MONETARY POLICY REPORT

PRESENTATION BEFORE THE FINANCE COMMISSION OF THE HONORABLE SENATE OF THE REPUBLIC[*]*

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[*]/ The December 2024 Monetary Policy Report can be found at http://www.bcentral.cl

Introduction

Mr. President of the Senate's Finance Commission, senators members of this Commission.

As is customary, I would like to begin by thanking the Commission for periodically inviting the Central Bank to present its views on recent macroeconomic developments, as well as the outlook for and implications of monetary policy. It is this view that is presented in detail in the December 2024 Monetary Policy Report (IPoM) that was published this morning. This background is also the rationale behind the decision taken by the Board at yesterday's Monetary Policy Meeting.

This IPoM examines a scenario where inflation is above our expectations of a few months back. The annual variation of the CPI reached 4.2% in November and in the projections of this Report we foresee that it will close the year at 4.8%, to then fluctuate around 5% during the first half of 2025. From that moment on, it starts to decline to converge to 3% in the first part of 2026.

The higher short-term inflationary trajectory responds to a combination of cost factors. On the one hand, there is the global appreciation of the dollar —which has raised the exchange rate— caused by intensified global uncertainty. On the other hand, although with a lesser impact, there is the rise in local labor costs.

These shocks have occurred simultaneously, contributing to the narrowing of the firms' operating margins and leading to a greater-than-expected pass-through of costs to final prices. In the medium term, cost pressures will tend to ease and the evolution of inflation will be determined by domestic demand, particularly by a weaker performance of household consumption. Meanwhile, private consumption has been weak, amid low job creation dynamism, the real depreciation of the peso and still pessimistic sentiment regarding the economy.

As I will detail in a few minutes, the convergence of inflation to the target will not differ much from what we previously estimated, with the outlook for activity remaining largely unchanged, but with consumption growing less than was considered in the September Report.

In this scenario, having lowered the MPR by 25 basis points at yesterday's monetary policy meeting to 5%, we completed a cumulative decline of 625 basis points (bp) from July 2023 to date. With this, monetary policy has substantially eased tightening and is closer to the range of its estimated neutral value. As I will show you briefly, the balance of risks to inflation is biased to the upside in the near term, which underscores the need for caution. This means that we will gather all incoming information on the economy's performance in order to best assess the timing of MPR cuts in the coming quarters.

Now let me detail for you the contents of this new IPoM.

The macroeconomic scenario

In November the annual change in total and core (non-volatile) CPI was 4.2% and 4.0%, respectively. These figures outperformed the assumptions in the last IPoM, especially in the core components of both goods and services.

Services inflation stopped falling in annual terms, with the component of administered and indexed services remaining stable, while the rest of the services have picked up. Regarding volatile CPI

items, worth noting was the new increase in electricity rates during October, thus continuing with the announced adjustment process. Also significant were the marked fluctuations in the prices of some foodstuffs. Fuel prices fell in recent months, affected by the decline in international oil prices. Volatile prices of goods and services rose, particularly those sensitive to the exchange rate (Figure 1). Recent inflationary dynamics have been influenced by the joint increase of several cost factors, including electricity prices, a depreciating peso and higher labor costs (Figure 2). In this scenario, short-term inflation expectations have risen, while in the two-year term they stand around the 3% target.

The peso's depreciation compared to the previous IPoM is mainly due to a global strengthening of the dollar, amid a more uncertain global scenario. The sources of uncertainty are related to ongoing war tensions, fears about the fiscal and sovereign debt situation worldwide, and the impact of a possible reconfiguration of international trade (Figure 3). All this takes place in a context of doubts regarding the policies to be adopted by the incoming U.S. administration.

The Federal Reserve, for its part, began cutting its interest rate in September, mitigating a risk that had been significant until recently, although uncertainty persists as to the speed and point of arrival of this process. In this scenario, long-term interest rates remain high at a global level and it is estimated that this combination of elements will continue to influence international financing conditions (Figure 4).

In our country, as I showed some minutes ago, wage indicators have posted significant expansion rates, despite the weak outlook on the employment side. This increase is explained by a mix of factors, such as the recovery of real wages after the high inflation of previous years and the upward adjustment of the minimum wage. Measured in real terms, the annual increase in the Labor Cost Index (prepared by INE) has exceeded its historical averages in recent months. At the same time, indicators obtained from administrative records (information from unemployment insurance administrators AFCs) show that the real annual variation in wages has been high over the last year. This has had direct effects on some CPI items, while at the same time adding to the cost pressures already noted for businesses.

On the activity side, although third-quarter GDP was in line with our September assumptions, domestic demand grew less than expected. By sectors, manufacturing and copper mining performed favorably, while financial and business services underperformed, adding to the prolonged sluggishness of construction (Figure 5).

As for this quarter, the October Imacec showed an increase in activity after falling in September. These results include the impact of temporary supply-side elements on some items, factors whose recurrence added volatility to figures throughout the year. For the same reason, as we have said repeatedly, one should try to infer trends rather than focus on a single data point. The data for the rest of 2024 will also be subject to these factors, particularly due to the combination of December holidays .

The lower dynamism of expenditure owes to a weaker private consumption, which was counteracted by greater public consumption. At the same time, the economy has been driven by external demand, as reflected by the evolution of exports of goods and services (Figure 6).

The slowdown of private consumption occurs in a context of low job creation performance. The data reported by surveys and administrative records show a fall or stagnation in several dimensions,

such as formal employment (AFC and AFP data), employment in some lagging sectors (INE) and also brackets of lower educational levels (INE) (Figure 7). Contributors to the slow pace of job creation are the meager investment that has been seen for several quarters in the non-mining sectors, the evolution of activity in the most job-demanding sectors —such as construction— and the rise in compensation costs. The real wage bill has tended to moderate its recovery, affecting disposable income for consumption.

Turning to the performance of gross fixed capital formation (GFCF), it has been aligned with our September forecasts. Its evolution continues to be marked by dissimilar behavior between components and sectors. Machinery and equipment remains more dynamic compared to the stagnant construction and works for several quarters. By items, the dynamics of investment in mining again contrast with the lag of other sectors (Figure 8).

Credit is still weak, reflecting still tight demand for funding, in a context where short-term lending rates continue to reflect the reductions to the MPR. Since their recent peaks, they have fallen by around 550 and 750 bp in the consumer and commercial portfolios, respectively (Figure 9). Long-term interest rates (BTP10) are about 10 bp lower than they were in September.

Projections

In the short term, the main adjustment to the central scenario of this IPoM is that we factored in the higher cost pressures. Compared to previous estimates, the projection also considers a greater pass-through of costs to prices in the coming months, given the simultaneity with which the different cost shocks have occurred and the tighter operating margins of businesses.

As I said, core inflation leads the revisions, with average inflation in 2025 to be 0.5 percentage points higher than forecast in September. For total inflation, this is partially offset by downward corrections in some external prices, particularly of fuels.

Over the medium term, inflationary pressures will be dominated by a weaker outlook for domestic demand and easing cost pressures, including the gradual reduction of the real exchange rate (RER). This, even though the reduction in the financial burden on individuals and in short-term interest rates will sustain the recovery of consumption (Figure 10).

In the central scenario, annual inflation will rise in the coming months, oscillating around 5% during the first half of 2025. It will then begin to fall, closing that year at 3.6% and converging to 3% in the first months of 2026 (Figure 11).

The GFCF projections are also adjusted downwards, while ratifying differences between sectors. The Capital Goods Corporation's survey continues to anticipate greater dynamism of mining investment in 2025 compared to other items, a divergence that is also reported in the Business Perceptions Report and confirmed by high-frequency tax data sources. The main factor behind the projection adjustment is the tightening of external financial conditions —in the context of high international uncertainty—, through a greater persistence of high long-term interest rates and a depreciation of the Chilean peso (Figure 12).

The GDP growth ranges forecast for 2025 and 2026 remain at 1.5%-2.5%. This incorporates higher public spending and a greater boost from abroad, which are offset by the lower projected boost to

household and business spending. The latter also affects the estimate of 2.3% growth for this year, at the lower end of the range forecast in September (2,25-2,75%) (Table 1).

Compared to September, somewhat more negative values of the activity gap are estimated until the end of 2025, which will contribute to mitigate inflationary pressures. After that, the output gap will return to its equilibrium levels as long as the economy keeps growing around its trend, demand recovers and the cuts in the MPR continue. The assessment regarding the level of the output gap is consistent with a labor market gap that is estimated to be narrow (Figure 13).

The projections include a real expansion of public spending consistent with the recently approved Budget Law. As a working assumption, the process of public finance consolidation is still expected to continue. Nevertheless, the coming years pose a challenging situation for compliance with the fiscal rule.

Estimates for the current account deficit during the next two years are slightly reduced. This considers a greater dynamism of exports of goods and services associated with the real depreciation of the peso, including tourism-related consumption and higher volumes shipped. Imports will also expand less due to the evolution of domestic demand.

Regarding world activity, our projection reiterates growth close to 3% of our trading partners for the period 2025-2026. This estimate recognizes the greater likelihood of a more moderate slowdown than previously expected for the United States, whose latest data have been a positive surprise. Furthermore, the outlook continues to show slower growth in China over the next two years. In this context, the average copper price will move towards US$4.3 over the projection horizon (Figure 14).

Monetary policy

Regarding monetary policy, I would like to start by highlighting that the short-term inflationary outlook has become more challenging due to higher cost pressures. As I have just shown you, this means that, in the central scenario, inflation will fluctuate around 5% during the first half of 2025. However, in the medium term, weaker domestic demand would mitigate inflationary pressures. Thus, if the assumptions of the central scenario of this IPoM materialize, the MPR will follow a descending trajectory over the policy horizon.

In any case, risk balance for inflation is biased upwards in the short term, so caution is most needed. This means that the Board will steadily accumulate information regarding the progress of the economy in order to assess the timing for MPR cuts in the coming quarters.

Regarding alternative scenarios for monetary policy, in this IPoM, the sensitivity scenario that defines the upper bound of the MPR corridor is associated with a greater impact of cost pressures. An intensification of these and/or a higher pass-through to final prices could lead to higher inflation scenarios, which would also increase second-round effects and the possibility of seeing higher inflation persistence. The short-term risks surrounding these scenarios are greater, considering the global uncertainty and the levels that inflation will reach in the central projection scenario. If such a scenario materialize, a more contractionary monetary policy strategy than the central scenario would be needed.

The lower bound refers to the effects of the greater uncertainty and weakness of the international scenario on the evolution of domestic spending. A more marked worsening of global financing conditions, associated with a worsening of the current sources of uncertainty, would further reduce the momentum of local agents' spending, especially in investment. A scenario in which employment deteriorated more than expected could be added. This would lead to capacity slack that would be discordant with the convergence of inflation to the 3% target, requiring more significant reductions in the MPR (Figure 15).

The risk scenarios involve global conditions, particularly in the financial sphere, but with more severe consequences that could drive the MPR to move outside the corridor. More extreme developments in trade scope, ongoing military conflicts or the fiscal situation of several economies mean that more complex episodes of risk aversion in the financial markets cannot be ruled out. This could lead to scenarios of a more pronounced exchange rate depreciation and a greater contraction of activity, considering that long rates have shown a weaker buffering role in the face of negative shocks.

Final thoughts

Dear senators, a constant throughout the year has been the high degrees of uncertainty in the external sector. On the one side, the increasingly complex geopolitical context. On the other side, a global economy where, despite some easing of inflation, the markets reflect concerns about the fiscal deficits and debt levels in several economies, several of them developed, and a process of de-globalization to which protectionist decisions in the strategic industries category have been added.

Recently, this panorama intensified, as latent conflicts burst out, as well as growing tension between blocs or alliances of countries, and internal tensions even in advanced democracies. On the economic front, doubts have arisen as to the direction of fiscal and trade policy in the United States, increasing the likelihood of an intensification of policies that accentuate protectionist tendencies.

Global financial conditions have tightened for the emerging world, where the appreciation of the dollar is noteworthy, in a context where the resilience of the U.S. economy stands out compared to the other countries' performance.

Moreover, such an environment exposes us not only to tighter financial conditions, but also to bouts of volatility because markets have become more sensitive to economic news.

Long-term interest rates, which are very important for financing investment projects, are still higher than in past years and the factors behind this increase do not seem to be going away any time soon. This poses an additional complication for a small economy such as ours.

At home, inflation has risen with respect to the beginning of the year. The normalization of electricity prices has played an important role in this process, which, despite being in line with expectations, has had a significant impact on inflation.

In any case, the most recent inflation figures have shown variations above expectations. As I showed you, these have been concentrated on core items, reflecting simultaneous hikes in several cost factors. These are supply-side items that put pressure on inflation, and as such, they are easing, unlike what we identify as typically more persistent shocks, for example, originating in

overspending. However, their joint occurrence and aggregate magnitude contribute to narrowing business margins, leading to a greater pass-through to prices than we saw just a few months ago.

As I noted, to the extent that these cost pressures diminish, the second-round effects remain and the effect of consumption and investment, which we expect to be lower than projected in September, will begin to dominate as well as a real appreciation of the peso,. These latter factors are relevant when defining the monetary policy path that achieves convergence to the target in the terms indicated in the Report.

This combination of factors will lead inflation to fluctuate around 5% during the first half of 2025. These are uncomfortable levels and with an upward balance of short-term risks, where any additional shock can further push up inflation. In this scenario, one cannot be too careful. The external context may provoke new inflationary pressures and we must be attentive and assess their medium-term impact, for which it is essential to pay attention to the origin of the shocks and their consequences.

Therefore, as we expressed in our monetary policy meeting statement on Tuesday, we will continue to accumulate information about the economy development, the evolution of risks, and we will evaluate the opportunity to reduce the MPR in the coming quarters. An uncertain scenario such as the one described above is a call for caution. Thus, in the near future, it should come as no surprise that we enter a stage of pauses in the monetary policy interest rate.

Dear senators, we face complex global circumstances, which should concern us all and call us to work urgently, due to important challenges ahead that we must address with the best collaborative spirit in search of a common goal: the well-being of the country and all its inhabitants.

It is well known that a balanced economy, with room for fiscal and monetary policy, can better weather any external shock, reducing the cost of its consequences on individuals and businesses. Monetary policy has contributed and has managed to correct the strong imbalances we have experienced in recent years. Some sectors are still lagging behind, some are indebted, and still some of them where the firms' margins have narrowed. Although this is a normal occurrence in the framework of any business cycle such as our recent one, as the cycle progresses, these problems will be gradually solved.

Fiscal policy made progress in reducing spending in 2022 and re-anchoring policy to a dual goal of both structural balance and prudent debt. The Autonomous Fiscal Council has cautioned that there are risks to such consolidation, as far as it requires strict behavior for revenues and expenditures. It is important to continue to address these challenges and consolidate the commitment to fiscal targets over time.

Aspects related to financial markets are also important. In line with the analysis in this IPoM, in our November Financial Stability Report (IEF), which we presented to this same Commission, we emphasized several points. Among them, the importance of external factors in the risk landscape and the need to further build resilience. The latter considers adequate regulation and supervision, the use of the instruments granted us by law (including the Countercyclical Capital Buffer, CCyB) and the promotion of measures that allow for a deeper capital market. However, the challenge of deepening the capital market requires policies that encourage savings and a solid and stable institutional framework.

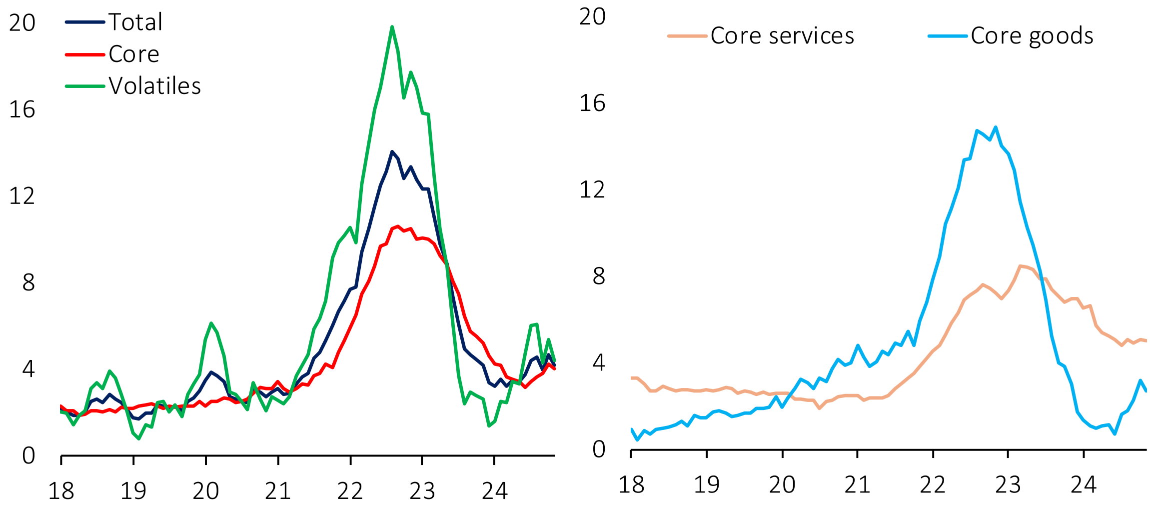
I would like to add another element to these challenges, the overall perception of the public regarding the progress of the economy. Beyond the fact that the economy is growing in line with its trend, around 2% annually, the perception is that this is not enough to satisfy the needs we have as a country. The challenge then is what should we do to grow more and create conditions for a better economic climate. This is an issue that we have been raising as a Bank for more than a year. We think it is positive to see that this is now part of the public debate. But more valuable still is the move to action.

A crucial point in this challenge is to reverse the downward trend of productivity, a phenomenon that has been going on for more than a decade. Improvements in growth and in the quantity and quality of employment directly strengthen household welfare. Productivity and the strengthening of investment are fundamental pillars. On our side, as we have said all along, the biggest and best contribution is to maintain macroeconomic conditions that allow for an adequate performance of public and private initiatives. In this regard, inflation in line with the two-year target of 3% is of vital importance.

Senators, our country has always been up to the challenges it comes across. Today Chile is facing a complex global scenario and our economy is growing, but not as fast as we would all like it to. We should not stop at detecting problems, but also take advantage of opportunities to work together and address them effectively. Perhaps the most immediate reaction to the projections we are presenting today is to highlight the change in growth for this year. And it is important. However, it is a figure that is in line with long-term growth. So the challenge lies not in the current data, it lies in focusing on the long term and looking for ways to improve our development conditions as a country.

Thank you.

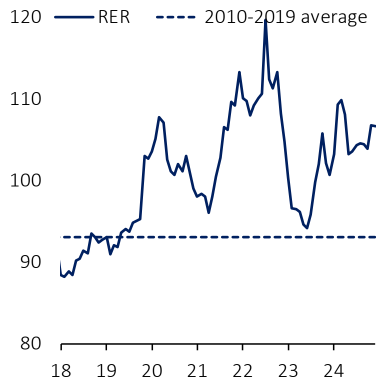
Figure 1
Consumer price index (CPI) (*)
(annual change, percent)



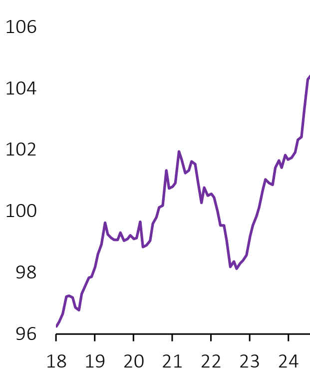
(*) The series consider the CPI's 2023 benchmark basket and the splicing done by the Central Bank of Chile.
Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 2
Cost factors

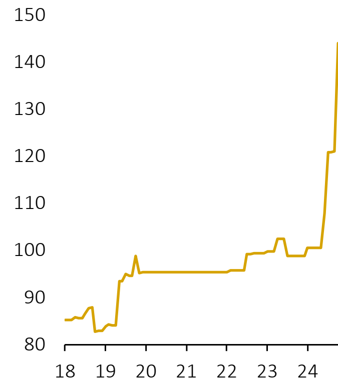
a) Real exchange rate (RER) (1)
(index, 1986=100)



b) Labor cost index (ICL)
(index, 2023=100, real deseasonalized series)

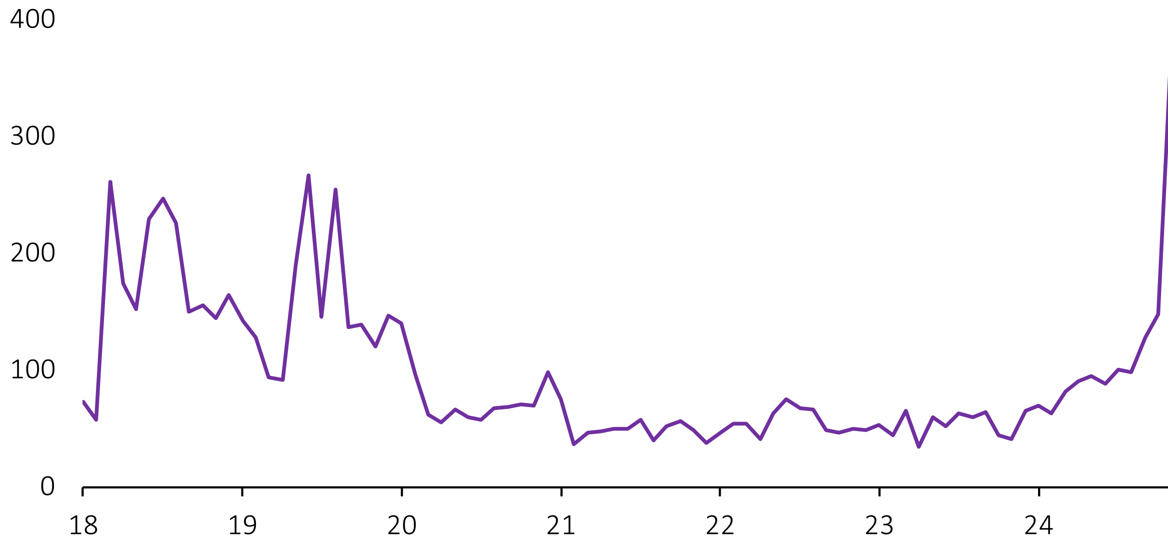


c) CPI for electricity (2)
(index, 2023=100)



(1) November 2024 figure is preliminary; December 2024 figure is average up to the 12th of the month. (2) The series considers the CPI's 2023 benchmark basket and the splicing done by the Central Bank of Chile.
Sources: Central Bank of Chile and National Statistics Institute (INE).

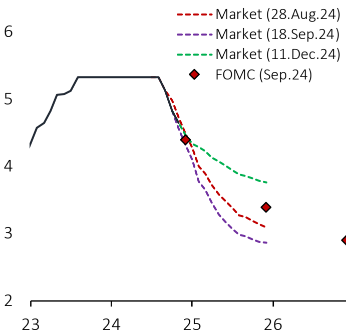
Figure 3
Trade policy uncertainty (*)
(TPU index)



(*) The Trade Policy Uncertainty (TPU) index measures the media's attention to news covering trade policy uncertainty. The index reflects the results of an automated text search of the digital files of seven major newspapers that discuss trade policy uncertainty: Boston Globe, Chicago Tribune, The Guardian, Los Angeles Times, New York Times, Wall Street Journal, and Washington Post. The index is scaled so that 100 denotes that 1% of news articles contain references to TPU.
Source: Caldara, Iacoviello, Molligo, Prestipino and Raffo (2020), "The Economic Effects of Trade Policy Uncertainty."

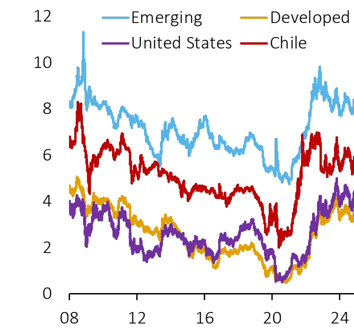
Figure 4

a) Fed funds rate (1)
(percent)



b) Dollar index (DXY) (2)
(index, 2000-2024=100)

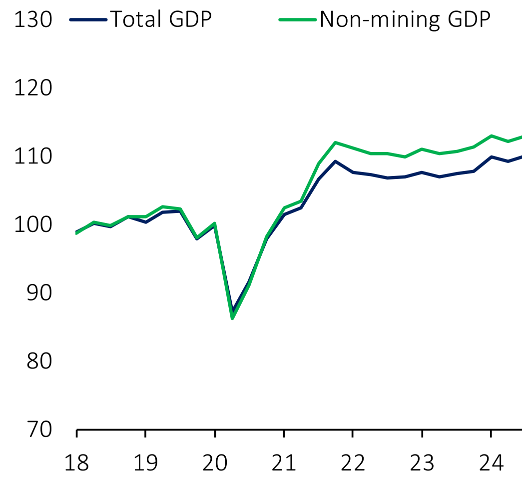
c) Sovereign 10-year rates (3) (4)
(percent)

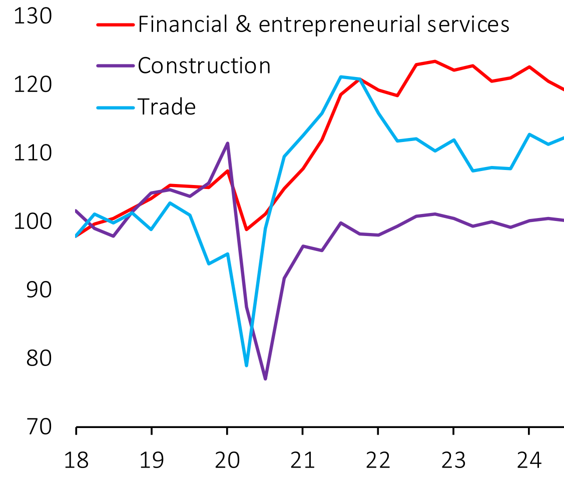


(1) FOMC projections correspond to the mid-range of the fed funds rate (FFR) presented in Sep.24, market projections refer to the mid-range of the FFR futures as of the September 2024 IPoM statistical close (Aug.28.24), the September FOMC (Sep.18.24) and the December 2024 IPoM statistical close (Dec.11.24). (2) A higher index means a dollar appreciation and vice versa. (3) Developed countries include Australia, Canada, Germany, Italy, Korea, New Zealand, Norway, Singapore, Spain, Sweden, the United Kingdom and the United States. (4) Emerging countries include Brazil, Chile, Colombia, Hungary, India, Indonesia, Mexico, Peru, Poland, South Africa and the United States.

Sources: U.S. Federal Reserve and Bloomberg.

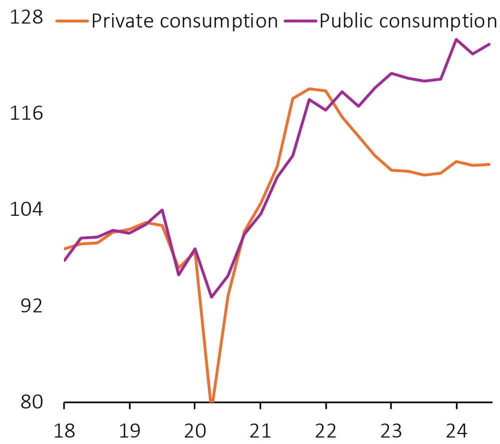
Figure 5
Gross domestic product
(index, 2018=100, deseasonalized series)



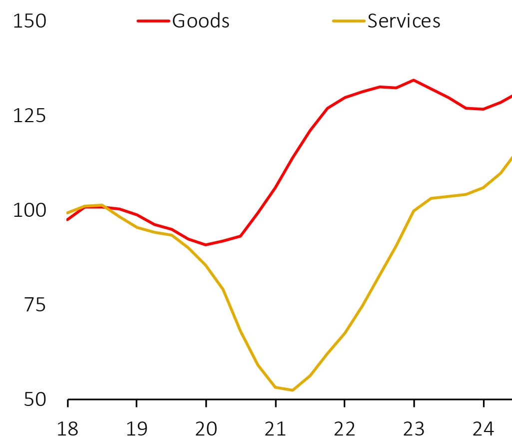


Source: Central Bank of Chile.

Figure 6
a) Domestic consumption
(index, 2018=100, deseasonalized series)



b) Nominal exports
(moving annual sum; index, 2018=100)

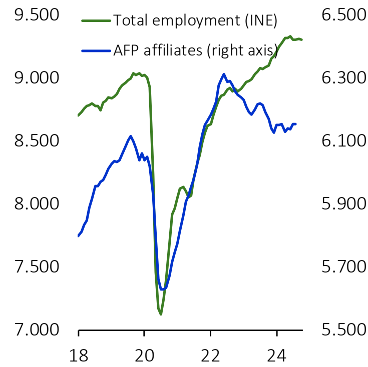


Source: Central Bank of Chile.

Figure 7

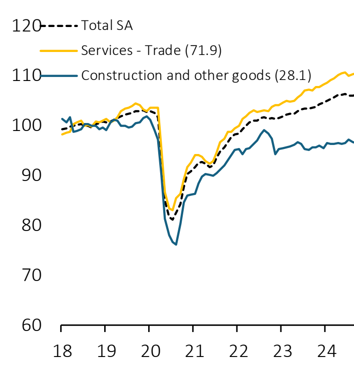
a) Employment indicators (1)

(thousands, deseasonalized series)



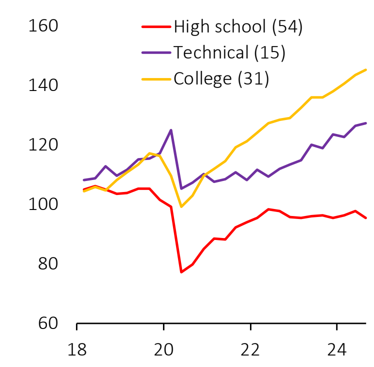
b) Employment by sectors (2) (3)

(2018 = 100, deseasonalized series)



c) Employment by education level (4)

(2010-2024 = 100, quarterly deseasonalized series)



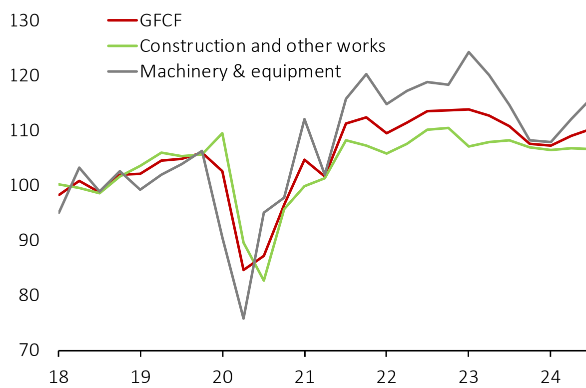
(1) Employment figures from surveys (INE) and pension administrative figures (AFPs) are not mutually comparable. (2) Data from INE. Other goods includes agriculture, manufacturing, EGW and mining. (3) In parentheses, percentage share of total employment in 2023. (4) In parentheses, weight of each group within the labor force during 2023.

Sources: National Statistics Institute (INE) and Pension Superintendency (SP).

Figure 8

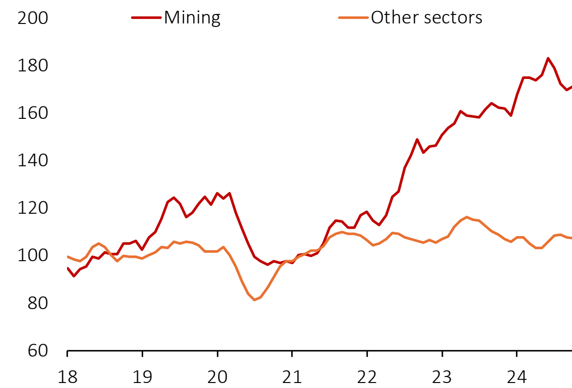
a) Gross fixed capital formation

(index, 2018=100, deseasonalized series)



b) Investment by sectors (*)

(index, 2018=100, moving quarterly average, real deseasonalized series)



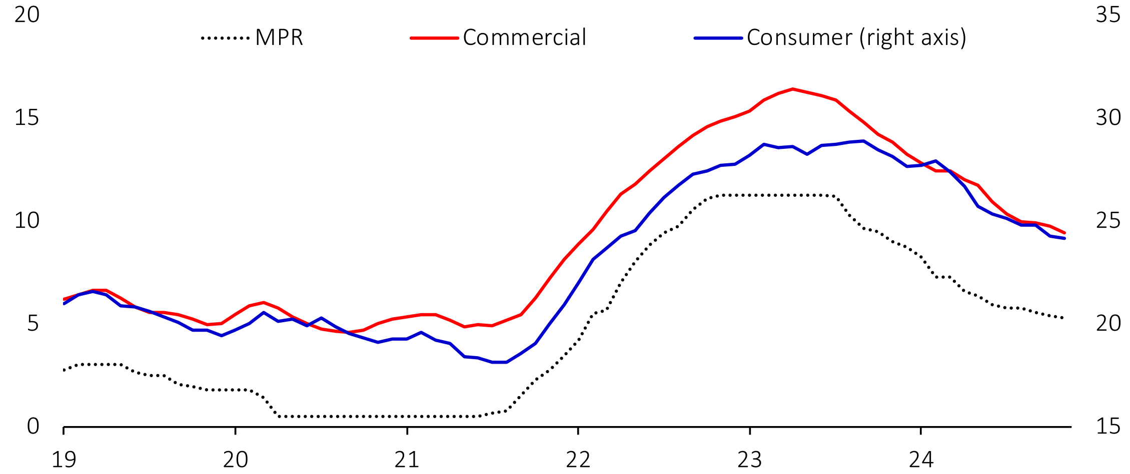
(*) For methodological details, see box minutes of the September 2024 IPoM.

Sources: Central Bank of Chile, Customs Office, and Internal Revenue Service (SII).

Figure 9

Lending rates (1) (2)

(percent)

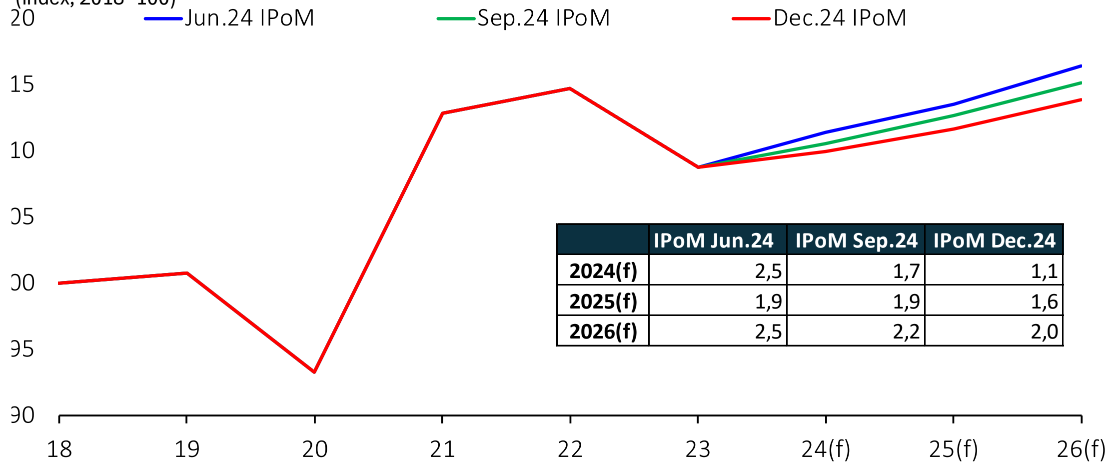


(1) Consumer and commercial credit rates are the weighted average of all transactions in pesos performed in each month in Chile's Metropolitan Region. Both series are moving quarterly averages. (2) The MPR series is its monthly average.
Source: Central Bank of Chile.

Figure 10

Private consumption

(index, 2018=100)



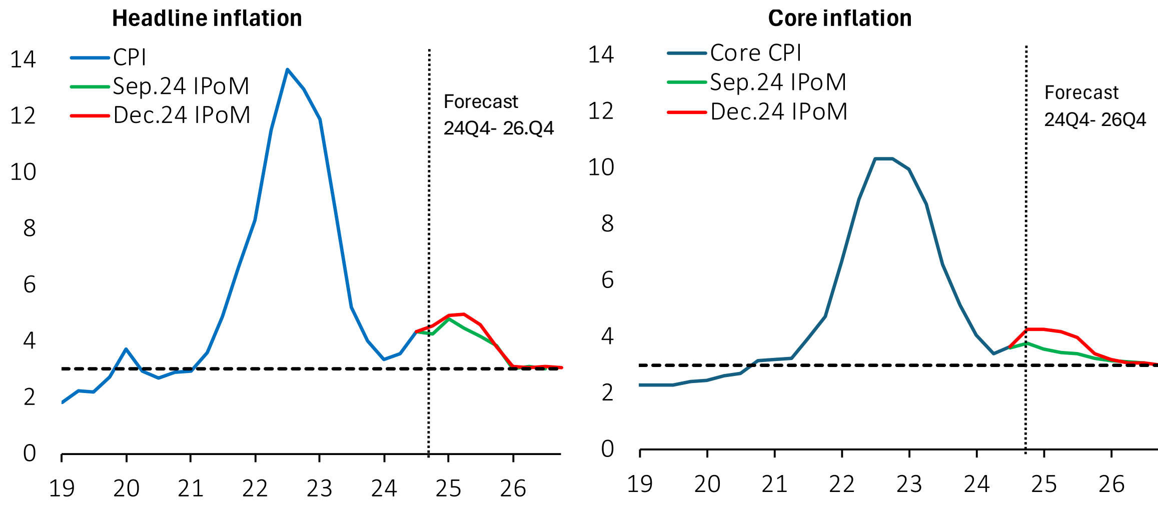
	IPoM Jun.24	IPoM Sep.24	IPoM Dec.24
2024(f)	2,5	1,7	1,1
2025(f)	1,9	1,9	1,6
2026(f)	2,5	2,2	2,0

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

Figure 11

Inflation forecast (*)

(annual change, percent)

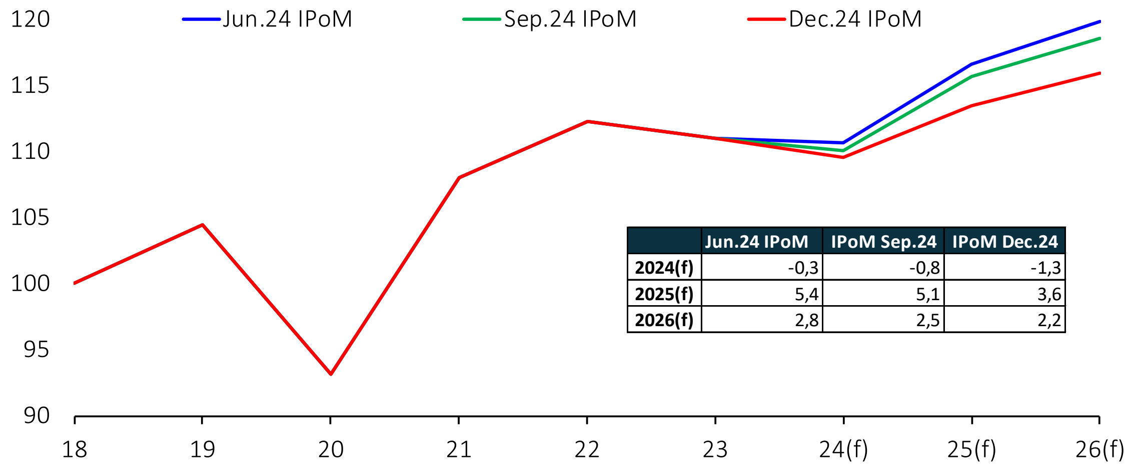


(*) Considers 2023 benchmark basket and splicing done by the Central Bank of Chile.
Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 12

Gross fixed capital formation

(index, 2018=100)



	Jun.24 IPoM	IPoM Sep.24	IPoM Dec.24
2024(f)	-0,3	-0,8	-1,3
2025(f)	5,4	5,1	3,6
2026(f)	2,8	2,5	2,2

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

Tabla 1

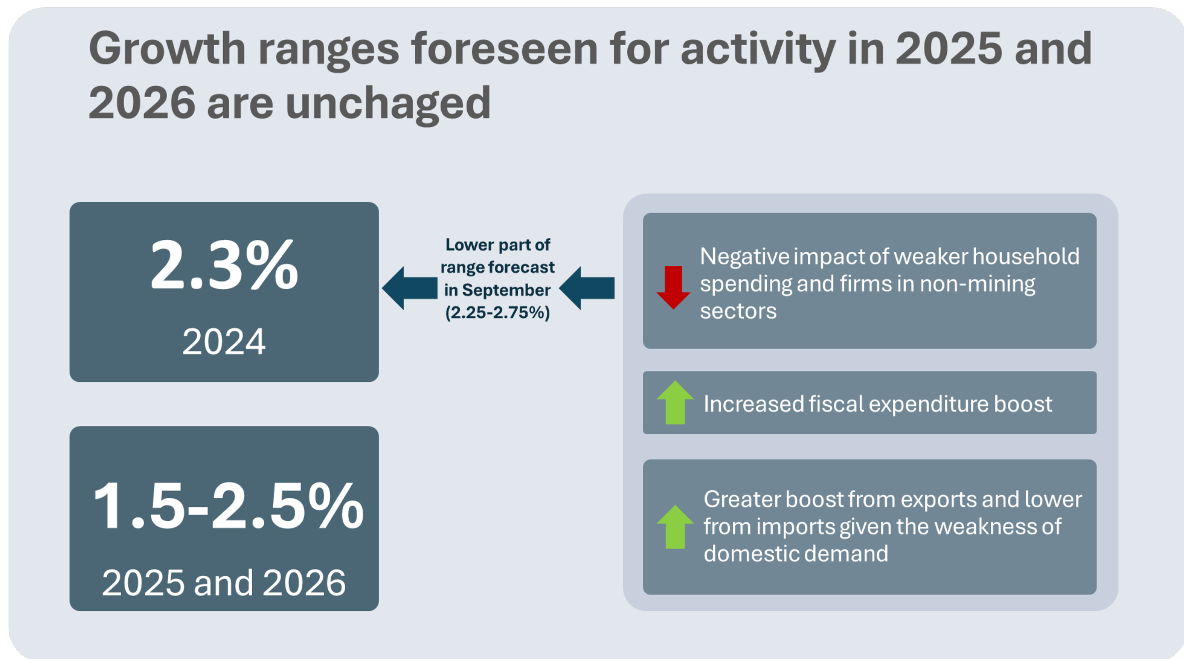
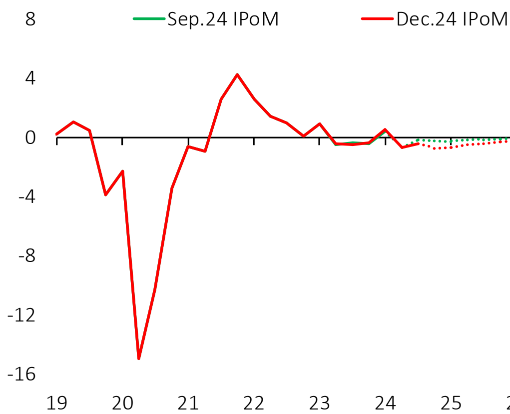
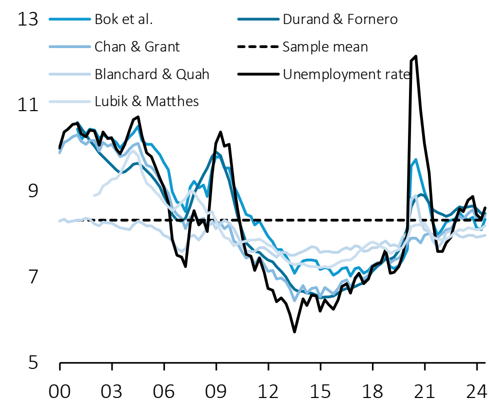


Figure 13

a) Activity gap (1) (2)
(level, percentage points)



b) Unemployment rate and estimated benchmark level (3)
(percent, deseasonalized series)

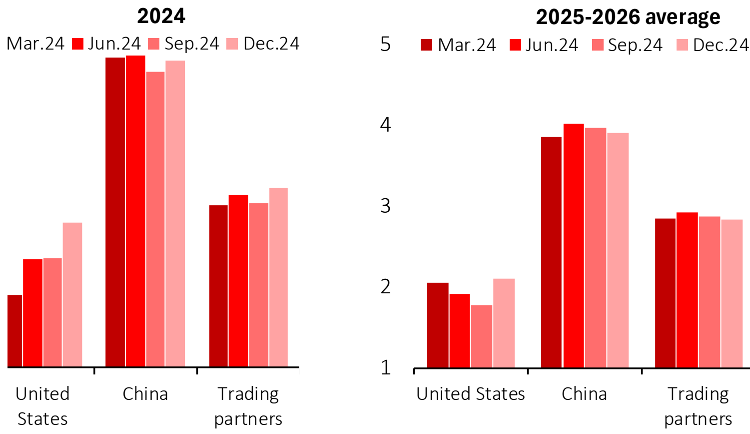


(1) Dotted lines show forecasts. (2) The forecast uses structural parameters updated in the September 2024 IPoM (trend and potential). (3) Unemployment rate prior to moving quarter Jan-Feb-Mar 2010 spliced using information from National Employment Survey (ENE).
Sources: Levenier et al. (2024) based on data from INE and Central Bank of Chile.

Figure 14

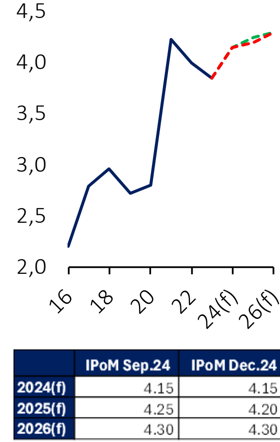
a) Trading partners' growth forecasts

(real annual change, percent)



b) Copper price (*)

(dollars per pound)



	IPoM Sep.24	IPoM Dec.24
2024(f)	4.15	4.15
2025(f)	4.25	4.20
2026(f)	4.30	4.30

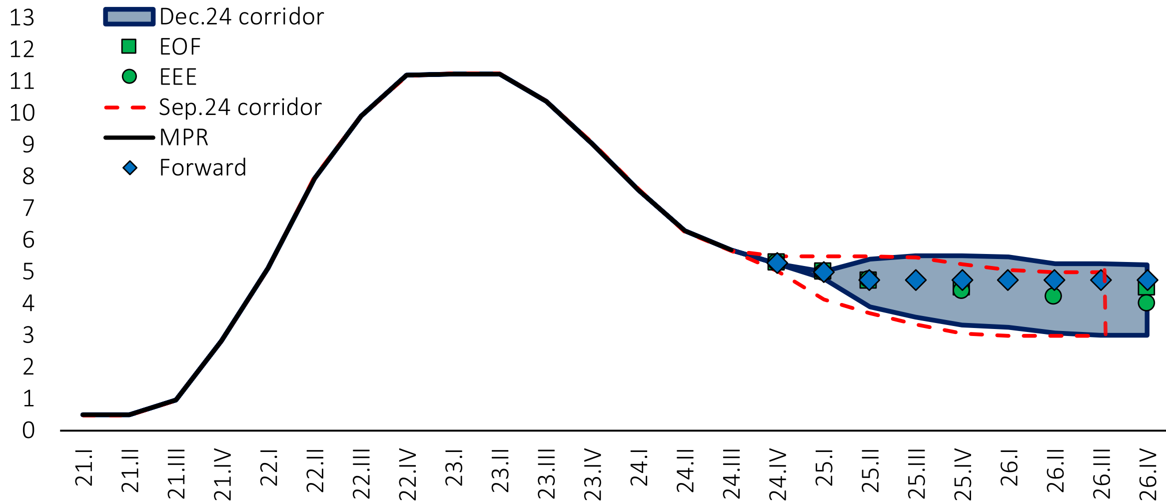
(f) Forecast. (*) Actual price is the average for each year. Dotted lines represent the 2024-2026 forecasts contained in each IPoM.

Sources: Central Bank of Chile based on sample of investment banks, Consensus Forecasts, the IMF and statistics bureaus of respective country and Bloomberg.

Figure 15

MPR corridor (*)

(quarterly average, percent)



(*) The 2025 and 2026 calendar considers two monetary policy meetings per quarter. The corridor is constructed following the methodology of Box V.1 in March 2020 IPoM and Box V.3 in March 2022 IPoM. It includes the December EEE and December pre-policy meeting EOF. EEE: Economic Expectations Survey; EOF: Financial Traders Survey. For details, see methodological note (Figure II.10, Chapter II, December 2024 IPoM).

Source: Central Bank of Chile.