Monetary Policy Report
September 2008

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Central Bank of Chile

Goldman Sachs
Emerging Markets Conference
New York City
Issues

I. Recent Trend in Inflation
II. Current Stance of Monetary Policy
III. Baseline Scenario
IV. Some Conclusions
I. Recent Trend in Inflation
CPI inflation is around 9%, more than three times the BCCh target.

Inflation: IPC, IPCX e IPCX1
(Annual change, Percent)

Sources: Banco Central de Chile and Instituto Nacional de Estadísticas.
This trend has been strongly influenced by large and persistent increases in world food prices...

Food Prices (*)
(Index: Jan 1, 2006=100)

... and oil prices.

WTI and futures (*)
(dollars per barrel)

Precio WTI  IPoM sep.06  IPoM sep.07
IPoM may.08  IPoM sep.08  15.sep.08

(*) Futures consider the average of last 10 previous to each Monetary Policy Report.
Source: Bloomberg.
A significant share of inflation is explained by an increase in domestic prices of gasoline, energy and food products.

### Incidence of food and energy on CPI

<table>
<thead>
<tr>
<th>Item</th>
<th>Share on CPI (Percent)</th>
<th>August 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Annual change (percent)</td>
</tr>
<tr>
<td>1. Fuel (1)</td>
<td>4.01</td>
<td>17.6</td>
</tr>
<tr>
<td>2. Electricity</td>
<td>1.64</td>
<td>27.7</td>
</tr>
<tr>
<td>3. Food</td>
<td>23.48</td>
<td>17.1</td>
</tr>
</tbody>
</table>

(1) Natural gas/liquefied gas/gasoline.  
Sources: Instituto Nacional de Estadísticas and Banco Central de Chile.
Also, we have seen a significant increase in prices not directly linked with food or energy.

CPI excluding food and energy(*)
(Annual change, Percent)

(*) In parenthesis their shares in CPI basket.
Sources: Banco Central de Chile and Instituto Nacional de Estadísticas.
This is also evident in the inflation dynamics of services.

CPI goods and services
(Annual change, Percent)

(1) Excludes Gasoline and fresh fruits and vegetables
(2) Excludes basic services and metro/bus tariffs
Sources: Banco Central de Chile and Instituto Nacional de Estadísticas.
The increase in ex-food ex-energy prices might reflect:

- Significant increase in production costs
- High growth in domestic demand
- A high degree of price/wage indexation
- An increase in inflation expectations
- Exchange rate dynamics
Domestic demand have grown at rates twice as large as the growth rate of output.

**GDP and domestic demand**
(Real annual change; percentage points)

Source: Banco Central de Chile.
Investment is the most dynamic component

Components of domestic demand
(Real annual change; percentage points)

Source: Banco Central de Chile.
These phenomena occur in a context of a dynamic labor market.

Total employment

Thousands of people (*)
Annual change, percent

(*) Seasonally-adjusted series.
Source: Banco Central de Chile and Instituto Nacional de Estadísticas.
We have observed an increase in inflation expectations.
Neither we can rule out the impact of exchange rate movements, but on an annual basis they seem to be of second order.

Nominal Exchange Rate
(Index: average 2007=100)

(1) Average up to September 5, 2008.
Source: Banco Central de Chile.
II. Current Stance of Monetary Policy
The Central Bank has increased the MPR substantially in the last months.

MPR, inflation and inflation expectations (percent)

(1) Monthly average.
Sources: Banco Central de Chile, Bloomberg and Instituto Nacional de Estadísticas.
Real rates of Central Bank bonds remain at historical levels

Interest rates of Central Bank bonds
(weakly averages, percent)

Sources: Banco Central de Chile
Neither we have observed significant increases in lending rates. At this stage, monetary policy is in a neutral phase.

Lending Rates
(base 360 days, percent)

Consumption (1)  Mortgages (2)  Corporate (1)

(1) Weighted average nominal rates.
(2) Rate 4–5% and Duration: 5–6.

Sources: Banco Central de Chile
Asset prices discount further increases in monetary policy rate

Source: Banco Central de Chile
III. Baseline Scenario
Emerging markets’ growth continues *surprisingly* very resilient to lower dynamism in developed countries

Global growth
(annual change, percent)

(f) Forecast.
(*) According to IMF.
Source: IMF.
We expect commodity prices to stay at levels similar to those currently observed.

Assumptions for international scenario
(annual average)

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008 (f)</th>
<th>2009 (f)</th>
<th>2010 (f)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2007</td>
<td>2008 (f)</td>
<td>2009 (f)</td>
<td>2010 (f)</td>
</tr>
<tr>
<td>Terms of Trade (*)</td>
<td>0.8</td>
<td>-7.2</td>
<td>-8.9</td>
<td>-4.3</td>
</tr>
<tr>
<td>Foreign Inflation, in US$ (*)</td>
<td>8.5</td>
<td>12.5</td>
<td>2.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Copper price BML (US$/cent/pound)</td>
<td>323</td>
<td>350</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>WTI Oil price (US$/barrel)</td>
<td>72</td>
<td>110</td>
<td>109</td>
<td>115</td>
</tr>
</tbody>
</table>

(f) Forecast.
(\*) Annual rate of change.
Source: Banco Central de Chile.
In the domestic front, we expect a lower dynamism in activity

Forecast for GDP
(Annual change, percent)

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008 (f)</th>
<th>2009 (f)</th>
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</thead>
<tbody>
<tr>
<td>GDP</td>
<td>4.3</td>
<td>5.1</td>
<td>4.5–5.0</td>
<td>3.5–4.5</td>
</tr>
<tr>
<td>National Income</td>
<td>6.7</td>
<td>7.8</td>
<td>5.2</td>
<td>3.5</td>
</tr>
<tr>
<td>Domestic Demand</td>
<td>6.4</td>
<td>7.8</td>
<td>9.1</td>
<td>3.9</td>
</tr>
<tr>
<td>Gross Fixed Capital Formation</td>
<td>2.9</td>
<td>11.9</td>
<td>19.3</td>
<td>2.9</td>
</tr>
<tr>
<td>Total Consumption</td>
<td>6.4</td>
<td>7.4</td>
<td>5.6</td>
<td>4.3</td>
</tr>
<tr>
<td>Total Exports</td>
<td>5.5</td>
<td>7.8</td>
<td>2.1</td>
<td>3.8</td>
</tr>
<tr>
<td>Total Imports</td>
<td>10.5</td>
<td>14.3</td>
<td>12.6</td>
<td>4.1</td>
</tr>
<tr>
<td>Current Account (% of GDP)</td>
<td>4.7</td>
<td>4.4</td>
<td>−1.1</td>
<td>−2.7</td>
</tr>
</tbody>
</table>

(f) Forecast.
Source: Banco Central de Chile.
In the baseline scenario, annual inflation will stay around the current level until 2009.I, reaching 3% by 2010.III.

### Inflation Forecast
(annual change, percent)

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<th>2010 (f)</th>
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<tr>
<td>CPI Inflation (average)</td>
<td>4,4</td>
<td>8,8</td>
<td>6,9</td>
<td>3,4</td>
</tr>
<tr>
<td>CPI Inflation (dec)</td>
<td>7,8</td>
<td>8,5</td>
<td>4,9</td>
<td></td>
</tr>
<tr>
<td>CPI Inflation (in two years) (*)</td>
<td>7,8</td>
<td>8,5</td>
<td>4,9</td>
<td>3,0</td>
</tr>
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<td>CPIX Inflation (average)</td>
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<tr>
<td>CPIX Inflation (in two years) (*)</td>
<td>6,3</td>
<td>8,4</td>
<td>4,8</td>
<td>3,3</td>
</tr>
<tr>
<td>CPIX1 Inflation (average)</td>
<td>4,1</td>
<td>7,9</td>
<td>6,7</td>
<td>3,6</td>
</tr>
<tr>
<td>CPIX1 Inflation (dec)</td>
<td>6,3</td>
<td>8,5</td>
<td>4,8</td>
<td></td>
</tr>
<tr>
<td>CPIX1 Inflation (in two years) (*)</td>
<td>6,3</td>
<td>8,5</td>
<td>4,8</td>
<td>3,4</td>
</tr>
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Source: Banco Central de Chile.
This outlook for inflation is based upon a downward adjustment in the growth rate for domestic demand due to:

- The effects of a restrictive monetary policy.
- The normalization of the spending cycle in durable goods and some components of capital formation.
- A lower growth rate of government expenditure.
- It does not rely on a drop in energy/food prices.
We also expect inflation expectations and wage adjustments to evolve coherently with inflation convergence.

Source: Banco Central de Chile and Instituto Nacional de Estadísticas.
This scenario considers a trajectory for the MPR that, in the short run, is higher than that implicit in assets prices.

Source: Banco Central de Chile.
IV. Some Conclusions
Current inflation dynamics require decisive actions from the Central Bank.

Inflation convergence requires a lower growth rate of domestic demand.

The BCCh will continue its process of monetary restrictiveness until the convergence process to 3% in 2 years is safeguarded.
- The baseline scenario is subject to significant uncertainty, specially on the external front.

- The balance of risks to global growth is tilted to the downside. Also, Chile has strong fundamentals, but there is a risk of further restrictions to access global financial markets. The optimal monetary policy response to these alternatives is not obvious. The bank will evaluate them and act accordingly.

- However, either scenario provides the adequate framework for inflation convergence.