First and foremost, thank you for inviting me to speak about the Chilean economy’s current situation and future prospects. The world crisis that is underway presents major challenges, and the effects it is having on our country stress how important it is to stay in contact with the entrepreneurial community, both to share our vision with you and to remain aware of your impressions.

When we presented our Monetary Policy Report last May, we gave an account of the difficulties facing the world economy, which will see output drop for the first time in six decades. Moreover, this crisis has been characterized by great synchrony among countries, regardless of their strengths or weaknesses (figure 1). As we have said over and over before, during and after the most stressful times in external financial markets, our country could not and would not be immune to the effects of the crisis. Actually, the macroeconomic outlook changed radically while fiscal and monetary policies reacted accordingly to the challenge, by adding a stimulus of unprecedented magnitude and speed. In the case of our Central Bank, between January and June we reduced the monetary policy rate (MPR) by 750 basis points to 0.75% annually, the lowest ever.

In recent weeks, news from abroad has ceased to be mostly negative. Various agents’ forecasts for world growth have stabilized, and some have even risen marginally (table 1). Still, this is not enough to imply a significant external boost for our economy, because world growth will remain low.

Commodity prices have increased substantially in the past few weeks. The prices of copper and oil have risen more than 50% since the end of 2008. The copper price hike reflects higher demand, especially from China. In the case of the oil price, the increase began showing in domestic prices, which has been partly offset by the recent appreciation of the peso.

Little by little, dislocations in international financial markets are being fixed. Interbank markets, which a few months ago had to deal with serious liquidity problems, have continued to normalize thanks to the liquidity provision measures adopted by authorities and the gradual recovery of expectations. On the other hand, institutions have been able to raise capital according to their needs; the US Treasury even authorized some of the bailed-out banks to repurchase the preferred stocks they issued when receiving government support under the TARP.

One key factor behind this set of indicators pointing at stabilization is, without a doubt, the scale of the monetary and fiscal stimulus packages that have been implemented in many parts of the world, in both developed and emerging economies. This is a significant

* Presented before the Executive Committee of Chile’s Confederación de la Producción y del Comercio, on 30 June 2009.
difference between this crisis and the Great Depression. Although it has been claimed that
the financial debacle we have experienced recently is similar in magnitude to the one
originated by the Great Depression, the lessons learned from it have enabled policies to act
much faster, with more effective and pragmatic responses.

In those days, fiscal authorities tried to keep their budgets balanced, even when the
economic depression had been established in 1937, thereby deepening the contraction of
aggregate demand. In the case of monetary policy, the premature reduction of the
monetary stimulus in 1936 contributed decisively to the recession of 1937-38. The current
monetary policy has played its role in providing liquidity and generating an expansionary
stimulus. Today’s higher fiscal and monetary policy flexibility has avoided the intrusion of
distortionary protectionist measures that prolonged the crisis of the 1930s, amplifying its
costs and deeply hurting subsequent economic development in several regions of the
world, including our country.

Still, it is likely that returning to levels of domestic demand observed before the crisis will
take time, especially in the United States. Active fiscal policy has compensated for the
reduction in private spending, but this cannot be sustained for long. The natural,
sustainable solution will require an increase in net exports from the United States and, to a
lesser extent, from Europe. How this will happen is an open question, because it is yet to
be seen which economies will, as counterparts, reduce their net exports to create the
necessary space for such an adjustment. Furthermore, this may require major exchange
rate adjustments in the main economic areas.

On this last point, today’s floating exchange rate regimes have played their role as
stabilizers, providing the degree of freedom needed by monetary policy and liquidity
 provision measures to tackle the cycle and the financial instability. This element was
nowhere to be seen in the 1930s, when the main central banks struggled hard, but
ineffectively, to defend the gold standard, severely magnifying tensions in the banking
systems. Many emerging economies have successfully applied the lessons learned in past
financial crises, which has helped them obtain increased financial resilience and a reduced
impact on growth compared to developed countries.

One feature of world financial markets’ behavior during the past few months has been the
increase in long-term interest rates on public instruments. These movements can be linked
to an environment of smaller risks and expected increases in fiscal debt certificates, and to
the fact that, for the first time in several months, there is incipient debate about the
convenience of a less-expansionary monetary policy, given the medium-term inflationary
risks. In the local financial markets, the interest rates on long-term Central Bank notes
have also risen—albeit with swings—above the levels that prevailed at the time of our
May Monetary Policy Report. The steepening of the yield curve coincides with what has
occurred in international markets, and may be signaling an increase in the markets’
appetite for risk. It may also be that they respond to more idiosyncratic factors, especially
because of the big momentum showed by the local bonds market this year.

The pass-through of MPR cuts to lending rates in recent months has been evident. While
the latest data suggest that it may have moderated, transmission should continue,
particularly as macroeconomic uncertainties phase out. The annual growth rate of credit
volume has slowed, in a context where lending standards remain tight and there is less
demand for credit due to a more cautious attitude among economic agents.
In addition, since the publication of our last Monetary Policy Report, short-term figures point at milder short-term inflationary prospects. The latest output indicators have been more negative than we foresaw in May. Although at the moment this does not alter our forecast of a recovery of activity and demand in the second half of this year, it does present a scenario where output gaps are wider than estimated and, therefore, inflationary pressures are reduced. The labor market also continues to reflect deteriorated macroeconomic conditions, with steadily increasing unemployment although drops in employment are moderating slightly.

May’s inflation was negative beyond expectations, especially its underlying components. Year-on-year CPI inflation, after many months, returned to the tolerance range of the inflation target (figure 2), but is expected to continue to fall and even cross into negative territory in the latter part of the year. Inflation expectations derived from various surveys also show some declines in the last few months.

Recent public discussions have centered on exchange rate movements. The real exchange rate is, without any doubt, a key variable in resource allocation and in the balance between saving and investment. Unlike episodes of past decades, in particular those of the mid-1980s, the Chilean economy has dealt with the complex global financial situation from a much sounder standpoint. The sudden global collapse of last year found us with no large current-account or fiscal deficit, nor with a high external debt that would have required strong fiscal adjustments and substantial real depreciation to place the economy in a sustainable medium-term path. On the contrary, the significant contraction in domestic demand, in particular for imported durable goods and inventories, spontaneously and rapidly eliminated the incipient external deficit of the second half of 2008 and interest rates in Chile dropped. The Chilean economy has continued to show a very solvent net external position.

As we have pointed out on earlier occasions, persistent movements of the exchange rate may have inflationary consequences that must be taken into account when deciding monetary policy. Our floating exchange rate regime admits intervening in exceptional cases, when an overreaction of the exchange rate is detected that is giving misleading signals to the financial markets. In addition, although there is no obvious misalignment of the real exchange rate from its long-term fundamentals, the current inflationary scenario may accommodate a nominal depreciation that does not compromise our price stability objective. In fact, imported inflationary pressures influence medium-term inflation, so if the recent appreciation of the peso persists, inflationary prospects will certainly moderate, which, as I just stated, has implications for the conduct of monetary policy.

From the public finance standpoint, it is not obvious that the aforementioned situation could have been avoided with a different mix of credit sources for the necessary fiscal impulse. This is because the level and the structure of interest rates are also important when trying to affect gaps and inflation in the medium term.

Summing up, the changes we have seen in the macroeconomic scenario since last May lead us to think that, if anything, inflationary pressures are lower than expected, so the risk of inflation remaining below the 3% target for longer than expected has increased. In this context, it may be necessary to increase the monetary stimulus. While the MPR is already at a very low level, such that there is limited room for maneuvering, an additional cut
cannot be ruled out. We must also keep in mind that expectations about the course of monetary policy affect the market interest rate structure and the exchange rate. The Board was clear—both in the May Monetary Policy Report and in June’s monetary policy meeting—in its estimates that, in the baseline scenario, it would be necessary to maintain the monetary stimulus for a longer period than the one implicit in financial asset prices. Recent information continues to validate this diagnosis (figure 3).

The macroeconomic scenario we are facing remains complex. Although it seems to have ceased to deteriorate at the margin, we must not lose sight of the fact that a global crisis of this magnitude has few precedents for comparison in modern economic history. As I said before and we have repeated endlessly, Chile could not and would not be immune to external developments. The crisis hit us hard. The consequences are visible in the drop in domestic output and demand, in a deteriorated labor market and in reduced inflationary pressures. More importantly, however, the economic juncture we are facing has required decisive action by economic policymakers. We at the Central Bank have responded, and will continue to respond, beyond the fact that our usual monetary policy tool, the MPR, is currently close to its minimum possible level.

Thank you very much.
Figure 1

World growth
(annualized q-o-q change, percent)

Sources: Central Bank of Chile based on sample of investment banks, Consensus Forecasts, Bloomberg and IMF.

Table 1

World growth (*)
(annual change, percentage)

<table>
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<tr>
<th></th>
<th>Ave. 90–99</th>
<th>Ave. 00–05</th>
<th>2006</th>
<th>2007</th>
<th>2008 (e)</th>
<th>2009 (f) May</th>
<th>2010 (f) May</th>
<th>2009 (f) June</th>
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<tr>
<td>World</td>
<td>2.9</td>
<td>3.8</td>
<td>5.1</td>
<td>5.2</td>
<td>3.2</td>
<td>−1.2 ▲</td>
<td>−1.1</td>
<td>2.1 ▲</td>
<td>2.3 ▲</td>
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<tr>
<td>World at market ER</td>
<td>2.4</td>
<td>2.9</td>
<td>3.9</td>
<td>3.8</td>
<td>2.2</td>
<td>−2.3 ▲</td>
<td>−2.2</td>
<td>1.4 ▲</td>
<td>1.6 ▲</td>
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<td>2.4</td>
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<td>−7.2 ▲</td>
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<td>0.9 ▲</td>
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<td>5.9</td>
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<td>−1.9 ▲</td>
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<td>0.9 ▲</td>
<td>1.3 ▲</td>
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<td>Trading partners</td>
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</tr>
</tbody>
</table>

(*) Regional growth weighted by its share in world GDP at PPP, published in the IMF’s World Economic Outlook (WEO, April 2009).
(e) Estimate; (f) Forecast.

Sources: Central Bank of Chile based on sample of investment banks, Consensus Forecasts and IMF.
Figure 2
CPI and selected inflation measures
(annual change, percent)

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

Figure 3
MPR and forward curve
(annual change, percent)

Source: Central Bank of Chile.