Rodrigo Vergara: Chile's March 2014 Monetary Policy Report

Presentation by Mr Rodrigo Vergara, Governor of the Central Bank of Chile, of the Monetary Policy Report before the Honorable Senate of the Republic, Santiago de Chile, 31 March 2014.

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Accompanying charts can be found at the end of the speech.

Mr. President of the Senate's Finance Commission, Senator Ricardo Lagos-Weber. Senators members of this Commission, ladies, gentlemen,

Thank you for your invitation to share with you the vision of the Central Bank Board about the recent macroeconomic developments, its outlook and implications for monetary policy. The detail of this vision is contained in our March 2014 *Monetary Policy Report*.

A year ago, when the Board gathered with this Commission on a similar occasion, we underscored the importance of investment in the Chilean economy's strength and its connection with the global cycle of mining investments. We then stated that the implementation of a large number of projects in mining and related sectors, such as energy, had provided a boom in investment. This had resulted in greater domestic spending, putting pressure on installed capacity utilization and the labor market, as well as on imports and the current-account deficit of the balance of payments.

The Board also noted that it foresaw at the time a gradual maturation of said investment cycle and expected a normalization of economic growth during 2013, after several years of expanding above trend. Accordingly, an easing of the pressure on domestic productive resources was also expected, together with a reduction in the trend current-account deficit.

Later on, beginning last June, we drew attention to the international financial conditions which were beginning to normalize, after announcements by the Federal Reserve Board of the United States. We noted then that this process could create increased short-term volatility in the global economy and the international financial markets, as portfolios were adjusted and spending plans were reviewed, but that, at the medium term it was a healthy development because it would create an environment that would help prevent the incubation of financial vulnerabilities. At the same time, we noted that the Chilean economy was on a good stand to address this transition in international liquidity. Our inflation-targeting and floating exchange rate regimes, our sound fiscal accounts and strong financial system, together with our healthy external financial structure allowed us to confront with relative calm this process and help cushion its impact on our economy.

Throughout the past year, we have seen both a moderation in the investment impulse in Chile as the gradual normalization of global financial conditions. Investment has adjusted more sharply than anticipated, such that our economy grew less than we projected in late 2013, which also reflects in a downward revision of Chile's growth forecast for 2014. Still, I would like to say that other mineral exporting economies have given a surprise in the same direction, hand in hand with the worsening of China's economic outlook. The convergence of metal prices toward their production costs has been somewhat faster than thought a year ago. In the case of copper, the price forecast for 2014 in this Report has been lowered by more than 10 percent in one year. Other demand components, such as consumption, have posted a more gradual deceleration, in line with still favorable, yet moderating, fundamentals.

International financial conditions have also been normalizing, which, while positive over the medium to long term, has caused increased volatility, higher risk premiums and capital outflows in emerging markets, together with a widespread depreciation of currencies vis a vis the U.S. dollar.

In Chile, contrasting with past episodes, the financial effects have been bounded. The risk premium, for instance, is the same or slightly higher than previous values. Unlike other emerging economies, Chile has seen a drop in interest rates in the recent past, and the Central Bank has not intervened in the forex market by selling reserves as have other countries.

Nonetheless, consistently with our macroeconomic policy regime, we have seen a substantial impact on the exchange rate. Actually, the Chilean peso depreciation is in the upper half of the group of emerging economies (figure 1). The real exchange rate has also depreciated significantly and is above its averages for the last fifteen and twenty years (figure 2). This depreciation of our currency, however, is an optimal response to the new circumstances, as it implies an adjustment of relative prices and thus contributes to the rebalancing of sources of growth across economic sectors. In other words, it shifts the growth dynamic from domestic demand to exports.

In this scenario, Chilean inflation has returned to the vicinity of 3 percent (bear in mind that last year it was most of the time in the lower part of the Central Bank's tolerance range: 2 percent) (figure 3).

So this big depreciation of the Chilean peso has not altered the forecast that inflation will remain in line with the target over the policy horizon. This reflects that the pass-through coefficient, which measures how much of the depreciation is translated into higher prices, so far has not created unwanted propagation to inflation. Of course there are items that immediately reflect any exchange rate movements, like fuels, for example. But the pass-through to core inflation trends and expectations is not so mechanical. On one hand, there is evidence suggesting that it depends on the economy's cyclical conditions, meaning that in the present circumstances, where gaps are being formed, this pass-through should be small. On the other hand, said coefficient has shrunk over time as the inflation targeting scheme has consolidated. Thus, the credibility of monetary policy also reduces the coefficient, allowing us to project that, beyond short-term effects, inflation will stay near the target over the policy horizon. (The Monetary Policy Report contains a box with more details on the pass-through coefficient).

For the same reason, monetary policy has moved to a more expansionary instance, and the monetary policy rate (MPR) has been lowered by 100 basis points over recent months to a level of 4 percent annually. Furthermore, as we said in our last press release, we will consider the possibility of making additional cuts to the policy rate, in line with the evolution of domestic and external macroeconomic conditions and its implications on the inflationary outlook.

Some market players and observers have suggested that the current scenario of slower growth and higher inflation poses a dilemma to monetary policy makers. This, meaning that, in the current circumstances of some deceleration and a slight rise in inflation, one must prioritize one or other of these variables. We believe, for the aforesaid reasons that there is no such dilemma. Actually, our baseline scenario assumes that, as we will see in a while, inflation will rise temporarily to the upper zone of the tolerance range, but by the end of this year it will be close to the target.

But if such a situation was to persist, there could be a dilemma. This is why we continually watch for the so-called "second-round effects", that is, if a change in the parity puts more persistent pressure on the other prices. In that case, the Central Bank will take every measure necessary for inflation to quickly return to the target. That is our mandate.

The way our economy has reacted to the recent changes in the terms of trade and external financial conditions is precisely a reflection of our policy regime, which allows for timely adjustments in the real exchange rate and interest rates, letting the economy grow near its potential, smooth the capital account's adjustments and maintain the credibility of the inflation target. This marks a difference with our economic history.

Over the years, the Central Bank has given proof of its commitment with price stability and the inflation target. It has operated with consistency in order to build credibility and trust, which gives us the necessary flexibility for monetary policy and the real exchange rate to work as buffers of the business cycle whenever advisable.

In the past, when our economy's fundamentals were not as strong, and the exchange rate regime was rigid and poorly suited to confront external shocks, when faced by a drop in the terms of trade or stringent financial conditions, in order to stop a currency depreciation the Bank had to sell international reserves and raise the interest rate to reduce capital outflows. Monetary policy, far from cushioning the external cycles, made them worse, generating economic costs and financial risks. More often than not, these experiences ended badly.

Overall, as usual, the present scenario has varied risks, most of them coming from emerging economies, because of both their importance in commodity prices and the behavior of world financial markets. Despite the strong fundamentals of the Chilean economy, we are not immune. We are a small, open economy, so external developments can and do affect us. Now, allow me to describe in detail the macroeconomic scenario we believe to be the most likely one in the coming quarters, and associated risks.

Macroeconomic scenario

Our baseline scenario assumes that in 2014 the emerging markets will grow below their averages of recent years. China is a case in point, whose growth forecast has been steadily revised downward during the past several months and is now even below the officially defined target of 7.5 percent per year (figure 4). Other Latin American economies, including Brazil, Mexico and Peru, have also revised downward their respective projections. This owes to a number of factors. On one hand, the weaker fiscal and monetary impulse in Brazil, poor growth in Mexico and a slowdown in investment and exports in Peru. On the other hand, Argentina and Venezuela are making substantial corrections to their growth outlooks for the year, of the order of 3 percentage points down (figure 5).

All this contrasts with the developed world, where growth forecasts for the year have been revised upward, although with different nuances. Worth noting is the improved performance of the United States and confirmed signals of recovery in the Eurozone. Taking these changes together, that is, higher expected growth in the developed economies and lower growth in the emerging world, considering their relative weights, drives our forecast for Chile's trading partners marginally up for 2014 and 2015, to an average of 3.8 percent (3.7 percent in December).

The financial conditions facing our economy have not changed materially since December, while the terms of trade have worsened. Overall, compared with recent years, our external scenario will be less favorable this year. This because, on the one hand, foreign interest rates have risen as has risk aversion towards emerging markets. On the other hand, the price of copper has been falling for some months. In fact, at the statistical close of this Report it had dropped past the barrier of 3 dollars per pound. Our baseline scenario foresees that the pound of copper will trade at an average of 3 dollars in 2014 and 2.85 dollars in 2015 (table 1).

As I said before, in the past few months output and demand growth fell short of our forecasts in the previous *Monetary Policy Report*, particularly in investment-related sectors. Output grew 4.1 percent annually in 2013, with a sharp deceleration during the second half. One determinant was the behavior of sectors unrelated to natural resources, especially those associated with investment such as construction and part of trade and manufacturing. Among the components of demand, gross fixed capital formation posted the sharpest downward adjustment. Machinery and equipment posted negative y-o-y growth in the third and fourth quarters of 2013, while construction and other works decelerated significantly during the same period (figure 6).

This correction to investment growth owes to various factors. For one, there is the aforementioned investment cycle of mining and related sectors, plus the postponement of some investment plans. Although this was an expected development, its magnitude was unclear. Another factor is the low basis for comparison of the same months of 2012, which were swollen by unusual imports of transportation material, which affects the y-o-y variation of capital goods imports. There is also the downturn of expectations reflected in business confidence surveys and our business perception report *Informe de Percepciones de Negocios*. Lastly, there is the drop of public investment in real terms during the last quarter of the year, and the depreciation of the real exchange rate, which raises the costs of foreign capital goods.

Accordingly, private growth forecasts for this year have been revised downward. Our March Economic Expectations Survey lowered GDP growth in 2014 from 4.1 percent in November to 3.7 percent in March. Thus, the baseline scenario of this Report has lowered the GDP growth estimate for 2014.

The Board estimates that this year our economy will grow between 3 and 4 percent (3.75 to 4.75 percent in December), that is, less than last year and below trend. This means that this year investment will fall short of projections, with an annual growth rate that is now estimated closer to 1 percent (4.1 percent in December). It also inputs first-quarter data available, as well as the downward revisions to investment in 2013 and the turn of 2014 shown by the latest survey of the capital goods corporation CBC. Another factor behind the lower growth forecast for the immediate future is the upward correction to inventory levels, meaning that this source of expansion will provide a smaller impulse. The baseline scenario also estimates that, as has been occurring for some quarters, private consumption will post a moderate slowdown, grounded on a looser labor income and a stable borrowing trend.

This year, growth will go from less to more. Such a trajectory assumes that investment will stabilize, due to several elements coming together. On one hand, the CBC survey shows an increase in investment plans in engineering works in the second half of 2014 and for the period 2015–2016. On the other, there is housing construction that should continue the trend of last year, considering that the supply of homes is still low, housing sales are strong, and financial conditions (i.e. credit cost and volume) remain favorable. Meanwhile, the fiscal budget for 2014 is expected to be more in line with historical patterns, implying greater public spending with respect to 2013, especially investment. Machinery and equipment imports have been stable for some months. Plus, the somewhat stronger growth of trading partners and the depreciation of the real exchange rate should also boost non-mining exports. And last but not least, there is the increased monetary impulse that has been added to the economy.

As for domestic inflation, it has returned back to the Central Bank target of 3 percent in annual terms faster than expected. In recent months, CPI inflation has been driven by energy price increases that reflect both the higher dollar price of fuels and the depreciation of the peso. The impact of the depreciation on other prices in the CPI basket has been in line with expectations; Core inflation (i.e., the CPIEFE that excludes foodstuffs and energy) has also risen, although at a slower pace than headline CPI. Inflation expectations have remained at 3 percent in the projection horizon, with a slight increase in the near term.

The baseline scenario assumes that y-o-y CPI inflation will rise temporarily to the 3.5 to 4 percent range, in the coming months, reflecting the direct propagation of the peso depreciation to the prices of goods and services. The lower use of installed capacity – proxied by the behavior of output – should mitigate inflationary pressures and the direct effects of the depreciation. As I just said, the credibility and consolidation of our inflation-targeting scheme also help. Therefore, already by the end of 2014 headline inflation should move closer to 3 percent, where it should stay until the end of the projection horizon, that is, the first quarter of 2016. Core inflation will hover around 3 percent throughout the same horizon (figure 7).

The current account deficit of the balance of payments is forecast to stand at 3.6 percent of GDP in 2014, up a little from 2013, but below the December estimate. Behind it is the expected decline in the copper price this year, which more than offsets the lower growth foreseen in domestic demand and imports. This implies that, measured at trend prices, the deficit will narrow further, approaching 3 percent of GDP. As for GDP, the rate of total investment will go slightly above 23 percent in nominal terms (somewhat more than 25 percent in real terms), while national savings should amount to 19.5 percent (table 2).

Aside from the already discussed trajectories foreseen for domestic growth and the world economy, this forecast uses as a working assumption that nominal wages will be adjusted in line with productivity and the inflation target. It also uses as a methodological assumption that the real exchange rate will remain stable, considering that it is now inside the range believed to be consistent with its long-term fundamentals. Finally, the baseline scenario uses as a working methodological assumption that the MPR will follow a trend comparable with the one that can be derived by the prices of financial assets prevailing at the statistical closing of this Report (figure 8).

The baseline scenario reflects those events that are believed to be the most likely to occur with the information at hand at the closing of this Report. There are risk scenarios, however, which if materialized, may reshape the macroeconomic environment and, therefore, may modify the course of monetary policy. On this opportunity, having evaluated the alternative scenarios, the Board estimates that the risk balance is downward biased for output and unbiased for inflation.

Abroad, one first risk has to do with the behavior of emerging economies, especially China. The latter risk has been present in several Reports already and has recently been exacerbated because of growing doubts posed by the fragility of the Chinese financial system and the overall increase in the risk perception of the emerging world. In particular, adeterioration in the Chinese economy would have first-order effects on Chile and the group of emerging economies, spreading through both real and financial channels. Of particular importance is its impact on the prices of commodities, including copper, as well as on the growth of other important trading partners. Moreover, it cannot be ruled out that the vulnerabilities that some emerging economies have accumulated may generate new episodes of volatility

It is also possible for the recovery process in the U.S. to end up being stronger than expected. The timing of its effects shows different signs. In the short term, the anticipated normalization of the monetary stimulus could lead to a worsening of financial conditions for the emerging world, inducing new episodes of volatility as in recent quarters. Going forward, the effect of increased external demand and higher commodity prices would prevail, with positive effects on economies like Chile that have solid fundamentals. Overall, the risk associated with the complex fiscal and financial situation in the Eurozone is still present and, moreover, heightening of geopolitical tensions in Ukraine could affect commodity prices, as well as confidence in Europe.

At the local level, an important part of the economic slowdown of recent quarters is due to a drop in investment. The baseline scenario assumes that this phenomenon will not deepen and for some components it will even be reversed. But there are risks, particularly since the drop in investment in late 2013 was sharper than expected. For example, it is possible that, due to its natural inertia, investment may remain weak for longer than foreseen. Another risk is that a deterioration of the global economy may pull down the copper price below its long-term level, deferring new projects and slowing economic growth.

Still locally, inflation of recent months, like the projections included in the baseline scenario, show limited pass-through of the peso depreciation to prices, in line with economic fundamentals. As I said, the consolidation of the inflation-targeting regime and the economic slowdown restrict the degree of propagation to final prices, wages and expectations, so the recent rise in inflation is believed to be transitory. However, it is necessary to watch out for second-round effects to make sure they remain contained, particularly considering that margins have narrowed in some sectors due to increases in costs, such as energy, and that the labor market remains relatively tight.

Final remarks

The macroeconomic scenario shows economic slowdown beyond projections of a few months back, with inflation hovering around 3%. The external short-term outlook for Chile is less favorable than it was a year ago. In addition, further doubts have emerged regarding the performance of some of the big economies, especially China.

Just like we have done in the past few years, we are facing challenging conditions. The world economy is going through a new stage, where the central banks of developing economies are beginning to withdraw their extraordinary monetary stimulus packages, and the prices of our exports are returning to normal.

Without a doubt, beyond the volatility and uncertainty that we have seen in recent quarters, the improved performance and recovery of developed economies is good news for everyone. It opens the door to markets that have been severely depressed for some years and, in the end, such unusual and persistent financial conditions eventually create imbalances. And imbalances are bound to become increasingly costly as time passes.

Chile has managed to navigate this period with no accumulation of imbalances. Still, we will inevitably be affected. The cycle of high commodity prices is starting to reverse and the copper price will thus approach its medium-term levels. As I noted, the recent reduction in investment is partly associated with this factor and is also one defined risk in our baseline scenario.

Thankfully, our policy regime provides us with the tools to mitigate the effects of a more adverse scenario. Moreover, our country is well prepared to deal with future challenges. The depreciation of the peso has been a buffer, especially because it allows relative prices to adjust and thus rebalance resources and lessen the impact on output and employment. It also has an effect on inflation. This effect has been limited, in line with our economy's fundamentals and the state of capacity gaps. This is also related with the credibility of our monetary policy's commitment with the inflation target.

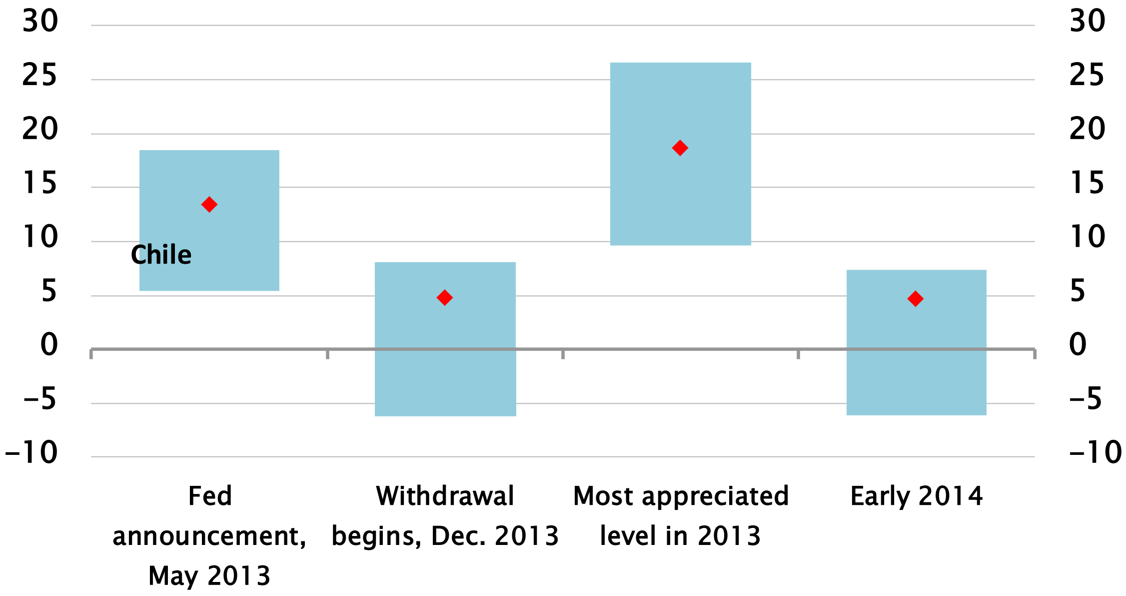
Inasmuch as macroeconomic conditions warrant, the Central Bank has the room and the determination to continue contributing to mitigate the cyclical slowdown of the economy. But we also reaffirm our commitment to achieving price stability, indicating that we will do everything necessary to ensure that projected inflation is aligned with the 3 percent target over the policy horizon. As we have said time and again, this is the main contribution that monetary policy can make to the development and well-being of our country.

Thank you.

Figure 1

Depreciation of emerging economies' currencies (*)

(percent)



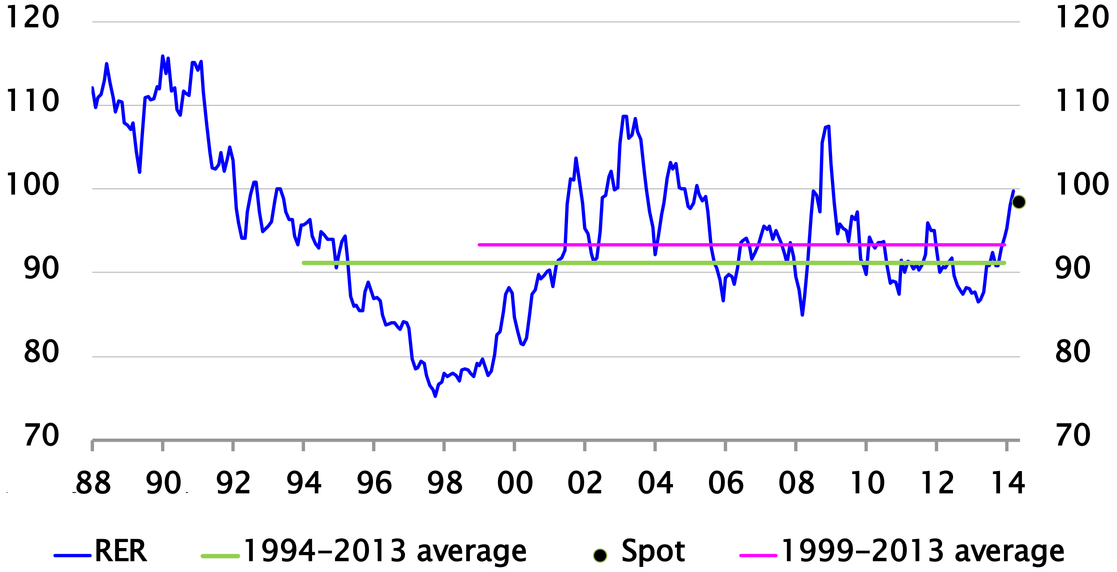
(*) Change between spot and specified date.

Sources: Central Bank of Chile and Bloomberg.

Figure 2

Real exchange rate (*)

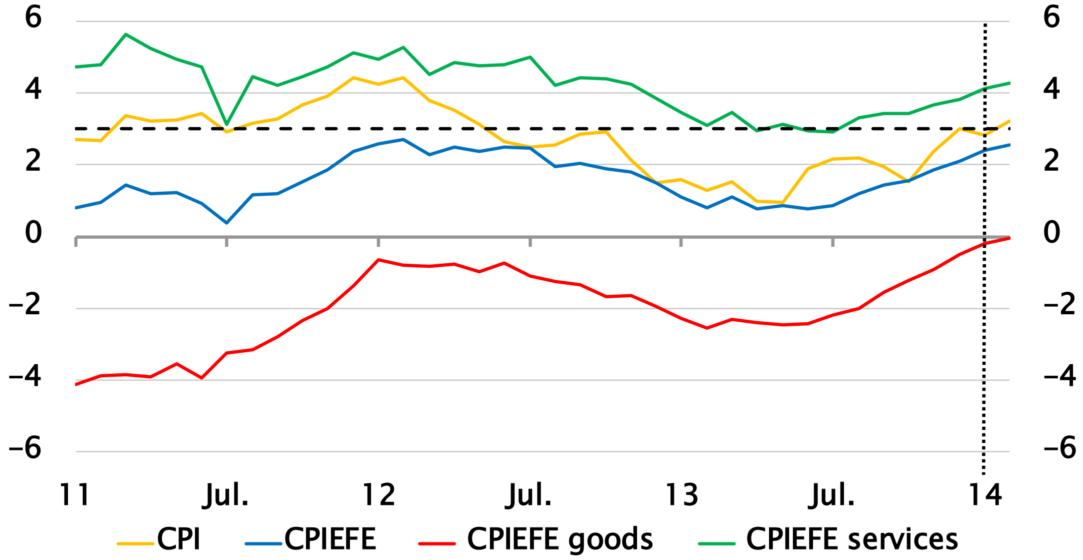
(index, 1986=100)



(*) The March 2014 figure covers information up to the 26th.

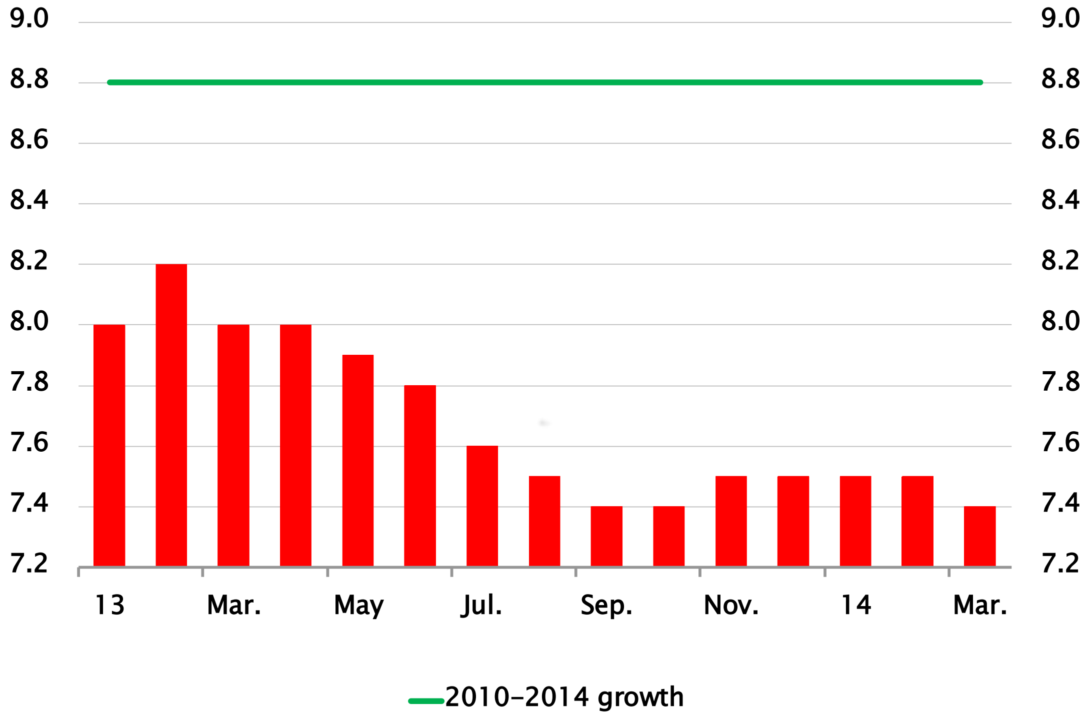
Source: Central Bank of Chile.

Figure 3
Inflation indicators (*)
(annual change, percent)



(*) As from January 2014, the new idexes 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).

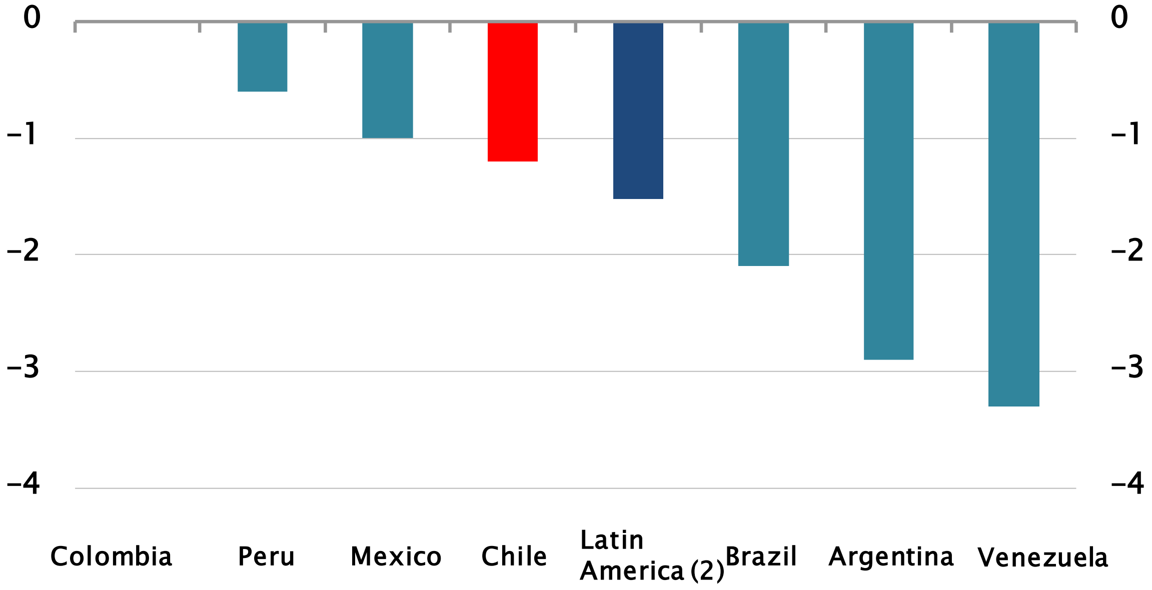
Figure 4
Evolution of China's 2014 GDP growth forecast
(percent)



Sources: Consensus Forecasts and Bloomberg.

Figure 5

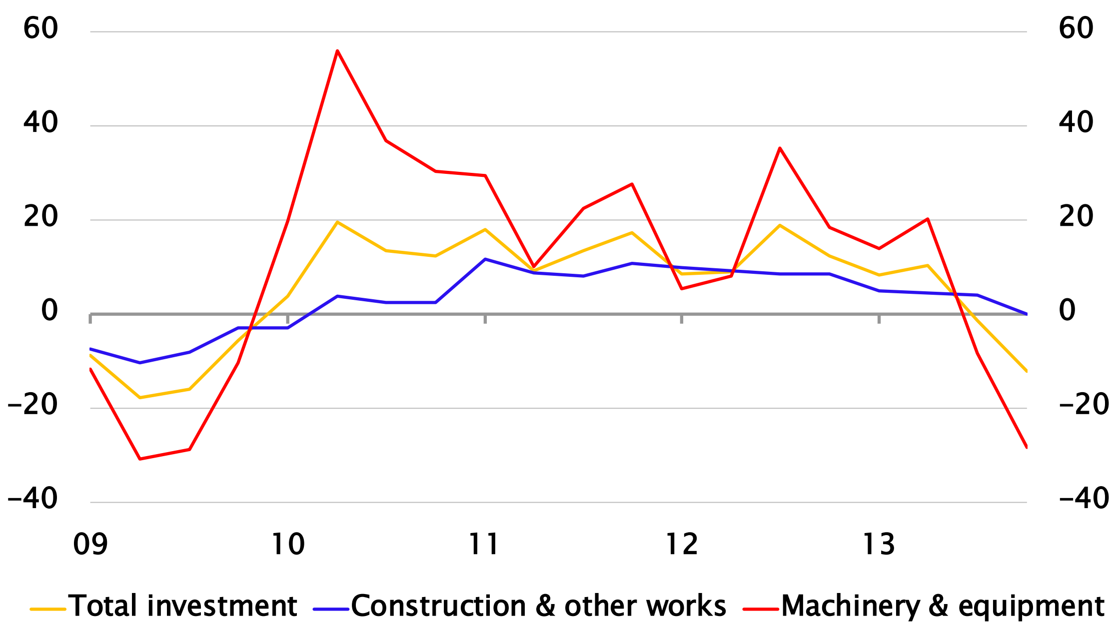
Cumulative revision to 2014 growth forecast for Latin America (1)
(percentage points)



(1) Between January 2013 and March 2014.
(2) Countries weighted at PPP by share of each economy according to WEO (IMF).
Sources: Central Bank of Chile based on Consensus Forecasts and IMF.

Figure 6

Gross fixed capital formation
(annual change, percent)



Source: Central Bank of Chile.

Table 1
International baseline scenario assumptions

	2012	2013 (f) March'13 Report	2013 (f) Dec.'13 Report	2013 (f) March'14 Report	2014 (f) March'13 Report	2014 (f) Dec.'13 Report	2014 (f) IPoM Mar. 14	2015 (f) March'13 Report	2015 (f) March'14 Report
GDP growth				(annual change, percent)					
Trading partners' GDP	3.4	3.6	3.4	3.4	4.2	3.6	3.7	3.8	3.9
World GDP at PPP	3.1	3.3	3.0	3.0	3.9	3.5	3.5	3.7	3.8
United States	2.8	1.9	1.7	1.9	2.5	2.6	2.7	2.7	2.9
Eurozone	-0.6	-0.4	-0.4	-0.4	1.3	1.0	1.2	1.4	1.5
Japa	1.9	1.1	1.8	1.6	1.3	1.3	1.5	1.0	1.1
China	7.7	8.1	7.6	7.7	8.2	7.4	7.3	7.2	7.2
India	5.1	6.3	4.1	4.5	6.4	5.3	5.4	6.3	6.3
Rest of Asia (excl. Japan, China and India)	3.8	4.3	3.8	3.9	4.7	4.0	4.1	4.5	4.5
Latin America (excl. Chile)	2.7	3.3	2.6	2.4	3.7	2.9	2.3	3.4	3.4
					(levels)				
LME copper price (US$cent/lb)	361	350	332	332	340	310	300	290	285
Brent oil price (US$/barrel)	112	108	109	109	101	106	106	100	101
				(annual change, percent)					
Terms of trade	-4.1	-0.4	-3.9	-3.2	-1.6	0.2	-0.9	-1.5	-1.1

(f) Forecast

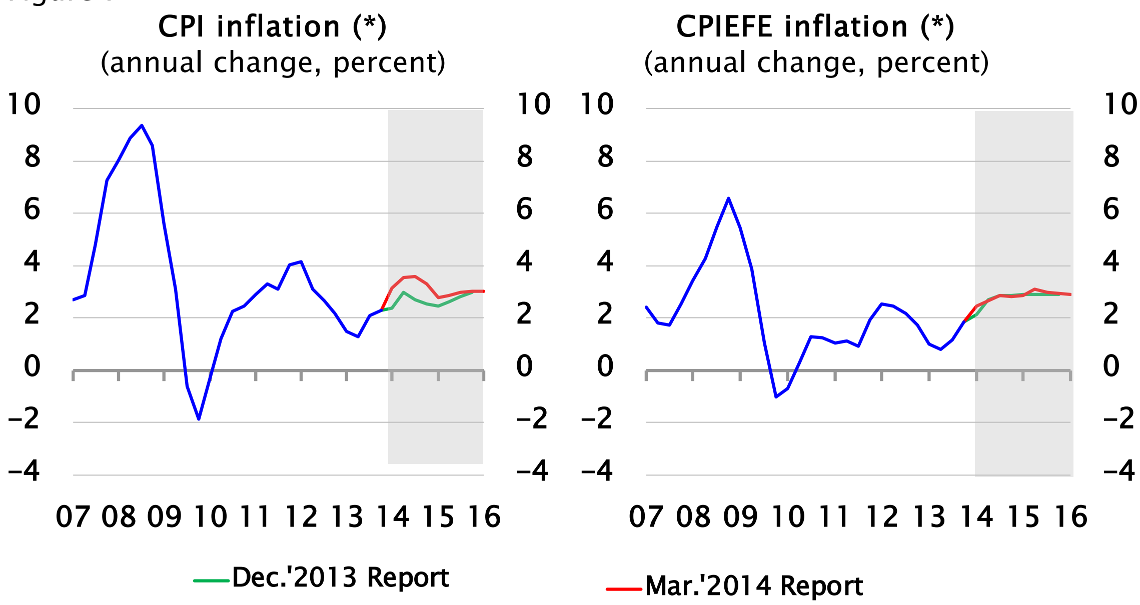
Sources: Central Bank of Chile based on a sample of investment banks, Consensus Forecasts, the IMF and statistics bureaus of respective countries.

Table 2
Domestic scenario
(annual change, percent)

	2012	2013 (e) Dec.'13 Report	2013 (e) Mar.'14 Report	2014 (f) Dec.'13 Report	2014 (f) Mar.'14 Report
GDP	5.4	4.2	4.1	3,75-4,75	3,0-4,0
Domestic demand	6.9	3.9	3.4	4.8	3.3
Domestic demand (w/o inventory change)	7.1	5.1	4.2	4.5	3.3
Gross fixed capital formation	12.2	3.9	0.4	4.1	0.8
Total consumption	5.6	5.4	5.4	4.7	4.1
Goods and services exports	1.1	5.3	4.3	3.1	3.2
Goods and services imports	5.0	4.4	2.2	4.6	2.4
Current account (% of GDP)	-3.4	-3.2	-3.4	-3.7	-3.6
Gross national savings (% of GDP)	21.7	21.1	20.5	20.6	19.5
December CPI	1.5	2.6	3.0	2.5	3.0
December CPIEFE	1.5	1.9	2.1	2.9	2.8

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

Figure 7



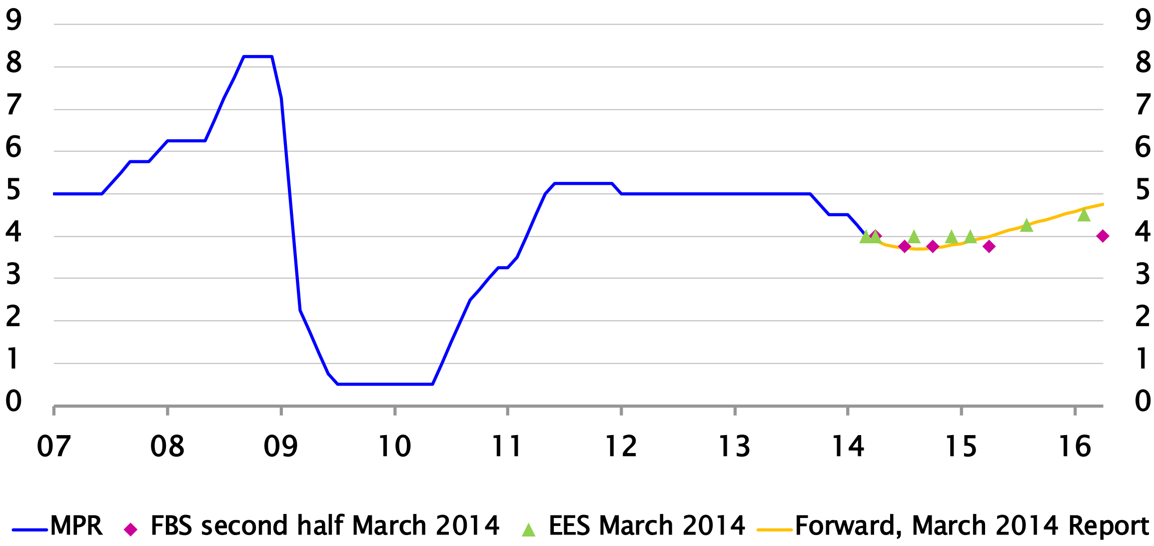
(*) Gray area, as from the first quarter of 2014, shows forecast.

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

Figure 8

MPR and expectations

(percent)



Source: Central Bank of Chile.