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* The statistical closing date of this Monetary Policy Report was 12 June, 2014
The main objective of the Central Bank of Chile’s monetary policy is to keep inflation low, stable, and sustainable over time. Its explicit commitment is to keep annual CPI inflation at around 3% most of the time, within a tolerance range of plus or minus one percentage point. To meet this target, the Bank focuses its monetary policy on keeping projected inflation at 3% annually over a policy horizon of around two years. Controlling inflation is the means through which monetary policy contributes to the population’s welfare. Low, stable inflation favors a better functioning of the economy and economic growth, while preventing the erosion of personal income. Moreover, focusing monetary policy on achieving the inflation target helps to moderate fluctuations in employment and output.

The Monetary Policy Report (the Report) serves the following main objectives: (i) to inform and explain to the Senate, the Government and the public the Central Bank Board’s views on recent and expected inflation trends and their consequences for the conduction of monetary policy; (ii) to communicate publicly the Board’s medium term analytical framework used to formulate monetary policy; and (iii) to provide useful information that can help shape market players’ expectations on future inflation and output trends. In accordance with Section 80 of the Bank’s Basic Constitutional Act, the Board is required to submit this Report to the Senate and the Minister of Finance.

The Report is released four times a year, in March, June, September and December. It centers on the main factors affecting inflation. These include the international environment, financial conditions, the outlook for aggregate demand, output and employment, and recent developments in prices and costs. The final chapter sums up the results of this analysis in terms of the prospects and risks for inflation and growth over the next eight quarters. A number of boxes are also included, to provide more detail on issues that are relevant for evaluating inflation and monetary policy.

This Report was approved at the Board’s session of 13 June, 2014, for presentation to the Senate’s Finance Committee on 16 June, 2014.
SUMMARY

In recent months, domestic output and demand continued on a decelerating path. The drop in investment that has been going on for some quarters was compounded by a decline in private consumption. CPI inflation has risen to more than 4% y-o-y at May, mainly due to pass-through from the peso depreciation to final prices. Although this increase has exceeded expectations, this situation is assessed as temporary and inflation is forecast to return to 3% annually within the normal horizon of monetary policy, a view that also reflects inflation expectations over the medium term, which have remained at 3%. The external scenario shows no major changes compared with the previous Report. The volatility of global financial markets has declined. In this context, the Board has kept the monetary policy rate (MPR) at 4% in the last months and has communicated that it will consider the possibility of making additional cuts to the MPR in line with the evolution of domestic and external macroeconomic conditions and its implications on the inflationary outlook.

In the past few months, the y-o-y variation of the various measures of the CPI has increased significantly and, as already noted, has exceeded projections. Headline CPI went from 1.5% annually in October 2013 to 4.7% in May 2014\(^1\). This rise in inflation was, to some extent, an expected development, because of both its previous low level, and the effect of the peso depreciation that has been observed since mid-last year. A closer look at inflation over the past six months reveals that the bigger increase has concentrated in those components of core inflation of goods and services whose prices are directly or indirectly linked to the exchange rate. Nominal wages have accelerated in the recent past.

This inflationary behavior has taken place in a context where the evolution of output and demand imply a reduction in installed capacity utilization. In the first quarter, output grew 2.6% annually, confirming its slowdown that began in the fourth quarter of 2013. Overall, this result was in line with the March forecast, but its composition changed toward higher growth in areas more closely linked to the world economy—like some branches of the manufacturing industry and agriculture—and lower growth in sectors more linked to domestic demand, especially services. Furthermore, excluding inventories, y-o-y growth in domestic demand picked up with respect to late 2013, mainly because of a smaller decline in investment—especially in the machinery and equipment component—and stronger public spending. However, the performance of domestic spending remains weak. Investment has posted negative annual growth rates for three successive quarters, which couples with a sharper-

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\(^1\) May 2014’s inflation is estimated using the reference basket 2013=100.
ECONOMIC GROWTH AND CURRENT ACCOUNT

<table>
<thead>
<tr>
<th></th>
<th>2012 (annual change, percent)</th>
<th>2013</th>
<th>2014 (f)</th>
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<tbody>
<tr>
<td>GDP</td>
<td>5.4</td>
<td>4.1</td>
<td>2.5-3.5</td>
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<tr>
<td>National income</td>
<td>4.6</td>
<td>3.4</td>
<td>2.8</td>
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<tr>
<td>Domestic demand</td>
<td>6.9</td>
<td>3.4</td>
<td>1.7</td>
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<tr>
<td>Domestic demand (w/o inventory change)</td>
<td>7.1</td>
<td>4.2</td>
<td>2.4</td>
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<tr>
<td>Gross fixed capital formation (GFCF) (%) of real GDP</td>
<td>12.2</td>
<td>0.4</td>
<td>-0.7</td>
</tr>
<tr>
<td>Total consumption</td>
<td>5.6</td>
<td>5.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Goods and services exports</td>
<td>1.1</td>
<td>4.3</td>
<td>3.2</td>
</tr>
<tr>
<td>Goods and services imports</td>
<td>5.0</td>
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<td>-1.1</td>
</tr>
<tr>
<td>Current account (%) of GDP</td>
<td>-3.4</td>
<td>-3.4</td>
<td>-2.5</td>
</tr>
<tr>
<td>Gross national savings (%) of GDP</td>
<td>21.7</td>
<td>20.5</td>
<td>19.9</td>
</tr>
<tr>
<td>Gros national investment (%) of GDP</td>
<td>25.1</td>
<td>23.9</td>
<td>22.4</td>
</tr>
<tr>
<td>GFCF (%) of nominal GDP</td>
<td>24.0</td>
<td>23.6</td>
<td>22.7</td>
</tr>
<tr>
<td>GFCF (%) of real GDP</td>
<td>26.8</td>
<td>25.8</td>
<td>24.9</td>
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(f) Forecast.
Source: Central Bank of Chile.

INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

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<th></th>
<th>Avg 00-07</th>
<th>Avg 10-12</th>
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<th>2014 (f)</th>
<th>2015 (f)</th>
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<tbody>
<tr>
<td>Terms of trade</td>
<td>8.2</td>
<td>4.1</td>
<td>3.2</td>
<td>-0.5</td>
<td>-1.5</td>
</tr>
<tr>
<td>Trade partners’ GDP (%)</td>
<td>3.6</td>
<td>4.6</td>
<td>3.3</td>
<td>3.6</td>
<td>3.9</td>
</tr>
<tr>
<td>World GDP at PPP (%)</td>
<td>4.2</td>
<td>4.0</td>
<td>3.0</td>
<td>3.3</td>
<td>3.7</td>
</tr>
<tr>
<td>World GDP at market exchange rates (%)</td>
<td>3.2</td>
<td>3.2</td>
<td>2.4</td>
<td>2.7</td>
<td>3.1</td>
</tr>
<tr>
<td>Developed economies’ GDP at PPP (%)</td>
<td>2.6</td>
<td>1.9</td>
<td>1.1</td>
<td>1.9</td>
<td>2.4</td>
</tr>
<tr>
<td>Emerging economies’ GDP at PPP (%)</td>
<td>7.4</td>
<td>5.9</td>
<td>4.5</td>
<td>4.5</td>
<td>4.8</td>
</tr>
<tr>
<td>External prices (in US$) (%)</td>
<td>4.6</td>
<td>5.3</td>
<td>0.3</td>
<td>1.0</td>
<td>1.3</td>
</tr>
<tr>
<td>LME copper price (US¢/lb)</td>
<td>154</td>
<td>367</td>
<td>332</td>
<td>310</td>
<td>290</td>
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<tr>
<td>WTI oil price (US$/barrel)</td>
<td>44</td>
<td>90</td>
<td>98</td>
<td>100</td>
<td>93</td>
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<tr>
<td>Brent oil price (US$/barrel)</td>
<td>42</td>
<td>101</td>
<td>109</td>
<td>108</td>
<td>103</td>
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<tr>
<td>Gasoline price (US$/gal)</td>
<td>367</td>
<td>742</td>
<td>785</td>
<td>792</td>
<td>799</td>
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<td>Libor US (nominal, 90 days)</td>
<td>3.6</td>
<td>0.4</td>
<td>0.6</td>
<td></td>
<td></td>
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</tbody>
</table>

(*) For a detailed definition, see glossary.
(f) Forecast.
Source: Central Bank of Chile.

Although the economy has been sluggish already for a couple of quarters, the labor market has been more resilient than it was in other slowdown cycles in the past. The unemployment rate has remained at historically low levels. Still, although nominal wages showed an acceleration, real wages have moderated. Job creation has deteriorated somewhat more, with salaried employment growth declining in favor of self-employment. Another factor worth noting is the observed slowdown in job vacancies.

Since October, the Board has reduced the MPR by 100 basis points, which has contributed to a decline in short-term interest rates and also the cost of long-term financing, in some cases to their decade-long minimums. Despite the lower cost of credit, expansion of bank loans has declined in recent months, especially in commercial credits, which are associated with the funding of inventories, working capital and fixed assets. In addition to demand factors, the Bank Lending Survey indicates that credit access conditions have tightened in recent months. The opinions expressed in April’s Business Perceptions Report agree with this assessment. In contrast, y-o-y growth in mortgage lending increased slightly, which is attributed to the completion of various real estate projects and the concretion of committed sales.

Internationally, the financial markets have been more calm than they were in the second half of 2013 and early 2014. This reflected in improved stock markets valuations, a drop in sovereign risk premiums and long-term rates, and an appreciation of emerging markets’ currencies. Several factors combined. On one hand, in the United States, the withdrawal of unconventional stimulus has been in line with expectations, and the Eurozone has made progress in its fiscal area and banking sectors. In addition, in Europe there has been also a more expansive monetary policy intended to prevent a deflation scenario. On the other hand, in China the risks to the financial system and economic growth are still present, but the authorities have announced some targeted fiscal stimulus measures and reforms to the capital market, and recent stress tests to the banking system revealed adequate levels of capital. The copper price oscillated importantly in recent months. After approaching US$3.15 per pound, it lately receded to around US$3 per pound. The baseline scenario assumes copper price forecasts of US$3.1 in 2014 and US$2.9 in 2015.

Regarding world activity, developed economies have further consolidated their upward growth trend, while emerging economies continue to slow down. However, several downward revisions have been made to the projections for this year, mostly driven by actual first-quarter data. Thus, it is expected that in the period 2014-2015 Chile’s trading partners will grow 3.7% on average, than-expected slowdown in private consumption, in particular its durable component. Inventories fell significantly in the first quarter, partly owing to a rise in mining exports, but also because other sectors have been less willing to stock up. Business expectations (IMCE) have shown a significant decline and, as of last May, domestic demand related industries are below their neutral values. The slower growth in final demand and higher export growth have also resulted in a faster reduction of the current account deficit, which at the end of the first quarter was at 3.1% of GDP (3.4% in end-2013). Measured at trend prices, the current account deficit has also had a major adjustment.
one tenth of a point less than expected in March. While this correction is small, growth scenario for Latin America has a larger downward revision particularly in Argentina, Brazil and Mexico. Inflation has remained contained in developed countries, while in the emerging world, particularly in Latin America, the short-term inflation outlook has been adjusted upwards, reflecting the depreciation of their currencies in the past year.

The Board estimates that in the baseline scenario, CPI inflation will remain above 4% annually still for some months, and end 2014 around 4% annually. Over the course of 2015 it should decline further to near 3% annually in the first half of the year, and remain around this value until the end of the forecast horizon, this time the second quarter of 2016. Core CPI inflation, which is now below headline inflation, will also decline in the coming months, hovering round 3% annually as from the first half of 2015.

The path forecast for inflation rests on several assumptions. For one, that the pass-through from the peso depreciation to prices will be according to historical pattern. The Board also uses as a methodological assumption that the real exchange rate (RER) will remain near its current values, since it is within the range of values that are considered consistent with its long-term fundamentals. Another working assumption is that nominal wages will be adjusted in line with productivity and target inflation. Finally, the baseline scenario uses as a methodological assumption that the MPR will follow a path comparable to the one that can be inferred from financial asset prices prevailing at the statistical cutoff of this Report.

Meanwhile, the baseline scenario assumes that the reduction in the use of installed capacity will ease domestic inflationary pressures, thus helping inflation to return to 3% within the projection horizon. In this sense, the Board estimates that this year the economy will grow between 2.5 to 3.5%, less than foreseen in March (3 to 4%). This revision responds to the weakness of domestic demand related sector indicators shown in the first quarter of the year. Private market expectations have also made adjustments during the period. According to the Economic Expectations Survey (EES), the year’s growth estimate fell from 3.7 to 3.0% between March and June.

The baseline scenario foresees that the economy will slowly regain strength towards the second half of this year, with annual expansion rates increasing in the last months of 2014. This projection assumes some recovery of investment, given the domestic and external financing credit conditions. The MPR has been lowered by 100 basis points in recent quarters and, as already mentioned, long-term interest rates are at their lowest in a decade, while risk premiums have also dropped. Also worth mentioning is the impulse from abroad, part of which was perceived already in the first quarter, as a result of higher prices in dollars but also the reallocation of internal resources resulting from the real currency depreciation. Plus the improved performance of the developed world. Finally, there is the impulse that will come from public spending, particularly investment, because of the low budget execution of 2013. In opposite direction point the aforesaid worsening of business expectations and the downward revisions to the 2014 investment projects timetable defined by the CBC.

### INFLATION

<table>
<thead>
<tr>
<th></th>
<th>2013 (annual change, percent)</th>
<th>2014 (f)</th>
<th>2015 (f)</th>
<th>2016 (f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average CPI inflation</td>
<td>1.8</td>
<td>4.1</td>
<td>3.2</td>
<td></td>
</tr>
<tr>
<td>December CPI inflation</td>
<td>3.0</td>
<td>4.0</td>
<td>3.1</td>
<td>3.0</td>
</tr>
<tr>
<td>CPI inflation in around 2 years (*)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average CPI inflation</td>
<td>1.2</td>
<td>3.5</td>
<td>3.2</td>
<td></td>
</tr>
<tr>
<td>December CPI inflation</td>
<td>2.1</td>
<td>3.7</td>
<td>2.8</td>
<td>2.8</td>
</tr>
</tbody>
</table>

(f) Forecast.

(*) Inflation forecast at the second quarter of 2016.

Sources: Central Bank of Chile and National Statistics Institute (INE).
The baseline scenario reflects those events that are estimated 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 unbiased for both output and inflation.

Abroad, the biggest risk continues to be the performance of the Chinese economy and the development of its financial system. The impact of this risk scenario is still significant, considering its importance in the commodities market, copper included, and its weight in world trade. Moreover, vulnerabilities in other emerging economies that could trigger new episodes of volatility cannot be ruled out. The risks associated with the withdrawal of monetary stimulus measures in the United States and the macro-financial situation in the Eurozone have eased, but still have the potential to cause greater volatility in the international financial markets. In particular, the present context of lower sovereign premiums might result in a more intensified reversal. However, a better performance of the U.S. economy would also entail a stronger impulse from abroad.

Domestically, a first risk is concentrated around the short-term inflation outlook. The baseline scenario assumes that CPI inflation will be above 4% annually temporarily and return to 3% annually over the course of 2015. This will occur partly because the economic slowdown of recent quarters will give way to lower inflationary pressures going forward. However, there are risks in this regard, particularly because of the difficulty in measuring the actual level of output gaps and the size of the margins. Thus, for example, the labor market is still tight by historical standards and compared to the recent evolution of GDP, which could affect the sensitivity and inertia of nominal wages to actual inflation. However, other labor market indicators, such as the evolution of salaried employment and vacancies, show that gaps are also opening up in this sector.

A second risk of the domestic scenario has to do with the poor performance of investment in the past few quarters. Although the baseline scenario assumes a mild recovery in the near future, the proper inertia of this component could prolong its weak performance beyond expectations. Actually, since September of last year, projected annual investment growth for 2014 has been revised downwards by more than five percentage points.

The external outlook shows no major changes. Domestically, inflation has increased beyond expectations a few months ago, while the economy is in a phase of slow growth. After reducing the MPR between October 2013 and March 2014, the Board has held the rate at 4% over the last few months. The Board will consider the possibility of making additional cuts to the monetary policy rate in line with the evolution of domestic and external macroeconomic conditions and its implications on the inflationary outlook. At the same time, the Board reiterates its commitment to conduct monetary policy with flexibility, so that projected inflation stands at 3% over the policy horizon.
MONETARY POLICY DECISIONS IN THE LAST THREE MONTHS

BACKGROUND: MARCH 2014 REPORT

In early 2014 output and demand had grown less than foreseen in the December 2013 Report, particularly in investment-related sectors. Annual inflation was somewhat above projections and had returned to around 3% annually. This was due mainly to rises in energy costs, which reflected higher than expected external prices as well as the peso depreciation. Expectations for inflation at the end of the projection horizon continued at around 3%, but had increased slightly for the short term.

The main change on the international front was the sharp fall in copper prices which deteriorated Chile’s relevant terms of trade. Neither the world growth scenario nor external financial conditions showed significant changes over the last months. However, some episodes of financial volatility in external markets and a widespread depreciation of emerging country currencies had occurred. The Chilean peso had depreciated significantly, above the average in those economies.

Against that background, the Board had cut the Monetary Policy Rate (MPR) in its February and March meetings, taking it to 4%. It had also indicated that it would consider the possibility of making additional cuts to the policy rate according to the evolution of domestic and external macroeconomic conditions and their implications for the inflation outlook.

For 2014, the baseline scenario in the March Report lowered GDP growth to a range of 3 to 4% (3.75 to 4.75% in December). This mainly reflected lower expansion of actual and expected investment, leading to growth rates over the course of 2014 that would be below the 2013 and also the trend rates. Inflation, measured as the annual change in CPI, would increase temporarily to a 3.5 and 4% range. This was due mostly to pass-through of the peso depreciation to prices of goods and services. The baseline scenario foresaw that a lower use of installed capacity, inferred from output performance, would mitigate inflationary pressures and the propagation of the direct effects of depreciation. Thus, already at the end of 2014, headline inflation would come closer to 3%, where it would remain until the end of the projection scenario, i.e., the first quarter of 2016.

The baseline scenario reflected the events that were most likely to occur according to information available at the closing of that Report. Nonetheless, some risk scenarios could change the macroeconomic outlook if they materialized, thus changing the course of monetary policy. Upon assessment of these scenarios, the Board concluded that the risk balance was biased downwards for output and balanced for inflation.

On the external front, the main risk involved the evolution of emerging economies, particularly China. Also, there was a chance that vulnerabilities accumulated by some emerging economies would lead to new episodes of volatility. Risks associated to the recovery process of the U.S. economy and to its monetary policy conduct were also considered, as well as the complex fiscal and financial situation in the Eurozone. Lastly, there was a chance that geopolitical tensions in Ukraine could heighten and impact prices of commodities as well as confidence in Europe.

Locally, on one hand the risks were linked to the possible recovery of output, particularly investment may remain weak for longer than foreseen, due to its natural inertia. In addition, there was a risk that the pass-through of the peso depreciation to inflation would be higher than foreseen.

APRIL AND MAY MEETINGS

In April, the international scenario remained similar to that of the previous meeting and to that considered in the March Report, except for improved international financial conditions. Domestic indicators confirmed that non-natural resource related output sectors and final demand were growing at moderate rates, lowering pressures on the use of installed capacity and the labor market. Nonetheless, the unemployment rate remained at historical lows. In March, inflation had again surprisingly picked up. This mainly reflected the impact of the peso depreciation as well as international increases of energy and food prices. Inflation expectations remained around 3% annually and output gaps were expected to contribute to lower domestic inflationary pressure in the medium term.
The Research Division presented as relevant options maintaining the MPR at 4% or cutting it by 25 basis points (bp) to 3.75%. Maintaining it could be justified by the 100 bp cut of the last months, by the fact that domestic credit was flowing normally, that short- and long-term interest rates had fallen, and that the real exchange rate was above its historical average, while at the same time inflation was around the 3% target. In addition, maintaining the policy rate, without precluding the possibility of cutting it later on, would allow gathering more information on the effects of adjustments already made and on the persistence of the inflation surprises present in the last months. The option of cutting the MPR was in line with expectations that output gaps would continue to accumulate in the economy, leading to lower inflationary pressures in the medium term. This option was also consistent with the view that the recent upswing in inflation measures was transitory—the result of the peso depreciation and other one-off factors, and that inflation expectations remained around 3%. As mentioned in the previous Report, this scenario could call for an additional monetary impulse to ensure that inflation remained around the goal within the policy horizon. However, at the time, a cut in the MPR would have been surprising, considering recent news on inflation. Anyway, even after this surprise, market expectations anticipated new MPR cuts in the short term. Hence, the Board decided to keep the MPR at 4%.

In May, the international scenario continued without major changes. The biggest news of the month had been the April’s inflation, well above what had been foreseen. Thus, during the last four months, CPI and CPIEFE had accumulated increases of 2.1 percentage points (pp) the first, and 2.2 pp the second. Overall, this performance reflected the impact of the peso depreciation as well as the increases in international food prices. Nonetheless, the upturn of services inflation attracted attention. It reflected an adjustment of various tariffs and was partly explained by the recent trajectory of the exchange rate. At the same time, items more directly linked to the evolution of wages showed an inertial behavior. On this matter, nominal wages’ variation had been rising in the last months, despite the lower dynamism of the labor market. Real wages, however, decelerated because of higher inflation.

Nevertheless, this inflationary surprise had affected short-term expectations but did not significantly impact longer-term prospects. In fact, inflation expectations for terms relevant in terms of monetary policy remained around 3% annually.

As to GDP, non-natural recourse related output sectors and final demand grew at moderate rates, similar to those foreseen in the last Report. This rate was below potential GDP growth and implied a lower use of installed capacity. In the medium term this would restrain domestic inflationary pressures and moderate the current account deficit. However, estimations of available output gaps were imprecise. The unemployment rate remained at low historical rate levels, although in recent months it had shown some signs of easing. Examples of this were the drop in creation of salaried employment, the decrease in job vacancies and the rise in the number of self-employed persons.

The Research Division presented as relevant options maintaining the MPR at 4% or cutting it by 25 bp to 3.75%. The option of keeping the MPR unchanged could be justified by the fact that over the last months it had already been cut by 100 bp, that short- and long-term market rates had fallen and that the real exchange rate was depreciated compared to its historical average. At the same time, inflation was temporarily above the upper limit of the tolerance range. On this occasion, maintaining the MPR without precluding possible adjustments further on would enable collecting more data on the persistent inflation surprises of the last months. Although in the most likely scenario the increase in annual inflation to over 4% would be transitory—as was also reflected in market expectations—the series of upward surprises called for caution on this matter.

The option of cutting the MPR was in line with the forecast that output gaps would continue to accumulate in the economy, leading to lower inflationary pressures in the medium term. As mentioned in the previous Report, this scenario could call for an additional monetary impulse to ensure that inflation remained around the target within the policy horizon. Hence, the Board decided to keep the MPR at 4%.
I. INTERNATIONAL SCENARIO

This chapter analyzes the recent evolution of the world economy and the outlook for the next two years. It also describes the most likely external scenario as well as its main risks.

WORLD GROWTH

The medium-term world growth scenario points to a gradual consolidation of recovery in developed countries, led by the United States. Although still fragile, the Eurozone recovers steadily. On the other hand, widespread deceleration in emerging countries continues, although there are prospects for some stabilization in growth (figure I.1). All in all, the baseline scenario lowers growth of Chile’s trade partners one decimal point in 2014, to 3.6%, basically because of actual data for the first quarter, and maintains it at 3.9% for 2015 (table I.1).

The main risk continues to be the more intense than expected deceleration of China’s economy, particularly because of the slowdown in its real estate sector and the ensuing effects on investment, quality of banking assets and finances of local governments. Materialization of this risk entails significant effects, mainly on world trade and commodity prices, including copper. Other risks have eased, such as those related to a faster normalization of U.S. monetary policy. The Eurozone has moved forward on the fiscal and banking fronts1, but its situation remains fragile and growth limited.

In the U.S. the labor market continued to improve. Significant job creation drove the unemployment rate down to 6.3% in April. Likewise, labor income picked up. Coupled with an increase in housing and stock prices—the latter to historical highs—they have boosted people’s confidence and consumption. Added to that, fiscal adjustment has eased. On the other hand, in May, purchasing managers’ expectations of services and manufactures anticipate an important rebound in output, which has been reflected, for example, in durable goods orders. Besides, standards for granting loans to companies continue to ease. All this supports the view that GDP slowdown of the first quarter, which led to a slight downward revision to the 2014 forecast, was only temporary, and most likely a result of an unusually severe winter weather in the northern hemisphere. In fact, the forecast for 2015 was revised upward.

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1 See Financial Stability Report, first half 2014.
During the first quarter, the Eurozone’s quarterly annualized growth rate was 0.7%, similar to the rate of the previous period but below market expectations. Germany continues to lead growth in the area, this time followed by Spain. In contrast, France and Italy slowed down the region, and Italy’s economy even underwent a slight contraction. Manufacturing sector expectations remain high and those of services rebounded, both within the expansion zone. Consumer confidence rose sharply in May, thus reaffirming the positive evolution of consumption expenditure. This supports prospects for output growth rate to pick up over the year. In addition, recently its Central Bank increased the monetary stimulus.

Japan grew at a quarterly annualized rate of 6.7% during the first three months of the year. Private consumption was the fastest growing component, in anticipation of the VAT increase imposed in April. However, other components, such as non-residential investment and exports, also contributed to growth. In the second quarter, consumer expenditure is expected to decline, reflected in a deterioration of retail sales and imports. Industrial output shrank and manufacturing expectations fell sharply in April—within the contraction zone. In May, the latter recovered somewhat, remaining around the neutral threshold.

China grew 7.4% annually during the first quarter (7.7% in the previous quarter). This modest deceleration was due to a loss of dynamism of investment in fixed assets and to the weak performance of exports during the early months of the year (figure I.2). Nonetheless, fragility of its financial system has brought about a response of the authorities, aimed at controlling the risks that had built up, mainly in shadow banking. Thus, together with some banking regulations, there was a slower loan expansion and increases in interest rates. At the beginning of the second quarter the Chinese government announced some more focused stimulus measures, such as building railway and basic housing. Retail sales and manufacturing output receded at the margin. In any case, manufacturing sector expectations improved at the tip, but remained below the expansion pivot. The deceleration of the real estate sector, both in terms of prices and sales, is noteworthy (figure I.3). Given its significant share in GDP, it continues to be a risk factor.

Regarding the rest of the emerging world, the baseline scenario lowers the growth rate forecast for Latin America by 3 and 4 decimal points to 2.0% in 2014 and 3.0% in 2015. The main revisions affected Mexico, Brazil and Argentina. In Mexico, private consumption remained weak, construction lost dynamism, but manufacturing and exports picked up. In Brazil, in spite of the drop in the unemployment rate, retail sales and consumer confidence receded. In Argentina, unemployment increased and manufacturing output and construction fell.

**INTERNATIONAL FINANCIAL MARKETS**

After the events of mid 2013 and early 2014, during recent months international financial markets have been calmer, as shown by the reduction in volatility and risk aversion. This has been partly due to the fact that the Federal Reserve has continued to pursue its asset purchase reduction process according to the
amounts and terms expected by the market. At the same time its authorities have reaffirmed signs of a gradual normalization of conventional monetary policy.

Thus, stock prices increased (figure I.4) and 10-year government bond rates fell (figure I.5), both in developed as well as emerging economies. Likewise, risk premiums on sovereign debt receded in both groups (figure I.6). Capital flows are starting to return to emerging countries (figure I.7), in line with the appreciation, at the margin, of their currencies, particularly against the U.S. dollar.

**COMMODITIES**

Fuel and copper prices have increased since the last Report, in contrast to those of agricultural products (figure I.8). Several factors underlie this. Outstanding among them are a better outlook for manufacturing and demand, particularly in developed countries. All in all, imports from China continue to sustain some commodity prices.

Albeit some fluctuations, WTI and Brent oil prices have risen, around 4% the first and 3% the second. The price of gasoline increased somewhat less. The recent positive data on output of most developed countries led to an increase in world demand for oil. Besides, China’s demand for this type of fuel remains solid. On the supply side, meeting increased demand requires OPEC to raise its output during the rest of the year, something about which there is no certainty. Based on implicit prices of futures for the last ten working days prior to the closing of this Report, the average price forecast for WTI and Brent is somewhat higher. In any case, a downward trend is still foreseen.

The copper price showed significant fluctuations over the last months. After reaching levels close to US$3.15 per pound, it recently returned to figures around US$3.05 per pound. Thus, it grew 4.5% since the statistical closing of the previous Report. This was due to increase in demand of industrialized countries, specially developed ones. In the latter, it was reflected in the high level of business expectations for manufacturing, added to recovery of this index in China. On the other hand, there has been a significant drain on stock exchange inventories, which have fallen close to 40% since the last Report. Overall, it is estimated that the increase in copper held by Chinese customs warehouses more than compensates this fall. Nonetheless, the degree of uncertainty is higher because copper is used as loan collateral. The baseline scenario in this Report raises the future trajectory of this price for 2014-2015, although the trend is still downward because of the increase in supply envisaged for 2015.

Prices of agricultural products fell around 1% during the last months. Stabilization of political tensions in Ukraine and improvement of weather conditions in some significant agricultural countries reversed the price increase that took place at the start of the second quarter.
INFLATION AND MONETARY POLICY

The developed world continues in an environment of modest inflation, partly because of surplus installed capacity, economic recovery that is still in an initial stage, and currencies that have appreciated since a year back. However, inflation expectations show that at the margin, in 2014, it has been higher than in 2013, in line with the stage of the economic cycle. In any case, it is anticipated that inflation will slowly return to targets set by the central banks. The Eurozone is an exception. There, expected inflation was revised downward, thus originating caution against the risk of deflation and driving the Central Bank to increase monetary policy expansiveness.

For the aggregate, inflation in the emerging world does not show significant changes. Nonetheless, the rebound of inflation in Latin America stands out. However, it has been led by its more volatile components. Overall, depreciation of currencies raised inflation expectations not only in Latin America but also in several other countries (figure I.9). However, the ongoing economic deceleration and its consequence of surplus installed capacity will lead to lower inflationary pressures, so that within a two year horizon it is anticipated that inflation will return to figures consistent with those countries’ targets (figure I.10).

As to conventional monetary policy, interest rates that show no major changes prevail. Looking ahead and considering the inflation outlook, developed countries will slowly normalize their reference rates. Accordingly, in the U.S. the first raise in its MPR would take place in mid 2015. The probability of this expectation has increased. As indicated, in the Eurozone the Central Bank slightly lowered its monetary policy rate and announced some additional measures aimed at encouraging more stimuli into the economy.

Among emerging economies there is a wider diversity in terms of future reference rate movements. The balance between the current state of the economic cycle and the recent measures of inflation contribute to this diversity. In some of these economies output deceleration predominates over inflation, and therefore there is also a greater monetary impulse, whereas in others the opposite is true. Mexico is an example of the first case, and surprised market analysts by lowering its monetary rate by 50 basis points.

Regarding non conventional monetary policy, Japan and the United Kingdom have not changed their asset purchase programs. Instead, the U.S. has moved forward in reducing its quantitative easing program in the amounts and terms announced and expected by the market.
II. FINANCIAL MARKETS

This chapter reviews the evolution of domestic financial markets in connection with the transmission of monetary policy.

MONETARY POLICY

In the last months, output and demand continued to perform poorly, while annual inflation rose above 4.0%. The rise in inflation has gone beyond the upper limit of the tolerance range. In the medium term, as is reflected in market expectations, it is foreseen that it will return to 3%. On the international front, recovery of developed countries continues, whereas emerging countries continue decelerating. International financial markets are calmer. After lowering the Monetary Policy Rate (MPR) to 4% in its March meeting, thus totaling a cut of 100 basis points (bp) since last October, the Board maintained it in its last monthly meetings. It has also indicated that it will assess the possibility of introducing additional cuts, depending on the evolution of domestic and external macroeconomic conditions and their implications for the inflation outlook.

Market expectations for the short-term evolution of the MPR—although with some fluctuations due to the recent high inflation—continue to anticipate two further cuts in the coming months. For the medium term, different expectation measures—excluding the Financial Brokers Survey (FBS)—foresee a decrease of MPR between 6 and 50 bp one year ahead, and between 15 and 55 bp two years ahead. Thus, two years ahead the MPR would lie between 3.7 and 4.6% (4.3 and 4.8% in March) (figure and table II.1).

### TABLE II.1

<table>
<thead>
<tr>
<th>MPR and expectations (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 2014</td>
</tr>
<tr>
<td>EES(1)</td>
</tr>
<tr>
<td>FBS(2)</td>
</tr>
<tr>
<td>Forward curve (3)</td>
</tr>
<tr>
<td>Swap contracts (4)</td>
</tr>
</tbody>
</table>

(1) March and June 2014 survey.
(2) Survey for the second half of March and first half of June 2014.
(3) Constructed using interest rates on swap contracts up to one year and interest rates on BCPs.
(4) Constructed using interest on swap contracts up to two years.
Source: Central Bank of Chile.

### FIGURE II.1

MPR and expectations (percent)

Source: Central Bank of Chile.

### FIGURE II.2

Money market spread in pesos (1) (2) (basis points)

Source: Central Bank of Chile.
In the money market, at the closing of this Report the rates and spreads did not show significant changes compared with those seen in March. However, in between they experienced significant fluctuations (figure II.2). Up to the outset of May, they continued to decline, reaching historical lows. Afterward they increased, due to the rise in short-term inflation expectations, in addition to other events such as sales of term deposits by mutual funds. Thus, prime rates continued to lie between 4 and 4.3%. The same occurred with the peso rates of deposits transacted in the stock exchange.

In the fixed income market, up to the beginning of May interest rates on Central Bank and Treasury instruments followed the trend of the money market. Then, the short-term inflation surprise affected the yield structure, raising nominal rates and lowering indexed rates for short-term tranches. During that same month there was also a slight rise in rates for longer terms, in line with the announcement of new Treasury issuances. Compared to the closing of the previous Report, BCP rates at 2-, 5- and 10-year terms decreased between 10 and 20 bp. BCUs at 5- and 10-year terms followed a similar, although more subdued, trend. BCUs at 1- and 2-year terms increased by 25 bp the first and 10 bp the second (figures II.3).

**FINANCIAL CONDITIONS**

Chile faced external financial conditions that improved marginally. Sovereign risk premiums at five years, as measured by the Credit Default Swaps (CDS), have fallen for all emerging economies. Although by comparison Chile’s CDS fell less, they are below the average of emerging economies and stand at around 70 bp (figure II.4). Albeit some ups and downs, spreads on loans contracted abroad by Chilean banks ended at levels somewhat lower than at the close of the previous Report. Risk premiums on corporate bonds placed abroad also had a similar evolution. Thus, CEMBI (Corporate Emerging Markets Bond Index) for Chile fell 25 bp between the closing of the previous and this Report.

In the local bonds market, both financial and non-financial corporate issuances remained dynamic—although somewhat less so than at the end of 2013, with more favorable conditions, as stated in the Financial Stability Report of the first half of 2014. The greater dynamism in bond issuance of financial companies, both domestically and abroad, could be substituting the lower volume of loans incurred with external banks (figure II.5).

Financial conditions for individuals and companies in domestic banks have shown some changes over recent months. Annual growth of commercial loans decelerated, falling to 7.5% in May, compared to 10.5% at the closing of the previous Report. As to individuals, growth of consumer loans was similar to previous months, whereas growth of mortgage loans increased slightly, possibly due to the conclusion of real estate projects and the materialization of committed sales (figure II.6). Interest rates on mortgage loans remained practically the same between February and May, while rates of the most significant tranche of consumer loans—those over three years, with a share
of 36.4% of total loans in this segment—increased 110 bp. Corporate loans showed varied interest rates in the most significant tranches. For loans whose terms lie within the 30- to 89-day range—23% of commercial loans—rates dropped 170 bp, whereas they raised 110 bp for terms below 30 days and 30 bp for terms between 180 days and one year.

On the other hand, the March Bank Lending Survey (BLS) reports supply conditions similar to those of December in the consumer segment—after tightening in previous quarters, while some banks report home-mortgage loans subject to more stringent conditions. Tighter conditions are also reported for corporate loans, particularly for larger companies. As to demand, except for small and medium enterprises (SMEs), the BLS shows a widespread weakness in loan applications (figure II.7). Lastly, data collected from different economic sectors and regions within the framework of the April Business Perceptions Report concur that some companies and banks report stricter demands for collateral and financial background.

Growth rates of monetary aggregates were lower in the last months, especially those of M2 and M3, which in May fell to 7% the first and 9% the second (both were around 13% in February). Growth rate of M1—made up mostly of non-remunerated bank liabilities, slightly decreased to 11% (13% in February) (figure II.8).

**FINANCIAL MARKETS**

The greater calm in international financial markets over recent months has also been reflected on the local stock exchange and the foreign exchange market.

As in other emerging economies, the Chilean stock market was affected at the beginning of the year by the Federal Reserve’s announcements and decisions on the start of the tapering process, as well as by other local and regional factors. In recent months it has shown less volatility. Since the previous Report, there has been a widespread rise in stock markets, higher in emerging economies than in developed ones. As measured by the MSCI in local currency, emerging and developed stock exchanges rose on average 7.3 the first and 4.4% the second (9.6 and 4.3% in U.S. dollars), compared to the closing of the previous Report. As measured by the IPSA (Selective Stock Price Index), the Chilean stock exchange rose 7.3% in local currency and 10% in US dollars (figure I.4).

In the foreign exchange market, the Chilean peso fluctuated. After depreciating strongly up to March, when it exceeded $570 per U.S. dollar, it has appreciated, and since then has fluctuated between $550 and $560 per dollar. Compared to the previous Report, the peso has appreciated close to 3% (figures II.9, II.10 and table II.2).

In line with the nominal exchange rate, the real exchange rate (RER) has fallen...
FIGURE II.9
Nominal exchange rate (1) (2)
(index 01/02/2012 - 06/12/2014 =100)

Source: Central Bank of Chile.

FIGURE II.10
Nominal exchange rate (1)
(index 01/01/2014 - 12/06/2014 =100)

Source: Bloomberg.

FIGURE II.11
Real exchange rate (*)
(index, average 1986=100)

Source: Central Bank of Chile.

TABLE II.2
Parities with respect to U.S. dollar (1) (2)
(percentage)

(1) A positive (negative) sign indicates depreciation (appreciation) of the currency against the U.S. dollar.
(2) Based on the last ten-day average of the cutoff date of indicated Reports.

Note:五月 2014 WEO weights.

Source: Bloomberg and International Monetary Fund.

(figure II.11). Considering the level of the nominal exchange rate and parities of the 10 days prior to the statistical closing of this Report, in June the RER stood at 96.8 (100 in March). The baseline scenario of this Report is based on the methodological assumption that the RER will remain at a level similar to the current one, inasmuch as it is situated within the range considered consistent with its long term fundamentals.
This chapter reviews the short-term outlook for demand and output on the basis of recent developments, in order to analyze possible inflationary pressures derived therefrom.

SECTORAL ACTIVITY

During the first quarter of the year, output and domestic demand confirmed the low dynamism of the last quarters. Annual GDP growth rate was 2.6% (2.7 in the previous quarter), in line with what was forecast in the previous Report. Again, the poor performance of sectors linked to domestic demand stood out. Added to the weak performance of sectors linked to investment was a larger deterioration of branches linked to consumption. Partial indicators for the second quarter indicate that the pace of growth remained low, specially affected by those sectors. With that, pressures on the use of installed capacity have continued to ease. At the same time, as foreseen, annual change of the natural resources sectors dropped again. These rates have shown significant ups and downs over the last two years (figure and table III.1).

Although other (than natural resources) sectors continued to grow around 3% annually during the first quarter, the rebalancing of their composition was surprising. One of the main novelties was in the agriculture, livestock and forestry sector, which experienced a significant recovery over previous periods, led by agriculture and fruit growing. By contrast, consumption related sectors moderated growth more intensively, in line with the sharper deceleration of that expenditure component during the first quarter. This was verified mainly by the low dynamism of services, for example, of restaurants and hotels, financial and business services, and transportation. In addition, moderation of retail sales has increased so far this year—mainly in durable goods—whereas wholesale trade continues depressed, although more stable at the margin.

Performance of investment linked sectors has generally been similar to the previous quarter. Anyway, some signs of stabilization have sprung up in certain branches. Construction showed signs of picking up some during the end of the first and early second quarters, although it continues to grow at rates lower than those existing up to September 2013. Business expectations (IMCE) for this sector, highly correlated with the Monthly Indicator of Construction Output (IMACON), anticipate that it has remained weak (figure III.2). Likewise, performance of investment related manufacturing branches remains weak. Nonetheless, other manufacturing sectors have recovered, in particular export oriented lines.

### TABLE III.1

<table>
<thead>
<tr>
<th>Share</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>I</td>
<td>II</td>
</tr>
<tr>
<td>Agriculture (and forestry)</td>
<td>2.7</td>
<td>6.0</td>
</tr>
<tr>
<td>Fishing</td>
<td>0.4</td>
<td>-14.7</td>
</tr>
<tr>
<td>Mining</td>
<td>11.1</td>
<td>9.8</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>10.5</td>
<td>0.0</td>
</tr>
<tr>
<td>EGW</td>
<td>2.8</td>
<td>4.2</td>
</tr>
<tr>
<td>Construction</td>
<td>7.8</td>
<td>4.2</td>
</tr>
<tr>
<td>Trade</td>
<td>8.5</td>
<td>8.9</td>
</tr>
<tr>
<td>Restaurants and hotels</td>
<td>1.7</td>
<td>3.6</td>
</tr>
<tr>
<td>Transportation</td>
<td>3.9</td>
<td>4.2</td>
</tr>
<tr>
<td>Communications</td>
<td>2.0</td>
<td>6.8</td>
</tr>
<tr>
<td>Financial services</td>
<td>4.7</td>
<td>7.7</td>
</tr>
<tr>
<td>Business services</td>
<td>14.4</td>
<td>3.0</td>
</tr>
<tr>
<td>Housing services</td>
<td>5.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Personal Services (2)</td>
<td>11.3</td>
<td>4.1</td>
</tr>
<tr>
<td>Total GDP</td>
<td>100.0</td>
<td>4.9</td>
</tr>
<tr>
<td>GDP other (3)</td>
<td>71.1</td>
<td>4.1</td>
</tr>
<tr>
<td>GDP natural resources (3)</td>
<td>14.4</td>
<td>8.1</td>
</tr>
</tbody>
</table>

(1) Preliminary figures.
(2) Includes education, health and other services.
(3) See glossary for definition.
Source: Central Bank of Chile.
During the first quarter, growth slowed down in most natural resources sectors. Annual growth in the mining sector was almost nil because of the decline in output of certain significant copper mining sites, and to a lesser extent, of gold and silver ones. Y-o-y growth of copper export volume—which, the same as total copper output, is highly volatile—picked up significantly, to 14.8% in the first quarter (-1.9% in the preceding quarter). Lower growth in the electricity, gas and water sector (EGW) resulted from using a less efficient composition of thermoelectric generation inputs which more than offset the greater value added derived from a rise in hydroelectric generation. In turn, annual expansion of fishing remained negative, as has been the norm over the last year. Underlying this result was a contraction of aquaculture during the first quarter, due largely to diminished cultivation of salmons.

The baseline scenario makes a downward revision to the growth forecast for 2014 in the last report, placing it within the 2.5 to 3.5% range (3 to 4% in March). This takes special account of an upcoming weaker recovery of sectors linked to domestic demand. The outlook for this year contained in the June Economic Expectations Survey also fell to 3% (3.7% in March), while it remained at 4% for 2015.

### DOMESTIC DEMAND

During the first quarter, domestic demand excluding inventories increased 2.1% in annual terms, above the rate of the previous quarter (0.4%). This rise occurred mostly towards the end of the quarter, and was linked mainly to signs of stabilization in investment. This trend continued at the outset of the second quarter. Nonetheless, dynamism in demand remains weak, particularly when compared to growth rates registered up to the first half of 2013. To a significant degree its poor performance during the first quarter was due to a marked moderation in private consumption. In contrast, government consumption expenditure recovered significantly. There was a significant fall in inventories, partly due to a rebound in mining exports but also because other sectors showed less inclination to hold stocks. As a result, during the first quarter domestic demand fell 0.3% in annual terms (+1.1% in the previous quarter) (figure III.3 and table III.2).

Private consumption decelerated at a faster pace than in previous quarters. This is reflected, for instance, in the fall of imports of these types of goods, which dropped in volume terms at an annual rate of 0.4% in the first quarter (+9.4% on average in 2013). Partial data for the second quarter reveal that they continue to moderate. The poor performance of private consumption was particularly noticeable in the services and durable goods components. The latter underwent the greatest adjustment in annual expansion, with a 2.9% growth rate in the first quarter (11.3% in the previous one). In April, retail sales of these goods even contracted in annual terms: -4.7% (+5.3% on average in the first quarter). Moderation in durable goods consumption has also shown up in the automotive market, and has intensified in the last months. Thus, car sales and imports have continued to fall. Sector expectations
in this market are less optimistic, considered both from the demand as well as from the supply side. Accordingly, the intended purchases of durable goods by households (Economic Perception Index, IPEC) and the outlook of companies in the automotive sector (Indicator of Business Confidence, IMCE) have recently deteriorated. The April Business Perceptions Report (IPN) also reflected this, reporting that in general companies sense that consumers are more cautious. The performance of non-durable goods consumption was similar to that of the previous quarter (figure III.4).

Private consumption has also evolved in line with the progressive deterioration of some labor market indicators. On one hand, job creation has lost momentum in the last months, as may be seen in the stabilization of its seasonally adjusted levels. Likewise, viewed from a broader perspective, some recent characteristics of the labor market are in line with what occurred in the declining phase of other economic cycles, such as, among others, the 1998 and 2009 episodes. One such characteristic is the rearrangement of employment among occupation categories, reflected in the rise of self-employed workers and the drop in salaried employment. This trend has consolidated over the last months and could continue to affect consumption, given the supposedly greater instability and lower level of independent workers’ income. Also, the continual fall in job vacancies suggests that creation of salaried employment will remain sluggish (figure III.6). In any case, so far this year annual expansion of this category has been aligned with growth of the working-age population, both close to 1%.

Overall, some labor market fundamentals still reveal a degree of dynamism that has extended beyond expectations. Despite its fluctuations, the unemployment rate remains low. Nominal salaries have remained particularly dynamic, gradually increasing their growth rate. In April, the annual rate was within the 6.3 to 6.8% range, above its historical average (around 5% between 2001 and 2010). As a counterpart, growth of real labor income declined, hand in hand with the increase in inflation measures (figure III.7).

Other indicators also point to a weaker performance of private consumption. Consumers’ expectations (Economic Perceptions Index, IPEC) have continued falling, reaching the neutral threshold in May. Financial conditions do not show major changes, although at the margin they reveal a somewhat smaller growth in consumer loans (chapter II).

Some investment indicators reached a certain degree of stability towards the end of the first quarter, after two quarters of intense moderation. The somewhat less negative growth rate of the first quarter reflected this more favorable evolution. As anticipated in the last Report, the machinery and equipment component continued to shrink, although at a lower rate. This resulted from a halt in the downward path followed by capital goods imports during the last months. Outstanding within the construction and works component is the strong dynamism of housing sales in the first quarter (Chilean Construction Chamber), and the low level of available housing (figure III.8). In seasonally adjusted terms, output of cement and concrete have recently improved. By contrast, annual variation of employment in construction declined significantly,
Public investment picked up during the first quarter. Added to it was a significant rise in growth of government consumption to an annual rate of 9.6% (3.1% in the previous quarter).

The outlook for the rest of the year continues to be that investment growth will recover, particularly during the second half of the year (box III.1). However, these rates are more modest than envisaged in the previous Report. In particular, the March version of the investment projects timetable compiled by the Capital Goods Corporation (CBC) considered a downward revision for 2014 for investment estimated in construction and engineering works. This is explained by the postponement of several energy projects, and to a lesser extent of mining ones. Rescheduling of energy projects and inclusion of new initiatives in the real estate sector, in turn, raised projections for the 2015 to 2017 period.

**CURRENT ACCOUNT**

The current account deficit shrank to US$795 million in the first quarter, accumulating 3.1% of GDP in the last moving year (3.4% in the fourth quarter) (figure III.9). This balance was US$1,075 million above that of the same period in 2013. The more intense moderation of this deficit over those of previous quarters was linked to a great extent to weaker private consumption. The sharp fall in consumer imports reflected this. In addition, the increase in exports raised the trade balance surplus (box III.2). This result was partially offset by larger outflows of accrued income on direct investment in Chile and a more negative balance on services. The baseline scenario considers a current account deficit of 2.5% of GDP in 2014 (3.6% in the March Report). Underlying this revision are better prospects for the trade balance, mainly because of less dynamic imports associated to a weaker than previously envisaged recovery of domestic demand during the rest of the year. The more adverse outlook for domestic expenditure also impacts the current account deficit at trend prices, whose forecast for this year was accordingly revised downward, to 2.2% of GDP (3% in the previous Report).
BOX III.1

RECENT DYNAMICS OF INVESTMENT

Over the last quarters, output and domestic demand have lost dynamism. To a significant degree, this was caused by a fall in Gross Fixed Capital Formation (GFCF) (figure III.10). Investment in machinery and equipment is the component of GFCF that has been affected the most. It has fallen, on average, around 18% in the last three quarters. Growth in construction and works has also fallen but still shows positive values.

Outstanding among the factors contributing to this loss of dynamism was the maturing of significant investment projects in the mining sector. This mining investment cycle reached its peak between 2011 and 2012 and in 2013 started a decline which is expected to continue for some time (figure III.11). This has coincided with the recent dynamics of GFCF in other economies whose mining sectors are significant (figure III.12).

Although it was anticipated that such a decline would occur, its quantitative impact is hard to assess. Another anticipated factor was the normalization of aircraft imports, which were unusually large in the second half of 2012 and the first half of 2013. This inflated investment in the machinery and equipment category during that period, thus accentuating the fall of recent months (figure III.13).

Beyond those factors, however, the dynamics of investment have been surprisingly weak. The baseline scenario of this Report revises GFCF downward and considers a slight contraction. This occurs against a background of favorable domestic and external financial conditions, both because long-term domestic rates are very low and the uncertainty present in external markets a few months ago has abated. Starting from standard theoretical relations, this box informs the factors that could be determining the recent performance of fixed capital investment.

FIGURE III.10
Gross fixed capital formation
(percent of GDP, accumulated in four quarters)

Source: Central Bank of Chile.

FIGURE III.11
Mining investment
(2013 US$ billion)

(1) Gray and white areas represent cycles of total mining investment.
(2) Green lines represent local maximums of each cycle.
Sources: Central banks of each country and Unstats.

FIGURE III.12
Gross fixed capital formation
(annual change, percent)

Sources: Central banks of each country, Comtrade, Consensus Forecasts.
Justin and Saravia (2014) estimate two multivariate models which relate GFCF with variables that have historically helped explain its performance: income related variables (GDP, GDP of trading partners and copper price); cost of using capital (adjusted for price variation of capital goods) and Tobin’s Q ratio (calculated as IPSA/GFCF deflator), expectations (IMCE); and uncertainty (intra quarterly volatility of daily IPSA stocks). Estimation of autoregressive vectors and correction of errors models show that towards the end of 2013 the fall in GFCF was larger than could be explained by the variables included in them (figure III.14). The same result is obtained if GFCF is broken down into its machinery and equipment and construction and works components. The residual for the latter, however, is lower.

To get a better idea of the factors that could explain the most recent dynamics of investment, and particularly of the high residual of late 2013, Justel and Saravia (2014) make a historical breakdown of shocks using the same models previously mentioned (figures III.15 and III.16). Results show that, in the first place, part of the fall in GFCF is explained by the evolution of variables that capture volatility and/or expectations, such as Tobin’s Q, IMCE and IPSA volatility. Nonetheless, in the last quarter, the fall in GFCF has been higher than explained by these historical factors, as is reflected in a negative residual in the models. This residual may reflect transitory factors not included in these models, or the chance of structural changes occurring in the relation between variables, such as the significance that mining investment reached during the last expansion cycle/.

The baseline scenario in this Report foresees that GFCF will recover moderately in the coming quarters, hand in hand with capital goods imports whose levels have stabilized, and a construction and works sector whose annual growth rates will be positive.

\textsuperscript{1} Justel and Saravia (2014) incorporate global mining investment as an explanatory variable in the estimation of investment models, but the residual persists.
BOX III.2
SENSITIVITY OF EXPORTS TO THE REAL EXCHANGE RATE

Over the last year, the Chilean peso has depreciated significantly both in nominal as well as real terms. Thus, the economy has responded to a weaker domestic scenario that requires rebalancing its sources of growth in favor of tradable sectors and domestic demand. In fact, just recently exports have increased and the current account deficit has shrunk. The most noticeable effects of the real depreciation of the peso over productive sectors take a longer time and depend, among other factors, on the state of the world economy. This box reports some possible effects that a real depreciation of the peso has over sectoral exports and other economic variables such as employment and investment.

In the first place, it is to be expected that a real depreciation of the peso has a positive effect on exports. Several studies for Chile back this hypothesis and report elasticities in the range of 0.1 to 1.6.\(^1\) The degree of response differs for short and long terms. At the same time, it depends on other factors, one of which is whether there is a substitution effect between domestic and external sales.

Beyond this general and expected effect, the question arises as to whether the effect of a real depreciation of the peso is uniform across sectors. Considering the standard breakdown of exports, i.e., mining, agricultural and manufacturing, Carrasco, Gianelli and Godoy (2014) show that the sensitivity of agriculture to the rise in the real exchange rate (RER) is higher than in the manufacturing sector: 0.7 the first and 0.4 the second. For the aggregate, elasticity is 0.2.

Carrasco et al. (2014) show that the effect of a real depreciation on exports is not uniform across destinations. Thus, the significance of the evolution of bilateral RERs with Chile’s trading partners. For the last year, bilateral RER was more depreciated vis a vis markets such as the United States and China than for Japan and other Latin American countries such as Brazil and Peru (figure III.17). Thus, using the measure of bilateral RER and reestimating the model for the aggregate, short-term elasticity in the agricultural sector rises to almost 1.2 and in manufacturing to 0.5, whereas for the aggregate it increases to 0.6 (figure III.18). Given the higher sensitivity of agricultural over other sector exports, the significant depreciation of the peso against the U.S. dollar plus the increased dynamism of domestic demand in the United States during recent quarters could give a great boost to exports.

\(\text{(*) Considers variables in differences.}
\)

Source: Carrasco, Gianelli and Godoy (2014).

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Added to its impact on the dynamics of exports, there is evidence that the real depreciation of the peso has effects over other economic variables in the manufacturing sector. Bertinatto and Saravia (2014) find that a real depreciation of the peso has an expansionary effect over investment levels of firms even greater than that of exports over total sales. Besides, the effect occurs regardless of the size of the plant. The authors show that the effect on employment is limited. Thus, a 1% real depreciation of the peso increases employment 0.04%, investment 0.57%, and the external to total sales ratio, 0.24%. The effect over employment and investment is mostly visible within one year.

Summing up, during the last year the Chilean economy has undergone a rebalancing process in its sources of growth. The real depreciation of the peso fosters adjustment to this new scenario. Although it is possible to gauge the quantitative effects and the scope that this could entail in productive sectors, the individual response at the level of each firm and subsector will certainly depend on factors beyond the real depreciation of the currency.
IV. PRICES AND COSTS

This chapter analyzes the recent evolution of the main components of inflation and costs, identifying the main sources of inflationary pressures at present and also their likely evolution in the future.

RECENT INFLATION TRENDS

CPI inflation has continued to increase in recent months. In May it was 4.7% annually, above that of the March Report and also higher than market expectations at the time (figure IV.1). Annual CPIEFE inflation, that is, CPI less energy and food, has also increased more than forecast, to 3.8% in May. By component, although both goods and services inflation increased, the former has done so at a faster pace (table IV.1). Against this background, inflation expectations remain in line with the target towards the end of the projection horizon, but have risen for the more immediate term.

### TABLE IV.1
Inflation measures (1) (2)
(annual change, percent)

<table>
<thead>
<tr>
<th></th>
<th>CPI</th>
<th>CPIEFE</th>
<th>CPI of tradables</th>
<th>CPI of non-tradables</th>
<th>CPI of goods</th>
<th>CPI of services</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012 Average</td>
<td>3.0</td>
<td>2.2</td>
<td>1.7</td>
<td>4.7</td>
<td>2.6</td>
<td>3.5</td>
</tr>
<tr>
<td>2013 Jan.</td>
<td>1.6</td>
<td>1.1</td>
<td>0.0</td>
<td>3.6</td>
<td>0.9</td>
<td>2.4</td>
</tr>
<tr>
<td>Feb.</td>
<td>1.3</td>
<td>0.8</td>
<td>-0.2</td>
<td>3.2</td>
<td>0.6</td>
<td>2.2</td>
</tr>
<tr>
<td>Mar.</td>
<td>1.5</td>
<td>1.1</td>
<td>-0.1</td>
<td>3.6</td>
<td>0.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Apr.</td>
<td>1.0</td>
<td>0.8</td>
<td>-0.7</td>
<td>3.1</td>
<td>-0.2</td>
<td>2.4</td>
</tr>
<tr>
<td>May</td>
<td>0.9</td>
<td>0.9</td>
<td>-1.0</td>
<td>3.3</td>
<td>0.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Jun.</td>
<td>1.9</td>
<td>0.8</td>
<td>0.9</td>
<td>3.1</td>
<td>1.5</td>
<td>2.3</td>
</tr>
<tr>
<td>Jul.</td>
<td>2.2</td>
<td>0.9</td>
<td>1.5</td>
<td>3.0</td>
<td>1.9</td>
<td>2.5</td>
</tr>
<tr>
<td>Aug.</td>
<td>2.2</td>
<td>1.2</td>
<td>1.2</td>
<td>3.4</td>
<td>1.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Sept.</td>
<td>2.0</td>
<td>1.4</td>
<td>0.7</td>
<td>3.5</td>
<td>0.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Oct.</td>
<td>1.5</td>
<td>1.6</td>
<td>0.0</td>
<td>3.5</td>
<td>0.2</td>
<td>3.2</td>
</tr>
<tr>
<td>Nov.</td>
<td>2.4</td>
<td>1.8</td>
<td>1.3</td>
<td>3.7</td>
<td>1.4</td>
<td>3.5</td>
</tr>
<tr>
<td>Dec.</td>
<td>3.0</td>
<td>2.1</td>
<td>2.4</td>
<td>3.8</td>
<td>2.5</td>
<td>3.7</td>
</tr>
<tr>
<td>2014 Jan.</td>
<td>2.8</td>
<td>2.4</td>
<td>1.9</td>
<td>4.1</td>
<td>2.0</td>
<td>3.7</td>
</tr>
<tr>
<td>Feb.</td>
<td>2.2</td>
<td>2.5</td>
<td>2.4</td>
<td>4.3</td>
<td>2.6</td>
<td>3.9</td>
</tr>
<tr>
<td>Mar.</td>
<td>3.5</td>
<td>2.7</td>
<td>2.9</td>
<td>4.3</td>
<td>2.9</td>
<td>4.1</td>
</tr>
<tr>
<td>Apr.</td>
<td>4.3</td>
<td>3.5</td>
<td>3.8</td>
<td>5.1</td>
<td>3.7</td>
<td>5.0</td>
</tr>
<tr>
<td>May</td>
<td>4.7</td>
<td>3.8</td>
<td>4.5</td>
<td>5.1</td>
<td>4.5</td>
<td>5.0</td>
</tr>
</tbody>
</table>

(1) See glossary for definition.
(2) Starting in January 2014, the new annual indices with base 2013=100 are used, so they are not strictly comparable to previous data.

**FIGURE IV.1**
Inflation indicators (1) (2)
(annual change, percent)

**FIGURE IV.2**
Monthly inflation (*)
(accumulated in six moving months, percentage points)

(*) Starting in January 2014, the new annual indices with base 2013=100 are used, so they are not strictly comparable to previous data.
Sources: Central Bank of Chile and National Statistics Institute (INE).
CPI has accumulated an increase of 2.8 percentage points (pp) over the last six months, explained mainly by the core component (CPIEFE), which reached 2.6 pp during the same period (figure IV.2). Measured in terms of semesters, accumulated increase of CPIEFE for goods moved from -1.5 to 1.6% between mid 2013 and May, 2014. In the same period, CPIEFE for services rose from 1.8 to 3.6% (figure IV.3). However, price increase of services included in CPIEFE continued to be the factor whose incidence on the current inflation level is the highest. This is due to its higher annual growth rate and weight (figure IV.4).

The depreciation of the peso has been the main driving force behind the rise in inflation of recent months. Since May 2013 the currency has depreciated around 18% and in March reached values above $570 per U.S. dollar. During the last weeks, it has fluctuated significantly, with values within the $550 to $560 range. This has had direct and indirect effects on CPI. Direct effects include those over fuel or tariffs expressed in U.S. dollars, such as in international air transport. Among the indirect effects are prices of different tradable (imported) goods and services, the cost of transportation related services, and other services that include the peso/dollar exchange rate in their indexation mechanisms. Another indirect effect of the higher exchange rate is present in costs of certain services such as health, educational and other basic services whose prices are usually indexed to past inflation.

During a long time, goods CPIEFE made negative contributions to annual inflation. However, starting in September 2013 its contribution to accumulated inflation changed sign and became positive (figure IV.4). With this, in the last six months its contribution to total inflation reached 0.4 pp. The prices of home equipment, which are directly linked to the exchange rate because of their high import content, are a striking example of this effect. The significance that the peso depreciation has over the higher cost of these products becomes evident by comparing the increase in import prices of consumer goods (IVUM) measured in U.S. dollars and in pesos (figure IV.5).

Prices of services included in the CPIEFE have also risen because of the peso depreciation. Noteworthy are increases in prices linked directly or indirectly to the exchange rate—for example, transportation services and tour packages—and those indexed to past inflation, such as education and health services. The sum of items whose price variations can be linked directly or indirectly to the exchange rate explain 0.9 pp of inflation accumulated over the last six months. For the same period, regulated services, whose indexation polynomials consider both past inflation and the exchange rate, account for 0.1 pp. Lastly, other services have made a contribution similar to that of previous semesters, around 0.5 pp (figure IV.6).

Another component of inflation that shows the direct effect of the peso depreciation is the price of energy. Data show that the increase in the exchange rate since June 2013 has been the biggest contributing factor to the rise in its price. Only considering the last months, international fuel prices have affected prices of those products upward (figure IV.7).
As to food, its contribution to accumulated inflation has been receding over the last six months. Accumulated incidences of fruits and vegetables prices have decreased and at the margin have even turned negative (figure IV.8). Behind this is the usual seasonality of these prices, although it is striking that their contribution to inflation is lower than a year ago. The effects of drought and frost over some crops could explain this result. The case of other food differs, as its incidence has been on the rise. Outstanding in this category are price increases of bread and meat, also linked in some way to the depreciation of the peso.

The sum of all these factors has brought about a significant increase in annual CPI inflation and its different measures during the last months (figure IV.9). Services inflation included in CPIEFE increased its annual growth rate from 3.7 to 5.1% between November 2013 and May of this year, whereas that of goods increased from -0.9 to 1.8% over the same period.

The increase in annual CPI inflation is above the forecast in the previous Report. Thus, while in March it was foreseen that inflation would lie within a range of 3.5 to 4%, today it is envisaged that it will be above the upper limit. Most of the difference can be explained by the rise in the exchange rate and by indexation mechanism to past inflation, as is evidenced by the fact that these surprises are concentrated in the goods component of CPIEFE, particularly in home equipment, and some components of services such as drinking water, university education and car insurance.

As to the evolution of labor costs, annual growth of nominal salaries has increased in the last months. Depending on the measure, in April it stood between 6.3 and 6.8%, above the range of 5.7 to 6.2% it averaged in 2013. Measured in real terms, the higher inflation rate has brought down its annual growth rate to a range of 1.2 to 1.7%, depending on the measure (between 3.9 and 4.4% on average in 2013) (figure IV.10). Noteworthy is the higher growth of nominal wages, given the cyclical position of the economy. However, it is less striking considering the labor market situation, specially the low level of unemployment rate. In any case, other sources of information, such as taken from April’s Business Perceptions Report indicate that most respondents agree that the labor market is less tight than in previous periods. As was already perceptible by the end of 2013, this lower pressure has restrained salary increases in different sectors and geographical areas in the country, and is expected to continue henceforth. Real unit labor costs have continued on a declining path.
INFLATION OUTLOOK

The baseline scenario in this Report estimates that the increase in inflation to over 4% annually will be transitory and that it will return to values close to 3% annually over the course of 2015. Private expectations are in line with this view. Thus, although they have risen for inflation over short-term horizons, expectations at longer terms remain around 3% (figure IV.11).

Private expectations for inflation two years ahead derived from the Economic Expectations Survey (EES) of June and the Financial Brokers Survey (FBS) of the first half of that month continue at 3%. In turn, the EES places inflation at the end of this year at 3.8% (3% in the previous Report), while maintaining it at 3% one year ahead. For the same term, the FBS lowered expected inflation rate from 3.0% in March to 2.8% in June. Likewise, in both surveys, the distribution of answers remained practically unchanged. Inflation expectations derived from inflationary compensations do not show significant changes either. At different terms, breakeven inflation derived from average interbank swap rates has remained practically at the same levels of the previous Report.

Other measures of inflation expectations derived from consumers and business surveys show increases, but mostly at shorter term. Inflation expectations one year ahead taken from the Monthly Business Confidence Indicator (IMCE) rose to 3.8% in May (3.2% in the March Report). In the same period, the share of people who believe that inflation "will increase a lot in the next twelve months", as measured by the Economic Perceptions Index (IPEC), increased from 51 to 55%.

In the baseline scenario, the Board estimates that inflation will remain above 4% annually for some more months, and end 2014 close to that rate. In the course of 2015, it will continue to fall, and will reach around 3% annually during the first semester of next year, level around it will remain until the end of the projection horizon, this time, the second quarter of 2016. Core inflation, which is below headline inflation, will also fall in the coming months, fluctuating close to 3% from the first half of 2015 onward.
This chapter presents the Board’s assessment on the Chilean economic outlook over the next two years. Projections are presented of the most likely inflation and growth trajectories. These are conditional on the assumptions in the baseline scenario, thus the Board’s assessment of the risk balance for output and inflation is also provided.

### BASELINE PROJECTION SCENARIO

In the baseline scenario, the international context shows no major changes from the March Monetary Policy Report, either in global growth, the terms of trade or international financial conditions. Thus, it still considers that the external impulse that the Chilean economy will be receiving will be milder than the average for the period 2010-2012 (table V.1).

Regarding global activity, estimations still point to a recovery in the developed world and a slowdown in emerging economies. The growth forecast for Chile’s trading partners is revised down by a tenth of a point to 3.6% in 2014, mainly because of first-quarter GDP data. The forecast for 2015 remains at 3.9%, but with changes in composition. Both figures are higher than those of 2013. Growth in developed economies in the period 2014-2015 is forecast to be up one percentage point from 2013. The recovery is driven by the United States, where the labor market has continued to improve, as have labor income and business and consumer confidence. In addition, the prices of various assets have increased, such as listed stocks and housing. This combines with a reduced fiscal adjustment. The Eurozone shows a sustained recovery, but at a slower pace than previously thought. In addition, it is anticipated that the stimulus measures announced by the European Central Bank will contribute positively to growth in this region.

As for emerging economies, the growth forecast for China remains lower than in previous years and the risk of its performance and its financial system is maintained. Thus, the baseline scenario maintains the 7.3 and 7.2% projection for 2014 and 2015, respectively. The biggest revision to the growth forecast is for Latin America: 3 and 4 tenths of a point to 2.0% in 2014 and 3.0% in 2015, with the larger corrections for Mexico, Brazil and Argentina. This is mainly due to the particulars of each country, which reflects in the downward revision in 2015, despite the unchanged growth perspective for China and upward revisions in the developed world.

### TABLE V.1
International baseline scenario assumptions

<table>
<thead>
<tr>
<th></th>
<th>2000-07</th>
<th>2007-12</th>
<th>2013 (f)</th>
<th>2014 (f)</th>
<th>2015 (f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terms of trade</td>
<td>8.2</td>
<td>4.1</td>
<td>-3.2</td>
<td>-0.5</td>
<td>-1.5</td>
</tr>
<tr>
<td>World GDP at PPP (f)</td>
<td>3.6</td>
<td>4.6</td>
<td>3.3</td>
<td>3.6</td>
<td>3.9</td>
</tr>
<tr>
<td>World GDP at market exchange rates (f)</td>
<td>4.2</td>
<td>4.0</td>
<td>3.0</td>
<td>3.3</td>
<td>3.7</td>
</tr>
<tr>
<td>Developed economies’ GDP at PPP (f)</td>
<td>2.6</td>
<td>1.9</td>
<td>1.1</td>
<td>1.9</td>
<td>2.4</td>
</tr>
<tr>
<td>Emerging economies’ GDP at PPP (f)</td>
<td>7.4</td>
<td>5.9</td>
<td>4.5</td>
<td>4.5</td>
<td>4.8</td>
</tr>
<tr>
<td>External prices (in US$) (f)</td>
<td>4.6</td>
<td>5.3</td>
<td>0.3</td>
<td>1.0</td>
<td>1.3</td>
</tr>
</tbody>
</table>

(*) For a detailed definition, see glossary.
(f) Forecast.
Source: Central Bank of Chile.

### TABLE V.2
Economic growth and current account

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2014 (f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>5.4</td>
<td>4.1</td>
<td>2.5-3.5</td>
</tr>
<tr>
<td>National income</td>
<td>4.6</td>
<td>3.4</td>
<td>2.8</td>
</tr>
<tr>
<td>Domestic demand</td>
<td>6.9</td>
<td>3.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Domestic demand (w/o inventory change)</td>
<td>7.1</td>
<td>4.2</td>
<td>2.4</td>
</tr>
<tr>
<td>Gross fixed capital formation (GFCF)</td>
<td>12.2</td>
<td>4.0</td>
<td>0.7</td>
</tr>
<tr>
<td>Total consumption</td>
<td>5.6</td>
<td>5.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Goods and services exports</td>
<td>1.1</td>
<td>4.3</td>
<td>3.2</td>
</tr>
<tr>
<td>Goods and services imports</td>
<td>5.0</td>
<td>2.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Current account (% of GDP)</td>
<td>-3.4</td>
<td>-3.4</td>
<td>-2.5</td>
</tr>
<tr>
<td>Gross national savings (% of GDP)</td>
<td>21.7</td>
<td>20.5</td>
<td>19.9</td>
</tr>
<tr>
<td>Gross national investment (% of GDP)</td>
<td>25.1</td>
<td>23.9</td>
<td>22.4</td>
</tr>
<tr>
<td>GFCF (% of nominal GDP)</td>
<td>24.0</td>
<td>23.6</td>
<td>22.7</td>
</tr>
<tr>
<td>GFCF (% of real GDP)</td>
<td>26.8</td>
<td>25.8</td>
<td>24.9</td>
</tr>
</tbody>
</table>

(f) Forecast.
Source: Central Bank of Chile.
The forecast for external inflation relevant to the Chilean economy (EPI) is revised up for this year and next, due to the depreciation of the U.S. dollar in international markets and domestic inflation rates in the rest of the world that are somewhat higher than foreseen last March.

The baseline scenario assumes that the terms of trade will be as projected in March, so they are still expected to return to demand related components and the reduced dynamism of demand that is foreseen in the second half of 2014. Accordingly, a lower degree of installed capacity utilization is assumed. The growth of the economy will be less than its trend rate for several quarters. In line with this, the expansion of final demand is also revised down for 2014: 2.4% (3.3% in March). This is explained by investment performance that has continued to adjust downward, coupled with a significant reduction in private consumption. The slowdown in domestic demand will be sharper: 1.7% (3.3% in March), because of lower inventory build-up consistent with the downward correction to imports, especially of consumer goods. Also worth taking into account is the lower intent to keep inventories in some sectors, something that was already present in the first quarter.

As regards private consumption, the sharper than expected slowdown of the first quarter was mainly observed in durable goods. There has been some deterioration of some of its fundamentals. In particular, job creation has slowed, with a shift towards greater expansion of self-employment and at the expense of salaried work. The deceleration of job vacancies suggests that growth in salaried employment will continue to decline. However, other labor market fundamentals remain favorable. Among them, the unemployment rate remains low and nominal wages regained strength, although in real terms they declined due to rising inflation. Consumer expectations also anticipate a worsening of private consumption, because although they are still in positive territory, they are now closer to their neutral value.

Investment is revised downward again, deepening the March adjustment. Thus, the y-o-y variation of gross fixed capital formation (GFCF) is lowered to -0.7% for 2014 (0.8% in March; 4.1% in December). These figures reflect a sharper-than-expected slowdown in investment in the first quarter, as well as less investment projects in construction and engineering works foreseen by the CBC in 2014. With it, GFCF would be at 22.7% of nominal GDP (23.6% in 2013).
The baseline scenario foresees that the economy will slowly regain strength towards the second half of this year, with annual expansion increasing in the last months of 2014. This projection assumes some recovery of investment, given the credit conditions of domestic and foreign financing. The MPR has been lowered by 100 basis points in recent quarters and long-term interest rates are at their lowest levels in a decade, while risk premiums have also dropped. Furthermore, worth mentioning is the impulse from abroad, partly perceived already in the first quarter, as a result of both higher prices in dollars, the reallocation of internal resources resulting from the real currency depreciation, and the improved performance of the developed world. Finally, there is the impulse that will come from public spending, particularly investment, because of the low budget execution of 2013. In opposite direction point the aforesaid worsening of business expectations and the downward revisions to the 2014 investment projects timetable defined by the CBC.

The current account deficit 2014 forecast is corrected downward mainly due to the expected slowdown in investment and somewhat higher savings associated with lower private consumption. At the level of the trade balance, this is seen mainly in a downward revision to imports. Thus, the baseline scenario projects the deficit at 2.5% of GDP in 2014 (3.6% in March). The lower prospects for domestic demand also imply that, measured at trend prices, the deficit will narrow further, reaching 2.2% of GDP.

Regarding CPI inflation, the Board estimates that in the baseline scenario, it will remain above 4% annually for some months, and end 2014 around 4% annually. Over the course of 2015, it should decline further to near 3% annually in the first half of the year, and remain around this value until the end of the forecast horizon, this time the second quarter of 2016. Core CPI inflation, which is now below headline inflation, will also decline in the coming months, hovering round 3% as from the first half of 2015 (figures V.1 and V.2; table V.3).

The path forecast for inflation rests on several assumptions. For one, that the pass-through from the peso depreciation to prices will be according to historical patterns, and the reduction in the use of installed capacity will ease domestic inflationary pressures. The Board also uses as a methodological assumption that the real exchange rate (RER) will remain near its current values, since it is within the range of values that are considered consistent with its long-term fundamentals. Another working assumption is that nominal wages will be adjusted in line with productivity and target inflation. Finally, the baseline scenario uses as a methodological assumption that the MPR will follow a path comparable to the one that can be inferred from financial assets prices prevailing at the statistical cutoff of this Report (figure V.3).

This calculation considers revisions to prices, not volumes. Long-term prices of US$2.85 per pound of copper and US$82 per barrel of oil are assumed.
RISK SCENARIOS

The baseline scenario reflects those events that are believed to be the most likely 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 alter the course of monetary policy. On this opportunity, having evaluated the alternative scenarios, the Board estimates that the risk balance is unbiased for both output and inflation (figures V.4, V.5 and V.6).

Abroad, the biggest risk continues to be the performance of the Chinese economy and the development of its financial system. The impact of this risk scenario is still significant, considering its importance in the commodities market, copper included, and its weight in world trade. Moreover, vulnerabilities in other emerging economies that could trigger new episodes of volatility cannot be ruled out. The risks associated with the withdrawal of monetary stimulus measures in the United States and the macro-financial situation in the Eurozone have eased, but still have the potential to cause greater volatility in the international financial markets. In particular, the present context of lower sovereign premiums might result in a more intensified reversal. However, a better performance of the U.S. economy would also entail a stronger impulse from abroad.

Domestically, a first risk is concentrated around the short-term inflation outlook. The baseline scenario assumes that CPI inflation will be above 4% annually temporarily and return to 3% annually over the course of 2015. This will occur partly because the economic slowdown of recent quarters will give way to lower inflationary pressures going forward. However, there are risks in this regard, particularly because of the difficulty in measuring the actual level of output gaps and the size of the margins. Thus, for example, the labor market is still tight by historical standards and compared to the recent evolution of GDP, which could affect the sensitivity and inertia of nominal wages to actual inflation. However, other labor market indicators, such as the evolution of salaried employment and vacancies, show that gaps are also opening up in this sector.

A second risk of the domestic scenario has to do with the poor performance of investment in the past few quarters. Although the baseline scenario assumes a mild recovery in the near future, the proper inertia of this component could prolong its weak performance beyond expectations. Actually, since September of last year, projected annual investment growth for 2014 has been revised downwards by more than five percentage points.

The external outlook shows no major changes. Domestically, inflation has increased beyond expectations a few months ago, while the economy is in a phase of slow growth. After reducing the MPR between October 2013 and March 2014, the Board has held the rate at 4% over the last few months. The Board will consider the possibility of making additional cuts to the monetary policy rate in line with the evolution of domestic and external macroeconomic conditions and its implications on the inflationary outlook. At the same time, the Board reiterates its commitment to conduct monetary policy with flexibility, so that projected inflation stands at 3% over the policy horizon.
REFERENCES

Aravena, Claudio. 2005. Demanda de exportaciones e importaciones de bienes y servicios para Argentina y Chile. Serie de Estudios Estadísticos y Prospectivos N°36, CEPAL.


International Monetary Fund. 2014. World Economic Outlook. April.


Asia, other: Philippines, Hong Kong, Indonesia, Malaysia, South Korea, Singapore, Thailand and Taiwan.

Average interbank swap: Derivatives contract between two parties who carry out an exchange of flows at future dates, between a fixed rate set when the contract is written, and a variable rate. The variable rate is the average interbank interest rate, which in turn is derived from the average interbank index.

CPIEFE: CPI excluding food and energy prices (72% of the basket).

Commodity exporters: Australia, Canada and New Zealand.

GDP, natural resources: Includes electricity, gas and water (EGW); mining and fishing.

GDP, other: Includes agriculture, livestock and forestry; manufacturing; construction; wholesale and retail trade; transport and communications; financial and business services; housing property; personal services and public administration.

Growth of trading partners: Growth of Chile’s main trading partners, weighted by their share in total exports during two moving years. Countries considered were those to which 93% of total exports on average were destined during the period 1990-2012.

Latin America: Argentina, Bolivia, Brazil, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela.

MER, Multilateral exchange rate: A measure of the nominal value of the peso against a broad basket of currencies, weighted as for RER. For 2014: Argentina, Belgium, Bolivia, Brazil, Canada, China, Colombia, France, Germany, Italy, Japan, Mexico, the Netherlands, Paraguay, Peru, South Korea, Spain, Switzerland, the United Kingdom, and the United States.

MER-5: MER considering the currencies of Canada, Japan, the United Kingdom, the United States and the Eurozone.

MER-X: MER excluding the U.S. dollar.

Prime-swap spread: Difference between the prime deposit rate and the average interbank swap rate. Similarly to its equivalent measures in other markets (e.g., the Libor-OIS spread), it is used as a benchmark for analyzing the conditions of the banking industry’s funding liquidity.
RER: Real exchange rate. It is a measure of the real value of the peso against a basket of currencies and is constructed using the currencies making up the MER.

Swap: Derivatives contract between two parties who carry out an exchange of flows at future dates. One of the most common swap contracts is the interest rate swap, in which the parties exchange predetermined flows at a fixed rate, set when the contract is written, for predetermined flows at a variable rate.

Volatility Index (VIX): Calculated by the Chicago Board of Trade, it is the most commonly used index to gauge market volatility at the international level. It measures the implied volatility being negotiated in option contracts over the S&P 500 index.

World growth at market exchange rate: Each country is weighted by its GDP in dollars as published by the IMF (2014). The sample of countries represents around 90% of world GDP. For the remaining countries, average growth is estimated at 1.8% for the period 2013-2015.

World growth: Regional growth weighted by its share in world GDP at PPP, published by the IMF (2014). World growth projections are calculated from a sample of countries that represent about 86% of world GDP. For the remaining countries, average growth is estimated at 3.5% for the period 2013-2015.

ABREVIACIONES

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>BCP</td>
<td>Central Bank bonds in pesos</td>
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<tr>
<td>BCU</td>
<td>UF-indexed Central Bank bonds</td>
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<tr>
<td>BLS</td>
<td>Bank Lending Survey</td>
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<tr>
<td>CPIEFE</td>
<td>Consumer price index excluding food and energy prices</td>
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<tr>
<td>CPIG</td>
<td>Consumer price index for goods</td>
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<tr>
<td>CPINT</td>
<td>Consumer price index for non tradables</td>
</tr>
<tr>
<td>CPIS</td>
<td>Consumer price index for services</td>
</tr>
<tr>
<td>CPIT</td>
<td>Consumer price index for tradables</td>
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<tr>
<td>EES</td>
<td>Economic Expectations Survey</td>
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<tr>
<td>FBS</td>
<td>Financial Brokers Survey</td>
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<tr>
<td>IMCE</td>
<td>Monthly Business Confidence Indicator</td>
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<tr>
<td>IPEC</td>
<td>Economic perceptions index</td>
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<tr>
<td>MPR</td>
<td>Monetary policy rate</td>
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