MONETARY POLICY REPORT

PRESENTATION BEFORE THE FINANCE COMMISSION OF THE HONORABLE SENATE OF THE REPUBLIC*

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* The *Monetary Policy Report* of March 2019 can be found at http://www.bcentral.cl.

I. Introduction

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

I am grateful for your invitation to present the vision of the Board of the Central Bank of Chile on recent macroeconomic developments, their prospects and the implications for monetary policy. This vision is contained in detail in the *Monetary Policy Report* (IPoM) of March 2019, released this morning. These antecedents provide the background for the decision adopted by the Board at the *Monetary Policy Meeting* last Friday.

At that Meeting, we decided unanimously to keep the *Monetary Policy Rate* (MPR) at 3%. At the same time, we noted that, in line with the lower level of inflation and its outlook, it would be necessary to maintain the monetary stimulus for a longer period, taking a break in the process of MPR normalization that began last October. To the extent that the economy continues on the foreseen path, this process should be resumed in the medium term to ensure the convergence of inflation within the policy horizon.

This decision is coherent with the analysis and baseline projection scenario that I will share with you now. In particular, it considers that the economy posted healthy growth in 2018, driven by investment, an impulse that is expected to continue in 2019. Externally, growth in the main economies has shown a sharper-than-expected deceleration, which has led its authorities to implement further economic stimulus packages.

The main difference with respect to December's baseline scenario was seen in local inflation. Measured by the benchmark Consumer Price Index (CPI) calculated by the *National Statistics Institute* (INE) based on the updated basket and new methodology, annual CPI variation is significantly below the forecast. This differential between forecast and actual inflation occurs in a context where activity and demand have behaved as expected, which in this Report is explained by a lower-than-expected peso depreciation pass-through, favorable supply factors in some markets and greater capacity gaps than had been estimated until now. Said gaps do not originate in weaker demand, but in the labor force effects of massive immigration to the country, an issue that the Bank has brought up in its presentations to this Commissions for some quarters now.

In this context, our projections yield that the convergence of inflation to the 3% target will take almost a year longer than we estimated in December. This provides room for the withdrawal of the monetary stimulus to proceed at a slower pace than was announced before by the Board.

This scenario plays out in a context of greater uncertainty in the world economy, where global financial markets remain very susceptible and more negative scenarios may occur. For the same reason, although we believe that the evolution of macroeconomic conditions will make it necessary to reduce the monetary stimulus and that the external impulse facing the Chilean economy has not seen significant changes, we will continue to implement this process with particular caution.

Let me now share with you some more detail of our assessment of the macroeconomic scenario, its prospects and monetary policy implications.

II. Recent evolution of inflation

As is well known, in January, the INE updated the CPI basket and measurement methodology, giving rise to a new CPI series with base 2018=100, that supersedes the former base of 2013. The new CPI uses a basket of products that responds to the current consumption patterns of the population, taken from the *Family Budget Survey* of 2017, and incorporates a series of methodological improvements in the collection of some price data. This certainly makes the new CPI a more accurate indicator of current inflation. In introducing the new series, the INE has applied the same procedures of the last two updates, in 2009 and 2014. Thus, for analytical purposes, it has generated a benchmark series, corresponding to the CPI level calculated with the new methodology for the months of January to December 2018. This allows estimating the average prices established by the base of the indicator and twelve-month variations, beginning in January 2019. The series spliced with the 2013 base CPI remains the official index, that is good for all legal and contractual purposes, including the calculation of the UF.

In its analysis of the behavior of inflation, the Central Bank uses, as in the previous changes, the benchmark series, because, for the reasons just explained, the new CPI is a better thermometer of the evolution of inflationary pressures and because, since it will be governing in the coming years, the information of its past behavior is more useful for estimating its outlook.

In doing so, an important difference is revealed with respect to the December estimates. Thus, while with the 2013=100 base the CPI accumulated a variation of 2.1% between February and December (eleven months), with the new basket and methodology (2018 = 100) it accumulated 1.7%. In the case of the CPIEFE index—which excludes food and energy—the figures were 2% and 1.5%, respectively. With this, at February the annual change in the CPI and the CPIEFE stood at 1.7% and 2% per year, respectively (figure 1). Compared with the change in the CPIEFE projected for this date in the December *Monetary Policy Report*, its current value is around 80 basis points lower.

Beyond the methodological reasons behind the changes in the figures produced by the new CPI, it is important to understand the macroeconomic fundamentals of the lower actual inflation. Our analysis identifies three key factors: first, there are differences in the goods component of the CPIEFE, which point to a lower transfer to local prices from the peso depreciation throughout 2018. This may be explained by the fact that during this period the variation of the peso/dollar parity responded to movements of the global value of the dollar, as opposed to past parity variations (e.g. in 2017) that responded to idiosyncratic shocks to Chile (figure 2). The difference in the pass-through coefficient of forex variations to inflation according to the origin of the former was widely documented in a box in the March 2016 Report and today we see it reflected in the recent behavior of inflation.

Second, there are also differences that could be more linked to supply factors in some markets of products and services. One example is the increased competition in the car industry, as well as the emergence of low-cost alternatives in passenger air transport, as seen in the behavior of the CPIEFE for services. The same applies to the increased competition in special offers of telecom packages mobile phone services. Some of these phenomena have been captured by the new CPI thanks to some of its methodological improvements (figure 3).

Third, the labor market presents greater slack, resulting from the massive immigration of recent years. Last December, the INE published the new population projections that use information from the 2017 Census, which ratified the significant increase in the immigrant population beginning in 2015. According to these figures, between 2015 and 2019 around 865 thousand people came to the country, which also has a significant effect on the demographics (figure 4). As we reported to this Commission last December, an immigration phenomenon of this magnitude has a strong effect on the labor force. Moreover, the immigrant population has a participation rate in the labor force of the order of 80% according to the 2017 Census, compared with the native population's which is somewhat above 60% according to the same source.

As we noted in a box in last December's Report, the effects of immigration manifest through supply and demand channels that together generate an expansionary effect on output and have a limited inflationary impact. On one hand, the increase in population brings with it an increase in aggregate demand for consumer goods and services, pushing inflation upward. But, on the other hand, immigration expands the supply of labor, which moderates wage increases and reduces the marginal costs of companies, putting downward pressure on inflation. While over time the economy adjusts to accommodate the population increase, it is unclear which channel will dominate, that of higher aggregate demand or that of the increased labor force. This will depend on the propensity to save of the immigrant population (considering remittances), the willingness to work at different wage levels and how fast the capital stock will adjust in response to the larger scale of the economy. The information of the last few months, with activity in line with forecasts, lower-than expected inflation and nominal wages decelerating during 2018, suggests that so far, the dominant channel has been the expansionary effect on the supply of labor.

Thus, it is possible to identify some recent economic phenomena that allow to analytically understand the fundamentals behind the lower inflation. Some of these phenomena (e.g. immigration and differences in exchange rate pass through) had been mentioned by the Central Bank in previous Reports, its effective translation into lower inflation only manifested with the calculation of the new CPI.

III. Recent evolution of activity

Recent months' data confirmed that the economy recovered its dynamism after the break of the third quarter of last year. As we reported in December, in said quarter activity slowed down more than expected because of, among other factors, a significantly higher calendar effect because of September's many holidays.

Fourth-quarter data that this effect was temporary, so total GDP closed the year with a growth of 4%, where 3.9% was non-mining. On the demand side, the greater dynamism of investment continues to stand out—especially in machinery and equipment—, which intensified over the year. Habitual consumption (i.e. nondurable goods and services) continued to expand in tandem with GDP, while durable consumption decelerated significantly mainly due to the normalization of volume car sales (figure 5).

About this year 2019, partial activity data for the first quarter show annual variations smaller than those at the end of last year. This combines a higher basis of comparison and, especially, a poor performance of the mining sector (figure 6). This worsened in February because of downtime in geographic areas affected by the intense highland winter, according to the INE's *Manufacturing Production Index*, which fell 9.4% in said month. Several indicators suggest that the lower growth of early this year will be a rather limited phenomenon.

About demand fundamentals Regarding the determinants of demand, it is worth noting that borrowing costs continue to be favorable by historic standards and that both supply- and demand-side conditions have improved in recent quarters. In terms of expectations, signals are mixed. While consumer expectations (IPEC) show a decline with respect to the end of the year, the business component (IMCE) shows an improvement in the same period, where worth noting is the progress in the construction sector. In the labor market, the national unemployment rate has been stable around 7%.

On the investment side, the latest survey of the *Capital Goods Corporation* (CBC) ratified the significant increase in projects under execution that we saw at the end of 2018. It even revised upward investment plans for this and the next two years, with special emphasis on 2020, with investment in mining projects continuing to contribute the most according to the survey. Inventories posted a significant increase throughout the year, where accumulated buildup went from 0.5% to 1.3% of GDP between 2017 and 2018, largely concentrated in the exporting sector and imports of machinery and equipment.

Chilean exports performed well during 2018, partly reflecting an increase in volume exports from all economic sectors in general. Worth noting were shipments manufacturing products, which reached their highest nominal growth since 2011, supported also by the favorable evolution of the international prices of many of these products (figure 7).

IV. International scenario

Internationally, there has been a more marked slowdown in growth in the main economies. The data was particularly weak in the Eurozone, with a significant adjustment of trade inside and outside the region in the fourth quarter of 2018. In China, growth went from 6.8% in the first quarter, to 6.4% in the fourth. Moreover, concerns about how intense this global deceleration may become have been exacerbated. Different short-term activity indicators underperformed the market forecast: the outlook for firms in the manufacturing sector (PMI) has deteriorated, manufacturing output has slowed or even contracted in several economies and international trade has weakened (figure 8).

Preoccupation over the weakening of the economies, together with lower inflationary pressures and high financial volatility, resulted in an increase in monetary and/or fiscal stimuli in several countries. In the US, the Federal Reserve took a considerable turn in its monetary policy stance, showing itself open to maintaining its expansionary orientation for some time longer, in contrast to the tighter signals emitted up to the third quarter. This led to a significant decline in US long-term interest rates. which has even translated into reversal of the US yield curve (figure 9). For its part, the European Central Bank postponed the start of monetary normalization and announced new initiatives for liquidity provision. Chinese authorities have announced new fiscal and monetary packages in addition to those adopted during 2018.

Nonetheless, global financial markets remain susceptible to potentially negative news, as reflected in the tensions at the end of 2018 and at the statistical close of this Report. Thus, there have been ups and downs in appetite for risk, capital flows and emerging currencies. The exchange rate in Chile has also been volatile. Considering the average of the ten days prior to the statistical closing, the real exchange rate (RER) is somewhat below its average of the last fifteen and twenty years. As a working assumption, the baseline scenario foresees that the RER will return to these levels during the projection horizon.

The baseline scenario of the *Monetary Policy Report* states that during 2019 and 2020 the world economy will grow 3.3% and 3.2%, respectively, less than the 3.7% average of the two previous years and the December Report's forecast (3.5% and 3.3%, respectively). Chile's business partners will show the same expansion rates in that period (3.6% in 2017-2018). These projections assume that the US will grow at rates closer to 2%, gradually approaching trend growth. In the case of China, it is projected to grow 6.1% this year and 6% in 2020, less than in previous years and consistent with the process of achieving lower expansion rates as the economy grows in size. These projections are somewhat inferior to those observed in the usual counterparties. In particular, in March the OECD said it expects global growth to grow 3.3% and 3.4% in 2019 and 2020, identical to the latest figures published by *Consensus Forecasts* and a little below the IMF's January projections (figure 10).

Turning to the terms of trade, most commodities increased their prices after the December Report. In the baseline scenario, prices for copper and oil are expected to be somewhat higher than predicted in December. A copper price of $2.9 per pound is forecast for this year and the next two, which compares with the prices of $2.85 and $2.80 per pound that we assumed in December for 2019 and 2020, respectively. In the case of oil, average Brent-WTI average prices are expected of $62 per barrel in 2019 and 2020 (59 dollars for both years, in December) and $60 in 2021. With this, and the revisions to the historical numbers, the terms of trade should increase this year by a higher rate than we thought in December, but in terms of levels, they will be similar (figure 11).

V. 2019 – 2021 Outlook

Our baseline projection assumes that the boost that the Chilean economy will receive from abroad in the next two years will be milder than it was in the last two. It will be still be positive, however, combining the downward adjustment of world growth and somewhat more favorable financial conditions than were foreseen in December. At home, the recent evolution of demand and prospects for consumption and investment continue to indicate that the economy will narrow its capacity gaps further over the coming quarters.

About the magnitude of these gaps, however, the mix between lower headline inflation and strong non-mining GDP imply that they will exceed previous projections, which, as has been noted, is consistent with the expansion of the labor force coming from massive immigration, among other factors. In order to tone down uncertainties about the values of this and other structural parameters used in the calibration of monetary policy, the Board has decided to update these estimates in the *Monetary Policy Report* next June.

V.1. Activity

In our baseline scenario, we expect the Chilean economy to grow between 3% and 4% in 2019. This range runs somewhat below our December forecast (3.25% to 4.25%), due to a poor-than-expected mining performance which, as I just mentioned, is clearly noticeable in the figures early this year. For 2020, we foresee that the economy will grow between 3% and 4%, a little above our December forecast. Finally, in this Report we present the first growth projection for the year 2021, that is, within a 2.75% to 3.75% range.

About expenditure, we still estimate that investment will be its most dynamic component, with annual growth over 6% in 2019. By 2020 and 2021, it should decline to around 4%. Consumption will continue to grow at rates consistent with GDP. In the fiscal area, our working assumption is that in 2019 the economy will receive a boost consistent with the approved Budget; from then onwards, the structural deficit will follow the path of gradual decrease defined by the authority (table 1).

V.2. Inflation

In terms of inflation, given its lower level today and the estimate of somewhat larger capacity gaps, its convergence to 3% will take longer than we predicted last December. Thus, it is estimated that the CPI will end this year with an annual increase of 2.6% and return to 3% in the first half of next year. From then on, it will fluctuate in the vicinity until the end of the policy horizon, that is, the first quarter of 2021. The CPIEFE is projected to end 2019 at 2.4% and approach 3% in the second half of next year (figure 12).

V.3. Monetary policy

As for monetary policy, the Board continues to believe that the evolution of macroeconomic conditions makes it necessary to reduce the monetary stimulus over the policy horizon. However, the change in the initial conditions of the baseline scenario caused by the lower inflation observed—in addition to other adjustments mentioned above—implies that its convergence to the target requires the pace of MPR normalization to be slower than anticipated. in December.

For short-term forecasting purposes, we use as a working assumption the MPR trajectory taken from our March Economic Expectations Survey, which foresees no changes in the MPR at least during the next two quarters. For the medium term, our projections are consistent with the MPR reaching its neutral level towards the end of the policy horizon. The Board has estimated for some time that the neutral MPR is between 4% and 4.5%. This parameter that will also be revised in the June Report.

V.4. Risk scenarios

The base scenario that I have just presented reflects the events most likely to occur with the information at hand at the close of this Report. There are risks, however, that, if materialized, may reshape the macroeconomic outlook and the course of monetary policy.

On the external front, despite having steadily input lower growth prospects, the risk balance continues to be biased downward. The main risk remains that of an abrupt reversal of financial conditions facing emerging economies, which could be triggered by various reasons, including a more abrupt and widespread slowdown in world growth or the negative evolution of the various geopolitical tensions that have persisted in the recent past. Although in such a scenario the main central banks would probably expand their monetary policies, a lower appetite for risk and declines in commodity prices are also possible, more than offsetting these lower interest rates.

At home, it is estimated that the risk balance for both activity and inflation is unbiased. First, the massive immigration of recent years may have a greater impact on growth and inflation. As I said, although in the medium-term immigration should have an expansionary effect on GDP and a limited one on inflation, it is unclear how the supply and demand channels will interact, and which one will dominate as the economy absorbs the population inflow. Second, on the activity side, it is possible for investment to be even more dynamic if larger-scale projects keep coming, but it can also happen that the greater external risks induce a more conservative behavior by entrepreneurs and consumers. Third, the expected evolution of inflation could also be affected if the pass-through of the peso depreciation returns to near average magnitudes earlier than expected and pushes up inflation of CPIEFE goods. Finally, we cannot rule out a faster depletion of the one-off effects of sectoral supply shocks, particularly the heavier competition in some areas.

V. Final remarks

The global economic scenario poses important challenges to our country. For two years now, events have been unfolding that have added uncertainty to the global growth Outlook, such as the trade conflict between the US and China or the Brexit resolution. Thus, we have seen several episodes in which global markets have been stressed, generating less favorable conditions for the emerging world. The most recent of these events is still underway, putting pressure on economies that are perceived to have weaker macroeconomic fundamentals.

Chile, being a small economy, commercially and financially integrated in the world, has not been spared these tensions. As I just mentioned, the impulse we will be getting from abroad in the next two years will be milder than the one of the last two. And as we have said in a number of Reports, we believe that the external risk balance is biased downward.

However, we must also be clear that this external scenario finds the Chilean economy on the right foot. Our growth rates have substantially outperformed those of previous years, investment is the most dynamic component of expenditure and our country has been absorbing a significant increase in the workforce without a corresponding increase in unemployment, while wages continue to grow. Today's lower level of inflation and its implications for the two-year convergence, not only allows adjusting the pace of monetary policy normalization, but also provides room to monitor and analyze the evolution of external conditions without the pressure of an imminent adjustment to the policy rate. Plus, there the traditional cushioning effect of the exchange rate float and a deep local capital market.

Summing up, monetary policy is now in an expansionary position, with the policy rate that has remained low for quite a while. Although in our baseline scenario we believe that it will still be necessary to raise it in the next two years, we have also been clear about the convenience of taking a break in the coming months.

Since we began the monetary policy normalization process, we have said that we will conduct this process gradually and cautiously, ensuring that the economy can adapt to a milder monetary stimulus and be on the lookout for changes in macroeconomic conditions that advise adjusting the pace of the process. The recent changes in the international economy and the new inflation measurement associated to the CPI updated belong to this class of changes. True to its commitment, the Bank has thoroughly examined these developments, factoring them into its projections, and has concluded that it is necessary to adjust the expected trajectory of monetary policy. Accordingly, we have put the normalization process on hold for some quarters, in order to allow inflation to go back to a path of convergence.

In the same way, faced with the uncertainty regarding the value of the structural parameters on which the monetary policy is based after important economic changes, we have decided to include an update in the June Monetary Policy Report, which will allow us to gauge its future trajectory.

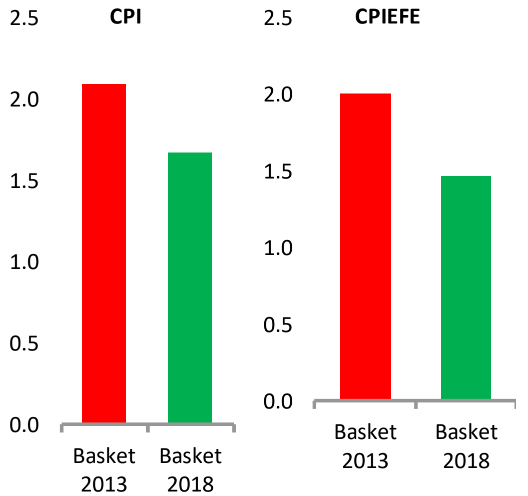
These actions attest to the Bank's commitment to its institutional mission, as well as its vocation to act on the basis of solid evidence and rigorous analysis of background information. In this way, we reflect our purpose of being an institution to which citizens can entrust the protection of price stability and financial stability, as essential determinants of their well-being.

Thank you.

Figure 1

Accumulated inflation, February - December 2018

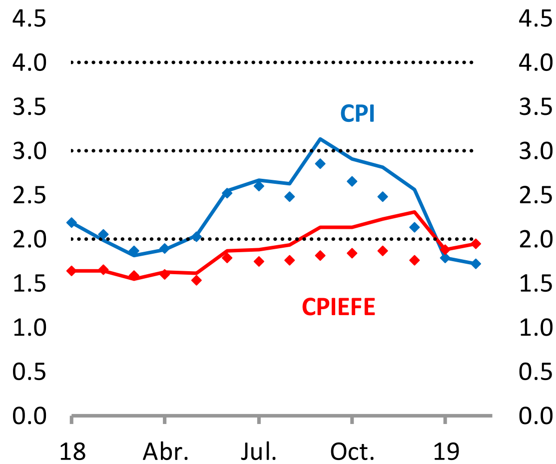
(percent)



Source: National Statistics Institute (INE).

Evolution of CPI and CPIEFE inflation (1) (2)

(annual change, percent)



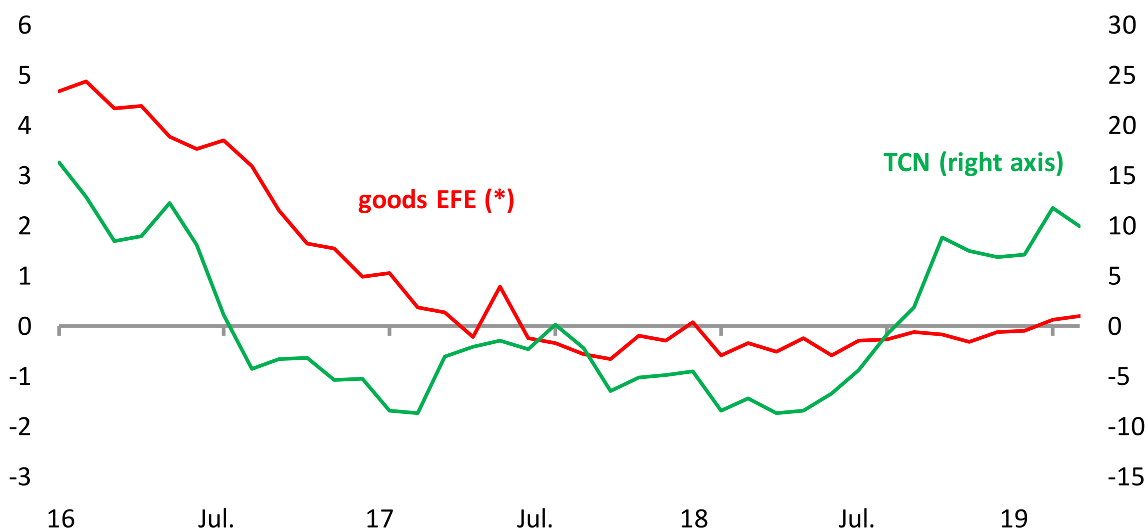
(1) As from January 2019 the lines use the new indexes with annual base 2018=100, so they are not strictly comparable with earler figures. (2) Blue (red) diamonds show the annual CPI (CPIEFE) variation using the 2013=100 basket. As from February 2018, they show the annual change that is obtained by splicing the 2013=100 basket series with the monthly variations in the 2018=100 basket.

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

Figure 2

Exchange rate and goods EFE

(annual change, percent)



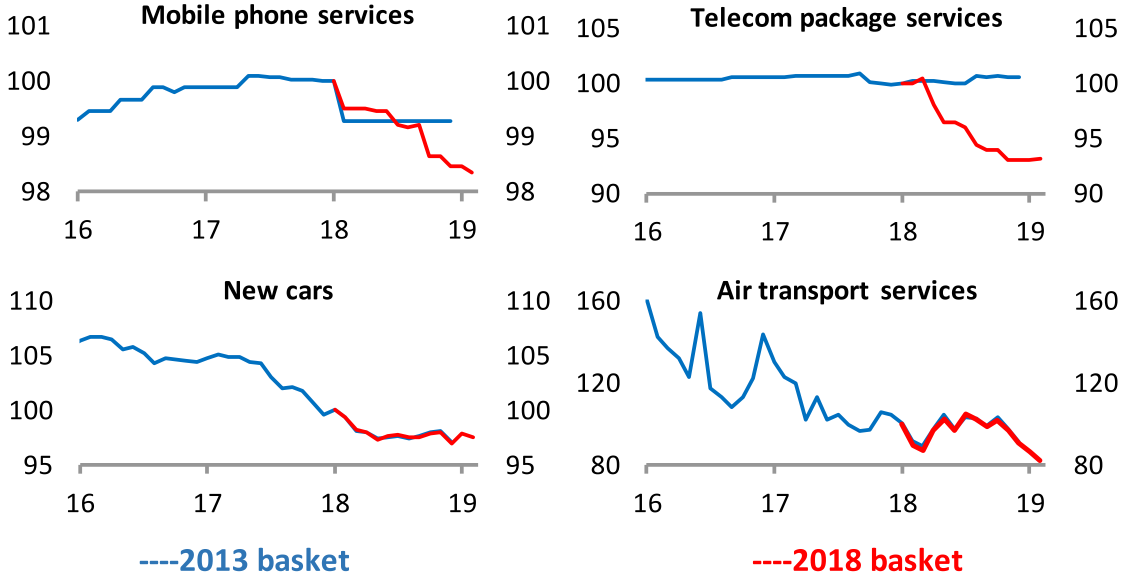
(*) As from January 2019 the line uses the new indexes with 2018=100 annual base, so they are not strictly comparable with past figures.

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

Figure 3

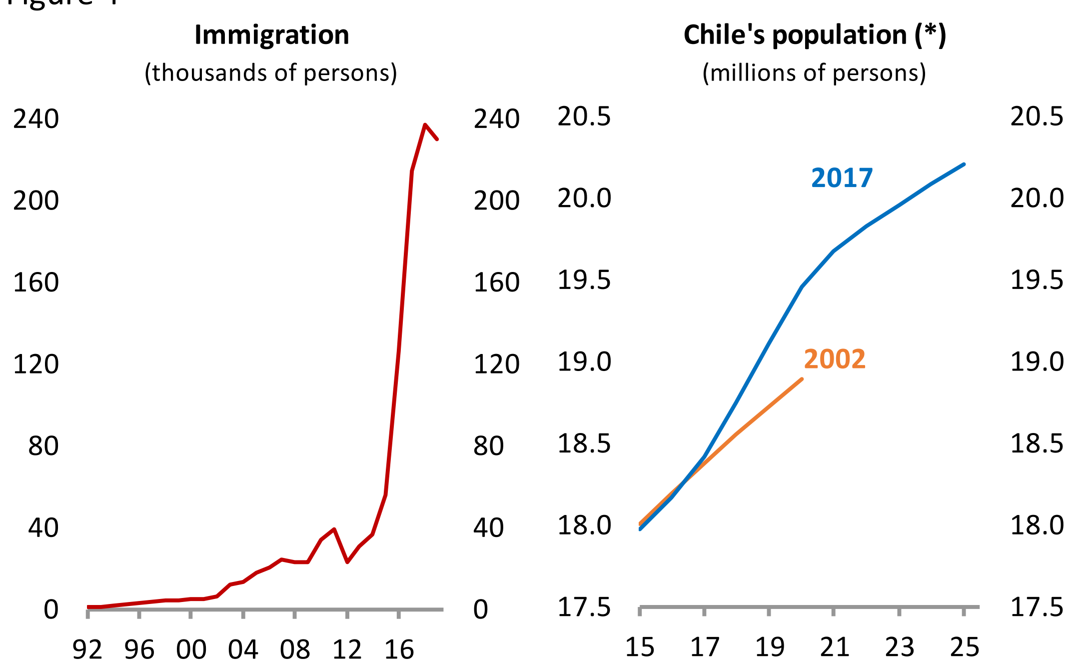
Selected CPI prices

(indexes, January 2018=100)



Source: National Statistics Institute (INE).

Figure 4



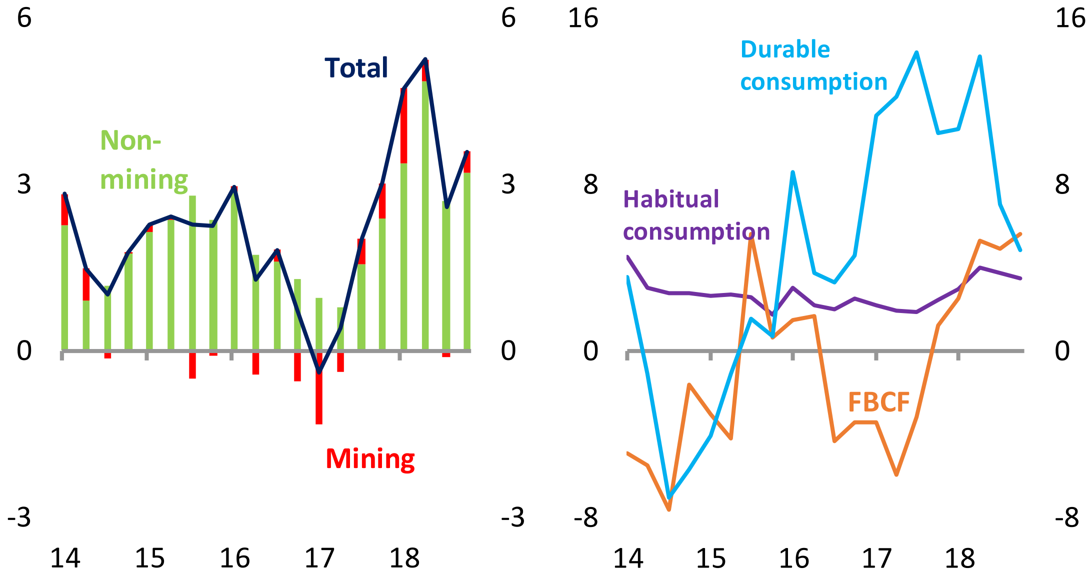
(*) Population estimates and forecasts using each Census. For 2002 the updated figures published in 2014 are used.

Source: National Statistics Institute (INE).

Figure 5

Annual GDP growth (contribution, percentage points)

Domestic demand (real annual change, percent)

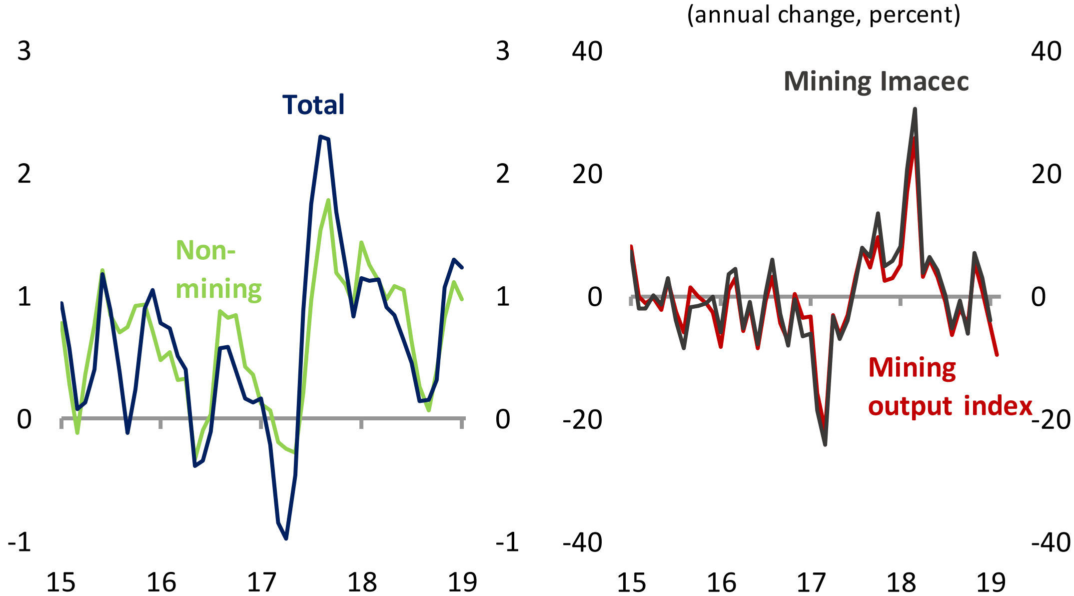


Source: Central Bank of Chile.

Figure 6

Imacec (*) (change from previous moving quarter, percent)

Mining activity (annual change, percent)



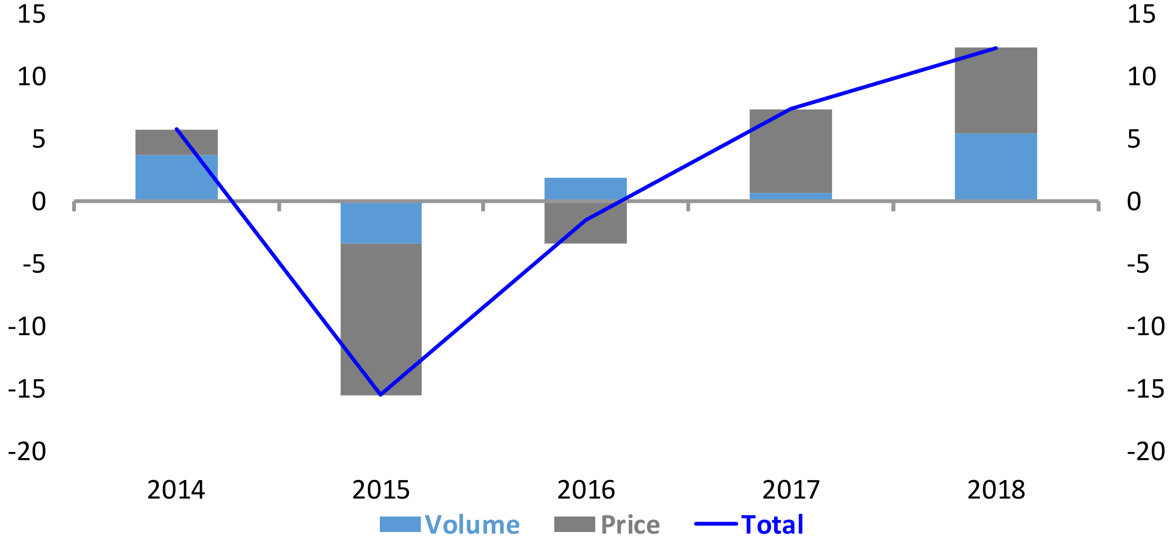
(*) Seasonally-adjusted series.

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

Figure 7

Manufacturing exports (*)

(contribution to annual change, percentage points)



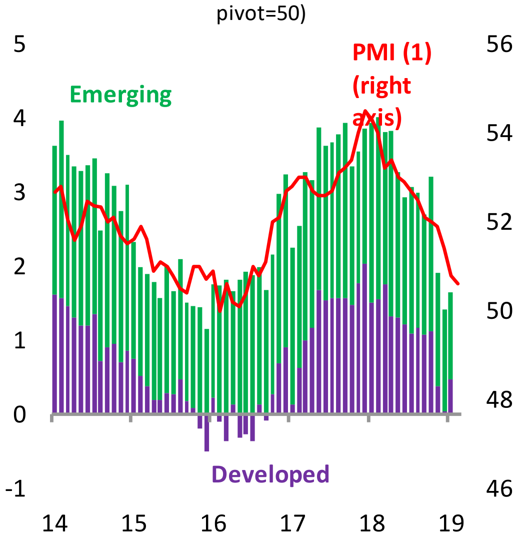
(*) Component of price obtained using differential between nominal and real exports.

Source: Central Bank of Chile.

Figure 8

Manufacturing output and global manufacturing outlook

(contribution, percentage points; original series, pivot=50)

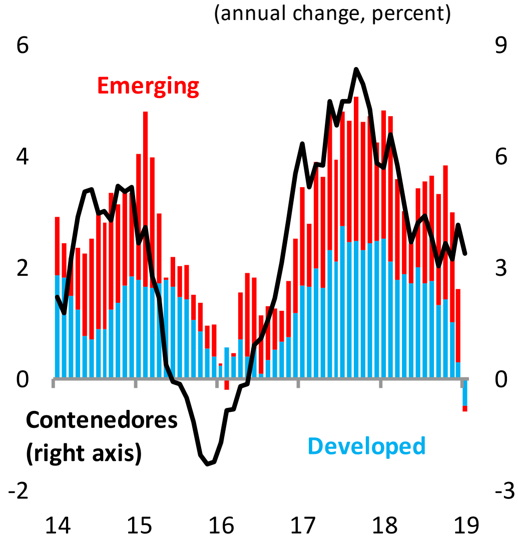


(1) Value above (below) 50 indicates expansion (contraction).

Sources: CPB Netherlands Bureau for Economic Policy Analysis and J.P. Morgan.

Exportaciones reales y tráfico de contenedores (2)

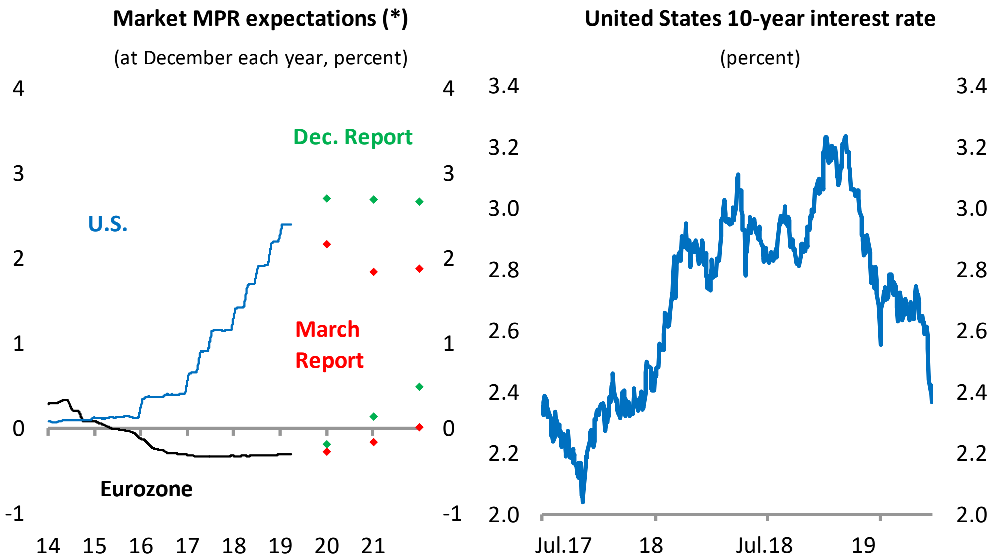
(annual change, percent)



(2) Moving three-month average.

Sources: CPB Netherlands Bureau for Economic Policy Analysis and Institute of Shipping Economics and

Figure 9

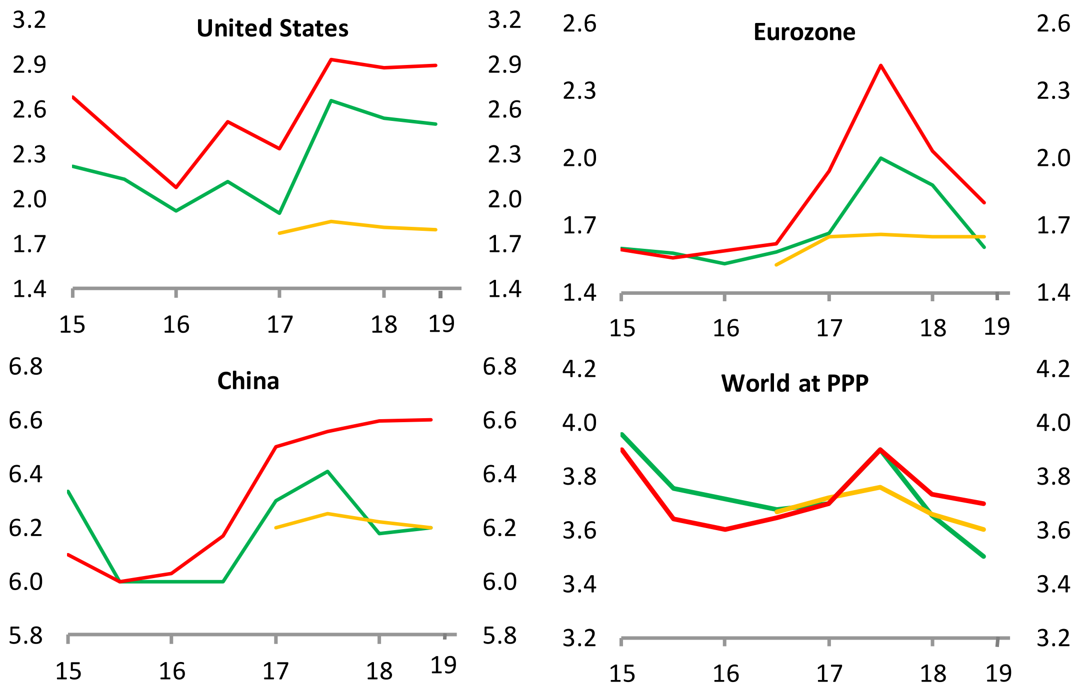


(*) Fed funds rate for the United States; Euribor rate for the Eurozone.
Source: Bloomberg.

Figure 10

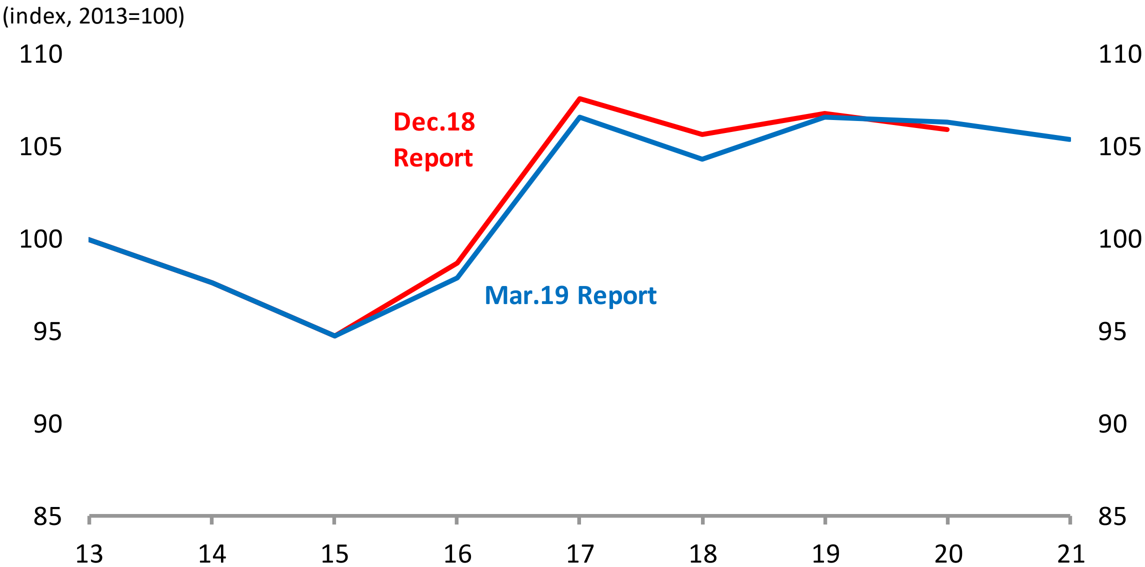
Growth forecasts

(annual change, percent)



Source: IMF.

Figure 11
Terms of trade



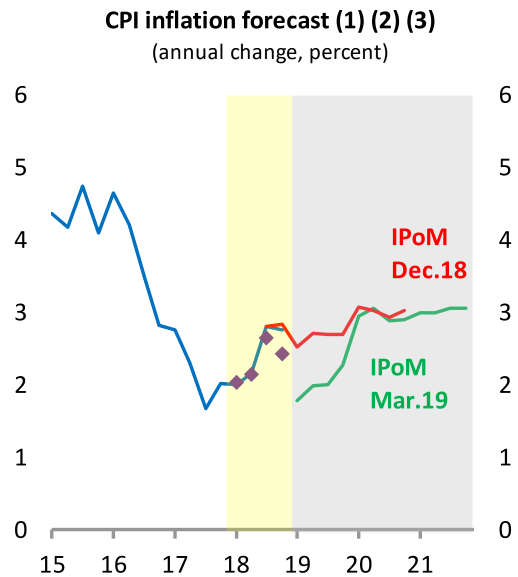
Source: Central Bank of Chile.

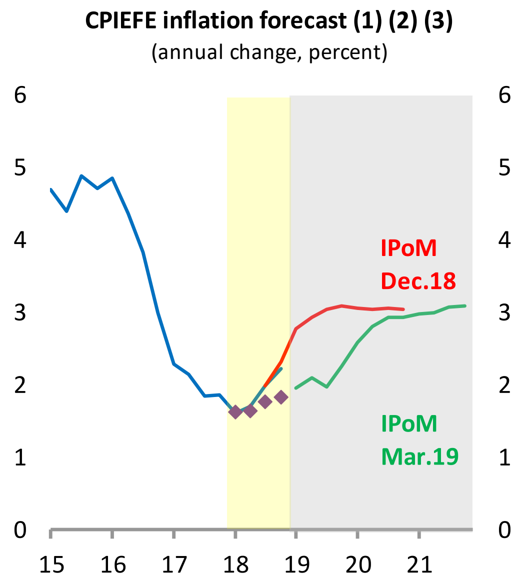
Table 1
Domestic scenario
(annual change, percent)

	2018	2019 (f) Dec.18 Report	2019 (f) Mar.19 Report	2020 (f) Dec.18 Report	2020 (f) Mar.19 Report	2021 (f) Mar.19 Report
GDP	4.0	3.25-4.25	3.0-4.0	2.75-3.75	3.0-4.0	2.75-3.75
Mining GDP	5.2					
Non-mining GDP	3.9					
Domestic demand	4.7	3.8	3.7	3.3	3.5	3.3
Domestic demand (w/o inventory change)	3.9	3.9	3.9	3.6	3.7	3.5
Gross fixed capital formation	4.7	6.0	6.2	3.9	4.3	3.9
Total consumption	3.7	3.3	3.3	3.5	3.5	3.4
Goods and services exports	5.0	4.1	3.6	2.8	2.9	2.9
Goods and services imports	7.6	5.0	4.5	3.0	2.9	2.6
Current account (% of GDP)	-3.1	-2.7	-2.9	-2.8	-2.7	-2.7
Gross national saving (% of GDP)	19.6	20.9	20.1	20.8	20.3	20.4
Nominal gross fixed capital formation (% of GDP)	21.3	22.6	21.8	22.8	22.0	22.2

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

Fig 12





(1) As from January 2019 the new indexes with 2018=100 annual base are used, so they are not strictly comparable with past figures. (2) Gray area, as from first quarter of 2019, shows forecast. (3) Yellow area shows annual CPI inflation using the 2013=100 basket (blue line) and the annual CPI inflation that is obtained by splicing said series (2013=100 basket) with the monthly variations of the 2018=100 basket starting in February 2018 (purple diamonds).

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