José De Gregorio: Monetary Policy Report

Speech by Mr José De Gregorio, Governor of the Central Bank of Chile, at the presentation of the Monetary Policy Report before the Finance Commission of the Honorable Senate of the Republic of Chile, Santiago, 13 May 2009.

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Introduction

Ms President of the Finance Commission, Senator Evelyn Matthei, senators integrating this Commission and senators present,

On behalf of the Board of the Central Bank of Chile I am grateful for your invitation to share our vision of recent macroeconomic developments, prospects and implications for monetary policy that are the substance of the *Monetary Policy Report* (the *Report*) of May 2009.

When we began presenting our *Report* to this Commission in January this year, we said we were in the midst of the worst economic and financial world crisis in several decades. Today, four months on, we can say the situation has worsened.

The world at large is in a severe recession. This year the level of global output will fall for the first time in over sixty years, and world trade will see an unprecedented decline. Since the Great Depression we hadn't seen a world crisis of the magnitude we are going through today. Big challenges remain open, but in the past few weeks there has been "a glimmer of hope" that suggests that the developed economies may be stabilizing. The lessons learned from the Great Depression and the commitment on the part of policymakers around the world to ensure that the misery that it caused will not replicate itself this time have prevented the current situation from causing even more severe disruptions.

One particular aspect of the current crisis has been the synchrony among different countries. The financial earthquake that devastated developed markets last September and October and its aftershocks that swept over the financial systems of every economy, over output prospects in the world, over income and wealth, just to name a few, propagated to expectations which deteriorated across the entire world.

The Chilean economy has not been absent to this phenomenon. As we said in the very beginning, our economy is not and cannot be immune. You can see it in the latest figures and projections contained in this *Monetary Policy Report*. The channels and mechanisms through which the crisis is transmitted to our economy are varied, and the severe international shock that hit us during the fourth quarter of last year has had damaging repercussions locally, even more so than we foresaw in January.

A question that arises naturally is, why the big impact on our economy? Unfortunately, no single answer exists and only time and the gathering of information will allow us more certainty. For now, from observing the data we see that one of the strongest factors in the downturn of both domestic demand and world trade, has been the global crisis of confidence, understood as worsened expectations and increased uncertainty around the world, not overlooking the impact of financial tightening that hit hardest in September and October of last year.

The sudden and widespread nature of the downfall of demand across countries that are so heterogeneous is proof of how difficult it is to differentiate and to avoid the instant impact of such an acute crisis. The downfall made no distinction based on the economies' strengths or weaknesses. GDP fell in nearly 90 per cent of the countries in the fourth quarter of last year (Figure 1). However, macroeconomic policies can build a solid base from where to weather the shock coming from abroad and create countercyclical impulses to mitigate them, thus making room for a rapid, sustained recuperation.

A few years back, it was hard to think that a world recession this big would not translate into major problems in our country and in developing economies in general, but it has not happened. The effects of the crisis in Chile have been mitigated thanks to policy efforts and to our own strengths as a country.

This crisis will bring about long discussions and analyses of its effects, and lessons will be drawn. We can now benefit from the lessons we learned the hard way from the profound financial and real crisis we suffered in 1982-1983. Chile has steadily built throughout the years solid macroeconomic and financial institutions that, although they do not shield us from world events, do permit us to adjust to external shocks at substantially lower costs than we would have faced in the past. Therefore, as we have also said since the current crisis turned into chaos, Chile has never been better prepared to weather a shock like the one we are now enduring. Proof of this is the enormous countercyclical effort of macroeconomic policies carried out in the context of a solid, stable financial system.

In fact, with respect to October of last year, and compared with the rest of the world, ours has been one of the greatest easing efforts of monetary policy, and our monetary policy rate (MPR) is at its historic low (Figure 2). Such an expansionary monetary policy has been implemented within the context of a credible inflation targeting regime, which ensures its effectiveness facing shocks of the magnitude we are seeing now.

Chile’s inflation was among the highest between early 2007 and October 2008, a period that saw commodity prices soar. Also, Chile’s inflation has been one of the fastest to drop (Figure 3). This reveals something we pointed out emphatically during 2008: that the origin of our high inflation was mainly foreign, but that it was the duty of monetary policy to control it from propagating excessively into other prices and expectations (Figure 4). Thanks to that determination we have been able to aggressively cut the MPR, without compromising our commitment to price stability.

A less credible policy would be incapable of being as expansionary as it is today, because it would not pass through to the interest rate structure or to market rates. In the past, monetary expansion was limited by fears of financial and macroeconomic instability. With the strong fundamentals of today’s Chilean economy, such limitations don’t exist.

Although nobody escaped the impact of the financial collapse of the end of last year on the real economy, the ability of each economy to bounce back will be largely determined by its own strengths. That is demonstrated both by recent projections by international organizations and private agencies and by the evidence discussed in this *Report*. Chile should be one of the first economies to reap the benefits of expansionary policies and take steps forward in a faster, sustained recovery. Therefore, as soon as in the second half of this year our economy should be back to trend growth rates.

Transmission channels of the international crisis to the domestic economy

Let me now review the various channels whereby we have been affected by the international crisis, which provides the necessary context to explain our policy decisions and the projections on our economy contained in this *Report*.

The complex moment for the world economy has prompted, on one hand, a sharp fall in world demand for our exports; growth projections for Chile’s trading partners for the two-year period 2009-2010 went from an average of 1.6 percent in January to 0.3 percent in the baseline scenario in this *Report*, affecting the prices of the products we sell to the world.

The terms of trade, as we had already anticipated in January, have seen a steep fall, hurting national disposable income. Nevertheless, the drop in commodity prices has had an immediate positive effect on household income, particularly through oil and other imported goods.

Although some specific sectors are having difficulties placing their products abroad, the volume of Chilean exports, largely linked to natural resources, has not declined significantly. This reveals that price adjustments have permitted them to continue to be present in markets around the world. This is quite different from the realities of some manufactured goods exporters that have experienced sharp, severe and widespread downfalls. The figures show that the impact in terms of economic deceleration during the fourth quarter of last year was much more severe in those economies whose export basket is tilted towards durables (Figure 5).

Another transmission channel of the global crisis has been the effect on domestic financial markets of the deteriorated financial conditions in developed economies together with the increase in the global risk perception. Despite reduced stress in the past several months, the world financial environment continues to cause concern. Still, conditions facing Chilean banks and firms to access external credit sources are more favorable than for other emerging economies, no sudden stop has occurred in external inflows, while the local bond market has taken a significant impulse.

Chile's foreign financing needs have been met easily, and the reduction in the current account deficit has lessened future requirements. Absence of tensions in this setting is reflected in the Chilean sovereign risk trend, in our country's credit rating upgrade applied a few months back, and in the foreign currency interest rates in the domestic market.

In addition, the change in risk perception and global financial conditions triggered a tightening of domestic lending standards, which has been offset by measures of monetary policy and liquidity provision. The interest rate cut applied by the banks has been evident, reflecting in consumer and commercial loan rates now hundreds of basis points below their peak in late 2008. Mortgage rates, meanwhile, have also declined, although somewhat less (Figure 6).

Accordingly, market rates are higher than they would be in normal conditions given the monetary impulse, because they are also affected by the risk assessment of operations and, in the current juncture, a higher premium is being tagged on sectors that are more exposed to the economic downturn. In addition, lending has slowed and, although somewhat less restrictive marginally, March's Survey on Economic Conditions, plus additional information, reveal that high requisites are in force for bank lending, and consumer demand has fallen.

The macroeconomic scenario

A corollary to the change of global macroeconomic scenario has been the significant deterioration of expectations combined with increased uncertainty about the future unfolding of the world economy. Income prospects for firms and households have become more uncertain, while problems in international financial markets could have been resolved faster to clear the picture on the true solvency of various financial institutions at the global level.

The aforesaid factors have naturally increased the risks associated to economic activities and to decision-making processes, contributing to the sharp reduction in expenditure by the end of 2008 and to the revision of consumption, investment and production decisions around the globe. This factor may be the culprit of a large share of the fall in the level of domestic demand in Chile, much larger than the fall in GDP, which cannot be fully explained by movements in the usual macroeconomic variables. This is particularly visible in the components that are most sensitive to the cycle and to expectations, such as durable consumption, inventories, and gross fixed capital formation in machinery and equipment. The evolution of indicators of consumers and entrepreneurs' expectations – IPEC and IMCE – despite a recent small rebound, shows levels below those seen in the few months leading to the crisis (Figure 7).

The fall in domestic demand also responds, albeit to a lesser extent, to a cyclical adjustment component. Up to the third quarter of 2008, domestic demand grew at annual rates above 10 percent during several quarters (Figure 8), driven primarily by investment and durable consumption. Output, meanwhile, was showing clearly lower growth rates, because a significant portion of the demand was deviating to imported goods. The worsening of the financial crisis in the developed markets only sped up and deepened this cyclical adjustment. The drop in domestic demand has been most visible in a fall in imports, limiting the extension of the current account deficit forecast for this year.

Accordingly, the impulse of the world economy and the response of domestic demand to the worsened expectations and to the prevailing uncertainty will be negative this year, although partly offset by expansionary monetary and fiscal policies. Because of the connection between our economy's prospects and the external environment, whatever judgment is made regarding the future pace of global recovery is crucial in the evaluation of our economy and its relevant external environment.

There are signs in developed market and commodity prices – particularly copper – that suggest that the world economic downturn may be coming to an end. Still, growth projects for the main industrialized areas for the remaining of 2009 and throughout 2010 are bleak. This is partly mitigated by growth forecasts in emerging economies, which are stronger than in developed countries, thanks to the normalization of financial flows, the higher levels of investors' appetite for risk and increased demand for commodities. Emerging Asia should have a quick rebound, which is already showing up in some figures of foreign trade, manufacturing output and confidence indicators in said area. All this will push global activity to an expansion of 2.1 percent in 2010, after dropping 1.2 percent in 2009 (Table 1).

As the aforesaid world growth scenario settles, the degrees of uncertainty should gradually dissipate, which combined with monetary and fiscal expansions, should allow for a steady increase in Chile's domestic demand and output. Thus, although in the first quarter of this year the level of economic activity dropped more mildly than in the end of 2008, its recovery should begin to be more evident during the current quarter. The lagged effect of diminished activity, consumption and investment of late 2008 anticipate that the economy will experience negative annual variation rates at least during this whole quarter, even though compared with the previous quarter is already picking up.

Over the course of the second half of 2009 and throughout the entire 2010, annual GDP growth will resume positive values, closer to trend, in line with the strong monetary and fiscal impulse and with the Chilean economy's sound fundamentals. Thus, for 2009 at large, annual GDP growth will be within the range between -0.75 and +0.25 percent, while domestic demand will drop 4.7 percent year-on-year. Consistently, the baseline scenario assumes that the current account deficit will amount to 1.8 percent of GDP in the year, lower than predicted in January (Table 2).

The labor market is already feeling the deterioration of the macroeconomic environment. Employment, after the usual seasonal adjustment, has shown a decline in the past few months and the rate of unemployment has begun to rise. Taking into account the typical relationship between the output gap and employment, it is likely that the labor market will continue to deteriorate in the months to come, with higher unemployment, despite early signs of recovery in the economy. Still, the implementation of the National Agreement for Employment recently announced by the Government could mitigate part of the rise in unemployment.

The increase in output gaps has affected inflationary pressures and perspectives in the large majority of countries. A big number of economies, Chile included, have seen a rapid decline in inflation since the final months of last year. This obeys to a large extent to commodity prices falling, particularly oil and its derivatives. Thus, annual CPI variation went from its 9.9 percent peak of October 2008 to 4.5 percent in April. Most measures of inflation expectations show a decline in recent months, particularly for the short term (Figure 9).

The baseline scenario of this *Report* assumes that year-on-year inflation will continue on a downward path in the coming months with large swings between the end of this year and the beginning of 2010. This, because of the changes in the basis of comparison that include high figures from May through October 2008 and negative ones that accumulated from last November to February (Figure 10). Therefore, in the baseline scenario, annual CPI inflation will be negative from the end of the third quarter to the beginning of the fourth, to close the year 2009 at 0.6 percent. Then it should pick up gradually, to reach 3 percent at the end of the policy horizon, this time the second quarter of 2011. The rate of annual variation of core indicators has also dropped, a trend that will prevail until the first half of 2010, when they will start growing steadily to also hit 3 percent by the end of the policy horizon (Table 3).

The path projected for inflation rests on a number of assumptions. On one hand, import costs will not be a source of additional inflationary pressures. Commodity prices will post small increases in the next two years, in line with the slow recovery foreseen for the world economy. In particular, based on the prices implicit in futures contracts over the ten days prior to the statistical closure of this *Report*, the average price for oil will be 52 and 64 U.S. dollars per barrel this year and next, respectively (Table 4). The peso has appreciated since the statistical closure of the January *Report*. As a methodological assumption, the long-term real exchange rate (RER) is assumed to be close to the levels it showed in the two weeks prior to the statistical closure of this *Report* (Figure 11).

On the other hand, unit labor costs' annual variation has risen in the past few quarters, due to sharp changes in productivity measures based on the path of output and employment. The increase in nominal wages, after peaking around 8 percent annually, began to decline. These dynamics suggest that the labor market is behaving in line with usual indexation clauses and the stage of the cycle. The baseline scenario assumes that these wages will be revised to accommodate the decline in inflation, the wider output gaps and movements in the employment rate.

One crucial aspect in the evolution of Chile's business cycle and prospects of higher growth in the rest of this year and during 2010 is stimulus of monetary conditions. The reductions in the monetary policy interest rate have transmitted to lending rates quite rapidly, reflecting more favorable financial conditions for both firms and households. In addition, the interest rate structure of CBC instruments shows, by and large, the possibility of a gradual closing of gaps and inflation approaching the target.

In the highly uncertain times at the end of 2008 and beginning of 2009, the CBC's and fiscal fixed-income bonds played the role of a haven for investors and individuals, pushing down the related interest rates. This marks a difference with other economies with weak financial situations, and even with ourselves in the past, when increases in global uncertainty used to coincide with an increase in these rates. We must thank the soundness of our economy and the solvency of our fiscal accounts. This process probably intensified with the aggressive cuts to the MPR early this year, and has tended to reverse with the reduction in uncertainty in international financial markets. Furthermore, the proper functioning of our capital markets has provided good alternatives for corporate financing (Figure 12).

A working assumption that is central to this *Report's* macroeconomic scenario is the MPR path defined to be consistent with attaining a 3 percent annual inflation over the usual policy horizon around two years. This time the baseline scenario assumes that, in the short term, the MPR will follow the path similar to the one implicit in the financial asset prices in effect on 8 May 2009, after the latest cut agreed on in last week's monetary policy meeting. However, towards the end of the projection horizon, the MPR path runs below the aforesaid assumed trend (Figure 13).

As usual, the baseline scenario described above reflects the events that are believed to be most likely to occur with the information available at the closing of this *Report*. Logically, different events will lead to different macroeconomic conditions and, therefore, an MPR path that will also differ. Currently, the level of uncertainty is definitely higher than normal and, after assessing the probability of alternative scenarios, the Board considers that the balance of risks for growth is biased downward, and is unbiased for inflation. The main risks are associated, once again, to the complex global economic outlook.

In the past few weeks, some signs of stabilization of the crisis in developed economies have begun to show up, with a marginal recovery of manufacturing output, exports and confidence indicators in different economies, particularly in Asia. It is possible that these signs may be just another stage in the volatility shown by the markets in the past several quarters, and new stressful situations may arise that could worsen the already precarious situation of the world economy. Meanwhile, if the rebound of stock markets and the reduced risk aversion are solid indications that uncertainty is fading out, a more widespread recovery of global output and demand may be seen in the short run at the global level.

The materialization of some of these risks could have important implications on the domestic economy, mainly consumers and entrepreneurs' expectations possibly taking longer than predicted to improve, or the economy quickly recovering from its current state.

Aside from the risks inherent to the short-run performance of the economy, there are doubts regarding the medium-term effectiveness of the measures adopted to try to resolve the international crisis, the potential protectionist actions by governments and a possible deflation in developed economies that may delay decisions to consume and invest. Global imbalances are still present, and there is also the risk of high global inflationary pressures in the medium term if the large fiscal and monetary stimulus packages in the developed world are not properly managed.

Domestically, we cannot rule out that, facing a relief in global uncertainty, the magnitude of the macroeconomic impulse under way, deriving from the combination of clearly expansionary fiscal and monetary policies, translates into a strong push to domestic output and demand. Nor can we rule out that the measures taken by the government to smoothen the functioning of credit markets, to stimulate investment and to cushion the impact on the labor market of the cyclical situation, facilitate a faster response of the economy to said macroeconomic stimulus and a rapid recovery of expectations.

Final considerations

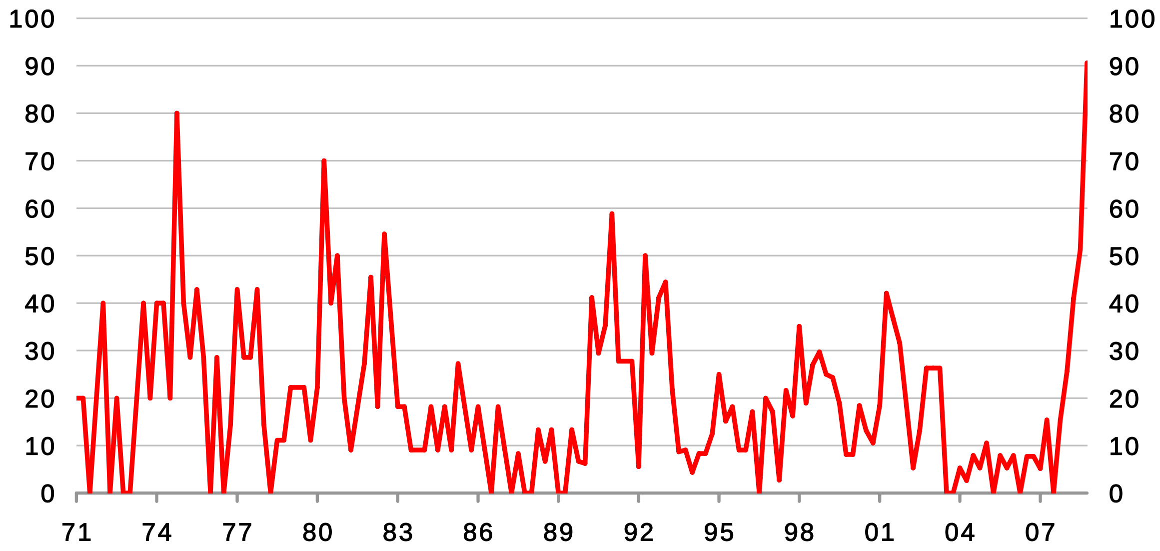
I would like to end this presentation with some reflections about the economic situation we are going through and the prospects for our economy. The worsening of expectations and the higher uncertainty at the global level are grounded on the change in macroeconomic conditions. However, in our country this is clearly contained, thanks to the soundness of our economy, with strong macroeconomic fundamentals, and capable of implementing and sustaining policies that mitigate the impact from abroad.

Our financial system, unlike that of other countries, has suffered no dislocations compromising its solvency. Inflation has rapidly been reduced, and medium-term expectations are consistent with the target. The Board has reduced the MPR aggressively and does not rule out that further cuts may be necessary. Accordingly, it reaffirms its commitment to conduct monetary policy so that projected inflation stands at 3 percent over the policy horizon.

The worst part of the financial turbulence seems to be fading into the past, but its effects on output and employment will remain with us for a while. Monetary policy will continue to aim at reducing these effects. It has proven to have significant degrees of flexibility, always consistent with reaching the inflation target. While in quiet times a gradualist behavior of monetary policy can be expected, when confronted to extreme conditions like we see today, proactive action is called for, and that is what we have been doing. We know this world crisis cannot last forever, and we are confident in the healthy fundamentals of our economy and in the expansionary capacity of the unprecedented and significant macroeconomic stimulus packages that are now under way.

Thank you very much.

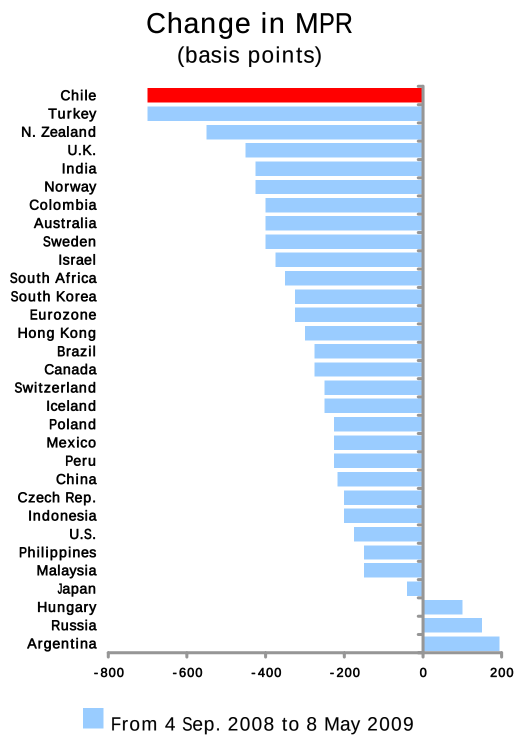
Figure 1
Countries experiencing drops in real GDP in the fourth quarter of 2008 (*)
(percentage of sample)

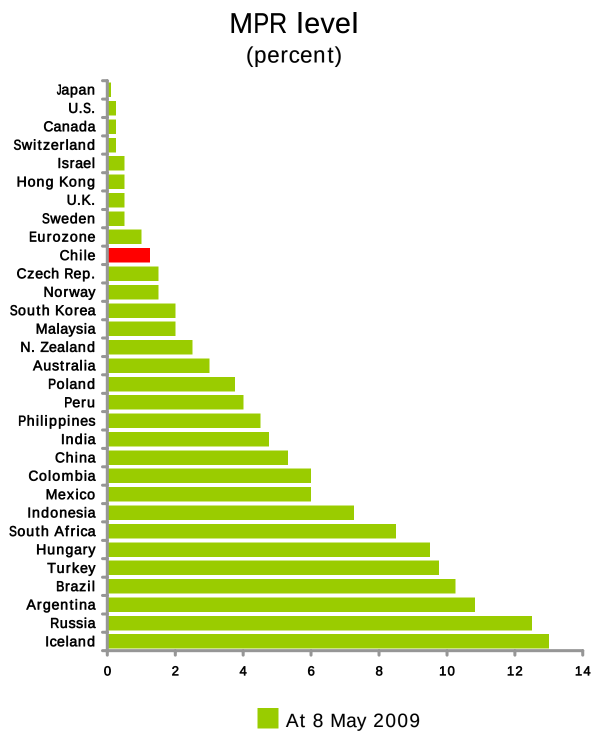


(*) Using the annualized quarterly GDP for a sample of 29 developed or emerging economies.

Source: Central Bank of Chile.

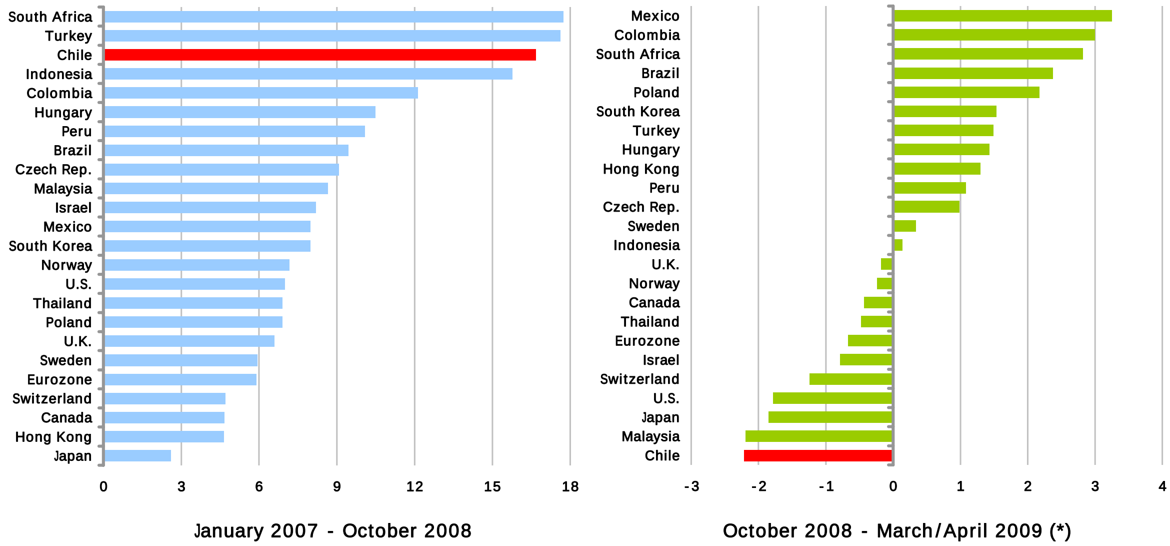
Figure 2
Monetary Policy Rate (MPR)





Source: Bloomberg.

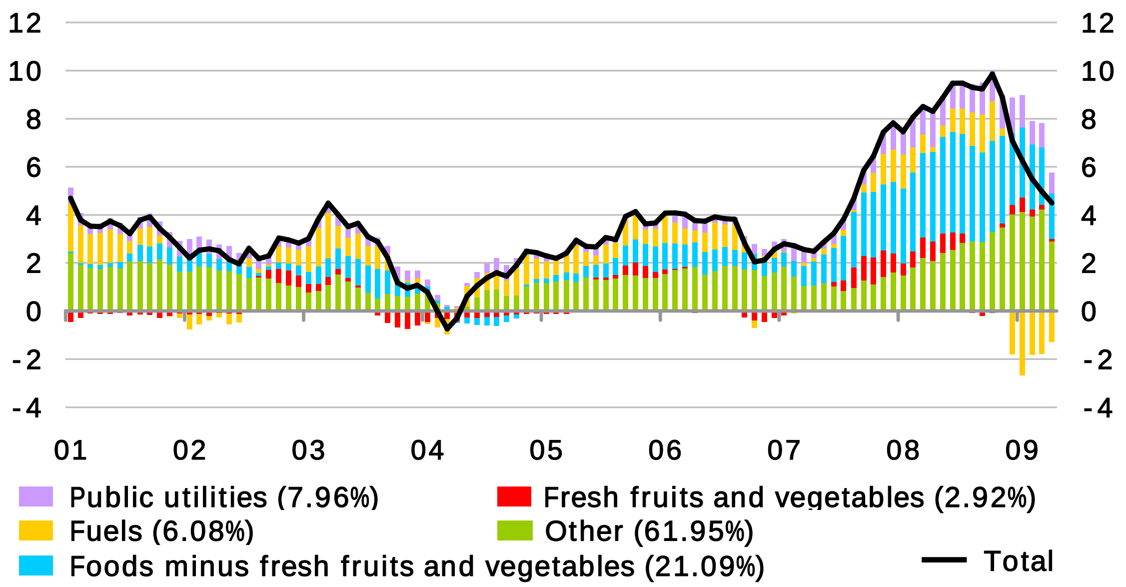
Figure 3
Accumulated CPI variation
(percent)



(*) In April for Brazil, Chile, Colombia, Indonesia, Mexico, Peru, South Korea, Switzerland, Thailand and Turkey.

Sources: Statistics Bureaus of each country and Bloomberg.

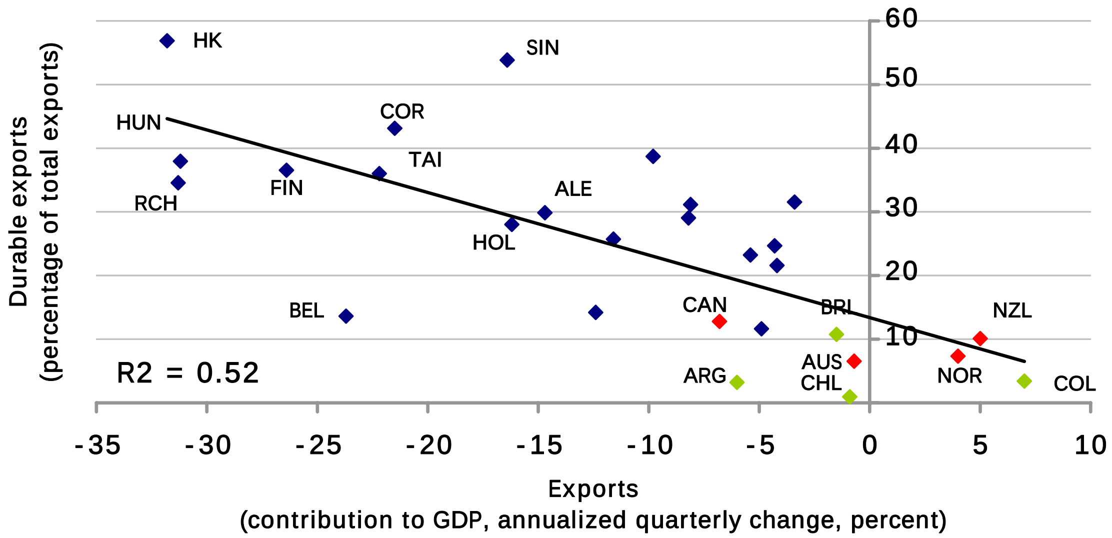
Figure 4
Incidences on annual CPI inflation (*)
(percentage points)



(*) In parentheses, weights in the CPI basket of December 2008. Before that, built using weights in the December 1998 basket.

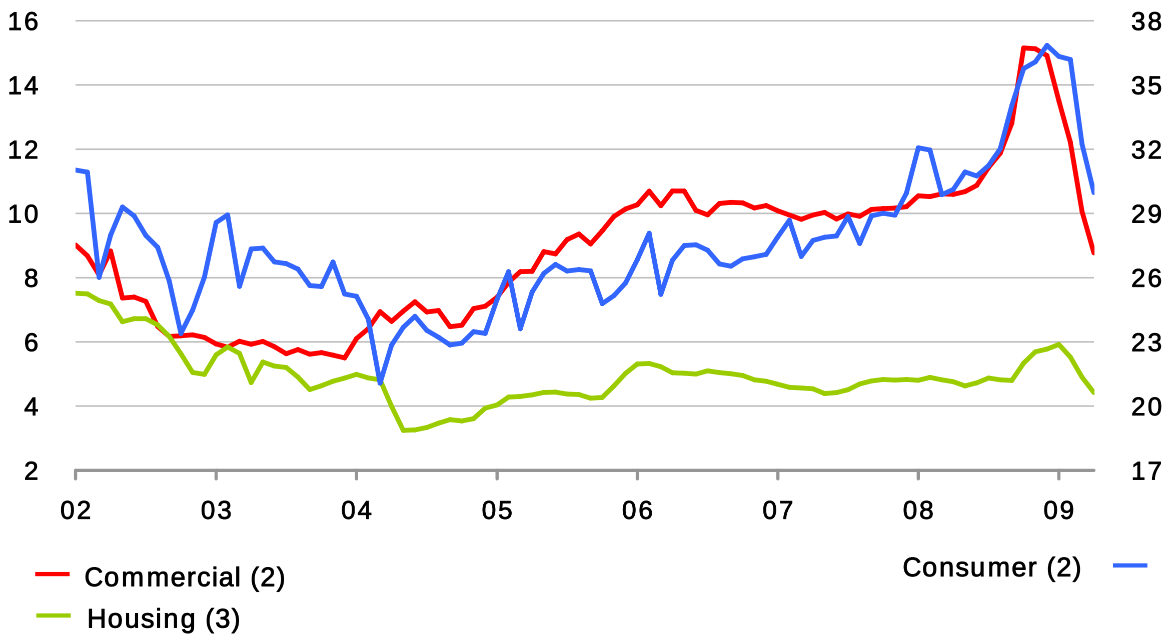
Sources: Central Bank of Chile and National Bureau of Statistics (INE).

Figure 5
Share of durable goods in total exports and contribution of exports to GDP quarterly growth in the fourth quarter of 2008



Source: Central Bank of Chile.

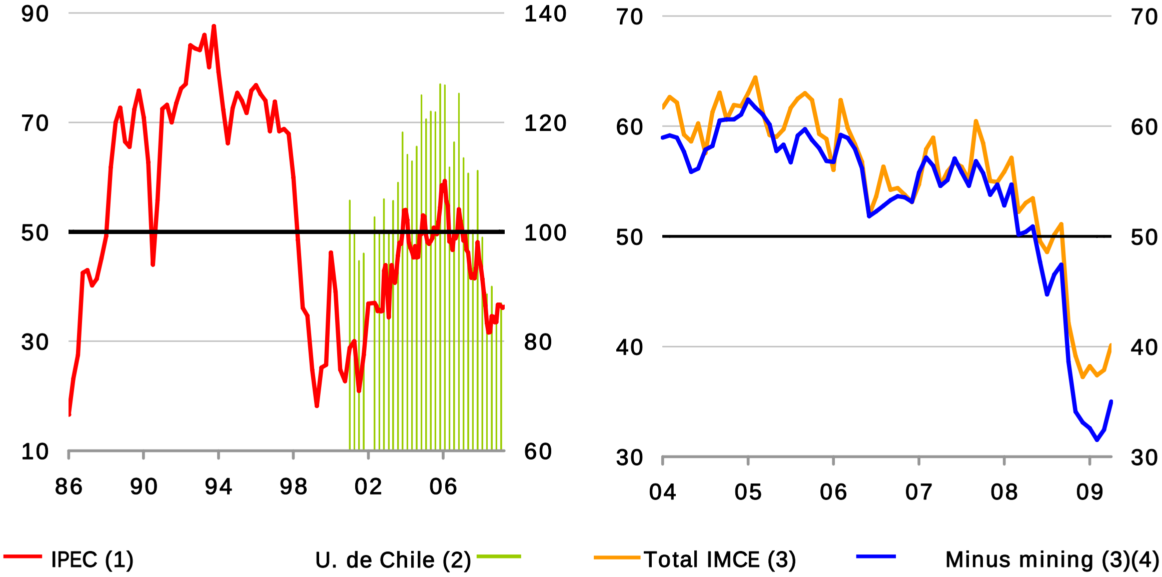
Figure 6
Lending interest rates (1)
(percent)



(1) Weighted average rates.
(2) Nominal rates.
(3) Rates in UF.

Source: Central Bank of Chile.

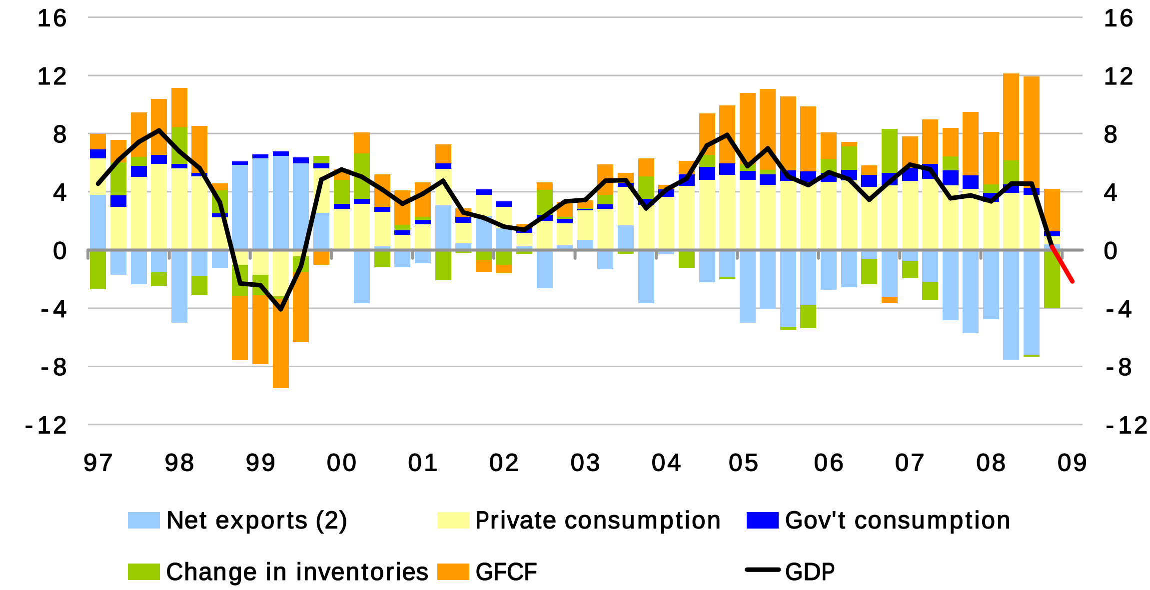
Figure 7
Consumers and entrepreneurs' perception indexes



(1) Values above (below) 50 points indicate optimism (pessimism). Before January 2003, the index was published quarterly. Since then it is published on a monthly basis.
(2) Index, March 2001 = 100.
(3) Values above (below) 50 points indicate positive (negative) expectations.
(4) Weighted average of three sector confidence indicators: manufacturing Industry, retail and construction.

Sources: Adimark, Universidad de Chile and ICARE/Universidad Adolfo Ibáñez.

Figure 8
Contribution to annual GDP growth (1)
(real annual change; percentage points)



(1) GDP of first quarter of 2009 corresponds to averaged published Imacecs.
(2) Exports of goods and services minus imports of goods and services.

Source: Central Bank of Chile.

Table 1
World growth (*)
(annual change, percent)

	Average 90-99	Average 00-05	2007	2008 (e)	2009 (f)			2010 (f)		
					Report Jan.09		Report May 09	Report Jan.09		Report May 09
World	2.9	3.8	5.2	3.2	1.2	▼	-1.2	3.3	▼	2.1
World at market nominal exchange rate	2.4	2.9	3.8	2.2	-0.3	▼	-2.3	2.3	▼	1.4
United States	3.1	2.5	2.0	1.1	-1.8	▼	-3.0	2.0	▼	0.5
Euro zone	2.2	1.9	2.7	0.9	-1.9	▼	-3.5	1.0	▼	0.4
Japan	1.5	1.6	2.4	-0.6	-2.4	▼	-7.2	1.2	▼	0.9
China	10.0	9.4	13.0	9.0	7.5	▼	6.5	8.0	▼	7.5
Rest of Asia	5.5	4.8	5.9	3.0	1.2	▼	-1.9	3.2	▼	1.4
Latin America	2.7	3.0	5.7	4.2	1.2	▼	-2.0	2.7	▼	1.5
Commodity exporters	2.7	3.1	3.2	1.0	0.2	▼	-1.7	1.8	▼	0.9
Trading partners	3.0	3.1	5.0	3.0	0.4	▼	-1.5	2.7	▼	2.0

(*) Regional growth rates weighted by share in world GDP at PPP as published by the IMF's World Economic Outlook (WEO, April 2009).

(e) Estimate; (f) Projection.

Source: Central Bank of Chile based on a sample of investment banks, Consensus Forecasts and International Monetary Fund.

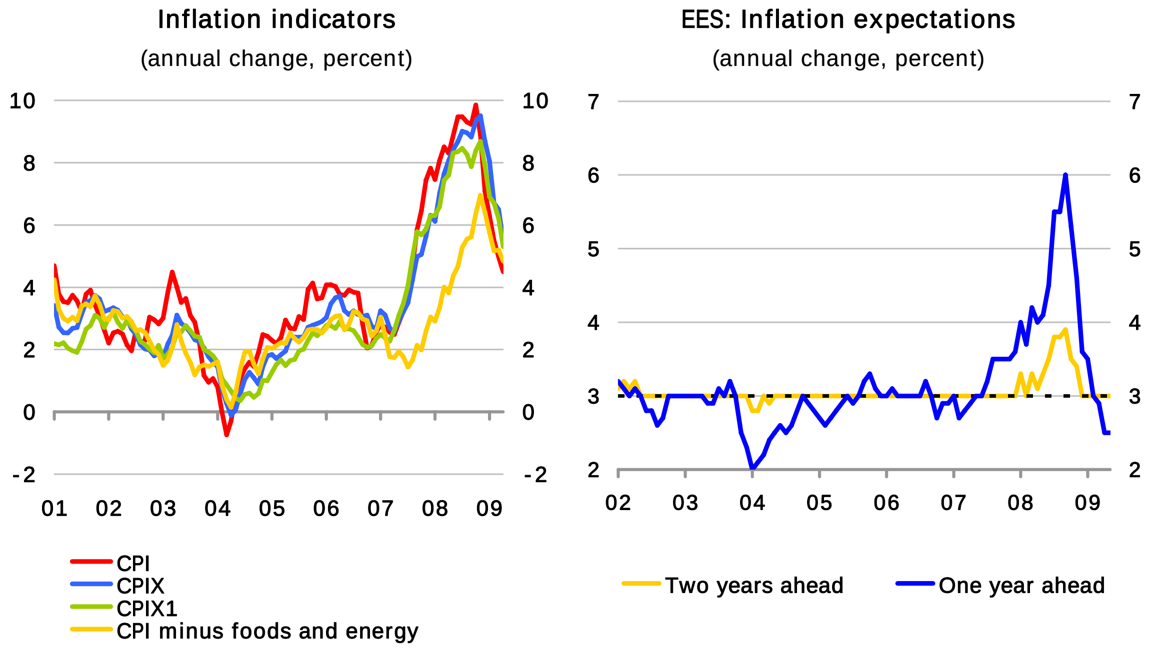
Table 2
Economic growth and current account
(annual change, percent)

	2007	2008	2009 (f)
GDP	4.7	3.2	-0.75 to 0.25
National income	7.1	3.8	-2.8
Domestic demand	7.8	7.4	-4.7
Gross fixed capital formation	12.0	19.5	-14.3
Total consumption	7.1	4.2	0.2
Goods and services exports	7.6	3.1	-1.7
Goods and services imports	14.9	12.9	-10.6
Current account (% of GDP)	4.4	-2.0	-1.8

(f) Projection.

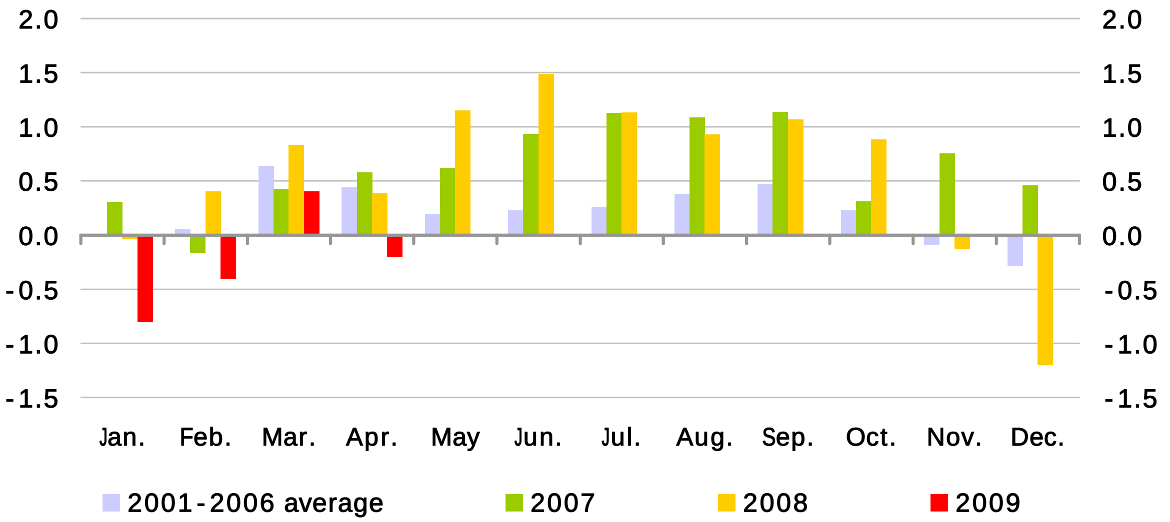
Source: Central Bank of Chile.

Figure 9
Effective inflation and inflationary outlook



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

Figure 10
CPI monthly inflation
(percent)



Source: National Statistics Bureau (INE).

Table 3
Inflation
(annual change, percent)

	2006	2007	2008	2009 (f)	2010 (f)	2011 (f)
Average CPI inflation	3.4	4.4	8.7	2.3	1.5	
December CPI inflation	2.6	7.8	7.1	0.6	2.3	
CPI inflation two years ahead (*)						3.0
Average CPIX inflation	3.2	4.0	8.4	3.7	1.1	
December CPIX inflation	2.7	6.3	8.7	0.5	2.2	
CPIX inflation two years ahead (*)						2.9
Average CPIX1 inflation	2.5	4.1	7.8	3.8	1.0	
December CPIX1 inflation	2.4	6.3	7.9	1.0	2.2	
CPIX1 inflation two years ahead (*)						3.0

(f) Projection.
(*) Inflation projected for the second quarter of 2011.

Source: Central Bank of Chile.

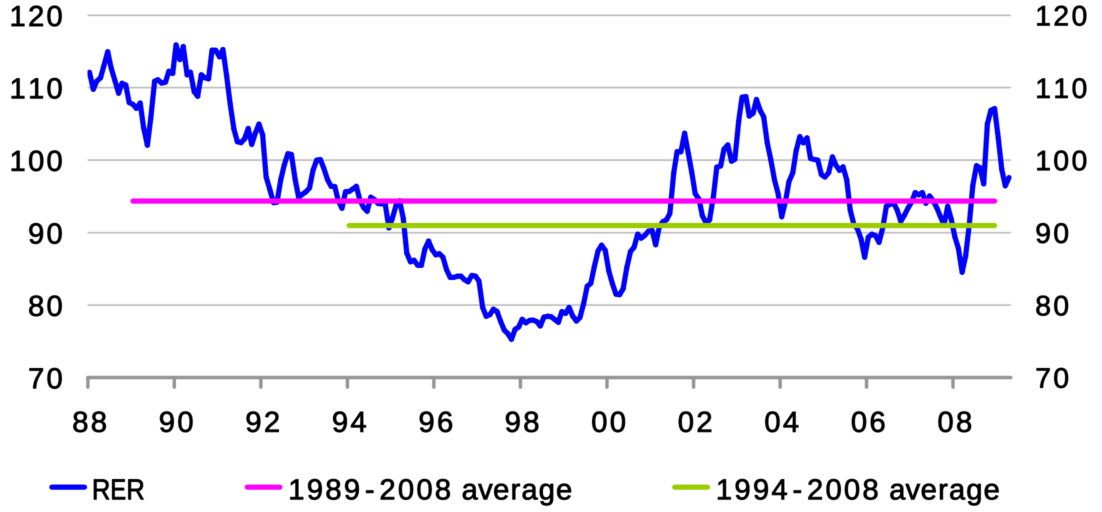
Table 4
Main assumptions of the international baseline scenario
(yearly average)

	2008	2009 (f)				2010 (f)			
		Sep.08	Nov.08	Jan.09	May 09	Sep.08	Nov.08	Jan.09	May 09
WTI oil price (US$/barrel)	100	116	70	50	52	115	80	60	64
LME copper price (US$cent/lb)	316	310	165	150	180	300	190	160	185
Terms of trade (annual change, %)	-15.0	-7.2	-18.2	-19.1	-13.5	-4.3	-2.5	-2.0	-3.8
External prices in US$ (annual change, %)	12.0	3.3	0.5	-0.8	-5.7	2.8	4.8	5.5	7.0

(f) Projection.

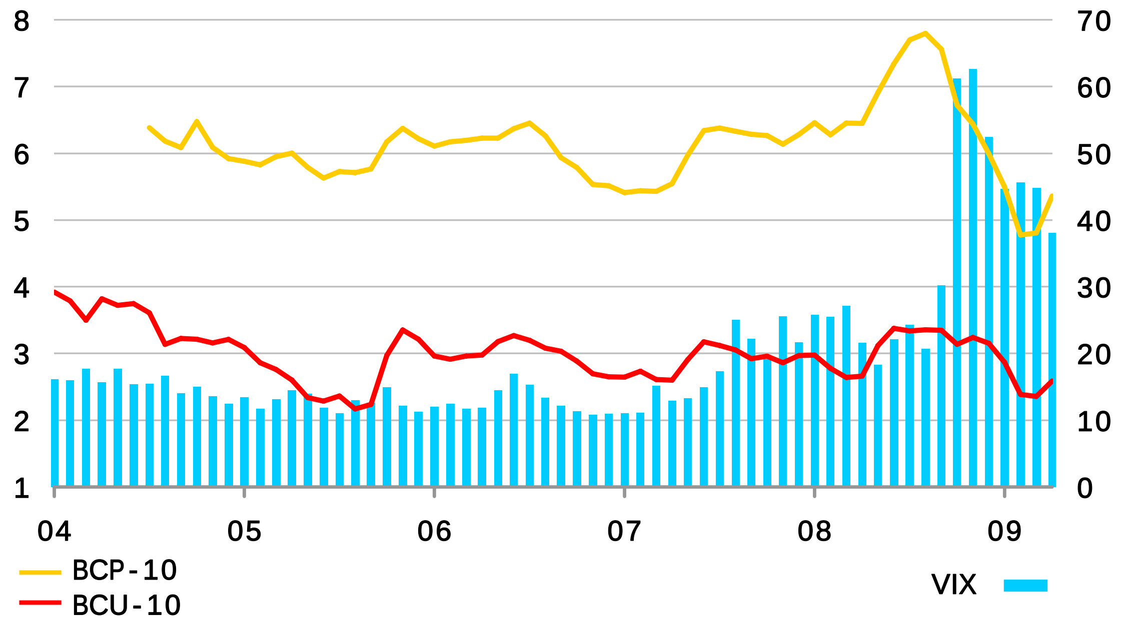
Source: Central Bank of Chile.

Figure 11
Real exchange rate
(index,1986=100)



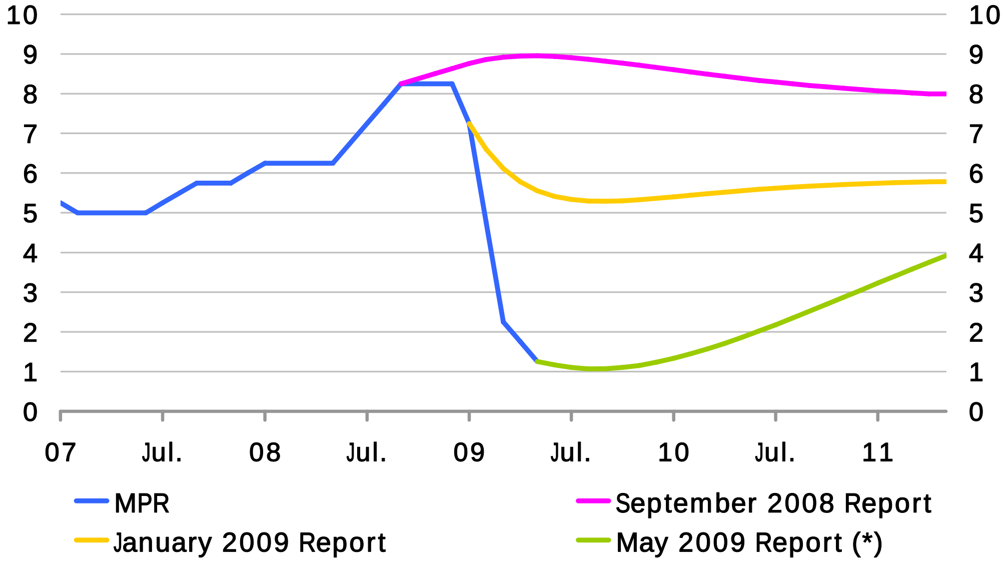
Source: Central Bank of Chile.

Figure 12
Interest rates on CBC instruments and VIX
(monthly averages, percent)



Sources: Central Bank of Chile and Bloomberg.

Figure 13
Monetary policy rate and forward curve
(percent)



(*) Estimated using financial asset prices at 8 May 2009.

Source: Central Bank of Chile.