Latam Flash: Chile's Central Bank Surprises with 75 bp Rate Increase

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CENTRAL BANK SURPRISES WITH 75 BP RATE INCREASE LEAVING BENCHMARK RATE AT 1.5%; EXPECT MPR TO REACH 2.25% BY DECEMBER

At its meeting on Tuesday, August 31, the Board of the Central Bank (BCCh) surprised the market increasing the policy rate by 75 basis points up to 1.5%, significantly above the consensus which expected between 25 bp and 50 bp. With this, the BCCh accelerated its stimulus withdrawal resulting from extended fiscal injections and ample liquidity in the economy that narrowed the policy capacity gap earlier than expected and added pressure on inflation. The measure is justified by activity data above what was expected in the BCCh's baseline scenario for the second quarter, as well as the extension of new fiscal aid recently delivered by the government that will remain until the end of this year, which implies a fiscal boost greater than that previously considered.

The output gap would turn positive in Q3-2021, while private consumption maintains an "extraordinary" dynamism, according to the BCCH. Although the labor market still shows capacity gaps, some heterogeneous recovery is observed, but which should improve given recent re-opening measures. The outlook for local activity and employment is positive, in general terms, with positive surprises even in the imported component of investment. These factors would support a faster-than-anticipated recovery, with the consequent closing of gaps and higher inflationary pressures, making it necessary to recalibrate the monetary stimulus and modify its normalization pace in the coming quarters.

More details will be needed about the risk scenarios and the adjustment of projections in the BCCH's baseline scenario to infer the expected trajectories of the Monetary Policy Rate (MPR). For now, however, our preliminary assessment is that no adjustments of this magnitude will come at the October meeting, especially if we have a reduction in inflationary expectations and Congress were to reject the 4th withdrawal of pension funds.

Our view is that the BCCH would be concerned about an inflationary acceleration due to the permanence of high logistics costs, the absence of disinflationary pressures from the exchange rate and the increase in gasoline prices. For now, we consider this 75 bp rise as a sharp, decisive signal to appease short- and medium-term inflationary expectations that were markedly above historical averages. If this objective is achieved, we expect the Central Bank to reduce the intensity of the withdrawal of the monetary stimulus, with an increase of 50 bp at the October meeting and a further 25 bp in the December meeting, which would leave the MPR at 2.25% by December 2021. The normalization path would reduce its intensity over 2022.

The financial market would react with a relevant appreciation of the Chilean peso (CLP) that could take it quickly to CLP 750, an increase in nominal swap rates, and decreases in inflation compensations for medium and long term durations driven by increases in inflation-linked rates.