BTMU LATIN AMERICA TOPICS

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CHILE: CENTRAL BANK CUTS 25BP AND MODERATES EASING BIAS

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Decision: BCCh lowers policy rate by 25bp

Chile's Central Bank (BCCh) reduced its monetary policy rate (*tasa de interés de política monetaria*—TPM) by 25bp to 4.0% per year on Thursday, March 13th 2014. The BCCh had previously reduced the TPM by 25bp on February 18th and signaled the continuation of its easing bias on account of the deceleration of economic activity.

With inflation and inflation expectations anchored near the 3% target, the BCCh has had the monetary policy flexibility to support the domestic economy in the context of an uncertain external environment. Since October 2013, the BCCh has now cut the policy rate by a combined 100bp. (Figure 1.)

In the statement accompanying the decision, the BCCh maintained a bias towards easing but moderated its tone. The statement was changed from the previous one to include the following:

"The Board will consider the possibility of making additional cuts to the policy rate in line with the evolution of domestic and external macroeconomic conditions and its implications on the inflationary outlook."

In our view, the BCCh has moderated the tone of its easing bias towards increased data-dependency. Growth continues to concern the Central Bank, but the next monetary policy moves will be dependent on the trajectory of inflation, inflation expectations, and the CLP.

Concern over moderating growth pace

The January 2014 result for the Central Bank's Economic Activity Index (IMACEC) strengthened the chance for the latest rate cut. The IMACEC expanded 1.4% year-on-year in January; this was the lowest annual figure since March 2010 (-0.1% yoy), when economic activity was impacted by the 8.8-magnitude earthquake. (Figure 2.)

Domestic demand has continued moderating since 2H13. The weakness of investment-related sectors has been a concern for the BCCh, which cites external risks to copper and metals prices from a slower-than-expected growth outlook in China.

Private consumption has remained resilient but it is expected to slow, as there are signs that the labor market is finally weakening. The unemployment rate rose to 6.1% during the November-January rolling quarter, from 6.0% in the same period the previous year and 5.7% in October-December 2014.

Economic activity should begin to pick up slightly upon a gradual recovery of the external sector and improved implementation of fiscal expenditures by the administration of President Michelle Bachelet, who took office on March 11th. However, the slowdown of the Chinese economy presents downside risks to growth through lower external demand for Chilean copper exports, and the pace of China's deceleration will be a key factor influencing the growth outlook. Chile's GDP growth is currently expected to be below 4% in 2014, per the market consensus.

Data-dependency: Inflation and inflation expectations to determine next move

While the BCCh remains concerned about growth, particularly in investment-related sectors, it does not appear to be in any rush to cut rates in the near-term. We are of the view that the BCCh is in data-dependent mode and that additional easing will depend on the evolution of inflation, inflation expectations, and the Chilean peso (CLP). The likelihood is for a pause in April and the continuation of the easing cycle by at least another 25bp in 2H14.

The 12-month headline inflation rate rose to 3.2% in February, above the 3% target, upon higher food and fuel prices as well as CLP depreciation. Core inflation stands at 2.5%. Importantly, the BCCh's loosening of monetary policy has been accompanied by the depreciation of the CLP, which has weakened 12% over the last six months amid lower growth of the Chinese economy and tapering of the US Federal Reserve's QE. Weak domestic economic activity should curb some pass-through from CLP depreciation to inflation, but the BCCh—a disciplined inflation targeter—will be vigilant of the trajectory of inflation and inflation expectations.

In addition to developments of inflation and the CLP, key releases before the April 17th monetary policy meeting include 4Q13 GDP (to be released on March 18th), the minutes from the latest meeting (March 28th) and BCCh's Monetary Policy Report (April 2nd).

Figure 1: Policy rate and 12-m inflation

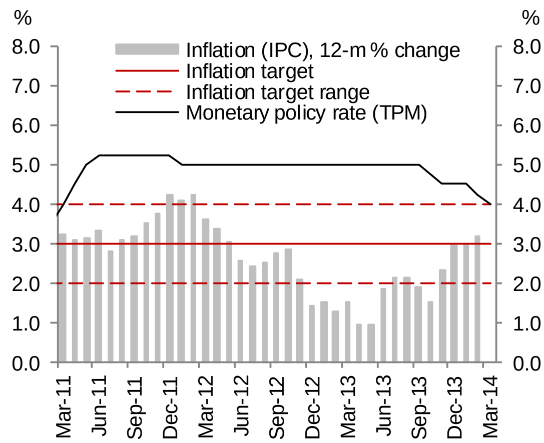


Figure 2: Weaker economic activity

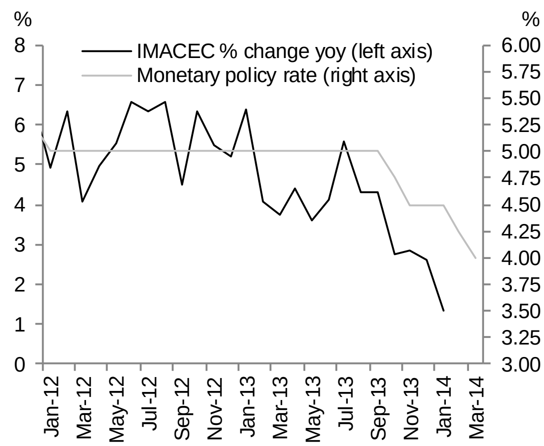
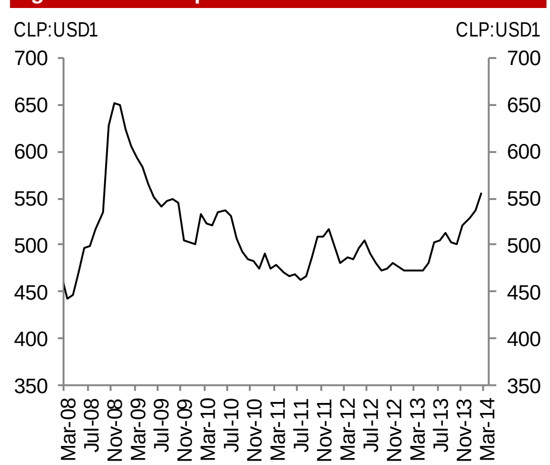


Figure 3: Chilean peso



Source: BCCh; BTMU Economic Research.

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