José De Gregorio: The Chilean economy in the current conjuncture

Speech by Mr José De Gregorio, Governor of the Central Bank of Chile, before the Executive Committee of Chile's *Confederación de la Producción y del Comercio*, Santiago, 30 June 2009.

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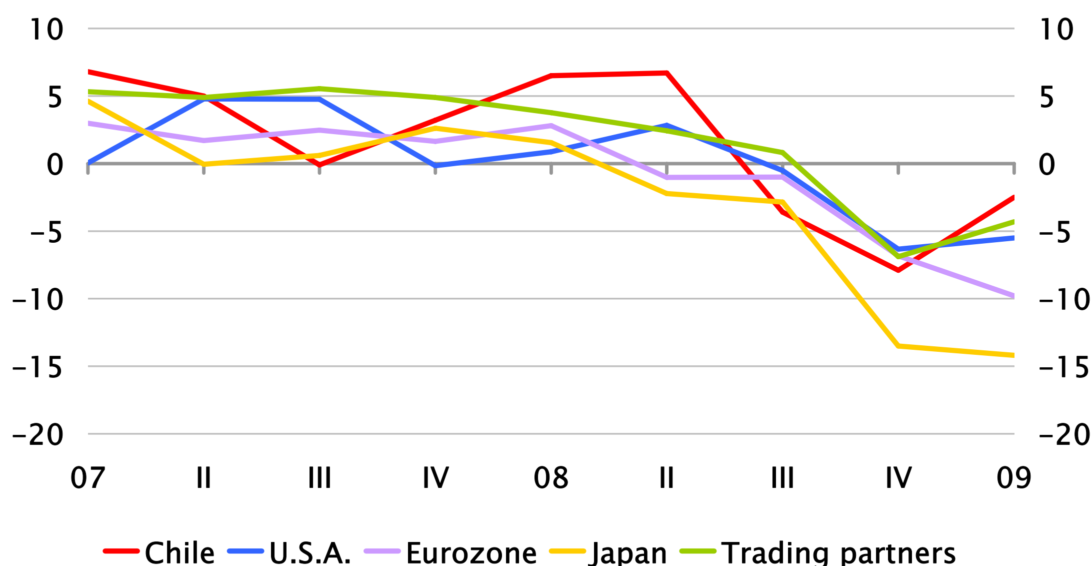
First and foremost, thank you for inviting me to speak about the Chilean economy's current situation and future prospects. The world crisis that is underway poses big challenges, and the effects it is having on our country as it unfolds stress how important it is to keep in contact with the entrepreneurial community to share our vision and become aware of your impressions.

When we presented our *Monetary Policy Report* (the Report) of last May, we gave an account of the difficulties facing the world economy, which will see output drop for the first time in six decades. Moreover, this crisis has been characterized by great synchrony among countries, regardless of the strengths or weaknesses of each one (figure 1). As we have said over and over during and after the most stressful times in external financial markets, our country could not and would not be immune to the effects of the crisis. Actually, the macroeconomic outlook changed radically while fiscal and monetary policies reacted accordingly to the challenge, by adding a stimulus of unprecedented magnitude and speed. In the case of our Central Bank, between January and June we reduced the monetary policy interest rate (MPR) by 750 basis points to 0.75% annually, the lowest ever.

Figure 1
World growth
(annualized q-o-q change, percent)



Sources: Central Bank of Chile based on sample of investment banks, Consensus Forecasts, Bloomberg and IMF.

In recent weeks, news from abroad has ceased to be mostly negative. Various agents' projections for world growth have stabilized, and some have even risen marginally (table 1). Still, this is not enough to be seen as a significant external boost for our economy, because world growth remains at low rates.

Table 1
World growth (*)
(annual growth, percentage)

	Prom. 90-99	Prom. 00-05	2006	2007	2008 (e)	2009 (f)			2010 (f)		
						Report May'09		June meeting	IPoM May'09		June meeting
World	2.9	3.8	5.1	5.2	3.2	-1.2	▲	-1.1	2.1	▲	2.3
World at market ER	2.4	2.9	3.9	3.8	2.2	-2.3	▲	-2.2	1.4	▲	1.6
US	3.1	2.5	2.8	2.0	1.1	-3.0	▲	-2.7	0.5	▲	0.6
Euro Area	2.2	1.9	2.9	2.7	0.9	-3.5	▼	-4.1	0.4	=	0.4
Japan	1.5	1.6	2.0	2.4	-0.6	-7.2	▲	-6.8	0.9	=	0.9
China	10.0	9.4	11.6	13.0	9.0	6.5	▲	7.3	7.5	▲	7.8
Rest of Asia	5.5	4.8	5.5	5.9	3.0	-1.9	▲	-1.8	1.4	▲	2.1
Latin America	2.7	3.0	5.6	5.7	4.2	-2.0	▼	-2.6	1.5	▲	1.9
Commodity exporters	2.7	3.1	3.0	3.2	1.0	-1.7	=	-1.7	0.9	▲	1.3
Trade partners	3.0	3.1	4.6	5.0	3.0	-1.5	▲	-1.4	2.0	▲	2.3

(*) Regional growth are weighted average by world GPP participation in IMF World Economic Outlook (WEO, April 2009)
(e) Estimated; (f) Forecasted.
Fuente: Central Bank of Chile base on investment bank data, Consensus Forecast and IMF.

Commodity prices have posted substantial increases in the past few weeks. Both copper and oil have seen their prices rise more than 50% since the end of 2008. The copper price hike reflects increased demand, especially from China. In the case of the oil price, the increase began showing in domestic prices, partly offset by the recent appreciation of the peso.

Little by little, dislocations in international financial markets are being fixed. Interbank markets, which a few months back had to deal with serious liquidity problems, have continued to normalize thanks to the liquidity provision measures adopted by the authorities and the gradual recovery of expectations. On the other hand, institutions have been able to raise capital according to needs; the US Treasury even authorized some of the bailed-out banks to repurchase the preemptive stocks they issued when receiving the governmental support under TARP.

One key factor behind this set of elements pointing at stabilization is, without a doubt, the scale of the monetary and fiscal stimulus packages that have been implemented in large parts of the world, in both developed and emerging economies. This is a significant difference between this crisis and the Great Depression. Although it has been claimed that the financial debacle we have experienced recently is similar in magnitude to the one that originated the Great Depression, the lessons learned from it have allowed policies to act much faster, with more effective and pragmatic responses.

In those days, fiscal authorities tried to keep their budgets balanced, even when the economic depression had settled in, in 1937, thereby deepening the contraction of aggregate demand. In the case of monetary policy, the premature reduction of the monetary stimulus in 1936 contributed decisively to the recession of 1937-38. The current monetary policy has played its role in providing liquidity and generating an expansionary stimulus. The much more flexible monetary and fiscal policies of today have also avoided the intrusion of protectionist distorting measures that so prolonged the crisis of the 1930s, amplifying its costs and deeply hurting the later economic development in several regions of the world, including our country.

Still, it is likely that returning to domestic demand levels like the ones we had before the crisis takes a while, especially in the United States. Active fiscal policy actions have taken up the room left by the shrinkage of private spending. However, it cannot be sustained for long. The natural, sustainable solution will come via net exports from the US and, to a lesser extent, from Europe. How it will happen is an open question, because it is also yet to be seen which economies will, as counterparts, have to reduce their own net exports to create the

necessary space for such an adjustment. Furthermore, this may call for major parity adjustments in the main economic areas.

Beyond this last point, currently floating foreign exchange regimes have played a stabilizing role, providing every degree of freedom needed by monetary policy and by liquidity provision measures to tackle the cycle and the financial stability objective. This element was nowhere to be seen in the 1930s, when the main central banks struggled hard, but ineffectively, to defend the gold standard, severely magnifying tensions in the banking systems. Many emerging economies have successfully applied the lessons learned in past financial crises, capitalizing them as increased financial resilience and a reduced impact on growth than developed countries.

One feature of world financial markets' behavior of the past few months has been the increase in long-term interest rates on public instruments. These movements can be linked to an environment of reduced risks and expected increases in fiscal debt certificates, and to the fact that, for the first time in several months, there is incipient debate about the convenience of a not-so-expansionary monetary policy, given the medium-term inflationary risks. In the local financial markets, the interest rates on long-term Central Bank notes have also risen—albeit with swings—above the levels that prevailed at the time of our May Report. The steepening of the yield curve coincides with what has occurred in international markets, and may be signaling an increase in the markets' appetite for risk. It may also be that they respond to more idiosyncratic factors, especially because of the big momentum showed by the local bonds market this year to date.

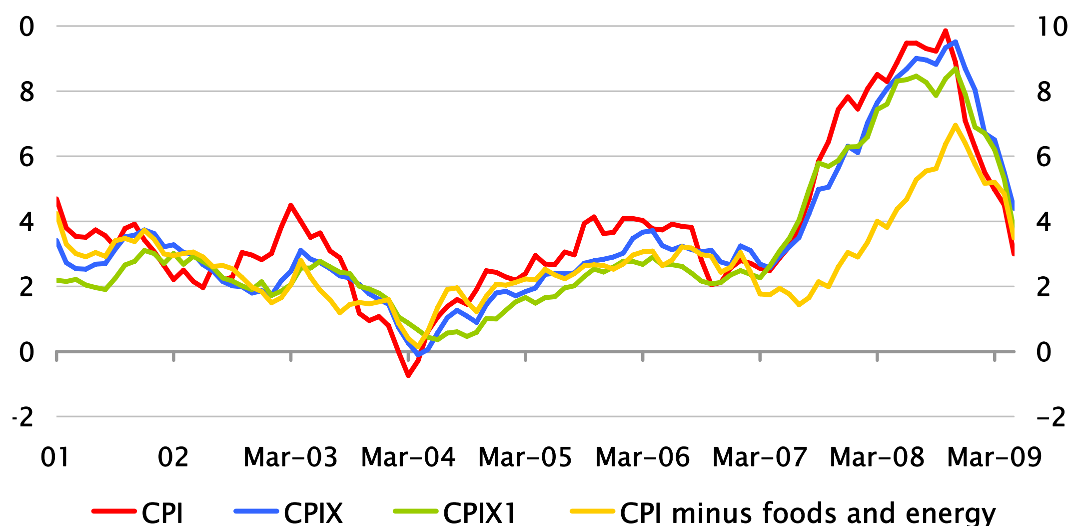
The pass-through of MPR cuts to lending rates in recent months has been evident. While the latest data suggest that it may have moderated, transmission should continue, particularly as macroeconomic uncertainties phase out. The annual growth rate of credit volume has slowed, in a context where lending standards are still tight and there is less demand for credit due to a more cautious attitude among economic agents.

In addition, short-term figures known since the publication of our last Report point at milder short-term inflationary prospects. The latest output indicators have been more negative than we foresaw in May. Although for the moment this does not alter our forecast of a recovery of activity and demand in the second half of this year, it does present a scenario where output gaps are wider than estimated and, therefore, inflationary pressures are reduced. The labor market also continues to reflect deteriorated macroeconomic conditions, with steadily increasing unemployment although with a marginally moderated drop in employment.

May's inflation was negative beyond expectations, especially its underlying components. Year-on-year CPI inflation, after many months, returned to the tolerance range of the inflation target (figure 2), but is expected to continue to fall and even cross into negative territory in the latter part of the year. Inflation expectations derived from various surveys also show some declines in the last few months.

Recent public discussions have centered on parity movements. The real exchange rate is, without any doubt, a key variable in resource allocation and in the balance between saving and investment. Unlike conjunctures of past decades, in particular those of the mid-1980s, the Chilean economy has dealt with the complex global financial situation from a much sounder standpoint. The sudden global collapse of late last year found us with no big current-account or fiscal deficit, nor with a high external debt requiring strong fiscal adjustments with substantial real depreciation that would place the economy in a sustainable medium-term path. On the contrary, the significant contraction of domestic demand, in particular for imported durable goods and inventories, spontaneously and quickly undid the incipient external deficit of the second half of 2008 and interest rates in Chile dropped. The Chilean economy has continued to show a very solvent net external position.

Figure 2
CPI and selected inflation measures
(annual change, percent)



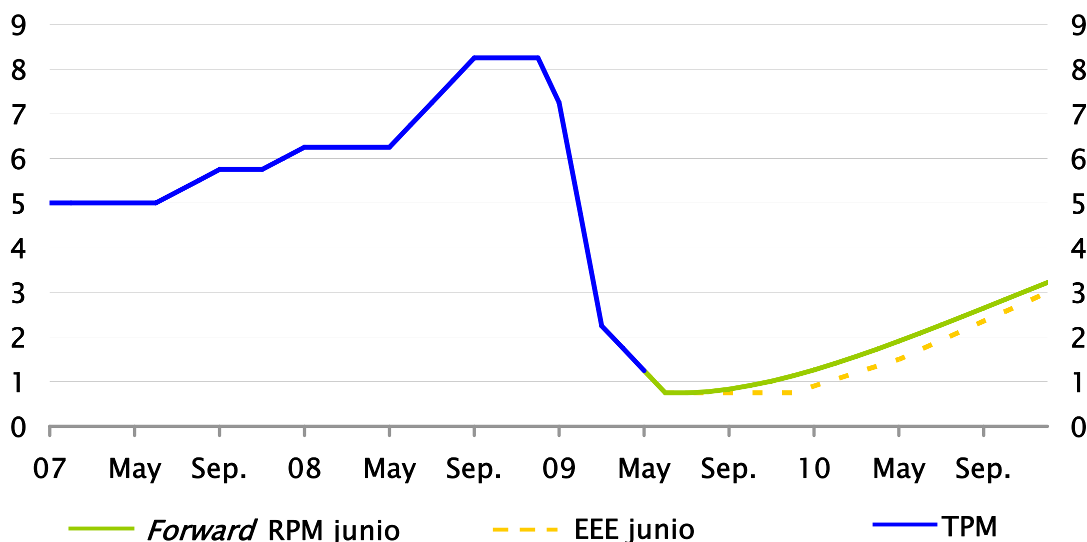
Sources: National Statistics Bureau (INE) and Central Bank of Chile.

As we have pointed out on earlier occasions, persistent movements of the exchange rate may have inflationary consequences that must be taken into account when deciding on the monetary impulse. Anyway, our floating regime admits intervening in exceptional cases, whenever an overreaction of the exchange rate is detected that is giving misleading signals to the financial markets. In addition, although there is no obvious misalignment of the current real exchange rate from its long-term fundamentals, the present inflationary scenario may accommodate a nominal depreciation that does not compromise our price stability objective. In fact, imported inflationary pressures influence medium-term inflation, so if the recent appreciation of the peso persists, inflationary prospects will certainly moderate, which, as I just stated, has implications on the conduct of monetary policy.

From the public finance standpoint, it is hardly obvious that the aforesaid situation could have been avoided with a different mix of credit sources for the necessary fiscal impulse. This, because the level and the structure of interest rates are also important when trying to affect gaps and inflation in the medium term.

Summing up, the changes we have seen in the macroeconomic scenario since last May lead us to think that, if anything, inflationary pressures are less than were forecast, so the risk of inflation remaining below the 3% target longer than estimated has increased. In this context, it may be necessary to increase the monetary stimulus. Although given the current low level of the MPR there is limited room for maneuvering, an additional cut cannot be ruled out. We must also keep in mind that expectations about the course of monetary policy affect the market interest rate structure and the exchange rate. The Board was clear—both in the May Report and in June's monetary policy meeting—in that it estimates that, in the baseline scenario, it would be necessary to hold on to the monetary stimulus for a longer period than the one implicit in financial asset prices. Recent information continues to validate this diagnosis (figure 3).

Figure 3
MPR and forward curve
(annual change, percent)



Source: Central Bank of Chile.

The macroeconomic scenario we are facing continues to be complex. Although it seems to have ceased to deteriorate in the margin, we must not lose sight of the fact that a global crisis of this magnitude has few precedents for comparison in modern economic history. As I said before and we have repeated endlessly, Chile could not and would not be immune to external developments. The crisis hit us hard. The consequences are visible in the drop in domestic output and demand, in a deteriorated labor market and in reduced inflationary pressures. More importantly, however, the economic conjuncture we are facing has called for decisive action by economic policymakers. Thus we have responded at the Central Bank and thus we will continue to respond, despite that our monetary policy tool, the MPR, is currently close to its minimum possible level.

Thank you.