Monetary Policy Meeting[1]/

JULY 2019

CENTRAL BANK OF CHILE

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MINUTES OF THE MONETARY POLICY MEETING

Monetary Policy Meeting No. 266, held on 17 – 18 July 2019.

Present: Mario Marcel, Governor; Joaquín Vial, Vice-Governor; Pablo García, Board member; Rosanna Costa, Board member; Alberto Naudon, 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; Miguel Fuentes, Macroeconomic Analysis Manager; Enrique Orellana, Strategy and Communication of Monetary Policy Manager; Diego Gianelli, International Analysis Manager; Matías Tapia, acting Economic Research 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

The international scenario

In the international scenario, the consolidation of more expansionary expectations for monetary policy at a global level stood out, with movements in that direction that had already taken effect in some economies. Following the recent communication from the Governor of the Federal Reserve Board (Fed), a large part of the market had internalized a cut in the US benchmark rate for the upcoming July meeting, adding statements with a more dovish tone by the monetary authorities in the Eurozone and England, among others. In terms of inflation, beyond seasonal increases, the numbers remained contained in the developed world, as did its outlook. Within the emerging bloc, in several Latin American countries inflation had decreased in the margin and was approaching the respective targets.

Overall, there was latent concern about the performance of the global economy, especially considering the negative surprise from manufacturing, foreign trade and investment indicators in several countries, which contrasted with incoming data from labor, consumption and services, that showed little change. About the developed world, the US manufacturing industry, although more stable in the margin, had contracted again in the second quarter, amid indicators of capacity utilization and business prospects for the sector (ISM) that showed some deterioration in recent figures. Meanwhile, the evolution of retail sales and job creation predicted that private consumption would complete the period with good performance. In the Eurozone, different expectations measures backed the region's weak outlook, especially those more closely linked to the tradable sector, coinciding with the worsening of exports from these economies. Germany, in particular, had disappointed again according to different data, with its evolution lagging somewhat with respect to other countries in the zone.

In the emerging world, China's GDP had expanded 6.2% annually in the second quarter. Worth noting was the lesser momentum from manufacturing and construction, while the behavior of services had not varied much. In any case, toward the end of the quarter some sectors had surprised positively, such as manufacturing and retail, pointing to some stabilization of the Chinese economy. In Latin America, despite rather improved confidence indicators in the margin, many economies had seen weak performance in the early part of the second quarter, as was evident in monthly activity figures. Domestic challenges persisted in several countries. In Mexico, the resignation of the Minister of Finance and government support for the state-owned oil company had triggered doubts in the markets, while Argentina was slowly leaving the recession behind, amid political uncertainty. In Brazil, meanwhile, there was progress in pension reforms.

This scenario continued to favor lenient global financial conditions. In line with the further easing expected for monetary policy, long-term interest rates had seen significant declines since the previous Meeting, to negative values in real terms in several economies, essentially the developed ones. Likewise, the appetite for risk had risen, with significant increases in the stock markets and greater capital flows to emerging countries in the margin. The risk premiums had receded, while the dollar had tended to weaken against other currencies. Trade tensions between the US and China had moderated somewhat, but with a limited impact on the markets.

After the June Meeting, commodity prices had risen slightly. Still, metals—copper included, with a near 3% rise since the previous Meeting—were below their prices of earlier months, in line with the uncertainty surrounding the external scenario. The oil price had risen around 6% according to the WTI-Brent average, boosted by supply factors and geo-political conflicts.

The domestic scenario

The evolution of the local financial market had been strongly influenced by the more expansionary monetary policy stance in Chile and by external developments. Medium- and long-term fixed income rates had declined sharply. The local stock exchange (IPSA) had posted increases during the last month, in line with stock markets abroad, all in a context in which risk indicators had declined for Chile and emerging countries in general. The nominal exchange rate, with some volatility, was down from the last Meeting, in line with the evolution of the dollar around the world and the copper price. Multilateral exchange rate measures had also declined. Meanwhile, the real exchange rate (RER index, 1986 = 100) was estimated at 93.4 in July, slightly below the June estimate (94.2) and close to the average of the last 15 and 20 years.

In the credit market, real loans showed a decrease in their annual growth rates in the consumer and commercial segments, and a slight increase in housing. Lending interest rates continued to decline, except for a minor rise in consumer loans due mainly to composition effect. The Bank Lending Survey of the second quarter reflected that supply conditions remained fairly stable, while demand was perceived to be weaker in large companies and with moderate rebounds in the segments of construction companies and housing credit.

As for local activity, between April and May the Imacec had accumulated an annual expansion of 2.2%, surpassing the 1.6% of the first quarter of the year. However, some early indicators and qualitative background suggested downside risks for the coming months. On the one hand, there was a contraction in exports, due to the weakness of some trading partners and low mining production. On the other hand, there had been some strikes in June. On the consumption side, imports of consumer goods had fallen deeper. Consumer expectations (IPEC) had continued to decline, becoming more pessimistic, and even the respondents to questions about consumption pointed to lower expansion going forward. This, beyond that in May the annual variation of retail sales (IACM) had been the largest of the year, owing partly to a one-off event of retail discounts during the month. The labor market showed no significant changes. The unemployment rate had remained around 7%, similar to the same period the year before, while different sources of information pointed to an increase in employment. Real wages continued to grow at or above 2% per year. Investment showed a mixed performance. On the one hand, there was the favorable evolution of some items linked to business services and wholesale trade and, on the other, a slower rate of construction expansion. Meanwhile, capital imports had shrunk in the margin. Qualitatively, business expectations (IMCE)—excluding mining—had become more pessimistic. It was worth noting the deterioration of the manufacturing industry, which posted the largest drop within the index.

In this context, market expectations for growth as per the Economic Expectations Survey had been revised downward with respect to the information available at the closing of the last Meeting, to 2.8% and 3.2% for this and next year (from 3.2% and 3.4% at the previous closing, respectively).

Preliminary information in August's Business Perceptions Report showed that the respondents continued to expect their businesses to improve growth in the second half of this year and over 2020, although their prospects had moderated, because of lower-than-expected results in the first half, and some sources of uncertainty externally and internally. By sectors, those linked goods trading were still among the most affected while those related to public infrastructure works lingered. By contrast, housing construction and the salmon industry posted good results. As for mining, the main impulse came from a handful of large projects underway, while output was seen as lower. Regarding investment, most of the respondents did not contemplate large initiatives in the short term, because they either had idle capacity or were waiting for a more sustained improvement in the economic context and/or the result of their businesses. Meanwhile, the mining, forestry and salmon sectors continued to develop important projects, which were boosting activity in some regions. In the labor market, most respondents reported that they were adequately funded for their current levels of activity, and that wage pressures remained low. Credit conditions remained favorable, with low interest rates and substantial availability of funds from the banking system for those who could show good results. Still, several respondents had no intention of taking more debt. In any case, in the segments of persons and companies, there were some reducing their financial burden, via debt renegotiations.

Annual CPI inflation—measured using the 2018=100 benchmark series—had remained at 2.3% in June, while the core measure (CPIEFE) had continued to hover around 2%. Among the items making up the latter, the generalized downward surprise from services prices, more linked to capacity gaps and labor costs, was most striking. On the contrary, the goods component of the CPIEFE had been above expectations, although largely motivated by the tourist package item. Inflation of the more volatile components of the CPI basket—food and energy—had brought marginal surprises. As for private inflation expectations, there was a decrease for the end of 2019 and one year ahead. At two years, the median of the Economic Expectations Survey had remained at 3%, while the median of the Financial Brokers Survey had declined to 2.8%.

In this context, expectations for the Monetary Policy Rate (MPR) foresaw an increase in the monetary stimulus in the coming months, despite that the consensus at this Meeting pointed to no change in the policy rate.

2. Background analysis and discussion

It was agreed that the main piece of news since the previous Meeting was the evolution of inflation. In particular, due to the general downward surprise from the services CPIEFE, which, given its historical persistence, suggested that its annual variation would flatline until the end of the year, as a result of a significant deceleration of its services component. As this tended to respond more to the activity gap and wages, and it had reached record lows, this was an important indicator of risk regarding inflation's convergence to the policy target.

It was noted that the surprise in services CPIEFE inflation suggested a rather widespread tendency in its components more related to wages, pointing to a potentially greater impact of immigration on its evolution. This signal was consistent with cost containment and low wage pressures that were repeatedly mentioned in successive Business Perception Reports. In the short term, it was pointed out, the projection of CPIEFE inflation would be materially different from what had been described in the latest Monetary Policy Report—partly a reflection of the persistence of services inflation—which was not part of private expectations. It was also noted that the evolution of inflation expectations had been noticeably downward, despite the clearly expansionary movement of the MPR in June, which had also taken the vast majority of people by surprise.

It was noted that the evaluation of risks called for a thorough analysis of the evolution of activity, demand, and capacity gaps. The Imacecs of April and May, adjusted for some one-off phenomena, had remained within expectations. For June, not-so-optimistic figures were expected, because the combination of two important strikes and the smaller number of business days would reduce activity's annual expansion by about half a percentage point. Thus, although the second quarter would exhibit greater growth than the first quarter, the weight of the acceleration would depend even more on the unfolding of the second half. The certainty about this, however, was toned down by some recent qualitative indicators, including the deterioration of consumer expectations and high-frequency information such as imports and construction data. It was stressed that the re-acceleration of the economy in the second half was an important component of inflation's convergence to 3%, and news coming from both abroad and within triggered significant doubts about whether the economy would have the capacity to begin closing the activity gap, or not.

The change in perspectives on the private consumption side was stressed. In particular, because imports of durable and non-durable consumer goods in the last month had brought significant unexpected nominal drops, in an environment of steadily deteriorating consumer expectations, which warranted weighting their incidence beyond the most recent figures. In any case, it was noted that there was less information about the consumption of services, which had shown greater dynamism in recent quarters, suggesting that production and employment in these sectors could be more stable or partially compensate for the aforesaid.

It was said that one hypothesis that seemed consistent with the observed changes was that immigration was having a somewhat greater-than-anticipated impact on the capacity gaps, reducing inflationary pressures. This was consistent with a greater creation of salaried employment, especially in services, which coincided with an increase in self-employment. How much this increase in the wage bill weighed was difficult to assess, given the problems of labor statistics in measuring the effects of immigration. In this context, it was noted that there were more doubts about the downward revision of private consumption, because forces operating in opposite directions were at play: consumer expectations were pointing down, while the possible evolution of the wage bill and better financial conditions pointed to some containment of these trends.

There was debate about risks for investment. On the one hand, the large investment projects were proceeding according to plan and their effects on certain sectors' and regions' economic activity was already becoming apparent, as the Business Perceptions Report showed. On the other hand, the possibility of slower investment dynamics in the rest of the sectors seemed to gain strength, partly fueled by recent figures that showed less momentum in some construction lines. In any case, the risk was of a lag in investment that would not significantly moderate the evolution of the economy in the near future, and that had already been present for some time.

About the external front, it was said that, far from being resolved, commercial conflicts and political uncertainty in the main economies of the world had intensified and extended into new dimensions of economic relations across countries. The markets seemed to have begun to internalize this dynamic as a more permanent element of reality, but at the same time had raised their wagers for an expansionary response by the monetary authorities. The words of the latter seemed to validate those expectations, but the most expected deeds of monetary policy were yet to be materialized. Just as it had been argued in the Monetary Policy Report, the complex external scenario was already having an impact on Chile, with opposing effects on exports and capital inflows, while the copper price had remained fairly stable. It was also said that, although some of the drop in Chile's valued exports could be blamed on the trade war—which was possibly being reflected in lower prices of several of the country's main export items—the worsened economic performance of our main Latin American trading partners was also playing a part.

3. Analysis of monetary policy options

All the Board members agreed that, as the downward risks in the local economy and particularly in inflation had intensified, the valid options for this Meeting should be to either hold the MPR at 2.5% with an expansionary bias, or reduce it by 25 bp, also with an expansionary bias.

Several Board members agreed that, in order to opt for one or the other, a rigorous analysis was necessary of the inflationary risks posed by the economy's current and expected dynamic, in order to assess what its true impact would be on this variable in the policy horizon. They agreed that, while the more qualitative information was enough to raise a warning sign in this regard, they would not necessarily suffice to compensate for the lack of more recent hard data and updated projections.

Given that at the previous Meeting it had been decided to make an important, surprise cut in the MPR, several Board members agreed that updating the macroeconomic scenario was particularly relevant to extract the implications for monetary policy. This was so because the monetary policy would not be exhausted by an immediate adjustment of the rate, but by defining the trajectory of which this possible change was part. In other words, adjusting again the rate based on partial and qualitative background could increase, rather than reduce, uncertainty in the economy if it was not clear how much the macro projections had changed and how deep and persistent the additional monetary stimulus was intended to be.

One Board member noted that, although the most profound analysis of the state of the macroeconomy was carried out in the Meetings that coincided with the preparation of the monetary policy reports, this did not imply that in Meetings like this one, where that was not the case, no changes in the orientation of monetary policy could be adopted. He added that this could occur when acting in line with a predefined bias, when powerful evidence of a change in the macro scenario arose, or when an intermediate update of projections was made in response to a significant set of antecedents. In addition, he agreed on the difficulties in forecasting or estimating the size of the additional monetary stimulus that would be required without a more detailed analysis of the medium-term impacts of the latest news. However, in his opinion, it was possible to think that this increase in momentum should not be less than that which at that date was incorporated in the prices of financial assets, which was, give or take, a reduction of 50 basis points off the MPR for a relatively long period of time.

One Board member felt that there were sufficient antecedents that made it necessary to lower the MPR by 25 bp, as it was clear that the 50-bp reduction of the last Meeting had not been enough to ensure the timely convergence of inflation to the target. In particular, activity and demand data showed less-than-expected growth for the next few quarters; inflation was still low and had surprised with lower numbers in a large group of services; plus the external scenario was uncertain, and steadily weakening. Furthermore, the evolution of the exchange rate and inflation expectations also contributed to postponing the convergence of inflation. He added that the market anticipated this assessment, as asset prices showed that the MPR would be reduced by 25 basis points in September, with a high probability of a second cut toward the end of the year. In addition, expectations surveys also showed reductions. Finally, he believed that the fact that now there were eight instead of twelve meetings every year, increased the costs of delaying the monetary policy decisions.

In contrast, some Board members considered that the information at hand did not yet allow validating a change in the macro scenario that would justify an MPR cut at this Meeting. One Board member added that, if indeed it was a scenario of greater slack and less dynamism of consumption, a greater monetary stimulus would be required. But if consumption remained dynamic, beyond the adjustment in the automobile market, which was something anticipated and desirable, it was possible for inflation to resume its convergence trajectory as the effects of the greater monetary stimulus adopted in the previous Meeting, so a new MPR reduction would be unnecessary. He concluded by noting that the cost of making mistakes in this sense could be high, since it would imply that within a few months a much more steep path of future rates would have to be communicated. Conversely, waiting a little longer to gather information and validate a scenario of wider gaps than those already anticipated in the last Report was less costly, precisely because the MPR had already been reduced by 50 bp a month ago.

The Board discussed the communicational considerations that a potential 25-bp reduction of the MPR would have, given that it was not the option most expected by the market. One Board member pointed out that it was important to keep in mind the existence of a trade-off between the effectiveness of the decision and the communication noise that a surprise would cause, which had already been present when it was decided to lower the MPR at the June Meeting. In his opinion, the greatest argument in favor of reducing MPR at this Meeting was its effectiveness, because any future movement committed entailed some degree of conditionality that would be difficult to leave. This time around, however, the decision of the previous month reduced the need to make a quick move. Meanwhile, the possible negative readings that a MPR cut at this Meeting could open also had to be considered, especially if it was interpreted as a worsening in the Bank's vision of growth. This, because although there was reason enough to think that the growth projection would be revised going forward, this derived in part from specific factors and it was still unclear how capable the economy was to resume a growth pace that would allow it to close the gap.

One Board member argued that the communicational risks of a potential 25-bp reduction were minor. On the one hand, it could be argued that the Board did not want to surprise the market again, after having done so at the previous Meeting. In his opinion, both situations were very different. At the last Meeting, not practically nobody, but downright nobody, remotely considered the possibility that the Board would lower the MPR, neither in magnitude nor in timing, like it did. On this occasion, the scenario was very different. The market considered reductions that did not exist at the time of the June Monetary Policy Report and the difference between a reduction now and one in September was negligible thanks to the practically unanimous expectations that the MPR would be reduced. He added that the concern for a more negative reading of the macro was not so obvious, and that the space granted by the Meeting Statement was sufficient to convey the changes that were being observed. In his opinion, it was not necessary to have a full Report to justify a movement of 25 basis points in the MPR, especially now that the market was already anticipating movements of that magnitude for the coming months.

4. Monetary policy decision

All five Board members agreed that the information accumulated since the publication of the last Report had increased the risks about the timely convergence of inflation to the target within the policy horizon, particularly due to the lower services inflation figures, whose persistence was high compared with other CPI components and the risks surrounding the future evolution of activity and demand, in a context of a highly uncertain external scenario.

Governor Mario Marcel, Vice-Governor Joaquín Vial, and Board members Rosanna Costa and Alberto Naudon voted for keeping the policy rate at 2.5%, with an expansionary bias. In their view, after considering the costs and benefits of the two options it was the most appropriate. In particular, they contrasted a relatively limited benefit of lowering the MPR on this occasion, given the adjustment already made the previous month and the fact that market expectations already incorporated an adjustment in September. In contrast, they assigned greater relevance to the costs that could involve a decision that was not backed by a sufficient analysis and projections. One Board member added that his decision was reinforced because of existing doubts regarding the need to increase the monetary stimulus and its possible magnitude. One Board member said he thought it necessary to increase the monetary stimulus; however, he was inclined to hold the rate considering the communicational risks entailed by a reduction now.

Board member Pablo García voted for cutting 25 basis points off the MPR, to 2.25%, as he believed that what should prevail in monetary policy decisions in general were the macroeconomic fundamentals, which, in his opinion, suggested that the previous cut had not been enough because activity and demand indicators showed less-than-expected growth for the next few quarters; inflation was still low and had surprised with lower numbers in a large group of services; plus the external scenario was gradually weakening. In this occasion, he estimated that communicational or tactical considerations did not warrant putting it off.