MONETARY POLICY AND INFLATIONARY CONVERGENCE IN CHILE

banco central Chile

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Recent Developments in Chilean economy (MP Report June 2023)

- After reach maximum levels of 14.1% in August 22, the inflation has been decreasing in line with what was anticipated. Last figure (May 23) shown an annual CPI on 8.7%.

- However, inflation remains high in historical perspective. Also, the reduction of the underlying component has been slower than that of the total CPI (9.9% in May 23).

- The reduction of inflation has been possible because the imbalances of previous years' spending has been resolving.

- Activity and demand have evolved as expected. For 2023, we expect that GDP growths between 0.25 and -0.5%, with negatives figures on consumption and investment. For 2024 and 2025 we expect positive figures: [1.25 – 2.25%] and [2-3%].

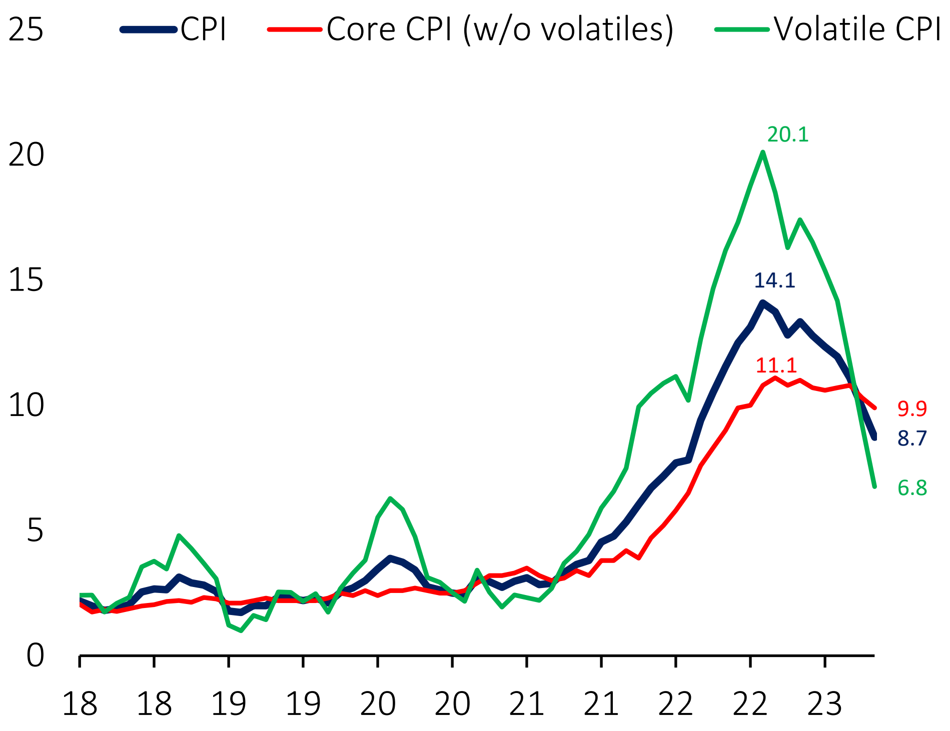
- The adjustment of activity and demand is largely explained by the contractive nature of monetary policy, which is necessary for the convergence of inflation to the target.

- If these trends of adjustment and inflationary convergence continue, the MPR will start a downward process in the short term. The magnitude and timing of its reduction will consider the evolution of the macroeconomic scenario and its implications for the inflation trajectory.

Annual inflation reached its highest level in three decades (14.1% in August 2022), driven by excess liquidity and supply shocks (pandemic, war in Ukraine). Monetary policy reacted strongly, which has contributed to the fact that inflation is already declining.

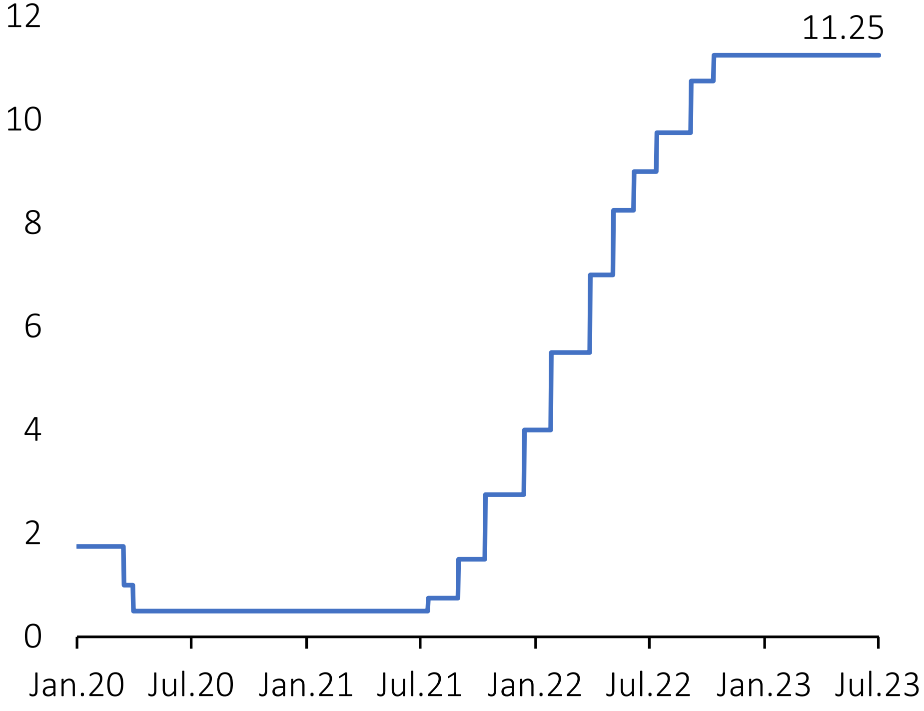
Inflation indicators (*)

(annual change, percent)



Monetary pollicy rate (MPR)

(percent)



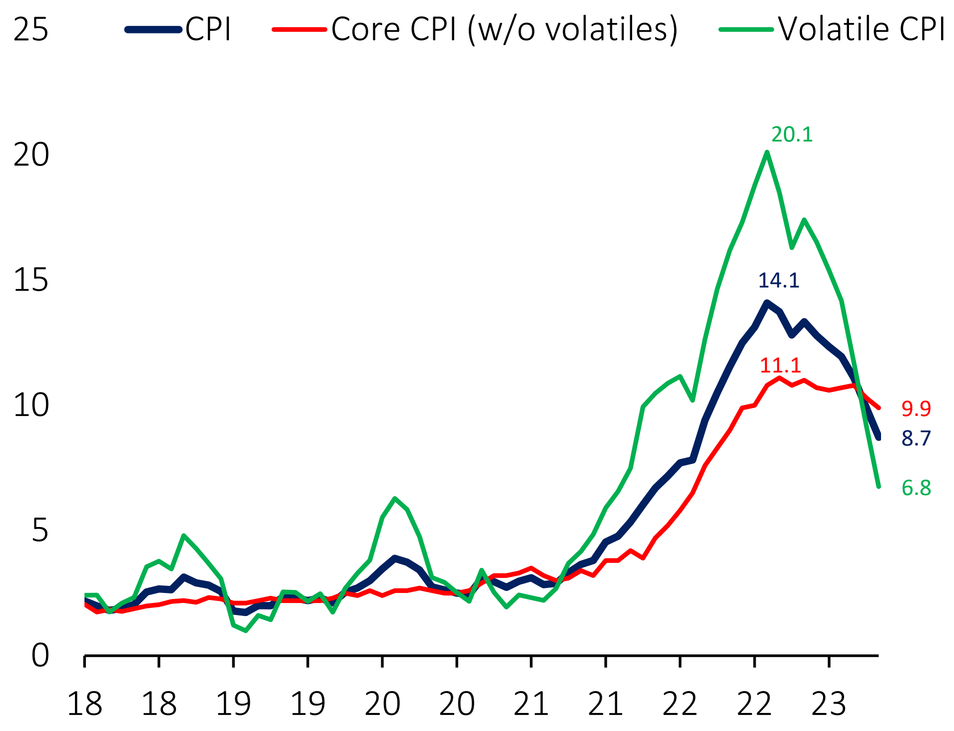
(*) For further details on the different groupings and their participation in the total CPI basket, refer to Box IV.1 IPoM December 2019, Carlomagno and Sansone (2019), and Economic Glossary.

Sources: Central Bank of Chile and National Statistics Institute (INE).

In the last months, total and core inflation have decreased as expected, the latter in a slower and more limited way. Goods components and volatile elements are leading the decrease in inflation.

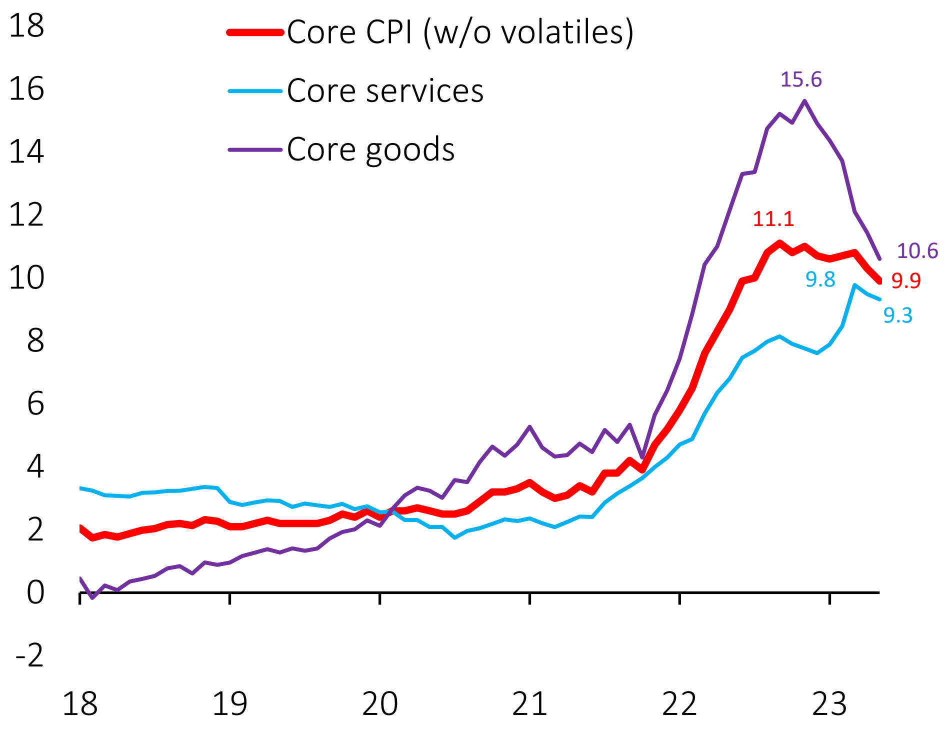
Inflation indicators (*)

(annual change, percent)



Core inflation

(annual change, percent)

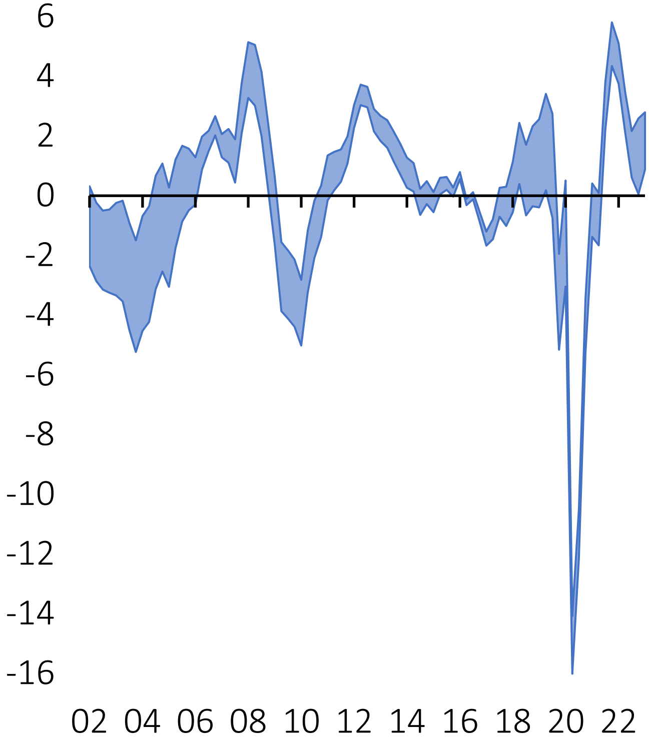


(*) For further details on the different groupings and their participation in the total CPI basket, refer to Box IV.1 IPoM December 2019, Carlomagno and Sansone (2019), and Economic Glossary.

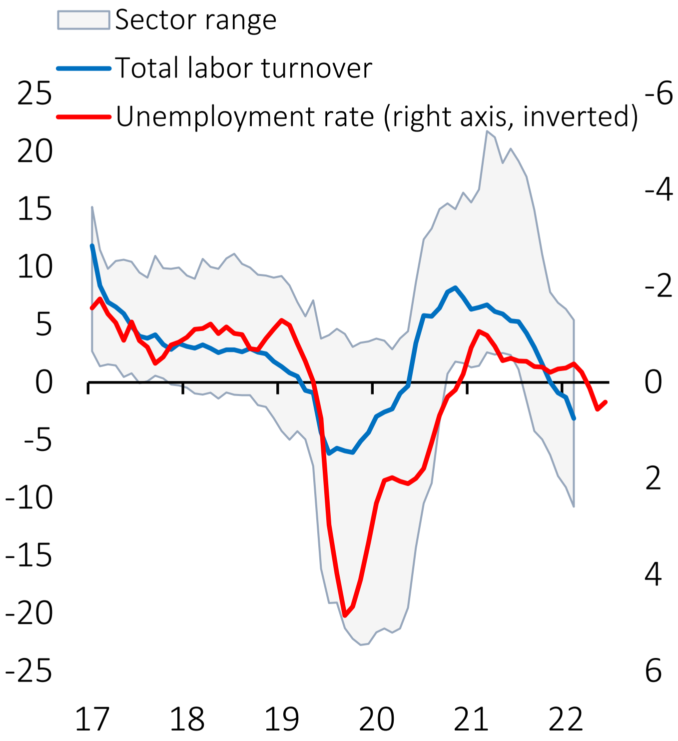
Sources: Central Bank of Chile and National Statistics Institute (INE).

Inflation has fallen in a context where the economy has been making progress in its necessary adjustment process, after the overspending of previous years.

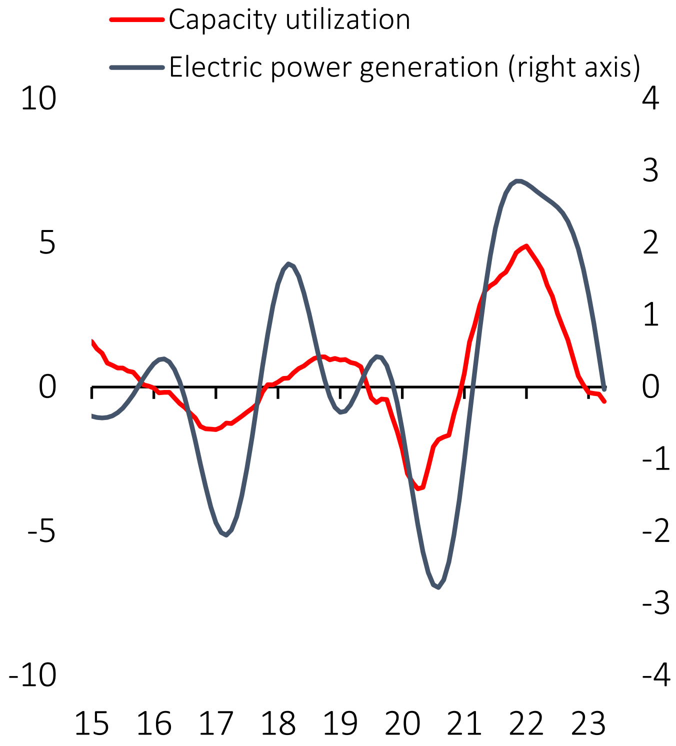
Activity gap by different methods (1)
(percent)



Labor market measures (2)(3)(4)
(percent)



Other measures of capacity gaps (5)(6)
(percent)



(1) Shaded area represents a range of models considered for calculating the gap. For details, see note to Figure II.12 in June 2023 Report. (2) Net Labor Turnover Rate (TRL): Movement of workers over twelve months in the formal wage employment sector. It is calculated from administrative records of companies as the difference between the job entry rate (job creation) and the job separation rate (job destruction). (3) The range of sectors is defined as the envelope of the net TRL for each sector (CIIU4 excluding agriculture). (4) Unemployment rate: Deviation from the average since September 2001 until December 2022. (5) Capacity utilization: Centered ±6-month moving average, normalized by the average capacity utilization in years 2017-18. (6) Electric generation: Cyclical component of electric generation in the National Electric System (SEN), calculated using a band-pass filter. Sources: Central Bank of Chile, ICARE/Adolfo Ibáñez University, National Electric Coordinator, and National Statistics Institute (INE).

The decrease in goods inflation is due to the relief from strong cost pressures, the appreciation of the nominal exchange rate, and the fall in demand for durables.

Commodity prices (1)
(index, 2018-2023=100)

Transportation cost (2)
(percent of GDP, quarterly)

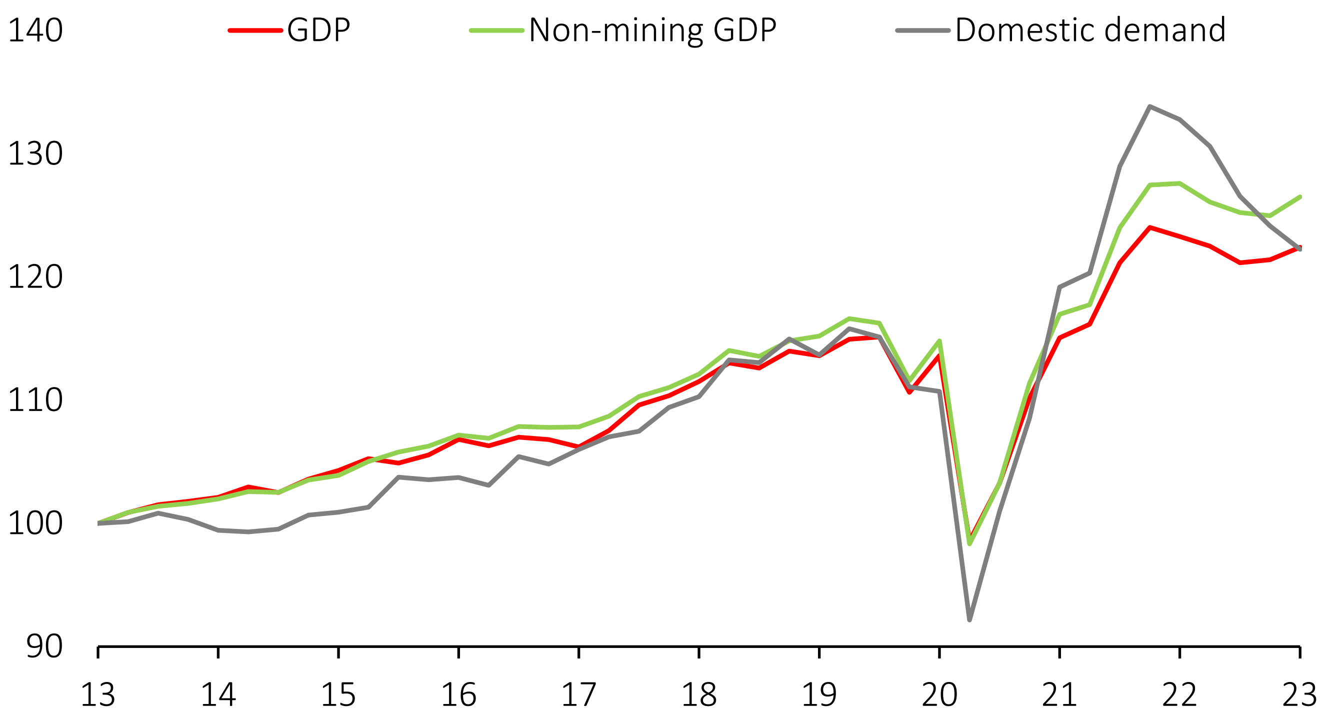
Real exchange rate (RER) (3)(4)
(index, 1986 average=100)

(1) Food prices consider the FAO index, and oil prices consider the average between Brent and WTI. (2) Cost of transportation for imported products to Chile, measured as a percentage of GDP. (3) Preliminary data for June 2023. (4) Average of the last 15 years corresponds to the period Jul.08-Jun.23.
Sources: Central Bank of Chile and Bloomberg.

In recent months, the evolution of activity and demand has been in line with what was forecast in the March Monetary Policy Report.

Activity and demand

(index, 2013.Q1=100, real deseasonalized series)



Source: Central Bank of Chile.

Main differences with respect to March Report projection:

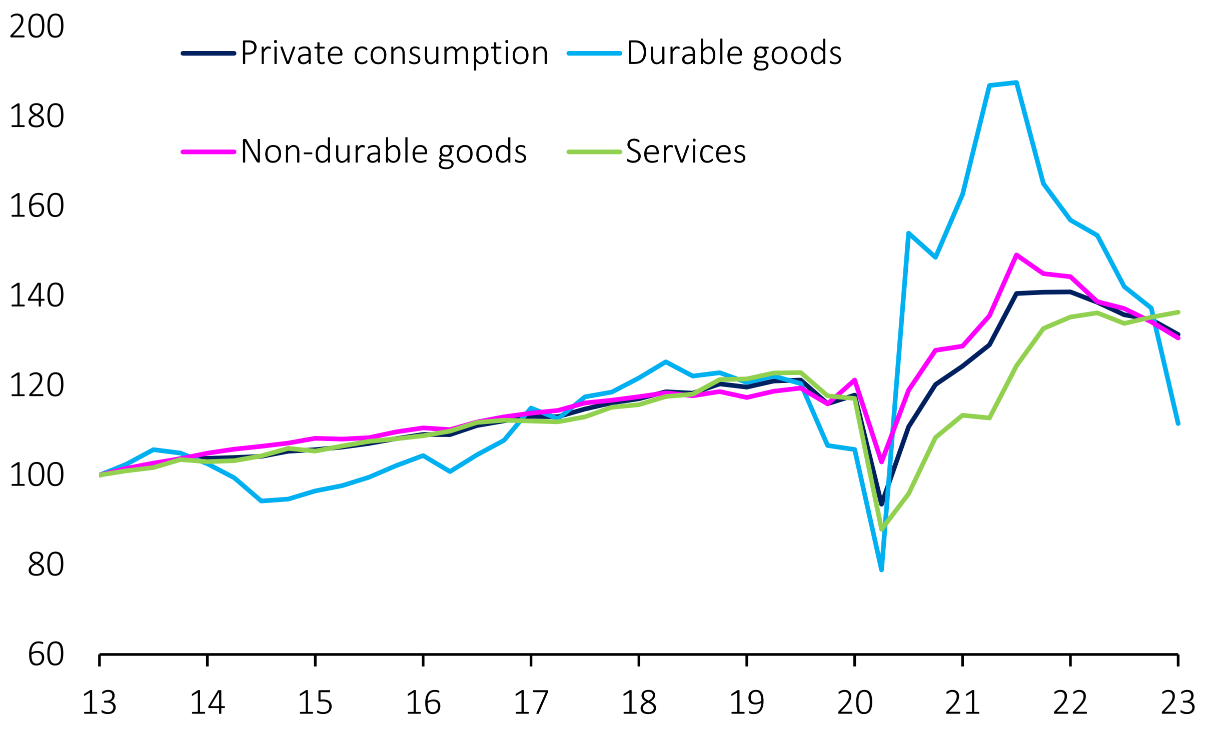
- Slower mining activity
- Sharper drop in households' imports consumption

First quarter results	Annual change	Quarterly change (SA)
GDP	-0.6	0.8
Non mining GDP	-0.6	1.2
Domestic demand	-8.0	-1.5

The decline in spending has been especially notable for imported products, particularly household durable goods.

Private consumption

(index, 2013.QI=100, real seasonally adjusted series)



Source: Central Bank of Chile.

Shares of private consumption components:

9% Durable goods

45% Non-durable goods

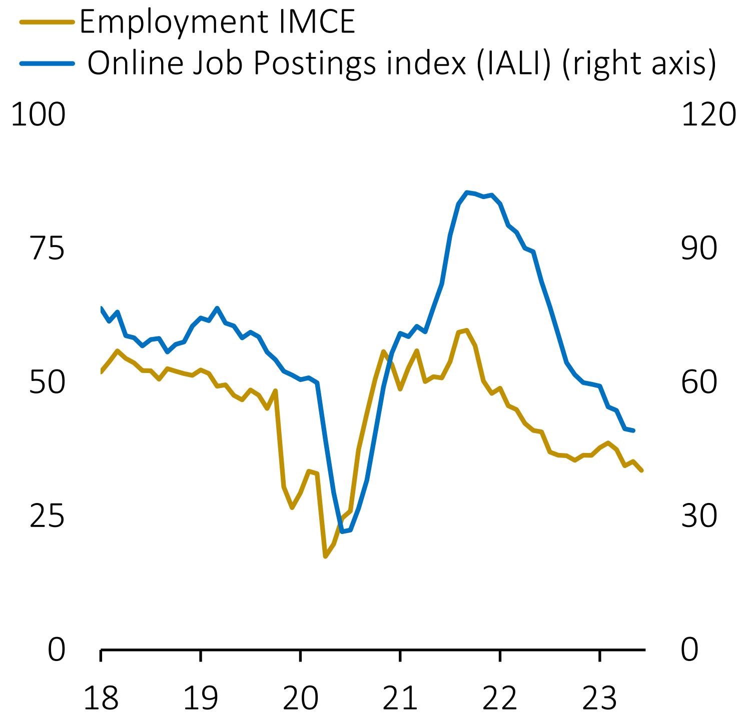
46% Services

First quarter results	Annual change	Quarterly change (SA)
Private consumption	-6.7	-2.5
Durable goods	-28.8	-18.8
Non-durable goods	-9.2	-2.7
Services	0.8	0.8

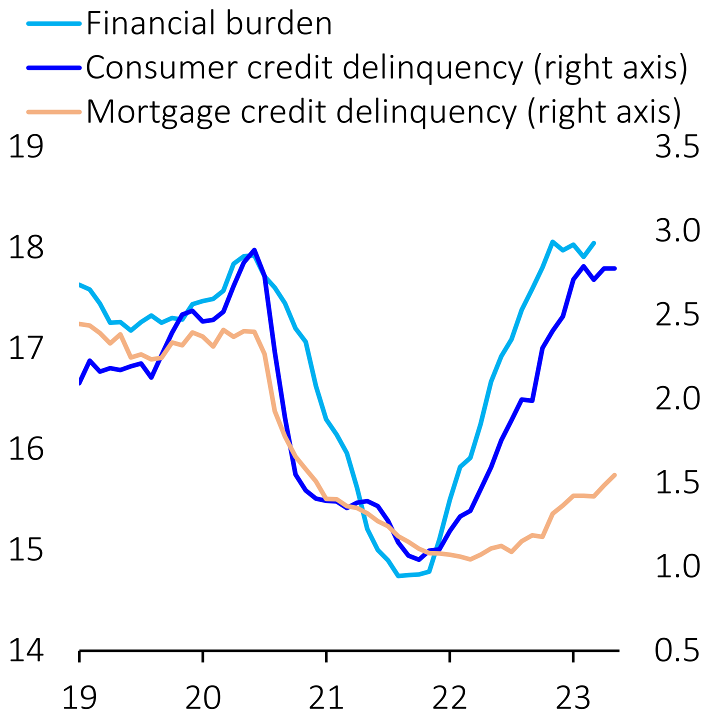
The adjustment in private consumption is explained by fewer jobs being created, in line with the economic cycle, as well as tighter financial conditions for households.

Unemployment and labor participation rate
(percent)

Employment expectations of firms (IMCE) and Online Job Postings Index (1)
(index; index January 2015 = 100)



Households' financial burden and delinquency (2) (3)
(percent)

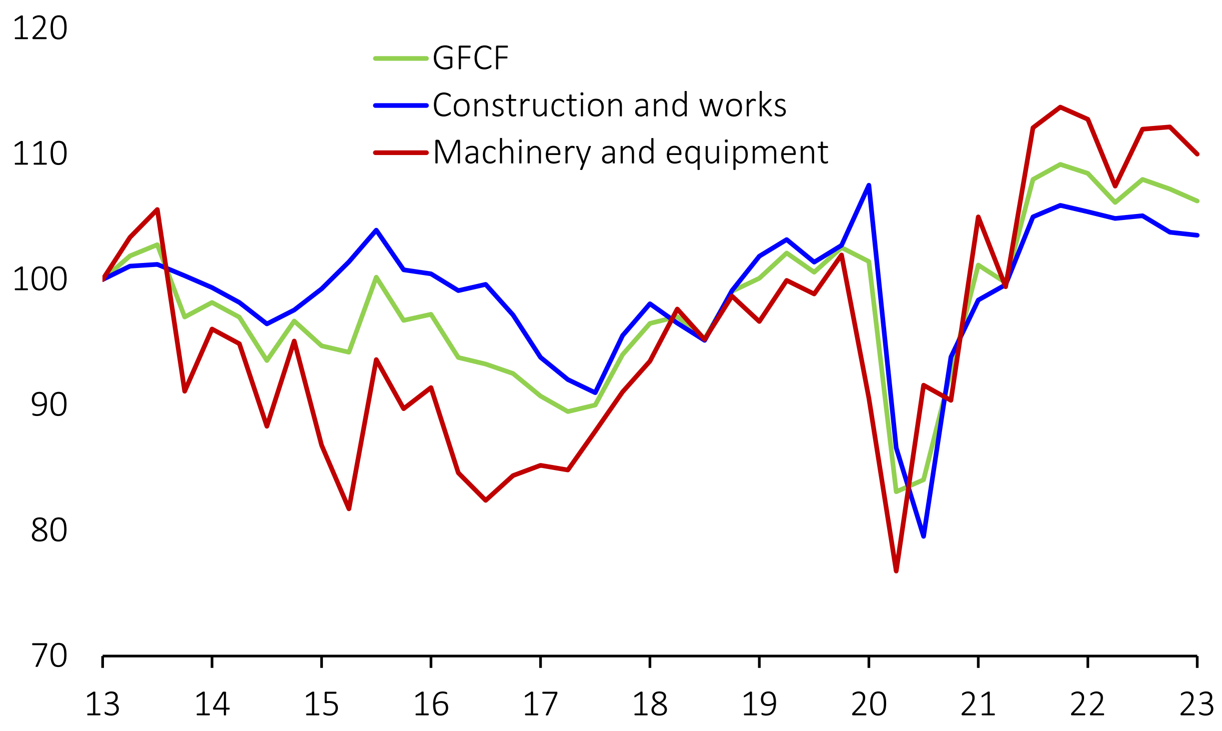


(1) For the IMCE, consider the average of the employment indicators in trade, industry, and construction. A value below (above) 50 points reflects expectations of decreases (increases) in the number of workers over the next three months. (2) The financial burden is that of the median debtor. Monthly income includes labor component (formal wage earners) and pension withdrawals prorated over six months from the payment received. (3) Delinquency indicator of 90 days or more, based on locally consolidated financial statements.
Sources: National Statistics Institute (INE), Icare/Adolfo Ibáñez University, CMF, SUSESO and Central Bank of Chile.

At the same time, investment shows weakness in all its aggregates.

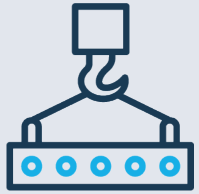
Gross fixed capital formation (GFCF)

(index, 2013.QI=100, real seasonally adjusted series)



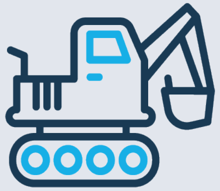
Source: Central Bank of Chile.

Shares of GFCF components:



60%

Construction & works

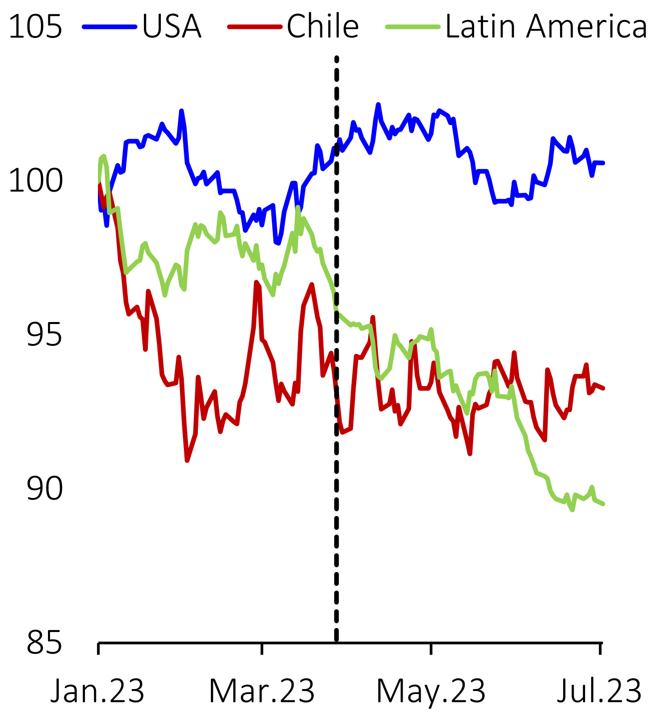


40%

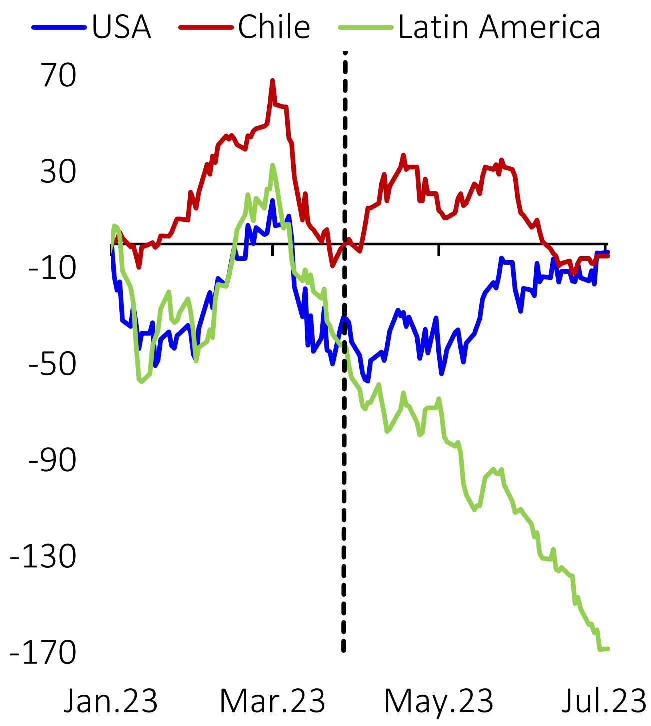
Machinery & equipment

The fundamentals of investment show a mixed evolution. While the appreciation of the peso reflects a greater global risk appetite and less idiosyncratic uncertainty in Chile, financial conditions remain tight and investment plans are not very dynamic.

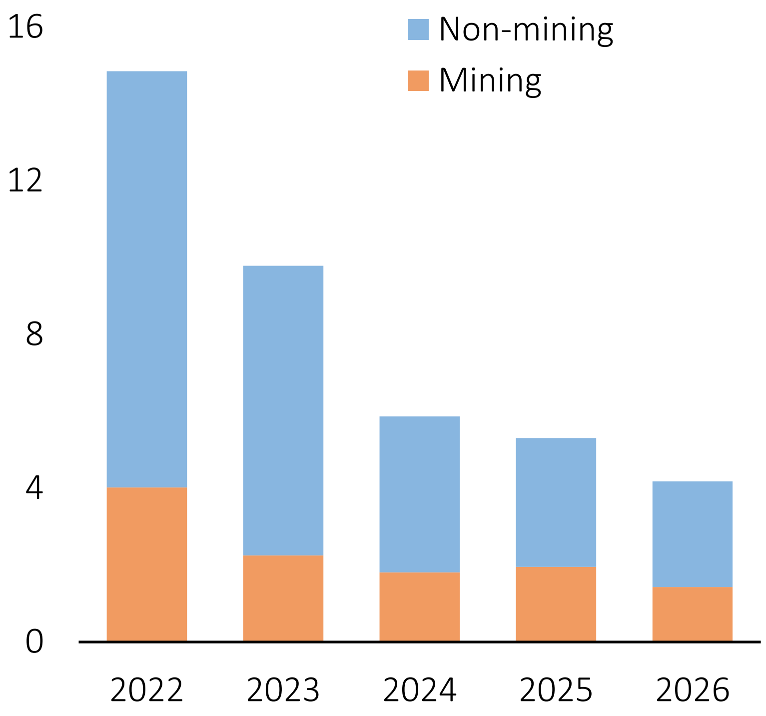
Currencies (1)(2)(3)
(index, 2.Jan.23=100)



10-year nominal interest rates (1)(2)
(difference w/respect to 2.Jan.23, basis points)



CBC investment amounts, 2023.Q1
(billions of dollars)

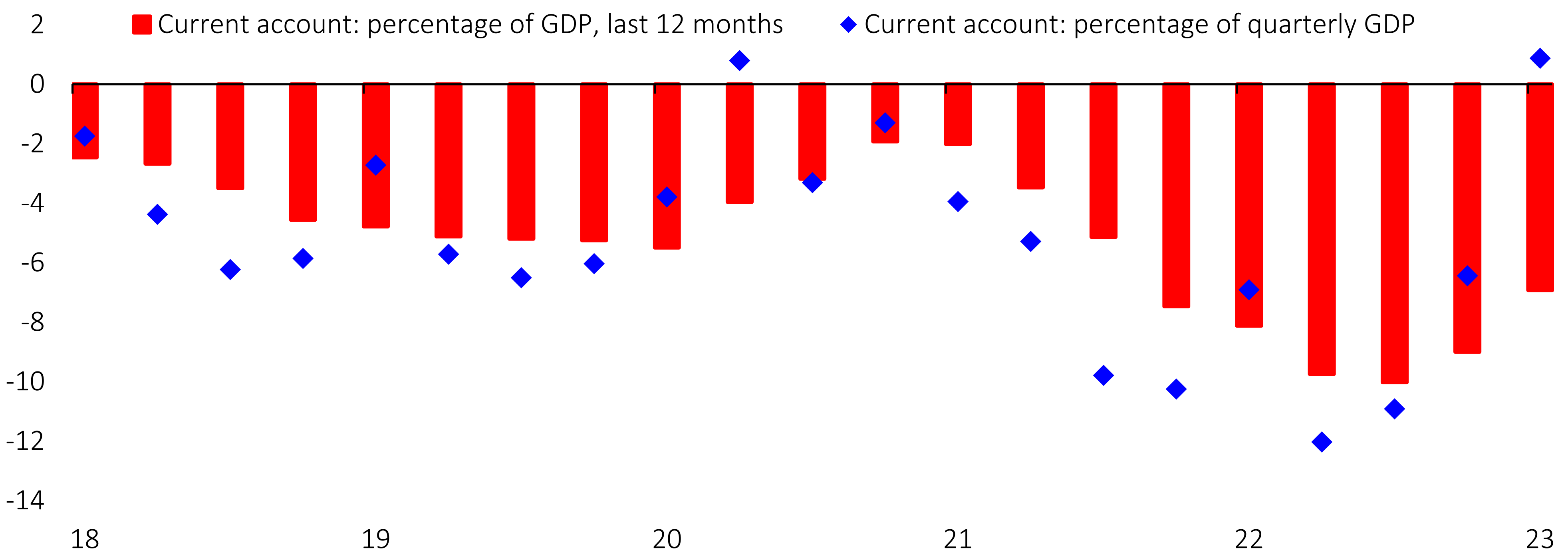


(1) For Latin America, consider the simple average of the indices of Brazil, Mexico, Colombia, and Peru. (2) Dotted vertical line marks the statistical closure of the March MP Report (March 29th). (3) An increase in the index corresponds to currency depreciation and vice versa.
Sources: Central Bank of Chile, Bloomberg, and Capital Goods Corporation (CBC).

The macroeconomic adjustment is also reflected in the normalization of the current account, where the reduced household spending on imported goods plays a significant role.

Current account

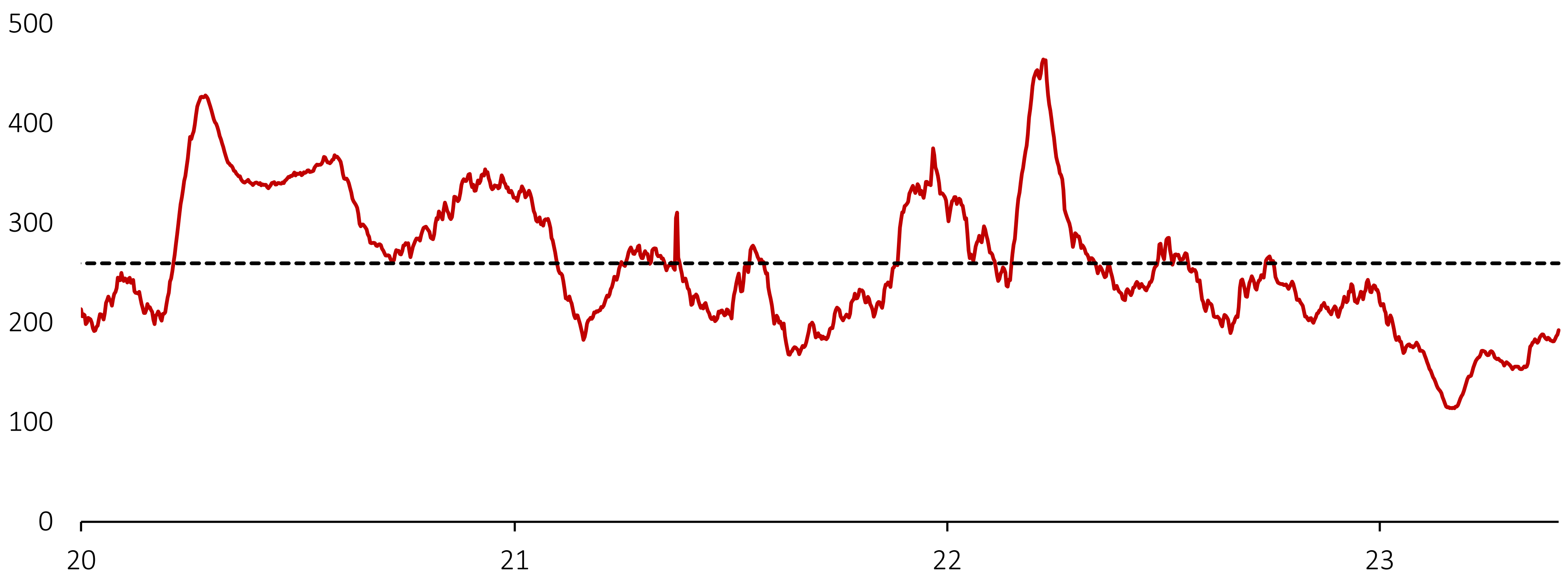
(percent of GDP)



Source: Central Bank of Chile.

This within a context of reduced local uncertainty.

Economic uncertainty (DEPUC) (*)
(index)

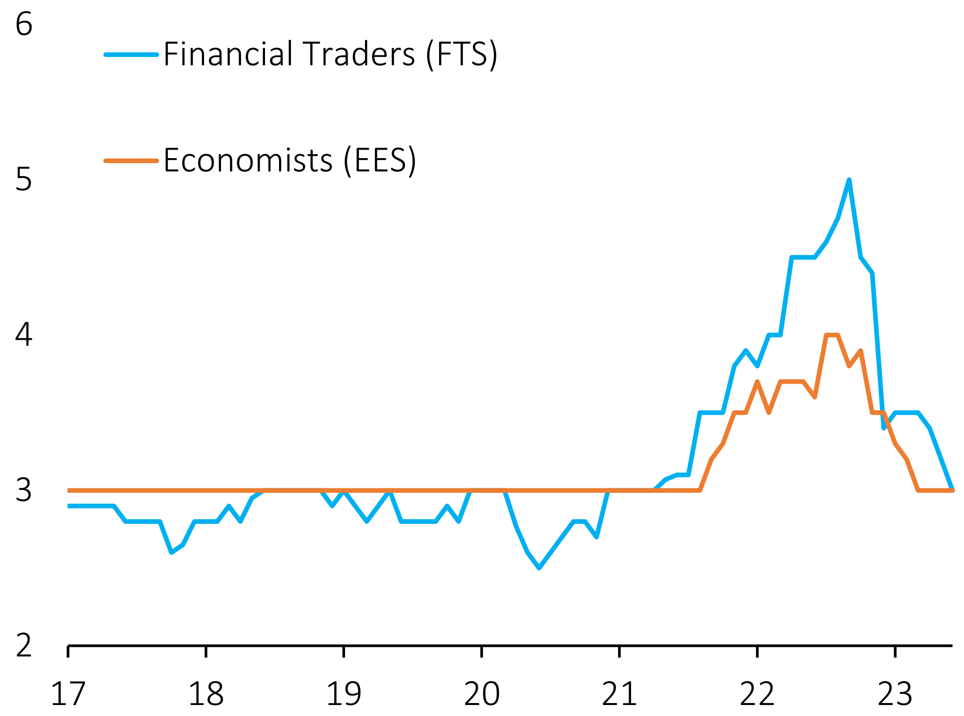


(*) Dashed horizontal line indicates the 2020-2023 DEPUC average.
Source: Central Bank of Chile.

In this context, the two-year inflation expectations of various market agents have decreased.

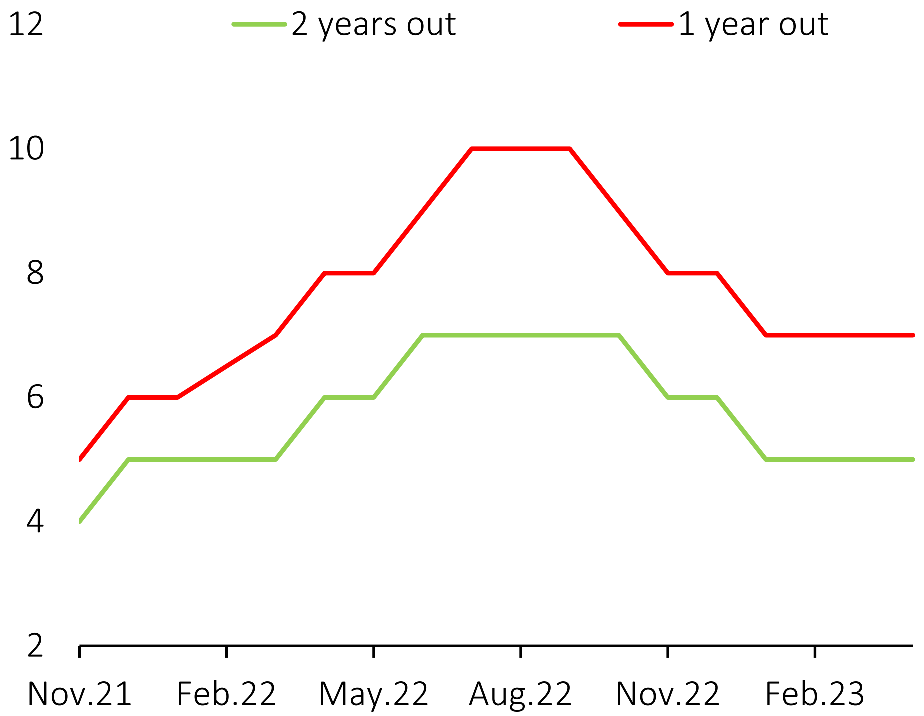
Two-year inflation expectations (1)(2)

(annual change, percent)



Business inflation expectations (EDEP) (1)

(annual change, percent)



(1) For the surveys, median responses are shown. (2) The Financial Traders Survey (FTS) considers responses in the first two weeks of each month until January 2018. From February 2018 onwards, it considers the last survey published in the month, including the one prior to the June 2023 Meeting. In the months with no published survey, the latest available is considered.

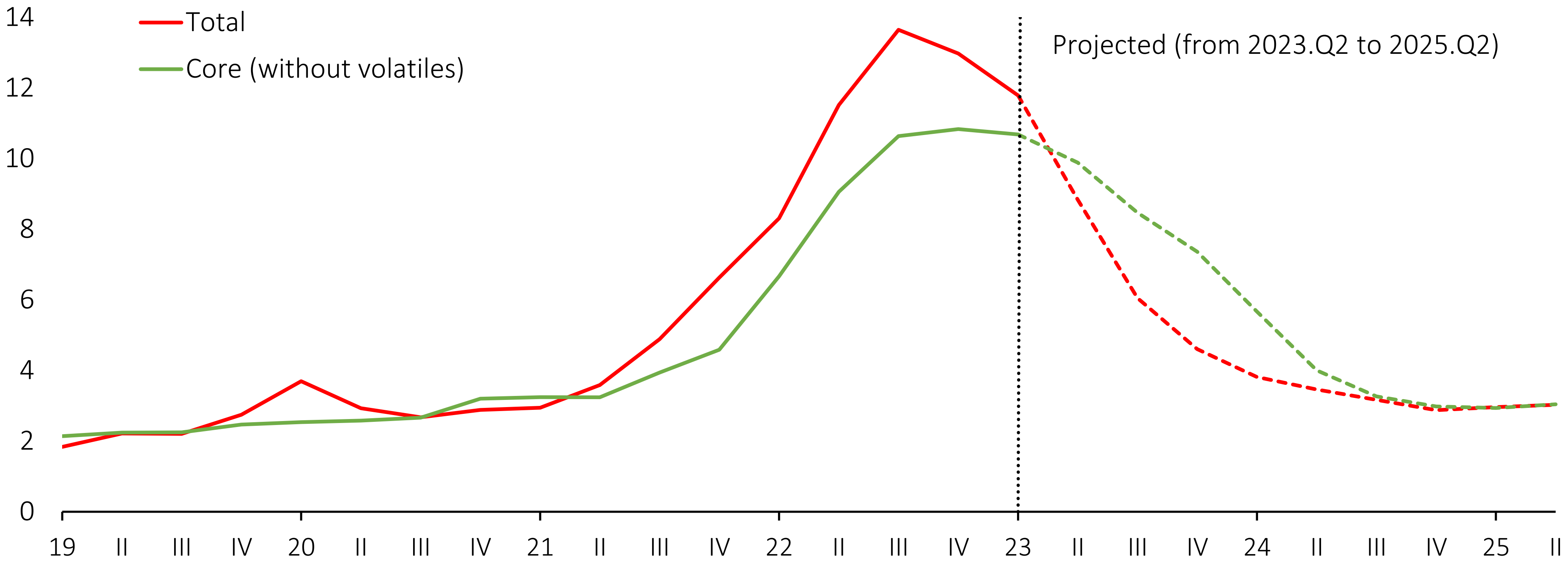
Source: Central Bank of Chile.

Projections

In the central scenario of last MP report, headline and core inflation will continue to decline, converging to 3% in 2024 and staying in the vicinity of 3% until the end of the policy horizon.

Inflation forecasts

(annual change, percent)



Sources: Central Bank of Chile and National Statistics Institute (INE).

The reduction in macroeconomic imbalances continues to be crucial for inflationary convergence. The activity gap will turn negative from the second half of the year onwards. Growth is expected to be somewhat lower this year, mostly due to changes in the mining industry forecast.

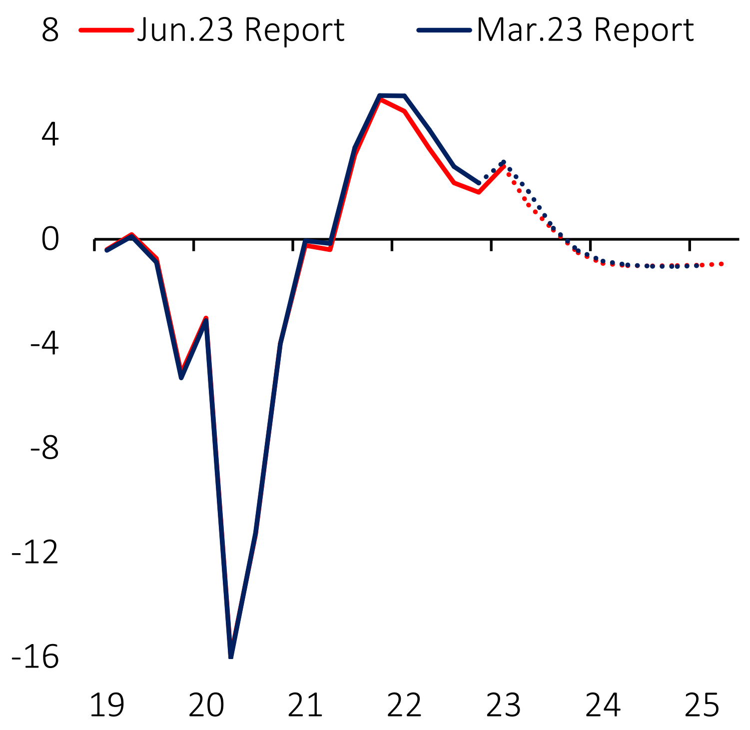
GDP growth forecasts (1)

(annual change, percent)

	March 2023	June 2023	
2023	-0.5 % – 0.5%	-0.5 % – 0.25%	↓
2024	1.0% – 2.0%	1.25 % – 2.25%	↑
2025	2.0 % – 3.0 %	2.0 % – 3.0 %	=

Output gap (2)(3)

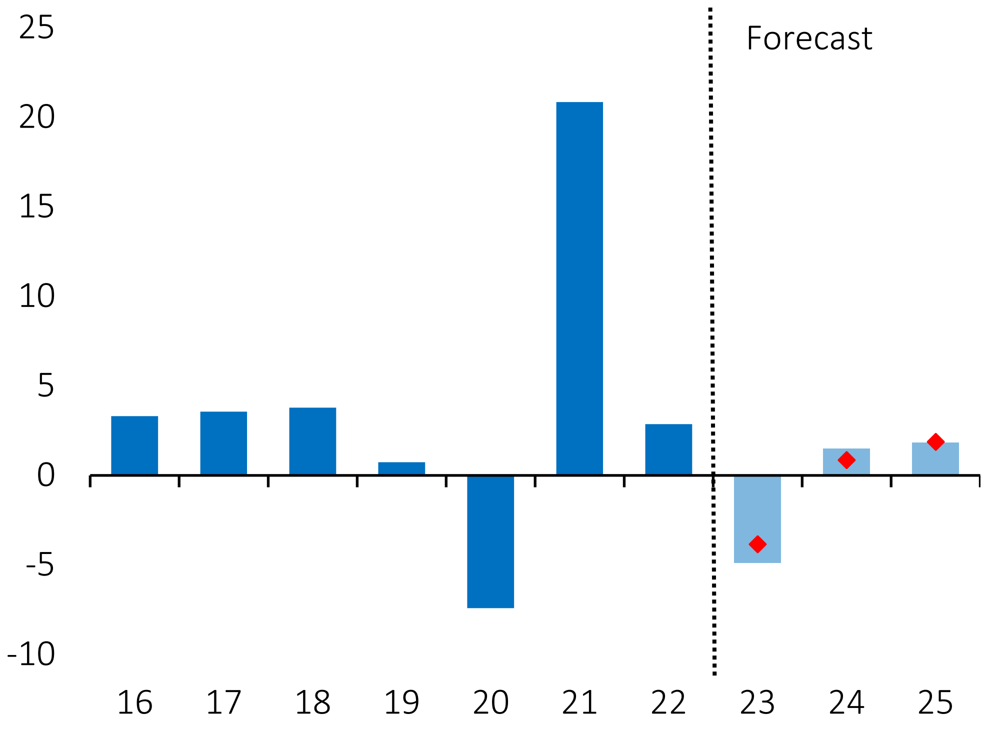
(level, percentage points)



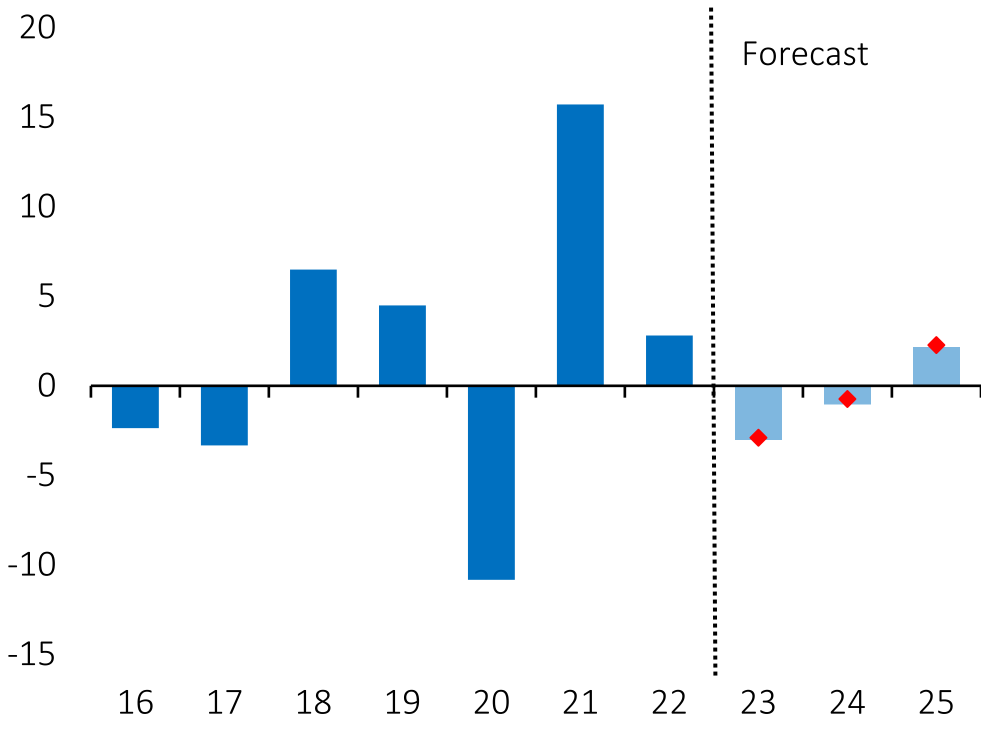
(1) Forecasts contained in each MP Report. Green arrows indicate change from March 2023 projection. (2) Dotted lines show forecasts. (3) Forecast uses structural parameters updated in the December 2022 MP Report (trend) with methodological revision of potential GDP.
Source: Central Bank of Chile.

Again, forecasts incorporate a contraction of the main components of demand this year. Further adjustment of household consumption will continue to help replenish national savings, after massive use during the Covid-19 pandemic.

Private consumption (*)
(real annual change, percent)



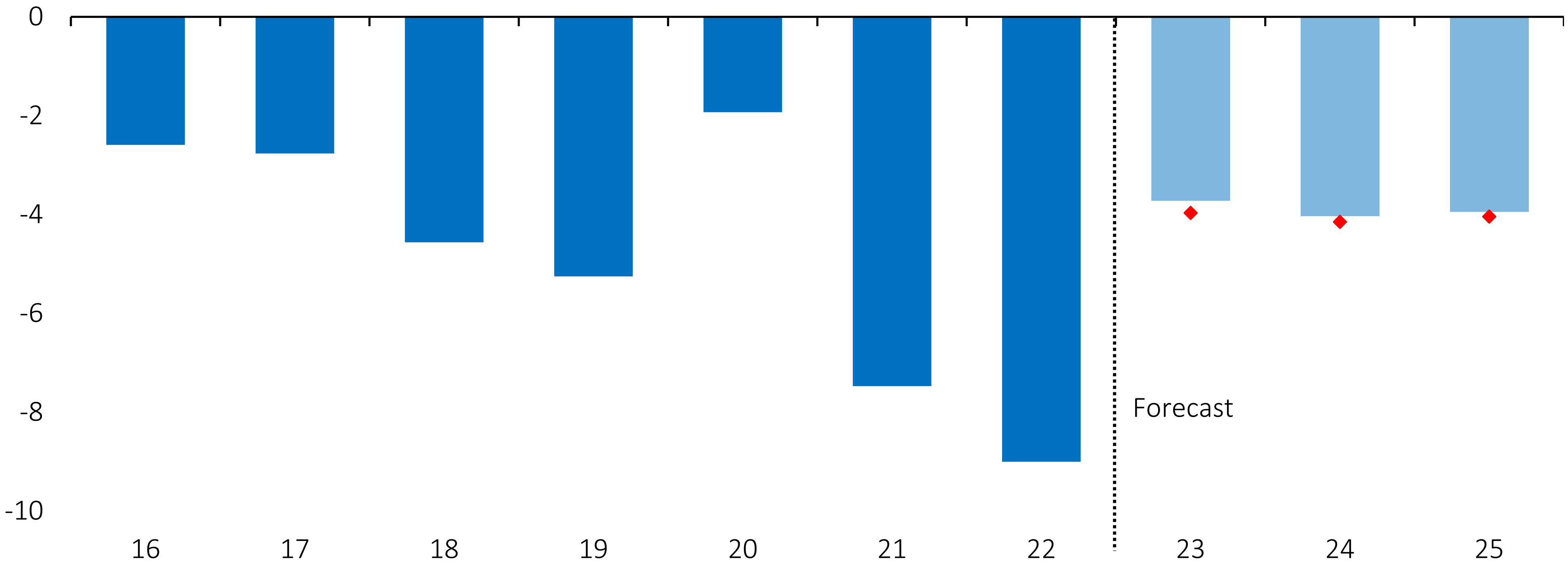
Gross fixed capital formation(*)
(real annual change, percent)



(*) Diamonds show forecasts in central scenario of March 2023 MP Report.
Source: Central Bank of Chile.

The recovery of savings is also essential for the current account deficit to continue to narrow in the future.

Current account (*)
(percent of GDP)

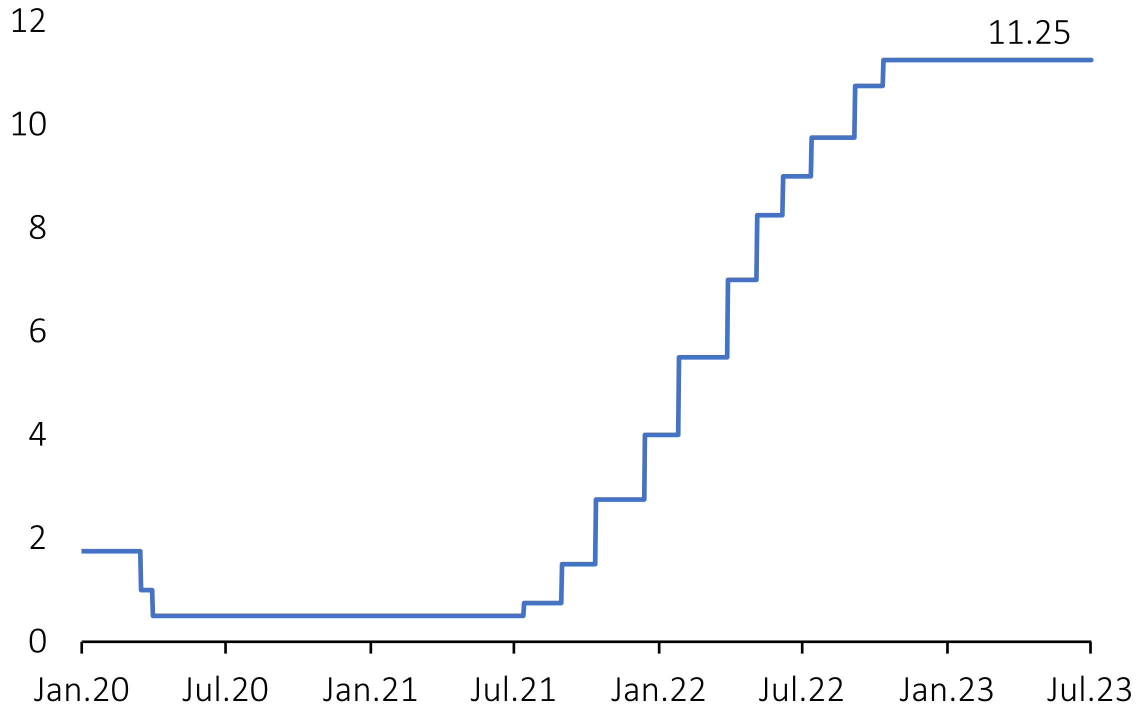


(*) Diamonds show forecasts in central scenario of March 2023 MP Report.
Source: Central Bank of Chile.

The monetary policy rate (MPR) has been kept contractionary for several quarters, which has contributed significantly to bring down inflation.

Monetary pollicy rate (MPR)

(percent)



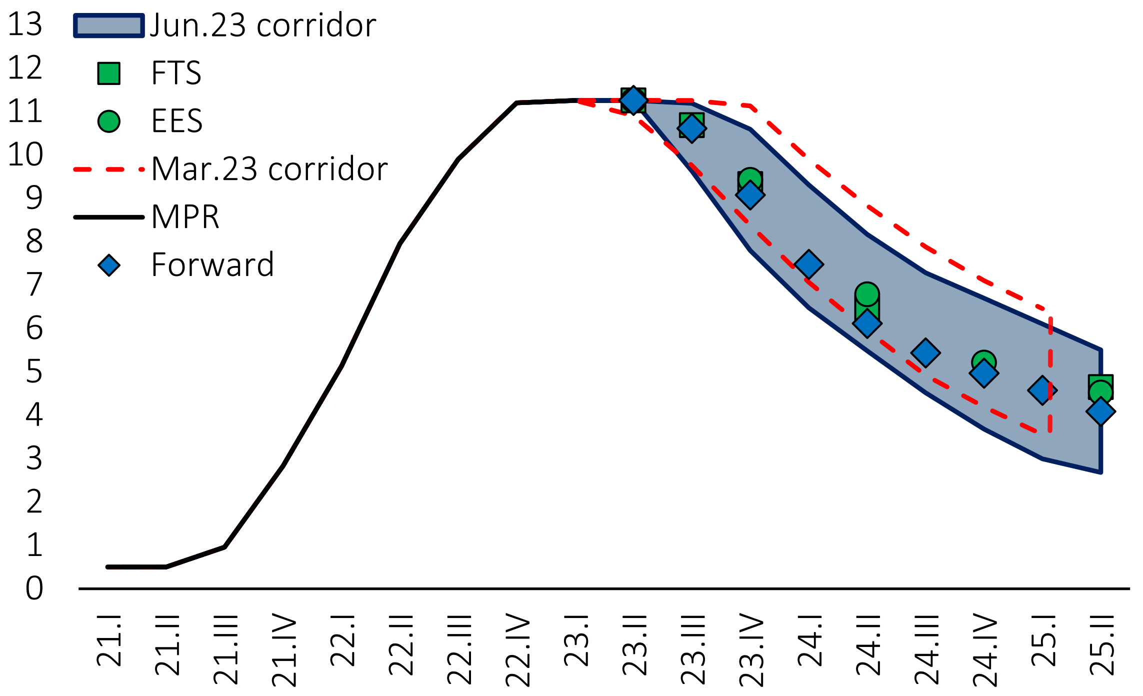
Source: Central Bank of Chile.

- While inflationary risks persist, they have been balancing out.
- The Board believes that the most recent evolution of the economy points in the required direction.
- If these trends continue, the MPR will start a downward process in the short term. The magnitude and timing of its reduction will consider the evolution of the macroeconomic scenario and its implications for the inflation trajectory.
- The Board reaffirms its commitment to act with flexibility in case any of the identified internal or external risks comes true and macroeconomic conditions so advise.

The borders of the MPR corridor reflect sensitivity scenarios where the speed of inflationary convergence leads to rate adjustments different from those in the central scenario.

MPR corridor (*)

(quarterly average, percent)



(*) The corridor is constructed following the methodology in Box V.1 in March 2020 MP Report and Box V.3 in March 2022 MP Report. For details, see methodological note (figure II.1, chapter II in March 2023 MP Report).
Source: Central Bank of Chile.

In this MP Report, the Board believes that **such scenarios are mainly associated with domestic conditions**. In particular, because of the dynamics of inflation and its fundamentals.

- The behavior of these variables will influence the timing and/or speed of the MPR reduction process.

Upper bound: the MPR is reduced at a slower pace due to higher-than-expected local inflation persistence.

- Expenditure and CPI records that differ from MP Report projections.
- Upward inflation surprises in developed economies, with further rate hikes and depreciation of emerging currencies in the short term. Medium-term contractionary effects mitigate impacts on the MPR.

Lower bound: Faster adjustment of the local economy, earlier inflation convergence and faster reduction of the MPR.

- Capacity gaps become more negative.
- This, in a scenario in which inflationary pressures have been gradually contained.

There are also risk scenarios that push growth outside the forecast range and would require a policy response that exceeds the corridor's limits for the MPR. On this occasion, the risks emanate mainly from the global macro-financial situation.

Risk scenarios

Risks are significant

- Further deterioration could trigger episodes of high volatility, reduce liquidity and encourage capital outflows away from the emerging world.
- This would lead to a stronger than expected tightening of global financial conditions, resulting in additional constraints for the Chilean economy, which would significantly reduce inflationary pressures.
- In such a risk scenario, more pronounced MPR cuts than those indicated by the lower bound of the corridor would be necessary.

Conclusions

The economy has made progress in resolving the macroeconomic imbalances accumulated in recent years. This has allowed to reduce inflation in line with expectations, advancing in the consolidation of its convergence to the 3% target. In general, domestic activity and demand have evolved in line with expectations, although with a greater than anticipated drop in the durable component of private consumption. Against this background, the central scenario projections contain few changes with respect to the March MP Report.

TPM

The MPR has been kept contractionary for several quarters, which has contributed significantly to bring down inflation. While inflationary risks persist, they have been balancing out.

The Board believes that the most recent evolution of the economy points in the required direction. If these trends continue, the MPR will start a downward process in the short term. The magnitude and timing of its reduction will consider the evolution of the macroeconomic scenario and its implications for the inflation trajectory.

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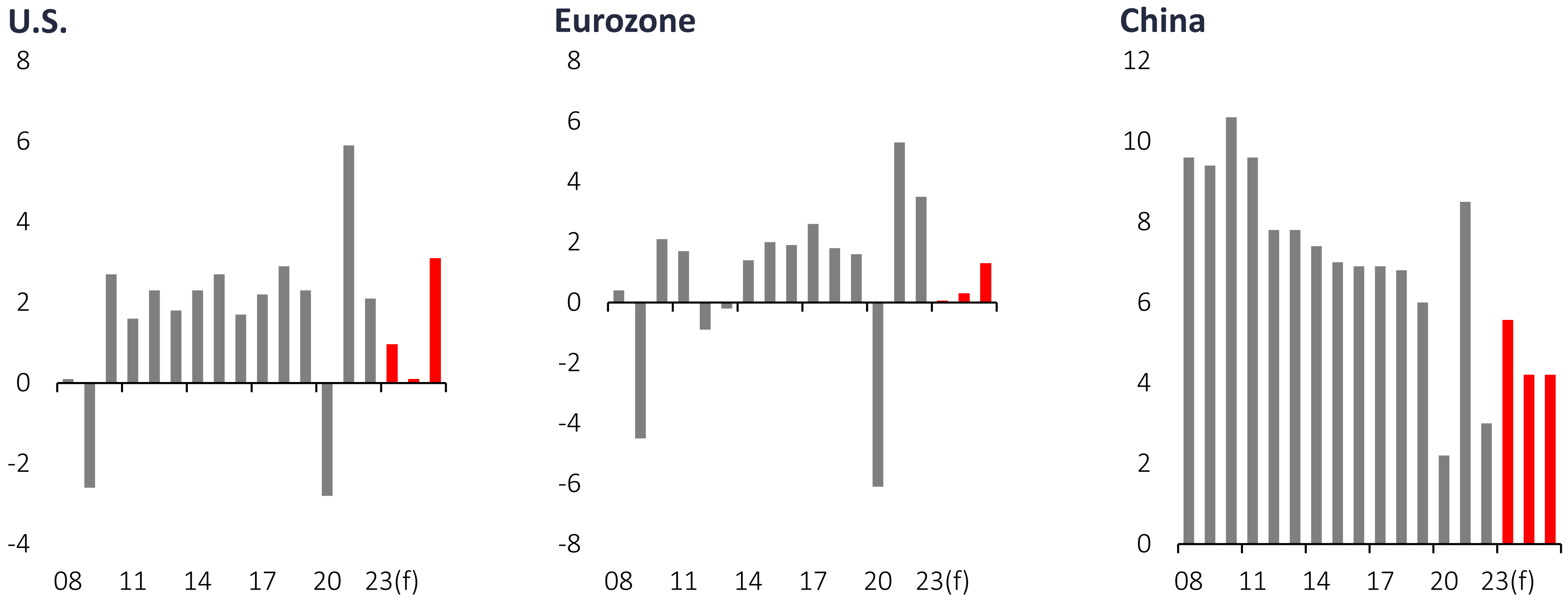
External impulse will remain constrained, considering the impact of tighter international financial conditions and low fiscal policy space for global growth.

Trading partners' growth (*)
(annual change, percent)

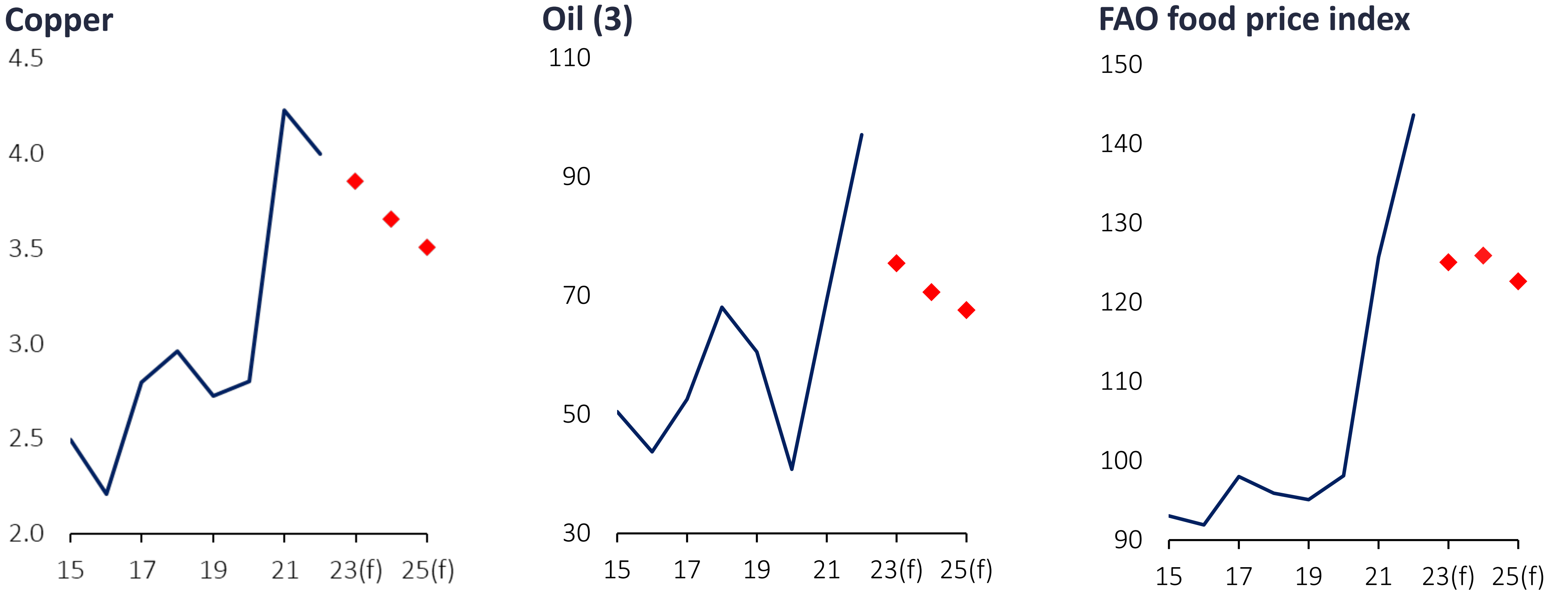


(f) Forecast.
(*) Red bars correspond to the central scenario projections in June 2023 Monetary Policy Report.
Source: Central Bank of Chile.

Commodity prices will continue on a downward trend, consistent with the expected weakness of the global scenario.

Commodity prices (1)(2)

(dollars per pound; dollars per barrel; index)



(f) Forecast.
(1) Average price or index for each year. (2) Red diamonds indicate forecasts in the central scenario of June 2023 MP Report for each year from 2023 to 2025.
(3) For oil, WTI-Brent average.
Sources: Central Bank of Chile, Bloomberg and FAO.