Servicio de Estudios Económicos

BBVA

Chile

BCCh Watch

February 12th, 2009

Central Bank surprises the market with the Monetary Policy Rate for February

- **In lowering the Monetary Policy Rate (MPR) 250 basis points to 4.75%, the BCCh went beyond market expectations of a maximum reduction of 200 bp.**
- **The decision to reduce the MPR was justified on the basis of a higher drop in domestic and foreign economic activity than anticipated in the previous ICOM, and the speed of convergence to the target inflation rate.**
- **We believe that this strategy carries a risk of lowering the forecasts of financial agents and outweighing its potential benefits.**
- **Despite the downward bias, we expect subsequent cuts to be more moderate, taking the rate to around 4% by the middle of the year.**

If the aim of the Central Bank was to surprise the market it certainly succeeded, lowering the Monetary Policy Rate (MPR) 250 basis points to an annual rate of 4.75%. The average predicted figure from a Central Bank survey of economic forecasts (6.25%), the results of which were released two days ago, corresponded to a cut of 100 basis points, and decile 1 (5.75%) showed that 90% of respondents expected a cut of 150 bp. The BBVA Research Department prediction of a cut in the region of 150-200 bp was among the more extreme.

The BBCh made clear that the basis for this measure was the performance of domestic economic activity and the international scenario, both of which are considerably worse than predicted in the last Monetary Policy Report. This is taken as an admission that growth forecasts of between 2 and 3% for 2009 have been discarded.

In terms of inflation, although the BBCh recognizes that the surprise January result of -0.8% was due largely to methodology changes, it anticipates a rapid convergence to the official target.

In addition, while the Central Bank has never based its decisions on exchange considerations, favorable movements in the exchange rate in the last few days may have given the BCCh a degree of freedom to make a larger cut than the market anticipated, by easing concerns of its possible effect on the exchange rate and prices.

However, the risk of such an aggressive strategy is that instead of viewing it as a stimulant of economic activity, the market sees the decision as evidence that the Central Bank is anticipating a pronounced economic slump, and the adverse effect of this interpretation on market forecasts could outweigh the benefits of the measure in driving down the cost of money.

This point is also relevant in terms of possible effects on the markets. While in theory the cut should boost the value of shares in companies linked to sectors that are more sensitive to rate fluctuations, such as banking, retail and construction, if the dominant effect of the measure is a drop in market expectations, the overall outcome could be negative. For example, in the case of credit, a rise in risk premiums would limit reductions in the system's rate structure.

The report concludes by stating that “in the most likely scenario, the MPR will evolve below the trajectory outlined in the Monetary Policy Report, converging in the short-term to levels comparable to those implicit in financial asset prices for the middle of the year”.

Two points should be made here. First, that the previous MPR gave a projected rate of between 5 and 5.5% for the middle of the year, and this cut takes the rate to below the projection well in advance of the stated date. Second, despite the continuing downward bias, we anticipate that subsequent cuts will be more moderate, taking the rate to around 4% by the middle of the year.

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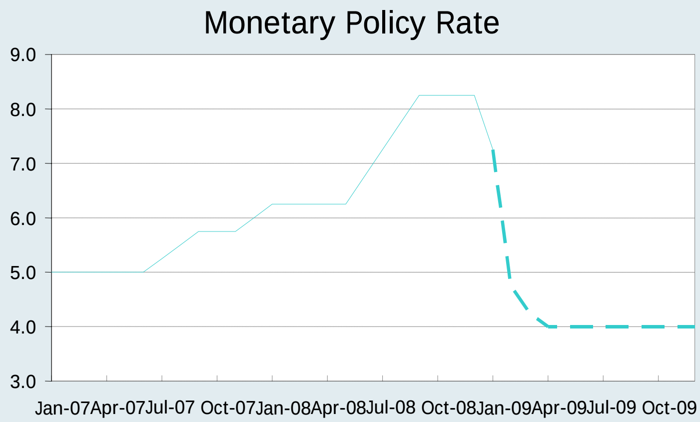

Source: BCCh, BBVA projections