Monetary Policy Meeting[1]

OCTOBER 2019

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. 268, held on 22–23 October 2019.

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, Monetary Policy Division Director; Beltrán de Ramón, Financial Markets Division Director; Solange Berstein, Financial Policy 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; Diego Gianelli, International Analysis Manager; Andrés Fernández, Economic Research Manager; Juan Carlos Piantini, International Markets Manager; Claudia Sotz, acting Domestic Markets Manager; Rodrigo Alfaro, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Felipe Lozano, Communications Manager; Hermann González, Advisor to the Finance Minister; Tatiana Vargas, Senior Economist; María del Pilar Cruz, Senior Economist; Marlys Pabst, Secretary General.

1. Analysis of the technical teams

The international scenario

The external scenario had evolved in line with forecasts in the September Monetary Policy Report. Regarding trade, despite preliminary agreements reached by China and the United States, there were still important issues unresolved, with new tariffs imposed by the latter on Europe, plus growing political unrest in the US. In the United Kingdom, some doubts about Brexit had been rekindled in the days before the Meeting, while in the Middle East several flanks of instability remained. Hand in hand with idiosyncratic factors, the situation continued to be complex in Latin America, where more countries reported internal political conflicts.

The overall picture remained marked by deteriorating manufacturing, international trade and investment activity, and growth projections had been adjusted downwards for several countries. In the developed world, manufacturing production had surprised in the major economies, most showing setbacks in annual terms, while business expectations saw no progress going forward. In the US, there was also some weakening of a number of consumption-related indicators that had previously proven more resilient. The same was true of some labor market indicators, which in any case continued to show signs of being tight. In the Eurozone, Germany again stood out among the most hurt, with further worsening exports data. The UK was stagnant in productive investment, amid generalized falls in different confidence indicators.

In China, third-quarter GDP growth (6% annually) had disappointed as once again it reached its lowest figure of several decades. Towards the end of the period there was some improvement in manufacturing output, retail sales, and credit, among others, which contrasted with the negative surprise of its external sector. The breakdown of the latter showed that the redirection of shipments had failed to compensate for the decreased activity with the United States. Political uncertainty was the tonic in Latin America, with falling confidence indicators in several countries. Argentina was in the run-up to elections. The situation had become much more complex in Ecuador—where the persistence of its fiscal deficit stood out—and Peru, whose investment prospects had fallen sharply. Monthly activity and manufacturing production in Mexico continued to post negative annual expansion rates. Meanwhile, in Brazil and Colombia the outlook was somewhat more encouraging, both with ongoing reforms that could result in greater dynamism going forward.

In this context, an important number of monetary authorities around the world had continued to increase their stimulus, with reductions in the benchmark rates in several countries together with unconventional measures. Worth noting were the policy rate cut applied by the US Federal Reserve, which had also announced the end of the adjustment of its balance sheet, and the set of measures adopted by the European Central Bank, which included revisiting quantitative easing. All this in the midst of still-contained inflation numbers in most economies.

There was still some volatility on the financial front. Thus, beyond some fluctuations, long-term interest rates and stock market indices posted slight increases with respect to the previous Meeting, while the bulk of currencies showed limited appreciations against the dollar. As for commodities, the price of copper had remained virtually flat since the September Meeting, combining inventory depletions and reduced imports globally. In the case of oil, apart from a sharp transitory increase resulting from the attack on an important refinery, its international price had tended to decline, within a context of weaker demand and higher inventory build-up.

The domestic scenario

Prior to the social upheaval that shook the country, local financial markets had been influenced by the more expansionary stance of monetary policy and developments abroad. Compared with September, beyond some ups and downs, the exchange rate had decreased and the stock market indices had risen. Interest rates in the fixed-income market, both real and nominal, had shown mixed behavior since the previous Meeting, with decreases in UF-denominated instruments, particularly at 2 and 5 years, and increases in the last week, in line with the international scenario and due to pension system affiliates shifting to riskier funds at the local level. Regarding financing conditions, there were interest rate reductions in all portfolios and increases in the real annual variation of commercial and mortgage loans. The Bank Credit Survey of the third quarter reported an unchanged supply, as well as a more dynamic demand in the housing segment and weaker demand among construction companies.

As for local activity, the third-quarter data at hand was in line with forecasts in the last Report's baseline scenario, with annual economic growth outperforming that of the first half of the year. This was consistent with the fading out of some supply factors that had temporarily affected the performance of some sectors in the first half (e.g. mining), and with the lower comparison base of the second half of 2018. Thus, in the July-August two-month period, the mining Imacec had increased its annual expansion to 3.2% and the non-mining index, to 3.5%.

On the expenditure side, investment remained dynamic, especially in mining, which continued to boost activity in other sectors, such as business services and construction. This contrasted with the deterioration of business expectations (IMCE) and capital goods imports. Private consumption kept growing moderately, in a context where the wage bill reflected no big changes and continued to outgrow consumption; consumer confidence had worsened further, imports of consumer goods had declined and the growth of private salaried employment was bounded. Exports remained weak, partly because of the poor performance of some trading partners and the impact of the trade war. In this context, growth expectations in the Economic Expectations Survey (EES) contained minor changes since the September Report. In particular, the October EES anticipated a GDP increase of 2.5%, 3% and 3.3% for 2019, 2020 and 2021, respectively.

The Business Perceptions Report, for which data had been collected up to October 18, reported that the business performance of most respondents had been similar to or somewhat better than the previous quarter, with results that were mostly in line with expectations. By sectors, the better performances continued to be seen in those having contracts with major mining projects, the salmon sector, those engaged in the construction of homes under UF3,000 or with a housing subsidy, and some services. Meanwhile, trade had continued to see stagnating sales, as had companies linked to the forestry sector. Beyond exchange rate movements, cost pressures had remained contained. In any case, many respondents drew attention to the increases in the prices of fuel and electricity. Selling prices had remained constant or had risen less than expected, a situation they expected to continue over the foreseeable future, in particular because in their opinion demand was still precarious. Investments remained concentrated mostly in process automation to increase efficiency and/or mitigate higher payroll costs. In the labor market, workforce remained abundant, but most respondents did not foresee big changes in their staffing. Financial conditions had improved in terms of rates. In any case, the banks noted that the demand for loans, beyond refinancing and/or portfolio repurchase motives, remained bounded.

Headline inflation had remained around 2% annually since the September Meeting. The components of core inflation (CPIEFE) continued with their behavior of previous months. The services CPIEFE was still low, while the goods CPIEFE had risen further. Among the more volatile items, it was worth noting the decline in some foodstuffs' inflation, which was below its historic standards, and that of fuels. As for the inflation outlook, various indicators showed increases, most notably one year ahead.

Expectations for the monetary policy rate (MPR) were for a 25 bp (basis point) cut at this Meeting. Going forward, the October EES did not foresee any new falls, while the Financial Brokers Survey and the information implicit in the financial asset prices anticipated another 25 bp cut between the end of this year and early 2020.

Regarding the effects of the events occurring in the country since 18 October, it was evident that they would have negative consequences on short-term activity, but there was more uncertainty regarding their medium-term effects, so it was necessary to evaluate, among many factors, the magnitude and speed of reconstruction works, the impact on expectations and the effects of the measures announced by the government. Until the time of the Meeting, the effects on local financial markets had been limited. Most affected were the stock market, which had reversed part of its previous increases, and the risk premiums, which showed minor increases. The peso had depreciated from around $715 to 725 per dollar —near its price at the September Meeting. With respect to the inflation outlook, after the announcements canceling the increases in electricity rates and public transport fares, inflation expectations implicit in market prices had undone earlier increases. In the case of the MPR expectations, financial prices showed that the 1.5% rate expectation had been prolonged until the first quarter of 2021.

2. Background analysis and discussion

It was noted that the overall figures of the domestic macroeconomic scenario had performed in line with forecasts in the September Report. For example, there was greater annual growth in activity in July and August, while private consumption and its fundamentals, as well as services inflation, continued to be weak, leading to persistent risks in this area. In the external scenario, manufacturing, investment and trade activity continued to fall, validating the cuts in the growth projections for the major economies. Likewise, the discussion on the space for and effectiveness of a more expansionary monetary policy in those economies had intensified, as had the viability of a timely action coming from the Treasury.

About the social turmoil affecting the country, all the Board members agreed that undoubtedly the social and political disorders of recent days would have implications on the evolution of the economy in the short and medium term. In the immediate future, it was clear that the partial paralysis of the country for several days, the destruction of public and private infrastructure and the greater sensitivity of some important sectors, such as trade and transport, would have a significant impact on activity, which would negatively change the growth prospects for the year. However, the short-term effects on inflation were difficult to assess and would depend largely on how long the interruptions in the production and distribution of goods and services would last.

There was consensus among the Board members that in the medium term the effects would also be seen in productive activity, expectations, consumption, investment, fiscal policy and financial indicators. However, the net effect that all these factors combined would have on inflation was not obvious. In particular, it could depend not only on the dynamics of some relevant prices, but also on the evolution of actual activity and potential growth. The Board agreed that it was therefore premature to size up the response that would be required from monetary policy. For example, some calibration was needed of the effects on business and household confidence, and how the investment and consumption plans of the various players would be affected. It would also require calibrating and knowing the ultimate size of the fiscal policy response to this scenario.

All the Board members stressed that so far the markets' reaction had been limited. They mentioned the fall in the stock market, which could be explained by the fact that adverse effects on short-term economic activity resulted in reduced the companies' expected profits and provided fewer incentives for longer-term investment. In any case, there was agreement that greater volatility in the future could not be ruled out and the Bank should be prepared to address anomalous situations.

3. Analysis of monetary policy options

All the Board members agreed that the evolution of the macroeconomic scenario confirmed the assessment made in the September Report. It implied that the convergence of inflation to the target required a greater monetary stimulus, part of which had already been added with the MPR cut at the previous Meeting. Unequivocally, recent events would negatively affect activity in the short term, but their effects on inflation in the short and medium term were not entirely evident. Some Board members said that the possible negative effect on demand would dominate in the evolution of inflation, while in the opinion of other Board members the effects on the productive capacity and the potential impact on demand of some proposals should not be ruled out, therefore the impact on inflation in the medium term was still uncertain.

In view of the above, all five Board members agreed that the option of reducing the policy rate by 25 bp clearly prevailed over all other alternatives. On the one hand, it was consistent with the evaluation of the data and the message delivered in the September Report. On the other, it was consistent with market expectations, which had correctly internalized the Board's message.

4. Monetary policy decision

Governor Marcel, Vice-Governor Vial and Board members García, Costa, and Naudon voted for lowering the MPR by 25bp, to 1.75%. They reasoned that this option clearly dominated, as it was not possible for the moment to anticipate the effects that the social situation would have on the medium-term macroeconomic scenario. Thus, a communication could be achieved that would not alter the current interest rate structure and would emphasize the need to evaluate the effects of the recent events before making any decision.