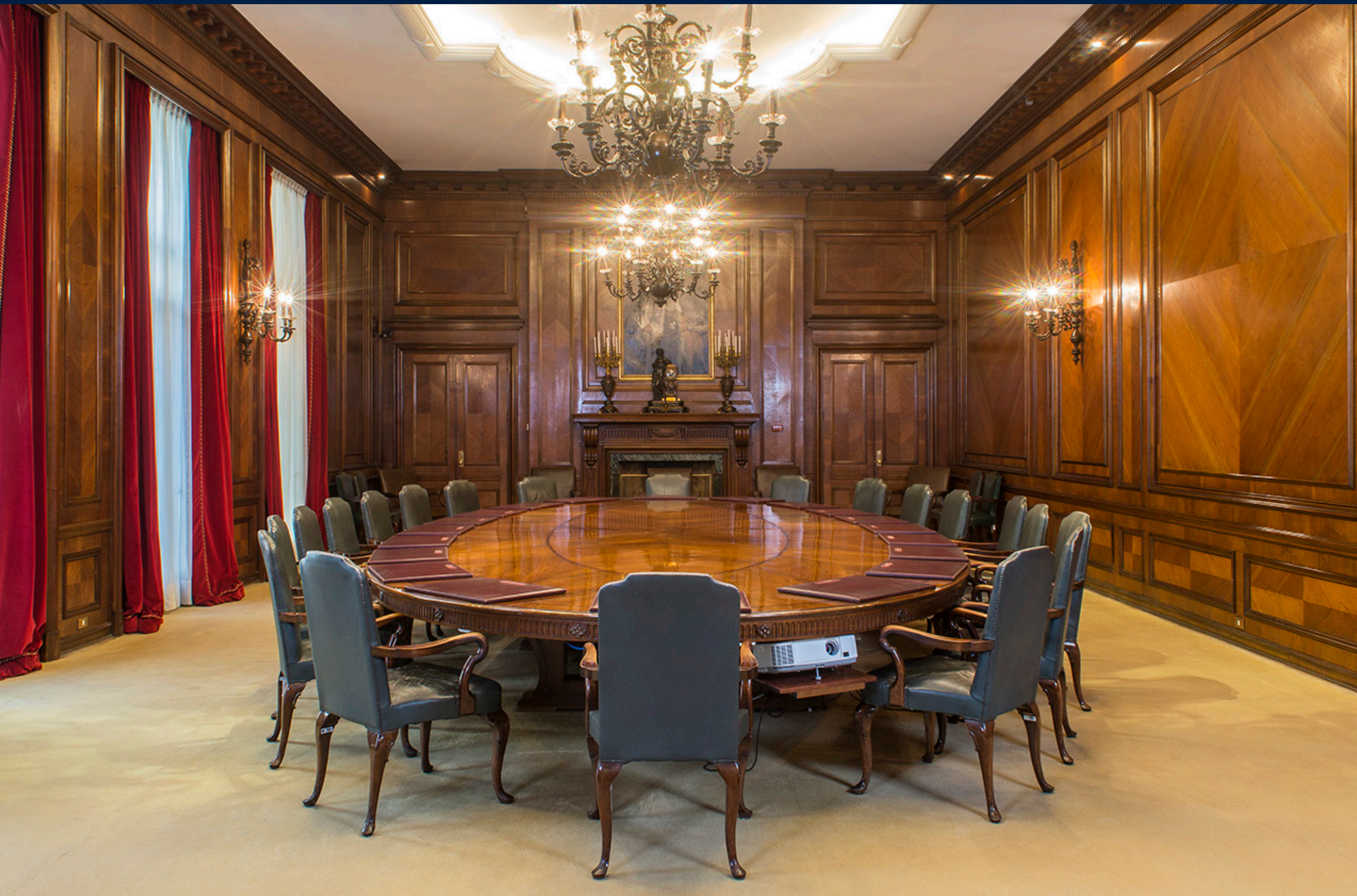
MONETARY POLICY MEETING

DECEMBER 2021



MONETARY POLICY MEETING[1]/

Monetary policy meeting No. 286 held on 14 December 2021.

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

Also present: Beltrán de Ramón, General Manager; Juan Pablo Araya, Legal Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Paulina Yazigi, Financial Markets Division Director; Solange Berstein, Financial Policy Division Director; Gloria Peña, Statistics Division Director; el 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; Diego Gianelli, Market Operations Manager; Felipe Lozano, Communications Manager; Felipe Guzmán, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

Since the September MP Report the economy had pursued a path of strong expansion driven by private consumption. The year's GDP growth exceeded forecasts, ending 2021 with activity significantly outpacing pre-crisis levels and its estimated potential.

Inflation kept rising steadily, to more than 6.5% annually, due mainly to the exceptional expansion of domestic demand and the depreciation of the peso caused by local factors. These elements had been coupled with global phenomena, such as increased world demand, pandemic-related disruptions in international value chains of goods, and higher commodity prices.

Higher inflation had persisted long enough to risk second-round effects through the indexation of contracts and wage increases. The burden of inflation on the economy was already visible and had become one of the main economic concerns of both households and businesses.

[1]/ This document was originally written in Spanish. In case of discrepancy or difference in interpretation, the Spanish version prevails.

Containing inflationary pressures would require withdrawing the domestic demand stimulus measures deployed during the crisis. On the fiscal side, this entailed public expenditure adjusting to the budget approved for 2022 and the medium-term projections contained in the Public Finances Report, initiating a path towards converging with debt levels sustainable in the medium term. On the monetary side, the central scenario projections in the MP Report's central scenario indicated that the MPR should be further increased in the short term, to place it above its nominal neutral level (i.e., that which is consistent with the 3% inflation target) during most of the monetary policy horizon. In the central scenario, this adjustment of fiscal and monetary policies would contribute to a gradual closing of the activity gap, helping to prevent the recent inflation dynamics from having a persistent impact on the price formation process.

2. Background analysis and discussion

Regarding the domestic scenario, it was noted that the most relevant surprise of recent times had been the dynamism of private consumption, which exceeded the already high estimates of September. Together with the stronger investment of recent months, growth in domestic demand was clearly overtaking growth in domestic supply, which translated into a significant increase in the current-account deficit. Measured at trend prices, this deficit would go from around 1% of GDP in 2020 to just under 7% of GDP in 2021. In such circumstances, it was noted, it was no surprise that the activity gap had turned more positive. It was further mentioned that the recent evolution of demand placed greater emphasis on the tensions between a very dynamic economy in the short term and a stagnant one in the medium term, a behavior in which local factors played a major role.

There was debate about the risks implied by the high level of inflation, particularly its second-round effects and its impact on expectations. About these, it was pointed out that, despite the significant shift towards a monetary policy contraction, two-year inflation expectations persisted above 3%. It was noted that this could be reflecting an overreaction to the short-term behavior of inflation, given the severe shock of recent months and the fact that inflation was becoming a much more widespread problem around the world than was typically the case. It was further noted that, although the present conditions were cause for concern, inflation was still determined by its fundamentals and, therefore, monetary policy remained intact in its maneuvering capacity to control it. In fact, while more slowly, the market continued to expect inflation to converge to 3%. In any case, it should be clear that inflation expectations were an important reference when gauging the market's perception but were not an intermediate monetary policy goal. The objective of monetary policy was still an MPR path that would bring inflation expectations to 3% over a two-year horizon.

The risks of the external scenario—which seemed to have increased in the last few months—were also discussed. It was said that the most striking change was the risk of a disorderly recovery from the Covid-19 crisis in different dimensions. First, a shift from a coordinated global cycle to one that could be quite unsynchronized, especially between China and the United States. This could have complex effect on exchange rate dynamics and commodity prices. A second dimension was a scenario in which different economies would accumulate inflation levels not seen in many decades. Such a situation could lead to a significant change in the financial conditions facing emerging economies.

It was mentioned that in the local financial markets' risks seemed to be receding somewhat from their peak. Their recent evolution showed that volatility was being reflected more in the exchange rate than in the dynamics of long-term interest rates. This implied that the positive correlation between depreciation and long-term interest rates was tending to reverse, beyond the fact that those rates were still high compared with the recent past.

3. Analysis of monetary policy options

The Board agreed that monetary policy should complete the withdrawal of the full monetary impulse adopted during the crisis and open the way to a contractionary stance, in order to ensure the convergence of inflation to the target over the two-year policy horizon. For this Meeting they considered three options: (i) raise the MPR by 100 basis points (bp); (ii) raise the MPR by 125bp; and (iii) raise the MPR by 150bp.

All five Board members agreed that, given the evolution of the macroeconomic scenario and related risks, the MPR needed to move towards a more restrictive level, as reflected in the MPR corridor depicted in the December MP Report. Based on this corridor, to ensure the convergence of inflation to the target within the policy horizon, in a few months the MPR had to stand between 275 and 325 basis points above its level prior to this Meeting (2.75%). Therefore, the decision on this occasion had important tactical and communicational components because, irrespective of the option chosen, the MPR had to be raised further in the coming months and the increase determined now could set the future pace of increases.

There was consensus on the Board that the option of raising the MPR by 100bp offered the least advantages. In the opinion of one Board member, this alternative had been lingering behind the markets' expectations and faced at least two risks. One, it would require accelerating hikes in future meetings causing some degree of confusion. And two, it could lead people to believe that the Bank was too lax regarding its commitment with the inflation target.

Several Board members appreciated the option of raising the MPR by 150bp. In their view, it helped to mark a more decisive step toward the interest rate levels they expected to achieve in the coming months, which could help prevent the impacts that high inflation was having on expectations. All the Board members agreed that the main risk of this option was to take the market by surprise again, since the last two decisions had already done so. About this, one Board member added that, although a hike of this magnitude would surprise part of the market, it could be explained because there was still a long way to go, the increases took place at a time that the economy was growing well above its capacity, nominal interest rates were substantially below the expected inflation for the coming quarters, and inflation expectations were above the target. The same Board member added that, nevertheless, at the same time there was the risk of it being perceived as the reflection of a more severe situation than had been estimated in the MP Report's central scenario, which could drive up the entire interest rate curve to undesirable levels.

About the option of raising the MPR by 125bp, all five Board members agreed that it was the one that best reflected the contents in the MP Report and the judgment of the Board. In particular, it would place the MPR somewhat above the median of expectations, but within the corridor, which would give full credibility to the Report's diagnosis and forecasts while, at the same time, it would reassert the Board decision to take every step necessary to ensure compliance with the inflation target.

4. Monetary policy decision

Governor Marcel, Vice-Governor Vial, and Board members García, Naudon, and Costa voted in favor of raising the MPR by 125 basis points, to 4%.

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