MONETARY POLICY MEETING

AUGUST 2021

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Monetary policy meeting No. 284, held on 31 August 2021.

Present: Mario Marcel, Governor; Joaquín Vial, Vice-Governor; Pablo García, Board member; Alberto Naudon, Board member; Rosanna Costa, Board member.

Present the Finance Minister, don Rodrigo Cerda.

Also present: Beltrán de Ramón, General Manager; don Juan Pablo Araya, Legal Counsel and Attestor; Elías Albagli Monetary Policy Division Director; Diego Gianelli, acting Financial Markets Division Director; Solange Berstein, Financial Policy Division Director; Gloria Peña, Statistics Division Director; Michel Moure, Institutional Affairs Division Director; Diego Ballivián, Corporate Risk Division Director; Markus Kirchner, Macroeconomic Analysis Manager; Enrique Orellana, Monetary Policy Strategy and Communication Manager; Miguel Fuentes, International Analysis Manager; Andrés Fernández, Economic Research Manager; Felipe Lozano, Communications Manager; Cristóbal Gamboni, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

The background information for this Meeting was contained in the September Monetary Policy Report to be published the morning after this Meeting. The Report noted that the Chilean economy had made a rapid recovery from the recession caused by the Covid-19 pandemic, which had far exceeded expectations. This recovery had been made possible by the adaptive capacity of businesses and individuals and the great progress made in the vaccination campaign, which had contributed to a significant process of opening up. All this had been underpinned by the large deployment of policy measures, as well as by the international environment marked by the simultaneous action to contain the crisis, led by the central banks and other authorities of the world's main economies.

The extension and persistence of some of the local measures, combined with a higher propensity of households to consume the resources received, had had an impact on private spending that exceeded all forecasts. In a context in which supply had not yet fully recovered, this had significantly changed the assessment of inflationary pressures facing the economy, reflected in an increase in inflation and its outlook for the near future. The depreciation of the peso also contributed to this, caused in part by the perception of a worsening of the economy's fundamentals as a result of the liquidation of long-term savings through the successive massive withdrawals of pension savings and the deterioration of the fiscal accounts, all in an environment of high local uncertainty. Thus, interest rates, risk premiums and stock prices showed an unfavorable performance when compared to their external counterparts.

The need to avoid the accumulation of macroeconomic imbalances which, among other consequences, could lead to a more persistent increase in inflation beyond the two-year 3% target, led the Board to modify the monetary policy stance. The rapid evolution of the macroeconomic scenario, inflation expectations and sensitivity scenarios associated with higher price pressures, set the stage for the Central Bank to act promptly to ensure the convergence of inflation.

2. Background analysis and discussion

Regarding the external scenario, it was agreed that it offered no major novelties in its evolution. On the one hand, the gaps in the speed of exit of developed economies with respect to emerging economies in general had intensified. On the other, problems with logistics chains persisted and inflation tended to increase moderately in most countries, while commodity prices remained relatively high. The risks surrounding the evolution of inflation in the United States, and the reaction of the U.S. monetary policy, were still important.

In contrast, there was consensus that the domestic scenario did offer significant changes. The extraordinary dynamism of consumption and a partial recovery of investment stood out. The former, which was being driven by successive liquidity injections to households, showed an expansion that went beyond projections, which led to an upward revision of the assumption of the marginal propensity to consume, in a context in which individuals had accumulated liquid resources in savings and demand accounts for some US$23 billion. If the increase in direct fiscal transfers was added to this, a scenario was configured in which the expansion of consumption was considerably greater than had been foreseen in the June MP Report. This was reflected in the upward revision to the growth projection for 2021, which, despite its magnitude, was not enough to absorb the full expansion of domestic demand and yielded the way for the current account to move from a surplus of 1.5% of GDP in 2020 to a deficit of slightly more than 2% of GDP in 2021. All this, despite the strong improvement in the terms of trade during this period.

About the labor market, there was agreement that the available data —including the results of the INE survey for the May-July 2021 quarter published on the day of the Meeting— also pointed to an improvement, although gaps remained to be closed. Salaried employment had made an almost full comeback and self-employment had recovered partially. However, participation rates and average hours worked remained below trend, while a significant portion of the female population was out of the labor force. Vacancies had increased, but companies reported difficulties in filling them, especially in the case of lower-skilled jobs. Wages had risen in real terms at a pace that was consistent with a tighter labor market.

It was noted that this scenario entailed a significant change in the assessment of the activity gap —whose estimate for the second half of this year went from being slightly positive in the June Report to being strongly so in the new Report—, which boosted inflationary pressures. These pressures had also increased by the rise in international inflation and the idiosyncratic depreciation of the peso. It was pointed out that, under normal circumstances, a rapid recovery such as the one observed in Chile, in a context of strong copper price increases, would have resulted in a strong appreciation of the peso and not in the substantial depreciation that was the case. This was even more evident when considering that it was occurring amid massive liquidations of investments abroad, by both the Treasury and the pension funds. Not only had this not occurred, but there had been a significant depreciation of the local currency with respect to the dollar and other comparable currencies. This could only be explained by significant increases in the perception of local risk and greater uncertainty regarding the future. Moreover, this type of exchange rate movement showed above-average passthrough and persistence on inflation, given the idiosyncratic nature of the shock.

There was agreement that this scenario was already affecting inflation. In fact, headline and core inflation had risen faster than expected, and some expectations indicators two years ahead already exceeded the 3% target.

3. Analysis of monetary policy options

The Board agreed that, as the worst of the pandemic was being left behind, it was also reasonable that the measures deployed to deal with this difficult situation should be phased out. There was no doubt that these actions had contributed decisively to limiting the economic consequences of the pandemic, but it was also evident that their continuation beyond necessary was generating macroeconomic problems and imbalances that needed to be avoided.

The main question was the speed at which these measures should be withdrawn. The Board agreed that, up until the previous meeting, the overall background was consistent with a gradual and partial reduction of the monetary impulse, which involved keeping the MPR below its neutral level for an extended period. However, the latest information known since then had prompted a change in this assessment. In particular, a scenario where inflationary pressures were stronger given the extraordinary dynamism of consumption —derived both from the extension and greater impact that the stimulus measures were having on it— and the idiosyncratic depreciation of the peso, and where the sensitivity scenarios associated with greater pressures on prices were somewhat more likely to occur.

Consistent with this assessment, and because the starting point was exceptionally low for the MPR, the Board concurred that it was necessary to implement a rapid adjustment of the monetary impulse that would bring the policy rate close to its neutral value by the middle of the first half of 2022. Considering the frequency of the monetary policy meetings under the rules in place since 2018, this translated into the MPR needing to be raised by between 50 and 75 basis points (bp) over several meetings, making them the plausible options for this occasion.

Several Board members noted that the option of a 75bp rise was the one that best suited the scenario being faced. In particular, considering that the stimulus measures weighing on the economy were already very significant, that their impact was being greater than anticipated and that such measures had also increased in magnitude. All this gave rise to a scenario where the convergence of inflation to the target was close to the policy horizon and where upside risk scenarios dominated. In addition, the current monetary stimulus did not fit easily with an economy that was growing at double-digit rates and had already closed the activity gap, despite some sectors still lagging behind. In short, this option was the most appropriate if the aim was to anticipate the withdrawal of the monetary stimulus and to gain room in the face of sensitive scenarios of higher inflation.

Several Board members agreed that the 50bp hike option had the advantage of being the one expected by the market consensus and, therefore, would not come as a surprise. They also noted that surprising with a higher-than-expected hike could have merit in terms of its impact on inflation expectations but could also come at a cost in terms of a less favorable response from other agents. One Board member recalled that in the last two years the economy had been strongly affected by surprises of various kinds, which had stressed the adaptive capacity of economic agents. Furthermore, the political-legislative climate had become very tense. In these circumstances, it was added, the cost of an unexpected decision by the Central Bank could be counterproductive to the objectives pursued. Several Board members pointed out that, while the decision of a 75bp hike might surprise the market, it was totally consistent with a scenario where inflation and projected growth were also higher than what the average analyst assumed. In addition, such a choice had the advantage of supporting a more effective communication regarding a rate path that ran clearly above what the market was considering at the time.

4. Monetary policy decision

Governor Marcel, Vice-Governor Vial, and Board members García, Naudon, and Costa voted for raising the monetary policy interest rate by 75 basis points, to 1.5%.

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