Rodrigo Vergara: Chile – economic outlook

Speech by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, at seminars held during the Annual Meeting of the Inter American Development Bank, Montevideo, Uruguay, 12 March 2012.

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I would like to thank you for inviting me to present our views on Chile's economic situation at this Conference. These last years have been particularly challenging for policymakers worldwide. Periodically we must make decisions in an uncertain environment, weighing the costs and risks of alternative scenarios. For this reason, we welcome opportunities for meetings and discussions such as this, as they allow us to communicate our views in greater detail, as well as to hear other opinions. A better understanding of our decisions strengthens the effectiveness of our policies.

More than four years have elapsed since the onset of the financial crisis that triggered the Great Recession. Nonetheless, we are still handling its legacy, experiencing periodic episodes of financial stress that will likely continue for some time. The situation in the Eurozone is complex, due to the interaction among fiscal, financial and macroeconomic vulnerabilities. From a historical viewpoint, growth perspectives for developed countries are weak. The outlook for emerging economies is noticeably better, although we are witnessing a slowdown whose pace is difficult to assess, particularly for China. Additionally, we are confronting new risks, in the face of international tensions related to Iran's nuclear situation and its impact on the oil market.

These sources of uncertainty are beyond our control. Therefore, our role as policymakers in emerging countries is to preserve flexibility and space for policies that will enable us to respond to and buffer the financial and real effects that those risks pose on our economies. Over the last years we have gained credibility, flexibility and space to implement a macroeconomic and financial policy framework that will help us smooth out the economic cycle. This framework rests on four pillars. First, monetary policy management is based on a flexible inflation-targeting regime, conducted by an autonomous central bank and supported by a floating exchange rate system. Second, a fiscal policy that is accountable and predictable thanks to a structural balance rule. The significant amount of savings accumulated during the run-up of copper prices was a crucial factor in bolstering the resilience of the Chilean economy and in providing a countercyclical fiscal boost. Third, a high degree of commercial and financial integration with the rest of the world. Finally, a sound financial system, with globally integrated, well capitalized, and adequately-regulated banks. These elements allowed us to be less affected by the Great Recession than by previous episodes.

In Chile, the effects of the world slowdown of the second half of 2011 and the financial turbulences coming from Europe have so far been limited. In terms of output, third quarter data showed a marked slowdown that continued into the beginning of the fourth quarter, but which has tended to dissipate according to incoming information. The most recent data show that this deceleration has continued, albeit at a slower pace than forecast. Likewise, as regards financial conditions, after a shift towards a tighter situation at the end of last year, more recently we have returned to a more normal situation. In particular, the monetary market frictions that occurred in late 2011 were quickly overcome after the Central Bank adopted transitory measures to provide greater liquidity.

To go into more detail regarding Chile's current economic situation, allow me to provide some background on the challenges we face in light of last year's economic developments in our country.

The Chilean economy in 2011

In early 2011, several emerging economies, among them Chile, experienced an increase in inflationary pressures due to an episode of rises in international prices of commodities, particularly oil and some foodstuffs. Additionally, in Chile domestic demand, output and employment recovered quickly, helping close output and labor market gaps. Likewise, in the face of rising prices of oil and foodstuffs, the private sector's inflation expectations rebounded, reflecting a greater risk of inflation. Core inflation measures remained at reasonable levels, below the minimum level of the target range. In this setting, the Central Bank Board decided to speed up the normalization of monetary policy during the first half of the year. Thus, between January and June of 2011, MPR (monetary policy interest rate) was raised 200 base points. The level reached at the time – 5.25% – was within ranges historically considered neutral. Further rises were not dismissed. However, events triggered during the second half of the year changed the bias of monetary policy.

In the Eurozone, the situation that at first was confined to peripheral economies, began to take its toll on systemically more important economies. This coupled with the political difficulties for the United States to reach an agreement on how to consolidate its fiscal position. Thus, international tensions escalated, with sharp increases in volatility, risk premiums and liquidity premiums, together with significant drops in stock markets. Commodity prices halted the upward trend they had followed in the first half, and although they remained high for a while, they started to fall afterwards. Especially important for us was the drop in the copper price. In addition, in Chile it was confirmed that the pass-through from international to local prices had been limited, and signs began to appear that domestic demand was decelerating. This, combined with monetary policy actions helped to reduce inflation expectations.

This series of events substantially changed the economic scenario faced by the Chilean economy. Thus, in August we eliminated the upward bias in our monetary policy releases. In October we said that if international economic events worsened, growth and inflation in Chile could be affected, as could the direction of monetary policy. The MPR was not changed during the second half of 2011.

Our December *Monetary Policy Report* highlighted the wide range of existing risks, which originated mostly in the directions that the Eurozone situation could take. The possibility of a debt event occurring in a systemic sized economy or of a disruptive breakdown of the euro were among the worst risk scenarios envisaged although we also considered the possibility of the Eurozone authorities agreeing on a set of measures and reforms that would restore market confidence. Considering the deleveraging process that households and governments of developed countries would need to go through, these economies would continue to grow at low rates for a long time, regardless of the way that the Eurozone situation was settled. All in all, the international baseline scenario was more negative than previously considered, and would impact Chile's growth and inflation rates. The working hypothesis of that Report was that there would be MPR cuts in the short term, coinciding with the results of several expectations surveys. The MPR was finally lowered at the monetary policy meeting of January 2012.

Current dilemmas

Tensions in financial markets stemming from the Eurozone crisis have recently eased. The European Central Bank's (ECB) measures to supply long-term financing to banks, the political agreements to define an institutional framework aimed at maintaining fiscal discipline in the medium term, and the announcement of a new rescue package for Greece, have all contributed to this. In the last few days there was wide adhesion from the private sector to the Greek debt swap, which warded off the possibility of a disorderly default, at least for now. Nonetheless, the situation remains complex. The ECB's recent actions open a window of time to allow implementation of fiscal adjustments in Europe, strengthening of banks and adoption of structural measures to boost growth. Implementing these programs, however, involves facing serious difficulties. Political, social and economic costs are paid in the short-run and may generate tensions, whereas benefits are to be seen only in the medium term. Therefore, we cannot rule out a rebound of financial tensions. All in all it seems as if, at least in the short run, the imminent threat of contagion to economies systemically most relevant has diminished. This is reflected in risk, volatility and liquidity indicators that have dropped from the maximum levels of late 2011, while stock market and other asset prices have recovered so far in 2012. Outstanding among the latter are commodities.

News in the United States is more encouraging, although recovery is still envisaged to be slow, and the labor market continues to show significant imbalances. However, the US evolution compensates the decline in the Eurozone. Data of emerging economies show that activity has decelerated. In several cases, it is difficult to distinguish how much is driven by international forces, how much by natural domestic slowdown or by specific events. An outstanding event has been the announcement by the Chinese authorities of a lower growth goal for this year.

In Chile, the effects of the international crisis have been limited and lower than was foreseen a few months ago. Several effects that were noticeable toward the end of last year have been reversed to a great extent or have become less intense. Terms of trade have improved over the last months, due to rises in the copper price. Conditions for external financing have also improved, as a result of increased confidence in international markets. Local financial markets – one of the transmission channels of external crises towards the domestic economy – show that stock indexes, risk premiums and exchange rates have gone back to levels similar to those that existed before the intensification of international financial tensions. Other indicators such as amounts and terms of external banking sector financing have stopped the decline that occurred toward the end of last year. The Chilean peso has appreciated nearly 7% so far this year. The real exchange rate is close to its average level of the past 15 to 20 years. The movements of the exchange parity have matched the evolution of the US dollar in international markets, in the face of calmer markets and a greater appetite for risk. This has occurred with the price of copper at 3.8 dollars a pound, its highest level of the last five months. Its trend has been similar to that of other markets of commodities.

As the Chilean peso, emerging market currencies have generally appreciated, and since the beginning of the year have been accompanied by a return of capital inflows to these economies. The continuation of this phenomenon brings back some issues, as the abundance of capital may be difficult to accommodate in a small economy like Chile. Such episodes are not new to us and bring with them discussions as to the convenience of exchange market intervention, which some Latin American economies have undertaken in recent weeks.

We are convinced that a floating exchange rate regime is the most appropriate one for Chile, as it facilitates macroeconomic and external accounts adjustments. Nonetheless, there are circumstances that may lead to Central Bank intervention in the exchange market, either to sustain an adequate level of foreign reserve assets, or to respond to overreactions in the exchange rate that are not aligned with medium-and long-term fundamentals. Associated to this type of intervention, there are costs. A first one is that it may create confusion as to the monetary authorities´ objective: inflation or the exchange rate. In our case, we have dealt with this by means of transparent mechanisms whereby we anticipate the amounts and terms of interventions, and by maintaining exchange rate flexibility. A specific exchange rate level has never been a Central Bank objective; at most these interventions are conducted to prevent excess volatility or temporary diversions from its long-term equilibrium. It has always been made clear that the Central Bank of Chile pursues a price stability target. A second cost is of a financial nature. Foreign reserves are invested in highly liquid and secure instruments of developed countries, whose interest rates are lower than those of the domestic instruments used to finance their acquisition. This originates a significant cost that deteriorates the Central Bank's capital. The benefit of having these reserves is the enhanced security in case of an abrupt cut of external financing. These benefits are hard to quantify, but it is reasonable to expect that they will diminish as the availability of reserves increases, as has been occurring in Chile since 2008.

On the real side, the deceleration of output and demand has been slower than expected, reflecting the fact that the external scenario has had a lower than projected impact. Although there are differences among sectors, economic activity in general shows a behavior consistent with convergence towards its long term trend. Some sectors have performed poorly and have shown more cautious inventory management, while others such as Trade and Construction have performed solidly.

There are several signs that activity and demand will decelerate in the coming months. On one hand, there is the behavior of imports of capital and consumer goods. Worth noting is the drop in car imports that has taken place during the last months, consistent with the cautious behavior I mentioned a few moments ago. On the other hand, domestic credit conditions have also become somewhat tighter these last months, specially for consumer loans. These elements and the fact that MPR is within a range considered neutral, makes us believe that the deceleration of domestic demand will become more evident in the coming months. Nonetheless, this process will occur at a rate lower than what we expected a few months ago.

A significant part of the impulse of private consumption relies on the strength of the labor market. The unemployment level is at its lowest level of the last 15 years, in spite of a deceleration in job creation. Outstanding is the quality of newly created jobs, with a greater share of wage earners. This type of employment, due to its stability, is more prone to generate consumption of durable goods and increases households' borrowing capacity, thus feeding back into a rise in consumption. As expected, a low unemployment rate with few output gaps is consistent with greater wage pressures. Real wages have increased between 2 and 3% during several months, while growth of nominal wages has been close to 7%. Indicators of consumer confidence have maintained a positive trend in the last months, although they remain in a pessimistic zone.

Investment in 2010 and 2011 was boosted by the acquisition of machinery and equipment. This has recently been changing, with a greater dynamism in Construction and Public Works. The increased importance of Construction is related to residential construction and infrastructure, the latter linked to Mining and Energy projects. Residential construction is consistent with the high level of lending for housing and with interest rates that are still low when compared to historical levels. Overall, the strength in gross fixed capital formation is consistent with the evolution of business perspectives. Although these expectations experienced a setback in 2011, they were never in the pessimistic range. They have rebounded during 2012, across different economic sectors.

I do not want to skip mentioning the new National Accounts data that we will be releasing shortly, as result of the recently published 2008 Reference Compilation. Besides the update of the reference year from 2003 to 2008, the new national accounts volume measures will be compiled using chained moving bases, instead of the traditional fixed base measures. Thus, these statistics are set in a level that can be compared with that of other OECD member countries.

As I stated recently, various indicators point out that activity and domestic demand will decelerate in the coming months. Nevertheless, we believe that it will do so at a slower pace than we expected a few months ago. In our December Monetary Policy Report we projected a baseline scenario where growth ranged between 3.75 and 4.75%. Some of the risk factors that in December we envisaged could reduce growth during this year – accounting for the downward bias that we announced then – have had a better evolution than forecast at the time. Examples are the recent evolution of demand, which coupled with the signs of a tight labor market suggest that output gaps are fairly limited. Another example are the terms of trade, which take place in an environment where the likelihood of more catastrophic external scenarios seems to have diminished. In March, private expectations point to a growth in GDP close to 4.5% this year, having been in the range of 4% at the end of 2011.

At the same time that some risks have diminished, others appear. An important matter for us is the widening of the current account deficit, explained by the dynamics of spending. In spite of the high level of our terms of trade, and following current account surpluses in 2009 and 2010, we estimate that in 2011 we had a small current account deficit and in 2012 it could expand further. This matter needs to be analyzed in depth.

On the other hand, a lower deceleration of domestic demand, in the context of narrow output gaps, could give rise to inflation pressures. During the last months core inflation measures converged towards 3% at a speed higher than forecast. Although this evolution may well be a lagged adjustment of core inflation, after it remained persistently at low levels during several months, its path must be carefully monitored, more so in the light of a narrowing of capacity gaps and a tightening of the labor market. Overall, in recent weeks, market expectations have raised the projections of short-term inflation.

In addition, in the short term, inflation is affected by supply shocks that can have significant effects. Developments in the international oil market do not help the outlook for domestic inflation. Recent geopolitical tensions in the Middle East, which, among other consequences, led to an embargo on Iranian exports, and a harsh winter in the Northern Hemisphere have made the actual and expected oil price to escalate. The Brent price has risen more than 15% during the current year, while projections taken from futures contracts have also risen and point to an average price for oil of near US$120 per barrel during 2012. The persistence of a high price always raises worldwide concern because of its implications on inflation and growth. Concerns regarding inflation deal with the direct impact of fuel and energy inflation, and also with the secondary effects that they cause, which could be accentuated in an environment with a narrow output gap.

Final thoughts

Before I end my presentation, I would like to share some thoughts on monetary policy.

As mentioned at the beginning of this presentation, our task as economic policymakers is made more difficult in a more uncertain environment. We make our best decisions based on whatever information is available at the moment. Currently, decision making relies on certain elements that point to opposite directions. On one hand, the international scenario is very complex, even though when compared to a few months back, the tensions seem somewhat smaller. Nonetheless, depending on the outcome of events, there could be contractive effects on emerging economies. Scenarios such as this back slacker monetary policies. On the other hand, the domestic scenario poses challenges in the opposite direction, inasmuch as the behavior of domestic demand may bring inflationary risks. Today, prudent monetary policy management has to be prepared for all kinds of scenarios and to adapt the amount of stimulus applied according to needs established on a case by case basis. In fact, in our latest Monetary Policy Meeting we decided to maintain the Monetary Policy Rate at 5% for a second month in a row. The greater caution in policy decisions that these events pose has been reflected in the fact that private expectations currently incorporate a higher probability of MPR to remain at 5% until the end of the year.

With the Board we have conditioned future changes in MPR to the implications that domestic and external macroeconomic conditions may have on inflation perspectives. The Board has also reaffirmed its commitment to conduct monetary policy in a flexible fashion, so that projected inflation remains at 3% within the policy horizon. Without a doubt, the best contribution that central bankers can make to prosperity in our countries is to conduct monetary policy aimed at maintaining low and stable inflation. This is perfectly clear for us at the Central Bank of Chile. As emerging economies we are long-time victims of inflation and are well aware of its devastating effects on our more vulnerable population. The objective is clear, but the difficulties we face are in its implementation, with the caution demanded by the complex macroeconomic environment.

Thank you.