Monetary policy in Chile: a look behind and beyond[(*)]

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Good afternoon, it is a pleasure to be with you today, in this new version of Chile Day.

The Central Bank of Chile has the mandate to keep inflation low and stable. To achieve its objectives, for more than 20 years the Bank has been conducting its monetary policy under the medium-term inflation targeting scheme with a flexible exchange rate. During this time, we have seen how the Bank has successfully overcome important challenges, generating confidence and credibility in its policies, as well as high institutional strength and value.

A LOOK BEHIND OUR MONETARY POLICY IN A CHALLENGING CONTEXT

The last few years have been particularly challenging for our country and for the Central Bank's policy framework. But they have also given us the chance to demonstrate its validity and strength not only to the public more involved in economic and financial issues, but also to the Chilean society at large. Our institution played a relevant role in reining in the effects on the financial markets after the social outbreak, in generating support measures to mitigate the effects of the pandemic and then in controlling the inflationary shock we experienced as a result of the excessive increase in domestic spending and a series of external factors. Today, we can say that monetary policy has done its job, stabilizing the economy and bringing inflation around its target. As a result, we are facing a different cycle. I will refer to all this in more detail later on.

(*) Presentation in the context of Chile Day in London, United Kingdom.

To put these statements in context, I would like to begin this presentation by describing the developments of our economy in recent years. Thus, it is worthwhile to dwell on the different types of shocks that have hit us, bearing in mind that their nature was unusual, that they required ad-hoc monetary policy responses and that the policy framework was flexible enough for an adequate conduct of monetary policy.

Let us start by recalling the weeks immediately following the social outburst of October 2019. This event had effects on several dimensions, including a significant drop in economic activity in the last quarter of that year, which also affected employment. The most lasting effect was undoubtedly the increase in uncertainty. We saw during the discussions on a new constitution how the local financial market became stressed, which was exacerbated by the impact of the pension savings withdrawals. At the end of 2019, the Bank accommodated its monetary policy, by reducing the monetary policy rate (MPR) to allow for further stimulus. But most important were probably the measures to promote the proper functioning of markets, including the November 2019 intervention in the foreign exchange market (Figure 1).

We were addressing idiosyncratic challenges when the Covid-19 pandemic emerged. The rapid spread of the disease in the world and the doubts about its scope in many dimensions placed a significant blanket of uncertainty on the world economy. The abrupt closures of various activities and the destruction of jobs posed a significant challenge for the world's economic authorities. As the debate began among specialists about the duration of the crisis and its potential scars on the economy, the central banks reacted promptly with a substantially expansionary monetary policy. In our case, that reaction was early. By mid-March 2020, we were already reducing the monetary policy rate to its technical minimum and implementing a significant package of measures to ensure the proper functioning of markets and to avoid an amplification of the crisis through a contraction of credit. Today, all these measures are no longer active. The evaluation of their effects, together with other measures adopted by the government, indicates that a drop-in activity that could have been more than 7 percentage points higher was prevented[1].

As a society adapted to operating in a pandemic, the economy began to open up and the measures adopted bore fruit, activity began to show greater resilience than expected. In the second half of 2020, GDP levels were already beginning to recover. Was in this context that a series of household income support measures began to be added. Thus, as supply restrictions were lifted, a large-scale demand shock was generated. During the first half of 2021, demand began to grow strongly, and significant macroeconomic imbalances were created, pushing inflation upwards.

During this period, both external forces and the high levels of domestic uncertainty, depreciated our currency, putting additional pressure on prices. In addition, at the end of 2021 and beginning of 2022, global factors had an even stronger impact on inflation. Global supply bottlenecks, the effect of the Russian invasion of Ukraine on energy and commodity prices, and the tightening of sanitary restrictions in China hit our country in this environment of already high inflation.

Monetary policy responded strongly to this scenario. The forces behind the sustained and generalized increase in prices came mostly from domestic demand. Furthermore, the formation of inflation expectations was being affected. In a few quarters, the MPR went from a low of 0.5% to a peak of 11.25%, the highest in nominal terms in the last 25 years. The monetary policy reaction was significant and swift, consistent with the size of the inflationary shock being faced and the risks it posed to inflationary convergence. In a context of high uncertainty, the Central Bank of Chile was one of the first central banks to react globally. Fiscal policy also did its part in 2022, reducing the substantial increase in fiscal spending of the previous year.

[1] Box V.1. The role of macroeconomic policies in mitigating the Covid-19 crisis.

It is important to note that this period was particularly difficult for a society that had forgotten what it was like to deal with high and volatile inflations. Public opinion made rising prices one of its main concerns. Explaining its origin, the actions taken by the Bank and what we expected to happen required a significant effort on the part of the institution in terms of communication, which was much more accustomed to dealing with specialized audiences. This entire process left us with important lessons and the constant challenge of explaining to every citizen our work and how it impacts their daily lives. Undoubtedly, this is a challenge that all central banks share and in which we strive to advance every day.

Recent quarters have shown the consistency of the Bank's monetary policy work. In mid-2023, when we were convinced that inflation had consolidated the process of convergence to the target, we began to lower the MPR. Our first reduction of 100 basis points was made in July last year, being again one of the first banks to move in that direction. Among the elements we considered in that evaluation were the steady decline in inflationary records, progress in the economy's adjustment, and two-year inflation expectations once again anchored to the 3% target. The latter is something that has yet to be seen in some countries.

Since July 2023 to date, we have reduced the MPR in 575 basis points (bp), considering the cut at our last meeting, a week ago. Thus, today the rate stands at 5.5%.

At this point, having taken a look behind what we have faced in recent periods, our monetary policy report (IPoM) for the third quarter, published last Wednesday, shows us that there are still challenges ahead. I will address the main aspects analyzed in this IPoM, but I will say now that there is something different from what we have seen for most of the last few years. Today the imbalances have closed, inflation has approached 3%, and two-year expectations are well anchored to the target. This puts us in a better position to face shocks with a more traditional monetary policy framework, where it is possible to absorb the shocks facing the economy within the policy horizon and with interest rate responses that entail a lower associated cost for economic activity.

THE MONETARY POLICY REPORT: CHALLENGES OF THE CURRENT SCENARIO

Firstly, the evolution of activity during the year has fluctuated, responding mostly to one-off and transitory factors. Thus, we saw high dynamism in the first quarter and a moderation in the second quarter, which was greater than expected. The data for the beginning of the third quarter continued this trend (Figure 2).

On the demand side, data for the second quarter also showed a slower-than-expected performance, particularly for private consumption. This behavior occurred in a context in which, in recent times, several of its fundamentals have evolved in line with expectations (Figure 3). Beyond the quarter-to-quarter volatility, taking mid-2023 as a reference point, consumption has begun to recover in line with the recovery of the labor market and the decline in interest rates.

Gross fixed capital formation (GFCF) stabilized after a sharp drop in the second half of last year. Preliminary information based on micro data reveals important differences across sectors. While weakness is observed in the vast majority of them, the dynamism of investment in mining contrasts (Figure 4).

Regarding inflation, as I mentioned a few minutes ago, it fell rapidly from its peak of 14% in August 2022 to 3.2% in March of this year. Since then, we have seen an increase in the annual variation of the CPI, due to the impact of higher transportation costs globally, the depreciation of the peso during the year and, especially more recently, the rise in electricity rates.

Total annual inflation rose to 4.6% in August, while core inflation reached 3.7% (according to reference series). The higher inflation of volatile items responds mainly to the increase in electricity prices. The relevance of this last factor can be seen in the evolution of core inflation, which has remained at figures of around 3.5% annually. All this in a context in which market inflation expectations remain anchored in the target in the policy horizon (two year) and the economy has largely closed it output gaps. However, one-year projections show a significant increase (Figure 5).

The reduction in the MPR has continued to be passed through to bank lending rates in line with the usual patterns, with declines in commercial and consumer credit interest rates, while mortgage rates have declined less in line with long-term rates that remain high by historical comparison. Lending remains weak. In commercial loans, this result is coherent with the behavior of sectorial investment, which is dynamic for mining --which uses Foreign Direct Investment more intensively to finance itself-- and weaker in the rest of the sectors that are more intensive in the use of bank credit.

On the other hand, in a box included in the last monetary policy report, we analyze the evolution of non-financial firm credit for Chile and other developed and emerging countries. Two observations stand out from the analysis of the data. First, in the first stage of the pandemic period, counter cyclical policies generated a significant expansion of credit worldwide. Second, the weakness of credit in recent years has been a global phenomenon and the case of Chile does not look particularly different from the rest of the world.

The Chilean financial market has followed the movements of global markets, adjusting to the volatility of the external scenario, dominated by the outlook for the Fed's next moves (Figure 6).

Thus, the projections for activity and demand continue to consider that the economy will grow around its trend over the next few years. For 2024, the range of GDP growth projections is reduced at its high end, to between 2.25% and 2.75%. This forecast is similar to the projections included in the June and March reports (between 2.25-3.0% in the first and between 2 and 3% in the second), the latter revision being largely due to the second quarter results. For 2025 and 2026, growth projections remain in a range between 1.5% and 2.5% (Table 1).

Private consumption will regain momentum, as the lower cost of credit and the increase in the real wage bill suggest that its recent moderation will not be persistent. By 2025 and 2026, private consumption is expected to grow at a pace in the order of 2% per year. The GFCF growth projection for the 2024-2026 period is somewhat lower than the one considered in June, as a result of the weakness of investment in the non-mining sectors. For the mining sector, the central scenario ratifies a positive investment momentum (Figure 7).

Regarding inflation, we project that the annual variation of the CPI will continue to rise in the short term, mainly due to sharper increases in volatile components. By the end of this year, headline inflation is expected to close at 4.5% (4.2% forecast in June). In the medium term, inflation will decline more rapidly than previously anticipated, given the lower inflationary pressures stemming from the performance of domestic demand. We estimate that its convergence to the 3% target will occur in the first months of 2026, to remain there until the end of the policy horizon (Figure 8).

The impulse that the Chilean economy will receive from abroad considers a growth of trading partners without major novelties with respect to the previous projection --of the order of 3% in the period 2024-2026--, somewhat more favorable international financial conditions and somewhat lower terms of trade. The price of copper is slightly below the previous estimate. For 2024, US$4.15 per pound is projected (US$4.3 in June), while for 2025 and 2026 values of around US$4.3 are still considered.

MONETARY POLICY STRATEGY

As we mentioned in our monetary policy meeting, the background described suggests limited changes in the outlook for activity, although spending shows greater weakness. This, together with inflation expectations aligned with the 3% target, reduces the risks of higher inflationary persistence in the medium term as a result of the cost shock.

In this context, we estimate that, if the assumptions of the central scenario of this IPoM materialize, the reduction of the MPR towards its neutral level will be somewhat faster than expected in June. This will occur at a pace that will take into account the evolution of the macroeconomic scenario and its implications for the inflation trajectory.

The MPR corridor is a tool through which we inform a rough path for the rate, it is not a commitment on a level or magnitude of changes on a meeting-by-meeting basis. It contains sensitivity scenarios that differ from the central one and have a significant probability of occurrence, in which monetary policy could follow a different path. The sensitivities around our central projection scenario, this time are mainly related to the evolution of local demand and/or the persistence of increase in inflation (Figure 9).

MONETARY POLICY: COMMITTED TO CONTROLLING INFLATION IN THE FACE OF FUTURE CHALLENGES

As you have been able to observe, and as I mentioned previously, although the scenario for monetary policy is not free of challenges to return to 3% inflation, today we are in a framework more associated with more normal times, where a supply shock, such as the increase in electric prices, can be accommodated within the policy horizon, keeping expectations anchored and without the need to overreact with the MPR.

Beyond monetary policy, our economy has challenges to face. Although we have controlled inflation and resolved the significant imbalances generated by some of the measures adopted during the pandemic, other effects are still being felt. An important challenge is that the stock of long-term savings in our economy has been unable to recover the size it lost after the three withdrawals of pension savings.

This leaves us more exposed to external financing, in a context in which long-term rates have risen globally and there is uncertainty about various structural factors. Not to mention the stabilizing effect that institutional agents that manage long-term savings have often played is practically no longer present.

Another important challenge is how to resume higher medium-term growth. In the Report we published last week, we updated the structural parameters of the Chilean economy, including trend or medium-term growth. This is an exercise that we do on a regular basis, as it serves as a guide to evaluate the current state of the macroeconomy, and to calibrate monetary policy accordingly.

This IPoM estimate shows virtually no change from the previous year. Trend GDP growth will slow over the course of the next decade, averaging 1.8% over the 2025-2034 period. The question that arises from this figure, and which we asked Congress in our presentation, is whether we are happy with it. Judging from the reactions, the answer is no.

Going back to what we mentioned before Congress, facing this challenge and overcoming it requires from all of us, good public policies, creativity, and public and private effort. Of solid institutions. Of a significant and persistent effort. The positive thing is that we have opportunities. In fact, the mere fact of attending these Chile Day meetings shows the interest to face these challenges.

Today's world is challenging for a small, open economy such as ours, particularly in a geopolitical scenario where various fronts of tension have been building up. We are not big enough to generate scale advantages in our markets, including our productive matrix. On the other hand, aspects such as climate change or technological innovation could imply a great potential for the development of important productive sectors in the country, but we still know little about their impact on the economy as a whole, or whether we will be able to have the flexibility and adaptability essential for this new environment.

We cannot yet even quantify what the magnitude and timing of some of these developments will be. However, as our economy moves into the future, our mandate is to keep inflation under control and ensure the stability of domestic and external payments. Our work will continue day-to-day to be committed to these objectives.

For this, we have our policy framework which, as I mentioned at the beginning, has given proof of its value in circumstances as complex as those we have experienced in recent years. With a simultaneity of supply and demand shocks, and with characteristics and persistence that had not happened in this way in decades. But its attributes came to light, allowing inflation to return to levels compatible with the target. We have been clear and have seen with concrete evidence that monetary policy has done its job. The good results obtained during the last 25 years in which we have operated under this scheme have given credibility to the Central Bank's actions. But this does not put us in passive mode. On the contrary, it encourages us to continue acting with the certainty that the framework at our disposal has been effective.

It is also important to highlight that, as a result of the challenges that arose during the pandemic, the law was adjusted to have a wider range of instruments to face new crises. These include, among others, the possibility of temporarily acquiring bonds issued by the Treasury in the secondary market under very exceptional circumstances, the possibility of implementing repos with non-bank agents, following the approval of the resilience law, and the option of acquiring bank bonds from entities supervised by the Financial Markets Commission and the Superintendency of Pensions in stress situations.

I would like to end this presentation by reaffirming that there should be no doubt about our commitment to the inflation target and that we will take all the necessary decisions to meet it. The period of high inflation reminded us of the costs to society of not controlling this phenomenon, which is particularly harmful to those who lack the resources to deal with it. The Central Bank has a legal mandate to control inflation, but this is also a commitment to society that becomes especially relevant in view of our first centenary. This is to contribute to a macroeconomic balance that favors the growth of the country and the welfare of all its inhabitants.

Thank you.

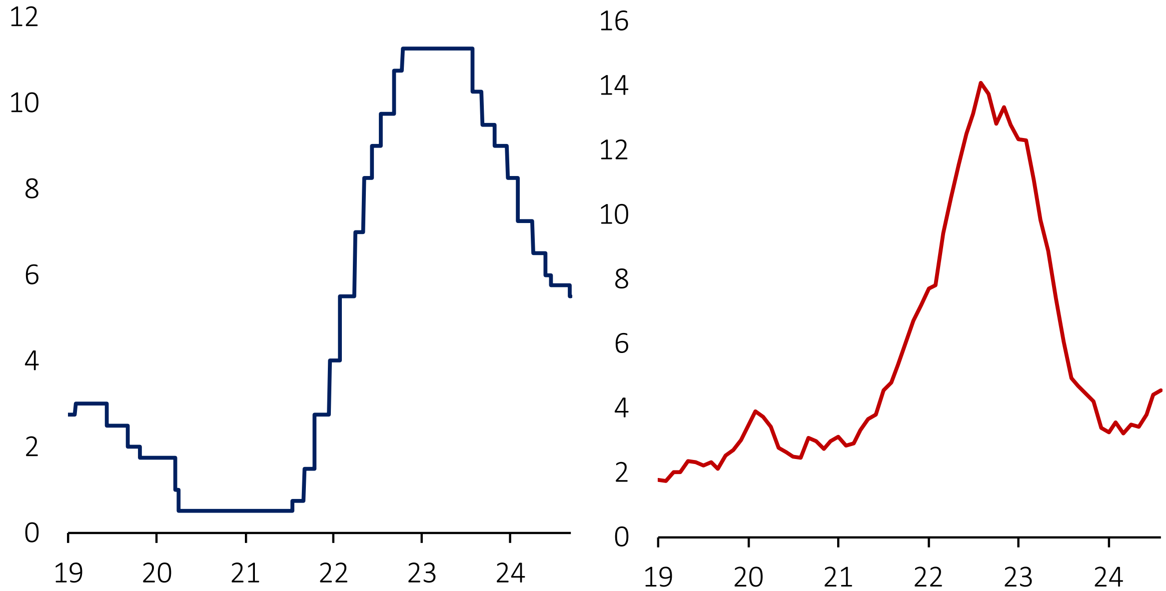
Figure 1

Monetary policy rate (MPR)

(percent)

Headline inflation (*)

(annual change, percent)



(*) Series consider the 2023 CPI reference basket and the splice made by the Central Bank of Chile.
Sources: Central Bank of Chile and National Statistics Institute.

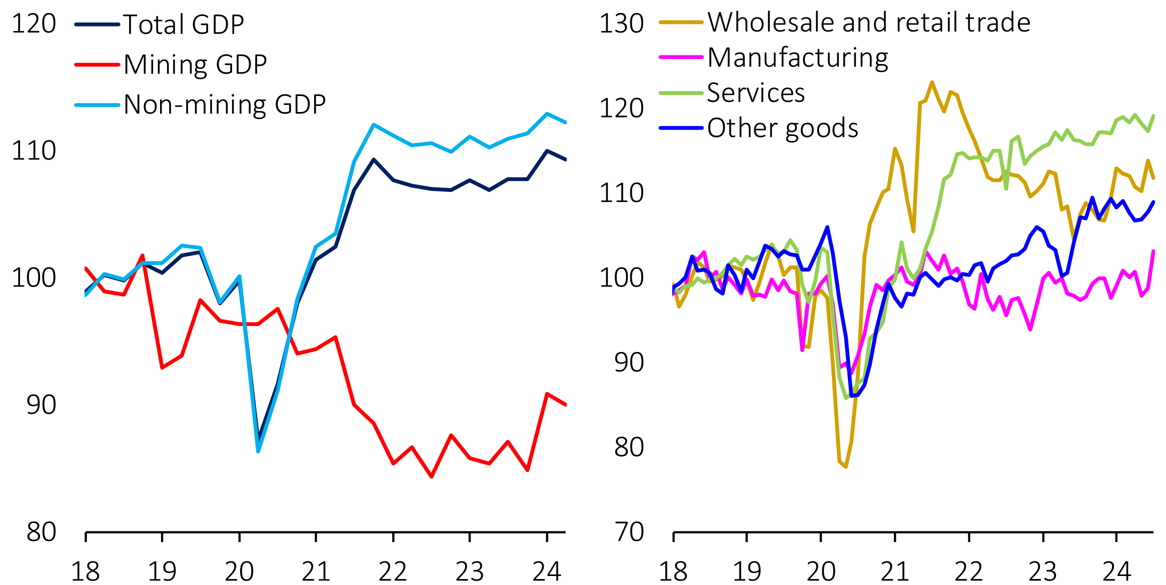
Figure 2

Gross domestic product

(index, 2018 =100, seasonally adjusted series)

Monthly activity (Imacec) (*)

(index, 2018 =100, seasonally adjusted series)

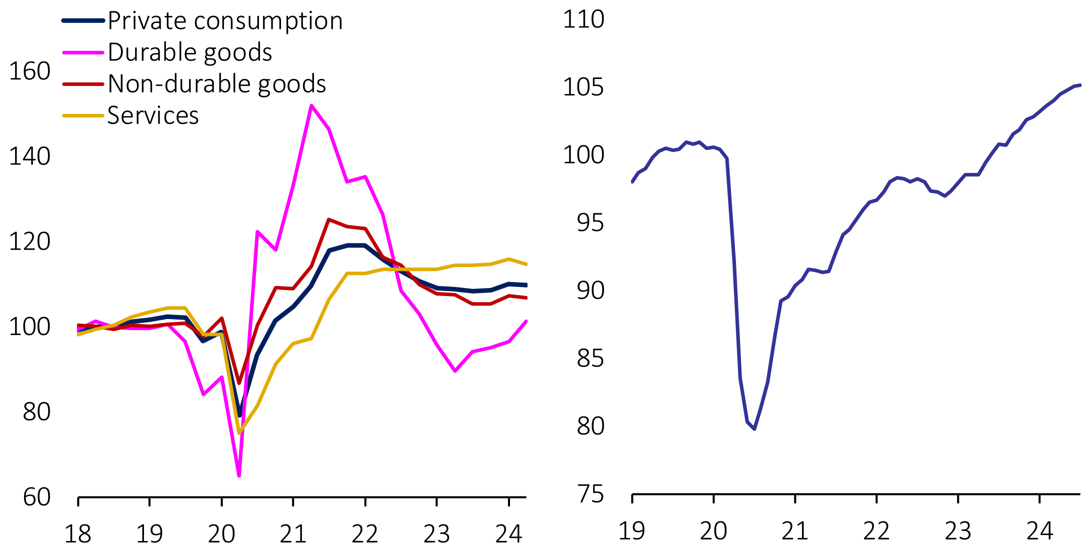


(*) Other goods series considers agricultural-forestry activities, fishing, electricity, gas and water supply, and construction. Source: Central Bank of Chile.

Figure 3

Private consumption | **Real wage bill (*)**

(index, 2018 =100, seasonally adjusted series) | (index, 2019=100, seasonally adjusted)

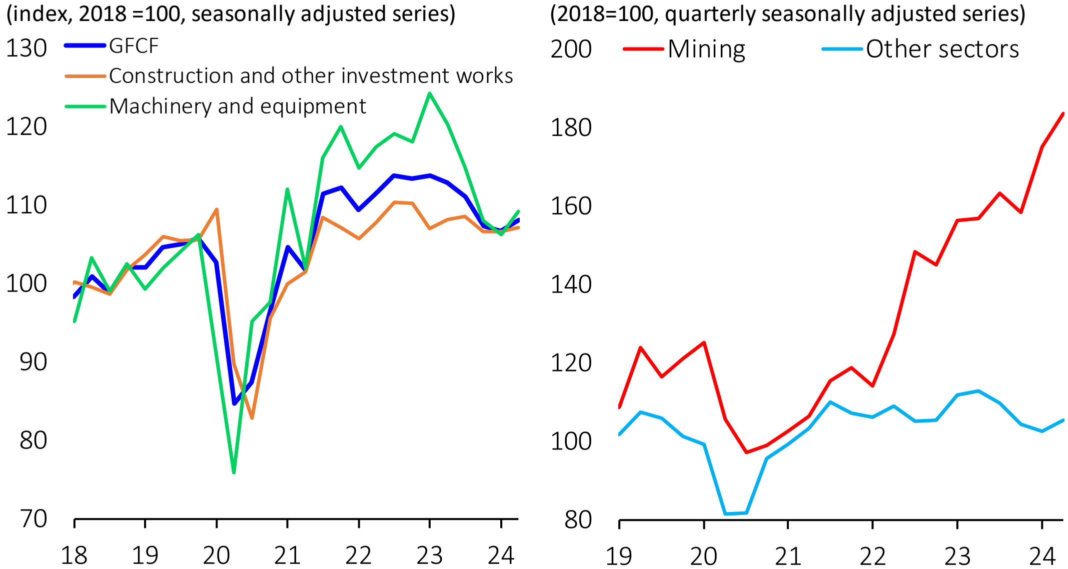


(*) Calculated using seasonally-adjusted series of the real LCI, hours worked and occupation.
Sources: Central Bank of Chile and National Statistics Institute.

Figure 4

Gross fixed capital formation (GFCF) | **Real investment according to microdata (1)(2)(3)**

(index, 2018 =100, seasonally adjusted series) | (2018=100, quarterly seasonally adjusted series)



(1) These figures correspond to an approximation of investment data based on high frequency information subject to revisions, they do not necessarily represent National Accounts figures. (2) Other sectors do not consider investment in the energy sector. (3) For more details, see Minutes of the September 2024 IPoM.
Sources: Central Bank of Chile, National Customs Service and the Tax Administration.

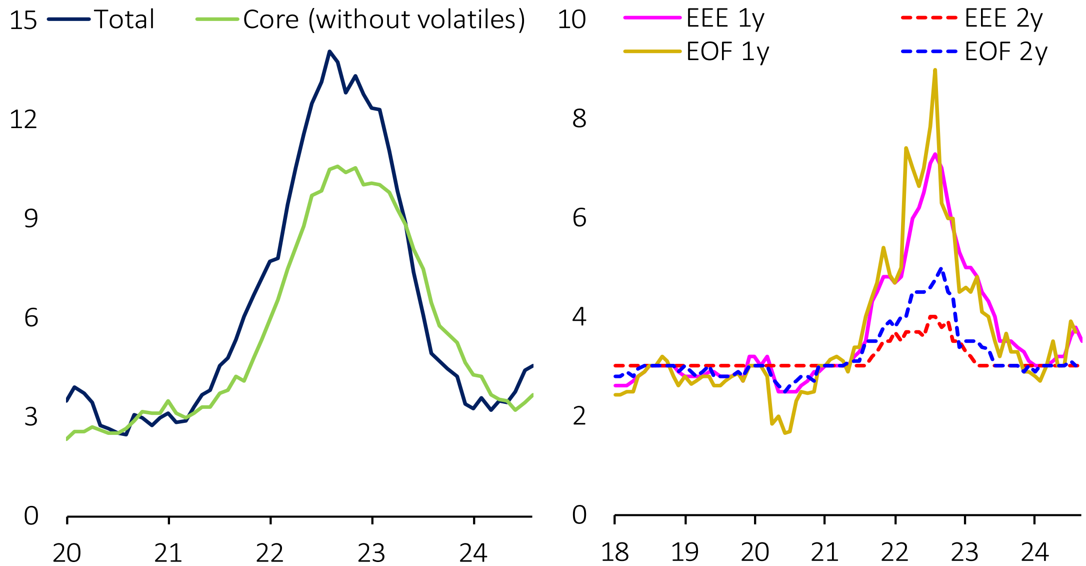
Figure 5

Inflation (1)

(annual change, percent)

Annual inflation expectations (surveys)

(percent)



(1) Series consider the 2023 CPI reference basket and the splice made by the Central Bank of Chile. (2) Median of responses are shown. (3) EOF considers the survey from the first half in January 2018. From February 2018 onwards, it considers the last survey published in the month. Sources: Central Bank of Chile and National Statistics Institute.

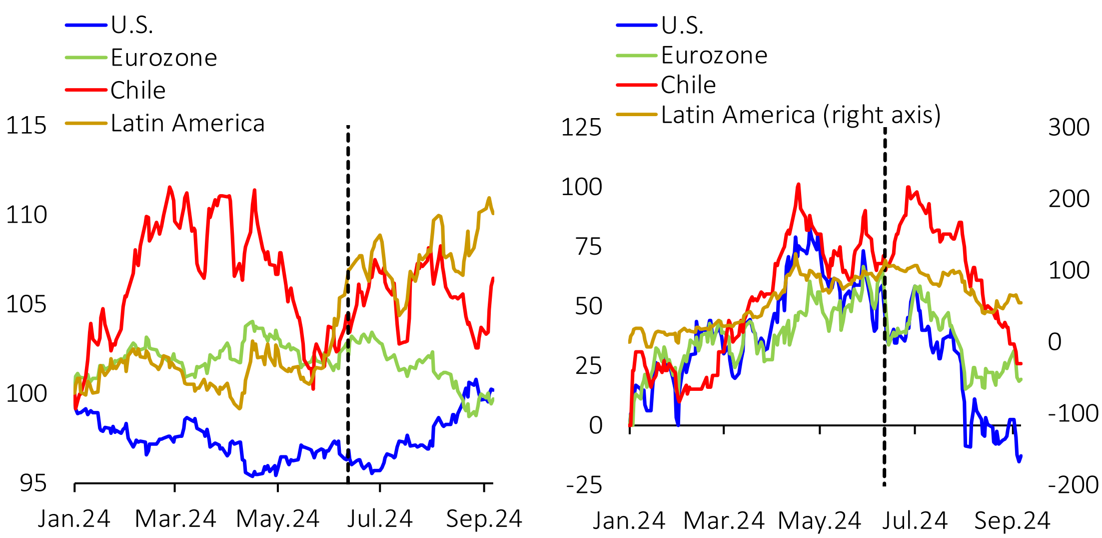
Figure 6

Currencies (1)(2)(3)

(index 1.Jan.24=100)

Interest rates on nominal 10-year bonds (1)(2)

(difference with respect to 1.Jan.24, basis points)



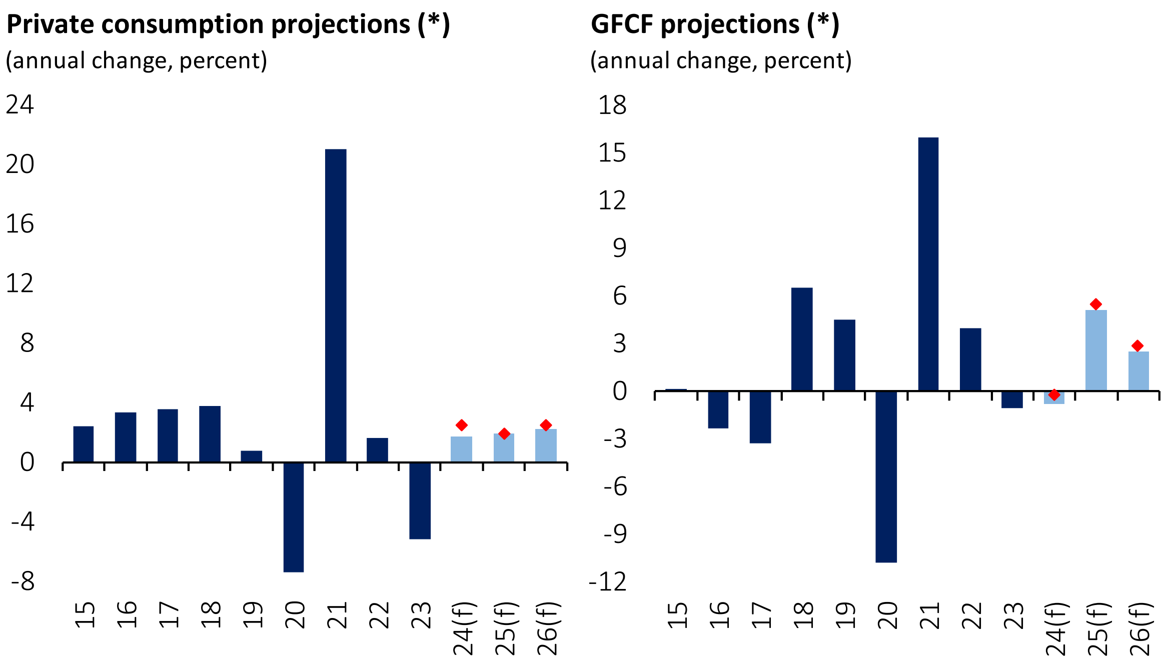
(1) For Latin America, considers the simple average of Brazil, Mexico, Colombia and Peru. (2) Dashed vertical line marks statistical cut-off of June 2024 IPoM. (3) An increase in the index indicates a depreciation of the currency and a decrease an appreciation. For the U.S., the multilateral dollar index (inverted) calculated by the Federal Reserve is used. Sources: Central Bank of Chile and Bloomberg.

Table 1
GDP growth projections (*)
(annual change, percent)

	June 2024	September 2024
2024	3.0% – 2.25%	2.75% – 2.25%
2025	1.5% – 2.5%	1.5% – 2.5%
2026	1.5% – 2.5%	1.5% – 2.5%

(*) Projections included in each Monetary Policy Report. Symbols on the right indicate change compared to June 2024 projection. Source: Central Bank of Chile.

Figure 7

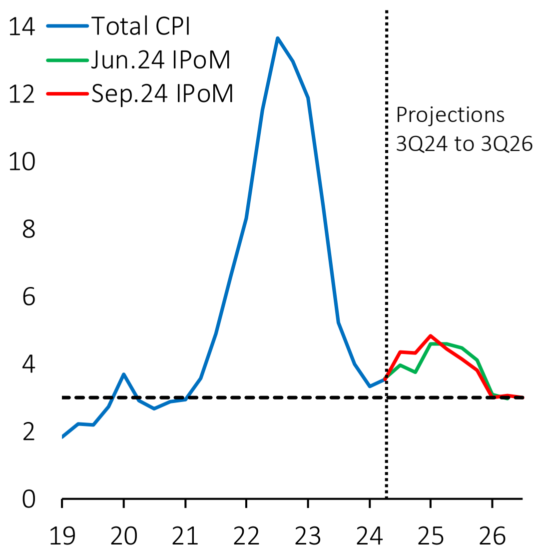


(f) Forecasts. (*) Red diamonds correspond to the projections of the June 2024 Monetary Policy Report.
Source: Central Bank of Chile.

Figure 8

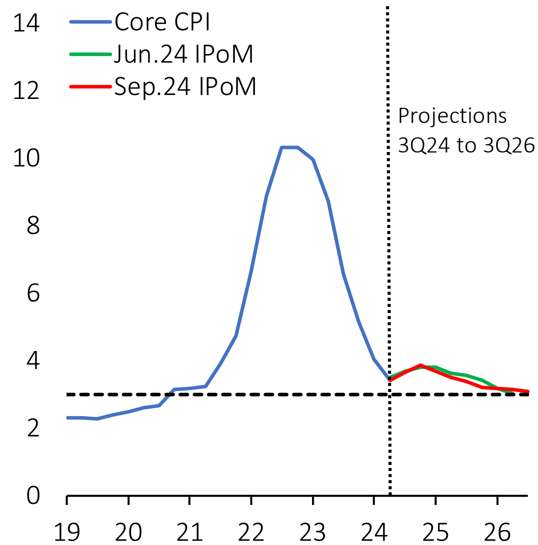
Total CPI projections (*)

(annual change, percent)



Core CPI projections (*)

(annual change, percent)

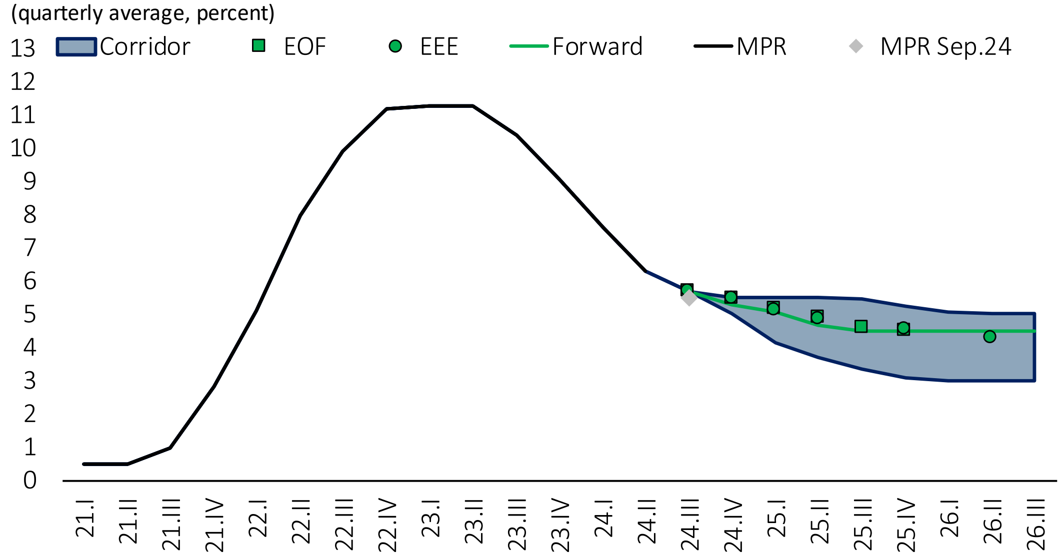


(*) Series consider the 2023 CPI reference basket and the splice made by the Central Bank of Chile.
Sources: Central Bank of Chile and National Statistics Institute.

Figure 9

MPR corridor (*)

(quarterly average, percent)



(*) The 2025 and 2026 calendar considers two MP meetings per quarter. The corridor is built by following the methodology described in boxes V.1 of March 2020 Report and V.3 of March 2022 Report. It includes the August Economic expectations survey (EEE) and September pre-MP meeting Financial traders survey (EOF) and the quarterly average smoothed forward curve as of August 28. This is calculated by extracting the implicit MPR considering the forward curve over the overnight index swap (OIS) curve for up to 2 years, discounting the fixed rates of each maturity at the simple accrual of the OIS index. For the current quarter, the surveys and the forward curve consider the average of daily actual data and are completed with respective sources. Quarterly average considers working days in each quarter. Gray diamond corresponds to the MP decision of September 2024. Source: Central Bank of Chile.