Rodrigo Vergara: Chile's March 2016 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, 28 March 2016.

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Accompanying figures and tables can be found at the end of the speech.

Introduction

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

Thank you for your invitation to present the vision of the Board of the Central Bank of Chile on recent macroeconomic developments, its outlook and implications for monetary policy. This vision is contained in detail in our *Monetary Policy Report* of March 2016.

Since our last Report saw the light December of last year, inflation has behaved as forecast. It has remained high, mainly due to the effects of the significant depreciation the peso has accumulated, in a context where indexation to past inflation and narrow capacity gaps have limited the decline of non-tradable inflation.

Regarding activity, 2015 figures showed weaker demand and slower than expected growth towards the end of the year. As I will describe in a moment, this factor, along with an expected weakening of the external scenario, results in reduced growth prospects for this year.

In our projection scenario, inflation is assumed to be slightly lower than we thought in December. In this trajectory, core inflation – the CPIEFE – will be less than 4 percent towards the fourth quarter, and the more volatile prices not included in the CPIEFE – mainly foodstuffs – should help headline inflation to converge to 3 percent slightly faster than we expected in December.

In the latter part of 2015, we raised the monetary policy rate (MPR) twice, bringing it to 3.5 percent. After that, we communicated that additional adjustments were still required, which would be made at a measured pace. Accordingly, we held the MPR unchanged in our meetings of January, February and March.

Now let me get in more detail into the macroeconomic scenario we believe to be the most likely for the coming quarters, and associated risks.

Macroeconomic scenario

The main developments of recent months show that in the latter part of last year the economy grew less than anticipated. A fall in mining activity, which we had already seen in previous quarters, was compounded with slower growth in sectors unrelated with natural resources. In particular, those linked to services. Domestic demand also grew less than estimated and is expected to remain weak. The slowdown in its private consumption and investment components stood out (figure 1).

Another important development of recent months came from abroad. Mainly, because the external impulse that the Chilean economy will face in 2016 and 2017 will be lower than we expected in December. The new information leads us to estimate that global growth will fall short of expectations, because of both downward corrections to projected activity in the developed world and a major adjustment in Latin America, which is headed to a contraction in 2016. At the same time, the external financial conditions relevant for Chile are estimated to be tighter, while the terms of trade will be lower (figure 2 and table 1).

The downscaling in output projections for 2016 is consistent with the lower base at the end of 2015, and with spot indicators suggesting that consumption and investment have remained weak this year to date.

On the consumption side, in the last two years the real wage bill has been outgrowing private consumption, leading us to expect a somewhat stronger recovery of the latter during this year. This has not happened, however, which together with the sharper deterioration of the labor market in recent months, plus consumers' expectations remaining pessimistic and low levels of imports of consumer goods in the first months of the year, mean that this component of growth has to be revised downward. However, by 2017 some recovery of this variable is expected, thanks to a gradual improvement in its fundamentals, particularly, moderate growth in the wage bill and a slight improvement in consumer expectations.

Investment, on the other hand, has seen a significant adjustment in recent years, due primarily to the end of the mining investment cycle (figure 3). The baseline scenario of this Report reduces the growth outlook for gross fixed capital formation. This new estimate assumes that mining investment will remain near its levels of 2015. Also, that the boost that the coming into force of the VAT on construction gave to housing investment will be diluted as time passes. Add to this the lower impulse coming from public investment associated with the recently announced fiscal adjustment. Other investments should recover gradually over the projection horizon, to the extent that expectations and external demand improve.

Meanwhile, in line with the expected slowdown of our trading partners, exports are also revised downward from December. Manufacturing shipments will be most affected, considering that their destinations are more concentrated in Latin America, and some sectors, such as salmon, have been beset by specific factors. On the imports side, changes are bigger, because we estimate that the adjustment in spending will be greater for tradables given the evolution of the exchange rate. Thus, the current account deficit should reach 2.5 percent of GDP in 2016. This correction reflects both price and volume adjustments. In 2017, the deficit will be reduced to 2 percent of GDP, considering increased exports of copper resulting from the entry into production of some deposits and improved terms of trade. Measured at trend prices the current account deficit will have a similar evolution.

Given these developments, the baseline scenario in this Report assumes that GDP will grow between 1.25 and 2.25 percent in 2016, less than was expected in December, and in 2017 it will grow between 2 and 3 percent (table 2). This implies that the economy will keep growing below its potential for the better part of the forecast horizon, so that a further increase in the output gap is projected. Just for refreshment, let me remind you that in the Monetary Policy Report of September last year we included several boxes that reflected our new estimate for trend growth (i.e. the medium-term growth rate) and potential growth – the non-accelerating-inflation rate of growth. Estimates remain as we communicated then: about 3.5 percent for trend growth and around 3 percent for potential growth.

The labor market has been strikingly resilient, with persistently low unemployment rates and strong growth in salaried employment in most of 2015. Most recently, however, the latter has tended to decelerate, which along with other indicators in the same direction suggests that this market could be weakening (figure 4).

About inflation, no big changes are foreseen from December. Incoming data confirm that it will gradually converge to 3 percent, after remaining above 4 percent during the first half of 2016. The better behavior of some components not included in the CPIEFE will help speed up this convergence. Thus, by December this year we expect inflation to be at 3.6 percent, two tenths of a point less than what we thought in December. We also project that during the first half of 2017 inflation will hit 3 percent and will remain in the neighborhood from then onwards (figure 5).

It should be noted that private inflation expectations are consistent with this scenario, assuming that it will stand somewhat above 3 percent in one year and at 3 percent in two years. One important thing that distinguishes Chile from other economies, is that this process where inflation has remained high for quite some time has not driven inflation expectations away from the policy target, which attests to the credibility of the Chilean monetary policy (figure 6).

In line with earlier Reports, inflation remaining high for almost two years responds largely to the direct and indirect effects of the exchange rate depreciation, in a context where past inflation indexation and tight capacity gaps have kept non-tradable inflation at a high level. In the baseline scenario, core inflation will converge to near its historic average by mid-2017. This process will be largely determined by the fact that, beyond the usual volatility, no further depreciations are expected of the magnitude seen in recent years. It is worth saying that, with significant fluctuations, the peso/dollar parity has dropped since December and, at the statistical cutoff date of the Report, it was near its levels of August 2015. The real exchange rate (RER) has also dropped in the past few months, and is now at 94 using the 1986=100 index, which puts it on its average of the past fifteen years. While this figure is consistent with the estimated long-term RER, the cyclical conditions of the economy point to a level somewhat above its current values. For this reason, the baseline scenario uses as a working assumption that the RER will have a slight depreciation in the projection horizon (figure 7).

The widening of output gaps will also help in the process of inflation convergence. They are still relatively bounded, however, and inflation's elasticity to the output gap is low. Thus, at least in the context of slow growth and a gradually adjusting labor market, no fast reductions are expected in core inflation as a result of this factor.

Chile's economic slowdown cycle of recent years is associated with several elements. The end of the commodity super-cycle has resulted in a fall in mining investment and production. The world economy has not rebounded as expected, global financial conditions facing emerging economies have tightened and local confidence levels have remained pessimistic for quite some time.

This scenario has prompted a major change in relative prices. Since indexation is still high, for the economy to adjust gradually, exchange rate flexibility is needed together with domestic financial conditions aligned with the new scenario. The Central Bank has contributed to this adjustment with an expansionary monetary policy and accommodating a sharp depreciation of the peso. One consequence of this and looser market conditions has been that long-term interest rates have remained at or near record lows (figure 8).

Monetary policy has taken into account the inflationary effects of the persistence of the exchange rate shock and gaps – particularly in the labor market – , in order for inflation to converge to 3 percent in the policy horizon. In this context, the Board considers that the convergence of inflation to the target still requires a partial withdrawal of the monetary stimulus, albeit at a more measured pace than estimated in December. In particular, the baseline scenario uses as a working assumption that the MPR will follow a trajectory like the one that can be deduced from the various expectations indicators at the statistical closing of this Report (figure 9).

Of course, and as usual, the implementation of monetary policy will be contingent on the effects of incoming information over the projected inflation dynamic. Thus, new data pointing in either direction will trigger the necessary monetary policy adjustments. If, for example, new information translates into projected inflation remaining high for longer, then the withdrawal of the monetary stimulus will be sooner and stronger, and vice versa.

Under the assumptions shaping our baseline scenario, our monetary policy will continue to boost the economy throughout the projection horizon. Actually, Chile's monetary policy rate is the lowest in Latin America and, in real terms, one of the lowest in the emerging world (figure 10).

Turning to fiscal policy, the baseline scenario assumes that the trajectory of public spending is consistent with the fiscal rule and with the Administration's announcements that it will follow a path of fiscal consolidation, which has resulted in an adjustment of expenditures planned for 2016. This is consistent with a lower trend price for copper than was assumed in the formulation of this year's budget.

Risk balance

One of the main external risks comes from the international financial markets. New volatility episodes may be repeated like the ones we saw in the early months of this year, because many of the underlying elements are still present. In particular, doubts around the situation in China, and doubts concerning the Fed's decision on the policy rate. This, because of both its difference with what can be inferred from market prices and the divergences with other developed countries' monetary policies. Nor can we rule out that the increased appetite for riskier assets observed in the past few weeks could persist. Any outcome will have effects, among others, on external financial conditions and emerging economies' currencies and, it will thereby have an impact on local output and inflation.

Another risk scenario has to do with the outlook for world activity. On the downside, there are doubts about the growth capacity of China, which couples with doubts surrounding the solidity of the US recovery. In addition, the electoral debates in several European countries and the United States reveal a higher probability of a shift to more protectionist policies. On the bright side, it is possible that the impulse policies, in the developed world and in China, will succeed more effectively in boosting global growth.

Finally, the situation in Latin America is also an important source of risks that, if they come true, could have negative effects on both financial conditions and external demand facing Chile. One preoccupation is the increased exposure of the region to the Chinese economy and the need of several economies to make an additional adjustment. All this in a context where inflation has risen in several countries, inflation expectations are above the target and the room for further monetary stimulus and/or taxes has narrowed. Plus the increased political risk, in Brazil and Venezuela. Meanwhile, it is worth mentioning that in Argentina there have been adjustments and negotiations with creditors, which could open the door for them to international markets.

At home, recent data show output and demand losing strength, a struggling labor market and still pessimistic expectations of consumers and firms. In this context, slower growth than was assumed in the baseline scenario cannot be ruled out, should any of these events intensify. Still, since our economy is well balanced from a macro standpoint, with virtually zero public debt, well-anchored inflation expectations and a stable, well regulated financial system, more favorable news may cause growth to recover faster than assumed in the baseline scenario.

As for risks for inflation: it has been high for a prolonged time, which could hurt its convergence velocity, both through its effects via indexation and its possible impact on the formation of expectations. In the short term, its dynamics will be closely linked to the exchange rate. Thus, considering the scenarios just described, there are risks in either direction.

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

Please allow me to share some final thoughts.

Final thoughts

If our projections come true, the Chilean economy will complete four full years growing around 2 percent. Inflation, meanwhile, will have converged to the 3 percent target, but only after standing for more than two years on or above the upper bound of the tolerance band. Of course these numbers describe a complex economic scenario, which makes us wonder what caused it and how we have dealt with it. Let me use the last minutes of my intervention to visit these topics briefly, and go in more detail into how monetary policy has behaved in this adverse economic environment.

Many factors lie behind our low growth, some of which have been more intense than previously thought. Lately, this has led not only us but also market analysts and international organizations to make significant downward corrections to the growth outlook for Chile. Just as a reference: in March 2014, 90 percent of the analysts consulted under our Economic Expectations Survey thought that GDP would grow by 4 percent or more in 2016. Two years on, 90 percent are betting on less than 2.1 percent. What caused this change in the forecast?

To begin with, the world economy is undergoing an important process of reconfiguration, which entails deep changes that have proven not only more intense, but also of a much more persistent nature than expected. Among them, it is worth singling out the evolution of the Chinese economy and its major effects on the commodity markets. The effects of this phenomenon have reflected strongly in a sharp reduction in mining investment, of nearly three points of GDP in the past few years, putting a brake in our economy, especially considering that in previous years this sector was an important driver of growth.

The situation in China has not only affected the prices of commodities. In addition, the uncertainty surrounding the changes in the Chinese economy has driven up global risks. After all, never had an emerging economy played such an important role in the world economy.

Secondly, the global financial crisis of 2008 hit the developed economies harder than we originally thought. The wounds it left have constrained their economic recovery and pushed them to experiment with ultra-expansionary monetary policies. This, coupled with the fragilities of many emerging economies, has led this group of countries to face tighter financial conditions than they did some quarters ago.

The weakness of the world economy and the higher volatility in global financial markets has certainly taken a toll on economic expectations. But in Chile, the business climate has also been affected by the years-long debate about what changes we must make to meet the challenges of being a middle-income country in the twentieth century aspiring to become developed in the shortest time possible. In my opinion, it would be self-indulgent to blame all our problems on the more adverse external scenario. We must analyze what we can improve internally in order to better weather the vicissitudes that such external scenario presents us, how to improve the investment climate and return to higher growth rates as fast as we can.

About how monetary policy has taken in this new situation, I think we must begin by recognizing that these phenomena come with major changes in relative prices, as this is how the markets tell economic agents that they must move resources from one sector to another. Contributing to such adjustment is a key role of monetary policy, and, in a context where indexation to past inflation is high, this must be done while allowing the exchange rate to fluctuate. Actually, it is no coincidence that our policy framework features exchange rate flexibility as an essential element.

Moreover, it is important for domestic financial conditions to be consistent with a lower growth scenario; in particular, that real interest rates are the right ones for the state of the business cycle. In this context, the Central Bank has applied an expansionary monetary policy that is actually one of the most expansionary among comparable economies.

Likewise, in the past few years we have made substantial revisions to our estimates of the Chilean economy's potential growth. This is important, because a good diagnosis of medium-term inflationary pressures requires a good measurement of the country's capacity for growth.

As we have explained before, the depreciation of our currency triggered an increase in tradable goods inflation. We expected this, since it is a well-established fact that in Chile, as in other emerging economies, the pass-through coefficient of the exchange rate to prices is high. And not only did we expect it but we also hoped for it, as it is the way to generate the necessary change in relative prices when indexation renders the prices of nontradables relatively sticky on the downward side.

In this context, it is important to understand that in our policy framework the main objective is to ensure that inflation will converge to the target within the policy horizon, which is usually two years. Of course this does not mean that we will overlook current inflation, but that we can tolerate deviations of inflation in the short term as long as we are convinced that such convergence within the above mentioned horizon is not at risk. That is why we are so careful in our inflation forecasts and in monitoring inflation expectations two years out: if the current high levels of inflation do not signal a deviation away from convergence within two years, they can be tolerated. Otherwise, they simply cannot. In other words, if inflation expectations over that term were above the target, they would call for immediate action in the form of a contractionary monetary policy. As previously shown, in Chile this has never happened, which is a significant difference with other countries. However, it is important to emphasize that it has not happened because the market clearly understands that the Central Bank will do whatever is necessary for that not to occur. The messages we have delivered, including the moderate withdrawal of the monetary stimulus, point precisely in that direction.

In this context, a string of more intense and persistent shocks ended up causing a depreciation of the peso that was also larger and longer lasting, which via second-round effects has put more pressure on medium-term inflation. Also, the labor market proved more resilient, a sign of smaller gaps in the economy. This limited the downward correction of non-tradable inflation. Thus, the Board of the Central Bank decided to downplay the monetary stimulus, at a pace that has obviously accommodated incoming news, especially their effects on the inflation forecast two years ahead.

The Central Bank lacks the capacity to alter the economy's potential growth or shield it from the shocks that affect it, but it can contribute to smooth the cyclical adjustment. This is what we have been doing, always with our eyes firmly focused on our constitutional mandate to safeguard price stability, which is one of our greatest contributions to our country's development. Our policy framework, especially exchange rate flexibility, has played a key role in this process. Suffice it to compare it with some past episodes where the exchange rate adjustment was not allowed or was tried to avoid, to later realize the important role that a fluctuating currency plays in this. But, as is always the case, every adjustment process of any significance has short-term costs to pay. In this case, inflation has been above the target range for longer than we expected.

As we have stated many times before, Chile has a sound macroeconomic policy framework that allows us to adequately address the changes occurring in the economic environment. In recent years, the adjustment has been made and there are no significant macroeconomic imbalances yet to be corrected.

The best contribution we can make as the Central Bank is to simply fulfill our mandate of price stability. Rest assured that we will do everything necessary to make it happen.

Thank you.

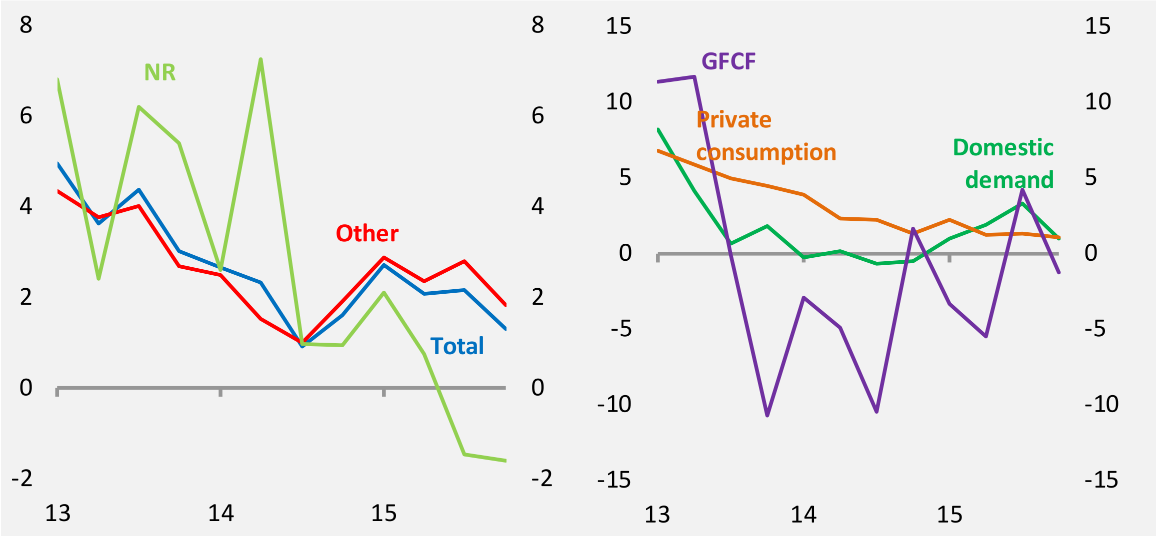
Figure 1

GDP: Total, natural resources and other

(annual change, percent)

Domestic demand by components

(annual change, percent)



Source: Central Bank of Chile.

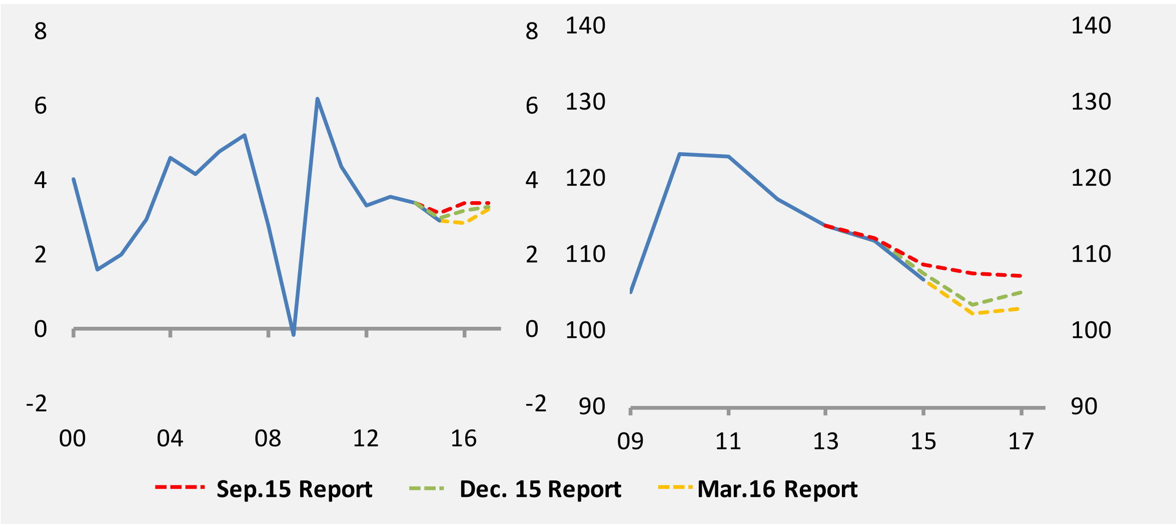
Figure 2

Trading partners' GDP (*)

(annual change, percent)

Terms of trade (*)

(index, 2008 = 100)



(*) Dashed lines show the forecast included in respective Monetary Policy Report.
Source: Central Bank of Chile.

Table 1

International baseline scenario assumptions

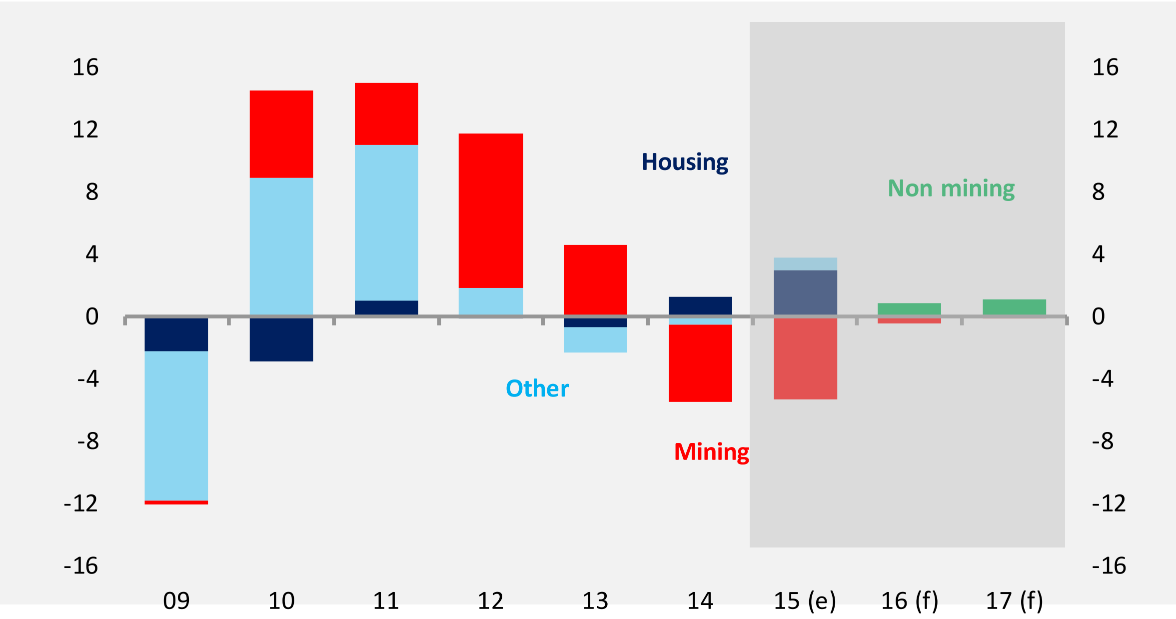
	2014	2015 (e) Dec.15 Report	2015 (e) Mar.16 Report	2016 (f) Dec.15 Report	2016 (f) Mar.16 Report	2017 (f) Dec.15 Report	2017 (f) Mar.16 Report
Terms of trade	-1.8	-4.2	-4.5	-3.8	-4.2	1.7	0.7
Trading partners' GDP	3.4	3.0	2.9	3.2	2.9	3.3	3.1
World GDP at PPP	3.4	3.1	3.1	3.4	3.1	3.5	3.3
World GDP at market exchange rates	2.7	2.5	2.4	2.8	2.4	2.9	2.7
Developed ec's GDP at PPP	1.7	1.9	1.9	2.1	1.8	2.2	1.9
Emerging markets' GDP at PPP	4.8	4.0	4.0	4.4	4.0	4.6	4.5
External prices (in US$)	-0.9	-9.3	-9.7	-2.8	-5.8	1.5	1.0
LME copper price (US$cents/lb)	311	249	249	220	220	230	230
WTI oil price (US$/barrel)	93	49	49	43	40	49	45
Brent oil price (US$/barrel)	99	53	52	45	41	52	46
Gasoline parity price (US$/m3)	731	466	467	373	398	384	420
Libor US$ (nominal, 90 days)	0.2	0.3	0.3	1.0	0.7	1.6	1.5

(e) Estimate.
(f) Forecast.
Source: Central Bank of Chile.

Figure 3

Real annual contributions to GFCF (*)

(percentage points)



(e) Estimate.
(f) Forecast.
(*) Mining investment in 2015 is estimated using available FECU information up to the third quarter, and Codelco's investment plan. Housing investment uses information from the Chilean Chamber of Construction and National Accounts by Institutional Sector. Other contributions are taken as residues. For 2016 and 2017, forecasting models from the Central Bank and sectoral sources are used, such as the Capital Goods Corporation's investment plans and surveys.
Source: Central Bank of Chile.

Table 2

Domestic scenario

(annual change, percent)

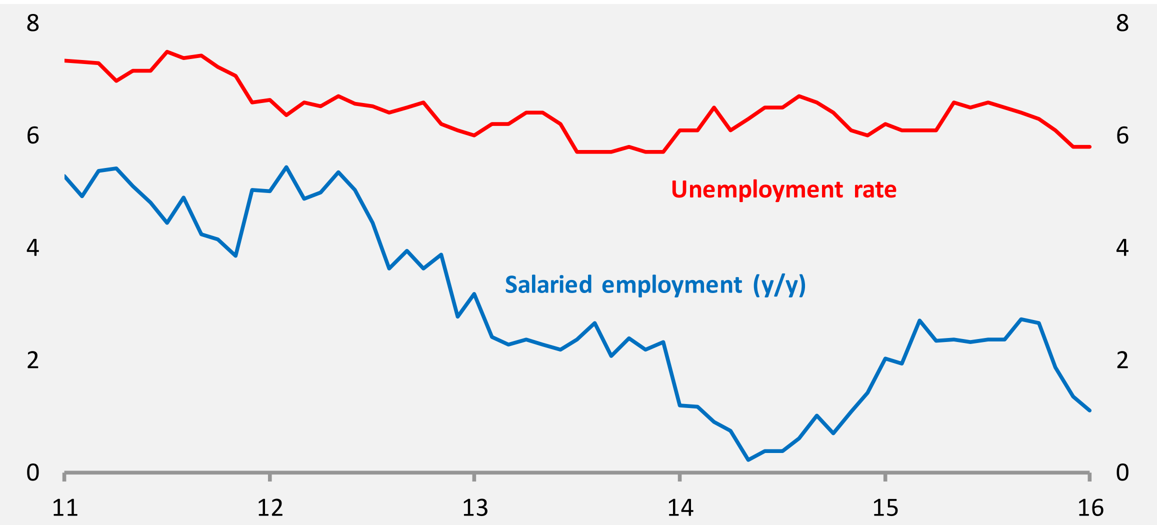
	2014	2015 (e) Dec.15 Report	2015 (e) Mar.16 Report	2016 (f) Dec.15 Report	2016 (f) Mar.16 Report	2017 (f) Mar.16 Report
GDP	1.9	2.1	2.1	2.0-3.0	1.25-2.25	2.0-3.0
Domestic demand	1.1	2.0	1.3	2.5	1.5	2.3
Domestic demand (w/o inventory change)	-4.2	0.7	-1.5	1.7	0.5	1.0
Gross fixed capital formation	2.8	2.4	2.2	2.7	1.8	2.7
Total consumption	1.1	-1.7	-1.9	1.0	0.6	2.40
Goods and services exports	-5.7	-1.4	-2.8	1.6	-0.6	2.10
Goods and services imports	-1.3	-1.7	-2.1	-2.6	-2.5	-2.0
Current account (% of GDP)	20.9	20.0	20.4	19.1	19.9	20.2
Gross national savings (% of GDP)	23.0	22.0	22.7	21.9	22.6	22.1
Nominal gross fixed capital formation (% of GDP)	23.0	22.0	22.7	21.9	22.6	22.1

(e) Estimate.
(f) Forecast.
Source: Central Bank of Chile.

Figure 4

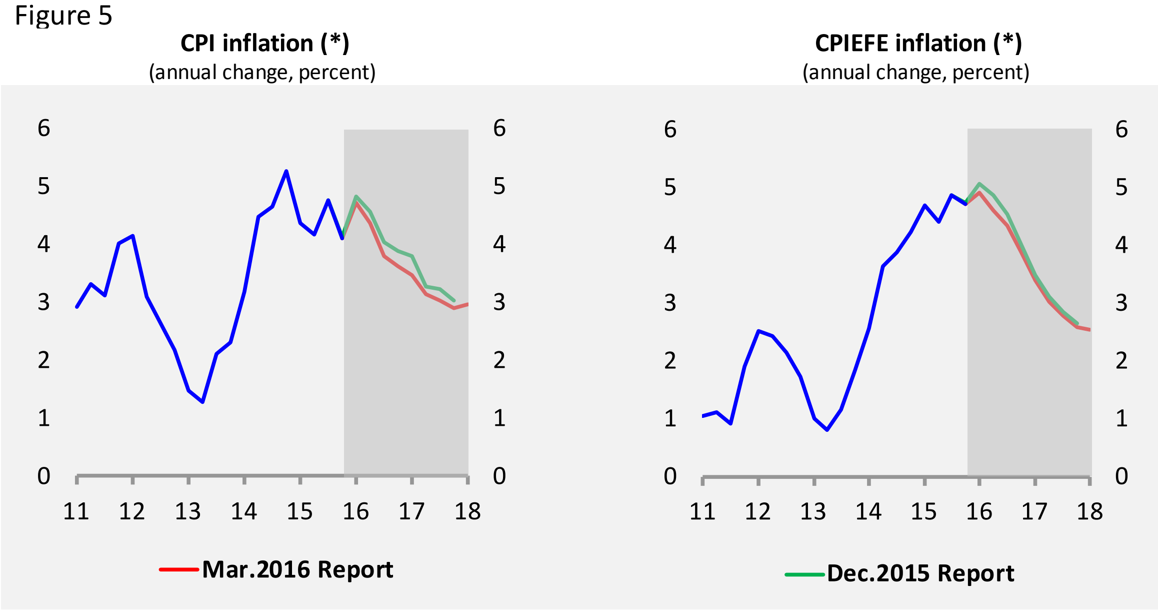
Unemployment rate and annual growth in salaried employment

(percent)



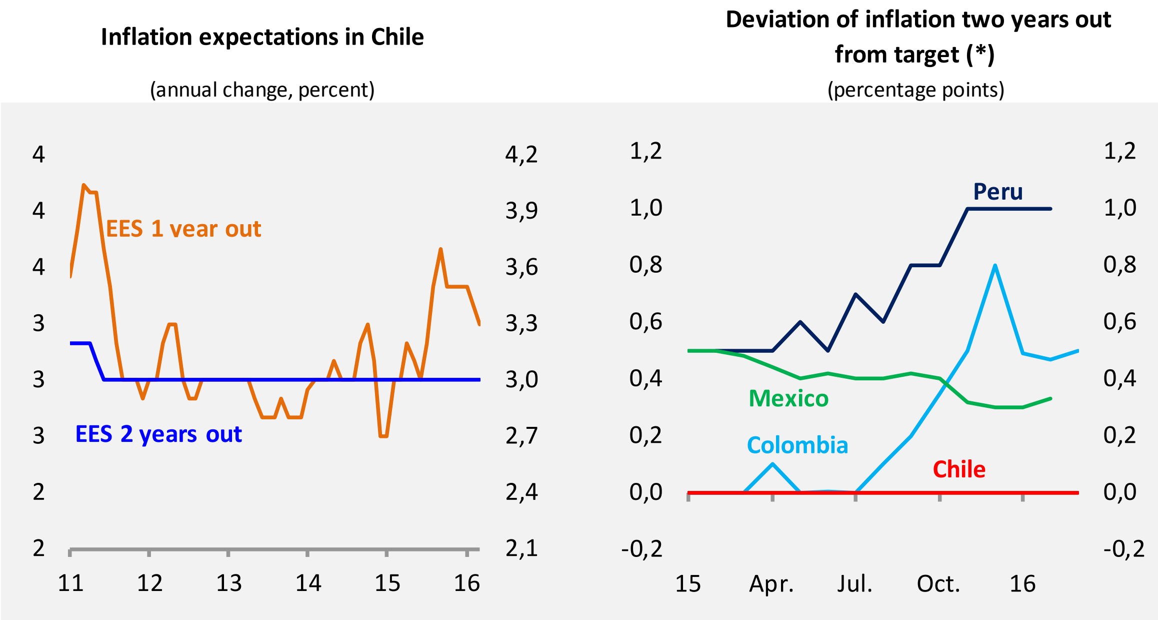
Source: National Statistics Institute (INE).

Figure 5



(*) Gray area shows forecast as from first quarter of 2016.
Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 6



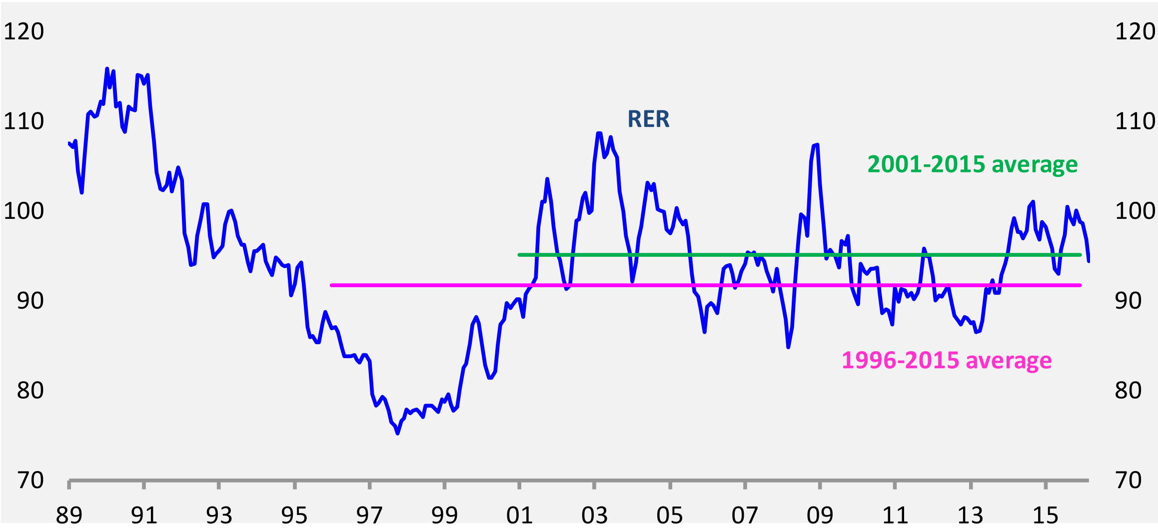
(*) Difference between target inflation and inflation expected at December 2017 for Peru and Mexico, and at two years for Chile and Colombia.

Sources: Central Bank of Chile and of respective countries.

Figure 7

Real exchange rate (*)

(index, 1986=100)



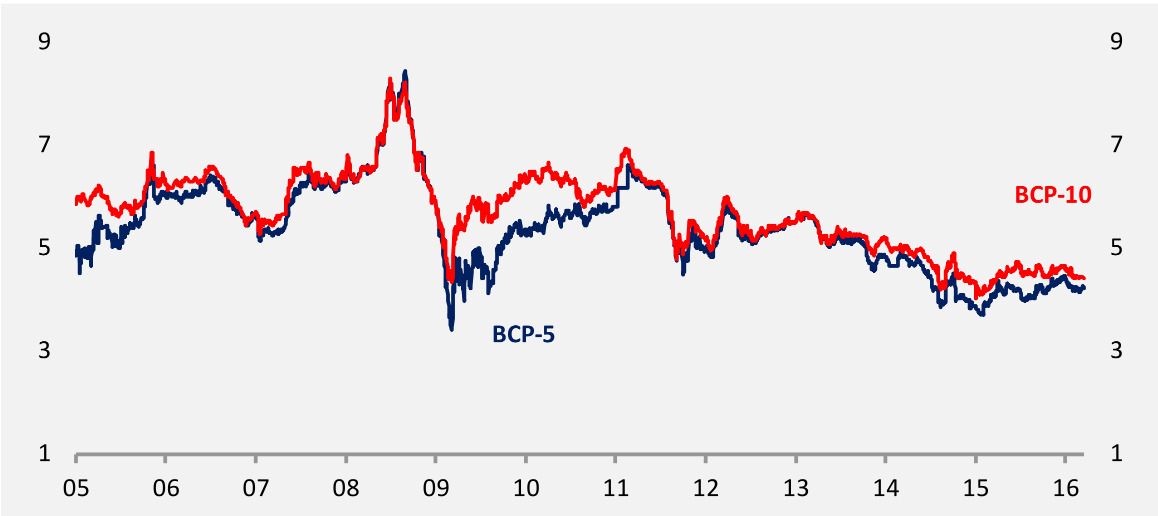
(*) March 2016 figure includes information up to the 21st.

Source: Central Bank of Chile.

Figure 8

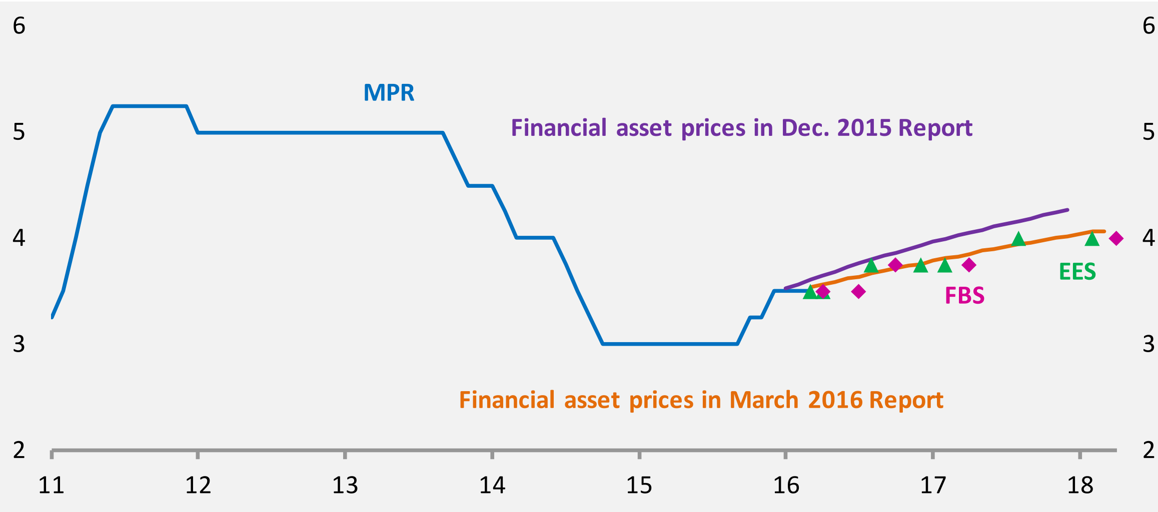
Interest rates on Central Bank of Chile documents

(percent)



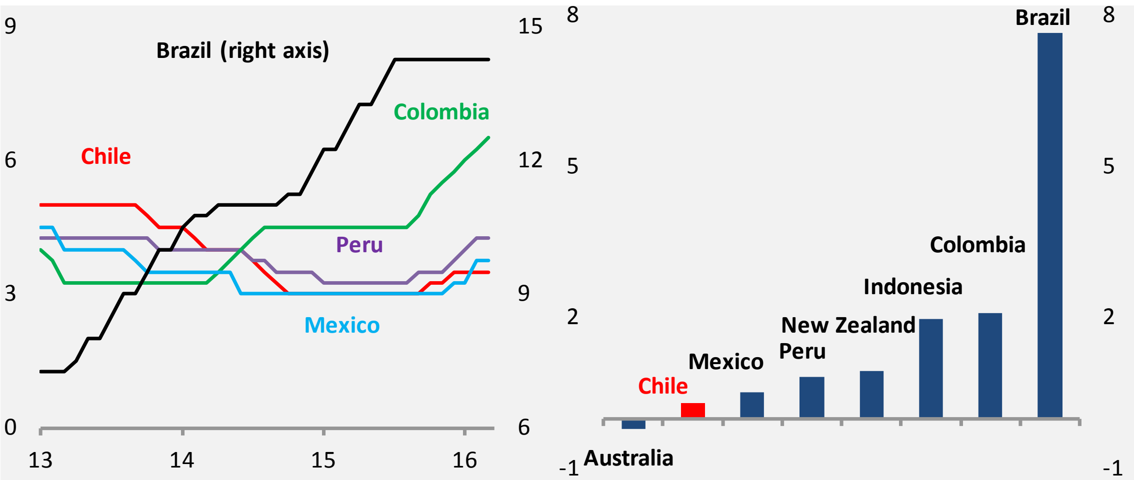
Source: Central Bank of Chile.

Figure 9
MPR and expectations
(percent)



Source: Central Bank of Chile.

Figure 10
Latin America: Nominal and real MPR (*)
(percent)



(*) Calculated as the current MPR minus expected inflation one year out.
Sources: Central Bank of Chile and of respective countries.