MONETARY POLICY REPORT

JUNE 2022

CATEDRALES DE MÁRMOL
Región de Aysén

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The Central Bank of Chile's Monetary Policy

Money plays a fundamental role in the proper functioning of any economy. To preserve such role, the monetary policy of the Central Bank of Chile (CBCh) must protect the value of the national currency —the peso—, in its quest to keep inflation low and stable. Achieving this fosters the population's wellbeing by safeguarding their income's purchasing power and making the economy function better. When inflation is low and stable, monetary policy can also moderate fluctuations in employment and production.

The inflation target and the monetary policy interest rate (MPR)

The Bank conducts its monetary policy seeking that, irrespective of the current level of inflation, its forecast for a two-year horizon will be 3%. This is similar to the practice of other countries in the world that have, as does Chile, a floating exchange rate; this is the so-called inflation targeting scheme.

The 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 reference interest rate to determine the cost of money and other financial prices, such as the exchange rate, and longer-term interest rates, among others. In turn, these variables affect the demand for goods and services and, thereby, prices and inflation. Monetary policy decisions take several quarters to be fully reflected in the economy, which warrants that monetary policy be made from a forward-looking point of view, having as its primary focus the inflation projection two years ahead, and not just today's inflation.

Communication, transparency and the Monetary Policy Report

Since the Central Bank makes its monetary policy decisions autonomously, it must constantly account for them and their results to the general public. This is so not only because it is a government agency within a democratic society, but also because a credible monetary policy, understood by the people, helps to keep inflation low and stable. Through the Monetary Policy Report (MP Report), the Bank communicates to the general public its view of the recent evolution of the economy, its projections for the coming years and the way in which, in this context, it will conduct monetary policy in order to meet the inflation target.

The MP Report is published four times a year (every March, June, September, and December) and is put together by a team of around 60 persons.

Cover picture: Catedrales de Mármol/ Región de Aysén

Beltrán de Ramón Acevedo / Legal Representative
Corporate Affairs Division
CENTRAL BANK OF CHILE
Agustinas 1180, Santiago, Chile

Tel.: 56-22670 2000
www.bcentral.cl
bcch@bcentral.cl
ISSN: 0716-2219

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*/ This Report incorporates the monetary policy decision of 7 June. For the central scenario construction purposes, the statistical cut-off date is 1 June. This document was originally written in Spanish. In case of discrepancy or difference in interpretation, the Spanish version prevails.

SUMMARY

Inflation in Chile has continued to escalate, hitting its highest level in decades. The main factor behind this trend is still the major increase in demand during 2021. In recent months, however, the impact of strong global cost pressures has deepened due to higher commodity, energy, and food prices. This occurs in a scenario where difficulties in global distribution chains have continued, the peso remains depreciated, and the activity gap is still positive. The short-term inflation outlook has risen considerably, responding to this combination of factors. In line with expectations, economic activity began to adjust in the first quarter, despite a demand composition where private consumption remains intense while investment is dwindling. In the medium term, the adjustment of macroeconomic imbalances remains the central element for inflation to converge to 3% within two years. The high level of inflation and the greater persistence of its fundamentals have called for a more contractionary monetary policy to achieve such convergence, which has led the Board to raise the MPR to 9%. The Board estimates that to ensure the convergence of inflation to 3% within the two-year horizon, additional adjustments to the MPR will be needed, although smaller in magnitude. Risks remain high, nonetheless, particularly given the high level and stubborn persistence of inflation.

Inflation is still on the rise and is significantly above the forecast in the March Monetary Policy Report. The excessive increase in domestic demand in 2021 continues to play an important role in the rise in inflation over the past year. However, its more recent behavior has been more heavily influenced by external cost pressures stemming from higher food and commodity prices, and persistent difficulties in production and supply chains globally. All this is taking place in a context of an exchange rate depreciation with respect to march, and a still high activity gap.

Unlike previous quarters, most of the inflationary surprise of the last few months has to do with the prices of foods and volatile items. Cumulative inflation between March and April (3.3 percentage points) was significantly higher than foreseen in the March Report. The surprise decomposition shows that over 90% of the difference came from higher-than-expected hikes in the prices of foods, energy, and other volatile components. Thus, between December and April, the prices of foods —volatile and not— included in the CPI basket accumulated an increase of 10% that coupled with a 7.7% increase in energy and compares with the 3.8% increase in core inflation minus non-volatile foodstuffs.

Early 2022 data show that the economy is already in an adjustment phase, with a slight decline from the high levels of last year. In the first quarter, the seasonally adjusted GDP series declined 0.8% with respect to the quarter before, with a drop of 0.2% in non-mining GDP. In April, the seasonally adjusted Imacec series showed a 0.3% drop with respect to March; however, this variation was positive (0.2%) for the non-mining Imacec.

Demand has performed with markedly different behavior between private consumption and investment, where the former remains high. First quarter data show that private consumption is still above expectations in March, around the highs it reached during 2021. Durable's goods consumption reversed part of the drop of late last year and services consumption has continued to show high performance. Gross fixed capital formation (GFCF), on the other hand, has contracted across the board, as anticipated in March. In the first quarter, its seasonally adjusted series fell by almost 6% with respect to the previous quarter. The most noticeable decline was seen in the construction and other works component.

On the external front, world inflation has risen substantially in recent months, with core inflation accelerating in several economies. The unfolding of Russia's invasion of Ukraine, together with the impacts of the confinements in China, have led not only to price increases in food and commodities, but also to a rise in their outlook. Most central banks have raised their benchmark rates and/or signaled a path of faster withdrawal of monetary stimulus, including the Federal Reserve and the European Central Bank. Compared to the close of the March Report, global markets have intensified their risk aversion, with a rise in long-term interest rates, a fall in stock markets and an appreciation of the dollar. In any case, these trends have undergone important changes during the period, with some reversal of these changes occurring lately. The Chilean market has performed more favorably than its external peers. Compared to the close of the previous Report, long-term rates show no variations, the peso depreciation is around the average of emerging economies and stock prices have risen, although specific factors have played a role in the latter.

Projections

The persistently high external costs and a more dynamic consumption than anticipated, lead to a significant revision of the inflation trajectory with respect to the March Report. Part of it had already been factored into the May monetary policy decision. In the central scenario, it is estimated that the annual CPI variation will continue to rise to values slightly below 13% during the third quarter. From there onwards, it will start to decline, ending 2022 at around 10%, which is significantly higher than forecast in March. The revision of the core inflation projection for December is also significant: 2,5 percentage points more than projected in March. In this case, the main changes are due to higher food prices included in the index, the effect of the exchange rate hike and logistical bottlenecks in the prices of goods. The higher private consumption that is being observed and the second-round effects of the increase in expected inflation also play a part.

Towards 2023 and 2024, the central scenario continues to foresee that total inflation and its core component will see a sustained decline, both of which will be around 3% by mid-2024, i.e., the end of the two-year monetary policy horizon. In this projection, total inflation will close 2023 at around 3%, while core inflation will be closer to 4% annually. The decline in core inflation will be slower than that of headline inflation and will start later than was expected in March, reflecting the greater persistence of external cost shocks and importance of second-round effects.

A key element for the convergence of inflation to the 3% target within two years is that the significant imbalances that accumulated in the economy in 2021 continue to be resolved. In the central scenario, in 2022 and 2023 the economy will grow below its potential, so the gap will continue to narrow and will be negative for some quarters. In addition, international fuel and food prices will slowly decline from their current levels and the real exchange rate (RER) will fall, but still remaining above its averages of the last 15 to 20 years. In this projection, no changes are assumed in the structural parameters of the Chilean economy.

The liquidity remaining from the stimulus measures implemented in 2021 will continue to support consumption in the immediate term. However, most of its fundamentals suggest that it will weaken during the second part of the year. In the labor market, jobs continue to be created, albeit at a slower pace than in previous months and with lower real wages, in a context in which the unemployment rate remains below 8%. The financial conditions for households have tightened, due to both higher interest rates and more stringent credit requirements. In this context, coinciding with the effect of inflation on household purchasing power, consumer expectations have deteriorated sharply in recent months, with worsening perceptions of employment, inflation, and the purchase of goods.

The stronger dynamism of consumption during in the first part of this year leads to an upward revision of its growth forecast for 2022, delaying its adjustment to the second half of this year and 2023. The opposite is true for GFCF, for which more significant declines are expected this year and next. Investment fundamentals have also worsened. Regarding financial conditions, the deterioration that has already occurred in the capital market and the lower levels of long-term savings to finance investment play an important role. Added to this are the revisions of the Capital Goods Corporation's investment survey, the persistence of high uncertainty and a general decline in business expectations.

The adjustment of the 2021 overspending will allow for a reduction in the current account deficit and an increase in national savings over the projection horizon. In the central scenario, the current account deficit estimated for this year is raised to figures in the vicinity of 6.5% of GDP, due to both the higher consumption forecast and the evolution of external prices. In 2023 and 2024, the deficit will be reduced between 4 y 4.5%, consistently with the adjustment in domestic spending. Domestic savings will grow from rates in the order of 18.5% to 20% of GDP between 2022 and 2024.

In the external scenario, the boost to the Chilean economy has been reduced, particularly due to the worsening of global financial conditions in view of the withdrawal of monetary stimuli (Box I.2). The central scenario projections consider that international food and commodity prices will remain high for several quarters. This is consistent with both lower terms of trade for Chile and tighter financial conditions, given the monetary policy response expected in the main economies (Box I.1). Additionally, the projections consider a slowdown in the growth of our main trading partners.

In the central scenario, the narrowing of the gap that began early this year will be prolonged for several quarters. Thus, GDP will post annual variation between 1.5% and 2.25% this year, between -1.0% and -0% in 2023, and between 2.25% and 3.25% in 2024. For this three-year period, the projection contemplates a fiscal spending path consistent with the one reported in the latest Public Finance Report.

The Board estimates that, after the hike determined at the June monetary policy meeting, to ensure the convergence of inflation to 3% within the two-year horizon, additional adjustments to the MPR will be needed, although smaller in magnitude. In any case, risks are still important, particularly because of the level where inflation stands today and its long-lasting persistence.

Risks surrounding the evolution of the macroeconomic scenario remain significant. The upper part of the MPR corridor reflects sensitivity scenarios where inflation persistence could be higher than expected. This could occur if private consumption continues to show no significant adjustment in the coming quarters. Although its fundamentals indicate that it should begin to weaken soon, it cannot be ruled out that it could continue to be more dynamic than expected, particularly due to the financing capacity provided by the remaining liquidity and the decrease in the level of household debt during 2021. Such a scenario could also occur if global cost pressures increase. This would exacerbate the inflationary problem, leading to a stronger monetary policy reaction from various central banks in the short term, but increasing the likelihood of a global recession in the medium term.

The lower part of the MPR corridor describes a scenario where inflationary pressures dissipate sooner than expected. It is possible for the contraction of activity and demand to be more intense, due to either investment being weaker or the speed of adjustment of private consumption occurring at a faster speed. Nor can it be ruled out that the external scenario will see a reduction in global cost pressures and inflation easing in most economies, including Chile.

There are also scenarios where the economy would face more significant changes, which would place growth outside the range of the central scenario projections. One such scenario could occur if the Russian invasion of Ukraine develops into a much more damaging scenario for the world economy. It could also occur if global financial conditions worsen even more sharply, for example in a scenario where the evolution of inflation leads to a much stronger than expected tightening of monetary policy in the leading economies.

Inflation has risen to levels not seen for decades, and its negative effects on families are reflected in public concern over this phenomenon. In addition, the two-year inflation expectations of economists and financial traders persist above 3%, and the expectations of companies at longer horizons have also increased. It is important to note that high inflation rates for prolonged periods become more persistent and the evidence indicates that the cost of adjusting it rises, with the consequent impact on the welfare of the population. The Board will carefully monitor the evolution of the macroeconomic scenario, ensuring that inflation convergence to the target is guaranteed over the two-year monetary policy horizon.

TABLE 1 : INFLATION (1)
(annual change, percent)

	2021	2022 (f)		2023 (f)		2024 (f)	
	MP Rep.	MP Rep. March 22	MP Rep. June 22	MP Rep. March 22	MP Rep. June 22	MP Rep. March 22	MP Rep. June 22
Average CPI	4.5	8.2	10.8	3.4	5.0	3.0	3.0
December CPI	7.2	5.6	9.9	2.9	2.7	3.0	3.0
CPI in around 2 years (2)						3.0	3.0
Average core CPI	3.8	7.7	9.1	4.7	6.4	3.0	3.1
December core CPI	5.2	7.2	9.7	3.3	3.8	3.0	3.0

(1) Core inflation is measured using the CPI without volatiles.

(2) For march 2022 MP Report corresponds to inflation forecast for the first quarter of 2024, for june to inflation forecast for the second quarter of 2024.
(f) Forecast.

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

TABLE 2 : INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

	2021	2022 (f)		2023 (f)		2024 (f)	
	MP Rep.	MP Rep. March 22	MP Rep. June 22	MP Rep. March 22	MP Rep. June 22	MP Rep. March 22	MP Rep. June 22
				(annual change, percent)			
Terms of trade	11.8	-3.1	-4.0	-3.1	-4.1	-1.5	-0.2
Trading partners (e)	6.3	3.3	2.7	3.3	2.9	3.1	3.1
World GDP at PPP	6.1	3.1	2.6	3.4	2.7	3.3	3.2
Developed GDP at PPP (e)	5.1	2.9	2.4	2.0	1.5	1.8	1.7
Emerging GDP at PPP (e)	7.0	3.2	2.6	4.3	3.5	4.3	4.2
				(levels)			
LME copper price (US$cent/pound)	423	435	425	390	370	365	345
Oil price, average WTI-Brent (US$/barrel)	69	94	104	83	92	77	83

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

TABLE 3 : INTERNAL SCENARIO
(annual change, percent)

	2021	2022 (f)		2023 (f)		2024 (f)	
	MP Rep.	MP Rep. March 22	MP Rep. June 22	MP Rep. March 22	MP Rep. June 22	MP Rep. March 22	MP Rep. June 22
GDP	11.7	1.0-2.0	1.5-2.25	-0.25/0.75	-1.0/0.0	2.25-3.25	2.25-3.25
Domestic demand	21.6	-1.2	1.4	-1.1	-3.4	2.8	2.5
Domestic demand (w/o inventory change)	18.0	-1.1	1.0	-0.7	-3.4	2.8	2.5
Gross fixed capital form	17.6	-3.8	-4.8	-0.2	-2.2	2.0	3.0
Total consumption	18.2	-0.2	2.8	-0.8	-3.7	3.1	2.4
Private consumption	20.3	-0.3	2.1	-1.1	-4.1	3.2	2.5
Goods and services exports	-1.5	3.3	1.3	5.4	5.7	2.8	3.0
Goods and services imports	31.3	-4.7	0.0	0.7	-3.0	2.7	2.3
Current account (% of GDP)	-6.6	-4.6	-6.6	-3.5	-4.5	-3.2	-4.0
Gross national saving (% of GDP)	18.8	19.7	18.4	20.3	20.0	20.5	20.1
Gross national investment (% of GDP)	24.0	23.1	23.3	23.2	22.8	23.2	22.4

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

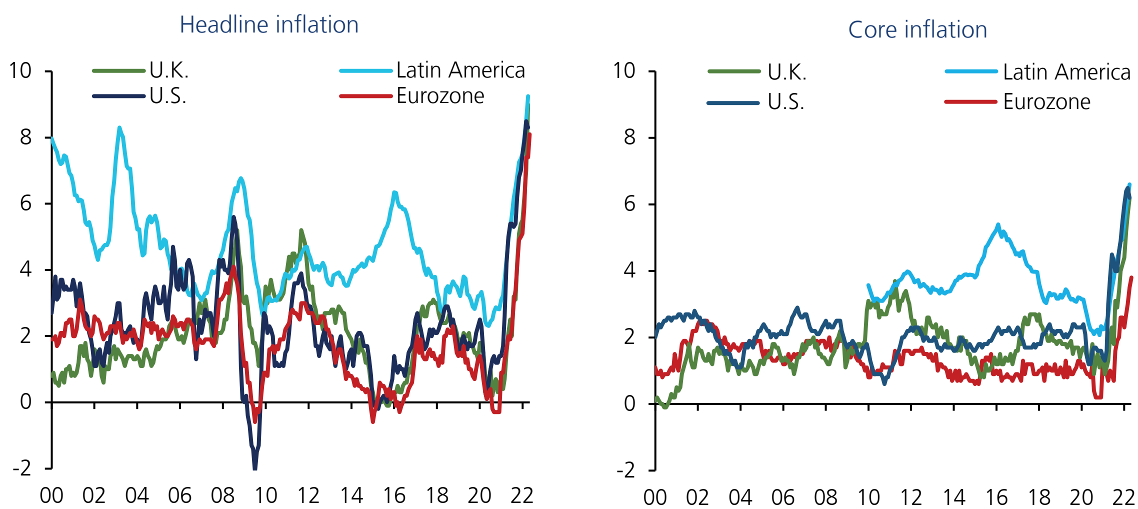
I. RECENT EVOLUTION OF THE MACROECONOMIC SCENARIO

Inflation has continued to escalate around the world as global cost pressures affect goods and services everywhere. This phenomenon has accelerated expectations of rate hikes at most central banks, becoming the main cause behind the deterioration in global financial conditions. In Chile, inflation rose further and reached its decades-long peak, and has become one of the citizens' main concerns. The hikes of recent months are largely explained by the impact of higher food, energy, and other volatile prices, which couple with already very high inflation levels, due to demand pressures accumulated during 2021. Activity began to adjust in the first quarter, marking important divergences among demand components: while consumption remains strong, investment is losing steam. Going forward, demand will continue on an adjustment path consistent with the reestablishment of macroeconomic balances, affected by tighter financial conditions, lower demand for labor, falling real incomes, declining liquidity, the worsened international scenario, the persistence of high uncertainty and the deterioration of agents' expectations.

THE INTERNATIONAL SCENARIO

Global inflation has risen significantly in recent months, with figures showing generalized price increases, which has resulted in an acceleration of core inflation in several economies (figure I.1). In the United States, in addition to high inflation of goods, there have been sharper increases in services and in the volatile components of the basket, amid a still tight labor market and high housing prices. In the Eurozone, although energy continues to be the main factor behind price increases, food inflation and core measures have accelerated lately. In the United Kingdom, in addition to higher goods and energy inflation, services have gained incidence, in a context of upward wage pressures. In Latin America, energy and food prices have continued to drive inflation, which has also been passed through as higher prices of some services.

FIGURE I.1 WORLD INFLATION (*)
(annual change, percent)

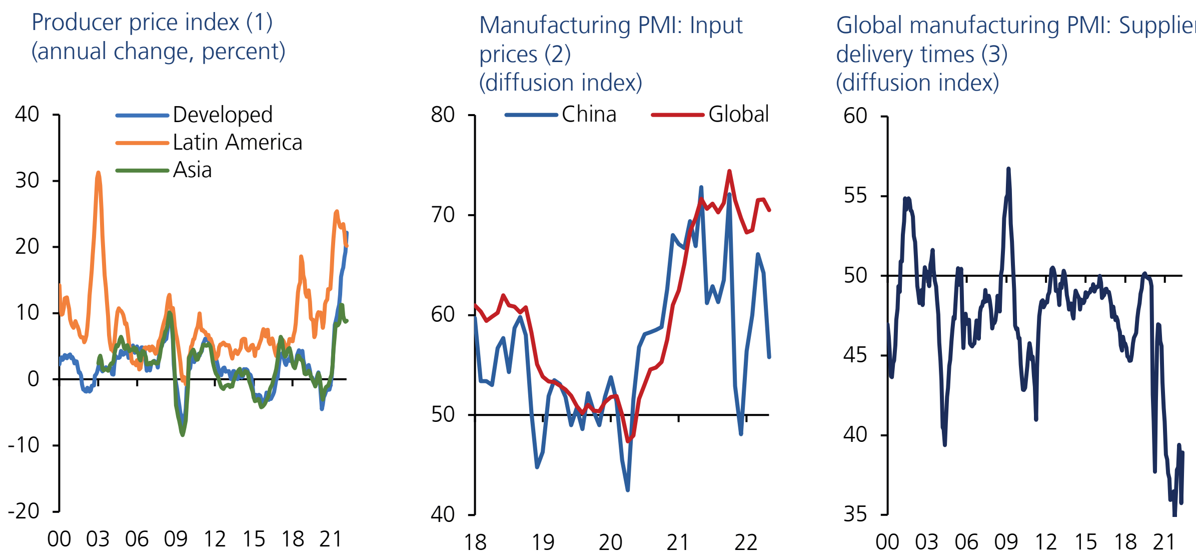


(*) For Latin America, the simple average of annual inflation of Brazil, Colombia, Mexico and Peru is used.
Sources: Statistics bureaus of respective countries.

Inflation has risen in a scenario of persistent cost pressures worldwide (figure I.2). In addition, more countries have shown signs of tightening labor markets. The continuing effects of the pandemic on global supply chains and commodity prices have been compounded by the Russian invasion of Ukraine and recent confinements in China. Producer price indexes have risen to unprecedented levels and across countries in the past year, reflecting the higher costs of commodities and intermediate inputs.

Reinstated confinements in China have put additional pressures on global supply chains, while the country maintains its zero-tolerance policy towards Covid-19. The slow normalization of value chains has been further delayed by the constraints in China resulting from the resurgences during March and April, which caused further supply disruptions and extensions in supplier lead times (figure I.2).

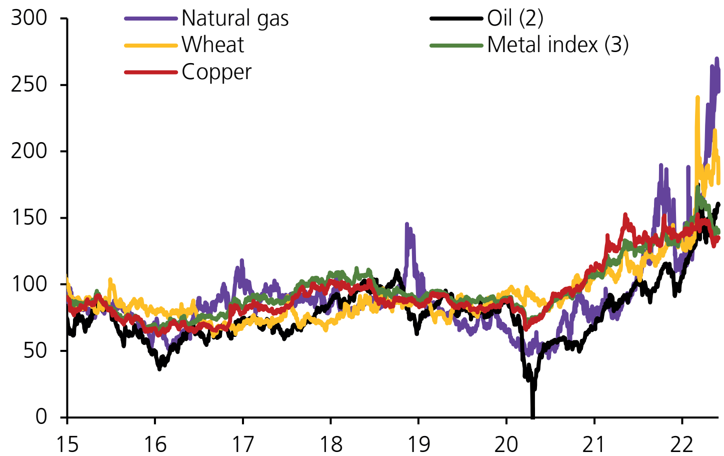
FIGURE I.2 COST PRESSURES AND BOTTLENECKS



(1) Weighted by PPP using IMF figures. (2) Value above (below) 50 means higher (lower) input prices. (3) Value below (above) 50 denotes an extension (reduction) in suppliers' delivery times.
Sources: Bloomberg, IMF, IHS Markit and JP Morgan.

One important factor behind the higher costs has been the significant increase in the prices of commodities, energy, and foods (figure I.3). The oil price persists above US$110 per barrel, in a market that is perceived to be tight given the inventory situation, uncertainty about the ability of OPEC+ to meet its production commitments and the extent of sanctions on oil imports from Russia. Food prices significantly steepened their upward trend in the wake of Russia's invasion of Ukraine. This was reflected not only in spot transactions, but also along the futures curve, signaling further persistence. As of May, the FAO index accumulated an increase of 17% over the end of 2021, most notably in vegetable oils and cereals. Wheat and corn prices have continued to rise, in a context where port blockades and damages to Ukrainian infrastructure have caused major difficulties in exports of these products. This has been compounded by poor harvests in other countries. In addition, high fertilizer prices continue to weigh on the costs of food producers globally, driven largely by natural gas prices and supply constraints in some of the main exporting countries, including Russia.

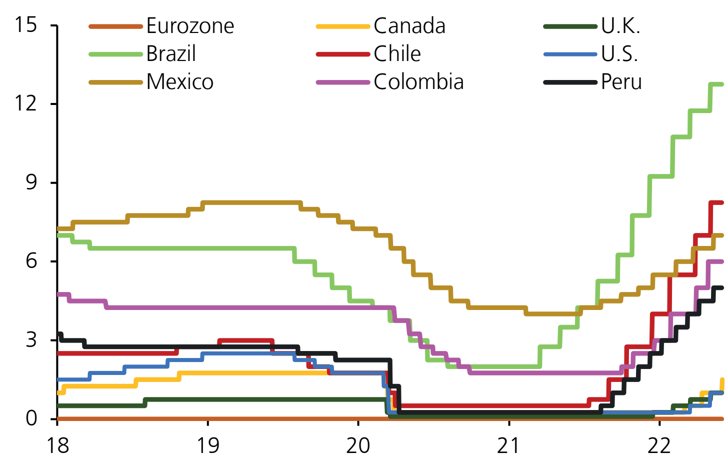
FIGURE I.3 COMMODITY PRICES (1)
(index, 2010-2022 average=100)



(1) For natural gas and wheat, 1-month futures are used. (2) WTI-Brent average. (3) S&P GSCI Industrial Metals.
Source: Bloomberg.

The generalized rise in prices of recent months, plus the high initial inflation levels, have led most central banks to raise their benchmark rates and/or to signal a more rapid withdrawal of their monetary stimuli (figure I.4). The Federal Reserve (Fed) implemented its biggest rate increase in two decades, and announced additional hikes in the upcoming meetings and the reduction of its balance sheet starting in June. Sweden, India, and Australia surprised the market by initiating their monetary normalization process in the face of increased inflationary pressures. The European Central Bank confirmed that it will end its unconventional stimulus program in the third quarter of this year, although it continues to maintain a more cautious stance regarding the benchmark rate. Latin American central banks have further raised their monetary policy rates in the face of higher inflation.

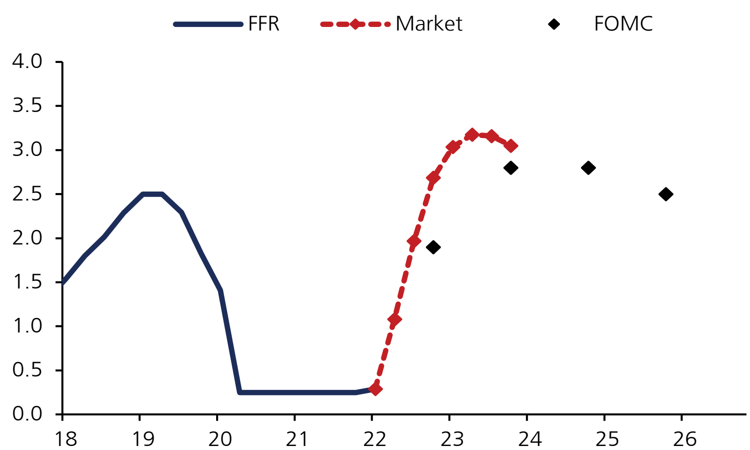
FIGURE I.4 MONETARY POLICY RATES
(percent)



Source: Bloomberg.

The speed of price increases, the strong global cost pressures and their expected stronger persistence have intensified doubts about the monetary tightening needed to contain inflation, which poses significant risks to financial conditions and, in particular, to emerging economies (box I.2). Particularly noteworthy is the situation in the U.S., where the evolution of inflation, its expectations and fundamentals, particularly the behavior of consumption and the labor market, raise questions about the path of interest rate hikes to be applied by the Fed, amid real rates that remain well below their neutral level (box I.1). In this scenario, the probability of an even faster rate increase by the Fed and other developed countries' monetary authorities has increased significantly, which would lead to a considerable worsening of global financial conditions, causing a sharper slowdown in world growth (figure I.5).

FIGURE I.5 FED FUNDS RATE (*)
(percentage points)

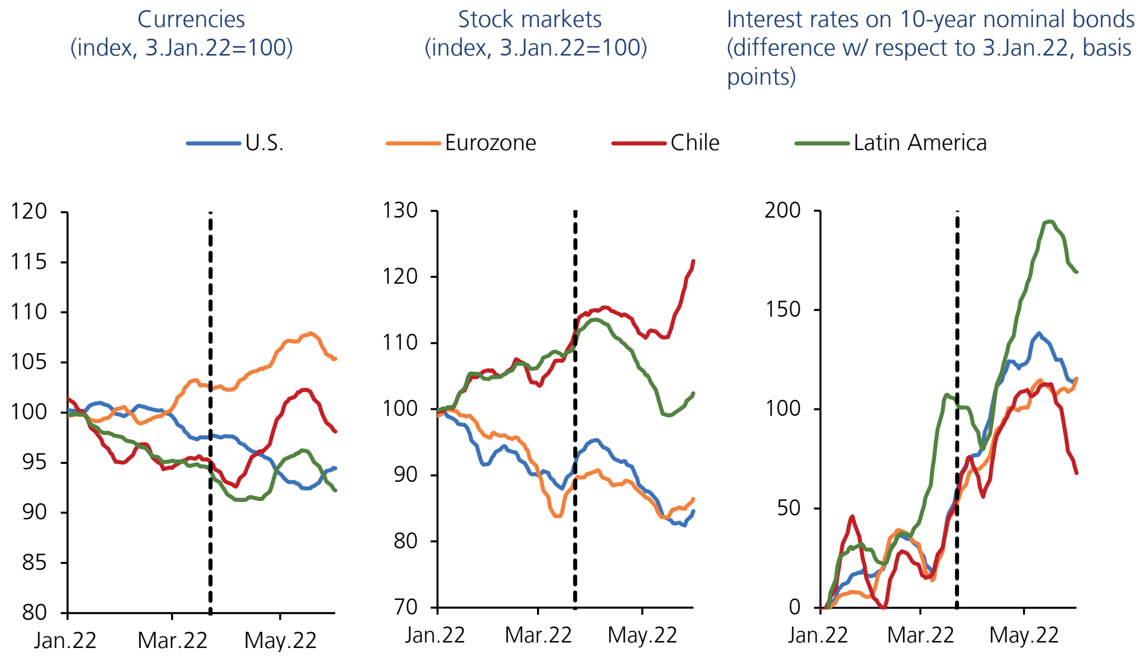


(*) FOMC forecasts correspond to March 2022. Market forecasts correspond to futures at 1 June 2022.
Sources: U.S. Federal Reserve and Bloomberg.

Developments in China also pose a risk to global financial markets and activity. The growth prospects of the Chinese economy have been significantly downgraded in recent months (chapter II), amid the aforementioned mobility restrictions, a weak housing market and high levels of corporate debt. Among other repercussions, this has had an impact on global demand for copper and its outlook. In fact, although the price of the metal is still high by historical comparison, its value has fallen from the peak of US$4.8 per pound it reached when the war broke out, to near US$4.3 at the close of this Report.

The higher risks surrounding the economic scenario have led to a deterioration in global financial conditions, especially for emerging economies (figure I.6). The reduced global risk appetite caused by inflation uncertainty gave way to generalized increases in long-term interest rates, declines in the main stock markets and a global appreciation of the dollar. Moreover, sovereign and corporate risk premiums have risen, particularly in emerging economies. Markets have become especially sensitive to reports on inflation and monetary policy, with important movements around these events. In Latin America, uncertainty about China's activity has affected the prices of some commodities, as well as local stock markets and currencies. The latter, however, have recently seen some reversal. The Chilean market, on the other hand, has performed more favorably than its external peers. Yields on 10-year peso bonds are in similar levels than the closing of the March Report, and the nominal exchange rate has continued to depreciate, with a rise of around 4% since the end of March. During this period, the IPSA has had a positive performance with accumulated gains, which can be attributed to some specific factors.

FIGURE I.6 FINANCIAL CONDITIONS (1) (2) (3)



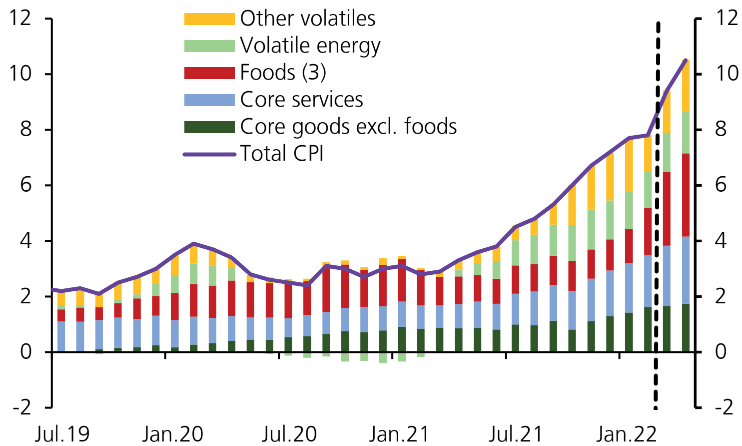
(1) Dashed vertical line marks statistical cutoff of March 2022 Report. (2) 7-day moving average. (3) Latin America uses simple averaged indexes of Brazil, Colombia, Mexico, and Peru.
Source: Bloomberg.

THE DOMESTIC SCENARIO

CPI inflation has continued to escalate, reaching 10.5% annually in April of this year, its highest in recent decades (figure I.7). Worth noting is the sharp increase in food prices, which explained slightly less than a third of annual cumulative inflation to April. Also noteworthy is the effect of higher energy prices, driven by fuels. This trend has been in line with the soaring international prices (figures I.2 and I.3). Core CPI —which excludes volatile items— posted an annual variation of 8.3% in April. This figure has continued to be linked mainly to the sustained rise in goods, but has recently also shown a greater contribution from its foods and services components, consistent with the dynamism of consumption during the first quarter of the year and with the price and utility rate price indexation adjustments that usually take place in March.

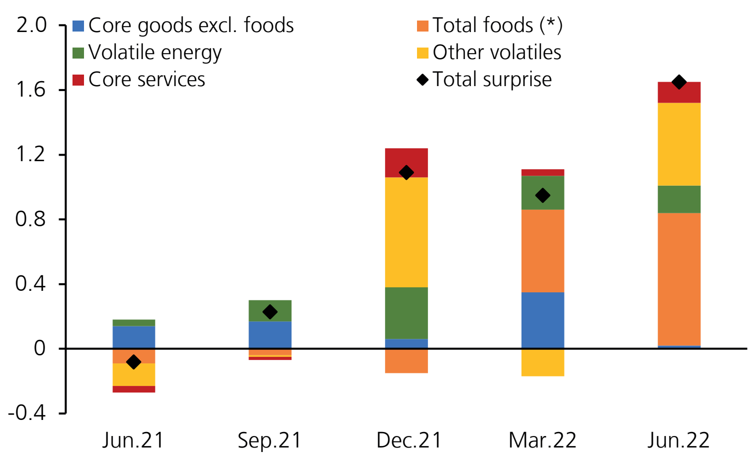
Cumulative inflation between March and April significantly exceeded the March Report estimates. This surprise is largely explained by the rise in volatile prices and foods (figure I.8). The CPI variation for March and April was 1.65 percentage points (pp) higher than expected. The sum of the surprises in food prices —volatile and not— explained much of the difference (+0.82pp). The higher increases in the prices of bread, meats, and fruits & vegetables stood out. Another fraction of the surprise, as has been the trend over the last year, was linked to fuel prices (+0.17pp). The remaining difference was mostly explained by other volatile items (+0.51pp), notably package tours. Meanwhile, core services inflation presented limited surprises in specific prices, while core goods inflation —excluding foods— was in line with projections in the March Report.

FIGURE I.7 INFLATION INDICATORS (1) (2)
(contributions to annual change, percentage points)



(1) Dashed vertical line marks statistical cutoff of March 2022 Report. (2) For more detail on the different groupings and their share in the total CPI basket, see box IV.1 in December 2019 Report, Carlomagno and Sansone (2019), and Economic Glossary. (3) Considers sum of volatile and non-volatile food items.
Sources: Central Bank of Chile and National Statistics Institute (INE).

FIGURE I.8 CUMULATIVE INFLATIONARY SURPRISES IN MPR REPORTS
(percentage points)



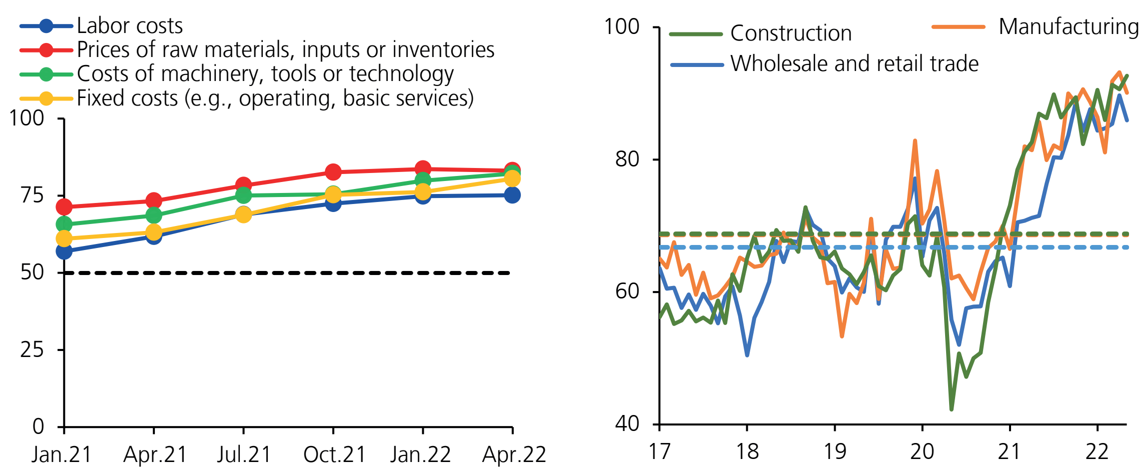
(*) Sum of volatile and non-volatile foods.
Sources: Central Bank of Chile and National Statistics Institute (INE).

This higher inflation comes in a context of substantially higher cost pressures on the economy. The INE transportation costs index has continued to rise, driven by fuel prices. The producer prices for manufacturing have seen widespread increases in every sector. In our Business Perceptions Report (BPR) last May, firms reiterated that cost pressures are among the factors dominating their performance (figure I.9). These pressures arise from various fronts, including the depreciated peso, fuel prices, persistent global supply problems, and the high prices of some inputs and raw materials. A similar scenario is reflected in business cost expectations as measured by the IMCE, which remain on an upward trend and continue to be well above their historical averages.

FIGURE I.9 COST PRESSURES

Perceptions of firms' cost trajectory in the last three months (1)
(diffusion index)

IMCE: Expected costs (2) (3)
(diffusion index)

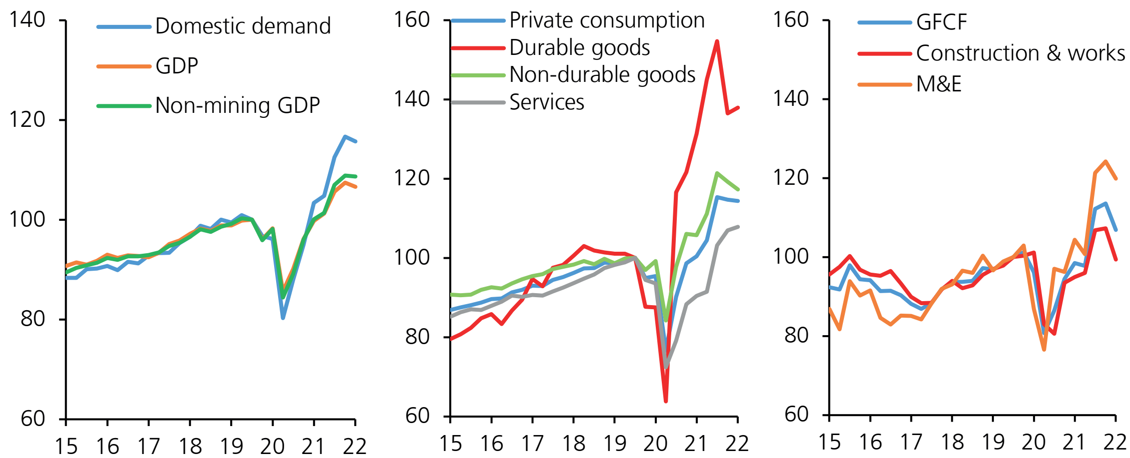


(1) Value above (below) 50 means a larger share of increase (decline) responses. (2) Value above (below) 50 indicates expected expansion (contraction). (3) Dashed horizontal lines show historical averages between January 2004 and May 2022.
Sources: Central Bank of Chile and Icare/Universidad Adolfo Ibáñez.

In turn, activity began an adjustment process in the first quarter of this year (figure I.10). During this period, the seasonally-adjusted GDP series decreased 0.8% with respect to the previous quarter. The declines in trade, agriculture-forestry, and mining activity stood out, in contrast to the expansion of services, especially personal ones. The Imacec for April maintains this trend at the aggregate level, although its non-mining component surprised on the upside, confirming that the adjustment of the economy is underway, but more slowly than expected, particularly in trade and transportation services.

The adjustment of activity proceeds with a marked difference between the behavior of consumption and investment, where the former remains strong (figure I.10). First-quarter data show that, contradicting expectations, private consumption has not lost significant dynamism, as it remains close to the highs it reached during 2021. Actually, durable goods consumption, which suffered a significant drop at the end of last year, increased again in the first quarter. Also noteworthy is the consumption of services, which has continued to exhibit high dynamism, especially in items such as healthcare, restaurants & hotels, and transportation, reflecting the reopening of the economy and eased mobility constraints.

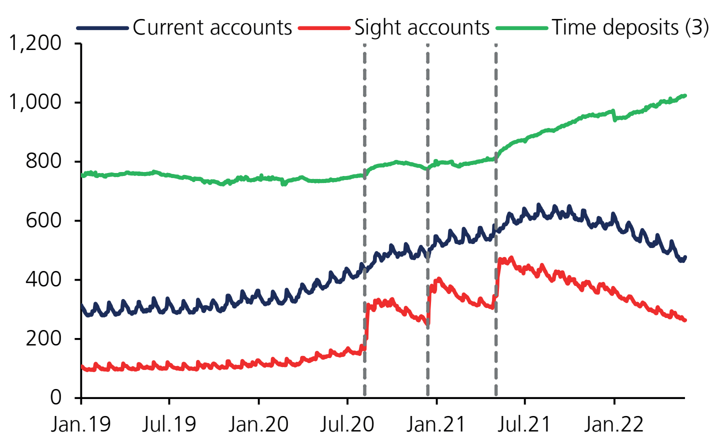
FIGURE I.10 ACTIVITY AND DEMAND INDICATORS
(index, third quarter 2019 =100; seasonally-adjusted series)



Source: Central Bank of Chile.

The resilience of consumption coincides with the increased use of liquidity that resulted from the fiscal stimulus measures and pension fund withdrawals. Nevertheless, it remains high from a historical perspective. While households' time savings have increased since the third withdrawal, individuals' checking and sight account balances show that aggregate household liquidity remains well above its pre-pandemic levels (figure I.11).

FIGURE I.11 REAL BALANCES IN PERSONAL ACCOUNTS (1)(2)
(millions of UFs)



(1) The three vertical lines indicate the beginning of payments associated with partial withdrawals of pension funds. (2) In January 2022 the Compendium of Banking Accounting Standards of the Financial Market Commission was updated; it is used for the preparation of monetary statistics. (3) Time deposits include personal time deposits and time savings accounts.
Source: Central Bank of Chile.

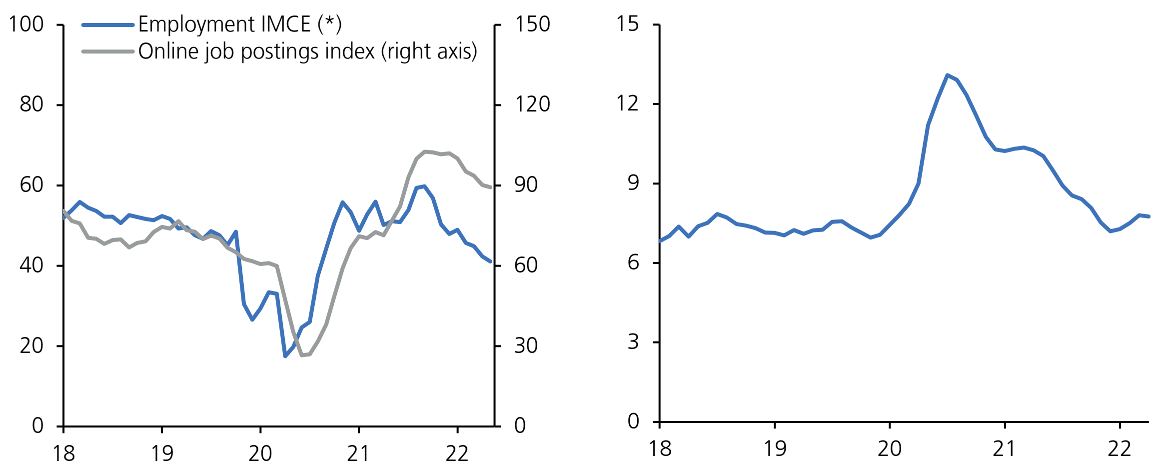
Unlike consumption, investment has lost some strength in all its lines (figure I.10). In the first quarter of the year, the seasonally-adjusted series of gross fixed capital formation (GFCF) fell 5.9% from the previous quarter. The most evident decline was that of the construction and other works component. Machinery & equipment also decreased, with a marked drop in imports of motors, generators, electric transformers, and machinery for industrial use.

In the labor market, the loss of strength in the demand for workers stands out. The online Job Postings Index has lost nearly 20 points from the highs of the second half of 2021, while hiring expectations (IMCE) have been falling steadily for several months (figure I.12). The background collected in the May BPR also pointed to weaker employment dynamism in the coming months. Labor surveys continue to show an increase in employment associated with higher labor participation, although at a slower pace at the margin. This is consistent with the significant decline in real wages amid rising inflation. In any case, the unemployment rate continues to be below its average of the last decades: -7.7% in the February-April moving quarter (figure I.12).

FIGURE I.12 LABOR MARKET

Employment IMCE and Online Job Posting Index
(index; index Jan.15 = 100, three months moving avg.)

Unemployment rate
(percent)

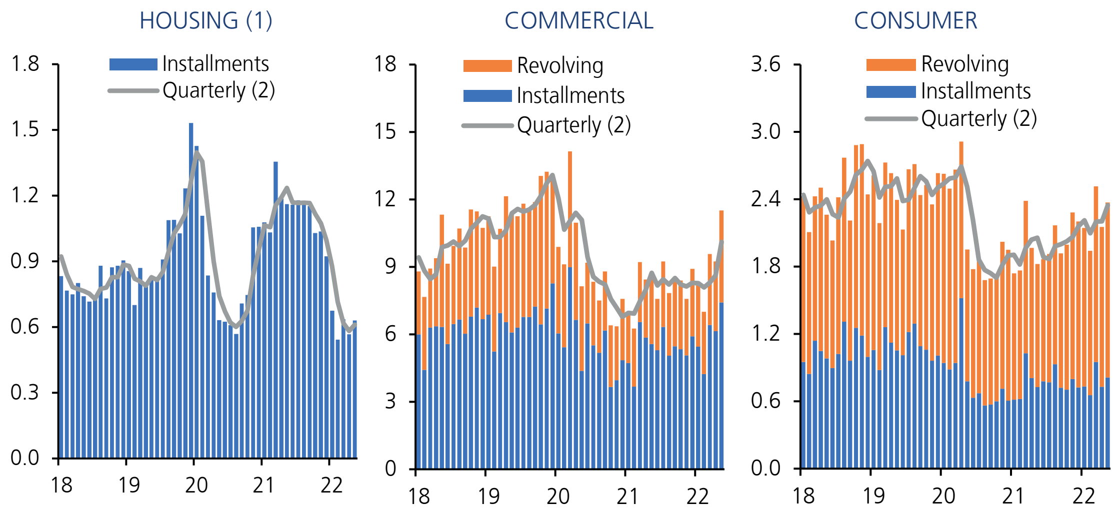


(*) Averaged employment indicators in trade, manufacturing, and construction.
Sources: Central Bank of Chile, National Statistics Institute (INE), and ICARE/Universidad Adolfo Ibáñez .

The financial conditions facing households and businesses have tightened as a result of higher interest rates and more demanding lending requirements. The average consumer lending rates are close to their seven-year highs, standing at 25.1% annually in May. Commercial rates, already well above their record-high of the last decade, stood at 12.3% annually. Meanwhile, mortgage rates in UF —at longer maturities and, therefore, more closely related to longer-term benchmark rates— are at 4.4% per year. In addition, according to information gathered in the May BPR, the increase in rates is accompanied by a more thorough borrowers evaluation and more stringent requirements by the banks. Our Bank Lending Survey (BLS) for the first quarter also shows that credit supply remained tight.

In this context, bank credit has decelerated further and its ratio to GDP is below its historical average. May data show a poor performance of real loans (figure I.13). The monthly flow of new housing loans has fallen by nearly 50% compared to May 2021 and is at its lowest levels of recent years. Consumer and commercial loan flows are still below their pre-pandemic levels. However, the former has grown in an annual comparison, mainly due to a sustained increase in revolving credit (i.e. credit lines and cards), and the latter showed a rebound in May. In any case, as mentioned in the Financial Stability Report for the first half of this year, delinquency remains low and stable, although provisions remain high, amid severe local uncertainty.

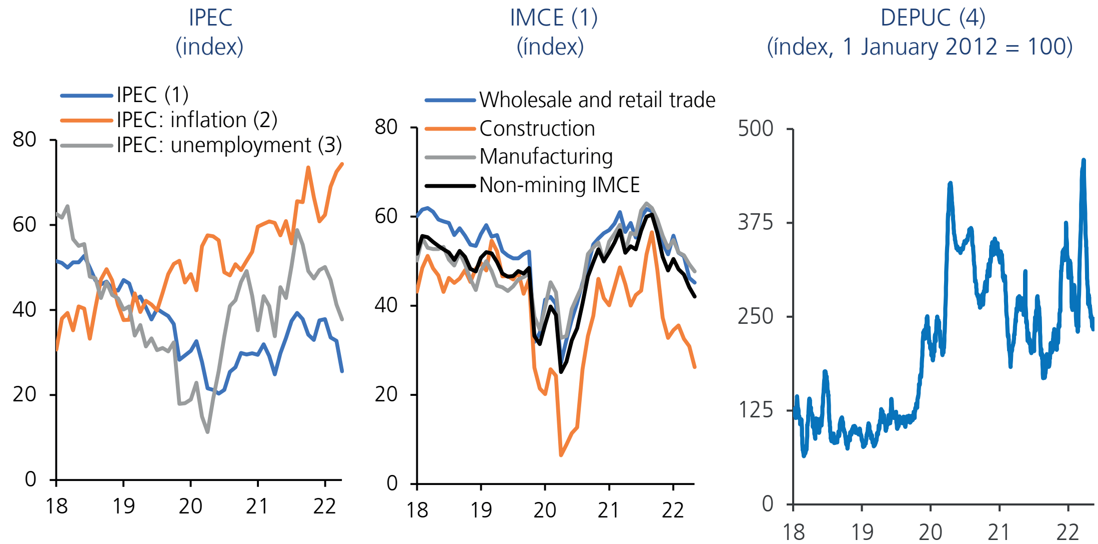
FIGURE I.13 CREDIT FLOWS
(billions of US dollars at April 2022 constant purchasing power)



(1) Includes only operations in UFs. (2) Moving quarterly average.
Source: Central Bank of Chile based on FMC data.

All the above coincides with a substantial deterioration in business and household confidence, coupled with the persistence of high uncertainty (figure I.14). Consumer expectations (IPEC) have fallen sharply in recent months, while the perception of employment and inflation has worsened. Accordingly, the BPR for May shows that companies are concerned about the possible effect of inflation on households' future consumption decisions. At the same time, business confidence (IMCE) declined across all sectors, especially in construction. The context for this has been still high uncertainty (Depuc), which has even surpassed the highs of the early days of the pandemic.

FIGURE I.14 OUTLOOK AND UNCERTAINTY INDICATORS



(1) Value above (below) 50 indicates optimism (pessimism). (2) Percentage of respondents who believe that prices will increase "a lot" in the next 12 months. (3) Higher (lower) value indicates less (more) unemployment. (4) Moving 30-day average. As from December 2021, the index includes an update to the dictionary of words used for its construction, as a way of incorporating new elements that influence local conditions.
Sources: Gfk/Adimark, UAI/ICARE, and Central Bank of Chile based on Becerra and Sagner (2020).

ECONOMIC EXPECTATIONS

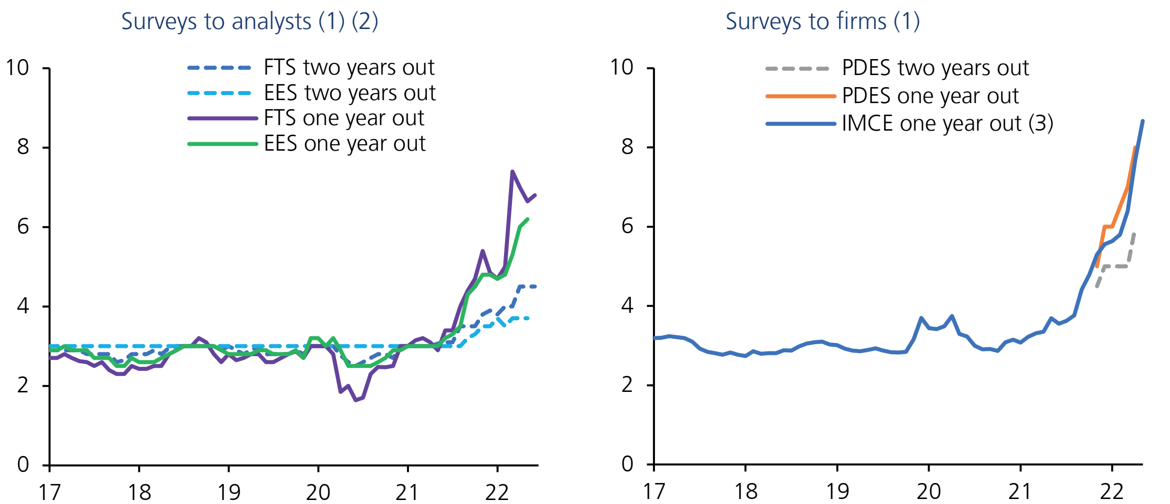
Two-year inflation expectations remain above 3%, although the biggest increase is found in the shorter-term measures (figure I.15). At one year, the median of the surveys —the May Economic Expectations Survey (EES) and the Financial Traders Survey (FTS) prior to the June Meeting— place inflation at 6.2% and 6.8%, respectively (5.3% and 7.4% in the March Report). For the end of the monetary policy horizon, the outlook shows no major difference with the March Report and continues to be above 3%. Inflation expectations derived from financial prices have also risen further, although their increases have been concentrated in the one-year horizon. At the statistical close, inflation protection insurance placed it at 6.8% in twelve months. Meanwhile, breakeven inflation at longer terms continue to place inflation above 3%: 6.2% and 4.7% at two and five years, respectively. In any case, it should be noted that the latter measure is affected by liquidity and risk premiums and other elements that are intensified when in highly uncertain scenarios such like the current one[1]/.

Firms' inflation expectations have also risen (figure I.15). Both the April Price Determinants and Expectations Survey (PDES) and the May IMCE indicate that businesses expect inflation to be close to 8% in one year. In turn, almost 80% of the firms interviewed in our May Business Perceptions Survey (BPS) estimate that inflation over the next twelve months will be well above what is considered normal for that horizon.

Expectations for activity have been revised downward for this and next year. In the May EES, median GDP expectations for 2022 and 2023 were reduced to 1.5% and 0.5%, respectively (2.0% and 1.5% in March). For 2024, the forecast is unchanged at 2.0%. The outlook for consumption and investment has also been downgraded to 1.0% and -1.0%, respectively, for this year, and around 0% for next year.

[1]/ See box IV.1 in December 2016 Report; box V.1 in March 2022 Report.

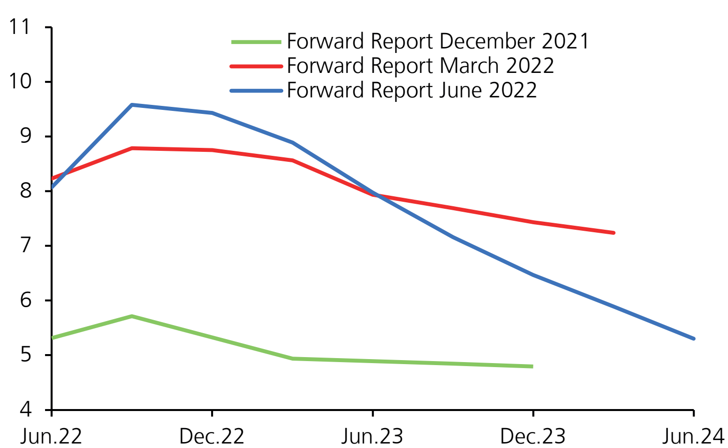
FIGURE I.15 INFLATION EXPECTATIONS
(annual change, percent)



(1) Response medians are shown. (2) FTS considers the survey for the first two weeks of each month through January 2018. From February 2018 onwards, it considers the last survey published in the month, including the one prior to the June 2022 Meeting. In months in which the survey is not published, the latest available survey is considered. (3) Average of wholesale & retail trade and manufacturing medians.
Sources: UAI/Icare and Central Bank of Chile.

In this context, the local market has adjusted upward the expected MPR trajectory. MPR expectations have been raised in both the EES and FTS surveys. The former puts its terminal level at 9.0%, which would be set at the June meeting. Meanwhile, the FTS estimates that the policy rate will reach 9.5% in July. Both surveys also anticipate that the MPR would be maintained at these levels until at least December of this year, to then begin to bring it down. In turn, the expectations implicit in financial prices predicted a somewhat different trajectory, placing the inflection point of the rate trajectory in September of this year (figure I.16).

FIGURE I.16 MPR EXPECTATIONS (1)(2)
(quarterly average, percent)



(1) Calculated by extracting the implicit MPR considering the forward curve on the average interbank swap curve for up to 2 years, discounting the fixed rates of each maturity at the simple accrual of ICP. (2) Quarterly average as of 7 December 2021, 23 March, 2022, and 1 June, 2022, respectively.
Source: Central Bank of Chile.

BOX I.1:

Rising of global inflation and monetary policy responses

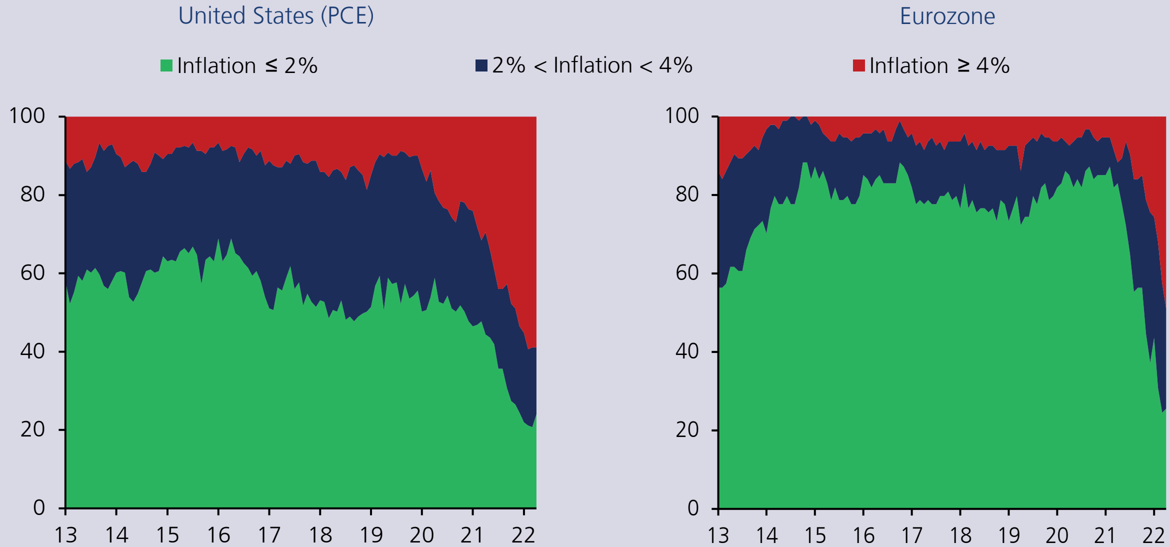
Inflation —actual and projected— have continued to rise globally, accumulating signs of persistence and exceeding estimates of central banks and analysts. The behavior of core measures suggests that price hikes have become increasingly widespread. The proportion of items whose price has risen above the target has reached record highs in the U.S. and the Eurozone (figure I.17). All this is taking place in circumstances where several economies are showing clear signs of labor market tightness and/or spending in services has continued to rise while spending in goods remains high. In addition, restrictions in China and the Russian invasion of Ukraine will keep food and energy prices high for a longer period, and at the same time will cause the bottlenecks present in some goods to persist.

Most central banks have begun to raise their monetary policy rates to curb inflationary rises; however, the speed and intensity of the process varies considerably from one country to another (figure I.18). In several emerging economies, and especially in Latin America, the cycle started around mid-2021 and has advanced rapidly, allowing them to have real rates above or around their own estimates of neutral rates. In developed countries, the pace of rate hikes has been noticeably slower and not as intense. Central banks in commodity-exporting countries have tended to respond more quickly than the U.S. Federal Reserve or the European Central Bank, which has not yet begun to raise interest rates, but has signaled that it will soon do so. In these two economies, real short-term rates are still negative and significantly below neutral rate estimates, which translates into still-positive stimuli (figure I.18).

The fact that major world economies maintain monetary policy rates at highly expansionary levels incubates significant risks, both for themselves and around the world. The longer inflation remains high, the greater the likelihood that these countries will enter a harmful wage-price spiral and/or that inflation expectations will become unanchored and affect price formation, causing inflation to persist at high levels for even longer. To the extent that this becomes widespread, it would hinder inflationary convergence even in economies that began raising their rates earlier, such as Chile. In such a scenario, whose probability increases as high inflation levels persist, central banks would have to suddenly intensify their rate hikes, which could generate significant turbulence in global financial markets, and worsen financial conditions facing emerging economies considerably (box I.2).

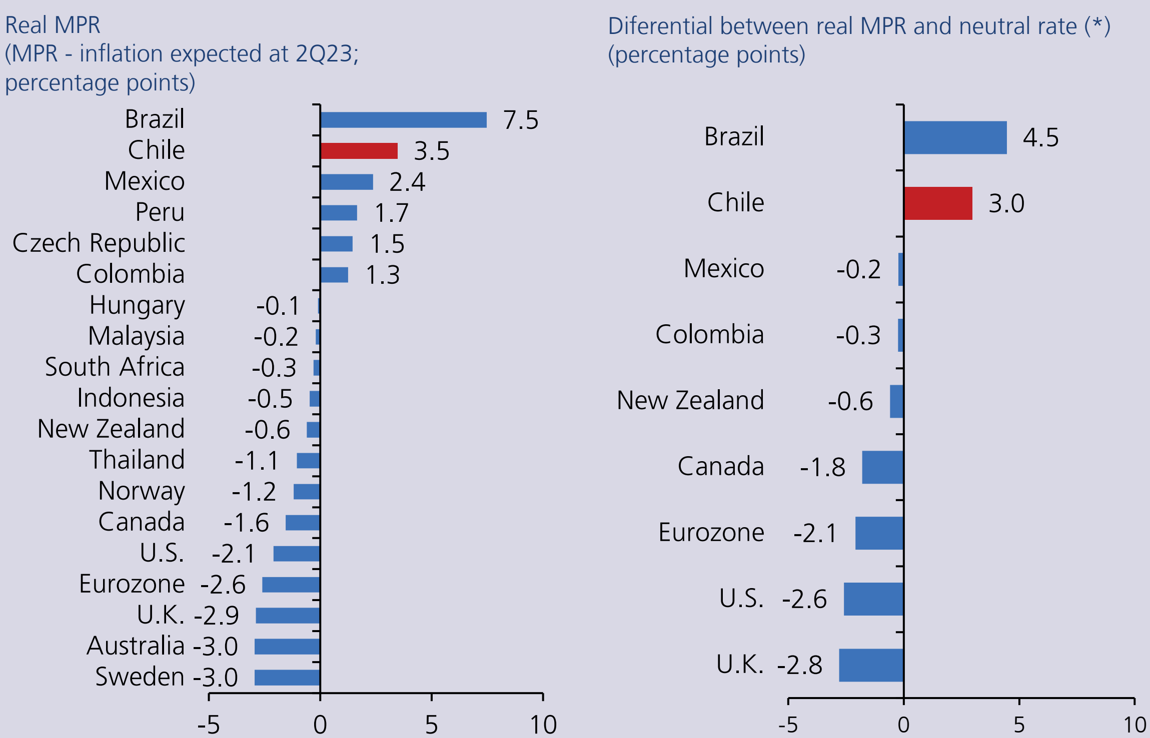
The central scenario of this Report assumes that the pace of the Fed's rate hikes will be somewhat faster and more intense than can be inferred from financial asset prices at the statistical cut-off of this Report. This more contractionary monetary policy, together with the recent significant fall in global financial asset prices, partly explains why the global growth prospects of the central scenario are below those of international organizations and/or the consensus of investment banks. Moreover, as in the last Reports, one of the sensitivity scenarios assumes new inflationary surprises at the global level and higher rate hikes by both the Fed and other central banks. In this scenario, the path of the MPR would run above that of the central scenario (chapter II). An alternative scenario is considered, in which inflationary pressures subside naturally, requiring more moderate monetary policy reactions in the leading economies. In other words, the framing is more similar to that implied by current market prices and global activity projections of the main counterparties.

FIGURE I.17 DISTRIBUTION OF CONSUMER BASKET ITEMS BY PRICE INCREASE
(percent)



Source: Bloomberg.

FIGURE I.18 REAL MPR AND DIFERENTIAL WITH THE NEUTRAL RATE



(*) Neutral rate estimates published by the central banks of respective countries.
Sources: central banks and Bloomberg.

BOX I.2:

Financial risks in the external scenario

High inflationary pressures have raised the outlook for global policy rates, constituting the main factor behind the deterioration in international financial conditions since the March Report. In particular, the Fed has begun the withdrawal of conventional and unconventional monetary stimulus, and the systematic inflationary surprises and the evolution of its fundamentals suggest that this could intensify going forward (box I.1). In the past, these events have caused significant capital outflows from emerging economies. Thus, the withdrawal of stimulus by the Fed, the uncertainty about the intensity with which this process will continue, and the potential consequences it would have on emerging economies, have considerably increased risk aversion, especially for emerging economy assets. Additional vulnerability factors include the still high level of some asset prices, particularly for housing; the high level of sovereign and corporate leverage; the increase in global uncertainty due to the conflict between Russia and Ukraine; and signs of weakness in the Chinese economy.

International stock markets have recently experienced sharp declines, and a deepening of these trends cannot be ruled out, especially in developed economies. There, although the level of stock prices already looks somewhat more consistent with the earnings outlook, they are expected to continue to fall as the global monetary policy tightening cycle intensifies, risk aversion continues to mount, and the growth outlook worsens. Following the onset of the pandemic, housing prices rose sharply in developed economies, driven by changes in preferences and the rapid growth of mortgage credit (figure I.19). However, recent increases in long-term interest rates and reduced global liquidity have been passed on to the cost of these loans, raising the probability of a reversal in property prices, which the European Central Bank highlighted as an important risk in its latest financial stability report. The deterioration in asset prices could also affect the global economy via a fall in consumption due to reduced households' wealth and disposable income[1]/.

The high levels of sovereign and corporate indebtedness also presage potential complications, especially in combination with higher interest rates and lower global liquidity. These factors have led to a significant increase in the cost of financing for governments and businesses in both developed and emerging economies. Although they are still not far from historical averages, the increase in debt after Covid-19 and the poorer growth outlook paint a weak picture that could trigger sustainability problems (figure I.20). In China, the situation also looks delicate, given the imbalances accumulated in recent years in the housing sector. Furthermore, several emerging economies show current-account deficits larger than their historical averages.

The current context raises the likelihood that financial conditions for Latin America and Chile will worsen further[2]/. The central scenario of this Report anticipates a faster pace of monetary normalization by the Fed than implicit in market prices, and also considers a sensitivity scenario where higher inflationary pressures could accelerate the process even more. In the past, these episodes have triggered significant capital outflows from the region, causing debt sustainability problems and economic recessions[3]/. In addition, several international mitigating factors for other episodes would be absent: the dollar has appreciated, long-term interest rates are on the rise, the business cycle is entering a phase of slower expansion, the outlook for China has worsened, and there are risks that the prices of some commodities, such as copper, may fall due to greater global weakness[4]/. In Chile, monetary and fiscal policy buffers have tightened given the current inflationary context, while the withdrawals from pension funds have reduced their capacity to mitigate a potential outflow of capital from non-residents[5]/.

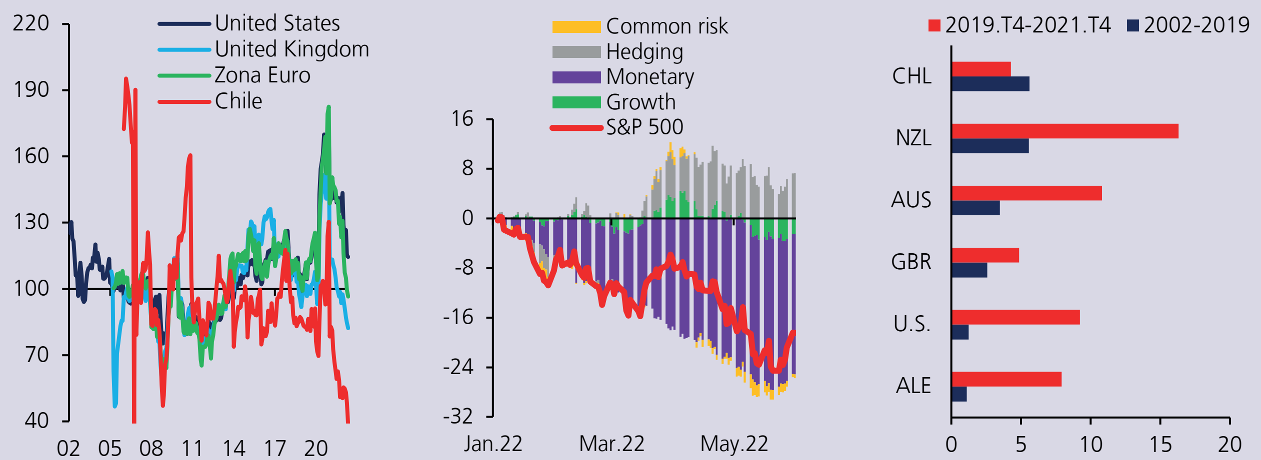
[1]/ Case, Quigley and Shiller (2013); Sousa (2009); Alfaro and Sagner (2021).
[2]/ This was recognized as one of the key elements shaping the external scenario in the recently published Financial Stability Report, first half 2022
[3]/ See Rey and Miranda Agrippino (2022); Miranda-Agrippino and Nenova (2022).
[4]/ Box I.1 in March 2017 Report.
[5]/ Financial Stability Report, first half 2022.

FIGURE I.19 PRICE TO EARNINGS RATIO, S&P DECOMPOSITION, AND HOUSING PRICES

a. Price/earnings ratio expected 12 months out
(2006-2019 average =100)

b. Decomposition of cumulative changes in S&P 500 (*)
(percentage points)

c. Average growth real housing prices
(percentage points)



(*) The model decomposes the common movements of the 2-, 5- and 10-year rates and the stock index, by identifying the different effects according to the coefficients' relative sizes and signs (Cieslak and Pang, 2019). The rates used are from the zero-coupon swaps.

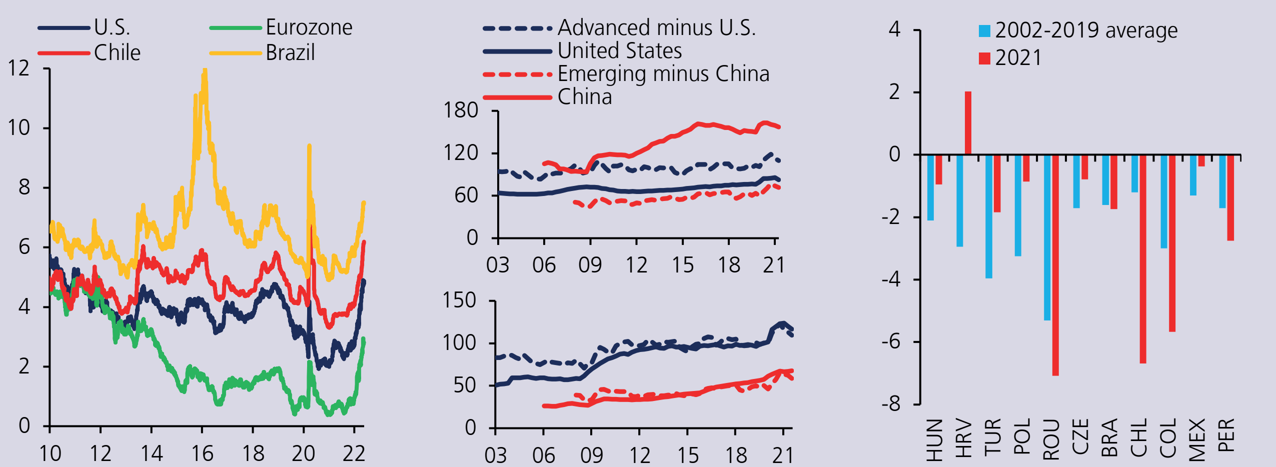
Sources: Central Bank of Chile, Bank for International Settlements, and Bloomberg.

FIGURE I.20 SOVEREIGN AND CORPORATE BOND RATES AND DEBT LEVELS

a. Corporate bond rates
(U.S. and Eurozone; BBB rating; Chile and Brazil; Cembi indexes; percentage points)

b. Non-financial corporate debt (upper panel) and sovereing debt (lower panel)
(percent of GDP)

c. Current account as percent of GDP (*)
(percentage points)



(*) The 2021 figure for Hungary, Croatia, Romania, Czech Republic and Brazil is obtained from the IMF estimate for that year.
Sources: Bank for International Settlements, Bloomberg, and International Monetary Fund.

BOX I.3:

Margins: recent trajectory and inflation outlook

Inflation has risen in Chile and the world in recent months. The causes and their importance vary among economies, including: high demand, in a context of costs affected by disruptions in production chains; increases in the cost of transportation and commodities; and a reduced labor supply. In this context, doubts have arisen as to whether higher inflation could also reflect an above-average pass-through of costs to prices, i.e., an increase in companies' sales margins that goes beyond the business cycle. This box uses firm-level microdata to test this hypothesis for the Chilean economy.

Sales margins are defined as the ratio of sales prices to marginal production costs and have an average value that depends on the demand faced by the company and its production structure. In the presence of nominal rigidities that slow down price adjustments, it is to be expected that in the presence of shocks that involve increases in production costs, margins will fall. If the increase in costs is due to higher demand pressures, then the fall in margins is related to increases in activity. On the other hand, if the increase in costs is due to shocks on the prices of inputs and production factors, the fall in margins is related to a fall in activity.

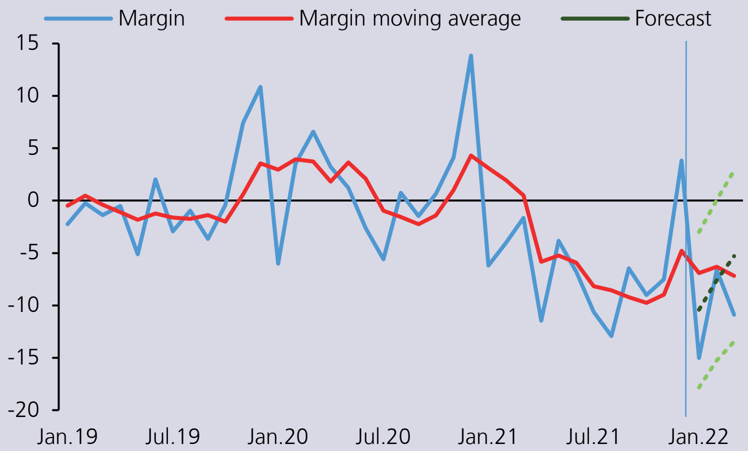
Bauducco *et al.* (2022) show that, in Chile, the narrowing of margins has been mostly associated with increases in activity and, most recently, they are below their historical average (figure I.21). It also shows a significant drop during 2021, associated with the strong increase in demand in a context of eased pandemic-related restrictions and household support policies.

If the determinants of average margins remain stable, margins will tend to go back to that value. Thus, margin compression is associated with increases in margins and future prices, both at the firm level and in the aggregate, over horizons of up to two years (Bauducco *et al.* (2022)). It is to be expected that, given the current low level of margins, their normalization will lead to inflationary pressures in the future. These adjustments are broadly consistent with those implicit in the inflation forecasts in this Report, given the expected evolution of the economy (figure I.21)[1]/.

It is important to mention some nuances regarding this assumption. In the first place, the behavior of businesses is assumed to be in line with historical patterns. This, however, could occur in a more accelerated manner, for example due to the effect that higher inflation expectations may have on the frequency of adjustment of company prices, which could push up inflation in the short term. Second, margin estimates assume production structures being stable over time. However, the changes brought about by the pandemic in some sectors, such as trade, could alter the validity of this assumption. Third, margin decompression associated with lower demand could be at least partially delayed by margin reductions resulting from increases in production costs caused by global factors. Finally, it is important to clarify that the verification of lower margins in the current context is not indicative of lower profits on the part of businesses, as these also depend on other factors, such as sales volumes. In fact, as shown in the Financial Stability Report of the first half of 2022, during the past year the profits of the larger-scale companies showed very substantial increases.

[1]/ Figure I.21 shows that the effective aggregate margin is within the confidence interval of a projection based on an autoregressive vector with data up until the end of 2021 —which uses as macroeconomic explanatory variables the Imacec, the CPI, the nominal exchange rate, and the MPR— and is therefore in line with the recent evolution of the main macroeconomic variables.

FIGURE I.21 MARGINS (*)
(percent)



(*) Blue line shows weighted median of the differences with respect to the margin mean; red line shows moving 3-month average of this variable. Dotted line shows out-of-sample projections for 2022 for the margin, estimated with a VAR(12) that includes margin, Imacec, CPI, and nominal exchange rate, with all confidence intervals at 90% significance.
Source: Central Bank of Chile based on SII.

II. FUTURE EVOLUTION OF MONETARY POLICY

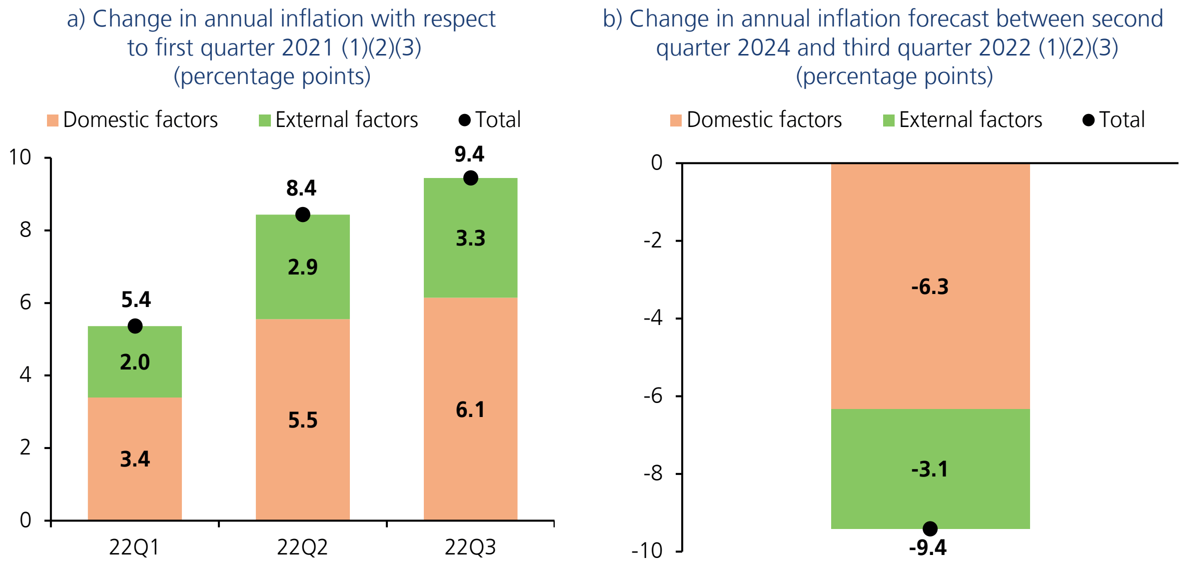
Domestic inflation has continued to rise in recent months and has accumulated a significant surprise with respect to forecasts in the last Report. The differences since then are largely related to external cost factors, which are recognized as more persistent. This has affected mainly the prices of foods and other volatile items. Beyond this, the excessive increase in the domestic spending in 2021 continues to have a strong bearing on today's high inflation levels. In the central scenario, headline inflation is expected to be somewhat below 13% annually in the third quarter and then begin to decline and converge to 3% over the two-year policy horizon. The risks associated with the level and persistence of inflation are very high. Actually, although core inflation —without volatiles— will be somewhat below the total measure, its speed of convergence to 3% will be slower and will only achieved it by mid-2024. Regarding activity, the economy has been gradually adjusting so far this year, although consumption remains high. Various demand fundamentals point to further weakening of both investment and consumption going forward. Nevertheless, the economy maintains significant imbalances in the activity gap and the current account balance. Monetary restrictiveness will continue to contribute to the normalization of domestic spending, a key element for easing inflationary pressures in the medium term. The change in the inflationary outlook has led the Board to make further increases in the monetary policy rate (MPR) at its May and June meetings, placing it at 9%, estimating that to ensure the convergence of inflation to 3% within the two-year horizon additional adjustments to the MPR will be needed, although smaller in magnitude.

MONETARY POLICY STRATEGY

Inflation has risen significantly in recent quarters and far exceeds forecasts in the last Report. The cumulative CPI variation between March and April was well above expectations, with the food component accounting for much of the surprise, linked to higher external prices of these products (chapter I, figure I.8). Core CPI, which rose 8.3% annually in April, was in line with March projections (excluding food prices).

Although the external determinants of inflation have been gaining importance, the increase accumulated in the last year continues to be strongly influenced by demand and cost domestic factors (figure II.1a). Local elements explain almost two-thirds of the increase in inflation between the first quarter of 2021 —when it reached 2,9% annually— and what is estimated for the third quarter of this year, when the annual inflation projection reaches its peak. This is mainly influenced by the boom in local spending during 2021, and to a lesser extent by the idiosyncratic depreciation of the Chilean peso. The economy began an adjustment path in the first quarter, although local demand continues to show a substantial divergence between the resilience of private consumption and the weakness of investment. The fundamentals of private spending suggest that consumption will weaken in the coming months, in a context where business and consumer expectations have deteriorated significantly in recent months.

FIGURE II.1 STRUCTURAL DECOMPOSITION OF THE CPI

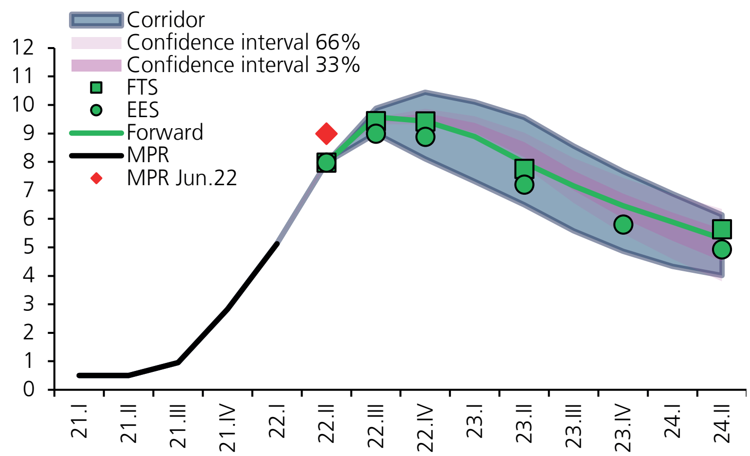


(1) Domestic factors: demand, cost pressures in goods and services, and inflationary persistence explained by second-round and indexation effects. Includes effect associated with idiosyncratic exchange rate depreciation. External factors: effect of higher oil price, imported food and other commodities, higher external inflation and less favorable external financial conditions. (2) Factor decomposition is based on the structural projection models of the Central Bank of Chile (XMAS-MSEP). (3) Data for the second and third quarters of 2022 and the second quarter of 2024 are forecasts. Sources: Central Bank of Chile and National Statistics Institute (INE).

Risks to the convergence of inflation are high, particularly because of its high level and greater persistence. The Survey of Price Determinants and Expectations (EDEP) reveals an increase in inflation expected two years ahead by companies, after several months of stability. The survey also shows that one-year-ahead expectations continued to rise. The latter is endorsed by the IMCE and, in the case of consumers, the IPEC, and coincides with what can be inferred from experts surveyed and the projections implicit in the prices of financial assets, which remain above 3% in the two-year term (figure I.15).

In this context, the Board has implemented a more contractionary monetary policy than it anticipated in March, by raising the MPR to 9%, estimating that to ensure the convergence of inflation to 3% within the two-year horizon additional adjustments to the MPR will be needed, although smaller in magnitude (figure II.2). The Board will remain attentive to the evolution of inflation and its determinants as risks remain high, particularly considering inflation's high level and increased persistence.

FIGURE II.2 MPR CORRIDOR (*)
(quarterly average, percent)



(*) The corridor is built by following the methodology described in boxes V.1 of March 2020 Report and V.3 of March 2022 Report. Includes May EES, FTS pre-policy-meeting of June and the average smoothed forward curve of quarter to 1 June. This is calculated by extracting the implicit MPR considering the forward curve on the interest rate swap curve up to 2 years, discounting the fixed rates at every maturity at the simple accrual of the ICP. For the current quarter the surveys and the forwards consider the average daily effective and are completed with the respective sources.
Source: Central Bank of Chile.

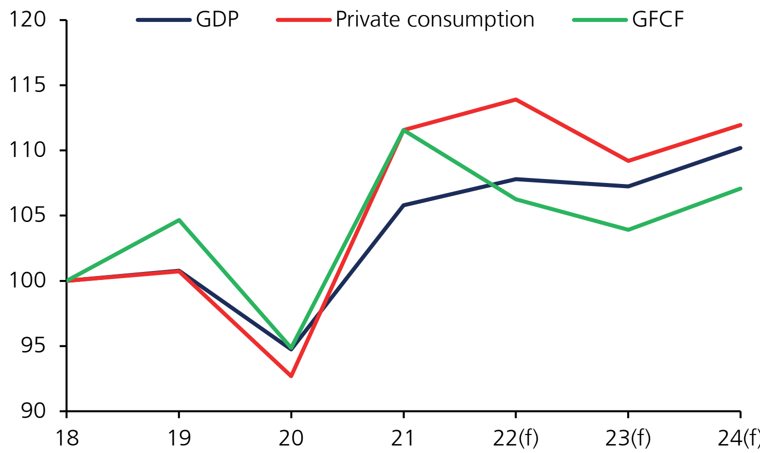
CENTRAL SCENARIO ACTIVITY AND DEMAND PROJECTIONS

Private consumption has remained more dynamic than expected, reaching in the first quarter levels similar to those of the previous quarter. Its resilience can be largely explained by a more intensive use of remaining liquidity from household support measures. The use of this resources has tended to be anticipated with respect to the assumptions made in previous Reports. Individual checking and sight account balances have declined by around 30% in real terms (UF) with respect to the peaks of mid-2021. By components, durable goods consumption showed the best performance in the first quarter, while services consumption was favored by a more consolidated reopening of the economy. This also boosted government consumption, mainly through the provision of educational services.

While the increased use of liquidity will help private consumption to remain strong in the immediate future, it will also lead to an earlier depletion of these resources (figure II.3). Partial second quarter data, such as electronically invoiced sales or the Imacec for trade and services, continue to reflect a solid performance. The central scenario assumes that people will spend their remaining income at a similar pace to that observed in the first months of the year, which will cause it to run out earlier. This provides a higher starting point for this component of spending in the second and third quarters, but also implies a larger drop in 2023. Thus, projections for private consumption expansion this year are raised to 2.1% (-0.3% in the last Report), and lowered to -4.1 next year (-1.1% in the March Report).

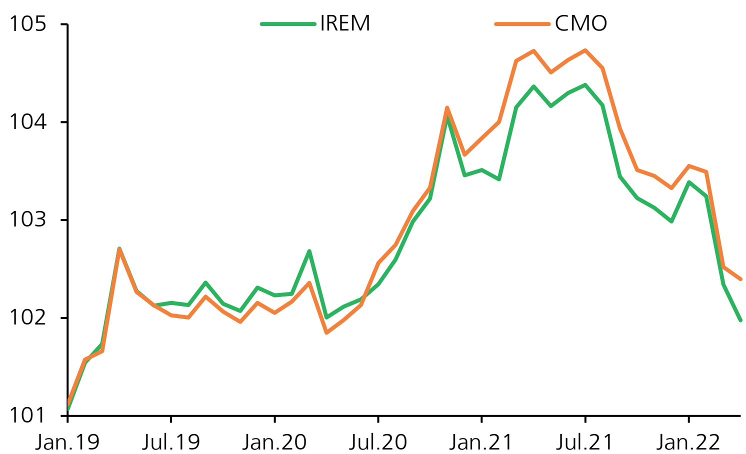
The outlook for consumption is also affected by the deterioration of its fundamentals. Consumer confidence (IPEC) has become even more negative (figure I.14) while lending conditions have tightened. Interest rates on consumer loans are near their highest in several years, consistent with the transmission of monetary policy changes. Add that real labor income has been decelerating, with wage indices showing negative annual variations (-2,2% real annually in April, CMO-IREM) (figure II.4), and job creation has been slowing down (chapter I).

FIGURE II.3 GDP, PRIVATE CONSUMPTION AND GROSS FIXED CAPITAL FORMATION (*)
(index, 2018=100)



(*) Projections consider the midpoint of the forecast ranges in this Report.
(f) Forecast.
Source: Central Bank of Chile.

FIGURE II.4 REAL WAGES
(index, 2018 average =100, seasonally-adjusted)

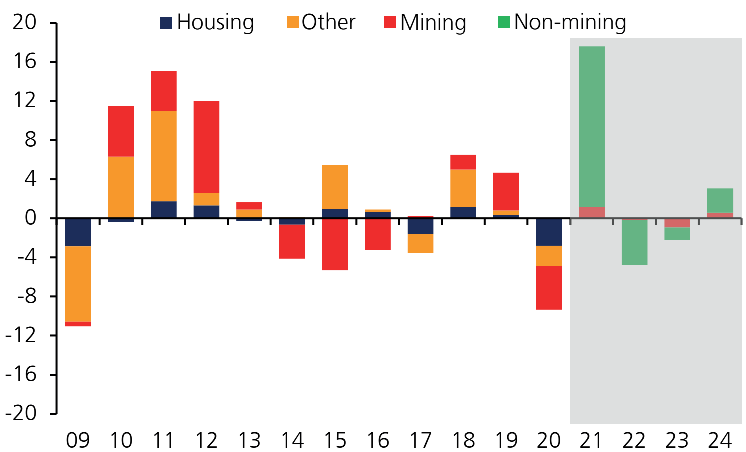


Sources: Central Bank of Chile and National Statistics Institute (INE).

Unlike consumption, gross fixed capital formation (GFCF) has been significantly debilitated, in line with the March forecast (figure II.3). The slower performance is especially observed in investment in construction and works. The slowdown in this component is evidenced by data such as housing sales (CChC) or surface area permits (INE), while the sectoral Imacec has been unable to recover its pre-pandemic levels of activity. Machinery and equipment also began to contract, beyond the positive surprise of the first quarter.

Going forward, investment is expected to deteriorate further, affected by the tightening of financial conditions, in a context where uncertainty has remained high for several quarters and business confidence has become more pessimistic (figure II.5). The deterioration that has already occurred in the capital market and the reduction in long-term savings have negatively influenced the conditions for financing investment. In fact, as pointed out in the Financial Stability Report and the Bank Lending Survey (BLS), lending standards have become increasingly stringent, because of both higher requirements and higher interest rates on longer-term loans, including mortgages. The further weakening of the peso in recent months will mainly affect the tradable component of investment, through higher capital goods prices. The real exchange rate (RER) is expected to be higher throughout the projection horizon than estimated in March, amid a less favorable external scenario. With this, GFCF is projected to fall by 4.8% and 2.2% in 2022 and 2023, respectively. For 2024, an increase of 3.0% is anticipated.

FIGURE II.5 REAL ANNUAL CONTRIBUTION TO GFCF (*)
(percentage points)



(*) The Other GFCF component is treated as a residue. Until 2020 effective data is used and for 2021 is an estimate. For 2022-2024, forecasting models from the Central Bank and sectoral sources are used, such as investment plans and the CBC Survey.
Source: Central Bank of Chile.

The projected decline in GFCF is consistent with information from various sources. The Capital Goods Corporation's first quarter survey lowered its investment forecast for the period 2022-2025 (-US$2.18 billion), while in the Business Perceptions Report for May, more than half of the companies reiterated some degree of uncertainty regarding the materialization of their investments. According to those interviewed, these doubts responded to a large extent to the high prevailing uncertainty, especially with respect to the political-legislative definitions in progress. Likewise, data from the last BLS point to a lower demand for commercial loans, in which lower needs for investment purposes are argued in view of the high uncertainty regarding the economic scenario. All this is in line with the permanence of the indicator of local political and economic uncertainty standing at a high level (DEPUC) (figure I.14).

In this context, the growth forecast for 2022 will be between 1.5% and 2.25% (1.0-2.0% in March). This considers a reduction in activity, which will gain strength as the year progresses (table II.1). In the first quarter, it contracted 0.8% with respect to the previous quarter (seasonally-adjusted series) and increased 7.2% compared to the same period last year. The central scenario projection anticipates negative annual variations from the second half of the year onwards, largely due to the effect of the high bases of comparison left by the spending boom of 2021.

The central scenario foresees annual variation of between -1.0 and 0.0% in 2023 (-0.25/0.75% in March) (table II.1). For 2024, GDP is still expected to expand by between 2.25% and 3.25%, which is in line with its potential growth.

TABLE II.1 ECONOMIC GROWTH AND CURRENT ACCOUNT

	2021	2022 (f)	2023 (f)	2024 (f)
		(annual change, percent)		
GDP	11.7	1.5-2.25	-1.0 / 0.0	2.25-3.25
National income	15.9	1.3	-0.5	3.3
Domestic demand	21.6	1.4	-3.4	2.5
Domestic demand (w/o inventory change)	18.0	1.0	-3.4	2.5
Gross fixed capital form	17.6	-4.8	-2.2	3.0
Total consumption	18.2	2.8	-3.7	2.4
Private consumption	20.3	2.1	-4.1	2.5
Goods and services exports	-1.5	1.3	5.7	3.0
Goods and services imports	31.3	0.0	-3.0	2.3
Current account (% of GDP)	-6.6	-6.6	-4.5	-4.0
Gross national saving (% of GDP)	18.8	18.4	20.0	20.1
Gross national investment (% of GDP)	25.3	25.0	24.5	24.1
GFCF (% of nominal GDP)	24.0	23.3	22.8	22.4
GFCF (% of real GDP)	24.3	22.7	22.3	22.4
		(US$ million)		
Current account	-20,307	-21,200	-15,500	-14,300
Trade balance	10,528	9,700	12,400	11,500
Exports	94,677	100,600	100,700	102,300
Imports	84,148	90,900	88,300	90,800
Services	-11,979	-14,100	-12,900	-12,300
Rent	-18,423	-17,100	-16,100	-14,600
Current transfers	-433	300	1,100	1,100

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

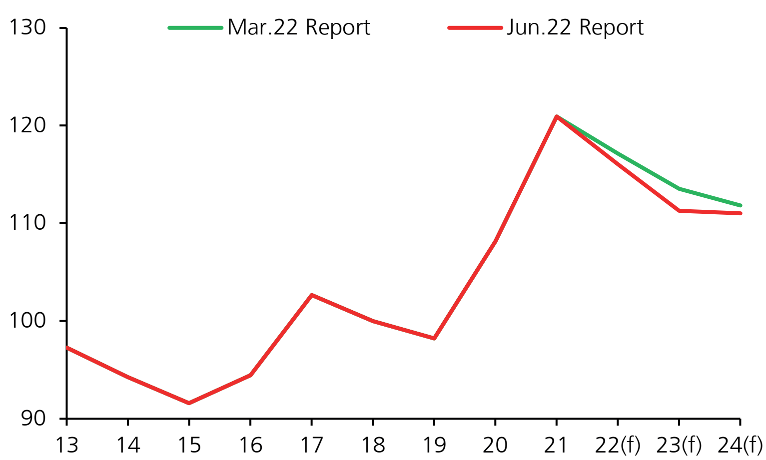
The central scenario continues to foresee a significant reduction in fiscal spending in 2022. This is part of a public finance normalization process aimed at ensuring the sustainability of gross debt in the medium term. According to the latest Public Finance Report (IFP), spending will be lowered by 25.2% in real terms this year, after hitting in 2021 its highest increase in recorded history (+33.4% real). Pending the ratification of the new administration's fiscal accountability decree anticipated in the IFP for the 2023-2024 period, a spending trajectory in line with the structural balance target set by the Ministry of Finance is considered.

The current account deficit will be larger than anticipated in March throughout the entire projection horizon. Nevertheless, it is still expected to narrow in the next two years, in line with the normalization of local spending. The estimate for 2022 is increased by 2 percentage points to 6.6% of GDP, which includes a more negative trade balance associated with the positive surprise of imports of machinery and equipment early in the year, the upward revision of consumption, the deterioration in the terms of trade and the expected slowdown in our trading partners' growth. The decrease in the deficit projected for 2023 and 2024 (4.5% and 4.0%, respectively) assumes an increase in national savings, aided by the adjustment of macroeconomic policies and the normalization of the autonomous dynamics of consumption, in a context of weak investment. Measured at trend prices[1]/, the deficit will be 6.7% in 2022, 4.1% in 2023, and 3.4% in 2024 (5.6%, 4.0%, and 3.5% in March, respectively).

The world economic outlook consolidates a scenario of lower momentum for the local economy. Figures reflect a more marked deterioration in external financial conditions, in a context in which central banks have intensified the withdrawal of their monetary stimulus policies in the face of higher and more persistent global inflation (figures I.4 y I.6). World markets have been incorporating expectations of further monetary tightening, especially from the U.S. Federal Reserve (Fed). Doubts about the speed with which the Fed will withdraw monetary stimulus have contributed to an increase in financial volatility and a decrease in global risk appetite, with widespread interest rate hikes and an appreciated dollar against other currencies (boxes I.1 y I.2). Sovereign spreads have risen, as have corporate spreads, amid high corporate indebtedness, especially in developed countries.

The terms of trade are revised downward in the projection horizon (figure II.6). This uses the assumption of a more protracted effect from the supply shocks that have affected oil and foodstuffs prices, associated mainly to the Russian invasion to Ukraine. The conflict-related effects on output and/or on the reorganization of the respective markets, in addition to other elements, have raised these prices (figure I.3) and will continue to affect their trajectory going forward, which in both cases exceeds the assumptions in the March Report, especially in the case of foods. These adjustments contribute to a higher outlook for the external inflation relevant to Chile (IPE) (table II.2).

FIGURE II.6 TERMS OF TRADE
(level, 2018=100)



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

[1]/ This measure adjusts the value of mining exports and fuel imports considering deviations of copper and oil prices from their long-term values. The same is done for rents and transfers associated with copper exports. Other exports and imports are valued using current prices. In addition, it does not correct for possible changes in the quantities exported or imported due to movements in copper and oil prices. The calculation considers long-term prices of US$3.3 per pound for copper and US$60 per barrel for oil (see Box V.2 in MP Report of September 2012, and Box V.3 in MP Report of June 2021).

TABLE II.2 INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

	Aveg. 10-19	2020	2021	2022 (f)	2023 (f)	2024 (f)
			(annual change, percent)			
Terms of trade	1.0	10.1	11.8	-4.0	-4.1	-0.2
External prices (in US$)	0.6	-1.1	9.3	6.7	3.9	2.7
			(levels)			
LME copper price (US$cent/pound)	306	280	423	425	370	345
WTI oil price (US$/barrel)	72	39	68	103	90	81
Brent oil price (US$/barrel)	80	42	70	106	94	85
Gasoline parity price (US$/m3) (*)	610	333	579	909	748	669
Federal Funds Rate (%)	0.7	0.5	0.3	1.6	3.5	3.3

(*) For definition, see Economic Glossary.
(f) Forecast.
Source: Central Bank of Chile.

The adjustment to the terms of trade is also influenced by the lower copper price, affected by weaker demand expected from China (table II.2). The reinstated sanitary restrictions and the deteriorating Chinese real-estate sector have dampened its performance and outlook. Even so, to date the copper price has remained high, above US$4 per pound, mostly supported by the current low level of inventories. In the 2022-2024 period, it is expected to reach US$3.8 (US$4.0 in March). The oil price continues to be expected to follow a downward path starting in the current quarter. It is projected to reach US$93 per barrel in the same period (WTI-Brent average), compared with US$85 projected in March.

Expected growth of our trading partners is reduced again: 2.8% on average in 2022-2023, compared to 3.3% anticipated in March. The two most important ones, i.e., the U.S. and China, account for most of the correction (table II.3). In the United States, the first-quarter GDP result confirmed the strength of final demand, beyond the negative surprise in the actual figure, which explains the adjustment for the whole year. This dynamism will continue in the short term, supported by a still robust labor market, while a slowdown in activity is expected for next year due to a more contractionary monetary policy and worsened financial conditions. China's expected slower expansion is mainly based on the impact of zero-Covid policies and the real-estate situation, which is already visible in the deterioration of various indicators, such as retail sales, housing sales, or the unemployment rate. In addition, there is limited room for economic policy action, especially monetary policy, as interest rates are already very low. For Latin America, the projections do not include major revisions and remain moderate. Meanwhile, the repercussions of Russia's invasion of Ukraine continue to affect the outlook for the Eurozone particularly hard, and it is lowered again despite the announced new fiscal packages in several of its member countries.

TABLE II.3 WORLD GROWTH (*)
(annual change, percent)

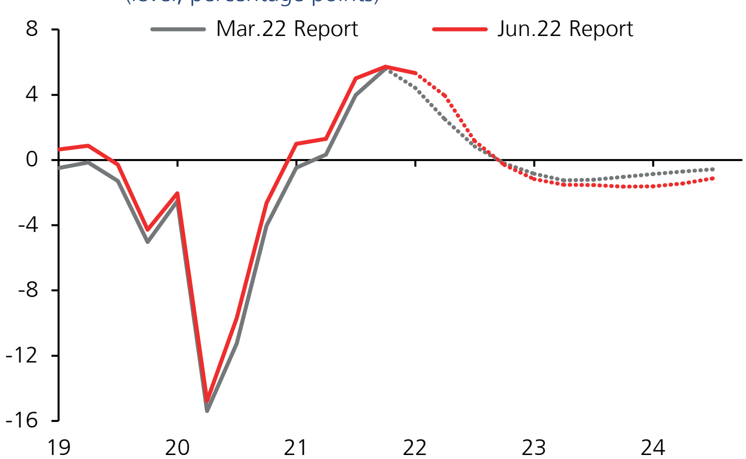
	Aveg. 10-19	2020	2021	2022 (f)	2023 (f)	2024 (f)
World GDP at PPP	3.7	-3.1	6.1	2.6	2.7	3.2
World GDP at market exchange rate	3.1	-3.3	5.9	2.6	2.4	2.7
Trading partners	3.9	-2.0	6.3	2.7	2.9	3.1
United States	2.3	-3.4	5.7	2.6	1.2	1.9
Eurozone	1.4	-6.5	5.4	1.9	1.9	1.7
Japan	1.2	-4.6	1.7	1.5	1.3	0.7
China	7.7	2.2	8.1	3.7	4.7	4.9
India	7.1	3.7	3.7	7.0	5.8	7.0
Rest de Asia	4.5	-2.3	4.1	3.2	3.5	3.7
Latin America (excl. Chile)	1.8	-7.5	6.1	1.7	1.5	1.9
Commodity exp.	2.2	-4.0	4.7	3.3	2.0	1.9

(*) For definition, see Glossary.
(f) Forecast.
Source: Central Bank of Chile based on a sample of investment banks, Consensus Forecasts, the IMF, and statistics bureaus of respective countries.

ACTIVITY GAP AND INFLATION'S CONVERGENCE TO THE TARGET

In the central scenario, the activity gap will continue to narrow in the coming quarters. In the medium term, it will become somewhat more negative than expected in the last Report, due to the expected further contraction of activity (figure II.7). The starting point of the gap is somewhat higher, due to the slight upward surprise of non-mining GDP in the first quarter. However, it is still expected to be below zero by the end of this year.

FIGURE II.7 ACTIVITY GAP (1) (2)
(level, percentage points)



(1) Dotted lines show forecast.
(2) Forecast assumes structural paramenters updated in June 2021 Report (trend GDP) with methodological review of potential GDP.
Source: Central Bank of Chile.

This projection assumes potential GDP growth[2] around 3% for the 2022–2024 average. The re-estimation of potential GDP infers a substantial increase in its level compared to 2021, when it grew by 1.3%. This is in line with the greater openness of the economy, after the fall in potential GDP in 2020 (-0.8%) as a result of the supply and mobility restrictions caused by the pandemic. From 2023 onwards, its rate of expansion will converge with trend GDP, which is more closely related to the economy's medium-term growth capacity and whose estimate is around 2.8% (box V.1 in June 2021 Report). This Report includes no revisions for the trend GDP or for the neutral monetary policy rate, the relevant structural parameters of the Chilean economy.

The inflation forecast is increased throughout the entire projection horizon, but especially in the short term. Most of the correction is related to external factors, associated with higher costs resulting from bottlenecks in international trade and, in particular, higher and more persistent increases in food prices. The upward adjustment of these products' world prices in the central scenario leads to revise the projections for both volatile and non-volatile items, whose positive surprise since the last Report is also assumed to be more persistent (figure I.8). Inflation of the energy component is also adjusted upwards due to changes in the central scenario for the external outlook, although its incidence in the correction of projected inflation is lower. Meanwhile, the renewed quarantines in China have intensified the global bottlenecks, which, due to their magnitude, will take several quarters to be resolved. This will generally keep the cost of imported goods and inputs high (figure I.2).

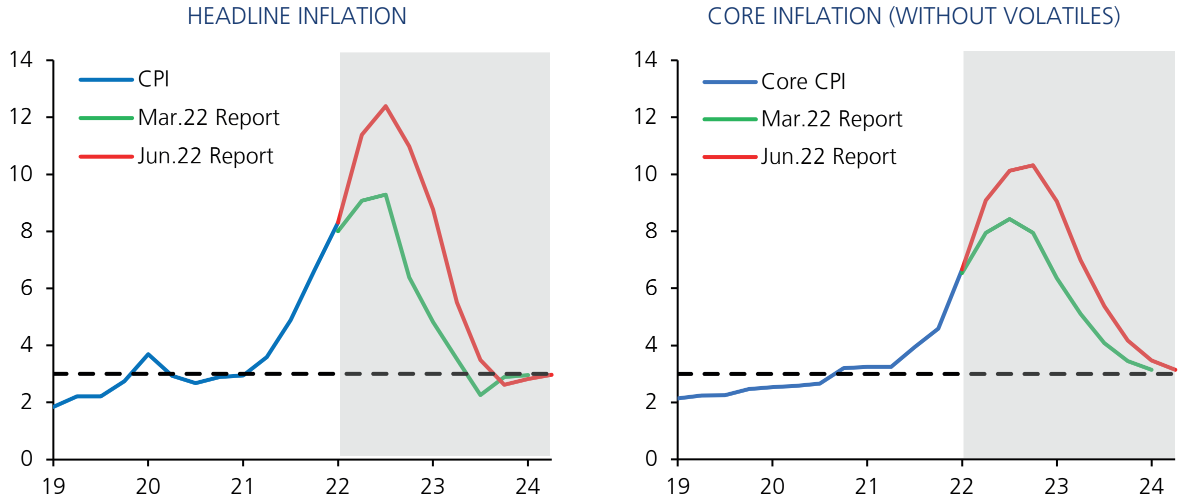
Some other elements behind the revision are the peso depreciation since the last Report and the higher incidence of second-round effects, given the higher inflation, both effective and estimated. The peso/dollar parity has shown significant fluctuations in recent weeks. Considering the average at the statistical cutoff of this Report and the previous one, its level is 4% more depreciated. The expected increase in inflation, given the higher effective records, will have an impact on inflation through the processes of price indexation of goods and services. This comes in the context of margins being compressed during 2021 (box I.3).

In the central scenario, total annual inflation will continue to rise, to stand somewhat below 13% annually during the third quarter of 2022. It will then begin to decline, influenced by the normalization of activity and demand from their current high levels and the moderation of external cost pressures (figure II.1b). It is projected to be close to 10% by the end of the year (5.6% in March). Convergence to the target continues to be expected within the two-year horizon (figure II.8 and table II.4). Two-thirds of the anticipated drop in inflation from its peak of the third quarter of this year to the end of the projection horizon is due to the reversal of domestic factors. This corresponds mainly to the expected adjustment of the local economy following the 2021 spending boom, which has been the major driver of inflation. The withdrawal of the large monetary and fiscal stimuli implemented in the previous two years will continue to contribute to this process. This will be compounded by a slow reduction in the global prices of fuels and foods. Likewise, the RER will gradually decrease, but remaining above its averages of the last 15 to 20 years. The decline in inflation in this scenario will also allow the second-round effects of inflation to subside.

Core inflation will begin to decline later this year, to end at 9.7% annually (7.2% in March). The risks regarding the persistence of inflation are observed in the slower pace of decline of core inflation. Although its peak will be lower than that of headline inflation, it will only converge to 3% by mid-2024.

[2] The concept of potential GDP refers to the level of GDP consistent with stable inflation and is therefore appropriate for measuring the activity gap associated with short-term inflationary pressures.

FIGURE II.8 INFLATION FORECAST (*)
(annual change, percent)



(*) Gray area, as from the second quarter of 2022, shows forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

TABLA II.4 INFLATION (1)
(annual change, percent)

	2021	2022 (f)	2023 (f)	2024 (f)
Average CPI	4.5	10.8	5.0	3.0
December CPI	7.2	9.9	2.7	3.0
CPI in around 2 years (2)				3.0
Average core CPI	3.8	9.1	6.4	3.1
December core CPI	5.2	9.7	3.8	3.0
Core CPI around 2 years (2)				3.1

(1) Core inflation is measured using the CPI without volatiles.
(2) Inflation forecast for the second quarter of 2024.
(f) Forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

SENSITIVITY AND RISK SCENARIO

As always, monetary policy conduct will be contingent on the effects of incoming information on the projected dynamics of inflation. Accordingly, the Board considers a range of sensitivity scenarios that may require a somewhat different monetary policy action, as derived from the MPR corridor (figure II.2).

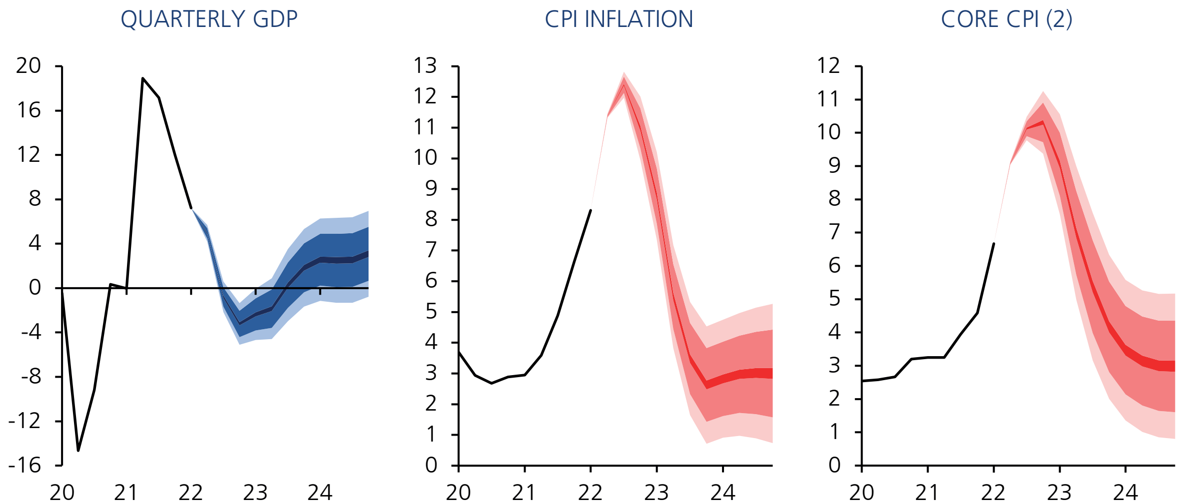
The upper part of the corridor is given by sensibility scenarios in which inflation could be more persistent than expected, leading to an MPR trajectory running above the central scenario. Beyond the deterioration of its fundamentals, it cannot be ruled out that private consumption will remain high for longer, due to the financing capacity provided by the remaining liquidity and household debt levels being lower than those at the beginning of the pandemic, or by other factors that favor an abrupt reactivation of credit. Another possibility is that external cost pressures will be exacerbated by the effects of Russia's invasion of Ukraine and quarantines in China, further boosting global inflation and intensifying the reaction of central banks, with negative effects on financial conditions for emerging economies. In both cases, inflationary pressures for the Chilean economy would increase.

Alternatively, the lower part of the corridor is defined by scenarios in which inflationary pressures ease sooner and a less contractionary monetary policy response is required than in the central scenario. On the one hand, the fall in activity and local demand may be sharper, due to the deterioration of expectations and high uncertainty. Thus, both consumption and investment could weaken more than expected, which would also have an adverse effect on employment. The fall in domestic spending would reduce inflationary pressures. There may also be a situation in which overall cost pressures decline sooner and, with them, inflation. The milder monetary tightening that would be needed in the different economies would also favor global growth and the performance of international financial markets.

In addition to the sensitivity exercises, scenarios are analyzed in which changes in the economy would be more significant and where the monetary policy reaction would exceed the limits of the MPR corridor (figure II.9).

Again on this occasion, the Board draws attention to the risks related to the external scenario. One possible scenario is that the impacts of Russia's invasion of Ukraine on the world economy will be more severe. There may also be a more marked deterioration in global financing conditions, among other factors, because the evolution of inflation triggers a more contractionary response than expected in the main economies, which in the medium term could also lead to a strong global recession. Any of these situations would pose important challenges for the conduct of local monetary policy, in a context in where domestic activity is expected to continue adjusting in the coming months.

FIGURE II.9 GROWTH AND INFLATION FORECASTS (1)
(annual change, percent)



(1) The figure shows confidence interval of central projection at the respective horizon (colored area). Confidence intervals of 10%, 70%, and 90% around the baseline scenario are included. Confidence intervals are built using the RMSE of XMAS-MEP models' 2009-2017 average. (2) Measured with the CPI without volatiles.
Sources: Central Bank of Chile and National Statistics Institute (INE).

banco central Chile