MONETARY POLICY REPORT

PRESENTATION TO THE FINANCE COMMITTEE OF THE HONORABLE SENATE OF THE REPUBLIC *

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*The *Monetary Policy Report* of March 2017 can be found at http://www.bcentral.cl/en

Introduction

Mr. Governor of the Senate's Finance Committee, Senator Carlos Montes, honorable members of this Committee, ladies, gentlemen,

Thank you for your invitation to present the views of the Board of the Central Bank of Chile about the recent macroeconomic developments, their projections and implications for monetary policy. This vision is contained in detail in our *Monetary Policy Report* (the Report) of March 2017. It is worth mentioning that this Report includes for the first time economic forecasts for 2018, as I will show you throughout this presentation.

I am here with the full Board and all the staff responsible for the topics covered in our Report. I wish to make a special mention of our new Board member, Ms Rosanna Costa, recently confirmed by this Senate, and Ms Solange Berstein, our Financial Policy Division Director, as of today.

In recent months, annual CPI inflation has continued to decline, in line with forecasts in the December Report. Goods inflation continues to be shaped largely by the movements of the exchange rate, while services inflation has continued to drop gradually, marked by the widespread indexation and consistently with the business cycle.

Meanwhile, in late last year and into this, GDP of non-natural-resources sectors performed weaker than forecast. Furthermore, incoming data suggest that it will take longer than expected to recover. This, coupled with recent events that have considerably eroded mining activity, will pull down annual GDP growth in 2017.

However, as can be seen in the outlook I will be sharing with you in a few moments, a number of elements will help the economy to regain momentum within the projection horizon. Worth noting among these are that no significant macroeconomic imbalances are observed, that the negative impact of the mining investment adjustment has diminished, that the external scenario has improved, and that monetary policy will remain clearly expansionary. Overall, capacity gaps foreseen for the next two years will be somewhat wider than we thought in December, toning down medium-term inflationary pressures.

In this context, the Board lowered the monetary policy interest rate (MPR) by 50 basis points during the early months of the year, speeding up the cuts with respect to provisions made in December. At the same time, we considered that, to ensure the convergence of inflation to the target, it will be necessary to enhance the monetary impulse somewhat, which reflects in an MPR trajectory similar to the one implied by financial asset prices during the ten days prior to the statistical closing of this Report.

Macroeconomic scenario

In February, annual CPI inflation was 2.7%, while core inflation—CPIEFE; CPI excluding energy and foodstuffs—was 2.2%, driven mainly by its goods component, whose annual growth fell to 0.4% in February, in line with the nominal exchange rate, which is now below its year-ago level. The services component of the CPIEFE posted an annual change of 3.4% in February, a quite milder fall than its goods component, reflecting its greater inertia (figure 1). About this, it is worth noting that one feature of the CPI services basket is that 75% of its prices are either managed or linked to another indicator or to past inflation, meaning that they are indexed. This fact in practice augments their inertia and causes the effect of any change in the activity gap to take longer to show up. Of course, this is not the case for every service price, as non-indexed or non-managed prices tend to show a more visible effect from changes in the gap. One of the boxes in the Report is devoted to this, showing how the differences in the recent evolution of services inflation appear when these recently mentioned price groups are taken separately.

In this Report's baseline scenario we foresee that headline inflation will continue to decline for some months, to return to 3% by year's end and hover around that mark until the first quarter of 2019, when the current projection horizon ends. The CPIEFE will decline steadily until the second half of 2017 and will take longer to hit 3% (figure 2).

This inflation path relies on two assumptions: first, a fairly stable real exchange rate around its current levels, which are estimated to be in line with fundamentals; second, that although the output gap will exceed the December estimate for some time, it is projected that, for the aforesaid reasons, it will begin to close towards the end of this year.

Activity growth ended 2016 in line with the December forecast, although characterized by a steeper slowdown during the year, which is expected to continue well into 2017. On 20 March, the Bank published the first National Accounts figures based on the new benchmark compilation that uses the base year 2013. This change is intended to update the way the evolution of the national economy is gauged, incorporating new estimation methodologies, changes in international standards and new sources of information. The Bank makes these changes regularly every five years, according to the respective international standards set by the IMF and the OECD. The most salient changes are depicted in a box in this Report, and all the details can be seen in several documents uploaded on our website.

The new data, which included a very small revision to 2014 and 2015 growth, confirmed the further weakening of the economy in the last quarter of the year, and at the same time modified the growth trajectories of the already published quarters of 2016. In particular, the economy would have slightly outperformed previous estimates for the first part of that year. By sectors, it confirmed that Mining posted negative y-o-y growth throughout the whole year, while activity in areas unrelated to natural resources (i.e. Other GDP) continued to worsen, going from growing 3% in the first quarter to 1% in the fourth (figure 3). In the other sectors, most weak in the fourth quarter were particularly those sectors linked to investment in construction and related services, which are usually more persistent. Also personal services decelerated, although it is estimated that it responded partly to the effects of the public sector strike at the end of last year (figure 4).

On the domestic expenditure side, y-o-y growth in final demand—minus inventory change—also showed a downsloping trend throughout the year. The biggest loss of dynamism was seen in investment in construction and other works, whose annual rate of change was -4.9% in the fourth quarter (0.5% average between the first and third quarters). Private consumption, as has been the case for some years, provided support to the economy, growing by over 2% annually throughout 2016. This was helped by growth in labor income, falling inflation and persistent low unemployment by historic standards. It is worth noting that while growth in non-durable consumption has remained stable, durable consumption growth has recovered, partly due to the appreciation of the peso in the last year and partly due to the necessary replenishment of stocks after several years of low or even negative expansion. Something similar is observed in gross fixed capital formation in machinery and equipment. Discounting unusual purchases of transportation equipment, this investment component has tended to perform better in the past few months (figure 5).

The labor market has continued to adjust. Salaried employment stands out with a fall of 2.1% annually in the December to February moving quarter, as does the moderation of annual wage growth. Plus the reduction in hours worked, at a time where a growing number of workers claim that they work fewer hours than desired. Anyway, self-employment, while more precarious, has significantly cushioned the disturbances coming from salaried employment (figure 6).

A constant concern in recent years has originated in the evolution of the labor market. In several Reports we have included boxes and research notes addressing various related topics, including the degree of working flexibility and how changes in labor conditions affect unemployment. Our last issue includes a box that explores the effects of the business cycle on workers' wages. Normally, wages are analyzed using aggregate data that, by their very nature, conceal the movements of individual wages. Using data per worker, we show that the dynamics of individual wages are much more correlated with the business cycle than what aggregate wages would suggest. In particular, because the wages of workers changing jobs—either voluntarily or involuntarily—are affected, for better or for worse, depending if the business cycle is favorable or not. This is a line of ongoing research that allows us to better understand the evolution of the labor market and its implications for medium-term inflationary pressures.

Domestic financial conditions, meanwhile, are still good in terms of interest rates. However, lending volumes have slowed compared to previous years, which the respondents to the Bank's Business Perceptions Report and Bank Credit Survey interpret as the consequence of weak demand (figure 7).

In our baseline scenario, we estimate that this year the economy will grow between 1% and 2%, down from the range we projected in December, 1.5% to 2.5%. Around 0.2 percentage points of this correction originate in the effects of the Escondida mine downtime. Because of the importance of this mine in the country's copper production—15% to 20% in 2016—, this downtime will have a substantial impact on first-quarter GDP, around 1 percentage point of reduced growth, taking the figure to near zero.

Despite its economic impact, the Escondida deadlock, plus the effects of massive forest fires in January and February, are all one-time events that not only do not affect the long-term trajectory, but neither do they influence the dynamic of the business cycle. Thus, we do not expect these events to have any material repercussion on the performance of other economic sectors or on inflation. In the case of mining production, although its impact on GDP of the first quarter is significant as it is determined mostly by supply-side factors, it is deleted from the Other GDP calculation that the Bank uses in its models to measure the activity gap and the medium-term inflation outlook.

Thus, the change in the projected range for 2017—of half of one percentage point—responds to two major factors. On the one hand, about half is explained by Escondida mining downtime and other incidents during the first quarter. On the other hand, the greater weakness we saw in the course of 2016 gives a lower starting point for the economy this year. In particular, because this weakness has been observed in sectors that tend to be more persistent in their dynamics, such as construction and associated areas. We must not forget that this sector received a significant boost in 2015, which lasted into early 2016, as a result of the new VAT that would be charged to the sector under the tax reform. Such reduced strength responds largely to the end of this boost. There is also the effect that the lending standards of mortgage loans have tightened too, given the higher down payment demanded by the banks. Another important issue worth looking into are the changes in inventories over recent years. The year 2016 completed three years of inventory depletion, which is quite uncommon. In general, inventory movements reflect how companies predict the future: if they are optimistic about it, they accumulate, and vice-versa. Recent years' relentless downward revisions to growth prospects have permeated companies' desired level of inventories and part of what we see in the 2017 growth outlook is also related to that.

For 2018, the baseline scenario assumes that the economy will perform better than this year, growing in the 2.25% to 3.25% range. This will allow the activity gap to narrow steadily throughout next year, keeping in mind that the Board still estimates our economy's potential growth rate between 2.5% and 3%, and trend growth at 3.2%.

These projections assume that, after a three-year-long fall, gross fixed capital formation (GFCF) will post a slightly positive growth in 2017 and a clearly stronger expansion in 2018. This result will be decisively influenced by higher investment in non-mining and non-housing investment (mainly machinery and equipment). This, because the former is expected to regain its positive numbers during 2018 and the latter to continue to adjust for a few more quarters, after the boom triggered by amendments to VAT payment regulations in the sector. As a percentage of GDP, in 2017 GFCF will reach 21.7% and 22.5% in real and nominal terms, respectively.

On the consumption side, no major changes are expected in annual growth, and it is foreseen that it will continue to sustain domestic output and expenditure. Our baseline scenario assumes that consumption will grow at a pace of 2.5% and 3% this and next year, quite like 2016. It also assumes that export volume will grow a little over 1.5% this year, and the rate will double in 2018. Behind this increase is an improved external scenario, which I will discuss in a moment. In this context, the current account deficit will be smaller than projected in December, and 2017 will be better than 2016, due to slower growth in domestic demand and improved terms of trade (table 1).

As I said earlier, the greater growth expected in 2018 originates in the economy having no major imbalances, the end of some factors that have hindered growth in recent years—for example, the four-year plunge of mining investment—an expansionary monetary policy stance and a stronger impulse from abroad compared with previous years. As for fiscal policy, it is assumed that the consolidation announced by the Administration will proceed further.

The recovery that reflects in the annual figures projected for 2018 should begin during the course of this year, considering the negative impact of the debilitated economic activity at the end of 2016 and early 2017. In fact, the average annual GDP growth of the last quarter of 2016 and the first of this year is somewhat above 0%. Already for the second quarter, in our baseline scenario, it will rise above 1.5% annually, which, on average, will be sustained and increased in the second half of the year. However, as we will see later, this scenario relies partly on a stronger monetary policy bias, which is necessary for the inflation target to be met.

Internationally, in the last few months a somewhat more favorable scenario has been forming. On the one hand, activity and expectations indicators in the developed world have revealed a better economic environment. Particularly noteworthy is the situation of the manufacturing sector, which after long years of stagnation shows improved results and prospects, which has been added to the greater dynamism of services sectors that has been observed for several quarters (figure 8). In the United States, persistent positive consumption figures—sustained by a robust labor market— have coupled with the much desired rebound in investment. In the Eurozone, the stronger and more synchronized recovery among its members stands out. In Japan, the depreciation of the yen has given a boost to the foreign sector. Thus, relative to the December forecast, the growth projection for 2017 of our trading partners in the developed world is revised upward by 2 decimals, to 1.8%, this year and next.

Improved conditions in the developed world have given way to expectations pointing to a normalization of inflation or have at least dissipated the risk of deflation that existed not long ago. Thus, the Federal Reserve continued normalizing of its monetary policy and policy makers in Europe and Japan have ruled out further QE. Markets have gradually incorporated these changes in their expectations avoiding major disruptions (figure 9). In the past, the processes of raising interest rates in the US were surrounded by complex economic and financial developments in some economies. In the 1980s, the most critical case, there was the debt crisis in Latin America. Then in the 1990s, the most significant effects were circumscribed to some countries. In the 2000s, the emerging world was not so affected directly, but the subsequent subprime crisis in the United States and all its implications for the world resulted the Federal Reserve rate hike. Today, the conditions in which the United States and the emerging world confront the episode are different as seen from both sides. China's growth and the size of Europe make them a potential risk for the Fed, so it cannot overlook the effect of its decisions on these economies. At the same time, economic policy frameworks have changed in emerging markets and are more capable of dealing with external shocks. Anyway, it is still an element of risk. A box in this Report provides a deeper analysis of these topics.

Beyond the volatility of recent months, the dollar remains strong with respect to most currencies, developed and emerging. Our peso, which has depreciated a little more than 30% from its 2013 average, has behaved similarly to most of our trading partners' currencies, so its multilateral variation has been much smaller. Accordingly, the real exchange rate index with base year 1986=100 is now near 93, some 3% above its 2013 average (figure 10).

Among emerging economies, the improvement in China's outlook is worth noting. In the fourth quarter of last year, the Chinese GDP grew 6.8%, so growth for the full year was 6.7%. Conjunctural numbers and financial indicators have been calmer, according to manufacturing output and foreign trade figures. The renminbi is depreciating gradually and the large capital outflows and reserves depletion of 2016 have stopped. Meanwhile, the authorities set the growth objective at 6.5%. Thus, our baseline scenario has revised the Chinese growth forecast upward by 2 decimals.

In Latin America, the main economies in the region are still adjusting. In Brazil, consumption and investment are weak, as is manufacturing production in Colombia. Argentina is also undergoing a difficult process and, although more lagging than in other countries, has shown signs of milder deterioration of activity, especially concerning manufacturing output. The Mexican economy could sustain good growth and performance in the labor market until the markets became aware of the potential effects of the US elections on trade and migration. This has resulted in weak investment. In this context, the Mexican authorities have taken steps to strengthen their macroeconomic fundamentals, through policies aimed at consolidating public finances, withdrawing the monetary stimulus to deal with inflationary pressures, and managing the exchange rate to counteract the sharp depreciation that the Mexican peso suffered towards the end of last year. In general, the inflation outlook has continued to improve in the region, opening room for further monetary stimulus. In addition, the external imbalances have moderated and the fiscal accounts continue to consolidate. Still, there is only weak support for a more robust expansion in the region.

In this context, there has been a widespread increase in risk appetite, raising stock prices, reducing sovereign premiums and boosting capital flows into the emerging world (figure 11). The terms of trade also show a significant improvement, largely due to a combination of higher prices for copper and lower for oil than assumed in December. The prices of other export products have also risen. Copper has remained at its highest price in two years. This responds partly to the aforementioned better performance of the manufacturing sectors and the better world growth outlook. Another part is explained by supply disruptions in some important producers and the lack of new investments. Thus, we have risen our projections of its price to US$2.55 and US$2.50 per pound for 2017 and 2018, respectively. The oil price, after some rise after the agreement between OPEC and other producers to reduce output, has fallen in recent weeks. Our baseline scenario foresees it close to 50 dollars per barrel in the projection horizon. With this, in 2017 and 2018 the terms of trade should not only outperform 2016, but should also be higher than was anticipated in December (table 2).

In the baseline scenario, monetary policy is providing a somewhat stronger impulse than estimated in December. As a working assumption we assume that the MPR will follow a trajectory similar to the one implied by financial asset prices during the ten days prior to this statistical closing of this Report. Thus, we assure that monetary policy will have responded swiftly to the changes in economic conditions and will remain expansionary through the whole projection horizon (figure 12). As always, the conduct of monetary policy and any possible adjustments to the MPR will be contingent on the effects of incoming information on the projected inflation dynamic.

On the external front, there are some sources of uncertainty that may have significant effects but by their nature are very hard to quantify. For example, political and economic uncertainty surrounding European elections, worries about Brexit implementation and possible shifts towards protectionism in several developed economies. Other risks that have long lingered in the external scenario have varied in intensity. The US economy has evolved favorably, averting the risk of a new recession. The much awaited fiscal impulse could help to sustain somewhat higher growth in the years to come. However, it is also a source of risk, as its implementation may have problems or inflationary effects that might trigger a faster withdrawal of the monetary impulse, creating disruptions in financial markets. China continues to be a source of concern, especially its leverage, although its authorities have successfully weathered its gradual slowdown without causing disruptions, and this has been welcomed by markets.

Neither can we rule out an intensification of the recent global trends and a stronger than expected impulse from abroad, by either a steeper recovery of world activity and/or better commodity prices. Some of this seems to have permeated financial markets, where the prices of riskier assets have risen. Although it is still premature to validate such optimism, it is clear that the markets are in a better mood than last year, including local markets, which have even been outperforming many of their peers.

On the domestic front, after several years of subdued growth, we cannot rule out that a more persistent phenomenon may be affecting the economy's ability to grow, in which case spending plans of both public and private agents would need some revision. One area calling for special attention is the labor market. While acknowledging that it has gradually adjusted without significantly increasing unemployment in the past several years, it is possible that, after years of low growth companies wish to make more drastic changes in their payrolls, particularly if the expected growth recovery towards the end of the year stalls. In contrast, in a context where no macroeconomic imbalances are hindering growth, a scenario where an improved external outlook consolidates, plus the end of a cycle of mining investment adjustments and a rebound in sentiment, could lead to a more dynamic recovery than expected.

All considered, the Board believes that the risk balance for both inflation and activity is unbiased.

Summing up, inflation has evolved in line with December forecasts. However, the economy has been weaker, widening the activity gap beyond expectations and reducing inflationary pressures. Accordingly, the Board deemed it appropriate to enhance the monetary stimulus between January and March. Going forward, we believe that it will be necessary to increase this monetary impulse a bit more, using as a working assumption that the MPR will follow a a trajectory similar to the one implied by financial asset prices during the ten days prior to this statistical closing of this Report. As always, we reaffirm our commitment to conduct monetary policy with flexibility, so that projected inflation stands at 3% in the policy horizon.

I will now share some final thoughts.

Final thoughts

The evolution of the economy in recent years has brought great challenges for monetary policy making around the world. The actions of central banks were paramount to take the world out of the financial crisis of 2008-2009 and to prevent a relapse in the following years, especially in those countries with less room for fiscal maneuvering. During this long period the effectiveness of monetary policy to influence inflation and economic activity was called into question. Though less dramatic than in other places, in Chile this discussion is also revisited every now and then.

Before responding to the question of how effective monetary policy is, we must clarify two points: what objective does it pursue, and how does it operate, and then we can explore whether the means contribute to the ends.

Chile's institutionality assigns the Central Bank two main functions: to safeguard the stability of prices and the stability of the payment system, understood as financial stability. The first of these objectives has been specified under the regime of flexible inflation targeting, and has governed us for over 15 years, setting the target that annual expected CPI inflation must stand at 3% in a two-year horizon. This regime also considers a floating exchange rate, where the Bank reserves the possibility of intervening in the market, a power it has exercised barely four times since this policy came into effect in 1999.

This should clarify what lies beyond the objectives of our Monetary Policy: on the one hand, under the foreign exchange policy I have just described, we do not have a target for the exchange rate. We allow it to settle freely in the market responding to local interest rates and its other macroeconomic determinants. This is relevant because, as the empirical evidence shows, in small, open economies the exchange rate is an important shock absorbing mechanism.

Second, our target is not short-term inflation, but longer-term inflation. Thus, to the extent that inflation fluctuations are perceived as transient, they should not have much impact on our policy decisions. A good example of this is the steep increase in inflation we had between 2014 and 2016. This process originated largely in a shock to the exchange rate that had transitory effects on inflation. Of course, the duration of the period of high inflation was long, but it responded to a succession of different shocks and not to the persistent effect of a single one.

On the contrary, whenever we identify medium-term pressures on inflation, either upward or downward, we must react with vigor. The same episode which I have just referred to is illustrative in this regard. While in the short term inflation rose as a result of a shock on the exchange rate, with transitory effects, medium-term pressures diminished as a result of a deteriorating economy. Had our target been short-term inflation, we should have raised the MPR. As it is not, and what we aim at is medium-term inflation, our decision was to lower the MPR to prevent inflation two years out from falling below the 3% target.

This response of monetary policy is very different from its not so distant past. In the 1990s, when our economy was not yet sufficiently prepared to deal with a currency shock, the Bank had to choose between an inflation target and an exchange rate target. The result of the exercise was complex for the Chilean economy. Not to mention what happened in the early 1980s, when the defense of a pegged exchange rate and changes in external financial conditions led us to a recession that cost us 15% of lost GDP and escalating unemployment. Applying our present scheme, monetary policy, coupled with a fiscal policy based on a structural balance sheet, has achieved its inflation objectives by dampening external and domestic shocks more strongly. The turbulences that in the past caused recessions in Chile, today are manifested only as changes in the pace of growth.

To this end, monetary policy operates through several channels. Primarily, it regulates market liquidity and it sets, through open market operations, an interest rate for the provision of liquidity to the financial system at very short terms. By way of these two mechanisms it affects market interest rates, which are the ones that influence asset prices and economic agents' decisions.

The effectiveness of monetary policy therefore depends on the operation of these mechanisms at different levels. First, the Bank's ability to ensure the provision of liquidity is critical, as it maintains market interest rates aligned with the MPR. This is done regularly through open market operations and the Bank itself operates systems that allow these operations to be carried out with the appropriate standards. There may be cases where there is a sudden rise in market rates, because players in the system are faced with potential or actual liquidity constraints. Such a situation occurred in 2008, when events associated with the collapse of Lehman Brothers swept over the world economy. On that occasion, the Bank announced to the market that it would resort to exceptional liquidity provision mechanisms in pesos and dollars, which allowed local rates not to be altered, despite severe external risks.

Although the Bank's monetary policy instrument is the short-term interest rate, its movements affect the complete yield curve. The effectiveness of changes in the MPR in this area hinges on the credibility of the Bank's decisions as perceived by economic agents. Here there are several areas, within which communication and transparency of decisions are essential. To the extent that individuals and companies understand and validate the Bank's decisions, their consumption and investment decisions will be consistent with the described scenarios, as well as with asset prices and market rates. For these reasons, the Bank makes special efforts be transparent and to communicate its decisions and scenarios in the best possible way. We publish a wide range of information and all members of the Board are constantly making presentations to raise awareness of the Bank's vision, among many other efforts.

Other important factors in the effectiveness of monetary policy are the changes in the external scenario. Being a small, open economy, Chile is subject to the vagaries of other countries. As we have said time and again, we can cushion their effects, but we cannot isolate ourselves from them. In that sense, significant fluctuations in the external scenario that, for example, produce unexpected or major changes in capital flows and external financial conditions, could affect local market rates. Again, the Bank's ability to provide liquidity that compensates for possible changes in external conditions is vital. The example of 2008 I just described is relevant here too.

It will not go unnoticed that several of these mechanisms also affect economic activity. For example, to the extent that a reduction of the MPR is properly transmitted to the cost of interbank funding, financial institutions may offer better credit conditions to their clients or, based on a better spread, bring to their portfolio of clients people and companies that were left out before because of, for example, a higher risk assessment. At the same time, as people and companies see a more attractive offer of credit in terms of amounts or costs, they will decide to spend and thereby boost activity.

Central banks are often caricatured as obsessed with inflation and indifferent to economic activity. Nothing further from the reality. The deviations of growth are very relevant for the evolution of inflation in the medium term, which means they play a fundamental role in our actions. The closer GDP is to its potential, the closer inflation will be to its medium-term target. Moreover, in the great majority of cases, monetary policy influences economic activity and inflation in the same direction, which is not surprising since both tend to correlate within the business cycle. This is especially important when the economy is in a weak phase of the cycle and a monetary stimulus can raise inflation and boost domestic demand. In any case, one must always keep in mind whether a persistent drop in activity is the result of a cyclical problem in the economy or responds to a more permanent phenomenon, such as lower potential growth. In the latter case, it is not evident that the output gap is much wider in the face of a slowdown and, therefore, it is not evident that medium-term inflationary pressures are lower.

Again, the conduct of monetary policy of the past few years is a good example of how it implicitly ensures economic stability, as its stance remained expansionary even with annual inflation rates above 4%, understanding that they obeyed to an exceptional episode of exchange rate depreciation.

The prolonged period of low growth that Chile has endured in recent years has put downward pressures on medium-term inflation. Therefore, within this framework that I have described, monetary policy has been and will continue to be expansionary. Measuring how expansionary monetary policy is, is no easy task. Typically, the so-called neutral rate is used as a benchmark. Our most recent estimates, which we reported in a box in our *Monetary Policy Report* of last September, place it between 1% and 1.5% in real terms. With a real MPR that is now at zero and with the prospect of a further reduction in the near future, which we use as a working assumption for the baseline scenario of this Report, there is no doubt that we are providing a considerable boost to the economy. Even more importantly, longer-term real rates are also below or around these levels, reflecting that the market considers that monetary policy not only is expansionary now, but is expected to remain so for some time, in line with the communications of the Bank itself.

The lower interest rates are reflected not only in the record-low level of risk-free rates, but also in that borrowing costs are now very low by historic standards. This applies both to mortgage loans and to commercial and consumer loans. The exchange rate has also reacted. In nominal terms, the peso is now about 35% below its levels of mid-2013. Compared with other countries, however, the behavior of our currency has been similar, so that multilateral and real depreciation have been less. Finally, from the perspective of other countries that have had cycles similar to ours, monetary policy rates in Chile are among the lowest in real terms.

Nonetheless, we must recognize that, even in normal situations, the effectiveness of monetary policy is not guaranteed, but depends on its correct implementation. This means respecting certain basic principles. Monetary policy, first and foremost, must be *coherent* with its policy framework and the situation of the country. This implies refraining from favoring short-term objectives, but rather calibrate the monetary impulse in such a way that projected inflation stands at 3% over a two-year horizon. Consistency is especially important to avoid unnecessary ups and downs in the economy causing market confusion.

Its implementation must also be *timely*, which requires having enough information for a better understanding of the economic environment, and acting promptly when changes occur. Obviously this entails taking some risks, as certainty is always elusive. One example of this may come from the recent evolution of monetary policy conduct in Chile. At our presentation before this Committee last December, we noted that our baseline scenario featured as a working assumption that the monetary stimulus would be boosted by 50 basis points, which would be done in the following months. New information convinced us that such impulse would need to be speeded up, so we took action in our monetary policy meetings of January and March. Moreover, the Report I am presenting you now uses a MPR trajectory that goes al little further as a working assumption. Also, as always, as circumstances change and the medium-term inflation outlook varies, monetary policy will be adjusted accordingly.

Furthermore, monetary policy and its underlying diagnosis must be *persistent* enough for it to influence economic decisions regarding saving, investment and pricing, which operate with significant lags. In Chile, estimates indicate that it takes from two to eight quarters for a MPR movement to completely pass through to the economy. Now, this can vary if economic conditions are complex or the magnitude of the impulse is estimated to be still not large enough. The events in the developed world during recent years provide a good example. After the crisis of 2008-2009 the Federal Reserve increased the monetary impulse beyond the usual limits set by the interest rate. It not only took it to zero percent, but it also added a quantitative boost through the purchase of bonds. In a normal environment, it probably would have been unnecessary to take the impulse to such extremes, and probably the economy would have taken less time to react. However, the post-crisis damage was very large and only the persistence of the momentum has allowed the US economy to make a successful recovery after nine years. We see something similar in Europe, with the difference that they took longer to apply the stimulus, suffered a banking crisis in 2011 and, in addition, the very agreement procedures of the European Community make it more difficult to take extreme decisions.

Finally, as I said, monetary policy must be *credible*, in order for the economic agents' reactions to its impulses to be in line with the objective. If inflation expectations are aligned with the two-year-ahead target of 3%, agents' decisions, market interest rates, and financial asset prices will harmonize with low, stable inflation.

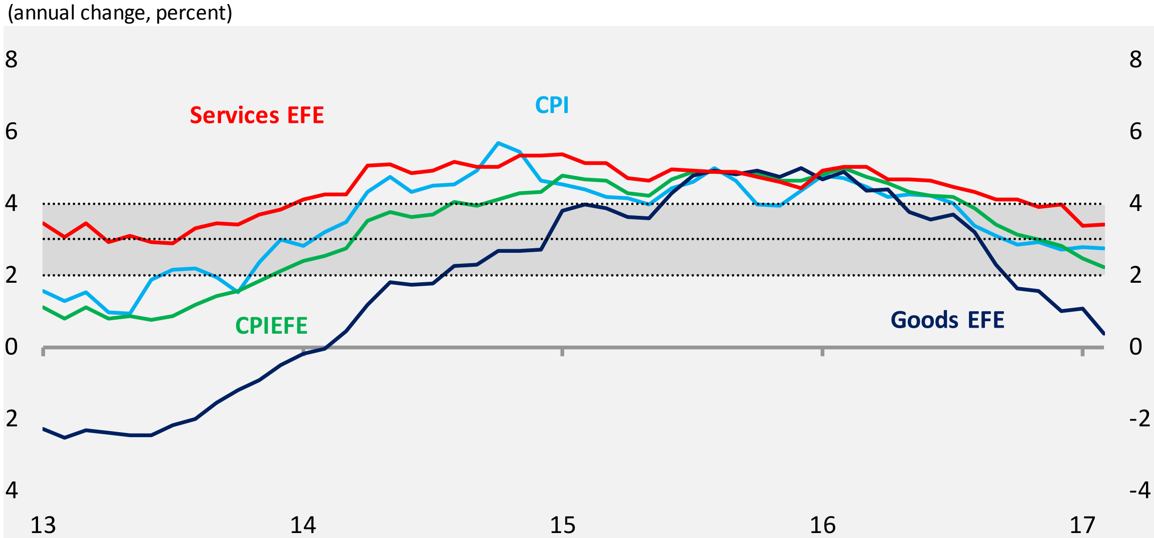
The need for persistence and credibility raises a warning about how inefficient an interest rate reduction may be if perceived as temporary by the market. This is very important, because in practice if agents consider that a rate cut will be very short lived, it will probably have no meaningful effect on the yield curve or on the decisions of households and businesses. Moreover, costs could outweigh the potential benefits. If agents consider the downturn not only to be ineffective but also to compromise the achievement of the inflation target, a much less expansionary monetary policy could be necessary to realign inflation expectations.

Thus, the effectiveness of monetary policy depends on our ability to *timely* diagnose the state of the economy and its implications on inflation, to respond consistently in setting the policy rate, giving it sufficient *persistence* to operate and generate the necessary *credibility* for markets to respond in accordance with the expected results of these interventions. At the Central Bank we are committed to ensuring these conditions. With this, monetary policy will continue to contribute to the country's welfare by maintaining low and stable inflation, cushioning the volatility of the business cycle.

Likewise, although the Central Bank does not have the instruments to directly influence the growth potential of the country, it can indirectly contribute by preventing the loss of welfare that results from economic volatility; reducing uncertainty to encourage investment, production, employment and consumption decisions, and contributing to make the financial sector safer and more efficient for the benefit of the entire population.

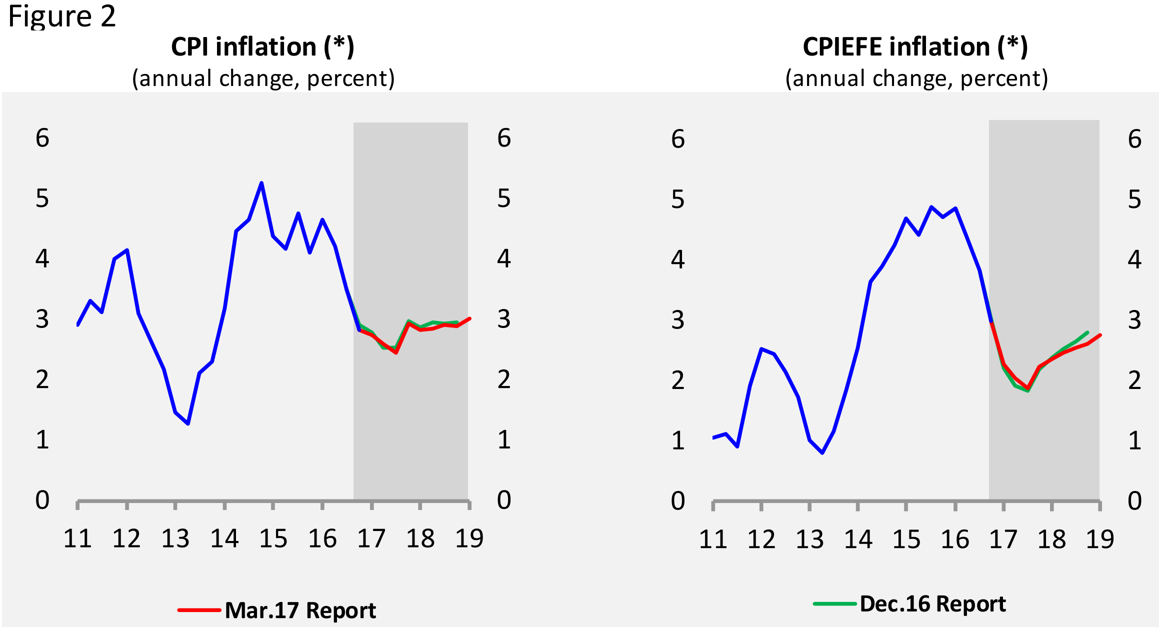
Thank you.

Figure 1
Inflation indicators (*)
(annual change, percent)



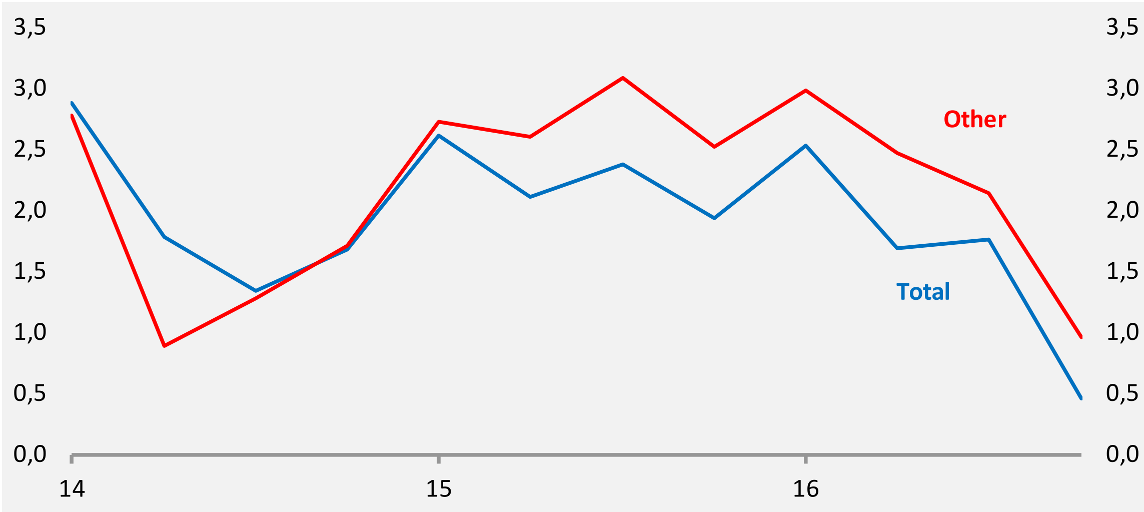
(*) As from January 2014, the new indices with anual base 2013=100 are used, so they are not strictly comparable with earlier figures.
Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 2



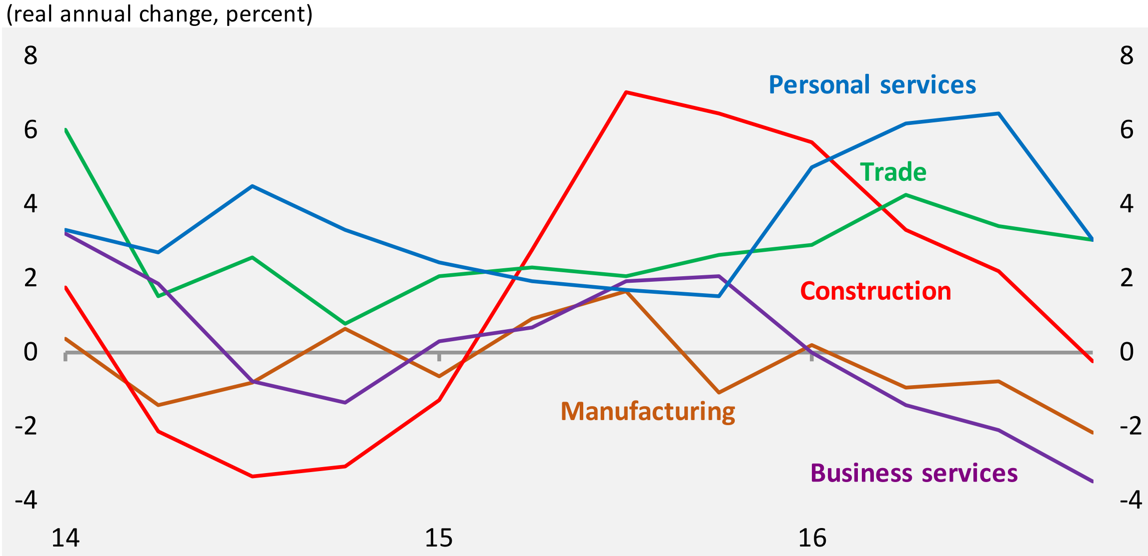
(*) Gray area, as from the first quarter of 2017, shows forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 3
GDP evolution
(real annual change, percent)



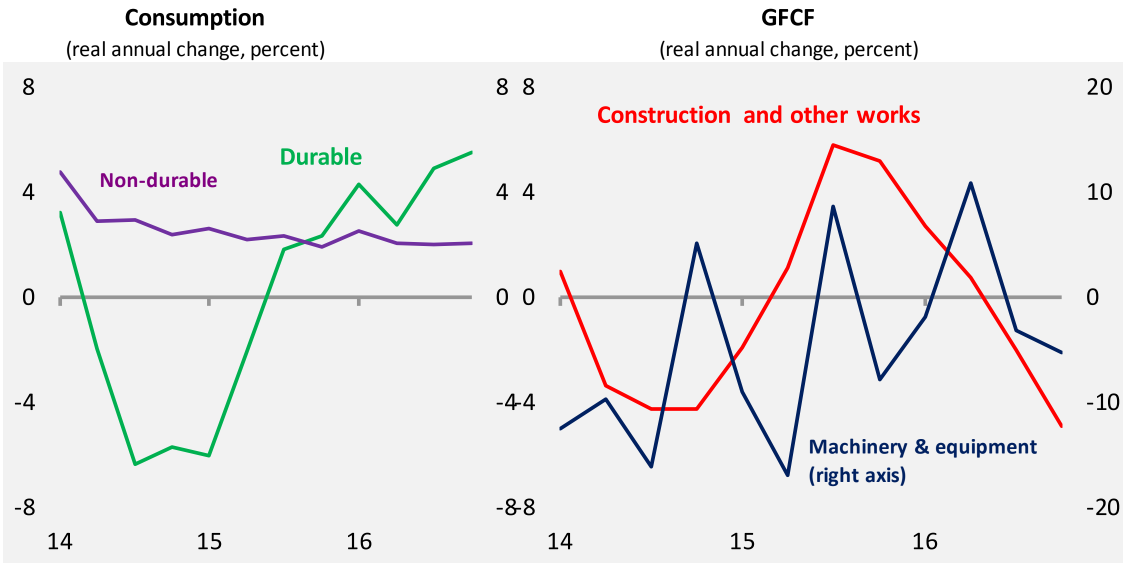
Source: Central Bank of Chile.

Figure 4
Other sectors
(real annual change, percent)



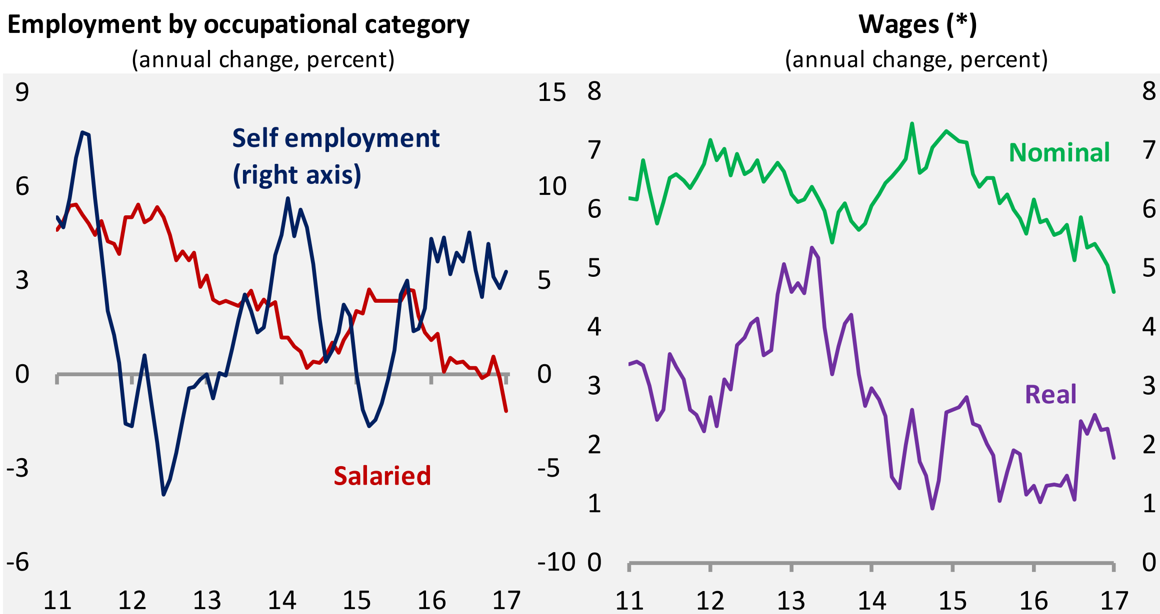
Source: Central Bank of Chile.

Figure 5



Source: Central Bank of Chile.

Figure 6



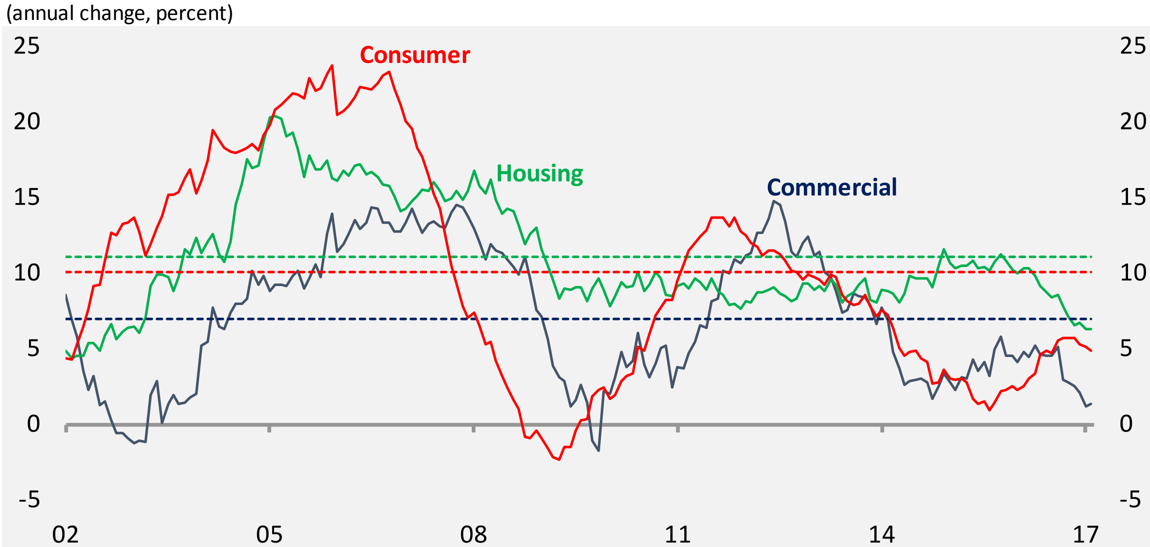
(*) Corresponds to the average annual change of wage and cost indices, for both nominal and real wages.
Source: National Satistics Institute (INE),

Table 1
Domestic scenario
(annual change, percent)

	2015	2016 Dec.16 Report	2016 Mar.17 Report	2017 (f) Dec.16 Report	2017 (f) Mar.17 Report	2018 (f) Mar.17 Report
GDP	2.3	1.5	1.6	1.5-2.5	1.0-2.0	2.25-3.25
Domestic demand	2.0	1.1	1.1	2.6	2.3	4.1
Domestic demand (w/o inventory change)	1.7	2.0	2.0	2.0	1.9	2.8
Gross fixed capital formation	-0.8	-0.6	-0.8	0.7	0.2	3.0
Total consumption	2.4	2.8	2.8	2.4	2.5	2.8
Goods and services exports	-1.8	0.1	-0.1	2.0	1.6	2.7
Goods and services imports	-2.7	-1.4	-1.6	4.1	4.3	7.2
Current account (% of GDP)	-2.0	-1.7	-1.4	-1.9	-0.9	-2.1
Gross national savings (% of GDP)	21.4	19.3	20.2	19.2	20.3	20.5
Nominal gross fixed capital formation (% of GDP)	23.6	22.2	23.2	21.7	22.5	22.6

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

Figure 7
Real lending by type of credit (*)
(annual change, percent)



(*) Horizontal dashed lines show last 15-year average for each series.
Source: Central Bank of Chile using SBIF data.

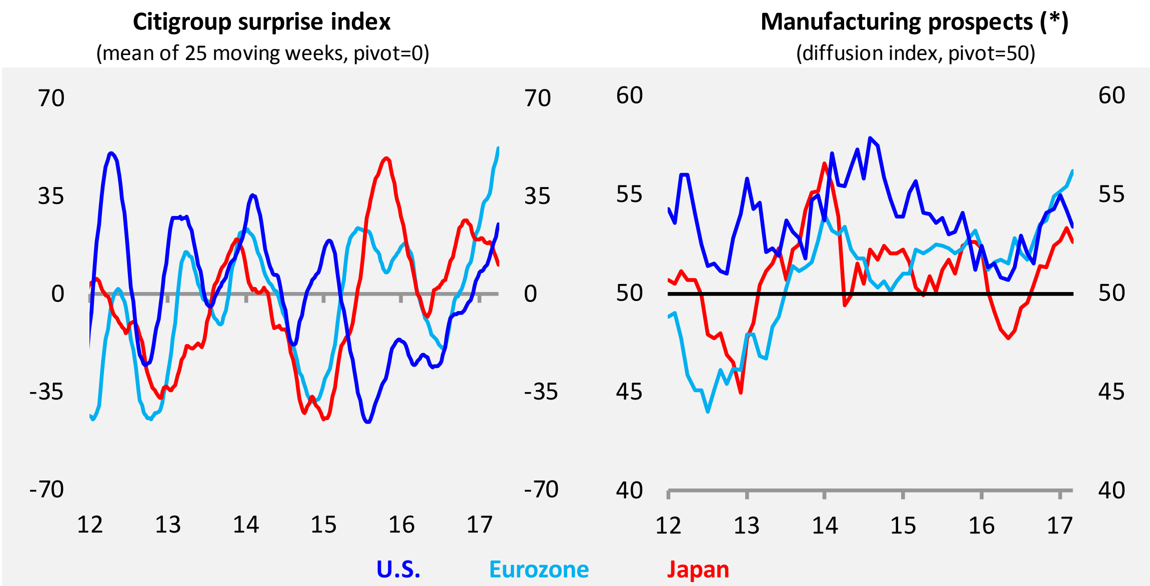
Figure 8

Bank credit survey (*)

(average for four moving quarters)

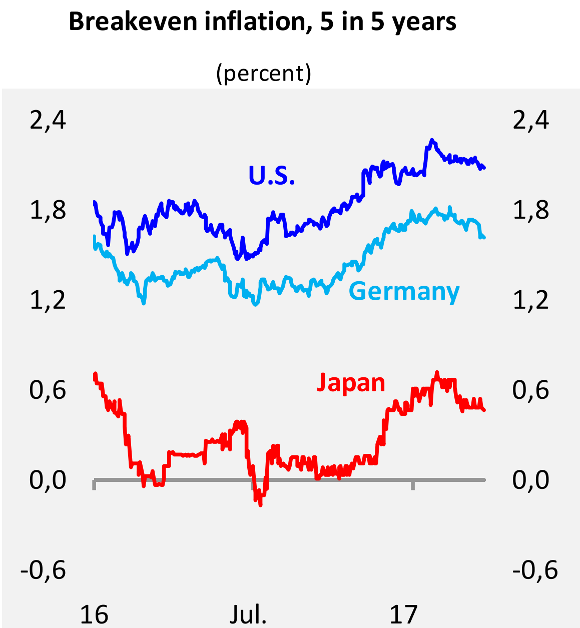
(*) Difference between percentage of respondents that said lending standards had become less stringent to some extent and percentage of respondents that said that lending standards had become more so to some extent.
Source: Central Bank of Chile.

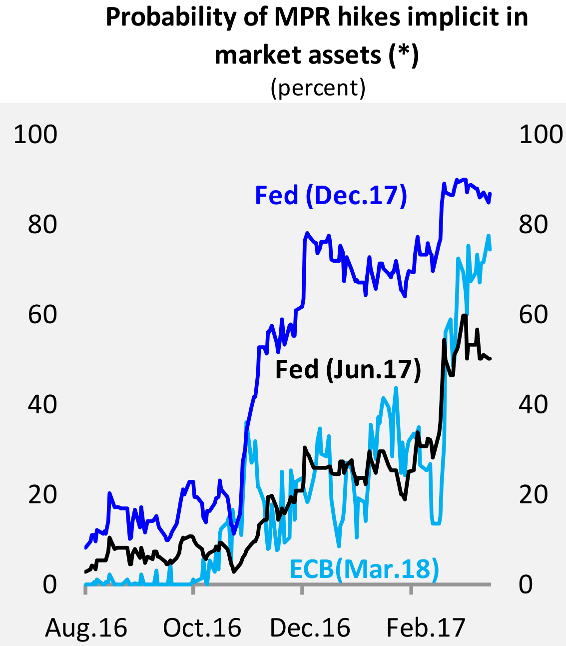
Gráfico 9



(*) Measured using the purchasing managers' index (PMI).
Source: Bloomberg.

Figure 10





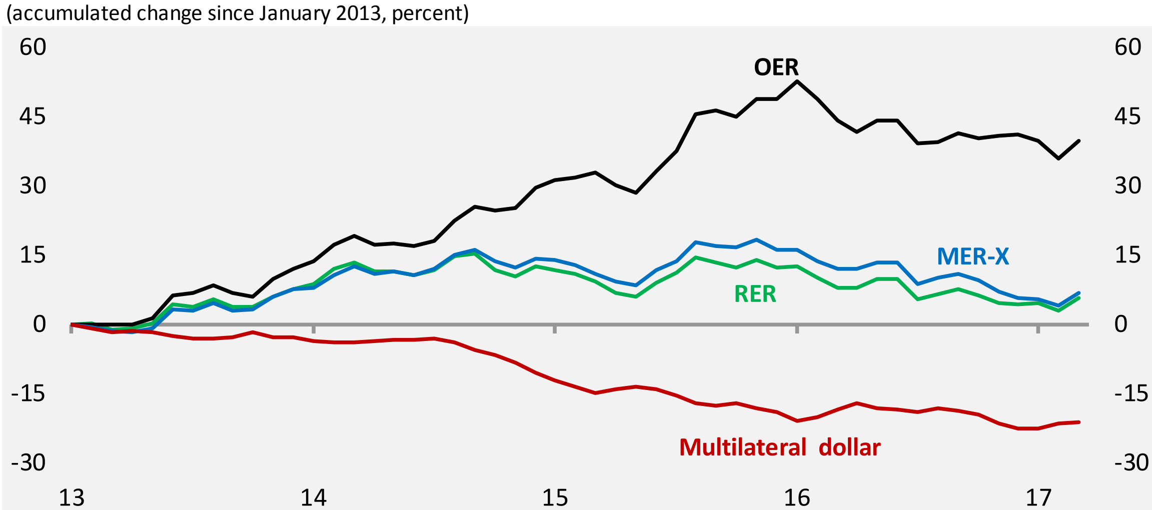
(*) Fed fund future contracts are used for the Fed; OIS for the ECB. In parentheses, the month at which the hike is expected.

Source: Bloomberg.

Figure 11

Exchange rate (1) (2)

(accumulated change since January 2013, percent)



(1) Increase (decrease) indicates depreciation (appreciation).

(2) March 2017 data contain information up to the statistical cutoff date.

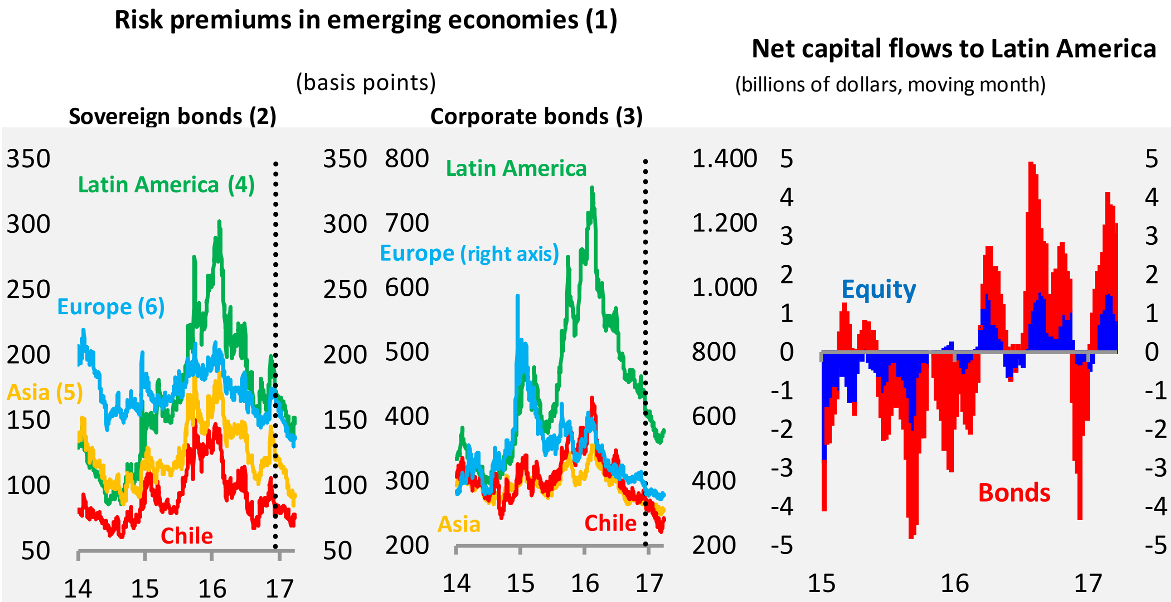
Sources: Central Bank of Chile and Bloomberg.

Table 2
International scenario

	2.015 €	2016 (e) Dec.16 Report	2016 (e) Mar.17 Report	2017 (f) Dec.16 Report	2017 (f) Mar.17 Report	2018 (f) Dec.16 Report	2018 (f) Mar.17 Report
	(annual change, percent)						
Terms of trade	-4.2	0.4	1.9	1.1	4.6	-0.5	-0.5
Trading partners' GDP	3.2	2.9	2.8	3.2	3.3	3.4	3.5
World GDP at PPP	3.2	3.1	3.0	3.3	3.4	3.5	3.5
World GDP at market exchange rates	2.6	2.3	2.3	2.6	2.8	2.8	2.9
United States	2.6	1.6	1.6	2.3	2.3	2.3	2.3
China	6.9	6.7	6.7	6.2	6.4	6.0	6.2
Eurozone	2.0	1.6	1.7	1.5	1.7	1.6	1.7
Latin America (excl. Chile)	-0.4	-1.2	-1.8	1.4	1.3	2.3	2.5
External prices (in US$)	-9.8	-2.5	-2.7	1.1	2.1	1.7	1.3
	(levels)						
LME copper price (US$cent/lb)	249	220	221	235	255	240	250
WTI oil price (US$/barrel)	49	43	43	54	50	55	50
Brent oil price (US$/barrel)	52	44	44	56	52	57	52
Gasoline parity price (US$/m3)	467	389	389	461	457	464	444
Libor US$ (nominal, 90 days)	0.3	0.8	0.7	1.5	1.5	2.5	2.5

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

Figure 12

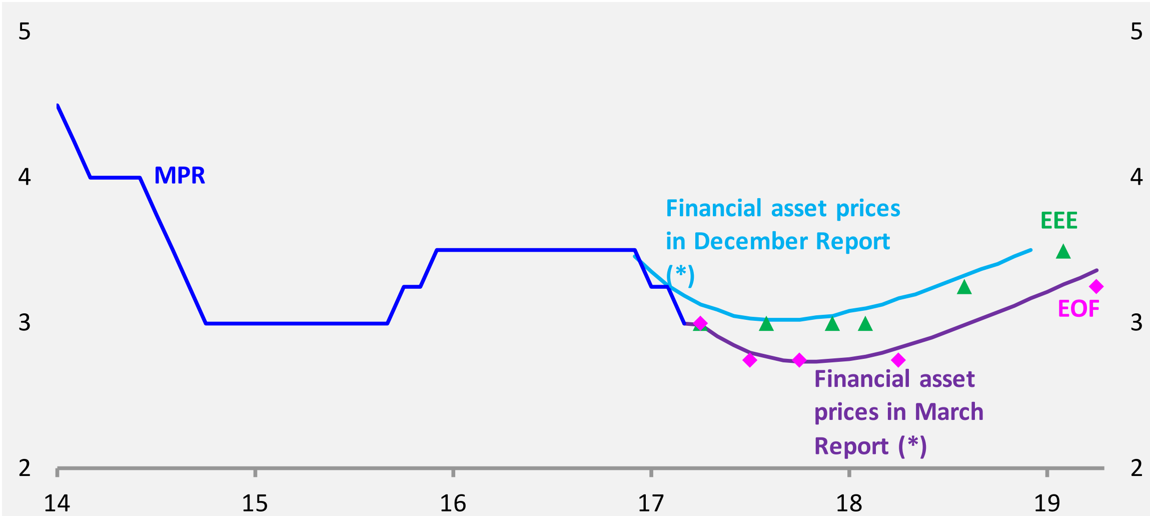


(1) Dotted vertical line marks statistical cutoff date for the December 2016 Monetary Policy Report.
(2) Measured by 5-year CDS premiums. Simple average of each region' countries. (3) Measured by the CEMBI. (4) Includes Brazil, Colombia, Mexico, Panama and Peru. (5) Includes China, Indonesia, Malaysia, the Philippines and Thailand. (6) Includes Bulgaria, Croatia, the Czech Republic, Hungary and Turkey.
Sources: Bloomberg and Emerging Portfolio Fund Research.

Figure 13

MPR and expectations

(percent)



(*) Built using interest rates in swap contracts up to 10 years.
Source: Central Bank of Chile.