SOUTHERN CONE AND ANDEAN OPPORTUNITIES CONFERENCE

CHILE: THE VIEW FROM THE CENTRAL BANK

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Current macroeconomic conditions and prospects in the monetary policy scenario

1. The last few months have brought mixed signals for the Chilean economy. On the one hand, 2016 ended in a low tone, with a slowdown in activity and inflation. A series of one-off events extended economic weakness into the first quarter of 2017, lowering forecasts for the year as a whole. On the other, the global outlook appears more favorable, both for the growth of trade partners and terms of trade. This suggests a gradual improvement of economic prospects for the Chilean economy which should be further supported by an expansionary monetary policy as long as inflation remains below target.

2. Activity data and expectations in advanced economies have been more upbeat, marked by better than expected performance by the manufacturing sector and a broadening of the growth outlook across countries following years of stagnation. As a result, deflationary risks have dissipated, as inflation is expected to return to more normal levels. The Federal Reserve (Fed) has continued to normalize monetary policy and monetary authorities in Europe and Japan appear to have set aside the possibility of additional stimulus measures. Markets have incorporated these changes in their expectations avoiding any serious disruptions. Along with better signs in advanced economies, activity in China has remained relatively stable, which contrasts with what had been observed one year ago.

3. In this context, there has been an increase in the willingness to take on risk in financial markets, increasing stock market indices, reducing sovereign risk premiums and increasing capital flows to emerging markets. Commodity prices have also benefitted. Copper, our main export product, has been trading at prices near two year highs and prospects for the next few years have improved, which has had a material impact on the Chilean terms of trade. Thus, based on better growth prospects for our trading partners, favorable external financial conditions and increased terms of trade, the baseline scenario included in the Monetary Policy Report published at the beginning of April, considered that, for the next two years, the Chilean economy will receive an external impulse higher than considered at the end of 2016 (Figure 1).

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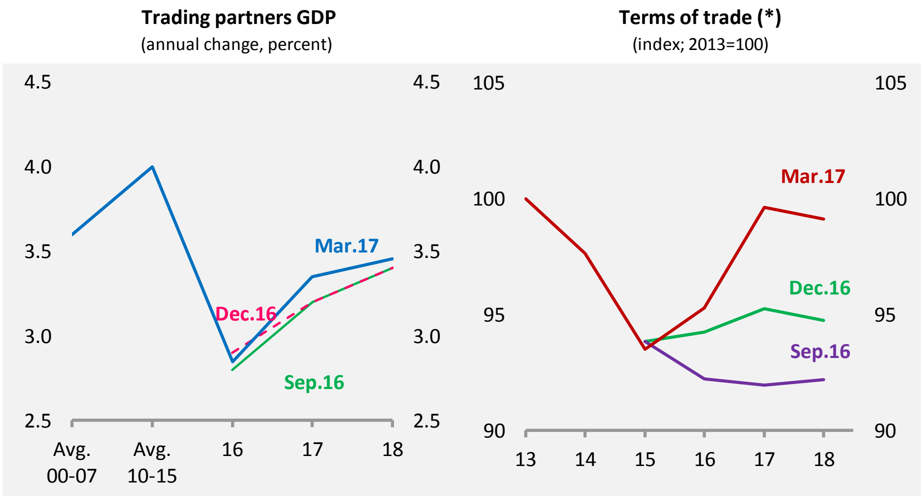
[1]/ Keynote speech at the VI JP Morgan Southern Cone and Andean Opportunities Conference, April 25th, 2017. This speech is based upon that delivered at The Council of the Americas, April 20th, 2017.

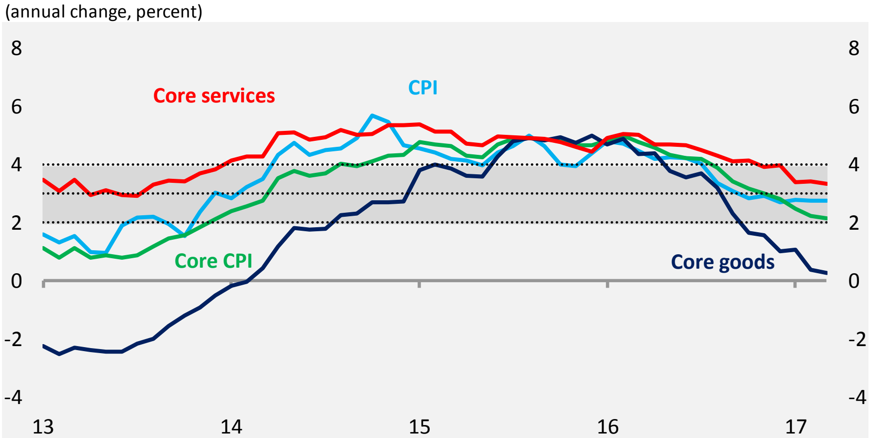
Figure 1



(*) For comparison effects with the new 2013 Benchmark Compilation, the ToT of previous Reports are adjusted to 100 for 2013.
Source: Central Bank of Chile.

4. On the domestic front, inflation has been consistent with what was expected in December. The annual variation of the CPI fell to 2.7% in March, a significant drop compared to the 4.5% figure of a year ago. The behavior of the nominal exchange rate, which has appreciated relative to its level one year ago, has been a fundamental driver of these dynamics. The appreciation has had a greater impact in the decline of the goods component of the CPIEFE index (our core inflation measure). In fact, the goods component of core inflation dropped from nearly 5% at the beginning of 2016 to 0.3% in March. The services component has been stickier, and has dropped from the same levels the first few month of last year to 3.3% in March. Approximately ¾ of the prices included in this component are managed or indexed prices, which enhances their inertia and, as such, makes them less sensitive to exchange rate fluctuations (Figure 2).

Figure 2
Inflation indicators (*)
(annual change, percent)

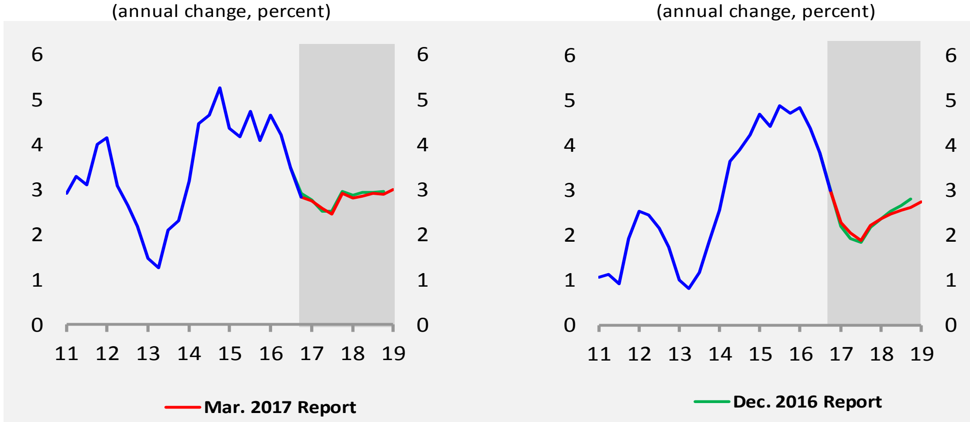


(*) Starting from January 2014 the new indexes with base year 2013=100 are used, and are thus not strictly comparable with previous figures.
Sources: Central Bank of Chile and National Statistics Institute.

5. Although in the baseline scenario headline inflation is expected to continue declining in the coming months towards the lower bound of our tolerance range, it is foreseen to return to 3% by the end of 2017 and fluctuate close to target towards the first quarter of 2019. Market expectations are very similar to our forecasts. Convergence of inflation rests on two main assumptions: first, that our RER will remain relatively stable at its current levels --a level we believe is consistent with fundamentals-- and, second, that the output gap will gradually close by the end of this year (Figure 3).

Figure 3

CPI Inflation (*) (annual change, percent) — **Core inflation (*)** (annual change, percent)

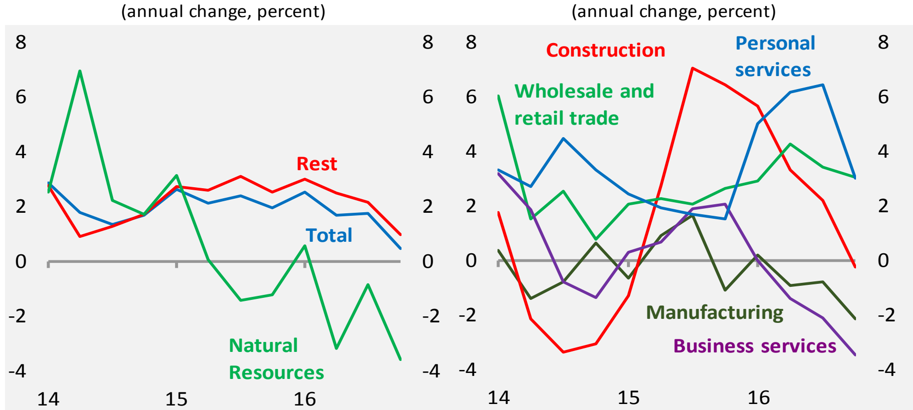


(*) The grey area, starting from the first quarter of 2017, corresponds to the forecast.
Sources: Central Bank of Chile and National Statistics Institute.

6. Activity has been somewhat weaker than expected. According to recent data the output gap is currently larger than we anticipated in December. GDP grew by 1.6% in 2016, in line with what was anticipated. However, revised national account data suggests the economy was somewhat stronger towards the beginning of 2016 and weaker towards the end of the year, leaving a low starting point for 2017 and a higher base of comparison for the beginning of the year. The new data also point to weakness in investment-related areas and in sectors that tend to be more persistent, such as business services (Figure 4).

Figure 4

GDP (annual change, percent) — **Non-natural resources GDP** (annual change, percent)



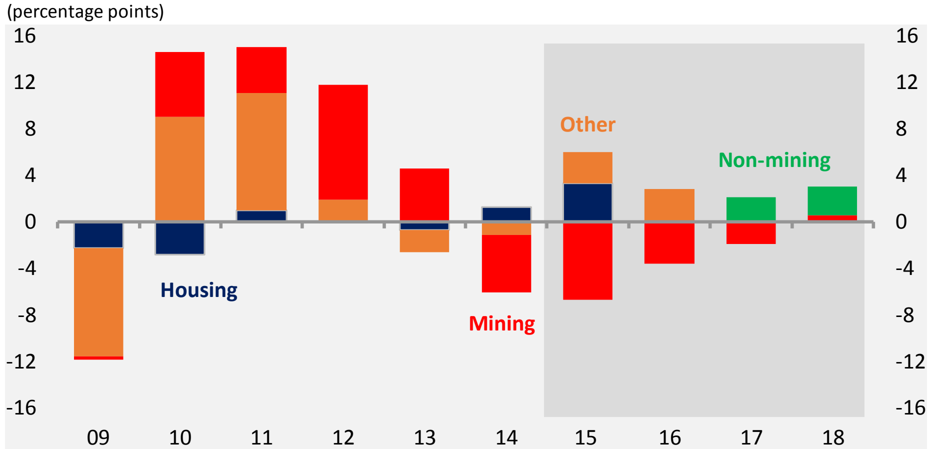
Source: Central Bank of Chile.

7. On the expenditure side, domestic demand—excluding changes in inventories—also tended to decelerate throughout last year. Weakness was most evident in investment in construction and other works, which contracted by 4.9% in annual terms during the fourth quarter (average growth of 0.5% between the first and third quarters).

8. Private consumption, in line with its behavior in previous years, provided support to the economy, growing by more than 2% annually throughout 2016, on the basis of wage growth and a low unemployment. However, it should be noted that while consumption of non-durables and services has remained relatively stable, durable goods have recovered, partly due to the appreciation of the peso during the last year and the necessary replenishment of inventories following several years of weak growth and even contraction. Something similar is observed with gross fixed capital formation in machinery and equipment. Excluding the purchase of non-regular transport machinery, this component of investment has improved in recent months.

9. In our baseline scenario, gross fixed capital formation should experience a slightly positive growth in 2017, after three consecutive years of contraction. A key factor in the negative figures of the last few years is the ending of the mining investment cycle, which reached its peak in 2012. More recently the deterioration of housing construction has added, as the boom triggered by tax incentives finished and a modification of loan-to-value norms reduced home sales. Going forward, our forecasts rely on an increase in non-mining and non-residential investment (mainly machinery and equipment). While mining investment will eventually return to positive territory during 2018, the gradual adjustment in residential investment is expected to continue during the following quarters (Figure 5).

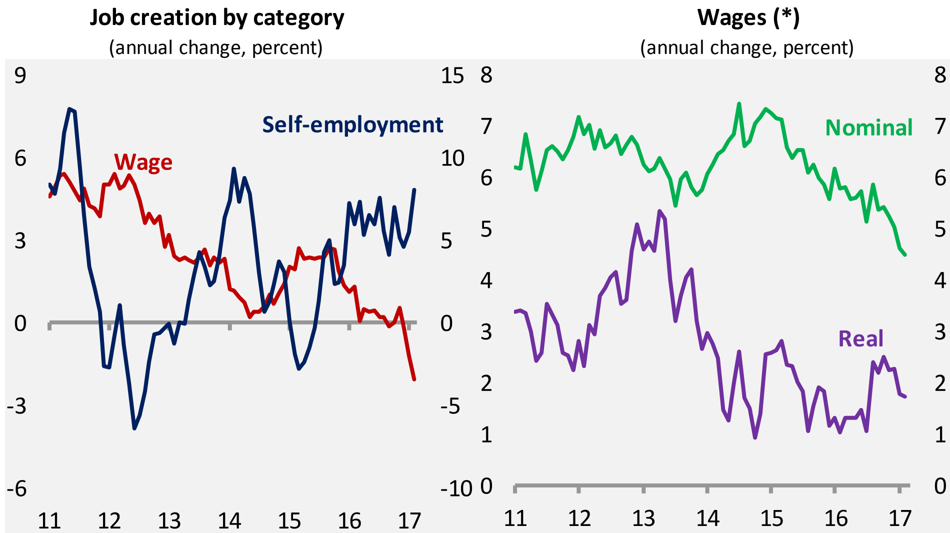
Figure 5
Real annual contribution to GFCF (*)
(percentage points)



(*) For sectoral GFCF, variations of the 2008 Benchmark Compilation are used. Since total GFCF is expressed using the 2013 Benchmark Compilation, annual variation of other GFCF is adjusted for consistency purposes. Estimations for 2015 and 2016 based on available information from listed companies (FECU), Capital Goods corporation surveys, Chilean Chamber of Construction and National Accounts by institutional sector. For 2017 and 2018, Central Bank projection models and sectoral sources are used, including investment plans and Capital Goods Corporation surveys.
Source: Central Bank of Chile.

10. The labor market continues to gradually adjust and runs the risk of becoming a drag on consumption. Wage employment declined by 2% annually in the moving quarter ending February, and annual wage growth moderated. In addition, working hours declined due to demand rather than supply reasons. Yet this has not translated into an increase in open unemployment, due to flexibility in the Chilean labor market: the unemployment rate is still low from an historic perspective. In fact, despite being more precarious, self-employment has acted as a significant buffer to the loss of dynamism in wage employment (Figure 6).

Figure 6

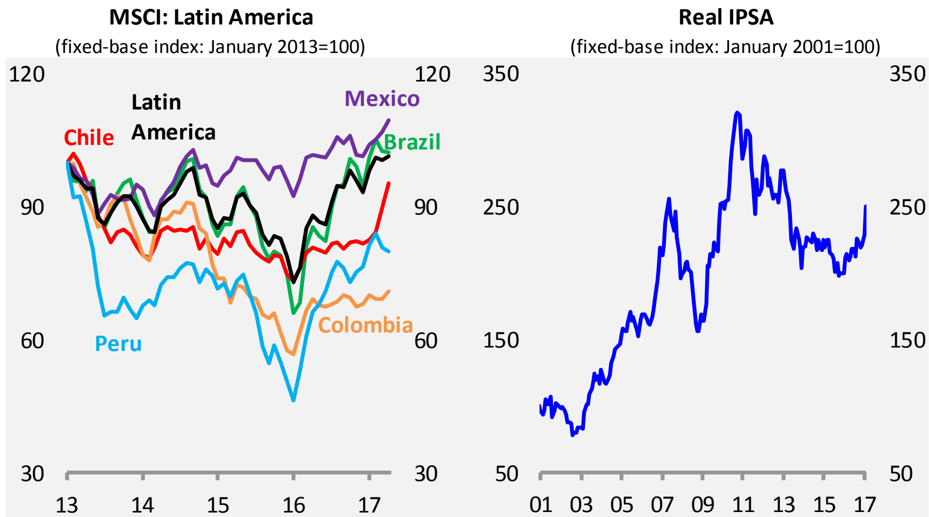


(*) Both the nominal and the real correspond to the average of the annual variation of IREM and CMO.
Source: National Statistics Institute (INE).

11. Domestic financial conditions remain favorable, particularly in terms of interest rates. Notwithstanding, credit volumes have decelerated with respect to previous years, as a result of overall subdued demand. Despite some increase in recent data, NPL ratios remain low, a clear sign that slower growth has not affected the financial health of companies and households.

12. The evolution of the local stock market has caught some attention lately, since the IPSA has increased about 17% this year and more than 30% since December 2015. Although these numbers might ring some bells, the performance of the Chilean index does not differ significantly from other regional stock markets and its recent behavior might just be a catch up from very low levels. Measured in real terms, its current value does not seem to be an outlier either (Figure 7).

Figure 7



Sources: Central Bank of Chile and Bloomberg.

13. The prolonged strike at La Escondida, the world´s largest open-pit copper mine, will have a very important effect on the first quarter GDP figures. It already did in the Imacec of February, which showed a yoy contraction of 1.3%, with a fall of 17.1% of its mining component. Since the strike ended in late March and resumption of production is not immediate, figures for that month will also be affected. Adding up the continued weakness in construction, the economy could experience an expansion close to 0% in the first quarter of the year. However, one should not forget that the strike at La Escondida, while very relevant to explain the first quarter figure, is a one-off event that is not expected to generate significant spillovers on activity elsewhere in the economy, nor on inflation.

14. On the basis of these data the Central Bank reduced its growth forecast for 2017 to 1-2%, compared to 1.5-2.5% in December. At the same time, for 2018 we are expecting the economy to grow between 2.25 and 3.25% (Table 1), based on the fact that the economy does not appear to have any relevant imbalances, the mining-related investment adjustment is expected to end, and a more favorable external outlook. Fiscal policy is assumed to follow the fiscal consolidation path announced by the Government.

Table 1
Domestic scenario
(annual change, percent)

	2015	2016 (e)		2017 (f)		2018 (f)
		Dec.16 *Report*	Mar.17 *Report*	Dec.16 *Report*	Mar.17 *Report*	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 saving (% of GDP)	21.4	19.3	20.2	19.2	20.3	20.5
GFCF (% of nominal GDP)	23.6	22.2	23.2	21.7	22.5	22.6

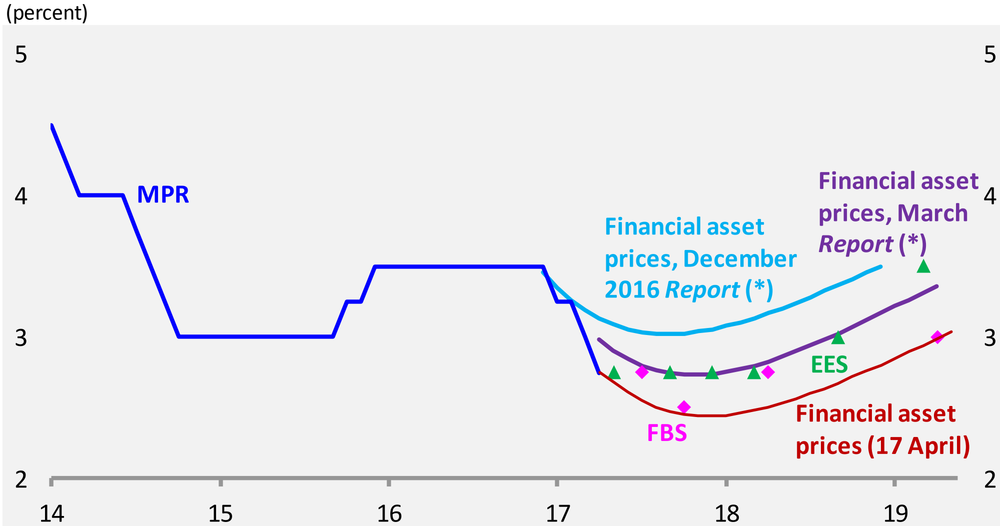
(e) Estimate.
(f) Forecast.
Source: Central Bank of Chile.

15. Our base scenario assumes that monetary policy will remain accomodative throughout the policy horizon. Following the adoption of an expansionary bias in December, the policy rate has been cut 75bp, acting promptly upon the prospects of a softer economy. In the April monetary policy meeting, while adopting the last 25bp cut in this series, the Central Bank Board signaled that it could consider some further policy easing if economic prospects remained subdued. This is reflected in the evolution of market expectations (Figure 8). Compared to a neutral real rate of 1%-1.5% Chile´s monetary policy continues to be one of the most expansionary among comparable economies.

Figure 8

MPR and expectations

(percent)



(*) Constructed using interest rates on swap contracts up to 10 years.

Source: Central Bank of Chile.

16. As usual with forecasts, this macroeconomic scenario is exposed to risks. External risks include political and policy risks, especially concentrated on fiscal and monetary policy decisions in the US. China remains a concern although its authorities appear to have successfully managed a gradual deceleration without a major disruption thus far. External risks are particularly relevant for a small open economy like Chile´s. Upside risks essentially emerge from a more robust expansion of the world economy and additional improvement in terms of trade.

17. On the domestic front, several years of subdued growth may have caused some underlying erosion that could compromise the economy’s ability to grow in the medium term. Deterioration of the labor market is particularly risky because it could weaken household consumption, which, by growing 2%-2.5% annually over the last three years has provided support for domestic demand and, ultimately, inflation. On the other hand, private investment may recover faster if export demand and expectations improve faster than expected.

Longer-term perspectives

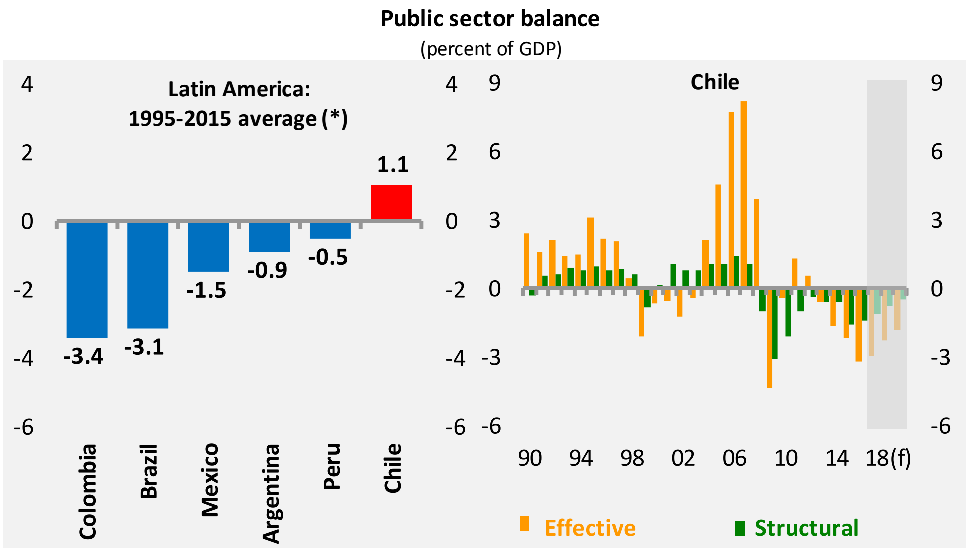
18. In 2012-2013 the Chilean economy was exposed to a substantial external shock given by the end of the commodities super cycle. However, contrary to past episodes, the economy did not fall into a recession. In fact, despite a substantial slow down, the signs of an economic contraction are not visible. Salaried employment slowed down but no massive layoffs have taken place. Companies saw their margins compressed by rising input costs and weak demand, but bankruptcies have not picked up. The demand for loans has weakened, but NPLs have remained stable.

19. The former is due to two major reasons. First, the macroeconomic policy framework has provided countercyclical support while allowing relative prices to adjust to the new circumstances via the exchange rate. Between mid-2013 and early 2016 the Chilean peso depreciated some 55%, putting some pressure on inflation, but the Central Bank kept monetary policy on a steady course until inflation decelerated from nearly 5% to less than 2% in less than a year.

20. The second reason is that domestic markets and economic agents have been able to adapt to changing circumstances. In the labor market there has been substantial mobility between sectors and from salaried to self-employment, while nominal wages and working hours have adjusted gradually. The corporate sector has cut on costs, improved operational efficiency and refinanced its debt. Financing conditions have remained historically favorable and banks have adjusted loan-loss provisions without rationing credit.

21. The above indicates not only that the Chilean economy has become more resilient than in the past but also that it is well prepared to resume growth. In fact, there are no major macroeconomic constraints to grow beyond the current rates. On the one hand, financial conditions are highly favorable and corporations and financial institutions face no liquidity constraints. On the other, with a current account deficit of 1.6% of GDP, Chile has little pressure from external savings. Finally, public net debt is only slightly positive and there is very little risk of crowding out private investment.

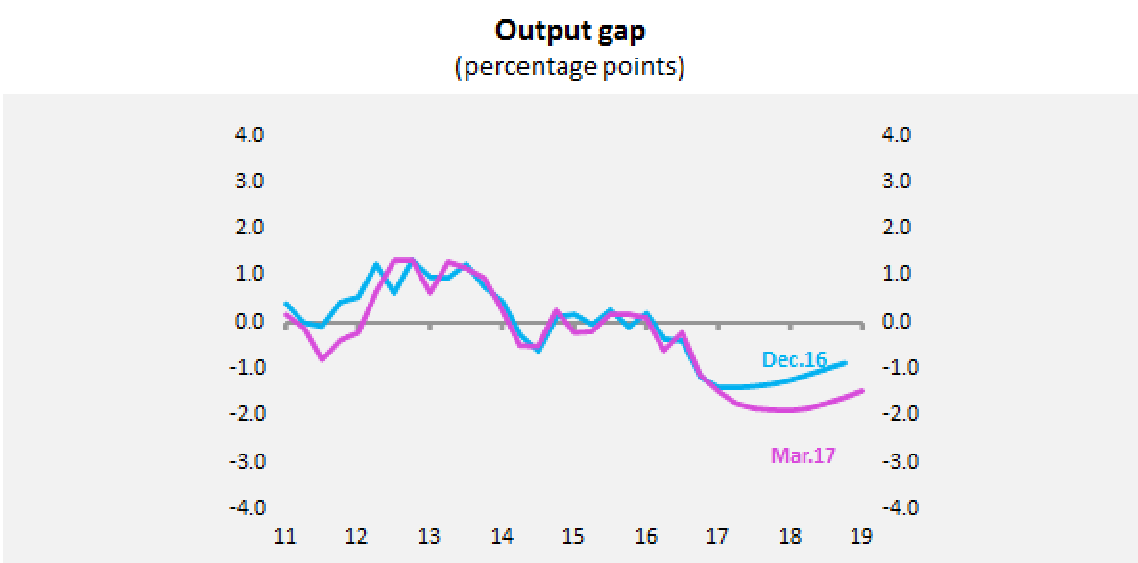
Figure 9



(*) General Government Financial Balance.
(f) For 2017 to 2019, forecasts obtained from the 2016 Public Finances Report.
Sources: Moody's and National Budget Department, Ministry of Finance of Chile.

22. This is one of the factors that explain the CB estimates of growth at 2.25%-3.25% in 2018. Other factors include improving external conditions, the expansionary monetary policy and the gradual disappearance of idiosyncratic factors that have dragged down economic activity in recent years. According to the CB growth should resume gradually from the second quarter of 2017 to gain speed and start reducing the output gap, currently at 1 ½ per cent, in the second half of the year (Figure 10).

Figure 10



Source: Central Bank of Chile.

23. The above compares to a potential growth between 2.5% and 3%, according to the latest Central Bank estimates. This is indeed significantly lower than trend growth rates close to 5% in the mid-2000s. However, the same Central Bank analysis indicates that reallocating resources beyond the shorter term, recovering the historical investment/GDP ratios and resuming the increase of participation rates of women in the labor force could allow the country to attain trend growth of about 3.5% per year. This suggests that the Chilean economy still has considerably headroom to grow.

The challenges

24. Speeding up growth with price stability in Chile still faces some important challenges. First and foremost, closing the current output gap would require recovering productive investment that has remained particularly weak over the last four years. Part of this is due to a substantial drop in investment in the mining sector, but gross capital formation in sectors other than mining has also faltered. While recent data points towards an increase in machinery imports, a more substantial change would require an improvement in business expectations that have remained in negative territory for some time.

25. The possibility of raising potential growth beyond the figures quoted above relies mainly on: (1) increasing human capital accumulation through increased labor participation, raising working skills above the already projected levels or the migration of workers with the competences required by the Chilean system; and (2) making productivity improvements via enhancing companies' efficiency, lowering production and trading costs, and changing output composition toward more competitive and productive sectors, while advancing in terms of innovation and technological development.

26. As Chile's concern for growth has intensified, many ideas about public policies have emerged that could help enhance productivity, with proposals coming from the government, private agents and the National Productivity Commission. In particular, policies have been developed that have permitted to diversify the energy matrix, increase supply reliability and reduce costs. There have been other factors, however, that pose a risk to productivity, including initiatives that may overburden corporate costs, generate new trading costs or reduce savings. Last, but not least, any discussion about productivity must necessarily cover technological development and innovation, which in Chile is limited by low private and public investment in R&D and by discontinuity in long-term policies aiming at economic diversification.

27. A third key challenge for the Chilean economy is to strengthen its institutions and making them more trustworthy. Even though Chile enjoys a substantial advantage in this respect over other emerging countries, trust in public and private institutions has suffered from a series of scandals in recent times and rebuilding such trust would require consistent action over a number of years. Such effort, however, would be well justified since a low-trust economy is likely to suffer from high transaction costs, free-riding behavior and low policy effectiveness.

28. The former three elements—investor expectations, potential growth and institutional trust—are certainly not part of the conventional agenda of central banks. However, even a narrow focus on stable and low inflation requires monitoring the key developments affecting the future path of the economy. While the Central Bank can contribute indirectly to these goals by reducing economic instability and uncertainty, it would greatly benefit from the additional flexibility, effectiveness and welfare that they would be able to build.