MONETARY POLICY REPORT

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

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*See the March 2018 *Monetary Policy Report* at http://www.bcentral.cl.

Mr. President of the Senate's Finance Commission, senator Juan Pablo Letelier, senators members of this Committee, ladies, gentlemen,

I am grateful for your invitation to present the vision of the Board of the Central Bank of Chile on the latest economic developments, their perspectives and implications for monetary policy. This vision is contained in detail in our *Monetary Policy Report* (the Report) of March 2018.

First and foremost, let me introduce to you our new Board member Mr. Alberto Naudon, who became part of the Board only a few days back, after being unanimously recommended by this Committee and then his appointment approved, also unanimously, by the Senate.

It is worth noting that this is the first time we present the Report under the new monetary policy scheme that we began this year and under which we have tied its release with the monetary policy meetings. With these changes, we have significantly increased the information we deliver, establishing its relationship with monetary policy decisions more clearly. The greater transparency required by this scheme makes it necessary for the dates of our Meetings and the subsequent publication of the Monetary Policy Report to be communicated to the market well in advance, so that there are no surprises in this regard. For the same reason, as was the case with this Report, the time span between the Report's publication and this presentation has been a little longer. Please note that we see this delay as a one-time thing and we are willing to attend this Committee to present our Monetary Policy Reports with all the haste that you may require. We have used this opportunity to add some information that came after the Report's cutoff date to this presentation, plus some issues that have come up in the days following its publication. Thus, we look forward to an exchange with the Committee as enriching as it can be.

Now let me share with you the main conclusions and projections of our Report. First, it is important to stress that this Report clearly marks a turning point in the business cycle that translates into higher growth and lower risks to both activity and inflation.

The National Accounts figures we published two weeks ago showed two important developments. On one hand, the economy was quite weak between late 2016 and early 2017. In retrospect, these figures are consistent with other recent indicators such as labor market fundamentals, which were some of the reasons why we lowered the monetary policy rate (MPR) by 100 basis points, thus significantly boosting the monetary impulse in the first half of 2017. On the other hand, they confirmed that the economy performed better in the second half of the year, accumulating two quarters of increasing growth, a significant recovery of investment and sustained export growth.

What is behind this economic improvement? Certainly, the substantial impulse from monetary policy has played a part. In addition, external financial conditions have been improving steadily over the past year and investment has recovered, all within a context of improved expectations.

It should be noted that this growth in activity in the past few quarters obeys to a recovery within the dynamics of the business cycle. We anticipated these improvements in our projections quite some time ago (figure 1). The evolution of our forecasts shows that at least as far back as a year ago we estimated growth for 2018 significantly stronger than in 2017; this projection did not change much throughout 2017. Private growth expectations for these years, albeit with some lag, gradually aligned with our own.

Overall, the upward correction to the 2018 growth forecast is important and responds to several factors. For one, the higher growth of the second half of 2017 gives a higher base for the beginning of the year. Also, there is a further improvement in external conditions, as reflected in stronger growth of Chile's trading partners (3.7% average for 2017/2019 in this Report vs. 3.5% in December) and commodity prices that remain above projections (figure 2).

Add to this the persistence of the expansionary impulse from monetary policy, as can be seen by simple observation of the interest rates of consumer, commercial or mortgage loans, which are all at or very near their all-time lows. Moreover, different qualitative measures produced by the Bank, such as the Banking Credit Survey or the Business Perceptions Report, coincide in their favorable evaluation of the cost of credit, considering its low interest rate. Another way to measure the expansionary nature of monetary policy is to review how far or near the MPR is from its estimated neutral level, which we place between 4% and 4.5%. Therefore, a 2.5% MPR is clearly expansionary and, in our baseline scenario, we assume that we will come near the neutral level only by 2020. Furthermore, beyond the comparison with market rates or their neutral levels, Chile's monetary policy rate is among the lowest when compared to its Latin American peers or with other commodity-exporting countries with a similar macroeconomic framework (figure 3).

The better prospects for 2018 growth also rely on the recovery of non-mining investment, including construction and other works, whose decline seems to be ending after one and a half years, which combines with a moderate growth in consumption (figure 4). All this is backed by improved consumer and business confidence indicators, which becomes all the more evident when referring to expectations about the future.

These factors are not necessarily independent of each other, so it is difficult to quantify the importance of each one precisely. The important thing is that taken together they set a more favorable outlook for activity in 2018 and, possibly, in the years to come. Actually, in this Report we present our first growth forecast for the years 2019 and 2020,[1] which indicates that the economy should grow between 3.25% and 4.25% next year, and between 3% and 4% in 2020. With these projections, we estimate that the activity gap will progressively close until 2020. This considers that potential GDP growth, currently estimated between 2.5% and 3%, is approaching trend growth, which we estimate between 3% and 3.5% (figure 5).

For the purposes of the inflation outlook, the somewhat faster closing of the activity gap will compensate in the medium term the downward pressure of inflation derived from the peso appreciation of recent months. At the end of March, the peso had fallen by 4.5% compared to its average value for the fourth quarter of 2017, which is equivalent to a drop of around CLP25 per dollar. This owes to several factors. Abroad, the main thing has been a global trend of depreciation of the dollar and a copper price persisting above US$3 per pound. The interest rate differential between Chile and the US, although theoretically important, empirically has a somewhat smaller effect. There have also been domestic factors mainly that the Chilean economy has been improving both its actual and expected performance. Plus, some short-term elements, for example in January and February the exchange

[1] As stated in a box in this Report, from now on, and with the purpose of enhancing the transparency the Board's vision about the economy and the path of monetary policy, it has been decided to add a third year in the projections published on each opportunity. Thus, starting in March 2018, every Report will include the growth and inflation forecasts for the next three years: the current year and the next two. These forecasts will continue to be reported in two ways; the estimated variable in the baseline scenario. For inflation, it will remain a specific number, while for growth it will be a range, as it is now done for the present year and next. This change adds to those adopted in March 2016, when the Board decided to extend by one year the growth forecast for activity.

rate decrease coincided with carry trade operations, foreign flows for company acquisitions, pension fund portfolio adjustments and the entry into the market of the funds from the issuance of public debt. All this has led the peso to appreciate more than other comparable currencies (figure 6). However, some of these factors have a transitory impact, with rapid trend shifts over a few days, making it difficult to establish a clear direction. Therefore, the peso has been very volatile in recent quarters, with peaks of over CLP650 in December and lows of less than CLP590 in February. However, the most notorious movements in the exchange rate have originated in its fundamentals (figure 7).

The recent appreciation of the peso is largely responsible for the lower inflation that will prevail in the short term.[2] In our Report's baseline scenario, CPI inflation will be around 2% annually until early next year, returning to near 3% by the end of 2019. Meanwhile, core inflation, as measured by the Consumer Price Index excluding Food and Energy (CPIEFE), will be close to 1.5% by the middle of this year. At the same time, we estimate that once these pressures ease and the effects of the narrowing activity gap are more notorious—it is expected to close faster than we thought before—inflation will converge to the policy target during next year (figure 8).

In this context, the Board will maintain the current monetary impulse until inflation shows clear signs of converging towards the target. This translates into a similar trajectory to the one that can be deduced from the surveys, that is, an MPR hovering around its current levels for several more months, but that by the turn of 2019 will have already begun a gradual normalization. Such normalization is likely to be completed beyond the monetary policy horizon of 24 months (figure 9).

These projections, as always, are subjected to various risks. On the external front, in terms of its impact on local activity, the risk balance is downwards biased. The main risk is the possibility of a sharp deterioration of global financial conditions facing emerging economies. A significant part comes from the US economy, which is currently near or above full employment and inflation pressures that could trigger a more forceful reaction from the Fed. Special mention deserves the fiscal stimulus package recently approved by the US Congress, which will put pressure on an economy where, as I just pointed out, gaps are already tight.[3]

It is worth stressing that the deterioration that this would cause in the global financial conditions could have particularly severe consequences for those emerging economies with weaker fiscal or financial positions or that are highly indebted. China's situation is worrisome, as there are still several imbalances in its markets yet to be

[2]/ This Report includes a box analyzing the magnitude of the pass-through coefficient of exchange rate variations to inflation, identifying the origin of the variation and establishing that its effects on inflation change depending on the type of shock faced. In particular, it reviews how the inflationary effects of exchange rate fluctuations change depending on where they originate, e.g. in a movement of the global value of the dollar as opposed to an idiosyncratic shock hitting the Chilean economy. The analysis finds that the inflationary impact of exchange rate movements associated with deviations of the interest rate parity is stronger and more persistent than if stemming from changes in foreign inflation. Thus, the implications for monetary policy are obvious: not all exchange rate variations have the same inflationary consequences and, therefore, the policy rate response must factor in their origin.

[3]/ This Report includes a box reviewing the possible impacts of the US fiscal measures. The conclusion is that, in the context of an economy with scarce capacity gaps and highly indebted, a bigger fiscal impulse will result in higher inflation and macroeconomic imbalances that will call for adjustments in the medium term. This makes the monetary-fiscal policy interaction in the US economy particularly delicate. A scenario where the Fed postpones the normalization process could create bubbles in asset prices, while if the Fed responds categorically to neutralize the fiscal stimulus, it might trigger an excessive adjustment in asset prices and an increase in volatility. Thus, the lack of coordination between fiscal and monetary policy in the United States is one of the main risks identified in this Report.

resolved, including a high level of domestic indebtedness. Any pitfalls in this process could have significant effects on the prices of global financial assets and commodities. Another important risk, which has gained importance in recent days, relates to the announced protectionist policies that may affect global trade. Beyond the short-term effects, such measures would negatively affect the world economy's and Chile's trend growth.

Domestically, the Board estimates that the risks to activity are upwards biased. The outlook for 2018 shows investment growing in line with GDP. However, it may prove more dynamic, considering the favorable external scenario, the expansionary nature of monetary policy, improved confidence indicators and the data of recent months. This risk is tempered in part because the stagnant creation of private salaried jobs and weaker growth in nominal wages continue to be causes for concern. In any case, different surveys show that the companies have improved their prospects for employment and investment in recent months, reflecting their better growth expectations (figure 10).

About inflation, the Board estimates that risks are unbiased. The threats to its convergence to 3% are milder, primarily due to the way the improved economic outlook affects the closure of capacity gaps. However, the evolution of the exchange rate over the coming months will pull inflation down below the December expectations, a situation that the Board will continue to monitor with special care, given that it could have negative implications on the convergence of inflation to the target in the policy horizon.

In short, as I noted at the beginning, this Report clearly shows a turning point in the business cycle that translates into an upward revision of the growth projections for 2018, giving way to lower risks for both activity and inflation. Anyway, in the baseline scenario that we have just presented, we consider that the risks for inflation and an economy that has yet to consolidate its greater dynamism make it necessary for the monetary stimulus to persist further. Therefore, we will only begin to raise the MPR when we are certain that the process of inflation converging to 3% is consolidating.

The analysis of external risks contained in this Report reminds us of the importance of the exchange rate being the first buffer of external shocks, causing the economy to respond through changes in relative prices rather than the levels of demand and activity. Additional evidence presented in this Report shows that countries with a floating exchange rate also reduce the volatility of long-term interest rates, which are a determinant of investment. Moreover, developing market instruments to manage foreign exchange risk generates a stronger basis for the development and diversification of exports than an uncertain state insurance through regular intervention or the fixing of the exchange rate.

It is important to recall that the attempts to sustain the exchange rate led the country to a recession in 1999, whereas the float significantly reduced the impact of the crises that originated in Argentina and Brazil in 2001-2003, the financial crisis of 2008-2009 and the end of the commodity boom in 2014. In each of these last three episodes, the exchange rate float has provided enough room for monetary policy to reduce cyclical fluctuations.

Monetary policy and its perspectives are also built using as a working assumption a defined trajectory for fiscal policy. The working assumption in this Report is that in 2018 the economy will receive a fiscal impulse in line with the budget announced by the authority. From then on, it is assumed that fiscal spending will follow the path of fiscal consolidation contained in the Medium-Term Financial Projection of the last Public Finance Report. This working assumption is based on the information made public by the tax authority. Possible adjustments to amounts and characteristics shall be incorporated as defined by the authority. This includes the formal definition of fiscal policy that the Administration must make through a decree within the first 90 days of its mandate. Finally, the public discussion on changes in fiscal figures reinforces the need to improve the institutional framework around the issue. Any policy based on rules is effective only if it is predictable, which relies on the stability and clarity of its methodology, the commitment to comply with it and the transparency of its effective compliance.

In any case, for the projections in this Report to come true, especially in terms of growth, an attentive and constructive attitude from all sectors is required. The Chilean economy may continue to grow in the short term because it has no major limitations on the macroeconomic side. The activity gap with respect to its potential is still significant, the current account deficit is moderate, financial conditions are favorable and inflation is low. If the plans of gradual normalization of monetary policy in the developed countries remain in place, the external conditions will continue to be good. Finally, the Central Bank will maintain the monetary impulse until it sees clear signs of inflation converging to the target and will then withdraw it gradually.

However, this recovery of growth will occur most certainly, if investment recovers accordingly. This is the component of demand that lags the most and, at the same time, contributes to increase potential growth, helping to avoid price pressures and thus generating a more gradual convergence of inflation. Although the latest data shows an improvement in investment, and our projections assume that this variable will increase more than GDP in the 2018/2020 triennium, this is not assured. For it to materialize, some conditions are necessary, including an efficient financial system and authorities maintaining a favorable climate, helping projects to meet the environmental, urban and social standards adopted by the country. It is always important to be aware that investment is very sensitive to changes in the external and internal scenarios and depends strongly on having favorable conditions for projects to develop.

In a more medium-term view, even in a scenario where the economy behaves as expected in the coming quarters, the fact that activity grows steadily at a faster-than-expected pace requires some changes of a more structural nature. Under current conditions, it is not possible to think that the Chilean economy can sustain growth rates above 3% to 3.5% in the long term, which is our estimate for trend growth in the medium term. In September of last year, we presented the Senate a document in which we gave an account of the factors producing this estimate of potential growth and possible ways to improve it. Importantly, behind the growth of sectors other than natural resources—Other GDP—was the fact that improvements in human capital, the incorporation of women into the labor force, and immigration, would help to offset the negative effects of the aging of the Chilean population and the tendency to reduce the actual number of hours worked that comes with development. This projection assumed a relatively neutral role for capital, in the sense that it expanded at the same rate as Other GDP. This assumption is consistent with the capital/product ratio remaining near its historical average, a stylized fact observed in other countries as well. For this to occur, however, it is necessary for investment to grow in consistency with potential GDP growth again.

Our projection also assumed that total factor productivity of the sectors unrelated to natural resources would go back to grow at rates around its average of the last twenty years, a major challenge, but clearly possible. The recovery of the growth trend of productivity of these sectors will be especially important, given the declining trend of natural resources, mainly associated with mining ore downgrade. Finally, we show that the Chilean evidence suggests that there are significant inefficiencies in the allocation of resources among firms and that there would be first-order gains from measures to improve them, which, unlike the case of human capital, could generate profits sooner. Although these policies fall outside the scope of the Central Bank, we believe it is important to reiterate their relevance to this Committee.

Another relevant issue beyond the economic conjuncture is the need for the economy to recover the buffers that allowed macroeconomic policy to operate countercyclically. Chile's macroeconomic policy framework proved especially effective in the current cycle. One example of this is that monetary policy was able to accommodate a significant rise in inflation caused by a depreciation of the currency, by favoring a reduction in interest rates. This, because it was evaluated that the effect of the cyclical weakness of the economy on inflation would weigh more than the effects of the exchange rate increase. In the past, a similar situation would have been solved with a rate hike that would have had negative effects on activity. This has been made possible by our economic policy framework that was built based on a low level of public indebtedness, a high degree of capitalization of financial institutions, the financial solvency of companies and households, the credibility of fiscal and monetary policy, and an adequate level of international reserves. However, the slow growth of the economy over the past several years has partly used up these buffers. The level of public indebtedness has increased, banks have reduced their capital gaps and household debt has grown, while employment, having moved to more self-employed occupations, has less room to sustain itself without an increase in mean productivity (figure 11).

For this reason, we believe it is important that as the economy returns to higher growth rates, we recover these buffers, in order to be well prepared for possible shocks in the future. Thus, this new cycle makes us once again face the challenge of laying the foundations for a more stable economy, so that negative cycles do not affect us as deeply as they used to in the past. The Central Bank will be available to do its part in this effort, especially in terms of controlling inflation and safeguarding financial stability, thereby contributing to the well-being of the Chilean population.

Thank you for your attention. Now if you have any questions, please feel free to ask.

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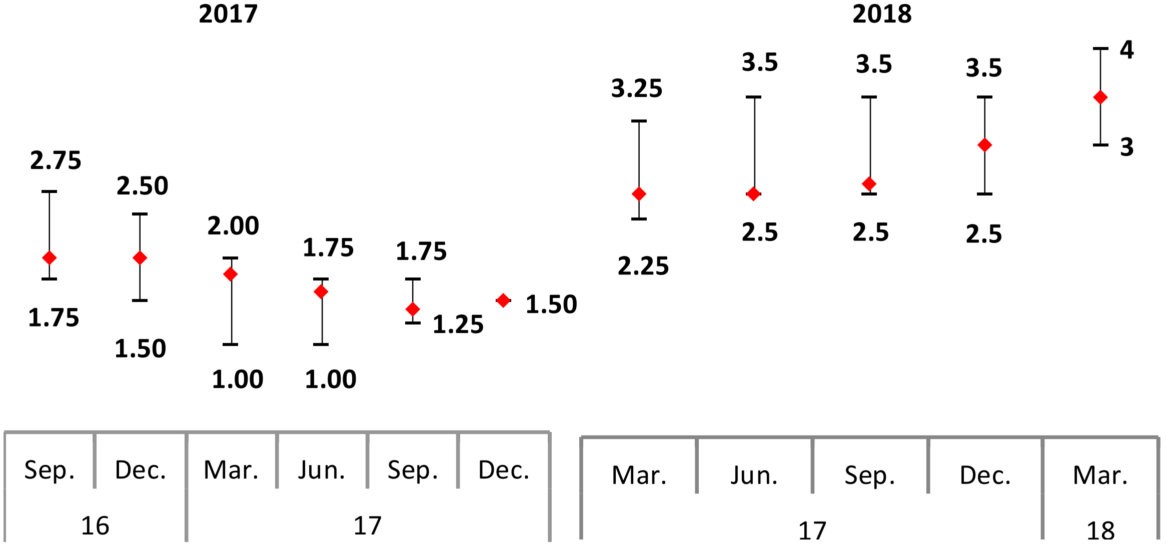
Figure 1

Growth forecasts (*)

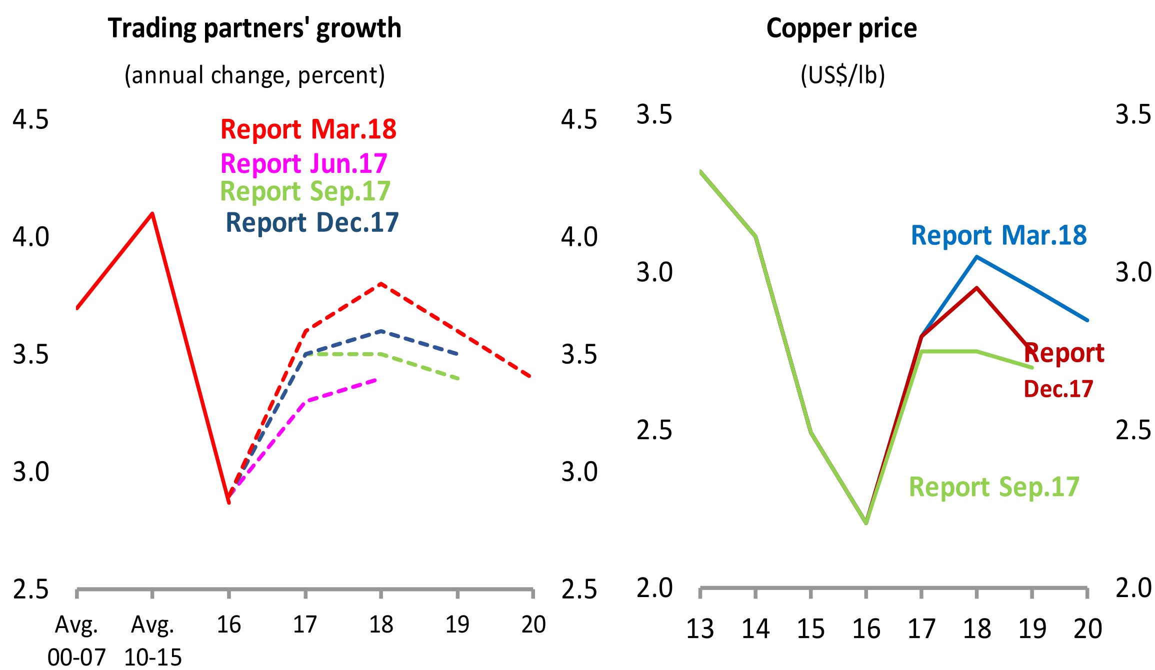
(real annual change, percent)



(*) The ranges show the growth forecast in each Report. Red diamonds correspond to the Economic Expectations Survey at the respective statistical cutoff.

Source: Central Bank of Chile.

Figure 2

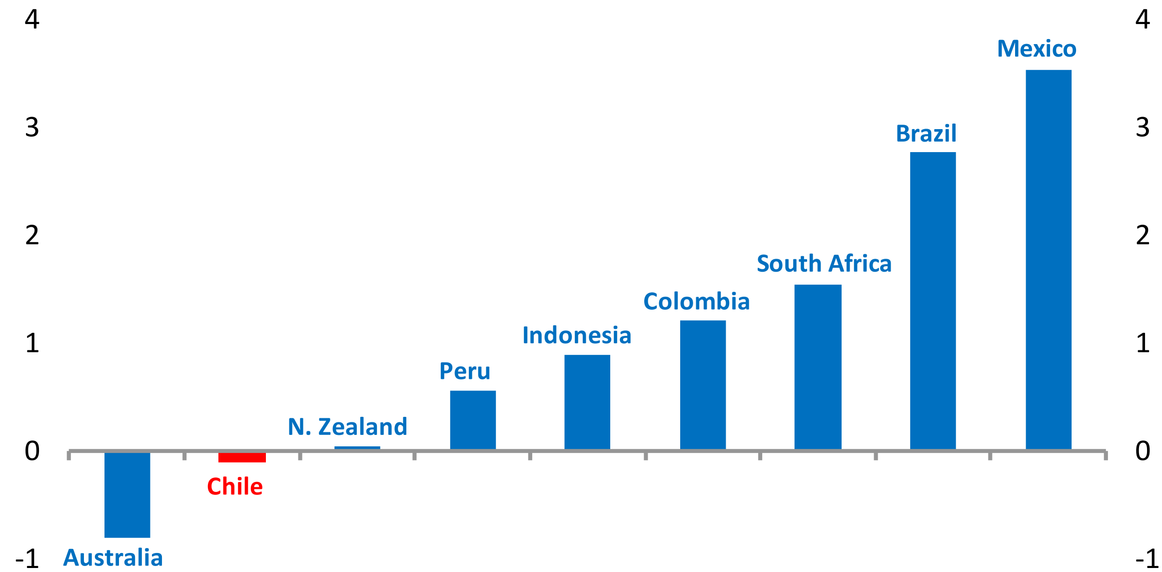


Source: Central Bank of Chile.

Figure 3

Real monetary policy rate (*)

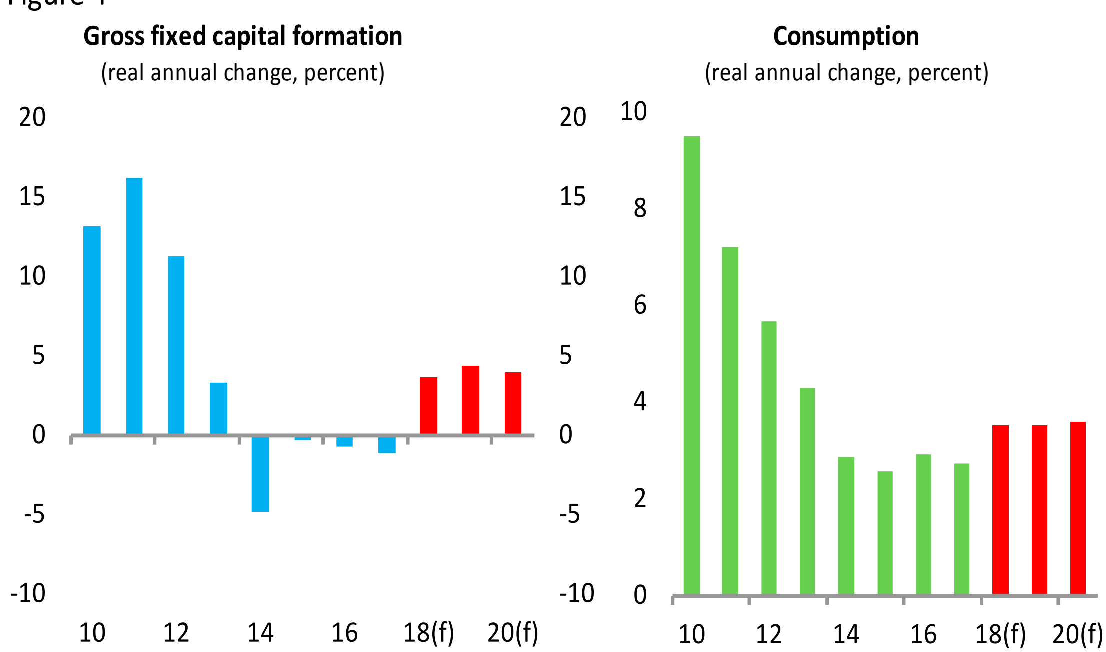
(percent)



(*) Estimated as the current MPR minus inflation expected one year ahead.

Source: the central bank of respective country.

Figure 4



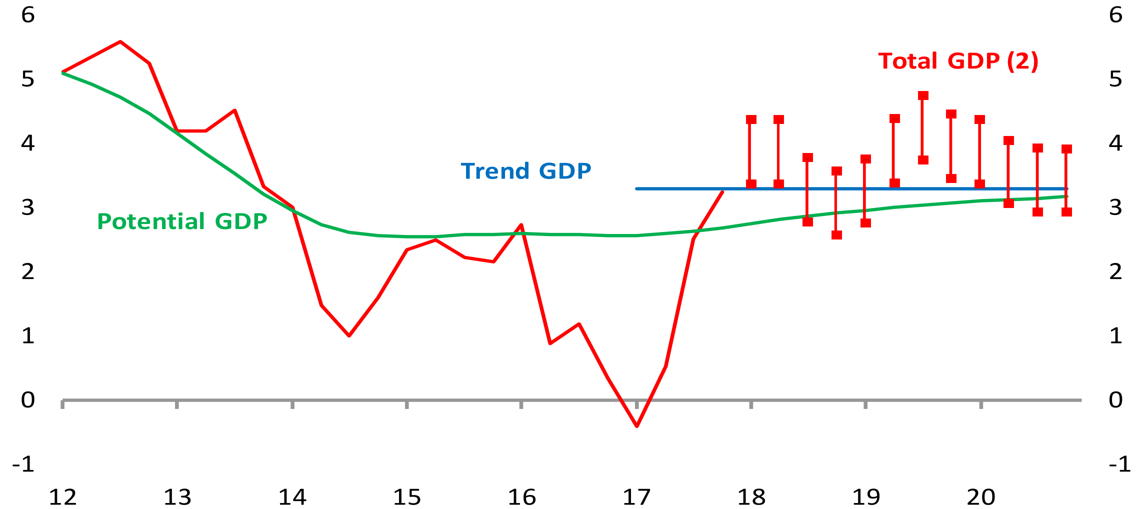
(f) Forecast.

Source: Central Bank of Chile.

Figure 5

Total, trend, and potential GDP (1)

(annual change, percent)



(1) For more details on trend and potential GDP, see "Trend growth: Medium-term Forecasts and Analysis of its Fundamentals", published in Spanish together with the September 2017 Monetary Policy Report. (2) Total GDP uses actual data up to 2017 and for subsequent dates the forecasts contained in the March 2018 Report.
Source: Central Bank of Chile.

Figure 6

Parities with respect to the US dollar

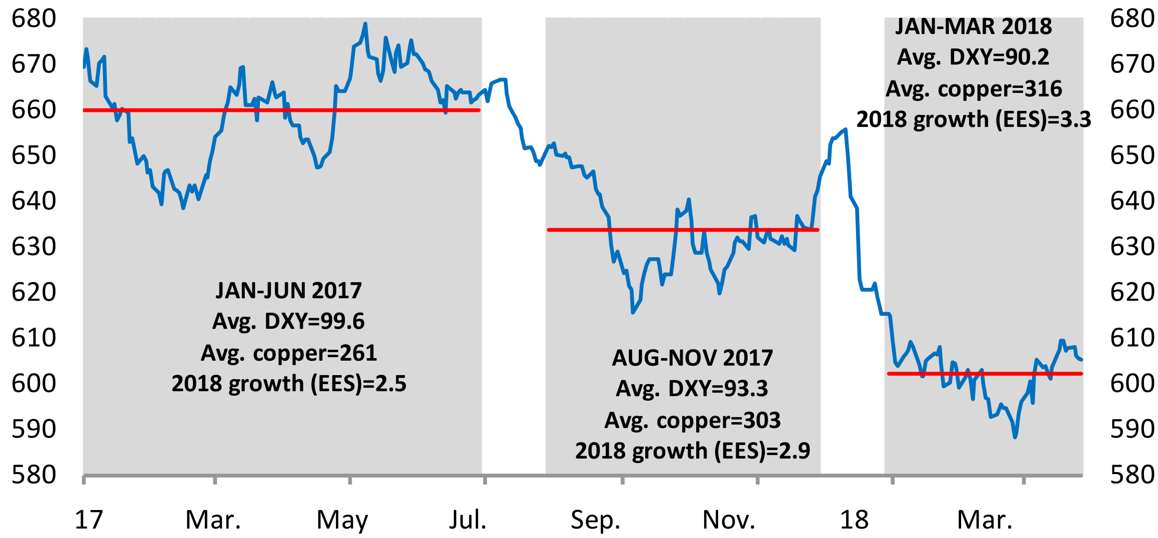
(index, 2017-2018=100)

Sources: Central Bank of Chile and Bloomberg.

Figure 7

Nominal exchange rate (*)

(pesos per dollar)



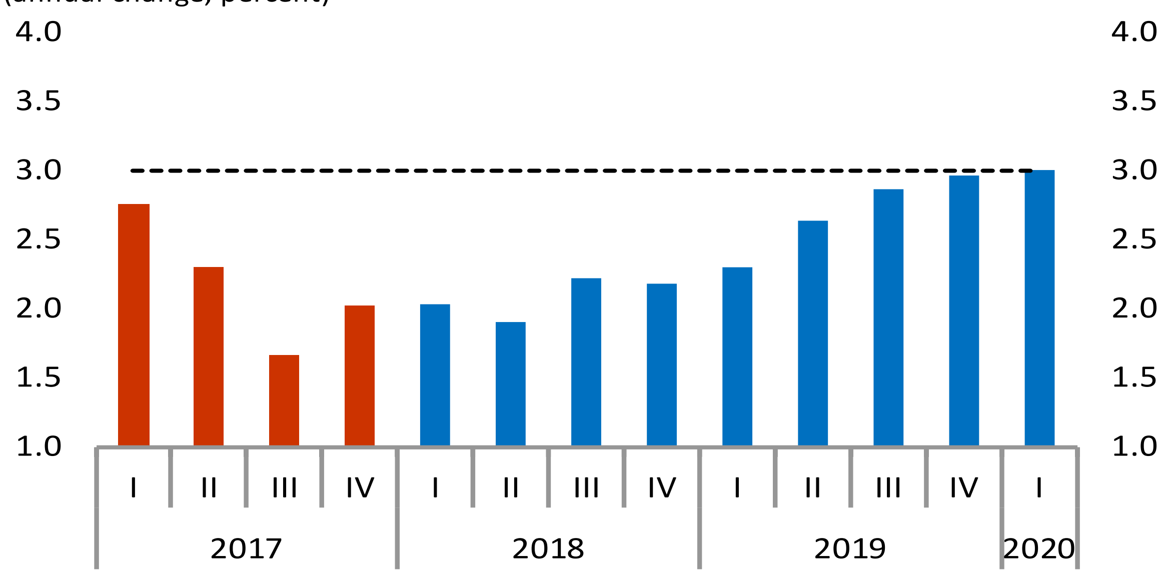
(*) Red line shows average of the period.

Sources: Bloomberg and Central Bank of Chile.

Figure 8

Actual and forecast inflation (*)

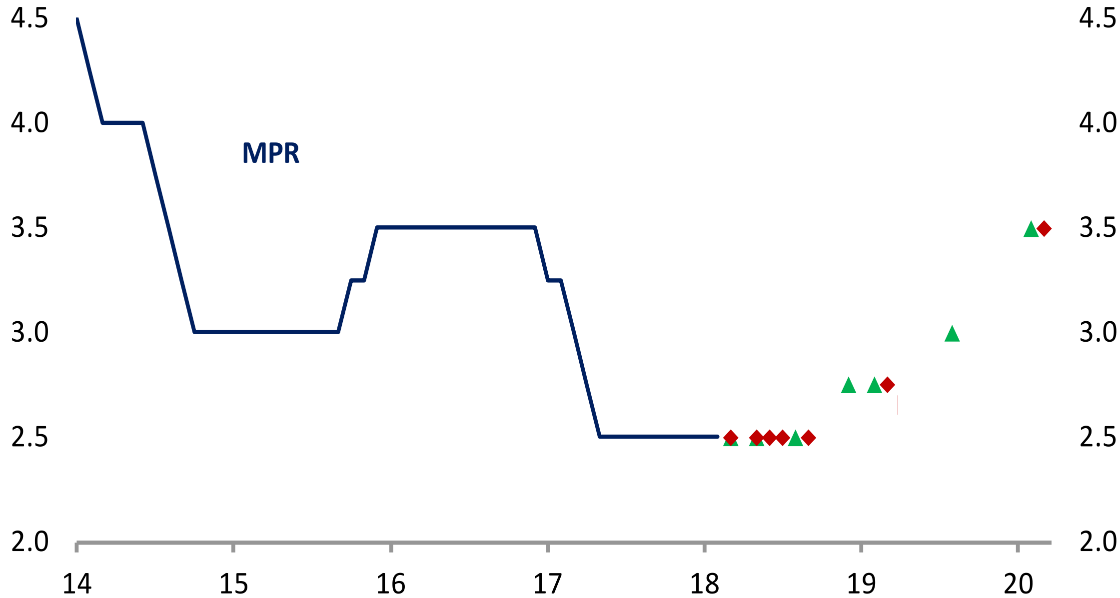
(annual change, percent)



(*) Forecast as of the first quarter of 2018.

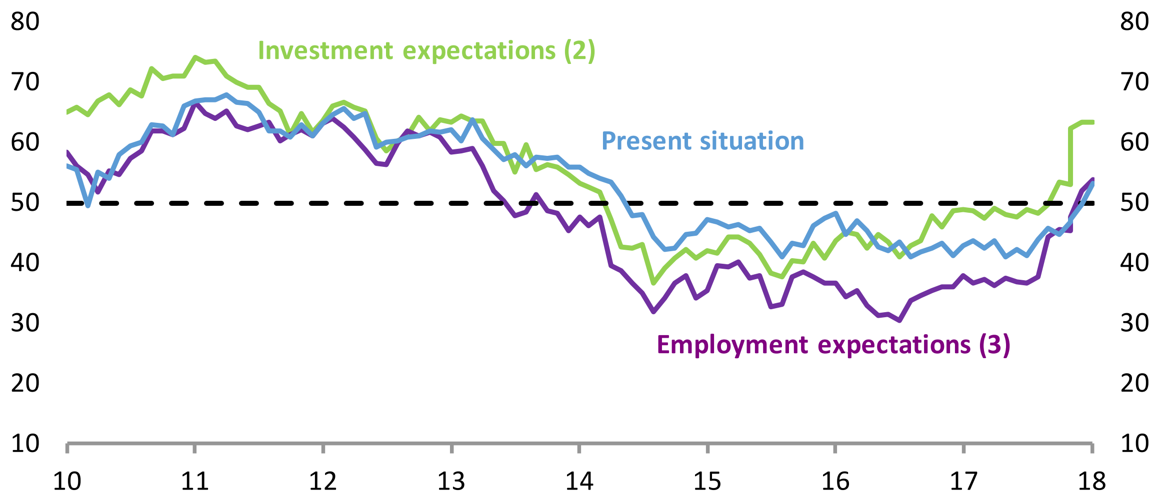
Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 9
Monetary policy rate
(percent)



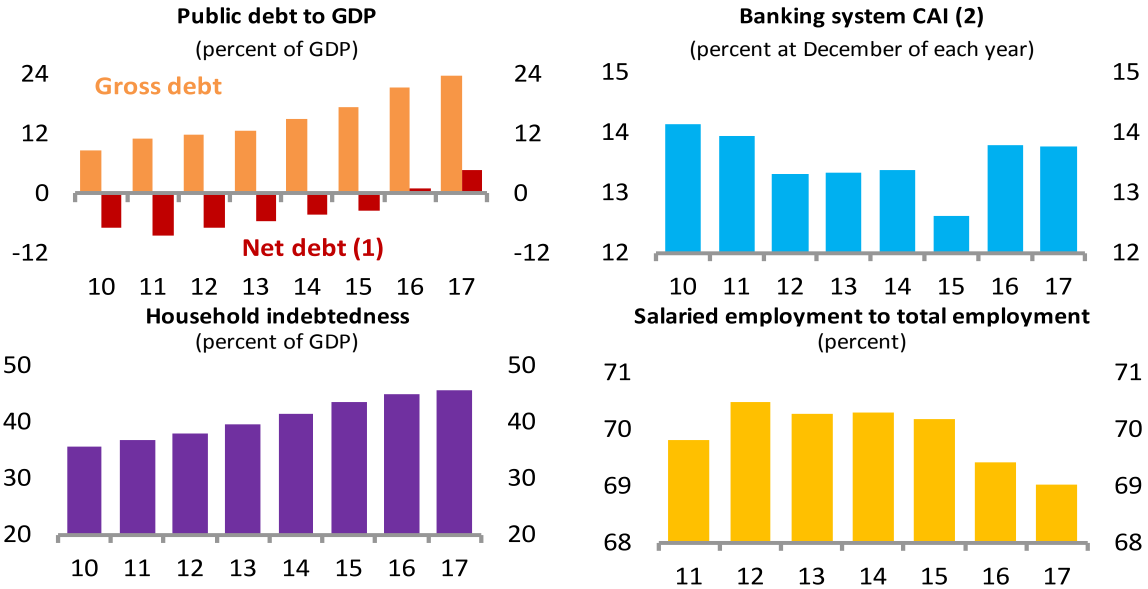
Source: Central Bank of Chile.

Figure 10
Business expectations (IMCE) (1)
(original index)



(1) Value above (below) 50 shows optimism (pessimism). (2) Simple average between expected investments in manufacturing and trade. (3) Simple average of expected employment in manufacturing, trade and construction.
Source: Icare/Universidad Adolfo Ibáñez.

Figure 11



(1) Net 2017 debt estimated using other assets as of September. (2) Corresponds to actual net worth over risk-weighted assets.

Sources: Central Bank of Chile using data from DIPRES, SBIF, SUSESO, SVS, and National Statistics Institute (INE).