# José De Gregorio: Monetary Policy Report

Presentation by Mr José De Gregorio, Governor of the Central Bank of Chile, before the Honorable Senate of the Republic, Santiago, 8 September 2010.

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## Introduction

Mr. President of the Senate, senator Jorge Pizarro, ladies and gentlemen senators, I am grateful for the invitation to the Board of the Central Bank of Chile to present our Monetary Policy Report. Like every year in September, this presentation coincides with the yearly report given by the Board of the Central Bank to the Senate, where we expose our vision of recent macroeconomic and financial developments in the Chilean economy, as well as its prospects and implications for the conduct of monetary policy.

In a few days we will be celebrating our country's bicentennial, in a year 2010 that has been marked by tremendous human and economic challenges, and after a biennium 2008–2009 characterized by episodes of global recession and financial crisis that we had not seen in decades.

The Chilean economy has been able to weather these difficulties in an unprecedented way. Macroeconomic stability has been preserved and the negative effects on employment and output of the turmoil of recent years have been properly dealt with. Thanks to that we are now in a process of economic growth and recovery that is substantial, strong and healthy for economic activity, demand and employment.

Indeed, despite the context of an increasingly uncertain global economy, Chile has continued to show significant growth rates, has reduced unemployment and has advanced in repairing the damages caused by the earthquake and tsunami that hit us last February 27th (27-F). At the same time, after a prolonged period of very low and even below-zero figures, inflation has returned to the defined tolerance range and is headed, according to our own projections and private expectations, toward levels consistent with the 3% target range (figure 1).

That the stimulative monetary policy applied during all of 2009 bore fruit is without question. The extraordinarily expansionary conditions implemented more than a year ago by way of a historical reduction in the monetary policy interest rate, together with special liquidity facilities and the communication that the monetary policy rate (MPR) would be kept at its minimum level throughout the second quarter of this year, limited the persistence of the negative effects of the crisis on the capacity of households, firms, and financial institutions to repay their debts and generate income. Furthermore, these measures helped set the grounds for the vigorous economic upturn we are seeing now.

The expansionary monetary stance of early this year permitted, also, to keep at bay the financial effects of the earthquake and provide a lending environment that would foster reconstruction. Toward the second quarter of this year, as confidence returned, with reliable information that output and demand were picking up, together with prospects of inflation returning to the target range, the Board began a gradual process of normalization of the stance of monetary policy. Overall, at its current level the MPR is still expansionary, and will continue to provide momentum to the economy (figure 2).

Since the last Report that we presented last June, incoming information point at the real sector consolidating its renewed strength. Output and demand growth have exceeded expectations, narrowing the output gap. In that context, as we have said before, the question is not to continue or not to continue raising the MPR, but how fast to do it. As we know, delaying this process can end up calling for drastic adjustments, higher interest rates and increased pressures from the exchange rate, all of which is detrimental to employment and economic activity.

As detailed in this Report, convergence of inflation to the target in the baseline scenario is determined by stronger output and stronger domestic expenditure, but combined with reduced pressures from abroad. In addition, in the short term we have seen some prices increases, such as transport fares, cigarettes and the stamp tax. As for earlier projections, these latter factors will contribute to somewhat less CPI inflation over the coming months.

The CPI figure published today is a little below the expectations of market agents and our own, but as we have said time and again we do not react to the news of the day, although we do take them into account to detect the trends. In any case this figure does not change the direction of monetary policy. Nor does it modify our forecasts of strong growth with limited inflation we include in this Report. Our monetary policy strategy is a preventive one, headed to normalization, and does not respond – luckily – to an inflationary spurt or to some unsustainable expansion process.

In this Report's baseline scenario, gradual progress toward MPR normalization is assumed, but its level will continue to be expansionary still for several quarters. As always, the pace of normalization will depend on how domestic and foreign macroeconomic conditions unfold, and will be consistent with the inflation target.

Accordingly, it is essential that we do not lose sight of the external scenario. The latest developments have increased uncertainty about the pace of global growth while financial markets are still highly volatile. Also, the nominal appreciation of the peso over the past few months has been substantial. Although the current levels of the real exchange rate do not reflect an obvious misalignment with its long-term fundamentals, exchange rate movements do affect the conduct of monetary policy significantly, as they play a stabilizing role. Indeed, in mitigating inflationary pressures, an exchange rate appreciation restrains the MPR adjustments that could result from only the closing of the output gap.

One working assumption we use in our projections is that the real exchange rate will change little into the long term. Any movements away from its trend are possible in a floating regime. Its potential financial effects on aggregate output and inflation will be definitely considered by the Board as an input for its future decisions.

As we have demonstrated in the past, our monetary policy is highly flexible. It has contributed enormously to the good standing the Chilean economy enjoys today, in an environment of stable prices and restored employment and output. Now I will review the main features of the macroeconomic conditions we believe are the most likely for the next two years and its implications for inflation and monetary policy.

## Macroeconomic scenario

The first closing of second-quarter National Accounts showed GDP growth at 6.5% y-o-y. In terms of velocity, the second quarter ended with an annualized quarterly variation of around 20% (figure 3). Domestic demand also grew above forecasts, driven by increased private consumption and a strong rebound of investment. Such dynamism has responded to not only temporary factors but also to more persistent ones. Among the temporary factors, what stands out is the immediate repair of the damages caused by the catastrophe of 27-F and the reversal of the dramatic contraction of domestic demand during 2009, associated to the then high levels of uncertainty. These elements resulted in a swelling of inventories, durable goods purchases and investments in machinery & equipment.

Among the more persistent phenomena that are driving demand and output are the stimulative effect of monetary policy, in an environment where the agents' balance sheets suffered no permanent damages from either the crisis or 27-F.

Furthermore, different measures show that financial conditions have advanced toward normalization in recent months, with a more favorable scenario in terms of both interest rates and banks' lending standards. According to the banking credit survey of the second quarter, credit access conditions were relaxed at the same time that a strengthening of demand was observed. Loans have continued to grow, and interest rates are still low (figure 4). This combines with the good performance of the labor market and expectations of consumers and firms in the optimistic or near-neutral levels.

Reconstruction works in the aftermath of 27-F have affected domestic expenditures, albeit with a different composition than was foreseen immediately after the disaster. At first, everyone expected that public and private efforts would focus primarily on infrastructure and construction, but capital goods imports and inventory replacement ended up being much more significant. Still, the baseline scenario assumes that building investment will pick up substantially towards the end of this year and in 2011, with some moderation of investment in machinery & equipment, which is already visible.

Internationally, the weak incoming indicators for output and employment in the U.S. have increased the concerns over a slower economic recovery of that country. World growth forecasts are maintained for 2010, basically due to better than expected figures in the first half, and because the latest data point at a weaker second half (figure 5). The breakdown across regions has changed, with increased participation of emerging economies. In the main developed countries, manufacturing production has decelerated. So far, consensus forecasts do not fully consider this scenario, although financial asset prices have implicit slower growth for the U.S. and foresee a delay in monetary policy normalization. Accordingly, the Board assumes for the baseline scenario global growth again lower than market consensus for 2010 and 2011 (table 1).

In international financial markets, risks associated to the fiscal and financial conditions in Europe are less imminent, as reflected in banks' risk premiums and some liquidity indicators in money markets. Uncertainty remains, however, relating with the risk of further weakening of output in the developed world, causing a decline in long-term interest rates in the U.S., the Eurozone, and Japan since June, to levels similar to or even below the troughs of late 2008 (figure 6).

Taking all these aspects in consideration, the Board estimates that during this year GDP will grow between 5.0% and 5.5%. The range for this year has been upgraded from June, based on actual data above projections in the first half and more dynamic figures available for third-quarter demand and output, which are foreseen to continue into the first half of 2011, prompting output gaps to close in this latter period (figure 7).

For the year 2011 GDP is expected to grow by 5.5%–6.5%. Moderation of world growth towards 2011, the dissipation of one-time effects of the crisis and 27-F, plus the gradual withdrawal of monetary policy stimulus will result in both output and domestic demand slowing down by the second half of 2011. It is worth noting that y-o-y GDP growth figures in the second quarter of 2011 will be high due to the low basis for comparison associated to the earthquake. Similarly, once the swelling of domestic demand is finished, it should expand next year at a rate the half of the strong growth it should post this year. This will come accompanied with more dynamic export volume growth that will revert the tough 2009 and 2010 years, when exports were affected by the global recession and by the disruptive effects of the earthquake (table 2).

The rebound of the Chilean economy is also apparent in a dynamic labor market, where employment is growing strongly and the rate of unemployment has dropped (figure 8). As for fiscal policy, this Report's baseline scenario considers the announcements made by the authority, which do not mention any significant changes in the fiscal stimulus for the coming years from last June.

The behavior of output and demand will determine a current account deficit of –1.1% of GDP this year increasing in 2011. At trend prices, these figures are large by historical standards, reflecting the transitory effects of post 27-F on investment and saving, but should moderate as these transitory effects dissipate.

In this Report's baseline scenario, despite the faster closing of the output gap, headline inflation will follow a path similar to the one forecast before, but core inflation will be somewhat more limited. This difference owes primarily to some specific prices and to the incidence of reduced inflationary pressures from abroad (excluding foodstuffs).

Also, the inflation path is also influenced by the recent and forecast dynamics of the real exchange rate (RER). The peso has appreciated in nominal terms by around 7% since our last Report, partly responding to the performance of the dollar in world markets. In our projections, we use as a working assumption that the RER will be unchanged in the long term, which is consistent with its long-term fundamentals (figure 9). Reduced inflationary pressures associated to the stronger peso certainly affect inflation prospects in this Report, partly offsetting the effects on prices of the rapid closing of the output gap. As has happened under different circumstances, any movements of the exchange rate away from the trend assumed as a working assumption is possible in a floating regime, and its potential effects on the financial system, output or employment will be considered by the Board as inputs for their future decisions.

Summarizing, for the rest of this year, annual CPI inflation is expected to return to figures around 3% to then move to the upper limit of the tolerance range for some months. This short-term trajectory is influenced by one-time effects, which will eventually revert, permitting inflation to hover around 3% throughout 2011 and to the end of the relevant projection horizon, this time the third quarter of 2012. Y-o-y CPIX1 inflation will describe a more gradual convergence to 3%, largely because the shorter-term effects on inflation are concentrated in items outside the CPIX1. Private expectations are not very different from this (figure 10).

The Board estimates that it will continue withdrawing the monetary stimulus at a pace that will depend on how domestic and external macroeconomic conditions unfold. This process of MPR normalization was begun in June and continued in the meetings of July and August – with increases of 50 basis points each time – taking the MPR to 2% y-o-y. Going forward, the market has internalized a process of withdrawal of the monetary stimulus in the coming quarters. This is consistent with the progressive normalization of credit conditions, which is visible in various markets and indicators. The different surveys and asset prices can be read in more than a way in regards the true pace of normalization.

Actually, the same as in June, the MPR implicit in swap contracts is lower than the one that can be inferred from the forward curve, mainly reflecting significant differences between the rates on non-indexed Central Bank bonds and swap contract as equivalent maturities. It is possible that these differences originate in the type of institutions operating in each market, which are not fully integrated, reflecting different preferences for instruments in pesos and in UF by resident and non-resident institutions. Similarly, this partial integration may mean that swap contract rates reflected more quickly and more intensely the movements of risk-free interest rates abroad.

The baseline scenario of this Report uses as a working assumption an MPR trend that is comparable to the one observed in various expectations surveys (figure 11). Certainly, if actual conditions differ from those assumed in this baseline scenario, alternative policy measures will be required.

Specifically, the Board believes that the scenario outlined here is subject to a number of risks. Considering that in June domestic demand – and output – already was showing faster than foreseen velocity, we cannot rule out gaps closing faster than assumed in the baseline scenario. Nor can we rule out that some part of that strength responded to merely temporary factors, such as the earthquake, and output will slow down before we think.

In the global context, several risks are still latent. U.S. growth may weaken more than foreseen, with effects on financial markets – in particular stock index reversals – and new postponements of the monetary stimulus withdrawal. The fiscal accounts in developed economies – especially in some countries in Europe – is still cause for concern, mainly because of their effects on perceived risks and in the final recovery of the world economy. Furthermore, measures adopted in China to limit credit growth and prevent an overheating may result in a weaker world economy and lower commodity prices. As usual, the persistence of global imbalances entails risks both on capital flows across economic areas and on the behavior of parities between different currencies.

In the recent past, the trajectory of international food prices has reopened the concern on its future performance and its impact on inflation, given the high degree of pass-through we observed in Chile from world price hikes in 2007 and the first half of 2008. Overall, it is not that clear that, if wheat prices continue to rise internationally, the local economy will replicate them, because domestic margins have remained fairly large.

If any of these scenarios materializes, there will be direct consequences for the growth and inflation scenario foreseen by the Board. After considering all the elements described, the Board believes that the balance of risks for inflation and output is unbiased, and we reiterate that we will continue to use our policies with flexibility so that projected inflation stands at 3% in the policy horizon.

## Concluding remarks

Let me finish with some short reflections. After several years of heavy turbulences and natural disasters, the Chilean economy is on a very good standing to continue on a path of sustained growth.

Price stability has been preserved, preventing inflation from affecting the purchasing power of citizens, especially those with less income and thus less capability to protect themselves against this menace. Growth has consolidated, pushing the rate of job creation to levels we had not seen in years. The contribution of monetary policy to this good performance is unquestionable. It has been flexible enough to be able to be applied when facing sharp changes in the economic environment, with no unnecessary dogma or rigidities.

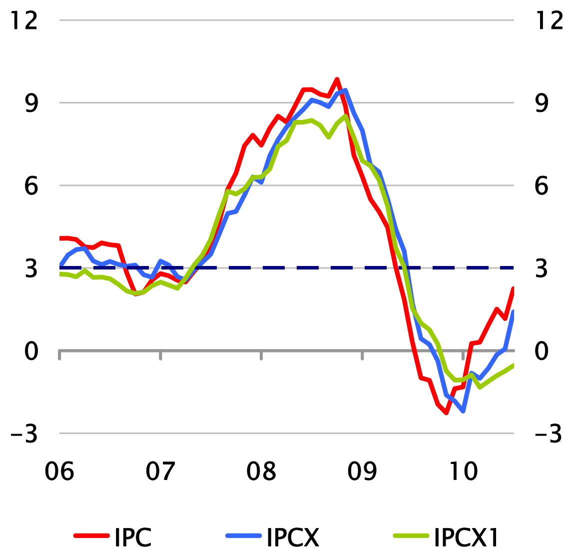
In order for this process to continue over time it needs to be balanced and operate in the context of an inflation rate in line with the target. Otherwise it will become just an unsustainable acceleration calling for drastic adjustments with its related costs in lost output and employment.

Evidently, as a country we continue to face challenges, particularly related to maintain sustainable growth rates for long periods and not create tensions on price stability. Guaranteeing low and stable inflation is the best contribution that the Central Bank of Chile can make to prosperity in this new century of independent life that is beginning for our Republic.

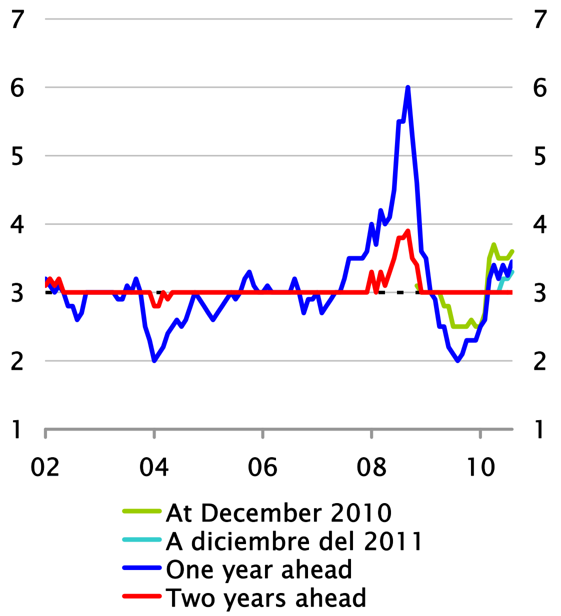
Thank you.

Figure 1

Inflation indicators
(annual change, percent)



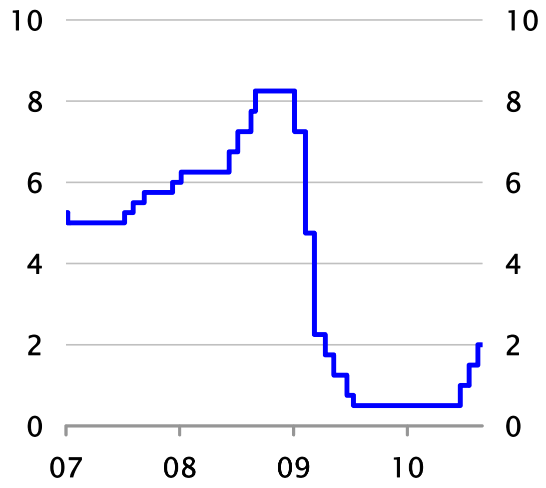

EES: Inflation expectations
(percent)



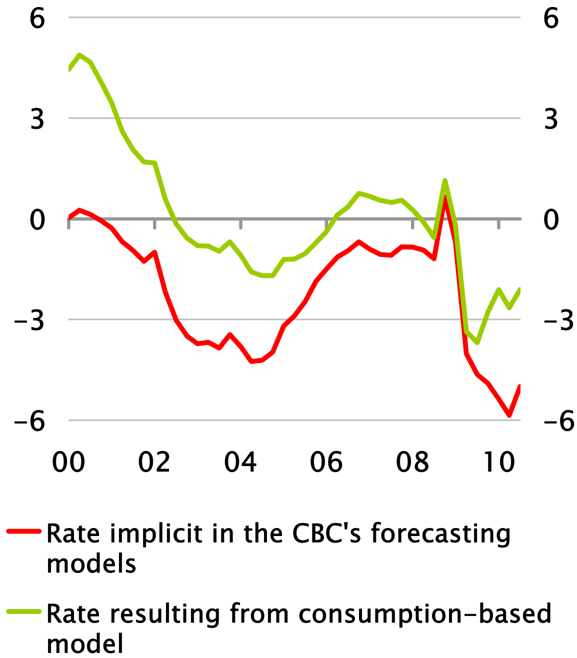

Sources: Central Bank of Chile and National Statistics Institute.

Figure 2

Monetary policy interest rate
(percent)

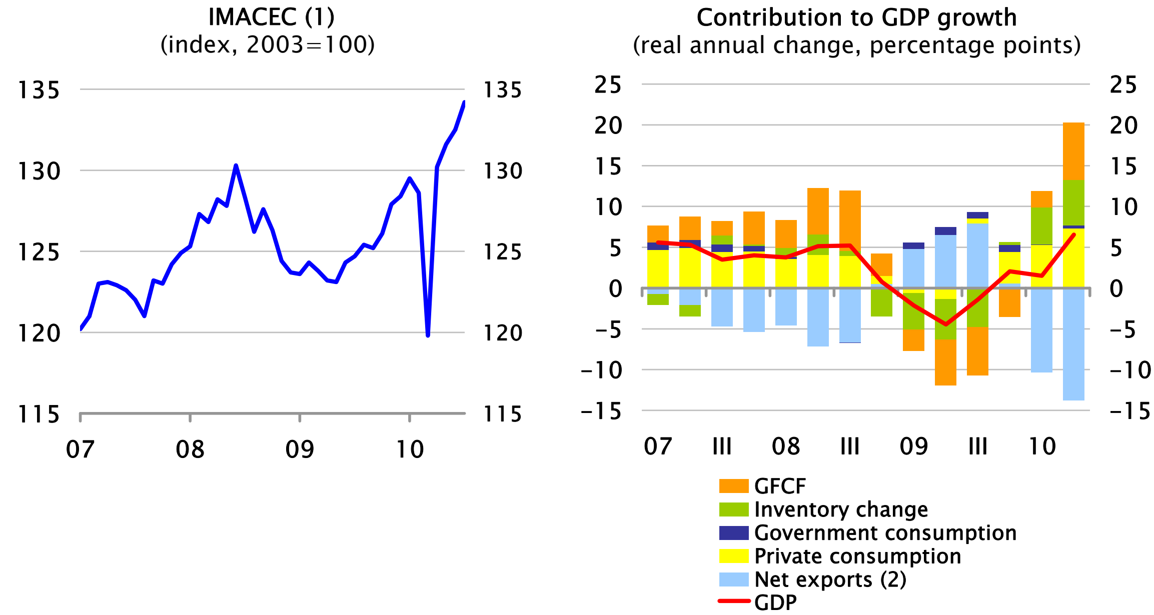



Real interest rate gap: Real MPR minus indicated neutral interest rate
(percent)




Source: Central Bank of Chile.

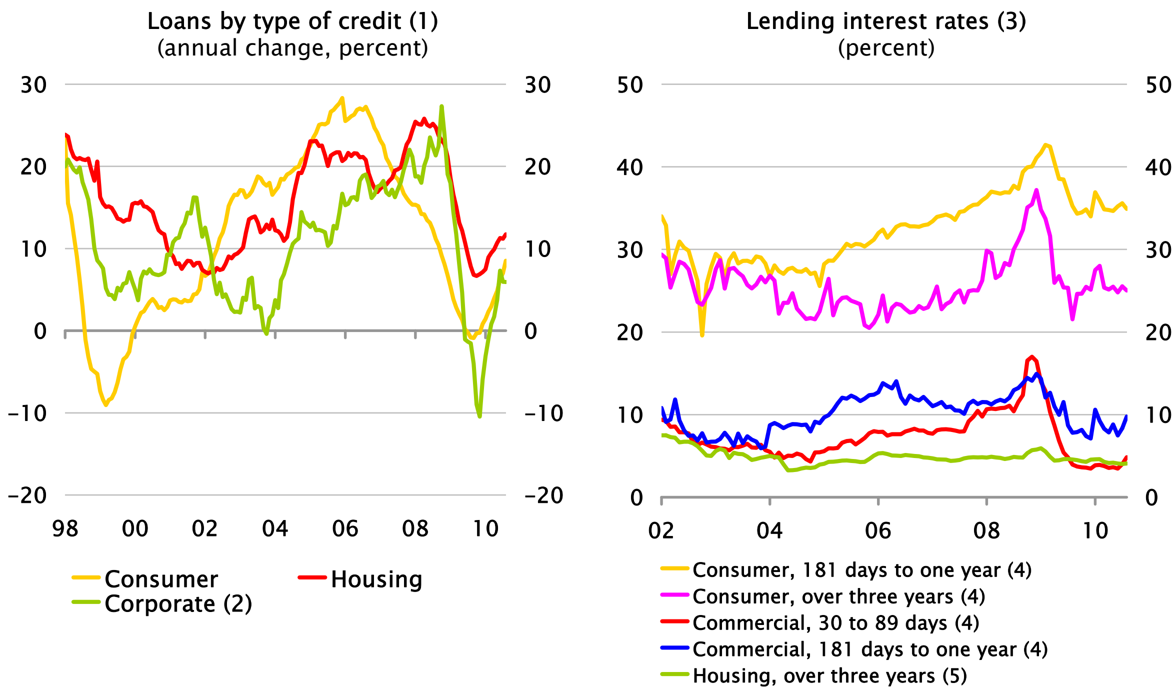
Figure 3




(1) Seasonally-adjusted series.
(2) Goods and services exports minus goods and services imports.

Source: Central Bank of Chile.

Figure 4

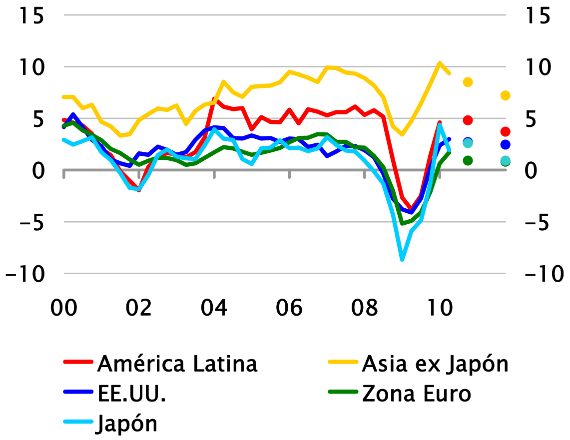



(1) Provisional data for August 2010. (2) Sum of commercial and foreign trade credits. (3) Weighted averaged rates of all operations performed in the month. (4) Non-indexed rates. (5) UF-indexed rates.

Sources: Central Bank of Chile and Superintendence of Banks and Financial Institutions.

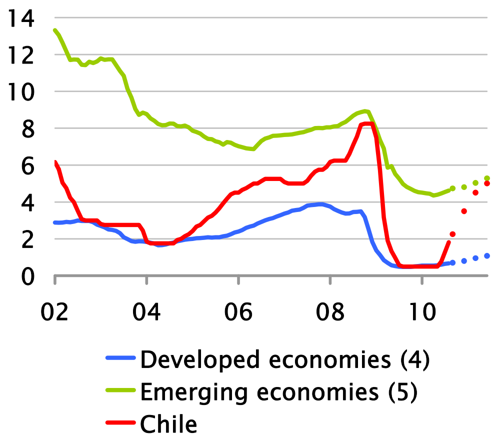
Figure 5

GDP growth in selected regions and countries (1) (2)
(annual change, percent)




Monetary policy rates in the world (3)

(percent)




(1) Regions are weighted by PPP as in WEO, April 2010. (2) Dots show growth forecasts for 2010 and 2011 respectively included in the baseline scenario of September 2010's Report. (3) Solid lines describe simple-averaged reference rates of each group of countries. Dots show averaged responses from analysts surveyed by Bloomberg during August 2010. These reflect expectations for September 2010, December 2010, March 2011 and June 2011. (4) Includes Canada, the Eurozone, Japan, Norway, Sweden, Switzerland, the U.K. and the U.S.. (5) Includes Brazil, Colombia, China, the Czech Republic, Hungary, Mexico, Peru, Poland, South Africa, South Korea and Turkey.

Source: Central Bank of Chile based on statistics institutes of each country, Bloomberg and IMF.

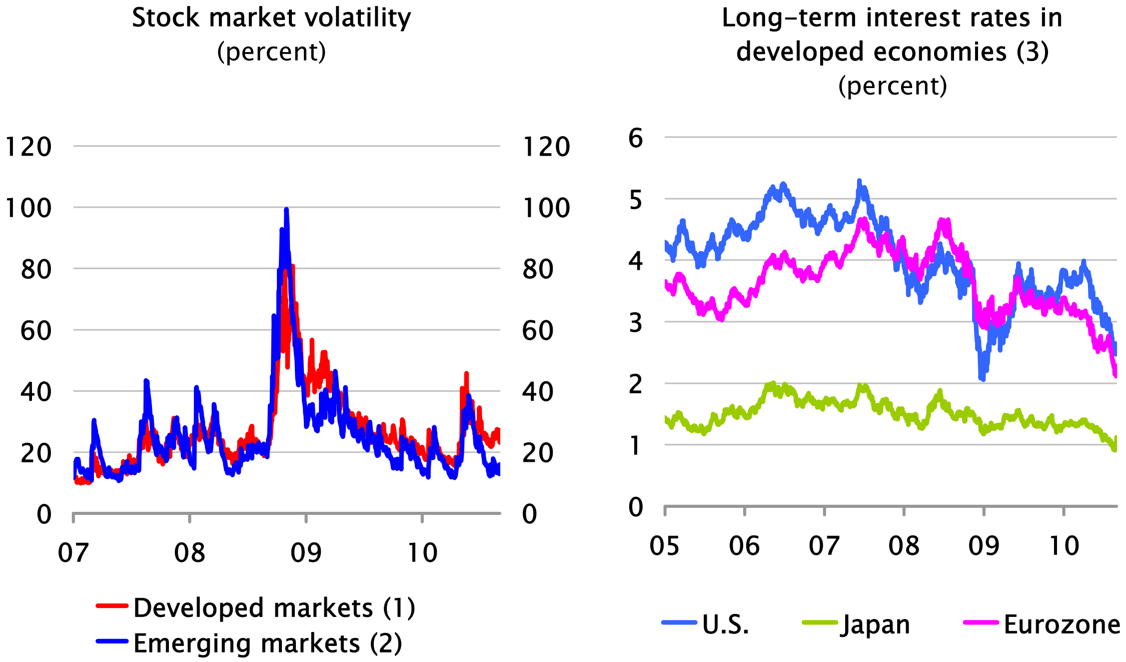
Table 1
**Main international scenario assumptions**
(yearly averages)

| | 2009 | 2010 (f) | | 2011 (f) | | 2012 (f) |
|---|---|---|---|---|---|---|
| | | Jun.10 | Sep.10 | Jun.10 | Sep.10 | Sep.10 |
| World GDP at PPP (annual change, %) | -0,6 | 4,3 | 4,3 | 4,0 | 3,8 | 4,7 |
| World GDP at market exchange rate (annual change, %) | -2,0 | 3,2 | 3,3 | 3,0 | 2,9 | 3,9 |
| Trading partners' GDP (annual change, %) | -0,2 | 4,4 | 4,4 | 3,7 | 3,5 | 4,6 |
| WTI oil price (US$/barril) | 62 | 77 | 77 | 80 | 79 | 82 |
| LME copper price (US$cent/libra) | 234 | 300 | 320 | 270 | 290 | 290 |
| Terms of trade (annual change, %) | 4,1 | 14,3 | 15,0 | -7,2 | -4,3 | 0,5 |
| External prices, in US$ (annual change, %) | -6,2 | 3,4 | 4,6 | 3,3 | 2,3 | 4,7 |

(f) Forecast

Source: Central Bank of Chile.

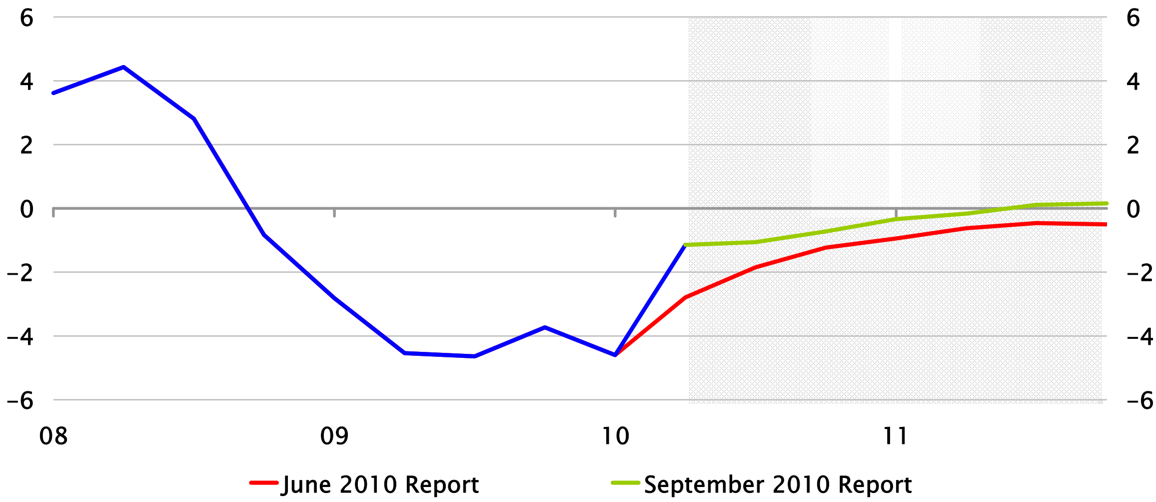
Figure 6




(1) Uses VIX volatility index.
(2) Estimated volatility of the MSCI index in dollars.
(3) 10-year government bond interest rates.

Sources: Bloomberg and Morgan Stanley Capital International.

Figure 7
**Output gaps (*)**
(percent)




(*) Gray area shows forecast as from the third quarter of 2010.

Source: Central Bank of Chile.

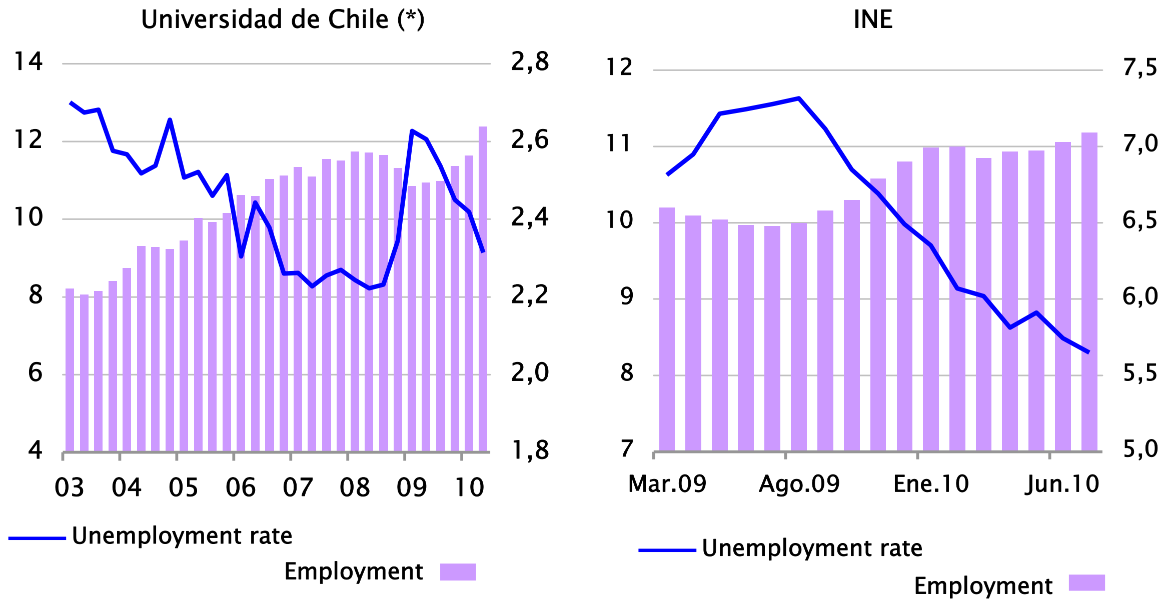
Table 2
**Economic growth and inflation**
(annual change, percent)

| | 2008 | 2009 | 2010 (f) | 2011 (f) | 2012 (f) |
|---|---|---|---|---|---|
| GDP | 3,7 | -1,5 | 5.0-5.5 | 5.5-6.5 | |
| Domestic demand | 7,6 | -5,9 | 16,1 | 6,2 | |
| Domestic demand (w/o inventory change) | 7,5 | -2,8 | 11,3 | 7,4 | |
| Gross fixed capital formation | 18,6 | -15,3 | 21,2 | 13,6 | |
| Total consumption | 4,0 | 1,8 | 8,3 | 5,3 | |
| Goods and services exports | 3,1 | -5,6 | -0,3 | 6,1 | |
| Goods and services imports | 12,2 | -14,3 | 26,3 | 6,4 | |
| Current account (% of GDP) | -1,5 | 2,6 | -1,1 | -2,5 | |
| Average CPI inflation | 8,7 | 1,6 | 1,7 | 3,3 | |
| December CPI inflation | 7,1 | -1,4 | 3,9 | 3,2 | |
| CPI inflation in around 2 years (*) | | | | | 3,0 |
| Average CPIX inflation | 8,4 | 2,8 | 0,8 | 3,6 | |
| December CPIX inflation | 8,6 | -1,8 | 3,5 | 3,5 | |
| CPIX inflation in around 2 years (*) | | | | | 3,1 |
| Average CPIX1 inflation | 7,8 | 2,8 | -0,3 | 3,0 | |
| December CPIX1 inflation | 7,7 | -1,1 | 1,5 | 3,2 | |
| CPIX1 inflation in around 2 years (*) | | | | | 3,0 |

(f) Forecast.
(*) Inflation forecast to the third quarter of 2012.

Source: Central Bank of Chile.

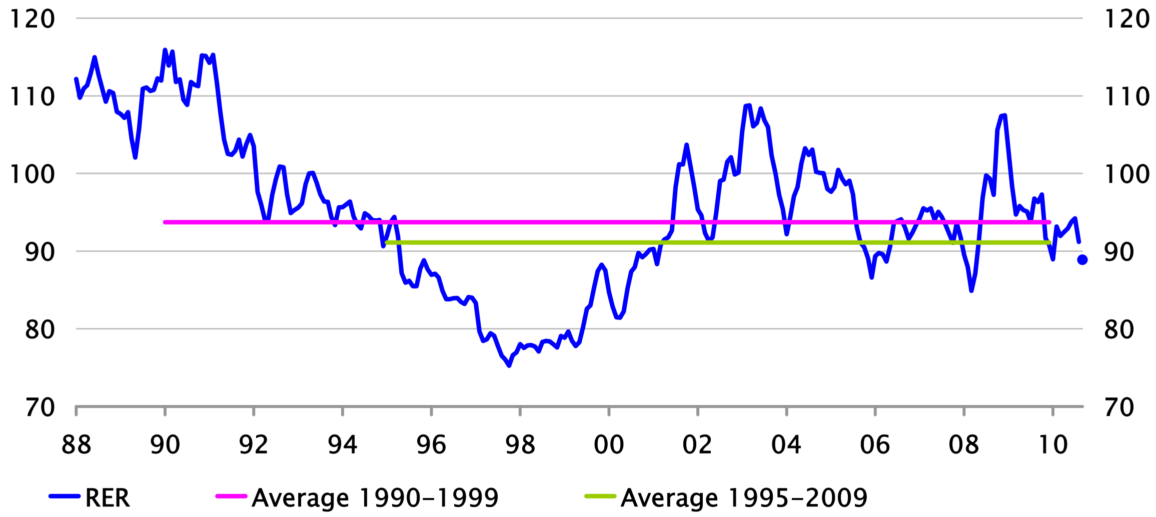
Figure 8
**National employment and unemployment rate**
(percent; millions of persons)




(*) Seasonally-adjusted series.

Sources: Central Bank of Chile, National Statistics Institute (INE) and Universidad de Chile.

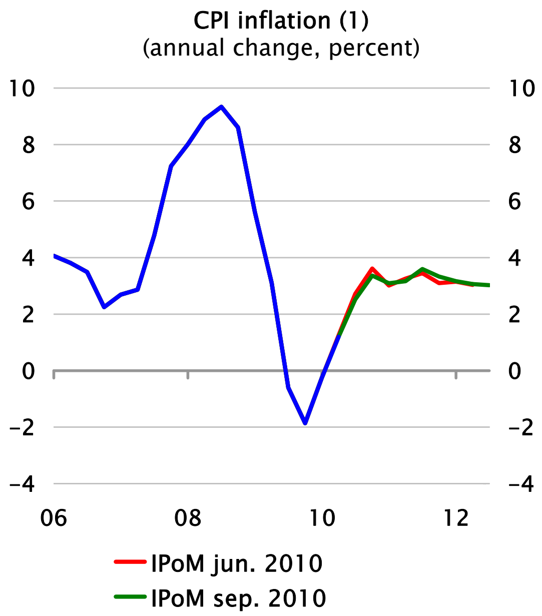
Figure 9
**Real exchange rate (*)**
(index, 1986=100)

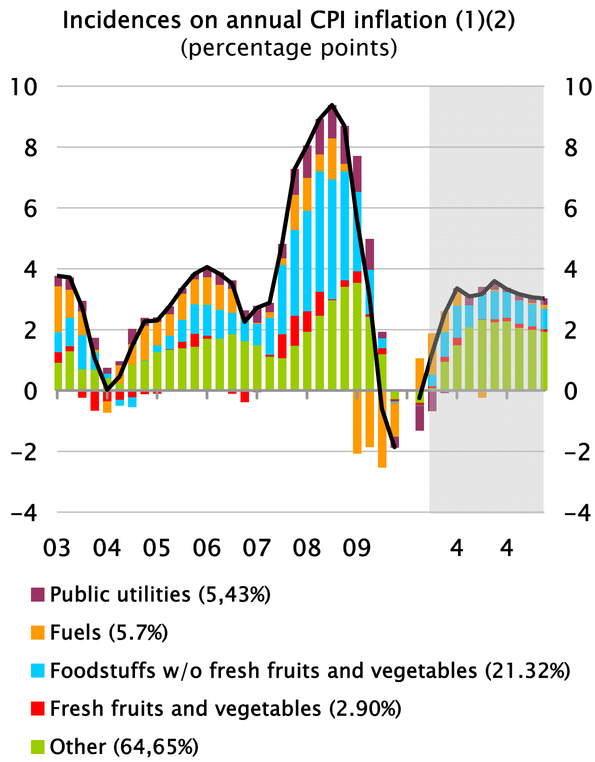



(*) The dot shows the real exchange rate as of 6 September 2010.

Source: Central Bank of Chile.

Figure 10

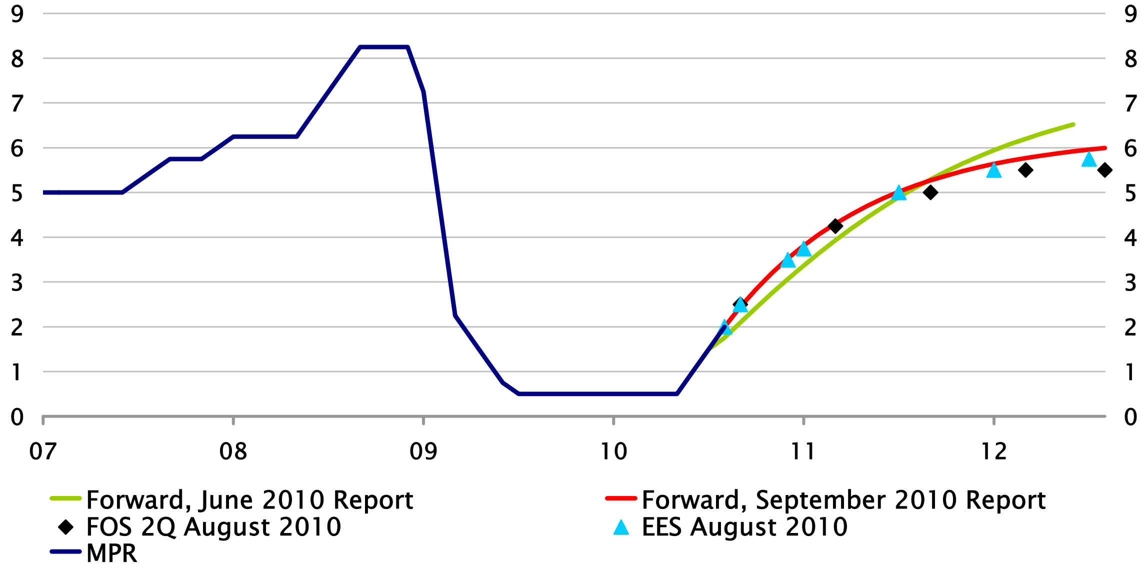



(1) Gray area shows forecasts as from the third quarter of 2010.
(2) In parentheses, shares in the CPI basket with annual base 2009. For the period 2003-2008, weights in the basket of December 1998. For 2009, weights in the basket of December 2008.

Sources: Central Bank of Chile and National Statistics Institute.

Figure 11
Actual and expected MPR
(percent)




Source: Central Bank of Chile.