SHORT-TERM MONETARY POLICY CHALLENGES (*)

Rosanna Costa
Governor, Central Bank of Chile
May 29th 2024

Good morning. First of all, I thank this platform from which our country is presented to the world, in this new version of the now traditional Chile Day. This meeting comes at a time when the process of reducing global inflation has made significant progress, beyond some differences among countries and pending challenges ahead. In Chile, inflation figures have been approaching the 3% target and, in line with the projections of the Monetary Policy Report (known as the IPoM) that we published in March, we will reach it over the course of next year. In this context, the Board of the Central Bank has made a significant reduction in the Monetary Policy Rate (MPR), which today stands at 6%, accumulating a drop of 525 basis points since July 2023.

I would like to take this opportunity to review what has characterized our economy since we began to reduce the MPR, what have been the factors that frame the continuity of this process and the short-term challenges that we perceive. All this, of course, when we will soon publish a new IPoM, where we will provide more details of these and other developments. I will also take a brief comparative look at other economies, which will allow me to highlight some distinctive elements of the Chilean economy in the process that we are currently going through of ensuring inflationary convergence and interest rate normalization.

Background of the inflationary cycle and the response of the Central Bank

As in most countries, the rise in inflation in Chile was due to multiple factors. However, one of the keys to understanding this process was the strong influence that idiosyncratic elements had. One of them, the unprecedented increase in domestic spending, motivated by the income support measures that were granted during the pandemic. Among other things, these considered universal fiscal transfers and three partial withdrawals of pension savings, the latter with additional effects on the capital market and the confidence of economic agents. The strong boost to household income far exceeded pandemic-related losses and its main repercussions were observed in massive private consumption, which at the end of 2021 was 50% higher than it had been in mid-2020. This allowed the incubation of large macroeconomic imbalances and a substantial amplification of the activity gap, giving rise to a significant inflationary problem.

Added to this were elements of a global nature, which are well known to all, so I need not go into them in depth. I will just mention the increases in international shipment costs and the prices of a set

(*) Presentation in the context of Chile Day in Toronto, Canada.

of inputs due to the restrictions caused by the pandemic, and which were later compounded with the impact of the war in Ukraine on commodity prices.

In this scenario, Chile's inflation peaked in August 2022, when the annual variation of the CPI reached 14.1%, a figure not seen in several decades. By then, the Central Bank had been raising the MPR for a year. It was standing at 9%, well above its neutral level and which would continue to be raised in the following months, up to the 11.25% it reached in October 2022.

The cycle of benchmark rate increases was very significant, because other events were added to the initial spending shock and the impacts of the pandemic. Among them were the already mentioned war in Ukraine and a significant depreciation of the Chilean peso, whose pass-through was favored by the dynamism of domestic demand. The weakening of the local currency occurred amid high levels of uncertainty that coincided with the constitutional discussion in Chile, which, like any political process, naturally raised concerns among agents while awaiting its results.

The MPR was held at 11.25% from October 2022 until July of 2023, when we considered it appropriate to begin reducing the level of monetary policy tightened. At that point, inflation had shown a sustained decline, inflation expectations had been back at the 3% anchor for several months, and domestic demand and its fundamentals were advancing on a path of adjustment, which was essential for normalizing the economy and containing the inflationary process.

By then, the National Accounts figures highlighted a considerable correction in household consumption and different high-frequency indicators confirmed this trend, coupled with a weaker labor market. In the June 2023 Report, we published a box on price adjustment patterns in firms, which reported a drop in the frequency of price increases and a rise in downward adjustments, trends that had been consolidating since the end of 2022. The results of the Bank's Business Perceptions Survey went in the same direction, where the complementary interviews also pointed to the deterioration in demand as one of its causes.

The Bank's monetary policy communication played a relevant role in this process, as it informed the markets of the Board's evaluation of the macroeconomy and its future actions. In fact, all these antecedents were progressively incorporated into the construction of the MPR corridor before making the first cut. This indicated the direction that the monetary policy rate would follow, realizing that the rate of reduction would be conditional on the speed of the economy's adjustment process and its implications for the convergence of inflation. In hindsight, the MPR has been on a path that has been fairly consistent with the MPR corridor over the last year and a half. Beyond the particular movements of each Monetary Policy Meeting, the evolution of the rate has been guided by a clear message from the Board about the need to gradually reduce the degree of monetary policy tightened (figure 1).

The decline in inflation and its challenges

In this way, after slightly exceeding 14%, inflation began to drop steadily since August 2022. After ending that year with figures that were close to 13% annually, during 2023 it saw a rapid decline, ending the year at 3.9%. In April of this year, which is the latest data available, the annual inflation of total CPI ─spliced series─ was 3.5% (figure 2).

Core inflation has also had a significant decline, which has been greater in recent months. Thus, it fell from a peak of 11% in November 2022 to 3.5% in April of this year. As in most countries, not all the components of inflation have evolved the same way (figure 2). In fact, goods inflation has fallen much more markedly than services inflation. This dynamic can be explained by various elements. On the one hand, the weaker consumption of goods compared to services, which is reflected in the gaps of each sector. On the other hand, the effects of widespread indexation, which in Chile has automatic mechanisms that tie prices to past inflation and where the increase in prices was already high by historical standards. This is an issue that we must continue to observe carefully, although we do not consider that this difference in the dynamics of goods and services poses risks for inflationary convergence.

Different factors are behind the decrease in inflation. On the one hand, the restriction of monetary policy —also supported by the reduction of fiscal spending in 2022— began to have effects on the economy, with private spending that adjusted and gradually resolved the significant macroeconomic imbalances. In this context, the economy completed several quarters of contraction and the activity gap normalized (figure 3). Added to this was a gradual reduction in local uncertainty, which mitigated the pressures on the behavior of the exchange rate associated with that factor.

On the other hand, global cost elements were eased, which helped reduce inflation around the world, especially goods inflation. However, the characteristics of the macroeconomic cycle, the inflationary process and the monetary policy reaction have resulted in big differences across countries. Chile was one of the first to raise the MPR and, furthermore, it also did so by a greater magnitude than other economies. In the opposite process, the decline in inflation in Chile has been faster, even though it began at higher levels than in several Latin American countries (figure 4). Another differentiating element of our process has been the realignment of inflation expectations, which occurred earlier than in other countries in the region (figure 5).

In this way, the significant drop in inflation, the resolution of large aggregate imbalances and the anchoring of inflation expectations have allowed us to cut the MPR with greater anticipation and emphasis than other countries have (figure 6). At the same time, this has posed an additional challenge. Particularly, the distance between Chilean short rates and those of their Latin American peers has widened, which is also observed in the dissimilar evolution of the respective rate differentials with respect to their American counterparts. This has had important impacts on the Chilean peso, in a context where its level of volatility and response to changes in global monetary policies has increased (figure 7).

The challenge of the last mile in an ever-changing environment

Let me continue this presentation talking a little more about the challenges of the near future. We have gone from a point of high inflation to one that is closer to the target, but where we still must stabilize inflation at 3%. At the same time, we are gradually moving towards resuming a growth path in line with the trend level of our economy.

In the March Report, our projection anticipated an increase in GDP between 2 and 3% this year, and between 1.5 and 2.5% in 2025 and 2026. Regarding the CPI, our projections pointed to a rise in annual inflation during the second half of the year, mainly due to cost increases linked to external factors. These elements would dissipate within the two-year policy horizon, so that, although annual inflation would rise in the second half of 2024, by 2025 it would already be in line with 3%.

At our latest Monetary Policy Meeting we decided that it was pertinent to cut the MPR by another 50 basis points, reinforcing the message that the macroeconomic scenario was in line with what we considered most plausible in the March Report. Again, we said that we will continue to reduce the MPR and that the magnitude and timing of this process will consider the evolution of the macroeconomic scenario and its implications for the trajectory of inflation.

We made this decision in a scenario in which the activity and inflation data that have been released are, in general terms, consistent with what we noted in the last Report. But we also have news in different areas. For example, somewhat less favorable global financial conditions or a significant increase in the price of copper that has led to an appreciation of the peso. We will announce the implications of all these changes for the evolution of inflation and monetary policy in the Report that we will publish in a few more weeks.

Beyond this, I do believe it is important to reinforce that having a more balanced economy, demand at levels more in line with its trend, inflation closer to the target and anchored expectations certainly give us greater flexibility to conduct monetary policy. This is so, especially in a scenario in which we continue to face significant challenges and the task of bringing inflation to 3% and ensuring that it stays there has not been completed. In what follows I will briefly discuss some of these challenges.

On the domestic front, recent signs regarding activity suggest that our economy has been gradually moving away from its lowest point of the cycle. The seasonally adjusted GDP series had a quarterly growth of 1.9% in the first quarter of this year, with increases in most economic sectors, while domestic demand increased 2.1% (figure 8).

However, we must keep in mind that the aggregate evolution of the economy contains heterogeneities across economic sectors and expenditure components, which may affect the evaluation of its aggregate performance. A relevant factor is the asymmetry observed between the expansionary and contractionary phases of the cycle. As I mentioned, in the first phase, the push from the demand stimulus measures particularly affected household consumption. However, in the contractionary phase, the necessary adjustment driven by macroeconomic policies has had effects not only on consumption, but on domestic demand as a whole.

This has implied, for example, that while consumption has seen positive quarter-on-quarter growth rates for a couple of periods, investment showed a strong contraction in the second half of 2023 and is just now reversing its deterioration.

At the level of economic activity, heterogeneity across sectors is also observed. Construction, more linked to investment, and the part of retail and wholesale trade more linked to the consumption of goods, show the weakest results. As we noted in our latest Financial Stability Report, these sectors are also the ones that have suffered the most significant increases in their default levels. We consider that, to the extent that the economy continues to advance towards expansion rates consistent with its trend level, the most lagging sectors and expenditure components will improve their performance, thus reducing the differences between economic activities.

A second element worth singling out is the high volatility of the global scenario, which is observed in various areas. This has come from various sources, some specifically economic and others that come from much more regrettable situations, such as the aggravation of geopolitical conflicts.

In the former, the news from the United States has clearly set the tone. The financial markets have been highly reactive to surprises in one direction or another in this economy, as well as to the Fed's communication. Beyond the fact that on the margin the inflation data were lower than expected and that the labor market has shown signs of less tightness, the truth is that the greater resilience of the U.S. economy has caused doubts to persist about the evolution of its inflation and the Fed's monetary policy. Thus, if a year ago markets expected the Fed funds rate to end 2024 at around 3.75%, today it is expected to do so at around 5% (figure 9).

This change in the economy and monetary policy expectations in the United States has caused global financial conditions to tighten, impacting both currencies and interest rates at different maturities. In fact, although it has improved somewhat in recent weeks, in general, the outlook for short- and long-term interest rates is less favorable than we anticipated.

In addition to financial factors —related to the doubts surrounding the Fed's actions—, the evolution of the peso/dollar exchange rate has been influenced by the increase in the copper price. A few weeks ago, the exchange rate climbed to record-high levels, which was subsequently followed by a significant drop when compared to its April peak (figure 10)

Regarding the rise in the copper price, as we highlighted in the last Monetary Policy Report, China's greater demand for copper, within the framework of the energy transition, coincides with the increase in its price. Added to this are some problems regarding supply from other producing countries and, to some extent, speculation regarding the availability of inventories in some of the world exchanges. With this, the price of this metal has risen around 20% from the end of March (figure 11).

Returning to the behavior of our peso, although its appreciation compared to the end of March eases short-term inflationary pressures, it does not seem advisable to assume that this scenario is definitive.

As I indicated, volatile markets have been the trend, and we cannot rule out or assert scenarios in any direction.

In any case, I want to reiterate that the Chilean policy framework grants the Bank flexibility to manage its monetary policy independently. This does not mean that we do not consider what happens in the rest of the world or its effects on the exchange rate. On the contrary, they are a relevant input for decision-making, considering the source of the movements, and their implications for the trajectory of inflation and monetary policy.

To sum up, I need to reiterate that we must carefully evaluate the information we are receiving, so as not to overreact, and to be able to identify the trends behind it. As we have stressed before, today's circumstances are different from those we had a few quarters ago. With the large imbalances corrected, the factors that affect inflation in the medium term have also been redirected. To the extent that inflation expectations remain anchored at the 3% target, monetary policy has the necessary flexibility to act and accommodate transitory shocks that may come our way. In any case, it is essential to monitor the origin, magnitude, timing, and direction of its impacts during the two-year policy horizon.

Concluding thoughts

The inflationary cycle that we have faced in recent years has tested the reaction capacity of central banks around the world. This episode has also reminded us that inflation continues to be a present phenomenon and that we must be responsible and careful so that our countries are not affected by this problem.

I cannot fail to mention that the particular characteristics of the inflationary scenario in Chile have required even greater efforts on the part of the institution that I preside over. I say this, especially because the problem was aggravated by the occurrence of idiosyncratic shocks, of unprecedented magnitude, which made the challenge greater.

Although, as I mentioned, the process of reducing inflation is still unfolding and we face important challenges, we can highlight some elements that have allowed us to deal with this episode and that we must continue to strengthen for future contingencies.

The policy framework of our economy plays a relevant role in this. A monetary policy based on a medium-term inflation target, with a clear objective and the commitment of the Central Bank to its achievement, allowed for an early detection of what was happening, communicating it and explaining to the general public the situation we were facing.

This enhances the importance of the credibility of the Central Bank and the transparency of its communication. Our institution was clear in pointing out the difficulties and costs of the process, which certainly would not be harmless, but could be mitigated as long as we acted in time. This contributed to re-anchoring inflationary expectations, which after moving between 100 and 200 basis points away from the 3% target in two years, have been near it since the end of the first quarter of 2023. This teaches us a lesson that, even when the messages are difficult, the Bank must clearly communicate its assessment of the situation, its implications and the measures to be taken.

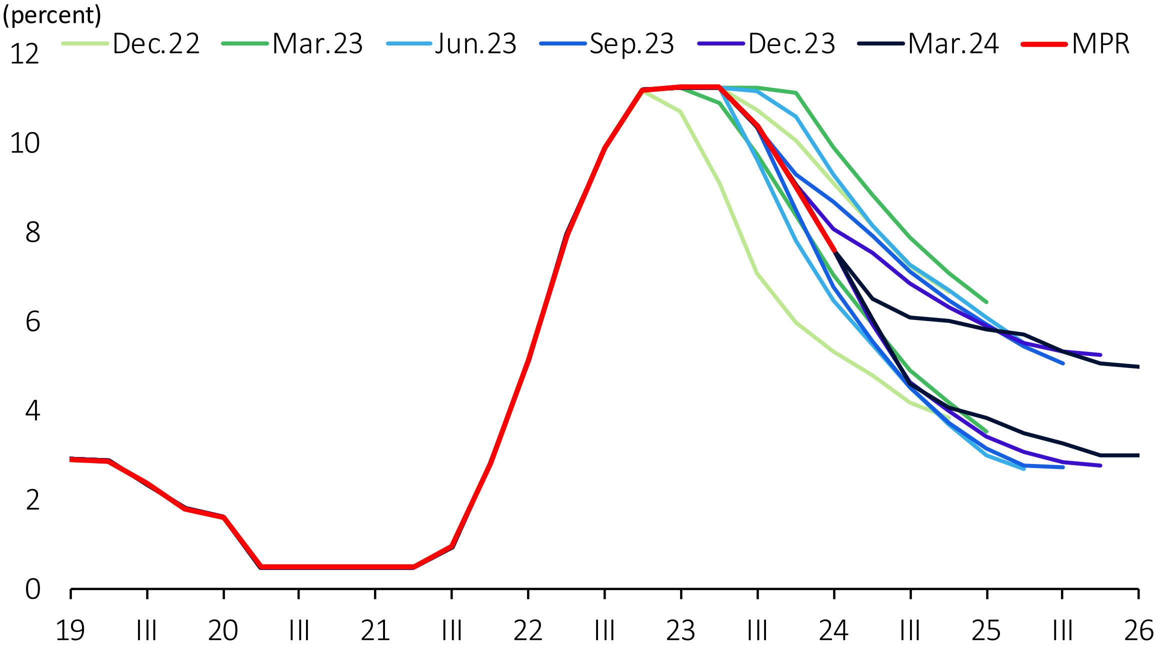
Nor can we ignore the fact that monetary policy cannot act effectively if it lacks an adequate general policy framework. Therefore, it is also necessary to emphasize the importance of having a policy framework with a fiscal rule and flexible exchange rate, in addition to the aforementioned monetary policy based on an inflation target. The contractionary monetary and fiscal stance made possible to reduce macroeconomic imbalances and helped lay the foundations for restoring the resources that will allow us to face new contingencies, which will surely come. Having had a credible framework, anchored monetary and fiscal policy, consistency over time, and had financial buffers was very important. This was largely possible after years of investing in trust and institutionality.

Going forward, we will continue to face challenging situations. The evolution of the macroeconomic scenario in Chile gives the Central Bank greater degrees of flexibility to adjust monetary policy, keeping in mind compliance with the inflation target and macroeconomic balances. The policy framework that we have had in recent decades has been a fundamental pillar to overcome complex scenarios in the past and will continue to be an ally for the future.

Thank you so much.

Figure 1

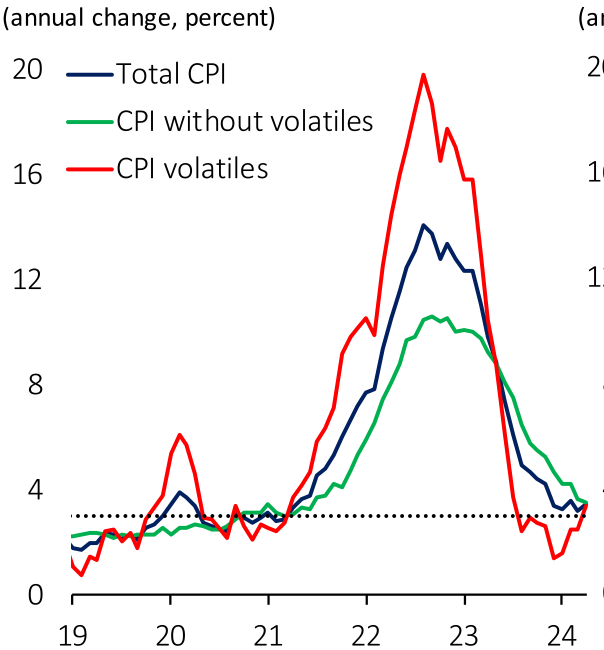
MPR and corridors (*)



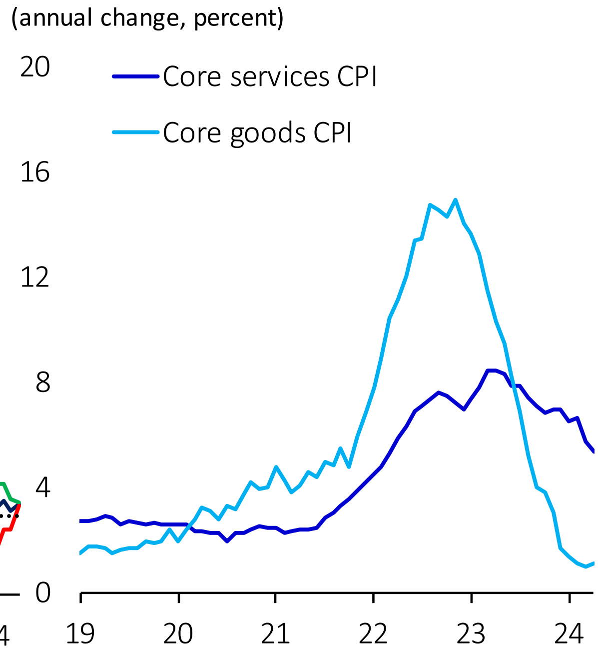
(*) Lines correspond to the upper and lower bounds of the MPR corridor of each Monetary Policy Report. Source: Central Bank of Chile.

Figure 2

Inflation (*)



Core inflation (without volatiles) (*)

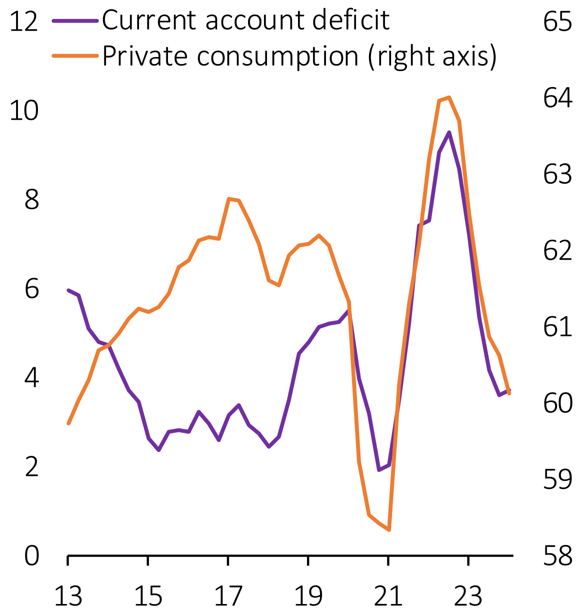


(*) Series consider the 2023 CPI reference basket with the Central Bank splice. Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 3

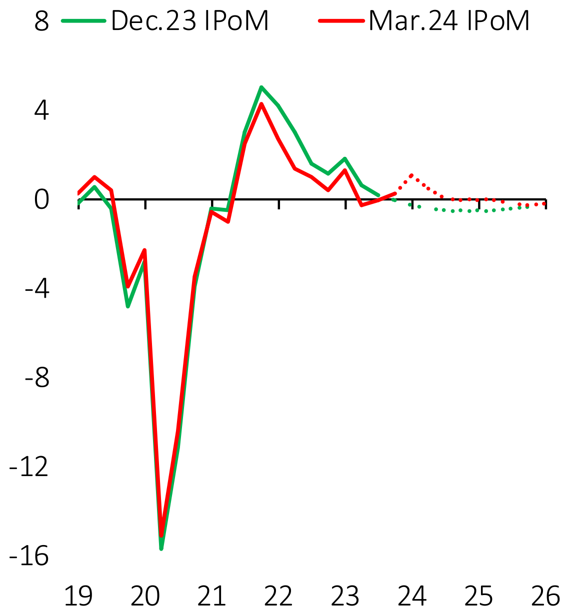
Macroeconomic indicators (1)

(percentage of GDP)



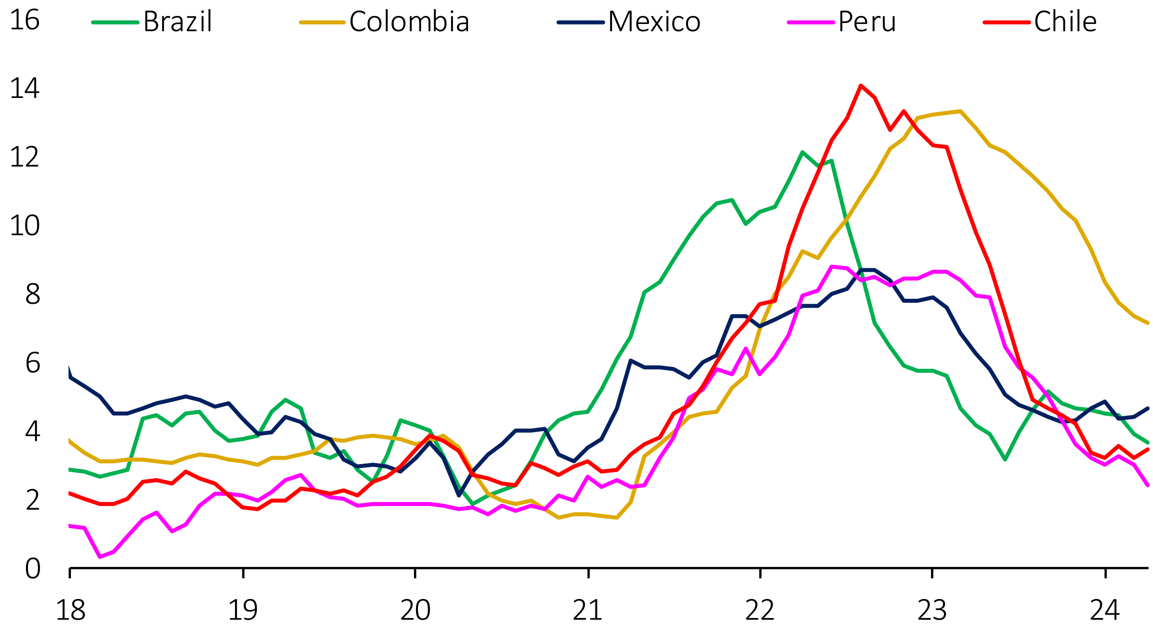
Activity gap (2)(3)

(level, percentage points)



(1) Considers the accumulated in 12 months of each variable with respect to GDP. Consumption measured at current prices. (2) Dotted lines show forecast. (3) Forecast assumes structural parameters updated in December 2023 MP Report (trend GDP). Source: Central Bank of Chile.

Figure 4
Inflation in Latin America (*)
(annual change, percent)

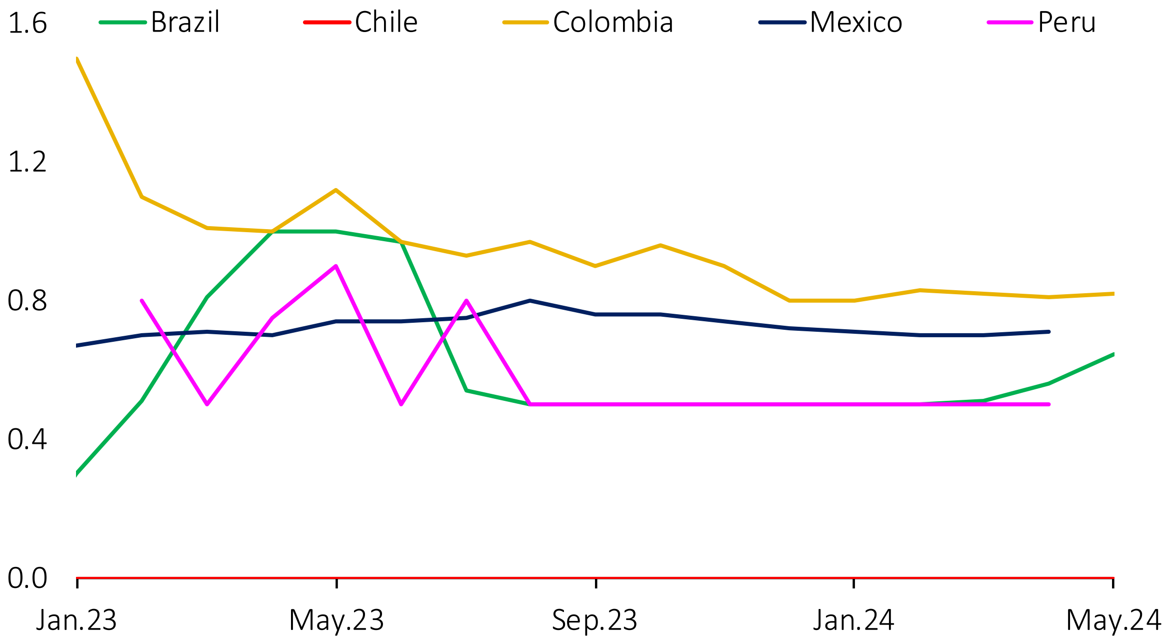


(*) For Chile, series considers the 2023 CPI reference basket with the Central Bank splice.
Sources: Bloomberg, Central Bank of Chile and National Statistics Institute (INE).

Figure 5

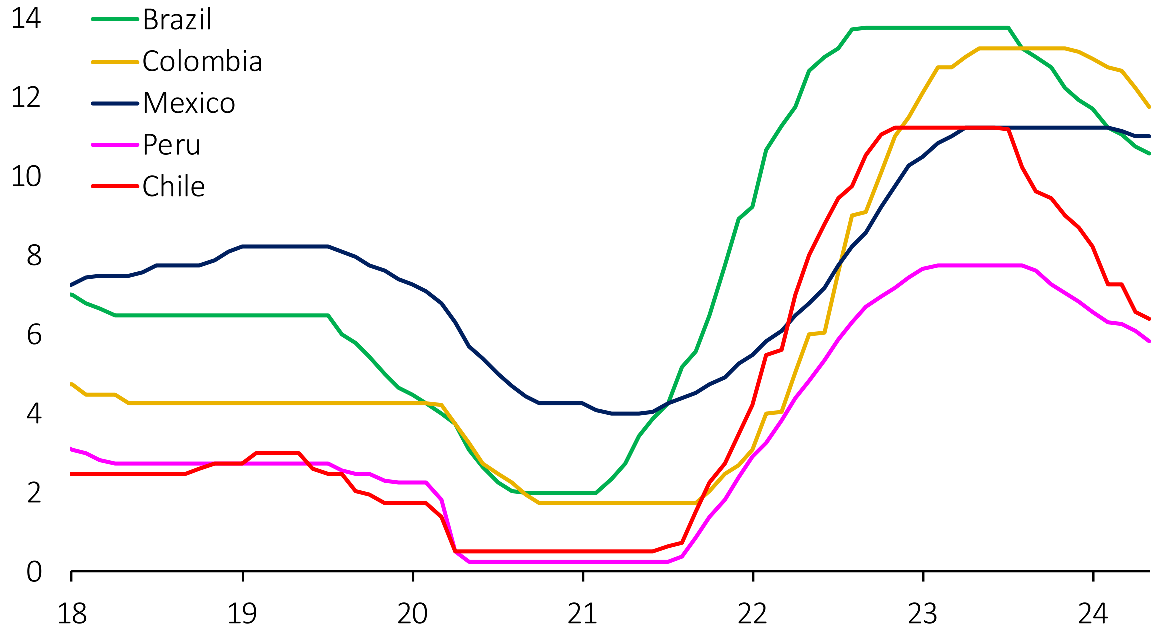
Deviations of expected inflation at the end of 2025 with respect to the target (*)

(percentage points)



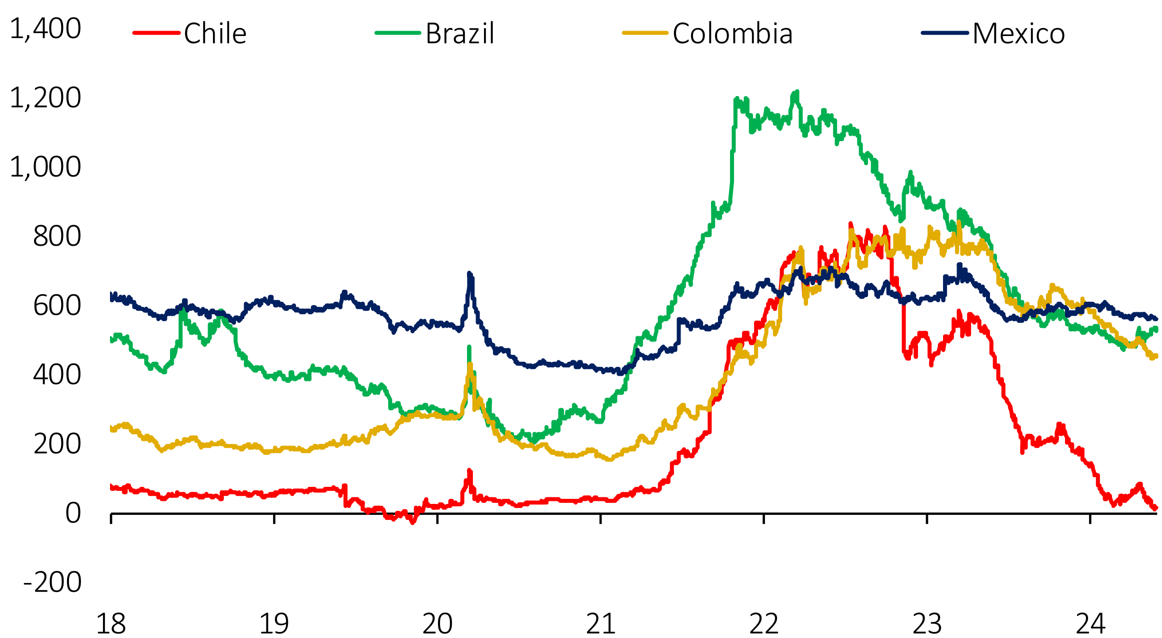
(*) Expectations contained in the analyst surveys of each central bank. Inflation targets: Brazil 3%, Chile 3%, Colombia 3%, Mexico 3% and Peru 2% (range between 1% and 3%). Sources: Central Bank of Chile and central banks of each country.

Figure 6
MPR in Latin America (*)
(percent)



(*) For the average for May 2024, considers data until the 28th of the month.
Sources: Bloomberg and Central Bank of Chile.

Figure 7
One-year rate differential with respect to the U.S.
(percentage points)



Sources: Bloomberg and Central Bank of Chile.

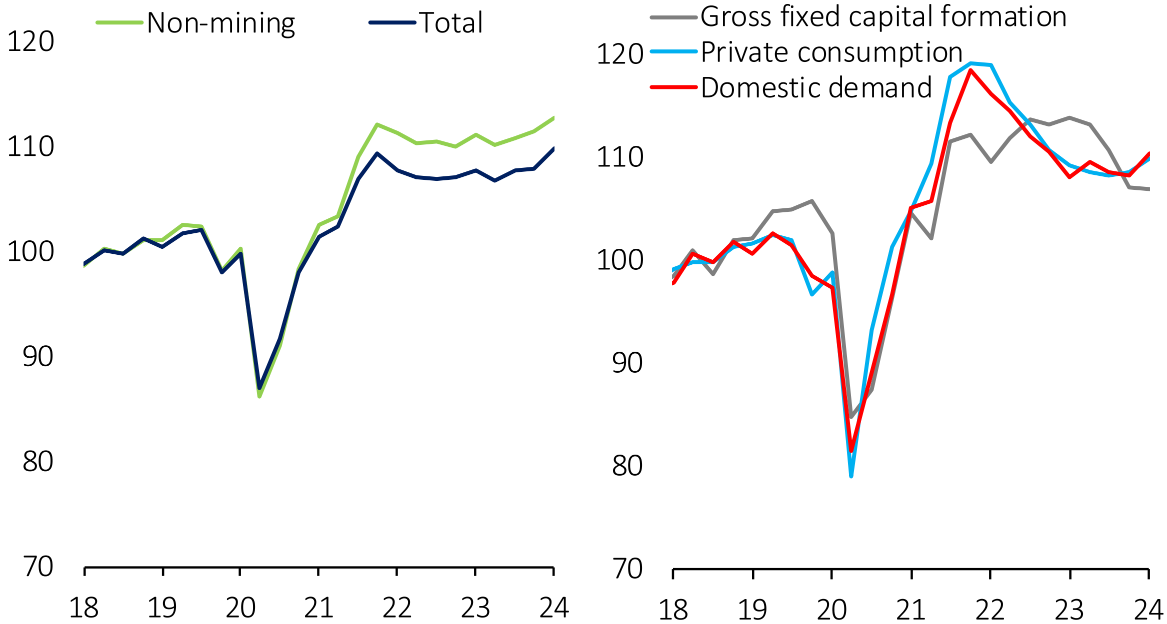
Figure 8

GDP

(index 2018=100, seasonally adjusted series)

Domestic demand and its components

(index 2018=100, seasonally adjusted series)

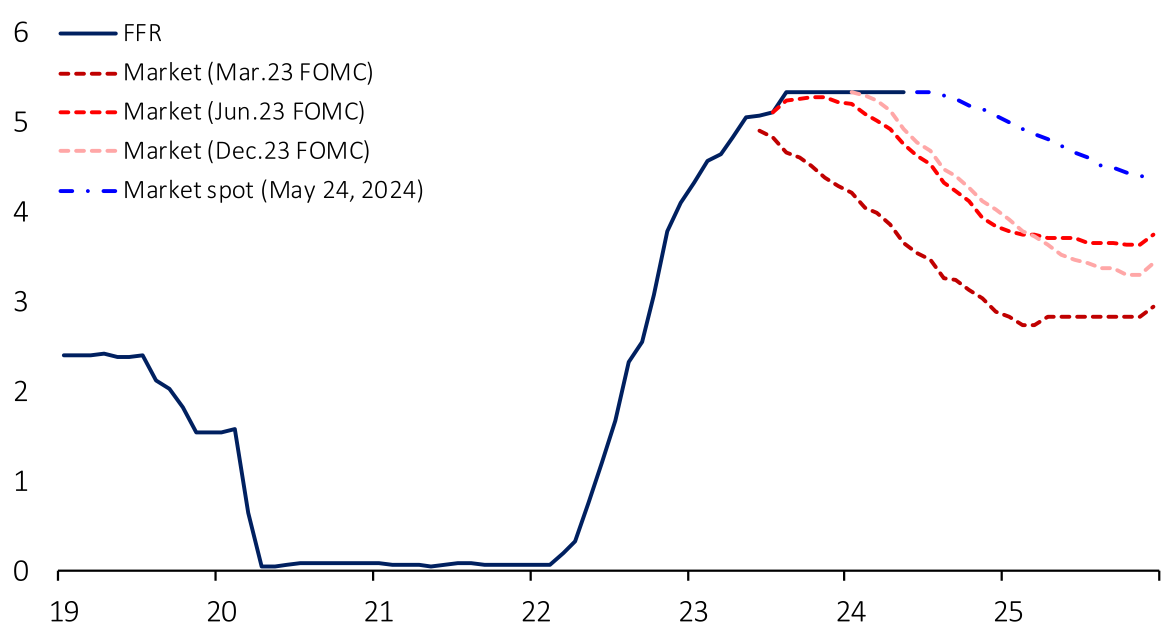


Source: Central Bank of Chile.

Figure 9

Fed funds rate (*)

(percent)



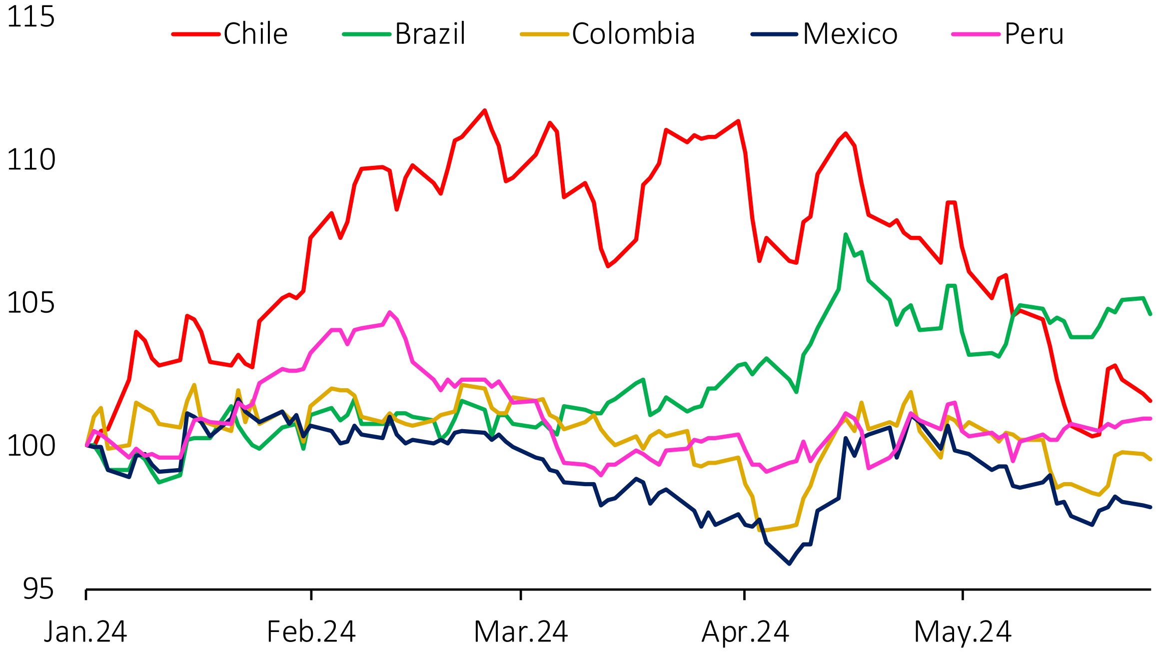
(*) Market projections are for the mid-range of the Fed funds rate of the FOMC futures for March, June and December 2023 (March 22, June 14 and December 13 of that year, respectively) and May 24, 2024.

Sources: Bloomberg and Federal Reserve.

Figure 10

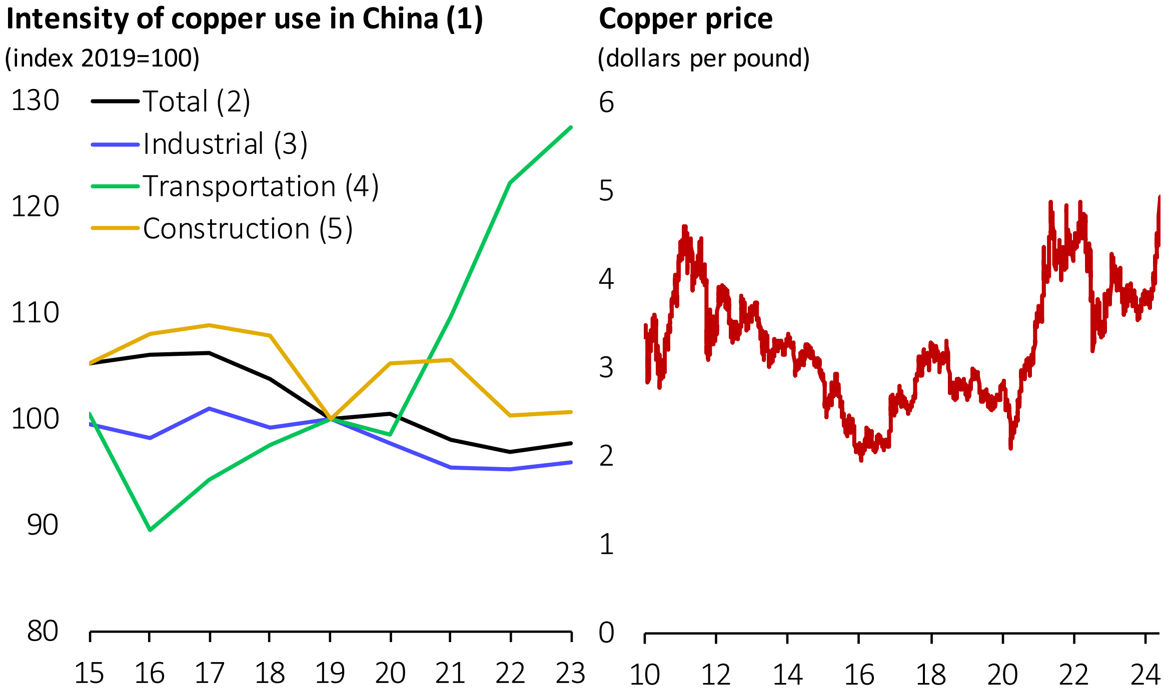
Nominal exchange rate

(index, 2.Jan.24=100)



Sources: Bloomberg and Central Bank of Chile.

Figure 11



(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.
Sources: Central Bank of Chile based on CRU Group and Oxford Economics information, and Cochilco.