Monetary Policy Meeting[1]

JANUARY 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. 270, held on 28–29 January 2020.

Present: Mario Marcel, Governor; Joaquín Vial, Vice-Governor; 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 Operations Division Director; Gloria Peña, Statistics Division Director; Michel Moure, Institutional Affairs Division Director; Andrés Sansone, acting Macroeconomic Analysis Manager; Enrique Orellana, Strategy and Communication of Monetary Policy Manager; Miguel Fuentes, International Analysis Manager; Andrés Fernández, Economic Research Manager; Juan Carlos Piantini, Financial Markets Manager; Diego Gianelli, Market Operations Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Felipe Lozano, Communications Manager; Luis Óscar Herrera, Advisor to the Finance Minister; Tatiana Vargas, Senior Economist; María del Pilar Cruz, Senior Economist; Marlys Pabst, Secretary General.

1. Analysis of the technical teams

The international scenario

In the external scenario, the advances in trade negotiations between China and the United States, particularly after signing the first phase of the agreement, and the positive surprise in incoming activity and demand figures from the main economies —especially the greater stability of manufacturing-related indicators— had a positive impact on financial markets and commodity prices. However, new sources of tension, in particular the coronavirus outbreak, had increased the global perception of risk, to a great extent because of how it could affect the performance of the Chinese and other Asian economies. In the days leading up to the Meeting, this had translated into higher risk premiums, widespread depreciations of currencies against the dollar, and falls in stock prices and interest rates. In the case of commodities, prices had fallen to their lowest of several months, and copper was no exception.

In terms of activity, better numbers could be observed in the US in starts of new homes and mortgage loans that showed a higher impulse in residential investment, while the outlook for consumption remained robust, especially considering the tight labor market according to many indicators, similarly to other developed countries. The high level of US consumer confidence persisted and suggested that it would support this part of spending going forward. In the Eurozone, manufacturing production and several measures of expectations were showing better performance in the margin. In Germany, in particular, preliminary information confirmed positive GDP growth in 2019, albeit the lowest rate since 2013. Meanwhile, in the United Kingdom the latest known economic data showed a deterioration, in the run-up to the signing of a Brexit deal with the European Union.

In the emerging economies, China's GDP had closed 2019 with a 6.1% expansion, in line with market expectations, while short-term activity data showed an acceleration in December from the previous month, including figures from the external sector. The upturn in investment in fixed assets stood out. The outlook in Latin America continued to be characterized by socio-political tensions in a significant group of countries, with monthly activity data that had been weaker at the margin in some countries, such as Mexico and Argentina. In Brazil, the approval of the pension reform had boosted confidence and several indicators suggested a gradual rebound there.

In a context where global inflation was still bounded, global monetary policy continued to be expansionary, with policy rates being held flat or further reduced in most countries. Meanwhile, in the Eurozone it had been announced that the monetary policy framework would be revised during 2020, which could result in an extension of the current mandate of the European Central Bank.

The domestic scenario

Since the last meeting, domestic financial markets had shown some volatility that matched the evolution of internal and external determinants, and in line with the impact of the measures adopted by the Bank. Thus, since the December Meeting, the peso had appreciated and had become notably less volatile, reflecting the effects of the exchange rate intervention carried out by the Bank. The measures aimed at favoring market liquidity had also been effective, contributing to reducing money market spreads in both pesos and dollars.

In the credit market, the marked deceleration of consumer loans stood out, while commercial and mortgage lending showed no major changes in annual expansion rates. At the same time, corporate bonds had been issued abroad in significant amount, with favorable financial conditions. Interest rates on commercial and mortgage loans had increased compared with data available at the previous Meeting.

Regarding qualitative information, credit conditions had tightened, as reflected in the Bank Credit Survey of the fourth quarter of 2019, which reported that credit supply was perceived as more restricted in all portfolios, particularly in the consumer and large company segments, together with weaker demand, mainly for consumer credit. Also, in the Business Perceptions Report (IPN) of February, most of the respondents saw a tightening of financial conditions, mainly due to some increase in interest rates in certain segments—although they noted that they were still low by the usual standards— and greater difficulties in credit granting requirements.

Regarding local activity, fourth-quarter figures available were in line with assumptions in the baseline scenario of the December Monetary Policy Report, which ratified that the disruptions caused by the social crisis had significantly affected the Imacec of October and November 2019 (-3.4 and -3.3% annually), where the annual fall in some services and trade deserved mention. On the opposite side of the spectrum, construction had shown positive growth in both months, and so had the manufacturing industry in November. At the same time, some indicators suggested that the negative effects had moderated in December.

On the expenditure side, the contraction of private consumption's tradable components stood out, as reflected in retail sales (INE) new car sales (ANAC), consumer goods imports (durable and non-durable), retail inventories that continued to be seen as high (IMCE) and consumer expectations that persisted in strong pessimistic territory.

In the labor market, INE data for the moving quarter ending in November showed the unemployment rate at around 7.0%, while private and public salaried job creation was increasing in annual terms, concentrated mostly in public. Meanwhile, Universidad de Chile fourth-quarter 2019 saw the unemployment rate for Greater Santiago rising up to 8.8% and slightly negative annual employment growth, influenced mainly by the annual contraction of salaried employment, in a context where administrative data, such as December's contract termination notices, showed an incipient deterioration. Furthermore, hiring expectations remained pessimistic in several sectors (IMCE). In addition, most respondents to the IPN of February said they had made no hiring and were more cautious in making and/or postponing this type of decisions. Some sectors reported layoffs, as well as fewer recruitments of seasonal summer workers, especially in the most severely affected sectors.

About investment, capital goods imports had continued to contract in annual terms and business expectations remained pessimistic. In any case, the Corporation of Capital Goods (CBC)'s investment project survey for the fourth quarter of 2019 showed no big changes so far in the amounts committed for 2020 and 2021. On the other hand, fourth-quarter exports had fallen in annual terms, mainly due to supply-side factors that had affected industrial and mining shipments, while agricultural shipments had risen. In this scenario, private expectations as per the January 2020 Economic Expectations Survey (EES) for total and non-mining GDP growth had dropped in both cases to 1.2% annually for 2020 and 2.5% annually for 2021.

The IPN of February showed a high level of uncertainty regarding the outlook for this year, beyond the fact that the immediate impact of the social crisis on business performance had been uneven across regions and economic sectors. Regarding fourth-quarter activity, in most regions performance was poor, especially in activities related to tourism, hotels and retail, where establishments in central areas had been the most affected, as they were more exposed to outbreaks of violence. In several regions, construction and real estate were also among the hardest hit. Still, more respondents reported some improvement in their activities in December compared to the previous two months. By contrast, some activities, such as those linked to the mining and salmon sectors, had continued doing business as usual.

Going forward, most respondents said they were anxious about developments in March and April, particularly for fear of the return of violence, the outcome of the constitutional plebiscite and the progress of the measures under discussion. Given the difficulties in making projections, many had decided to postpone their investments. However, the large-scale projects under way in the mining, forestry and salmon sectors had not been modified significantly.

Since the last Meeting, annual inflation had risen to 3% and the core measure (CPIEFE) had remained at around 2.5%. The evolution of both indicators had been lower than foreseen in the December Report. Going forward, the evolution of inflation remained exposed to opposing forces, whose relative impact was still uncertain. On the one hand, the outlook for activity remained weak and its recovery continued to depend on the economic agents' reaction to the new scenario. On the other hand, the inherent pressures of the idiosyncratic depreciation that the peso had accumulated since October 2019 were still present. In this regard, most of respondents to the February IPN reported that costs had remained stable or increased slightly caused mainly by the higher prices of imported inputs, which they anticipated might intensify in the future. In some cases, this had resulted in higher final prices or fewer clearance sales. In others, respondents pointed out that the highly volatile exchange rate had led them to postpone adjustments to final prices, and that the pass-through could begin to occur as the large inventories were used up. Also, the cost outlook that was reflected in the IMCE business confidence showed increases in recent months. With respect to private inflation expectations, one-year-ahead measurements had risen, while two years ahead they had remained around 3%.

In this context, expectations for the MPR implicit in the prices of financial assets and inferred from surveys to specialists (i.e. the Financial Brokers Survey and the EES) anticipated that the benchmark rate would remain at 1.75%, at least until the first half for 2021.

2. Background analysis and discussion

It was noted that the volatility of the domestic macroeconomic scenario had decreased significantly since the December Meeting, thanks to several factors combined, in particular the decline of the most violent episodes—and a lower level of disruptions in productive activities—and the extraordinary measures taken by the Bank. Plus the more favorable response of the world markets to the first phase of the US-China trade agreement, coupled with early signs of stabilization or even improvement in developed economies. Most recently, the latter had been overshadowed by the Coronavirus crisis.

It was mentioned that now that several weeks had passed since the outburst of the social crisis, it was clear that local agents had made major adjustments to their investment portfolios. Exchange rate intervention and liquidity measures by the Central Bank, as well as the government sales of dollar assets to finance its deficit, had helped to accommodate this adjustment, thus avoiding excessive strain on domestic financial markets. In the near future, this situation should continue to be monitored, as should foreign investors' perceived risk in Chile. The data showed that investment flows from non-residents were still on positive ground and recent bond issues abroad by both the government and companies had been successful, with no big increases in risk premiums. In this sense, the evolution of the risks of the external scenario was particularly important, as although the occurrence of more positive or more negative scenarios could be just as likely, at this point the impact of the latter could have more severe consequences on the local economy.

It was noted that overall domestic growth figures had performed in line with the Monetary Policy Report, but there were still several aspects that needed resolution. One was the magnitude of the contribution of fiscal expansion to the cycle, as there could be tensions between short-term needs and medium-term sustainability of the fiscal accounts. Another was that consumer loans were decelerating rapidly, suggesting a more cautious behavior of households, together with credit constraints that were perhaps becoming more stringent on the credit suppliers' side. Although the labor market was not showing strong evidence of weakening in the surveys, consumption was a matter to be monitored very carefully, because, in the last few years, this component had sustained a good part of domestic growth. With regard to the situation of companies and investment, the short-term data also showed nuances. On the one hand, expectations were very negative, as was the evolution of some investment components and, on the other, credit creation figures remained fairly reasonable, while investment components more closely linked to mining maintained an interesting rate of expansion.

It was stressed that risks of a further weakening of the economy were still present. It was brought up that the December Report noted that uncertainty was fundamentally affecting the performance of the economy and that a recovery would be conditional on this uncertainty being reduced. In the weeks following the December Report, progress had been made on the legislative agenda, both on political and economic issues, and even on issues related to the protection of public order. However, it was yet to show up in economic indicators reflecting better expectations, and this would continue to hold back economic recovery.

About inflation, it was noted that it had been below the forecast in the December Report. A first reading led to think that this surprise did not signal a substantial change in the medium-term outlook, as it originated in the behavior of some more volatile prices. However, it did raise a red flag, as it could somehow mean that the transmission of the idiosyncratic peso depreciation was not evolving with the intensity expected in December, or that disinflationary pressures were more acute than expected. The March Report, where some more information would be available, would allow a better assessment of the implications of this surprise. In any case, in the medium term, inflation expectations remained at around 3%, even though in the shorter term they were below the Bank's projections.

3. Analysis of monetary policy options

All five Board members agreed that the option of holding the MPR at 1.75% dominated over any other. In a context where news accumulated since the latest Report did not alter substantially the macroeconomic scenario, holding the MPR was consistent with keeping a highly expansionary monetary impulse and the contents of the Statement from the last Meeting.

All the Board members agreed that beyond the decision of this Meeting, the recovery of the economy and the achievement of the inflation target required monetary policy to remain expansionary during the coming quarters, lending counter-cyclical support to the economy. One Board member stressed that keeping the MPR unchanged contributed to said expansionary monetary policy, considering that inflation was somewhat higher than had been projected before the social crisis. Moreover, he felt that the Bank's extraordinary measures had made it possible to maintain this monetary stimulus, because otherwise financial and monetary conditions would clearly be much tighter than they are today. He concluded by indicating that the March Report should assess whether the monetary conditions were indeed contributing to the process of refinancing and deleveraging of persons and companies unfolding in an environment aligned with macro projections and the achievement of the inflation target. In his view, the risk of having an inflation rate below the target could become significant in the coming quarters.

4. Monetary policy decision

Governor Marcel, Vice-Governor Vial and Board members García, Naudon and Costa voted for keeping the MPR at 1.75%. In the Board's opinion, the orientation of monetary policy in the December Report remained fully in force, so the MPR had to hold on to its strong expansionary stance to cushion the adverse impacts of the deteriorated internal confidence.

At the same time, the Board considered that the persevering uncertainty limits the possibility of anticipating now a course of action for the trajectory of monetary policy over the coming months. All five Board members reiterated their disposition to calibrate monetary policy to meet the inflation target, factoring in the responses of the Chilean economy to the effects and evolution of the ongoing crisis.