MONETARY POLICY MEETING

JANUARY 2022

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Monetary policy meeting No. 287, held on 25-26 January 2022.

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

Also present: Beltrán de Ramón, General Manager; Juan Pablo Araya, Legal Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Paulina Yazigi, Financial Markets Division Director; Solange Berstein, Financial Policy Division Director; Gloria Peña, Statistics 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; Miguel Fuentes, International Analysis Manager; Andrés Fernández, Economic Research Manager; Juan Francisco Martínez, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Felipe Lozano, Communications Manager; Marlys Pabst, Secretary General.

1. Background

The national scenario

Inflation rose to 7.2% annually in December, exceeding market expectations and forecasts in the last MP Report. The increase in prices was widespread among the different items of the CPI basket. Worth noting was again the increase in the core component (CPI without volatility) which reached 5.2% annually. The latter combined the increase in both the goods component —which exceeded expectations— and the services component, especially when excluding indexed prices and administered utility rates. In the volatile component --also unexpectedly high--, the contribution of fuels and some specific items, such as tourist packages, continued to stand out. These developments occurred in the midst of still high cost pressures, as confirmed by preliminary data for the Business Perceptions Report (IPN) of February 2022, where the persistence of procurement and product availability problems were widely mentioned by the companies consulted and continued to put pressure on margins, while still facing high demand. Private inflation expectations remained above 3% in the two-year term.

Aggregate activity and demand indicators led to estimate that GDP growth would be at the upper part of the December Report's projected range for 2021. The November Imacec had increased 14.3% annually (0.3%

*/ The Spanish original prevails.

monthly seasonally adjusted). The contribution of services stood out, with annual growth of 20%, driven by personal services in particular, reflecting the consolidation of eased sanitary restrictions and the boost of the remaining resources from household support measures. Trade followed with +16.7% annually in November. Retail trade sales (INE) maintained high dynamism, as did imports of consumer goods, reflecting the strong momentum of this spending component, especially durable goods. Consumer confidence (IPEC) remained in pessimistic territory, although with some rebound at the margin. In investment, the good performance of capital goods imports stood out, suggesting a favorable performance of the machinery and equipment component. This contrasts with the outlook for construction and works, where several indicators, such as the Imacec or the sectoral IMCE, showed a deterioration in incoming figures.

Most of the firms surveyed in the IPN indicated that the performance of their businesses had remained stable or had declined slightly in recent times, in the context of still strong demand and where some businesses had ended 2021 at new highs. One exception was the construction sector, where several respondents reported a somewhat gloomier outlook, coinciding with tighter credit constraints. Although less so than at the end of last year, the high degree of political-legislative uncertainty at the local level maintained certain reluctance regarding investments or the results of the companies going forward. In general, however, performance was expected to remain largely unchanged.

The labor market continued its gradual recovery, with labor supply still tight on the part of households and high demand from companies. According to INE data, in the moving quarter ending in November, the number of employed persons had increased by 102 thousand (+8.1% annually), with notable advances in the self-employed and formal wage-earning categories. Nevertheless, total employment nationwide still remained below pre-pandemic levels. Although certain elements again pointed to improvements on the labor supply side, such as the increase in the participation rate, its mismatch with demand was still evident. This had continued to have an upward effect on wage growth, especially in less skilled positions. Feedback from the IPN confirmed this picture. One of the main concerns was the difficulty in filling vacancies. This had led, in many cases, to the payment of higher salaries to new hires, while others were adjusting to operate with less staff on a more permanent basis.

The evolution of the local financial market had been marked by external and internal factors, with the latter predominating, possibly related to reduced local uncertainty. Since the previous meeting, the stock market had shown a 5% advance and the country risk (CDS) had fallen by 10 basis points (bp). The peso had appreciated close to 5%, with more moderate volatility. Nominal long-term interest rates, with ups and downs, were at similar levels, while maintaining a significant differential with their external counterparts. In particular, the 10-year term bond yield outperformed its U.S. counterpart by around 390bp, versus 160bp in the 2021 account. This discrepancy was in line with domestic uncertainty levels that remained high by historical standards. Fixed-income interest rates for shorter maturities had risen, in response to increased headline inflation and rising expectations for the monetary policy rate (MPR). In the corporate bond market, in both the financial sector and the rest of the companies, there were fewer transactions and lower amounts traded, with spreads fairly constant.

Lending activity by local banks remained sluggish in all portfolios. As of December, in real terms, the annual growth of consumer loans remained negative (-6.7%) —despite continuing to rise—, for mortgage loans it had not changed much (5.9%) and for commercial loans it had resumed positive values (2%). This weak performance of credit was mainly influenced by demand factors. This was reflected in the preliminary information for the February IPN, in a scenario in which financing conditions were also seen as tighter by a significant group of respondents. Similarly, the fourth-quarter Bank Lending Survey had reported tighter supply and demand conditions than in the quarter before for most portfolios, with special emphasis on mortgages and real estate. Meanwhile, interest rates had risen across all portfolios, but mainly in the consumer segment. In this same category, there was an incipient rise in delinquency rates, which however remained contained in the system at large.

Expectations for the level that the MPR would reach this year had been revised upwards. The Economic Expectations Survey (EES) and the Financial Traders Survey (FTS) took it up to 6% and 6.5%, respectively, while financial asset prices pointed to a slightly higher level. Thus, all these measures were around the upper limit of the MPR corridor in the December MP Report.

The international scenario

The world economy had lost some dynamism, but the outlook for the year was largely unchanged. The rise in Covid-19 infections had been significant in many countries, pushing some of them to new records. Although mobility had been affected, the impact on activity looked rather limited, mainly in countries with high booster vaccination rates. However, the situation had been more complex in China, where delays in the application of the booster jab, as well as the zero-Covid policy, had led to tighter restrictions. These posed greater risks to economic activity and the potential effects on the persistence of bottlenecks around the world. The latter had continued to put pressure on supply chains, which reinforced the view that their impact would last longer than previously expected.

Global inflation had continued to accelerate, particularly with increases in the United States and Latin American countries. In the U.S., the most recent data had been surprising again, with record-high figures that this high inflation was a persistent phenomenon across the board. This had led to an increase in inflationary expectations at different horizons, coupled with concerns about wage cost pressures in the face of a still tight labor market. In Latin America, inflation had also risen sharply, driven by higher food and energy prices. The oil price had climbed to around US$85 per barrel (+19% since the last meeting, for the WTI-Brent average). This increase was related to the low impact of the Omicron variant on the global demand for crude oil and the existence of some supply constraints in this market. The increase in geopolitical tensions, particularly in Europe, raised the risk of further increases in energy prices. Copper prices were around US$4.5 per pound, amid favorable demand expectations and stock market inventories that remained low from a historical perspective.

Accordingly, several central banks had intensified the shift towards the withdrawal of monetary stimuli. The U.S. Federal Reserve had begun to signal the need to accelerate this process, given the greater persistence of inflation, while the Bank of England had surprised with a rate hike. The European Central Bank was one of the few that had not yet adopted this more contractionary stance. With a greater degree of volatility, the financial markets reported a widespread increase in long-term interest rates, the appreciation of a significant number of currencies against the dollar, and stock market declines, particularly in developed countries.

2. Background analysis and discussion

The data known since the publication of the December Report pointed to somewhat higher than expected inflationary pressures. Headline inflation had been a little above expectations, and this surprise was not expected to disappear anytime soon. In fact, the monthly dynamics of inflation showed that in the last six months it had been significantly above historical patterns. Moreover, no significant deceleration was expected for the following six months, especially in the core component. In terms of activity, GDP growth would have been at the high end of the estimated range for 2021. Thus, inflationary inertia, a gap that remained positive, a depreciated real exchange rate, and significant external cost pressures continued to exert upward pressures on inflation.

In the financial markets, the exchange rate had fallen in recent weeks, but its expected trajectory was not perceived to be very different from the one foreseen in the Report. There were a number of factors at work here. On the one hand, the markets had undoubtedly taken the recent political scenario in stride. But on the other, the more fundamental elements that had kept uncertainty high were still present, and coupled with growing tension in the external environment.

3. Analysis of monetary policy options

The Board agreed that the risks to the evolution of inflation were still significant and their possible materialization was particularly relevant in a context in which both the annual change in the CPI and its outlook were already high.

There was consensus that the relevance of risk management argument in the policy rate decision had intensified most recently. In fact, both activity and inflation were somewhat higher than expected in December, while inflationary pressures stemming from abroad had increased. All things considered, the Board members agreed that it seemed reasonable to follow, in the short term, a monetary policy path around the upper edge of the MPR corridor of the last Report. In this context, the Board evaluated the options of raising the MPR by (i) 125bp, (ii) 150bp, or (iii) 175bp.

All the Board members agreed that the option of raising the MPR by 150bp best addressed the greater intensity of the risks to inflation. One Board member noted that, while such a hike would marginally surprise the markets, it had the advantage of addressing the fact that inflation had been higher than expected, that the macroeconomic imbalances underlying the higher inflation persisted, and also that two-year inflation expectations were above 3%. Another member added that, if greater weight was given to risk management and the asymmetry of its costs, the 150bp option was the best, as it signaled more decisively the idea of going faster in raising the MPR and positioning it near the upper edge of the corridor.

They all agreed that a 125bp raise was a valid option. In fact, it was also consistent with being on the upper bound of the MPR corridor and provided continuity to the process of upward moving MPR of previous months. However, it had the counterpoint that further surprises in inflation, or in the evolution of inflation fundamentals, could force a further acceleration of increases in the policy rate at later meetings.

Finally, all the Board members agreed that the 175bp increase seemed inappropriate at this time. One Board member pointed out that such a decision could cause confusion and, in this opinion, the current differences between expectations and projections did not warrant a surprise of that magnitude.

4. Monetary policy decision

Vice-Governor Vial and Board members García, Naudon, and Costa voted for raising the monetary policy interest rate by 150bp, to 5.5%.