MONETARY POLICY REPORT

JUNE 2023

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The Central Bank of Chile's Monetary Policy

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

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

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

The MPR is the main instrument used by the Bank to achieve the inflation target. Its level is decided at the Monetary Policy Meeting, which is held eight times a year. In practice, the MPR is a reference interest rate to determine the cost of money and other financial prices, such as the exchange rate, and longer-term interest rates, among others. In turn, these variables affect the demand for goods and services and, thereby, prices and inflation. Monetary policy decisions take several quarters to be fully reflected in the economy, which warrants that monetary policy be made from a forward-looking point of view, having as its primary focus the inflation projection two years ahead, and not just today's inflation.

Communication, transparency and the Monetary Policy Report

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

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

Cover picture: Valle de la Luna, San Pedro de Atacama.

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*/ This Report incorporates the monetary policy decision of 19 June. For the central scenario construction purposes, the statistical cut-off date is 13 June. This document was originally written in Spanish. In case of discrepancy or difference in interpretation, the Spanish version prevails.

SUMMARY

The economy has been advancing in the resolution of the macroeconomic imbalances accumulated in recent years. This has helped to reduce inflation in line with expectations, making progress in consolidating its convergence to the 3% target. In general, domestic activity and demand have evolved as expected, although with a steeper-than-expected decline in the durable component of private consumption. The central scenario projections show limited changes in magnitude. For this year, activity is expected to grow between -0.5% and 0.25%. In 2024 it will grow between 1.25 and 2.25% and between 2% and 3% in 2025. World activity began the year with greater dynamism and financial volatility has been reduced. Nevertheless, a scenario of tight financial conditions continues to be projected, in an environment where uncertainty remains high and a more contractionary monetary policy is expected in the main economies in the face of the challenge of curbing their inflation rates. The monetary policy rate (MPR) has been kept contractionary for several quarters, which has contributed significantly to bring down inflation. While inflationary risks persist, they have been balancing out. The Board believes that the most recent evolution of the economy points in the required direction. If these trends continue, the MPR will start a downward process in the short term. The magnitude and timing of its reduction will consider the evolution of the macroeconomic scenario and its implications for the inflation trajectory. The Board reaffirms its commitment to act with flexibility in case any of the identified internal or external risks comes true and macroeconomic conditions so advise.

Headline and core inflation have declined as expected, the latter by less and more slowly. The annual variation of these indicators stood at 8.7% and 9.9% respectively in May. The decline in inflation has been driven by the volatile component and the goods component, while the core services component remains high. At the same time, the different measures of inflation expectations have receded and in the two-year horizon have been aligning themselves with the 3% target.

The context for the decline in headline inflation is one in which the economy has been making progress in reducing the macroeconomic imbalances accumulated in previous years. Incoming data suggest that the activity gap has resumed its closing process in recent months, as anticipated in March. A more comprehensive look at capacity gaps shows that they have been closing for some time now (Box II.1).

In addition, cost pressures have been easing, although they remain high by historical standards. Of note are the reestablished supply chains, the normalization of global transportation costs, the decrease in external prices and the appreciation of the peso from the end of 2022. Meanwhile, headline and core inflation levels are still high, and their effects are still present in various areas of the economy. In this context, more contained cost pressures are observed in companies, as reported by the Survey of Price Determinants and Expectations (EDEP), and a trajectory towards normal values in the frequency of upward adjustments in the prices of goods (Box I.2).

In the past few months, activity and demand have evolved according to forecasts in the March Report. On the expenditure side, the main developments are concentrated in consumption. In seasonally adjusted terms, private consumption fell 2.5% quarter on quarter (q/q), more than expected and mainly explained by the 18.8% q/q decline in durable consumption. Government consumption, on the other hand, grew more than projected. In any case, the adjustment in private consumption is interpreted as an anticipation of the decline expected for this year, in line with high-frequency data, such as imports. On the supply side, the worsened performance of the mining industry stood out.

On aggregate, the performance of private consumption has been adjusting along with less dynamism in the labor market and tighter financial conditions for individuals. The composition of job creation has shifted from formal wage earners to self-employed and informal salaried occupations. Taken together, this has maintained a low job creation rate for several months. In turn, the unemployment rate rose to 8.7% in the February-April quarter and real wages remain sluggish, still affected by high inflation. Conditions for accessing credit have tightened for households (Bank Lending Survey, first quarter), while their financial burden has increased (Financial Stability Report, first half 2023).

Investment remains weak, in line with the evolution of the macroeconomic scenario. Adjusting for seasonality, gross fixed capital formation (GFCF) has remained stagnant for several quarters in its different components. Indicators such as imports of capital goods, housing sales and construction activity (Imacon), all confirm this low performance outlook.

The cumulative 12-month current-account deficit narrowed from 9% of GDP in the latter part of 2022 to 6.9% of GDP in the first quarter of this year. This fall was somewhat deeper than expected. The current-account balance improved significantly early in the year, in line with the ongoing adjustment of the economy. This affected via a decrease in imports of consumer goods, consistent with a rebound in household savings. The higher value of exports in some goods categories also contributed to this result.

On the external front, even though in the first quarter China expanded more than expected and labor markets in developed countries remained dynamic, global growth prospects remain poor. The inflationary problem persists, mainly due to the high levels of core inflation in much of the world. In developed economies, although several central banks are close to ending their rate hike cycles, market expectations suggest a more prolonged monetary contraction than anticipated in March. This is particularly noticeable in the U.S., where the dynamism of the labor market and consumption has been surprisingly strong. In the Eurozone, the most recent data points to weakness in the bloc's economy, but monetary authorities continue to signal future hikes. Going forward, tight external financial conditions —linked to inflation control— and low fiscal policy space are expected to have a negative impact on the global economy. In this sense, credit dynamics in developed countries anticipate a weak performance of activity and investment (Box I.1).

Global financial conditions remain tight, even as volatility associated with the recent bank-related tensions has diminished. With respect to the March Report, long-term interest rates have shown mixed movements, with increases in developed countries contrasting with decreases in emerging ones. Currencies have also performed unevenly, while stock markets, in general, have traded upwards. In any case, the evolution of the U.S. banking system continues to be a source of uncertainty. Market sentiment remains fragile, with doubts about the extent and magnitude of vulnerabilities in the financial system.

In Chile, the financial market has become aligned with a scenario where inflation will converge to the 3% target and the MPR will reduce its level of restrictiveness. All this has occurred in a context where the economy has further adjusted and local uncertainty has diminished. It is worth highlighting the local exchange market, whose proper functioning has allowed the Central Bank to dismantle the position of the NDF program and activate a program to hoard international reserves, aimed at strengthening the country's international liquidity position.

Projections

The central scenario projections contain minor changes with respect to the March Report. Inflation is expected to drop further, converging to the target in the second half of 2024. For December of this year, the annual variation of total and core CPI is projected to be somewhat less: 4.2% (4.6% in March) and 6.5% (6.9% in March), respectively. Both indicators will converge to 3% during 2024 and will remain there until the end of the policy horizon, i.e., the second quarter of 2025.

Core inflation will decline more noticeably towards the end of 2023 and the turn of 2024, matching forecasts in the March Report. The projections reiterate that, in the short term, services inflation will maintain monthly variations above historical averages. This incorporates the greater rigidities that these prices normally present and the impact of the still high inflation on the usual indexation mechanisms. Goods inflation, meanwhile, will benefit from a real exchange rate (RER) that will be lower than estimated in March. This is consistent with the nominal appreciation of the peso in recent months, in a context of reduced local uncertainty. Going forward, the effects of tight external financial conditions continue to be considered.

Compared to March, activity projections show minor changes, mainly associated with the performance of the mining industry. This year, the annual variation of GDP will be between -0.5% and 0.25% (-0.5 to +0.5% in March). The economy is expected to grow between 1.25% and 2.25% next year (1% to 2% in March) and between 2% and 3% in 2025 (same range in March). In this scenario, the activity gap will turn negative during the second half of 2023 and will remain at these values for several quarters.

Projections continue to assume an adjustment in spending concentrated in its imported component, especially in consumption. During this year, private consumption is expected to further decline, with a variation of -4.9% in 2023 (-3.8% in March). Going forward, the speed of adjustment of this spending component is projected to be slower than in the first quarter. The projected path for consumption considers that the labor market will perform in line with the business cycle, including worsening hiring prospects and a gradual rebound in labor participation. It also factors in consumer pessimism, tighter lending conditions and a heavier financial burden.

The drop in consumption is consistent with a recovery of household savings, after their massive use in previous years, which is a key factor in the reduction of the current-account deficit. Private savings already posted a recovery in the first quarter this year. From now on, its level will be above those of the years immediately preceding. Public savings will remain around 2% of GDP over the projection horizon, consistent with compliance with the structural balance target. The current-account deficit is expected to close this year at 3.7% of GDP, to stand at around 4% in 2024 and 2025.

In the central scenario, GFCF will maintain a low performance. This projection continues to consider the complex external scenario, with high uncertainty and still stringent financial conditions. Survey information also points to low investment levels for the coming quarters, while entrepreneurs' expectations remain pessimistic, particularly in the construction sector.

The external impulse relevant to Chile will remain moderate. However, the higher-than-expected expansion in the first quarter, particularly of China, leads to higher trading partners' growth for 2023, going from 2.4% in March to 3.0% in June. For 2024 and 2025, there is no change, with projected increases of 2.3% and 3.0%, respectively. The outlook for commodity prices is also largely unchanged. A downward trajectory is again anticipated, in line with the weakening of the international scenario.

Monetary policy

The MPR has been kept contractionary for several quarters, which has contributed significantly to bring down inflation. While inflationary risks persist, they have been balancing out. The Board believes that the most recent evolution of the economy points in the required direction. If these trends continue, the MPR will start a downward process in the short term. The magnitude and timing of its reduction will consider the evolution of the macroeconomic scenario and its implications for the inflation trajectory.

The borders of the MPR corridor reflect sensitivity scenarios where the speed of inflationary convergence leads to rate adjustments different from those in the central scenario. On this occasion, the Board believes that such scenarios are mainly associated with domestic conditions. In particular, because of the dynamics of inflation and its fundamentals.

The upper bound is defined by events in which local inflation is more persistent than expected. In this aspect, the information provided by the actual expenditure and CPI records will be key. The Board will evaluate the inflationary implications of these events, as they could mean slowing down the process of reducing the MPR. At the same time, upward inflation surprises in developed economies could call for higher international monetary policy rates, which would contribute to a depreciation of emerging currencies, including the peso. This would push up local inflation in the short term, although its impact on the MPR would be mitigated as it would imply a greater contraction in activity and spending.

The lower bound of the MPR corridor reflects a scenario where the adjustment of the Chilean economy is faster than expected, leading to an earlier convergence of inflation. Various indicators of capacity gaps suggest that inflationary pressures have been gradually contained. A scenario where such gaps become more negative than expected would lead to a more accelerated reduction of the MPR. Such could be the case if the labor market and private consumption would show a more marked deterioration.

As for risks, they are significant and emanate mainly from the global macro-financial situation. A further deterioration could trigger episodes of high volatility, reduce liquidity and encourage capital outflows away from the emerging world. This would lead to a greater than expected tightening of global financial conditions, which would cause additional restrictions for the Chilean economy, significantly reducing inflationary pressures. In such a risk scenario, more pronounced cuts in the MPR than indicated by the lower bound of the corridor would be needed.

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

	2021	2022	2023 (f) MP Rep. Mar.23	2023 (f) MP Rep. Jun.23	2024 (f) MP Rep. Mar.23	2024 (f) MP Rep. Jun.23	2025 (f) MP Rep. Mar.23	2025 (f) MP Rep. Jun.23
Average CPI	4.5	11.6	7.9	7.7	3.6	3.3	3.0	3.0
December CPI	7.2	12.8	4.6	4.2	3.0	2.9	3.0	3.0
CPI in around 2 years (2)							3.0	3.0
Average core CPI	3.8	9.3	9.3	9.1	4.3	4.0	3.0	3.0
December core CPI	5.2	10.7	6.9	6.5	3.1	3.0	3.0	3.0
Core CPI around 2 years (2)							3.0	3.0

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

(2) For March 2023 MP Report corresponds to inflation forecast for the first quarter of 2025, for June 2023 MP Report to inflation forecast for the second quarter of 2025.

(f) Forecast.

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

TABLE 2 : INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

	2021	2022	2023 (f) MP Rep. Mar.23	2023 (f) MP Rep. Jun.23	2024 (f) MP Rep. Mar.23	2024 (f) MP Rep. Jun.23	2025 (f) MP Rep. Mar.23	2025 (f) MP Rep. Jun.23
				(annual change, percent)				
Terms of trade	11.9	-7.7	2.3	1.7	-1.6	-2.4	-2.1	-3.1
Trading partners	6.7	2.8	2.4	3.0	2.3	2.3	3.0	3.0
World GDP at PPP	6.3	3.3	2.1	2.6	2.2	2.2	3.1	3.1
Developed GDP at PPP	5.3	2.7	0.3	0.5	0.3	0.3	1.8	2.2
Emerging GDP at PPP	7.5	3.7	3.2	3.8	3.3	3.4	3.9	3.7
				(levels)				
LME copper price (US$cent/pound)	423	400	385	385	365	365	350	350
Oil price, average WTI-Brent (US$/barrel)	69	97	73	75	70	71	67	68

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

TABLE 3 : INTERNAL SCENARIO
(annual change, percent)

	2021	2022	2023 (f) MP Rep. Mar.23	2023 (f) MP Rep. Jun.23	2024 (f) MP Rep. Mar.23	2024 (f) MP Rep. Jun.23	2025 (f) MP Rep. Mar.23	2025 (f) MP Rep. Jun.23
GDP	11.7	2.4	-0.5 / 0.5	-0.5 / 0.25	1.0 / 2.0	1,25 / 2,25	2.0 / 3.0	2.0 / 3.0
Domestic demand	21.7	2.3	-4.0	-4.2	1.1	1.0	2.1	2.0
Domestic demand (w/o inventory change)	18.5	3.0	-3.0	-3.3	0.7	0.8	1.9	1.9
Gross fixed capital form	15.7	2.8	-2.9	-3.0	-0.7	-1.0	2.3	2.2
Total consumption	19.3	3.1	-3.0	-3.4	1.1	1.4	1.8	1.8
Private consumption	20.8	2.9	-3.8	-4.9	0.9	1.5	1.9	1.8
Goods and services exports	-1.4	1.4	4.5	2.4	3.7	4.4	2.2	2.5
Goods and services imports	31.8	0.9	-6.5	-8.3	2.5	2.2	0.5	0.6
Current account (% of GDP)	-7.5	-9.0	-4.0	-3.7	-4.1	-4.0	-4.0	-3.9
Gross national saving (% of GDP)	17.0	16.4	18.7	19.1	18.9	18.7	19.2	19.2
Gross fixed capital formation (% of nominal GDP)	23.1	24.8	23.3	23.0	23.2	23.0	23.2	23.2

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

I. RECENT EVOLUTION OF THE MACROECONOMIC SCENARIO

In broad terms, the macroeconomic scenario has evolved in line with forecasts in the March Report. Globally, early this year activity was somewhat more dynamic than anticipated, although the outlook continues to signal weak prospects going forward. Headline inflation has declined, driven by energy and food prices, but core inflation remains high. As a result, while major central banks have moderated or halted their rate hikes, they are expected to remain contractionary for some more time. At home, activity and demand in the first quarter were in line with expectations, although the imported component of private consumption fell more than expected. Inflation returned to single digits, in both total and core measures. The current-account deficit narrowed and the labor market showed signs of slowing dynamism, consistent with the stage of the business cycle. The perception of companies and households continues to be negative, while financial burden indicators have returned to their pre-pandemic values and local financing conditions continue to be tight. In this context, agents' growth and inflation expectations have moved closer to the central scenario of this Report, which estimates that the economy is closer to resolving its misalignments in the near term.

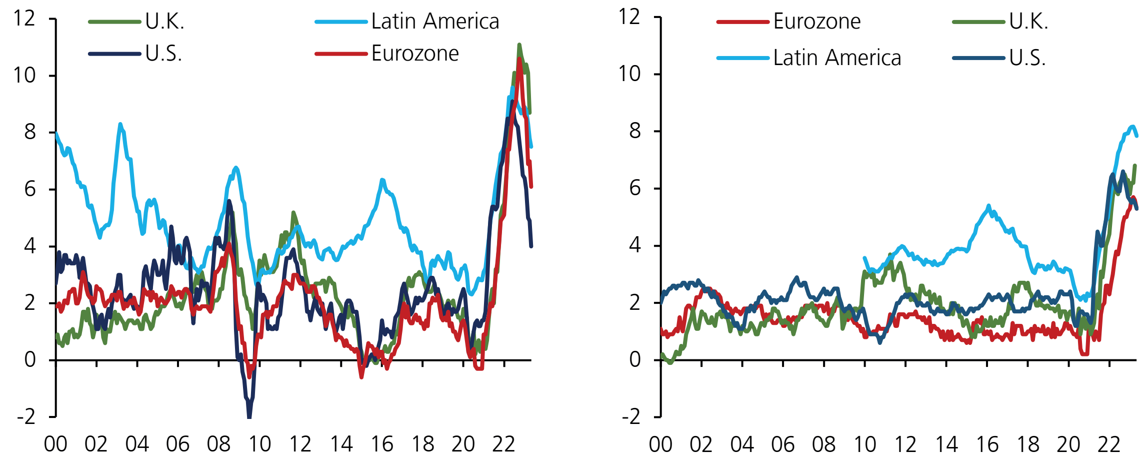
THE INTERNATIONAL SCENARIO

During the first quarter, global activity evolved heterogeneously in the main economies. Worth noting was the recovery of China, which grew more than expected during this period. This was supported by strongly dynamic services, favored by the end of the zero Covid-19 policy. In the U.S., first-quarter figures showed stronger than expected private spending, despite sluggish expansion of supply. The acceleration in goods consumption was offset by the negative contribution of inventories and by further contraction in investment, albeit at a slower pace than in previous quarters. In the Eurozone, for the second quarter in a row, activity fell slightly. This was largely explained by the fall in government spending and private consumption, associated, in part, with the deterioration of real income. Within the bloc, Germany stood out with a decline in activity for second succesive quarter. In Latin America, the figures once again showed greater resilience than expected, due to the strength of services and the labor market. In addition, there were one-off temporary factors, such as the strong dynamism of Brazil's agricultural sector.

Headline inflation has declined in several economies, driven by the prices of energy and foods. Meanwhile, core indicators remain at high levels, underscoring the risks surrounding the convergence process (figure I.1). The evolution of service prices is the main factor behind the behavior of core inflation at the global level. In developed countries, it coincides with tight labor markets, a situation that has influenced wages and, consequently, services prices. However, the market outlook for global inflation, in general, has remained largely unchanged for some months (figure I.2).

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

Headline inflation | Core inflation (2)

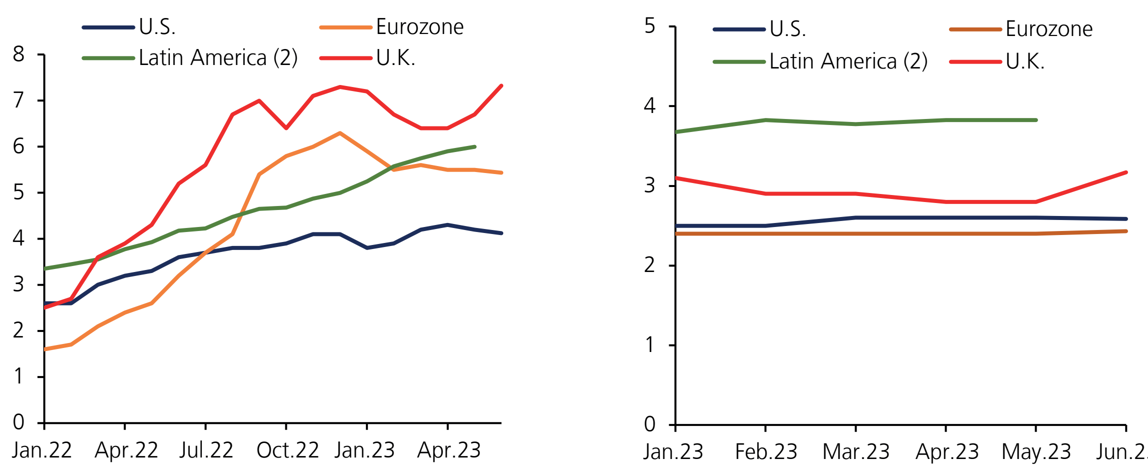


(1) For Latin America, the simple average of annual inflation of Brazil, Mexico, Peru and Colombia is used. (2) Excludes foods and energy.
Source: Bloomberg.

FIGURE I.2

Inflation forecasts for 2023 (1)
(average annual change, percent)

Inflation forecasts for 2024 (1)
(average annual change, percent)



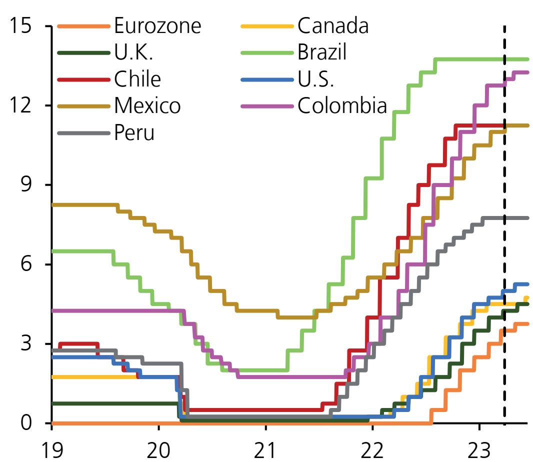
(1) For Latin America, the latest information available at the close of this Report is from May 2023. For the rest of the economies, June 2023. (2) Simple average of annual inflation as of December 2023 (left figure), December 2024 (right figure) for Mexico, Colombia, Brazil and Peru.
Source: Consensus Forecasts.

While several central banks may be nearing the end of their rate hike cycles, the markets expect monetary tightening to be more protracted in the developed world, especially in the U.S. At its June meeting, the U.S. Federal Reserve (Fed) paused its rate hike cycle and emphasized that future decisions will be conditional on incoming information. Likewise, its authorities have ruled out cuts for this year, in line with a gradual reduction in inflation, and the FOMC's projections point to additional increases in the next meetings and a higher terminal rate than was communicated in March (figure I.3). The European Central Bank (ECB), on the other hand, reduced the pace of hikes, although its authorities have continued to communicate the need for additional increases. Recently, the central banks of Australia and Canada surprised the market with unexpected rate hikes in response to higher-than-expected inflation and activity figures. In Latin America, most monetary authorities halted increases, with the exception of Colombia, where headline inflation has fallen more slowly and core inflation has continued to rise.

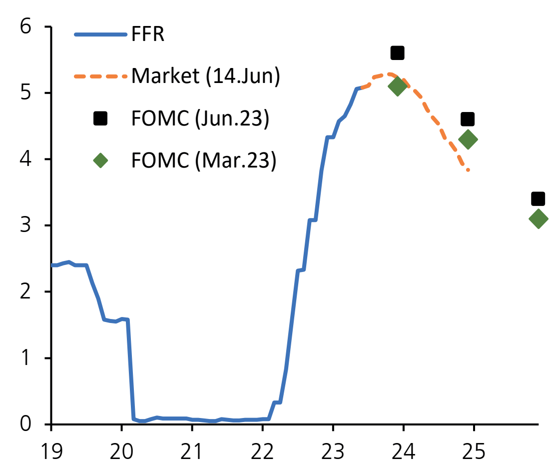
In this context, global financial conditions remain tight (figure I.4). In recent months, the volatility associated with tensions in the banking system experienced in March subsided. With respect to the March Report, and considering the 10-day average prior to the statistical closure of this Report, long-term interest rates have risen moderately in developed economies, while the dollar has been stable (figure I.5). Stock markets have shown gains, reflecting a reduction in risk aversion linked, in part, to the containment of banking tensions and the good performance of the U.S. technological sector. Brazil stands out with a significant reduction in inflation and monetary policy expectations. All in all, interest rates, risk premiums and the global dollar remain high by historical standards.

FIGURE I.3

Monetary policy rates (1)
(percentage points)

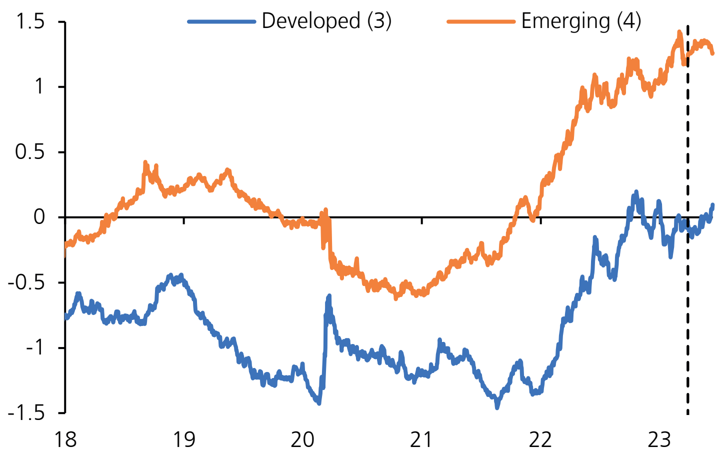


Fed funds rate (2) (3)
(percentage points)



(1) Dashed vertical line marks statistical closure of the March Report (3/29). (2) FOMC projections correspond to the mid-range of the fed funds rate presented in June 2023 and March 2023, while Market corresponds to mid-range of fed funds rate futures as of the date of the Fed's June meeting (6/14).
Sources: Bloomberg and Federal Reserve.

FIGURE I.4 GOLDMAN SACHS FINANCIAL CONDITIONS INDEX (1) (2)
(standard deviations)

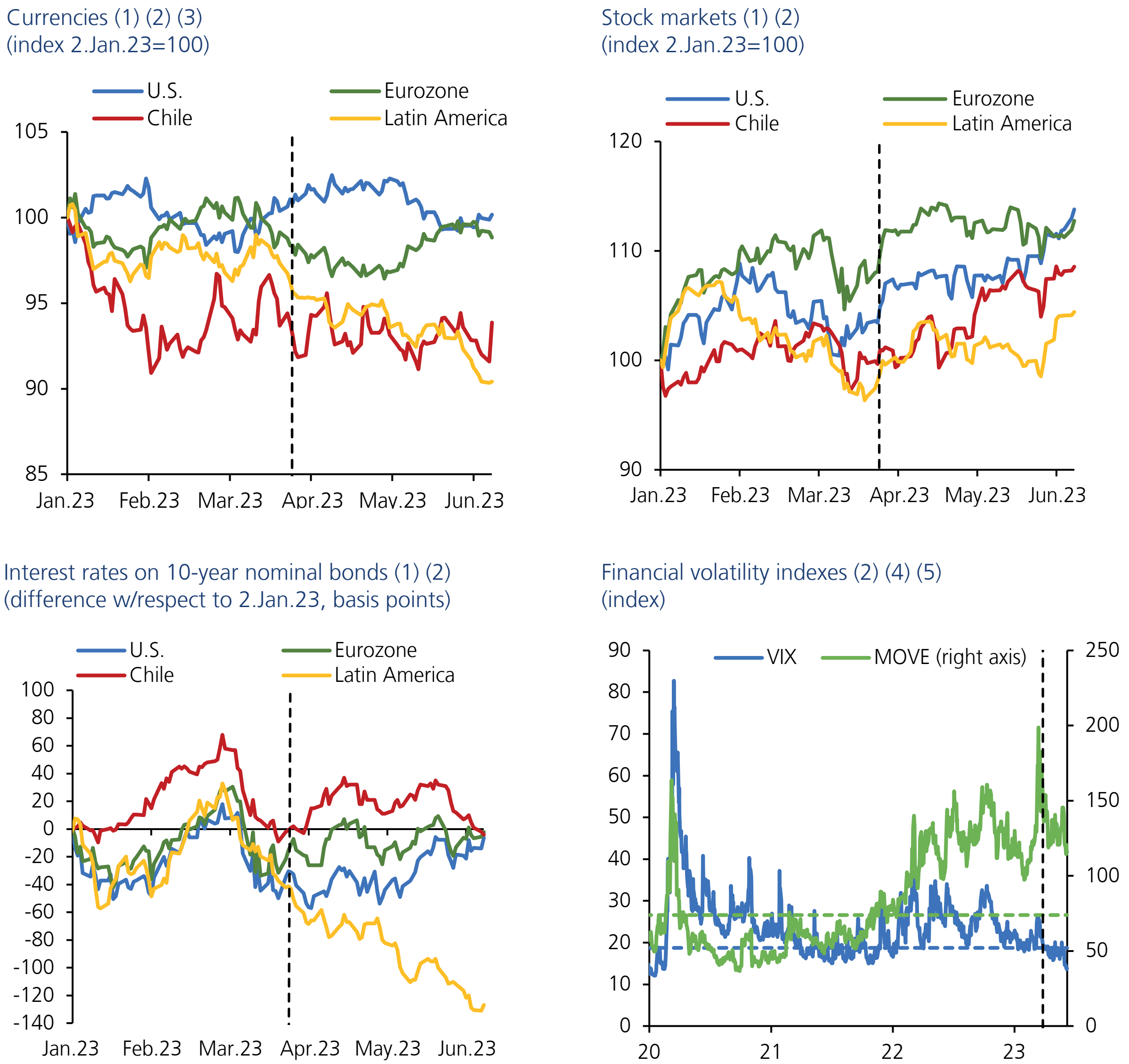


(1) Standard deviations with respect to historical average, calculated since 2007. (2) Dashed vertical line marks statistical closure of March Report (3/29). (3) Average of the U.S., Eurozone, United Kingdom, Canada, Australia, New Zealand, Norway and Sweden. (4) Average of Thailand, Malaysia, Indonesia, South Africa, Czech Republic, Hungary, Brazil, Mexico and Chile.
Source: Bloomberg.

Regarding the outlook for activity, the better start to the year in some economies is reflected in improved projections for 2023. However, expectations remain weak, consistent with unfavorable financial conditions, high inflation and external uncertainty (figure I.6). In China, recent signs suggest that the dynamism associated with the recovery following the reopening was transitory. Confidence indicators are still weak, in the midst of high unemployment among the young population. Furthermore, vulnerabilities in the real-estate sector will continue to affect investment, in a scenario of high debt in the country, which limits economic policy responses. All this foreshadows weak domestic demand dynamism. In the U.S. and the Eurozone, the tightening of credit conditions, derived from the contractionary monetary policy and the banking tensions that occurred in March, augurs less dynamic investment and consumption (box I.1). In Latin America, in addition to the deterioration of financial conditions, there are stress factors in several economies, which explain the unfavorable expectations for the region. In this context of global fragility, and given the fiscal consolidation process, public spending is not expected to be an important source of economic momentum.

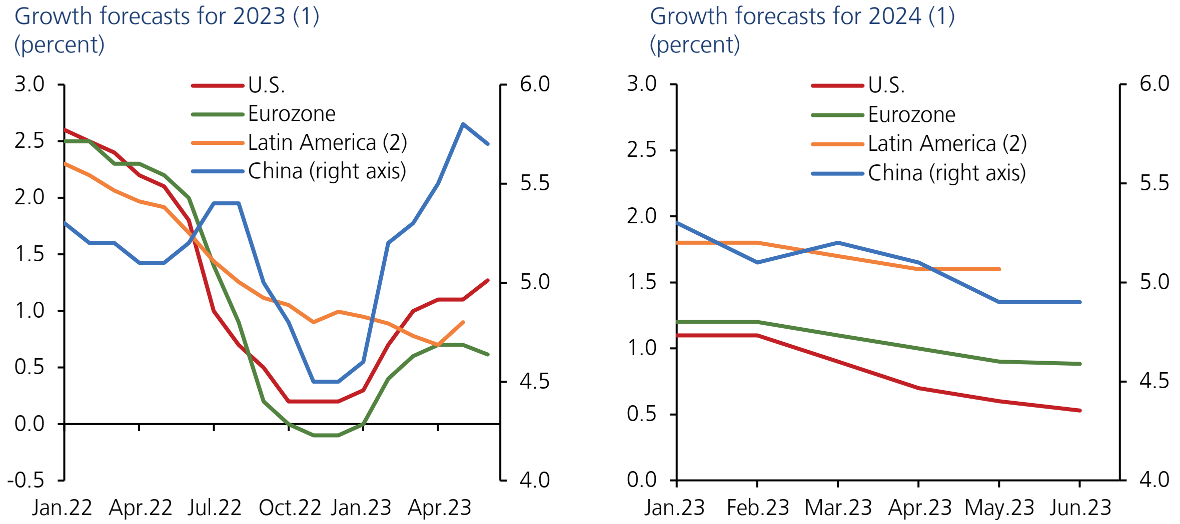
In the developed world, uncertainty persists regarding the magnitude and extent of latent vulnerabilities in the financial sector, for both banking and non-banking institutions, in a scenario of high interest rates and reduced liquidity. In the U.S. and the Eurozone, swift action by the authorities helped contain the pockets of financial stress that emerged from March onwards. Nevertheless, market sentiment remains fragile regarding the banking situation in these countries. In the U.S., greater uncertainty was added during the debt ceiling discussion period, which had an impact mainly on short-term rates and CDS in that country, an effect that dissipated after the agreement was reached. This was compounded by doubts about the Fed's upcoming monetary policy decisions. In this context, the risks of abrupt asset price corrections and capital outflows, especially from emerging economies, continue to be significant. There are also global vulnerabilities associated with these events, as discussed in the Financial Stability Report for the first half of 2023.

FIGURE I.5 FINANCIAL CONDITIONS



(1) For Latin America, the simple average of Brazil, Mexico, Colombia and Peru is used. (2) Dashed vertical line marks statistical closure of March Report (3/29). (3) An increase in the index denotes a depreciation of the respective currency and vice versa. (4) The VIX index measures the implied volatility of one-month options on the S&P500 in the U.S. The MOVE index measures the implied volatility of options on the U.S. Treasury bond with different one-month durations. (5) Dashed horizontal lines show historical averages of each index between 2015 and 2023.
Sources: Central Bank of Chile and Bloomberg.

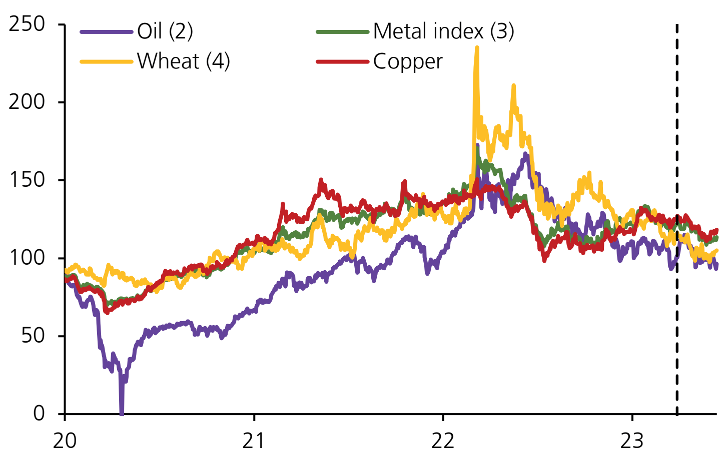
FIGURE I.6



(1) For Latin America, the latest information available at the close of this Report is from May 2023. For the rest of the economies, June 2023. (2) Considers Brazil, Argentina, Peru, Colombia and Mexico. PPP-weighted growth, shares of each economy according to WEO (IMF).
Sources: Consensus Forecasts and IMF.

Commodity prices have generally declined since the last Report, reflecting weak global growth prospects and concerns about China's performance (figure I.7). In the case of copper, although the market remains tight, its price has been dominated by uncertainty regarding global activity. Thus, at the close of this Report, it had dropped to around US$3.8 per pound (-6% since the last Report). Regarding oil prices, the expectations of a slowdown in activity and the production cuts announced by OPEC+ in the last few months have had opposite impacts. At the close of this Report, the WTI-Brent average was around US$73 per barrel, unchanged from the March statistical closure. Food prices, in general, have continued on their downward trend. Last May, the FAO index fell by 21% annually, with significant declines in vegetable oils, cereals and dairy products. In contrast, meat prices have continued to rise in recent months.

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



(1) Dashed vertical line marks statistical closure of the March Report (3/29). (2) WTI-Brent average. (3) S&P GSCI Industrial Metals. (4) One-month futures price.
Source: Bloomberg.

THE DOMESTIC SCENARIO

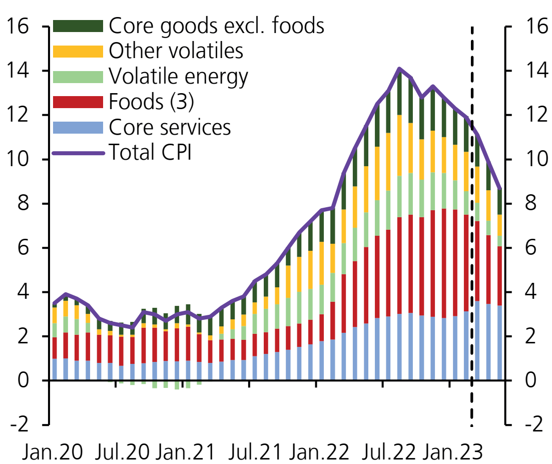
Local inflation has declined as expected. In May, headline inflation reached 8.7% annually and core inflation —measured by the CPI minus volatile items— reached 9.9% annually (figures I.8 and I.9). The fall in total inflation in recent months has been driven by the reduction in the volatile component. Of particular note are food prices, whose annual rate of change has declined in the last five months. Fuel prices have also continued to decline. Meanwhile, the adjustment in electricity rates applied in April was reflected in a rise in energy prices during that month.

Goods prices have also contributed to bring down headline inflation, which posted new drops in annual terms. This occurs in a context of adjusting goods consumption in recent months, lower internal and external cost pressures and a gradual pass-through of the lower exchange rate levels, which also contributed to the fall in the inflation of imported fuels and foods (figure I.10). In the May Business Perceptions Report (IPN), although businesses continued to perceive their costs as high, some reported falls in international transportation fares and in the prices of certain inputs and foodstuffs. In addition, there are more limited cost pressures at companies, according to the Survey of Price Determinants and Expectations (EDEP), and a trend towards normal values in the frequency of upward repricing of goods (box I.2).

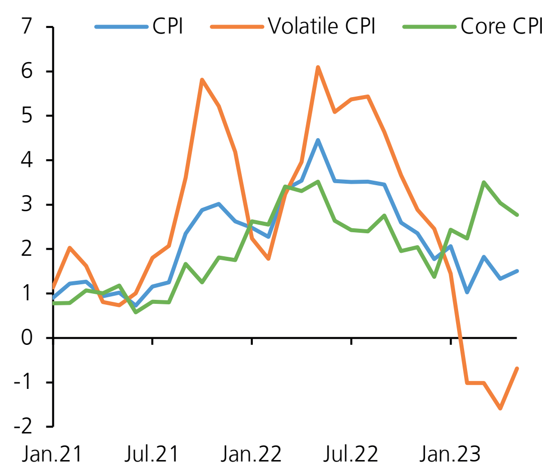
Nonetheless, core inflation remains high, especially influenced by high prices of services (figure I.9). The annual variation of the latter has increased since the March Report, mainly in administered and indexed items. This is partly linked to the adjustments of prices and rates that usually take place in March. In annual terms, the prices of other services have continued to moderate so far this year, although their rates of change remain high.

FIGURE I.8

Inflation indicators (1) (2)
(contributions to annual change, percentage points)



Cumulative inflation in moving quarter
(quarterly cumulative change, percent)

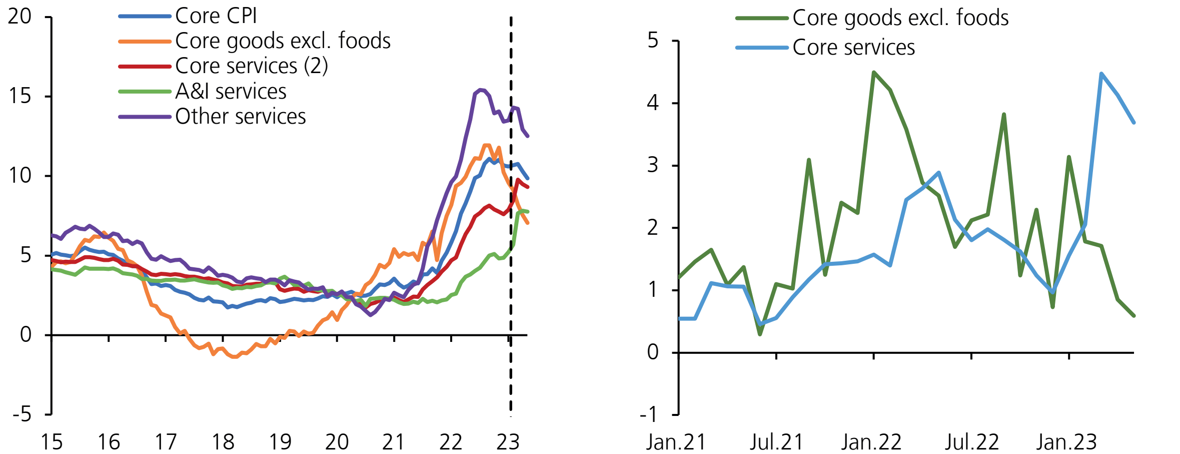


(1) Dashed vertical line marks statistical closure of the March Report (3/29). (2) For details on the different groupings and their shares in the total CPI basket, see Box IV.1 in December 2019 MP Report, Carlomagno and Sansone (2019) and Economic Glossary.
(3) Volatile and non-volatile foods added together.
Sources: Central Bank of Chile and National Statistics Institute.

FIGURE I.9

Core inflation (1)
(annual change, percent)

Cumulative inflation in moving quarter
(quarterly cumulative change, percent)

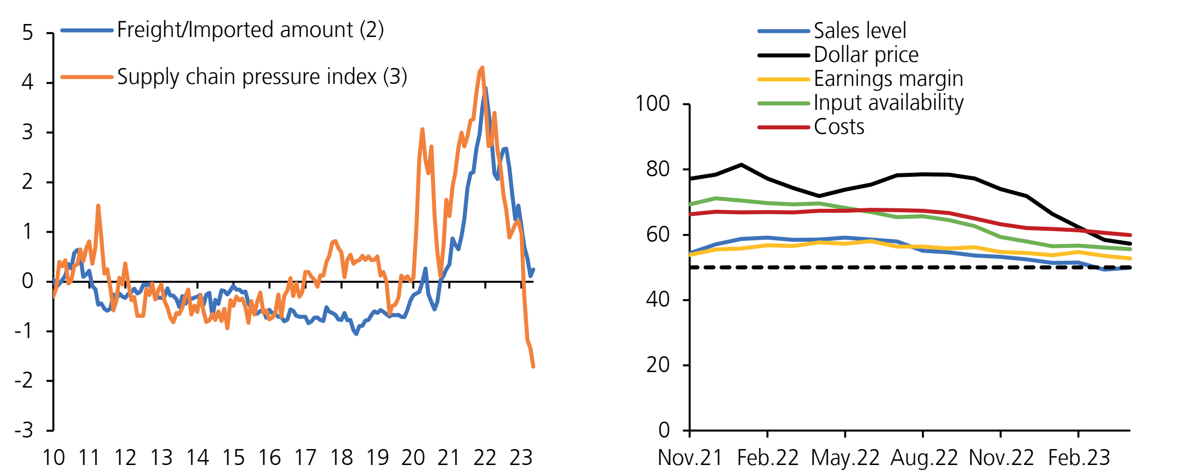


(1) Dashed vertical line marks statistical closure of the March Report (3/29). (2) Considers sum of Administered & indexed services and Other services.
Sources: Central Bank of Chile and National Statistics Institute.

FIGURE I.10 COST PRESSURES

Transportation costs and bottlenecks (1)
(standard deviations)

EDEP: Influence of factors on the price of the main product or service in the past three months (4)
(diffusion index)

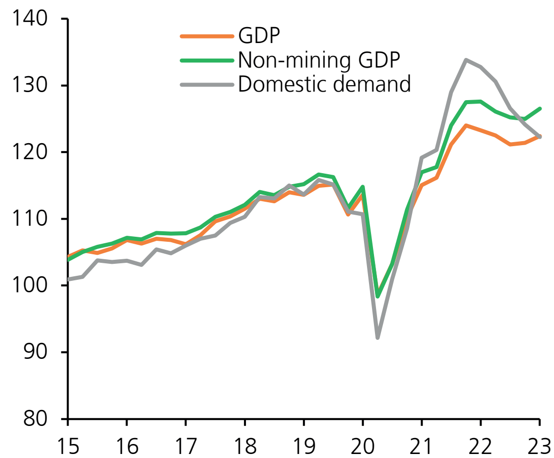


(1) Standard deviations from average. (2) This study is carried out within the scope of the research agenda of the Central Bank of Chile (BCCh) on economic and financial matters within its competence, in the framework of which the BCCh has access to unnamed information from various public and private entities, under cooperation agreements signed with these institutions. (3) For more details, see Global Supply Chain Pressure Index. (4) Values above 50 represent increases and below 50, decreases.
Sources: Central Bank of Chile using microdata of Chile's National Customs Service, NY Federal Reserve and Central Bank of Chile.

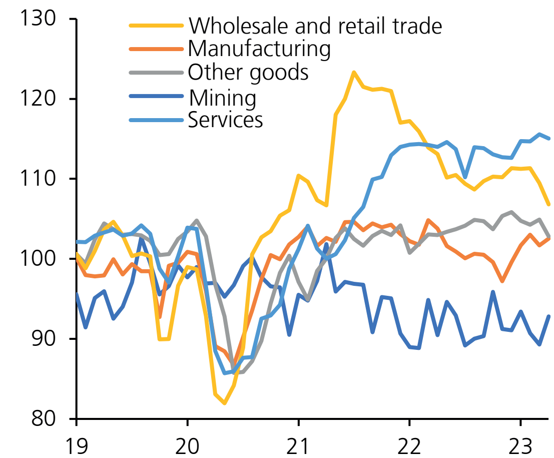
In terms of activity and demand, the economy has been making progress in its adjustment process, especially by reducing the high levels of spending that were verified in 2021 and part of 2022 (figure I.11). According to first quarter National Accounts data, seasonally adjusted, domestic demand fell 1.5% with respect to the previous quarter (-8.0% in an annual comparison, original series). Total GDP and non-mining GDP grew in their deseasonalized series (0.8% and 1.2%, respectively), mainly due to a transitory accounting effect in the transportation sector (see Revisions to economic activity figures: GDP and Imacec). This had already been anticipated in the March Report. By annual variation, both had a 0.6% drop. By sectors, the good results of personal services, restaurants & hotels, manufacturing industry and fishery during the first quarter stand out. In contrast, wholesale and retail trade has continued to adjust and construction continues to underperform. Both activity and total demand performed in line with expectations for the first quarter.

FIGURE I.11

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



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

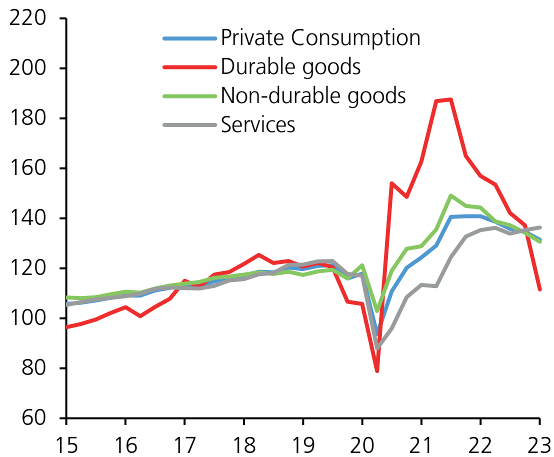


Source: Central Bank of Chile.

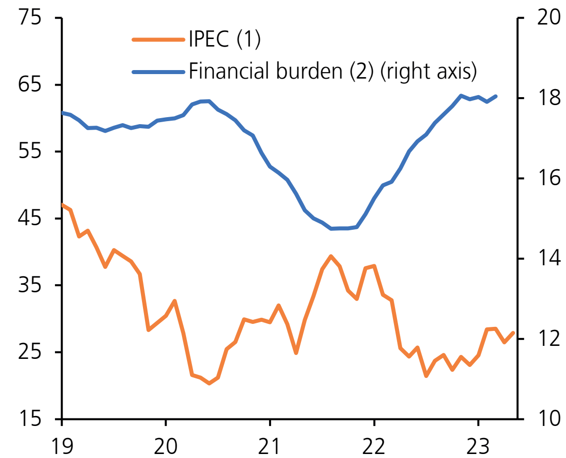
Private consumption of goods saw a significant drop in the first quarter, mainly in its imported component (figure I.12). In the first quarter of 2023, private consumption fell 2.5% quarterly in its deseasonalized series (-1.5% on average in the three preceding quarters) and posted an annual variation of -6.7%. This responded especially to a notorious decrease in the consumption of durable goods (-18.8% q/q), mostly imported. Non-durable goods consumption had a more limited decrease (-2.7% t/t). On the other hand, consumption of services continued to grow: +0.8% in quarterly comparison. The context for all this is that several of the fundamentals of consumption continue to show signs of weak dynamism. The Economic Perception Index (IPEC) shows that households continue to have a negative assessment of the economic situation, which adds to the significant increase in their financial burden, which is already back to pre-pandemic levels. Moreover, consumption components are evolving in such a way that only the highest income quintile has increased its consumption in recent months, and they are the ones who usually consume a greater proportion of their income in services (box I.3). All in all, some recent indicators —car sales (ANAC), digital invoiced sales and Transbank— show signs of a smaller drop in consumption in the second quarter.

FIGURE I.12

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



Households' perception of the economy and financial burden
(index; percent of monthly income, moving annual avg.)



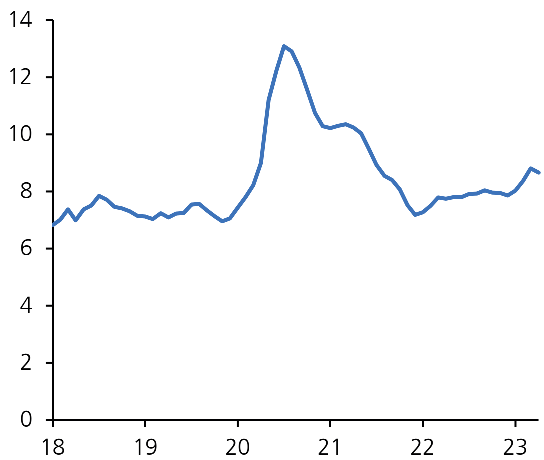
(1) A value above (below) 50 denotes optimism (pessimism). (2) Financial burden of median debtor. Monthly income includes labor component (salaried formal employees) and pension withdrawals prorated over six months from receipt of payment.
Sources: Central Bank of Chile, CMF and SUSESO.

The labor market has lost dynamism, in line with the business cycle. The unemployment rate was 8.7% in the moving quarter ended in April. In net terms, the number of employed has not changed significantly since the end of 2022. However, there has been a shift towards an increase in self-employment (figure I.13). Real wages have continued to recover, but remain below their level prior to the start of the inflationary cycle. This happens in a context of low demand for workers, according to the Online Job Postings Index (IALI), and where the labor force shows a gradual recovery of the labor supply. This coincides with the companies' perception of an increase in labor market slack, as reported in the May Business Perception Index (IPN). In terms of staffing, companies again reported below-normal levels. In addition, according to the Monthly Business Confidence Index (IMCE), they are pessimistic about their short-term employment situation.

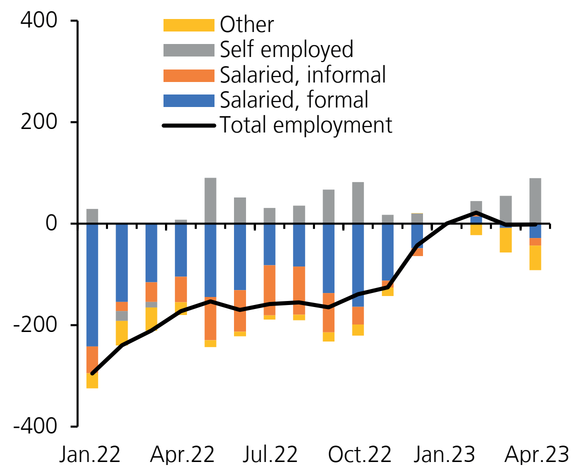
Investment continues to underperform (figure I.14). During the first quarter, seasonally adjusted GFCF fell by -0.9% compared to the previous period. This decline was reflected both in construction and other works and in machinery and equipment, which showed quarterly variations of -0.2% and -1.9%, respectively. The above is consistent with the weakness of construction, as reflected in the activity data of the National Accounts, the Construction Activity Indicator (Imacon) and the decline in capital imports since mid-2022. As for perceptions, companies continue to evaluate the economic outlook negatively (IMCE). In fact, the Business Perceptions Survey (EPN) for May reflects a decrease in the proportion of companies that plan to make investments this year, although, among those that do plan to invest, there is greater certainty regarding their execution.

FIGURE I.13

Unemployment rate
(percent)



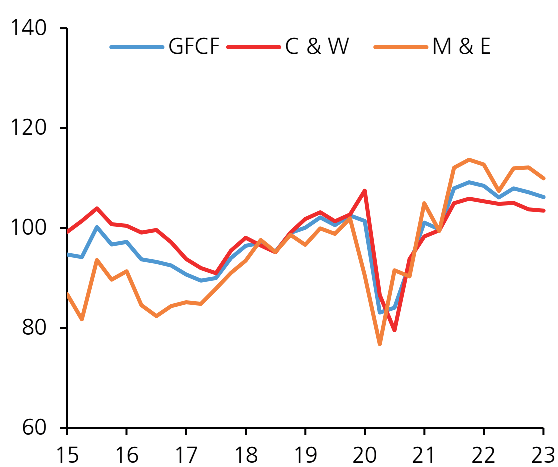
Employment by occupational category
(difference with respect to Jan.2023)



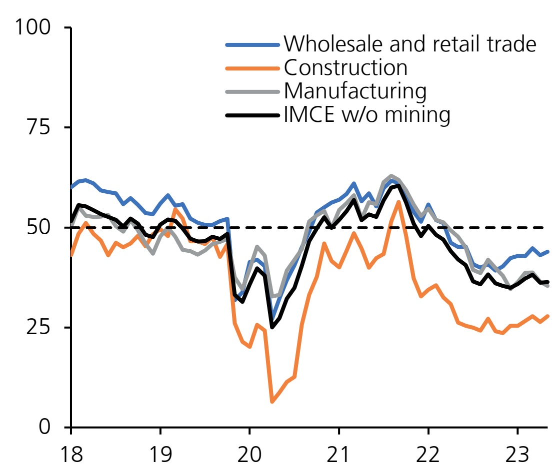
Source: National Statistics Institute.

FIGURE I.14

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



IMCE (*)
(diffusion index)

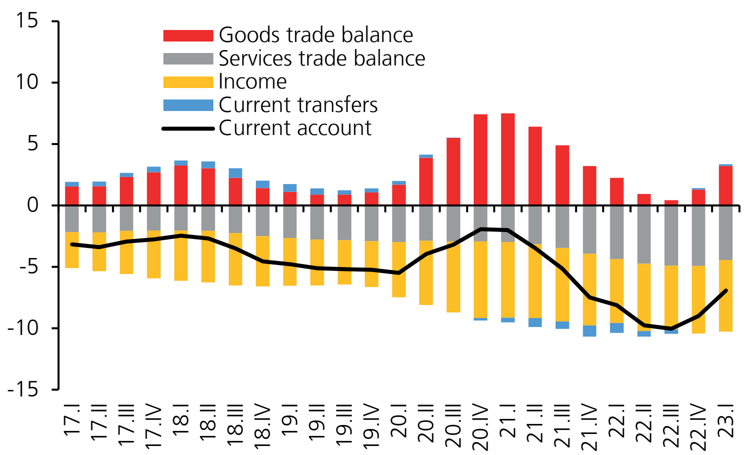


(*) Value above (below) 50 indicates optimism (pessimism).
Sources: Central Bank of Chile and UAI/ICARE.

Government consumption increased significantly during the first quarter. According to National Accounts data, seasonally adjusted, this component of expenditure grew by 5.4% in a quarterly comparison. According to data from the Public Finances Report (IFP) for the first quarter, this is associated with a budget execution above the average of recent years, which would be partly related to a higher provision of education and healthcare services during the quarter. The central scenario of this Report continues to assume that fiscal spending will be in line with the aforementioned Report, which kept the fiscal spending forecast for 2023 at 25.0% of GDP.

In the first quarter, the current-account deficit fell by more than expected (figure I.15). On a cumulative annual basis, this fell to 6.9% of GDP in said period (-9.0% in the previous quarter). The improvement in the balance of the trade balance for goods was key to this decline, mainly due to higher prices of some exported products and lower imports of goods that have accompanied the adjustment of household consumption. The evolution of the latter has been counterbalanced by a rebound in private savings, which has allowed for a gradual recovery of the savings-investment balance. Government saving remains high, but below the levels it reached in 2022. This responds partly to the revenues associated with property tax revenues from lithium mining, which, according to the first quarter IFP, are expected to remain high for the remainder of the year.

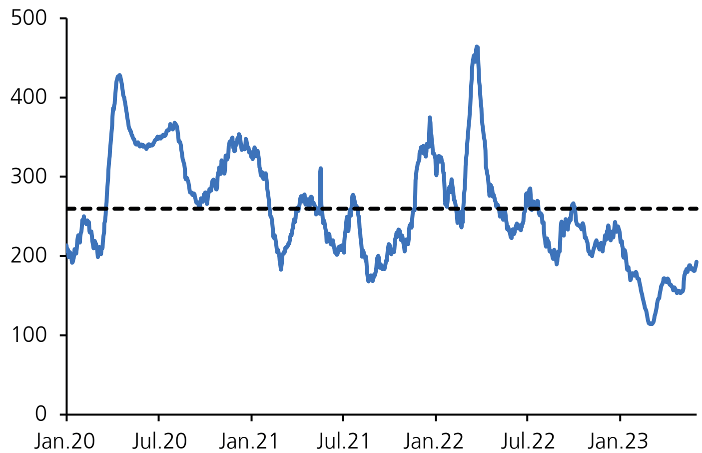
FIGURE I.15 CURRENT ACCOUNT AND CONTRIBUTIONS BY COMPONENT
(percent of GDP, moving annual sum)



Source: Central Bank of Chile.

The local financial market has matched global trends and internalized the BCCh's announcement of reserve buildup, although with more contained movements than its international peers (figure I.5). This has occurred in a scenario where local uncertainty has receded with respect to a year ago (figure I.16). In this context, the exchange rate is at levels in the order of $800 per dollar, accumulating a drop of close to 25% from its highs of 2022. Considering the average of 10 business days prior to the close of this Report, short-term rates are somewhat below those of the end of March, in line with local macroeconomic adjustments. Long-term rates, in turn, exhibited limited increases and the IPSA has posted gains of close to 8% since then.

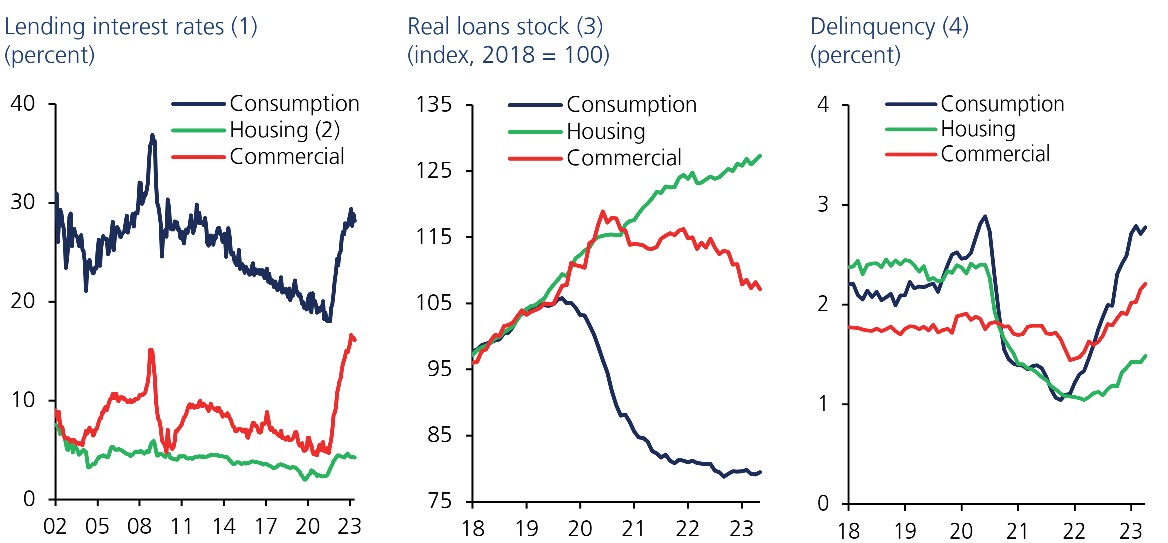
FIGURE I.16 INDEX OF ECONOMIC UNCERTAINTY (DEPUC) (*)
(index)



(*) Dashed horizontal line indicates average index between 2020 and 2023.
Source: Central Bank of Chile.

Financial conditions remain restrictive (figure I.17). The first-quarter 2023 Bank Lending Survey reports that the supply of credit is still constrained for households and businesses. This is consistent with the tightening of lending standards reported by firms in the May IPN. Annual nominal rates on consumer and commercial loans remain high. In May, they averaged 28.2% and 16.1%, respectively, reaching 4.2% for UF-indexed mortgage rates. The stock of real loans continues to be low in all three portfolios, in line with the business cycle. In addition, real flows of bank loans have declined so far this year, while credit risk has continued to increase, which is reflected in the notorious upward trend in non-payment rates among households and firms, and in the increase in bank provisions (see Financial Stability Report, first half 2023).

FIGURE I.17

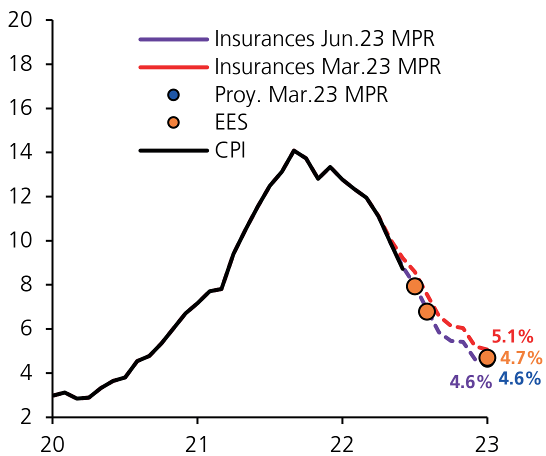


(1) Weighted average rates of all operations performed in each month in the Metropolitan Region. (2) UF-denominated loans. (3) Real data built with spliced CPI in 2018 annual base. (4) 90-days-or-more delinquency indicator, based on locally consolidated financial statements.
Source: Central Bank of Chile based on CMF information.

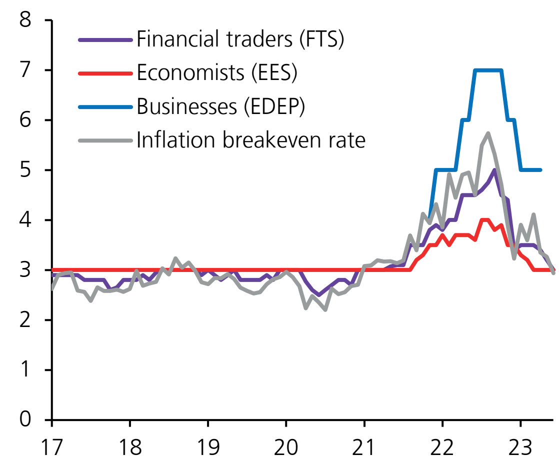
Inflation expectations have continued to decline and are approaching 3% in the two-year horizon (figure I.18). According to both the June Economic Expectations Survey (EES) and the Financial Traders' Survey (FTS) prior to the June monetary policy meeting, specialists expect inflation over the two-year horizon to stand at 3.0% (3.0% and 3.5% prior to the March Report, respectively). In addition, the EES also places non-volatile CPI inflation at 3.0% in the same period. Meanwhile, breakeven inflations yield two- and five-year inflation expectations of 2.9% and 3.1%, respectively[1]/. Meanwhile, according to the EDEP, companies maintain their expectations above the rest of the agents (5.0% in two years), which is usual and in line with what has been documented in other economies (see box I.5 in March 2023 Report). For the remainder of 2023, insurance companies reflect a downward adjustment in the expected evolution of inflation and anticipate that its annual variation will be 4.6% by December, equal to our forecast in the March Report and close to what is expected by the respondents to the EES survey (4.7%).

FIGURE I.18

Actual and expected annual inflation (1)
(annual change, percent)



Two years inflation expectaction on surveys (2) (3) (4)
(annual change, percent)



(1) Inflation insurances consider the average prices of 10 days at the statistical closure of each MPR (March MPR: March 30th; June MPR: June 13th). (2) Shows median responses. (3) 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. (4) Breakeven inflation considers averaged prices of the last 10 days of each month. For June 2023 it takes into account the average of the last 10 days prior to the statistical closure of this Report.
Source: Central Bank of Chile.

Growth expectations reflect better prospects for the short term and somewhat worse for the medium term. The median of the June EES responses foresees -0.5% growth in 2023. For 2024, it stands at 2.0% (-0.8% and 2.1% in the March version, respectively). The projections included in the May Consensus Forecasts depict a similar picture, with growth of -0.3 and 2.0% for this year and next.

At the statistical closure of this Report, the expected trajectories of the monetary policy rate (MPR) anticipated that the first cut would be made at the July monetary policy meeting (table I.1). The EES and FTS surveys, as well as the expectations implicit in the overnight index swap (OIS) anticipated a very similar trajectory for the remainder of the year and agreed that the MPR would be reduced by 50bp in the July meeting. All three indicators anticipated that during the second half of 2023 the rate would fall consecutively to around 8.25% and 8.5% in December and between 3.75% and 4.5% at the end of the monetary policy horizon.

[1]/ At two years, it corresponds to breakeven inflation 1 in 1. At five years, it is 3 in 2. In both cases, it corresponds to the average of 10 days prior to the statistical closure.

TABLE I.1 MPR EXPECTATIONS
(percent)

	Jun.23	Jul.23	Sep.23	Oct.23	Dec.23	Jun.25
Swap curve (*)	11.25	10.75	10	9.5	8.25	3.75
June EES	11.25	10.75	-	9.25	8.5	4.5
FTS before June MPM	11.25	10.75	10	9.25	8.25	4.5

(*) Uses average prices over the last 10 days prior to the statistical closure of this Report.
Source: Central Bank of Chile.

BOX I.1:

Bank credit evolution and outlook in developed economies

Financial conditions for businesses remain tight in developed economies due to high interest rates. Thus, in recent months, credit to companies has declined. At the same time, their fundamentals and leading indicators suggest that such declines will intensify. These dynamics anticipate a weak performance of investment and activity in the developed world, which is one of the arguments that justify the poor performance foreseen for them in the central scenario of this Report. Furthermore, the resilience of the labor market and consumption in some developed economies, including the U.S., keeps open the possibility that central banks will have to adopt a more contractionary monetary policy and, moreover, financial conditions are likely to tighten further.

In the U.S., lending conditions for companies remain tight. This is so even though the authorities' response, including agreements reached with other private banks to address the fragilities of other banks, seems to have defused the most acute tensions in the financial markets. In fact, bank lending to companies has shrunk following the crash of Silicon Valley Bank. Although bank financing for companies is less significant in the U.S. than in other developed economies, the importance of this credit increases considerably for small and medium-sized companies, which account for around 50% of private employment in the country. At the same time, the rates on corporate bond, the most important source of funds for large-scale companies, have been high for almost a year, and that had not been observed in a sustained manner since the Global Financial Crisis. This has occurred although corporate spreads have not risen as high as they have in episodes of financial stress in the past (figure I.19).

Bank credit performance depends on several factors, such as economic activity, monetary policy, banks' perception of risk and banking regulation.[1]/ Over the past year, all these factors have moved in the direction of anticipating that the declines in bank credit to corporations will intensify. Recent bank lending surveys in the U.S. and the Eurozone foresee that corporate credit will continue to fall due to both demand and supply factors. These are associated with tight monetary policy and increased risk perception by banks. This anticipates a weak performance of investment and, consequently, of economic activity in those economies (figure I.20).

By contrast, consumption and the labor market have shown greater resilience in several economies, among which the U.S. stands out again. Several factors could explain this behavior, most notably the improvement in the financial position of households during the pandemic. This could require higher real interest rates to ensure inflationary convergence and, therefore, a further deterioration of financial conditions for companies, which will further undermine investment and growth. This Report considers a sensitivity scenario in which central banks in developed economies must raise their monetary policy rates above what the market expects and the path they themselves have conveyed as the most likely. The monetary policy response by the Central Bank of Chile to this alternative scenario is contained within the MPR corridor of this Report.

New episodes of financial turbulence cannot be ruled out and their materialization will have an even greater impact on financial conditions for businesses and activity in developed economies. Despite some greater financial calm in recent months, the vulnerabilities of the global financial system will remain in place as long as interest rates remain high or have to rise further in the face of persistently high core inflation. Thus, the share prices of several U.S. regional banks have remained 40% to 50% lower than at the beginning of the year, while their bond rates are still high by historical standards, reflecting that their associated risks are still present (figure I.20). At the same time, other vulnerabilities and financial stability risks persist worldwide, whose materialization cannot be ruled out given the current context of liquidity withdrawal and high rates.[2]/

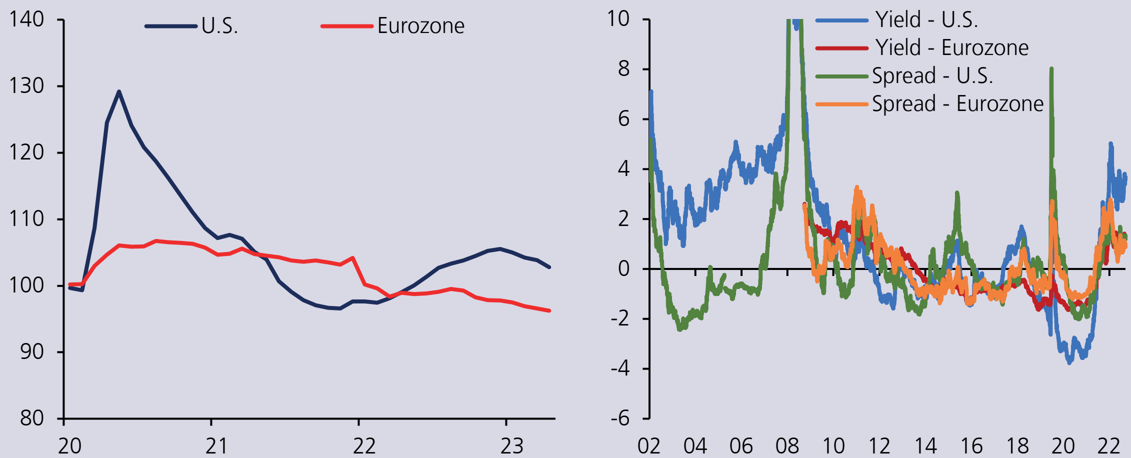
[1]/ Balke *et al.* (2021).

[2]/ See Financial Stability Report, first half 2023.

FIGURE I.19

Stock of real bank credit to non-financial companies
(index, Dec.19=100)

Corporate spreads and yields (*)
(standard deviations)

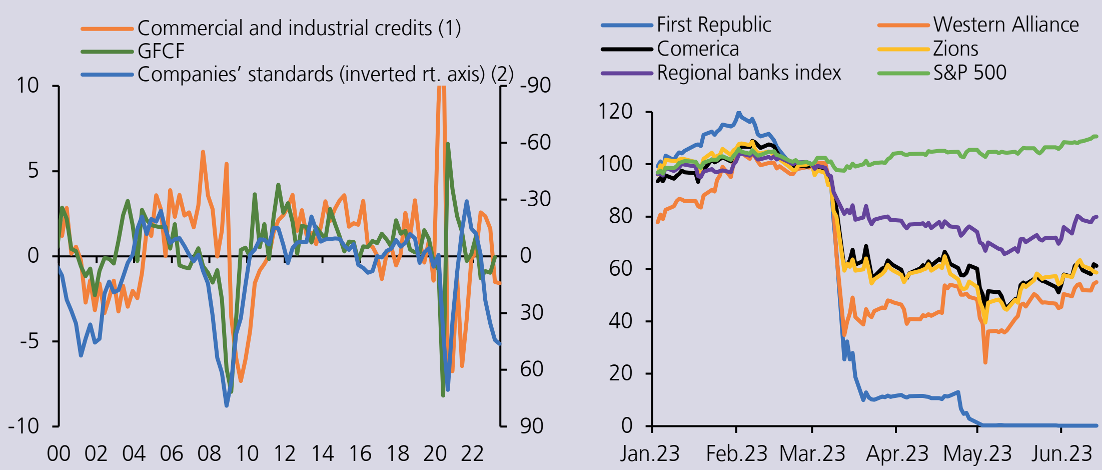


(*) Standard deviations w/respect to 2010-2019 average.
Sources: Respective central banks, Bank of America and Bloomberg.

FIGURE I.20

Credit, lending standards and investment in the U.S.
(quarterly change, percent; diffusion index)

Share prices of U.S. regional banks
(index, 1.Mar.23=100)



(1) Real loans, CPI-deflated. Weekly credit data, 2Q23 indicates averaged data through 2 of June. (2) Average of commercial and industrial loans to large, medium-sized and small companies.
Sources: SLOOS Fed and Bloomberg.

BOX I.2:

Nominal rigidities and inflation normalization

Characterizing the pricing decisions of companies is relevant to understand the dynamics of inflation, since they provide information on cost pressures, demand and changes occurring in the markets. The Central Bank has been making efforts in this area for years, with the Business Perceptions Report. A new recent one is the Survey of Price Determinants and Expectations. In this box we add new information based on the microdata available.

In particular, the box reviews how firms' pricing decisions have behaved in two areas: (1) the frequency with which they adjust their prices, known as the extensive margin; and (2) the magnitude of the adjustment, known as the intensive margin. Empirically characterizing the evolution of these margins provides information on how firms react to changes in market conditions. In an economic environment of above-normal inflation, firms may be modifying the frequency and/or magnitude of their price changes. Making this differentiation is useful for the conduct of monetary policy, as it serves as additional input for defining the price adjustment rules used in the macroeconomic models employed by the BCCh in its analyses and projections.

Repricing frequency and magnitudes

González and Rojas (2023) study the behavior of these adjustment margins for the period spanning from February 2018 to May 2023[1]/. They document that the monthly frequency of positive price adjustments increased significantly following the onset of the pandemic and peaked during 2022. Since September of that year, that frequency has dropped considerably, but still remains somewhat above its levels of 2018-2019. Conversely, the frequency of prices being adjusted down remained stable for much of the period and began to increase noticeably and steadily in February of this year (figure I.21).

Extensive and intensive margins

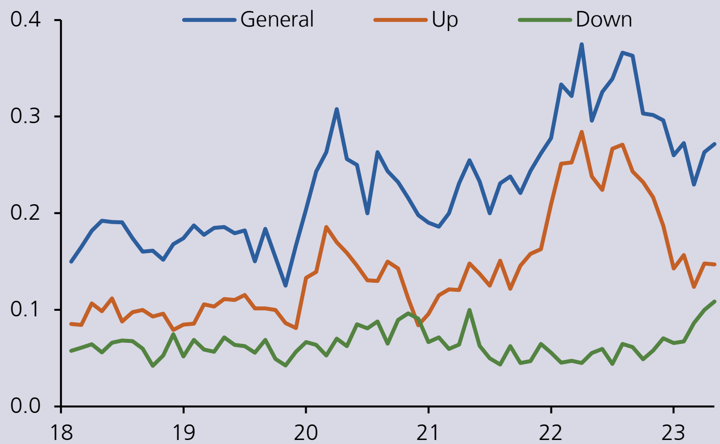
The magnitude of both upward and downward adjustments has been very stable throughout the period. In fact, when the variation of inflation with respect to its average is broken down into percentage points (pp), it shows that its recent increase is mainly due to the firms making more frequent price increases, but of a similar magnitude to the usual ones (figure I.22). Thus, in recent months, the more frequent price adjustments have been the main factor behind the decline in monthly inflation variations.

Conclusions

The extensive pricing margin (i.e., the frequency with which firms change their prices) explains the bulk of the CPI's inflationary dynamics in the period of high inflation that began in mid-2021. In other words, companies adapted to the new market conditions primarily by reducing the rigidity of their prices. The reversal of this recent phenomenon —the decrease in the frequency of upward adjustments and the increase in price reductions— provides additional evidence regarding the normalization of price decision-making behavior at the company level. Together with the favorable evolution of inflation expectations of different economic agents in recent months (Chapter I), this evidence is consistent with the process of inflation convergence towards the 3% target.

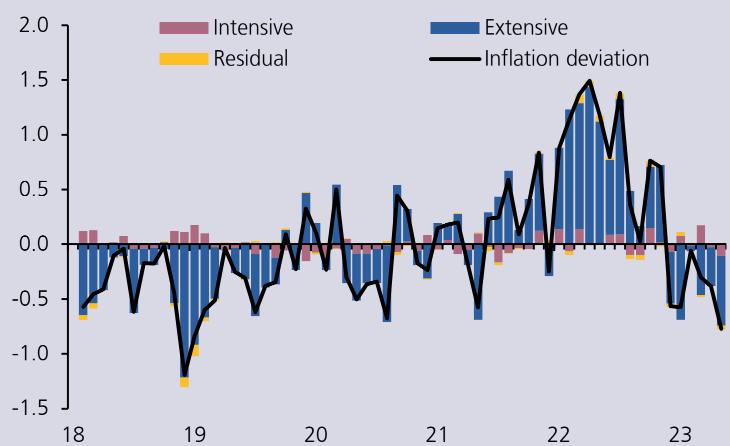
[1]/ Information from transactions performed at the product level, using digital invoices provided by the Internal Revenue Service, is used for products accounting for slightly more than 50% of the CPI basket. This 50% is broken down into 42 pp associated with goods and 8pp associated with services. In the total CPI basket, this breakdown is 52% for goods and 42% for services. For details on the services included in this calculation, see González and Rojas (2023).

FIGURE I.21 FREQUENCY OF PRICE CHANGES (*)
(proportion)



(*) Blue line shows the median proportion of a firm's products that change prices within a month. Red line shows the median proportion of a firm's products that see their prices go up within a month. Green line shows the median proportion of a firm's products that see their prices go down within a month.
Source: González and Rojas (2023).

FIGURE I.22 INTENSIVE AND EXTENSIVE MARGINS (*)
(percent)



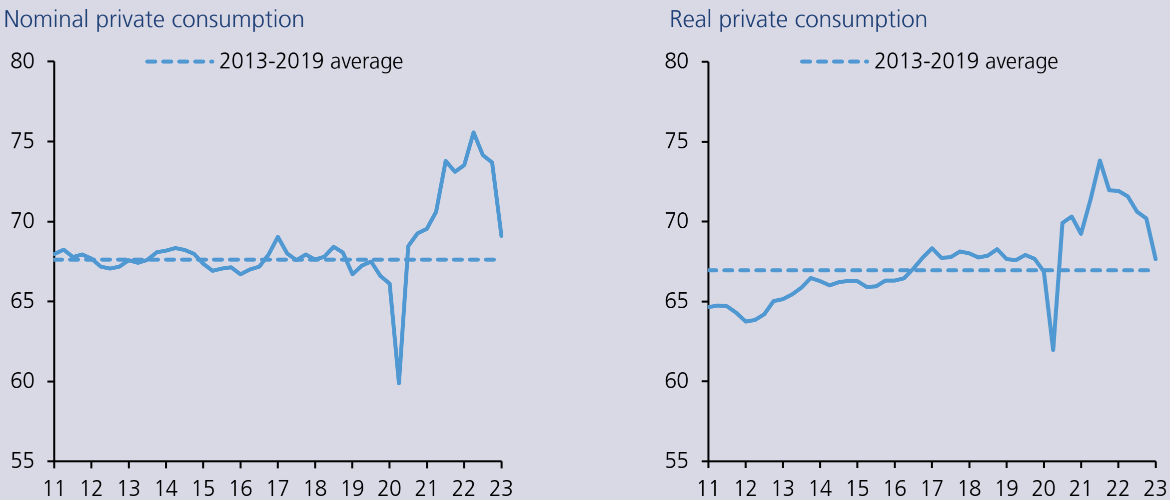
(*) Black line describes the difference in percentage points between observed and average inflation during the period February 2018-May 2023. The blue bars represent the percentage points of that difference that are explained by changes in the frequency of price adjustments. Red bars represent the percentage points explained by changes in the magnitude of price adjustments for those products that do change prices. Yellow bars are the residual of the approximation described in Source below.
Source: González and Rojas (2023).

BOX I.3:

Recent evolution of private consumption

In recent years, the behavior of private consumption has been far from its historical patterns. In 2021, it increased significantly in response to the liquidity measures implemented during the pandemic. From 2022 onwards, its share in aggregate expenditure has fallen as a result of the decrease in household liquidity and a contractionary monetary policy, most recently approaching its trend levels. Early this year it fell more than expected, which is interpreted as an anticipation of the expected decline towards levels consistent with its usual trend (figure I.23).

FIGURE I.23 NOMINAL AND REAL PRIVATE CONSUMPTION
(% of non-mining GDP, quarterly deseasonalized series)



Source: Central Bank of Chile.

This box extends the review of the recent evolution of private consumption, considering two dimensions of heterogeneity: type of product consumed and income quintile of the consuming household. For the analysis, two data sources are mainly used: 1) information from Transbank on transactions in retail establishments using credit and debit cards; and 2) information from the CASEN survey on mean household income. The analysis is carried out at the municipality level. The coverage of consumption based on credit and debit card purchases is mostly representative of habitual consumption items —non-durable— and spending on services that exclude education and healthcare.[1]/

The data show that, after the social outbreak, the fall in consumption was somewhat more intense in the services sector than in the goods sector (figure I.24, panel b). The onset of the pandemic put strong downward pressure on the consumption of services, which is highly dependent on mobility and personal interaction. In fact, this caused a change of about 10 pp in the share of goods and services in private consumption (figure I.24, panel c).

[1]/ For the analysis at the municipal-level income quintile, only face-to-face transactions are considered. More details on the data and methodologies used for analysis in this box, including sources, coverage, representativeness and statistical filters applied to minimize biases in the analysis, are described in García *et al.* (2023).

At the quintile level, the biggest drop occurred in the highest income quintile (5th), which is the largest consumer of services [2]/ (figure I.24, panel a). The strong injection of liquidity from withdrawals of pension savings and fiscal transfers caused a significant increase in consumption in the lower income quintiles, driving spending to levels well above its trend. The higher spending was concentrated mainly in goods, less affected by sanitary restrictions and with a higher share in the usual basket of lower-income households. As these restrictions were lifted, the services sector was recovering, while the consumption of goods remained at high levels.

The tightening of liquidity, a restrictive monetary policy and the normalization of fiscal support to households led to a fall in consumption among lower-income households, particularly in goods consumption, which only returned to near trend levels by the second half of 2022. Lately, consumption of the lowest income quintile continues to exhibit a negative trend, while the middle and upper income quintiles have stabilized their consumption or have even begun to return to trend levels.

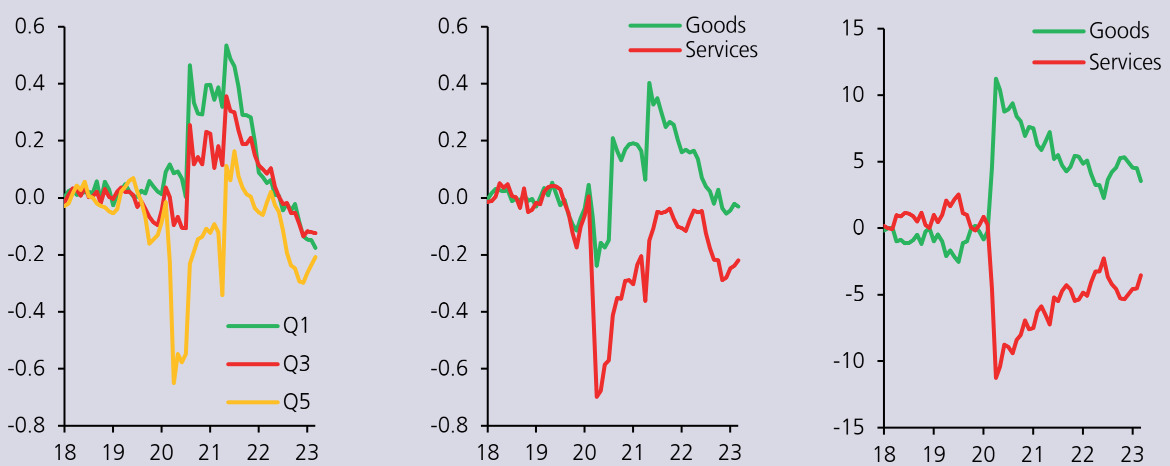
Since the beginning of 2020, consumption of services has remained persistently below its trend, which has been reflected in a share of the consumption basket below pre-pandemic values (figure I.24, panel c). In recent months this has been reversing, as a result of the shift of consumption from goods to services. This is also consistent with the partial recovery of consumption in the highest income quintile.

FIGURE I.24 EVOLUTION OF PRIVATE CONSUMPTION (*)

(a) Evolution of consumption by quintiles (log deviation with respect to growth)

(b) Evolution of consumption by sectors (log deviation with respect to growth)

(c) Changes in shares in consumer basket (percentage points)



(*) Panels (a) and (b) show the evolution of the (log)level of the respective consumptions discounted from the average growth between 2015 and September 2019. Quintile decomposition considers only face-to-face purchases. Panel (c) shows change in share in the consumer basket of the goods and services sectors, in percentage points.

Source: Central Bank of Chile.

[2]/ The systematic relationship between income level and the consumer basket of Chilean households shows that, as income increases, the fraction of expenditure devoted to consuming services increases (see Romero, 2022; García *et al.*, 2023).

II. FUTURE EVOLUTION OF MONETARY POLICY

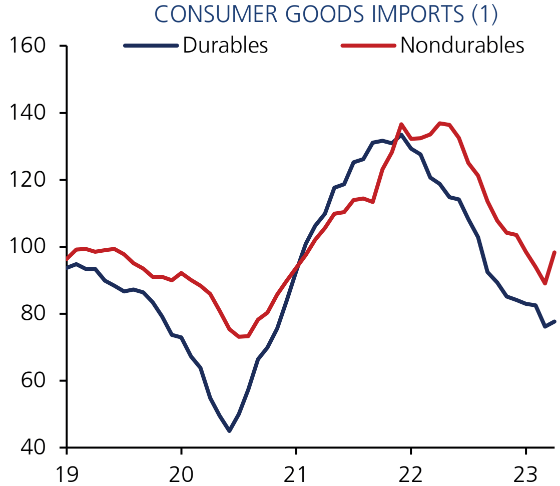
In line with expectations, inflation has continued to decline as the economy has made progress in resolving the macroeconomic imbalances accumulated in recent years. Domestic activity and demand figures for the first quarter also were in line with forecasts in the March MP Report. However, private consumption contracted more than anticipated, and its outlook continues to point to an adjustment going forward. Investment will continue to underperform. Thus, activity will grow between -0.5% and 0.25% this year and between 1.25% and 2.25% in 2024. In 2025 it will grow between 2% and 3%. The impulse that the Chilean economy will receive from abroad will remain limited, in line with still tight financial conditions, weak prospects for trading partners' growth and somewhat lower terms of trade. The monetary policy rate (MPR) has been kept contractionary for several quarters, which has contributed significantly to bring down inflation. While inflationary risks persist, they have been balancing out. The Board believes that the most recent evolution of the economy points in the required direction. If these trends continue, the MPR will start a downward process in the short term. The magnitude and timing of its reduction will consider the evolution of the macroeconomic scenario and its implications for the inflation trajectory. The Board reaffirms its commitment to act with flexibility in case any of the identified internal or external risks comes true and macroeconomic conditions so advise.

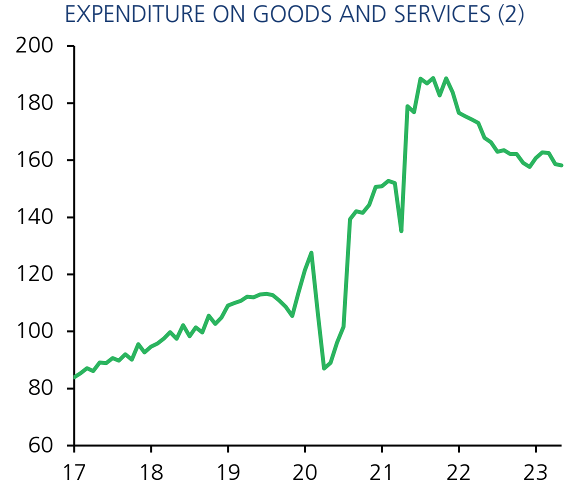
ACTIVITY AND DEMAND PROJECTIONS IN THE CENTRAL SCENARIO

Activity and demand have evolved in line with the March forecast, despite weaker private consumption. The contraction of this expenditure component in the first quarter —of 2.5% compared to the previous quarter, seasonally adjusted— was greater than expected, mainly due to the durable component. The information available for the second quarter, which includes high-frequency data such as consumer imports, digital invoicing and Transbank purchases, among others, suggests that this decline has moderated (figure II.1).

For the near future, the central scenario envisages an additional adjustment in consumption, wich will be limited, in line with its fundamentals. The labor market is expected to continue to behave according to the evolution of the economic cycle, which takes into account the increase in labor participation, the deterioration of companies' hiring prospects (IALI) and employment partly shifting towards self-employment and informal wage earners (INE). The projection also factors in consumer pessimism (IPEC), the heavier financial burden (Financial Stability Report, first half of 2023) and tighter financing conditions (Bank Lending Survey, first quarter of 2023). Accordingly, private consumption will show a variation of -4.9% this year (-3.8% in March). This translates into a lower basis for comparison, wich slightly improves the projection for next year (to 1.5%; 0.9% in March). For 2025, the projection changes little: +1.8% (+1.9% in March) (table II.1).

FIGURE II.1 PRIVATE CONSUMPTION: HIGH FREQUENCY INDICATORS
(index, 2018=100, seasonally adjusted real series)





(1) Quarterly moving averages. Seasonally adjusted using X13-ARIMA models.
(2) Sales to residents. Subject to review.
Sources: Central Bank of Chile and Transbank.

TABLE II.1 ECONOMIC GROWTH AND CURRENT ACCOUNT

	2022	2023 (f)	2024 (f)	2025 (f)
	(annual change, percent)			
GDP	2.4	-0.5 / 0.25	1.25 / 2.25	2.0 / 3.0
National income	1.5	1.1	1.5	2.4
Domestic demand	2.3	-4.2	1.0	2.0
Domestic demand (w/o inventory change)	3.0	-3.3	0.8	1.9
Gross fixed capital form	2.8	-3.0	-1.0	2.2
Total consumption	3.1	-3.4	1.4	1.8
Private consumption	2.9	-4.9	1.5	1.8
Goods and services exports	1.4	2.4	4.4	2.5
Goods and services imports	0.9	-8.3	2.2	0.6
Current account (% of GDP)	-9.0	-3.7	-4.0	-3.9
Gross national saving (% of GDP)	16.4	19.1	18.7	19.2
Gross national investment (% of GDP)	25.4	22.8	22.7	23.1
GFCF (% of nominal GDP)	24.8	23.0	23.0	23.2
GFCF (% of real GDP)	23.6	22.9	22.3	22.2
	(US$ million)			
Current account	-27,102	-13,000	-14,200	-14,600
Trade balance	3,807	13,300	10,900	9,100
Exports	98,548	97,800	100,600	102,300
Imports	94,741	84,500	89,700	93,200
Services	-14,824	-10,100	-8,900	-9,100
Rent	-16,520	-16,600	-16,700	-15,100
Current transfers	434	400	500	500

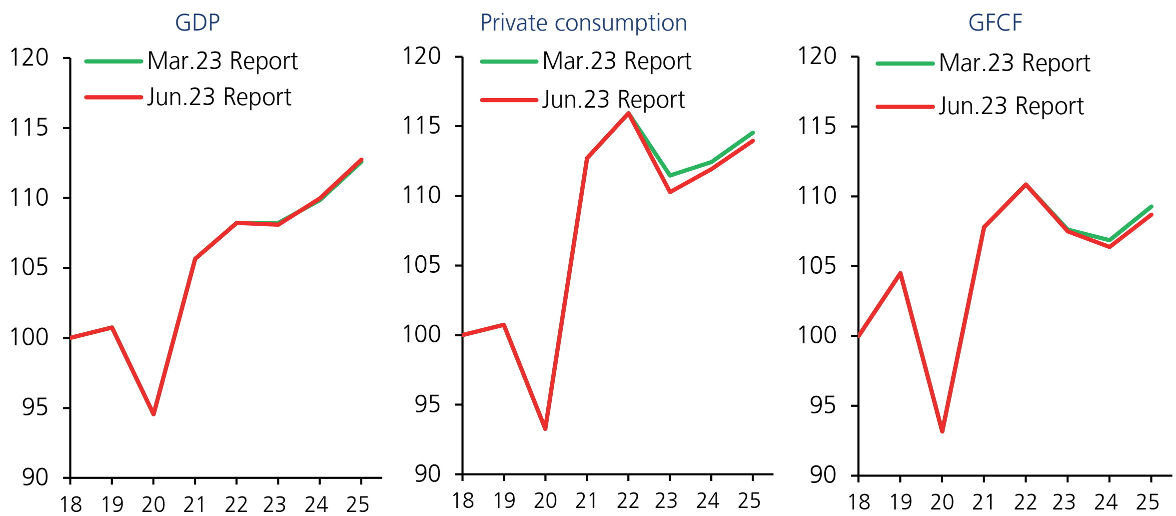
(f) Forecast.
Source: Central Bank of Chile.

The determinants of investment point to continued weakness ahead, especially in construction. Entrepreneurial expectations (IMCE) remain pessimistic and the available investment project surveys continue to show low levels for the coming years. This, in the midst of still stringent credit conditions and still significant levels of global uncertainty. In any case, the projection for 2023 (-3%) and 2024 (-1%) are not very far from the March forecast (–2.9 and –0.7%, respectively) (table II.1).

On aggregate, the projection for activity for this and the next two years remains largely unchanged with respect to the March outlook. For this year, a slightly lower growth is expected, which is linked to the performance of the mining industry. At the beginning of the year, the sector showed lower results than expected, due to maintenance-related downtime and operating difficulties. This is compounded by cuts in production plans for this year by some operations. The projection for non-mining GDP has marginal changes over the projection horizon. Consequently, this year's annual change in GDP will be between -0.5% and +0.25% (-0.5%/0.5% in March). For 2024, growth is expected to be between 1.25% and 2.25% (1% to 2% in March) and for 2025, it remains between 2% and 3% (table II.1, figures II.2 and II.3).

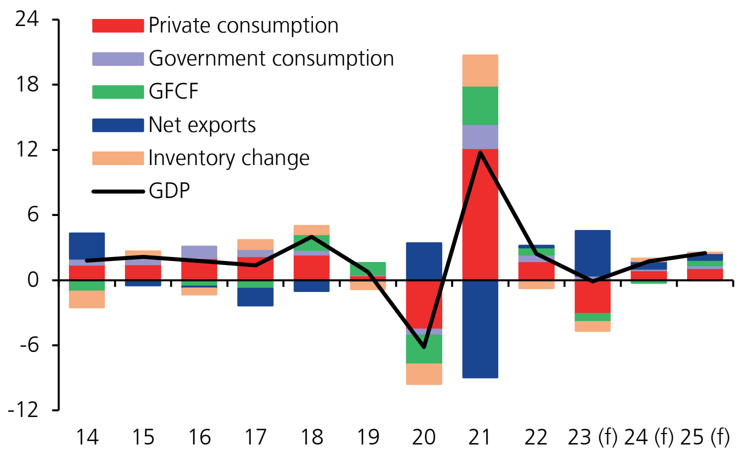
The central scenario assumes a public expenditure trajectory in line with the Public Finance Report ("IFP") for the first quarter. The latest IFP estimates that this year fiscal spending will see slower real growth than projected at the end of 2022 (0.6% annually with respect to the actual execution of 2022; compared to 1.2% annually in the previous IFP). Moreover, although the structural balance would have a less deficit position during this and next year, the 2025 estimate continues to be at -1.1% of GDP.

FIGURE II.2 ACTIVITY, PRIVATE CONSUMPTION AND GFCF (*)
(index, 2018 =100)



(*) For 2023, 2024 and 2025 correspond to the forecast contained in this MP Report. The projections for GDP consider the midpoint of the forecast ranges.
Source: Central Bank of Chile.

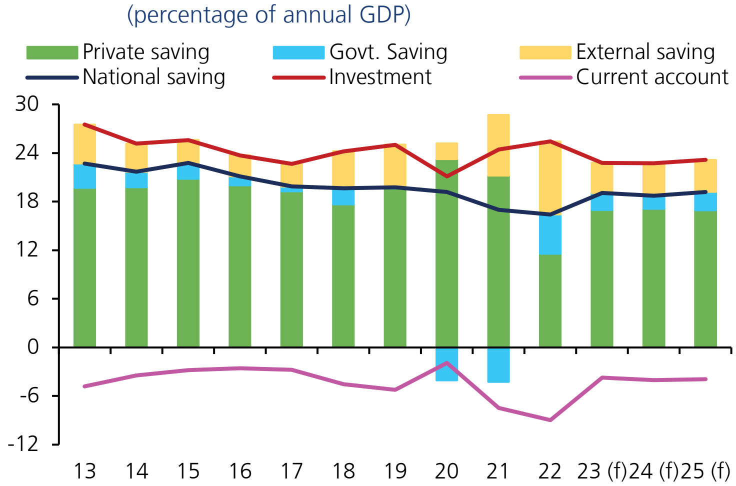
FIGURE II.3 GDP GROWTH AND AGGREGATE DEMAND COMPONENTS CONTRIBUTIONS (*)
(annual change, percentage points)



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

The current-account deficit is projected to end this year slightly below 4% of GDP. The recovery of private savings will play a key role in this. The latter is expected to reach 17% of GDP in 2023, from the 11.6% of GDP it accumulated in 2022, favored by the adjustment in consumption. The fact that most of the adjustment in private spending is focused on foreign goods contributes to the decline in imported goods forecast for this year. Although to a lesser extent, exports are also revised downward in line with the gloomier outlook for mining production. All in all, the trade balance will show surpluses this and next year. The central scenario considers that the current account deficit will be slightly below 4% this year, to then fluctuate around that figure in 2024 and 2025 (figure II.4).

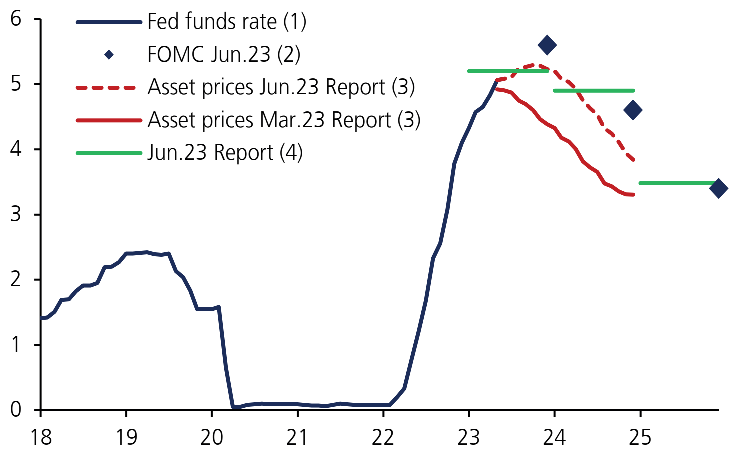
FIGURE II.4 CURRENT ACCOUNT: SAVINGS AND INVESTMENT (*)
(percentage of annual GDP)



(*) 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.

The international scenario will continue to provide a limited boost to the Chilean economy. External financial conditions will remain tight, reflecting the high uncertainty and efforts to control inflation in developed economies. Inflation has receded globally, favored by non-core prices, namely energy and foods, while core indicators remain high. This has occurred amid tight labor markets in developed countries, which has fueled services inflation. In the United States and the Eurozone, this background has led to reinforcing monetary policy messages stating that it will remain contractionary still for some time (figure II.5).

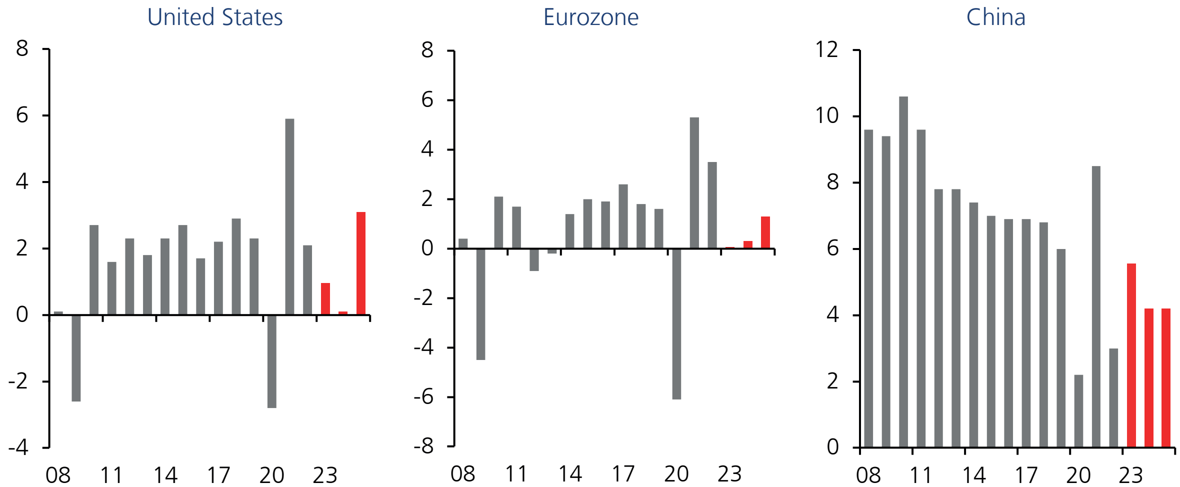
FIGURE II.5 EVOLUTION AND FORECASTS FOR THE FED FUNDS RATE
(percentage points)



(1) Effective Fed funds rate. For June 2023, consider spot value as of the 14th.
(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 MP Report.
Sources: Bloomberg and Federal Reserve.

Global growth prospects for 2023 and 2024 continue to be weak, explained by the tight financial conditions and still high degrees of uncertainty (figure II.6 and table II.2). Although the first quarter figures were better than expected in some economies, especially China, several factors suggest that this may be transitory (Chapter I). In fact, bank credit to companies has tightened in the U.S. and the Eurozone, suggesting a weak performance of activity and investment going forward (Box I.1). In Latin America, although first-quarter data came in better than expected, the outlook remains unfavorable. This combines the deteriorated financial conditions with stress factors in several economies. In this context, it is expected that fiscal spending will not be a major source of global momentum, given the process of fiscal consolidation.

FIGURE II.6 TRADING PARTNERS GROWTH PROJECTIONS
(annual change, percent)



(*) Red bars correspond to the projections of the central scenario of the June 2023 MP Report.
Source: Central Bank of Chile.

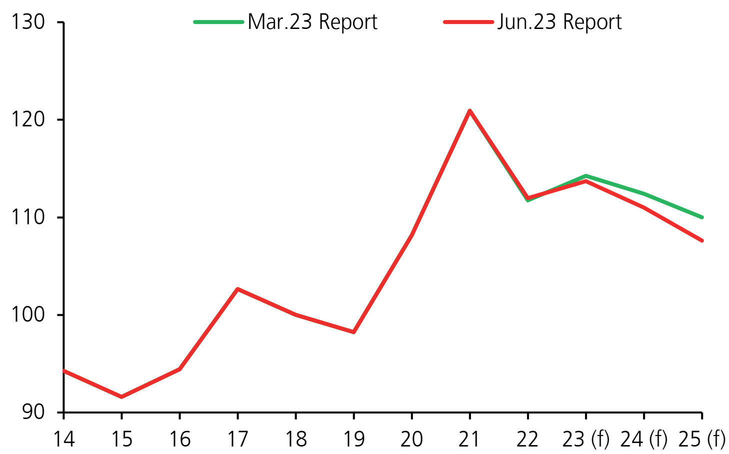
TABLE II.2 WORLD GROWTH (*)
(annual change, percent)

	Aveg. 10-20	2021	2022 (e)	2023 (f)	2024 (f)	2025 (f)
World GDP at PPP	3.1	6.3	3.3	2.6	2.2	3.1
World GDP at market exchange rate	2.7	6.3	2.9	2.1	1.6	2.9
Trading partners	3.4	6.7	2.8	3.0	2.3	3.0
United States	1.8	5.9	2.1	1.0	0.1	3.1
Eurozone	0.7	5.3	3.5	0.1	0.3	1.3
Japan	0.7	2.1	1.0	1.2	0.7	0.6
China	7.2	8.5	3.0	5.6	4.2	4.2
India	5.8	9.1	6.8	5.9	5.9	5.8
Rest de Asia	3.8	4.4	4.1	3.3	3.2	3.3
Latin America (excl. Chile)	1.0	6.4	3.6	1.1	0.5	2.0
Commodity exp.	1.7	5.0	3.2	0.8	0.6	3.0

(*) For definitions, see Glossary of economic terms.
(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.

The terms of trade will be somewhat lower than expected in March (figure II.7 and table II.3). This is explained by the weak global growth outlook, in a context where commodity prices have already fallen compared to the beginning of the year. For copper, average prices of US$3.85, US$3.65 and US$3.5 per pound are forecast for 2023, 2024 and 2025, respectively. For oil, the projection points to average Brent-WTI prices of US$75 in 2023, with a gradual decrease to US$68 in 2025. Food prices have evolved in line with forecasts, and new declines continue to be expected.

FIGURE II.7 TERMS OF TRADE
(level, 2018=100)



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

TABLE II.3 INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

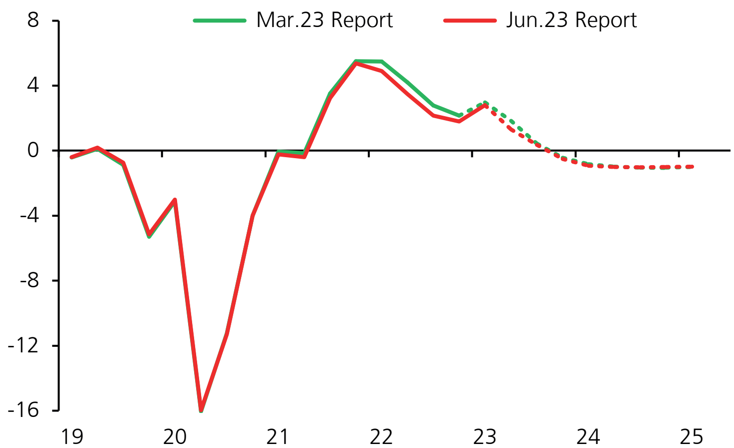
	Aveg. 10-20	2021	2022	2023 (f)	2024 (f)	2025 (f)
			(annual change, percent)			
Terms of trade	1.8	11.9	-7.7	1.7	-2.4	-3.1
External prices (in US$)	0.5	9.3	4.4	1.4	4.5	4.7
			(levels)			
LME copper price (US$cent/pound)	304	423	400	385	365	350
WTI oil price (US$/barrel)	69	68	94	73	69	65
Brent oil price (US$/barrel)	76	70	100	78	73	70
Gasoline parity price(US$/m3) (*)	585	579	850	666	550	520
US Federal Funds Rate (%)	0.7	0.3	1.9	5.2	4.9	3.5

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

THE ACTIVITY GAP AND CONVERGENCE OF INFLATION TO THE TARGET

The activity gap has evolved in line with the March forecast and the projection shows no major changes. Thus, a downward trajectory is still envisaged, leading to negative values during the second half of this year (figure II.8). The latest available data suggest that the activity gap resumed its closing process in recent months, as anticipated in the March MP Report. A more complete view of capacity gaps show that they have been closing for some time now (Box II.1). The indicators analyzed show a lower net labor turnover rate, an increase in unemployment, and a reduced use of installed capacity in manufacturing and electricity generation.

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

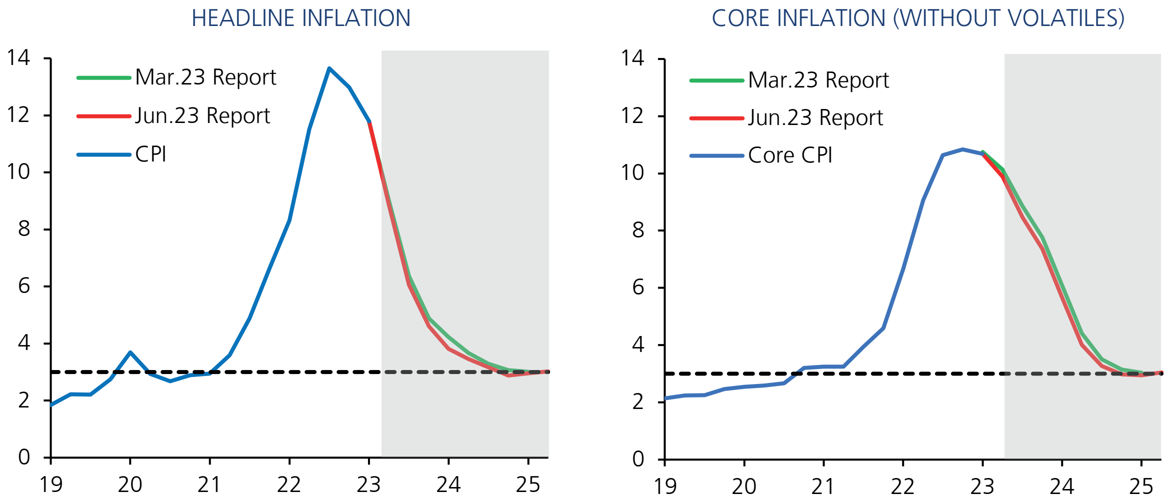


(1) Slashed lines show forecast.
(2) Forecast assumes structural parameters updated in December 2022 Report (trend GDP) with methodological review of potential GDP.
Source: Central Bank of Chile.

The projection for inflation is somewhat lower than in March. Therefore, both headline and core inflation will converge to 3% in the second half of 2024 (figure II.9). This correction incorporates the lower speed of adjustment shown by private consumption, especially of tradable goods, the lower level of the exchange rate, and the somewhat lower inflation figures known so far, especially of the volatile component. As a result, total inflation will end 2023 at 4.2% annually (4.6% in March), while the core measure will stand at 6.5% (6.9% in March).

The central scenario continues to consider that the core component will see a slower decline than the total inflation, which will be more noticeable towards the end of this year and the beginning of 2024. This expected trajectory is warranted by the fact that, in the short term, services inflation will sustain monthly variation rates above historical averages. This is consistent with these prices' usual greater stickiness and with adjustments that will be made considering a still high inflation level. Meanwhile, goods inflation will benefit from a real exchange rate (RER) trajectory below that forecast in March MP Report. A relevant factor behind this is the nominal appreciation of the peso in recent months. Going forward, the effects of tight external financial conditions continue to be considered in the estimations.

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



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

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

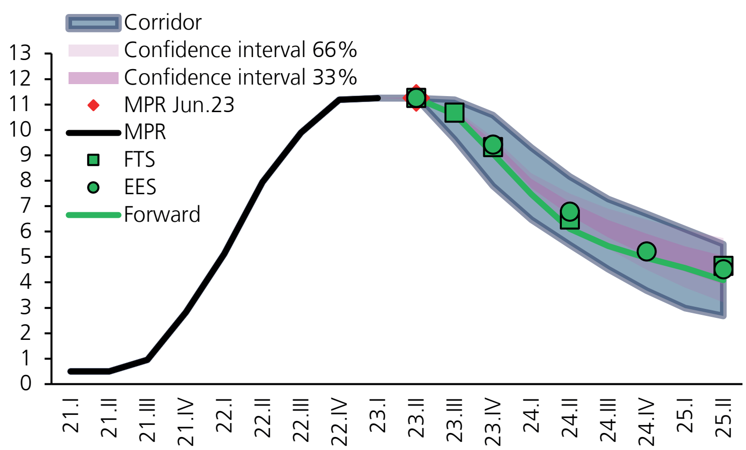
	2022	2023 (f)	2024 (f)	2025 (f)
Average CPI	11.6	7.7	3.3	3.0
December CPI	12.8	4.2	2.9	3.0
CPI in around 2 years (2)				3.0
Average core CPI	9.3	9.1	4.0	3.0
December core CPI	10.7	6.5	3.0	3.0
Core CPI around 2 years (2)				3.0

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

MONETARY POLICY STRATEGY: THE CENTRAL SCENARIO, SENSITIVITIES AND RISKS

The Monetary Policy Rate (MPR) has been contractionary for several quarters, contributing significantly to the resolution of the imbalances accumulated in previous years and to the decline in inflation. Going forward, the central scenario considers that the weaker private consumption and the evolution of the exchange rate will contribute to easing inflationary pressures at the margin (figure II.10).

FIGURE II.10 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 June EES, FTS pre-policy-meeting of June and the average smoothed forward curve of quarter to 13 June. This is calculated by extracting the implicit MPR considering the forward curve on the interest rate swap curve up to 2 years, discounting the fixed rates at every maturity at the simple accrual of the ICP. For the current quarter the surveys and the forwards consider the average daily effective and are completed with the respective sources.
Source: Central Bank of Chile.

The borders of the TPM corridor reflect scenarios where the speed of the inflationary convergence process gives way to interest rate adjustments different from those contemplated in the central scenario (figure II.10). On this occasion, the Board considers that this type of situations is mainly related to the behavior of domestic inflation and its fundamentals. In any case, as always, the conduct of monetary policy will be contingent on the effects that new information will have on the projected dynamics of inflation.

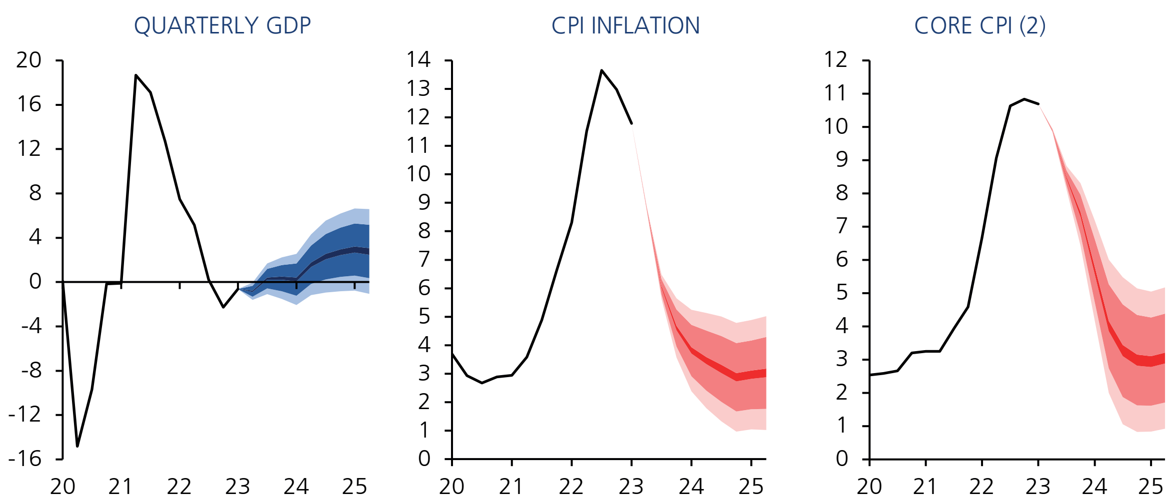
The upper bound of the corridor is given by sensitivity scenarios in which local inflation is more persistent than expected. In this aspect, the information provided by actual expenditure and CPI figures will be key. The Board will evaluate the inflationary implications of these events, as they may require to slow the process of lowering the MPR. Also, upward inflation surprises in developed economies could call for higher international monetary policy rates, contributing to a depreciation of emerging currencies, the peso included. This would increase local inflation in the short term, although its impact on the MPR would be mitigated insofar as it implies a greater contraction in activity and spending.

On the other hand, the lower bound of the corridor is related to a faster-than-expected adjustment of the economy, which would lead to inflation converging sooner than expected in the central scenario. Various indicators of capacity gaps show that inflationary pressures have been gradually contained. A scenario where such buffers become more negative than expected would lead to a more accelerated reduction of the MPR. Such an event could occur if there is a more marked deterioration in the labor market and in private consumption.

As always, in addition to the sensitivity scenarios, situations are analyzed in which more drastic changes in the economy would have a more significant impact and would require a monetary policy response that exceeds the corridor's limits for the MPR (figure II.11).

The Board considers that the risks are significant and are mainly related to the macro-financial situation worldwide. A further deterioration could trigger episodes of volatility in financial markets, reduce liquidity and encourage capital outflows away from emerging economies. This would result in a tightening of global financial conditions beyond expectations, which would cause additional restrictions for the Chilean economy and would significantly reduce inflationary pressures. The occurrence of this risk scenario would make it necessary to lower the MPR more rapidly and/or abruptly than indicated by the lower bound of the corridor.

FIGURE II.11 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).

BOX II.1:

Current state of capacity gaps

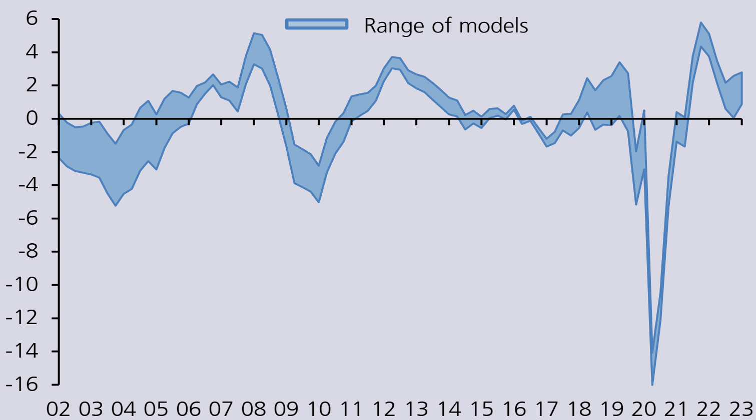
In the past few quarters, the Chilean economy has been making progress in resolving the macroeconomic imbalances caused by the excess demand of previous years, which has contributed to the decline in inflation in recent months. As noted in several previous Reports, the convergence of inflation to the 3% target within the two-year policy horizon is consistent with the activity gap remaining negative for several quarters, reflecting greater capacity slack.

However, data for the end of 2022 and the beginning of 2023 show a widening of the gap (figure II.8). Behind the fourth-quarter drop there are one-off factors associated with the transportation sector[1/]. In general, it is useful to analyze different indicators of capacity slack, including the activity gap, to provide a broader view of the slack exhibited by the economy. In addition, the activity gap —described below— is an unobservable variable whose calculation may change over time (see Box V.1 September 2018 MP Report). As such, it is a useful benchmark measure, but it is valuable to complement it with other measurements.

The activity gap

The activity gap is the difference between actual output and its potential level. It is a common measure of capacity slack, where potential output is the level of activity consistent with stable inflation. That level is not directly observable, but can be proxied using different methods (see Box V.2 September 2015 MP Report). The range of estimates shows that during 2021 the activity gap reached values of up to 5.8 pp, its highest in more than two decades, revealing strong inflation pressures. In 2022, the gap began to narrow and in the first quarter of 2023 it was in a range between 0.9 and 2.8pp (figure II.12).

FIGURE II.12 ACTIVITY GAP, VARIOUS METHODS (*)
(percent)



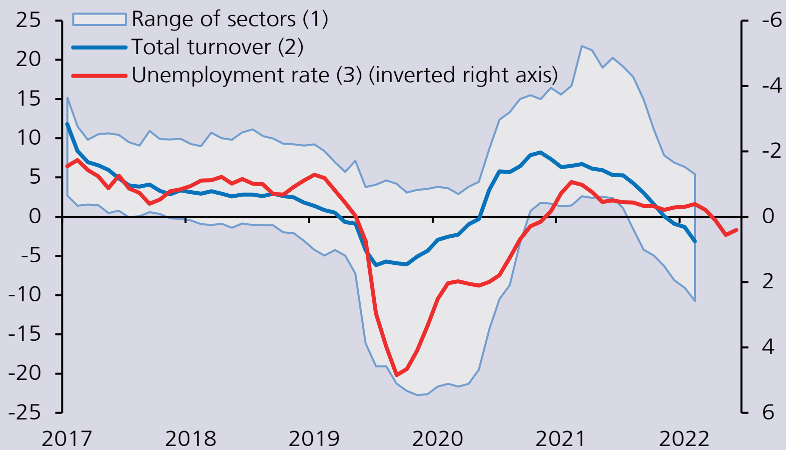
(*) The different methods include multivariate and trivariate statistical filters (see Bauducco *et al.*, 2022), the Hodrick-Prescott (HP) filter and a "neutral financial gap" (see Borio *et al.*, 2017), which considers the evolution of real bank credit excluding loans for foreign trade and real housing prices (general IPV) as relevant information for estimating potential output. Real non-mining GDP at factor cost is used for these estimations. Additionally, an estimate that excludes transportation activity from non-mining GDP is included, based on the multivariate filter. Source: Central Bank of Chile.

[1/] The estimated gap for the fourth quarter of 2022 is affected by the payment of financial commissions by a transportation company, which temporarily reduced the aggregate value of this activity in GDP (see Avilés *et al.*, 2023).

The labor market

The labor market has recently been less dynamic. After a period of this market being very tight or with little slack between 2021 and 2022 —understood as a situation of high labor demand or vacancies in relation to the number of available workers—, labor supply has been recovering, while demand has fallen back. All this has contributed to greater slack and contained real wage growth (see Box I.2 in December 2022 MP Report 2022 and Andalaft *et al.*, 2022). This development is consistent with the assessment of companies in the May Business Perception Report. It can also be corroborated by such measures as the net labor turnover rat[2]/, which has declined steadily since 2022, and the unemployment rate, which has been gradually increasing with respect to its long-term averages (figure II.13).

FIGURE II.13 LABOR MARKET METRICS
(percent)



(1) The range of sectors is defined as the envelopment of the net labor turnover rates for each sector (CIIU4 excluding agriculture).
(2) Net labor turnover rate (LTR): twelve-month movement of workers in the formal salaried employment sector. It is calculated from firms' administrative records as the difference between the job entry rate (jobs created) and the job exit rate (jobs destroyed).
(3) Unemployment rate: deviation from the September 2001-December 2022 average.
Sources: Central Bank of Chile and National Statistics Institute.

Other gap metrics

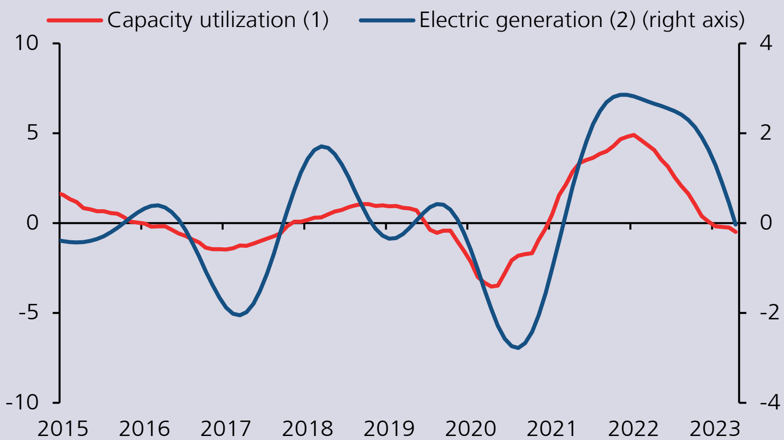
Other variables that shed light on the state of gaps in the economy are the use of installed capacity in manufacturing, which is measured from surveys, and the cyclical deviation of electricity generation. The latter is related to the intensity of capital use in the sectors that use such energy and, therefore, reflects their capacity slack. In line with previous results, both variables point to capacity overutilization between 2021 and 2022. Most recently, they have converged to their neutral levels and long-term trends, respectively (figure II.14).

[2]/ The net labor turnover rate measures the movement of workers in a given period, as the difference between job creation and job destruction. The turnover margin is related to the tightness of the labor market and the slack present in it, since in a tighter market (smaller slack), more jobs creation relative to its destruction results in higher net labor turnover.

Conclusions

The measures presented in this box indicate that capacity gaps have been normalizing in recent times, showing a high degree of synchrony. The different estimates of the activity gap see it declining since 2021, in line with the adjustment of domestic spending, although it remains positive. However, other measures of capacity utilization show resource utilization consistent with the potential level of the economy. According to the central scenario of this Report, the consolidation of the inflation convergence process to the 3% target in a two-year horizon is supported by greater slack going forward, including that the economy will operate somewhat below its potential level still for some time.

FIGURE II.14 OTHER CAPACITY GAP METRICS
(percent)



(1) Capacity utilization: centered moving average of ±6 months, normalized by average capacity use in the years 2017 and 2018.
(2) Electric generation: cyclical component of upstream power generation in the National Electric System (SEN), calculated with a band-pass filter (Christiano and Fitzgerald, 2003).
Sources: Central Bank of Chile, ICARE/Universidad Adolfo Ibañez, National Electricity Coordinator and National Statistics Institute.

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