José De Gregorio: Chile's latest Monetary Policy Report

Presentation by Mr José De Gregorio, Governor of the Central Bank of Chile, of the Monetary Policy Report before the Honorable Senate of the Republic, Santiago de Chile, 7 September 2011.

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The Monetary Policy Report of September 2011 can be found at http://www.bcentral.cl.

Introduction

Mr. President of the Senate, Senator Guido Girardi, Senators:

I am grateful for your invitation to the Board of the Central Bank of Chile to present our Monetary Policy Report. As in September of every year, this presentation coincides with the Central Bank Board's yearly account to the Senate, where we share with you our vision regarding recent macroeconomic and financial developments in Chile, as well as their prospects and implications on monetary policy conduct.

At the time of presenting this Report, we are about to complete three years since the outbreak of one of the worst economic and financial crises in modern history, known as the Great Recession. The string of events that followed the collapse of Lehman Brothers drove the world to an unprecedented confidence crisis, with a drop in global output that has no comparison with any other episode over the last eighty years.

Chile was able to mitigate the adverse effects of the crisis, and succeeded in quickly recovering its levels of output and employment, in sharp contrast with what happened in developed economies (figure 1). In fact, the closure of domestic output gaps – i.e., the difference between actual and trend growth – that a year ago we expected to occur over the course of 2011, took place in the first part of the year. The unemployment rate has fallen rapidly and is now below its historic average.

Inflation, meanwhile, has concluded a process of convergence to the 3-percent target. Inflation fears resurfaced during the first quarter of this year, but subsided after the Board's monetary policy decisions and the changes in the external macroeconomic scenario. We have thus arrived at a situation where the monetary policy interest rate (MPR) stands within a range that is considered normal.

However, the events of 2008 still cast their shadow over the world economic outlook. Despite the time elapsed and the economic and financial measures adopted by economic policy-makers around the world, we are still seeing the aftereffects of this episode. The underlying problems that caused the disaster have not been totally resolved, and continue to hold back the recovery of private demand. Added to this is the erosion of trust in the public finance management in some Eurozone members and in the U.S., which prompted a new episode of financial stress in early August, and still another one a few days ago.

The world economy is going through an extremely complex situation. Certainly, Chile has tools to soften the impact of adverse external conditions. But as we have said time and again in the past, we are not and cannot be immune to what happens outside our borders. We can mitigate its effects, but we cannot avoid them altogether. Therefore, the external situation is likely to have repercussions on our economy and, consequently, on our monetary policy conduct. As I just mentioned, at the August meeting the Board withdrew the tightening bias on the MPR it had communicated in previous minutes, which has reflected in the behavior of market interest rates.

The baseline scenario I will be presenting in a moment assumes that the world economy will grow less than we anticipated just three months ago. First-half output figures were pretty

weak in the developed world. Recent financial turmoil could aggravate in the second half of the year. Developed economies' households continue to tighten their belts in order to reduce their massive debts, but, in turn, this deleveraging process is restraining growth in domestic demand and employment, prolonging balance sheet vulnerability. In addition, the fiscal position of these economies has deteriorated after several years of fiscal deficit. Remedying this situation will call for substantial adjustments in their public finances. Some of them could be done in the medium term, for instance in the United States, while others need immediate action, as is the case in some emerging European economies. In moments of weak private demand, these adjustments could postpone the much expected recovery even further.

Add to this that monetary policy interest rates are at their all-time lows, with which the capacity of central banks to increase the stimulus is also limited. In short, the tools traditionally used to boost growth have little room for maneuver in the developed world.

Another source of risks that is being increasingly debated is the possibility of developed economies, especially the U.S., enduring a long time of slow growth. Excessive private debts, particularly of households, and public debt, combined with weak labor markets, are determinants of this assessment. This could shape a similar situation to that of Japan after the bursting of its housing bubble in the late 1980s, which gave way to a period of stagnation that has seen no end. Although we believe this to be an unlikely scenario, its consequences on the global economy could be severe.

Amidst these conditions, emerging economies continue to grow strongly. The risks of overheating we saw only a few months back have diminished, partly because of the very action of the adopted economic policies and, especially, of monetary measures. There are still risks, however. For one, it is obvious that if developed economies continue to lag, the external demand facing the emerging world will fall, hurting their growth potential. Although in the current scenario some dynamism and a certain degree of decoupling are expected, this cannot go on indefinitely.

Given the weakness of domestic demands in developed countries, they rely on their exports to grow and to resolve their global imbalances. This puts pressure on emerging economies' exchange rates and external accounts. This is one element we have seen in the past year, with parities against the dollar posting the greatest appreciations of the last decade (figure 2). So far, the Chilean economy has been able to withstand this challenge, but the risk of these pressures intensifying is still latent. The real exchange rate has risen after the announced intervention early this year, and now its level is near its average of the past 15 to 20 years (figure 3).

Among the policies that emerging economies have used to mitigate the impact on their currencies has been the adoption of foreign exchange measures. These have taken a variety of forms, including foreign currency purchases and the implementation of administrative measures. In Chile, in early January, we announced a program of reserves accumulation of 12 billion dollars, which will be completed over the course of this year. This is the equivalent of 5 GDP points, the largest since the first half of the 1990s (figure 4). To this date, we have already made purchases amounting somewhat more than 8.5 billion U.S. dollars.

This program serves two purposes. The first, as we emphasized in the announcement, is to transitorily attenuate the appreciation of the peso. This should allow the productive sector to make the necessary adjustments within a context in which these pressures could remain for a long time. The program did have an effect on the peso. Without the intervention, it would have appreciated further. However, as proven by the evidence, and as our communication highlighted, taking this kind of measures grants no permanent solution. The solution must necessarily come from improvements in competitiveness and productivity.

The second purpose of the program is to strengthen our international liquidity position. This means having the tools to deal with external turbulences. All the available evidence shows that a strong international reserves position helps to protect the economy of financial shocks coming from abroad, which in turn reduces the risk premiums of the economy. In our present

conjuncture, the level of reserves we are pursuing with the program sets us on a very good foot in case of a major global disruption.

Holding reserves is tantamount to having an insurance policy. During the good times, it bears a cost associated with the differential between the yield of foreign liquid and safe assets, and the cost of the domestic liabilities that finance them. However, during episodes of global recession and financial stress, the available reserves permit to cushion the impact of the shock on the cost of the country's external financing and provide increased flexibility to economic policies to mitigate the effects on the domestic economy.

Fluctuations in the international value of the peso cause significant volatility of our accounting results, as we have seen in recent years. In good times, the peso tends to appreciate, which generates accounting losses as the net worth is measured in pesos due to the effect of reserves revaluation. But during times of global slowdown and increased financial stress, the opposite occurs, with a peso depreciation and greater net worth in the books (figure 5).

As is typical of our yearly account to the Senate, in this Report we present the evolution of the Bank's balance sheet and its prospects for the next year. In the baseline scenario, if the gap between external and internal interest rates remains, we expect that the profitability of our assets will continue to fall short of the cost of our liabilities. Although we foresee no further deterioration in the Bank's equity, it will continue to be negative. The recent increase in international reserves has a negative effect on these results, but it has to its favor the intangible benefit of a strengthened liquidity position. However, as we said when we announced the intervention program, the level of international reserves we will reach by the end of the year is close to the limits that can be absorbed by our equity position. Still, this net worth – which originates mainly in the costly financial crisis of the 1980s – has not been an obstacle for the Bank to conduct its monetary policy with independence and flexibility.

To sum up, we face a complex external scenario. Doubts about how it will unfold and how it will affect the Chilean economy advise acting with prudence, but the Board is convinced that the country is on a good stand to deal with it. In the baseline scenario I will present to you in a moment, we assume that the effects of the external scenario will be limited, and the Chilean economy will grow close to its trend, with inflation near the target.

Now I will describe the factors that shape this baseline scenario and the implications of the risks I have mentioned.

Macroeconomic scenario

In Chile, the dynamism of output and demand moderated further during the second quarter, although somewhat less than had been forecast in June. Inflation, meanwhile, was slightly below expectations of a few months earlier. Headline y-o-y inflation has hovered around 3 percent, while the annual growth rates of core measures remain contained (figure 6). The inflation outlook has been characterized by limited transmission of food prices to the local market. Similarly, the propagation of the price increases of these goods and fuels to other prices has been in line with projections.

As I said a while ago, the external scenario has brought important news, with the materialization of some of the risks considered in the last quarters. This, coupled with prospects of slower growth in developed economies and concerns about the debt spreading to Central Europe, has had a significant impact on global financial markets. The sovereign spreads of several Eurozone members, like the premiums of some banks, are in all-time highs (figure 7). Asset prices have seen substantial changes, where worth noting is the decline in interest rates on long-term T-bonds of several developed economies that act as safe havens. Stock exchanges have dropped significantly at the global level (figure 8). To this is added, to a lesser extent, the strengthening of the dollar against some currencies, and the strong appreciation of gold and the Swiss franc, also used as safe havens. Finally, it is

worth mentioning the decline in commodity prices, with the exceptions of agricultural goods and, again, gold (figure 9).

Domestically, some variables of local financial markets have felt the external turmoil. The Stock exchange has experienced significant setbacks and interest rates on Treasury and Central Bank documents have fallen sharply (figure 10). The money and interbank markets have continued to operate normally, and liquidity conditions in both dollars and pesos have been unaffected by the increase in interbank premiums in developed markets. The peso, with swings, stands now close to its levels at the statistical cutoff of June's Report.

In light of these developments, output figures for the second quarter and advanced indicators for the third – which are still weak in developed economies – , the baseline scenario revises downward by 0.2 percentage points the world growth estimate for 2011, and by half a percentage point the one for next year (table 1).

The biggest change is for the U.S., where, aside from the low growth seen thus far, there is the incidence of foreseeable fiscal adjustments after the approval of the higher limit for public borrowing. Growth in the Eurozone is still expected to be slow. Also, it is foreseen that the weakening of the developed world will have an impact on emerging economies which, in any case, will continue to outperform their developed counterparts. This projected world growth forecast is lower than consensus, which at the closing of this Report probably does not reflect the full effect of current financial turmoil. Nonetheless, incoming reports by investment banks do carry significant downward corrections for these developed economies, in line with the assumptions that make up our baseline scenario.

As I said, concerns about an overheating of the emerging world and its consequences on inflation have subsided. Adjustments already made to the monetary policies of several economies, the weakening of the global economy, and the recent drop in commodity prices are behind this assessment. So, several countries have already suspended their cycles of policy rate increases and, in general, market expectations have adjusted to expect a flattened rate. In the developed economies, it is most likely that monetary policy will hold on to – or possibly even intensify – its current degree of expansiveness for some time. The Federal Reserve has just announced its intention to keep the fed funds rate at a minimum at least through mid-2013 (figure 11).

All these facts combined will result in that the external impulse that the Chilean economy will be receiving over the coming quarters will be milder than previously estimated. On one hand, the worsened global performance will have a negative impact on our trading partners' economies. However, they will continue to grow above their 2000–2007 average. The change in composition and weight of this group of countries, where emerging economies – especially China – have sharply increased their share, explains this result. While in 2000 emerging economies weighed less than one third in the group of Chile's trading partners, they are expected to be closer to one half in 2011 (figure 12). On the other hand, a drop in the terms of trade is expected. This last projection is based on a copper price of US$3.7 per pound in 2012 and US$3.5 in 2013, and a WTI oil price averaging around US$90 per barrel in 2012–2013 (table 2).

In this scenario of reduced external impulse, the Chilean economy is forecast to grow in the range of 6.25% to 6.75% this year, in line with June's projections. Up to the second quarter, output was growing above the trend and above expectations in the June Report; consumption was slowing down from its strong expansion but not as much as foreseen; the labor market continued to give signs of being tight and financial conditions were still favorable, with credit showing an increasing growth rate (figure 13). Our present scenario foresees that domestic demand will grow 9.1% this year, more than forecast in the last Report. This will reflect the impact of increased gross fixed capital formation of the first half, especially in machinery & equipment, as well as greater inventory accumulation. Compared with June, this projection assumes a faster convergence of output and demand during the

second half of the year. July's output figure, although influenced by specific developments in the mining sector, reflects this trend.

The biggest impact of the change in external conditions will be visible in GDP growth of 2012. For then, the baseline scenario assumes that GDP will grow in the 4.25% to 5.25% range (table 3). The slowdown from this year responds to a number of factors. First there is the convergence to expansion figures consistent with trend growth, which the Board continues to estimate around 5 percent. Such convergence reflects the normalization of both the durable components of aggregate demand and the MPR. Moreover, the effects of the low basis of comparison associated to the earthquake and tsunami of 2010 – that influenced first-half growth figures – will disappear. There is also the reduced impulse from abroad we will see in the coming quarters, which I have already mentioned. We also assume that the fiscal balance will converge to a structural deficit of 1 percent of GDP towards the end of the current Administration, as announced by the authorities and in conformity with the Fiscal Accountability Law.

This change in external conditions has also triggered significant changes in the inflation outlook, especially in the short run. In the baseline scenario, the increase in y-o-y CPI inflation towards the end of the year will be less than forecast in June, mainly responding to the lower price of fuels. Accordingly, by year's end, CPI inflation will be 3.3 percent instead of the 4 percent estimated in June. Going forward, inflation will remain close to the target through the third quarter of 2013, which this time marks the end of the projection horizon (figure 14). Private inflation expectations have been revised in the same direction and point at CPI inflation being somewhat above 3 percent at the end of the year, and in line with the target thereafter (figure 15).

Such a trend for inflation is based on several assumptions. As I said, that the economy will grow around its trend in the coming quarters; that the real exchange rate will remain fairly stable, in the range believed to be consistent with its long-term fundamentals; and that labor costs will grow in line with the inflation target.

Regarding monetary policy, the MPR has reached a range considered normal. Unlike predictions of some months ago, when most thought that the MPR would be raised further, the changes in the macroeconomic scenario have led to a greater dispersion of private expectations. Even so, the baseline scenario uses as a working assumption that, in the short run, the MPR will stay where it is today (figure 16).

As usual, this scenario reflects the events that are believed to be the most likely to occur with the information at hand at the Report's statistical cutoff date. There are risks that, if materialized, will shape a different macroeconomic scenario than the one described here. On this occasion, after thorough evaluation of the alternative scenarios, the Board estimates that the risk balance is downward biased for output, and unbiased for inflation.

As I mentioned first, the main risks have to do with the complex global economic situation. It cannot be ruled out that the recent episodes could happen again or intensify, affecting the financial system and confidence of economic agents. The little room for maneuvering of monetary and fiscal policies in the developed world complicates the response to such a scenario.

Another part of external risks is associated to developed countries' growth beyond the projection horizon. The forecast in the baseline scenario is less than market consensus, but an even stronger than foreseen impact cannot be ruled out. Doubts persist about the strength of the recovery of developed economies, and there is still the possibility of these economies' potential growth having dropped as an aftereffect of the crisis. Such an occurrence could have consequences on the level of interest rates, the speed at which leverage problems will be resolved, and growth in emerging economies. In this scenario, the world economy will grow less than in the past.

Nor can we rule out a scenario where the postponement of monetary policy rate increases in developed economies and their lack of dynamism could lead investors to hunt for better returns in emerging economies. This would trigger a resurgence of capital flows towards the latter, complicating their macroeconomic policy-making.

Internally, risks are centered on the persistently strong output and demand. Although the economy has evolved as predicted, the moderation has been softer than expected, the labor market is still tight – various sources of casuistic information report difficulties and pressures in the labor market – and the rate of credit expansion has increased. It is possible that, beyond tensions in the external scenario, the Chilean economy continues to grow above trend, leading to inflationary pressures incompatible with the inflation target.

There is no doubt that risks are important, but our monetary policy has the necessary tools to mitigate the potential impact of worse-than-expected external scenarios, as it has shown in the recent past.

Now allow me a few remarks to wrap up this presentation.

Final remarks

The external scenario is complex, but our economy has been very resilient to the effects of the Great Recession. In 2009, the combination of significant fiscal and monetary impulses averted the worse effects of the global crisis. Thus, after a couple of quarters in which uncertainty swept the entire world and hit our economy with special force, we recovered with great vigor. Even in the aftermath of the earthquake and tsunami of February 2010, Chile rapidly returned to a path of sustained growth, with an unprecedented recovery of employment, and unwavering strength. All within a context of low inflation, despite the international price shocks.

Monetary policy has given practical proof that it can act with flexibility and determination, and be resolute in attenuating the effects of the external cycle on our economy. As I said, at three years after the outbreak of the crisis we are still enduring its consequences. Chances are, its reverberations will continue for a while longer. The task of monetary policy is to preserve its necessary capacity to react in difficult times, the same capacity it has displayed to withdraw the stimulus packages in due time and prevent costly adjustments later.

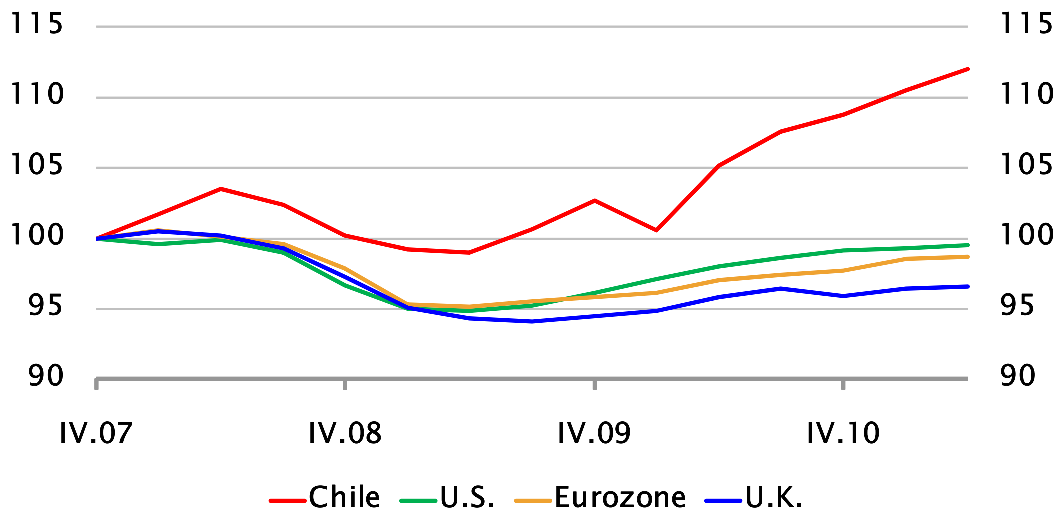
The Board will continue to fulfill its legal mandate of safeguarding price stability and the normal functioning of the payments system. Accordingly, it reaffirms its commitment of conducting monetary policy with flexibility, in order for projected inflation to stand at 3 percent over the policy horizon. An environment of low inflation improves households' welfare, particularly those less capable of protecting themselves from rising prices. Furthermore, keeping inflation low and stable permits to soften the fluctuations of output and employment, which contributes to the people's well-being. Chile must continue on a path of growth that will ensure continual progress of the living standards of its inhabitants.

The world, including our country, is living a decisive moment. Developed countries must make costly, complex, yet unavoidable adjustments. The experience of the developed world confirms the need to safeguard macroeconomic balances, both public and private, as well as a strong, well regulated financial system. The fragility of financial systems and fiscal accounts of some developed economies have caused a recoiling of living standards and could compromise their growth ability for a long while.

Figure 1

Gross domestic product

(index, IV.2007=100, quarterly series)

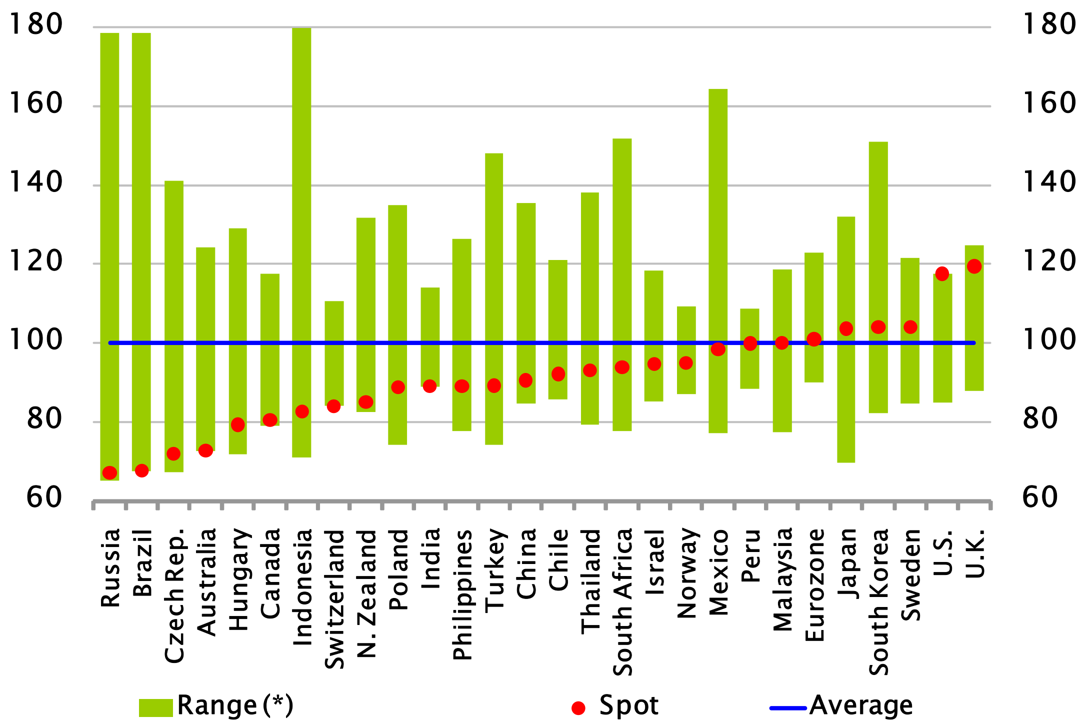


Sources: Central Bank of Chile and Bloomberg.

Figure 2

Real exchange rates around the world

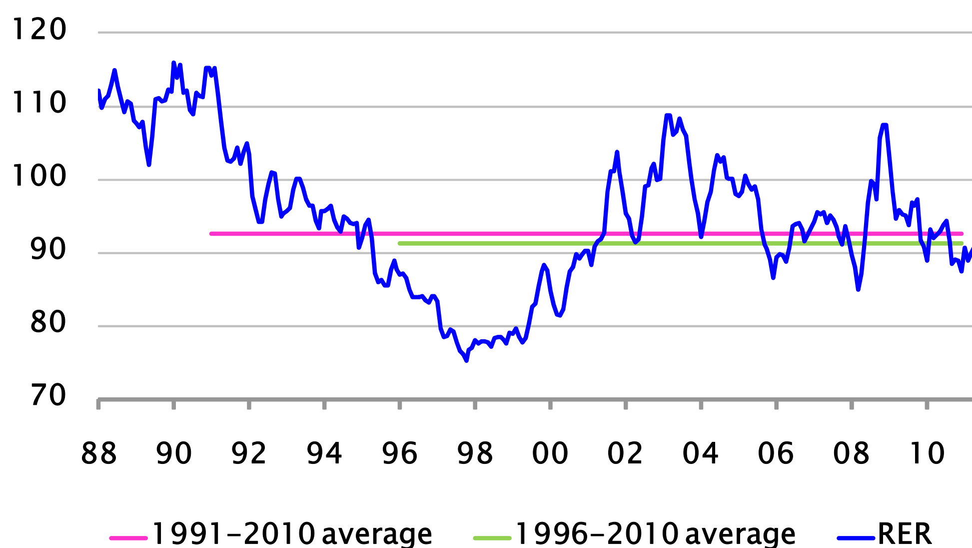
(index, July 1994–July 2011 average = 100)



(*) The range shows peaks and troughs of the local currency during indicated period. The scale has been adjusted to 180. The peak value for this country was 225.

Sources: Central Bank of Chile and Bank for International Settlements (BIS).

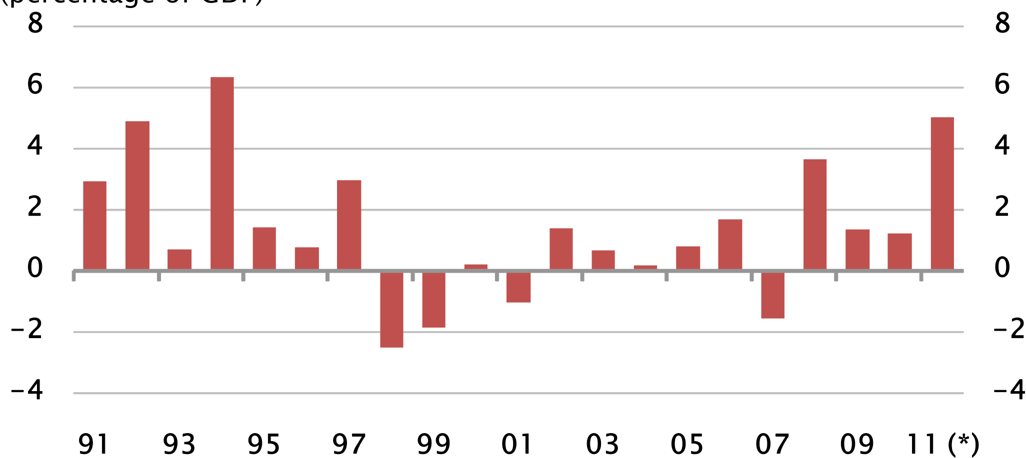
Figure 3
Real exchange rate (*)
(index, 1986=100)



(*) Preliminary for August 2011.

Source: Central Bank of Chile.

Figure 4
Change in Central Bank of Chile's international reserves
(percentage of GDP)



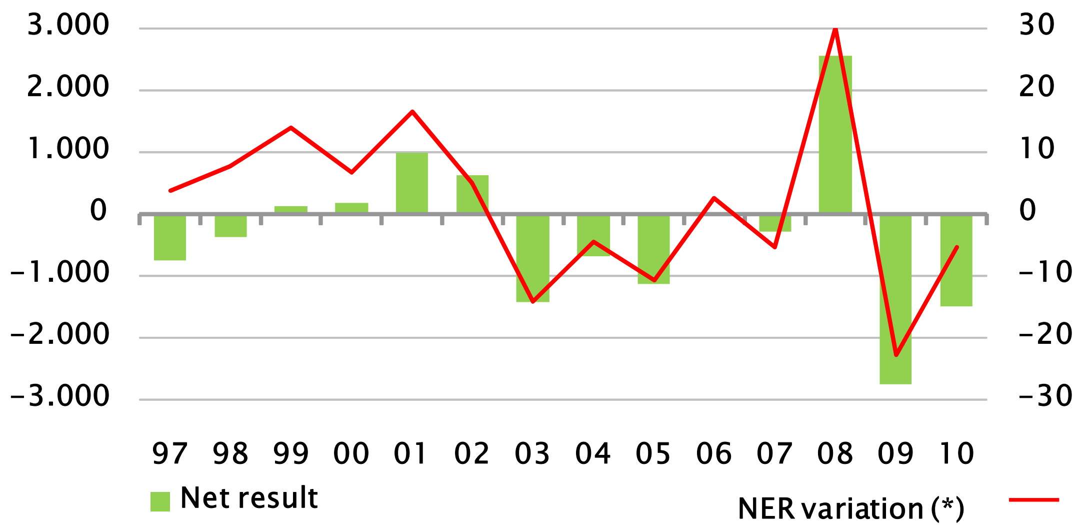
(*) The reserves include the purchase of US$12.0 billion announced in January 2011. To forecast GDP, growth and inflation projections in the September Report are used.

Source: Central Bank of Chile.

Figure 5

Central Bank of Chile balance sheet

(billions of pesos, percent)



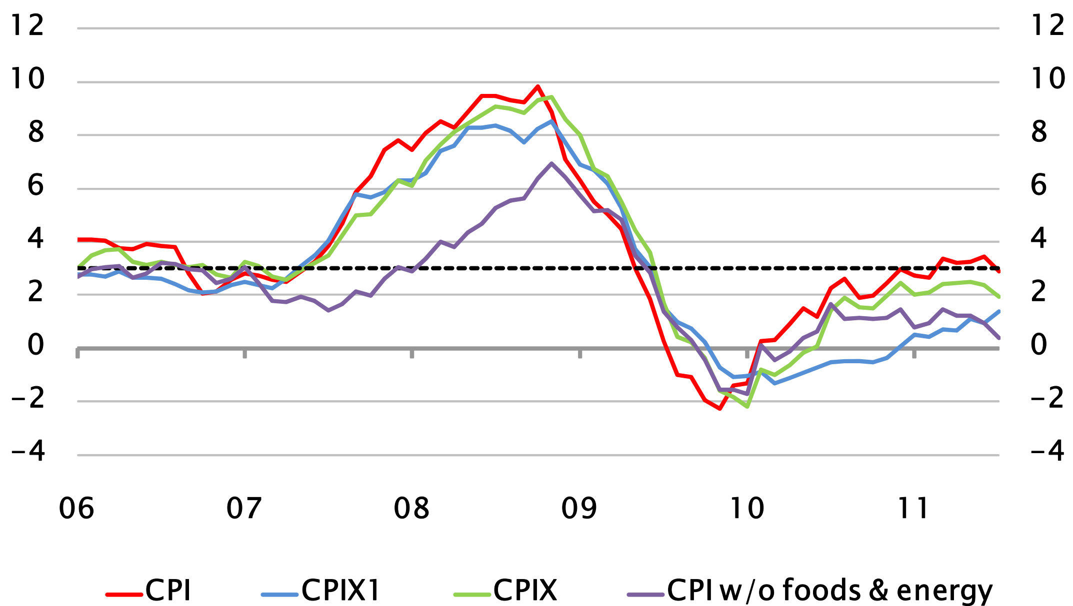
(*) Corresponds to y-o-y exchange rate variation at December of each year.

Source: Central Bank of Chile.

Figure 6

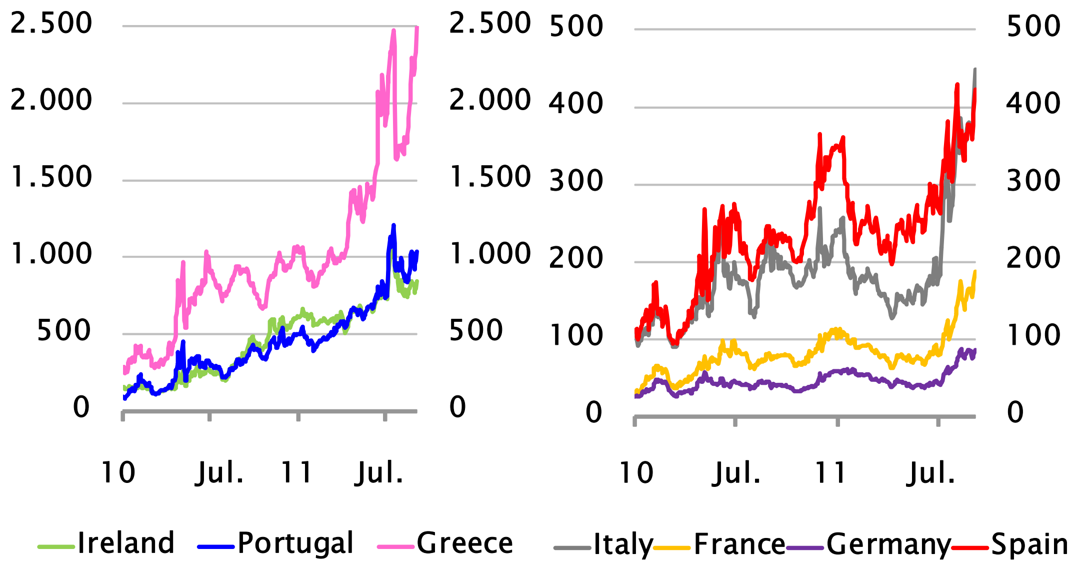
Inflation indicators

(annual change, percent)



Source: National Statistics Institute (INE).

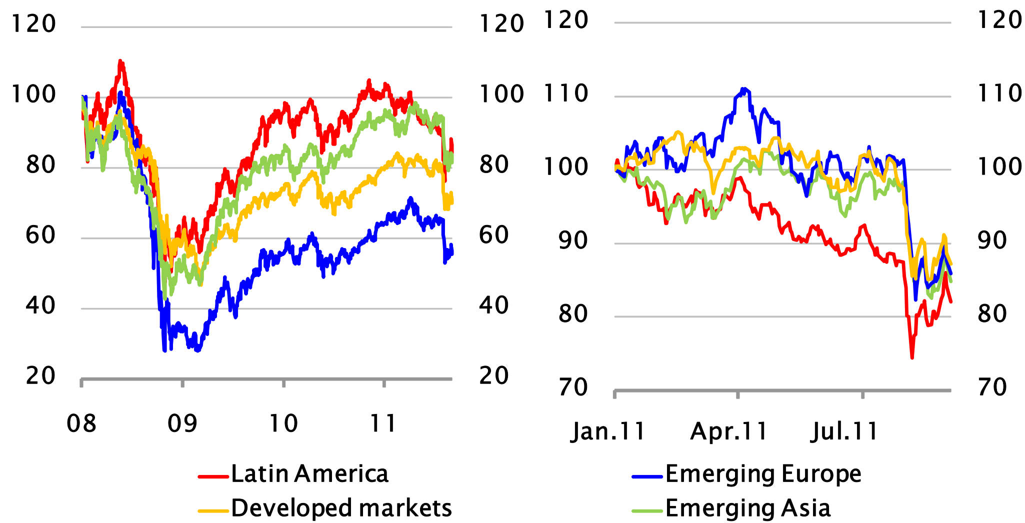
Figure 7
Sovereign risk premiums (*)
(basis points)



(*) Measured using 5-yr CDS premiums.

Fuente: Bloomberg.

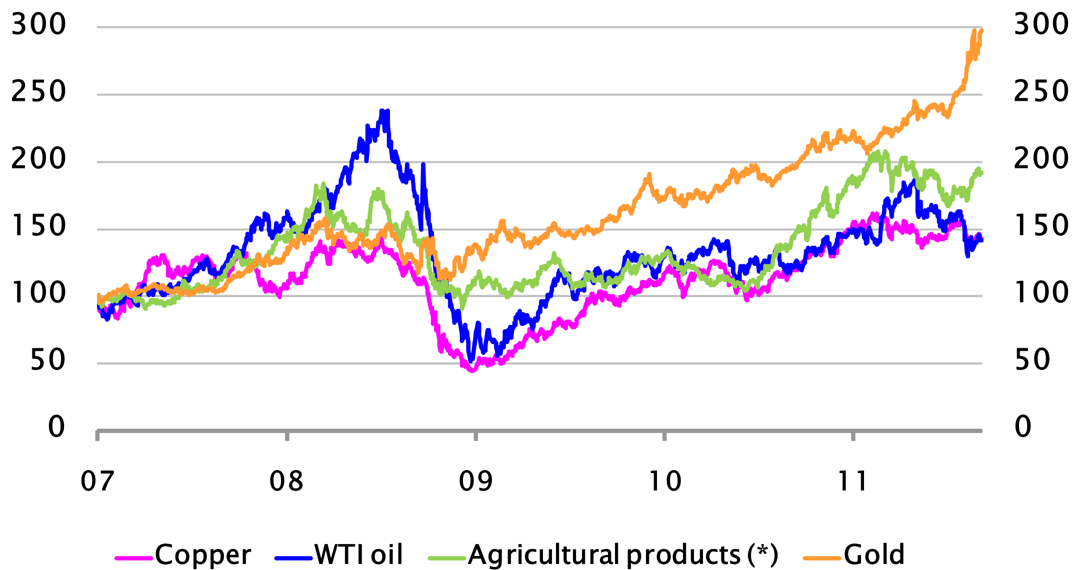
Figure 8
World stock exchanges (*)
(index, 01/01/2008=100; 01/03/2011=100)



(*) Corresponds to MSCI indes in local currency.

Source: Bloomberg.

Figure 9
Commodity prices
(index, 01/01/2007=100)

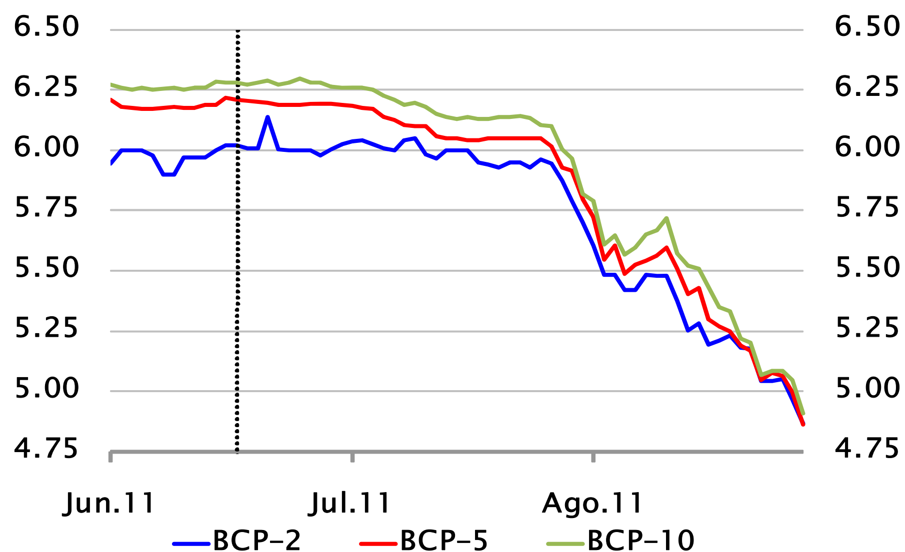


(*) Using the Godman Sachs aggregate index.

Sources: Central Bank of Chile and Bloomberg.

Figure 10

Nominal interest rates on Central Bank of Chile bonds (*)
(percent)



(*) Dotted vertical line marks date of publication of June 2011's Monetary Policy Report.

Source: Central Bank of Chile.

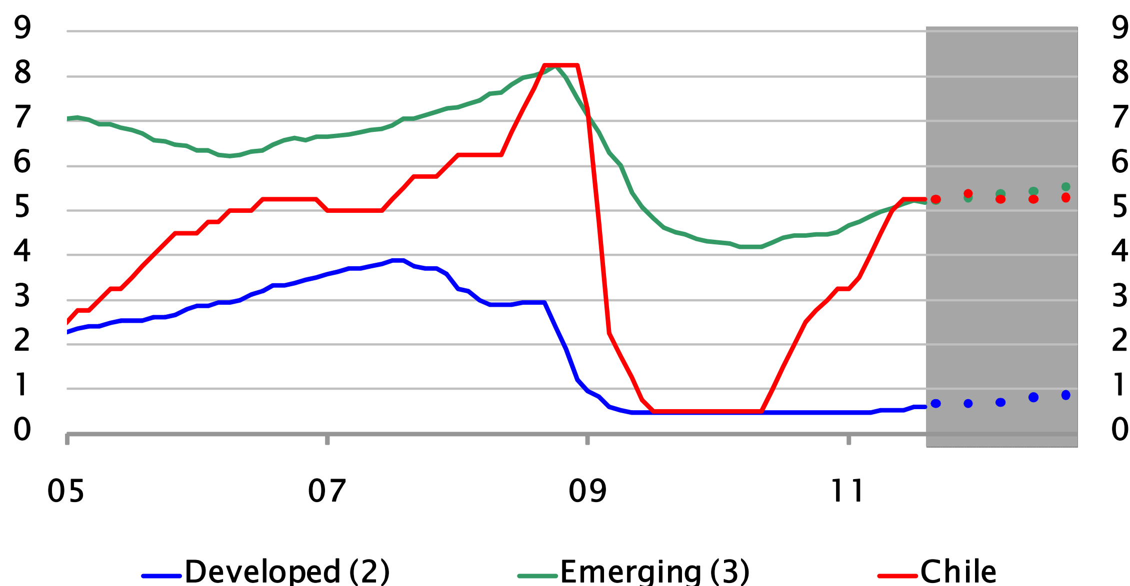
Table 1
World growth
(annual change, percent)

	2000-2007 average	2009	2010 (e)	2011 (f) Jun.11 Report		2011 (f) Sep.11 Report	2012 (f) Jun.11 Report		2012 (f) Sep.11 Report	2013 (f) Sep.11 Report
World at PPP	4.2	-0.6	5.0	4.1	▼	3.9	4.5	▼	4.0	4.5
World at mkt exchange rate	3.2	-2.1	3.8	3.2	▼	3.0	3.8	▼	3.3	3.7
United States	2.6	-3.5	3.0	2.7	▼	1.6	3.2	▼	2.0	2.8
Eurozone	2.2	-4.1	1.7	1.7	=	1.7	1.5	▼	1.2	2.1
Japan	1.7	-6.3	4.0	-0.6	▲	-0.5	3.1	▼	2.8	1.8
China	10.5	9.2	10.3	8.9	▲	9.0	8.6	▼	8.3	8.7
Rest of Asia	5.1	0.1	7.8	4.8	▲	4.9	4.9	▼	4.5	5.0
Latin America (excl. Chile)	3.5	-2.0	6.3	4.2	=	4.2	4.3	▼	3.9	4.2
Commodity exporters	3.1	-1.2	2.9	2.7	▼	2.2	3.0	▼	2.5	3.2
Trading partners	3.6	-0.4	5.9	4.3	▼	4.2	4.7	▼	4.3	4.6

(e) Estimate. (f) Forecast.

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

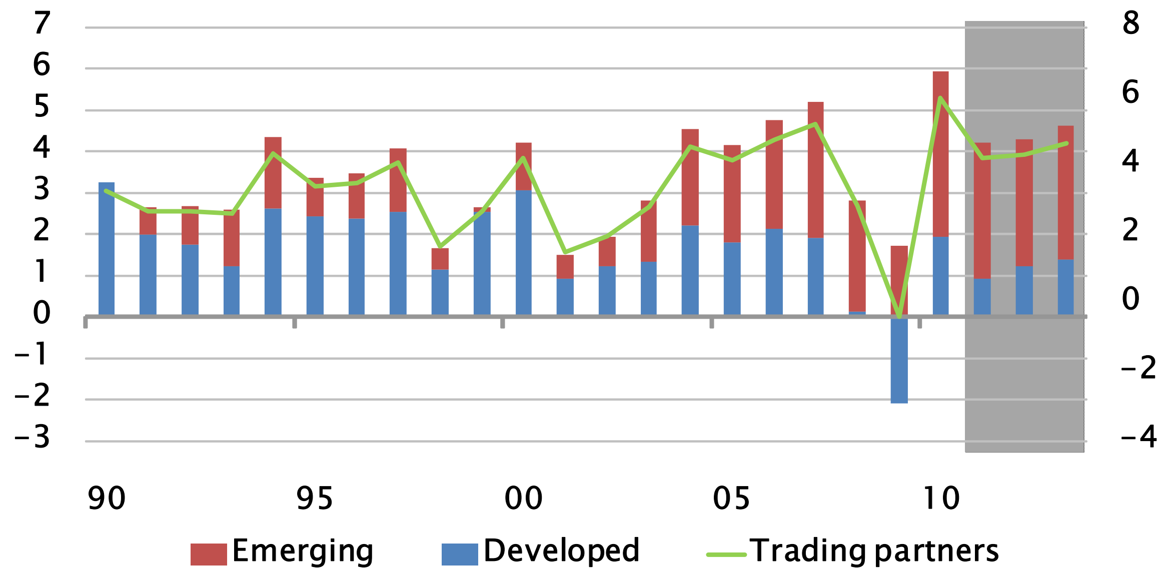
Figure 11
Actual and expected monetary policy rates around the world (1)
(porcentaje)



(1) Simple average of monetary policy rates of each group of countries. Gray area, as from September 2011, shows market expectations in Bloomberg survey. For Chile, the averaged linear interpolation between the August EES and the FOS of the second half of August is used. (2) Includes the Eurozone, Japan, the U.K. and the U.S. (3) Includes Brazil, China, Colombia, the Czech Republic, Hungary, Mexico, Peru, Poland, South Africa and South Korea.

Sources: Central Bank of Chile, central banks of respective countries and Bloomberg.

Figure 12
Contribution to trading partners' growth (*)
(percentage points)



(*) Gray area, as from 2011, shows forecast.

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

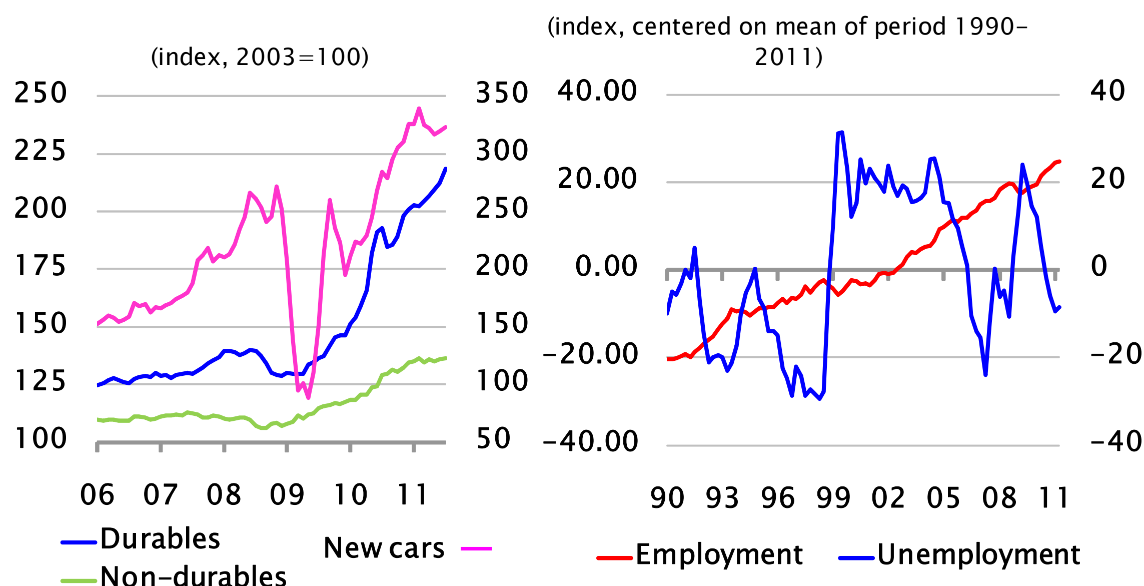
Table 2
International baseline scenario assumptions

	2009	2010 (e)	2011 (f)		2012 (f)		2013 (f)
			IPoM jun. 11	IPoM sep. 11	IPoM jun. 11	IPoM sep. 11	IPoM sep. 11
			(annual change, percent)				
Terms of trade	4.6	23.8	-1.6	-1.8	-2.1	-5.3	-2.6
Trading partners' GDP	-0.4	5.9	4.3	4.2	4.7	4.3	4.6
World GDP at PPP	-0.6	5.0	4.1	3.9	4.5	4.0	4.5
World GDP at mkt exchange rates	-2.1	3.8	3.2	3.0	3.8	3.3	3.7
External prices (in US$)	-6.2	5.8	9.0	9.8	2.8	2.9	2.1
			(level)				
LME copper price (US$cents/lb)	234	342	415	415	400	370	350
WTI oil price (US$/barrel)	62	79	99	93	103	89	91
Gasoline parity price (US$/m3)	471	598	825	816	832	797	774
Libor US$ (nominal, 90 days, %)	0.7	0.3	0.3	0.3	0.9	0.3	0.3

(e) Estimate. (f) Forecast.

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

Figure 13



(1) Seasonally-adjusted series. (2) Sold during moving quarter.

Sources: National Automobile Association of Chile, Central Bank of Chile, National Chamber of Commerce, and Ricaurte, M. 2011, "Indicadores de Mercado Laboral para la Comparación de las Crisis Asiática y Financiera Internacional". Preliminary document, Central Bank of Chile, June.

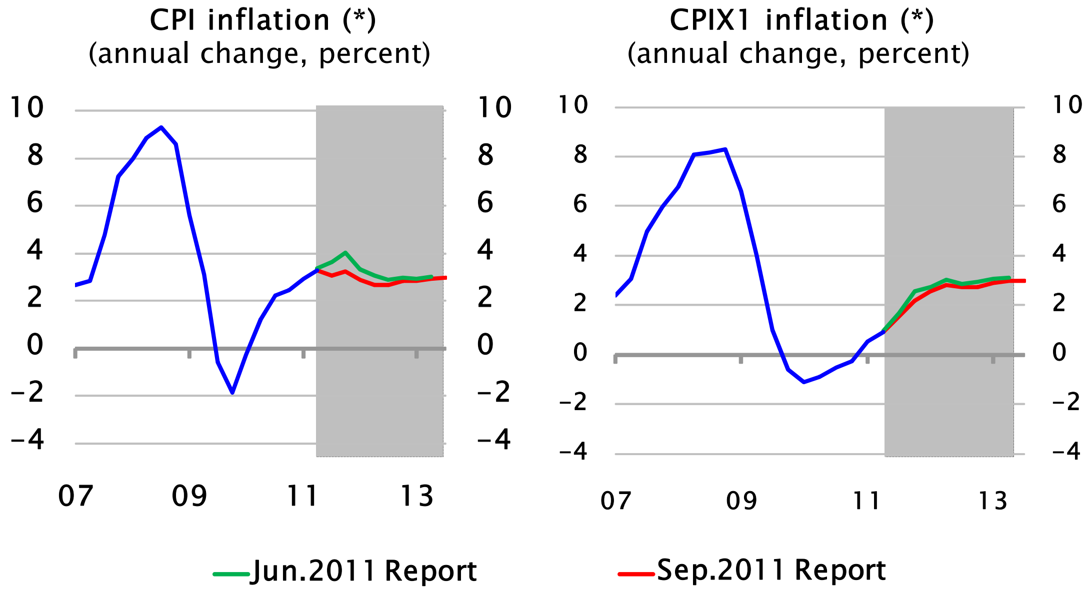
Table 3
Economic growth and current account
(annual change, percent)

	2009	2010	2011 (f)	2012 (f)
GDP	-1.7	5.2	6.25-6.75	4.25-5.25
National income	-1.9	15.7	6.6	4.2
Domestic demand	-5.9	16.4	9.1	4.5
Domestic demand (w/o inventory change)	-2.9	11.5	9.7	5.4
Gross fixed capital formation	-15.9	18.8	14.4	7.1
Total consumption	1.9	9.3	8.2	4.9
Goods and services exports	-6.4	1.9	6.5	5.0
Goods and services imports	-14.6	29.5	12.0	4.6
Current account (% of GDP)	1.6	1.9	-1.0	-2.1

(f) Forecast.

Source: Central Bank of Chile.

Figure 14

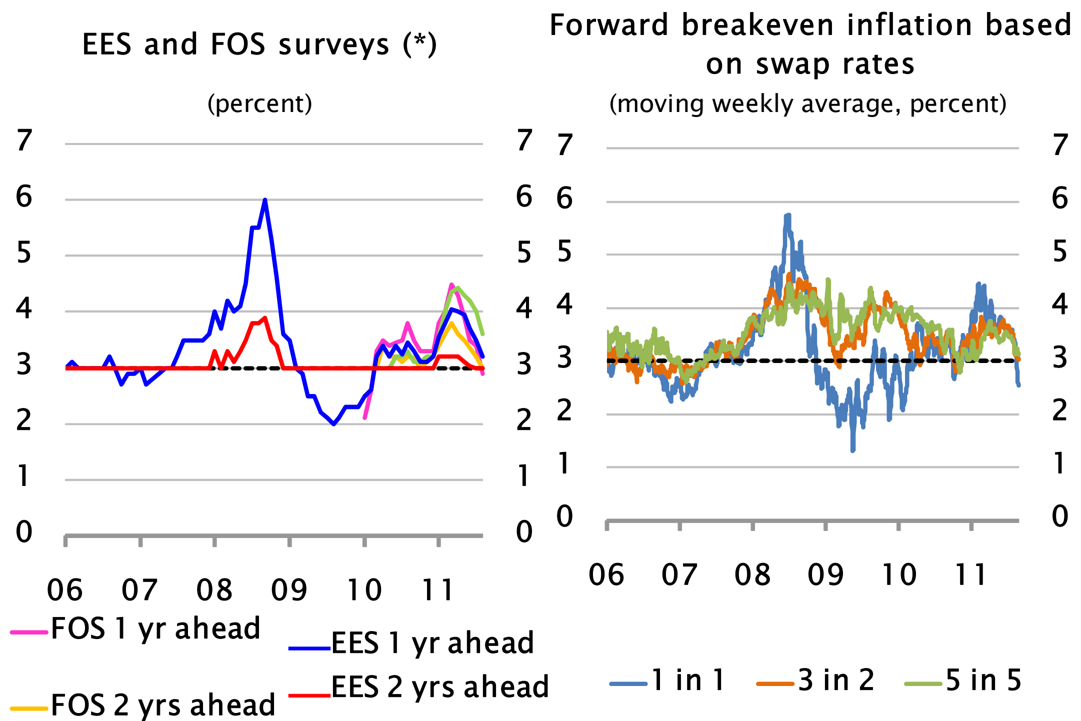


(*) Gray area, as from third quarter of 2011, shows forecast.

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

Figure 15

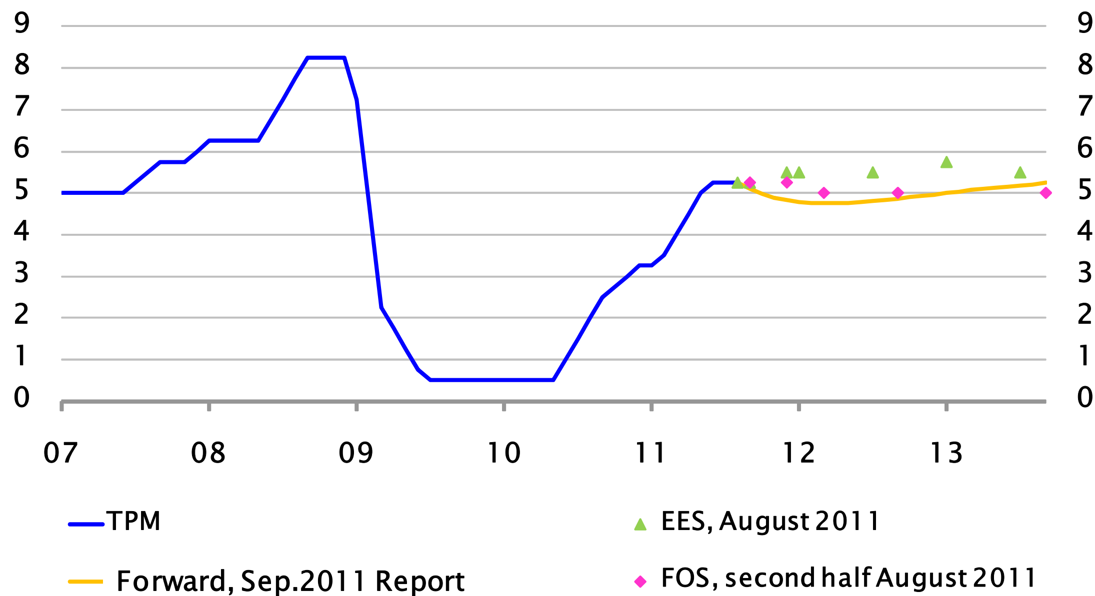
Inflation expectations



(*) The FOS uses survey of first half of the month, except for August 2011, which uses survey of second half of the month.

Source: Central Bank of Chile.

Figure 16
MPR and expectations
(percent)



Source: Central Bank of Chile.