José De Gregorio: The Central Bank of Chile's financial stability and monetary policy

Speech by Mr José De Gregorio, Governor of the Central Bank of Chile, before the Senate at the presentation of the financial stability and monetary policy report, Valparaíso, 20 December 2010.

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Introduction

Mr. President of the Finance Committee, senator Camilo Escalona, honorable senators,

I am grateful for the Committee's invitation to the Board of the Central Bank of Chile to share our vision on recent macroeconomic and financial developments, their outlook and implications for monetary policy. They make up the content of our *Monetary Policy Report* (IPoM) of December 2010 and our *Financial Stability Report* (IEF) for the second-half 2010.

When we presented our third IPoM of the year last September, we said that expansionary policies applied during 2009 had borne fruit and set the ground for sound growth in the Chilean economy. Today, we see that as a result our country will grow by around 5.2% this year, despite the effects of the earthquake and tsunami of last February. Also, prospects for 2011 are favorable, with projected growth in the range of 5.5 to 6.5%.

Inflation has approached the 3% target, but more gradually than foreseen. In this behavior there have been transitory factors related with the peso appreciation since mid-year. Our projections are consistent with inflation hovering around the 3% target during the next 24 months.

Chile is facing an unusual international scenario. On the one hand, the recovery of developed economies goes on, but only moderately and insufficiently to reduce the high rates of unemployment (figure 1). Risks are substantial. In fact, the intensity and velocity of the events we saw in Europe in early November are proof of the fragility of the world economy. On the other hand, growth prospects in emerging markets are still positive; commodity prices are still high, with copper standing out recently at record highs, and external financing conditions are good. The sustainability of this imbalanced scenario for the global economy is one of the primary risk factors for next year. Some of the questions we must try to answer and monitor closely are: How fast can emerging economies grow if the advanced economies are further weakened? How can advanced economies grow without incurring in unsustainable current-account deficits? How will the financial tensions in Europe be resolved? Is it possible for expenditure in Chile to grow excessively while ignoring the risks coming from abroad?

In this context, the Board has continued to gradually normalize the monetary policy interest rate (MPR), setting it at 3.25% in its December meeting. In the most likely scenario, it will continue to gradually withdraw the monetary stimulus, which will depend on the unfolding of internal and external macroeconomic conditions.

Let me now take a closer look at the scenario we believe is the most likely for the next two years and its implications for inflation and monetary policy.

Macroeconomic scenario

I will begin with the world economy.

After the global recession of 2009, the recovery has been imbalanced between developed and emerging economies. Among developed ones, especially those that encountered problems in their financial systems during the crisis, are growing below trend.

Thus, the main developed economies are still enduring high unemployment rates. Stimulus measures adopted during the recession helped the world economy to begin recovering. But private demand remains weak in the advanced world and inflation, both headline and core, is still contained. Households, banks and governments in the main developed economies are facing a fragile financial situation. Within this context, the process of de-leveraging and restoring the damaged balance sheets will take some time.

Such a scenario has called for additional monetary expansion measures and postponing interest rate normalization in those economies. The dollar has depreciated in global markets (figure 2) while in the U.S., additional fiscal stimulus packages have been adopted and in Europe fiscal adjustment plans are being applied.

In emerging markets, especially in Asia and Latin America, economic activity has been growing strongly, although it is expected to converge to trend levels during 2011. As a response to this and to signs of increased inflation, emerging economies are gradually withdrawing their fiscal and monetary stimulus packages. Differences in the growth outlook, risk perceptions and interest rates have created conditions that favor capital flows towards these economies (figure 3).

Commodity prices remain high by historic standards, consistently with the strength of emerging economies, some specific supply-side elements and the depreciation of the dollar. Worth noting are the recent sharp increases in the international prices of some foodstuffs and the copper price peaking at US$4.2 per pound (figure 4).

The baseline scenario in the IPoM we are presenting today assumes that some of these factors will persist over the projection scenario. In the case of copper, even if it will not be as high as today, it will exceed September's projections, at US$3.3 and US$3.2 per pound in 2011 and 2012, respectively. The price outlook for WTI oil is also revised up from September, to US$89 per barrel in the two years.

The baseline scenario for the international economy is good, albeit with important associated risks. We expect an average growth rate of 4.2% for the world economy over the next two years, fairly high by historic standards, but around 0.3 percentage points below the market consensus forecast. This differential is based on the effects of the financial turbulences in Europe, tighter fiscal adjustment plans in the region and the absence of a vigorous recovery of demand in developed economies. In addition, because of the inflationary pressures present in some emerging economies, it is obvious they cannot continue to grow at the same pace they did this year (table 1).

It is worth noting that the Board of the Central Bank of Chile believes that the risk of an even weaker performance of the world economy is still latent and is more likely to occur than is a more optimistic scenario. A lasting recuperation of the developed world calls for a reduction in the current-account deficits accumulated before the crisis. Some advanced economies like the U.S. must reduce their trade imbalances, but their possibility of basing growth on their external sectors is limited. In the Eurozone, the rigidities associated to the common currency slow the exchange rate adjustment inside the region. In China, high savings and exchange rate interventions lock the parities' adjustments.

At the national level, third-quarter figures for output and demand continued to show strong dynamism, although with some deceleration compared with the first half (figure 5). In that quarter, GDP rose 7% annually, with a velocity of 8.1%. In aggregate, third-quarter output was in line with the baseline scenario we had foreseen in September, but with a different composition both on the output side and on the expenditures side. From the expenditures standpoint, it is worth mentioning the moderation of the durable components of demand – i.e., purchases of durable goods and investment in machinery & equipment – with respect to indicators for the first half. Investment, although at a slower pace than forecast in September, continued to expand during the third quarter, driven by imports of machinery & equipment. Meanwhile, non-durable private consumption outperformed expectations again.

Among the factors underlying the demand trend is the recovery from the crisis and the earthquake, together with the banking credit expansion combined with reduced lending spreads, which is consistent with the flexibilization of lending standards as reported in the Banking Credit Survey to financial institutions undertaken by the Bank.

Therefore, projections are that GDP will grow 5.2% in 2010, while demand will increase 16.1% annually, reflecting that output gaps are narrowing and close to exhaustion (figure 6).

In 2011, domestic demand will continue to drive GDP growth, with a y-o-y increase of 6.6%. Consumption and investment will be dynamic, but not as much as in 2010. This trajectory is based on still optimistic confidence indicators, a positive labor market, ongoing expansionary monetary conditions and a favorable scenario for borrowing (figure 7).

In addition, next year will see a stronger impact of public and private reconstruction works, which should be visible mainly in infrastructure investment, in line with a dynamic construction sector. Accordingly, the investment rate will rise next year, to more than 30% of GDP in real terms. Inventory change, meanwhile, will be smaller than in 2010, due to the completion of the inventory replacement process triggered by depletion in late 2008 and the earthquake last February. In the case of the public sector, the baseline scenario is consistent with provisions in the Budget Law.

Thus, GDP will grow in the 5.5%–6.5% range in 2011, with a smaller contribution of supply-side sectors – i.e., fishing, mining and hydroelectric generation – than foreseen in the latest IPoM, while the other sectors will converge to trend growth as the monetary and external impulses are normalized (table 2).

Prospects for trend growth are similar to September’s, that is, around 5%. In this scenario, which also features improved terms of trade, the current account of the balance of payments will post a surplus of 0.3% of GDP in 2010, contrasting with the deficit forecast in September, owing mainly to better export prices. However, estimations yield that in 2011 the current account will reach a deficit of 1.4% of GDP.

Y-o-y headline inflation has remained in the lower zone of the tolerance range, while the core measure CPIX1 is still in negative territory. This low core inflation has been partly offset by increases in the prices of foodstuffs, both perishable and non-perishable and, most recently, by increased fuel prices (figure 8).

Since last July, there has been a renewed, markedly ascending trend in food prices in the global market. Given the experience of 2008, it has become again cause for concern for policy-makers in some countries. As shown in a box in our IPoM, in Chile a little more than one percentage point of inflation is due to food prices. Until now, the recovery of margins in the aftermath of the crisis has allowed cushioning the local inflationary effects of world price increases. Still, this is an important risk for inflation, particularly because of the potential propagation effects it might cause, and it calls for close monitoring and follow-up.

The CPI will end this year with a variation of 2.8% (table 3). Going forward, the absorption of output gaps and increased food prices suggest that annual inflation will stay near the target until the end of the projection horizon, this time the fourth quarter of 2012. The path of normalization of the CPIX and the CPIX1 will be slower. They are forecast to converge to the target only towards the end of next year, to stay there for the remaining part of the projection horizon. Market inflation expectations, in line with this scenario, remain at 3% in the medium term. However, for the near future reduced inflation figures are foreseen (figure 9).

In addition to the already mentioned assumptions about output gaps and higher prices of foods and commodities, imported inflationary pressures are assumed to be well contained. Also, nominal wages are expected to be adjusted in accordance with the economy’s stage of the business cycle and inflation dynamics.

As I said last Tuesday in my visit to the full Senate, the Chilean peso has been gaining value against the dollar since our latest IPoM, although not as strongly as it did between June and

September. In multilateral terms, the appreciation has also been smaller, because of the dollar's loss in value with respect to other currencies; even some currencies of Chile's trading partners have shown higher bilateral appreciations than the peso (figure 10).

Among the long-lasting elements underlying this appreciation, we may highlight improved terms of trade, a better cyclical position of the Chilean economy compared with developed ones, the accumulated increase in the ratio of public expenditure to GDP and the reduction in our net debtor position relative to the rest of the world.

In Chile, net capital flows have been limited. We have seen capital inflows as direct foreign investment and placement of bonds abroad by Chilean firms. But at the same time, these inflows have been offset by outflows due to higher investments abroad by residents, including pension funds.

Considering the level of the nominal exchange rate and currency parities prevailing at the statistical closing of this IPoM, the real exchange rate (RER) is around its minimum consistent with its long-term fundamentals. The baseline scenario of this IPoM uses as a working assumption that the peso will post a moderate real depreciation into the long-term.

Projections also use the assumption that the monetary stimulus will continue to be gradually withdrawn at a pace comparable to what can be inferred from the various expectations surveys (figure 11). The Board hereby states that this will depend, in any case, on the unfolding of domestic and external macroeconomic conditions.

As is usual, in our diagnosis and assessment of developments of the world and local economy, we identify the risks whose potential consequences on inflation and output warrant special attention. These are also the risk scenarios that we consider when evaluating the resilience of the domestic financial system.

On this occasion, the main concern in the international outlook is global recovery being slower than foreseen in the baseline scenario, thus producing a milder external impulse for the national economy.

One of the reasons tilting the risk balance toward the negative side are constraints facing macroeconomic, fiscal and monetary policies in the main advanced economies to mitigate potentially negative trends in private confidence. These facts could originate in the persistence or intensification of financial turbulences associated to European countries, or in the application of tighter policies in some emerging economies to avoid a resurgence of inflation and/or an overheating of the economy. This entails the risk of the emerging world being unable to sustain world growth. In addition, this would have a negative impact on the prices of commodities, including copper. Barriers to exchange rate adjustments help amplify those effects on world economic activity.

Regarding inflation, the main risks are associated to pressures coming from higher prices of foodstuffs and/or other commodities, which could continue rising globally and be more intensely transmitted to local prices. Also, it may so happen that local demand and output is stronger than projected in 2011, thus creating higher than foreseen inflationary pressures. Finally, labor cost pressures are still latent with tighter conditions in the labor market.

The materialization of these risks would have direct implications on the inflation and growth rates estimated to be the most likely by the Board. Thus, after evaluating all the elements described, the Board believes that the risk balance is unbiased for inflation and downward biased for output.

Although the recent financial turbulences have centered mainly in the peripheral countries of the Eurozone, we cannot rule out that they intensify and spread to other economies, including emerging ones. In this scenario, in addition to the slowdown in growth I just commented, there would be the risk of a sharp change in the supply of external capital that could translate into higher costs or constraints in external financing to Chilean banks and firms. Therefore, in the present context of abundant supply of external funds, it is important to safeguard the resilience that has characterized the Chilean financial system in the past several years, preventing vulnerabilities to be created as a result of asset price misalignment, exchange rate mismatches, excessive short-term borrowing or unsustainable increases in credit taken by firms and households.

So far, none of that has happened. As has been the case since the exchange rate float, and despite greater external credit, firms' mismatches are limited and leveraging is stable. In the case of households, borrowing and financial burdens have remained at 2007 levels. Banks, meanwhile, show low and stable exchange rate mismatches, and have managed to extend the tenor of their external debt. At the same time, our reported stress tests show that the banks' level of capital allows them to absorb a risk episode like the one just described.

On the other hand, the main financial prices have generally proceeded in line with short-term fundamentals. For the stock exchange, the IEF reports results showing some degree of optimism in stock prices with respect to fundamentals. It is necessary to point out that, in the case of Chile, the risks of financial instability from potential price corrections in the stock exchange are low, because the level of debt associated to higher stock prices is small.

However, it is important not to become too indulgent because of the resilience of the financial system. Credit users and financial intermediaries must internalize the risks I have just mentioned in their consumption, investment and financing decisions. On its part, the Central Bank permanently monitors these variables and, through instances such as the Capital Market Committee and the Board of Superintendents, coordinates with other institutions to watch over the health of the national financial system within the framework of its legal authorities. In this context, the Central Bank will not hesitate to perform – or request the relevant institutions – regulatory amendments whenever it detects risks threatening the financial system.

To finish, let me share with you some thoughts.

Final remarks

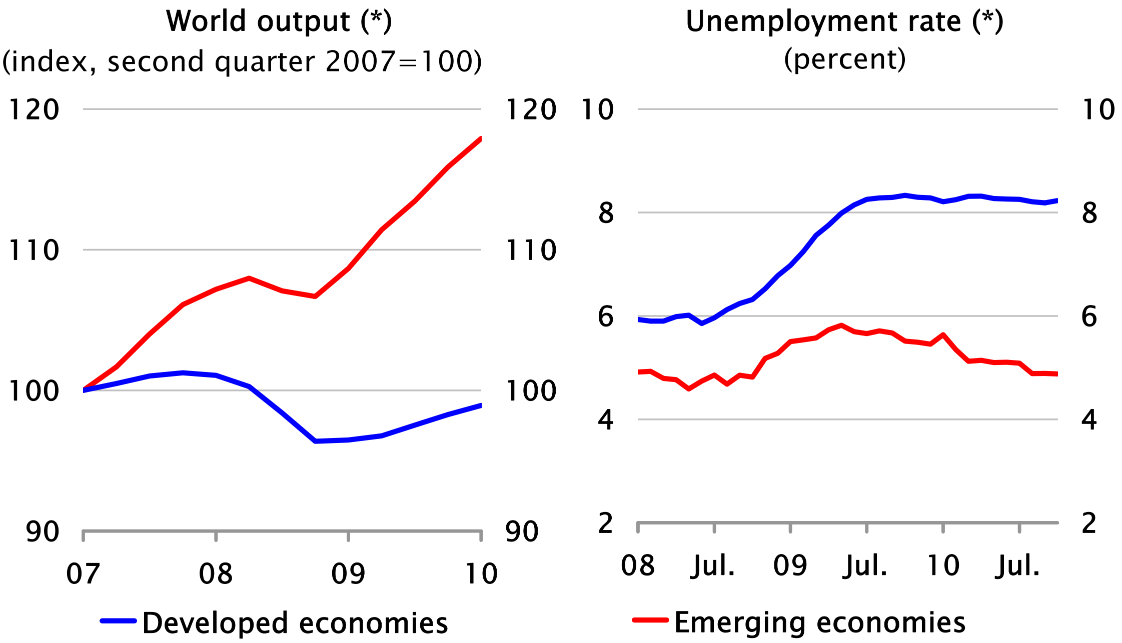
After being hit by the Great Recession that swept through the world in 2008 and 2009, the Chilean economy has picked up strongly. Expansionary policies applied have paid off. Today the challenge is to attain sustainable growth, and, to that end, the Board of the Central Bank of Chile will continue to conduct monetary policy to ensure that inflation stands near 3% over the two-year policy horizon.

Despite the favorable outlook, in the international scenario there are still tensions and it is not totally clear how the global recovery will proceed. The Central Bank will continue to monitor the performance of the world economy to determine its implications on our policy conduct.

Prospects for the Chilean economy in 2011 are good, but, as I just said, not free of risks. We expect our economy to continue along its strong growth trend during the next 24 months, boosting increases in income, employment and welfare of our fellow citizens. Our mandate is to oversee that this process is sustainable in an environment of price stability and financial stability. We will do our best to make it happen, taking every necessary measure.

Thank you.

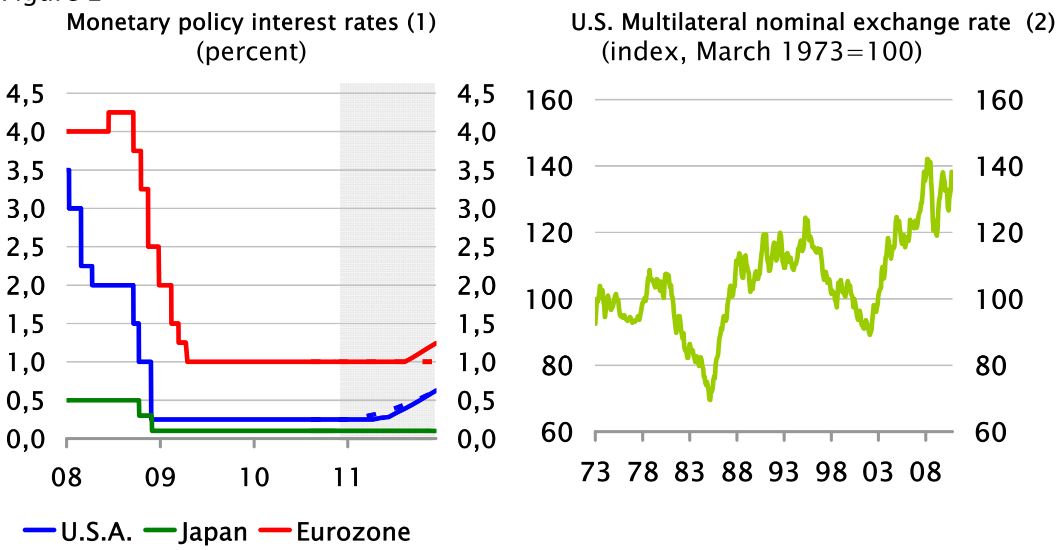
Figure 1



(1) Regions weighted at PPP. Developed economies include: Australia, Canada, the Eurozone, Japan, Sweden, Switzerland, the U.K. and the U.S. Emerging economies includes: Argentina, Brazil, Chile, China, Colombia, Hong Kong, India Indonesia, Israel, Malaysia, Mexico, the Philippines, Saudi Arabia, South Korea, Russia, Singapore, Taiwan, Thailand and Venezuela. (2) Regions weighted at PPP. Developed economies include: Canada, the Eurozone, Japan, the U.K. and the U.S. Emerging economies include: Brazil, Mexico, South Korea, Thailand and Taiwan.

Sources: Central Bank of Chile based on Bloomberg, OECD and each country's statistics offices, and U.S. Federal Reserve.

Figure 2



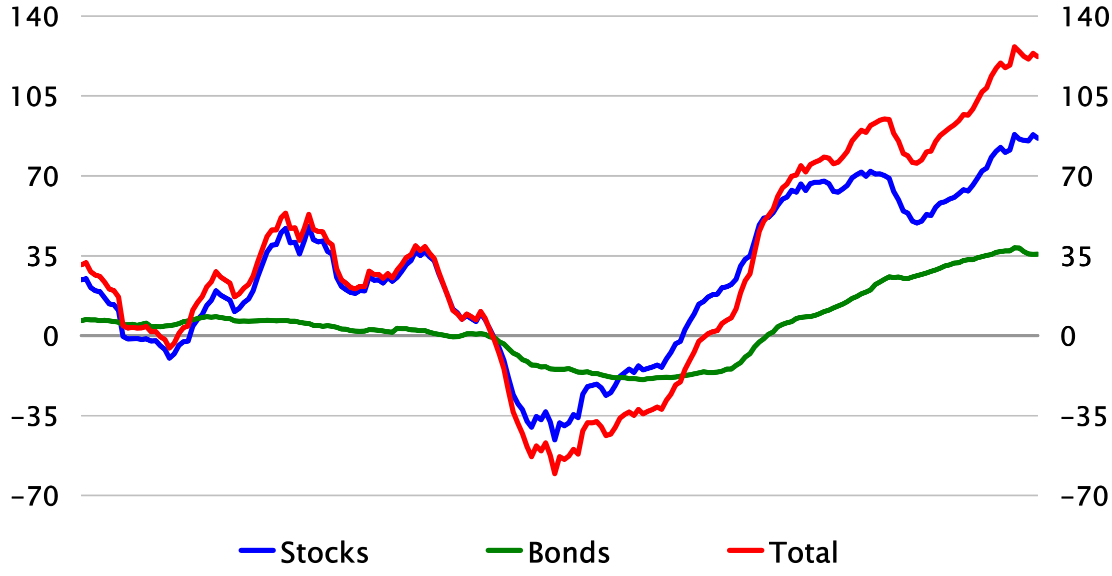
(1) Gray area shows forward curve. Dotted line shows forecasts in September's IPoM.
(2) Increase denotes a depreciation of the dollar against main trading partners. Last figure corresponds to November.

Sources: Bloomberg and U.S. Federal Reserve.

Figure 3

Net investment flows towards emerging economies (*)

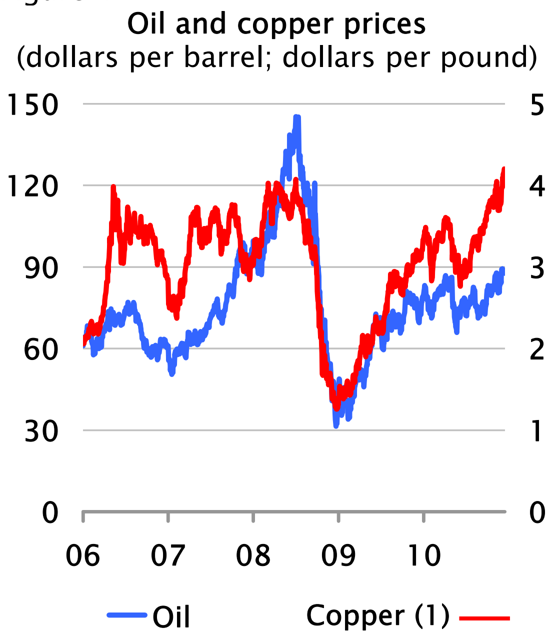
(billions of dollars, accumulated in 12 months)

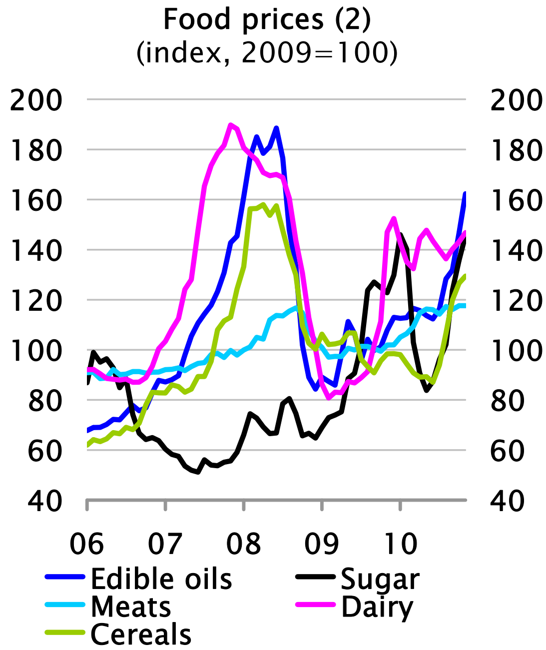


(*) From investment funds investing in emerging economies.

Source: Emerging Portfolio Fund Research.

Figure 4





(1) At the London Metal Exchange.

(2) Based on FAO figures that consider average trading prices in main markets.

Source: Bloomberg.

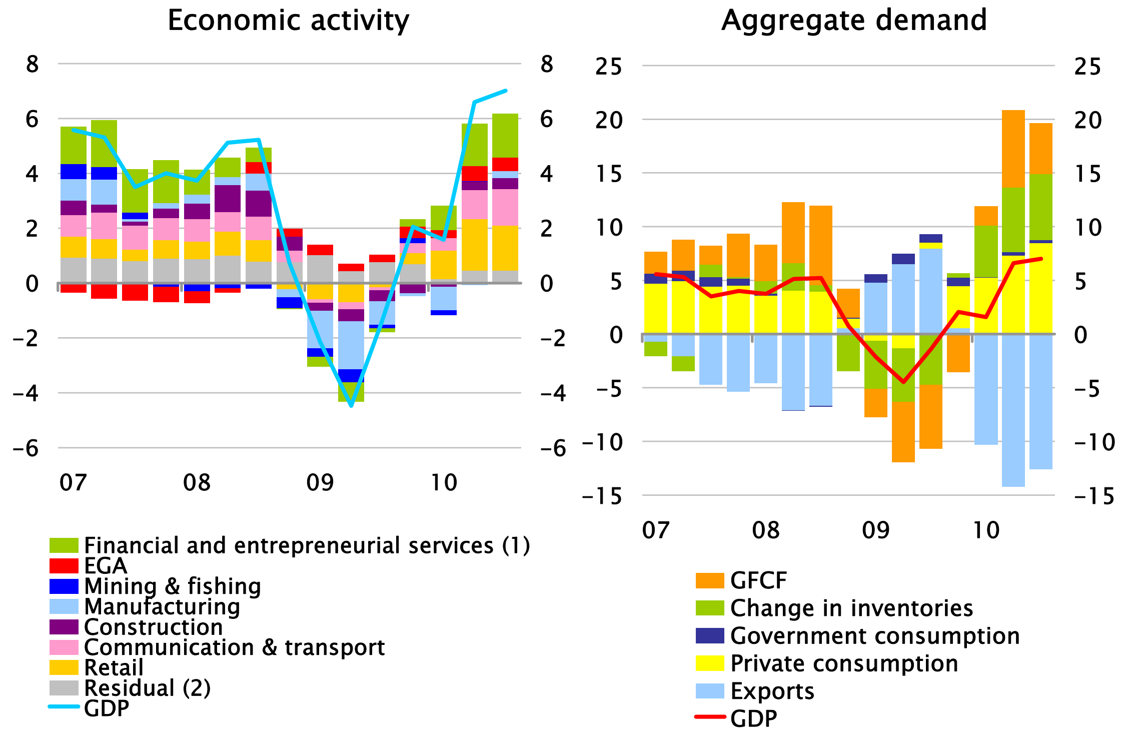
Table 1
World growth and commodities
(annual change, percent)

	Average 90–99	Average 00–07	2009 (e)	2010 (f)	2011 (f)	2012 (f)
World GDP at PPP	2.9	4.2	−0.6	4.9	3.8	4.5
World GDP at mkt exchange rate	2.4	3.2	−2,0	3.7	2.9	3.7
Trading partners	3.1	3.6	−0.2	5.1	3.6	4.2
United States	3.2	2.6	−2.6	2.7	2.3	3.3
Eurozone	2.2	2.1	−4,0	1.6	0.8	1.4
Japan	1.5	1.7	−5.2	3.5	0.8	1.9
China	10,0	10.5	9.1	10.1	8.5	8.8
Asia excl. China, India, and Japan	5.6	5.1	0.1	7.1	4.2	5.1
Latin America (excl. Chile)	2.7	3.6	−2.2	6.0	3.7	4.3
WTI oil price (US$/barrel)	20	44	62	79	89	89
LME copper price (US$cents/lb)	101	156	234	340	330	320

(e) Estimate. (f) Forecast.

Sources: Central Bank of Chile based on investment banks, Consensus Forecasts and International Monetary Fund.

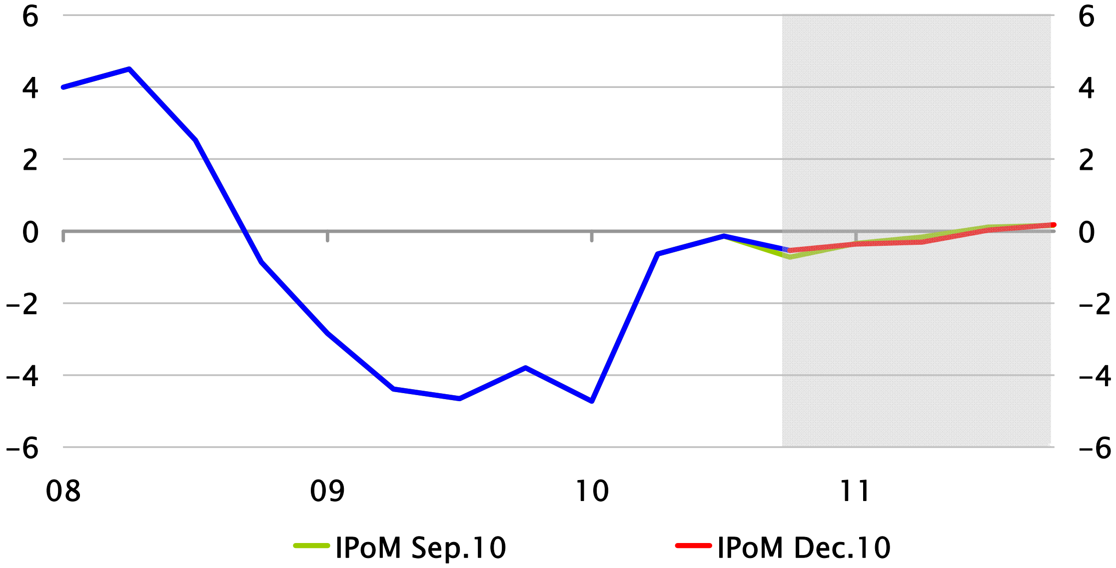
Figure 5
Contribution to annual GDP growth
(variación real anual, puntos porcentuales)



(1) Includes financial services, insurances, housing leases and services provided to firms. (2) Includes agricultural-forestry, housing property, public administration and personal services (i.e., education, health-care and other services). (3) Exports of goods and services minus imports of goods and services.

Source: Central Bank of Chile.

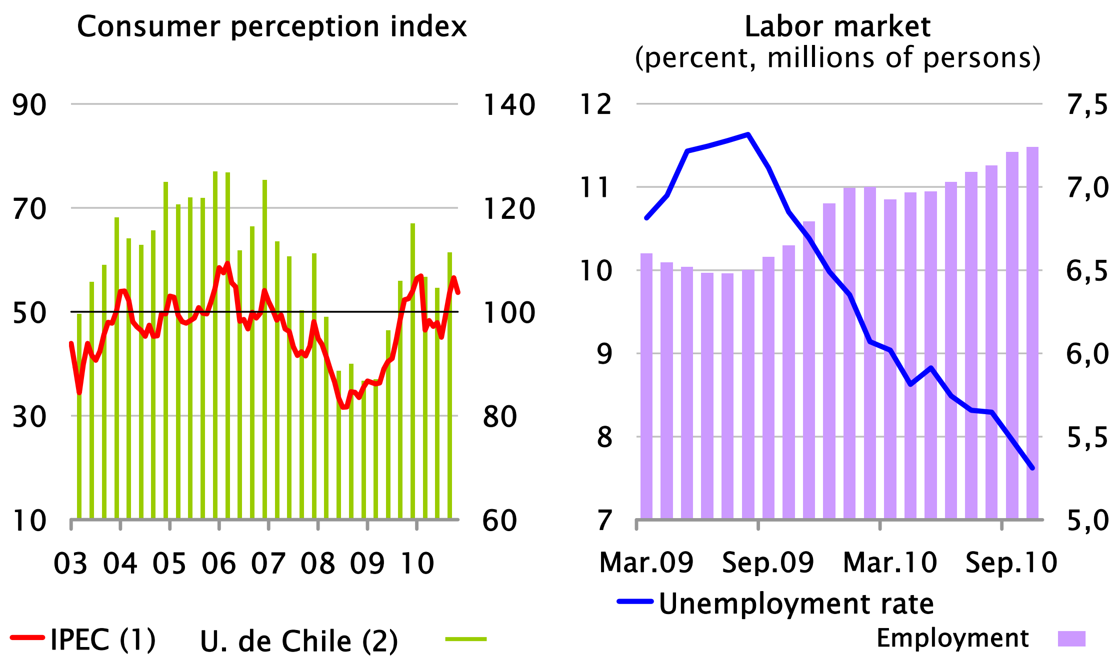
Figure 6
Output gaps (*)
(percent)



(*) Gray area, as from fourth quarter of 2010, indicates forecast.

Source: Central Bank of Chile.

Figure 7



(1) IPEC: value above (below) 50 points indicates optimism (pessimism).
(2) Index, March 2001 = 100.

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

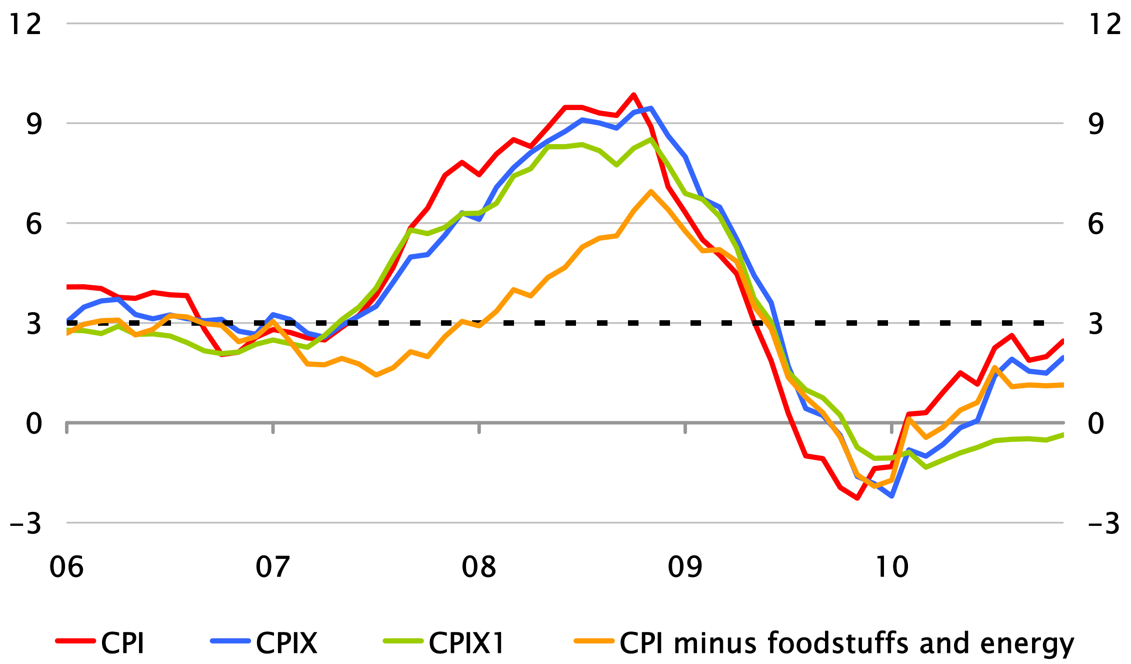
Table 2
Economic growth
(annual change, percent)

	2008	2009	2010 (f)	2011 (f)
GDP	3.7	-1.5	5.2	5.5-6.5
Domestic demand	7.6	-5.9	16.1	6.6
Domestic demand (w/o inventory changes)	7.5	-2.8	11.2	8,0
Gross fixed capital formation	18.6	-15.3	18.9	14.6
Total consumption	4,0	1.8	8.9	5.8
Goods and services exports	3.1	-5.6	1.5	4.9
Goods and services imports	12.2	-14.3	28.5	6.9
Current account (% GDP)	-1.5	2.6	0.3	-1.4

(f) Forecast.

Source: Central Bank of Chile.

Figure 8
Indicadores de inflación
(annual change, percent)



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

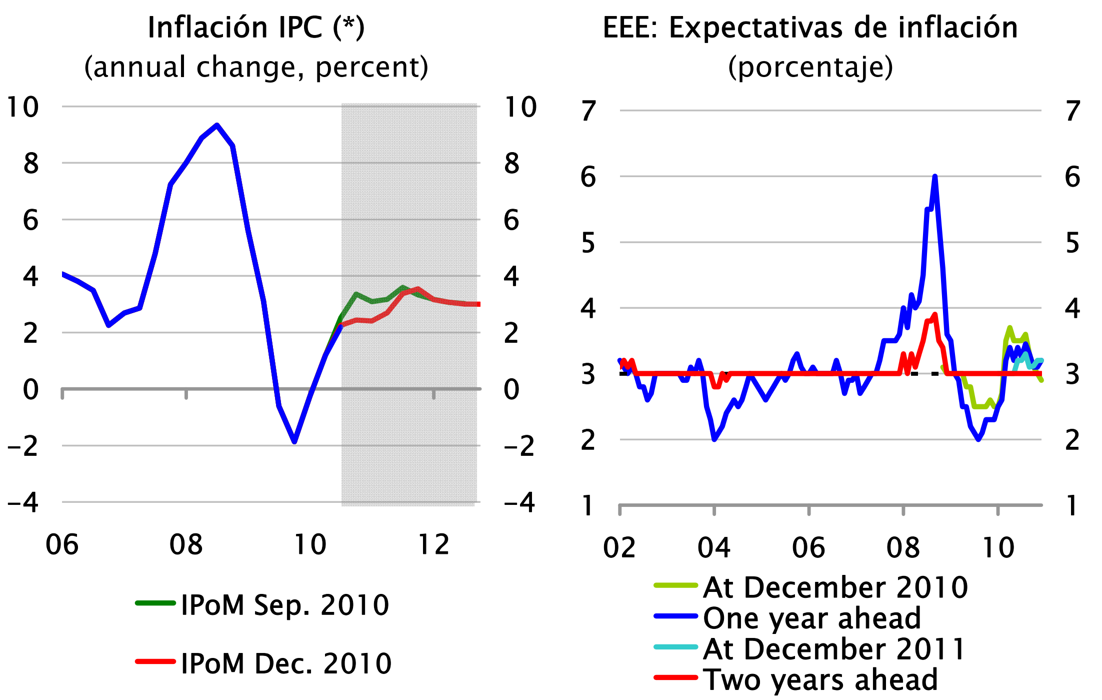
Table 3
Inflation
(annual change, percent)

	2008	2009	2010 (f)	2011 (f)	2012 (f)
Average CPI inflation	8.7	1.6	1.4	3,0	3.0
December CPI inflation	7.1	-1.4	2.8	3.3	
CPI inflation in around 2 years (*)					3.0
Average CPIX inflation	8.4	2.8	0.5	2.7	3.1
December CPIX inflation	8.6	-1.8	2.3	3.1	
CPIX inflation in around 2 years (*)					3.0
Average CPIX1 inflation	7.8	2.8	-0.7	2.0	3.0
December CPIX1 inflation	7.7	-1.1	-0.1	3.0	
CPIX1 inflation in around 2 years (*)					3.0

(f) Forecast.
(*) Inflation projected at fourth quarter of 2012.

Source: Central Bank of Chile.

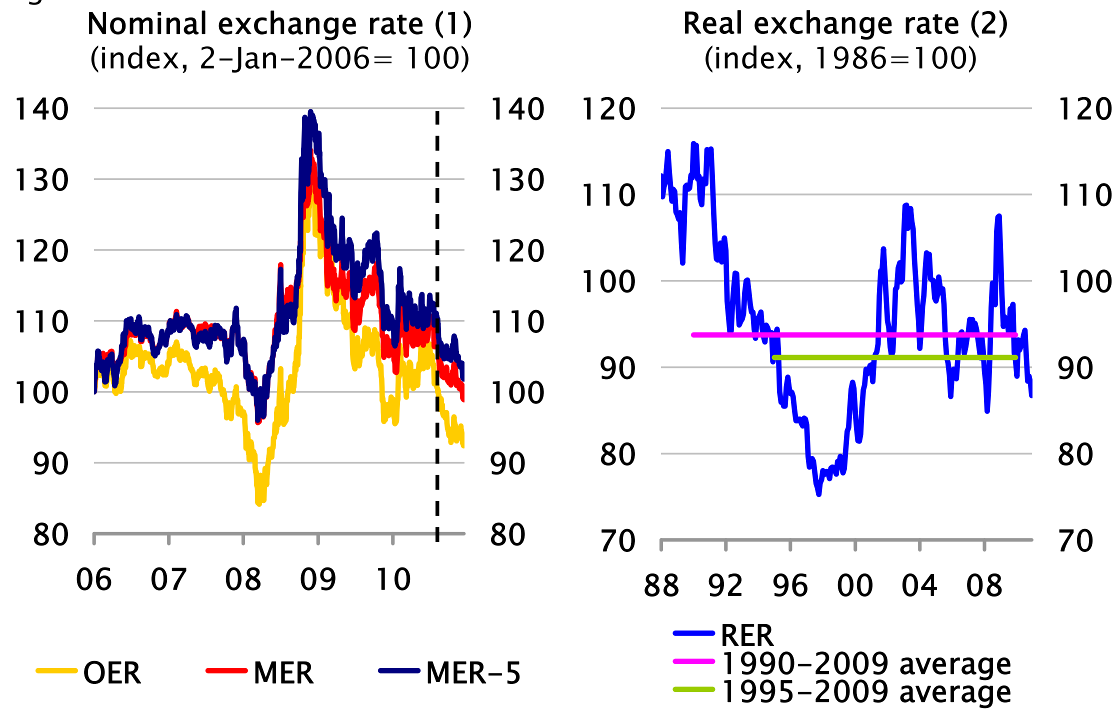
Gráfico 9



(*) Gray area, as from the fourth quarter of 2010, indicates forecast.

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

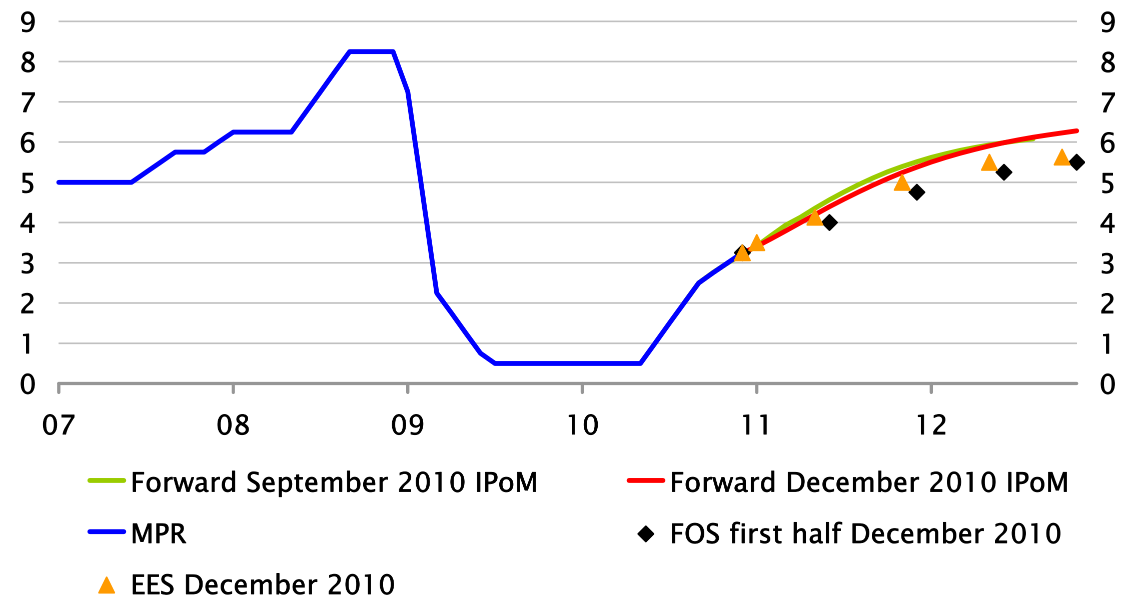
Figure 10



(1) Vertical dashed line marks date of publication of the September 2010 IPoM.
(2) Information at 16 December 2010.

Source: Central Bank of Chile.

Figure 11
MPR and expectations
(percent)



Source: Central Bank of Chile.