banco central Chile

MONETARY POLICY MEETING

JUNE 2024

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Monetary policy meeting No. 306, held on 18 June 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; Carmen Gloria Escobar, acting Statistics and Data Division Director; Michel Moure, Institutional Affairs 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; Andrés Sansone, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

The local economy had evolved in line with forecasts in the March Monetary Policy Report (IPoM). Activity was heading to a growth path consistent with its trend, but showing heterogeneity across sectors. It was worth noting that, as expected, part of the higher growth early in the year had come from supply factors that had been reversing. At the same time, differences continued to be observed in the performance of the economic sectors, especially in the dynamism of services, better figures in some trade branches and poor construction activity.

Domestic demand was outperforming expectations to some extent, particularly in consumption. The gradual recovery of household spending was taking place in the context of an increase in employment and real wages, sustaining the growth of the wage bill. As for Gross Fixed Capital Formation (GFCF), although still weak, the deterioration observed in the second half of last year had ceased, reflecting a more stable behavior of both machinery & equipment and construction & works. In any case, all GFCF components continued to contract year by year.

Annual growth in the total CPI remained around 3.5%, while core CPI (i.e., without volatile items) dropped from 4.2% to 3.5% between February and May (spliced series). In cumulative terms, both

measures were in line with forecasts. The annual change of services CPI excluding volatiles had dropped considerably from late 2023 (from 7% in December to 5.3% in May), reflecting indexation to lower inflation rates in the period that is most intensive in past-inflation adjustments. Inflation expectations at two years remained at 3%.

The global economy continued to be dominated by the adjustment of expectations for monetary policy in the United States. World growth projections showed minor changes, although it was still necessary to bear in mind that several economies were performing somewhat better than expected.

Regarding projections, local inflation was expected to rebound significantly and that convergence to the target would occur in the first half of 2026. This reflected the impact of the supply shock associated with the electricity prices hike and the greater momentum of domestic demand, considering early-year data and the higher copper price.

About activity, the contractionary effect of energy costs on real household income was counterbalanced by the greater momentum of domestic spending given its improved fundamentals, and a higher copper price projection. The metal's value had risen sharply in recent months and the projection scenario assumed that more than half of this increase would be permanent.

2. Background analysis and discussion

There was important news in the global scenario. On the one hand, a postponement of the monetary easing in the United States was foreseen, which had put new pressures on the dollar at the global level. On the other hand, both the current and the expected copper price had risen. At the same time, long-term interest rates were high and were becoming more sensitive to changes in expectations regarding the Federal Reserve's next decisions. The backdrop for this was higher uncertainty regarding several more structural global factors.

Locally, it had been confirmed that part of the surprises observed at the beginning of this year had proved transitory, for both activity and inflation. It was also worth noting the appreciation of the peso and marginal data suggesting that domestic demand could be showing more dynamism. It was mentioned that the analysis included in the June IPoM indicated that commercial credit was performing in line with its fundamentals. However, incoming data showed a further weakening that called for close monitoring, as it could be signaling a less favorable behavior in some demand components in the near future.

Two facts stood out regarding the central scenario projections in the June IPoM. First, the data for the last few months were in line with expectations, although demand showed a somewhat better performance than expected in the first quarter, which provided a more dynamic starting point for spending. Second,

there were two factors that would have a significant impact on the evolution of inflation. On the one hand, the somewhat stronger domestic demand, in a context where the higher copper price boosted up the terms of trade. On the other, the impact of successive increases in the electric bill over the coming quarters.

Regarding the factor first mentioned above, it was commented in the short term the copper price hike had generated an appreciation of the currency —with the resulting downward impact on inflationary pressures. Nonetheless, in the medium term, given the persistent nature of a part of the shock, domestic spending would strengthen, which would add to inflationary pressures. Thus, part of this effect would be transmitted to the external sector via imports.

As for the second factor, the rise in the electric bill would be of such a magnitude that, other things being equal, it would have a significant effect on the CPI, especially in 2025. The most likely scenario considered that it would have a limited effect on medium-term inflation, as it was a one-time supply shock to the price level. Nevertheless, it was pointed out that there were scenarios in which the spillover mechanisms of this shock could make its inflationary effects more persistent than expected assuming the usual historical patterns. This could occur due to the importance of energy as a production input or due to the indexation processes to which the economy was subject. Meanwhile, the effects on households' disposable income had to be factored in, as they could weaken demand beyond expectations.

It was noted that the central projection scenario considered that, while important, the impact of this shock was transitory, and therefore contained a monetary policy response that on average did not alter the real monetary impulse considered in the March Report. It could even be argued that the monetary policy was somewhat more expansionary if the better scenario of aggregate demand resulting from improved terms of trade and slightly higher growth of trading partners was taken into account. In any case, there was agreement on the need for caution, as the evolution of inflation expectations and the impact of the spillover mechanisms on all other prices called for careful observation.

3. Analysis of monetary policy options

All the Board members agreed that the macroeconomic scenario had evolved as foreseen in March. In this context, the local economy was returning to a growth path consistent with its trend and inflation continued to slow, with two-year inflation expectations remaining at 3%. The novelties of the central projection scenario were the better starting point of domestic demand, supported by the higher copper price, and the adjustment of electricity prices, which would significantly impact inflation, particularly in 2025.

There was agreement that the two most important developments in the projection scenario suggested a path for the nominal MPR somewhat above that considered in March, as contained in the June IPoM. The Board remarked on the effect that the electricity rate hike would have on inflation, but also noted that,

given its characteristics, a transitory supply shock, the monetary policy was capable of accommodating it without the nominal MPR having an equivalent reaction to the inflation hike. It was stressed that this was conditional on the second-round effects being in line with the forecast, which would be a matter for the Board to carefully evaluate.

All five Board members agreed that the current MPR level was still above the neutral values that had been estimated in late 2023, so monetary policy was still contractionary in nature. For the same reason, as long as activity gaps remained relatively closed, medium-term inflationary pressures were in line with the target being achieved and expectations remaining anchored at 3%, the MPR should continue to be reduced over the monetary policy horizon. In the immediate term, the central scenario of the June IPoM estimated that the MPR had accumulated during the first half of the year the bulk of this year's expected cuts. Consistent with this, all the Board members evaluated the option of lowering the MPR by 25 basis points (bp) to be plausible. Several Board members evaluated the options of lowering it by 50 bp or keeping it at 6%.

About the decision to cut 25bp off the MPR, it was noted that this option was the most consistent one with the IPoM's central scenario. It had the advantage of clearly stating that, despite how important the shock on inflation was, it was transitory, and monetary policy could accommodate it by further reducing the MPR in the quarters ahead. Moreover, it was a decision that, if the central scenario proved true, it left room for a further reduction in the remainder of the year.

As for the options of cutting 50 bp off the MPR or keeping it unchanged, it was said that they were valid insofar as the sensitivity scenarios defining the MPR corridor were given more weighting. On the one hand, the option of keeping the rate unchanged was consistent with a scenario where the impact on inflation of the higher expenditure and the supply shock would exceed the forecast, leading to a more contractionary than expected monetary policy. It was added that, because most of the MPR adjustments had been made in the first part of the year, it was possible to monitor the evolution of the scenario. In turn, the option to cut 50bp was based on a less benign reading of recent spending developments, a more negative view on the weakness of commercial credit according to the latest data, or that the negative effects of the electric utility rate hike on disposable income would be larger than expected. In contrast to the option of reducing the MPR by 50bp, it was mentioned that, if the central scenario were to materialize, that decision could force a prolonged pause in the process of reductions. Regarding the option to maintain the policy rate unchanged it was mentioned that it could send the wrong signal about the risks that the Board was analyzing.

4. Monetary policy decision

Governor Costa and Board members Naudon, Céspedes and Soto voted for lowering the monetary policy rate by 25 basis points, to 5.75%. Vice-Governor Novy voted for lowering it by 50 basis points.

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