banco central Chile

MONETARY POLICY MEETING

JUNE 2022

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Minutes of the Monetary Policy Meeting No. 290, held on 7 June 2022.

Present: Rosanna Costa Governor; Pablo García, Vice-Governor; Alberto Naudon, Board member; Luis Felipe Céspedes, Board member; Stepanka Novy, 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; Rosario Celedón, Financial Policy Division Director; Gloria Peña, Statistics Division Director; Michel Moure, Institutional Affairs Division Director; María Jesús Orellana, acting 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; Andrés Sansone, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

Inflation in Chile had been escalating further, to its highest level in decades. The main factor behind its rise continued to be the significant increase in demand during 2021. However, in recent months the impact of strong global cost pressures resulting from higher prices of commodities, energy, and foods had intensified, in a context of ongoing difficulties in global supply chains, and where the peso remained depreciated and the activity gap was still positive.

The short-term inflation outlook was steadily rising in response to this combination of factors. In line with expectations, activity had begun to adjust in the first quarter, although in a composition of demand where private consumption remained strong while investment weakened.

Over the medium term, the reassessment of the macroeconomic scenario suggested that the commodity and food price shock would be more persistent than thought before, which had implications for inflation. In any case, the resolution of macroeconomic imbalances remained the central element for inflation to converge to 3% within the two-year horizon. This process would occur in large part through the adjustment of private consumption and investment, in a context where the vision of a significant contraction in fiscal spending was maintained. However, the high level of inflation and the greater persistence associated with its main determinants called for a more contractionary monetary policy to ensure such convergence.

Risks continued to be high in the macroeconomic scenario, particularly because of how high and persistent inflation was at the time.

2. Background analysis and discussion

In general terms, incoming news in recent weeks tended to confirm the view of the macroeconomic scenario adopted at the May Meeting, including the change in the monetary policy rate (MPR) trajectory anticipated at the moment. On the one hand, it was noted that inflation had been clearly above the forecast in the last Monetary Policy Report. On the other, although a moderate fall in activity and a more significant drop in investment were confirmed, private consumption remained dynamic due to a greater use of household liquidity, delaying its adjustment with respect to earlier projections.

It was commented that information at hand depicted a scenario of higher and more persistent inflationar y pressures, which called for a more contractionary monetary policy than what had been foreseen in the March Report. It was pointed out that, although the inflation surprise of recent months had a clear focus on food prices and not so much on the core component, this did not imply that monetary policy should be neutral or take no action in this regard. Instead, what was needed was to assess whether these shocks affected the persistence of inflationary dynamics over the policy horizon. If they did, there should be a monetary policy response. It was added that it was important to bear in mind that the advantage of the inflation targeting scheme was that by establishing a two-year horizon, it avoided reacting to shocks that had transitory effect on inflation dynamics and did not jeopardize the achievement of the target. However, if these shocks had more permanent effects, irrespective of their origin, monetary policy had to react, because otherwise the inflation target would be compromised. It was noted that the conduct of monetary policy was based not only on analyzing inflation, but it also had a component of economic growth. However, in order for this mechanism to operate, it was necessary to maintain the credibility of monetary policy.

It was recalled that the outlook for economic activity pointed to a significant weakening in the near future. There was consensus on the importance of specifying that this weakening was not an "externality" of the process of raising rates, but rather a fundamental element to achieve the convergence of inflation to the 3% target. It was also recalled that after the significant measures to stimulate spending adopted in 2021, the economy had reached unsustainable levels of activity from a medium-term perspective. Undoing this imbalance meant that economic activity would see negative growth rates. The importance of keeping this in mind was also stressed, as resolving the imbalances was a necessary condition for the economy to grow in a healthy manner while creating jobs and boosting real wages.

On the external front, it was pointed out that the global inflationary problem was becoming more and more important. It was noteworthy that the central banks of the leading economies were still reacting rather cautiously, which generated the risk of larger corrections than those already seen in global financial conditions if a more abrupt and marked change in the monetary policy stance of those economies were to become necessary. The greater likelihood of the latter scenario increased the risk of a recession in the major economies. This put greater pressure on financial conditions for emerging economies, including the value of their currencies, which in the medium term would be an additional drag on growth.

It was discussed that, in this context, the economy was facing a particularly complex scenario of very significant risks. For one, given how high inflation was going, there was the risk that it would become more persistent, which would have impacts in multiple dimensions: inflation expectations above the target; more frequent price adjustments by companies and, therefore, more frequent margin adjustments; and increased pass-through of the exchange rate to local prices. It was mentioned that a key factor to avoid the negative effects of this greater persistence and to ensure the achievement of the 3% inflation target within two years was the credibility of monetary policy. In this regard, it was noted that monetary policy could only fulfill its countercyclical role of alleviating the costs in terms of economic activity, employment, and wages, if it succeeded in maintaining its credibility and expectations aligned with the target. Such a scenario was also needed to mitigate the impact of a potential global liquidity crisis, an important risk given the progress of the world' s inflationary situation and the reaction of the main central banks so far. Finally, it was mentioned that there was the risk of a steeper-than-expected economic slowdown, with negative and undesirable effects on investment and employment. In this scenario, it was noted, the Bank would have enough room to lower the MPR and generate a significant monetary stimulus. The reason for this was that in such a scenario inflation would fall gradually, and a relatively rapid decline in the MPR would allow the Bank to promptly produce negative real rates.

3. Analysis of monetary policy options

The Board agreed that the monetary policy framework had been particularly stressed over the past year. The magnitude of the aggregate demand and supply shocks was unprecedented in terms of both size and synchrony. Moreover, their short- and medium-term implications were also diverse and much of the analysis was aimed at evaluating these different trade-offs. In addition, all this was taking place in a local context where there was quite significant financial tension, amid an environment of uncertainty and volatility.

The Board recalled that the process of monetary normalization had already begun almost a year ago, so that a good part of the adjustment deemed necessary to resolve macroeconomic imbalances had already been made. Accordingly, they estimated that, given the background described in the June Report, the MPR was already close to its terminal level in this cycle and considered two possible options: (i) raise the MPR by 75 basis points (bp); or (ii) raise the MPR by 100bp.

All five Board Members agreed that, as the MPR approached its target level, tactical considerations took on greater prominence when evaluating monetary policy options. In this scenario, there was agreement that the 75bp option struck a good balance between different considerations. On the one hand, it was consistent with the path judged necessary for inflation convergence in the Report's central scenario, and at the same time it allowed room for additional hikes of a smaller magnitude that could be calibrated with information of the months ahead. On the other hand, this option was widely expected by the market, whose rate expectations were very close to the central part of the MPR corridor in the June Report. As for the 100bp option, although it could be justified as a sign of greater concern about the risk scenarios being faced, its counterpart was that it provided less flexibility for the future. In particular, to make it consistent with the idea that the MPR was approaching a terminal level, it would need to be accompanied by a clearly neutral bias, which was thought not to be feasible as yet.

4. Monetary policy decision

Governor Costa, Vice-Governor García, and Board members Naudon, Céspedes, and Novy voted to raise the monetary policy rate by 75 basis points, to 9%.

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