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, 3 December 2013.

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The Monetary Policy Report of December 2013 and the Financial Stability Report of the second half of 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.

I am grateful for your invitation to present the vision of the Central Bank's Board on the recent macroeconomic and financial developments, its Outlook and implications on monetary and financial policy. This vision is contained in detail in our December *Monetary Policy Report* and our second-half *Financial Stability Report* we are presenting now.

The macroeconomic scenario has evolved along the trends described in the latest Monetary Policy Reports. In the external scenario, growth is more balanced between developed and emerging economies than it was before the subprime crisis hit. International financial conditions are steadily normalizing, while the terms of trade are declining and approaching their trend values.

In this scenario, the Chilean economy will receive a milder boost from abroad than we saw in recent years. The less expansionary monetary policies in the developed world will be coupled with a rebound in developed economies that will favor not only these countries but the world economy at large. Certainly, some countries have more reasons to worry than others about these adjustments in the world economy, because of their external and domestic vulnerabilities. Meanwhile, the past and present volatility of the world will continue to affect our economy, but, while we are certainly not immune to what happens outside our borders, we feel we are on a good stand to deal with this transition.

At home, output and demand are gradually decelerating and inflation is still low. Our projections, which I will be reviewing shortly, indicate that in the short term the Chilean economy will continue to expand somewhat below trend, affected by the normalization of the mining investment cycle and labor market conditions. We thus estimate a 4.2 percent growth for this year and a 3.75 to 4.75 percent range for next. This 2014 forecast range is slightly less than what we were expecting in September. Although these growth rates represent a slowdown from previous years, we see no obstacles ahead that could prevent our economy from resuming growth at closer to trend rates, which we continue to estimate at 5 percent annually.

In this context, the Board decided to lower the monetary policy rate from 5 to 4.5 percent in its meetings of October and November, in order to accommodate the monetary stimulus to our slower economy and not jeopardize the convergence of inflation to the target. The recent reduction of the MPR is part of a necessary adjustment to deal with recent changes in our macroeconomy and, as I said, ensure compliance with our inflation objective. Going forward, further changes to the MPR will depend on incoming information and its implications on the economy's evolution. Actually, the baseline scenario does not foresee the need for any significant changes in the MPR but, should such need arise, monetary policy has room and is prepared for further adjustments.

Over the period, both the real and the nominal exchange rates have depreciated, which is part of the process of restructuring the sources of growth after some time when domestic demand has been the primary driver of such growth.

Let me now describe for you our baseline scenario and the main risks we have identified in our reports.

Macroeconomic scenario

Chile's third-quarter growth was 4.7 percent y-o-y. Mining grew strongly, boosted by the startup of major investment projects of recent years. Thus, mining exports have increased, helping to reduce the current account deficit. Sectors other than natural resources, meanwhile, continued to post lower growth rates than in 2012 (figure 1). This, together with the revision to growth rates of earlier quarters, confirmed that the Chilean economy has lost some strength compared with last year.

On the expenditure side, the slowdown extended to each and every component, including private consumption, which was accompanied with significant inventory depletion (figure 2). In this trajectory, the maturation of the mining investment cycle discussed in previous Reports has played a major role. In addition, the extraordinary imports of transport materials of the last quarter of 2012 did not continue into this year, and imports of other capital goods were weak in the past few months. Consumption has also slowed down, although its adjustment has proceeded gradually, because of still tight labor market conditions, real wages growing strongly and consumer expectations still optimistic, although less so than in the first half of the year. The deceleration of private consumption is expected to continue over the coming months coupled with a not so strong labor market, a vision that is grounded on our business perception report *Informe de Percepciones de Negocios*.

CPI inflation has been below expectations, mainly reflecting the drop in international fuel prices, which more than offset the seasonal price increases of some perishable foods and the peso depreciation. Thus, in October the CPI rose 1.5% y-o-y, which again placed it temporarily below the tolerance range. In contrast, the core measure CPIEFE brought no major surprises and continued to increase up to 1.6% annually in the same month. Two years ahead inflation expectations remain around 3% (figure 3).

In the international financial markets, movements in the last few months have been largely determined by news about the future course of monetary and fiscal policies in the United States. Recall that, after the signs delivered by the Federal Reserve last May, the withdrawal of the monetary stimulus was expected to begin in September. This drove up long-term interest rates by more than 100 basis points in the U.S., the currencies depreciated against the dollar and volatility increased, with particularly harsh effects on emerging economies. Later on, as such withdrawal did not occur in September, interest rates receded some and calm returned to the markets. Although this resulted in some improvement of the external lending standards to emerging economies, our baseline scenario considers the possibility of recurrent episodes of volatility during the transition towards more normal financial conditions. For one thing, the temporary nature of the U.S. fiscal agreements could bring new tensions in early 2014, although this seems less likely.

At any rate, external lending conditions are less favorable than they were early in the year. Compared with September, long-term interest rates dropped as the Federal Reserve kept the asset purchase plan unchanged, and at the same time international stock markets improved. Several emerging market currencies depreciated against the dollar – the Chilean peso included – which was trading at more than $520 per dollar in November and has recently surpassed $530. The real exchange rate, as I said, has risen to near its 15 to 20 years' average.

In terms of the outlook for global growth, developed economies are still in a process of gradual recovery. In the third quarter, the U.S. exceeded market consensus expectations and, although inventory accumulation played a part, the improved performance of the housing and labor markets, combined with better entrepreneurial and consumer expectations, the behavior of stock and other asset prices and, in particular, the lower intensity of the fiscal adjustment suggest that next year the country will outperform its 2013 figures. The recovery of the Japanese economy is still ongoing, but the tax increases announced for 2014 will taper economic growth. The Eurozone posted positive growth for the second consecutive quarter, although less than expected by the consensus. Worth noting were the slower growth of Germany and the contraction of the French economy and, on a positive note, that some of the peripheral economies grew again.

Emerging economies have slowed down further and consensus forecasts have seen new downward revisions. In China, after a substantial correction to its growth projections in the first half of the year, recent data show growth stabilizing around 7.5 percent, quite less than in recent years, however. The baseline scenario assumes that the Chinese economy will slow further to reach 7.2 percent annually in 2015, which points to the need to continue to restructure its sources of growth and resolve some of the vulnerabilities of its financial system.

In the rest of the emerging world, economic activity continues to moderate, leading some economies to lower their benchmark rates. Others, however, have restricted their monetary policies responding to higher inflationary and exchange rate pressures related to fiscal, monetary or external vulnerabilities. Anyway, the slower growth expected in China, lower commodity prices, less expansionary international financial conditions, the contractionary adjustments in some large emerging economies and the need to progress in the strengthening of the Chinese financial system plus its growth re-composition are behind the vision that emerging economies will expand at a slower pace than during the last three years.

The baseline scenario of our Monetary Policy Report foresees that, after expanding at 3.4 percent in 2013, our trading partners will grow by 3.6 and 3.8 percent in 2014 and 2015, respectively, somewhat less than we thought in September. In this context, inflation has been below expectations in both emerging and developed economies. Commodity prices have dropped. Geopolitical tensions in the Middle East have eased with respect to a few months ago, as have some refinery problems in the United States, which led to lower actual and expected fuel prices compared with September. The copper price, after remaining fairly stable for some months, posted a decline in recent weeks, so the price outlook for the metal remains unchanged from the previous Report. Accordingly, the baseline scenario assumes that the terms of trade will not divert from those in the last Report (table 1).

As I have already mentioned, our baseline scenario estimates that the Chilean economy will expand 4.2 percent in 2013, and between 3.75 and 4.75 percent in 2014, slightly less than forecast in September. In 2014, gross fixed capital formation will grow near the rate of this year. As for consumption, the baseline scenario foresees a slight deceleration from 2013. This forecast combines, on one hand, a moderation in private income growth, inflation converging to 3 percent and an exchange rate depreciation that will affect durable consumption. On the other, still optimistic consumer expectations and a strong labor market – although not as tight as this year – that will continue to underpin consumption. This scenario assumes an external impulse similar to September's. Furthermore, it considers that part of the inventory depletion of recent quarters is an unwanted development, so it will be reversed in the coming months. Taking into account the weaker imports and stronger exports, this scenario also foresees a narrowing of the current account deficit compared with the September estimate: 3.2 percent of GDP this year and 3.7 percent in 2014. The surprise here – a positive one indeed – is that some of the trends that were anticipated in previous reports, have come sooner and stronger. In particular, the maturation of the mining investment cycle, which has been one of the main sources of the higher deficit due to its import component, has allowed copper exports to grow beyond expectations, while capital imports have begun to decline. The estimate of the current account deficit measured at trend prices is also adjusted downward, so the risk associated with the evolution of the current account that had been identified in the last Monetary Policy Report is reduced (table 2).

In the baseline scenario, CPI inflation will converge to 3 percent towards the end of the projection horizon, this time the last quarter of 2015. Thus, reaching the target will take longer than expected in September. The CPIEFE will continue to gradually approach 3 percent, without major changes from the September forecast (figure 4). This projection implies that nominal wages will be adjusted in line with productivity and the inflation target. It also includes as a methodological assumption that the RER will remain virtually unchanged. Finally, the baseline scenario uses as a working methodological assumption that the policy rate will follow a path similar to the one shown in the latest Economic Expectations Survey (figure 5).

The baseline scenario reflects those events that are estimated to be the most likely to occur with the information at hand at the closing of this Report. There are risk scenarios, however, which if materialized, may reshape the macroeconomic environment and, therefore, may modify 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.

On the external front, one risk relates to growth in emerging economies, particularly China. Concerns persist about the fragility of the Chinese financial system, which together with doubts about the evolution of real-estate prices could limit its future growth prospects. As has been noted before, China's evolution is cause for unrest because of its weight in world GDP and its impact on the pricing of commodities, copper included.

The volatility that financial markets have shown in recent months implies that ending the quantitative easing in the U.S. will not be stress-free, especially because of the difficulty to calibrate the policy actions of this unprecedented process. In this regard, a major risk has to do with its effects on some of the larger emerging economies that have accumulated macroeconomic imbalances and are more dependent on external financing. The risk associated with the complex interaction between weak growth, a frail fiscal situation and financial problems in Europe is still present.

At home, headline inflation of recent quarters has been lower than forecast, and the moment when it will expectedly reach the target has been postponed time and again. While the recent cuts to the MPR will help inflation converge to 3 percent, if the widespread slowdown in all the demand components is confirmed, along with longer-lasting low inflation in the rest of the world and maybe a sharper fall in international fuel prices could further postpone such convergence to 3 percent. However, the depreciation of the peso and the still tight labor market could work in the opposite direction.

Projections indicate that in the short term the Chilean economy will continue to expand somewhat below trend for still some quarters. However, labor market conditions and a faster recovery in inventories, among other factors, could result in a faster recovery of the economy that would bring it closer to its trend.

In the Financial Stability Report we are presenting today, the same risk scenarios coming from abroad that I have just identified are examined, this time from the perspective of their impact on our domestic economy's financial stability. We conclude that of the three risk scenarios described, the episode of volatility originating in the monetary stimulus withdrawal is the most likely to occur. However, a deepening of the Eurozone crisis or a sharp deceleration of a systemic emerging economy would have stronger effects on the Chilean financial system. Especially because, as I have noted, the withdrawal of the monetary stimulus in the United States will come about when the U.S. economy's improved growth is already confirmed.

The banking industry's capital levels are adequate to remain solvent before a significant deterioration of economic growth and financial conditions. Stress tests show that the banks' current capital levels allow them to absorb potential losses generated by a macroeconomic risk scenario that combines a GDP contraction – like that of the subprime crisis – higher financial costs for the short and long term, and a sharp depreciation of the exchange rate. One such test – motivated by the risk scenarios identified in the process of monetary tapering in the U.S. – shows little exposure of the banking system to a sharp increase in the interest rates of long-term securities.

Meanwhile, households' aggregate borrowing and financial burden indicators show a marginal decline, although with some changes in the composition of the debt. The share of bank debt has increased compared with other credit providers, while total corporate debt is stable as a ratio to GDP and the financial indicators of companies reporting to the Superintendence of Securities and Insurance (SVS) are also fairly stable. Capital inflows to Chile continue to be dominated by FDI while aggregate solvency and liquidity figures are also stable.

In this way, our general analysis of the domestic financial system yields that it is on a good standing to deal with the risk scenarios described, and we see no incubation of systemic risks at the local level. This explains, in part, why the recent volatility episode in foreign financial markets had lesser effects on the Chilean financial system than in other emerging economies, where risks did incubate over the past few years.

However, to maintain this resilience the different players making up the financial system must take the necessary decisions and safeguards, especially considering the dynamism of the financial sector. One first firewall, perhaps the most important one, is the one related to corporate stockholders, who should establish and implement clear policies aimed at restricting their operating risks via corporate governance, boards and management. A second firewall is related to public institutions such as the Superintendences and the Central Bank, which have complementary roles in the monitoring, supervision and regulation of the financial system. The continual improvement of regulations and laws, as well as the search for best practices at the global level is one objective that must always be present in our actions. Within this monitoring role, our Financial Stability Report plays a key role. In it we identify developments which, if intensified, might create risks, or where we believe there is room to reduce residual risks.

I would like now to describe some of these developments as well as the main regulatory amendments that have been implemented during the last six months.

In our Financial Stability Reports a couple of issues ago we warned about some developments in the real estate sector which, if intensified, could become a source of risk. We were particularly concerned about the combination of dynamic prices with a credit acceleration originating in this sector. In this context, one good element is that mortgage credit growth has remained stable, with no relaxation of lending standards for mortgage loans or credit to construction and real estate firms. However, housing price indexes are as dynamic as in previous periods, in a scenario of high demand and low inventories. Meanwhile, the expected supply of office space continues to rise and is in historically high levels. In this context, it is important that all players involved consider in their investment and funding decisions that the current price and demand trends of the sector might not continue, especially considering the external risks described, the expected increase in supply and the economic slowdown.

While total household debt over income has dropped, the available evidence suggests that bank debt remains dynamic, particularly in the middle to upper income homes. To the extent that banks properly evaluate and analyze the credit risks inherent in this segment, it should not be a source of vulnerability. However, there are factors that could contribute to an underestimation of these risks. First, rolling credits have been pretty dynamic in recent years. Second, the absence of a consolidated debtor data base hinders any household credit risk assessment for supervisors and suppliers – a concern we brought up before this Senate last time we presented our Financial Stability Report. Finally, those banks that have recently expanded a lot their consumer loan portfolios have seen a sharper deterioration of their

NPLs indicators, consistent with greater risk taking in this segment. So far, this has been accompanied by increased provisions.

While in recent years the overall Chilean banking system has tended to reduce its dependence on short-term wholesale funding, some small and midsize banks remain highly dependent on this source. Although wholesale funding plays an important role in market discipline, it is particularly sensitive to changes in perceptions about the risk of issuers and to the assets' liquidity in the secondary market. In addition, the events of recent years show that negative developments in foreign or local financial conglomerates may adversely affect the cost of funds in the wholesale market for the banks belonging to these groups.

Accordingly, it is important that banks maintain a diversified funding base in terms of counterparties and maturities. Also, banks should use in their liquidity management stress tests and contingency plans that appropriately reflect their risks, business strategies, financial condition and financing ability under different scenarios. In addition, it is important that banks properly internalize the economic and reputational risks of their exposure to related entities, for which a proper corporate governance framework is crucial.

In this context, I would like to bring to your attention four regulatory elements. First, the Superintendence of Banks and Financial Institutions (SBIF) perfected its regulatory framework on corporate governance in banks. Second, based on the possible contagion effects in financial conglomerates the SBIF enhanced the regulations restricting transactions with related debtors, increasing their supervision tools in this area. Third, in relation to funding structures, the Central Bank is reviewing the liquidity rules governing the banks in order to strengthen management policies in this field, include binding regulatory limits on a consolidated basis, standardize the assumptions of our own models, expand information disclosure to the market about the liquidity position of each bank and move towards the new Basel liquidity standards. Finally, the bill of law sent to the National Congress to institutionalize the Financial Stability Board (FSB) is an important step, because it grants capabilities that provide more space to the authorities to monitor the risks facing the financial system and coordinate responses to them.

To sum up, the Chilean economy is well positioned to address the changing internal and external conditions that we are already seeing. The adjustments observed in relative prices, the real exchange rate and interest rates have gone in the right direction to facilitate the adjustment of the economy. 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% in the policy horizon. At the same time, it will continue to improve financial legislation in order to maintain and enhance this resilience, in those issues that are legally mandated.

Let me end with some final thoughts.

Final thoughts

As is customary in our presentations to the Senate, we have tried to present as clearly and transparently as possible our assessment of the current economic situation and its implications for managing the policy tools entrusted to us. Always keeping a watchful eye on the compliance of the mandates we have been given.

The Chilean economy is on a good stand to face the challenges ahead, which certainly does not mean that we feel immune to whatever happens beyond our borders. We have managed economic policies seriously and responsibly in good times, which should allow us to move with relative ease through a not so favorable period.

The country's domestic and external position is strong, our financial system has limited risks, and the monetary policy is in a position that, if necessary, can deal with a different, more complicated phase. In addition, a strong fiscal position with public debt that in net terms is virtually nil, something that not many countries can show.

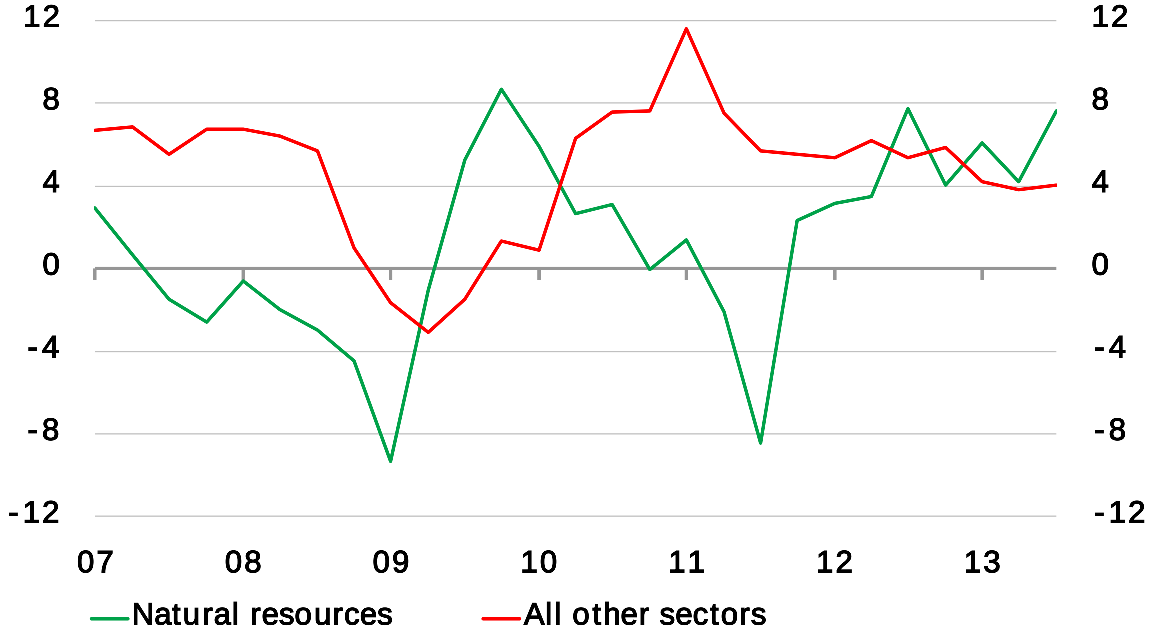
In the last two months we cut 50 basis points off the MPR, to 4.5 percent. The scenario that today we see as the most likely does not envisages the need for significant additional adjustments to the policy rate. However, in a different scenario where further adjustments are called for, there is the room and the will to carry them out. We, as the Central Bank, will continue to contribute with our assigned duty, that is, to safeguard the stability of our currency and the normal functioning of the internal and external payment system, to Chile's development and welfare.

Many thanks,

Figure 1

GDP growth

(annual change, percent)

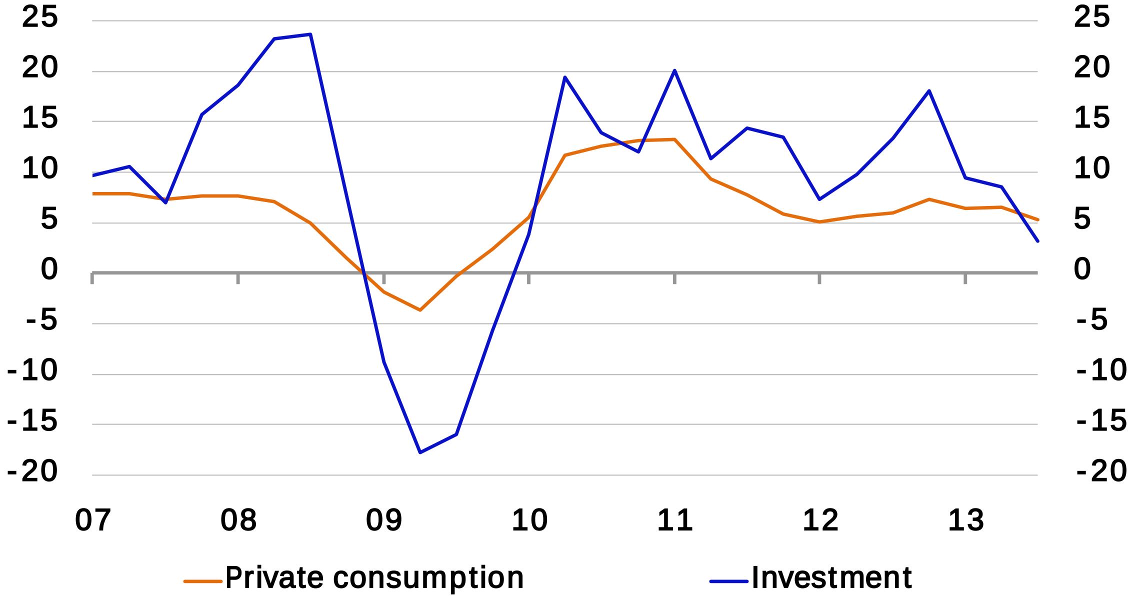


Source: Central Bank of Chile.

Figure 2

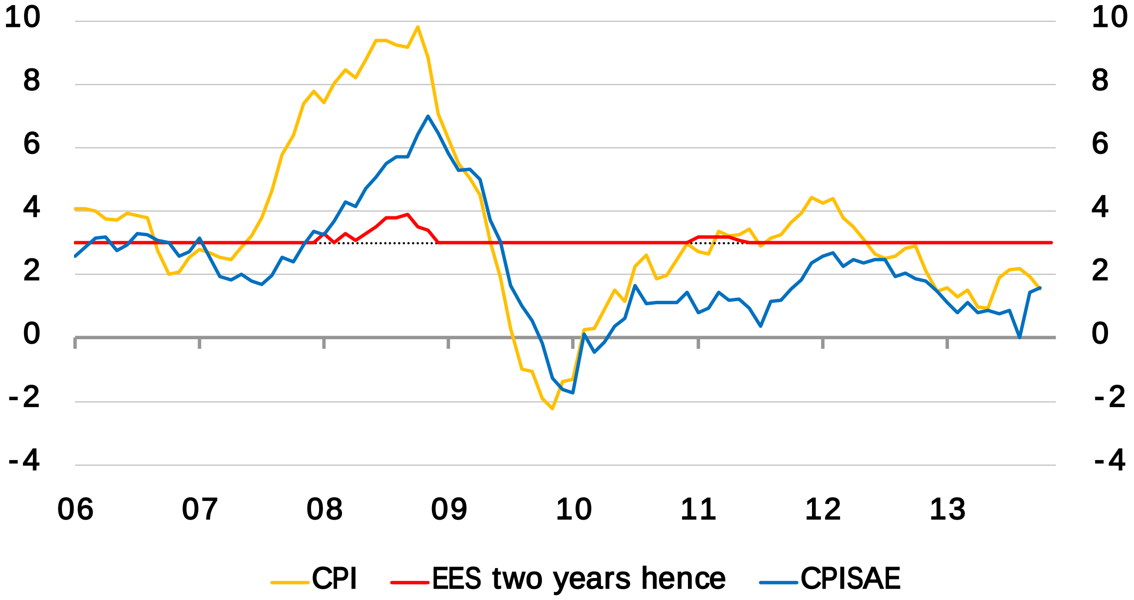
Private consumption and investment

(annual change, percent)



Source: Central Bank of Chile.

Figure 3
Inflation indicators
(annual change, percent)



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

Table 1
International baseline scenario assumptions

	2012	2013 (f)			2014 (f)			2015 (f)	
		Mar.13 Report	Sep.13 Report	Dec.13 Report	Mar.13 Report	Sep.13 Report	Dec.13 Report	Sep.13 Report	Dec.13 Report
Growth					(annual change, percent)				
Trading partners' GDP	3.4	3.6	3.3	3.4	4.2	3.6	3.6	4.0	3.8
World GDP at PPP	3.1	3.3	3.0	3.0	3.9	3.5	3.5	3.9	3.7
United States	2.8	1.9	1.5	1.7	2.5	2.6	2.6	2.7	2.7
Eurozone	-0.6	-0.4	-0.5	-0.4	1.3	1.0	1.0	2.1	1.4
Japan	1.9	1.1	1.7	1.8	1.3	1.0	1.3	0.8	1.0
China	7.7	8.1	7.5	7.6	8.2	7.4	7.4	7.5	7.2
India	5.1	6.3	5.4	4.1	6.4	5.8	5.3	6.3	6.3
Rest of Asia (excl. Japan, China and India)	3.8	4.3	3.8	3.8	4.7	3.9	4.0	4.1	4.5
Latin America (excl. Chile)	2.7	3.3	2.7	2.6	3.7	2.9	2.9	3.7	3.4
					(levels)				
LME copper price (US$cent/lb)	361	350	330	332	340	305	310	290	290
Brent oil price (US$/barrel)	112	108	108	109	101	108	106	97	100
					(annual change, percent)				
Terms of trade	-4.1	-0.4	-5.2	-3.9	-1.6	0.1	0.2	-1.2	-1.5

(f) Forecast.

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

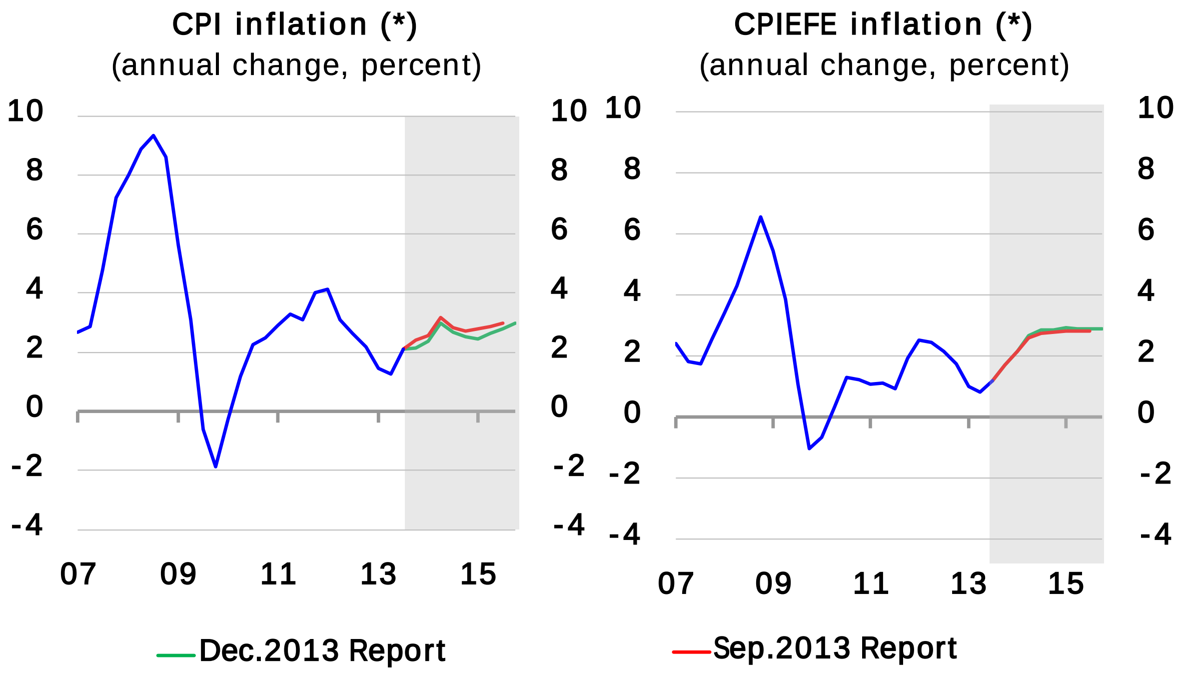
Table 2
External scenario
(annual change, percent)

	2012	2013 (f)			2014 (f)	
		Mar.13 Report	Sep.13 Report	Dec.13 Report	Sep.13 Report	Dec.13 Report
GDP	5.6	4.5-5.5	4.0-4.5	4.2	4.0-5.0	3.75-4.75
Domestic demand	7.1	6.1	4.9	3.9	4.9	4.8
Domestic demand (w/o inventory change)	7.3	6.1	5.7	5.1	4.8	4.5
Gross fixed capital formation	12.3	7.2	5.6	3.9	4.5	4.1
Total consumption	5.8	5.7	5.6	5.4	5.0	4.7
Goods and services exports	1.0	3.1	4.0	5.3	3.3	3.1
Goods and services imports	4.9	5.9	5.6	4.4	4.5	4.6
Current account (% of GDP)	-3.5	-4.4	-4.5	-3.2	-4.8	-3.7
December CPI	1.5	2.8	2.6	2.6	2.8	2.5
December CPIEFE	1.5	2.5	1.7	1.9	2.8	2.9

(f) Forecast.

Source: Central Bank of Chile.

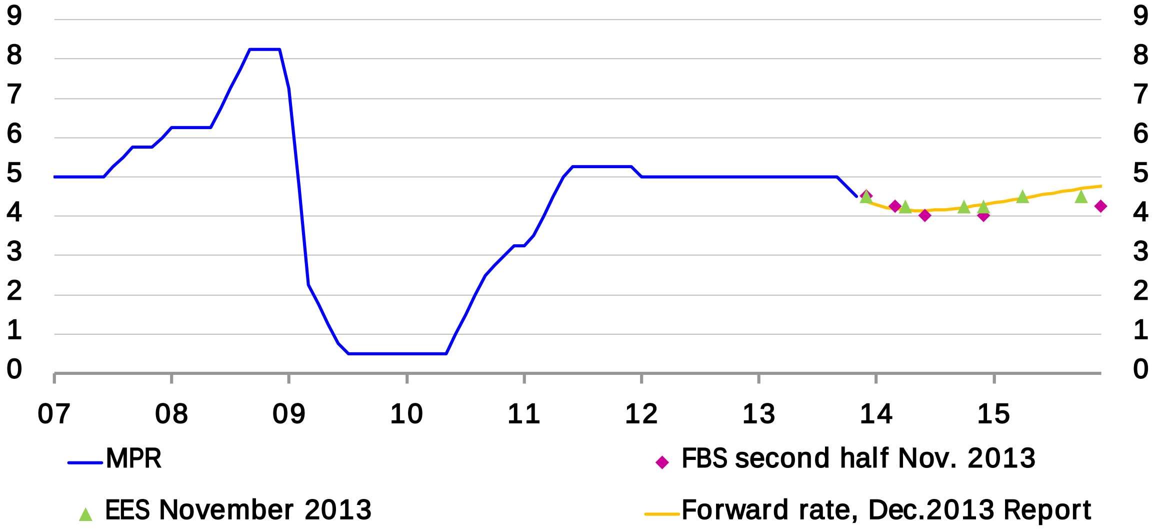
Figure 4



(*) Gray area, as from the fourth 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.