Monetary Policy Meeting[1]/

SEPTEMBER 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. 259, held on 4 September 2018.

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

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 Manager; 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 Financial Markets Manager; Luis Álvarez, Communications Manager; Hermann González, Advisor to the Finance Ministry; Marlys Pabst, Secretary General.

1. Background analysis and discussion

The information submitted to the Board and analysis thereof make up the content of the September Monetary Policy Report. Overall, indicators received over the year reflected more-than-expected economic growth and showed that inflation had consolidated its prospects of converging to the target. This, in a context of positive surprises in several economic sectors, an upward revision to potential growth and a faster closing of the activity gap. Regarding inflation, the annual CPI variation had risen to 2.7%, but its CPIEFE —CPI excluding food and energy prices— counterpart was still below 2%, both in line with expectations. The risks of the external scenario had become more present. The US-China trade conflict had intensified, which, coupled with the cyclical state of the US economy and its difference from that of other developed economies, had caused a global appreciation of the dollar and a fall in commodity prices. All this was having a stronger impact on those emerging economies seen as more vulnerable. However, for the moment, global growth projections had had limited changes.

About the domestic scenario, there was agreement that for several months there had been a number of positive surprises in activity, which were already occurring in more sectors and expenditure components, reflecting a stronger economy. Also, the increase in potential GDP showed that the higher growth was not only the effect of a cyclical upturn, but also represented a more structural behavior. It was also noted that although July's activity data has seen a slowdown, it was fully consistent with the baseline scenario of the September Report, which assumed that, in line with the exhaustion of capacity gaps, growth rates would begin to moderate in the second half of the year. Moreover, y-o-y variation figures would decrease as the low basis of comparison of last year faded out.

There was debate about the evolution of the labor market, noting that the better understanding of some key variables had allowed dissipating many doubts about its strength. Although it had always been argued that the recovery of employment should follow activity growth with some lag, only recently had there been incipient increases in private salaried employment that had been spreading to various sectors, while self-employment decelerated at the same time. Meanwhile, a more in-depth review of the impact of immigration on the labor market showed that, in principle, in the last two to three years many more jobs had been created than was indicated by the surveys, whose designs did not allow to properly capture demographic changes of such magnitude. In addition, although compensation indicators pointed to an unusual deceleration of wages, the Social Security administrative records did not support that vision.

About the evolution of inflation, there was agreement that there had been no significant surprises, and that the increase in CPI inflation was an anticipated development that owed mainly to the evolution of the more volatile prices, since the CPIEFE was still below or near 2%. It was noted that the evolution of inflation was consistent with the gradual closing of gaps in the economy and that going forward the gradual withdrawal of monetary stimulus needed restructuring in proper balance with the closing of these capacities. It was also pointed out that beyond the variations of the CPI in the short term or the temporary boost that the exchange rate could cause, the focus was rather on the outlook for inflation within the policy horizon, its relationship with the activity gaps and the necessary reaction of monetary policy. In this sense, the projections pointed to a faster convergence of inflation, both headline and core, to the policy target, which came from a point where core inflation was still below 2%.

On the international economy, although the baseline scenario contained limited downward revisions to growth in the world economy and our trading partners, it was agreed that the risks associated with the external situation had increased significantly, becoming the main source of uncertainty. It was pointed out that the worsening of the economic outlook was more pronounced for emerging economies, particularly because the perception of risk had increased and those countries perceived as most vulnerable had suffered massive capital outflows. In this context, the peso had depreciated, albeit less than the average of emerging countries, despite a sharp adjustment in the copper price. The importance not to downplay the magnitude of external risks was also stressed, especially in the case of emerging countries. Today they were more significant, concrete and complementary than they seemed a few months back.

2. Analysis of monetary policy options[2/]

All five Board members agreed that both the analysis contained in the September Report and incoming data after its statistical cutoff date indicated that the evolution of macroeconomic conditions, and the convergence of inflation to 3% in the usual horizon, made it less necessary to maintain the current monetary stimulus. Given the medium-term implications of this scenario, the Board opined that the monetary stimulus should begin to be reduced in the coming months and that by 2020 it would stand around its neutral level, which was estimated between 4% and 4.5%.

The monetary policy decision was taken in a context where the accumulation of new data, its analysis and medium-term implications advised starting the process of monetary normalization as soon as possible. In fact, in the context of a strengthened economy, as time passed it was becoming more costly to delay starting said process. On the other hand, although the evolution of the external scenario caused some concern, it was important to draw a line between the baseline scenario and its implications for monetary policy decisions and the risk factors. These were two elements that unfortunately tended to be often confused in the public discussion and that affected the perceptions of the situation and economic perspectives. In short, in the presence of a recovering economy that was growing above trend, with gaps that tended to close, and inflation that would converge to 3% earlier than expected, it was logical to communicate that the MPR had to begin an upward path.

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

Option 1: Begin to withdraw the monetary stimulus

The main argument for this option was that the evolution of macroeconomic conditions and their immediate prospects were sufficient to push inflation to 3%, which warranted beginning the monetary policy rate normalization shortly. Moreover, delaying it for too long would force to compress the adjustment process into a shorter time span, leaving less space for taking pauses in the process, which could be helpful in decanting information. In addition, the current scenario —of above trend growth and inflation nearing the target— was a quite different picture than last year's, when the economy was growing below the trend and inflation was clearly below 3%. Therefore, the MPR, in one and the other circumstance, obviously had to be different.

The main argument against this option was that raising the MPR at this Meeting would be unexpected and, consequently, confusing, opposing the desirable practices of a duly informed and anticipated policy. Although the market could always be surprised, this entailed some costs and, therefore, doing so required good reasons. At the same time, for the adjustment to be effective, it was important that its foundation and opportunity be clear to the market. In that sense, there were elements that interfered in that understanding. First, an important gap between the diagnosis contained in the Report that would be disclosed the next day and the current market perceptions, which take some time to be assimilated. Second, a recent exchange rate escalation that could blur the meaning of an MPR increase and inflation fundamentals to which the Board assigned greater importance to make its decisions. Third, core inflation still below 2% that could raise doubts about the immediate need for an adjustment. Upon the release of the Monetary Policy Report, all the economic agents would be in a better position to assess the situation and understand the adjustments that were required in the monetary impulse.

Option 2: keep the MPR at 2.5%

The main argument in favor was that holding the MPR and communicating that the withdrawal of the monetary stimulus would begin in the coming months avoided upsetting the market, which could convey a sense of haste or delay in the normalization process that was not consistent with the analysis presented in the Report. Instead, it was said that the evolution of macroeconomic conditions pointed clearly to the need for a gradual withdrawal of the monetary stimulus. This would indicate that, as long as conditions didn't change, there was increasing probability that the withdrawal of the monetary stimulus would begin sooner. It could also be argued that the option to keep the MPR unchanged would allow collecting additional high-frequency information prior to taking this first step. However, this argument seemed weaker, beyond certain recent news that the market had read in an adverse way. The option would always be present to pause and wait for more background data to enhance the diagnosis. However, domestic risks were limited today while external risks would remain there for a longer period of time.

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 2.5%.