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 Honorable Senate of the Republic, Santiago de Chile, 4 September 2013.

*   *   *

The *Monetary Policy Report* of September 2013 can be found at http://www.bcentral.cl. Accompanying figures and tables can be found at the end of the speech.

Mister President of the Senate, Senator Jorge Pizarro, honorable senators, ladies, gentlemen,

Thank you for inviting the Board of the Central Bank of Chile to present our Monetary Policy Report. Each September, this presentation coincides with the annual report of the Central Bank to the Senate, where we share our vision on the recent macroeconomic and financial developments in Chile and the world, together with the economic-financial outlook and its implications on monetary policy.

When I presented our Monetary Policy Report to the Senate’s Finance Committee in early July, I said that the world economy had begun to move towards a more normal configuration, with a more balanced growth outlook between developed and emerging countries, and where the terms of trade and financial conditions would not be as favorable to Chile as they had been for some years. This scenario would imply a lower external stimulus to our economy and increased volatility in international financial markets in the short term, but at the same time it contained some positive elements such as recovering growth in developed economies and more normal international interest rates, which would help achieve a more sustainable global economy in the medium term.

In recent months, the world has continued to advance towards a more balanced situation, but it has also unveiled some of the risks we pointed out last July. Some countries have been more volatile in this transition, as reflected in strong devaluations of their currencies, higher interest rates, downward adjustments in growth expectations and capital outflows (figure 1). The list includes some of the biggest emerging economies like Brazil, India, Indonesia, Turkey and South Africa. This reflects a combination of a lower monetary stimulus expected in the U.S. with the vulnerabilities that were created in previous years in some emerging economies. The latter include greater reliance on external funding, currency mismatches, fiscal imbalances, rapid growth in domestic credit and relatively high inflation rates. These shortcomings mean less room to maneuver economic policies to compensate for the deterioration in the external scenario. Several economies that had intervened very actively to prevent exchange rate appreciations have begun to act now to curb the depreciation of their currencies. Brazil, for example, announced an intervention amounting to 60 billion dollars by the end of the year, while India has introduced capital controls to grapple with the sharp fall in the rupee. An important risk we highlight in this Report is an intensification of financial volatility and the slowdown in the growth of emerging economies. In Chile, the effects of this greater international volatility have so far been limited and have manifested mainly in the depreciation of the peso and a stock market downturn.

Another important source of risk that we consider in this Report is related to China. As we have mentioned time and again, the evolution of this economy concerns us not only for its importance as driver of global growth, but also for its impact on exports from Chile and, in particular, the price of copper, since China is the largest copper consumer in the world. In recent times there have been doubts about the situation of their financial system, especially after the strong growth in bank credit and non-bank intermediation from 2009 onwards. Another source of risk is the behavior of oil prices because of the geopolitical situation in the

Middle East. Moreover, although there are encouraging signs from the Eurozone, risks remain associated with its complex political, fiscal and financial outlook.

These external risks are important enough for us to evaluate that Chile's economic growth risks are biased downward. The challenges from abroad are diverse, but as we have mentioned several times, the Chilean economy is well prepared to face them. As a country we have worked for years in strengthening a solid institutional framework with an economic policy scheme based on inflation targeting and a floating exchange rate, with a fiscal rule, a well regulated and supervised financial system, and trade and financial openness.

As we have said on other occasions, our scheme of inflation targeting and floating exchange rate allows us to better cope with fluctuations in international markets. The float facilitates early and flexible adjustment of relative prices to changes in the external environment and prevents distortions in the decisions on external financing and exchange-rate hedging of companies and financial institutions in Chile. The recent depreciation of the peso is going in the right direction to help the economy to adjust. Furthermore, the credibility of the inflation targeting framework grants flexibility to the central bank to make changes to the monetary policy and the cost of credit if so required by the macroeconomic scenario, along with allowing adjustments to the nominal and real exchange rate.

In order for us to grasp these benefits in times of shortage, we need to act consistently in times of abundance. We have often been confronted with social pressures to intervene the exchange rate market or lower the interest rate to prevent an appreciation of the peso, following the example of countries that are more active in this field. While recognizing that overreactions can occur in the short term in either direction that could warrant such an intervention, we need to be aware that it entails carry costs for the Central Bank and affects the overall economy.

Focusing on keeping inflation near the target and preserving the flexibility of the exchange rate in times of bonanza allows the peso to accommodate conditions like the present ones and adjust more efficiently to the new situation. We also know that exchange rate flexibility plays a critical role in preventing currency mismatches, which have taken such a great toll elsewhere in the region and in Chile in the past. Overall, the appreciation of the peso that we saw a few months back was milder than that of other currencies, so now the depreciation has not been as sharp either.

Domestically, monetary policy has continued to face many short-term challenges. The sound economic slowdown we were expecting has been gradually occurring. On the expenditure side, however, consumption continues to be very strong, boosted by labor market conditions. Actually, the latest indicators confirm the strength of the labor market.

The information we have reviewed for this Report suggests that this component of domestic demand will moderate in the coming quarters, but we must not overlook the risk of a slower than expected adjustment of consumption, affecting the use of domestic resources and the deficit of the current account of the balance of payments.

In this context, the Board has held the MPR at 5%, but noting that if these trends consolidate adjustments to the policy rate may be required.

Let me now describe for you our baseline scenario for the Chilean economy and the main risks examined in our Report.

Macroeconomic scenario

International trends depicted in June have settled. News coming from the developed economies, particularly the United States, confirms a gradual recovery. The revision of U.S. economic figures lowered the growth forecast for the whole year, but showed that the U.S. economy picked up sooner than expected. In the second quarter it accelerated thanks to increased investments in fixed assets, a steady improvement in the labor market and more optimistic expectations of consumers and enterprises. In addition, the markets foresee that the Fed will anticipate the withdrawal of the monetary stimulus in place. The recovery of the Japanese economy continues, but questions remain regarding its sustainability. After six quarters of contraction, the Eurozone recorded positive growth in the second quarter, driven by Germany and France, and also favored by the economies of the periphery that moderated their contractions. However, it is still premature to conclude a change in trend.

The emerging world, on the other hand, has continued to show widespread deceleration. China settled in lower growth figures, despite some signs of stabilizing output and messages from the authorities that they will sustain an economic expansion of 7% annually. Accordingly, our baseline scenario has revised the growth outlook for the world and our trading partners for 2013 and 2014 slightly downward (table 1).

The portfolio realignment originating in the transition to a more balanced configuration of the external scenario has not been without volatility, which again was evident in the weeks before the close of this Report. Although the authorities of the U.S. Federal Reserve (Fed) have pointed out that the unconventional stimulus program will be withdrawn gradually – helping to tone down the reaction of the markets – most recently volatility has been on the rise. Capital flows to emerging economies have retreated and become costlier, especially in the most vulnerable economies. The U.S. dollar depreciated against the currencies of developed economies, but appreciated in the emerging world. As I said at the beginning of this presentation, the latter has complicated macroeconomic management in some countries because of its inflationary and financial effects, and has led to reverse previously adopted exchange rate interventions. In the developed markets, long-term interest rates have risen again, internalizing that the Fed will soon begin reducing its asset purchases.

In Chile, since our June Report, domestic output and demand have continued with the gradual normalization process that began this year, growing less than in 2012 for the second consecutive quarter. In the second quarter, GDP expanded 4.1%, confirming the slowdown (figure 2). The natural resources sector reduced its annual growth rate by more than two points compared with the previous quarter, primarily related to lower mine production early in the quarter, but also to the significant drop in fishery. Sectors other than natural resources performed below trend in the second quarter. Growth was mainly driven by trade and construction, while other areas linked to investment slowed. Installed capacity utilization has declined accordingly.

Domestic demand slowed down further in the second quarter. Final demand, however, which excludes inventories, continued to grow at the same pace of the first quarter. Gross fixed capital formation posted y-o-y expansion flat from the first quarter of this year, but below the figures of the second half of 2012. As has been noted before, this slowdown owes mainly to the maturing of mining investments after three years largely outperforming GDP. Also in an external context where the copper price has dropped and moderating expectations for growth around the world but especially in China, which call for more caution when evaluating investment decisions. On the other hand, private consumption was more dynamic, especially in its non-durable component, while durables remained high. Labor market conditions have continued to tighten, but are still the main driver of this component. Nominal and real wages have moderated their annual variation, while the unemployment rate remains near all-time lows. Again, unlike previous cycles, credit growth has accompanied private income, but has not been the main determinant of household spending. This last quarter saw a significant depletion of inventories, reversing the opposite trend seen in the first quarter of the year, due to, among other factors, the effects of the port strike.

As forecast, CPI inflation has returned to the tolerance range, as the temporary factors that affected it have eased (figure 3). In particular, the prices of electricity and gasoline rose, the former due to the end of price recalculations, the latter because of world prices and, to a lesser extent, the exchange rate depreciation. Yet the core measure – CPIEFE, which excludes foods and energy – has remained near 1% annually, affected by the persistent negative incidence of the goods component. Inflation expectations two years ahead remain close to 3% annually.

Although the Board has held the MPR constant, there have been variations in domestic interest rates and the real exchange rate that smooth the economy's adjustment to a scenario of lower external impulse and less pressures on internal resources. Market interest rates have dropped in the year so far. The real exchange rate (RER) has depreciated, approaching its average of the past 15 to 20 years, and is believed to be within the range consistent with its long-term fundamentals (figure 4).

The baseline scenario assumes that Chile's GDP will grow between 4.0 and 4.5% this year. This range is consistent with assumptions in last June's Report. In 2014, growth should be in the 4.0 to 5.0% range. The baseline scenario reflects the slowdown in output that has been occurring during the year. It also assumes that investment will moderate further as the investment cycle is completed, consistently with adjustments seen in business surveys and investment plans. Consumption is expected to slow gradually because of the still strong labor market and the relative stability of household saving during the expansionary phase of the cycle. Consumer expectations are less optimistic these past few months and are approaching neutrality, which will help moderate this component of expenditure. So will the slower pace of marginal job creation, particularly salaried work, and the slowdown of real wages. Coupled with this is the depreciation of the real exchange rate which will affect durable consumption. Also, moderating investment will help to take pressure off the labor market. Finally, there is the foreseen reduction in the impulse from abroad (table 2).

Inflation is expected to continue to grow steadily to reach 3% during the first half of 2014 and and be stable until the end of the projection horizon, this time the third quarter of 2015. The CPIEFE will take somewhat longer to hit 3%. The underlying assumption is that nominal wages will rise in line with productivity and the inflation target. There is also the methodological assumption that the RER will remain near its recent values. Finally, the baseline scenario uses as a working assumption that the MPR will follow a path similar to the one implicit in expectations surveys available at the closing of this Report (figure 5).

The baseline scenario reflects the developments that the Board believes to be the most likely to occur with the information at hand at the statistical closing of the Report. However, there are risk scenarios that, if materialized, might change the macroeconomic outlook and, therefore, the course of monetary policy. On this occasion, after evaluating the alternative scenarios, the Board estimates that the risk balance is downward biased for output and unbiased for inflation.

On the global front, a first risk comes from China, namely the fragility of its financial system, among other factors. As I said at the beginning, the banks' off-balance-sheet financial intermediation has been increasing and credit has accumulated enormous growth in the past few years, with a substantial portion going to local governments. In other economies, episodes of rapid credit growth have resulted a few years down the line in a deterioration of the quality of banking assets and financial intermediaries' balance sheets, and in a slowdown in domestic demand. Although the Chinese financial system has some features that differentiate it from others, there is no denying that any difficulties in this field could have negative effects on China's growth for a longer period. If so, it would hurt world growth and commodity prices, particularly for copper.

A second risk coming from abroad has to do with the way emerging economies will accommodate the withdrawal of monetary stimulus packages in developed countries. The credit conditions facing emerging economies have tightened, which is causing financial, exchange-rate and inflationary difficulties in those where vulnerabilities built up during the boom. Special attention deserve the economies with high external financing needs, including not only emerging ones but also some in peripheral Europe. Finally, there is still the risk associated with the complex fiscal and financial situation of the Eurozone. Add to this the intensifying geopolitical tensions in the Middle East, which could significantly affect the oil price, causing negative effects on world growth and higher pressures on fuel inflation.

In Chile, although the economic slowdown is underway, it is possible that final demand, particularly private consumption, continues to adjust at a slower-than-desired pace, increasing the risk of higher inflation and a constant or growing current-account deficit. The risk of a wider current-account deficit would increase in a scenario of further deteriorated terms of trade. However, as we have pointed out before, this deficit comes largely from investment flows into the tradable sector – especially mining – financed by foreign direct investment. The recent slowdown of investment and the exchange rate depreciation are some of the adjustments needed. Moreover, the evidence shown in a box in this Report suggests that the mining investment cycle is maturing. This will moderate domestic demand and pressures over internal resources, the labor market and imports of capital goods. Meanwhile, the startup of mining projects has driven volume exports up. All of this points at more favorable current-account balances in the medium term. Anyway, for the purposes of assessing this risk we also need to review the evolution of the deficit measured at trend prices. In this sense, news is pointing in the right direction, because the estimate for this year went from 5.7% of GDP last March, to 4.9% in this Report. We estimate that in 2014 it will continue to recede to 4.6% of GDP.

The international economy is undergoing a normalization process that influences the Chilean economy. This means a lower external impulse, with more balanced world growth between developed and emerging economies, terms of trade approaching their long-term level and global financial conditions more in line with historic patterns. A smaller boost from foreign investment is also to be expected – especially in mining –, which will take pressure off the current-account deficit and the use of internal resources. Monetary policy is well equipped, if so required, to back this adjustment process. The Board follows closely the evolution of the external and domestic macroeconomic scenario and its implications on inflation, and reaffirms its commitment to conduct monetary policy so that projected inflation stands at 3% over the policy horizon.

I would like to end by sharing with you some final thoughts.

Final thoughts

We have been 19 months with the same monetary policy interest rate. And as with the exchange rate, during this time we have received the most diverse recommendations and suggestions from the market. From taking prompt action to prevent the economy from overheating to acting just as promptly to avoid deterioration. In this dilemma, we have always opted for a medium- to long-run look over the short-term ups and downs, and therefore considered all the risks involved. So far this has allowed us to properly anticipate events and stick to what we believe has been the right monetary policy.

The international conjuncture puts us to the test; we have identified many risks in this area. Over the months they have increased in both variety and origins. We know that we are prepared to face them in the best way possible. It is impossible to be immune. In fact, a small open economy like Chile is always subject to the vagaries of the international economy: it could not be otherwise. However, policy makers should be able to overcome them without major setbacks.

There are also challenges within our borders, especially doubts about the evolution of a number of variables, such as employment and consumption, among others. It is precisely this medium- to long-term vision what helps us not to make hasty decisions. We have said that we are ready to take action if necessary, but overreacting to one particular event would be tantamount to throwing away the well-earned credibility of the Central Bank, which is a fundamental anchor to achieve our goal of safeguarding the stability of the price level and the financial system.

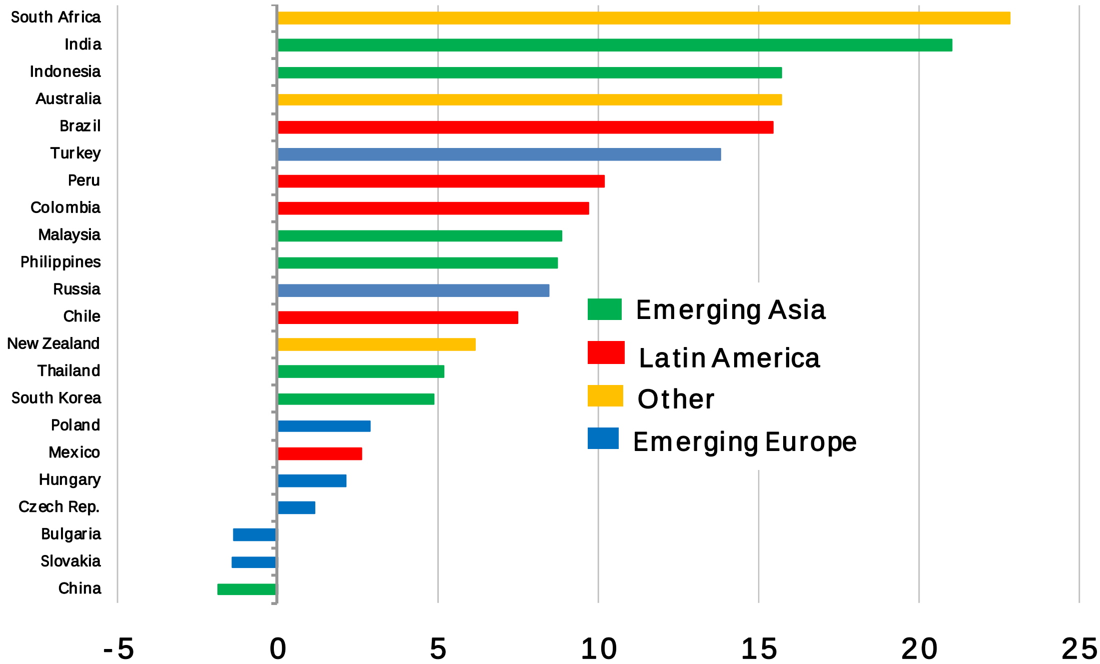
In short, the country is prepared to face a somewhat less favorable external scenario next year, which undoubtedly will have effects on the domestic economy. For years we have built solid macroeconomic balances, which yield their fruit when adverse situations hit. We are confident that, in such a scenario, this will be no exception. Our institutions, solid but flexible at the same time, distinguish us in the world. This allows us to look at the country's future with calm and optimism. We as central bank will continue to contribute our own efforts to the stability of the currency and the normal functioning of the internal and external payment system, the development and welfare of the Chilean population.

Thank you.

Figure 1

Nominal exchange rate variation in 2013 (*)

(percent)



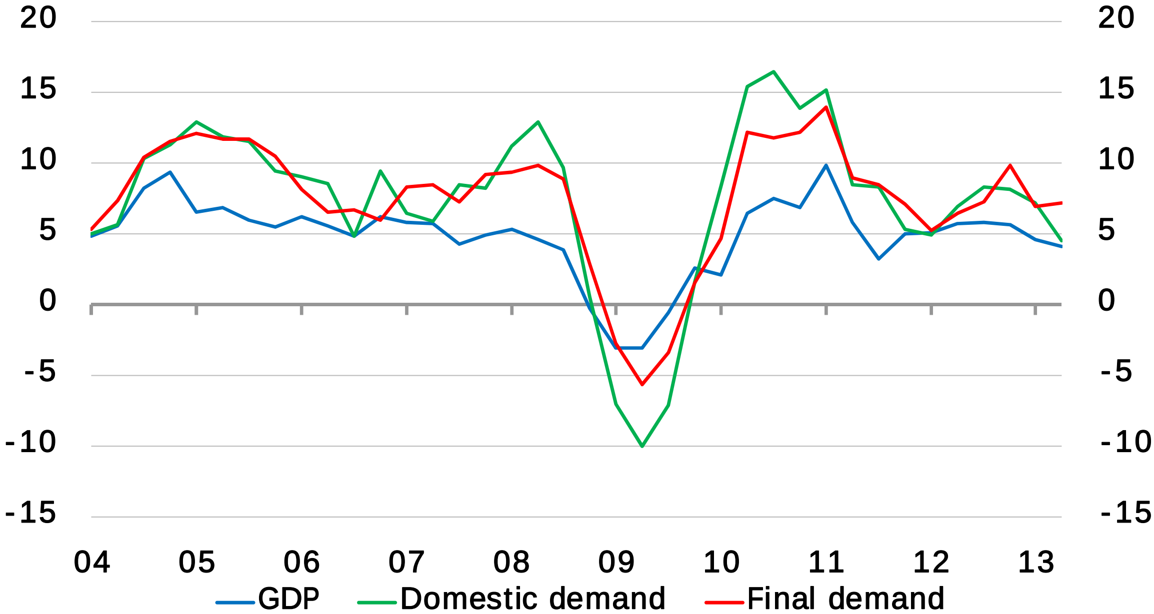
(*) An increase denotes a depreciation.

Sources: Central Bank of Chile and Bloomberg.

Figure 2

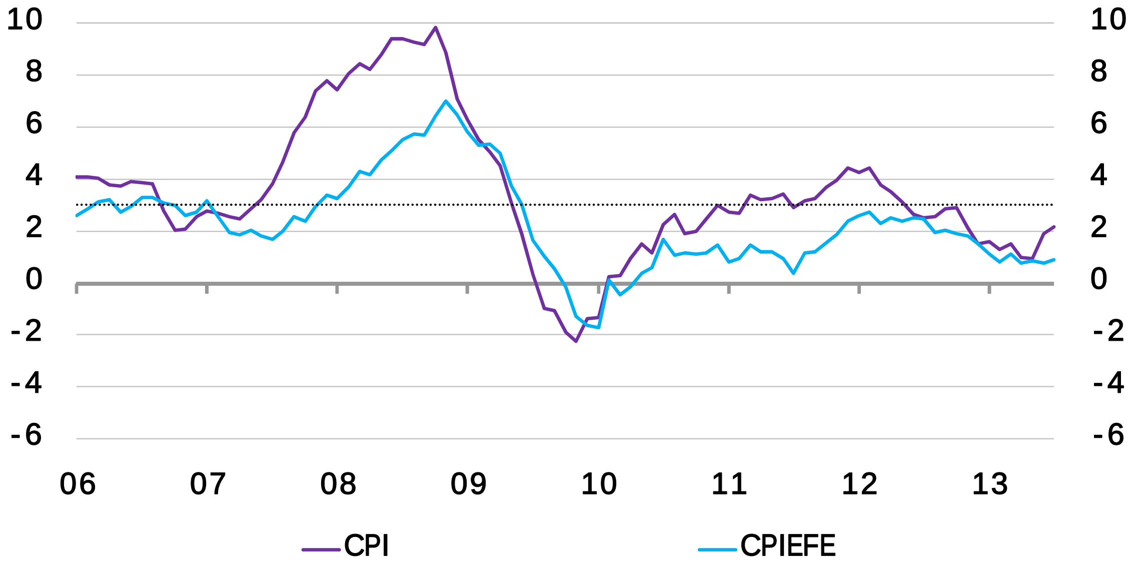
GDP and final demand

(annual change, percent)



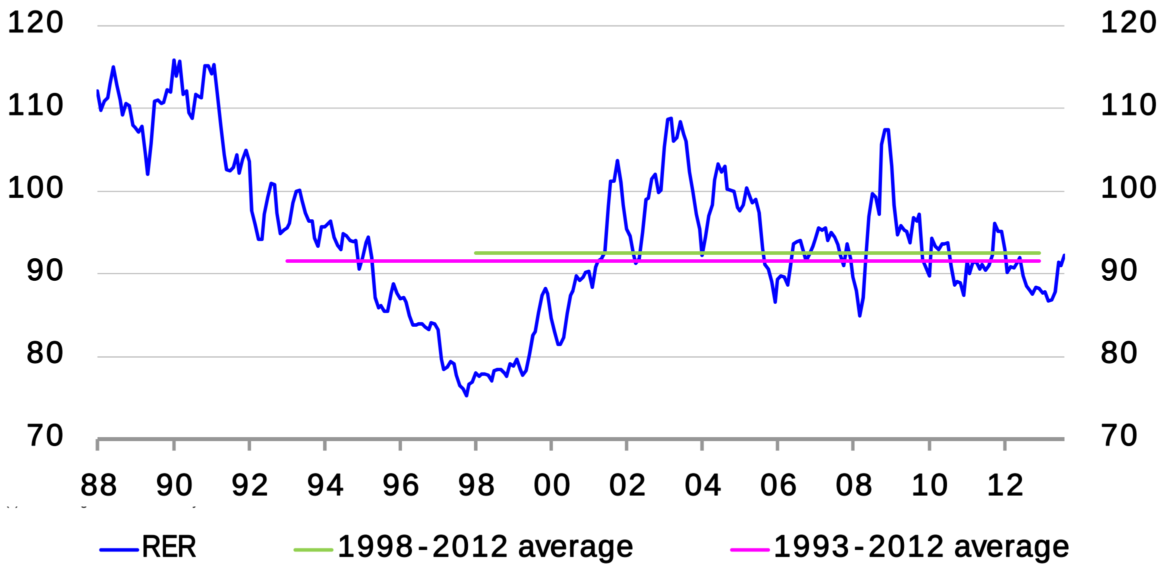
Source: Central Bank of Chile.

Figure 3
Inflation indicators
(annual change, percent)



Source: National Statistics Institute (INE).

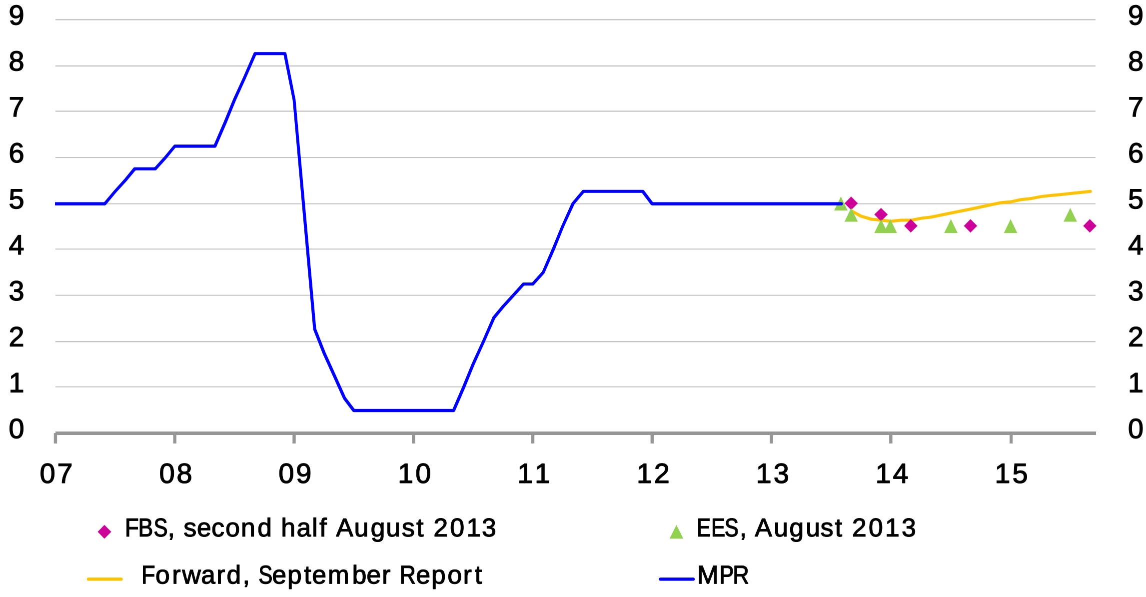
Figure 4
Real exchange rate (*)
(index, 1986=100)



(*) Includes information up to 27 August.

Source: Central Bank of Chile.

Figure 5
MPR and expectations
(percent)



Source: Central Bank of Chile.

Table 1
International baseline scenario assumptions

	2012	2013 (f) Mar. 13 Report	Jun. 13 Report	Sep. 13 Report	2014 (f) Mar. 13 Report	Jun. 13 Report	Sep. 13 Report	2015 (f) Sep. 13 Report
GDP growth		(annual change, percent)						
Trading partners' GDP	3.4	3.6	3.4	3.3	4.2	3.7	3.6	4.0
World GDP at PPP	3.1	3.3	3.1	3.0	3.9	3.6	3.5	3.9
United States	2.8	1.9	1.9	1.5	2.5	2.7	2.6	2.7
Eurozone	-0.5	-0.4	-0.6	-0.5	1.3	1.0	1.0	2.1
Japan	2.0	1.1	1.8	1.7	1.3	1.0	1.0	0.8
China	7.8	8.1	7.6	7.5	8.2	7.5	7.4	7.5
India	5.1	6.3	5.4	5.4	6.4	5.9	5.8	6.3
Rest of Asia (excl. Japan, China and India)	3.8	4.3	3.8	3.8	4.7	4.1	3.9	4.1
Latin America (excl. Chile)	2.7	3.3	2.8	2.7	3.7	3.1	2.9	3.7
		(levels)						
LME copper price (US$cent/lb)	361	350	325	330	340	305	305	290
Brent oil price (US$/barrel)	112	108	105	108	101	98	108	97
		(annual change, percent)						
Terms of trade	-4.1	-0.4	-3.5	-5.2	-1.6	0.4	0.1	-1.2

(f) Forecast.

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

Table 2
Domestic scenario
(annual change, percent)

	2012	2013 (f) Mar. 13 Report	Jun. 13 Report	Sep. 13 Report	2014 (f) Sep. 13 Report
GDP	5.6	4,5-5,5	4,0-5,0	4-4,5	4,0-5,0
Domestic demand	7.1	6.1	4.9	4.9	4.9
Domestic demand (w/o inventory change)	7.3	6.1	5.1	5.7	4.8
Gross fixed capital formation	12.3	7.2	5.5	5.6	4.5
Total consumption	5.8	5.7	5.0	5.6	5.0
Goods and services exports	1.0	3.1	3.8	4.0	3.3
Goods and services imports	4.9	5.9	5.0	5.6	4.5
Current account (% of GDP)	-3.5	-4.4	-4.7	-4.5	-4.8
December CPI	1.5	2.8	2.6	2.6	2.8
December CPIEFE	1.5	2.5	2.0	1.7	2.8

(f) Forecast.

Source: Central Bank of Chile.