Vittorio Corbo: Conditions and prospects of the Chilean economy

Speech by Mr Vittorio Corbo, Governor of the Central Bank of Chile, at a Conference organised by the Exporters' Association of Manufacturers and Services (ASEXMA), Santiago, 25 July 2007.

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The world economy

The world economy continues along a prolonged and robust expansionary phase that started in 2002. This expansion has been especially dynamic in the past four years, with an average annual growth rate of 4.9%, reaching 5.4% in 2006, the highest growth rate in over thirty years. Projections by *Consensus Forecast*, weighted by purchasing power parity, place growth for this year at 4.9%. If they prove correct, this will be the best five-year period since the early nineteen seventies. To put it in perspective: long-term annual growth of the world economy runs close to 3.5%.

World growth is now not only high but also more balanced in comparison with previous years. The American economy is slowing down, reflecting the correction in the housing sector while, in contrast, the euro zone, Japan and emerging economies are gaining strength. The correction of the housing sector in the US, with a 16% plunge in investments in housing the first quarter of 2006 has resulted almost in a whole percentage point less aggregate growth. The adjustment has been deeper and lengthier than forecasted. In addition, the set of housing indicators show that the correction is still under way. At the same time, the adjustment of low-quality mortgage credits continues to deepen, adding to the decline in housing demand. So far, the economy has absorbed both the housing correction and the worsening of credits fairly well. Although more stringent criteria have been introduced regarding approval of loans to more risky clients, effects on other borrowers' categories have been very limited.

Meanwhile, private consumption has lost some strength, affected by housing prices correction and the high prices of gasoline. Still, the strength in the labor and stock markets continue to support it. As a result, a soft landing and increased dynamism in coming quarters seem more likely, in a time where the inventory correction cycle is coming to an end and the manufacturing industry is beginning to pick up. The risk remains, however, that the household sector adjustment will have deeper effects on private consumption and will extend the low growth period. Surprisingly, despite the strong correction in the housing market, employment in the construction sector has declined modestly and the unemployment rate has remained at 4.5%.

In the euro zone, growth has been accelerating. The widespread dynamism of the German economy stands out, benefiting from increased efficiency and competitiveness thanks to major reforms implemented in recent years. Growth is driven by exports and investment, but private consumption also plays a part. In contrast, Italy is slowing down, while France grows, but not as strongly as Germany. In Japan, good news comes from the labor market – with unemployment at 3.8%, the lowest rate in eight years – and from private consumption that is waking up after a long period of stagnation.

Emerging Asia continues to show high growth rates, led by China and India. In particular, China surprised with an annualized growth rate of 11.9% the second quarter. Growth is fairly widespread with important contributions from retail sales, investment in fixed assets and exports.

Despite sharp rises in world prices of foods and fuels, CPI inflation has remained stable in the U.S., the euro zone and Japan. In the U.S., recent indicators show a fall in core inflation and are more consistent with inflation converging to the ceiling of the comfort zone defined by the Fed's open market committee. In the euro zone, despite 1.9% of annual inflation in the past two months, output growing above potential, combined with the closing of output gaps and strong credit growth, there is a higher risk of inflation acceleration, which has led the ECB to continue with its process of monetary policy normalization. In Japan, although inflation is still low, with an expanding economy, the Bank of Japan introduced two rises of 25 basis points each in the policy rate to reduce distortions and vulnerabilities associated to excess liquidity. In China and other emerging economies, inflation is increasing.

One of the consequences of this prolonged cycle of high world growth is global utilization of resources (i.e., productive capacity and labor) being at its highest level in 25 years. The combination of high rates of resource utilization, large recent rises in prices of foods and fuels, and great international liquidity increases the risk of inflation acceleration, with a repercussion on the market's expectations on the future course of policy rates. In the U.S., the evidence of a moderate deceleration of growth and of a decline in inflation has driven financial markets to project, on average, that the policy rate will remain unchanged, approaching the baseline scenario that the Fed has been communicating for some time already. Financial market expectations, however, are split between one group foreseeing cuts in the policy rate and another that now foresees rises. The main source of uncertainty originates in the future course of growth and inflation. The second quarter should feature a strong increase in measured growth, but future growth is still a question mark.

About the euro zone, the market anticipates that, in order to hold inflation around the target – annual inflation below but close to 2% – the ECB will need to raise the policy rate a couple of times during the next 12 months by 25 basis points each. In the case of Japan, markets also project two rises in the policy rate over the next 12 months.

On the other hand, long term interest rates are on the rise in industrial economies, mainly reflecting increased real rates rather than an increase in inflation expectation or of duration premiums. The increases in long-term interest rates may be indicating better growth prospects in the U.S. now that a soft landing is more likely. However, overall global financial conditions are very accommodating, with risks premium that, although beginning to rise, are very close to their record lows. This, despite the flight to quality phenomenon observed in the past several weeks as a result of perceived risk increase because of the market status of low-quality mortgage loans in the U.S. In any case, the levels of market volatility in emerging economies are significantly smaller than they have been in earlier episodes.

The dollar has depreciated against the currencies of industrial economies, responding to the evolution of the business cycle. In the past few days, this has been aggravated by concern about how the U.S. housing market situation will unfold. The Chilean peso, similarly to currencies in the rest of emerging economies, has also appreciated against the U.S. dollar due to weakness of the latter. Exporting or import-substituting sectors that are selling their produce at a dollar price not too different from the price they were getting towards the end of 2001, have possibly endured a large loss of profitability. This is directly associated with the multilateral depreciation of somewhat more than 40% suffered by the dollar in the world since then.

In connection with the expansionary cycle of the world economy, and also with the depreciated dollar, prices of copper, oil and derivatives – especially gasoline – are picking up again. The rise in commodities' prices has now spread to foods.

For the year 2008, projections from *Consensus Forecast* foresee global growth similar to that of 2007 but with a rebound in the U.S. and a slight deceleration in the euro zone and in emerging economies, influenced by the process of monetary normalization implemented to keep inflation under control.

Such a favorable global scenario may continue longer, but it can also deteriorate if a number of latent risks materialize. The most important ones facing the world economy are: (1) a deeper deceleration in the U.S. as a result of a stronger adjustment in the housing sector that ends up shocking the rest of the economy and the world; (2) an acceleration of inflation because of supply-side shocks in a global economy with little output gaps, which generates a sudden and large increase in the monetary policy rates of industrial economies, especially the U.S. and the euro zone; (3) an unforeseen sharp increase in risk premiums and a liquidity shortage affecting asset prices and world activity as a result of an unexpected increase in inflation in the developed world or a shock in financial markets, at a time when risk premiums are in unusually low levels. There is widespread incertitude regarding the potential effects of such a shock on financial markets, since the resilience of the new financial securities and intermediaries to this type of shocks is yet to be tested.; (4) deeper distortions and tensions created by severe global imbalances, which might result in an increase of protectionism and a disorderly correction of international parities to sudden changes in capital flows financing those imbalances, affecting financial markets and asset prices; and (5) the ever present geopolitical perils.

The Chilean economy

The Chilean economy has reaped the benefits of the dynamic world economy through a very significant terms-of-trade improvement that accumulates 70% since 2002, and through a strengthening of markets for our exports. Part of the better terms of trade goes to foreign owners of mining projects in the form of profits and dividends, but a substantial fraction stays in Chile in the form of greater profits and dividends paid to companies owned by nationals (including the State as the owner of the copper corporation CODELCO), increased tax collection and better salaries and bonuses to workers producing the commodities. The expansionary effects of this gain in terms of trade become larger as it is believed to be more permanent. The favorable external conditions, the stronger fiscal impulse – associated to the more permanent portion of the copper price increase – and the good financial conditions are behind this solid expansion, leaving behind the unexpected deceleration experienced by the Chilean economy in the third quarter of last year.

On the demand side, private consumption remains strong, growing more than 7% per annum in the first quarter of this year. Consumption is backed by the sustained growth in salaried employment and good financial conditions. But the main change has been the recovery of fixed capital investment which went from an average increase of 2.4% during the last three quarters of 2006, to a solid 7.9% in the first quarter of this year. Behind this strong investment are good corporate profits and favorable credit conditions, the progressive exhaustion of output gaps and good prospects for growth. In addition, exports of goods and services have strengthened, going from average growth of 3.8% in the last three quarters of 2006, to an average around 10% in the first quarter of 2007. Recent fuel price hikes begun in January have acted as a brake to the expansion of private consumption, through their effect on households' disposable income.

The renewed strength of output has also contributed to a remarkable improvement in the labor market, with significant job creation and reduction in the seasonally-adjusted rate of unemployment.

From a longer perspective, in the past 13 quarters GDP has grown at an average annualized quarterly rate of 6%, considerably above trend GDP growth. Over the same period, the seasonally-adjusted rate of unemployment went down from 9.5% in 2003 to only 6.8% in the quarter ending last May.

The evaluation available with partial data for output and domestic expenditure over the second quarter of this year is that domestic activity continues to be strong, exceeding projections in the last Monetary Policy Report of May. In particular, the monthly index of economic activity IMACEC grew at an annual average rate of 5.7% in April/May, spreading to the various components of aggregate demand, namely private consumption, public consumption, fixed capital investment and exports of goods and services, especially non-copper. The baseline scenario in May's Monetary Policy Report projected for this year a growth rate in the range of 5% to 6%, biased upward. With the evidence accumulated this year so far, the probability that the risks considered in said Report will materialize increases, taking this year's growth to the upper part of the range. Important elements to consider are the strength of consumption and the recovered dynamism of investment. Private-sector expectations have internalized this higher growth expectations in their 2007 GDP projections.

The aggravation of natural gas restrictions, combined with low rainfall, has increased the risk of energy shortage and higher costs. For the moment, the impact is believed to be non-significant, except obvious effects on electricity, gas and water, and have concentrated mainly in smaller value added from electric generation. However, this is an element of risk in the internal scenario that must be monitored with special care, in particular because of its medium-term implications.

Regarding inflation, the main development of the past few months have been sharp rises in the prices of non-perishable foods (i.e. grains, powdered milk and others) and of fuels, which combined with the also sudden increase in the prices of perishable foods, have resulted in a major rise of measured CPI inflation, way above projections in May's Monetary Policy Report.

As a result, CPI and CPIX variation stands at 3.2% per annum, while CPIX1 inflation stands at 3.5%. The rebound of CPIX1 inflation has reflected the sharp increase in the prices of some non-perishable foods, the CPIX has been influenced by the above plus the rise in electric rates, and the CPI by all the above plus the rise in prices of fuels and perishable foods. The different measures of trend inflation have risen in recent months, in line with the reduction in output gaps and the upturn of the prices of foods. In contrast, labor cost pressures are limited despite the strong increase in the wage index.

Short-term inflation expectations have also changed, and there is widespread belief that inflation will be, in the short term, higher than foreseen in May's Monetary Policy Report. Short-term inflation expectations one year ahead are close to 4%. Over a longer horizon, expectations remain well anchored to 3%, reflecting the credibility of the Central Bank's commitment with target inflation.

Long-term interest rates have increased recently, partly because of the rise in international rates for the same maturities and because of stronger growth rates. Meanwhile, nominal rates have been also influenced by higher observed inflation. Growth rates of monetary and credit aggregates have moderated but are still high. Despite these changes in the margin, financial conditions are still positive.

Favorable terms of trade and a fiscal policy where government spending is tied to the Central Government's permanent income have helped avoid a major real appreciation and, at the same time, have permitted to accumulate public resources to guarantee that future expansion of public spending will be less dependent of commodity price cycles. In fact, despite the enormous terms-of-trade gain of the last four years, the actual real exchange rate is today slightly higher than the average of the past 15 years.

Because monetary policy operates with a lag, in a monetary policy system such as the inflation targeting regime adopted by the Central Bank of Chile, it has to ground itself in economic prospects 24 months ahead and their implications on projected inflation. Within this context, persistently high economic growth signals a future additional narrowing of output gaps that, in a context of supply shocks on the prices of foods and fuels, and a monetary policy rate below the neutral interest rate by any estimation anticipates that, in the most likely scenario, it will be necessary to reduce the monetary stimulus in coming months to drive annual inflation projected over the policy horizon to 3%. This process of monetary normalization is favored by medium- and long-term inflation expectations well anchored around the target, where agents preview that the Central Bank will do whatever it takes to prevent inflation from deviating away from the target in the policy horizon. If inflation stays too high for too long, there is the risk of it affecting medium- and long-term inflation expectations more permanently, thus making convergence with the target more difficult and costlier. As usual, future changes to the monetary policy rate will depend on incoming information and its implications on projected inflation.

Consistently, the higher inflation rates of the past several months has prompted a revision to market expectations with respect to the future course of monetary policy, switching from a prolonged maintenance of the rate to two to three rises of 25 basis points each before year's end.

Price stability is one factor behind long-term economic growth. In order to ensure that GDP will grow for a long time more than 5% – the estimated rate of trend GDP growth – while keeping inflation under control, it is necessary to increase the rate of trend GDP growth and this does not depend on demand elements but rather on factors determining the growth in supply, such as policies and institutions that affect the increase in the amount and quality of the labor force, the amount and quality of capital stock and the productivity with which both factors are used in production.

Chile and global risks

Globalization and strong growth of the world economy have opened great development opportunities for the Chilean economy, but at the same time have increased the risks of shocks coming from abroad. The natural question is what should be the policy regime that most adequately could maximize the benefits of interacting with a world that becomes ever more integrated. Here, as elsewhere, the best policy is prudence. This includes macroeconomic policies and institutions that contribute to stability, to keeping a sound financial system and easing the adjustments to less favorable world scenarios. Chile's present policy regime (i.e., mature inflation targeting regime with floating exchange rate, fiscal policy whereby government spending is tied to the public sector's permanent income, thus enhancing its solvency before transitory terms of trade improvements, and an efficient system to regulate and supervise the baking system) increases resilience and facilitates the adjustment of the Chilean economy to less favorable external scenarios.

This policy framework permits to prevent episodes of unsustainable expansion and crises that accompanied terms of trade cycles in the past. In particular, with inflation expectations well anchored around 3%, the Central Bank of Chile can apply countercyclical monetary policy. Furthermore, the flexible exchange rate helps to make foreign exchange adjustment if and when circumstances so warrant.

Final remarks

The world economy is headed toward completing its most dynamic five-year period in over thirty years. Strong growth in the world and in China and India are driving a very good terms of trade scenario, together with good access to our products in world markets. Thanks to its openness and to its macroeconomic policy framework, Chile has reaped the benefits of this good scenario both in the sense of reaching average growth close to the trend and in accumulating resources that may permit to prevent a real appreciation while ensuring funding for public spending, should the terms of trade deteriorate. This policy framework permits to prevent episodes of unsustainable expansion and crises that came with terms of trade cycles in the past.