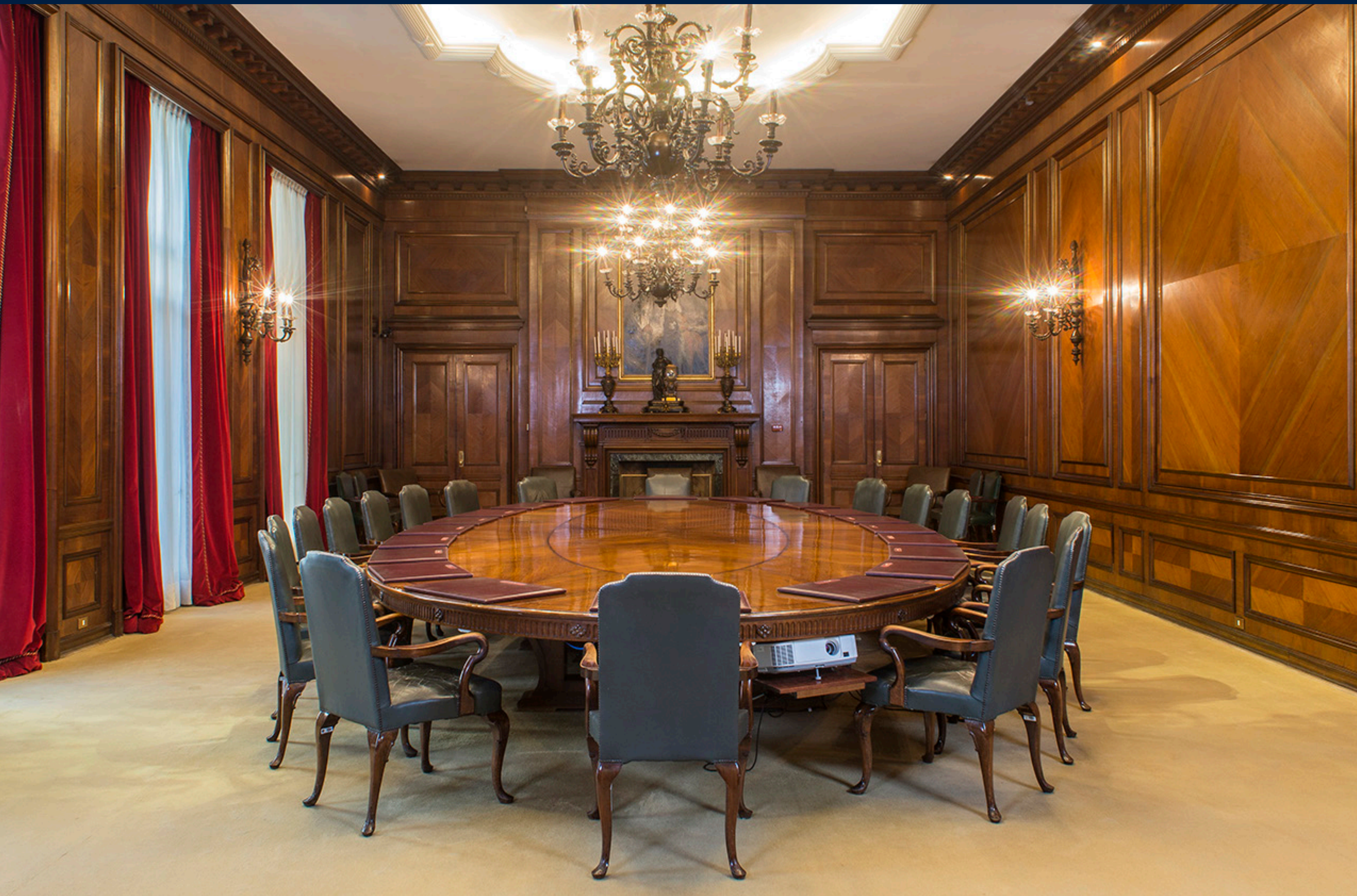
MONETARY POLICY MEETING

JULY 2021



MONETARY POLICY MEETING

Monetary policy meeting No. 283, held on 13-14 July 2021.

Present: Mario Marcel, Governor; 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; Diego Gianelli, acting 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 Carlos Piantini, Financial Markets Analysis Manager; Juan Francisco Martínez, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Felipe Lozano, Communications Manager; Tatiana Vargas, Senior Economist; María Pilar Cruz, Senior Economist; Cristóbal Gamboni, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

The domestic scenario

Once again, activity had been higher than expected. In particular, in May the Imacec was back at its pre-pandemic level, up 18.1% annually. In seasonally adjusted terms, it had risen 2.6% over its April value, showing growth in most economic sectors. Trade stood out as the fastest growing one (51.3% annually; 13.4% monthly, deseasonalized), as a result of highly dynamic consumption, still boosted by the massive fiscal transfers —which had far exceeded plans of the beginning of the year— and the withdrawals of pension savings. Increases in demand were observed in all types of consumer goods, which in May was reflected in the strong monthly increase in the Retail Trade Activity Index and the Supermarket Sales Index (controlling for seasonality and at constant prices). Consumer expectations (IPEC) had improved from the previous Meeting, but were still in pessimistic territory. As for investments, capital goods imports remained dynamic and business confidence (IMCE) was still on the optimistic side. Other indicators, however, were less favorable, such as the low number of new building projects in the pipeline, the evolution of stock markets, and levels of uncertainty that were still high by the usual standards.

The information gathered up to the time of the Meeting in the context of the Business Perceptions Report (IPN) also indicated that activity had increased, which also resulted in a more positive outlook for 2021. This was associated with the increased household liquidity and the gradual reopening of the economy. The latter had immediately reflected in more cash flow in personal services firms, which in some cases had reached pre-pandemic levels. However, various sources of uncertainty continued to be reported, where those related to the presidential elections and the constituent process had taken on greater relevance. The pandemic continued to be a source of concern, but with somewhat reduced intensity.

Government projections presented in the second-quarter's Public Finance Report confirmed the prospect of a significant fiscal impulse during 2021, with projected real fiscal expenditure growth of 27.3% (9.2% in the previous issue) and projected effective and structural fiscal deficits of 7.1% and 9.5% of GDP, respectively, ranking among the biggest among OECD economies.

Private expectations for this year's GDP growth had improved further thanks to better effective data for activity and demand, significant progress in the national vaccination campaign and in the re-opening of the economy, among other factors. Accordingly, the median of the July Economic Expectations Survey foresaw GDP growth in 2021 at 8.0% (7.0% in June).

The labor market continued to be influenced by a number of opposing forces. On the one hand, INE data showed the unemployment rate at around 10%, high inactivity —which had even risen in May— and employment affected in all its categories. On the other, the data on pension-fund contributors showed that formal salaried employment had made a full recovery. In addition, the Internet Job Postings Index was at its highest of the last five years, the annual variation of real wages was close to its 2019 values and employment expectations (IMCE) were in optimistic territory. On the other hand, the partial information gathered for the August IPN indicated that the difficulties in hiring labor had been accentuated in a greater number of economic sectors and had translated into wage increases in several cases. Most of those interviewed linked this to the income-support measures, an increase in informal work, people's fear of getting infected, and the closure of international borders.

In the local financial system, interest rates in the fixed-income market had seen further increases since the previous Meeting, which had been influenced by different idiosyncratic elements. The two-year nominal rates spike of nearly 110 basis points (bp) stood out, explained by factors such as the change in the economic and monetary policy outlook, especially after the publication of the June Meeting minutes. The recent operations of the Finance Ministry had affected performance of longer bonds. The BCP10 had shown high volatility in the period, widening the divergence with its external peers (+35bp differential with respect to the U.S.) Meanwhile, the peso had depreciated, to its peak so far this year, coinciding with the fall in copper prices and the global strengthening of the dollar. The IPSA accumulated slim gains and the sovereign risk premium (CDS) showed some decline. In the money market, the banks' abundant liquidity in dollars kept the local cost of dollar financing contained. In pesos, this cost had risen, influenced by adjustments in monetary policy expectations.

Regarding bank credit, the commercial segment had sustained positive credit flows in recent months, in a context of continuous rescheduling, refinancing and amortizations, in the midst of special liquidity and guarantee programs. Fogape-Reactiva loans showed a rather stable recent performance, while non-Fogape loans had increased flows, which were focused on smaller firms. Likewise, the commercial portfolio maintained negative annual growth rates (–4.5% real annual growth in June), relating to the high comparison base left by the Fogape-Covid lines granted during 2020. Consumer loans had continued to reduce their annual contraction (–14.6% real annual contraction in June), in response to abundant household liquidity, and flows in the mortgage portfolio were stable in the margin. Meanwhile, interest rates showed more limited variations, and remained low across all portfolios, and delinquency rates for the overall system remained well contained.

In the Bank Credit Survey (ECB) for the second quarter, the lower demand by companies for both working capital and investment was worth noting, amidst somewhat tighter lending conditions, due, among other reasons, to a sense of a deteriorating economic environment or greater debtor risk. This was complemented by information gathered for the IPN, which revealed that most of the firms interviewed thus far had not requested new loans due to improved cash flows or out of caution given the various sources of prevailing uncertainty. Those that had taken out loans reported tighter requirements, especially in areas such as tourism and construction. As for households, the Bank Lending Survey noted that supply remained flexible, while demand was dynamic in the consumer portfolio and weaker in the mortgage portfolio. The latter was partly linked to higher interest rates in the segment, a phenomenon that had also been mentioned in the IPN.

Headline inflation had risen to 3.8% annually as of June, which was mainly due to the evolution of fuel prices in recent months, because of both their increase and the low comparison base left by the same period of 2020. In contrast, food prices had been reducing their contribution to total inflation. The annual variation of the core component —the CPI without volatiles— was comparatively lower and remained somewhat above 3% annually. In this sense, some services stood out, which could have been affected by the extension of quarantines, lagged openings and/or because part of them continued to be imputed. On the cost side, qualitative indicators —the IMCE and partial results of the August IPN interviews— showed greater pressures, which coupled with the acceleration in nominal wage growth. About market expectations, although the June figure was lower than the consensus forecast, expected inflation for December 2021 and for the twelve-month term had risen after the previous Meeting. In the two-year term, surveys continued to place it at around 3% annually.

In this context, expectations for the monetary policy rate (MPR) contained in the Financial Traders Survey and financial asset prices pointed to a +25bp adjustment in the July Meeting, which in the Economic Expectations Survey was foreseen in September. The one-year-ahead MPR forecast by these indicators ranged from 1.5% to 2.5%, and two years ahead, from 2.5% to 3.75%.

The international scenario

Incoming international data showed a continuing recovery, consolidating the outlook for this year. This had been especially noticeable in countries displaying a more controlled epidemiological situation, either due to the effectiveness of their sanitary containment measures or to the progress of their vaccination programs, which had allowed them to proceed with their reopening plans. Thus, the business outlook (PMI) in developed economies had remained optimistic, and the upturn in services in the Eurozone was particularly noteworthy. The consumer and business confidence indicators endorsed this scenario, standing in highly favorable territory. Meanwhile, many emerging economies continued to lag, while the spread of new strains of Covid-19 emerged as a new risk factor. In Latin America, in spite of the fact that short-term indicators had generally surprised on the downside, the outlook for 2021 was still better than a few months ago due to the positive surprises accumulated during the first quarter.

The behavior of external financial markets had been influenced, among other factors, by recent epidemiological developments, surprises in the confirmed data of the main economies and the outlook for monetary policy in the U.S. Since the previous Meeting, the dollar had appreciated against all other currencies and the stock markets showed mixed results, and important new highs had been achieved by some stock market indicators in the U.S. Long-term interest rates, in general, accumulated limited decreases, although increases were observed in certain countries of the emerging bloc —especially in Latin America—, which continued to receive capital inflows. All this occurred in a context in which cost pressures continued to be present, linked to the difficulties in the supply of goods, soaring transportation costs and/or the high prices of inputs and commodities. In any case, the latter had decreased at the margin, except for oil, whose price continued on an upward trend (+8.1% for the WTI-Brent average since the previous Meeting). This was partly explained by the difficulties in OPEC+ to reach an agreement on the increase in production quotas. Meanwhile, there were recent falls in the prices of some metals, with copper at around US$4.3 per pound (–6.3% with respect to the previous Meeting). The decline in these prices had been influenced to some extent by China's announced sale of part of its metal reserves in order to curb price increases. Some monetary authorities, particularly the Federal Reserve, had described these pressures as transitory, which had mitigated concerns about recent higher inflationary records and the movements in financial markets following its latest Meeting. At the same time, several central banks had announced or begun to implement their respective monetary policy normalization processes, especially in commodity-exporting economies.

2.Background analysis and discussion

It was agreed that, in essence, the external and local scenarios had evolved in line with projections in the June MP Report. On the external front, the progress in vaccinations in the world's main economies stood out, as it had allowed to gradually overcome the recession. Another important development was the greater concern about inflation, which continued to be a latent threat, especially in the United States, but about which the market still had a rather benign view, seeing it as a transitory phenomenon. Finally, a noteworthy fact was that global financial markets continued to be very constructive, although for Latin America, including Chile, they seemed to be gradually worsening.

On the domestic front, there was a new upward surprise in activity and dynamic consumption that contrasted with investment which, beyond some improvements, was still sluggish and there was concern about its future performance. Inflation, in turn, was somewhat lower than expected, but not by much. The mixed signals coming from the labor market were also discussed. On the one hand, according to surveys, in the aggregate there were lags in the recovery of employment, a significant loss in labor participation and high unemployment. On the other hand, according to administrative data, formal salaried employment had made a full comeback, with an increase in vacancies and, according to the CNSI for the first quarter, the wage bill had recovered. There was also a feeling that people remained cautious about taking a job —particularly no salaried—, because of the risk of being infected, the difficulties for women to reincorporate to the labor market while their children did not return to school, and the presence of income transfer programs for families. This was reasonably consistent with the difficulties in finding workers in certain sectors reported in the preliminary background information leading to the Business Perceptions Report.

Emphasis was placed on the persistence of uncertainty prevailing in the country and its effect on the financial market. On this point, it was pointed out that the decoupling from external markets that had already been reported at the previous Meeting continued, with long-term interest rates showing greater volatility and new increases, an exchange rate that was partially more depreciated than could be justified by the copper price and the global behavior of the dollar, and a stock market that continued to lag behind the global benchmarks. In the case of shorter rates, significant increases were observed, although mostly linked to the improved macroeconomic outlook and expectations of a faster withdrawal of the monetary impulse. Overall, however, the general assessment was that these developments had not translated into tighter local financial conditions. In fact, the annual variation of commercial credit was still very much affected by a very high base of comparison, and the qualitative background —Bank Lending Survey and Business Perceptions Report— drew attention to the weakness of demand for credit. On this last point, abundant liquidity seemed to be playing an important role.

3.Analysis of monetary policy options

All the Board Members agreed that the information gathered since the previous Meeting reaffirmed the need to gradually reduce the high degree of expansionary monetary policy. They also agreed that, to ensure the convergence of inflation to the target, it would be necessary to continue stimulating the economy for a long time, although with a lesser intensity than the current one. This, because pockets of weakness still persisted in some sectors and a significant degree of uncertainty, to which was added the considerable fiscal consolidation assumed for 2022. In this context, the Board evaluated two options: keep the MPR at 0.5% or increase it by 25 basis points, up to 0.75%.

All the five Board members agreed that an increase of 25 basis points in the MPR was sufficiently robust to the different scenarios that had been analyzed for the economy and, therefore, made it the best option. In fact, it was the dominant alternative for an economy showing a rate of recovery consistent with closing the activity gap faster than anticipated, but also with lower growth prospects for the medium term. Increasing the MPR by 25 basis points was also consistent with signals previously delivered and internalized by the market. Regarding the option to keep the MPR at 0.5%, this could be considered to the extent that it was estimated that the probability of the materialization of less favorable scenarios was still high; however, that probability had decreased given the evolution of the economy.

The Board considered it relevant to reaffirm that, as usual, future adjustments to the MPR would depend on the evaluation made at each Meeting regarding the behavior of the economy. The signals obtained so far made the scenarios that marked the limits of the interest rate corridor of the June Report unlikely. In fact, several Board members highlighted that at the time of the Meeting, market prices had tended to internalize a process of monetary policy adjustment faster than was considered appropriate given the central scenario of the June Report. In this context, all the Board members agreed that medium-term risks and the need to understand more precisely the state of the labor market and the evolution of credit, made it convenient for the pace of monetary policy adjustment to be gradual. This, it was concluded, was fully consistent with the idea that, even in a context of gradual normalization, monetary policy would continue to accompany the recovery of the economy, anticipating that the MPR would be below its neutral value throughout the complete policy horizon of two years.

4. Monetary policy decision

Governor Marcel, Vice-Governor Vial and Board members García, Naudon, and Costa voted for raising the MPR by 25 basis points, to 0.75%.

banco central Chile

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