Monetary Policy Meeting[1]/

JULY 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. 258, held on 23–24 July 2018.

Present: Mario Marcel, Governor; Joaquín Vial, Vice-Governor; Pablo García, Board member; Rosanna Costa, Board member, Alberto Naudon, Board member.

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; Diego Saravia, Economic Research Manager; Matías Tapia, acting Economic Modeling and Analysis Manager; Juan Carlos Piantini, International Markets Manager; Rodrigo Alfaro, Financial Stability Manager; Francisco Ruiz, Macroeconomic Statistics Manager; Diego Gianelli, Head of the International Analysis Department; Hermann González, Advisor to the Finance Minister; Tatiana Vargas, Senior Economist; María del Pilar Cruz, Senior Economist; Carlos Medel, Senior Economist; Marlys Pabst, Secretary General.

1. Analysis of the technical teams

The international scenario

After the publication of the Monetary Policy Report in June, the main developments had concentrated on the international scene. The materialization of US tariff increases on Chinese imports, the consequent reprisals of China and statements about this situation, had intensified the risks associated with a commercial conflict, triggering some movements in the global financial markets. This has also been fueled by the more noticeable discrepancy in performance across developed countries. Although the world growth outlook had not changed substantially, the strengthening of the United States stood out, to the detriment of the cyclical position of the other developed economies. The US showed narrowing gaps, with investment and consumption fundamentals that remained solid, especially because of a seemingly tighter labor market.

Meanwhile, some short-term indicators continued to perform below expectations in the Eurozone—although levels were consistent with a recovery of the economy's growth pace—, while in Japan they pointed to weaker activity. In emerging economies, China's GDP growth had slowed marginally in the second quarter, while other conjunctural data suggested a somewhat sharper slowdown, although in line with the rebalancing proposed by its authorities. In Latin America, the deterioration of Brazil's growth outlook, where monthly activity had surprised to the downside — influenced in part by a truckers' strike— stood out and business confidence continued to worsen. In Mexico, at the statistical cutoff date, the proposals announced by the newly-elected government generated uncertainty at the fiscal level, while the expansion projections for Argentina had been cut due to the narrowing of monetary conditions, beyond the positive surprise from first-quarter GDP.

Inflation in the developed world showed advances, largely associated with the higher energy prices. Nonetheless, US figures differed from those of other developed countries, in line with discrepancies in terms of activity, with increases in both headline and core measures. In the rest of these economies, the total figures had shown mixed movements, although core inflation remained contained or exhibited some moderation in the margin. Accordingly, monetary policies continued to increase their divergence from the US, reinforcing the worldwide appreciation of the US dollar. In its June policy meeting, the Federal Reserve had widened the range for the fed funds rate to 1.75-2% and adjusted upward its forecasts for 2018 and 2019. The European Central Bank announced the end of the asset purchase program and confirmed that it would hold the rates unchanged until at least mid-2019. The Bank of England was using a more contractionary tone, while Japan confirmed it would maintain the stimulus measures. In the emerging world, various indicators suggested that the Chinese authority could further relax monetary conditions. In Latin America, with some exceptions, several countries showed increased inflation, although no big changes in monetary policy in the margin.

The global financial markets had been affected in part by intensified trade tensions in the weeks leading up to the Meeting. The currencies of emerging and commodity- exporting economies showed depreciations against the US dollar, with a significant weakening of the Yuan. In this context, long-term interest rates in developed economies had fallen across the board, risk premiums remained contained and volatility indexes, after a temporary rise, were back to mid-June levels. The stock markets exhibited mixed returns, where the fall in certain emerging economies was worth noting, in the midst of continuous capital outflows from some of these countries.

Since the previous Meeting, the price of most commodities had decreased, especially copper with a near 15% drop. This responded largely to trade tensions and the appreciation of the dollar, in a context in which China's activity figures had been weaker at the margin. Regarding the price of a barrel of oil, WTI and Brent showed opposite movements (of the order of +5.8 and -3.4%, respectively), significantly reducing the spread between the two. The movements of the former coincided with inventory reductions in the US, while in the latter they were mainly due to supply-side factors, including the markets' reaction to OPEC announcements.

The domestic scenario

In local financial markets, the depreciation of the peso stood out, close to 4.5% since the June Meeting, standing at around $ 660 per dollar, in line with the fall in the copper price and the global appreciation of the dollar. Among the multilateral measures, the MER-5 showed a slightly lower rise than the exchange rate, while the MER and MER-X showed more limited movements. The real exchange rate (RER) base 1986 = 100, had stood at 90.4 in June and, with the information at hand, estimates placed it near 91.6 in July. The stock market (IPSA) was coupled with the international trend and had declined in both peso and dollar terms. The interest rates of the fixed income market had remained relatively stable, especially the ten-year peso rates, contrasting with the decreases recorded in most economies. The local risk premiums had changed little from the previous Meeting and remained low from a historical perspective.

Regarding domestic credit, market interest rates were still low and real credit growth remained limited, with a rise in the commercial segment in recent months, due to greater loans in installments. On the other hand, housing loans continued to show a downward trend. The Bank Lending Survey for the second quarter of 2018 had reported a somewhat stronger demand in the consumer segments and for large companies, SMEs and real-estate firms, as well as slightly less restrictive supply conditions for mortgage loans and big-size companies.

Expectations for the Monetary Policy Rate (MPR) taken from the surveys —of Economic Expectations (EES) and Financial Brokers (FBS)— and implicit in the prices of financial assets, projected that the rate would not be changed at this Meeting. The first MPR increase was expected to occur towards the end of 2018, which in the case of the July EES meant it would be sooner than thought at the previous Meeting. One year ahead, the different measures showed no big changes. At two years, the EES continued to place the MPR at 3.5%. For its part, the FBS placed the rate at 25bp higher than in the previous meeting, at 3.75%, while the prices of financial assets placed it somewhat below 4%.

About local activity, the data known since the release of the June Monetary Policy Report were somewhat higher than implicit in the Report's baseline scenario. The Imacec had risen 4.9% annually in May, more than a substantial fraction of the market was expecting (4.2% and 4% per year according to the June EES and the median of the Bloomberg survey, respectively). In any case, the sectoral panorama was not very different from the one discussed at the previous meeting, and the better performance of several investment-related lines stood out, both in the goods trade —especially wholesale— entrepreneurial services and manufacturing industry. Some data suggested that the greater dynamism of these items seemed to be mainly concentrated in mining. In this context, the outlook for growth (EES) for this year continued to be revised upwards (4% in July, 3.8% in June), while for the next two years they had changed little and stood at 3.8%.

On the domestic demand side, investment was still driven mainly by the machinery and equipment component, as reflected in the persistently high levels of capital goods imports. In construction and other works, various indicators for both housing and non-housing building, showed limited dynamism at the margin. Also, business expectations in the construction sector (IMCE) at June had become more pessimistic, but other sectors remained optimistic.

About consumption, durables maintained a better performance than non-durables, despite some moderation in recent data, including automobile sales —which in any case were still growing at double-digit annual rates. The fundamentals of consumption, in general, showed a similar behavior to that of previous months. The labor market continued to lag behind output development. The creation of private salaried employment continued to be quite weak, while the public component showed some moderation at the margin. Salaries (INE), nominal and real, continued to grow below their historical averages. At the same time, consumer confidence (IPEC) at June was still in optimistic territory.

The information collected in the framework of the Business Perceptions Report continued to show positive prospects going forward, although with effective results that, according to the majority of respondents, were somewhat lower than was expected in recent months. There was growing concern about the economic effects of the trade war between the US and its trading partners. The mining and salmon sectors stood out among the most dynamic according to respondents' opinions, in contrast to the weakness that was noted in the trade sector. About private investment, the generality had mentioned that its plans were oriented to the replacement of depreciated capital, as well as to the improvement and / or automation of processes, but there were no large projects in the pipeline. On public investment, the views were not optimistic. The perception of the labor market pointed to a stagnation of employment and wage pressures that remained contained. In several regions, the substantial supply of labor was worth noting, supported by the presence of foreign labor. In terms of costs and prices there were no major changes. In the financial sector, some improvements in supply and demand conditions were reported.

Monthly inflation had been 0.1% in June, in line with market expectations. In annual terms, it had risen to 2.5%, explained largely by price increases in the most volatile items in the basket. In particular, the prices of fresh fruits and vegetables had risen 9.6% in June, explained largely by a low base of comparison and unusual seasonal behavior in June of 2017. The price of energy had risen 6.1% annually, due to the increase in fuel prices in pesos. Core inflation excluding foods and energy —CPIEFE— had increased, standing at 1.9% in June. By components, annual Inflation of goods had gone from -0.6% in May to -0.3% in June, while the annual services inflation EFE had increased from 3.0% to 3.2 in the same period. In this context, inflation expectations showed no big changes. At December of this year they had remained between 2.8% and 2.9% per year. At one year, expectations had increased slightly and were between 3.0% and 3.1%. At two years, they remained around 3.0%.

2. Background analysis and discussion

There was debate around the evolution of the international scenario and its risks, which in the opinion of several participants were not only present, but also seemed to have accentuated. It was noted that the scenario was still favorable in terms of global growth and financial conditions, however significant changes had been observed in commodity prices and exchange rates. Although this latter risk was nothing new, it presented different dimensions that were not necessarily independent of each other. On the one hand, there was a dissociation between the evolution of the US economy —which remained more dynamic than other developed countries— and that of the Eurozone —which showed some marginal normalization of its growth rates. This ensured that the conditions for a strengthened dollar remained. On the other hand, there were still risks associated with an inherently complex monetary normalization process. These had increased considering that the markets were more sensitive to changes in the perception of how monetary policy would be calibrated over time and also because of the vulnerability of some economies and/or their exposure to some degree of contagion. This was more important as complexities and new tensions were added, such as a pro-cyclical fiscal policy in the United States. In that already complex environment, there was also the threat of a more far-reaching trade war that affected the United States and China the most. This had resulted in a devaluation of the Chinese currency, of other emerging and commodity exporting countries, and a fall in commodity prices. Although effective advances in this area were limited, the risk of persistent stress had effects on financial channels, as well as on expectations, that altered investment decisions. Of course, a tighter restrictions on trade had effects on productivity too.

Several participants commented on the slope of the US yield curve, whose levels compared with 2007. This because this phenomenon is usually seen as a signal anticipating a recession in that economy. However, it was pointed out that given the quantitative stimulus policies still present, it was perhaps more indicative to analyze the spreads in the shortest part of the curve, even more so considering that the investment of the yield curve contrasted with other sources of information, such as the stock market. It was also pointed out that probably the US economy was already at a turning point in its cycle and it was difficult for it to continue to see such positive figures going forward. However, this did not imply that, in case of a sharper increase in inflation, the Federal Reserve would abstain from advancing its monetary normalization process.

Regarding the local economy, the state of capacity gaps was discussed, in particular the different signals that could be seen by observing the evolution of activity, the different components of demand and the evolution of cost and price pressures. On the one hand, there was agreement among participants that the latest data confirmed greater than projected growth in 2018. This stronger dynamism was seen particularly in sectors related to investment in machinery and equipment, including trade and financial and entrepreneurial services, and in durable consumption. However, it was stressed that there were doubts about what were the implications of this greater activity in terms of inflationary pressures. Based on complementary information, it was estimated that the increase in investment responded rather to a demand for replacing outdated machinery than to new and/or projects that increased production capacity. In fact, construction activity was on a path with no big surprises. Thus, one challenge was to see whether the surprise in activity and demand —mainly investment— was focused on some tradable sectors, particularly mining. If so, the expected impact on the rest of the economy would be more limited. It was also said that the revisions that were being made to the growth forecasts could be pointing rather to the economic cycle process occurring sooner and not necessarily deepening or accelerating. Therefore, it was possible that the economy could grow above trend and potential growth for a while, followed by a smoothing of the cycle. Plus, despite a rise in projected inflation, this was mainly due to the evolution of the exchange rate —not activity—, which was desirable in order to accommodate the changes in the macroeconomic environment. It was mentioned that, in any case, it should be clear that the analysis continued to indicate that the economy would grow at a pace consistent with trend growth and the gradual closure of the existing gaps, after several years of slow growth, but that for now it was not possible to infer from the better indicators observed that this process could differ significantly from the estimates in the most recent Reports. In addition, local confidence levels gave grounds for thinking that the private sector would continue pushing a normalization of demand and investment towards levels more aligned with their potential.

Meanwhile, the behavior of the labor market suggested that there were still gaps in the economy, in particular because employment seemed to lag behind the business cycle. And there was little pressure from wages, while the Business Perceptions Report did not report any prospects of greater dynamism in hiring, and instead efforts to automate functions was cited. It was added that this evidence or feeling of capacity gaps in the labor market could be related, on the demand side, with a labor hoarding behavior on the part of companies, while, on the supply side, to the evolution of the labor supply and the participation of different components had been more dynamic than estimated, because, for example, of the strong contribution of immigrant workers. For the same reason, it was said that possibly wages had moderated growth beyond what the usual indexation patterns suggested. In any case, there was discussion about the difficulty of evaluating the current state of the labor market from sources of information that led to different interpretations. It was commented that some of them could have greater difficulties to capture the potential effects of immigration, stressing the importance of complementing the information of surveys with administrative data.

3. Analysis of monetary policy options[2]/

All five Board members agreed that the macroeconomic scenario was well aligned with the baseline scenario of the June Report. This scenario considered that the MPR would begin to return to a more neutral stance between the end of this year and the turn of the next, so the dynamic of this normalization process had to be outlined. They all agreed that the option to boost the monetary stimulus was no longer relevant, since the downside risks to the convergence of inflation —which had been a topic of concern in recent quarters— had lost strength. It was added that the option to lower the rate could not be warranted by the changes in the external scenario, because although it was undeniable that it had become more risky, the current conditions were still favorable. Thus, all the Board members agreed that the relevant options were to (i) keep the MPR at 2.5%; and (ii) start at this Meeting the process normalizing the MPR.

Option 1: keep the MPR at 2.5%

All the Board members agreed that this option was totally consistent with the baseline scenario in the June Monetary Policy Report and, in particular, with the monetary policy strategy outlined there. In favor of this option, it was mentioned that although short-term inflation was higher than expected, it was mainly due to exchange rate depreciation and higher fuel prices, which in turn —particularly for the depreciation— could be related to the worsened outlook for the external scenario, in a context of a greater risk of a trade war and overheating of the US economy, in circumstances that the Chinese economy had shown signs of further weakening. In this framework, it was said that the greater local activity was associated more with transitory factors, which would have little impact on medium-term inflation, a diagnosis that was compatible with the evolution of prices, since there were no deviations or unexpected or unexplained inflationary pressures. In addition, the labor market continued to show slack. With this, it was mentioned that it would not be surprising to observe, during the second half of the year, lower-than-expected effective growth rates, reducing the probability of a more systematic acceleration of growth driven by investment. It was also noted that the external risks had implications for inflation and monetary policy in Chile that could differ in both the short and the long term. In particular, a worsening of trade conflicts and imbalances in the developed world, although they could put pressure on inflation through the exchange rate, on the other hand they could be contractionary for activity and inflationary pressures in the medium term.

Option 2: begin the process of MPR normalization

All the Board members noted that taking this option would be right only if it was considered necessary to anticipate the normalization process of the monetary

[2]/ In order to preserve the regulatory individual anonymity in the discussion, all the Board members are herein referred to as males, including female member Ms. Rosanna Costa.

stimulus with respect to forecasts in the last Report. The main argument was that the greater dynamism of activity and domestic demand could translate into a faster closing of the activity gap, causing additional inflationary pressures. This scenario could find support in the upward revisions to the growth and inflation forecasts. However, there was conflicting evidence about the size and evolution of capacity gaps. In that sense, the background data rather indicated that the economy was moving away from the period of cyclical weakness —characterized by slow growth and low inflationary pressures —and was moving towards one in which growth was more of a self-sustained nature and the risks of persistently low inflation were cleared. Finally, it was also mentioned that, although the decision to not change the MPR was the most appropriate at this Meeting, the risk of a more vigorous recovery of investment had been gaining strength, which, if materialized, could alter the way the process of MPR normalization would unfould.

4. Monetary policy decision

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%.