Monetary Policy Meeting[1]/

JUNE 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. 265, held on 7 June 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; Juan Pablo Araya, General Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Juan Carlos Piantini, acting Financial Markets Division Director; Solange Berstein, Financial Policy 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; Felipe Lozano, Communications Manager; Hermann González, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background analysis and discussion

The background information presented to the Board and the analysis thereof are contained in June's Monetary Policy Report. That is, in recent months annual CPI inflation had remained around 2%, both in its headline and core measures. In turn, activity had reduced its annual expansion rate in the first quarter, falling below expectations. This adjustment had concentrated especially on mining, agriculture and other sectors dominated by supply factors. On the expenditure side, there had been a significant deceleration of investment, particularly of machinery and equipment, and of exports. In contrast, consumption had sustained the expected dynamism. Externally, the main development since the last Report had been the escalating conflict between the United States and its main trading partners, which had resulted in increased risk aversion, affecting the valuation of assets, currencies and commodities, as well as Chile's terms of trade, in a context of marked deterioration of global trade figures.

In this Report, the Board had updated the structural parameter estimates that were used to assess the state of the economy, their prospects and implications for monetary policy. Most importantly, this had allowed to quantify the effect of the strong immigration flow of recent years on trend and potential growth, increasing both. Meanwhile, the neutral MPR had been revised downward by 25 basis points (bp), partly reflecting the fall in neutral rates around the world and despite the opposing effect that could be expected from the higher trend growth. The widened gaps that were derived from the updating of the parameters and the weakness of first-quarter activity and demand were consistent with the low inflationary pressures observed.

2. Analysis of monetary policy options

All five Board members agreed that the new combination of precedents justified the need to increase the monetary stimulus. In particular, the updating of the structural parameters pointed to greater potential and trend growth, which, if added to the lower dynamism of the economy in the first quarter, resulted in a wider and more-persistent-than-expected capacity gap. This was compounded with the worsening of external conditions, especially the risks, and a lower neutral MPR, which translated into a somewhat weaker-than-expected monetary stimulus.

In such context, a needed discussion was about how this monetary expansion would proceed. A first option was to signal that the MPR would remain flat for longer than had been announced in March. Although this option matched market expectations, the Board members agreed that it had two important problems that ruled it out. First, it implied a delayed convergence of inflation to the target, which was obviously a problem in a context in which risks related to the external scenario and activity were biased downward. Thus, any shock entailing a greater delay in the convergence of inflation would make it difficult to meet the target within the policy horizon and would require sharper cuts to the MPR in the future. Second, under this option, the more expansionary monetary policy would rely essentially on signs of future decisions, which would have more limited effects than would concrete actions now. One Board member said that this second apprehension also applied to the option of not changing the rate at this Meeting with an expansionary bias, for which reason he also ruled it out.

All the Board members also agreed that, at this Meeting, the most relevant options were those that considered MPR cuts of 50 bp. This could be done in two ways. One, with a 25 bp reduction and a bias indicating that there would be another movement of the same magnitude. Or two, with a 50 bp reduction and a neutral bias stating that the next MPR movement will hinge on how certain the Board is about the convergence of inflation to the target.

Some Board members noted that, in terms of their macroeconomic effects, both options were practically identical so, in essence, the decision was tactical. These Board members opined that the main advantage of lowering the MPR by 25 bp and include a downward bias, was its lower communicational cost, mainly because it reduced the risk of this action being seen as a more adverse signal with respect to the macroeconomic scenario, compared with the scenario in the June Report. One Board member emphasized that this risk could be mitigated by the fact that the Report was due to be released the following Monday. The entire Board agreed that, given the surprise that the MPR cut would involve, on this occasion it was advisable to provide more information in the statement, including the Bank's outlook for activity.

Meanwhile, several Board members mentioned that the option to lower the MPR in two steps was not free of communicational costs. On one hand, it could convey some conditioning of the second cut, which was inconsistent with the Report's baseline scenario. For example, it could be the case that the next 25 bp occurred with no bad news in the margin, which perhaps would be difficult to explain. On the other hand, such two-step cut could be construed as a scenario that required a reduction of more than 50 bp, which was neither consistent with the Report's baseline scenario.

About the option to lower the MPR by 50 bp, the Board members emphasized that although it would come as a surprise, it was important to make it clear that the combination of factors behind the decision was unusual. In particular, due to the upward revision of potential and trend growth, which occurred along with a fall in the neutral rate, in a context of low inflation and economic slowdown. Furthermore, it had to be made clear that in the new scheme —eight meetings per year— this kind of MPR movements —50 bp— would be more frequent, partly because more background information could be accumulated between meetings. Thus, as the option to lower 50 bp was now relevant, it could not be ruled out that different scenarios should mean raising the MPR by the same amount without this being interpreted as fear of an imminent inflationary outburst.

Summing up, all the Board members agreed that either option would be a surprise and there was no clear-cut reason indicating the convenience of making a gradual adjustment instead of doing it in one take, while including more information in the statement and in the understanding that the Report's release would mitigate any possible misinterpretation.

3. Monetary policy decision

The entire Board agreed that the evaluation of the macroeconomic scenario raised no doubts about the need to lower the MPR by 50 bp altogether. This was much more consistent with the Report's baseline scenario and associated risks, allowing for greater certainty regarding the convergence of inflation to 3% in the policy horizon.

The Board also agreed that reducing the MPR by 50 bp accompanying a neutral bias would allow focusing the upcoming analysis in the evolution of the economy and its implications for monetary policy.

The Board decided, with the votes of Governor Marcel, Vice-Governor Vial, and Board members García, Costa and Naudon, to reduce the MPR by 50 basis points, to 2.5%.