Monetary Policy Meeting[1]

DECEMBER 2019

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. 269, held on 4 December 2019.

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

Present the Finance Minister, Ignacio Briones.

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 Operations Division Director; Gloria Peña, Statistics Division Director; Michel Moure, Institutional Affairs Division Director; Miguel Fuentes, Macroeconomic Analysis Manager; Enrique Orellana, Strategy and Communication of Monetary Policy Manager; Diego Gianelli, Market Operations Manager; Felipe Lozano, Communications Manager; Hermann González, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background analysis and discussion

The data submitted to the Board and analysis thereof are contained in the December Monetary Policy Report. This document highlighted that the macroeconomic scenario has undergone an abrupt change since mid-October. Until then, the economy had behaved in line with projections in the September Report, with annual GDP growth at 3.3% in the third quarter and an annual CPIEFE variation of around 2%. The crisis that had broken out on 18 October was characterized by social demands that had prompted the discussion of relevant institutional changes —including a new Constitution— and pressures for social reforms. This process, however, had been accompanied by significant and prolonged episodes of violence, which had triggered major disruptions in the productive system, severely reducing activity and weakening employment. The information at hand showed a significant rise in uncertainty and a deterioration in confidence that were amplifying these effects.

The financial markets had been strained by sharp price movements, which in some cases had gone beyond what one would expect given the country risk. The Board had taken various measures to ensure liquidity in both pesos and dollars, and had decided to intervene in the foreign exchange market to rein in the high exchange rate volatility and help in the adjustments so they would proceed appropriately.

About projections, the recently announced increase in the fiscal impulse, coupled with the already very expansionary monetary policy, would help contain the economic downturn in the policy horizon, so after a contraction of 2.5% annually in the fourth quarter of 2019, GDP would grow between 0.5% and 1.5% in 2020. The important deceleration of growth would widen the activity gap over the monetary policy horizon, pulling down inflation. However, the financial impacts of the higher uncertainty and the more persistent effects of the peso depreciation, would increase inflationary pressures over the policy horizon.

All the Board members agreed that the diagnosis of the current state of the economy was highly uncertain, so in the coming months efforts would need to concentrate on making comprehensive evaluations of the macroeconomic scenario in order to determine its most likely short-term evolution. In addition, in the immediate future the consequences of the disruptions in economic activity and the protraction of disturbances of the public order had been clearly reflected in the drop in October's Imacec. Still, in the medium term the situation could be further complicated by increased uncertainty. It was affecting consumer and business confidence, financial asset prices and the value of the dollar, signaling a perception that negative effects would last longer. Among many issues, this was related to the lack of certainty on several political, economic and social issues so, to avoid major adverse effects, new agreements were required in order to narrow the spaces of uncertainty as quickly as possible. In fact, it was noted that the Report's baseline scenario pointed to very low growth in 2020 to begin recovery in 2021, which relied partly on the assumption that uncertainty would dissipate throughout this period, so that companies and individuals would invest again and regularize their consumption decisions. Absent this, the economy could stagnated for several years.

There was debate around the evolution of inflation in the next few quarters, particularly because of uncertainty regarding which effect would dominate, either the impact of the idiosyncratic depreciation of the peso or the widening of the activity gap. It was brought up that the unusual nature of the phenomenon affecting the economy meant that its effects on inflation were more difficult to forecast and called for a special effort of analysis and scrutiny. Actually, this characteristic of the current situation assigned much value to the information that would be gathered in the coming months. Thus, going forward, information on the evolution of inflation, activity, and financial and credit conditions would be much appreciated.

Some Board members raised concern about the need to monitor very carefully how the monetary policy pass-through channel was working. In their view, in an environment of uncertainty and risk, the sensitivity of spending and production decisions to monetary policy was likely to be altered. While the measures taken by the Bank had succeeded in normalizing the functioning of the money and foreign exchange markets, their evolution had to be continually monitored in the coming quarters. In particular, how credit risk would evolve, how this might affect the behavior of banks, and what measures could be taken to ensure the expeditious transmission of monetary policy.

2. Analysis of monetary policy options

All five Board members agreed that the underlying factors that generated uncertainty and influenced the evolution of economic activity and inflation were outside the scope of macroeconomic policies, despite the fact that they could help to mitigate their negative impacts somewhat. In this sense, when defining the course of the monetary policy, it was necessary to take into account that in moments of falling GDP and employment it was essential for the MPR to have a strong expansionary tone.

They also agreed that the decision to hold the MPR at 1.75% dominated every other option. First, the current degree of monetary expansion was estimated to be consistent with the cyclical weakness of the economy, with the high level of uncertainty regarding its future evolution, and with the fiscal stimulus program that the government had announced in previous days. Second, the necessary consistency between exchange rate intervention and monetary policy limited the room for rate reductions over the coming months, as speculation on the latter could generate the kind of volatility the intervention sought to avoid. Finally, it would be inconvenient to consider raising the MPR, as the Report's scenario did not contemplate rises for some time, even taking into account the short-term inflationary impact of the peso depreciation.

One Board member recalled that in the recent past the Bank's reaction to an environment of deteriorating activity had been to boost the monetary stimulus, always keeping in mind the right calibration of the impact of the peso depreciation on inflation, which now would be even bigger due to its idiosyncratic nature. This time around, however, he thought that the prudent thing to do was to signal a flat MPR during a period, because the direction that the social unrest had taken had created a climate of stress and uncertainty that could take various forms. In particular, he noted that the Bank had adopted extraordinary measures of liquidity provision and had begun a foreign exchange intervention that limited —especially the latter— the countercyclical action that in principle could be expected from monetary policy.

3. Monetary policy decision

Governor Marcel, Vice-Governor Vial and Board members García, Costa and Naudon voted for keeping the MPR at 1.75%. Furthermore, they agreed that a signal had to be given that the MPR would be kept stable over the coming months, awaiting for more information about the unfolding to the macroeconomic scenario. With such information factored in, the next movements could be either up or down depending on the true state of the economy and the inflationary outlook.

In the Board's opinion, flatlining the MPR not only was consistent with inflation's convergence in the policy horizon, but it also contributed to reducing uncertainty within the economy during a troubled period. In addition, it would be coupled with the greater exchange rate stability generated by the intervention and the provision of liquidity to the market that had been assured through different instruments. In the Board's view, reducing uncertainty was imperative in order to spur the economic recovery, reduce the probability of a recession and prevent unemployment from reaching high levels difficult to reverse. True enough, for the Central Bank it was not possible to reduce this uncertainty in its roots, but at least it could prevent it from multiplying via its impact on the markets.