Rodrigo Vergara: The Monetary Policy Report and the Financial Stability Report

Presentation by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, before the Finance Commission of the Honorable Senate of the Republic, Santiago de Chile, 20 December 2011.

The Monetary Policy Report *of December 2011 and the* Financial Stability Report *of the second half of 2011 can be found at http://www.bcentral.cl/eng/index.asp.*

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Introduction

Mr. President of the Finance Commission of the Senate, Senator Eduardo Frei, senator members of this Commission, ladies, gentlemen:

This is my first time presenting as the Governor of the Central Bank of Chile before the Senate's Finance Commission. I thank you this invitation to share with you the vision of the Central Bank Board on recent macroeconomic and financial developments, its prospects and implications for monetary and financial policy. This vision is contained with detail in the latest *Monetary Policy Report* (December 2011) and *Financial Stability Report* (second half 2011), which we today make available for this Commission and the country at large.

The Chilean economy is evolving soundly. During the past few quarters it has been able to sustain vigorous growth in output and employment. Inflation is currently within the tolerance range and medium-term expectations are aligned with the midpoint of said range. Public finances are solvent. The private sector shows healthy conditions. The financial system shows strong indicators, the corporate sector is on a good standing and the households' debt has – on average – evolved in line with income. In recent years, our exports have benefited from growth in emerging Asia and our terms of trade, despite a recent drop, are still high by historic standards. The terms of our access to international credit are still privileged. And we have the resources we need to deal with potential emergencies.

Our macroeconomic policy framework, which comprises a monetary policy governed by an inflation target, a floating exchange rate and the fiscal rule, has been determinant in this result, as has been the regulation and supervision framework of our financial system.

Despite this favorable internal scenario, the evolution of the developed world's economic outlook has made us again uncertain about how the global economic situation will unfold and how it will affect our country. The lateness and lack of resolution of fiscal and financial problems in the Eurozone have constrained global financial conditions, deteriorated the growth prospects of the world in general and our trading partners in particular, and reduced our terms of trade. All these factors combined have an effect on Chile's economic growth, whose magnitude is yet to be seen. The baseline scenario of the *Monetary Policy Report* assumes a limited impact, but there are important risks.

The Great Recession of developed economies in 2008–2009 is not totally over. Solving the macroeconomic and financial imbalances where the crisis originated will take a long time, and its effects will remain visible in the world economy. In the past few months, the concerns about the Eurozone have escalated, significantly raising the cost of public financing in some economies like Italy and Spain and, a little less so, France and Germany, among others. The problem has grown to a vicious circle from government's financing costs to the bank's financial situation to credit and liquidity conditions to economic growth. The lack of exchange rate adjustment mechanisms inside the Eurozone only aggravates the situation. Policy makers have been facing severe difficulties to implement structural and emergency measures to help contain the effects. The announcements of the European Union early in December are one first step in that direction, but there are elements that must be figured out and the road to the solution is still uncertain and probably winding. The prospects for the rest of the developed world are not as bad, but not good either. Certainly their problems are not as severe as the Eurozone's, but they are growing slowly and will not pick up for a long while. Consumers there are still in the process of cutting down their debts and governments need to begin a phase of austerity to try to make their sovereign debts sustainable.

The emerging economies, without the problems of their developed counterparts, have been affected via their commercial and financial links with them. Despite strong growth in the past several quarters, the weakness of the developed countries will eventually erode their dynamism, a situation that is already apparent in some countries. However, unlike the developed economies, the emerging world has more space to implement economic policies that help mitigate the effects of the worsened external scenario. Chile has this capacity too. Actually, according to several international assessments, Chile is among the best suited to confront such a scenario.

Our country has made progress in recent decades to build an economic policy framework, which has already given proof of its capacity to properly deal with a difficult conjuncture. If necessity demands it, we have the capacity to adopt the necessary measures to mitigate the effects of the global crisis on our economy. The lessons learned from the experience of 2008–2009 give us a positive edge.

The external impulse that our economy will be receiving in the coming quarters will be smaller than we thought just a few months back. However, we must not forget that still our relative position in the world is favorable. We have managed to diversify the destinations of our exports and China is now our main client. The copper price and the terms of trade, although not as good as some months ago, are still high from a historical perspective. Our country risk is low and, although our external financing cost has risen in recent weeks, it is still lower than it was in previous years ago. Also, as discussed in depth in our *Financial Stability Report*, our financial system is well prepared to deal with more adverse conditions abroad without becoming an additional source of unrest.

But as I said before, there are important risks. We are attentive to the evolution of the external scenario and its effects on our economy. We have the tools necessary to deal with adverse situations, and, most importantly, we have the firm determination to act to mitigate the impact of external environment on the Chilean economy.

Now let me describe in detail the current macroeconomic scenario, our projections, the risks that remain and where our economy – particularly its financial system – stands, to address them.

Macroeconomic scenario

As I just said, economic and financial developments of the past few months have been dominated by events from abroad. The crisis of the Eurozone has widened and deepened as distrust builds up with respect to the region's fiscal, banking and economic situation. All this has reflected in high volatility in global financial markets, increases in risk premiums and liquidity, falling prices of financial assets and commodities, an appreciation of the dollar and a downward revision of global growth projections (figure 1).

The transmission of the global crisis to the emerging world has proceeded through the financial channel – via higher debt premiums and net capital outflows –, falling commodity prices – especially for metals and agricultural products –, and a reduction in manufacturing exports. For the moment, the signs of output deceleration in the emerging world are moderate and consistent with September's forecasts. Manufacturing production is down in some economies, and distrust has increased. Worth noting is the slowdown in Brazil and, to a lesser extent, in China (figure 2). Considering forecasts of slower global growth and its effects on the inflationary outlook, a number of central banks at both developed and emerging economies have begun to increase the monetary impulse.

In Chile, these events have had limited effects. The financial market is showing somewhat tighter conditions echoing the situation in the global markets, which can be seen also in other emerging economies (figure 3). In recent months, Chile's sovereign and corporate long-term debt premiums increased 50 and 70 basis points, respectively, mainly from August and coinciding with a reduction in investments in local bonds by international investors. After being stable for a long period, the cost of short-term bank credit rose to spreads around 110 basis points lately – 45 basis points more than in September. It is worth noting, however, that the local banking system has a diversified credit base. It recently reduced its funding from European banks, but compensated with increased funds from the United States, Canada and Asia.

The higher volatility has also affected stock, fixed-income and currency markets, a phenomenon that is also present elsewhere (figure 4). Said volatility, although not as high as it was in late 2008, may be unchanged or even higher for as long as the fiscal and financial problems of developed economies remain unresolved. Hence, as underscored in our *Financial Stability Report*, it is important that financial agents and firms in the real sector internalize this extra volatility in their risk management operations.

Domestic output has performed somewhat short of September's projections, although domestic demand is still strong, partly driven by higher employment and wages (figure 5). In recent months, there is evidence of inventory depletion in some sectors such as retail and manufacturing, reflecting the higher external uncertainty.

CPI inflation has been above 3% in the past few months and is expected to end the year in 3.9% (annual). Core measures are still bounded. The latest CPI figures have exceeded the September forecasts because of the prices of some particular items (e.g. meats), plus the effect of the exchange rate depreciation (figure 6).

Within this context, the Board has held the monetary policy rate (MPR) at 5.25% since July.

Our assessment is that the worsened external scenario will have consequences on growth and inflation in Chile, as well as for the orientation of our monetary policy. Let me now describe the assumptions shaping the baseline scenario of our *Monetary Policy Report* and *Financial Stability Report*. It forecasts that financial tensions in world markets will go on, as difficulties in the Eurozone will take time to clear. This will mean that in the two-year period 2012–2013 world growth will be slower than foreseen in September. We now anticipate a recession in the Eurozone in 2012, based on the recent indicators of manufacturing output and expectations in the region.

In the U.S., recent output indicators have been somewhat better than expected, but not so much as to modify the view that this economy will experience a long period of slow growth, but not a recession. Political difficulties to agree on a gradual fiscal adjustment plan have increased the uncertainty about the performance of the U.S. economy.

Emerging economies will grow less than we thought in September, but still outperforming their developed counterparts. China's GDP growth will slow down in 2012–2013, to 8.2% in 2012 and 8.5% in 2013. These figures, although high, are the lowest since 2001.

All these data combined result in a forecast for world growth in 2012 and 2013, 0.5 and 0.4 percentage points less than assumed in September. The terms of trade will also drop from 2011. The scenario assumes a copper price averaging US$3.5/lb and US$3.4/lb in 2012 and 2013, respectively. The prices of oil and fuels will follow a downward trend (table 1).

The reduced external impulse assumed in the baseline scenario will translate into slower growth in Chile than forecast in September. The main sources of this revision are the weak external demand affecting domestic activity, stringent international financial conditions and reduced terms of trade. In 2012, the Chilean economy will grow in the 3.75%–4.75% range, after growing 6.2% in 2011 (table 2). In this scenario, headline inflation will drop to around

3% in the first half of 2012, and will hover around that figure through the end of the projection horizon, this time the fourth quarter of 2013 (figure 7).

These projections use as a working assumption that the real exchange rate will be fairly unchanged over the next two years, based on our assessment of its current level, which is within the range that is thought to be consistent with its long-term fundamentals. The appreciation of the dollar in the global market has also affected the Chilean peso. The peso/dollar parity has depreciated around 10% between the statistical cutoff of this and the latest *Monetary Policy Report*. Over the same period, the level of the real exchange rate has also risen, almost 4%. This behavior of the dollar has eased to some extent the exchange rate pressures that were being felt in emerging economies by mid-year (figure 8).

Regarding monetary policy, in a baseline scenario where the effects of external uncertainty over our economy are bounded, the working assumption used is that the MPR will follow a path that in the short term is comparable with what can be inferred from the various expectations surveys (figure 9).

As usual, the baseline scenario reflects the events that are estimated to be the most likely to occur with the information at hand at the close of the *Monetary Policy Report*. However, there are many risks that might significantly divert the performance of the world economy from the baseline scenario. In fact, today these risks are greater than on other occasions. The repercussions on the Chilean macroeconomic outlook of scenarios other than the one described are varied and, in some cases, difficult to calculate. This time, after assessing the likelihood of alternative scenarios, we estimate that the risk balance is biased downward for output, and unbiased for inflation.

The main risks have to do with the way the Eurozone situation will unfold. The possibilities range from a deeper recession than foreseen in the baseline scenario due to a sharper contraction of fiscal expenditure and credit, to a financial or currency crisis with a severe impact on the world economy and financial markets.

It is also possible that emerging economies are hurt more than foreseen, causing deeper or more lasting effects on world growth and commodity prices. And we cannot rule out a further weakening of the U.S. economy, depending on the fiscal policy trajectory.

Such a scenario abroad would affect the Chilean economy. The combination of tighter external financial conditions, a drop in the terms of trade and slower growth of our trading partners could have a more negative incidence in the evolution of Chile’s GDP growth in the projection horizon. However, its effects can be mitigated by monetary, fiscal and financial policy actions.

Although the negative scenarios dominate, it is possible that Eurozone policy makers succeed in building a set of measures and reforms that soon restore market confidence. In any case, in such a scenario, given the required fiscal adjustments, the developed economies would continue to lag for a long period and would hold on to their loose monetary policies for some time. This would intensify the dichotomy between growth in advanced and emerging countries. In this context, a resurgence of capital inflows to emerging economies is a possibility.

Domestically, one risk that cannot be ruled out are stronger effects from the higher external uncertainty, hitting harder the local financial markets, confidence, and consumption and investment decisions.

Notwithstanding the capacity of economic policies to mitigate the effects of a more adverse external environment, it is important for the private sector to properly administer financial risks. Worth noting are the favorable financial indicators of the corporate sector (figure 10). In addition, currency mismatches continue to be stable and bounded, despite the increasing role of external debt as a source of funding. Still, it must be pointed out that financial intermediaries would be wise to keep a watchful eye on credit risk, considering its negative effects on external demand implied in the risk scenarios.

As for households, on average the financial situation has not deteriorated. The recent increase in private consumption has evolved hand in hand with labor income. The evidence suggests that, so far, borrowing has not risen above its long-term trend, and the average debt-to-income and debt-to-financial burden ratios are stable. Along the same line, households' past-due portfolio indicators have tended to stabilize in relatively low levels during the past year (figure 11).

In the present scenario, however, we need to continue to closely monitor the evolution of household debt. If it continues to grow at the current pace, it is possible that households' debt and financial burden will increase significantly in the face of a more severe risk scenario. Finally, and considering the deterioration of the financial indicators of the lower-income households in the period 2007–2009, they could find themselves in a situation of greater financial vulnerability. Although the volume of debt of these households is fairly limited, it could prove substantial for some credit providers focusing on lower-income segments.

Problems in international financial markets have caused a widespread rise in the banks' external financial cost. Meanwhile, no reduction in volume or maturity of external credit for this sector is observed. (figure 12). The banking system has maintained a looser liquidity position since late 2008 – thanks to increases in longer-term liabilities and greater liquid assets. As stated in our *Financial Stability Report*, our banking system has the capital levels needed to absorb the materialization of a severe risk scenario. The stress tests show that the current levels of capitalization of the banking industry would permit it to absorb an episode of sharp GDP slowdown, an increase in CLP funding cost and an exchange rate depreciation.

As I said at the beginning, if some of the described risks materialize, the country can resort to its robust economic policy framework, capable of mitigating the negative effects of the external situation. The Central Bank has the necessary mechanisms and tools in place to react decisively to adverse scenarios and reduce the costs on the domestic economy, always honoring the Board's commitment to conduct monetary policy aiming to ensure that projected inflation stands at 3% over the policy horizon.

Now let me share with you some final thoughts.

Final thoughts

The presentation of our two reports coincides with a period where global financial tensions have increased and are posing great risks. Also with the start of my term as Central Bank governor, in which I expect not only to keep and continue to consolidate the position this Institution has achieved, but also to continue to adjust our policy framework to the challenges that impose us the deep changes that the global economy is going through.

In the immediate future, our greatest challenge is to address in the best way possible the effects of the external crisis on our country. To that end, it will be necessary to use both our expertise and the tools available in the right dosage and in a timely basis. In the past decades we have made significant advances in our economic policy framework. These advances allow us to feel at peace in the face of the present scenario, being confident that we have the necessary tools to cushion the effects of a scenario of those characteristics.

On the other hand, the evolution of the global economy and the causes and consequences of the Great Recession of 2009 have left important lessons for economic policy makers. It is our responsibility now to incorporate these lessons into the design and management of our macroeconomic policy framework.

A first lesson is that price stability is a necessary but not sufficient condition for financial stability. In an adverse, highly volatile external environment like we have seen in recent years, our inflation targeting regime with a flexible exchange rate has performed quite well.

During the global crisis, the Chilean financial system displayed great strength. However, the experience of other countries has confirmed the importance of paying special attention to financial developments and the possible creation of vulnerabilities on that front. To that end, it is critical to develop a systemic view of financial risks, aside from the soundness of individual financial institutions. The *Financial Stability Report* we prepare at the Bank seeks to deliver said overall view. The creation of the Financial Stability Board provides a forum to which we have committed our active participation. Our challenge in the coming years will be to consolidate this Board, in order to enhance our assessment of risks threatening the stability of the Chilean financial system.

Lesson number two is that, in the face of threats to financial stability, preventive actions work best, seeking to anticipate the problems. The costs of a crisis of this nature are high and long-lasting, so even at the risk of being mistaken, we'll rather be safe than sorry. Still, the interest rate as an instrument is neither sufficient nor necessarily effective in preventing financial imbalances to develop. More focused instruments are needed – ranging from financial regulation to given the market clear signals of the risks –, which permit to take direct action on the problem. Given the nature of the regulation and supervision framework of the Chilean financial system, every now and then this policy will call for close coordination between the Central Bank and the Superintendences.

Lesson number three is that, during episodes of financial stress, the Central Bank also requires using a battery of instruments – aside from the short-term interest rate – to help stabilize the economy. During the crisis of 2008–2009, the Central Bank of Chile introduced new tools to inject liquidity into the economy and enhance the effectiveness of its monetary policy making. Also, in 2008 and 2011, we intervened in the forex market, obeying both to a prudential motivation (i.e., accumulating more international liquidity) and to a conjunctural one: the evolution of the real exchange rate.

Today we are again facing a scenario of external turbulence. Thus, we need to continue developing and adjusting our policy toolkit to the changes in the financial environment.

Our experience of recent years has also taught us the importance of close and transparent communication of our assessments of the economy and its prospects, as it fosters a better understanding and effect of our decision. This is an area where we have made substantial progress in the past few years, but where there are always new challenges ahead. Among these challenges, we believe that improving the general public's financial education is an important one. We will actively cooperate in initiatives in that sense.

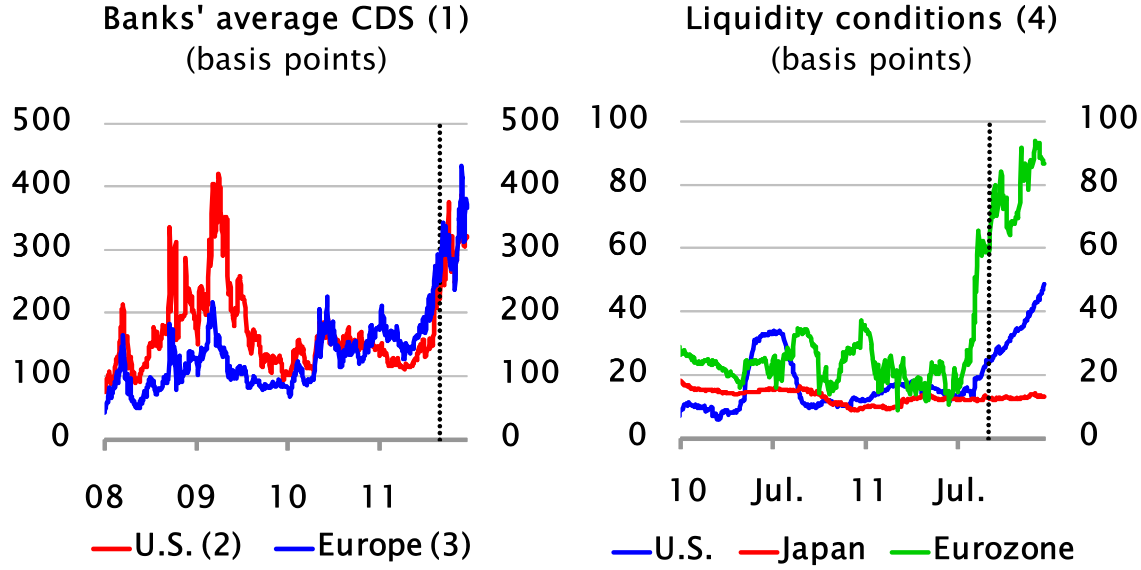
During these years the Central Bank has contributed to the country's economic development by acting on inflation which, throughout history, has proven to be one of the greatest plagues a society can suffer, especially its most vulnerable segments.

As the new Governor of the Central Bank of Chile, I want to confirm to this Commission our commitment to carry on the work done to this date, always ensuring high technical rigor in the analyses and decisions, as well as making every effort to take our Institution to the highest possible standards.

Our responsibility is twofold. On one hand, keeping inflation low and stable, favoring sustainable growth. On the other, using our powers to identify and address the risks that could jeopardize the normal functioning of our financial system. This, of course, seeking to preserve the conditions that will foster economic growth and the welfare of the population.

Thank you.

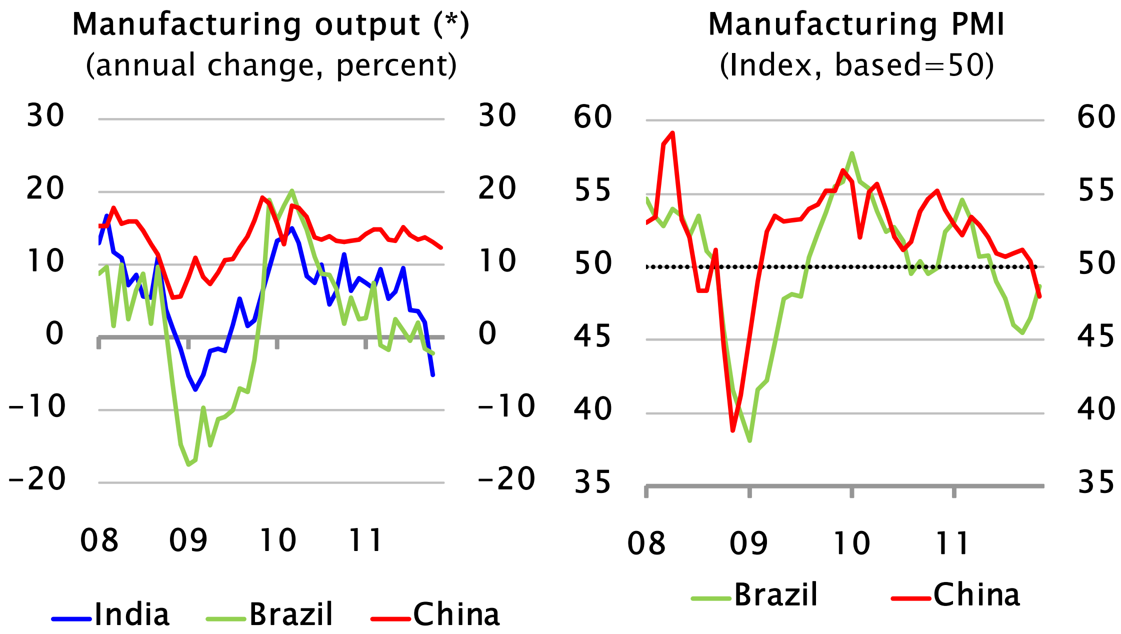
Figure 1



(1) Simple average of 5-year CDS premiums. Dotted line marks statistical cutoff date of previous Report. (2) U.S. includes Citigroup, Goldman Sachs, Merrill Lynch, JP Morgan Chase and Bank of America. (3) Europe includes Société Générale, Deutsche Bank, UBS AG, Santander, BBVA and UniCredit. (4) Difference between the Libo rate and the *overnight indexed swap* (OIS), both at three months. For the Eurozone, difference between Euribo rate and respective OIS.

Source: Bloomberg.

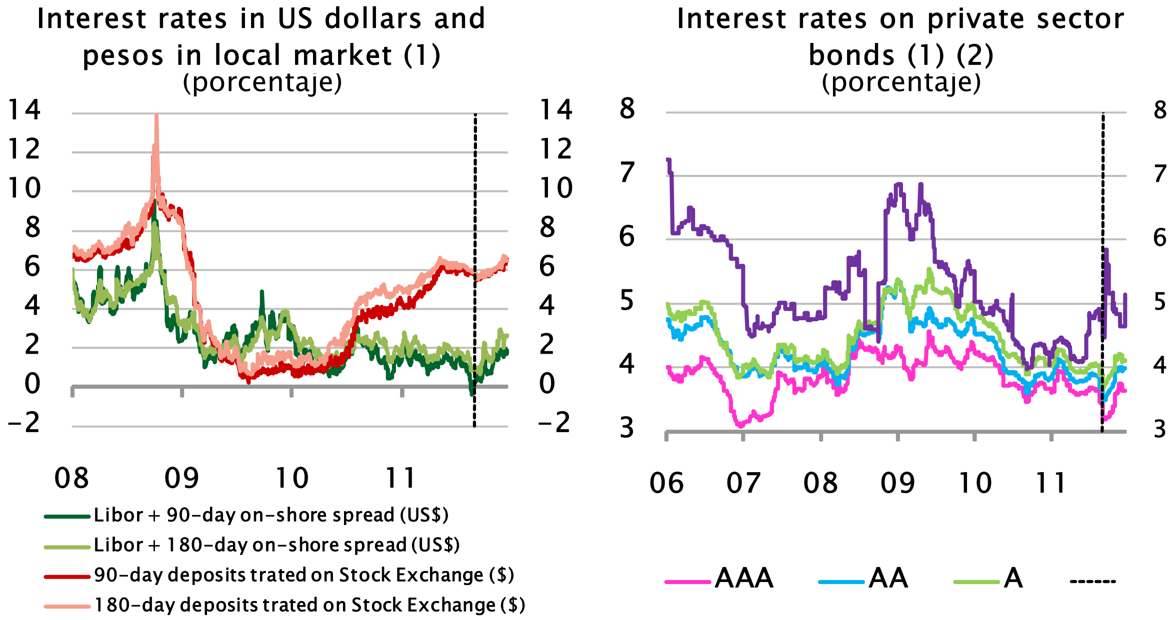
Figure 2



(*) For China, data up to November 2011; for the rest, up to October.

Source: Bloomberg.

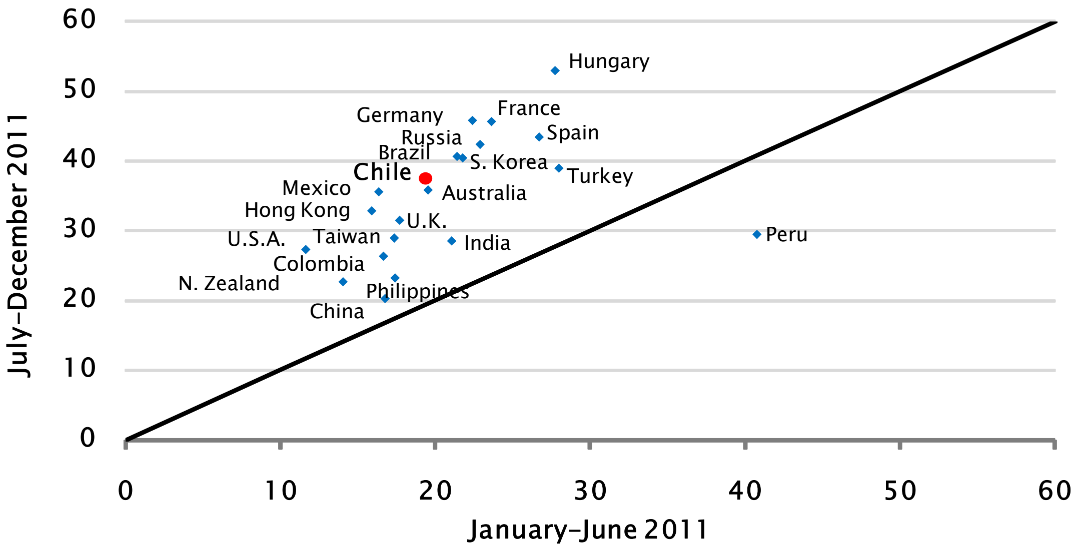
Figure 3



(1) Vertical dotted line marks statistical cutoff date of September's Report. (2) Considers long-term interest rates on corporate and bank bonds with over 9-year duration, except for BBB bonds, which considers more than 8-year duration.

Sources: Central Bank of Chile and LVA Indices.

Figure 4
Stock-index volatility (*)
(annualized percentage)



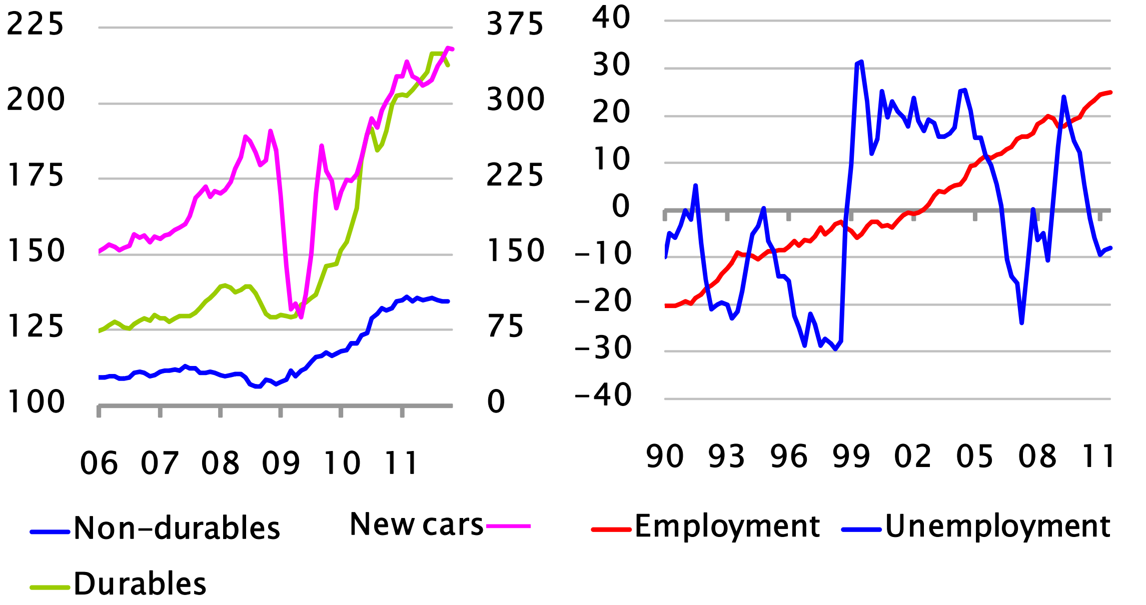
(*) Calculated with daily return of stock indexes, base 100=2010. Data at 16 December.

Fuentes: Banco Central de Chile a base de información de Bloomberg.

Figure 5

Retail sales and new car sales (1)(2) (index, 2003=100)

Emploment and unemployment rate (index, centered on mean of period 1990-2010)



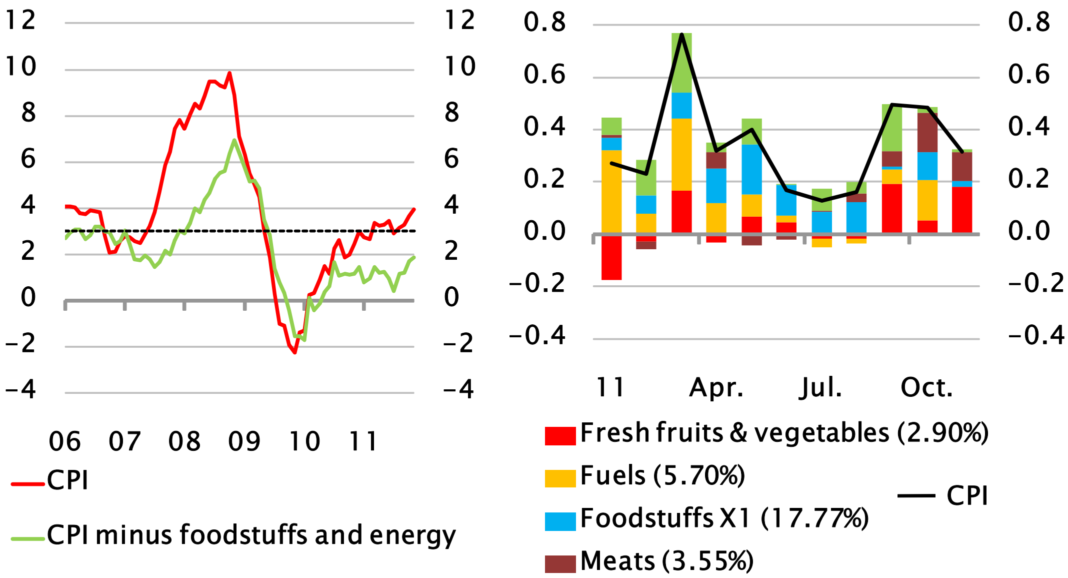
(1) Sold in moving quarter. (2) Seasonally-adjusted series.

Sources: Chile's National Automobile Association, Central Bank of Chile, Chile's 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.

Figure 6

Inflation indicators (annual change, percent)

Incidences on monthly inflation (*) (percentage points)



(*) In parentheses, shares in CPI basket.

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

Table 1
International baseline scenario assumptions

	2009	2010 (e)	2011 (f) Sep. 2011 Report	2011 (f) Dec. 2011 Report	2012 (f) Sep. 2011 Report	2012 (f) Dec. 2011 Report	2013 (f) Sep. 2011 Report	2013 (f) Dec. 2011 Report
			(annual change, percent)					
Terms of trade	4.6	23.8	-1.8	-2.9	-5.3	-6.7	-2.6	-3.5
Trading partners' GDP	-0.4	6.1	4.2	4.2	4.3	3.8	4.6	4.2
World GDP at PPP	-0.7	5.0	3.9	3.8	4.0	3.5	4.5	4.1
World GDP at market exchange rates	-2.3	3.9	3.0	2.8	3.3	2.7	3.7	3.2
External prices (in US$)	-6.2	5.8	9.8	9.8	2.9	1.3	2.1	2.1
			(levels)					
LME copper price (US$cent/lb)	234	342	415	401	370	350	350	340
WTI oil price (US$/barrel)	62	79	93	95	89	100	91	96
Gasoline parity price (US$/m3)	471	598	816	804	797	784	774	748
Libor US$ (nominal, 90 days, %)	0.7	0.3	0.3	0.3	0.3	0.3	0.3	0.3

(e) Estimate. (f) Forecast.

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

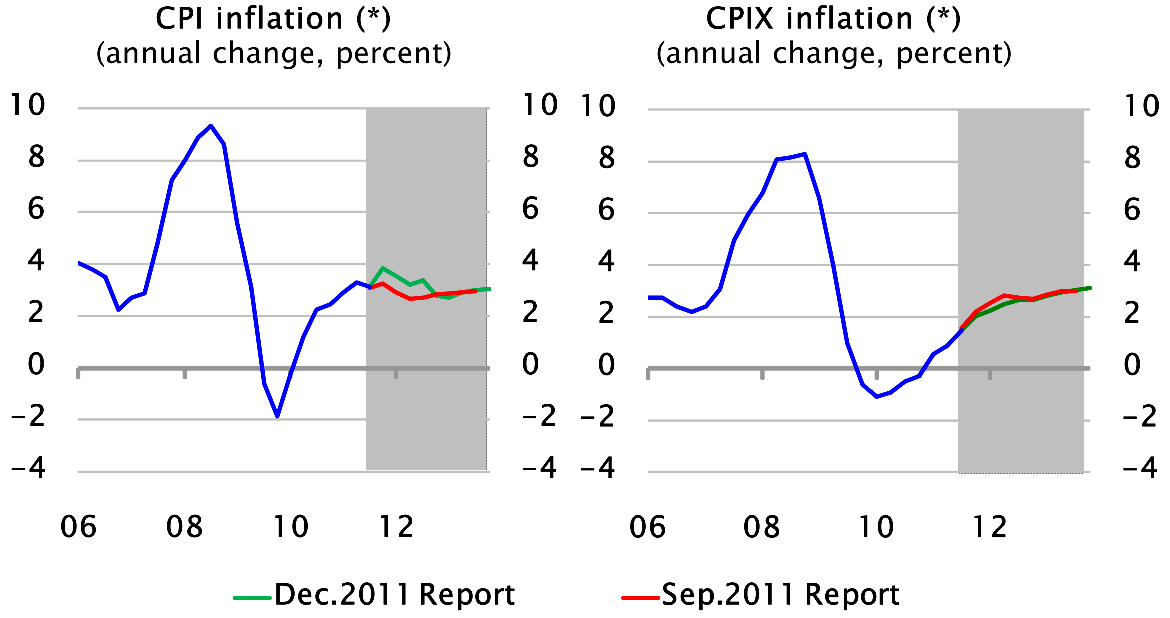
Table 2
Economic growth and current account
(annual change, percent)

	2009	2010	2011 (f)	2012 (f)
GDP	-1.7	5.2	6.2	3.75-4.75
National income	-1.9	15.7	6.5	2.5
Domestic demand	-5.9	16.4	9.5	3.7
Domestic demand (w/o inventory change)	-2.9	11.5	10.2	4.8
Gross fixed capital formation	-15.9	18.8	16.9	5.8
Total consumption	1.9	9.3	8.1	4.5
Goods and services exports	-6.4	1.9	7.4	3.7
Goods and services imports	-14.6	29.5	14.3	3.0
Current account (% of GDP)	1.6	1.9	-1.5	-3.3

(f) Forecast.

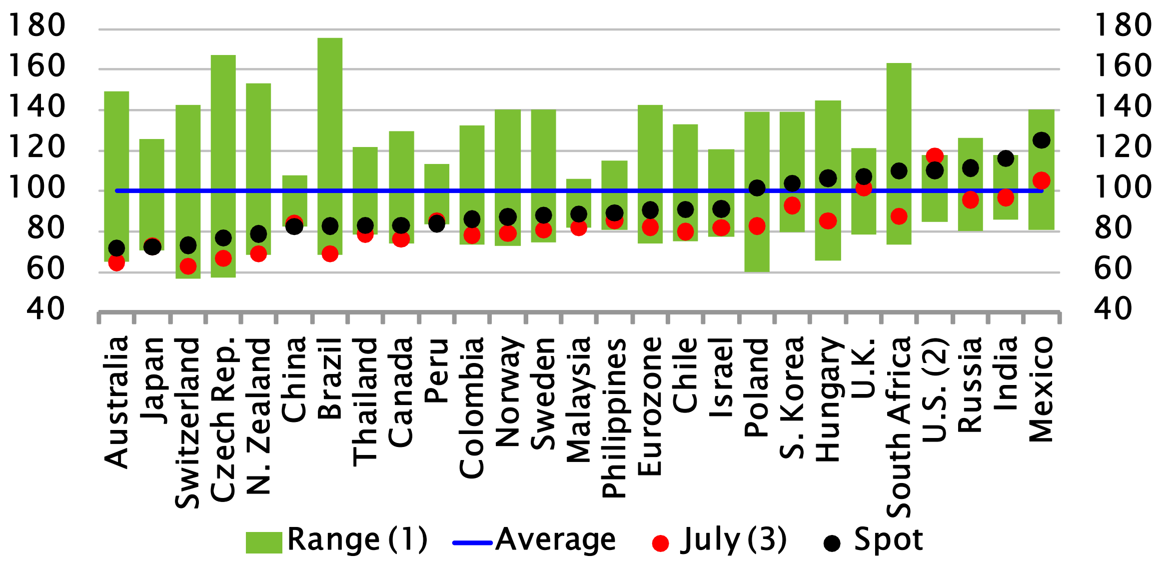
Source: Central Bank of Chile.

Figure 7



(*) Gray area, as from fourth quarter of 2011, shows forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

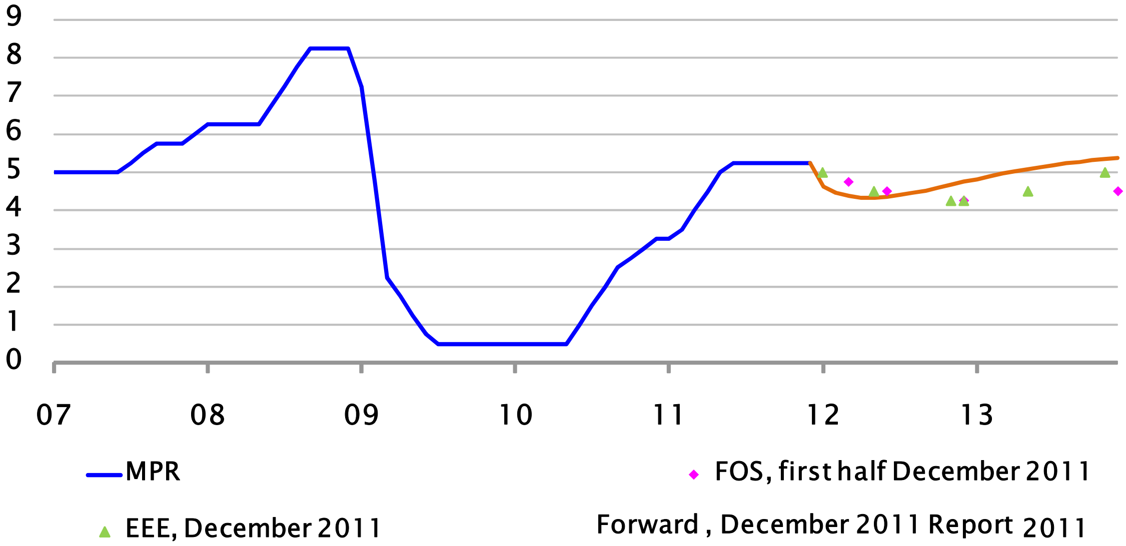
Figure 8
Nominal exchange rate
(index, 1 Jan 2000 – 19 Dec 2011=100)



(1) The range shows maximum and minimum values of the currency during indicated period. (2) Considers *Broad index*. (3) At 27 Junly.

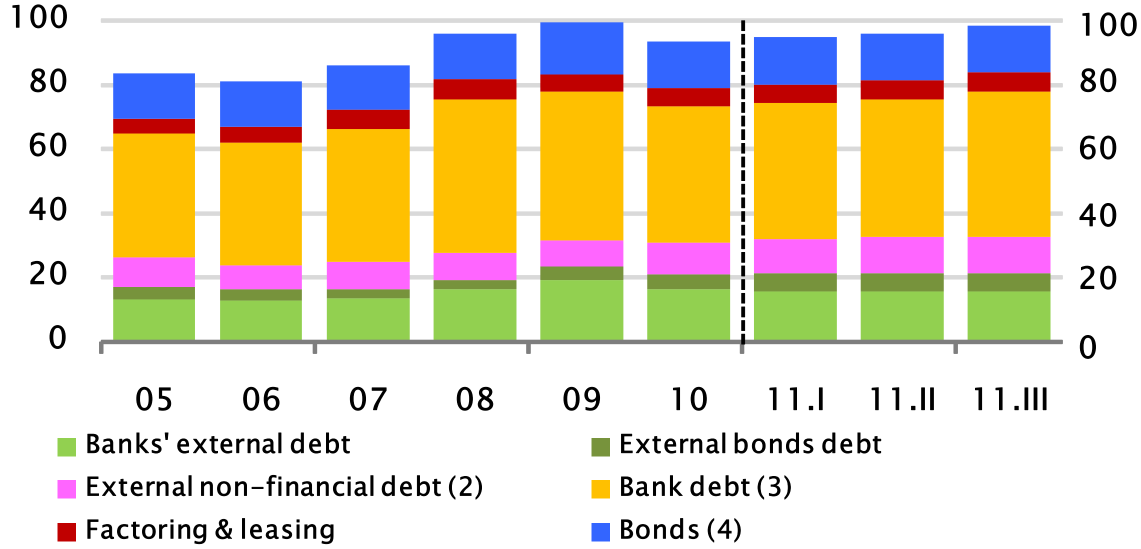
Sources: Central Bank of Chile and Bloomberg.

Figure 9
Actual and expected MPR
(percent)



Source: Central Bank of Chile.

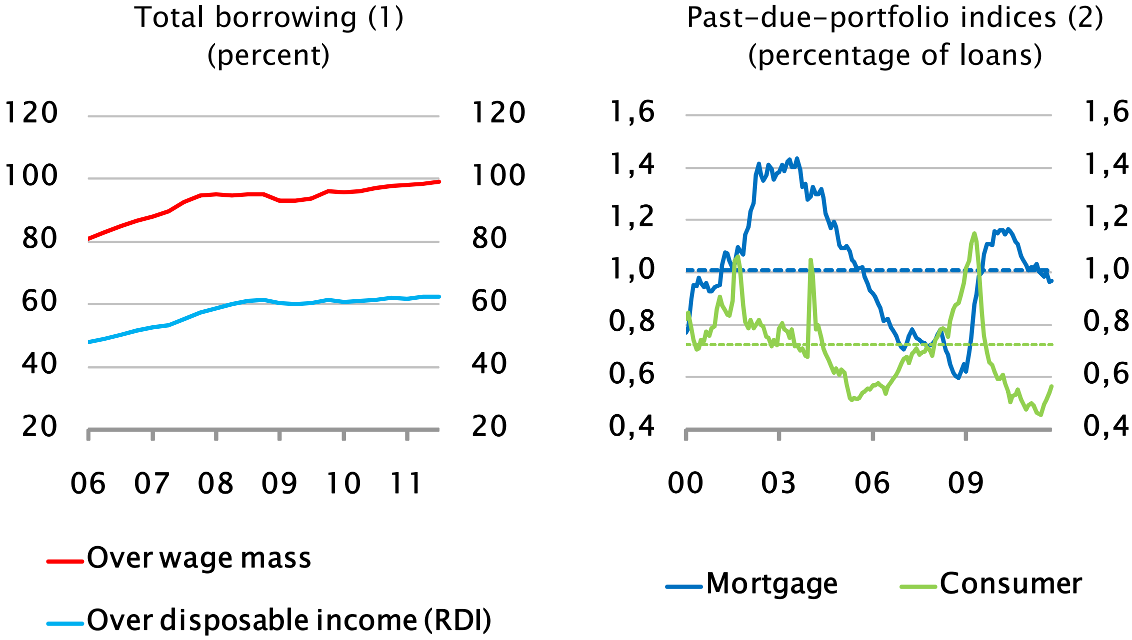
Figure 10
Total corporate debt (1)
(% of GDP)



(1) Total debt Chilean non-financial firms. (2) FDI-related loans and commercial credits. (3) Commercial & comex. (4) Corporate bonds (except Codelco), securitized bonds with non-banking underlying origin and marketable securities.

Source: Central Bank of Chile based on data from Achef, SBIF, and SVS.

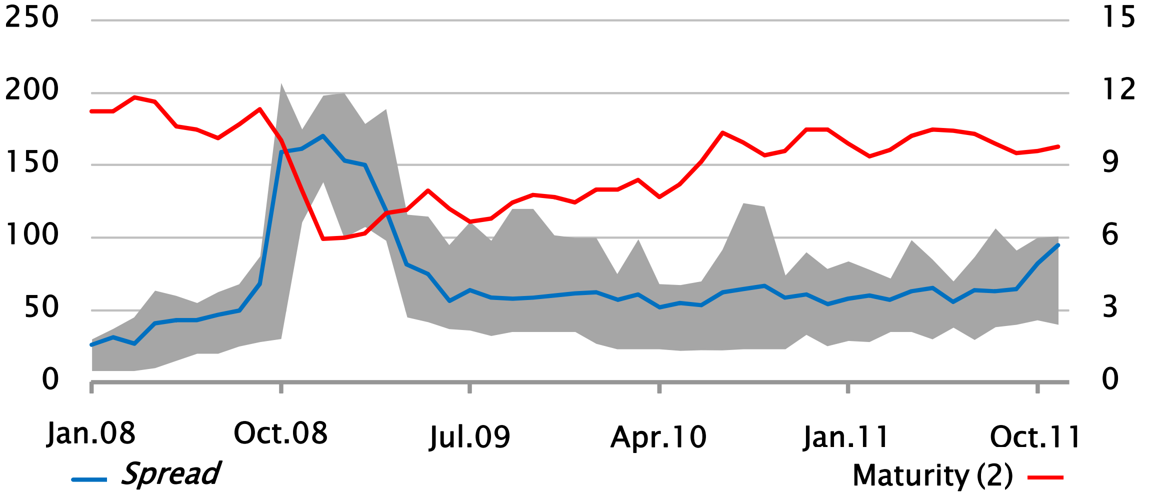
Figure 11
Households' banking risk indicators



(1) Preliminary data for third-quarter 2011 disposable income. (2) Dotted lines show effective index average.

Source: Central Bank of Chile based on SBIF data.

Figure 12
Cost of short-term external financing of resident banks (1)
(basis points; months)



(1) Non-related bank loans, at variable rate. Gray area shows interval between percentiles 5 and 95 of each month's sample.

(2) Moving quarterly average.

Source: Central Bank of Chile.