Rodrigo Vergara: The Monetary Policy Report and the Financial Stability Report

Presentation by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, before the Finance Commission of the Honorable Senate of the Republic, Santiago de Chile, 18 December 2012.

The Monetary Policy Report of December 2012 and the Financial Stability Report of the second half of 2012 can be found at http://www.bcentral.cl.

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Introduction

Mr. President of the Senate's Finance Commission, Senator Jose García, senators members of this Commission, ladies and gentlemen,

I appreciate your invitation to present our Board's vision on recent macroeconomic and financial developments, their prospects and implications for monetary and financial policy. This vision is contained in detail in our *Monetary Policy Report* of December 2012 and our *Financial Stability Report* of the second half of 2012.

The year that is ending has brought good news to our economy. The inflationary fears we expressed early in the year have abated. This year our economy will grow 5.5 percent. Unemployment is low, labor income is growing steadily and consumer and business expectations are optimistic. Investment is high by historic standards.

A year ago, when we presented our reports to this Commission, we foresaw that the deepening of the Eurozone crisis at the time could have significant effects on our economy, including a major slowdown during 2012. It did not. Although the world economy froze significantly in the last year, other important dimensions of the external scenario, such as the terms of trade and international financial conditions, took a course that is favorable to us.

Actually, Chile's economic performance has been quite different from that of many other countries. The main advanced economies are still struggling with the consequences of the financial crisis that resulted in the world recession of 2009. They have a long road ahead to resolve the imbalances and weaknesses associated with this situation before they can resume sustained growth. The Eurozone countries have made progress in resolving their fiscal and financial problems, as well as strengthening the institutional pillars of the monetary union. These steps have been welcome by the markets, but the efforts must continue. Achieving a solution is a slow, costly and complex process, considering the great number of players involved. There is also the ongoing deterioration of the economic situation, which only makes things worse and complicates the required adjustments. Countries suffering negative growth rates and high unemployment for too long already cannot easily implement new austerity measures. Furthermore, the core European economies, which until recently had been relatively spared of the recession of the peripheral countries, have begun showing signs of weakness. Accordingly, the risks in the Eurozone remain.

In the United States, the recovery of output and demand is weak, insufficient to quickly absorb its high unemployment. The Federal Reserve has undertaken to keep an ultra-expansionary monetary policy in place for as long as this situation persists and does not jeopardize inflation, which has important implications for the global financial scenario that the Chilean economy will continue to face in the coming years. Plus, the U.S. has a high fiscal deficit that reflects in an excessive increase of its public debt. If a political agreement is not achieved, early next year a number of automatic adjustments of taxes and expenses (the so-called fiscal cliff) will be forced into the economy. Given the sluggish growth in this country, if they have to apply such major adjustments, the economy will relapse into a new recession. Unfortunately, when the deadline is only days away, there are no signs of agreement in sight.

The emerging world continues to outperform the developed economies, although with greater diversity within the group. In China, indicators suggest that growth is picking up after the deceleration of most of 2012. Latin America, meanwhile, has shown reduced growth during the year and the outlook for the next two years has also been revised downward. The slowdown has been sharper in Brazil and it is not clear what the velocity of its recovery will be. Mexico and Colombia have also begun giving signs of a slowdown. Peru continues to grow strongly, while Argentina is dealing with major adjustments.

The Chilean economy has remained on an upward slope, driven by strong domestic demand and, particularly, fixed investment. Also, private consumption has increased in line with the significant increase in personal income. Still, we face significant risks, which I will look in more detail in a moment. Those coming from abroad have to do with the world economic situation I just described; domestically, they relate to the possibility of an exacerbation of output and expenditure.

Beyond these risks, in the baseline scenario that today we believe to be the most likely, the Chilean economy will resume growth in line with the trend, while inflation will gradually return to levels that are consistent with the target. Let me now describe this scenario and the risks we have identified.

Macroeconomic scenario

The macroeconomic scenario facing the Chilean economy has not changed significantly in the past several months. As I just said, Chile's output, and especially domestic demand, has grown above expectations. Some progress has been made abroad, but the risks derived from the Eurozone crisis are still present. In this context, headline inflation has fluctuated substantially in recent months, due to one-time events associated with supply shocks. Core inflation – discounting foodstuffs and energy – has declined slightly to near 2 percent y-o-y. The Board, continuing with what has been the tone throughout the year, held the monetary policy interest rate at 5 percent.

Domestic situation

As of November, y-o-y CPI inflation was 2.1 percent, after rising to almost 3 percent in October (figure 1). Y-o-y growth in nominal wages has remained roughly constant in the 6% to 7% range, although with differences across sectors.

Output, meanwhile, grew 5.7 percent y-o-y in the third quarter of 2012, flat from the previous quarter, but more than expected. The Economic Expectations Survey (EES) of August – available at the closing of the previous Monetary Policy Report – forecast 4.6 percent growth for said quarter. The greater increase was due to better performance in general. However, output's velocity of expansion dropped from 8.3 to 5.7 percent annualized.

In the baseline scenario, the Board estimates that GDP will grow 5.5 percent this year. This projection is higher than the ceiling we estimated in September, with a similar revision as has been made in private forecasts. Still, both our forecasts and private ones have experienced sustained upward revisions in the past year (figure 2).

On the domestic spending side, third quarter growth (i.e. 8.0 percent y-o-y) largely surpassed second-quarter figures, however swollen by some specific factors. While every component of expenditure posted higher increases, the large increase in machinery and equipment investment is worth noting: 19.9 percent y-o-y. The acceleration of domestic spending amplified the negative current account balance, which in the third quarter went to 2.9 percent of the GDP accumulated in the last year. The baseline scenario assumes that the deficit will end the year 2012 at 3.8 percent of GDP, exceeding September's forecast of 3.2 percent.

Meanwhile, the national financial system has operated normally in a context of strong investment and favorable external credit conditions. Household credit has continued to grow in tandem with disposable income, although the increase in loans by non-bank suppliers – with a higher penetration in lower-income households – has been smaller than in previous periods. Corporate debt has grown somewhat above GDP, driven by strong local banking credit and external financing via bonds, in a context of favorable financing conditions in international markets. In turn, the banking system keeps robust indicators, with capital significantly above regulatory levels, a more diversified external funding base, and a stable liquidity position.

Toward 2013, the Board estimates that GDP growth will be within the range of 4.25 to 5.25 percent. This range is above the one foreseen in September. In this scenario, domestic demand will increase 5.7 percent y-o-y, further amplifying the current account deficit to 4.6 percent of GDP. This projection supposes that macroeconomic conditions facing the Chilean economy will remain fairly unchanged in the near future, and that the economy will grow in line with trend rates, which the Board continues to estimate around 5 percent (table 1).

Internationally, the baseline scenario foresees that in 2013 and 2014 the world economy and Chile's trading partners will grow by averages of 3.6% and 3.8%, respectively, not far from those of 2011–2012. Important differences remain between the performances of the developed world and the emerging world. The recession in the Eurozone has settled and is expected to last some more time. Expectations regarding the United States are that it will continue to recover at a slow pace, and that moderate adjustments to the fiscal policy will take place. The downgraded outlook for Japan needs mention, due to both its relation with the Eurozone and some fiscal adjustment measures foreseen for 2014. In the emerging world, incoming data from China suggest that the slowdown of most of 2012 may be reverting. Thus, again y-o-y growth rates around 8 percent are forecast for the Chinese economy for 2013 and 2014. Growth prospects for Latin America are revised downward for this and the next two years.

In this scenario, commodity prices will not change much from forecasts a few months back. In the two-year period 2013–2014, the baseline scenario foresees average prices of US$3.45 per pound of copper and US$102 per Brent oil barrel. Accordingly, terms of trade estimates for Chile continue to be high, but lower than they were this year (table 2).

External financial markets have shown some calm these months. However, as I noted at the beginning, there is still a long way ahead before the Eurozone crisis can be resolved. The commitment of various organizations to work out a solution seems to be bearing fruit in the market's evaluation. Anyway, the baseline scenario again considers the possibility of new stress episodes in the world markets. Such greater calm has also reflected in stock markets and currency parities. In recent months, the U.S. dollar has depreciated slightly against the main currencies. The peso/dollar parity, with ups and downs, is somewhat lower than in the previous Monetary Policy Report, while the real exchange rate (RER) has shown no significant variation. The Board continues to estimate that, with the prevailing nominal exchange rate and currency parities, the RER is in the lower part of the range of values consistent with its long-term fundamentals (figure 3).

In the baseline scenario, y-o-y CPI inflation will stand below the tolerance range in the coming months, to start rising later and approach 3% by the end of 2013 and over the projection horizon, this time the last quarter of 2014. There are several factors explaining the lower figures foreseen for the near future, including the high basis for comparison of late 2011 and the turn of 2012. Core inflation will post y-o-y variations below 2% over most of 2013, then it will rise gradually to near 3% over the course of 2014 (figure 4).

This path assumes that wages will grow in line with productivity and target inflation. In addition, it relies on the methodological assumption that, over the projection horizon, the RER will be fairly unchanged from its recent values. Finally, the baseline scenario uses as a working assumption that the MPR trajectory will be stable, as suggested by the latest surveys available at the statistical closing of this Monetary Policy Report (figure 5).

The baseline scenario reflects those events that are believed to be the most likely with the information at hand at the closing of this 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 unbiased for both output and inflation.

In the world economy, the main risk continues to be the situation in the Eurozone. On one hand are the difficulties in implementing agreements. On the other, like I said, as time has passed, the economic situation of the most affected countries has complicated further, while core European economies seem to be taking a turn for the worse. A sharper deceleration in Germany or France could aggravate the problems in the region and amplify pass-through channels to other economies. Neither can this analysis rule out episodes of volatility in the financial markets that could be more severe than the ones considered in the baseline scenario.

However, the potential effects on Chilean banks of a deepening of the crisis in the Eurozone are still bounded. While banks' profitability and solvency indicators have dropped most recently, stress tests show that the banking system's level of capital is appropriate to absorb the losses caused by a risk scenario of this kind.

Another risk is the ongoing discussion in the United States to ward off a sharp fiscal adjustment in 2013. Failure to reach an agreement could significantly hamper growth and increase market volatility.

And central banks of developed economies have continued to boost, and even intensify, very expansionary monetary policies, which can bring consequences on capital flows, asset prices, currency parities, commodity prices and credit growth in the other economies, including Chile. So far the domestic effects of these policies have been limited, but they are certainly a source of concern.

Finally, in the emerging world, the biggest risk continues to be the pace of economic activity. Incoming data indicate that China has resumed strong growth, but the weakening of Europe and pending discussions in the United States could affect the Chinese economy, and through it the emerging world. Chile would be especially affected because of its incidence in the determination of the copper price. In addition, the recent drop in world trade growth figures is cause for concern.

In Chile, despite particularly low inflation, medium-term inflationary risks remain present. The sustained dynamism of Chile's economic activity has intensified the use of installed capacity, and a strengthening of domestic demand could trigger inflationary pressures incompatible with the inflation target. So far, inflation has remained bounded and has even decreased. Our evaluation is that the recent drop is a transitory event that will be gradually reversed within the next few quarters to return to levels around the Central Bank's target. Behind its recent performance there may have been factors such as compressed trade margins, increased mean labor productivity and lower prices of imported goods. However, these are typically procyclical factors, so it is quite possible that their effects are transitory. With this uncertainty, one must not overlook the medium-term inflationary risks of a more dynamic trajectory of the economy.

A more dynamic domestic demand could also amplify the deficit of the current account of the balance of payments and increase the economy's external vulnerability, eventually confronting it with costly potential adjustments. The Board pays close attention to the evolution of the current account deficit. Its level, persistence, composition and funding sources are all aspects that may affect the vulnerability of the Chilean economy, particularly if confronted with adverse external scenarios.

However, the current deficit has several peculiarities that mitigate the associated risks. First, a significant part is explained by higher investment in a number of projects aimed at the production of exportable goods and services. Second, a major part of the deficit is being financed via foreign direct investment rather than external debt. Finally, the evolution of domestic and external credit is showing no signs of overborrowing by either households or firms. Accordingly, the evolution of private consumption does not divert far from the increase in labor income, the low rate of unemployment and financial conditions. Similarly, from a longer perspective, in nominal terms, the ratio between private consumption and private national disposable income is close to its historic average.

Overall, an increase in the current account deficit could entail unwanted risks, which is particularly important in a context where sudden changes may occur in macroeconomic conditions, which could precipitate difficult adjustments to the national economy. In the past, most of the crises that the country endured were preceded by high and persistent current account deficits, an excessive increase in borrowing, and important currency mismatches. However, today's economic policy framework is more advanced, including a rule that governs fiscal policy and cushions the impact on public expenditure of both copper price fluctuations around its long-term trend and the ups and downs of the business cycle. It also includes a floating exchange rate regime that puts currency risks under the light allowing an early response to sudden changes in external conditions. And it contemplates proper financial regulation and supervision to prevent the incubation of excessive risk. Accordingly, the Board estimates that it is paramount to closely monitor those factors that are behind the current account deficit, in order to avoid the incubation of imbalances that may affect the future performance of the economy.

Another risk factor we have identified is the dynamic of the real estate sector. In mid year, we called the attention to the evolution of real estate prices, with a focus on some districts. Today, seeing that some of those trends have deepened and widened, we need to return to this topic. As we have noted and is now part of public debate, during the last few quarters real estate prices have been steadily increasing in some districts and for some types of construction (table 3). Aggregate prices of office space also continued to grow, but less than did residential prices.

In the residential sector, the sales of houses and apartments have risen substantially, especially in blueprint or catalog stage, indicating some shortage in the short-term supply (figure 6). In the commercial sector, although the available vacancy indicators are still low, private real estate firms continue to forecast significant growth in the supply of office space for this purpose.

Although such price increase can find justification in its macro and microeconomic fundamentals, it must be monitored closely. These price increases have occurred in a context of high growth in housing demand and a significant expansion in output in the sector, accompanied with higher leverage among real estate firms. Meanwhile, and because of the stage of the supply-demand cycle the residential real estate sector is in now, an acceleration of mortgage credit in the medium term cannot be ruled out. It must also be kept in mind that the lending standards for these credits have eased somewhat, which reflects in an increase in the fraction of the property price that is lent (figure 7).

This type of developments could create vulnerabilities in the real estate and construction industry, or in those households searching for a new home. It is also worth noting that the current combination of higher property prices, low long-term interest rates, favorable lending standards and higher volatility of other financial asset categories, configure a scenario that could motivate an increase in financial investment in the sector, potentially exacerbating these risks.

Therefore, we have stressed how important it is that agents consider these risk factors when evaluating their investment and lending decisions in the sector. In particular, these decisions need to bear in mind that past price increases are no guarantee of further increases in the future. We believe that raising this type of alert, thus increasing the amount of information available for risk assessment, is part of our role of promoting the normal functioning of the financial system. We believe that the extended discussion that has taken place on the topics of the real estate sector is extremely valuable.

Another risk factor requiring close attention is the evolution of medium-sized banks. Recently, credits granted by these banks have increased faster than those of other banks (figure 8). There is certainly a positive side to it, as it implies lower concentration of risks in the system. However, its growth dynamic could become a source of vulnerabilities. On one hand, because of higher exposure both to those sectors more closely linked to the business cycle and to individual debtors who, faced with a deterioration of macroeconomic conditions could be severely affected. On the other hand, because of the higher relative growth of roll-over consumer credit (i.e., credit cards and credit lines). This, because of the possible underestimation of the risk that these products may cause, as they allow for sharp increases in borrowing that may affect repayment ability without a timely reflection in the borrower's payment behavior. Finally, and as has been noted before, the greater reliance of some midsized banks to wholesale funding makes them more vulnerable to episodes of greater difficulties in bank lending.

As already noted, the present scenario depicts significant risks that call for policy responses in different directions. The MPR is within the range of values considered neutral. However, from the policy makers' perspective, the task of dealing with the challenges posed by this type of risks goes beyond the scope of monetary policy, and requires the concurrence and coordination of a broader set of macroeconomic and financial policies. Actually, some of these risks (e.g., those relating to the current account deficit and the just mentioned real estate sector) can be observed even in a situation where inflation remains bounded and in line with the target.

At the international level, we have seen growing interest in the use of macroprudential measures. This concept covers a significant number of possibilities, some of which are the direct decision of the central banks while others rely on other authorities. For example, the potential risks that could be generated in the real estate sector have driven some regulators and supervisors elsewhere to use a series of prudential instruments to safeguard the financial system and reduce the sector's volatility. Worth mentioning are the limits to the loan to value ratio, the limits to the ratio between debt and income, changes in the credit risk weighting, and capital requirements. The particulars of these measures vary from country to country, but normally more than one of them applies and entails coordination of several authorities. Because of its short history, a full evaluation of the results is yet to be done. The Financial Stability Board, created one year ago in Chile, is a proper instance of coordination to analyze these issues.

In any case, the Board follows closely the evolution of the external and domestic macroeconomic scenarios and their implications on inflation, and reiterates its commitment to conduct monetary policy in such a way that projected inflation stands at 3% over the policy horizon, as well as to continue to closely monitor any risk factors that could affect the financial stability of the country.

Let me finish with some reflections.

Final reflections

The Chilean economy is in a good standing. The results we have obtained in the last year have been quite better than the world's average and much better than we projected a year ago. But there is still a long road ahead before we achieve the stage of development we all wish for. Besides, the present situation poses significant risks. Coordination with every organization in charge of policies is critical to succeed in meeting this challenge.

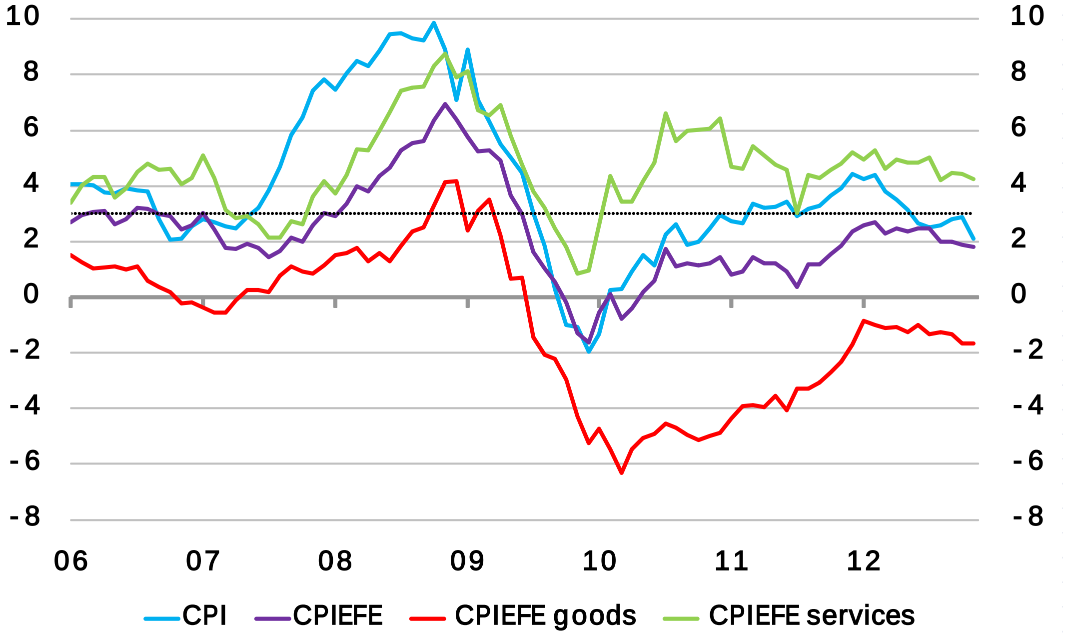
If the economy continues to grow above trend, or spending exceeds our true possibilities, especially in some sectors, some imbalances may be incubated that may generate significant vulnerabilities and require costly adjustments going forward. Our history has taught us how difficult these adjustments can be, and we must do everything in our power to avoid revisiting these situations. More so considering that these events hit the most vulnerable population hardest.

As I have said on previous opportunities, Chile enjoys a high international reputation in many circles. The laudatory words about our economy recently uttered by the IMF's Managing Director attest to that. Our country stands out for its soundness, its good macroeconomic management and the functioning of its institutions. This is an important asset, especially in a small country geographically distant from economic centers, so that should be valued and nurtured.

Our duty is to protect this reputation and conduct policies that allow maintaining sustainable development of the economy economic aiming to achieve greater welfare of our country. Our contribution as the Central Bank is to keep inflation low and stable. Also to help, within the scope of our powers, to identify and deal with any risks that may jeopardize the normal functioning of our financial system.

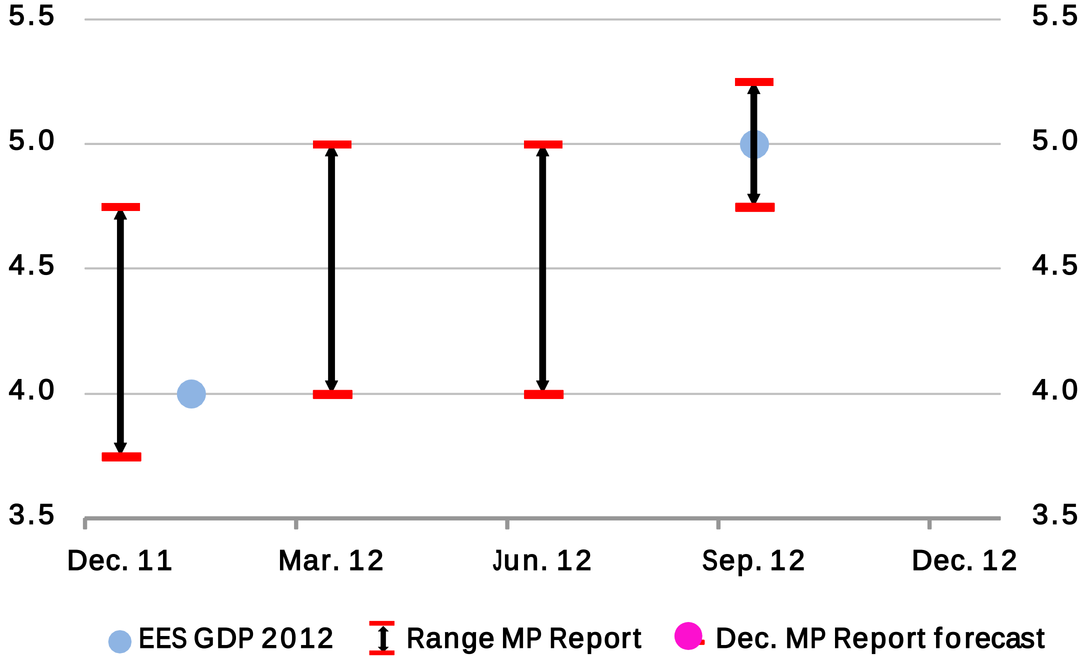
Thank you.

Figure 1
Inflation indicators
(annual change, percentage)



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

Figure 2
Gross Domestic Product
(annual change, percentage)



Source: Central Bank of Chile.

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

	2011	2012 (f) MP Report Sep. 12	2012 (f) MP Report Dec. 12	2013 (f) MP Report Sep. 12	2013 (f) MP Report Dec. 12
GDP	6.0	4.75-5.25	5.5	4.0-5.0	4.25-5.25
Domestic demand	9.4	5.6	6.6	5.5	5.7
Domestic demand (w/o inventory change)	10.2	5.5	6.8	5.8	6.0
Gross fixed capital formation	17.6	7.0	11.3	7.1	7.6
Total consumption	7.9	5.1	5.3	5.4	5.5
Exports of goods and services	4.6	3.5	2.7	3.6	3.0
Imports of goods and services	14.4	4.0	5.5	5.8	5.9
Current account (% of GDP)	-1.3	-3.2	-3.8	-4.4	-4.6

(f) Forecast.

Source: Central Bank of Chile.

Table 2
International baseline scenario assumptions

	2011	2012 (f) MP Report Sep. 12	2012 (f) MP Report Dec. 12	2013 (f) MP Report Sep. 12	2013 (f) MP Report Dec. 12	2014 (f) MP Report Sep. 12	2014 (f) MP Report Dec. 12
Growth		(annual change, percentage)					
Trading partners	4.2	3.5	3.3	3.8	3.5	4.3	4.0
World at PPP	3.8	3.1	3.0	3.6	3.3	4.1	3.8
United States	1.8	2.2	2.3	2.0	1.9	2.4	2.3
Eurozone	1.5	-0.4	-0.5	0.3	-0.3	1.7	1.2
Japan	-0.7	2.7	1.6	1.3	0.5	1.4	0.9
China	9.3	7.8	7.7	8.1	8.0	8.3	8.2
India	6.5	5.8	5.6	7.1	6.6	7.3	6.4
Rest of Asia (excl. Japan, China & India)	4.2	3.5	3.5	4.5	4.3	4.8	4.7
Latin America (excl. Chile)	4.4	3.0	2.8	3.4	3.3	3.9	3.7
		(levels)					
External prices (in US$)	10.1						
LME copper price (US$cent/lb)	400	355	361	340	340	350	350
WTI oil price (US$/barrel)	95						
Brent oil price (US$/barrel)	111	113	112	109	105	103	100
		(annual change, percentage)					
Terms of trade	0.5	-7.4	-5.0	-2.6	-0.8	1.3	1.3

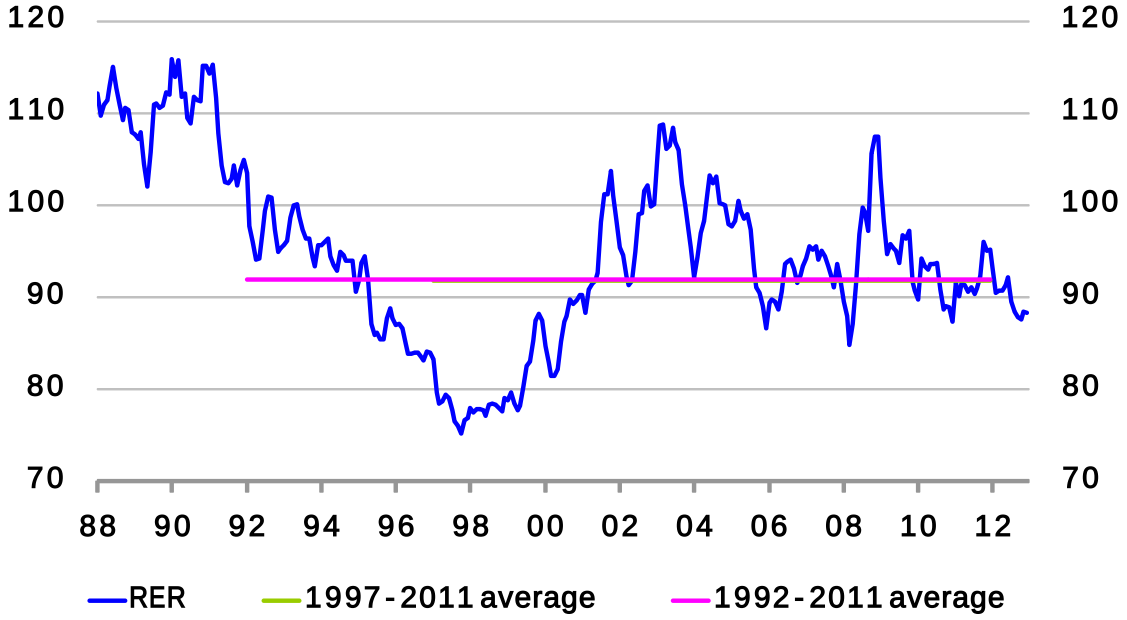
(f) Forecast.

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

Figure 3

Real exchange rate (*)

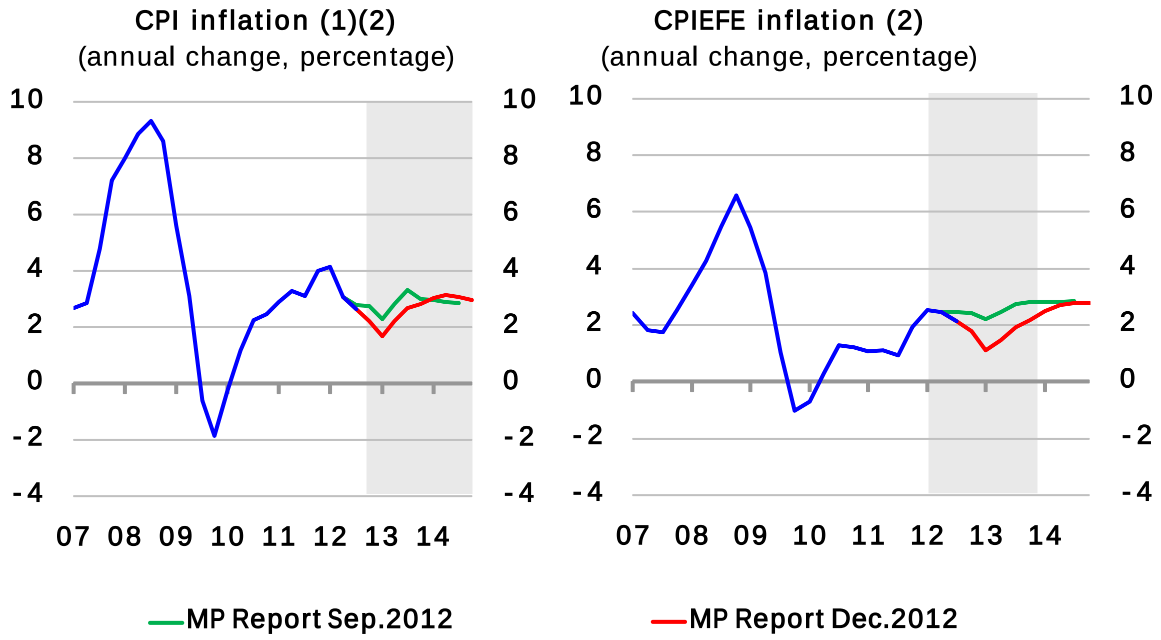
(index, 1986=100)



(*) December figure includes information up to 13 December 2012.

Source: Central Bank of Chile.

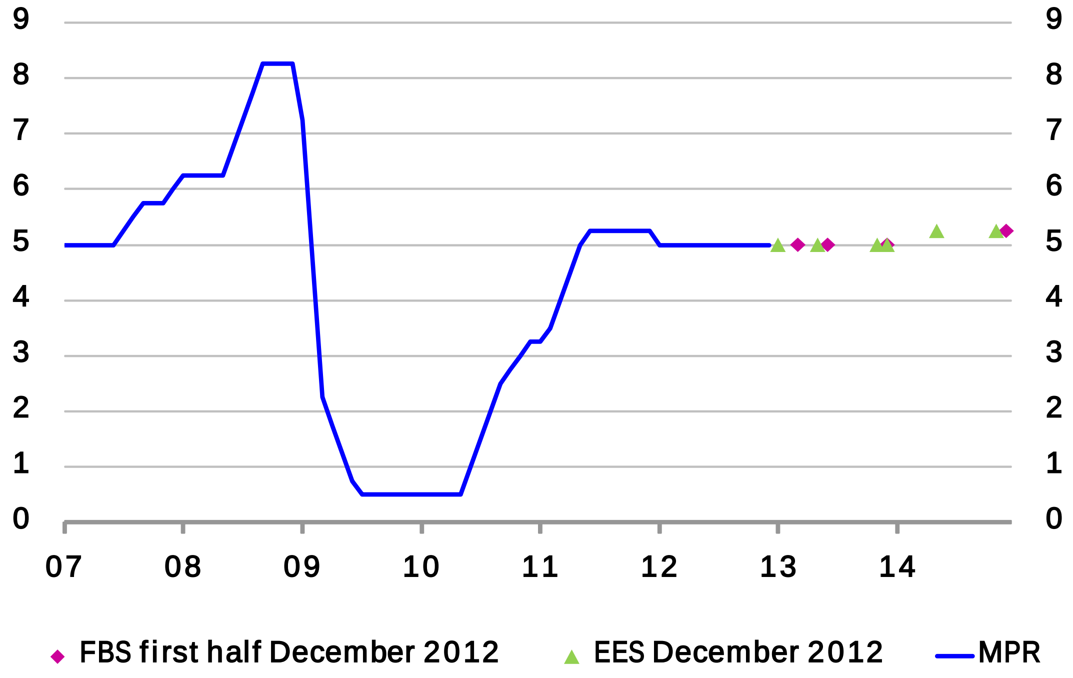
Figure 4



(1) December 2012 figure uses median of monthly inflation forecast in the EES. (2) Gray area, as from the fourth quarter of 2012, shows forecast.

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

Figure 5
MPR and expectations
(percentage)



Source: Central Bank of Chile.

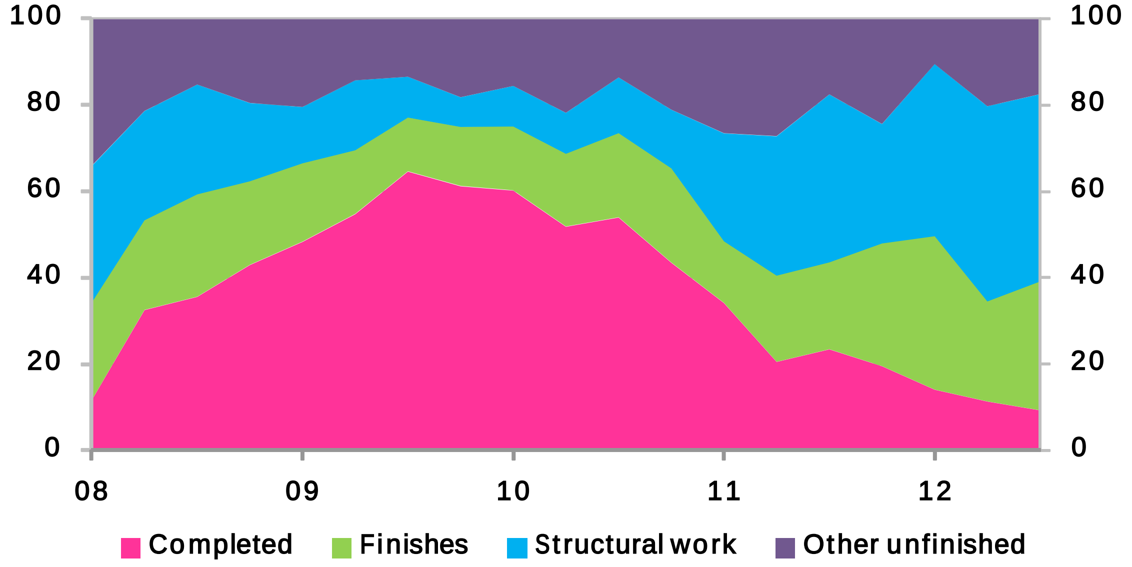
Table 3
Growth in housing prices (1)
(real annual growth, percentage)

	2002-2007	2009-2T2012
Nation-wide total (2)	3.1	5.7
Average of districts with significant increases (3)	1.6	8.3

(1) Averaged y-o-y growth between first quarter of initial year and last quarter of final year in each case.
(2) Obtained using stratified method.
(3) Average of districts with structural growth breakdown, according to methodology of Ferreira and Gyourko (2011).

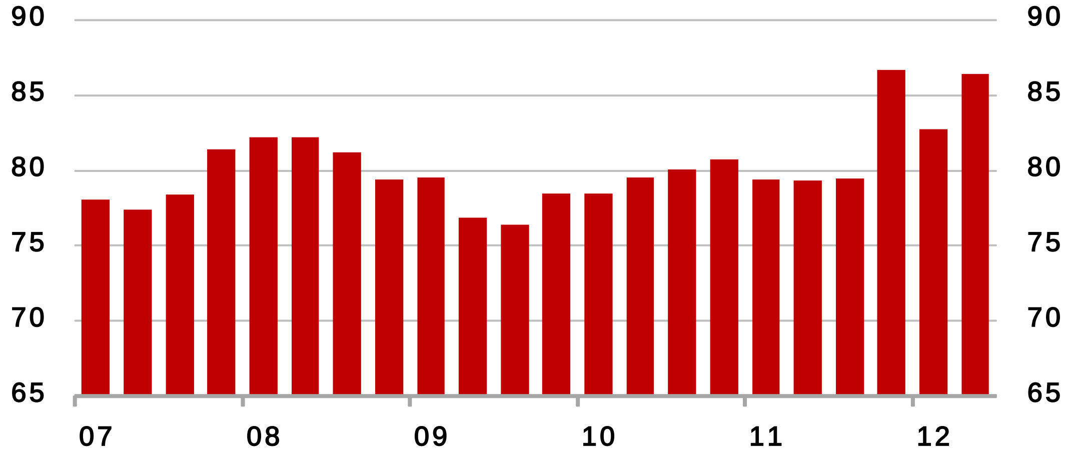
Source: Central Bank of Chile based on Internal Revenue Service (SII) data.

Figure 6
Housing sales by building phase
(percentage of total)



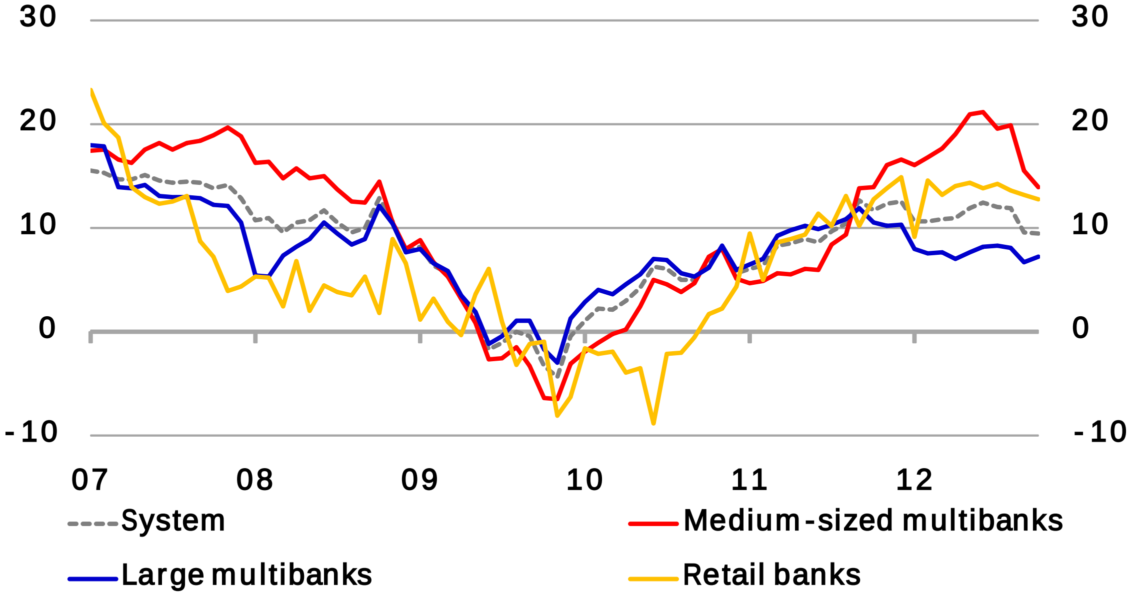
Source: Cámara Chilena de la Construcción.

Figure 7
Mortgage debt to collateral ratio (*)
(percentage)



(*) Preliminary figures of new operations approved in respective quarter.
Source: Superintendence of Banks & Financial Institutions (SBIF).

Figure 8
Total loans
(real annual change, percentage)



Source: Central Bank of Chile based on SBIF data.