Monetary Policy Meeting[1]/

2–3 MAY 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. 256, held on 2–3 May 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; Miguel Fuentes, acting Research Division Director; Beltrán de Ramón, Financial Markets Division Director; Solange Berstein, Financial Operations Division Director; Gloria Peña, Statistics Division Director; Diego Saravia, Economic Research Manager; Enrique Orellana, Strategy and Communication of Monetary Policy Manager; Elías Albagli, Modeling and Economic Analysis Manager; Matías Bernier, Domestic Financial Markets Manager; Juan Carlos Piantini, International Markets Manager; Rodrigo Alfaro, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Luis Álvarez, Communications Manager; Diego Gianelli, Head of the International Analysis Department; Hermann González, Advisor to the Finance Minister; Tatiana Vargas, Senior Economist; Carlos Medel, Senior Economist; Marlys Pabst, Secretary General.

1. Analysis of the technical teams

The international scenario

The international scenario relevant for the Chilean economy remained favorable, with downward-biased risks on domestic activity, consistently with projections in the March Monetary Policy Report. Some risks, such as protectionist measures, geopolitical conflicts and potential changes in the interest rate trajectories in the developed world, had gained some visibility, causing some disruptions in the financial markets. The outlook for activity had stabilized above the values of the previous year, beyond the fact that, with some nuances, optimism had moderated during the first months of the year, especially in the developed economies. However, in the US, first-quarter GDP growth had exceeded expectations and slowed down compared to the quarter before. The positive performance of investment and the deceleration of consumption stood out. Expenditure fundamentals remained strong with high levels of confidence and a robust labor market. First-quarter GDP growth in the Eurozone also slowed down from the quarter before, in line with market forecasts and activity indicators that had lately been unexpectedly low in general. Similar developments were seen in the United Kingdom, although in this case they had been partly due to weather conditions. In the emerging world, China's first-quarter GDP had remained as strong as the previous quarter and the mixed marginal numbers had continued to support the deceleration and rebalancing of activity foreseen for the next quarters. In Latin America, activity indicators were still mixed.

Regarding inflation, in the developed economies the gradual increase in the US headline and core inflation indicators—near or above the Federal Reserve's (Fed) target—contrasted with the more moderate and below central bank target figures of the Eurozone and Japan. In the Eurozone and the United Kingdom, recent inflation rates had fallen short of market forecasts. The Central Bank of Japan, in its latest statement, had ceased to mention that inflation would reach the target in 2019. Thus, the market outlook pointed to a larger divergence with respect to the future path that monetary policy in the US would follow compared with other developed economies. In any case, these central banks continued to signal a gradual withdrawal of their expansionary monetary policy stances.

In the emerging economies, China had given mixed signals of monetary conduct by marginally raising its repo rate while reducing the banking reserve requirement. In Latin America, low inflation in most countries and price pressures that led to additional moderation provided some leeway for additional monetary easing. In fact, the Central Bank of Colombia had reduced its benchmark rate by 25 basis points (bp). Conversely, the Argentinean authority had decided to raise the monetary policy rate in two exceptional meetings by 300 bp each time.

Global financial conditions were still good by historic standards in most economies, because despite the aforementioned tensions coming from geopolitical frictions and additional protectionist measures, volatility had returned to its levels of the last Meeting, while risk premiums remained contained. In this context, stock market indexes rose slightly further in most countries. Long-term interest rates posted mixed movements across economies. Parities showed an appreciated US dollar around the world in the few days before this Meeting. Capital inflows to emerging economies had moderated in recent weeks.

Commodity prices moved primarily up. The Brent–WTI average oil price had risen by 10% since the March Meeting, owing mainly to the geopolitical conflicts. Still, futures continued to show the transitory nature of the rise, because the easy entry of oil producers in the US shaped a downsloping trajectory going forward. The copper price, with ups and downs, remained near its levels of the last Meeting, coinciding with positive news of Chinese imports and increased inventories in the reference markets.

The domestic scenario

In the local financial market, long-term interest rates were near those prevailing at the time of the previous meeting, both in pesos and in UFs. The stock indices had risen, favored by companies' better results, in the midst of risk premiums that continued to be low historically. In the two weeks prior to the Meeting, the Chilean peso had depreciated against the US dollar by close to 4%, following the trends of global markets. In any case, since the previous Meeting, the Chilean peso had shown a slight depreciation with respect to the dollar, contrasting with the appreciations of similar magnitude exhibited by other multilateral measures in the period. The real exchange rate (RER), using the 1986=100 base measurement, was estimated to have approached 89 in April and in the first days of May, a level similar to those of the previous Meeting.

About domestic credit, the Bank Credit Survey of the first quarter 2018 had reported a strengthened demand in various segments—especially for consumer loans and commercial credit to big and real-estate companies—, together with marginal improvements in the supply of consumer and commercial loans for large companies. The cost of credit was still low, with declines in the interest rates on consumer and commercial loans that responded largely to seasonal and composition effects of these portfolios, while mortgage credit had been virtually unchanged. Credit growth was still bounded, with a mortgage segment that, aside from a slight decline recently, had continued to outperform the other portfolios. The increase in the commercial segment reflected a one-off operation.

The different measures of expectations for the monetary policy rate (MPR) i.e. surveys and financial asset prices, anticipated no change at this Meeting. Furthermore, they foresaw that the first 25 bp upward adjustment would take place between the fourth quarter of 2018 and the first of 2019, which for the prices of financial assets and the Economic Expectations Survey (EES) meant a one-quarter deferral of said movement compared to estimates at the previous Meeting. All in all, the different expectations indicators still considered that the MPR would reach 3.5% at the end of the policy horizon.

The activity and demand data received after the publication of the March Report was consistent with the baseline scenario described therein. The Imacec had grown by 4% annually in February (3.5% in January), somewhat less than reflected in the March EES and the expectations contained in the Bloomberg survey—between 0.2 and 0.5 percentage points (pp). First-quarter GDP growth stemmed to a large extent from mining, influenced by a low annual comparison base. All the other sectors maintained the better performance achieved in the latter months of 2017, where the increased contribution of several investment-related lines stood out, such as entrepreneurial services or some wholesale trade categories. In this scenario, the April EES showed no substantive changes in the activity growth expected for this year and next, the two somewhat above 3.5%.

There were no major developments regarding the evolution of domestic demand components or most of its fundamentals. On the consumer side, the sale of durable goods, again led by automobile sales, kept performing more favorably than non-durables, whose imports were dynamic nonetheless. This, amidst levels of consumer confidence (IPEC) in optimistic territory. However, the labor market outlook deserved attention, due to the limited momentum that private salaried employment continued to show together with slow wage growth, which in both nominal and real terms remained below historical averages at February (spliced with base 2016=100). This could affect both the increase in the wage bill, which in the first quarter of the year had been somewhat above 3% in real annual terms (4% annual average in the second half of 2017), and consumption.

Indicators of investment in construction and other works continued to point to a bounded recovery in the immediate future, such as various building and real estate indexes. The March survey of the Capital Goods Corporation reported a cut in the investment forecast for this year, mainly due to the postponement of projects (energy and public works), where everything in the 2018-2021 period adjusted upwards. About machinery and equipment, imports of capital goods excluding uncommon transport vehicles, maintained the improved performance of earlier months, which had begun to be reflected in some related branches of trade. The expectations of companies (IMCE) of April remained in optimistic ground on aggregate.

The Business Perceptions Report continued to show positive expectations for this year according to the bulk of opinions, especially towards the second half, beyond the disparity of businesses' actual results. Investment prospects had also improved. About the labor market, respondents generally mentioned no major immediate changes in their staff, and they shared their perception of low wage-related pressures. This latter factor was attributed to the weak performance of the last few years, which had decelerated wage growth and often led to freeze compensations during some quarters. The presence of immigrants had also helped to contain wage pressures according to some respondents. As for local credit, it was worth noting the low levels of interest rates, the favorable lending standards for lower-risk borrowers and the increase in applications for new credits.

March inflation had been 0.2%, slightly below market expectations (by around one tenth of a point). This result was mainly explained by the positive impact of core inflation—CPIEFE—for services, which had contributed 0.34 pp to headline inflation. The CPIEFE for goods continued to reflect the peso appreciation of recent months. Thus, in March it had fallen again, with a negative impact of 0.1 pp. As for the most volatile components, fresh fruits and vegetables had had a total impact on headline inflation, as did energy, while fuels contributed negatively (–0.07pp). In annual terms, inflation had fallen to 1.8% and the core index had remained at 1.6%. Its evolution, as had been the trend of recent quarters, was still driven by the aforementioned appreciation of the peso, the current capacity gaps and the indexation to lower inflation rates.

In this context, inflation expectations showed no big change. If anything, they had increased slightly one year ahead, between one and two tenths of a point. Thus, one year ahead, inflation insurances and the April EES had adjusted up to 2.6% and 2.7%, respectively, while the latest Financial Brokers Survey before the May Meeting continued to forecast a 2%. Inflation expectations two years ahead remained between 2.8% and 3%. For April, the market estimated that inflation would stand between 0.1% and 0.2%.

2. Background analysis and discussion

All the participants in the Meeting agreed that the economy, both externally and internally, had behaved within the framework depicted in the baseline scenario of the last Monetary Policy Report, although risks remained and had even varied on some fronts.

On the external scenario, the discussion centered on the implications of recent developments, concluding that it was ever more evident that the risks in this area had a clearly negative bias on domestic activity. For example, the inflationary outlook in the United States was discussed, together with how an increase could lead to faster interest rate hikes in the US, affecting global financial conditions. In this regard, there were comments on the appreciation of the dollar in international markets, arguing that this movement might have to do with the mentioned expectations that the Federal Reserve could accelerate the process of rate hikes. One participant added that he believed that the main risk continued to be that of a lack of coordination between monetary and fiscal policy in the United States that could be resolved in a disorderly manner, culminating in an overheated economy with excessive credit expansion. He added that this had been known to happen in the past and its consequences were not positive for either the developed or the emerging economies.

There was also a discussion on how the stronger dollar had affected more intensively the currencies of emerging economies with some particular vulnerabilities. The case of Turkey was noted due to its high current-account deficit; the case of Brazil due to the difficulties it has endured in regaining higher growth rates; and that of Argentina and its problems with high inflation. One participant commented that Chile was clearly not in any of those categories. Other participants also said that the Bank had always considered the risk that an increase in interest rates in developed economies could have disruptive effects on financial conditions facing emerging economies; therefore, the current events should come as no surprise. It was pointed out that the important thing was not the origin of the disruptions in the financial markets, but to analyze the way in which it could affect financing conditions in Chile. On this matter, one participant noted that, in principle, the effect in Chile was quite evident: a depreciation of the peso, but a negative effect on activity. He recalled that in the past, shocks of this kind had generated a response of more—not less—expansionary monetary policy, despite the higher short-term inflation. This, because in the end the effects of lower activity on medium-term inflation dominated and that was what determined the monetary policy decision. Therefore, if this risk had intensified somewhat in the recent past, the probability of a scenario where monetary policy was a little more expansionary than previously thought might have increased.

Also noted was the surge of new geopolitical risks, more difficult to evaluate or anticipate. Trade issues between the United States and several of its major trading partners were mentioned, where tensions increased and decreased; the increases in oil prices due to conflicts in the Middle East, be it in Syria, Iran or any other state, also with agents that tended to be the same in each of these risks and interacted with each other. In the opinion of one participant, each and every one of these elements could trigger a scenario of global stress or unrest among the economic agents that would cause greater volatility or some discreet adjustment in market prices. One participant noted the risks posed by the oil price rise to an economy such as Chile, which is a net importer. Finally, the discussion turned to developments in Europe, a region that had shown some economic vigor, even more than expected, and whose latest results reflected some rather weak and less optimistic data, a situation that should be observed carefully to figure out how persistent this trend could be.

On the domestic front, participants agreed that the figures for activity and inflation were not very different from expectations. The scenario in which the recovery of the economy would be more visible towards the second half of this year, leading to a gradual closing of the activity gap and sustaining the return of inflation to the target within the policy horizon was still valid. In this regard, one participant mentioned that it was important to note that, despite the good twelve-month figures and the difficulty to interpret seasonally adjusted figures, activity remained weak, which was consistent with the meager creation of private salaried employment, low cost-side inflationary pressures and general information that had been collected for the Business Perceptions Report. Anyway, he added, the closing of gaps outlined in the last Report remained perfectly possible, because the conditions leading to it had not changed. Still, it was convenient to properly balance current data showing weak activity and a still negative output gap with a projected recovery, which showed that at the moment there was no need for a near-neutral policy rate, but rather for sustaining a monetary impulse at least as significant as the one projected in the Report.

The discussion turned to the labor market, especially regarding the origin of the slowdown in wage growth and its consequences for activity and inflation. It was mentioned that there were several elements to be clarified on the matter, in particular how much of the deceleration in nominal wages could be blamed on supply-side factors and how much on demand-side ones. About supply, at least two events that were gaining importance were brought up, namely the increase in female participation—which in recent quarters had risen significantly, and faster than in the past—and immigration which, despite official figures, seemed to be having a greater weight in the work force. As for demand, attention was drawn to the technological adjustments and changes in productivity of recent years and how this would affect hiring once the economy more clearly recovered its near-potential growth rates. Several participants agreed that it was difficult to determine whether supply or demand factors were determining the evolution of the labor market, but the fact was that private salaried employment growth had been stagnant for some time, which made it difficult to attribute it only to immigration or female participation. They added that the sectors where one could assume greater participation of these groups were not those that showed the greatest changes in wage expansion. Moreover, the economy performing below potential was clearly consistent with a still weak labor demand. Therefore, it was possible that the deceleration of nominal wages was reflecting a labor market with greater gaps, signaling disinflationary forces somewhat more intense than expected, a situation that was complex considering that inflation was already low.

It was said that it was important to try to figure out which factors were affecting the evolution of wages, because its effects on inflation looked different under the assumption that the biggest impact would be on costs or the wage mass. Even more so, when in the latter case the effect of a change in labor supply was the opposite of that of a change in labor demand. Therefore, it was complex to move the current dynamic of the labor market to the typical interpretation of the Phillips curve, which further complicated a good analysis of its implications on the evolution of inflation.

It was agreed that the lower wage growth was a relevant issue at the current juncture, but the scope of the information should be clear, because what the National Statistics Institute (INE) data showed was a dramatic change in a very short time. Also, that other sources of information, delivered with lags, had still not shown such behavior, so it was necessary to wait for more data to become available.

Several participants analyzed the fiscal situation. It was said that the announcements on fiscal policy and its implications on the structural balance that the Administration had to make within the first 90 days of its mandate were key to analyze the matter. The fact that the increasing participation of non-residents in the ownership of local bonds during the past year could end up having effects on the evolution of interest rates if the fiscal situation changed was also discussed.

3. Analysis of monetary policy option[2/]

Based on this diagnosis, all the Board members considered that the monetary policy options analyzed in the previous Meeting were still valid. Consistent with this, they agreed that the relevant options were to either (1) keep the MPR at 2.5%, but communicating that the Bank was still concerned about the effect of downward deviations of inflation, or (2) lower the MPR by 25 bp to 2.25%, with a possible downward bias.

Option 1: keep the MPR at 2.5%

The entire Board agreed that in a context where the baseline scenario of the March Report was coming true, this option allowed for an adequate monetary

[2/] In order to preserve the regulatory individual anonymity in the discussion, all the Board members are herein referred to as males, including female member Ms. Rosanna Costa.

impulse to assure convergence of inflation to the target within the policy horizon. Some Board members added that the news rather suggested that the policy rate would probably remain unchanged for longer than previously thought. Finally, participants agreed that given market expectations and recent actions of the Central Bank, this option had no communicational risks, something that would strengthen monetary policy predictability, helping the effectiveness and efficiency of decisions in this matter.

Option 2: lower the MPR by 25 bp

All the Board members noted that in favor of this option was the fact that it limited the risks about the convergence of inflation described in the last Monetary Policy Report, which were still fully present. In particular, in a context where inflation was low —and was expected to linger for a while— and activity remained weak—as the negative output gap reflected—, the risks in the convergence of inflation were still present and, therefore, preventive actions should be analyzed. According to one Board member, on this occasion the option had more weight and validity because the news of lower short-term inflation came despite the fact that the economy had been growing more strongly for some quarters. Some members added that doubts about the evolution of wages were also an antecedent that enhanced the validity of this option.

Again they all agreed that the main element against this option was the difficulty of communicating it. Particularly, this option implied a change of criterion compared to the latest decisions of the Board, which in similar situations had decided that it was not necessary to take preventive actions to mitigate risks to inflation convergence and had signaled that the current monetary impulse was adequate. In line with this, almost any market agent anticipated a rate cut. One Board member added that in the time elapsed between the Monetary Policy Report and the March Meeting there had been no accumulation of elements that significantly changed the baseline scenario outlined therein, so that medium-term projections continued to point to a convergence of inflation to the target within the policy horizon. It was added that just as there were factors that pulled inflation down, such as the wage deceleration, there were others that could raise it, such as a faster closing of the gaps, with a greater dynamism of investment and the recent rise in the exchange rate.

4. Monetary policy decision

The Board decided, with the votes of Governor Marcel, and Board members Vial, García, Costa and Naudon, to keep the monetary policy interest rate at 2.5%.