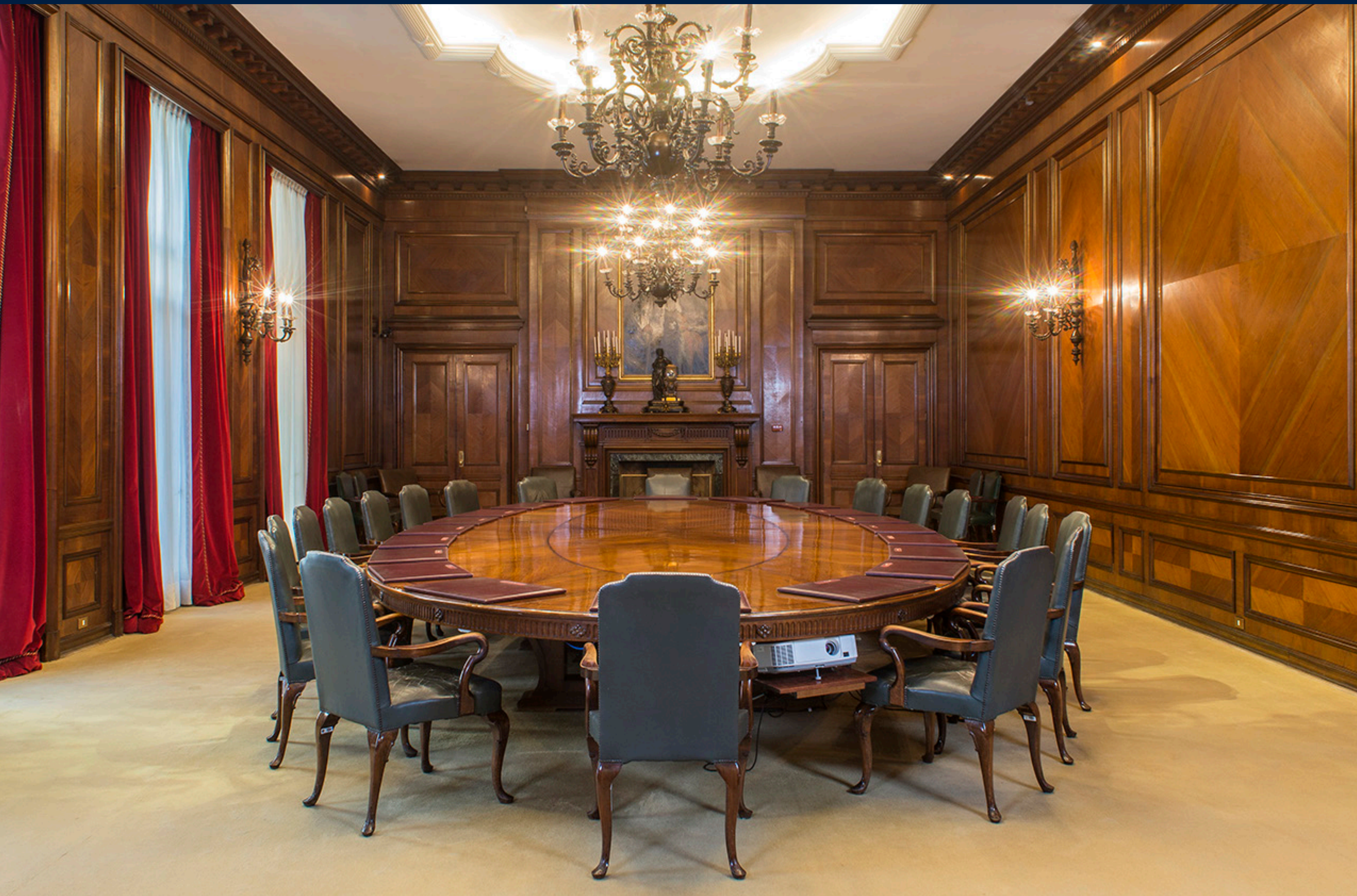
MONETARY POLICY MEETING

JUNE 2023



MONETARY POLICY MEETING

Monetary policy meeting No. 298, held on 19 June 2023.

Present: Rosanna Costa, Governor; Pablo García, Vice-Governor; Alberto Naudon, Board member; Luis Felipe Céspedes, Board member; Stepanka Novy, Board member.

Present the Finance Minister, Mario Marcel.

Also present: Beltrán de Ramón, General Manager; Juan Pablo Araya, Legal Counsel and Attestor; Elías Albagli, Monetary Policy Division Director; Juan Carlos Piantini, acting Financial Markets Division Director; Rosario Celedón, Financial Policy Division Director; Gloria Peña, Statistics and Data Division Director; Diego Ballivián, Corporate Risk Division Director; Juan Pablo Rioseco, acting Institutional Affairs Division; 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, Market Operations Manager; Andrés Sansone, Advisor to the Finance Minister; Marlys Pabst, Secretary General.

1. Background

The economy had been making progress in resolving the macroeconomic imbalances accumulated in recent years. This had brought inflation down in line with expectations, taking steps towards the consolidation of its convergence to the 3% target.

In general, domestic activity and demand had evolved in line with expectations, although with a larger than expected decline in the durable component of private consumption. The central scenario projections of the June Monetary Policy Report showed modest changes in magnitude with respect to the March Report. For this year, activity was expected to grow between -0.5% and 0.25%. In 2024 it would grow between 1.25% and 2.25% and in 2025, between 2% and 3%.

On the external front, activity had begun the year with increased dynamism and reduced financial volatility. However, the outlook for financial conditions continued to be tight, in an environment of high uncertainty and in which a more contractionary monetary policy was expected in the main economies, considering their challenge to reduce inflation.

2. Background analysis and discussion

There was consensus that the accumulated information brought no surprises with respect to the last Meeting and to expectations contained in the March Report. Abroad, there were minor changes in the global growth outlook. Although global inflation had eased in various economies, pressures remained, particularly in the United States. Thus, a scenario was outlined in which the financial constraints in the developed world would last longer, so the inflationary problem in those economies could be tackled. Thus, beyond the better performance of the first quarter, the projections continued to anticipate that Chile would receive a limited impulse from other economies.

Locally, activity, demand and inflation indicators were well aligned with the March projections and the revisions made at the previous Meeting. From a demand-side point of view, although on aggregate neither consumption nor investment showed any significant deviations, the larger drop in private consumption of durable goods stood out. High-frequency figures for the second quarter — credit and debit cards transaction records (Transbank) and imports data— showed that this spending component was stabilizing at the margin. In that context, the central scenario of the June Report assumed that the first quarter's drop in durable consumption represented an advance of the expected trajectory. Moreover, the lower durable consumption contrasted with steadily growing consumption of services, reaffirming the trend towards a restructuring of consumption in favor of the latter. Finally, government consumption had also surprised in the first quarter, with a higher-than-expected increase.

Headline Inflation had diminished to 8.7% in May and non-volatile inflation had slowed to 9.9%. Both components were still high, beyond the fact that, headline inflation had seen six consecutive months of declines. The fall in overall inflation had been driven by volatile prices, and in the core part, by the appreciation of the peso and the adjustment of goods consumption. The services component continued to be more stable. Going forward, the lower local uncertainty would contribute to a more favorable evolution thanks to its impact on the exchange rate, while cost elements, such as labor expenses, provided a partial counterbalance. Two-year inflation expectations in the surveys had returned to 3% after a long time.

3. Analysis of monetary policy options

The Board noted that the macroeconomic scenario had evolved in line with expectations, and therefore the economy was approaching a point where the data indicated that the convergence of inflation to the target looked more consolidated. In that context, a less contractionary monetary policy would be needed.

There was agreement that this consolidation process had made positive strides in several respects. Headline inflation continued to decline, even somewhat more than expected. Two-year inflation expectations had made significant progress, and market projections for shorter terms were narrowing their differences with the Bank's projections. Activity was proceeding as expected, which was consistent with an inflationary convergence process in line with estimates in the central scenario of the Report. Several Board members stressed that, while the risk of further inflationary persistence had subsided, it still seemed premature to rule it out completely. In their opinion, one should not lose sight of the fact that inflation was still high and the reduction in the core was less marked, suggesting that inflationary pressures had not yet dissipated to a significant degree.

All five Board members agreed that the recent evolution of the economy pointed in the required direction. The fact that the monetary policy stance had been contractionary over several quarters had contributed considerable to bring down inflation. Moreover, although related risks persisted, they had been balancing out. In that context, if the trends continued, the process of reducing the MPR would begin briefly.

The magnitude and timing of said process would take into account the evolution of the macroeconomic scenario and its implications for the inflation trajectory. In the central scenario of the June Report as approved by the Board, this was expressed in MPR cuts of the order of 250 basis points (bp) by the end of the year. Based on this, all the Board members considered that the following options were plausible: (i) keep the MPR at 11.25%; (ii) lowering it by 25bp. Some Board members added the option of cutting 50bp of the monetary policy rate.

One Board member estimated that the best decision was to cut 50pb off the MPR, noting in the Statement that similar moves could be made at future meetings depending on the information accumulated. In this Board member's view, this was consistent with the scenario in the Report and with suitable degrees of flexibility to deal with risks in either direction. Given the current monetary policy constraints, this Board member found it doubtful that such a move would be seen as a relaxation of monetary policy. This Board member considered this strategy more appropriate than keeping the MPR unchanged with an explicitly downward bias, which could be interpreted by the market as an anticipation of very aggressive cuts in the MPR.

Several Board members agreed that the macroeconomic scenario had been evolving in line with expectations and that, accordingly, monetary policy should follow a trajectory relatively aligned with what had been said in an earlier Report. Based on this analysis, maintaining the MPR at this Meeting seemed to be the best alternative, since it was consistent with new information and with the foreseen trajectory for inflation convergence. This did not preclude the possibility of initiating an MPR reduction process in the short term if current conditions remained the same. In fact, one of these Board members recalled that the MPR corridor contained in the June Report depicted no path where the MPR would not begin to decline before the end of the year.

In the view of one Board member, the risk of inflation falling more than projected, even below target, possibly accompanied by a partially unnecessary downturn in the economy, investment and employment, seemed to be quite high, adding that, in annual terms, private consumption had fallen quite significantly in the first quarter of 2023, mostly in durable and imported goods, but also in other categories. This larger than anticipated drop significantly reversed an earlier trend in which private consumption fell less than projected. This Board member added that inflation expectations had fallen in every term and instrument, coming closer to the Report's forecasts and the 3% target two years ahead, emphasizing that the significant appreciation of the peso since October 2022 contributed substantially to easing inflationary pressures.

One Board member noted that one way of assessing the relevance of reducing the MPR at this Meeting was to review whether or not the process of consolidation was taking place and/or whether the magnitude of the costs being caused by the process of lowering inflation exceeded expectations. Regarding the former, it was clear that important progress was being made in this process. As for the latter, there was no doubt that the economy was adjusting. Some figures showed it more clearly, others less so, but from labor to economic activity data, all reflected an ongoing adjustment. However, there was no indication that this adjustment was proving greater than expected.

Several Board members recalled that the Report's central scenario assumed that economic activity would be below potential GDP for several quarters. This projection had been maintained in similar terms for several reports, as it was considered a necessary condition for solving the inflationary problem.

One Board member added that to argue that the distribution of inflation risks had been shifting in balance was a factual description of the state of the macroeconomy. At the same time, to argue that said distribution had moved in the direction of a faster fall in inflation and activity was not well grounded. It was not sustained by the available information on activity, demand, slack, labor market, etc., nor was it supported by the simple observation of the inflationary levels still exhibited by the economy. He recalled that the objective of monetary policy was to ensure the convergence of inflation to the 3% target over two years and that this was based on the management of the business cycle. In this Board member's opinion, conveying the feeling that a risk about the performance of the business cycle was beginning to guide monetary policy could jeopardize the ultimate goal, namely the convergence of inflation to 3% within the two-year horizon. According to this Board member, conveying a message that what dominated in monetary policy conduct was the risk of an bigger adjustment of economic activity than was needed to ensure the convergence of inflation, would be inconsistent with the available macro information and would damage the effectiveness of monetary policy.

4. Monetary policy decision

Governor Costa and Board members Naudon and Céspedes voted for holding the MPR at 11.25%. Vice-Governor García and Board member Novy voted for a 50bp cut.

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