Economic and financial stability. Perspectives for the Chilean economy

LarraínVial Virtual Investor Seminar – September 8, 2021

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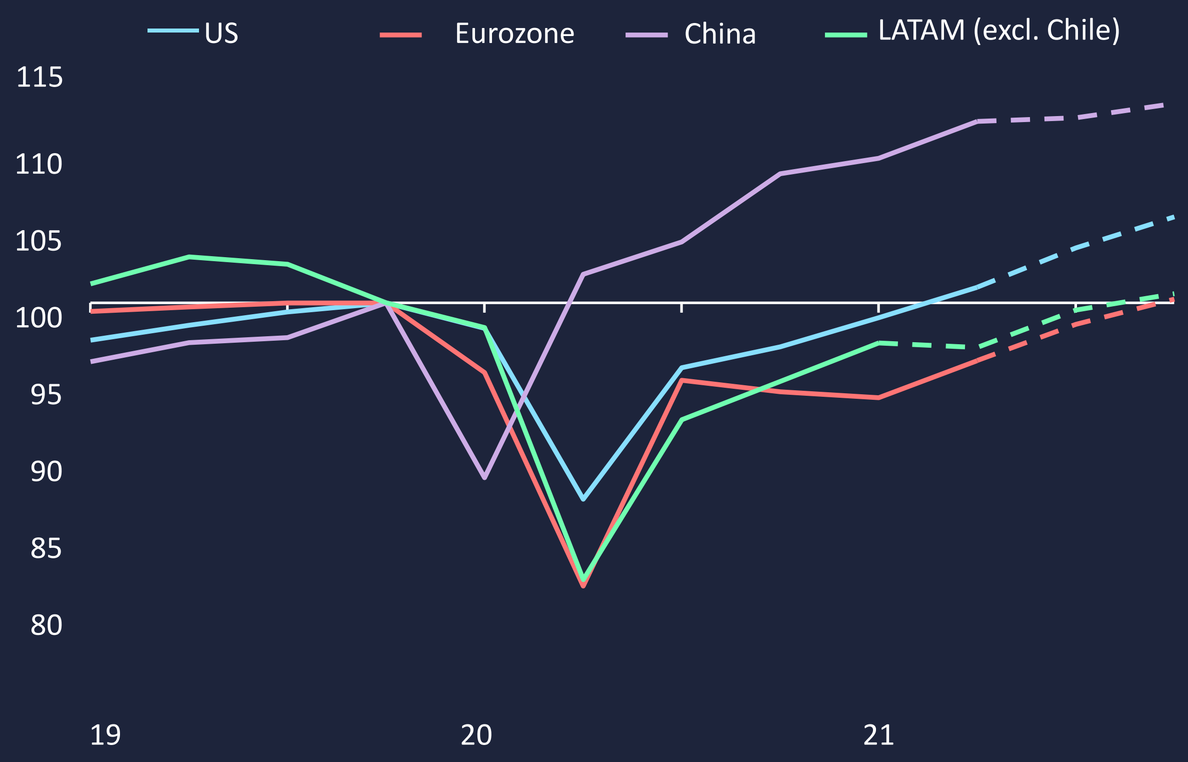
banco central Chile

Preview

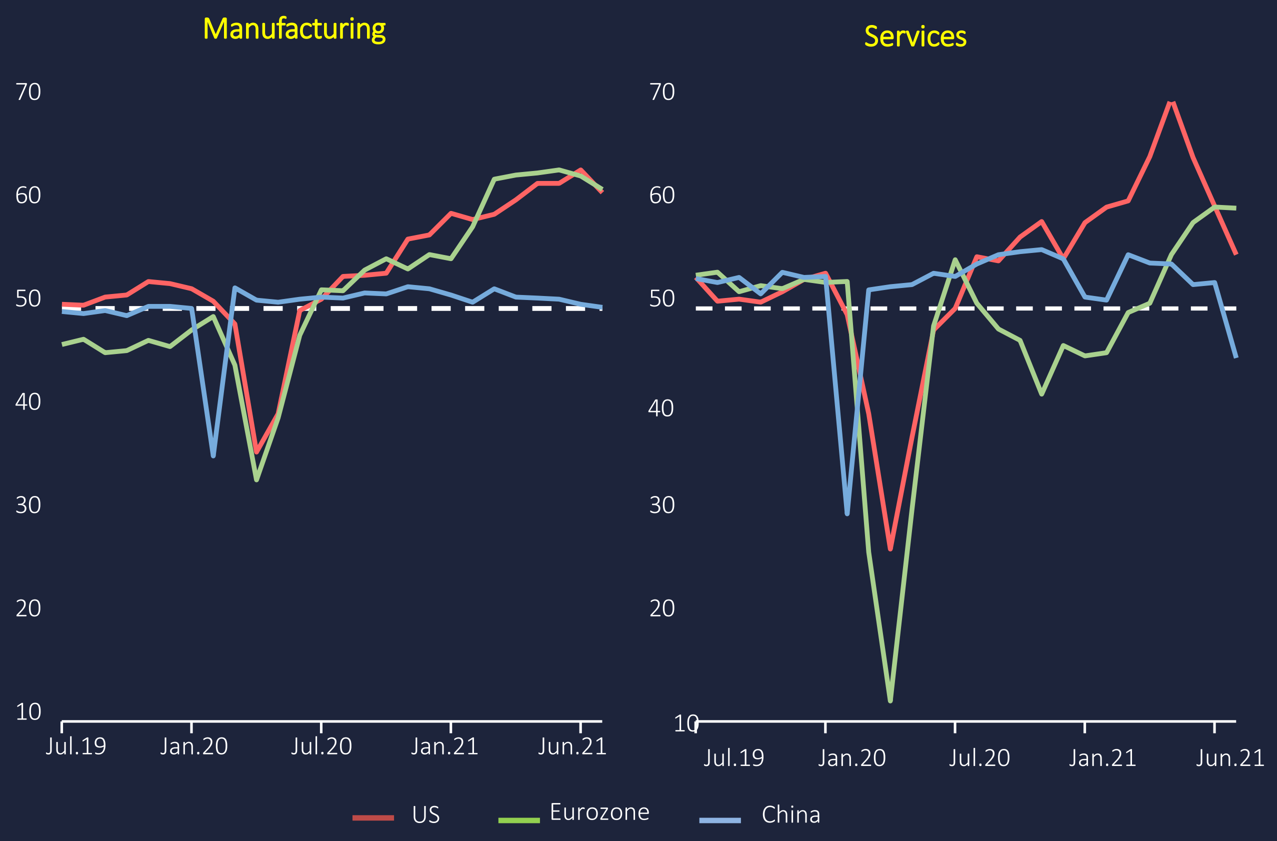
- The Chilean economy has seen a rapid recovery from the Covid-19 recession, which has far exceeded expectations. This has been possible thanks to the adaptability of companies and individuals and the great progress of the vaccination campaign.
- All this has been underpinned by the largest deployment of policy measures ever known in Chile in the face of an exogenous shock, as well as by an international environment marked by the simultaneous actions to contain the crisis.
- Yet the response of private spending to stimulus measures and the broadening of fiscal support has created potential imbalances that need to be prevented.
- The Central Bank has started to withdraw monetary policy stimulus to prevent a buildup of inflationary pressures. This process will continue until the monetary policy rate reaches its neutral level in the first half of 2022.
- Authorities have a unique opportunity to complete a remarkable closing of the Covid-19 crisis. Yet there are a number of risks to a soft landing, some of them policy related.

World activity has continued to recover, although at different pace. Stronger performance of services in the US and the Eurozone stand out. Expectations remain in positive territory.

Actual and projected quarterly GDP (1)
(index 2019.IV=100)



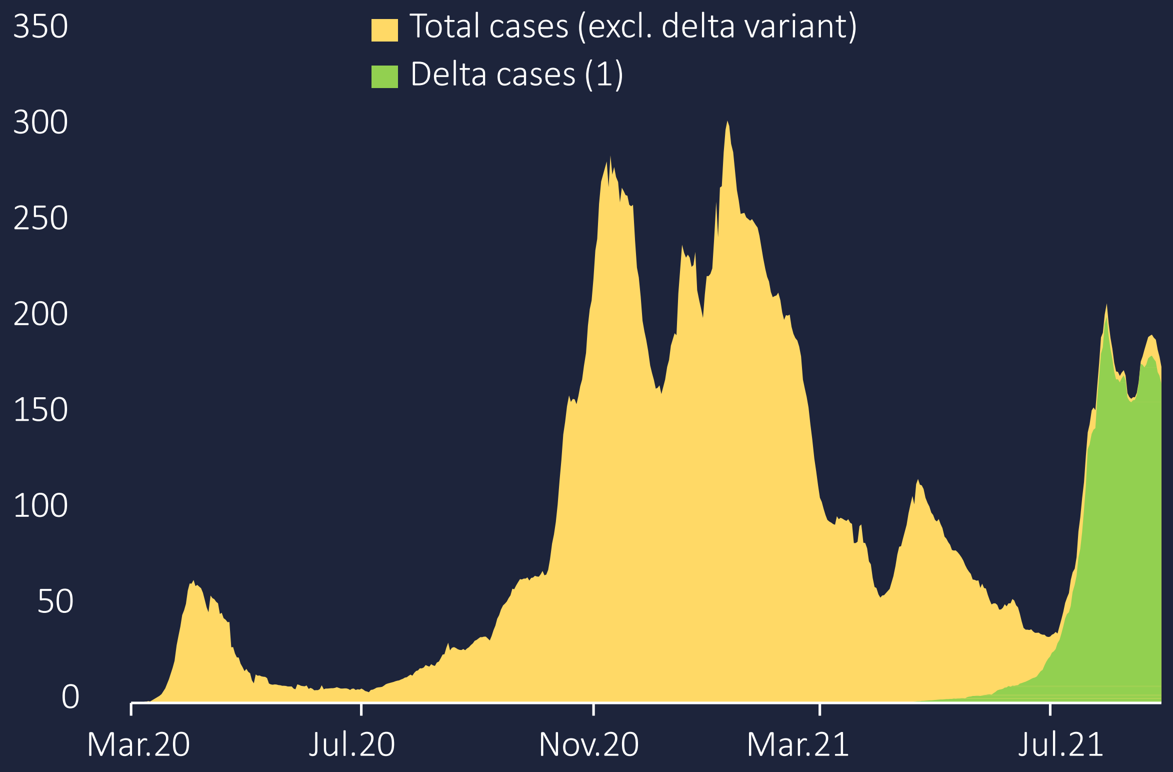
Business confidence (PMI) (2)
(diffusion index)



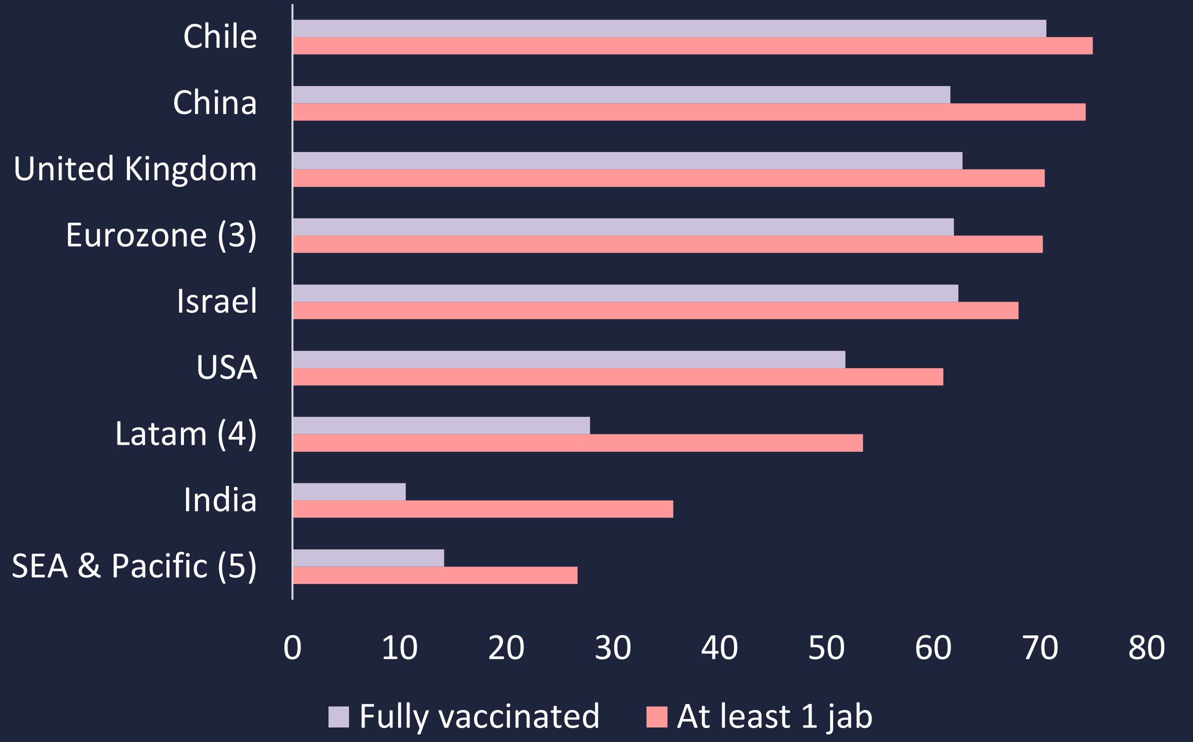
(1) Dashed lines show projections starting in 2021.III, with exception for Latin America, where they start in 2021.II. Sources: Central Bank of Chile based on a sample of investment banks, *Consensus Forecasts*, the IMF, and statistical offices in respective country. (2) Value below (above) 50 indicates pessimism (optimism). Source: Bloomberg.

However, the spread of the Covid-19 delta variant around the world, and the uneven progress of vaccination plans have induced caution.

New daily cases of Covid-19
(cases per million inhabitants)



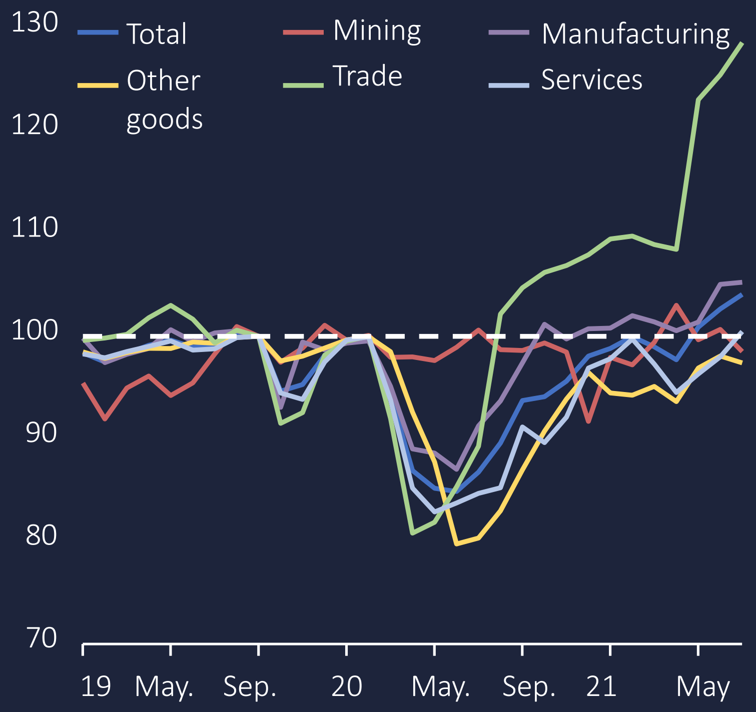
Vaccination progress (2)
(percent of population)



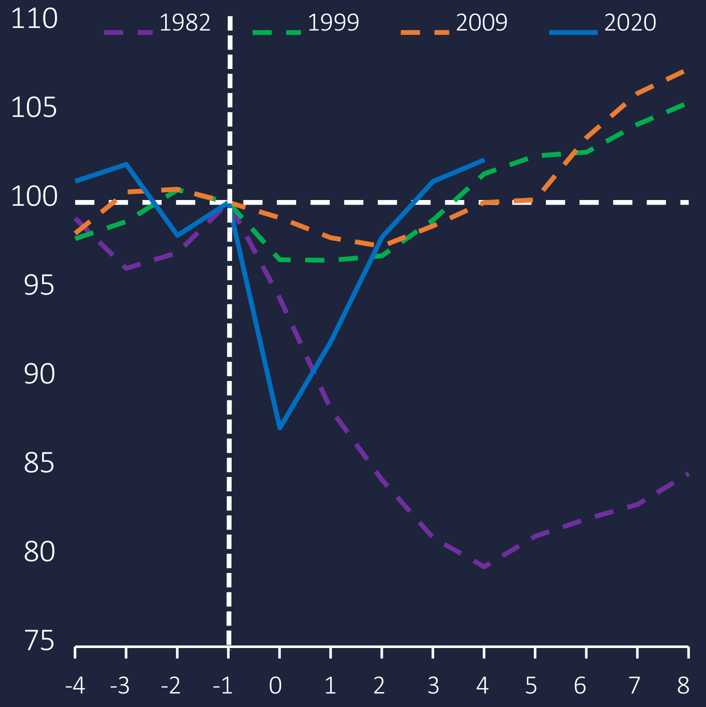
(1) Based on total new cases per day and the proportion of cases with delta variant found from Covid-19 genomic sequencing performed in each country. Corresponds to the median of a group of 14 countries selected by information availability (the US, the UK, Germany, France, Italy, Spain, the Netherlands, Portugal, Australia, India, Japan, Israel, South Africa and Indonesia). (2) Percent of population with at least one dose. Information as of 31/Aug/21. (3) Population-weighted average for Germany, Spain, France and Italy. (4) Population-weighted average for Argentina, Brazil, Colombia, Mexico, and Peru. (5) Population-weighted average for Malaysia, Philippines, Indonesia, Vietnam, Thailand, Australia and New Zealand. Sources: Central Bank of Chile based on *Our World in Data* information.

The Chilean economy has recovered its GDP level prior to the outbreak of the social crisis and the pandemic, at record speed compared to past recessions.

IMACEC by sectors (1)
(SA levels, Sep-2019=100)



Total GDP in crisis episodes (2)
(SA series, index period $t-1=100$)



GDP growth 2020 and 2021 (f) (3)
(annual change, percentage)

(1) Source: Central Bank of Chile. (2) Respective zero periods: 1981.IV, 1998.IV4, 2008.IV, 2020.II. Source: Central Bank of Chile. (3) Source: September 2021 *Monetary Policy Report*, Central Bank of Chile.

Preliminary evidence suggests that the greatest deployment of policy actions in the face of an exogenous shock has played a fundamental role.

Effects on GDP of measures adopted during the Covid-19 crisis
(percent change with respect to same period, previous year)

	2020	2021.H1
Conventional monetary policy (1)	[0.2 - 0.8]	[0.6 - 2,1]
Unconventional credit policies (2)	[2.2 - 4.8]	[2.7 - 4.4]
Fiscal policy	0.8	1.7
Total fiscal and monetary policy	**[3.2 - 6.4]**	**[5.0 - 8.2]**
Pension fund withdrawals	1.2	2.9
Total	**[4.4 - 7.6]**	**[7.9 - 11,1]**
Actual GDP	-5.8	8.7
Counterfactual GDP	**[-10.2 / -13.4]**	**[0.8 / -2.4]**

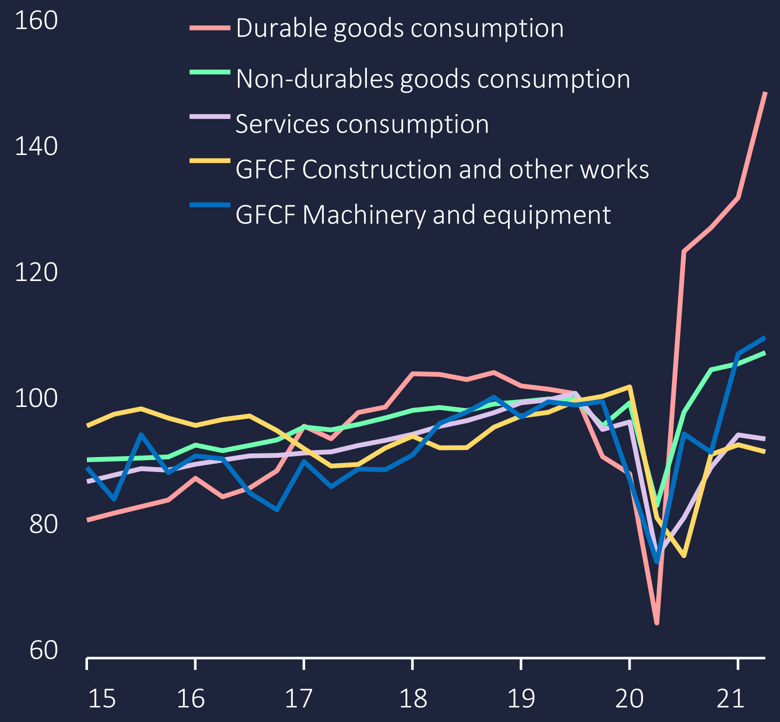
(1) Conventional monetary policy is MPR related. (2) Figures encompass monetary and sovereign guarantee policies that sought to stabilize financial markets, including the FCIC-Fogape program, bond purchases, and domestic- and foreign-currency liquidity programs. Source: Central Bank of Chile.

- Without domestic policy action, GPD contraction in 2020 would have more than doubled the actual figure
- Credit policies made the largest contribution to limit the impact of the crisis
- The impact of fiscal policy was far larger in 2021H1 tan in 2020
- Pension fund withdrawals contributed to boost demand and output, yet at a considerably larger cost
- External financial conditions, marked by an unprecedented policy response increased the impact and sustainability of local policies
- External and domestic policy responses jointly contributed to avoid the epidemic and economic crisis turning into a financial crisis
- Negative spillovers into the financial sector would have made the crisis far deeper and longer

The various stimulus measures have boosted demand and driven private consumption well above expectations.

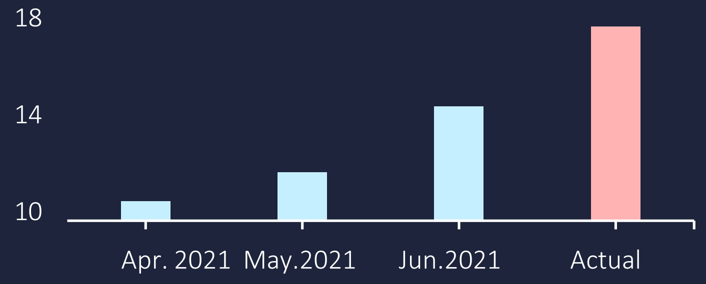
Domestic demand

(SA series; index, 2019 average=100)



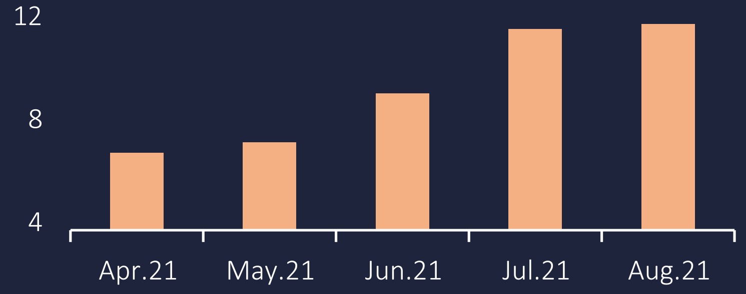
GDP 2021.II: actual vs market projection (1)

(annual change, percent)



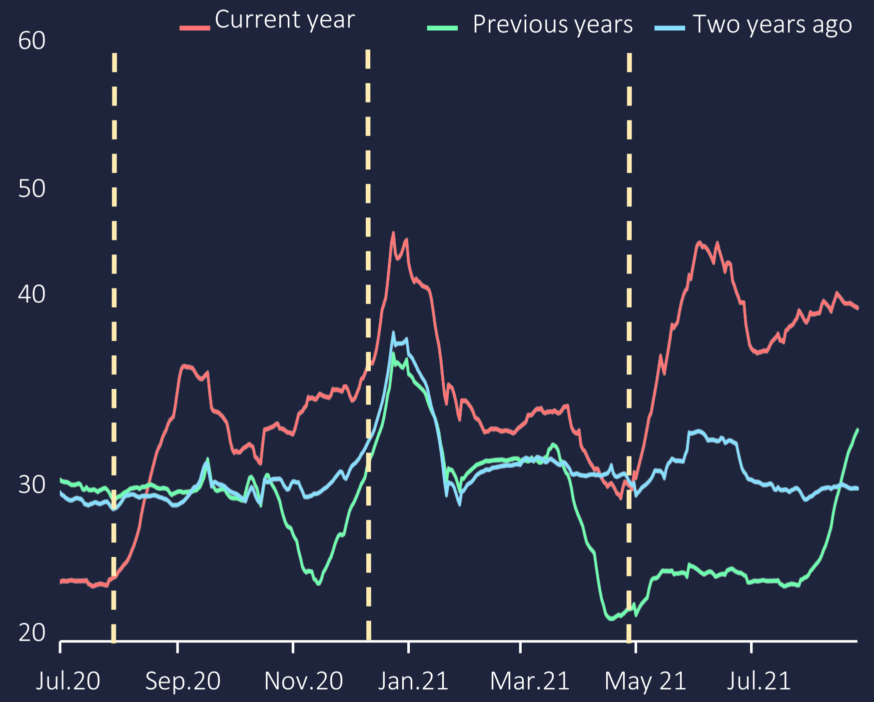
Private consumption 2021: market projection (1)

(annual change, percent)



Retail sales with digital invoicing (2)

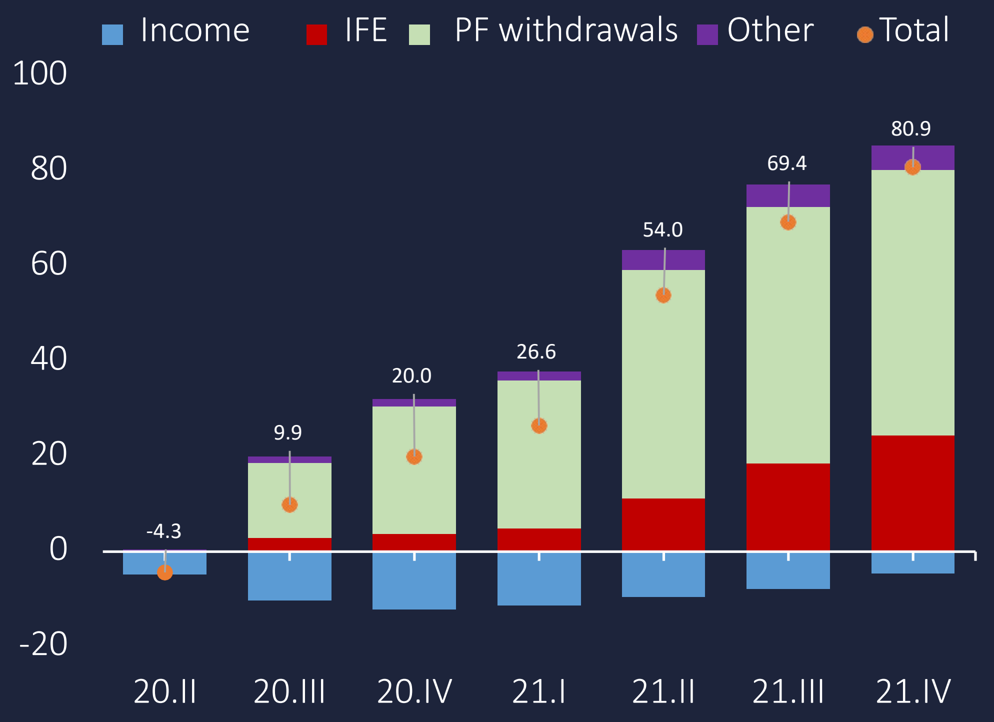
(billions of CLP, 28-day moving average)



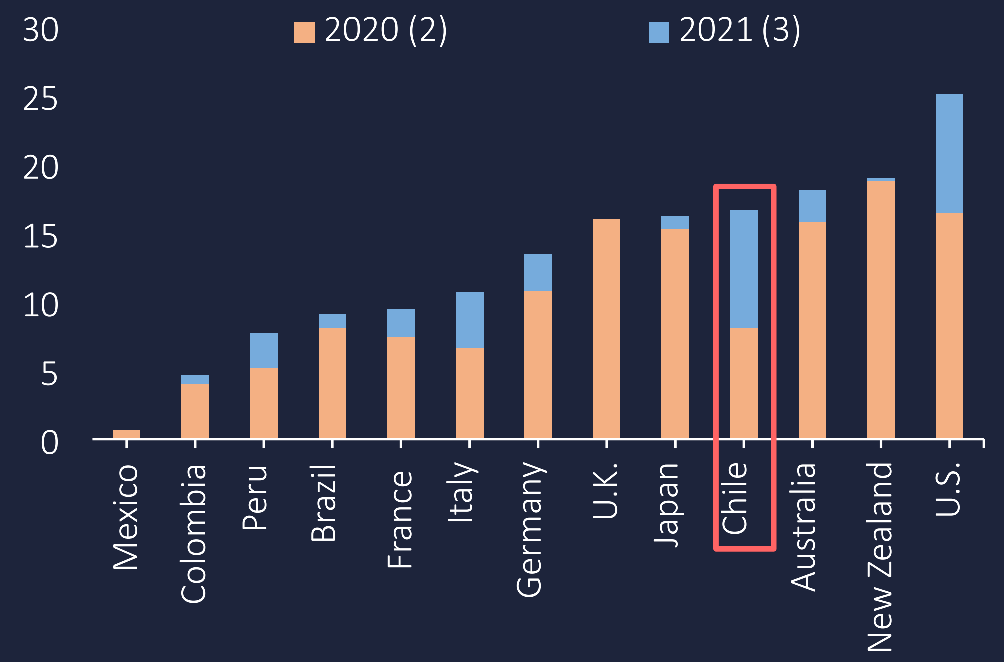
(1) Projections contained in Economic Expectations Survey. Source: Central Bank of Chile. (2) Dotted lines show projections of each *Monetary Policy Report*. The June and September projections use the structural parameters updated in the June 2021 *Monetary Policy Report*. Source: Central Bank of Chile.

The accumulation of massive pension savings withdrawals and fiscal transfers have significantly increased household liquidity, which should continue fueling consumption.

Households' cumulative income and liquidity injections (1)
(billions of dollars)



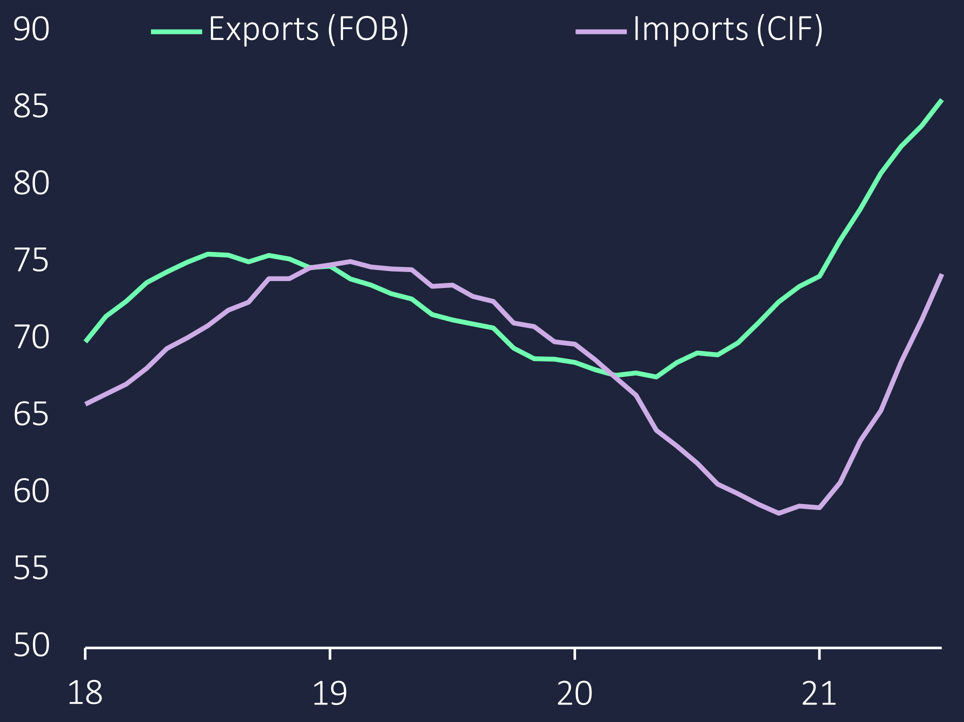
Expenditures or revenues foregone by governments in response to Covid-19
(percent of 2020 GDP)



(1) For details on the methodology, see Chapter III in the September 2021 *Monetary Policy Report*. (2) Corresponds to IMF's *Fiscal Monitor* data for January 2021. (3) Difference between July and January 2021 delivery. Chile considers an additional 2.8% for IFE. Sources: International Monetary Fund, Chile's Ministry of Finance, Superintendence of Pensions, and Central Bank of Chile.

Domestic demand boosted imports, turning the Current Account into a deficit. Once again, mining exports stood out, favored by copper prices.

Exports and imports (*)
(billions of USD, 12-month accumulation)



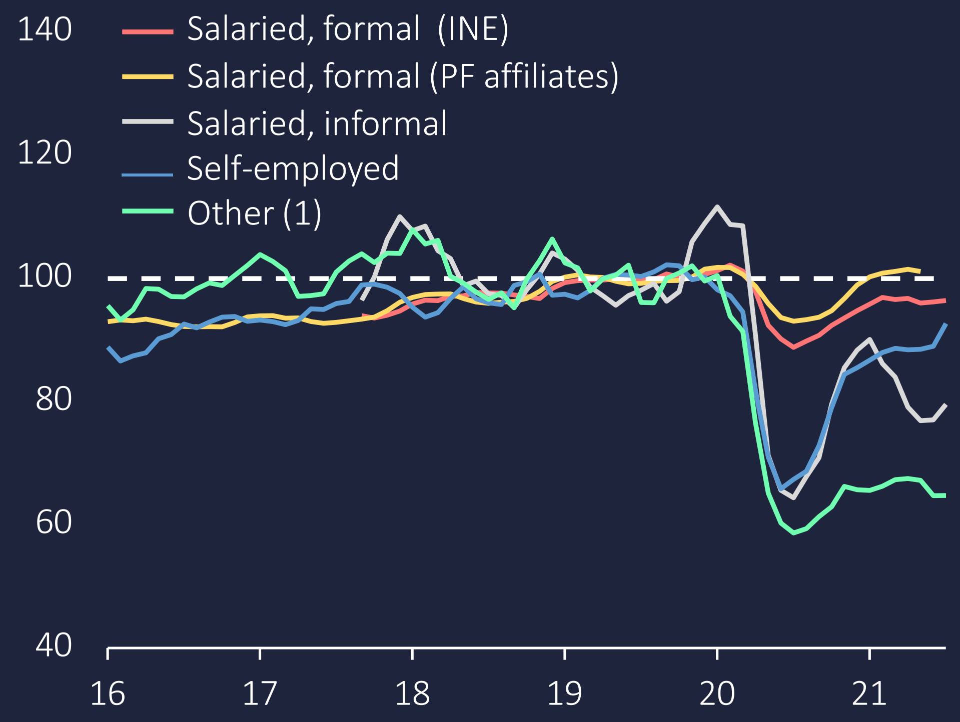
Terms of trade (*)
(level; 2013=100)

(f) = Forecast. (*) Source: Central Bank of Chile.

Contract employment has recovered almost to pre-crisis levels. Self-employment, service sectors and female employment are lagging behind, partly due to supply-side factors.

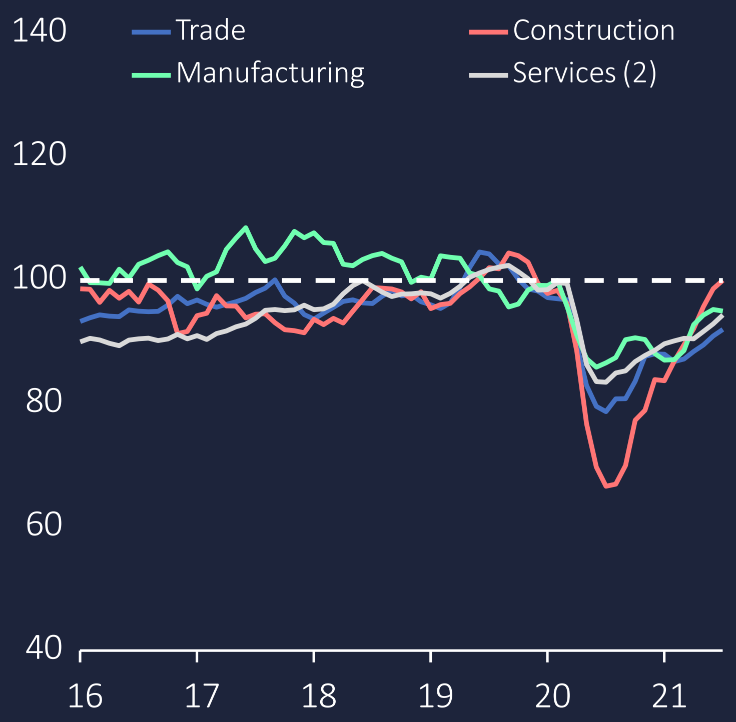
Formal salaried employment

(index, 2019 average=100)



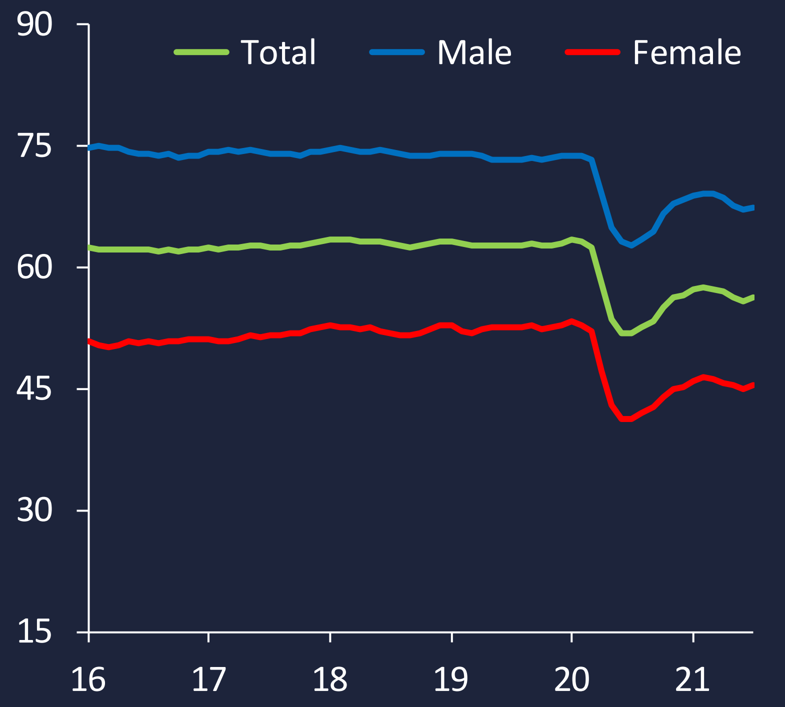
Employment by sectors

(SA series, index, 2019=100)



Participation rate by gender

(percentage)

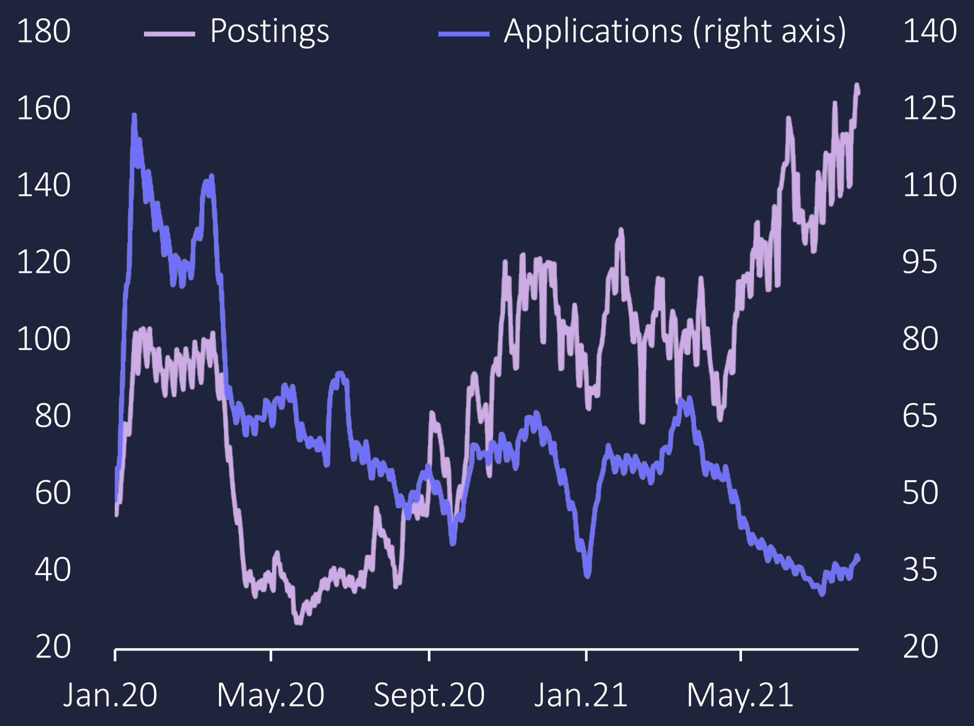


(1) Corresponds to the sum of household help, employers and non-remunerated household work. (2) Corresponds to the sum of lodging and food service activities, community services, financial services and transportation. Sources: Central Bank of Chile, National Statistics Institute, and Superintendency of Pensions.

There is evidence of labor shortages and mismatches that may pressure salaries and delay a complete adjustment in the labor market.

Job postings and applications on the Internet (*)

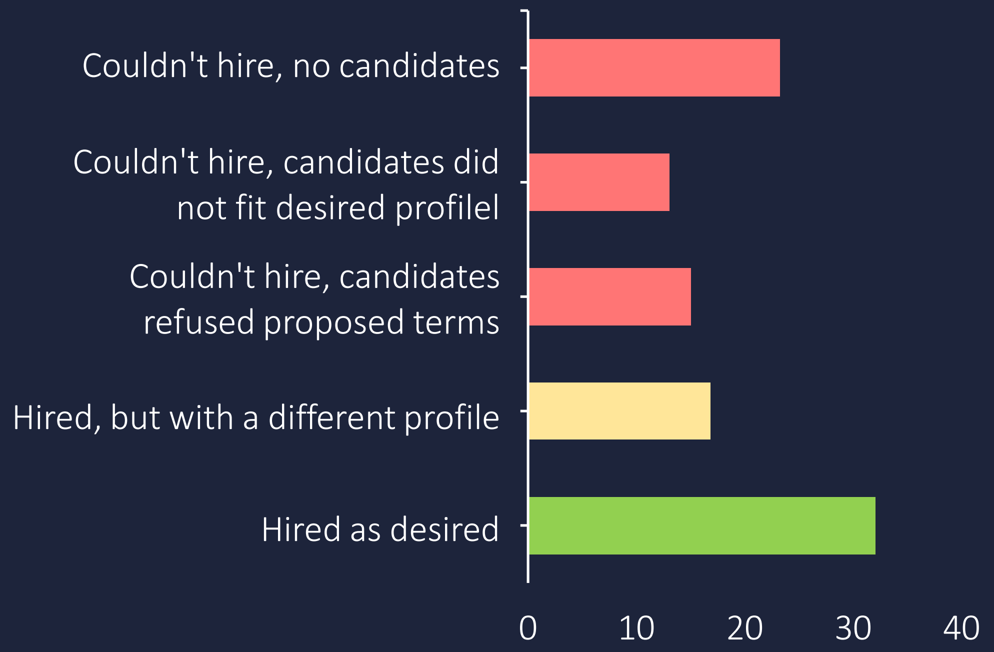
(index, base 03/Mar/20=100, 15-day moving average)



August *Business Perceptions Report*:

Among firms wanting to hire, what happened with labor search?

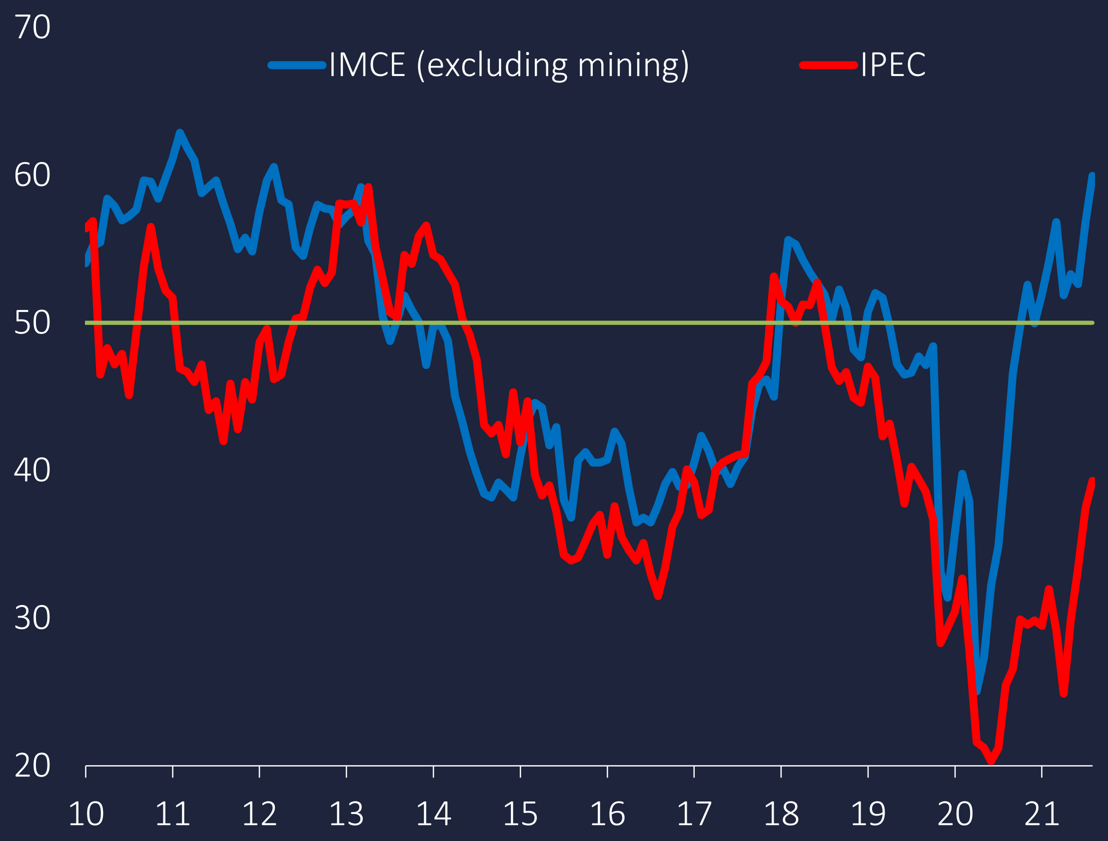
(percent of total respondents saying they had searched for labor in 2021)



(*) Sources: Central Bank of Chile and SABE Project of SENCE Labor Observatory and ISCI-WIC, University of Chile, based on websites trabajando.com and laborum.com.

Economic and health developments have driven expectations up, but uncertainty remains above normal times.

Consumer and businesses expectations (1)
(diffusion index)



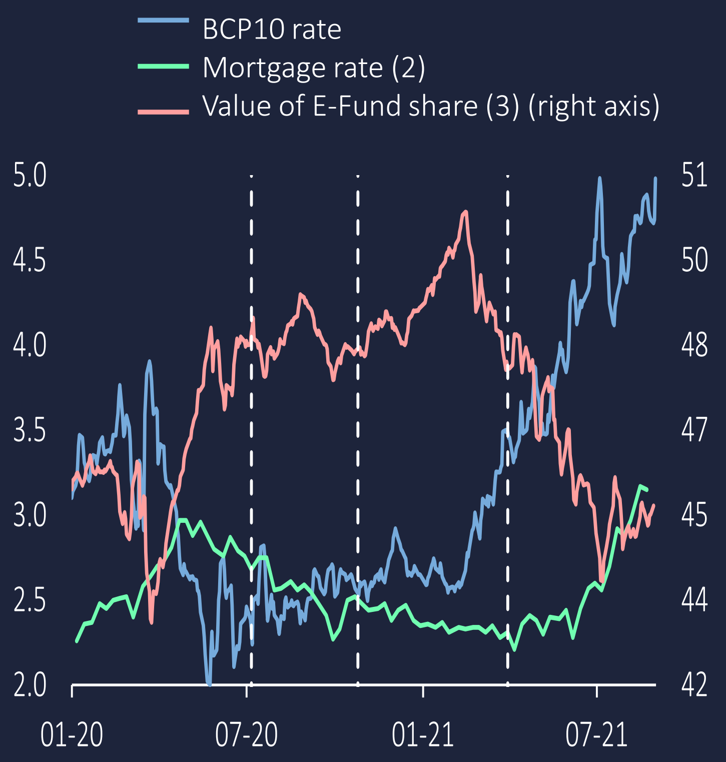
Daily index of economic and political uncertainty (DEPUC) (2)
(index, 01/Jan/12=100)

(1) Value below (above) 50 indicates pessimism (optimism). Source: UAI/ICARE and GfK/Adimark. (2) 30-day moving average. Source: Becerra and Sagner (2020).

The liquidation of long-term savings linked to the successive and massive withdrawals of pension funds, coupled with the deterioration of the fiscal accounts, have led to an adverse evolution of local financial variables. In this context, the CLP weakened the most in recent months.

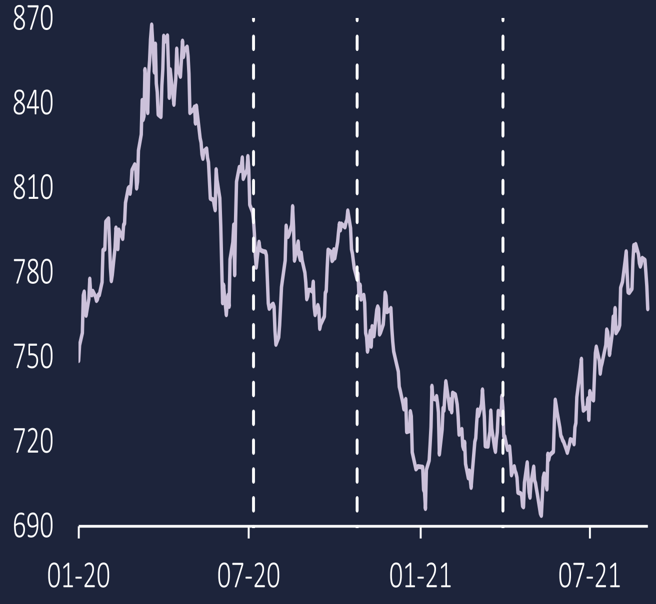
Interest rates and value of E-Fund share (1)

(percent; thousands of CLP)



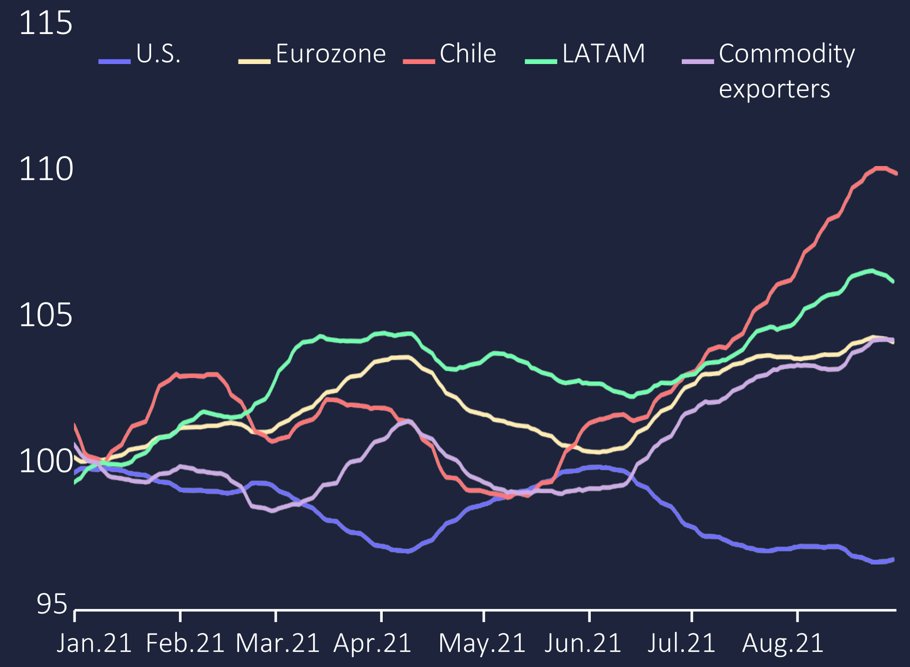
Nominal foreign exchange rate (1)

(CLP/USD)



Currencies (4)(5)

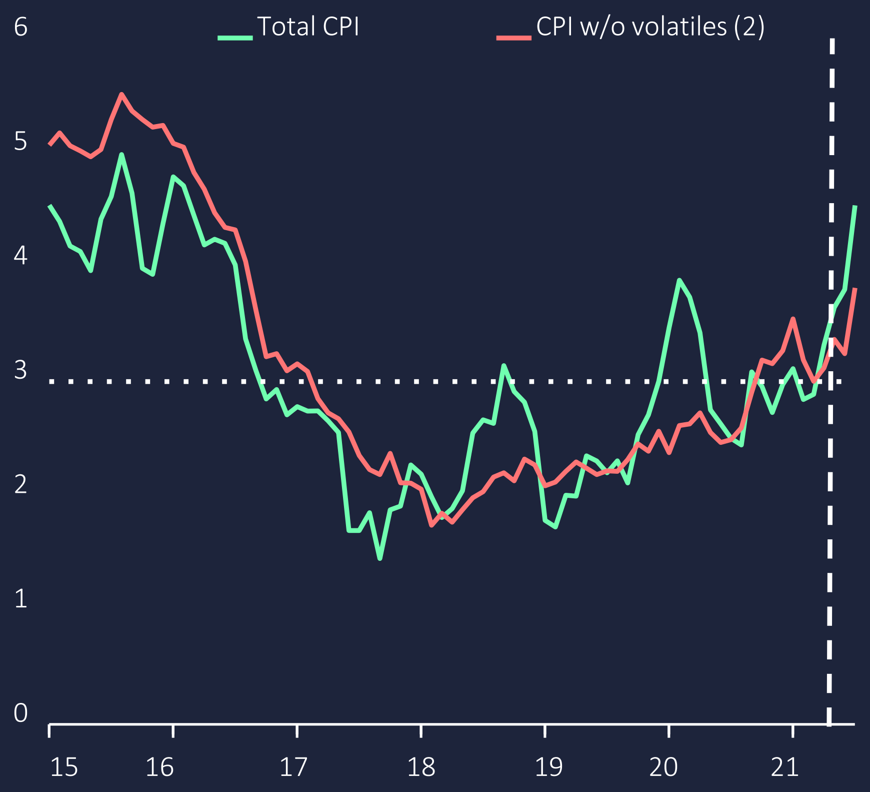
(index, 4/Jan/21=100)



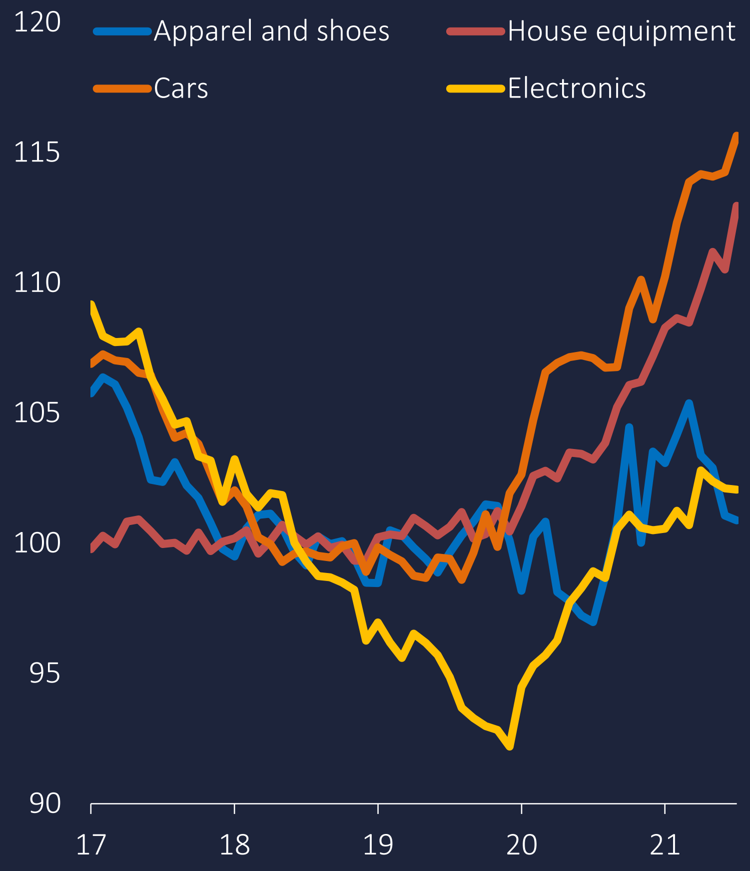
(1) Vertical lines indicate the beginning of the discussion in the House (approval of the idea to legislate) of the three Pension Fund withdrawals. (2) Weekly data. (3) Weighted average of the Pension Funds quota value according to respective asset values. Sources: Central Bank of Chile and Superintendency of Pensions. (4) 15-day moving average of respective indexes. (5) Latin America considers simple average between the indexes of Brazil, Colombia, Mexico, and Peru. Commodity exporters consider simple average between Australia and New Zealand. Sources: Central Bank of Chile and Bloomberg.

Headline and core inflation have been growing, led by fuels and categories most affected by growing demand.

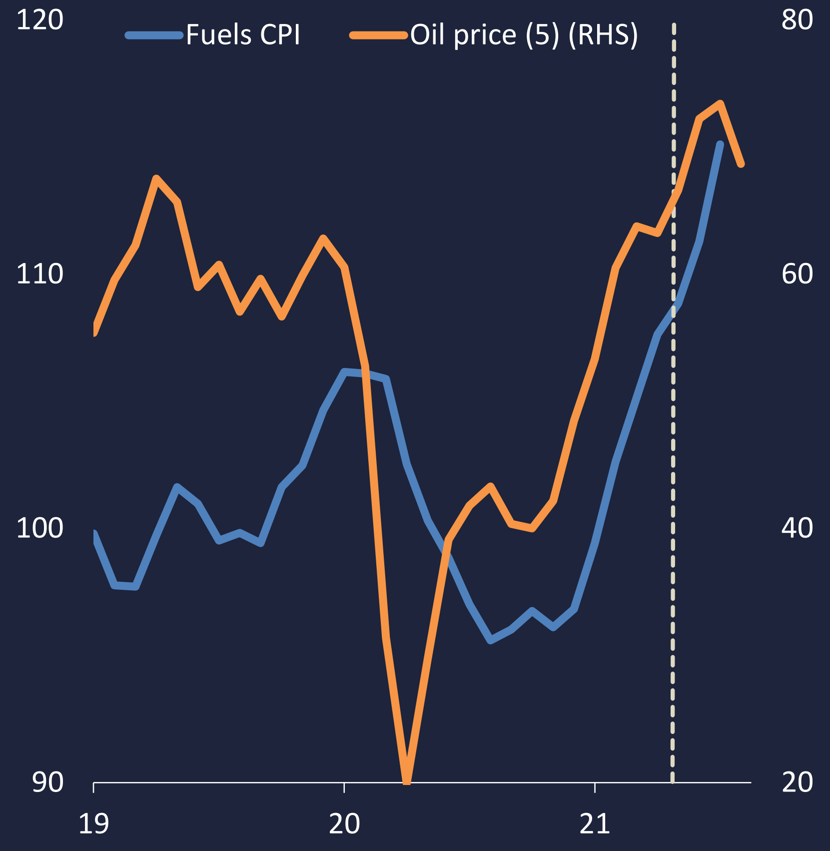
Headline and core inflation (1)
(annual change, percent)



Items affected by higher demand (3)
(index, base 2018=100)



CPI of fuels and oil price (4)
(index, base 2018=100; USD per barrel)

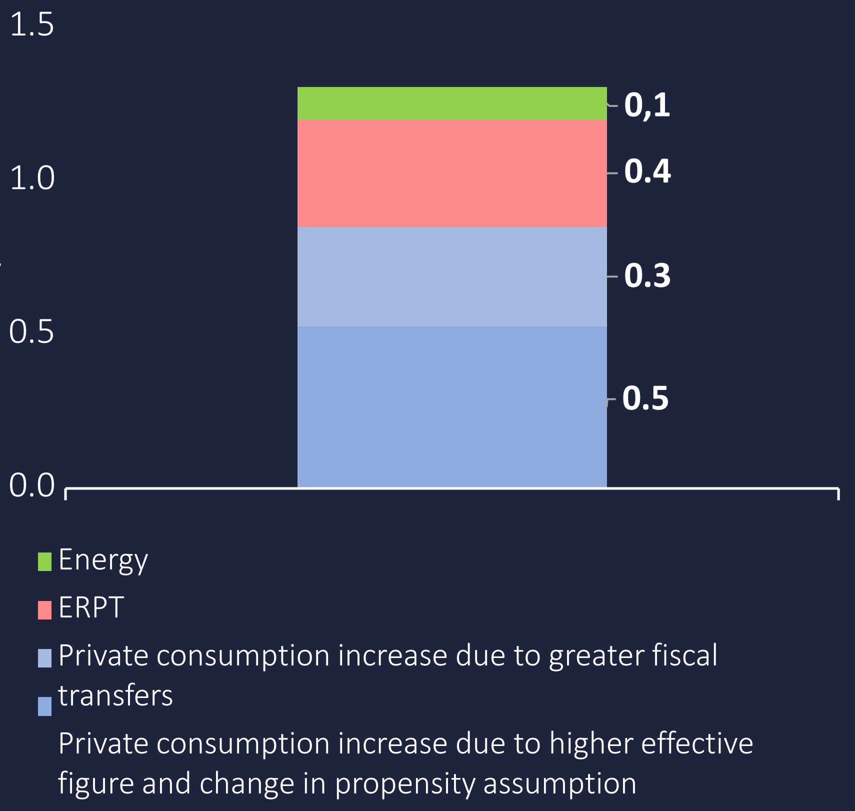


(1) Dashed vertical line indicates statistical cut-off of June 2021 *Monetary Policy Report*. (2) CPI without volatility has 65.1% share in total CPI basket. For more details, see Box IV.1 in December 2019 *Monetary Policy Report*. (3) It shows the evolution of the CPI price indices of the selected groupings of goods. (4) Dashed vertical line indicates statistical cut-off of June 2021 *Monetary Policy Report*. (5) Average price between Brent and WTI oil barrels. Sources: Central Bank of Chile, Bloomberg, and National Statistics Institute.

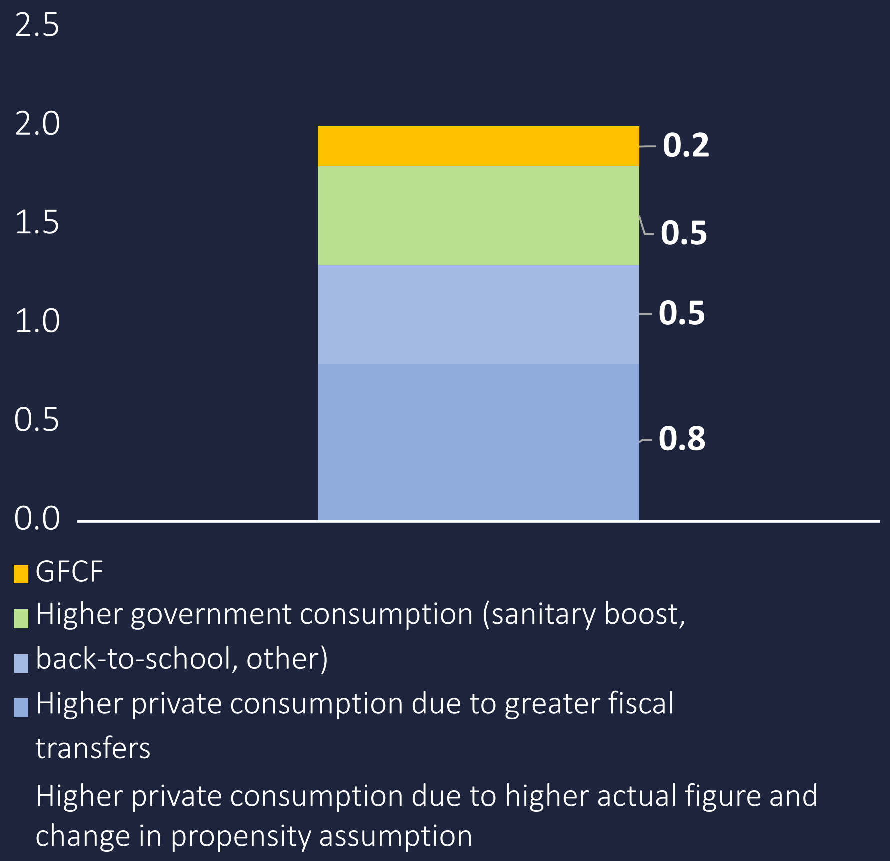
Increase in demand due to a higher propensity to consume and extended fiscal transfers explain most of the upward correction in 2021 growth and inflation estimates. This is turning the large negative output gap into a substantial positive gap.

Activity gap (1)
(level, percentage points)

Contribution to revision to inflation forecast in December 2021 (2)
(percentage points)



Contribution to revision to 2021 GDP growth (3)
(percentage points)

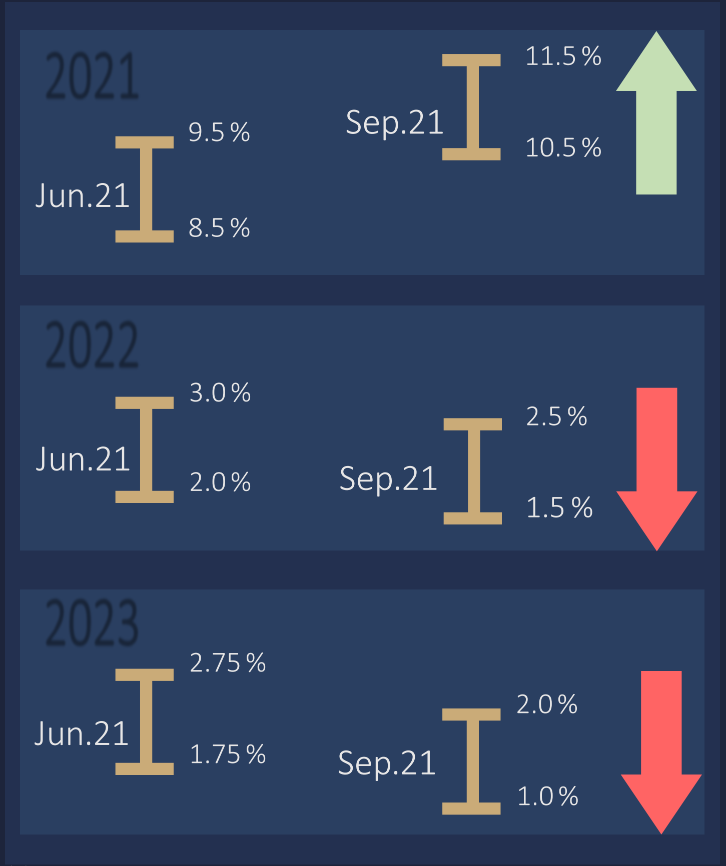


(1) Dotted lines show projections of each *Monetary Policy Report*. The June and September projections use the structural parameters updated in the June 2021 *Monetary Policy Report*. Source: Central Bank of Chile. (2) Built using the projections for total CPI inflation from the *Monetary Policy Reports* of June and September 2021. Sources: Central Bank of Chile and National Statistics Institute. (3) Built considering the midpoint of the *Monetary Policy Report* forecast range of June and September 2021.

Towards 2022 and 2023 the economy will slow down significantly. Consumption should moderate, in line with receding pandemic impacts and reduced economic policy momentum. Investment recovery is still expected to be sluggish, due idiosyncratic headwinds.

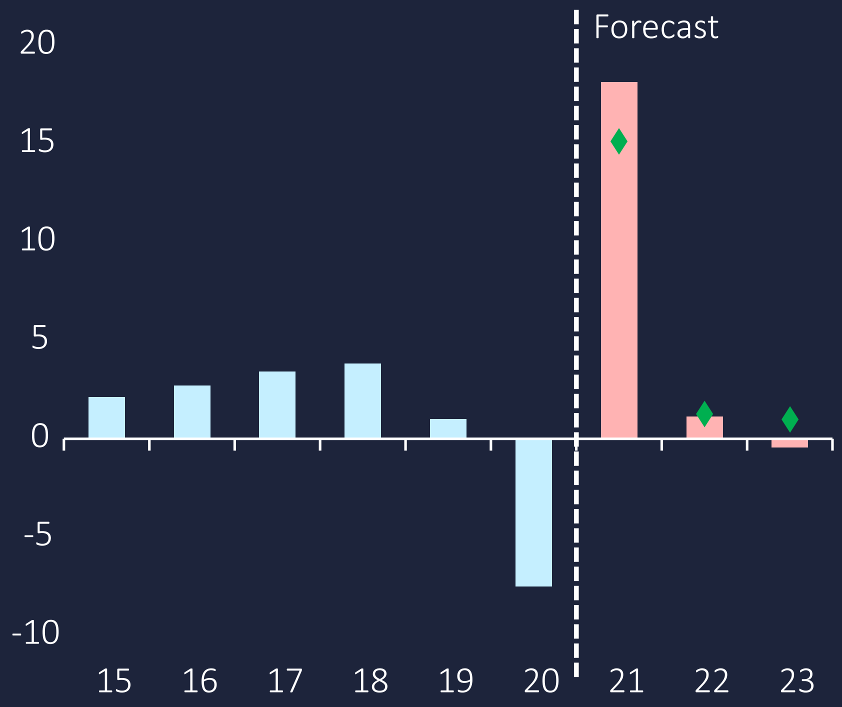
GDP growth forecast

(annual change, percent)



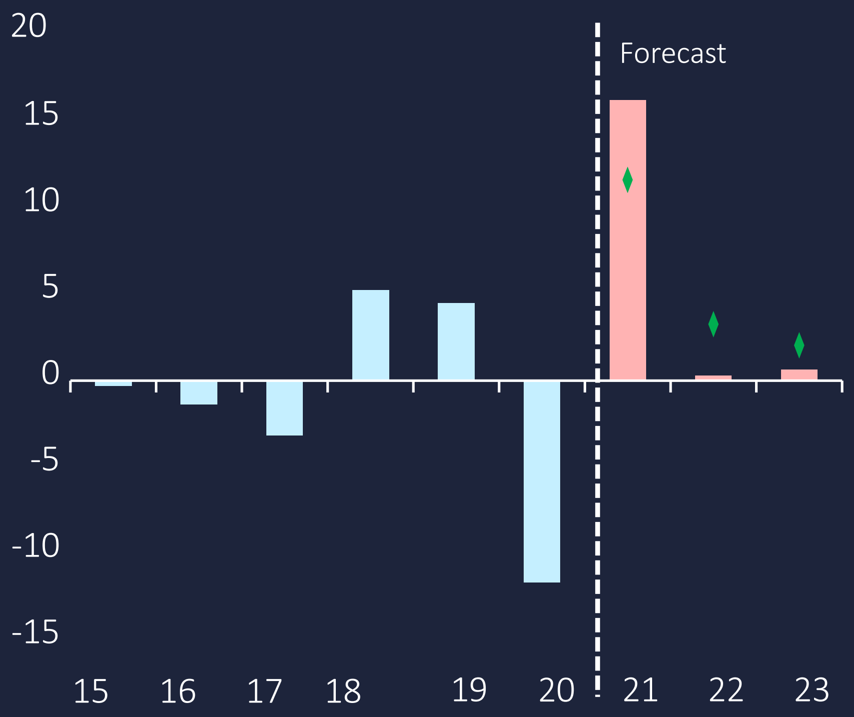
Private consumption (2)

(real annual change, percent)



Gross fixed capital formation (2)

(real annual change, percent)

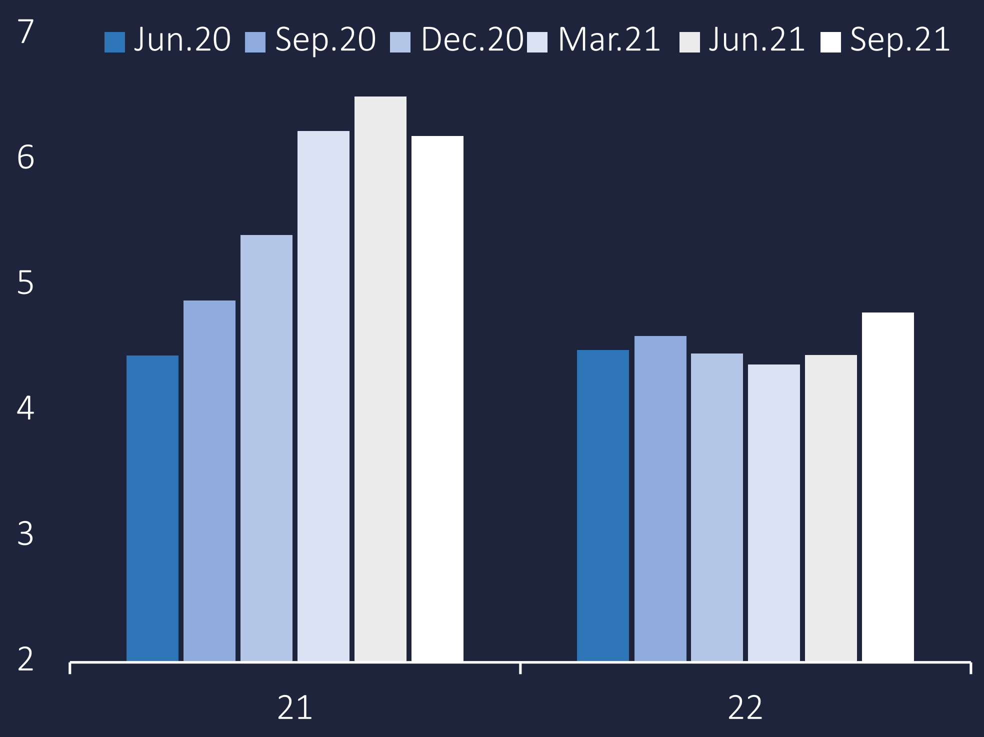


(f) Forecast. Considers midpoint of growth ranges contained in *Monetary Policy Reports* of June and September 2021. Source: Central Bank of Chile. (2) Diamonds indicate forecast in June 2021 *Monetary Policy Report*. Source: Central Bank of Chile.

The impulse that the Chilean economy will receive from abroad is virtually unchanged from June.

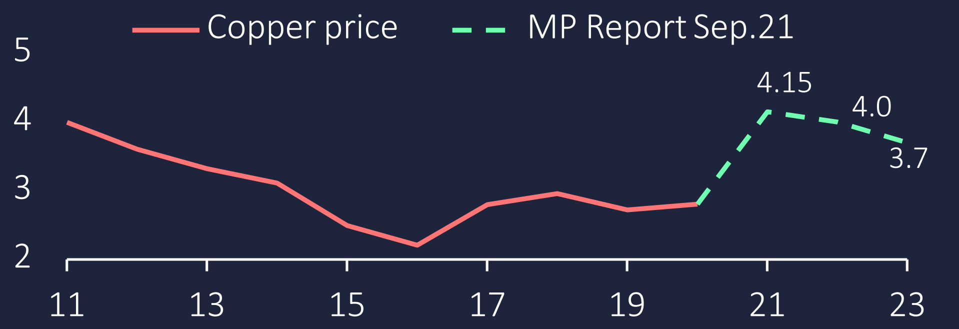
World growth forecast

(annual change, percent)



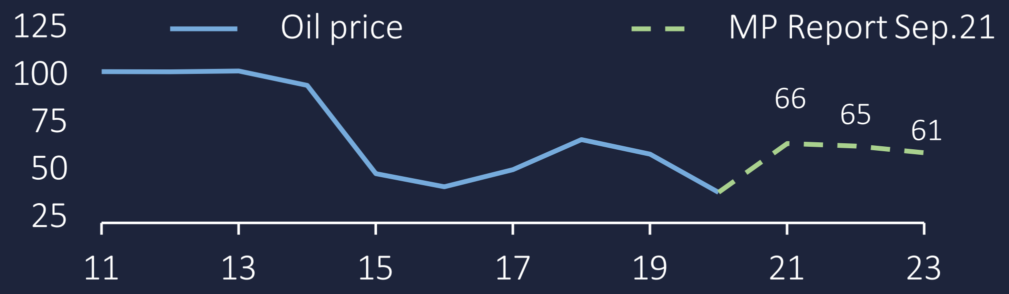
Actual and projected copper price (1)

(USD per pound)



Actual and projected oil price (1)(2)

(dollars per barrel)

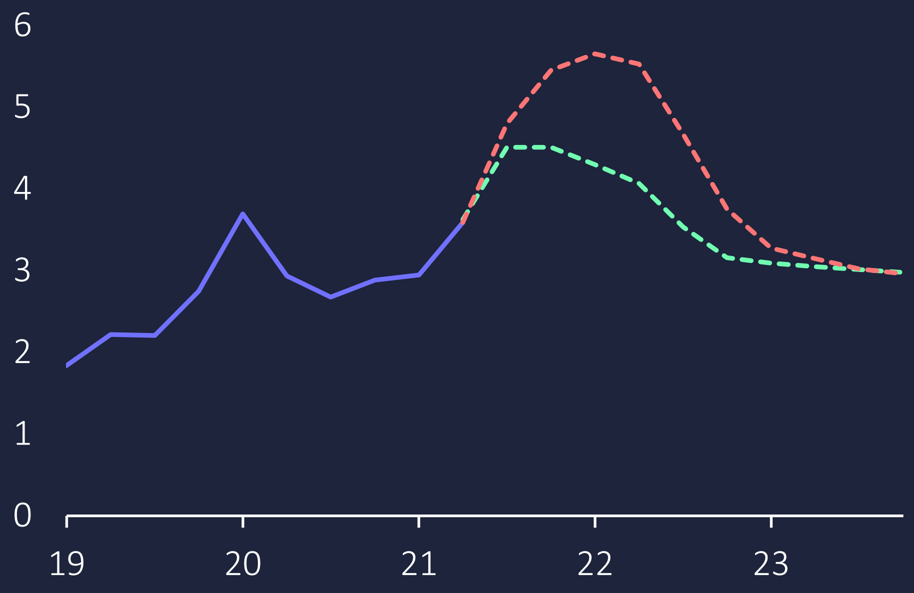


(1) Effective prices are the average for each year. Dotted line indicates 2021-2023 projections contained in the *Monetary Policy Report* of September 2021. (2) Average price between WTI and Brent oil. Sources: Central Bank of Chile and Bloomberg.

Annual inflation will end this year at 5.7% and will be above 5% during 2022H1. Core CPI will peak above 5% around mid-2022.

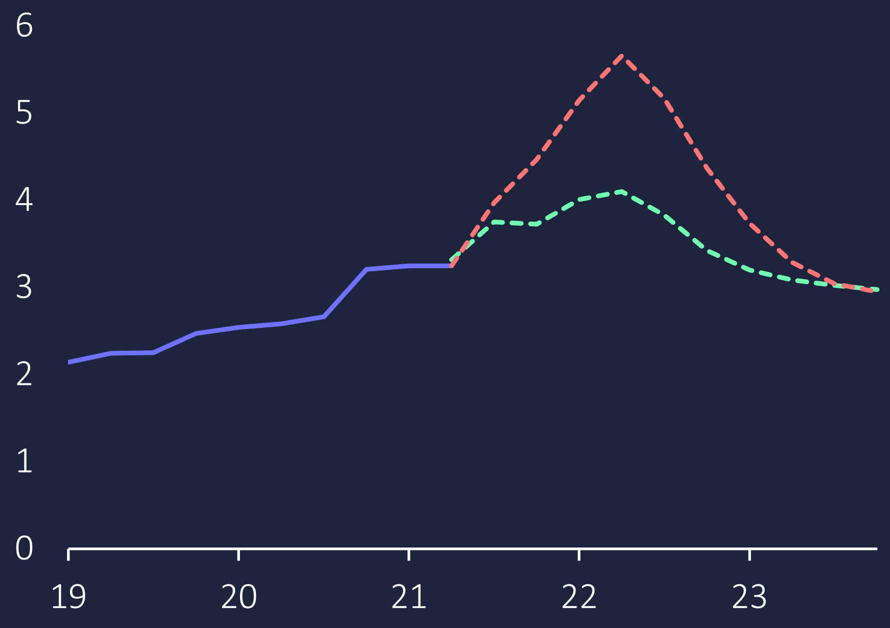
Inflation forecasts: Headline CPI

(annual change, percent)



Inflation forecasts: Core CPI

(annual change, percent)



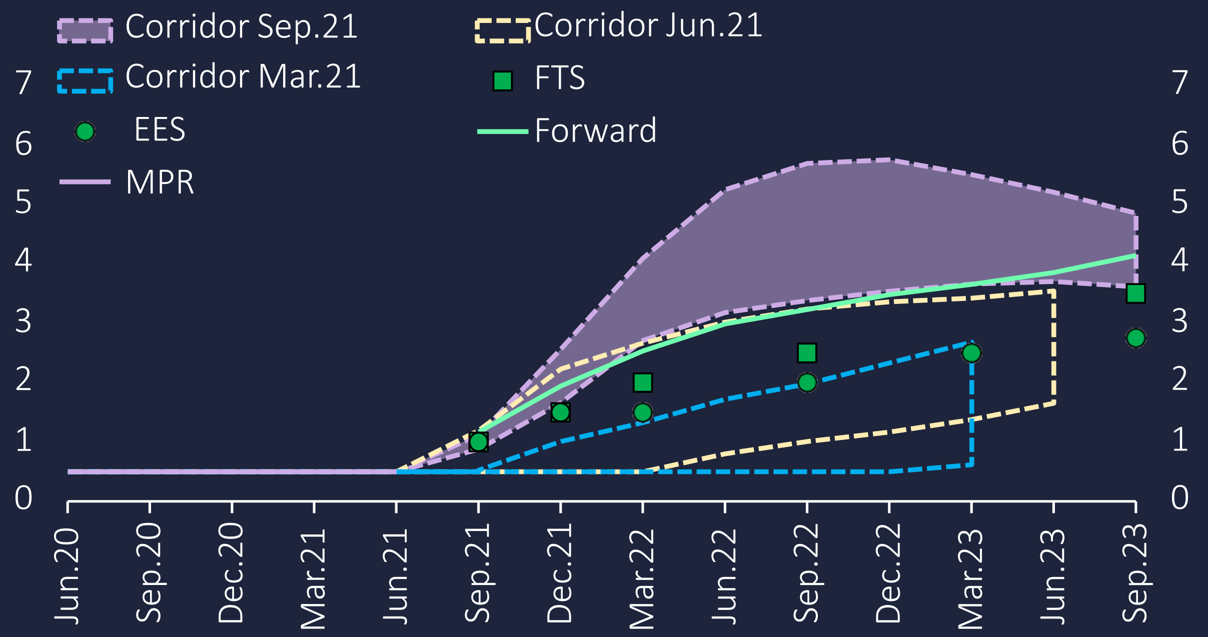
Effective MP Report Jun.21 MP Report Sep.21

(1) Dashed lines indicate forecast in respective *Monetary Policy Report*. (2) Measured by CPI without volatiles. Sources: Central Bank of Chile and National Statistics Institute.

The CBC Board raised the MPR by 75 basis points in its Aug meeting and, in the baseline scenario, believes it will need to reach its neutral level in the first half of 2022.

MPR corridor (*)

(percent)



The CBC Board decided to intensify the withdrawal of monetary stimulus to avoid the accumulation of macroeconomic imbalances that could jeopardize the convergence of inflation to the 3% target.

This is so because a scenario has emerged in which the CBC Board has less room for maneuver, as a result of:

1. Rapid evolution of macroeconomic scenario
2. Inflation expectations dynamics
3. Sensitivity scenarios associated with higher pressures on prices

(*) The corridor is built following the methodology of Box V.1 of the March 2020 *Monetary Policy Report*. It includes the FTS of August 26, the EES of August 10 and the quarter's mean smoothed forward curve (statistical cutoff). The methodology corresponds to the extraction of the implicit MPR considering the forward curve on the interest rate swap curve up to 2 years, discounting the fixed rates for each term at the simple accrual of the CPI. Source: Central Bank of Chile.

There are sensitivity scenarios that may require monetary policy action somewhat different from that envisioned in the central scenario

Sensitivity scenarios

Scenario 1: Possible reasons

Less Dynamic consumption because of:

- Pandemic resurgence
- Current dynamism could be due to anticipated demand
- Reduction in domestic uncertainty

Implications:

- Reduced inflationary pressures

More gradual contraction of monetary stimulus

Scenario 2: Possible reasons

Slower reduction in public spending:

- Higher inflation in developed economies
- Greater than expected consumption

Implications:

Higher inflationary pressures

Amplified impacts on local financial market

More vigorous monetary policy response

Risk scenarios: changes in the economy that would require a policy response beyond the limits of the MPR corridor

1: Lack of clarity about the long-term stabilization of public finances

- Increased spending pressures and amplified impacts on the local financial market,
- Implies a more accelerated increase in the MPR, despite which inflation does not converge to the target over the policy horizon.

2: Approval of new pension fund withdrawals

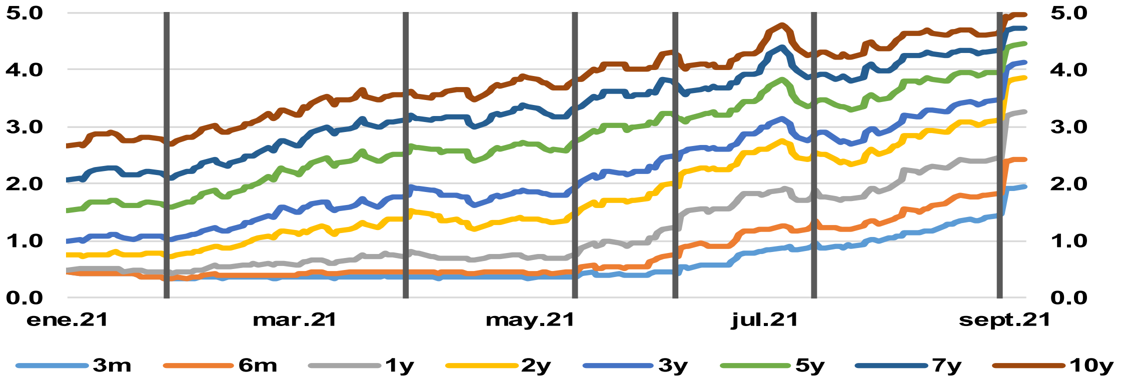
- More dynamic consumption and greater pressure on prices,
- Even greater impact on the financial system, increasing the cost of indebtedness, capital outflows and strong accumulation of funds in USD,
- The probability of its materialization could already be affecting the behavior of economic agents.

No central bank has the powers, instruments, or resources to neutralize these risks and restore macroeconomic equilibrium.

Market response: Interest rates, inflation expectations, and the foreign exchange rate strongly reacted to the August *Monetary Policy Meeting* and the *Monetary Policy Report.*

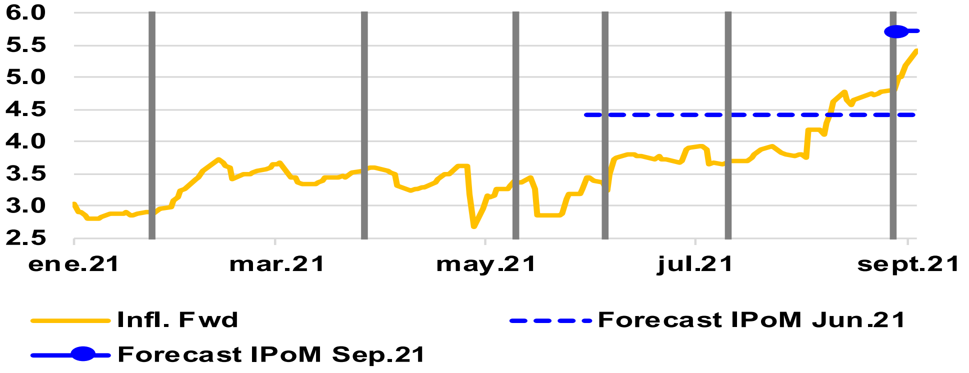
Nominal SPC zero rates (1)

(percent, daily data)



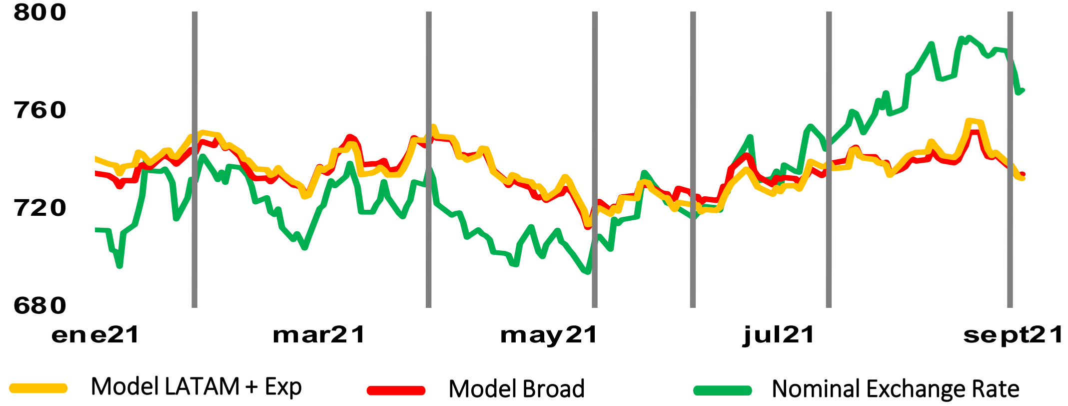
Inflation forward to December 2021 (3)

(annual growth rate, percent)



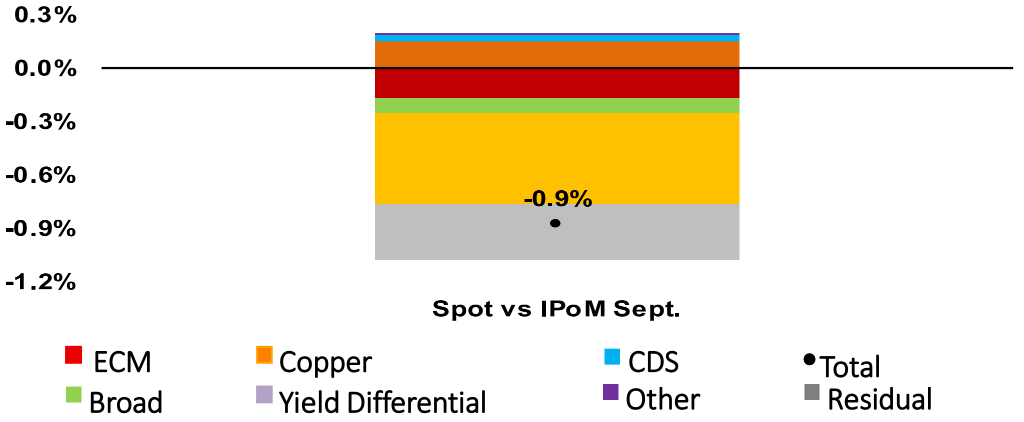
Nominal foreign exchange rate (1) (2)

(CLP/USD, daily data)



Change from an event (LATAM + Comm. exp.)

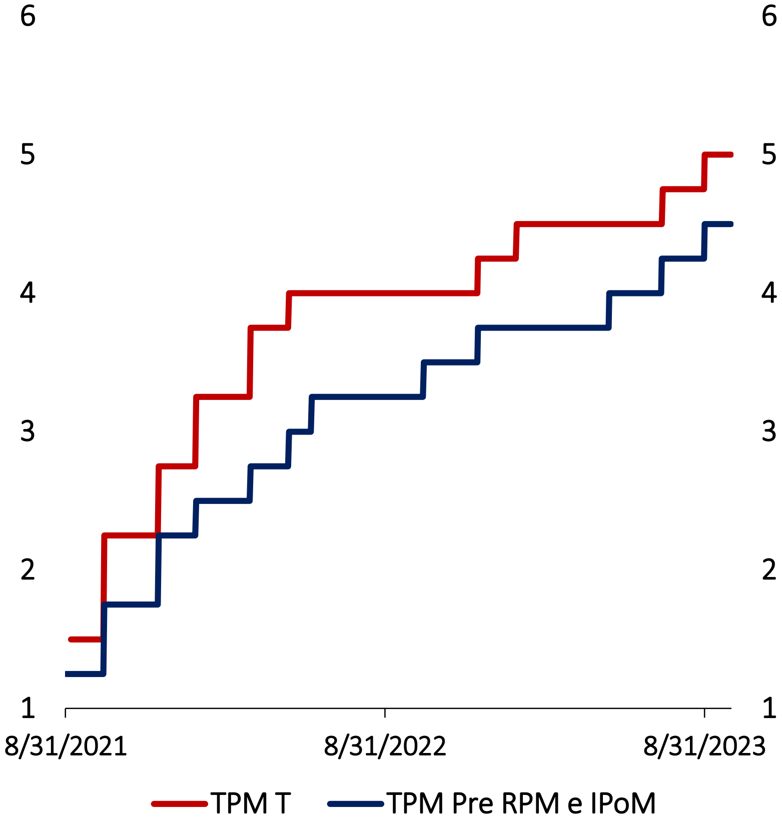
(cumulative contribution to change, percent)



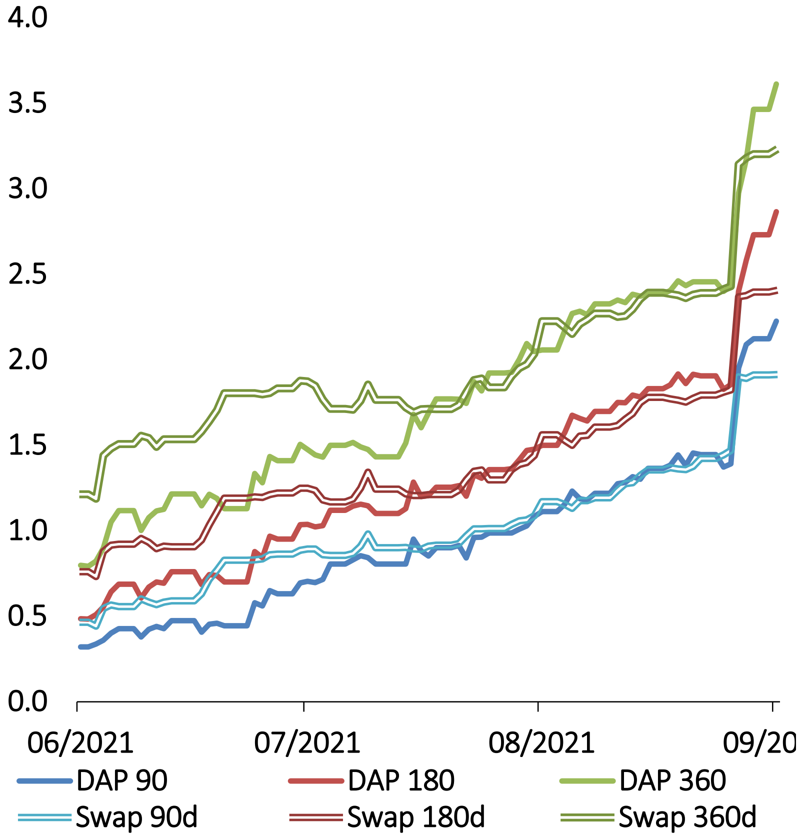
(1) From left to right vertical lines correspond to Monetary Policy Meetings of 2020 and January, March, May, June, July, and September 2021.(2) Last observation: 3/Sep/21. (3) From left to right vertical lines correspond to *Monetary Policy Meetings* of January, March, May, June, July and September 2021. Sources: Bloomberg, Central Bank of Chile, and *RiskAmerica*.

In the domestic market, MPR expectations also reacted upwards as well as in the money market.

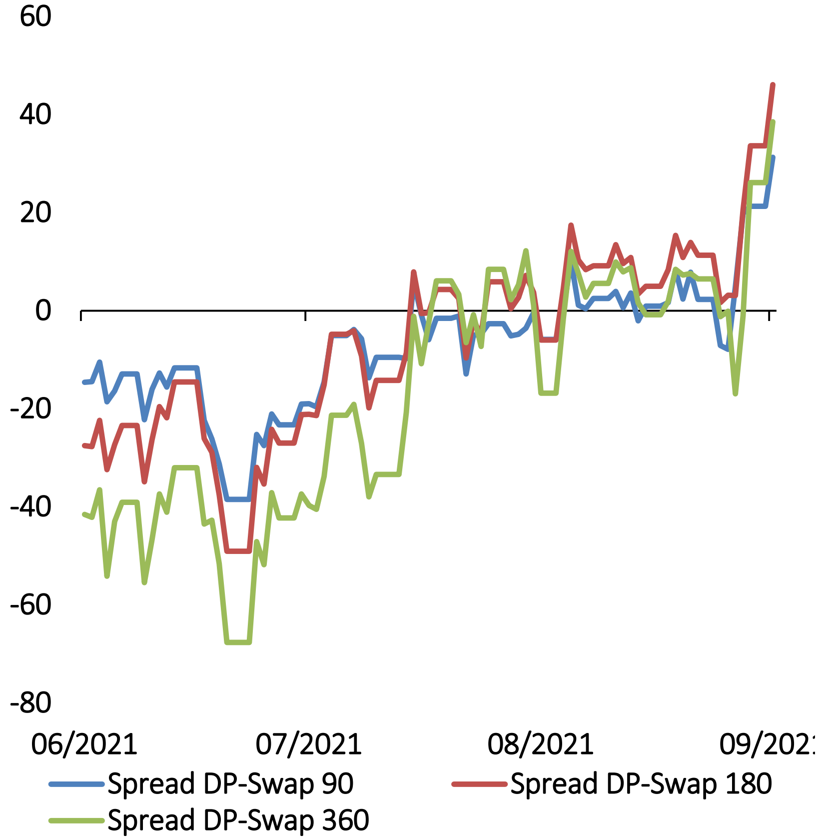
MPR expectations
(percent, daily data)



DAP swap
(percent)

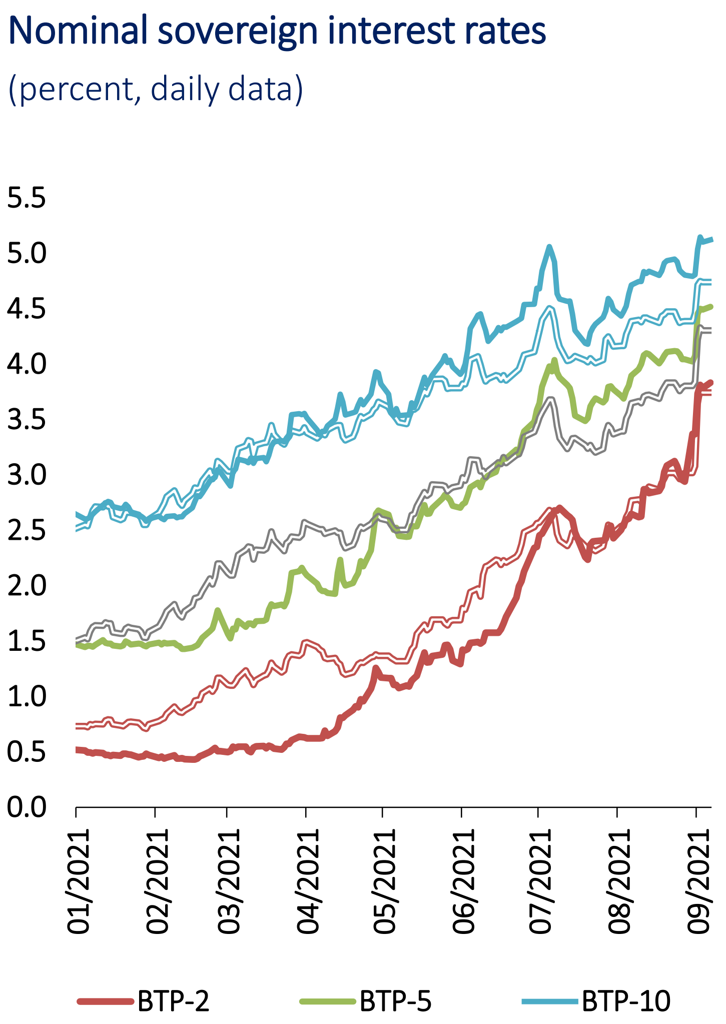


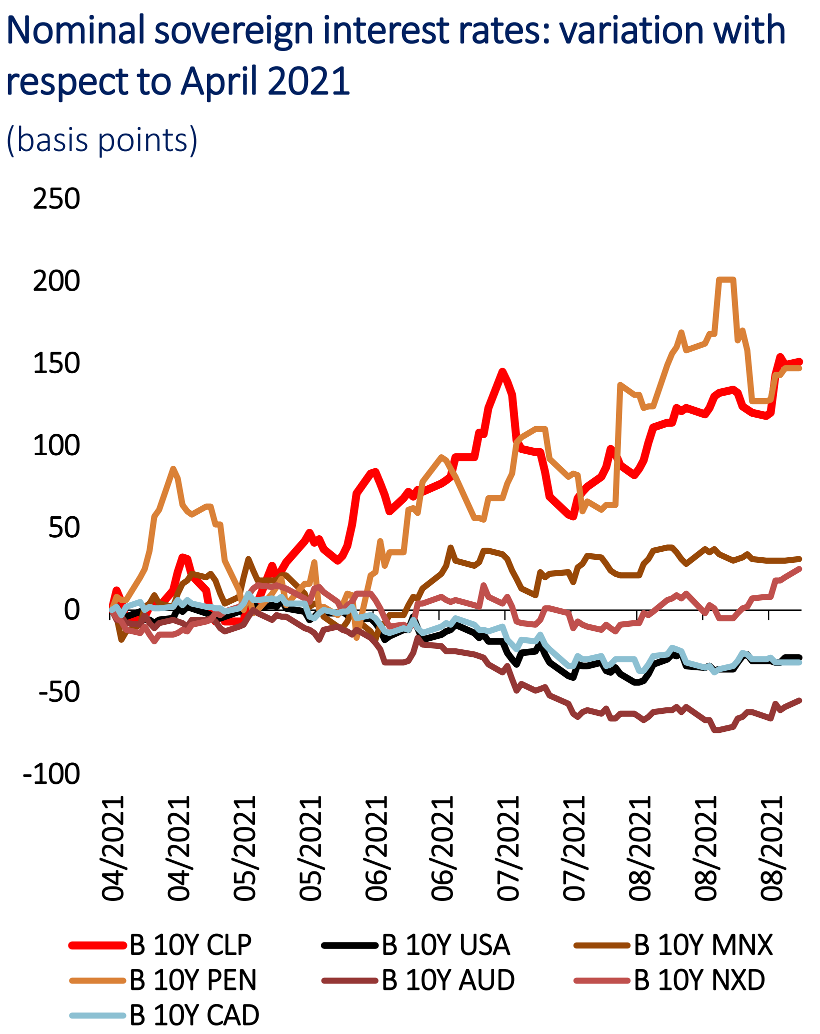
Term deposit swap spread
(basis points)

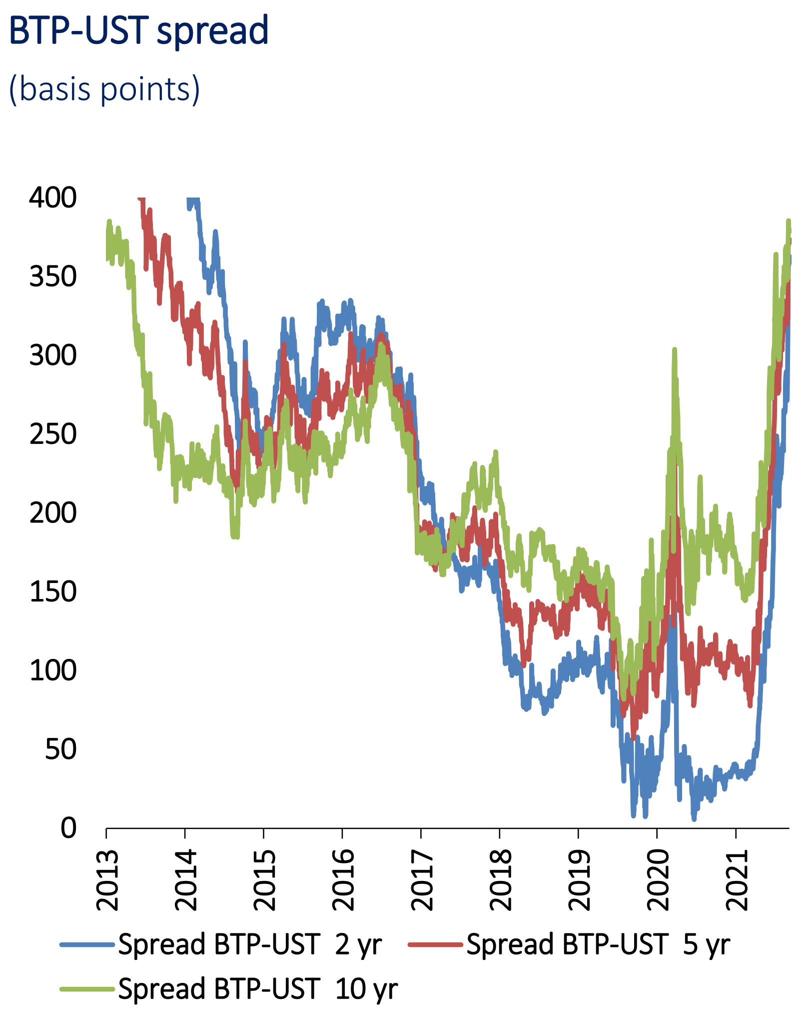


Source: Central Bank of Chile.

The reaction was also noticeable in the fixed-income sovereign bond markets.







Source: Central Bank of Chile.

Summary

- The extension and persistence of some of the local measures, combined with high propensity of households to consume the resources received, has had an impact on private spending beyond all forecasts.
- In a context where supply has yet to fully recover, this has significantly changed the assessment of the pressures facing the economy, reflected in an increase in inflation and its immediate outlook.
- The depreciation of the CLP also contributes to this, caused in part by the perception of a worsening of the economy's fundamentals as a result of the liquidation of long-term savings through successive massive withdrawals of pension savings and the deterioration of the fiscal accounts, all in an environment of high local uncertainty. Thus, interest rates, risk premiums, and the stock market show an unfavorable performance when compared to their external peers.
- The need to avoid the accumulation of macroeconomic imbalances which, among other consequences, could lead to a more persistent increase in inflation exceeding the 3% two-year target, has led the CBC Board to alter the monetary policy stance.
- In this scenario, the Central Bank must act promptly. Accordingly, the CBC Board raised the MPR to 1.5% at its August Meeting after increasing it by 25 basis points in July and anticipates that it will continue to withdraw the monetary impulse, bringing the MPR closer to its neutral level by the middle of the first half of 2022.

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Mario Marcel, Governor of the Central Bank of Chile

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Chile