José De Gregorio: What happened and where are we headed?

Speech by Mr José De Gregorio, Governor of the Central Bank of Chile, at the meeting *Visión Económica y Empresarial 2009-2010*, organized by *SOFOFA* and *Universidad del Desarrollo*, Santiago, 23 October 2009.

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I thank the federation of Chilean industry *SOFOFA* and *Universidad del Desarrollo* for inviting me once again to take part in this important annual event.

When I was preparing this presentation, I realized I had two choices: one was to analyze the current situation in light of our latest Monetary Policy Report, which I already did in another public seminar and that may overlap other presentations you will hear today. The other was to take a longer perspective and examine how we came to where we stand today, how we sailed through the troubled waters of the world economy and where we are headed. I think this is the perfect audience to take this second option.

To begin with, it is important to bear in mind that the Central Bank of Chile (CBC) complies with its mandate of safeguarding price stability via a monetary policy based on a flexible inflation targeting regime. The objective is to keep annual inflation around 3% most of the time. When deviations occur, monetary policy focuses on correcting them over a period of two years. In practice, in our discussions we estimate a path for the interest rate that is consistent with the inflation forecast 24 months ahead converging to the target. This is done both because we recognize the lags with which monetary policy operates, and because of our concern about the costs in terms of output loss and employment of adjusting inflation to the target. If we do not do this, the adjustment would take much less time to complete.

All this is common knowledge. But I feel it needs to be stressed in order to clear, yet one more time, the mistaken argument that the CBC does not consider the level of economic activity when making its decisions. Additionally it serves to insist on the issue that the current global financial crisis was not caused – as some argue – by monetary policy's orientation to price stability, but by a tremendous failure in the financial systems of the developed world.

Neither the private sector nor policymakers were able to foresee the danger of the imbalances that were accumulating during this decade. Today, the monetary and fiscal stimulus packages are precisely what have allowed the world economy, which suffered an initial shock similar to that of the Great Depression, to show a substantially better performance. This is particularly true in the case of Chile.

The evolution of the economy and monetary policy from 2007 onwards

In just three years, the Chilean economy has gone through two radically different episodes, although related to one another. From a significant inflationary shock caused by the rise in oil and food prices to the effects of an unprecedented international financial crisis accompanied by a drop in output and a sharp reduction in inflation.

Since mid-2007, the Chilean economy went through a process of significant increase in inflation, due to the sharp rise in commodity prices in world markets (figure 1). This rise was caused by supply and demand factors specific to those markets. Therefore, it was an adjustment of relative prices in foreign markets and not a generalized increase in domestic prices.

The fact that it was an adjustment of relative prices made us not act with the strength that we would have if, for example, it had been a widespread increase in prices caused by a demand shock. In fact, the purpose of the increases in the monetary policy rate (MPR) applied in 2007 and early 2008 were to avoid the incubation of undesired second-round effects that might unreasonably prolong the inflationary impact of the shocks. Also, in that period we decided to begin a process of reserve accumulation consistent with the prevailing financial uncertainty and the evolution of the exchange rate.

As from May of last year, the macroeconomic picture changed. Inflation rates began to show a fast and unexpected propagation of these shocks to other prices (figure 2). It could be argued that the Bank reacted too late. However it is worth recalling that when this massive inflation propagation began, private agents were expecting 4.4% for December 2008 inflation, while May's Monetary Policy Report placed it at 4.7%. The actual figure was 7.1%, with a peak in October of 9.9%.

The inflationary upsurge certainly took everybody by surprise, coinciding with peaking oil prices. Chile was, at the same time, one of the countries where inflation rose fastest during the episodes of increasing commodity prices and also where inflation dropped fastest afterwards (figure 3).

Why was that? We know it was not because of changes in the traditional variables, such as the evolution of economic activity or the exchange rate. The speed of the adjustments may be explained by us being an open, market economy, with few price distortions. The rise in the oil price may have also created the perception that the increase would be very persistent, accelerating the adjustment of local prices. However, beyond the need to deepen our understanding of inflationary dynamics, what counts here is the capacity to react and the flexibility of monetary policy, two characteristics that it exhibited in its response to this phenomenon.

In our May Report of last year, when the MPR was at 6.25%, we announced that in the most likely scenario the path of the MPR would be in line with market expectations, that showed a further increase of at most 25 basis points in the next twelve months.

Things changed and, naturally, monetary policy decisions changed as well. In four meetings we raised the MPR by 200 basis points, to 8.25%. The purpose was to limit the propagation effects, via reducing the demand through a more restrictive monetary policy. Just as we then stated, although a deceleration of global growth was expected, we did not see that it would have the necessary force to contain inflation and therefore monetary policy had to be tightened.

As a matter of fact, our Report of September 2008, before the economic plunge and when *Consensus Forecasts* estimated 2.6% growth for the world this year, we announced that the MPR would probably be raised above 9%. But the world changed again, and very strongly. What at first seemed just as a deceleration of global activity, resulted being the first drop in world growth in over sixty years (figure 4).

This led to a change in policies with no precedent in Chile's monetary history. The drop in world demand would result in a larger slowdown in domestic demand than the one we intended to cause via monetary policy. In this new setting, the obvious reaction was to change the sign of monetary policy.

The first important signal was revising our projections – in November 2008 – and announcing that the increases that had been forecast in September would not occur. Such an announcement had an immediate impact on financial conditions. This way, the CBC initiated the most aggressive interest rate cut ever implemented in Chile, and one of the sharpest in the world (figure 5).

Likewise, in September and October 2008, at the peak of the world financial crisis, the spreads of the peso and dollar rates increased significantly. In scenarios of financial stress, it is imperative to align market rates with the MPR, because the latter may cease to act as a benchmark for the financial system. Therefore, the first actions we took were to provide the necessary liquidity and ensure that the financial system could continue operating as usual (figure 6).

The timing of the interest rate cut can be subject to debate. It is possible that, with the information we have today, we could have done it sooner. But I must insist that monetary policy decisions are made with the information available at each moment in time, so it is useful to refresh some facts.

In December 2008, we entered the monetary policy meeting with an annual inflation rate of 8.9%. The market expected the MPR to be at 6.25% and annual inflation to be at 3.9% by December 2009. Thus, despite the downward bias of monetary policy, the MPR was not reduced until January, and began a process rate cuts with a speed and magnitude unexpected by the market (table 1).

This is how, after accumulating signals that the inflation phenomenon had ended and was strongly reversing, we began reducing the MPR, and we did it with vigor, taking it to the level we believe is the minimum it can take without jeopardizing the normal functioning of the money market.

But this cut did not exhaust our monetary policy tools. In July we took additional measures to make monetary policy still more expansionary.

Beyond adopting the commitment that we still keep, of holding the MPR at its minimum level for a prolonged period of time, we made it explicit by creating a time liquidity facility, the "FLAP." This was meant to ascertain to the market that they would be able to obtain resources at a rate equivalent to the MPR for three- and six-month terms, and thus generate an interest rate structure that would allow a faster and stronger transmission of the monetary stance to market interest rates. The success of these measures is tangible proof of the diversity of monetary policy tools at the Bank's disposal as well as of its commitment with meeting the inflation target.

The global crisis and the weakening of economic activity

The effects of the global crisis in Chile, on both the financial and the trade sectors, do not reflect its full impact on the domestic economy. The increase in risk premiums and the tensions in the world financial markets last year tightened local financial conditions, with a direct effect on the demand. Although at some point every country feared a generalized shutdown of international financial markets, Chile maintained its normal access and the direct financial impact was milder (figure 7).

On the trade side, Chile has seen a drop in export prices, whose greatest effect can be observed in disposable income, which affects the demand, although the effects of the lower copper price are offset by the fiscal rule. Nonetheless, because the Chilean economy is primarily an exporter of commodity-related products, the effects of the drop in world activity were smaller than on exporters of manufactured goods. This is because the demand for manufactures has been the hardest hit by the global recession. In our case, prices have fallen, but it has been always possible to sell our products. On the other hand, in manufactures exporting countries, purchase orders came to a sudden halt, giving way to inventory build-up and a severe drop in production. This explains the magnitude of the initial fall in many Asian and industrialized economies.

Overall, it is interesting to note that an essentially healthy economy like Chile was hit surprisingly fast by the international crisis. Here we must underscore that the effects of the global crisis had an unprecedented degree of synchrony. Roughly 90% of the world's countries posted a contraction of output the fourth quarter of last year.

The culprit of the deteriorated economic activity, in my opinion, was the confidence crisis that took over the whole world, Chile included. Uncertainty multiplied. There was genuine concern that the financial systems of developed economies might paralyze completely and that the economic meltdown would trigger a much deeper recession than the one we see today. Households and firms reduced their expenditures in preparation for a possible catastrophe, causing a much larger drop in demand than would have occurred without the crisis of expectations. In hindsight, you can say that we overreacted, because the catastrophic scenario did not materialize. But the loss of confidence had a real foundation, both because of the deteriorated global macroeconomic and financial conditions and because we were enduring the deepest crisis ever.

In this context, there was also the uncertainty about how and how effectively policies would operate, which has faded thanks to the determination of central banks and finance ministries in the larger part of the world. In our case, the quick reaction of macroeconomic policies has been essential in mitigating the impact of the external crisis.

Although our GDP will fall this year, the performance of our economy, from a historic perspective, has been remarkable. In 1982 and 1983, the Chilean economy grew nearly 18 percentage points lower than the world's average. In 1998 and 1999, this difference was around 4 percentage points. In 2009, estimations point at the drop in output in Chile similar to the world's average (figure 8).

Monetary policy can do little to avoid the immediate effects of this kind of confidence crisis. However, policies do play an essential role in preventing these crises from aggravating, and they provide the grounds for the recovery of expectations. To that end it is necessary to act in a timely manner and with conviction. Any hasty behavior, or, on the contrary, being complacent and ignoring the severity of the crisis, could have eroded the effectiveness of the policies and deepened the recession.

There will be plenty of time to analyze the phenomena that deepened the crisis, but what is clear is that the confidence crisis exacerbated the effects of the world turmoil on global economic activity. The upside is that the reaction of policies and the responses of firms have set us on the right foot for the recovery of the local economy. The adjustment of demand has put households and firms in a healthy financial position to resume demand growth. The various indicators of demand, expectations and production suggest that the Chilean economy has begun the process of recovery we foresaw for this half. The monthly index of economic activity, Imacec, seasonally adjusted, has been rising since May and the unemployment rate, which at some point was thought to be headed to exceeding 12%, has stabilized under 11%. Also, monetary policy will continue to be expansionary for a prolonged period of time and, as we stated in our last Report, in the most likely scenario, the slow withdrawal of the monetary stimulus will begin during the second quarter of next year.

Meanwhile, the Chilean peso has remained somewhat more depreciated that the currencies of other commodity exporters. There are several hypotheses to explain this, including the effect of the monetary policy stance. Anyhow, the real exchange rate is currently at levels believed to be consistent with its long-term fundamentals (figure 9). Accordingly, in a context of high uncertainty about the evolution of global exchange rates, the CBC will continue monitoring the impact of the exchange rate path on expected inflation in its monetary policy decisions.

In this scenario, annual inflation will be in negative territory for some months, to gradually converge to 3% toward 2011, while the economy will grow between 4.5% and 5.5% in 2010 (table 2). This scenario is consistent with a gradual closing of output gaps, a necessary condition for inflation to return to 3%. If we consider that trend GDP growth will be in the 4%-4.5% range in 2010, a figure estimated by the CBC and consistent with the opinions of the committee of experts that perform the estimation for the design of the budget, such a range seems not excessive but rather moderate to close the output gap. If growth falls short, the economy will not close the gaps and, therefore, inflation will continue dropping or will adjust at a much slower pace, which obviously would require a stronger monetary impulse.

Final remarks

We have suffered the worst financial-economic crisis in many years. The strength of the Chilean economy, rigorously built over a long time period, has allowed us to mitigate the costs of a crisis that in the past would have impacted us much harder. The lessons about the need to maintain a solid financial system and the capacity to apply countercyclical policies have been critical in this performance. At the same time, they serve as a solid foundation for a steady recovery. There are many tasks ahead of us, in particular to reinforce Chile's growth capacity, but our macroeconomic fundamentals are consolidated.

However, the horizon is not completely clear. Although risks are more limited than they were a few quarters ago, vulnerabilities remain. The financial systems of developed economies remain weak. World growth forecasts point to a slow recovery and the world will hardly regain the growth rates of 2006-2007 in the coming years. A proper conduct of economic policies should provide the support for such recovery.

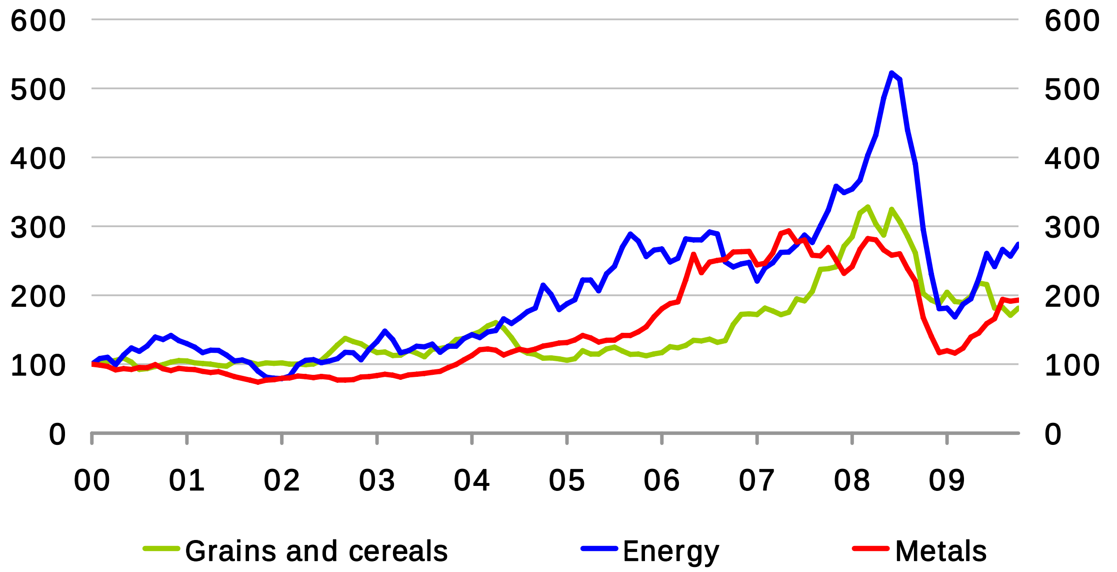
Adding to the problems still present in the financial systems and the level of private sector indebtedness, the fiscal situation of many industrialized economies, which met the crisis with already fragile positions, leaves several questions open. Global imbalances are not a problem today, because the drop in demand has taken part of the adjustment, but as the world economy picks up they could become a threat again. Finally, we have seen an optimistic attitude in international stock exchanges. They anticipate a healthy recovery, but if wrong they might result in asset revaluations that could pave the way for new uncertainties.

The role of the Central Bank of Chile is to monitor all these risks and their implications on the monetary stance, in order to regulate it in consistency with its inflationary objective. We remain at a stage where making projections is a complex task, but the scenario for output, inflation and monetary policy path we presented in our last Report remains in force.

Although private forecasts already recognize that the worst is over, it is still too soon to say that the work is complete. Output gaps are wide and we face the challenge of bringing inflation back to the target. Markets are incorporating a faster withdrawal of the monetary stimulus than the Bank considers appropriate for the purposes of meeting the inflation target. Particularly now that, as in the rest of the world, fiscal policy is entering a consolidation phase, monetary policy will have to continue providing the necessary stimulus to the economy for a prolonged period of time. This, in order for the recovery of output and the normalization of inflationary expectations to be well entrenched. One lesson from past crises is that a premature withdrawal can be very costly and can lead to subsequent policy reversals.

Thank you very much.

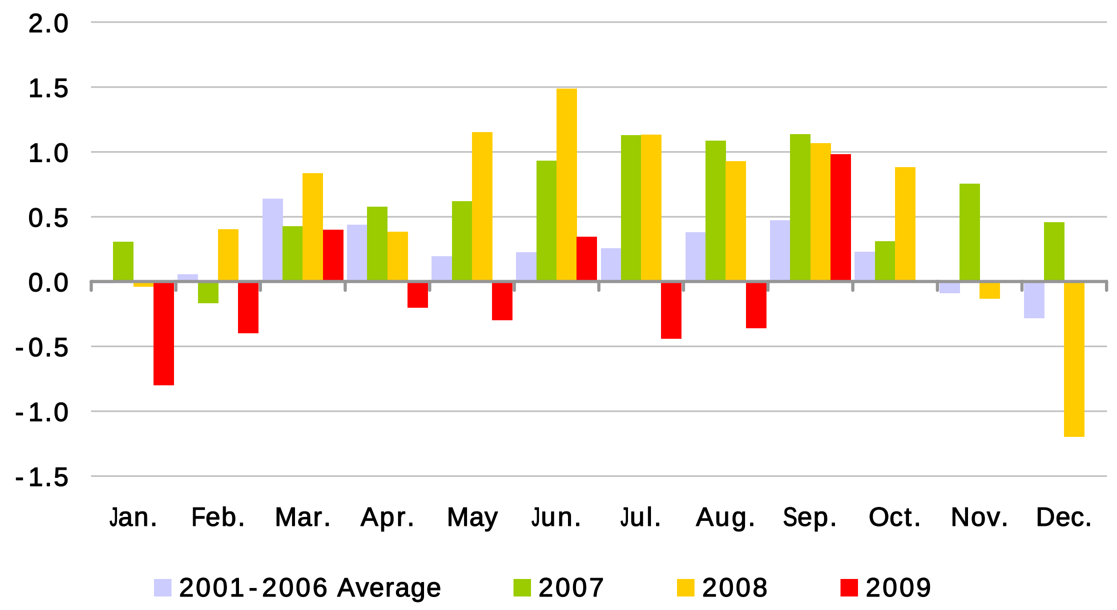
Figure 1
Commodity prices (*)
(index, January 2000=100)



(*) By the Goldman Sachs Commodity Index (GSCI).

Source: Bloomberg.

Figure 2
CPI monthly inflation
(percentage)

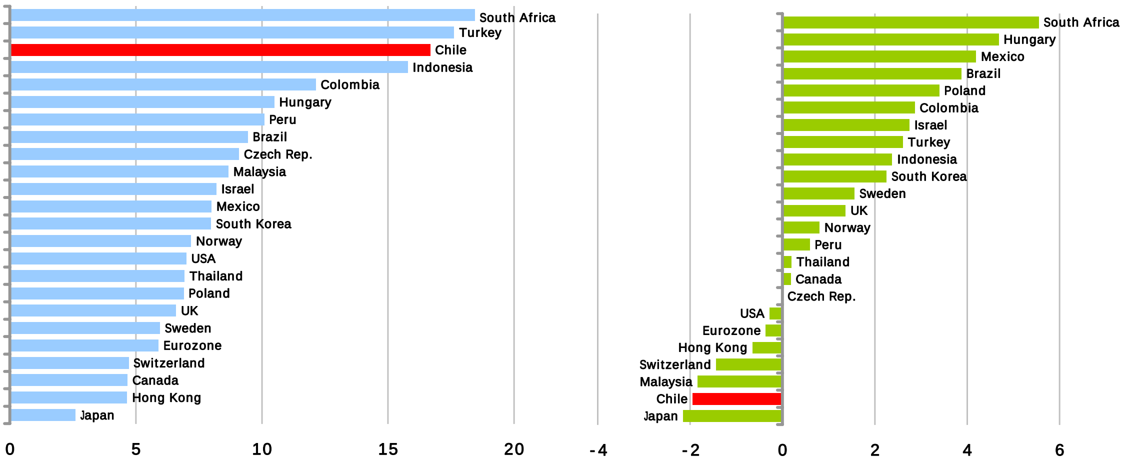


Source: National Statistics Bureau (INE).

Figure 3

Accumulated CPI variation by country

(percentage)



(a) Between January 2007 and October 2008.

(b) Between October 2008 and September 2009 (*)

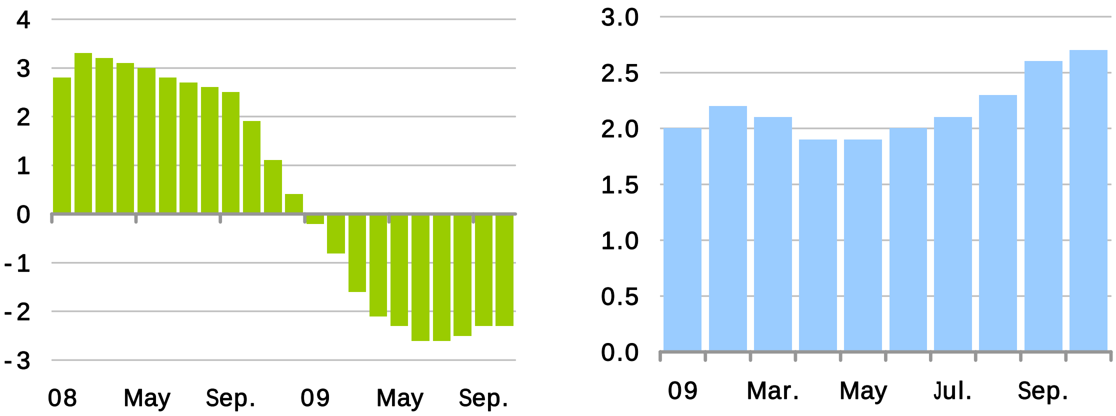
(*) For Hong Kong, Japan, Malaysia and South Africa, data at August 2009.

Sources: Statistics bureaus of each country and Bloomberg.

Figure 4

World growth forecasts

(annual change, percentage)

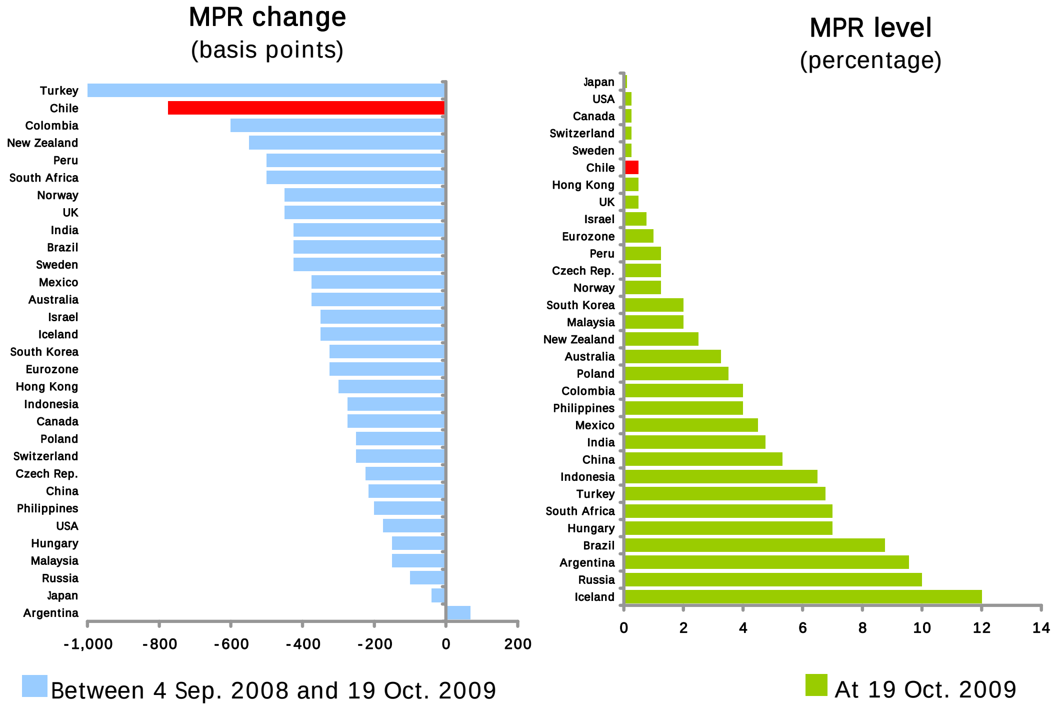


(a) Forecasts for 2009

(b) Forecasts for 2010

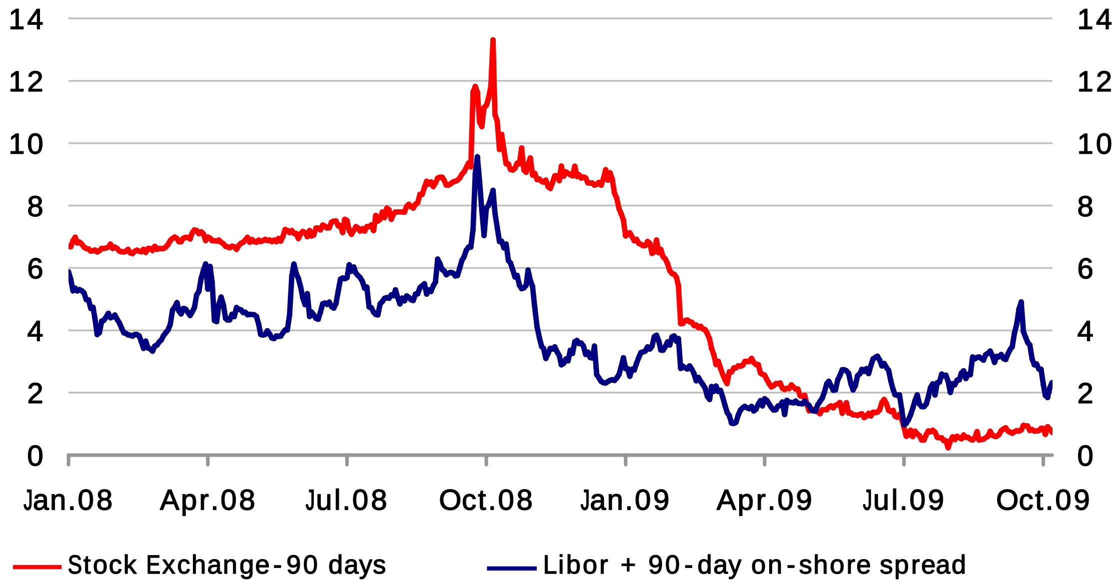
Source: Consensus Forecasts.

Figure 5
Monetary policy rate (MPR)



Source: Bloomberg.

Figure 6
Interest rates in pesos and dollars in the local market
(percentage)



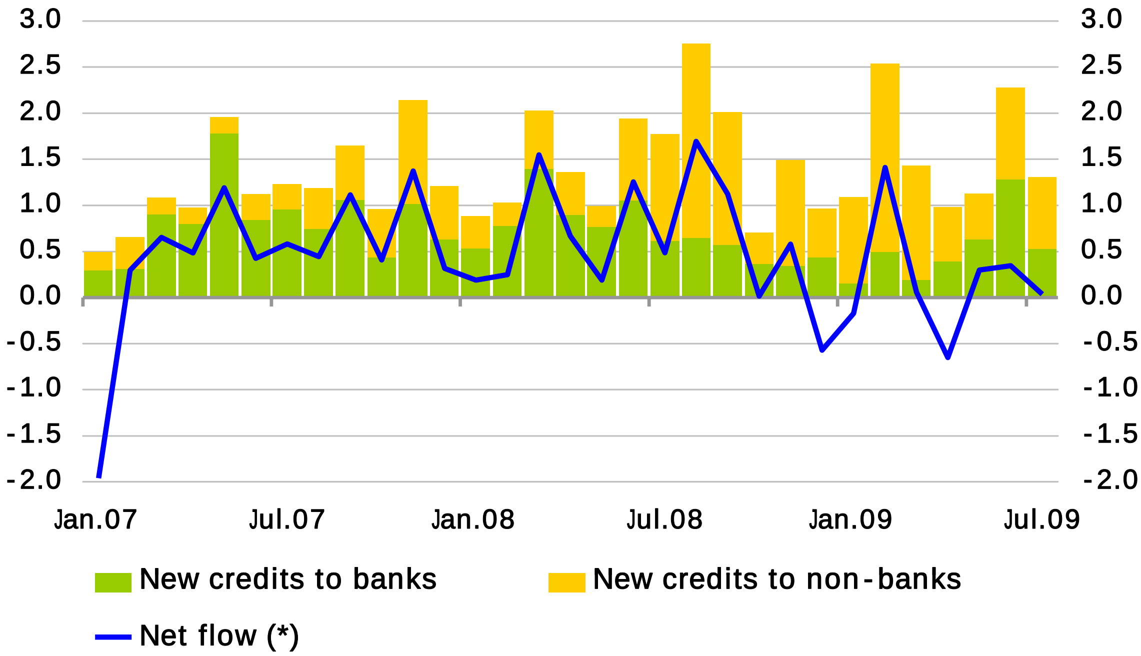
Sources: Bloomberg and Central Bank of Chile.

Table 1
Monetary policy rate and expectations according to EES
(percentage)

	Actual level	Expected for same month	Expected 2 months ahead	Expected for Dec.09
Oct. 2008	8.25	8.50	8.50	7.00
Nov. 2008	8.25	8.25	8.25	6.63
Dec. 2008	8.25	8.25	7.75	6.25
Jan. 2009	7.25	7.50	6.75	5.50
Feb. 2009	4.75	6.25	5.00	4.00
Mar. 2009	2.25	3.13	2.50	2.00

Source: Economic Expectations Survey (EES), Central Bank of Chile.

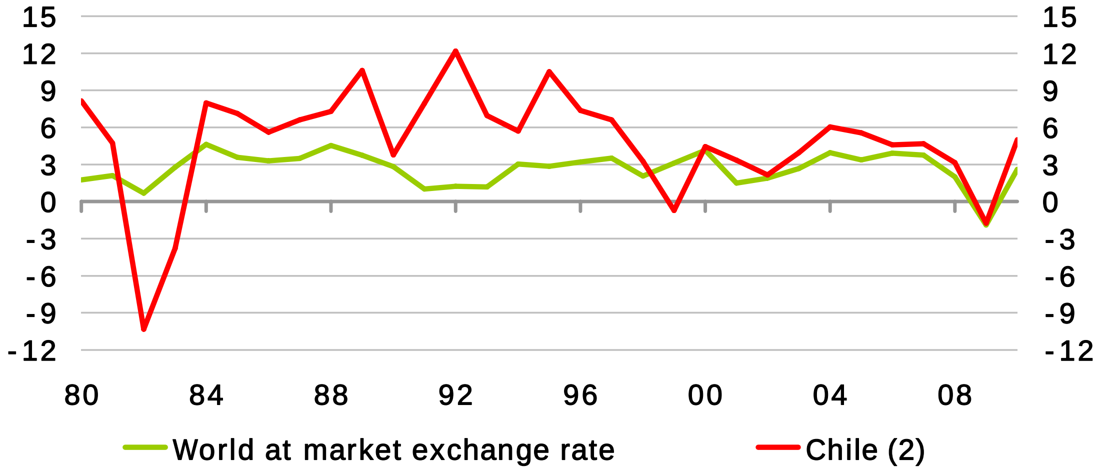
Figure 7
Foreign credit flows to residents
(billions of dollars)



(*) Discounting bank and non-bank amortizations from total new credits.

Source: Central Bank of Chile.

Figure 8
World growth (1)
(annual change, percentage)

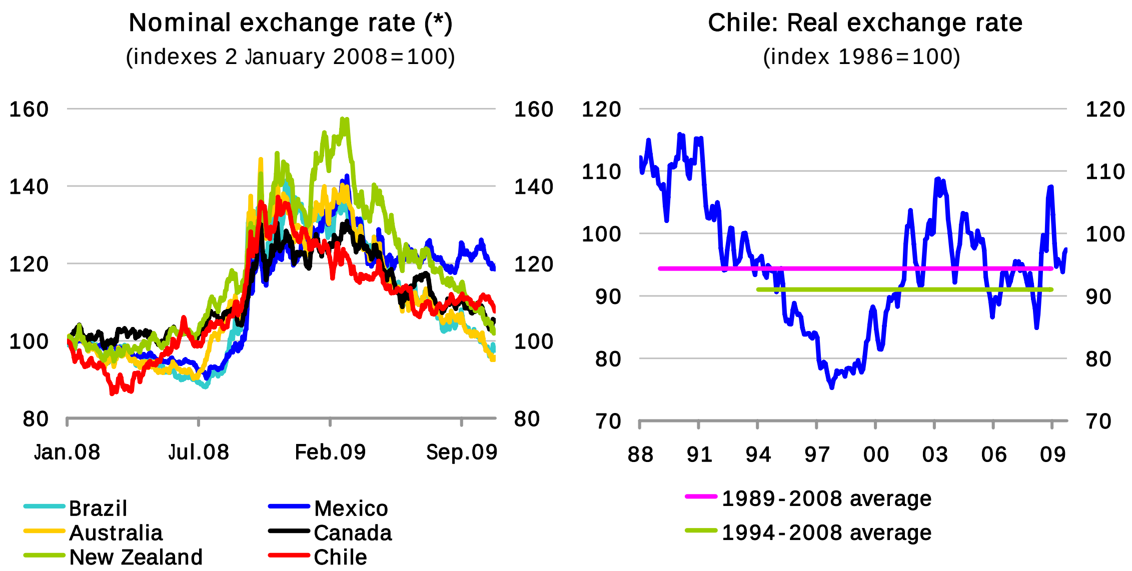


(1) Gray area shows projections as from 2009.

(2) Figures for growth in 2009 and 2010 stand for the midpoint of the range of projections shown in the Monetary Policy Report.

Sources: Central Bank of Chile, International Monetary Fund and World Bank.

Figure 9



(*) Parity with the US dollar.

Sources: Central Bank of Chile and Bloomberg.

Table 2
Economic growth, current account and inflation
(annual change, percentage)

	2007	2008	2009 (f)	2010 (f)
GDP	4.7	3.2	-2.0 to -1,5	4.5 to 5.5
Domestic demand	7.8	7.4	-6.2	6.7
Domestic demand (w/o change in inventories)	8.2	7.9	-3.5	3.7
Gross fixed capital formation	12.0	19.5	-12.9	7.4
Total consumption	7.1	4.2	0.0	2.5
Goods and services exports	7.6	3.1	-4.7	4.9
Goods and services imports	14.9	12.9	-13.8	9.0
Current account (% of GDP)	4.4	-2.0	1.9	1.2
CPI inflation	4.4	8.7	1.7	1.5
December CPI inflation	7.8	7.1	-0.8	2.8
CPIX inflation	4.0	8.4	2.8	1.0
December CPIX inflation	6.3	8.6	-1.2	2.6
CPIX1 inflation	4.1	7.8	2.8	1.2
December CPIX1 inflation	6.3	7.7	-0.6	2.6

(f) Forecast.

Source: Central Bank of Chile.