Monetary Policy Meeting[1]/

SEPTEMBER 2019

CENTRAL BANK OF CHILE

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MINUTES OF THE MONETARY POLICY MEETING

Monetary Policy Meeting No. 267, held on 3 September 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 Operations 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; Claudia Sotz, acting Domestic Markets Manager; Felipe Lozano, 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 analysis thereof are contained in the September Monetary Policy Report. In it, it was noted that since the previous Report, both headline and core inflation had remained around 2%, within a context where the macroeconomic outlook had weakened, increasing the risks concerning the timely convergence of inflation to 3%.

The change in macroeconomic conditions was largely due to the evolution of the external scenario, where the trade tensions had increased global uncertainty, slowed down growth in different countries and reduced trade volumes. The persistence and increasing complexity of the conflicts, as well as the predominance of greater pessimism in the markets, led to forecast that the external impulse for the remainder of the year and much of 2020 would be considerably lower than had been estimated in the June Report.

In the second quarter, domestic activity and demand had grown less than expected. Although some of this was due to some sector-specific factors, also noteworthy was the deceleration of consumption and a deterioration of its fundamentals, including the lower dynamism of private salaried employment, and that consumer expectations had fallen since early in the year. Although investment looked somewhat more dynamic in the margin, this was mainly associated with large-scale mining projects, while the worsening of business expectations, the depreciation of the peso and the poor performance of the stock market led to revise downward the previous growth forecast of this expenditure component for the rest of the year. Accordingly, the higher growth rates of the second half would be explained mainly by the low comparison bases of 2018, not to a significant rebound in economic growth. This implied that the activity gap would remain open for some time. All of this occurred in a context in which headline and core inflation were still low, particularly in their components more closely linked to said gap.

About the external scenario, there was agreement in pointing out that beyond the fact that marginal data had worsened somewhat, what was most important was the deterioration of the medium-term outlook, largely linked to the escalating trade war. Attention was drawn to the context of much greater uncertainty, which had become persistent and was having negative consequences on investment, trade and other important macro variables. The weakness of several emerging economies against this backdrop had become apparent, as reflected in revised growth figures for Asia and Latin America. It was added that, although a global recession was still far away, the change in the international scenario was reason enough to substantially modify the external impulse for the Chilean economy. In particular, there were no foreseeable elements that would allow anticipating a reversal of this scenario.

Regarding the domestic economy, it was noted that the first half of the year had shown a much weaker than expected recovery. Although supply-side factors still prevailed, there was also lower growth in sectors such as the manufacturing industry. The biggest surprises came from the demand side, particularly because the behavior of consumption in the second quarter made it necessary to review its future dynamism. On the one hand, expectations had deteriorated, trade had disappointed expectations and consumer loans had decelerated. On the other hand, the wage bill continued to outpace consumption. It was agreed that the evolution of the labor market required special attention. The information at hand pointed to low wage pressures and an increase in employment based on a significant participation of self-employment, all in the midst of a scenario of labor market complexity due to the immigration shock.

There was agreement that external and internal developments shaped a scenario where this and next year the Chilean economy would grow less than previously estimated, which affected the evolution of the activity gap and jeopardized the convergence of inflation to the target over the policy horizon. This was reflected, in part, in the recent behavior of services component of core inflation —more sensitive to capacity gaps and remunerations— has slowed down significantly.

The doubts regarding the projected evolution of the output gap and its implications for inflation and monetary policy were discussed. On the one hand, the baseline scenario assumed that economic growth would resume its stronger dynamism in 2020. On the other hand, there was uncertainty regarding the measurement of potential GDP, in a context where productivity growth could be lower than estimated and where it seemed that the burdens for investment and the recovery of labor could be somewhat heavier. Such visions had differences about the implications for inflation and monetary policy, because the former implied a more expansionary monetary stance than that described in the baseline scenario, while the latter reduced inflationary pressures and, therefore, led to a less expansionary monetary policy. The great uncertainty regarding the measurement of the output gap, especially in a context of significant immigration flows, led one Board member to believe that the evolution of the output gap could not be reason enough to decide on a change in the monetary stimulus. One Board member pointed out that the relevance of the output gap estimate depended on the state of the cycle. In his opinion, in an economy that was apparently accelerating (or slowing down) —and growing more (less) than its trend or potential— and inflation was also increasing, having an estimate of the magnitude of the output gap was perhaps more important than in a situation like the current one, where the economy was growing below potential and inflation was quite stubbornly below the target. Some Board members agreed that the current direction of the monetary policy was crystal clear and signaled the need for greater monetary expansion, so seeking a more accurate measure of the magnitude of the output gap seemed less important.

2. Analysis of monetary policy options

All five Board members agreed that the evolution of the macroeconomic scenario and its outlook made it clear that, in order to ensure the convergence of inflation to the target, it was necessary to lower the MPR. This, in a context where the world economy was clearly in a scenario of greater risk and slowdown, whose main internal transmission channel was the deterioration of financial conditions and expectations, compounded with a local scenario that also failed to cooperate in reducing the uncertainty that surrounded consumption and investment decisions. All the Board members agreed that the issue of how much more expansionary should monetary policy be was still under discussion, but that the Report's analysis indicated that an MPR reduction of at least 50 to 75 basis points (bp) seemed necessary.

The Board ruled that the plausible options were an MPR cut of 25, 50, or 75 basis points.

The entire Board agreed that since there was no doubt regarding the need to lower the MPR, the decision had to do rather with tactical and communicational aspects. Thus, all the Board members agreed that the option of cutting it by 75bp was a complex one. If it was done with a neutral bias, certainty signals would be sent as to the actual magnitude of the required monetary impulse, which seemed incompatible with the downside risks of the baseline scenario. Several Board members added that such a decision ran the risk of generating polar interpretations: either it could convey an unrealistic degree of certainty in the Board's projections and decisions, or it could increase uncertainty by fueling interpretations that the Chilean economy was more vulnerable than it actually was. This latter view could be exacerbated by a decision to apply a 75bp reduction with a downward bias.

About the options of lowering the MPR by 25 or 50bp, all the Board members agreed that both were consistent with the baseline scenario and posed less communication problems because they left the door open to new adjustments given the expansionary bias considered in either of the two. However, several Board members agreed that lowering the MPR by 25bp was not the best option as it entailed the risk of reflecting an excessively prudent or passive Central Bank, at a time when the economic scenario was changing rapidly and the

Report's analysis suggested boosting the impulse by more than 25bp. In their opinion, such a decision could call into question the Board's reaction function and raise doubts about the true policy space available, which could affect the perceptions of risks facing the Chilean economy. One Board member noted that the fundamental difference between both options was the different signals they gave. In that sense, a 50bp cut could signal an urgency, which was mitigated because the decision was anticipated by the market. One Board member added that the option of lowering the MPR by 50bp was most consistent with the decision of the July Meeting. He recalled that an expansionary bias had been communicated then, deferring the MPR adjustment until the evolution of the external scenario and the data of the first half could be framed into a foreseeable monetary policy trajectory, supported by medium-term projections. From July to date, the external scenario had worsened and domestic activity, demand, and price figures had been below expectations, fully justifying a somewhat stronger adjustment to the monetary policy rate.

One Board member estimated that in certain aspects the option of a 25bp reduction dominated over the 50bp option. In his opinion, the degrees of uncertainty were important, and just as more negative scenarios could not be ruled out, neither could more positive scenarios be dismissed. In his view, the need to lower the MPR so fast was tempered by the fact that inflation had begun to rise towards the target and the current-account balance measured at trend prices was high. Moreover, the probability of some improvement in the scenario was not negligible. The persistence of weak consumption could disappear thanks to better financial conditions, due to the impact of a wage bill that grew somewhat more than consumption, or due to the likely increase in consumption by immigrants once they began to consolidate their labor insertion in Chile. That could also be the case with investment, because the background provided by the Capital Goods Corporation Survey tended to reinforce the perception of more dynamic investment.

3. Monetary policy decision

Governor Marcel, Vice-Governor Vial and Board members García, Costa and Naudon voted for reducing the MPR by 50 basis points, to 2%. They also agreed that a further increase in the monetary stimulus might be required, which would be assessed in the following Meetings in light of the unfolding of the macroeconomic scenario.

There was agreement among the Board members that this decision was fully consistent with the analysis in the Report, which yielded that the monetary stimulus needed to be enhanced in order to ensure inflation's convergence to the target. At the same time, beyond the magnitude of the MPR cut at this Meeting, the change was consistent with the expectations of the markets, which also saw the need to lower the MPR. Finally, the Board members agreed that a 50bp cut left them in a more comfortable position to evaluate the monetary impulse that would be needed in the meetings ahead.