Monetary Policy Meeting[1]/

JANUARY 2021

CENTRAL BANK OF CHILE

[1]/ This is a translation of a document 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. 279, held on 26-27 January 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: Alejandro Zurbuchen, General Manager; Juan Pablo Araya, General Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Solange Berstein, Financial Policy Division Director; Diego Gianelli, Financial Markets Division Director (S); Gloria Peña, Statistics Division Director; Michel Moure, Institutional Affairs Division Director; Markus Kirchner, Macroeconomic Analysis Manager; Enrique Orellana, Monetary Policy Strategy and Communications Manager; Miguel Fuentes, International Analysis Manager; Andrés Fernández, Economic Research Manager; Juan Carlos Piantini, Financial Market Analysis Manager; Juan Francisco Martínez, Financial Stability Manager; Felipe Lozano, Communications Manager; Tatiana Vargas, Senior Economist; María Pilar Cruz, Senior Economist; Cristóbal Gamboni, Finance Ministry Advisor; Marlys Pabst, Secretary General.

1. Background

The domestic scenario

On the domestic front, November's Imacec was giving signs of a steady recovery of activity, advancing in the economy's gradual reactivation process. In annual terms, growth had achieved 0.3% and the seasonally-adjusted series had risen 1.1% with respect to the month before. Disparities across sectors remained, with services lagging the most. Despite having grown month on month, services continued to be severely affected by the sanitary constraints. Mining activity had declined from the previous month and year. The sectors with the best relative performance were manufacturing and trade, the latter maintaining its high dynamism resulting from the pension fund withdrawals and fiscal transfers. Accordingly, the levels of retail activity and vehicle sales (ANAC) were high, while inventories, as reflected in the underlying trade index, had been significantly reduced. However, the recovery of consumer imports had the potential to mend part of the latter in the short term. On the investment side, home sales and capital goods imports were indicative of some reactivation.

The labor market showed some recovery from mid-year declines; however, the gaps that had been generated by the pandemic were still significant. Employment and hours worked continued to rise month on month. The IMCE's vacancy job rate and hiring expectations reflected an increase in demand for employment, although supply continued to be tight, mainly for reasons related to Covid-19 or family duties. Meanwhile, business and consumer expectations reflected a limited impact from the increase in restrictions implemented in December. In this scenario, private expectations reported in January's Economic Expectations Survey (EES) anticipated for 2021 an expansion of 5.0% in total GDP and 5.2% in non-mining GDP.

Preliminary qualitative data derived from the February's Business Perceptions Report showed some relapse in the latest performance of many businesses, after a significant rebound between the end of the third quarter and early fourth quarter of 2020. The outlook for 2021 was subject to high uncertainty, owing particularly to the evolution of the sanitary situation and its implications for companies' revenues, investments and staffing. Half of the respondents had expressed that they would invest in 2021 and a larger fraction had said that they would do so in 2022. The main constraints to their decisions had to do with the uncertainty of the sanitary situation, the evolution of demand and the political environment. Access to new credits was perceived as being restricted by the higher financial burden on companies, especially in the areas most affected by social distancing. In the labor market, stability continued to prevail, although there were new layoffs reported in some companies and reduced availability of lower-skilled labor. Meanwhile, costs had risen for a fraction of interviewees, who attributed this to factors such as shortage of inputs and/or products for sale. They also noted that they hadn't always been able to pass on these increases to prices.

Local financial markets, overall, had matched the more positive tone of their international peers. The selected stock index IPSA had accumulated even higher gains than some comparable economies' indicators, and the peso had appreciated with respect to its year-before average. In the fixed-income market, interest rates had fallen at different maturities, especially at the longer terms, with the 10-year BCP and BCU falling by 30 and 40 basis points (bp), respectively. Indexed instruments also recorded significant drops at shorter terms (-35bp at 2 years), affected by better prospects for domestic consumption.

Regarding bank credit, commercial loans had continued to decline in real annual terms (2.9% in December; 4.4% in November), while activity linked to Fogape-Covid lines and the use of phase 2 of the Funding Facility Conditional on Increased Lending (FCIC 2) remained at moderate levels. This was coupled with a further contraction of consumer loans (-16.5% real annual rate in December) and relatively stable growth of the mortgage portfolio in recent months (5% real annual rate in December). Interest rates remained low for all lending categories. As for risk indicators (Financial Market Commission), on aggregate, the banking system's delinquency rate remained contained, while the increase in provisions and the expected loss in the commercial segment stood out.

The Bank Lending Survey (BLS) of the fourth quarter again reported a decline in companies' credit demand for investment and working capital purposes, while the supply was tighter, especially for SMEs. This was consistent with the increased financial burden and risk perception at the corporate level, mainly in a context of a slower-than-expected recovery of the local economy. The authorities had responded by enacting the law that extended the uses of Fogape —Fogape Reactiva—, so as to adapt it to the new needs of the firms. As for households, the BLS revealed greater demand and softer lending standards at the margin. In addition, the qualitative information gathered in the last Business Perceptions Report confirmed the high levels of indebtedness of companies and their impact on access to credit, especially in businesses most intensive in human interaction. A fraction of the respondents reported difficulties to meet their financial obligations, and in some cases noted that they had to cut down on expenses as a strategy to be able to pay their debts.

Headline inflation had ended the year 2020 at 3% annually, 3.3% for core inflation—CPI minus volatiles. December's monthly rate (0.3%) had responded mainly to some high-demand goods that had continued to drive inflation in recent months, while services inflation was still weak. This scenario had been shaped amid low inventory levels, where replenishment was occurring gradually, and transportation costs ran high. This had been validated in the preliminary information gathered in February's Business Perceptions Report, which reported shortage of some inputs and/or products for sale attributed to logistical issues, mainly the increased cost of maritime transportation, production problems and inventory depletion. At the medium term, inflationary pressures remained contained, as the gradual closing of the wide activity gap dominated. As for market expectations, one year out the EES showed they had risen to 3%, the same figure that the Financial Traders Survey (FTS) showed at the same horizon. Two years out, both the EES and the FTS remained at 3%.

The international scenario

On the external front, the general outlook for 2021 presented no major changes with respect to the forecasts in the last Monetary Policy Report, combining a somewhat weaker short-term scenario —due to the evolution of contagions— with improving longer-term expectations thanks to progress in vaccine development and application. Household and business expectations were consistent with this scenario, showing a worse outlook for the short term and a better outlook going forward, which was also reflected in the market's GDP growth expectations. The latter also showed the differences between the recovery process expected by developed and emerging economies, in which the speed of the vaccination process played an important role.

External financial conditions remained favorable, in a context of monetary stimulus that would be kept in place for a long period of time, as had been stated by the authorities of various central banks. Plus, the announcements of new fiscal packages, particularly in the United States, which had driven stock market hikes globally, increases in long-term interest rates in developed economies, capital inflows to emerging economies and commodity price rises. Among these, it was worth noting the strong recovery of the oil price (close to 15% for the Brent-WTI average since the last Meeting) and the copper price climbing to US$3.6 per pound (a little more than 3% since the last Meeting). These increases were a response to the weakening of U.S. dollar, a more favorable outlook for demand and a somewhat weaker outlook for supply.

2. Background analysis and discussion

There was consensus that the evolution of the economy, both globally and locally, had generally been in line with the forecasts in the last MP Report. Local activity had closed 2020 within projections, while inflation had slightly exceeded expectations for the end of the year. It was noted that the sanitary backdrop for these developments had been shaped by the combined effects of increased restrictions on mobility associated with soaring Covid-19 infections and concrete progress in vaccine production and application. Thus, the greater weakness in activity early in 2021 was offset by better prospects for the rest of the year. In this context, the financial markets reflected this heightened optimism, driving up stock markets, capital inflows to emerging economies and commodity prices.

It was agreed that, despite everything, persistent risks and challenges remained on the horizon. One such challenge would be the capacity to implement a massive and efficient vaccination process, while following all sanitary measures, until the risks of contagion and its most severe impacts were well under control. In this context, a major challenge would be to maintain the impulse of monetary and fiscal policy, as well as the ability to safeguard financial stability, until the economy was able to achieve a self-sustained growth rate, reducing the gaps and frictions that still remained.

It was highlighted that after months of weakness due to an unprecedented crisis, where the focus of concern had obviously been on the short term, it was now time to look more closely at the challenges posed by the medium term. Moreover, this debate was taking place in many places and, in practice, it could be understood as a shift from a damage control approach, which had largely focused on financial stability issues, to policies aimed at sustaining the economic recovery, while keeping inflation in line with the target. In any case, it was emphasized that this was not an imminent task, but it was important to bear in mind, because the usual timeline under which monetary policy operated was longer now, and several of the measures implemented had a quite extensive application horizon.

The evolution of local inflation was also examined. There was agreement that its recent increase was explained mainly by short-term phenomena, adding that the projections for the coming months incorporated additional impacts from the rise in volatile prices, partially offset by the peso appreciation and the weaker performance of services. Into the medium term, inflation convergence would be achieved as the economy returned to trend growth, supported by external, fiscal, and monetary impulse, and as progress in sanitary control would allow lifting the supply restrictions, which would require maintaining a strong monetary stimulus. Although everything indicated that short-term factors did not necessarily imply medium-term trends, it would be important to monitor them in the coming months in order to properly calibrate the level of monetary stimulus and the instruments that the economy needed to consolidate its recovery.

3. Analysis of monetary policy options

All five Board members agreed that, given the macroeconomic context caused by the pandemic, the monetary policy message should continue to emphasize that a high monetary impulse would be maintained for a prolonged period of time, in order to ensure the consolidation of the economic recovery and the achievement of the Bank's objectives. This suggested that the MPR would be kept at its minimum level over most of the two-year monetary policy horizon, and that unconventional measures would remain in effect.

All the Board members also agreed that the advances in the economic recovery process made it necessary to adjust financial conditions so that companies could meet the needs arising from this new stage of the business cycle. In particular, there was an agreement that the weaker demand and supply of commercial credit that had been observed in recent months reflected the fact that the simple availability of new credit for working capital would no longer be enough to meet the needs of companies. This was so because some of them need financing for investment or because others had accumulated obligations that they were unable to meet with the income flows they expect to have in the coming months.

All the Board members noted that the Bank could play an important role by supplying the necessary liquidity for the financial system to generate the conditions for firms to successfully adjust their financial burdens. In particular, the recently approved legislation on state guarantees—Fogape Reactiva— opened space for the Bank to adapt the FCIC and comply with its commitment established in the last Meeting's statement. This adaptation of the FCIC involved completing the momentum committed by the Board through unconventional instruments, by means of a mechanism that had ensured its effective monetary policy transmission. To this end, while maintaining the residual financial conditions of the FCIC 2, it would be necessary to adjust the access conditions, incorporating the new definitions of Fogape, focusing on gross flows —as the aim was not necessarily to increase the companies' leverage— and extend collaterals.

4. Monetary policy decision

Governor Marcel, Vice-Governor Vial, and Board members García, Naudon and Costa voted for keeping the MPR at 0.5% and maintaining the reinvestment policy under the bank bond stock program announced last December. They also agreed to adapt the FCIC, by opening a third phase covering an amount of US$10 billion in effect for six months. In addition, they agreed to extend the eligible collateral for this phase, adding the A5- and A6-category commercial portfolio with state guarantee.