Monetary Policy Meeting[1]

DECEMBER 2018

CENTRAL BANK OF CHILE

[1] This is a translation of a document originally written in Spanish. In case of discrepancy or difference in interpretation, the Spanish original prevails. Both versions are available at www.bcentral.cl

MINUTES OF THE MONETARY POLICY MEETING

Monetary policy meeting No. 261, held on 4 December 2018.

Present: Mario Marcel, Governor; Joaquín Vial, Vice-Governor; Pablo García, Board member; Rosanna Costa, Board member, Alberto Naudon, Board member.

Present the Finance Minister, Felipe Larraín.

Also present: Alejandro Zurbuchen, General Manager; Juan Pablo Araya, General Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Beltrán de Ramón, Financial Markets Division Director; Solange Berstein, Financial Operations Division Director; Gloria Peña, Statistics Division Director; Michel Moure, Institutional Affairs Division Director; Miguel Fuentes, Macroeconomic Analysis Manager; Enrique Orellana, Strategy and Communication of Monetary Policy Manager; Matías Bernier, Domestic Markets Manager; Luis Álvarez, Communications Manager; Hermann González, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background analysis and discussion

The information presented to the Board and its analysis are contained in the December Monetary Policy Report. It mainly shows that, after being under 2% almost the entire second half of 2017, annual inflation rose throughout this year, and has been around 3% during the past few months. Although part of this increase is explained by the more volatile CPI items and the depreciation of the peso, inflation of those components of the basket that are most sensitive to the activity gap (i.e. services and non-tradables) has grown steadily over the course of 2018, in line with the recovery of the growth rate that began more than a year ago.

Despite taking a pause in the third quarter, due to particular mining- and manufacturing-specific factors, growth was expected to resume in the fourth quarter. Thus, estimates were that the economy would grow 4% this year and between 3.25 and 4.25% in 2019, and that headline and core inflation would converge to 3% before the end of the policy horizon.

Critical factors in this outlook were the observed dynamism of investment and a vision of the labor market which, once all the available information was factored in, together with the impact of the significant immigration flow of recent years, showed a dynamic consistent with the improved performance of activity.

In this context, the evolution of macroeconomic conditions made it necessary to reduce the monetary stimulus, a process that the Board estimated it would continue to undertake gradually and cautiously, while the uncertainties coming from the external scenario were still high.

Regarding the information at hand at the Meeting, it was mentioned that, generally speaking, the evaluation of the macroeconomic scenario showed a continuation of what had been assessed in the September Report. This was reflected in minor changes in the Board's view on growth, with downward corrections to inflation, but linked to the more volatile elements, excluded from core inflation. This, with a scenario that was not very different at the start, considering the analysis of the particular factors that had explained the economy's performance of the third quarter, which was confirmed by fourth-quarter data already available.

All this occurred in a context where the message of monetary policy normalization conveyed in September had been, largely, correctly internalized by the market, as could be inferred from the evolution of market rates more closely related to monetary policy, especially at terms shorter than two years.

About the external scenario, it was mentioned that risks remained that were important for the Chilean economy, especially of an abrupt tightening of financial conditions for emerging economies, the evolution of the US economy and its implications for the US monetary policy, plus various risks of a geopolitical nature.

What was new, was the fall in the oil price, where it seemed that supply-side factors prevailed. Still, this diagnosis called for some caution, particularly because of the possibility that demand-side factors could have a greater impact on the recent evolution of this price.

In any case, incoming news suggested that the risks had not worsened, because the markets had interpreted that the Fed had signaled some moderation in its future course of action while the fall in the oil price, with copper relatively stable, gave way to a terms-of-trade improvement.

On the domestic front, it was noted that one element that had weighed significantly in recent analyses was the evaluation that the labor market behaved according to the rest of the economy, having succeeded in absorbing a significant increase in the labor supply causing no big rise in the unemployment rate and only a moderate slowdown in wage growth.

Furthermore, the latest data pointed to a tendency of private salaried employment to consolidate a gradual recovery accompanied by a reduction in self-employment.

2. Analysis of monetary policy options

All five Board members agreed that the macroeconomic scenario in which the monetary policy decision was based was virtually a continuation of that in the September Report, meaning that the economy had regained its ability to grow and its capacity gaps were narrowing.

Hand in hand with the reduction of these gaps, inflation of services and non-tradables had accelerated steadily since the beginning of the year. Core inflation, as measured by the CPIEFE, had been more subdued, but it was expected to accelerate over the months. All this meant that it had become less necessary to hold on to the monetary impulse established when the economic cycle was at its lowest, so now the appropriate thing to do was to continue withdrawing it in order for inflation to converge to the policy target within its medium-term horizon.

In this scenario, it was agreed that it was logical to follow a monetary policy path similar to the one proposed in September. This meant leaving no doubt about the need for a normalization of monetary policy, but, in turn, ensuring that this normalization would be done gradually and with caution. “Gradually” should be understood as gradual and predictable adjustments to the MPR, which would give economic agents the necessary time to adjust; “with caution” referred to the need to opportunely analyze changes in the macroeconomic scenario that could warrant a change of trajectory. These changes were especially important given the risks characteristic of today’s world economy and the hypotheses that had been incorporated into the projections of the domestic scenario. In the external environment in particular, although the baseline scenario assumed a mild worsening, with a slowdown in Chile’s trading partners’ growth, tighter financial conditions and a deterioration in commodity prices, the possibility of more dramatic changes remained latent in the perceptions of risk, in the trajectories of monetary policy in the developed world, and an escalation of the trade conflict.

The Board agreed that there was no doubt about the need to go ahead with the process of monetary withdrawal. The baseline scenario of the December Report assumed that the MPR would reach its neutral level during the first half of 2020. Being more precise than in September was necessary as time passed and the evolution of macroeconomic conditions confirmed the contours that the Report’s baseline scenario had maintained during the year.

For some Board members, specifying that the arrival at the neutral level would occur in the first half of 2020 was not intended to modify market expectations —which assumed it would do so in late 2020— but only to be transparent about what the baseline scenario of the Monetary Policy Report looked like and to be able to maintain consistency in the Board’s statement.

Board members commented on the rationality of the assumption for the MPR’s trajectory as a reference for the Board’s discussion. It was agreed that this should not be considered as a commitment, since depending on the evolution of risks and, in particular, the costs of these risks scenarios, the Board could decide on a trajectory of the MPR different from the one of the baseline scenario. In the opinion of one Board member, it was possible, for example, to think of a path of MPR increases slower than indicated by the working assumption of the Monetary Policy Report, as considered by market expectations. However, the validity of one or another path would only be solved in the light of the evolution of the economy.

Option 1: hold the MPR at 2.75% with an upward bias

The Board agreed that the main reason for not changing the MPR at this Meeting was the consistency between the Bank’s actions and their communication, especially in that the withdrawal of the monetary stimulus would be done gradually and with caution. At the same time, they agreed that the upward bias that accompanied this decision reaffirmed that this process would continue in the months ahead.

One Board member noted that holding the MPR this time, with an upward bias, could lessen the flexibility for the next Meeting's decision, since it could be seen as a commitment to raise it in January, even if incoming data were less favorable than now. However, he added, there was also the opposite possibility —of better data than today's— and, in that case, considering the option of raising the rate by 25 or 50 basis points would be inevitable at the next Meeting.

Option 2: raise the MPR by 25 basis points with an upward bias

The option of raising the MPR at this Meeting could be based on the idea that, given the wide gap between the current MPR and its neutral level, the risk of erring was low and would permit to pace future increases. However, its main caveat was that it could give a signal of urgency in the withdrawal of the monetary stimulus that was not consistent with the gradualism and caution committed by the Board.

3. Monetary policy decision

The Board decided, with the votes of Governor Marcel, Vice–Governor Vial and Board members García, Costa and Naudon, to keep the monetary policy interest rate at 2.75%.