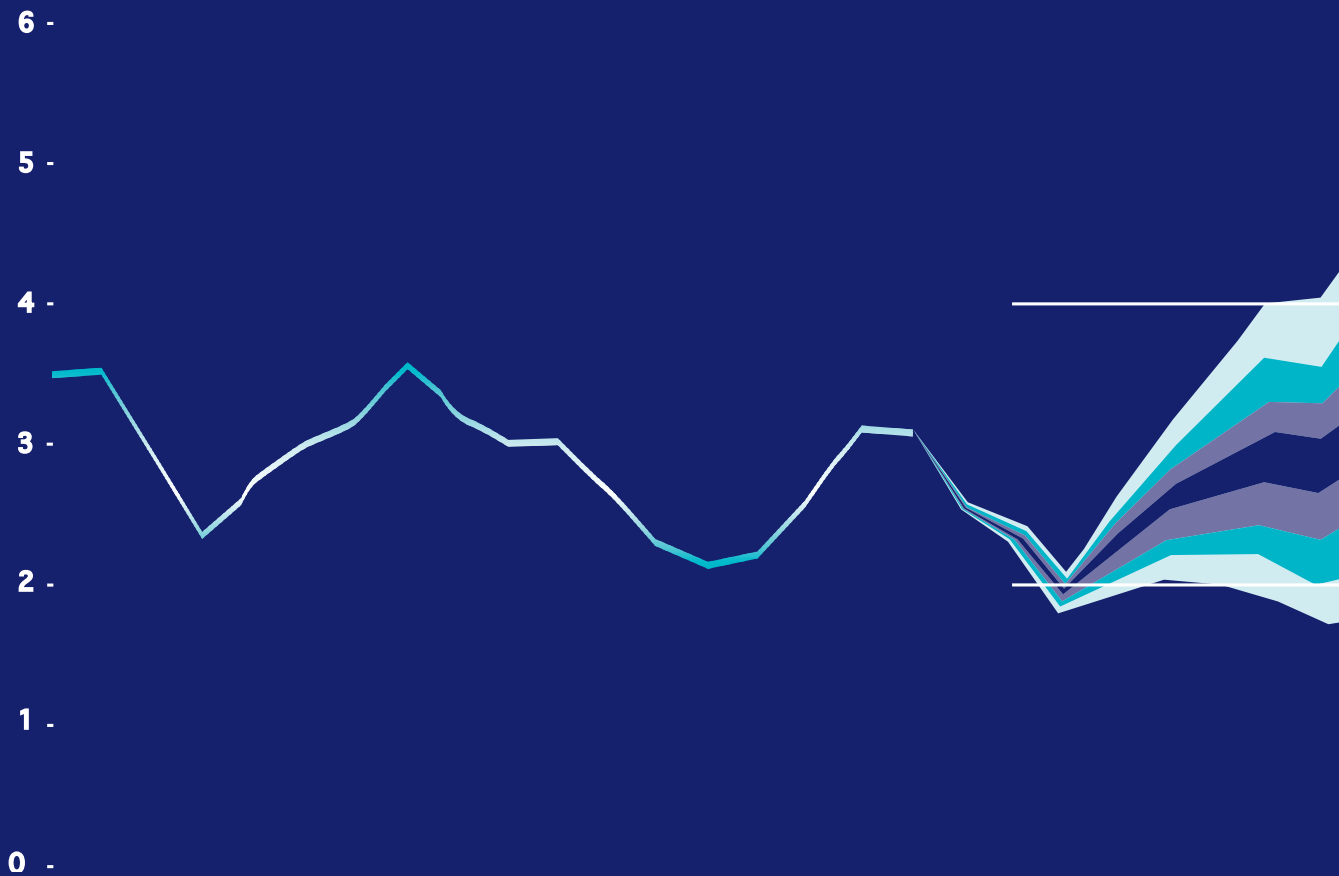


Monetary Policy Report

SEPTEMBER 2007



BANCO CENTRAL
DE CHILE

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*/ This is a translation of a document written originally in Spanish. In case of discrepancy or difference in interpretation, the Spanish original prevails. Both versions are available at www.bcentral.cl

Summary

Since last May, annual CPI, CPIX, and CPIX1 inflation has risen considerably, to near 4%, due mainly to unusually high and simultaneous increases in several specific prices. The baseline scenario assumes that headline inflation will ascend to around 5.5% year on year—partly because of rises already occurred in the CPI—, to then decline toward 3% over the course of 2008. This path mostly reflects the behavior of food prices, given rises in their foreign similes and harsh weather conditions, plus increases in electric power rates. These shocks do not necessarily represent inflationary pressures associated to the business cycle in Chile. At the same time, this year to date has seen strong GDP growth, above projections, stimulated by domestic macroeconomic policies and the international scenario. The level of output is estimated to be now and in coming quarters around its trend. In recent weeks, however, significant adjustments have taken place in asset prices, together with high volatility in international financial markets, deteriorating financial conditions for some emerging economies and threatening world growth, although at the closing of this *Report* no major changes are apparent in the external scenario relevant for the Chilean economy.

The monetary policy has accommodated to changes in the macroeconomic scenario, to ensure that the increase in inflation is transitory and that, given a faster closing of gaps, it approaches 3% within the policy horizon. Thus, the Board went from communicating prospects of a prolonged maintenance of the monetary policy rate (MPR) in May's *Report*, to communicating in June that future rises were likely, to effectively apply increases of 25 basis points in July and August. Market expectations adjusted to the changed scenario. In the last days previous to the statistical closing of this *Report*, the market was foreseeing additional rises in the MPR that amounted to a combined 50 basis points until year's end. These prospects, in any case, were higher and declined as the behavior of international financial markets raised doubts about the solvency of the external scenario and its implications for the Chilean economy.

The baseline scenario in this *Report* considers that a part of the shocks that have affected inflation will not deepen during 2008, that other part will largely revert in coming months and that the output gap will remain closed over the next few quarters. Also, in what remains of 2007, monthly CPI inflation will be less than it was from April to August. Annual CPI inflation, however, due to some extent to recent figures, will continue rising in coming months, to then decline toward 3% over the course of 2008 and remain there until the end of the projection horizon. Economic activity, confirming what

had been stated as an upward risk in May, will grow between 5¾ and 6¼% in 2007, while in 2008 it will do so in the 5.0%-6.0% range. The Board believes that, in this conjuncture, the balance of risks for growth is biased downward, and unbiased for inflation.^{1/}

A large part of the change in the inflation scenario derives from the evolution of the prices of some foods. On one hand, dynamism of the world economy sustained for several years—especially high growth in China and India—has driven commodity prices much higher than expected. This episode that in the beginning was visible mainly in products like copper, wood pulp and oil, has quickly and strongly spread to foods, aggravated by worsened supply conditions this year and the use of some goods as inputs in the production of other products, such as biofuels. Thus, already in the first quarter of this year there was a substantial increase in the prices of corn and wheat derivatives, and signs of increases in others, such as milk. In this context, *May's Report* considered as a risk that prices in the aforesaid foods could increase more than projected. However, that these increases would be as simultaneous and as large was beyond any forecast based on historical information.

On the other hand, beginning in June, but with increased strength in July, there was a large rise in the domestic prices of perishables, because of harsh weather conditions that the agricultural sector had to endure this winter. This increase, unusually high for this time of the year, hit hardest on a wide variety of products, especially fresh vegetables. To make things worse, scarce hydric resources and natural gas restrictions have also had an effect on electric rates.

Largely because of the price hikes already materialized, here the short-term annualized inflation forecast is raised substantially over projections in *May's Report* and is forecast to deviate, significantly but temporarily, from the tolerance range of 3% plus/minus one percentage point per annum. In any case, this type of deviation has been seen in the past when facing shocks of magnitude similar to the present one. For example, in early 2004, CPI inflation dropped to around -1% annually, with a temporary deviation of almost four percentage points from the inflation target.

Discounting some specific goods, other prices show no significant increase. The inflation measure that excludes prices of energy and all food products—keeping 68% of the full CPI basket—records annual increments of less than 2% at July that are even smaller than in the fourth quarter of 2006. The CPIX1 measure that excludes the prices of foods—keeping 74% of the CPIX1 basket and 52% of the CPI basket—shows annual inflation close to 2% for several months, not too different from the average annual variation of 2006. Trend inflation measures, which in principle reflect more clearly inflation's medium-term prospects, have increased slightly in recent data and are somewhat above 3% annually. Still, it should be noted that a lag exists between the closing of gaps and its effect on inflation, so the fact that other prices in the CPI are increasing at low rates today is not, by itself, an indication of its future dynamics.

^{1/} In this context, risk means a possible positive or negative occurrence driving the economy significantly away from conditions considered in the baseline scenario.

The medium-term inflation scenario has also brought some news, since the strong GDP growth of the second quarter resulted in output gaps closing faster than foreseen in May. In said quarter, output grew by 6.1% annually, with sectors not related with natural resources growing by 6.5%, and natural resources (i.e., mining, fishing and electricity, gas, and water, EGW)—growing by 1.8% annually, affected by the drop in EGW's value added. Narrow output gaps are also visible in indicators such as seasonally-adjusted unemployment, which is below several estimates of its rate consistent with price stability.

Higher growth for 2007 relies on sustained increases in private consumption and an acceleration of fixed capital investment in the second quarter. Beyond short-term fluctuations due partly to a calendar effect, projections for the rest of the year are that output will continue to grow at a rate not different from that of the first half of this year. For 2008, the baseline scenario considers that output will grow at an average interannual rate somewhat smaller than this year's, but still more than trend GDP, which is expected to grow around 5% annually. These projections are based on the impulse of macroeconomic policies. On one hand, the MPR is currently in the lower end of a range of estimates of its neutral value, so the Board believes that monetary policy continues to provide momentum to the economy. On the other hand, the change in the structural surplus target from 1.0 to 0.5% of GDP, combined with the revision of its parameters, higher costs and the trend of copper production in Codelco and molybdenum prices, will imply a fiscal impulse for 2008 similar to the one implicit in the budget for 2007. It should be noted that, beyond recent changes, the fiscal policy continues to contribute to the country's stability, since it continues to operate within a reference framework where transitory fiscal earnings are saved.

The scenario for economic activity also benefits from domestic demand's continuing growth, based on the low level of unemployment and increased access to the financial system, reflected in high credit growth, still relatively low and stable market interest rates and less restrictive access to credit for SMEs, as shown by the Central Bank's Survey on Banking Credits.

Projections in the baseline scenario consider also that growth in 2008 will draw on a still positive external impulse, even despite recent swings in international financial markets. An episode of tighter credit conditions and an adjustment in risk premiums like the one observed in recent weeks was part of the *May Report's* risk scenario, in principle associated to fears of a weakened sub-prime sector in the US. This risk has not only become true, but has also spread to other segments of the world financial market, creating volatility and, as aforesaid, deteriorating financial conditions in some economies, either developed or emerging. Lately, actions from central banks in developed economies, which have been supplying the necessary liquidity for the normal functioning of the markets, have brought some tranquility. However, effects on the credit market are now thought to be more persistent.

Baseline scenario assumptions

	2005	2006	2007 (f)	2008 (f)	2009 (f)
	(annual change, percent)				
Terms of trade	11.3	22.5	2.8	-7.9	-4.6
Trading partners' GDP (*)	3.9	4.5	4.2	4.2	3.9
World GDP at PPP (*)	4.9	5.4	5.1	5.1	4.9
World GDP at market exchange rate (*)	3.3	3.9	3.6	3.6	3.4
External prices (US\$)	7.5	5.3	6.9	3.0	2.3
	(levels)				
LME copper price (US\$/lb)	167	305	310	270	245
WTI oil price (US\$/barrel)	56	66	67	70	69
Gasoline parity price (US\$/m ³) (*)	451	526	567	561	548
Libor US\$ (nominal, 90 days)	3.6	5.2	5.3	4.8	4.9

(*) For definition, see Glossary.

(f) Projection.

Source: Central Bank of Chile.

For the time being, market consensus expects the world economy to grow by around 5% annually in 2008-2009. The baseline scenario projects that terms of trade (ToT) will begin gradual normalization in 2008, in line with a steadily declining copper price, from US\$3.1 per pound this year, to US\$2.7 in 2008 and to US\$2.45 in 2009. At the same time, financial conditions relevant for emerging economies are expected not to deteriorate more than they have in recent weeks and remain fairly positive. In this conjuncture, however, downward risks and the variety of possible international scenarios have increased, considering the potential consequences of the recent event of lack of liquidity and upward corrections in the prices of a wide spectrum of more risky assets.

The final effects of this episode on world growth prospects cannot be foreseen yet. At the statistical closing of this *Report*, consensus projections were not fully capturing recent adjustments in foreign markets, nor were they showing any changes aside from minor variations in growth forecasts for the US. Financial markets have reacted with a big change in monetary policy perspectives in developed economies and the US Federal Reserve even put a negative bias on the US economy's growth rate.

The risks of the external scenario offer an array of options with varied implications. There are intermediate scenarios where market adjustment and volatility persist without deepening, with consequences such as a more notorious weakening of the US economy that ultimately affects other economic zones and thus debilitating world growth. This could aggravate the worsening of financial conditions for emerging economies and increase the possibility of an acceleration of commodity price corrections and, therefore, a faster normalization of the ToT. There can be even more negative risk scenarios, whose implications are more difficult to foresee. In the extreme, it is possible that credit and liquidity constraints that have been observed, and that have driven central banks in developed economies to intervene, become more pronounced and hurt the solvency of major entities.

It should be noted that, within the current macroeconomic policy framework, the Chilean economy has been able to smooth the effects of the recent bonanza without generating imbalances, creating the conditions to cushion the possible effects of an unfavorable external setting better than in the past. The former reflects on a large surplus in the current account and in the fiscal account without obvious misalignments in key relative prices; the latter, in

that, despite the uncertainty of recent weeks, the effect on Chilean asset prices has been much smaller than in other emerging economies.

Economic growth and the current account

	2005	2006	2007 (f)	2008 (f)
	(annual change, percent)			
GDP	5.7	4.0	5¼ - 6¼	5.0 - 6.0
National income	9.2	5.1	5.3	6.6
Domestic demand	11.0	6.0	7.9	6.9
Gross fixed capital formation	21.9	4.0	12.1	5.7
Total consumption	7.5	6.6	7.4	7.1
Goods and services exports	3.5	4.2	9.9	6.6
Goods and services imports	17.7	9.4	14.3	9.7
Current account (% of GDP)	1.1	3.6	5.4	2.6
	(US\$ million)			
Current account	1,315	5,256	8,900	4,500
Balance of trade	10,805	22,213	24,900	18,800
Exports	41,297	58,116	67,100	66,600
Imports	-30,492	-35,903	-42,200	-47,800
Services	-636	-922	-1,100	-1,200
Income	-10,645	-19,392	-18,300	-16,400
Current transfers	1,791	3,356	3,400	3,300

(f) Projection.

Source: Central Bank of Chile.

Based on the aforesaid elements, this *Report's* baseline scenario considers activity growing between 5¼% and 6¼% this year, and between 5.0% and 6.0% in 2008. Also, after examining alternative events, the Board estimates that the balance of risks for economic activity is biased downward.

The evaluation of trend growth incorporated by the baseline scenario has not changed since May, which, combined with estimated economic growth results in the output gap remaining closed over the next few quarters, considering the implicit instant velocity of expansion. As usual, there is the risk that growth differs from projections or that the economy's trend growth and available gaps, both unobservable variables, deviate from estimates.

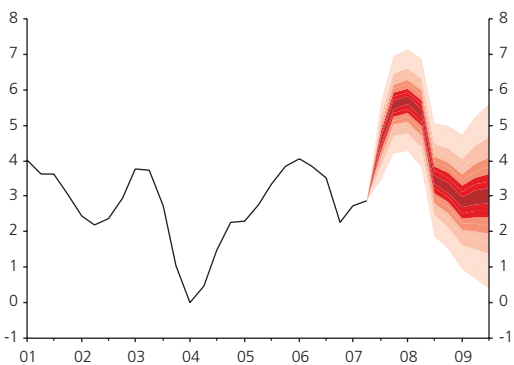
On the costs side, excluding the external prices of some foods, no significant changes are observed in imported inflationary pressures with respect to May's forecasts. The nominal exchange rate, with ups and downs, is in a similar level to the closing of May's *Report*, considering the average of the ten working days previous to the statistical closing in both cases. The real exchange rate (RER) shows no major movements either, and is estimated to be at a level consistent with its long-term fundamentals. The baseline scenario uses as a methodological assumption that, over the long run, the RER will not differ materially from the average of the two weeks previous to this *Report's* statistical closing. Such an assumption entails a high degree of uncertainty, especially in light of recent developments in international financial markets and their future path. On the other hand, the prices of oil and derivatives are above May's projections. Although this has significant incidence on the difference between actual and projected inflation to date, it does not weigh much on the recent increase in annual inflation. The baseline scenario assumes that the oil price will hover around US\$70 per barrel in coming months, but other settings cannot be ruled out, especially if world growth falls short of projections.

The baseline scenario projects that domestic prices of non-perishable foods (i.e., corn, wheat, dairy products) will continue showing mild increases in the very near future, to later grow at a similar pace to the average of remaining prices until the end of the projection horizon. Prices of perishables (i.e., fresh fruits and vegetables) will also increase immediately, but will revert largely before year's end. These assumptions are subject to significant uncertainty, particularly relating to non-perishable foods. On one hand, given the experience of recent months, it is not possible to rule out that prices continue to rise more than expected. Nor can a sharp reversal within the projection horizon be ruled out either, leading to a big drop in inflation. Once again, this would take particular importance in a context of world growth decelerating more markedly.

The baseline scenario also contemplates that specific shocks that have affected inflation will not spread to other prices aside the normal inflationary inertia implicit in some of them, nor will they affect the formation of medium- and long-term expectations. Nominal salaries continue to grow at annual rates of 4% to 7%, depending on how they are measured, while labor costs are increasing consistently with target inflation. Inflation expectations derived from surveys to the financial sector or from financial asset prices show a sharp increase in very short horizons, but around the target in the medium to long run. The change in the baseline scenario between this and last *Report* is comparable with the adjustment of private sector inflation projections, reflecting widespread surprise from these shocks. As usual with substantial price movements, there is the risk that its propagation is larger, which could happen through higher labor costs, for example. Actually, surveys to consumers and entrepreneurs already show increased concern on expected inflation one year ahead. This is one risk where the Board will place special focus, because confidence in the inflation target is crucial in the determination of trend inflation. It is appropriate to reaffirm that, as it has done in the past, the Board will adopt whatever decisions it deems necessary to maintain its commitment with the inflation target.

No significant variations in the electric generation matrix are expected for the rest of 2007 and during 2008. Although electric generation with fuels instead of hydric and natural gas resources has effects that until now are more evident only in the EGW sector, it has significant incidence on electric power rates. The baseline scenario assumes that, in addition to July's 6% increase in rates, there will be new increments in the rest of 2007—all because of increased costs of electric generation—, with an impact on CPI inflation somewhat greater than half a percentage point. For 2008, the working assumption is that rates will rise again, in a magnitude comparable to the average increase of the period 2004-2005. This scenario is subject to high uncertainty, with results that will depend on the evolution of the energy matrix, fuel prices and increases deriving from the electric power rate, among many factors.

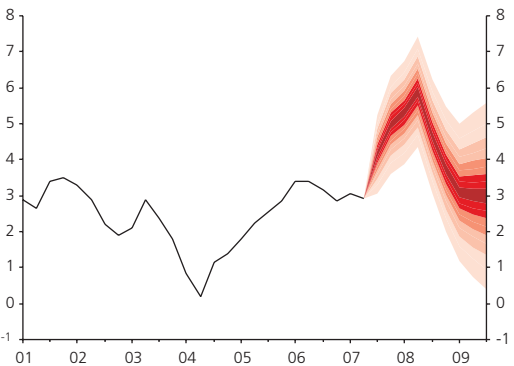
CPI inflation projection (*)
(annual change, percent)



(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future inflation. The baseline scenario is constructed using the methodological assumption that in coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this Report.

Source: Central Bank of Chile.

CPIX inflation projection (*)
(annual change, percent)



(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future inflation. The baseline scenario is constructed using the methodological assumption that in coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this Report.

Source: Central Bank of Chile.

Inflation

	2005	2006	2007 (f)	2008 (f)	2009 (f)
	(percent)				
CPI inflation average	3.0	3.4	3.9	4.4	
CPI inflation December	3.7	2.6	5.5	3.1	
CPI inflation around 2 years (*)					3.0
CPIX inflation average	2.3	3.2	3.7	4.8	
CPIX inflation December	2.9	2.7	5.2	3.7	
CPIX inflation around 2 years (*)					3.0
CPIX1 inflation average	1.9	2.5	3.9	4.5	
CPIX1 inflation December	2.6	2.4	5.2	3.3	
CPIX1 inflation around 2 years (*)					2.9

(*) Average inflation projected for the third quarter of 2009
(f) Projection.

Source: Central Bank of Chile.

In summary, the baseline scenario foresees annual CPI inflation near 5.5% until mid 2008, then declining to 3% in the second half and remaining relatively constant until the end of the projection horizon, this time the third quarter of 2009. CPIX1 inflation will converge to 3% at a similar pace as headline CPI, while CPIX variation will do so somewhat more slowly. In addition, considering alternative events, the balance of risks for inflation is unbiased.

The Board estimates that, in the most likely scenario, new increases in the MPR will be necessary in coming months to ensure that projected inflation over the policy horizon remains at 3%. As usual, the evolution of the MPR will depend on incoming information and its implications on projected inflation. In particular, the Board will follow closely the evolution of international financial markets and its implications on growth and inflation. The Board considers also that a setting of large shocks in specific prices and scarce gaps as the present one requires special attention, both to the possible propagation to other prices and to medium- and long-term inflation expectations.

Inflation scenarios

This section presents the Board's evaluation of Chile's economic prospects for the next two years. It provides projections for the most likely trajectories of inflation and growth, and points out the most significant risks. These projections are based on the methodological assumption that the monetary policy rate (MPR) will, over coming quarters, follow a path similar to the one that can be inferred from the prices of financial assets over the past two weeks. This is a working assumption and does not commit future monetary policy, which will adjust to the evolution of the macroeconomy and inflation projections. Aside from this assumption, projections depend on a set of events that make up the baseline scenario, so this chapter also presents the Board's evaluation of the balance of risks for both output and inflation.

External scenario

The baseline scenario in this *Report*, with information available at its statistical closing, considers that during 2008 the Chilean economy will continue to reap the benefits of a growth-stimulating external scenario. Nonetheless, episodes of volatility in international financial markets observed in recent weeks sound a cautious note and negatively bias the external scenario, although the magnitude of their possible effects cannot be quantified with the information available.

The baseline scenario considers, in line with market consensus, that the world economy will continue to show high growth rates in the period 2008-2009, with trading partners' GDP growth averaging 4.1%. This setting assumes a slowdown of the US economy during this year, to then resume growth closer to the trend. The terms of trade, contrary to projections, will increase again this year and will begin declining only in 2008, at a lower pace than foreseen earlier. These forecasts rely on the assumption that copper price will average US\$3.1 per pound this year, US\$2.7 in 2008 and US\$2.45 in 2009, gradually converging to its estimated long-term level.

Given recent events in world financial markets, there is more uncertainty than usual around this scenario. There is the possibility that market adjustment and volatility persist without deepening, causing a more notorious weakening of the US economy and affecting other economic zones, debilitating world growth. This setting could further deteriorate financial conditions for emerging economies, increasing the possibility of acceleration of commodity price corrections and a faster normalization of the terms of trade. There can be other risk scenarios whose implications are more difficult to foresee. In the extreme, it is possible that credit and liquidity constraints that have been observed, and that have driven central bank intervention in developed

economies, become even more pronounced. Their effects on projections would depend on the shape that the deterioration of the external scenario could take. Although domestic inflation would tend to decrease because of a widening of the output gap—caused by a drop in external demand, worsened financial conditions, reduced export prices and adverse effects on expectations—and a decline in the prices of goods such as oil and foods, the possibility of increased financial risks and deteriorated terms of trade driving a peso depreciation that attenuates said effect cannot be ruled out.

Aggregate demand

The baseline scenario considers that domestic demand will grow in 2007 and 2008 in the range of 7% to 8% annually. It is worth highlighting in this projection that consumption will continue to grow at annual rates similar to recent ones, and for the year 2007 somewhat above May's estimates. This projection considers that the composition of the increase in private consumption will remain fairly stable, and that annual consumption growth—durable and non-durable—will also change little from the last few quarters. Gross fixed capital formation is projected to increase during 2007 at higher annual rates than considered in the last *Report*. Aside from actual figures for the second quarter, that already exceeded May's forecasts, capital goods imports are projected to post during the second half the same variation rates of recent months. The scenario for gross fixed capital formation is based, among other factors, on the stage of development of various projects in the energy sector and the results of the investment survey that, in its June revision, revised upward the value of investments planned for this year. Therefore, the ratio of fixed capital investment to GDP at prices of 2003 will increase to 25.5% during this year and will stay close to it in 2008.

The domestic demand scenario relies on the low level of unemployment and ongoing good financial conditions, plus the impulse provided by macroeconomic policies. The MPR, despite recent increases, is in the low end of a range of estimates for its neutral level, so the Board estimates that it continues to be a driving force in the economy. Also, the change in the fiscal surplus target from 1.0% to 0.5% of GDP and the revision to its parameters, combined with Codelco's increased costs and production behavior, and the price of molybdenum, will imply a fiscal impulse for 2008 in line with the budget for 2007.

The baseline scenario assumes that, during 2007, volume exports will largely outperform 2006, with significant growth in mining and manufacturing shipments, both associated to increased capacity in their respective sectors. Mining exports, in particular, will go from registering slightly negative variation rates in 2006 to growing close to 13% this year. Agricultural exports will also increase in 2007 at higher annual rates than last year's. It is possible, however, that given this winter's harsh weather conditions, agricultural activity will slow down in the second half, hurting the sector's exports. Overall, dollar exports will be higher than foreseen in May because of both more volume and higher prices, particularly for copper. Meanwhile, goods imports will record an increase in volume, also greater than in 2006. In line with the scenario for consumption and investment, purchases of consumer goods will increase at a rate similar to last year's, while capital goods will show stronger growth. The rise in volume imports of fuels also stands out, consistently with electric generation's response to natural gas

restrictions and lack of hydric resources. All considered, the trade balance is forecast to close 2007 with a balance of US\$24.90 billion, exceeding May's estimates. For 2008, volume sales abroad are projected to be less dynamic than this year. This tendency will extend to every export category, although more strongly to mining. Imports will also grow less than projected in 2007, especially those related with capital and consumer goods.

The current account of the balance of payments is expected to close 2007 with a surplus of 5.4% of GDP, exceeding May's projections by far. This reflects the fact that a big portion of earnings coming from export prices, unusually high and thought not to be persistent have been saved, largely due to a fiscal spending policy based on structural income. Toward 2008, consistently with projected normalization of the terms of trade and less dynamic external conditions than this year, the current account should post a much smaller surplus: 2.6% of GDP. Measured at trend prices, for 2007 and 2008 the current account is expected to post a deficit of around 3% of GDP^{1/}.

Economic activity and gaps

The baseline scenario maintains May's evaluation of trend GDP growth around 5% for the period 2007-2009. This figure is also similar to the recent estimate of the Experts Committee called by the Ministry of Finance to revise the parameters of the fiscal budget for 2008. The closing of gaps during the course of the second quarter of 2007, combined with the trend growth assumption and the economic growth scenario considered the most likely, will keep the output gap closed over the projection horizon. As usual, the risk persists of economic growth differing from expectations or of the economy's trend growth and available gaps, both unobservable variables, differing from today's projections.

Tight output gaps are also visible in the conjuncture's evaluation of the labor market. Employment has continued growing at average rates above 3%, with stronger growth in salaried employment. The rate of unemployment, seasonally adjusted, is below the levels of the beginning of the year and below several estimates for its level consistent with price stability.

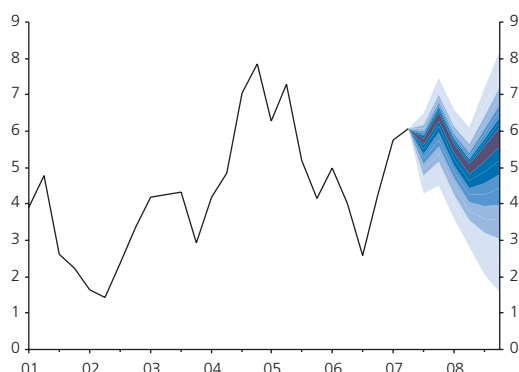
As aforesaid, the baseline scenario considers that the economy will continue to benefit from an external scenario that stimulates output. However, in the present conjuncture and with the information available at the closing of this *Report*, the magnitude of the effects that the volatility of international financial markets can have on the external scenario considered the most likely is hard to predict.

All considered, the baseline scenario contemplates output growth in 2007 between 5¾% and 6¼%, and between 5.0% and 6.0% in 2008. Also, taking into account possible alternative events, the balance of risks for output is biased downward (figure 1).

^{1/} This calculation considers long-term prices for copper and oil of US\$1.2 per pound and US\$56 per barrel, respectively.

Figure 1

Quarterly GDP growth scenarios (*)
(annual change, percent)



(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future economic growth. The baseline scenario is constructed using the methodological assumption that in coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this Report.

Source: Central Bank of Chile.

Cost pressures

On the costs side, apart from the sharp rise in the world prices of some foods, no changes are observed in imported inflation pressures. The real exchange rate (RER) has remained fairly constant since the closing of May's Report, considering the average for the ten working days prior to the statistical closing. This level is consistent with the equilibrium RER. The baseline scenario uses as a methodological assumption that, in the long run, the RER will not differ much from its average for the two weeks prior to the statistical closing of this Report. This assumption is subject to a high degree of uncertainty, especially in light of recent developments in international financial markets and their future trend.

The price of oil and derivatives is above projections in last Report. Although it has significant incidence in the difference between actual inflation and May's projection, it is not a key determinant of the recent increase in annual inflation. Ahead, the baseline scenario considers that oil prices will hover around US\$70 per barrel over the projection horizon, but other scenarios cannot be ruled out, especially if world growth falls short of projections.

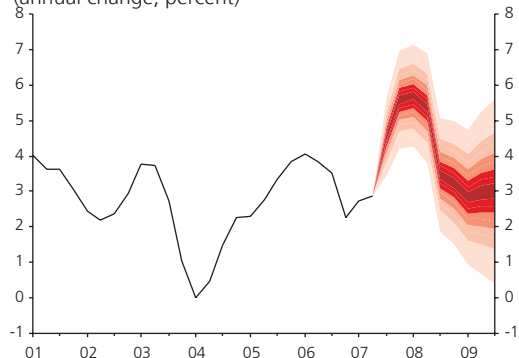
The baseline scenario contemplates that the increase in domestic prices of non-perishable foods (i.e., corn, wheat, milk and dairy products) will continue posting slight rises in the very near future, to later grow close to the average of the other prices until the end of the projection horizon. Prices of perishables (i.e., fresh fruits and vegetables) will also increase in the very near future, but are foreseen to show a substantial reversal before year's end. These assumptions are subject to high uncertainty. On one hand, given the experience of recent months, it cannot be ruled out that these prices may increase above projections. On the other hand, given the unusual magnitude of the shock, it cannot be disregarded that prices may have a drastic reversal within the projection horizon, leading to a significant drop in inflation. In the present context, the potential implications on domestic inflation if world prices of the goods that have pushed inflation up in recent months reverse substantially in a worsened external scenario become more important.

Labor costs are increasing consistently with the inflation target, with salaries growing between 4% and 7% annually depending on how they are measured, with average productivity increasing at a rate close to 2%. There is the risk, however, of the present price shock spreading to other prices more than expected, which could occur, for example, through higher labor costs. This is one risk where the Board will put special attention, because confidence in the inflation target is crucial in the determination of trend inflation. In this sense, it is appropriate to reaffirm that, as it has done in the past, the Board will adopt whatever decisions it deems necessary to maintain its commitment with the inflation target.

For the rest of 2007 and 2008 no big variations are foreseen in the electric generation matrix. While the effects of generating electric power with fuels instead of natural gas and hydric resources are more evident only in the electricity, gas, and water sector, it has significant incidence in electric rates. The baseline scenario assumes that, in addition to July's 6% increase in rates, there will be new increments in the rest of 2007—all because of increased costs of electric generation—with an impact on CPI inflation somewhat greater than half a percentage point. For 2008, the working assumption is

Figure 2

CPI inflation projection (*)
(annual change, percent)

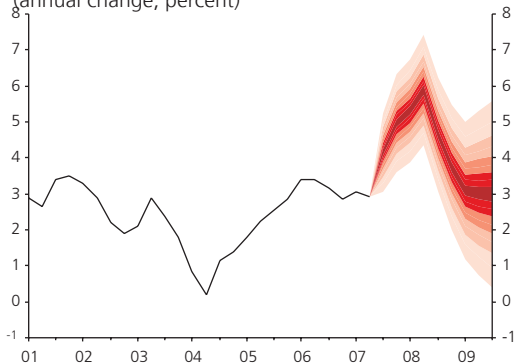


(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future inflation. The baseline scenario is constructed using the methodological assumption that in coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this Report.

Source: Central Bank of Chile.

Figure 3

CPIX inflation projection (*)
(annual change, percent)



(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future inflation. The baseline scenario is constructed using the methodological assumption that in coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this Report.

Source: Central Bank of Chile.

that rates will rise again, in a magnitude comparable to the average increase of the period 2004-2005. This scenario is subject to high uncertainty, with results that will depend on the evolution of the energy matrix, fuel prices and increases deriving from the electric power rate, among many factors.

Inflation scenario

The baseline scenario projects annual inflation to continue rising in coming months. CPI inflation should stand around 5.5% until mid 2008, partly due to price increases already in place. This short-term inflation scenario is materially different than the one considered most likely in January and May of this year, owing to the unusual shocks endured in recent months and also reflecting changes occurred in the global macroeconomic scenario.

After the temporary deviation foreseen for the next several months, annual CPI inflation will decline toward 3% in the course of 2008 and will remain fairly constant until the end of the projection horizon, this time the third quarter of 2009. In the baseline scenario, CPIX1 inflation will converge to 3% at a similar pace as headline CPI, while CPIX variation will do so somewhat more slowly. In addition, considering possible alternative events, the balance of risks for inflation is unbiased (figures 2 and 3).

Trend inflation projection is based on medium- and long-term inflation expectations in line with the target, output gaps remaining closed until the end of the projection horizon, labor costs growing consistently with target inflation and an RER not very different from its average for the two weeks prior to the statistical closing.

The Board estimates that, in the most likely scenario, new increases in the MPR will be necessary in coming months to ensure that projected inflation over the policy horizon remains at 3%. As usual, the evolution of the MPR will depend on incoming information and its implications on projected inflation. In particular, the Board will follow closely the evolution of international financial markets and its implications on growth and inflation. The Board considers also that a setting of large shocks in specific prices and scarce gaps as the present one requires special attention, both to the possible propagation to other prices and to medium- and long-term inflation expectations.