

CHILE – Assessing the inflationary impact of the Middle East conflict

- ▶ The conflict in the Middle East has triggered a sharp spike in international oil prices and a tightening of global financial conditions.
- ▶ Market-based inflation expectations have jumped in Chile, leading to significant repricing in the market-implied BCCCh policy rate path. While the situation remains fluid, the impact on Chile’s economic outlook fundamentally depends on the intensity, breadth, and duration of the ongoing strife.
- ▶ We present scenarios for this year’s inflation outlook considering different levels of oil and CLP. Potential changes to the smoothing mechanism applied to local fuel prices (MEPCO) add a layer of uncertainty to our forecasts.

To assess the inflationary effects of the ongoing oil shock we rely on pass-through estimates for FX and international oil prices. The CLP averaged \$952 in 2025 (\$944 in 2024), and as of March 18 is trading close to \$915, albeit with significant volatility since the conflict in the Middle East began. In our view, if the CLP drifts above last year’s average, we should see a higher FX passthrough. We use a low pass-through coefficient of roughly 5% effect on domestic prices; however, for CLP levels above \$950, we incorporate a slightly higher pass-through coefficient of 8%. We believe these relatively low coefficients are consistent with the FX swings, as described earlier. Importantly, the MEPCO smoothing mechanism delays the passthrough of international oil prices to domestic ones. We also incorporate a second-round effect associated with weaker economic activity—due to higher costs—on expected inflation.

The table below shows different combinations and the estimated impact of a permanent shock to oil prices and the exchange rate on our pre-conflict baseline CPI forecast. Prior to the conflict in the Middle East, we forecasted February 2027 annual inflation at 2.9%. If the currency depreciates towards \$1000 and WTI prices stabilize through yearend at \$80 per barrel, our one-year ahead inflation forecast increases by 1.9 pp towards close to 5.0% YoY.

Inflation Sensitivity Scenarios

Percent, nominal

CPI (+pp)	USDCLP	WTI					
		12 months*		24 months			>24 months
		60	>=80	90	100	150	150
860	2.9	0.6	0.9	1.2	2.2	2.7	
903	0.3	0.8	1.2	1.5	2.4	3.0	
946	0.5	1.1	1.4	1.7	2.6	3.2	
1000	1.3	1.9	2.2	2.5	3.3	4.0	

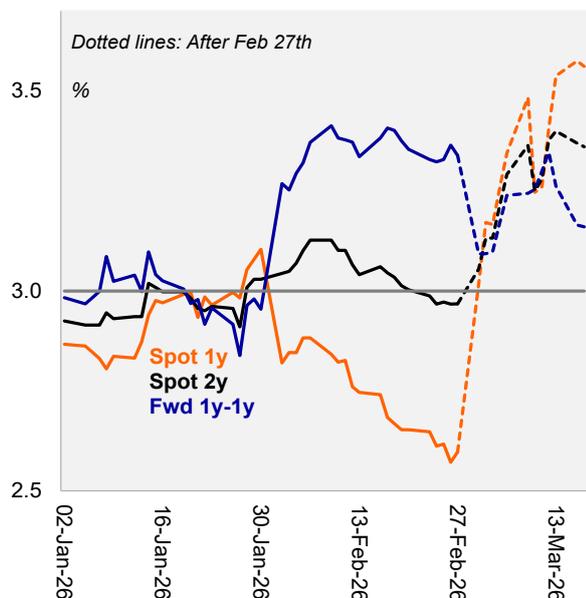
Source: Itaú. *Note: Our estimates are based on the MEPCO’s current parameters.

In a “worst-case” scenario, one-year-ahead inflation could increase by 1.9 percentage points taking annual inflation close to 5.0% towards 1Q27. Again, these estimates reflect the impact of a permanent shock to oil prices and the exchange rate. Consequently, if the shock proves to be transitory, the inflationary effect would be significantly

lower. Naturally, inflation will also be shaped by the central bank’s policy response, particularly if survey-based inflation expectations begin to drift above the target, which has not taken place yet.

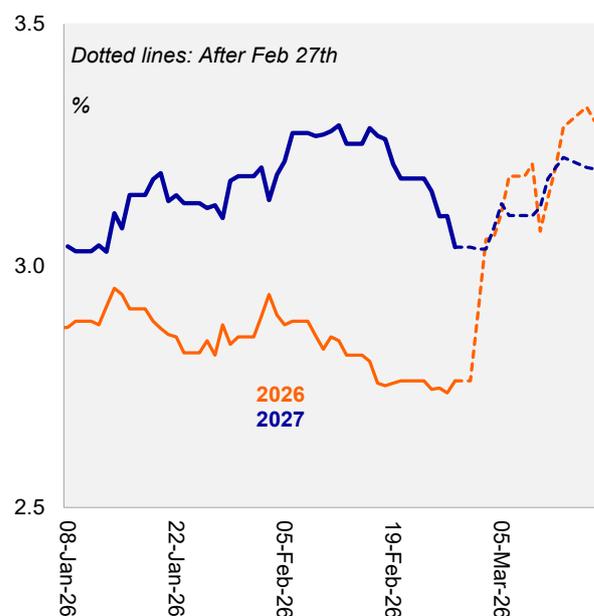
Market-based inflation expectations have jumped. The weight of all fuel items in Chile’s CPI basket nears 4%. Prior to the conflict in the Middle East, financial markets expected year-end 2026 inflation to reach around 2.8%, but that figure has now risen to roughly 3.4%. Likewise, longer-term breakevens have risen above the BCCh’s 3% inflation target, also likely incorporating greater risk premium.

Inflation Breakevens



Source: BCCh, Itaú

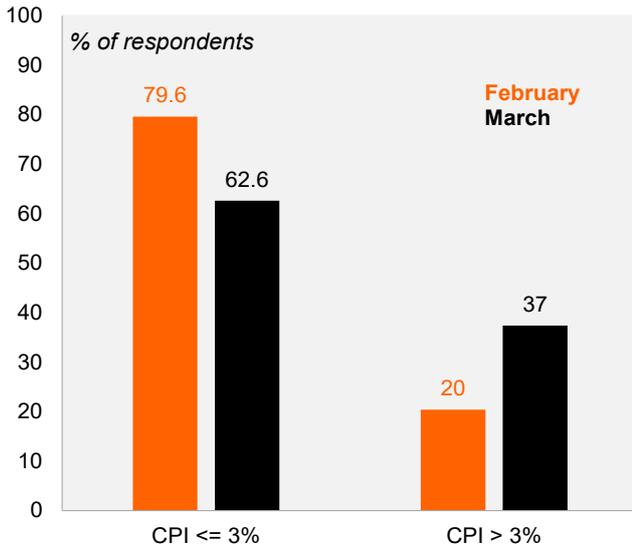
Year-end inflation breakevens



Source: BCCh, Itaú

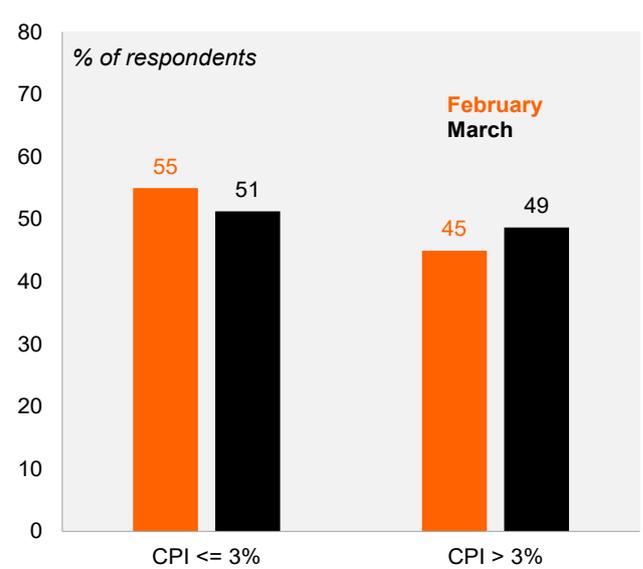
Although the median results of the Central Bank of Chile’s March analyst survey showed both one-year and two-year inflation expectations remaining anchored at the 3% target, the distribution of responses revealed an upward bias. Similarly, the Traders’ Survey conducted ahead of the March monetary policy meeting indicated a notable increase in medium-term inflation expectations, largely driven by the recent oil price shock.

Dist. of Survey-based 1yr ahead Inflation Exp.



Source: BCCh, Itaú

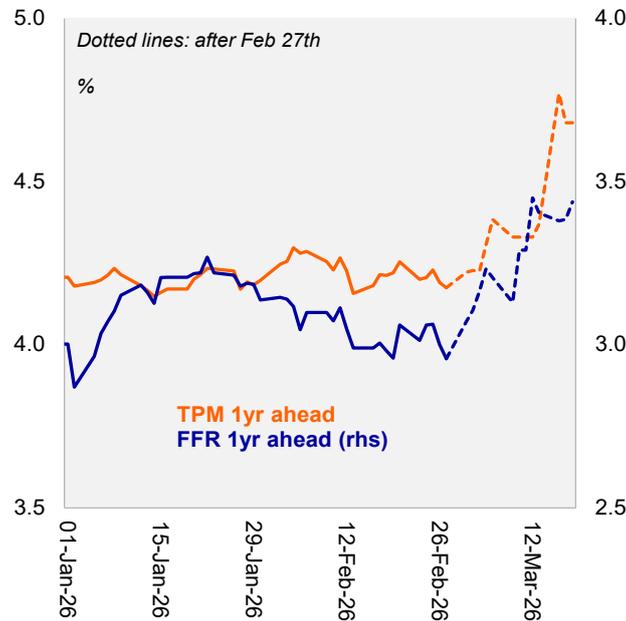
Dist. of Survey-based Dec26 Inflation Exp.



Source: BCCh, Itaú

Consistent with this repricing, the market-implied policy rate path erased cuts and brought hikes forward. In our view, this adjustment reflects the growing likelihood that higher inflation generated by the oil shock will be non-negligible, yet transitory. The lion's share (78%) of the BCCh's March analyst survey expects a hold at 4.5% in the March policy meeting (previously a 25bp cut was envisioned). A hold is also expected at the April meeting, with the final cut to 4.25%, the center of the nominal neutral range, seen unfolding by August.

Rates expectations rising accordingly



Source: BCCh, Haver, Itaú

Our take: Prior to the Middle East conflict, the inflationary outlook in Chile seemed relatively benign with surveys persistently revising forecasts down and our yearend forecast penciled in at 2.8%. Chilean authorities may well adjust parameters of the fuel price smoothing mechanism (MEPCO), adding a layer of uncertainty to the forecasts. However, higher international oil prices and a weakened exchange rate suggest inflation should bounce back, as suggested by market-based measures.

Prior to the shock, Chile's activity outlook was benefiting from record terms-of-trade, surging private sentiment, lower interest rates, a growing investment pipeline and recovering productivity. Among his first measures, President Kast implemented several measures that seek to streamline investment processes and bolster security, which should support the ongoing investment cycle further. Given elevated copper prices and the backwardation of the oil futures curve (signaling the market's transitory interpretation of the war), the dent to activity from higher oil prices may be limited. Still, the combination of higher short-term supply-driven inflationary pressures with the expected acceleration of domestic demand may sustain a market view of higher inflation going forward.

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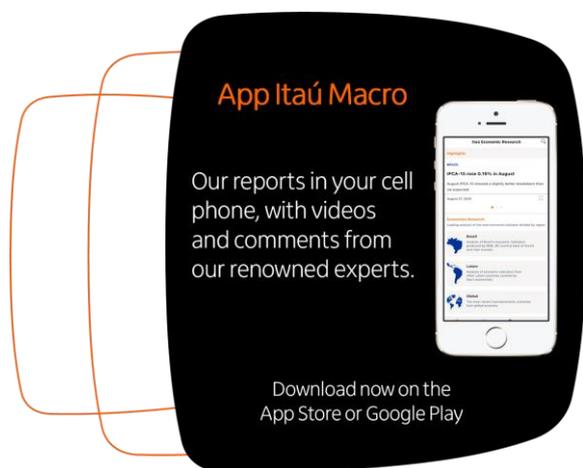
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