Monetary Policy Meeting[1]/

JUNE 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. 257, held on 13 June 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; Elías Albagli, Research Division Director; Beltrán de Ramón, Financial Markets Division Manager; Solange Berstein, Financial Operations Division Director; Gloria Peña, Statistics 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 Minister; Marlys Pabst, Secretary General.

1. Background analysis and discussion

The background information presented to the Board and the analysis thereof are contained in June's Monetary Policy Report. Broadly, these showed that the evolution of the macroeconomy had reduced the risks facing the convergence of inflation to 3% in the policy horizon. The economic recovery was consolidating, inflation expectations at two years remained at 3%, while at shorter terms had risen due to the direct impact of the oil price hike on the more volatile elements of the CPI basket. In the baseline scenario, the trajectory of core inflation had not changed much and would reach 3% by the end of 2019, although headline inflation would do so sooner than expected. This, in a context where activity had been a little above expectations in the first quarter of the year, due to (probably transitory) surprises in supply sectors and stronger dynamism in areas relating to investment and durable consumption. However, beyond some narrowing, capacity gaps still persisted, as suggested by the evolution of labor market, core inflation and capacity utilization indicators. In the baseline scenario, the closing of these gaps would consolidate at a speed not very different from that expected in March. This also considered that the impulse that the Chilean economy would receive from abroad would be slightly milder than assumed in the previous Report, because of somewhat less favorable financial conditions and some decline in the terms of trade due to the higher oil price. In this context, the Board had held the MPR at 2.5%, and reaffirmed that it would begin to withdraw the monetary impulse insofar as macroeconomic conditions continued to drive inflation to converge to 3%.

In discussing this background, all the participants agreed that the risks to inflation's convergence had decreased, as could be observed in the Report's baseline scenario projections and conjunctural analysis. In this regard, it was mentioned that in recent months the process of economic rebound that had begun in mid-2017, with activity levels that had advanced somewhat faster than expected, had been established. In this context, it was noted that the gradual closing of the capacity gaps caused by this acceleration, as had the reversal of the trajectory of the nominal exchange rate —which, with fluctuations, had been seen since the closing of the past Report— and the oil price increase, had significantly reduced the risks that the low current inflation would hinder the convergence of inflation to the target within the policy horizon.

About the evolution of activity, there was consensus among the participants that its recent evolution reduced the risks of insufficient traction to ensure the convergence of inflation to 3% within the policy horizon. However, several participants acknowledged their concern about how consolidated and self-sustainable this improved economic performance was. It was mentioned, for example, that some high-frequency data pointed to a good performance of investment and consumption, such as imports, but at the same time other data, more closely associated with construction, had a rather mixed nature. It was also noted that the evolution of the labor market and of core inflation, especially in its non-tradable component, were rather consistent with a scenario where significant capacity gaps remained, which was endorsed in one way or another by more qualitative evidence in the Business Perceptions Report and by larger-scale investment plans that had not varied much in recent months.

There was debate around how much certainty there was about the lower risks for the convergence of inflation, considering that there were still doubts about the sustainability of the economic recovery. About this, it was mentioned that although the process of closing gaps was far from over, it had been settling with increasing clarity, coupled with the fact that the vision of inflationary weakness that permeated part of the market was clearly retreating, as could be inferred from the surveys and the different asset prices. It was noted that the effect of the higher oil price on the short-term inflation projections, without being negligible, was not a big factor in this risk assessment. It was mentioned that the reduction of risks could also lean on the inflation acceleration observed lately.

2. Analysis of monetary policy options[2]/

All five Board members agreed that, given the current economic conditions (as detailed in the Report's baseline scenario), the convergence of inflation to 3% in the usual policy horizon was consistent with a monetary stimulus remaining near its present levels at least for the rest of the year, as indicated in the latest Financial Brokers Survey, and that would begin to be reduced towards its neutral levels as macroeconomic conditions continued to drive the convergence of inflation towards 3%. All the Board members thought that the option of increasing the monetary impulse had become less relevant. In previous meetings, this option had been justified mainly under a risk management argument to lower inflation that could affect its convergence to the goal in the policy horizon. In line with the Monetary Policy Report, as these risks had decreased significantly, it was only logical for the option's importance to follow suit. However, some Board members considered that the option to lower the rate could still be relevant to the extent that the risks associated with the external scenario materialized. One Board member pointed out that the option to lower the MPR should be included because CPI and CPIEFE inflation were on the edge of or outside the tolerance range. At the same time, the option to raise it had to be included if an important increase was anticipated in either, the CPI or the CPIEFE, even if it responded to movements in the most volatile components of the basket. The main arguments in favor and against of each of these options were the following:

[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: holding the MPR at 2.5%

All the Board members agreed that this option was fully consistent with the baseline scenario in the June Monetary Policy Report and, in particular, with the monetary policy strategy outlined in it. A further argument was the tight anchoring of medium-term inflation expectations to the policy target and agents' expectations for the monetary policy decision on this occasion. In addition, it provided room for a timely reaction in case some of the risk scenarios came true. In any case, the risks for inflation were perceived as unbiased, as the costs of inflation deviating above or below its convergence trajectory were assumed to be symmetrical.

Option 2: raising the MPR by 25bp

Several Board members noted that choosing an option like this one depended on whether it was considered necessary to start the process of normalizing the monetary stimulus sooner. In this regard, it was mentioned that it seemed premature, considering that the Report's baseline scenario assumed that investment, while growing more than expected in March, had begun strengthening only recently, with some mixed signs from construction and waiting for the process to be consolidated at the level of large-scale projects. Because of the direct impact on demand and activity, it was necessary to wait and see the evolution of the cycle before deciding on a monetary policy option such as this one. It was also pointed out that such an option would be justified if there was certainty that the economic recovery was to be clearly faster, longer lasting, more persistent, plus it was pushing inflation upwards. But now it was still too early to be certain about the form this recovery would take in the coming quarters, so deciding on how and when to withdraw the monetary stimulus required one or two more quarters' worth of information. It was mentioned that although it was true that the economy was outperforming estimates, it should also be kept in mind that this occurred in a context where no greater cost-push or price-pull pressures were discernible, which could be consistent with greater than estimated gaps in the economy. This, in addition, coincided with the labor market showing no improvement and with some capacity use indicators at low levels. Finally, it was also mentioned that a movement in this direction would be completely unexpected and would give an unwarranted sign of urgency regarding the concern about upward deviations of inflation, much less now that CPIEFE inflation had not even reached 2%.

Option 3: lowering the MPR by 25pb

It was said that this option was losing strength in a scenario in which, since the last Meeting, there had been only positive surprises on the activity side, tinged in part by its transitory components, and a positive price shock in the shortest term due to the oil price increase. It was said too that this option was easy to rule out because the recovery was perceived to be more solid, and although the creation of salaried jobs was yet to pick up, this did not seem to be an impediment to the recovery. It was pointed out that if the MPR had not been reduced two or three quarters ago, lowering it now would be inexplicable, since the risks that justified it had diminished significantly. It was mentioned that this option could continue to be valid if it was thought that the risks came from the effects of the external scenario on activity and inflation. For example, if the international scenario deteriorated further, as had happened in the past, an additional monetary push could be required, due to its medium-term disinflationary impact. However, taking an insurance based on such justification would also be difficult to explain.

3. Agreed policy action

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%.