MONETARY POLICY REPORT

September 2020

MONETARY POLICY REPORT*/ SEPTEMBER 2020

*/ This is a translation of a document originally written in Spanish. In case of discrepancy or difference in interpretation the Spanish original prevails. Both versions are available at www.bcentral.cl.

Summary

The evolution of the macroeconomic scenario continues to be determined by the unfolding of the Covid-19 pandemic and the containment measures necessary to protect the population's health. After a sharp fall early in the second quarter, in recent months the Chilean economy has shown signs of stabilization, combining a timid improvement in some sectors and marginal deterioration in others. This has been accompanied by an improved sanitary response, a faster adaptation to new operating conditions in several activities and the boost from the various measures adopted. Still, the negative impact caused by the pandemic is very significant, as evidenced by lost income for a large number of people and companies. Reversing the loss of jobs, addressing the fall in household income and the deterioration of consumption, plus maintaining a flow of credit aligned with companies' needs for working capital and investment are the biggest challenges for economic recovery and for the role of public policy in achieving it. Considering actual activity data for the first half of the year and the rebound associated with the measures adopted for a gradual withdrawal of sanitary controls and support to household income, our estimates are that GDP will end 2020 with a drop between 4.5% and 5.5%. The underlying assumptions are that the second half of the year will see a significant recovery, but the capacity gaps created over this period will close and inflation will converge to the target only in 2022. This scenario, however, remains surrounded by high levels of uncertainty and exposed to high risks. The Board will continue to maintain a highly expansionary monetary policy stance and will remain vigilant to avert risks to financial stability.

The control of the pandemic varies across countries: in some the outlook is more favorable, while in others there are new outbreaks, and yet others are still struggling to control the spread of the disease. Some countries that have improved their sanitary response have avoided reinstating the tighter restrictions on mobility in the face of new epidemic outbreaks. Latin America, as a whole, continues to show high rates of infection, but with large differences between countries. As indicators have improved in Chile, the authority has decided to gradually lift confinement measures on a national level. This process, however, is not exempt from possible setbacks, as has occurred in other parts of the world and some regions of the country.

INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

	Avg. 10-19	2020 (f)	2021 (f)	2022 (f)
	(annual change, percent)			
Terms of Trade	1.3	4.1	-0.5	0.3
Trading partners GDP (*)	3.8	-3.5	4.7	4.5
World GDP at PPP (*)	3.8	-4.6	4.9	4.6
World GDP at market exchange rate (*)	3.1	-5.2	4.6	4.4
Developed economies' GDP at PPP (*)	1.9	-7.2	4.1	4.1
Emerging economies' GDP at PPP (*)	5.1	-2.5	5.5	5.0
External prices (in US$)	0.6	-2.3	4.4	2.0
	(levels)			
LME copper price (US¢/lb)	306	270	280	290
WTI oil price (US$/barrel)	72	40	45	47
Brent oil price (US$/barrel)	80	43	48	51
Gasoline parity price (US$/m3) (*)	610	336	362	405
Fed Fund Rate (%)	0.7	0.5	0.3	0.4

(*) For definition, see glossary.
(e) Estimation.
(f) Forecast.
Source: Central Bank of Chile.

The relaxation of confinements and increased mobility have helped world activity to leave behind its minimums of April and May. Production, sales and expectations show improvements in some countries. Notably, China's second-quarter data outperformed expectations. Financial markets and commodity prices have been favored by these trends and by the highly expansionary monetary policies implemented by the main central banks. The copper price has fluctuated around US$3 per pound and the volatility of the markets has seen significant reductions from its March and April peaks.

The Chilean economy posted a contraction of 14.1% annually in the second quarter, its worst record in several decades. The sharpest month-on-month drop occurred in April. More recently, activity has seen some upturn in sectors that had been hit particularly hard, such as retail and certain services. In contrast, construction has suffered greater and unexpected consequences, as quarantines have been extended in terms of both duration and territory.

Because of the high risk of infection, the pandemic caused a particularly sharp contraction in areas most intensive in social contact, directly affecting the income of related businesses and workers. This contraction has seen its impact amplified through a fall in self-employment—mostly in services requiring social interaction—which has been unable to perform its traditional containment role in the present circumstances. On the aggregate demand side, consumption and investment have been depressed by income losses, limited social interaction and high uncertainty.

Nonetheless, the outlook for consumption has improved thanks to a number of support measures that have been deployed in the third quarter and which are reflected in improved business—particularly retail—and consumer expectations. Among them, a significant number of direct aid programs, subsidies, payment deferrals, tax breaks and the approval of the withdrawal of a portion of pension savings. The latter is estimated to involve resources in the order of 6% of GDP, of which nearly half will be spent in consumption. In any case, its impact will be limited because of its transitory nature and the weight of imported goods in the composition of the increased demand.

The Central Bank has adopted a variety of measures aimed at providing liquidity to the markets and stimulating the flow of credit toward the productive sector, in order to avoid a more severe disinflationary cycle and prevent risks to financial stability, which could escalate the economic and social cost of the current shock. After the June Monetary Policy Meeting, interest rates at different terms declined significantly, in line with the boost to the monetary stimulus via the purchase of assets and the announced phase 2 of the FCIC. The decline in long-term rates was temporarily reversed during the final stage of the Congress debate on the individuals' withdrawal of part of their pension savings, consistent with

ECONOMIC GROWTH AND CURRENT ACCOUNT

	2019	2020 (f)	2021 (f)	2022 (f)
	(annual change, percent)			
GDP	1.1	-5,5/ -4,5	4,0-5,0	3,0-4,0
National income	0.8	-4.3	4.8	3.6
Domestic demand	1.0	-7.1	5.6	2.7
Domestic demand (w/o inventory ch.)	1.5	-5.6	7.0	2.4
Gross fixed capital formation	4.2	-10.6	8.0	4.9
Total consumption	0.8	-4.2	6.8	1.7
Goods and services exports	-2.3	-2.2	5.0	4.8
Goods and services imports	-2.3	-9.4	8.6	2.2
Current account (% of GDP)	-3.9	-1.4	-2.5	-1.7
Gross national saving (% of GDP)	18.9	18.5	16.8	18.2
Gross national investment (% of GDP)	22.8	19.9	19.3	19.9
GFCF (% of nominal GDP)	22.4	21.0	21.8	22.2
GFCF (% of real GDP)	21.8	20.6	21.2	21.5
	(US$ million)			
Current account	-10,900	-3,400	-6,800	-5,100
Trade balance	4,200	11,200	8,200	10,500
Exports	69,900	67,800	72,700	77,700
Imports	65,700	56,600	64,500	67,200
Services	-5,100	-5,200	-5,200	-5,300
Rents	-11,400	-10,700	-10,900	-11,600
Current transfers	1,400	1,300	1,100	1,300

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

INFLATION (1)

	2019	2020 (f)	2021 (f)	2022 (f)
	(annual change, percent)			
Average CPI	2.3	2.8	2.6	2.9
December CPI	3.0	2.4	2.8	3.0
CPI in around 2 years (2)				3.0
Average core CPI	2.3	2.5	2.7	2.9
December core CPI	2.6	2.5	2.8	3.0
Core CPI in around 2 years (2)				3.0

(1) Core inflation is measured using CPI excluding volatile items.
(2) Inflation forecast for the third quarter of 2022.
(f) Forecast.
Source: Central Bank of Chile.

the fall in the prices of the assets in which they are invested. However, after a package of measures was announced by the Central Bank and the regulators, and the Pension Funds implemented a portfolio management strategy that mitigated the impact on the local markets, volatility has declined and interest rates have fallen again. Stock market valuations, meanwhile, have followed a trajectory below that of their foreign counterparts.

The liquidity provided by the Central Bank, coupled with state guarantees, various regulatory adjustments and the adequate solvency of the banking system, have contributed to commercial loans breaking down their usual relationship with the business cycle, showing higher than 10% growth rates by mid-year. Linked to these instruments, to date nearly 230 thousand loans have been granted to small and medium-sized enterprises. The analysis at the individual level shows that a large number of these loans have reached the companies whose sales have been most affected by the pandemic. There is evidence that this access to credit has sustained the operational continuity of these businesses and helped mitigate the drop in investment. In turn, the asset purchase program announced in June has improved financing conditions in the corporate- and bank-bond market. In this context, the prospects for investment have also improved with respect to the last Monetary Policy Report, supported by the recent evolution of imports of machinery and equipment, large-scale projects associated with the energy sector and the recent announcements of public investment and reactivation measures.

Considering the performance of the economy in the second quarter, the gradual relaxation of the most stringent sanitary measures and the temporary boost to income support policies, the projection scenario limits the economic contraction foreseen for 2020. Thus, it is estimated that GDP will fall between 4.5% and 5.5% this year, still within a wider range than usual, reflecting the greater uncertainty surrounding the effects of the pandemic. Towards 2021 and 2022, GDP will grow between 4% and 5% and between 3% and 4%, respectively. These growth rates are consistent with a sanitary scenario that permits a gradual deconfinement process, where economic sectors continue to adapt their operations to carry out their activities and where credit continues to flow to sustain the recovery process. Our forecasts also assume an institutional channeling of the social crisis evidenced at the end of last year.

Inflation will converge to 3% by 2022, and its level will not fall below 2% annually in the short term. Although in the short term this trajectory runs somewhat above our June forecast, largely due to the projected growth in private consumption, into the medium term its main determinant continues to be the lower accumulated activity. The core measure will remain above 2.5% in the short term, to gradually converge to 3%, also in 2022. Two-year inflation expectations remain around 3%.

Monetary policy will remain highly expansionary, combining the MPR kept at its 0.5% minimum with unconventional measures. These will be renewed or expanded if the economic recovery and the convergence of inflation so require. In turn, the MPR will remain at its lower bound over most of the two-year monetary policy horizon.

The macroeconomic scenario continues to show more uncertainty than normal. Projections recognize that social distancing will alter the way of operating in areas where social interaction is key for a long time. Nevertheless, more negative than estimated impacts would have particularly harmful effects on the recuperation of the labor market, because of the many people employed in these activities. This would further weaken demand and negatively affect growth and the inflationary convergence, calling for a stronger monetary impulse. On the other hand, the picture of sanitary risks looks somewhat more balanced. The accumulated experience, the prevention measures applied and reinforced sanitary systems reduce the probability that, in the event of a virus resurgence, the worst episodes of the pandemic are repeated and strict quarantines have to be re-imposed. Thus, deconfinement could proceed at a somewhat faster pace, allowing activity and employment to rebound more quickly. In such a case, the monetary impulse needed for inflation's convergence could be of slightly shorter duration.

The possibility of more negative risk scenarios, associated especially with the economic scars inflicted by the pandemic, is still present. Varied measures have allowed maintaining credit flowing in line with working capital and investment needs, breaking down the pro-cyclical relationship of credit. Going forward, the materialization of investments, the productive adjustments in sectors that have been forced to make profound changes in their operation, and the increase in activity, will continue to require this financing channels. For this reason, it is essential to ensure a steady flow of credit, in order to avoid a deterioration of the financial system's capitalization and liquidity levels, whether due to regulatory changes and/or a more pronounced deterioration in the repayment capacity of households and businesses. Should this be the case, the financial sector could not be able to sustain credit growth, becoming an amplifier of the recession as has been known to happen in the past. The Board is committed to maintain the strong monetary impulse for an extended period of time and to increase it if it deems it is necessary for the achievement of its objectives of controlling inflation, as well as taking the measures to safeguard financial stability.

FUTURE EVOLUTION OF MONETARY POLICY

This chapter presents the most likely trajectory of monetary policy over the next two years, based on the Board's assessment of the dynamics projected for inflation in the policy horizon, with the information at hand at the close of this Report. It also describes sensitivity scenarios and explains how the policy response could change in such cases.

In the most likely macroeconomic scenario, meeting the inflation target requires that monetary policy remains highly expansionary. This assumes that the capacity gaps will close and inflation will converge to 3% only by 2022. It is assumed that the economy will begin to recover in the second half of this year, consistent with the gradual withdrawal of sanitary control measures, the boost coming from the initiatives that have been adopted to mitigate the impact on business and household income, and credit continues to flow to meet the financing needs for working capital and investment. Still, the levels of uncertainty remain high. While the Board is on the lookout for changes in the macroeconomic scenario that may require some adjustment to its policies.

PROJECTIONS FOR DOMESTIC DEMAND AND ACTIVITY

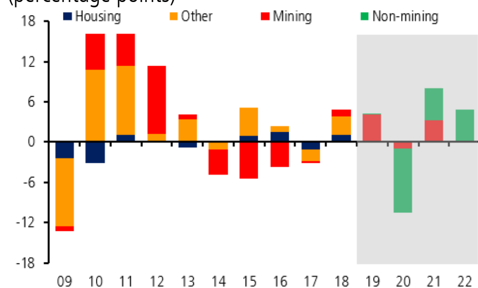
The projections in this Report foresee that in the third quarter the economy is beginning a gradual process of recovery, with positive quarterly expansion rates starting from this period. However, this year activity will contract between 4.5% and 5.5% annually. This assumes that deconfinement will continue to advance gradually nationwide and that the various income support measures will have a significant effect on consumption in the second half of the year. In any case, the uncertainty surrounding the short-term impact of the pandemic, its containment measures and the effect of household income support programs, implies that the GDP growth range for this year is wider than its usual width[1]/.

The evolution of activity will be determined by progress in the control of the pandemic and the ability of businesses and households to overcome its adverse effects. This projection assumes that the sectors where social interaction is most relevant will continue to be affected as long as there is no vaccine, so it will take several quarters for their activity to return to pre-pandemic levels. At the same time, it is considered that both

[1]/ Normally, in every September's Monetary Policy Report the forecast range for the current year has a width of 0.5 percentage points.

companies and individuals will be able to recover their income levels, as long as activity recovers, a process in which the support of monetary policy will be key. Greater control of the pandemic elsewhere in the world will also allow the external impulse to improve next year with respect to 2020. For 2021 and 2022 GDP is forecast to grow in the 4.0%–5.0% and 3.0–4.0% ranges, respectively.

Figure 1
Real annual contributions to GFCF (*)
(percentage points)



(*) Housing investment uses household investment data from National Accounts by Institutional Sector. The Other GFCF component is treated as a residue. Forecasts for the years 2019, 2020, 2021 and 2022 are made using forecasting models of the Central Bank of Chile and sectoral sources, such as investment plans and the CBC survey.
Source: Central Bank of Chile.

Compared with the June forecasts, the milder contraction estimated for 2020 is explained by the economy being not so weak as expected in the second quarter and which, furthermore, is expected to have a more favorable behavior of spending in the second half. This reflects build-up of stimulus measures that have been added in the last few months, including the withdrawal of part of pension savings, a strong increase in the fiscal deficit, and unconventional monetary policy actions. These effects are being partly offset by the extension of quarantines, relative to the forecast in June, in some zones of the country, particularly the Metropolitan Region.

On the expenditure side, after contracting by 4.2% this year, total consumption will return to positive rates of expansion in 2021 and 2022, in line with the recovery of employment and household income. Our short-term forecast is improved due to the withdrawal of part of the pension savings and increased fiscal transfers. The recovery of economic growth is projected to be coupled with an increase in employment levels. In the immediate future, as the tighter sanitary measures are lifted, employment in sectors such as construction and retail is expected to show a significant upturn, and so is self-employment. However, employment in general will take longer than activity to match its pre-pandemic levels, because of the already mentioned effect of social distancing on the operation of some of the more labor-intensive sectors. Moreover, in the short term, the expected recovery in consumption would be more inclined toward imported goods—whose production and marketing are less labor-intensive— than toward services. The projection scenario assumes that after increasing 6.8% in 2021, in 2022 total consumption will reduce its expansion to 1.7%, considering that the transitory stimulus to household spending provided by the various income support measures will have dissipated and that 2021 will leave a higher basis for comparison.

Anyway, the consumption trajectory considers two effects operating in opposite directions. On one hand, the group of individuals whose income has been eroded by the pandemic—and who have needed to borrow and/or deplete their savings to cope during these months— will probably take longer to go back to their usual consumption patterns. On the other hand, those whose income has been spared, but have put aside their

consumption decisions due to the sanitary measures, could return to their usual spending patterns sooner as measures are relaxed.

Gross fixed capital formation (GFCF), particularly its construction and other works component, will start recovering as quarantines are lifted and investment projects shelved this year are resumed, according to the CBC Survey of the second quarter of this year. The highly expansionary monetary policy stance, the increase in public investment and the reactivation measures announced by the Government will also sustain its recovery. Non-mining investment will increase next year, but it will be less dynamic than was expected before the pandemic, given the corporate indebtedness that has been necessary to cover the cash deficits of recent quarters (Figure 1). Considering all of the above, this Report assumes that GFCF will contract 10.6% annually in 2020, to then grow 8% annually in 2021 and 4.9% in 2022.

Forecasts in this Report assume that this year and next the Treasury will provide a significant boost to the economy, consistent with the various measures adopted. Overall, it is assumed that this boost will decline as the economy converges to its trend growth rates and the fiscal consolidation process announced by the Government is launched.

Contrary to our June Report's forecasts for this year and next, the current account is expected to post a deficit. This considers that the various measures to sustain household income will alleviate the liquidity problems identified in June. Added to it is a somewhat lower than foreseen deterioration in investment and somewhat better prospects for recovery. All this significantly reduces domestic savings compared to June estimates. Thus, for this year the current account is expected to post a deficit of 1.4% of GDP (a 0.8% surplus in June), increasing to 2.5% in 2021 (-0.7% in June). For its part, and consistent with an adjustment of the current account that responds more to quantities than to prices, the estimated current account deficit at trend prices[2]/ also sees an important revision, rising to 3.5% and 4.6% of GDP in 2020 and 2021, respectively (-1 and -2.4% of GDP in June).

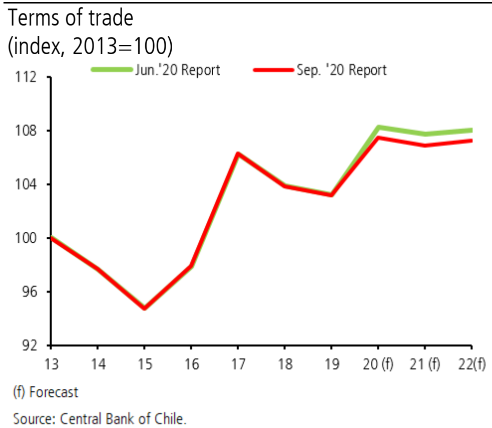
PROJECTIONS OF THE INTERNATIONAL SCENARIO

Global growth prospects continue to suggest that, after the sharp contraction in activity this year, expansion rates above the averages of the past ten years will resume in 2021 and 2022. This outlook is slightly

[2]/ This measure adjusts the value of mining exports and fuel imports considering deviations in the prices of copper and oil from their long-term values. The same applies to income and transfers associated with copper exports. Other exports and imports are valued using current prices. In addition, it does not correct possible changes in the quantities exported or imported due to movements in copper and oil prices. The calculation uses long-term prices of US$2.7 per pound of copper and US$70 per barrel of oil (see box V.2 in the September 2012 Report, and box V.1 in the December 2015 Report.

Figure 2

Terms of trade
(index, 2013=100)

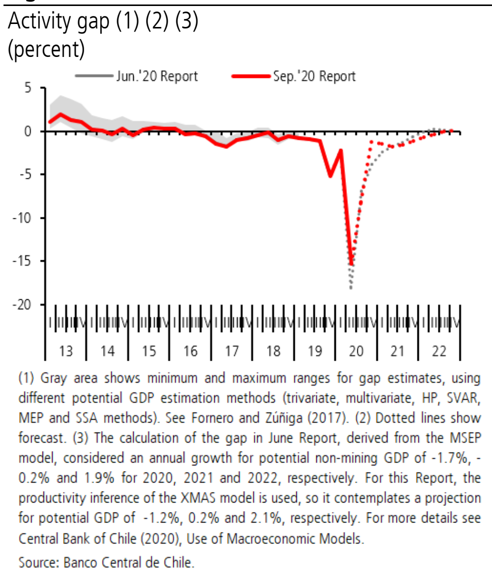


(f) Forecast

Source: Central Bank of Chile.

Figure 3

Activity gap (1) (2) (3)
(percent)



(1) Gray area shows minimum and maximum ranges for gap estimates, using different potential GDP estimation methods (trivariate, multivariate, HP, SVAR, MEP and SSA methods). See Fornero and Zúñiga (2017). (2) Dotted lines show forecast. (3) The calculation of the gap in June Report, derived from the MSEP model, considered an annual growth for potential non-mining GDP of -1.7%, -0.2% and 1.9% for 2020, 2021 and 2022, respectively. For this Report, the productivity inference of the XMAS model is used, so it contemplates a projection for potential GDP of -1.2%, 0.2% and 2.1%, respectively. For more details see Central Bank of Chile (2020), Use of Macroeconomic Models.

Source: Banco Central de Chile.

more favorable than was estimated a few months ago, mainly due to the better expected performance of the Eurozone and China. This is mainly due to the greater stimulus provided by the authorities, in addition to the relative success in the pandemic control in the European bloc—even considering the acceleration of contagion of recent weeks—and the better than expected performance of China in the second quarter. This contrasts with Latin America, where the sanitary situation remains particularly complex, even though many of these countries have maintained strict restrictions on mobility for a long time. Chile's trading partners are projected to have a GDP contraction of 3.5% this year and an expansion of 4.7% in 2021 (-3.6% and 4.2% in June, respectively). For 2022, projections remain at 4.5% growth. External financial conditions will remain favorable, in line with a still expansionary global monetary policy according to announcements by the different authorities, and with the recovery of the world economy.

The terms of trade will be better than in previous years (Figure 2), assuming that in the period 2020-2022, the prices of copper and oil will average US$2.8 per pound and US$46 per barrel (Brent-WTI average), respectively. Both prices are projected to be higher than estimated in June (US$2.65 and US$43), in line with the effective increases of recent months and the prospects of a somewhat faster recovery of the world economy.

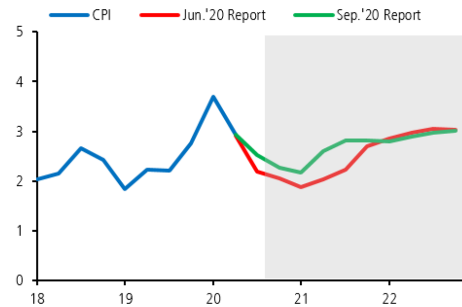
CAPACITY GAPS AND CONVERGENCE OF INFLATION TO THE TARGET

Normally once a year we recalculate the structural parameters that are used to evaluate the state of the economy. On this occasion, given the magnitude of the pandemic's shock and the high uncertainty surrounding its impacts make it necessary to postpone such updating, pending the accumulation of more information that would allow for a comprehensive assessment of them, including medium- to long-term trend growth and the neutral level for the monetary policy interest rate (MPR). As for the MPR's technical minimum, considering the information available, it is still estimated at 0.5%.

As for short-term potential growth, notwithstanding the aforementioned uncertainty, it can be anticipated that it has declined, a result that factors in the set of shocks that have affected the economy since the fourth quarter of 2019. Although the supply-side disruptions generated by the social crisis were transitory, the greater uncertainty surrounding its evolution plus the constitutional discussion caused a significant drop in investment forecasts for 2020 and 2021. This led to a reduction in the potential GDP growth estimation for both years to 1.4% and 1.9% respectively in the December 2019 Report (around 3.4% for both years in the September 2019 Report).

Figure 4

CPI inflation forecast (1) (2)
(annual change, percent)



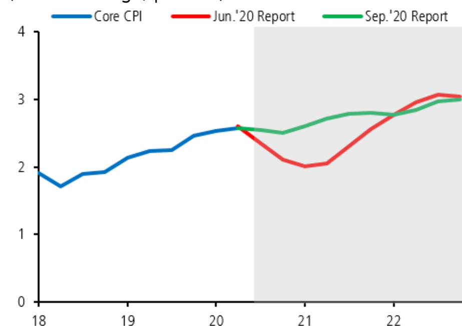
(1) For 2018, the annual variation of CPI is obtained by splicing the 2013=100 series with the monthly variations of the 2018=100 basket starting in February 2018. See box IV.1, March 2019 Report.

(2) Gray area, as from third quarter 2020, shows forecast.

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

Figure 5

Core CPI inflation forecast (1) (2)
(annual change, percent)



(1) For 2018, the annual variation of CPI is obtained by splicing the 2013=100 series with the monthly variations of the 2018=100 basket starting in February 2018. See box IV.1, March 2019 Report.

(2) Gray area, as from third quarter 2020, shows forecast.

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

This year, productivity has again been affected by supply constraints associated with the pandemic control measures. Thus, already by June, the estimated potential growth for this year was in the negative. This, considering the most persistent effects of the economic crisis, such as some companies going bankrupt and employment and investment being gradually reallocated among sectors. This, in addition to the necessary adjustments to comply with the sanitary protocols in face-to-face work and the fact that distancing measures will remain in place for as long as there is no vaccine, affecting more intensely the activity of those businesses that rely the most on social interaction. In this Report, the annual variation of potential GDP is estimated to be around -1.2% in 2020 and 0.2% in 2021.

The revision to potential GDP results in a somewhat narrower activity gap than that considered up until June, although quite wide compared to any recent episode, because of the sharp drop in activity in the second quarter. Going forward, it is expected that the gap will close significantly in the second half of 2020, as confinements are relaxed and driven by the temporary boost in consumption resulting from the withdrawal of pension savings, as well as increased fiscal transfers. However, the activity gap is expected to remain open until the turn of 2022 (Figure 3).

Labor market gaps have widened significantly. Indicators reveal 1.8 million lost jobs comparing both salaried and self-employment in June 2020 and June 2019. All this has translated into increased inactivity (i.e. persons that were not looking for a job but were available for work) from 5.7 to 7.5 million between January and June (a little more than 30% annually). Add to this the fall in labor income due to shorter working days or adjustments in different components of remunerations.

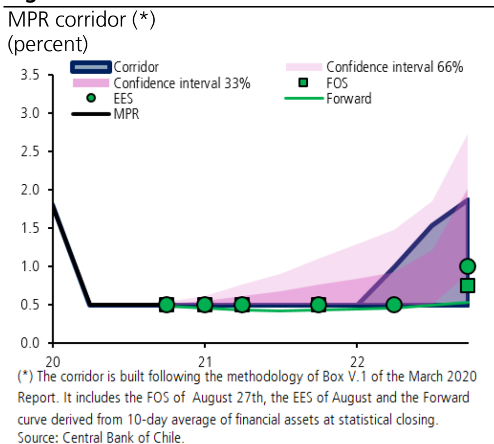
The evolution of inflation has been heavily influenced by the downward pressures resulting from the slowdown in domestic demand. These have been partly buffered by upward pressures from declining potential growth. In the short term, a somewhat faster convergence towards the target is expected due to the aforementioned boost in consumption (Figures 4 and 5). After that, falling household and business incomes, coupled with prospects for a recovery of the economy and the closing of gaps that will take a long time to be completed, continue to dominate the inflation outlook over the policy horizon.

MONETARY POLICY STRATEGY

The Board has held the MPR at 0.5% since March and has continued to implement several unconventional measures to lend support to credit and liquidity, within a context where the process of closing the capacity gaps and the convergence of inflation to the target will materialize no sooner

Figure 6

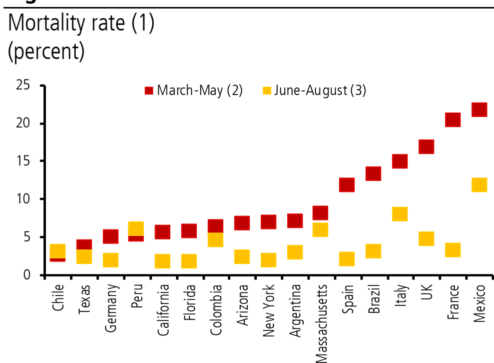
MPR corridor (*)
(percent)



(*) The corridor is built following the methodology of Box V.1 of the March 2020 Report. It includes the FOS of August 27th, the EES of August and the Forward curve derived from 10-day average of financial assets at statistical closing.
Source: Central Bank of Chile.

Figure 7

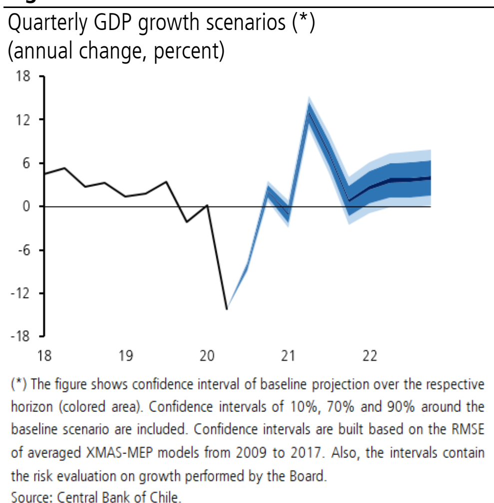
Mortality rate (1)
(percent)



(1) The lethality is calculated on cases and deaths detected by examinations. (2) Division between the accumulated deaths from the first registered death to May 31st and from the first registered case to May 16th. (3) Division between the deaths accumulated between May 31st and August 25th and the cases between May 16th and August 10th.
Source: Central Bank based on information from Our World in Data, The Covid Tracking Project and the Ministry of Science, Technology, Knowledge and Innovation.

Figure 8

Quarterly GDP growth scenarios (*)
(annual change, percent)



(*) The figure shows confidence interval of baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 70% and 90% around the baseline scenario are included. Confidence intervals are built based on the RMSE of averaged XMAS-MEP models from 2009 to 2017. Also, the intervals contain the risk evaluation on growth performed by the Board.
Source: Central Bank of Chile.

than 2022. Moreover, the Board has stated that it will continue to maintain a highly expansionary monetary policy stance and will remain vigilant to avert risks to financial stability.

As always, there are sensitivity scenarios, where the evolution of the macroeconomic situation could call for adjustments to the monetary impulse, as is derived from the MPR corridor[3]/ (Figure 6). On the one hand, the scars that the pandemic will leave will condition the recovery of the activity going forward. The projections recognize that social distancing will alter --for a longer period--the operation of businesses where human interaction is key. However, stronger than expected effects of the pandemic on these sectors cannot be ruled out. Moreover, the impacts of the pandemic on the operation of the various economic sectors could trigger an intra- and inter-sectoral reallocation of resources. In the labor market, this process could take some time, given the greater uncertainty, a different configuration of work modalities and organization, and mismatches between demand for and supply of competencies. Another factor is the cost in human capital of high inactivity and company closures. A slower recovery of the labor market could lead to a more prolonged weakness in demand, negatively affecting growth and inflation's convergence, requiring a greater than anticipated monetary impulse.

On the other hand, the accumulated experience, the prevention measures and the reinforcement of the healthcare systems reduce the probability of repeating the most critical episodes of the pandemic in case of virus outbreaks. Indeed, the mortality of the virus has declined in most countries (Figure 7). This could lead the ongoing deconfinement to proceed at a somewhat greater speed, allowing activity and employment to recover more quickly, and limiting the need for product adaptation and reconversion. This could be boosted by the prompt discovery of a vaccine, in view of the series of investigations underway. In this context, a somewhat lesser monetary impulse would be required to ensure the convergence of inflation. Considering these scenarios, the Board estimates that the risk balance for both activity and inflation is unbiased (figures 8, 9 and 10).

More negative risk scenarios, especially associated with the economic scars the pandemic is leaving, are still possible. These would push GDP growth away from the projection ranges, inducing policy decisions that are materially different from those outlined above, to ensure inflation's convergence to the target and sustain financial stability. The measures implemented by the monetary and fiscal authorities have allowed for maintaining a flow of credit in line with working and investment capital needs, breaking down the pro-cyclical relationship of credit. However, the growth in bank lending has lost some strength in recent weeks. It is

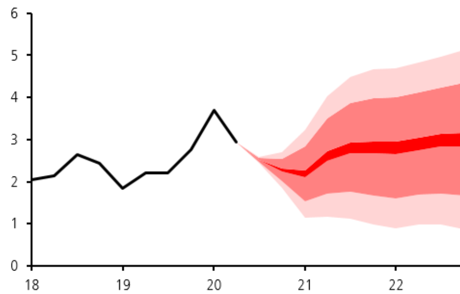
[3]/For details, see Box V.1 in Monetary Policy Report, March 2020.

not evident whether this responds to demand or supply factors; for example, because the reopening of some businesses has allowed them to regain their income flows or because of a greater perception of risk, respectively. In the near future, the materialization of investments, the productive adjustments in some sectors where the sanitary emergency has demanded deep changes in their operation, and increases in the levels of activity, will require financing. For this reason, it is essential to ensure a sustained flow of credit, ensuring that the financial system does not see its capitalization and liquidity levels deteriorate, whether due to regulatory changes and/or a sharper deterioration in the repayment capacity of households and businesses. If such a situation were to occur, the financial sector might be unable to sustain aggregate credit growth, becoming an amplifier of the recession as it has been on previous occasions.

The Board is committed to maintain the strong monetary impulse for an extended period of time and to increase it if it deems it is necessary for the achievement of its objectives of controlling inflation, as well as taking the measures to safeguard financial stability.

Figure 9

CPI inflation forecast (*)
(annual change, percent)

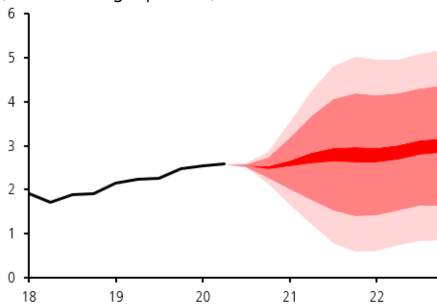


(*) The figure shows confidence interval of baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 70% and 90% around the baseline scenario are included. Confidence intervals are built based on the RMSE of averaged XMAS-MEP models from 2009 to 2017. Also, the intervals contain the risk evaluation on inflation performed by the Board. For 2018, the annual variation of CPI is obtained by splicing the 2013=100 series with the monthly variations of the 2018=100 basket starting in February 2018. See box IV.1, March 2019 Report.

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

Figure 10

Core CPI inflation forecast (*)
(annual change, percent)



(*) The figure shows confidence interval of baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 70% and 90% around the baseline scenario are included. Confidence intervals are built based on the RMSE of averaged XMAS-MEP models from 2009 to 2017. Also, the intervals contain the risk evaluation on inflation performed by the Board. For 2018, the annual variation of CPI is obtained by splicing the 2013=100 series with the monthly variations of the 2018=100 basket starting in February 2018. See box IV.1, March 2019 Report. This Core CPI Report refers to CPI without Volatiles.

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

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