Rodrigo Vergara: Chile's latest Monetary Policy Report

Presentation by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, of the Monetary Policy Report before the Finance Commission of the Honorable Senate of the Republic, Santiago de Chile, 3 April 2012.

The Monetary Policy Report of March 2012 can be found at http://www.bcentral.cl.

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Introduction

Mr. President of the Senate's Finance Commission, Senator José García Ruminot, senators members of this Commission, ladies, gentlemen. I am grateful for your invitation to present the vision of the Board of the Central Bank of Chile on recent macroeconomic developments, their prospects and implications for monetary policy making, which is contained in detail in our March 2012 *Monetary Policy Report*.

When we presented our previous Report to this Commission last December, the international financial markets – and, though to a lesser extent, the Chilean market too – were going through significant tension. The outlook for growth in Chile and in the world at large reflected great uncertainty, and there was significant risk of the situation in the Eurozone aggravating and becoming the Lehman Brothers' downfall of September 2008 revisited. We then were emphatic in saying that the Chilean economy was healthy, but that the crisis abroad could end up affecting our growth prospects. We also said that the magnitude of those effects was difficult to estimate. In that context, we lowered the growth range forecast for 2012 and pointed out that, given the international threats facing us, the balance of risks for growth was biased downward. We stated our willingness to take action in order to mitigate the impact of the external scenario on the Chilean economy, having the necessary tools to deal with adverse situations.

Thus, in late December we took exceptional measures to ease the frictions present in the domestic money market and, in January, we preemptively reduced the monetary policy rate (MPR) by 25 basis points. Facing the uncertain external situation, the expectations of most market analysts and brokers anticipated the need for further reductions of the MPR.

With the passing of time, we have seen a somewhat more favorable evolution of the external scenario. In general, confidence has partially returned to global financial markets, expressed in lower risk spreads and higher commodity prices. The outlook for world growth is still weak, even lower than our expectations in December, but the likelihood of a more adverse scenario has decreased.

In Chile, domestic demand and output have outperformed December's projections. Meanwhile, inflation has also exceeded projections and core inflation measures have normalized rapidly. All this has modified the balance of risks for the Chilean economy from December to date. Some months ago, the biggest risk was that a deteriorated external scenario could trigger a sharper deceleration of domestic demand and output and, thus, of inflation too. Today, the medium-term growth and inflation risks are unbiased, although in the short-term there are greater inflation-related risks.

Our monetary policy is based on an inflation target two years ahead, so it requires having an opinion with respect to the most likely evolution of the macroeconomic scenario and associated risks. We are continually on the lookout for news about the local and international economic environments, checking them for consistency with our vision of the most likely or other alternative scenarios. To do so, we need to permanently adapt our vision on the economy and conduct monetary policy with flexibility, being careful not to overreact to one-time news that could trigger excessive pessimism or optimism that occasionally affect the expectations of consumers, businesses or investors in the financial markets. This prudence in our assessment of the state of the economy and related risks is vital for us to properly meet our obligations. At the same time, it is our job to provide grounds for our vision about the macroeconomic scenario and its consequences on the orientation of our monetary policy.

The developments of recent months exemplify this. Many market agents' opinions pointed at the Chilean economy being severely hit by the external situation. However, incoming data have shown us, as I said, that the risks coming from abroad are smaller than we thought before. Also that the domestic economy has continued to grow strongly, which is reflected in our GDP growth range for this year that we have revised upward from December.

The tensions we saw at the end of last year in external financial markets have eased, thanks to a combination of facts. On one hand, the provision of three-year loans by the European Central Bank helped to alleviate banks' liquidity and sovereign debt problems. On the other hand, the second rescue package for Greece and the debt swap with the private sector warded off the possibility of a disorderly outcome there. And somewhat better output and employment indicators for the U.S. have been disclosed. Thus, the markets' volatility decreased, risk and liquidity spreads fell, the dollar depreciated in international markets, while asset prices rose, and so did commodity prices.

All considered, the risks in the external scenario, although more limited, are still significant. The economies of peripheral Europe need substantial funding this year and next. The governments must implement large fiscal adjustments, which in practice may encounter increasing political and social resistance, the same as the financing of new rescue packages in the surplus economies in the region. The economic, social and political costs are paid in the short term and may create tensions, while its fruits can only be reaped in the medium term. Furthermore, the banking system is facing capitalization challenges that may curtail credit to the private sector. Rigidities of exchange rates and wages delay the resolution of competitiveness problems in some economies. All this, aside from shaping a very frail growth scenario in the zone, opens the door to new stress episodes in external financial markets. Although so far the international scenario has not been as negative as was expected, taking for granted that the slower global growth and tensions in external financial markets will not affect our economy is not wise thinking.

Thus, while the inflation trajectory in Chile, the stronger growth in demand and output and changes in certain prices such as oil and fresh fruits & vegetables, have risen the risks for short-term inflation, the risks in the external scenario are still significant.

Let me now describe the macroeconomic scenario assumed in our *Monetary Policy Report*.

Macroeconomic scenario

Relative to December, world growth shows no major change on aggregate, although its composition has changed and, certainly, so have the associated risks. In the United States, improved figures of job creation, manufacturing output and expectations reflect on upward revisions to forecasts for this year, partly offsetting the gloomier outlook for the Eurozone. A somewhat deeper recession is expected in the zone for this year, which, due to its commercial and financial links, reflects, albeit marginally, in revised growth projections elsewhere, especially in emerging Europe and Asia. With respect to December forecasts, trading partners' growth is unchanged for 2012 and 2013.

The baseline scenario also assumes that the oil price will remain high for longer than projected in December. It also raises projections for the copper price to averages of US$3.7 and US$3.6 per pound this year and next. This translates into better terms of trade than previously thought (table 1). Greater appetite for risk has also fostered a resumption of capital inflows to emerging economies. Facing reduced tensions, many emerging economies' central banks have suspended their processes of enhanced monetary stimulus they began in the second half of 2011.

In Chile, the external financial turbulence has had limited impact, and a number of the signs of spill-over that were perceived in late 2011 have reverted, at least partially. Money market frictions have eased. Stock markets and the exchange rate have returned to values from before the resurgence of international financial tensions, although corporate risk premiums are now higher than they were in mid-2011. At the statistical cutoff date of this Report, the peso had appreciated nearly 6% against the dollar, since the closing of December's Report. Considering the current level of the nominal exchange rate and the parities prevailing at the closure of this Report, the real exchange rate (RER) is estimated to be within the range consistent with its long-term fundamentals.

On the other hand, domestic output and demand have grown faster than forecast in December. After losing strength in the third quarter of 2011 – which was the information at hand at the closing of the December Report – output figures of the fourth quarter accelerated. Domestic demand has posted high y-o-y growth rates, yet declining. The same has occurred with consumption, supported by a strong labor market. The unemployment rate is near its fifteen-year low, which also reflects on the evolution of wages. Consumers' expectations have improved in the past few months. On the investment side, the dynamism of engineering works – mainly related to energy and mining projects – and the recent recovery of building are worth signaling out. Other indicators are consistent with a moderation of demand and output, such as the lower y-o-y growth rates of durable consumption and imports. In addition, the slower pace of growth in employment, labor income and consumer loans suggests a deceleration going forward. The Board's evaluation is that output gaps are closed, which is also based on signs of a tight labor market and a rapid normalization of core inflation.

Y-o-y CPI inflation is above the tolerance range, while core measures hover around 3%, growing at a faster pace than in the last quarter of 2011 and forecasts in the December Report. Still, as I just said, the level of core measures is consistent with our assessment of the state of output gaps. The recent inflation trend is also explained by the behavior of transport fares and the prices of fresh fruits & vegetables. The latter, probably affected by climatic conditions, have followed a pattern that contrasts with their usual patterns and have declined in the past few months. Market inflation expectations have risen, particularly for the short term, but are still close to 3% over the policy horizon.

In this Report's baseline scenario we foresee that GDP will grow this year between 4% and 5%. This range is higher than December's, as it responds largely to the faster output growth of late 2011 and early 2012. In addition, a number of the risks that were examined in the last Report have moderated and the dynamic of the domestic demand adjustment will be somewhat more gradual than was envisaged in December. This scenario assumes a stronger impulse from abroad, associated with better terms of trade and external credit conditions. Overall, the occurrence of temporary and limited frictions in international financial markets is a possibility that cannot be ruled out. We also assume that growth will continue to approach its trend levels – which the Board still estimates at 5% – and respond to the lagged effects of the increases made to the MPR in 2011 (table 2).

The baseline scenario foresees a current account deficit in 2012 that is virtually unchanged from the December forecast: 3.4% of GDP, after posting a deficit of 1.3% of GDP in 2011. This enlargement obeys primarily to a bigger deficit of the trade balance, determined mainly by the copper price, which is down from 2011. Furthermore, the oil price has risen from last year. In trend prices, in 2012 the current account would post a deficit of somewhat less than 6% of GDP, not very different from that of 2011.

We foresee y-o-y CPI inflation hovering around 4% well into the second half of this year, to later converge to 3% and remain there until the end of the projection horizon, this time the first quarter of 2014. Y-o-y changes in core measures will continue to rise in the coming months, and will converge to 3% more slowly than the CPI (figure 1).

This foreseen trajectory is based on the assumption that the propagation of supply shocks to other prices will occur according to historic patterns. It also assumes that wages will be adjusted on the bases of productivity and the inflation target, and that the RER will not change much. On the fiscal side, the baseline scenario estimates that the structural deficit will converge to 1% of GDP towards the end of the current Administration, as announced by the authority and in conformity with the Fiscal Responsibility Act. Finally, it uses as a working assumption that the MPR will follow a path comparable to the one that can be derived from the prices of financial assets observed at the statistical cutoff of this Report (figure 2).

The baseline scenario reflects the events that the Board believes to be the most likely to occur with the information at hand at the statistical cutoff date of the Report. However, there are risk scenarios which, if materialized, may alter the macroeconomic outlook, with implications on monetary policy. On this occasion, after assessing the alternative scenarios, the Board estimates that the risk balance for both output and inflation is unbiased.

Although the risks in the international scenario are similar to those in previous Reports, their possibility of occurrence is smaller. Still, structural issues persist in the Eurozone, so the regained confidence in financial markets is yet to be consolidated. Repeated or intensified financial stress episodes, in a context where banks are more cautious in their lending decisions and capital requirements have increased, could deepen credit constraints, complicating the growth outlook for the region and the world at large.

There are also persistent doubts about how China's slowdown will be. If more intense, its effects will not only hinder world growth, but also pull down commodity prices, especially for copper. Conversely, other economies could well perform better than expected, and offset part of these effects.

The calmer external financial markets and the renewed appetite for risk have revived concerns about how to accommodate the new capital flows into emerging economies. Prolonging the strong monetary stimuli in the developed world, particularly in the U.S., may foster an extension of global imbalances. Public indebtedness is elevated in the U.S. and the high oil price hinders the resolution of its external deficit.

Now there is also the worsening of geopolitical tensions surrounding Iran which could significantly affect the oil price, with negative effects on world growth and stronger pressures on inflation.

In Chile, the persistence of strong domestic spending may alter the baseline scenario in two ways. On one hand, it may intensify the inflationary risks now perceived, and increase the propagation of supply-side shocks, like those in oil or fresh fruits & vegetables. It is also possible that the velocity at which core inflation has increased is associated with tighter output gaps than assumed in the baseline scenario. On the other hand, the sustained growth in domestic demand may trigger a widening of the current account deficit and amplify the effects of shocks from abroad on the Chilean economy, especially if accompanied by a falling copper price.

Let me share with you some final thoughts.

Final thoughts

The macroeconomic environment just described has opposing effects, as there are significant risks from different fronts.

As I said, the baseline scenario uses as a working assumption that the MPR will follow a path comparable to the one that can be derived from the prices of financial assets observed at the statistical cutoff of this Report. Any deviations away from this trajectory will depend on the implications of domestic and external macroeconomic developments on the inflation outlook. As I also said at the beginning, while risks for short-term inflation have increased, the risks from abroad are still important and may cause significant damage to the Chilean economy.

Accordingly, the complexity of the present scenario calls for particularly prudent monetary policy making.

On the side of domestic output, the projections we are now presenting show stronger growth, mainly because recently output and demand have risen above December's forecasts. On the prices side, our evaluation points at a higher level of inflation, especially in the short run. Our view that output gaps are closed implies that economic growth should converge to its trend in order not to cause imbalances that end up being very costly. Experience has taught us how damaging an increase in inflation can be, particularly to the poorer population. It has also taught us the importance of expenditure not growing excessively, in order to avoid imbalances in the external accounts that erode our capacity to deal with shocks of different kinds. This is especially true at this moment, when we are confronting these risks of the domestic economy with doubts about how warranted this better mood of external markets is. The situation of developed economies is very complex, and teaches a great lesson in how phenomena that are overlooked and not addressed on time may end up taking a massive toll on the people.

For all this, I want to stress the importance of proper management of the expectations about the behavior of our economy and, of course, of our monetary policy. Prudent monetary policy conduct means being prepared for any scenario, assessing them carefully, and adjusting policy as required. Let me reiterate the commitment of the Board of the Central Bank of Chile with a monetary policy oriented at keeping inflation low and stable. This is certainly the best contribution we can make to the prosperity of our country.

Thank you.

Table 1
International baseline scenario assumptions

	2010	2011 (e)	2012 (f) Sep.11 Report	2012 (f) Dec.11 Report	2012 (f) Mar.12 Report	2013 (f) Sep.11 Report	2013 (f) Dec.11 Report	2013 (f) Mar.12 Report
			(annual change, percent)					
Terms of trade (*)	19.4	0.5	-5.3	-6.7	-5.3	-2.6	-3.5	-0.1
Trading partners	6.1	4.1	4.3	3.8	3.8	4.6	4.2	4.2
World at PPP	5.1	3.7	4.0	3.5	3.3	4.5	4.1	3.9
United States	3.0	1.7	2.0	1.8	2.1	2.8	2.2	2.3
Eurozone	1.9	1.4	1.2	-0.1	-0.3	2.1	1.0	1.0
China	10.4	9.2	8.3	8.2	8.1	8.7	8.5	8.5
Rest of Asia	7.7	4.3	4.5	4.4	4.3	5.0	4.8	4.8
Latin America (excl. Chile)	6.3	4.2	3.9	3.6	3.6	4.2	4.0	4.0
			(levels)					
LME copper price (US$cent/lb)	342	400	370	350	370	350	340	360
Brent oil price (US$/barrel)	80	111	108	107	121	106	102	115

(e) Estimate. (f) Forecast.
(*) September and December forecasts were done with national accounts with 2003 as the base year. Figures for 2010 and 2011 as well as the March forecast, with the national accounts with 2008 as the base year, using chained indexes.

Sources: Central Bank of Chile based on a sample of investment banks, Consensus Forecasts, the IMF and statistics bureaus of respective country or region.

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

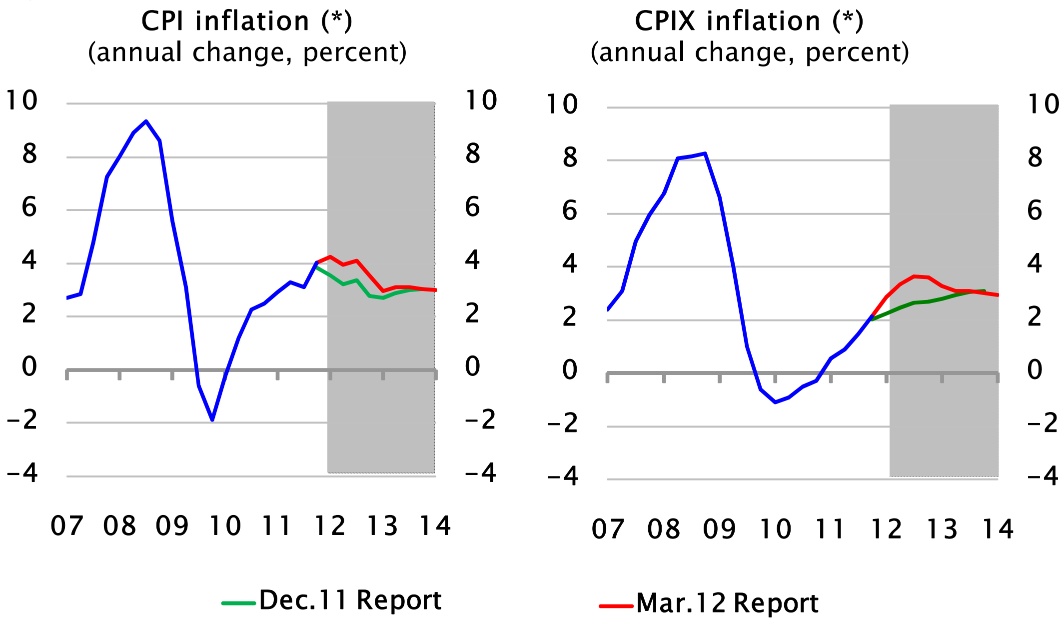
	2012 (f) Sep.11 Report	2012 (f) Dec.11 Report	2012 (f) Mar.12 Report	2013 (f) Sep.11 Report	2013 (f) Dec.11 Report	2013 (f) Mar.12 Report
GDP	6.25-6.75	6.2	6.0	4.25-5.25	3.75-4.75	4.0-5.0
Domestic demand	9.1	9.5	9.4	4.5	3.7	5.3
Domestic demand (w/o inventory change)	9.7	10.2	10.3	5.4	4.8	5.8
Gross fixed capital formation	14.4	16.9	17.6	7.1	5.8	8.9
Total consumption	8.2	8.1	7.9	4.9	4.5	4.8
Goods and services exports	6.5	7.4	4.6	5.0	3.7	3.8
Goods and services imports	12.0	14.3	14.4	4.6	3.0	5.9
Current account (% of GDP)	-1.0	-1.5	-1.3	-2.1	-3.3	-3.4

(f) Forecast.

(*) September and December forecasts were done with national accounts with 2003 as the base year. Figures for 2010 and 2011 as well as the March forecast, with the national accounts with 2008 as the base year, using chained indexes.

Source: Central Bank of Chile.

Figure 1



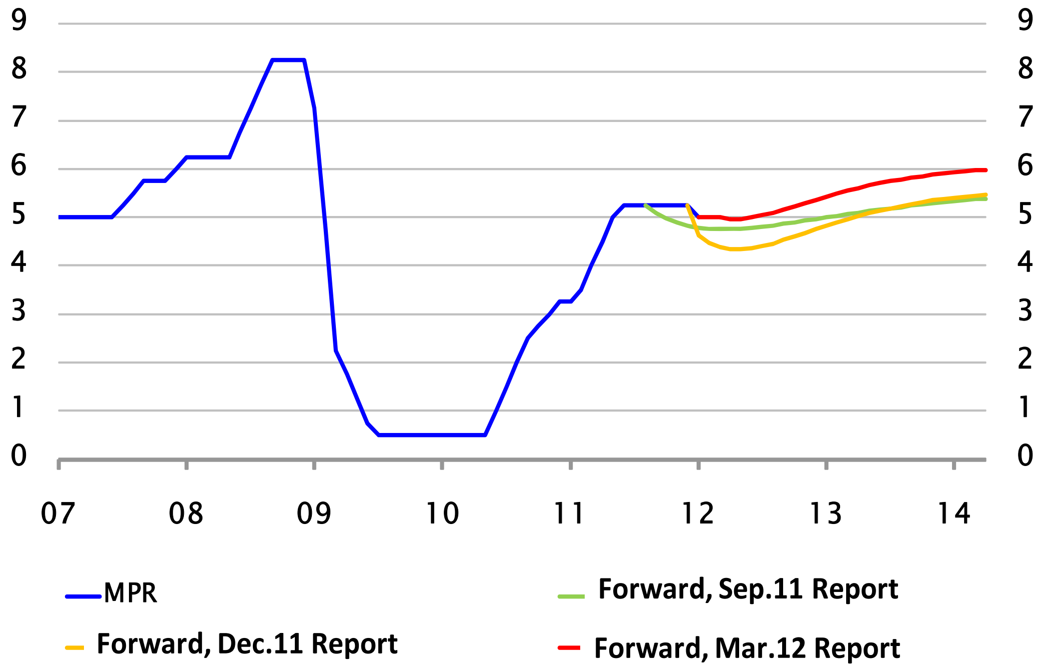
(*) Gray area, as from the first quarter of 2012, shows forecast.

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

Figure 2

MPR and expectations

(percent)



Source: Central Bank of Chile.