Monetary Policy Meeting[1]

JULY 2020

CENTRAL BANK OF CHILE

[1] This is a translation of a document originally written in Spanish. In case of 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. 275, held on 14-15 July 2020.

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

Also present: Alejandro Zurbuchen, General Manager; Juan Pablo Araya, General Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Beltrán de Ramón, Financial Markets Division Director; Solange Berstein, Financial Policy Division Director; Gloria Peña, Statistics Division Director; Michel Moure, Institutional Affairs Division Director; Markus Kirchner, Macroeconomic Analysis Manager; Enrique Orellana, Strategy and Communication of Monetary Policy Manager; Miguel Fuentes, International Analysis Manager; Andrés Fernández, Economic Research Manager; Diego Gianelli, Market Operations Manager; Juan Carlos Piantini, Financial Markets Analysis Manager; Rodrigo Alfaro, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Bernardita Piedrabuena, Corporate Risk Manager; Felipe Lozano, Communications Manager; Luis Óscar Herrera, Advisor to the Finance Minister; Tatiana Vargas, Senior Economist; Pilar Cruz, Senior Economist; Marlys Pabst, Secretary General.

1. Background

The domestic scenario

The macroeconomic scenario had continued to reflect the evolution of the Covid-19 pandemic. In Chile, the second-quarter data available confirmed a sharp economic contraction. Considering wider sanitary containment measures, May's Imacec had dropped 15.3% annually, with decreases in almost every sector. Exports had shown greater resilience than expected, particularly in mining shipments and some industrial lines. Import levels, in turn, showed some stabilization, after the significant falls of previous months. Business and consumer expectations remained markedly pessimistic. In this context, the most stringent sanitary containment measures continued to affect an important part of the country, although health indicators had evolved favorably, which had allowed some regions to begin reducing the confinement measures.

Various sources of quantitative information (i.e. surveys and administrative sources) reported a sharp deterioration of the labor market, in particular a significant fall in employment and a decrease in hours worked and wages. Inactivity had risen substantially, which, together with the Employment Protection Law, had contained an even greater increase in the unemployment rate, although indicators of underutilization had worsened further. The Bank's Online Help Wanted index had stabilized in a low level and hiring expectations (IMCE), despite some improvement, remained in pessimistic territory. Preliminary qualitative information drawn from the Business Perceptions Report confirmed this evaluation of the labor market and revealed concerns on this front. Some respondents commented that they saw pending workforce adjustments and most said that they expected no further hirings in the near future. Hence, more respondents than not anticipated that employment would recover at a slower pace than activity. Several also pointed to a reduction in labor income resulting from shorter working hours, no overtime, reduced sales commissions, elimination of benefits and wage adjustments, among others. On the other hand, government measures to compensate for income loss had been strengthening since June. The evolution of consumption continued to be affected by these dynamics, in particular the sale of non-essential goods. In this context, the median of private expectations in July's Economic Expectations Survey (EES) anticipated a GDP drop of 6.1% annually for this year, in line with the central scenario of the latest Monetary Policy Report, albeit with a high dispersion in these estimates.

The domestic financial markets reflected both the somewhat better tone of the external scenario and the stronger boost from the domestic monetary policy. Long-term interest rates —BCP and BCU at 5 and 10 years— saw sharp decreases in the days following the June Meeting, of between 30 and 40 basis points. However, in the run-up to the July Meeting, amidst the Congress debate around the withdrawal of 10% of individual pension funds, this decrease had been importantly reversed. In the same context, the stock market returns had worsened and the peso, with ups and downs, had appreciated. In the money markets, financing costs remain contained in both pesos and dollars, despite a reduction in dollar liquidity. With respect to the previous meeting, bank spreads had widened in both the AA and AAA segments. Meanwhile, non-bank corporate spreads showed a heterogeneous evolution; while in the AA segment no changes were observed, in the AAA the spreads had increased noticeably.

The annual variation in commercial loans had continued on the rise, while for consumer loans it had continued to fall (13.3% and -7.8%, in real annual terms respectively). The mortgage segment had decelerated its real annual growth from 8.8% to 7.8%. Commercial banks had applied to nearly 95% of the funds available under phase 1 of the Facility Conditional on Increased Lending (FCIC), and many had used up their full assigned amount. In addition, the resources of FCIC – phase 2 were already available. As for portfolio risk, between April and May the Financial Market Commission data showed no significant change in bank arrears of 90 days or more. Provisions had increased, albeit to a limited extent, between February and April, especially in the consumer segment.

The second-quarter Bank Lending Survey reflected a tightening of credit supply conditions in every segment, owing partly to the risks present in the customer portfolio. Meanwhile, household demand for credit had fallen substantially, for both consumption and housing. In the corporate segment, demand continued to rise for funds to meet working capital needs, while it declined for funds to finance investment projects. Demand indicators from the real estate and construction sector pointed to further weakening.

Since the previous Meeting, annual inflation had dropped to 2.6% while core inflation—CPI minus volatiles—had declined to 2.5%. This figure was in line with forecasts in the June Report, with persistently weak areas more closely related to services, in a context of low inflationary pressures due to the abrupt widening of the activity gap. Accordingly, June's business expectations (IMCE) continued to show a weak outlook for future costs and prices. Inflation expectations showed no big change. One year ahead, in the EES they had remained at 2.5% while the Financial Brokers Survey (FBS) showed a decline to 1.7%. Two years ahead, the EES remained at 3.0% and the FBS at 2.6%.

Expectations for the Monetary Policy Rate (MPR) contained in both the EES and the FBS continued to foresee it unchanged at is technical lower bound of 0.50% for a protracted period of time, while those implicit in the prices of financial assets anticipated a transitory cut to 0.25%. At longer terms, asset prices pointed at the MPR standing at 0.5% over the entire two-year monetary policy horizon, while the FBS and the EES estimated a rise towards mid-2022, up to levels of 0.75% and 1%, respectively.

The international scenario

In the external scenario, the figures for May and June showed improvements in the main economies, coinciding with their gradual reopening after historic falls in the previous two-month period. The upturn was visible in the manufacturing and retail sectors, along with labor market information which, at the margin, was also more positive in some of them. Business expectations (PMI) had recovered. Household expectations had also improved, although their performance and that of other indicators more closely related to private consumption augured a slow rebound in this expenditure component. In any case, all these variables remained well below pre-pandemic levels, while important risks remained concerning the performance of activity going forward, mainly considering the recent resurgence of Covid-19 in several countries, and restated confinements in some places. The sanitary situation had complicated particularly in the United States, where the new quarantines imposed threatened to halt the recovery of mobility and the performance of its economy.

In this context, the overall markets' estimates for world growth had not changed materially in the last month, although some further deterioration in Latin America stood out. This region was facing the most complex situation, with long-standing doubts regarding the handling of the sanitary emergency and deep damage especially on employment, which pointed to a sluggish recovery.

Central banks and governments had maintained their efforts or made additional economic policy announcements, holding on to their highly expansionary tone. On the monetary side, this included further interest rate cuts in some countries or the extension of unconventional plans, with actions concerning the pandemic being led by the Fed and the European Central Bank. On the fiscal front, there was also increased spending packages in some economies, further swelling the debt of governments, in some cases to their bulkiest in decades.

In the last month, the international financial markets had seen some fluctuations associated with the aforementioned upsurges, and with news from the commercial and geopolitical scenarios. In any case, they had kept a more positive tone, because of both the economic measures adopted and the improvement of effective activity data. Thus, although with limited movements overall, in the last month several economies had exhibited improvements in their stock markets, spreads and currencies, while a large part of long-term interest rates had declined. The emerging world continued to see reversals in capital outflows. Commodity prices had also picked up, driven particularly by a brighter outlook for activity in China and, in the case of copper, also by supply-side factors. Thus, copper had risen 14%, to near US$3 per pound, oil (the WTI-Brent average) had risen 9%, to US$42 per barrel, while foods posted their first monthly increase in the year so far.

2. Background analysis and discussion

There was discussion about the evolution of the external scenario, noting that the recent developments were in line with expectations. On the one hand, global growth prospects had stabilized and financial markets maintained a favorable outlook, leaving the most stressful moments behind. On the other hand, there was progress in the successive openings in several economies, with numbers that confirmed this gradual recovery in line with projections or even with some positive surprises. In addition, the price of copper, which was affected by supply and demand conditions, had outperformed expectations. However, the risks of new epidemiological outbreaks and the need to impose new containment measures—or to impose a more paused withdrawal of the ones in place—had been increasing in recent weeks, especially in the United States, and new sources of conflict were re-emerging in the political arena, particularly in the relationship between the US and China.

Internally, there was agreement that the activity and price data of recent months fell within the scope of the June Report's baseline scenario. However, the risks were high, especially since the more stringent sanitary containment measures had been extended beyond predictions and the labor market had worsened significantly. In particular, it was mentioned that the extension of quarantines might significantly tighten financing and credit conditions for companies that, given their size, were neither small enough to access Covid-related credit lines nor large enough to access the capital market. Coupled with the poorer performance of the labor market, a scenario could be emerging in which the post-pandemic economy's ability to recover would be affected. This was especially complex in a context where the political cycle was introducing more uncertainty about the future evolution of the economy, particularly because of its impact on investment. In any case, they stressed the improvements in sanitary indicators and the possibility that stricter containment measures might be relaxed over a shorter time horizon, something that was not thought possible just a few weeks back.

As for the domestic financial market, it was pointed out that liquidity levels were still high, with interest rates aligned with the message of the MPR being kept at its technical minimum for an extended period and long-term rates that had fallen in response to the monetary policy announcements of the previous Meeting. However, the latter's reversal of recent days was also mentioned, in the midst of the discussion about the withdrawal of funds from the pension funds. Regarding credit, there was agreement that the growth in commercial loans showed that the stimulus measures provided by the Bank, the CMF and the Government were helping to provide significant financing flows to companies, which were vital to overcome the economic emergency caused by the pandemic. It was noted that the existence of Fogape guarantees, which complemented the liquidity available with a credit-risk buffer, had been a very relevant factor in the good evolution of credit. However, it was also said that the data suggested that the credit-risk problem was still significant and might be escalating, and this was an important issue, because the increase in credit flows not only depended on the provision of liquidity, but also required limiting the risks associated with credit intermediation. In particular, care had to be taken to ensure that the longer-lasting quarantines and weaker activity would not imply firms going from facing a liquidity problem to facing a solvency one, which had very different consequences for the economy and for the kind of actions that had to be taken.

3. Analysis of monetary policy options

All five Board members agreed that, given the macroeconomic context created by the pandemic and with the MPR at its 0.5% technical lower bound, there was no other option than to keep it untouched and strengthen the message that it would remain there for a prolonged period of time.

On unconventional measures, all the Board members agreed that the decisions made at the last Meeting had been fully validated, which justified keeping them in place. The increased monetary stimulus continued to help ensure that commercial credit, backed by the established guarantees plus regulatory measures, continued to sustain the productive sector. In turn, the asset purchase program had been well received, whose magnitude and timing seemed appropriate under the circumstances.

All the Board members agreed that beyond the fact that the data of recent months were in line with expectations, the most relevant question to ask was how robust and sustainable the economic recovery would be. The answer was not obvious, because the scale of the shock was causing many scars, particularly to individuals and businesses, whether due to lost jobs and income, solvency problems, or more permanent adjustments that should be made to the operation of some sectors.

In the Board's opinion, all the above heightened the importance of the role played by public policy. In the upcoming stage, these would be as important as they had been during the shock containment stage, especially regarding the rehiring of workers, the restructuring of companies and the administration of financial conditions and obligations, all of which while also preventing sources that could reactivate the epidemic. There was agreement that the challenges for monetary policy were also considerable in this context. The measures adopted by the Bank in recent months had been effective not only in helping mitigate further damage to the economy and the population, but also in ensuring the countercyclical behavior of credit and financial conditions. Maintaining this orientation would sustain the economy's recovery capacity and, with it, the convergence of inflation to the policy target.

All the Board members drew attention to the effects that Congress approval of the bill of pension fund withdrawal could have on the economy, because of its impact on both the financial markets and domestic demand. They agreed that there was no obvious policy response, beyond the fact that the necessary measures should be implemented to ensure that there would be no excess volatility that would compromise financial stability as the pension funds were being liquidated. They also agreed that a clearer assessment of these issues should be made as the bill advanced in its legislative process, which together with the fine-tuning of the diagnosis on the economy's evolution would be priority tasks until the September Monetary Policy Report.

4. Monetary policy decision

Governor Marcel, Vice-Governor Vial and Board members García, Naudon and Costa voted for holding the MPR at 0.5%. They also agreed to keep in place the unconventional measures lending support to liquidity and credit.