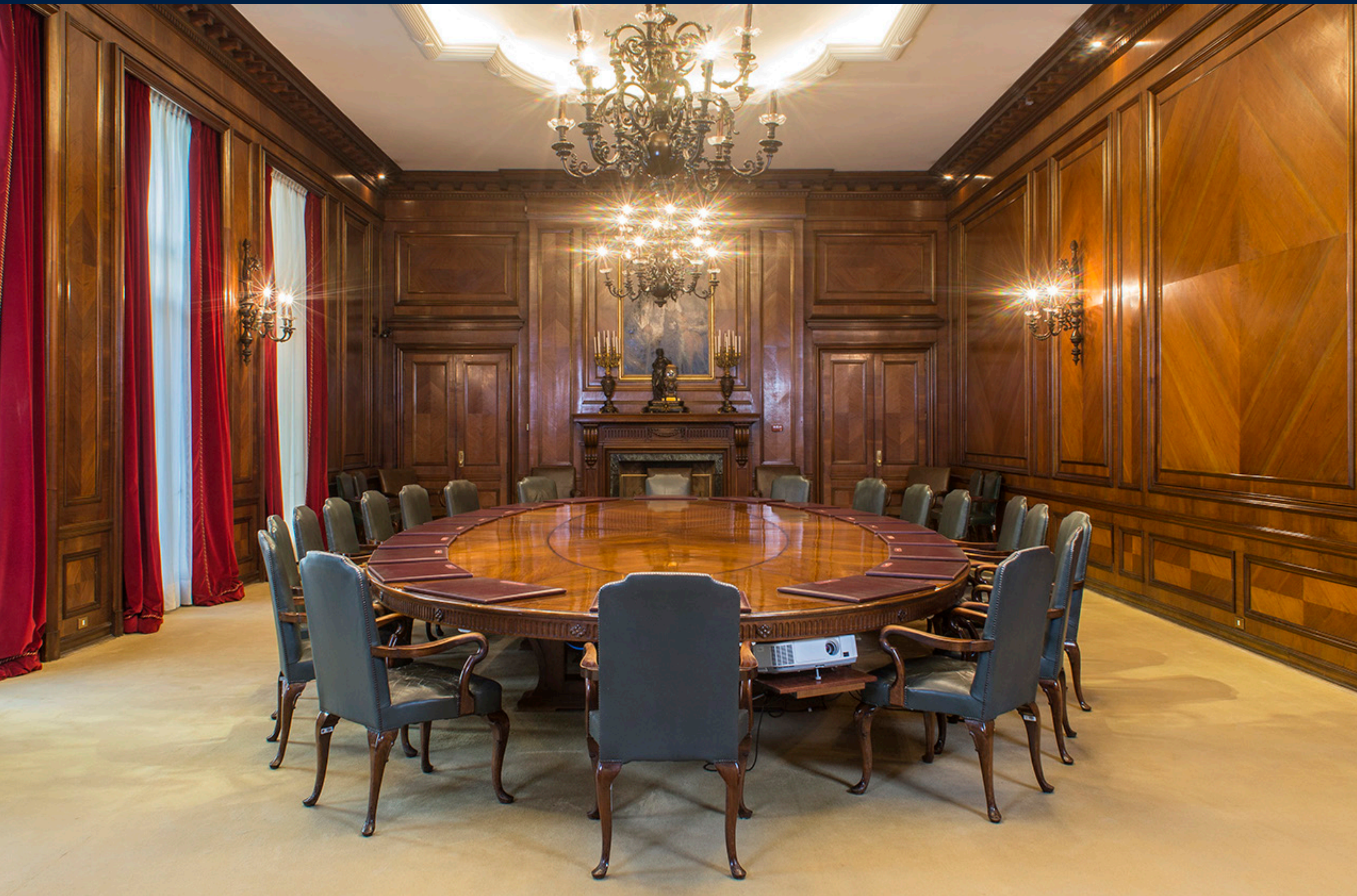
banco central Chile

MONETARY POLICY MEETING

MARCH 2022



MONETARY POLICY MEETING

Monetary Policy Meeting No. 288, held 29 March 2022.

Present: Rosanna Costa, Governor; Pablo García, Vice Governor; Alberto Naudon, Board member; Luis Felipe Céspedes, 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; Paulina Yazigi, Financial Markets Division Director; Rodrigo Alfaro, acting 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; Miguel Fuentes, International Analysis Manager; Diego Gianelli, Market Operations Manager; Felipe Lozano, Communications Manager; Andrés Sansone, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

Inflation and its short-term outlook had continued to rise and was projected to approach 10% by mid-2022. Higher inflation was having a significant impact on households, and continued to respond mainly to the recent quarters' overspending wave. This impact had been exacerbated against a backdrop of significant cost pressures, which had been further increased by the commodity price shock triggered by Russia's invasion of Ukraine. The central scenario of the December Monetary Policy Report projected that in the latter part of 2022 inflation would begin to converge to the 3% target, which it would reach within the two-year horizon.

Resolving the imbalances that the economy had accumulated over some quarters was vital for this convergence, fundamentally by adjusting the fiscal and monetary impulse, among other factors. Accordingly, and with a less favorable external scenario after the excessive growth of 2021, the economy would expand at a rate below its potential in 2022 and 2023, with contractions in private consumption and investment.

2. Background analysis and discussion

The discussion centered around the evolution of the macroeconomic scenario, noting that the current situation seemed particularly challenging for monetary policy decision-making. First, there was an apparent change in the cyclical direction of the economy, which posed difficulties in properly calibrating monetary policy signals, as there was the risk of arriving too late or going too fast. Second, despite the rapid and significant increases in the MPR in recent quarters, inflation expectations from expert surveys and market prices indicated that risks of further persistence in inflationary dynamics continued. Third, there was the geopolitical shock present, which was having a negative impact on supply, implying higher costs and inflationary pressures in the short term, but which could lead to disinflationary effects in the medium term.

The discussion turned to the evolution of inflation expectations and the reasons behind their divergence from the two-year 3% target. It was said that it was important to understand the motives behind these expectations, specifically whether they responded to a judgment on the Bank's capacity to meet the inflation target or there were originated in a different view of the future evolution of the determinants of inflation.. It was noted that it was difficult to establish which of the two reasons had greater weight: the first of them seemed less relevant considering that the Bank had raised the rate sharply over a short time span, even taking the market by surprise, and it was one of the world's most proactive central banks in this matter. Therefore, the second explanation seemed more reasonable. Various sources suggested that the market had a clearly less contractionary view of demand, which was naturally associated with higher inflation.

It was mentioned that beyond the reasons behind the behavior of inflation expectations, the fact that they remained above 3% in the two-year horizon was a matter of concern. On the one hand, it could lead to high inflation persisting longer than assumed in the central scenario of the Report, which was a problem in itself, because it would entail a more contractionary TPM trajectory, in the different scenarios under analysis, in order to ensure the convergence of inflation to the 3% target over the monetary policy horizon. On the other hand, in a context of high short-term inflation and a weak economy in the medium term, keeping inflation expectations in line with the target was essential for monetary policy to be able to deal appropriately with this scenario.

3. Analysis of monetary policy options

The Board agreed that the Monetary Policy Rate (MPR) should be further raised at a significant pace, consistent with a scenario where annual inflation was already high and was set to continue rising in the near future. The central scenario of the March Report considered an MPR that would be close to 7.5% in the second quarter of the year. While this scenario did not constitute a commitment by the Board, as decisions were subject to macroeconomic developments, it did allow for the establishment of policy options relevant to this Meeting: (i) raising the MPR by 125 basis points (bp); (ii) raising it by 150bp; and (iii) raising it by 175bp.

All the Board members agreed that the three options were plausible, but that the 150bp option was the one that best fit in both technical and communicational terms with the intended message to be conveyed. Such a decision left them in a more comfortable position to react to any deviation or to accelerate the adjustment if deemed prudent as new information would become available going forward.

Regarding the 125-bp and 175-bp options, there was agreement among the Board members that both had disadvantages, particularly the former. In the view of one Board member a 125bp increase could be ruled out based on the current inflation expectations scenario and what such an option would signal. In particular, because it would come as a major surprise, which could convey a relatively lower concern about the inflationary scenario and its outlook. Regarding the 175-bp option, all the Board members agreed that it could give stronger signals of concern about inflation, but it could also indicate an MPR trajectory that would go beyond the conditions described in the central scenario, and was therefore complex to communicate. All the Board members also agreed that increases in the MPR above 175bp —as could be observed in the expectations of some market agents— were outside the macroeconomic scenario that the Bank considered plausible.

All the Board Members agreed that the Chilean economy was facing a complex scenario, and that the Bank's main task was to ensure the convergence of inflation to the 3% target within the two-year horizon. For this reason, the Board would take every action necessary to meet this objective. Failure to do so would not only call the Central Bank's credibility into question, but would also put the economy at risk, as it could end up causing a higher cost in terms of reduced economic activity and employment by weakening its ability to implement a countercyclical monetary policy.

4. Monetary policy decision

Governor Costa, Vice-Governor García, and Board members Naudon and Céspedes voted for raising the monetary policy interest rate by 150 basis points, to 7%.

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