

Chile Watch

Headline inflation progress but underlying stickier. More data needed to cut rates

Headline inflation progress. Underlying more sticky

Underlying inflation remains high in Chile, declining at a slower pace than headline inflation. Granted, May was a relatively favorable month on the inflationary front coupled with a weak economic activity print, increasing the likelihood of a rate cut in 3Q. We expect the first cut in September, with some risk of a cut in July.

Chile inflation was 0.1% mom in May, below the 0.3% expected by the Bloomberg consensus and down from 0.3% mom in the previous month. However, ex-volatile inflation (BCCh's preferred measure) was still high at 0.5% mom, down from 0.7% previously (3-month moving average 0.9% vs. 0.7% three months ago). Core ex-energy and food was 0.2% mom down from 0.4%.

In the last 12 months, headline inflation fell to 8.7% from 9.9%. However, underlying inflation ex-volatiles is stickier at 9.9%, down from 10.3%, showing small progress from the 11.1% peak in September and at same level as in June 2022. Core ex-energy and food was down to 7.9% (from 8.7%).

Main inflation drivers: hotels & restaurants +0.8% mom (0.06pp incidence), followed by household equipment & maintenance up 0.7% (0.04pp incidence), healthcare services +0.6% (0.04pp incidence).

Factors putting less pressure include communications dropping 0.2% mom (-0.01pp incidence) and transport -1% mom (-0.14pp incidence) while food & non-alcoholic beverages was flat at 0%. Air transport and bus transport services are still volatile (-0.16pp incidence).

More evidence needed to consolidate the adjustment

This is the first reasonably favorable month for inflation this year. While headline inflation continues to decline substantially, underlying inflation is falling but at a much slower pace, reflecting inertia and indexation. Wages remain strong (+10.8% yoy in April). In fact, the bulk of the decline in headline inflation is due to volatile factors including energy (which dropped 0.6% mom in May). And tradable inflation remains very low at 0.1% mom average in the last four months, helped by exchange rate appreciation (8% year-to-date).

All in all, the progress on inflation coupled with an economic activity showing incipient signs of weakness increase the likelihood of the BCCh starting the normalization of monetary policy in 3Q. Indeed, non-mining Imacec fell 1.6% yoy in April with a sequential decline of 0.7% mom (after a strong 1Q). Industrial production remains depressed while retail sales resumed its adjustment to the downside (continued inside).

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GEM Economics
LatAm | Chile

Sebastian Rondeau
LatAm FI/FX Strategist
BofAS
+1 646 855 3767
sebastian.rondeau@bofa.com

LatAm FI Strategy & Economics
BofAS

GEMs FI Strategy & Economics
BofAS

[See Team Page for List of Analysts](#)

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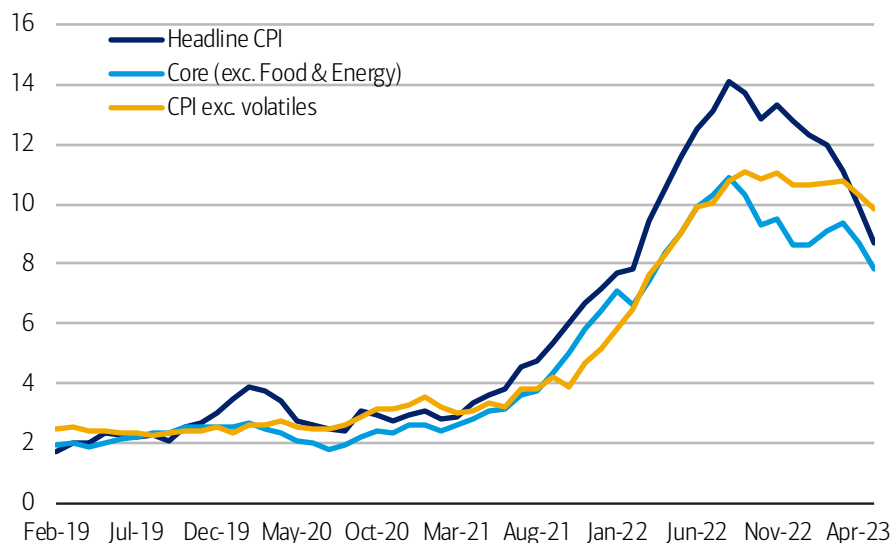
However, as shown in the most recent BCCh's minutes, we believe that a patient central bank needs to accumulate more evidence of declining underlying inflation and economic activity adjustment to start the cutting cycle, coming from a positive output gap, very high underlying inflation in previous months and very noisy data. We see the first cut in September and the policy rate at 9.25% year-end, declining to 6.25% in 2024 above the center of the policy corridor. BCCh should also be patient, in our view, in the face of a minimum wage hike (+14% this year) and fiscal policy turning expansionary.

We see some risk of cuts in July, which could increase if activity shows a more decisive downward path, as by then BCCh will have at best only two monthly prints of more subdued inflation. The rejection of the pension withdrawal bill by the lower house also helps to reduce tail risks (it cannot be presented again for another year). The increase in countercyclical capital requirement (0.5% of risk-weighted assets) was seen by the market as opening room to ease rates (to compensate tightens credit conditions), but we think it can also be interpreted as a hawkish BCCh that is not afraid to tighten financial conditions.

We forecast inflation at 5.4% (down from 5.8% previously) this year due to the headline downward surprise and CLP appreciation, declining to 3.9% in 2024; we see core inflation at 6.6% in 2023). Inflation expectations have improved in the economic survey (2y ahead expectations already at 3%).

Exhibit 1: Headline, ex-volatiles, and core inflation (in %)

Underlying inflation remains stickier than headline, showing little progress from its peak.



Source: INE, BCCh

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Research Analysts

LatAm FI Strategy & Economics

BofAS

Claudio Irigoyen

LatAm FI/FX Strategy/Economist

BofAS

claudio.irigoyen@bofa.com

David Beker >>

Bz Econ/FI & LatAm EQ Strategy

Merrill Lynch (Brazil)

david.beker@bofa.com

Jane Brauer

Sovereign Debt FI Strategist

BofAS

jane.brauer@bofa.com

Carlos Capistran

Canada and Mexico Economist

BofAS

carlos.capistran@bofa.com

Pedro Diaz

Caribbean Economist

BofAS

pdiaz2@bofa.com

Antonio Gabriel

LatAm Local Markets Strategist

BofAS

antonio.gabriel@bofa.com

Christian Gonzalez Rojas

LatAm Local Markets Strategist

BofAS

christian.gonzalezrojas@bofa.com

Lucas Martin, CFA

Sovereign Debt FI Strategist

BofAS

lucas.martin@bofa.com

Alexander Müller

Andean(ex-Ven) Carib Economist

BofAS

alexander.muller@bofa.com

Natacha Perez

Brazil Economist

Merrill Lynch (Brazil)

natacha.perez@bofa.com

Sebastian Rondeau

LatAm FI/FX Strategist

BofAS

sebastian.rondeau@bofa.com

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