banco central Chile

MONETARY POLICY REPORT

MARCH 2023

MUELLE PEATONAL FRUTILLAR
Región de Los Lagos

MONETARY POLICY REPORT

MARCH 2023

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)

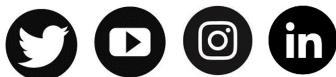
The Bank conducts its monetary policy seeking that, irrespective of the current level of inflation, its forecast for a two-year horizon will be 3%. This is similar to the practice of other countries in the world that have, as does Chile, a floating exchange rate; this is the so-called inflation targeting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

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*/ This Report incorporates the monetary policy decision of 4 April. For the central scenario construction purposes, the statistical cut-off date is 29 March. This document was originally written in Spanish. In case of discrepancy or difference in interpretation, the Spanish version prevails.

SUMMARY

Inflation remains at very high levels. Despite the decline in the annual variation of the CPI to 11.9% in February, it is still well above the 3% target. The core part of the CPI has been at around 11% annually for some time now, accumulating a significant surprise in recent months. Several factors explain why inflation is taking so long to come down. Most importantly, the economy has been unable to undo the impact of the overspending that accumulated in previous years. In fact, the revision of the national accounts showed that the level of consumption in previous years was higher than previously thought. Moreover, the pace of adjustment in recent years has been slower than expected. The improved performance in early 2023 leads to an upward revision of this year's GDP growth outlook. Nevertheless, the economy will further continue its adjustment process in the coming quarters, reflected in a lower forecast for 2024. Considering both years, cumulative growth is not far from our December forecast. Inflation will return to the 3% target in the latter part of 2024. The global economic outlook has become more difficult in recent weeks. The Chilean economy will be affected by weaker external demand and tighter global financial conditions. Overall, the current scenario is associated with a higher-than-usual degree of uncertainty. On the one hand, there is the risk of a more abrupt deterioration of the external scenario, with greater implications for Chile. On the other, the slow decline in domestic consumption could result in a more complex inflationary dynamic. The Monetary Policy Rate (MPR) has remained at 11.25% since October 2022. The Board considers that it will be necessary to keep the MPR at that level until macroeconomic conditions indicate that the process of inflation convergence to the 3% target has been consolidated. As described in the central scenario of this Report, this process will take longer than expected in December. The Board reaffirms its commitment to act with flexibility in case any of the internal or external risks materializes and macroeconomic conditions so require.

Annual inflation is still very high. In February, the CPI posted an annual increase of 11.9% which, while lower than its peaks of the third quarter of 2022, is still well above the inflation target. February's monthly variation was negative (-0.1%) for the first time in several quarters. However, it responded mainly to a fall in volatile prices. In fact, the core component of the CPI rose significantly in said month (+0.7%).

Even though most inflation fundamentals have been easing, the annual change in core inflation has remained around 11% for several months. On the one hand, the peso has appreciated around 11.5% with respect to the statistical cut-off of the previous Report. On the other hand, global cost pressures have eased. Commodity prices, including oil, have fallen, supply chains have normalized, and transportation costs have declined, all in a context marked by a clearly contractionary monetary policy stance.

In addition, compared with projections in the last Report, core CPI has accumulated a considerable upward surprise, of nearly one percentage point. Most of the difference is concentrated in the prices of non-volatile goods. In any case, services inflation has also exceeded projections, with escalating annual variation rates.

One relevant factor behind the persistently high inflation has been the slow reversal of the excessive private consumption levels of the past few years. The revision to the National Accounts yielded that between 2020 and 2022, household consumption was close to US$4.3 billion higher than previously estimated. With this, national savings figures were revised downward and the current account deficit increased, pointing to larger macroeconomic imbalances (Box I.2). Meanwhile, data for the end of 2022 and the turn of 2023 show that the pace of the reduction in private consumption has been slower than expected.

The slow decrease in consumption is consistent with a recent rebound in employment and lower political and economic uncertainty. In de-seasonalized terms, employment has picked up in recent months, especially in salaried jobs, which has contributed to a slight rebound in the wage bill. Local uncertainty indicators have declined importantly, up to levels comparable to those observed prior to October 2019. The smaller consumption adjustment also coincides with increases in rolling consumer credit flows, i.e., credit lines and credit cards.

Contrasting with consumption, investment has been performing weakly for several quarters. The revision of the National Accounts also shows that, seasonally adjusted, the level of gross fixed capital formation has been stagnant since mid-2021 (Box I.2). This is consistent with a scenario in which: the cost of credit increased; entrepreneurial expectations deteriorated; and local political-economic uncertainty was high. Some of these factors have lost significance in recent months.

In the last quarter of 2022, the current-account deficit saw a significant decline, and partial first-quarter 2023 data point to a continuation of this trend. Considering end-of-2022 data, the deficit accumulated over the last four quarters declined to 9% of GDP (10% in the third quarter). This result was significantly influenced by the positive trade balance, due to both higher exports and lower imports. In the services balance, the reduction in transportation costs and the transitory rise in imports of services stood out (Box I.2).

Internationally, up to early March, a scenario was being configured of stronger growth and inflationary concerns. On the one hand, the increase in global growth expected for this year was based on upward surprises in activity of several important economies, including the United States, China and the Eurozone. On the other hand, developed economies reported high core inflation indicators, despite the fall in headline inflation. All this raised concerns about inflation and the need for interest rate hikes by the main central banks. In this environment, commodity prices rose and risk aversion decreased. In general, interest rates rose as a result of the higher inflation outlook.

The tone of the external scenario changed significantly in the last month. The problems of several banks in the U.S. and Europe generated a scenario of greater global uncertainty. This has spurred volatility in financial markets, which has reduced risk appetite and led to a decrease in government bond yields, anticipating a slower pace of rate hikes by the main central banks. It has also led to declines in stock markets and reductions in the prices of some commodities.

There is significant uncertainty regarding the evolution of financial situation. Policymakers in involved countries adopted measures to contain the impact of these episodes. Worth noting are the coordinated actions among central banks to safeguard the provision of liquidity to the markets. Private banks have also made efforts, especially in the U.S. However, market agents remain worried and volatility remains high.

The Chilean banking system is subject to adequate regulation and supervision standards that prevent the occurrence of situations like those that triggered the current episode of uncertainty in international banks. The dominant banking business model in Chile is traditional in nature. It is focused on granting credit on a more diversified basis of financing and proper management of maturity mismatches. The regulatory framework has been updated and considers Basel III capital and liquidity standards for all banks. All of them are subject to exhaustive annual risk management, capital adequacy, liquidity and transparency supervision processes. Furthermore, both the Central Bank and the FMC permanently monitor the banks' capacity to withstand adverse events through stress tests.

Still, changes in the external scenario will have effects on our economy. As foreseen in this Report's central scenario, projected growth for the U.S. and Europe will be negatively affected by slower credit expansion and increased global uncertainty. This effect will be mostly visible in the second half of 2023 and early 2024. For these years, growth in developed economies that are Chilean trading partners is expected to average 0.4% (0.7% in December). Emerging economies will face tighter financial conditions, which will also affect external demands relevant to Chile (Box I.1).

The Chilean financial market has followed the trends of global markets. Particularly, the Chilean bond market showed significant falls in sovereign bond rates, while allowing the placement of bank and corporate debt. Although these developments are positive, it is important to note that the depth of the Chilean capital market has been significantly reduced in recent years. For the same reason, a relevant factor for the resilience of the Chilean economy is that this market is not affected again.

Projections

The central scenario projects that headline inflation will decline further over the coming quarters and will converge to the 3% target towards the end of 2024. Inflation will end 2023 at 4.6% annually, up from the forecast in the last Report. This correction stems from the higher levels of inflation of recent months —particularly its core component—, the slower adjustment of consumption and the activity gap closing later than expected. In this scenario, core inflation exceeds the previous estimate and will reach annual variations in the order of 3% only towards the end of the projection horizon.

For 2023 and 2024, our projection assumes that, on average, the real exchange rate will be lower than estimated in December. This is largely due to the nominal appreciation of the peso since last December. Going forward, it factors in the impact on the dollar of a scenario of tighter global financial conditions. In any case, the pass-through of the lower exchange rate to inflation is expected to be relatively slow. This is a phenomenon that usually occurs in episodes of currency appreciation, even more so considering that corporate margins have not recovered all the fall that it is estimated they had in previous years (Boxes I.3 and I.4). For the period 2023-2025, the projection considers oil prices to be 8% lower than those forecast in December, which reduces the variation of the volatile component of the CPI.

The convergence of inflation to the 3% target continues to consider that the economy needs to adjust from its high spending levels of 2021 and 2022. Non-mining GDP completed three quarters of contraction during 2022. In the central scenario, this trajectory will be temporarily interrupted in the first quarter of 2023 (Box I.2). Towards the second quarter of this year, the activity gap will narrow again and will be in negative territory during the second half of 2023 and all of 2024.

In the central scenario, activity will accumulate growth in the order of 1.5% between 2023 and 2024, close to the forecast in the last Report. For 2023, the growth range is corrected upward to -0.5% to +0.5% (between -1.75% and -0.75% in December). This responds mainly to the slower speed of consumption adjustment in late 2022 and upside surprises in early 2023. For 2024, the growth range is reduced by an equivalent magnitude, between 1% and 2% (2% to 3% in December). By 2025, the economy is projected to grow between 2% and 3%.

Private consumption is projected to make further adjustment going forward. Compared with December, this component of spending will see a more moderate fall in 2023 and a more moderate rise in 2024. This projection considers wider gaps in the labor market, consistent with the expected performance of the economy. It also foresees greater uncertainty associated with external conditions and a local monetary policy that will remain contractionary for a longer period of time. Access to credit will imply higher restrictions to consumption than in previous quarters, in line with a financial burden and household delinquency that has increased rapidly in recent quarters, especially among lower-income households. This will occur in a context of tighter international financial conditions. Information from the March 2023 Bank Lending Survey reports a perception of lower demand for consumer credit and more stringent conditions in its supply.

Investment will continue to perform poorly this year and next. This estimate includes a more deteriorated external scenario, greater global uncertainty and still tight financial conditions. Information from surveys —prior to the recent international developments— showed low investment levels for the coming quarters.

The current account deficit will continue to narrow, reaching a figure of around 4% of GDP by the end of this year. The continuation of the rebalancing between savings and investment will be a determining factor in this result. Deficits of similar magnitude are expected for 2024 and 2025.

The Board considers that it will be necessary to keep the MPR at 11.25% until macroeconomic conditions indicate that the process of inflation convergence to the 3% target has been consolidated. As described in the central scenario of this Report, this process will take longer than expected in December. For inflationary convergence to consolidate, among other factors, the resolution of the imbalances that have affected the economy in recent years should be considered, including a significant slowdown in consumption, the activity gap gradually turning negative and core inflation showing a clear downward trend.

The borders of the MPR corridor reflect sensitivity scenarios where the speed of the inflationary convergence process gives way to earlier or later adjustments of the policy rate with respect to the assumption in the central scenario. Particularly relevant will be the occurrence and sign of new inflation surprises, the evolution of consumption and the unfolding of external conditions.

The upper bound of the corridor reflects scenarios where inflation stays high for a longer period, consumption maintains low pace of adjustment and the external economy performs more favorably than expected. In such case, the MPR would remain at its current level for longer than assumed in the central scenario.

The lower bound of the corridor represents a scenario where the international context deteriorates more than expected, causing increased global risk and affecting financial conditions, world activity and commodity prices more intensely. In such context, a faster adjustment of the domestic economy could lead to a somewhat earlier reduction in inflation and of the MPR.

The Chilean economy continues to be exposed to significant risks. On the one hand, the evolution of the external scenario requires constant monitoring. In a scenario of major disruption of global financial conditions, a significant deterioration of the global and local economy is to be expected, which would lead to a faster convergence of inflation and would be consistent with more abrupt reductions in the policy rate than those signaled by the lower bound of the MPR corridor.

On the other hand, the inflationary problem is still present. The inflation convergence process has yet to be consolidated. Inflation continues to be very high, with its core component showing no declines in recent months. The adjustment in private spending has been slower than expected. Some measures of inflation expectations remain above 3% in the two-year term. A scenario where private consumption resumes more significant growth rates would compromise the convergence of inflation to the target and would require a significant monetary policy reaction to ensure that it is achieved.

The Chilean economy is experiencing a complex moment. Inflation has remained high for a long period, overspending has not been fully corrected and the external scenario has become more uncertain. Reducing inflation is an unavoidable condition for the economy's performance to improve in a sustainable manner and to be able to cope as effectively as possible with the impact of external shocks. It is particularly important that all policies point in the same direction, which means avoiding any measures that push private spending beyond its possibilities. The Board considers that it will be necessary to keep the MPR at 11.25% until the macroeconomic conditions indicate that the process of inflation convergence to the 3% target has been consolidated. Additionally, the Board reaffirms its commitment to act with flexibility in case any of the internal or external risks materializes and macroeconomic conditions so require.

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

	2022		2023 (f)		2024 (f)		2025 (f)
	MP Rep. Dec.22	MP Rep. Mar.23	MP Rep. Dec.22	MP Rep. Mar.23	MP Rep. Dec.22	MP Rep. Mar.23	MP Rep. Mar.23
Average CPI	11.6	11.6	6.6	7.9	3.2	3.6	3.0
December CPI	12.3	12.8	3.6	4.6	3.0	3.0	3.0
CPI in around 2 years (2)					3.0		3.0
Average core CPI	9.3	9.3	7.5	9.3	3.8	4.3	3.0
December core CPI	10.4	10.7	5.3	6.9	3.0	3.1	3.0
Core CPI around 2 years (2)					3.0		3.0

(1) Core inflation is measured using the CPI without volatiles.
(2) For December 2022 MP Report corresponds to inflation forecast for the fourth quarter of 2024, for March 2023 MP Report to inflation forecast for the first quarter of 2025.
(f) Forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

TABLE 2 : INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

	2022		2023 (f)		2024 (f)		2025 (f)
	MP Rep. Dec.22	MP Rep. Mar.23	IPoM Dic.22	IPoM Mar.23	MP Rep. Dec.22	MP Rep. Dec.22	MP Rep. Mar.23
	(annual change, percent)						
Terms of trade	-6.5	-7,7	-1.1	2.3	0.4	-1.6	-2.1
Trading partners (e)	3.0	2,8	2.1	2.4	2.7	2.3	3.0
World GDP at PPP	3.2	3,3	1.9	2.1	2.8	2.2	3.1
Developed GDP at PPP (e)	2.5	2,7	-0.1	0.3	1.3	0.3	1.8
Emerging GDP at PPP (e)	3.7	3,7	3.1	3.2	3.7	3.3	3.9
	(levels)						
LME copper price (US$cent/pound)	400	400	355	385	345	365	350
Oil price, average WTI-Brent (US$/barrel)	98	97	81	73	76	70	67

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

TABLE 3 : INTERNAL SCENARIO

	2022		2023 (f)		2024 (f)		2025 (f)
	MP Rep. Dec.22	MP Rep. Mar.23	MP Rep. Dec.22	MP Rep. Mar.23	MP Rep. Dec.22	MP Rep. Mar.23	MP Rep. Mar.23
GDP	2.4	2.,4	-1.75/-0.75	-0.5/0.5	2.0-3.0	1.0-2.0	2.0-3.0
Domestic demand	2.5	2.3	-5.3	-4.0	1.7	1.1	2.1
Domestic demand (w/o inventory	3.2	3.0	-4.6	-3.0	1.9	0.7	1.9
Gross fixed capital form	2.9	2.8	-5.0	-2.9	-0.2	-0.7	2.3
Total consumption	3.3	3.1	-4.5	-3.0	2.5	1.1	1.8
Private consumption	2.7	2.9	-5.9	-3.8	2.5	0.9	1.9
Goods and services exports	0.9	1.4	6.0	4.5	3.2	3.7	2.2
Goods and services imports	1.1	0.9	-5.4	-6.5	0.9	2.5	0.5
Current account (% of GDP)	-8.7	-9.0	-4.9	-4.0	-4.1	-4.1	-4.0
Gross national saving (% of GDP)	17.7	16.4	20.2	18.7	19.8	18.9	19.2
Gross fixed capital formation (% of nominal GDP)	25.6	24.8	24.3	23.3	23.8	23.2	23.2

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

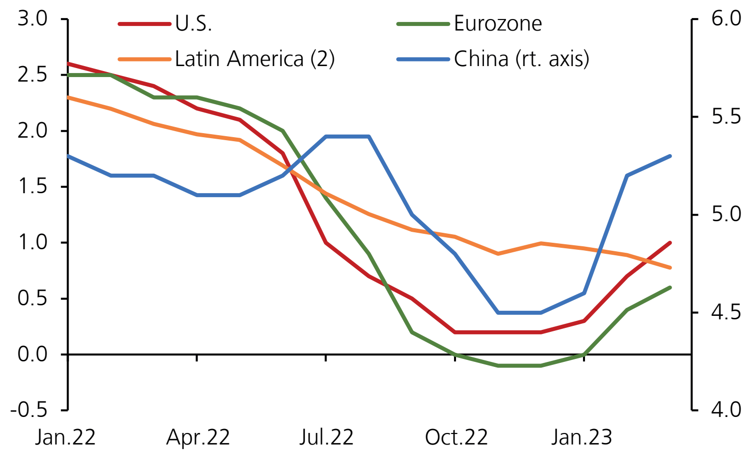
I. RECENT EVOLUTION OF THE MACROECONOMIC SCENARIO

Between the end of 2022 and the turn of 2023, several countries, including Chile, showed better-than-expected activity and high inflation. This scenario resulted, on the one hand, in an increase in global risk appetite and, on the other, in financial markets expecting a more contractionary monetary policy in these countries. In the Chilean case, this was reflected in expectations that the MPR would be unchanged for a longer period of time. The financial tensions associated with the U.S. and European banking sector that broke out in March have generated greater volatility in global financial markets. The local market has been affected by these events, although there have been improvements in some variables compared with the December Report, including a significant appreciation of the exchange rate and a reduction of local uncertainty indicators. Meanwhile, the macroeconomic scenario has shown no signs that the inflationary convergence process has been consolidated. Inflation remains high. Particularly relevant is that core inflation has not declined from its 2022 highs and accumulated a considerable surprise in recent months. This is occurring in a context where private consumption has declined somewhat but at a slower pace than expected before. Going forward, the economic imbalances of previous years are expected to be gradually resolved and, thus, inflation is expected to continue its convergence process towards the target.

THE INTERNATIONAL SCENARIO

Between December 2022 and the beginning of March 2023, global growth prospects for this year were favored by positive surprises in actual activity data in the main economies. The better outlook for China following the lifting of sanitary restrictions also stood out (figure I.1). In the latter, fourth-quarter GDP exceeded market expectations. Incoming data reflect a significant rebound in demand, particularly in the services sector. This is linked to the easing of the zero-Covid policy. Although this would boost Chinese growth in the short term, its impact on overall activity would be limited, considering that the main impulse would come especially from the non-tradable sector. Moreover, the medium-term outlook for the Chinese economy has not changed, in a scenario where risks associated with the vulnerabilities of the real-estate sector and the high levels of public and corporate debt there remain in place. In the U.S., recent months' indicators have also outpaced expectations. In last year's fourth quarter growth, the continued dynamism of consumption, especially in services, stood out, beyond the significant contribution of volatile components such as inventories. This, in a context where employment continues to grow strongly and the labor market remains at record-high levels. In the Eurozone, the effects of the energy crisis have been more contained than expected, so activity has not been so weak compared with previous estimates. Nevertheless, domestic demand fell during the last part of the year, explained by consumption and especially by investment, which posted declines in every component, while net exports contributed positively. In Latin America, the outlook has remained weak, amid tightening financial conditions and pockets of domestic uncertainty in several countries.

FIGURE I.1 GROWTH FORECASTS FOR 2023 (1)
(percent)

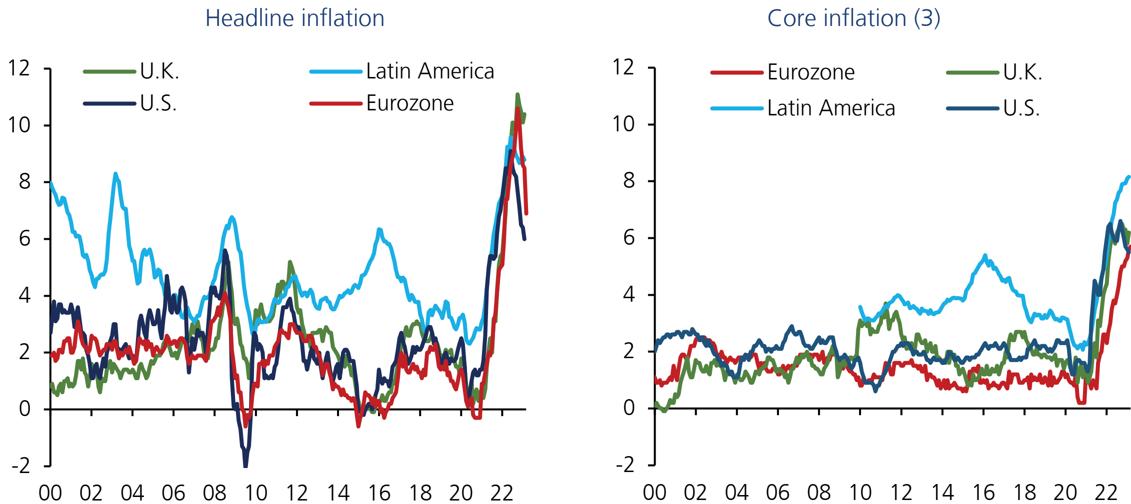


(1) March 2023 forecasts were made in different periods during March. For this reason, in some cases, they only contain partial information on recent financial developments. (2) Considers Brazil, Argentina, Peru, Colombia and Mexico. PPP-weighted growth, shares of each economy according to WEO (IMF).
Sources: Consensus Forecasts and IMF.

At the same time that the outlook for global activity was improving, fears resurfaced about the inflation which has remained high, especially in its core components (figure I.2). Since our last Report, headline inflation has dropped in several economies, mainly associated with the behavior of volatile prices, particularly energy. However, core measures remain high and driven, in large part, by the prices of services. In the U.S., the tight labor market, strong nominal wage growth and the savings balances that households have held since the pandemic have boosted consumption dynamism. Wage growth has also been one of the main drivers of high services inflation in the United Kingdom. Conditions have become more complex in the Eurozone, where price increases have spilled over across the board. Latin American news has been mixed in recent months. In Brazil and Mexico, overall inflation has gradually moderated, while rising in Peru and Colombia. However, most countries in the region share high core figures. In this scenario, the market outlook suggests that inflation will remain high throughout 2023 (figure I.3)

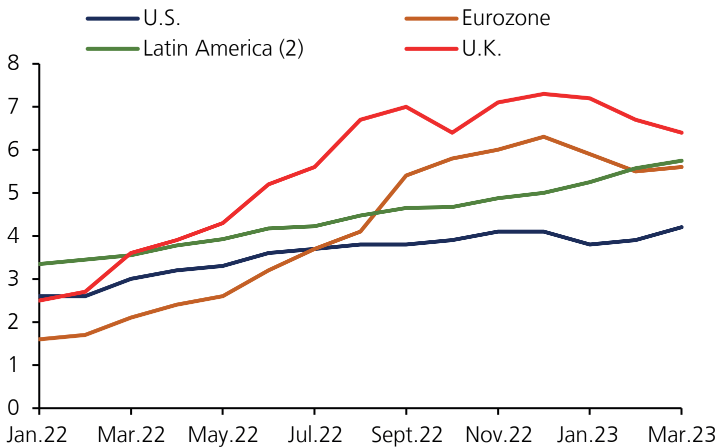
In this context of heightened inflationary concerns, the main central banks were aiming for a tighter monetary policy. Until early March, the Fed and the European Central Bank (ECB), together with the actual increase in their rates, were signaling successive increases going forward. This was reaffirmed by the statements of their authorities, who emphasized the need for a more contractionary monetary policy than previously considered, in order to guarantee inflationary convergence. In Latin America, the central banks of Mexico and Colombia had continued to raise their monetary policy rates. Peru's Central Bank halted its hiking cycle at its February meeting, although it did not rule out resuming it if necessary, as Brazil had done a few months before (figure I.4).

FIGURE I.2 WORLD INFLATION (1) (2)
(annual change, percent)



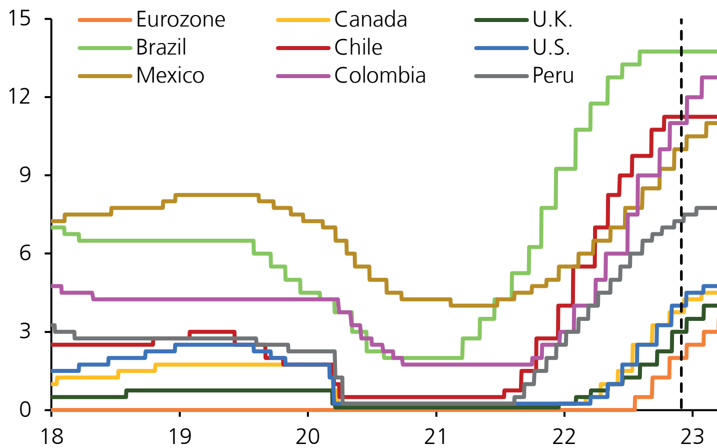
(1) For Latin America, simple average of annual inflation of Brazil, Mexico, Peru, and Colombia is considered. (2) For Eurozone, the March figure is preliminary. (3) Excludes foods and energy.
Source: Bloomberg.

FIGURE I.3 INFLATION FORECASTS FOR 2023 (1)
(average annual change, percent)



(1) March 2023 forecasts were made in different periods during March. For this reason, in some cases, they only contain partial information on recent financial developments. (2) Simple average of annual inflation expected at December 2023 in Brazil, Colombia, Mexico and Peru.
Source: Consensus Forecasts.

FIGURE I.4 MONETARY POLICY RATES (*)
(percentage points)



(*) Dashed vertical line indicates statistical closing of December 2022 Report (30 November).
Source: Bloomberg.

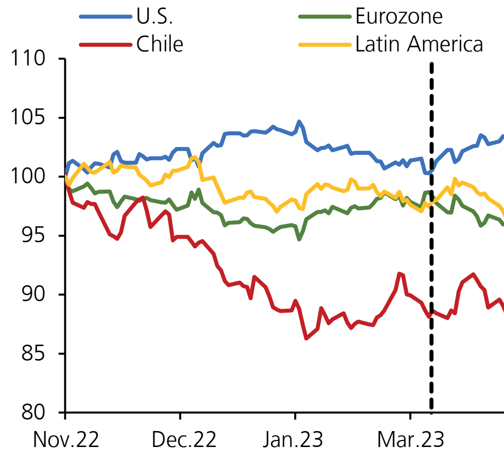
Despite the anticipated more contractionary stance of global monetary policy, the improved global growth outlook had contributed to a fall in risk perceptions (figure I.5). This provided support to a better performance of the stock markets and a depreciation of the dollar. At the same time, interest rates had incorporated the high inflation outlook and were rising across the board, although without having a major impact on the other financial assets.

However, the international scenario has seen a significant change in tone in the last month. The doubts about the financial health of international banks that were raised early in March have set the tone since then. The news about the bankruptcy of Silicon Valley Bank and other banking entities in the U.S., in addition to the fragile situation of some European banks, caused an increase in uncertainty and volatility in world financial markets (figure I.5). This also reduced global short-term and long-term interest rates significantly, reflecting expectations of lower monetary policy rates and an increase in risk aversion, respectively (box I.1). The economic authorities have adopted various measures to contain the impact of these developments, most of which consist of increasing liquidity facilities for the banking system.

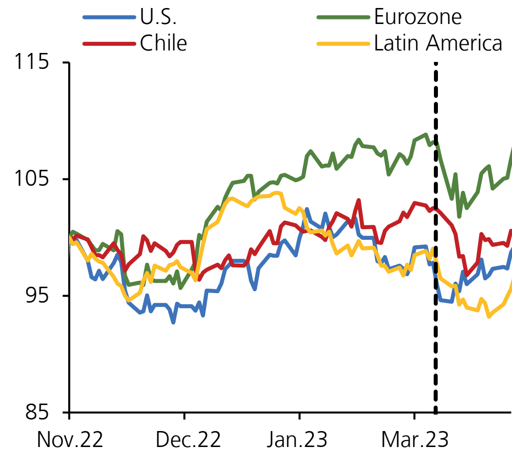
In this scenario, the leading central banks have become more cautious about the future path of their monetary policies. This has coincided with an adjustment of monetary policy rate expectations in several economies. In the U.S., the market expects a faster rate cut than that signaled by the Fed (figure I.6). At their latest meetings, the Fed and the ECB raised their benchmark rates by 25 and 50 basis points (bp), respectively. This was accompanied by a more cautious message regarding the future course of their actions. In the case of the Fed, although its Governor had said, prior to the failed bank episode, that the terminal rate was probably going to increase above what had been expected in December, the dots recently published by the FOMC did not reflect any significant change. The ECB, meanwhile, stopped signaling future rate hikes one meeting in advance, as it had done in previous months, and will assess the situation at each meeting. Nevertheless, the monetary authorities of these countries continue to emphasize that the inflationary problem is far from being solved. In this context, market expectations show significant mismatches with the Fed's forward guidance and it cannot be ruled out that these differences will continue, thus adding to the risk of abrupt corrections in financial conditions.

FIGURE I.5 FINANCIAL CONDITIONS

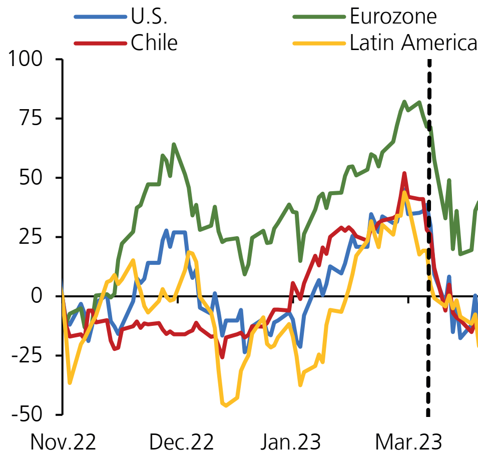
Currencies (1) (2) (3)
(index 30.Nov.22=100)



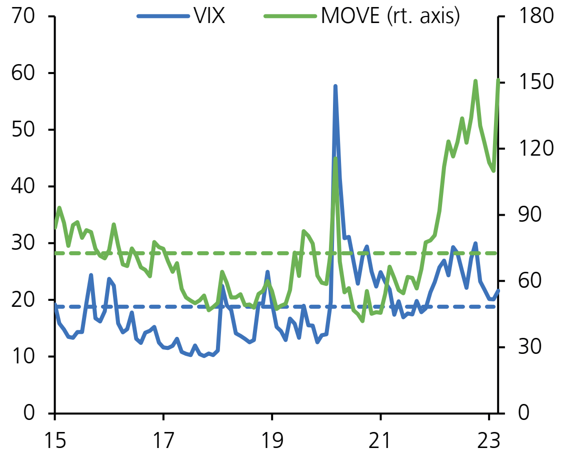
Stock markets (1) (2) (3)
(index 30.Nov.22=100)



Interest rates on nominal 10-year bonds (1) (2) (3)
(difference with respect to 30.Nov.22, basis points)



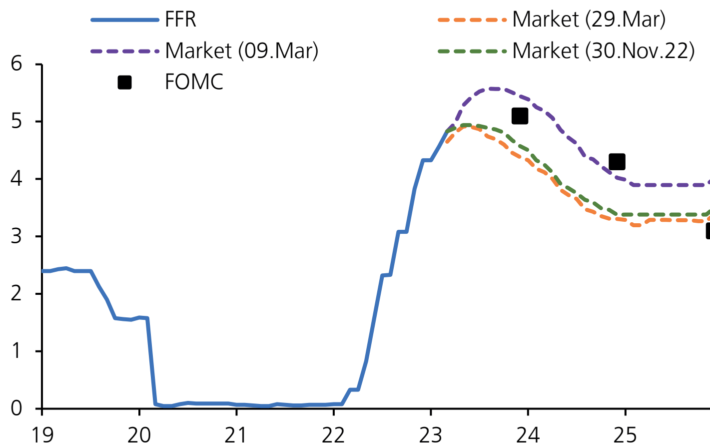
Financial volatility (4) (5)
(index)



(1) Considers movements from the statistical closing of the December 2022 Report (30 November). (2) For Latin America, simple average of Brazil, Mexico, Colombia and Peru. (3) Dashed vertical line indicates March 9th. (4) Dashed horizontal lines represent historical averages between 2015 and 2022 for each index. (5) The VIX index measures volatility implicit in options on the one-month U.S. S&P500. The MOVE index measures the volatility implicit in options on the U.S. Treasury bond with different durations at one month.

Sources: Central Bank of Chile and Bloomberg.

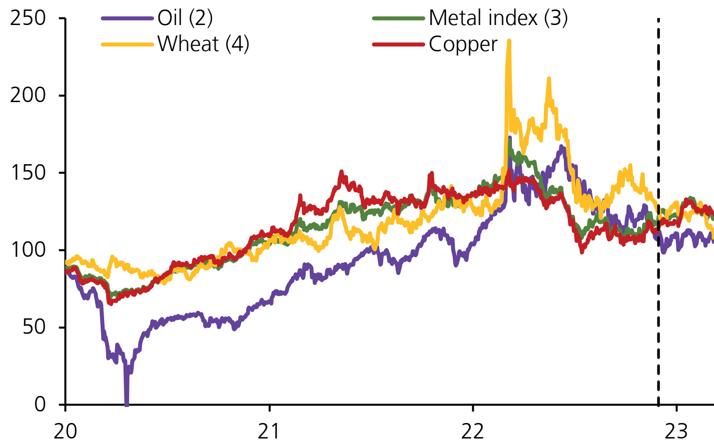
FIGURE I.6 FED FUNDS RATE (1) (2)
(percentage points)



(1) FOMC dots published in March 2023, market expectations correspond to futures at respective dates. (2) Dates correspond to statistical closing of December 2022 Report (30 November), previous to Silicon Valley Bank bankruptcy (9 March) and statistical closing of March Report (29 March).
Sources: Fed and Bloomberg.

The evolution of commodity prices has been mixed, reflecting heterogeneous behavior in the midst of global financial tensions and China's improved performance (figure I.7). Worth noting are the better copper prices, which entail a substantial correction for Chile's terms of trade. Metal prices, in general, have been favored by the reopening of the Chinese economy and its better prospects. Regarding copper, there are also concerns about the tight supply. Thus, at the close of this Report, copper was trading at US$4 per pound (+10% since the last Report). In contrast, the price of lithium posted further declines, explained in large part by lower demand for electric vehicles in China and improved supply prospects. Since the December Report, the price of a barrel of oil showed some volatility, which escalated following the financial tensions. At the close of this Report, its price dropped to around US$73 (-12% since December for the WTI-Brent average). Food prices have continued to decline, combining better supply expectations and lower global demand for certain products. In February, the FAO index continued its downward trend, falling to 19% below the March 2022 peak.

FIGURE I.7 COMMODITY PRICES (1)
(index, 2010-2023 average=100)



(1) Dashed vertical line indicates statistical closing of December 2022 Report (30 November). (2) WTI-Brent average. (3) S&P GSCI Industrial Metals. (4) One-month futures prices.
Source: Bloomberg.

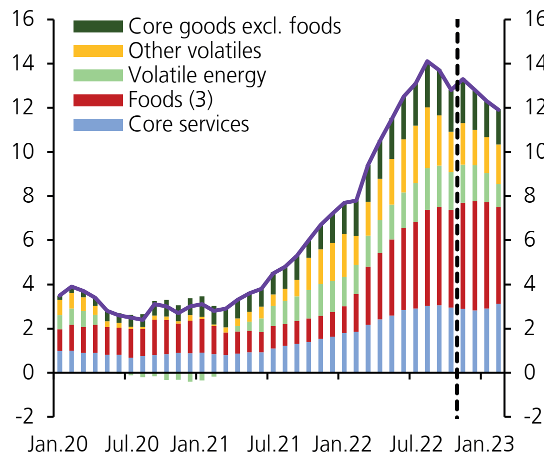
THE LOCAL SCENARIO

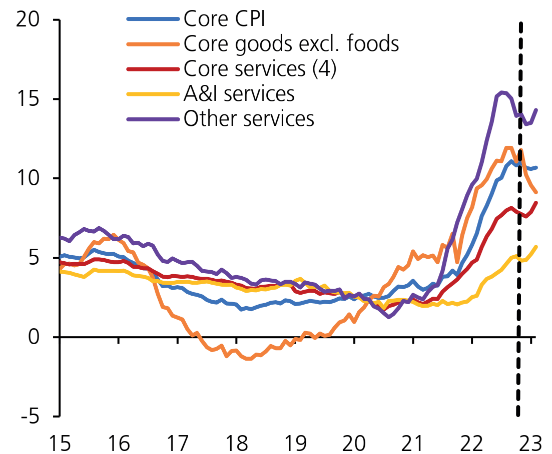
As in other economies, activity indicators show that demand has been slower to adjust and inflation has remained high. This had an impact on the local financial market, which has been showing hikes in the yield curve since mid-January, partly linked to expectations of greater activity and higher inflation in the short term, and of monetary policy remaining contractionary for a longer period of time. The exchange rate had shown a significant appreciation, even outperforming comparable economies, and reached around $790 during most of February. The IPSA accumulated gains of nearly 3% between the close of the December Report and early March (figure I.5).

After the external financial events of the last month, some of the previous trends have reversed (figure I.5). With respect to the beginning of March, long-term interest rates have shown a considerable decrease and at the close of this Report are somewhat below the close of the December one. The exchange rate fluctuated above $800 during March. Considering the average of the ten business days prior to the statistical close of this Report, the exchange rate appreciated 11.5% with respect to the December cutoff. The IPSA showed fluctuations and now stands where it did in December.

This has occurred while local inflation remains high, beyond a gradual decline in recent months. As of February, headline inflation fell to 11.9% annually, while core inflation —CPI without volatiles— was 10.7% (figure I.8). The decline in headline inflation was driven by the volatile prices of the basket. Among these, fuels stand out, which, in annual terms, have been decelerating for the past five months. This has occurred as lower international prices and exchange rate appreciation have been built into the stabilization mechanism (Mepco). The most volatile food items showed a retreat in the margin, although they are still high and exhibit a high incidence in annual inflation.

FIGURE I.8





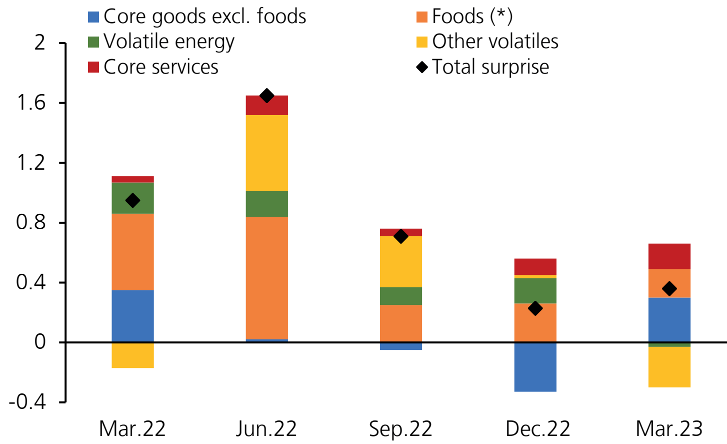
(1) Dashed vertical lines indicates statistical closing of December 2022 Report (30 November). (2) For more detail on the different groupings and their shares in the total CPI basket, see box IV.1 in December 2019 Report, Carlomagno and Sansone (2019) and Economic Glossary. (3) Considers sum of volatile and non-volatile foods. (4) Sum of Administered and Indexed services (A&I) and Other services.
Sources: Central Bank of Chile and National Statistics Institute.

In addition to remaining around its six-month highs, core inflation has accounted for most of the upward surprise since the December Report (figures I.8 and I.9). Between November and February, inflation accumulated 0.36 percentage points (pp) more than forecast in the previous Report. However, this difference was bigger in core prices, accumulating more than 1pp of surprise, whose incidence in the total CPI was almost 0.7pp. In these prices, the goods component accumulated the largest difference, especially the surprises in housing equipment and clothing and footwear. In services, upside surprises were contributed by both some indexed items and the rest of the services, whose prices have also rebounded in recent months. The less volatile food components also showed higher-than-expected increases. In turn, the group of other volatile items partially offset the decline, mainly due to the item of air fares.

The high core CPI is explained by various factors. Household spending has not adjusted as strongly as expected (box I.2). In addition, the unusual combination of supply and demand shocks that have affected the economy in recent years, whose effects on business margins and second-round mechanisms have also had an impact on inflationary dynamics (box I.3). In addition, in the short term, the pass-through of the peso appreciation to prices would be slower than usual (box I.4).

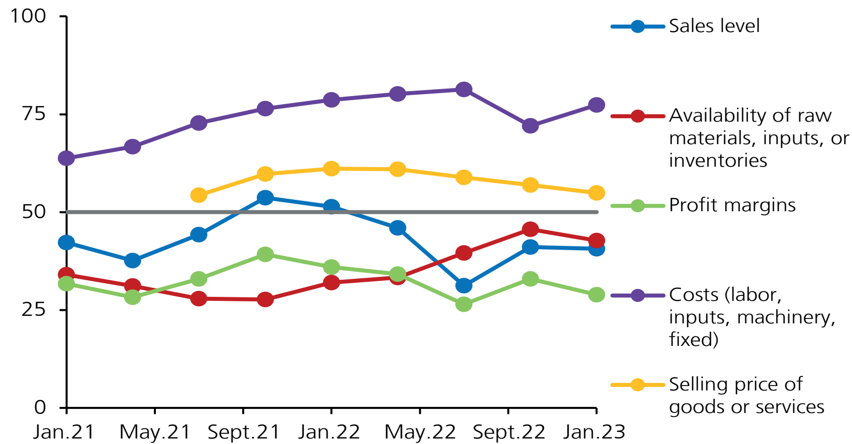
Qualitative information indicates a lagged pass-through from costs to inflation on the part of companies. In the February Business Perceptions Survey (EPN), companies indicated that at the end of 2022 their costs were still high and their margins remained depressed (figure I.10). This view is endorsed in the February Business Perceptions Report (IPN), where some respondents anticipated possible price increases or lower discounts as a way of passing on the costs accumulated over the past year.

FIGURE I.9 CUMULATIVE INFLATIONARY SURPRISES IN EACH MP REPORT
(percentage points)



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

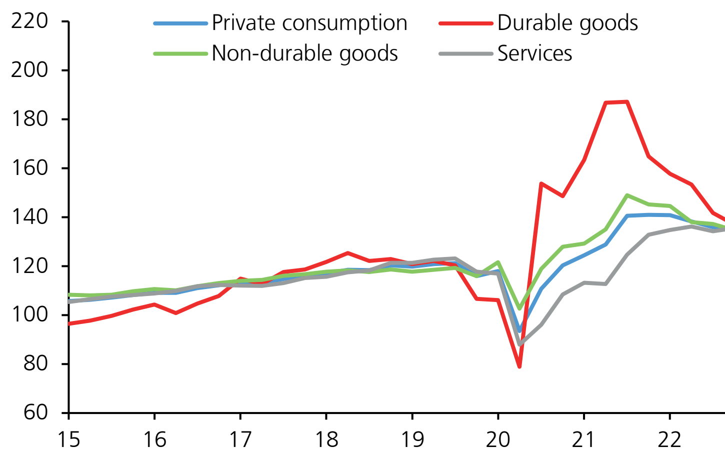
FIGURE I.10 EPN: EVOLUTION OF FIRMS' FACTORS IN THE LAST THREE MONTHS (*)
(diffusion index)



(*) Value above (below) 50 denotes higher proportion of "have increased" ("have decreased") responses. Responses weighted by firm size. The weighting by size incorporates the economic importance of firms in the index, giving greater weight to the responses of firms with a larger share of value added.
Source: Central Bank of Chile.

The adjustment process of the Chilean economy has been slower than anticipated, owing mainly to a more moderate reduction in private consumption. The revision to past National Accounts show this expenditure component on a higher trajectory. Thus, between 2020 and 2022, household consumption was close to US$4.3 billion higher than previously estimated (box I.2). In addition, its seasonally-adjusted series shows a slowdown in the speed of contraction in the latter, with a decline of 0.7% in the fourth quarter (-1.7% in the third). By components, the consumption of non-durable goods decreased 1.9% and that of durable goods decreased 3.3% during the fourth quarter, both seasonally adjusted. In contrast, consumption of services recorded an increase of 0.9% (-1.7% in the third quarter) (figure I.11).

FIGURE I.11 PRIVATE CONSUMPTION
(index, 2013 =100, seasonally-adjusted series)



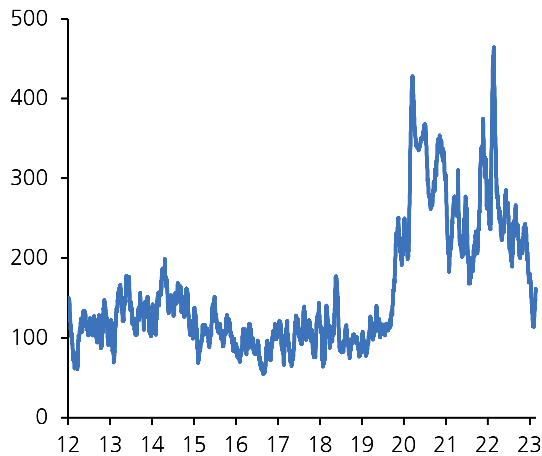
Source: Central Bank of Chile.

The smaller reduction in consumption can be associated with various fundamentals, including less local uncertainty and a better performing labor market (figure I.12). Different indicators point to a significant reduction in local uncertainty and an improvement in the economic outlook of different agents between the end of 2022 and the first months of 2023. On the one hand, the reduction of the exchange rate and long-term rates beyond the movements of their international peers is largely associated with the reduction of local uncertainty. In our labor market, INE data report that the real wage bill grew 0.4% between October and January, in seasonally adjusted terms. To some extent, this is explained by the increase in real incomes as measured by the Wage Index (IR) and the Labor Cost (CMO). It is also associated with the positive evolution of employment, with an increase of about 160 thousand jobs since October. It should be noted that this growth in employment has been concentrated in salaried workers (+217 thousand since October), which has more than offset a reduction in self-employment (-55 thousand in the same period).

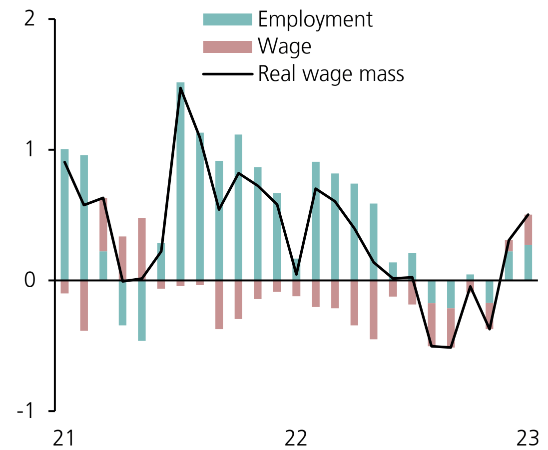
All in all, there are still indicators that point to a less dynamic labor market going forward (figure I.13). This is consistent with the decrease in companies' search for workers and the perception that it is not as difficult to find them, as reported in the February EPN. In addition, the employment expectations in the Monthly Business Confidence Index (IMCE) continue to be below its neutral level in all the sectors evaluated, although they do reflect a certain recovery recently. Added to this is the rise in the unemployment rate to 8.4% in March, due to the increase in the labor force, which is in line with the rebound in the labor supply observed in the data of the SENCE Labor Observatory.

FIGURE I.12

Daily index of economic uncertainty (DEPUC)
(index)

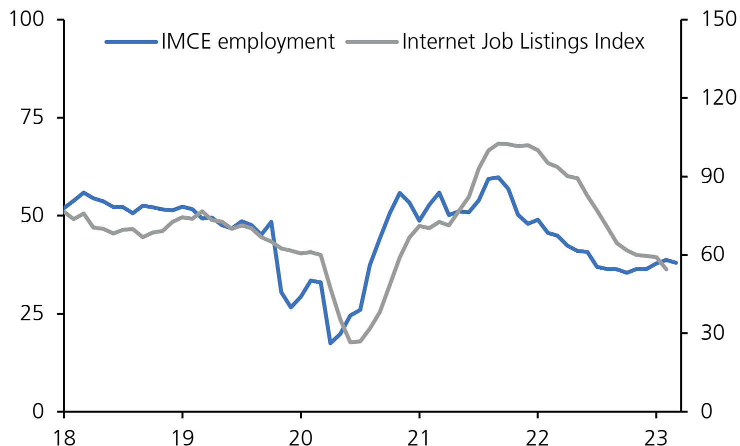


Real wage bill (*)
(percent, contribution to monthly variation, seasonally-adjusted)



(*) Estimated using seasonally-adjusted series of real labor costs, hours usually worked and employment.
Sources: Central Bank of Chile, Becerra and Sagner (2020), and National Statistics Institute.

FIGURE I.13 IMCE EMPLOYMENT AND INTERNET JOB LISTINGS INDEX (IALI)
(index; index Jan.15 = 100)



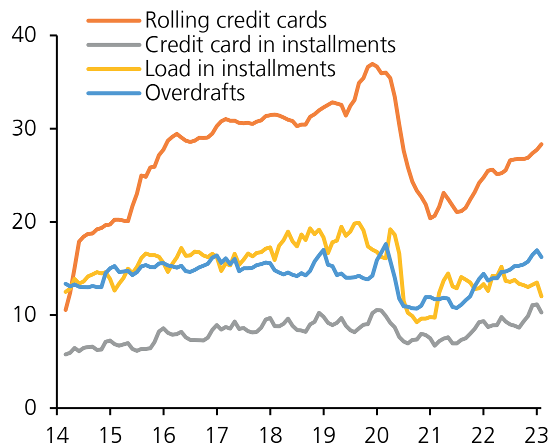
(*) Average employment indicators in wholesale and retail trade, industry, and construction. A low value (under) 50 points reflects expectations of decreases (increases) in the number of workers over the next three months.
Sources: Icare/UAI, INE and Central Bank of Chile.

The behavior of household consumption also coincides with a more intensive use of shorter-term credit financing sources and higher interest rates (figure I.14). Since the end of 2021, a greater proportion of private consumption has been sustained by the use of revolving credit, replacing installment loans. This is consistent with what is reflected in the cross-checking of data between the Financial Market Commission (CMF) and the Unemployment Fund Administrator (AFC), which shows that, on average, the terms of consumer loans have shortened. This, added to the general trend of interest rate increases, has caused a notorious growth in the financial burden of households, especially in the lowest income quintiles. According to data from the CMF and the Superintendency of Social Security (Suseso), the proportion of household income used in the

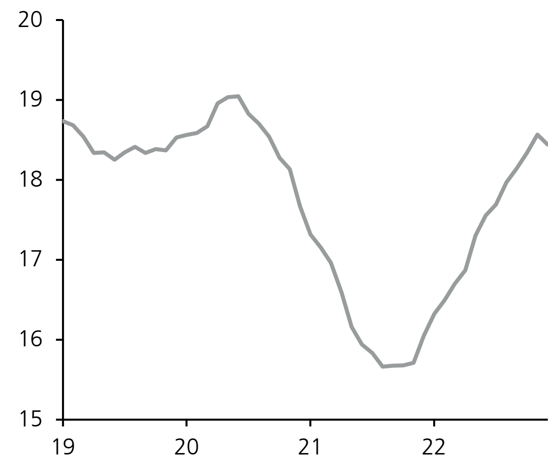
payment of bank obligations increased significantly between mid-2021 and the end of 2022, approaching its pre-pandemic levels. Non-performing loans, meanwhile, doubled during 2022, reaching 2.5% of the portfolio in February. In response, banks have considerably increased the provisions associated with this segment, with an expense that rose to 8.6% in February of this year. In any case, these developments are expected to have a limited impact on the assets of the banking sector, which is well provisioned.

FIGURE I.14

Real consumer credit flows
(millions of UFs, moving quarterly average)



Households' bank financial burden (*)
(percent of monthly income, moving annual average)



(*) Median debtor's bank financial burden. Monthly income includes labor component (salaried formal) and pension fund withdrawals prorated over six months as from receipt of payment. Sources: Central Bank of Chile, CMF and SUSESO.

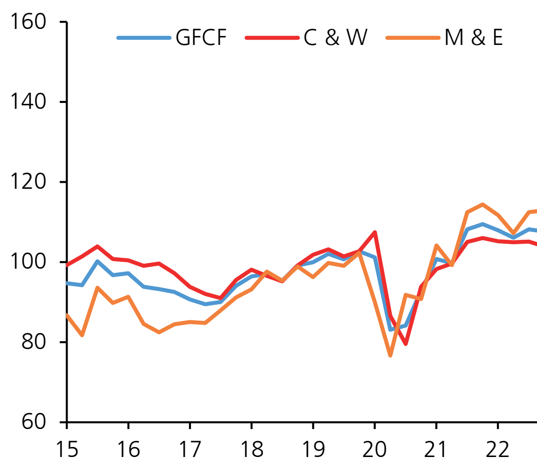
In contrast with consumption, investment has been stagnant for several quarters. The revision to the National Accounts reported a downward correction in gross fixed capital formation for the period 2020-2022 equivalent to US$5.8 billion (box I.2). Considering this, during 2022 this demand component grew 2.8%, but with a 0.5% drop in the fourth quarter in its seasonally adjusted series. By components, and also seasonally adjusted, investment in machinery and equipment increased 0.4% during the same quarter, while construction and other works decreased 1.1% (figure I.15). The evolution of both components is largely supported by mining demand. In the case of engineering works, those related to maintenance and repairs are particularly relevant, according to information gathered from digital invoices. Non-mining investment shows low dynamism, partly affected by the unfavorable scenario of financing conditions. This is consistent with the Imacon, which as of December continued near its historical lows, and with the downward trend of capital imports. All of the above in a context in which companies' perception about the local economy continues to be pessimistic, according to IMCE data.

Access to bank credit conditions remain tight. Our Bank Lending Survey (BLS) from March 2023 shows that credit granting conditions are still constrained for both the personal and corporate segments, and that demand has continued to weaken in almost all categories. This is confirmed by February's Business Perceptions Report and Business Perceptions Survey, which reflect the negative assessment made by companies regarding their credit access capability, despite some improvement compared to the previous six-month period. In this context, the average rate of the commercial portfolio hit 16.6% in February, mainly related to the increase in the rates on overdrafts. The rates for consumer loans rose to 29.4% in February, which continues to be marked by the increase in the share of revolving loans. These greater restrictions are also reflected in an increase in recent

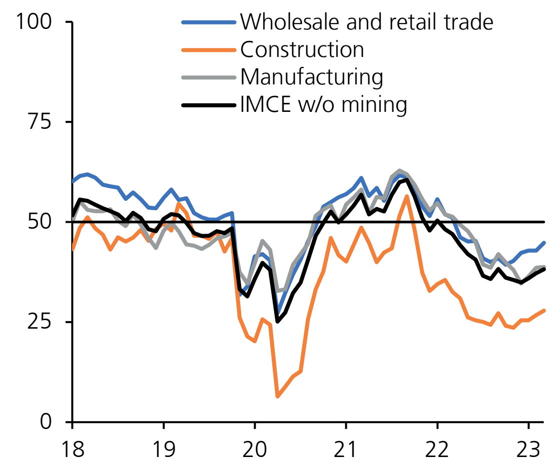
months in the spreads of consumer credit rates charged to households of different income brackets. Rates on UF-indexed mortgage loans, on average, decreased to 4.3%. In this scenario, the stock of loans continues to be low in all portfolios, especially in consumer credit, where the effect of debt repayments since 2020 is still present, despite a recovery in credit flows. Consumer and commercial loans continue to show negative annual variations, while mortgage loans, despite continuing on the rise, show the lowest annual growth in recorded history (figure I.16).

FIGURE I.15

Investment
(index, 2013 =100, seasonally-adjusted series)



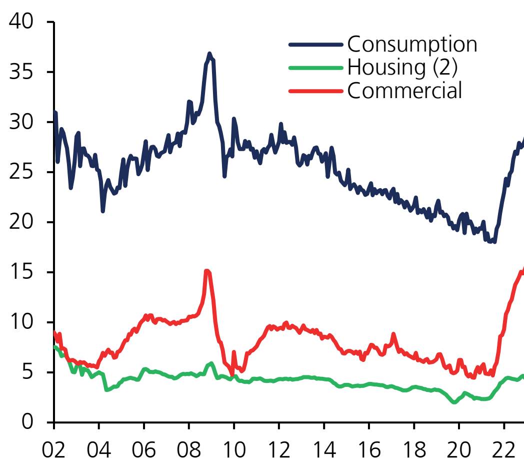
IMCE (*)
(diffusion index)



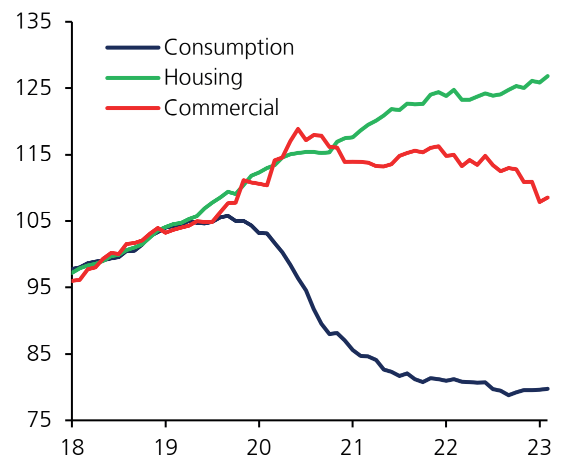
(*) Value above (below) 50 indicates optimism (pessimism).
Sources: Central Bank of Chile and UAI/ICARE.

FIGURE I.16 CREDIT MARKET INDICATORS

Lending interest rates (1)
(percent)



Real loans (3)
(index, 2018 = 100)

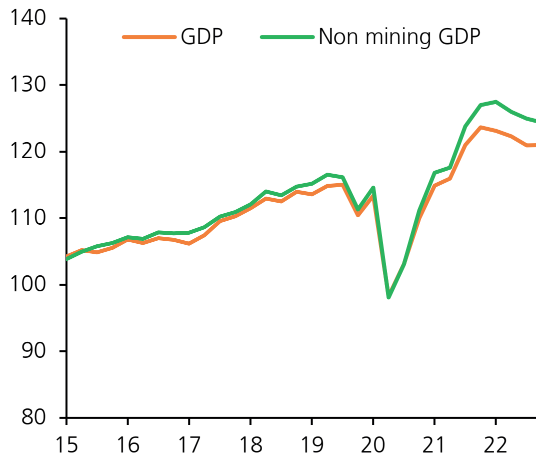


(1) Weighted average rates of all operations performed in each month. (2) UF-denominated loans. (3) Real data built with spliced CPI in 2018 annual base.
Source: Central Bank of Chile based on CMF information.

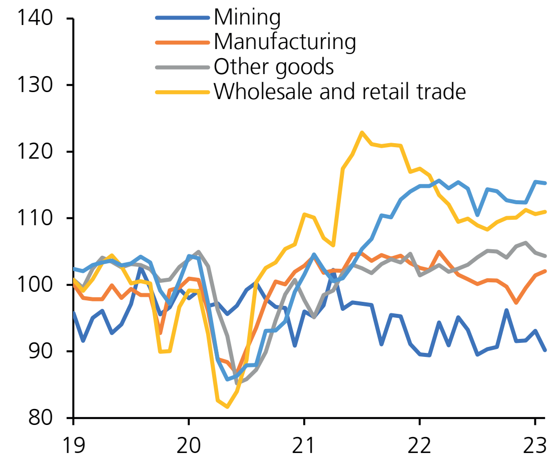
With regards to activity, the evolution of the different sectors is in line with the outlook for domestic spending, with a better performance of those linked to the consumption of goods and services (figure I.17). Non-mining GDP for the fourth quarter decreased 0.5% in its seasonally adjusted series, less than forecast in the December Report. By sectors, personal services maintained their good performance of previous quarters (+4.8%), the agriculture and forestry sector had a good season (+4.2%), and trade recorded a recovery (+1,4%) [1]/. This contrasts with the relapse of construction (-2.0%) and manufacturing (-1.5%). The sharp fall in transportation during this period (-14.4%) stood out, largely due to the execution of an airline reorganization plan (box I.2). All in all, the evolution of non-mining GDP for 2022 was in line with what was projected in the December Report (+3.5%), which was also affected by the downward revision of the previous quarters to the National Accounts. More recent Imacec data suggest that activity has evolved above December estimates, thanks to greater dynamism of services and trade, among other factors.

FIGURE I.17

GDP
(index 2013 =100, seasonally-adjusted series)



Imacec by sector
(index 2018 =100, seasonally-adjusted series)

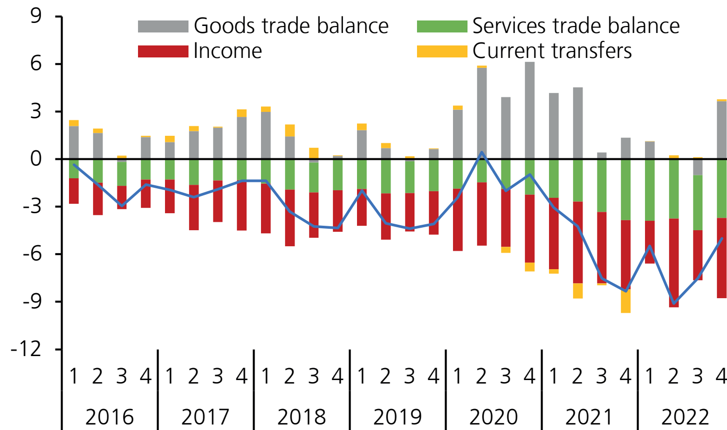


Source: Central Bank of Chile.

The current account has continued on its deficit correction trend, although with a higher starting point than previously estimated, based on the revisions to the National Accounts. The adjustments to the National Accounts revealed macroeconomic imbalances greater than those considered before, as a result of lower national savings. Thus, during 2022, the current account recorded an annual deficit of 9.0% of GDP (10% in the third quarter). On the trade balance side, this would be explained by higher exports —with an important influence of exports of lithium derivatives— and a marked drop in imports, especially of consumer goods (figure I.18). In addition, the most recent trade balance data suggest that during 2023 the external imbalance would have been further corrected. On the savings side, there was a significant drop in external savings during the fourth quarter, approaching its average of the last decade. In turn, Treasury revenues related to lithium exploitation, both from property and income taxes, would have boosted government savings.

[1]/ All numbers are from deseasonalized series and in variations from the previous quarter.

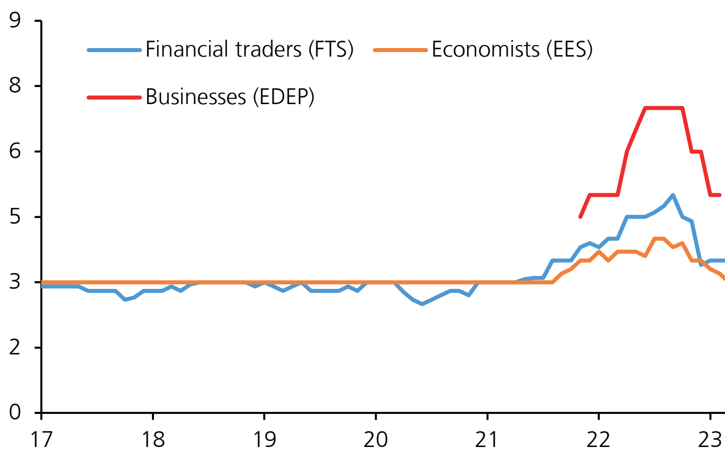
FIGURE I.18 CURRENT ACCOUNT
(USD billion, quarterly)



Source: Central Bank of Chile.

Some measures of inflation expectations remain above 3% over the monetary policy horizon (figure I.19). According to our surveys of specialists —the Financial Traders Survey (FTS) prior to the April Monetary Policy Meeting and our Economic Expectations Survey (EES) from March— inflation expectations stood at 3.5% and 3% over the two-year horizon, respectively (3.8% and 3.5% prior to the December Report). In the Survey of Price Determinants and Expectations (EDEP) (box I.5), businesses have lowered their inflation expectations for the same period, placing it at 5%. Meanwhile, breakeven inflation indicates that financial market agents foresee inflation at 4.0% and 3.1% in two and five years, respectively [2]/.

FIGURE I.19 TWO YEARS INFLATION EXPECTACTION ON SURVEYS (1) (2)
(annual change, percent)

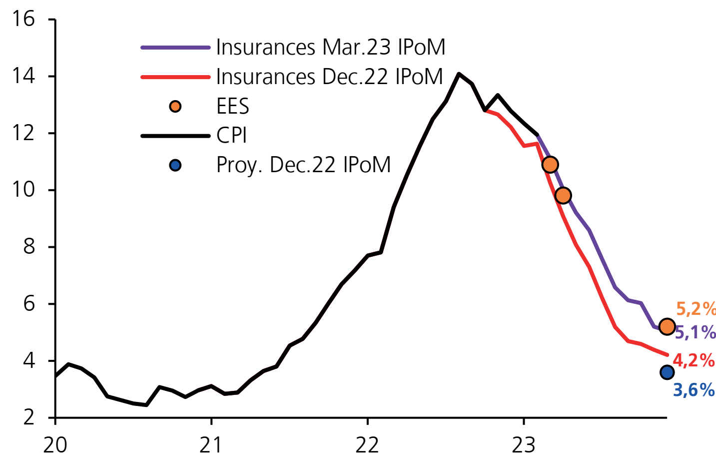


(1) Shows median responses. (2) The FTS considers the survey of the first half of each month up to January 2018. From February 2018 onwards, it considers the last survey published in the month, including the one prior to the March 2023 monetary policy meeting. In the months where no survey is published, the latest available one is used.
Source: Central Bank of Chile.

[2]/ Two years ahead corresponds to breakeven inflation 1 in 1. At five years, to breakeven inflation 3 in 2. In both cases, it corresponds to the average as of 10 days prior to the statistical cutoff date.

Inflation expectations for 2023 are higher (figure I.20). In the case of the EES, median inflation expectations to December 2023 rose to 5.2% in March (5.1% in November). Meanwhile, the outlook implicit in inflation insurance contracts stood at 5.0% (4.2% prior to the December Report).

FIGURE I.20 INFLATION, INSURANCE AND EXPECTATIONS (*)
(annual change, percent)



(*) The inflation insurances consider the average prices of 10 days at the statistical closing of each MPR (December IPoM: November 30th; March IPoM: March 29th).
Source: Central Bank of Chile.

Expectations for economic growth in 2023 were corrected upward, particularly between February and March. In the March EES, median growth expectations for this year rose to -0.8% (-1.5% in February), while Consensus Forecasts saw GDP for the year at -0.5% (-1.1% in February). However, these projections were surveyed shortly after banking tensions broke out in the U.S. and Europe. For 2024, the EES and CF maintain their projections almost unchanged, placing it at 2.1% and 2.0%, respectively.

The trajectory of the monetary policy rate (MPR) expected by the market and specialists was adjusted upward with respect to December. As in foreign markets, local monetary policy expectations —reflected in the overnight index swap rates (OIS)— have shown high volatility. After rising between December and early March due to the positive surprises in activity and inflation, a significant drop was observed as a result of the international financial tensions of the last month. All in all, the MPR expectations implicit in the financial market are above those at the statistical close of the December Report. Specialists' expectations (EES and FTS) are somewhat above, foreseeing the first decline between June and July, and, in the case of the EES, placing the rate at 8.0% in December 2023 (table I.1).

TABLE I.1 MPR EXPECTATIONS
(percent)

	Apr.23	May.23	Jun.23	Jul.23	Dec.23
Swap curve (*)	11.25	11	10.5	10	8.25
March EES	11.25	11.25	-	10.25	8
FTS pre March Monetary Policy Reunion	11.25	11.25	10.5	10	-

(*) Prices at the statistical closing of this Monetary Policy Report.
Sources: Central Bank of Chile.

BOX I.1:

International financial conditions: macroeconomic impact

The massive withdrawal of monetary stimulus in the U.S. and the Eurozone has been identified as a potential source of stress for the global financial system by many observers, including mentions in several MP Reports. This is so because prolonged periods of near-zero rates and abundant liquidity encourage leverage by various agents and tends to increase risk-taking in credit markets. Indeed, during 2022, events in the United Kingdom and some banks in Europe pointed out these risks. Recent tensions in the U.S. and Eurozone banking systems are another expression of vulnerabilities in the current financial environment.[1/] Although its outcome is still uncertain, the central scenario of this Report considers that this banking turmoil in developed economies will have negative consequences both internationally and at home. However, their effects are more limited than have been observed in past episodes of stress in the financial markets, such as the 2007-2008 financial crisis.

Lower credit growth is one of the central mechanisms through which economic activity will suffer this time around. Prior to the onset of this episode, banks in both Europe and the U.S. were already declaring a significant tightening of lending standards (figure I.21), which anticipated a slowdown in growth that would contribute to the adjustment of activity required to contain inflationary pressures.[2/] Most recently, there has been a noticeable deterioration in several factors that determine bank credit. For one, the fall in the value of bank shares and the capital ratio (figure I.22), explained to a large extent by the increase in interest rates in the last year, tends to predict a slowdown in the dynamism of lending.[3/] For another, in the U.S., increased uncertainty about the health of banks has intensified the outflow of bank deposits, especially from smaller institutions, which would also anticipate a more cautious behavior in the granting of credit. This is particularly relevant since these institutions, despite representing 30% of banking assets in the U.S., provide roughly 40% of total loans and close to 70% of commercial mortgage loans. The significant provision of liquidity by the Federal Reserve to contain tensions in the system, although it relieves short-term pressures on banks, does not eliminate the root of the problem, especially if credit quality also begins to be affected by the macroeconomic environment.

These financial tensions in developed economies in a context of a more restrictive monetary policy will be transmitted to emerging economies, including Chile, through several channels. On the one hand, the slower growth of activity in the developed world will dampen demand for exports. On the other, greater uncertainty in global markets will reduce risk appetite, thus widening financing spreads. Moreover, greater external uncertainty will affect consumer and business confidence in Chile, lowering the dynamism of spending and activity.[4/]

It is worth noting that the Chilean banking system presents important strengths, both in its development and in its regulation and supervision. The local banking business model is predominantly based on a traditional banking approach, with diversified financing, focused on granting credit, low share of investment assets and no significant maturity mismatches and with appropriate currency hedging. On the other hand, its regulation is in line with Basel III standards, being applied equally to all the banks in the market. There are periodic risk management and liquidity adequacy supervision processes carried out by the Financial Market Commission (CMF). This means that local banks are in a robust liquidity and capital position, which would allow them to appropriately withstand stress scenarios, as shown every six months in the Financial Stability Reports. There are also differences between Chilean monetary policy and those of developed economies, particularly the U.S. and Europe. Unlike the latter, in Chile the monetary adjustment process is sufficiently advanced, which offers more room to react to external shocks. Thus, complex situations in certain U.S. and European banks have not occurred in the Chilean case, given the strengths described above. In consideration of all this background, the Board concludes that Chilean banks are not a source of risk for the macroeconomic scenario.

1/ A more detailed account of the causes and evolution of the recent banking tensions can be found in Governor Rosanna Costa's presentation to the Senate Finance Committee on 23 March.

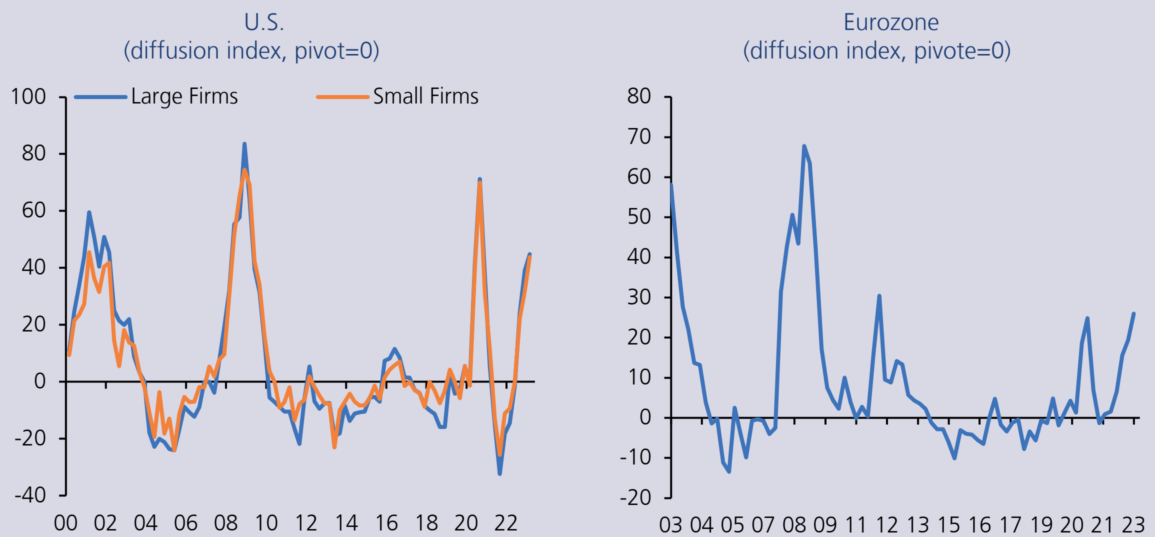
2/ Basset et al. (2014).

3/ See Girotti and Horny (2020); Boucinha et al. (2017); Kangiesser et al. (2017).

4/ Albagli and Luttini (2015) and Albagli et al. (2019) report on the influence of external factors in Chile's confidence indicators.

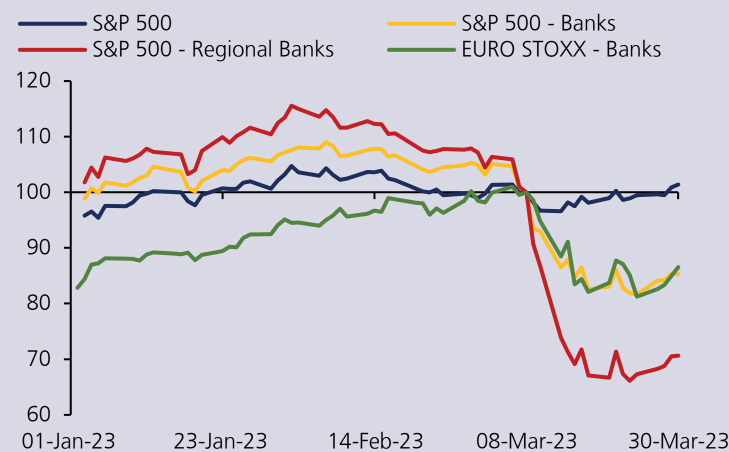
All in all, the evolution of the external scenario entails a high degree of uncertainty and occupies a central place in this Report. This is reflected, beyond its impact on the central scenario projections, in the construction of sensitivity and risk scenarios. In particular, the lower bound of the MPR corridor considers a scenario where external conditions worsen even further. It also considers a risk scenario where the magnitude of the problem resembles that observed in the Global Financial Crisis. Meanwhile, the upper bound considers, in addition to better fundamentals of the local economy, a more positive external scenario than depicted in the central scenario (chapter II).

FIGURE I.21 LENDING STANDARDS FOR BUSINESSES



Sources: Fed and ECB.

FIGURE I.22 U.S. AND EUROZONE STOCK INDEXES
(index, 08.Mar.23=100)



Source: Bloomberg.

BOX I.2:

Macroeconomic implications of revisions to the National Accounts and the Balance of Payments

The publication of the National Accounts and Balance of Payments for the fourth quarter of 2022 included revisions to the figures for the 2020-2022 period[1]/. These revisions are part of the usual process of producing macroeconomic aggregates, where basic information increases with time, in terms of coverage and breakdown[2]/. By incorporating them, statistics can be strengthened and macroeconomic analysis can be refined. This box discusses the most important aspects of these changes for the purposes of interpreting the recent evolution of the Chilean economy.

Activity and demand

Regarding activity, moderate changes were made in the levels and growth rates of GDP since 2020. In the Imacec, the implicit annual variation of non-mining GDP for the fourth quarter of 2022 was reduced (effective: -2.4%; Imacec: -1.7%). This owed mainly to the drop in transportation, associated with the incorporation of the payment of financial commissions by a company in the sector (see Revisions to economic activity figures: GDP and Imacec). Without this effect, non-mining GDP in the fourth quarter would have fallen 1.5% annually and the seasonally adjusted quarterly rate would have been 0.4% (effective: -0.5%). This is a one-off effect that will disappear in the first quarter of 2023; therefore, the velocity of the first quarter and the annual variation of the fourth quarter will be higher as a result of the low comparison base (figure I.23).

Final demand saw significant changes in its composition in the 2020-2022 period, with higher consumption and lower investment levels. In particular, private consumption increased by around US$4.3 billion, equivalent to approximately 0.6% of annual GDP. Gross fixed capital formation (GFCF) decreased by around US$5.8 billion, slightly more than 0.7% of annual GDP (table I.2).

The increase in the levels of consumption of goods, especially non-durables, stands out, explained, in part, by the incorporation of administrative records and statistics on non-durable goods collected by private institutions. The downward revision to GFCF reflects lower investment in construction and works, particularly due to the use of the annual survey of spending on engineering works. The machinery and equipment component was also reduced, due to the reallocation of some imports from investment to consumption, among other factors (figure I.24).

The current account and national savings

The current account deficit —equivalent to external savings— was revised upwards, especially for 2021 (table I.2), related to a downward revision to domestic savings: -0.8pp of GDP in 2020, -1.8pp in 2021 and -0.4pp in the first three quarters of 2022. These revisions are mainly explained by lagged information from financial statements and the foreign investment survey. It should be noted that balance of payments data for the fourth quarter, and partial information for the first quarter of 2023, show a significant correction of the external deficit with respect to previous quarters.

National savings in 2020, 2021 and 2022 were well below their historical average (23.3% in the period 1996-2019), most recently explained by the low level of private savings. The annual closing of the National Accounts by institutional sector, to be published on 18 April, will contain the breakdown of savings figures by sector (i.e., households, businesses and government).

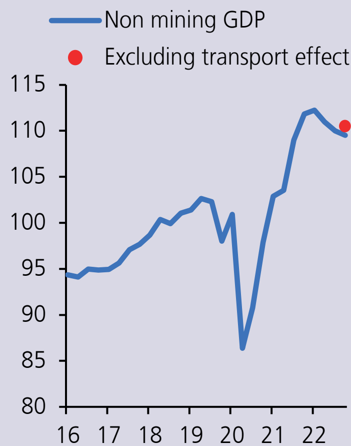
[1]/ The sanitary emergency posed challenges in the collection of basic data, for which efforts were made with information providers to minimize their impact on the quality of statistics. Nevertheless, the revisions to the annual variation rates for each year were within the historical range (Economic and Statistic Studies N° 131).

[2]/ For 2020, INE surveys were included, allowing for more accurate macroeconomic aggregates to be prepared with greater accuracy and breakdowns. For 2021, annual tax records and the annual survey of investment in engineering works were incorporated. Production and expenditure figures for 2022 have been updated.

Conclusions

The revisions to the National Accounts and Balance of Payments 2020-2022 show greater macroeconomic imbalances, reflected in higher consumption, lower national savings and a larger current account deficit. Worth noting are the higher levels of consumption of goods, which could at least partially explain why inflationary pressures have exceeded our initial estimates. Investment appears weaker than anticipated, having stagnated for several quarters. The drop in investment levels cancels out part of the positive surprises of the second half of 2022, and generates a baseline effect for 2023, which explains part of the upward revision to the annual projection for this aggregate.

FIGURE I.23 NON MINING GDP
(index 2018 = 100, s.a.)



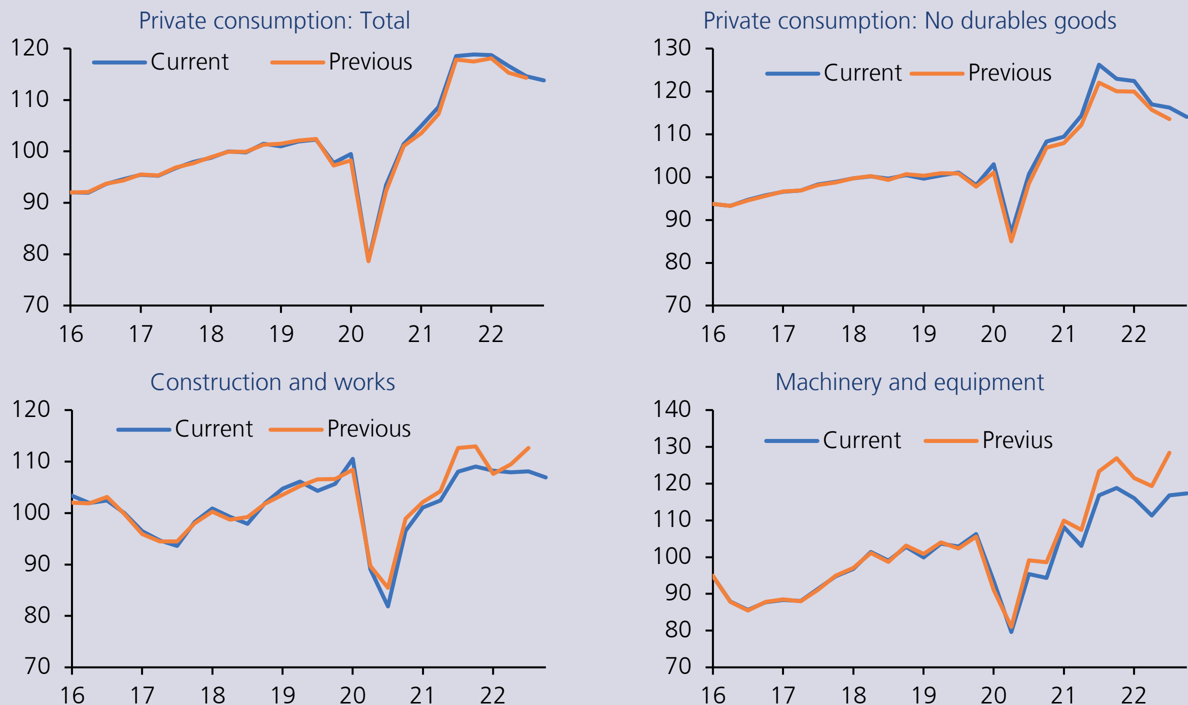
Source: Central Bank of Chile.

TABLE I.2 MACROECONOMIC AGGREGATES
(percentage of nominal GDP)

	2020		2021		2022 (1)	
	Current	Previous	Current	Previous	Current	Previous
Total consumption	74.4	73.8	76.3	75.3	78.4	77.7
Private consumption	58.4	57.8	61.7	61.0	64.2	63.7
GFC	21.1	21.6	24.4	25.3	26.6	27.1
GFCF	22.5	23.0	23.1	24.0	24.5	25.4
National Savings	19.2	20.0	17.0	18.8	16.7	17.1
External Savings (2)	1.9	1.7	7.5	6,6	9.9	10.1

(1) For 2022 the accumulative ratios of 21.T1-22.T3.
(2) Corresponding to the current account deficit.
Source: Central Bank of Chile.

FIGURE I.24 DEMAND LEVELS
(index 2018 = 100, seasonally adjusted)



Source: Central Bank of Chile.

BOX I.3:
Longer duration of high inflation

CPI inflation continues to be very high, in both the total measure and its core —non-volatile— component. On the one hand, this may be because the type, size and sequence of shocks that have affected inflation have been different than usual ("inherited" persistence). On the other, it is possible that upward shocks have generated more prolonged effects via internal propagation mechanisms ("intrinsec" persistence)[1]/.

This box explores some hypotheses that could explain the longer duration of high inflation. Among them: (i) that the shocks that explained the increase in inflation were unusually large and consecutive. This would have contributed to compressing business margins, mitigating the initial impact of these shocks on prices, but making it more lasting; (ii) that second-round mechanisms —via indexation and inflation expectations of different agents— also contribute to slowing down the fall in inflation.

The longer duration of local inflation and its causes

A common way to measure inflation persistence is to estimate what is known as the "half-life" of shocks. That is, how long it takes for half of their effect on inflation to dissipate[2]/. Barrero *et al.* (2023) show that the estimated half-life of core inflation shocks has increased considerably since the second quarter of 2022. In that time frame, it went from about six months to about twelve months. Initially, the greater persistence was more associated with goods inflation, but more recently it is services that account for the bulk of the increase. In fact, the latter has risen sharply since the end of 2022, and shows no signs of stabilizing (figure I.25). This methodology, while useful for formalizing the concept of the protraction of the inflationary problem, does not allow us to establish its root causes; in particular, whether these changes are the result of inherited or intrinsec persistence.

To assess the importance of the inherited persistence component in the longer duration of inflation, Barrero *et al.* (2023) estimate a monetary time series model that allows for changes in the dynamics of disturbances affecting the economy, and decomposes inflation into supply, demand, and monetary policy shocks. They find that supply shocks associated with problems in global supply chains and increases in commodity prices were unusually strong during the second and third quarters of 2022, but have been dissipating recently.

It is also observed that, since mid-2021, demand shocks have been significantly stronger and more frequent than usual, reflecting the successive demand stimulus measures. The upward revisions to private consumption show that demand pressures have been higher than previously estimated (Box I.2), and at the margin they have moderated more slowly. Overall, the shocks explaining the rise in inflation have been larger and more frequent (figure I.26), and with a longer half-life than usual.

The behavior of business margins has also contributed to the high inflationary persistence. The sharp rise in costs during 2021 was only partially passed on through to prices, consistent with a marked compression of margins (Box I.3 in June 2022 MP Report). However, these margins have been recovering since the second quarter of 2022 (figure I.27), which is associated with a lower pass-through to prices of the most recent cost reductions (Acevedo *et al.*, 2023). This explanation is the counterpart, for example, of the low degree of pass-through to prices of the recent significant exchange rate appreciation (Box I.4). In other words, the adjustment of margins mitigates the initial impact on prices of the different shocks, but tends to prolong their effects on inflation.

[1]/ For a discussion on the concepts of "intrinsec" and "inherited" inflationary persistence, see for example Fuhrer (2010).
[2]/ The "half-life" of the shocks is calculated using the roots of the polynomials of autoregressive models (see Barrero *et al*., 2023).

FIGURE I.25 AVERAGE LIFE OF SHOCKS TO THE CPI
(months)

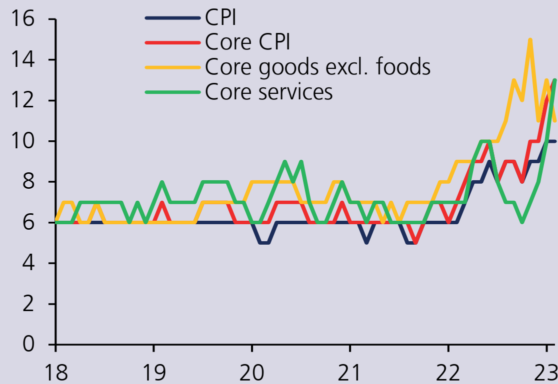
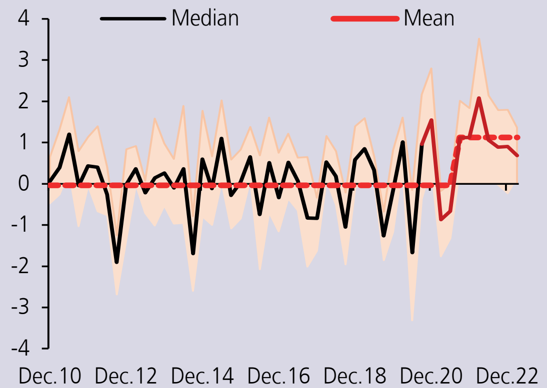
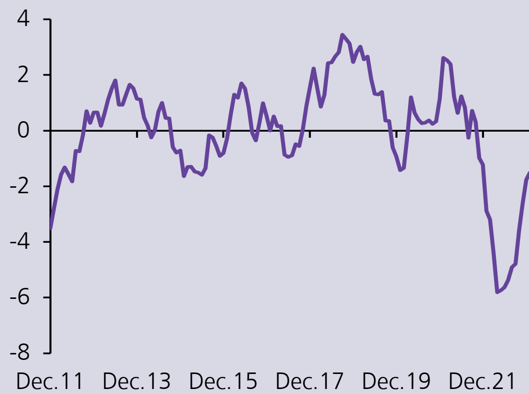


FIGURE I.26 ESTIMATED DEMAND SHOCKS (*)
(standard deviations)



(*) Bands are percentiles of 25 and 75%.
Source: Barrero *et al.* (2023).

FIGURE I.27 CYCLICAL COMPONENT OF AGGREGATE MARGINS
(three-month moving average, percent)



Source: Acevedo *et al.* (2023).

Finally, regarding the intrinsic part of persistence, second-round mechanisms could have contributed to the longer duration of high inflation. On the one hand, inflation expectations of firms and households have remained high for a prolonged period of time, which may be a mechanism that increases inflation persistence beyond what is consistent with its fundamentals (Box V.1 in March 2022 MP Report). As from March 2022, the Central Bank's inflation projections have factored in an additional persistence effect associated with this phenomenon. Some measures of inflation expectations have been returning to the 3% target, suggesting that the relevance of this second-round mechanism is diminishing at the margin. On the other hand, although there is no clear evidence of a greater degree of indexation in the items most sensitive to past inflation, the fact that it is high also slows down the convergence to the 3% target.

Conclusions

Prolonged high inflation has been the main focus of concern for the Central Bank in recent quarters. The reasons behind this include the size and sequence of demand and supply shocks, the dynamics of business margin adjustments and second-round effects. In the central scenario of this Report, the upward revision of headline and core inflation is explained to a greater extent by a smaller adjustment in the gap and private consumption. The elements discussed in this box, however, motivate some of the scenarios of sensitivity and risk of higher inflation levels considered in this Report.

BOX I.4:

Pass-through of nominal exchange rate appreciations to prices

Since October 2019, the nominal exchange rate (NER) has been characterized by high volatility, going from just over CLP 700 per dollar to peaks above CLP 1,000 in July 2022. Comparing the statistical close of this Report and that of December, the peso has appreciated nearly 11.5%. Exchange rate movements of this magnitude affect inflationary dynamics considerably throughout the monetary policy horizon. Their effect is measured through the pass-through coefficient (PTC) from the NER to domestic prices. Based on past estimates, the average PTC in Chile is between 0.1 and 0.2 after one year. This means that, over a one-year period, a 1 percentage point (pp) change in the NER is passed through, on average, to a change in the same direction of between 0.1 and 0.2pp in inflation[1]/.

Evidence has it that the magnitude and timing of this pass-through depends on multiple factors, including the intensity of NER movements, their sign and the nature of the originating shocks[2]/. Therefore, to inform inflation projections, in addition to the estimation of an average PT coefficient, it is necessary to study the particular coefficient at some point in time. The literature based on non-linear empirical models allows investigating the dependence of the coefficient on the intensity and sign of the exchange rate movement, while methodologies based on dynamic and stochastic general equilibrium models allow identifying the origin of the exchange rate movement.

Studies for several countries find that the pass-through is greater for depreciations than for appreciations, and is also greater in the face of strong exchange rate movements. This literature has drawbacks because it is based on aggregate measures that do not always meet the exogeneity conditions necessary for an appropriate identification of causal effects. To overcome these problems, recent methodologies have been oriented towards studying the PTC and its determinants based on micro data[3]/.

Estimates using the administrative data of companies available at the Bank allow investigating the hypothesis of whether the PTC is higher in the face of a depreciation than in the face of an appreciation of the NER (figure I.28). The results show that, for the average firm, around eight months the PTC is 0.13 for depreciations and 0.07 for appreciations[4]/. After one year, however, the pass-through measures converge at similar levels. In other words, appreciations take longer to pass through to lower prices, but after one year, the cumulative pass-through is already very similar to that of depreciations.

Based on the stochastic and dynamic model XMAS[5]/, the effects of exchange rate movements observed as from the last quarter of 2022 were studied. This exercise yields a PTC of 0.055 by mid-2023 and 0.07 by the end of 2023. This contrasts with the average (or unconditional) measure which is close to 0.1 according to the same model[6]/. However, it coincides with estimates of the effect of appreciations based on micro data. The model also identifies the factors that explain recent movements in the NER. These are changes in international prices, interest rate parity and external interest rates. The first two have generated appreciations and have also been associated with significant pass-through. The latter has depreciated the NER and has mitigated the effects on the coefficient.

[1]/ For related discussions in previous Reports, see box IV.1 in March 2018 Report and box IV.1 in March 2016 Report.

[2]/ The pass-through coefficient may also depend on the country's inflation level and the monetary policy regime in place.

[3]/ For a more detailed discussion and examples for Chile, see Arenas et al. (2023) and the literature cited therein.

[4]/ A regression is estimated of a monthly price index by firms against an interaction between an import intensity variable with the change in the multilateral exchange rate (MER), controlling for import intensity, time and firm effects. Monthly data are considered for formal firms, from January 2014 to February 2023. For more details, see Arenas et al. (2023).

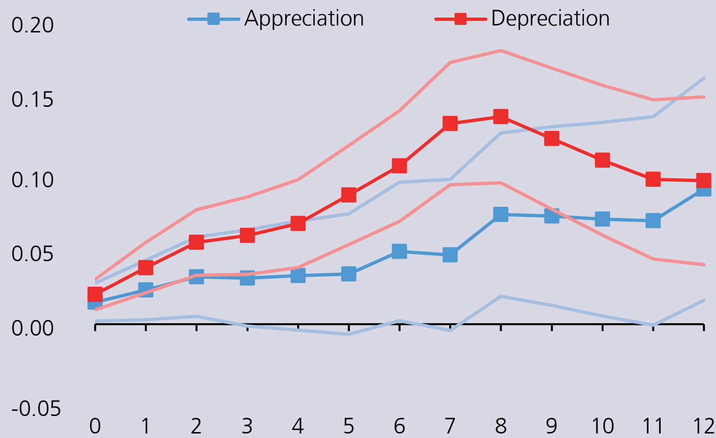
[5]/ The model is described in detail in the document "Use of Macroeconomic Models in the Central Bank of Chile 2020."

[6]/ See Garcia-Cicco and Garcia (2020) for the methodology and an application for Chile.

Conclusions

The nominal exchange rate has appreciated significantly with respect to the statistical close of the December 2022 Report. The central scenario of this Report assumes that, in the short term, the pass-through to prices will be lower than usual. However, at the one-year horizon, a PTC close to its historical estimates for Chile is anticipated, that is, around 0.1.

FIGURE I.28 ESTIMATES OF THE PASS-THROUGH COEFFICIENT BASED ON MICRODATA, DISTINGUISHING BETWEEN APPRECIATIONS AND DEPRECIATIONS (*)
(percentage change in prices in response to a +-1% change in the exchange rate)



(*) The graph displays 95% confidence intervals based on standard errors clustered by firm. The plotted coefficient corresponds to that of the average company with an intensity level of 0.12.
Source: Arenas et al. (2023).

BOX I.5:

Publication and dissemination of the results of the Survey on Price Determinants and Expectations

In its constant effort to strengthen the available economic information, the Central Bank will begin publishing the Survey on Price Determinants and Expectations (EDEP). This survey has information available since November 2021 and will be launched in May 2023, the data will be reported on a monthly basis and its results will be uploaded to the Central Bank's website and Statistical Database.

The EDEP's objective consists of investigating the pricing dynamics of the companies. For this purpose, the survey contains indicators that allow characterizing their perceptions on the performance of their operations, and how the movement of the different factors and costs of the company affect their pricing pressures. At the same time, the survey inquires about the firms' economic expectations, including those for inflation at 12 and 24 months.

As noted by Muñoz *et al.* (2023), the survey and consideration of inflation expectations and their determinants, both in businesses and consumers, is a matter of growing relevance among the different central banks of the world. The importance of these expectations lies in the fact that they are the basis for the agents' economic decisions, especially those related to investment, hiring, pricing and/or wage setting in the case of companies, and, for households, those linked to consumption and savings dynamics are particularly important.

In the case of business surveys, evidence shows (see Muñoz *et al.* (2023)) that their inflation expectations tend to have greater similarities with those of consumers than with those of experts. This implies that, when contrasting their expectations with the actual movements of inflation indicators, they tend to overestimate the movement of final price indexes such as the CPI.

This difference is due to several reasons, among which is that the expectations of business managers, in general, do not necessarily follow the paradigm of full-information rational expectations (FIRE). Rather, these expectations are formed with incomplete information, to the extent that agents do not necessarily monitor the data that characterize the macroeconomic scenario on a regular basis, or do not analyze it with the same depth as an expert in the field would. At the same time, several authors (see Muñoz *et al.* (2023)) report the existence of significant heterogeneity in the inflation expectations of these agents, associated with the sociodemographic conditions of the respondents and the characteristics of the economic units they lead.

All this suggests that a relevant interpretation of firms' inflation expectations requires a careful analysis that considers the specificity of the type of respondent and the nature of the data collected. This implies considering not only the point estimates, but also the movement of the series, as well as the stability and persistence of these expectations.

From the methodological point of view, the EDEP is composed of a rotating panel of approximately 450 firms that are surveyed monthly, but reported on a rolling quarterly basis. These firms were selected through a semi-probabilistic design, with a benchmark universe of large companies with commercial legal status, excluding firms in primary activities and electricity, gas and water companies.

As for the variables that will be published, ten indicators will be reported monthly:

- **Perception and expectations of input costs in the last three and next 12 months:** Prevalence of companies that have perceived that their input costs have increased, decreased or remained the same. Expectations of these variations for the next 12 months are also reported.

- **Perception and expectations of sales prices in the last three and the next 12 months:** Prevalence of companies that have perceived that their sales prices have risen, ballen, or remained the same. Expectations of these variations for the next 12 months are also reported.

- **Perception and expectations of factors and costs of companies in the last and next three months:** Diffusion index that indicates the variations in the availability of inputs, profit margins, sales levels, sales prices, machinery and technology costs, fixed costs, labor costs and input prices. Expectations of these variations for the next three months are also reported.

- **Perception of the influence of factors and costs of the firms on the selling price in the last three months:** Diffusion index that indicates whether the influence of the variation of the factors and costs of the firm is upward or downward on prices. The exchange rate is added to the factors considered in the above indicator.

- **Inflation expectations for the next 12 and 24 months:** Mean and median of the expected percentage change in cumulative inflation for the next 12 months, and for the 12 months thereafter.

Results will be available as of 4 May 4, 2023 and future publications will be made on the following dates:

Last moving quarter	Published on
JFM	4 May 2023
FMA	5 June 2023
MAM	5 July 2023
AMJ	3 August 2023
MJJ	4 September 2023
JJA	4 October 2023
JAS	6 November 2023
ASO	5 December 2023

II. FUTURE EVOLUTION OF MONETARY POLICY

Annual CPI variation has decreased to 11.9%, but remains at a high level and well above the 3% target. Its core component has remained at around 11% for some time now and has accumulated most of the inflationary surprises since the previous Report. This occurs amid a scenario in which the adjustment of excess spending accumulated in the past few years has been slower than expected in December and which, following the revision of National Accounts, is reflected in higher-than-expected private consumption and the activity gap that will take longer to close. One important factor for the reduction of these imbalances lies in maintaining the contractionary stance of monetary policy for a longer period of time. Moreover, the tightening of international financial conditions in response to banking problems and financial tensions in developed economies, together with the associated increase in global uncertainty, will result in a lower external impulse. With this, the economy is expected to match the cumulative growth in 2023 and 2024 assumed in the previous Report, with a slightly better result in the first year and slightly worse in the second, in accordance with the adjustment the economy needs to make. Inflation will continue to decline and reach the 3% target by the end of 2024, in line with the expected adjustment in consumption and an activity gap that will turn negative from the second part of this year. Meanwhile, core inflation will take a little longer and will reach 3% by the end of the projection horizon of this Report. The Monetary Policy Rate (MPR) has remained at 11.25% since October 2022 and it will be necessary to keep it at that level until macroeconomic conditions indicate that the process of inflation convergence to the 3% target has been consolidated. As described in the central scenario, this process will take longer than expected in December. The Board reaffirms its commitment to act with flexibility in case any of the internal or external risks materializes and macroeconomic conditions so require.

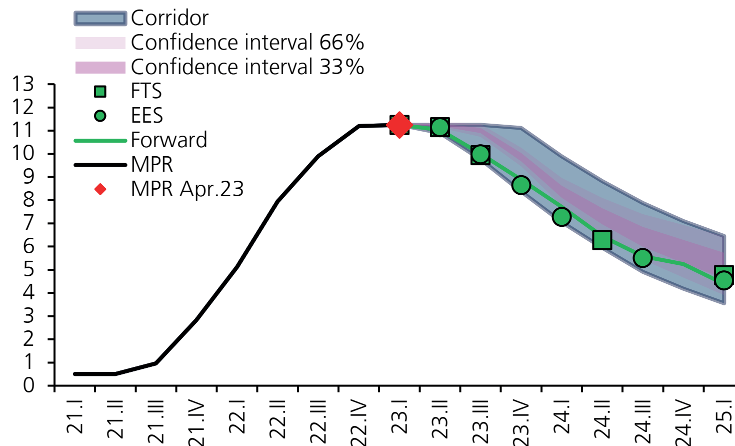
MONETARY POLICY STRATEGY

Headline inflation remains very high, and has been so for longer than previously foreseen. Although the annual CPI variation fell to 11.9% in February, it was still well above the 3% target. The core component has remained around 11% for several months. At the same time, it concentrates most of the upward surprise in inflation since the previous statistical closing, which has occurred in both goods and services, although with a greater prevalence of the former.

In this context, inflation expectations for this year have risen, while several two-years-ahead measures continue to put it above 3%. For December 2023, the median of inflation expectations derived from the March Economic Expectations Survey (EES) rose to 5.2%, while those implicit in inflation insurance contracts reached 5% (5.1 and 3.6%, respectively at the December statistical cutoff). Two years out, the Financial Traders Survey (FTS) prior to the April monetary policy meeting estimated it at 3.5%, while the March EES had returned to the 3% target (3.5% and 3.8% in the surveys available at the December statistical close). Business expectations for the same term had also declined, to 5% in the case of the Survey of Price Determinants and Expectations (EDEP) (Box I.5).

The Board considers that it will be necessary to keep the MPR at that level until macroeconomic conditions indicate that the process of inflation convergence to the 3% target has been consolidated. In the central scenario, this process will take longer than expected (figure II.1). The Board reaffirms its commitment to act with flexibility in case any of the internal or external risks materializes and macroeconomic conditions so require.

FIGURE II.1 MPR CORRIDOR (*)
(quarterly average, percent)

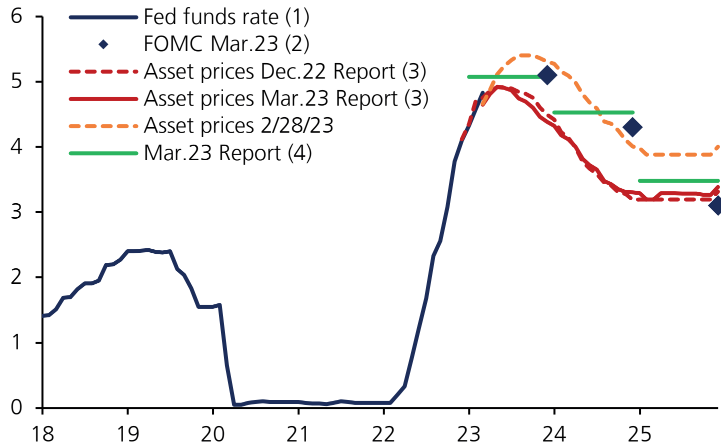


(*) The corridor is built by following the methodology described in boxes V.1 of March 2020 Report and V.3 of March 2022 Report. Includes March EES, FTS pre-policy-meeting of April and the average smoothed forward curve of quarter to 29 March. This is calculated by extracting the implicit MPR considering 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

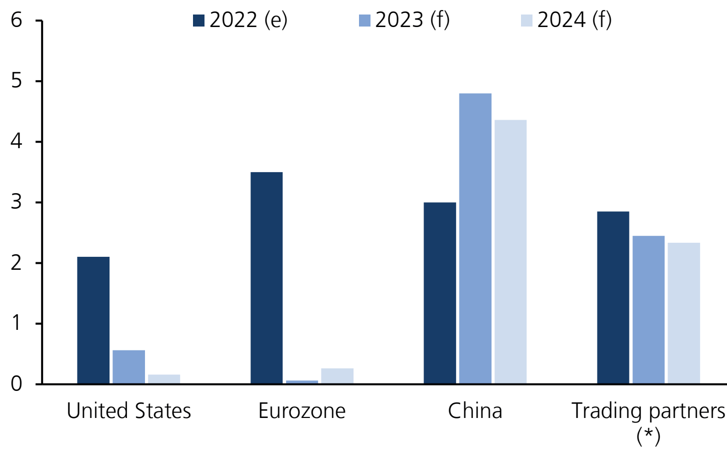
The impulse that the Chilean economy will receive from abroad will begin to decrease by the second half of this year, as a consequence of the weakening of world growth due to the more contractionary monetary policy and financial stress at the global level, especially in the developed world (figure II.2 and II.3, table II.1). This combines, on the one hand, the continuation of the process of rate hikes by the main central banks in order to control inflation, which has remained high for longer than expected. The core component, which has led monetary authorities such as the U.S. Federal Reserve (Fed) and the European Central Bank (ECB) to raise their benchmark rates once again, is drawing particular attention. On the other hand, the expected effects of the increased uncertainty following the recent events in the United States and European banking sector on the evolution of financial markets, credit and expectations stand out. In fact, after expecting a more contractionary monetary policy, the market once again significantly adjusted downwards the expected path for the Fed funds rate in reaction to the financial turmoil of March, which has once again widened the gap with respect to the Fed's statement.

FIGURE II.2 EVOLUTION AND FORECASTS FOR THE FED FUNDS RATE
(percentage points)



(1) Effective Fed funds rate. For March 2023, consider spot value as of the 29th.
(2) Forecast by the the Federal Open Market Committee (FOMC) at the indicated meeting.
(3) Asset prices consider the statistical cut-off dates of each MP Report.
(4) Annual average for the Fed funds rate in 2023, 2024 and 2025, according to the central scenario of this Report.
Sources: Bloomberg and Federal Reserve.

FIGURE II.3 GROWTH PROJECTIONS SELECTED ECONOMIES
(annual change, percent)



(f) Forecast. (e) Estimate.
(*) For definitions, see Glossary.
Source: Central Bank of Chile.

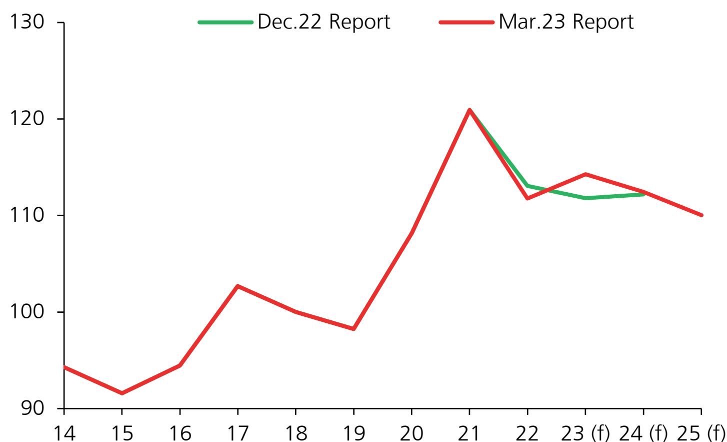
TABLE II.1 WORLD GROWTH (*)
(annual change, percent)

	Aveg. 10-20	2021	2022 (e)	2023 (f)	2024 (f)	2025 (f)
World GDP at PPP	3.1	6.5	3.3	2.1	2.2	3.1
World GDP at market exchange rate	2.6	5.9	3.0	1.7	1.7	2.8
Trading partners	3.4	6.6	2.8	2.4	2.3	3.0
United States	1.8	5.9	2.1	0.6	0.2	2.7
Eurozone	0.7	5.3	3.5	0.1	0.3	1.2
Japan	0.7	2.2	1.0	0.7	1.0	0.9
China	7.2	8.4	3.0	4.8	4.4	4.3
India	5.7	8.7	7.0	5.9	5.3	6.1
Rest de Asia	3.8	4.3	4.1	2.9	3.1	3.7
Latin America (excl. Chile)	1.0	6.5	3.6	0.3	0.8	2.1
Commodity exp.	1.7	4.7	3.6	0.7	0.1	1.6

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

In contrast, better prospects are anticipated for the Chinese economy after its reopening which, together with the evolution of the copper and oil market balances have been behind the improvement in the terms of trade, which are herein revised upwards compared to the previous Report. his combines the improved outlook for copper prices and lower projected prices for foods and fuels (figure II.4 and table II.2). For copper, the higher prices of recent weeks, the better demand outlook after China's reopening and a market balance that would remain tight this year and next, raise the projected price for the 2023-2025 period: US$3.85, US$3.65, and US$3.5 per pound for 2023, 2024 and 2025, respectively (US$3.55 and US$3.45 per pound for 2023 and 2024 in the last Report). Regarding food prices, the downward revision responds mainly to the FAO index decline of recent months, while going forward a downward trajectory similar to that depicted in the December Report is maintained. The oil price replicates, as it has been quite volatile due to the tensions in the financial markets in recent weeks and their possible implications for world growth, in addition to a recent increase in inventories. Thus, the average price of a barrel of Brent-WTI oil, which reached US$97 in 2022, is projected to continue to fall gradually to US$73 in 2023 and reach US$67 in 2025. All in all, the slower growth of trading partners will reduce the external demand that Chile faces more noticeably from the second half of this year.

FIGURE II.4 TERMS OF TRADE
(level, 2018=100)



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

TABLE II.2 INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

	Aveg. 10-20	2021	2022	2023 (f)	2024 (f)	2025 (f)
			(annual change, percent)			
Terms of trade	1.8	11.9	-7.7	2.3	-1.6	-2.1
External prices (in US$)	0.5	9.3	4.4	2.2	4.2	3.2
			(levels)			
LME copper price (US$cent/pound)	304	423	400	385	365	350
WTI oil price (US$/barrel)	69	68	94	71	67	65
Brent oil price (US$/barrel)	76	70	100	76	72	70
Gasoline parity price (US$/m3) (*)	585	579	850	659	563	548
Federal Funds Rate (%)	0.7	0.3	1.9	5.1	4.5	3.5

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

Activity and demand indicators show that the Chilean economy has moved ahead with its adjustment process, albeit more gradually than expected, which has been most evident in private consumption. The publication of the National Accounts showed a restructuring of domestic demand. On the one hand, private consumption levels in 2020-22 were about US$4.3 billion higher than previously estimated. This translated into a downward revision of national savings and a larger current account deficit, revealing bigger macroeconomic imbalances (Box I.2). In addition, the figures for the end of last year and early 2023 show that the fall in private consumption has been slower than anticipated, consistent with the reduction in local political-economic uncertainty, the recent rebound in employment and the greater use of revolving loans (figure I.12 and I.14).

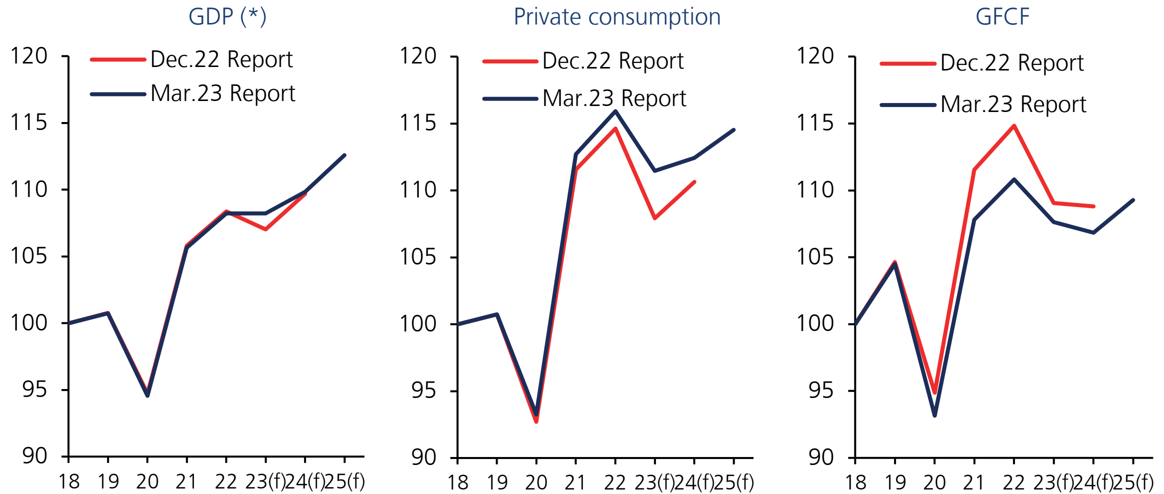
Private consumption fundamentals suggest that it will adjust further in the near future, although it will have a less marked drop in 2023 and a more moderate rise in 2024. To begin with, workers' income will remain low, with the labor market evolving in line with the expected performance of the economy. In addition, the aforementioned effect of external conditions on consumer confidence locally will also contribute to keeping consumption subdued. On the financial side, the combination of local monetary stance remaining contractionary for a longer time pan, the credit restrictions that could result from the global financial situation and the increase in the financial burden and delinquency of households, especially lower-income households, will imply greater restrictions on consumption as compared to previous quarters. This is consistent with the lower demand for consumer credit and tighter conditions in its supply reported by the latest Bank Lending Survey.

The determinants of investment suggest that its weak performance will continue this year and next. The main factor behind this is the further worsening of the external outlook, including greater uncertainty and tighter global financial conditions, as well as local monetary policy remaining contractionary for a longer period of time. This will also impact on entrepreneurs' expectations and their investment decisions. Available investment project surveys, which consider information up to the onset of global financial tensions, continue to show low levels of investment going forward. Imports of capital goods remain on the downward trend observed since the end of 2021.

The central scenario of this Report assumes that activity will see accumulated growth around 1.5% between this year and next, similar to our December forecast. For 2023, this takes into account the persistent slow adjustment of consumption, the upside surprises at the beginning of 2023 and the recent rebound in employment, which translates into a higher growth range: between -0.5% and 0.5% (between -1.75% and -0.75% in December). For 2024, there will be a downward adjustment of similar magnitude, resulting in a range between 1% and 2% (2% to 3% in December). By 2025, the economy is projected to grow in the range of 2% to 3%.

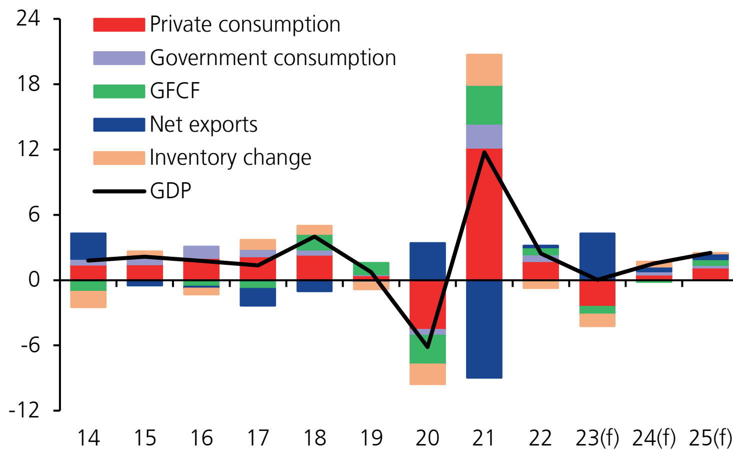
Going forward, a gradual adjustment of the economy is expected, as monetary policy tightening and a weaker boost from abroad contribute to the gradual normalization of domestic demand. This will cause private consumption to contract by -3.8% this year and grow by 0.9% next year (-5.9% and 2.5%, respectively, in December). GFCF will underperform: -2.9% this year and -0.7% in 2024 (-5.0% and -0.2%, respectively, in December). Net exports will contribute positively during 2023 and subsequent years, factoring in the production prospects of the exporting sectors —mining and others-—, the decline in imports expected for this year, as well as a lower accumulation of inventories (figure II.5 and II.6; table II.3).

FIGURE II.5 ACTIVITY AND DOMESTIC DEMAND
(index, 2018=100)



(*) For 2023, 2024 and 2025, the projections consider the midpoint of the forecast ranges of this Report.
(f) Forecast.
Source: Central Bank of Chile.

FIGURE II.6 GDP GROWTH AND AGGREGATE DEMAND COMPONENTS CONTRIBUTIONS (*)
(annual change, percentage points)



(*) For 2023, 2024 and 2025, the projections consider the midpoint of the GDP forecast ranges of this Report.
(f) Forecast.
Source: Central Bank of Chile.

TABLE II.3 ECONOMIC GROWTH AND CURRENT ACCOUNT

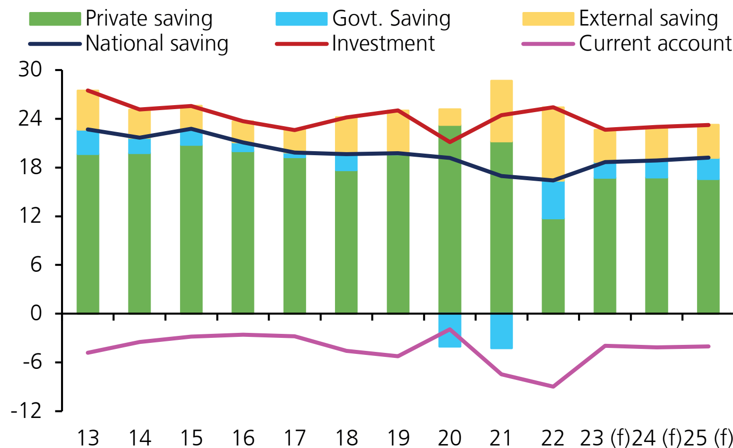
	2022	2023 (f)	2024 (f)	2025 (f)
		(annual change, percent)		
GDP	2.4	-0.5/0.5	1.0-2.0	2.0-3.0
National income	1.5	1.9	1.6	2.4
Domestic demand	2.3	-4.0	1.1	2.1
Domestic demand (w/o inventory change)	3.0	-3.0	0.7	1.9
Gross fixed capital form	2.8	-2.9	-0.7	2.3
Total consumption	3.1	-3.0	1.1	1.8
Private consumption	2.9	-3.8	0.9	1.9
Goods and services exports	1.4	4.5	3.7	2.2
Goods and services imports	0.9	-6.5	2.5	0.5
Current account (% of GDP)	-9.0	-4.0	-4.1	-4.0
Gross national saving (% of GDP)	16.4	18.7	18.9	19.2
Gross national investment (% of GDP)	25.4	22.6	23.0	23.3
GFCF (% of nominal GDP)	24.8	23.3	23.2	23.2
GFCF (% of real GDP)	23.6	22.9	22.4	22.3
		(US$ million)		
Current account	-27,102	-13,400	-14,300	-14,700
Trade balance	3,807	11,900	9,200	8,200
Exports	98,548	99,900	102,500	103,600
Imports	94,741	88,000	93,300	95,400
Services	-14,824	-11,400	-10,700	-10,900
Rent	-16,520	-14,500	-13,400	-12,600
Current transfers	434	600	600	600

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

The central scenario considers a public expenditure trajectory as described in the latest Public Finances Report (IFP). Following the contraction of fiscal spending in 2022, a slight expansion of real expenditure is anticipated this year of around 1%, reflecting the deficit position to which the actual and structural balance would return in 2023. From next year onwards, the structural balance is expected to converge in line with the aforementioned IFP.

The process of current-account adjustment will be faster than estimated in December. The current account deficit will decline to 4% of GDP in 2023 and remain fairly constant for the next two years. This responds mainly to the significant rebound anticipated for private savings to 16.7% of GDP this year (11.8% of GDP in 2022), in line with the expected adjustment in household consumption. Government savings will decrease towards levels closer to their historical averages (around 2% of GDP) and will remain around that value in 2024. This will be reflected in an improvement in the trade balance of goods and services, which will also be boosted by improved terms of trade -including higher copper prices and lower prices of imported commodities- and lower transportation costs (figure II.7).

FIGURE II.7 CURRENT ACCOUNT: SAVINGS AND INVESTMENT (*)
(percentage of annual GDP)



(*) The government saving component considers the general government balance as effective data until 2022; for 2023 to 2025, government saving from the central government balance are used as a projection.
(f) Forecast.
Source: Central Bank of Chile.

ACTIVITY GAP AND INFLATION'S CONVERGENCE TO THE TARGET

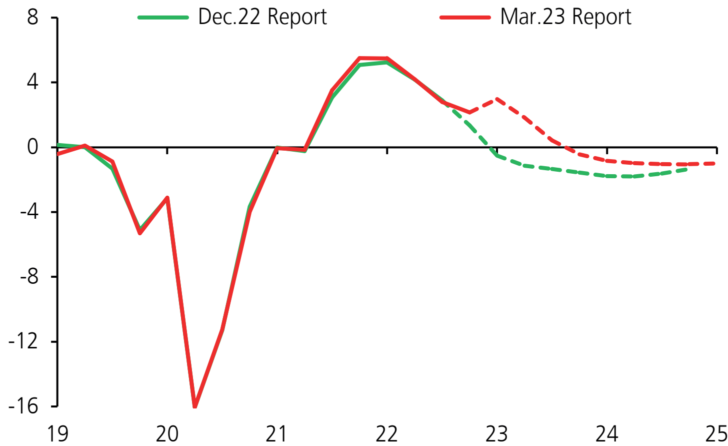
The latest National Accounts figures showed that the activity gap has continued to narrow, albeit much more slowly than expected in December. It should be noted that the downward revision of the non-mining GDP for the last quarter of 2022 reported in the new National Accounts —associated with the one-off decline in the transportation sector— had a downward impact on the activity gap for that quarter. Excluding this effect, the activity gap would have been somewhat larger, non-mining GDP would have fallen 1.5% annually (effective -2.4%) and the quarterly velocity discounting seasonality would have been 0.4% (effective -0.5%). In any case, this effect will disappear in the first quarter of this year, so the velocity of the first quarter and the annual variation of the fourth quarter will be higher, as a result of the low comparison base (Box I.2). From then on, the activity gap is expected to continue to narrow, in line with the expected adjustment in private consumption and the contractionary stance of monetary policy. Thus, towards the second half of 2023 and throughout 2024, the activity gap will be negative (figure II.8).

Our projections for headline and core inflation are revised upward, to converge to the 3% target by the end of 2024 and early 2025, respectively (figure II.9 and table II.4). The correction stems from the higher inflation records of the last few months, particularly of its core component. This is coupled with the slower adjustment in consumption reported by the National Accounts and with the activity gap taking a little longer to close. As a result, total CPI inflation will end 2023 at around 4.6% annually while core inflation will be higher and will take longer to converge to 3%.

The central scenario of this Report considers a real exchange rate (RER) for this year and 2024 that, on average, is below the forecast in the previous Report. This responds mainly to the nominal appreciation of the peso since December. It also incorporates the effect that tighter global financial conditions will have on the dollar in the near future. In any case, the pass-through of the lower exchange rate to inflation is expected

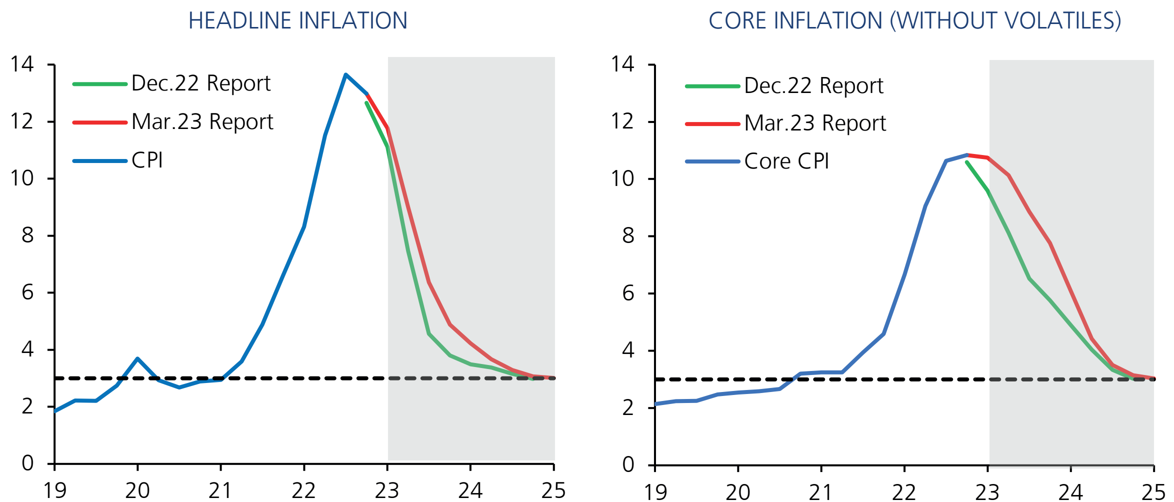
to be relatively slow. This is a phenomenon that usually occurs in episodes of currency appreciation, even more so considering that corporate margins have not recovered all the fall that it is estimated they had in previous years (Box I.3 and I.4). Our projection also considers the impact of the oil price decrease (about -8% compared to the December forecast), which will reduce the variation of the volatile component of the CPI.

FIGURE II.8 ACTIVITY GAP (1) (2)
(level, percentage points)



(1) Slashed lines show forecast.
(2) Forecast assumes structural parameters updated in December 2022 Report (trend GDP) with methodological review of potential GDP.
Source: Central Bank of Chile.

FIGURE II.9 INFLATION FORECAST (*)
(annual change, percent)



(*) Gray area, as from the first quarter of 2023, shows forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

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

	2022	2023 (f)	2024 (f)	2025 (f)
Average CPI	11.6	7.9	3.6	3.0
December CPI	12.8	4.6	3.0	3.0
CPI in around 2 years (2)				3.0
Average core CPI	9.3	9.3	4.3	3.0
December core CPI	10.7	6.9	3.1	3.0
Core CPI around 2 years (2)				3.0

(1) Core inflation is measured using the CPI without volatiles.
(2) Inflation forecast for the first quarter of 2025.
(f) Forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

SENSITIVITY AND RISK SCENARIOS

As always, the implementation of monetary policy will be contingent on the effects of new information affecting the projected dynamics of inflation. Thus, a range of sensitivity scenarios --compatible with the projected ranges for GDP growth-- are considered which may call for some change in monetary policy action, as inferred by the MPR corridor (figure II.1 and II.10). Particularly relevant will be the occurrence, magnitude and sign of new inflation surprises, as will be the evolution of consumption and of the external scenario.

The upper part of the corridor is given by sensitivity scenarios in which inflation remains high for longer, consumption continues to adjust slowly and the external scenario is more favorable than anticipated. The occurrence of this scenario would lead to the adoption of an MPR trajectory above the central scenario of this Report, which could imply maintaining the MPR unchanged throughout 2023.

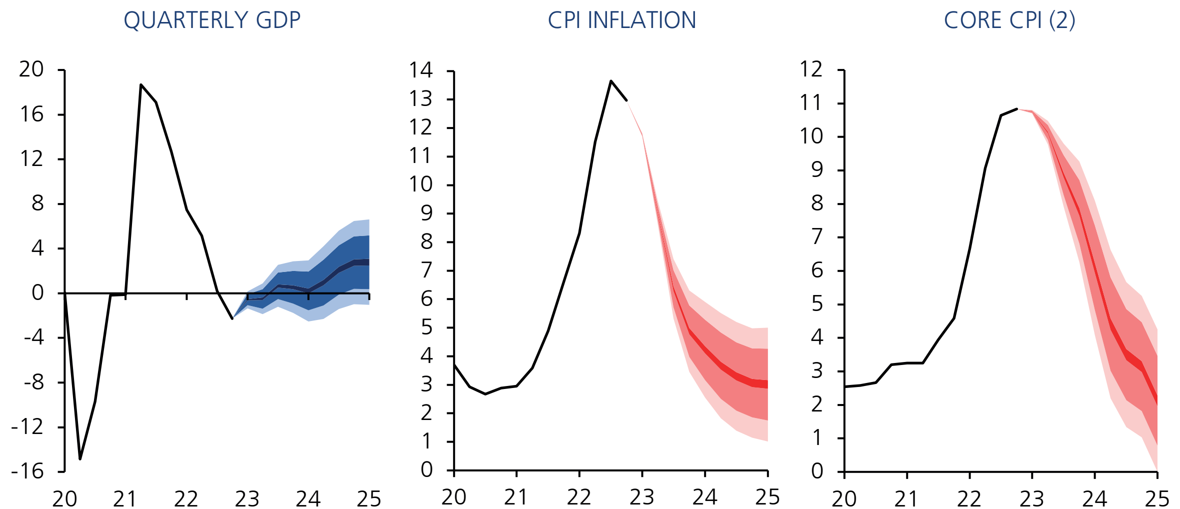
In turn, the lower part of the corridor relates to a sharper than expected deterioration of the international scenario, which would increase the perception of global risk and would have a stronger impact on activity and commodity prices. International financial markets have calmed down in recent days, but new surprises associated with U.S. banking weaknesses cannot be ruled out, especially in smaller institutions subject to lower regulatory and supervisory standards, highly exposed to corporate loans and commercial real estate portfolios. In addition, there are still risks associated with high levels of public and corporate indebtedness in China, as well as the imbalances that persist in its real-estate sector. Such a scenario would lead to a faster adjustment of our domestic economy, which could bring down inflation and the MPR sooner. It is important to point out, in this context, that the Chilean banking system faces this scenario with all banks subject to robust capital and liquidity regulation standards, in accordance with Basel III, which prevent situations such as those that affected certain banks in the U.S. and created international financial tensions.

In addition to the sensitivity exercises, we analyze scenarios where changes in the economy would be more significant and where the monetary policy reaction would overshoot the MPR corridor's limits (figure II.1).

The Board highlights the risks linked to the external scenario, which pose challenges for the management of local monetary policy and will require constant monitoring. In this sense, an abrupt and significant worsening of the global financial situation cannot be ruled out, which would entail a major economic deterioration both globally and domestically, as well as to a significant change in the medium-term inflation trajectory. This would imply faster MPR reductions than those indicated by the lower bound of the MPR corridor.

On the other hand, the inflationary problem is still present. The process of convergence to the target has not been consolidated, the economy has taken longer than expected to adjust and inflation is still very high, while core inflation has shown no declines in the past few months. The adjustment speed of private consumption has been lower than expected and some measures of inflation expectations two years ahead remain above 3%. In the event that private spending resumes more significant growth, the convergence of inflation to the target would be compromised, which would require further MPR hikes to ensure compliance with the inflation target over the two-year policy horizon.

FIGURE II.10 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).

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