Prospects for inflation and monetary policy

Rosanna Costa

Board member

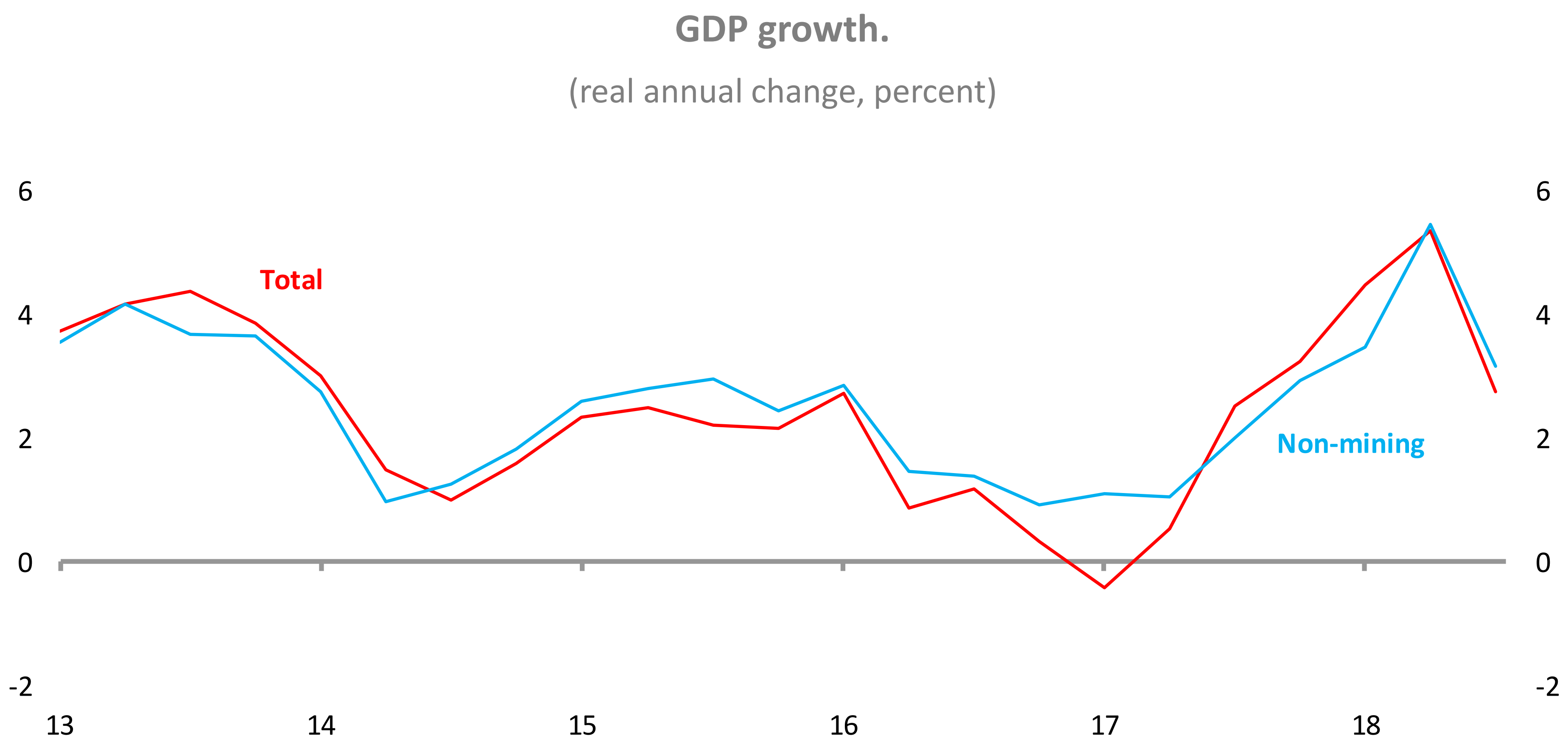
Central Bank of Chile, December 2018

I. Context for the Chilean economy.

II. Institutional elements. The role of monetary policy.

III. The current inflation outlook.

The economy has regained its growth pace, after a period of low growth.

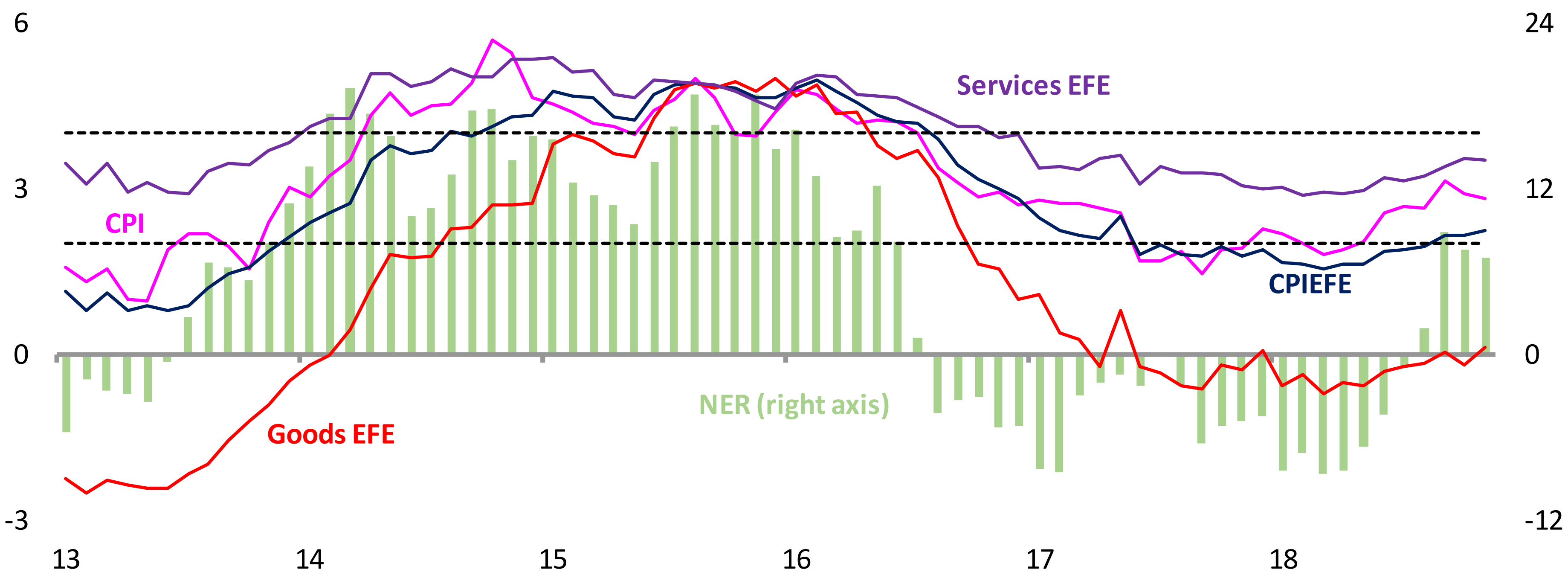


Source: Central Bank of Chile.

Inflation, with ups and downs, has averaged around 3% in the past several years. The impact of the exchange rate shock has been relevant to understand the fluctuations of core inflation.

Inflation and the nominal exchange rate.

(annual change, percent)



Sources: Central Bank of Chile and National Statistics Institute.

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Institutional framework.

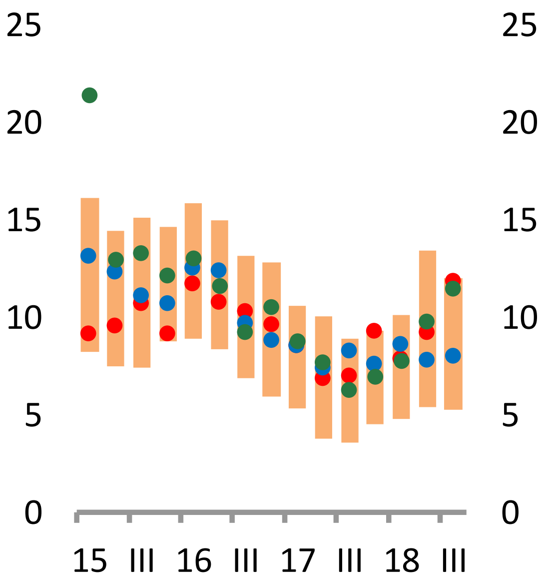
Chile’s macroeconomic and financial institutionality rests on four main pillars:

- The autonomy of the Central Bank of Chile (BCCh), which conducts monetary policy based on a two-year-ahead inflation target and a free-floating exchange rate.
- A fiscal policy based on a structural balance rule.
- A proper framework for the regulation and supervisión of the financial system.
- Integration with global markets via trade openness and free capital mobility.

Being an open and integrated economy, Chile has opted for an institutional environment that has as its first line of defense the exchange rate as a shock absorber. This framework has allowed having fairly stable long-term interest rates.

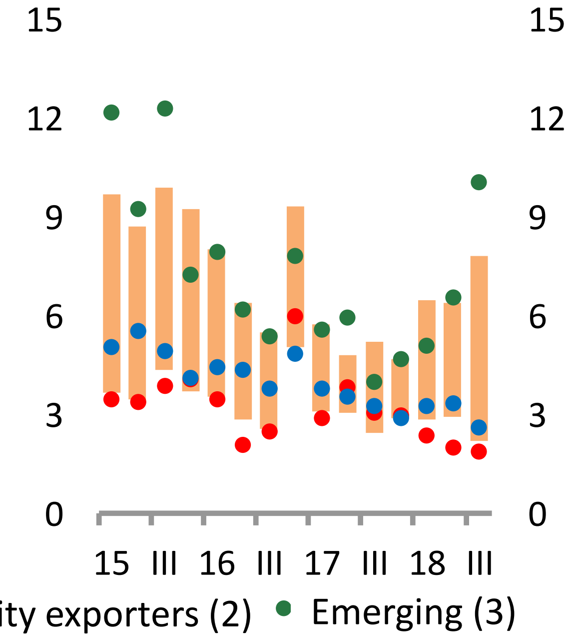
Y-o-y exchange rate volatility.

(percent)



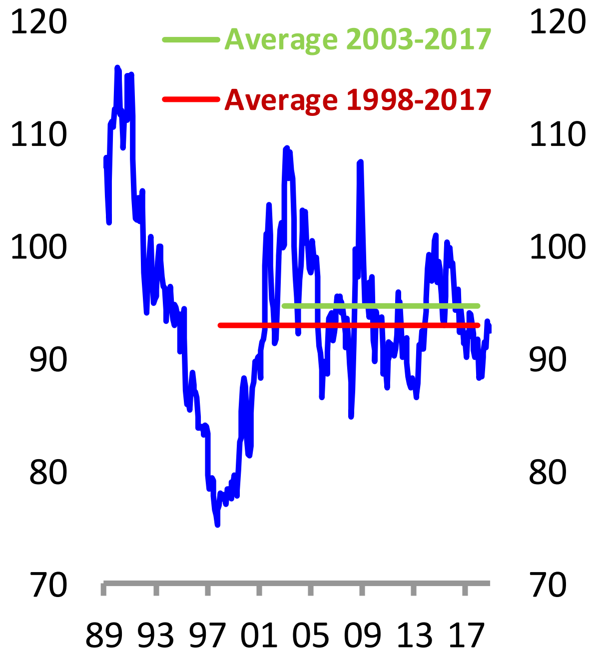
Volatility of 10-year interest rates. (1)

(basis points)



Real exchange rate. (4)

(index,1986=100)



(1) Calculated as the standard deviation of daily change in rates. (2) Includes Chile, Brazil, China, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Poland, Russia and Turkey. (3) Includes Australia, Canada, New Zealand and Norway.

Sources: Central Bank of Chile and Bloomberg.

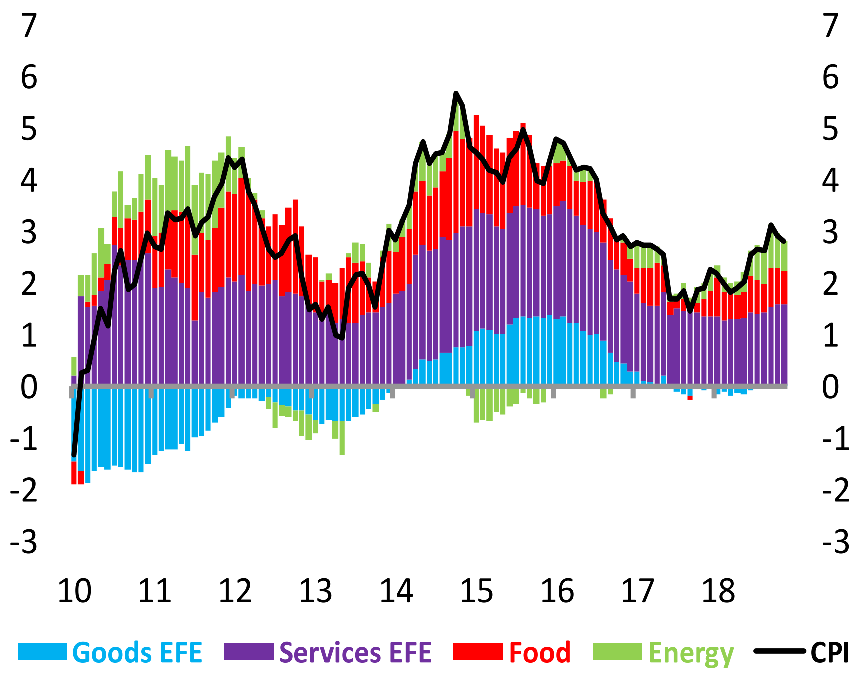
(4) November 2018 figure corresponds to a preliminary estimate. December 2018 figure uses information up to the 12th.

Source: Central Bank of Chile.

A free floating exchange rate, however, also implies some effects on inflation. Their magnitude and duration depends on the source of the exchange rate shock.

Contributions to annual CPI.

(percentage points)



Pass-through from exchange rate to inflation. (*)

(permanent shocks)

Horizon (quarters)	Global Price shock (conditional)	Interest rate parity shock (conditional)	Unconditional shock
1	0.02	0.04	0.03
4	0.05	0.26	0.10
8	0.06	0.54	0.14

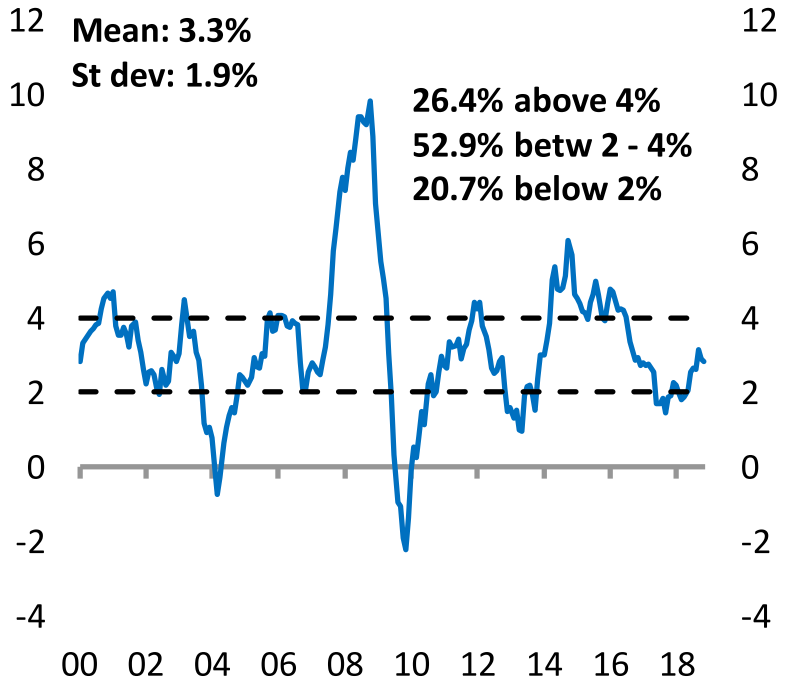
Sources: Central Bank of Chile and National Statistics Institute.

(*) Each entry shows indicated pass-through for the prices in the first row, in the horizon indicated in the first column. Source: Central Bank of Chile based on García and García-Cicco (2018) and Contreras y Pinto (2016).

The volatility of the exchange rate has resulted in headline inflation being as often inside as outside the target range but, thanks to the credibility of monetary policy, expectations have remained well anchored.

Headline inflation.

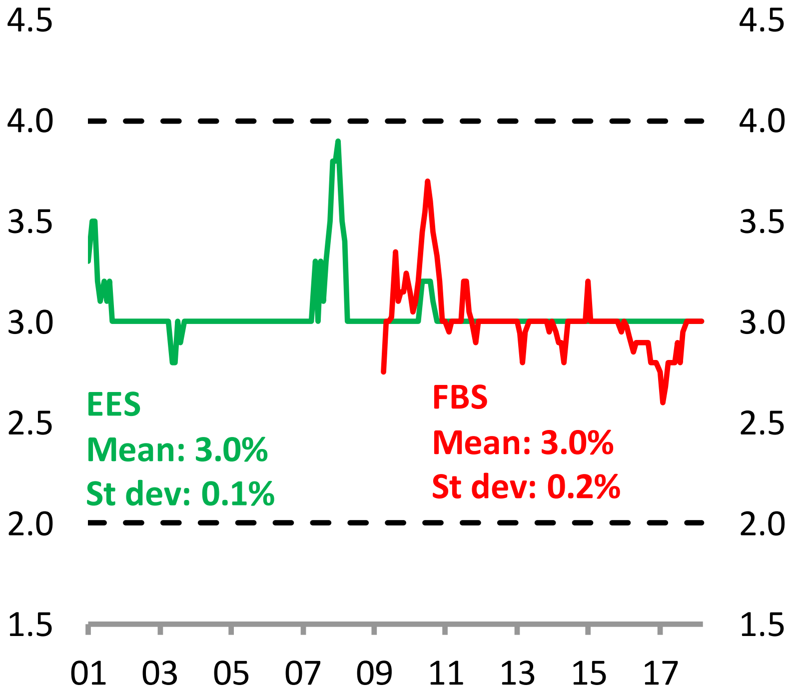
(annual change, percent)



Source: Central Bank of Chile.

Inflation expectations at 24 months.

(annual change, percent)



Source: Central Bank of Chile.

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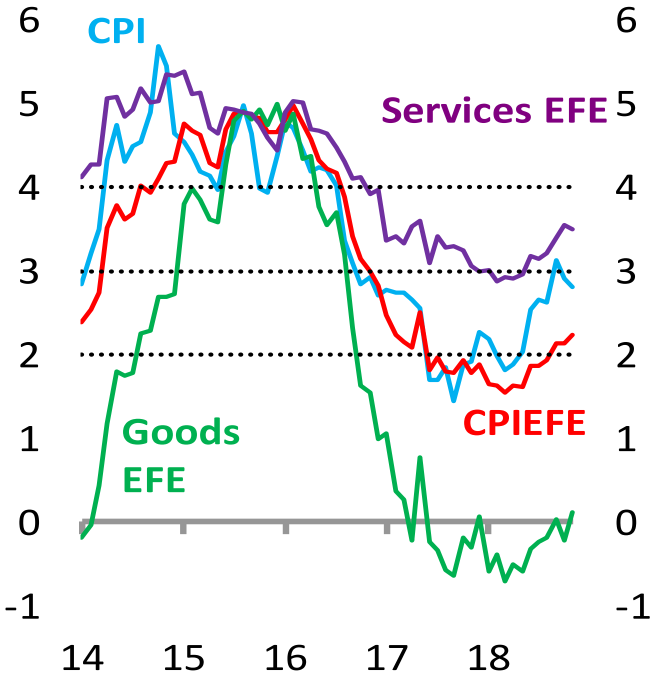
Inflation has risen to around 3% annually in recent quarters. Still, the sharp drop in fuel prices has reduced somewhat our inflation forecast for 2018 and 2019. To the extent that supply-side factors determine the oil price reduction, this should not affect achieving the two-year inflation forecast.

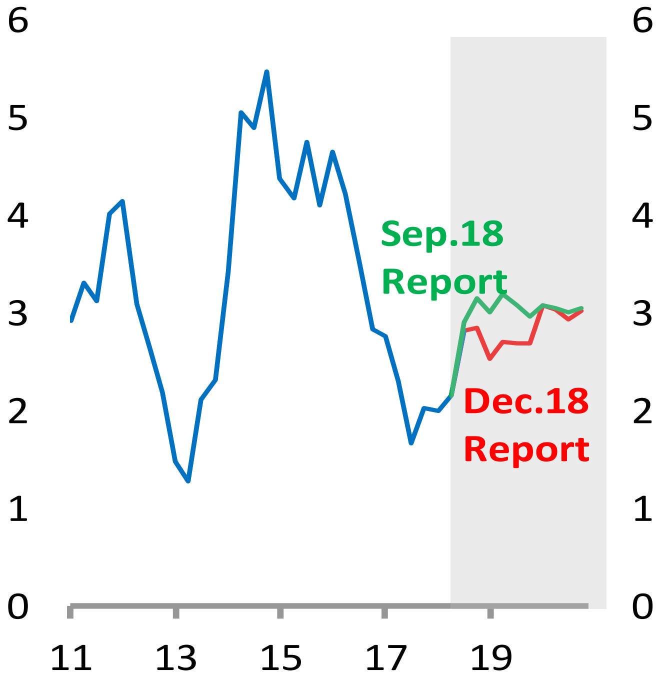
Inflation indicators.

(annual change, percent)



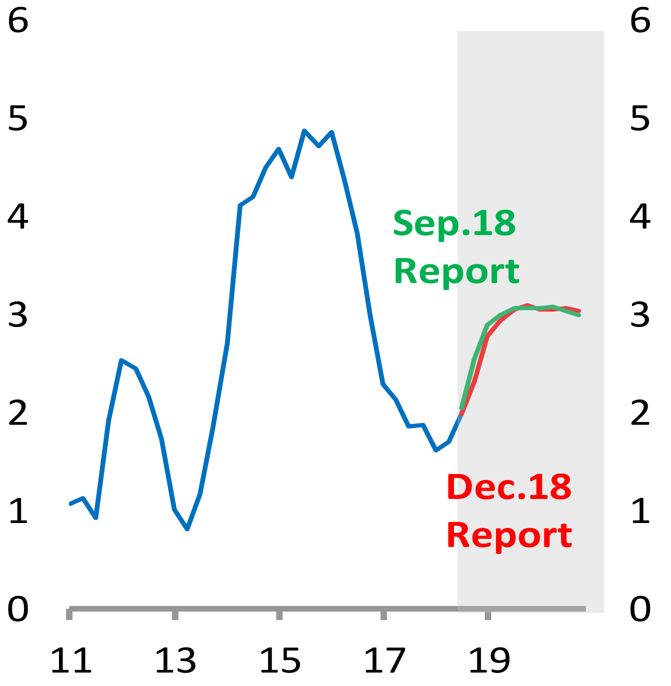
CPI. (*)

(annual change, percent)



CPIEFE. (*)

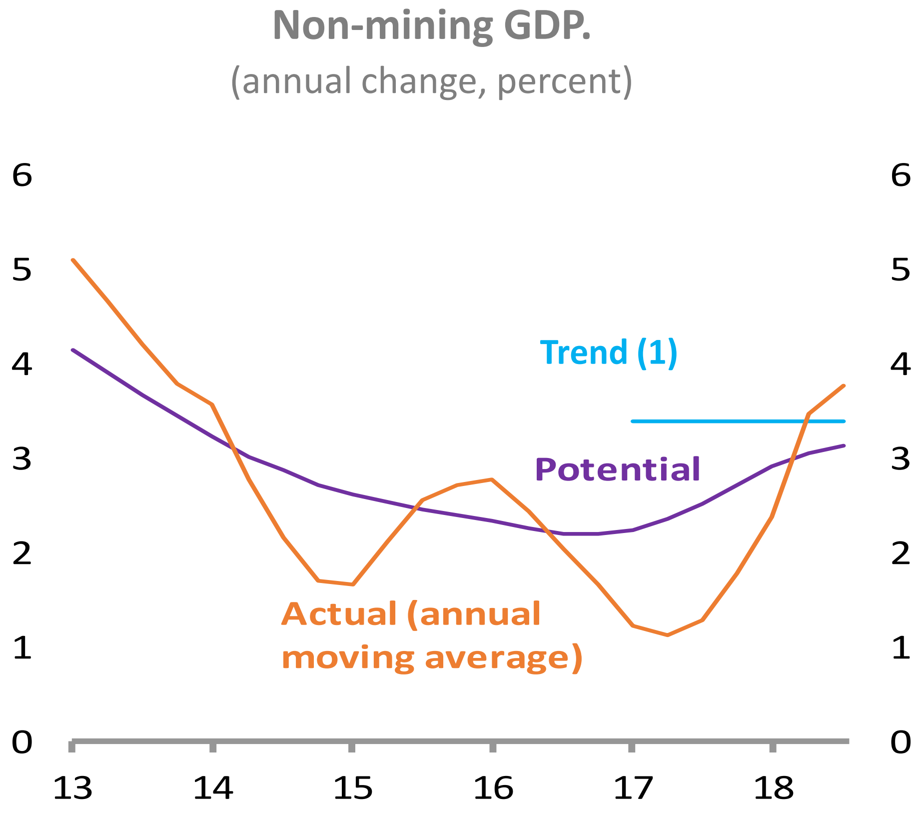
(annual change, percent)

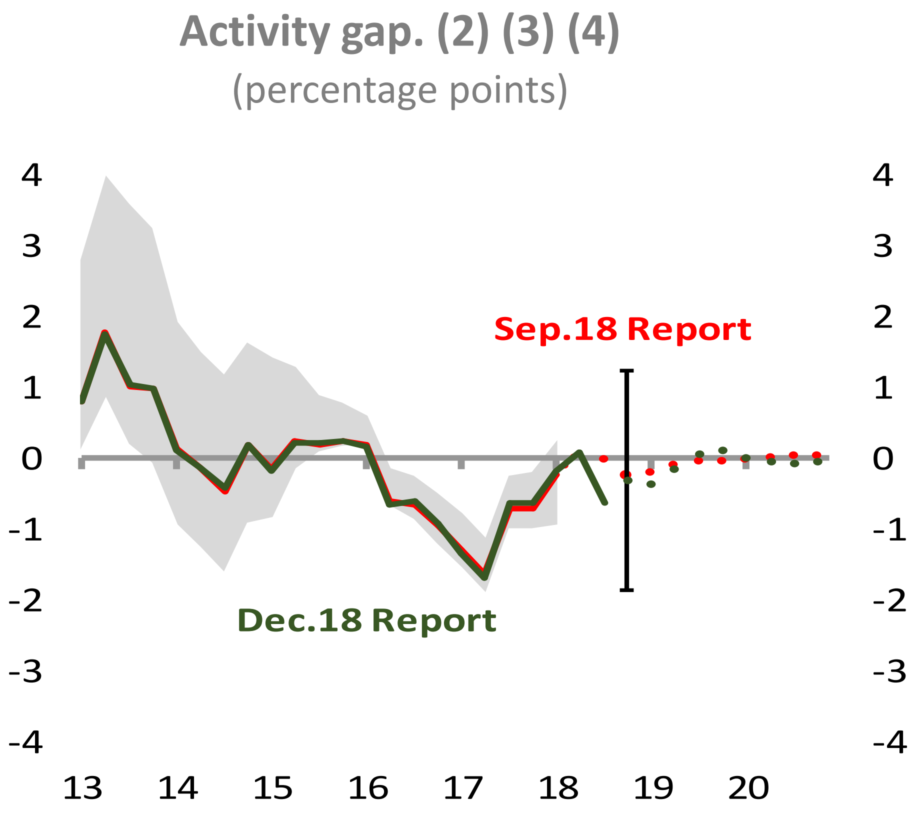


(*) Gray area, as from the fourth quarter of 2018, shows forecast.

Sources: Central Bank of Chile and National Statistics Institute.

All in a context in which this year growth has been above potential, helping to reduce the slack in the economy.





(1) Non-natutal resources GDP. Period 2017-2026.

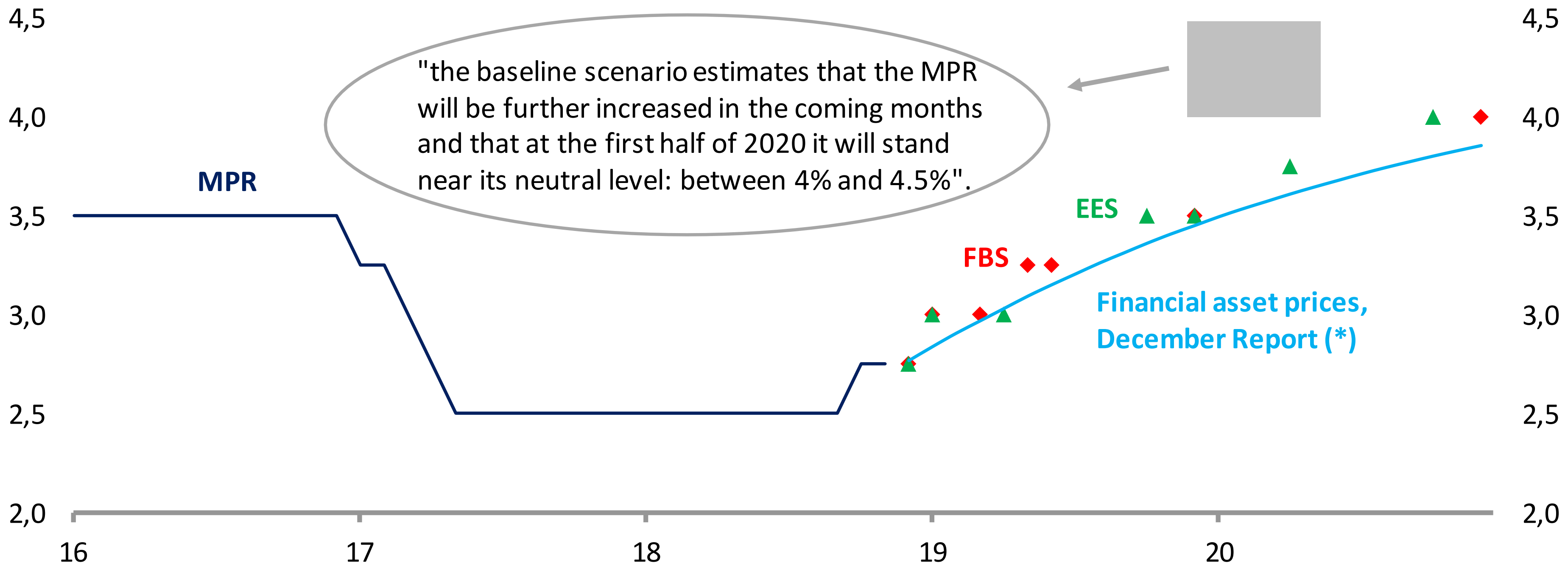
Source: Central Bank of Chile.

(2) Gray area shows range of gap estimates using different methods to estimate potential GDP (i.e. trivariate, multivariate, HP, SVAR, MEP and SSA). See Fornero and Zúñiga (2017). (3) Dotted lines show forecasts. (4) Bar in the fourth quarter 2018 includes +/-1.3% range corresponding to one standard deviation of the historical revisions to the gap. Therefore, the final stance of the gap will be within a 68,3% confidence interval. Source: Central Bank of Chile.

As a working assumption, the baseline scenario estimates that the MPR will be further increased in the coming months and that at the first half of 2020 it will stand near its neutral level: between 4% and 4.5%.

MPR and market expectations. (1)

(percent)



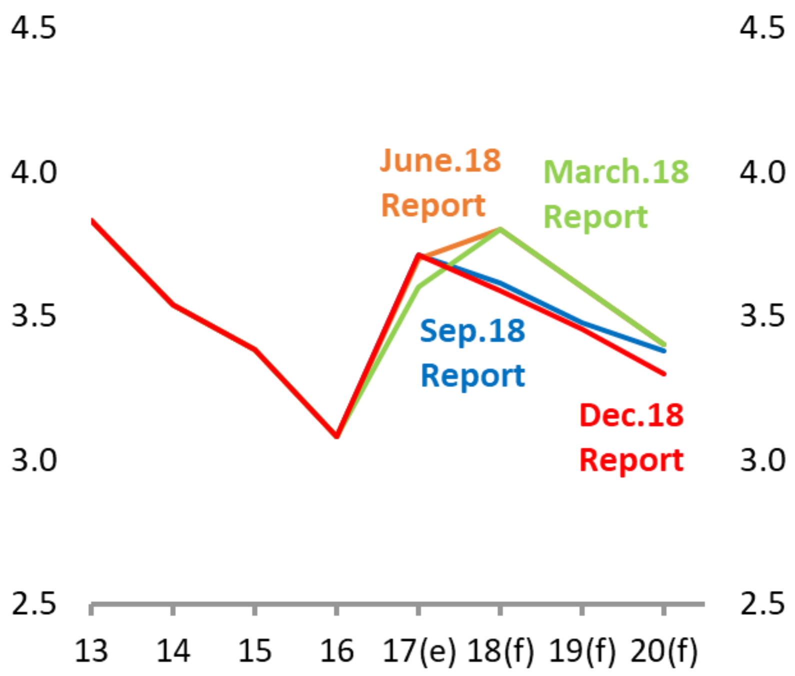
(*) Constructed using interest rates on swap contracts up to 10 years.

Source: Central Bank of Chile.

Our external scenario assumes that the impulse that the Chilean economy will be receiving from abroad will diminish gradually over the next two years, but will remain positive. It is also conditional on how risks unfold.

Trading partners' growth.

(annual change, percent)

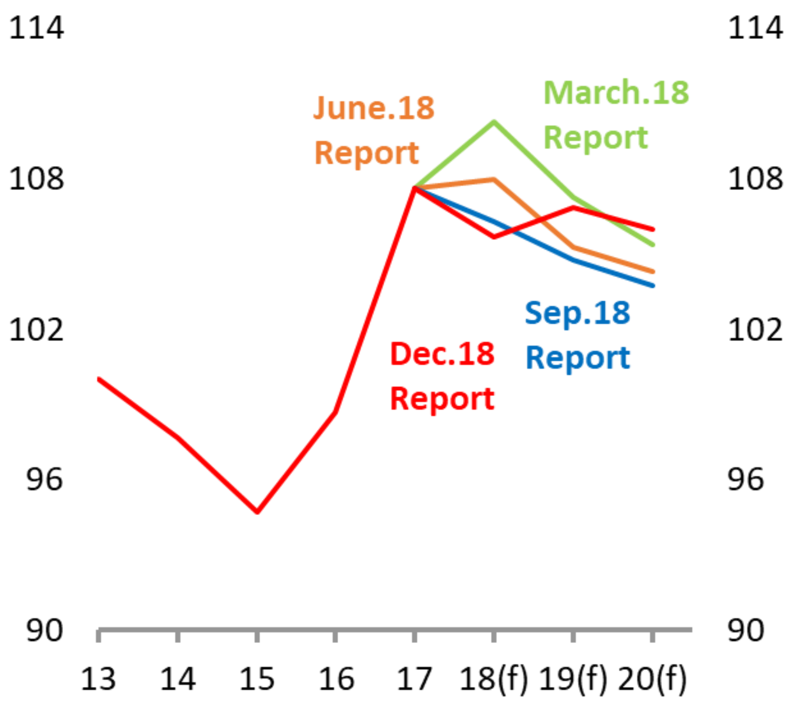


(e) Estimate.
(f) Forecast.

Source: Central Bank of Chile.

Terms of trade.

(index, 2013=100)



(f) Forecast.

Source: Central Bank of Chile.

Risks and sensitivity scenarios.

External risks: biased downard for activity

- Financial conditions facing emerging economies
- U.S.: inflation, monetary policy, activity outlook
- Trade war
- China
- Oil price
- Europe: Brexit and Italy

Local risks for activity: unbiased

- Consumption recovery is taking longer
- Greater rebound of investment

Risks for inflation: unbiased

Sensitivity scenarios.

Scenario	GDP	Inflation	MPR
Worsened financial condition	**(-)**	**(-)**	Remains constant for longer
Reduced consumption	**(-)**	**(-)**	More gradual withdrawal of monetary stimulus
Increased investment	**(+)**	**(+)**	Faster withdrawal of monetary stimulus

Final remarks

- The Chilean economy, after years of slow growth, has evolved favorably and is expected to converge to its trend.
- In our institutional framework, the flexible exchange rate plays an important role as a first-instance adjustment variable.
- This could poses challenges to short term inflation developments. A credible monetary policy has however succeeded in holding average inflation at 3% and expectations well anchored.
- The two-year target focuses on those factors affecting the medium term (2 years), which allows for short-term deviations. Thus the cycle can be smoothed, but not avoided.

Final remarks

- The macroeconomic scenario outlined continues to depict an economy that has recovered its capability for growth and is gradually reducing its capacity gaps. This leans on dynamic investment and a labor market that has been able to absorb an important positive immigration shock.

- Given the baseline scenario of a gradual and prudent normalization of monetary policy, then core inflation will converge with headline CPI inflation --and both with the 3% target-- towards the end of 2019.

- This strategy considers a gradual increase in the monetary policy rate, cautiously converging to the neutral level in the first half of 2020.

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