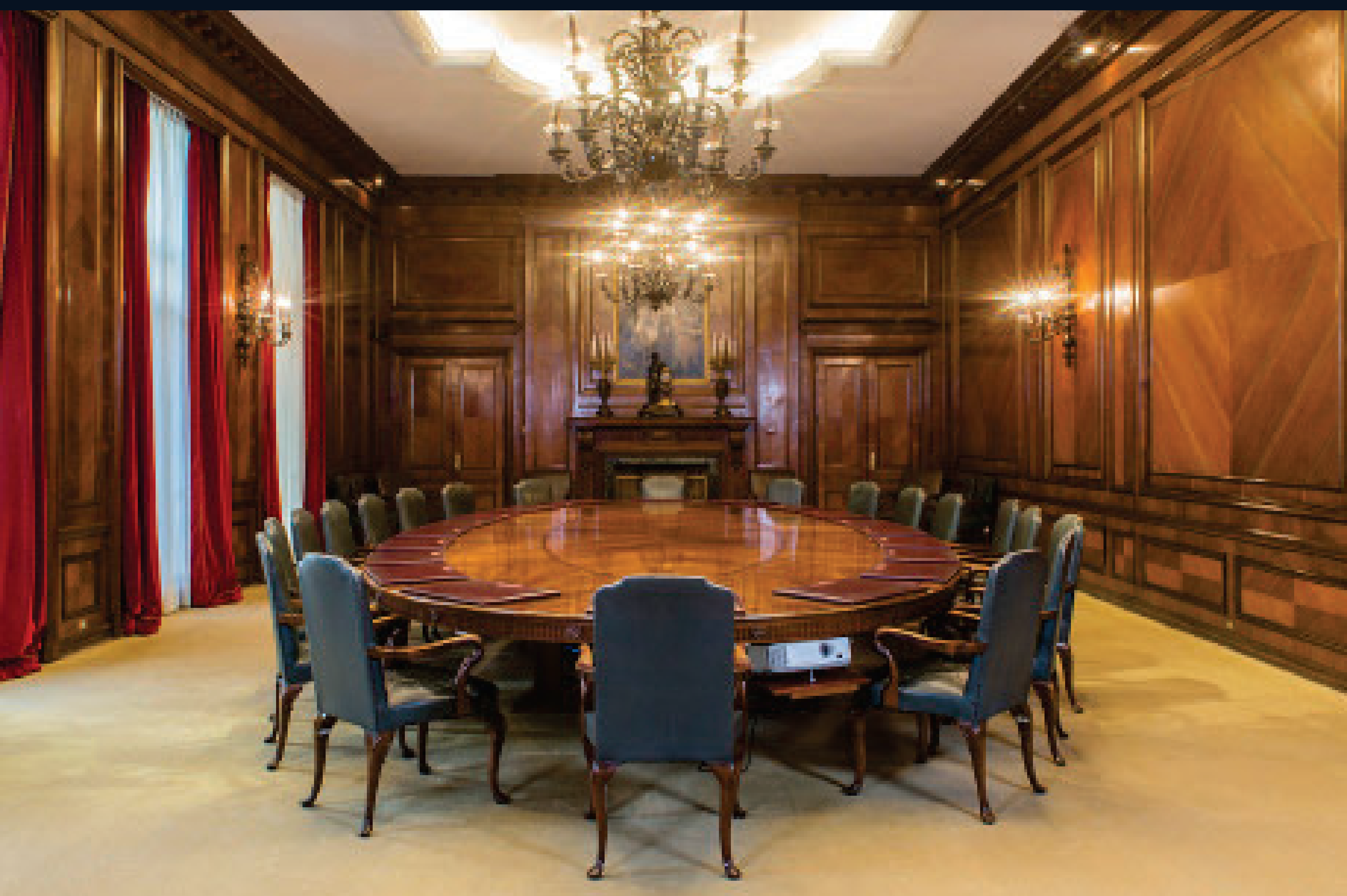
MONETARY POLICY MEETING

JANUARY 2024



MONETARY POLICY MEETING

Monetary policy meeting No. 303, held on 30–31 January 2024.

Present: Rosanna Costa, Governor; Stepanka Novy, Vice-Governor; Alberto Naudon, Board member; Luis Felipe Céspedes, Board member; and Claudio Soto, Board member.

Present the Finance Minister, Mario Marcel.

Also present: Juan Pablo Araya, interim General Manager; Mauricio Álvarez, acting Legal Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Ricardo Consiglio, Financial Markets Division Director; Rosario Celedón, Financial Policy Division Director; Gloria Peña, Statistics and Data Division Director; Silvana Celedón, acting Institutional Affairs Division Director; Markus Kirchner, Macroeconomic Analysis Manager; Enrique Orellana, Monetary Policy Strategy and Communication Manager; Guillermo Carlomagno, International Analysis Manager; Sofía Bauducco, Economic Research Manager; Felipe Musa, Market Operations Manager; Juan Carlos Piantini, Strategic Business Manager; Miguel Fuentes, Financial Stability Manager; Andrés Sansone, Advisor to the Finance Minister; Erika Arraño, Senior Economist; Marlys Pabst, Secretary General.

1. Background

The international scenario

On the external front, headline inflation had continued to decline, beyond some heterogeneity among economies and basket components. In the United States, inflation had maintained a downward trajectory, mainly influenced by core inflation of goods, while core inflation of services remained high. In the Eurozone, despite an increase in total inflation during December, explained mostly by volatile items, core indicators were still moderating. In Latin America, the decline in volatile components stood out, while core inflation was taking longer to decrease, given the slower progress of services inflation relative to goods inflation. All in all, high levels of inflation persisted in some economies in the region.

This took place in a context in which world activity had maintained moderate dynamism and its outlook remained contained. In China, figures for the fourth quarter of 2023 showed an economic slowdown, with growth expectations remaining cautious for 2024. Similarly, the outlook for the Eurozone remained weak, amid the consequences of recent supply shocks, weak global demand and the ongoing effects of tight monetary policy on certain sectors. The exception to the weak global activity remained the U.S., whose figures had again outperformed expectations in the fourth quarter of 2023, with demand still being driven by private consumption.

In this context, the markets' vision for the U.S. monetary policy had postponed the first reduction in the fed funds rate to the end of the first half of the year, thus affecting global financial conditions. The movements after the December FOMC, associated with the markets' perception that the U.S. Federal Reserve had to some extent relaxed its monetary policy, had tended to be reversed during the past few weeks. Since the December meeting, long-term interest rates had shown moderate increases in some of the major economies, while the dollar had strengthened somewhat globally and stock markets had generally moved upwards.

During the same period, the conflict in the Red Sea had been pushing up shipping costs in some international routes, while also driving some increase in oil prices. With respect to the December meeting, the price of a barrel of oil had risen to around US$80 (+6% since the last meeting, for the WTI-Brent average). The price of copper, although fluctuating, was around US$3.8 per pound, similar to the last meeting.

The domestic scenario

In December, both headline and core inflation had posted negative monthly variations, which were below the expectations contained in the latest Monetary Policy (MP) Report. There was a significant difference in the core components of goods and in most volatile items. As a result, their annual variation continued to decrease, standing at 3.9% and 5.4% for total and core CPI, respectively. As for inflation expectations two years ahead, both the Economic Expectations Survey (EES) and the Financial Traders Survey (FTS) remained around 3%.

Domestic activity continued to evolve in line with forecasts in the December MP Report. In November, the Imacec grew 0.3% month-on-month in its seasonally adjusted series (1.2% year-on-year), driven by the progress of most economic sectors. On the demand side, consumption- and investment-related indicators remained in line with projections, showing no significant changes.

The labor market remained consistent with the trajectory of the economic cycle. The unemployment rate had reached 8.5% during the moving quarter ending in December, as the labor force was showing a gradual recovery. Beyond some limited variations in the margin, the expectations of persons (IPEC) and firms (IMCE) lingered in pessimistic territory.

Trends in global financial markets and the faster-than-expected decline in local inflation had had an impact on the Chilean financial market. Since the last meeting, long-term rates —more sensitive to external conditions— had risen slightly, while short-term rates had declined. The peso had depreciated by 6% and the IPSA stock index showed no significant changes. Meanwhile, the Bank Lending Survey (BLS) for the fourth quarter of 2023 showed that supply conditions were still tight, especially for large companies and in sectors such as construction and real estate. Credit demand showed improvements in the consumer portfolio, but remained sluggish in other segments. Interest rates on commercial loans had continued to fall, while mortgage rates —i.e., longer term— remained high by historical standards.

The EES anticipated a 75 basis points (bp) reduction in the monetary policy rate (MPR) for this meeting, while the FTS and the outlook implicit in financial asset prices contemplated a 100bp cut. In turn, the expected MPR one year ahead had shown falls in both surveys, to 4.75% and 4.25%, respectively. Meanwhile, the market curve placed the MPR at 4.0% at December 2024.

2. Background analysis and discussion

Regarding the external scenario, it was noted that inflation, although still high, continued to fall in several economies. As for global activity, the likelihood that the U.S. economy would undergo a smooth adjustment had increased, which would have implications for the country's inflation and monetary policy. In this context, global financial conditions had tightened somewhat, after incoming economic data had reduced the likelihood of an early rate cut by the Federal Reserve. China had closed 2023 with negative inflation and weak demand, especially for consumer spending. Moreover, geopolitical conditions had deteriorated, which was already affecting shipping costs and posing future risks in a number of areas.

Locally, it was noted that activity, in broad terms, had behaved in line with December's forecasts. The Imacec data for November showed the impact of specific supply-related factors —in sectors such as fishing and mining—, as well as unexpected and transitory disruptions in manufacturing output. In general, all sectors were performing in line with expectations, reflecting the heterogeneity that had been the trend in recent months. On the demand side, indicators linked to consumption and investment did not show major changes. The labor market showed a slight growth in employment, with sectoral heterogeneity, and a growing wage bill in real terms. The Capital Goods Survey showed an increase in major projects for this and next year, with mining projects standing out. In any case, these figures were still considerably lower than historical ones and were below the previous year. Meanwhile, there were risks associated with the performance of certain business services activities and capital goods imports, although the latter variable generally presents a volatile behavior.

As for local financial conditions, there was agreement that they were still tight. Qualitative sources, such as the BLS and the Business Perceptions Report, reported still high interest rates —despite a recent decrease in some portfolios—, higher collateral requirements and contained demand. It was pointed out that tighter financial conditions than what was being perceived was a risk for the future evolution of activity, the gap and inflation.

There was agreement that the main novelty with respect to the previous meeting was the negative variation of both headline and core inflation in December. While normally a single data point at the margin would not overly affect the interpretation of the macroeconomic framework on its own, this time there were some particularities. First, its size, which was larger than usual; and, second, that it added to other differences in the same direction in recent months. Both elements suggested lower inflationary pressures than anticipated, even considering the November figure which had gone the opposite way.

Particularly, it was noted that understanding what this accumulation of lower CPI records meant for the future inflation trajectory and for monetary policy decisions was a must. On the one hand, it raised questions about the size of the activity gap, in a context in which the evolution of activity and demand had not changed much over the last few quarters and the differences with respect to projections had been smaller. On the other hand, it called for an assessment of the level of pass-through of the peso depreciation of the last few months and the role played by external prices, in a context of a weaker Chinese economy. While various sources of information suggested that businesses had sufficient margins to accommodate a rise in imported costs, especially in a context of what they described as lower demand, goods inflation was showing rapid declines in several economies, reflecting the aforementioned global prices factor. However, these issues would be analyzed in depth as part of the reassessment of the macroeconomic scenario leading to the next MP Report.

Comments were made on the possible impact that the INE's consumer basket updating would have on the CPI measurement. Difficulties in foreseeing its effect on annual inflation were mentioned, since changes in weights, products and calculation methodologies were involved, which made the end result uncertain. In fact, the analyses conducted by market economists yielded significant differences in the final impact. For the same reason, and without having more information than what was publicly available, the Board noted that any analysis on the impact of the change in the CPI measurement would be made after the publication of the data and the evaluation of its implications.

3. Analysis of monetary policy options

All the Board members agreed that the evolution of the macroeconomic scenario showed that inflation was converging to the 3% target at a faster rate than had been expected some time ago. Beyond the surprise in December figure —which had been significant—, inflation had been falling faster than expected for several months, in a context in which it was estimated that the economy had already narrowed the activity gap and inflation expectations were in line with the 3% target in the two-year horizon. In this scenario, there was agreement that the MPR should reach its neutral level during the second half of 2024. Consistently, all the Board members assessed that more aggressive cuts than contemplated in the central scenario of December MP Report were necessary. Several Board members considered the options of reducing the MPR by 100 and 125bp. One Board member thought it was appropriated to analyze the option of reducing the MPR by 150bp, but then added that it would be preferable to wait for the next MP Report to implement such a change in the monetary policy strategy.

All the Board members agreed that the options proposed reflected the need to speed up the pace at which the monetary restriction would be reduced. Therefore, the differences regarding the implementation of one or the other were more tactical in nature. The option of lowering the MPR by 100bp had the advantage that it would not come as a big surprise to the market, but it had to be accompanied by a clear communication that the MPR would reach its neutral level earlier than expected in the December MP Report. This favored signaling over surprising, which was of particular value in conditions of higher volatility and uncertainty.

As for the 125bp option, it was noted that its advantage was that it would allow a faster approach to lower MPR levels, which might be preferable given the rapid fall in inflation and the state of the activity gap. One Board member pointed out that this option or a higher cut were, in his view, the ones that best responded to the macro scenario and reduced the risks of inflation being lower than desired.

Several Board members mentioned that a cut above 100bp could be a surprise that might generate unnecessary volatility in some financial prices, which would end up undermining the correct transmission of the Board's decision. They noted that one of the desirable characteristics of monetary policy was its predictability. This did not imply that the Board should make decisions guided by what the market expected, but that it should guide the market regarding the future evolution of monetary policy. This could be achieved with a 100bp cut decision on this occasion, which allowed for more background information to be accumulated to strengthen the diagnosis on the state of the economy in the next MP Report and then give a clear communication of its future path. In any case, the market had already priced in several additional MPR cuts than expected in the December MP Report, which had shifted the rate curve in the appropriate direction given the changed scenario. All the Board members agreed that the proper monetary policy conduct implied meeting the inflationary target efficiently, i.e., at the lowest possible cost in terms of activity. This could require an early convergence of the MPR, which would reach its neutral level during the second half of 2024.

4. Monetary policy decision

Governor Costa, Vice-Governor Novy and Board members Naudon and Soto voted for reducing the monetary policy interest rate by 100 basis points, to 7.25%. Board member Céspedes voted for reducing it by 125 basis points.