banco central Chile

MONETARY POLICY MEETING

JULY 2022

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Minutes of the Monetary Policy Meeting No. 291, held on 12–13 July 2022.

Present: Rosanna Costa, Governor; Pablo García, Vice-Governor; Alberto Naudon, Board member; Luis Felipe Céspedes, Board member; Stepanka Novy, Board member.

Present the Finance Minister, Mario Marcel.

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; Rosario Celedón, 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; Diego Gianelli, Market Operations Manager; Juan Carlos Piantini, Strategic Business Administration Manager; Juan Francisco Martínez, Financial Stability Manager; Andrés Sansone, Advisor to the Finance Minister; Erika Arraño, Senior Economist; Marlys Pabst, Secretary General.

1. Background

The local scenario

Headline inflation had continued on an upward path, reaching 12.5% annually in June, while the core component had risen to 9.9% annually. CPI data for May and June had been largely in line with forecasts in the June Monetary Policy Report. The surprises were restricted to specific products, mostly volatile ones, and concentrated in the air transportation item. Inflationary pressures had continued to be reflected in the different lines of the core basket component. Cost pressures remained strong, amid a growing impact of labor costs and a more depreciated exchange rate. Business costs expectations as reported in the June IMCE remained near their historical highs. Inflation expectations derived from the July Economic Expectations Survey (EES) and the Financial Traders Survey (FTS) prior to the July meeting had been adjusted upward and remained above 3% over the two-year horizon.

In May, the Imacec had posted annual variation of 6.4%, which included a 0.9% monthly drop in its non-mining component in its seasonally-adjusted series. Despite the positive surprise on the mining side, activity in all other sectors had continued to fall at a gradual pace, consistent with what was anticipated in the June Report. Again, the greater resilience of the sectors most closely linked to household consumption —especially services— stood out. The demand indicators had evolved in line with projections and continued

to reflect a notorious disparity between the performances of private consumption and investment. Business (IMCE) and consumer (IPEC) confidence remained in pessimistic ground.

In the labor market (INE), job creation had slowed further, with a fall in salaried employment (formal and informal) and an upturn in self-employment. The unemployment rate remained stable and close to historical averages, which was partly explained by the still high level of inactivity. Labor demand continued to lose momentum, as suggested by the online job postings index, which had declined again marginally. Business expectations for employment had continued to recede (IMCE). Annual real wage growth remained negative, reflecting the rising inflation.

The domestic financial market had adapted to the deteriorating global financial conditions, in a context of high local uncertainty. Since the last Meeting, the IPSA had fallen by nearly 5%, the sovereign risk premium (CDS) had increased and the nominal 10-year interest rates (BTP-10) showed no major variation. The exchange rate had depreciated sharply (just over +20% since the last meeting), with high volatility. Up to that moment, the markets had been able to absorb the shocks adequately and the volatility in the forex market had not been transmitted to other segments of the financial system, which had operated with adequate liquidity levels.

Bank lending remained subdued in the various segments, with financing conditions perceived to be tighter and demand for new loans lower, according to the second-quarter Bank Lending Survey. Lending interest rates had risen further in most portfolios.

Market expectations about how far up the MPR would go in the current cycle of hikes had risen again. Both the EES and the FTS surveys placed it at 10% at the September meeting. Financial asset prices spoke of a higher level.

The international scenario

As global inflation was still increasing central banks had either continued to raise their benchmark rates or signaled a faster hike if the rising inflation proved more persistent. At its June meeting, the U.S. Federal Reserve had made an unannounced 75 basis-point (bp) increase and had anticipated that rate hikes would continue going forward until inflation was brought under control. The European Central Bank had confirmed the end of its asset purchase program and announced that the rate hike cycle would begin in July. In this scenario, financial conditions had tightened around the world. Increased risk aversion had led to declines in world stock markets, while the dollar had appreciated sharply against other currencies and long-term interest rates had shown mixed movements.

Since the last Meeting, the market's outlook for global growth had deteriorated, approaching estimates in the June Report. In the U.S., concerns about an upcoming recession had increased. Tighter financial conditions had begun to affect investment, and consumer confidence had fallen further, as high inflation continued to erode real wages. In the Eurozone, higher inflation continued to show signs of spilling over the

consumer basket. Consumer confidence and business and investor expectations had continued to worsen, amid Russia's protracted invasion of Ukraine. In China, activity had seen some recovery after the reopening of the economy, although consumption fundamentals had remained weak and the risks associated with the zero-tolerance policy for Covid-19 were still present. Although activity in Latin America had shown positive surprises and the outlook for 2022 was broadly unchanged, for 2023 the outlook looked more unfavorable in the face of worsening financial conditions, weaker external momentum, low confidence levels, and the persistent rise in inflation.

Commodity prices had fallen more than anticipated in the June Report, in large part because of fears of a global recession, the financial volatility, and the resulting appreciation of the dollar. Food prices posted the biggest drop, among which wheat stood out (-24% since the last meeting), which was also explained by a more favorable outlook on the supply side. The price of copper had declined significantly to around US$3.3 per pound (slightly more than -20% since the last meeting), even though inventories remained at historically low levels. Although the price of an oil barrel remained high, it had been corrected downwards to just over US$100 at the time of the meeting (-15% since the last meeting, for the WTI-Brent average). However, several of the factors that had driven commodity prices up were still present, including the Russian invasion of Ukraine and the constraints present in several markets, which kept prices under pressure, especially for food and energy. All of the above resulted in the external scenario being worse than expected in the June Report.

2. Background analysis and discussion

The discussion touched on the evolution of the international scenario, noting the speed and magnitude of its downturn. The fall in commodity prices was stressed, affecting not only those products most sensitive to the economic cycle, such as copper, but also foods and energy, whose supply forces had been decisive in recent months. There were also lower prospects for world growth and tightened financial conditions. All these movements seemed to be linked to the inflationary cycle in the U.S. and the way the Federal Reserve should respond, although other negative phenomena linked to the dynamics of the war and the uncertainty about its repercussions in Europe could not be ruled out, which could also accentuate the downward risks in our international scenario.

It was pointed out that, under normal circumstances of orderly macroeconomic conditions, it would be natural to evaluate the recent macro developments and the monetary policy outlook, by placing more weight on its medium-term effects than on the short-term inflationary impact. This was true both for what was happening with the sharp depreciation of the peso and the evolution of the external scenario. It was argued that, unfortunately, the Chilean economy was not in a normal situation; on the contrary, it continued to show significant imbalances: the activity gap remained wide; inflation was at levels not seen in many decades; and the current account deficit also showed very significant values. It was added that, beyond the Bank's active response to the strong inflationary outbreak, it was evident that inflation was

still high and that its local drivers, particularly consumption, was yet to show clear signs of normalization, beyond the fact that investment showed a clear weakness. Moreover, inflation expectations at different terms were also markedly above the inflation target, reflecting a view of greater inflationary persistence.

The discussion focused on the events that were occurring the forex market, and there was agreement that the situation should be monitored on an ongoing basis, since changes were taking place at unusual speed. In fact, in recent days a significant increase in exchange rate volatility had been accumulating, which could introduce a difference with respect to the assessment made early in that week. It was agreed that the Bank had no limitations to act in the foreign exchange market, but that any action in this matter should be analyzed on its merits, referring to the functioning of such market and its potential repercussions on other segments of the financial market. Consistently, the Board agreed that, despite existing communicating vessels, the monetary policy decision does not relate to a specific exchange rate level, but rather to the evaluation of the inflationary implications of movements in the currency parity.

3. Analysis of monetary policy options

The information received since the publication of the Report, particularly the short-term inflationary effect of the peso's sharp depreciation, indicated that the annual variation of the CPI would be higher than that estimated in the last Report. In this context, just to ensure the same level of real interest rates as previously considered, a higher level of nominal rate was required in the horizon in which inflation expectations had risen. Meanwhile, it was estimated that the deterioration of financial conditions and the greater uncertainty of the macro scenario would have a negative effect on demand in the coming quarters. Although no projections were available at this Meeting to assess the medium-term trajectory of the MPR consistent with these developments, all the Board members agreed that the recent indicators called for higher rates in the short term, especially when the evolution of inflation expectations was factored in.

All five Board Members agreed that the background information presented suggested that, in order to ensure the convergence of inflation to 3% over the policy horizon, it would be necessary to have a higher MPR trajectory than the one estimated in the June Report. Accordingly, three options were analyzed: (i) to raise the MPR by 50bp; (ii) to raise it by 75bp; and (iii) to raise it by 100bp.

There was agreement that the option of raising the MPR by 50bp did not seem consistent with the current macro framework. It was pointed out that one way to consider this option valid would be to assume that the new scenario would be associated with a further contraction in demand whose effects on prices would offset much of the higher short-term inflation, which was seen as unlikely. One Board member mentioned that this option could also be valid if less negative effect it would have on the already plummeting investment was considered. Several Board members dismissed this option. One of them pointed out that, given the evolution of the macro scenario, this option was not consistent with the monetary policy path required

for inflation to converge to the 3% target within two years. Several Board Members added that a hike of this magnitude was below expectations inferred from market prices, which could intensify exchange rate volatility and eventually cause problems in other segments of the financial market.

All the Board Members agreed that the 75bp and 100bp options had the virtue of bringing the MPR closer to a level that looked more in line with the monetary policy needed for inflation to converge to the target within the two-year horizon.

In the Board's opinion, choosing one or the other had to consider conflicting aspects, such as the risks associated with higher inflationary pressures or medium-term contractionary forces. There was consensus that beyond this assessment, it was quite likely that the process of raising the MPR should be continued and that a 75bp hike provided more leeway for the assessment that would be included in the September Monetary Policy Report.

4. Monetary policy decision

Governor Costa, Vice-Governor García, and Board members Naudon, Céspedes, and Novy voted for raising the MPR by 75bp, to 9.75%.

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