banco central
Chile

MONETARY POLICY MEETING

APRIL 2024

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Monetary policy meeting No.304, held on 2 April 2024.

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

Present the Finance Minister, Mario Marcel.

Also present, Luis Óscar Herrera, General Manager; Juan Pablo Araya, 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; 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; Sofía Bauducco, Economic Research Manager; Guillermo Carlomagno, International Analysis Manager; Felipe Musa, Market Operations Manager; Silvana Celedón, Communications Manager; Andrés Sansone, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

Inflation had declined rapidly and was closer to 3%, in a scenario of domestic spending adjustment and a narrowing of the activity gap, which had contributed to resolving the large macroeconomic imbalances of previous years. In this context, two-year inflation expectations had remained at 3% for several quarters.

Early-year data showed some increase in annual inflation. Both January and February had seen high and above-expected monthly CPI variations. Among other factors, this had been due to the depreciation of the exchange rate, world price increases and inflation-adjustment of some local prices. In addition, monthly inflation had shown greater volatility in the past few months.

This recent inflation performance took place in a context where at the beginning of the year both the mining and non-mining Imacec components had improved somewhat above expectations. This combined several elements, namely: greater external demand, supply factors and signs of greater local impulse. Given the transitory nature of some of these factors, slower expansion velocities were foreseen for some months ahead, in line with assumptions contained in the previous Monetary Policy Report (IPoM).

In turn, in the second half of 2023, final demand had been somewhat weaker than projected, particularly in its tradable components. The 2023 National Accounts showed that the deseasonalized series of household consumption had fallen up to the third quarter, with a modest recovery towards the end of the year. Gross fixed capital formation (GFCF) showed a strong reduction in the last quarter of 2023, particularly for machinery and equipment.

On the external front, world inflation had continued to ease, although there were some risks due to the reversal of cost factors and the persistence of high services inflation. Doubts rested especially on the United States, where the resilience of its economy stood out, supported by strong dynamism in the labor market and private consumption. The greater dynamism of the economy, along with recent inflation figures somewhat higher than expected, had led the Federal Reserve (Fed) and the market to believe that interest rate cuts would be postponed to the second half of the year.

The postponement of the interest rate cut in the US and the slower reductions central banks elsewhere had affected Chile's interest rate differential with other economies. This, coupled with the evolution of its other determinants, was behind the significant depreciation of the peso, showing greater than usual sensitivity.

These factors, combined with the recent rise in some international prices, are expected to push up annual inflation in 2024. Our projections are that it will converge to the 3% target within the two-year monetary policy horizon, which considers the temporary nature of the aforementioned elements, that the economy will post growth rates consistent with its trend, and that the real exchange rate (RER) will gradually decline. Regarding activity, the IPoM's central scenario assumes GDP growth for this year to range between 2% and 3%, and between 1.5% and 2.5% for 2025 and 2026.

2. Background analysis and discussion

It was emphasized that domestic activity and demand reflected the resolution of the significant imbalances of previous years, which had been the main cause of the high inflation observed in the period. Incoming data showed somewhat more dynamic activity; however, it was difficult to infer from this any change in inflationary pressures. Partly because many of the activity surprises could be transitory and partly because some sectors of domestic demand looked weaker. In fact, an evaluation of the state of the gaps showed them to be bigger in the sectors linked to goods consumption.

It was noted too that, despite the temporary nature of some elements, data from the beginning of the year made it possible to project somewhat stronger growth in activity in 2024, as reflected in the growth range of the central IPoM scenario. Moreover, despite the weak domestic demand in late 2023, the most

recent labor market, credit and expectations data, among others, pointed to a continuation of moderate consumption growth and a recovery in investment in the second half of 2024. This showed that the possibility of significantly lower-than-expected activity, which could pull inflation below the 3% target, was seen as unlikely.

With respect to inflation, it was noted that several surprises had led to the annual CPI variation to end 2023 below the December forecast, which had been compounded by a reduction in its levels during the past year as a result of the updated basket and improved methodological measurements. However, in the first two months of 2024, monthly inflation had been high and above expectations. These results were explained by a specific set of elements, including the depreciation of the peso, external price increases and some local inflation-based repricing. In this context, the outlook for 2024 considered in the IPoM central scenario increased, based on higher external costs, the exchange rate hike and the inflation rates of the beginning of the year. In any case, the assessment of the macroeconomic scenario suggested that the inflationary pressures facing the economy were lower than they had been six months earlier. Even so, the risks were significant and required careful analysis.

The evolution of the exchange rate in recent months was discussed. It was recalled that, since the last IPoM, the nominal exchange rate had depreciated significantly, going from around 870 pesos to nearly 980 pesos in the days prior to the MP meeting. Part of this depreciation was explained by the evolution of interest rate differentials with the U.S. and other economies, which had added more than expected pressure on the peso. In particular, because the futures for the Fed funds rate indicated that they would be kept for a longer period and would be reduced more gradually than expected some time ago, while for the monetary policy rate (MPR), although it had changed in the meantime, the trajectory expected by market prices was similar to the one considered last December. Background information was discussed suggesting that the peso's reaction to these rate differentials was greater than in the past and potential reasons were explored. It was mentioned that the central scenario considered that, as the prospects of rate cuts for the rest of the world began to consolidate --particularly for the US and Latin American countries--, the RER would appreciate and would ease inflationary pressures on the economy.

3. Analysis of monetary policy options

All five Board Members agreed that the background information accumulated since the last Meeting indicated that the MPR should be further reduced. On the one hand, beyond the recent evolution of activity, the economy still presented weak domestic demand. Actually, it was estimated that some of the factors that had led to higher growth in the Imacec at the start of the year were temporary in nature. On the other hand, although the peso depreciation and global cost shocks pointed to greater pressures on prices, both factors would tend to dissipate within the monetary policy horizon. Moreover, given the slack in sectors linked to goods consumption, the pass-through of their effects on inflation would be moderate. Therefore, although

it was possible that inflation would rise in the short term, in the medium term there were still forces at work that would bring it back to the 3% target within the two-year policy horizon.

In this way, the strategy of concentrating a significant part of the MPR reductions in the first half of this year remained in place. Therefore, starting from MPR levels that were still above what could be considered neutral, the right action at this Meeting was to continue reducing it at fairly fast. In this scenario, all the Board members considered that the options of reducing the MPR by 75 or 100 basis points (bp) were plausible. One of them estimated that a 50bp cut could be considered if more weight was assigned to the risk of increasing inflationary pressures However, the option was quickly ruled out because there was not enough background to validate it.

There was consensus in the Board that the options of reducing the MPR by 75 or 100bp seemed the most appropriate. Both of them satisfied the need to continue to make substantial cuts to the MPR, better reflecting the economy's progress in resolving the significant macroeconomic imbalances and the inflationary convergence process. Therefore, leaning to one or the other option had connotations more closely related to tactical and risk elements.

The option of cutting 75bp off the rate provided greater degrees of freedom in the event that some assumptions in the central scenario failed to materialize as expected, particularly those that considered that some of the recent phenomena, such as the rise in cost pressures, were temporary in nature. This could also be the case if activity and domestic demand were to recover more rapidly, putting upward pressure on inflation. In addition, it coincided with what the markets expected, avoiding surprises that could affect the correct transmission of the Board's assessment of macroeconomic conditions and the expected path of inflation. This, in a context where market expectations for inflation, growth and the MPR trajectory during 2024 did not differ substantially from the central scenario depicted in the IPoM.

4. Monetary policy decision

Governor Costa, Vice-Governor Novy, and Board members Naudon, Céspedes and Soto voted for lowering the monetary policy interest rate (MPR) by 75 basis points, to 6.5%.

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