Rodrigo Vergara: Chile's latest Monetary Policy Report and Financial Stability Report

Presentation by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, of the Monetary Policy Report and the Financial Stability Report, before the Finance Commission of the Honorable Senate of the Republic, Santiago de Chile, 18 June 2012.

The Monetary Policy Report of June 2012 and the Financial Stability Report of the first half of 2012 can be found at http://www.bcentral.cl/eng/index.asp

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Introduction

Mr. President of the Finance Commission of the Senate, Senator José García, senators members of this Commission, ladies, gentlemen.

I am grateful for your invitation to the Board of the Central Bank of Chile to share our views on recent macroeconomic and financial developments, prospects and implications for monetary and financial policy making. These views are contained in detail in our *Monetary Policy Report* of June 2012 and our *Financial Stability Report* of the first half of 2012.

For several quarters now the world economy has been suffering constant swings. We have said time and again that the causes and consequences of the financial crisis of 2008 are yet to be resolved. Thanks to a combination of economic policy responses and its healthy economies and financial systems, the emerging world succeeded in mitigating its effects and resuming a growth trajectory. But the developed world, especially the Eurozone, has been unable to regain its strength. We have seen continuing tensions in world financial markets, doubts over the future behavior of the global economy, together with risks appearing, disappearing and reappearing again. As time has passed, with no evident signs of improvement in these economies' outlook, problems have been exacerbated. Weak growth and the need for households, firms, banks and governments to reduce their debts, have created a vicious circle that hampers the solution to the macroeconomic and financial problems facing the advanced economies.

Certainly, the case of the United States is different from the case of the Eurozone, because their institutions and the way they solve their internal imbalances are different. In the Eurozone, the situation of some economies is hardly sustainable. However, there are differences. While the economic block as a whole has a practically balanced current account, it varies from one country to the next. Germany has kept excess savings for several years, which has resulted in a current account surplus, while many peripheral countries post a deficit (figure i). Exchange rate and wage rigidities do not help resolve the imbalances within the region. Overall, in the past few quarters part of the necessary adjustments have been taking place. Germany has increased imports from peripheral Europe, and has cut down its exports to the same countries. Solving the imbalances of the Eurozone will take time and it will not be easy. Any solution will be costly, without a doubt.

The events of recent weeks have confirmed that the crisis is far from over and that imbalances persist in the developed world that keep financial markets under stress. The reappearance of risks and the tensions we have seen are a reflection of that, and have deepened the differences between the behavior of the world economy and our own (table 1).

Thus, today we are again facing significant risks. After some improvement in the first quarter of the year, conditions in the Eurozone relapsed and their financial markets have experienced tensions in the levels of last December or worse. The baseline scenario of our March *Monetary Policy Report* assumed that temporary, limited frictions would occur, although it warned about existing risks. In recent months those risks have resurfaced. There is new debate about a possible disorderly resolution of the Eurozone crisis. Several economies are questioning the political support to the fiscal austerity measures. Economic and financial conditions in Spain have worsened further and its risk premium is in record highs, despite the announced capitalization of its banking industry. In addition, there are still doubts whether other countries will be needing similar action.

Financial markets respond with increased risk premiums and greater appetite for safer assets. Stock prices are falling across the board, volatility is up, the dollar has appreciated again and the interest rates of government bonds from economies perceived as safe have dropped to record lows. At the same time, commodity prices have fallen sharply, especially oil. As in late 2011, the main effects of these tensions in emerging economies, aside from lower commodity prices, have been the depreciation of their currencies, fallen stock prices and increased risk premiums on their external bonds. Chile has not been spared, although as of the statistical closing of these *Reports* the effects have been limited. Compared with March, the peso/dollar parity has depreciated somewhat below 5 percent; the stock market, as measured by the selected price index IPSA in pesos, has lost over 7 percent, and the sovereign premiums of Chilean CDS have risen nearly 40 basis points. Money markets, meanwhile, have operated normally.

In contrast with the developed world, in Chile domestic output and demand are still strong. In the first quarter, y-o-y GDP growth exceeded March's forecasts. However, in quarter-to-quarter terms it lost strength with respect to late 2011 and grew according to trend. Inflation has been lower than expected, which, combined with the drop in international fuel prices, has reduced the risks for its short-term evolution. In general, medium-term inflationary risks are still latent because domestic markets remain tight.

In this context, the Board has kept the monetary policy interest rate (MPR) at 5 percent since January, and has conditioned its future movements to the implications of domestic and external conditions on the inflation outlook.

Chile is on a healthy position to confront further deterioration of the global scenario. We have built economic institutions that allow us to reach substantial levels of growth, and the necessary tools to mitigate any adverse shocks facing our economy. But we are not immune. In the globalized world of today, any change in conditions is rapidly propagated to other economies. The movements in financial markets that I mentioned a while ago are proof of this. Trying to isolate ourselves from the rest of the world would be not only useless, but harmful in the long run. The important thing is for us to have the capacity to shield ourselves from negative events and, when necessary, to take action to reduce their effects on our country. We already did so when the Lehman Brothers crisis hit in 2008. We couldn't prevent the global recession from affecting our economy, but we did succeed in fostering a fast, sustainable recovery from 2009 onwards.

In any case, our domestic macroeconomic situation has varied in these four years. Today, inflation is at 3 percent, GDP is growing at near-trend rates and the MPR is in a neutral range. This provides room to respond with monetary policy if necessary, although the timing and magnitude of the measures will have to be evaluated with special prudence and in light of the actual effects of external developments on our economy. Our financial system, meanwhile, has been solid and resilient to sudden changes in the international economy. The Board of the Central Bank is firmly determined to adopt any measures needed to mitigate the adverse effects of a worsened external scenario, but it also must be careful not to allow medium-term inflationary risks to end up triggering an unwanted increase in inflation.

In the baseline scenario that we believe to be the most likely, the world economy will remain weak and will give us less impulse than we expected a few months ago. Although the Chilean economy will be affected, it will continue to perform well. Inflation will stay around 3 percent. But the external risks facing said baseline scenario are significant. Let me now look into this setting in more detail, examining the risks we have identified in our *Monetary Policy Report* and our *Financial Stability Report*.

Macroeconomic scenario

As I just said, the external impulse on the Chilean economy in the next two years will be weaker than forecast in March. The poor performance of the developed world – for several quarters already – is being compounded with early signs of weakness in emerging economies, thus exacerbating the risks coming from abroad.

I want to begin by the developed world. In the Eurozone, the new financial tensions have tightened credit constraints, while ongoing fiscal measures will not contribute to boost growth in the near term. The recession foreseen for the region this year will be deeper than previously estimated.

The other developed economies will grow slowly. The U.S. will fall short of March forecasts, due to the slow recovery of its labor market, a real-estate sector that is still unable to leave the subprime crisis behind, a household deleveraging process that continues its course, and little additional room to apply any measures to boost growth.

But, compared to March, the biggest difference in terms of world growth lies in the emerging world. In contrast with 2011, the main emerging economies have lost dynamism. Some indicators for China suggest that the decline in its growth rate will be sharper than forecast in March. This has prompted the adoption of more expansionary fiscal and monetary policies, and India has followed suit. The rest of emerging Asia is feeling the effects of lower growth in China, the U.S. and Europe in its exports and its manufacturing industry. In Latin America, although there is more heterogeneity, the poor performance of Brazil in the first quarter stands out. Other economies, like Mexico, Peru, Colombia and Chile remain strong, sustained by their domestic demands. This world scenario of weaker economies and reduced inflationary pressures due to the lower oil price has triggered a relaxation of monetary policies of several emerging economies.

The baseline scenario forecasts that Chile's trading partners will grow 3.6 and 3.9 percent in 2012 and 2013, respectively, a little less than was foreseen in the previous *Monetary Policy Report*. This will also result in lower prices for copper and oil than were expected in March. In summary, the baseline scenario considers a reduced external impulse associated to slower world growth and somewhat tightened external financing conditions. It also considers that new stress episodes will occur in external financial markets (table 2). As has been observed in recent months, these events can be triggered by negative news coming from the fiscal accounts, economic growth and the banking situation in the Eurozone.

The feeble external outlook contrasts with the performance of Chile's domestic demand and output in the last few quarters. In the first quarter of this year, GDP grew 5.6 percent, exceeding forecasts in the March *Monetary Policy Report*. In quarter-on-quarter terms, it expanded at trend rates, leading the Board to estimate that output gaps are still narrow. This view is based on the fact that, although the labor market continues to show signs of being tight, these signs have not intensified: employment has reduced its rate of expansion, the unemployment rate has settled at low levels and y-o-y growth in wages, while still strong, has moderated lately. In the first quarter, domestic demand grew somewhat less than output, but private consumption and investment are still robust.

Inflation has behaved favorably in the past few months, below March's forecasts. This, combined with oil prices falling in external markets, has reduced the risks that were envisioned then for its short-term trajectory. Still, the services component of inflation continues to be the largest contributor to its increase, so medium-term risks remain present, due to the closing of output gaps and the tight labor market (figure 2). Market inflation expectations have moderated for the short term and remain around 3 percent over the projection horizon.

The baseline scenario foresees GDP growing this year between 4 and 5 percent, which is the same range forecast in March. Although the economy outgrew forecasts in the first quarter, the worsened external conditions will result in output slowing down more deeply than forecast in March. Still, GDP growth will not drift substantially away from the trend, which the Board estimates at 5 percent.

This projection also considers that y-o-y growth in consumption will moderate further, in line with decelerating labor income and less expansionary lending conditions than some months ago. Interest rates on consumer loans have risen lately, coinciding with a decline in the y-o-y growth of these credits. In addition, the Survey on Lending Conditions of the first quarter revealed greater constraints in the supply of consumer loans by some financial institutions. Demand for consumer loans continued to rise, according to this survey.

For investment, the more persistent construction and infrastructure component – largely associated to the execution of mining and energy projects – suggests that it will remain strong in the coming quarters. Accordingly, measured in real terms, it will amount to 26.9 percent of GDP in 2012, up from 26.2 percent of GDP in 2011.

The effects of the worsened external scenario will be visible mainly in inventories. The baseline scenario estimates that in 2012 inventories as a percentage of GDP will vary less than they did in 2011, reflecting the inventory adjustments that enterprises will be carrying out because of the uncertainty coming from abroad. Consumption and investment will also be partly affected by the worsened global conditions, but the main determinants will be the aforesaid factors. All these elements combined depict a scenario for 2012 where domestic demand grows less than in 2011, although still faster than output.

The baseline scenario foresees the current account of the balance of payments posting a deficit of 3.1 percent of GDP this year, that is, bigger than in 2011, but somewhat smaller than forecast in March. Despite the lower price assumed for copper and the weak domestic demand, the expected adjustment in domestic demand plus the drop in the oil price are behind this smaller deficit (table 3).

The Board estimates that y-o-y CPI and core inflation will continue to hover around the target until the end of the projection horizon, this time the second quarter of 2014 (figure 3). This trajectory assumes that wages will be adjusted to reflect productivity and the inflation target. As a working assumption, the real exchange rate is assumed to remain fairly unchanged, because it is estimated to be now within the range believed to be consistent with its long-term fundamentals. Finally, the baseline scenario also uses as a working assumption that, over the short term, the MPR will be stable.

The baseline scenario reflects those events that are believed to be the most likely with the information at hand at the statistical closing of the Report. There are risk scenarios, however, which, if materialized, may reshape the macroeconomic environment – in some cases, significantly – and, therefore, may alter the course of monetary policy. On this opportunity, having evaluated the alternative scenarios, the Board estimates that the risk balance is downward biased for output, and unbiased for inflation.

The greater risk originates abroad, because of the situation in the Eurozone. This is very complex and the developments of recent months have revived the possibility of more extreme scenarios. Most importantly, economic and financial problems in the region could be worked out in a costly and disorderly manner, for example with Greece leaving the monetary union. Despite its small size within the Eurozone, such an outcome could inflict severe damage on the rest of the world if there is contagion to bigger European economies. The macroeconomic and financial situation of Spain continues to spur doubts, as reflected in the steady increase in its risk premiums. The lack of clarity about the capitalization plan announced for the Spanish banking industry, its difficulties to meet the fiscal targets given the gloomy growth outlook and its impact on its sovereign debt are still cause for concern. Similarly, apprehensions have increased about other countries in the region, such as Italy, because of the bulk of its public debt and its slow growth. The coupling of risk premiums in Spain, Italy and France provides evidence of this risk. Also possible is a reversal of current tensions, for instance if there are agreements favoring compliance with the adjustment measures agreed or new announcements of support by economic authorities in the zone, that could buy time to advance in the necessary structural changes. The outcome of yesterday's elections in Greece where the winner was the political option whose program is more in line with the country staying in the Eurozone, mitigates somewhat the eventuality of a Greek default triggering a crisis in the rest of the Eurozone. However, it is still premature to draw any conclusions. But undoubtedly the coming days will bring important news and we must be watchful of its effects on our economy. Additionally, other events will bring new information. More detail about the capitalization plan of Spain's banks and the EC meeting later in the month may shed some light on new bailout measures.

Other risks have to do with world growth prospects beyond the Eurozone. Doubts persist in the U.S. about how the transition to a sustainable medium- and long-term debt trajectory will proceed. Special attention is due to the possibility that political difficulties to reach agreements on the fiscal front could trigger the automatic adjustments foreseen towards 2013, hurting its GDP growth. In the emerging world, a sharper and/or longer Chinese slowdown than foreseen in the baseline scenario cannot be ruled out, hindering growth in other economies due to its weight in the global economy, and affecting commodity prices significantly.

Domestically, as aforesaid, medium-term risks for inflation are still present. The growth rate of domestic demand and output has dropped, albeit not as fast as expected. Although the Board estimates that output gaps have not narrowed further, if output again takes up a more dynamic path, there can be pressures pushing inflation up and demanding a monetary policy response.

Domestic demand has outgrown GDP in the last two years, thus widening the current account deficit. Households' saving is low compared with earlier years, while corporate savings have decreased in the past year and investment is in record-high levels. If domestic demand becomes more dynamic, it could amplify the current account deficit. This could be risky in a scenario of weak world growth.

As noted in our *Financial Stability Report*, aggregate solvency and liquidity of the Chilean economy remains stable. This is important, considering that banks' and enterprises' access to external credit could be hampered by a further deterioration of the global financial environment. In any case, and despite the impact of external volatility on the prices of some assets, financial markets have operated normally. In this context, I would like to highlight the need to continue advancing in initiatives to strengthen our regulatory and supervisory framework. One such case is the bill to reform insurance companies currently being debated in Congress.

The banks' solvency and liquidity indexes have been stable in the first half. In a context of good rents, core capital has hovered around 10 percent while regulatory capital – as measured through risk-weighted assets – around 14 percent. Meanwhile, since the last *Financial Stability Report* the banking industry has increased its long-term debt certificates, and some medium-sized banks have pursued strategies to attract retail deposits. Another favorable development is the greater diversification of banks into different types of credit from abroad. Also worth noting is the hoarding of liquid assets in foreign currency. The stress tests presented in our *Financial Stability Report* show that the banking industry's current capitalization levels allow it to cushion an episode characterized by a GDP slowdown, higher financing costs in local currency and an exchange rate depreciation associated with the materialization of the external risk scenario.

As for household debt, it should be noted that, on aggregate, borrowing has increased in tandem with disposable income. This has translated into fairly stable aggregate debt indicators, whether comparing the debt level or financial burden with disposable income or the wage mass. Corporate debt shows a similar pattern, increasing along with economic activity, without any widespread deterioration of financial indicators.

Thus, it is our view that the Chilean financial system has not suffered any material increase of its systemic vulnerabilities.

However, our *Financial Stability Report* also identifies some elements that might be sources of risk and that must be closely monitored. The construction and real estate sector has been strong lately. Activity in the real estate market has had stronger sales as a counterpart, for both housing and commercial use. While the vacancy rate in the commercial sector has remained low, the expected substantial expansion of supply and its inertia, especially in top-quality offices, is one factor that must be monitored closely given the risk scenarios facing economic activity. The evaluation of any new project should take this element into consideration.

In the same token, aggregate housing prices have evolved in line with the economy's level of interest rates and income. However, at some higher-priced districts, prices are still outgrowing their historic trends, possibly due to limited land available. It is important to keep in mind that the materialization of negative risk scenarios could lead to a breakdown in current price trends. The potential implications of this are price adjustments influencing the returns of executed projects and, additionally, the collaterals backing mortgage loans.

With respect to household debt, two factors deserve careful attention. One is its rate of expansion. This, because if it continues to grow at the present rates, the debt and financial burden of households could rise substantially if a negative risk scenario materializes. In this context, having a consolidated data base is particularly important, to allow proper risk administration by suppliers and enhance the monitoring capacity of supervisors.

The second factor is the behavior of credit-risk indicators. Although moderately, since mid-2011 there have been increases in banks' non-performing consumer loans and in delinquency rates of commercial stores (figure 4). This element, as well as the sustained growth of credit-card financing and car loans should also be taken into account when evaluating the credit risk of households.

Medium-sized, retail, and investment banks are persistently dependent on institutional financing sources. Besides, and despite the smaller relative weight of foreign banks in the external debt of local banks, the reduction in credits from banks based in peripheral Europe has resulted in greater concentration in banks from abroad.

The complexity of today's scenario calls for prudent monetary policy making and careful risk administration, in order to be prepared to deal with significant changes in the macroeconomic scenario. The international economy's situation is worrisome and a further worsening could have major effects in Chile. Domestically, some risks persist relating to inflation, and it is the Central Bank's task to be vigilant. The Board monitors closely the evolution of the external and internal macroeconomic scenario and its consequences on inflation, and it reaffirms its commitment to conduct monetary policy in a way such that projected inflation stands at 3 percent in the policy horizon.

Allow me some final remarks.

Concluding remarks

As has happened often in the past several years, our presentation of these *Reports* coincides with increased global financial stress and poses important challenges.

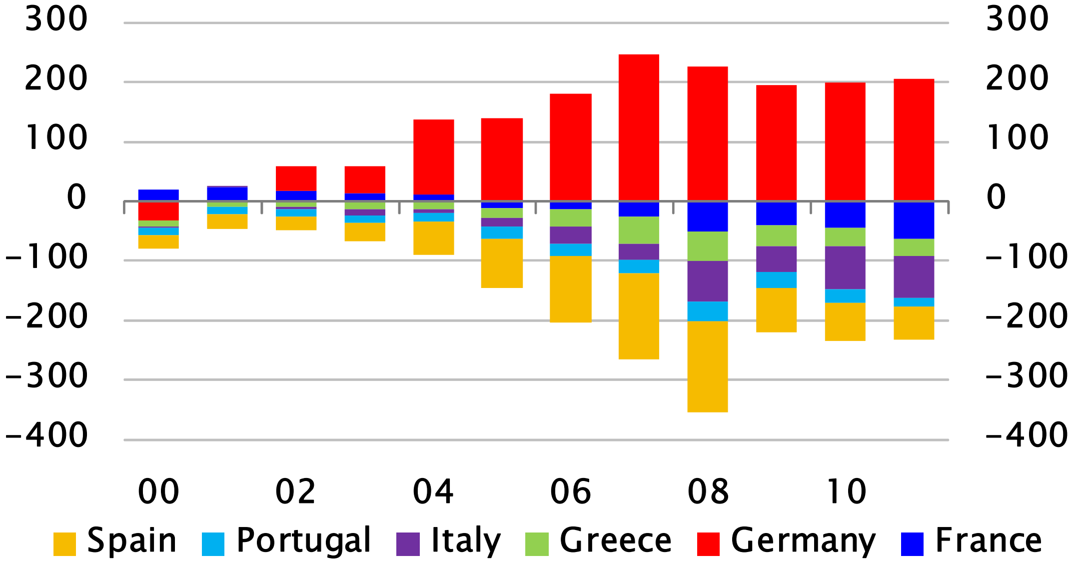
The short-term inflationary risks we identified in March have lessened, although for the medium term they are still present. Our immediate challenge, however, is dealing in the best way possible with any effects from the external crisis on our economy. The Board of the Central Bank is willing to adopt whatever measure it deems necessary if more adverse scenarios occur. Events abroad are being monitored with special attention. For the moment, however, we estimate that worst-case scenarios are possible but not the most likely, although they are more likely now than before. In our projections we use as a working assumption that, in the short term, the monetary policy rate will remain stable. A change in scenery will certainly lead to a change in decisions. As I said before, the Board – present in this session – monitors macroeconomic conditions closely and will act promptly whenever said changes warrant reorienting our monetary policy or using other tools at our disposal. There is the room and the will to do so.

Let me share with you some thoughts about what I have perceived at the meetings I have held in recent months with monetary authorities around the world. The central bank governors of developed economies, plus some from emerging markets, get together once every two months to share our views on the global economic and financial situation. Two things have called my attention in the three meetings I have attended since I assumed as the governor of the CBC. On the one hand, the severity and gravity of the situation of some developed countries. Being so distant geographically from the main financial centers of the world, in Chile we often fail to grasp in full dimension the hardships facing some economies that interact with us. These meetings allow us to see firsthand these situations and feel their true magnitude. On the other, I am amazed by the high prestige that the Chilean economy enjoys in these same arenas. It is clearly set apart from others, because of its strength, its sound macroeconomic administration and the efficacy of its institutions. Of course this makes us confident as it gives us more and better tools to confront possible shocks coming from abroad.

Our responsibility is twofold. On the one hand, is to keep inflation low and stable, to help in achieving sustainable growth. On the other hand, is to contribute with our powers to identify and address the risks threatening the normal functioning of our financial system. This certainly helps create an environment that facilitates economic growth and the population’s welfare. This is the main contribution that our institution can make to the development of our country, and the Board of the Central Bank of Chile is firmly committed to fulfilling this role.

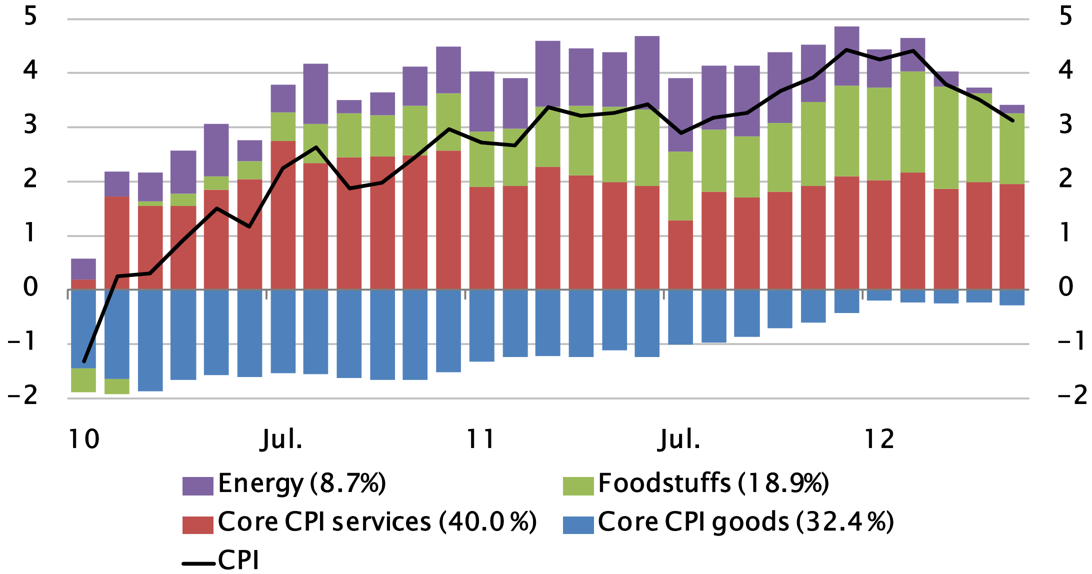
Thank you.

Figure 1
Current account balance
(US$ billion)



Source: International Monetary Fund.

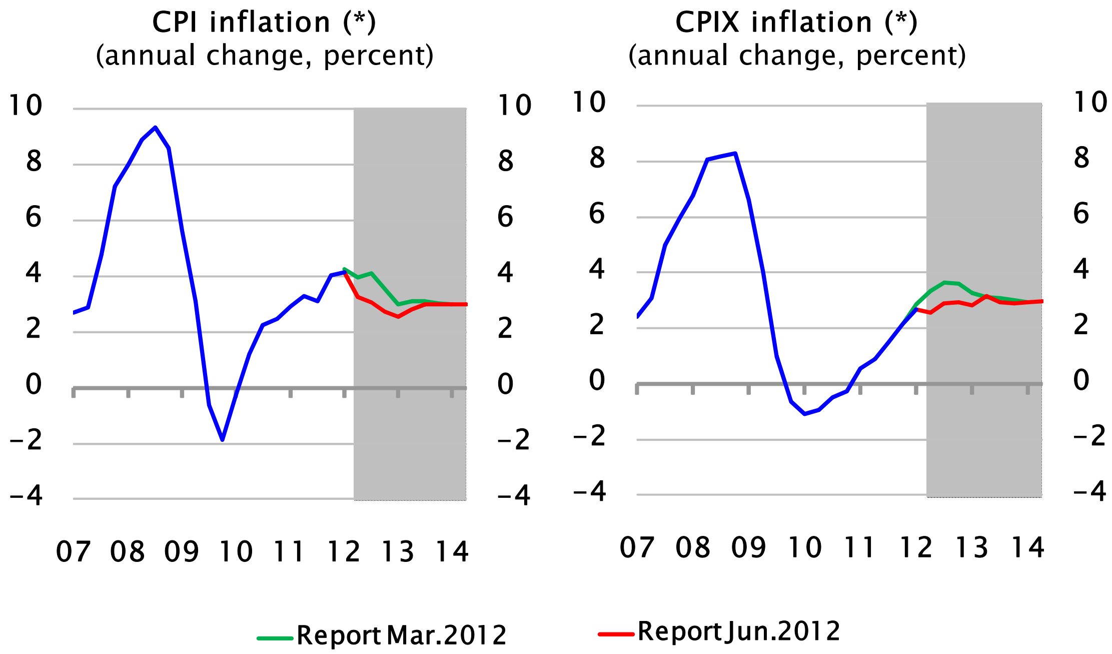
Figure 2
Incidences on y-o-y CPI inflation (*)
(percentage points)



(*) In parentheses, shares in 2009 CPI basket.

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

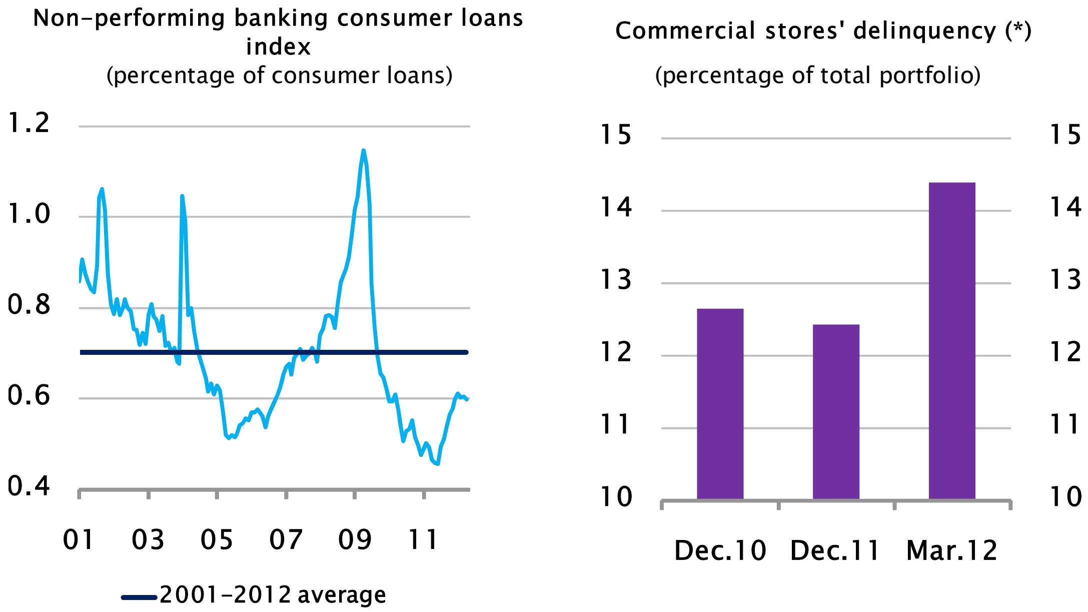
Figure 3



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

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

Figure 4



(*) Considers over 30-day delay, using a simple average of the six largest commercial chains.

Source: Central Bank of Chile based on SBIF and SVS data.

Table 1
Annualized quarter-to-quarter GDP growth
(percent)

	III.2011	IV.2011	I.2012
Spain	0.2	−1.2	−1.3
Italy	−0.8	−2.6	−3.2
Portugal	−2.5	−5.0	−0.4
Greece (y–o–y)	−5.0	−7.5	−6.5
Germany	2.3	−0.7	2.1
France	1.2	0.3	0.2
Eurozone	0.5	−1.3	0.0
United Kingdom	2.4	−1.2	−1.2
United States	1.8	3.0	1.9
Japan	7.8	0.1	4.7
China (y–o–y)	9.1	8.9	8.1
India (y–o–y)	6.7	6.1	5.3
Russia (y–o–y)	5.0	4.8	4.9
Brazil	−0.6	0.6	0.8
Peru (y–o–y)	6.7	5.5	6.0
Colombia	6.2	5.3	--
Mexico	4.8	2.9	5.3
Chile	1.3	8.2	5.7

Sources: Central Bank of Chile and Bloomberg.

Table 2
International baseline scenario assumptions

	2009	2010	2011 (e)	2012 (f) Report Dec. 11	Report Mar. 12	Report Jun. 12	2013 (f) Report Dec. 11	Report Mar. 12	Report Jun. 12
				(annual change, percent)					
Growth									
Trading partners	-0.3	6.2	4.1	3.8	3.8	3.6	4.2	4.2	3.9
World at PPP	-0.7	5.3	3.8	3.5	3.3	3.2	4.1	3.9	3.6
World at market exchange rates	-2.3	3.9	2.7	2.7	2.5		3.2	3.2	
United States	-3.5	3.0	1.7	1.8	2.1	2.0	2.2	2.3	2.0
Eurozone	-4.2	1.9	1.5	-0.1	-0.3	-0.6	1.0	1.0	0.3
Japan		4.4	-0.7	2.0	2.0	2.7	1.6	1.6	1.3
China	9.2	10.4	9.2	8.2	8.1	7.9	8.5	8.5	8.2
India		10.6	6.7	7.7	7.3	6.5	8.0	7.9	7.2
Rest of Asia (excl. Japan, China and India)	0.2	7.8	4.2	4.4	4.3	3.9	4.8	4.8	4.6
Latin America (excl. Chile)	-2.0	6.4	4.4	3.6	3.6	3.3	4.0	4.0	3.7
					(levels)				
Brent oil prices (US$/barrel)		80	111	107	121	107	102	115	97
				(annual change, percent)					
Terms of trade (*)	3.6	19.4	0.5	-6.7	-5.3	-6.9	-3.5	-0.1	-1.5

(e) Estimate. (f) Forecast.

(*) Forecasts at December, projected with national accounts, base year 2003; 2010 and 2011 figures, plus forecasts at March and June, with national accounts, base year 2008, considering chained indexes.

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

Table 3
Economic growth and current account (*)
(annual change, percent)

	2011	2012 (f) Report Dec. 11	Report Mar. 12	Report Jun. 12
GDP	6.0	3.75–4.75	4.0–5.0	4.0–5.0
Domestic demand	9.4	3.7	5.3	5.2
Domestic demand (minus inventory change)	10.2	4.8	5.8	5.5
Gross fixed capital formation	17.6	5.8	8.9	7.4
Total consumption	7.9	4.5	4.8	4.8
Goods and service exports	4.6	3.7	3.8	3.9
Goods and service imports	14.4	3.0	5.9	4.9
Current account (% of GDP)	-1.3	-3.3	-3.4	-3.1

(f) Forecast.

(*) Forecasts at December, projected with national accounts, base year 2003; forecasts at March and June, with national accounts, base year 2008, considering chained indexes.

Source: Central Bank of Chile.