MONETARY POLICY REPORT

December 2014

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

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*/ The statistical cutoff date of this *Monetary Policy Report* was 11 December 2014.

PREFACE

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 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 promotes economic activity and growth while preventing the erosion of personal income. Moreover, focusing monetary policy on achieving the inflation target helps to moderate fluctuations in national employment and output.

The *Monetary Policy Report* serves three central objectives: (i) to inform and explain to the Senate, the Government, and the general public the Central Bank Board's views on recent and expected inflation trends and their consequences for the conduct of monetary policy; (ii) to publicize the Board's medium-term analytical framework used to formulate monetary policy; and (iii) to provide information that can help shape market participants' expectations on future inflation and output trends. In accordance with Article 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 *Monetary Policy Report* is published four times a year, in March, June, September and December. It analyzes the main factors influencing inflation, which include the international environment, financial conditions, the outlook for aggregate demand, output, and employment, and recent price and cost developments. The last chapter summarizes the results of this analysis in terms of the prospects and risks affecting inflation and economic growth over the next eight quarters. Some boxes are 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 on 12 December 2014 for presentation to the Senate on 15 December 2014.

The Board

SUMMARY

In recent months, inflation has increased more than anticipated in a context where output growth has fallen short of expectations. The high inflation figures, which brought annual CPI to 5.5% in November, have largely reflected the significant depreciation of the peso in nominal terms. Most recently, however, inflation has also been influenced by specific and transitory elements. In the baseline scenario, inflation is expected to close this year somewhat below 5% and approach 3% in mid-2015. Private expectations also point to a rapid reduction in inflation over the next year, and at two years out they remain at 3%.

Inflation surprised throughout 2014. Early in the year, the Board estimated that inflation would stand at 3% by the end of 2014, partly because the depreciation accumulated until then would have a limited impact on inflation within historical patterns. This estimate was based on, among other factors, the fact that the slowdown the economy was showing would limit the degree of transmission to final prices, wages and expectations. That assumption was modified when actual figures showed a larger than expected pass-through to prices. Thus, already in June the CPI inflation forecast was substantially revised upward. In the past few months, the transmission has proceeded as expected, but the sharper depreciation of the peso and some one-time developments—namely the increase in the prices of some fresh fruits and vegetables—pushed inflation above the forecast. These increases reversed somewhat in November, to which the decline in fuel prices also contributed. This latter factor should continue to help pull inflation down in the coming months.

Regarding output, in the third quarter both GDP growth and domestic demand growth were slower than had been foreseen in September, although the magnitude of the surprise was smaller than in the second quarter. As for the components of expenditure, private consumption grew little and investment continued to decline in annual terms. The sharp deterioration of durable consumption and investment in machinery and equipment stood out once again. Thus, the sharp adjustment in expenditure and the peso depreciation have resulted in a fast reduction in the current-account deficit, when measured at either trend or actual prices.

The sluggish third-quarter economic figures are compounded with partial fourth-quarter indicators showing no significant recovery in expenditure. Annual variation in imports of consumer and capital goods is still in negative territory; various sales indicators show similar trends to those of previous months, while construction-related figures show persistent weakness in the sector. The same is true of manufacturing activity which, with the exception mainly of exports, shows a steady decline. The outlook for investment in construction and other works, one of the most inertial components of expenditure, has also worsened. The survey

ECONOMIC GROWTH AND CURRENT ACCOUNT

	2013	2014 (f)	2015 (f)
	(annual change. percent)		
GDP	4.1	1.7	2.5-3.5
National income	3.4	1.3	3.7
Domestic demand	3.4	-0.7	3.0
Domestic demand (w/o inventory change)	4.2	0.4	2.6
Gross fixed capital formation	0.4	-6.2	1.9
Total consumption	5.4	2.4	2.8
Goods and services exports	4.3	1.4	4.0
Goods and services imports	2.2	-5.9	3.7
Current account (% of GDP)	-3.4	-1.6	-1.1
Gross national saving (% of GDP)	20.5	19.7	20.8
Gross national investment (% of GDP)	23.9	21.3	21.9
GFCF (% of nominal GDP)	23.6	22.0	21.6
GFCF (% of real GDP)	25.8	23.8	23.6
		(US$ million)	
Current account	-9,485	-4,150	-2,770
Trade balance	2,117	7,600	9,020
Exports	76,684	75,550	75,600
Imports	-74,568	-67,950	-66,580
Services	-2,908	-3,300	-3,600
Rent	-11,102	-10,550	-10,230
Current transfers	2,408	2,100	2,040

(f) Forecast.

Source: Central Bank of Chile.

INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

	Avg. 00-07	Avg. 10-12	2013	2014 (f)	2015 (f)	2016 (f)
			(annual change, percent)			
Terms of trade	8.2	4.1	-3.2	-1.1	1.7	-2.1
Trading partners GDP (*)	3.6	4.6	3.5	3.2	3.5	3.9
World GDP at PPP (*)	4.2	4.0	3.1	3.2	3.5	3.9
World GDP at market exchange rate (*)	3.3	3.2	2.4	2.6	3.0	3.3
Developed economies' GDP at PPP (*)	2.6	1.8	1.2	1.6	2.1	2.3
Emerging economies ' GDP at PPP (*)	7.4	5.9	4.7	4.5	4.7	5.2
External prices (in US$*)	4.6	5.2	0.3	0.0	-0.7	0.6
			(levels)			
LME copper price (US¢/lb)	154	367	332	311	295	285
WTI oil price (US$/barrel)	44	90	98	93	64	68
Brent oil price (US$/barrel)	42	101	109	99	70	75
Gasoline parity price (US$/m^3) (*)	367	742	785	733	483	495
Libor US$ (nominal, 90 days)	3.6	0.4	0.3	0.2	0.6	1.8

(*) For definition, see Glossary,
(f) Forecast.

Source: Central Bank of Chile.

of the Capital Goods Corporation (CBC) of September again revised the amounts foreseen for 2014 and 2015, to levels below those of 2013.

This slow growth of the economy has occurred in a context in which the expectations of enterprises and households have turned more pessimistic. The scenario for consumers is one where higher inflation has affected the purchasing power of households. The unemployment rate remains around 6.5%, which is low by historical standards, but salaried job creation has remained low and surveys reveal greater uncertainty regarding the evolution of the labor market. For enterprises, the greater degree of pessimism has coincided with low levels of profitability, as depicted in the *Financial Stability Report*, and a climate for investment that firms judge less attractive. Plus a perception that inventories are above the desired levels, despite successive reductions in recent quarters. Thus, private expectations for growth this year and the next two have posted continuous declines, so an average annual increase of 2.7% for 2014-2016 is expected.

The cost of domestic financing, conversely, has become more favorable, in line with the significant reduction in the Monetary Policy Rate (MPR) that has been implemented over the past year. However, the real annual growth of banks' consumer and commercial loans is slow, in some cases in their lowest in many years. The exception is mortgage credit, which continues to grow strongly. The September Bank Lending Survey shows more supply-side constraints and mainly a reduction in demand.

In the baseline scenario, output is estimated to grow 1.7% this year—somewhat below the September forecast—, reflecting poor third-quarter figures that are prolonged over the fourth quarter. There is also consumers' and enterprises' expectations that so far have failed to improve as was expected a few months back. In 2015, GDP will grow between 2.5% and 3.5%, still less than the medium-term figure, which the Board estimates to be in the 4% to 4.5% range.

Growth is forecast to grow in 2015 more than in 2014. This assumption is based on the rapid and substantial adjustment the economy has made this year, as reflected in the current account, interest rates and the real exchange rate (RER). It is also based on the external conditions expected for 2015, although less auspicious than expected in September, are somewhat better than this year's, partly due to the impulse provided by lower oil prices. Another factor is that confidence of consumers and enterprises will tend to improve. The significant monetary stimulus that has already been added, the greater fiscal stimulus and the effect of the peso depreciation on the tradable sectors will provide an additional boost. Finally, although the financial situation of households and enterprises is less comfortable than it has been in recent years, it is estimated that this will not be an obstacle to the recovery of our economy.

On the external front, the baseline scenario considers a less dynamic outlook for output than projected in September, but still pointing to growth rates in 2015 and 2016 exceeding those of 2014. This combines the world economy that has lost momentum recently but is offset, at least partially, by the stronger impulse that will come from the drop in oil prices. By region, what stands out is the growing divergence between the performance of the United States—and its more consolidated recovery— and other developed economies such as the Eurozone

and Japan, where projections have been revised down again. In the emerging world, the outlook is also somewhat weaker, with Latin America posting the larger revisions. In the baseline scenario, out trading partners will grow 3.5% and 3.9% in 2015 and 2016, respectively.

In the baseline scenario, external financial conditions and prospects will be less expansionary than this year, but will remain favorable from a historical perspective. In the United States, the Fed ended its asset purchase program and the fed funds rate is expected to be increased in 2015, which will likely have upward effects on long-term rates there. The Eurozone and Japan, have implemented a more expansionary monetary policy to address the weaker economy and deflationary risks, and further measures are expected in that direction over the coming quarters. Thus, long-term interest rates in the main developed economies receded further or remained low. The better relative performance of the U.S. compared with the rest of the world has led to a worldwide strengthening of the dollar, affecting the other currencies, including the Chilean peso. The trajectory of the peso has also been influenced by adjustments in the local macroeconomic scenario, the changes in monetary policy and the decline in copper prices.

The falling prices of commodities have led to significant changes in the outlook for global inflation. In particular, oil prices and perspectives decreased substantially, mainly due to supply-side factors that have given rise to a surplus balance in the crude oil market. This has resulted in a lower forecast for the relevant foreign inflation (IPE) and improvements in Chile's terms of trade. However, part of this is offset by a lower actual and expected price of copper, whose value was below US$3 per pound in the weeks prior to the cutoff of this *Report*. In the baseline scenario, this price will average US$2.95 and US$2.85 per pound in 2015 and 2016, respectively.

Chile's expected annual CPI inflation is expected to stay above 4% still for some months. Nonetheless, the high basis for comparison of 2014 combined with the behavior of fuel prices and the accumulation of capacity gaps will lead to a decline towards 3% over the course of 2015. It should then hover around 3% until the last quarter of 2016 —the end of the projection horizon. The projected CPIEFE for 2015 is revised upward, considering the sharper depreciation of the peso, its transmission to prices and the evolution of nominal wages. At any rate, this indicator is expected to be around 3% by the end of 2015 and remain in the neighborhood throughout 2016.

This trajectory assumes that the transmission to prices from recent months' peso depreciation will proceed as it has historically, wages will be adjusted according to changes in productivity, and output gaps will remain over the projection horizon. About the RER, the methodological assumption used is that it will move little or nothing, considering that it is within the range believed to be consistent with its long-term fundamentals. Also the working assumption is used that the MPR will remain stable in the short run.

The baseline scenario reflects those events that are believed to be the most likely to occur with the information at hand at the closing of this *Report*. There are risks, however, which, if materialized, may reshape the macroeconomic outlook and, therefore, may alter the course of monetary policy.

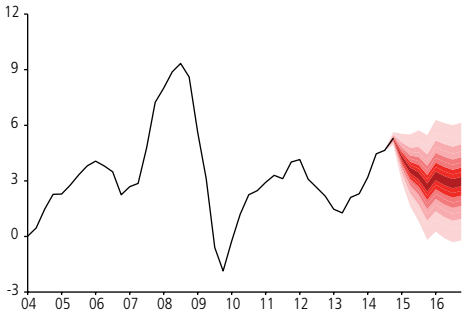
INFLATION

	2013	2014 (f) (2)	2015 (f)	2016 (f)
	(annual change, percent)			
Average CPI inflation	1.8	4.4	3.4	
December CPI inflation	3.0	4.8	2.8	
CPI inflation in around 2 years (1)				3.0
Average CPIEFE inflation	1.2	3.6	3.4	
December CPIEFE inflation	2.1	4.3	2.8	
CPIEFE inflation in around 2 years (1)				2.9

(f) Forescast.
(1) Corresponds to the proyected inflation for the fourth quarter of 2016.
(2) The December 2014 figure considers the average of the median monthly inflation forecast in the EES and the FBS of that month.

Source: Central Bank of Chile.

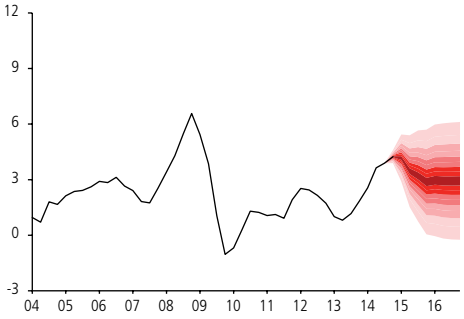
CPI INFLATION FORECAST (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on inflation as assessed by the Board. The baseline scenario uses as a working assumption that the policy rate will remain stable in the short run.

Source: Central Bank of Chile.

CPIEFE INFLATION FORECAST (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on core inflation as assessed by the Board. The baseline scenario uses as a working assumption that the policy rate will remain stable in the short run.

Source: Central Bank of Chile.

Abroad, the risks referred to in previous *Monetary Policy Report* remain. There is the risk of when and how fast the Federal Reserve will begin to raise its benchmark rate, and how this will affect the prices of financial assets. The risk of increased market volatility has risen as a result of the growing discrepancy between private expectations and the announcements of the Federal Reserve, and the divergence of monetary policy of central banks in major developed economies. About China, the risks related to its economic performance have regained importance, reflecting the recent weakening. The evolution of the Chinese financial system and real estate sector are the main focus of attention, which could lead to a further decline in copper prices. In the Eurozone, despite advances in the financial and banking field—reflected in the results of stress tests—credit expansion continues to be low and the risk of further slowdown is still latent.

All these external risks could lead to new episodes of volatility in world financial markets, with important negative effects on credit costs and activity. They could also trigger an additional depreciation of emerging currencies—our peso included—, affecting the short-term inflation outlook.

Meanwhile, it is possible for the drop in oil prices to have more intense effects on world growth. It cannot be ruled out, either, that the cycle of lower prices is extended or intensified, which would accentuate these effects and could also generate a scenario of stronger global growth. In any case, the fiscal accounts of some oil-exporting countries have deteriorated, a phenomenon that could spread to other economies should the cycle of low prices continue for some time.

Locally, one risk has to do with the behavior of economic activity, but especially the dynamics of domestic demand. Its expected recovery has been pushed back a number of times, while its materialization has weakened. The baseline scenario assumes that business and consumer confidence will improve gradually. If not, the slower growth in expenditure and output may be prolonged, generating longer-lasting capacity gaps and lower inflationary pressures.

Nor can it be ruled out that the current size of output gaps—an unobservable variable with great measurement uncertainty—is smaller than estimated and thus reduces its expected contribution to decelerating inflation. The low employment and strong growth in nominal wages put a note of caution in the evaluation of inflation dynamics.

After assessing these risks coming from both the local and external scenario, the Board estimates that the risk balance is unbiased for inflation and downward biased for output.

Inflation is high, but it is expected to approach 3% in the course of next year. Domestic output and demand continue to look weak and their growth prospects for 2015 have been revised downward, despite the strong stimulus from monetary and fiscal policy, and the boost coming from abroad is somewhat better than it has been this year. The Board took the MPR to 3% and has indicated that future changes in it will depend on the evolution of domestic and external macroeconomic conditions, and its implications for the inflation outlook. At the same time, it reaffirms 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: SEPTEMBER 2014 *MONETARY POLICY REPORT*

As of the cutoff date of the September *Monetary Policy Report,* the slowdown in output and domestic demand had been sharper and more persistent than forecast in June, with a bigger drop in investment and a more marked slump in private consumption. The labor market showed signs of slowing down, but the unemployment rate remained low and the growth of nominal wages had increased. Annual inflation, in contrast, was in line with expectations, and its high level was still projected to be temporary. The two-year forecast remained around 3%. The external scenario was somewhat less dynamic in terms of growth, but it was not substantially different from June, with minor changes in commodity prices and favorable international financial conditions. The geopolitical tensions had had limited effects on the markets. The Chilean peso had depreciated, partly due to the global strengthening of the dollar and partly to idiosyncratic factors, including a more expansionary monetary policy.

In this context, the Board had cut the monetary policy rate (MPR) by 50 basis points (bp) since June, to 3.5%, and had communicated that it would examine the possibility of introducing additional cuts depending on the evolution of internal and external macroeconomic conditions and its implication for the inflation outlook.

The baseline scenario considered that the slower national economy would be more persistent than previously forecast. GDP growth was adjusted to a range of 1.75–2.25% in 2014 and 3.0–4.0% in 2015. The recovery, albeit moderate, was based on a greater monetary and fiscal stimulus and a more dynamic external scenario (due to the growth of trading partners and the real depreciation of the peso), as well as an improvement in private expectations. The Board reduced its medium-term growth estimate for the Chilean economy (4.0–4.5%), incorporating a revision to total factory productivity, the capital growth forecast, and the natural convergence of an economy that had achieved higher per capita income levels. The growth of domestic demand in 2014 was revised downward, in particular for investment, although public investment was expected to provide a boost. Private consumption was expected to increase, but below the level forecast in June. Annual CPI inflation would stay over 4% for the rest of 2014. Moving into 2015, it would rapidly fall to 3%, in line with the lower inflationary pressures due to the phase of the economic cycle and the high basis of comparison, and then fluctuate around that level through the end of the forecast horizon, in this case the third quarter of 2016. This forecast took into account the fact that the indirect effects of the peso depreciation in recent months would be more than offset by the evolution of the output gap.

The baseline scenario reflected the events with the highest probability of occurrence based on the available information as of the cutoff of that *Monetary Policy Report.* However, there were risk scenarios that, if they materialized, could change the macroeconomic environment and, therefore, the course of monetary policy. After evaluating the alternative scenarios, the Board considered that the risk for inflation was balanced, while the risk for output was balanced in 2014 and skewed downward in 2015.

Internationally, the risk described in previous *Reports* remained current. The performance of China continued to be a risk factor, especially given the uncertainty associated with the country's financial system and real estate sector. There was also a possibility of new episodes of volatility related to the vulnerability of other emerging economies or the increases in the Federal Funds rate. In the Eurozone, the macrofinancial situation continued to be a source of uncertainty, exacerbated by the geopolitical tensions on the continent. Domestically, output and domestic demand could grow slower than forecast, which could lead to a faster, sharper adjustment in the labor market, with negative effects on consumption and output. A worsening of business expectations could intensify the adjustment in investment. This could also trigger a larger rebalancing toward the tradable sector, partially mitigating the slower domestic growth. In addition, the exchange rate effects of a weaker domestic economy could delay the convergence of inflation.

MEETINGS IN SEPTEMBER, OCTOBER AND NOVEMBER

As of the September meeting, the United States continued to lead growth in the developed world, while the Eurozone and Japan showed further signs of weakness. Inflation was also diverging between the United States and the Eurozone, which was clearly being passed through to monetary policy. The international financial markets showed limited improvement. Most commodity prices had fallen in the month. In Chile, output had grown 0.9% in annual terms in July, confirming the weak economy. In August,

the monthly change in the CPI showed a surprise increase, but in contrast to the first half of the year, this was mainly explained by a few items. Together with the greater peso depreciation, this was reflected in a change in inflation estimations for the end of the year.

In this context, the Research Division presented two main options: cutting the MPR by either 25 or 50 bp, in line with the *Monetary Policy Report*, which suggested considering two, or at most three, additional cuts of 25 bp each. There were two objectives to cutting the MPR by 50 bp, while also changing the policy bias to neutral: giving the economy a necessary stimulus and communicating that, in the absence of major changes in the economic scenario, no additional monetary policy adjustments were expected beyond what was already present in market expectations. This strategy had some drawbacks: (i) since the market was not expecting the move, it could be misinterpreted; (ii) the change in policy bias limited the flexibility of monetary policy, at least in the short term; and (iii) rushing the MPR reduction would have a lower impact, since the objective was to affect the behavior of medium- and long-term interest rates. The option of taking the MPR to 3.25%, while maintaining a downward bias but communicating that the reduction cycle was coming to an end, represented a continuity of the gradual reduction strategy that had been in place for almost a year. This strategy had provided a strong monetary stimulus to the economy, while also maintaining a good degree of flexibility. The Board thus decided to reduce the MPR by 25 bp, to 3.25%.

In October, the external scenario was less favorable in terms of output than had been projected in the *Monetary Policy Report,* and commodity prices had fallen substantially, especially oil. This had intensified the reduction in inflationary pressures in the developed economies, which was reflected in falling interest rates. It also coincided with downward trends on the stock exchanges, currency depreciation in the emerging countries and increases in sovereign spreads. In Chile, aside from a negative surprise in mining production, output was in line with the September *Report*, while the labor market continued to adjust. However, business and consumer expectations continued to deteriorate, and investment variables pointed to a worse scenario than expected. Inflation expectations one year ahead had fallen, although they remained around 3% at longer horizons—despite annual inflation of 4.9% in September and expectations that it would soon exceed 5%, after several months of upward surprises.

Based on this information, the Research Division presented two main options: cutting the MPR by 25 bp, to 3.0%, or holding it at 3.25%. Holding it at the current level was justified to the extent that, given the high inflation levels, it was possible that the downward rate cycle would end at 3.25%, rather than the 3.0% that was widely expected. This surprise measure would help to prevent a possible misalignment of inflation expectations. Moreover, although the inflation surprises of the past few months stemmed from isolated factors, the possibility of more persistent underlying causes could not be ruled out. The concern for a possible misalignment of inflation expectations seemed premature, since medium-term conditions were, if anything, less favorable to rising inflation. Finally, holding the MPR at its current level might be interpreted as a sign of a tighter monetary policy than the Central Bank wanted to communicate. The option of cutting the MPR by 25 bp and changing the policy bias to neutral was consistent with the policy of gradual adjustments, which had helped guide the market toward medium- and long-term interest rates that were in line with the Bank's assessment of the macroeconomic scenario. The change to a neutral policy bias was consistent with the view that monetary policy was already providing the necessary stimulus for the convergence of inflation. Even taking into account that in the short term the inflation forecast is subject to a large degree of uncertainty, its recent evolution did not represent a serious risk for the future trend and, therefore, did not merit a change in the direction or intensity of the monetary stimulus proposed in the September *Monetary Policy Report*. The Board thus decided to reduce the monetary policy interest rate by 25 bp, to 3.0%, and to change the future bias neutral.

In November, the international scenario continued to be relatively favorable. Domestically, data for the third quarter and the earliest indicators for the fourth confirmed that the economy had weakened markedly, as discussed in recent months. The growth outlook for 2015 and business and household expectations had continued to decline. The most salient news of the month was inflation, which had unexpectedly spiked to 5.7% in annual terms. However, the nature of this surprise was different from the inflation analysis in the June *Monetary Policy Report:* at that time, the inflation surprises were primarily explained by idiosyncratic factors and were mostly related to concrete exogenous phenomena, whose effect on prices should be reversed or at least not repeated in the future. The high inflation posed an important challenge for the conduct of monetary policy, to the extent that it could represent a risk to inflation convergence. The risk stemmed not only from the possible second-round effects and the possible impact on medium-term expectations, but also from the possibility that the high inflation was a reflection of lower excess capacity than projected, as suggested by some measures associated with the labor market.

According to the Research Division, the news that month confirmed the need to continue providing the economy with a strong monetary stimulus in order to achieve the convergence of inflation with the target. Thus, the possibility of easing off on the monetary stimulus did not seem like a feasible option. Moreover, the risks associated with the high inflation eliminated the possibility of new cuts. Accordingly, the Board held the MPR at 3.0%.

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 and the main risks.

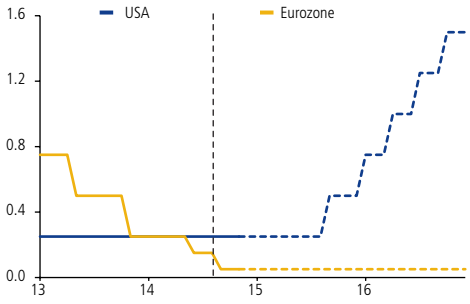
The international scenario facing the Chilean economy is somewhat less favorable than projected in September. World growth forecasts for 2014–2016 are moderately lower than projected then, although the sharp drop in oil prices has improved the terms of trade, despite the lower copper price. More importantly, however, the risks affecting the external scenario have increased.

Since the September *Report*, the disparity between the performance of the United States and the rest of the world has widened. Whereas the recovery has strengthened in the U.S. economy, the rest of the world continues to decelerate. This has translated into significant differences in monetary policy (both current and expected), a continuous strengthening of the dollar and financial markets that have become more sensitive to episodes of stress (figure I.1).

The U.S. Federal Reserve (the Fed) concluded its unconventional monetary policy measures, in line with the economic recovery, especially in the labor market. However, the market gave a tighter interpretation than anticipated to the announcement and the minutes from the November meeting, which indicated that the policy rate normalization could begin sooner than expected, insofar as employment and price indicators reached their targets. The slow adjustment of wages has reduced that probability somewhat, due to its effect on inflation; but unemployment and job creation have improved, supporting strong personal consumption in recent months, especially of durable goods. This component was the main driver of growth in the third quarter, which recorded an annualized quarterly rate of 3.9% (4.6% in the second quarter).

Monetary policy has generally been loosened in the rest of the developed world, with a few exceptions such as the United Kingdom. This reflects the continued poor performance of these economies, which has intensified the downward pressure on inflation. The Eurozone grew at a quarterly rate of 0.2% in the third quarter (0.1% in the second quarter), which illustrates the region's fragility. The performance of Germany, the main economy, was disappointing, which again underscores the weakening of investment, consistent with the decline in business expectations since the start of the year. This trend is partly influenced by the threat of ripple consequences of the neighboring geopolitical conflict. Given the strong business links between Germany and Russia, the complicated scenario in the latter country raises a note of caution, mainly due to the possible

FIGURE I.1
MPR expectations in developed economies (1) (2)
(percent)

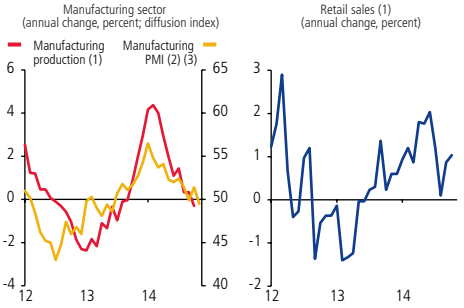


(1) The vertical dashed line indicates the cutoff of the September *Monetary Policy Report*.

(2) The dashed lines indicate the MPR forecast by the Central Bank of Chile based on interest rate futures.

Source: Bloomberg.

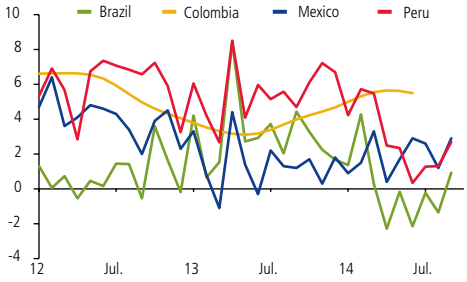
FIGURE I.2
Economic indicators for Germany



(1) Quarterly moving average.
(2) A value over (under) 50 indicates optimism (pessimism).
(3) Seasonally adjusted series.

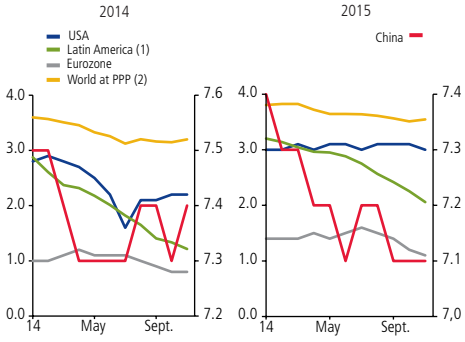
Source: Bloomberg.

FIGURE I.3
Output indicators for Latin America
(annual change, percent)



Sources: Bloomberg and CEIC.

FIGURE I.4
Growth forecasts
(annual change, percent)



(1) PPP growth; weights of each economy per WEO (IMF).

(2) Based on a sample of countries that represents, on average, 86% of the world economy. For the rest of the world, average growth is estimated at 3.5% for the period 2013–2016, per estimates for the December 2014 *Monetary Policy Report*.

Source: Consensus Forecasts.

effects on investment. This is especially true for the industrial sector, where production has lost momentum over the course of the year. Nevertheless, consumption picked up in the third quarter, in line with the favorable labor market indicators (figure I.2).

Spain and France posted the greatest improvement in the region in the third quarter—the latter after contracting in the second. While Spain's performance has been improving for several months now, unemployment remains well above the Eurozone's average that remains stubbornly at historical highs of nearly 12%, and the public debt is high. Thus, the country's situation is still complex.

In response to these trends, the European Central Bank (ECB) surprised the markets in September by cutting its benchmark rate to a historical low of 0.05%. It also implemented a series of unconventional measures to stimulate credit, including a new scheme to buy collateralized bonds and asset-backed securities. The program's effectiveness in expanding the ECB's balance sheet will determine the possible purchase of sovereign bonds. At the same time, the first long-term refinancing operations for banks were carried out in September and December.

In Japan, the main action taken was an unexpected increase in the annual growth rate target for the monetary base, which, together with other provisions, would expand the balance sheet of the Bank of Japan to nearly 80% of GDP. In the last few weeks, the monetary authority did not rule out the possibility of new stimulus measures, insofar as the risk of deflation remained. This reflects the continuing deterioration of the economy, which contracted again in the third quarter (–1.9% annualized quarterly; –6.7% in the second). The biggest negative contribution came from investment, while private consumption continues to show more persistent effects than expected from the tax increase in April—the fragile outlook even led the government to postpone the second part of the VAT increase. Apart from commerce, the adjustment has had an impact on sectors such as manufacturing, where production has slowed in the face of weaker consumption forecasts. Data for the fourth quarter, such as the decline in consumer expectations and the relative stagnation of manufacturers, do not bode well for a quick recovery.

The emerging economies, in general, have maintained a more moderate growth rate. The sharpest downturn has been in Latin America, in part because of its role as a net commodity exporter and the resulting effects of the drop in commodity prices. The poor performance of gross capital formation is a common factor throughout much of the region. Brazil, the largest economy, decelerated sharply in the past year, contracting in annual terms in the third quarter (–0.2%; –0.9% in the second). In the same period, private consumption lost dynamism—as in the rest of the bloc—after having been the main driver of growth. In October, manufacturing production continued to contract in annual terms. In Peru, the economic slowdown has been more persistent than expected, with annual growth of less than 2% in the second and third quarters (5.1% in the first quarter). The decline was particularly steep in the external sector, where valued shipments fell 10.5% in annual terms in the third quarter (–8.8% in the second) (figure I.3).

At the same time, both Peru and Brazil increased public spending in the third quarter. In Peru, policy makers have even announced new reforms to return the economy to the higher growth path of the start of the year. In Brazil, the increase in spending should be transitory, given that one of the main goals of the new authorities is to reduce the fiscal deficit.

Mexico and Colombia show more encouraging indicators, but the fall in the oil price has heightened the risks to their future performance. Given the importance of oil in Colombia, investment is expected to suffer in the coming months. In Mexico, the main effects are expected to be felt in the fiscal area, due to the large share of oil income in the public finances.

China continued to slow gradually in the third quarter, although more recent data points to greater risks to performance. In the third quarter, the annual growth rate was 7.3% (7.5% in the second), largely supported by the improvement in external demand. However, domestic spending was less dynamic, and the real estate sector continued to struggle. In addition, the manufacturing and retail sectors grew at lower rates than in the first half, and different expectations did not point to an improvement in the coming months.

In this context, world growth forecasts are somewhat lower than in the last *Report*. Growth is still expected to recover over the next two years, led by the United States. In contrast, a slower recovery is expected in the Eurozone, with a focus on Germany. The main cutback is in Latin America. This largely explains the downward revision of the forecast for Chile's trading partners to 3.5% in 2015 and 3.9% in 2016 (versus 3.8 and 3.9% in September) (figure I.4 and table I.1).

The dollar has continued to strengthen as a result of the disparity between the performance of the United States and the rest of the world. Since the cutoff date of the last *Report*, the U.S. currency has appreciated around 8% against a basket of currencies (figure I.5). Other international financial conditions are generally favorable, although there is still a risk of high-volatility episodes, as occurred briefly in October (figure I.6). Long-term interest rates have mostly fallen or remained low in the past three months. Spreads are tight by historical standards, and capital inflows to emerging economies remain fairly dynamic.

Inflation has been low in the developed world, while emerging countries show diverse figures (figure I.7). The inflation level has been modest in Asia, but higher in Latin America and part of Europe. In Latin America, most inflation-targeting countries have watched inflation rise above the upper end of the target range. In general, the monetary policy response has also varied among the emerging economies. In Latin America, in particular, there have been few monetary policy movements, and they have been downward more often than not. In contrast, Brazil raised its rate: despite the abrupt slowdown, the economy shows signs of capacity restrictions that make it difficult to provide a monetary stimulus without creating pressure on prices. In Europe, Russia also increased its rate, to avoid a sharper depreciation of the ruble and to contain inflationary pressures. Even after the authorities let the currency float in early November, they continued to use interventions to support it.

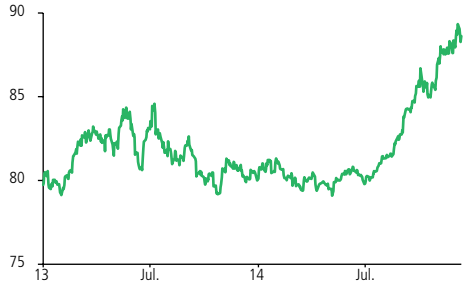
TABLE I.1
World growth (*)
(annual change, percent)

	Avg. 90-99	Avg. 00-07	2012	2013 (e)	2014 (f)	2015 (f)	2016 (f)
World at PPP	3.1	4.2	3.0	3.1	3.2	3.5	3.9
World at market FX rate	2.7	3.3	2.5	2.4	2.6	3.0	3.3
Trading partners	3.1	3.6	3.4	3.5	3.2	3.5	3.9
United States	3.2	2.7	2.3	2.2	2.3	3.0	3.1
Eurozone	1.6	2.2	-0.7	-0.4	0.8	1.0	1.5
Japan	1.5	1.7	1.7	1.6	0.3	1.3	1.4
China	10.0	10.5	7.7	7.7	7.4	7.1	6.9
India	5.8	7.1	4.7	5.0	5.6	6.3	6.5
Rest of Asia	5.6	5.1	3.8	3.9	3.6	4.3	4.8
Latin America (excl. Chile)	2.8	3.5	2.7	2.3	1.1	1.9	3.0
Commodity exporters	2.7	3.1	2.5	2.2	2.5	2.7	2.6

(e) Estimate.
(f) Forecast.
(*) See glossary for definitions.

Sources: Central Bank of Chile, based on a sample of investment banks, Consensus Forecasts, International Monetary Fund and the statistics offices of respective country.

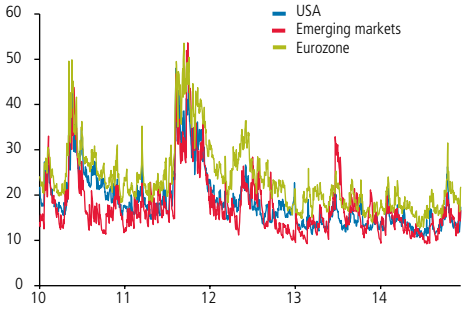
FIGURE I.5
Multilateral dollar (1)(2)
(index)



(1) An increase indicates appreciation of the dollar vis-à-vis the rest of the currencies.
(2) See glossary for definitions.

Source: Bloomberg.

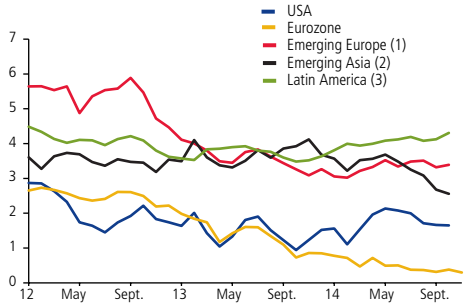
FIGURE I.6
Stock market volatility (*)
(percent)



(*) For the United States, the VIX; for the Eurozone, the VSTOXX; for emerging markets, an estimate of the historical volatility of the MSCI index in dollars

Source: Bloomberg.

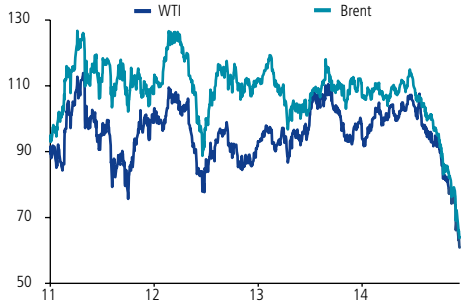
FIGURE I.7
Total inflation
(annual change, percent)



(1) Geometric mean of Czech Rep., Hungary, Russia, Poland and Turkey.
(2) Geometric mean of China, India, Indonesia, South Korea, Malaysia, Taiwan and Thailand.
(3) Geometric mean of Brazil, Colombia, Peru and Mexico.

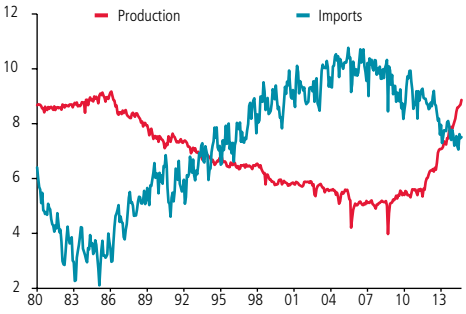
Sources: Bloomberg, CEIC and national statistics offices of respective country.

FIGURE I.8
Oil price
(US$ per barrel)



Source: Bloomberg.

FIGURE I.9
U.S. oil sector
(millions of barrels per day)



Source: Bloomberg.

The inflation scenario has been affected by the drop in oil prices in the past three months. Since September, both the WTI and the Brent price have fallen more than 30%, trading at under US$65 per barrel, on average, as of the cutoff date of this *Report*. This is mainly explained by supply-side factors, although the weaker global demand, especially from China and the Eurozone, has also had an impact (box I.1). World production is being reconfigured on the basis of improved extraction techniques, which has resulted in an oversupply that should keep prices low over the next two years. The United States led this trend: the country's production has grown notably in the past few years, while its crude oil imports have decreased. Based on futures prices, the baseline scenario incorporates a lower oil price forecast than in September (figure I.8 and I.9).

The lower oil price will benefit world growth, although estimates of the size of the impact vary widely. Some of the difference derives from the price level before the drop and from the fact that the impact is different for net oil exporters versus importers. In particular, the fiscal accounts of some oil-exporting countries have deteriorated, and more economies may be affected as the low prices persist over time.

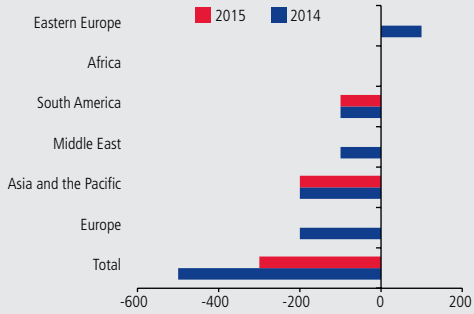
Other commodity prices have also declined, although much less than in the case of oil. In particular, the copper price fell almost 8% since the last *Report*, trading below US$3.00 per pound as of the cutoff date for this *Report*. The main factor behind this trend is China's deceleration, in particular its real estate sector, which is a big copper consumer. The baseline scenario has thus reduced the price forecast for the next two years, to US$2.95 per pound in 2015 and US$2.85 in 2016.

The risks associated with the external scenario could cause episodes of volatility in the international financial markets, with a strong negative impact on the cost of financing and on output. They could also trigger further depreciation of emerging currencies, including the Chilean peso, with effects on the short-term inflation outlook. At the same time, the lower oil price could have a stronger impact on world growth. If the low prices hold or continue to drop, it could accentuate these effects and potentially contribute to a scenario of higher world growth.

BOX I.1
THE FALL IN OIL PRICES: FOUNDATIONS, IMPACT AND OUTLOOK

Between 2011 and mid-2014, the average oil price fluctuated around US$100 per barrel (both WTI and Brent). Starting in July of this year, however, oil prices fell sharply, trading below US$65 on the cutoff date of this *Report*. The drop is mainly explained by supply factors, although lower demand has contributed to a market surplus, which is expected to extend into 2015. Consequently, the different market estimates—collected from futures contracts, investment banks and specialized international and government agencies—have revised the price outlook for the next two years. This box reviews the trends underlying these forecasts and identifies the potential effects of crude oil price movements on the macroeconomic scenario.

FIGURE I.10
Revision of the oil demand forecast (*)
(thousands of barrels per day)



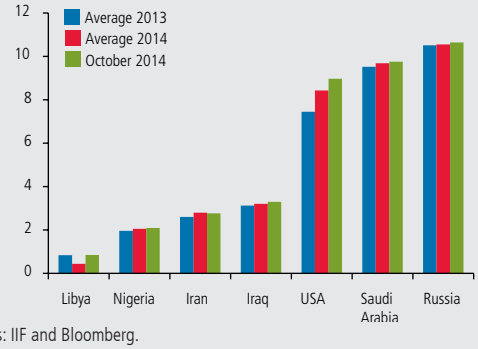
(*) The difference between forecasts in June and November 2014.
Source: International Energy Agency.

Over the past few years, world oil production grew at a similar rate to expected demand, which upheld the price. Since mid-2014, however, an increase in supply has coincided with lower demand.

On the demand side, several agencies lowered their projections over the course of the year. Investment banks[1]/, the International Energy Agency (IEA), the U.S. Energy Information Agency and OPEC have all lowered their estimates of world consumption for 2014 and 2015, to below the level of global production. The adjustments were particularly significant for Europe and Asia, which account for a large share of world consumption (figure I.10).

On the supply side, while crude oil production has grown at a steady pace in the past few years, the United States has picked up its production since 2012. The rest of the suppliers—in particular the OPEC countries, which represent 39% of the world oil supply—have maintained stable production levels (figure I.11).

FIGURE I.11
Main oil-producing countries
(millions of barrels per day)



Sources: IIF and Bloomberg.

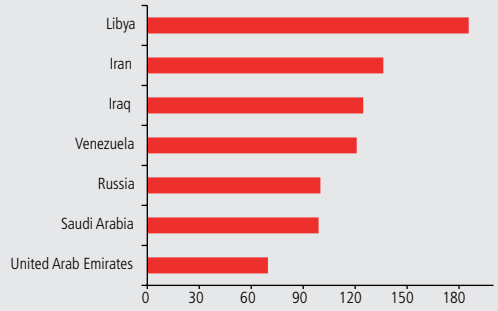
The increase in U.S. production reflects the investments made and the new technologies applied when crude oil was trading around US$100 per barrel, which lasted for several years. As a result, the scenario has slowly changed in terms of the key market participants. The U.S. share of world production has expanded from 6% in 2010 to 9% in 2014, which is on par with other large producers such as Russia and Saudi Arabia. Moreover, the U.S. economy has reduced its dependence on foreign markets, in particular imports from the OPEC countries, and that trend has intensified since mid-2014. In this context, Saudi Arabia and Iraq reduced their export prices to the United States so as not to lose market share, and at the November meeting, OPEC did not lower its members' production quotas.

[1]/ Including Goldman Sachs, Deutsche Bank, Barclays, JP Morgan and Morgan Stanley.

All of this has translated into a substantial drop in spot and future oil prices in the past few months, and market expectations have followed the same trend. In mid-2014, different sources of market information estimated the value of crude oil at around US$100 per barrel for 2015 and slightly lower for 2016. Starting in July, these forecasts were revised downward, with cuts of up to US$30 per barrel. These projections are subject to a high degree of uncertainty, and some analysts believe the price per barrel could continue to fall, possibly hitting as low as US$40 some time soon. Based on average futures contracts in the last five business days prior to the cutoff for this *Report*, the baseline scenario used in this *Report* assumes that the price per barrel will average around US$67 in 2015 and US$71 in 2016.

Other analysts doubt that the current low prices are sustainable over time. First, the oil-exporting countries have suffered a loss in fiscal income. Several are now running a fiscal deficit, including some important producers such as Russia and Venezuela (figure I.12). Second, at these prices, planned investments may be postponed, both in OPEC members and in other countries, which could lead to a downward revision in supply projections in the medium term. Saudi Arabia could offset this trend, but only for so long. Finally, the geopolitical tensions in the Middle East add an element of uncertainty.

FIGURE I.12
Fiscal breakeven oil price
(US$ per barrel)



Sources: IIF and Bloomberg.

In the medium term, the price forecast remains around US$85 per barrel. Market estimates, including those from the U.S. Energy Information Agency and investment banks, assume a gradual recovery of world demand in late 2015, which should contribute to clear the market in 2016. U.S. production will continue to explain a large share of the growth in the crude oil supply in this period, but that trend is expected to start declining in 2017. This will be offset by an increase in the growth share of the OPEC countries, due to their large reserves (80% of the world's crude oil). Saudi Arabia, in particular, has the greatest capacity to increase production levels.

The lower oil price has important implications for the outlook for output and inflation. In particular, a drop in the oil price reduces costs for households and businesses, which increases their disposable income and stimulates output and demand for the bulk of the world economy, which is a net oil importer.

There is a wide range of estimates on the impact of lower oil prices on world economic activity. For example, Goldman Sachs calculates that a permanent drop in the oil price of 20% would increase world growth by 0.5 percentage points (pp) in the first year. The IIF (2014) and JP Morgan (2014b) estimate that a 25% reduction in the price of crude oil would increase world growth by 0.4 pp. An important factor to take into account is that the effects are not comparable across economies, but rather depend strongly on whether the country is a net importer or exporter of oil. The IMF (2014c) estimates that a 30% reduction in the oil price would increase growth in the developed economies by 0.8 pp.

II. FINANCIAL MARKETS

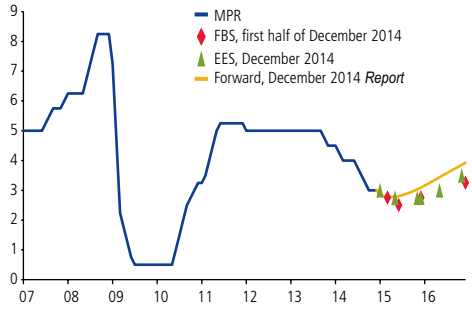
This chapter reviews the evolution of local financial markets in connection with the transmission of monetary policy.

MONETARY POLICY

The macroeconomic scenario continues to be characterized by less dynamic output and domestic demand, together with higher inflation than projected. Inflation expectations remain around the target in the policy horizon. Internationally, the growth performance of the United States has diverged from the rest of the world's, and the oil price has fallen sharply. World growth forecasts continue to be expansionary, with higher rates projected for 2015 and 2016 than 2014. In this context, the Board reduced the monetary policy rate (MPR) at its September and October meetings, gradually to 3%. With these cuts, the MPR has undergone a total reduction of 200 basis points (bp) since October 2013. At the time of the announcements, the Board indicated that any future changes in the MPR would depend on internal and external macroeconomic conditions and their implications for the inflation outlook. Thus, the MPR was held at 3% in November and December.

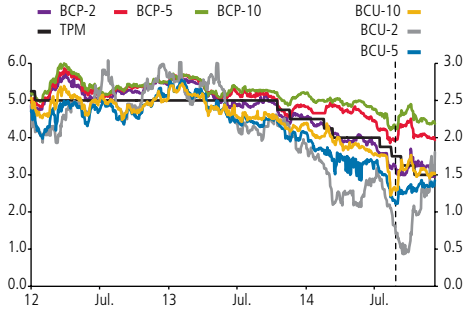
Market expectations for the MPR aligned with the end of downward rate cycle announced in October, although in the most recent period they have incorporated the possibility of additional cuts over the course of 2015 (figure II.1). Since the cutoff date of the last *Monetary Policy Report*, the expectations derived from financial asset prices have been revised slightly downward in the short term. Expectations captured in the different surveys place the MPR at somewhat lower levels in one and two years (table II.1). Thus, considering the different measures of expectations, the MPR one year ahead would be between 2.75 and 3.1% (2.9 and 3.1% in the September *Report*) and two years ahead between 3.25 and 3.9% (3.3 and 3.9% in the September *Report*). In the baseline scenario for this *Report*, the working assumption is that the MPR will be stable in the short term.

FIGURE II.1
MPR and expectations
(percent)



Source: Central Bank of Chile

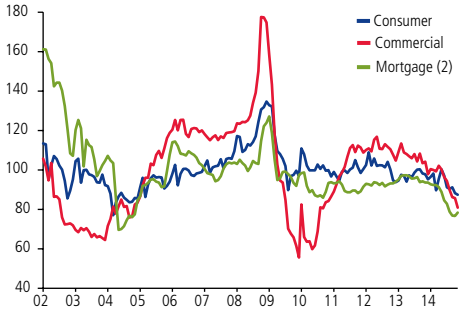
FIGURE II.2
MPR and interest rates on Central Bank of Chile bonds (*)
(percent)



(*) The vertical dashed line indicates the cutoff of the September 2014 *Report*.

Source: Central Bank of Chile.

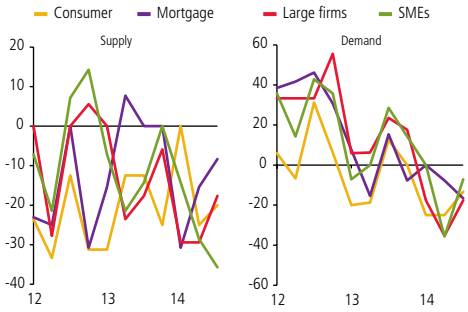
FIGURE II.3
Lending rates (1)
(fixed-base index, 2002–2014=100)



(1) Weighted average rates of all operations in the month.
(2) Mortgage interest rates are in UF.

Source: Central Bank of Chile, based on data from SBIF.

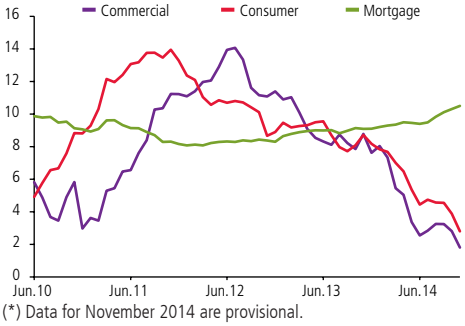
FIGURE II.4
Bank Lending Survey (*)
(average response, percent)



(*) Average response by quarter. Negative (positive) values indicate tighter (looser) conditions than in the immediately prior quarter.

Source: Central Bank of Chile.

FIGURE II.5
Growth of bank loans (*)
(real annual change, percent)



(*) Data for November 2014 are provisional.

Source: Central Bank of Chile, based on data from SBIF.

TABLE II.1
MPR expectations
(percent)

	One year ahead		Two years ahead	
	September *Report*	December *Report*	September *Report*	December *Report*
EES (1)	3.00	2.75	3.75	3.50
FBS (2)	3.00	2.75	3.50	3.25
Forward curve (3)	3.12	3.10	3.93	3.92
Swap contracts (4)	2.90	2.82	3.31	3.36

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

In the fixed-income and money markets, the more expansionary monetary policy continues to be reflected in historically low interest rates, albeit with some fluctuations. In the money market, most of the rates and spreads have not changed substantially since the last *Report*. The spread between prime deposit rates and swap contracts at different maturities have risen between 30 and 50 bp, but they remain low from a historical perspective. According to the analysis in our *Financial Stability Report* for the second half of 2014, one of the factors that could be behind this increase is the trend among the pension funds and mutual funds to pull out of time deposits, in order to increase their investments abroad.

The interest rates on Central Bank and General Treasury instruments have changed little since the cutoff of the last *Report*, again with some fluctuations. The exception is short-term inflation-indexed notes (BCUs), which have risen markedly. Nominal interest rates (BCPs) on maturities between two and ten years are between 3.0 and 4.4% (3.2 and 4.3% in the last *Report*). As mentioned, the interest rates on two-year BCUs have risen: they are currently 76 bp higher than at the cutoff of the last *Report*, which reflects the reduction in short-term inflation expectations (figure II.2). The reduction in long-term interest rates since mid-2013 is largely explained by the lower expectations for future rates. The decrease in term spreads is even more significant when the rate reductions between late 2011 and mid-2013 are taken into account (box II.1).

FINANCIAL CONDITIONS

Local funding costs continue to reflect the impact of the monetary stimulus. The interest rates charged by banks have fallen, on average. Relative to the cutoff of the last *Report*, the interest rates on consumer loans fell 102 bp—and almost 290 bp since October 2013, when the Board began to lower the MPR. The interest rates on commercial loans fell 116 and 192 bp, respectively, in the same periods, while mortgage rates dropped by 21 and 74 bp. In addition, the average interest rate is at its minimum of several years: mortgage and consumer loans are recording the lowest rates of the last ten years, and commercial loans

the lowest of the last four years (figure II.3).

Access to financing has tightened. The Bank Lending Survey (BLS) for September reports tighter conditions than in June for consumer, mortgage and commercial loans. Furthermore, banks perceive that the demand for these types of loans has weakened (figure II.4). In the *November Business Perceptions Report,* the majority of the interviewees mentioned that while banks are charging lower interest rates, they have increased the requirements imposed for access to credit. This view is shared by the banks consulted.

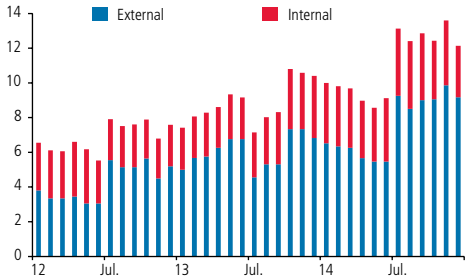
According to preliminary data for November, the real annual growth rate of consumer and commercial loans has continued to decline since the last *Report*. This coincides with the weak growth of the economy and the more pessimistic consumer and business expectations. The real annual growth rate of mortgage loans remains dynamic (figure II.5).

With regard to the other funding sources for firms, placements on the local bond market have been stable in the past few months. However, as described in the *Financial Stability Report* for the second half of 2014, from a longer-term perspective, the amounts have been high and the conditions, favorable. Thus, business funding costs continue to be low.

Bond placements by nonfinancial corporations in external markets are still high (figure II.6), apparently because funding conditions remain favorable in historical terms. Despite the fluctuations recorded in October of this year, U.S. long-term rates were low as of the cutoff date for this *Report*. Chile's sovereign spreads at five and ten years, measured through credit default swaps (CDS), are low from a historical perspective, as are emerging economy spreads. Most recently, however, Latin American spreads have risen, driven by increases for some economies in particular (figure II.7). The spreads for Chilean corporations that seek financing abroad have been relatively stable, although the possibility of new outbreaks of volatility cannot be ruled out.

The world stock exchanges have fallen since the cutoff of the September *Report*, especially in emerging Europe and Latin America. Initially, the exchanges deteriorated in all the different economic blocs, mainly due to the decline in world growth expectations. After this episode of high volatility, the situation normalized. The developed exchanges have, on average, performed better than the emerging markets. This was mainly due to the higher returns of the U.S. stock exchanges, driven by higher growth expectations. As a whole, the stock exchanges in the developed economies, measured by the MSCI, rose 2.8% in local currency between the last ten business days prior to the cutoff of this and the last *Reports*, while emerging markets fell 3.6% in local currency. In the same period, the Chilean exchange, measured by the IPSA, declined slightly (–0.6%). The performance of the local exchange stands out considering that, on average, the Latin American exchanges fell 10.6% in local currency. The drop is even greater measured in dollars, given the currency depreciation in emerging economies (figure II.8).

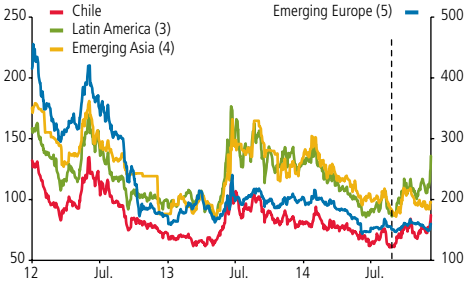
FIGURE II.6
Bond placements by nonfinancial corporations (*)
(US$ billion accrued in 12 months)



(*) The figure for December 2014 includes data through the 11th.

Source: Central Bank of Chile, based on data from Bloomberg and Santiago Stock Exchange.

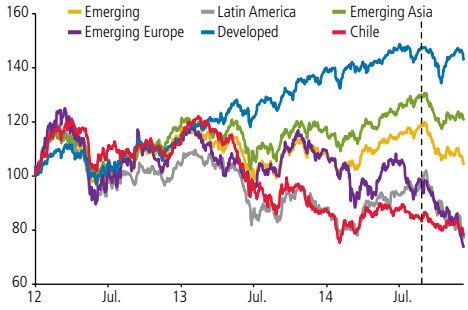
FIGURE II.7
Emerging economy spreads (1) (2)
(basis points)



(1) Measured as the five-year CDS spreads. Simple average of the countries in each region.
(2) The vertical dashed line indicates the cutoff of the September 2014 *Report*.
(3) Includes Brazil, Colombia, Mexico, Panama and Peru.
(4) Includes China, Indonesia, Philippines, Malaysia and Thailand.
(5) Includes Bulgaria, Croatia, Czech Rep., Hungary and Turkey.

Source: Bloomberg.

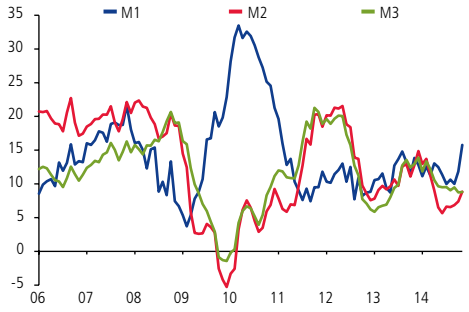
FIGURE II.8
Stock markets (1) (2)
(fixed-base index, 03.Jan.12=100)



(1) The vertical dotted line indicates the cutoff of the September 2014 *Report*.
(2) Morgan Stanley Capital International (MSCT) regional stock indices measured in dollars.

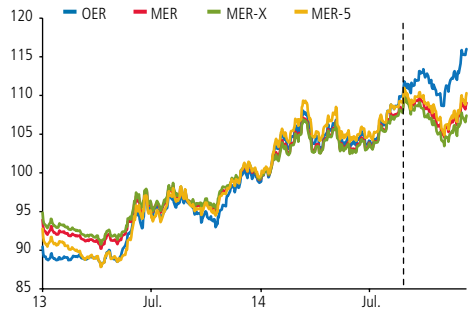
Source: Bloomberg.

FIGURE II.9
Monetary aggregates
(annual change, percent)



Source: Central Bank of Chile.

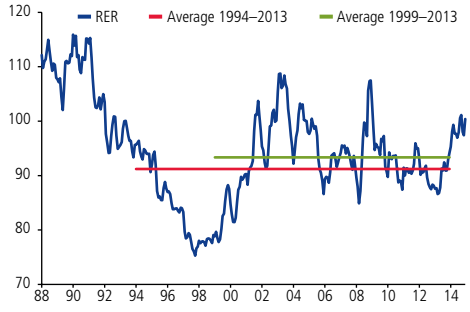
FIGURE II.10
Nominal exchange rate (1) (2)
(fixed-base index, 02.Jan.13–11.Dec.14=100)



(1) See glossary for definitions.
(2) The vertical dashed line indicates the cutoff of the September 2014 *Report*.

Source: Central Bank of Chile.

FIGURE II.11
Real exchange rate (*)
(fixed-base index, 1986=100)



(*) The figure for December 2014 includes data through the 11th.

Source: Central Bank of Chile.

With regard to the monetary aggregates, the available data for November indicate that M1 (primarily unremunerated bank liabilities) recorded a nominal annual growth rate of 15.8% (10.6% in August). This coincided with an expansion in the annual rate on time deposits and savings. In contrast to the first half of the year, M2 also recorded an increase in its nominal annual growth rate of 8.8% (6.6% in August). Finally, the nominal annual growth rate of M3 was relatively stable (figure II.9).

EXCHANGE RATE

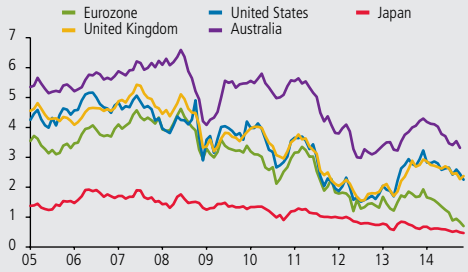
The peso-dollar exchange rate has fluctuated sharply over the past few months, ending the period with a depreciation of 4.8% relative to the last *Report* (figure II.10). This was due to the gains of the U.S. dollar at the international level, the changes in monetary policy and the drop in the copper price. Thus, after the publication of the last *Report*, the peso continued to depreciate strongly in September, reaching $602 to the dollar. The trend reversed in October, when the exchange rate dropped to a minimum of $577 to the dollar, but this was followed by a new depreciation trend. As of the cutoff date for this *Report*, the currency was trading at around $615 to the dollar. The increased volatility is due, in part, to external factors. In multilateral terms, the peso has been relatively stable, albeit with fluctuations. If the U.S. dollar is excluded, the Chilean currency appreciated 0.9%.

The real exchange rate (RER) fell 1.2% relative to the last *Report*. Taking into account the nominal exchange rate and the parities in the ten business days prior to the cutoff for this *Report*, the RER was 99.6, where 1986=100 (figure II.11). In the baseline scenario used in this *Report*, the methodological assumption is that the RER will stay around its current level, insofar as it stays in the center of the range deemed consistent with its long-run fundamentals.

BOX II.1
LONG-TERM INTEREST RATES

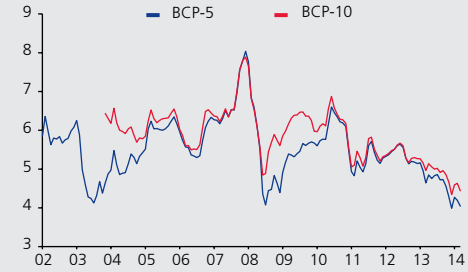
In recent years, several countries have recorded a downward trend in long-term interest rates (figure II.12), although this trend has been less common among the emerging economies. In Chile, the interest rates on long-term bonds have hit historically low levels (figure II.13). This reduction has occurred gradually since late 2011, but it intensified after mid-2013. This box explores the reasons behind the evolution of Chilean long rates and how they would be affected by an increase in the U.S. Federal Funds rate.

FIGURE II.12
Interest rates on ten-year government bonds
(percent)



Source: Central Bank of Chile.

FIGURE II.13
Interest rates on Central Bank of Chile bonds
(percent)



Source: Central Bank of Chile.

Generally speaking, there are two factors that help explain the level of long-term interest rates. One is the average future short-term rate expected by the market, which is mainly determined by the medium-term expectations for the monetary policy rate (MPR). The second is the term spread, which represents the spread that a risk-averse investor demands to invest in instruments with a longer duration, given that the price of a longer-term bond is more sensitive to changes in the discount rate than a short-term bond. Separating these two factors is a complex task, which has been addressed with different methodologies, yielding results that are sensitive to the methodology used.

This box applies the methodology described in Adrian et al. (2013)[1]/,to a Chilean ten-year zero-coupon bond[2]/. In November 2014, the rate on this bond was close to 140 basis points (bp) lower than the average for the period 2005–2007 (figure II.14). The results of the exercise show that the drop is explained, in relatively equal parts, by lower expectations on future rates and a reduction in the term spread.

However, the rate reduction can be subdivided into two distinct periods. In the first, from late 2011 to mid-2013, the drop was mainly due to a lower term spread—just over 70 bp of an 85 bp rate reduction. In the second period, from July 2013 to November 2014, the decrease is mostly related to the lower future rate expectations: nearly 60 bp of a 70 bp rate reduction. This coincided with the cycle of MPR cuts first announced by the Board in mid-2013 and carried out between October 2013 and October 2014.

FIGURE II.14
Chile-10: Spreads and neutral interest rate
(percent)

Source: Ceballos (2014).

The risk scenario considered in this *Report* includes the possible effect of an increase in the U.S. Federal Funds rate on long-term rates and, in particular, on Chilean long rates. It is therefore pertinent to analyze the correlation.

[1]/ For details, see Ceballos (2014). In Ceballos et al. (2014), the authors repeat the exercise using the methodology described in Bauer et al. (2014), with similar results.
[2]/ This rate differs from the BCP-10, which has a shorter duration.

First, the Chilean monetary policy framework, with a flexible exchange rate, supports a monetary policy conduct that is largely independent of the rate movements in other economies. This is reflected in both the low correlation between the Federal Funds rate and the MPR and the greater volatility of the peso relative to other currencies.

Nevertheless, an independent monetary policy does not imply that the MPR and the Federal Funds rate follow completely separate paths. In a more integrated world, the economies can be affected by the same shocks and implement common monetary policy responses. One example is the global financial crisis of 2008–2009, when both the MPR and the Federal Funds rate were cut to historically low levels. However, as the situation of the two countries evolved separately, with a faster recovery in the Chilean economy, the expansiveness of the monetary policies diverged. Thus, independence suggests that, controlling for common shocks, Chilean monetary policy responds more to domestic macroeconomic conditions than to the decisions of other central banks. In this sense, a change in expectations for the U.S. future rate will not necessarily affect long-term rates in Chile.

At the same time, it is also important to review the degree of correlation with term spreads. As mentioned, this was a key factor in the rate reduction in Chile when the current level is compared with a few years back. The same occurred in the United States (figure II.15). There is much debate on the factors that explain the lower term spreads. Among the strongest explanations, the literature highlights the reduction in uncertainty about future output and inflation[3]/ and the unconventional monetary policy measures implemented by the U.S. Federal Reserve and the Bank of England, among others[4]/.

In small open economies like Chile, it is possible that changes in global liquidity could affect the path of term spreads. However, the correlation between the local spread and the U.S. spread is unstable. It was high at the start of the global financial crisis of 2008–2009, but it declined in 2013, when the Federal Reserve began to announce the withdrawal of quantitative easing. At that time, in May 2013, the long-term rates of the United States and other developed and emerging economies increased, while Chile's long rates fell.

Nevertheless, the possibility of a steep hike in U.S. long rates continues to represent an important risk for Chile. Several market analysts have suggested that the large capital inflows into U.S. fixed-rate instruments present risks in the medium term, to the extent that a rise in the Federal Funds rate could trigger a reversal, if agents try to anticipate the drop in long-term bond prices[5]/. If this drains global liquidity, it could have a significant impact on interest rates in other countries, including Chile, through larger spreads.

Consistent with global market expectations, the baseline scenario in this *Report* expects the Federal Reserve to increase its rate in 2015, in order to bring it up to more normal levels over the next few years. In principle, this evolution should not have a strong impact on the MPR—given the independence of the MPR in Chile, consistent with a floating exchange rate regime—provided there are no common shocks affecting both countries.

FIGURE II.15
Term spreads for Chile and the United States
(percent)

Source: Ceballos (2014).

However, Chilean long rates could be affected if the rate normalization process in the United States is associated with a decompression of the term spread. Given that this relation has been unstable over time, it is difficult to estimate the effect precisely. Thus, the Central Bank will continue to monitor the development of this and other scenarios, so as to achieve its objective of price stability.

[3]/ Bernanke (2013).
[4]/ Gagnon et al. (2011); D'Amico et al. (2012); Krishnamurthy and Vissing-Jorgensen (2011).

[5]/ Feroli et al. (2014); IMF (2014).

III. OUTPUT AND DEMAND

This chapter reviews the recent evolution of demand and economic activity and their short-term outlook, in order to examine possible inflationary pressures.

OUTPUT AND DEMAND

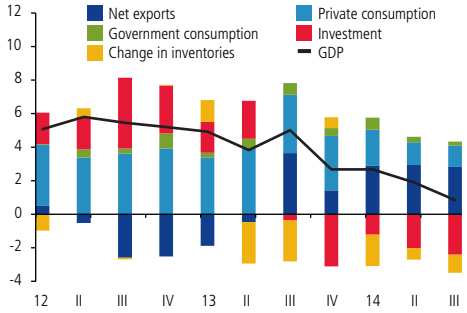
In the third quarter, output and domestic demand continued to post a weak performance. In that period, total GDP increased 0.8%, while domestic spending contracted 1.9%, both relative to the third quarter of the previous year. Consumption and investment continued to lose ground, the former with marginal growth and the latter with an intensification of the contraction underway for several quarters (figure III.1 and table III.1). Consequently, most economic sectors recorded a poor performance (table III.2).

The growth of total consumption continued to decline in the third quarter: 1.9% in annual terms in the period (versus 2.2% in the second quarter) (figure III.2). Private consumption followed a similar trend, growing 2.0% in annual terms in the third quarter (2.1% in the second). The weak private consumption was mainly concentrated in the durable goods component, which posted a negative annual growth rate of –2.6% in the third quarter (–0.5% in the second). Nondurable goods increased slightly, to an annual growth rate of 1.6% (1.5% in the second). Services continued to record the highest growth rate of this part of spending, despite falling a percentage point to 3.1% in the third quarter. In the case of government consumption, the annual growth rate dropped from 2.5 to 1.8% between the second and third quarters of this year.

The decline in investment deepened in the third quarter (figure III.3). The annual growth rate continued to fall, reaching –9.9% (–8.4% in the previous quarter). This weak performance is mainly centered on the machinery and equipment component, which was the driver of the downward trend, falling 24.6% in annual terms in the third quarter (–21.5% in the second). Construction and engineering works contracted 0.7% in annual terms in the same period, the same as in the previous quarter.

The lower domestic spending and the peso depreciation contributed to a steep reduction in the current account deficit: in the third quarter, the current account balance fell to –1.9% of GDP in the last moving year, versus –3.5% of GDP one year ago. One factor contributing to this trend was the sharp decline in imports in the past year, which fell from around US$77 billion in September 2013, to US$69 billion in September 2014. Exports declined from about US$78 billion

FIGURE III.1
Quarterly contribution to GDP growth
(real annual change, percent)



Source: Central Bank of Chile.

TABLE III.1
Domestic demand (1)
(share of GDP; real annual change, percent)

	Share	2013				2014		
	2013	I	II	III	IV	I	II	III
Domestic demand	100.3	7.2	4.4	1.3	1.1	-0.2	-1.0	-1.9
Domestic demand (excl. change in inventories)	100.0	6.1	7.1	3.7	0.4	1.8	-0.3	-0.9
Gross fixed capital formation	23.6	8.2	10.2	-1.5	-12.3	-5.1	-8.4	-9.9
Construction and engineering works	15.2	4.8	4.5	4.0	0.0	1.5	-0.7	-0.7
Machinery and equipment	8.4	14.0	20.1	-8.3	-28.5	-18.1	-21.5	-24.6
Total consumption	76.4	5.4	6.1	5.4	4.6	4.1	2.2	1.9
Private consumption	64.0	5.7	6.4	5.4	4.9	3.5	2.1	2.0
Durable goods	6.6	14.5	15.9	12.8	11.3	2.9	-0.5	-2.6
Non-durable goods	26.4	5.1	7.0	5.7	4.7	3.8	1.5	1.6
Services	31.1	4.5	4.2	3.6	3.8	3.4	3.2	3.1
Government consumption	12.4	3.4	4.6	5.6	3.1	8.1	2.5	1.8
Change in inventories (2)	0.3	1.4	0.7	0.2	0.4	-0.2	-0.4	-0.6
Goods and services exports	32.6	1.1	6.4	11.3	-0.9	4.3	0.0	1.0
Goods and services imports	32.9	7.0	8.1	0.5	-5.3	-4.5	-8.9	-7.2
Total GDP	**100.0**	**4.9**	**3.8**	**5.0**	**2.7**	**2.7**	**1.9**	**0.8**

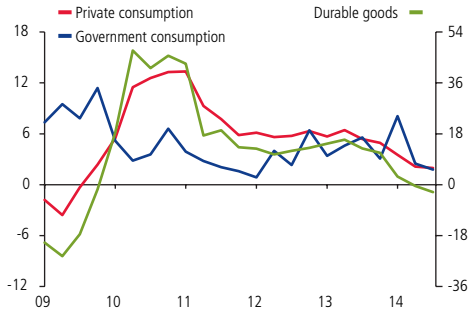
TABLE III.2
Gross domestic product (1)
(share of GDP; real annual change, percent)

	Share	2013				2014		
	2013	I	II	III	IV	I	II	III
Agriculture, livestock and forestry	2.7	6.0	3.2	4.5	3.9	3.3	-6.7	-6.6
Fishing	0.4	-14.7	-12.2	-10.1	-14.2	19.7	35.8	10.7
Mining	11.1	9.8	3.9	9.4	2.1	0.0	3.9	-0.5
Manufacturing	10.5	0.0	-0.4	2.8	-1.3	0.1	-1.6	-2.7
EGW	2.8	4.2	7.5	6.8	10.3	3.4	7.4	8.4
Construction	7.8	4.2	4.4	4.3	0.2	2.4	1.1	-0.5
Trade	8.5	8.9	7.5	8.1	4.6	2.0	-0.4	-0.6
Restaurants and hotels	1.7	3.6	3.3	4.6	0.7	0.2	0.0	0.2
Transport	3.9	4.2	3.1	4.7	1.0	3.6	1.7	1.9
Communications	2.0	6.8	5.3	4.0	3.7	3.4	2.8	2.7
Financial services	4.7	7.7	5.8	5.1	3.6	3.6	2.2	2.0
Business services	14.4	3.0	3.6	3.3	4.0	3.7	2.6	1.1
Housing services	5.1	3.4	3.4	3.4	3.4	3.5	3.5	3.5
Personal services (2)	11.3	4.1	3.3	3.2	3.7	3.7	3.5	4.3
Total GDP	**100.0**	**4.9**	**3.8**	**5.0**	**2.7**	**2.7**	**1.9**	**0.8**
Other GDP (3)	**77.1**	**4.1**	**3.6**	**4.3**	**2.7**	**2.8**	**1.3**	**0.9**
NNRR GDP (3)	**14.4**	**8.1**	**3.9**	**8.4**	**2.9**	**1.2**	**5.7**	**1.4**

(1) Preliminary data.
(2) Includes education, health and other services.
(3) See glossary for definitions.

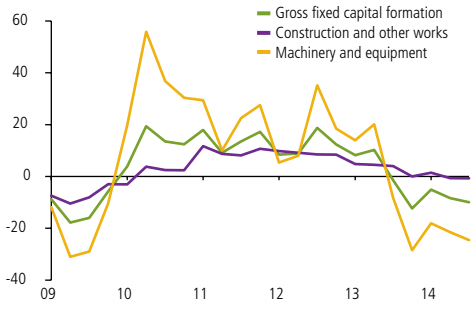
Source: Central Bank of Chile.

FIGURE III.2
Consumption
(annual change, percent)



Source: Central Bank of Chile.

FIGURE III.3
Gross fixed capital formation
(annual change, percent)



Source: Central Bank of Chile.

to US$77 billion in the same period. From the perspective of equality between total savings and investment, the smaller current account deficit coincides with the drop in investment, which has gone hand in hand with the lower external savings, while national savings declined slightly (figure III.4).

The counterpart of weak spending is the deterioration in output growth in most economic sectors. Sectors that are more closely tied to domestic demand (other GDP) recorded a decline in their annual growth rate, to 0.9% (1.3% in the previous quarter). For the second consecutive quarter, manufacturing and retail contracted, this time more sharply than in the second quarter: 2.7 and 0.6%, respectively. Construction also posted a negative annual growth rate in the third quarter, of –0.5% (+1.1% in the second quarter). Business and financial services had a lower growth rate in the third quarter: 1.1 and 2.0%, respectively (2.6 and 2.2% in the second). The agriculture, livestock and forestry sector continued to feel the effects of the climatic problems in late 2013, posting a strong contraction (–6.6% annual in the third quarter). Personal services, transport, and restaurants and hotels saw an increase in their annual growth rate in the third quarter.

The natural resource sectors displays important differences. On aggregate, the annual growth rate of the sector declined to 1.4% in the third quarter (5.7% in the second), but the results were mixed. Fishing and electricity, gas and water (EGW) recorded solid growth: 10.7 and 8.4% annual, respectively. In the case of EGW, this was possible due to the larger share of hydroelectric power in the generation matrix, as it carries a larger value added. In contrast, mining contracted 0.5% in annual terms in the third quarter (+3.9% in the second), mainly due to declining ore quality.

DETERMINANTS OF EXPENDITURE

The evolution of domestic expenditure reflects the uneven behavior of its fundamentals. On one hand, the annual growth of real labor income has declined, the growth of private wage employment has been null for several months, business profits are down relative to previous years, and consumer and business expectations have deteriorated markedly. In addition, the significant change in relative prices has raised the cost of imported goods, which has mainly affected durable goods consumption and investment in machinery and equipment. On the other hand, the cost of financing has decreased, external financial conditions remain favorable, and the 200 bp reduction in the monetary policy rate (MPR) has passed through to interest rates.

With regard to the latter, the interest rates on business and personal loans have continued to decrease since the cutoff for the last *Report*, in line with a more expansionary monetary policy. Thus, in the past year, commercial and consumer rates have fallen a total of 150 and 270 bp, respectively. At the same time, the cost of mortgage loans has fallen significantly and is now close to historically low levels, reflecting the significant reduction in long-term rates. Moreover, as highlighted in the *Financial Stability Report,* the interest rate reduction has had a strong impact on the household financial burden and business interest expense.

Nonetheless, in October of this year, the real growth of commercial and consumer bank loans continued to decline. The annual growth rate of commercial loans was under 2%, while consumer loans grew less than 3%. This was not the case with mortgage loans, which grew at a real annual rate of around 10%. The evolution of commercial and consumer loans is in line with tighter lending conditions and lower demand, as reported by the banks in the Bank Lending Survey (BLS) for the third quarter. According to the survey, the demand for credit has been declining for several quarters, reflecting weak demand and worsening expectations.

In the labor market, the data points to disparate trends. On one hand, the unemployment rate remains low and has even decreased in the most recent period, while the annual growth rate of total employment is somewhat higher than it was a few months ago. On the other, data from the National Statistics Institute (INE) shows that the growth of private wage employment has been null since the second quarter of this year (figure III.5). In addition, the growth of real labor income eased in the third quarter (figure III.6). The growth rate of national employment is at its lowest level of the last four years, and the composition of employment has shifted toward self-employment. The higher inflation has affected the growth of real wages, suggesting an erosion of the purchasing power of families. Consequently private consumption is expected to weaken, which could be aggravated by the deterioration in the employment outlook evident in business and consumer expectations, together with fewer job vacancies (figure III.7). Finally, the continued strong growth of nominal wages could slow the recovery of employment in the reactivation phase.

Another factor behind the performance of spending is the effect of the peso depreciation on imports. The change in the parity caused the price of imported goods to rise nearly 14% in annual terms in the first three quarters of this year, relative to the same period of 2013. This trend was most evident in the price of imported consumer goods, which increased 14.7%, while capital goods rose 13.1% in the same period.

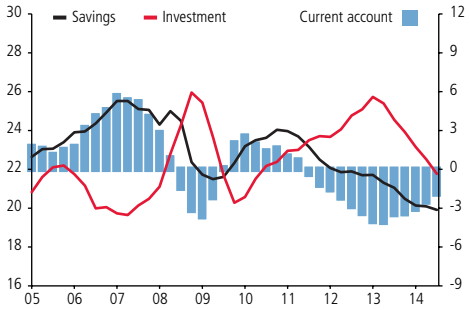
Finally, business expectations (IMCE) and consumer expectations (IPEC) have deteriorated across the board over the course of the year. This shift was accentuated in the third quarter, and both indicators are now strongly pessimistic (figure III.8).

SHORT-TERM OUTLOOK

The Board estimates that, In the baseline scenario, GDP will grow 1.7% in annual terms this year. This figure is somewhat lower than the projection in September. The revision responds to a weaker-than-expected third quarter and partial data for the fourth quarter that gives no indication of a significant recovery of expenditure. Nevertheless, fourth-quarter growth should be higher than the third quarter's, given the low basis of comparison of the fourth quarter of 2013.

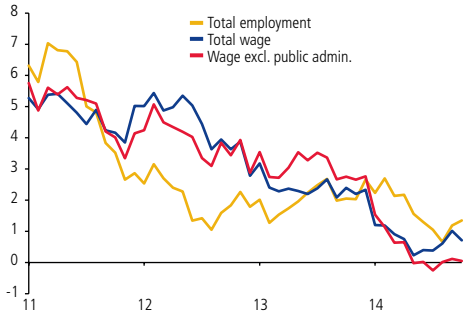
According to the most recent data, in terms of private consumption, the growth of durable goods sales continued to decrease in what is known of the fourth

FIGURE III.4
Current account (*)
(percent of GDP)



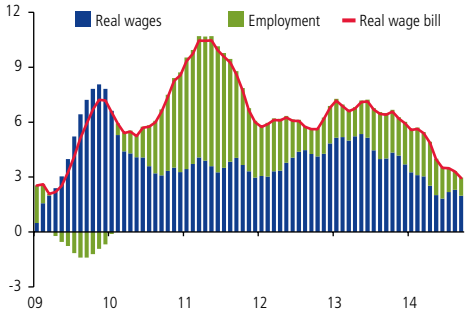
(*) Accrued in a moving year.
Source: Central Bank of Chile.

FIGURE III.5
Employment
(annual change, percent)



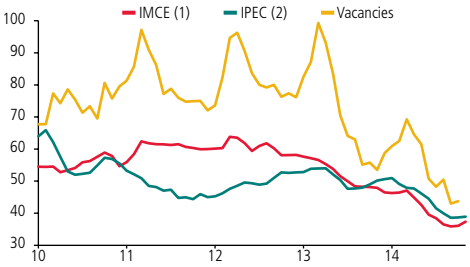
Sources: Central Bank of Chile and National Statistics Institute (INE).

FIGURE III.6
Real labor income (*)
(annual change, percent)



(*) Quarterly moving average.
Sources: Central Bank of Chile and National Statistics Institute (INE).

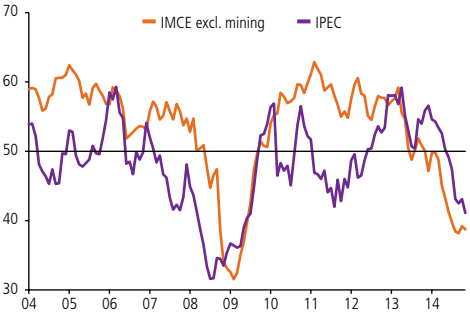
FIGURE III.7
Employment indicators
(index, quarterly moving average)



(1) A value over (under) 50 points indicates an increase (decrease) in employment in 3 months.
(2) A value over (under) 50 points indicates a decrease (increase) in unemployment in 12 months. The IMCE and IPEC include data through November. Vacancies include data through October.

Sources: Adimark GfK, Central Bank of Chile and Icare/Universidad Adolfo Ibáñez.

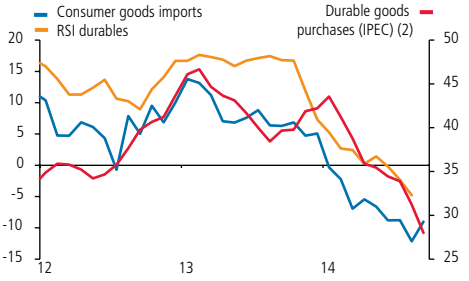
FIGURE III.8
Business and consumer expectations(*)
(original series)



(*) A value over (under) 50 points indicates optimism (pessimism).

Sources: Adimark and Icare/Universidad Adolfo Ibáñez.

FIGURE III.9
Durable goods consumption (1)
(annual change, percent; index)



(1) Quarterly moving average.
(2) Simple average of the percent of affirmative responses to the following questions: Do you think this is a good time or a bad time to buy: (i) a house, (ii) a car, (iii) household goods like furniture, a refrigerator or a range? Imports and the IPEC include data through November. The RSI (retail sales index) includes data through October.

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

quarter. That is the picture painted by INE data on retail sales (IVCM), where the annual growth rate of the durable component was –7.4% in October (0.3% in the second quarter and –2.3% in the third). For imported durable goods, the annual growth rate was –15.9 and –20.7% in the second and third quarters, respectively, which steepened to –24.4% on average in October and November. New car sales (ANAC) followed a similar trend, with an annual growth rate of –4.1% in the third quarter and –24.1% in October–November, on average. This is reflected in consumer expectations on durable goods purchases (figure III.9).

With regard to private investment, most of the recent data does not point to a recovery, at least not in the short term. Capital goods imports continued to post a meager performance, with a contraction in October and November: –17.1% annually on average, after falling 24.6 and 27.3% in the second and third quarters, respectively. Construction activity, measured by the IMACON, has followed a downward trend since the beginning of the year, growing 3.2, 0.7 and –1.9% annual in the first three quarters. In September, construction fell 2.1% in annual terms, more than the average for the corresponding quarter. Also in September, the Capital Goods and Technological Development Corporation (*Corporación de Desarrollo Tecnológico y de Bienes de Capital, CBC*) lowered its estimate of construction investment for this year and next, to below the 2013 levels, mainly in construction projects and mining and engineering works. Business expectations have not improved, diverging from projections. In the real estate market in Greater Santiago (Adimark), the gap between the supply and demand for new houses widened in the third quarter, after narrowing in the 2012–2013 period.

In contrast, the outlook for public investment is more favorable. In recent weeks, the government announced a significant new investment plan for 2015, which, if implemented, will have a strong impact on activity in sectors tied to public works.

In line with the low business and consumer expectations, private expectations for growth have repeatedly been revised downward in recent months. According to the December Economic Expectations Survey (EES), growth in 2014 will be 1.8%. The forecasts for 2015 and 2016 have also been revised downward substantially.

The November *Business Perceptions Report* showed a diversity of perspectives for year-end 2014 and the full-year 2015. On the more negative side, some of the interviewees think their businesses will continue to deteriorate, with no sign of recovery before 2016. On the more positive side, some interviewees expect a small upturn in 2015. The majority project that the scenario will not change significantly in the coming months. This is consistent with perceptions of investment: most of the people surveyed said investment would be low and primarily focused on capital replacement.

IV. PRICES AND COSTS

This chapter analyzes the recent evolution of the main components of inflation and costs, identifying the current sources of inflationary pressure and their likely evolution into the future.

RECENT INFLATION TRENDS

Since the publication of the last *Monetary Policy Report,* CPI inflation has risen substantially, accumulating an increase of 2.2 percentage points (pp) between August and November and reaching 5.5% in annual terms (figure IV.1 and table IV.1). This value is above the target range, and it exceeds both the forecast in the September *Report* and market expectations at that time, which put annual inflation closer to 4% at year-end 2014. Inflation excluding foodstuffs and energy—the CPIEFE—also increased between August and November, to an annual rate of 4.3%.

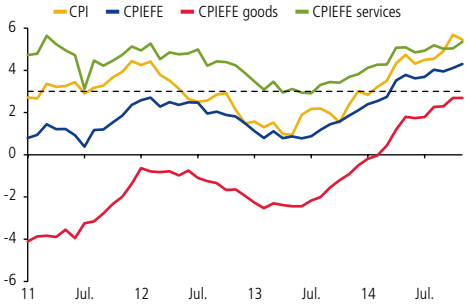
TABLE IV.1
Inflation indicators (1) (2)
(annual change, percent)

	CPI	Food	Energy	CPIEFE	CPIEFE Goods	CPIEFE Services
2012 Average	3.0	7.7	-0.4	2.2	-1.1	4.6
2013 Jan.	1.6	5.3	-2.7	1.1	-2.3	3.5
Feb.	1.3	3.7	0.1	0.8	-2.5	3.1
Mar.	1.5	3.1	1.2	1.1	-2.3	3.5
Apr.	1.0	3.8	-3.5	0.8	-2.4	2.9
May	0.9	4.9	-6.5	0.9	-2.4	3.1
Jun.	1.9	6.3	0.7	0.8	-2.4	2.9
Jul.	2.2	5.7	4.1	0.9	-2.2	2.9
Aug.	2.2	5.1	3.3	1.2	-2.0	3.3
Sept.	2.0	3.2	3.0	1.4	-1.6	3.4
Oct.	1.5	2.8	-1.6	1.6	-1.2	3.4
Nov.	2.4	4.5	1.5	1.8	-0.9	3.7
Dec.	3.0	4.9	5.5	2.1	-0.5	3.8
2014 Jan.	2.8	4.4	3.2	2.4	-0.2	4.1
Feb.	3.2	5.6	3.8	2.5	0.0	4.3
Mar.	3.5	5.7	5.1	2.7	0.4	4.3
Apr.	4.3	6.4	6.6	3.5	1.2	5.1
May	4.7	6.6	8.8	3.8	1.8	5.1
Jun.	4.3	5.7	7.1	3.6	1.7	4.9
Jul.	4.5	6.2	7.4	3.7	1.8	4.9
Aug.	4.5	6.7	4.1	4.0	2.3	5.2
Sept.	4.9	8.3	5.3	3.9	2.3	5.0
Oct.	5.7	10.2	8.8	4.1	2.7	5.0
Nov.	5.5	8.7	7.7	4.3	2.7	5.3

(1) See glossary for definitions.
(2) Starting in January 2014, calculations are based on the new indices with base year 2013=100, so they may not be strictly comparable with earlier figures.

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

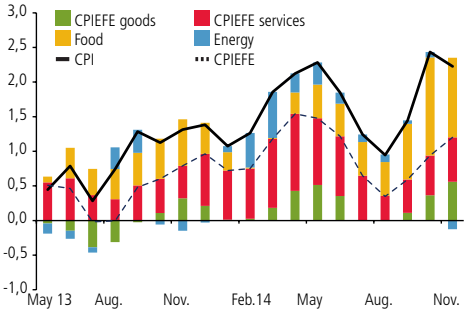
FIGURE IV.1
Inflation indicators (1) (2)
(annual change, percent)



(1) See glossary for definitions.
(2) Starting in January 2014, calculations are based on the new indices with base year 2013=100, so they may not be strictly comparable with earlier figures.

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

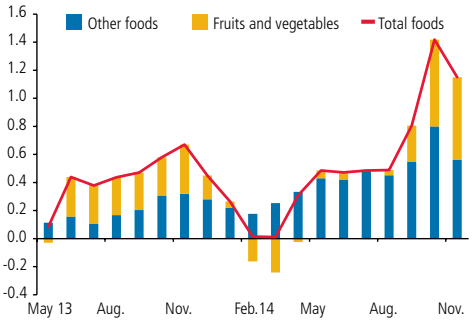
FIGURE IV.2
Contribution to monthly CPI inflation (*)
(accrued in a four-month moving window, percentage points)



(*) Starting in January 2014, calculations are based on the new indices with base year 2013=100, so they may not be strictly comparable with earlier figures.

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

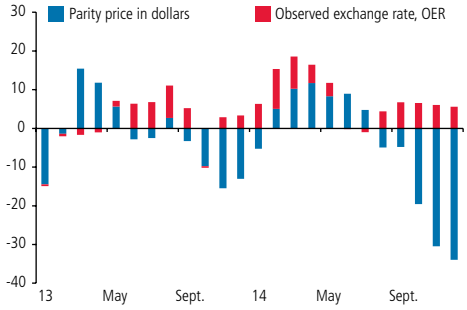
FIGURE IV.3
Contribution of food goods to monthly CPI inflation (*)
(accrued in a four-month moving window, percentage points)



(*) Based on the new indices with base year 2013=100.

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

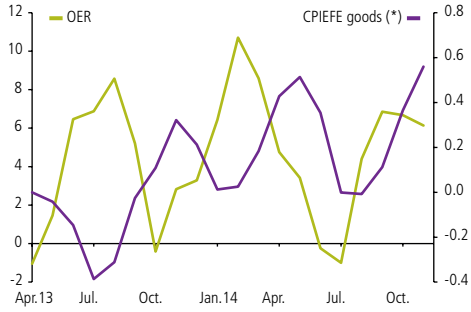
FIGURE IV.4
Change in gas price and exchange rate (1) (2)
(accrued in a four-month moving window, percentage points)



(1) Starting in August 2014, the National Energy Commission publishes the parity price in pesos; since then, the price is converted to dollars using the average OER of the last two weeks prior to the date of publication.
(2) The figure for December includes data through the cutoff for the *Monetary Policy Report.*

Sources: Central Bank of Chile and National Energy Commission.

FIGURE IV.5
CPIEFE goods inflation and exchange rate
(change accrued in a four-month moving window, percent)



(*) The contribution of CPIEFE goods to the CPI, accrued in a four-month period.

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

The higher inflation during these months has been driven, in part, by increases in specific prices, many of which are clearly temporary, especially some foodstuffs. In fact, monthly CPI inflation was null in November, due to both the early reversal of some of these prices and the drop in fuel prices. In the immediate future, this reversal is expected to continue, and fuel prices should continue to make a negative contribution, such that annual CPI inflation is expected to end the year below 5%. Market expectations one year ahead are consistent with the view that the high inflation will continue to recede in the coming months. Moreover, at the forecast horizon, expectations remain around 3%.

From a longer perspective, the high annual CPI inflation mainly reflects the depreciation of the peso (box IV.1). These effects could tend to ease off to the extent that the pass-through of depreciation follows historical patterns. This trend, combined with the higher basis of comparison, the wider output gap and the lower oil price, underlies the forecast of lower inflation in 2015. The Board will continue to carefully analyze the inflation trend and will conduct monetary policy so as to keep projected inflation at 3% within the policy horizon.

Over the last four months, the CPI rose 2.2 pp. Of that, 1.1 pp corresponded to increases in food prices and 1.2 pp to increases in the CPIEFE. Energy prices—fuels and electricity—made a negative contribution of 0.1 pp in the period (figure IV.2).

In the case of foodstuffs, the increase was explained in equal parts by fresh fruit and vegetable prices and other food prices (figure IV.3). With regard to the former, the increase in the price of tomatoes (due to supply problems) contributed 0.3 pp between August and November. The impact was greatest in October, but it began to lessen in November. Avocados and lemons also recorded substantial increases. With regard to other food prices (excluding fresh fruits and vegetables), the increase was again due to the effect of specific components. Meat and meat products increased 0.3 pp between August and November. In this case, the higher exchange rate played a key role, in a context of tighter margins in the sector. In addition, according to the November *Business Perceptions Report,* higher external demand for certain types of meat has redirected shipments to foreign markets, pushing up local prices, especially for pork and processed meats. Another isolated factor that has had a considerable effect is carbonated soft drinks, which contributed an increase of 0.1 pp in the period due to the price increase associated with the entry into effect of the Tax Reform.

The energy component—which includes fuels and electricity—made a negative contribution to inflation in the last four months. This reflects the pass-through to local prices of the fall in international oil prices, which has more than offset the increase in the exchange rate (figure IV.4). In particular, after peaking in June, the price per barrel of crude oil fell more than 40%. As of the cutoff for this *Report*, the average price of both WTI and Brent oil was under US$65 per barrel. The Gulf of Mexico gasoline price has followed

a similar trend. In mid-November, a change to the parameters of Chile's Fuel Price Stabilization Mechanism resulted in a one-time drop of almost $60 per liter of gasoline in the local market. In the weeks that followed, there were additional price drops, albeit of a lower magnitude. Consequently, the contribution of gasoline prices to CPI inflation was –0.2 pp in November. In the coming months, gasoline should continue to make a negative contribution, given that international fuel prices have continued to fall. The cost of residential electricity made almost no contribution to CPI inflation between August and October, but it increased sharply in November due to rate adjustments. Thus, in the full four-month period, electricity contributed a total of 0.1 pp to CPI inflation.

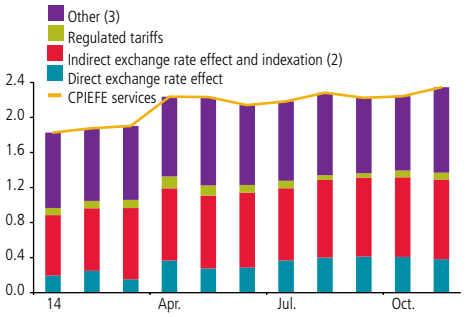
Core inflation—the CPIEFE—contributed 1.2 pp to total CPI inflation between August and November. This increase breaks down fairly equally into goods and services inflation. In both cases, the dominant factor explaining the increase was the exchange rate, although there were also other isolated factors.

With regard to CPIEFE goods inflation, the exchange rate effect is fairly direct in the case of imported and tradable goods (figure IV.5). One example is new car prices, which contributed 0.2 pp to CPI inflation between August and November. As mentioned, there are also some isolated factors, such as the increase in cigarette prices (0.2 pp between August and November) due to the entry into effect of the Tax Reform.

With regard to CPIEFE services inflation, the depreciation effects are more indirect. Thus, while some items were directly affected by the increase in the exchange rate, such as international air transportation, a number of prices had an indirect effect. For example, for services such as public or interurban transportation, the cost of imported goods is important in the cost structure. In addition, items indexed to past inflation capture exchange rate effects in the inflation of the past few months. Examples include rental costs, utilities and prices linked to wages, which in turn have some degree of indexation to past inflation. The decomposition of CPIEFE services inflation shows that more than half of the annual increase in November is directly or indirectly explained by price changes that are related to the exchange rate movements (figure IV.6).

The evolution of nominal wages is an important factor in the current inflationary pressures, in particular with regard to CPIEFE services inflation. The annual growth rate of nominal wages remains high and has increased over the course of the past year (figure IV.7). This nominal wage trend calls attention to the phase of the economic cycle and the low growth of wage employment. However, when the effect of higher inflation on real wages is taken into account, the trend is the complete opposite, with annual reductions since mid-2013. Regardless, the low unemployment and high growth of nominal wages raise a note of caution for the analysis of inflation dynamics. Estimating the size of the output gap is subject to a high degree of uncertainty. If the gap is smaller than estimated, it will contribute less to slowing inflation.

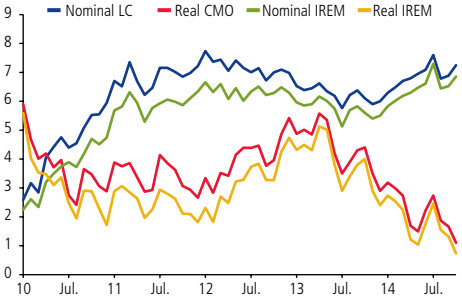
FIGURE IV.6
Contribution of CPIEFE services to annual CPI inflation (1)
(percentage points)



(1) Based on the new indices with base year 2013=100.
(2) Includes education, health, rental, tolls, insurance and motor vehicle inspection services.
(3) Includes food, recreation, financial, clothing, personal care, housing and other services.

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

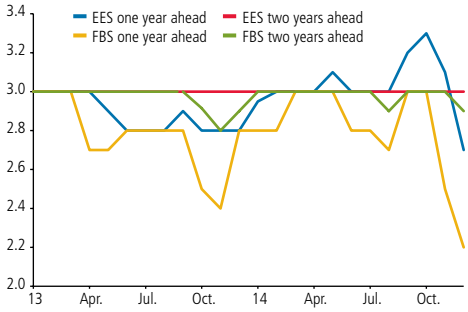
FIGURE IV.7
Wages (*)
(annual change, percent)



(*) See glossary for definitions.

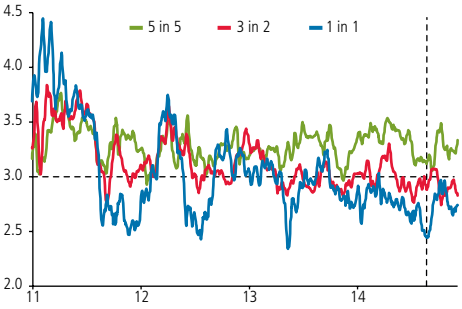
Sources: Central Bank of Chile and National Statistics Institute (INE).

FIGURE IV.8
Inflation expectations (*)
(annual change, percent)



(*) The FBS corresponds to the survey for the first half of the month.
Source: Central Bank of Chile.

FIGURE IV.9
Breakeven inflation (*)
(weekly moving average, percent)



(*) Forward breakeven inflation based on swap rates. The vertical dashed line indicates the cutoff of the September 2014 *Report*.
Source: Central Bank of Chile.

INFLATION OUTLOOK

As mentioned earlier, the current high inflation has exceeded the forecast in the last *Monetary Policy Report,* as well as market expectations. Consequently, private inflation expectations have been revised upward for the short term. However, given that the factors explaining these figures are temporary in nature, inflation is expected to return to the 3% target relatively quickly and to stay at that level through the end of the Central Bank's policy horizon.

According to projections in the Economic Expectations Survey (EES) for December 2014 and the Financial Brokers Survey (FBS) for the first half of the month, annual CPI inflation should close the year at 4.8%. The baseline scenario used in this *Report* projects that inflation will then return to 3% over the course of 2015 and fluctuate around that level through the end of the forecast horizon in the last quarter of 2016.

Private expectations are mixed for inflation 12 months ahead (figure IV.8). Some suggest that price inflation will ease markedly over the next year. The median response of the FBS puts one-year-ahead inflation near 2%. In contrast, the median EES response projects inflation of 2.9% at year-end 2015. Two years ahead, inflation expectations are concentrated around 3%. This is corroborated by the forward breakeven inflation rate, derived from average interbank swap rates, which points to inflation around 3% two years ahead and longer (figure IV.9).

BOX IV.1
INFLATION IN 2014

In 2014, annual CPI inflation recorded an upward surprise, and it has been above the Central Bank's target range since April. Expectations indicate that it could remain over 4% in annual terms in the coming months. This box reviews the factors that have determined inflation over the past several months. It also shows how the evolution of inflation in 2014 has led to changes in private forecasts as well as in the forecasts used as input in the *Monetary Policy Reports*.

The *Monetary Policy Report* for December 2013 projected that the annual CPI inflation rate would be 2.5% at year-end 2014. This forecast was revised to 3% in the March *Report*, to 4% in June, to 4.1% in September, and finally to 4.8% in this December *Report* (table IV.2).

TABLE IV.2
Changes in the CPI inflation forecast for December 2014

	Mar.14	Jun.14	Sept.14	Dec.14
Forecast in last *Report*	2.5	3.0	4.0	4.1
Fuels	0.4	0.1	0.0	-0.6
Food excl. fresh fruits and vegetables	0.2	0.1	0.2	0.3
Fresh fruits and vegetables	0.0	0.1	-0.1	0.2
Electricity tariffs	0.0	0.0	0.1	0.0
CPI excl. food and energy	0.0	0.7	-0.2	0.6
IPoM Forecast	3.0	4.0	4.1	4.8

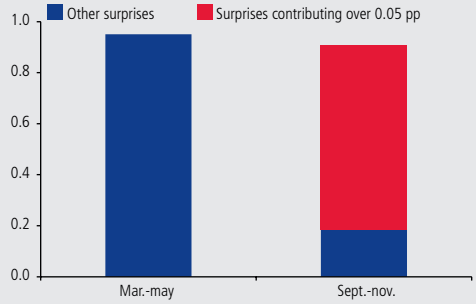
Source: Central Bank of Chile.

The increases in CPI inflation in 2014 and the upward revision of inflation forecasts have occurred in a context in which the nominal exchange rate has depreciated more than 15% between January and November of this year. Thus, it is no surprise that a large share of the observed price hikes can be linked to exchange rate movements. The transmission channels are both direct and indirect. The direct channels are evident in fuel prices and, in general, in imported or tradable goods. There are also services whose prices in pesos are directly related to movements in the peso-dollar exchange rate, such as international air transportation. With regard to the indirect channels, the biggest impact is seen in goods or services where the exchange rate is an important factor in the cost structure, or in prices that are indexed to past inflation and that thus capture how the exchange rate movements had on inflation some months ago.

In addition, high wage growth has put pressure on costs. In 2014 nominal wages have been surprisingly dynamic, with increases of over 6.5% in annual terms in the second half of the year. While a large share of the wage growth is itself a consequence of inflation, the expansion of wages has probably also caused the inflationary pressures to dissipate more slowly than expected. For the immediate future, widespread wage indexation is likely to be a source of price growth persistence.

The reasons behind the surprises in projected inflation have varied over the course of the year. In the June 2014 *Report*, the inflation forecast for this year increased by 1 percentage point (pp) relative to the forecast in the March *Report*. The biggest revision was in CPIEFE inflation (that is, excluding foodstuffs and fuels), due to small surprises that were fairly generalized across most of the prices in the basket. All of the 0.95 pp surprise accumulated between March and May responded to products where the price increases contributed less than 0.05 pp (figure IV.10). Part of the error in the March forecast stemmed from the assumption that the pass-through from the exchange rate would be limited, based on historical patterns. In particular, it was assumed that the economic downturn would limit the degree of pass-through to final prices, wages and expectations. This assessment was amended as actual data demonstrated a higher pass-through to prices than expected and justified the correction of the forecast in the June *Report*.

FIGURE IV.10
CPI surprises
(percentage points)



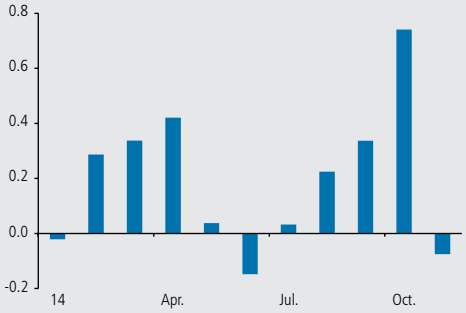
(*) Surprises are the difference between the forecast in the March (September) *Report* and the actual data between March and May (September and November).

Source: Central Bank of Chile.

In this *Report*, the December inflation forecast was again revised upward, from 4.1 to 4.8%. The nature of the adjustment is different, however. In recent months, a smaller number of products have recorded price rises, but the increases have been very significant. Furthermore, many of the increases are due to isolated and/or transitory factors, as in the case of fruits and vegetables, soft drinks and cigarettes. The assumption on the pass-through of the peso depreciation to inflation has not changed relative to June, and it is estimated to have been in line with projections. Going forward, the exchange rate is expected to continue to rise.

The change in the inflation forecasts contained in the different *Reports* has also been seen in private expectations. The data from the Economic Expectations Survey (EES) for each month show significant differences between real and projected inflation in February, March, and April, as well as between August, September and October (figure IV.11). The survey's inflation forecast for December has also increased over the course of the year: in January 2014 the EES expected an annual CPI inflation rate of 3% at year-end, versus 4.9% in December[1]/.

FIGURE IV.11
Monthly CPI inflation surprises (*)
(percentage points)



(*) The difference between inflation expectations in the Economic Expectations Survey in the immediately prior month.

Source: Central Bank of Chile

Despite the annual CPI inflation rate having hit 5.7% in October, expectations at longer horizons remain aligned with the Central Bank's target. Throughout the year, the different measures of expectations have projected a two-year-ahead inflation rate of around 3% (figures IV.8 and IV.9). At shorter horizons, the surveys imply that the annual inflation rate will return to 3% fairly quickly, although there is a lot of disagreement among analysts with regard to how much inflation will fall in 2015. For example, of the 60 people surveyed for the EES, 35% believe that in 12 months inflation will be 3% or higher, whereas 40% believe that it will be 2.5% or lower.

Going forward, the baseline scenario assumes that inflation will remain above 4% for a few more months before declining to 3% over the course of 2015. It will then fluctuate around 3% through the last quarter of 2016, which is the end of the forecast horizon for this *Monetary Policy Report*. The projected inflation path rests on the assumption that the pass-through to prices of the recent peso depreciation will be in line with historical patterns; that wages will adjust in line with productivity; and that there will be excess capacity in the forecast horizon. It also takes into account the effect of the fall in fuel prices recorded in recent months and the high basis of comparison from 2014.

[1]/ The December EES does not include an annual inflation forecast for December 2014. The figure is obtained based on actual inflation in November and the monthly inflation forecast for December.

V. INFLATION SCENARIOS

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.

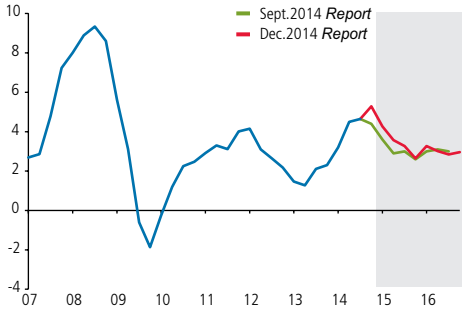
BASELINE PROJECTION SCENARIO

Like in previous *Reports*, domestic output and demand again showed a more severe and persistent weakness than had been expected, although this time the surprise was smaller in magnitude than in the second quarter of the year. Nevertheless, estimates are still that both will recover in 2015, but moderately. Inflation was again unexpectedly high, and should stay above the tolerance range still for some months. But unlike the surprise of early in the year, which was widespread, now it concentrated in some specific factors, many of which should have an only temporary impact on inflation. As for the impulse the economy will receive from abroad in 2015 and 2016, it is expected to be milder than the one in the September *Report*, primarily because of a slower recovery of world growth. All this in a context where the terms of trade will be somewhat better and external financial conditions, while not so expansionary as this year's, will remain favorable by historical standards.

In the baseline scenario, the inflation forecast is revised upward at the end of this year, considering the higher figures observed and the sharper depreciation of the peso. Over the short term, inflation will remain above 4%, but the forecast still assumes a down-sloping trajectory for the coming quarters. This leans on the mix of a high basis for comparison in 2014, the evolution of fuel prices and the accumulation of output gaps in the economy. Accordingly, inflation should decline, hitting 2,8% at the end of 2015, and then hover around 3% until the last quarter of 2016— that is, the end of the projection horizon— (figures V.1 and V.2, and table V.1). CPIEFE inflation is also revised upward for 2015, because of the sharper depreciation of the peso, its transmission to prices and the evolution of nominal wages. Still, this index is expected to approach 3% by the end of 2015 and remain in the neighborhood throughout 2016.

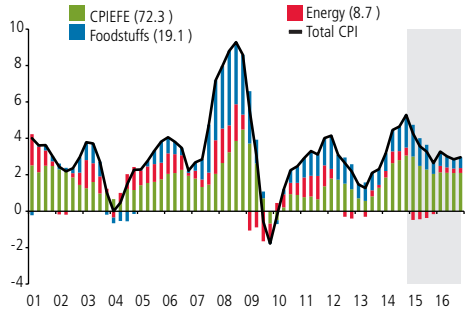
This trajectory assumes that the transmission to prices of the peso depreciation of recent months will proceed according to historical patterns; wages will be adjusted in line with productivity; and capacity gaps will remain over the projection horizon. About the RER, the methodological assumption is used that it will move little or nothing, as it is now within the range that is estimated to

FIGURE V.1
CPI inflation forecast (*)
(annual change, percent)



(*) Gray area, as from the fourth quarter of 2014, shows forecast.
Sources: Central Bank of Chile and National Statistics Institute (INE).

FIGURE V.2
Contribution to annual CPI inflation (1) (2)
(percentage points)



(1) Gray area, as from the fourth quarter of 2014, shows forecast.
(2) In parentheses, share in CPI basket.
Sources: Central Bank of Chile and National Statistics Institute (INE).

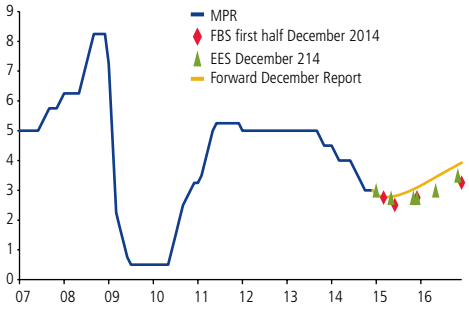
TABLE V.1
Inflation

	2013	2014 (f) (2)	2015 (f)	2016 (f)
		(annual change, percent)		
Average CPI inflation	1.8	4.4	3.4	
December CPI inflation	3.0	4.8	2.8	
CPI inflation in around 2 years (1)				3.0
Average CPIEFE inflation	1.2	3.6	3.4	
December CPIEFE inflation	2.1	4.3	2.8	
CPIEFE inflation in around 2 years (1)				2.9

(f) Forecast.
(1) Corresponds to the proyected inflation for the fourth quarter of 2016.
(2) The December 2014 figure considers the average of the median monthly inflation forecast in the EES and the FBS of that month.

Source: Central Bank of Chile.

FIGURE V.3
MPR and expectations
(percent)



Source: Central Bank of Chile.

TABLE V.2
Economic growth and current account

	2013	2014 (f)	2015 (f)
		(annual change. percent)	
GDP	4.1	1.7	2.5-3.5
National income	3.4	1.3	3.7
Domestic demand	3.4	-0.7	3.0
Domestic demand (w/o inventory change)	4.2	0.4	2.6
Gross fixed capital formation	0.4	-6.2	1.9
Total consumption	5.4	2.4	2.8
Goods and services exports	4.3	1.4	4.0
Goods and services imports	2.2	-5.9	3.7
Current account (% of GDP)	-3.4	-1.6	-1.1
Gross national saving (% of GDP)	20.5	19.7	20.8
Gross national investment (% of GDP)	23.9	21.3	21.9
GFCF (% of nominal GDP)	23.6	22.0	21.6
GFCF (% of real GDP)	25.8	23.8	23.6
		(US$ million)	
Current account	-9,485	-4,150	-2,770
Trade balance	2,117	7,600	9,020
Exports	76,684	75,550	75,600
Imports	-74,568	-67,950	-66,580
Services	-2,908	-3,300	-3,600
Rent	-11,102	-10,550	-10,230
Current transfers	2,408	2,100	2,040

(f) Forecast.

Source: Central Bank of Chile.

be consistent with its long-term fundamentals. Estimates also use as a working assumption that the policy rate will remain stable in the short term (figure V.3).

In the baseline scenario, output is seen growing by 1.7% annually in 2014, somewhat below the range foreseen in September, reflecting the aforementioned weakness in output during the third quarter and its extension into the fourth quarter. Plus business and consumer expectations that so far have failed to show the improvement that was expected a few months back.

In 2015, GDP is foreseen to grow between 2.5% and 3.5% annually, still below the medium-term growth figure, which the Board estimates in the 4%-4.5% range. The assumption that growth in 2015 will outperform growth in 2014 is based on the rapid and important adjustment that the economy has made during this year, as reflected in the behavior of the current account, interest rates and the real exchange rate (RER). It is also based in that the foreseen external conditions in 2015, while not as good as expected in September, are somewhat better than this year's, partly due to the impulse provided by lower oil prices. Plus consumer and business confidence that should tend to improve. The significant monetary impulse already implemented, the stronger fiscal boost and the effects of the peso depreciation on the tradable sectors' activity should also contribute. Finally, although the financial situation of households and firms is not as comfortable as it was in recent years, it is estimated that it will not be an obstacle to the economy's recovery (table V.2).

Regarding domestic demand, discounting inventories, annual growth rates of 0.4% in 2014 and 2.6% in 2015 are projected (1.0% and 3.2% in September). The downward correction in its growth rate responds to lower than expected third-quarter actual figures, especially in investment, and partial fourth-quarter indicators that are weaker than expected, for both consumption and investment. Inventories, meanwhile, have continued to adjust and enterprises feel that they have accumulated more than their desired levels. Thus, the annual increase in total domestic demand becomes negative for 2014, at -0.7% (0.1% in September). For 2015, in line with a moderate recovery of our economy, total domestic demand is now projected to grow 3.0% (3.4% in September).

By expenditure components, the biggest correction goes to investment, where annual variation is further adjusted downward, to -6.2% (-4.1% in September). The biggest correction, again, goes to machinery and equipment, which has been growing less than forecast. There is also the correction by the Corporation of Capital Goods (CBC) which placed investment in both 2014 and 2015 below that of 2013. The worsening of business expectations also plays a significant part in this weakening.

Investment growth in 2015, despite its poor performance in 2014, is similar to the projection, at 1.9% annually (1.8% in September). While some improvement is foreseen in private investment, the larger part of the recovery is related to public investment announcements for 2015. Thus, GFCF would reach 22% of nominal GDP in 2014 and 21.6% in 2015.

Corrections are smaller for private consumption than for investment. However, they are still based on fourth-quarter indicators that show no significant recovery

from the poor figures they already posted in 2014 so far. Moreover, contradicting projections, consumer expectations continued to worsen already on pessimistic ground. About fundamentals, the unemployment rate is still low from a historical perspective, although salaried employment is growing little and the surveys reveal increased uncertainty regarding the workings of the labor market. Furthermore, the annual expansion of real labor income has slowed, owing partly to higher inflation. At any rate, the lower price of oil and its effect on domestic prices should have a positive impact on households' disposable income and private consumption.

The adjustment in expenditure and the depreciation of the peso leads to a reduction in the current account deficit forecast for this year and next, at both actual and trend prices. In the trade balance, this continues to reflect mainly in a decline in valued imports in the two years, 2015 being especially influenced by the drop in the oil price. Accordingly, our estimate for the current account deficit is 1.6% for 2014 and 1.1% for 2015. Measured at trend prices[1]/, the current account deficit is estimated to remain around 2% of GDP in 2014 and 2015.

Abroad, the baseline scenario assumes an outlook for output that continues to point at stronger growth in 2015 and 2016. This combines world activity losing strength, but offset—at least partially—by the boost coming from the lower oil price. Thus, the forecast for trade partners' growth are corrected to 3.2 and 3.5% annually, respectively (table V.3). It is worth noting the divergence between the United States and other developed economies, which is expected to continue throughout the projection horizon. Growth projections for emerging economies are revised downward for most countries, particularly for Latin America (table V.4).

As for commodity prices, it is worth noting the sharp drop in the oil price, principally due to supply-side factors that have given way to a surplus balance in the crude oil market. Thus, averaging the prices of WTI and Brent oil yields a reduction to US$67 in 2015, and US$71 in 2016. This translates into lower prospects for the external inflation relevant to Chile (IPE) and better terms of trade compared with September. Nonetheless, part of this improvement is canceled out by the drop in the price of copper, which was trading at US$3 per pound in the weeks prior to the statistical closing of this *Report*. The baseline scenario assumes that the copper price will average US$2.95 and US$2.85 in 2015 and 2016, respectively.

RISK SCENARIOS

The baseline scenario reflects those events that are believed 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 materialize, may reshape the macroeconomic environment and, therefore, may alter the course of monetary policy.

External risks foreseen in previous *Reports* remain. On one hand is the risk of when and at what speed the Federal Reserve will begin raising its benchmark rate, and how it will affect the prices of financial assets. The risk of greater volatility in the markets has increased, due to the growing discrepancy between

[1]/ The calculation at trend prices considers revisions to prices, not volumes. Long-term prices of US$2.85 per pound of copper and US$85 per barrel of oil are assumed.

TABLE V.3
International baseline scenario assumptions

	Avg. 00-07	Avg. 10-12	2013	2014 (f)	2015 (f)	2016 (f)
			(annual change, percent)			
Terms of trade	8.2	4.1	-3.2	-1.1	1.7	-2.1
Trading partners GDP (*)	3.6	4.6	3.5	3.2	3.5	3.9
World GDP at PPP (*)	4.2	4.0	3.1	3.2	3.5	3.9
World GDP at market exchange rate (*)	3.3	3.2	2.4	2.6	3.0	3.3
Developed economies' GDP at PPP (*)	2.6	1.8	1.2	1.6	2.1	2.3
Emerging economies ' GDP at PPP (*)	7.4	5.9	4.7	4.5	4.7	5.2
External prices (in US$*)	4.6	5.2	0.3	0.0	-0.7	0.6
			(levels)			
LME copper price (US$cent/lb)	154	367	332	311	295	285
WTI oil price (US$/barrel)	44	90	98	93	64	68
Brent oil price (US$/barrel)	42	101	109	99	70	75
Gasoline parity price (US$/m3) (*)	367	742	785	733	483	495
Libor US$ (nominal, 90 days)	3.6	0.4	0.3	0.2	0.6	1.8

(*) For definition, see glossary.
(f) Forecast.

Source: Central Bank of Chile.

TABLE V.4
World growth (*)
(annual change, percent)

	Avg. 90-99	Avg. 00-07	2012	2013 (e)	2014 (f)	2015 (f)	2016 (f)
World at PPP	3.1	4.2	3.0	3.1	3.2	3.5	3.9
World at market Fx rates	2.7	3.3	2.5	2.4	2.6	3.0	3.3
Trading partners	3.1	3.6	3.4	3.5	3.2	3.5	3.9
United States	3.2	2.7	2.3	2.2	2.3	3.0	3.1
Eurozone	1.6	2.2	-0.7	-0.4	0.8	1.0	1.5
Japan	1.5	1.7	1.7	1.6	0.3	1.3	1.4
China	10.0	10.5	7.7	7.7	7.4	7.1	6.9
India	5.8	7.1	4.7	5.0	5.6	6.3	6.5
Rest of Asia	5.6	5.1	3.8	3.9	3.6	4.3	4.8
Latin America (excl. Chile)	2.8	3.5	2.7	2.3	1.1	1.9	3.0
Commodity exporters	2.7	3.1	2.5	2.2	2.5	2.7	2.6

(e) Estimate.
(f) Forecast.
(*) See glossary for definitions.

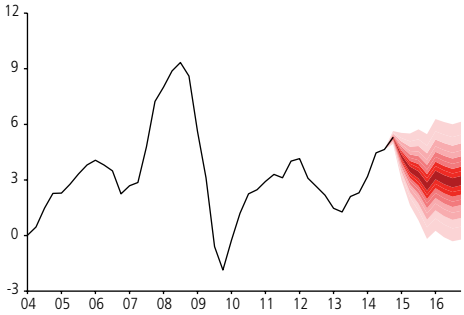
Sources: Central Bank of Chile, based on a sample of investment banks, Consensus Forecasts, International Monetary Fund and the statistics offices of respective country.

FIGURE V.4
GDP growth (*)
(annual change, percent)

(*)The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on growth as assessed by the Board. The baseline scenario uses as a working assumption that the policy rate will remain stable in the short run.

Source: Central Bank of Chile.

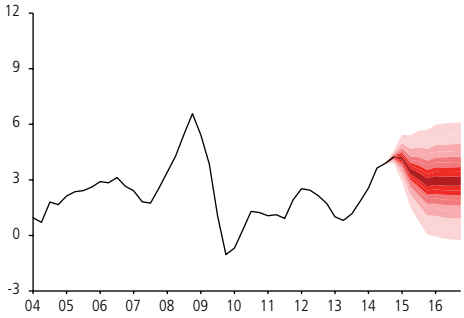
FIGURE V.5
CPI inflation forecast (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on inflation as assessed by the Board. The baseline scenario uses as a working assumption that the policy rate will remain stable in the short run.

Source: Central Bank of Chile.

FIGURE V.6
CPIEFE inflation forecast (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on core inflation as assessed by the Board. The baseline scenario uses as a working assumption that the policy rate will remain stable in the short run.

Source: Central Bank of Chile..

private expectations and the Fed's announcements, and the divergence of monetary policies of the main developed economies' central banks. In China, risks associated to its economic performance have regained importance, reflecting its steady weakening of recent times. The evolution of the Chinese financial system and real estate sector draw the most attention, which could further pull down the copper price. In the Eurozone, despite progress in the financial and banking fields—as reflected in stress test results—credit growth is still slow and the risk of a sharper deceleration is latent.

All these risks in the external scenario could generate new episodes of volatility in global financial markets, with significant negative effects on funding costs and activity. They could also generate an additional depreciation of emerging currencies—the peso included—with effects on the short-term inflation outlook.

Meanwhile, it is possible for the lower oil prices to have more intense effects on world growth. And it cannot be ruled out that the cycle of lower prices is extended or intensified, accentuating these effects and creating a scenario of greater global growth. In any case, the fiscal accounts of some oil-exporting countries have deteriorated, a development that could spread to other economies should this phase of low prices continue for some time.

Locally, one risk has to do with output performance, but especially with the dynamics of domestic demand. Its expected recovery has been pushed back again, while its materialization has lost momentum. The baseline scenario assumes that business and consumer confidence will improve gradually. If not, the slow growth in expenditure and output may be prolonged, resulting in longer-lasting output gaps and lower inflationary pressures.

It cannot be ruled out, either, that the current size of output gaps—an unobservable variable subject to high measurement uncertainty—falls below expectations and thus contributes less to decelerating inflation. The low unemployment and the strong growth in nominal wages puts a note of caution in the evaluation of inflation dynamics.

After assessing these risks, which originate both locally and externally, the Board estimates that the risk balance is unbiased for inflation and downward biased for output (figures V.4, V.5, and V.6).

Inflation is high, but is expected to approach 3% during next year. Domestic output and demand continue to look weak and prospects for growth in 2015 have been revised downward, despite substantial impulse from monetary and fiscal policy, and the boost from abroad will be somewhat better than this year. The Board has taken the MPR to 3% and has stated that any future changes will depend on the evolution of domestic and external macroeconomic conditions and its implications on the inflationary outlook. At the same time, it reiterates its commitment to conduct monetary policy with flexibility, so that projected inflation stands at 3% over the policy horizon.

GLOSSARY

Average interbank interest rate swap (*promedio cámara*): Derivatives contract between two parties, who carry out an exchange of flows at future dates, between a fixed rate established when the contract is written and a variable rate (fixed-for-floating swap). The variable rate corresponds to the average interest rate in the interbank clearing house (*cámara*), which in turn is derived from the average clearing house index.

Commodity exporters: Australia, Canada and New Zealand.

CPI excluding food and energy (CPIEFE): CPI excluding food goods (food goods and beverages in the CPIX1, fresh fruits and vegetables, meats and fish) and energy prices, leaving 72% of the total CPI basket.

Credit default swap (CDS): A derivative instrument that provides insurance against the credit risk of sovereign or corporate debt. The premiums implicit in the cost of this hedge (the CDS spread) are commonly used as a measure of sovereign or corporate risk.

GDP, natural resources: includes the following sectors: electricity, gas and water (EGW); mining; and fishing.

GDP, other: Includes the following sectors: agriculture, livestock and forestry; manufacturing; construction; retail; transport and communications; financial and business services; residential property; personal services; and public administration.

Growth of trading partners: The growth of Chile's main trading partners, weighted by their share in total exports over two moving years. The countries included are the destination for 93% of total exports, on average, for the 1990–2013 period.

IREM: Wage index. The average wage paid per hour, weighted by the number of regular hours worked.

IREMX: IREM excluding community, social and personal services, electricity, gas and water (EGW) and mining.

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

LCX: Labor costs (LC) excluding community, social and personal services, electricity, gas and water (EGW) and mining.

M1: A measure of the money supply that includes currency in circulation, the value of checking accounts held by the non-financial private sector (net of clearing), non-checking demand deposits and demand savings accounts.

M2: M1 plus time deposits, time savings deposits, mutual fund shares with investments in debt instruments with a maturity of up to one year, and deposits with savings and loan cooperatives, less the time deposits of the aforementioned mutual funds and savings and loan cooperatives.

M3: M2 plus foreign currency deposits, Central Bank of Chile notes, General Treasury bonds, mortgage bonds, commercial papers, corporate bonds, other mutual fund shares, pension fund shares in voluntary savings (AFPs), less mutual fund and pension fund investments in the assets that make up M3.

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

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

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

Multilateral dollar: The U.S. dollar measured against a basket of currencies. Calculated as the geometric mean of currencies of the six main trading partners of the United States.

Prime-swap spread: The difference between the prime deposit rate and the average interbank swap rate. Like equivalent measures in other markets (such as the Libor-OIS spread), it is used as a benchmark for analyzing funding liquidity conditions in the banking sector.

Repos: Repurchase (reverse repurchase) agreements. A sale (purchase) collateralized with an agreement or commitment to repurchase (sell back) the security.

RER: Real exchange rate. A measure of the real value of the peso against a basket of currencies, which includes the same countries used to calculate the MER.

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

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.

VIX: Stock volatility index calculated by the Chicago Board of Trade, and the most commonly used measure of general market volatility at the international level. Measures the implicit volatility in S&P 500 options contracts.

World growth at market exchange rate: Each country is weighted according to its GDP in dollars, published in the IMF's World Economic Outlook (WEO, October 2014). The sample of countries used in the calculation represent around 90% of world GDP. For the remaining 10%, average growth is estimated at 1.8% for the period 2013–2016.

World growth: Regional growth weighted by its share in world GDP at PPP, published in the IMF's World Economic Outlook (WEO, October 2014). World growth projections for 2013–2016 are calculated from a sample of countries that represent about 86% of world GDP. For the remaining 14%, average growth is estimated at 3.5% for the period 2013–2016.

ABBREVIATIONS

BCP: Central Bank bonds denominated in pesos.

BCU: Central Bank bonds denominated in UFs.

BLS: Bank Lending Survey

CPIG: Consumer goods price Index

CPINT: Consumer price Index for nontradables

CPIS: Consumer services price Index

CPIT: Consumer price Index for tradables

CPIEFE: CPI excluding food and energy

EES: Economic Expectations Survey

FBS: Financial Brokers Survey.

IMCE: Monthly Business Confidence Index

IPEC: Consumer Confidence Index

MPR: Monetary policy rate

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