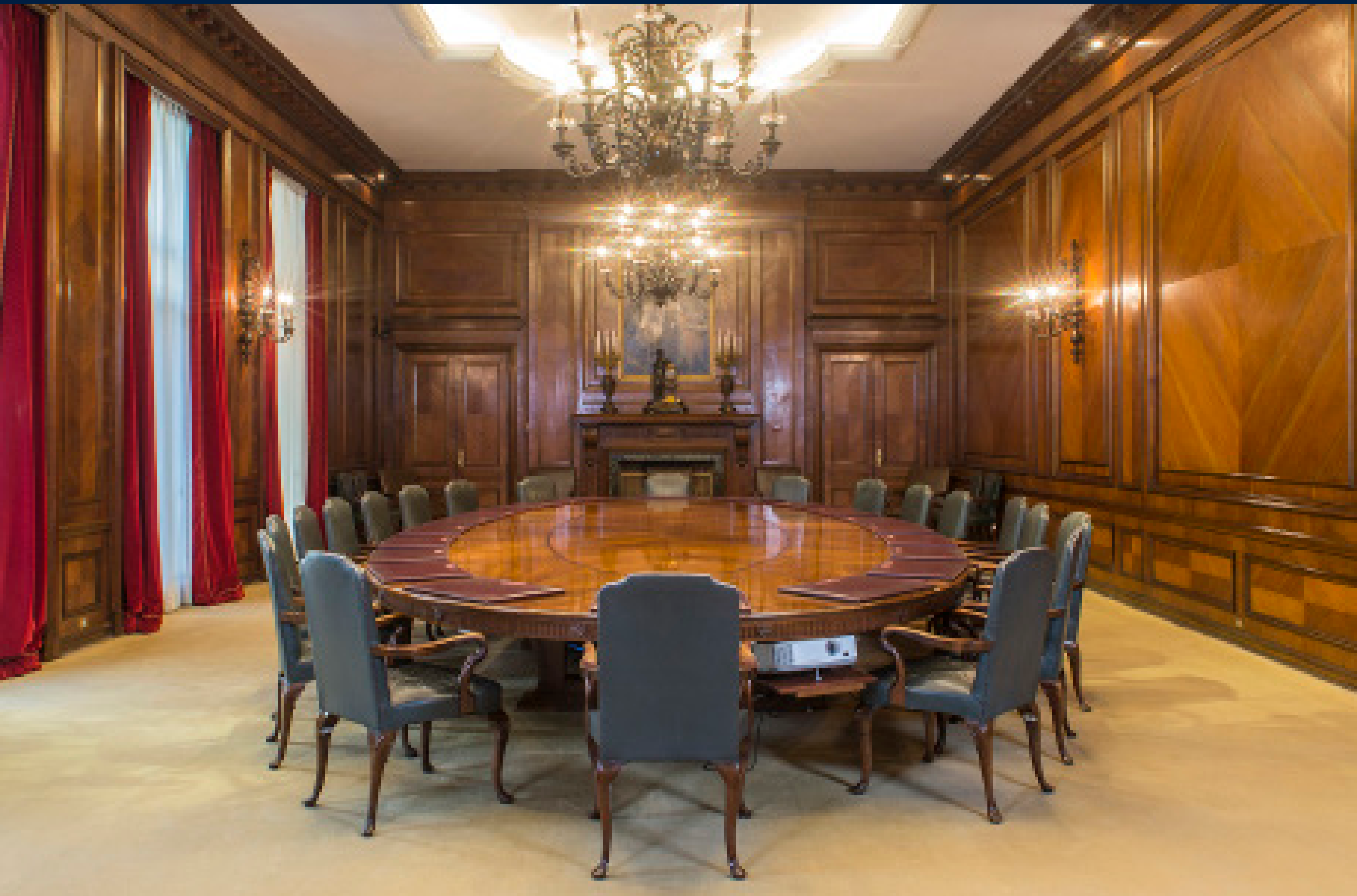
MONETARY POLICY MEETING

SEPTEMBER 2024



MONETARY POLICY MEETING

Monetary policy session No. 308, held on 3 September 2024.

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

Also present, Luis Óscar Herrera, 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 and Data Division Director; Silvana Celedón, Institutional Affairs Director (s); Markus Kirchner, Macroeconomic Analysis Manager; Enrique Orellana, Monetary Policy Strategy and Communication Manager; Sofía Bauducco, Economic Research Manager; Guillermo Carlomagno, International Analysis Manager; Felipe Musa, Market Operations Manager; Silvana Celedón, Communications Manager; Andrés Sansone, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

As had been anticipated, the strong dynamism of activity at the beginning of the year had subsided, which was partly associated with the reversal of some transitory elements. However, the magnitude of the reversal was somewhat greater than expected. Part of the difference was explained by the decline in service-related activities and another part by the impact of some on-off supply elements, related to the availability of fishery resources in the industry, the effect of a climatic shock and maintenance downtime in mining operations. The July Imacec showed a significant acceleration of month-to-month activity, although it was estimated that once again a significant part was due to these transitory factors, in a context of high volatility.

Demand had also underperformed in the second quarter, held back by private consumption. Household spending on non-durable goods and services had declined, breaking the upward trend of previous quarters. This behavior occurred in a context in which several of its fundamentals had evolved in line with expectations. Gross fixed capital formation (GFCF) had stabilized after the sharp drop of the second half of last year. However, high-frequency indicators reveal important differences between sectors, as most sectors exhibited poor results in contrast with the dynamism of investment in the mining industry.

Total annual inflation had risen to 4.4% in July, while core inflation remained close to 3.5% (benchmark series). The higher-than-expected headline inflation in the June IPoM was related to volatile items, mainly due to the increase in electric power rates and the prices of goods included in that CPI measure. Market inflation expectations exhibited a sharp contrast between the short and medium term. In line with financial asset prices, one-year inflation expectations had risen significantly, while at two years they remained aligned with the 3% target.

The MPR cuts continued to be passed through to bank lending rates according to the usual patterns. Bank credit remained weak, especially its commercial component, amid conditions of access to financing without major changes. This result was consistent with the behavior of sectoral investment, dynamic for mining, which used Foreign Direct Investment more intensively to finance itself and weaker in the rest of the sectors, more prone to borrowing from banks.

On the external front, news from the United States continued to dominate the economic landscape. The last few weeks had been characterized by the markets' assessment of the American economy's growth and the actions of the Federal Reserve (Fed). After the latter signaled the imminent start of the Fed funds rate (FFR) cutting cycle, short- and long-term rates had fallen in the main economies and the dollar had depreciated globally. The Chilean peso followed the movements of global markets, responding to the volatility of the external scenario.

The projections for activity and demand continued to estimate that the economy would grow around its trend over the next few years. For 2024, the range for the GDP growth forecast was lowered at its high end, and unchanged for 2025 and 2026. Private consumption would regain momentum, although its level at the end of the projection horizon would be lower than in the previous estimate. The evolution of several of its fundamentals —such as the lower cost of credit and the increase in the real wage bill— suggested that its recent moderation would not last long. The GFCF growth forecast for the period 2024-2026 was somewhat lower than the one considered in June, reflecting the weak investment in the non-mining sectors. For the mining industry, the central scenario confirmed the greater impulse from investment, which would positively boost activity in other sectors, especially construction.

The headline inflation projection was revised up for the short term, mainly due to the greater increase in volatile items. In the medium term, it is expected to decline more rapidly than foreseen in June, given the lower inflationary pressures stemming from domestic demand. It is estimated that it will converge to the 3% target in the early months of 2026, and remain nearby until the end of the projection horizon.

The estimated impulse that the Chilean economy would receive from abroad considered that our trading partners' growth would be fairly the same as our previous projection —i.e., around 3% in the period 2024-2026—, with some improvement in international financial conditions, including low long-term interest rates and somewhat lower terms of trade.

2. Background analysis and discussion

It was noted that, with respect to the June IPoM and the July monetary policy meeting, there had been three developments that deserved analysis. First, the Fed Governor had communicated that "the time has come to lower the target range for the FFR…," which was interpreted by all market participants as an imminent start of the cycle of monetary policy adjustments. In addition, the number of expected cuts for this year had risen compared to the assumption in the last IPoM and in the July meeting. This occurred in a context where, despite no major surprises in U.S. activity, the markets had intensified their perception that the U.S. economy could slow down more rapidly. In fact, this had led to episodes of high volatility at the beginning of August and was also generating movements at the time of the meeting. It was also noted that global interest rates at different maturities had declined and the peso had appreciated over the course of the past month, due to both changes in the rate differential and a decrease in foreign exchange premiums.

A second factor worth mentioning was the evolution of domestic activity and demand in the second quarter. Although activity did not differ much from what had been projected after factoring in a series of supply-side factors that had affected various sectors, demand had been less buoyant. Private consumption posted a quarter-on-quarter decline, after its significant expansion in the first quarter of the year. It was estimated that this result would have little persistence given the evolution of consumption fundamentals, so the projected quarterly variations going forward did not differ from previous projections. However, the level of consumption would remain below the previous forecast throughout the projection horizon, which explained the expected behavior of domestic demand. Investment, although in line, showed significant weakness in every sector other than mining. In this scenario, consumption and investment projections were revised downwards by around 1% until 2026. All this took place in a scenario of still weak credit —a behavior that appeared consistent with the evolution of investment in the non-mining sectors— and employment had shown a marginal deceleration.

Finally, the behavior of inflation expectations showed that market agents had considered the transitory nature of the effect of the increase in electric rates. There was a significant rise in inflation expectations in the short term, while in the two-year term they remained at around 3%. This occurred in a scenario where inflation had ultimately risen to some extent, as a result of a slightly higher-than-expected increase in electricity prices.

3. Monetary policy options

The Board agreed that the combined information accumulated since the June Monetary Policy Report showed that the lower demand was being counterbalanced by the pressure on prices from energy costs, among other factors. This, together with inflation expectations aligned with the 3% target, reduced the risks of greater inflationary persistence in the medium term as a result of the cost shock, which pulled down the balance of inflationary risks present at the previous meeting.

In that context, the Board members agreed that the MPR could be further reduced toward its neutral level. Given the lower risks to inflation that were assessed, this decline would be somewhat faster than previously considered.

The Board considered reducing the MPR by 25 or 50 basis points, quickly discarding the latter. There was consensus that the option of cutting 25 points off the MPR was perfectly coherent with the central scenario of the September IPoM, with further lowering the MPR later on, and with the risks that menaced the economy. Moreover, the decision had undisputable communicational advantages.

4. Monetary policy decision

Governor Costa, Vice-Governor Novy and Board members Naudon, Céspedes and Soto voted for reducing the MPR by 25 basis points, to 5.5%.

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