Monetary Policy Meeting[1]

OCTOBER 2018

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. 260, held on 17-18 October, 2018.

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; 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, acting International Analysis Manager; Matías Tapia, acting Modeling and Economic Analysis Manager; Matías Bernier, Domestic Markets Manager; Juan Carlos Piantini, International Markets Manager; Rodrigo Alfaro, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Luis Álvarez, Communications Manager; Claudia Sotz, Head of the Financial Conjuncture Department; Hermann González, Advisor to the Finance Minister; Tatiana Vargas, Senior Economist; María del Pilar Cruz, Senior Economist; Carlos Medel, Senior Economist; Marlys Pabst, Secretary General.

1. Analysis of the technical teams

The international scenario was still characterized by the volatility and risk aversion of financial markets, coinciding with the markets' perception that the Federal Reserve (Fed) would speed up its monetary normalization process more than expected, in a context where the divergence between the cyclical state of the US economy and the rest of the developed world had deepened. Regarding the unfolding of the trade conflict, tensions had tended to focus on the US-China exchange, while there had been a favorable evolution of those among other countries within the framework of new trade agreements. Worth noting was the reduction of import tariffs by China to other trading partners, and the new agreement signed by the US, Canada and Mexico. The negotiations around Brexit and the fixing of Italy's fiscal budget had generated uncertainty in the markets. In this scenario, long-term interest rates had risen in most countries, especially in the US. This had triggered episodes of risk aversion with the consequent reshuffling of investment portfolios. Thus, the more risky assets, including stock markets, had had significant reversions, while capital continued to flow out of the emerging economies.

The widening of the divergence between the cyclical position of the US economy and the rest of the developed countries could be seen in various indicators. On the one hand, while GDP growth figures remained dynamic in the US, they had adjusted slightly downwards in the Eurozone, with a widespread moderation in all the bloc's economies. On the other hand, the more conjunctural activity figures showed that this divergence continued, especially in short-term expectations. The surveys to purchasing managers (PMI) pointed to significant disparity in manufacturing and services that anticipated a favorable performance in the US and some moderation in the Eurozone, but with activity growth still above potential.

In Japan, the manufacturing and services outlook had also moderated, although it remained above the pivot of expansion. All this was consistent with the inflationary pressures affecting each one. Thus, annual core inflation in the US continued to stand at or above 2%, depending on how the measurement, while in the Eurozone it had dropped to somewhat less than 1% and near 0% annually in Japan.

In this scenario, the Fed had once again raised the benchmark rate at its September meeting with prospects that, without new developments, it would continue to advance in the monetary normalization. However, the authority's statement had put on the table the possibility that monetary policy could become contractionary in the policy horizon. Thus, the market internalized that the Fed could go faster than previously expected, which pushed the long-term rates up. Monetary policy and its outlook in the rest of the developed world had seen no major changes.

In this environment, current Chinese activity indicators continued to show some slowdown. Authorities had taken further measures to boost activity, such as reducing the bank's reserve requirement. In Latin America, Argentina had reached a new agreement with the IMF that had helped to calm the markets, while in Brazil there was a better mood in the markets especially after the outcome of the first presidential round. In Mexico, the aforementioned trade agreement with its northern neighbors had toned down the uncertainty of previous months.

The price of most commodities, although with significant fluctuations, had risen since the September meeting. The copper price had risen about 5% since then, driven by Chinese imports that showed more dynamism in September while inventories continued to show some depletion in the margin. The price of Brent and WTI oil had risen by around 4% and 1%, respectively, mainly due to supply disruptions in important producer countries.

Domestic scenario

In the local financial system, the high volatility of the trajectory of the Chilean peso stood out, ranging between CLP 655 and 700 per dollar, to settle at CLP 670 at the time of the meeting, fairly unchanged from the previous instance. The multilateral measures had shown a similar evolution, with an MER appreciation of 0.5%. Thus, the real exchange rate (RER, index 1986 = 100) had reached 93.4 in September and it was estimated that, considering the information available, it had approached 91.8 so far in October. The stock market (IPSA) measured in pesos had also seen significant fluctuations in recent weeks, dropping around 2% since the previous monetary policy meeting. In the local fixed-income market, interest rates had risen across the board, although the increase in shorter-term rates stood out, in line with the increase in MPR expectations since the last meeting: close to 55 and 40 bp for BCP2 and BCU2, respectively. Meanwhile, the longer-term rates had risen less than their external counterparts, in a context in which the local risk indicators remained contained.

Domestic credit continued to be characterized by low interest rates and limited real growth in loans, except for the commercial portfolio that showed greater dynamism. The Bank Credit Survey for the third quarter of 2018 indicated supply conditions with some minor restrictions in lending to households (consumer and housing) and big companies. Meanwhile, demand was perceived to be stronger in the different segments, especially in households, big companies and real estate.

The market's expectations about the trajectory of the monetary policy rate (MPR) —from surveys to specialists and prices of financial assets— suggested that the withdrawal of the monetary stimulus would begin some time during the fourth quarter of the year, although with some divergence on the exact moment it would happen. During the policy horizon, the different measures had revised upwards the expected MPR level. For this meeting they placed it between 3.25% and 3.75% at twelve months (between 3.0% and 3.25% in September), while two years ahead they placed it between 4.0% and 4.25% (between 3.5 and 4% in September).

About domestic activity, figures known after the latest Monetary Policy Report depicted an economy that was expanding at a somewhat slower pace than anticipated. In the July-August period, the mining Imacec had shown a decline in annual terms (-3.6% average), associated with specific elements in some works, although the evolution of the other sectors (3.9% annual average) was consistent with the baseline scenario of September as well as with the average of private expectations (as per the Economic Expectations Survey, EES) for that period. As in previous months, the performance of several investment-related lines continued to stand out, such as business services and wholesale trade. In this context, the outlook for GDP growth (EES) for this year had not changed since the close of the September Report (4%). For the 2019-2020 period they had some changes, but all consistent with the projections in the current baseline scenario.

Regarding domestic demand, investment in machinery and equipment continued to lead the increase in spending, with imports of capital goods showing new highs. In the construction and works component, some indicators showed a certain acceleration in the margin, especially in the production of building materials. Business expectations (IMCE) remained in positive terrain, with improvements in all areas. Private consumption of durable goods continued to stand out for its high dynamism. As had been the trend previously, this was based especially on the behavior of the automotive segment, whose sales growth was still among its highest in recent years. In the labor market, the review of the group of information sources —including not only surveys, but also administrative records and qualitative information compiled for the Business Perceptions Report, among others— pointed to a bounded dynamism of employment and salaries, but stronger than suggested by the traditional surveys. Consumer confidence (IPEC) showed some decline in the second half of the year so far and was slightly below the neutral threshold. All in all, expectations about the economic situation of households one year ahead are still positive.

The opinions gathered in the framework of the Business Perceptions Report (IPN) confirmed a rebound of the economy, whose performance in many cases surpassed that of the previous year. In any case, most of the respondents revealed that their total results were worse than expected, mainly blaming the difficulty to adjust prices in the face of strong competition, and in certain areas and/or regions a persistent reluctance in the customers' spending decisions. Investment plans were somewhat more dynamic in a greater number of economic sectors. Regarding the labor market, again those surveyed did not intend to make changes in their staff in the near future, with wage pressures that were still generally contained, backed by increased migratory inflows for certain types of jobs according to the respondents' visions. In terms of costs, without being a matter of great concern, the mention of the higher fuel prices appeared as a novelty in the conversations. And there was no great concern about the recent exchange rate movements in the opinion of many respondents. In the financial area, several banks surveyed reported less stringent lending conditions, reiterating also the low interest rate levels in place. They added that the operations aimed at restructuring the financial burden of customers continued to dominate.

September's inflation had been 0.3% monthly, slightly below the forecast in the last Report and market expectations. In annual terms, headline inflation had risen to 3.1%. By components, the annual change in energy prices had risen to 11%, in particular because of higher fuel prices in pesos, a price increase at the global level and the depreciation of the peso. The price of fruits and vegetables had posted an annual variation of 12%, mainly explained by a low base of comparison because of an unusual seasonal behavior in September 2017. Meanwhile, core inflation —CPIEFE— had also risen, to 2.1% annually. By components, the CPIEFE for services had risen to 3.4% annually, while for goods it had remained unchanged.

The outlook for inflation remained similar to that in the baseline scenario in the September Report, because although inflation had been slightly below the forecast, it had been partly affected by one-off occurrences, such as lower food inflation. In this context, private expectations for inflation had remained around 3% one and two years ahead. As of December of this year, the prospects derived from inflation insurance had dropped to 2.9% (3.1% at the September meeting), while those derived from the EES were at 3.0% (2.9% at the previous meeting).

2. Background analysis and discussion

There was agreement among the participants that the incoming figures since the publication of the September Monetary Policy Report were consistent with the baseline scenario in it and with the monetary policy orientation communicated at the time.

On the external front, it was noted that the main piece of news was related to the reinforcement of a scenario where the United States diverged from other developed economies, and market expectations now indicated a faster adjustment of monetary policy in the US. It was also pointed out that the risks around the trade tensions were being circumscribed to the United States and China, and that since the last meeting, market prospects seemed to improve in this sense, as reflected in the higher commodity prices. Meanwhile, concerns about Europe had resurfaced, both because of Brexit-related difficulties and because of greater political uncertainty in the region. It was pointed out that in recent weeks the external scenario seemed less adverse for the emerging world. The latest developments had been more about volatilities in specific countries dealing with idiosyncratic issues rather than a negative shock on the emerging economies as a bloc. This did not prevent the persistence of high degrees of uncertainty, which would also remain for a long time. For this reason, there was coincidence that, rather than postponing monetary policy decisions pending the eventual dissipation of threats, the wise thing to do was to remain alert to the unfolding of events and be prepared to respond to the materialization of risks, especially those that involved a contractionary shock on the Chilean economy.

About the local economy, it was noted that the evolution of non-mining GDP had been in line with the projections in the last Report. That had not been the case with mining GDP, which had been unexpectedly low, but this had to do with specific, non-cyclical factors. Moreover, it was said, the deceleration of GDP growth, total and non-mining, and its velocity was part of the projections, not only since September, but since several Monetary Policy Reports. On the demand side, investment was still dynamic, which was consistent with growth in imports in machinery and equipment and, furthermore, was corroborated by the change of tone in the preliminary interviews for the Business Perceptions Report. It was added that, although this greater investment was offset by slightly lower consumption growth, it allowed to have more confidence on the growth trajectory projected for 2019 and 2020. Regarding inflation, it was noted that it had evolved as foreseen. This included the fact that the annual increase in some inflation measures was still low, but that, at the same time, its evolution reflected that the process of inflation recovery was proceeding according to plan, something that was particularly evident in those products that historically had been more closely associated with the evolution of activity. In the area of fiscal policy, it was mentioned that the proposed budget of the public sector for 2019, currently being discussed by the Congress, was consistent with the fiscal consolidation plan announced at the beginning of this Administration. For the same reason, the fiscal impulse that was deducted from the proposed budget was consistent with the assumptions in the September Report's baseline scenario.

Mention was made of the fact that both the assessment of the current state of the economy and its outlook continued to point to narrowing capacity gaps in recent quarters. Overall, the projections continued to indicate that the most reasonable thing was to assume an economy growing in line with the baseline scenario in the September Report, with headline and core inflation hovering around 3% in a few months' time. In addition, these projections were shared by the vast majority of market agents, as was visible, for example, in the Economic Expectations Survey (EES).

It was pointed out that one of the factors that brought most uncertainty to the evaluation of the state of capacity gaps was the state of the labor market. In this regard, it was noted that in recent months a thorough review of all available information on the behavior of the labor market had been carried out, concluding that, in terms of both employment and compensations, it had performed somewhat better than suggested by the traditional surveys. In particular, the data from administrative records, the analysis of the magnitude and impact of immigration, the qualitative information of the Business Perceptions Report and the review of data collection methodologies and expansion of the sample results, shaped a scenario where the labor market had been able to absorb a supply shock from immigration, in which wage growth could have been partially contained by a greater labor supply and in which the wage bill had grown as expected. All this was consistent with the expansion of private consumption and with capacity gaps that would allow inflation to adjust gradually.

3. Analysis of monetary policy options

All the Board members agreed that the analysis of the new information made available since the last monetary policy meeting —and the publication of the Monetary Policy Report— were consistent with the projections in the baseline scenario and supported the orientation of the monetary policy that had been communicated in September. Therefore, the need to start the gradual process of monetary stimulus withdrawal was ratified.

It was said that the economy already accumulated four quarters of growth above potential, which, beyond the doubts about its exact magnitude, had been consolidating a process of reducing the activity gap. This was reflected in the behavior of the CPIEFE for services, which had accelerated visibly since the beginning of the year. In addition, the prospects for greater dynamism of investment and a strong expansion of private consumption suggested that this process would continue in the coming months. In turn, the analysis of a broad set of information on the labor market, reduced the doubts about the evaluation of the state of the gaps in the labor market. All the above meant that a timely start of the monetary normalization process was an expression of the progress made by the Chilean economy in the last year and not the response to an imminent inflationary problem.

All five Board members agreed that, in the absence of reasons to modify the diagnosis contained in the September Report on the prospects for inflation and its medium-term fundamentals, tactical elements could be considered to help define the precise moment to begin the monetary normalization process. On this, it was noted that, beyond the reservations that part of the market or analysts might have about the decision to normalize the MPR, the available data, plus the analysis and the published statement, led to the conclusion that starting normalizing the monetary policy was absolutely consistent with the current macroeconomic scenario and inflation perspectives. In any case, it was added, the growth prospects synthesized in the EES were fairly aligned with the baseline scenario in the Report, which was of the first order for the achievement of the inflation target. For this reason, they said, it was not strange that the focus was placed rather at the most appropriate time to start the process of withdrawal of the monetary stimulus and the differences were concentrated in periods very close to each other.

Option 1: start to withdraw the monetary stimulus, by raising the MPR by 25 basis points

The main argument in favor of this option was its total consistency with the evaluation made after the publication of the Monetary Policy Report and with the fact that the baseline scenario in it was still fully valid. In this sense, initiating the withdrawal of the monetary stimulus at this meeting favored a more gradual convergence to the neutral rate, which bought more time to consider the necessary pauses and flexibility that might be required later on. Also, that the current expansionary stance of monetary policy —between 150 and 200 basis points below the neutral rate— was high considering that the economy had been growing for several quarters above potential and inflation was heading towards 3%.

It was also essential to bear in mind the importance of consistency between the actions of central banks and their narrative as a fundamental element to enhance the credibility of monetary policy. At the previous Meeting, the decision to hold the MPR constant had been based essentially on tactical elements —in particular, not to take the market by surprise— rather than on macroeconomic elements associated with the baseline scenario. Likewise, on that occasion it was reported that if there were no significant variations in the macro scenario, it would be appropriate to start the process of monetary normalization relatively quickly, which was understood as doing it at this meeting or, at the most, at the next. Raising the MPR at this meeting was consistent with the previous statement, since the current analysis did not point to mayor deviations from the macroeconomic scenario, to which it was added that an important fraction of the market had internalized the message that the MPR would be raised sooner than had been expected until early September.

Opposing this option, it could be argued that an increase in the MPR at this meeting could be over-interpreted by the market and cause an excessive steepening of the curve, causing a monetary policy bias markedly more contractionary than the Board considered reasonable. Although this risk was always present, especially after a long period with a flat rate, it was important to draw a line between the decision to start the normalization process and its subsequent velocity. For this reason it had to be communicated that the future process of moving the MPR would probably include pauses and would have a gradual pace that, as always, would be calibrated according to the evolution of the macro cycle and inflation.

Option 2: keep the MPR at 2.5%

The main argument for this option was the persistence of the risks and the need to collect more information on their evolution before proceeding with the MPR normalization process. However, especially abroad, its materialization remained diffuse and it seemed unlikely that waiting a little longer would bring greater clarity in this regard. Rather it seemed that these risk scenarios would accompany monetary policy decisions for a long time. Moreover, should a change in the orientation of monetary policy be required, the Board would have the usual flexibility to communicate a different situation effectively and opportunely.

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 2.75%.