MONETARY POLICY REPORT

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

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*The June 2018 *Monetary Policy Report* can be found at http://www.bcentral.cl.

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

Thank you for your invitation to present the vision of the Board of the Central Bank of Chile (CBC) about the latest macroeconomic developments, prospects and implications for monetary policy. This vision is detailed in our *Monetary Policy Report* (the Report) released this morning. The information therein provide the backdrop for the decision adopted by the Board at yesterday's monetary policy meeting.

In this Report we confirmed that the evolution of the macroeconomic scenario has lowered the risks for the convergence of inflation to 3% within the policy horizon. This risk, that lingered for quarters, has faded in line with the gradual consolidation of the recovery it has shown since mid- last year and which has received an upward inflationary impulse coming from the increase in fuel prices in pesos. Accordingly, the lower bound defined for the 2018 growth range and the headline inflation forecast at December have been revised upward, while we reaffirm the trajectory of gradual convergence of core inflation to the 3% policy target over a two-year horizon. These projections are consistent with the two-year-ahead inflation expectations that have remained well anchored to the target.

The scenario of gradual convergence of inflation to the policy target, despite improved prospects for activity and short-term prices, relies in the fact that there are still important gaps in the economy. This is reflected in the evolution of the labor market, capacity utilization indicators, and the evolution of those prices most sensitive to said gaps. It also assumes that the impulse the Chilean economy will receive from abroad will be a little milder than we estimated in the last Report, showing not-so-favorable financial conditions going forward and somewhat lower terms of trade because of the higher oil price.

It is with this context in mind that at yesterday's monetary policy meeting we held the policy rate at 2.5%, thus sustaining the significant monetary impulse that has been there for over a year. Our Report's baseline scenario assumes that this impulse will still be necessary for a while longer and we will only begin to withdraw it insofar as macroeconomic conditions continue to drive the convergence of inflation to 3% within the policy horizon. Let me now share with you the details of our macroeconomic scenario and the main risks we observe.

The macroeconomic scenario

Recent data for the first four months of this year show activity outpacing our projections. In part, this responded to specific supply-side factors such as fishery and electricity, gas, and water, and part to investment in machinery and equipment, hired services, wholesale trade and some durables.

Measured in terms of velocity, after significant acceleration in the third quarter of last year, activity has moderated growth this year so far (Figure 1).

In our baseline scenario, we project that the rate of expansion of final domestic demand will moderate further in the remainder of 2018. This will occur once the effect of the higher growth of more volatile items that have less capacity to permeate the rest of the economy dissipates, like the ones just mentioned. On the consumption side, this opinion assumes that the slowdown of the wage bill—given the behavior of employment and wages—limits the increase in household spending. In response to the traditional lag with which the labor market operates in the cycle, we can expect that the recovery of growth will translate into an increase in employment and greater growth of wages in the coming quarters (Figure 2).

On the investment side, gross fixed capital formation grew 3.6% annually in the first quarter, thanks to the construction and other works component that resumed positive expansion rates after almost two years. Plus, that machinery and equipment continues to be the most dynamic component of investment, with imports of capital goods that, as of May, excluding non-regular transportation, continued to improve. This, in a context where business expectations have returned to optimistic territory on aggregate (Figure 3).

However, some numbers suggest that we cannot be sure yet that investment will be very dynamic, particularly because there we still see no significant change in the execution of large-scale projects. Several construction indicators show some stagnation lately, such as sales and shipments of materials and sectoral employment. The last survey of the *Capital Goods Corporation* revised downward the expected investment in construction and engineering works for this year, as some plans have been postponed. About housing, updated figures from the *Chilean Chamber of Construction* show that housing sales have remained stable, while the available stock, in general, is still high. Finally, our latest Business Perceptions Report, published in May, reports dissimilar views about companies' investment plans, with significant idle capacity in some of them, especially in the north of the country and in some specific sectors.

For this year, we estimate that GDP will grow in the range between 3.25% and 4%, which compares with the 3% to 4% expected in March. This combines the actual activity data known so far with annual rates of change for the second half of the year that are lower than those of the first half, reflecting a higher comparison base for the same period of 2017 and the aforementioned moderation in the pace of growth in final domestic demand.

Beyond this year's forecast, our view on the evolution of growth in the 2018-2020 period and our assessment of capacity gaps in the economy has not changed much. For 2019 and 2020, the projected ranges are unchanged. Thus, we continue to expect that in 2019 the economy will grow between 3.25% and 4.25%, and between 3% and 4% in 2020 (Figure 4).

We continue to estimate that the economic recovery is grounded on a favorable external scenario, a clearly expansionary monetary policy, the completion of the adjustment of mining and housing investment and the absence of important macroeconomic imbalances. As a working assumption, we assume that in 2018 the economy will receive a fiscal impulse consistent with the current budget, including the adjustments announced by the Administration. Going forward, we assume that expenditure will follow the path of gradual fiscal consolidation defined in the fiscal policy decree just issued by the authority.

With these figures, on average our economy will grow above potential in the period 2018-2020, closing the activity gap during the policy horizon, as we projected in the March Report. Also, our estimate for the economy's potential growth continues to lie between 2.5% and 3% and it will gradually approach trend growth—between 3% and 3.5%—to the extent that the rate of investment recovers, short-term constraints disappear, and resources are reallocated to more productive activities. Come September, as has been the case for some years, we will reassess these estimates.

The projected evolution of activity considers an external impulse slightly lower than that estimated in March, due to less favorable financial conditions and lower terms of trade associated to the oil price hike.

Activity and inflation data of recent months have consolidated the differences between the cyclical position of the United States and the other developed economies. Thus, while in the United States there seem to be no gaps and incoming data on prices and wages show more clear inflationary pressures, in the rest the gap is still to be closed and inflation seems bounded (Figure 5).

This has widened the differences regarding the expected evolution of monetary policy across economic blocs, triggering movements in interest rates and an appreciation of the dollar globally (Figure 6). This divergence was importantly confirmed at the Federal Reserve meeting yesterday, where along with the approval of the second increase in the federal funds rate for the year, it signaled it would speed up the normalization process foreseen for the next two years.

One striking element in the way the external scenario has behaved in recent months is the stronger reaction to news of different sign. Part of it was observed in February, due to higher than expected figures for wage growth in the United States. A similar phenomenon happened more recently relating to the configuration of the government in Italy. Although this is an important economy within the European Union, it had not been common for interest rates, exchange rates and risk premiums to react in such a degree to similar events. This makes us think that changes in the markets' appetite for risk have made them more reactive to incoming news and the possibility of observing episodes of high volatility seems greater than in the past.

In this context, financial conditions facing the emerging world have taken a downward turn. In recent weeks, currencies have depreciated against the dollar and capital flows have fallen. The Chilean peso has followed the global trend, posting a depreciation since the close of the March Report, which in the last few days has fluctuated around 630 pesos per dollar, which amounts to an increase of more than 4.5%. The multilateral exchange rate measures—where the evolution of the peso is compared to a broader set of currencies—show a more limited nominal depreciation. Compared with the currencies of other commodity exporters, the depreciation of the peso has been similar, while it has been in the lower side of the variations in Latin American economies (Figure 7).

The fact that the peso depreciation responds to a global phenomenon also implies that the real exchange rate (RER) has increased moderately with respect to the level it has shown since the beginning of the year and with a real depreciation similar to those of other comparable economies, standing around 90 in the 1986=100 index towards the statistical closure of this Report. Our baseline scenario assumes that the RER will return to near its average of the last fifteen to twenty years over the course of the policy horizon (Figure 8).

The greater speed of adjustment of financial conditions has not been reflected in a change in the outlook for global activity. Thus, the growth projections for 2018-2020 continue to indicate that, on average, the world economy will grow to outperform the last three years. Also, compared to the baseline scenarios of this Report and the previous one, the expected growth for most of the regions shows no major changes. In Europe and Japan, the medium-term vision has not changed much. For China, a growth rate of 6.6% is projected for 2018, considering that in the first quarter the Chinese economy grew 6.8% annually and the most recent data continue to support a vision of gradual deceleration going forward. In the rest of Asia, the projection remains at 4.3% for 2018, explained by improvements in industrial production and volume exports. In emerging Europe the market has also maintained its growth outlook.

On the contrary, the growth projections for Latin America are reduced, partly because several economies continue to be subject to idiosyncratic risk factors and/or because they are more severely affected by the adjustment of external financial conditions. Such is the case of Argentina, where the fragility of its macroeconomic fundamentals has become evident. The country reached an agreement with the IMF for a stabilization loan with several conditions for its concretion, including advancing the reduction of inflation and the fiscal deficit, implementing the exchange rate float and giving autonomy to its Central Bank. In Brazil, the slowdown in activity in the first quarter was compounded by greater political uncertainty, the difficulty in implementing the fiscal adjustment and a paralyzation of transport. In Peru, the expansion of annual GDP in the first quarter was higher than in the previous year, but the continued decline in consumer and business confidence has reduced dynamism going forward. Activity projections are maintained for the other countries (Figure 9).

On commodities, the increase in the oil price stands out—the Brent rose to 80 dollars a barrel at some points in the second quarter—driven by geopolitical factors and changes in supply and inventory levels. The baseline scenario, in line with the market futures in the ten days prior to the statistical closing, supposes that the price will decline slowly with respect to its current levels. Thus, Brent and WTI will average 70 dollars per barrel in 2018, 68 dollars in 2019 and 64 dollars in 2020. This contrasts with prices of 63, 59 and 56 dollars that were considered for the same years last March.

As for copper, the average price estimates for 2018, 2019 and 2020 are practically unchanged at 310, 295 and 285 cents of dollar per pound, respectively. Towards the statistical closure, the price of the metal climbed to about 330 cents per pound and, according to market reports, has been affected by the uncertainty surrounding possible labor-related downtime in some mines. In the baseline scenario, this increase is assumed to be temporary, so it does not modify the average price projections. Should a mine paralyze, it could be necessary to review both the projected copper price and other macroeconomic variables for Chile.

The prices of oil and copper combined, plus those of other Chilean exports, determine a less favorable trajectory of the terms of trade in the policy horizon. Thus, between 2018 and 2020, the terms of trade will accumulate a decrease of the order of 3% compared to a fall of 2% estimated in March (Figure 10).

On the side of inflation in Chile, the annual variation of the CPI and the CPI excluding food and energy (CPIEFE) levels remains around or slightly below 2%, without showing significant differences than expected in March. As has been the trend of recent quarters, CPIEFE inflation has been dominated by the evolution of the exchange rate, the persistent capacity gaps in the economy and the indexation of some prices to lower inflation rates (Figure 11).

In the baseline scenario, we continue to expect CPIEFE inflation to have a slow convergence to 3%–not very different from what we expected in March–, while for headline inflation we foresee it reaching 3% sooner than we thought then. In the former case, this is consistent with an economy that, beyond recent data, will close its capacity gaps over the next two years, and with a real exchange rate that, as I said, will return to near its historical average during the policy horizon. For headline inflation, its faster achieveent of 3% is explained by the increase in fuel prices measured in pesos (Figure 12).

Regarding monetary policy, the Board estimates that the monetary stimulus will remain as it is and will begin to be reduced as macroeconomic conditions continue to drive the convergence of inflation to 3%. As a working assumption for the monetary policy rate, for the short term we assume a trajectory similar to that shown in the Financial Brokers Survey available at the close of this Report. For the medium term, the Board continues to estimate that the monetary policy rate stand around its neutral level towards 2020, which it believes to be between 4% and 4.5% (Figure 13).

As usual, there are internal and external elements that could modify these projections. The same as in March, from the point of view of its impact on domestic activity, the balance of risks in the external scenario is biased to the downside. The main risk on this front continues to be an abrupt deterioration of external financial conditions, especially in a context in which markets seem to be more reactive to negative news. Developments in the United States economy are important in this area, particularly because a more marked increase in inflationary pressures may require a faster rise in the federal funds rate. Nor is it possible to rule out that in an environment of lower appetite for risk, news of different signs may result in increased volatility.

Risks also persist coming from trade policy measures promoted by the United States, considering the renewed tensions with its main trading partners. China continues to be a source of risk, since it still has to resolve imbalances in several of its markets. Added to this is the evolution of the oil price. If it increases or remains flat for longer than expected, it could have stronger effects on global growth and inflation.

The bias and probability of external risk scenarios reinforces the need to maintain solid macroeconomic fundamentals, particularly for a small and open economy such as Chile's. Actually, the recent events have had greater impacts in countries with greater indebtedness, fiscal deficit and / or current account deficits.

At home, we estimate that the risks for activity are biased upwards. The data of the last few months have been higher than expected and we cannot rule out a scenario in which this greater dynamism persists, especially if investment improves above projections. This risk is partly moderated by the possibility that the labor market, and in particular private salaried employment, could take longer than expected to respond to the higher growth rates.

On inflation, we estimate that risk balances are unbiased. The downward risks for its convergence to 3% have moderated. However, we forecast that CPIEFE inflation will remain below 2% for a while longer, considering that the determinants of inflation's convergence to 3% in the medium term have not change significantly from March.

Summing up, our assessment of the macroeconomic scenario, beyond the recent data and the adjustment in the GDP range and the inflation projection for 2018, is not very different when viewed from a longer perspective, that is, considering the period 2018/2020.

For all the above we believe that our economy still needs a positive monetary impulse over the next two years. Certainly this impulse will be withdrawn as the gaps close and inflation converges to 3%, but when will this withdrawal begin will depend on the evolution of our macroeconomy, which we do not see happening before the end of this year.

It is important to bear in mind that although we see a balance of risks biased upwards on domestic activity, on the negative side the main risks come from abroad. The smaller slack for monetary policy making in the United States, the renewed divergence with other developed economies and its pressure on currencies; the political tensions in the Eurozone; the oil price increase and associated geopolitical risks configure a complex scenario for the emerging world. This is especially true for economies that are seen as more vulnerable, either because their macroeconomic fundamentals are weak and/or because they do not possess the institutional characteristics that allow them to deal with external shocks and implement counter-cyclical policies.

The link between institutional characteristics and macroeconomic fundamentals with the financial results when facing a stressful episode has been widely documented. A box in our Report makes a brief review of the factors that intervene in this relationship, showing that the transmission of global financial shocks to emerging economies is more intense when they have a fixed exchange rate regime. It has also been shown that, in the face of episodes of financial stress, the volatility of interest rates is higher in economies where the currency does not float freely. In fact, one characteristic of the developments of recent weeks has been that the increase in long-term interest rates in several emerging economies has occurred along with the depreciation of their currencies.

About the fragility of the macroeconomic fundamentals, we can see that countries with high levels of inflation; high interest rates and bulging current account deficits are more likely to suffer significant adjustments in the prices of their assets when external conditions tighten. On this issue, a recent study published by the Bank presents empirical evidence that a rise in the interest rate of the Federal Reserve affects more those countries that have a worse solvency situation—measured by their level of indebtedness—and liquidity, measured through their external asset position.

How vulnerable does Chile look based on these criteria? Within the group of emerging economies, Chile stands out positively in institutional matters. In particular, it has an independent Central Bank, committed to a floating exchange rate regime; It also has an appropriate fiscal institutional framework, where the structural balance rule is worth noting. In part, this translates into well-anchored inflation expectations, which give monetary policy more room for maneuvering.

On the other hand, Chile is committed to a free-float exchange rate that is more comparable to the situation of developed economies than other emerging economies, with fairly stable long-term rates along with the aforementioned depreciation of the currency.

Even so, exchange rate adjustments can have significant effects on the local economy in as much as economic agents exhibit significant mismatches in their balance sheets. In the same way, exposure to interest rate and refinancing risks can amplify the economic impact of even mild changes in lending standards. In other words, not only the level of indebtedness is important, but also its composition and its relationship with financial assets. This helps explain why a floating exchange rate regime is the more effective in cushioning external shocks the more developed the local financial system is.

In this sense, the data available for Chile indicate that the main Chilean economic agents (*i.e*. companies, banks, households and government) have moderate levels of exposure to exchange rate and financial risks, as a result of either its regulations or the development of financial products.

In the case of banks, the stress tests we perform regularly in the context of our Financial Stability Report show that market risk, which includes interest rate risk, is low compared to credit risk. Similar results are found for the corporate sector, where a shock to the interest rate has a low impact on performance. In addition, in the most recent period, corporate indebtedness has decreased after being driven by loans related to foreign direct investment. Likewise, currency mismatches have continued to decline.

Among households, in Chile, consumer debt is made up of close to 75% of term bank loans, 18% credit cards and 7% credit lines. Virtually all consumer loans bear a fixed interest rate, with an average maturity of between 4 and 5 years. In turn, mortgage loans account for most of the increase in household debt in the last six years. As is well known, mortgages are issued almost entirely at fixed rates (adjusted for inflation), long maturities, and a prudent housing loan-to-value ratio. Together, these elements reduce the potential impact of an increase in interest rates on the financial burden of households.

Regarding the government sector, the mitigation of interest rate risk depends also on the behavior of the economy's investor base. This makes the way in which the demand for and supply of bonds behave in stressful times particularly relevant. The importance of the participation of pension funds and mutual funds in sovereign bond holdings and the fact that in the face of external shocks, the less risky funds—and with a greater share of sovereign bonds—become more attractive, also offers a cushion to the effects international interest rate shocks.

Even so, this is an especially important moment to strengthen potentially vulnerable flanks in emerging economies. As I have said before, it is important to restore the slack that has helped sustain Chile's macroeconomic policy framework. Especially important in this regard is to moderate and possibly reverse the course of public indebtedness, adopt a framework to capitalize the banking system and ensure a sustainable evolution of household borrowing.

The signals of the government regarding the orientation of its fiscal policy, its backing of the new General Banking Act and the reactivation of its search for mechanisms to consolidate borrowers' financial information are very positive in this regard. Equally valuable in dealing with future turbulences seems to be to strengthen fiscal institutions by enhancing the status and autonomy of the *Fiscal Advisory Council*, as well as acknowledging the role of institutional investors in the Chilean economy in the face of future reforms.

Dear senators, the Chilean economy is progressing in the recovery of growth and the closing of gaps. Rather than a result, this is a good start for a more favorable stage of the business cycle. Many challenges lie ahead. It is important to deepen the recovery of investment, that the labor market be strengthened and that competitive advantages be exploited to make this recovery more self-sustained and shared. Greater long-term growth calls for more structural changes that will help raise productivity.

The Central Bank will be there to ensure that imbalances or vulnerabilities do not incubate in the process, which later may require more costly adjustments. Together we also have the responsibility to strengthen those factors that allow us to better withstand external shocks that will sooner or later be felt. The analysis and projections in this Report contribute to the understanding of how the Central Bank exercises its responsibilities, as well as the opportunities and challenges that we face together. We remain at your disposal to deepen this discussion.

Thank you.

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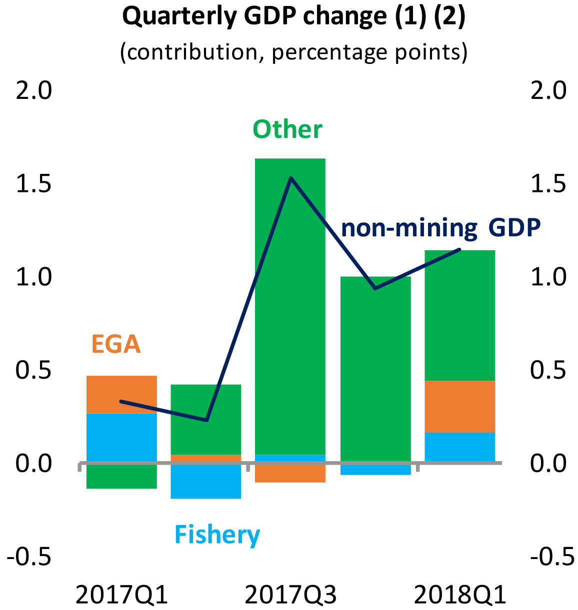
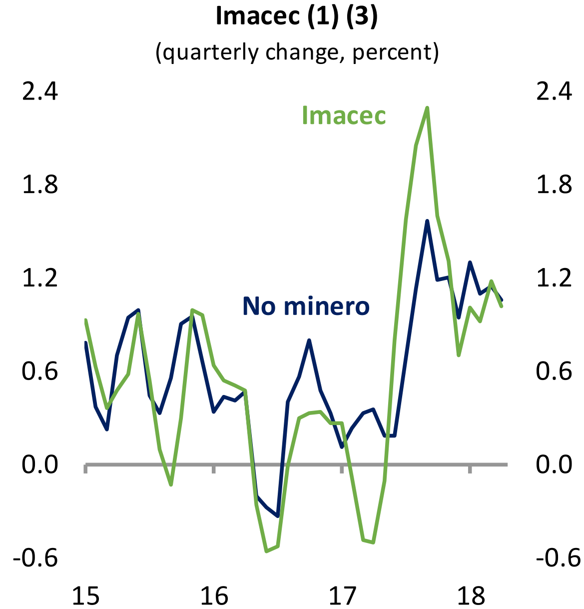
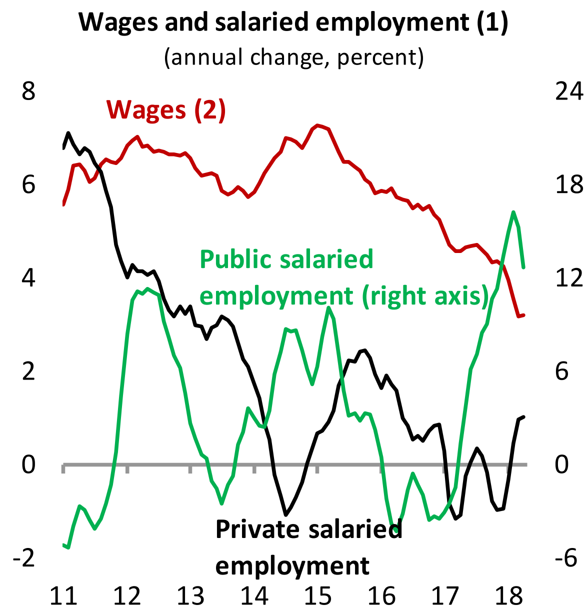
Figure 1

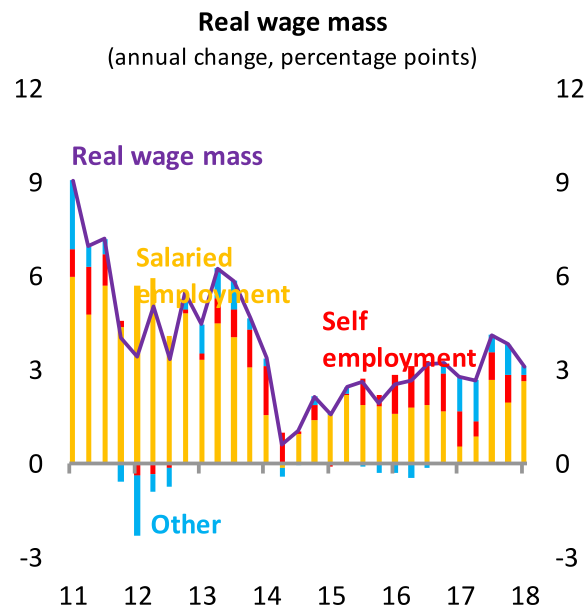




(1) Seasonally-adjusted series. (2) Other includes trade, manufacturing, financial and entreprenurial services, construction, agriculture, transport&communications, housing services, personal services, public administration, VAT and import duties. (3) Moving quarters.
Source: Central Bank of Chile.

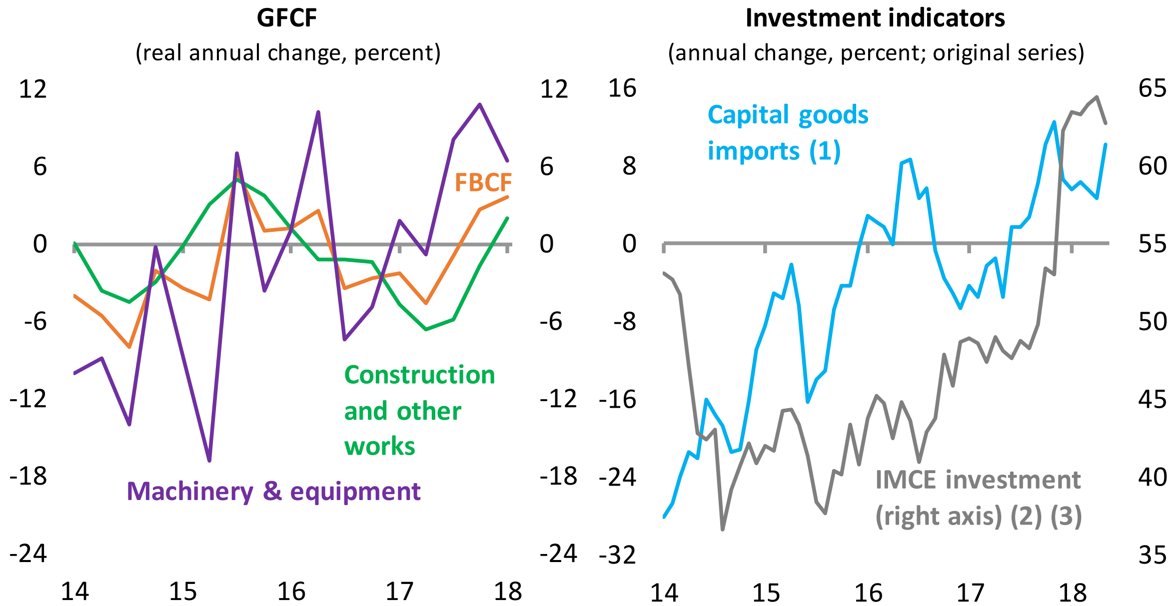
Figure 2





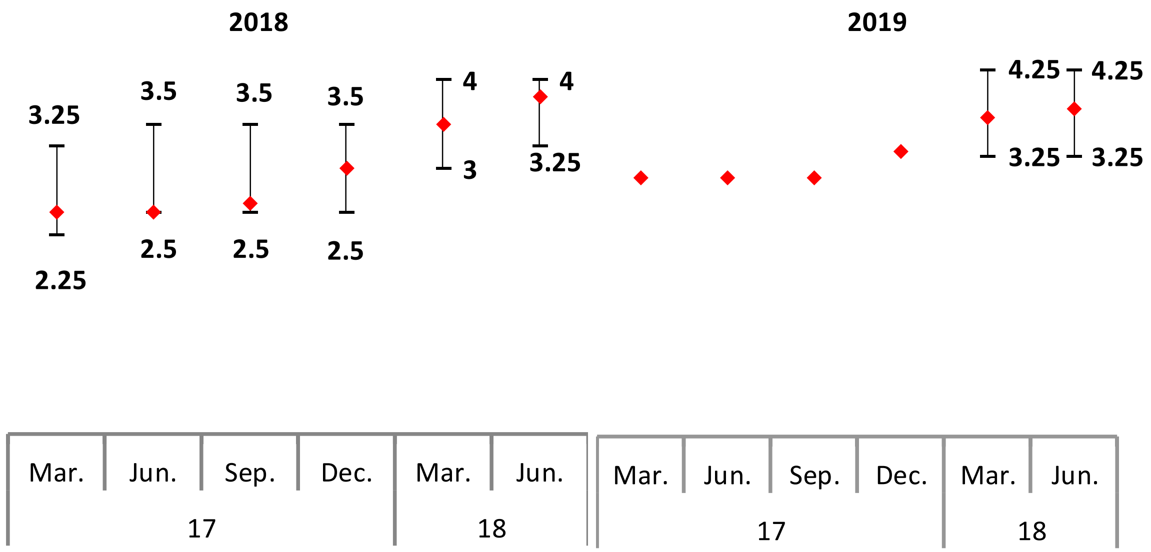
(1) Quarterly moving averages. (2) Simple average between Wage Index and Labor Cost.
Sources: Central Bank of Chile and National Statistics Institute.

Figure 3



(1) Moving six-month average. (2) Value above (below) 50 indicates optimism (pessimism). (3) Simple average between manufacturing industries' and trade sector's expected investment.
Sources: Central Bank of Chile and Icare/Universidad Adolfo Ibáñez.

Figure 4
Growth forecasts (*)
(real annual change, percent)

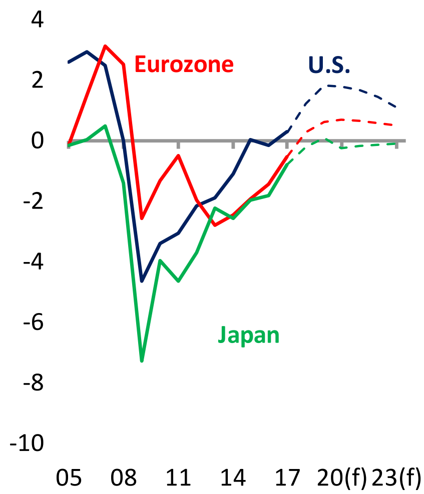


(*) Ranges correspond to projected growth in each Monetary Policy Report. Red diamonds correspond to the Economic Expectations Survey at respective statistical cutoff.
Source: Central Bank of Chile.

Figure 5

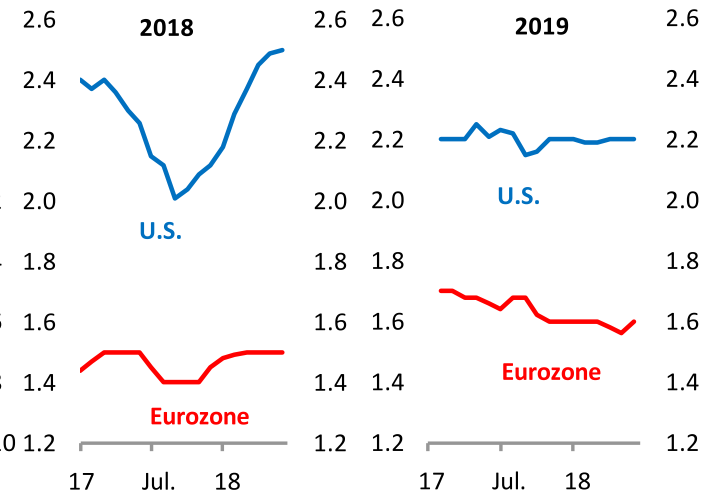
Actual and expected activity gap

(percent of potential GDP)



Inflation expectations

(percent)

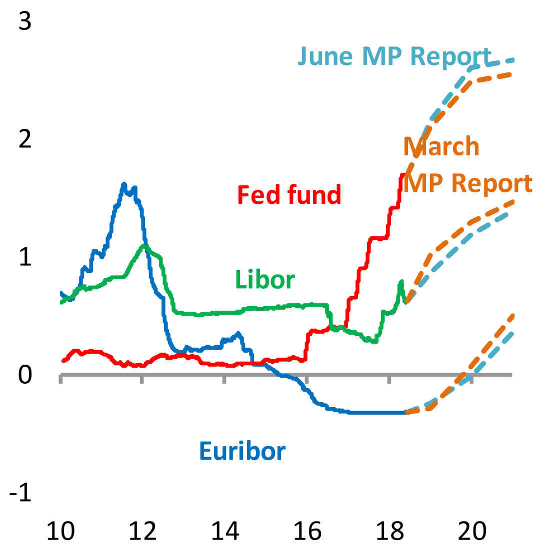


(f) Forecast.
Source: Bloomberg.

Figure 6

MPR expected by the market

(at December of each year, percent)



Source: Bloomberg.

Interest rate differential between the US and Germany and multilateral dollar

(basis points; index)

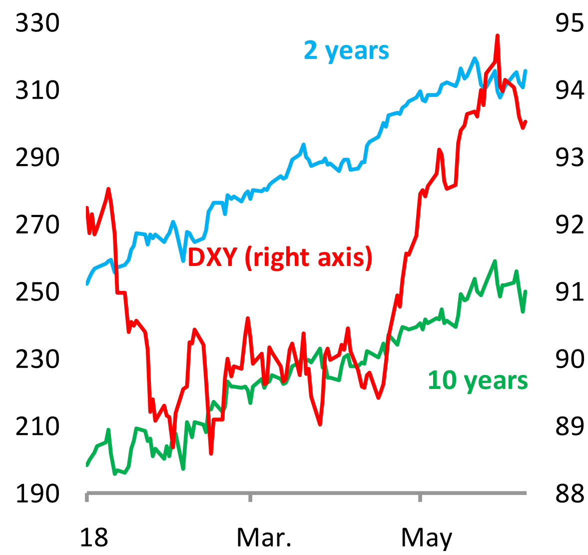
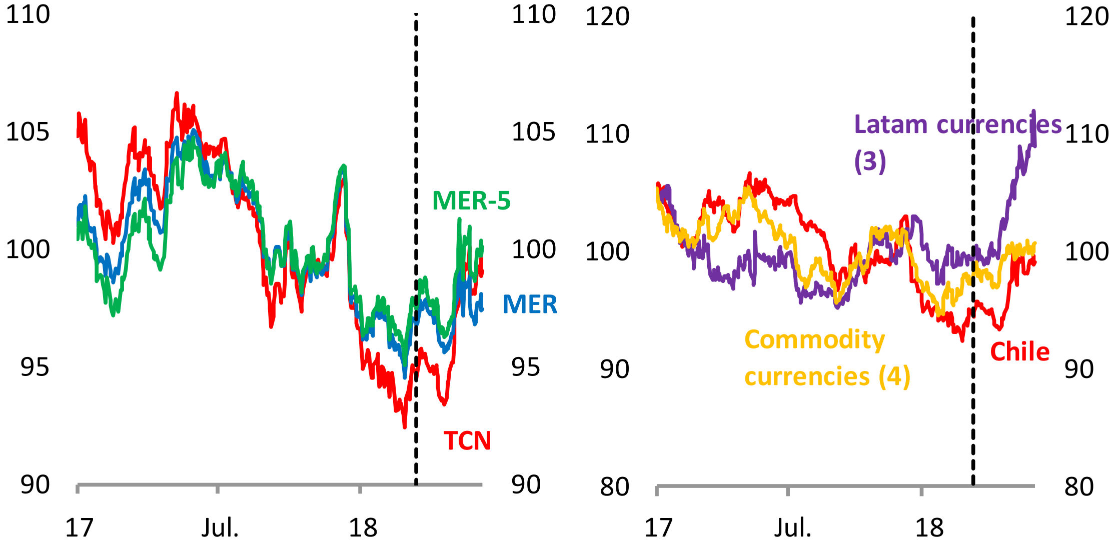


Figure 7

Nominal exchange rate and multilateral measures (1)
(index, 2017-2018=100)

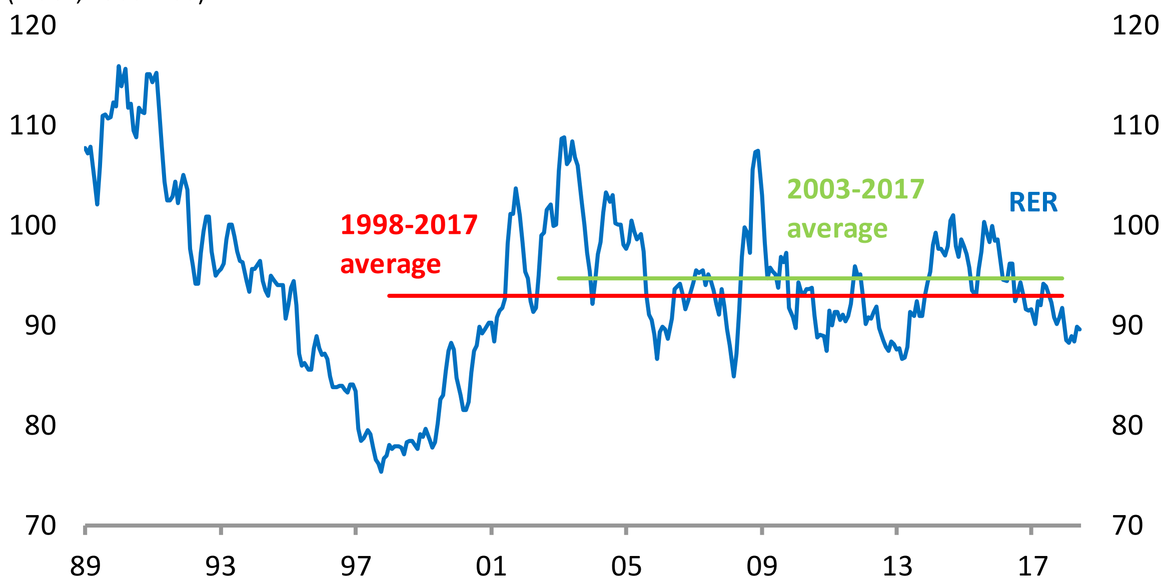
Parities against the US dollar (1) (2)
(index, 2017-2018=100)



(1) Dashed vertical line shows statistical cutoff date of March 2018 Monetary Policy Report. (2) Uses April 2018 WEO weights. An increase denotes a depreciation of the currency with respect to US dollar. (3) Includes Brazil, Colombia, Mexico and Peru. (4) Australia, Canada, New Zealand and South Africa. Sources: Central Bank of Chile, Bloomberg and International Monetary Fund.

Figure 8

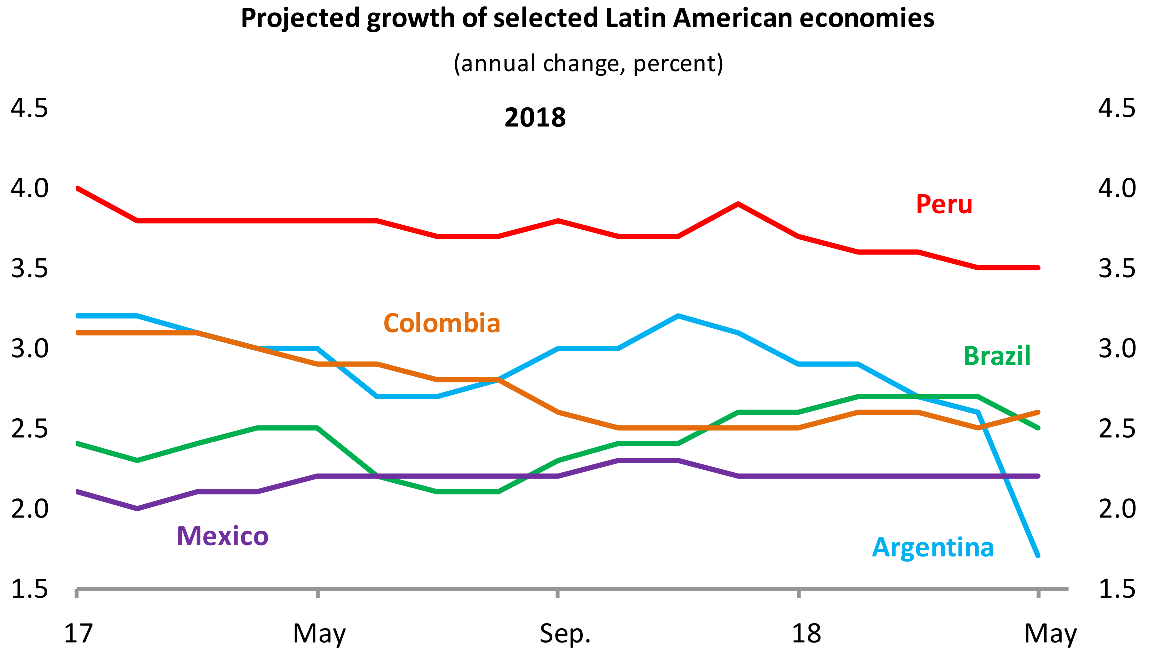
Real exchange rate (*)
(index, 1986=100)



(*) The May 2018 figure is preliminary estimate. The June 2018 figure uses information up to the statistical cutoff.

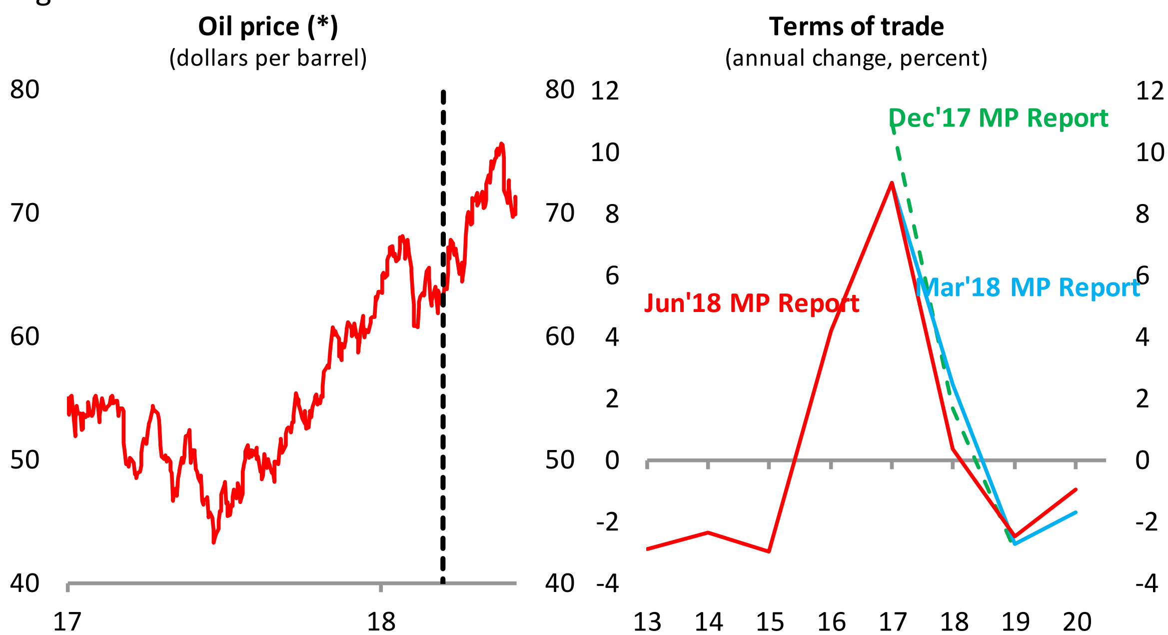
Source: Central Bank of Chile.

Figure 9



Source: Consensus Forecast.

Figure 10



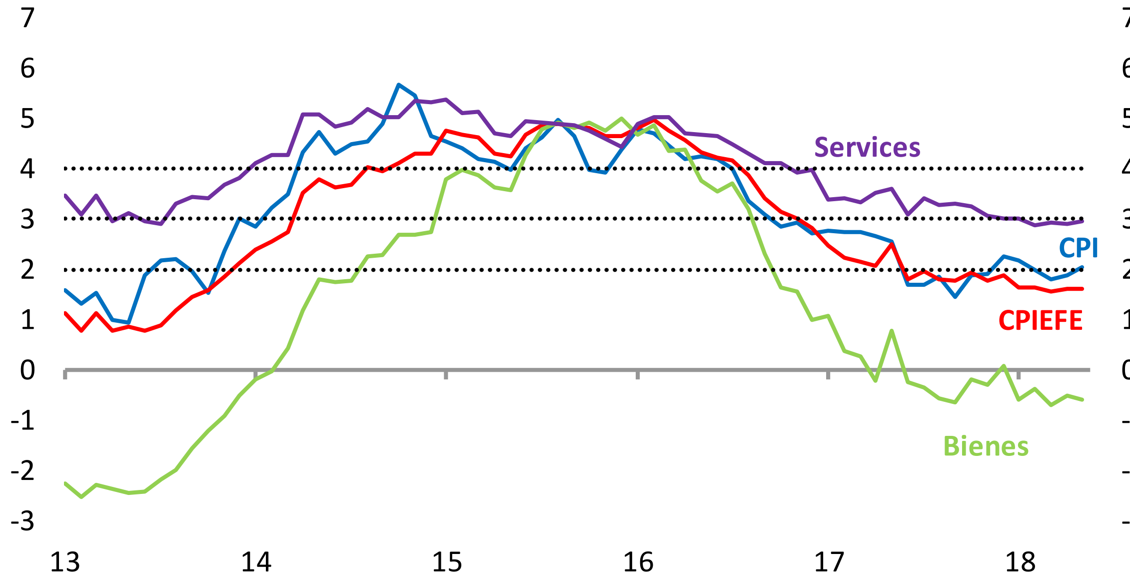
(*) Simple average of the prices per barrel of Brent and WTI oil.

Sources: Central Bank of Chile and Bloomberg.

Figure 11

Inflation indicators (*)

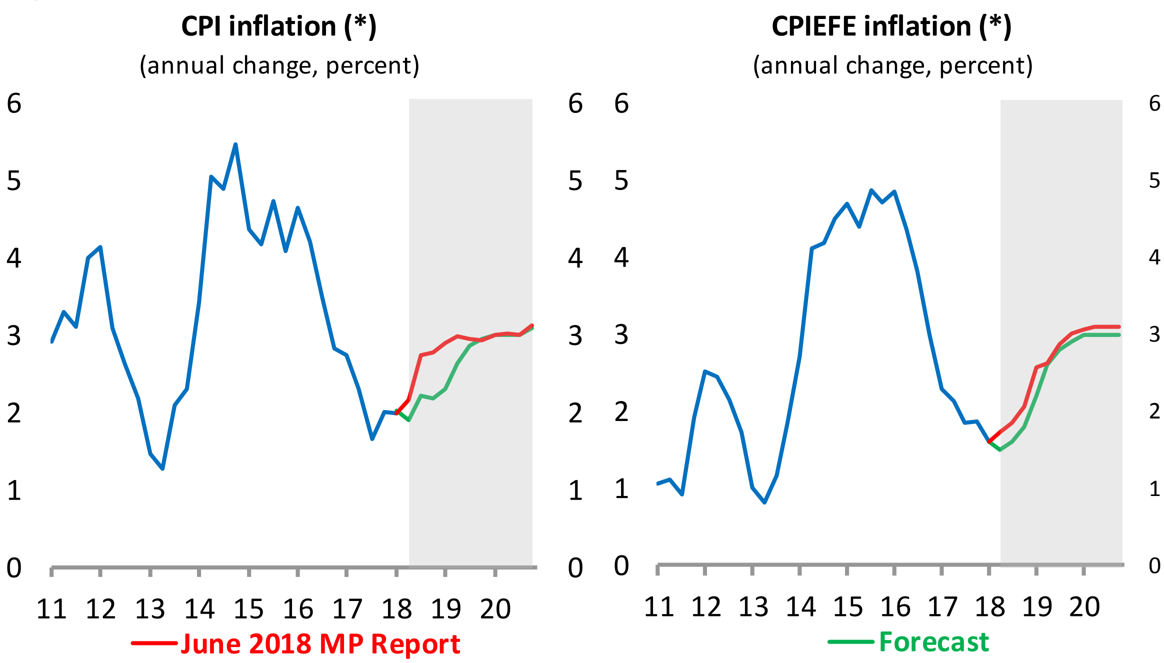
(annual change, percent)



(*) As from January 2014 the new indexes with annual base 2013=100 are used, so they are not strictly comparable with earlier figures.

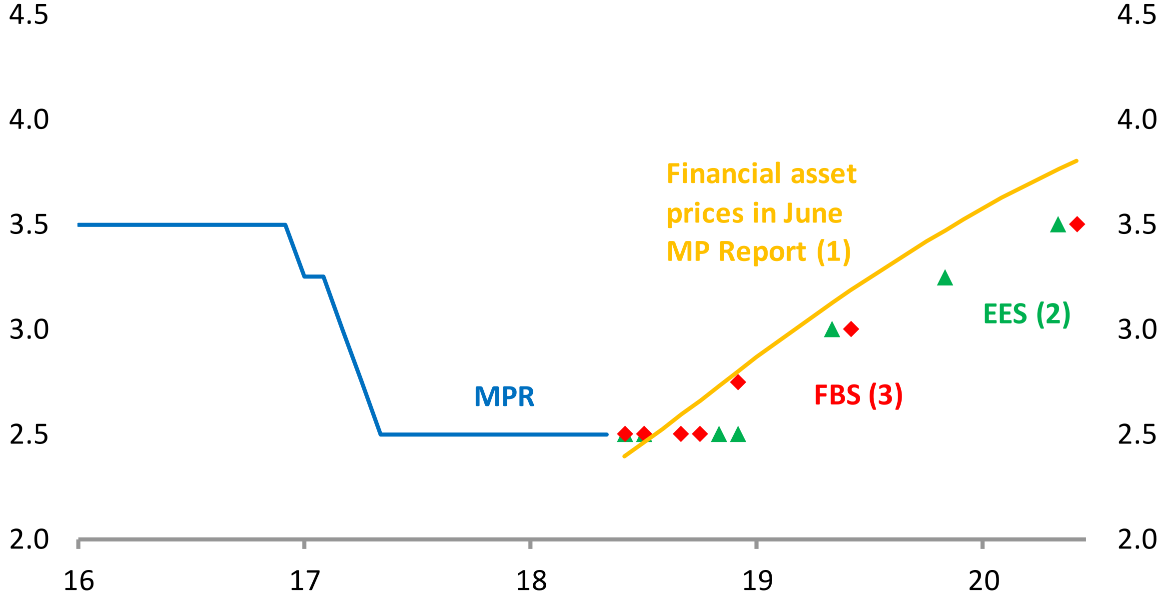
Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 12



(*) Gray area, as from the second quarter of 2018, shows forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 13
MPR and expectations
(percent)



(1) Built using interest rates in swap contracts up to 10 years. Uses average of last 10 working days at 8 June 2018. (2) Corresponds to the June survey. (3) Corresponds to last survey before the June monetary policy meeting.

Source: Central Bank of Chile.