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CONTACTS

Adriana Vega
613.564.5204
Scotiabank Economics
adriana.vega@scotiabank.com

Jorge Selaive
+56.2.2619.5435 (Chile)
Scotiabank Chile
jorge.selaive@scotiabank.cl

Anibal Alarcón
+56.2.2619.5435 (Chile)
Scotiabank Chile
anibal.alarcon@scotiabank.cl

Waldo Riveras
+56.2.2619.5465 (Chile)
Scotiabank Chile
waldo.riveras@scotiabank.cl

CHILE: CENTRAL BANK HIKES POLICY RATE BY 125 BPS TO 4.0%, AS EXPECTED

Earlier today (Tuesday, December 14), Chile's Central Bank (BCCh) increased the Monetary Policy Rate by 125 basis points to 4%, in line with our expectations. According to the BCCh, external inflation has increased, showing signs of persistence in several countries. In our view, the latter would not have supported a decision to delay the process of normalization of local monetary policy. Despite the drop in oil prices—also mentioned by the BCCh—we estimate that we will continue to see increases in the price of fuels at the local level during the first quarter of next year, which will continue to inject inflation. As for global economic activity, the BCCh continues to see a moderation in the growth prospects mainly in emerging economies, associated with supply restrictions due to continued effects of COVID-19.

In the local scenario, the BCCh is facing a historical de-anchoring of inflation expectations, while the drivers of which have not yet given up. The 24-month median inflationary expectations remain at 3.5% according to the latest Economic Expectations Survey, in a scenario where the Chilean peso (CLP)—the main driver of inflation alongside high dynamism of private consumption—has depreciated around 2.5% in multilateral terms since the last Central Bank Board meeting and 7% since the last *Monetary Policy Report* of September. The 35-month expectations are at 3.0% for now, and any short-term inflationary surprise can lead to losses in monetary policy credibility that are difficult to recover, with second-round effects that would give more persistence to recent inflationary developments.

The political uncertainty has not prevented the recovery of employment and, for now, it has not affected private investment plans contemplated for the coming years. However, financial assets (CLP, interest rates and the stock market) have internalized a scenario with a greater probability of expansionary public spending, an increase in the public debt and a lesser depth of the capital market. These, together with the successive withdrawals of pension funds and fiscal support for households (among the greatest for economies with a similar income level), have jointly contributed to adding idiosyncratic inflation to the already abundant external inflation. At Scotiabank we project that annual inflation would approach 8% by the middle of the first half of 2022, slowly declining the rest of the year to just under 5%. See our recent *Latam Weekly* from December 10 for more forecasts.

Today's decision by the BCCh to increase the rate by 125 bps, as we had anticipated, signals an intention to place the rate above its nominal neutral level as soon as possible. We expect a path towards normalization with a 100 bps increase at the January meeting to reach a rate of 5.00%—a somewhat more aggressive pace than in our earlier scenario where we envisaged reaching that level by March. Yet another hike would then take place in March, of between 25–50 bps towards a rate of 5.25% or 5.50%.

The description of the macroeconomic scenario made by the BCCh in its press release shows a positive diagnosis in employment and investment with an expansion of GDP in 2021 higher than that contemplated in its previous baseline scenario. Inflation has not surprised to the downside, as its determinants for now show no signs of mitigation. In this context, we foresee levels around 5.25% and 5.50% as the terminal interest rate of this cycle, towards the March 2022 meeting, which—as stated above—would imply an increase of 100 bps in January's meeting. This would be in line with the Board's message to "help the economy resolve the imbalances it has accumulated" helping to ensure that inflation does not have a persistent effect on the price formation process, revealing concern regarding the second-round effects that we would continue to observe on inflation in the coming months.

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