banco central Chile

MONETARY POLICY REPORT

MARCH 2024

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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 (BCCh) 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 (IPoM), 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 IPoM 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: Martín Pescador - Región de los Lagos.

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*/ The statistical cut-off date was on March 26, except for activity data, where information until April 1 was considered. This document was originally written in Spanish. In case of discrepancy or difference in interpretation, the Spanish version prevails.

SUMMARY

Inflation has declined rapidly and now stands closer to 3%. Data from the beginning of the year show some increase in annual inflation, in a context where activity has exceeded expectations somewhat, and consumption and investment ended 2023 slightly below previous estimates, particularly in their tradable components. The postponement of the rate cut in the U.S. and the slower process of reductions by central banks elsewhere have had an impact on Chile's rate differential with other economies. Together with the evolution of its other fundamentals, this has caused the peso to depreciate. Coupled with the recent rise in some international prices, these factors will push up annual inflation in 2024. It is expected to converge to the 3% target within the two-year monetary policy horizon, which considers the transitory nature of the aforementioned elements, that the economy will see expansion rates consistent with its trend, and a gradual decline in the real exchange rate (RER). For this year, GDP growth is expected to be between 2% and 3%, with a range between 1.5% and 2.5% for 2025 and 2026. The Board foresees that, in line with the central scenario of this Monetary Policy Report (IPoM), the Monetary Policy Rate (MPR) will be further reduced. The magnitude and timing of the MPR reduction process will take into account the evolution of the macroeconomic scenario and its implications for the trajectory of inflation.

Inflation dropped rapidly from its 2022 peaks and is now closer to the 3% target. This occurred in the context of an adjustment in domestic spending and a reduction in the activity gap, which contributed to resolving the large macroeconomic imbalances of previous years. In this scenario, two-year inflation expectations have remained at 3% for several quarters now.

The process of inflation decline has been heterogeneous across its components, with a faster decrease in goods than in services. This is consistent with bigger gaps in those sectors representing goods than services consumption (Box II.1), a moderate pass-through of the exchange rate depreciation —in line with wider gaps in tradable sectors— and the significant relief of global cost factors in previous years. For its part, the relevance of indexation processes in the inertia of service inflation stands out.

Inflation ended 2023 below the levels projected in the previous IPoM. In December, inflation was unexpectedly low, resulting in the annual variation of total and non-volatile CPI closing the year at 3.9% and 5.4%, respectively (4.5% and 5.8% in the last IPoM). The difference between what was estimated in the last IPoM and the actual figure was even greater after the change in the CPI basket and methodology was published. The monthly variations of both the total and core indicators showed uneven dynamics between both baskets, especially in the first part of the year, while in the second half it was similar (Box I.2).

At the turn of 2024, inflation accelerated with higher-than-expected figures, and its evolution must continue to be monitored. Both January and February had high monthly CPI variations above expectations. Among other factors, this was due to the peso depreciation, world price increases and indexation of some local prices. Moreover, they occurred in a context in which monthly inflation has shown greater volatility in recent months. As a result, the annual variation of the total CPI rose to 3.6% in February, while core CPI inflation fell to 4.2%[1]/.

The recent behavior of inflation occurs in a context where both the mining and non-mining components of the Imacec posted slightly better than expected results in January and February. This combines several elements, namely: higher external demand, reflected in the growth of some manufacturing and agricultural lines; supply factors, such as the higher value added of power generation; and some items associated with a greater local impulse, as seen in services. This dynamic would have increased the GDP of the first quarter. Given the transitory nature of some of the aforementioned elements, the central scenario anticipates a slower pace of growth in the coming months, in line with those considered in the previous IPoM[2]/.

In the second half of 2023, final demand was somewhat weaker than projected, particularly in its tradable components. The 2023 National Accounts showed that the seasonally adjusted series of household consumption fell up to the third quarter, with a faint recovery towards the end of the year. This resulted in a higher-than-expected annual contraction: -5.2% (-4.6% in the December IPoM). In turn, gross fixed capital formation (GFCF) showed a sharp reduction in the last quarter of the year. This was the case especially in the machinery & equipment component, which tends to show high volatility and was affected by the exchange rate depreciation. Still, its 2023 drop was less than expected (-1.1%; -1.9% in the December IPoM), due to the upward correction of its levels in the first quarter of that year.

In the external scenario, global inflation has continued to ease. Anyway, there are some risks due to the reversal of cost factors and the persistence of high inflation of service items. Although lower than a few quarters ago, transportation fares and fuel prices have been rising over the course of the year, influenced by developments relating to the conflict in the Middle East (Box I.1).

Doubts about inflation focus especially in the U.S. economy, whose resilience stands out, sustained by the dynamism of its labor market and private consumption. Activity growth in this country was well above forecasts of a few quarters ago and employment indicators have exceeded expectations, maintaining a tight labor market. This, in a context of continued contribution from public spending and improved performance of investment at the margin.

The greater dynamism of the U.S. economy, together with recent inflation figures somewhat higher than expected, have led the Federal Reserve (Fed) and the market to believe that interest rate cuts will be postponed to the second half of the year. The Fed has maintained the Fed funds rate flat at its recent meetings and, although it reiterated that there were three 25 basis point (bp) cuts to be made this year, it also anticipated fewer cuts in the next two years. All this has affected the performance of different financial variables, including a dollar appreciation worldwide.

[1]/ For the purposes of macroeconomic analysis and the conduct of monetary policy, the Board uses the series with base year 2023, called the reference CPI, which considers information from the new basket only. For price-level restatement purposes of indexed contracts, bonds or securities, the annual variation of the CPI reported by the National Statistics Institute (INE) is used. This combines the CPI base 2018 and base 2023. As of February, it showed an annual increase of 4.5%.

[2]/ The number of working days in February and March differs significantly from an average first quarter, given the leap year and Easter week holidays. This can affect the measurement of seasonality in these months, so their variations should be evaluated carefully.

The postponement of benchmark rate cuts in the U.S. and the slow process of reductions in other central banks have affected Chile's rate differential with other economies, in line with the lag of their business cycles. These divergences have been adding greater pressure than anticipated on the peso's performance, along with the movement of the rest of its fundamentals. Compared to the beginning of the year, the peso has depreciated around 12% against the dollar and close to10% in multilateral terms (TCM).

The reduction in the MPR has been passed on to the cost of local financing, in line with the normal transmission of monetary policy. Interest rates have fallen especially for shorter-term loans —mainly commercial—, while longer-term loans continue to be influenced by the persistence of high long-term rates. In parallel, credit risk has increased, as suggested by indicators of delinquency and provisions, among others. On the other hand, some sectors still face restrictions in accessing a loan, as indicated by various sources of information, including the Business Perceptions Report (IPN).

Projections

The outlook for inflation is revised upward, especially for 2024. As of December of this year, annual headline and core inflation are estimated to reach 3.8% (2.9% and 3.2% in the last IPoM, respectively[3]/).

This adjustment is influenced by the depreciation of the exchange rate, the deterioration of global cost factors in recent months —including the price of oil— and higher inflation early in the year. In the medium term, among other elements, the convergence of inflation to the target considers that the economy will not exhibit significant imbalances and that the RER will decline gradually. The intensity of this decline will be subject to the unfolding of financial conditions. This scenario assumes a moderate coefficient of exchange rate pass-through to final prices, in line with what has been observed in the most recent period and with a still weak demand for tradable items.

GDP growth is foreseen to be between 2% and 3% this year (1.25%-2.25% in December). Much of this revision is explained by the acceleration of activity in the first quarter. As some of its transitory elements reverse, activity will resume growing at a slower rate, matching previous forecasts.

For 2025 and 2026, growth is projected to range between 1.5% and 2.5%, with the economy converging to its potential growth rate. The improved performance in early 2024 involves a somewhat larger activity gap in the immediate future, but in the medium term it will remain around its equilibrium point.

Private consumption will expand at near the rates considered in December. Its foreseen path —and that of the other components of demand— considers the lowest starting point of late 2023. Going forward, household spending will gradually increase, consistent with high-frequency data. This will be supported by increasingly more favorable financial conditions and the rebound in the real wage bill driven by rising real wages and employment. The labor market still exhibits some slack, although it is estimated that part of the lag in the participation of certain age groups may be more permanent (Box I.3). Consumer confidence has been improving (IPEC), yet it persists in pessimistic ground.

[3]/ This figure is not comparable for the core indicator. The December forecast was done with the 2018=100 base index, and the present one with the 2023=100 basket.

GFCF will show a contraction again in 2024, due to a higher comparison base, its evolution towards the end of 2023, and still weak fundamentals. Some background data point to a continued deterioration of GFCF in the near term, especially in machinery and equipment. Imports of capital goods have weakened further, amid the exchange rate depreciation of recent months. Projections consider that in the first half of the year the speed of expansion of this fraction of GFCF will be less negative than it was at the end of 2023 and that it will turn positive in the second half of the year. In any case, it is important to bear in mind that this is a traditionally volatile component of expenditure. In construction and other works, the greater momentum of engineering works projected by the surveys is opposed by a low dynamism of the real estate sector. Financial conditions continue to hold back investment, especially due to the interest rates on longer-term loans.

The current account deficit will be 3.4% during 2024-2026. The improved projection for this year and next especially incorporates the effect of exchange rate depreciation and greater external demand on exports, as well as the impact of the weakness of domestic spending on imports.

Higher growth foreseen for the U.S. in 2024 contributes to having a stronger boost from abroad. The central scenario assumes that in 2024 this economy will grow more than anticipated in the last IPoM (1.9%; 0.6% in December) and rules out the possibility of a recession. This correction explains about two thirds of the adjustment in the outlook for Chile's trading partners this year (3%; 2.7% in December). For the rest of these countries, the projections confirm low growth. Doubts about China stand out, where growth is still expected to slow down this year and in some years to come. In any case, China's demand for copper remains strong, thanks to growing role in the renewable energy transition and electromobility, which raises the estimate for the copper price (US$3.85 per pound in 2024-2026).

Monetary policy

The local economy has succeeded in closing the significant macroeconomic imbalances of previous years, inflation has declined rapidly and stands closer to 3%, while inflation expectations are aligned with the target. However, rising inflation figures at the beginning of the year and higher imported cost pressures emphasize the need to continue closely monitoring its evolution. To the extent that the shocks that affect inflation are transitory, the monetary policy framework based on a two-year target allows them to be accommodated within the policy horizon without putting inflationary convergence at risk.

The Board foresees that, in line with the central scenario of this IPoM, the MPR will be further reduced. The magnitude and timing of the MPR reduction process will take into account the evolution of the macroeconomic scenario and its implications for the trajectory of inflation.

The sensitivity scenarios (i.e., the borders of the MPR corridor) consider situations where the evolution of domestic demands diverges from projections in the central scenario. The upper bound incorporates a better performance of spending that would encourage price increases and a re-composition of business margins, creating a more inflationary outlook. The lower bound presents a further deterioration of domestic demand. For example, there could be a slower recovery of some economic sectors, with their respective repercussions on the labor market, which would mitigate pressures on inflation.

The main risks —scenarios that go beyond the limits of the MPR corridor— are still mainly linked to external front. Worth noting is the deteriorated global geopolitical situation. Other areas of concern are the weak Chinese economy and the vulnerability of its real estate sector, doubts about the U.S. fiscal situation and possible financial disruptions associated with the evolution of commercial real estate sector worldwide.

The world economic scenario is subject to higher-than-usual degrees of uncertainty. In particular, because there are still questions about the Fed's benchmark rate cut process, in addition to doubts regarding the economy's fiscal situation. In this context, the discussion about the evolution of global financial conditions continues, especially with respect to long-term interest rates and their relationship with the levels of neutral rates.

TABLE 1: INFLATION (1)(2)
(annual change, percent)

	2022	2023 Dec.23 IPoM	2023 Mar.24 IPoM	2024 (f) Dec.23 IPoM	2024 (f) Mar.24 IPoM	2025 (f) Dec.23 IPoM	2025 (f) Mar.24 IPoM	2026 (f) Mar.24 IPoM
Average CPI	11.6	7.6	7.3	3.5	3.8	3.0	3.4	3.0
December CPI	12.8	4.5	3.4	2.9	3.8	3.0	3.0	3.0
CPI in around 2 years (3)						3.0		3.0
Average core CPI	9.0	8.5	7.5	3.5	3.8	3.1	3.5	3.0
December core CPI	10.0	5.8	4.7	3.2	3.8	3.0	3.1	3.0
Core CPI around 2 years (3)						3.0		3.0

(1) Core inflation is measured using the CPI without volatiles. (2) Figures for 2022 and those from the March 2024 IPoM consider the 2023 CPI reference basket and the splice made by the Central Bank of Chile. These are not strictly comparable with the figures from the December 2023 IPoM, which consider the 2018 reference basket. (3) For December 2023 IPoM corresponds to inflation forecast for the fourth quarter of 2025, for March 2024 IPoM to inflation forecast for the first quarter of 2026. (f) Forecast. Sources: Central Bank of Chile and National Statistics Institute (INE).

TABLE 2: INTERNATIONAL SCENARIO

	2022	2023 Dec.23 IPoM	2023 Mar.24 IPoM	2024 (f) Dec.23 IPoM	2024 (f) Mar.24 IPoM	2025 (f) Dec.23 IPoM	2025 (f) Mar.24 IPoM	2026 (f) Mar.24 IPoM
				(annual change, percent)				
Terms of trade	-6.8	1.5	2.4	-1.5	-3.2	0.2	-0.6	0.9
Trading partners	2.8	3.4	3.3	2.7	3.0	2.5	2.8	2.9
World GDP at PPP	3.3	3.1	3.2	2.6	3.0	2.6	2.9	3.1
Developed GDP at PPP	2.6	1.5	1.5	0.5	1.1	1.2	1.4	1.9
Emerging GDP at PPP	3.8	4.1	4.2	3.8	4.1	3.4	3.8	3.8
				(levels)				
LME copper price (US$cent/pound)	400	385	384	380	385	380	385	385
Oil price, average WTI-Brent (US$/barrel)	97	80	80	75	81	72	76	72

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

TABLE 3: INTERNAL SCENARIO
(annual change, percent)

	2022	2023 Dec.23 IPoM	2023 Mar.24 IPoM	2024 (f) Dec.23 IPoM	2024 (f) Mar.24 IPoM	2025 (f) Dec.23 IPoM	2025 (f) Mar.24 IPoM	2026 (f) Mar.24 IPoM
GDP	2.1	0.0	0.2	1.25 - 2.25	2.0 - 3.0	2.0 - 3.0	1.5 - 2.5	1.5- 2.5
Domestic demand	2.3	-4.6	-4.2	2.0	1.6	2.7	2.2	2.5
Domestic demand (w/o inventory	2.9	-3.0	-3.2	1.5	1.0	1.9	2.1	2.1
Gross fixed capital form	3.9	-1.9	-1.1	0.0	-2.0	2.4	3.0	1.9
Total consumption	2.6	-3.3	-3.9	2.0	2.0	1.8	1.9	2.2
Private consumption	1.6	-4.6	-5.2	2.1	2.0	1.8	1.9	2.3
Goods and services exports	0.8	1.0	-0.3	3.4	4.5	1.9	2.7	1.8
Goods and services imports	1.5	-11.1	-12.0	4.3	1.3	2.9	3.5	3.0
Current account (% of GDP)	-8.7	-3.3	-3.6	-4.0	-3.4	-.9	-3.4	-3.4
Gross national saving (% of GDP)	16.9	18.8	19.4	18.4	20.0	19.1	20.6	20.3
Gross fixed capital formation (% of nominal GDP)	25.3	23.3	23.8	23.1	23.1	23.0	23.5	23.7

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

I. RECENT EVOLUTION OF THE MACROECONOMIC SCENARIO

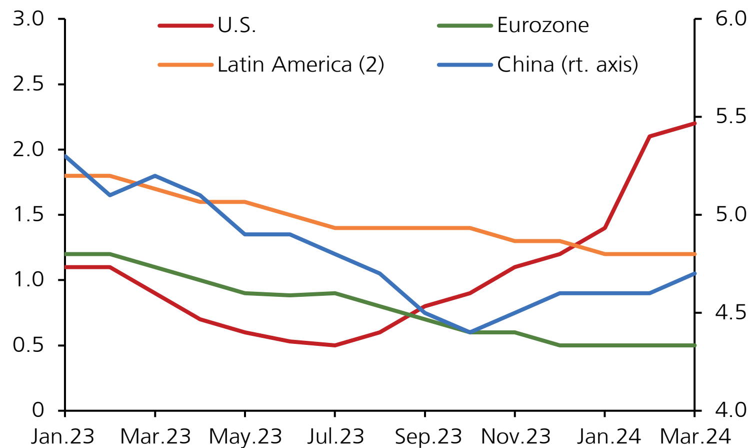
In the external scenario, the resilience of activity in the U.S. stands out, with an upwardly revised outlook for this year. Global inflation has continued to ease, although the services components remain high, and risks associated with the reversal of some global cost factors have emerged. In this context, market expectations have been delaying the start of Fed funds rate cuts. At home, inflation has seen a rapid decline from the highs of 2022, although at the beginning of the year it posted significant monthly increases that exceeded expectations. Activity expanded slightly in 2023, and in the first two months of this year, it outperformed expectations. This was influenced by more favorable external demand, various supply factors, some of them transitory, and the improved performance of some sectors. All this contrasts with weak domestic spending. Investment contracted significantly in the second half of the year, and the adjustment in private consumption was somewhat sharper than projected. The evolution of the interest rate differential with respect to other economies and the movements in their fundamentals have led to a depreciation of the peso of around 12% since the beginning of the year. The monetary policy rate (MPR) has been reduced by 475 basis points (bp) since last July.

THE INTERNATIONAL SCENARIO

About global activity, the resilience of the U.S. economy continues to stand out, with an upward revision of its outlook for 2024 (figure I.1). During the fourth quarter of last year, demand posted strong signs again, driven mainly by growth in private consumption. Government spending stayed high, and residential investment remained subdued. The American labor market shows solid job creation marginally and gradually rising real wages, although not as tight as it was a few months ago. Thus, the market upgraded its growth expectations for the U.S. in 2024, although fundamentals such as the lower savings rate and the increase in households' financial burden again suggest a moderation in consumption going forward.

In the rest of the world, activity continues to perform poorly and expectations have not changed significantly, although recent figures are more favorable in some economies (figure I.1). In China, gross investment has been steadily recovering, driven by manufacturing and infrastructure, which contrasts with deteriorating consumption. Indeed, the weak outlook for the latter —affected to some extent by consumers' pessimism— and the continued worsening of the real estate market are behind the limited growth outlook in that economy. This has prompted the authorities to continue implementing measures to stimulate activity. The Eurozone remained stagnant at the end of 2023, which was affected by the low momentum of domestic and external demand amid a still contractionary monetary policy. Germany's weak performance is worth noting, particularly that of its manufacturing industry. In Latin America, after some dynamism in the first half of 2023 due to on-off factors —such as good harvests in Brazil and the effects of nearshoring in Mexico—, activity in the main economies moderated as the year drew to an end. Low levels of consumer confidence, as well as some uncertainty factors in different countries, anticipate a weaker momentum for 2024.

FIGURE I.1 GROWTH FORECAST FOR 2024 (1)
(percent)

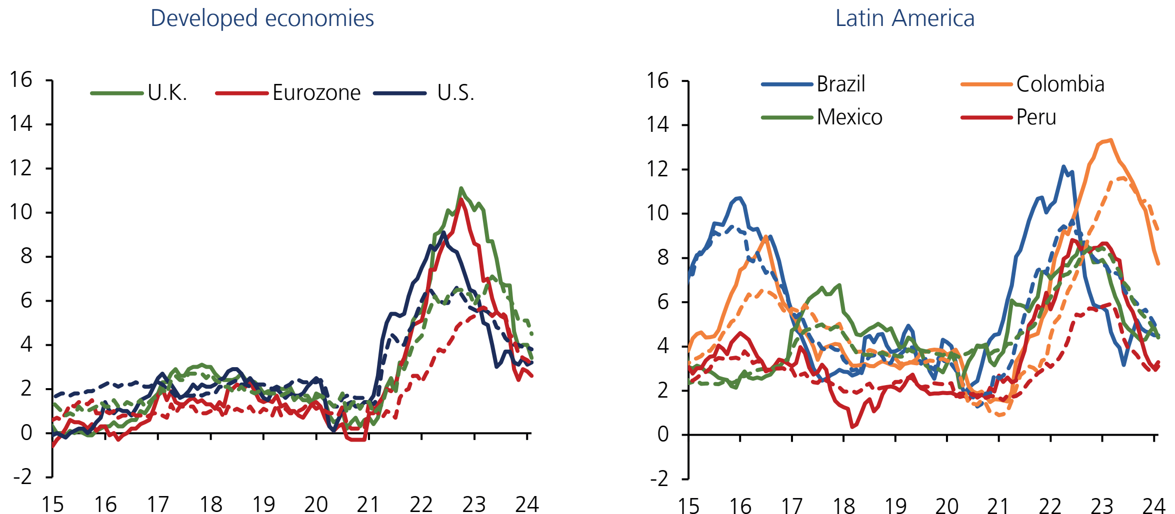


(1) The latest information available at the close of this IPoM refers to the month of March 2024. (2) Considers Brazil, Argentina, Peru, Colombia and Mexico. PPP-weighted growth; shares of each economy according to WEO (IMF).
Sources: Consensus Forecasts and IMF.

Headline inflation has continued to ease, although the reversal of some cost factors poses a few risks (figure I.2). The evolution of inflation has continued to reflect heterogeneity among its components. Goods have driven global disinflation, supported by reductions in transportation costs and fuel prices from their peaks of previous years. More recently, these figures have been partly reversed, resulting in higher inflation in some countries. Since the outbreak of the Red Sea conflict, the escalation of shipping freight rates and the reduction in cargo traffic through certain international routes deserve a special note (Box I.1).

The persistence of high inflation figures in the services sector also remains a source of concern. Among other factors, this situation can be explained by the dynamism that has characterized these sectors in recent years. The U.S. is one of the countries where this phenomenon has been present, thanks to its tight labor market. This factor will play a significant role in future monetary policy decisions in that country.

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



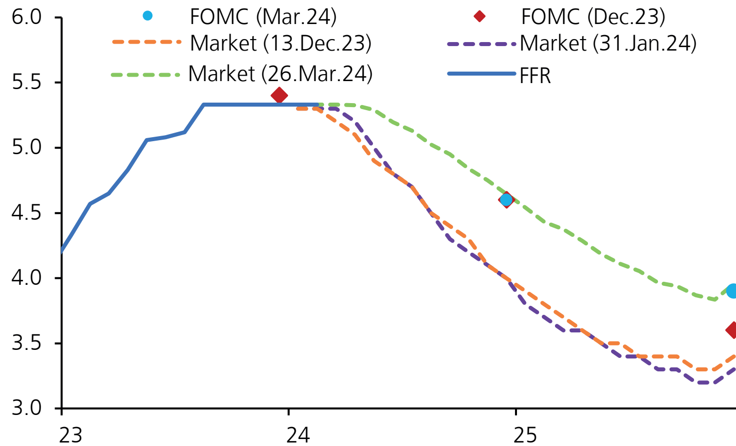
(1) Dashed lines correspond to core inflation. (2) Core figures exclude foods and energy.
Source: Bloomberg.

In this scenario, the U.S. Federal Reserve (Fed) has signaled a somewhat tighter monetary policy stance for the medium and long term (figure I.3). At its last meeting, the FOMC again stressed the need for more data to confirm that the disinflationary process is sustainable. Comparing the March and December projections, the three expected cuts in the fed funds rate in 2024 are maintained, but one less is anticipated for 2025 and 2026, reflecting a slightly slower inflationary convergence.

The financial markets have been delaying the start of the Fed's rate reductions (figure I.3). This comes after the figures released have reaffirmed the soundness of the U.S. economy and doubts about the evolution of inflation. These factors, coupled with a greater appetite for global risk, have been behind the movements in asset prices in that country in recent months, where the higher short-term interest rates stand out.

In the other economies, monetary policies have not substantially reduced their level of constraint. The European Central Bank has maintained its benchmark rates and has continued to communicate that its forthcoming decisions will be conditional on the evolution of the economic scenario. The Swiss National Bank surprised the market by cutting its rate by 25bp, becoming the first developed economy to jumpstart the cutting cycle. In Latin America, Brazil and Peru have continued to progress slowly in their monetary easing cycles, now joined by Colombia and Mexico. The market outlook is for these processes to take somewhat longer than was expected months ago. This considers the latest communication from the monetary authorities of these countries and, in contrast with Chile, inflation expectations are above the target in a number of them.

FIGURE I.3 FED FUNDS RATE (*)
(percentage points)

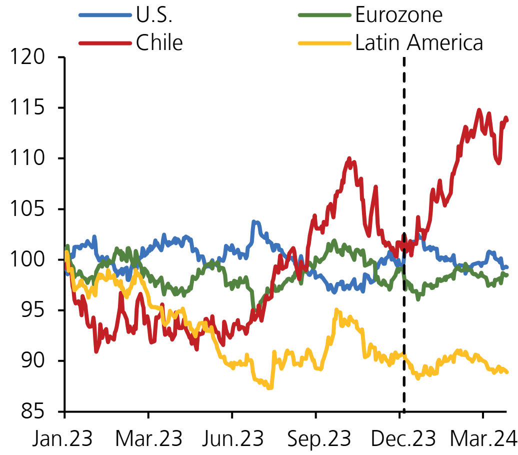


(*) FOMC projections correspond to the mid-range of the fed funds rate presented in December 2023 and March 2024; market projections are for the mid-range of the fed funds rate of futures at the closing date of the December 2023 IPoM (13.Dec.23), at the January FOMC (31.Jan.24) and at the statistical close of this IPoM (26.Mar.24).
Sources: U.S. Federal Reserve and Bloomberg.

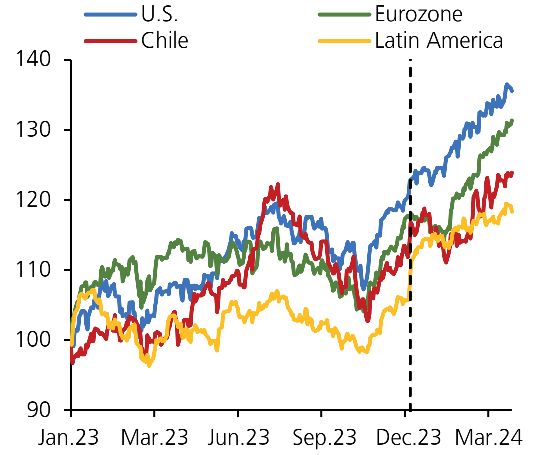
Assessment of external financial conditions is not very different from that of the last IPoM. Conditions remain tight for emerging economies, although stock markets have performed better globally (figure I.4). Despite changes in U.S. monetary policy expectations, markets have favored higher risk-taking. This has been mainly reflected in a rise in technology stocks' prices. Considering the 10-day average prior to the statistical closing of this IPoM and that of December, long-term interest rates and the multilateral dollar have not changed substantially. However, this performance has not been free of fluctuations, as markets remain sensitive to the release of new data and statements by monetary authorities.

FIGURE I.4 FINANCIAL CONDITIONS

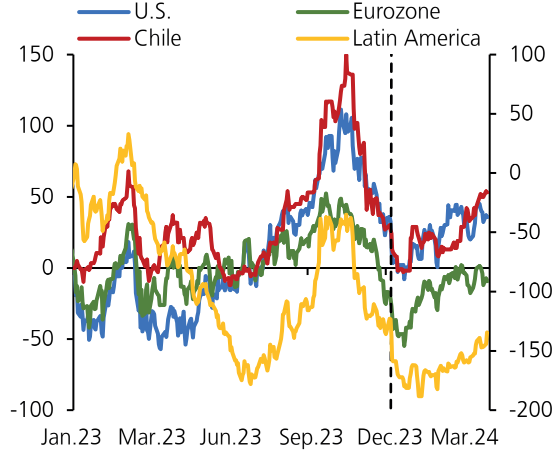
Currencies (1) (2) (3)
(index, 2.Jan.23=100)



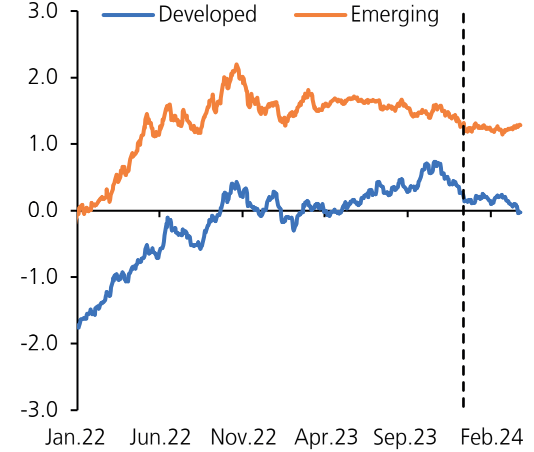
Stock markets (1) (2)
(index, 2.Jan.23=100)



Interest rates on nominal 10-year bonds (1) (2) (4)
(difference with respect to 2.Jan.23, basis points)



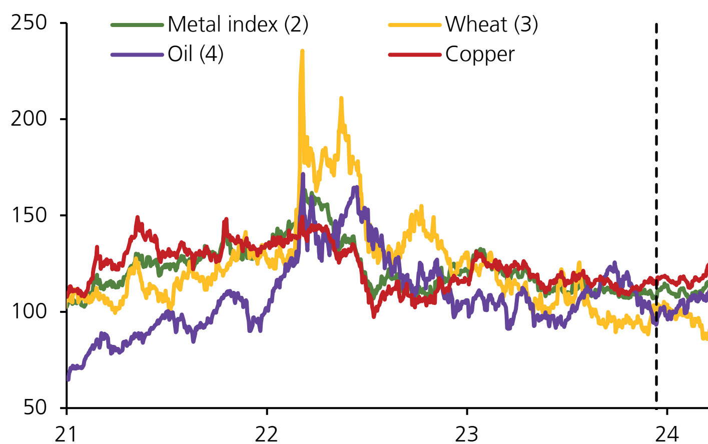
Goldman Sachs financial conditions index (1) (5)
(standard deviations)



(1) Dashed vertical line marks statistical close of December 2023 IPoM. (2) For Latin America, considers the simple average of Brazil, Mexico, Colombia and Peru. (3) An increase in the index indicates a currency depreciation, and vice versa. For the U.S., uses multilateral exchange rate. (4) For Latin America, it corresponds to the right axis. (5) Standardized with mean and standard deviation between 2010 and 2019. For developed countries, simple average of U.S., Eurozone, U.K., Canada, Australia, New Zealand, Norway and Sweden. For Emerging markets, simple average of Thailand, Malaysia, Indonesia, Philippines, South Africa, Hungary, Poland, Brazil, Mexico and Chile.
Sources: Bloomberg and Goldman Sachs.

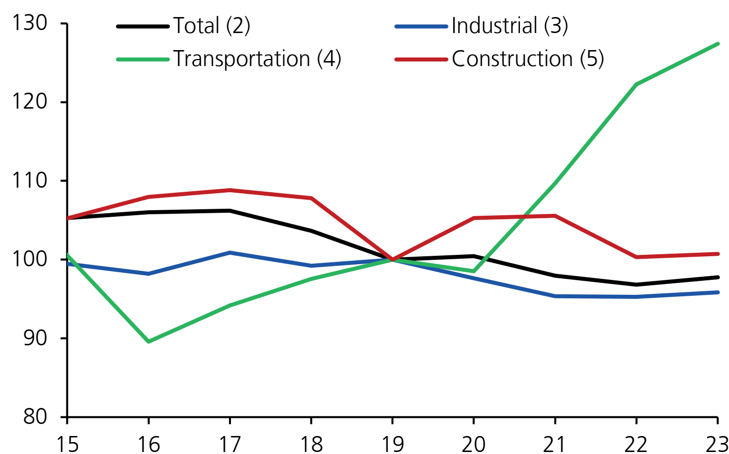
The prices of oil and copper have risen since the last IPoM, contrasting with price falls in some foodstuffs (figure I.5). Crude oil prices have been affected by, among other reasons, the developments of geopolitical conflicts in the Middle East and the announcements of OPEC+ that production cuts would be extended. At the close of this IPoM, these were close to US$84 for the WTI-Brent average (+13% since the December IPoM). The price of copper has also risen, spurred by the dynamism of the industrial sector in China. In recent years, within this sector, transportation has become more copper-intensive as part of the energy transition (figure I.6). The price per pound of copper was around US$4 at the statistical close of this IPoM (+6% since the December IPoM). Meanwhile, prices of several grains have fallen in recent months due to better expected crops and increased supply. The FAO food price index accumulated a 3% drop as of February with respect to November (last data known at the close of the December IPoM), with declines in the cereal, sugar, and vegetable oil sub-indexes.

FIGURE I.5 COMMODITY PRICES (1)
(index, 2010-2024 average=100)



(1) Dashed vertical line marks statistical close of December 2023 IPoM. (2) S&P GSCI Industrial Metals. (3) Prices of futures one-month ahead. (4) WTI-Brent average.
Source: Bloomberg.

FIGURE I.6 INTENSITY OF COPPER USE IN CHINA (1)
(index 2019=100)



(1) Ratio of copper consumption to output unit. Numerator and denominator are (separately) indexed to 2019=1, then the ratio is multiplied by 100. (2) Total refined copper consumption over real GDP. (3) Total refined copper consumption in different industrial sectors over China's total industrial output. (4) Total refined copper consumption in the transportation industry over total vehicle production. (5) Total refined copper consumption in the construction industry over the added value of construction sector.
Source: Central Bank of Chile based on CRU Group and Oxford Economics information.

THE DOMESTIC SCENARIO

Inflation declined rapidly from the highs of 2022 and is now closer to the 3% target (figure I.7). This fall in inflation has taken place in a scenario where most of the macroeconomic imbalances accumulated in previous years have been resolved, thanks to the adjustments of excessive spending levels and a narrowing of the activity gap.

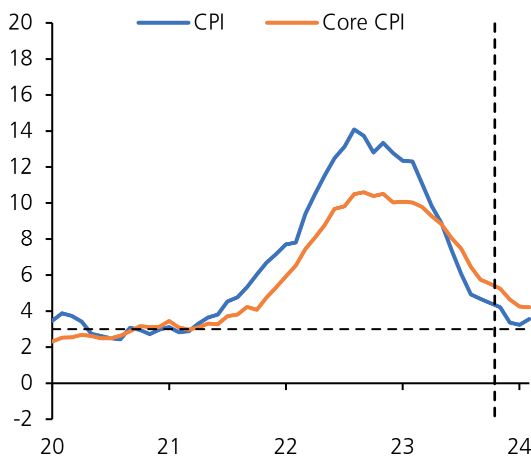
The inflation decline has been heterogeneous across components. The rapid reduction in the goods component contrasts with the higher level sustained by services. The evolution of goods inflation reflects the negative activity gap observed in the sectors associated with commerce in goods (Box II.1), in addition to the easing of global cost factors and the moderate pass-through of the peso depreciation on these prices. This was reported by several retailers in the February 2024 Business Perceptions Report (IPN). Services inflation has seen a more gradual decline and maintains high month-to-month variations, partly due to its characteristically higher inflationary inertia.

In any case, inflation accelerated at the beginning of this year, exceeding expectations. In February, headline and core inflation reached 3.6% and 4.2%, respectively[1]/.

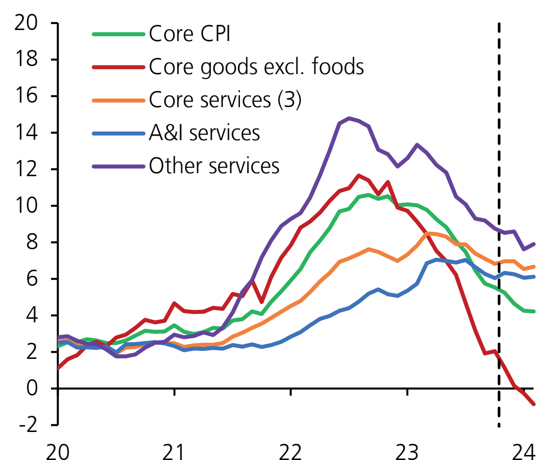
The rise in monthly inflation in January and February responded to factors such as exchange rate depreciation and external price hikes, along with the indexing of some domestic prices. The main increases were concentrated in specific items, while the month-to-month evolution of CPI figures has shown greater volatility for some months now (Box I.2). The variability of the data has taken the market by surprise time and again, even with discrepancies going in opposite directions (figure I.8).

GRÁFICO I.7 INFLATION INDICATORS

Headline and core inflation (1) (2)
(annual change, percent)



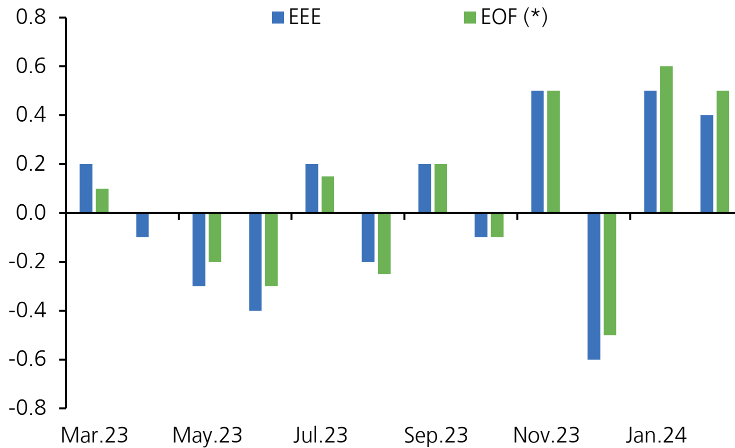
Core inflation (1) (2)
(annual change, percent)



(1) Series consider the 2023 CPI reference basket with the BCCh splice. (2) Dashed vertical line marks statistical close of December 2023 IPoM. (3) Considers the sum of administered and indexed services (A&I) and Other services.
Sources: Central Bank of Chile and National Statistics Institute (INE).

[1]/ For the purposes of macroeconomic analysis and monetary policy conduct, the CPI reference series for the year 2023 published by the National Statistics Institute (INE) are used. For details, see INE's *Manual metodológico* for the new 2023 basket and the BCCh's blog *Evolución de la inflación según la nueva canasta del IPC* y *Reestimación del IPC sin volátiles tras el cambio de canasta*.

FIGURE I.8 DIFFERENCE BETWEEN ACTUAL AND FORECAST MONTHLY INFLATION (percentage points)

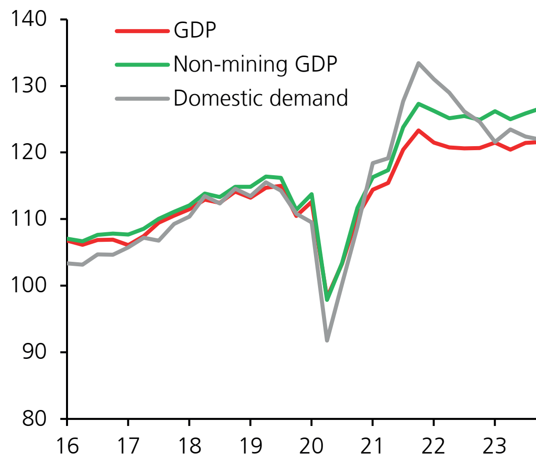


(*) For months where there are two publications, averaged data are used.
Source: Central Bank of Chile.

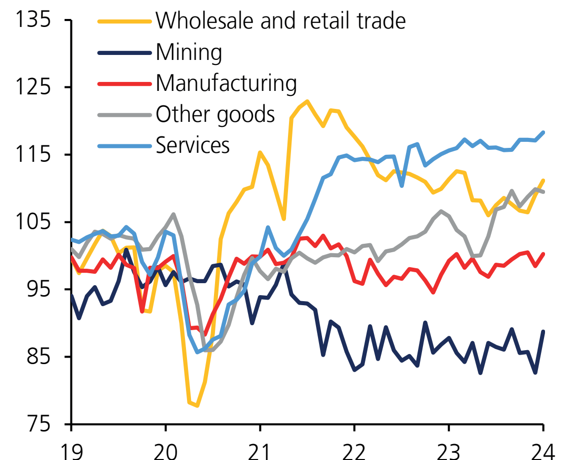
This recent behavior of inflation coincides with activity indicators that exceeded expectations at the beginning of 2024. Before this, GDP had shown positive quarterly and annual variations in the last two quarters of 2023, closing the year with a growth of 0.2% (0% in the December IPoM) (figure I.9). So far this year, the seasonally adjusted series of the Imacec accumulated increases of 2.9% and 1.7% in the total and the non-mining component, respectively. Both were higher than expected in those months. Part of these differences is due to greater external demand which, added to the impact of the exchange rate depreciation, has favored the performance of some manufacturing and agricultural sectors. Supply factors also played a role, particularly in the value added of power generation and fisheries. There are also elements that signal greater local impulse, such as the performance of business services. Some of these developments —especially those related to supply factors— would be transitory in nature.

FIGURE I.9

Activity and demand
(index, 2013.Q1 = 100, real seasonally-adjusted series)



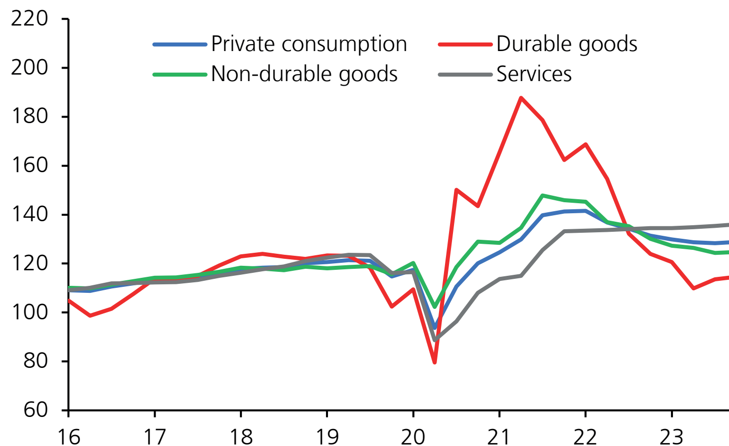
Imacec by sectors
(index, 2018 average = 100, real seasonally-adjusted series)



Source: Central Bank of Chile.

The better performance of the activity contrasts with a weaker than expected tradable component of domestic demand. During 2023, the seasonally adjusted series of household consumption fell through the third quarter, with a modest recovery in the last quarter of the year. It thus completed the year below the projection, at 5.2% (-4.6% in the December IPoM). Its contraction was particularly strong in the goods components (durable and non-durable), most strongly in the first half of the year, while spending on services increased slightly (figure I.10).

FIGURE I.10 PRIVATE CONSUMPTION BY COMPONENTS
(index, 2013.Q1 = 100, real seasonally-adjusted series)



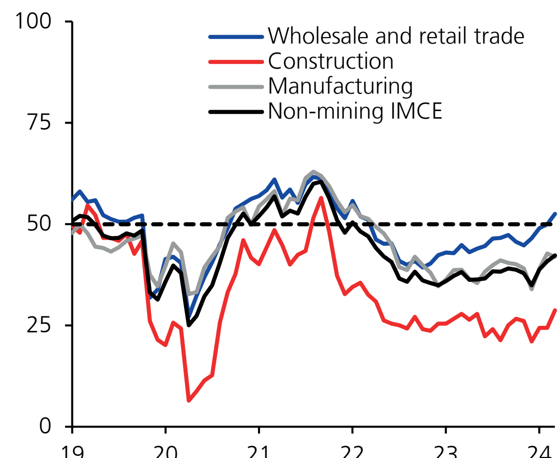
Source: Central Bank of Chile.

In any case, several high-frequency indicators reveal a gradual recovery of consumption in recent months (figure I.11). This is shown by the retail trade activity index (IACM), the retail daily sales index (IVDCM), and digital invoicing. All this happens in a context of gradual improvement in consumer confidence (IPEC), although it remains on pessimistic ground. At the same time, expectations of retail companies, measured by the IMCE, exceeded the neutral value (50) after two years of negative figures.

FIGURE I.11

Sales to residents through Transbank (1)
(index, 2019 average = 100, seasonally-adjusted series)

IMCE (2)
(difussion index)



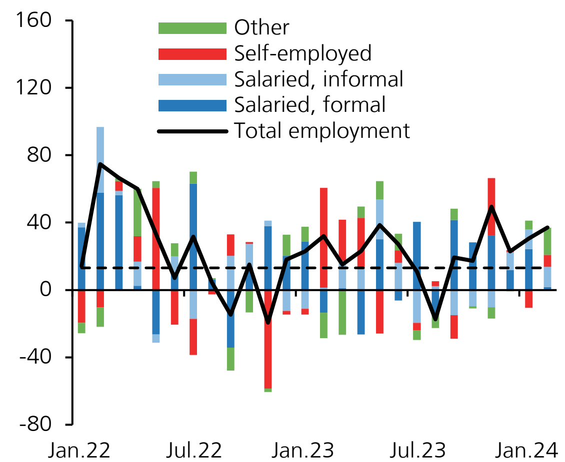
(1) Data may be subject to corrections in case of future revisions or updates. (2) Value above (below) 50 denotes optimism (pessimism).
Sources: Central Bank of Chile, SII, Transbank and ICARE/Universidad Adolfo Ibañez.

The evolution of consumption occurs while the labor market shows that employment and participation rates have gradually returned to their trend levels (figure I.12). It is worth noting the increase in salaried employment in recent months. In the recovery of the total participation rate, there is a lag in the over-55 age bracket, which could be associated with more structural reasons (Box I.3). All in all, the unemployment rate for the moving quarter ending in February was 8.5% and continues to be above its long-term average. Real wages continue to reflect a normalization of household labor income after the shock of the pandemic and the rise in inflation.

FIGURE I.12

Unemployment and participation rates
(percent)

Employment by occupational category (*)
(moving quarter difference, thousands, seasonally-adjusted)

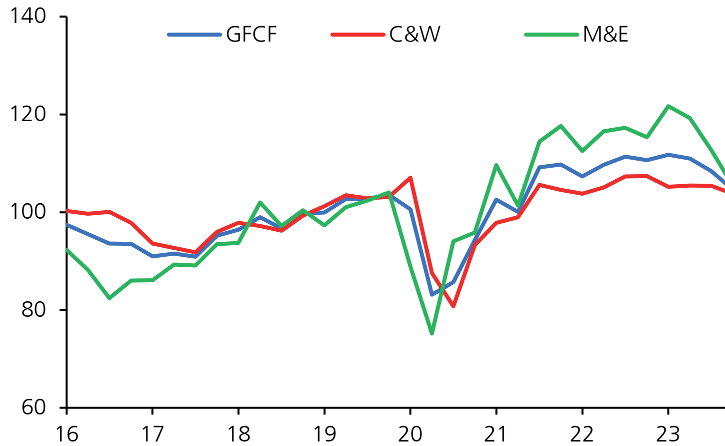


(*) Total employment is the official data seasonally adjusted by INE, while occupational categories were internally seasonally-adjusted using X13-ARIMA-SEATS. Dashed horizontal line shows 2013-2019 average. Other includes employers, domestic service and unpaid family work.
Sources: Central Bank of Chile and National Statistics Institute (INE).

Gross fixed capital formation (GFCF) was also weaker than expected, especially due to the deterioration of investment in machinery and equipment (M&E) in the last part of 2023 (figure I.13). This component contracted 5.5% and 6.4% q/q in the third and fourth quarters of the year, respectively. It is worth noting that this GFCF component is usually more volatile. Recently, it may have been more affected by the tightening of global financial conditions at the beginning of the fourth quarter, as well as the peso depreciation. In any case, the M&E drop in 2023 was smaller than projected in the last IPoM due to an upward correction of first quarter figures. This influenced the result for the year as a whole (-1.1%; -1.9% in the December IPoM). So far this year, imports of capital goods have continued to fall across the board.

In construction and other works (C&W), the real estate segment remains weak, with somewhat better signs in engineering works. This coincides with information taken from investment surveys, especially for mining. The IMCE subcomponents capture the discrepancy between the two sides of C&W investment. In terms of the outlook for investment, February IPN interviewees ruled out relevant projects for 2024 and anticipated a similar or lower path compared to 2023.

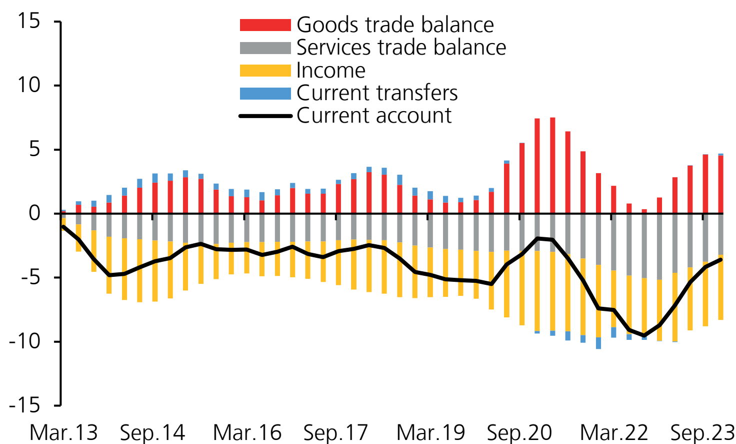
FIGURE I.13 GROSS FIXED CAPITAL FORMATION
(index, 2013.Q1 = 100, real seasonally-adjusted series)



Source: Central Bank of Chile.

The current account deficit continued to decline in late 2023 and ended the year at 3.6% of GDP (figure I.14). The better performance of the fourth quarter was essentially due to an increase in the trade balance. On the one hand, mining exports rose, boosted by greater external demand and better prices. On the other, imports of goods fell, mainly due to the contraction of capital goods. This deterioration has continued so far in 2024, in the context of a further depreciation of the peso. In any case, the current account deficit for the full year 2023 exceeded expectations (3.3% in December), largely influenced by the increase in remittances abroad in the first three quarters. All in all, national savings rebounded in 2023, reaching 19.4% of GDP, a record high since 2019.

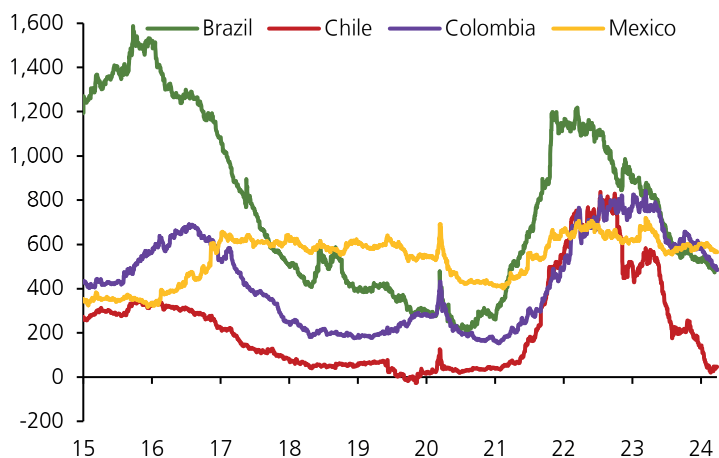
FIGURE I.14 CURRENT ACCOUNT: CONTRIBUTIONS BY COMPONENT
(percent of GDP, moving annual sum)



Source: Central Bank of Chile.

In the local financial market, the peso depreciation in recent months stands out. In addition to its usual fundamentals, this has been shaped by the influence that the postponement of the U.S. rate cut and the slower process of reductions in other central banks have had on Chile's rate differential with other economies (figure I.15). This has led to a depreciation of the peso of around 12% against the dollar and around 10% in its multilateral measure (MER) since the beginning of the year. Considering the average of the 10-day prior to the close of this and the previous IPoM, the one- and two-year nominal overnight index swap (OIS) fell by around 130 and 60bp, respectively. In the same period, UF-indexed OIS rates at the same terms fell 190 and 80bp. Long-term interest rates have fluctuated and at the close of this Report they are nearly 20bp above those at the end of December. In the same period, the IPSA has accumulated gains of around 9% (figure I.4).

FIGURE I.15 INTEREST RATE DIFFERENTIAL AT ONE YEAR TERM WITH RESPECT TO THE U.S.
(basis points)

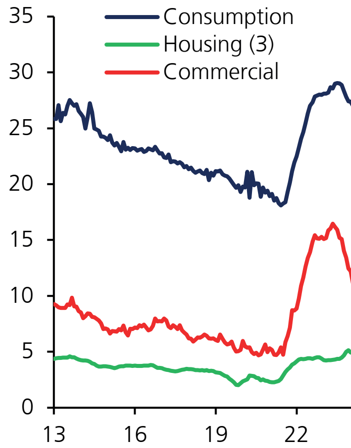


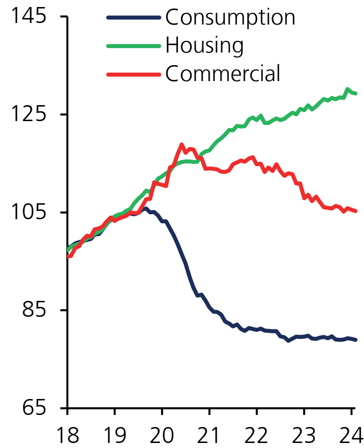
Source: Bloomberg.

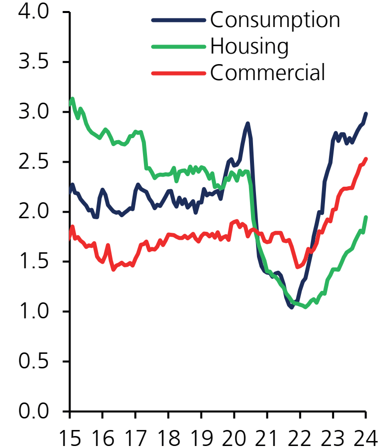
Beyond their seasonality, shorter-term lending rates have continued to reflect the cuts in the monetary policy rate (figure I.16). Commercial loan rates have declined since the December IPoM and averaged 12.1% in February 2024. Meanwhile, consumer rates have decreased more gradually. While mortgage rates have fallen most recently, they remain high, in line with the recent evolution of long-term interest rates. The variation in the stock of real loans has been limited in most portfolios.

However, there are risks associated with increased delinquency and more stringent bank requirements. Delinquency has continued to increase in the different portfolios, especially in commercial loans, whose above-90-days default ratio significantly exceeds its ten-year highs (figure I.16). This is consistent with the findings presented in the February 2024 IPN, in which interviewees maintain their view that lending conditions are still tight, especially in terms of delayed loan repayment by clients, and higher requirements for bank guarantees (figure I.16).

FIGURE I.16







(1) Weighted average rates of all transactions performed each month in the Metropolitan Region. (2) Series seasonally-adjusted using Census X-12. (3) UF-indexed loans. (4) Real data built using the 2023 annual base CPI, considering its most recent revision.
Source: Central Bank of Chile.

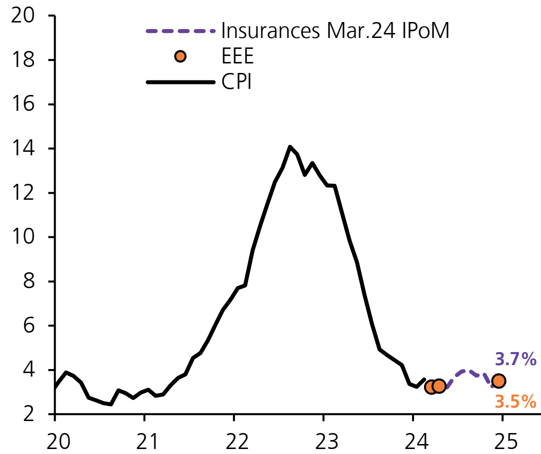
According to various measurements, inflation expectations two years ahead remain close to 3% (figure I.17). Towards the end of the monetary policy horizon, both the Economic Expectations Survey (EEE) and the Financial Traders Survey (EOF) suggest that inflation will be at its 3% target. Meanwhile, breakeven inflation anticipates 2.8% for the same period. On the other hand, the Survey of Price Expectations and Determinants (EDEP) for the moving quarter ending in January places businesses' inflation expectations at 4% in two years. Inflation expectations in December this year are at 3.5% according to the March EEE and at 3.7% according to the figures inferred from inflation insurances.

At the statistical closing of this Report, market expectations for economic growth in 2024 remain in line with our December forecast, and slightly above 2% for 2025. Respondents to the March EEE foresee growth of 1.8% for the current year, while Consensus Forecasts places it at 2.0%. For 2025, the EEE and Consensus Forecasts expectations stand at 2.2% and 2.4%, respectively.

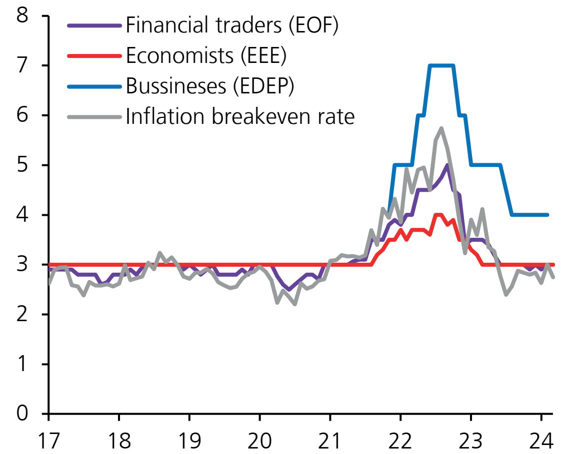
Expectations for the MPR continue to reflect the monetary normalization process currently underway. The EEE and the EOF foresee the MPR at 4% and 4.25% over the monetary policy horizon, respectively, while the expectations implicit in the OIS rates suggest that it will be at 4.75% in the same period. By the end of 2024, the EEE places the rate at 4.5% and the expectations implicit in the financial markets at 4.75%.

FIGURE I.17

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



Two-year inflation expectations (2) (3) (4)
(annual change, percent)



(1) Series consider the CPI 2023 reference basket. Insurances consider average prices of last 10 days to 1 April. (2) Median responses are shown for surveys. (3) EOF uses the survey of first two weeks of each month until January 2018. From February 2018 onwards the last survey published in the month is used, including the one prior to the April 2024 monetary policy meeting. In months with no survey published, the latest available one is considered. (4) Breakeven inflation considers averaged prices of the last 10 days of each month. For March 2024 it uses the average of the last 10 days as of 1 April.
Source: Central Bank of Chile.

BOX I.1:

Risks in international inflation convergence

Since mid-2022, inflation has fallen across the board in both advanced and emerging economies. This has been largely explained by the evolution of goods components, in a global context where disruptions to production chains have been resolved and transportation costs and the prices of various commodities have fallen. Services inflation, on the other hand, has remained high by historical standards in most cases (figure I.18). In recent months, some reversal of the factors that contributed to the deceleration of tradable prices has been observed, which poses some elements of risk in the evolution of inflation. These include transportation costs, energy prices, and the contribution of Chinese manufacturing prices to global disinflation.

The normalization of transportation costs was an important factor in the easing of the supply constraints that arose during Covid (figure I.19a). Econometric and accounting estimates based on input-output matrices for 57 countries indicate that, at the peak of the third quarter of 2022, the increase in shipping costs would have contributed around 0.8 percentage points (pp) to global inflation. Furthermore, their recent normalization would be having a negative impact of around 0.7pp to global inflation[1]/ (figure I.19b). Naturally, with shipping costs normalizing, deflationary pressures will tend to disappear by the end of 2024. In addition, conflicts in the Middle East and the Red Sea are generating new upward pressures on transportation costs. If they remain at their current level for six months, they would generate additional inflationary pressures in 2025, in the order of 0.4pp (figure I.19b).

The fall in energy prices from their 2022 peak—following the Russian invasion of Ukraine— was also an important factor in global disinflation. The release by the United States of a significant portion of its strategic petroleum reserve (SPR), together with the positive evolution of global supply—particularly in non-OPEC+ countries—helped to mitigate the effects of the deteriorating geopolitical situation. However, going forward, the supply outlook is less auspicious. U.S. production is expected to moderate and OPEC+ members not to increase their production levels[2]/. Added to this is the possibility for the geopolitical situation becoming more persistent or even worsening, which would put additional pressure on the oil price.

Finally, China's macroeconomic scenario, with weak consumption and dynamic industrial production, has contributed to global disinflation of goods in the most recent period. It is estimated that, during the second half of 2023, the combined effect of China's demand and supply contributed more than 1pp to the fall in goods inflation —excluding food and energy— in the U.S. (figure I.20). Going forward, if consumption does not continue to weaken and/or the rate of expansion of manufacturing output moderates, these deflationary effects could diminish.

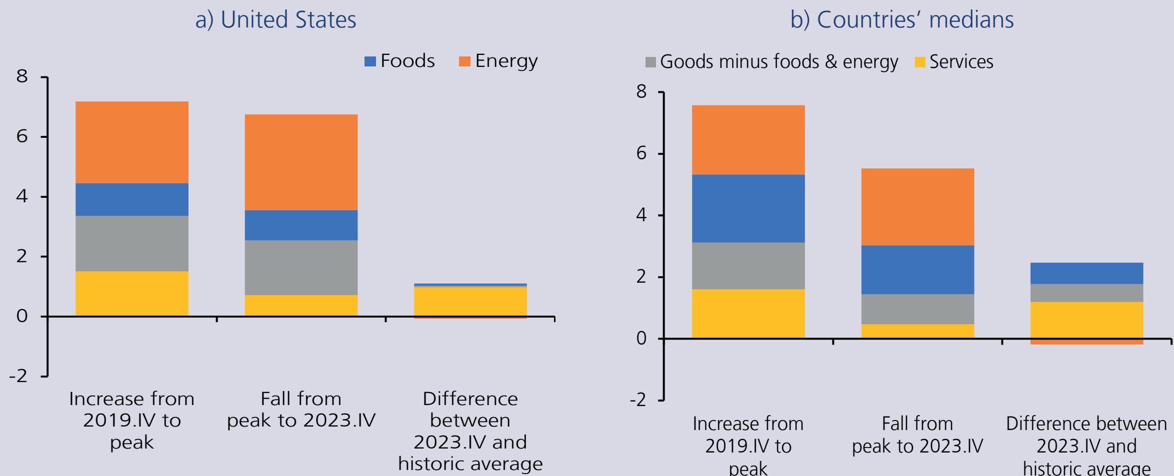
[1]/ Thus, between its peak of the third quarter of 2022 (+0.8pp) and its normalization at the beginning of 2024 (-0.7pp), the normalization of transportation costs would have contributed around 1.5pp to the fall in global inflation. Details on this estimate and other aspects of this box are available in Pustilnik *et al.* (2024).

[2]/ In the U.S., investments in extraction have remained contained and no further reductions in the SPR are expected, as they are rather low. Meanwhile, OPEC+ has recently agreed to extend voluntary production cuts by 2.2 million barrels during the second quarter of 2024.

Conclusions

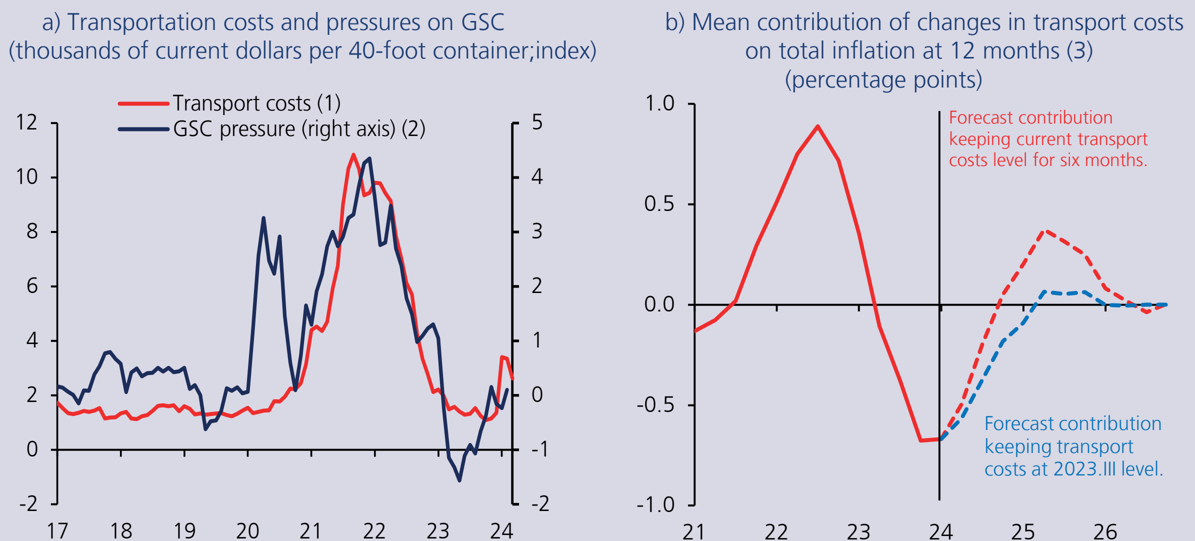
The rapid decline in global inflation has centered on goods. Some supply-side factors have contributed to this, the impact of which is being diluted (i.e., transportation costs, value chains and pressures from China), in addition to the recent rise in shipping costs and the outlook for fuel prices. This scenario imposes certain degrees of uncertainty on the velocity of global inflation convergence.

FIGURE I.18 CONTRIBUTION OF MAIN CPI COMPONENTS (*)
(puntos porcentuales)



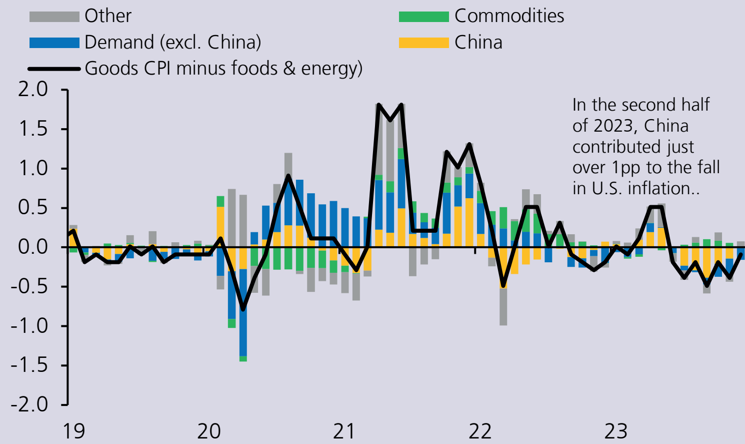
(*) Contributions computed with harmonized CPI baskets (ECOICOP) and original weights of each country. For details, see Bajraj *et al.* (2023).
Source: Global inflation base, according to Bajraj *et al.* (2023).

FIGURE I.19 TRANSPORTATION COSTS AND INFLATION



(1) Freightos Baltic Index. (2) Global Supply Chain Pressure Index (GSCPI). (3) Local Projection Model (Jorda, 2005) with harmonized quarterly inflation for 57 countries (Bajraj *et al.*, 2023) between 2010 and 2023. Cumulative incidence of transportation cost shocks over the previous eight quarters. For details, see Pustilnik *et al.* (2024).
Sources: Freightos Baltic Index, New York Fed and Pustilnik *et al.* (2024).

FIGURE I.20 BREAKDOWN OF THE U.S. CPI FOR GOODS (EXCLUDING FOOD AND ENERGY) (*)
(monthly change, deviation from mean)



(*) Historical breakdown of the U.S. CPI for goods (excl. foods and energy) based on a VAR with sign constraints. Values expressed as deviations from the mean between 2012 and 2023. Shocks are identified using China's producer price index, China's industrial production China's producer price index, China's industrial output, global industrial output excluding China, and global commodity prices. China's supply and demand factors are added together to calculate their total contribution. For details, see Pustilnik *et al.* (2024).
Sources: China Bureau of Statistics, Bureau of labor Statistics, S&P and Bloomberg.

BOX I.2:

Recent evolution of core inflation

Different factors have shaped the analysis of the evolution of Chile's core inflation since the December IPoM. First, the INE published a new CPI basket and calculation methodology, with base 2023=100. Second, the Central Bank re-estimated the basket used to calculate the CPI without volatiles, as well as the parameters used for other measures of trend inflation. And in December, January and February, monthly inflation showed higher volatility than usual. This box details the dynamics of core inflation in light of these developments.

Publication of the new CPI basket with 2023=100 base

Pursuant to its commitment adopted in 2009, the INE updated the basket of goods and services used to calculate inflation. The reference series for 2023 calculated with the new basket showed inflation for 2023 around 0.6 percentage points (pp) lower than estimated with the former basket. The difference was mainly explained by the adjustment of the weights of the products in the new basket that increased the share of goods and reduced the share of services. In terms of monthly variations, the main differences were concentrated in the first months of the year, with no big changes in the measurements from August 2023 onwards[1]/. Therefore, the differences in the annual variations between baskets will decrease steadily during the first half of this year.

Re-estimating the CPI without volatiles

The CPI without volatiles items is an index that excludes products whose movements are uninformative of the inflation trend. As noted in the Bank's blog on the re-estimation of the CPI without volatiles following the change of basket, the index is obtained by finding the basket of sub-classes that minimizes a loss function that evaluates four desirable properties of a measure of core inflation, that is: persistence, volatility, bias with respect to total inflation, and predictive error. With respect to the original methodology[2]/, in the re-estimation of the index, the optimization process was made more robust by incorporating an algorithm that allowed considering small modifications to the initial arrangement of the volatility subclasses. The re-estimation of inflation without volatiles, considering the reference series for its calculation, showed that cumulative inflation during 2023 was 0.8pp lower than that calculated with the previous basket. In any case, as with the CPI, no significant changes were observed in the monthly figures at the end of 2023, so that the differences in the annual variations between baskets will be decreasing in the coming months.

Along with the CPI without volatiles, the Central Bank regularly monitors other indicators that seek to capture inflationary trends by excluding "noisy" CPI components. Among these, the trimmed mean, the volatility-trimmed mean, the variance-adjusted mean and the median stand out. Recently, the parameters of these measures were also calibrated in order to achieve a good performance in terms of the aforementioned properties. In any case, when compared to the CPI without volatiles 2023=100, the latter performs better in terms of the desirable properties described above. Guzmán et al. (2024) describe the methodologies used for re-estimating the different core measures and present a brief comparison between these methodologies.

Recent dynamics of core inflation

The update of the various measures shows a marked decline in core inflation in 2023 from the 2022 highs. This was driven by lower goods inflation (figure I.22a), which reflects a disinflationary trend common to other economies (box I.1) and was reinforced by sectoral gaps that turned negative in 2023 (box II.1). Core services inflation also declined from its peaks, albeit more slowly, which places it still at historically high inflation levels.

[1]/ See the analysis after the publication of the new basket on the blog *Evolución de la inflación según la nueva canasta del IPC*.

[2]/ Based on Carlomagno et al. (2023).

The last few months have been characterized by a speed up of inflation and its different core measures (figure I.22b). This has been influenced by higher goods figures than those of mid- 2023, but which continue to point to a moderate pass-through of the peso depreciation. The last month also showed important acceleration in services, although concentrated in a small number of products (figure I.22c), among which rent prices stand out, as it posted a strong monthly increase in February, beyond the usual patterns of past-inflation indexation, which will require close monitoring to better figure out its causes and determine its persistence.

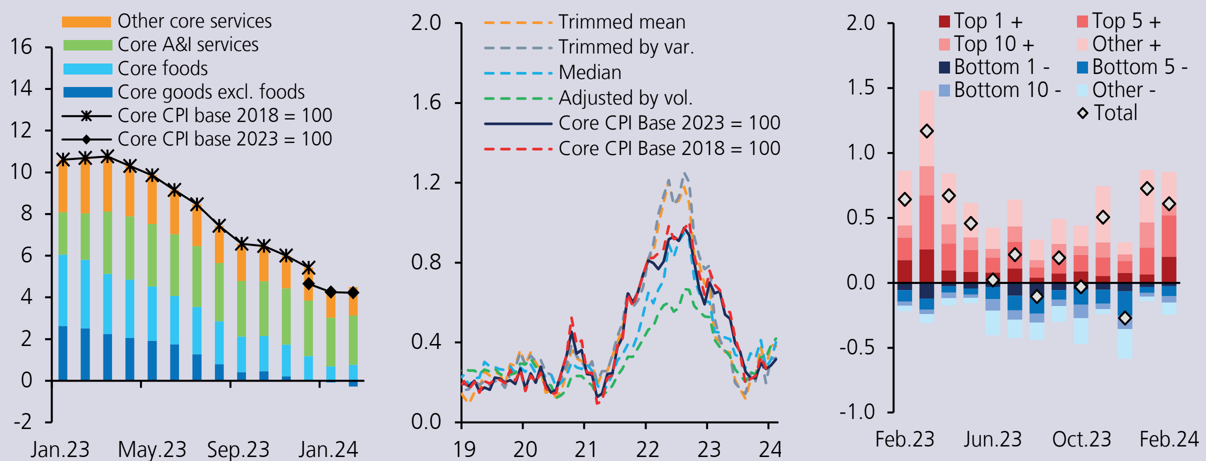
In the near future, it is expected that cost pressures will continue to pass through to inflation. In non-volatile services, a gradual convergence is foreseen —even slower than in our previous forecast— as prices and labor costs are indexed to lower inflation rates. Core goods will be affected by the peso depreciation, although it is expected that the exchange rate pass-through will remain moderate given the slack present in consumption-related sectors. However, scenarios are recognized in which a greater exchange rate pass-through along with greater external pressures —particularly shipping costs— could have an even greater impact on goods inflation.

Closing remarks

The new CPI basket and the re-estimated measure without volatiles yield a lower annual inflation than was obtained with the previous basket, thus confirming the pronounced process of declining inflation during 2023. In any case, the monthly variation of both indicators showed a similar dynamic to what was estimated before in the second half of last year. In turn, most recently an acceleration of core inflation has been observed, in line with the peso depreciation of recent months and partly associated with specific items, whose evolution must continue to be closely monitored.

FIGURE I.21

a) CPI w/o volatiles and contributions (1) (annual change, percentage points) | b) Core inflation measures (2) (monthly change in 3-month mov. avg., percent) | c) Contributions to CPI w/o volatiles (3) (contributions over monthly change, percentage points)



(1) As from January 2024 the contributions are calculated using the indexes with annual base 2023=100, so they are not strictly comparable with previous figures. (2) Considers reference and seasonally adjusted CPI series. (3) Top (bottom) correspond to the positive (negative) cumulative contribution by one, five, and ten products that have the strongest (smallest) impact on the monthly variation of the CPI without volatiles.
Source: Central Bank of Chile.

BOX I.3:

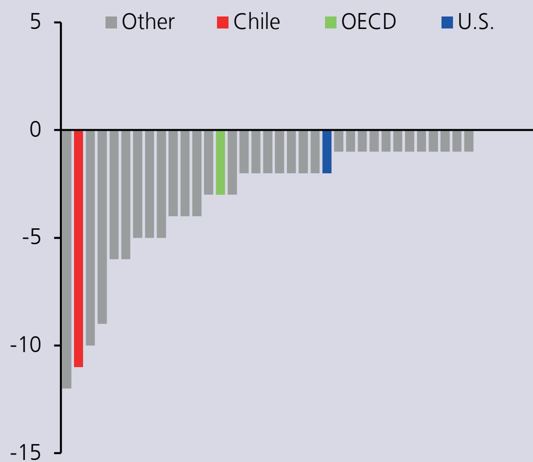
Labor participation of older persons

The Covid-19 pandemic prompted an unprecedented drop in labor force participation rates for all age groups in the second quarter of 2020 (figure I.22a). Strict sanitary measures to mitigate the effects of the health crisis on the population were accompanied by economic measures to reduce the impact on the economy's productive capacity. This situation and the very perception of pandemic risk on the part of some groups of workers meant that many of them left their jobs. This phenomenon was, to a greater or lesser extent, a global phenomenon (Bertinatto *et al.*, 2022). By 2023, the fall in labor participation had reversed in virtually all OECD countries. However, in Chile this reversal has not been complete, which is largely accounted for by a weak re-entry of workers over 55 years of age into the labor force (55+) (figure I.22b).

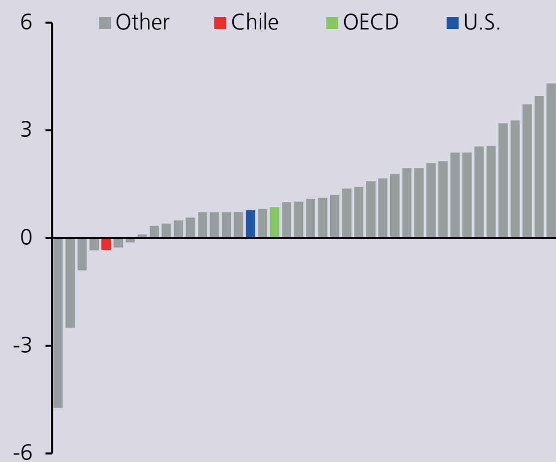
FIGURE I.22 CHANGE IN PARTICIPATION RATE IN OECD COUNTRIES
(percentage points)

a) Change in participation rate: 15 to 64 years of age

Second quarter 2019 to second quarter 2020

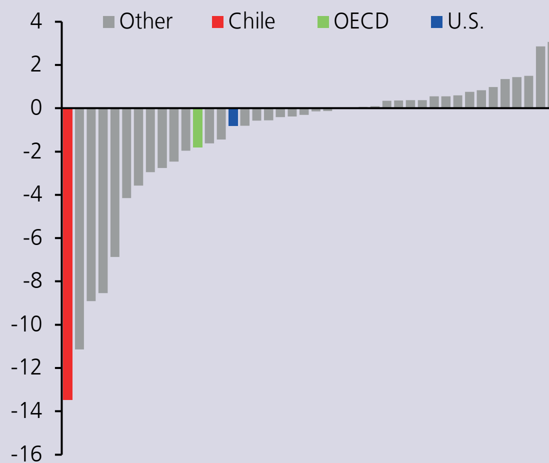


Second quarter 2019 to second quarter 2023

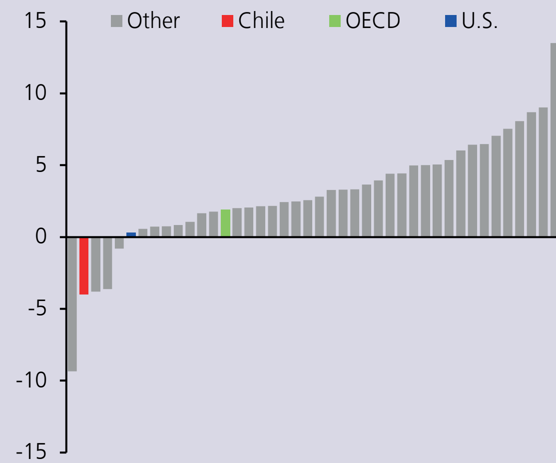


b) Change in participation rate: 55 to 64 years of age

Second quarter 2019 to second quarter 2020



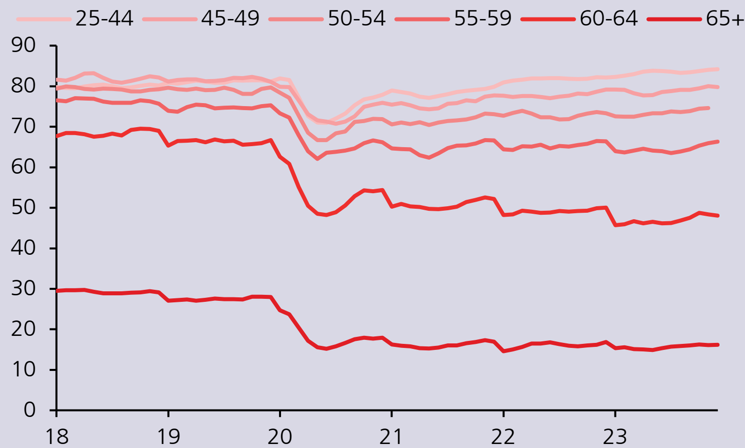
Second quarter 2019 to second quarter 2023



Source: Organisation for Economic Co-operation and Development (OECD).

The changes in the participation rate shown in figure I.22 measure not only the evolution of workers who were 55+ at the time of the pandemic, but also the composition effect associated with the incorporation of workers who reached that age in the interim. A more granular analysis, taking as a reference the age that workers were at the onset of the pandemic, shows that the older they were at the beginning of 2020, the more permanent their drop in participation was (figure I.23). This contrasts with the younger age groups, which have gradually recovered pre-pandemic participation levels.

FIGURE I.23 LABOR FORCE PARTICIPATION BY AGE IN 2020
(percent)



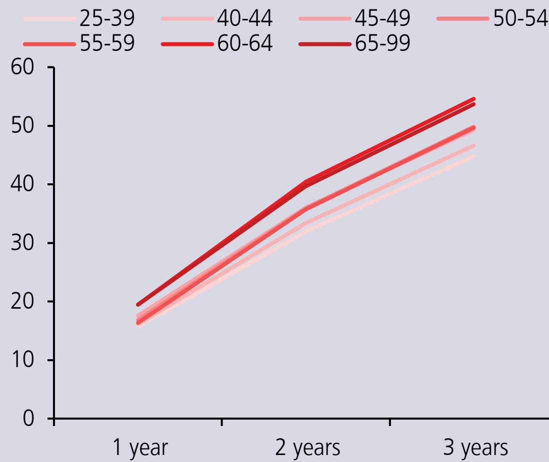
Source: own calculations using data from the National Employment Survey (ENE).

The evidence shows that the probability of re-entering the labor market from inactivity depends mainly on the worker's age, the time elapsed since the last job and the reason for inactivity. The older the worker is and the longer the time elapsed since their last job, the lower the probability of re-entering the labor market[1]/. In Chile, in the case of formal employment, there is a 45% probability that workers between 25 and 39 years of age will not return to formal employment if they have been out of the labor market for three years. This probability increases to about 55% if the worker is 60 years of age or older (figure I.24a). For workers 55+, the discouragement motive does not seem to play an important role in the recent drop in labor force participation. On the contrary, the reason most reported for the decline in labor participation is retirement, which could indicate that the inactivity status is permanent (figure I.24b)[2]/.

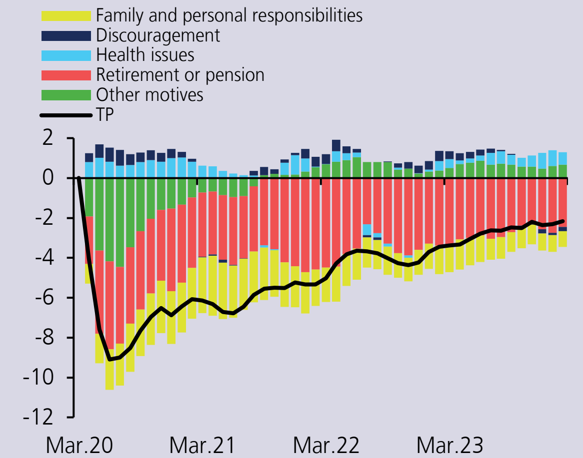
[1]/ The low rate of re-entry into the labor force from inactivity is the main reason behind the lower participation rate of older workers in the U.S. (Choi *et al.*, 2014). This may be linked with factors such as the loss of targeted skills, which are difficult for older workers to regain, and which affect potential re-entry wages.
[2]/ The proportion of marginal inactive people for the cohort that was 55+ in 2020 has remained constant since then. For details, see Bauducco, Castillo y Tapia (2024).

FIGURE I.24

a) Conditional probability of not returning to formal employment, given the time (years) elapsed since last job (percent)



b) Change in participation rate of persons 54 years of age or older due to inactivity (1)(2)
(difference w.r.t. March 2020, percentage points)



(1) Internally deseasonalized levels using X13-ARIMA-SEATS. (2) Since the participation rate is equal to 1-(inactivity/working-age population), the participation rate can be decomposed into the different motives for inactivity. Source: own calculations based on data from the National Employment Survey (ENE) and Chile's Internal Revenue Service (SII).

Conclusions

Labor force participation of the 55+ worker group fell sharply during 2020 and, unlike the other age groups, is still far from its trend levels (11 percentage points below participation in 2019). Given the age of these workers, the long time elapsed since the Covid outbreak, and the fact that the main reason reported for the increase in inactivity in this age group is retirement, it is reasonable to conclude that this drop in participation rates will be prolonged, at least for the cohort that was already 55 years of age or older at the beginning of the pandemic. This implies a persistent effect on the aggregate participation rate of the economy while this cohort is included in the population on which that rate is calculated.

A corollary of this analysis is that, in order to characterize current labor market conditions, it is more appropriate to look into unemployment rates rather than employment levels of different age segments compared to the pre-pandemic period.

II. FUTURE EVOLUTION OF MONETARY POLICY

Inflation has declined rapidly after its 2022 highs and is closer to 3%[1]. This, in a scenario in which activity has outperformed the December forecasts, while final demand has been weaker, due especially to tradables consumption and gross fixed capital formation (GFCF)[2]. The postponement of the rate cut in the U.S. and the slower process of reductions by central banks elsewhere have had an impact on Chile's rate differential with other economies. This, along with the behavior of its other determinants, has put pressure on the peso beyond what was expected. The higher exchange rate, coupled with increases in some international prices, will push up headline and core inflation this year. Thereafter, both indicators are expected to gradually return to 3% within the two-year monetary policy horizon. This considers the transitory nature of the aforementioned factors, growth in domestic activity gradually approaching its trend rates, and a steady reduction in the real exchange rate (RER). GDP growth is foreseen to be between 2 and 3% this year, given the transitory acceleration of activity of recent months and a stronger impulse from abroad. For 2025 and 2026, growth is expected to range between 1.5% and 2.5%. The Board foresees that, in line with the central scenario of this Montery Policy Report (IPoM), the Monetary Policy Rate (MPR) will be further reduced. The magnitude and timing of the MPR reduction process will take into account the evolution of the macroeconomic scenario and its implications for the trajectory of inflation.

ACTIVITY AND DEMAND PROJECTIONS IN THE CENTRAL SCENARIO

Responding to several factors, local activity regained momentum at the beginning of this year and has exceeded expectations. This is evident in both the mining and non-mining components of the Imacec (table II.1; figures II.1 and II.2). The manufacturing industry and the agricultural sector benefited from increased external demand. Supply factors also played a role, such as the higher added value of power generation in Electricity, Gas and Water (EGW). Trade and some services also recovered. For mining, the dynamism came from both the non-metallic and metallic sectors (INE). These dynamics will raise the first quarter GDP, but the transitory nature of some factors point to slower velocities in the short term, in line with those previous considered[3].

[1] For the purposes of macroeconomic analysis and the conduct of monetary policy, the Board uses the series with base year 2023, called the reference CPI, which considers information from the new basket only. For price-level restatement purposes of indexed contracts, bonds or securities, the annual variation of the CPI reported by the National Statistics Institute (INE) is used. This combines the CPI base 2018 and base 2023. As of February, it showed an annual increase of 4.5%.
[2] As every March, the publication of the National Accounts considers the GDP estimate of the previous year and the revisions to the figures of the two previous years. The Imacec series are also revised in line with this added information.
[3] Seasonality measurements and the variation rates of February and March 2024 should be assessed with caution, as the leap year and the Easter Week holidays make significant differences in the composition of working days of the months of the first quarter of this year. For details, see blog: The importance of the calendar effect in Chilean economic activity – Central Bank of Chile (bcentral.cl)

Contrary to activity, in the second half of 2023, final demand (which excludes changes in inventories) was lower than expected, particularly in the tradable component of private consumption and GFCF (table II.1; figures II.1 and II.2). The latest National Accounts reported higher GFCF levels in 2022 and early 2023, which led to an upward revision of both years' results to 3.9% and -1.1% y/y, respectively (2.8% and -1.9% in the December IPoM, in each case). However, the new figures also showed a sharp decline in the second half of 2023, which intensified in the last quarter. This GFCF behavior reflected the evolution of machinery and equipment (M&E), which is generally more volatile. All this, in the midst of a period of exchange rate depreciation and worsening global financial conditions.

In 2023, private consumption fell more than expected (-5.2% annually versus -4.6% in the December IPoM), after growing strongly in the two preceding years (table II.1; figures II.1 and II.2). Household spending showed quarterly declines in its seasonally adjusted series up to the third quarter of last year, turning slightly positive only at the end of 2023. The consumption adjustment process was particularly evident in both durable and non-durable goods. Services showed a more stable performance. This has had its correlation in the inflationary dynamics, where goods have driven the fall in inflation, in line with the larger gaps in the representative sectors of this component of consumption (Boxes I.2 and II.1).

In the central scenario, GDP is projected to grow between 2.0 and 3.0% this year (1.25-2.25% in the December IPoM). This responds largely to the transitory acceleration of activity in the first quarter and a greater boost from abroad. This projection assumes the reversal of some of the elements that boosted activity in the first quarter, which will imply a moderation of its expansion rates in the second quarter. The somewhat more favorable external scenario and the depreciation of the RER will give greater impulse to the export sector (table II.1, figures II.1 and II.2).

In both 2025 and 2026, the economy is expected to grow between 1.5 and 2.5%, which means that activity will be converging to its potential growth rate. The better performance early this year translates into an activity gap that turns positive in the immediate term, but that will return to zero and remain close to that figure in the medium term (table II.1, figures II.1 and II.2).

Projections continue to assume that consumption will have positive rates of change in the three-year period 2024-2026, similar to those of the last IPoM. This relies on financing conditions becoming more favorable, improved consumer confidence (IPEC) and rising labor incomes, thanks to higher real wages and increased employment. High frequency indicators —retail sales, digital invoicing— account for this better consumption performance. Private consumption is thus expected to grow by around 2.0% in 2024 and 2025, and 2.3% in 2026 (table II.1; figures II.1 and II.2).

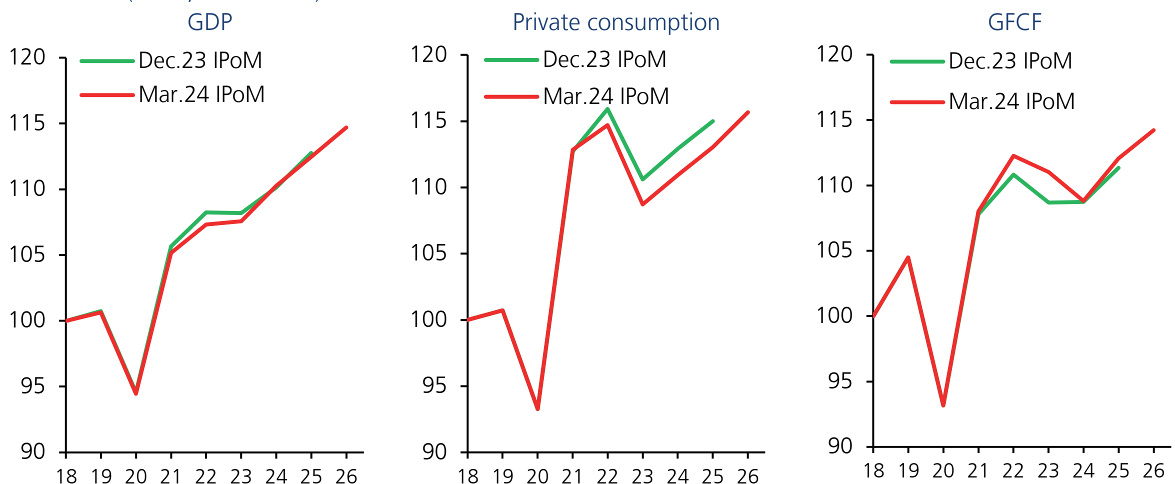
GFCF is projected to fall again in 2024 (-2.0% versus 0% in the December IPoM). This considers the higher base of comparison, its contraction at the end of 2023 and the weak situation of its fundamentals. So far this year, imports of capital goods have continued to fall across the board, as the peso has depreciated. In construction and other works (C&W), the weak real estate sector contrasts with more favorable signals in engineering works, in line with information from the investment surveys, particularly for mining. Investment remains constrained by lending conditions, especially the high levels of interest rates on longer-term loans (table II.1; figures II.1 and II.2).

TABLE II.1 ECONOMIC GROWTH AND CURRENT ACCOUNT

	2023	2024 (f)	2025 (f)	2026 (f)
		(annual change, percent)		
GDP	0.2	2.0-3.0	1.5-2.5	1.5-2.5
National income	0.8	1.5	2.6	2.6
Domestic demand	-4.2	1.6	2.2	2.5
Domestic demand (w/o inventory change)	-3.2	1.0	2.1	2.1
Gross fixed capital form	-1.1	-2.0	3.0	1.9
Total consumption	-3.9	2.0	1.9	2.2
Private consumption	-5.2	2.0	1.9	2.3
Goods and services exports	-0.3	4.5	2.7	1.8
Goods and services imports	-12.0	1.3	3.5	3.0
Current account (% of GDP)	-3.6	-3.4	-3.4	-3.4
Gross national saving (% of GDP)	19.4	20.0	20.6	20.3
Gross national investment (% of GDP)	23.0	23.4	24.0	23.7
GFCF (% of nominal GDP)	23.8	23.1	23.5	23.7
GFCF (% of real GDP)	23.8	22.7	23.0	22.9
		(US$ million)		
Current account	-11,899	-11,000	-12,200	-13,100
Trade balance	15,323	16,200	14,500	14,600
Exports	94,557	98,600	103,700	107,100
Imports	79,234	82,400	89,200	92,500
Services	-10,782	-10,700	-10,800	-11,600
Rent	-17,009	-16,700	-16,100	-16,300
Current transfers	568	200	200	200

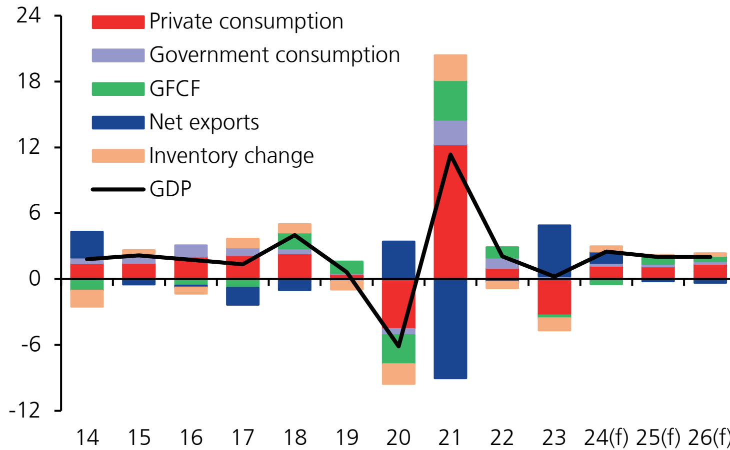
(f) Forecast.
Source: Central Bank of Chile.

FIGURE II.1 ACTIVITY, PRIVATE CONSUMPTION AND GFCF (*)
(index, 2018 =100)



(*) For 2024, 2025 and 2026, considers midpoint of GDP growth ranges projected in respective Monetary Policy Report (IPoM).
Source: Central Bank of Chile.

FIGURE II.2 GDP GROWTH AND AGGREGATE DEMAND COMPONENTS CONTRIBUTIONS (*)
(annual change, percentage points)

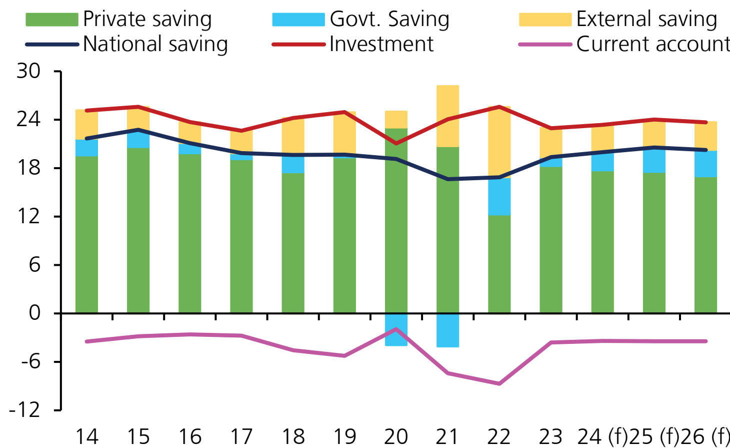


(*) For 2024, 2025 and 2026, considers midpoint of GDP growth ranges projected in this Report's central scenario. (f) Forecast.
Source: Central Bank of Chile.

The current-account deficit will be 3.4% of GDP during 2024-2026. The lower projected deficit mainly reflects the improved outlook for the trade balance. This includes the greater external impulse on exports and, to a lesser extent, somewhat better copper prices. Plus, lower domestic spending on tradable goods, consistent with the higher level of the exchange rate. As a result, domestic savings will increase again (table II.1 y figure II.3).

Regarding public spending, the central scenario considers the assumptions contained in the Public Finance Report (IFP) for the fourth quarter of 2023. Fiscal spending is expected to expand by around 5% annually in real terms this year, and then show real annual growth of slightly more than 1% in 2025. The projected trajectory for the structural balance in 2024 and 2025 is unchanged (-1.9% and -1,1% of GDP, respectively).

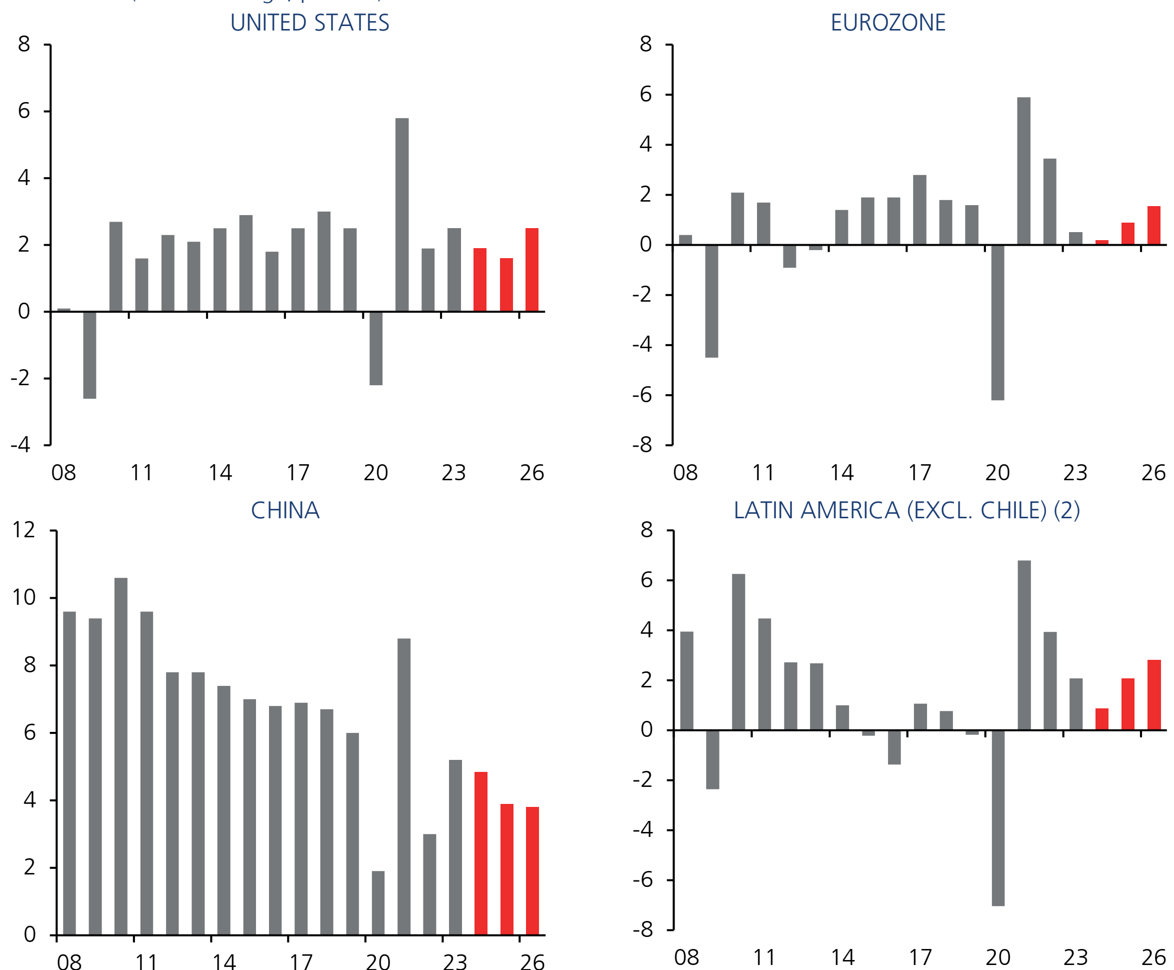
FIGURE II.3 CURRENT ACCOUNT: SAVINGS AND INVESTMENT (*)
(percentage of annual GDP)



(*) The government savings component considers as actual data up to 2023 the general government's balance sheet; the government savings of the central government's balance sheet is used for the 2024-2026 forecast. (f) Forecast. Source: Central Bank of Chile.

The economy will receive a stronger external impulse than was forecast in December, thanks to the higher growth of trading partners in 2024 (3%; 2.7% in the December IPoM). The main revision comes from the improved outlook for the US, where a recession is no longer expected in the central scenario. This combines the actual performance of activity in that country, well above projections, and a revision to the level of potential GDP4/, in line with counterparties such as the International Monetary Fund. Part of this reassessment is related to the revised duration of the effects of the pandemic and of some supply-side factors, among other hypotheses5/ (figure II.4 and table II.2).

FIGURE II.4 TRADING PARTNERS GROWTH PROJECTIONS (1)
(annual change, percent)



(1) Red bars correspond to the projections of the central scenario of this Monetary Policy Report (IPoM). (2) The Region considers Argentina, Bolivia, Brazil, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela. The series projection is based on GPM model region made up by Brazil, Chile, Colombia, Mexico and Peru. Source: Central Bank of Chile.

4/ It should be noted that the higher level of potential GDP does not imply a revision of the trend growth rate for this economy.
5/ There are various arguments that could justify this revision to potential GDP, including the higher-than-expected increase in the country's labor force (Congressional Budget Office) and the recovery of productivity per worker (Bureau of Labor Statistics). It is important to note that this reassessment of potential GDP is not risk-free, and it is possible that the current activity gap is wider than estimated, which would imply the need for the convergence of activity to a lower potential GDP, as well as higher inflationary pressures.

The outlook for activity in the rest of the world shows no significant changes and continues to point to some weakness. In China, the outlook for growth remains subdued for this and the next two years, in line with weak household spending, depressed consumer confidence, historically low levels of household credit and a persistently weak employment outlook, largely related to the major adjustments in the real estate sector. In contrast, the resilience of manufacturing output and the adoption of a series of measures to stimulate activity stand out. In the Eurozone, performance this year is still expected to be modest, in line with still weak household and business confidence levels, as well as a monetary policy that continues to be contractionary. At the margin, some high-frequency indicators point to some improvement this year. In Latin America, after a good first half of 2023, activity in the main economies moderated in the last part of the year. However, recent high-frequency activity figures also indicate better performance in certain economies. This, added to the limited slack in some of the labor markets, the greater external momentum and the advancement of the process of interest rate cuts in the region lead to improve the outlook for the next two years (figure II.4 and table II.2).

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

	Aveg. 10-19	2022	2023 (e)	2024 (f)	2025 (f)	2026 (f)
World GDP at PPP	3.7	3.3	3.2	3.0	2.9	3.1
World GDP at market exchange rate	3.3	2.9	2.8	2.5	2.4	2.7
Trading partners	3.9	2.8	3.3	3.0	2.8	2.9
United States	2.4	1.9	2.5	1.9	1.6	2.5
Eurozone	1.4	3.5	0.5	0.2	0.9	1.5
Japan	1.2	0.9	1.9	1.2	1.3	0.5
China	7.7	3.0	5.2	4.8	3.9	3.8
India	7.0	7.2	6.3	6.5	6.4	6.3
Rest de Asia	4.5	4.2	3.2	4.1	3.8	3.7
Latin America (excl. Chile)	1.7	3.9	2.1	0.9	2.1	2.8
Commodity exp.	2.2	3.2	1.4	1.0	2.0	1.8

(*) For definition, 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.

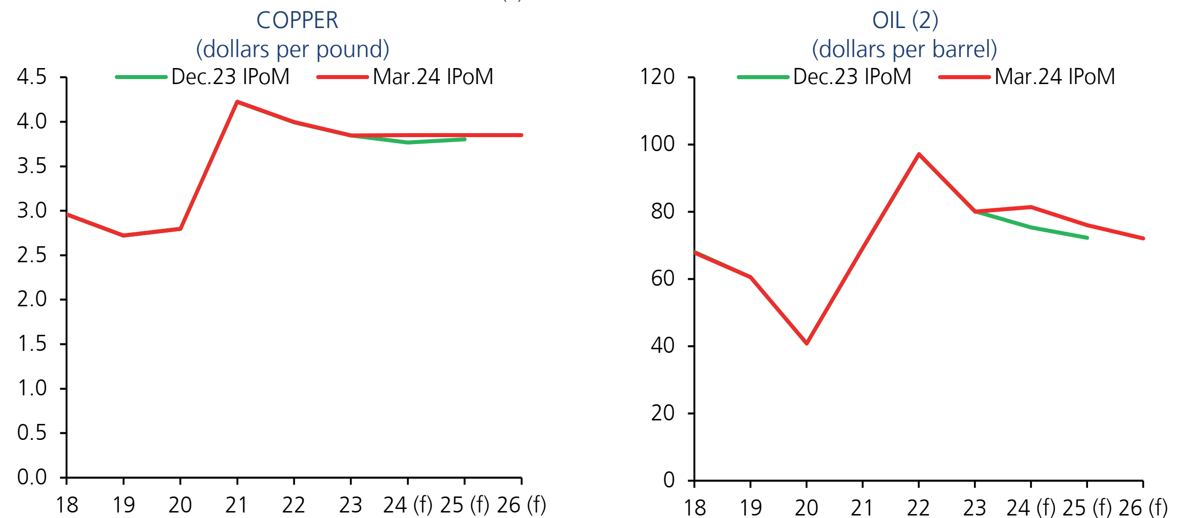
The higher projected prices for oil and copper contrast with the downward revision for foodstuffs. Accordingly, the terms of trade remain largely unchanged (table II.3 and figures I.6, II.5 and II.6). The projected oil price increases in line with its higher effective value. This has been driven by the production cuts announced by OPEC+ and supply-related risks due to geopolitical conflicts. It is projected to average US$81 this year (Brent-WTI average), rising to US$76 and US$72 in 2025 and 2026, respectively (US$75, US$72 and US$69 in the December IPoM, respectively). For copper, the projection factors in the higher actual price, driven by the dynamism of Chinese demand aimed at the energy transition, particularly in the automotive industry. The copper price is projected to remain around US$3.85 per pound for the next two years. The outlook for international food price indices (FAO) is downgraded, reflecting the declines in some components, particularly cereals.

TABLE II.3 INTERNATIONAL SCENARIO ASSUMPTIONS

	Aveg. 10-19	2022	2023	2024 (f)	2025 (f)	2026 (f)
			(annual change, percent)			
Terms of trade	1.0	-6.8	2.4	-3.2	-0.6	0.9
External prices (in US$)	0.6	4.4	-0.2	1.5	4.8	3.8
			(levels)			
LME copper price (US$cent/pound)	306	400	384	385	385	385
WTI oil price (US$/barrel)	72	94	78	79	74	70
Brent oil price (US$/barrel)	80	100	83	84	78	75
Gasoline parity price(US$/m3) (*)	610	850	721	688	611	594
US Federal Funds Rate (%)	0.7	1.9	5.2	5.3	4.2	3.6

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

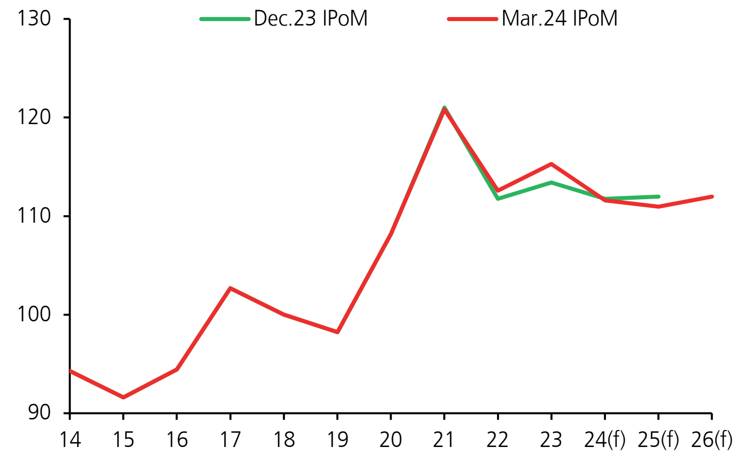
FIGURE II.5 COMMODITY PRICES FORECASTS (1)



(1) Actual or projected average price for each year as conatained in respective Monetary Policy Report (IPoM).
(2) For oil, WTI-Brent average price per barrel.
Source: Central Bank of Chile.

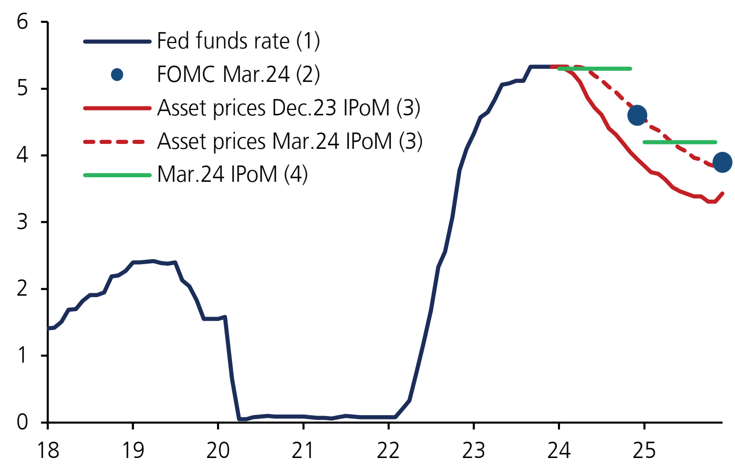
The central scenario continues to assume that global financial conditions will improve over the projection horizon, and that the peso will appreciate during 2024-25. According to market expectations, the projection considers that the Federal Reserve will begin to reduce the Fed funds rate in the coming months, thus accumulating several reductions between now and 2026 (figure II.7). Other central banks will further reduce their interest rates as their disinflation process advances. In this context, interest rate differentials with respect to other economies will gradually reduce their pressure on the peso, which is expected to appreciate as a result. In any case, there are risks that should continue to be monitored, particularly the reversal of some global cost factors and the sustained high level of services inflation in some economies.

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



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

FIGURE II.7 EVOLUTION AND FORECASTS FOR THE FED FUNDS RATE
(percentage points)

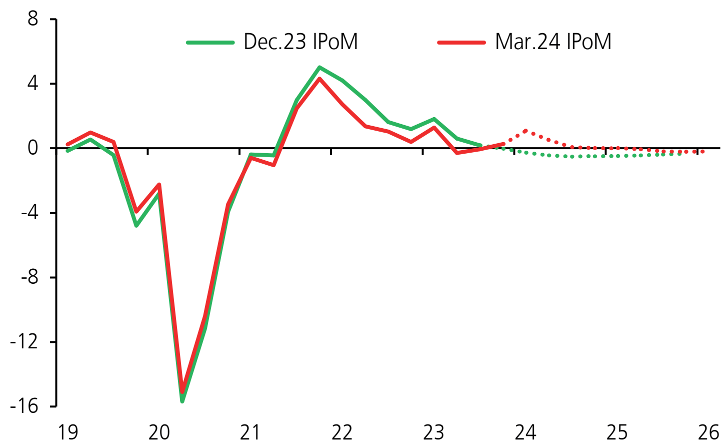


(1) Actual Fed funds rate. Considers data through February 2024.
(2) Projection of the Federal Open Market Committee (FOMC) at respective meeting.
(3) Consider the dates of the statistical closings of each Monetary Policy Report (IPoM).
(4) Annual average for the Fed funds rate in 2024 and 2025, according to the central scenario of this IPoM.
Sources: Bloomberg and US Federal Reserve.

ACTIVITY GAP AND INFLATION'S CONVERGENCE TO THE TARGET

The activity gap is still estimated to remain close to zero throughout the projection horizon (figure II.8). As is usual in March, the revision to the National Accounts for previous years involves a re-estimation of potential GDP and the level of the activity gap. This year it resulted in a slight upward adjustment of potential GDP and a downward correction of the activity gap for previous years. Beyond this historical revision, recent data suggest that the gap will be slightly positive in the immediate term, due to the performance of non-mining activity at the margin, which will reverse as some transitory effects dissipate so that the gap will remain around zero over the projection horizon. In any case, the analysis of sectoral gaps reveals the presence of more significant capacity slack in the sectors related to the consumption of goods (Box II.1).

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



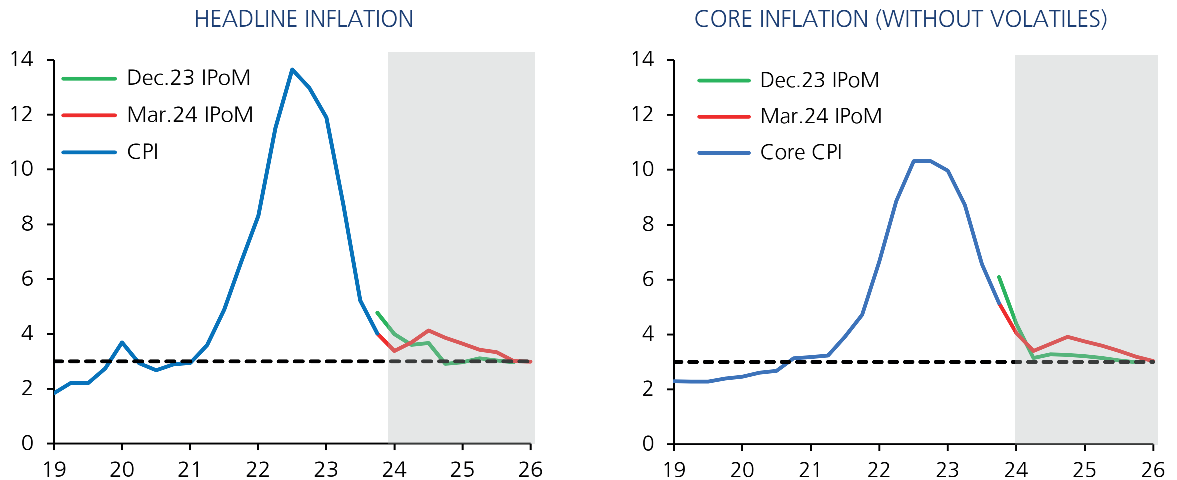
(1) Dotted lines show forecast.
(2) Forecast assumes structural paramenters updated in December 2023 Monetary Policy Report (IPoM) (trend GDP).
Source: Central Bank of Chile.

In the central scenario, headline and core inflation will rise in the short term, in response to the depreciation of the peso, higher global costs, and the inflation figures for January and February (figure II.9 y table II.4). Monthly CPI variations at the beginning of the year were high and above expectations. This was partly due to factors such as exchange rate depreciation and external price increases, but also to the rise in the prices of some services, which are not expected to reverse in the short term. The peso's depreciation will continue to be passed on to domestic prices, particularly the most volatile items. Fuels stand out, which will also be affected by higher international prices. For core goods, a moderate exchange rate pass-through is expected, in line with incoming data and with the negative gaps in sectors linked to tradable consumption. Thus, headline and core inflation are projected to end 2024 at 3.8% (2.9% and 3.2% annualized in the last IPoM, respectively[6]/).

Inflation is expected to converge to the target within the projection horizon, supported by, among other factors, the absence of significant imbalances in the economy and the gradual decline of the RER. The intensity of the RER decline will be conditional on how financial conditions evolve.

[6]/ This figure is not comparable for the total and core indicators. The December projection was made with the 2018=100 base index; the current projection was made with the 2023=100 basket.

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



(*) Effective data consider 2023 reference basket and BCCh splicing. Gray area, as from first quarter of 2024, shows forecast. December Monetary Policy Report (IPoM) projections are consistent with official splicing, while current forecasts (March 2024 IPoM) are consistent with splicing based on the reference CPI series of 2023=100 base basket.
Sources: Central Bank of Chile and National Statistics Institute (INE).

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

	2023	2024 (f)	2025 (f)	2026 (f)
Average CPI	7.3	3.8	3.4	3.0
December CPI	3.4	3.8	3.0	3.0
CPI in around 2 years (2)				3.0
Average core CPI	7.5	3.8	3.5	3.0
December core CPI	4.7	3.8	3.1	3.0
Core CPI around 2 years (2)				3.0

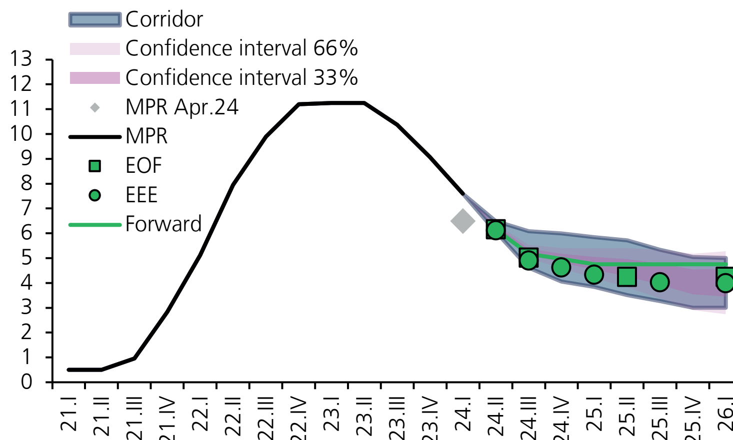
(1) Inflation figures consider 2023 CPI basket using BCCh splicing. Monthly and annual variations of this index do not coincide with official INE variations –useful for indexation purposes– as these use the previous basket series for base year changes.
(2) Inflation forecast for the first quarter of 2026.
(f) Forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

MONETARY POLICY STRATEGY: THE CENTRAL SCENARIO, SENSITIVITIES AND RISKS

The local economy has succeeded in closing the significant macroeconomic imbalances of previous years, inflation has declined rapidly and stands closer to 3%, while inflation expectations are aligned with the target. However, rising inflation figures at the beginning of the year and higher imported cost pressures emphasize the need to continue closely monitoring its evolution. To the extent that the shocks that affect inflation are transitory, the monetary policy framework based on a two-year target allows them to be accommodated within the policy horizon without putting inflationary convergence at risk.

The Board foresees that, in line with the central scenario of this IPoM, the MPR will be further reduced. The magnitude and timing of the MPR reduction process will take into account the evolution of the macroeconomic scenario and its implications for the trajectory of inflation.

FIGURE II.10 CORREDOR DE TPM (*)
(promedio trimestral, porcentaje)



(*) The corridor is built by following the methodology described in boxes V.1 of March 2020 IPoM and V.3 of March 2022 IPoM. It includes the March Economic expectations survey (EEE) and April pre-MP meeting Financial traders survey (EOF) and the quarterly average smoothed forward curve as of March 26. This is calculated by extracting the implicit MPR considering the forward curve over the overnight index swap (OIS) curve for up to 2 years, discounting the fixed rates of each maturity at the simple accrual of the OIS index. For the current quarter, the surveys and the forward curve consider the average of daily actual data and are completed with respective sources. Quarterly average considers working days in each quarter. Gray diamond corresponds to the MP decision of April 2024. Source: Central Bank of Chile.

In this IPoM, the sensitivity scenarios —which are reflected in the borders of the MPR corridor— are defined by situations in which the path of domestic demand differs from that considered in the central scenario (figures II.10 and II.11).

The upper bound of the MPR corridor reflects more inflationary sensitivity scenarios in which the process of monetary policy reductions would be more gradual. This could be the case if domestic demand, particularly private consumption, performs better than expected in the central scenario. This, in the context of greater cost pressures faced by businesses, would encourage price increases and the re-composition of margins, generating stronger inflationary pressures.

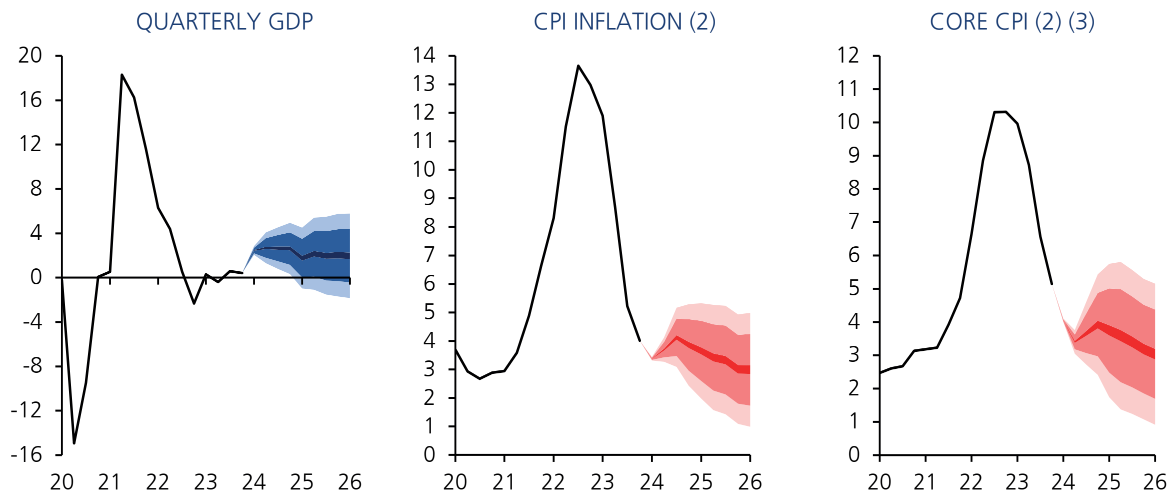
The lower bound of the corridor is given by scenarios with lower inflationary pressures and which would require accelerating the process of MPR cuts. Such would be the case if domestic demand were to deteriorate further, which could occur, for example, in the event of a slower recovery in some economic sectors, with its associated consequences on the labor market, which would ease inflationary pressures.

On this occasion, an intermediate scenario in which U.S. inflation is more persistent than expected was also analyzed. A situation like this would induce the Fed to alter the course of its monetary policy, which could have repercussions on global financial conditions. In the event of such a scenario, the magnitude of the shock must be taken into account and its implications for the convergence of inflation at the local level must be carefully analyzed in order for the Board to take the most appropiate monetary policy response.

In addition to the sensitivity exercises, situations are analyzed in which changes in the economy are more significant and would require a monetary policy response that would exceed the limits of the corridor for the MPR.

The world economic scenario is subject to higher-than-usual degrees of uncertainty. The gradual but significant deterioration of the geopolitical situation in recent years, where new sources of conflict could affect commodity prices, in addition to putting additional pressures on fiscal balances and financial conditions, deserves special mention. In the U.S., furthermore, questions persist as to how the Fed will lower rates, in addition to the doubts regarding fiscal matters in that economy. In this context, discussions continue regarding the evolution of global financial conditions, especially with respect to long-term interest rates and their impact on neutral rates.

FIGURE II.11 GROWTH AND INFLATION FORECASTS (1)
(annual change, percent)



(1) The figure shows the confidence interval of the central projection to the respective horizon (colored area). Includes 10, 70 and 90% confidence intervals around the central scenario. Confidence intervals are constructed from the RMSEs of the XMAS-MEP models, 2009-2017 average. (2) Inflation figures consider the 2023 CPI basket using BCCh splice. The monthly and annual variations of this index do not coincide with the official INE variations –useful for indexation purposes– because the latter use the series of the previous basket for the base-year change. (3) Measured with the CPI without volatiles.
Sources: Central Bank of Chile and National Statistics Institute (INE).

BOX II.1:

Inflation of goods and services and sectoral gaps

Annual CPI inflation has declined rapidly since its 2022 highs. In this result, the dissimilar behavior of the inflation of goods and services that make up the CPI has been notorious. Discounting volatile prices, the former reached peaks close to 15% in the second half of 2022, while the latter rose to 8.5% in March of last year. After those peaks, goods inflation has fallen much faster, standing at 1.1% as of February of this year. Services inflation has declined more slowly, down to 6.7% y/y. The reasons behind this different pace of decline lie in the factors that caused it to rise. In the case of goods, overspending was compounded by the depreciation of the peso and the increase in global costs. In a context in which the latter factors, after improving, have been marginally deteriorating and pose risks to the inflation scenario (Box I.1), it is important to assess the role that domestic spending pressures played in containing external factors.

Typically, the BCCh evaluates these pressures through the aggregate activity gap, excluding the mining sector. However, the aggregate measurement can mask dissimilar behaviors between sectors that could be informative for the evolution of relative prices. This box presents a differentiated analysis of activity gaps at the sector level and links them to the evolution of relative prices between goods and services during the last period.

Aggregate activity gaps

Nowadays, different measurements suggest that the activity gap is around zero and is expected to remain fairly constant throughout the projection horizon (figure II.7). This means that activity is around potential GDP, which is the level of output consistent with inflation stability . Alternative measures of activity gap[1]/ —that consider, for example, labor market information— suggest greater slack, but essentially, they do not differ in the diagnosis that resource utilization today hovers around the economy's potential level.

Sectoral gaps

Even with the aggregate non-mining activity gap closed, it is possible that the dynamics of a sector may be influencing its relative price and, thus, inflation dynamics in a context where price adjustments are gradual. The estimation of sectoral gaps helps to determine this pressure by reflecting more directly the state of costs, margins or other sector-specific factors. In turn, it can be expected that certain sectors will have a higher correlation with final demand, in particular with private consumption and its components[2]/.

To estimate sectoral gaps, Vivanco et al. (2024) use different filters at the economic activity level, which are then aggregated using the weight of each sector in GDP. This gap shows a close correlation with the usual measurement of the aggregate non-mining GDP gap and has the advantage that it allows decomposing its evolution into sectors. Along these lines, it is observed that the gap around zero at the end of 2023 can be decomposed into an important negative activity gap in sectors associated with the consumption of goods such as retail, and a positive gap, particularly in power generation (figure II.12).

[1]/ For a review of various gap measurements, see box II.1 in June 2023 IPoM.

[2]/ For example, the recent dynamism of sectors such as electric power generation could make it difficult to read the activity gap due to supply shocks (higher rainfall) that affected the economy. See blog *Rol reciente de la generación eléctrica en la actividad y sus perspectivas.*

In addition, one gap is built for the sectors that supply goods for household consumption, and another for services. These showed a heterogeneous evolution during the last few years, with a goods gap that more than doubled that of services during 2021, which —together with external pressures— is consistent with the rise in relative prices of goods during that period. From 2022 onwards, the goods gap started to narrow more rapidly than the services gap and, since 2023, it has been negative, while the services gap is close to zero (figure II.13).

This is coherent with the faster decline in goods inflation, as well as the moderate pass-through of the recent peso depreciation to goods prices. Consistent with this González et al. (2024) find that firms with high markups —which is consistent with negative gaps— pass through a smaller fraction of a currency depreciation to their prices than those with low markups.

Closing remarks

The decline in inflation from its 2022 highs has been due to the resolution of macroeconomic imbalances accumulated during previous years. The closing of the activity gap mitigated inflationary pressures in an economy that had previously grown above its capacity. The decomposition presented in this box shows that the macroeconomic adjustment was more intense in the goods sectors than in the services sectors, which helps to explain the dissimilar behavior of the relative price adjustment of these two components of spending. The central scenario projections of this IPoM consider a moderate pass-through of the recent depreciation to the prices of core goods, in line with the accumulated evidence and the reading of negative gaps in the sectors that supply these goods. The sensitivity scenarios incorporate dynamics where this pass-through may be higher or lower depending on the evolution of the sectors most closely associated with consumption and the different measures of slack, including sectoral gaps.

FIGURE II.12 Sectors' contributions to non-mining GDP gap at factor costs (1)
(percent of potential)

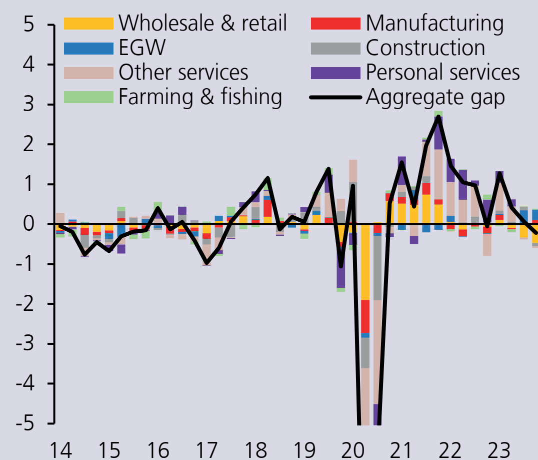


FIGURE II.13 Goods and services gaps (2)
(percent of potential)

(1) Sector gaps estimated using median of 6 univariate filters. Sector aggregation based on nominal GDP weights. (2) Gaps using 6 univariate filters of activity subsectors related to consumption of goods and services, aggregated using weights from the input-output matrix.
Source: Central Bank of Chile.

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