MONETARY POLICY REPORT

DECEMBER 2021

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Monetary policy of the Central Bank of Chile

Money plays a fundamental role in the proper functioning of any economy. To preserve that role, monetary policy must protect the value of the national currency, the peso, by seeking to keep inflation low and stable. Achieving this promotes people's well-being by safeguarding the purchasing power of their income and ensuring a better functioning economy. When inflation is low and stable, monetary policy can also moderate fluctuations in employment and production.

The Central Bank of Chile conducts its monetary policy so that, irrespective of the current level of inflation, its projection over a two-year horizon is 3%. This resembles what is done in other countries that, like Chile, have a floating exchange rate, which is known as the inflation targeting scheme.

The Monetary Policy Rate (MPR) is the main instrument used by the Bank to achieve the inflation target. Its level is decided at the Monetary Policy Meeting, which is held eight times a year. In practice, the MPR is a benchmark interest rate to determine the cost of money and other financial prices, such as the exchange rate and longer-term interest rates. These variables, in turn, affect the demand for goods and services and, in turn, prices and inflation. Monetary policy decisions take several quarters to be fully reflected in the economy, which justifies that monetary policy is made with a forward-looking view, having as its primary focus the two-year inflation projection and not just today's inflation.

Since the Central Bank makes its monetary policy decisions autonomously, it must constantly report on them and their results to the general public. This is so not only because it is a government agency in a democratic society, but also because a credible monetary policy, understood by the people, keeps inflation low and stable. Through the Monetary Policy Reports, the Bank communicates to the general public its view on the recent evolution of the economy, its outlook for the next few quarters, and the way in which, in this context, it will manage monetary policy to meet the inflation target.

What does this MP Report tell us?

Although the economy is experiencing a significant recovery, its growth rate is not sustainable over time.

Among other negative effects, this growth is generating a significant increase in inflation.

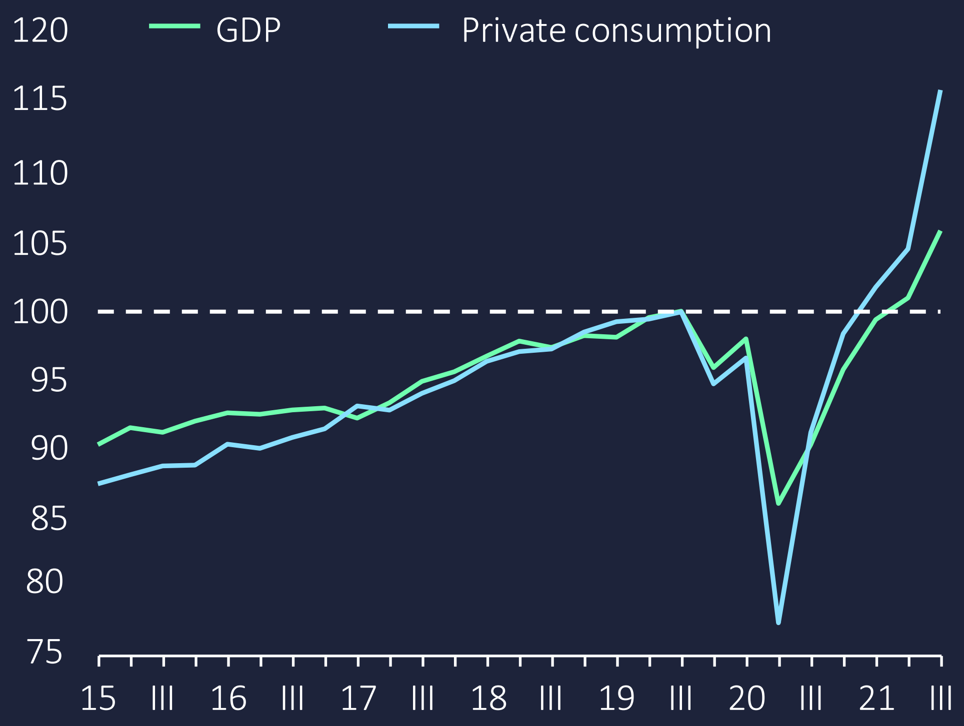
This is a problem that affects everybody, although more significantly those who have less resources.

This is why the Central Bank has been raising the interest rate. Precisely to watch over people’s pockets.

The economy's recent evolution

Economic activity has remained very dynamic, even exceeding expectations. It has been driven by private consumption, which now stands almost 20% above its levels prior to the social outbreak.

GDP and private consumption
(deseasonalized levels, 2019.III=100)



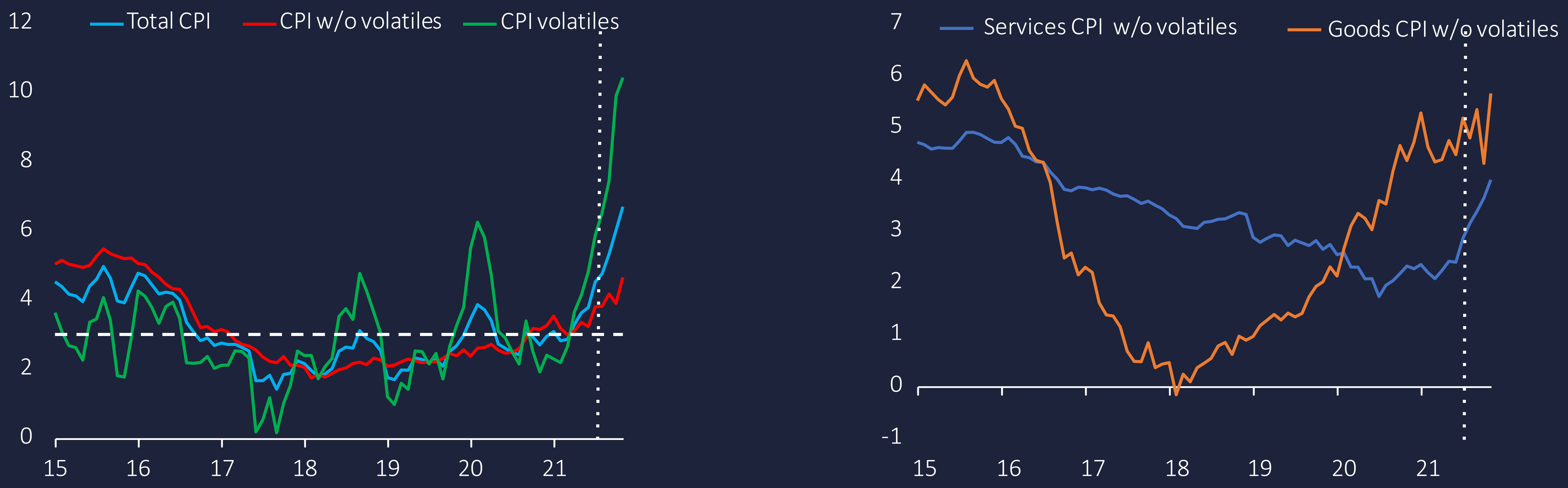
Source: Central Bank of Chile.

Private consumption continues to be the most dynamic component of expenditure.

Annual inflation increased further, to 6.7% in November. The rise has been visible in its every component. Although core CPI posted a more contained annual rate of expansion, it has risen steadily during 2021 and is at its six-year peak.

Inflation indicators (1) (2)

(annual change, percent)



(1) Dotted vertical line marks statistical close of September 2021 MP Report. (2) For more detail on groupings and shares in total CPI basket, see box IV.1, MP Report December 2019, Carlomagno & Sansone (2019), and Economic Glossary.

Sources: Central Bank of Chile and National Statistics Institute.

Along with the increase in inflation, there has been a significant rise in market expectations regarding its value in the short and medium term.

Inflation expectations in surveys (*)

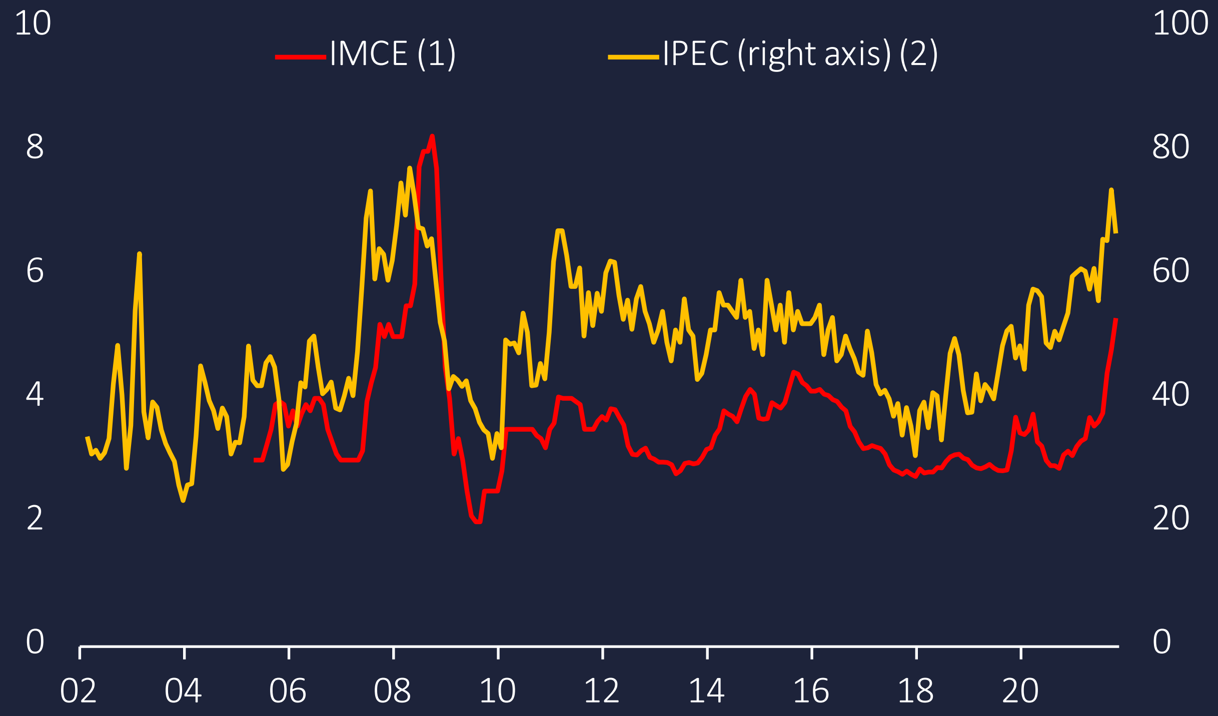
(annual change, percent)

(*) The Financial Traders Survey (FTS) uses the survey of the first half of each month up to January 2018. From February 2018 onwards, it considers the last survey published in the month, including the one prior to the December meeting. In the months in which no survey is published, the last available survey is considered. The Economic Expectations Survey (EES) considers up to the survey published in December 2021.

Source: Central Bank of Chile.

The costs of inflation on the economy are already visible and have become a major economic concerns for households and businesses.

Inflation expectations 12 months ahead
(percent)



(1) Business confidence (IMCE), considers a simple average of 12-month inflation expectations by trade and industry. (2) Consumer confidence (IPEC), respondents answering "A lot" to the question "How much do you think the prices of things will rise within the next 12 months?"

Sources: UAI/ICARE and Gfk/Adimark.

"We are cutting down everything a little bit. If I used to drink two cups of tea, now I drink one. I used to eat two loaves of bread in the morning, I eat one, and one in the afternoon.... that's when we realize that we have to squeeze our budget (...).

"Meat is kind of expensive, so we're just eating chicken".

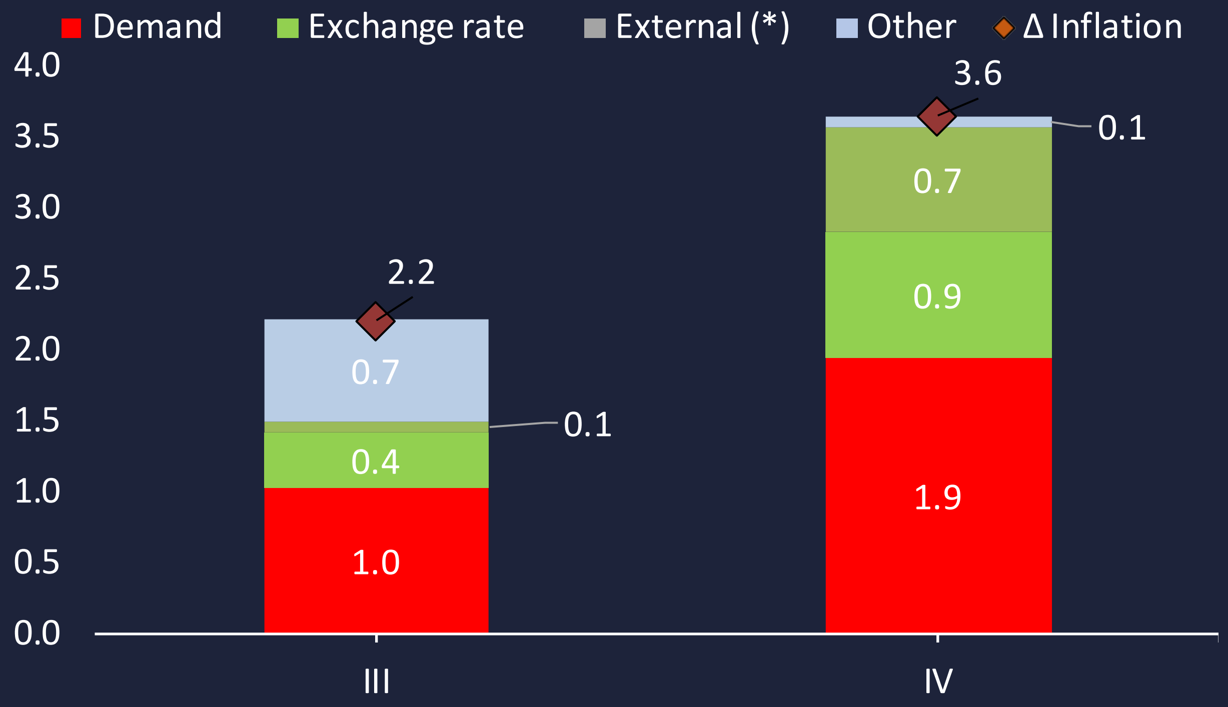
"I don't buy what is too pricey.... And changing y'know, buying less quantity... And the way of cooking, y'know, cooking for two days, for three days (...) I avoid making that expense, in these two days (...) This way I save gas and I save on everything."

* Quotes contained in a qualitative study that collects citizens' opinions on inflation.

The increase in inflation has been influenced by several factors, most importantly the increase in domestic demand and the depreciation of the Chilean peso, both of which have been driven by local phenomena.

Change in annual inflation 2021 with respect to same quarter a year before

(quarterly data, percentage points)



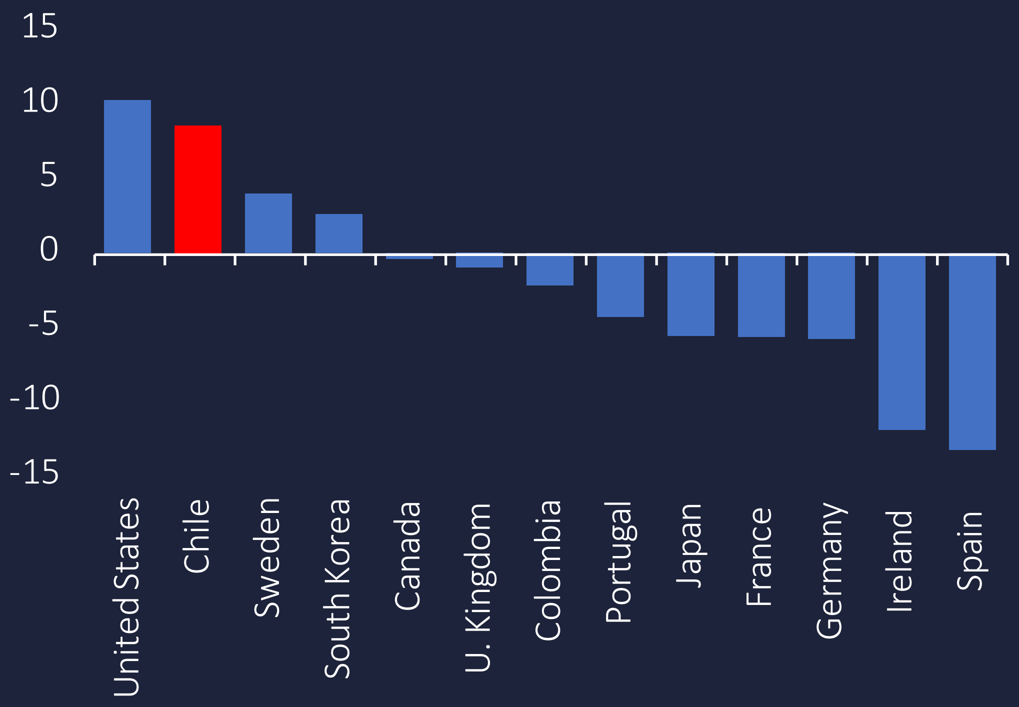
(*) Includes oil and copper prices, trading partner activity and other external factors
Source: Central Bank of Chile.

Main factors explaining higher inflation in the third and fourth quarters of 2021:

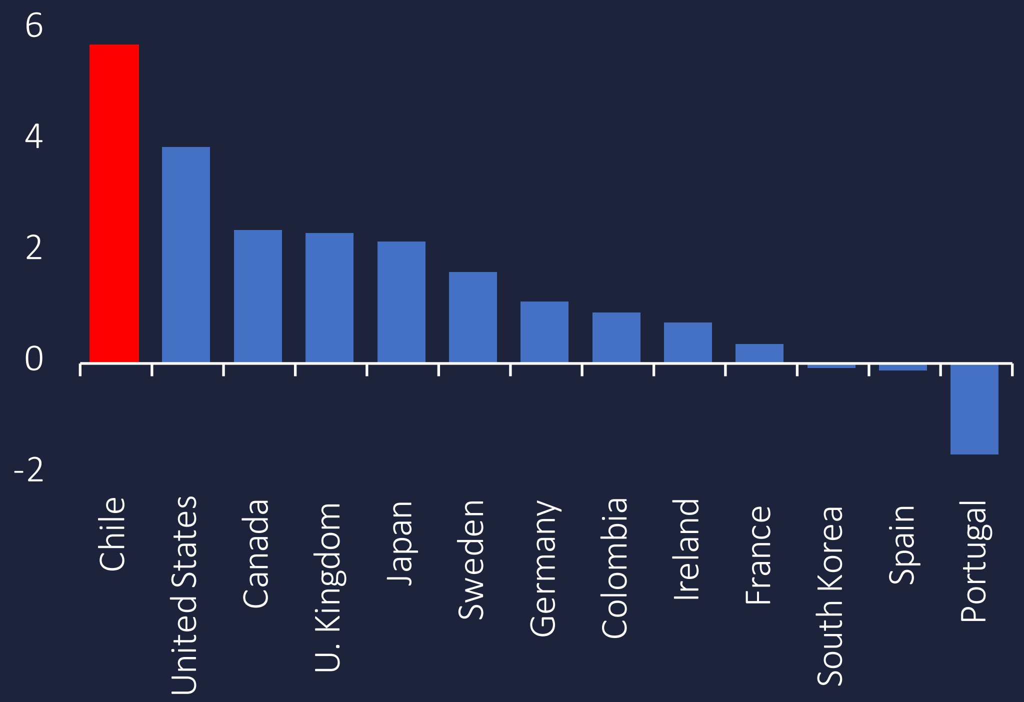
- Increased domestic demand (about half)
- Peso depreciation in recent months due to local factors (about 20%)

Actually, Chile is one of the countries where consumption and inflation are rising the most.

Durable goods consumption (1)
(percentage points)



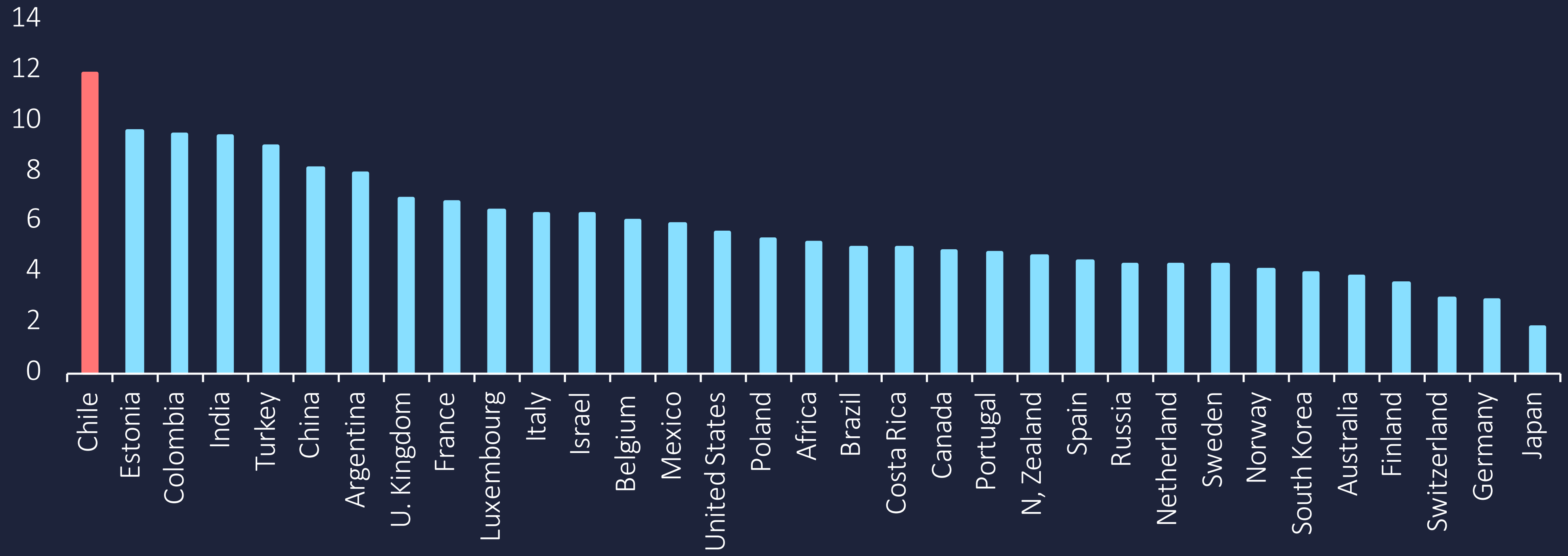
Core goods inflation (2)
(percentage points)



(1) Shows deviation of annual consumption growth between first half of 2019 and first half of 2021 from the average annual growth between 1998 and 2021. (2) Based on Bajraj, Carlomagno and Wlasiuk (2021). The figure shows the deviation of annual price growth from third quarter 2019 and third quarter 2021 from the average annual growth between 1998 and 2021. Sources: Central Bank of Chile, Bloomberg, DANE, and OECD data ilibrary.

The dynamism of spending has placed Chile's GDP growth among the highest in the world for 2021, far exceeding its short-term potential.

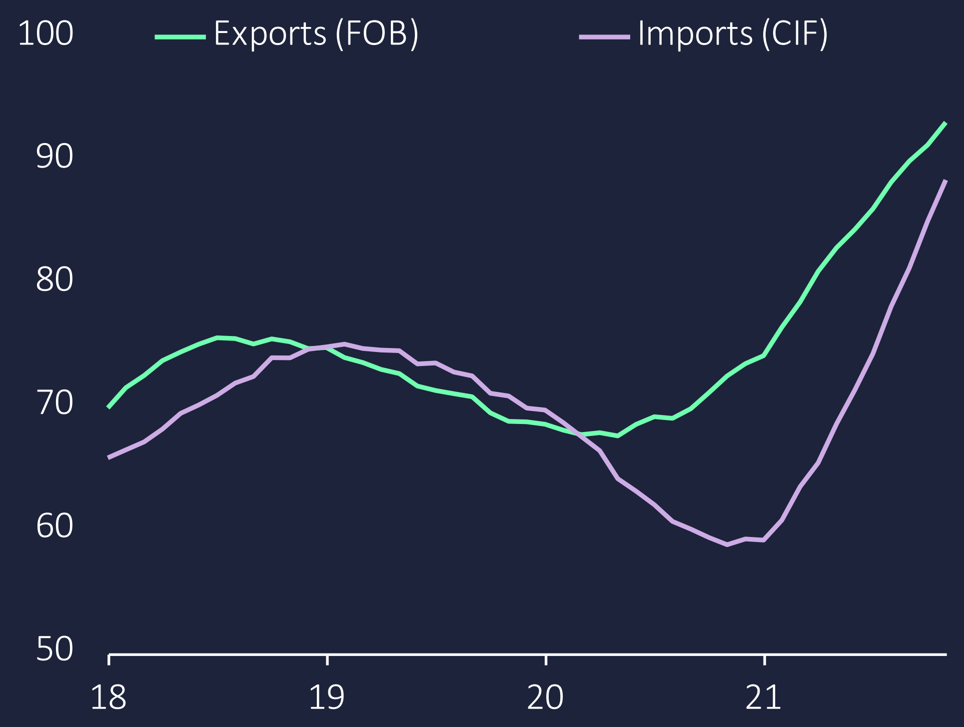
2021 GDP growth forecast
(annual change, percent)



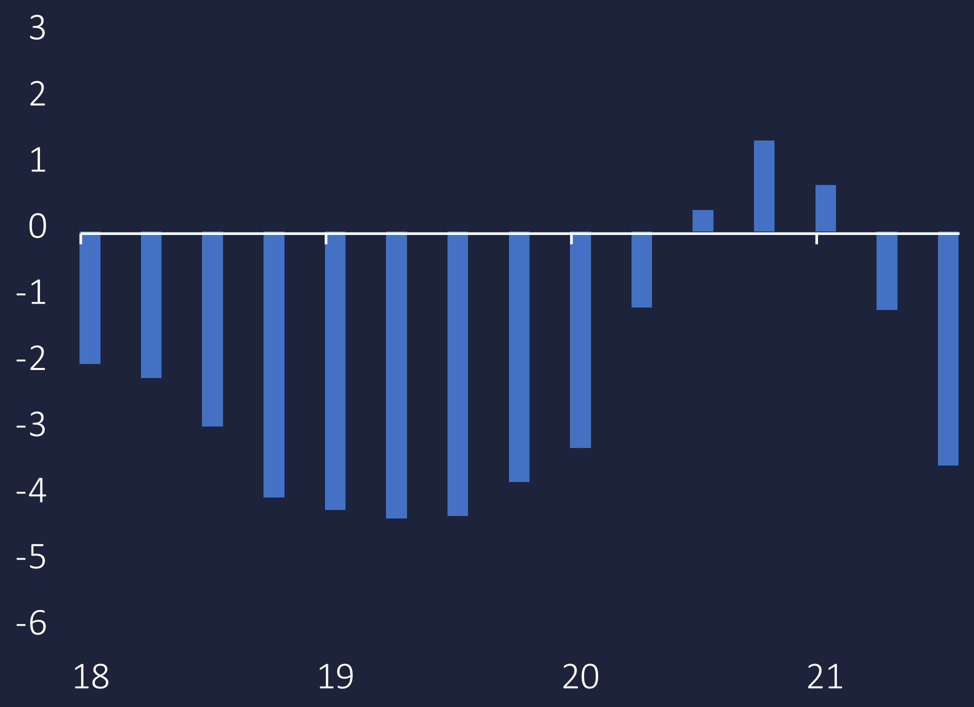
Source: OECD.

An unmistakable reflection of the excess domestic demand is the higher current-account deficit.

Exports and imports
(billions of dollars, 12-mo cumulative)



Current account
(percent of GDP, last 12 months)

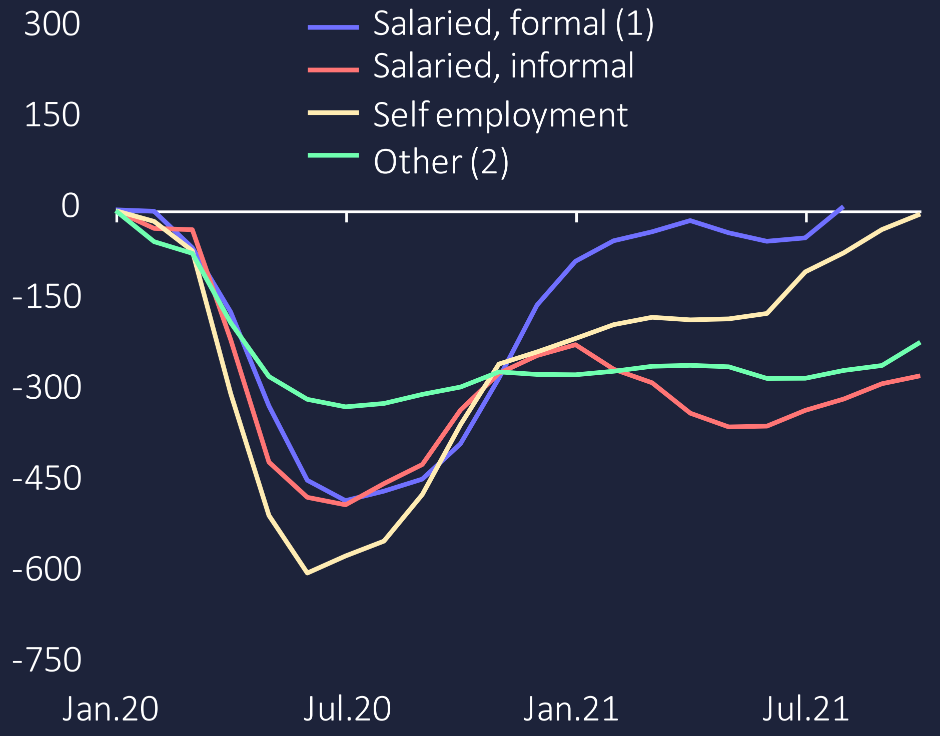


Source: Central Bank of Chile.

Employment is recovering more slowly than activity and is being held back by labor supply, which has yet to return to its pre-crisis levels.

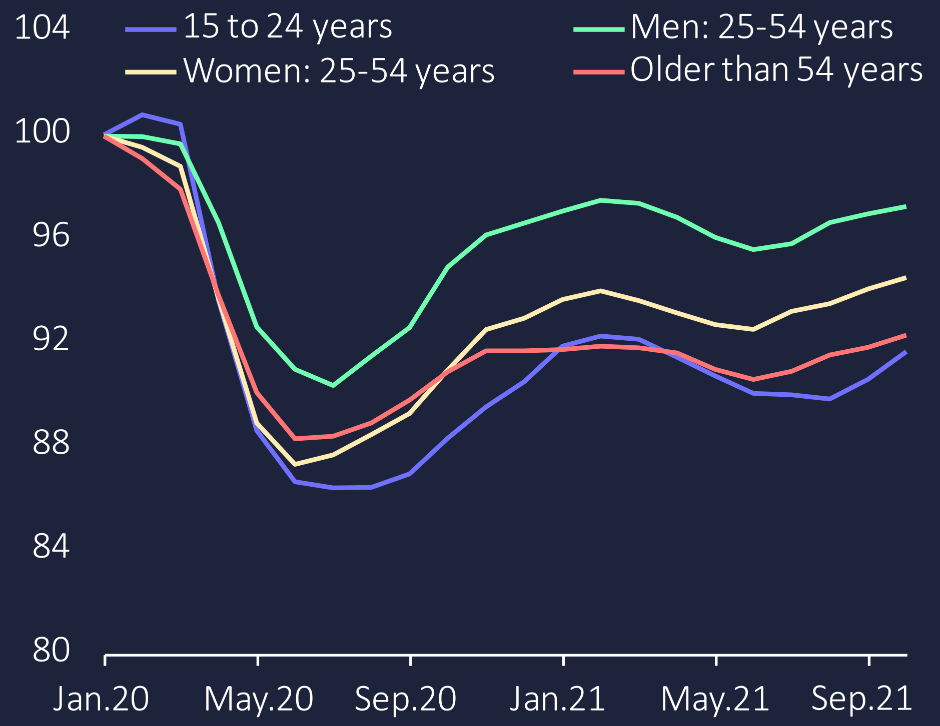
Employment by category

(difference in thousands of people from January 2020, deseasonalized series)



Participation rate by age bracket

(index, January 2020= 100)

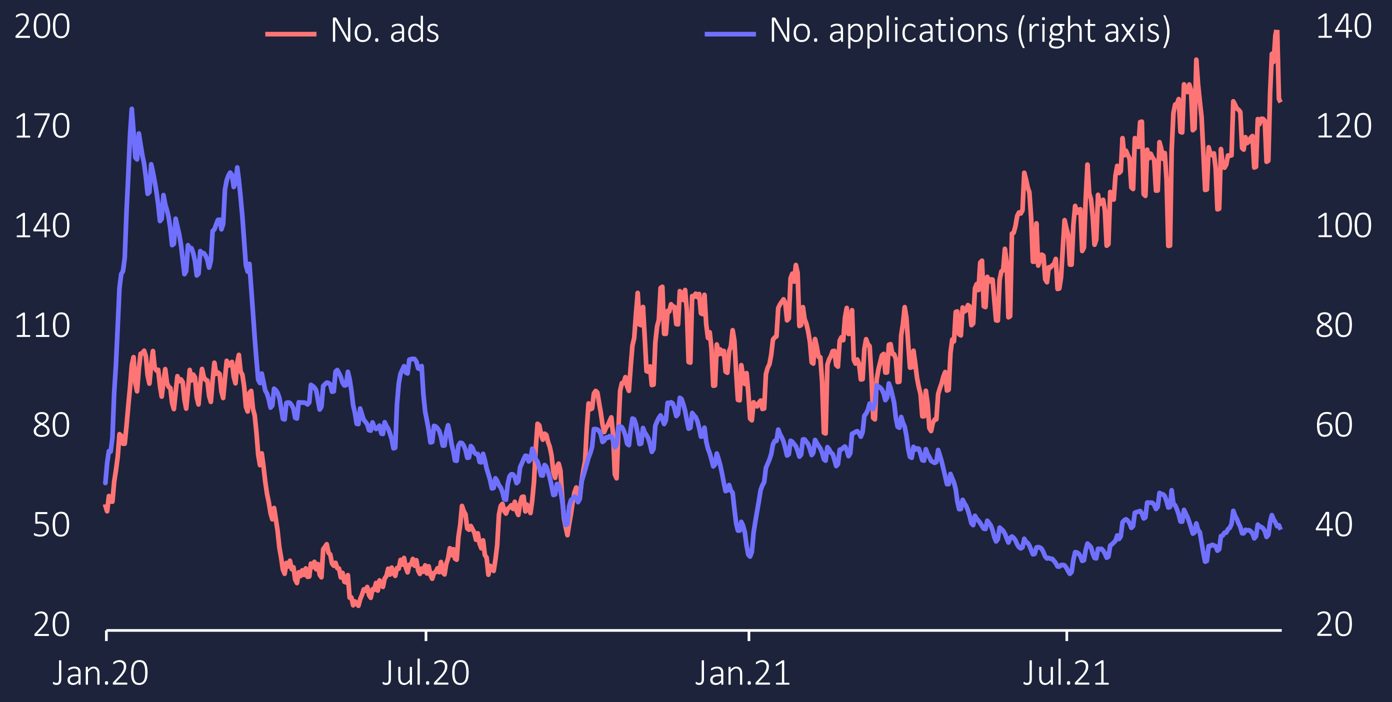


(1) Estimated with AFP data. (2) Corresponds to the sum of household help, employers and unpaid family members.
Sources: National Statistics Institute and Superintendency of Pensions.

Job vacancies have increased this year, although labor shortages continue to be a major difficulty for businesses.

Job postings and applications on the internet (*)

(index, base 100= 3 March 2020, moving 15-day average)



(*) For further detail, see figure III.8, MP Report December 2021.
Sources: SENCE Labor Observatory and Job Analysis Systems of job boards.

"Workers are in very short supply, they see the job postings, 2 send background information and zero make it to the interview" (restaurant manager)

"Hiring costs have gone up... I have to give a little more incentive to the workers to come or else I will fall behind in the works". (construction and real-estate manager)

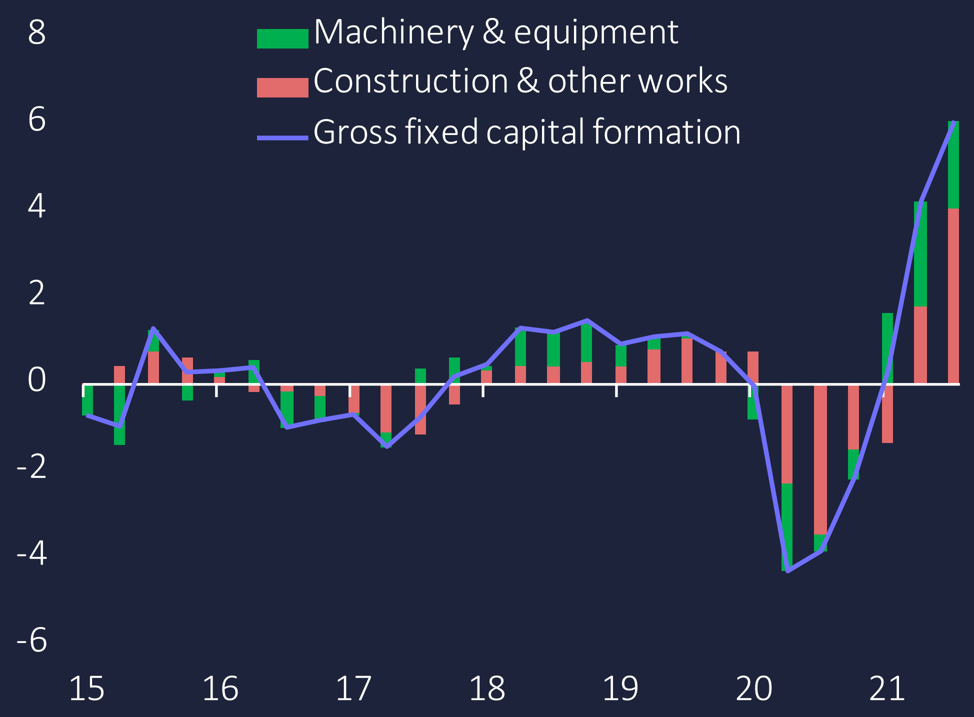
"We normally adjust salaries in May, but this year I have already had to raise salaries three times, otherwise people leave"

(mining services manager)

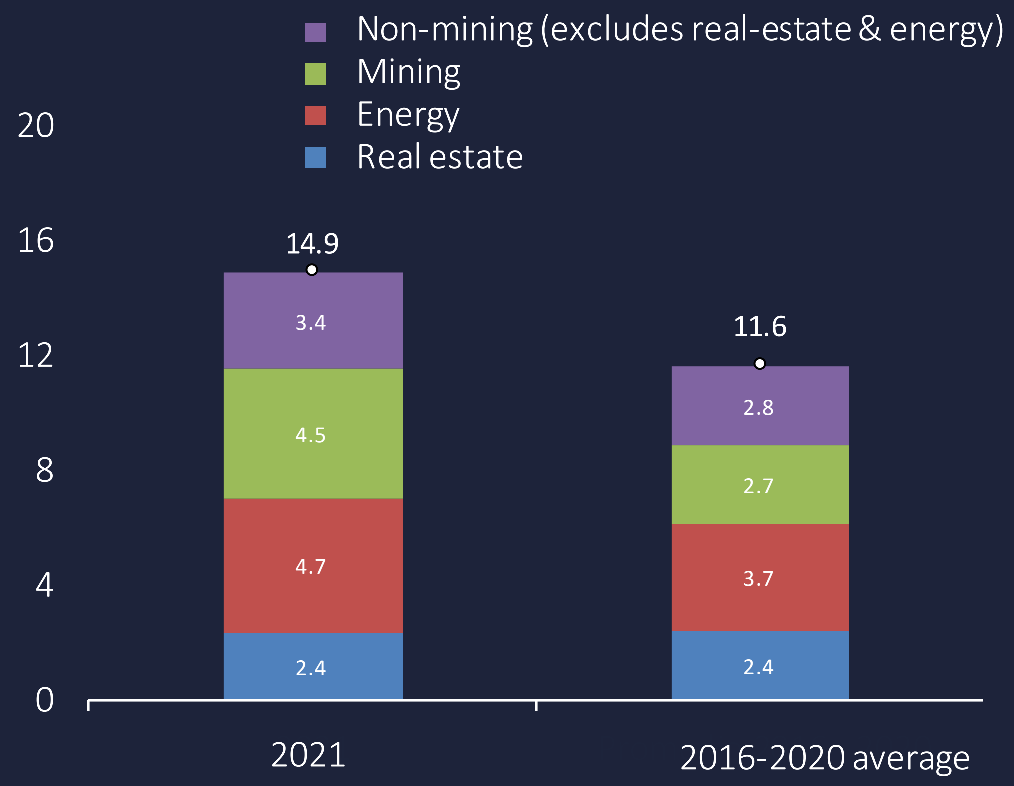
Source: Business Perceptions Report (IPN), Central Bank of Chile.

Investment continued to recover, with significant dynamism in all lines.

Contribution of GFCF to annual GDP growth
(percentage points)



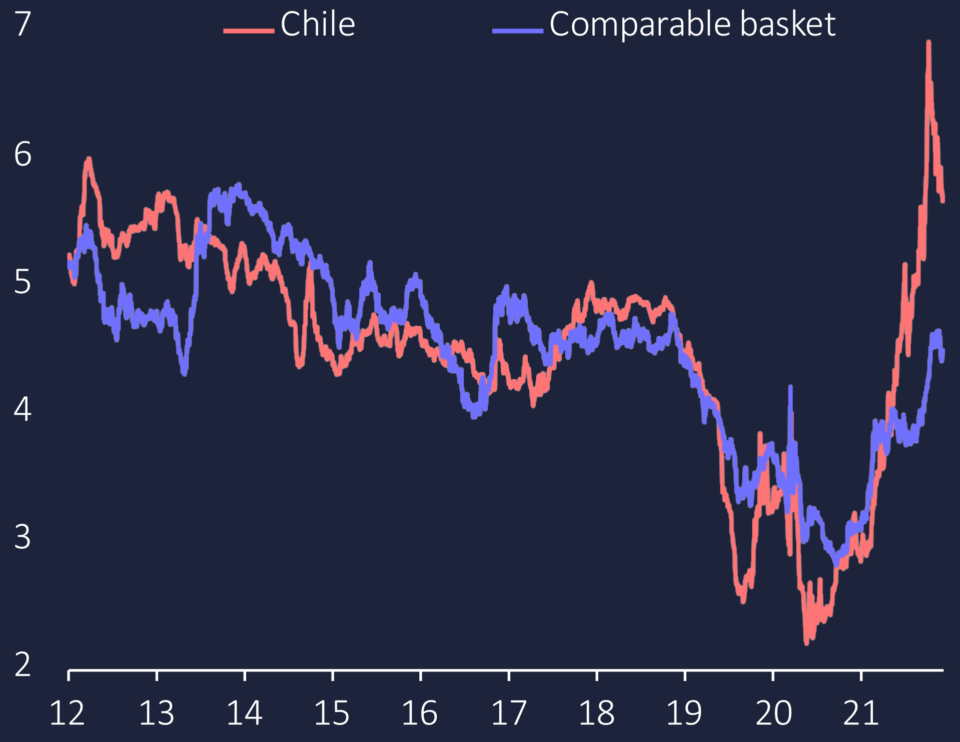
CBC: total investment (*)
(billions of dollars)



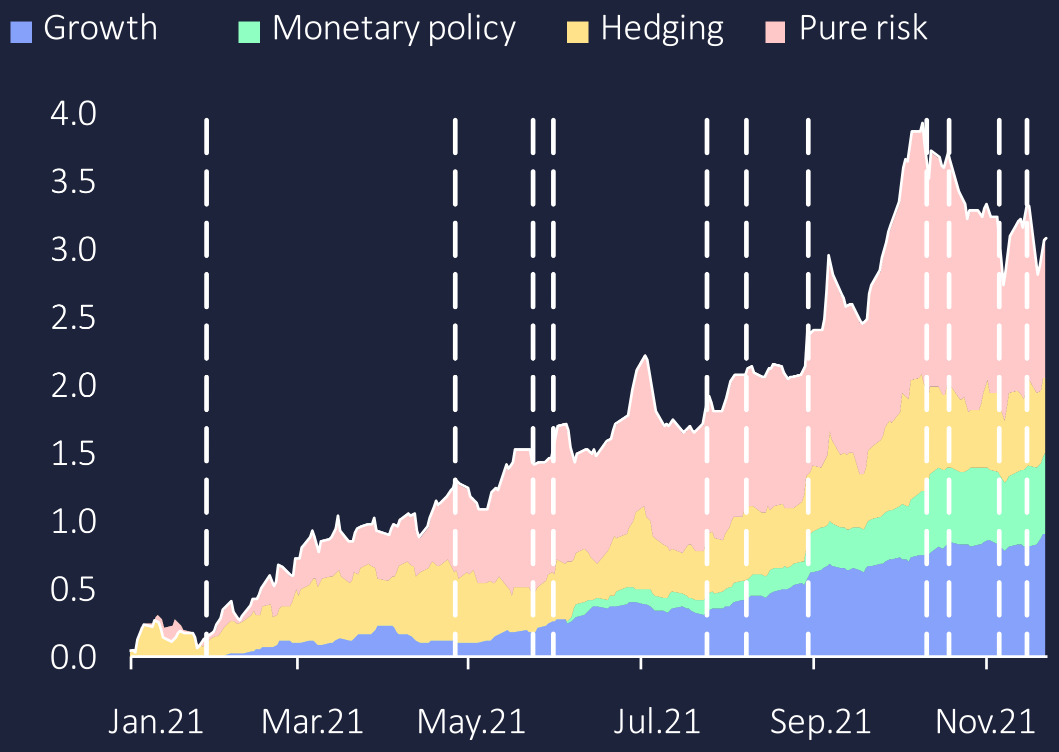
(*) The 2021 data corresponds to October. The 2016-2020 average considers the latest available data for each year.
Sources: Central Bank of Chile and Capital Goods Corporation (CBC).

Local financial conditions have deteriorated sharply over the last year, explained by domestic factors. The rise in long-term interest rates stands out.

10-year interest rate (1) (2)
(percent)



Structural decomposition of 10-year zero rate (3) (4)
(difference from December 2020, percentage points)



(1) For all countries, zero-coupon bond interest rates are considered, which correct market rates of bond coupon payments. (2) The basket of comparable economies combines the baskets of Latin American countries and commodity exporters (Brazil, Colombia, Mexico, New Zealand, and Peru). The weights are the coefficients of a cointegration relationship with Chile's interest rate. (3) Structural decomposition based on Cieslak and Pang (2021). (4) Vertical lines from left to right indicate the events detailed in box V.1.

Sources: Central Bank of Chile, Bloomberg, and RiskAmerica.

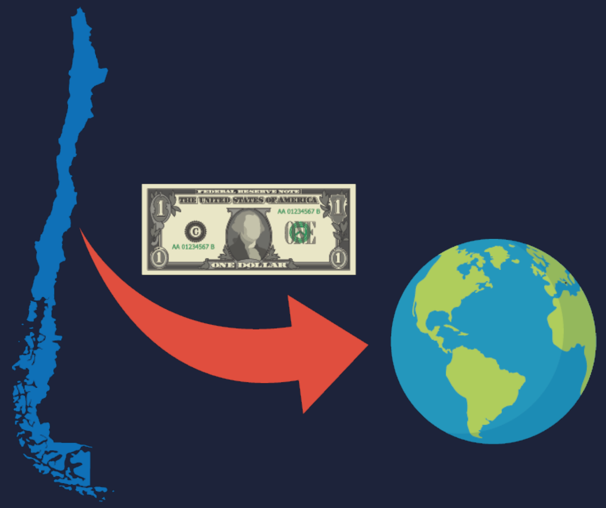
High uncertainty and increased risk perception regarding the Chilean economy has reduced appetite for local assets and long-term assets.

Assets abroad of firms and households (*)
(billions of dollars)

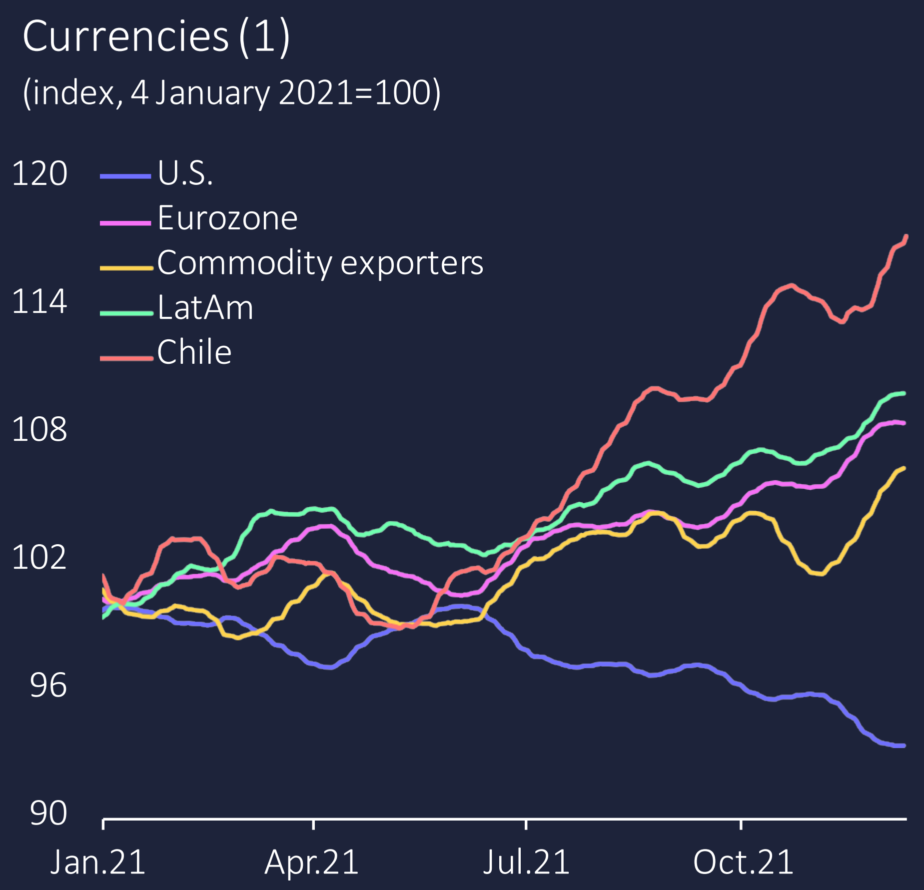
(*) Moving 24-month sum. Excludes FDI inflows.
Sources: Central Bank of Chile and Financial Market Commission.

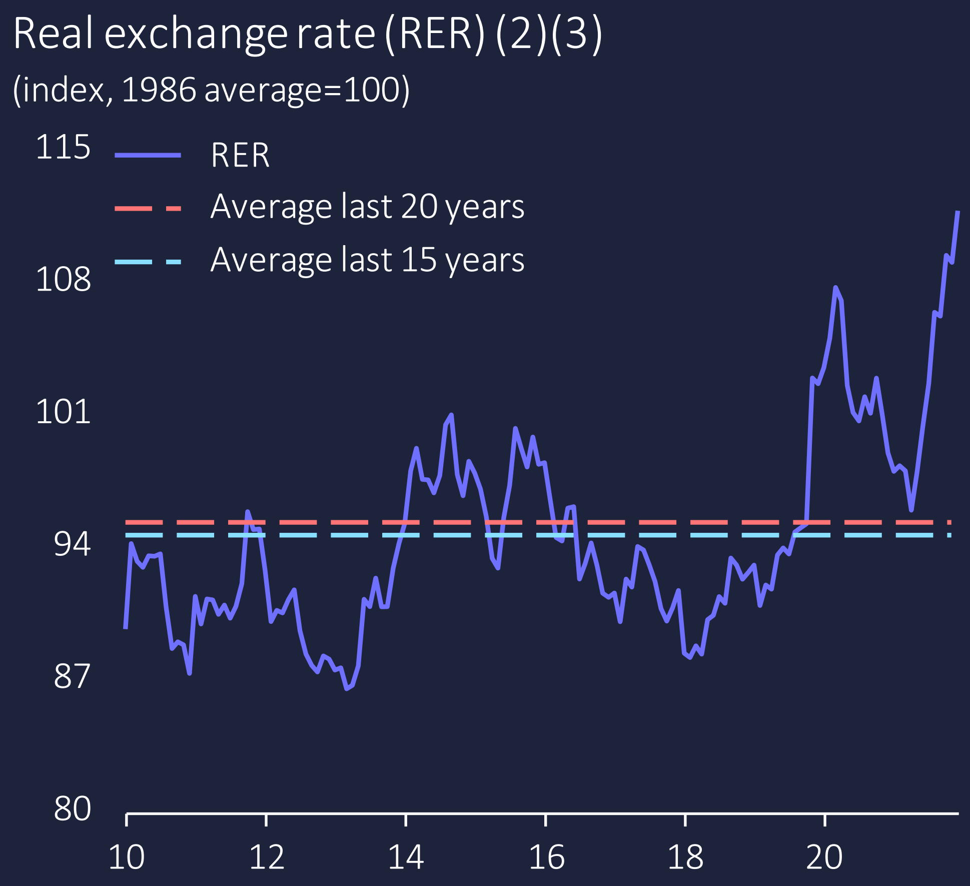
The increase in the number of current accounts in foreign currency is worth noting. At September 2021 :

- Natural persons: +38% y-o-y (+75% since Sep.19)
- Legal persons: +15% y-o-y (+27% since Sep.19)



Accordingly, the Chilean peso has depreciated significantly and the real exchange rate is well above its 20-year average.





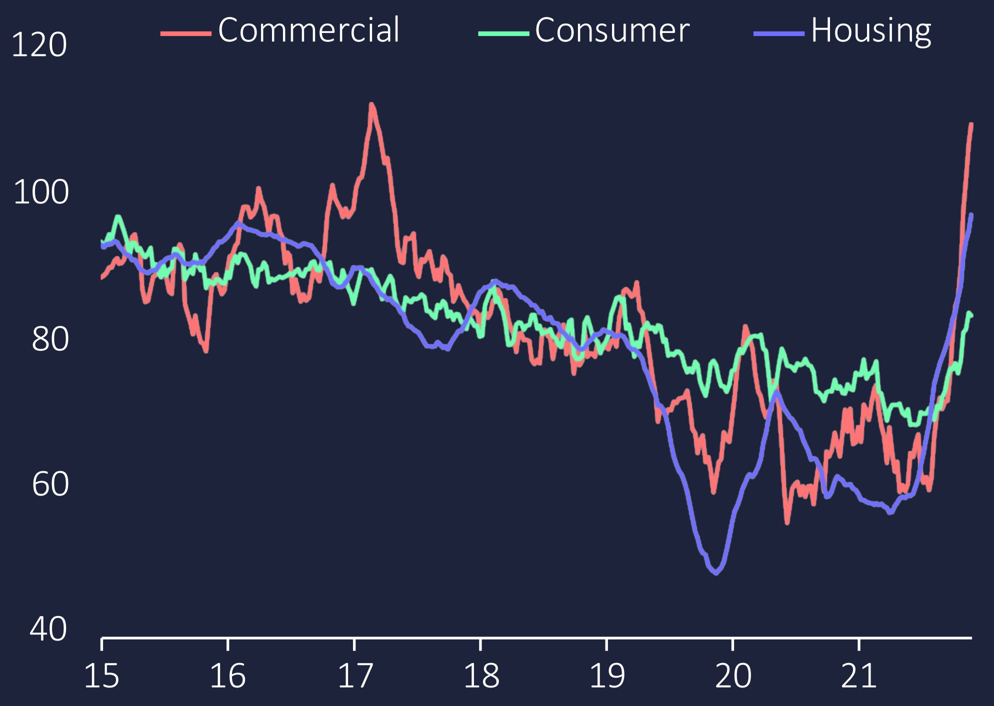
(1) Fifteen-day moving averages for each series. For Latin America, simple average between the indices of Brazil, Colombia, Mexico, and Peru; for commodity exporters, simple average between the indices of Australia and New Zealand. (2) RER data for November and December 2021 correspond to the preliminary average of the month and to the data available at the statistical closing, respectively. (3) Averages for the last 15 and 20 years consider the periods Dec.06-Nov.21 and Dec.01-Nov.21.

Sources: Central Bank of Chile and Bloomberg.

Credit supply has tightened and demand remains subdued, due to the higher cost of bank funding and uncertainty about the evolution of the economy.

Lending interest rates (1)(2)

(index, 2003-2021=100)



(1) Weekly data, weighted average rates of all transactions performed in each period. For housing, transactions in UF are considered. (2) Moving 4-week average.

Source: Central Bank of Chile based on Financial Market Commission data.

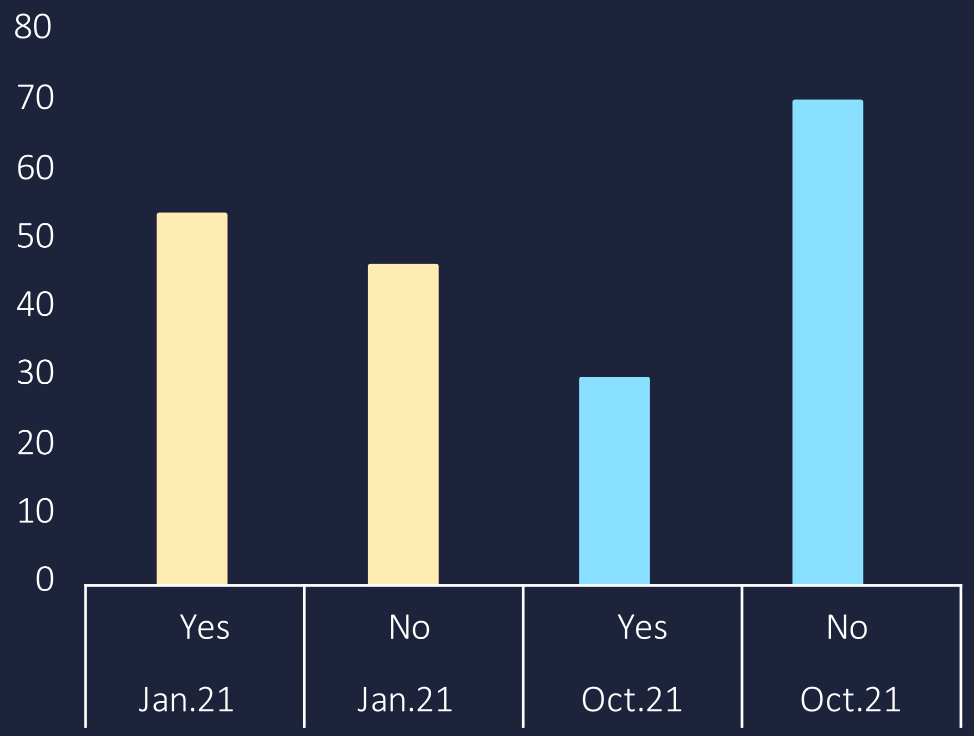
The IPN points to tighter financing conditions, especially for medium- and long-term projects. High liquidity has kept demand for consumer credit contained.

➡ *"The situation today is very complex due to the contingency of rates; there are important disruptions in credit flows, especially in mortgages" (bank agent)*

The worsened financial conditions have contributed to depressing investment prospects for next year.

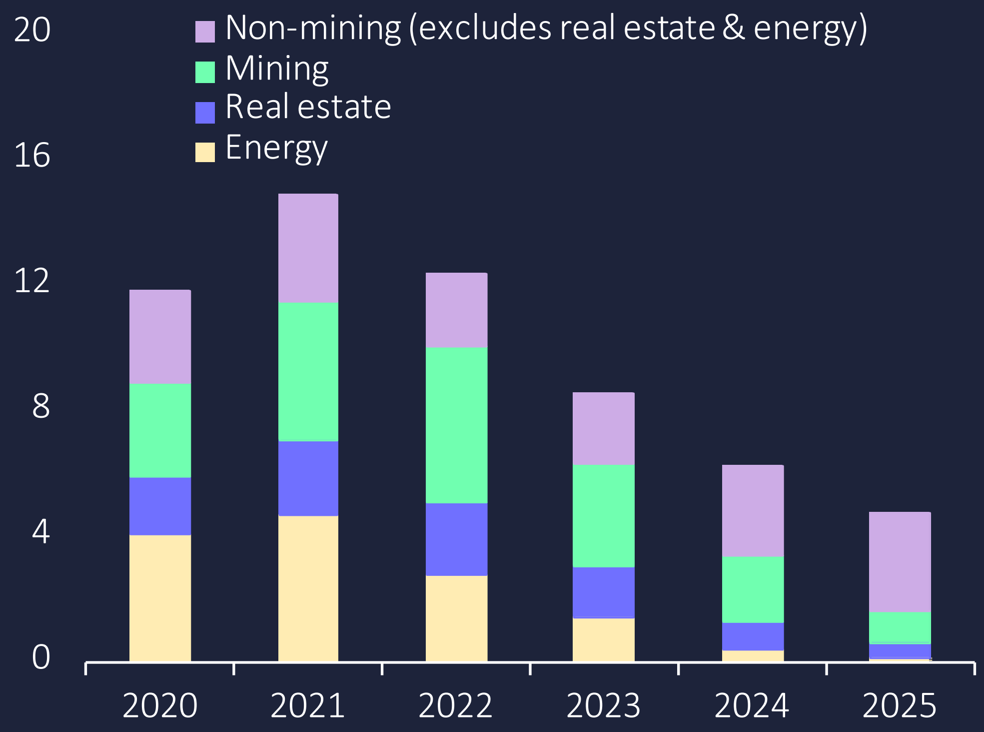
IPN: About your current business plans, do you think your company will make investments during 2022?

(percent)



CBC: total investment

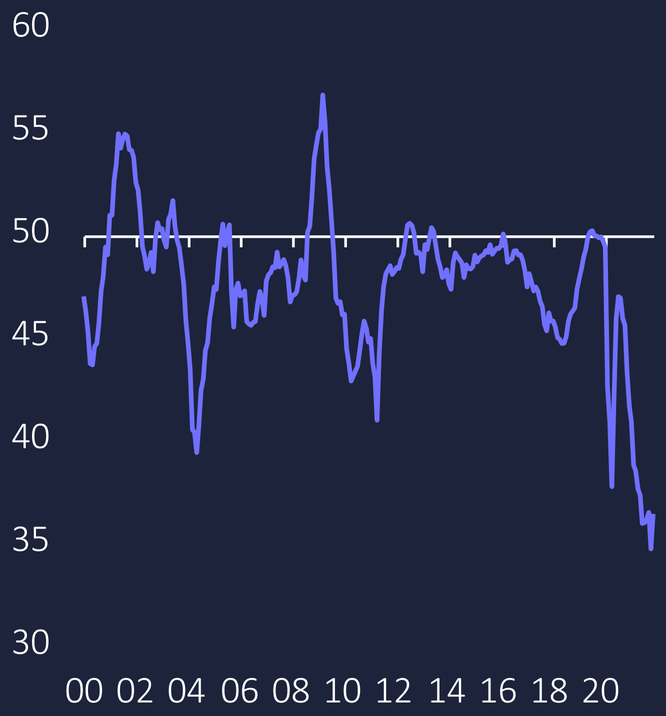
(billions of dollars)



Sources: Central Bank of Chile and Capital Goods Corporation (CBC).

Abroad, the pandemic has continued to affect the availability of goods and supply chains, amid the dynamism that sustains demand.

Supplier delivery times (1)
(diffusion index)



Maritime transport costs (2)
(index, 2018=100)

Transportation costs and logistical problems have been compounded by higher commodity prices:

Copper price:

+4%

since MP Report Sep.21

Oil Price
(Brent-WTI avg.):

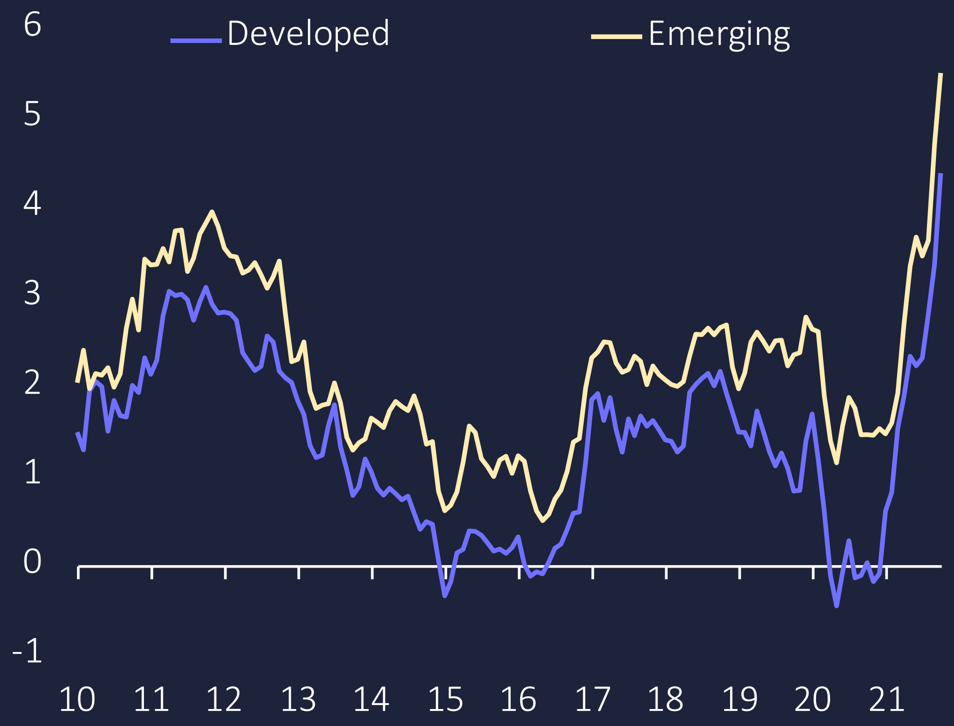
+7%

since MP Report Sep.21

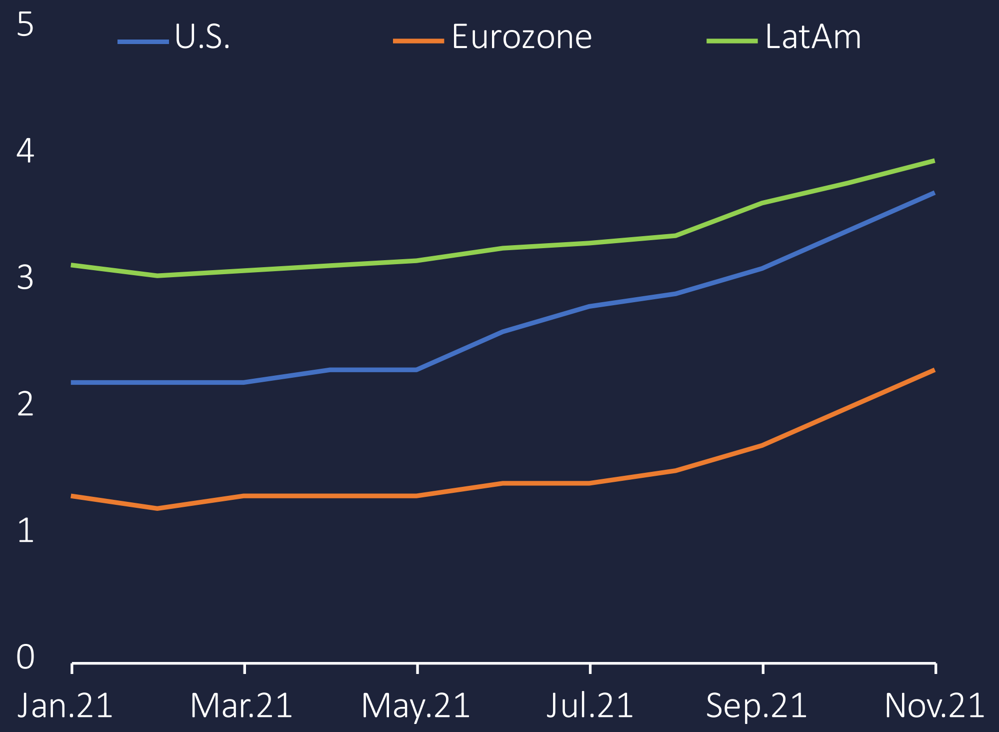
(1) Corresponds to manufactuing global PMI. A drop in the index means an extension of suppliers' delivery times and vice versa. (2) Rate for transporting a 40-foot container on the respective routes.
Sources: Bloomberg, IHS Markit, and JP Morgan.

Inflation has continued to rise around the world, changing the perception of the transitory nature of the inflationary phenomenon.

World inflation (1) (2)
(annual change, percent)



Market inflation expectations for 2022 (3)
(annual average change, percent)



(1) Based on Baraj, Carlomagno, and Wlasiuk (2021). (2) Median of each group of countries. (3) For Latin America, geometric average of annual inflation as of December for Mexico, Colombia, Brazil, and Peru.
Sources: Central Bank of Chile based on countries' oficial data and Consensus Forecast.

In this context, a growing number of monetary authorities have announced, initiated, or continued to remove their monetary stimulus measures.

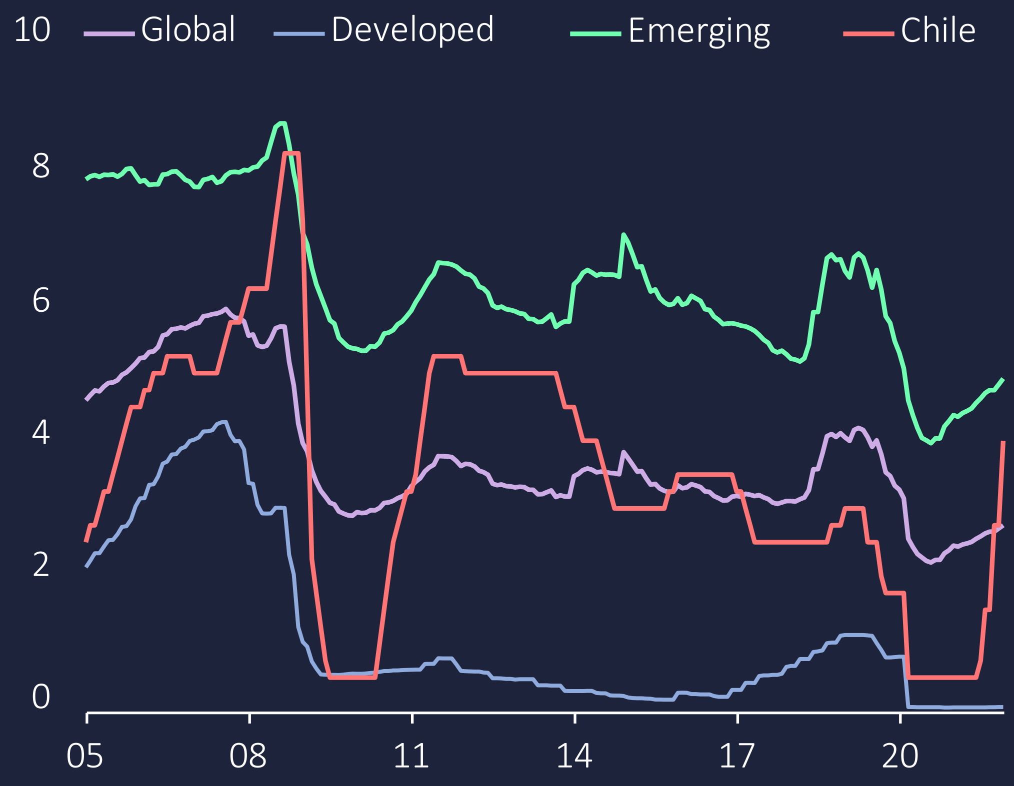
Evolution of monetary policy rates in selected economies

(percent; cumulative change in percentage points)

	Current MPR	Cumulative change from January 2021	Expected change in 2022
Brazil	9.25	725	175
Chile	4.00	350	175
Czech Republic	2.75	250	50
Peru	2.50	225	50
Hungary	2.40	180	100
Poland	1.75	165	75
Mexico	5.00	75	100
Colombia	2.50	75	250
New Zealand	0.75	50	100
Norway	0.25	25	100

Monetary policy interest rates (*)

(percent)

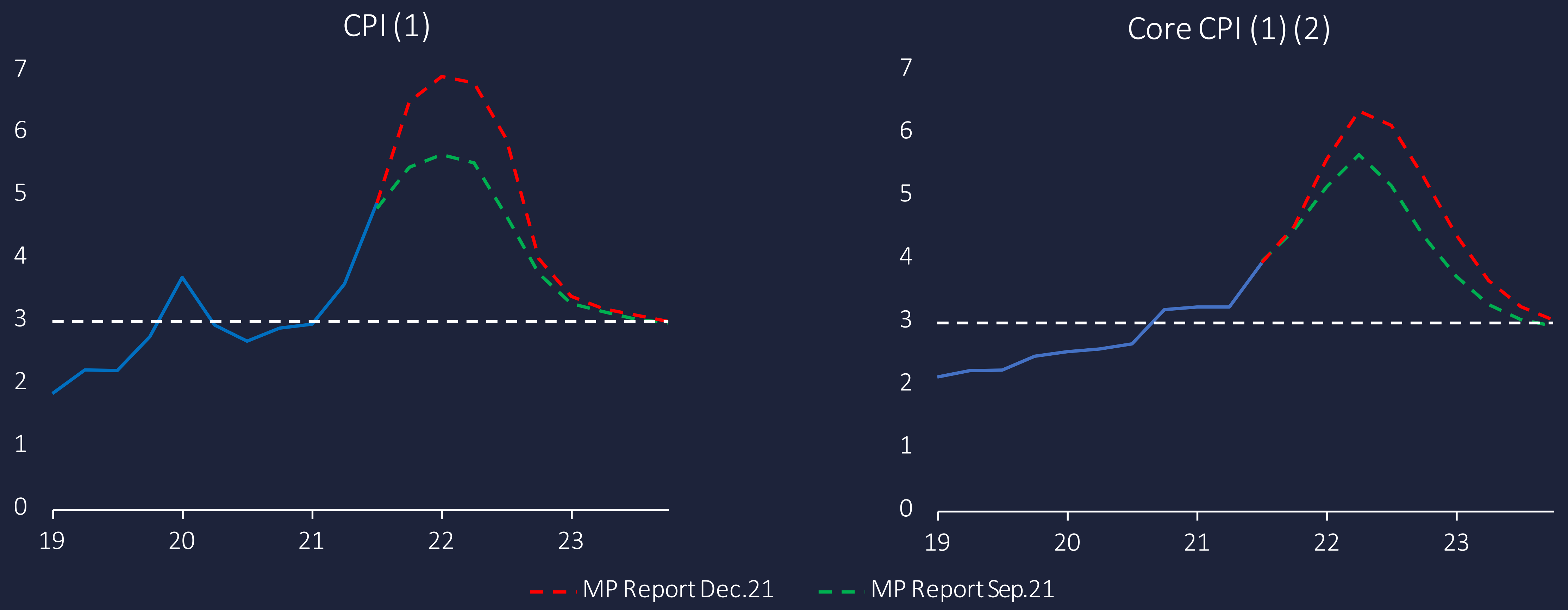


(*) For developed and emerging economies, GDP-weighted rates for each country, at PPP.
Source: Central Bank of Chile based on Bloomberg, BIS, and IMF data.

Forecasts

The central projection scenario assumes that headline CPI inflation will remain around 7% for a few months, to then begin to decline to 3% over the two-year policy horizon.

Inflation forecast
(annual change, percent)

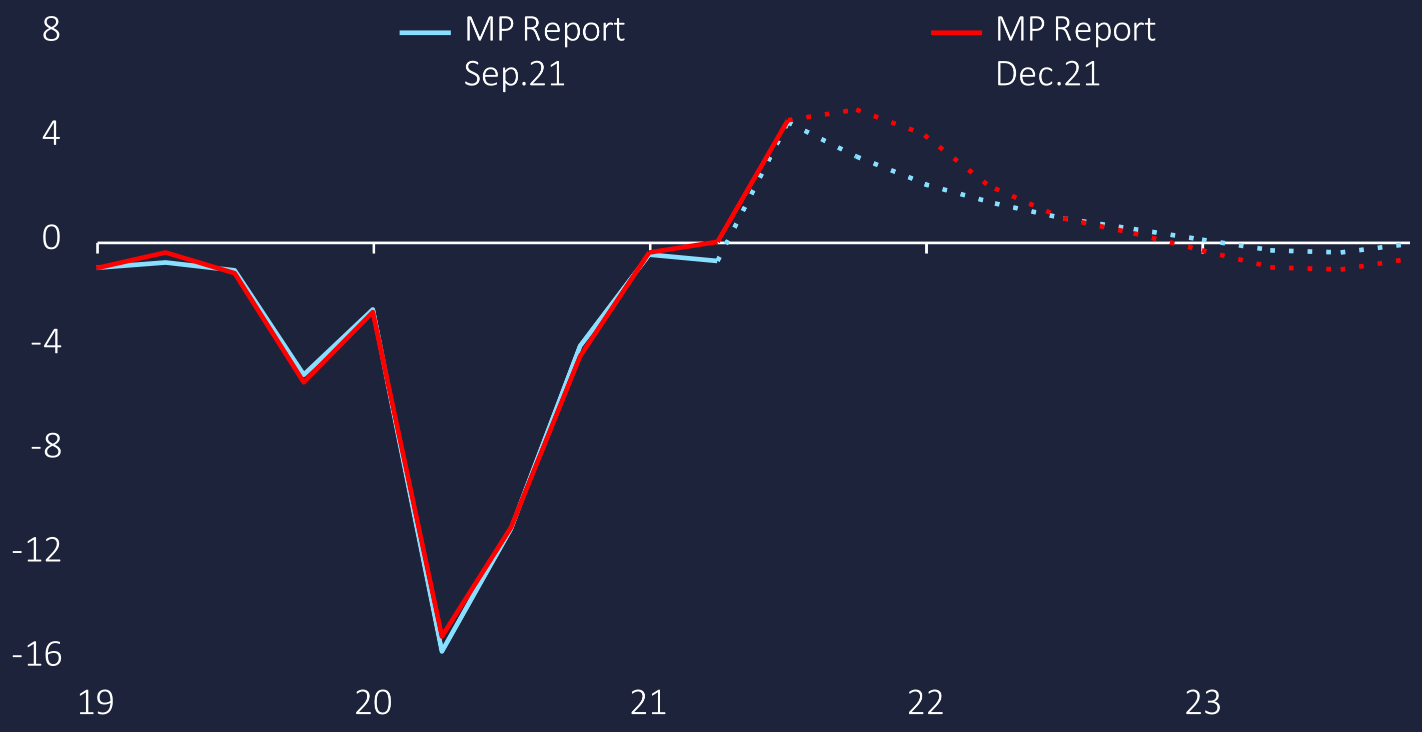


(1) Dashed lines show forecast in respective MP Report. (2) Measured by CPI w/o volatiles.
Sources: Central Bank of Chile and National Statistics Institute.

A key assumption for the convergence of inflation to the target is the resolution of the imbalances in the Chilean economy.

Activity gaps (1) (2)

(level, percentage points)



(1) Dotted lines show forecasts. (2) Forecast uses structural parameters as updated in the June 2021 MP Report.
Source: Central Bank of Chile.

In the central scenario, the gap will close gradually from the first quarter of 2022, returning to levels near zero between the end 2022 and early 2023.

This forecast assumes:

- End of the massive government transfer programs, and of the extraordinary withdrawals from pension funds
- Tighter monetary policy and return of two-year inflation expectations to 3%
- Still high uncertainty that affects investment and job creation

Between 2022 and 2023, the economy's annual expansion rates will see a significant slowdown, consistent with the expected change in macroeconomic momentum and the closing of the activity gap.

GDP growth forecast

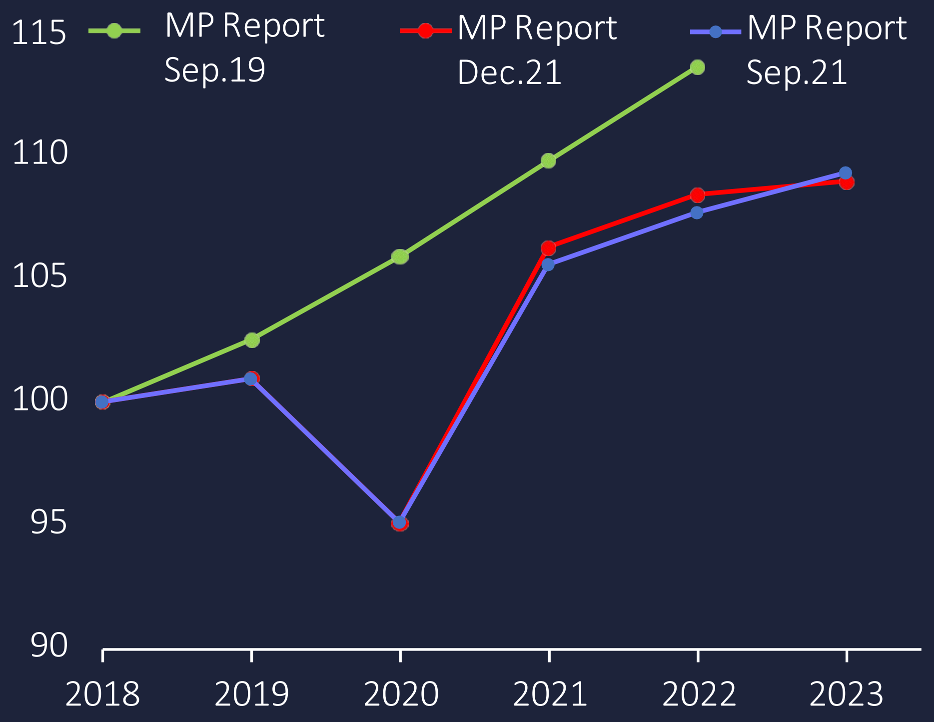
(annual change, percent)

	Sept.21	Dec.21
2021	11.5 % – 10.5 %	12.0 % – 11.5 %
2022	2.5 % – 1.5 %	2.5 % – 1.5 %
2023	2.0 % – 1.0 %	1.0 % – 0.0 %

(f) Forecast. (*) Growth for each year considers midpoint of respective MP Report range.
Source: Central Bank of Chile.

GDP forecasts (*)

(index, 2018=100)

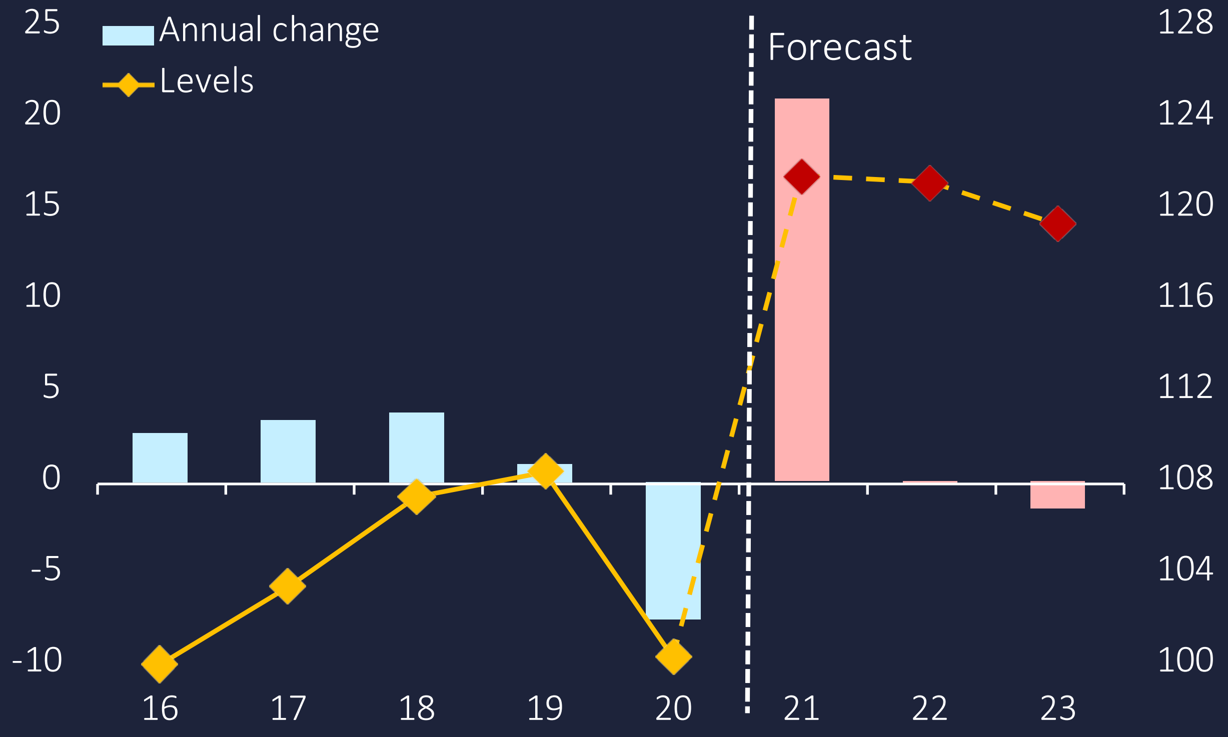


If these forecasts come true, average growth between 2018 and 2022 would be 2.5% annually and 2.7% annually for non-mining GDP.

Towards 2022 and 2023, a moderate contraction of private consumption is expected, particularly of durable goods, as they recorded a very significant accumulation in 2021.

Private consumption (*)

(real annual change, percent; index, 2016=100, levels)



(*) Diamonds and bars show forecasts in MP Report 2021.
Source: Central Bank of Chile.

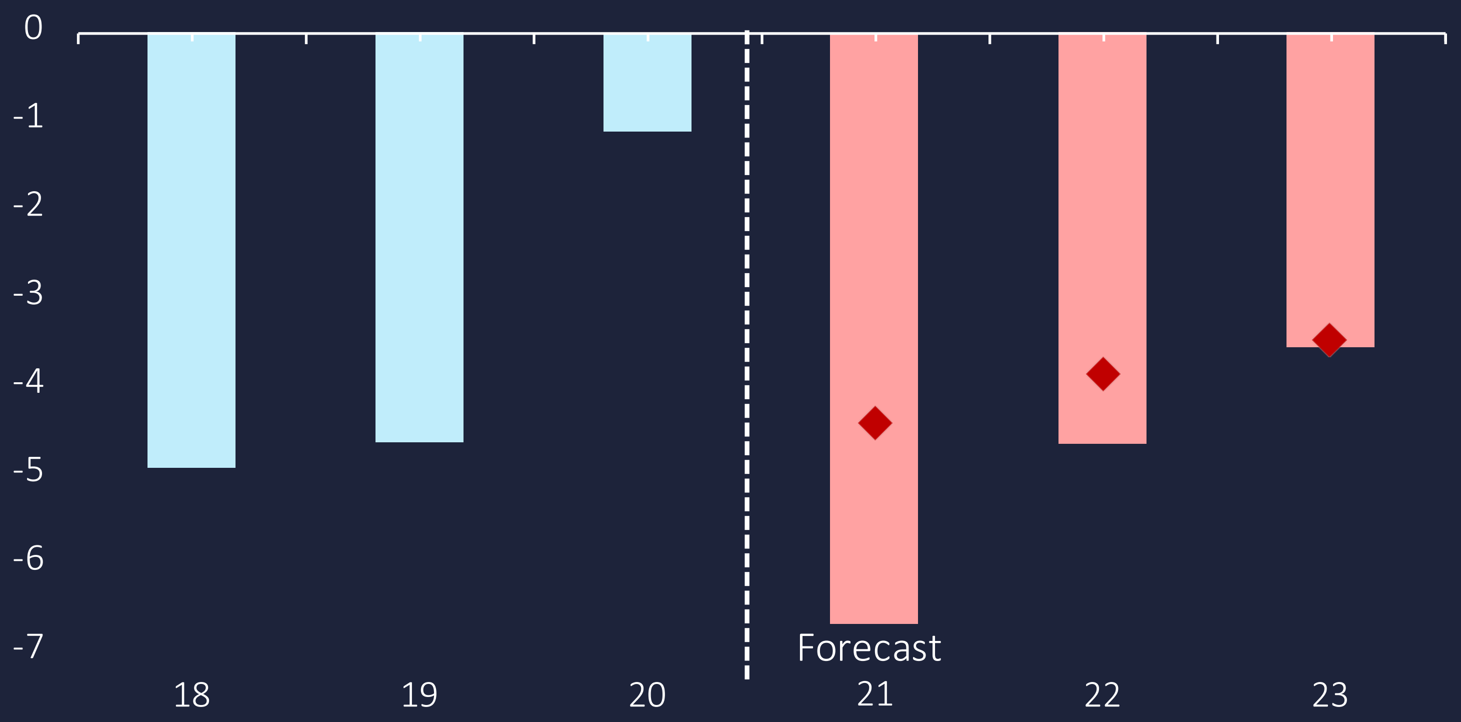
This forecast considers:

- High comparison base
- Extinction of Universal IFE and depletion of resources withdrawn from pension savings
- Tighter financial conditions

The current account will run a larger deficit this year, approaching numbers not seen since 2008. It is expected to moderate as domestic demand slows.

Current account at trend prices (*)

(percent of GDP)



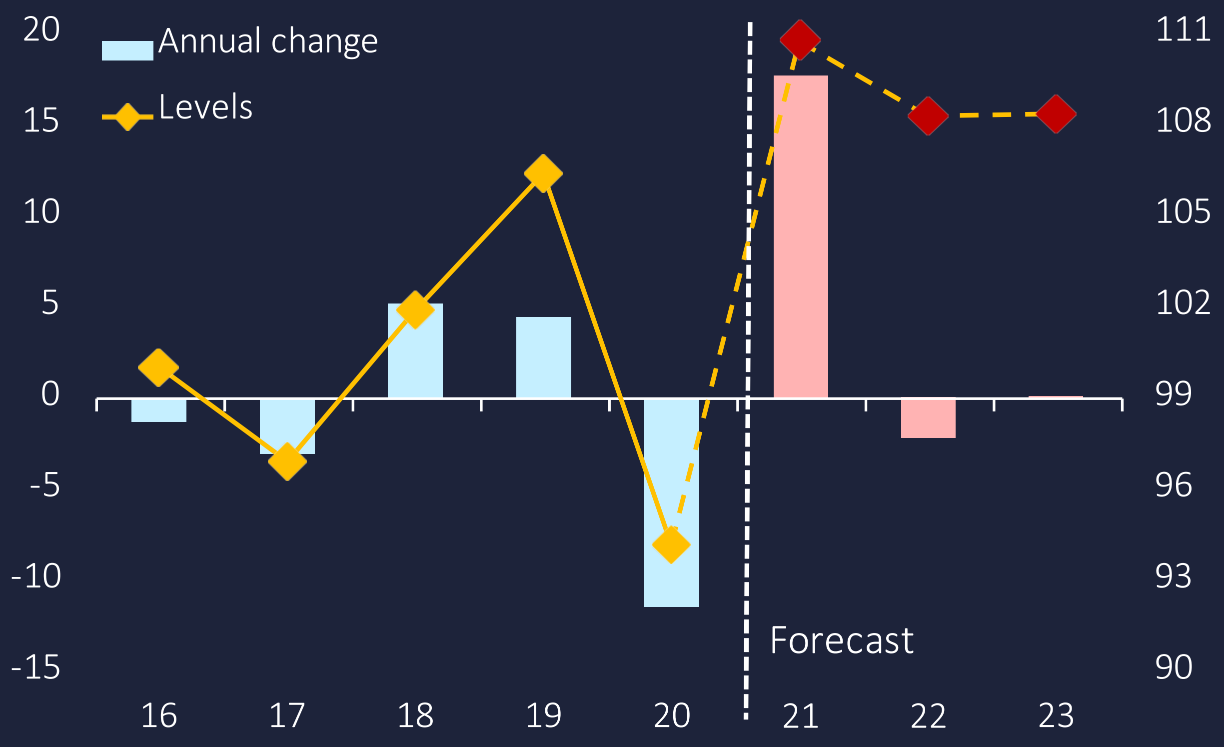
The current account at trend prices will post a deficit of 6.7% of GDP. This measure controls for price movements, so it focuses on volumes.

(*) Red diamonds show forecasts in September 2021 MP Report.
Source: Central Bank of Chile.

Investment will also perform weakly over the next two years, mainly because of the rise in long-term interest rates.

Gross fixed capital formation (*)

(real annual change, percent; index, 2016=100, levels)



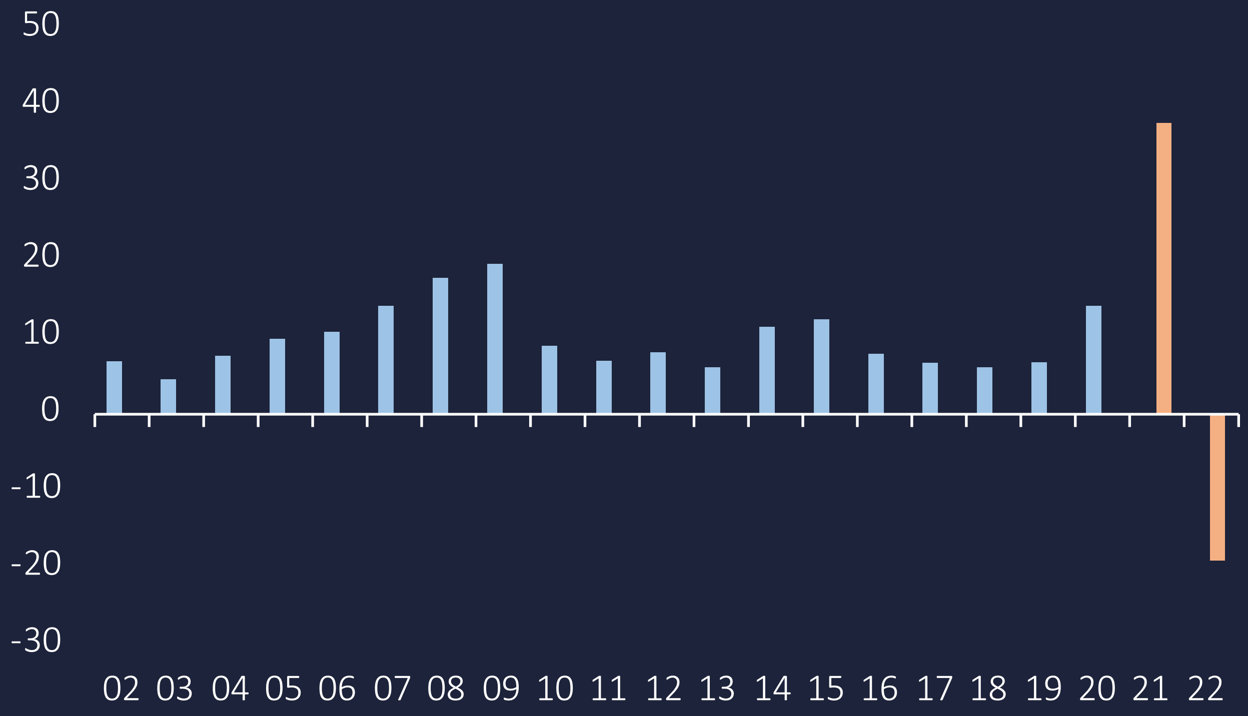
(*) Diamonds and bars show forecasts in December 2021 MP Report.
Source: Central Bank of Chile.

This forecast considers:

- Public investment and carryover of new projects will not offset the effect on private investment of high local uncertainty and increased long-term rates.
- Peso depreciation
- Poor stock market performance
- Slower expected growth for 2022-23

The forecast assumes that public spending will be adjusted to the budget approved for 2022 and the convergence trajectory set out therein.

Actual and projected tax expenditure (*)
(nominal annual growth, percent)



This forecast implies:

- Significant drop in spending due to the end of the massive transfer programs motivated by the sanitary emergency.

This will result in a significant reduction of the effective and structural fiscal deficit in 2022.

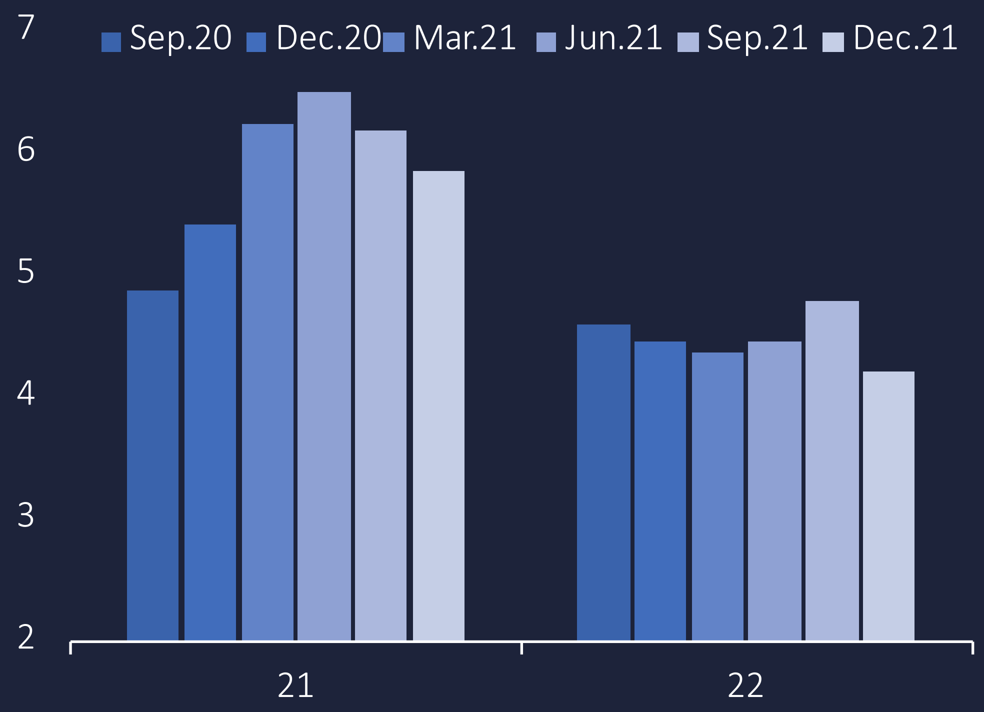
- In the medium term, the scenario assumes following the trajectory laid out in the latest Public Finances Report, which would be consistent with a gradual convergence to sustainable public debt levels.

(*) Red bars show Public Finances Report forecasts for 2021 and 2022.
Sources: Central Bank of Chile and Finance Ministry's Budget Office (DIPRES).

The impulse the Chilean economy will receive from abroad will be milder than was foreseen in the September Report.

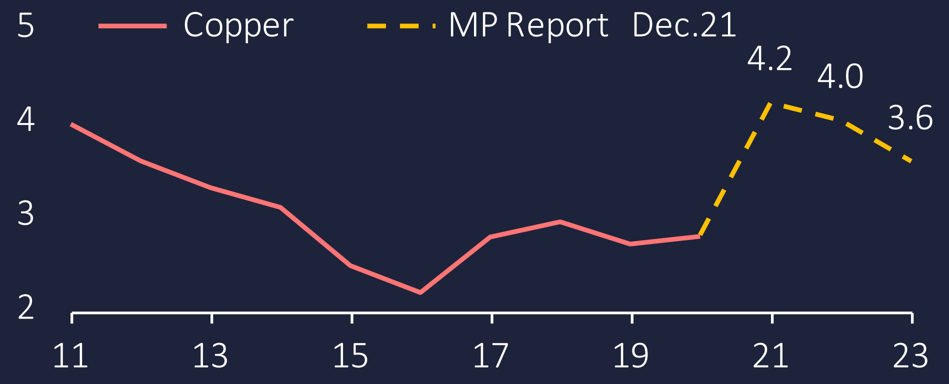
World growth forecast

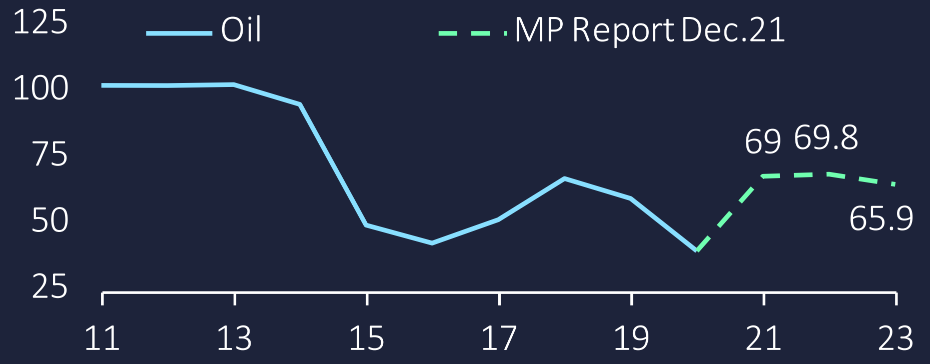
(annual change, percent)



Actual and projected prices (1) (2)

(dollars/pound; dollars/barrell)



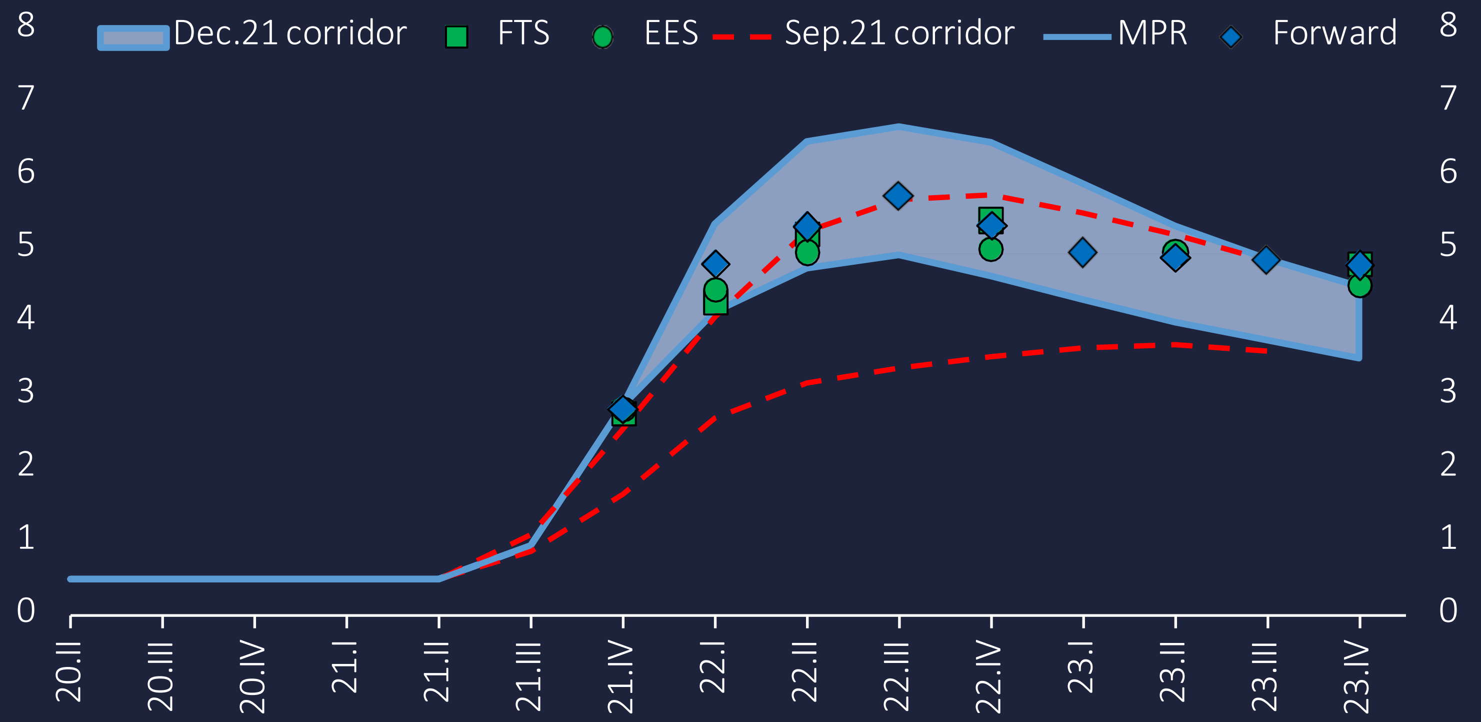


(1) Effective prices are the averages for each year. Dotted line corresponds to the 2021-2023 forecasts contained in the December 2021 MP Report. (2) For oil, WTI-Brent average price.

Sources: Central Bank of Chile and Bloomberg.

The Board raised the MPR by 250 bp between its meetings in October and December, placing it at 4.0%, exceeding the forecast in September's central scenario.

MPR corridor (*)
(percent)



- Faster monetary policy tightening responds to risks to the convergence of inflation to target, which have increased in recent months.

- The Board estimates that the MPR will continue to be increased in the short term, to be above its nominal neutral level during most of the monetary policy horizon.

(*) For further detail, see methodological note to figure V.1, in December 2021 MP Report.
Source: Central Bank of Chile.

There are sensitivity scenarios that may call for somewhat different monetary policy action than foreseen in the central scenario.

Scenario A: upper bound of corridor

- Private consumption adjustment to be longer-lasting or be less intense
- Higher inflationary pressures
- More contractionary monetary policy, placing the MPR at the upper limit of the corridor

Sensitivity scenarios

Scenario B

- Degree of idiosyncratic uncertainty subsides
- Lower inflationary pressures from the exchange rate
- Less contractionary monetary policy

Scenario C: lower bound of corridor

- Persistent local uncertainty could have a further negative impact on consumption and investment
- Lower medium-term inflationary pressures
- Monetary policy would return sooner to levels around neutral, marking the lower limit of the corridor.

There are risk scenarios in which changes in the economy would be more significant and where the monetary policy reaction would exceed the limits of the MPR corridor.

Long-term stabilization of public finances is unclear.

- Increased spending pressures and further deterioration of the local financial market and the value of the peso.

Increase in the MPR above the upper limit of the corridor.
Inflation might not converge.

Risk scenarios

Hasty removal of monetary stimulus in the U.S. and weakness of Chinese economy.

- Rapid removal of monetary stimulus in the U.S. due to inflation concerns, which would significantly deteriorate financial conditions for emerging economies.
- Recent weakness in the Chinese economy and financial problems in some of its bigger companies could amplify this situation.

MPR reduced below the lower limit of the corridor.

CONCLUDING REMARKS

- Although the local economy has managed to avert some important risks, it is still in a vulnerable situation derived from the strong and unbalanced expansion of 2021.
- This is manifest in the rapid increase in inflation and the sharp reversal of the current account, which is evidence of consumption growing at a non-sustainable pace.
- The approval of a budget for 2022 that opens a path of fiscal consolidation and the rapid withdrawal of monetary stimulus by the Central Bank are key steps to bring the Chilean economy back to balance without a harmful adjustment for the population.
- Advancing in the implementation of these policies will allow the upcoming authorities to start their administration on a path of convergence that will facilitate the implementation of their projects for the country.
- The Central Bank will contribute to this effort with further increases in the MPR in the next meetings, so as to ensure the convergence of inflation to 3% in the two-year horizon.
- This will allow total inflation to begin its turnaround between the second and third quarters of 2022, which will allow the MPR to become less contractionary in the second half of the year.
- In the meantime, the next administration will have the room to contribute to a more favorable 2023 than the one presented in our forecasts, to the extent that it is able to reduce uncertainty, stimulate investment and raise productivity.

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