MONETARY POLICY MEETING

APRIL 2023

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Monetary Policy session No.296, held on 4 April 2023.

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; Juan Carlos Piantini, acting 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; Sofía Bauducco, Economic Research Manager; Felipe Musa, Market Operations Manager; Juan Pablo Rioseco, acting Communications Manager; Andrés Sansone, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

Inflation remained very high. Pending the March figure, which was to be known the day after the Meeting, the CPI's annual variation had fallen to 11.9% in February, which was still well above the 3% target. In addition, the core part of the CPI —without volatile items—– had been at around 11% annually for some time, accumulating a significant surprise over the last few months.

Several factors explained why inflation was taking so long to come down. Most importantly, the economy was still struggling to reverse the impact of the excess spending accumulated in previous years. In fact, the revisions to the National Accounts showed that between 2020 and 2022 consumption levels had been significantly higher than estimated. Moreover, the speed at which this spending component was adjusting in the most recent period had been slower than previously assumed. In any case, going forward, the decline in inflation would be sustained by the appreciation of the peso in recent months and the reduction of a number of cost factors.

The central scenario of the March Monetary Policy Report had revised upward the GDP growth forecast for 2023. This was in response to the better performance early in the year. Going forward, the central scenario assumed that the economy would continue with its adjustment process. Therefore, the projection for 2024 has been reduced. Considering both years, cumulative growth was not very different from the December Report's forecast. As for inflation, it was expected to return to the 3% target in the latter part of 2024.

Globally, the world economic outlook had worsened in the last few weeks. The Chilean economy would be affected by lower external demand and tighter global financial conditions.

The current scenario was associated with a higher than usual degree of uncertainty. On the one hand, there was the risk of a more abrupt deterioration of the external scenario, with greater implications for Chile. On the other, a more complex inflationary dynamic could not be ruled out.

2. Background analysis and discussion

About the international scenario, it was pointed out that its evolution showed two phases. Towards the end of 2022 and the turn of 2023, markets had become more optimistic, betting on a smooth inflationary control and practically no recession. However, in early March, turbulence in the U.S. and European banking systems abruptly changed the picture, introducing additional concerns. Although in the days leading up to the Meeting the effect seemed contained, the scenario was likely to be dominated by greater caution in the supply of credit. Primarily, its effects would be channeled through lower external demand and tighter financial conditions. The central scenario of the March MP Report had assumed that this would have an impact on the local macroeconomic scenario in the second half of the year.

Mention was made of the uncertainty as to the magnitude and duration of the impact of the change in external financial conditions. It was pointed out that, although the turbulence had abated and been confined to certain events, there were vulnerabilities at the global level. Particularly important was high corporate and government indebtedness and, probably, increased risk-taking in some sectors in search of higher returns after years of low rates. Attention was drawn to how it would affect credit volume, especially in economies like the United States, where smaller banks are a significant source of financing. Nonetheless, all of this was rather speculative, so it was part of important risk scenarios to consider and address in case they came true.

Locally, the adjustment was more moderate than expected, with upward surprises in demand and inflation. The revision to the National Accounts from 2020 onwards revealed a different composition of domestic demand, with higher consumption and rather stagnant investment. Moreover, new data on the consumption trajectory revealed a slower than expected speed of adjustment. All this certainly contributed to explaining the upward surprises in headline inflation and why core inflation had persisted between 10.5% and 11% in annual terms for several months.

It was noted that the overall information available indicated that the economy was having difficulties in closing its gaps. The activity gap, far from closing, as would be expected in an ongoing adjustment process, was wider than had been expected in late 2022 and early 2023. The current account, despite some correction, also reflected these high imbalances, accounting for the households' deficit savings.

3. Analysis of monetary policy options

The Board recalled that during the last several meetings a clear message had been delivered regarding the future evolution of the Monetary Policy Rate (MPR), that was, that the rate would be maintained at 11.25% until the state of the macroeconomy indicated that the convergence of inflation to 3% had been consolidated.

All five Board members agreed that, from the analysis of the background information submitted in the preparation of the March MP Report, it could be concluded that there was still no evidence of consolidation of said inflationary convergence.

Actually, while headline inflation had continued to decline, it was still high. Core inflation, assumed to be a better predictor of future inflation, was not declining. As of February, it stood at 10.7%, fairly constant for several months. Moreover, with an upward surprise of about one percentage point when compared to the forecast in the December MP Report.

Activity was not adjusting in line with expectations, either. The activity gap was significantly revised upwards when removing the transitory effect on activity in the transport sector. Moreover, the revisions to the National Accounts showed that the composition of domestic demand was more inflationary than expected, with consumption much higher and investment stagnant for several quarters. All this pointed to a scenario in which inflationary pressures were evidently higher than previously estimated.

In this context, all the Board members agreed that the only plausible option was to keep the policy rate at 11.25%.

The five Board Members agreed that the economic scenario posed significant risks. On the one hand, inflation was at risk of becoming more persistent. In such a situation, the Bank would have to respond with a particularly aggressive and contractionary monetary policy. The costs in terms of lost economic activity and jobs would be "transitory," but certainly substantial. However, the Board would have no other choice in order to fulfill its mandate and, just as important, to avoid significant "permanent" costs to macroeconomic stability and economic welfare.

At the same time, there were also very significant external risks. There were risk scenarios in which the international situation could deteriorate abruptly and sharply. In such case, the Bank would have to aggressively lower the MPR. This would occur precisely because inflation would converge more rapidly to the target in a context of a strong deceleration of economic activity. The above, without considering the potential additional economic policy measures that a global financial crisis scenario might require implementing either ex post and/or ex ante.

The Board was unanimous in agreeing that any of these situations formed part of the risks of the macroeconomic scenario. For the same reason, they were not considered in the sensitivities underpinning the corridor for the MPR. However, there was agreement that the Bank should act with flexibility in the event that any of the internal or external risks materialized and macroeconomic conditions so required.

4. Monetary policy decision

Governor Costa, Vice-Governor García and Board members Naudon, Céspedes and Novy voted for holding the MPR at 11.25%.

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