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, 1 July 2013.

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The *Monetary Policy Report* of June 2013 and the *Financial Stability Report* of the first half of 2013 can be found at http://www.bcentral.cl.

Introduction

Mr. President of the Senate's Finance Commission, Senator Andrés Zaldívar, senators members of this Commission, ladies and gentlemen,

I appreciate your invitation to present our Board's vision on recent macroeconomic and financial developments, their prospects and implications for monetary and financial policy. This vision is contained in detail in our *Monetary Policy Report* of June 2013 and our *Financial Stability Report* of the first half of 2013.

The macroeconomic scenario facing the Chilean economy has undergone significant changes in recent months. Output and demand decelerated and, although some moderation in their growth rates was expected and desirable, the first quarter brought a sharper adjustment than had been anticipated. On the external front, there have been significant developments in the composition of global growth, the trajectory of commodity prices and the evolution of global financial markets.

From a medium-term perspective, recent developments point to a healthy normalization of the unusual international conditions that have prevailed for some years now, and their effects on our local economy. In the short term, however, these adjustments can lead to greater volatility in the real economy and financial markets as investment portfolios are adjusted to new conditions and spending plans are reviewed. I can responsibly say that our economy is well prepared to accommodate these changes in the international arena, emphasizing the contribution of our inflation targeting with floating exchange rate scheme, the strength of the fiscal accounts and the financial system as well as our sound external financing structure. All these elements allow us to be reasonably confident in dealing with the ups and downs of the external environment and mitigating its impact on the Chilean economy and the welfare of our population.

In the first quarter of 2013, output increased 4.1 percent annually, 1.6 percentage points less than it did in late 2012. On the expenditure side, the slowdown of investment stood out. Part of this adjustment was expected, considering that a number of wide-ranging mining and energy projects are entering their final phase. There are also transitory elements relating to one-time imports of capital goods that are more volatile. Another portion of the adjustment has to do with our external scenario, where the world economy is expected to slow down, manufacturing industries are decelerating across the board and where, moreover, the copper price has fallen around 20 percent from the $4 per pound it averaged in 2011. These factors have introduced greater caution in assessing new investments, so some of them have been postponed pending further clarity in the international scene. In any case, this investment slowdown is expected to continue, but not as intensely as in the first quarter (figure 1).

As I was saying, there has also been important news on the external front, notably a major increase in the volatility of the world financial markets in the last month. These tensions originate in two forces. First, the consolidation of the recovery of output and employment in the United States and the Federal Reserve has indicated that, if the recovery continues, during the second half of the year it will begin to gradually withdraw the extraordinary monetary stimuli now in effect. As there is no comparable precedent regarding these policies, these signals have shaken international financial markets in recent weeks, because of the implications that such withdrawal could have.

Second, the Chinese economy has slowed down beyond expectations and apparently the Chinese authorities would be more than willing to accept lower growth rates in an effort to safeguard the stability of its financial system and achieve a better balanced growth structure. This situation creates volatility because of China's major contribution to world growth and its enormous weight in the commodity markets. The deceleration of emerging economies has been widespread, some of them affected by slower growth in China and others by the maturation of its expansion cycle, after several years of rapid economic growth.

These two forces have created uncertainty and triggered a readjustment of portfolios to accommodate falling prices of financial assets and commodities, higher risk premiums and a generalized depreciation of emerging market currencies against the dollar. Overall, all these factors combined may have exacerbated the process of market adjustments, making it difficult to distinguish whether these are temporary or permanent in nature (figure 2).

Although the aforesaid adjustments in the world are good news in the sense that they signal a transition towards a more balanced configuration of the global economy, for this year and next a less favorable international scenario for the Chilean economy is being configured. Accordingly, our growth projections for our trading partners are revised downwards, with higher credit costs and lower terms of trade than previously expected. The baseline scenario incorporates prices of $3.25 and $3.05 per pound for 2013 and 2014, respectively. This is quite lower than what we anticipated just a few months ago, when we projected prices of $3.5 and $3.4 per pound for those years. These elements add to the normalization that is being observed in domestic demand. Our economy is on a good standing to face the transition to this new configuration of the external scenario. The recent depreciation of the real exchange rate facilitates the adjustment of the Chilean economy, and monetary policy is available to make adjustments if required.

We have often referred to the benefits of having a floating exchange rate regime in an open economy like Chile, which is regularly subject to shocks in its terms of trade and external financing. Preserving the float during good times provides exchange rate flexibility to address situations like the present one and thus promote a more efficient adjustment of the economy. It also plays a key role in preventing currency mismatches that have been so costly in other countries in the region and in Chile in the past. Thus, the period of favorable financial conditions that we have seen in recent years has not resulted in higher short-term debt or currency mismatches in the banking system or in the non-financial sector.

The credibility of the inflation target of the central bank is another important asset, which provides room for monetary policy action, as are compliance with the fiscal rule and the soundness of our banking system, which is well-regulated and supervised. Free trade and diversified target markets for our exports also play a key role in ensuring that the transition to the new macroeconomic configuration is smooth. One example of its usefulness is the way in which non-mining exporters have managed to avoid the appreciation of the local currency in recent years and weather the international crisis. Despite the difficulties they have faced in some markets such as Europe and the United States, they have been able to retain global leadership positions, maintaining or increasing their shares in world trade.

Some of the adjustments are already taking place. The nominal exchange rate has depreciated more than 6 percent since the closing of the March Monetary Policy Report, while the real exchange rate has done so by 5.5 percent and domestic demand has begun to slow. These movements go in the direction of reducing the trend current account deficit, which excludes the fluctuations in the terms of trade, which is a worrying factor as we have said throughout the last year.

Let me now turn to our baseline scenario for the Chilean economy and the main risks we have identified in our two Reports.

Macroeconomic scenario

In Chile, in the first quarter of 2013 the q-o-q seasonally-adjusted annual rate of GDP dropped to 2.1 percent from 7.7 percent in the last quarter of 2012. This slowdown was particularly visible in the sectors linked to domestic demand, which was partly offset by a better performance of natural resources. As I noted a moment ago, spending was primarily driven by investment. Partial second-quarter indicators suggest that the deceleration will continue, but with less intensity than in the first. Imports of capital goods remained at their lowest level of the first quarter. Existing home sales have moderated their growth rates, but other sectoral indicators are less conclusive.

In this context of economic deceleration, banks' commercial loans have reduced their annual variation rate significantly. This reflects slower growth in investment, but also a process of substitution of corporate financing sources. Total corporate debt has remained stable as a percentage of GDP. In the domestic market, the corporate bond placement has remained high and many companies took advantage of the favorable global conditions and resorted to external financing via bonds. In addition, stock issuance increased and there was a substantial inflow of foreign direct investment, including capital and credit.

Dynamic consumption continues to rely on favorable labor market conditions, with near record-low employment rates and personal income growing strongly. Consumer confidence, despite receding recently, is still on the optimistic side while the household debt to income ratio is stable. However, there are significant changes in composition, with banking debt overriding other credit suppliers. The available data suggests that such dynamism might be concentrating in middle- to upper-income households. And I say "suggests", because neither us nor the industry supervisors have the whole picture of overall household borrowing. In a dynamic financial system, with many important non-bank lenders such as ours, we cannot afford to go on without a consolidated registry of debtors. Thus, I would like to reiterate, as has the Financial Stability Board (FSB), that it is crucial to push forward the bill that will improve the current system for sharing credit information.

Both headline inflation and its core indicator CPIEFE, that is, the CPI excluding foodstuffs and energy, have remained near 1 percent annually. While there were no big surprises for the CPIEFE regarding expectations in March, headline inflation figures were below projections, affected by some temporary factors which are expected to reverse in the coming months. On one hand, the decline in international fuel prices, along with an appreciation of the peso in the first four months of the year, reflected in lower energy inflation. The recent depreciation of the peso will help to reverse this situation soon. Electric power has also helped to keep inflation low, but this effect is reversible once the impact of refunds implemented in April and May fades away and the forthcoming entry into force of new price regulation. In addition, the low basis for comparison of June 2012 will mean that CPI inflation will enter the tolerance range in the coming months.

With respect to the CPI measurement, and as I pointed out on when I presented the last Monetary Policy Report to this Commission, I want to reiterate that the measurement of this index and other statistics, poses many methodological and practical challenges that must be dealt with in a continuous and transparent fashion. The improvements announced by the National Statistics Institute to the measurement methodology of certain specific products in the basket, as well as other improvements to be made on the occasion of the regular review of the household basket, are most welcome. At the same time, I take this opportunity to reiterate that the incidence of the specific products in question on the final result of inflation is minor and does not alter the inflation outlook presented on this occasion or that we have presented in the past (figure 3).

The world economy has begun moving towards a more balanced configuration in many dimensions, including a narrowing of the growth gap between developed and emerging economies, the normalization of financial conditions and the prices of commodities.

On the output side, the slowdown of emerging economies, partly offset by stronger growth of some developed ones, results in a downward revision to Chile's main trading partners' growth forecast by two and five tenths of one point in 2013 and 2014, respectively, as compared with our March Monetary Policy Report (table 1).

In the developed world, the performance of the United States stands out. Its upturn has been accompanied by growing private consumption and a gradual recovery of real estate, with positive numbers from the labor market, credit growth and consumer confidence. Plus the momentum of investment in the energy sector that are pulling costs down. The Japanese economy grew strongly in the first quarter of the year and short-term prospects have risen in response to the current policies of fiscal and monetary stimulus, but the sustainability of this improvement is yet to be seen.

The outlook for the Eurozone continues to point to a contraction this year. The weakness of the peripheral economies has propagated inwards, which along with the fragility of the fiscal accounts and the banking systems creates a vicious circle difficult to break. Emerging economies are decelerating across the board, most notably China. The Chinese authorities have shown greater tolerance for lower growth rates, in an effort to achieve a more balanced demand structure and address some imbalances in the financial system.

Meanwhile, the change in world growth composition, along with expectations of an early withdrawal of the monetary stimulus in the U.S. has led to a realignment of investment portfolios. Thus, long-term interest rates rose across the board, stock markets fell and risk premiums increased. The effects were more pronounced in emerging economies, whose currencies, including the Chilean peso, have depreciated. This has been accompanied by a decline in the prices of commodities, including copper. For Chile, the terms of trade are less favorable than they were in March, and are expected to remain so over the projection horizon.

Thus, a new scenario has been created where the very favorable conditions for emerging economies in terms of growth, commodity prices and financing conditions have started to normalize. Although some of the reasons behind these movements are positive, since they reflect better growth expectations particularly for the United States, they have triggered market volatility that may unsettle those economies with more vulnerable financial or fiscal positions.

In the baseline scenario, Chile's GDP will grow between 4 and 5 percent in 2013, less than expected in March. This reflects the deceleration of the first quarter and the prospect of a smoother trajectory of sectors other than natural resources in the remainder of the year, partially offset by higher growth in mining. Partial second-quarter indicators show an ongoing deceleration of investment, but milder than earlier in the year. Private consumption, although receding somewhat, continues to show robust fundamentals related to labor market conditions and strong real wages, which should normalize as economic activity slows. Despite the slower growth of domestic demand, a lower copper price will result in a wider current account deficit this year, at 4.7 percent of GDP (table 2).

Annual inflation is expected to return to the tolerance range once some transitory elements are reversed, hitting 3 percent during 2014. At the end of the projection horizon, this time the second quarter of 2015, it should stand at 3 percent. Core inflation will take somewhat longer to converge to 3 percent (figure 4).

This forecast assumes that nominal wages will be adjusted in line with productivity and the inflation target. It also uses as a methodological assumption that in the projection horizon, the real exchange rate (RER) will remain fairly stable. This is based on the estimation that with the nominal exchange rate and currency parities in force today, the RER is in the range consistent with its long-term fundamentals (figure 5).

Finally, the baseline scenario uses as a working assumption that, in the short term, the MPR trend will be aligned with market expectations. As I have said time and again, this is a working assumption and in no way must it be taken as a commitment on our part. We at the Board assess the course of monetary policy every month considering every incoming piece of information (figure 6).

The baseline scenario reflects those events that are believed to be the most likely with the information at hand at the closing of this Monetary Policy Report. There are risk scenarios, however, which if materialized, may reshape the macroeconomic environment and, therefore, may alter the course of monetary policy. On this opportunity, having evaluated the alternative scenarios, the Board estimates that the risk balance is unbiased for both output and inflation.

Internationally, there is the possibility of a sharper slowdown in the emerging world, especially motivated by a deceleration in China. In addition to its effects on our trading partners' growth, such a scenario is worrisome because of its potential impact on copper prices, our current account and our external financing needs. Scenarios of this type, with significant exchange rate depreciations, may induce inflationary pressures in the short term, especially if combined with a persistently tight labor market and increasing real wages.

Complex political and financial conditions persist in the Eurozone, so recurrent episodes of increased volatility are part of the baseline scenario. However, we cannot rule out that more serious events can occur with more severe and longer-lasting effects on global markets, in light of their renewed political difficulties to implement fundamental structural reforms, and where the banking sectors are still dealing with deteriorating portfolios due to slow economic activity.

Another risk coming from abroad has to do with how the conventional and unconventional measures of monetary stimulus will ultimately be withdrawn in the United States. Having no history in this creates uncertainty in the markets, mainly about the financial effects it might have. There may be an overreaction of the markets, with increased stress and sharp rises in long-term interest rates. The rising cost of financing this would entail for emerging markets and some Eurozone economies more dependent on external financing, would pose important policy challenges for them. In Chile, this could lead to increases in both the cost of external financing of companies and banks and higher long-term interest rates domestically. As emphasized in our Financial Stability Report, it is important for banks in this context to keep the exposure of their balance sheets at bay.

In any case, the U.S. monetary authorities have argued that if confronted with an unwanted reaction the process could be delayed or even reversed to some extent, so it is possible for the effects of the withdrawal to be fairly limited. Moreover, these measures should be adopted in line with a recovering U.S. economy and ongoing financial stability, so this scenario is not necessarily detrimental to the emerging economies, but rather could be a normalization from the extraordinary conditions prevailing in the advanced economies over the last five years. If confirmed, this normalization would reduce concerns about an excess supply of foreign capital that have been emphasized in several Financial Stability Reports. These concerns relate to excessive borrowing by companies and banks abroad and asset price misalignments.

Domestically, a sharper deceleration of expenditure, and particularly investment, is a possibility. This would entail, with some lag, an also sharper or faster slowdown of the other components of expenditure, triggering inflationary pressures and affecting the course of monetary policy.

Lately there has been an increase in provisions for consumer credit, coinciding with a deterioration of the payment behavior of this segment, somewhat worse than could be expected given the economic cycle. Although the banking system's capitalization levels are above the regulatory minimums and the stress tests we present in the Financial Stability Report indicate that they are sufficient to deal with a severe shock to growth and lending conditions, it is essential to closely monitor the evolution of these indicators and any factors that may affect them. In this sense, it is important to avoid any measures that might encourage non-payment.

The increase in the current account deficit of the balance of payments has been cause for concern in the latest Reports. As has been noted, this deficit is largely explained by FDI-financed investment flows into the tradable sector (i.e. mining). In recent months some of the necessary adjustments have begun to take place to correct this situation: the real exchange rate has depreciated and domestic demand has slowed. This will help to reduce the current account deficit in the medium term, beyond the transitory effects of fluctuations in the terms of trade. Still, this risk becomes even more significant if the copper price falls further, external financial conditions worsen and domestic demand remains strong.

Our previous Financial Stability Report identified as a risk factor the performance of the real estate sector. Incoming data points to a moderation of some of the trends reviewed at the time. However, factors remain that call for careful monitoring by financial intermediaries and relevant policy makers. No acceleration has been observed in mortgage lending, against our worries in the last Report, while residential home sales have slowed, banks have been more cautious in lending to companies in the industry and the leverage of real estate firms has stabilized.

Despite these developments, housing sales are still fairly high and aggregate price indexes maintain their pace of expansion in a context where the standards of mortgage lending have not changed much. Keep in mind that the main factors that have pushed these aggregate prices up (i.e. household income and long-term interest rates) have been exceptionally favorable in the past few quarters. Meanwhile, the profits of small and medium-sized construction enterprises have deteriorated, which could result in an increase in the sector's payment delays. Finally, the outlook for the supply of new office space remains high by historical standards.

The Chilean economy is well positioned to deal with the changing internal and external conditions ahead. Internationally, conditions facing the Chilean economy have been benign for a long time, with high terms of trade and very favorable external financing conditions. At home, the progression of the investment cycle has led to strong growth in employment and spending in a context of contained inflation and neutral ranges for the MPR. Indicators of recent months suggest that external and internal conditions have started to normalize. The adjustments in relative prices, such as the real exchange rate, have gone in the right direction to help the economy to accommodate the new situation, that is, lower terms of trade, and the normalization of domestic demand and external financing conditions. The Board follows the evolution of external and domestic macroeconomic conditions and their implications on inflation closely, and reiterates its commitment to conduct monetary policy so that projected inflation stands at 3% over the policy horizon.

Let me finish with some reflections.

Final reflections

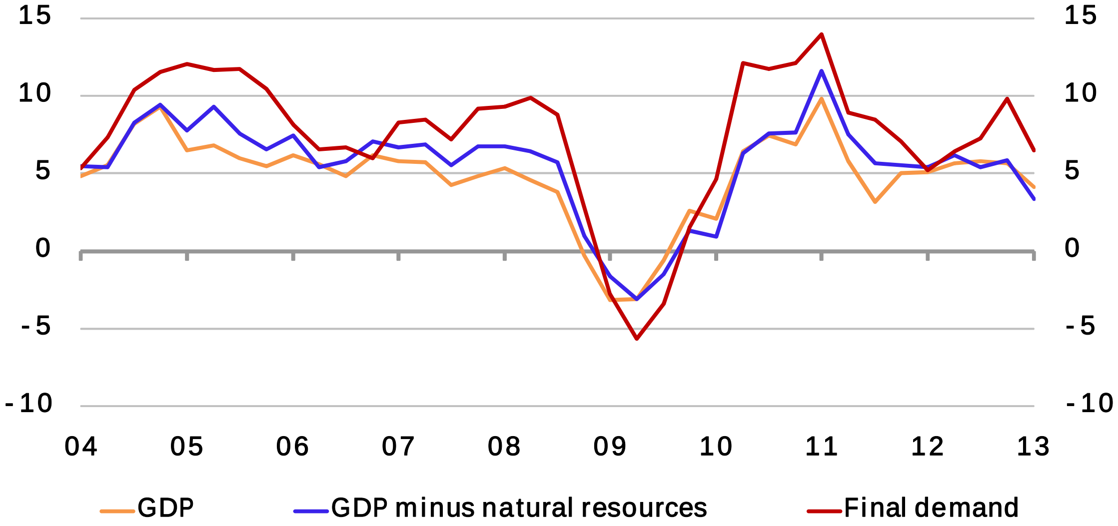
The economic conjuncture always presents challenges to those of us who are in charge of economic policy making. Now we must face a different configuration than what we've seen in recent years. The challenge will be to lead our economy on the path that will allow it to adjust at the lowest possible cost. The improvements we have made to our scheme of economic and financial policies in the past several decades are a precious asset for the task.

Certainly our current position is very good compared with that of other emerging economies. Not every country took advantage of the great external conditions we faced in recent years and some may have allowed the creation of vulnerabilities, which will become more clearly evident when facing the changes that are approaching.

We all wish dynamic, sustainable development for the Chilean economy, in order to enhance the country's welfare. Our contribution as a Central Bank is to keep inflation low and stable. Also, to contribute, from our policy maker's position, to identify and address the risks that may affect the normal functioning of the financial system.

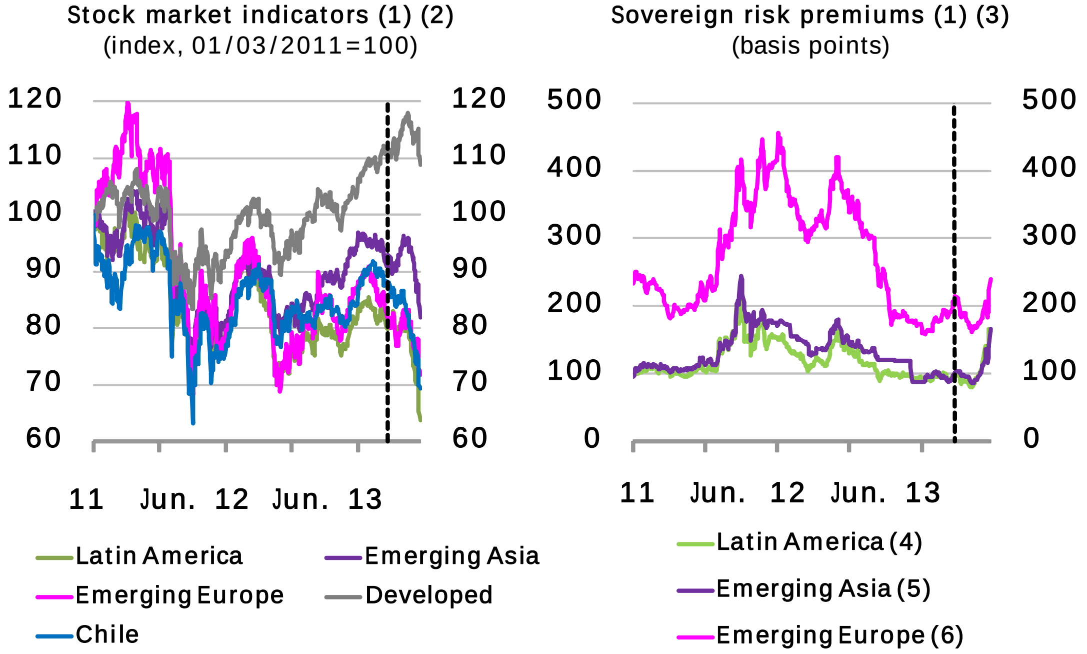
Thank you.

Figure 1
GDP and final demand
(annual change, percent)



Source: Central Bank of Chile.

Figure 2



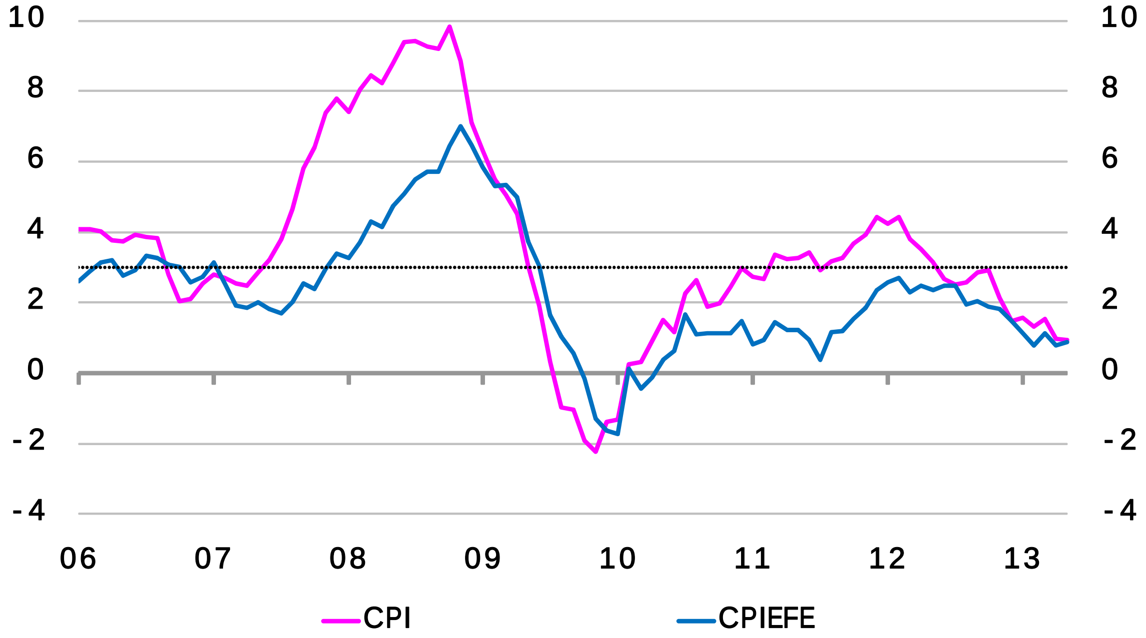
(1) Dotted vertical line marks statistical closing of March 2013 Report. (2) Stock market indexes by region from dollar-denominated Morgan Stanley Capital International. (3) Measured by 5-year Credit Default Swap (CDS). Simple average of countries in each region. (4) Includes Chile, Brazil, Peru, Mexico, Panama and Colombia. (5) Includes China, the Philippines, Indonesia, Thailand and Malaysia. (6) Includes Czech Rep., Hungary, Croatia, Bulgaria and Turkey.

Source: Bloomberg.

Figure 3

Inflation indicators

(annual change, percent)



Source: National Statistics Institute (INE).

Table 1
International baseline scenario assumptions

	2011	2012 (e) Mar.13 Report	2012 (e) Jun.13 Report	2013 (f) Mar.13 Report	2013 (f) Jun.13 Report	2014 (f) Mar.13 Report	2014 (f) Jun.13 Report
Growth		(annual change, percent)					
Trading partners' GDP	4.3	3.4	3.4	3.6	3.4	4.2	3.7
World GDP at PPP	3.9	3.0	3.0	3.3	3.1	3.9	3.6
United States	1.8	2.2	2.2	1.9	1.9	2.5	2.7
Eurozone	1.4	-0.6	-0.6	-0.4	-0.6	1.3	1.0
Japan	-0.6	2.0	2.1	1.1	1.8	1.3	1.0
China	9.3	7.8	7.8	8.1	7.6	8.2	7.5
India	7.9	4.9	4.7	6.3	5.4	6.4	5.9
Rest of Asia (excl. Japan, China and India)	4.2	3.8	3.8	4.3	3.8	4.7	4.1
Latin America (excl. Chile)	4.5	2.8	2.7	3.3	2.8	3.7	3.1
		(levels)					
LME copper price (US$cent/lb)	400	361	361	350	325	340	305
Brent oil price (US$/barrel)	111	112	112	108	105	101	98
		(annual change, percent)					
Terms of trade	-0.6	-4.1	-4.1	-0.4	-3.5	-1.6	0.4

(e) Estimate.
(f) Forecast.

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

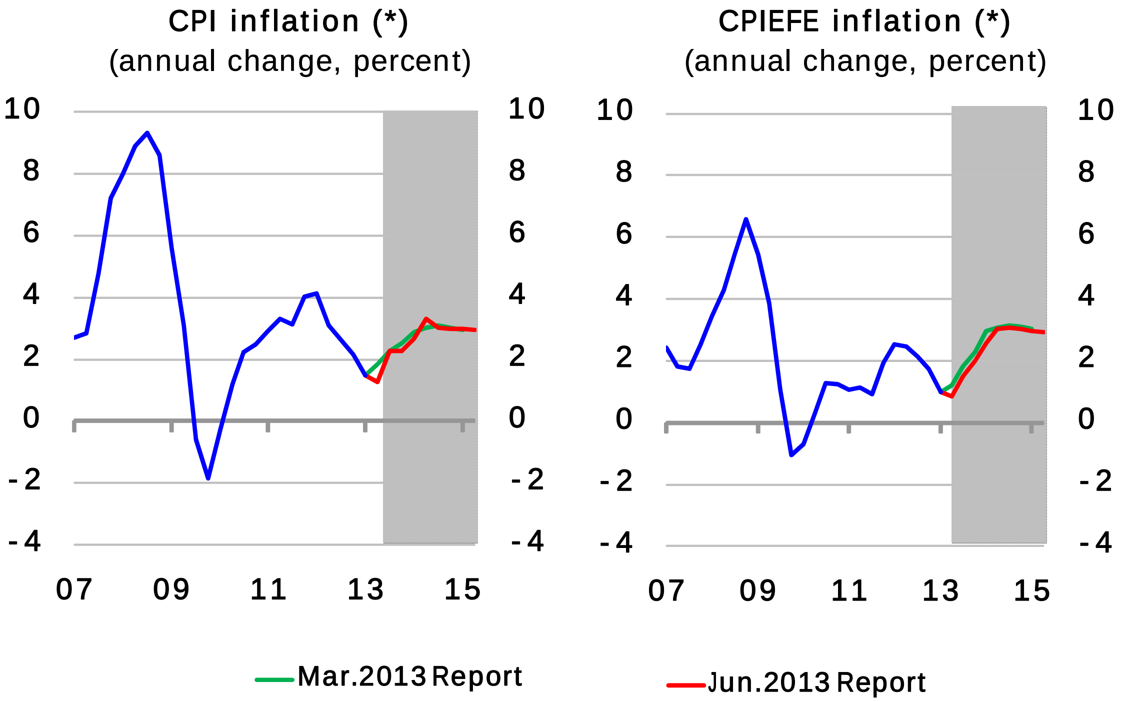
Table 2
Economic growth and current account
(annual change, percent)

	2010	2011	2012	2013 (f) Mar.13 Report	2013 (f) Jun.13 Report
GDP	5.8	5.9	5.6	4.5-5.5	4.0-5.0
Domestic demand	13.6	9.1	7.1	6.1	4.9
Domestic demand (w/o inventory change)	10.3	9.4	7.3	6.1	5.1
Gross fixed capital formation	12.2	14.7	12.3	7.2	5.5
Total consumption	9.7	7.9	5.8	5.7	5.0
Goods and services exports	2.3	5.2	1.0	3.1	3.8
Goods and services imports	25.9	14.5	4.9	5.9	5.0
Current account (% of GDP)	1.5	-1.3	-3.5	-4.4	-4.7

(f) Forecast.

Source: Central Bank of Chile.

Figure 4



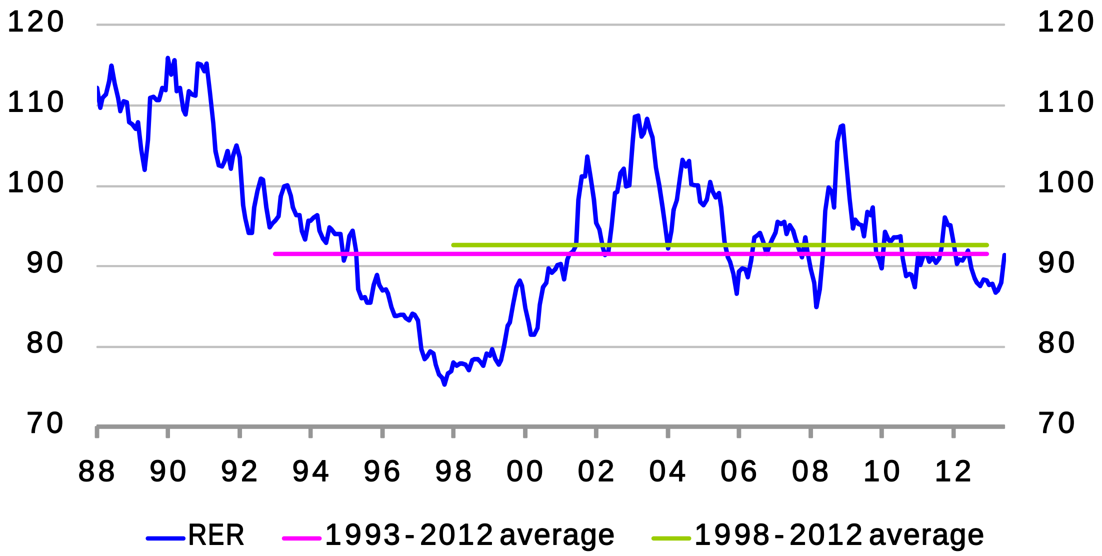
(*) Gray area, as from second quarter of 2013, shows forecast.

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

Figure 5

Real exchange rate (*)

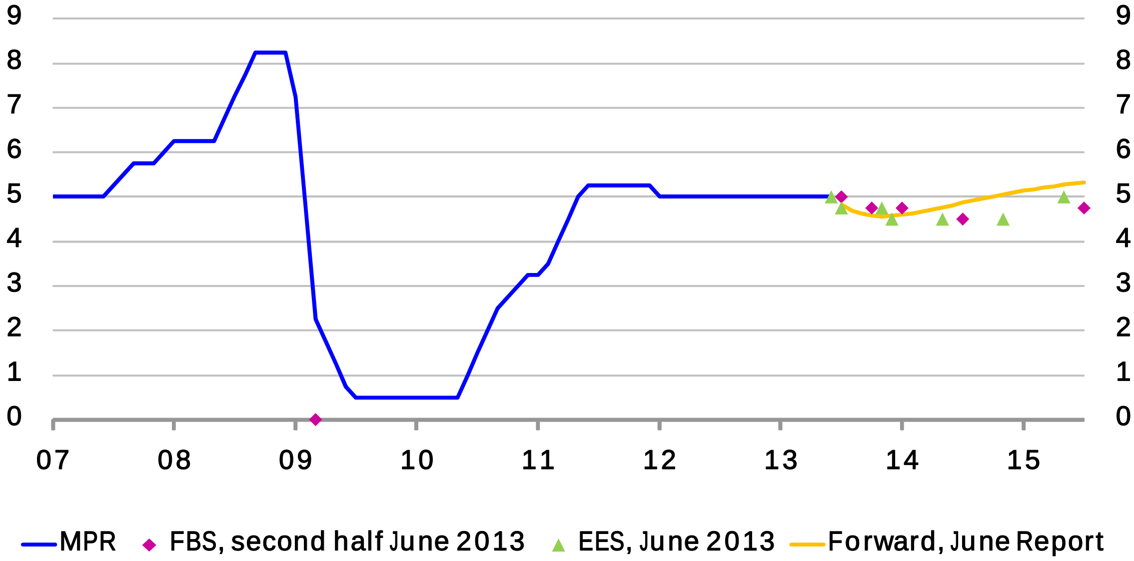
(index, 1986=100)



(*) Includes information up to 28 June.

Source: Central Bank of Chile.

Figure 6
MPR and expectations
(percent)



Source: Central Bank of Chile.