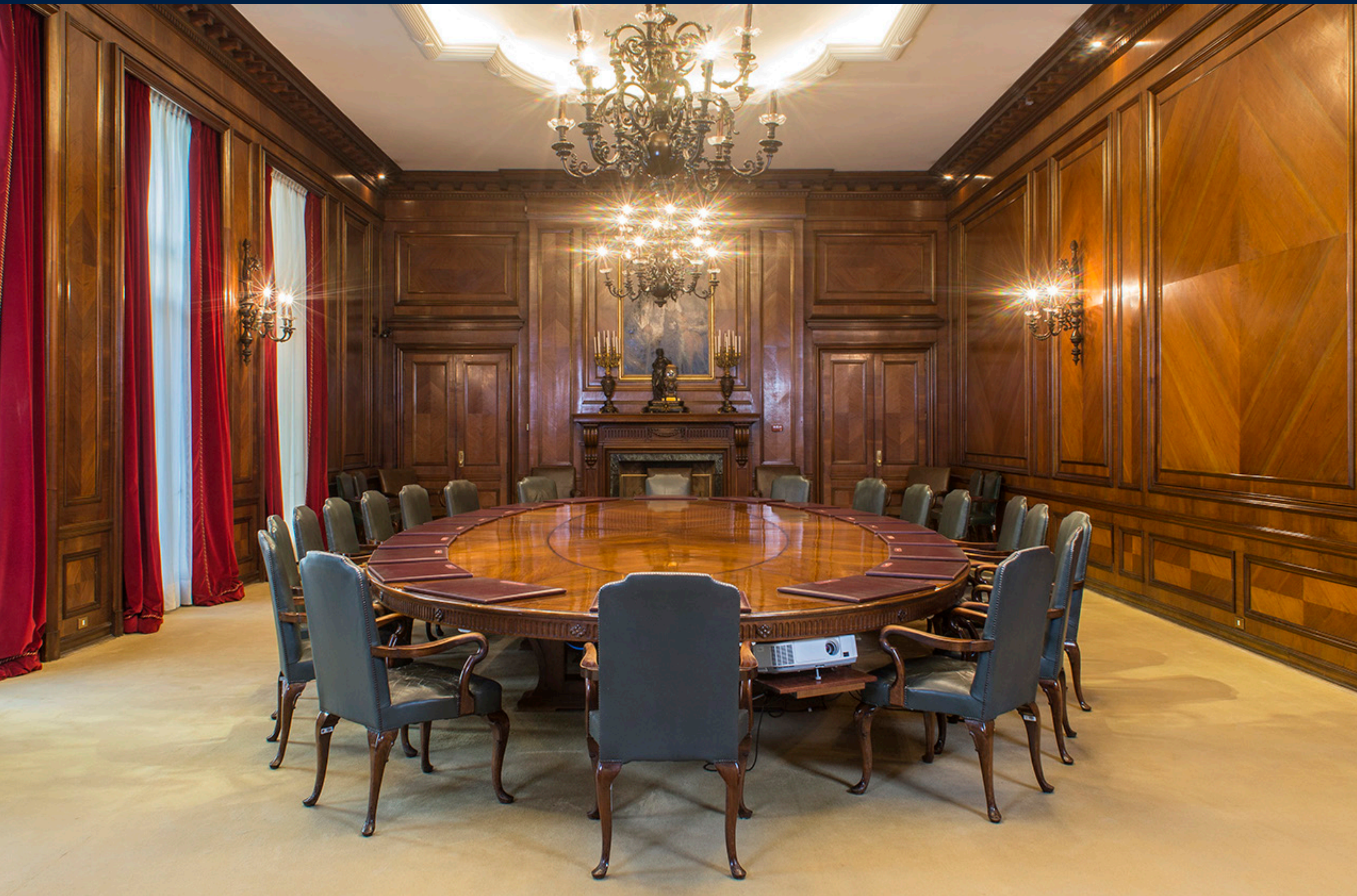
MONETARY POLICY MEETING

SEPTEMBER 2022



MONETARY POLICY MEETING

Monetary policy meeting No. 292, held on 6 September 2022.

Present: Rosanna Costa, Governor; Pablo García, Vice-Governor; Alberto Naudon, Board member; Luis Felipe Céspedes, Board member; Stepanka Novy, 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; Rosario Celedón, 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; Sofía Bauducco, Economic Research Manager; Felipe Musa, acting Market Operations Manager; Felipe Lozano, Communications Manager; Andrés Sansone, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

Global inflation had continued to rise, showing signs of increased persistence. Central banks had further raised their benchmark rates, notably the European Central Bank, which had begun its monetary normalization process in July, and the U.S. Federal Reserve (Fed), which had adopted a more restrictive policy stance to rein in inflation.

The outlook for global growth had deteriorated, amid still unfavorable conditions, especially for emerging economies. The central scenario of the September Monetary Policy Report considered that our trading partners would grow by an average of 2.6% in 2022 and 2023, i.e., less than expected in the previous Report.

Global financial markets maintained high volatility, due mainly to uncertainty regarding the Fed's future monetary policy path and its impacts. Long-term interest rates had generally risen in recent weeks and the dollar had continued to appreciate globally. Commodity prices had shown declines for some weeks, as had the prices of foods.

At home, after the Central Bank had announced a foreign exchange intervention, tensions in the forex market had subsided. Volatility had decreased and the peso had appreciated. Credit continued to be weak, in a context in which banks and companies felt that financial conditions were restrictive.

Activity and demand were still in their adjustment process after the strong imbalances accumulated in 2021, with second-quarter data showing declines in both investment and consumption. The labor market was losing strength, with weak job creation and a decline in vacancies. The unemployment rate showed no major changes, while the annual change in real wages remained negative. Consumer and business confidence indicators remained in pessimistic territory.

Headline inflation had risen again, touching 13.1% annually in July, while core inflation —the CPI without volatiles — had been 10% annually in the same month. Surveyed inflation expectations —EES and FTS— had adjusted upwards in the two-year horizon.

High inflation was having a significant impact on the incomes and expectations of economic agents. The projections contained in the September MP Report revised upwards the inflation forecast for the end of 2022 and all of 2023, estimating that by the turn of 2024 it would return to values closer to the 3% target.

The reduction in inflation from its current high levels to 3% was based on the assumption that the economy would continue to adjust the imbalances accumulated in 2021, which considered a slowdown in activity and demand for several quarters.

The Central Bank's objective was to achieve inflation convergence via an adjustment in economic activity that would be brief, orderly, and at the lowest cost possible. For this to occur, a necessary condition was for inflation not to become more persistent. The upside risks to inflation remained high, in particular because, in a high inflation scenario, such persistence could increase.

The details of the central scenario, sensitivities, risks and future evolution of the MPR were included in the September Report, which served as the basis for the discussion at this Meeting.

2. Background analysis and discussion

The discussion focused on the evolution of the international scenario, especially the increase in inflation at the global level, the challenges that this entailed and, especially, the tightening of monetary policy in developed countries. Although this change seemed entirely appropriate, it undoubtedly posed a challenge to the Chilean economy. For one thing, it would imply receiving a lower external impulse, in terms of both its effect on global activity and its negative impact on commodity prices and the tightening of financial conditions. In addition, the risks in the external scenario were high and more drastic adjustments of interest rates in the developed world could not be ruled out, which, if materialized, would further deteriorate the external impulse relevant for Chile.

About the domestic economy, it was pointed out that activity was adjusting in line with expectations and that the central scenario of the September MP Report projected that the economy would see negative growth rates for several quarters. The importance of not losing sight of the fact that this reduction in activity, that should translate into a negative activity gap, was an unavoidable condition for the convergence of inflation to the target was emphasized. With respect to the labor market, it was pointed out that, despite stagnant job creation and contained real wages, it was unclear how much of this evolution was related to the business cycle and how much was due to structural aspects. For this reason, there was no conclusive information that would allow judging that the beginning of a potential cycle adjustment in the labor market was underway.

Regarding inflation, it was pointed out that, although its core component had been in line with expectations, the volatile component had surprised strongly, placing total inflation above 13% annually. It was added that, normally, the Board might have reacted with little intensity to such a surprise, especially in a context where medium-term demand and activity expectations had been deteriorating. However, in the current circumstances, marked by inflation well above the 3% target, with upside surprises for several months and where everything indicated that inflation had become more persistent, it was very difficult for the Bank not to respond strongly to this news. The Board felt that these impacts should not be downplayed and, therefore, had been factoring them into its projections, communications, and decisions for several quarters ago.

The implications of the outcome of the constitutional plebiscite were discussed, noting that, although this was an important milestone in the process, the road to a new institutional framework was long and would not be free of challenges. In this sense, it was to be expected that uncertainty would remain relatively high, beyond some reduction. For this reason, it was necessary for the Bank to remain very vigilant of the evolution of the process and its effects on the markets.

3. Analysis of monetary policy options

All the Board Members agreed that there were very important risks to future inflationary dynamics. Particularly relevant were the impact that high inflation was having on inflationary persistence, the way this phenomenon was extending, and the worsening of inflationary expectations indicators. Regarding the latter, the increase in the different measures of expected inflation in the two-year horizon was emphasized, together with the fact that businesses had sped up the frequency of price adjustments in the last few quarters.

In this context of more persistent inflation, all the Board members agreed that it required a more restrictive monetary policy —in both nominal and real terms— than had been anticipated in the June MP Report. Part of this tightening had already begun at the July Meeting and was to continue this time around. The central scenario of the September Report assumed that the MPR would reach a maximum level of close to 10.75%, so the evaluation of the different options had to take into account the speed with which that level was to be attained, the need to reinforce the Board's concern about the inflation dynamics and the option of making a substantial adjustment that would open more possibilities for a future pause. The Board evaluated the options of raising the rate by: (i) 75 basis points (bp); (ii) 100bp; and (iii) 125bp.

Some Board members considered that the 75bp option was plausible, because it was within the upper range of market expectations and was evaluated in a context in which monetary policy had already made a very significant adjustment, while activity and demand were showing the expected weakness, as evidenced by the evolution of consumption, investment, and real wages. In addition, the outlook was deteriorating, particularly due to the worsened external scenario. One Board member mentioned that this option was plausible only if it was considered as part of a monetary tightening to be continued later. Other Board members mentioned that this option was less efficient if the intention was to give clear signs of concern regarding the evolution of inflationary dynamics and expectations.

About the option of raising the MPR by 100bp, several Board members noted that it had the value of being a decision consistent with the central scenario and easier to communicate, as it did not require the Board to commit to a closure of the rate-increasing process. Some Board members said that the message of closing down under uncertain conditions seemed too risky in a scenario as complex as the current one, with a lot of unfolding events. Therefore, such an option was consistent with the idea of assessing the evolution of economic variables over some months and then making adjustments where necessary.

Several Board Members considered that the option of raising the MPR by 125bp could be understood as being more consistent with risk assessment in terms of inflationary dynamics, while signaling more clearly the concern about the persistence of the deviation of two-year inflation expectations from 3%, the concern about a change in the dynamics of price adjustment by firms and the obvious need for the economy to adjust activity. Some Board Members mentioned that this option had the disadvantage of taking the market by surprise and meant that the message of closing the upward cycle had to be delivered more strongly.

All five Board Members agreed that a necessary condition for the resolution of the inflationary problem was a reduction in activity — as expressed in the September MP Report projections—, which was costly for the economy, but a requisite to bring down inflation. There was agreement that the MPR would stay high until there was clear evidence of inflation converging to 3% over the two-year policy horizon. Accordingly, it was emphasized that the Board's main concern was that a scenario would arise in which the inflationary phenomenon would become much more persistent. Given the high inflation levels and two-year expectations above 3%, the realization of this risk would require significantly more restrictive monetary actions, sharply increasing the cost of bringing inflation back to target.

4. Monetary policy decision

Governor Costa and Board members Naudon and Céspedes voted in favor of raising the MPR by 100bp to 10.75%. Vice-Governor García voted for raising it by 125bp. Board member Novy voted for raising the MPR by 75bp.

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