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, 3 June 2015.

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

The Monetary Policy Report *of June 2015 and the* Financial Stability Report *of the first half of 2015 can be found at http://www.bcentral.cl.*

Introduction

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

Thank you for inviting me to share the vision of the Board of the Central Bank of Chile on recent macroeconomic and financial developments, their prospects and implications for monetary and financial policy making. This vision is contained in detail in the *Monetary Policy Report* of June 2015 and the *Financial Stability Report* of the first half of 2015.

The macroeconomic scenario shows minor changes with respect to forecasts in March. Annual inflation declined between February and April, but it remains above 4%. Output and demand continue to grow at a moderate pace, and the first quarter was better than expected, but incoming data suggest that the remainder of the year will be somewhat less dynamic than previously estimated.

In the global economy, the growth outlook showed no major changes either. The weaker US figures early in the year and the consolidation of better prospects in Europe are worth mentioning. The dollar lost some of the strength it had gained during the first months of the year, while the market has pushed back its expectations regarding the beginning of the US monetary tightening process. Nevertheless, long-term rates rose in the US, as in most developed markets. The prices of most commodities rose, especially oil.

In this context, the Board has held the monetary policy rate (MPR) at 3 percent, maintaining a significantly expansionary monetary policy stance.

Let me now describe our baseline scenario and the main risks we have identified in the two reports I am presenting today.

Macroeconomic scenario

In recent months, core inflation (i.e. the CPIEFE, which excludes the prices of energy and foodstuffs) has brought no major surprises and its behavior continues to be largely determined by the effects of the peso depreciation and the usual indexation of the economy. However, annual CPI and CPIEFE inflation is still above 4% and, the same as in March, the baseline scenario of this Monetary Policy Report assumes that it will hover around 4% for some months. After the publication of the previous Report, private inflation expectations for this year increased in line with that Report and have remained at a higher level since then. At one to two years' term, expectations remain at or around 3%, which is the target set by the Central Bank (figure 1).

In the first quarter, domestic output and demand grew slightly more in annual terms than was expected in March. This was visible in private and public consumption, and in investment in construction and other works, with the resulting increase in growth in construction, trade and some services. However, March figures and incoming indicators suggest that the recovery of growth in the remainder of the year will be somewhat slower than expected. This is reflected by several indicators, such as retail sales, imports of consumer goods and business and consumer expectations. Particularly worrisome is the possibility of consumer and business confidence remaining in clearly pessimistic territory, a situation that, if not reversed, will hinder the recovery of growth in the second half of the year (figure 3). The evolution of credit also reflects weak private spending. Annual growth of consumer and commercial loans is still bounded, despite the low interest rates.

Job creation in the private sector has also been in line with the economic slowdown. Hiring in the most cycle-sensitive sectors, such as manufacturing and construction, post negative y-o-y rates of variation, which however have moderated in recent months. Nevertheless, the stronger increase in employment in agriculture and services, especially some linked to the public sector, has led total employment to grow by about 1% annually. The unemployment rate remains low, because the slower employment growth is matched by also slower growth in the labor force (figure 4).

Nominal wages continue to grow strongly, slightly more than 7 percent. The empirical evidence suggests that this owes mainly to the indexation to higher past inflation. Although this phenomenon is not as intense as it was in past decades, it is still significant. There is still the risk, however, that if wages remain high, the convergence of inflation may take longer. Another risk is that the evolution of wages may be reflecting a narrowing of output gaps with respect to the baseline scenario and, therefore, increased inflationary pressures.

World economic data have shown lower growth in the US and a strengthening of the more positive outlook in the Eurozone. Although the worsened US data for the first quarter are believed to be mostly temporary, as I said, the moment when the market expects the Fed to begin adjusting the policy rate has been postponed. Nevertheless, long-term interest rates have risen, although with some reversal in recent days, and the yield curve has steepened in the US and several other economies (figure 5). This phenomenon is partly related to the change in the macroeconomic outlook-the recovery process in the developed world and higher inflation-, but also to the decompression of the low term premiums associated with portfolio reallocations. Still, external financing conditions remain favorable by historic standards.

In Chile, with ups and downs, the peso has appreciated in nominal and real terms. The peso/dollar parity is around 615 as of the closing of the Monetary Policy Report, and has risen further to a little over 620 pesos to the dollar since. This, after surpassing CLP 640 in March and standing near CLP 600 in May. At the same time, the real exchange rate (RER) has fallen from around 97 in February to a value near its last fifteen years' average most recently (figure 6). Long-term nominal interest rates have fluctuated less than their external counterparts have.

In the emerging economies, the growth outlook is not very different from the one foreseen a few months ago, confirming the slowdown in China. Latin America remains the region suffering the most profound and continuous deterioration, which is particularly intense in Brazil. Inflation remains low in a large part of the world, but not in Latin America where it is still high. Moreover, the prices of most commodities, although with fluctuations, are higher than those included in the March Report. Copper, after trading around US$2.9 per pound for a few days, moved closer to US$2.8 at the statistical cutoff date (although recently it has approached 2.7), while WTI oil is trading near $60 per barrel. This contrasts with the decline in food prices.

I should note two important trends that are being observed in the world, implying greater convergence of growth. On one hand, while the US is expected to continue to grow faster than Europe, the gap between the two regions has been narrowing. On the other hand, emerging markets will continue to outgrow developed economies, but this gap is also closing.

Turning to our estimates, the baseline scenario foresees that this year GDP will grow between 2.25% and 3.25%, a range that is somewhat lower than estimated in the last Report (table 3). This projection considers that the floods in the north of the country and one-time effects on important mines reduce the mining growth estimate, with a downward incidence on the estimate for annual GDP growth of one tenth of one point compared with the March forecast. Meanwhile, since the partial data of recent months show weaker private expenditure, it is foreseen that the recovery that was expected for the second half will occur at a slower pace than was projected in March. The Business Perceptions Report of last May confirmed bounded expectations regarding the performance of businesses and investments in 2015. Moreover, the CBC's survey continued to point to a fall in valued projects for this year compared with 2014 (table 1).

On the external front, our projection assumes trading partners' growth to drop by one tenth of a point in 2015 and 2016, to 3.3% and 3.7%, respectively. This adjustment responds largely to the reduced projection for the US. In the Eurozone, prospects remain unchanged because first quarter data brought no surprises other than some differences within the region. Growth is revised down for China and Latin America, because of actual first-quarter data and weaker prospects. As for the terms of trade, our estimate continues to assume an improvement over 2014, although not as big as was expected before. In the baseline scenario, in 2015 and 2016 copper and oil are expected to trade at somewhat higher prices than we thought in March (table 2).

The Chilean economy has made a major adjustment in recent quarters, improving its external position and laying the foundation for a recovery without imbalances. This projection assumes that monetary policy will remain significantly expansionary and that fiscal policy will continue to contribute to expenditure growth in accordance with the fiscal rule and with the objectives set by the Administration. It also considers that the exchange rate depreciation accumulated since 2013 will continue to boost those tradable sectors that are more sensitive to the exchange rate. In addition, the price of fuels, which runs below the average of previous years, will continue to help reduce business costs and improve household income, even if its effects are smaller than expected a few months ago.

As for inflation, in the baseline scenario the CPI should hover around 4 percent annually still for some months, and stabilize near 3 percent during 2016. The CPIEFE is expected to post an annual variation of close to 3 percent in 2016 and stay near that figure until the end of the projection horizon, this time the second quarter of 2017 (figure 7).

This trajectory considers that the transmission to prices of the peso depreciation accumulated in the past year will be in line with its historical patterns; that real wages will be adjusted as a function of productivity; and that output gaps will remain over the projection horizon. For the RER, the methodological assumption used is that, the same as now, it will fluctuate in the upper part of the range believed to be consistent with its long-term fundamentals.

As for the MPR, the working assumption is that the gradual withdrawal of the monetary impulse will be similar to what is suggested by surveys over a one-year horizon, meaning that monetary policy should start normalizing by the turn of next year (figure 8).

The baseline scenario reflects those events that are believed to be the most likely to occur with the information at hand at the closing of this Report. There are risks, however, which, if materialized, may reshape the macroeconomic outlook and, therefore, may alter the course of monetary policy.

Abroad, the main sources of risk remain, only more moderate. The possibility of specific events generating episodes of high volatility in global financial markets persists, affecting funding costs, the exchange rate and the short-term inflation outlook.

On the one hand, any surprises regarding the timing or the pace at which the Fed will increase its benchmark rate can cause fluctuations in asset prices. On the other, there remains the risk of a default in Greece having an impact on global financial markets and GDP growth in the Eurozone. While these are still significant risks, the ability of the larger central banks to handle these situations has improved, reducing to some extent the intensity of the negative impact of such events. This is not to say that there are no associated risks or that their persistence for so long would have lesser effects.

A positive note is the more consolidated growth in the Eurozone, which has helped to configure a more balanced global economic scenario.

In the emerging economies, there are still significant risks. While the risk of commodity prices dropping further seems to have eased, Latin American economies have been weaker for longer than expected. This has occurred in a context where the high fiscal and current account deficits persist in many economies, making the necessary adjustments expensive and difficult to implement. The risk of slower growth in China and its implications for the copper prices remains, although the Chinese authorities have given proof of their ability and desire to avoid abrupt corrections in their economy.

Domestically, the economic recovery in the second half of the year should be accompanied by a significant improvement in confidence indicators, but so far it has not happened. To the extent that this situation continues, it is possible that domestic output and expenditure will fail to show the greater dynamism that is expected in the baseline scenario. Conversely, a scenario where expectations improve significantly would allow for a faster recovery of the economy, particularly in 2016.

Regarding inflation, pressures are somewhat milder than expected in March, due to lower activity and the fact that, although with volatility, the peso has not continued to depreciate. However, in a context of persistently high inflation, with bounded margins, strong wage growth, higher fuel prices and external risk scenarios that can drive a significant further depreciation of the peso, inflationary risks remain important. As we are permanently aware of our legal mandate, this is one risk we analyze and monitor with special care.

After evaluating these risks, the Board estimates that the risk balance is unbiased for both output and inflation.

Summing up, inflation remains high, despite some decline in recent months. Domestic activity picked up in the first quarter, but the outlook for the second half of the year has moderated. As has been mentioned before, macroeconomic policies have played a countercyclical role. In particular, the stronger monetary impulse translated into a reduction of 200 basis points off the monetary policy rate, which helped to drive the long-term rates close to their historic lows.

The not so buoyant economy and the gradual decline in inflation-in line with expectations-suggest that, under the assumptions of the baseline scenario, the discussion about the gradual withdrawal of the monetary stimulus could be delayed with respect to March expectations. Overall, any future changes in the MPR will depend on the evolution of domestic and external macroeconomic conditions and their implications for the inflation outlook. Indeed, if inflation is higher and more unrelenting than we have foreseen, the normalization should be anticipated; but if the convergence of inflation to the target is faster than foreseen, the opposite should happen.

Let me now present a brief review to the main issues in our Financial Stability Report.

The Financial Stability Report

Our Financial Stability Report discloses, on a half-yearly basis (in June and December), the recent macroeconomic and financial developments that might have an incidence on the Chilean economy’s financial stability. The Report we present today examines the same external risk scenarios I have just described.

As I said, monetary policy in developed economies remains expansionary. The measures of the ECB and other central banks that cut down their benchmark rates have continued to push down sovereign long-term rates, although lately they have shown some reversal. This, plus still bounded risk premiums, have led to increased issue of debt, mainly corporate. Thus, an environment of low-cost funding and incentives to risk taking persists, where vulnerabilities may be incubating that could emerge as the global financial situation approaches normality.

Again, the outlook for emerging economies has continued to deteriorate. Despite a very recent increase, the prices of commodities-especially oil-are below their levels of recent years, affecting net exporting countries. Meanwhile, the growth prospects for China, Russia, and particularly Latin America are also declining motivated by idiosyncratic elements. Therefore, there is the risk that, beyond the real channel, commercial links and direct investments by Chilean companies, one cannot rule out financial contagion episodes in the prices of some assets, such as the exchange rate and sovereign spreads.

Internally, the note of caution of previous Reports with respect to the situation of the corporate sector is maintained. Indebtedness as a percentage of GDP reached 114 at the end of 2014. This increase came mainly from a higher external debt and the peso depreciation (figure 9). Financial strength indicators of the companies reporting to the SVS are similar to those described in previous Reports, but low compared with historical averages (figure 10). This reflects a loss in the sector's resilience to the possibility of a less favorable macroeconomic environment. Finally, some bank payment indicators have also deteriorated, with varying effects across banks, but especially affecting medium-sized ones.

Activity in the residential housing market remains strong, with prices still on the rise. The moderation of production costs and anticipated purchases facing the upcoming enactment of the tax reform could be behind the sustained dynamic of the residential sector; meanwhile, price indicators continue to grow, although some moderation is observed in specific areas.

In the office space sector, new square meters built were not matched by an equivalent increase in demand, generating a significant increase in the vacancy rate, as we warned in previous Reports. These levels could remain for a prolonged period due to the inertia of the market and the incorporation of new projects (figure 11).

Aggregate household indicators remain relatively stable, but with some of them showing a marginal deterioration. The debt over disposable income rose in 2014, while the financial burden remained around 14 percent of income, due to low interest rates (figure 12). The lower interest rates facing households are also the result of a change in debt composition, away from higher-rate consumer loans to lower-rate mortgage loans. No changes in indicators of bank default are seen, whereas in non-bank lenders a new increase is observed. This latter phenomenon is partly explained by regulatory adjustments, although a worsening of the credit portfolios of said lenders cannot be ruled out.

Commercial and consumer credit exhibit bounded growth rates, not so mortgage loans, which remain strong (figure 13). The behavior of commercial and consumer loans is in line with the slower growth in private spending. Demand-side factors could be behind these dynamics, as suggested by the Bank Lending Survey. The expansion of mortgage lending is largely explained by the increase in the average debt, which is consistent with the dynamic of housing prices and debt to collateral ratios, which have remained stable.

Bank financial indicators have been stable. Operating income continues to be the primary contributor to the profitability of banks, which fell from the end of 2014, to 16 percent of equity in March. This was due to the reversal of the temporary impact of inflation on the indexation margin and a reduction in interest rate spreads. Bond issues by the banks contribute to the diversification of funding sources, but medium-sized banks remain highly dependent on wholesale funding. Stress tests yield that the levels of capitalization permit to absorb the materialization of a scenario of severe conditions (figure 14).

In short, the internal and external scenarios are virtually unchanged from the last Report, although the persistence of very favorable global financing conditions can incubate vulnerabilities that would emerge if and when such conditions disappear. This would have a significant impact on global financial markets, particularly in emerging economies, whose growth prospects have been on a downward trend.

In this context, the increasing indebtedness of domestic credit users (firms and households) translates into lower resilience to possible financial stress events, or to a deterioration of the macroeconomic environment. Chile maintains adequate solvency and external liquidity to confront international financial stress scenarios. However, this does not insulate the country from such developments and their effects.

I would like to finish with some final thoughts.

Final thoughts

The macroeconomic outlook has not changed much with respect to projections in March. Output and demand are posting moderate annual growth rates, but still with some improvement over the second half of last year. This is good news. However, marginal data show some loss of strength which, combined with low confidence indicators for firms and households, leads us to estimate that the recovery foreseen for the second half of this year will proceed at a slower pace. Accordingly, we have adjusted our growth forecast for this year downward, by one fourth of a point.

Inflation has moderated but is still high and thus it is our main worry. In our baseline scenario, we have it around 4 percent for some months to later descend toward our 3 percent target.

About the risks facing financial stability, the Report shows no big changes either. Corporate borrowing continued to rise in the past few quarters. Although there are obvious factors behind this trend, such as increased external borrowing-a logical development given the good credit conditions-and the depreciation of the peso, we must not relent in our efforts to closely monitor these tendencies. Anyway, figures also show that the households' and firms' financial burden has not increased, largely because interest rates are low, in line with our clearly expansionary monetary policy.

The external scenario has also behaved as we outlined in March. The recovery of developed economies looks more balanced across countries, boosting confidence in consolidated growth of the developed world. Emerging markets continue to show some further weakening, especially in our region. Global financial conditions are still on the favorable side from a historical perspective, which in no case means that a sudden turnaround cannot happen. As a matter of fact, the consequences on global financial markets of a negative outcome in Greece or the ever closer rise in US interest rates are still significant risk situations which, despite having been on the horizon for so long, must not be overlooked or forgotten.

Chile, as we have said time and again, has been able to confront the changes in external and internal conditions via a significant and quick adjustment. The absence of large imbalances, combined with the proper macroeconomic policy framework, are, in our view, key elements, although not sufficient, to generate the conditions required to resume growth levels that allow us to reach the desired development of our country.

In this context, I would like to note that I fully endorse what the Finance Minister said recently, that fiscal stimulus-and I would add monetary stimulus as well-cannot by itself persistently maintain the growth of the economy. On the fiscal front, it is clear that, as stated by the appropriate authority, to honor the commitments on the matter, spending cannot grow eternally at the rates projected for this year. On the monetary front, given the baseline scenario, the convergence of inflation is inconsistent with a bigger impulse than the present one. Thus, beyond any minor adjustments, which depend on the evolution of the business cycle, it is clear that both monetary and fiscal policies have already done their job and there is not much room for either one to do more.

Thus, to resume growth, we need to create the environment that allows investment to recover, resource allocation to gain efficiency and productivity to improve. One key element of this task is for households and businesses to regain confidence in that the economy will provide the proper environment to carry out their projects. Sadly, and against our predictions, this is taking longer than we thought.

For our part, we will continue to do our best efforts to smooth the business cycle, but always with price stability as the primary objective. This is why, as I mentioned earlier, inflation remains our primary concern, and although it has dropped as we projected, it is still high. In that context, as has been our assessment since late last year, we see no room for further cuts to the monetary policy rate. And while the current conditions make it more likely that the gradual withdrawal of the monetary stimulus will take place in the first months of 2016, I want to emphasize that it will depend on actual and inflation projected for the months ahead behaving in line with our estimates.

And last but not least, on behalf of the Board, I wish to stress that we will conduct our monetary policy to ensure that inflation stands at 3 percent over the policy horizon, and we insist on the need for every participant in the financial system to thoroughly evaluate their borrowing and lending decisions. In addition, we will continue to contribute with what is our task, i.e., safeguarding the stability of the currency and the normal functioning of internal and external payments, to Chile's development and welfare.

Thank you.