Rodrigo Vergara: Chile's latest Monetary Policy 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, 2 April 2013.

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The Monetary Policy Report of March 2013 can be found at http://www.bcentral.cl.

Introduction

Mr. President of the Senate's Finance Commission, senator Andrés Zaldívar; senators members of this Commission, ladies and gentlemen.

Thank you for inviting me to present the view of the Bank's Board on recent macroeconomic developments, together with the macroeconomic outlook and its and monetary policy implications. This view is contained in detail in our March 2013 *Monetary Policy Report*.

There is no doubt that the Chilean economy is in good standing. In a complex international context where growth in the developed world is still sluggish and particularly the Eurozone continues in recession, Chile continues to grow at over 5 percent annually, unemployment has fallen and inflation remains low. In these circumstances we must avoid complacency and be alert to the risks facing our economy to reduce their likelihood of occurrence, or otherwise be prepared to deal with them in the best way possible. Precisely our *Monetary Policy Report* traditionally analyzes the baseline scenario, and also risk scenarios.

International economic conditions, while still complex, have improved in recent months from the deteriorated conditions of the first half of 2012. China's economic growth has stabilized and the U.S. has avoided much of the drastic fiscal adjustments that were legally programmed for early 2013. This time around, we have revised the global growth outlook slightly upward and external financial conditions have improved thanks to very expansionary monetary policies in the main advanced economies. In contrast, the Eurozone remains in recession with still fragile financial and fiscal conditions, as illustrated by the recent events in Cyprus. World commodity prices remain high, although copper has had a relapse.

Chile continues to display a dynamic economy and limited inflation. GDP increased 5.6% in 2012, while domestic expenditure rose 7.1%, thus increasing the current account deficit to 3.5% of GDP (figure 1).

In this regard, it is worth noting that in recent years the dynamism of domestic demand has been driven by investment, especially in mining. As shown in a box inside our *Report*, the current level of mining investment is the highest of the past four decades. Most recently, the implementation of these projects has had a number of direct and indirect effects on domestic demand, other sectors' activity, the labor market, imports of capital goods and the current account deficit. In the medium term, as these projects mature and the full expansion of the capital stock is completed, the level of imports will be reduced, output and exports will rise, and the growth rate of consumption will stabilize together with personal income.

The way the current account deficit is being financed is also important to underscore. Earlier episodes of balance of payments crises have typically been associated with high debt and liquidity and currency mismatches, which leave economies vulnerable to abrupt deterioration of international financial conditions. In Chile, the present current account deficit is being financed mainly by FDI flows, associated with reinvested earnings and new investments, thus providing more strength to the capital account.

Despite these factors, we need to remain vigilant because an economic scenario like the present one can favor the incubation of future risks. Domestically, a scenario of very dynamic final sales and personal income, low unemployment and high utilization of installed capacity, can exacerbate the response of domestic demand and further expand the current account deficit. Abroad, the present abundance of international funding as a result of expansionary monetary policies in developed economies may facilitate the financing of the external deficit and push asset prices up, at the expense of incubating vulnerabilities for the future.

All this means that we must be particularly alert to prevent financial vulnerabilities from incubating, since these situations can lead to higher leverage of households, firms and financial intermediaries, as well as currency and liquidity mismatches. In this regard, one reassuring element is that in recent months there has been a moderation in household indebtedness, which in any case has remained in line with the income trajectory. It is also important to continue to monitor the evolution of key financial prices and their interaction with lending. This is a task that is not confined only to the Central Bank, but is for all economic and financial policy makers.

Beyond these risks, in the scenario we consider today to be the most likely, the Chilean economy will expand at a pace that is consistent with its trends. Inflation will gradually return to 3% as specific temporary factors that have influenced recent indicators dissipate. Let me describe this scenario and the risks identified in some detail.

Macroeconomic scenario

Since the last Monetary Policy Report, the Chilean economy has continued to show high strength and inflation has remained limited. Contractionary risks coming from abroad have eased, while expansionary risks originating domestically have gained importance. Domestic output and demand growth exceeded projections, with a greater boost from investment and more recently also from private consumption. Dynamic expenditure has resulted in a smaller trade surplus and a high degree of internal resource utilization. Headline and core inflation indicators have dropped to near 1% annually because of a number of temporary factors, and forecasts are that they will return to 3% within the projection horizon. Internationally, the threats associated with the situation in the Eurozone are still in full force, but other risks, relating to the U.S. and China, have moderated. In this scenario, the Board has held the Monetary Policy Rate (MPR) at 5%.

As I mentioned at the beginning, Chile's GDP grew 5.6% in 2012. The fourth-quarter figure was slightly higher than estimated in the previous *Monetary Policy Report* and expected by the market, largely due to the greater contribution of mining. In the last six quarters, the expansion of sectors other than natural resources, that better reflect changes in the use of installed capacity, has continued showing relatively stable rates, around 5.5%, not far above the trend.

Domestic demand growth, in contrast, has picked up again. After falling steadily during 2011 and approaching GDP growth rates in early 2012, it rose again in the following quarters, to end the year with a y-o-y expansion that outperformed GDP by 1.5 percentage points. This reacceleration reflects stronger investment and, most recently, also stronger private consumption.

On the investment front, the strong momentum of mining and energy projects has persisted, while imports of capital goods have continued to reflect the strong increase in the purchases of transport equipment. Moreover, in the real estate industry, sales have remained strong, particularly for housing in construction stage, and other indicators such as dispatches, sales and imports of materials for this sector have remained high despite some marginal slowdown.

The expansion of consumption has found support in rising personal income, which reflects the evolution of employment and real wages. In the fourth quarter of 2012 consumption grew 7.3% in real terms, owing primarily to durable goods. Partial data from the first quarter of this year, such as retail, household items and car sales, signals dynamic private consumption. Domestic financial conditions show no major changes in recent months. Importantly, unlike previous cycles, this time consumer loans have not been an important catalyst for personal spending, since such loans have been growing at a slower pace. This is important information, because it reduces the probabilities of a strong deceleration or contraction in the near future due to households' need to reduce their debt, a factor that has been behind the weakness of developed economies for years already (figure 2).

The dynamism of domestic demand has manifested in increased imports, so its impact on the use of internal resources and inflation has been limited. The fastest-growing components of expenditure, namely investment in machinery & equipment and durable consumption, have been favored by the drop in relative import prices. The deficit of the current account of the balance of payments moved from 1.3% of GDP in 2011 to 3.5% in 2012, slightly less than projected last December. As has been noted before, the bigger deficit is a matter of concern, but its risks are mitigated by the greater investment flows to the tradable sector – related to major mining projects – as well as by the weight of FDI flows in its funding. Portfolio inflows and debt levels have remained at similar levels than previous years.

Inflation has continued to follow a downward trend. In February, the annual change in CPI stood at 1.3% and core inflation – in its CPIEFE measure, which excludes food and energy – reached 0.8% annually (figure 3). The recent trend has reflected a number of specific and transient influences, such as the high basis for comparison of the same months of 2012, the appreciation of the peso, the normalization of previous shocks to the prices of some perishables, and the stamp tax reduction. These effects have also been expressed through indexation mechanisms and expectations, and in the moderate services inflation rates despite strong demand and tight domestic markets. Other more lasting effects cannot be ruled out, such as the observed increase in productivity or the reduction in trade margins. In any case, the procyclical behavior of these elements leads to conclude that the medium-term inflationary risks associated to the intensity of use of installed capacity are still present. However, it is worth noting that private expectations one and two years out remain anchored around 3%.

Internationally, the outlook of slow growth in developed economies is maintained, but with some improvements. In the U.S. there are signs that private spending is gaining momentum, but growth prospects remain bounded because of the need for further fiscal adjustments. The Eurozone is still in recession and its recovery is being held back by the need to advance towards fiscal consolidation, persistent problems in the financial systems and the difficulty in making the necessary relative-price adjustments within the region. Plus the political difficulties to implement reforms that would allow raising trend growth rates. The emerging world continues to exhibit higher growth rates, although its performance has been more mixed. Fears of a pronounced slowdown in China have eased, and indicators point to a stabilization of output. Other emerging Asian economies are also signaling an improvement. In Latin America, the strong growth of Peru contrasts with the deceleration in Colombia and slow growth in Brazil and Argentina. The growth rates of other developed economies and commodity exporters have been affected by fiscal processes and lower prices of some of their exports, simultaneously with high current-account deficits. From December, the baseline scenario of this *Report* corrects the growth projection for our trading partners upward to an average of 3.9% in the forecast horizon, the first upward revision in over a year.

Global financial conditions have improved in recent months, partly reflecting a perception of lower probability of occurrence of extreme scenarios, particularly in the U.S., after learning that only some of the drastic fiscal adjustments previously approved will take effect. The greater confidence was reflected in greater preference for variable-income assets in developed economies, where long-term interest rates and stock prices have risen. The U.S. dollar has appreciated since December, mainly against the yen, reflecting expectations of a more expansionary monetary policy in Japan. Most of the currencies of emerging economies, including the Chilean peso, have appreciated against the dollar in the same time span.

The gasoline price has risen substantially this year so far, largely because of supply-side factors. This results in an upward revision of its forecast for this year and next. The copper price trend is forecast to slope downward, because of a larger response of supply than in previous years, but it is revised up in 2013, incorporating actual first-quarter figures. Thus, the baseline scenario assumes that the terms of trade will be slightly higher than foreseen last December (table 1).

In the baseline scenario, GDP growth will be in the 4.5%–5.5% range in 2013, exceeding December projections. The revision is partly explained by stronger growth foreseen in the mining industry, as revealed by incoming indicators. It also considers that the external impulse the Chilean economy will be receiving from abroad will be somewhat stronger, in line with upward revisions to growth of our trading partners and terms of trade.

Domestic demand growth, because of both its dynamism of the end of 2012 and partial indicators of early 2013, is also corrected upward, to 6.1% (5.7% in December). Annual growth in investment and consumption is up from earlier projections, bringing the current account deficit to 4.4% of GDP in 2013, compared with 4.6% forecast in December. In any case, the path of domestic demand and investment assumes variation rates declining in the coming quarters (table 2).

Y-o-y inflation will remain low in the short term, still affected by the specific factors that have influenced recent indicators. As they dissipate, CPI inflation will start to rise, reaching 2% by mid-year. In early 2014, both headline and core CPI inflation should hit 3% and stay there until the end of the projection horizon, this time the first quarter of 2015 (figure 4). This projection assumes that wages will adjust in line with productivity and the inflation target. This forecast also uses as a methodological assumption that in the projection horizon, the real exchange rate (RER) will remain around its recent values. This, because with the nominal exchange rate and currency parities currently in effect, the RER is estimated to be within – although in the lower part of – the range consistent with its long-term fundamentals. Finally, the baseline scenario uses as a working assumption that the MPR trajectory will be similar to what can be inferred from the latest surveys available at the statistical closing of this *Report* (figure 5).

In the past few quarters, the Chilean peso has appreciated both bilaterally against the dollar and in multilateral terms (figure 6). This gain in value has also resulted in an appreciation of the RER. The factors behind this trend are varied, but in essence have to do with the cyclical position of the Chilean economy relative to other countries, especially the developed world, and the weight of commodities in its export basket. However, as we note in a box in this *Report*, if these factors are taken into account, the appreciation of the Chilean RER is not different from that of other emerging economies, other commodity-exporting countries and other economies with closed output gaps (figure 7). When a longer period is used for the comparison (e.g. the last ten or fifteen years) the conclusions are the same.

In this context, some economies have implemented foreign exchange measures, including interventions to mitigate the appreciation of their currencies. While these actions may be desirable in certain situations – Chile has actually used them in the past and they are part of its policy toolkit – implementing them requires a careful evaluation of both the benefits and costs to the country. These measures are appropriate to correct an over-reaction in the value of the currency against its medium- and long-term fundamentals or as a way to build an international reserve position, providing greater safety in the event of a sharp contraction of external financing. These benefits are difficult to quantify objectively, but it is reasonable to think that the lower the availability of reserves or the further away the real exchange rate is from its long-term trend, the greater the benefits.

At the same time, we must always bear the costs associated with these interventions in mind. First, there is the direct financial cost, because the reserves are invested in highly liquid and safe instruments, but whose interest rates are lower than that of the local instruments financing their acquisition. This generates a significant cost that eats into the

Central Bank's net worth. Moreover, it is important to preserve the flexibility of the exchange rate in the Chilean economy because it facilitates accommodating external shocks. The major external crises we have faced in the past have been associated with overly rigid exchange rate regimes, which exacerbate credit cycles and mismatches, delay relative-price adjustments and when they finally occur, they have high financial and real costs for the economy.

As usual, our 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 biased upward for output and unbiased for inflation.

Internationally, the probability of negative scenarios in the United States have moderated in recent months and in China the threat of a sharp correction in growth has eased. However, the possibility of tensions intensifying in the Eurozone has not receded. The fiscal and financial fragility in this region persists and the ability of policy makers to implement reforms is weakened due to meager growth prospects. The recent episode of Cyprus is a case in point. Italy also deserves special concern, because of the size of its public debt and its weight in the European banking system. New stress episodes in international financial markets could lead to adjustments in the prices of financial assets and commodities, and in global growth prospects. In particular, a sharp and persistent decline in copper prices originating in real or financial factors would have significant effects on the current account, domestic demand and inflation.

The emerging world is facing big challenges in the conduct of economic policies in a scenario that foresees that the strongly expansionary monetary policy of developed economies will continue for a long period. This, because of the possible effects of interest rate differentials between emerging and developed countries on capital flows, asset prices, credit growth and currency behavior. Currency-related tensions may create frictions that may hamper international trade and world growth.

The greatest risks have to do with the persistence of highly dynamic domestic demand. On one hand, the economy is already using its internal resources intensively, so if the current expansion of domestic expenditure continues, it could generate, in the medium term, additional pressures on the labor market, the use of installed capacity and inflation. On the other hand, because of its incidence in the behavior of the current account deficit and its potential impact on the vulnerability of the Chilean economy. Any sudden change in external conditions, say, a reduction in the terms of trade or unfavorable financial conditions, could expose the country to costly adjustments. History provides several episodes of this nature. While the Chilean economy has refined its economic policy framework to make it more resilient to external shocks, and both the funding of the current account deficit and the destination of its resources mitigate these risks, it is essential to prevent the incubation of imbalances.

The opposing forces facing monetary policy remain. Some external risks have eased, but the European situation is delicate. Inflationary risks in the medium term remain in place due to strong demand. The MPR is within an estimated neutral range, but its current level is high by international standards. (figure 8).

Interest rate differentials with the developed world pose challenges for policy making in emerging economies, including Chile. The Board follows closely the evolution of the external and internal macroeconomic scenarios and their impact on inflation, and reiterates its commitment to conduct monetary policy so that projected inflation stands at 3% over the policy horizon.

Allow me some final thoughts.

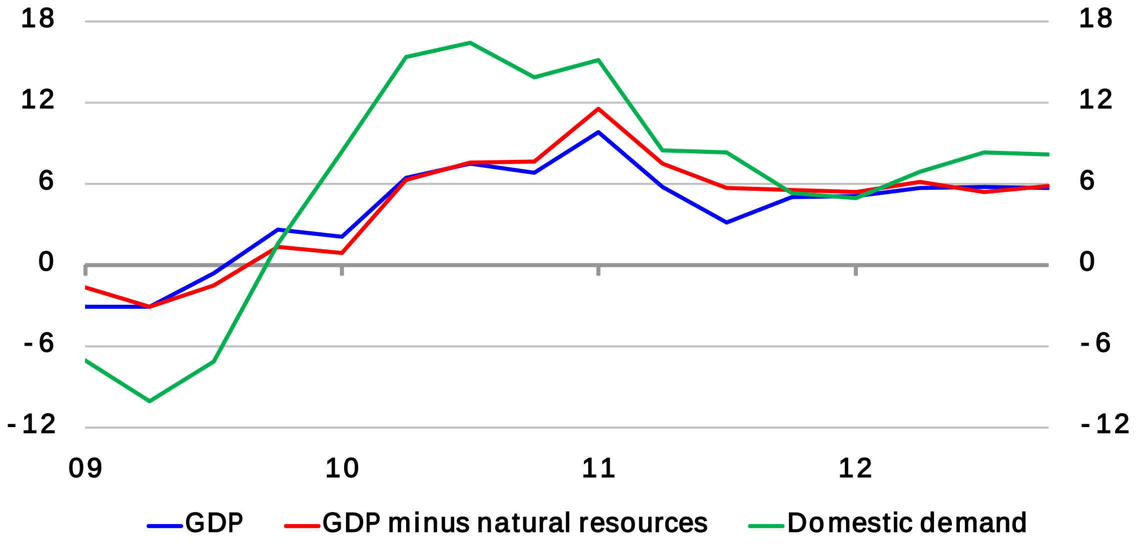
Final remarks

The Chilean economy has made great progress in the past several decades. The improvements to our economic and financial policy regimes, together with an external environment that has been relatively favorable for our country – particularly the price of copper, which owes in turn to the strength of the Chinese economy – permitted us to successfully weather the worst international crisis of the last sixty years. We healed quickly and today we are close to full employment, with personal income growing steadily and low inflation. Plus high investment levels that will help us sustain this growth trend into the future.

Still, there are big challenges ahead. Risks are present and the policies we need to adopt to confront them are not always evident. So it is essential that we keep the road clear and take good care of that which has taken so much effort to achieve. Let me say again what I said at the beginning: self complacency is one of the worst mistakes the entities responsible for our country's economic policies can make. Thus we must pay close attention to events. As a central bank our focus is on ensuring the stability of prices and the financial system. This is the best contribution we can make to the well-being of our population.

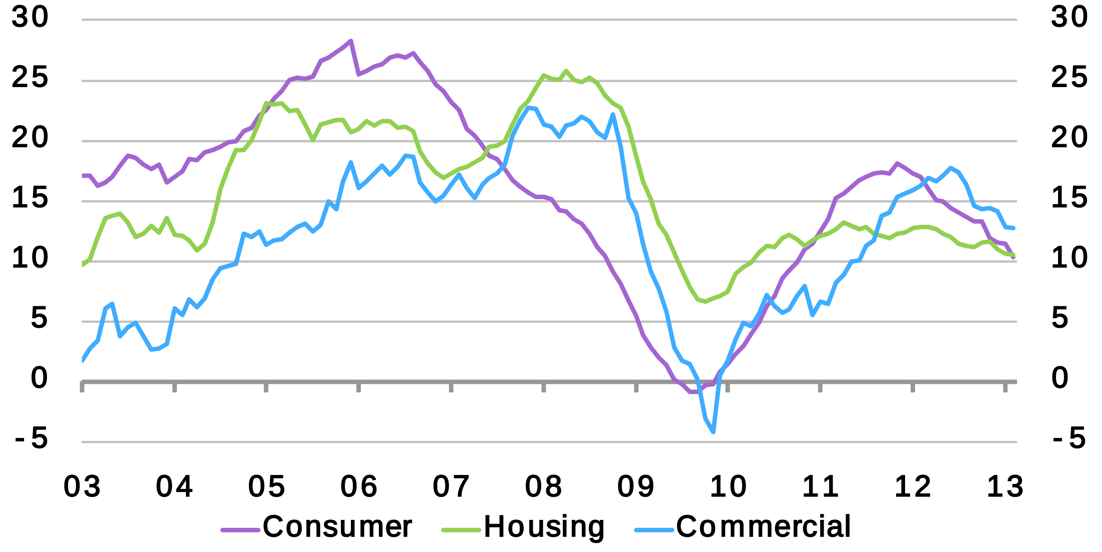
Thank you.

Figure 1
GDP and demand
(annual change, percent)



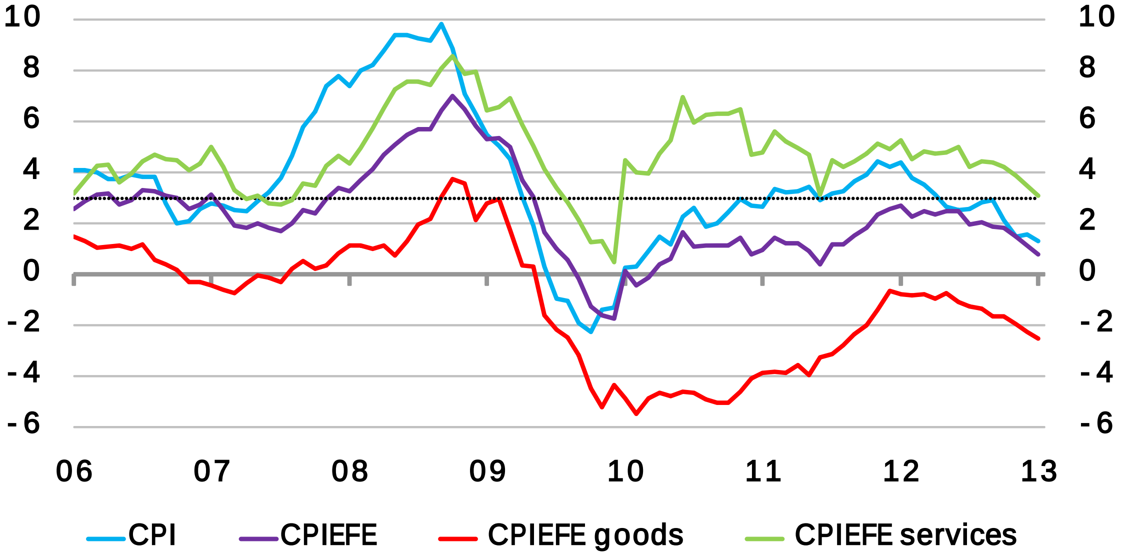
Source: Central Bank of Chile.

Figure 2
Nominal loans by type of credit
(annual change, percent)



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

Figure 3
Inflation indicators
(annual change, percent)



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

Table 1
International baseline scenario assumptions

	2011	2012 (e) Dec.12 Report	2012 (e) Mar.13 Report	2013 (f) Dec.12 Report	2013 (f) Mar.13 Report	2014 (f) Dec.12 Report	2014 (f) Mar.13 Report
Growth		(annual change, percent)					
Trading partners' GDP	4.2	3.3	3.4	3.5	3.6	4.0	4.2
World GDP at PPP	3.9	3.0	3.0	3.3	3.3	3.8	3.9
United States	1.8	2.3	2.2	1.9	1.9	2.3	2.5
Eurozone	1.4	-0.5	-0.6	-0.3	-0.4	1.2	1.3
Japan	-0.6	1.9	2.0	0.5	1.1	0.9	1.3
China	9.3	7.7	7.8	8.0	8.1	8.2	8.2
India	7.9	5.6	4.9	6.6	6.3	6.4	6.4
Rest of Asia (excl. Japan, China and India)	4.2	3.5	3.8	4.3	4.3	4.7	4.7
Latin America (excl. Chile)	4.5	2.8	2.8	3.3	3.3	3.7	3.7
		(levels)					
LME copper price (US$cent/lb)	400	361	361	340	350	350	340
Brent oil price (US$/barrel)	111	112	112	105	108	100	101
		(annual change, percent)					
Terms of trade	-0.6	-5.0	-4.1	-0,8	-0.4	1.3	-1,6

(e) Estimate.
(f) Forecast.

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

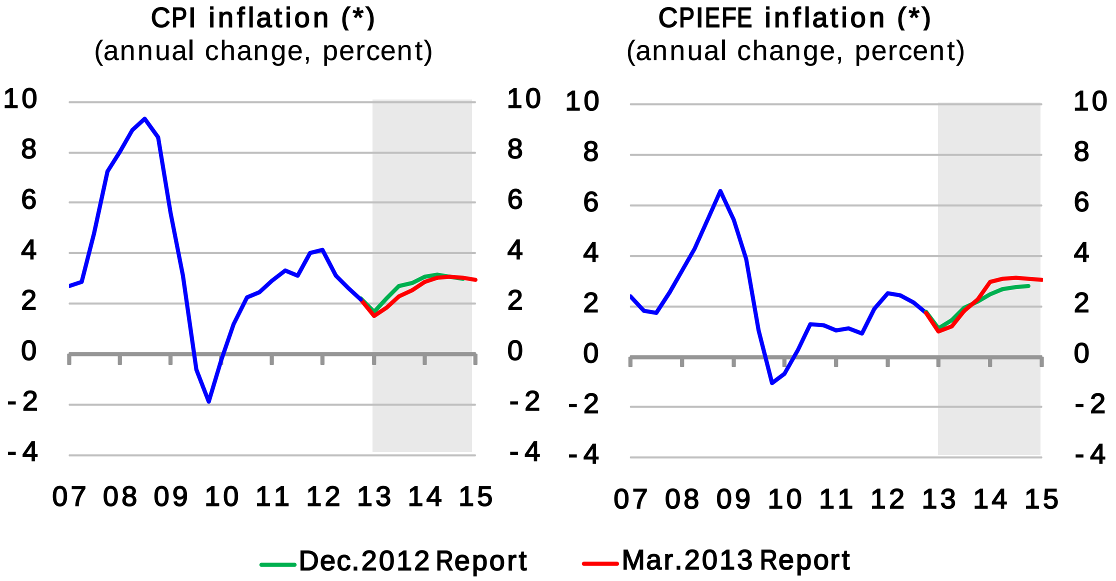
Table 2
Economic growth and current account
(annual change, percent)

	2011	2012 (e) Dec.12 Report	2012 (e) Mar.13 Report	2013 (f) Dec.12 Report	2013 (f) Mar.13 Report
GDP	5.9	5.5	5.6	4.25-5.25	4.5-5.5
Domestic demand	9.1	6.6	7.1	5.7	6.1
Domestic demand (w/o inventory change)	9.4	6.8	7.3	6.0	6.1
Gross fixed capital formation	14.7	11.3	12.3	7.6	7.2
Total consumption	7.9	5.3	5.8	5.5	5.7
Goods and services exports	5.2	2.7	1.0	3.0	3.1
Goods and services imports	14.5	5.5	4.9	5.9	5.9
Current account (% of GDP)	-1.3	-3.8	-3.5	-4.6	-4.4

(e) Estimate.
(f) Forecast,

Source: Central Bank of Chile.

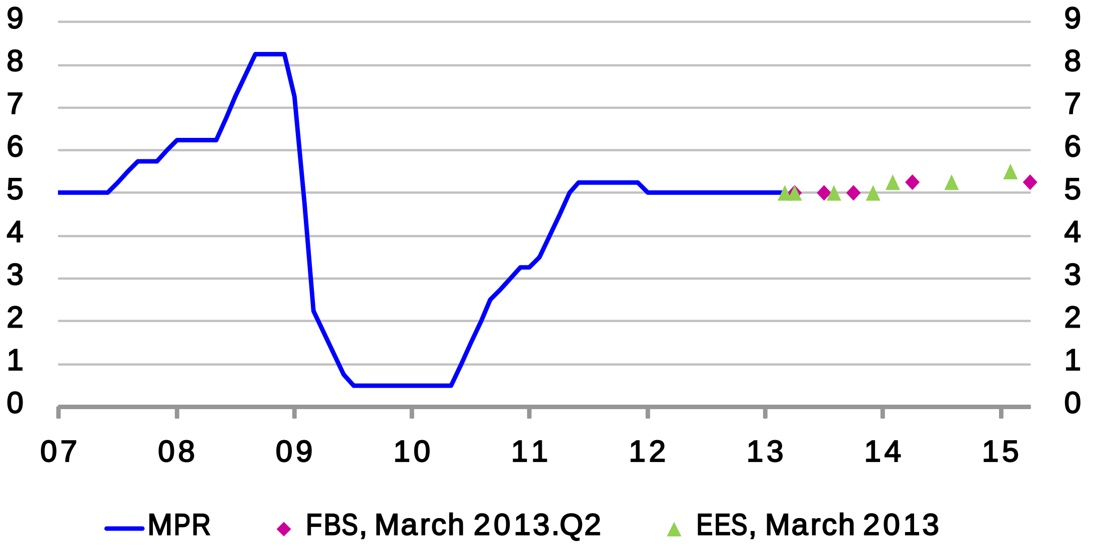
Figure 4



(*) Gray area, as from the first quarter of 2013, shows forecast.

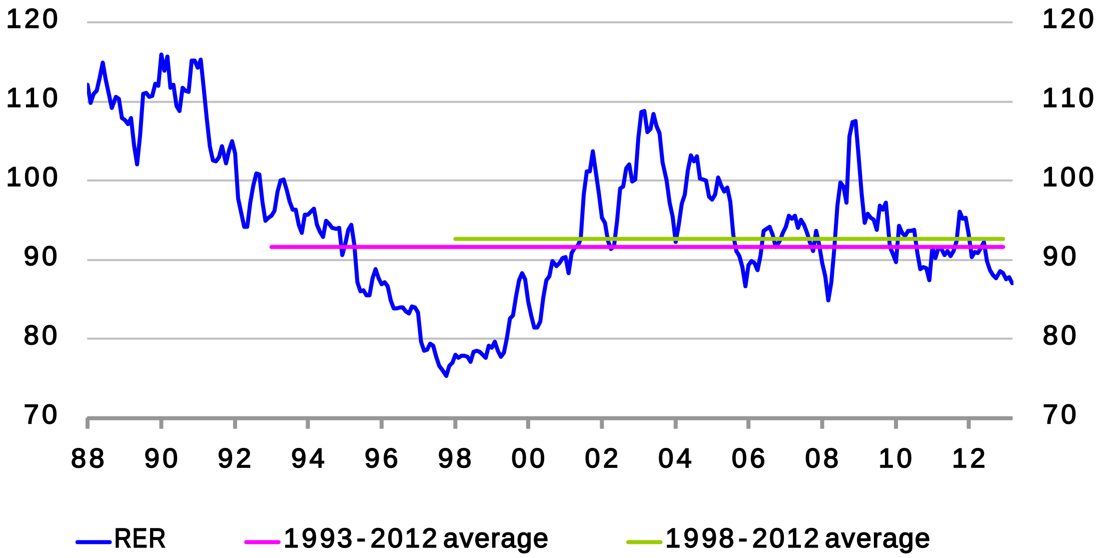
Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 5
MPR and expectations
(percent)



Source: Central Bank of Chile.

Figure 6
Real exchange rate
(index, 1986=100)

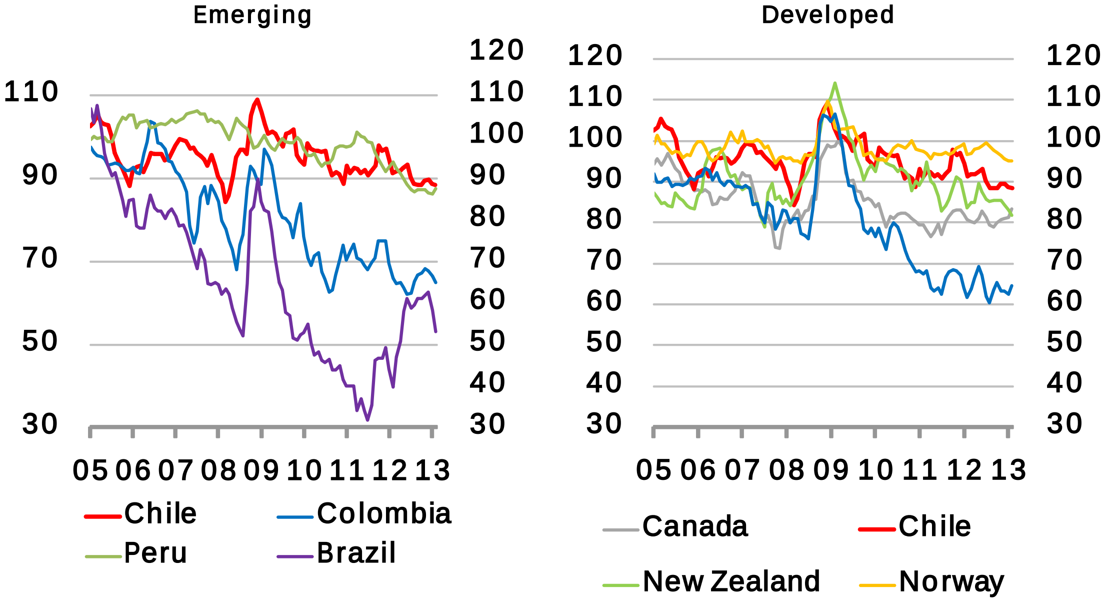


Source: Central Bank of Chile.

Figure 7

RERs of commodity-exporting countries (*)

(index, 2000-2007 average=100)



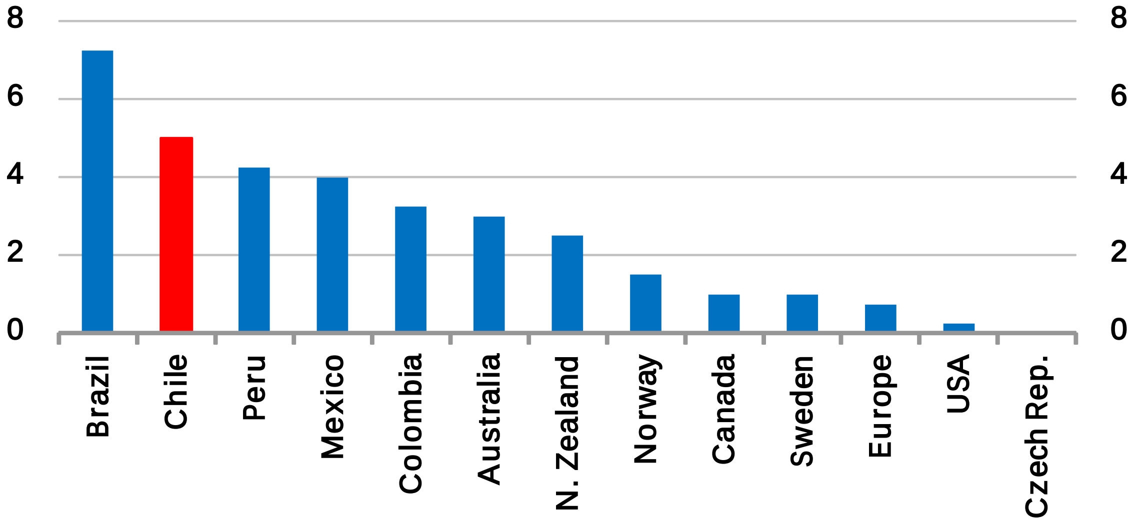
(*) An increase indicates depreciation.

Source: BIS.

Figure 8

Monetary policy rate

(percent)



Sources: Central Bank of Chile and central banks of respective countries.