Rodrigo Vergara: Chile's March 2015 Monetary Policy Report

Presentation by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, of the Monetary Policy Report before the Finance Committee of the Honorable Senate of the Republic, Santiago de Chile, 30 March 2015.

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The Monetary Policy Report *of March 2015 can be found at http://www.bcentral.cl.*

Accompanying charts can be found on the Central Bank of Chile' website.

Introduction

Mr. President of the Finance Committee of the Senate, senator Andrés Zaldívar, senators members of this Committee, ladies, gentlemen,

I am grateful for your invitation to present the vision of the Board of the Central Bank of Chile about the recent macroeconomic developments, their prospects and implications for monetary policy. This vision is detailed in our *Monetary Policy Report* (IPoM) of March 2015.

But first and foremost, a few words of solidarity towards my fellow citizens that have recently suffered Nature's wrath. The images and stories we have been receiving of the catastrophe that has swept across our country's north are devastating and fill us with concern.

In the past few months, inflation has exceeded December's forecasts, and it is stubbornly above 4 percent. This Report's baseline scenario also estimates a slower return to the target range than foreseen at the end of 2014. The depreciation of the peso continues to be the main factor behind the price dynamics, which, coupled with widespread indexation and a tighter than expected labor market, has pushed the core measure, i.e. the CPI excluding foodstuffs and energy, CPIEFE, from 4.3 to 4.7 percent annually between November and February. However, the lower oil price in international markets and its pass-through to domestic prices helped to moderate annual growth in CPI inflation, which went from 5.5 percent in November to 4.4 percent in February (figure 1).

Recent inflation figures have taken the market by surprise, as it had assumed a clearly downward position with respect to the behavior of prices, even below our predictions in the December Report. Thus, the market expectation for inflation at the end of 2015 has been revised to somewhat above 3 percent, as has been inflation one year out. Expectations two years out remain anchored in 3 percent (figure 2).

On the contrary, output and expenditure have evolved as forecast in December. Again this time the baseline scenario I will be sharing with you in a moment foresees a gradual recovery that will gain strength towards the second half of this year.

Consistently with this scenario and the Board's statement, market expectations for the monetary policy rate (MPR) have ruled out new cuts and, in some cases, point at a cycle of increases beginning late this year.

In what follows I will describe the macroeconomic scenario we believe to be the most likely for the coming quarters, and its associated risks.

Macroeconomic scenario

The external environment and related risks remain largely determined by the impending monetary normalization process in the United States. Changes in expectations about when and how fast it will finally occur have affected world financial markets significantly. By contrast, in the Eurozone and other developed and emerging economies, monetary policy has become more expansionary, largely responding to the lower inflation figures and lower medium-term inflation outlook. Such scenario is quite opposite to what we are seeing in Chile and Latin America in general.

The Eurozone showed a more stable output trajectory towards the end of 2014, driven by Germany. Preliminary first-quarter figures suggest that Germany will continue to lead the bloc. It is also worth mentioning that in 2014 Spain posted positive GDP figures after three years in recession. Meanwhile, Italy and France continue to show meager results. All in all, in the past few months the region's growth prospects have improved. In our baseline scenario, we expect the Eurozone to grow 1.5 percent this year, up from 1 percent in December. Still, there are some risks relating to the political situation, especially what may happen in Greece.

About Latin America, there is a marked deterioration of the region's economies, which is compounded with lower commodity prices and in some countries, public and private expenditure imbalances. So while the main economies in the region grew on average nearly 4 percent between 2010 and 2013, in 2014 they barely grew 0.7 percent in 2014 and are expected to grow by 0.8 percent this year. By countries, the biggest correction goes to the Brazilian forecast, which the market expects to post a GDP drop of 0.7 in 2015, its worst in several years.

The greater relative strength of the United States, plus the ever closer beginning of its monetary policy normalization, has prompted a substantial appreciation of the dollar in recent quarters. For sure, news about the situation of the US economy plus the Fed's statement has caused important swings in the dollar price in the past few weeks. This has reflected in large movements in most currencies around the world. As for the Chilean peso, in the middle of March it was trading above 640 units to the dollar, to later drop to near 620 pesos per dollar at the statistical cutoff of this Report (figure 3).

The peso depreciation cycle that began in 2013 stands out as the longest in the last decade and it occurs in the context of a gradual economic slowdown and not a sharp recession. This is one of the main reasons behind inflation remaining above 4 percent. The data indicate that the pass-through coefficient from the exchange rate to inflation has been in line with historic patterns, although in the upper part of available estimates.

Besides, the peso depreciation has had different timing than most emerging or commodity exporting economies. The earlier adjustment of the Chilean economy, in terms of both private expenditure and the monetary policy reaction, meant that for the larger part of 2014 our currency was one of the most depreciated globally. Subsequently, as the rest of the emerging economies entered a more marked adjustment cycle, those differences narrowed and the peso even appreciated in multilateral terms (figure 4). As of March, the real exchange rate is somewhat above its average for the last two decades (figure 5).

Domestic activity has behaved as foreseen in December, although last year closed with somewhat higher growth than forecast in the previous Report: 1.9 percent. Revisions to earlier figures and a somewhat stronger fourth-quarter growth explain this result. Partial first-quarter figures continue to reveal moderate growth, but definitely better than the figures it showed since mid- 2014.

On the demand side, there is no big news either with respect to the end of last year. Aside from specific factors, consumption and investment remain weak. Durable consumption and investment in machinery and equipment continue to grow at low or negative annual rates, albeit with some marginal stability. Anyway, it is worth noting the greater impulse from fiscal spending, particularly public investment, and the positive effect of the peso depreciation in the productive performance of some tradable sectors.

The labor market continues to show more strength than previously foreseen. The unemployment rate, despite a marginal increase, is still low. Annual growth in salaried employment has picked up again in recent months, although job creation in the most cycle-sensitive sectors has remained slow. Meanwhile, nominal wages continue to grow at a strong pace, partly because they are generally indexed to past inflation (figure 6). Although the low level of unemployment seems to conflict with the state of the business cycle, there are some structural factors that might explain the unemployment rates below historic averages, such as changes in the demographic composition of the labor force (figure 7).

Turning to our projections, in the baseline scenario GDP will grow in 2015 more than it did in 2014 and will stand between 2.5 and 3.5 percent, not very different from the December forecast. In this projection, GDP growth will remain below the medium-term growth estimate, which we place between 4 and 4.5 percent. The baseline scenario also assumes that in the first half of the year the economy will post a growth rate near the average of the past few months, with a recovery process that will become more visible towards year's end.

Growth in final domestic demand – without inventories – is revised downward from the December projection. This, because of a slower than expected recovery of both private consumption and investment, particularly the imported components. With this, total domestic demand growth drops to 2.5 percent annually. In the case of private consumption, there is also a reduction in durable goods consumption due to the peso depreciation and slower growth in real wages associated to the upward revision to the inflation forecast. As for investment, there is the downward correction of the survey from the Capital Goods Corporation on investment plans for 2015. Thus, measured in real terms, gross fixed capital formation should be 23.7 percent of GDP this year.

In this projection, gross national savings rises to 21.5 percent of GDP in 2015, reflecting an increase in private saving in the past few quarters. This greater national saving has driven a further reduction in the current account. Accordingly, we estimate that this year it will be near 0 percent of GDP (table 1).

On the external front, this projection assumes that our trading partners will grow more in the two-year period 2015–2016 than in previous years. The terms of trade should improve, helped by the drop in oil prices, whose impact will partly outdo the downward adjustment of the copper price. The baseline scenario assumes that copper will trade at an average of 280 dollar cents per pound in 2015–2016. In the same period, Brent oil should average 62 dollars per barrel and WTI oil, 55 dollars per barrel (table 2).

Another element contributing to domestic output and demand resuming greater growth is that monetary policy continues to add significant boost to the economy, helping to keep medium- and long-term interest rates at or near record lows (figure 8). Likewise, we foresee that fiscal policy will contribute to expenditure growth significantly during this year, especially through increased public investment.

As usual, our projections rely on a number of assumptions, and an important one is that consumer and business expectations will recover. Recent data show a slight revision upward of these indicators, which are still clearly pessimistic nonetheless. Meanwhile, information gathered in the Business Perceptions Report a quarterly publication by the Bank, points to moderate performance in businesses in 2015, with investment plans primarily focused on capital replenishment.

Turning to inflation, in the baseline scenario the CPI will stay above 4 percent annually for some more months, approaching 3 percent over the course of 2016. For the CPIEFE, our preferred measure of core inflation, our forecast for 2015 is revised up and is expected to approach 3 percent in 2016 and stay in the neighborhood until the end of the projection horizon (figure 9).

This trajectory assumes that the pass-through from the peso depreciation of recent months to prices will stand in the upper part of historic patterns; that real wages will be adjusted in line with productivity; and that capacity gaps will persist over the projection horizon. For the real exchange rate, the forecast uses as a methodological assumption that it will remain similar to its current value, considering that it is within the range believed to be consistent with the state of the business cycle and its long-term fundamentals. About the monetary policy rate, at the statistical cutoff of this Report market expectations showed differences in the expected path for 2015. The surveys indicated that the MPR would remain in 3 percent throughout this year, to rise during 2016. Meanwhile, the prices of financial assets suggested that it should be raised during the second half of 2015. As a working assumption, the MPR is assumed to follow a trajectory that is somewhat above what is implicit in the surveys (figure 10).

As is usual in our projections, the baseline scenario reflects those events estimated to be the most likely to occur with the information at hand at the close of this Report. There are risks, however that, if materialized, may reshape the macroeconomic scenario and, therefore, may alter the course of monetary policy.

Abroad, there are several elements that might trigger new episodes of volatility in world financial markets, with significant effects on credit costs, currency parities and the short-term inflation outlook. On one hand, important surprises regarding the timing and the speed with which the Federal Reserve will raise the benchmark rate may cause significant volatility in global financial markets, pushing interest rates up and further appreciating the dollar. In such a scenario, one cannot rule out that, additionally, we observe an abrupt portfolio rebalancing, given the low level of long-term interest rates and the high stock prices in the United States.

Although the latest statement by the Federal Reserve has attenuated the possibility of drastic changes, the risk is still present. On the other hand, there is the situation some emerging markets are enduring, where the macroeconomic scenario could be further complicated if their commodities continue to trade at low prices. This risk is most important for Latin America, as it compounds with complex economic and political factors. Furthermore, in several countries in the region, fiscal and current-account deficits persist, making the necessary adjustments more difficult and costly. This is not the case of Chile, where the policy framework has allowed for a timely macroeconomic adjustment in the last year and a half.

And let's not forget the geopolitical conflicts in the Middle East and parts of Europe, with which we have sadly lived for quite some time. In Europe, there is the Greek situation and the quirks that have characterized the agreements to finance the debt. On the positive side of risks, it could also happen that the recovery is stronger in the Eurozone, which could mean a stronger boost to the world economy and Chile. In addition, it is possible that the effects of the drop in the oil price is larger than projected and also that this price remains low for longer. Finally, there is still the risk associated to lower growth in China and its consequences on the price of copper. The state of the Chinese financial system and real estate sector continue to draw the most attention.

At home, the main risk has to do with the evolution of inflation, mainly because of the unrelenting exchange rate depreciation and its accumulated effects on costs. This, in a context of margins that seem to have narrowed because of the high annual growth in nominal wages and the limited pass-through of lower fuel prices in some sectors. Therefore, the materialization of an external risk scenario that triggers a significant additional depreciation of the peso may have substantial effects on the short-term inflation outlook, which will depend on the state of the business cycle.

On the other hand, it is also possible that, despite a recent improvement in domestic expenditure and output compared with previous quarters, private expectations will not improve sufficiently to stimulate further spending, especially in investment. Conversely, a scenario where expectations recover more strongly than expected would allow for more dynamic economic activity. The same can happen if the increase in national income has greater effects on expenditure in a context of more comfortable external accounts.

After evaluating these risks, we estimate that, although local risks have moderated, the risk balance is still downward biased for output, while the risk balance for inflation is unbiased.

Let me share with you some final thoughts now.

Final thoughts

Lately, the Chilean economy has responded to the big changes in the local and external environment, by making a major adjustment. Domestic spending went from an annual average growth of about 8 percent in 2011 and 2012, to 3.7 percent in 2013 and a decline of 0.6 percent in 2014, with significant contractions in the last year in spending in imported goods, especially those for durable consumption and investment in machinery and equipment. This helped the current account deficit, which in mid-2013 was thought to be around 5 percent of GDP to drop to 1.2 percent of GDP the past year and is projected to nearly attain equilibrium by 2015. Beyond the discussion about what shock triggered the adjustment, it is clear that the process has been sound, as evidenced, for example, by the behavior of the labor market, with an unemployment rate that for all this time has never exceeded 6.5 percent.

I have no doubt that our country's economic policy framework has played a fundamental role on this. A strong, well regulated banking system has permitted credit to continue to flow dynamically to those activities where it is needed. Our fiscal policy based on a rule that determines public expenditure seeing past the cyclical ups and downs, has allowed for a significant spending program to be carried out without jeopardizing public finances.

From the Central Bank we have contributed by smoothing the cycle, aggressively and opportunely reducing the monetary policy rate by 200 basis points, thus helping to drive medium- and long-term interest rates to or near record lows. Last but not least, our free floating exchange rate system has permitted the exchange rate to depreciate nearly 11 percent in real terms with respect to its trough of 2013, helping adjust the current account and favoring the competitiveness of our export sector.

The saying goes that what is obvious is not talked about, and what is not talked about is forgotten. So I have thought relevant, especially in this environment that at times becomes overwhelmingly pessimistic, to stress how well equipped our economy is to deal with adverse situations. I think that the comparison with other economies of the continent, which have also suffered the brunt of the fall in the prices of our commodities, is revealing: most of them have high current account deficits and several show fiscal situations that are worrying to say the least. In many of them, high levels of dollarization or currency mismatches in the financial sector, restrict the room for exchange rate adjustment and force authorities to use less efficient instruments to achieve their goals. Chile's reality is different: our economy's adjustment occurred sooner than in other countries and it did so rapidly and deeply. This situation allows us to look into this and the coming years with some peace of mind.

In this context, and as we projected in December, output growth has tended to stabilize around 2.5 percent annually, which is low, but in line with our baseline scenario should increase gradually through the year. True, our baseline scenario contemplates, among other assumptions, that such dynamism will be accompanied by improved agents' expectations. As we have said before, this is a sensitive point that requires us all to cooperate. We must also bear in mind that the terrible natural disaster that just hit the north of our country will have some effect on the output figures that will be released in the coming months, which at this moment we can only guess and which will be able to assess only as time goes by.

Moreover, as we well know, every adjustment process has its costs. In our case, the main associated cost has been higher inflation. In recent months inflation has exceeded forecasts and we estimate that it will remain above 4 percent for a longer time, strongly influenced by the depreciation of the peso, which has been greater and more persistent than previously thought. Thus, although we understand that higher inflation is part of the adjustment process I have described above, I want to be clear that its current levels have exceeded our estimates, and that inflation being above the upper limit of the tolerance range for several months in a row is a situation that does not leave us satisfied.

This is why I hereby reiterate the unwavering commitment of the Central Bank Board to safeguard price stability, a commitment that involves introducing any changes to monetary policy that we deem necessary for inflation to converge to the target level within the projection horizon.

In the baseline scenario, we foresee that the exchange rate will stabilize so its effects on prices will decrease, allowing inflation to slowly converge to its target level. Other factors contributing to inflation's convergence will be further widening capacity gaps, as the economy will continue to grow below potential still for some time, and the price effects of indexation and the Tax Reform will tend to lose significance. Additionally, a global environment of reduced inflation and its incidence on the dollar price of imported goods will also contribute to a slower growth of prices.

As a working assumption, our projections assume that to guarantee inflation's convergence, MPR will be slightly above what surveys imply. Accordingly, in the most likely scenario there should be no additional cuts. So, toward year's end we should be debating what is the best time to begin normalizing the monetary impulse. Of course, if the present inflationary trends end up being deeper and more persistent than expected, this debate could be anticipated. The opposite should happen if such trends prove milder than foreseen.

I would like to finish recalling that these years have brought major changes in the world economy. On one hand, in the aftermath of the 2008–2009 crisis the main central banks of the world had to adopt unconventional policies to cheer up their ailing economies, flooding the world with unprecedented levels of liquidity and thus increasing the price of financial assets. Today, the start of the US monetary policy normalization is around the corner, which will intensify the divergence with other developed economies whose cycles are behind. Meanwhile, after years of seemingly endless increases in commodity prices, we have seen the so-called super cycle of commodities wear out, and with it, the boom of investment and income that we experienced for the better part of the past decade.

These two situations pose major challenges to emerging economies and Chile in particular. In the short term, it is very likely that we will see increased financial volatility, including unusual fluctuations in the exchange rate. This may complicate the inflation outlook, at least in the short term, as inflation is closely linked to fluctuations in the nominal exchange rate over short periods. The effects of these situations of increased volatility on the inflation trajectory at longer terms, which certainly are more important for monetary policy, are difficult to predict, as they depend on many factors, such as the cyclical state of the economy and expectations, which we carefully assess when making our decisions.

Certainly these are not the only challenges that these transitions face us with. We will need a flexible economy that allows to redirect resources rapidly and efficiently from those sectors that are losing appeal to those that are gaining it; a financial system able to weigh the risks and help new ventures thrive; and we must double our efforts to improve our productivity, and so on. The good news is, as I just mentioned, we have an appropriate macroeconomic policy framework to confront changes in the external environment and an economy that, having made significant adjustments, is now free of significant imbalances. This is why I believe that, never forgetting that we are a small and very open economy and therefore ever exposed to external shocks, we can look into the future with confidence.

Thank you.