José De Gregorio: The Monetary Policy Report and the Financial Stability Report

Presentation by Mr José De Gregorio, Governor of the Central Bank of Chile, before the Finance Commission of the Honorable Senate of the Republic, Santiago de Chile, 16 June 2010.

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Introduction

Mr. President of the Finance Commission, Senator Camilo Escalona, senators:

I am grateful to this Commission for the invitation to the Board of the Central Bank of Chile to share our views on recent macroeconomic and financial developments and their implications for monetary policy. These are detailed in our *Monetary Policy Report* (IPoM) of June 2010 and in our *Financial Stability Report* (IEF) for the first half of 2010.

We are presenting our Reports in the midst of a unique scenario for the Central Bank. On the one hand, both the Chilean economy and the global economy have been on a sustained path of recovery since the second half of 2009. This path has not been free of difficulties. The earthquake and tsunami that swept Chile last 27th of February, and which was a major part of our concerns when we visited this Commission in March, had negative effects on the February and March output figures. As we said in that occasion, those disruptions were restricted to the short term, as is evident in the strength of the most recent indicators. This does mean that the hardest hit areas are in a precariousness situation, especially in housing. In addition, despite a promising domestic growth scenario, the Chilean economy remains operating below full capacity with above normal unemployment levels. This limits inflationary pressures, which is consistent with maintaining a highly and exceptionally expansionary monetary policy (figure 1).

On the other hand, financial stress in Europe is raising the level of uncertainty regarding the speed with which the world economy will recover and the smooth functioning of global financial markets. Although the baseline scenario in the two reports we are presenting today assumes that both the world economy and the Chilean economy will keep growing in the coming quarters, the international situation, particularly in Europe, together with its impact on our economy and its implications for monetary policy will have to be assessed carefully and continually.

All these elements, which are taken into account in every monthly monetary policy meeting, determined that in yesterday’s meeting we began the process of normalizing the significant monetary stimulus currently in place in Chile. This is the natural step after the gradual withdrawal of the extraordinary facilities for liquidity provision and the term liquidity facility FLAP, implemented in recent years to deal with the severe effects of the crisis of 2008–2009.

In the current juncture, it is highly convenient to normalize the monetary stimulus. In the first place, because the current monetary policy instance was implemented in a context of significant economic weaknesses and strong disinflationary pressures observed in the first half of last year. As output gaps have begun to narrow, that dosage of stimulus is not necessary. Secondly, as output gaps close, inflationary pressures will be incubated that will need to be contained in time. The level of inflation is currently low, but the problem is neither today’s nor the coming months’ inflation figures, but its medium-term trend.

In that context, as we have stated before, our dilemma is not if we must raise the monetary policy rate (MPR), but rather when and by how much to do so. Delaying this process will lead to faster and larger adjustments along the road to prevent the incubation of inflationary bubbles. We are aware of the costs of sharp upward adjustments of the interest rate, so it is necessary to time our actions to ensure a gradual and timely normalization process. This allows withdrawing the monetary stimulus flexibly and in the right dosages.

The baseline scenario of this IPoM foresees that the normalization of the MPR will proceed gradually, but it will remain expansionary for several more quarters. Naturally, the pace and magnitude of the normalization will depend on how the uncertain external scenario and the domestic macroeconomic conditions unfold, so that the adjustments are consistent with the inflation target.

Both our *Financial Stability Report* (IEF) and our *Monetary Policy Report* (IPoM) identify a set of risks for the medium-term scenario, to which I will come back in a moment. If some of them materialize, the Board will definitely revise and adjust its withdrawal strategy for the monetary stimulus taking into account their effects on inflation. As we have shown in the past, monetary policy has a high capacity to adjust to changes in the macroeconomic scenario. This flexibility, combined with a financial system prepared to deal with risk scenarios, allows monetary policy to play a key role in mitigating their impact of these changes on the national economy. Let me begin by reviewing the most likely scenario for the next to years in our view and its implications for inflation and monetary policy.

Macroeconomic scenario

To assess the future course of monetary policy, the implications of both external and internal developments have to be taken into account. Worth singling out are the reaction of local financial markets to the external turmoil, the response of the economy to the earthquake and tsunami of last February and the trends of output and demand in the coming quarters.

The world economy has turned more volatile. After several quarters of gradual normalization and relative financial calm, the international scenario presented significant tensions during the second quarter of 2010. The weak financial situation in some European countries spread to other economies and banking systems, and at the same time raised doubts about the effectiveness of existing crisis resolution mechanisms. As underscored in the IEF, the intensity and speed with which these events have occurred reflect the economic and financial fragility that still persists in advanced economies following the crisis of 2008. In many of these countries, banks' balance sheets still include deteriorated assets, while facing major refinancing needs for 2010.

Accordingly, in the past several months we have seen main stock indexes falling substantially, interbank spreads rising again and commodities prices falling, with only a few exceptions, including gold (figure 2). Increased appetite for safe financial assets has triggered a worldwide reduction in interest rates on this type of instruments, while the dollar has strengthened and the euro has depreciated. The significant capital flows to emerging economies have stabilized or reversed partially, in particular stock-portfolio flows. Nevertheless the preoccupation remains in many emerging economies – especially in Asia – about the creation of bubbles in their asset prices.

As shown in the IEF, the domestic financial market, like those in other emerging economies, has been fairly resilient to the instability in external markets, which is visible in several dimensions. The bulk of the price adjustment has taken place in the foreign exchange and stock markets, but even these movements have been comparatively small (figure 3). Unlike recent episodes of financial volatility, local monetary markets have operated normally, and credit spreads have no risen significant. Chilean sovereign risk premiums have not changed much, and local banks have managed to obtain external loans in similar conditions to those at the end of 2009. Recently, pension funds have reduced their assets abroad, a phenomenon that also occurred during the worst external turbulences at the end of 2008. The baseline scenario assumes that this relative resilience will continue over the projection horizon.

Despite the size of the international financial adjustment, no evident effect has been observed in the global growth projections consensus. On the one hand, the emerging world, especially in Asia and Latin America, is showing much faster recovery rates than the main industrialized economies. On the other hand, in the latter, manufacturing output, sales, employment and confidence indicators do not reflect any obvious impact of the global financial volatility. Therefore, in the past few months strong effective growth has consolidated with notorious differences in the rate of expansion across different economies (figure 4).

Still, we estimate that the higher volatility we see today has been sufficiently large and persistent so as to affect world growth projections to some extent. Accordingly, contrary to habit, the Board considers as the baseline scenario for global growth in 2011 around half a percentage point less than the updated consensus forecast. This responds to the combined effects of recent turbulences, their persistence for some more quarters, and the fiscal adjustments under way in several economies (table 1).

Domestically, first-quarter figures suggest that the immediate impact of the earthquake and tsunami on output and demand differ from March projections. Whereas output initially fell more than expected, largely because of the manufacturing industry, demand tended to rise, with significant increases in durable consumption, in imports of consumer and capital goods, and in retail sales. Second-quarter figures show that, although the affected zones are still enduring a hard situation, especially in the housing conditions of affected areas, the disruptions of the productive process have quickly dissipated (figure 5).

With respect to firms, our estimates suggest that the effects of the earthquake and tsunami on their financial situation was not severe. Estimates of the impact of the catastrophe on their payment capacity reveal focalized effects on small and medium firms of the hardest hit regions. Larger firms have relied on insurance that cushion the effects of the earthquake on their solvency, but delays in the payment of claims might generate liquidity pressures.

Accordingly, output will be similar to March projections, while domestic demand will continue to grow very strongly. In the baseline scenario, the expansion of demand will begin to diminish over the course of the second half of this year, mainly because part of its current strength is temporary, related to the consumption of durable goods, investment in machinery and equipment and inventory replacement. The Board foresees that in 2010 y-o-y GDP growth will between 4% and 5%. This range is slightly lower than March estimates, due to slower effective growth in the first quarter. Domestic demand will approach a growth rate of 15% in 2010, determined by the foreseen increase in gross fixed capital formation and private consumption (table 2).

The scenario for domestic demand is also based on the substantial impulse of macroeconomic policies in the past several quarters, boosted by the progressive normalization of internal financial conditions. Credit has begun to present month-on-month increases, lending rates remain fairly low and the evaluation of both suppliers and demanders of credit show less restrictive lending standards despite the earthquake (figure 6). As highlighted in the IEF, it is important for the local banking industry to remain proactive in keeping and diversifying the sources of external credit and adequately manage credit risks within a context of economic recovery.

Since mid-2008, household borrowing ratios and their financial burden have decreased. Consumer and firm expectations are still near or somewhat above their neutral values. This combines with the labor market recovering in aggregate terms, which overall was not affected by the earthquake and tsunami.

Investment growth relies on both favorable macroeconomic conditions and the boost of reconstruction efforts. As for fiscal policy, the baseline scenario considers that the structural balance will be reached towards the end of the current Administration and that there will be tax changes, budget reallocations and new financing sources for the reconstruction, according to the government's announcements.

The performance of output and demand will result in a current-account deficit of 1.2% of GDP this year. Measured at trend prices, this deficit is large by historical standards, but it responds partly to temporary reconstruction and replacement expenditures associated with the earthquake.

Year-on-year CPI inflation has continued to rise in recent months, consolidating in positive figures. Core indicators for annual variations are still in negative territory but they steadily approach above-zero numbers. Annual inflation figures are somewhat below levels foreseen in March. This is because the immediate effects of the earthquake and tsunami, if any, were bounded and certainly smaller than projected in the last IPoM or by overall market expectations. Despite this difference, the assumptions about changes in some specific prices such as public transport fares, the tobacco excise tax or the unchanged stamp tax will result – in the baseline scenario – in inflation being at the end of 2010 in the upper area of the tolerance range of the inflation target.

Towards 2011 and 2012, annual CPI inflation will oscillate around 3% and will stay there through the end of the relevant projection horizon, this time the second quarter of 2012. Core inflation will show a slower convergence to 3%, to hit that figure over the course of 2011. These projections are consistent with June's Economic Expectations Survey, which foresees y-o-y inflation for December of this and next year at 3.5% and 3.2%, respectively, and at 3% two years ahead (figure 7).

Aside from the assumptions just described for domestic and external growth, the baseline scenario considers that in the long run the real exchange rate (RER) will be similar to its current level. This, considering that, with the current level of the nominal exchange rate and the parities prevailing at the statistical closure of this IPoM, the RER is aligned with its long-term fundamentals.

The domestic growth scenario foreseen for the coming quarters assumes output gaps closing fully during 2011. Today, however, the economy is still operating below full capacity, which limits inflationary pressures and is consistent with monetary policy remaining significantly expansionary. Nonetheless, as output gaps close, inflationary pressures will be incubated which must be contained in time in order to ensure that annual inflation will stand at 3% over the two-year policy horizon. Hence, the Board estimates that achieving the inflation target in the projection horizon requires, as has been said in recent months, a progressive normalization of the current significant monetary stimulus. As a working assumption, the baseline scenario estimates that the level of the MPR one year ahead will be similar to the one inferred from private expectations. In the long term, it will converge to its neutral level (figure 8).

As usual, the outlined scenario is subject to several risks. Internally, the greatest risks come from domestic expenditure. The baseline scenario considers that a significant part of its current strong expansion is temporary. However, there is a risk that said strength is largely the response to stimulative macroeconomic conditions, which would mean that the downturn foreseen in the second half of this year may not occur, speeding the closing of output gaps. The medium-term impact on aggregate demand of reconstruction works and the funding thereof will have to be assessed continually. In the immediate term, April data and the reaction of economic sectors to the earthquake and tsunami reduces the possibility of a generalized delay in the economic recovery.

Internationally, the baseline scenario assumes that the world economic recovery will be more gradual than suggested by average consensus estimates. There are risks, such as a significant deceleration in the economic activity of the U.S. or China or, as is usual, persistent global imbalances. However, the greatest source of risks at this moment comes from financial stress, given the remaining by markets regarding whether the fiscal adjustment and financial support measures announced in Europe will be feasible and large enough. The magnitude and reach of the effects of a scenario in which the weak fiscal and/or financial situation in Europe intensifies or spreads to other regions materializes, are highly uncertain, but potentially substantial.

Stress tests reported in the IEF show that current levels of capitalization of the banking industry allow it to absorb the probable consequences of this scenario of increased global financial instability. Meanwhile, banks have high levels of liquidity. Despite these strengths, banks must pay special attention to the management of their liquidity positions in foreign currencies and take any necessary actions to ensure smooth access to foreign markets. This consideration is especially important due to the fact that the European commercial banks account for a major fraction of Chilean banks' external financing. In addition, in the risk scenario, other forms of contagion cannot be ruled out, considering the presence of foreign banks in Chile. Certainly, the deteriorated external financial conditions and the world deceleration that would be created in this risk scenario could have a negative impact on the Chilean economy. However, as it did at the end of 2008, the Chilean financial system is prepared to adequately deal with this tighter external scenario, and the Central Bank has the necessary tools to mitigate these effects on the liquidity and proper functioning of local monetary markets.

The materialization of some of these risks would have direct consequences for the projected scenarios for national growth and inflation. After considering all the above elements, the Board estimates that the risk balance for output and inflation are unbiased. In any case, as it has done before, the Board will adopt all measures necessary to address any events reshaping the macroeconomic scenario and inflationary forecasts.

Let me share with you some final thoughts before I finish.

Final thoughts

In the past few years we have faced several external shocks that have required us to act flexibly, even changing abruptly the direction of monetary policy. For that we have relied on our policy system designed to accommodate to changes in the economy within the framework of a price stability objective.

It is enough to recall that in 2007–2008 we lived through a period of high and very complex inflationary upsurge. The causes were essentially external, aggravated by an unusual propagation to other domestic prices. Then, at the end of 2008 and at the beginning of 2009, we endured a severe economic downturn and disinflation, also triggered by a foreign event, namely the severe global financial crisis and the associated collapse of confidence. In both episodes the baseline scenario we outlined in the IPoM and IEF at the time went through unprecedented changes. Most recently, February's catastrophe made it necessary to adjust our projections, particularly for the short term, to include the effects on output of this natural disaster.

As we shared with you a minute ago, the data for the last quarters show, beyond the immediate and medium-term effects of the earthquake, that the economy is growing strongly, financial conditions have been steadily normalizing, employment is on the rise and inflation is approaching the 3% target. The most important difference between now and previous episodes during 2007–2009 are the fundamentals behind our current macroeconomic scenario. While in earlier years the larger part of inflationary and output fluctuations originated abroad, today they are related with macroeconomic developments at home. In particular, the foreseen closing of output gaps and the current level of the MPR, which is highly stimulative compared with several measurements of its neutral level. Thus, monetary policy must be applied in consistency with a stronger domestic scenario and in line with the inflation target.

High risks persist internationally. Financial markets around the world and in some European countries are raising a red flag. Although not part of the baseline scenario, we cannot rule out a worsening of global economic and financial conditions. Overall, the tensions in Europe are something we had commented in several previous presentations and were related not only with the need to put forward expansionary policies to avert further deterioration of output in the face of the global crisis, but also with the gradual and orderly withdrawal of fiscal and monetary policy stimulus packages in the world.

What prevented the financial collapse of late 2008 from becoming a second Great Depression were the strong fiscal and monetary stimulus packages around the world. Larger fiscal deficits are the outcome of increased expenditure and reduced taxes, in addition to a normal deterioration associated with a recessive period.

Chile was able to make an unprecedented effort thanks to its solid financial situation and sound macroeconomic policies: the exchange rate adjusted without triggering larger imbalances; the inflation targeting scheme was consistent with a drastic and significant change of sign the monetary policy stance and the conduct of public finances managed to implement a highly countercyclical fiscal package that used part of accumulated savings from previous years.

However, not all the economies were in the same position when the crisis hit. The situation has been particularly complex for those countries that started this process with fragile fiscal situations, that is, with high levels of public debt. Furthermore, in Europe, the existence of a common currency has introduced an extra constraint to the adjustment process.

The foregoing shows how important it is to preserve macroeconomic balances and to act on a timely basis. The latest events in Europe demonstrate how a weak fiscal situation combined with a couple of years of relaxation, however warranted, may damage the economy's financial position and compromise its recovery. The fiscal adjustments required in Europe, some very drastic and with risky implications on output, are living proof of what happens when adjustments and the withdrawal of stimulus measures are delayed. Hence the importance of conducting this process gradually in order to ensure a strong and uninterrupted recovery.

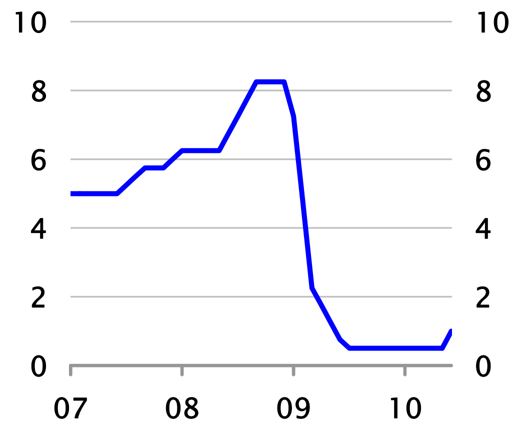
This also applies to monetary policy in Chile. To the extent that the withdrawal of the monetary stimulus is done at a gradual pace, in anticipation to the manifestation of inflation deviations, it will be possible to ensure stable and sustained growth of the Chilean economy. Any unnecessary postponement of the adjustment will only risk aggravating the costs in terms of output and employment in the future.

Monetary policy played a key role in mitigating the severe effects of the international crisis over the last year. It is still playing an important role in this phase of recovery. However, we must prevent inflationary pressures from incubating that would jeopardize the achievement of the inflation target. Today, monetary policy must allow that the foundations for the reconstruction after the earthquake and the recovery from last year's recession to be strong and sustainable, within a context of low, stable inflation. As I have said on several occasions, this is the main contribution of the Central Bank of Chile to growth and stability of the Chilean economy.

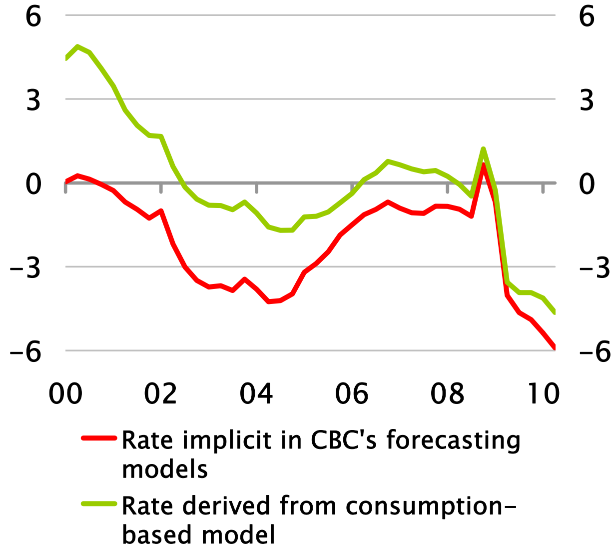
Thank you very much.

Figure 1

Monetary policy interest rate (MPR)
(percent)



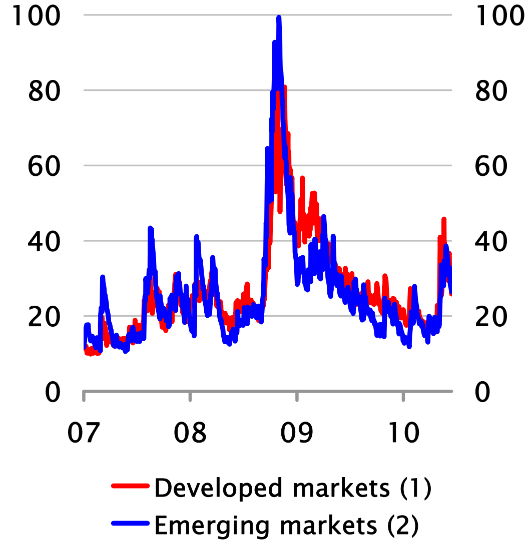
Real interest rate gap: Real MPR minus indicated neutral interest rate
(percent)



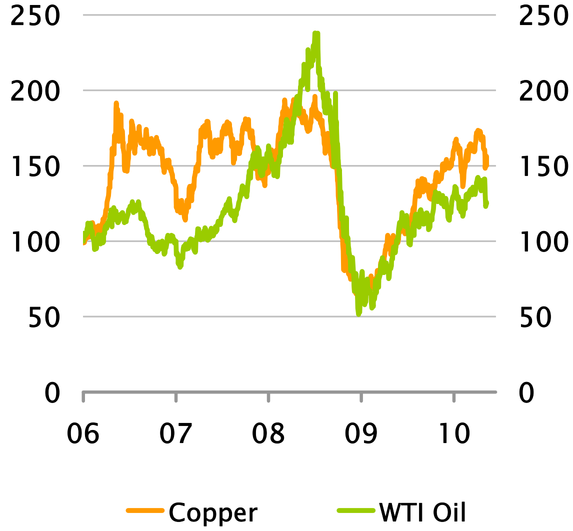
Source: Central Bank of Chile.

Figure 2

Stock-market volatility
(percent)



Commodities prices
(indexes, 02/01/2006=100)

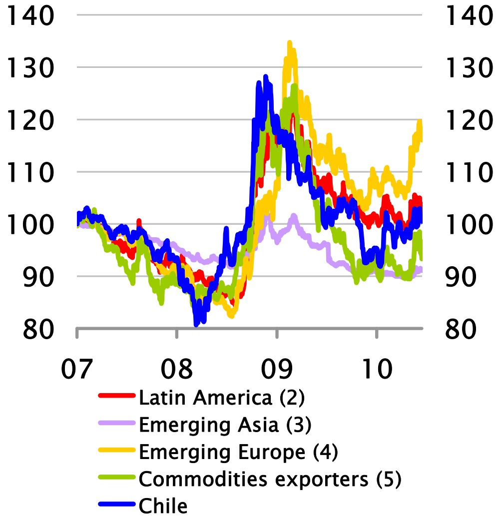


(1) VIX volatility index.
(2) Estimated volatility of MSCI index in dollars.

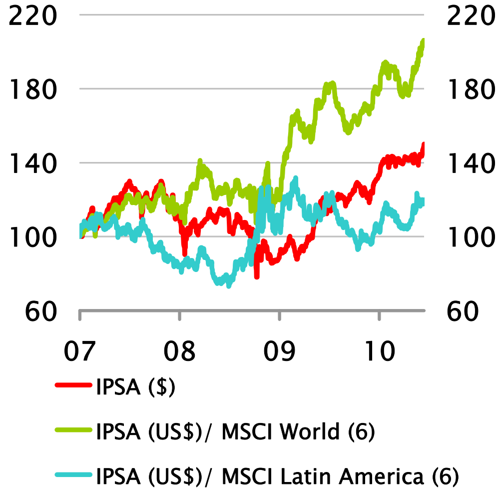
Sources: Bloomberg and Morgan Stanley Capital International.

Figure 3

Currency parities (1)
(index, 01/01/07=100, local units per dollar)



Stock-market indicators
(indexes, 02/01/07=100)

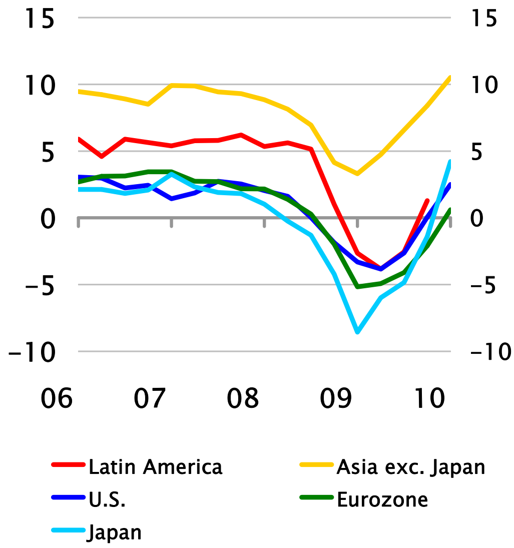


(1) Weighted averages at PPP for each region. Increase denotes depreciation. (2) Includes Argentina, Brazil, Chile and Mexico. (3) Includes China, Hong Kong, Indonesia, the Korean Rep., Malaysia and Thailand. (4) Includes the Czech Rep., Hungary, Poland and Russia. (5) Includes Australia, Canada and New Zealand. (6) Stock indexes by region, taken from Morgan Stanley Capital International.

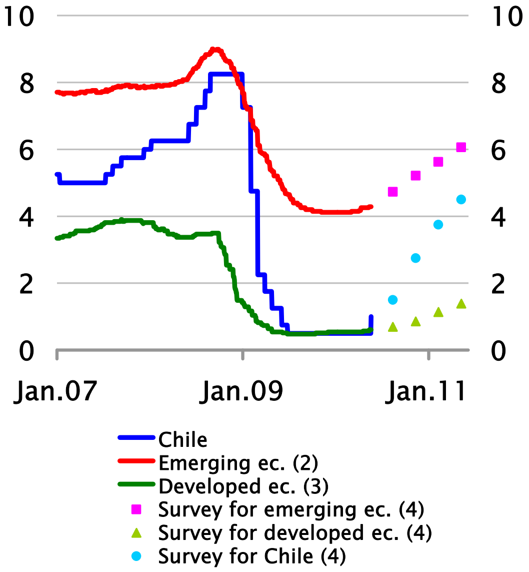
Sources: Central Bank of Chile, Bloomberg and International Monetary Fund.

Figure 4

GDP growth in selected regions and countries (1)
(annual change, percent)



Monetary policy rates in the world
(percent)



(1) Regions weighted by PPP as in April 2010's WEO. (2) Simple average of reference rates of Brazil, Chile, China, India, Israel, the Korean Rep. Mexico, Peru, Poland and Turkey. (3) Simple average of reference rates of Canada, the Eurozone, Japan, Norway, Sweden, Switzerland, the U.K. and the U.S. (4) Averaged responses of analysts surveyed by Bloomberg during May of 2010, indicating expectations for September and December of 2010, and March and June of 2011.

Sources: Central Bank of Chile based on respective country's statistics bureau, Bloomberg and IMF.

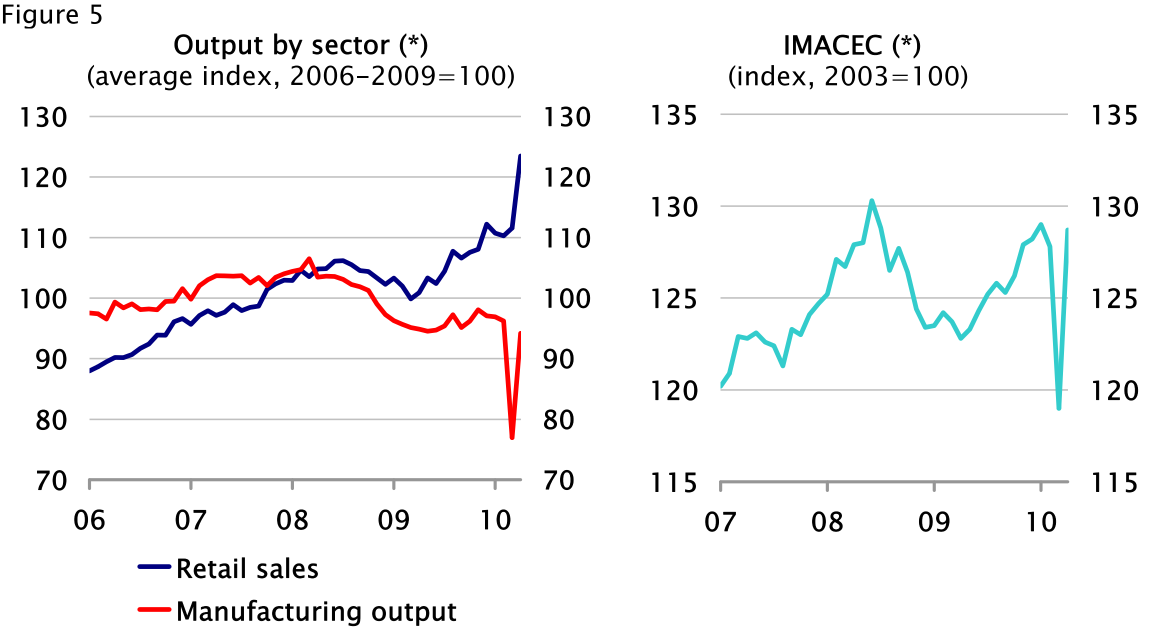
Table 1
Main international scenario assumptions
(annual averages)

	2008	2009 (e)		2010 (f)		2011 (f)	
		Mar.10	Jun.10	Mar.10	Jun.10	Mar.10	Jun.10
World GDP at PPP (annual change, %)	3.0	-0.6	-0.6	4.3	4.3	4.4	4.0
World GDP at MER (annual change, %)	1.8	-1.7	-2.0	3.5	3.2	3.5	3.0
Trading partners' GDP (annual change, %)	3.0	-0.8	-0.3	4.0	4.4	3.8	3.7
WTI oil price (US$/barrel)	100	62	62	82	77	85	80
LME copper price (US$cent/lb)	316	234	234	310	300	290	270
Terms of trade (annual change, %)	-16.1	4.1	4.1	12.5	14.3	-5.6	-7.2
External prices, in US$ (annual change, %)	12.2	-6.1	-6.2	3.7	3.4	3.0	3.3

(e) Estimate.
(f) Forecast.

Source: Central Bank of Chile.

Figure 5



(*) Seasonally-adjusted series.

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

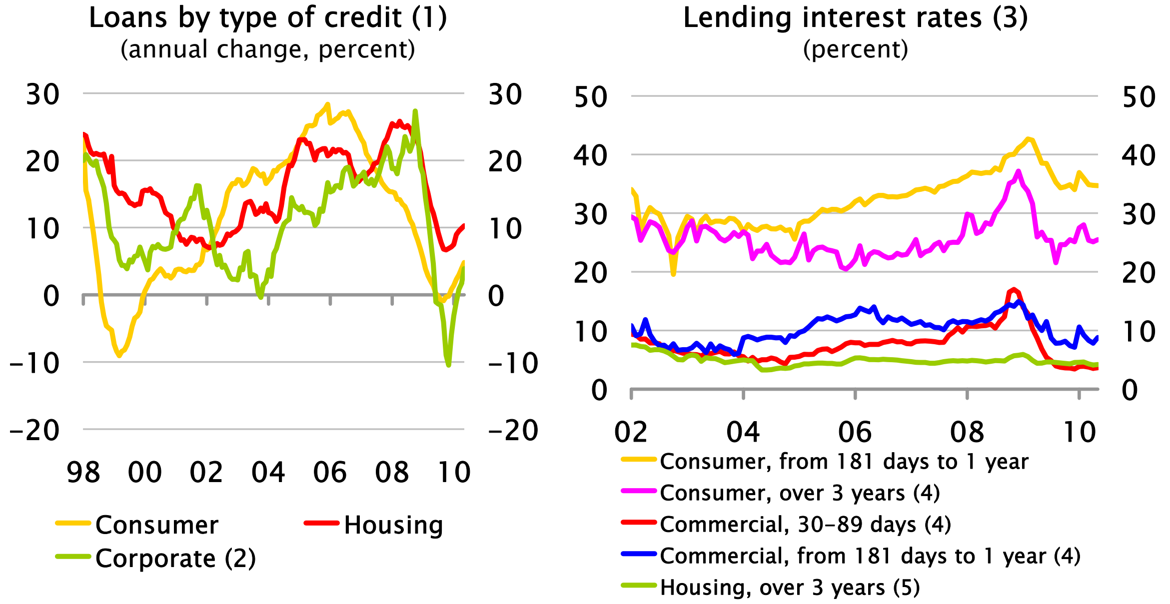
Table 2
Economic growth and inflation
(annual change, percent)

	2008	2009	2010 (f)	2011 (f)	2012 (f)
GDP	3.7	-1.5	4,0-5,0		
Domestic demand	7.6	-5.9	14.5		
Domestic demand (w/o inventory change)	7.5	-2.8	11.3		
Gross fixed capital formation	18.6	-15.3	23.0		
Total consumption	4.0	1.8	7.8		
Goods and services exports	3.1	-5.6	1.0		
Goods and services imports	12.2	-14.3	25.8		
Current account (% GDP)	-1.5	2.6	-1.2		
Average CPI inflation	8.7	1.6	1.8	3.2	
December CPI inflation	7.1	-1.4	3.8	3.1	
CPI inflation in around 2 years (*)					3.0
Average CPIX inflation	8.4	2.8	0.7	3.5	
December CPIX inflation	8.6	-1.8	3.3	3.5	
CPIX inflation in around 2 years (*)					3.2
Average CPIX1 inflation	7.8	2.8	-0.1	3.2	
December CPIX1 inflation	7.7	-1.1	1.8	3.2	
CPIX1 inflation in around 2 years (*)					3.1

(f) Forecast.
(*) Inflation forecast for second quarter 2012.

Source: Central Bank of Chile.

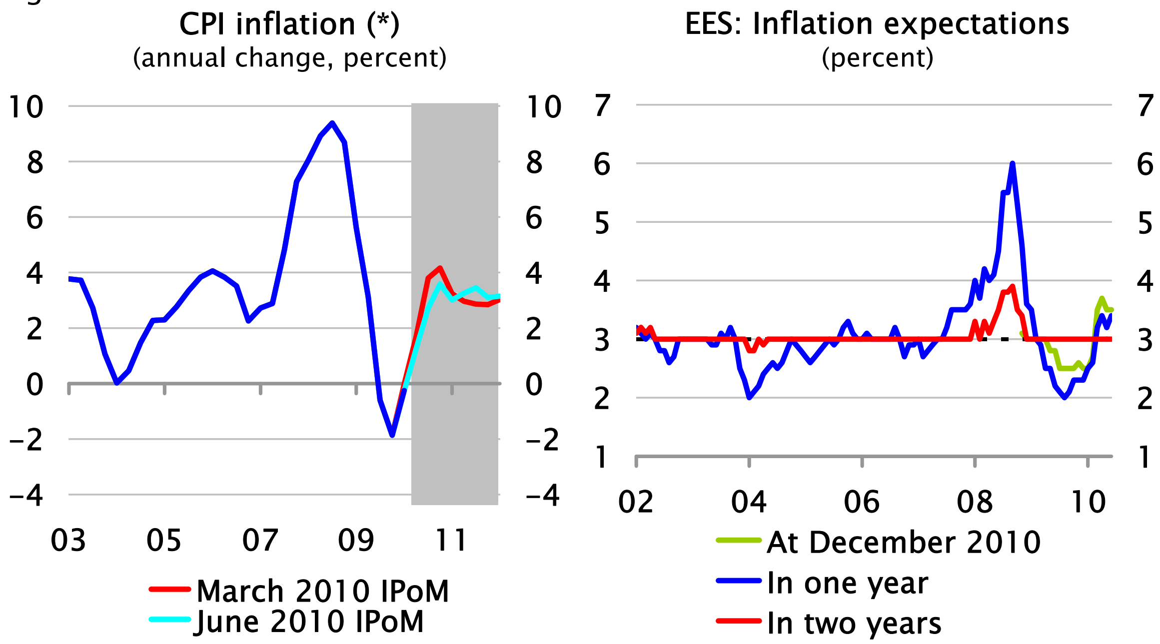
Figure 6



(1) Data for May 2010 are provisional. (2) Sum of commercial and foreign trade loans. (3) Weighted averaged rates of all operations performed in the month. (4) Nominal rates. (5) UF-indexed rates.

Sources: Central Bank of Chile and Superintendence of Banks & Financial Institutions.

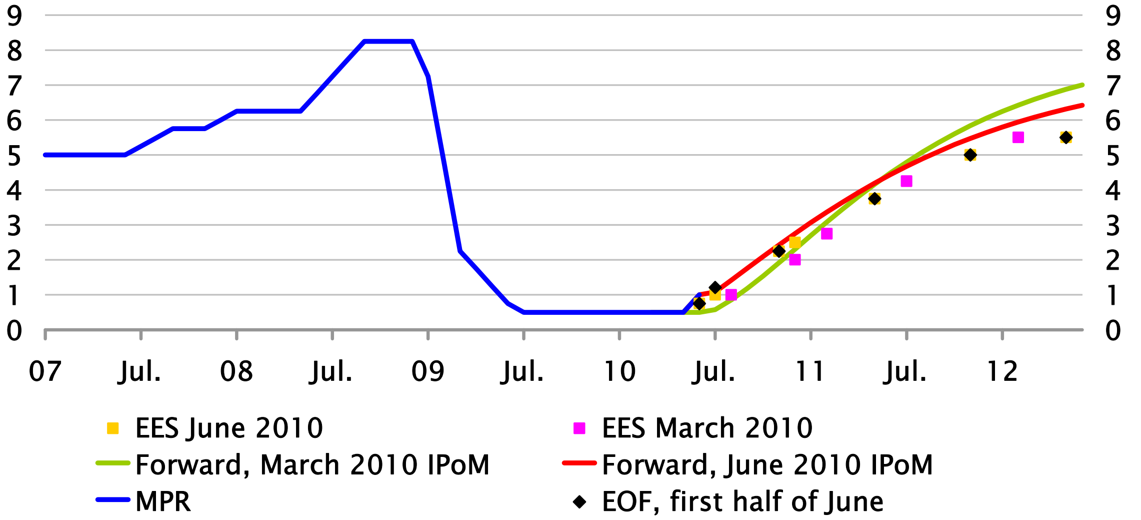
Figure 7



(*) Gray area: as from second quarter 2010, forecast.

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

Figure 8
MPR and forward curve
(percent)



Source: Central Bank of Chile.