José De Gregorio: The monetary policy report and the financial stability report

Presentation by Mr José De Gregorio, Governor of the Central Bank of Chile, before the Finance Commission of the Honorable Senate of the Republic, Santiago de Chile, 16 December 2009.

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Introduction

Ms President of the Finance Committee, senator Evelyn Matthei, senators.

Thank you for your invitation to the Board of the Central Bank of Chile to share our vision of the recent macroeconomic and financial developments and their implications for monetary policy making. These topics make up the contents of our *Monetary Policy Report* of December 2009 and our *Financial Stability Report* of the second half of 2009.

As of this issue, the publication of our Monetary Policy Report is beginning a new frequency, changing from three to four times per year. In addition, the publication of the Reports of December and June will now coincide with our two *Financial Stability Reports*, which will continue to be released twice yearly. The purpose of this change is to share more often our vision on the economy and the rationale of and prospects for our policy decisions, a key element to deliver a more effective and credible monetary policy.

The year that we are leaving behind will be recorded in economic history as the one where the world economy was on the verge of collapse. The financial crisis that shook the industrialized world could have caused a major disaster with unimaginable consequences on developing economies, much more severe than actually occurred.

Had it not been for the determination of the economic policymakers around the world to stabilize the financial systems and implement significant fiscal and monetary packages, the economic performance would have been much worse. Nevertheless, the world could not prevent the “Great Recession”, the name with which this period has been already labeled, and world output will fall for the first time in sixty years.

The ability of macroeconomic policies to react promptly was particularly important for developing economies, cushioning the impact of the global crisis and making it much milder than in the past.

Chile was no exception. As we said time and again from the onset of the crisis, our economy could not and would not be immune to the events occurring in the world. Nonetheless, as we have also insisted, the policy framework we have in place allowed us to mitigate the effects of the global economic scenario. Today, two weeks short of the end of the year, we know that although we were not spared the recession, its impact was much milder than we had been accustomed to. It is enough to recall just a couple of episodes. In 1982–1983, while Chile saw GDP fall dramatically, the world economy was growing. Measured in market prices, Chile’s GDP variation was around 18 percentage points below the world average. In 1998–1999, this difference was close to 4 percentage points. But in 2009, the drop in output in Chile has been similar to the world average, and projections for 2010 are that Chile’s economy will outperform global growth (figure 1).

From an international perspective, the resilience of the Chilean economy also stands out. Considering the size of the economy, the per capita GDP and the terms of trade, Chile’s output drop could have been around two percentage points higher than today’s estimates, with negative consequences on employment and the quality of life of the population (figure 2).

The response of fiscal and monetary policy, together with a strong, well regulated financial system, has been key in our capacity to recover from the shock of the crisis. Toward the end of 2008, the Board's first actions were to provide the necessary liquidity for the financial system to operate in full normality and to dissipate the uncertainties surrounding future peso and dollar liquidity conditions. Changing the monetary policy rate is useless if market rates cannot be guaranteed to follow suit. Once liquidity pressures had been contained and there were signs that inflationary pressures were easing off even faster than expected, the Board reduced decisively the MPR to the level we feel is the lowest possible without jeopardizing the good functioning of the money market.

This has been one of the most significant monetary relaxation measures in the world, and is certainly the greatest in our history (figure 3). Moreover, the low inflationary pressures we were dealing with and the risk of inflation staying below the target range beyond the policy horizon made us adopt complementary measures, making monetary policy even more stimulative. Thus, apart from stating in all our communications that the MPR would be held at its lowest for a prolonged period, we created a long term liquidity facility (the FLAP), whose main purpose was to enhance the signal that the MPR would be kept low.

This facility affected the structure of money market interest rates significantly. It reduced the expected MPR by nearly 100 basis points in the relevant policy horizon and led the market to adjust expectations about how long the MPR would be held at its lowest level. It had important quantitative effects, which is proof of its success in incrementing the monetary stimulus. In November, to reduce uncertainty about how this facility would operate, we announced how and when we would withdraw it, but keeping a significant monetary impulse to help the closing of output gap and thus pushing inflation closer to the target.

Now that the worst of the financial crisis has been behind us for one year, the international economy has stabilized, uncertainty has declined, and the world is resuming moderate growth. In Chile, we have seen household and corporate confidence pick up, within a context of highly expansionary macroeconomic conditions. Economic activity began to rise in the third quarter; the labor market stopped deteriorating, and financial conditions have become less stringent. Inflation is still negative and even below earlier projections.

Unlike developed countries, Chile is entering this recovery phase with a strong financial system. Our banking system has, on average, similar or better solvency levels than it had in the years leading to the external financial crisis. This should allow the financing of investment and consumption during the economic recovery phase. Meanwhile, the market for bonds and commercial paper has become ever more important as a source of funding for larger firms.

Risks remain, however, and the return to sustained growth in Chile and the world is not a done deal. In particular, macroeconomic packages need to be continued until the recovery is well established. Emerging economies and commodity exporters deal with their own tensions. Most recently, these have centered on the appreciation of their currencies, largely dependent on the US dollar. In Chile, with a floating exchange rate system, the peso is not spared the effects of the world events. Certainly, we will have to continue monitoring the exchange rate very closely. In particular, we will have to figure out its policy implications in order to ensure a persistent closing of the output gap and the return of inflation to the target. We foresee, as stated in the Monetary Policy Report, that the MPR will be kept low for an extended period, to reduce pressures on the strength of the peso and open the way for a sustained recovery of private demand.

Next, I will describe the latest economic and financial events, projections and risks surrounding our economy, and the way in which inflation will converge to 3% over a two-year horizon.

Macroeconomic scenario

As I pointed out before, the international economy has stabilized. The change in financial conditions has reduced risk premia, recovered key financial prices and restored investment flows towards emerging economies. Risk indicators are back to the levels they were before August 2007 (figure 4).

The external borrowing conditions for Chile have also improved. Premia charged to Chilean banks above external reference rates have dropped (figure 5). The dispersion of these premia is greater than before the crisis, which reveals more discrimination by the suppliers of credit and gives the right signals to potential borrowers by rewarding those with a stronger financial position. New external counterparties have also been observed in these operations. Other constraints remain, however, such as shorter terms for the loans. Finally, some Chilean firms have placed their bonds in international markets after shunning these opportunities given the tight conditions by late 2008.

Global economic activity has taken a path to recovery that is, generally, in line with projections in September's Monetary Policy Report. Third-quarter output data show an upward trend, even exceeding expectations, while Consensus forecasts for global growth show a slightly stronger recovery than foreseen earlier, 4% on average for 2010–2011. However, the Board estimates that the risks of a weaker economy are still latent (figure 6).

In Chile, domestic demand continues to reflect substantial inventory depletion and, to a lesser extent, a drop in gross fixed capital formation, particularly the machinery & equipment component (figure 7).

Inventory depletion has exceeded September projections and those of other economies, shaving-off four percentage points of domestic demand in the last year. More recently, some indicators suggest that the inventory cycle is entering a new phase, where part of the depletion could respond to sales increasing faster than production (figure 8). The end of the drop in inventories has a positive effect on GDP by itself, but the size and timing of its contribution to growth is still uncertain. This will depend on the level that firms consider adequate to face a cyclical recovery. It is very likely that such level will be smaller than it was before the global crisis.

The adjustment of gross fixed capital formation has been similar to that of Asian economies, with quarterly drops of around 10% between end-of 2008 and beginning-of 2009 (figure 9). Weak investment is reflected in sluggish imports of capital goods, which are yet to show a rebound.

Investments in engineering and construction works have improved. Although a fall is expected for this year, information from the Capital Goods Survey shows a new increase in investment projects in the period 2009–2012, with some of them being pushed off from this year to the next one or two. Gross fixed capital formation will drop more than 15% annually in 2009, which will presumably revert in part during 2010. The investment to GDP ratio will fall from its nearly 30% level of 2008, to 26% in 2010, both figures in prices of 2003.

Private consumption has been the component of domestic demand least affected by the crisis, and is expected to close 2009 with a slight increase driven by non-durable consumption. Consumer expectations have turned optimistic in the latest data, after two and a half years in the pessimistic zone. The not so restrictive financial conditions have also helped consumption and, most specially, its prospects.

The Banking Credit Survey of the third quarter showed that more banks have eased their lending conditions, while at the same time demand for banking credit has increased from the previous quarter. The increase of household debt recovered slightly, particularly for consumer borrowing. The ratio between total household debt and disposable income fell in the last two quarters, as did the ratio between the financial burden (principal and interests) and disposable income. This latter decline obeys to both a fall in borrowed amounts and lower interest rates (figure 10). As underscored in our Financial Stability Report, these

adjustments are welcome from a financial stability perspective, because of the higher risk of redundancy faced by households this year. Given the lags between the recovery of output and employment, both households and lenders must continue to be cautious for some time.

The performance of the labor market also supports the prospects for consumption. Latest data show that the decline has stopped. After seasonal adjustment, employment has been increasing since the second quarter of last year. The unemployment rate, although significantly up from late 2008, did not go as far as some projections foresaw and is already descending (figure 11). Lately, the velocity of the creation of salaried jobs has outperformed that of total employment. Although aggregate employment has not restored the jobs lost between late 2008 and early 2009, the drop in employment in this cycle has been milder and shorter than it was in the late 1990s, with less social costs from lost output.

The countercyclical stimulus from fiscal and monetary policies has been determinant in this behavior of consumption (figure 12). Baseline projections consider the fiscal policy scenario contained in the Budget Law.

The drop in external demand has been reflected on the volumes of shipments abroad, which are forecast to fall by nearly 3% annually this year. However, it is worth mentioning, on one hand, the improvement in mining shipments and, on the other, the sharp deterioration of salmon exports in the past few quarters. Both factors, especially the reduced salmon exports, have affected GDP significantly.

Thus, the baseline scenario of this Monetary Policy Report foresees the Chilean economy growing between 4.5% and 5.5% in 2010, after dropping 1.9% in 2009. This growth rate is not enough to fully bridge the gaps in the policy horizon. This setting, which matters for determining the inflationary pressures that will be facing our economy and the future path of the policy rate, is similar to what is forecast for other economies. In this scenario, the current account of the balance of payments will post a surplus of 0.6% of GDP in 2010 (table 1).

As for costs, imported inflationary pressures have remained well contained. Baseline projections for the average prices of oil and copper have been revised up from September. The nominal peso/dollar exchange rate, in contrast, has appreciated substantially during the fourth quarter. Although the exchange rate fluctuations along an extended period do not differ substantially from that of other emerging currencies, these have occurred at different times. First, at the beginning of the most difficult period in world financial markets, the peso depreciated faster than other currencies. The weakest level occurred between late October and early December 2008, while other economies saw it closer to the turn of 2009. Second, its recent period of appreciation began strongly in mid-October 2009, while other currencies had begun in July. All in all, at the statistical closing of this Monetary Policy Report, the magnitude of the peso appreciation with respect to its through is fairly similar to that of other emerging currencies (table 2).

This difference in the peso performance, at least since July, can be explained by local factors. The decoupling of the peso from the global trend of emerging currency strengthening with respect to the US dollar that began in mid-July, coincided with the building up of carry trade positions that used the peso as funding currency, and with increased dollar exposure of institutional investors. These aspects may have been favored by the low level of the monetary policy rate and the adoption of complementary monetary policy measures. Later, some of these operations eased, and the peso aligned itself with the path of other emerging markets' currencies (figure 13).

Considering the nominal exchange rate at the closing of this Monetary Policy Report, the real exchange rate (RER) is within the range of values believed to be consistent with long-term fundamentals, so the baseline scenario uses the working assumption that, over the long run, it will be close to where it stands today. This level is nearly 6% lower than at the statistical closing of the September Report, and thus has an important effect on the projected path of inflation in the coming months which will be taken into account in future policy decisions.

Labor cost pressures show no significant changes. Y-o-y growth in nominal wages has continued to fall, responding to the drop in inflation. Real wages deflated by the CPI have increased but, if the implicit deflator in non-natural resource GDP is used, they fall. The annual variation of unit labor costs increased because of the sharp cyclical fall in measured labor productivity. Such fall has been partly undone and is expected to continue to do so over the projection horizon. Trend growth projections are the same as in the previous Monetary Policy Report, that is, between 4.0% and 4.5% in the next two years. Beyond the projection horizon, a gradual return to trend growth figures approaching 5% is expected, to the extent that investment recovers and the general cost structure of the economy continues to reflect the lower energy costs.

Annual CPI inflation has been negative since August, and the Board estimates it will become positive over the course of the first half of 2010 and will gradually converge to 3% in the monetary policy horizon, this time the last quarter of 2011. The progressive – yet incomplete – closing of the output gap that is expected in the projection horizon, together with higher commodity prices, explain headline inflation increasing faster than the core measures. Y-o-y changes in CPIX and CPIX1 will stay flat in negative figures for some months longer than CPI, and will converge to 3% later than headline inflation (table 3). Market inflation expectations remain at 3% in the medium term, despite low inflation expected for the next few months (figure 14).

Several factors determine inflation's convergence to the target. In particular, this projection relies on the external scenario steadily adding a boost to economic activity, with the recovering of confidence and global financial conditions gradually normalizing and allowing domestic and international demand to pick up. Domestically, monetary policy will remain expansionary, which, together with less tight financial conditions, also backs this projection.

It is worth saying that these projections use as a working assumption that the policy rate will be kept at its low of 0.50% until at least the second quarter of 2010 and that its normalization will occur at a similar pace to that in December's Economic Expectations Survey (EES), which is more gradual than the one implied by financial asset prices in the two weeks before the statistical closing of this Monetary Policy Report (figure 15).

The scenario outlined here is, as usual, subject to several risks. On one hand, doubts about how robust will the global economic recovery ultimately be still persist. The latest data have been better than predicted in several economies, but financial markets continue to react with volatility in the face of unexpected events while credit losses are still being absorbed by financial intermediaries. The labor market situation is still complex in several economies, which, combined with the de-leveraging process under way, adds doubts about the capacity of consumption and investment around the world to regain strength.

Another substantial risk has to do with the way in which central banks and governments will withdraw their unconventional monetary policy measures and fiscal and financial packages, and how this could affect the functioning of financial markets. Part of the recent relative stability relies on specific programs to support the financial system and in monetary policy conditions that have allowed access to liquidity at a very low cost. This has allowed generating profits that strengthened the banks' balance sheets. However, credit risk in certain assets, such as the commercial mortgage portfolio of US and European banks is still high. The recent default in Dubai is one example of such risk being materialized, considering that Eurozone banks with systemic importance in the area show a high degree of exposure to this type of operations.

Another risk comes from challenges posed to macroeconomic management by portfolio rebalancing or external savings being redirected to emerging economies which could cause significant increases in capital flows. Like its emerging peers, Chile has been at the receiving side of important portfolio investment flows. The difference is that outflows from institutional investors have been particularly high, more than offsetting the inflows (figure 16). Another

risk, as has been said repeatedly, relates with uncertainty surrounding the persistent global imbalances. Domestically, it is possible that in the short run economic activity picks up faster than expected because of faster inventory replenishment.

Also noteworthy is the risk associated to the trends of the different exchange rates and their effects on the RER. The RER has appreciated since September, with direct consequences on projected inflation. The Board reiterates that it closely monitors the implications of the RER level on inflation and compliance with its monetary policy objective. In any case, the RER is within the range considered to be consistent with its long-term fundamentals.

The materialization of any of these risk scenarios will have direct effects on domestic growth and inflation scenarios foreseen by the Board. After consideration of the aforesaid elements, the Board believes that the balance of risks for inflation and growth is unbiased. As pointed in the Financial Stability Report, these risks are also relevant for the Chilean economy's financial stability. Therefore, banks and other financial intermediaries should consider these threats in their management and planning for 2010, assessing the adequacy of their capital base, prudently managing their liquidity in pesos and other currencies, and actively diversifying by counterparties and credit sources. The Board will continue evaluating the probabilities of these risks and their consequences on domestic inflationary and financial stability prospects.

Conclusions

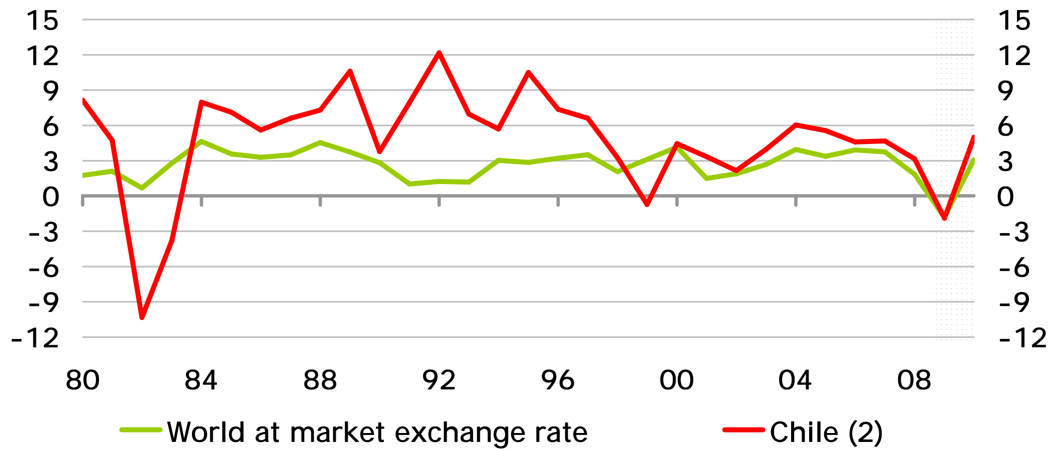
I wish to wrap this presentation with some brief concluding remarks. As I said at the beginning, the last eighteen months have brought events that will be forever recorded in world history. Chile suffered the consequences of the financial earthquake of developed markets on confidence around the world. Economic activity dropped not only sharply but also with unprecedented speed. The same happened with inflation, which was in its long-time peak in October 2008 and is now in its lowest for decades.

Activity already began to pick up in the third quarter. Although the y-o-y variation of the Imacec remains in negative territory, in four of the last five months it posted a monthly increase. Furthermore, as suggested by these projections and private expectations, in the fourth quarter the GDP will post a positive annual growth rate. Annual inflation, in turn, is expected to begin rising and become positive during the first half of 2010. Our financial system has been able to weather the external turmoil and the Central Bank has taken actions to avoid inconveniences in the provision of liquidity and implemented a highly expansionary monetary policy, not just reducing the policy rate to its lowest possible.

However many risks are still there and we must be extremely careful in our decisions. The economy is beginning a recovery process that is yet to be well grounded. Output gaps are significant and will close gradually; probably taking more than the next two years. Inflationary pressures are generally low. We have said in our communications that we will hold the policy rate at its lowest at least until the second quarter of 2010.

However, it is not a mechanical commitment in the sense that after that time we will begin to withdraw the monetary impulse. Experience has taught us the importance of moderation, and a hasty withdrawal could severely hinder economic recovery and jeopardize convergence to the inflation target. As in earlier occasions, our inflation-targeting regime and the credibility it has earned allow us to handle monetary policy very flexibly. Accordingly, we reiterate that the Board will use all the policy tools at hand so that projected inflation stands at 3% over the policy horizon. As I have also said repeatedly, this is how the Central Bank of Chile contributes to the Chilean economy's growth and stability.

Figure 1
World growth (1)
(annual change, percent)

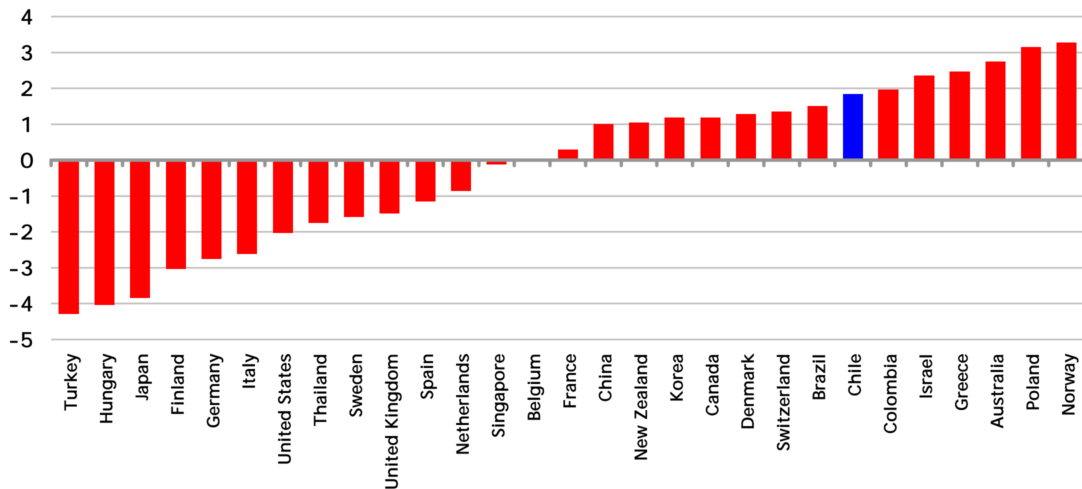


(1) Gray area shows projections from 2009 onwards.

(2) Growth for 2010 is the midpoint in the range of forecasts included in the Monetary Policy Report.

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

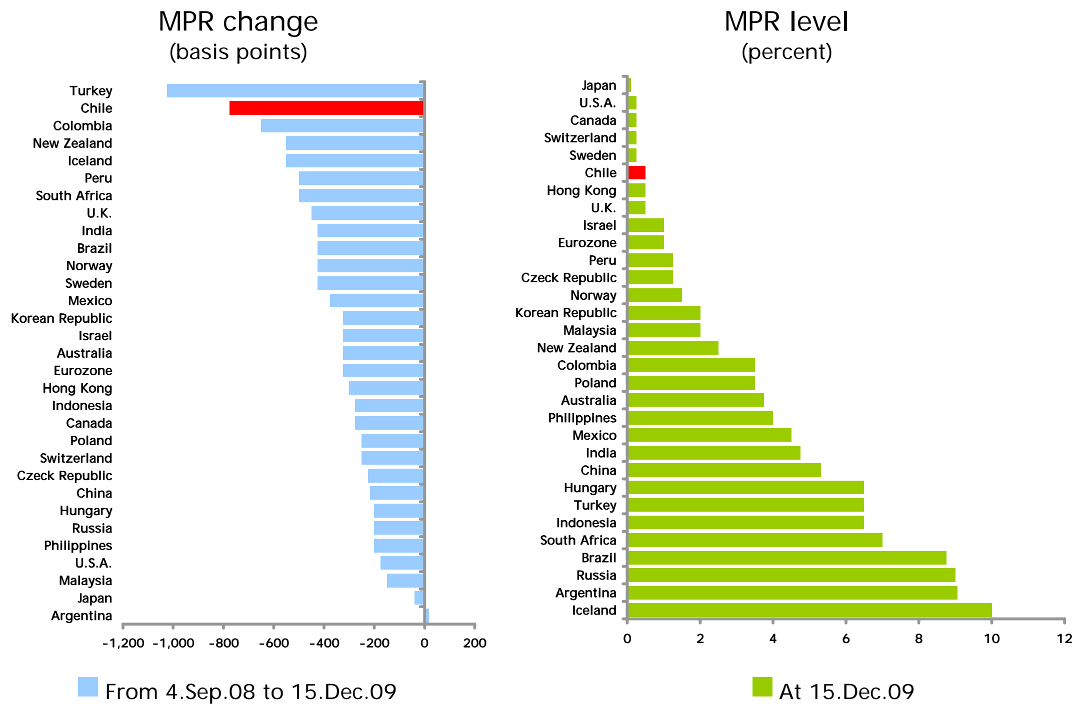
Figure 2
Difference in growth in 2009 (*)
(percent)



(*) Actual growth minus estimated growth. Growth estimate for 2009 based on change in the terms of trade, population, and per capita GDP.

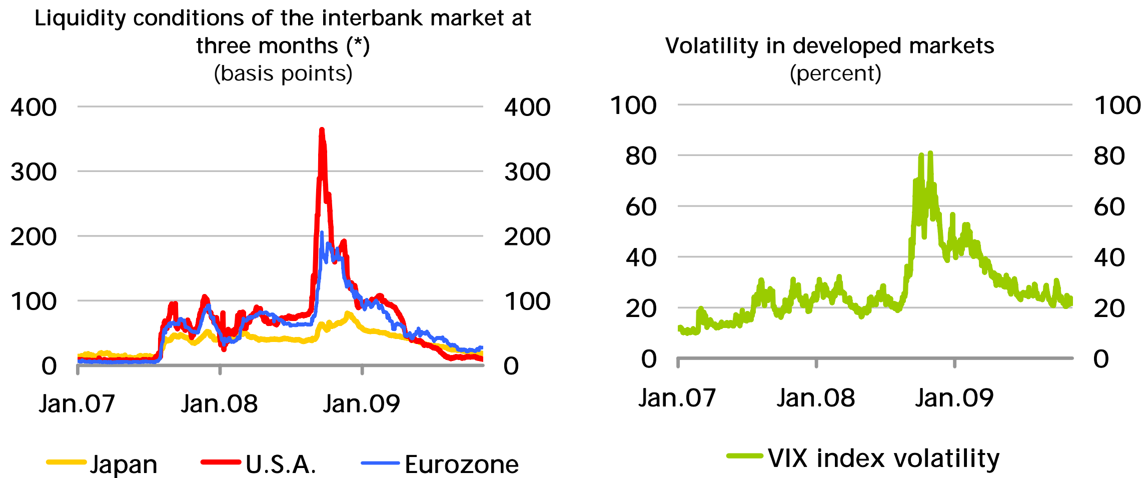
Sources: Central Bank of Chile, International Monetary Fund and World Bank.

Figure 3
Monetary policy interest rate (MPR)



Source: Bloomberg.

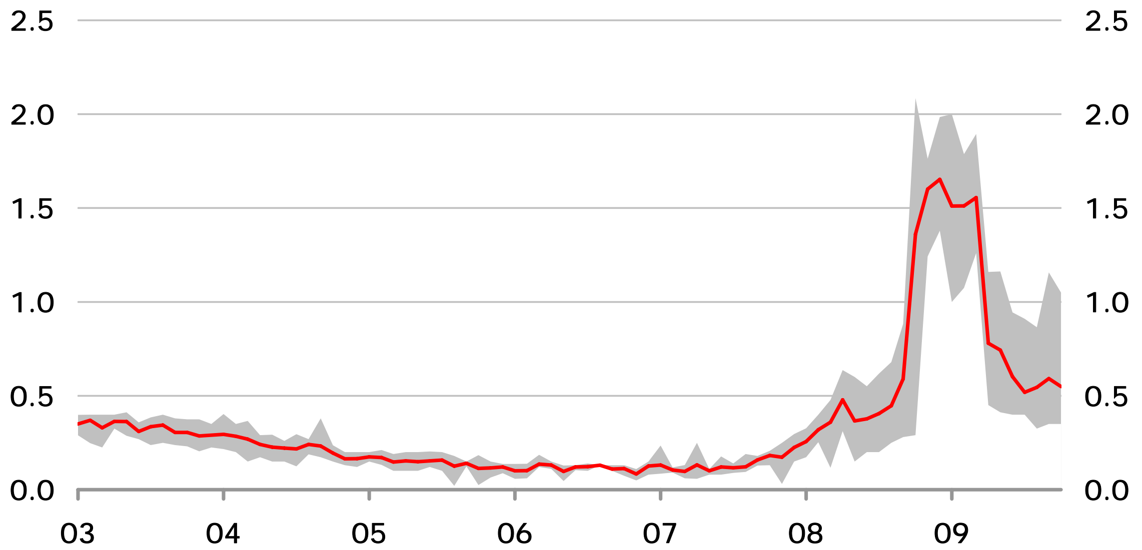
Figure 4



(*) *Spreads* between the Libo rate and the *Overnight Index Swaps rate.*

Source: Bloomberg.

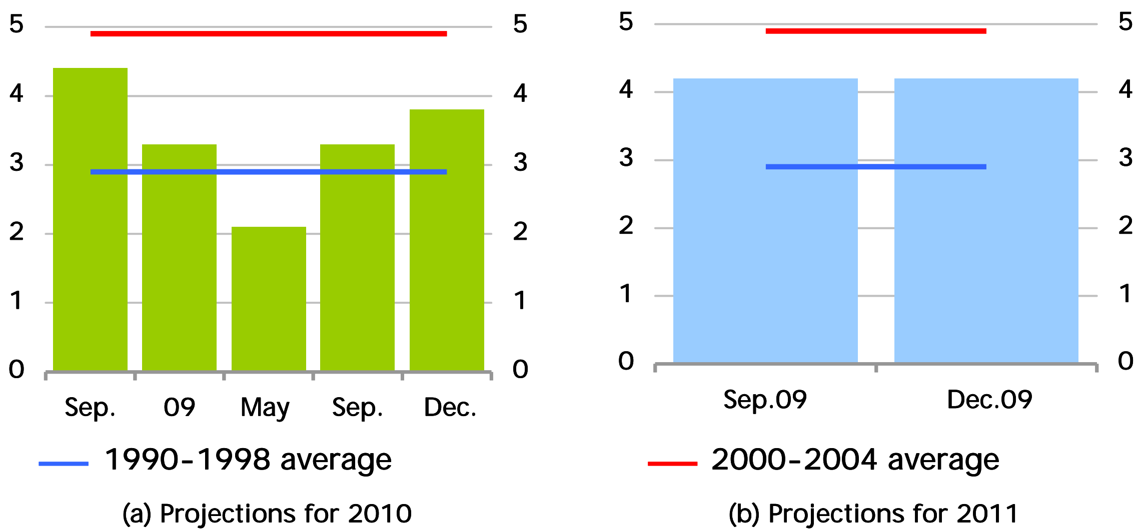
Figure 5
Spread of short-term external financing of resident banks (*)
(monthly average, percent)



(*) Loans of non-related banks at variable rates. Gray area depicts the interval between percentiles 5 and 95 of the sample in each month.

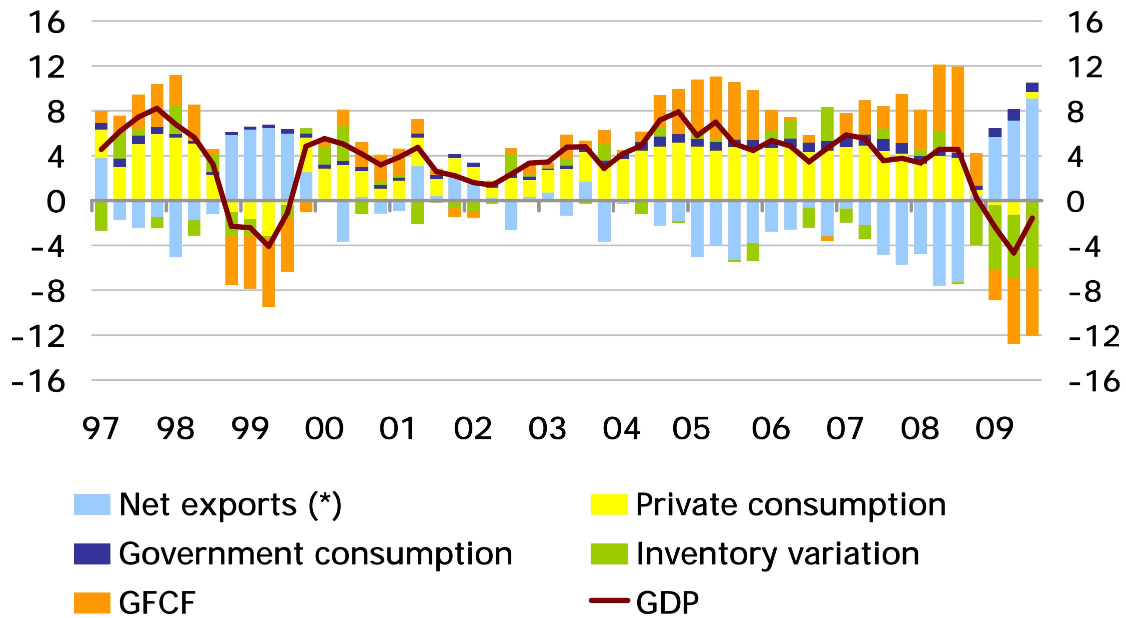
Source: Central Bank of Chile.

Figure 6
World growth
(annual change, percent)



Source: Central Bank of Chile.

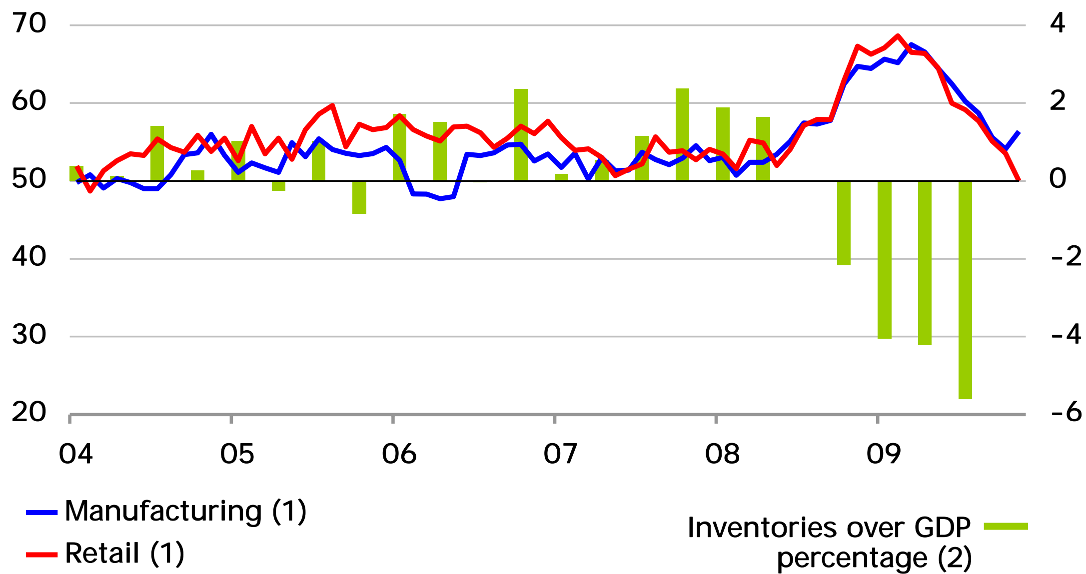
Figure 7
Contribution to annual GDP growth
(real annual change, percentage points)



(*) Goods and services exports minus goods and services imports.

Source: Central Bank of Chile.

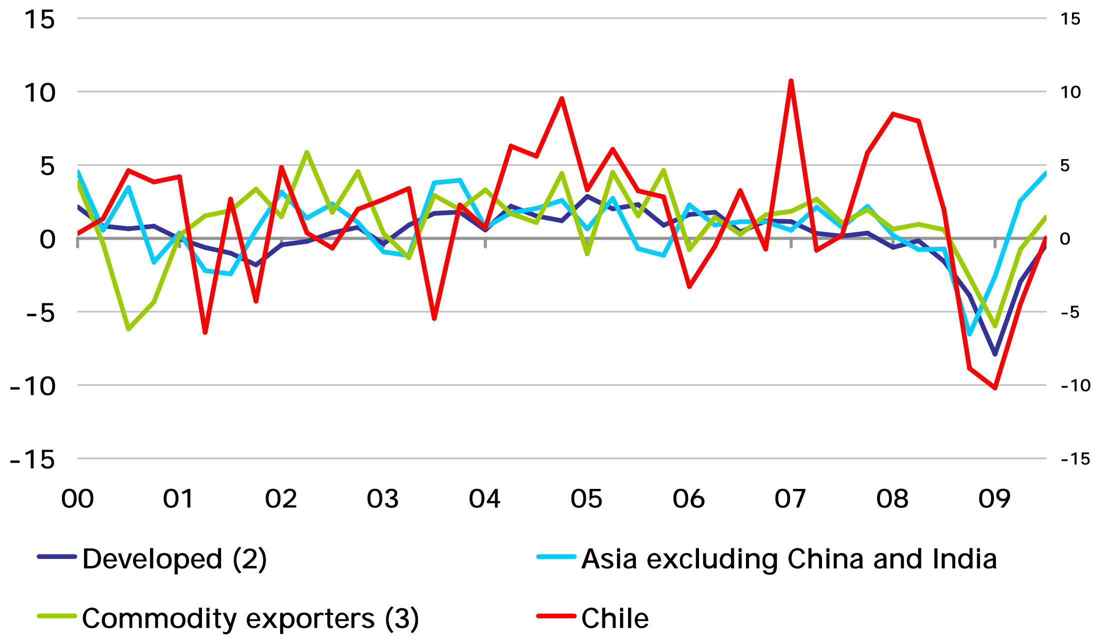
Figure 8
Current inventories



(1) Figures above (below) 50 points indicate more (less) than desired.
(2) Seasonally-adjusted quarterly series.

Sources: Central Bank of Chile and Icare/Universidad Adolfo Ibáñez.

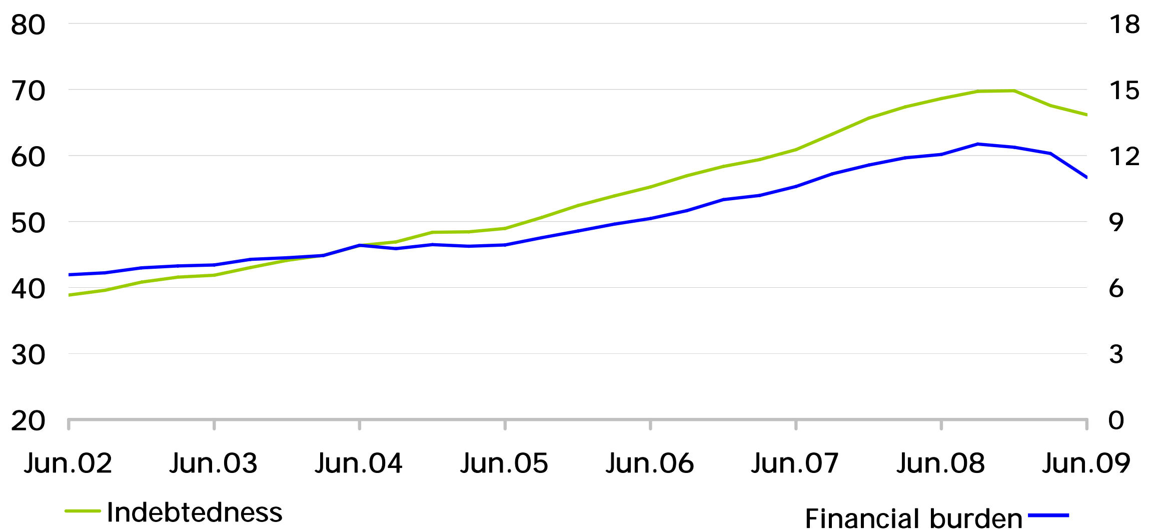
Figure 9
Gross fixed capital formation (1)
(quarterly change, percent)



(1) Seasonally-adjusted series.
(2) Includes the United States, Japan, the United Kingdom and the Eurozone.
(3) Includes Australia, Canada, Norway and New Zealand.

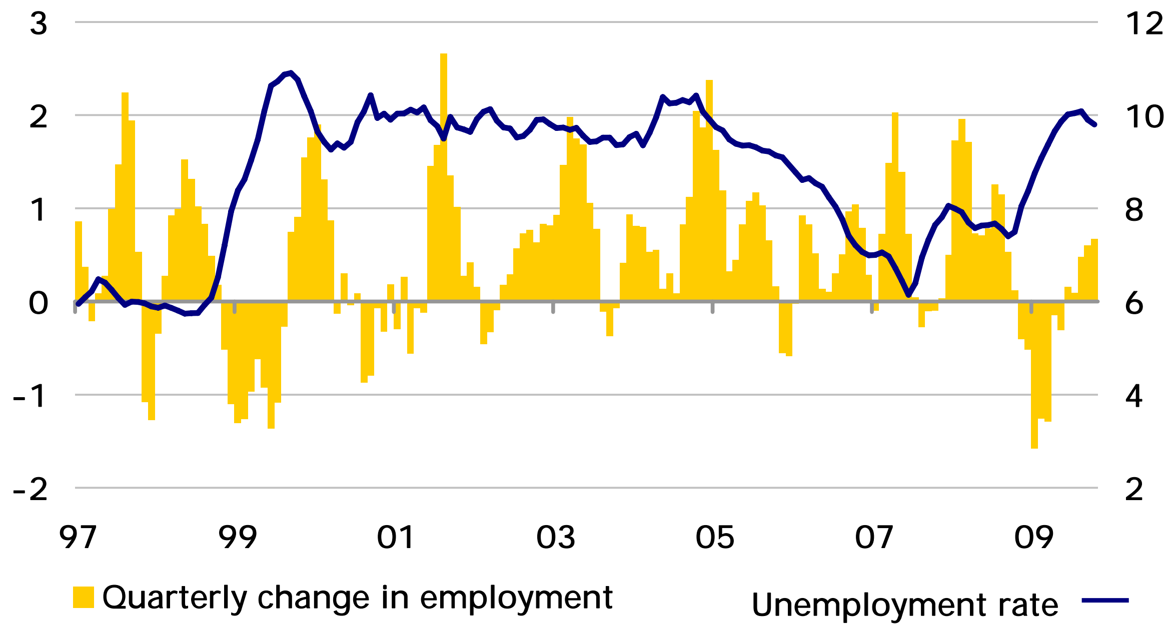
Source: Central Bank of Chile based on data from CEIC and the International Monetary Fund.

Figure 10
Long term indebtedness and financial burden
(percentage of disposable income)



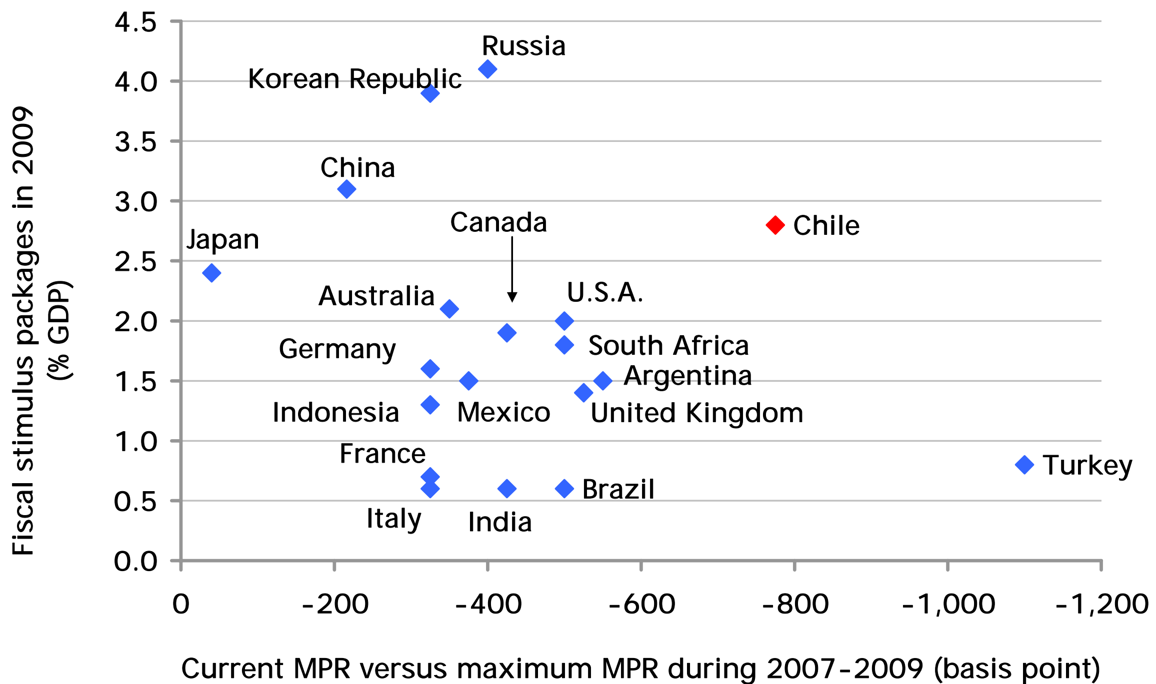
Source: Central Bank of Chile based on information from SBIF, SVS, SuSeSo.

Figure 11
National employment and unemployment rate
(seasonally-adjusted series, percent)



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

Figure 12
Monetary impulse and fiscal packages



Sources: Central Bank of Chile, Bloomberg, International Monetary Fund and Finance Ministry.

Table 1
Economic growth and current account
(annual change, percent)

	2007	2008	2009 (f)	2010 (f)
GDP	4.7	3.2	-1.9	4,5 - 5,5
National income	7.1	3.8	-2.3	7.5
Domestic demand	7.8	7.4	-7.4	8.9
Domestic demand (w/o change in inventories)	8.2	7.9	-3.3	4.6
Gross fixed capital formation	12.0	19.5	-16.1	8.2
Total consumption	7.1	4.2	1.5	3.5
Goods and services exports	7.6	3.1	-4.1	5.4
Goods and services imports	14.9	12.9	-15.7	14.3
Current account (% of GDP)	4.4	-2.0	2.1	0.6

(f) Forecast.

Source: Central Bank of Chile.

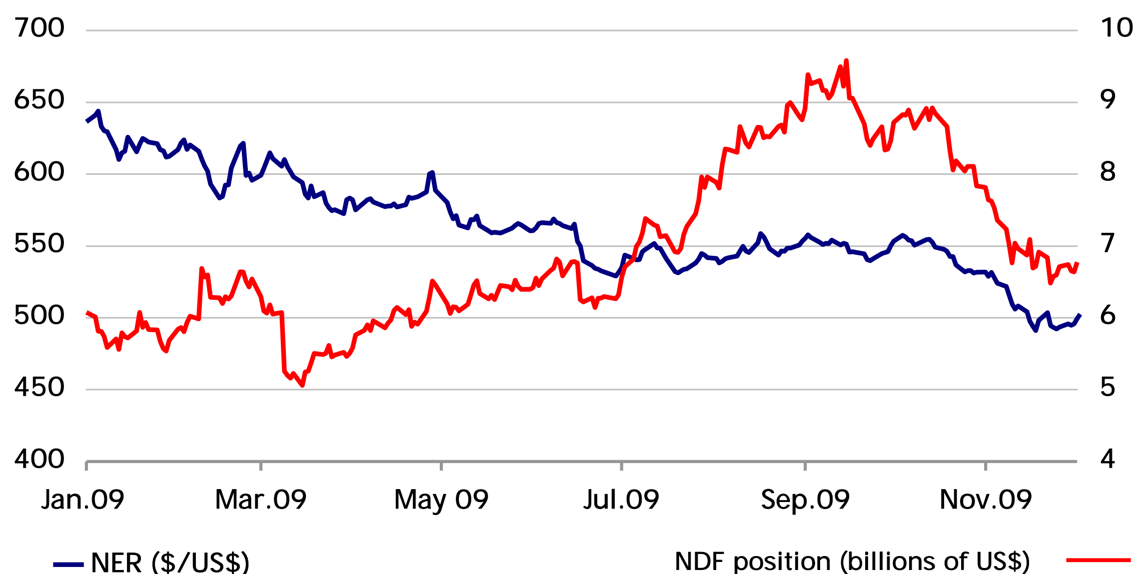
Table 2
Parities with respect to the U.S. dollar (1)
(index 2005=100)

Currency	15-Sep-08	Maximum	Depreciation (2) percentage	Minimum	Appreciation (3) percentage
Australian dollar	96.5	129.4	34.1	83.0	-35.8
Brazilian real	67.8	93.9	38.4	63.5	-32.4
Canadian dollar	88.7	107.8	21.5	84.8	-21.3
Chilean peso	94.7	121.4	28.2	87.6	-27.8
Colombian peso	88.5	111.5	26.0	78.0	-30.1
Czeck koruna	74.7	103.9	39.1	75.2	-27.6
Euro	94.5	108.1	14.4	89.0	-17.7
Hungarian forint	93.3	138.5	48.4	96.6	-30.2
Indonesian rupiah	101.9	136.2	33.7	100.6	-26.2
Israeli shekel	81.5	97.5	19.6	84.5	-13.3
Japanese yen	101.8	104.5	2.7	84.1	-19.6
Korean won	107.3	151.3	41.0	111.1	-26.6
Mexican peso	95.7	138.6	44.9	112.5	-18.8
New Zealand dollar	108.2	144.9	33.8	93.9	-35.2
Norwegian krone	94.4	118.0	25.1	90.4	-23.4
Peruvian peso	90.6	99.2	9.6	86.9	-12.4
Polish zloty	77.9	128.7	65.1	89.5	-30.4
Russian ruble	91.9	131.0	42.6	103.3	-21.1

(1) From 15 September 2008 to the statistical closing of the Monetary Policy Report.
(2) Difference between the currency's highest exchange rate over US dollars and the rate at 15 September 2008.
(3) Difference between the currency's highest and minimum exchange rate in US dollars.

Source: Bloomberg.

Figure 13
Nominal exchange rate and NDF position



Source: Central Bank of Chile.

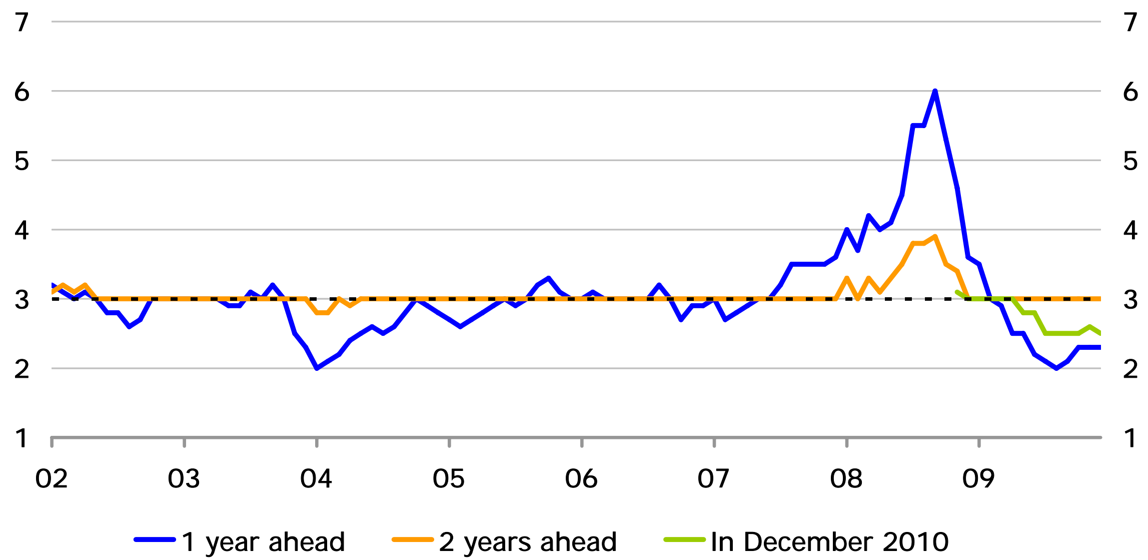
Table 3
Inflation
(annual change, percent)

	2008	2009 (f)	2010 (f)	2011 (f)
Average CPI inflation	8.7	1.6	1.0	2.7
December CPI inflation	7.1	-1.4	2.5	
CPI inflation in around 2 years (*)				3.0
Average CPIX inflation	8.4	2.8	0.3	2.5
December CPIX inflation	8.6	-1.5	1.9	
CPIX inflation in around 2 years (*)				3.0
Average CPIX1 inflation	7.8	2.8	0.8	2.6
December CPIX1 inflation	7.7	-0.6	2.1	
CPIX1 inflation in around 2 years (*)				3.0

(f) Forecast.
(*) Inflation forecast to the fourth quarter of 2011.

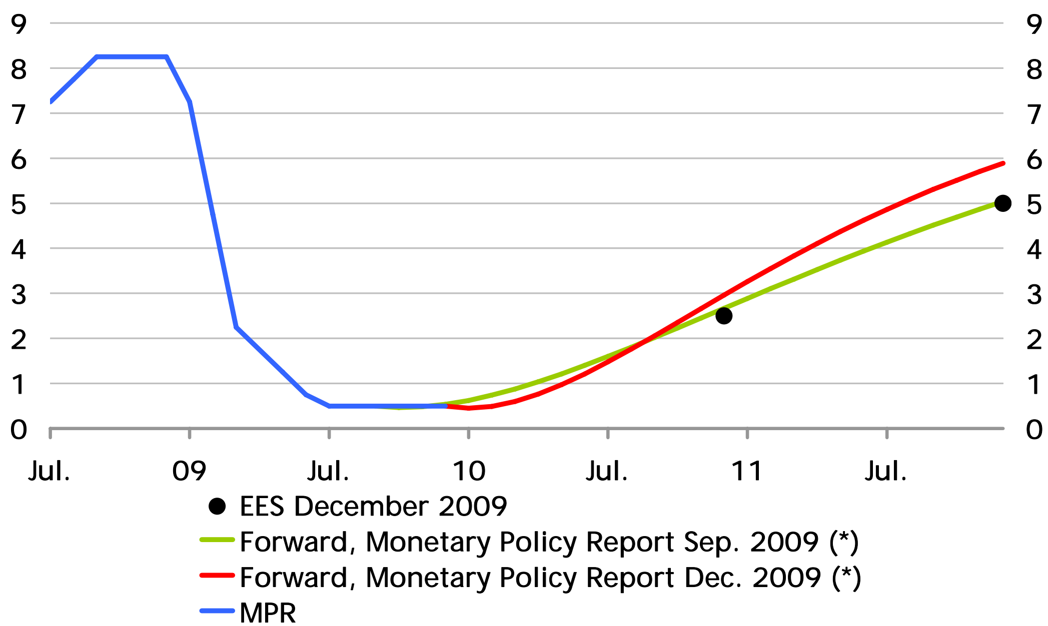
Source: Central Bank of Chile.

Figure 14
EES: Inflation expectations
(annual change, percent)



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

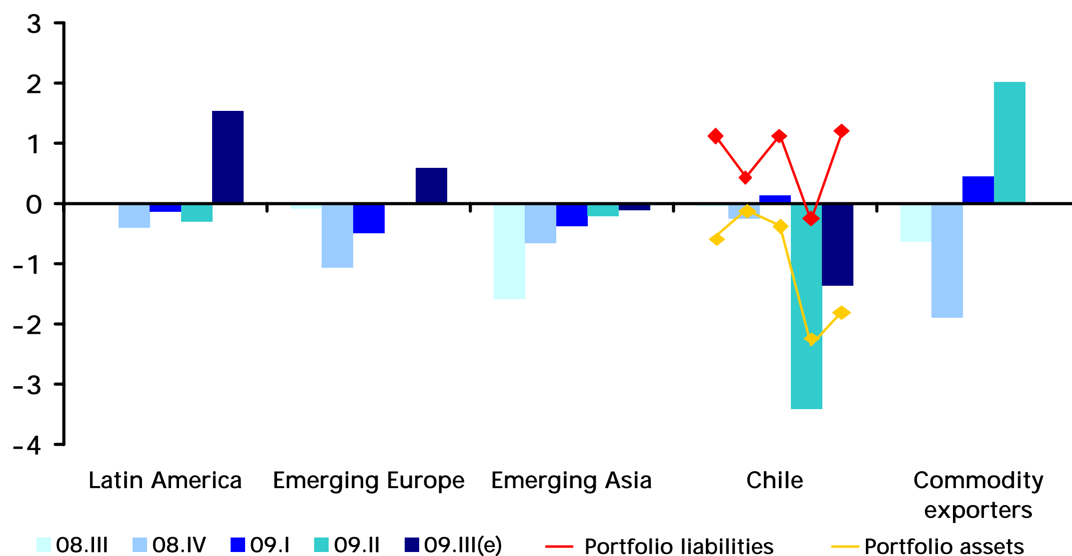
Figure 15
Expected MPR
(percent)



(*) Estimated using average financial asset prices in 2 weeks before 15 December 2009.

Source: Central Bank of Chile.

Figure 16
Net portfolio balance (*)
(percentage of GDP)



(e) Estimated with preliminary data from Brazil, Czeck Republic, Indonesia, Pakistan, Poland, Taiwan and Turkey.

(*) Flow of the quarter over GDP accumulated in 12 months. Simple averages. Latin America: Brazil, Colombia, Mexico and Peru; Emerging Europe: Bulgary, Czeck Republic, Hungary, Poland, Russia, Turkey and Ukraine; Emerging Asia: India, Indonesia, Malaysia, Pakistan, Philippines, Taiwan, Thailand and Vietnam; Commodity exporters: Australia, Canada and New Zealand.

Source: Central Bank of Chile based on CEIC Data.