Monetary Policy Meeting[1]/

JANUARY 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. 262, held on 29-30 January 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, Felipe Larraín.

Also present: Alejandro Zurbuchen, General Manager; Mauricio Álvarez, acting 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, International Analysis Manager; Matías Tapia, acting Economic Analysis Manager; Matías Bernier, Domestic Markets Manager; Juan Carlos Piantini, International Markets Manager; Rodrigo Alfaro, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Hermann González, 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

International scenario

Recent international data had increased the possibility for the world economy to experience a sharper-than-expected slowdown, in a context of persistent volatility in the financial markets and where political and financial risks remained fully in force. In the developed world, economic expectations had deteriorated. Inflation had moderated in most countries, largely due to the oil price drop of the last quarter of 2018. In this scenario, some external risks had gained strength. The uncertainty surrounding the Brexit had intensified, with little time left for the parties to reach an agreement before the deadline of the actual departure. In China, there were doubts concerning the magnitude that the slowdown of activity could achieve and the effectiveness of its stimulus policies, coupled with medium-term risks that might continue to incubate. Meanwhile, the trade conflict between the US and China showed no major advances, beyond the fact that the market was still awaiting the possible results of their bilateral talks.

In terms of activity, the conjunctural data and economic outlook of the Eurozone were still moderating and posting lower figures than the market expected, raising doubts going forward. In November, annual growth in manufacturing output had dwindled across the entire bloc. Purchasing managers' indexes (PMI) for manufacturing and services continued to decline towards neutrality and consumer confidence had weakened somewhat in recent months. In the US, incoming data remained dynamic, with a still tight labor market that was sustaining consumption in the short term. However, market investment prospects for 2019 had declined further.

In the emerging world, China's GDP had grown 6.4% y-o-y in the fourth quarter, still on a path of gradual deceleration. December's exports and imports had contracted in annual terms and the manufacturing outlook was below the expansion-indicator pivot. In this context, the Chinese authorities had continued to announce and implement stimulus measures to stabilize the economy into the near future. Latin American data was mixed. Brazil showed improvement in industrial and consumer confidence, while announcements were expected regarding structural reforms that would sustain the fiscal accounts. In Mexico, the economic proposal focused on fiscal responsibility had calmed the markets. Argentina had officially entered a recession in the third quarter of 2018 and partial figures for the fourth quarter pointed to a new contraction.

In this context, the main central banks had attenuated the restrictive character of their monetary policy communication. In addition to its direct effect on short-term interest rates, the change in tone in the communication had had effects on the prices of different assets, including reductions in long-term interest rates and partial recoveries in the stock markets, after their poor performance of the latter months of 2018. This had also driven capital flows towards the emerging world.

Commodity prices had shown mixed movements since the December monetary policy meeting. Brent and WTI oil prices had risen around 1% each, mainly because of production cuts being applied by OPEC countries and other important producers. The copper price had receded nearly 5%, largely because of concerns about the Chinese economy's slowdown and a global scenario that pointed to lower demand. In parallel with this policy meeting, the FOMC's meeting was taking place, after which it decided to keep interest rates unchanged and announced that it would be patient as it determines further adjustments, while it would revise its plans to adjust its balance sheet.

Domestic scenario

Regarding local financial conditions, again the peso/dollar parity had shown significant ups and downs, but it was not far from its level at the previous meeting. Among the multilateral measures, the MER posted a depreciation in the period. The real exchange rate (MER index, 1986=100) had been at 93 in December 2018 and, using all the available information, it was estimated at 93.4 in January 2019, close to its average of the last 15 and 20 years. This, in a context in which the local risk indicators had remained contained and the fixed-income market interest rates had declined slightly, converging with the global trend. The stock market (IPSA) had increased in every sector, owing partly to the improvement in global stock markets following the reorientation of the monetary policy statement in developed countries, but also influenced by a recovery in the Brazilian economic outlook.

In the credit market, inflation-indexed loans had grown since the previous meeting, in particular the consumer and commercial segments. Interest rates were still low from a historical perspective, despite a slight increase recently. The Banking Credit Survey for the fourth quarter of 2018 showed strengthened demand for the different credit types, especially to large corporations, real estate and construction companies. On the supply side, credit constraints had eased for large companies while mortgage lending conditions had tightened somewhat.

About local activity, in line with the December Monetary Policy Report, partial fourth-quarter figures showed that the economy had regained dynamism, having left behind the specific factors that had slowed it down during the third quarter. Between October and November, the Imacec had averaged 3.6% annually, from an average y-o-y growth of 2.7% in the third quarter. The non-mining sectors had improved their performance, where again the greater momentum of those more related to investment, such as business services and some wholesale trade lines, was worth noting. Also, construction had recovered recently. Mining, after several months, had returned to positive annual expansion. With this information, the markets' growth expectations, as measured by the Economic Expectations Survey, were consolidated at 4% for 2018, while for this year and the next they were at 3.6% and 3.5%, respectively, almost unchanged since the close of the December Report.

Domestic spending behavior was consistent with that of activity. Investment continued to be its most dynamic component, with still optimistic prospects. On the side of machinery and equipment, imports of capital goods were growing strongly. In construction and other works, among other elements the upward correction of the CBC's Project Survey reflected that a greater number of economic sectors had increased the number of initiatives for this and the next few years, adding to the high flows that continued to be projected for mining. Business expectations (IMCE), on aggregate, remained around their neutral value. About private consumption, annual growth in the second half of 2018 had been slower than in the first, and below forecasts, especially regarding durables. Indicators of services consumption, in any case, suggested that it sustained a more favorable performance. The labor market showed no change with respect to the evaluation included in the December Monetary Policy Report. The unemployment rate and the annual expansion of nominal and real wages continued to be around 7%, 4% and 1%, respectively. Salaried employment continued to slightly outpace self-employment. Consumer expectations as measured with the IPEC had moderated. However, alternative indicators—built on the basis of the IPEC components more highly correlated with consumption—showed minor movements. Imports of consumer goods persisted at high levels.

Most of the interviewees for the Business Perceptions Report of February 2019 expected their businesses to perform this year as they did last year. Many of them responded that 2018 had closed with better results than in previous years, although less than they initially expected. This, in a context in which, competition among companies was still strong in general terms, they found it difficult to adjust prices upwards and their margins were narrow. There was a more positive perception of investment across the different regions, especially those related to mining, forestry and salmon farming. In contrast, opinions about consumption pointed to less dynamism, as was evident from interviews to retail agents, among others. About the labor market, no big changes were foreseen in the staffing of the interviewed firms and the vision remained of low wage pressures. Cost control continued to be an important focus point for the bulk of the companies consulted. On the credit side, lending conditions were still seen as favorable.

December's inflation had been at -0.1%, affected mainly by a fall in the prices of its most volatile items. With respect to the December Report, inflation had been somewhat below projections, mainly because of specific factors, such as lower inflation of some typically highly volatile services. In annual terms, inflation had fallen to 2.6% in December. By components, the annual growth rate of fuel prices had decreased to 8% and that of fresh fruits and vegetables, to 7.8%. Meanwhile, core inflation —CPIEFE— had risen to 2.3% annually, less than previous projections. By components, the CPIEFE for goods exhibited a slightly positive annual variation, while the CPIEFE for services had dropped to 3.4%.

In any case, prices more sensitive to the activity-gap, such as non-regulated utilities in the CPIEFE, continued to rise steadily. The private inflation outlook, albeit with fluctuations and following the evolution of international fuel prices, had decreased in the short term, standing at 2.8% annually for December of this year. Two years ahead, they were still around 3%.

The different market expectations (i.e. from surveys to specialists and implicit in the prices of financial assets) anticipated an increase of 25 basis points in the monetary policy rate (MPR) at this meeting. The surveys to specialists continued to predict that the MPR would stand at 3.5% and 4.0% one and two years ahead, respectively. Meanwhile, the prices of financial assets remained on a more stable trajectory with respect to the surveys and somewhat below what they had anticipated at the December meeting, placing the policy rate in the neighborhood of 3.25% one year ahead and somewhat above 3.5% in two years.

2. Background analysis and discussion

There was debate about the evolution of the global economy, noting that although the indicators showed slower growth than expected in Europe —particularly Germany— and in China, the US economy maintained its growth rate in line with projections, and a steady strengthening of its labor market. However, concerns about the evolution of global risks and their impact on growth had triggered a major adjustment in asset prices late last year, which had affected the expectations in all these countries significantly and had led monetary authorities to state that the interest rate hikes would be moderated going forward. This, coupled with the US and Chinese governments' willingness to negotiate their trade issues, had brought a little more calm to the financial markets, with some recovery in stock prices and declines in interest rates. It was mentioned that, despite this noisier environment, the situation for emerging countries had not changed much so far. After the capital outflows at the end of last year, calm had returned to the markets, risk premiums had fallen and commodity prices had tended to stabilize.

It was commented that the present economic climate had to be related to the persistent uncertainty that was accumulating, at least since the beginning of 2017, around important economic policy decisions. All this in a context in which the markets' sensitivity to potentially negative news seemed to have risen. It was concluded that the current global scenario was on a relatively atypical phase of the global economic cycle, which called for a more thorough analysis aimed at anticipating its future dynamics and possible transmission channels to the Chilean economy. A key element in this regard was to elucidate how the structural factors, the trade conflict and the policy responses that were operating in parallel would be reflected on the Chinese economy. Summing up, the assessment of the risks in the more negative external scenarios, associated with the international political-economic conduct, had increased significantly.

There was discussion about what could be underlying the slowdown in activity in the Eurozone and why the likelihood of a US recession had increased. This, in a context in which the reasons that usually hold back growth —for example, an accelerated monetary contraction as a reaction to inflationary pressures, or the exposure of important financial vulnerabilities— were not present. Among the possible causes, some specific issues that had affected activity in Germany and the slowdown of activity in China were mentioned. The hypothesis was also raised that it could be due to the prolonged time during which some risks had been present in the international scenario without being cleared, which could have led to a worsening of expectations.

There was also discussion regarding the central banks' reaction to the evolution of the global economic outlook. It was mentioned that, although the changes in the external baseline scenario were not big, the generalized reaction of the central banks had clearly been to signal greater caution. One way of interpreting this reaction was that the most recent recovery had responded rather to an expansionary monetary policy than to a more structural upturn. This could indicate that the international economy was weaker than had been considered in the baseline scenario, beyond the fact that the data had fairly matched the forecasts. The risk that emerged in this area was about the growth capacity of the world economy, because it could hardly be thought that monetary policy, or other countercyclical measures, had the capacity to continue providing an impulse of the same magnitude as in the past.

On the domestic front, there was agreement that, for the moment, the information at hand gave no obvious signs that the evolution of the external scenario was permeating the local economy. In particular, although inflation had closed 2018 somewhat below projections, it was adjusting in the foreseen direction. On aggregate, the non-mining GDP had brought no surprise either, although it did show a divergence between the evolution of the more investment-related sectors —which showed greater dynamism— relative to those more related to consumption, which had fallen below estimates. Exports and imports also evolved somewhat above forecasts. The local financial conditions continued to be stable and favorable, the credit channel had strengthened, with increased lending and higher demand for consumer and commercial loans, according to the Banking Credit Survey. Finally, the faster than expected advancement of the fiscal consolidation objectives was worth noting as a positive development in the domestic scenario.

The debate covered the reasons that could explain why inflation had been somewhat lower than expected, in particular the CPIEFE. It was said that it was difficult to associate this difference with a change in the business or the credit cycle, since after the doubts of the third quarter of last year, the fourth quarter had shown a recovery. It was added that core inflation for goods could be responding to a delay in the pass-through of the exchange rate rise of the second half of the year to prices, in which case a reversal should be expected in the short term, provided that the exchange rate stayed longer at its current levels. Alternatively, the fact that lower inflation seemed to affect every category of goods, suggested that it could be reflecting the weaker than expected consumption, in which case the convergence of inflation could take a little longer. Figuring out the relevance of these alternatives emerged as a priority task for the analysis of the upcoming March Report. Also, the possible changes associated to the new CPI basket had to be considered.

The implications of the evolution of the external scenario for the path of monetary withdrawal were also discussed. On one hand, the new information caused no significant change in the external impulse projected in the Report's baseline scenario. However, it was obvious that downward biased risks for activity had increased. The quantification of the effects of these developments was not evident and it would be a matter of the March Report to gauge its effects more accurately. At the local level, the outlook was somewhat more positive for investment, reflecting that, for now, the greater global uncertainty had not permeated the local economy so much. It was added that, actually, the easing of external monetary conditions had driven capital flows to emerging economies, so it could be thought that it was having a rather expansionary effect.

Facing the complete revision of the forecasting exercise —to be included in the March Report— it was noted that the external scenario depicted in the December Report was already below the market's projection. The discussion turned to the uncertainty surrounding the evaluation of structural parameters that sustained monetary policy (i.e. trend and potential growth, activity gap and neutral interest rate). It was noted that this made it especially necessary to update those estimates over the course of this year.

3. Analysis of monetary policy options

All the Board agreed that, given the information available, it was right to think that the baseline scenario continued to estimate closing capacity gaps and inflation converging to the target within the next two years. Therefore, they agreed that the monetary policy's orientation should continue to point at a normalization of the policy rate towards its neutral level, as had been expressed in the December Report.

Several Board members added that, in any case, it was important to bear in mind that multiple MPR trajectories were consistent with a given baseline scenario, and the convenience of signaling to the market one or another path as the most likely one depended not only on the starting point but also on the risk scenarios. However, all the Board members agreed that given the distance that still existed with respect to the neutral interest rate, these considerations were not an obstacle for the two policy options proposed at this meeting (i.e. holding the MPR at 2.75% or raising it to 3%) to be fully valid, as was a restrictive bias going forward.

Option 1: proceed further with the monetary stimulus withdrawal, by raising the MPR by 25 basis points

All the Board members agreed that the main argument for this option was that it was totally consistent with the baseline scenario, which showed no significant deviations. In addition, it was what the market expected, and the current degree of monetary stimulus, including its distance with the MPR's neutral level, provided room to raise the policy rate without entailing higher costs associated with the related risks.

One Board member noted that, beyond the decision to raise the MPR and further withdraw the monetary stimulus, it was important to communicate that such withdrawal would be done with greater flexibility, consistent with the commitment to proceed gradually and cautiously. This greater flexibility should leave no doubt that it was still necessary to continue with the normalization process, but, in turn, it was possible that this process could be somewhat slower than was communicated in the last Report.

Option 2: keep the MPR at 2.75%

The Board members agreed that the main argument for this option was that it bought time to await for more information on the evolution of the external scenario, its fundamentals and its transmission channels to the Chilean economy. This option, however, would not only take the market by surprise, it could also signal a change in the baseline scenario or in the need to continue with the normalization of the MPR, without having any information that could justify this.

One Board member noted that the evolution of the external scenario had led to a flattening of the MPR curve implicit in the prices of local assets. In his opinion, there was a quite remarkable divergence, since from the point of view of market prices, monetary policy would be more expansionary than projected some time ago without the ingredients that had motivated this movement in the world occurring at home. This, he concluded, could suggest that monetary policy was unnecessarily more expansionary than needed. Accordingly, from the standpoint of aligning the monetary policy with the international scenario, keeping the MPR and validating a scenario of a much flatter trajectory seemed very inconsistent with local developments, especially because Chilean economic indicators did not factor in developments in other countries, particularly in the developed world, and that was what had led other central banks to react.

4. Monetary policy decision

The Board decided, with the votes of Governor Marcel, Vice-Governor Vial and Board members García, Costa and Naudon, to raise the monetary policy interest rate by 25 basis points, to 3% annually.